Journal of Macroeconomics 39 (2014) 233–239

Contents lists available at ScienceDirect

Journal of Macroeconomics

journal homepage: www.elsevier.com/locate/jmacro

The Crisis in the Euro Area: An Analytic Overview

Heather D. Gibson [a], Theodore Palivos [b], George S. Tavlas [a,*]

[a] Bank of Greece, 21 E. Venizelos Ave., 102 50 Athens, Greece
[b] Department of Economics, Athens University of Economics and Business, 76 Patission Str., 104 34 Athens, Greece

ARTICLE INFO

Article history:
Available online 8 October 2013

JEL classification:
E51
E52
F33
F41
G01

Keywords:
Financial crises
Euro-area
Monetary integration
Optimum currency areas
Adjustment mechanism

ABSTRACT

This paper provides an introduction to the special issue "The Crisis in the Euro Area". We take stock of what the euro area crisis has taught us about monetary integration. At the inception of the euro area in 1999, the main parameters of the theory of monetary integration seemed to have been pretty well-settled. Although it was common knowledge that the euro area fell short of fully satisfying all the conditions needed for an optimally-functioning monetary union, most politicians and many economists thought that the euro area satisfied enough conditions so that it would not encounter major difficulties. This paper discusses several developments that came as surprises about the conditions needed for monetary unification as the euro crisis unfolded. These developments include the need of an adequate adjustment mechanism, the links between banking and sovereign crises, and the sharp costs of adjustment to adverse asymmetric shocks.

© 2013 Elsevier Inc. All rights reserved.

1. Introduction

The year 2009 was the tenth anniversary of the creation of the euro. Throughout the year, academic conferences were held to celebrate what at that time was widely considered to be the success of the boldest attempt ever by diverse sovereign states to reap the efficiency gains of a single currency. Despite the earlier misgivings of some economists about the feasibility of a common currency in Europe (e.g., Feldstein, 1997; Friedman, 2007), by 2009 evidence of the euro's success was plentiful. The euro had created a low-inflation, low-interest-rate environment (even for formerly high-inflation countries) conducive to sustainable growth. It had fostered trade integration and the integration of financial (and, to some extent, labor and commodity) markets among the members of the euro area. The number of participating countries had risen from eleven in 1999 to sixteen in 2009. Notwithstanding the eruption of the global financial crisis in August 2007 and its intensification in September 2008 with the collapse of Lehman Brothers, the euro area had been relatively unscathed by the effects of that crisis. To mark the euro's tenth anniversary, at the end of 2009 the European Commission published a study that sought to explain the reasons the skeptics of the single currency could have been so misled in their assessment of the euro's feasibility (Jonung and Drea, 2009).

Yet, amidst the celebrations in 2009, in Greece a shock was unfolding that, by the end of the year, would materialize into a full-blown financial crisis.[1] Krugman (2012, p. 4) would later characterize that shock as "the mother of all asymmetric shocks – a shock that was, in a bitter irony, caused by the creation of the euro itself." During the ensuing years, the euro crisis broadened

* Corresponding author. Address: Bank of Greece, 21 E Venizelos Ave., Athens 10250, Greece. Tel.: +30 210 320 2370; fax: +30 210 320 2432.
E-mail address: gtavlas@bankofgreece.gr (G.S. Tavlas).

[1] See Provopoulos (2014) for an analysis of the origins of the Greek crisis.

0164-0704/$ - see front matter © 2013 Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jmacro.2013.09.014

and deepened, threatening the sustainability of Europe's common currency. What had started as a sovereign-debt crisis in Greece spilled over to that country's banking system, creating twin crises. In other euro-area countries, including Ireland, Spain and Cyprus, the crises originated in the banking systems and spilled over to the sovereign debt. While at the time of this writing (August 2013) the euro-area crisis is by no means over (although it has subsided considerably), the events of the past four years provide the opportunity to take stock of what went wrong and what can be done to prevent future crises in the euro area.

In order to gain a better understanding of the issues involved, on May 23–24, 2013 the Bank of Greece held a conference on "The Crisis in the Euro Area." The papers presented at the conference examined two main sets of issues. One group of papers, adopting a union-wide perspective, assessed the aspects of the euro area's institutional architecture that, with the benefit of hindsight, may have contributed to the crisis, and the policy responses to the crisis at the union level. A second group of papers focused on developments in three crisis countries – Greece, Ireland, and Portugal. This issue of the *Journal of Macroeconomics* is comprised of the papers presented at the Bank of Greece conference and the discussions of those papers at the conference.

2. Monetary integration reconsidered

At the inception of the euro in 1999, the main parameters of the theory of monetary integration seemed to have been well-settled. Beginning with the work of Mundell (1961) on optimum currency areas, academic research had delineated (i) the conditions under which nations should adopt a common currency and follow a common monetary policy, and (ii) the benefits and costs of participating in such a currency arrangement. The literature pointed to several key conditions that were thought to be necessary for joining a common-currency area. These included the similarity of structural characteristics (e.g., labor market institutions, inflation rates, levels of economic development, and production structures) among the participants to reduce the incidence of asymmetric shocks, and the existence of adequate adjustment mechanisms (e.g., labor mobility and fiscal integration) to lessen the impact of asymmetric shocks, should they occur. The benefits of a common currency were shown to include the elimination of both currency risk and competitive devaluations, lower inflation for countries with histories of high inflation (providing that the central bank of the monetary union follows a credible monetary policy), reducing the uncertainty produced by inflation distortion, increased transparency and possibly greater competition in product markets because of the ease of comparing prices, the lowered risk premia incorporated into the cost of raising capital, and reduced costs of servicing the public debt stemming from the reduction in risk premia in domestic interest rates, a factor that would facilitate fiscal adjustment and free resources for other uses. The main disadvantage attributed to a common currency was the reduced flexibility to adjust to asymmetric shocks because of the loss of (i) monetary-policy independence and (ii) the ability to use the exchange-rate instrument to change the terms of trade in order to restore external and internal balance.

It was common knowledge in 1999 that the members of the euro area did not fully satisfy all the conditions for a monetary union. Empirical studies had shown that the participants were subject to asymmetric shocks, with a clear divide among northern and southern members (De Grauwe, 2012, pp. 76–80) while Europe fell far short of the United States, for example, in terms of labor mobility and (especially) fiscal integration.

Despite the existence of asymmetric shocks and the lack of sufficient adjustment mechanisms, European political leaders and many economists thought that monetary union would succeed without major difficulties. What accounted for their optimism? First, they believed that the incidence of (fiscal-induced) asymmetric shocks would be reduced if countries maintained sound fiscal policies (Krugman, 2012). Second, they thought that, with the reduced ability to use demand-side policies to counter asymmetric shocks, national policy makers would undertake structural reforms, including the freeing of labor and product markets, to lessen the impact of asymmetric shocks. Third, they thought that since the euro would eliminate exchange-rate risk from national interest rates it would be easier to evaluate risk characteristics and, therefore, investment opportunities across countries. In other words, the elimination of exchange-rate risk would lead to increased market discipline on governments (Fernández-Villaverde et al., 2013, pp. 146–48).

Four years into the euro-area crisis, what have we learned about the underpinnings of monetary integration? Clearly, those who thought that all the participants in the euro area would take the necessary fiscal and structural measures to ensure the success of the common currency were overly optimistic. In addition, the unfolding of the euro-area crisis has revealed that the state of the theory of monetary integration, *circa* the late-1990s, was incomplete. In what follows, we sketch several developments that came as surprises as the euro-area crisis unfolded – developments that were not foreseen by policy makers or, for the most part, discussed in the academic literature.

3. The adjustment mechanism

An underlying feature of the euro-area countries that have been hit by crises is that they experienced large and growing current-account deficits in the years leading up to the crises (Holinski et al., 2012; Honkapohja, 2014). At the time of the inception of the euro area, a prevailing view was that current-account imbalances among participating countries should not be a major concern in a monetary union (Blanchard and Giavazzi, 2002). Underlying this view is the idea that intertemporal utility maximization helps ensure that diverging current-account positions are the natural consequence of a convergence

Download English Version:

https://daneshyari.com/en/article/965346

Download Persian Version:

https://daneshyari.com/article/965346

Daneshyari.com