

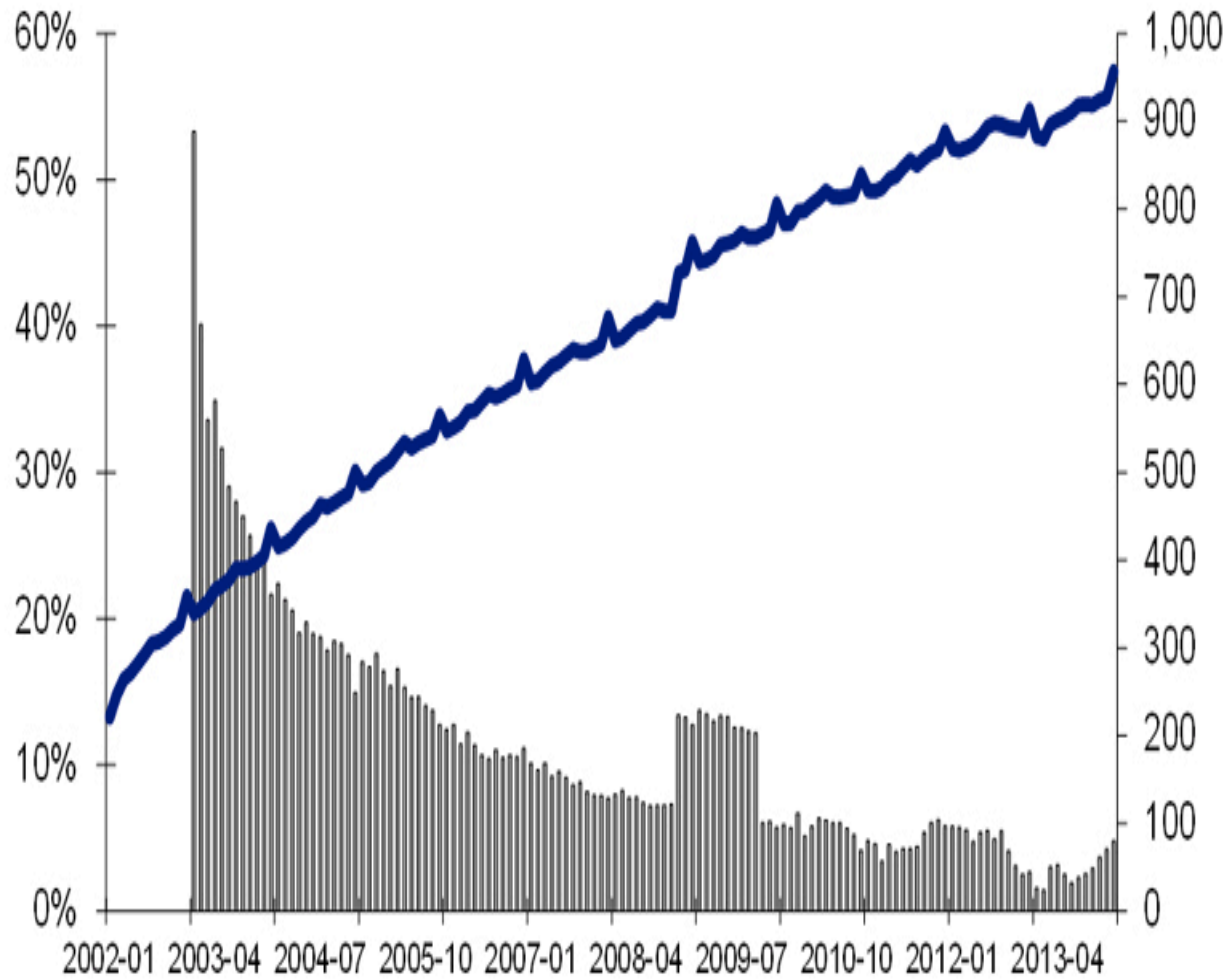
# future of the Euro

may 2015

for ten first years, euro is a big success:

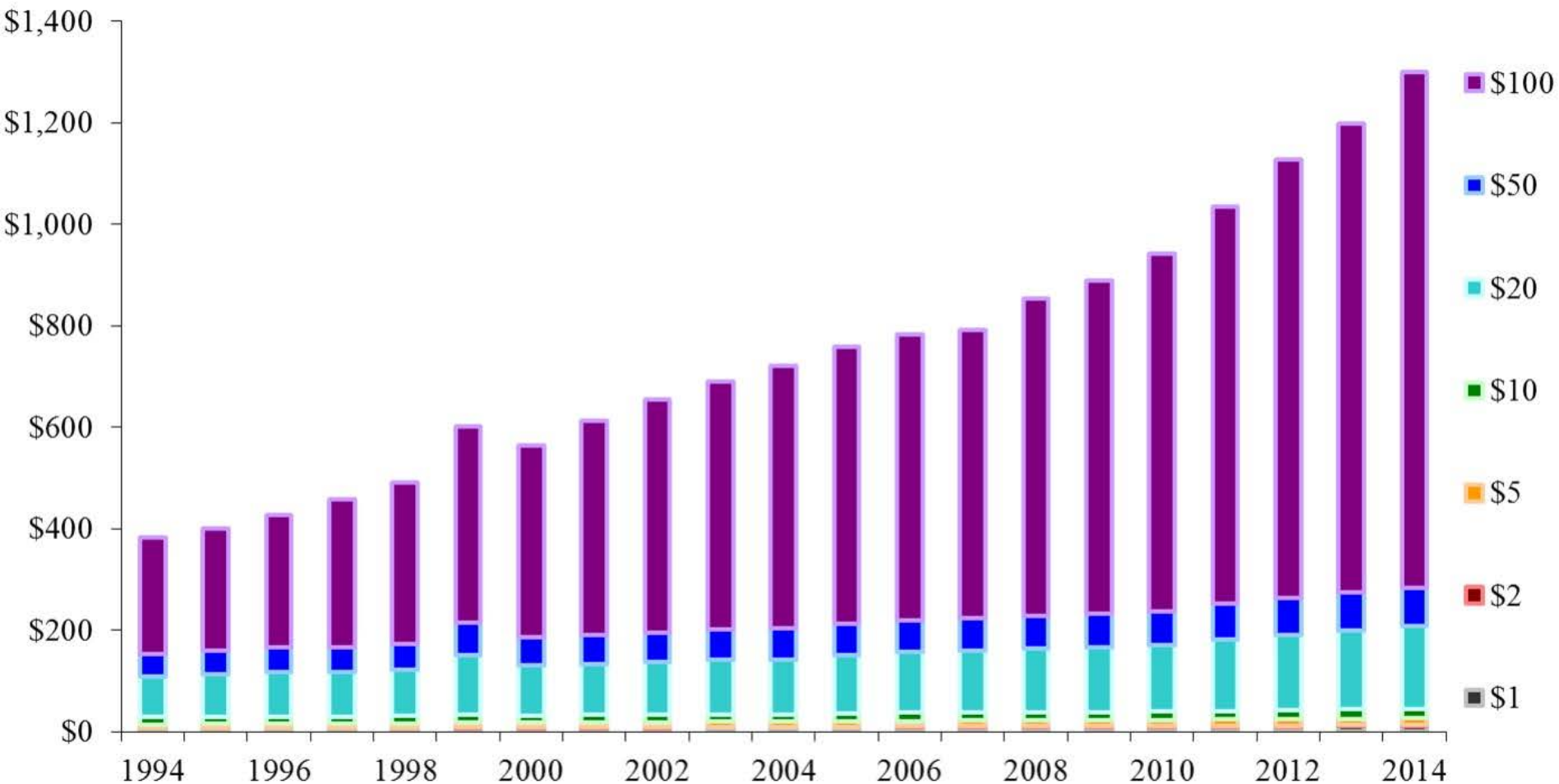
- 1<sup>st</sup> currency in the world for banknotes' use (value)
- 2<sup>nd</sup> reserve currency in the world for foreign exchange reserves
- "strong" exchange rate
- 2<sup>nd</sup> biggest financial market in the world
- an area of price stability

# Euro bank notes



## Value of Currency in Circulation

(Billions of dollars, as of December 31 of each year)



Includes Federal Reserve notes, U.S. notes, and currency no longer issued.

Excludes the dollar value of denominations larger than the \$100 note.

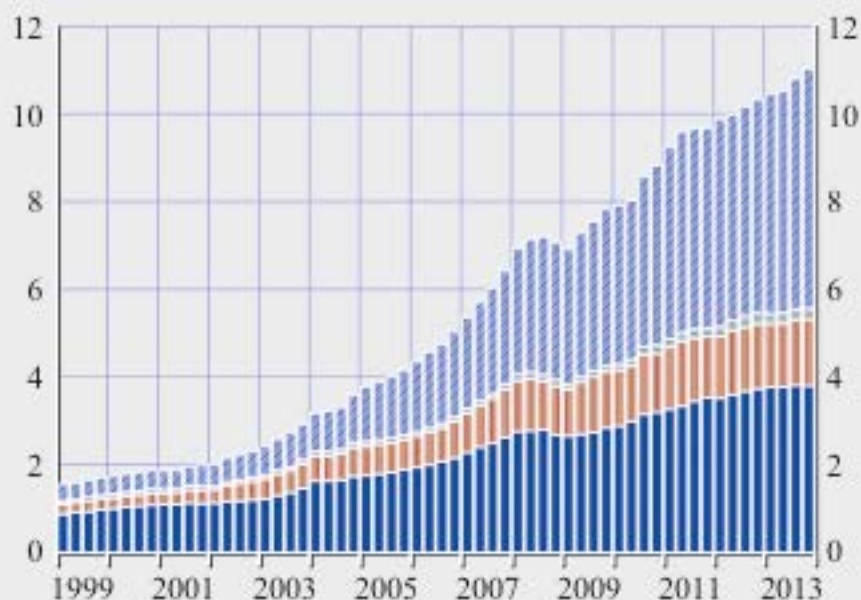
## Chart 1 | Currency composition of global foreign exchange reserves

(USD trillions; at current exchange rates)

(percentages; at constant end-2013 exchange rates)

### a) Amounts

- USD
- EUR
- JPY
- undisclosed



### b) Shares

- USD
- ... EUR
- - - JPY



Sources: IMF and ECB calculations.

Note: The latest observation is for the final quarter of 2013.

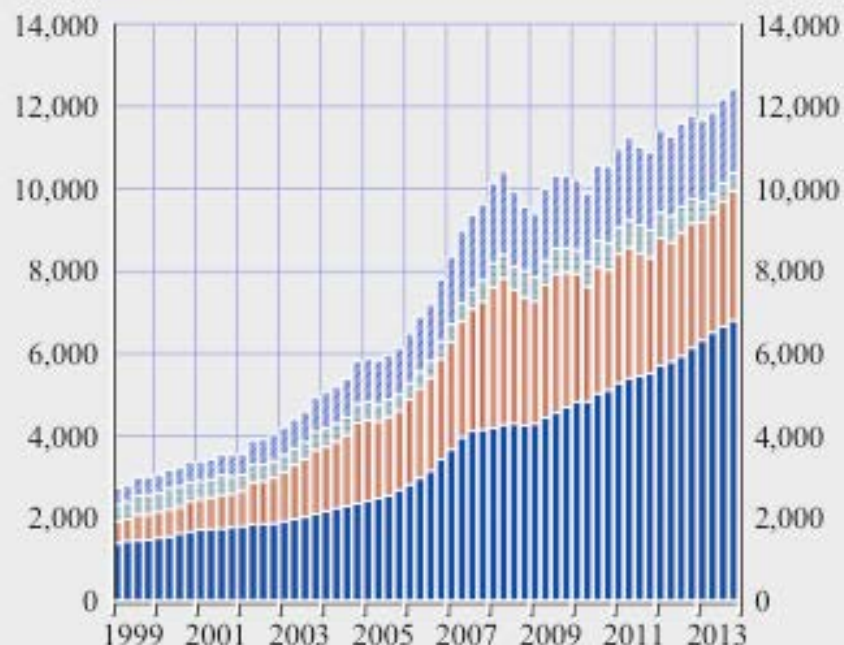
## Chart 12 Stock of international debt securities (narrow measures): outstanding amounts and currency shares

(USD trillions; at current exchange rates)

(percentages; at constant end-2013 exchange rates)

### a) Outstanding amounts

- USD
- EUR
- JPY
- other currencies



### b) Shares

- USD
- EUR
- JPY



Sources: BIS and ECB calculations.

Note: The latest observation is for December 2013.

# then the crisis

- first phase ( 2010) : Greece's unsustainable finances
- second phase ( 2011-2012) : peripheral "divergences" and internal convertibility doubts
- third phase ( 2013 – 2015) : doubts on growth and deflation risk

# Three points of view

- The project was flawed from the start
- The crisis was poorly managed
- A "redesign" is necessary



# three points

1. does the project make (economic) sense ?
2. what are the weaknesses revealed by the crisis ?
3. Progress and challenges ahead

# Currency union

- Sharing the same currency
- The same monetary policy
- No exchange rate between participating countries

# the "theory"

- A currency union must rest upon :
  - Either full capital or labor mobility
  - Or a fiscal union as well
- Euro has neither
- Therefore it must fail

# asymmetric real shocks

- Can be demand or supply
- An asymmetric shock needs either
  1. a change in the (real) exchange rate
  2. or a move in the supply schedule : factor mobility
  3. or a move in the demand schedule : factor mobility and/or fiscal transfers

# an optimum currency area

- needs :
  - either full factor mobility
  - and/ or fiscal transfers
- but geographical area does not necessarily coincide with nations' borders
- Mundell “father of the Euro”

# the response

- Some benefits not captured by the theory (financial stability)
- The capital market will do the job
- A good framework for fiscal policy : the Growth and Stability Pact

# convergence criteria and GSP

- Convergence criteria
  - Inflation
  - LT interest rates
  - Budget balance
- GSP
  - Deficit(3%) and debt(60%) criteria
  - Attempts to refine ( structural balance)
  - Attempts to enforce ( the procedure, the majorities)

# It worked for ten years

- Capital markets looked as if they did the job : no instability; and capital flew from "north" to "south" fostering convergence and development
- Fiscal framework was not respected but debt was under control



## 2. what are the weaknesses revealed by the crisis

- Pre crisis
  - Imbalances were accumulating
  - Financial relationships were fragile
- During the crisis
  - Disagreements between countries
  - Perverse political dynamics

Imbalances were accumulating

# Euro Area Household Debt Ratios

Percentage of Disposable Income

	1999	2007	Change
Greece <sup>a</sup>	26	75	49
Ireland <sup>b</sup>	113	205	93
Portugal	95	143	48
Spain	66	118	52
Germany	107	95	-12
Memo:			
United States	88	122	33

Sources: Eurostat; Haver Analytics; Board of Governors of the Federal Reserve System.

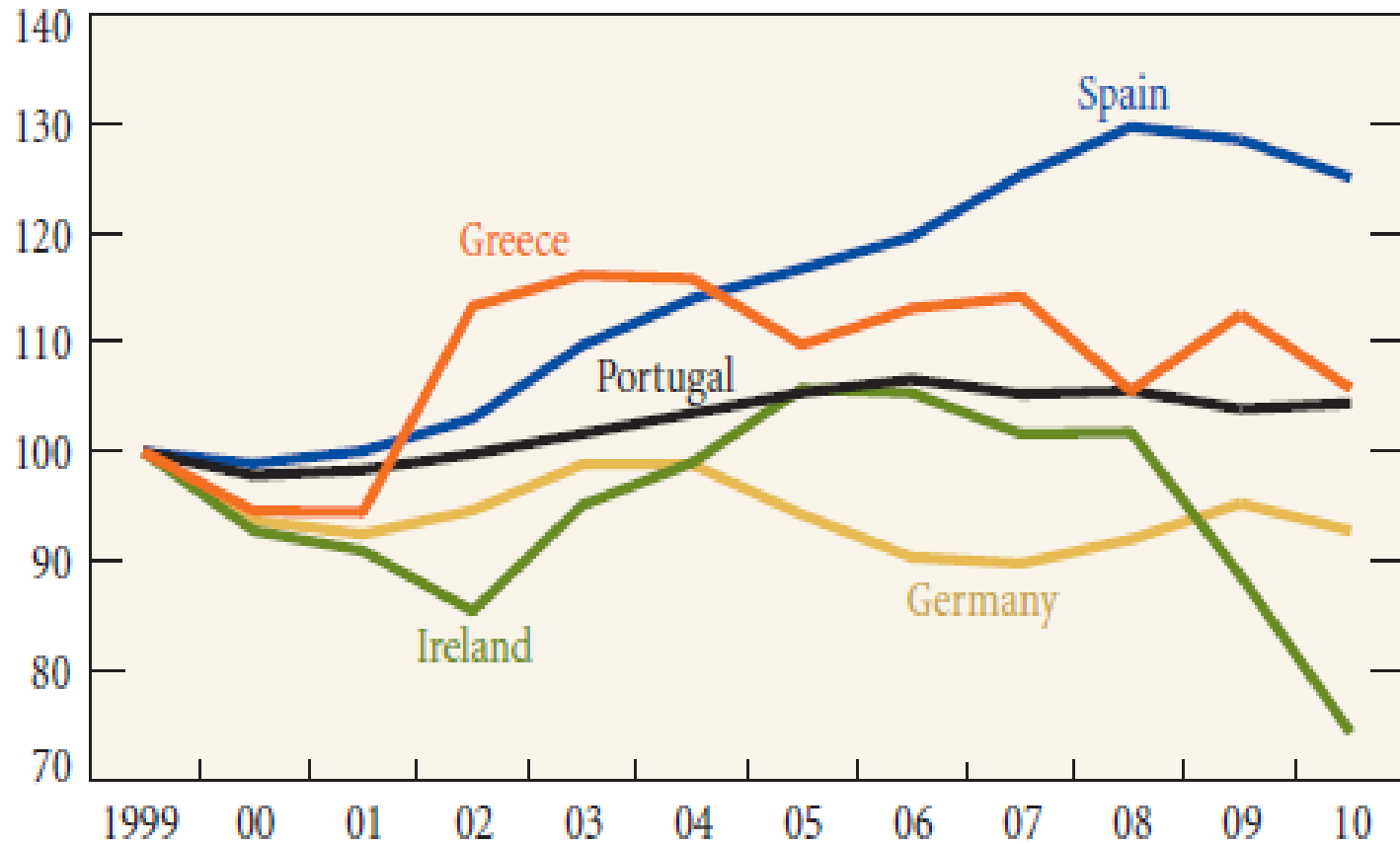
Note: To ensure comparability across countries, we measure disposable income

--- of capital consumption

Chart 7

## Relative Unit Labor Costs in Manufacturing

Index: 1999 = 100

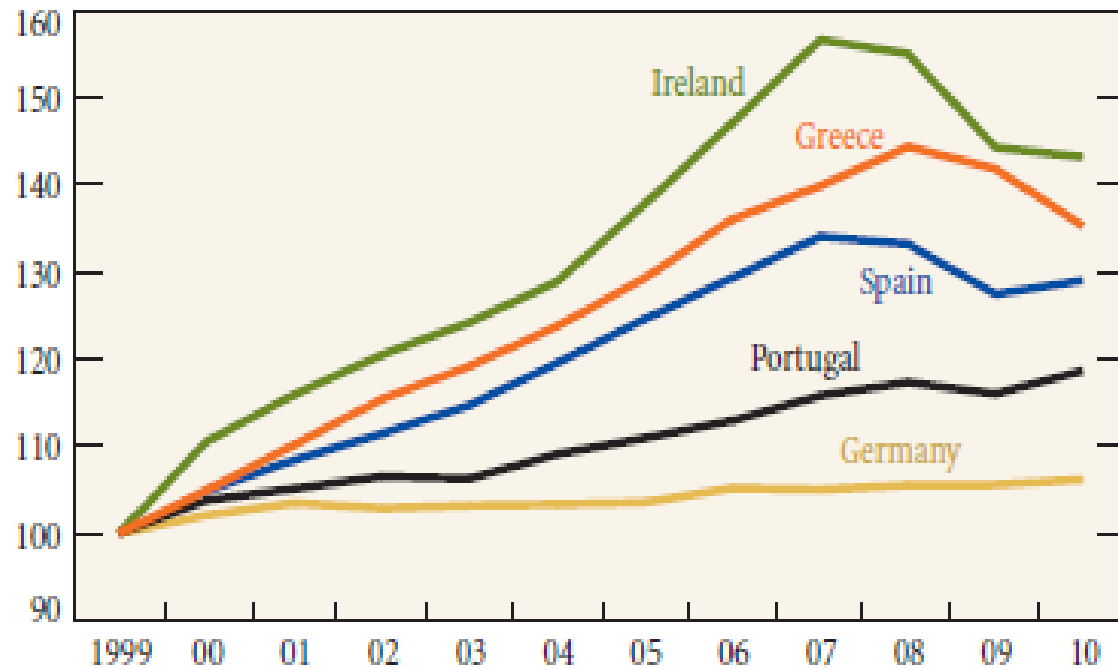


Source: Organisation for Economic Co-operation and Development.

Chart 5

## Private Real Consumption Spending

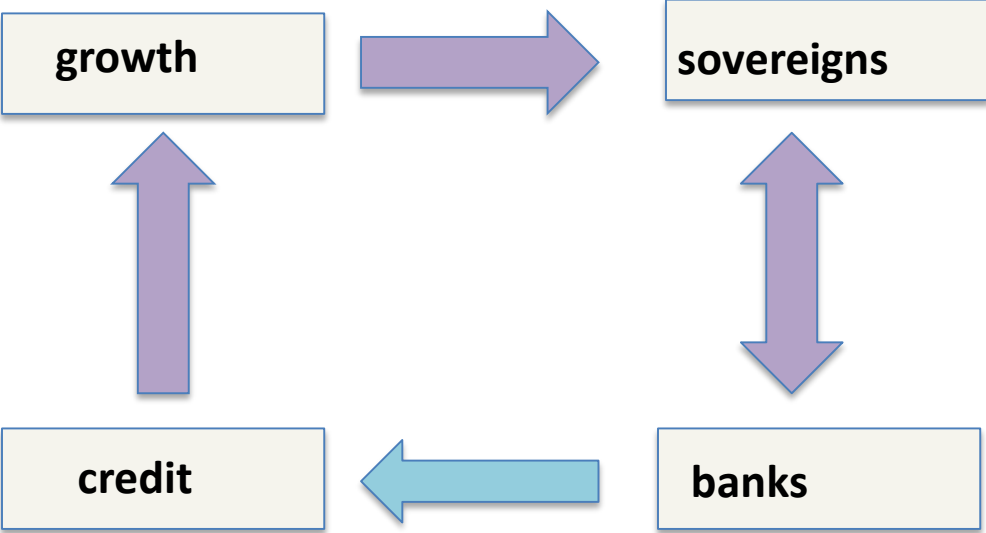
Index: 1999 = 100



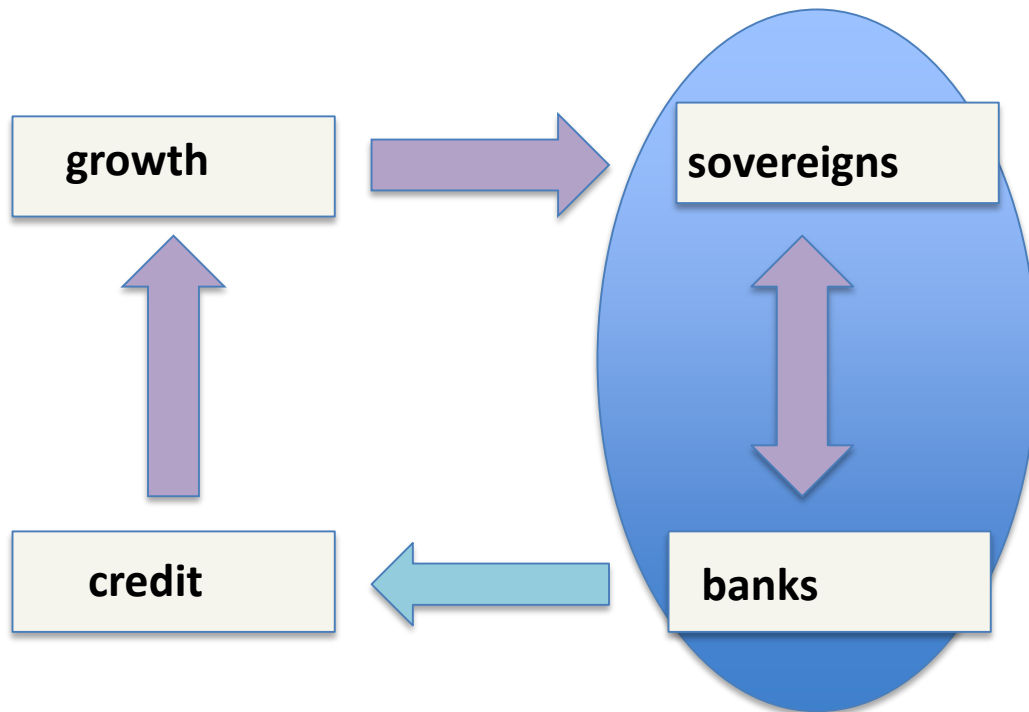
source : Higgins and Klitgaard

Financial relationships were fragile

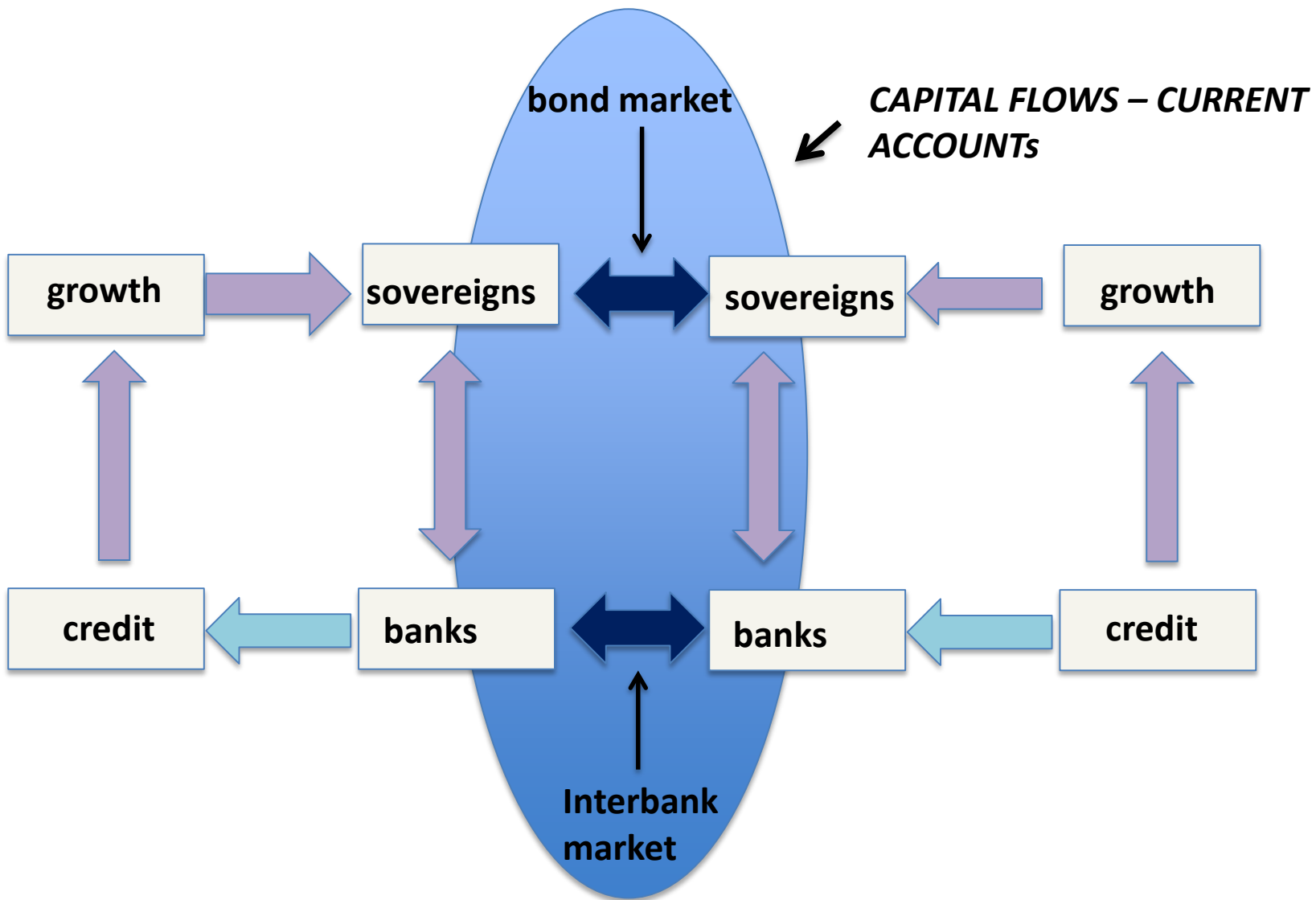
# feedback loop



**we did not see that : the link  
between sovereigns and  
banks**







# cross border capital flows were fragile

- mainly interbank and short term
- Fueled expansion of credit and bubbles

# Euro Area Household Debt Ratios

Percentage of Disposable Income

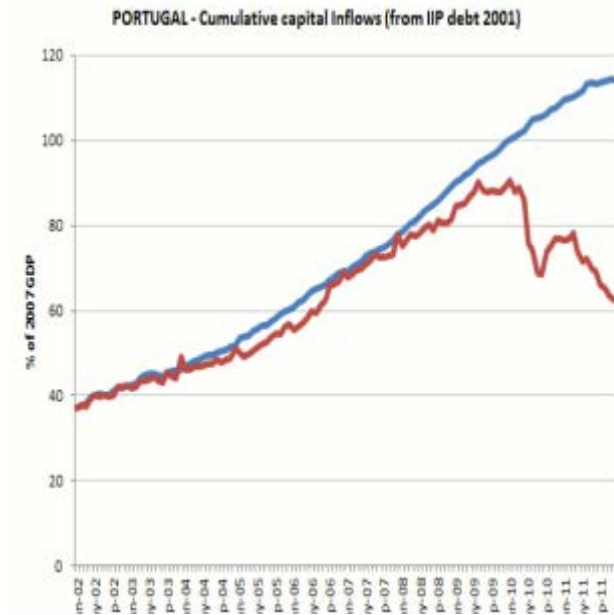
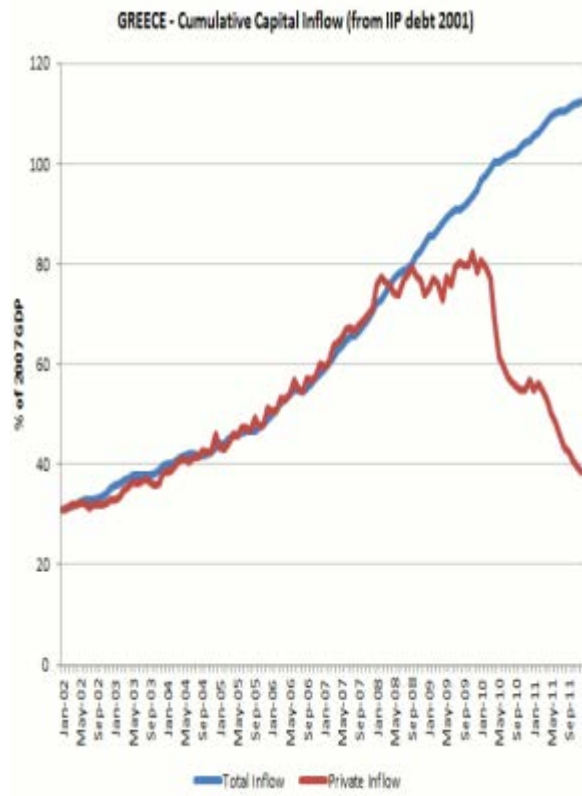
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source : Higgins and Klitgaard

# the crisis : a collapse of cross border financial intermediation

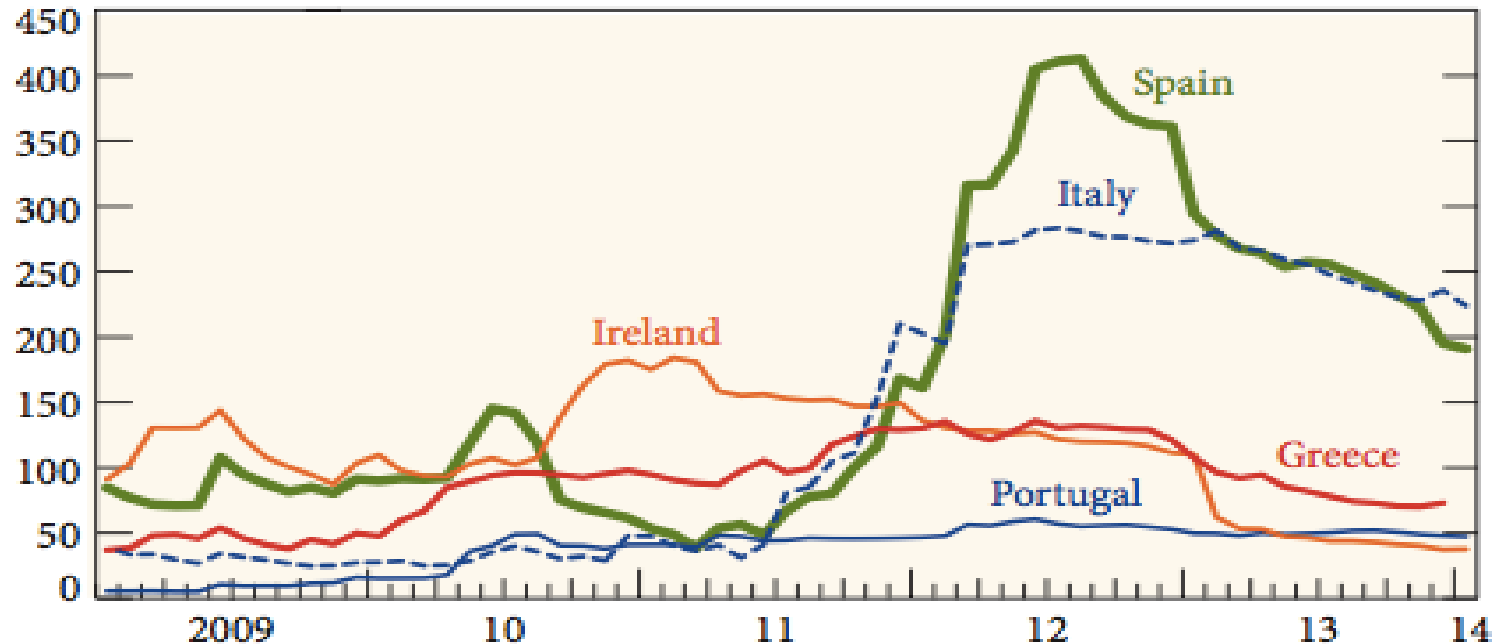


source : Merler and Pisani Ferry

Chart 5

## Periphery Banks: Use of Central Bank Credit

Billions of euros



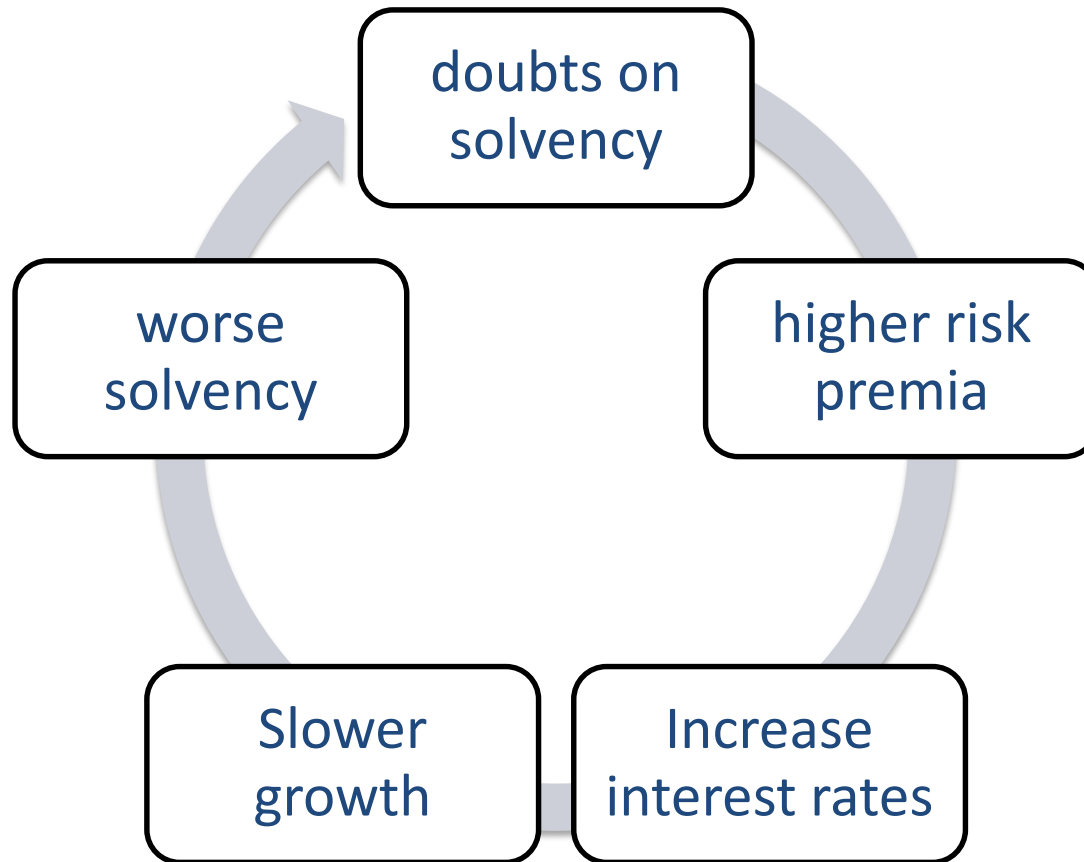
Sources: European Central Bank; national central banks.

Note: The values plotted for Greece include funding from the European Central Bank and estimated emergency liquidity assistance from the national central bank.

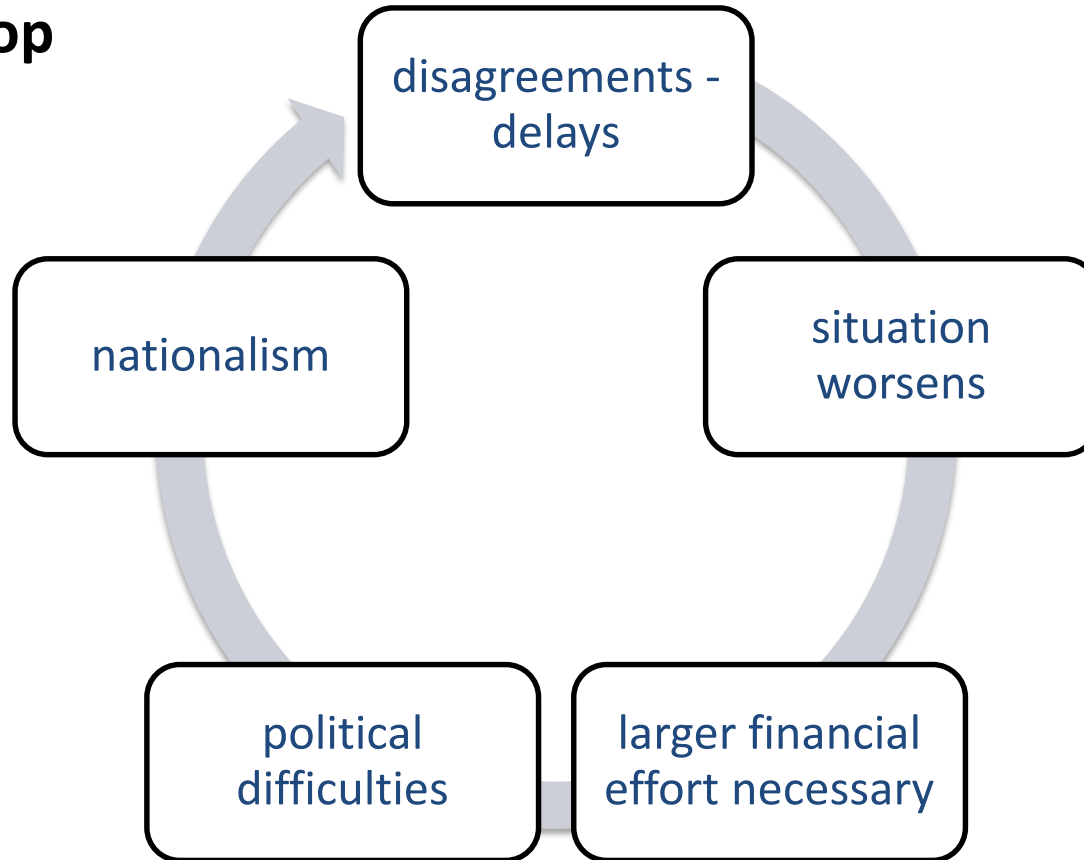
# during the crisis

- initial shock
  - *usually small when compared to ultimate consequences*
  - *total Greek public debt < 1.5% of euro area GDP*
- amplification mechanisms
- possibly aggravated by misguided policy responses
- revealing underlying vulnerabilities

# Financial feedback loop



# political feedback loop

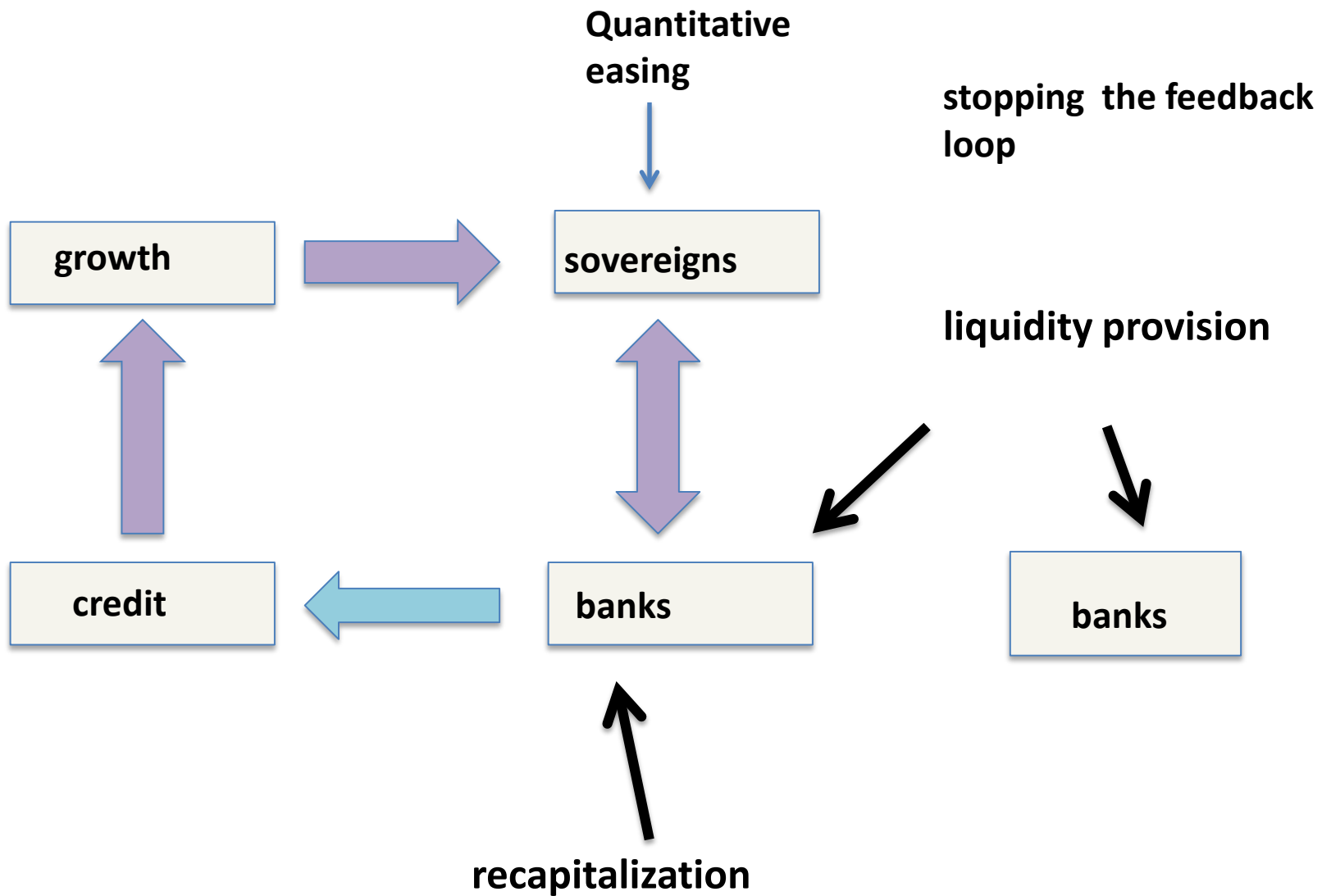




# 3. Progress and challenges ahead

- Stopping the feed back loops
- Looking at the future

# stopping the feedback loop

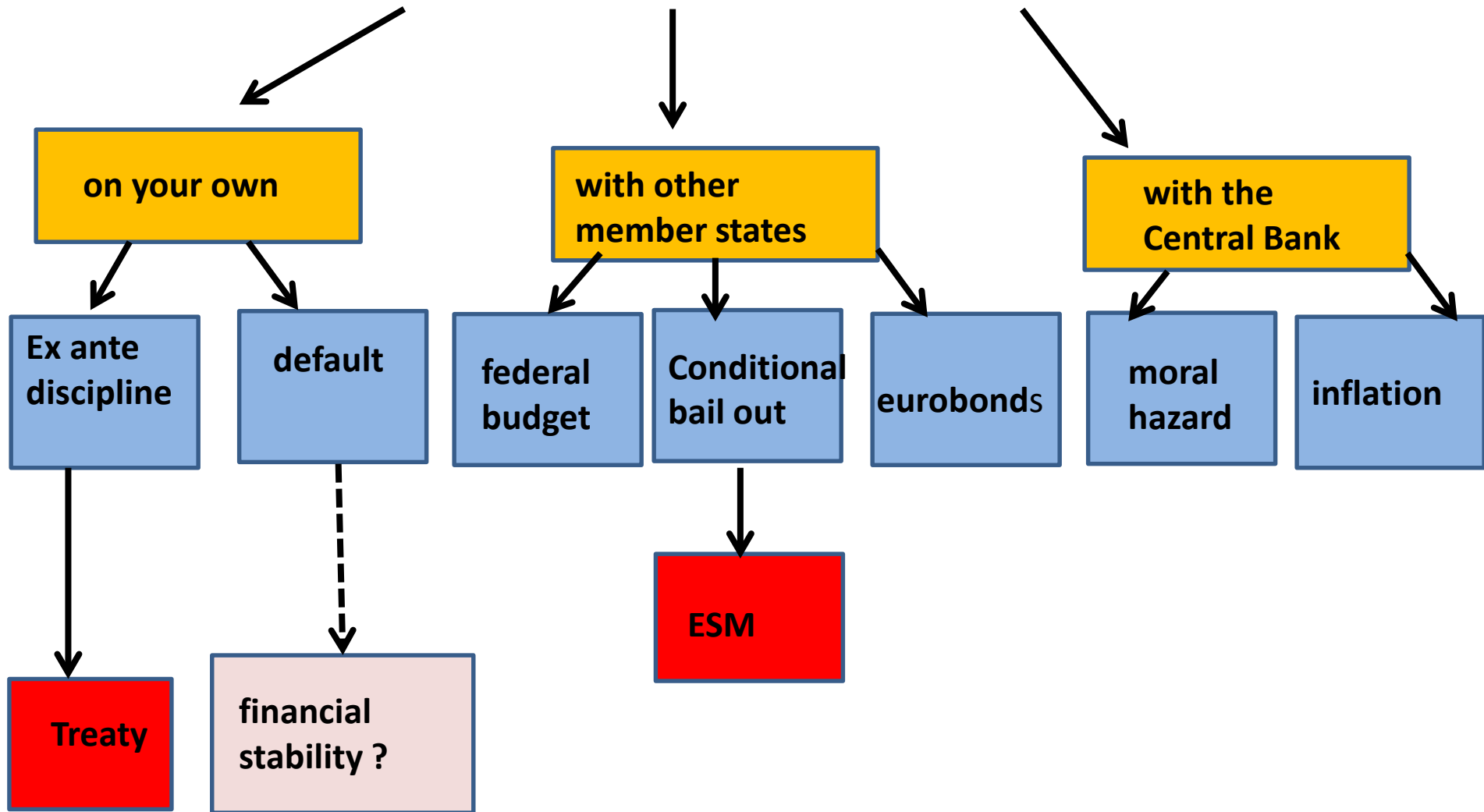


# Looking at the future

# currency unions and fiscal policies

- the theory : fiscal coordination
  - to absorb asymmetric shocks and mimic the federal budget
  - To get the right policy mix
- The policy
  - Skepticism towards Keynesian based fiscal policies
  - The risk of free riding and implicit transfers: no bail out
  - The threat to monetary policy independence and effectiveness

# how do you absorb a fiscal shock ?



# conclusion : the misguided search for clarity

- **“extreme” scenarios unlikely**
  - *No miraculous agreement on fundamental issues*
  - *No fiscal federalism*
  - *No general break up - ECB won't allow it*
- **Long period of “muddle through”**