

In the absence of fiscal union, the Eurozone needs a more flexible monetary policy: A reply

PIETRO ALESSANDRINI and MICHELE FRATIANNI*

Andrea Terzi's two main objections to our analysis are:

1. Diverging current-account (CA) balances enhanced the fragility of the member countries of the Euro Area (EA), but were not the cause of the liquidity crisis that occurred between 2010 and 2012; and
2. Our quantity-theoretic view of monetary policy implementation is not applicable to a floating currency like the euro, or to the Target 2 (T2) payment system.

Let us deal with them separately.

1. Fragility of the EA versus cause of the liquidity crisis

On page 281 of Alessandrini and Fratianni (2015) we state that:

“external imbalances between Member States ('inter-member external imbalances') are relevant for the performance of a monetary union, when it is not backed by a strong political commitment, which does not exist. EA policymakers have historically ignored these inter-member imbalances and have instead concentrated on union-wide imbalances, so much so that statistical data on the former phenomenon still remain largely incomplete.”

We did not elaborate on the difference between fragility of the EA and the causes of the 2010-2012 liquidity crisis because it would have required an extensive analysis we presented in an earlier publication (Alessandrini et al., 2014). In that article we emphasize several issues, but two stand out for the purpose of our reply to the first comment by Terzi. The first is the fragility of the EA, resulting from an incomplete

* Alessandrini: Università Politecnica delle Marche and MoFiR, email: p.alessandrini@univpm.it. Fratianni: Indiana University, Università Politecnica delle Marche and MoFiR, email: fratiann@indiana.edu.



union coupled by a heterogeneous membership. The global financial crisis exposed this fragility:

“the South, burdened with external imbalances and rigid economies, cannot benefit from the fiscal equalization and bail-out commitments normally available to sub-national governments in a fiscal union. The only adjustment mechanism, outside of fiscal austerity, is for money to flow from deficit to surplus countries” (ibid., p. 10).

By relaxing differentially fiscal austerity, fragility would have lessened because the adjustment burden would have been shared between surplus and deficit countries rather than falling almost entirely on deficit countries. There is an extensive literature, starting with the seminal works first by Keynes (1943) and later by Mundell (1968), on external imbalances and burden sharing, which would be redundant to reproduce here. The essential point to emphasize is that the strict and uniform application of fiscal austerity in the EA impeded surplus country Germany from reflation.

The second is the causal connection or connections. Starting from the basic identity, $S - I = DEF + CA$, where S stands for private saving, I for fixed capital formation, DEF for government budget deficit and CA for the current-account balance, if a current account deficit appears for any reason ($CA < 0$), either the government has to run a deficit ($DEF > 0$) or private saving must fall relative to investment. But in a recession, private saving tends to rise and investment to fall, leading to a further rise in the budget deficit. A crisis emerges with the private sector carrying too much debt. The ensuing deleveraging forces a precipitous fall in asset prices, liquidity losses in the banking system, a likely banking crisis and a larger budget deficit to rebalance economic activity, or to smooth consumption or sustain the banks. In essence, public debt replaces private debt. The collapse in asset value is especially steep in problem countries of a currency union like the EA, where assets can move, without cost or exchange rate risk, to low-risk member countries. The market reacts to this by pricing sovereign risk and segmenting national markets. The expected value of the euro adjusts to sovereign risk. High-risk member countries are bound to lose deposits to low-risk member countries. Our analysis predicts that

a lender of last resort – Draghi’s “whatever it takes” – can stop the bleeding of deposits and reduce national differences in the expected value of the euro.

In sum, our policy prescription for targeting current-account balances is based on the proposition that relevant underlying factors “such as losses of competitiveness, sticky real exchange rates, persistent trade deficits, sudden stops in capital flows, and vanishing liquidity can account for a liquidity crisis independent of fiscal irresponsibility” (Alessandrini et al., 2014, p. 14).

2. Implementation of our monetary policy proposal

Terzi objects to our analysis on the theoretical grounds that:

“EA countries [...] belong to a monetary union whose currency is floating, not to a fixed-rate arrangement where gold or foreign assets are needed to operate. In the context of a floating currency, A&F’s emphasis on the quantity of the ‘monetary base’ reflects a quantity-theoretic view, typical of conventional expositions of monetary policy implementation, that conflicts with modern analysis of monetary policy” (p. 282).

Furthermore, Terzi finds that the monetary base is not a useful concept.

It is true that the EA, as a whole, floats vis-à-vis the rest of the world, but each member in the currency union faces a combination of fixed and flexible exchange rates: the fixed rate applies to the rest of the EA and the flexible rate to all other countries in the world. Thus, from the viewpoint of individual member countries the exchange rate is neither completely fixed nor completely flexible. The consequence is that a country like Italy is confronted with a euro that is too appreciated in a situation where Italy would have faced a comprehensive flexible exchange rate regime; Italy, in the EA, is at a competitive disadvantage. The opposite is true for Germany, whose current account surplus is enormous both in absolute size and in relation to its GDP. The competitive disadvantage of deficit countries largely reflects real exchange rate misalignments in the EA due to

perfectly rigid nominal exchange rates. Surplus member countries such as Germany, with relatively low inflation rates, benefit from real exchange rate depreciations compared to deficit member countries such as Italy, with relatively high inflation rates.

In terms of balance-of-payments accounting, the monetary settlement (the 'below the line' item) that is relevant for the fixed exchange rate area shows up in the T2 balances, balances that each national central bank (NCB) keeps with the ECB. A risk exists that a member country may exit the euro and not honour its accumulated negative T2 balances. Should that occur, the losses would be distributed between the remaining member countries according to their capital shares in the ECB. A T2-surplus country like Germany is exposed to the risk of default by T2-deficit countries, the size of which is proportional to its capital share in the ECB. In response to this risk, banks in the T2-surplus countries may refuse to provide unsecured lending to banks located in a large and persistent T2-deficit country. The interbank market becomes locked.

Suppose that the locking of the interbank market occurs simultaneously with a sudden stop in capital flows, as happened in 2010, and that the T2-deficit NCB does not compensate the increase in the T2 negative balance with an equal amount of lending to their own banks (in other words, there is no institutional sterilization, using our terminology). A decline in the monetary base would take place in the T2-deficit country, which would unleash an expenditure decline (Keynesian effect) and/or a change in relative prices (Humean effect). That, in turn, would impact the current account through an imports reduction due to an income reduction, if the Keynesian mechanism prevails, or through an export increase and an import decrease, if the Humean mechanism prevails. Given the empirical evidence that, in the short run, the negative impact on income is stronger than the positive impact of a decline in the terms of trade, an argument can be made for smoothing unsterilized money flows, as we argue in our paper.

Finally, as to the usefulness of the monetary base, the literature is far from uniform. Here we simply want to point out that, in the aftermath of the financial crisis, the size of the balance sheets of major

central banks has exploded. Considering the high correlation between balance sheet size and the monetary base, the obvious question is: if the quantity of the monetary base is not a useful concept, why are we having an indigestion of QE (quantitative easing)?

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