The Euro and the Theory (and Practice) of Monetary Unions

by

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DISCUSSANT

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Barry’s two grim conclusions

1. Twenty years from the establishment of the EMU, the EZ is still further from an OCA than the US is

“shocks are still asymmetric”

2. The euro had some efficiency effects but led to large capital flows from the North to the South and loss of competitiveness

“ the perils of financial integration”

My discussion
Two facts

1. **Big effect of the euro has been nominal convergence and not much change in business cycle synchronization pre-crisis**

- ex post risk sharing mechanisms in the euro area not that different than in the US (evidence on labor mobility, automatic stabilizers) in normal times

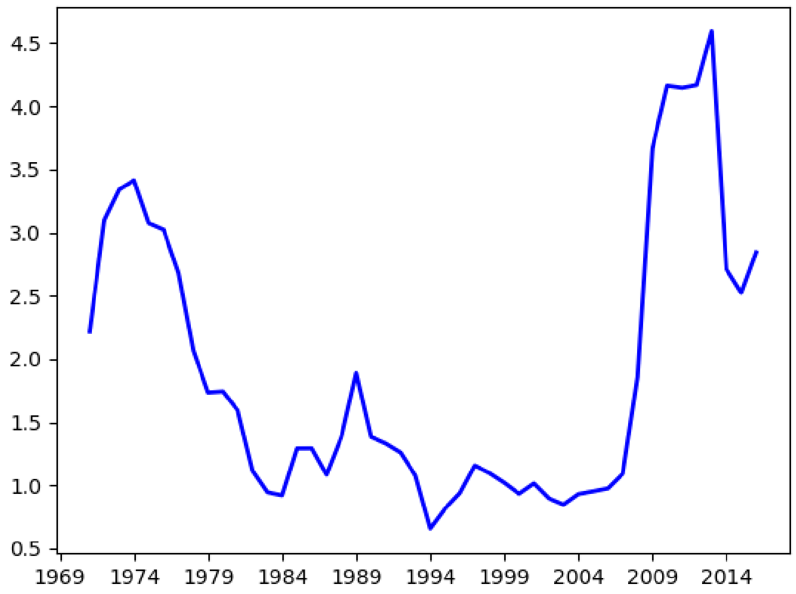
2. **Things went wrong when EMU faced LARGE shocks – post crisis**

- Financial frictions leading to asymmetries
- Pro-cyclicality fiscal policy
- Drop of confidence in the euro leading to balkanization of financial markets
- ….

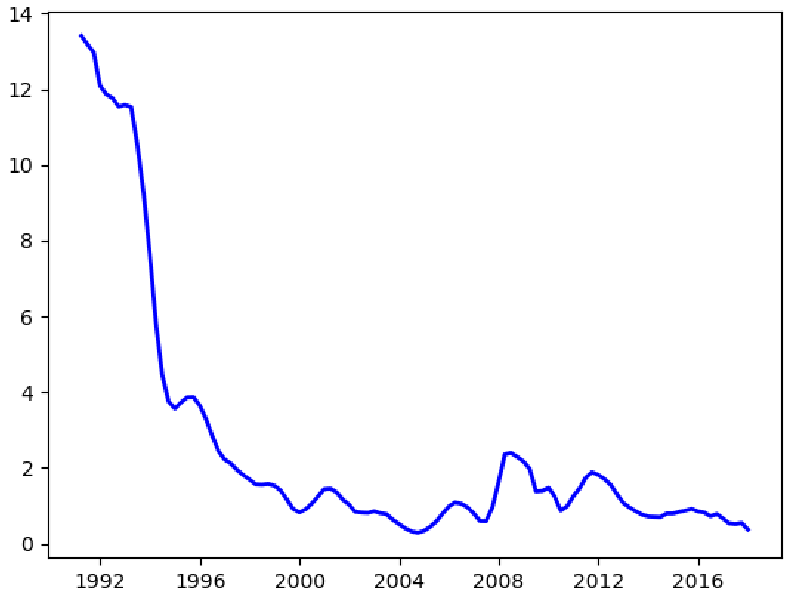
POINT 1: nominal and real asymmetries

$$\mathrm{E}(\Delta y_t^i - \Delta y_t^{ea})^2, \quad i = DE, FR, IT, SP, \ldots$$

REAL ASYMMETRIES

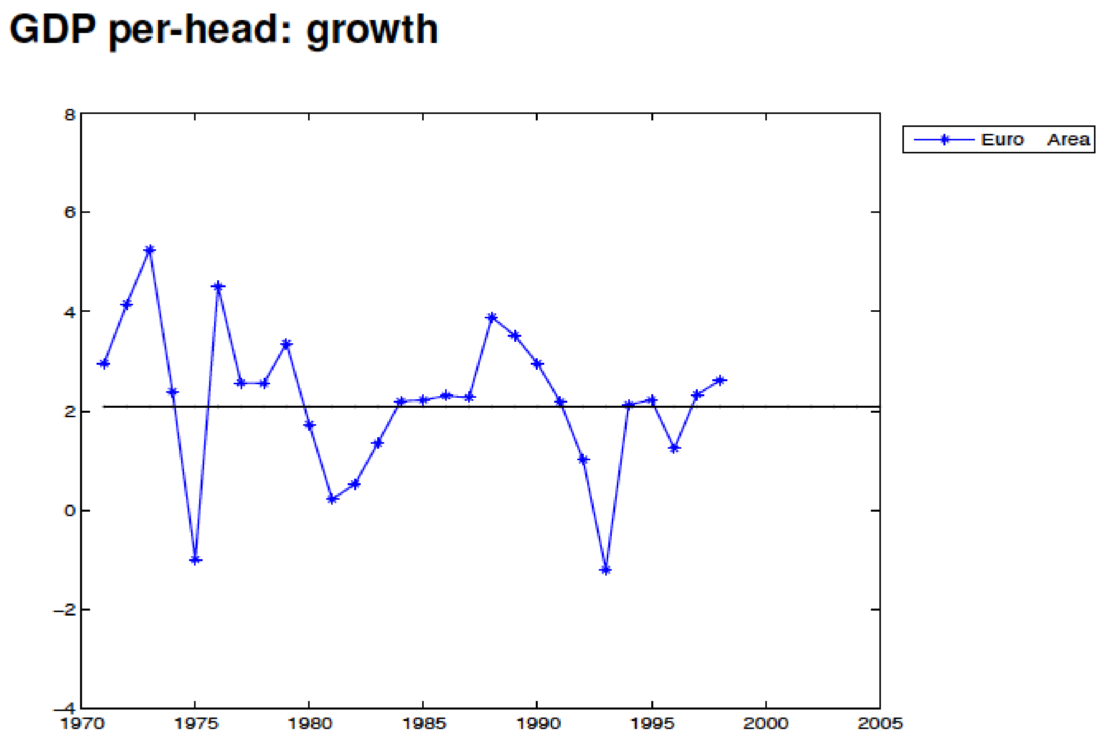


NOMINAL ASYMMETRIES



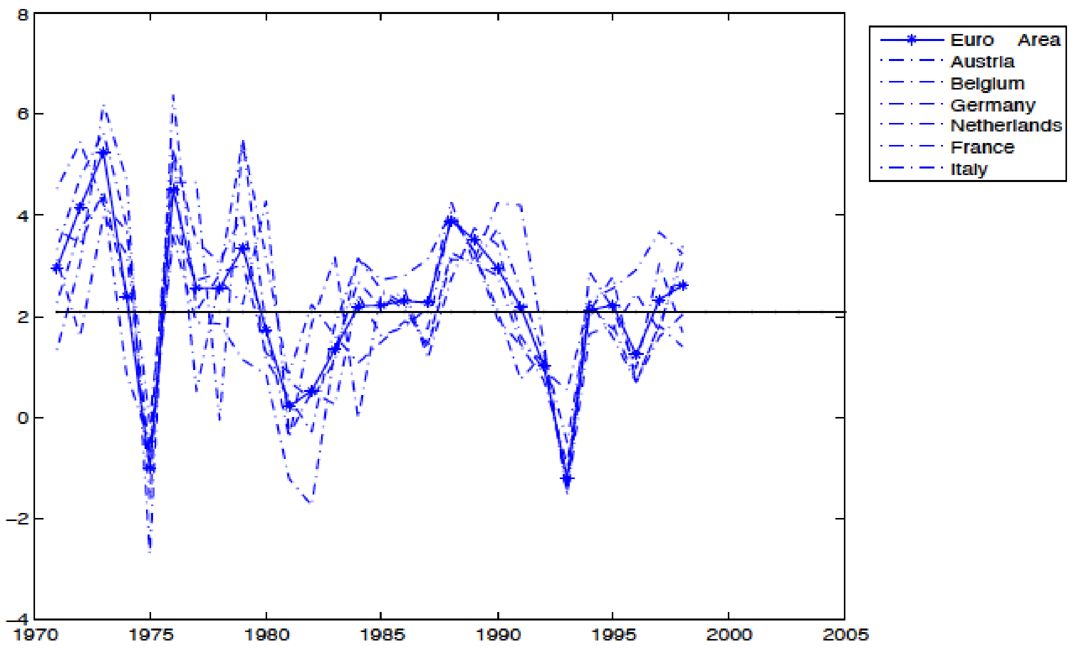
Point 2: real correlation across countries did not change in the euro pre-crisis sample

EMU GDP 1970-1999

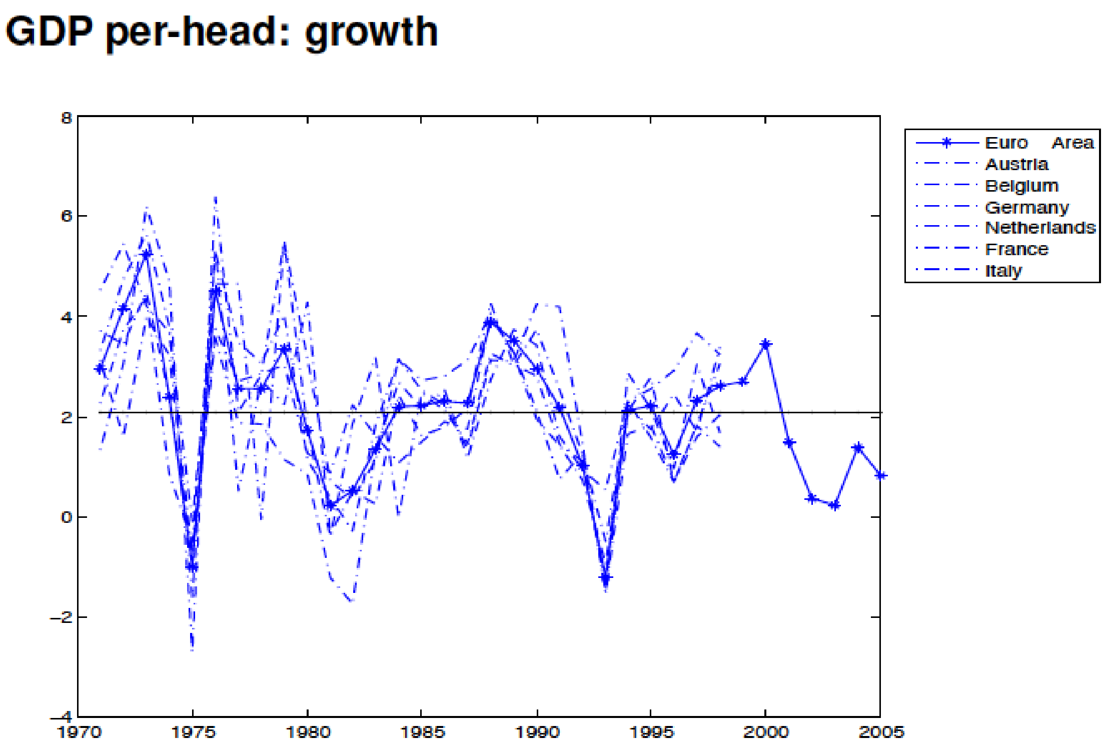


EMU and the blue countries
1970-1999

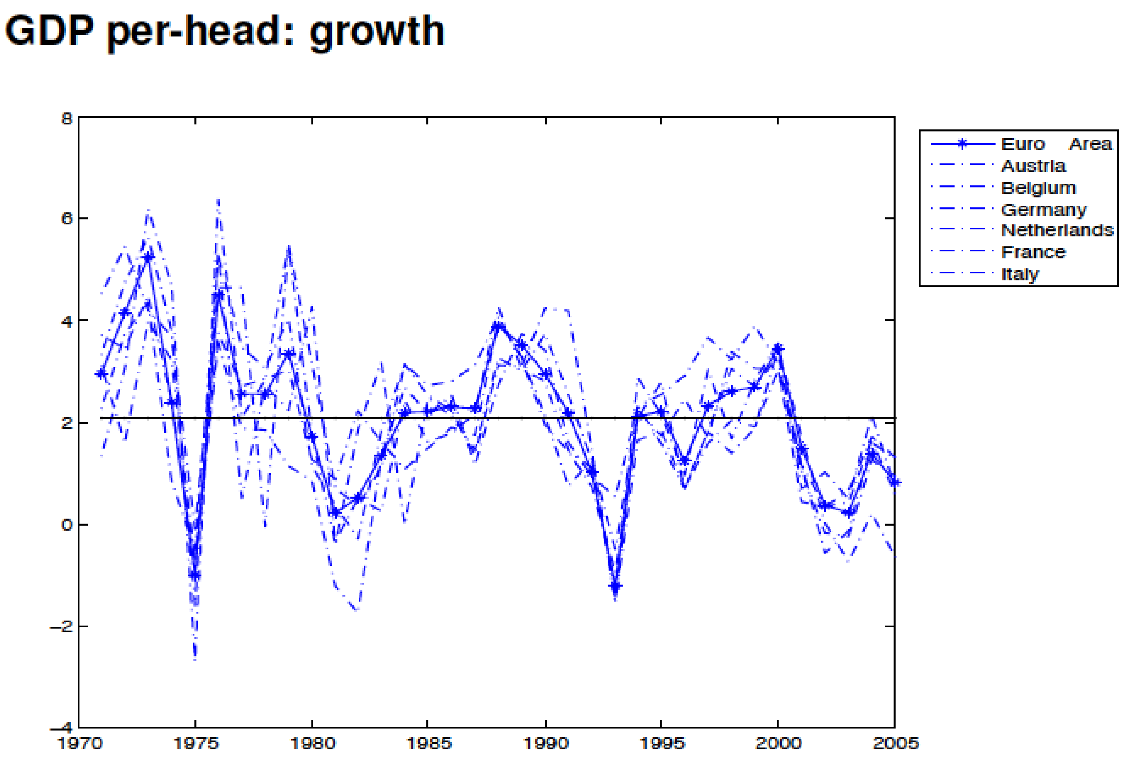
GDP per-head: growth



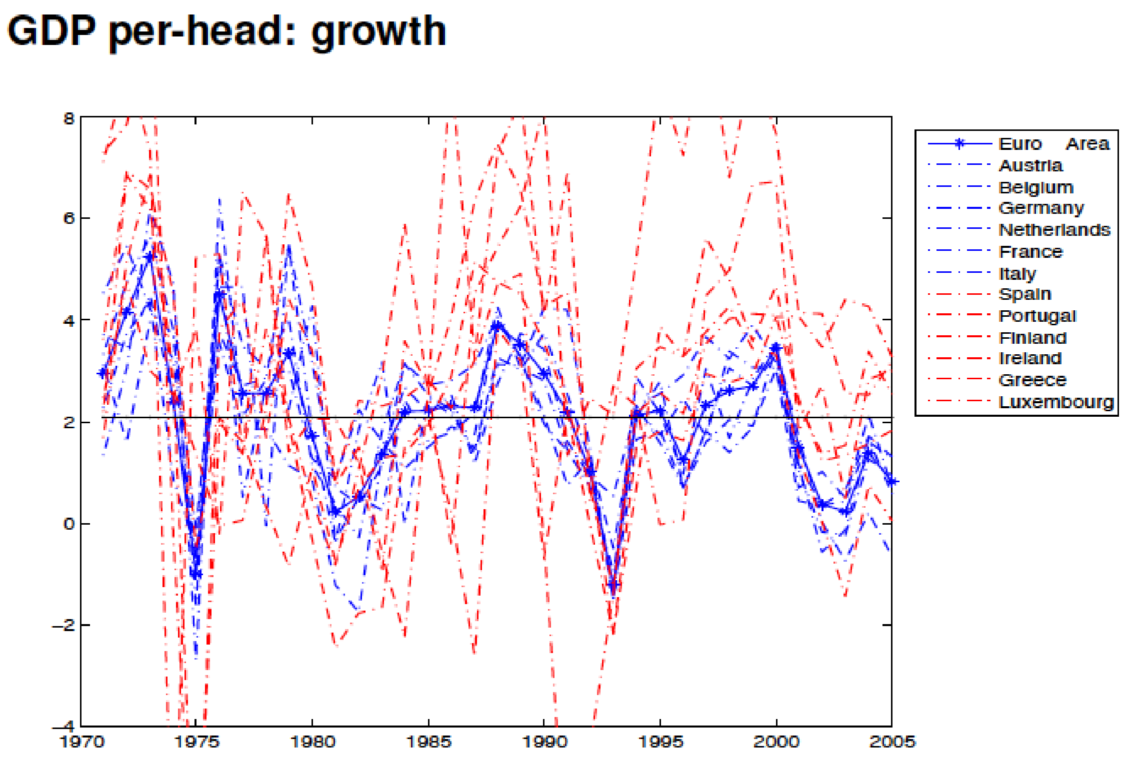
Add 6 years: 1970-2005 - average euro area



Add 6 years: 1970-2005 – blue countries



Add 6 years: 1970-2005 – red countries

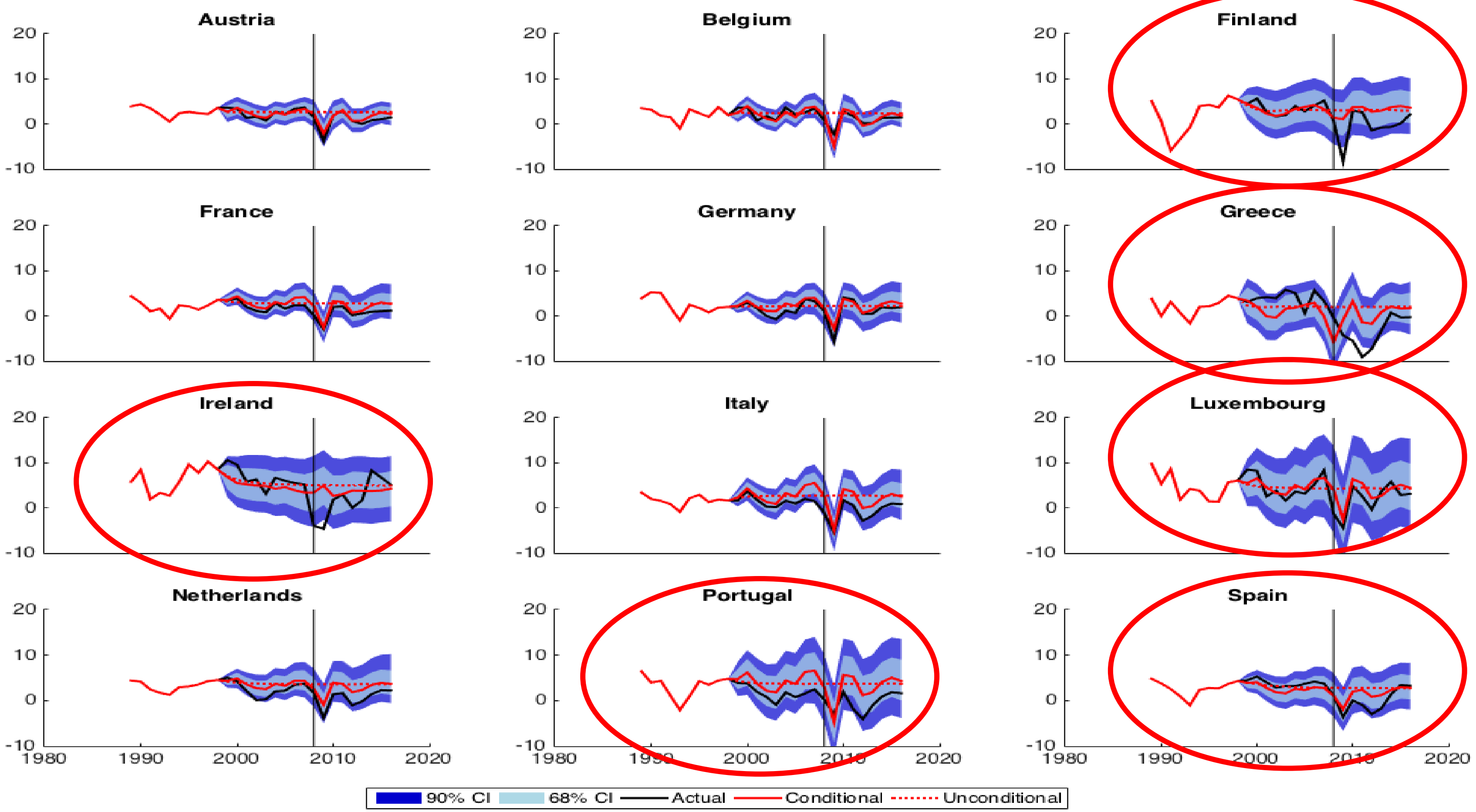


Formal exercise 1

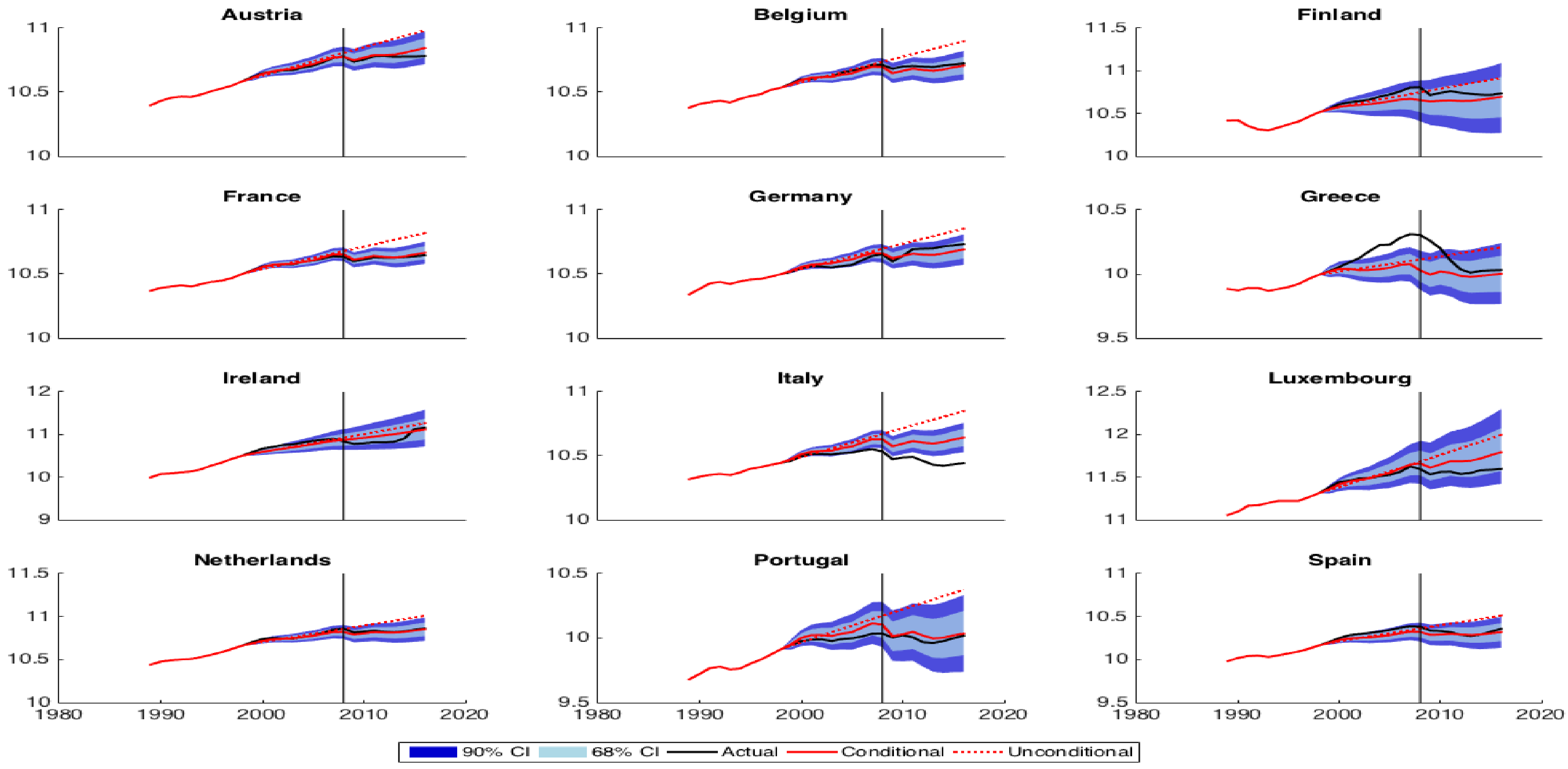
- Suppose you were in 1999 and you knew the future EA GDP.
- Could have you anticipated single countries’ GDP on the basis of the past correlation and the knowledge of EA aggregate GDP?

- **Answer: YES but uncertainty is large in red countries!**

GROWTH RATES – focus on pre-crisis sample
-- Huge uncertainty in red countries (not the PIIGS!)
-- Conditional and unconditional forecasts not significantly different



LEVELS
Before the big crisis all inside the bands except for Greece

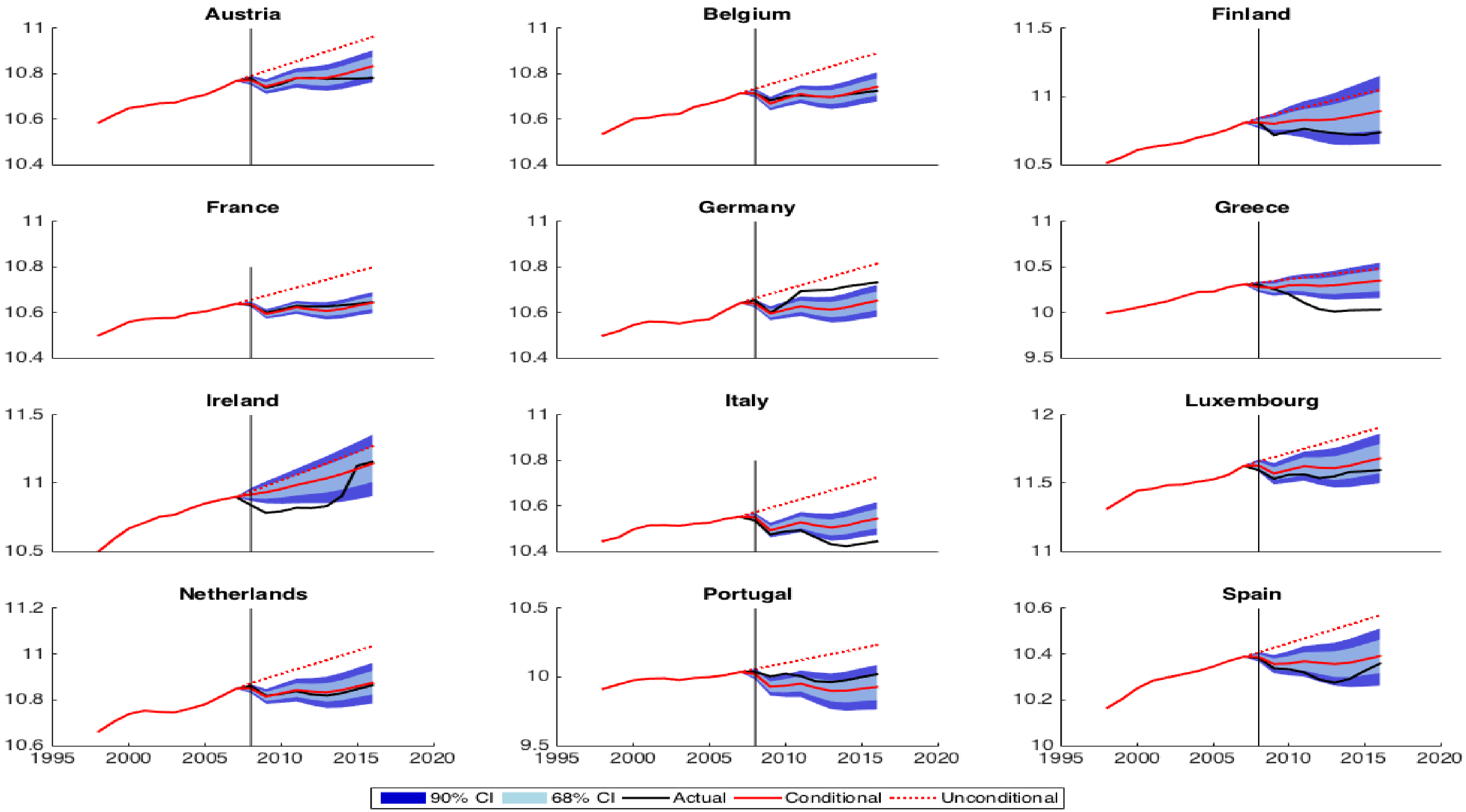


Formal exercise 2

- Do the same exercise but start conditional forecast in 2008
- Could have you anticipated observed heterogeneity in 2009-2017?
- Answer: NOT REALLY!

POINT 3: The crisis is different

Levels of GDP per capita
1970-2007 sample



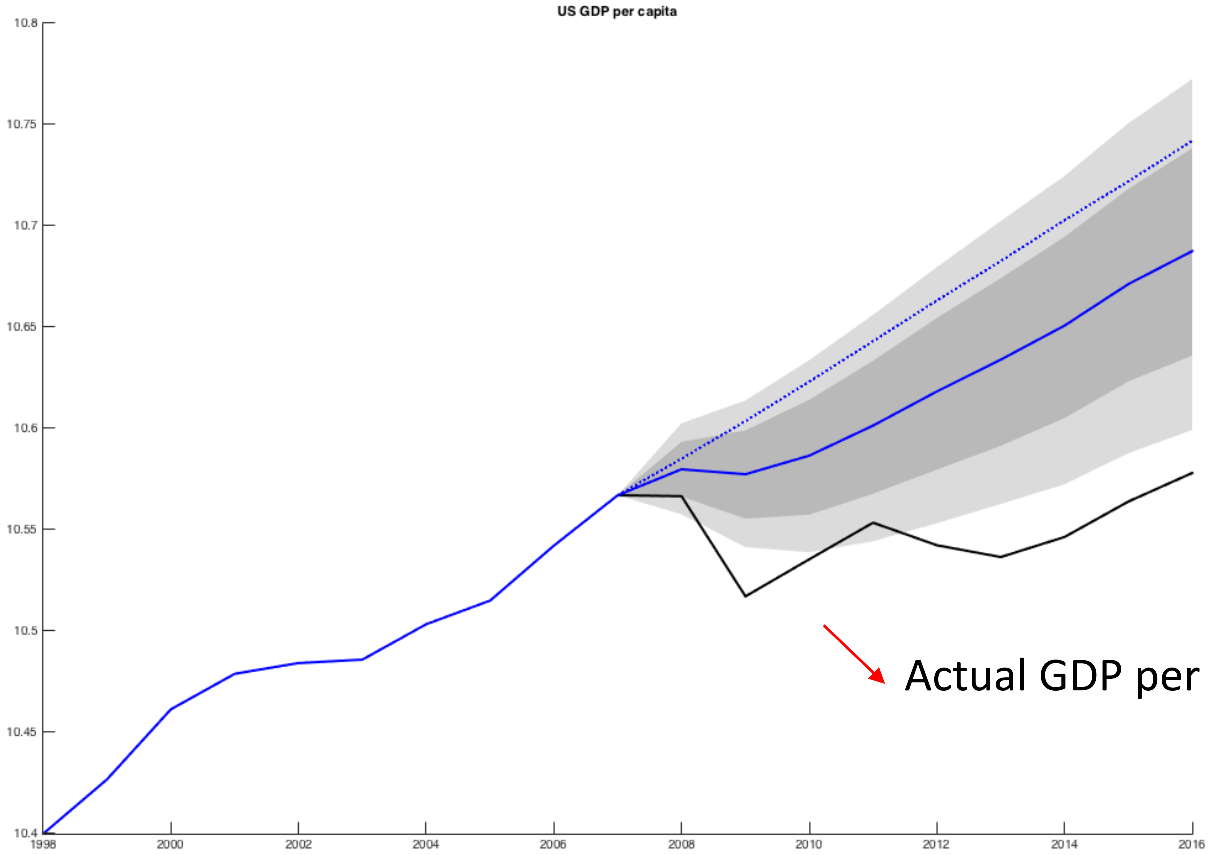
NOW YOU SEE SIGNIFICANT DIFFERENCES!!

- Germany
- Italy
- Greece
- Ireland but less persistent

- **LARGER UNCERTAINTY**

- **ALL BELOW UNCONDITIONAL FORECAST**

Point 4: We did significantly worse than the US in the aggregate
Conditioning on pre-crisis correlations and observed US GDP



Unconditional forecast

What we would have expected conditionally on US realization and Pre-crisis correlation

Actual GDP per capita

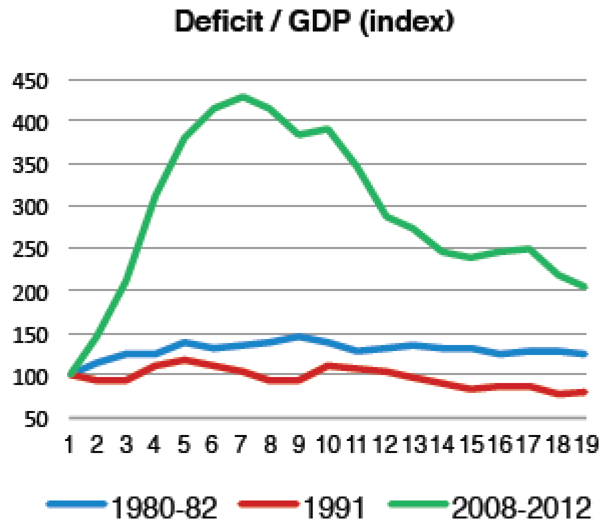
Why are big shocks different?

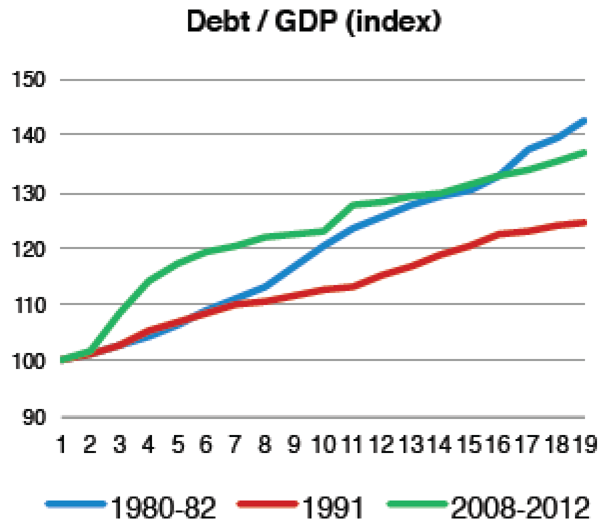
Recession with financial crisis – large symmetric shocks with asymmetric effect / everywhere

In the euro area compounded by:

- Poor crisis management capacity
- Pro-cyclical fiscal policy

Fiscal space: this time was different
Comparisons of three recessions in the EA





What does it say about optimal currency areas?

Not sure OCA is very useful as a model of the euro area crisis

- It does not take into account the role of monetary policy credibility (nominal convergence)
- Does not deal with countries growing at different rates (catch-up dynamics)
- Does not deal with financial disruption

Conclusions

- It might be …. that the euro area is dysfunctional …. but for reasons which were not anticipated by the OCA literature

- To function will need to strengthen the euro area governance
- And I agree with Barry … a lot is about finance!

Thank you!