The international monetary system and the Eurozone

MSE-MGU (1)

Jacques SAPIR

Professor of Economics

EHESS-Paris

- **What is the lecture about**.
  - What is the international monetary system and how it evolved since Bretton Woods
  - What is the actual economic situation of the EMU? (European Economic and Monétary Union
  - What is the responsibility economists, why are they so violently diverging, how are tools available reliable?
  - How the situation could lead to a complete change in the international monetary system?

- **How we will proceed**
  - The virtual (or electronic) library.
  - Inter-active lectures.
  - Examination.

WARNING:
Important documents to be read before the actual lecture.

Students are expected to read carefully each "lecture bibliography" on the electronic library. This is why, the complete bibliography is communicated before the lectures begin. Only part of the complete bibliography is however mandatory reading, but the whole bibliography is important to fully understand the whole curriculum.

Content of the electronic library:

- **Chapter 1.**

- Bibow, J., "The Euro and Its Guardian of Stability: Fiction and Reality of the 10th Anniversary Blast." In *Monetary Policy and Central Banking: New Directions in Post- Keynesian Theory*, edited by L.-P. Rochone and Salewa 'Yinka Olawoye. Cheltenham, U.K. and Northampton, MA, U.S., Edward Elgar, 2012, pp. 190-226.
- Bibow, J., "At the Crossroads: The Euro and Its Central Bank Guardian (and Savior?). *Cambridge Journal of Economics*, Vol. 37, 2013, (3), pp. 609-26.
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- **Carney M (2009). The Evolution of the International Monetary System, Foreign Policy Association, New York City.**
- **Grabbe (1996), International Financial Markets, 3rd edition, by J. Orlin Grabbe, 1996 Prentice-Hall, Inc., a Simon & Schuster Company, Englewood Cliffs, New Jersey.**
- Kenen, P.B. (1969). "The Theory of Optimum Currency Areas: An Eclectic View, " in Mundell R.A. et A.K. Swoboda (edits) *Monetary Problems of the International Economy*, Chicago, Ill., Chicago University Press.
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- European Central Bank : Technical Features of Outright Monetary Transactions, Press Release, September 6, 2012, http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html

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- European Commission, PRESS RELEASE, (pdf).
- European Commission, REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation, July 10, 2013, (pdf).
- Gomis-Porqueras P. and Puzello L., *Winners and Losers from the euro*, Working Paper, 2014.
- Rose, A.K. (2000), « One money, one market: the effect of common currencies on trade », *Economic Policy* Vol. 30, pp.7-45 et Rose, Andrew K., (2001), “Currency unions and trade: the effect is large,” *Economic Policy* Vol. 33, 449-461.
- Sapir J. The Euro vs Europe, report for the Valdai Club, Moscow, March 2017

- **Chapter 2**

- Hein E. and Truger A., **Fiscal Policy and Rebalancing in the Euro Area: A Critique of the German Debt Brake from a Post-Keynesian Perspective** The Levy Economics Institute, Septembre 2013 (in PDF)
- Bibow J., **Germany and the Euroland Crisis: The Making of a Vulnerable Haven,** The Levy Economics Institute, Septembre 2013 (in PDF)
- Brecht, M., Tober, S., Truger, A. and van Treeck, T. 2012. « Squaring the Circle in Euro Land? Some Remarks on the Stability Programmes 2010-2013 » In Papadimitriou, D.B. and Zezza, G. (eds.), *Contributions to Stock-flow Modeling. Essays in Honor of Wynne Godley*. Basingstoke, UK: Palgrave Macmillan.
- Europeam Council. 2012. *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, 2 March 2012, (Brussels: European Council). (http://www.consilium.europa.eu/media/1478399/07_-_tscg.en12.pdf.)
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- **Chapter 3.**

- Baum A., Marcos Poplawski-Ribeiro, and Anke Weber, *Fiscal Multipliers and the State of the Economy*, IMF Working Paper, WP 12/286, December 2012. (pdf)

- Blanchard O., et D. Leigh, *Growth Forecast Errors and Fiscal Multipliers***,** IMF Working paper, WP 13/1, January 2013, (pdf).
- Eggertsson Gauti B., and Paul Krugman, DEBT, DELEVERAGING, AND THE LIQUIDITY TRAP: A FISHER-MINSKY-KOO APPROACH, The Quarterly Journal of Economics, 2012, n−6. (pdf)
- Galbraith, J.K., "The collapse of Monetarism and the Irrelevance of the New Monetary Consensus", *Public Policy Note 2008/1*, Annadale-on-Hudson, N.Y., The Levy Economics Institute of Bard College, 2008.
- Goodhart, C.A.E., "The Continuing Muddles of Monetary Theory: A Steadfast Refusal to Face facts", paper presented to the 12 th Conference of the Research Network *Macroeconomics and Macroeconomic Policy* , Berlin, Germany, October 31 st – November 1 st , 2008.
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- **Chapter 4.**

- Athanassio, P. (2009). "Withdrawal and Expulsion from the EU and EMU: Some Reflections. », ECB, *Legal Working Paper*, No. 10, December. http://www.ecb.int/pub/pdf/scplps/ecblwp10.pdf
- Berger Helge, and Volker Nitsch, *The Euro's Effect on Trade Imbalances*, IMF Working Paper, WP/10/226, October 2010. (pdf).
- Bootle, R. (2012). "Leaving the Euro: A Practical Guide. » Capital Economics, https://www.capitaleconomics.com/data/pdf/wolfson-prize-submission.pdf
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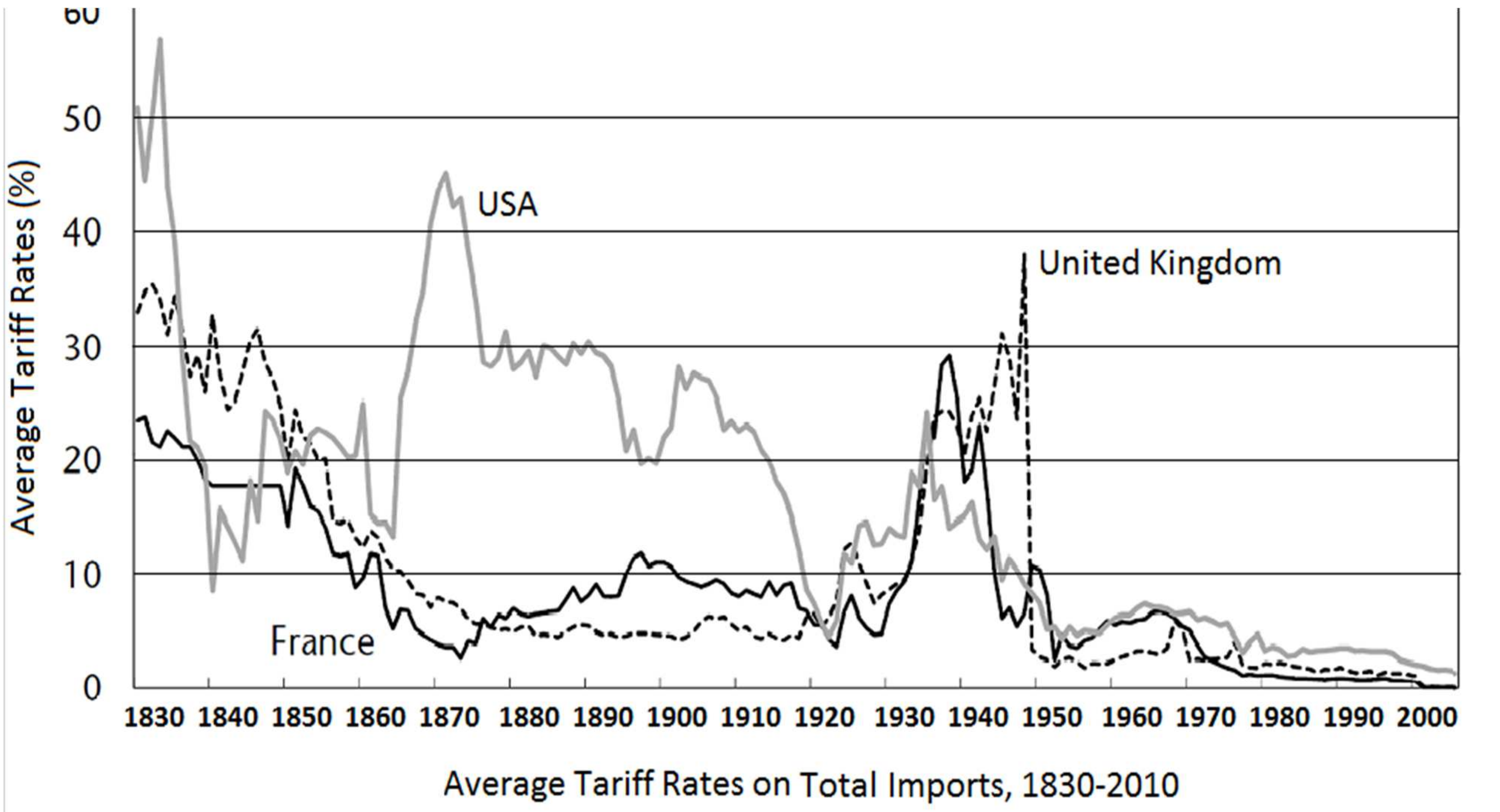
- **1**
- **The International Monetary System and the EMU**

I

The Origins of the International Monetary System

- **1. Before Bretton Wood (pre-1914)**
- From the 2nd half of the XIXth century to the outbreak of World War I in 1914, the world benefited from a well integrated financial order, sometimes known as the "First age of Globalisation".
- Transactions were facilitated by widespread participation in the gold standard, by both independent nations and their colonies. Countries switched from the silver standard to adopt the "gold standard" which was dominated by Great-Britain (France, Russia)
- If money and capitals were more or less free to circulate, protectionism was quite important in this time with Tariffs established by all countries but GB from 1875 on:
  - USA (Mc Kinley), France (Méline), Russia (Mendeleïev and Witte), Germany

Protectionism (late XIXth century)



Sources: Imlah, Economic Elements

- **2. The “Inter-Wars” period**
- Consequences of the First World War (and the seminal book from Keynes: *The Economic Consequences of the Peace*.). The massive inbalances linked to the war. The United States, however, was reluctant to assume Great Britain's leadership role, partly due to isolationist influences and a focus on domestic concerns.
- The “return” to the Gold Standard and the “Golden Bloc” (UK and the fateful decision on 1924).
- The collapse of the international monetary system and the “floating” rate

Pre-1945 international monetary system

	System	Assets	Leaders
1803–1873	Bimetallism	Gold, silver	France, UK
1873–1914	Gold standard	Gold, pound	UK
1914–1924	Anchored dollar standard	Gold, dollar	US, UK, France
1924–1933	Gold standard	Gold, dollar, pound	UK, France

• 3. The Bretton Woods system

- The objective was to create an order that combined the benefits of an integrated and relatively liberal international system with the freedom for governments to pursue domestic policies aimed at promoting full employment. Architects of the new system: John Maynard Keynes and Harry Dexter White
- A system of fixed but adjustable exchange rates where the currencies were pegged against the dollar (to the contrary of what Keynes wanted), with the dollar itself convertible into gold. So in effect this was a gold – dollar exchange standard.
- The new exchange rate system allowed countries facing economic hardship to devalue their currencies by up to 10% against the dollar (more if approved by the IMF) – thus they would not be forced to undergo deflation to stay in the gold standard. A system of capital controls was introduced to protect countries from the damaging effects of capital flight and to allow countries to pursue independent macro economic policies

4. A system without a name?

- But Bretton Woods was not the actual system implemented as several “sub-systems” were actually in operation:
  - The European Payment Union
  - Japan
- The international Monetary system was actually a “Western” system as USSR, China and Eastern Europe were not part of it.
- The Rio conference (1964) and the creation of the SDR
- The Vietnam War, the Gaullist attempt to undermine the system and its final demise

The post-1945 international monetary system

	System	Assets	Leaders
1945–1971	Anchored dollar standard	Gold, dollar	US and possibly G10
1971–1973	Dollar standard	Dollar	US
1973–1985	Flexible exchange rates Dollar,	Dollar, mark, pound	US, Germany, Japan
1985–1999	Managed exchange rates	Dollar, mark, yen	US, G7, IMF
1999- ?	Toward disintegration ?	Dollar, euro, Yen, Yuan	US, Eurozone, IMF, China

- **5. What were main problems in the 1970's and the 1980's.**
- The "Dollar domination" and the consequences of the 1973 decision.
- The "German domination" in Europe. Why interest rates became slave of Germany's ones.
- The floating rates and speculative attacks.
- The growing financiarisation of economies
- The prospects of the EMU

II

Why a « monetary union » and what arguments are to support the case of the European Monetary Union

- **1. Fundamentals**

- The theory of optimum currency areas (or OCA) was stated by economist Robert Mundell in 1961. He founded the theoretical reasons for the existence of areas where it would be advantageous to have only one currency. The OCA theory is based on the assumption of perfect mobility of factors (Labour and Capital).
- McKinnon (1963) then explains that the process of opening-up an economy on the outside is greatly reducing the importance of the exchange rate. The value of an adjustment in the exchange rate is low if the economy is largely open. However, he admits that adjustment could be important when facing what is called an «exogeneous shock ».
- Peter Kennen shows that if the country's economy is diversified, that diversification reduces the magnitude of what economists call "exogenous shocks" and allow the country to be linked to others by a fixed exchange rate.

- **2. What was forecasted**

- Andrew Rose has assumed in 2000 that monetary union could lead to a huge increase in trade flows between countries in the currency area thus formed and grow production accordingly. In the early works of Andrew Rose an increase in the internal trade of 200% and even more was then assumed.
- But the initial work of Rose were heavily criticized on the econometric method used. A more fundamental criticism was that these models do not take into account the persistence of international trade. Finally, these models neglect the existence of endogenous factors in trade development, factors that are not affected by the existence - or non-existence - of a currency.
- This led to a fundamental rethink of résultats. Capitalising on nearly twenty years of research on international trade Harry Kelejian made a new estimation of effects of monetary union on the international trade of member countries. The impact of the Economic and Monetary Union was then an estimated trade growth of 4.7% to 6.3%, not 200% as initially estimated by Rose.

- **3. Assessing the EMU**

- Works done by Jorg Bibow and other show that the Economic and Monetary Union has created in Europe a low-growth area. One of the reason behind was the very low mobility of labour and the imperfect mobility of capital. This low growth has important consequences for the world economy as a whole.
- Moreover, the impact of the exchange rate was revaluated in several recent studies. IMF economists have made a fairly systematic study of fifty countries. They found no sign of the famous "disconnection" as quoted by Peter McKinnon or Kennen between international trade flows and exchange rates. The study shows that on average for a depreciation of the exchange rate of 10% we have an average gain of 1.5% of GDP.
- The impact of the Economic and Monetary Union appears as disturbing when looking at developments not only of growth but also of investment for the countries concerned.

- **4. The long ongoing crisis**

- The Economic and Monetary Union has been established as the basic institutions for its success were not present. There is still no social or fiscal harmonization in the eurozone. Also it lacks a budgetary mechanism of solidarity between countries of the Euro zone. Germany has consistently opposed such a mechanism.
- The Economic and Monetary Union has faced a major exogenous shock to the financial crisis of 2007-2009. This exogenous shock has multiplied the asymmetries present at the creation of the Euro Zone. This unfortunately was to be expected.
- This exogenous shock has highlighted the fact that the structures adopted by the countries of the Euro zone to obtain a convergence of fiscal policies resulted in paralyzing the budget and fiscal policies and left to monetary policy alone the responsibility to fight against the economic crisis.

- **5. The disciplinary framework of the EMU**

- The Economic and Monetary Union stems from the "Maastricht Treaty" signed on 7 February 1992. In this treaty was defined a "monetary union" in which the signatory countries had to "qualify" by supporting constraints on the size of the deficit budget (rule of the "3%") or on the public debt (60% rule). This was confirmed by the Pact for Stability and Growth, or PSC, this Pact was adopted at the Amsterdam summit on 17 June 1999. If the domain of fiscal policy remains in theory the domestic jurisdiction, a warning system allows the Council bringing together the ministers of economy and finance of the Union, called the Ecofin Council, on a recommendation to the State in case of permanent fiscal slippage.
- The ECOFIN Council may then make recommendations to the State does not respect the clauses of the treaty put an end to this situation. If it does not, this Council may take sanctions: deposit with the ECB which can become a fine (0.2 to 0.5% of the state GDP in question) whether the excessive deficit does is not filled.
- On 22 and 23 March 2005, the Heads of State and EU governments decided to revise the Stability and Growth Pact and make it more restrictive. This led to the creation of the procedure for "excessive deficit". The 2007-2008 financial crisis led to a latent crisis of EMU. This crisis provoked, then the implementation of a set of five regulations and one directive proposed by the European Commission and approved by the 27 member states and the European Parliament in October 2011. We call this group of measures the "Six- Pack "

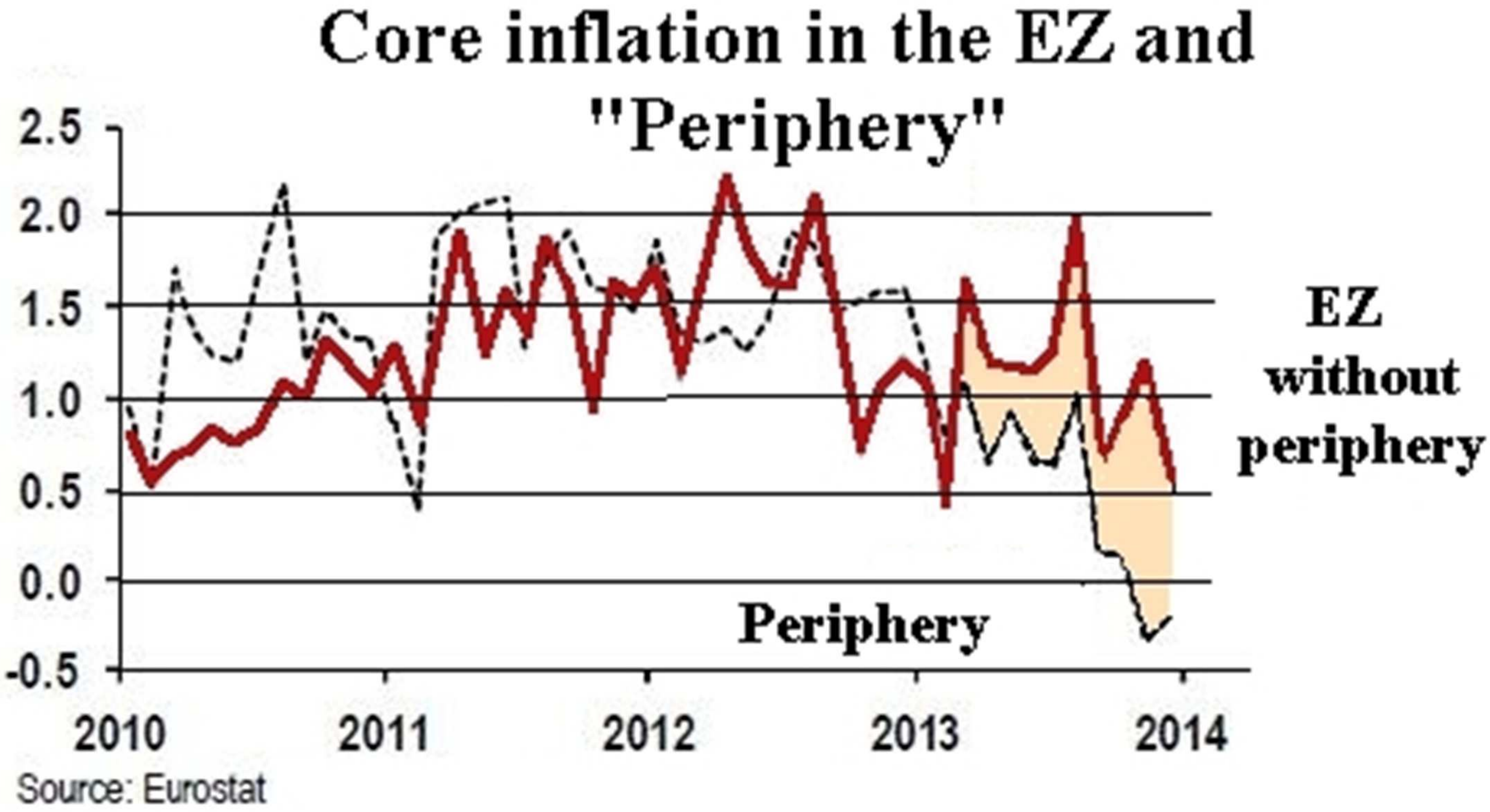
- Thus, a procedure for excessive imbalances will now be launched and sanctions be taken against the States on a series of indicators: a moving average over three years of the current account as a percentage of GDP evolution market share for exports, or a three-year change in nominal unit costs of labor. It is also one of the indicators the change over three years of real effective exchange rates relative to 35 other industrial countries, the private sector debt as% of GDP (160% level), the credit flow to the private sector % of GDP (15% threshold) and changes year on year in real estate prices compared to a consumption deflator calculated by Eurostat last debt of the general government sector% of GDP.
- The disciplinary framework induced by the Euro was already well established by the end of 2011. However, it is with the Treaty on Stability, Cooperation and Governance, a treaty that was negotiated by Nicolas Sarkozy and Angela Merkel, but which was ratified under the presidency of Francois Hollande in October 2012, we took a decisive course. This is a mechanism which agreed 25 of the 28 Member States of the European Union.The Treaty on Stability, Coordination and Governance supports the European Commission to ensure the implementation of the rules adopted offering a convergence schedule signatory states. In this, it is a milestone in the process of transferring sovereignty to the European Commission which, it must be remembered, is an unelected body and irresponsible to the European Parliament.

III

The EMU crisis: No stabilization but a temporary respite

1. The interest rates situation – A comparison.

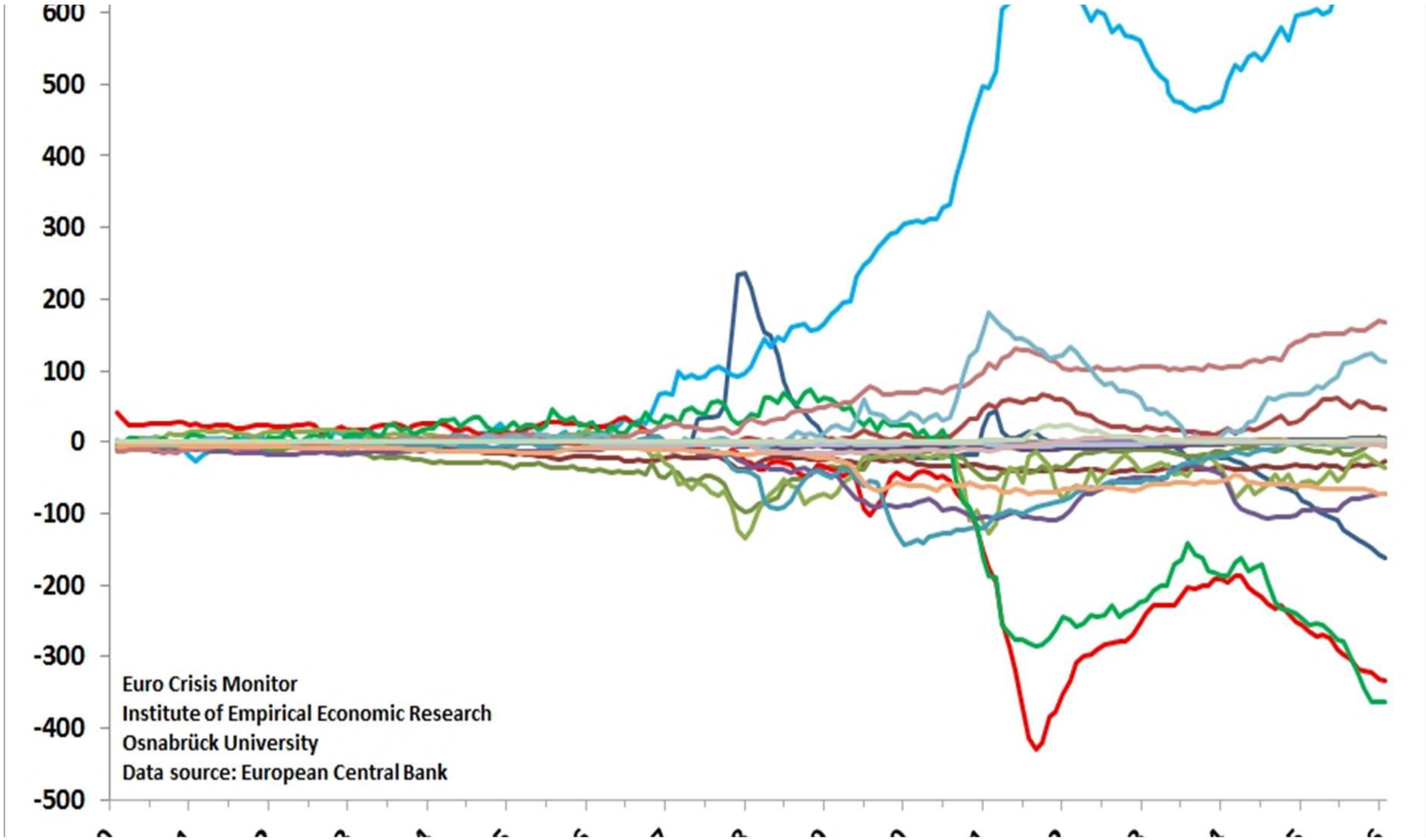
- **a. What has been the evolution of interest rates and the Policy of the BCE.**
  - Italy:
  - Spain
  - France
  - Germany
- **b. From LTRO to OMT: the powerful but limited actions of the ECB.**
  - What has been the LTRO
  - The OMT and the Damocles' Sword of the German Supreme court.
  - The failure of the "new" LTRO (September 2014)
  - Mario Draghi "new" quantitative easing
- **c. What is the possibility for a new speculative crisis?**
  - A situation now relatively under control.
  - But serious problems problems still present.
  - A Southern Europe systemic frailty


Core inflation in the EZ and "Periphery"
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
2010
2011
2012
2013
2014
EZ without periphery
Periphery
Source: Eurostat

- **2. Real vs. Nominal rates.**
  - **a. How real interest rates are evolving.**
    - » The recent swing and the turn toward “negative rate”.
    - » Investment figures.
  - **b. What do they implies for economic agents?**
    - » A proxy of financial costs.
    - » When nominal rates are relevant.

- **3. What are the transmission tools left for monetary ?**
  - **a. Asset prices and the wealth effect.**
    - » A difference between USA and Europe.
    - » The distribution of assets.
  - **b. The funding of economic activity.**
    - » Households
    - » Non-financial enterprises.
  - **c. Depreciation and appreciation of a currency.**
  - **d. The Target2 issues.**

Investment rates of non-financial entreprises in the EZ and the EU-28



- **4. The situation of the banking sector and the Monetary union.**
  - **a. Is European banks situation good?**
    - » Asset prices and the business cycle.
    - » The “Minsky depression” effect.
    - » The situation in large European economies and the amount of “bad loans”.
      - » Italy 18% (1/2017)
        - » Spain 14,6%
  - **b. What is the reality of the Banking Union.**
    - » What was aimed for.
    - » From 2012 to 2014: a long bargaining.
    - » The German position.
    - » Banking union: protracted birth or illusion?
  - **c. Why some countries are against the banking union.**
    - » The French/German divide and the union.
    - » The Banking Union and the European project.

- **5. Is the situation stabilized?**
  - **a. Short term, medium term and long term stability.**
    - » A short term quietness.
    - » Growing problems in the medium term.
    - » Unsolved problems are a cause of concern for long-term stability.
  - **b. Can a sound monetary situation develop in a bad real-sector one?**
    - » Can a single monetary policy manage an heterogeneous Union?
    - » Do the EU has the power to balance structural heterogeneity?
    - » How an unsound real sector translate into the monetary economy?

- European Commission, REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation, July 10, 2013, (pdf).

- European Commission, PRESS RELEASE, (pdf).

- Commission Européenne, December 12th, 2011, « EU Economic governance "Six-Pack" enters into force », http://europa.eu/rapid/press-release_MEMO-11-898_en.htm

  – And

- Bibow, J., "At the Crossroads: The Euro and Its Central Bank Guardian (and Savior?) » *Cambridge Journal of Economics*, Vol. 37, 2013, (3), pp. 609-26.