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# The known unknowns and unknown unknowns of European Monetary Union<sup>☆</sup>



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### A B S T R A C T

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The early literature on Economic and Monetary Union (EMU) in Europe provided insights into the difficulties involved in forming a monetary union among diverse economies. Several of the problems that emerged in the euro crisis were correctly diagnosed beforehand. The fact that they were not addressed is not attributable to the shortcomings of research but to a complacent reading of the literature by the policy community. The possibility of balance-of-payments crises within monetary union and the degree of correlation between the default risks of banks and sovereigns were however underestimated or even ignored in the literature. An analytical reassessment of EMU helps define options for policy reform.

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The European crisis is of such magnitude that it forces us to ask ourselves new questions and rethink answers to old ones. Building on Donald Rumsfeld's famous distinctions, one can speak of the 'known unknowns' and the 'unknown unknowns' of monetary union. There were, indeed, things we knew we did not know: some questions were raised already long ago, but never properly answered and then forgotten, or buried, until the crisis broke out and shone the spotlight on them. At least for academics, who can refer policymakers to old writings full of neglected warnings, and largely also for the policymakers themselves who knew problems could arise, these were non-surprises.

But there were also things that we did not know we did not know: genuine surprises that were not, or not fully, foreseen in the academic literature, and that were not discussed by policymakers. These

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*unknown unknowns* lead us to re-examine assumptions about the economics of the common currency, and to rethink the policy architecture of economic and monetary union.

## 1. Known unknowns

The first thing everyone knew was that the countries participating in the monetary union were no siblings. At the time of joining they had significant structural differences (in terms of, for example, their degrees of development, specialisation and labour market institutions) and had different macroeconomic histories, notably in respect of inflation and the exchange-rate regime. The whole discussion during the 1980s about the wisdom of creating a monetary union was about the degree of convergence reached, and if a common currency could be envisioned before economic integration had made further progress.

Significant research effort was devoted in the 1990s to testing if would-be participants in the euro were fit for currency unification. The main research strategy was to 'operationalise' Mundell's theory of Optimal Currency Areas (OCA) and develop ex-ante criteria for assessing the potential consequences of monetary unification. 'Operationalise' was a term first used by Bayoumi and Eichengreen (1999), but it applies to a much wider strand of research than their own.<sup>1</sup>

The main conclusion from this research programme was that compared to the benchmark case of the US, European Monetary Union (EMU) would be characterised by stronger asymmetry across countries (especially the peripheral countries) and would only be able to rely on significantly weaker adjustment mechanisms (especially because of the low degree of labour mobility and the absence of any risk-sharing arrangement).

Based on these assumptions, concerns were expressed about the destabilising impact of a one-size-fits-all monetary policy. They were probably best captured in a simple but powerful argument put forward by Sir Alan Walters, the former economic adviser to British PM Margaret Thatcher, who argued that in the presence of major asymmetries across countries, a single monetary policy would result in country-specific inflation which would reduce the real interest rate and have destabilising pro-cyclical effects.

Against this background, two debates emerged in the 1990s. Although there was little doubt that EMU was not born with the genes of an optimal currency area, the first debate concerned the possibility of the euro turning *endogenously* into an OCA. Frankel and Rose (1997, 1998) argued that a common currency would act as a powerful driver of convergence and that its trade-creation effect would result in a higher degree of business-cycle harmonisation, which in turn would ease the task of monetary policy. However, Krugman (1993) argued instead that by reinforcing agglomeration effects, currency unification would ultimately strengthen, rather than ease, specialisation and asymmetry.

The second debate was about the Walters critique. The destabilising effects of a one-size-fits-all interest rate was rebutted on the grounds that, with rational expectations, agents would internalise the monetary constraint and prevent a lasting real exchange-rate appreciation (Emerson et al., 1990; Miller and Sutherland, 1993). In other words, the optimistic view was that the real exchange-rate channel would be strong enough to balance the effect of the interest-rate channel. Optimism even continued to prevail after a degree of inflation persistence was found in the early years of EMU (Hofmann and Remsperger, 2005): in the mid-2000s, it was hoped that remaining divergence would be short lived.

It is striking to observe the degree to which optimistic convergence bets proved wrong. From 1999 to 2007 – nine years in total, until the global crisis took over and markets started discovering who was bathing without a swimming suit – intra-euro area differences accentuated, real exchange-rate misalignments aggravated, the traded-goods sector shrank in the South and grew in the North, current-account imbalances widened and net foreign asset positions built up. The common monetary policy translated for the southern countries into too-low interest rates, triggering a major credit boom that fuelled domestic demand and resulted in an unprecedented increase in private indebtedness. Against this background, hopes that trade-creation effects could reduce asymmetries

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<sup>1</sup> References to the literature are kept at minimum in this paper. It is not intended to be a comprehensive survey.

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