

The Eurozone: Problems and Prospects

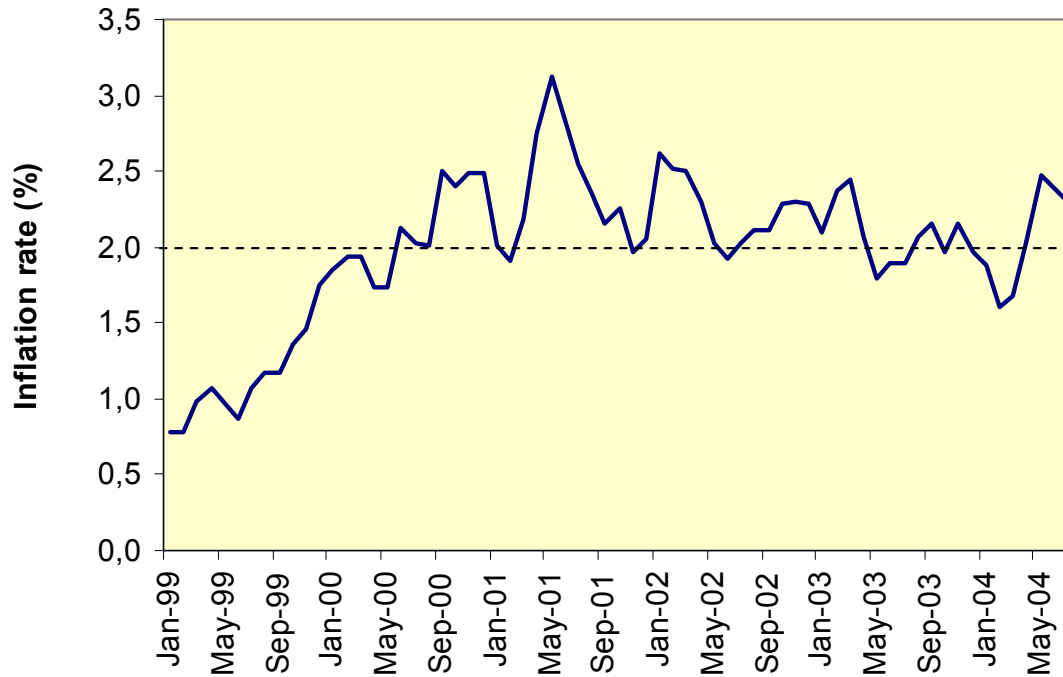
Paul De Grauwe

- The creation of the euro was a major historical event in the process of European unification
- The fact that it happened can be called one of the major positive surprises in recent European history
- Few persons just 15 years ago thought this would be possible in their lifetimes

- There have been other surprises both positive and negative since the start of the eurozone in 1999
- Let's look at the positive surprises

Low inflation in eurozone

Inflation rate in euro area (HICP)



ECB has been very successful in maintaining inflation close to 2%

As a result, inflationary expectations are now firmly anchored around 2%

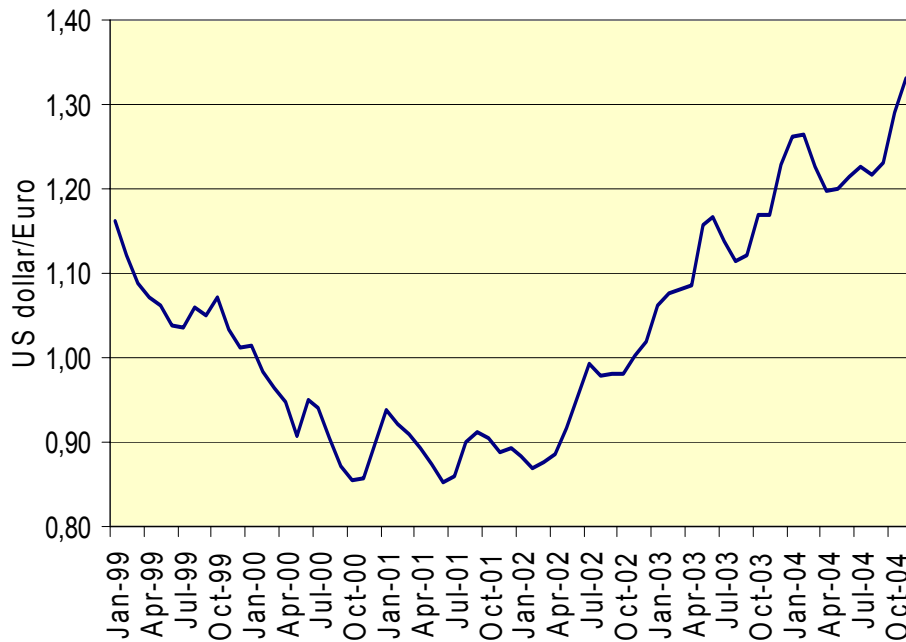
This has made it possible for the ECB to build up a strong reputation for price stability

Spectacular progress in financial integration

- Money and bond markets are now fully integrated
- Home bias in investors' portfolios is disappearing
- Financial market integration has increased the size of the capital markets in the Eurozone leading to a decline in the cost of capital.

A strong euro: symbol of a financial success story

Euro-dollar exchange rate (1999-2004)



The symbol of the success of the eurozone is the steady rise of the euro vis a vis the dollar

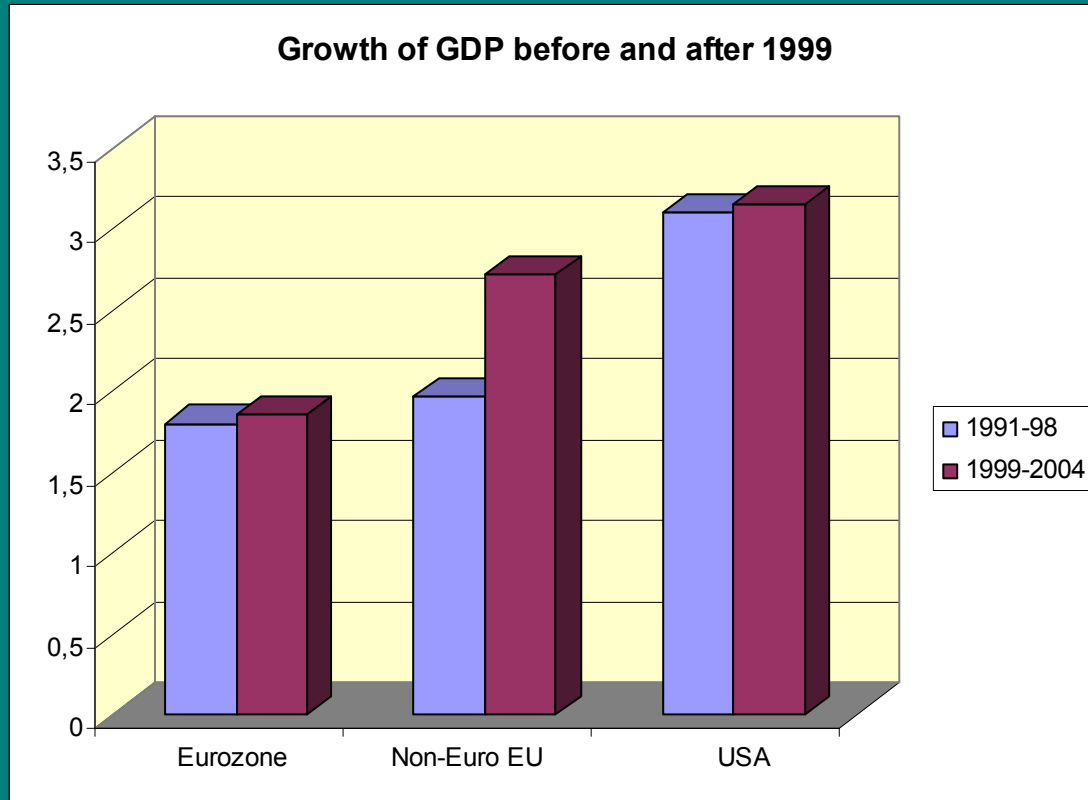
Financial markets have given a strong vote of confidence in the euro, (after a period of hesitation from 1999-2001)

While giving a vote of no-confidence in the dollar

Financial markets trust the euro more than the dollar

Does all this translate in an economic success story?

The less happy surprises: low growth performance



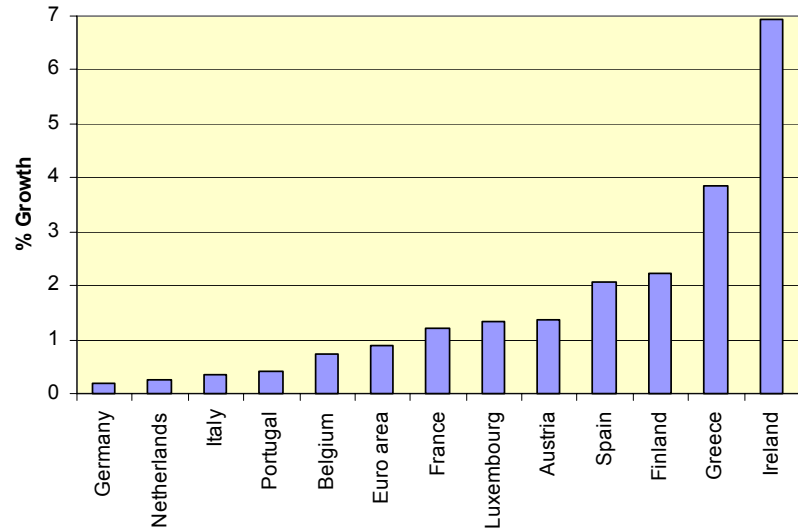
Expectations that euro would boost growth in Europe were strong

Up to now growth performance in eurozone has been disappointing: euro has not been instrument boosting growth

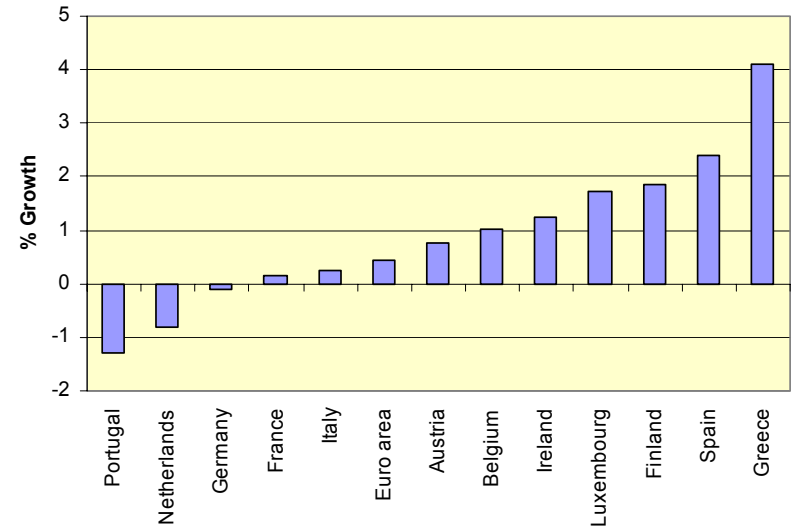
Contrast with EU-member countries which decided to stay outside the eurozone is strong and quite spectacular.

There are other unpleasant surprises: large asymmetric shocks

Growth of real GDP in Euroland in 2002 (in %)



Growth of real GDP in Euroland in 2003 (in %)

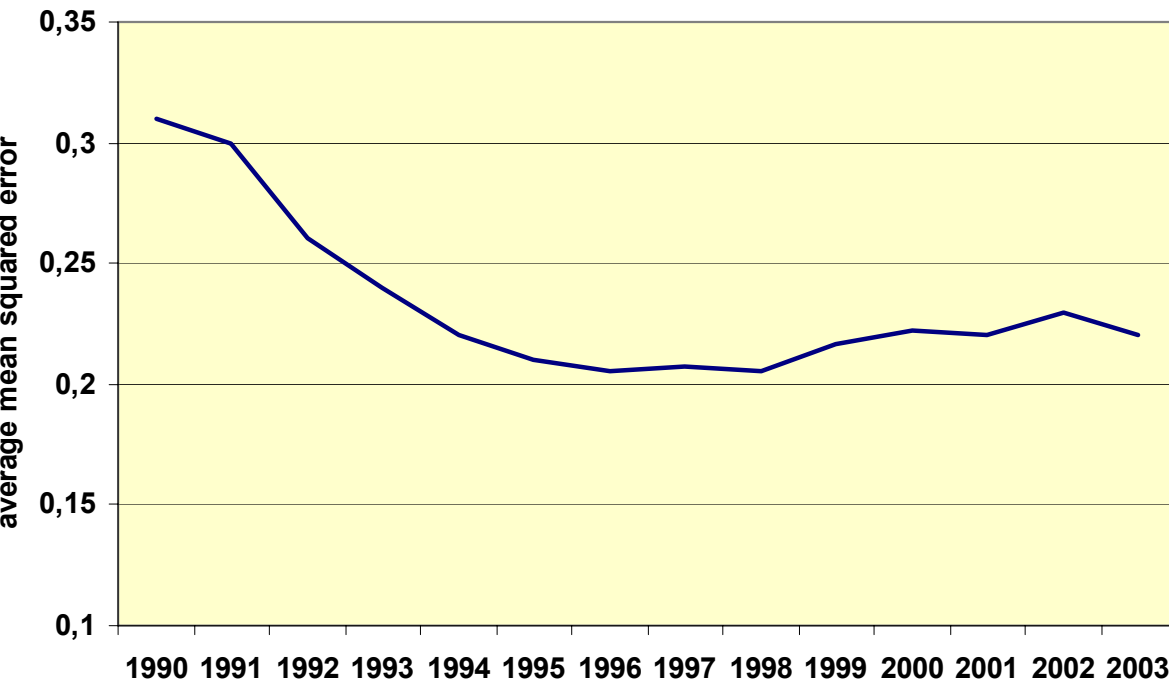


Differences in growth performance within Eurozone are certainly much larger than expected

Some countries experiencing recessions while others strong booming conditions

Other unpleasant surprises: no price convergence

Price dispersion of consumer products



Euro would lead to more price transparency

Thus more competition in the consumer goods markets

Lowering prices

benefiting consumers

This has not happened up to now

A final nasty surprise ... especially in Italy

Table 1: Price increases of food products (from Nov 2001 to Nov 2002)

Breakfast (bread, snacks)	23,3%
Pasta, bread, rice	20,1%
Beverages	32,9%
Meat, eggs and fresh fish	22,1%
Cold cuts	27,5%
Canned food	30,9%
Fruit and vegetables	50,8%
Frozen food	23,6%
Total	29,2%

This phenomenon, that was also observed in Germany, Greece has contributed to a loss of enthusiasm about the euro

In some countries the euro is now perceived as having contributed to the economic slowdown.

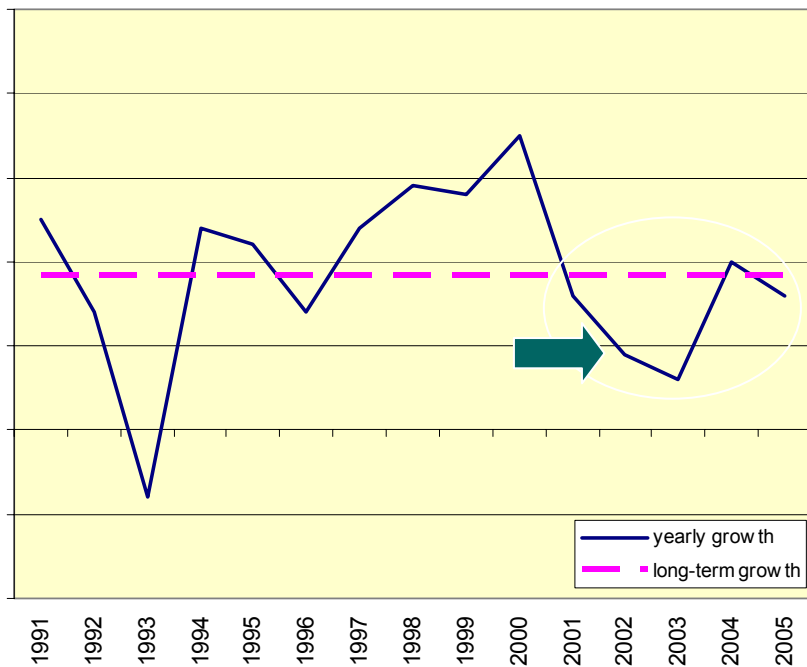
The bottom line

- Euro is a great financial and monetary success
- It has become popular in financial markets and in banking circles
- This success does not seem to have been translated in the “real” part of the economy, i.e. in economic growth and employment
- As a result, for many people concerned about their economic future the euro is not associated with a success story.

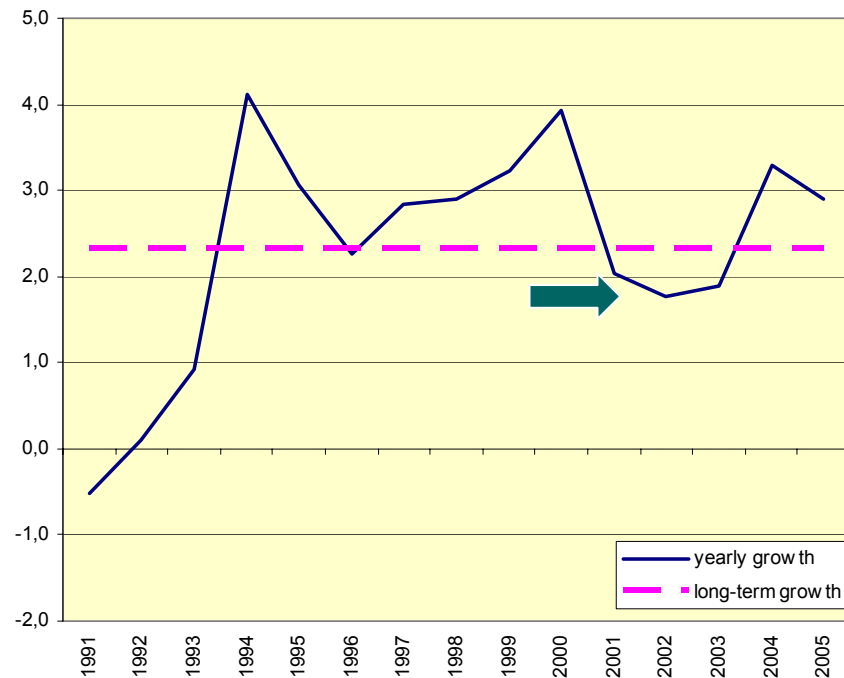
Where does the contrast between financial success and lack of economic success come from?

- I focus on the growth performance
- Is the lack of success here due to structural rigidities that have nothing to do with the euro? (This is the story we hear from Frankfurt)
- Or is there a flaw in the macroeconomic management of the eurozone?
- As so often in economics, it's going to be a little bit of both.
- Let's try to disentangle the structural from the cyclical

Yearly growth rate and long-term growth in Eurozone



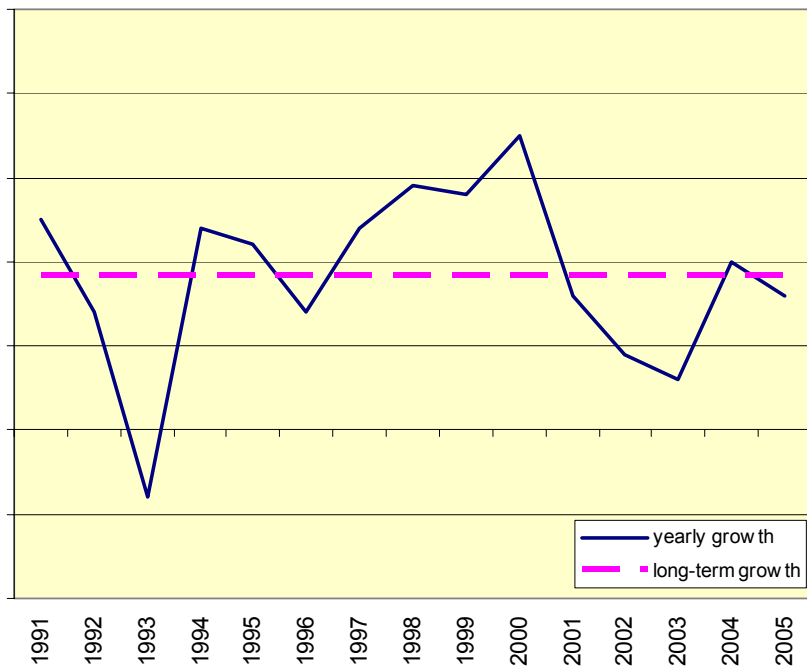
Yearly growth rate and long-term growth in Non-Euro EU



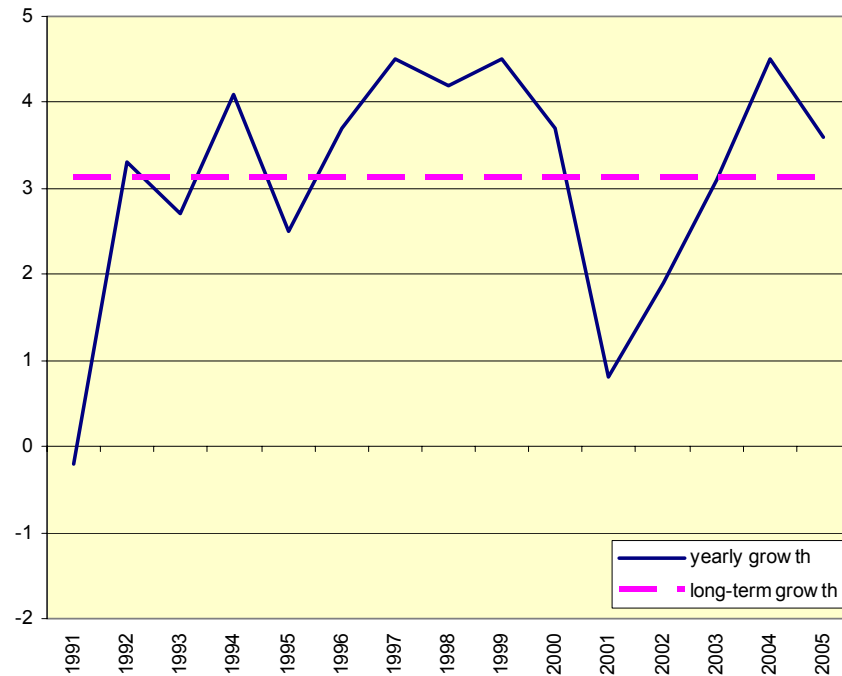
We contrast the eurozone with the non-eurozone EU-15

1. Long-term growth in non-Euro EU is 2.3, in Eurozone 1.8
2. Since start of euro output growth in eurozone has been below long-term growth for longer time than in Non-euro EU.

Yearly growth rate and long-term growth in Eurozone



Yearly growth rate and long-term growth in the US



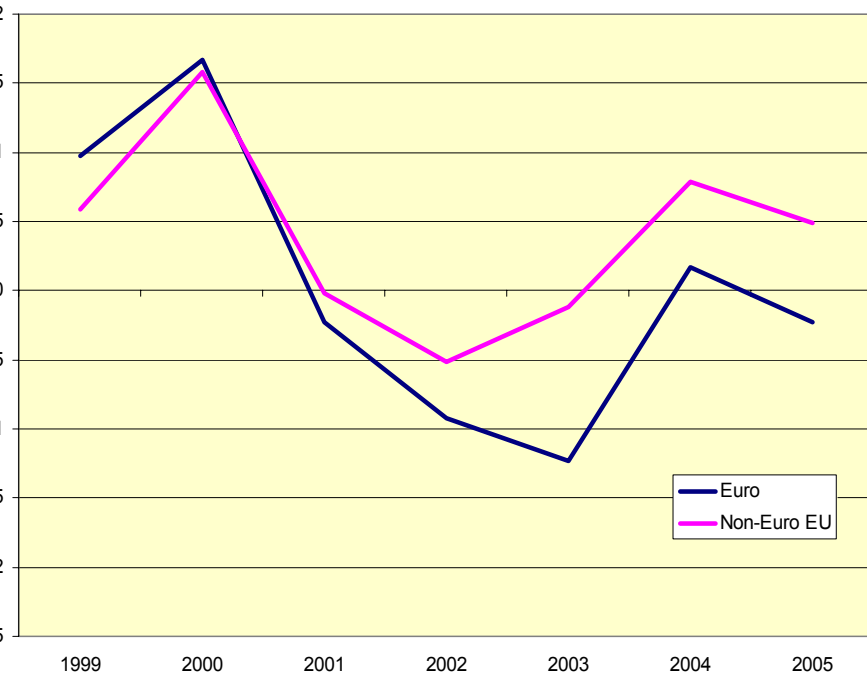
We contrast the eurozone with the US

1. Long-term growth in US is 3.1, in Euro 1.8
2. Since start of euro output growth in eurozone has been below long-term growth for longer time than in US.

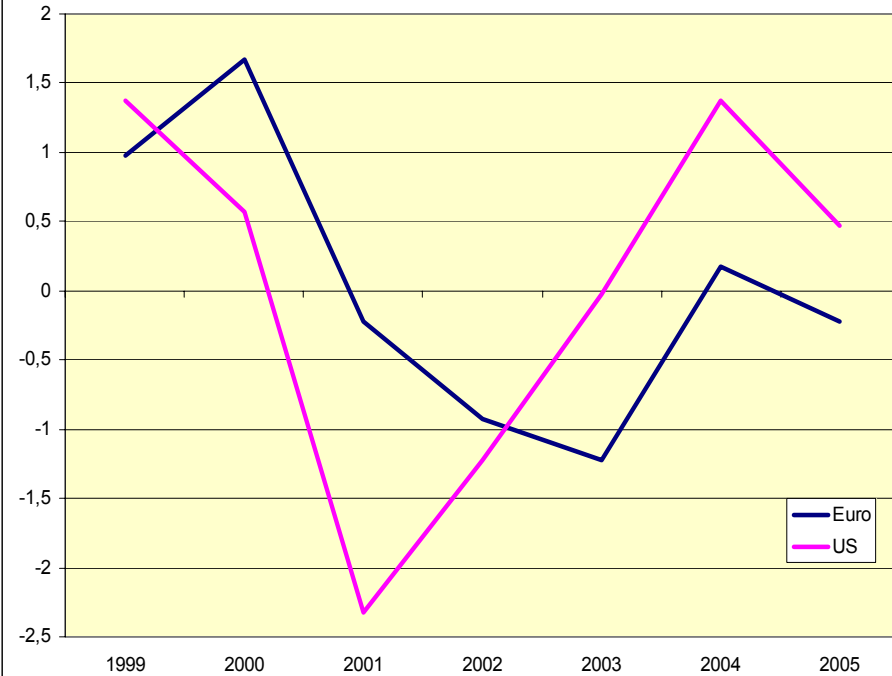
The structural rigidities story

- It is undeniable that countries in eurozone struggle with structural rigidities
- These lower the long run growth potential of the eurozone
- But this is insufficient explanation for the continued slowdown in the eurozone since 2001
- There is also a problem of stabilization in the eurozone

Difference between current and long-term growth rates
in Eurozone and non-Eurozone EU since 1999



Difference between current and long-term growth rates
in Eurozone and the US since 1999



Non-Euro EU has been able to pull itself out of the recession more quickly and more strongly

This is not due to differences in long-term growth rate only, since this difference is not more than 0.5%

The difference in growth rates between Euro and non-euro since 2001 is 1.1%

US-recession was more intense, but very short-lived

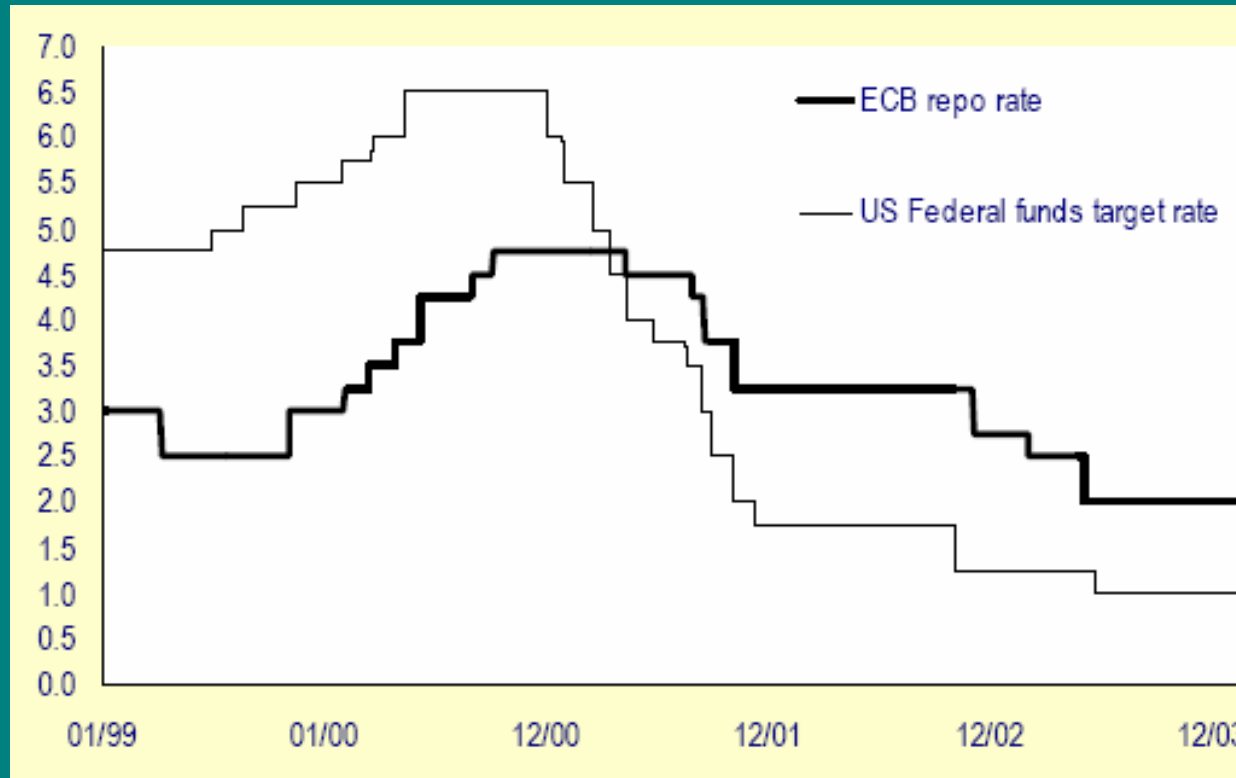
Euro-recession was less intense but protracted

Again these differences cannot be explained only by structural factors.

Thus, there is more than the structural rigidities story

- Too many economists keep repeating the Frankfurt story that it's all structural
- There is also a large cyclical component
- The flaws in macroeconomic management are visible
 - in the monetary field
 - and in the field of fiscal policies

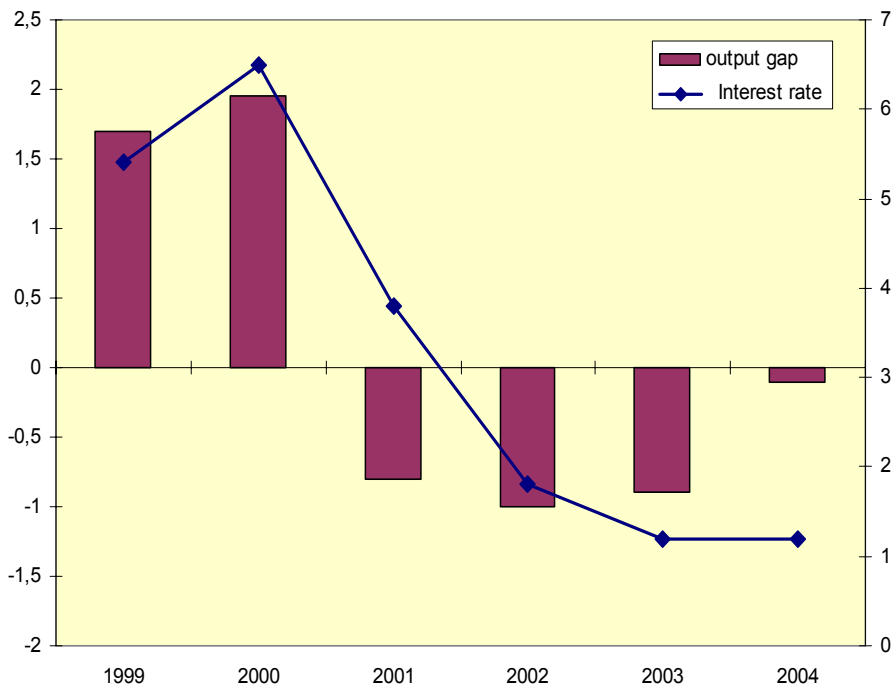
The contrast between the ECB and the FED



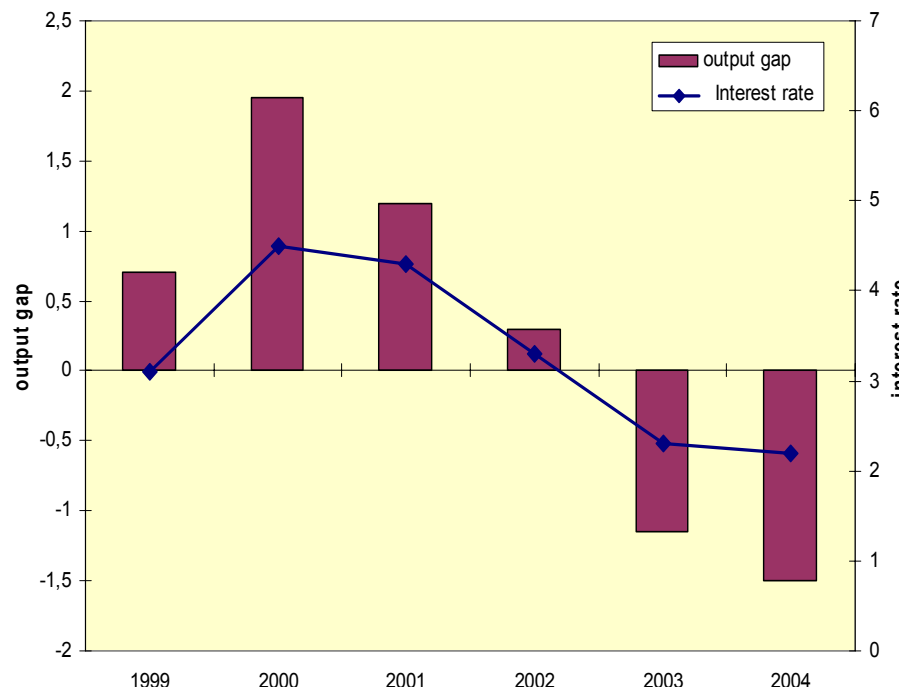
An aggressive series of cuts in the US interest rate in 2001

Slow and less intense interest rate cuts in the Eurozone

Short-term interest rate and output gap in the US (1999-2004)



Short-term interest rate and output gap in the Eurozone (1999-2004)



US Fed went further in its interest rate cuts than the ECB
Thereby contributing to a speedy recovery.

Conclusion: ECB has been more cautious than FED in fighting the economic slowdown

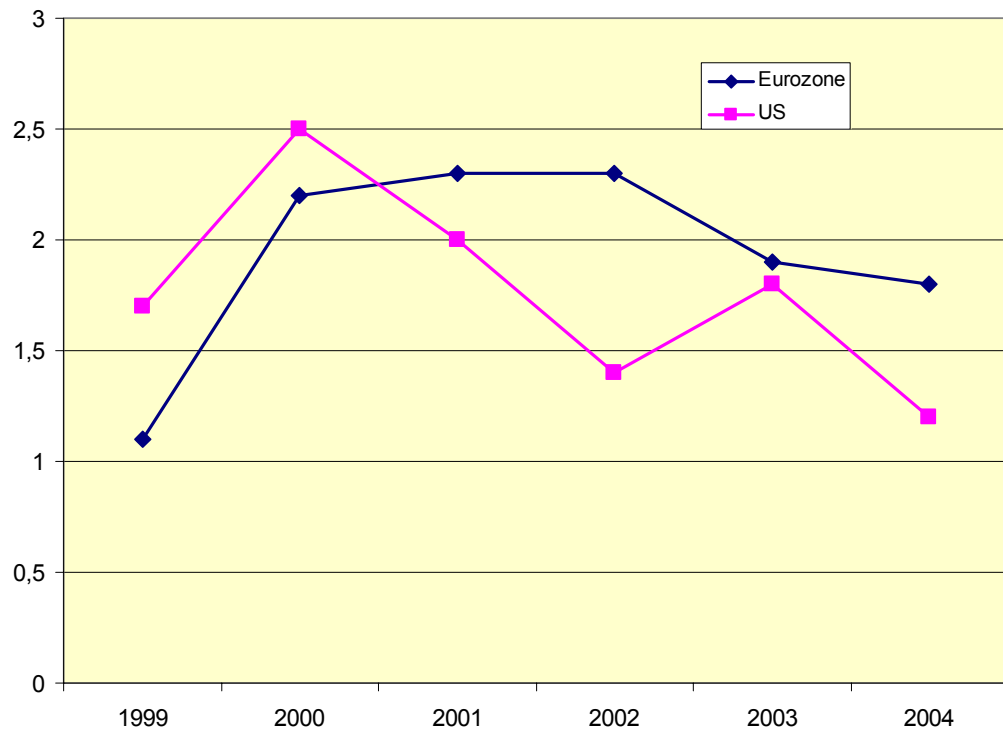
- Why?
 - Different mandate
 - Need to establish credibility of toughness on inflation
 - Different underlying theory (monetarist in Europe; Keynesian in the US)
 - Lots of asymmetries in monetary union paralyzing monetary policies

Different mandate

- Fed's mandate described in the Employment act of 1946 requires the Fed to care about the business cycle
- The ECB's mandate is to maintain price stability. This is the primary objective. Other objectives should not interfere with this primary objective.

ECB's desire to establish credibility led it to define too tight an inflation target (<2%)

Inflation in Eurozone and in US (1999-2004)



Thus in 2001 and 2002 when the economy slowed down the ECB perceived an inflation rate of 2.3 to be excessively high

This perception, however, was the result of a self-imposed limit of 2%

It traumatized the ECB

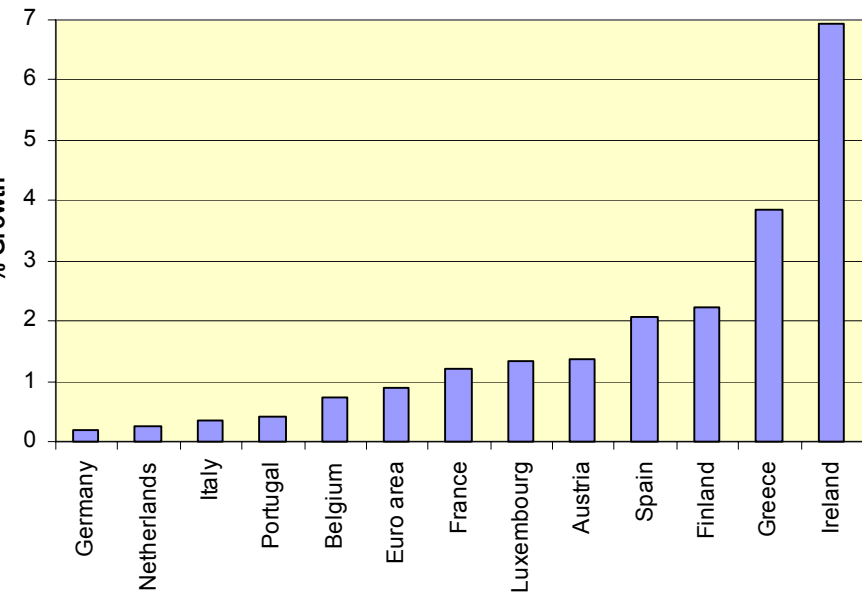
The problem was artificially created by the ECB

Different paradigms in the US and the Eurozone

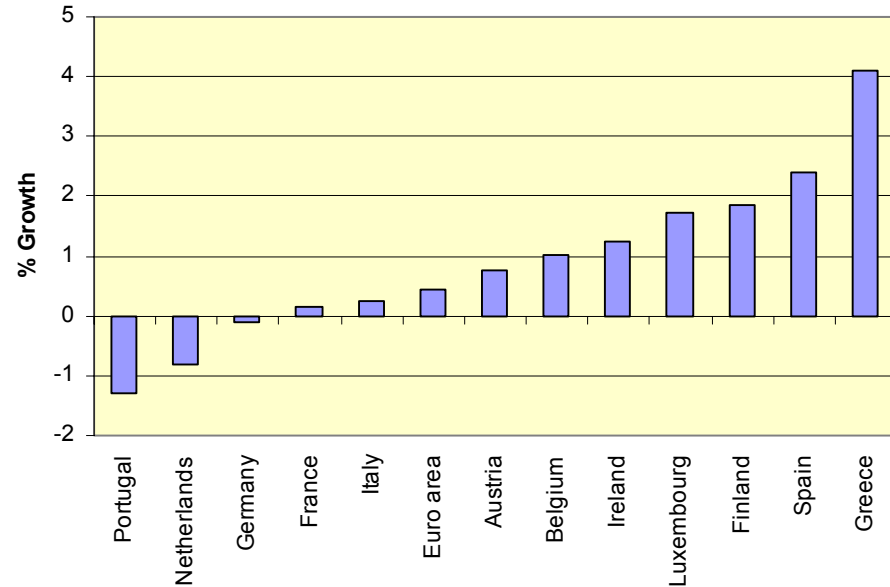
- Surprisingly the Fed has shown to be strongly Keynesian
- While the ECB adheres to strong form of monetarism
 - In this view central bank should stick to its core business, which is fighting inflation
 - Central bank can't do anything to reduce unemployment
 - If it tries, it will just produce more inflation
 - Unemployment is structural and should be solved by structural reforms.

Surprisingly strong asymmetries in business cycles paralyze monetary policies

Growth of real GDP in Euroland in 2002 (in %)



Growth of real GDP in Euroland in 2003 (in %)

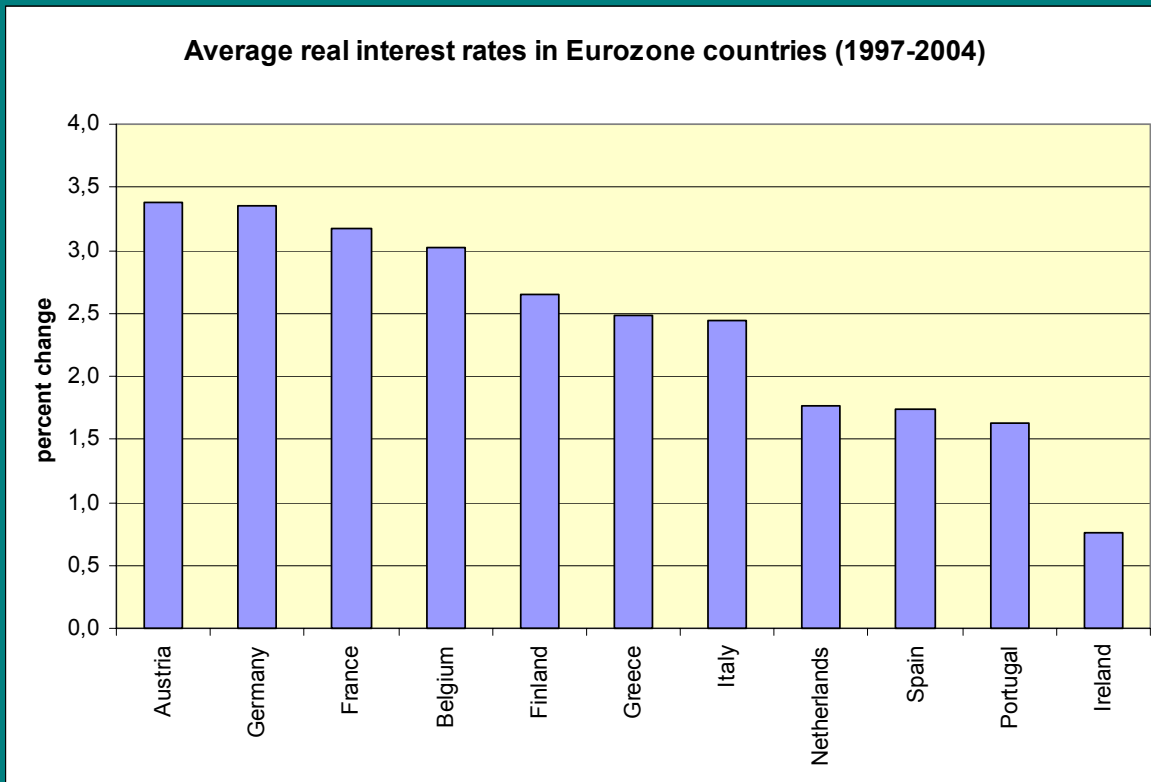


Wide range of experiences made it difficult to react appropriately to the average slowdown in the Eurozone during 2002-03

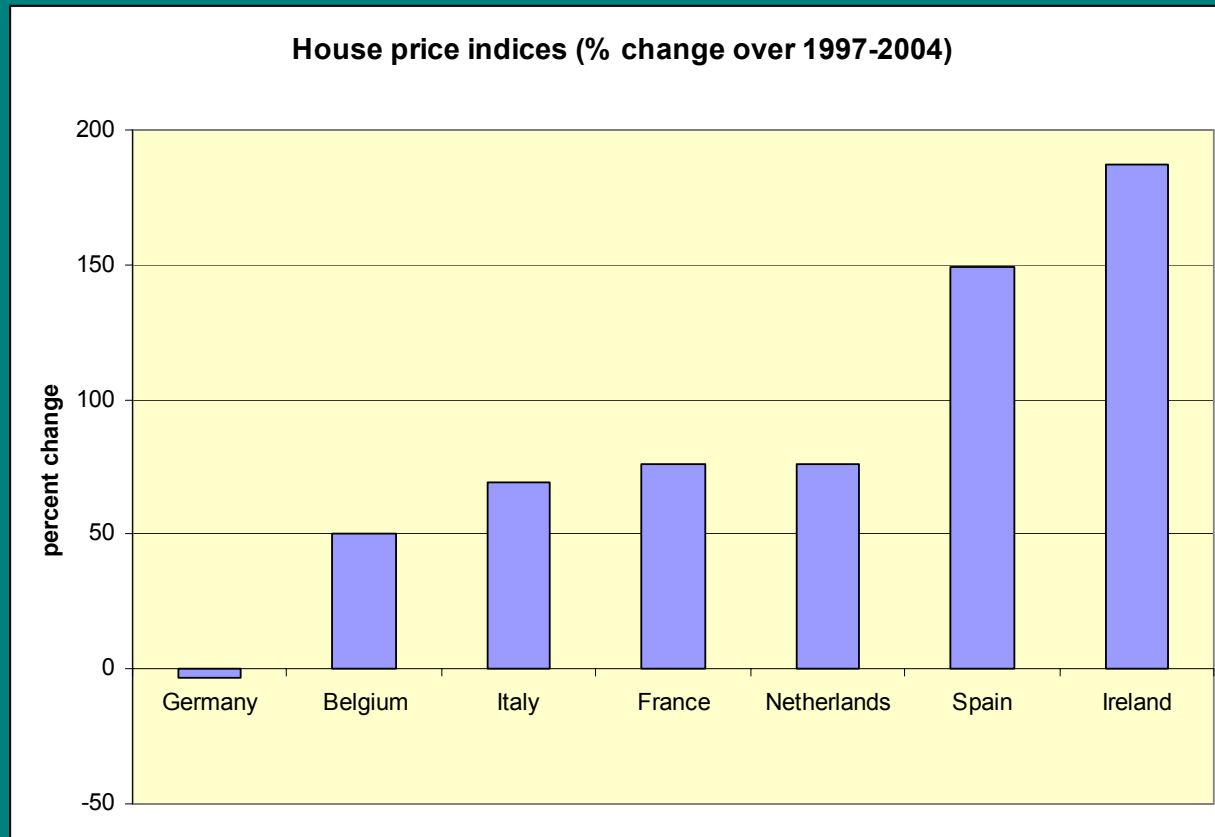
Other asymmetries complicate monetary policies

- Large inflation differences within Eurozone
- combined with the same nominal interest rate in the Eurozone
- create large differences in real interest rates

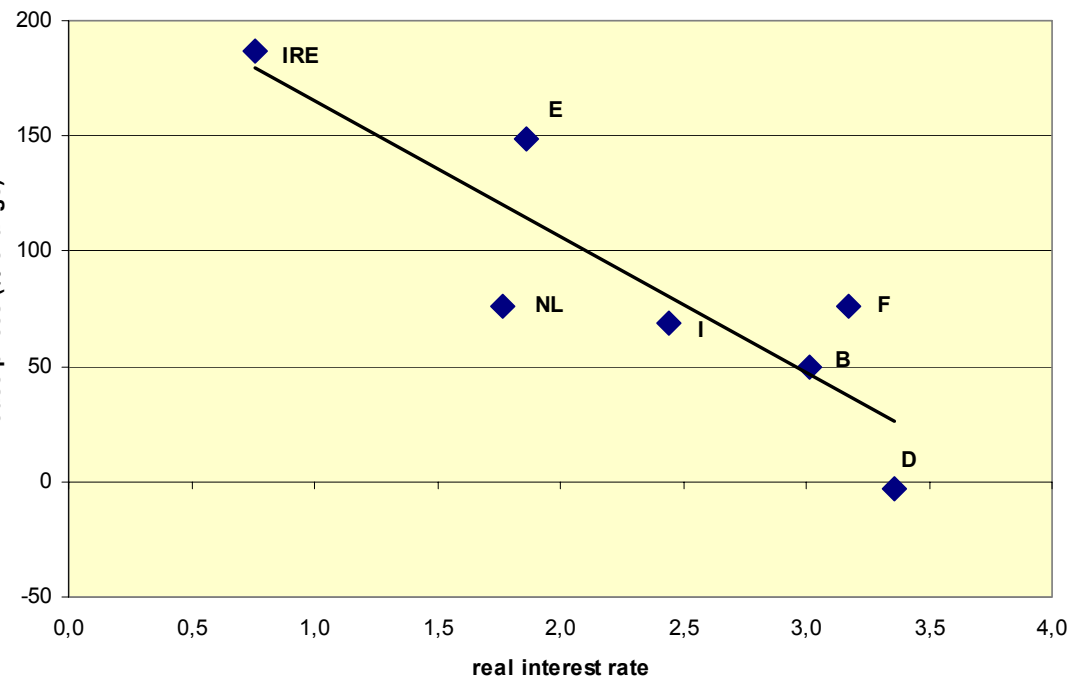
Large differences in real interest rates in Eurozone



Create large differences in house price inflation



Real interest rate and house prices (% change)
1998-2004



The effect of this endogenous asymmetry is that ECB hesitated to lower interest rate

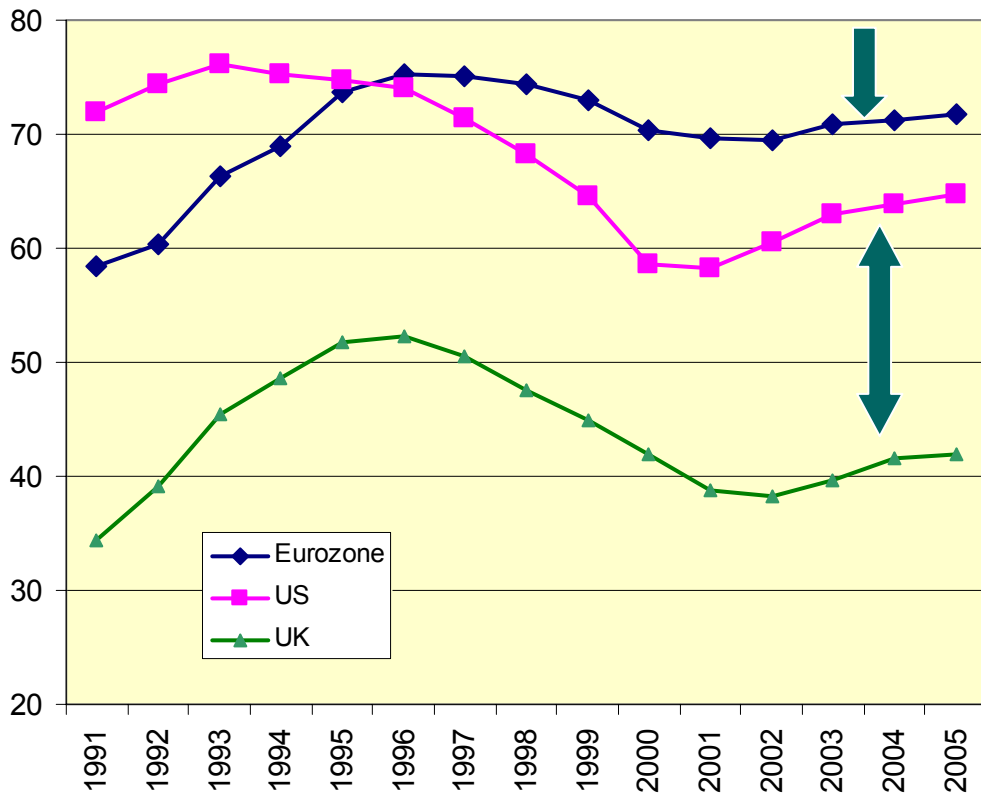
lest it would exacerbate the housing bubbles in a number of eurozone countries.

Thus, this housing market asymmetry contributed to the policy paralysis during recession.

What about fiscal policies?

Similar paralysis

Debt to GDP ratios Eurozone, US, UK



Eurozone countries have kept government debt ratios constant despite economic slowdown

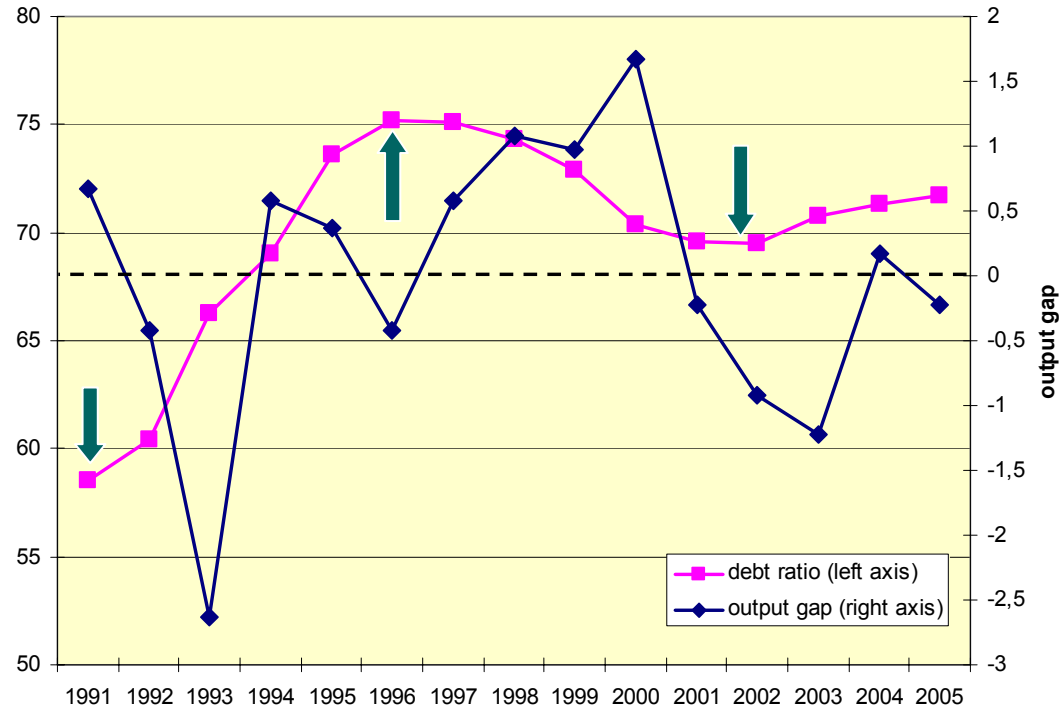
US and non-eurozone countries have been willing to follow stronger Keynesian policies, allowing stronger increases in government debt ratios.

Why Eurozone countries failed to follow countercyclical budgetary policies

- The legacy of the past
 - High debt levels
 - Failure to reduce debt during boom
- The role of the stability pact

The legacy of the past

Debt to GDP ratio and output gap in Eurozone



During recession of 1992-93 there was very strong increase of debt

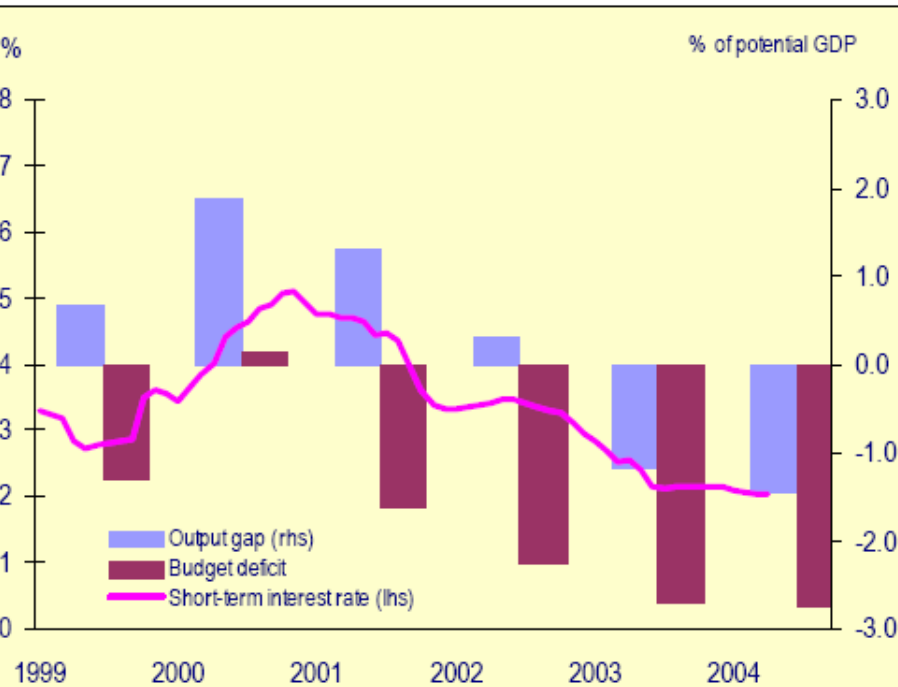
This contributed to making the recession short-lived

However during boom of 1996-2000 debt decumulation was very weak

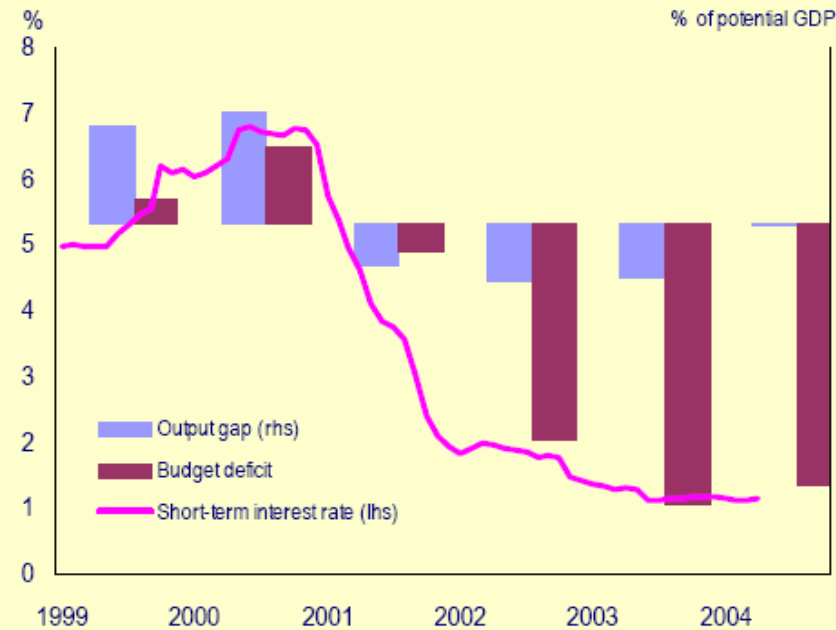
As a result, during recession of 2001-05 there was little room to expand the debt.

Summary of the contrast between eurozone and US

Graph I.13: Euro area macroeconomic policies



Graph I.12: US macroeconomic policies



Has US gone too far in using Keynesian monetary and fiscal policies?

Future will tell

Eurozone certainly could have done a little more

Prospects for the future of the eurozone

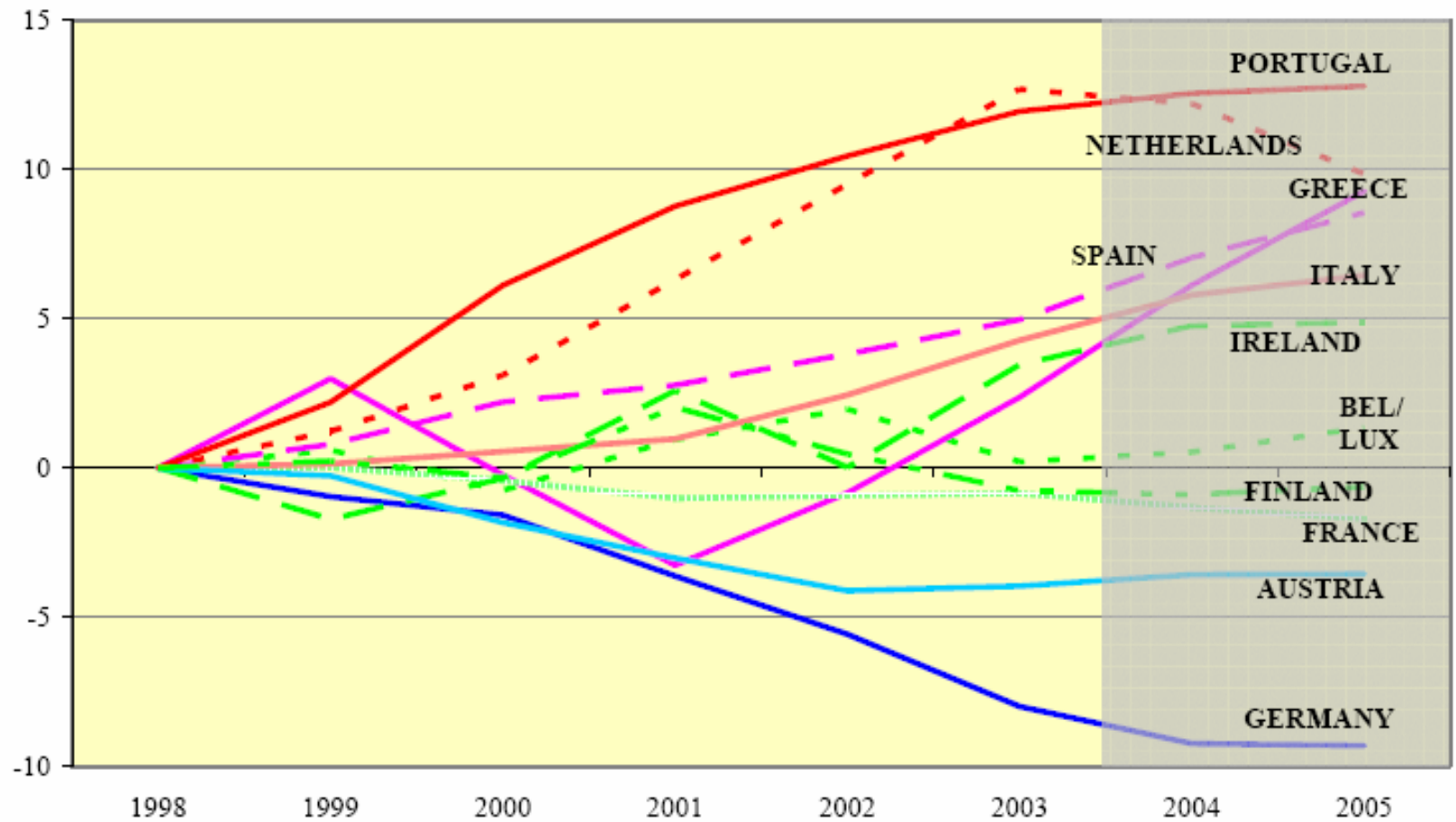
- The past is always easier to analyze than the future which is clouded in mystery
- Much of what I have to say about the future will be highly speculative

- Present situation is dangerous:
 - The euro has not provided clear benefits for a number of countries
 - In fact it is perceived to have contributed to economic slowdown
- Much of the problem has to do with asymmetric, divergent developments within the Eurozone
- which paralyze the ECB

- Some of these divergencies are structural
- Others have a political origine
- i.e. many economic decisions continue to be made at the national level
 - Spending and taxes
 - Social policies (e.g. 35-hour week in France)
 - Wage agreements
 - Housing policies

- These create large asymmetric shocks
- and contribute to divergencies
- This is unlikely to stop
- In fact these divergencies accumulate over time
- Example: relative competitiveness

Graph II.17: Intra-euro area real effective exchange rates 1998-2005
(ULC Total economy, Index 1998=100)



Source: European Commission

- These divergencies can only be countered by further political integration
- There is however an “integration fatigue”
- Worse, in some countries there is a danger of a setback in political integration (e.g. the risk of a ‘Non’ to the constitution in France)
- Failure to move towards further political integration puts Eurozone at risk
- When we moved into Eurozone we moved into a beautiful house
- ...which lacked a roof

- Without political integration the Eurozone will be a house without a roof
- which will become increasingly uncomfortable
- Many inhabitants at some point will want to move out of the house.
- This outcome can be avoided, if our politicians have the courage to tell people that the process of political integration has to move on.

- Without further political integration one can predict with great confidence that the European Monetary Union will not last.