

The Future of Europe: the Euro and Brexit

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The problem

- Eurozone has been ill-designed
- It will have to be redesigned to survive in the long run. How?
- Let me first explain the nature of these design failures.

Eurozone's design failures: in a nutshell

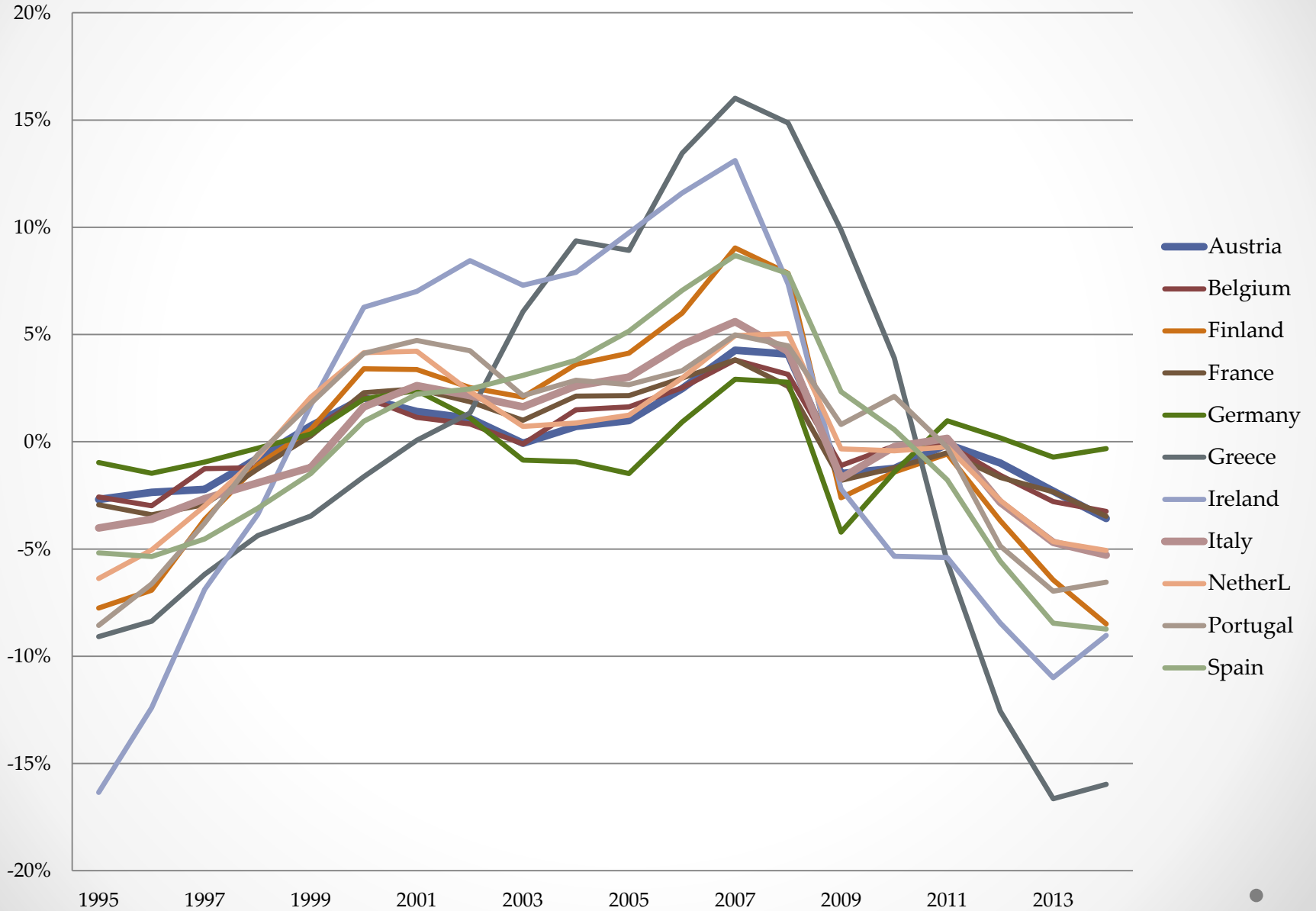
1. Dynamics of booms and busts are endemic in capitalism and continued during Eurozone,
 - triggering large divergent movements in competitiveness
 - while adjustment mechanisms are failing
2. Stabilizers that existed at national level were stripped away from the member-states without being transposed at the monetary union level.
 - This left the member states “naked” and fragile, unable to deal with the coming disturbances.

Let me expand on these points.

Booms and busts

- These were strongly synchronized in Eurozone
- Asymmetry was in the amplitude of the booms and busts
 - Some countries (Ireland, Greece, Spain) experiencing wild swings
 - While others (Germany, France, Netherlands, Belgium) experiencing mild swings

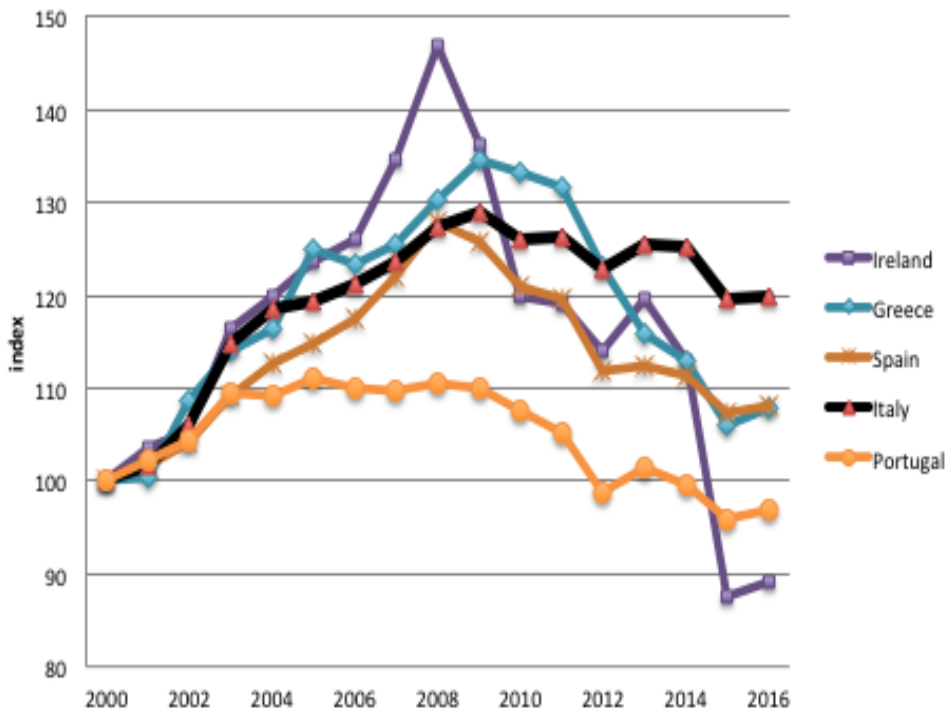
Business cycle component of GDP



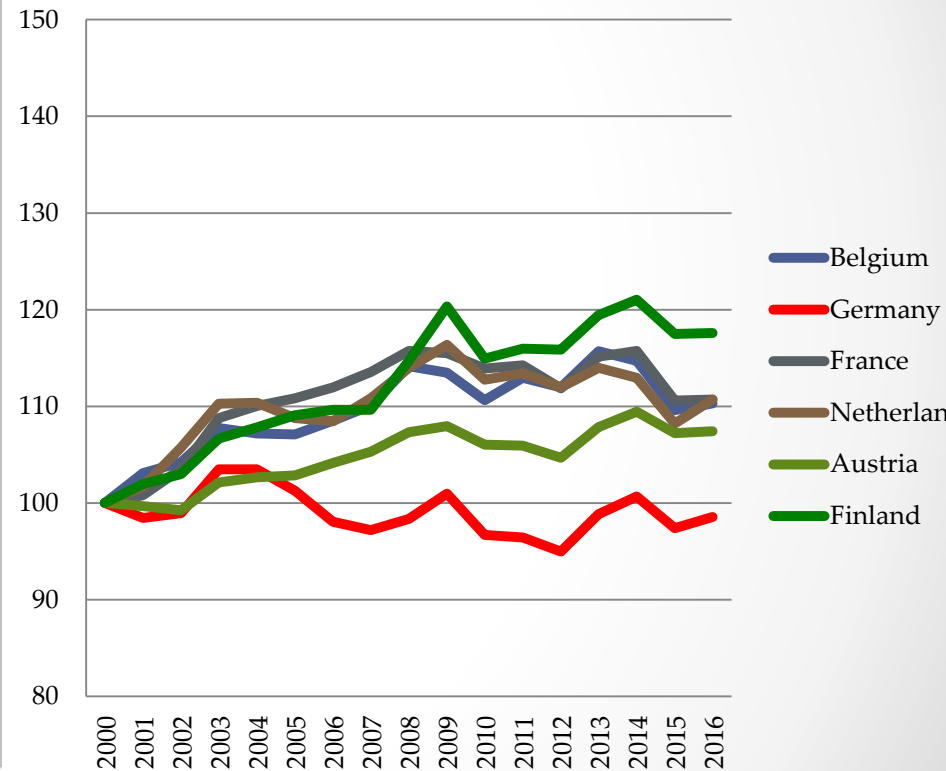
- This led to two problems
 - Build-up of large divergences in competitive positions
 - Instability in government bond markets during downswing

Diverging trends in competitiveness

Relative unit labour costs Eurozone debtor countries (2000=100)



Relative unit labour costs Eurozone creditor countries (2000=100)



- Adjustment through internal devaluation very painful
- Asymmetry in adjustment puts all the costs of the adjustment onto the deficit countries
- All this leads to political upheaval
- And dynamics of rejection

Second problem: No stabilizers left in place

- Absence of lender of last resort in government bond market in Eurozone
- exposed fragility of government bond market in a monetary union
- Self-fulfilling crises pushing countries into bad equilibria

Fragility of government bond market in monetary union

- Governments of member states cannot guarantee to bond holders that cash would always be there to pay them out at maturity
- Contrast with stand-alone countries that give this implicit guarantee
 - because they can and will force central bank to provide liquidity
 - There is no limit to money creating capacity

Self-fulfilling crises

- This lack of guarantee can trigger liquidity crises
 - During recession, budget deficits increase automatically
 - Distrust leads to bond sales
 - Interest rate increases
 - Liquidity is withdrawn from national markets
 - Government unable to rollover debt
 - Is forced to introduce immediate and intense austerity
 - Intensifying recession and Debt/GDP ratio increases

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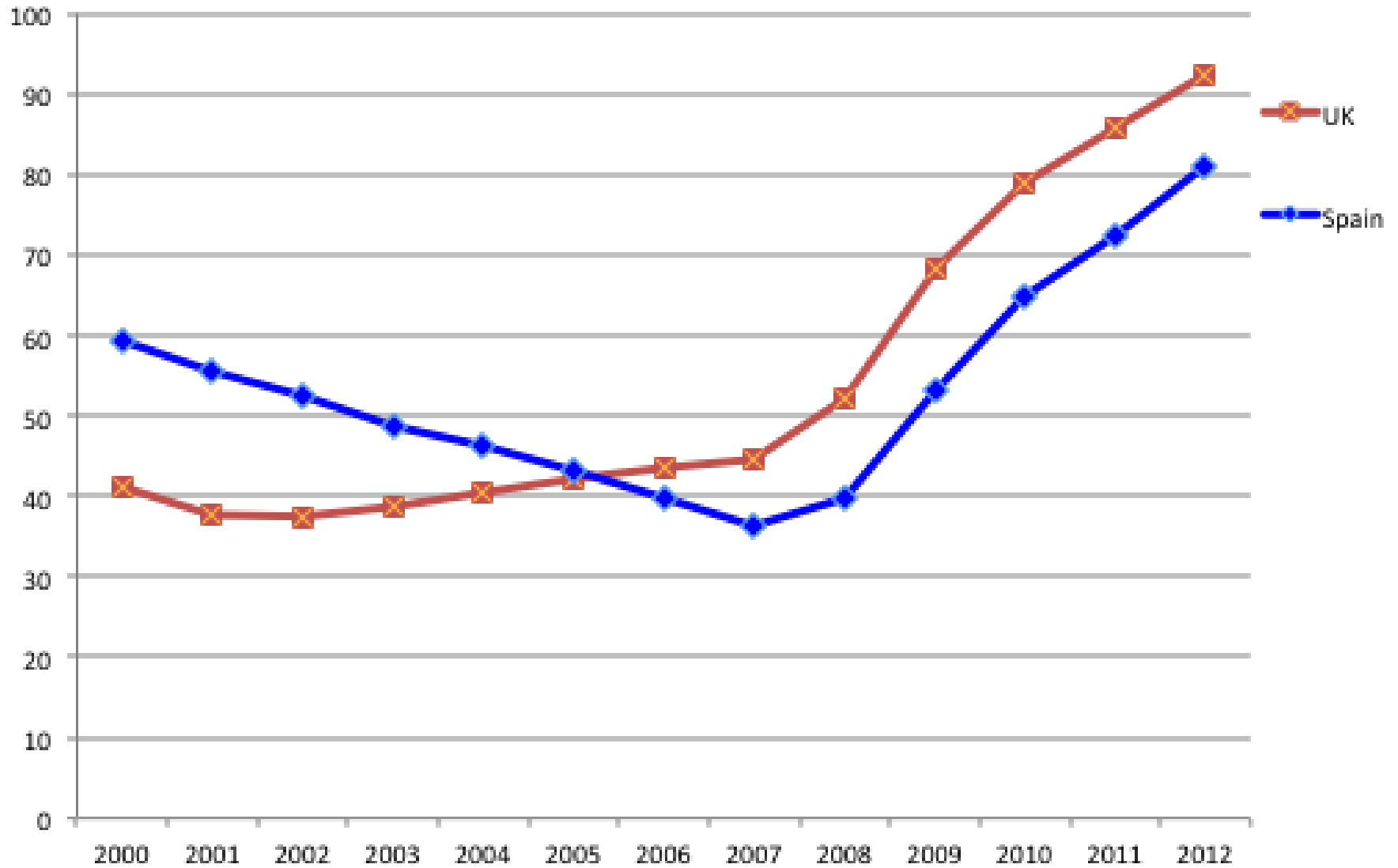
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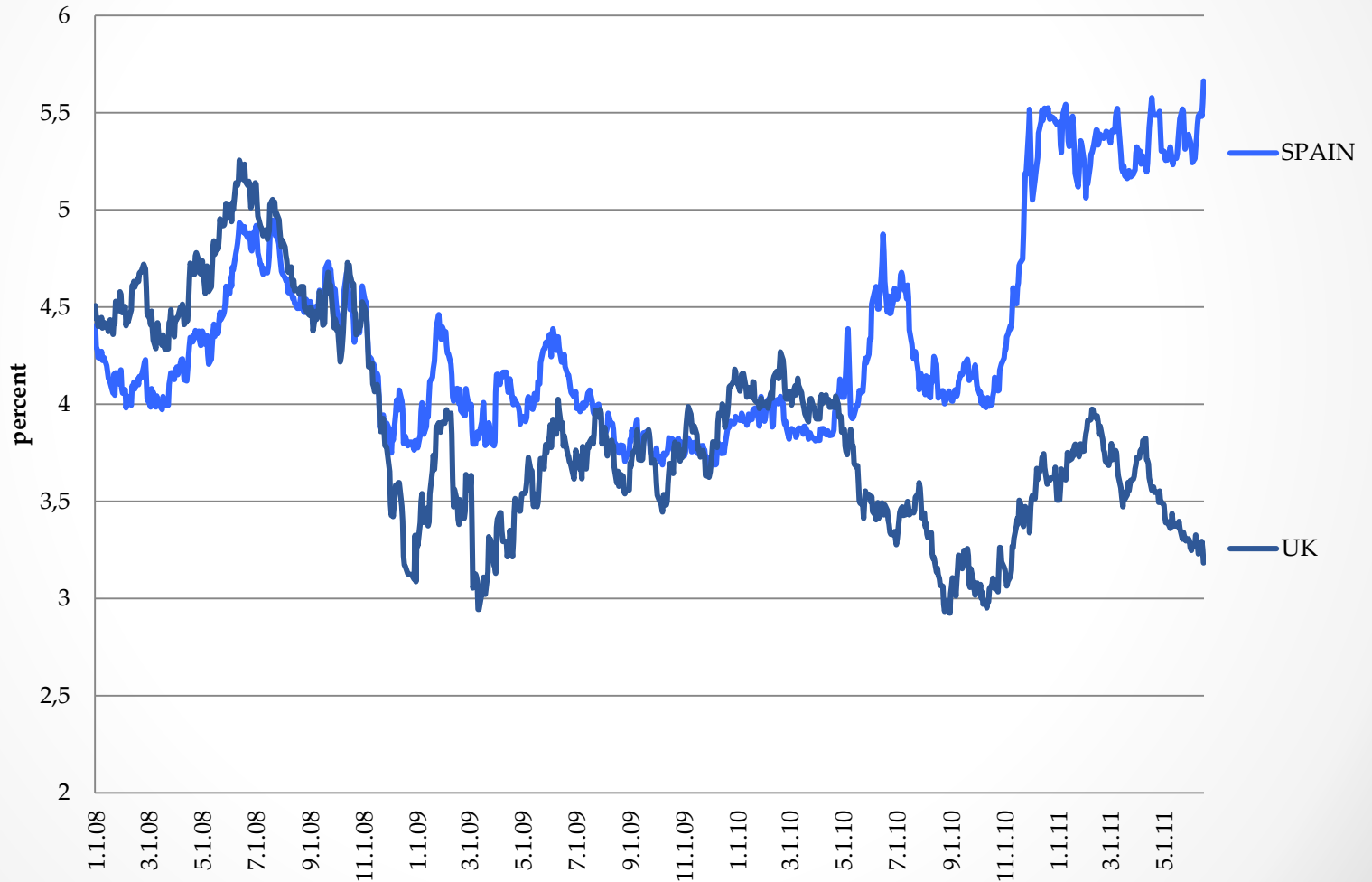
- This leads to default crisis
- Countries are pushed into bad equilibrium
- That can lead them into default

- Thus absence of LoLR tends to eliminate other stabilizer: automatic budget stabilizer
 - Once in bad equilibrium countries are forced to introduce sharp austerity
 - pushing them in recession and aggravating the solvency problem
 - Budget stabilizer is forcefully switched off
- Investors know this and flee from the government bond markets hit most by recession to invest in bond markets less hit by recession
- Destabilizing capital flows in monetary unions
- Case study: pain in Spain

Gross government debt UK and Spain (% of GDP)



10-Year-Government Bond Yields UK-Spain



Redesigning the Eurozone

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How to redesign the Eurozone?

- Role of ECB
- Budgetary and Political Union

The common central bank as lender of last resort

- Liquidity crises are avoided in stand-alone countries that issue debt in their own currencies mainly because central bank will provide all the necessary liquidity to sovereign.
- This outcome can also be achieved in a monetary union if the common central bank is willing to buy the different sovereigns' debt in times of crisis.

ECB has acted in 2012

- On September 6, ECB announced it will buy unlimited amounts of government bonds.
- Program is called “Outright Monetary Transactions” (OMT)
- Success was spectacular

- This was the right step: the ECB saved the Eurozone
- However, the second Greek crisis of 2014-15 casts doubts about the willingness to activate OMT in future
- And surely there will be new crises when next recession hits
- We need more than lender of last resort

Criticism of OMT

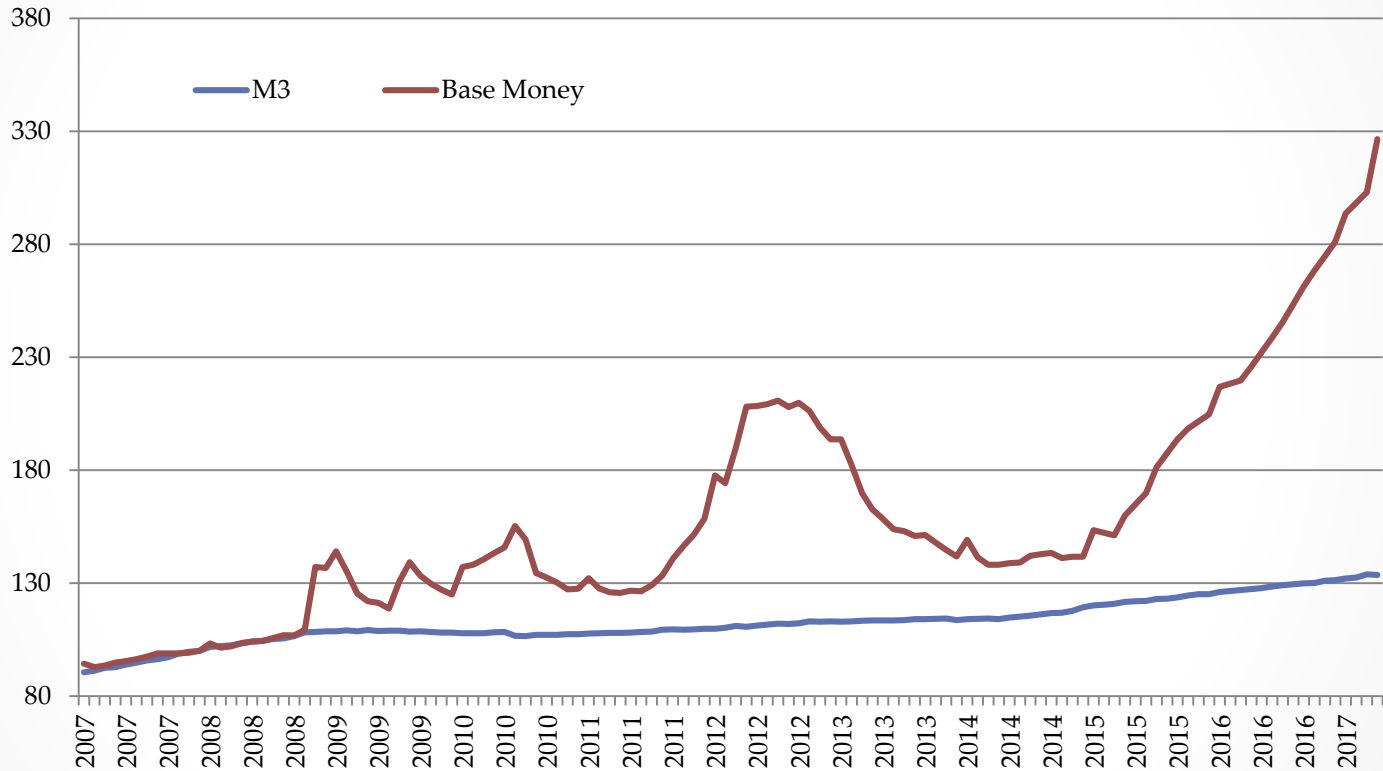
- Points of criticism
 - Inflation risk
 - Moral hazard
 - (Fiscal implications)
- Is this criticism valid?

Inflation risk

- Distinction should be made between money base and money stock
- When central bank provides liquidity as a lender of last resort money base and money stock move in different direction
- In general when debt crisis erupts, investors want to be liquid

Money base and money stock (M3) in the Eurozone 2007

December=100



- Thus during debt crisis banks accumulate liquidity provided by central bank
- This liquidity is hoarded, i.e. not used to extend credit
- As a result, money stock does not increase much;
- No risk of inflation

Moral hazard

- Like with all insurance mechanisms there is a risk of moral hazard.
- By providing a lender of last resort insurance the ECB gives an incentive to governments to issue too much debt.
- This is indeed a serious risk.
- But this risk of moral hazard is no different from the risk of moral hazard in the banking system.
- It would be a mistake if the central bank were to abandon its role of lender of last resort in the banking sector because there is a risk of moral hazard.
- In the same way it is wrong for the ECB to abandon its role of lender of last resort in the government bond market because there is a risk of moral hazard

Separation of liquidity provision from supervision

- The way to deal with moral hazard is to impose rules that will constrain governments in issuing debt,
- very much like moral hazard in the banking sector is tackled by imposing limits on risk taking by banks.
- In general, it is better to separate liquidity provision from moral hazard concerns.
- Liquidity provision should be performed by a central bank; the governance of moral hazard by another institution, the supervisor.

- This should also be the design of the governance within the Eurozone.
- The ECB assumes the responsibility of lender of last resort in the sovereign bond markets.
- A different and independent authority (European Commission) takes over the responsibility of regulating and supervising the creation of debt by national governments.
- This leads to the need for mutual control on debt positions, i.e. some form of political union

Metaphor of burning house

- To use a metaphor: When a house is burning the fire department is responsible for extinguishing the fire.
- Another department (police and justice) is responsible for investigating wrongdoing and applying punishment if necessary.
- Both functions should be kept separate.
- A fire department that is responsible both for fire extinguishing and punishment is unlikely to be a good fire department.
- The same is true for the ECB. If the latter tries to solve a moral hazard problem, it will fail in its duty to be a lender of last resort.

Towards a budgetary and political union

- Most important component of political union is budgetary union.
- What do we mean with budgetary union?

Budgetary union has two dimensions

1. consolidation of national government debts.
 - A common fiscal authority that issues debt in a currency under the control of that authority.
 - This prevents destabilizing capital movements within the Eurozone
 - and protects the member states from being forced into default by financial markets.

2. Insurance mechanism

- mechanism transferring resources to the country hit by a negative economic shock.
- Limits to such an insurance: **moral hazard** risk,
- But that is problem of all insurance mechanisms
- Budgetary union also allows to stabilize the business cycle at the Eurozone level

Strategy of small steps

- Budgetary union (consolidation of national debts and insurance mechanisms) is necessary in long run
- Budgetary union as defined here can only be a very long-run process
- There is no political willingness today to realize this quickly
- Only strategy of small steps can have some probability of success

Common unemployment benefits scheme as a small step

- Many proposals have been made: e.g. Four Presidents report
- Common unemployment schemes should be allowed to have deficit during recession compensated by surpluses during boom
- This means issuing common bonds
- First step on the road to budgetary union

Conclusion

- Long run success of the Eurozone depends on continuing process of political unification.
- Political unification is needed because Eurozone has dramatically weakened
 - the power and legitimacy of nation states
 - without creating a nation at the European level.
- This is particularly true in the field of stabilization

Conclusion: Integration fatigue

- Budgetary union is needed but is far away
- Willingness today to move in the direction of a budgetary and political union in Europe is very weak.
- This will continue to make the Eurozone a fragile institution
- Its long-term success cannot be guaranteed

Brexit

Introduction

- Political objective of Brexit is to “take back control over borders, laws and money”,
 - i.e. it is an objective of full sovereignty.
- The PM claims that this is possible while going global,
 - i.e. while at the same time pursuing free trade agreements that will keep the UK fully anchored into the global economy
- and all this while maintaining democratic decision making processes.

Impossible trilemma

- These objectives of full sovereignty, democracy and globalisation are inconsistent.
- This follows from Rodrik's "impossible trilemma" theorem
- This says that only two of the three objectives can be satisfied simultaneously
 - If UK chooses for sovereignty and democracy it cannot have globalisation, i.e. it will have to move towards protectionism.
The reason is that globalisation imposes rules on nations that reduce its sovereignty.
 - Whether these rules come from Brussels or from elsewhere is of no importance

Fantasy world

- These inconsistent objectives pursued by the UK government have created a fantasy world in which this government continues to operate
- The awakening will be rude forcing the government to make hard choices.
- Two scenarios:
 1. UK obsessed with sovereignty
 2. UK wants to keep borders open



Scenario 1

- Primacy of national sovereignty
- This implies a refusal to accept rules imposed from outside the UK and the jurisdiction of ECJ on British soil
- UK will end up in a situation where it has to take on the WTO statutes that will lead to the imposition of import tariffs and full control over immigration
- This is the only option that preserves the objective of sovereignty and democracy.



Implications for trade

- “New globalisation” is very different from “old globalisation” (Richard Baldwin)
- Old globalisation was based on strong reduction of the cost of moving goods, while the cost of moving ideas and people did not decline at the same rate.
- The ICT revolution has changed this
- It has made it possible to substantially reduce the cost of moving ideas.

- As a result, it became possible to “unbundle” production stages
- and transfer many of these to other countries
- This has created long “global value chains” that encompass many borders
- leading goods to frequently cross the same borders
- while with each border crossing new components have been added
- Result: A BMW is not a German car and Iphone is not an American product



- A country that introduces protectionism (US, UK) cuts itself off from this global production networks
- and will see its competitiveness decline significantly
- Thus the UK, when leaving the single market, will cut itself off from the production network with Europe which is the most significant one.
- The UK government has created the myth that while it cuts itself from the European network and value chains
- It will easily replace this with new global networks.
- This is Wonderland Economics



Scenario 2

- In this scenario UK keeps primacy of open borders
- This can only happen if it accepts rules originating and monitored outside Britain
 - The Norwegian model
 - The Swiss model
- The latter is most likely
- Even there Britain will lose in that it is not part of decision making process.

Implications for the EU

- Good news
- Brexit creates window of opportunities to strengthen the union
- Why?
- Historically strategy of UK has always been to ensure that Europe remains weak
- After World War 2 it first refused to join because it speculated that European integration effort would lead nowhere

- When it became success, it asked to join
- Not to strengthen the union
- But to make sure it would no become strong
- Or worse to deconstruct it from inside
- It tried as much as possible to impose inter-governmental system where each country maintains veto power
- If that did not work it negotiated opt-outs

- UK was a member country dedicated to keeping the union weak.
- Now that it is leaving, a window of opportunity is created to go forward
 - In defence
 - In taxation