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WIM MEEUSEN

The Economic Crisis and European Integration

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Contents

1. Introduction and Outline

Wim Meeusen

The credit crunch and the ensuing financial and economic crisis of 2007-2009 did not only strike hard at the economy in the Western world itself, but also at its policy-makers, many of whom lost their bearings, at economics as a scientific discipline and, specifically, at the process of European integration itself. The latter aspect of the crisis was the theme of a conference held at the European Parliament on 2 June 2010 in Brussels, under the title 'The Economic Crisis and the Process of European Integration'. Obviously, the other aspects mentioned were never far away. The papers in this volume are a selection of the keynote addresses and of the contributions to this conference.

In Part I European governance issues are discussed. *De Grauwe*, in Chapter 2, argues convincingly that the present sovereign debt crisis in a number of Western economies finds its origin in unsustainable debt accumulation in the private sector and the operation of automatic stabilisers set in motion by the economic crisis. A tightening of the parameters of the Stability and Growth Pact of the European Monetary Union (EMU), regardless of the fact that this pact did not work well in the past, is therefore not the right answer. De Grauwe subsequently asks the question why there is presently such a high degree of macroeconomic divergence in the eurozone. After having dismissed a number of alternative explanations, like structural rigidities on labour markets, he concludes that 'idiosyncratic' (i.e. national) credit-fuelled 'animal spirits' must lie at the source of the crisis and the divergence across countries it created. The European Central Bank (ECB), being responsible not only for price stability but also for financial stability, is in his view the right instrument to deal with this. Its ability to apply differential minimum reserve requirements and to impose anti-cyclical capital ratios should be used to the full, and it should follow up its presidency of the recently created European Systemic Risk Board (ESRB) by action, and not only by issuing warnings.

Ioannou and Heipertz, in Chapter 3, write in the same vein. They forcefully advocate more political integration in the EU. Their thesis is that, more than being desirable as a matter of principle or from a normative, federalist point of view, increased political integration, in the face of the economic crisis and the divergence it caused across EU member states, should be seen as a necessary pre-condition for improving socio-economic performance in the EU. They argue that a 'quantum leap' in the political governance of the EU is necessary to continue to be able to provide 'SEES' ('stability, equity, efficiency and security' (Padoa-Schioppa et al., 1987)), in a period when the crisis has incited nation states to retreat behind their own borders, possibly endangering the long-term survival of the eurozone itself.

While the sovereign debt lapse is indeed a consequence rather than a cause of the present difficulties in the EU and the EMU, it became at the same time of course also a problem in itself. In Chapter 4, *Lejour, Lukkezen and Veenendaal* therefore examine in a technical way the sustainability of government debt in Europe. They carefully provide results for a number of alternative but related key indicators of debt sustainability under a few scenarios. The 'usual suspects' surely come out, but there are also some surprises. When the extra costs related to an ageing population are taken into account, Germany, France, the Netherlands, Spain, Italy and Portugal have to make larger efforts than the present ones to maintain sustainability of debt. Surely, in Greece and Ireland these efforts should be even more considerable.

In Chapter 5, *Coniglio and Prota* look into intra-country regional convergence/divergence and the role of economic and financial crises herein. They note that current growth theory does not yield consistent answers, and they therefore come up with a challenging hypothesis that would explain the observed 'accordion effect', i.e. the succession over time of increases and decreases of the movement towards convergence in many EU member states. The clue would be that less developed regions are hit by the negative shocks more severely than rich regions because existing firms localised in central regions are on average more modern and technologically more advanced, and thus better able to adjust their production to the shocks. Moreover, in the lagging areas spells of unemployment in the workforce induced by adverse shocks will with a higher probability lead to a permanent loss of skills and to a faster obsolescence of the stock of equipment and infrastructure (hysteresis).

In Chapter 6, *Sarisoy Guerin* deals with a more specific question of European governance. She examines empirically whether Bilateral Investment Treaties (BITs) have the desired positive effect on FDI inflows and outflows. She also addresses the question whether the transfer of competences from the member states to the EU for the conclusion of new BITs and the 'grandfathering' of existing BITs by the EU is expected to be beneficial.

Part II of the book is devoted to the effect of the crisis on global economic imbalances. *Bagliano and Morana*, in Chapter 7, ask the question whether economic and financial crises in the US have had an influence upon economic convergence in the euro area. They use a factor vector autoregressive (F-VAR) econometric methodology. They convincingly show that the interaction between US and Euro Area (EA) real and financial markets are complex and involve not only first, but also second and third moments. One of their results is that there is no evidence for a linkage between the state of the US business cycle and inflation dynamics in Europe. This result is, however, less striking than it may seem, in the light of Leijonhufvud's argument that (in spite of the new-classical and new-Keynesian inflation-targeting rhetoric of the Fed and also of the ECB) the inflation rate in both regions, in reality, is determined by not much more than massive and cheap but highly price-elastic imports from China (Leijonhufvud, 2008).

Lee, in Chapter 8, also uses a VAR econometric methodology, the S-VAR (structural vector autoregression) method popularised by Blanchard and Quah (1989), but in a context in which he examines whether a US dollar peg or, alternatively, a euro peg system for the Chinese yuan would be warranted in the light of sufficient symmetry between these entities of aggregate demand and supply shocks. His conclusions are mixed. His relatively positive evaluation of the euro peg alternative is not derived from any observed tendency to greater symmetry between macroeconomic shocks in Europe and China, but rather from the longer-term convergence one might expect on the basis of the endogeneity argument of Frankel and Rose (1998).

In Chapter 9, *Berger and Nitsch* examine the source of the observed increase in trade imbalances between countries (EU, EMU and non-EU), and more in particular the role of inflexibilities, both on labour, exchange and goods markets. Their empirical econometric approach is a neat and transparent one. Their conclusion is, not surprisingly, that all three of these inflexibility types matter to explain the persistence and sometimes increasing degree of trade imbalance, but that this should not lead us to doubt the efficiency of a monetary union if at the same time one tries to introduce more flexibility on national labour and goods markets.

Qian, in Chapter 10, goes in great detail into the issue of the supposed excess liquidity in China and its possible relation to financial risk. He questions the results obtained by Zhang and Pang (2008) and Zhang (2009). With the help of a careful econometric study he finds that excess liquidity has not significantly affected China's CPI inflation rate. Rather, a large amount of the over-supply of money has entered the real estate market through direct FDI and other channels. That in itself is, however, sufficient to conclude that the risk of a Chinese real estate bubble is not to be taken lightly.

In Part III of the book we have collected papers that deal with the euro perspectives and financial perspectives in Central and East European countries (CEEC) after the crisis. In Chapter 11, *Lewis*, in a sweeping empirical study of the main indicators, demonstrates that it is mainly the Maastricht deficit criterion that creates a problem. What seemed, before crisis, to be a cyclical issue, now turns out to have a structural character. But also the problems with the exchange rate, inflation and interest rate criteria seem to be challenging. Overall the euro prospect is receding in CEEC, at least in the medium run.

Pirovano, Vanneste and Van Poeck, in Chapter 12, examine empirically the patterns and determinants of the inflow of portfolio and short-term capital in the new and potential EU countries. They differentiate explicitly between 'push' and 'pull' factors. New and potential member countries show a clearly different pattern. All in all, they observe that the potential member countries are on average less exposed to short-term capital inflows, while many of the new member countries rely heavily on this form of financing. It also appeared that portfolio and other investment flows (bank loans, trade credits, transactions in currency and deposits and other short-term capital) are very different in nature and can hardly be grouped under the same heading.

Chapter 13, by *Horobet and Dumitrescu*, focuses on the role of diversification in investment behaviour in old and new EU member states and in a few important non-EU countries. More in particular the authors consider the possible, but theoretically ambiguous, benefits for eurozone investors of holding internationally diversified portfolios, as compared to other investors. It would seem that diversification benefits are still high for a eurozone investor and they have slightly increased after 2004. In times of financial crisis international diversification may bring attractive benefits in the form of low portfolio volatility, although these benefits are smaller than in normal times.

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PART I

Global European Governance after the Crisis

2. What Kind of Governance for the Eurozone?

Paul De Grauwe

1. INTRODUCTION

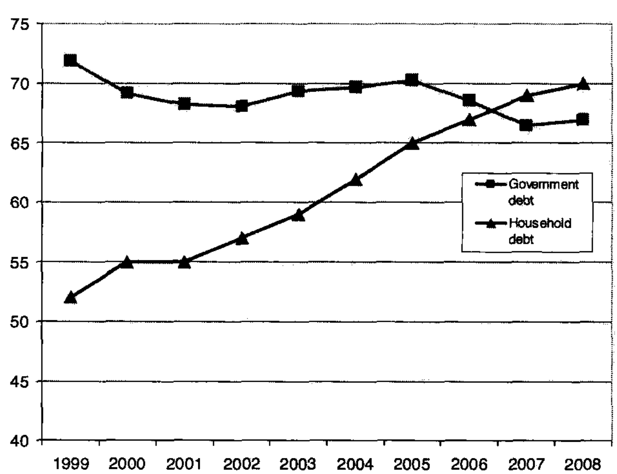
The survival of the eurozone hinges on the capacity of its leaders to improve the eurozone's governance. This has become very clear since the eruption of the government debt crisis in the eurozone in 2009, which can be said to result from a failure of economic governance. In order to answer the question of how the economic governance of the eurozone should be reformed, we should first make a diagnosis of the crisis in which the eurozone has been thrown since 2009.

2. DIAGNOSIS

A consensus seems to building up in Europe identifying the failure of the Stability and Growth Pact (SGP) to keep a lid on national budget deficits and debts as the root cause of the government debt crises in the eurozone. I want to argue that, with the exception of Greece, the reason why countries got into a sovereign debt crisis has little to do with the poor performance of the SGP. The root cause of the debt problems in the eurozone is to be found in the unsustainable debt accumulation of the private sectors in many eurozone countries. I show the evidence in Figures 2.1 and 2.2. It can be seen that household and bank debt were increasing very fast prior to the debt crisis. Surprisingly, the only sector that did not experience an increase in its debt level (as a percentage of GDP) was the government sector.

The private debt accumulation in the eurozone then triggered the well-known debt deflation dynamics (analysed by Irving Fisher (1933) and later by Minsky (1986)) forcing the governments of the eurozone countries to allow their own debt levels to increase. This was achieved through two channels. The first one consisted in governments actually taking over private debt (mostly bank debt). The second one operated through the automatic stabilisers set in motion by the recession-induced decline in government revenues. As a result, the government debt/GDI ratio started increasing very fast after the eruption of the financial crisis. In Figure 2.3 we show the government debt to GDP ratios before and after the crisis for the eurozone countries. The most surprising feature of Figure 2.3 is that except for Germany and Portugal, the government debt ratios of the other eurozone countries were all declining prior to 2008. Even more striking is to find that in two countries that have experienced severe government debt problems recently, Ireland and Spain, the government debt ratios were declining spectacularly prior to the crisis. These were also the countries where the private debt accumulation has been the strongest.

From this evidence it is clear that it is difficult to maintain that the cause of the government debt crisis in the eurozone is due to government profligacy prior to the crisis. The only country where this can be said to be true is Greece. It does not apply to the other countries, where the fundamental cause of the crisis is to be found in unsustainable private debt accumulation forcing governments to step in to help out (in some cases to save) large segments of the private sector.



Source: European Commission, AMECO database and CEPS.

Figure 2.1 *Household and government liabilities in the eurozone (percent of GDP)*

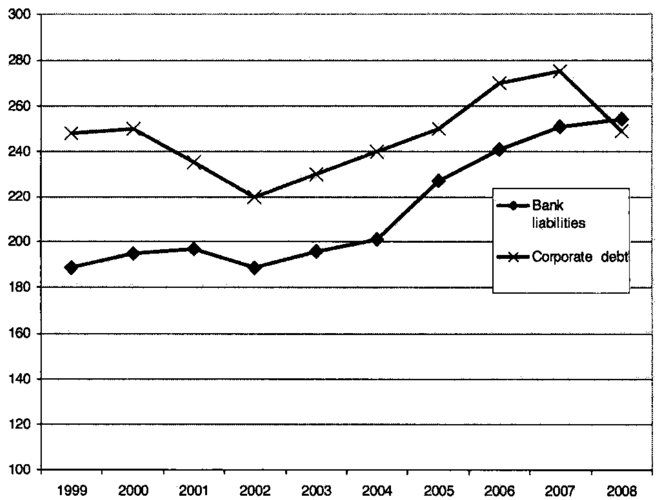
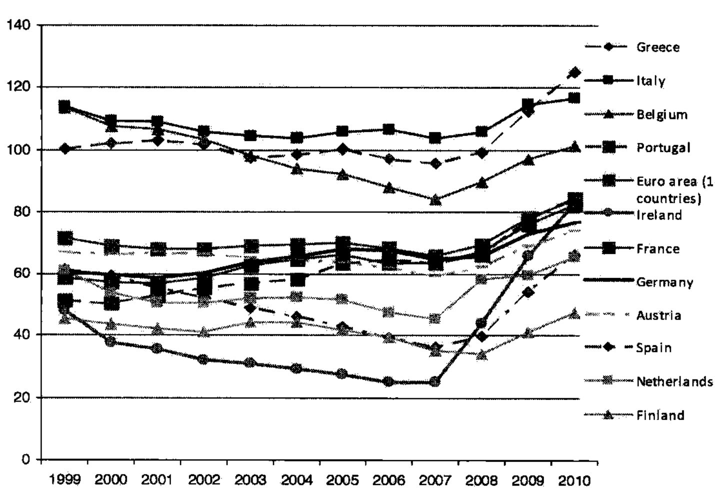


Figure 2.2 *Bank and corporate liabilities in the eurozone (percent of GDP)*



Source: European Commission, AMECO database.

Figure 2.3 *Government debt in the eurozone countries (percent of GDP)*

Although the cause of the government debt crisis is not to be found in the poor workings of the SGP, it remains true that the latter does not work well. This was shown dramatically in 2003 when France and Germany decided to waive the SGP rules unilaterally. It is therefore important to understand why the SGP does not work well, before we decide to tighten its rules and to impose more sanctions, or before we try to apply its method to other areas of national economic policies.

The reason why the SGP worked poorly can be described as follows. As long as budgetary policies (spending and taxation) remain vested in the hands of national governments and parliaments, the political responsibility for the decisions about spending and taxation rests with these national governments and parliaments. The latter face the political sanctions by national electorates. Neither the European Commission nor the other members of the Council face the political sanction for the measures they impose on one member country. 'No taxation without representation' belongs to the essence of democracies. The SGP has been an attempt to short-circuit this principle, by giving powers to individuals and institutions that do not face the political responsibility for their actions. Such an attempt had to fail and happily so.

The Commission has proposed to tighten the rules and to apply stiffer sanctions in the SGP. It is unclear how stiffer rules and sanctions will help to salvage the SGP that is deeply flawed because it disregards elementary principles of political economy. It looks increasingly likely that the Task Force presided over by the President of the European Council will propose a similar tightening of the SGP rules.

The previous analysis leads to the following two conclusions. First, the crisis in the eurozone is mainly the result of the divergent developments in private debt. The latter have much to do with macroeconomic divergences in general. So, something must be done about these divergences. The question is what, exactly.

Second, the method of convergence implicit in the SGP should not be the model used to impose convergence in other areas of national economic policies. This method has not worked well in imposing convergence in the budgetary field; it is unlikely to do so in other fields.

3. HOW TO DEAL WITH MACROECONOMIC DIVERGENCES?

Here also we need the right diagnosis. Where do these macroeconomic divergences come from? I think we do not have a very good answer today. We do not understand very well how these macroeconomic divergences in the eurozone have come about.