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Financial (*Dis*)Integration of the Euro area
Some considerations from an analysis of ECB's official reports

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Lecture Contents

1) The ECB reports' bias

2) The role of external imbalances

3) A simple example

4) Are austerity measures irrational?

5) Is there an alternative?

6) Final remarks

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What is wrong in ECB's analysis of the crisis?

- Thesis: a clear 'quantitativist' and 'equilibristic' bias prevented the ECB's staff to rightly interpret the signals and the nature of the crisis of the Euro area. This bias, along with the harsh conflict between different country-based capitals (and social classes), still prevents the Euro area to exit the financial turmoil and the economic recession.

- According to the ECB's staff the crisis has been triggered by the *Lehman Brothers*' collapse and the resulting world-wide financial turmoil. The 'flight to safety' of international investors eventually hit weakest (i.e. most indebted) European economies.

- It is true that *LB*'s bankruptcy was the trigger, however…

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Trigger, fuel and oxygen of the crisis

1) Trigger of the (American and then European) crisis: *LB*'s collapase (**financial or *final* cause**)

2) Fuel of the crisis: permanent 'external imbalances' of Euro area member-states (**real or *first* cause**) and not governments' profligacy

3) Oxygen of the crisis: the status of the ECB (**institutional cause or *unmoved mover***)

Points 2 and 3 have been clearly undervalued by ECB's staff. Why? External imbalances were regarded as signal that integration was proceeding. The 'independence' of the central bank is one of the dogmas of the Washington Consensus and the linked neoliberal paradigm.

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The real cause: 'external imbalances' within the EMU

- External imbalances = Imbalances in the 'balance of payments' (BOP)

- BOP = accounting record of all monetary transactions between a country and the rest of the world (i.e. exports and imports of goods & services, and in/out-flows of capitals)

- One of the components of the (current account of the) BOP is the **balance of trade**, that is, the difference between the monetary value of exports and imports (over a certain period). More precisely:
  - Imports > exports = **trade deficit** → foreign debt
  - Exports > imports = **trade surplus** → foreign credit

Balance of Payments (Italy Dec. 2012*, Millions Euro)

Exports   **Imports**   **Balance of trade**

Current Account

	Credits	Debts	Balance
Goods	**390.150**	**370.150**	**20.000**
Services	82.762	82.983	-221
Incomes	51.081	62.271	-11.190
Curr. Transfers	18.292	36.379	-18.087
			-9.498

Capital Account

	Credits	Debits	Balance
Cap. Transfers	3.147		
Intangible Assets		2.364	
			783
Total (Current + Capital)			**-8.715**

Financial Account

	Assets	Liabilities	Total
Direct Investment	-23.836	6.832	-17.004
Portfolio Invest.	59.701	-23.164	36.537
Derivatives	10.218	-8.491	1.727
Other Investment	-43.269	38.572	-4.697
Change in Off. Reserves	-1.461		-1.461
			15.102
Errors & Omissions			-6.386

Source: our elaboration on Bank of Italy statistics (March 2013)   (*) 12 months ending in Dec. 2012

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A two-country artificial economy

- **Similar (but not identical) outputs**
- **Free trade and mov. of capitals (same rate of profit)**
- **Preference for a balanced basket**
- **Same rate of growth**
- **Same degree of competitiveness**

Country A

Country B

- **Produces A-good**
- **Issues currency A**

- **Produces B-goods**
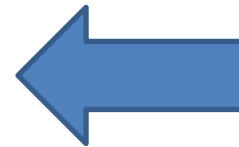- **Issues currency B**

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Same degree of competiveness

- What is competiveness?

- If outputs are similar, competitiveness depends on **price**:

$$\text{price} = \left(\frac{\text{nominal hourly wage}}{\underbrace{\text{hourly labour productivity}}_{\text{unit labour cost} \rightarrow \text{competivness}}} \right) \times (1 + \text{rate of profit})$$

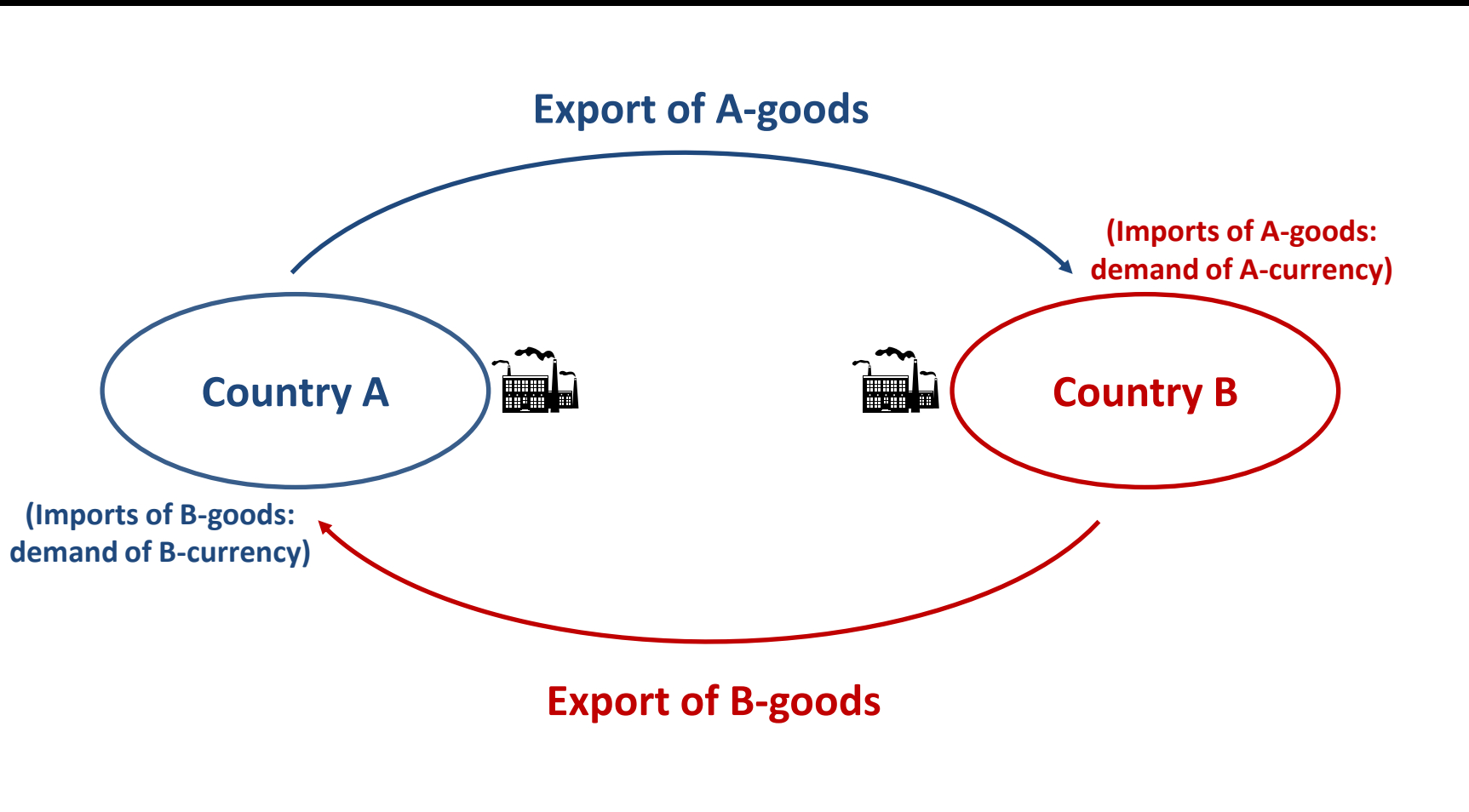- What matters is *change in* price level (i.e. **inflation rate**), that is:

$$\boxed{\underbrace{\Delta \text{ price}}_{\text{inflation}} = \Delta \text{ wage} - \Delta \text{ productivity}}$$
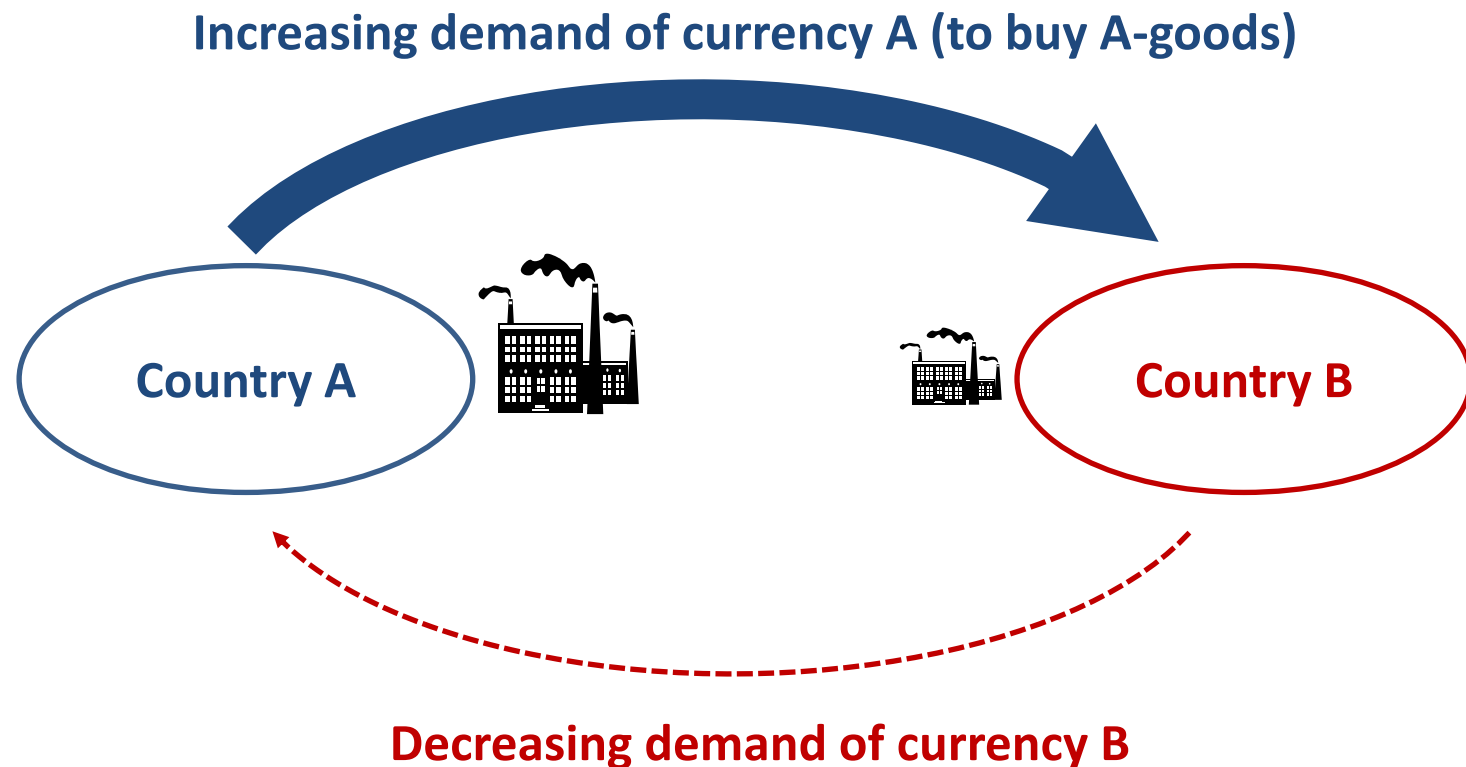
Two production systems and two currencies

What if country A becomes more 'competitive'

Export of A-goods increases
(because of an 'improvement' in either wage-cost or productivity)

Country A

Country B

Export of B-goods reduces
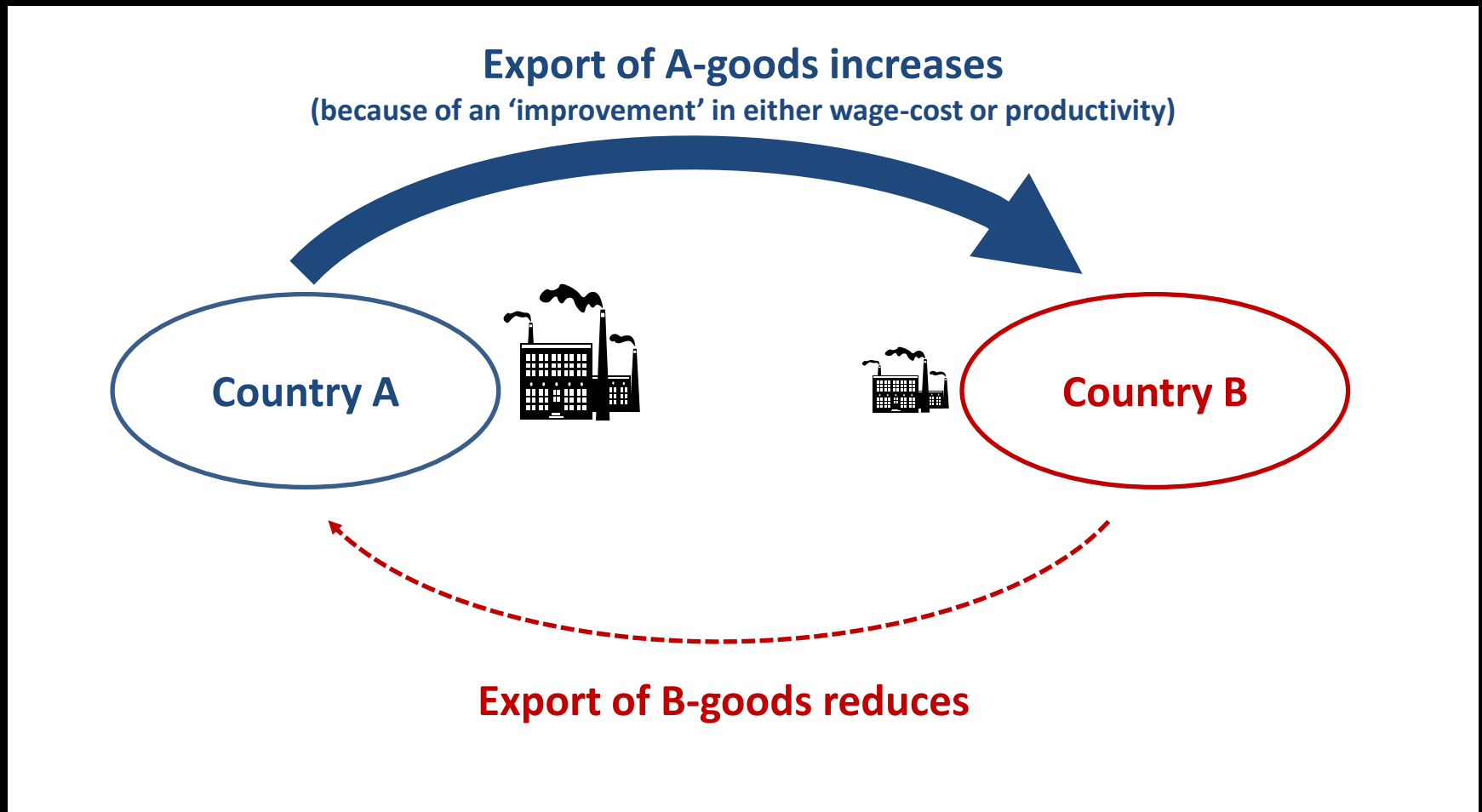
But what about currencies?

Increasing demand of currency A (to buy A-goods)

Country A

Country B

Decreasing demand of currency B

Competiveness and the exchange rate

- The **exchange rate** is the number of units of currency B in exchange for one unit of currency A. The more currency A is demanded, the higher will be the exchange rate.

- Thus competitiveness of A-goods (on B-market) depends on:

$$\text{price}'_A = \left(\frac{\text{wage}_A}{\underbrace{\text{productivity}_A}_{\text{unit labour cost}_A}} \right) \times (1 + \text{rate of profit}) \times \text{exchange rate}$$

- And therefore:

$$\Delta\,\text{price}'_A = \Delta\,\text{wage}_A - \Delta\,\text{productivity}_A + \Delta\,\text{exchange rate}$$
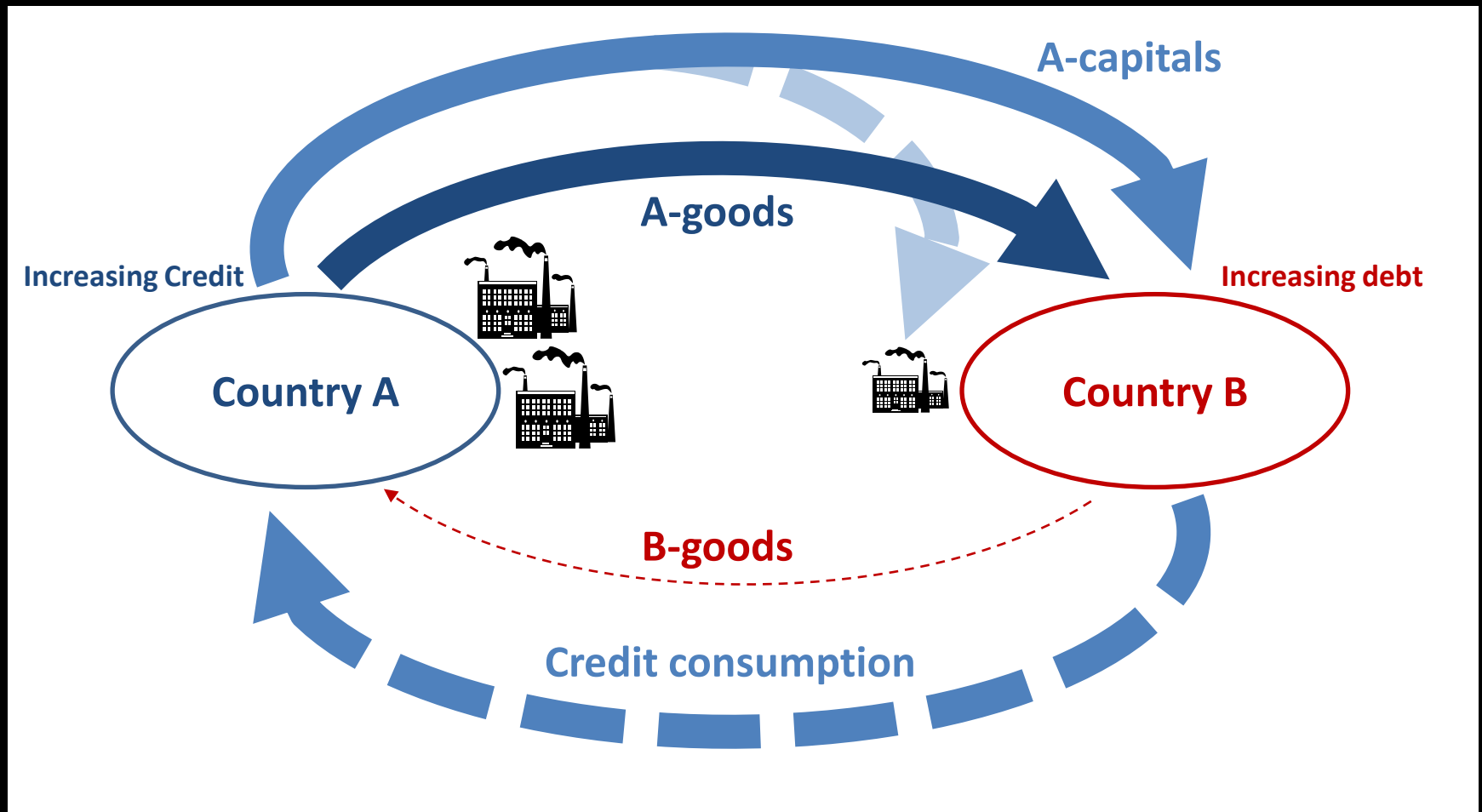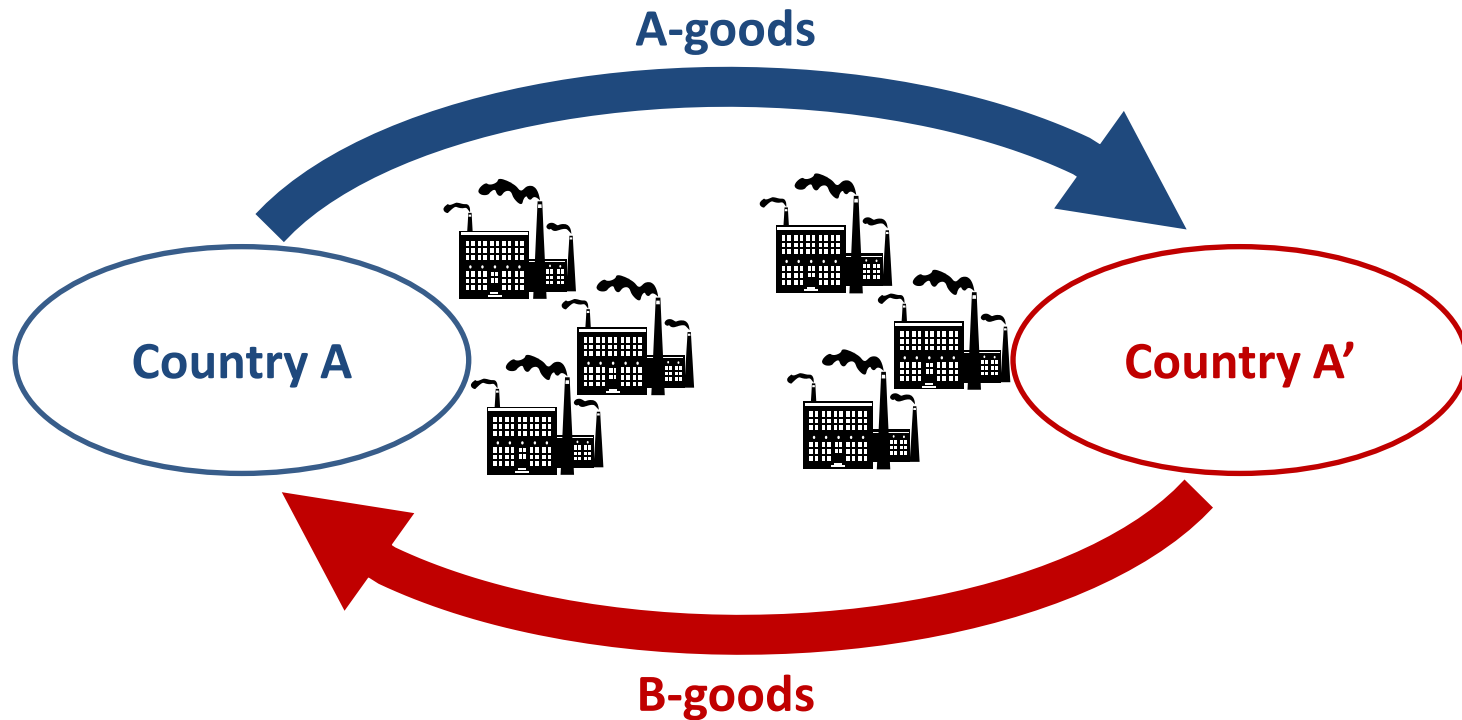
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The appreciating of currency A offsets the lower cost

(Currency A appreciates)
Export of A-goods reduces

Country A

Country B

- **Higher productivity (or lower wages)**
- **But stronger currency**

- **Lower productivity (or higher wages)**
- **But weaker currency**

Export of B-goods increases
(Currency B depreciates)
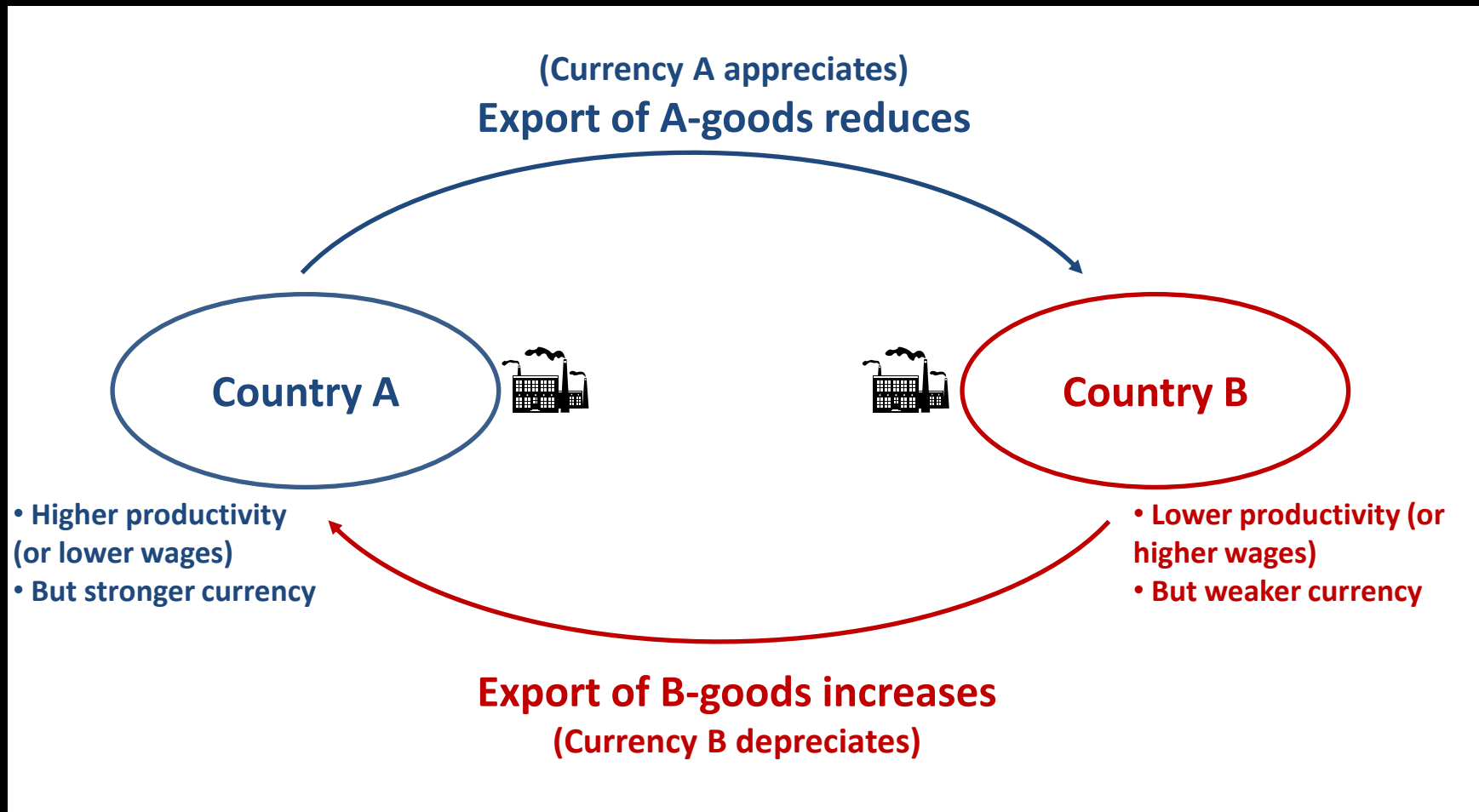
# Can you swim? The advantage of tying one's hands...

| Country A	Country B
• New (more profitable) investment opportunities • New end markets for goods (and capitals) • No exchange rate risk	• Inflow of capitals to finance 'productive' investment • Lower inflation rate • Higher rate of growth • Becoming like the country A

Two countries, one currency (or pegging)

A-capitals

A-goods

Increasing Credit

Increasing debt

Country A

Country B

B-goods

Credit consumption

The happy end: everybody learns to swim

A-goods

Country A

Country A'

B-goods

Can you remember?

| Country A	Country B
• New (more profitable) investment opportunities • New end markets for goods (and capitals) • No exchange rate risk	• Inflow of capitals to finance 'productive' investment • Lower inflation rate • Higher rate of growth • Becoming like the country A

The true story: no hands, no swim

Country A	Country B
• New (more profitable) investment opportunities	• Inflow of capitals to finance ~~'productive' investment~~ consumption
• New end markets for goods (and capitals)	• ~~Lower inflation rate~~ Higher real exchange rate ($\uparrow$ price$_B$ / price$_A$)
• No exchange rate risk	• Higher rate of growth (good news?!)
• **Acquisition of competitors**	• Becoming like the **colony of the** country A

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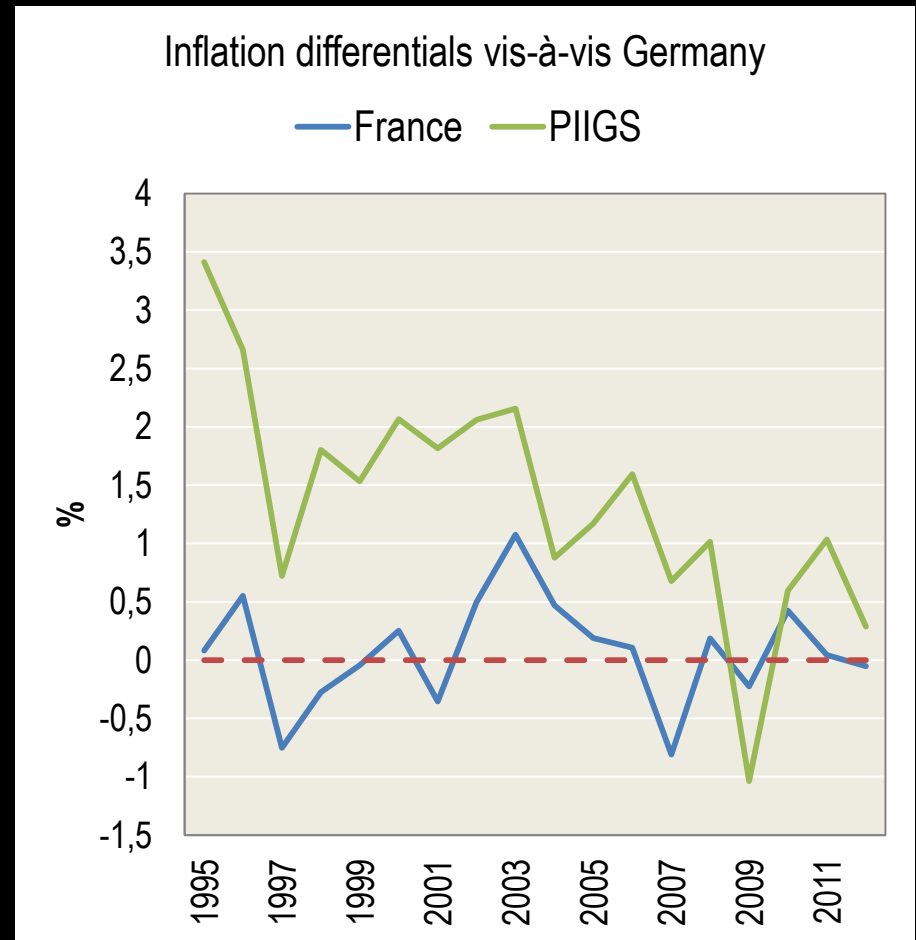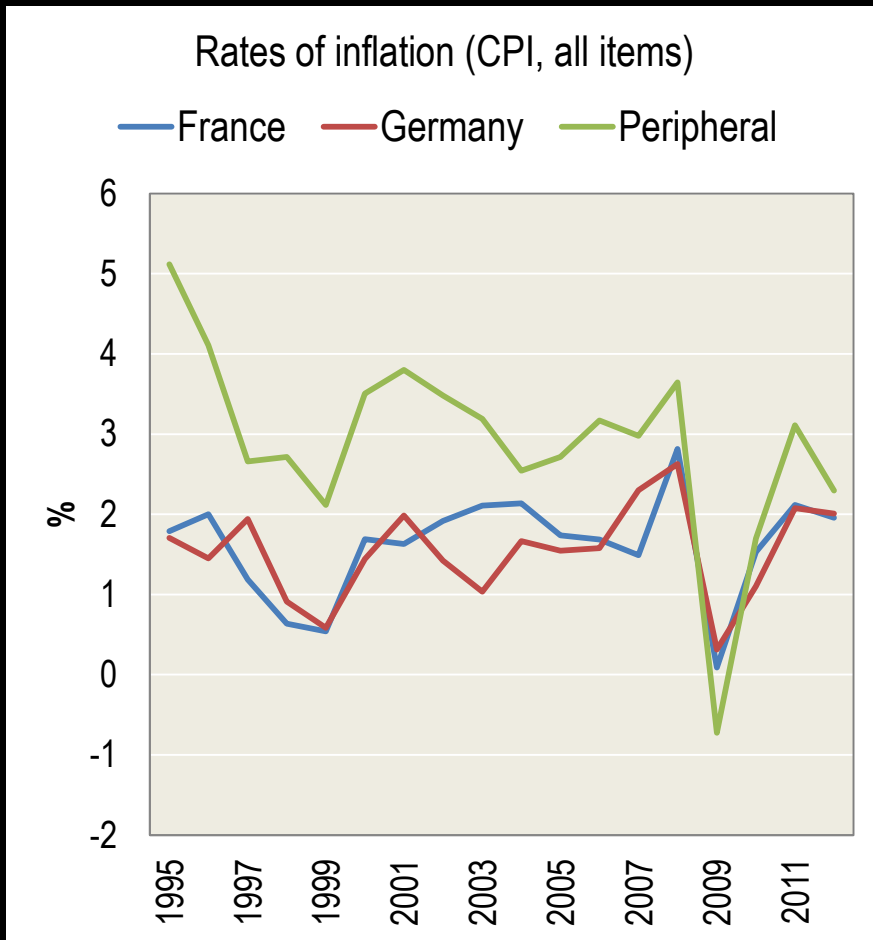# Desertification of the economy B
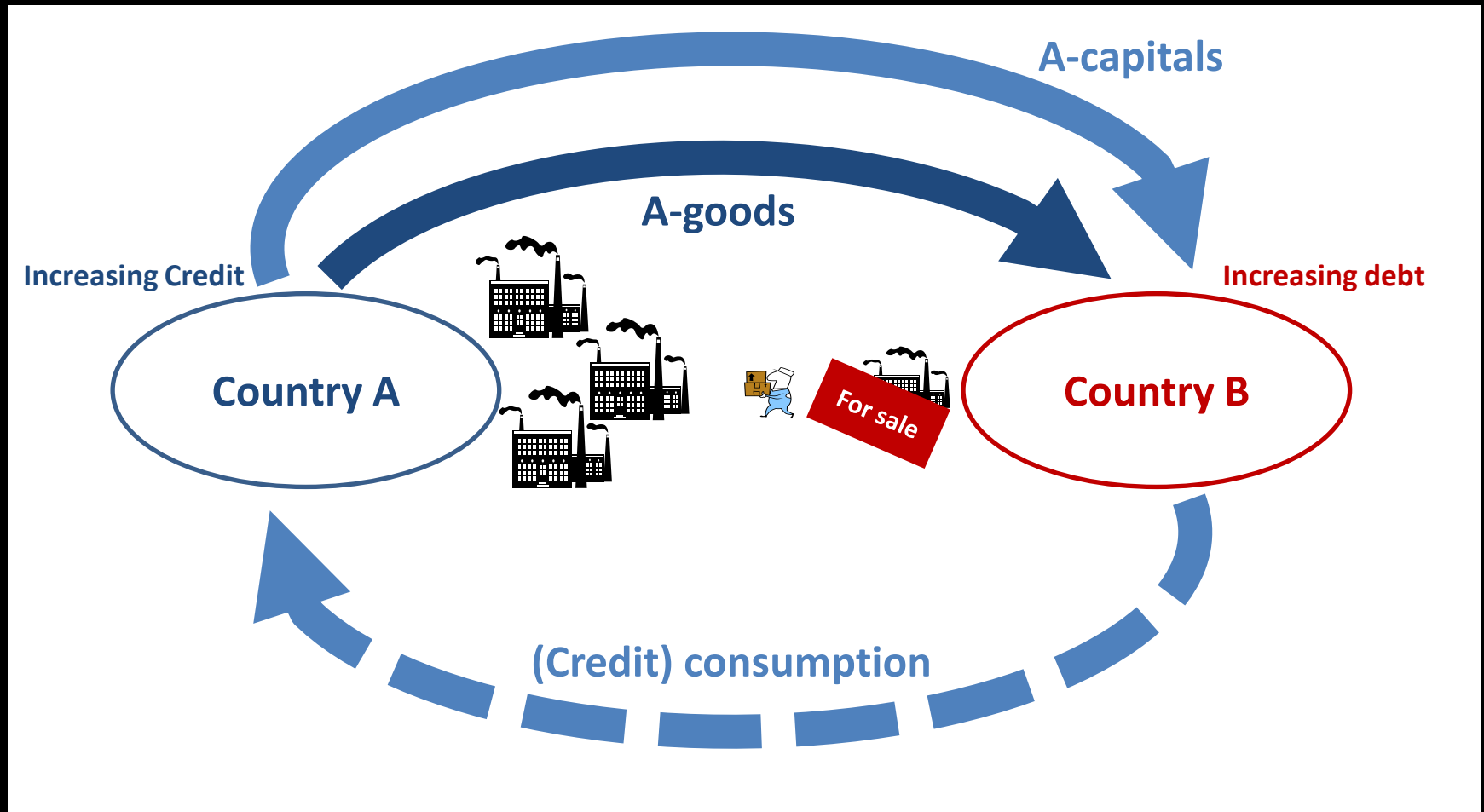
Euro area current account (im)balances
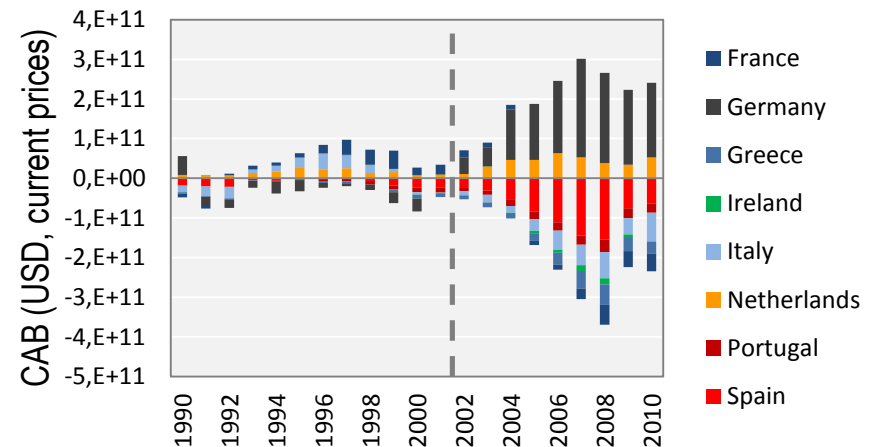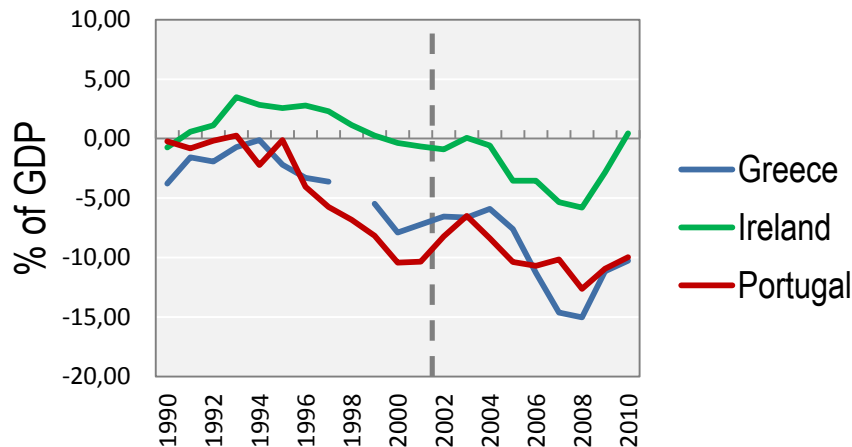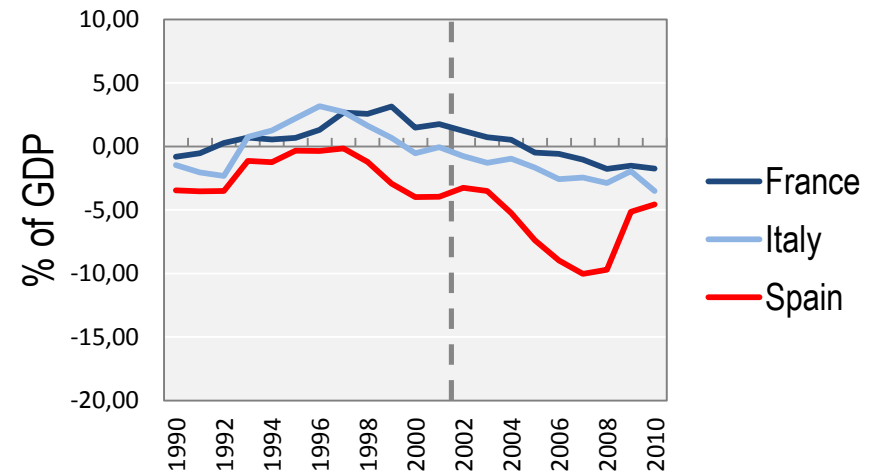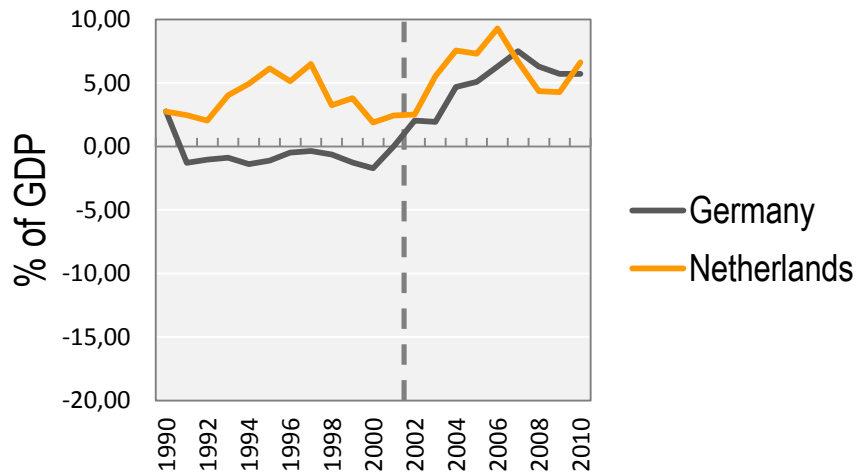
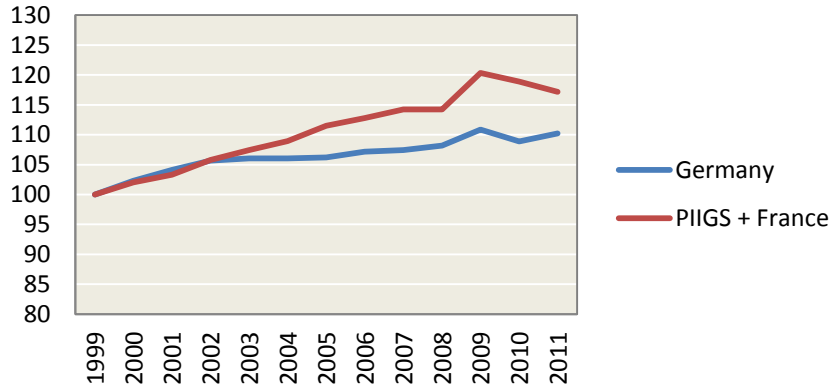Source: our elaboration on World Bank statistics (February 2012)

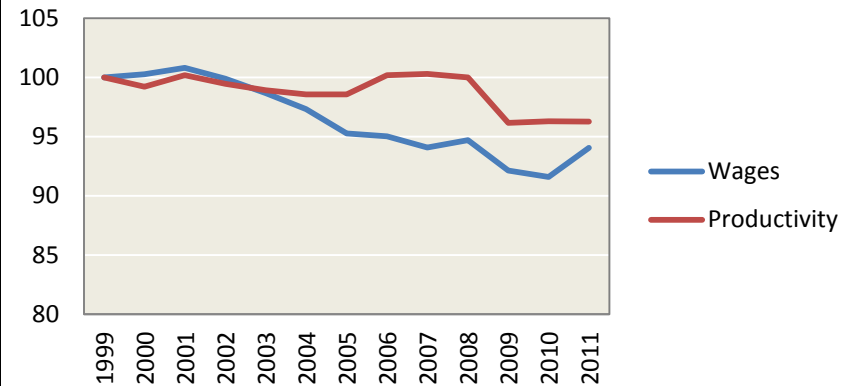# Converging but *permanent* inflation differentials

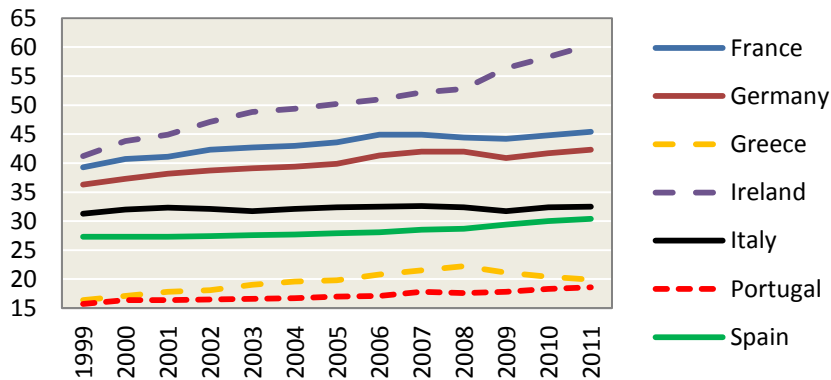Source: our elaboration on OECD statistics (March 2013)

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Productivity spread or wage spread?

Hourly wages (PPPs), 1999=100

Legend: Germany, PIIGS + France

Germany/(PIIGS+France), 1999=100

Legend: Wages, Productivity

Labour productivity (GDP per w.h., const. prices)

Legend: France, Germany, Greece, Ireland, Italy, Portugal, Spain

Source: our elaboration on OECD statistics (March 2013)

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France vis-à-vis Germany
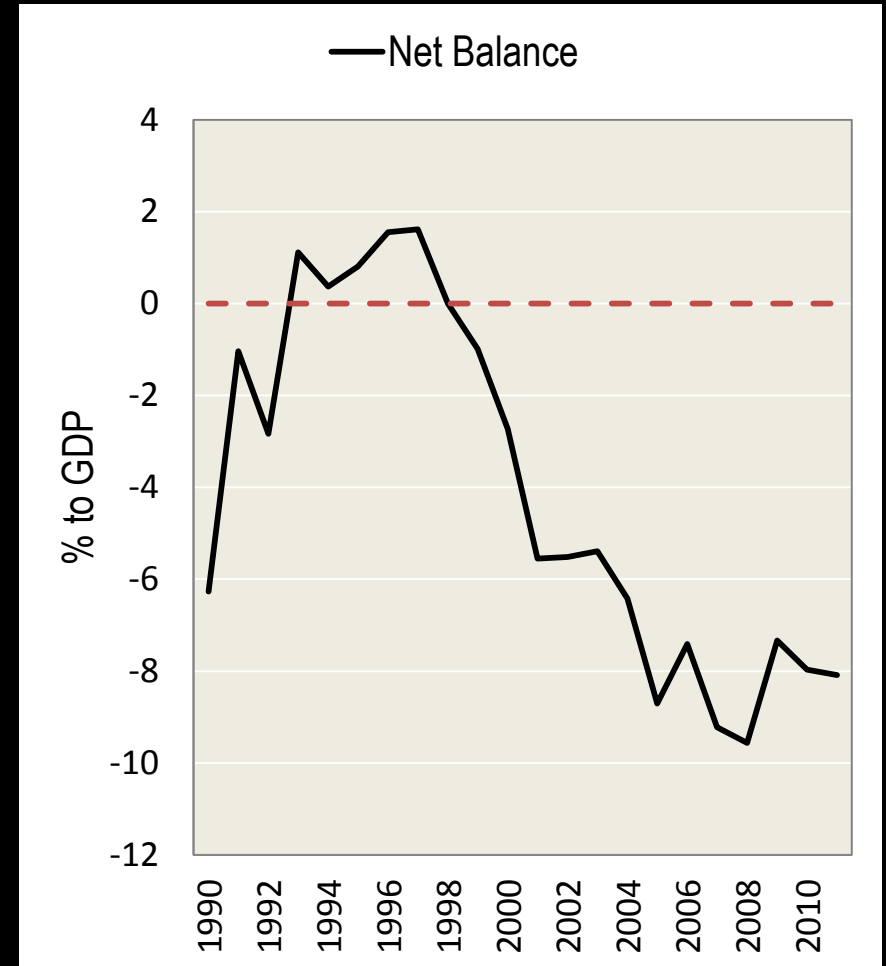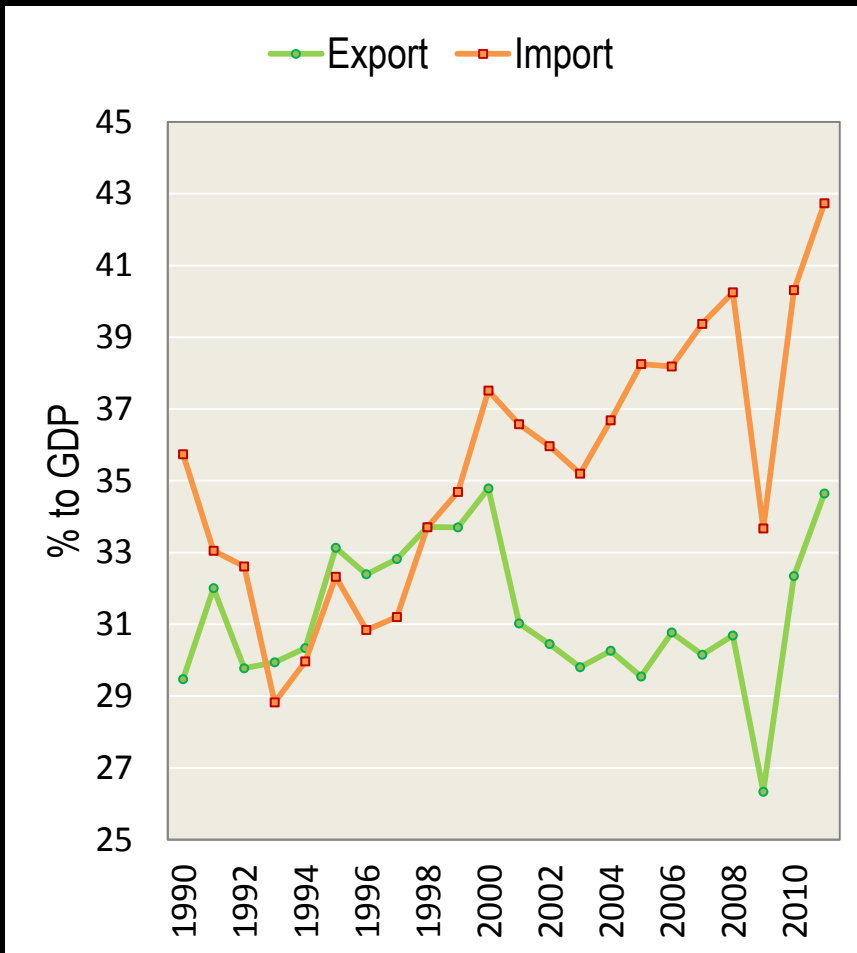
Source: our elaboration on OECD statistics (March 2013)

Are external imbalances (un)sustainable?

- It depends on the **will of the lenders** (that is, on countries A).

- When the financial turmoil hit the EMU (in 2009) flows of capitals (from core countries to periphery) suddenly reversed: creditors wanted their money back.

- The sharp increase in PIIGS' government bond rates measures the risk that PIIGS are unable to pay off their debts, therefore exiting the EMU and adopting a new currency which devaluates over time.

- Austerity measures (that is, cuts in government expenditures to reduce the government debt) have been the way through which **core EMU countries have compelled peripheral EMU countries to pay off their (both private and government) debts**.

Correlation between CAB deficits and interest rates
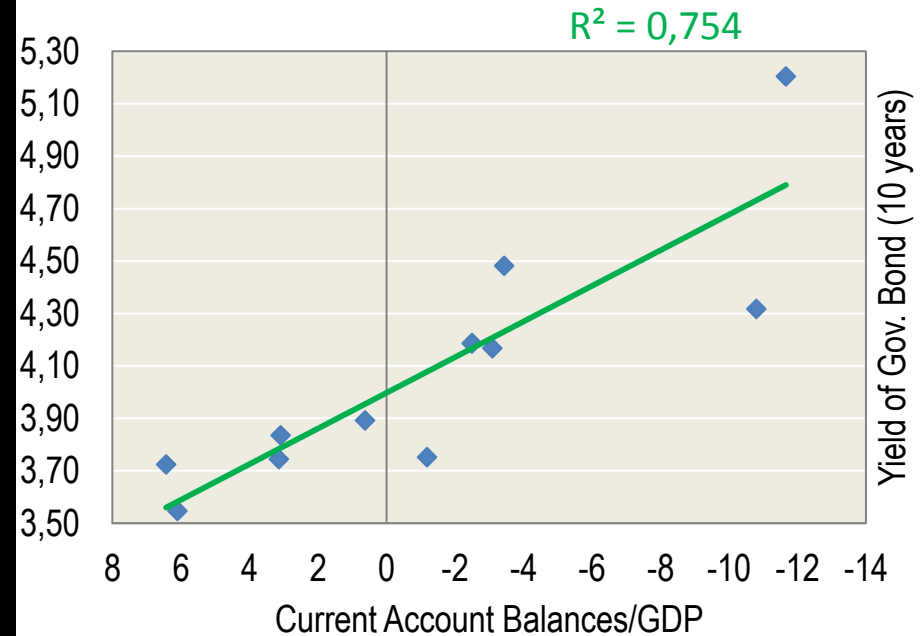

CAB and yield of government bonds (average 2005-2010)

◆ Austria   ■ Belgium   ▲ Finland   ✕ France
✳ Germany   ● Greece   + Ireland   – Italy
– Netherlands   ◆ Portugal   ■ Spain   ▲ UK
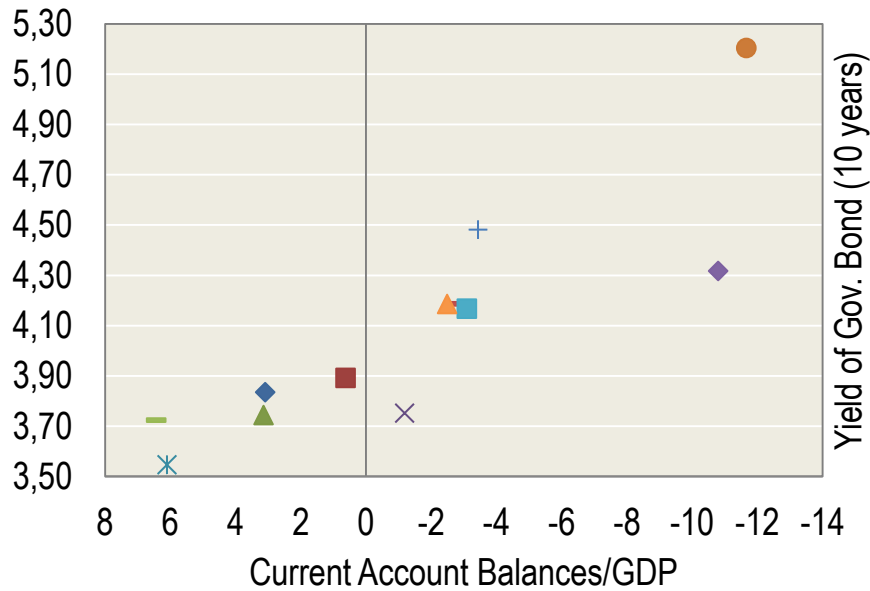
CAB and yield of government bonds (average 2005-2010)

◆ Countries

R² = 0,754

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GDP and the effect of austerity measures

- GDP is the market value of all goods and services produced within a country in a given period of time, that is:

$$GDP \equiv C + I + G + X - M$$

- From which we obtain:

$$\Delta GDP = \frac{1}{1 - c \cdot (1 - t) + m} \cdot \Delta(I + G + X)$$

$C = c_0 + c \cdot (1 - t) \cdot GDP$ = consumption
I = investment
G = government expenditure
X = export
$M = m \cdot GDP$ = import
c = marginal propensity to consume
t = tax rate
m = marginal propensity to import

- By reducing G, **austerity policies reduce GDP**. The reduction in GDP, in turn, reduces tax revenues (given t). The government deficit to GDP ratio could therefore increase! (as it is happening in Greece)

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Austerity and the foreign debt

- From GDP identity we obtain :

$$\downarrow(S-I) \quad + \uparrow(G-T) \quad + \downarrow(M-X) \quad \equiv 0$$

Private Sect.   Government   Foreign Sect.
balance   balance   balance

- If government sector balance 'improves' then private sector and/or foreign sector balances have to worsen, namely:
  - o   Given the investment, private sector reduces its saving
  - o   Net export of domestic firms increases (i.e. foreign sector's net import increases)

- By increasing unemployment and reducing internal demand, **austerity keeps wages low**. This would **improve net export** (because export increases whereas import falls) **and reduce foreign debt**.

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Fallacy of composition or the law of capital?

- Yet, if everybody wants to export, nobody will be actually able to do it: Euro area recorded a balanced balance with the rest of the world in the last decade. Internal exchanges are a zero-sum game!

- But **this is rational for country A** (that is, Germany). This latter can take advantage from the crisis, because of the low market values of B-assets which allow **A-firms to expand by acquiring their B-competitors**.

- As Karl Marx clearly foresaw, **capital destruction / concentration / centralisation is the historically standard way to raise the (otherwise declining) rate of return**.

Alternative measures within the Euro

- The oxygen of the crisis has been the (initial) refusal of ECB to protect government bonds of peripheral (that is, B-) countries against speculation (without any condition). By contrast, we need **a central bank acting like a lender of last resort**.

- A set of **coordinated fiscal policies**:
  - A-countries should expand their government spending in order to allow their demand (and/or their inflation rate) to increase
  - B-countries should be permitted to undertake productive investment (notice that the increase in export would enforce this)

- A set of **coordinated wage policies**:
  - A common target (higher) wage-share to achieve over a given period
  - A new rule: the higher the trade surplus, the higher the nominal wage growth

A 'plan B' for B-countries

- Are previous measures realistic?

- Why should German government be happy with them?

- What should B-governments do if nothing would change?

  They should arrange a plan, call it 'plan B', for a coordinated exit strategy (that is, exit from unique currency, *plus* adoption of capital controls). However paradoxical, **the only way to re-launch the Euro project could be a clear statement about the risk of its total failure**.

Thank you

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