

# Quo vadis, Eurozone?



Oldřich Dědek

Chief coordinator for euro adoption in the CR

March 2011

# Manifold triggers of crisis

- ❖ Lax fiscal discipline
- ❖ Growing imbalances within Euro Area
  - Current account deficits
  - Real estate bubbles
  - Accumulated private external debt
- ❖ External financial turbulences and world-wide economic recession
- ❖ What is the contribution of single currency to the current problems in Eurozone?
  - Logical consequences of flawed project of single European currency?
  - Government and market failures not directly linked to euro?

# Benign neglect of fiscal indiscipline

- ❖ Cynical examples of creative accounting to meet Maastricht deficit requirements
  - France: one-off privatisation revenues from Télécom
  - Italy: refunded eurotax
  - Germany: revaluation of gold reserves
- ❖ Episodes from the history of SGP
  - Ireland: small budget surplus in good times
  - France and Germany: initiation of the reform of SGP to avoid sanctions for excessive deficits
  - Ignorance of excessive debt (approaching the reference value at a satisfactory pace)
- ❖ Eurostat
  - Rejection of the EC proposal to conduct on-site inspections in case of suspicious reporting

# Building up of Greek debt

Criticism of euro: No threat of currency crises encourages excessive indebtedness

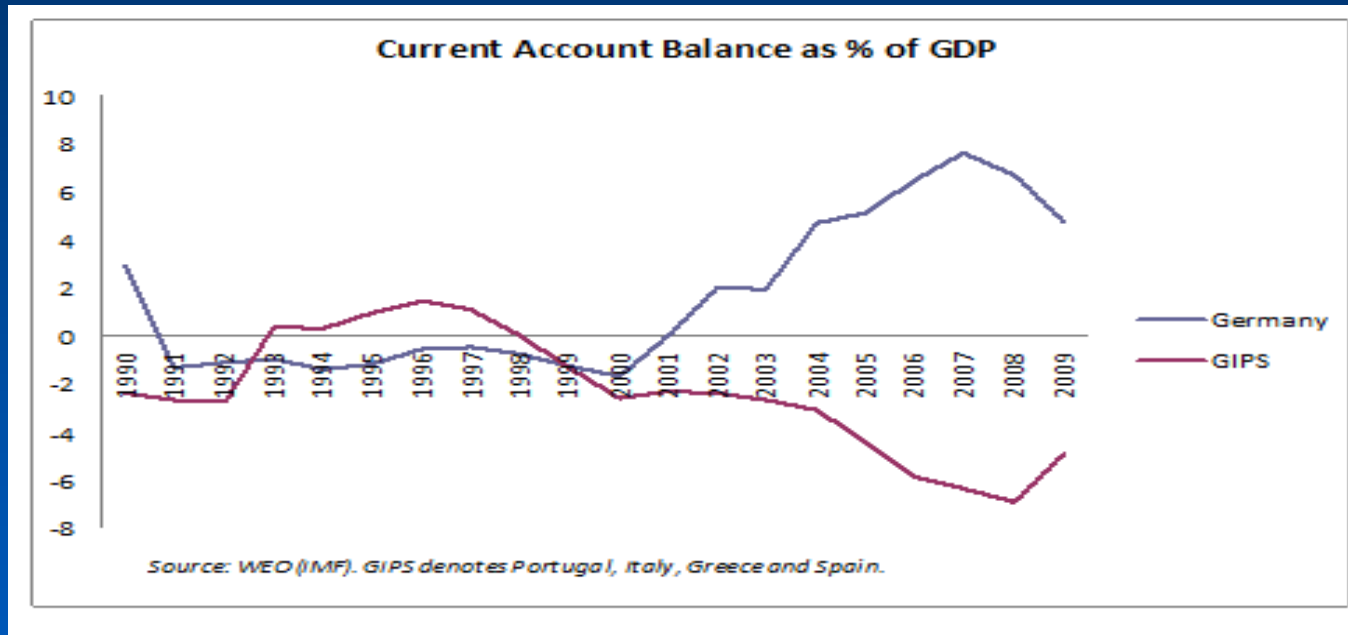
1970	1980	1990	1993	1995	2000	2005	2007	2009	2010
17.7	22.3	71.0	98.3	97.0	103.7	100.3	105.0	126.8	140.2

Economic Commission: General government consolidated debt (excessive deficit procedure)

- ❖ Sharp increase of debt occurred much earlier prior to entry into the Eurozone
- ❖ Crisis revealed long-term structural deficiencies and is enforcing corrective actions
- ❖ Back to fragmentation of European financial markets?

# Current account imbalances

Criticism of euro: Single currency precludes adjustment through exchange rate changes



Gros D.: The long shadow of the fall of the wall, Vox, June 2010

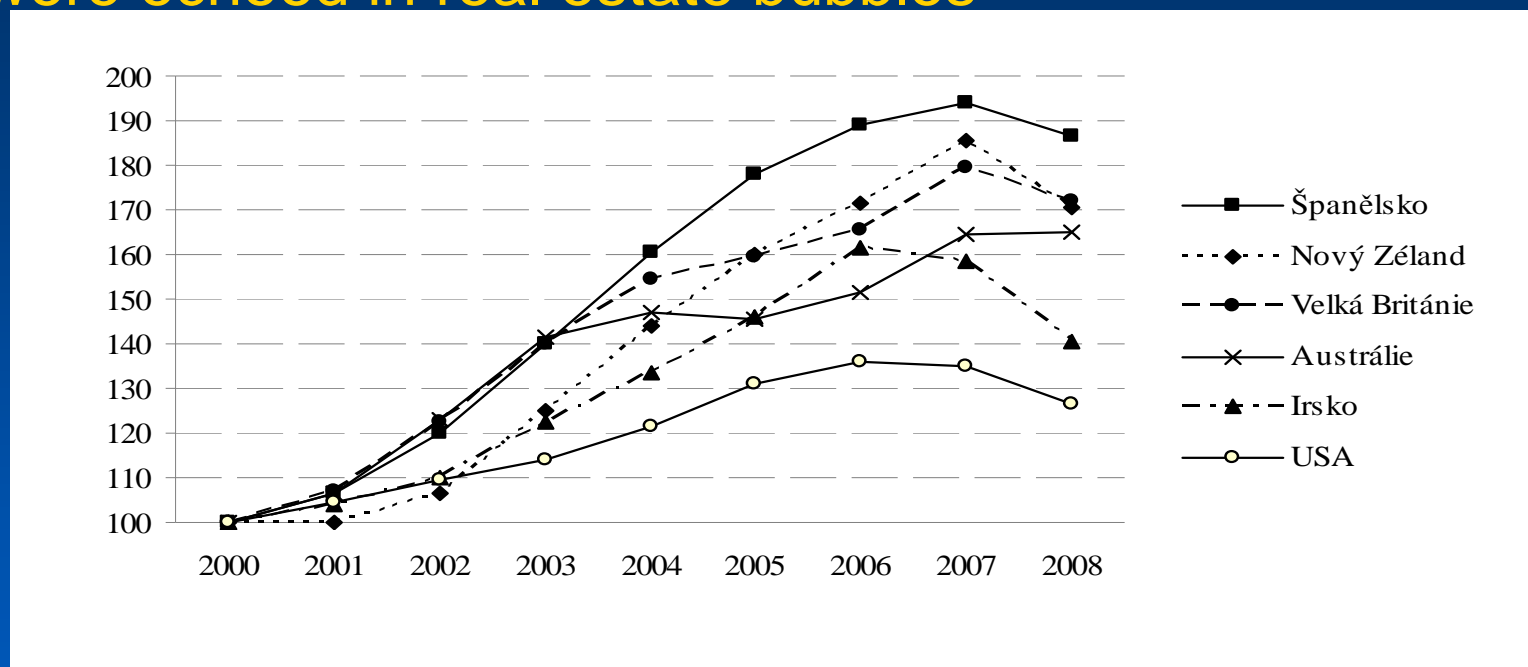
- ❖ Germany: from „sick man of Europe“ to engine of European growth

# Benefits from lost exchange rates

- ❖ **More fair and less distortive competitive environment**
  - Devaluation has equivalent effects to across-the-board export subsidy and import surcharge
  - Discrimination of tradable goods
- ❖ **Devaluations tend to weaken the pressure on restructuring inefficient production**
- ❖ **Overshooting and herd behaviour of floating exchange rates**
  - Floating rates never seen as viable option for single market
  - Fixed but adjustable regimes incompatible with free capital mobility (Impossible Trinity)
- ❖ **Global recession is a symmetric shock**
  - Absence of uncoordinated monetary easing, competitive devaluations or monetary wars in Euro Area

# Real estate bubbles

Criticism of euro: Excessively weak monetary conditions were echoed in real estate bubbles



Cumulative increase in housing prices (in real term). OECD, Economics: Key tables from OECD.

- ❖ Limited power of monetary policy to address effectively asset bubbles (likely sharp conflicts with other objectives)

# Institutional descendants of crisis

- ❖ **More integrated regulatory framework**
  - European System of Financial Supervisors
- ❖ **Strengthened fiscal surveillance**
  - Amendments to the Stability and Growth Pact
  - Directive on minimum requirements for national fiscal frameworks
- ❖ **Strengthened macroeconomic surveillance**
  - European Systemic Risk Board (ECB)
  - System for prevention and correction of macroeconomic imbalances
- ❖ **European Semester**
- ❖ **Euro bulwark**
  - European Financial Stabilisation Mechanism (60 bil.)
  - European Financial Stability Facility (750 bil.)
  - European Stability Mechanism
- ❖ **Pact for Euro (former Pact for Competitiveness, former Franco-German proposal for economic government)**



# New features in SGP

## ❖ Preventive arm

- Constraint on spending windfall fiscal gains in booms (prudent growth of fiscal expenditures)
- Sanctions for significant deviations from prudent path behaviour
- Numerical benchmark for sufficiently diminishing debt

## ❖ Corrective arm

- Initiation of EDP for non-compliance with the debt benchmark
- Sanctions imposed immediately after Council decision

## ❖ Reverse voting

- Commission proposal for sanction adopted unless the Council rejects it within ten days by qualified majority
- Issue of automaticity of sanctions

## ❖ Czech position

- Costs of pension reforms should be considered for a longer time period for the purpose of calculating excessive deficit
- Reverse voting should be seen as exceptional and strictly limited on SGP decision making

# Macroeconomic surveillance

## ❖ Preventive arm

- Annual review process
- Alert mechanism based on a set of indicators (scoreboard)
- Country specific recommendations to tackle non-severe imbalances

## ❖ Corrective arm

- Excessive imbalance procedure (EIP) in case of severe imbalances (presentation of corrective action plan with deadlines)
- Sanctions in case of repeated failure to correct excessive imbalances

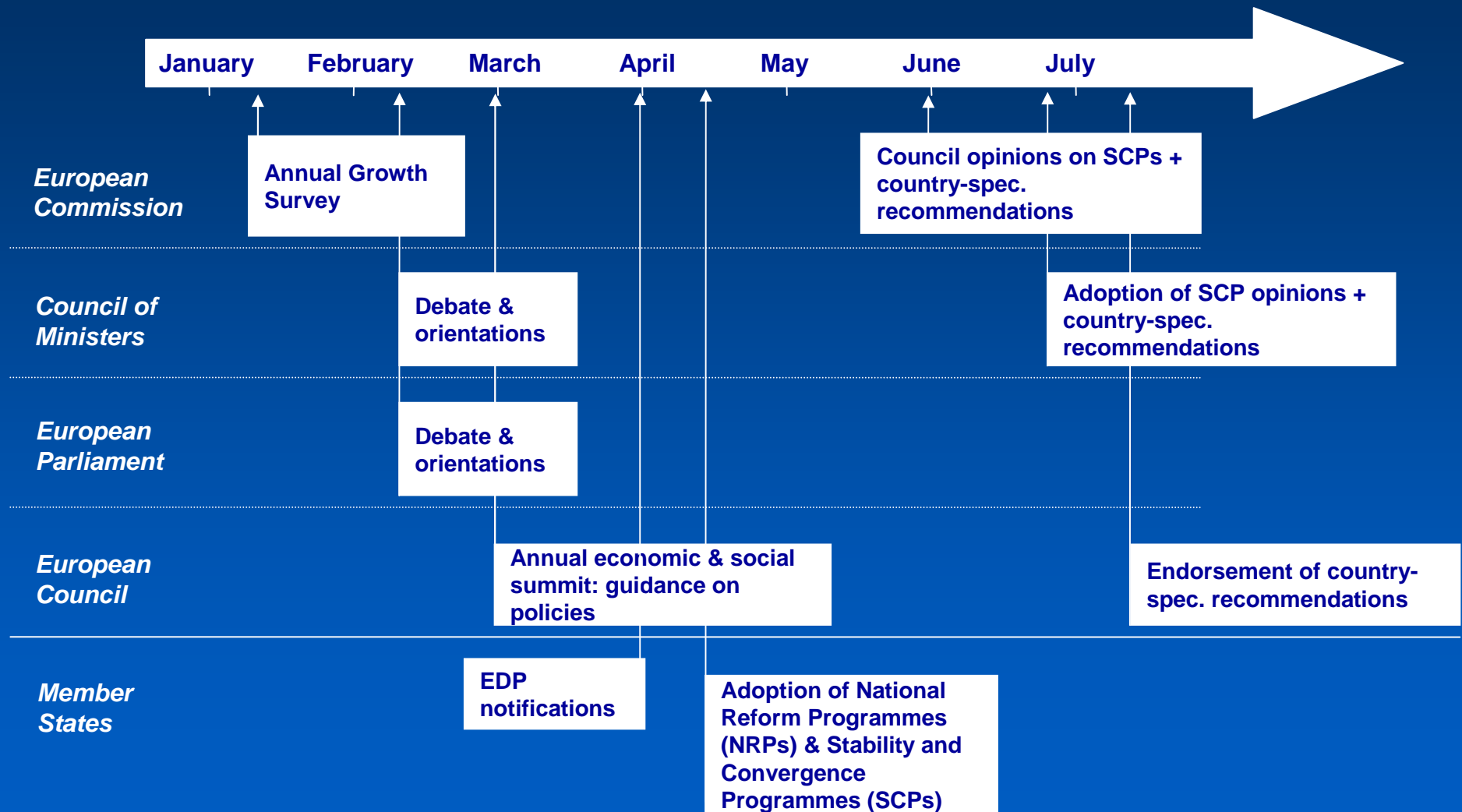
## ❖ Czech position

- Warning against overly simplified assessment of imbalances
- Asymmetrical treatment of current account deficits and surpluses
- Specific features of catching-up economies should be reflected in the scoreboard indicators and their threshold levels

# Pact for Euro

- ❖ **Motto:** Economic stability of Eurozone must be underpinned not only by fiscal prudence but also by structural policies aimed at promoting competitiveness
- ❖ **Method:** Concrete measures incorporated in National Reform Programs and „politically monitored“ by heads of governments on annual basis
- ❖ **Key areas**
  - Fostering competitiveness (wage development in line with productivity, opening sheltered sectors, reducing red tape, improving education, common consolidated corporate tax base, etc.)
  - Fostering employment (promoting flexicurity, shifting taxes from labour to consumption, etc.)
  - Sustainability of public finances (sustainability of pension and social benefits, debt brakes)
  - Financial stability (national legislation for banking resolution)
- ❖ **Czech position:** Supports the concept of the Pact but needs more time for assessing all of its implications

# European Semester



# European Stability Mechanism

- ❖ Activated after June 2013 (taking over the functions of European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM))
- ❖ Financial assistance provided under strict conditionality (stringent programme of economic and fiscal adjustment)
- ❖ Non-euro area Member States may decide to participate on an ad hoc basis in financial assistance operations
- ❖ Agreement reached among ECOFIN members (distribution key, lending capacity, private sector involvement, financial instruments, pricing policy)
- ❖ Czech reservation: ESM membership should not be seen as an automatic precondition for Eurozone membership

# Quo vadis, Eurozone?

- ❖ Impressive political support for single currency across political leaders in Eurozone countries (despite sharp decline in popularity among citizens)
- ❖ Impressive capacity of European political leaders to reach consensus about unpopular measures
- ❖ Wait and see strategy adopted by majority of non-Eurozone countries