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# *Remarks on the future of the European Monetary Union*

The problem of the Union's imbalances is wider and more complex than a pure European issue.

What is happening in the Union in macroeconomic terms can be described as follows :

***1. After the sovereign crisis of 2010 and thereafter, peripheral countries were forced by the markets to adjust. And they did :***

- ✓ Their budget deficits have regained "acceptable levels" in the vicinity of 1 to 2% of GDP (and primary surpluses are typically above 1%). Therefore debt levels are stabilizing ;
- ✓ Their current accounts have reached equilibrium and even, in some cases, significant surpluses (against 2 digit deficit figures a few years ago) ;
- ✓ This has been achieved by the containment of domestic demand in the face of high unemployment.

***2. But, as this adjustment was taking place, "northern" current surpluses were reaching unsustainable levels (NL 10%/GDP - Germany 8,7%/GDP in 2017).***

This was not the result of peripheral profligacy. The surpluses were exacerbated by the "specialization factor" common in Monetary Unions : the most productive players get more and more successful as they benefit from the relatively weak average exchange rate of the Union at large.

In a way, the adjustment realized by the South has been offset by the growing imbalances (surpluses) of the North.

In a "normal" Union, the excess savings of the North would irrigate the South and this would tend to even out the cyclical imbalances between different parts of the Union.

***3. But this financial offsetting mechanism is not happening in Europe because of*** :

- ✓ A lingering lack of confidence ;
- ✓ Which has crept into the regulatory setting : each country wants to "protect" its banks against potential contagion and the financial system is compartimentalized through systematic national "ring-fencing".

Therefore the need for a true banking Union which in many aspects does not exist.

***4. Furthermore, current imbalances in the Union are becoming an international problem :***

- ✓ Around 10% of GDP surpluses in major exporting countries is just not compatible with the functioning of any international Monetary system.

It would mean the existence of a persistent regional engine of savings that would eventually distort world trade.

- ✓ Such surpluses are thus considered as "fundamental" imbalances in IMF parlance and, therefore, must be corrected.

***5. How to correct them ?***

The "old way" cannot work.

You can ask a major deficit country to adjust. But you cannot ask a balanced country to continue to tighten its belts in order to mitigate the lasting and high surpluses of some other partners.

Why ?

- ✓ Firstly because it makes no sense :

If the German national currency is undervalued – as has been calculated – by some 20%, it would not be wise to ask peripheral countries to nurture a 2% annual lesser inflation level than in Germany for 10 years in order to eliminate the discrepancy.

It would mean continuing for years the shrinking of domestic demand in peripheral countries that need to grow.

It would feed into political tensions and exacerbate populism …

A Monetary Union should not lead to such a situation.

- ✓ Secondly because the external world cannot tolerate for long the existence of a significantly depreciated currency that fosters a major trade surplus in the world.

The present American reactions are there to keep us conscious of this danger.

***<u>6. There are many ways to solve the problem. Of course one of them does not exist anymore, by construction, it is the change in depreciated exchange rates.</u>***

But others are available :

- ✓ Surplus countries should to some extent rebalance their policy mix and support domestic demand (by promoting infrastructure expenditures for example) ;

- ✓ They should allow some form of income rebalancing : “a little more to wages and dividends and a little less to savings”. These are rather usual traits of changes in macro economic policies ;

- ✓ Some collective forms of action in the Union should be promoted (a more significant European budget could support automatic stabilizers in case of asymetric shocks) ;

- ✓ Barring that, one could imagine some automatic rules that would force large surplus countries as well as large deficit countries to adjust. Some ideas are contained in the memo. They have nothing to do with a “transfer Union” ; they are intended to help achieving a more symmetric and fair adjustment.

These are not new ideas : the Macro Economic Imbalance Procedure has been approved and ratified by the EU Council but never implemented.

All of this is extremely urgent because the political changes are moving very fast.

If nothing is done, the worst can happen.

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