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Economics of Monetary Union 12e

Chapter 12: The Euro and Financial Markets

The euro intensifies financial integration

Ranking of degree of integration

1. The money markets: fully integrated
   However, since debt crisis increasing segmentation
2. The bond market: highly integrated
   However, since debt crisis renewed segmentation
3. The equity markets: integrated but obstacles at issuing side
4. The banking sector: retail banking segmented

Interaction between government bond market and interbank market

- Crisis in sovereign bond market of country A leads to banking crisis in that country
- As a result, banks of country A lose access from interbank market
- Interbank market becomes segmented
- This does not happen in complete monetary union (monetary union + budgetary union)

Interaction between government bond market and interbank market

- Example: banks in California are not affected by debt crisis of California government
- Because Federal government is guaranteeing California bank (through deposit insurance for example)
- Thus banks and interbank market in US are insulated from state government debt crises.
- Conclusion: budgetary union is necessary to maintain integrated interbank market

Banking union and budgetary union are intertwined

- Member countries decided to create banking union aimed at resolving deadly embrace between sovereign and banks.
- Banking union was created when in 2014, when ECB became the single supervisor of the systemic banks in the Eurozone.
- Unfortunately, the other components of a banking union are less well developed
  - There is still no common deposit insurance mechanism
  - and the resolution mechanism is insufficient

Banking union and budgetary union are intertwined

- Thus, banking union in the Eurozone remains incomplete.
  - As a result, when a national government experiences a debt crisis in the future it will again pull the domestic banks into a crisis also, shutting these banks out of the interbank market.
  - integration of a key part of the financial system, i.e. the interbank market, can only be maintained if there is some form of budgetary union

Banking union and budgetary union are intertwined

- The disruption of the interbank market in the Eurozone has had another important effect.
  - It has disrupted the payment system in the Eurozone.
  - When prior to the crisis Country A made net payments to Country B (e.g. because it had a current account deficit), this appeared in the fact that banks of Country B accumulated claims on banks of Country A. And nobody noticed.

Banking union and budgetary union are intertwined

- When the sovereign debt crisis led to a breakdown of the interbank market in 2010 this was no longer the case.
- Instead these payments led to an accumulation of claims of the national bank of Country B on the rest of the system and liabilities of country A.
- This has led to fears of large losses for Germany if the Eurozone were to collapse

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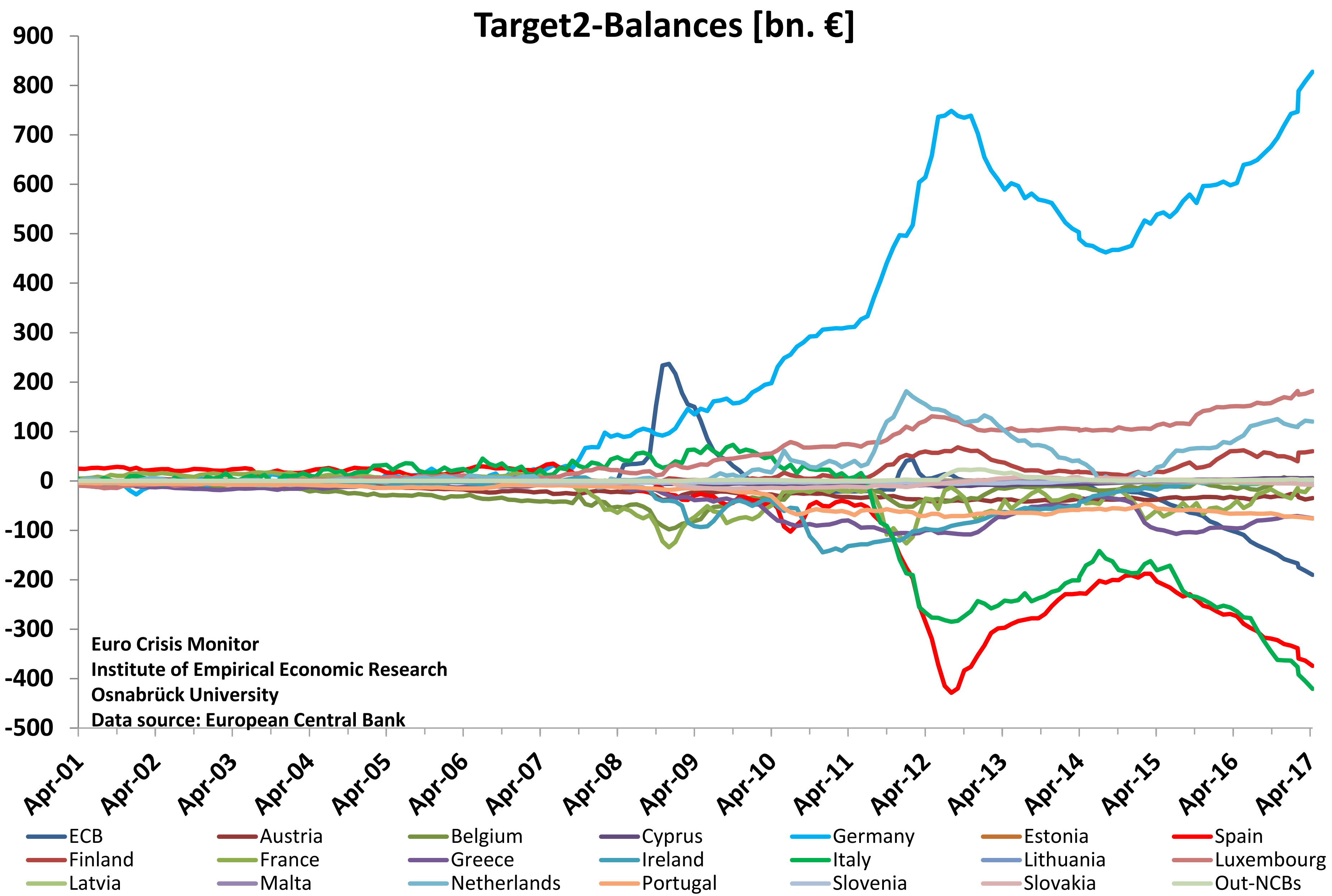

Source: Euro Crisis Monitor, Institute of Empirical Economic Research, Osnabrück University

- Since 2015 the Target-2 balances increased again. This has much to do with the QE programme of the ECB.
  - This has created large amounts of liquidity (money base) in the Eurozone. This has also led to a lot of excess liquidity in countries like, Italy, Spain, and Portugal.
  - As the confidence in domestically created assets is not yet fully restored in these countries, this excess liquidity has been used to buy assets in Germany.
  - As a result, large capital flows from Southern Eurozone countries into Germany have been initiated since the start of QE.
- These show up as claims of the Bundesbank in Target-2 and liabilities of the Banca d'Italia and Banco de España.

Important obstacles remain mainly in retail banking

- Retail banking remains segmented despite euro
- Reason: national regulators and supervisors have no incentive to open up banking sector
- As long as deep differences in legal systems remain in place financial integration will be incomplete.

Why financial integration is important

- Financial integration is a substitute for fiscal integration.
- It provides for risk sharing.
- In US this is twice as important as risk sharing through the government budget.

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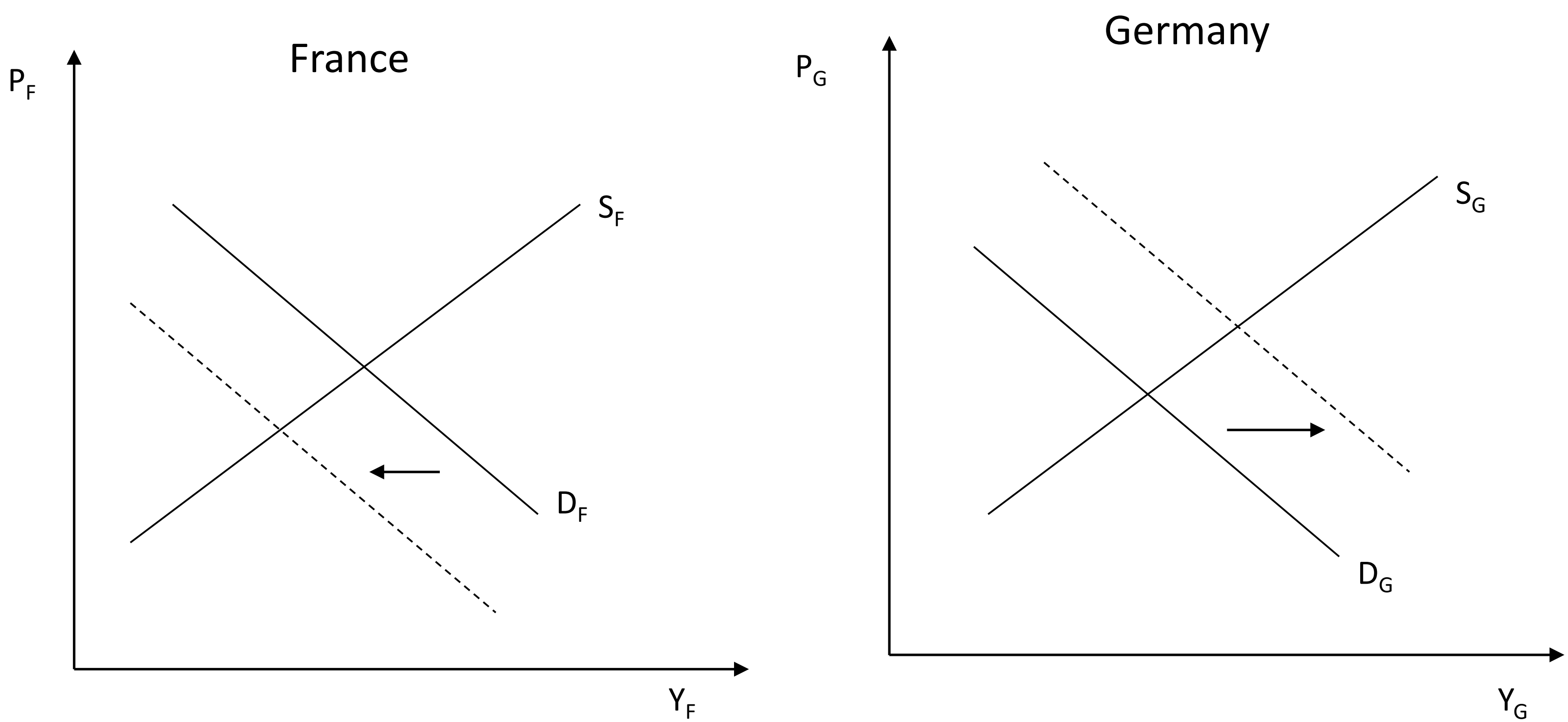
Figure 12.2 Aggregate demand and supply with asymmetric shocks

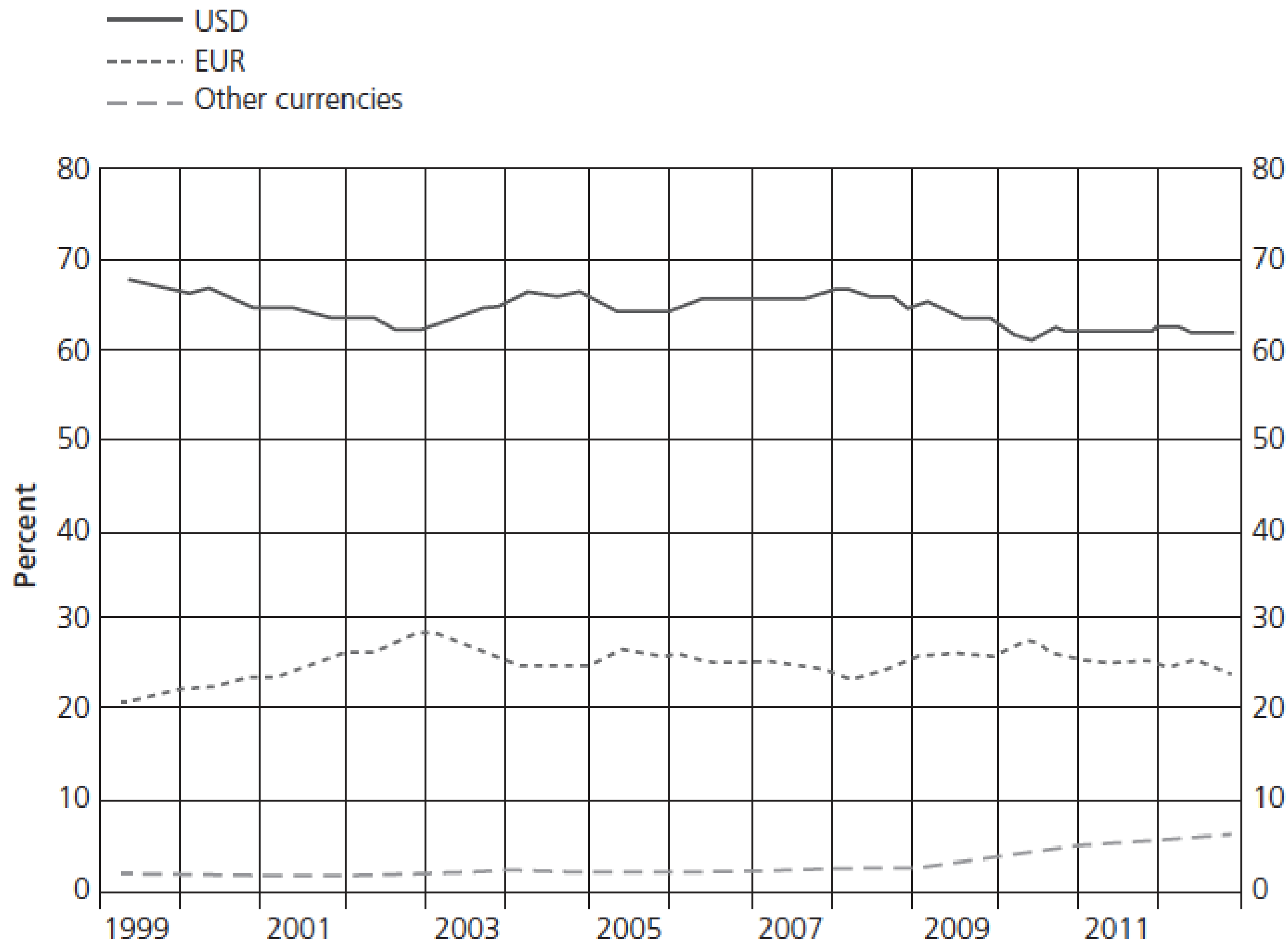


- Empirical evidence shows that the insurance system in the Eurozone is poorly organized at this moment.
- The only risk sharing mechanisms that are in place involve. redistributions between different generations within the same countries

The Euro as an international currency

- Share of the Euro as a reserve currency held by foreign central banks has been increasing since the start of the eurozone (next slide).
- Share of Euro in international bonds issue has also increased.

Figure 12.3 Share of euro in global foreign exchange reserves



Source: European Central Bank, The International Role of the Euro, July 2013.

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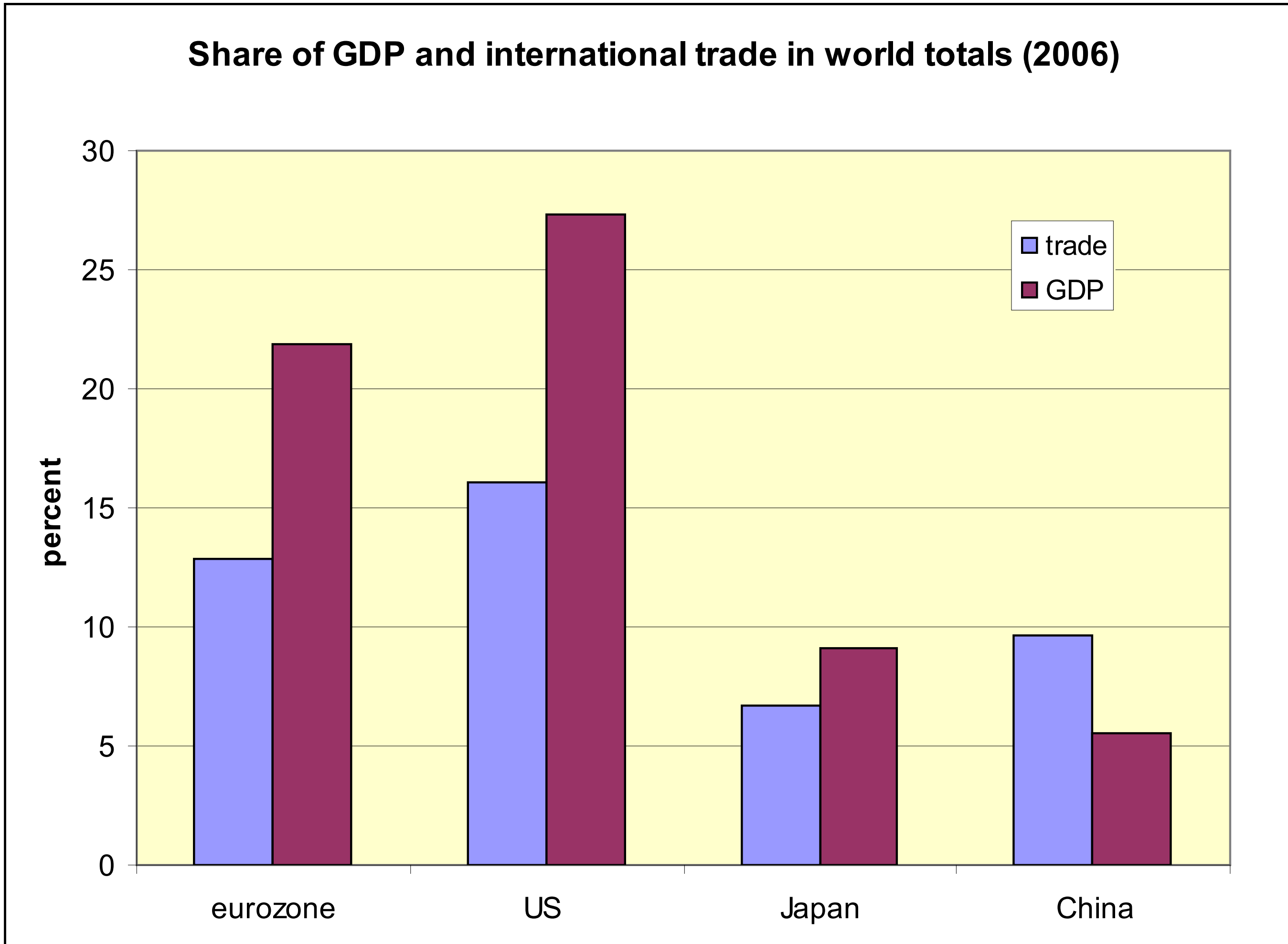
Will the euro overtake the dollar as an international currency ?

For this to happen a number of conditions must be satisfied:

- Size: real and financial
- Degree of integration and deregulation
- Price stability
- Macroeconomic stability

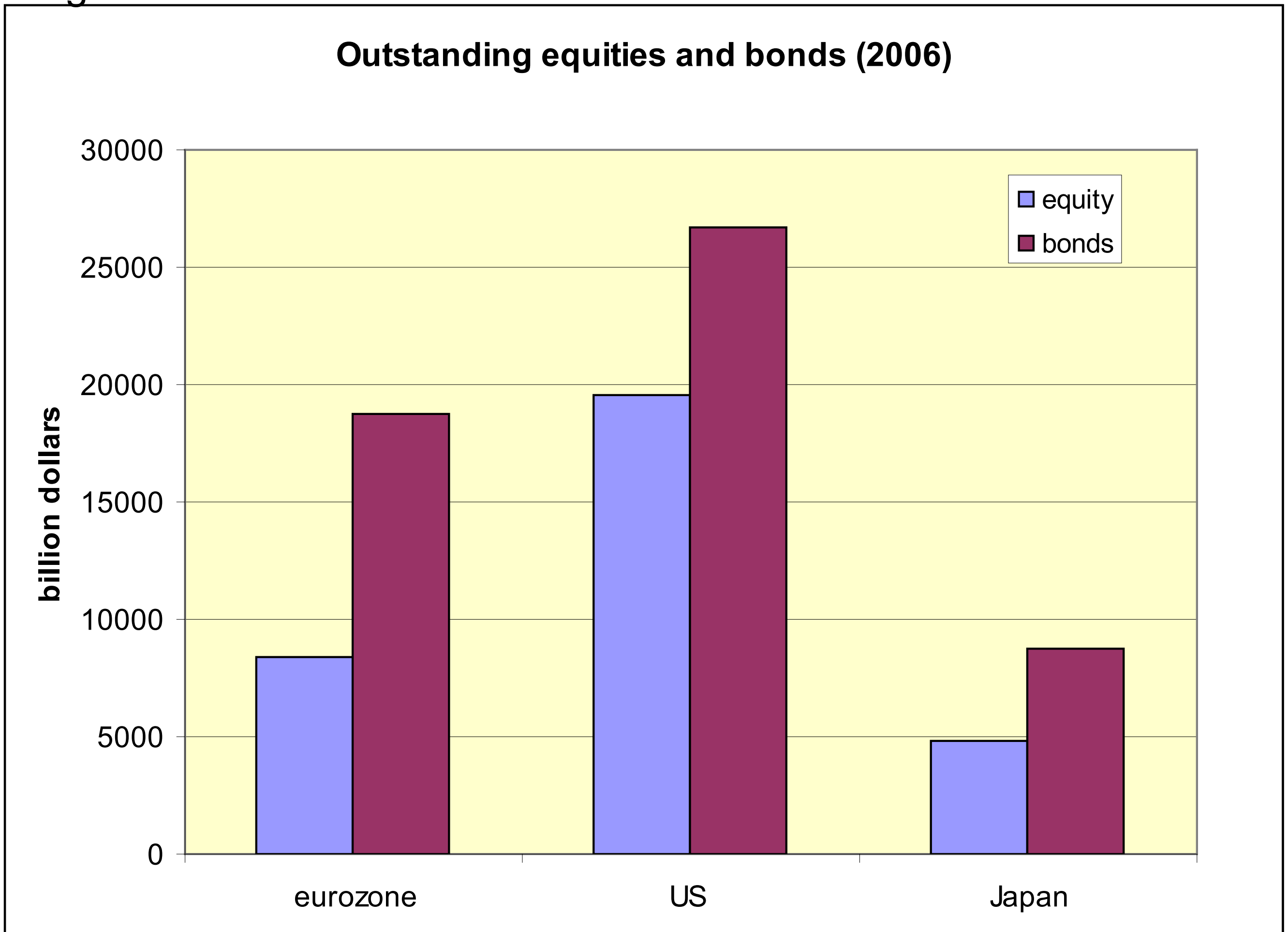
Eurozone’s real economy about as big as US

Figure 12.4



Size of equity and bond markets

Figure 12.5



Source: European Commission, Euro@10, 2008

The policy environment

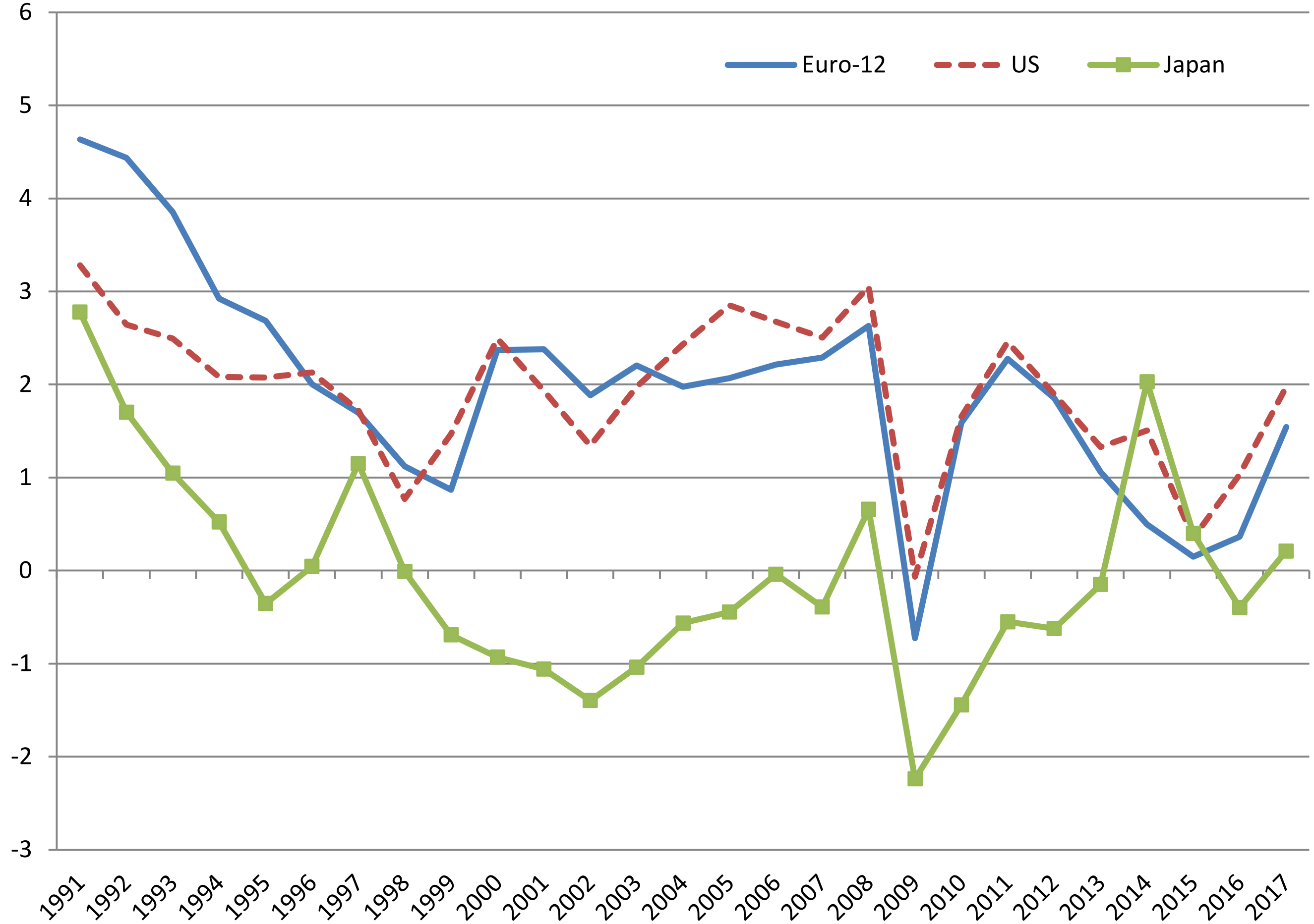
- A currency can only graduate to an international role if there exists monetary and financial stability at home.
- The foremost indicator of *monetary stability* is the rate of inflation (which measures the stability of the purchasing power of money).
- In both Europe and the USA, price stability has become the major objective of policy-making.

The policy environment

- *Financial stability* matters
- Japan was even more successful in maintaining price stability than Europe and the USA during the 1990s and the early 2000s
- Yet a financial crisis erupted that has led to a serious setback for the yen as an international currency.
- Financial stability conditions have to do with government debts and deficits, and the stability of the financial system.

Inflation in the Euro area, USA, and Japan

Figure 11.6 Price deflator private final consumption expenditure (yearly % change)



Source: European Commission, AMOCO

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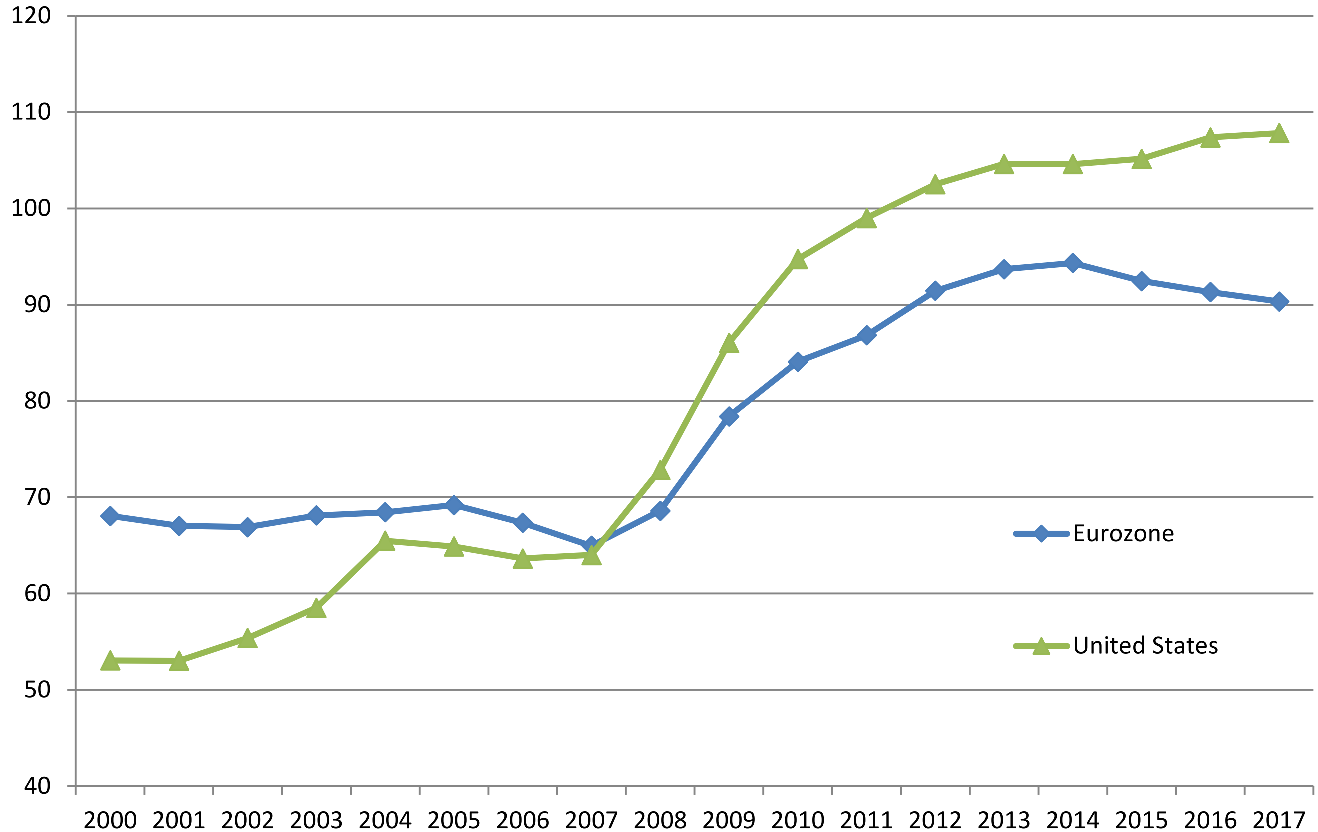
Figure 11.7 Government debt in the Euro area and USA (% of GDP)



Source: European Commission, *European Economy*.

- Despite a significantly worse public debt situation in the US than in the Eurozone. it is the Eurozone that has been hit by a government debt crisis in 2010.
  - We analyzed the reasons why this is so in previous chapters.
- Clearly if the Eurozone does not manage to overcome that crisis, there is no chance the euro will become a currency capable of challenging the dollar.

Inertia in the international position of a currency

- Due to network externalities in the use of a currency,
  - i.e. the utility of the use of a currency derives mainly from the fact that others use the same currency.
  - And the more users there are for one particular currency the greater the utility for all the users.
- This implies that when a particular currency, say the dollar, is the dominant one, this very fact makes it very useful.
- People will not easily switch to another currency under those conditions.

Inertia in the international position of a currency

- This explains why the pound sterling remained the leading international currency until the Second World War even though the UK had already lost its dominant economic and financial position.
- All this means that the dollar is likely to remain the dominant currency for some time to come. (For a contrary view see Chinn and Frankel(2005)).

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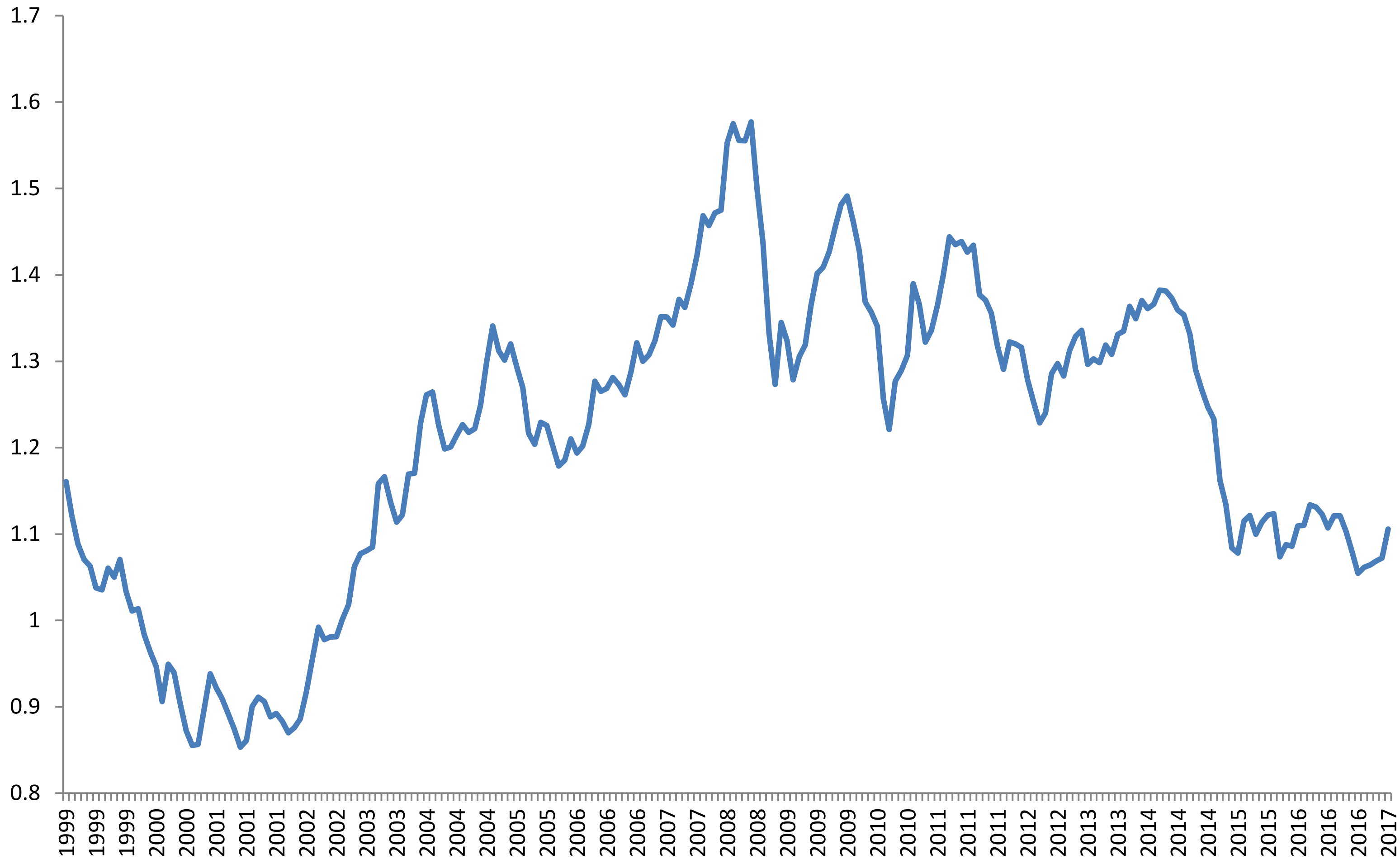
Conclusion

- The euro has the potential to become an international currency.
- It will take some time to match the dollar
  - Differences in size
  - Insufficient integration
- Crucial factor: resolution of debt crisis in eurozone

Note: factors that affect potential for a currency to become a global one are not directly related to factors that affect strength of a currency.

Euro–dollar exchange rate: a bubble during 1999–2009; since then lots of volatility

Figure 11.8 Euro–dollar exchange rate (1999–2017).



Source: European Central Bank

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