European integration and the eurozone

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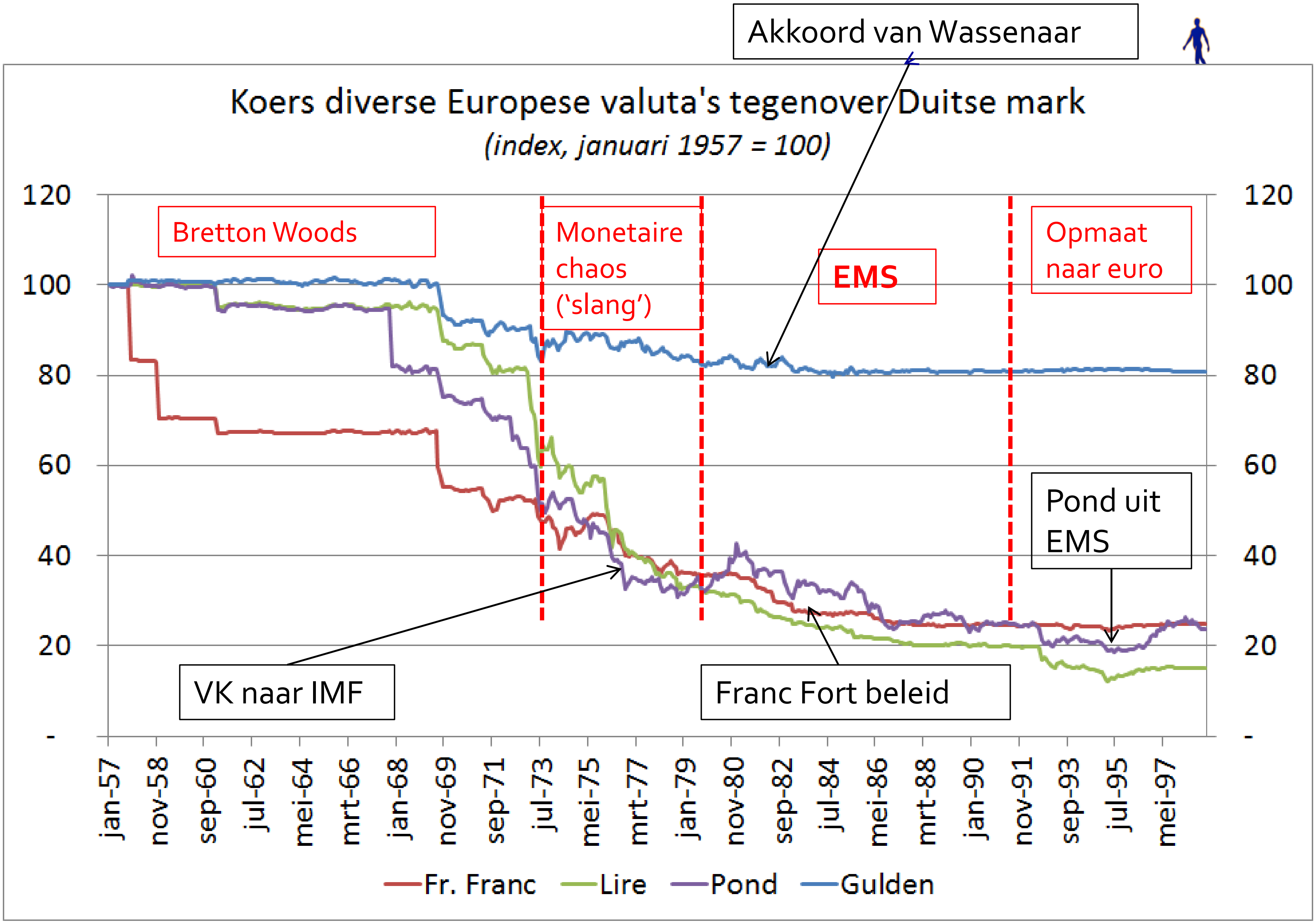
European integration
Why European integration?

- It is not about the single currency
- It is not about the Internal Market or the economy
- The goal of European integration is 100% political: try to keep the peace!

European integration
Why is EMU important?

- Consolidation of internal market
- Size matters in a world of free flowing capital
- Future position of Europe in world economy
- Efficiency gains
- And remember the monetary chaos in the pre-euro era…..
- And remember:
  - Monetary chaos in 1970s and 1980s
  - EMU plans were not new: Werner Plan of 1970


Akkoord van Wassenaar
Koers diverse Europese valuta's tegenover Duitse mark
(index, januari 1957 = 100)
Bretton Woods
Monetaire chaos ('slang')
EMS
Opmaat naar euro
Pond uit EMS
VK naar IMF
Franc Fort beleid
120
100
80
60
40
20
-
jan-57
nov-58
sep-60
jul-62
mei-64
mrt-66
jan-68
nov-69
sep-71
jul-73
mei-75
mrt-77
jan-79
nov-80
sep-82
jul-84
mei-86
mrt-88
jan-90
nov-91
sep-93
jul-95
mei-97
Fr. Franc
Lire
Pond
Gulden

Let's analyse some weaknesses

- European rules were focussing too much on public sector
- Europe started to build houses, but failed to finish them
  - Economic and Monetary Union
  - Schengen
- Countries failed to make cost/benefit analyses of EMU-membership

European integration
EMU ≠ Optimal Currency Area

- OCA: minimal costs of external shocks.
  - What are economic costs and benefits of EMU participation?
  - How is EMU effected by external shocks?

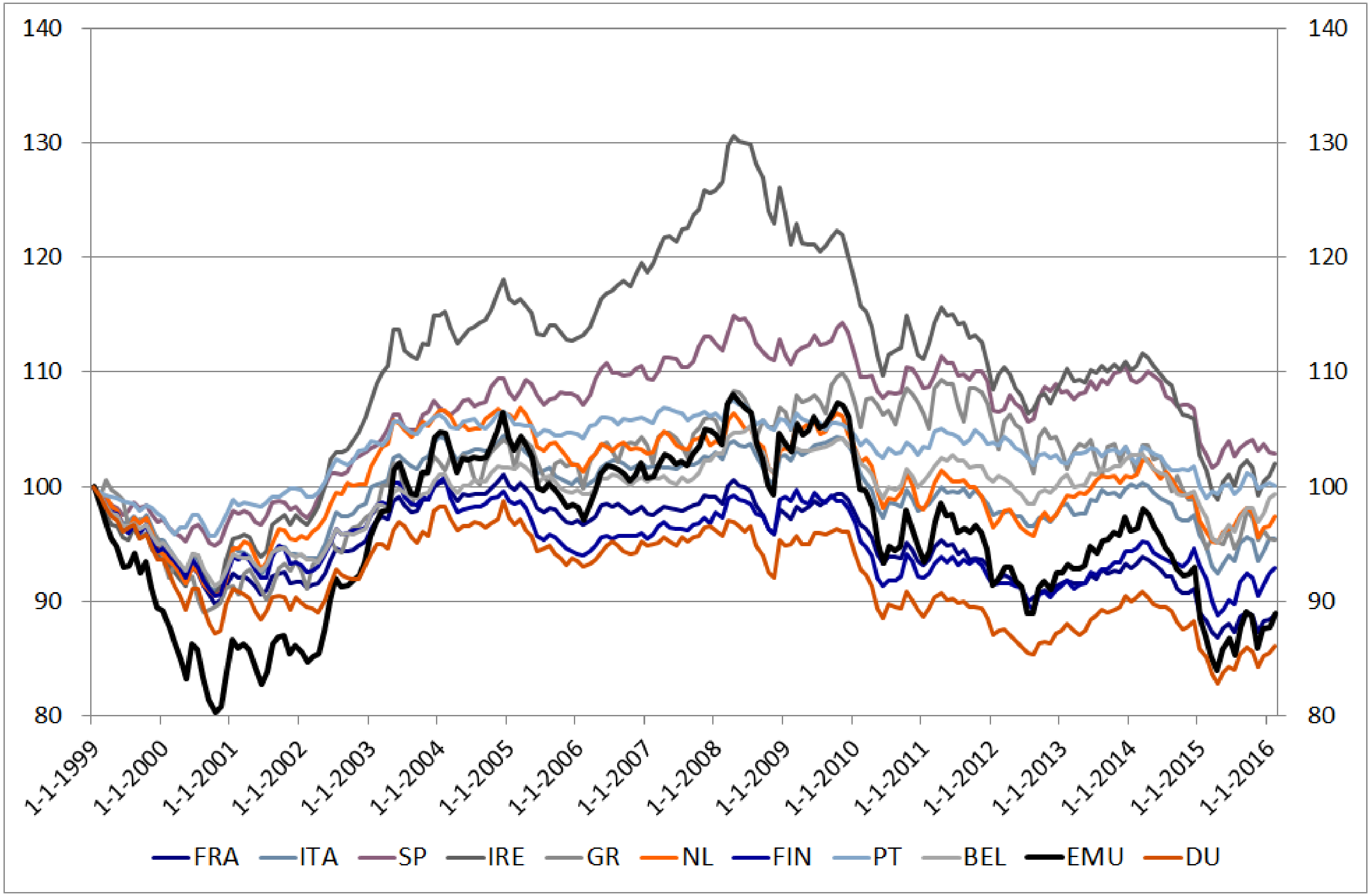
- Relevant factors are:
  - Mobility of production factors
  - Diversity in production structure
  - Federal Budget of sufficient size
  - Integrated financial markets

- Examples:
  - How do individual countries react to a weaker US dollar?
  - Are (fiscal and economic) policies sufficiently harmonized?

European integration
EMU ≠ Optimal Currency Area (2)

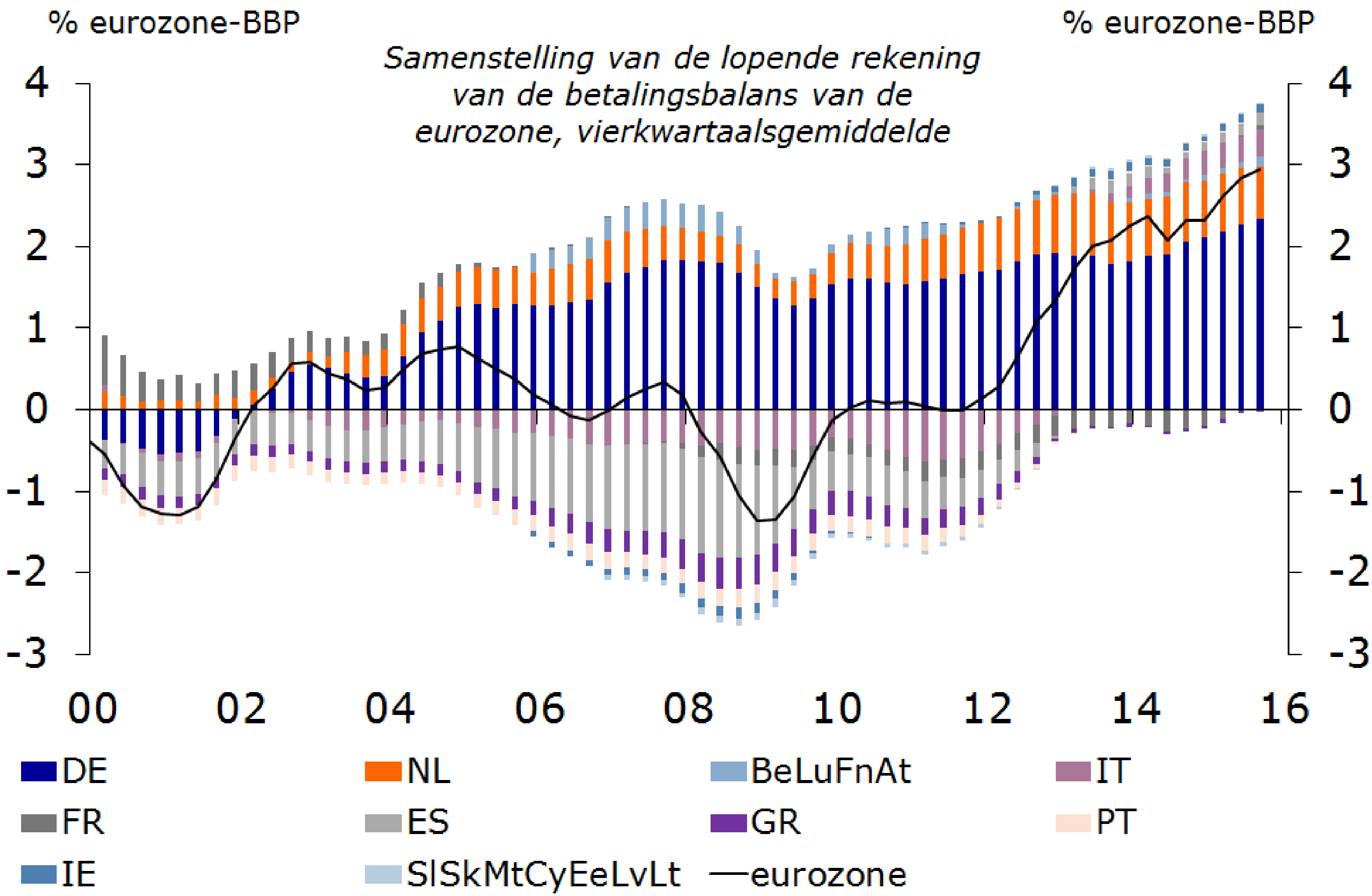
- EMU:
  - Common monetary policy, but no common fiscal policy
  - No federal budget
  - Incomplete and faltering integration of labor markets
  - No eurobonds
  - Halfway house with financial market integration
- EMU: a bunch of countries that share a currency and a central bank
- But hardly a full-fledged monetary union. Still work in progress.

One currency, but multiple effective exchange rates
(REER, Jan 1999 = 100)



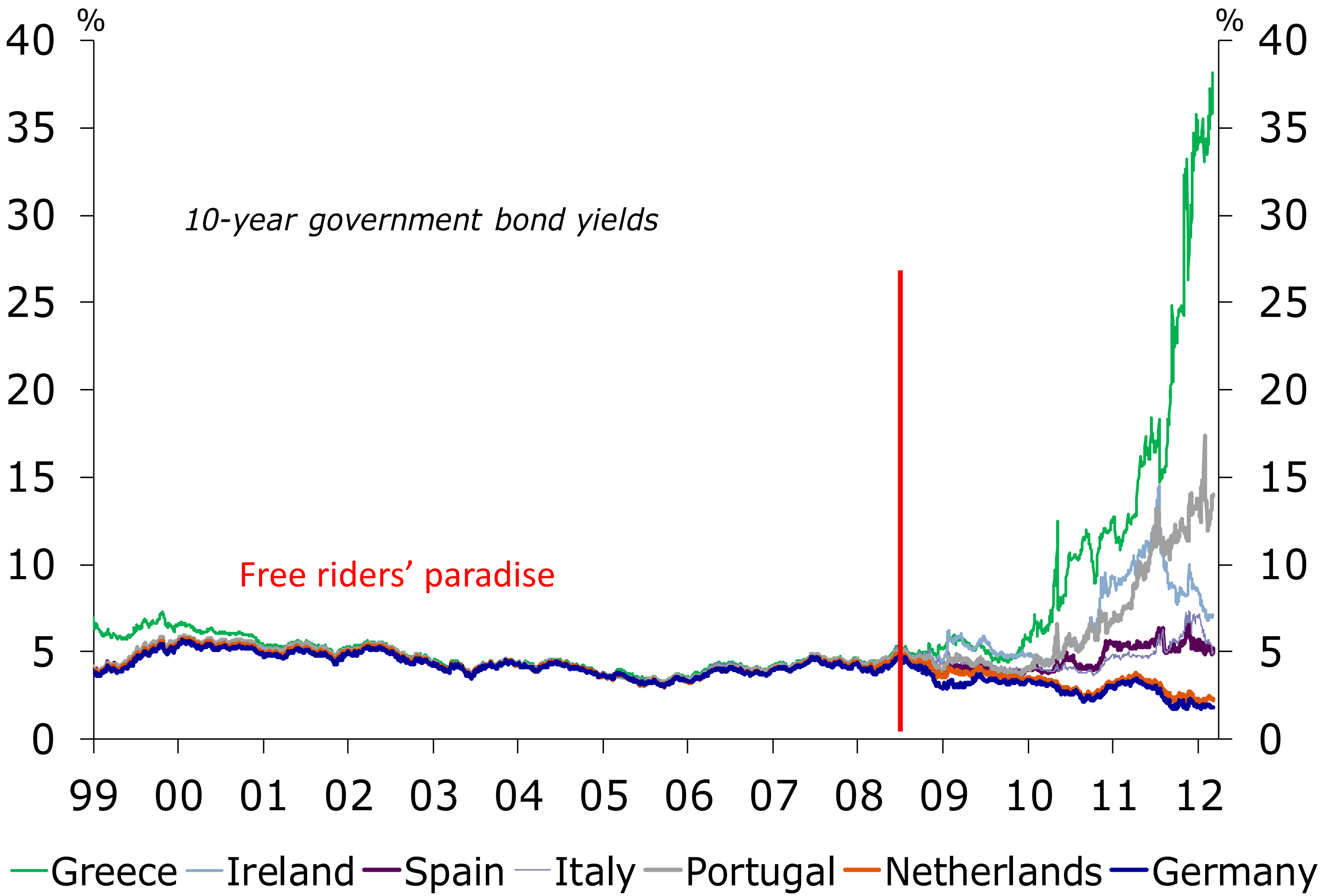
Source: BIS

EMU: current account balance and country distribution



Policy toolkit and crisis fighting

Markets do not discipline policymakers!



Benefits of exit

For a weak country: Currency depreciation easier than internal devaluation. Only works if wages do not rise in tandem.	Monetary policy independence is regained	**For a strong country:** No more tolerating fiscal profligacy of the Southerners and offering loans/guarantees.

General costs of exit

Country cannot leave the eurozone without leaving the EU. Access to EU structural and cohesion funds as well as the Single Market will be lost.

Huge logistical headaches (switching vending machines, invoicing, auditing, etc.).

Containing contagion is extremely difficult and costly.

A significant step backwards on 54 years of European integration.

Costs of exit for a *weak* country

Massive run on the banks. Deposits must be frozen. Banks can be recapitalized by the CB at the risk of higher inflation.

Sudden stop of capital inflows in combination with surge in capital outflows. Capital controls are porous and not highly effective.

Primary budget deficit must be corrected in a short period, further aggravating the situation.

Post-exit interest rates very high once market access is regained. (Exchange rate and inflation risk are added to high default risk).

Asset-liability mismatch will push many companies towards bankruptcy as contracts under int. law cannot be redenominated.

Costs of exit for a ***strong*** country

A massive flight to safety results in strong appreciation of the currency.

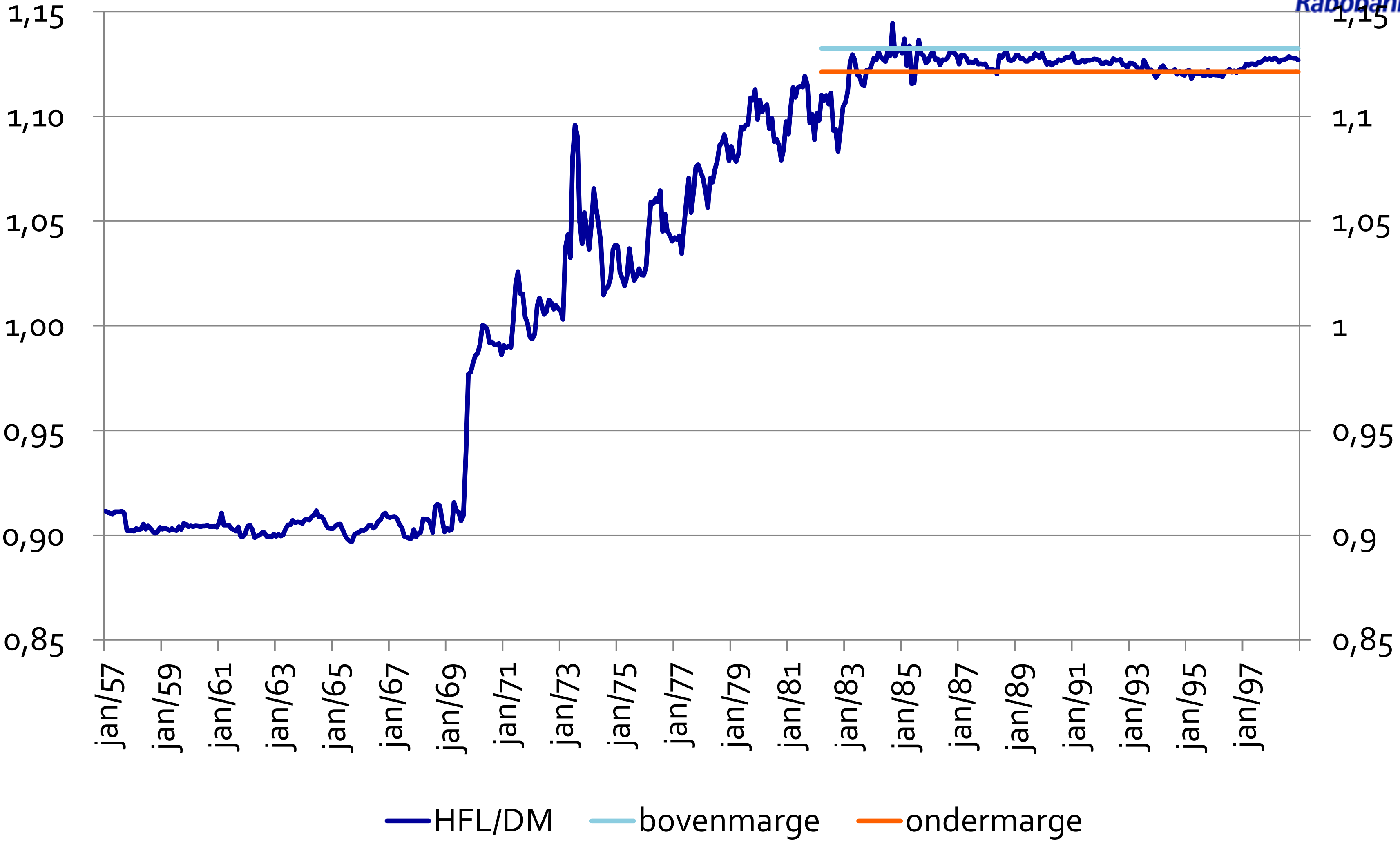
Exporters will suddenly lose their competitiveness edge. The slow adjustment of the economy means growth will suffer.

To restore competitiveness, years of painful wage moderation is on the cards.

Foreign assets and liabilities have to be written down significantly. As a net creditor, the country will stand to lose.

The associated negative wealth effect will act as an extra drag on growth.

The exchange rate of the DM against the Guilder



Dutch style monetary autonomy

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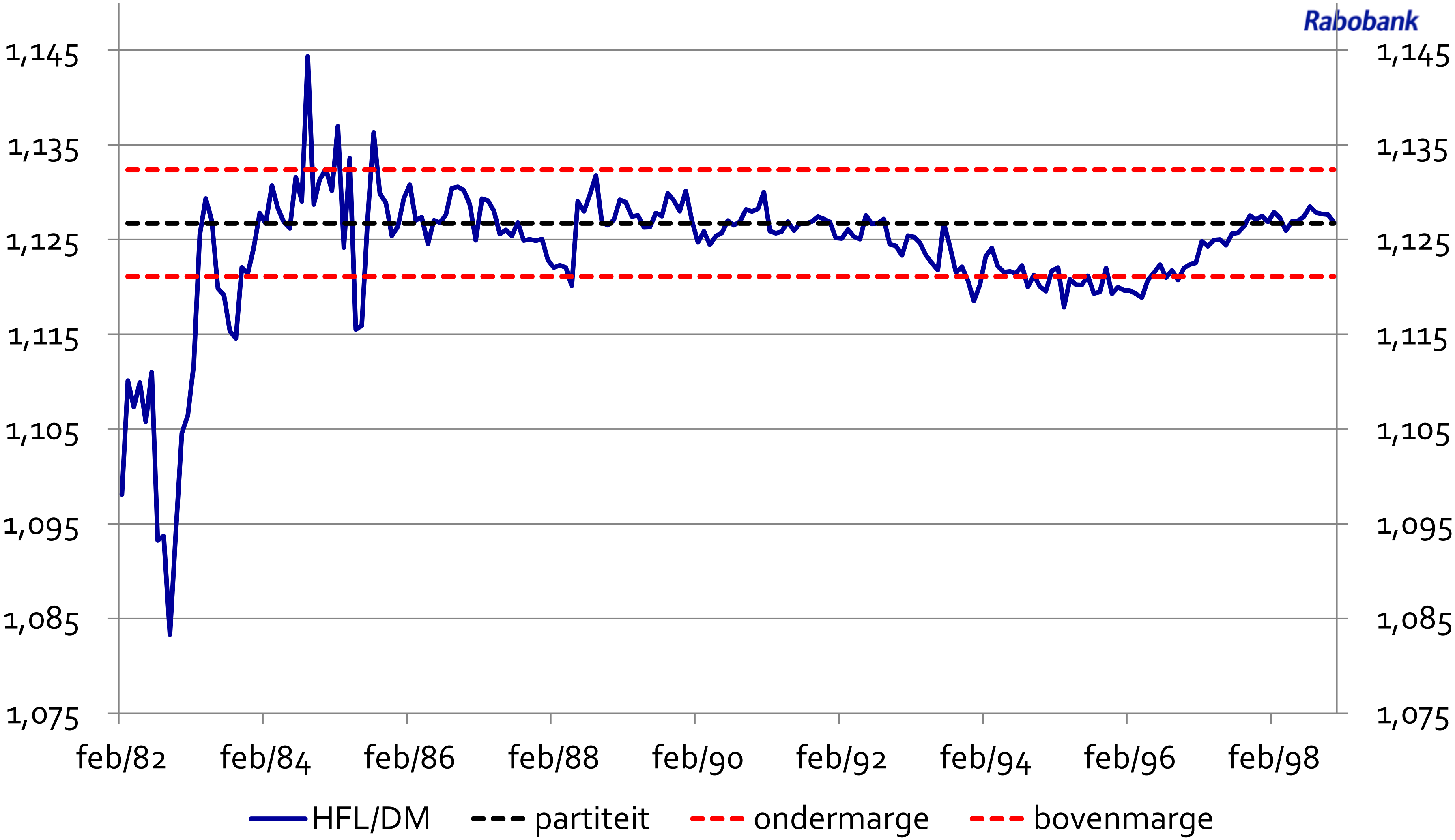

Brexit: negative for everyone

- ***Bad for Europe***
  - Loss of a prominent country with a large economy
  - Loss of a pro free trade partner
  - Loss of face for the EU
  - Loss of a Member State that is able to project power
  - Who’s next? ==> hard negotiations

- ***But even worse for the UK***
  - Exit EU = exit from Europe’s Internal Market
  - Long period of uncertainty: foreign investors will stay at the sideline
  - Many banks and other companies will move to the continent
  - New Scottish referendum: the UK may crumpble

Four possible scenarios for Europe (note: a scenario is NOT a choice menu)

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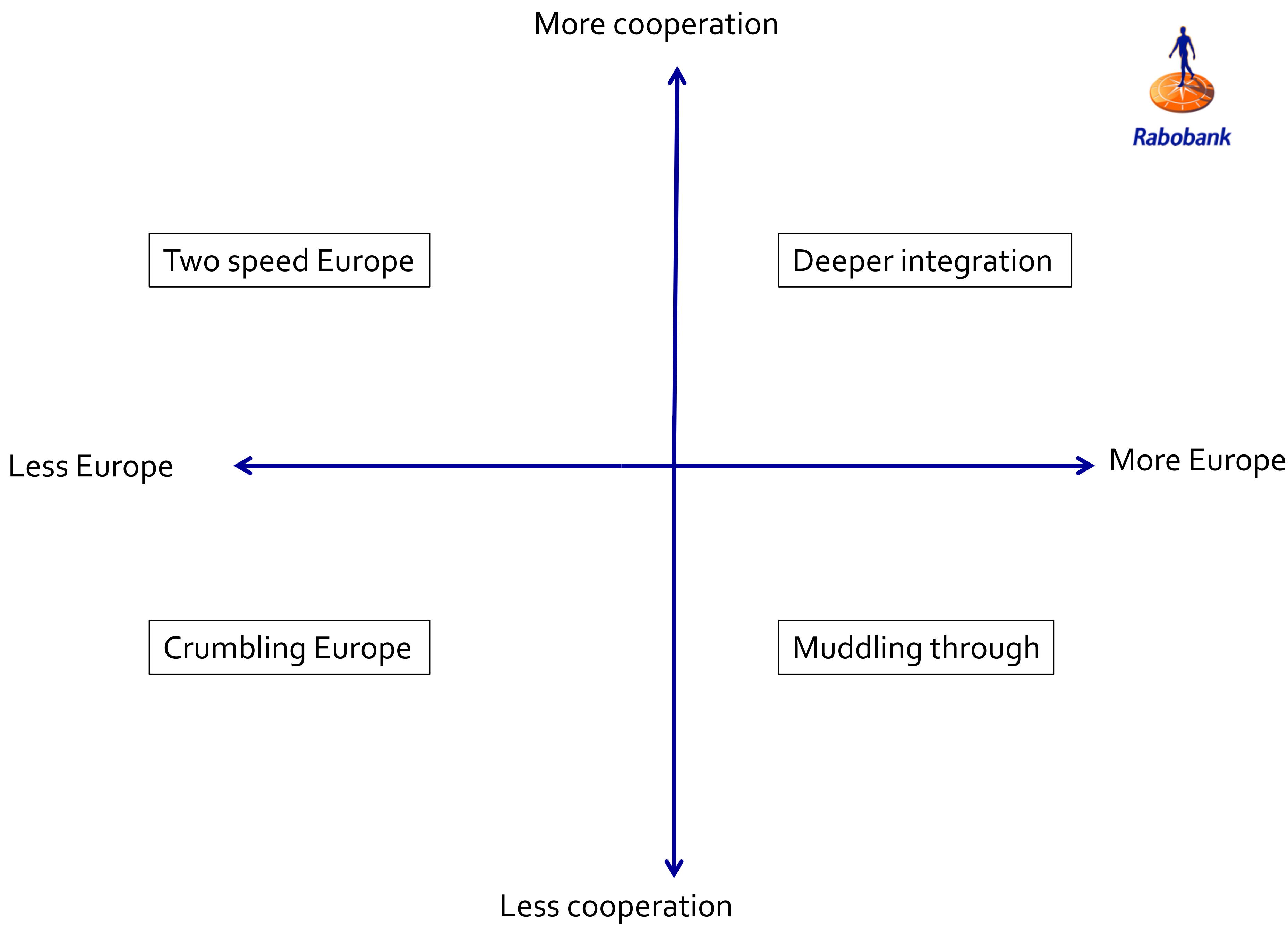
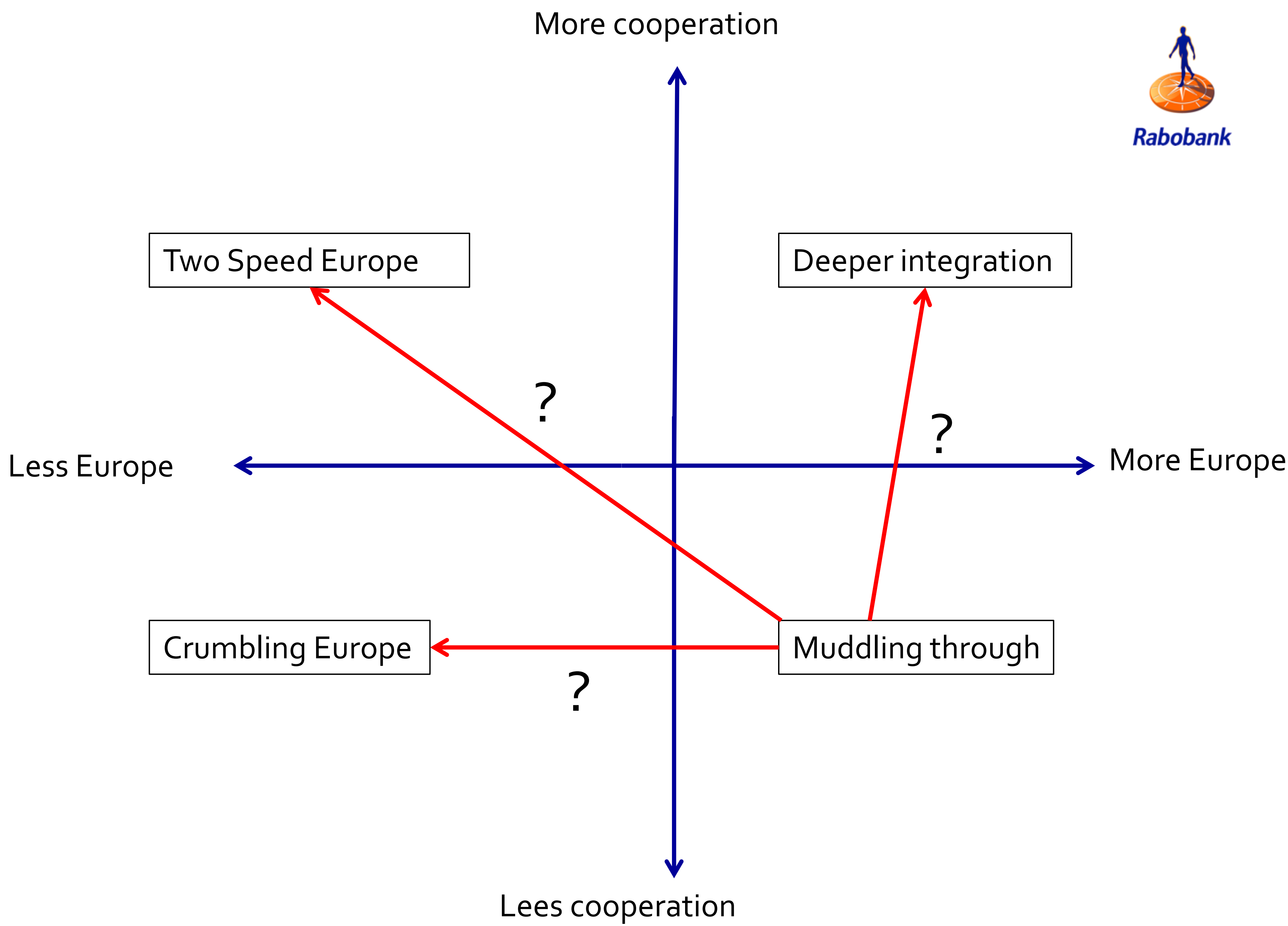
- Muddling through (base line)
  - Approaches its expiry date

- More Europe: deeper integration
  - Deepening of cooperation, better functiong EMU
  - Higher growth, more jobs, but less national autonomy

- Crumbling Europe: EU collapses
  - Deflationary shock for NL,recession, bad news for pension funds, negative wealth effects
  - Southern Europe: higher inflation

- Two-speed Europe


More cooperation
Two speed Europe
Deeper integration
Less Europe
More Europe
Crumbling Europe
Muddling through
Less cooperation


More cooperation
Two Speed Europe
Deeper integration
?
?
Less Europe
More Europe
Crumbling Europe
Muddling through
?
Lees cooperation

Muddling through

- The EU and the eurozone continue to exist, but cooperation between Member States becomes increasingly difficult
- Problems are repeatedly addressed with half measures, creating new unrest and crises, and popular dissatisfaction continues to grow
- Economic growth remains limited and unemployment declines at a slow rate
- Over the long term, this scenario is not sustainable and will ultimately lead to a different scenario: Further Integration, Disintegration or Two-Speed

Further integration (i.e. ‘more Europe’)

- More cooperation between the Member States improves and European integration progresses in important areas
- Problems occurring are effectively and collectively addressed
- Convergence between Member States increases
- Economic growth picks up and unemployment declines sharply
- However: further integration is highly impopular today

European disintegration

- Cooperation between the Member States deteriorates and collective problems cannot be adequately addressed
- Financial chaos as departing countries remain in default on their government debt
- An economic crisis ensues and unemployment rises sharply
- The eurozone disintegrates first, followed by break-up of the EU

Two-speed
(better cooperation but less ‘Europe’)

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- The Member States decide amicably to rebase the eurozone
- Some countries leave in a process controlled by the ECB, but remain in the EU and retain access to the Internal Market
- The remaining countries intensify their cooperation economically, politically and militarily and form a ‘core union’. However, core groups may differ per subject.
- Initially, economic growth slows in the Netherlands and unemployment rises, but ultimately economic growth is higher and unemployment lower than in the muddling through scenario

Whilst each scenario has its costs and benefits, some choices are likely to prove more costly than others

Muddling through	More cooperation	Disintegration	Two-speed
Economic growth remains feeble	Economic growth accelerates	Economic growth falls sharply	Economic growth Gradually accelerates
Unemployment falls slowly	Unemployment falls sharply	Unemployment rises sharply	Unemployment falls over time
Netherlands remain gateway to Europe	Netherlands strengthens role as gateway to Europe	Netherlands loses role as gateway to Europe	Netherlands remain gateway to Europe
Coverage ratio of pension funds remains low	Coverage ratio of pension funds rises significantly	Coverage ratio of pension funds falls	Coverage ratio of pension funds rises slightly
No foreign exchange losses on net external assets	No foreign exchange losses on net external assets	Significant foreign exchange losses on net external assets	Some foreign exchange loss on net external assets

Concluding remarks
Alternative solutions to euro breakup

- Redesign of EMU ➔ remove crowbar for financial markets
- A stronger stability pact
- Introduction of a rescheduling framework
- Growth oriented policies in the surplus countries
- Austerity measures plus structural reform policies in deficit countries
- Effective monetary policy
- Strenghtening of Schengen

Concluding remarks
Will the euro survive?

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- There is no economic rationale for breaking up the euro, although it is also clear that some countries may be better off outside the eurozone
- Much is at stake: an uncontrolled eurozone break-up may herald the end of European cooperation
- Do we need a governance structure that makes a euro exit orderly for both the remaining and the leaving countries? Or should we stick to irreversibility?

A demise of the EU would be bad thing

- European cooperation has been extremely succesfull in keeping the peace and creating prosperity
- The EU as a whole has the largest economy in the world and will continue to be one of the largest in the century to come ==> The EU as a whole is major economic, diplomatic and political force
- The individual economies are relatively rich, but have low growth and are relatively declining ==> a divided Europe will be a backwater and gradually lose political influence
- This is larger than Europe alone, this about the impact of Western values in the world

Thank you for your attention

Any questions?

Read our research on: https://economie.rabobank.com

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