

Overcoming the euro crisis

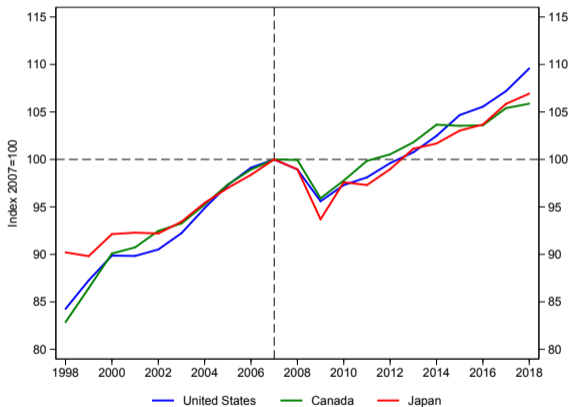
Athanasios Orphanides
MIT

The Euro Area After the Crisis
Greece and the Euro: From Crisis to Recovery
Tufts University, April 12, 2019

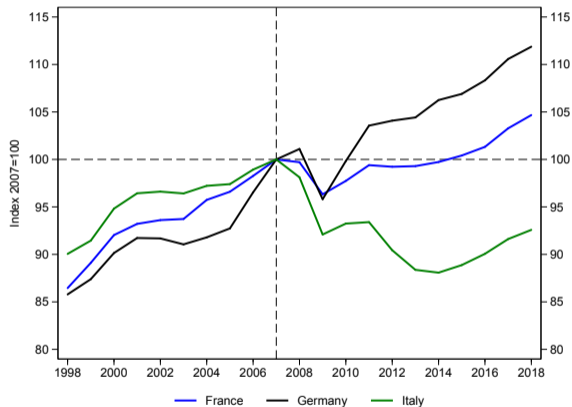


Real GDP per person: G7 advanced economies

Non-EU



Euro Area



IMF WEO, April 2019. Index, 2007=100.

What is the cause of divergence in the euro area?



Overcoming the euro crisis

- ▶ Three stages of treatment of a systemic failure
 - ▶ Analysis of failure
 - ▶ Identification of the cause of the problem
 - ▶ Correction

- ▶ Three obstacles hindering progress
 - ▶ Denial
 - ▶ Misdiagnosis of failure (blame game)
 - ▶ Politics



Politics over economics: Federation vs confederation

- ▶ Federation
 - ▶ Common government protecting common interest.
 - ▶ Common government accountable to all citizens of all states.
- ▶ Confederation
 - ▶ Competing interests among member states.
 - ▶ Leaders in each state accountable only to citizens in their state.



The fragility of confederations

- ▶ United States (under the Articles of Confederation, until 1789).
- ▶ Delian League.



The role of independent institutions

- ▶ How are common policies decided when the interests of individual Member States diverge?
- ▶ The success of the Union rests on the ability of Europe's independent institutions to protect the common good over the interests of any individual Member State.
- ▶ Individual Member States that manage to exert undue influence on these institutions can distort policy to benefit their own citizens at the expense of others and the euro area overall.



A closer look at the ECB

- ▶ Europe's unique central bank—the most independent and least accountable central bank ever created in history.
- ▶ The most appropriate monetary policy for the euro area as a whole is not best for all Member States.
- ▶ Success in influencing ECB policy can disproportionately benefit a Member State at the expense of the common good.

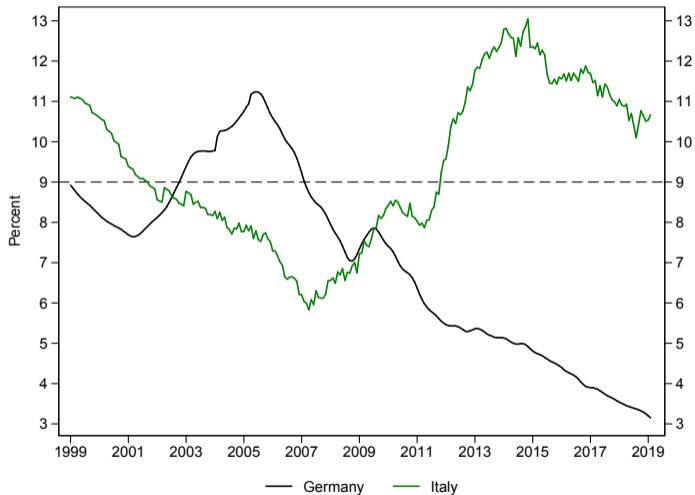


A closer look at the ECB

- ▶ Has the **overall stance** of monetary policy been properly calibrated?
 - ▶ Interest rate policy
 - ▶ Balance sheet policy.
- ▶ Has the **implementation** of monetary policy been well managed?
 - ▶ Deviation from profit/loss sharing in asset purchases.
 - ▶ Delegation of collateral policy to rating agencies.

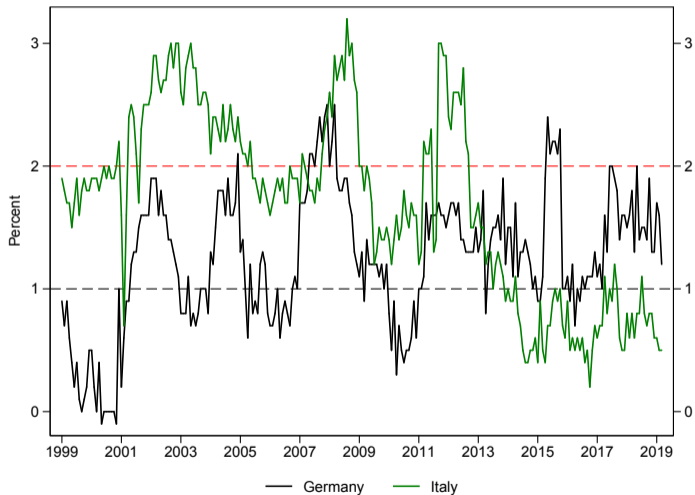


The unemployment rate in Germany and Italy



ECB policy: Too loose or too tight?

Core inflation in Germany and Italy



ECB policy: Too loose or too tight?

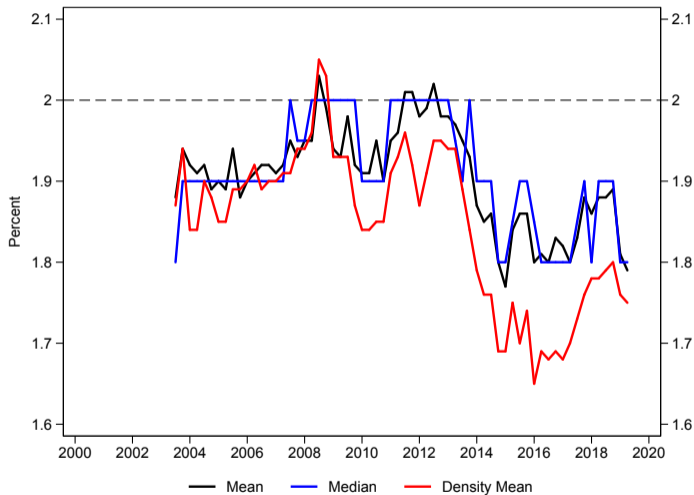
ECB policy outcomes: Core inflation in euro area



Notably below and **not** close to 2% for several years.



Evaluating ECB policy: Long-term inflation expectations

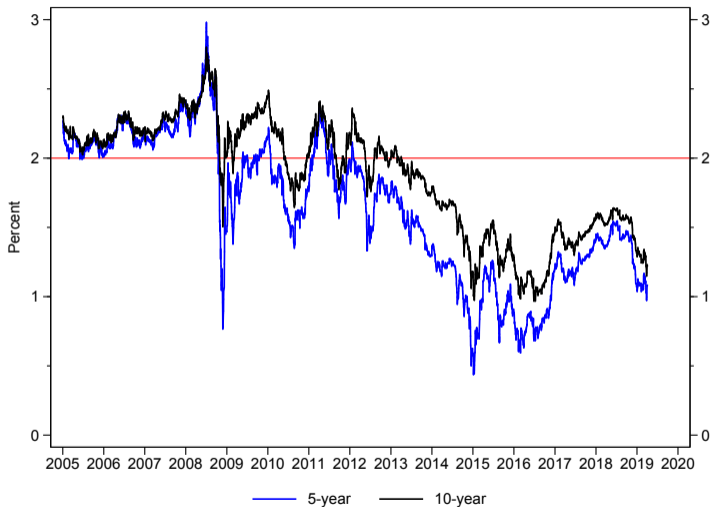


ECP SPF. Surveys after May 2003 clarification of ECB inflation objective.

An unhelpful disanchoring of inflation expectations.



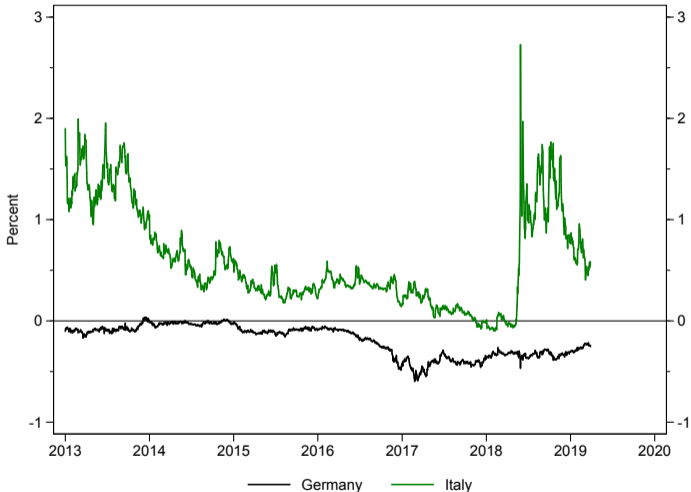
Evaluating ECB policy: Inflation swaps



An unhelpful disanchoring of market-based readings of long-term inflation expectations.



What is the source of the continuing fragility?



Two-year government bond yields.



Adverse expectational equilibria in sovereign debt markets

“In 2011, after the Deauville episode and the early talk about the Greek debt private sector involvement, financial markets attacked Italian and Spanish sovereign bonds **without any change in their fundamentals . . .**”
(Vitor Constancio, 17 May 2018)

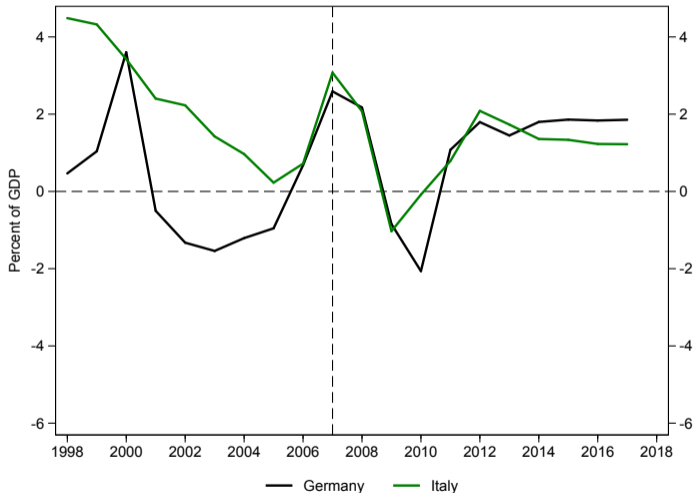


Interactions with fiscal policy?

“Turning to fiscal policy, since 2010 the euro area has suffered from fiscal policy being less available and effective, especially compared with other large advanced economies. This is not so much a consequence of high initial debt ratios-public debt is in aggregate not higher in the euro area than in the U.S. or Japan. **It reflects the fact that the central bank in those countries could act and has acted as a backstop for government funding.** This is an important reason why markets spared their fiscal authorities the loss of confidence that constrained many euro area governments’ market access.” (Draghi, 2014.)



“Sub-optimal” * fiscal policy

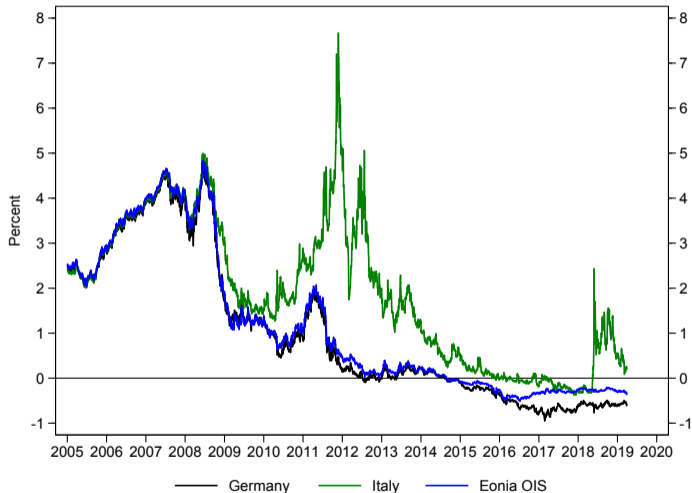


IMF WEO, April 2019. Primary balance as a percent of GDP.

* European Commission (2016).



Distributional consequences of ECB policy

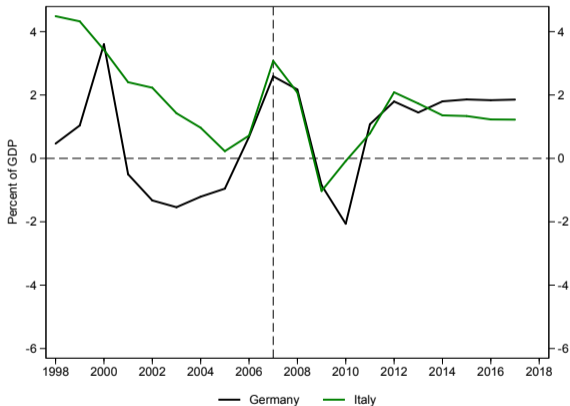


Two-year government bond yields and euro OIS rate

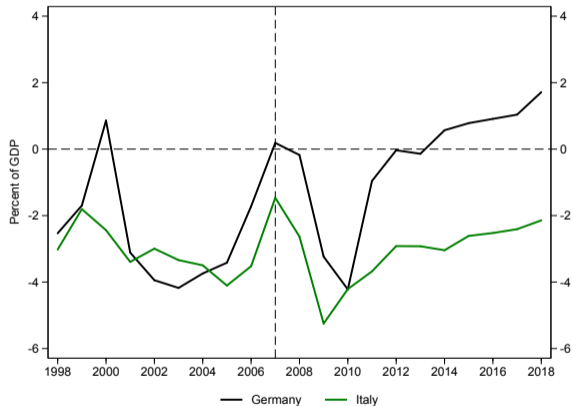


Distributional consequences for fiscal policy

Primary balance



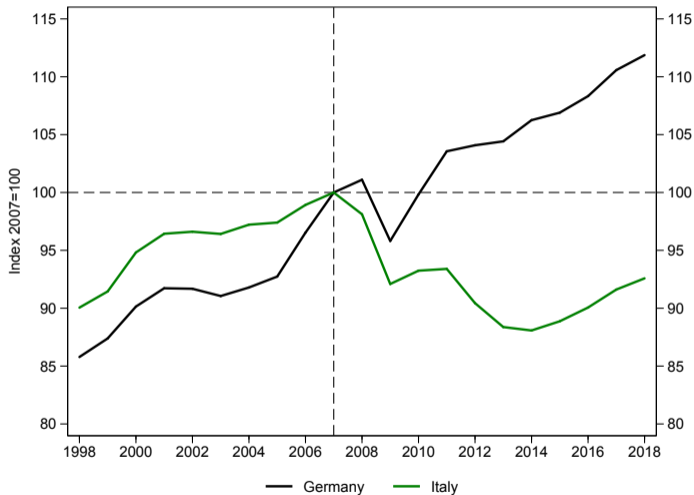
Total balance



IMF WEO, April 2019.



The ongoing euro crisis: Winners and losers



Real GDP per person. IMF WEO, April 2019. Index 2007=100



Shared prosperity: The key to overcoming the euro crisis

- ▶ At present, the euro is a threat to Europe.
- ▶ To overcome the crisis, Europe's common independent institutions must assert their independence and act in accordance to the Treaties.
- ▶ In accordance to the Treaties, common institutions must use their independence to effectively counterbalance narrow national interests.
- ▶ Policy must protect and promote the common good.
- ▶ The key to overcoming the euro crisis is **shared prosperity**.

