

# The euro challenge to Europe

Athanasios Orphanides  
MIT

The euro: Voices from the Commonwealth  
Central Bank of Malta and Queen Mary University of London  
London, 13 April 2018



## A Commonwealth perspective

“[T]he Commonwealth is a voluntary association of independent and equal sovereign states, each responsible for its own policies, consulting and co-operating in the common interests of our peoples and in the promotion of international understanding and world peace, and influencing international society to the benefit of all through the pursuit of common principles and values.”  
(Charter of the Commonwealth, 2013, p. 1.)



## A Commonwealth perspective

“We recognise the inalienable right of individuals to participate in democratic processes, in particular through free and fair elections in shaping the society in which they live.” (Charter of the Commonwealth, 2013, p. 3.)

“We are committed to an effective, equitable, rules-based multilateral trading system, the freest possible flow of multilateral trade on terms fair and equitable to all, while taking into account the special requirements of small states and developing countries.” (Charter of the Commonwealth, 2013, p. 5.)



# The European project? The EU? The euro (EMU)?

- ▶ The European project originated with noble objectives.
- ▶ Peace, democratic values, free trade, mutual respect, ...
- ▶ Considerable success ... until the euro.
- ▶ The euro has become a threat to the European project.



# “Euro Fantasies”

“If there was ever a bad idea, EMU is it.”

Rudi Dornbusch, *Foreign Affairs*, 1996.



# What makes the euro area unique?

- ▶ Common currency limits crisis management tools for individual states.
- ▶ Lack of common fiscal authority and ineffective fiscal policy coordination.
- ▶ Incomplete governance necessitates unanimous decisions among member state governments for crisis management.
- ▶ Lack of common leadership with mandate to manage crisis in the interest of the euro area as a whole leads member state governments to focus on protecting own interests at the expense of the euro area as a whole.
- ▶ Governments that succeed in using their political leverage can protect their interests at the expense of the euro area as a whole.

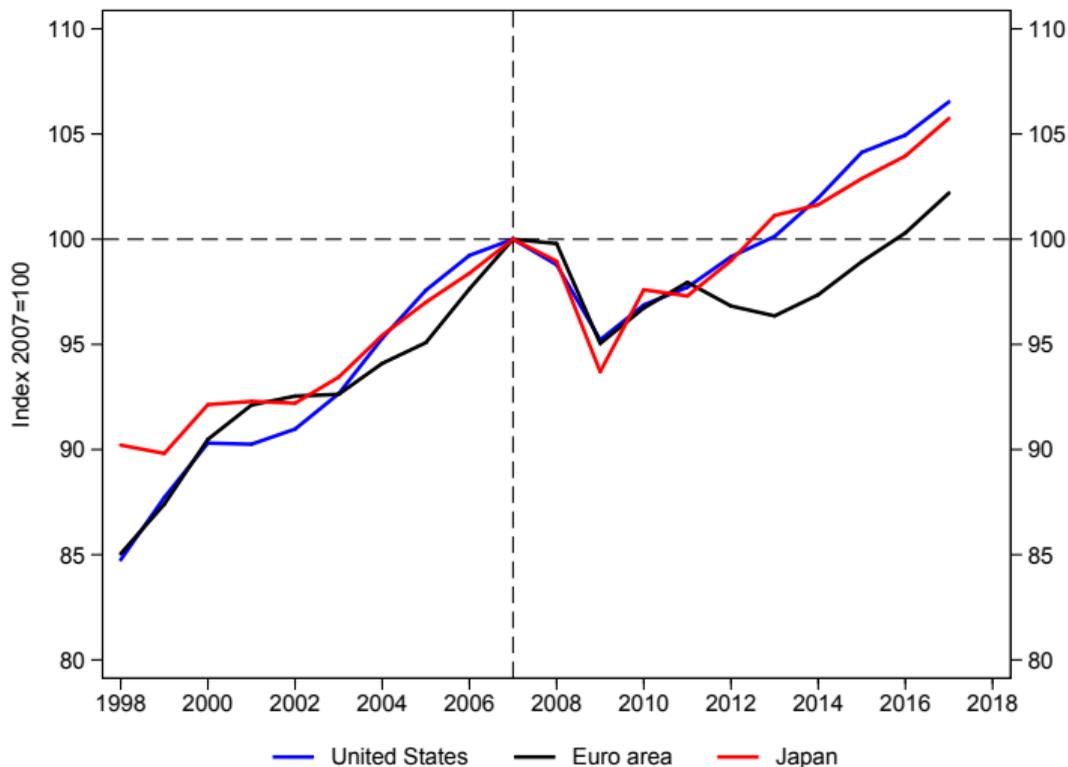


# The euro crisis is a political crisis

“What we have, in fact, is a crisis of the ability of the European Union’s *political* bodies to act. This glaring weakness of action is a much greater threat to the future of Europe than the excessive debt levels of individual euro area countries.”  
(Helmut Schmidt, 2011, emphasis in the original.)



# An ongoing crisis: Real GDP per person

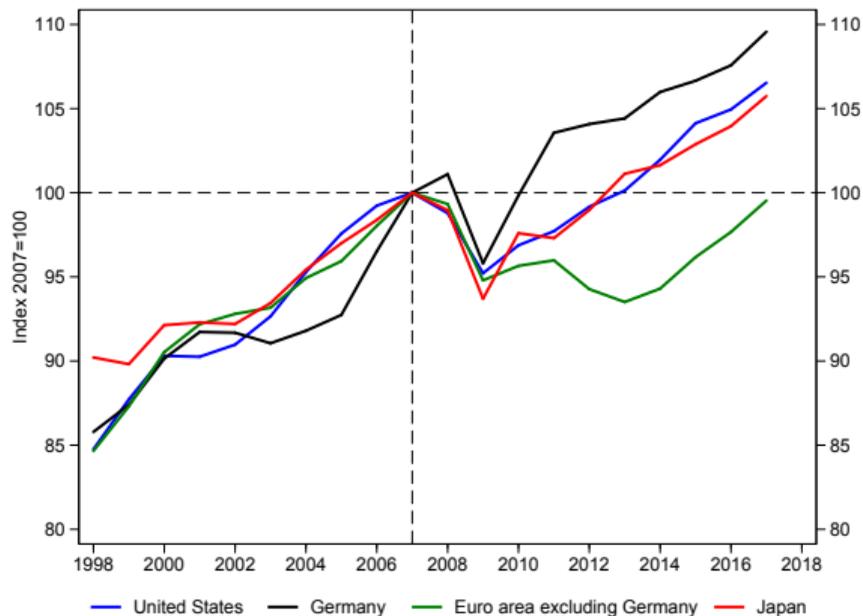


Real GDP per person. IMF WEO, October 2017. Index 2007=100

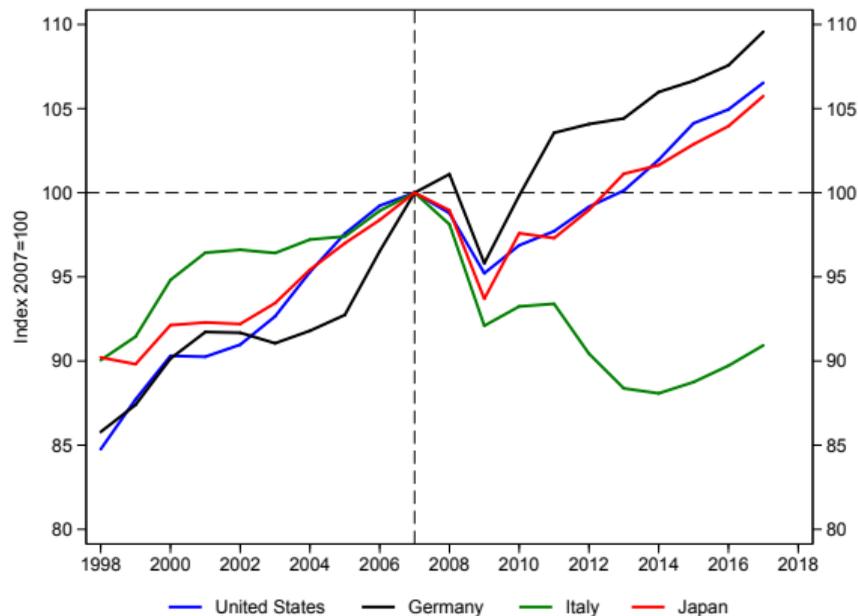


# An ongoing crisis: Winners and losers

## Which EMU?



## Italy vs Germany



Real GDP per person. IMF WEO, October 2017. Index 2007=100



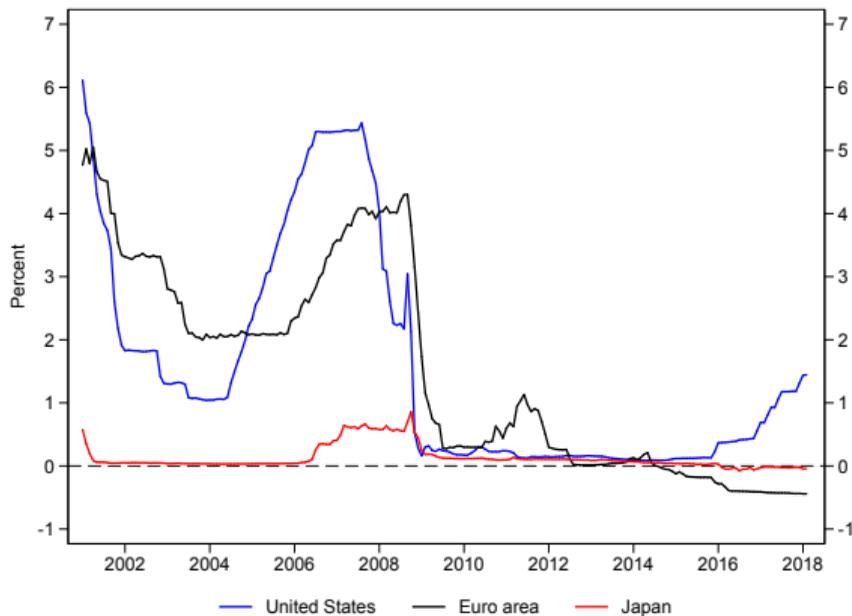
# The ECB: A common central bank for the common interest?

- ▶ Has the ECB adopted the best possible monetary policy for the euro area as a whole, in accordance with the Treaty?
  - ▶ Inflation close to 2% for euro area as a whole?
  - ▶ Positive contribution to growth and all other goals of Union?
- ▶ Has the ECB managed to stay clear of discretionary decisions that would appear not entirely consistent with its mission?
  - ▶ Use of discretionary power to address “moral hazard” concerns?
  - ▶ Use of collateral framework as a disciplining device?
  - ▶ Immersion in politics of crisis? Troika programs?

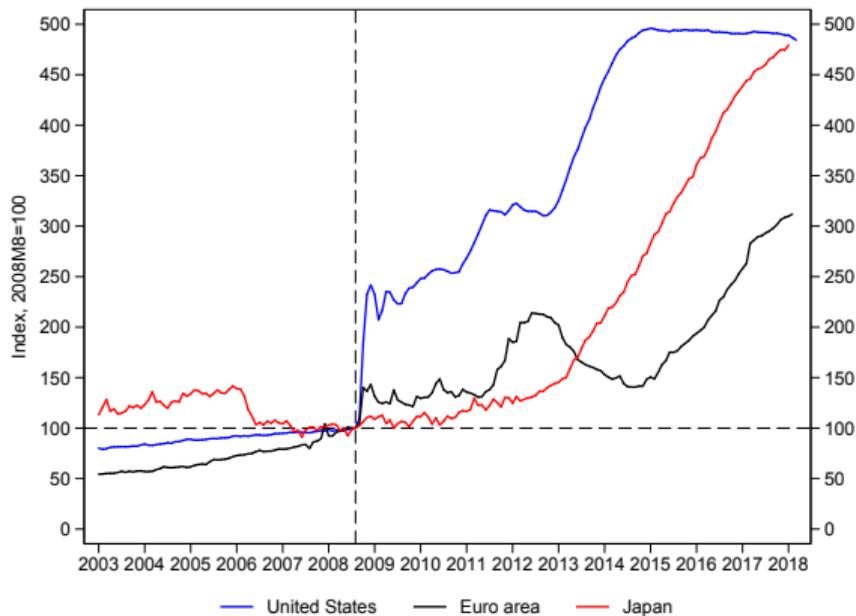


# Comparing monetary policy: Fed, BoJ, ECB

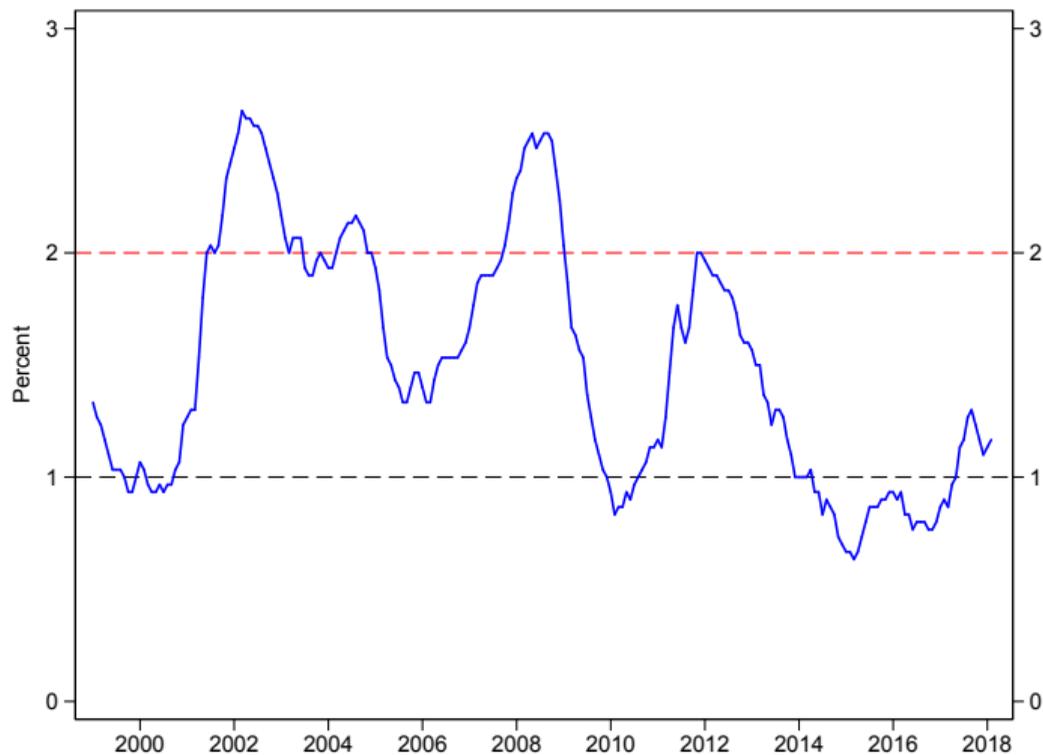
## Interest rates



## Balance sheet



# ECB policy outcomes: Core inflation in euro area



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



## ECB inflation projections: A premature exit from QE

Forecast Date	ECB Forecast			
	2017	2018	2019	2020
Mar. 2017	1.7	1.6	1.7	
June 2017	1.5	1.3	1.6	
Sept. 2017	1.5	1.2	1.5	
Dec. 2017	1.5	1.4	1.5	1.7
Mar. 2018	1.5	1.4	1.4	1.7

April 2017: Reduction in QE purchases from 80 to 60 billion euro per month.

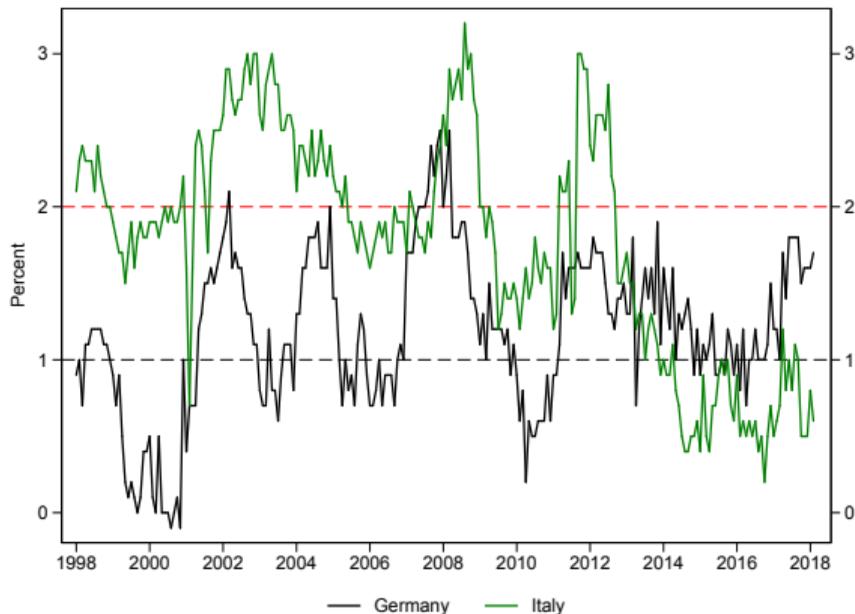
January 2018: Reduction in QE purchases from 60 to 30 billion euro per month.

Why the reluctance to do enough?

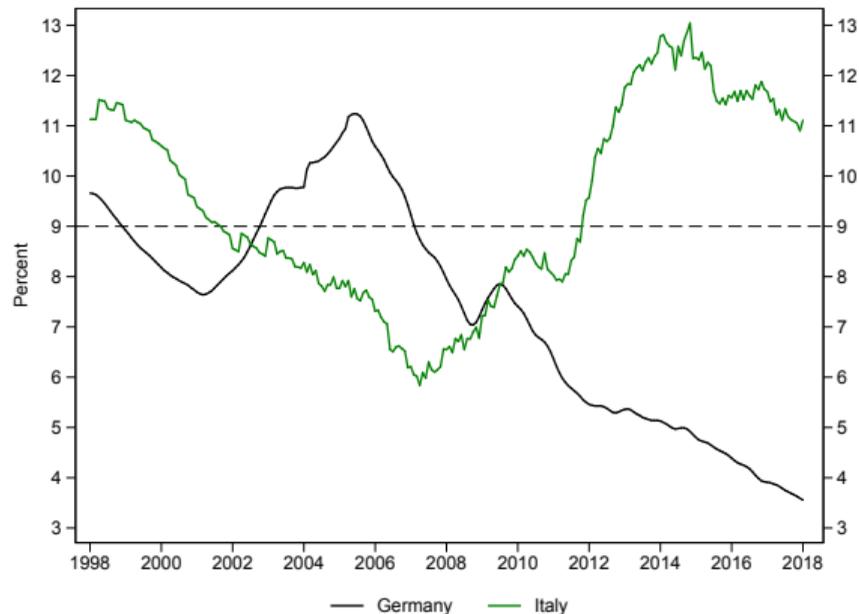


# Evaluating ECB policy: Germany vs Italy

## Core inflation



## Unemployment



ECB policies similarly supportive of price stability and growth in Germany and Italy?



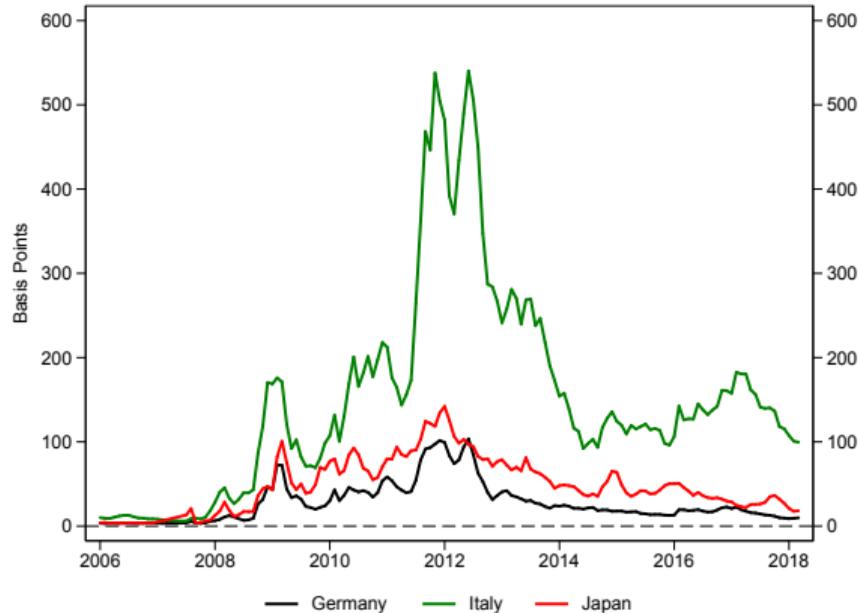
# The precarious position of the ECB

- ▶ Focus on mandate for euro area as a whole?
- ▶ Manage political risk from pursuing policies that are unpopular in one very influential member state?
- ▶ Deviate from best policy for euro area as a whole to manage political risk?

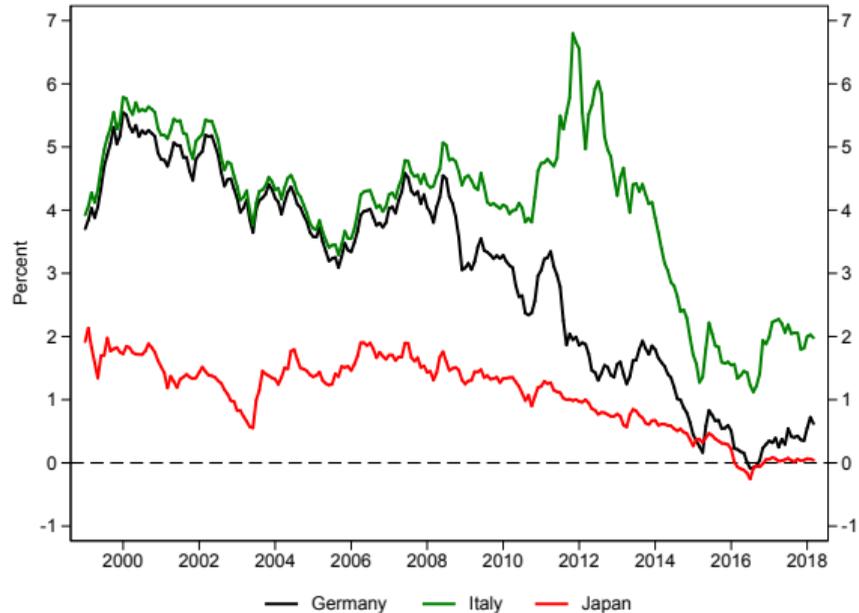


# What sustains the euro crisis?

## Five-year CDS spread on sovereign debt

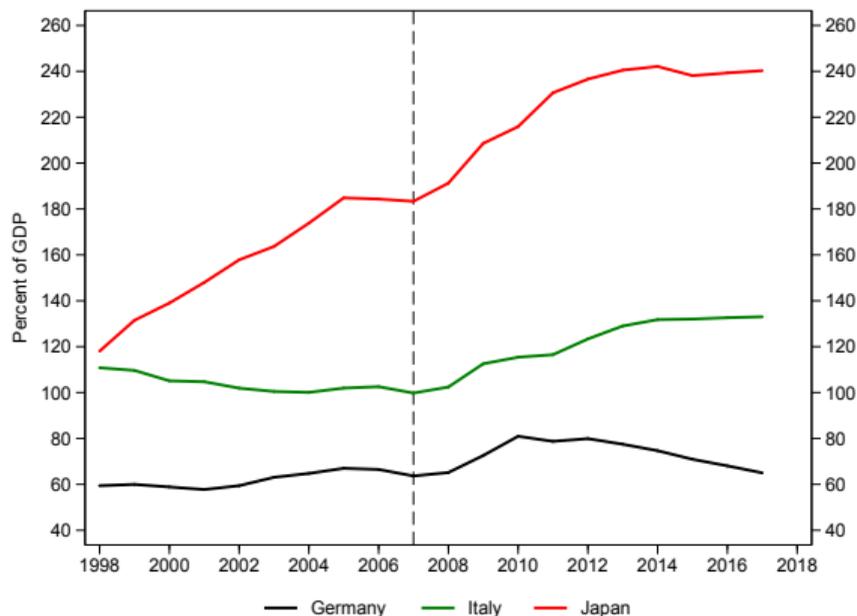


## Yield on ten-year sovereign debt

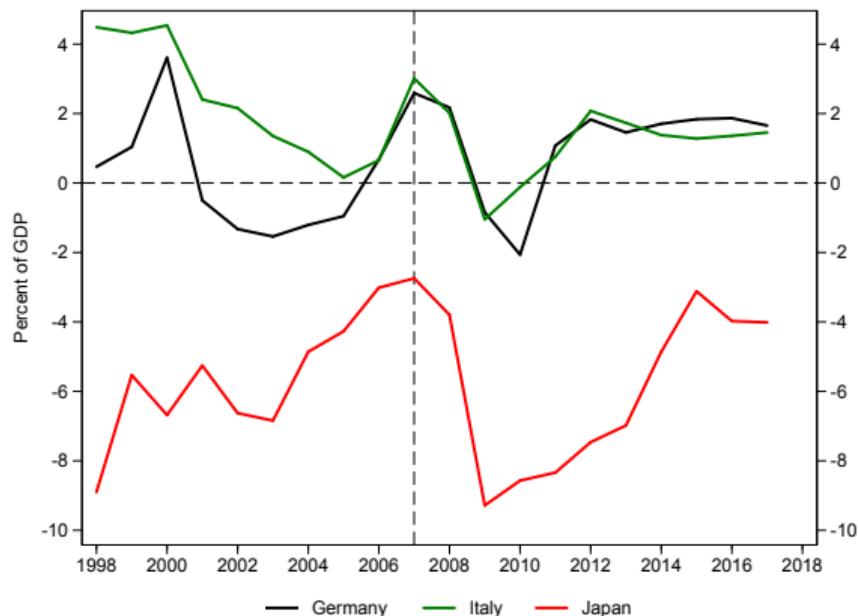


# Japanese frugality vs Italian profligacy?

## Gross debt



## Primary fiscal balance



Debt and primary fiscal balance as a percent of GDP. IMF WEO, October 2017.

Negative fiscal balance corresponds to fiscal deficit.



# Debt dynamics and fear of default

$$\Delta b_t = (r - g)b_{t-1} + d_t$$

$b_t$ , debt (ratio to GDP).

$d_t$ , primary deficit (ratio to GDP).

$r$ , real interest rate.

$g$ , real GDP growth.

- ▶ Has the ECB adopted policies that unnecessarily raise  $r$  for “weak” states while reducing it for “strong” states?
- ▶ Does the ECB sustain the crisis?



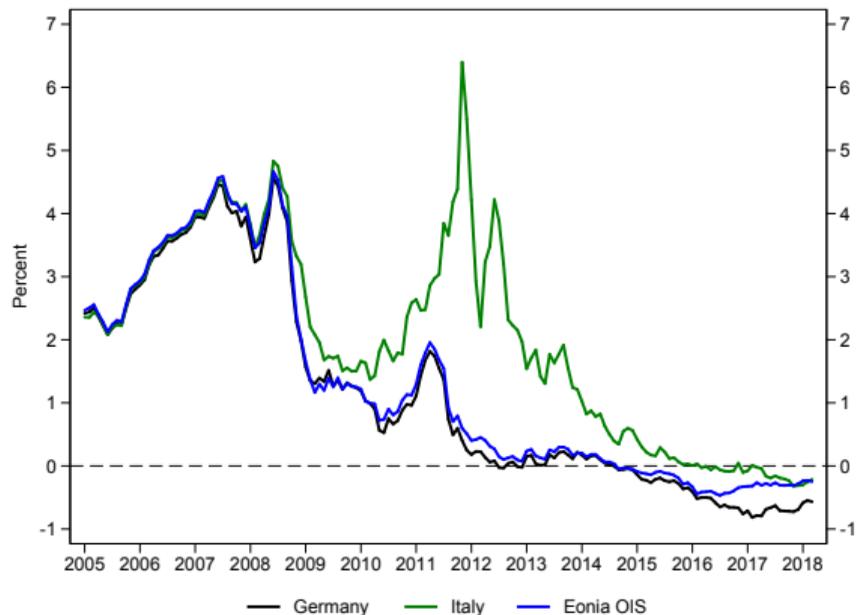
# What sustains the crisis?

- ▶ Discretionary ECB decisions have:
  - ▶ compromised the safe asset status of the government debt of most states.
  - ▶ generated unnecessarily high government bond yields for “weak” states  
artificially low government bond yields for “strong” states
  - ▶ generated a fiscal transfer from “weak” states to “strong” states.
- ▶ Examples of discretionary decisions:
  - ▶ Delegation of collateral eligibility of government debt to rating agencies.
  - ▶ Deviating from profit/loss sharing for QE.
  - ▶ Use of market yields in debt sustainability analysis for member states.

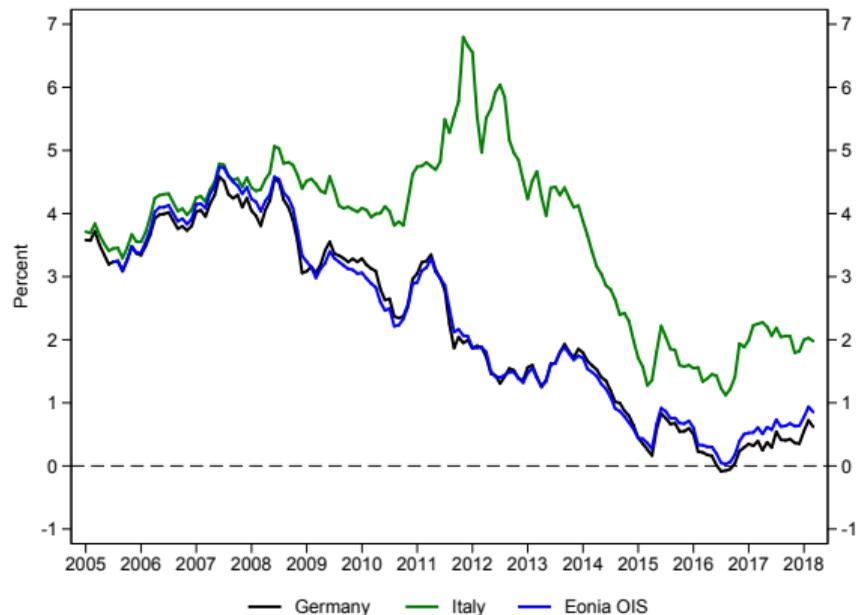


# Quantifying the fiscal transfer: Government bond yields vs OIS

## Two-year maturity

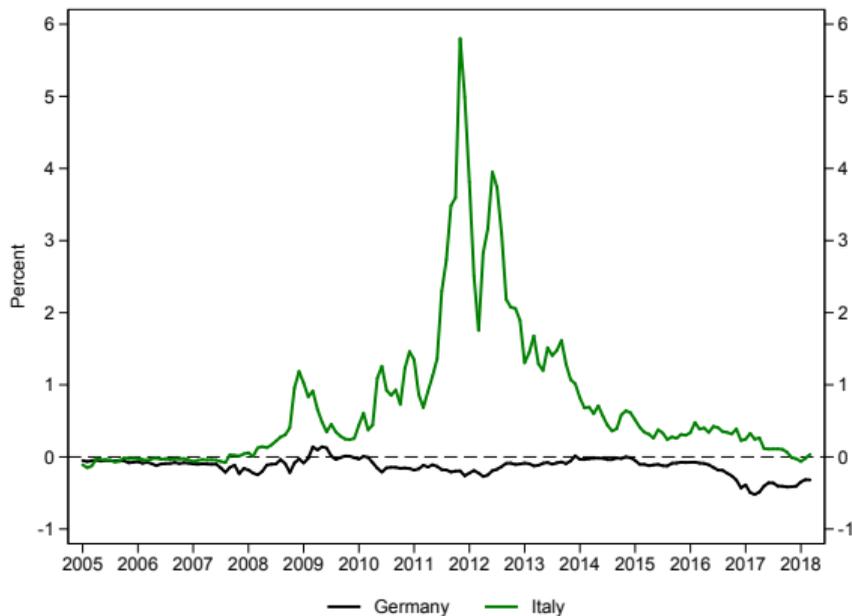


## Ten-year maturity

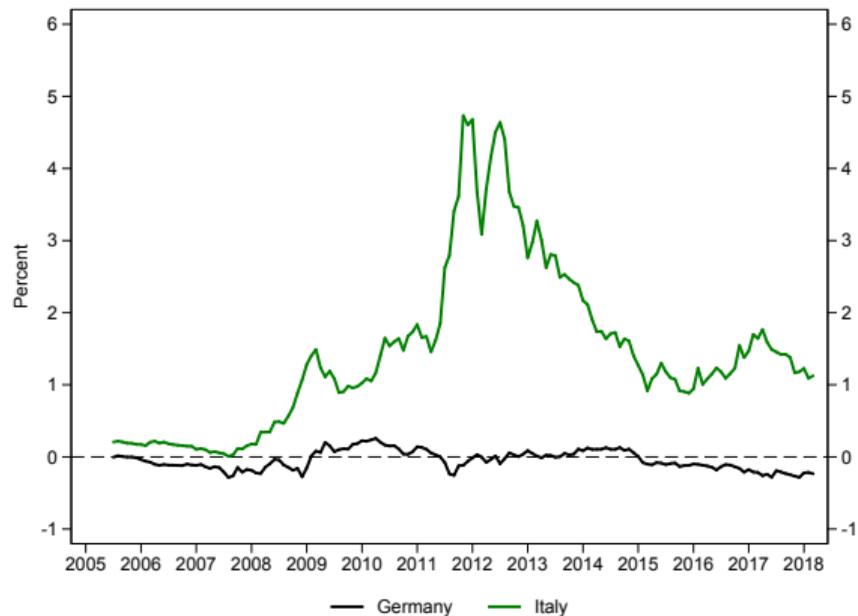


# Government bond yield spread over OIS

## Two-year maturity



## Ten-year maturity



# The ECB's predicament

- ▶ The problems induced by ECB discretionary decisions can be easily corrected by the ECB, within its mandate.
- ▶ However, improving ECB policy would worsen the “moral hazard” problem created by the Maastricht framework for the euro area.
- ▶ Are concerns regarding moral hazard a proper justification for discretionary ECB decisions that sustain the status quo?
- ▶ Is “saving the euro” a proper justification for doing “whatever it takes,” including actions that are inconsistent with democratic legitimacy and the ideals of the European project?



# Prolonging the status quo to “save” the euro?

“It would be tragic and fatal if we were to lose democracy on the road to saving the euro.”

Andreas Vosskuhle, February 2012  
(President of the German Constitutional Court)

