CHALLENGES OF THE EUROZONE – CAN THE EURO SURVIVE?

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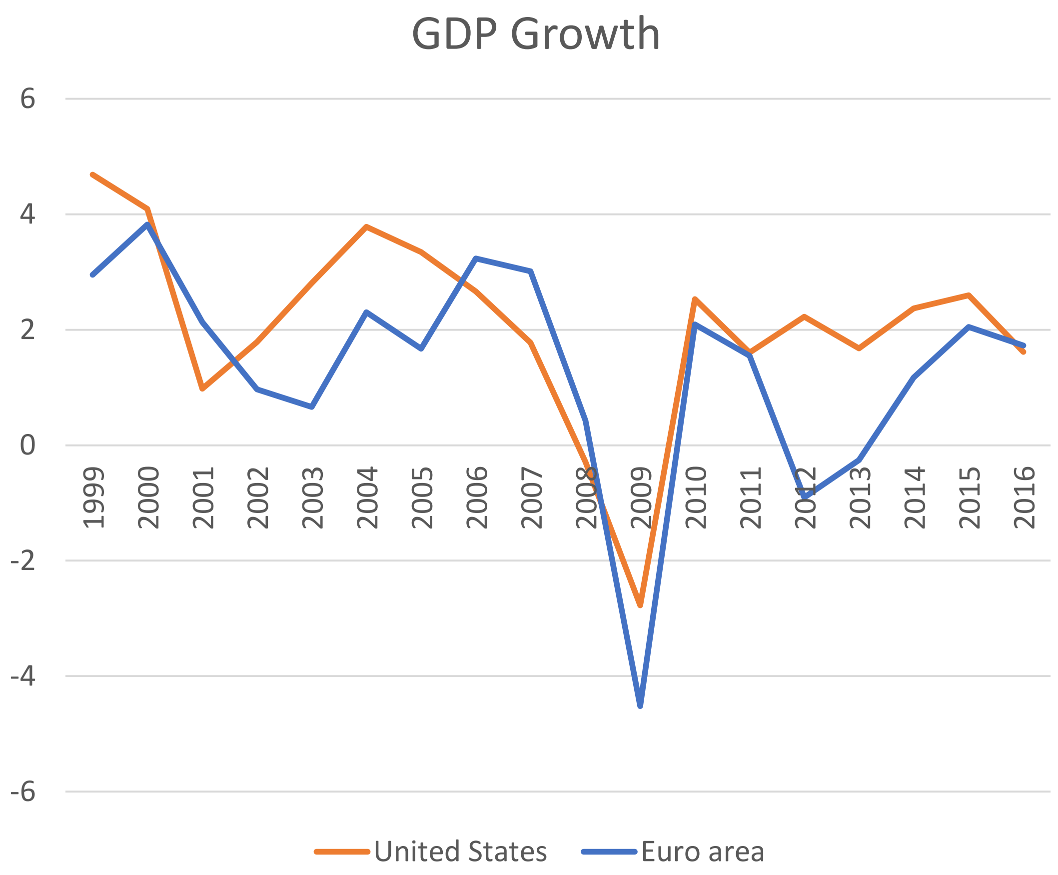
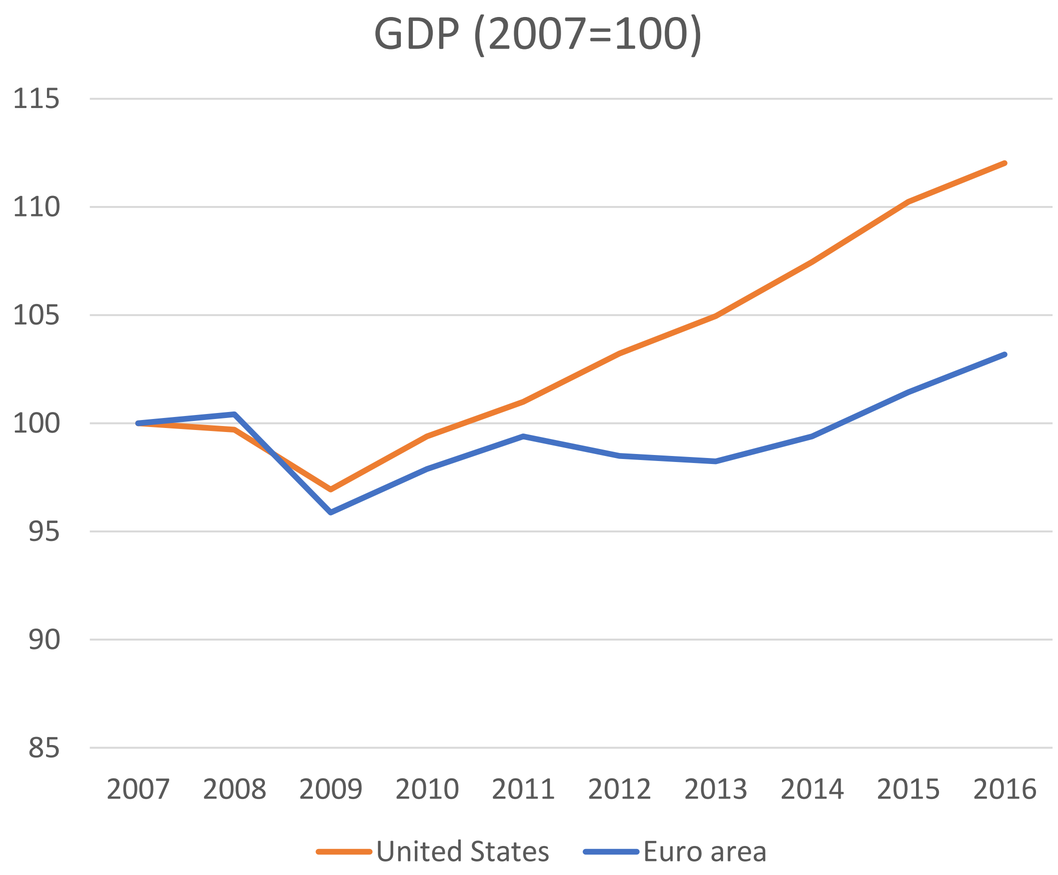
Outline

I. Euro crisis: What went wrong?
II. How the Euro was saved, so far at least
III. How effective are structural reforms?
III. The great divide: Maastricht 2.0 versus Euro 2.0
IV. Intermediate solutions

I. What went wrong?

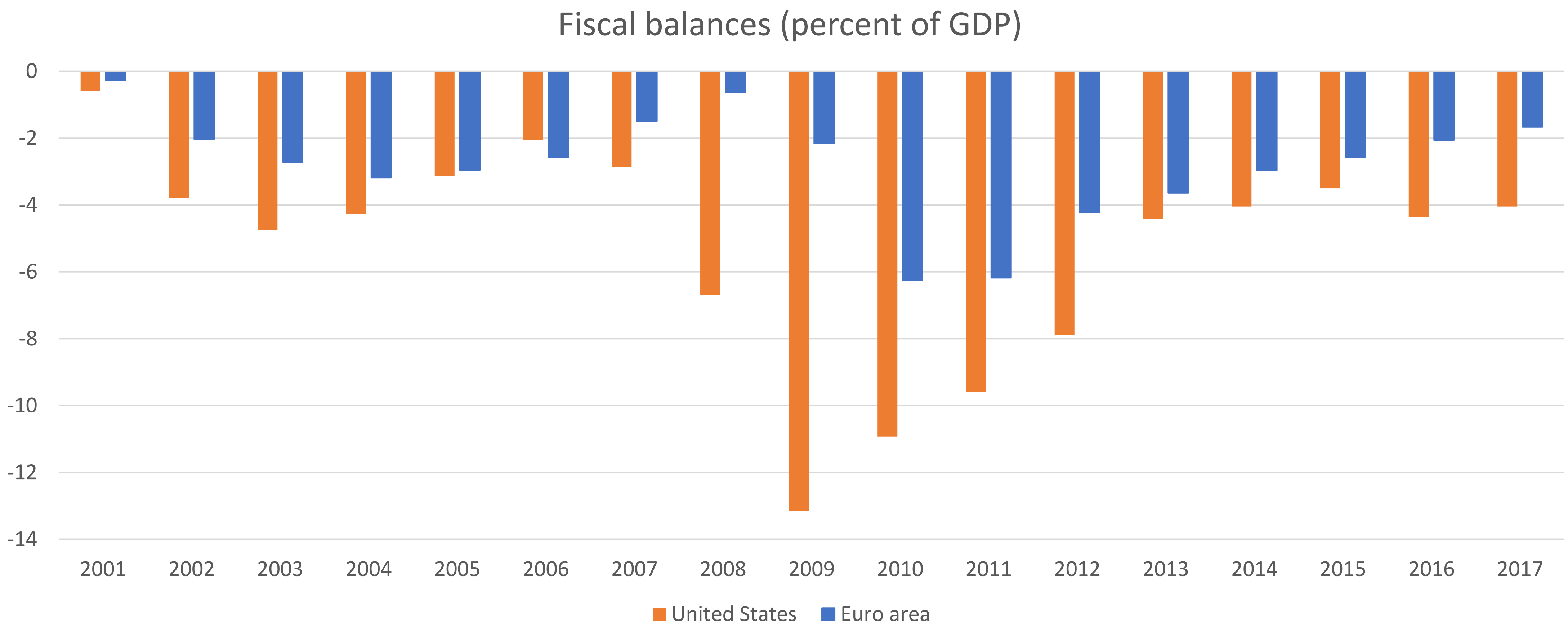
Dismal growth performance of the EZ since 2007





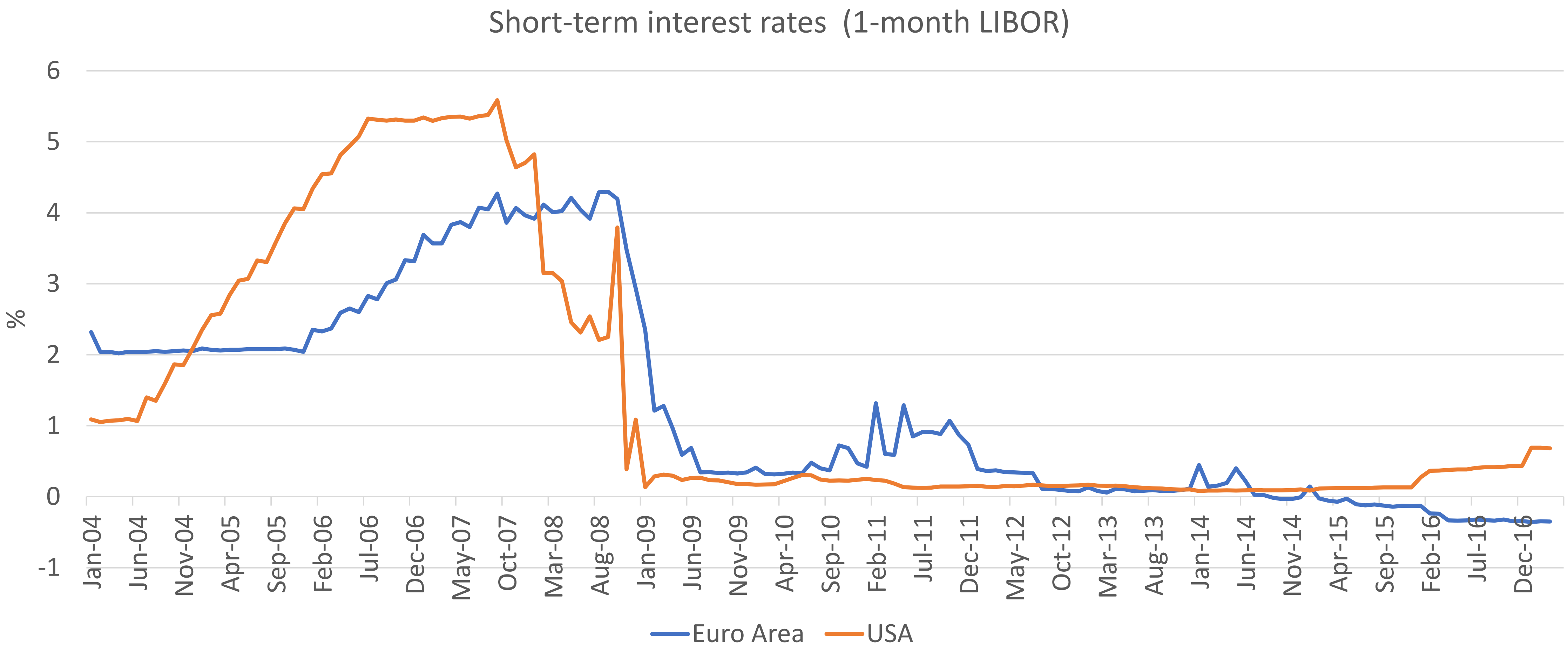
Source: OECD, Economic Outlook Annex Tables

Fiscal policy response was too weak



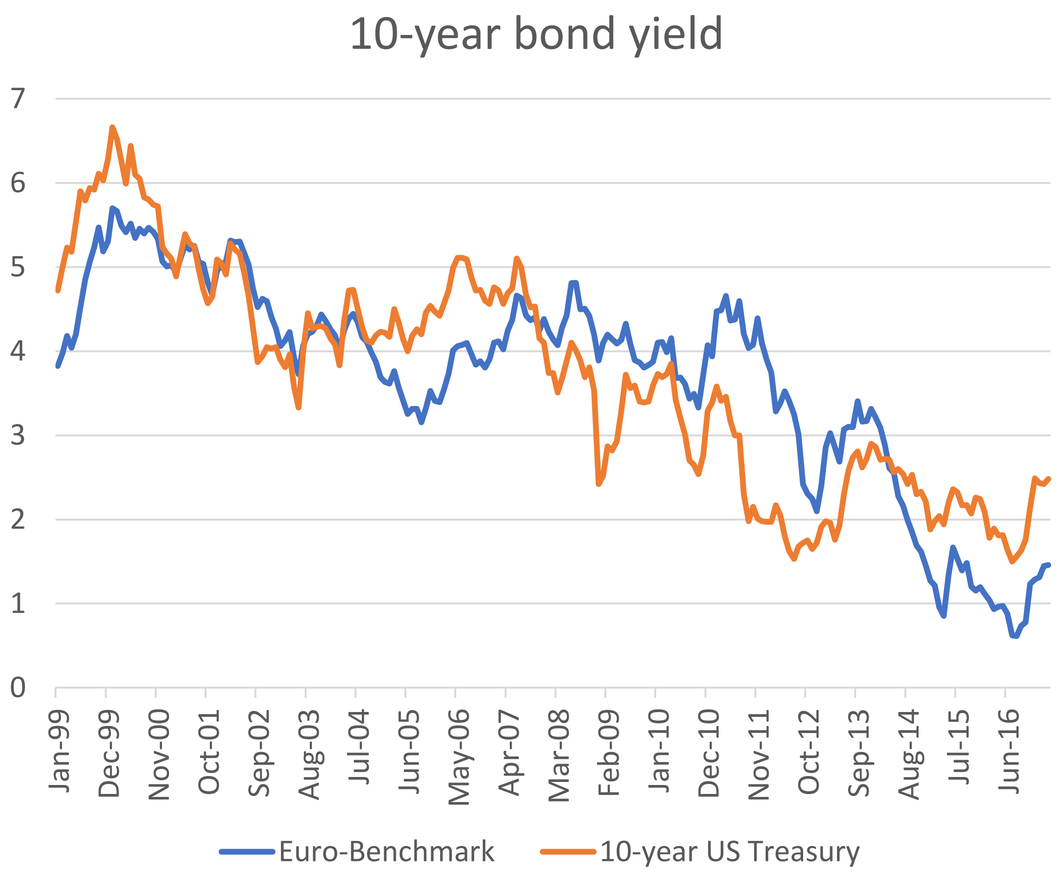
Source: OECD, Economic Outlook Annex Tables

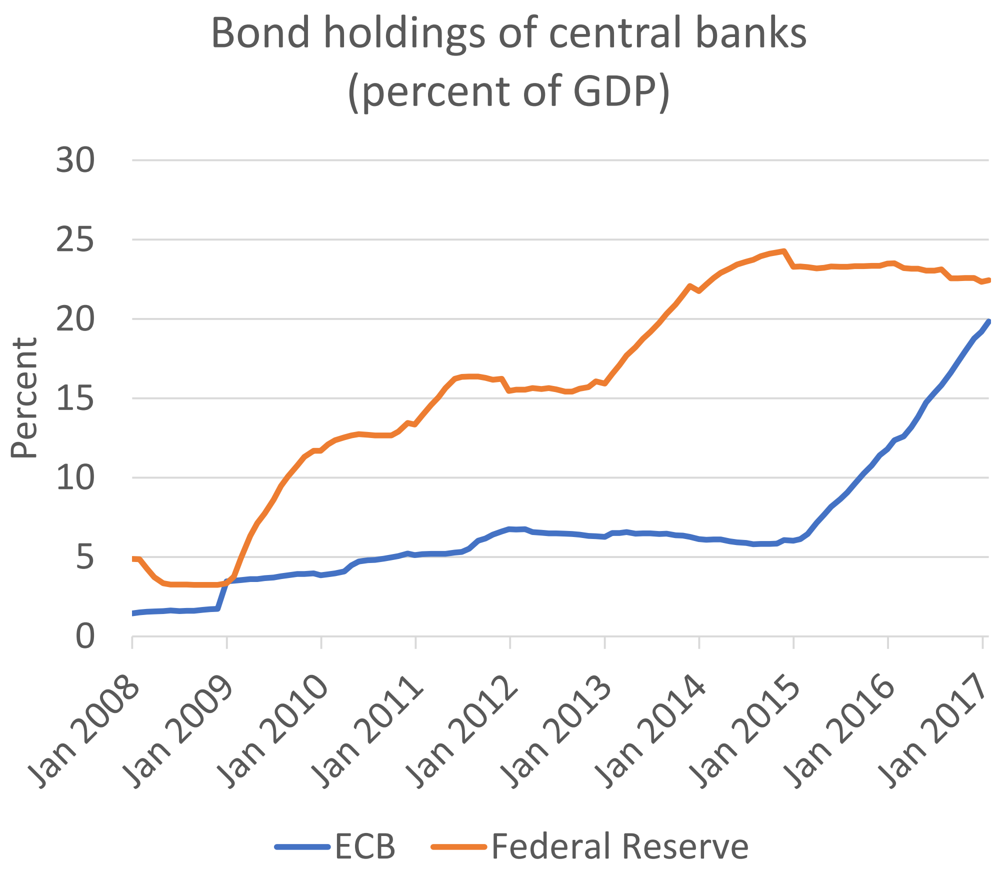
ECB policy rate was too high



Source: FRED, Federal Reserve Bank of St. Louis

Quantitative easing was delayed





Sources: ECB, Federal Reserve Bank of St. Louis, Board of Governors

The Euro Area‘s main problem

Bond-Run: Financial markets in panic

Source: Thomson Reuters Datastream

Vicious circle of the problem countries

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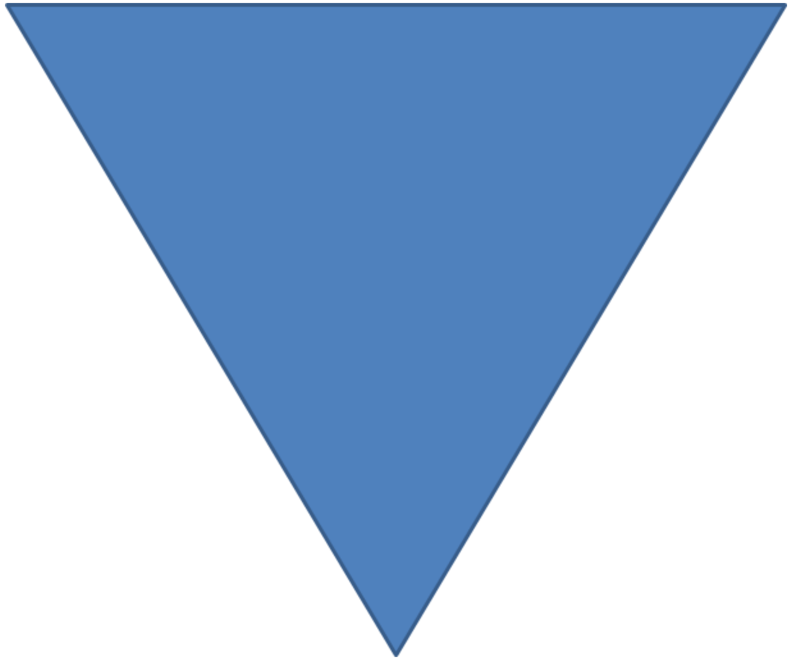
Banking crisis

Government debt crisis



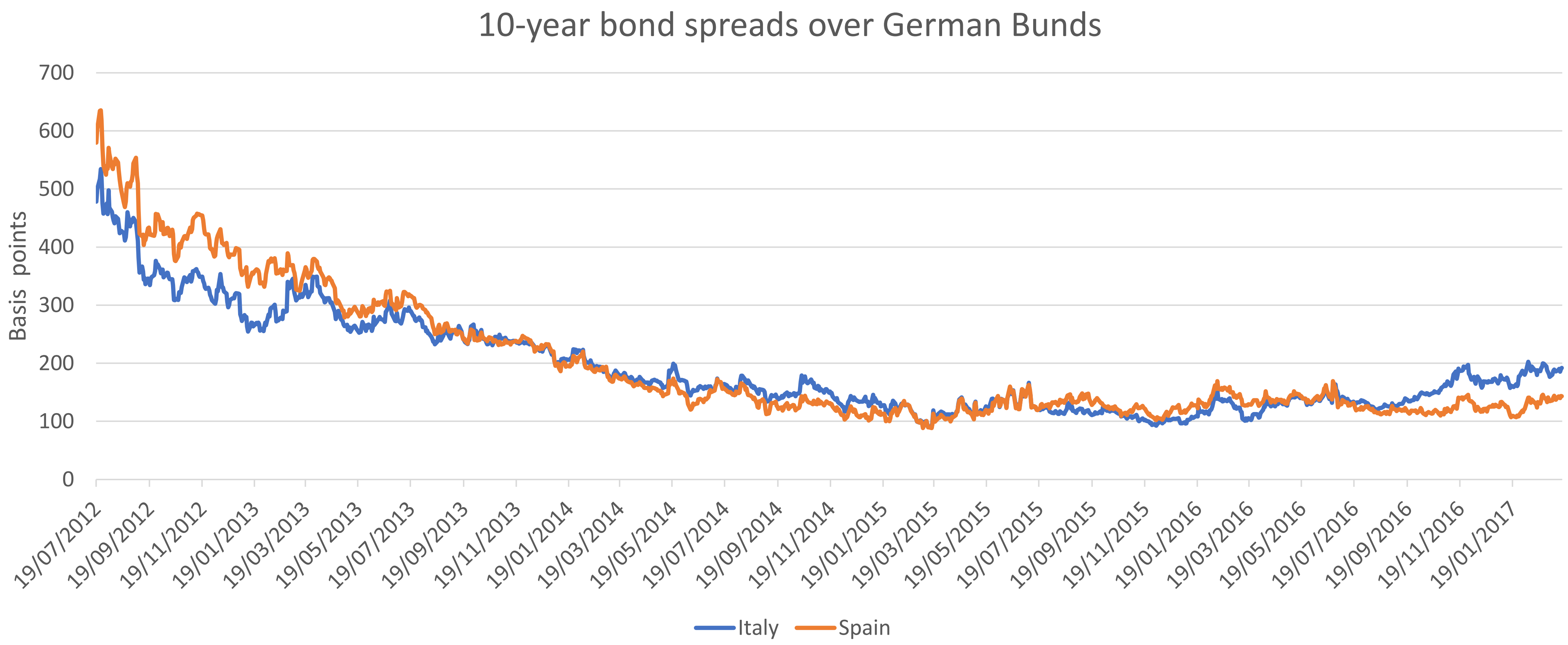
Macroeconomic crisis

II. How the Euro was saved – so far at least

Mario Draghi‘s magic moment

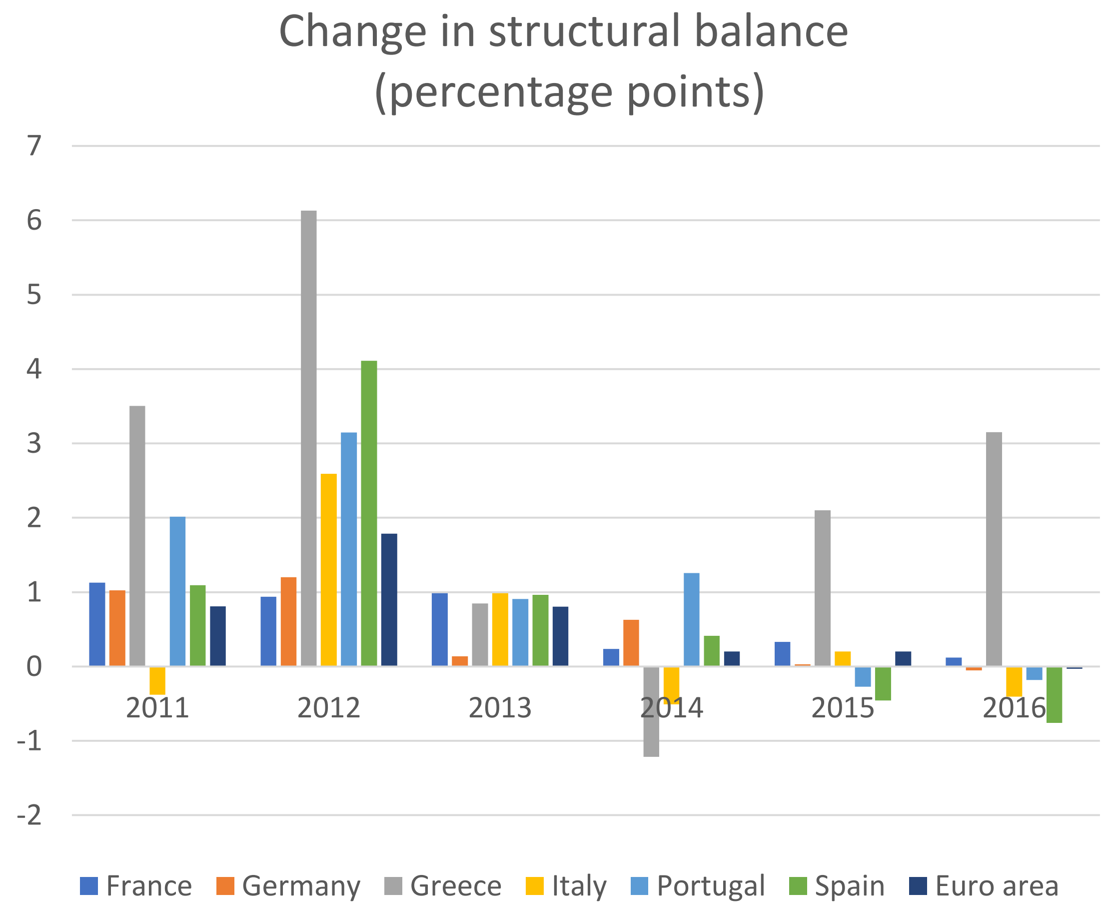
"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

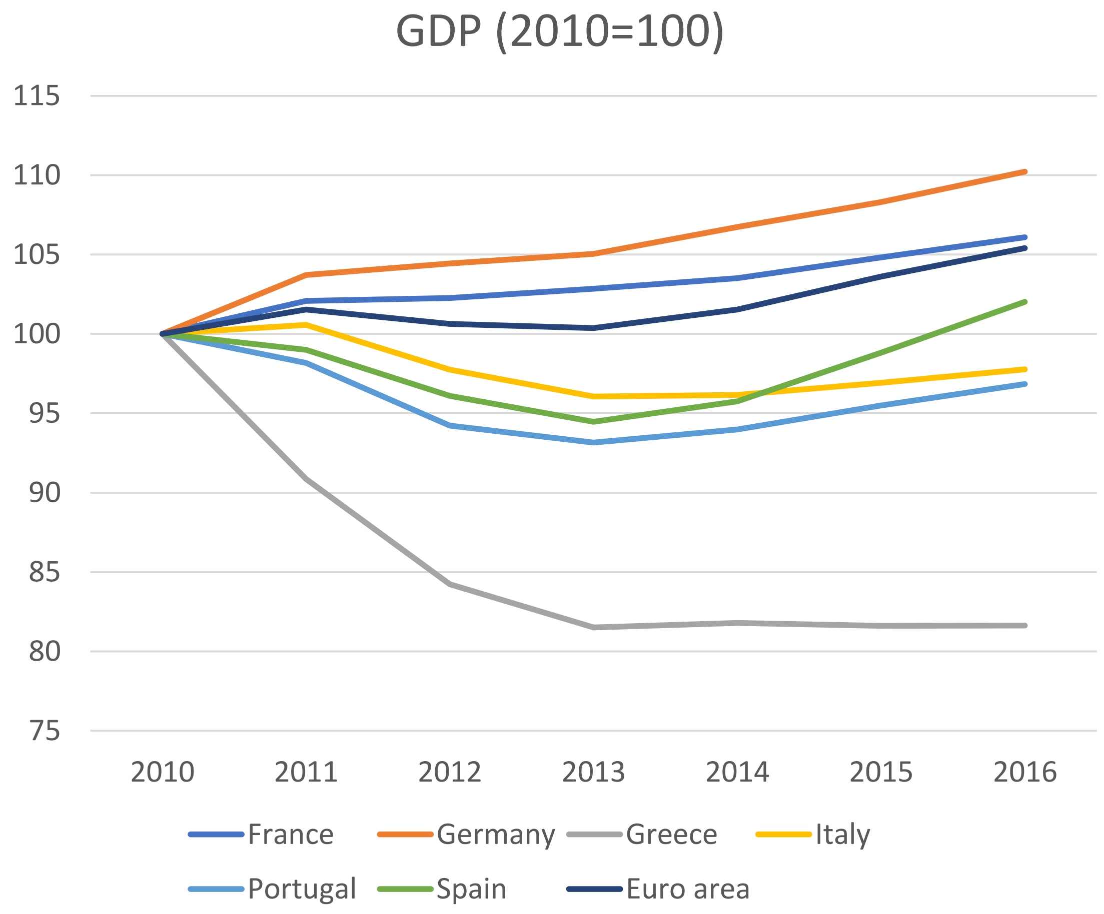
Risk premia declined substantially



Source. Thomson Reuter Datastream

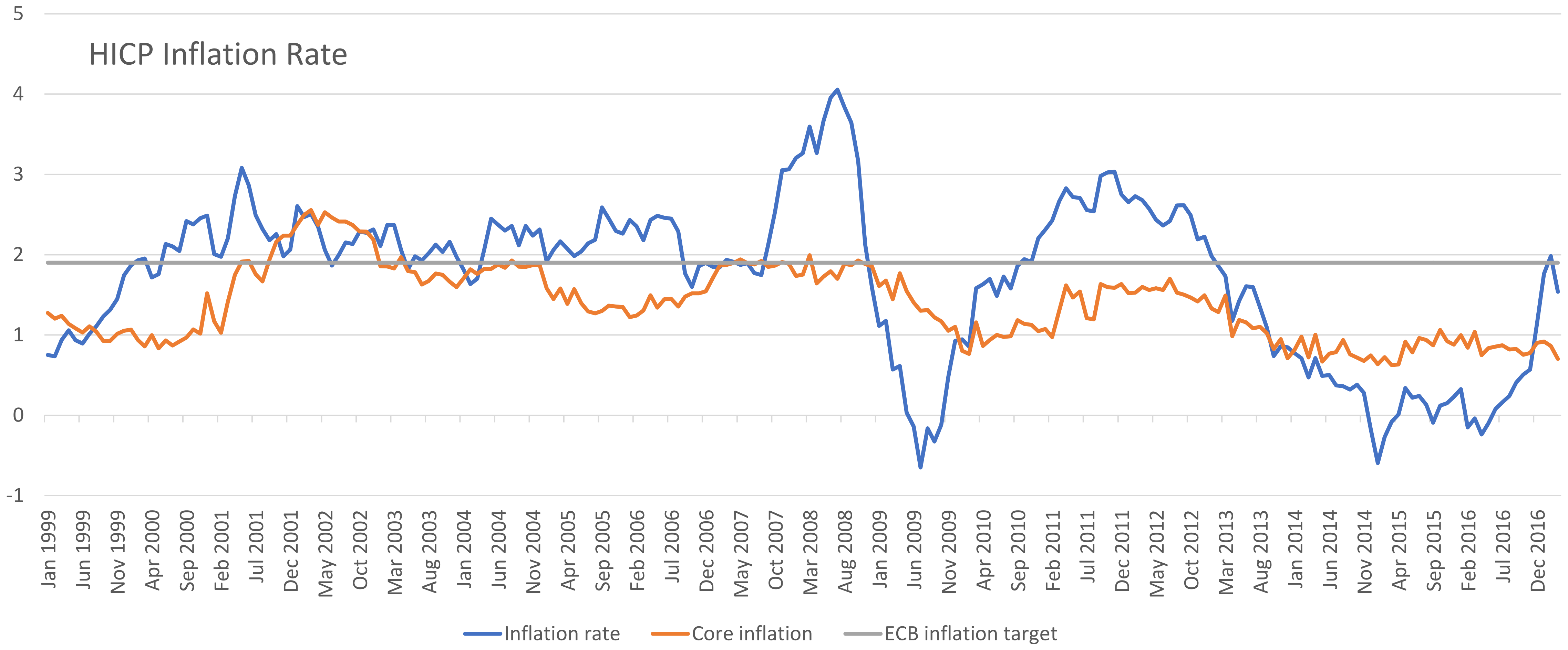
Silent paradigm change in 2014





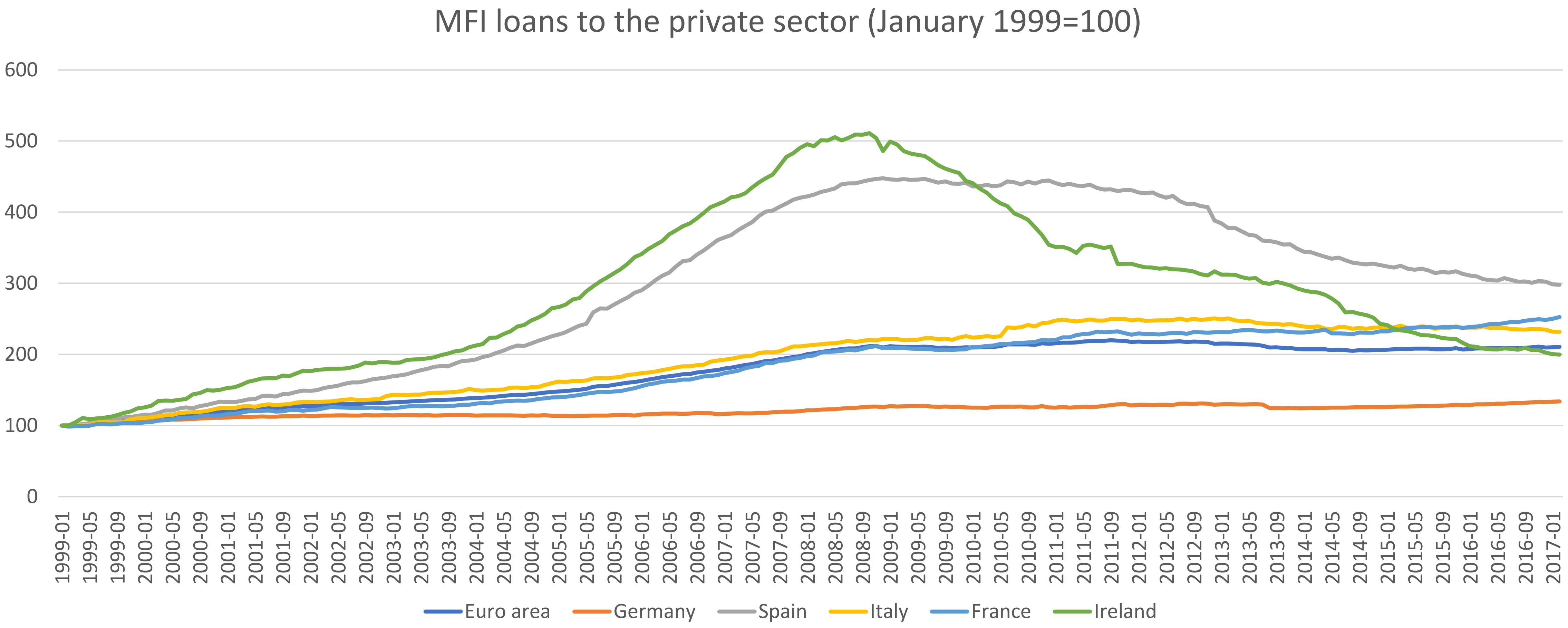
Source: OECD, Economic Outlook, Annex Tables

The risk of deflation in the euro area



Source: ECB

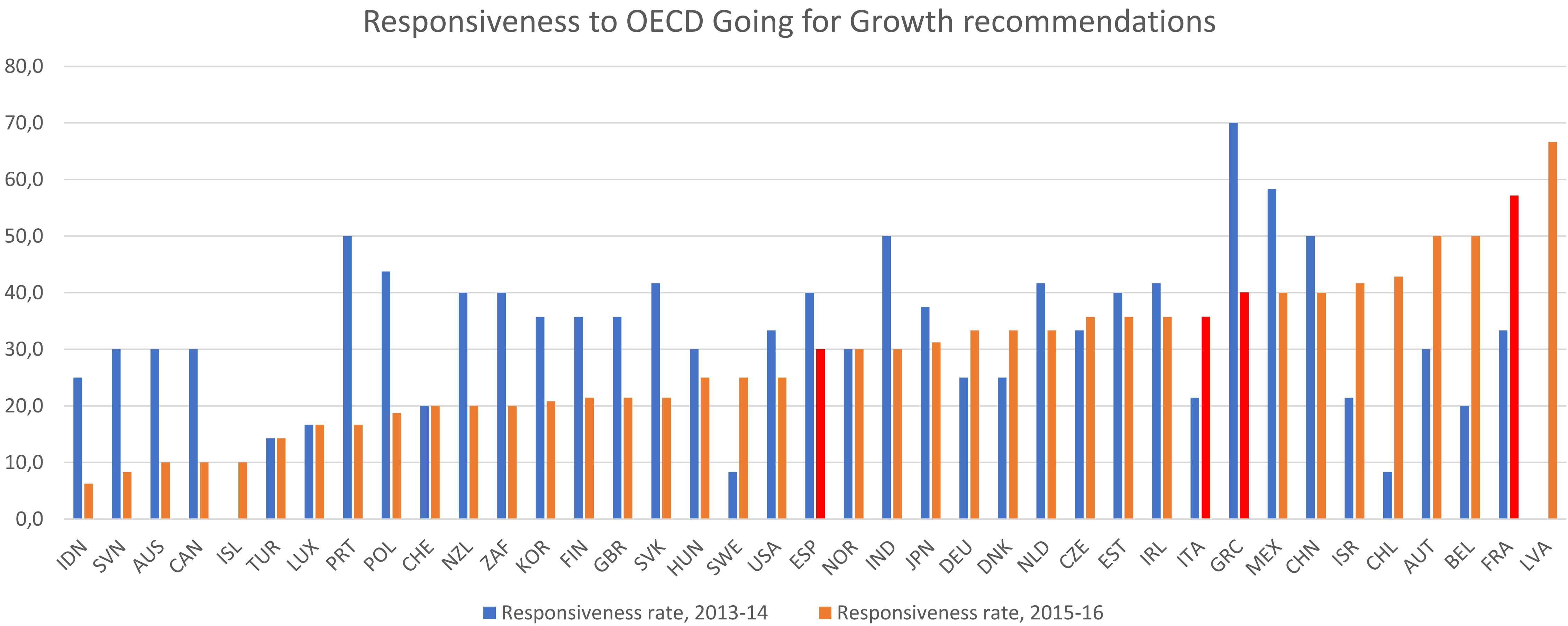
No indications of a new financial bubble in the EZ



Source: ECB

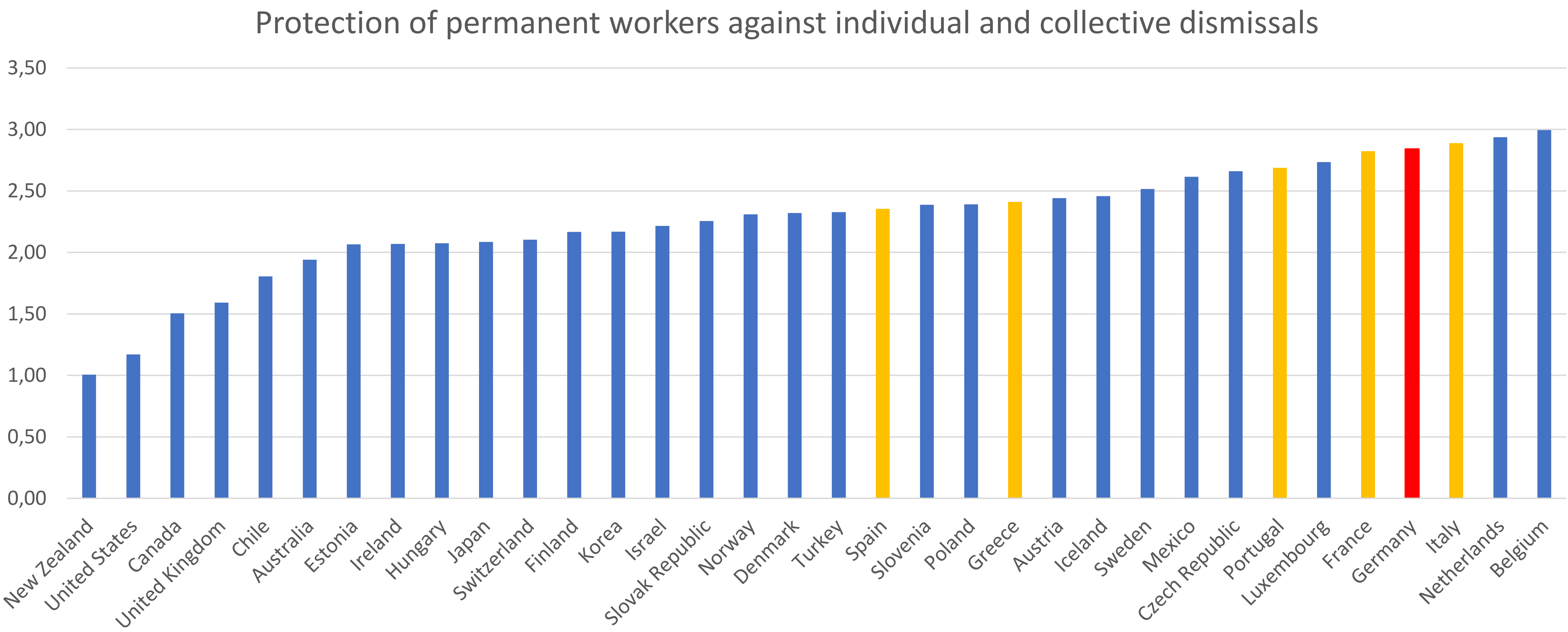
III. How effective are reforms?

Responsiveness to reforms is not so bad



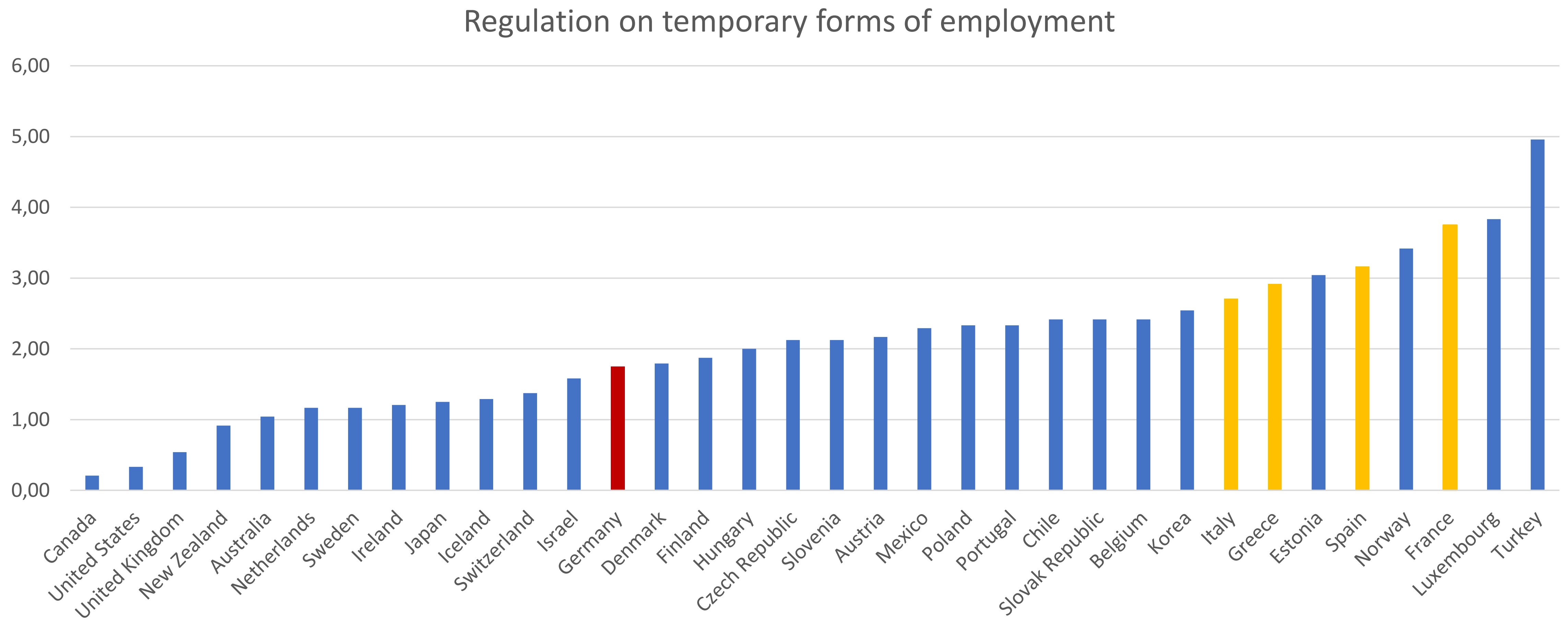
Source: OECD Going for Growth

Employment protection legislation I



Source: OECD

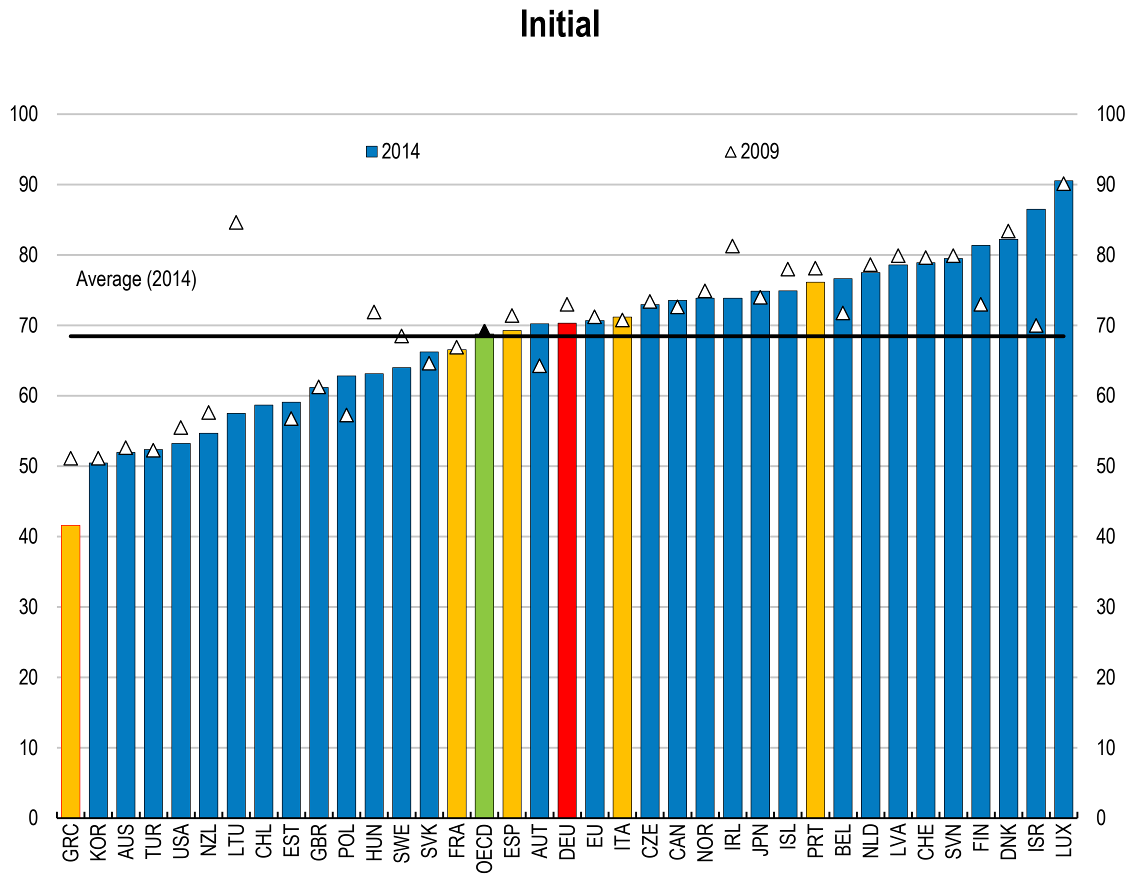
Employment protection legislation II

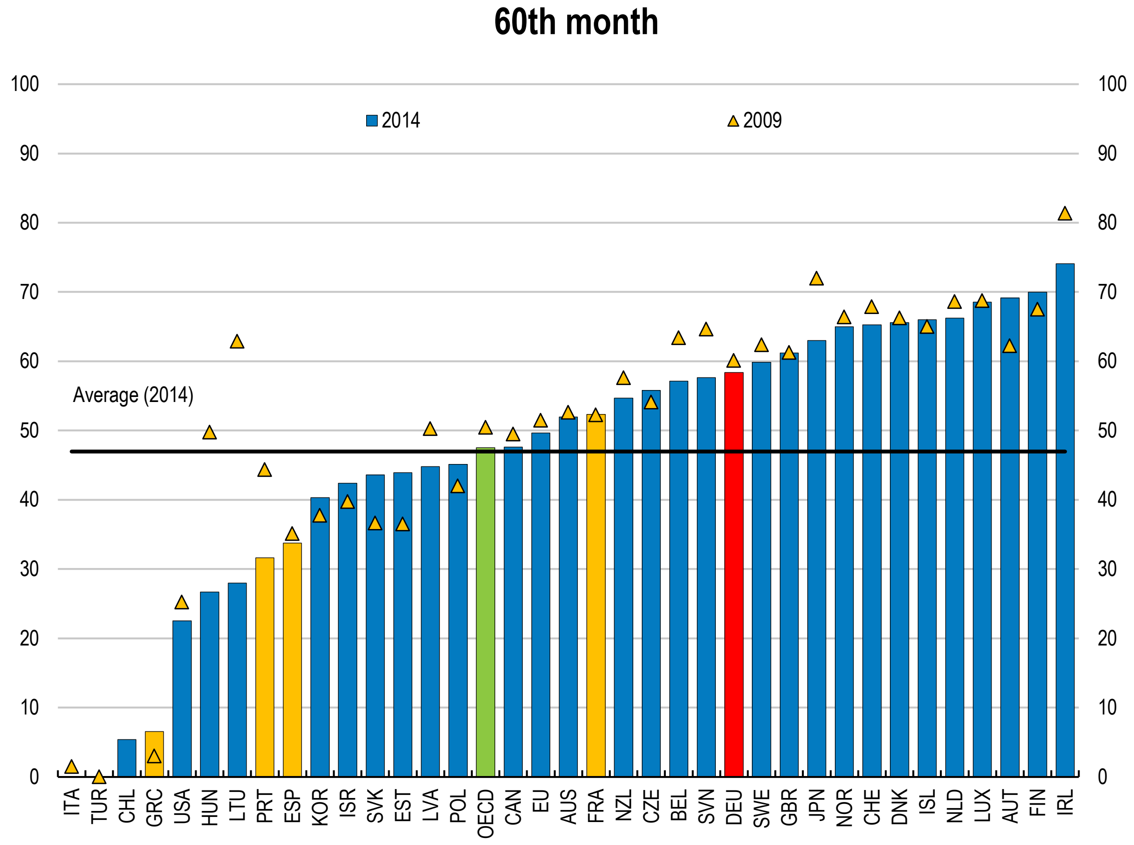


Source: OECD

Are Hartz IV reforms a model for other countries?

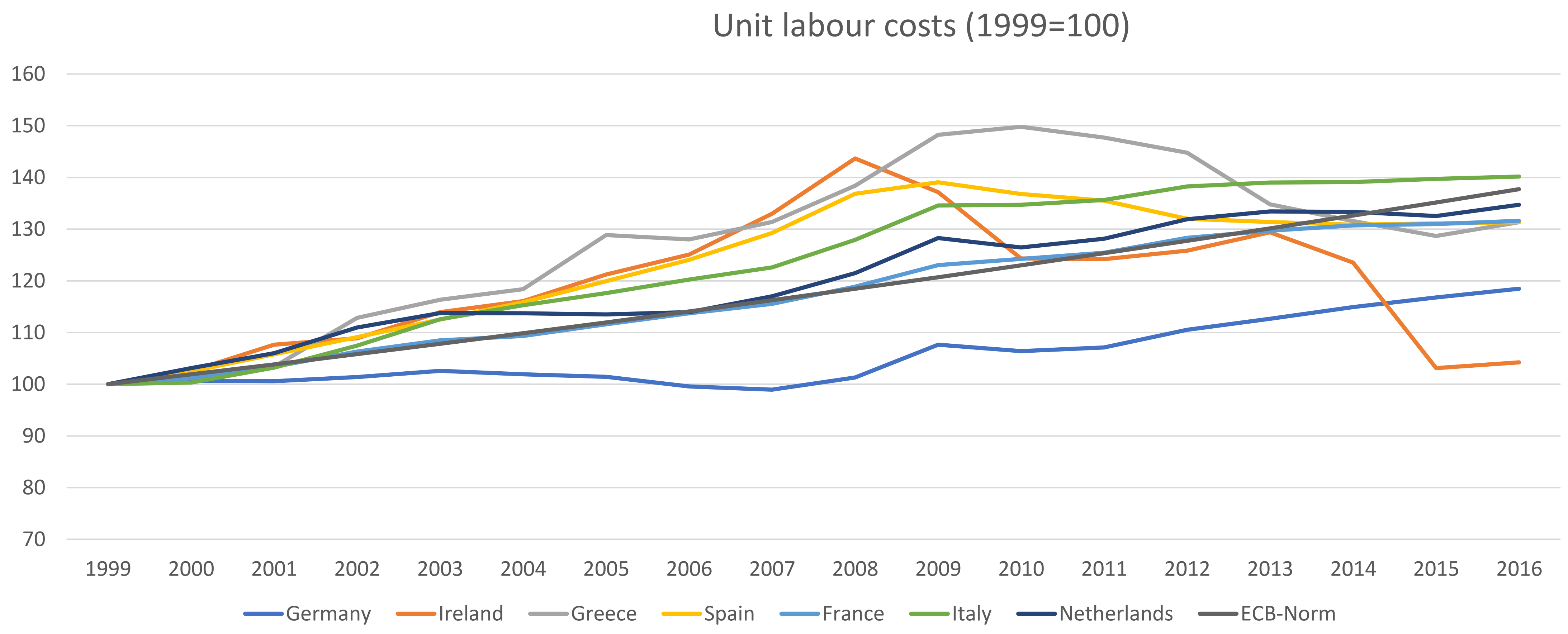
Net income replacement rates for unemployment (percent)





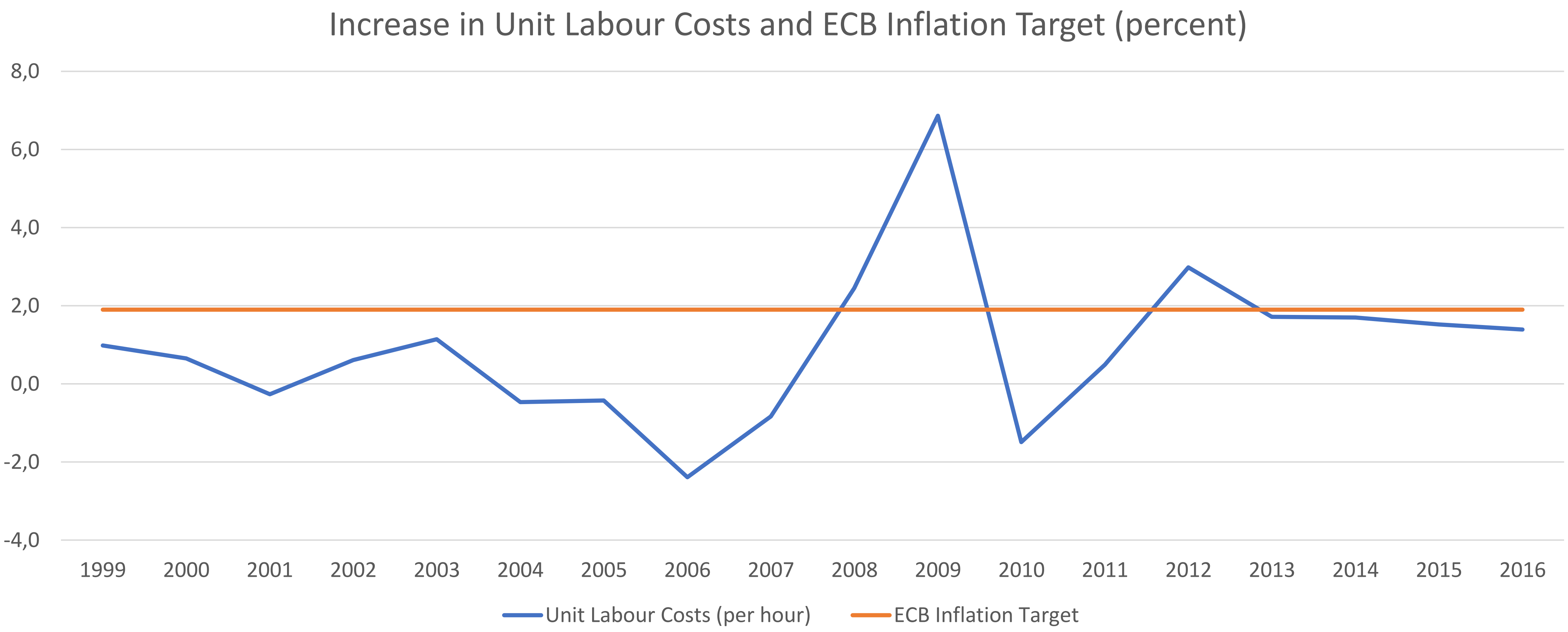
Source: OECD, Going for Growth 2017

Wage moderation for all?



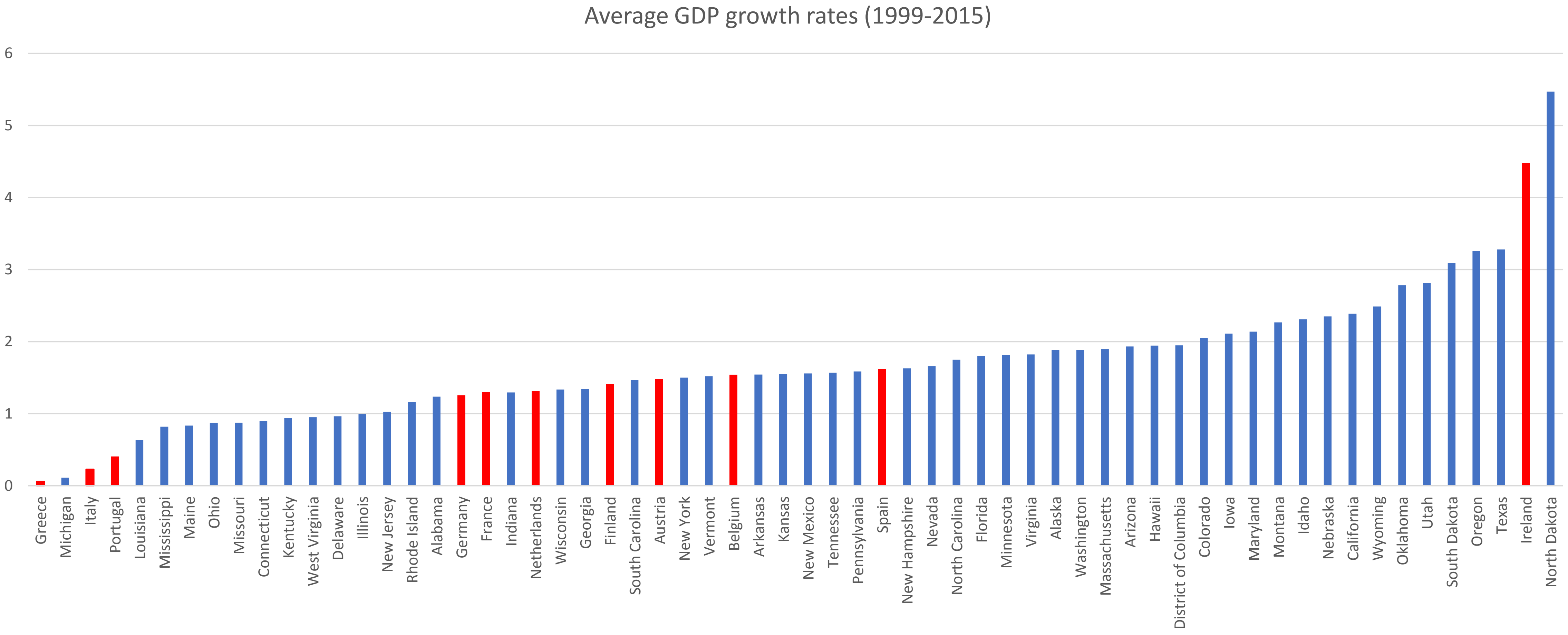
Source: AMECO Database

German wage increases are still too low



Source: Destatis

Does Michigan need structural reforms?



Source: Ameco and Bureau of Economic Analysis

IV. The great divide: Maastricht 2.0 versus Euro 2.0

Polar views on the insolvency problem

Maastricht 2.0:

Insolvency risk is a positive feature: necessary for achieving full market discipline

- Strict no-bail out and formal insolvency procedures for sovereigns
- Fiscal competences at the national level

Euro 2.0

Insolvency risk is a negative feature: exposes member states to unpredictable effects of market forces

- Debt mutualisation
- Transfer of fiscal competences to EZ-level (EMF, EFI, European Finance Minister)

Two views on market discipline

Feld et al. (2016, p.55):

“An insolvency mechanism for sovereigns that credibly stipulates a creditor bail-in would not only help with burden sharing (similar to the bail-in rules for the banking sector), but also give creditors incentives to assess the default risks of government bonds and loans accurately and factor them in when calculating risk premiums. This should result in ex -ante disciplining of government budgetary policy and would, thus, support crisis prevention.“

Delors-Report (1989):

“ (...), experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.”

Underlying assumptions of reform proposals

	More political integration is not possible	**More political integration is possible**
Market discipline more effective than political discipline/Markets self-stabilizing	**Maastricht 2.0: Insolvency regime for Euro area** (German Council of Economic Experts majority)	Hybrid forms of Maastricht2.0/Euro 2.0
Political discipline more effective than market discipline/Markets need stabilization by state	**Muddling through** Stabilising the the Status quo which relies on heavy ECB support (QE/OMT)	**Euro 2.0: Some form of debt mutualisation. Transfer of policy competences to the Euro area level**

V. Intermediate solutions

Intermediate solutions

- More effective fiscal policy coordination in the European Semester
- Golden rule for the Stability and Growth Pact
- Debt mutualisation for new debt, related to joint investment projects or for debt raised in exceptional conditions
- EZ unemployment insurance
- EZ budget

Main challenges of the Eurozone

- Insolvency risk
- Insufficient fiscal policy coordination
- Beggar-my-neighbour policies
- Compensation of regions which are negatively affected by trade shocks
- Willingness to reform detrimental political and economic structures

Can the Euro survive?