No. 1406 [EN]

IMI Working Paper

The Dynamics of Fragmentation in the Euro Zone: Theory and Political Implications

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INTERNATIONAL MONETARY INSTITUTE

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The Dynamics of Fragmentation in the Euro Zone: Theory and Political Implications

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October 2014

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Four and a half years after the burst of the Euro crisis, the Eurozone economy seems to be doing better. In peripheral countries, economic growth is picking up and investors from abroad are coming back. Nevertheless there is no denying that serious obstacles to full recovery still exist. The Euro zone has yet to find the right path for a return to a sustained and robust economic growth.

In order to design the policies which the Eurozone has to implement, one must start by deciphering the forces which have been at work since the creation of the European currency. In my previous lectures in China, I already gave theoretical insights on these mechanisms, which I will use in this paper to build a more comprehensive explanation of the evolution of the Euro area during this period. This approach will lay the foundations which underpin my personal view on the policies that are presently being followed and on the measures that should be taken in order to improve the working of the Euro area.

In this paper, I will firstly give an assessment of the present economic situation in the Eurozone. I will then focus on the role of financial markets. Thanks to the use of a simple theoretical model which will rest on the working of a "genuine" currency area, I will show that their integration is a prerequisite but not a sufficient condition to having a "genuine" currency area. This analysis will lead me to make an appraisal of the integration process in the Euro zone and to conclude by some remarks on the orientations that in my view need to be pursued in order to speed it up.

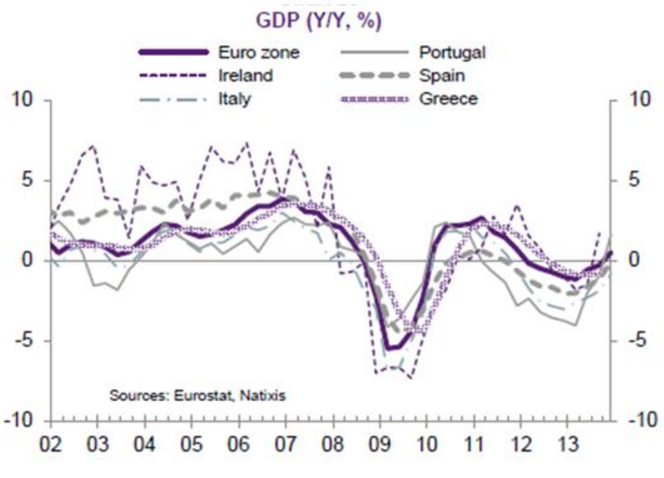
1. The Aftermath of the Euro Crisis: Where Do We Stand?

When one looks at the overall picture of the Euro area economy four and a half years after the burst of the crisis, one may feel that the worst is behind us and that the Euro zone is back on the right track. There is in fact some good news which should not be underestimated.

1.1 Mood has dramatically improved

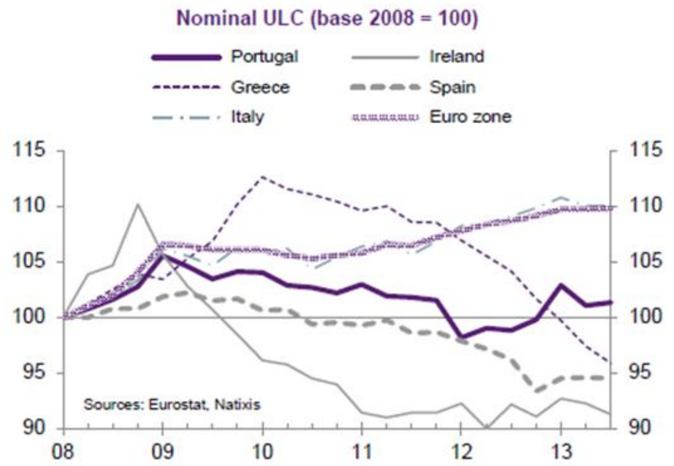
Economic growth has started to resume in the Euro area as a whole. In all peripheral countries growth is expected to return in 2014.

Chart 1



Furthermore, competitiveness has improved in the most embattled economies: nominal unit labor costs have decreased relatively to the Eurozone average in all peripheral countries (Italy excepted).

Chart 2



No wonder then that export is picking up in these countries (Greece excepted), and that their current account balance has moved back to equilibrium.

Chart 3

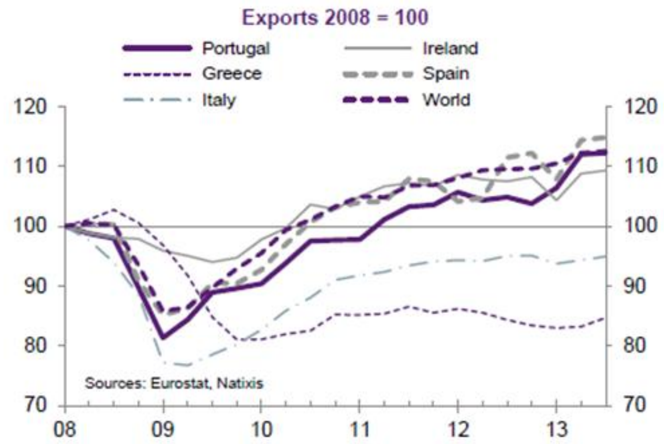
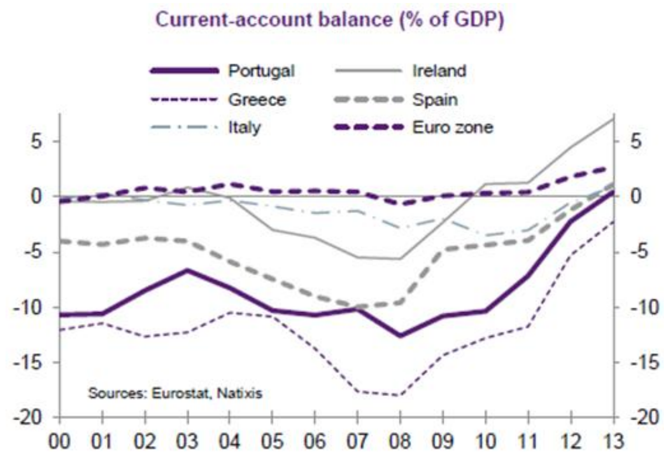


Chart 4



In peripheral countries, fiscal deficits, while not yet abiding by the stability and growth pact ceiling, have for most of them come back to their pre-crisis levels.

Chart 5

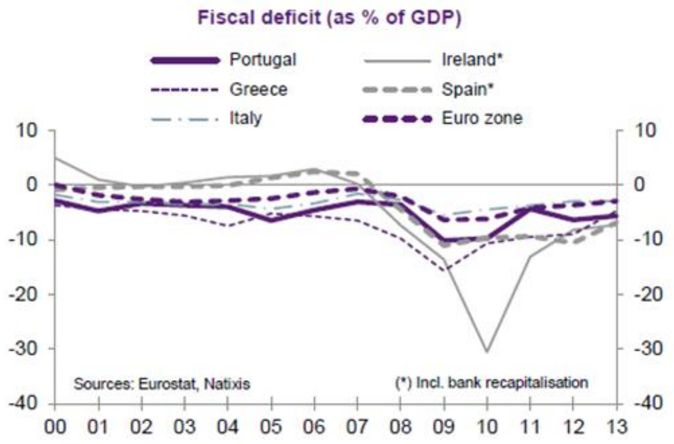
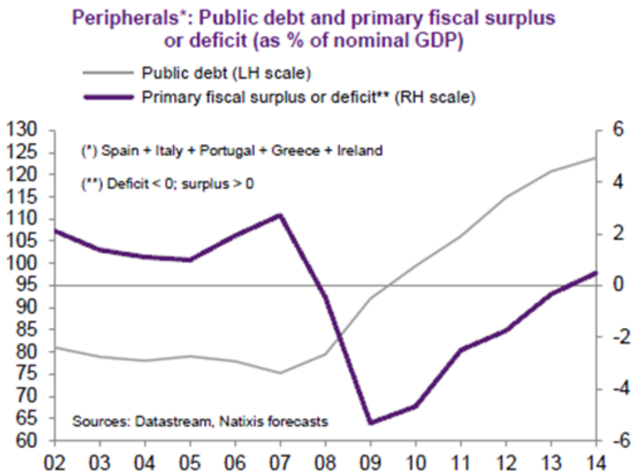


Chart 6



Investor's confidence has come back as can be seen on the sovereign yield spreads which have returned to their pre-crisis level in many peripheral countries.

Chart 7

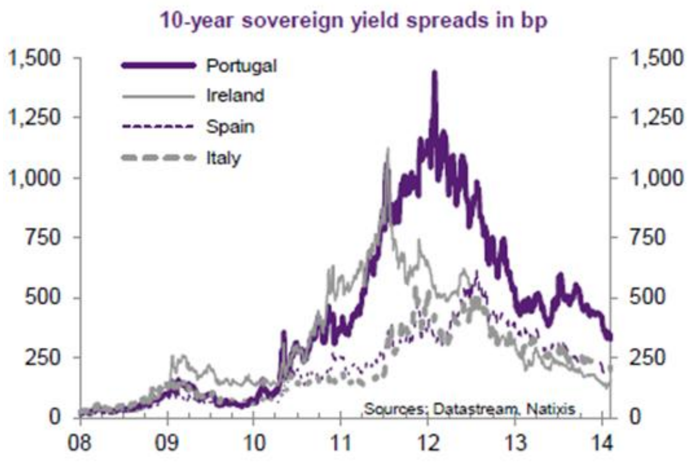
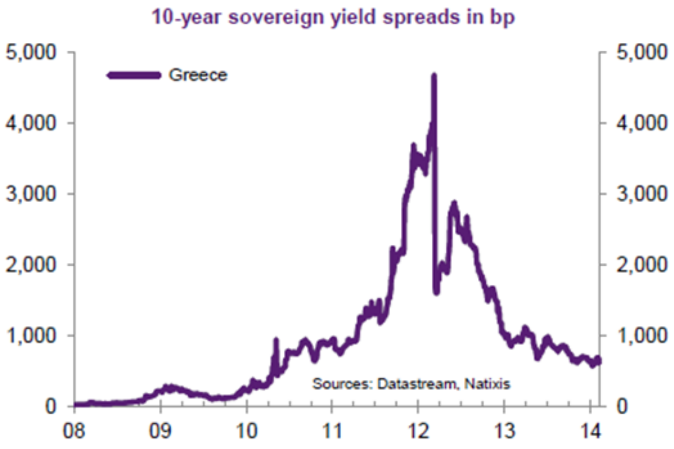


Chart 8



Last but not least, European parliamentary elections which saw a surge of Euro-skepticism in many countries have also shown the resilience of embattled governments in the periphery, except Greece. Despite the harsh economic reforms implemented in many countries, there has hardly been any real threat to the euro: anti-euro sentiment has been confined to the extreme right; the crisis has not dangerously dented the feeling of the public opinion in the Eurozone in favor of the European currency.

Nevertheless, there is no room for complacency.

1.2 Serious drawbacks still exist to a full recovery

Compared to the rest of the world, the prospect of the Eurozone economic growth remains sluggish.

Relative to the US, manufacturing production, productive investment and total employment lag behind.

Chart 9

Chart 10

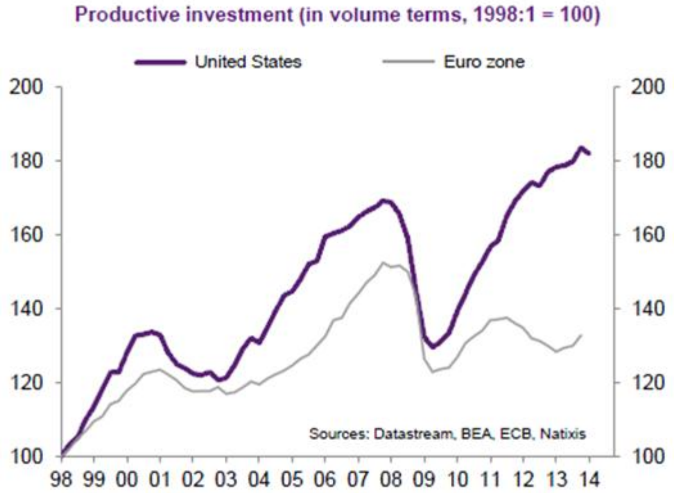


Chart 11

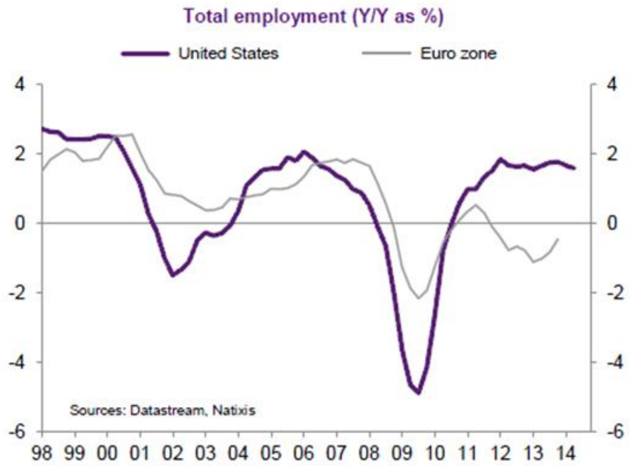
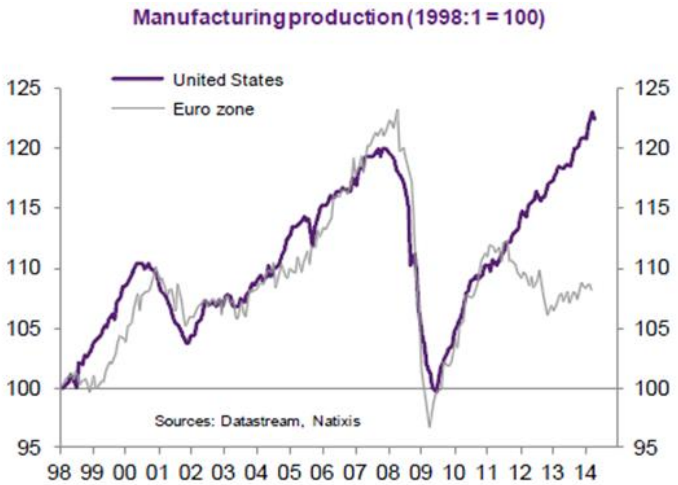
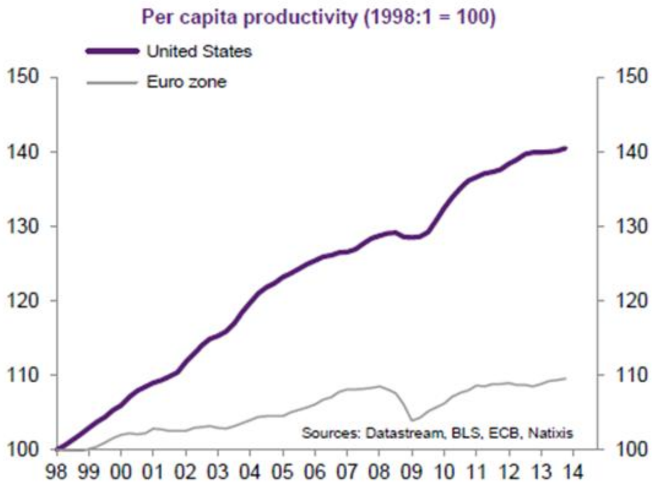


Chart 12



And productivity is still growing in the US more rapidly than in the Eurozone.

Chart 13



If we look now at the challenges that the Eurozone has to overcome, the three main concerns which we must heed in the first place are in my view the following:

1.3 The three major challenges facing the Eurozone

1.3.1 The first major issue rests on the insufficient dynamism of its productive sector: despite Germany's performance, total real corporate investment in the Eurozone taken as a whole doesn't really take off.

Chart 14

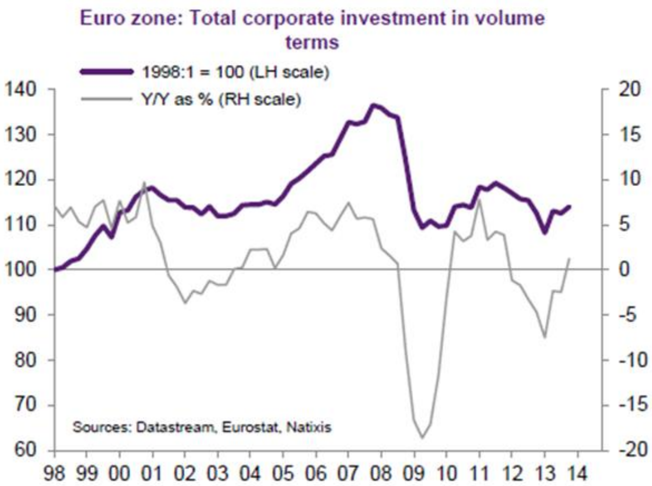
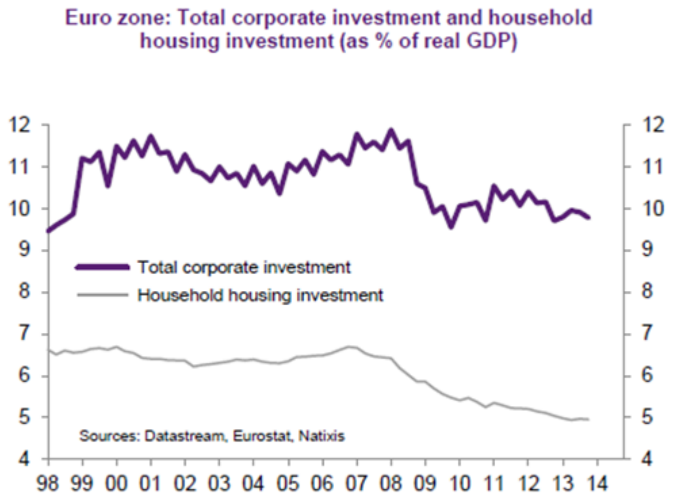


Chart 15



The level of debt (public and private) remains high, which leads to deleverage by firms and households prior to investment.

Chart 16

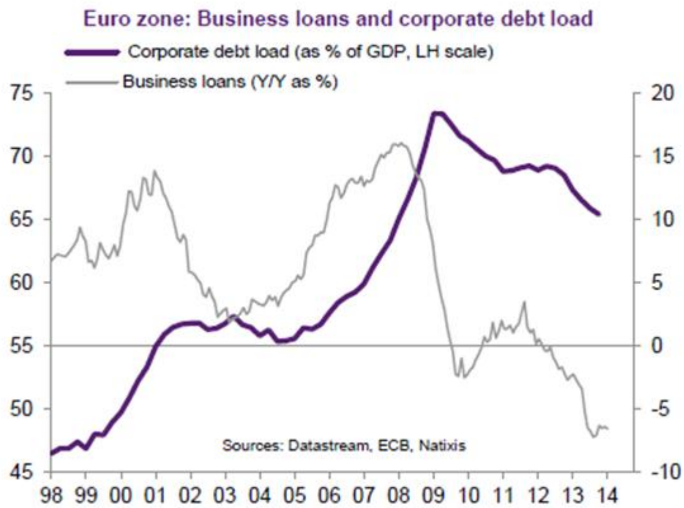
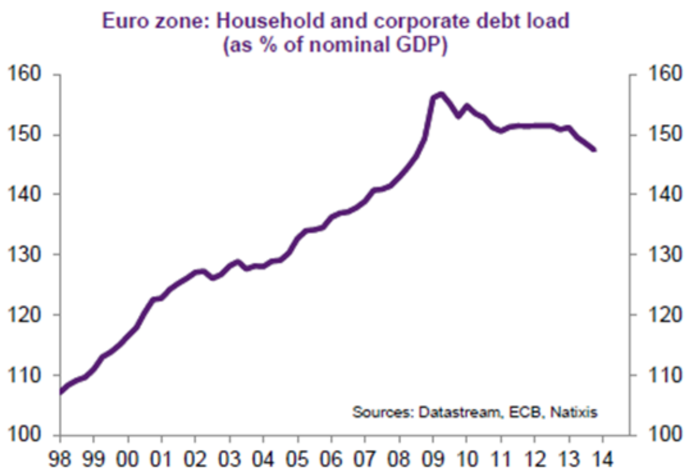


Chart 17



1.3.2 Heterogeneity is another major challenge. The North South divide is far from being overcome.

It can be seen in the manufacturing production capacity and in per capita income of Southern countries relative to Germany.

Chart 18

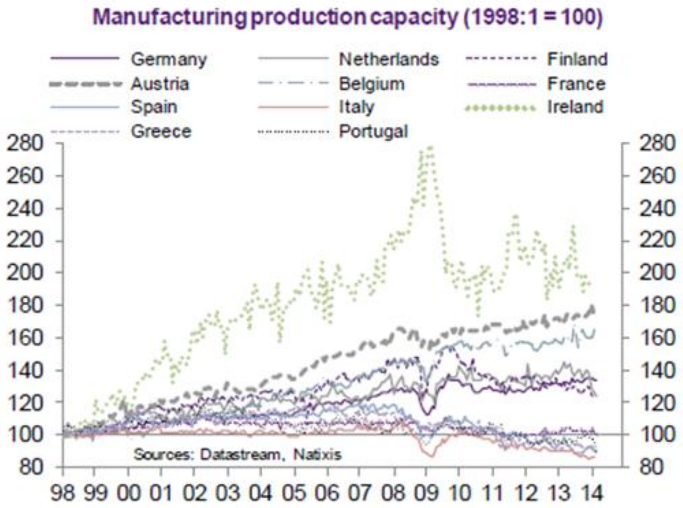
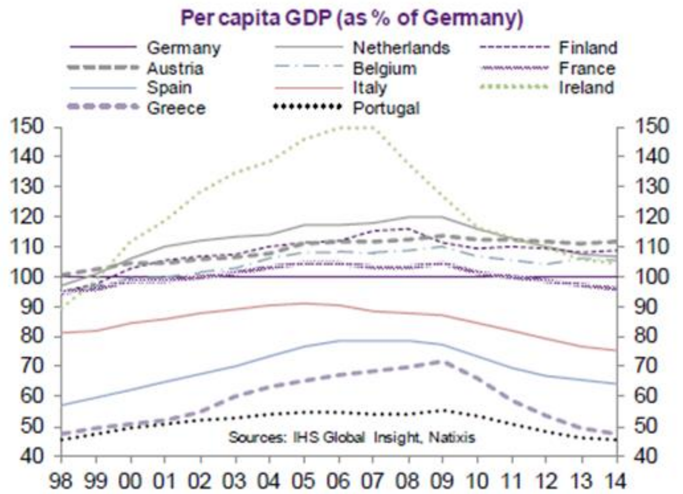


Chart 19



In all peripheral countries, the share of productive investment in GDP has decreased on average from 15% in 2008 to 11% in 2013. Productive investment fell sharply during this period and remains still low.

Chart 20

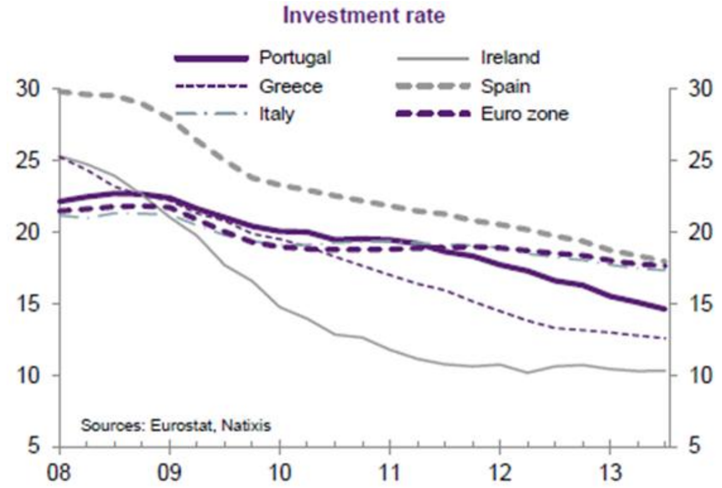
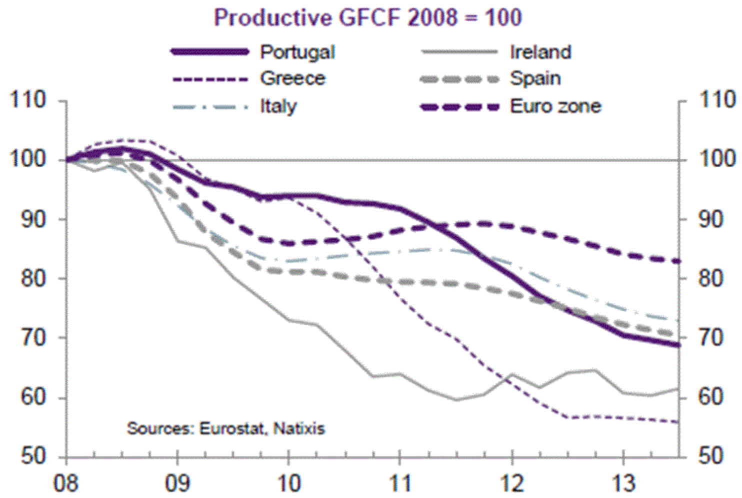
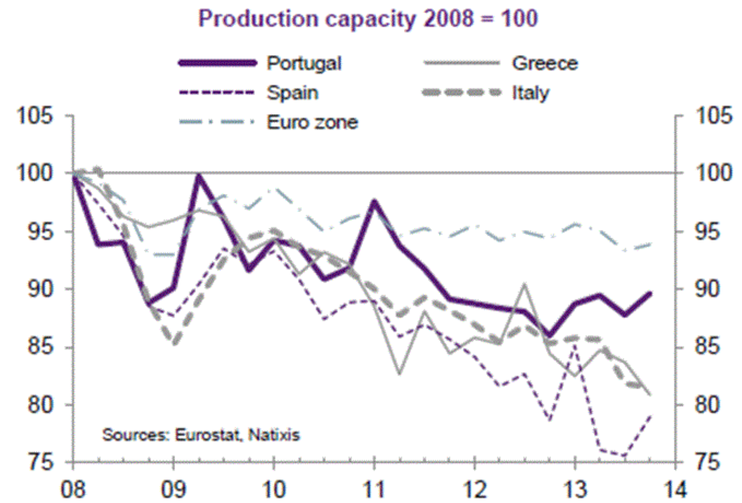


Chart 21



Production capacity has plummeted in all these countries (much more than the average in the Eurozone), therefore reducing their potential growth.

Chart 22



No wonder that their rate of unemployment has surged, sometimesskyrocketed (in Spain and Greece)and stayshigher than the average level of the Euro area.

Chart 23

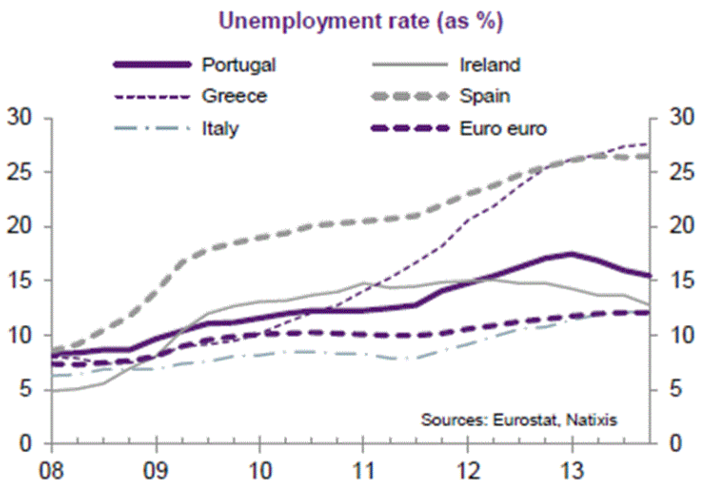
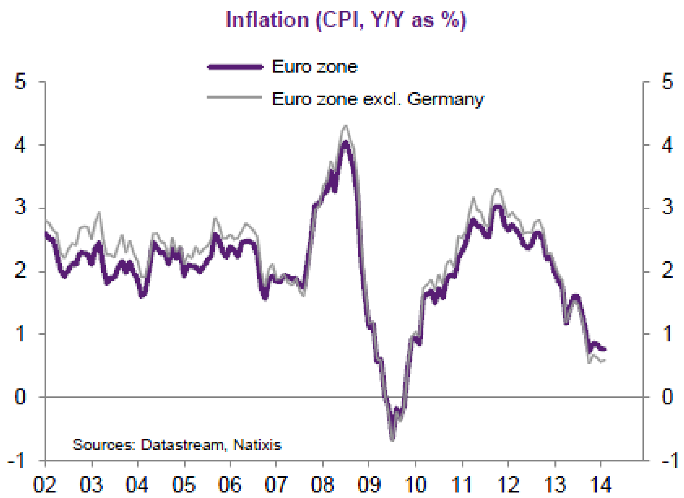


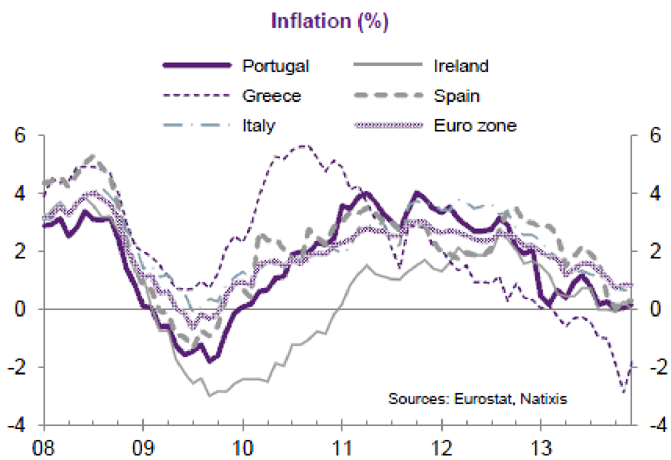
Chart 24



1.3.3 The last major challenge on which I deem necessary to point out concerns the current account of the Euro area, the exchange rate of the euro and the risk of deflation.

As a matter of fact, the price level is decelerating dangerously in the Euro area.

Chart 25



Price level is decreasing more rapidly in peripheral countries than in the core of the Euro area.

This evolution isnot only negative since it is improving the relative competitiveness of these economies. But we have to keep in mind that fall of imports which is a consequence of the decline of domestic demand is the main driver of return current accounts to equilibrium.

Chart 26

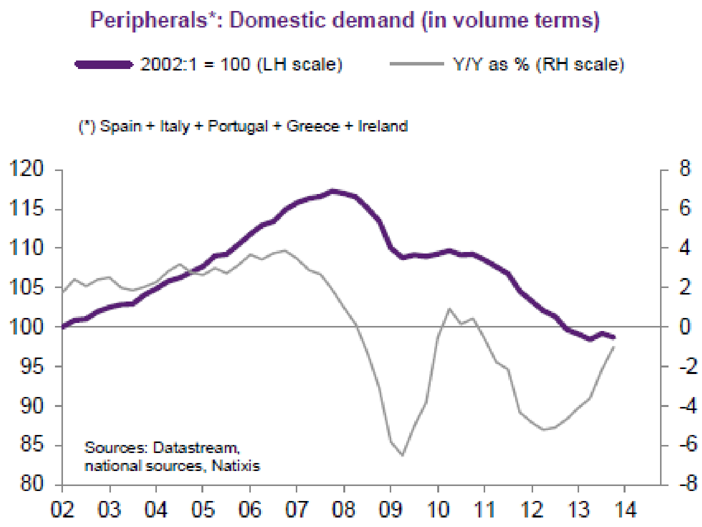
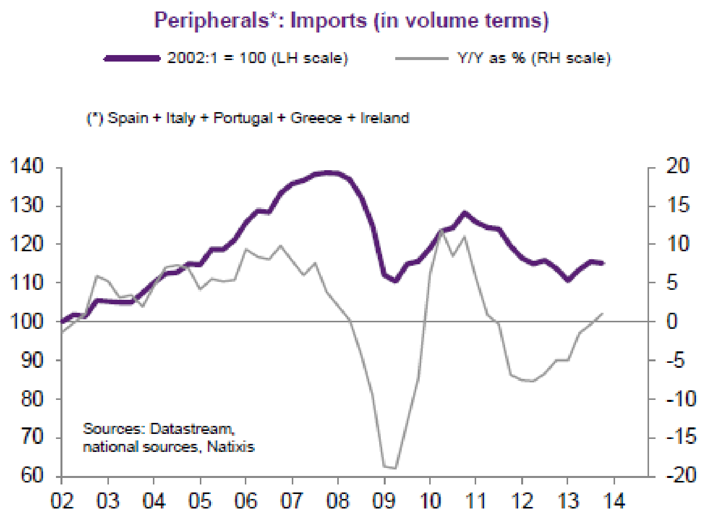


Chart 27



As for the Eurozone as a whole, while the monetary base is contracting, the stock of money does not increase and we observe a real "credit crunch" in the private sector.

Chart 28

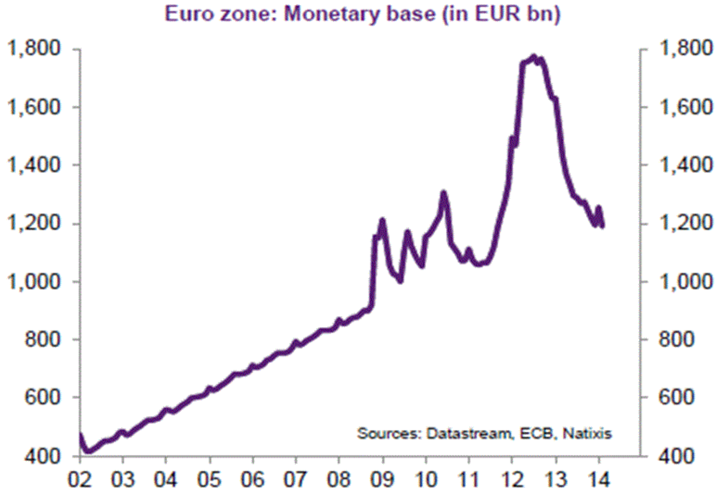
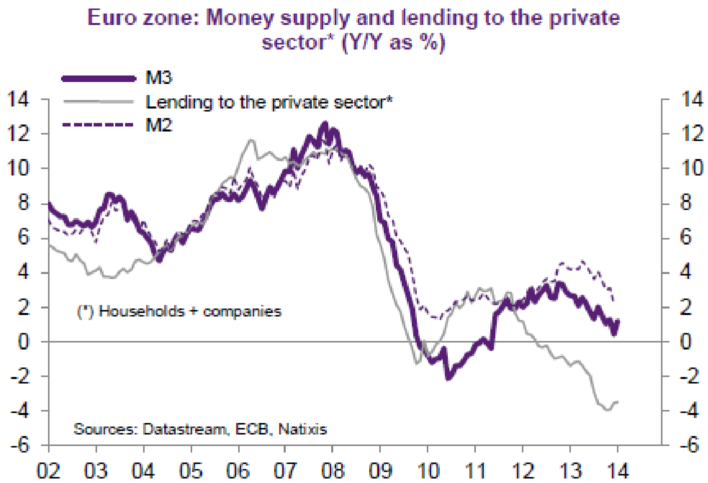


Chart 29



Concerning the value of the euro, its trade-weighted exchange rate is again on the rise. Import prices are declining, contributing therefore to the disinflationary dynamics.

Chart 30

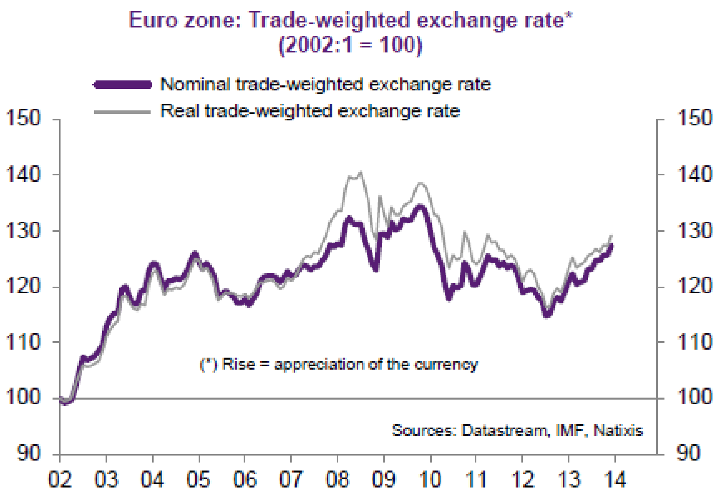
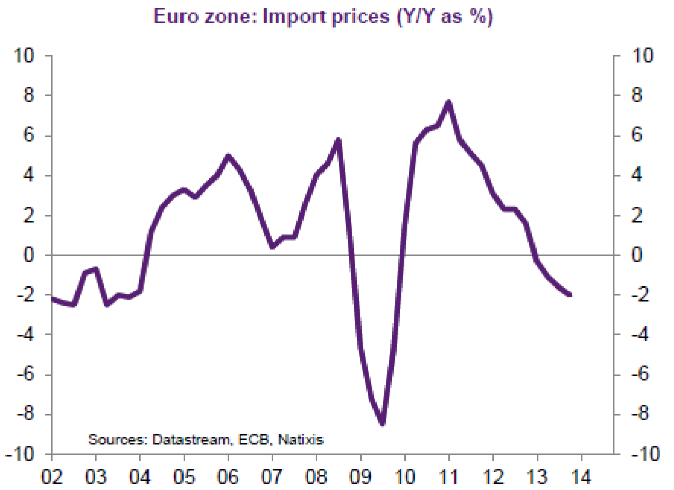


Chart 31



The Eurozone incurs a serious asymmetry problem with its current account. On the one side, countries of the South would be better off with a weaker Euro which would help boost their exports, their main engine for growth. But on the other side, Germany which posts a high current surplus sdoes not suffer from a strong euro. Its falling exports to Eurozone have been replaced by rising sales to the rest of the world.

Chart 32

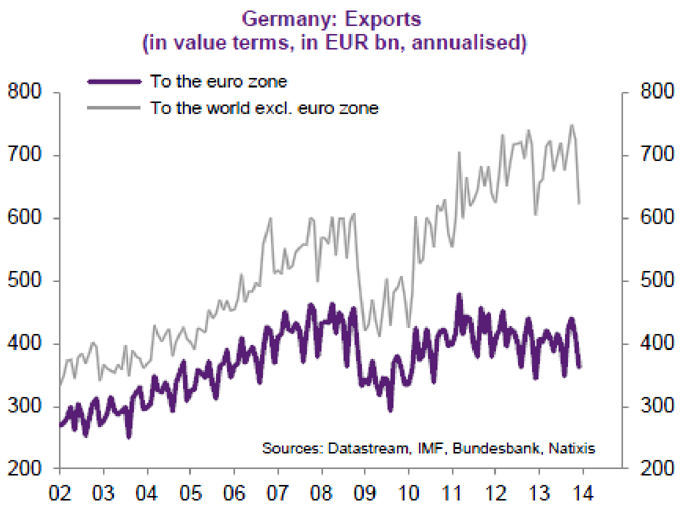
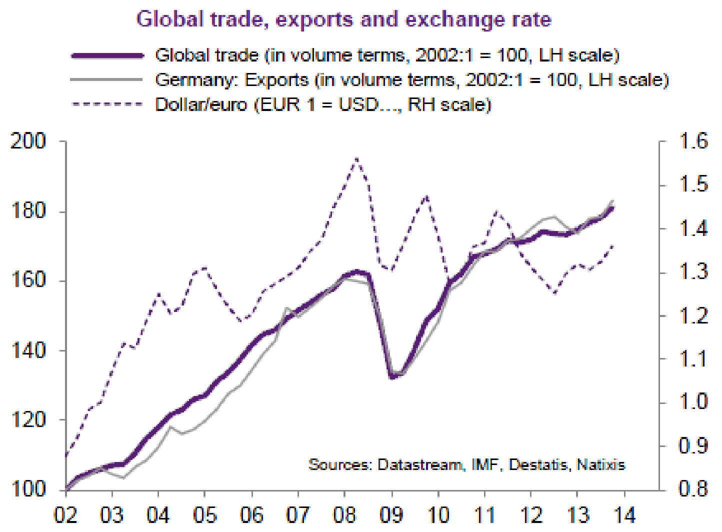


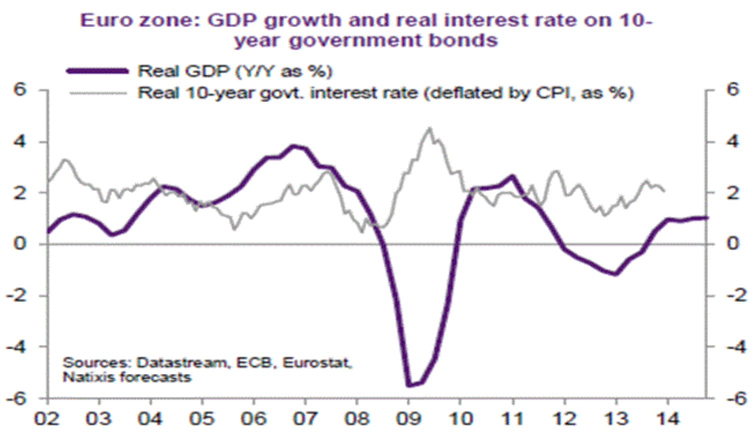
Chart 33



The Eurozone external surplus and the return of capital flows to peripheral countries sovereign markets help contribute to strengthening the European currency.

This disinflationary process entails another consequence: despite the low level of nominal interest rates, real interest rates in the Euro area remain relatively high. Contrary to the US, they are higher than the rate of economic growth, contributing therefore to endogenously raise the debt to GDP ratio.

Chart 34



The three challenges that I have described are all directly or indirectly related to fragmentation of the Eurozone. Before looking into the strategy to bring it back to a full recovery, let us try to have a comprehensive understanding of the mechanisms at work leading to this fragmentation.

2. A Theoretical Model of Currency Areas Fragmentation

Let us start by looking at the functioning of a "genuine" currency area as it functions in the US.

2.1 The macroeconomic dynamic model of a "genuine" currency area

Let us assume that two regions called North (N) and South (S) belong to the same ("genuine") currency area which is supposed, for the sake of simplicity, to be always maintained in external equilibrium (the currency area is either a closed economy or has adopted a "pure" flexible exchange rate regime so that the current account of the currency area is always balanced). Assume that North has a structural surplus of its "current account" vis à vis South (its production is higher than its domestic demand), meaning in other words that domestic saving in North is higher than domestic

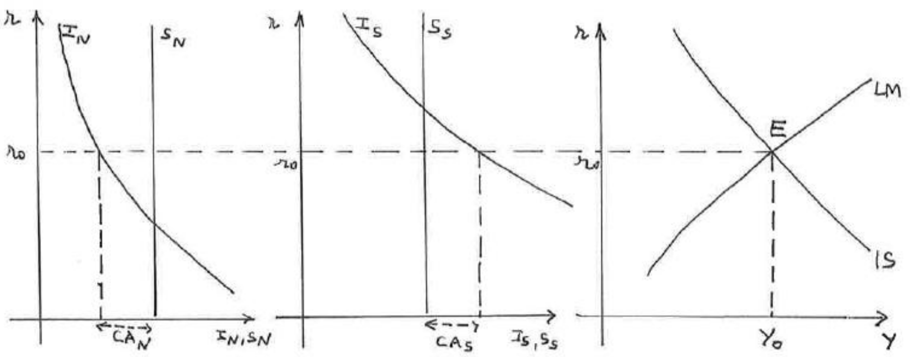
Investment[1]. On the contrary, South has an excess demand (current account deficit) of the same amount.

In order to visualize with clarity how forces interact between North and South, we will use the usual macroeconomic graphical apparatus of market equilibrium between saving and investment (the supply of and demand for saving), and introduce the monetary equilibrium in the traditional Hicksian IS-LM model. This model will allow us to see interaction between the markets of goods and services (the "real" equilibrium), the financial market (the equilibrium between saving and investment) and the monetary market (the equilibrium between the demand for and supply of money).

We start from a position of general equilibrium (E) with an interest rate for which saving is equal to investment in the currency area as a whole (aggregate supply is equal to aggregate demand), while simultaneously the demand for money is equal to its supply (see graph 1). The only macroeconomic equilibrium which matters in this "genuine" currency union is the equilibrium for the whole area (North and South).

At equilibrium, investment in South is always financed through domestic saving in South and the flow of saving coming from North which is the counterpart of the "current account surplus" of North. In North, equilibrium is obtained by the drain of saving from North to South. At equilibrium (E) on graph 1, saving and investment are equal both in South (through a net flow of capital from North to South) and North.

Graph 1



(North)
Sn: Saving in North
In: Investment in North
(CAn): Current account surplus in North

(South)
Ss: Saving in South
Is: Investment in South
(CAs): Current account deficit in South)

(North and South)

In this "genuine" currency union, let us assume an asymmetric shock due for example to a fall in private investment[2] in South (graph 2): the investment curve in South shifts to the left in (II). How

[1]Starting from general equilibrium: Y + M = C + I + G + X

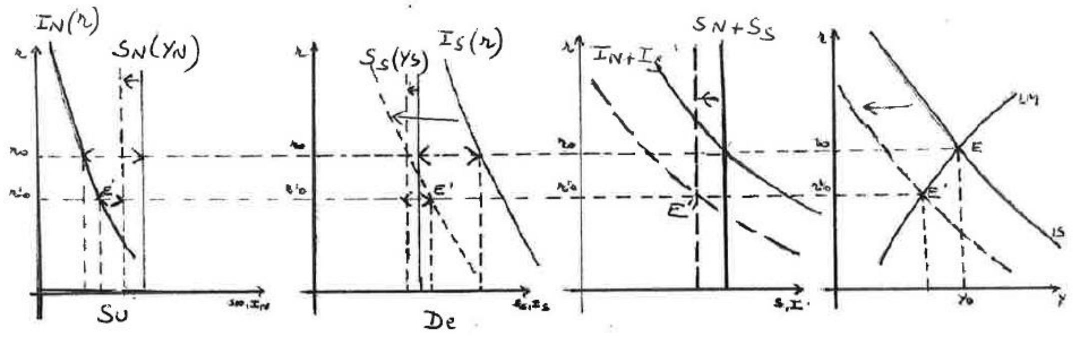
We can write: (Y-T-C) +(T-G)=I + (X-M), Private saving (S – I) = Public saving (X-M)

Y being National income; C: Private consumption; I: private investment; G: public expenditures; M and X: imports and exports of goods and services; T: taxes, S: (private plus public) saving.

[2]If we take the assumption of a fall in public expenditures, the saving curve would then shift to the left. A similar mechanism would be

do we come back to general equilibrium?

Graph 2



(N) (I) (S) (II) (N+S) (III) (N+S) (IV)

(Su): Current account surplus of North;(De): current account deficit of South

Since this shock represents a fall of aggregate demand in the currency area as a whole, one can see its impact directly in (IV): there is a downward shift of IS and a new equilibrium in the currency area at a lower level of economic activity and lower interest rate.

In each region of the currency area, impact is the following: fall in domestic demand in South leads to a decrease of income and therefore of domestic saving (the domestic saving curve in South (II) shifts to the left); it leads also to a corresponding decrease in exports of North to South which induces a fall of income in North, therefore of its domestic saving: the North domestic saving curve shifts to the left (I). We also have an impact of the fall of income in North on income in South (through reduction of its exports), and therefore of domestic saving in South which shifts again to the left (II).

At the new equilibrium (E) where economic activity is down both in North and South and interest rate is lower as well, North investment has increased along its investment curve while domestic saving is lower (I): North therefore posts a decrease in its "current account surplus" (II). In South, there is a corresponding decrease in "current account deficit". At the new equilibrium, "domestic excess saving" (current account surplus) in North is still equal to ("domestic excess investment") in South.

In a "genuine" currency area, thanks to the functioning of an integrated financial market between North and South, there is therefore a smooth transmission mechanism throughout the whole currency area of a shock which has hit any of its regions.

Correspondingly, any monetary policy impulse is transmitted to North and South: an increase in the supply of money leads to a shift to the right of the LM curve and simultaneously to a shift to the right of both saving curves of North and South, leading to a new (internal and external) equilibrium at a lower interest rate with higher levels of investment and saving both in North and South.

The model which I have used here is the standard equilibrium mechanism which is in fact a simplification of the setting of a simultaneous microeconomic general equilibrium on all goods and services, financial and monetary markets. It tells us that in the case of a "genuine" currency area we don't have to bother about "current accounts" between regions which in fact are hardly looked upon.[3]

2.2 What went wrong in the Eurozone?

at work, but from a different starting point.

[3] Except if one is interested in the distribution of productive capital and labour, and therefore of wealth amongst regions.

Before the creation of the European currency, countries which now belong to the Euro area, in particular those in its periphery were struggling to avoid falling into any significant current account deficit. With the emergence of the euro, the Euro area seemed to function as a “genuine” currency area: interest rate spreads between member states nearly disappeared. They converged to a unique interest rate. As described in graph 1, flows of capital were leaving North towards South: the building of excess demand in South due to low interest rates was matched by excess supply in North. During the first ten years of the euro, sustainability of current account deficit of the South was made possible thanks to excess saving in North which was the counterpart of exports of goods from North to South. This movement was not only fuelled by excess demand (public and private) in South, but by its lack of competitiveness due to wage increases incompatible with the rise of labor productivity.

After the burst of the global financial crisis as soon as 2009, financial markets started to question the value of sovereign debt in Portugal and Spain. After the disclosure of fiscal deficit in Greece, ratings of southern countries (and Ireland) started to move down (see table 1). This down grading reached in successive waves “intermediate countries” in 2011-2012 and a few “core countries” thereafter (table 1). Correspondingly interest rates spreads started to widen not only on sovereign bonds markets, but on all the segments of the financial markets as well.

Had we been living in a “genuine” currency Union, the asymmetric shock caused by the global financial crisis in the various parts of the Eurozone would have led to a fall of interest rate and a decrease of economic activity all over the Eurozone. Impact of the shock would have been distributed among Member states according to the model which I have previously described.

Chart 35 Standard & Poor's Eurozone Sovereign Ratings Since 1999

CORE COUNTRIES

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Austria	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA+ *(Jan)*	AA+	AA+
Finland	AA+	AA+ (Oct)	AA+	AAA *(Feb)*	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
France	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA+ *(Jan)*	AA (Nov)	AA
Germany	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
Luxembourg	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
Netherlands	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA+*(nov)*	AA+

INTERMEDIATE COUNTRIES

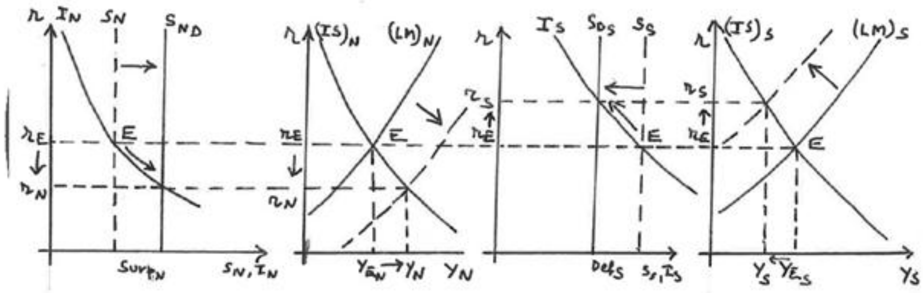
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Belgium	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA *(Nov)* AA+ *(Aug)*	AA	AA	AA
Estonia	A-	A-	A-	A-	A-	A*(Nov)*	A	A	A	A	A	A	AA- *(Aug)*	AA-	AA-	AA-
Malta	AA-	AA-	AA-	AA-	A+		A *(May)*	A	A	A	A	A	B *(June)*	A- *(Jan)*	BBB+	BBB+
Slovakia	BBB+	BBB+	A- (Oct)	A-	A-	A-	A *(Dec)*	A	A	A+	A+	A+		A *(Jan)*	A	A
Slovenia	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA- *(Oct)*	A+ *(Jan)*	A-	A-

PERIPHERAL COUNTRIES

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Cyprus	AA-	AA-	AA-	AA-	AA-	AA-	AA-	AA-	A *(July)*	A+ *(April)*	A+	A *(Nov)* A- *(Feb)*	BBB *(Oct)* BBB+ *(Aug)* A- *(Mar)*	BB+ *(Jan)*	CCC	B
Greece	A-	A-	A *(March)*	A	A	A	A	A	A	A	BBB+ *(Dec)* A- *(Jan)*	BB+ *(Aug)*	CC *(Jul)* CCC*(Jun)*B *(May)* BB- *(Mar)*	B- *(Dec)*	B-	B-
Ireland	AA+	AA+	AAA (Oct)		A+ *(June)*	A *(Nov)*	A	A	A	A	AA *(June)* AA+ *(Mar)*	A *(Nov)* AA- *(Aug)*	BBB+ *(April)* A- *(Feb)*	BBB+	BBB +	BBB+
Italy	AA	AA	AA	AA	AA	AA- *(July)*		A+ *(Oct)*	A	A	A	A	A *(Sept)*	BBB+ *(Jan)*	BBB	BBB
Portugal	AA	AA	AA	AA	AA		AA- *(June)*	AA-	AA-	AA-	A+ *(Jan)*	A- *(April)*	BBB- *(March)*	BB *(Jan)*	BB	BB
Spain	AA+	AA+	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AA+ *(Jan)*	AA *(April)*	AA- *(Oct)*	A *(Jan)*	BBB-	BBB

In fact, due to its lack of integration, Euro area peripheral countries had to take the pain of mechanisms that enter into play in a fixed exchange rate system in countries which lose confidence of their creditors due to their excessive current account deficits. The dynamic forces which entered into play to bring peripheral countries back to external equilibrium can be described thanks to our standard model.

Graph 3



(I) (II) (III) (IV)

North South

Let us assume that fear of sovereign default which starts in one country (Greece) ends up spreading in other peripheral countries (graph 3). We then observe capital outflows from these countries back to the core countries. Saving curve in South shifts to the left (III) while the LM curve shifts to the left (IV) (due to outflow of capital, the supply of money decreases): interest rates in South increase. Simultaneously in North, as capital comes back the saving curve shifts to the right (I) while the LM curve is moving downwards (II) pushing interest rates down. During this process, the current account deficit of South decreases whereas economic activity is contracting and unemployment rising. In North, we observe on the contrary a decrease of the current account surplus, a rise of income and lower unemployment. The move stops when the need to borrow from South to North has disappeared, that is when current account in South is in equilibrium.[4]

We should not be surprised by this dynamics: it corresponds to the adjustment process which gets under way in countries living with a fixed exchange rate, which are under pressure of markets due to their unsustainable current account deficits. Our model is focusing on the action of the "real forces" (aggregate demand) for return to equilibrium. But the real exchange rate, can play as well. Even though in the euro area the "nominal exchange rate" is unchanged, the "real" exchange rate is affected through differential between North and South in the evolution of price and wages. Both movements which have been at work can alleviate the downward pressure on economic activity and unemployment. A last comment on this model will be about the assumption made for the construction of our model which is that the current account of the whole euro area is always in equilibrium. As a matter of fact as already

4 See appendix.

indicated, the Eurozone posts a surplus which comes mainly from Germany. Buoyant German exports contribute to sustain economic activity in the whole Eurozone and give birth to outflows of capital abroad. But a strong euro is an obstacle to more dynamic exports in South. Furthermore, sovereign bond markets in peripheral countries are attracting capital flows from abroad in search of yields. Inflows of capital in South alleviate the pressure on interest rates, but one should keep in mind that those capital flows are volatile, and should they leave those countries, spreads might be rapidly rising again. Both phenomena nevertheless do not change fundamentally the lessons to draw from the model which is the key role of capital flows between North and South in the explanation of the evolution of the Euro crisis.

3. Financial Markets and Fragmentation of the Eurozone

In his lecture on financial integration and banking union at the conference for the 20th anniversary of the establishment for the European Monetary Institute[5] Mario Draghi, the President of the European Central Bank, recalled that: *Financial integration and the single currency are in many ways two sides of the same coin. One fundamental reason for the single currency was to maximize the benefits of the single market for capital. And conversely, it was understood when the euro was conceived that integrated financial markets would be necessary for an effective single currency*"…

Compared to the United States which has a "genuine" currency union with integrated markets in the real, financial and monetary sectors, we lived in the euro area during the first ten years of the euro with markets which appeared to have become fully integrated in the monetary field due to the euro. The markets of goods and services were on an ongoing process of integration on the demand side (thanks to the "single market" policy carried out in Brussels and also due to the catalyst impact of the introduction of the European currency). But they were not being fully integrated on the supply side (due to wage disparities and discrepancies in the environment of firms in terms of tax, bureaucracy constraints and economic policies of Member states).

The financial sector, despite the removal of all barriers to capital movements, was not fully integrated either. This point is outlined in a report prepared for an informal meeting of EU Finance Ministers which met in September 2013[6].

If retail banking and therefore bank credit had remained largely fragmented along national lines, thanks precisely to the introduction of the common currency the interbank market rapidly became integrated, while shares of foreign government bonds and of foreign corporate bonds increased "*by 23 and 29 percentage points, reaching 47 percent and 51 percent of the total holdings of government and corporate bonds respectively*).[7] But contrary to the US, inside the euro area cross-border financial activities remained limited: not only in retail banking but also on the stock market and on bond markets, market participants continued to proceed mainly inside

5 Brussels, February 12th, 2014

6 André Sapir, Guntram B. Wolff, "the Neglected Side of Banking Union: Reshaping Europe's Financial System", note presented at the informal Vilnius ECOFIN September 14, 2013.

7 *Andr éSapir, Guntram B. Wolff, Op. Cit.*

their own national borders.

The euro crisis revealed the lack of integration. The first warning signal occurred precisely in the monetary realm itself when the interbank money market abruptly dried up in August 2007, forcing the ECB to provide liquidity to banks on a large scale.

Move towards a return to more fragmented financial markets started again after the burst of the euro crisis. The foreign share in total holdings of government and corporate bonds fell "*24 and 10 percentage points, standing at 22 percent and at 41 percent respectively"*. We have described in our model the consequences during the first ten years of the euro, of the underestimation by the markets of the discrepancies in sovereign risks between Member states. After the burst of the Greek crisis, their appraisal changed dramatically. The widening of interest rates on sovereign debt started to spread on bank credit to firms, mainly SMEs and to households, contributing to reinforce bank credit fragmentation along national borders. Fuelled by the fear that the euro might explode, this fragmentation led to great economic and financial disparities between Member states and made the adjustment process even more painful for peripheral countries. It was worsened by three idiosyncratic features of the Euro zone financial sector[8]:

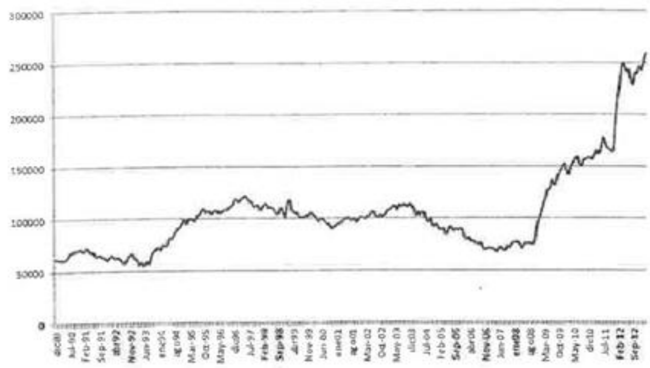
First, European banks traditionally hold a significant portfolio of public securities. Down rating of sovereign debt had an immediate impact on banks' balance sheets. All the more so since for many reasons (regulatory, liquidity management…) banks had refocused their holdings in public securities of their own country as shown in the following graph for Spain raising their dependency on its fiscal outlook.

But on the other side, "when the Irish government issued a blanket guarantee to protect its banks, it quickly transformed a banking crisis into a Sovereign debt crisis".[9] A "diabolic loop", according to Spanish economist Luis Garicano, is taking root in some countries. The European authorities are still far from breaking this vicious circle. On the contrary, new Basels III regulation is pushing banks to increase their portfolio of public securities.

[8]I already outlined this point in my previous lectures in China.

[9] Richard J. Herring, The Danger of Building a Banking Union on a One-Legged Stool, in Political, Fiscal and Banking Union in the Eurozone, Florence European Institute, 2013

Chart 36



Source: Bank of Spain. OTHER MONETARY FINANCIAL INSTITUTIONS 8.5 Assets. Domestic B) Aggregated balance sheet according to the euro area returns Debt securities: general government http://www.bde.es/webbde/es/estadis/infoest/a0805e.pdf

Second contrary to the US or the UK, at least before the announcement of *OMT operations* by the ECB there was a lack of a lender of last-resort on sovereign debt. In the former, if markets of sovereign debt are to dry up, everybody expects the central Bank to jump in. This mere prospect suffices to prevent any sharp rise in interest rates. In the euro area, absence of this lender of last-resort function is one of the explanations for the dangerous interest rates hikes in many peripheral countries.

Last but not least, the effect of the fragmentation of sovereign debt markets had spilled over the whole economy due to the importance in Europe of the banking sector for the financing of its economy (about 2/3) relative to the financial markets (1/3). The rise in the spreads of bank credit terms, which is heavily weighing on the financing of SMEs in the South, has contributed to the contagion of the fragmentation to the real sector.

Fragmentation remains the main problem of the Euro area. If due to capital inflows from abroad, pressure has diminished, we should not be fooled by reduction of interest rate spreads. Financial activities remain entrenched behind natural borders and the conditions for a smooth functioning of the Euro area which also require more integrated markets of goods and services and more flexible labor markets are not yet fulfilled. Sustainability of the Euro area cannot rely over time on the restrictive economic policies implemented in peripheral countries. As in any other currency area, discipline should come for the market forces themselves in the first place.

Concluding Remarks: Policy Recommendations

In order ensure the smooth functioning of the Euro area and to prevent any further crisis, we can now, thanks to our model, make the list of the missing pieces of the current EMU framework. Comprehensive implementation of a “genuine” currency area should bring us:

- To limit powers of Member states in terms of economic policies, and consequently to strengthen the capacity of the EU governing body to conduct an economic policy of its own for the whole Euro area,
- As a consequence, to extend the European budget to a more significant size and therefore to transfer competencies from Member states to the EU level,
- To build a true comprehensive Banking Union which facilitates the working of

an integrated pan-European financial system,

- To foster the single market, and to promote more flexible labor markets.

The Euro crisis led us to become aware of the danger of the current framework. The Van Rompuy Report: "Towards a "genuine" Economic and Monetary Union", helped us to realize that the European currency needed more integration of the Eurozone if it were to become a "genuine" currency area. It is worth noting nevertheless in this respect that proposals for reform by Mr. Van Rompuy, the President of the European Council, have gone unheeded. There is a long way to go before we finally achieve this federal European Union which would provide EMU with a comprehensive "Economic leg".

It would be unfair to deny the many achievements of the European bodies in tackling the crisis since its beginning. But as the recent European polls have shown, the present mood of European public opinion does not favor more integration. Instead of fostering "more Europe", the Euro crisis has exacerbated national sentiments. At the eve of a change of team at the European Commission, let me tell you the orientation that in the present institutional setting I deem necessary to take in order to improve the functioning of the Euro area. I would personally suggest five main lines of action:

1. Fostering financial markets integration must be high on the agenda. We have to complete the Banking Union which is indispensable for overcoming fragmentation along national borders. If we want to give the economic recovery in the Eurozone a chance, it is crucial as well to combat the current "credit crunch" which doesn't come only from the demand side of the credit market. We therefore also have to alleviate the pressure on credit distribution by banks due to the implementation of the new Basel III rules and also to the upcoming supervision framework. It is also crucial that we enhance the securitization activities of banks in order to facilitate the financing of the economy at a time when credit may remain tight for an extended period of time.

2. The single market must be fully implemented in line with Mario Monti's 2010 Report to the President of the European Commission. It is unfortunate to see that the orientations proposed in this report, which are crucial for the effective working of the Euro area, remain unheeded.

3. We have to make sure that Member states undertake the structural reforms to which they are committed in order to meet the Europe 2020 competiveness agenda and pursue consolidation of their public finances. In this respect, the European Commission's Macroeconomic Imbalance Procedure (MIP) needs to be fully applied to all the Member states without any exception.

4. We have to put in place a policy which is addressing the North-South divide of the Eurozone. In this respect, we should not hesitate to mobilize the structural funds of the European budget in favor of southern countries, and to allocate them for enhancing qualification of labor, improving the environment of firms and therefore fostering competiveness in the periphery. The ECB should play its part by acquiring credit assets from SMEs in order to facilitate their financing. We could also make use

of public financial institutions to gather saving funds from the core of the Eurozone and recycle them to finance the private sector in the south.[10]

5. Last but not least, the Eurozone is in need of a more accommodative policy mix. At the present time, fiscal consolidation is pursued by all Member states due to the discipline framework put in place by European authorities. It is coupled with a monetary policy which, despite very low interest rates, remains relatively restrictive compared to other main Central Banks (the Fed, the Bank of England, the Bank of Japan). Due to the "credit crunch", the stock of money is no longer increasing. The strength of the euro brings down the price of imported goods. The price level in the euro area is down to 0,5% on a yearly average. The European Central Bank is aware of the deflationary risk ahead. On June 5th 2014 it has decided to lower its main intervention rate to the record low of 0, 15%. It has also imposed a negative interest rate on European Bank reserves held in its accounts. And it has not excluded if necessary to use unconventional tools of monetary policy akin to "quantitative easing", such as the purchase of public or private bonds or securitized credit on the markets. The ECB does not hide that it wants a weaker euro. It wants the banks to start supplying credit again, and it hopes to foster economic recovery to prevent the Eurozone from falling into the deflationary trap.

As you see there is much to do in the current framework to improve the situation of the Eurozone. Needless to say that any measure which could be undertaken in order to promote political integration of the Eurozone would be most welcome for the future of the European Monetary Union.

[10] This proposal was suggested to President Van Rompuy in early 2014 by a team of the Euro50 group which I chair, composed of Jacques de Larosière, Olivier Garnier, Daniel Gros, Thomas Mayer and myself.

Appendix

Looking at the evolution of aggregate demand in peripheral countries between 2008 and 2013 (Patrick Artus, Flash Economics March 18, 2014), we get the confirmation the adjustment fell mainly on private investment.

During the period ratio of private consumption and public expenditures to GDP remained fairly the same. Imports decreased everywhere (except in Ireland) while exports increased. Investment (GFCF) decreased in all these countries as well. Starting from the accounting equality:

$Y + M = C + I + G + X$

$C/Y+G/Y+ I/Y + X/Y – M/Y = 1$

If $(C/Y + G/Y)$ is constant, then a rise of $(X/Y – M/Y)$ must be matched by a decrease of I/Y.