The Global Economy

European Monetary Union

NYU STERN

European Union

- Emerged from post-WWII Europe
  - ECSC to foster peace between France and Germany
- Evolved into the EU and eventually the monetary union, the EMU (a subset of the EU)
  - 1 currency; 1 central bank; **1 monetary policy**
  - "one market, one law, one money" (maybe?)
- EMU challenge:
  - 1 monetary policy, 17 heterogeneous countries

Economic benefits and costs

- Benefits
  - Wide euro acceptance is a public good
  - Promotes international trade and finance
    - Lowers transaction costs
    - Makes pricing transparent
    - Expands size of market
  - Eliminates exchange rate risk within EMU
- Costs
  - Sacrifice local monetary policy and lender of last resort
  - Can't inflate away debt; increase risk of government default; diminish ability to recapitalize banks

Two monetary unions

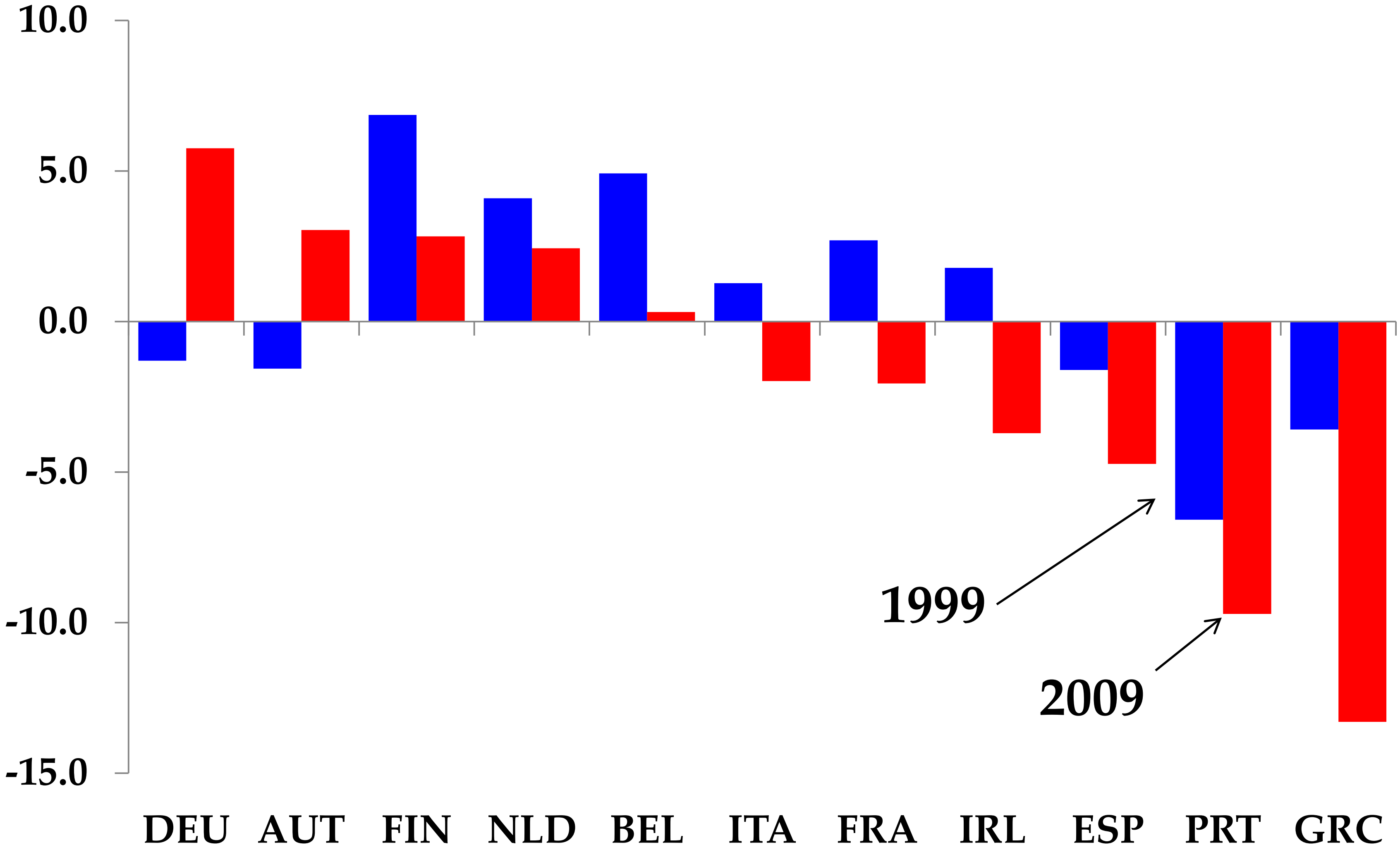
	US States	EMU Countries
Common monetary policy	Yes	Yes
Common fiscal policy	Yes	No
Fiscal burden sharing	Yes	No
Labor market mobility	High	Low
Official languages	1	23
Unemployment rate, average	9	10
Unemployment rate, high/low	NV=13.4, ND=3.5	ESP=22.6, NLD=4.5
Prices and wages	Flexible	Less flexible
Richest/Poorest	CT/MS=1.8	LUX/EST=7.2
Common: deposit insurance, bank regulator and backstop	Yes	No

Rules and time consistency

- Secure price stability
  - Independent ECB
  - "No bailout" clause
- Fiscal entry conditions in Treaty
  - Seek to contain fiscal moral hazard
  - Pressure to comply weakens after entry
  - Applied very flexibly even at start
- Stability and Growth Pact
  - Supplement to the Treaty
  - Excessive deficit procedure
  - Violated early by Germany, France and others

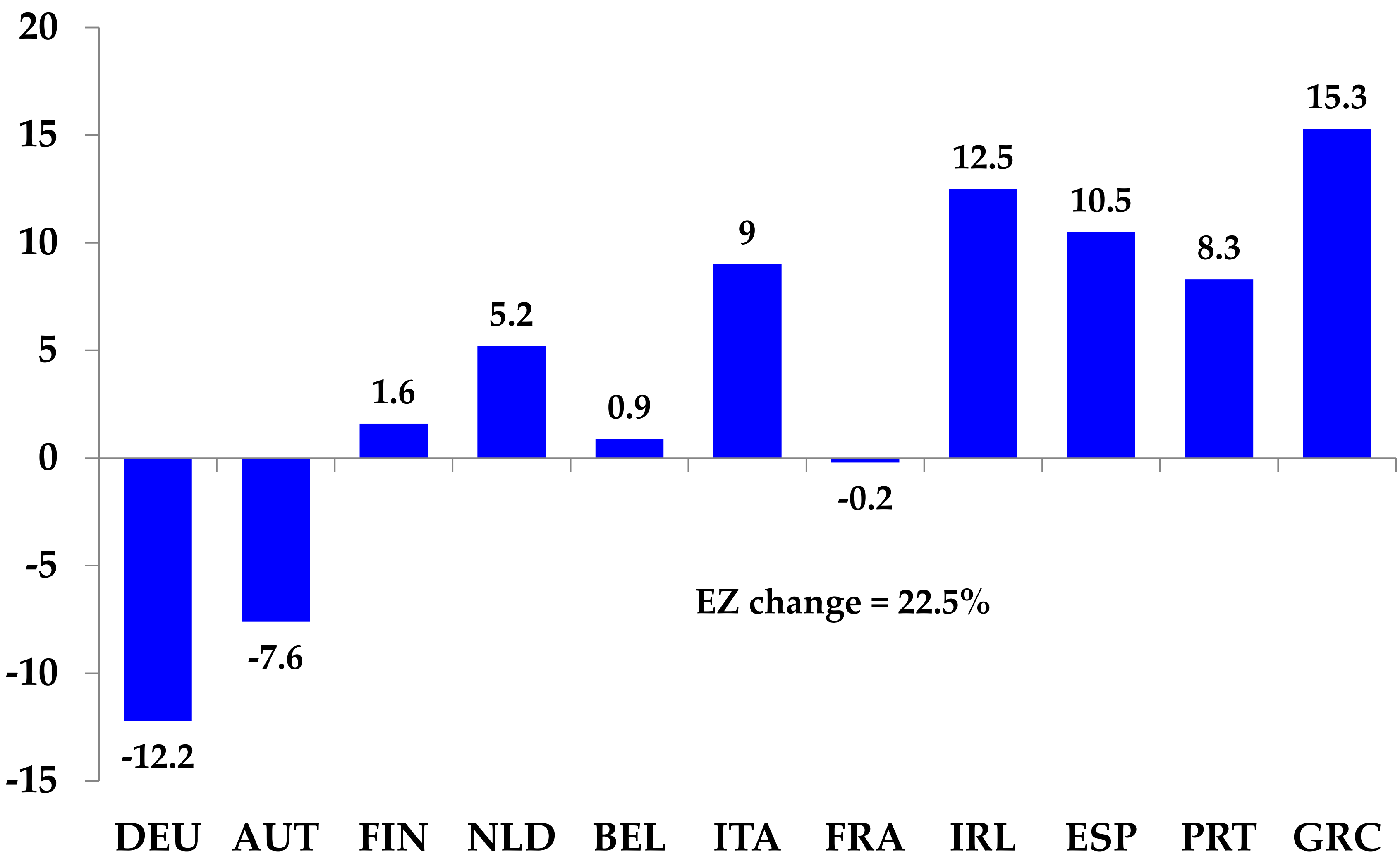
Current accounts

percent GDP

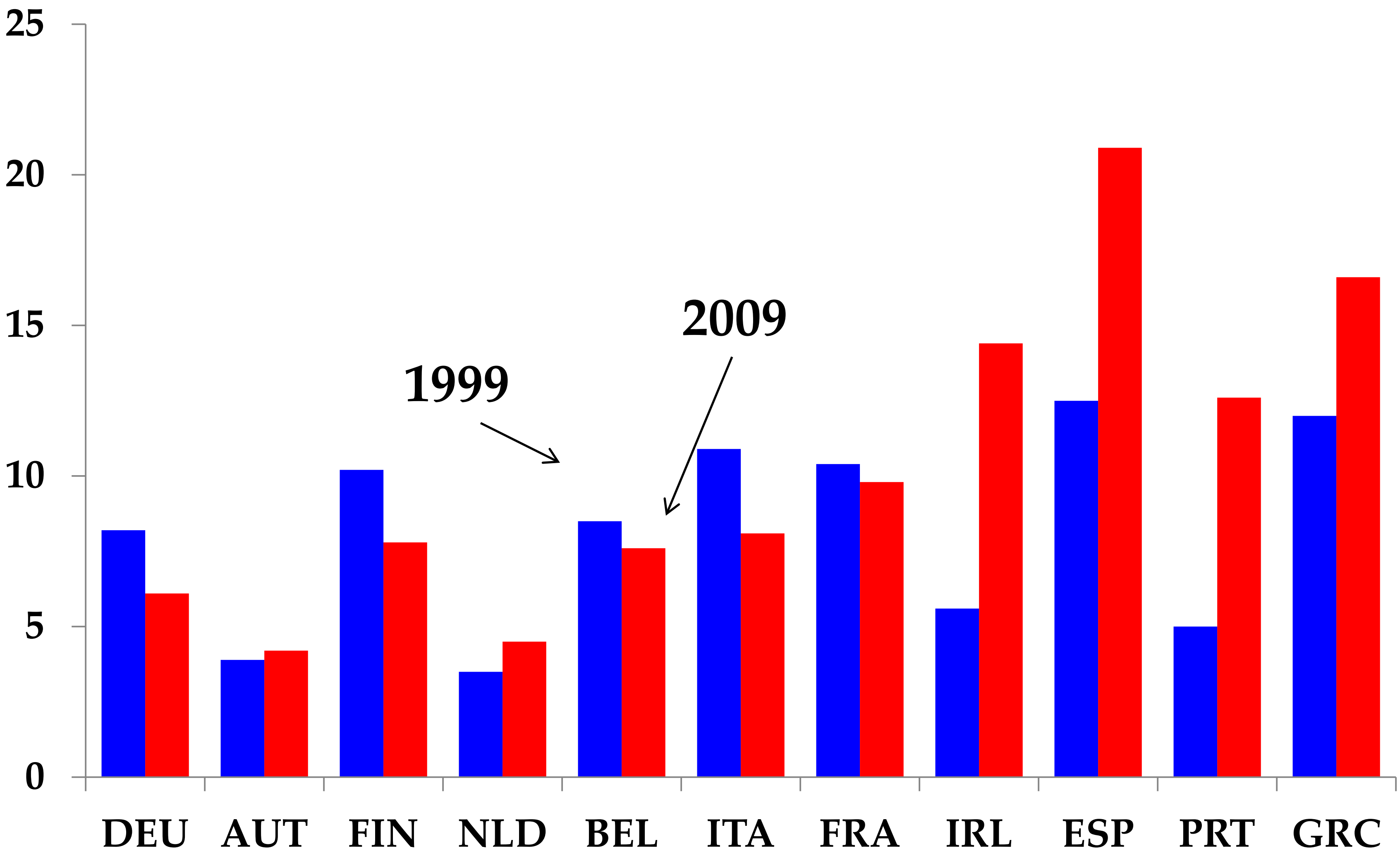


Unit labor costs

percent change 1999-2009, relative to EZ change



Unemployment rate

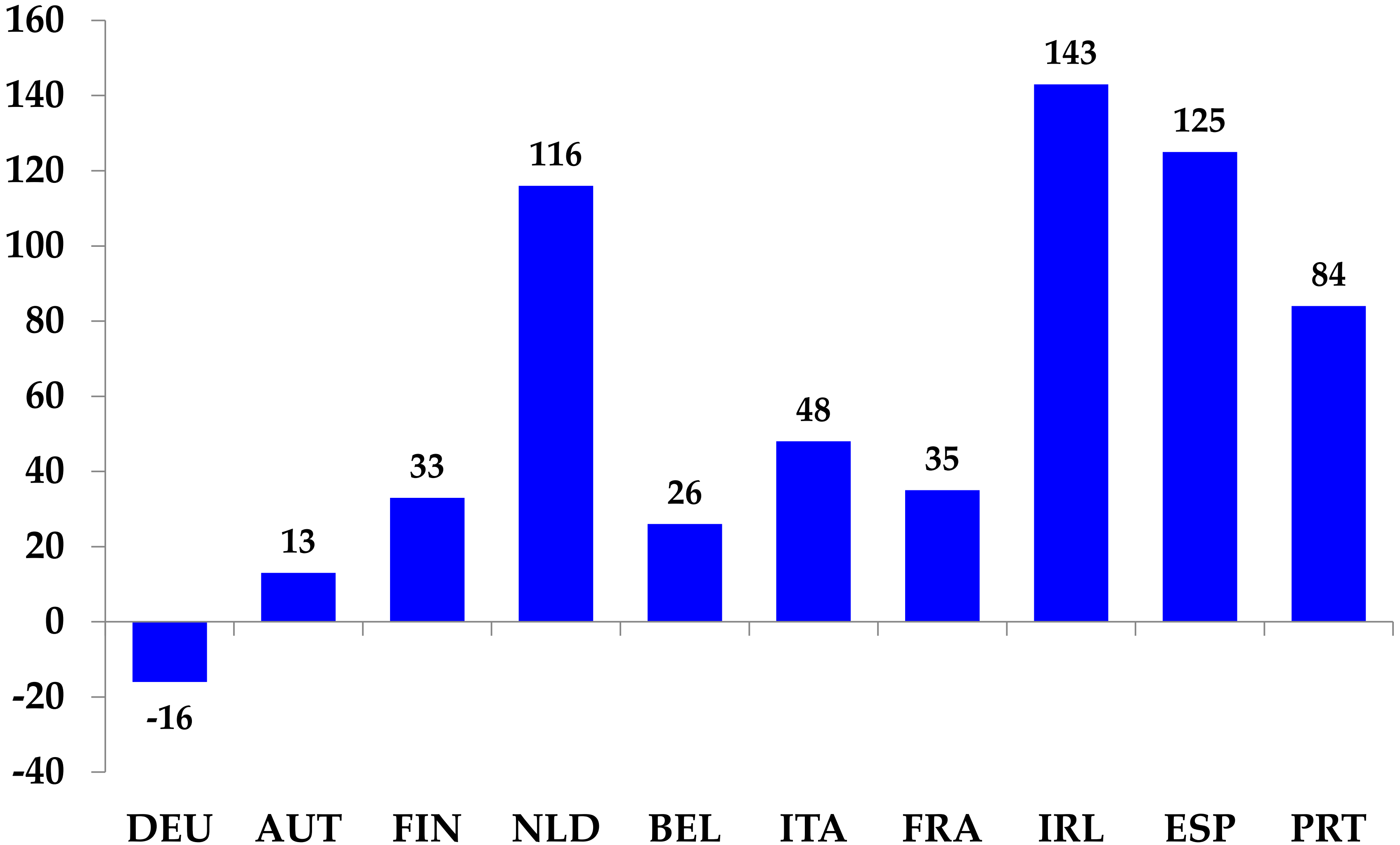


Spain, Greece, Ireland, Portugal, Italy

- Borrowing costs fall on joining EMU
  - "Inherit" central bank discipline
  - Can no longer inflate away debt (i vs. g)
- Portugal and Greece
  - Government debt grows: increase net spending
- Ireland and Spain
  - Private sector debt grows: housing, consumption
  - Private debt becomes public after bank bailouts
- Italy
  - Already had large debts, but runs primary surplus
  - Problem is slow growth (i vs. g, again!)
  - GDP/capita 1999-2011: avg 11.5%, Italy 1.8%

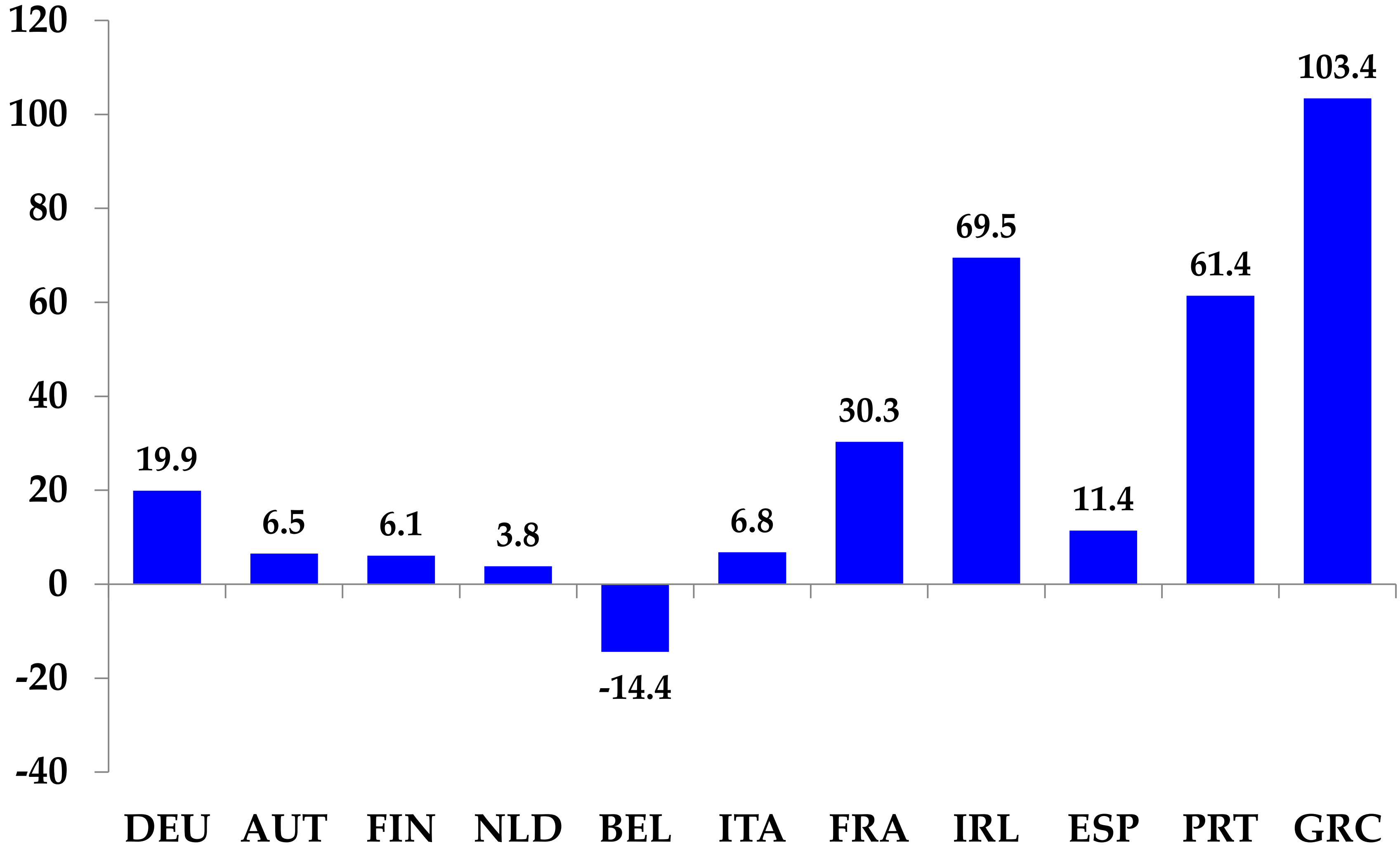
Private credit

change from 1999-2009, percent GDP



General government debt

percent GDP, change 1999-2012



What would happen with no EMU?

- Fixed exchange rate system (ERM in 1990s)
  - Capital flight out of Greece, etc
  - Fixed exchange rates are adjusted/abandoned
  - More on this next week
- Flexible exchange rate
  - Peripheral currencies would depreciate
  - Early adjustment likely
  - Capital inflows to the peripheral economies would have been smaller, less debt would have been possible

What are the options?

- Abandon EMU?
  - Not an economic decision, a political one
    - Threatens the entire EU
  - The whole thing?
    - Germany leaves? Left with a "weak" EMU.
    - Greece, Italy leave? Left with a "Northern" EMU.
      - Need recapitalization of banks
      - Would France be next?
  - What happens during transition?
    - Cataclysm: banks runs, capital flight, sovereign default
  - Eventually settle on a system of fixed exchange rates?

What are the options?

- Fiscal compact?
  - Anchor credible fiscal rules in new Treaty and/or state constitutions; require debt paydown over time
  - Transition: creditworthiness of Germany used to lower Italy’s borrowing costs (reduce “i – g”)?
- Inflate away debt?
  - Sacrifices credibility of ECB, perhaps irreversibly
  - Unacceptable in Germany