I will speak from the point of view of a citizen of the South who is looking at what has happened in the euro area and worries about its future.

The North-South divide, or debtors-credits divide, makes the euro area feel like it is 1997. Only Germany feels it qualifies for the Economic Monetary Union (EMU); the others must adjust before they can receive any benefit from monetary union.

This implies that some countries are stuck in a fixed exchange rate system with just the minimum benefit from monetary union. We know this doesn't work.

A monetary union needs an insurance mechanism. Insurance via bail-ins won't work. A union of stability can't be based on defaults. What is the rationale? Mostly short-term German domestic politics, which is the wrong way of designing the future of EMU.

This divide feels very similar to the debate on inequality—why is there an obsession with fiscal and monetary austerity? Because, at the margin, it benefits the wealthy. Why did Japan take so long to fight deflation? Because rural voters, overrepresented in the Diet, didn't mind and politicians just wanted to be reelected.

It is the same in EMU now. At the margin, all the policy choices benefit a German minority. I wonder how sustainable this is.

Let me discuss three points (1) the neglect of the demand side, (2) the asymmetric focus on rules, and (3) the insistence in the wrong narratives. None of this is really new, but it continues to impede the adoption of the right policies.

1. The neglect of the demand side

The euro area has the tightest policy setting in the G-7, with long term interest rates still positive versus negative in the United States, the United Kingdom, and Japan—and I would say probably in the G-20, given the growth and inflation outlook (figure 1). Both fiscal and monetary policy are too tight, lending conditions are very tight, and the euro is overvalued.
It is time we admit that reforms without demand stimulus don't work. But not only that, it is time to admit that tight demand policies hurt potential growth via hysteresis effects in long term unemployment. Research by the European Central Bank (ECB) shows that about 25 percent of cyclical unemployment becomes structural after 12 months. The cyclical policy mix is just inconsistent with the insistence on reforms. Monetary policy has a responsibility in supporting potential growth.

I've been watching Japan since 1997. Japan tried for a long time to implement monetary austerity, to put all the focus on government policies, and failed. The result, I should remind the audience, was the government taking over the central bank. Independence must be earned and deserved. And the mood in Japan has improved materially with the Bank of Japan's (BoJ) new monetary policy strategy.

In Europe we think that because we are doing the asset quality review (AQR) everything will be okay. Why? Japan did its AQR in 2002, and deflation never really improved. US banks have been well capitalized for a few years now, and corporations are swimming in cash. And yet, only in the fifth year of recovery and after a few years of negative real rates is lending starting to pick up. Supply doesn't create its own demand. Why should the euro area be different?

Let's not forget that former Federal Reserve Chairman Ben Bernanke and Mark Gertler’s financial accelerator is mostly demand driven, and the key transmission channel is adverse selection. Banks don't lend to small and medium enterprises (SMEs) because the outlook is grim, not because of lack of capital. We are getting too stuck in the minor details of how quantitative easing (QE) may or may not work. QE works by showing that the central bank is serious about its mandate and will deliver a good macro outlook. That's what the ECB's Outright Monetary Transactions (OMT) program did, after all. It is the insurance channel of monetary policy.

We must look at the big picture. The Bank of England's (BoE) recent experiment with forward guidance has been very telling: Corporates have internalized the guidance "everything will be okay, we'll be as slow raising rates as needed in order to deliver the growth and inflation outlook". All they want to know is that growth will be okay and rates not too high.

2. The asymmetric focus on rules

The asymmetry in the application of the rules is observed in several ways.

On the one hand, the asymmetry in the design of the excessive imbalances procedures: Current account deficits of more than 3 percent are penalized, but penalties apply only to current account surpluses of more than 6 percent. Why? Because when the rule was created, Germany already had a surplus of more than 3 percent.
It is true that an excessive deficit can create more problems than excessive surplus. But it is also true that the surpluses of Germany, now above 6 percent, are a reflection of their lack of commitment to the euro. After all, Germany is one of the countries that has done less in terms of reforms in recent years and refuses to take steps to boost domestic demand and contribute to the growth of the euro area—for example, liberalizing the service sector and reforming its antiquated banking system to reduce its excessive level of savings.

On the other hand, the asymmetry in the application of the rules of fiscal and monetary policy is palpable. There is constant insistence that the multiple rules of fiscal adjustment must be met, but the ECB is allowed to adopt a monetary policy that violates its price stability mandate (see figure 2), complicating the fiscal adjustment. Why?

Because one of the consequences of the ECB try to increase inflation in the euro area to 2 percent is that inflation in Germany will have to increase towards 3 percent (as inflation in the countries of the periphery is likely to stagnate at low levels), and this will be politically complicated for Germany.

In addition, remember that the world is stochastic, not deterministic. Imagine the euro area has a negative shock, like Japan did, and falls into deflation. Could the ECB do what the BoJ is doing now, and openly declare that it wants to inflate the economy? It is not clear, given the political climate in Germany. Therefore why run the risk now?

It seems clear to me that if interest rates were positive, the ECB would be cutting rates, no question. It also seems clear to me that if inflation were near 3 percent and inflation expectations had increased, the ECB would be tightening policy aggressively. The ECB’s asymmetry is damaging the euro area economy. The ECB is accountable to the euro area, not to Germany.

So here a proposal for a change in rules to reduce the asymmetry. Bring to the ECB the best practices of other central banks, and change the price stability mandate to inflation at 2 percent, symmetric, over 2 to 3 years. If this rule were in place now, the debate would be much simpler.

3. The insistence in the wrong narratives (which lead to policies driven by the politics of the perceived winners)

The most powerful impact of a crisis is the narrative, as it dictates the policy reactions. The key narrative of the crisis is that Germany is the best performer thanks to reforms and fiscal consolidation. Running a current account surplus is a sign of economic success. Therefore it must follow that the German economic model is a success. This conclusion is not so clear. Germany’s GDP per capita growth has been similar to France’s over the last few decades.

First narrative. Germany’s overperformance is structural. Figure 3 shows the very sharp relative monetary easing in Germany versus Spain and Italy. This doesn’t capture the whole extent of
tightening, as the sudden stop in the periphery led to “infinite” interest rates in some sectors. The surprise is that the recession in the periphery wasn't sharper. The increase in the interest cost of debt also meant that to achieve a given reduction in the structural balance, the periphery had to adopt a much more drastic reduction in the primary deficit. Germany was in better shape than others at the beginning of the crisis because it had no drag from housing. But that is not by design; it is by the vagaries of history, as Germany had its housing bust a generation before. The key source of overperformance in Germany is a massive monetary easing—in fact, Germany enjoyed a policy easing similar to the United States. Germany, de facto, has enjoyed quantitative easing. It is mostly cyclical policy, not reforms or fiscal austerity, what has driven the overperformance.

Second narrative. Everything will be solved via competitiveness gains, and the German export boom is due to the wage moderation of the 2000s. Yes, we all want higher potential growth, and competitiveness will help. But what really matters for exports is the right product mix and external demand.

Chen, Milesi-Ferretti, and Tressel (2012) show that the current account differentials in the euro area were explained mostly by strong demand for German products from China and Middle East (who benefitted from oil wealth) and the use of offshoring to lower costs. Yes, German wage growth was flat. But the export boom came mostly from having the right product and geographical portfolio of exports, not from wage moderation. What wage moderation did was to suppress consumption.

Spain has regained competitiveness based on real equilibrium exchange rate (REER) charts. But Spain's recent export boom has not been due to lower export prices, but rather strong demand from emerging markets and good product mix. In fact, lower wages have gone to higher export margins, not to lower export prices. Something like firm size—which reforms must address, no question—is much more important for the export outlook than wage moderation.

So the question is: Were the aggressive wage cuts in the periphery really worth it? They haven’t contributed much to export growth: They have depressed confidence and demand and increased inequality.

Conclusion

The euro area is no longer a club of equals. It has become a club of lenders and borrowers, of first and second class members, of each country for itself, of punishing the sinners. That led to the disastrous Deauville declaration that sharply amplified the GDP cost of the euro area crisis, and that divergence remains the key fragility of the euro area. There is little solidarity left, and no clear intention to restore it. The many constraints put to the European Stability Mechanism (ESM) and Single Resolution Mechanism (SRM), the insistence in the “legacy assets” doctrine, demonstrates this. We hail process as success, but there isn't much substance in what has been achieved so far in completing the economic infrastructure of EMU.
Let’s be very clear: The crisis abated because of the announcement of OMT and the German decision to stop pushing for a Greek exit (basically, the correction of two self-inflicted mistakes), not because of any reform or banking union noise. Once the mistakes were corrected, markets reacted accordingly. Unfortunately, along the way a lot of permanent damage was caused.

So when the next recession comes (don’t forget the United States is in its fifth year of expansion already), with debt ratios at 100 percent of GDP, will markets take the crisis as a template and debate default and exit again? Will fiscal policy have to become procyclical again?

The long run interest rate versus growth differential is positive in the euro area, while being negative in the United States, the United Kingdom, and Japan. One can argue spreads need to be positive to match differential outlooks, but real rates also have to be adequate to facilitate fiscal adjustment. Otherwise we are setting ourselves up for failure.

Of course, with eurobonds this wouldn’t be an issue. Thus my suggestion—a blue/red eurobond framework, with blue eurobonds worth 30 percent of GDP to ensure fiscal policy doesn’t become procyclical in a systemic crisis and the rest red eurobonds. This framework would create insurance while preserving discipline. And, very importantly, having blue eurobonds would eliminate any doubt about the ability of the ECB to undertake QE, as it would have plenty of blue bonds to buy.

The European elections have put the process of improving the economic infrastructure of EMU on hold. The improvement in market sentiment shouldn’t create complacency; there is still a lot to do to make EMU a true monetary union. Otherwise, when the next negative shock arrives, it will be much more difficult to deal with it.

Reference

Figures

Figure 1 The evolution of 10-year real rates

Figure 2 EU inflation term structure
Figure 3 The evolution of 10-year real rates

- Germany
- US
- UK
- Spain
- Italy