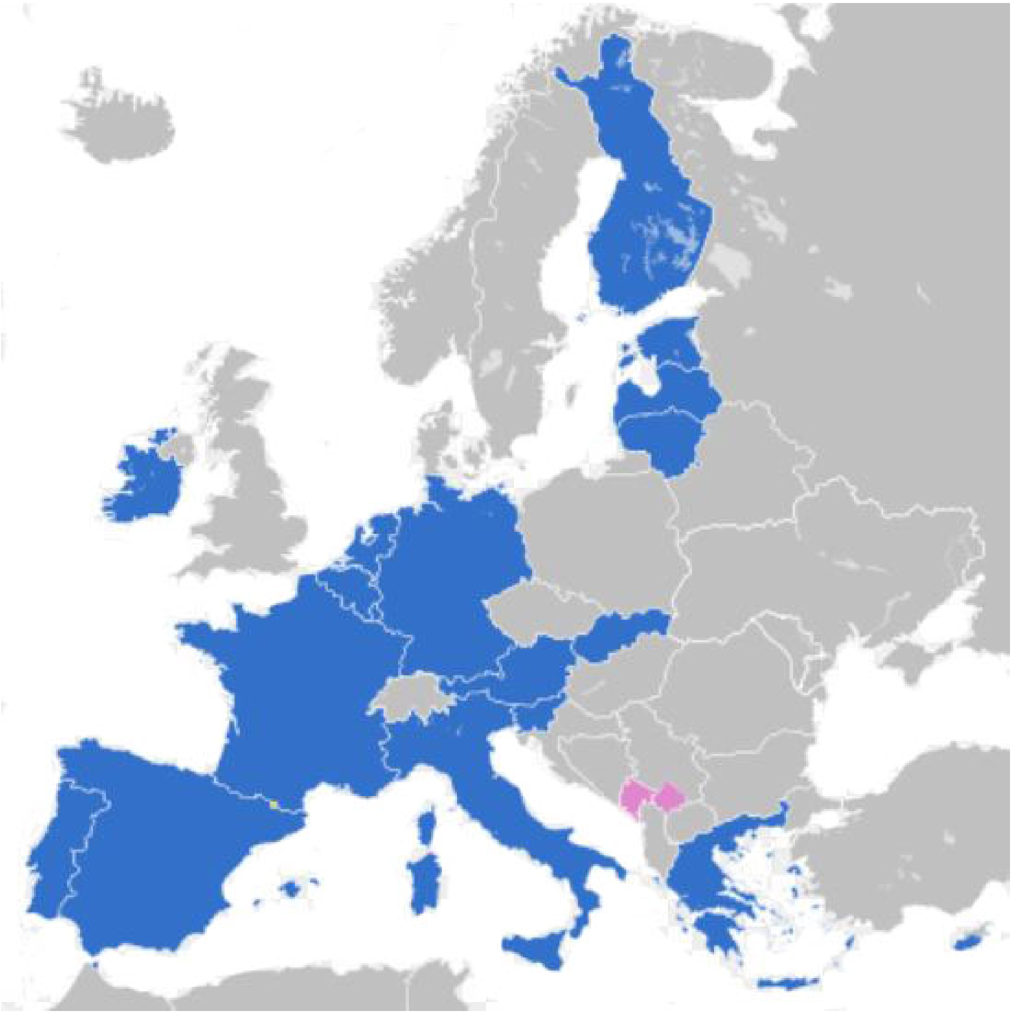
Hour 4

The Euro Area – Strengths and Challenges



Major Economic Challenges

1. Single Monetary Policy with Many Fiscal Policies
2. Negative Interest Rates and Deflationary Pressures
3. Refugee and Immigration Controversies*
4. Demographic Pressures
5. Brexit and Fallout
6. German Current Account Surpluses

1. Single Monetary Policy with Many Fiscal Policies

Put very briefly, OCA theory produces the policy recommendation that countries should only lock themselves into a fixed exchange rate if their economies are sufficiently similar (‘convergent’) that the policy instrument of exchange rate adjustment is not needed. It implies that the countries in the euro periphery have suffered badly in the crisis because they could not devalue. It also suggests that, if the euro is here to stay, then the euro area needs to become more like an OCA by adopting ‘structural adjustment policies’ to make its constituent economies converge. Weirdly, Krugman states his critics advocate structural reform, whereas this is the prescription favoured by OCA adherents.

Critics of OCA theory point out the singular lack of evidence that countries which devalued had a ‘better’ crisis, and ask for the causal mechanism whereby devaluation helps a country to deal with the results of a financial crisis. They note that ‘orderly’ devaluations, whereby the exchange rate is set at just the level the real economy needs, are not available to most countries in our world of high capital flows. Floating exchange rates (such as the UK has) do not help the export sector to thrive, because the exchange rate is an asset price determined in financial markets. Exporters did not rush to invest when the pound depreciated in the crisis, as they were doubtful how long the new parity would last (a well-founded doubt, as it turned out). Krugman interprets these issues as a revival of ‘elasticity pessimism’ (the belief that exports are not elastic – responsive – to changes in relative prices brought about by exchange rate changes). This is a trivialising interpretation: the real issue raised by critics is whether the exchange rate can be made to function as a policy instrument for steering the real economy, given that it is subject to speculative over- and under-shooting.

But most important of all, critics of OCA theory challenge the idea that ‘structural adjustment’ by the periphery is needed to deal with the euro crisis. They offer a different analysis of what has gone wrong in the euro area and a different set of policy prescriptions. Their starting point is that the euro crisis came in the aftermath of a global financial crisis. The euro area did not have the institutions necessary to deal with the financial crisis. The ECB acted as lender of last resort to the banking system, but there was no euro-wide mechanism for bank resolution and restructuring; nor was there a common debt instrument that would prevent sovereign borrowers being picked off by the financial markets.

Single Currency – Generally Accepted Theory

Greece and Germany (euro)

If Greek economy goes bad, German economy is still strong and keeps the euro high. Greece cannot adjust using the euro. Greece cannot export more because the currency is not competitive.

Greece must use internal adjustment like prices, wages, employment, and real GDP to make the painful adjustments

All the pain is on Greece

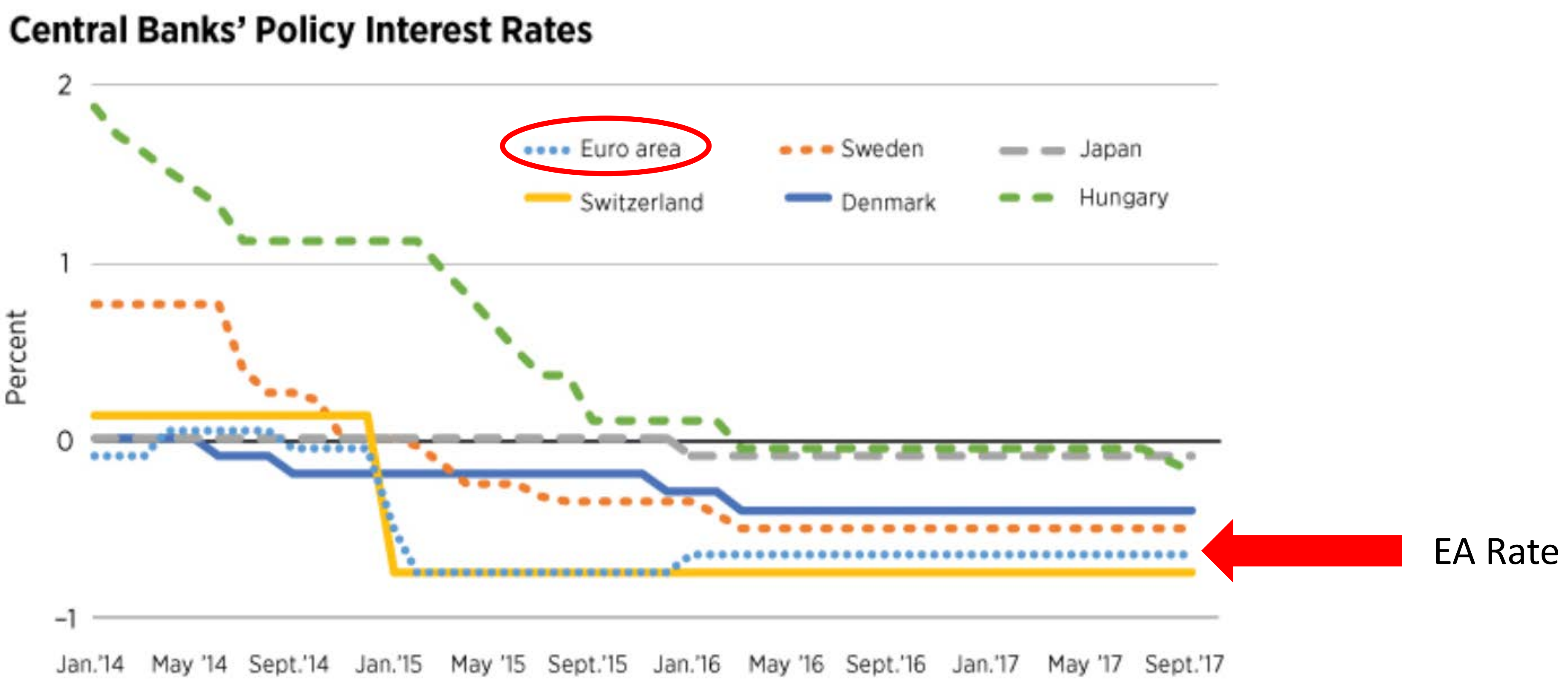
Single Currency – Alternative Theory

Greece and Germany (euro)

If Greek economy goes bad, the member countries can band together and coordinate fiscal policy to help Greece. Taxes can be lowered for Greece and taxes raised in Germany. Spending can be earmarked for Greece, less for Germany. Banks that lent to Greece can be protected by an EA banking union.

Members equally share the pain of its members

2. Negative Interest Rates and Deflationary Pressures



SOURCES: European Central Bank, Riksbank, Denmark Nationalbank, Swiss National Bank, Bank of Japan, Central Bank of Hungary, Haver Analytics, Bloomberg, World Bank, Trading Economics.

3. Refugee and Immigration Controversies*

This topic is covered on Day 2 by the Second Group

4. Demographic Pressures

By 2030 half the population of Western Europe will be over 50 with a life expectancy at that age of a further 40 years. This will be historically unprecedented as we have never before had a region of the world with over half its population over 50.

This will in effect limit the economic growth of the European Union as for every four economically active people, there will be three economically dependent retirees, this suggests that due to the pension system citizens of the European Union will have less disposable income. This equates to each economically active person paying for three quarters of a retiree.

The Reflection group suggest that in order to tackle the challenge of an aging population, "priority measures must **include increasing the proportion of women in the workforce**; **facilitating a better work-life balance**; **reforming our approach to retirement**, so that it is seen as a right and not an obligation; and **developing a more pro-active immigration policy suited to our demographic and labour market needs**" Therefore, they suggest that migration to the European Union as the key solution to meeting the challenge of an ageing population as well as reform of the pension system.

However, the reflection group also propose the introduction of other initiatives designed to increase the working age of the current European Union population as well as an attempt through legislation to create a labour market especially for 50 to 70 year olds (Reflection Group 2010, p. 27) so that the conditions exist to keep older workers within the work force and contributing to the economic growth of the European Union. The Reflection group also suggests that through initiatives focusing on equal opportunities, non discrimination and the increase in the priorities for childcare programs, the European Union can provide the conditions in which working parents especially women with young children can contribute to and feel comfortable in the workforce.

http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/614646/EPRS_IDA(2017)614646_EN.pdf

5. Brexit and Fallout

The UK has voted to leave the European Union. It is scheduled to depart at 11pm UK time on Friday 29 March, 2019. The UK and EU have provisionally agreed on the three "divorce" issues of how much the UK owes the EU, what happens to the Northern Ireland border and what happens to UK citizens living elsewhere in the EU and EU citizens living in the UK. Talks are now focusing on the detail of those issues and on future relations - after agreement was reached on a 21-month "transition" period to smooth the way to post-Brexit relations. The UK cabinet has just agreed how it sees those future relations working and will now be seeing if the EU agrees.

- **18 October 2018:** The key EU summit. Both sides hope to agree outline of future relations to allow time for UK parliament and EU members to ratify deal by Brexit day
- **13 December 2018:** EU summit. If deal not done by October, this is the fall back option if the two sides still want to reach agreement
- Commons and Lords vote on withdrawal treaty - MPs could reject the deal but it's not clear what would happen if that is the case
- The UK Parliament also needs to pass an implementation bill before Brexit day
- **29 March 2019:** As things stand, deal or no deal, Brexit is due to happen at 11pm UK time
- **31 December 2020:** If all goes to plan a transition period will then last until midnight on this date

Why is Britain leaving the European Union?
A referendum - a vote in which everyone (or nearly everyone) of voting age can take part - was held on Thursday 23 June, 2016, to decide whether the UK should leave or remain in the European Union. Leave won by 51.9% to 48.1%. The referendum turnout was 71.8%, with more than 30 million people voting.

Theresa May was against Brexit during the referendum campaign but is now in favour of it because she says it is what the British people want. Her key message has been that "Brexit means Brexit" and she triggered the two year process of leaving the EU on 29 March, 2017. She set out her negotiating goals in a letter to the EU council president Donald Tusk. She outlined her plans for a transition period after Brexit in a big speech in Florence, Italy. She then set out her thinking on the kind of trading relationship the UK wants with the EU, in a speech in March 2018.

5. Brexit and Fallout

David Cameron, his Chancellor George Osborne and many other senior figures who wanted to stay in the EU predicted an immediate economic crisis if the UK voted to leave and it is true that the pound slumped the day after the referendum - but it has now regained its losses against the dollar, while remaining 15% down against the euro. Predictions of immediate doom were wrong, with the UK economy estimated to have grown 1.8% in 2016, second only to Germany's 1.9% among the world's G7 leading industrialised nations.

The UK economy continued to grow at almost the same rate in 2017 although there was slower growth, of 0.1% in the first three months of 2018. Inflation rose after June 2016 but has since eased to stand at 2.4%. Unemployment has continued to fall, to stand near a 40-year year low of 4.2%. Annual house price increases have steadily fallen from 9.4% in June 2016 but were still at an inflation-beating 4.2% in the year to March 2018, according to official ONS figures.

Brexit negotiations
They officially started a year after the referendum, on 19 June, 2017. Here's a picture from that first session:

The UK and EU negotiating teams met face-to-face for one week each month, with a few extra sessions also thrown in ahead of EU summits. Their first tasks were trying to get an agreement on the rights of UK and EU expat citizens after Brexit, reaching a figure for the amount of money the UK will need to pay on leaving, the so-called "divorce bill", and what happens to the Northern Ireland border. A provisional deal on these issues was reached on 8 December: 'Breakthrough' deal in Brexit talks. They then agreed terms for the "transition" phase and now have moved on to the permanent post-Brexit relationship, while trying to agree on the precise wording of the divorce issues.

5. Brexit and Fallout

Article 50 is a plan for any country that wishes to exit the EU to do so. It was created as part of the Treaty of Lisbon - an agreement signed up to by all EU states which became law in 2009. Before that treaty, there was no formal mechanism for a country to leave the EU.

It's pretty short - just five paragraphs - which spell out that any EU member state may decide to quit the EU, that it must notify the European Council and negotiate its withdrawal with the EU, that there are two years to reach an agreement - unless everyone agrees to extend it - and that the exiting state cannot take part in EU internal discussions about its departure.

When is the UK due to leave the EU?

For the UK to leave the EU it had to invoke Article 50 of the Lisbon Treaty which gives the two sides two years to agree the terms of the split. Theresa May triggered this process on 29 March, meaning the UK is scheduled to leave at 11pm UK time on **Friday, 29 March 2019**. It can be extended if all 28 EU members agree, but at the moment all sides are focusing on that date as being the key one, and Theresa May was now put it into British law.

What's going to happen to all the EU laws in force in the UK?

The Conservative government has introduced the European Union (Withdrawal) Bill to Parliament. It will end the primacy of EU law in the UK on Brexit Day. This "Great Repeal Bill", as it was originally called, incorporates all EU legislation into UK law in one lump, after which the government will decide over a period of time which parts to keep, change or remove. The government is facing claims from Remain-supporting MPs that it is giving itself sweeping powers to change legislation without proper Parliamentary scrutiny. **Read a full guide to the bill.**

5. Brexit and Fallout

What is the Labour Party's position on Brexit?

Labour says it accepts the referendum result and that Brexit is going to happen. Leader Jeremy Corbyn says he would negotiate a permanent customs union with the EU after Brexit, which would be very similar to the one it has now. This is the only way to keep trade flowing freely and protect jobs, he says, as well as ensuring there is no return to a "hard border" in Northern Ireland. He has ruled out staying a member of the single market, as some of his pro-EU MPs want, so he can carry out his plans to nationalise key industries without being hampered by EU competition rules. He says the UK should have a very close relationship with the single market. Labour accepts that some form of free movement of people might have to continue. He also insists he could persuade Brussels to let the UK have a say in its rules post-Brexit.

What do 'soft' and 'hard' Brexit mean?

These terms are used during debate on the terms of the UK's departure from the EU. There is no strict definition of either, but they are used to refer to the closeness of the UK's relationship with the EU post-Brexit.

So at one extreme, "hard" Brexit could involve the UK refusing to compromise on issues like the free movement of people even if it meant leaving the single market or having to give up hopes of aspects of free trade arrangements. At the other end of the scale, a "soft" Brexit might follow a similar path to Norway, which is a member of the single market and has to accept the free movement of people as a result of that.

6. German Current Account Surpluses

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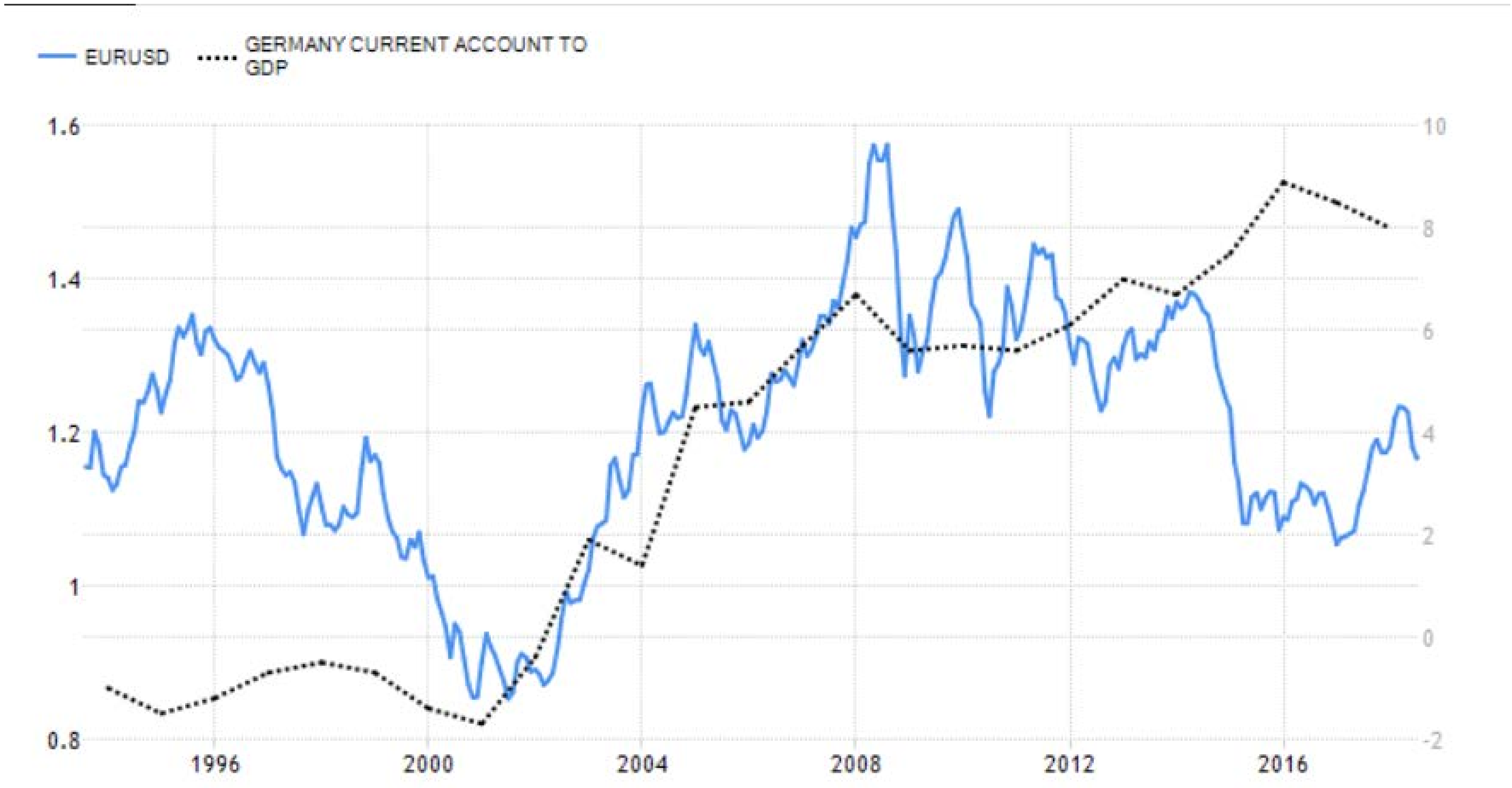

Summary 4 Hour

1. EA has 340 m people, 19 countries, UK and Denmark have opted out. UK will withdraw from EU on 29 March 2019.
2. EA has a single central bank but 19 fiscal policies. Impossible to coordinate. Basic problem is one that US faced 230 years ago. Solution involves the principle of Federalism. How can power be shared between a central government and local or regional governments.
3. Greece is a good example of what is wrong. It's government needs euros to pay its debts, it cannot depreciate its own currency to help run a trade surplus, other countries do not share euro tax revenue, it cannot easily borrow euros anymore, it must reduce its imports and government budget deficits, and it can only do this if its economy goes into recession. Strong arguments for austerity and for stimulus. Writing off debts seems to be unacceptable.
4. ECB has been using negative interest rates to try to raise inflation to just under 2%. However, from 2014-2016 inflation was under 1%. Recently inflation has been closer to 2%. There are limits to monetary policy and it is not known what will happen when US interest rates rise.
5. Refugee and immigration discussed by Group 2.
6. Demographics ar turning against EA. Aging and lack of births are raising the dependency ratio 1 worker for ¾ retiree by 2030. Usual policies being suggested to deal with problem.
7. Brexit may have an impact on the EA economy. Brexit illustrates the problem of EU Federalism.
8. Germany continues to be a powerhouse that is crushing other countries in the EA.

Next up Japan – Strengths and Challenges