Euro Area Woes

David Beckworth wrote an enlightening essay on the Eurozone in the National Review "The Euro Zone Should Integrate or Separate". According to Beckworth:

> **The Proximate Cause of Economic Pain**
>
> As the above figures show, some euro-zone economies have fared much worse than others since the crisis. A major reason for that divergent performance is that one monetary policy cannot work equally well for very different economies.
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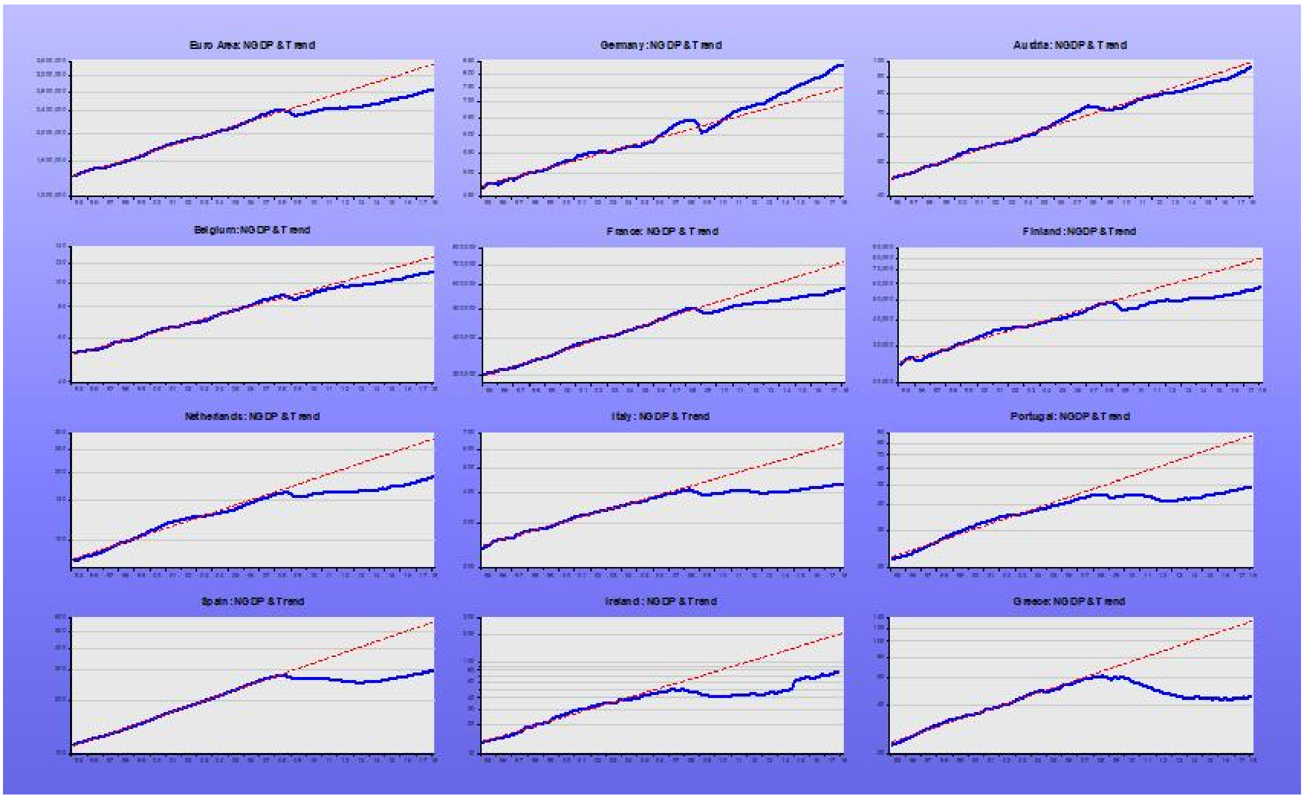
> This challenge can be illustrated using Taylor Rules, which seek to establish what interest-rate targets the European Central Bank (ECB) should set based on changes in inflation and slack in the economy.
>
> Studies that estimate Taylor Rules for regions in the euro zone find that different interest rates should have been used across the currency union since its inception in 1999. The ECB's interest-rate target was too low for the "periphery" countries during the boom period of the early-to-mid 2000s, but it was set too high during the crisis years after 2008. For "core" countries, on the other hand, interest rates have been closer to ideal. Taylor Rule analysis therefore suggests that ECB policy has been persistently destabilizing for the periphery economies since 1999.

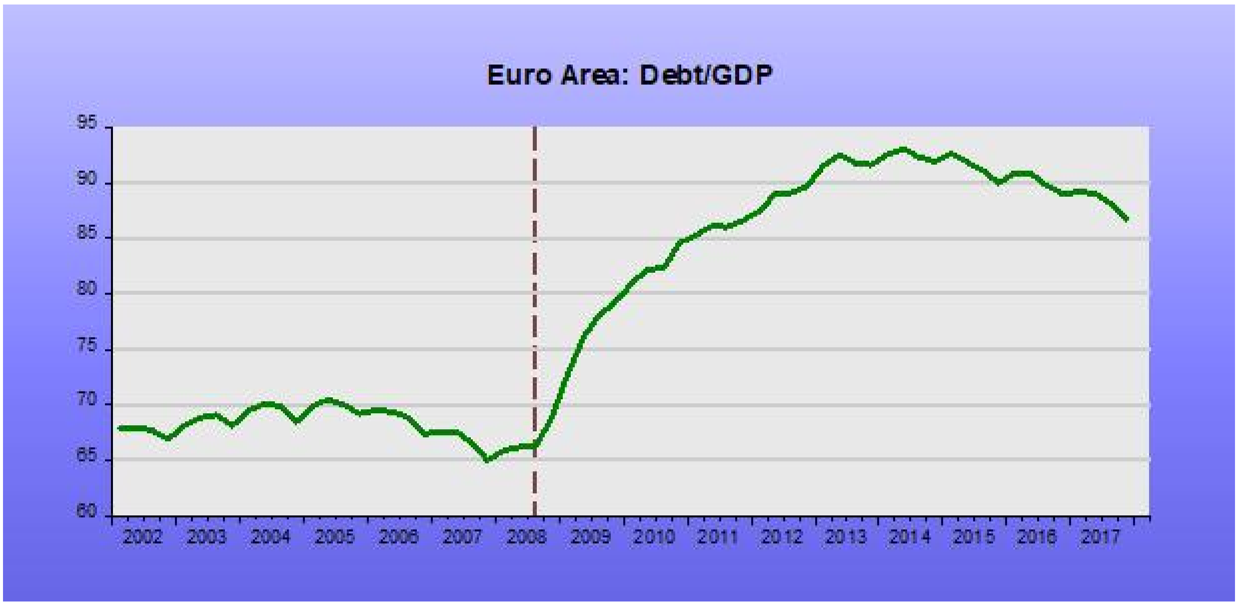
That´s the only point with which I have some quibbles.

Prior to the crisis, all counties, both "core" and "periphery", were growing along a stable NGDP growth path. Therefore, we cannot say that ECB monetary policy was expansionary for the "periphery" countries and "close to ideal" for the "core" countries. It was close to "ideal" for each country as well as for the group as a whole. Taylor Rules are not an adequate measuring rod of the stance of monetary policy.

As the panel shows, following the crisis, ECB monetary policy has been tight, to varying degrees, with the exception of Germany and maybe Austria, for all other countries, notably the “periphery”. Aggregating the “core” countries to show that monetary policy has been closer to “ideal” is deceiving. That comes out only because the weight of Germany and the fact that Germany´s NGDP is significantly above trend.



Initially, the crisis was dubbed a “debt crisis”. The chart indicates the reason. However, debt did not explode. It was NGDP that tanked for the region as a whole. In other words, a monetary crisis!

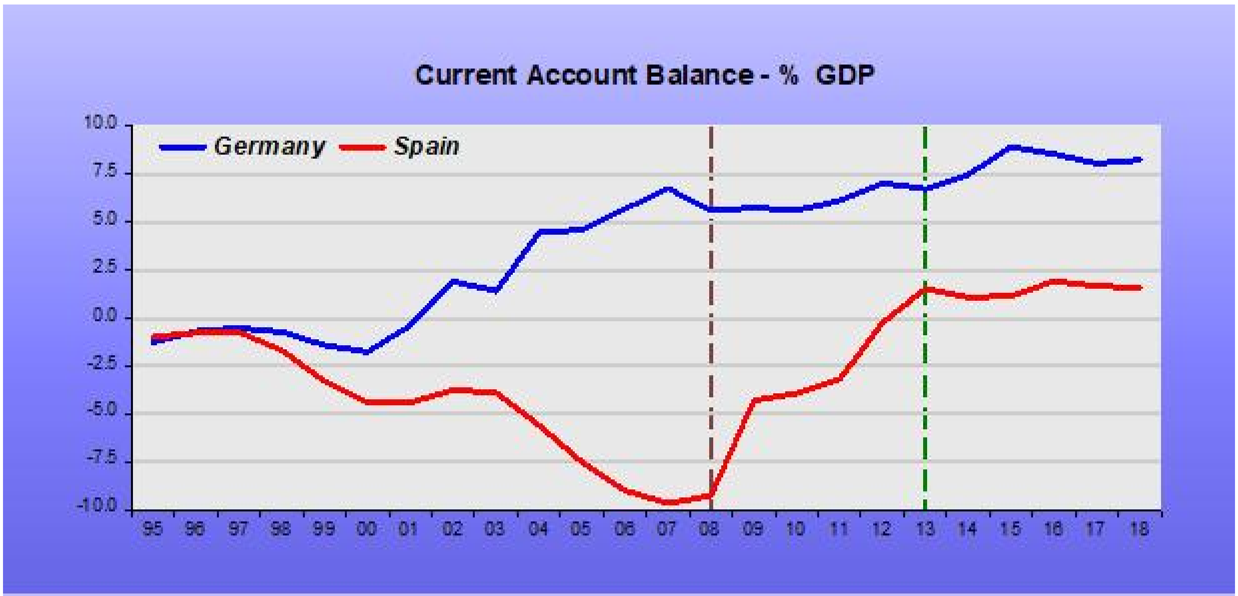


When an economy or area is jostled from monetary equilibrium, underlying “problems” show up. In this case, what became evident from lack of “integration” was the current account “imbalances” between the “core” and “periphery”.

Using Germany and Spain as “representative agents” for the “core” and “periphery”, respectively, we get a good handle on the lack of integration. Spain had to do the adjustment all by itself, without a “helping hand” from Germany.

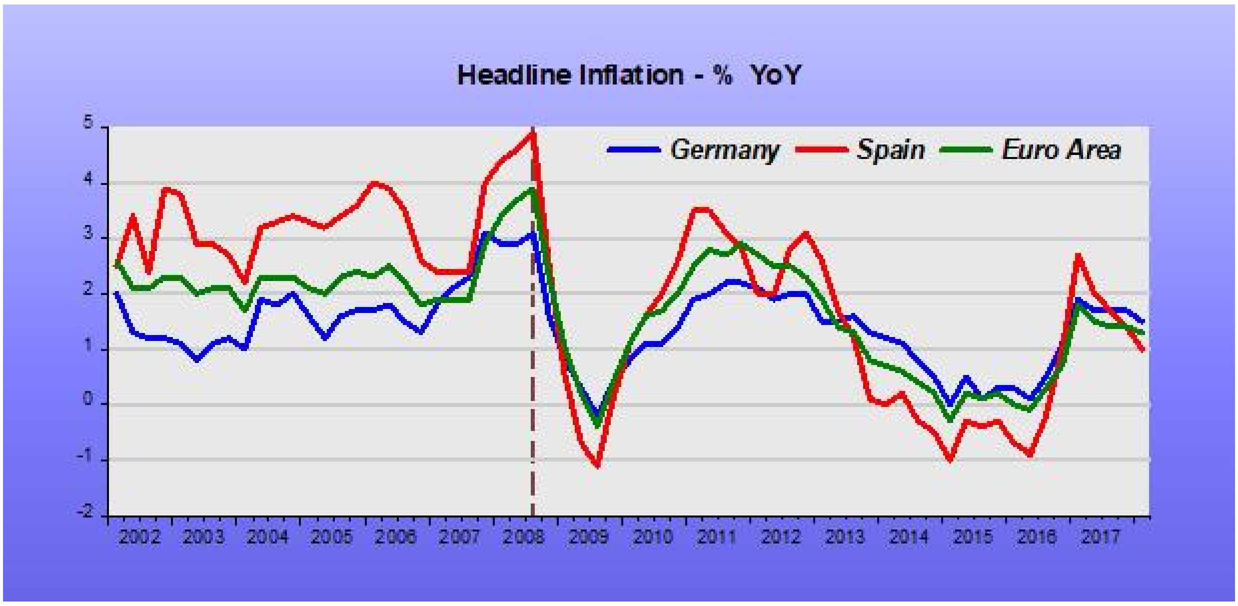
In this situation, the exchange rate/wage (e/w) ratio in Spain has to rise. Given the absence of an independent exchange rate instrument, all the adjustment has to come from a fall in wages in Spain. The chart illustrates what happened.

Germany could have helped by adopting expansionary policies and a rise in wages. However, the current account balance in Germany even increased! As in “old times”, all the burden of adjustment falls on the deficit country. As a result, unemployment in Spain shoots up.



Why did monetary policy failed to such an extent? The reason is the same as for what happened in the US, the UK and several other countries; the obsession with headline inflation, which spiked due to the 2007-08 oil shock.

Looking at headline inflation in Germany, Spain and for the Euro Area as a whole, inflation was well behaved and very close to target overall until the spike. That brought forth a massive monetary policy tightening which, compounded by the lack of integration among the individual countries, derailed the euro project.



Headline Inflation - % YoY
Germany
Spain
Euro Area
5
4
3
2
1
0
-1
-2
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017