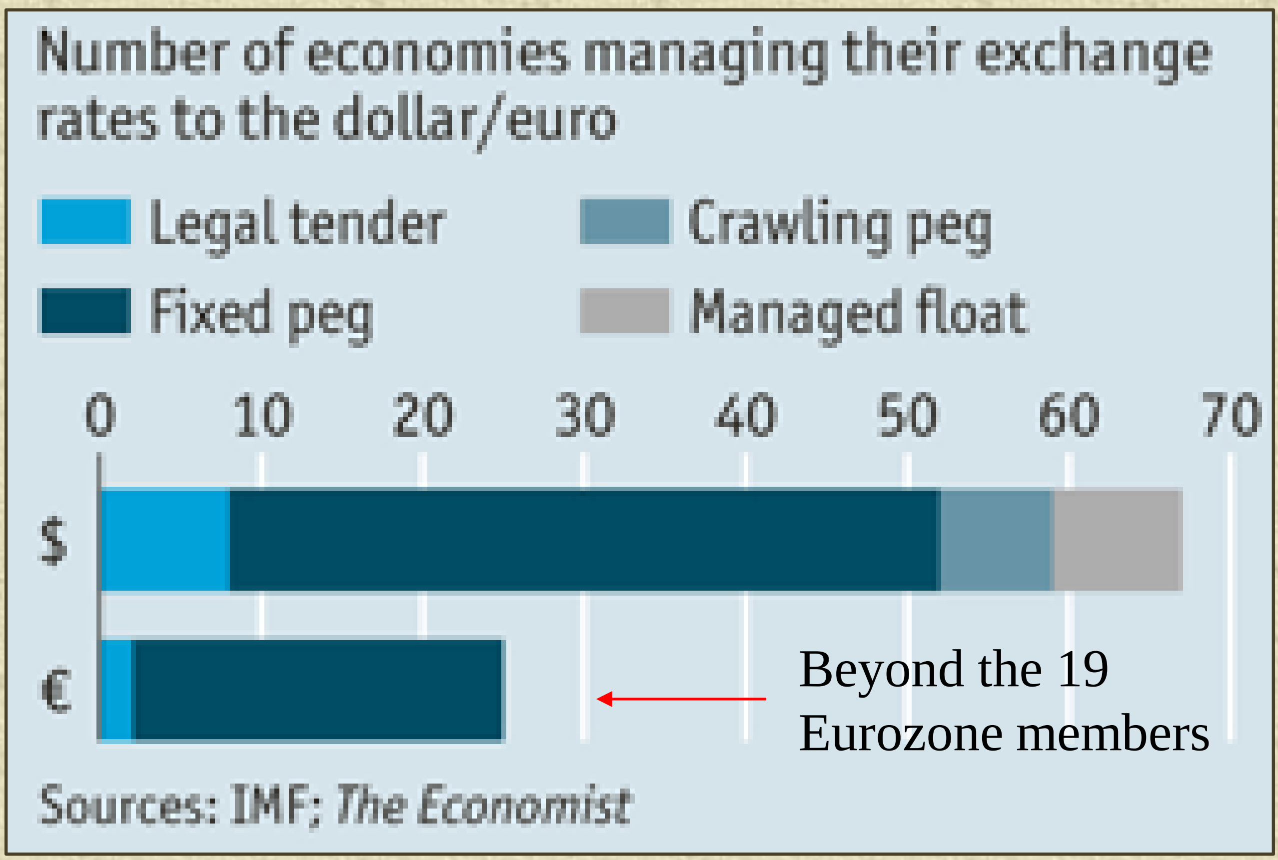
11. Alternative Exchange Regimes

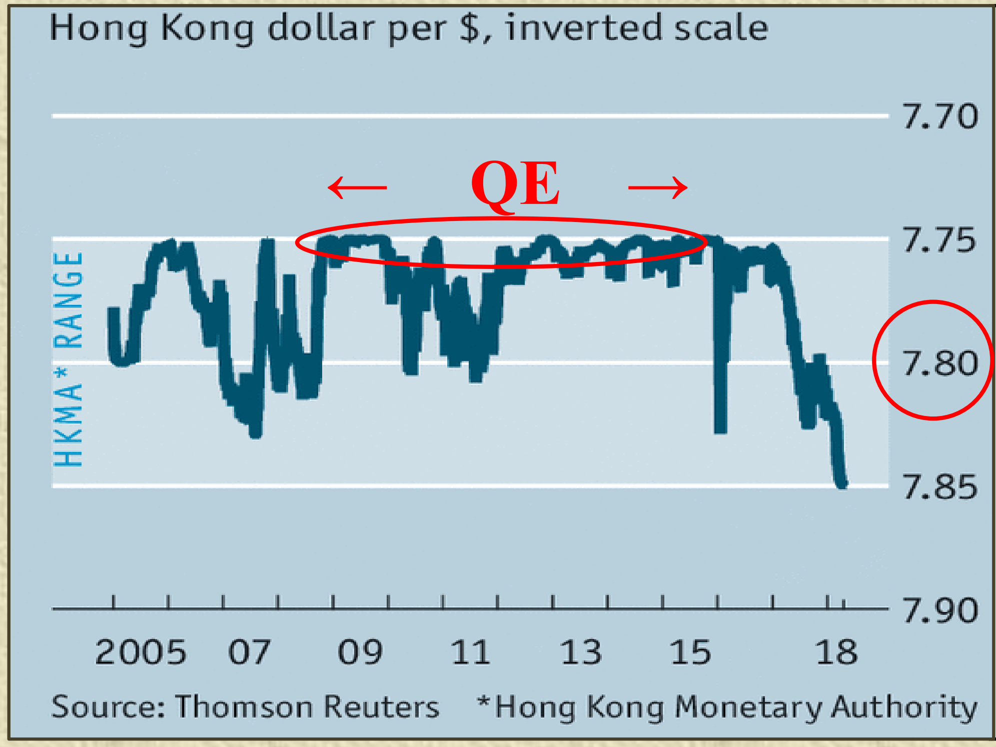
- From flexible regimes to fixes



Economist, “Currency pegs: Poor dollar standard”, 13 Aug 2011, p. 57

Alternative Exchange Regimes

- Hard fixes: currency board, dollarization, monetary union



1983: Hong Kong $ pegged to $US at 7.8. In 2005, peg refined with 2 promises: buy $US at HK$7.75 and sell at HK$7.85. During QE, Fed ↓ i-rates and promised to hold them low, overheating HK's economy, ↓ unemploy and → property boom. 2011: If E floated, CB could ↑ i-rate and lc would ↑ value. Instead P allowed to ↑ and real i-rate went negative. E is fixed, but W, P are flexible up and down.

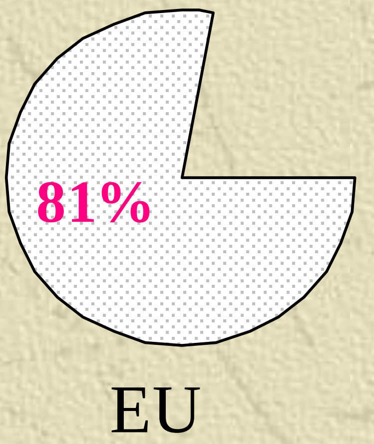
Economist, "Hong Kong dollar: Pershing missile", 24 Sep 2011, p. 92 and "Reserve peg", 21 Aug 2018, p. 65.

12. European Monetary Union

12.1 Case study of MU in eurozone

- Free trade in goods/services over integrated area
  - Single market initiative supports intra-regional trade
  - Intra-regional trade

Intra-regional trade as % of total, 2016

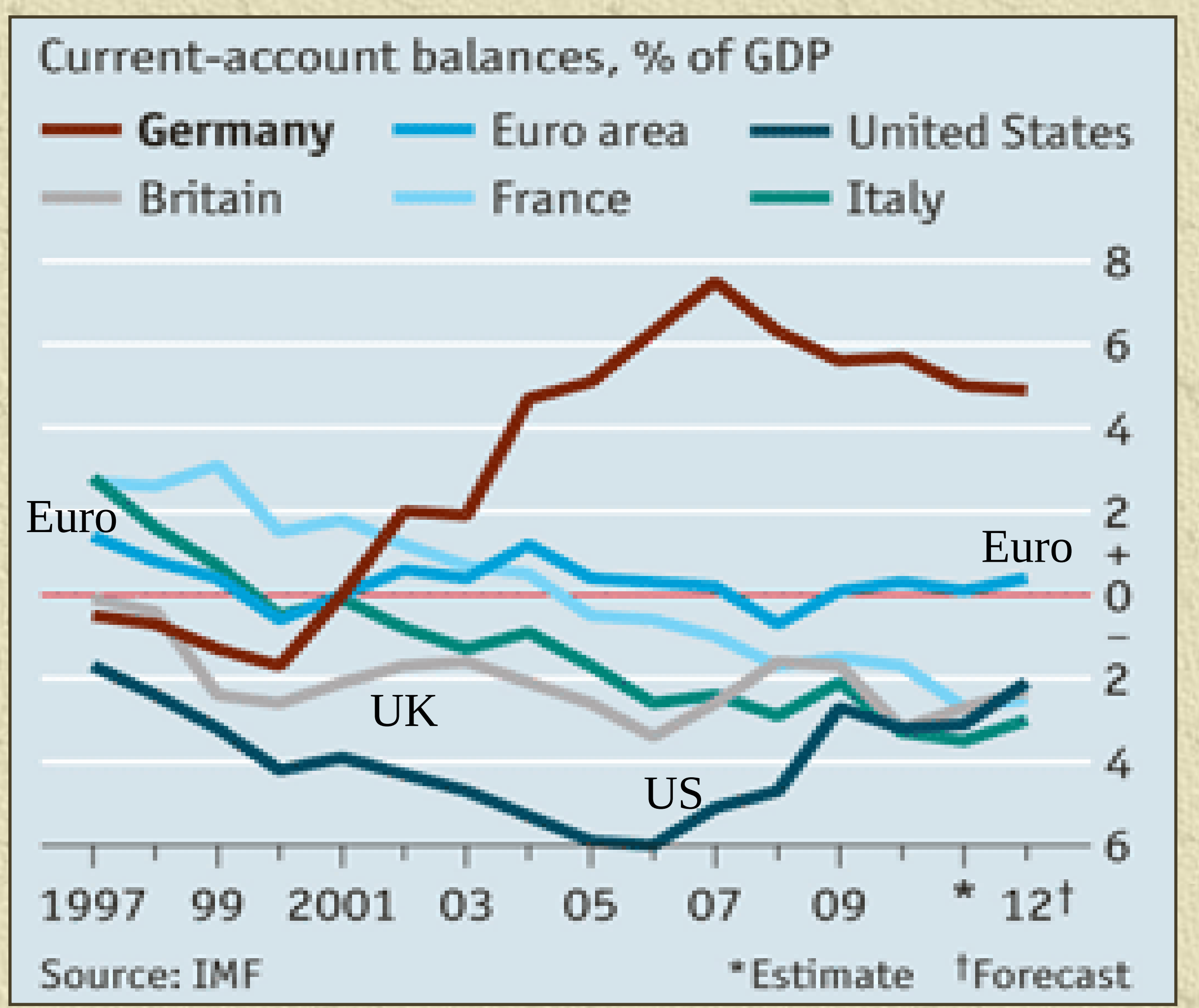


Source: WTO

Economist, "Trade in Latin America: Unity is strength", 10 Mar 2012, p. 19

European Monetary Union, continued . . .

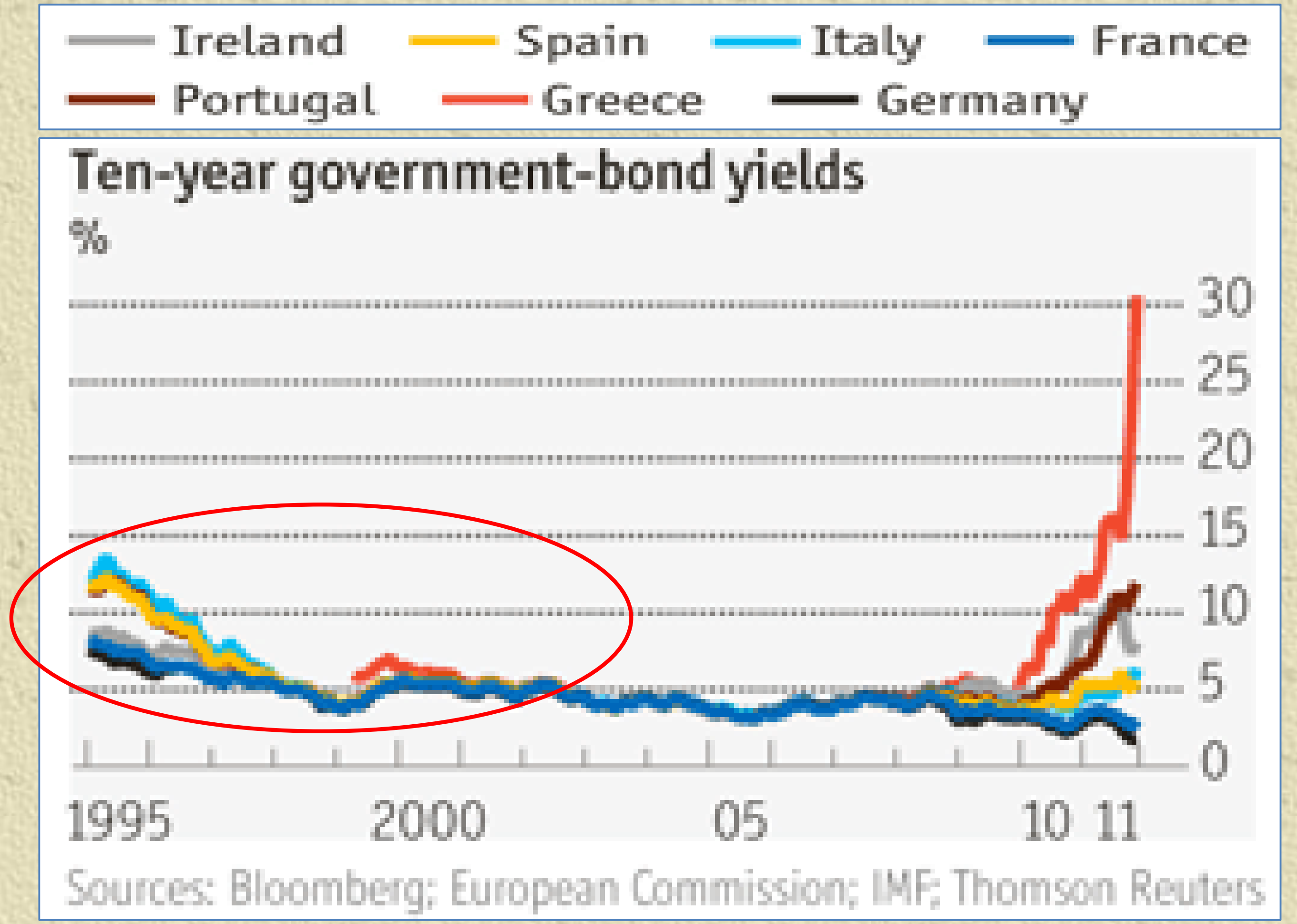
- Overall Eurozone BOT balance masked underlying imbalances



The origins of the GFC and the euro crisis were macro imbalances and failure of the financial system's mgmt over supervision.

European Monetary Union, continued . . .

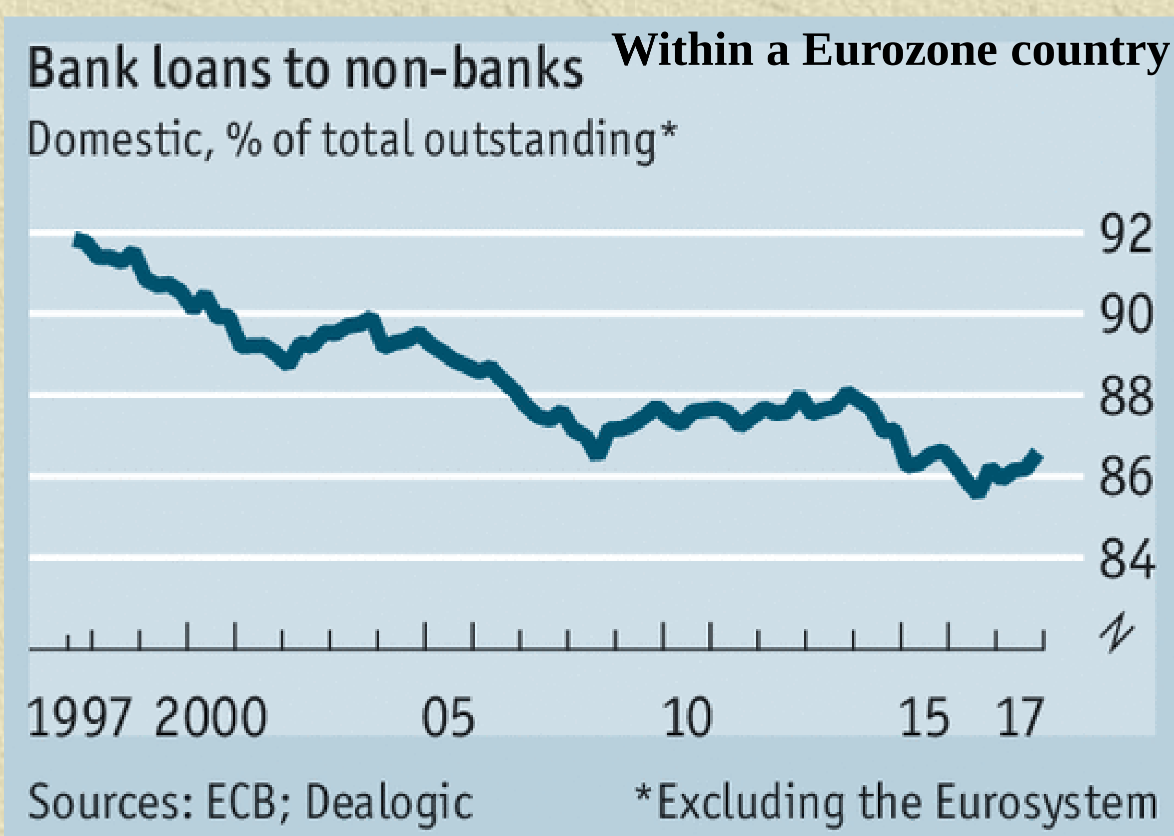
- Integrated EU capital markets
  - Convergence in gov't bonds (common rate)



Economist, "The causes: a … short history", Special report on Europe and currency, 12 Nov 2011.

European Monetary Union, continued . . .

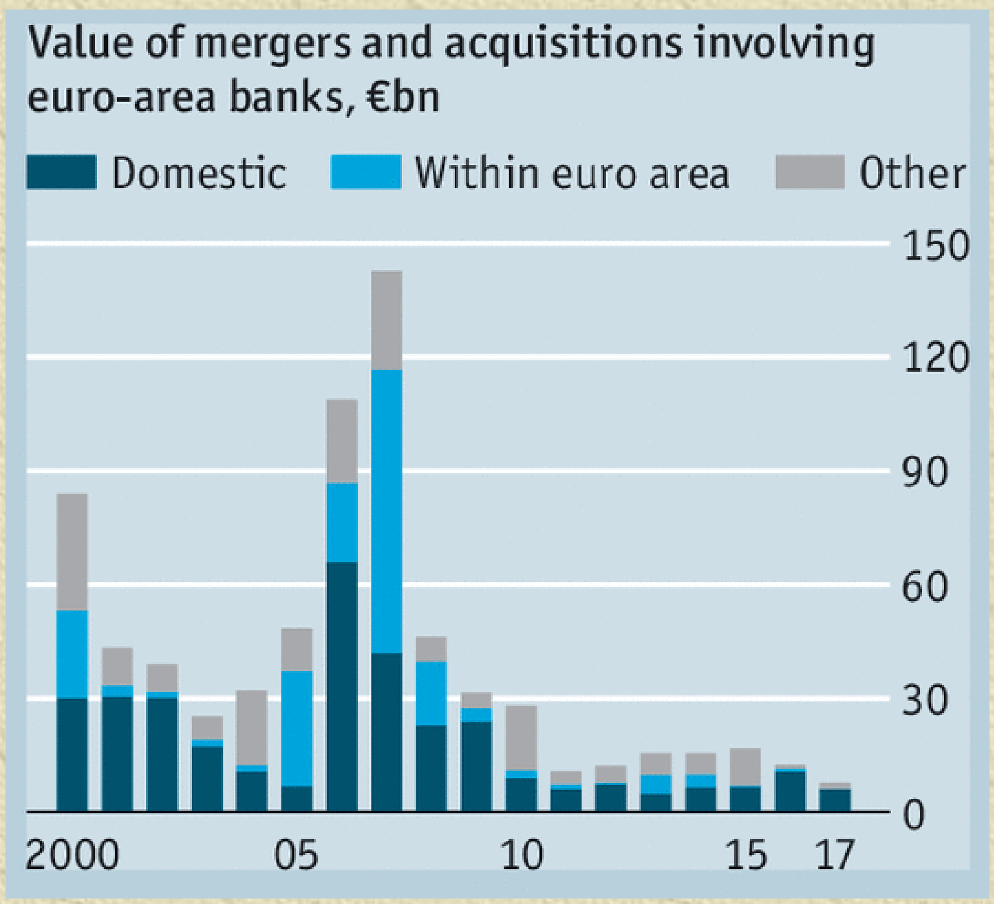
- Eurozone banking mkts still essentially national
  - Pan-zonal banks would ↓ risk of intertwined lenders and national gov’ts
    - 7/8 of lending is domestic
    - 3/5 of banks holdings of corporate and gov’t bonds are from “home”



Economist “European banks: Fumbling in the dark”, 14 Jul 2018, p.63.

European Monetary Union, continued . . .

- Trend toward K-mkt integration thru M&A activity – before crisis



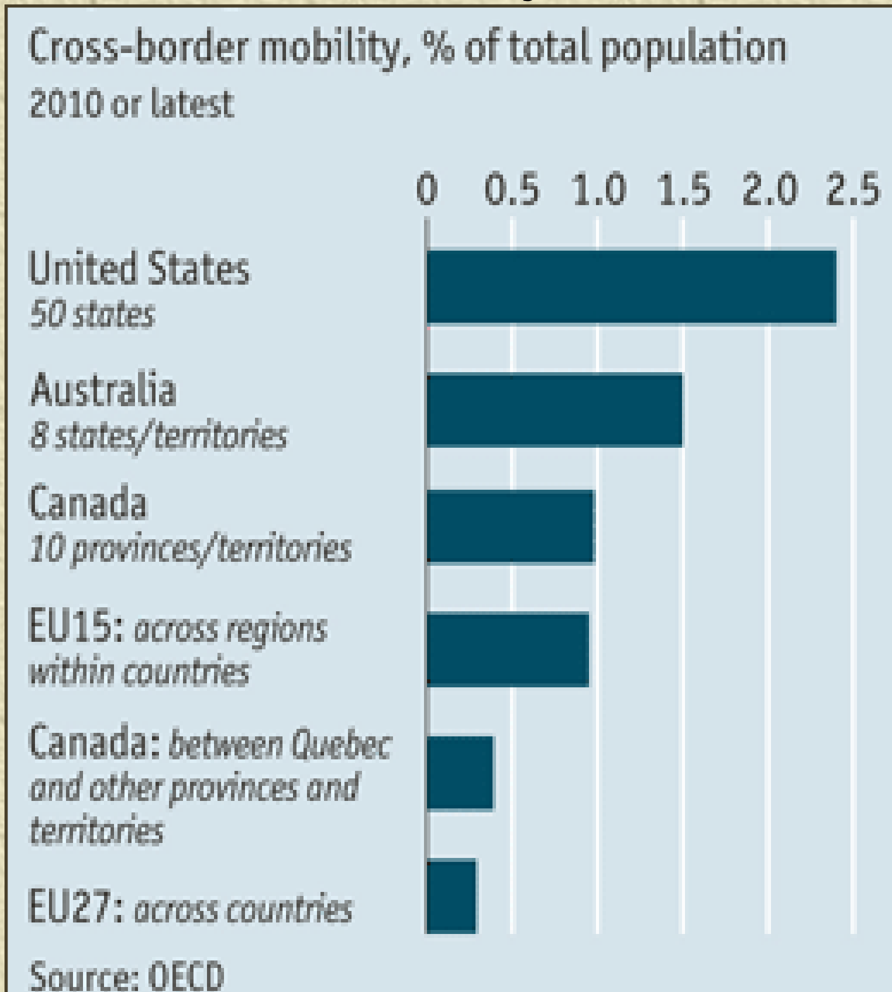
Economist, "European bank mergers: Passport check", 28 Mar 2015, p. 70-1; and "European banks: Fumbling in the dark", 14 Jul 2018, p.63.

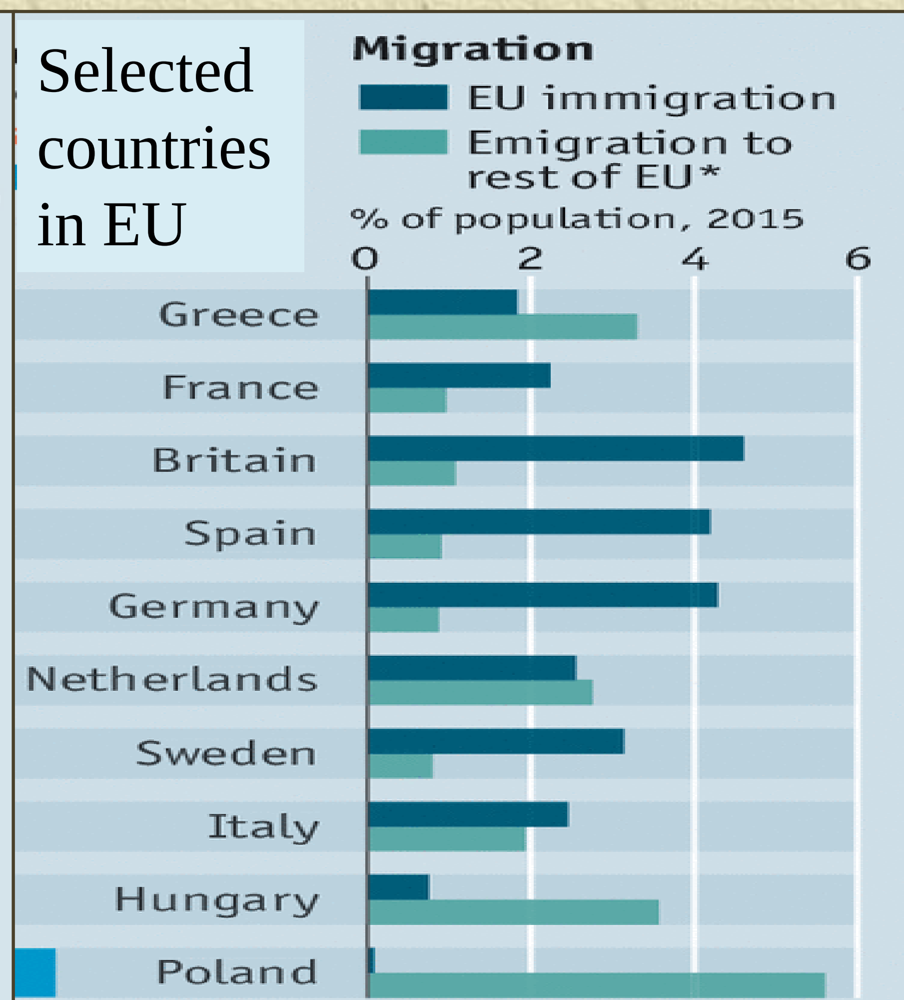
Regulators still not keen on the idea (incomplete banking union).

- Big banks that operate across eurozone complain that local regulators prevent a bank from putting deposits raised in Germany to use in K-scarce areas of the eurozone.
- The ECB as a single regulator has not changed much: more leniency on the liquidity side but none on capital side
- Concern is scale is offset by complexity of cross-border banking – need banking union.

European Monetary Union, continued . . .

- Integrated EU labor markets
  - Labor mobility

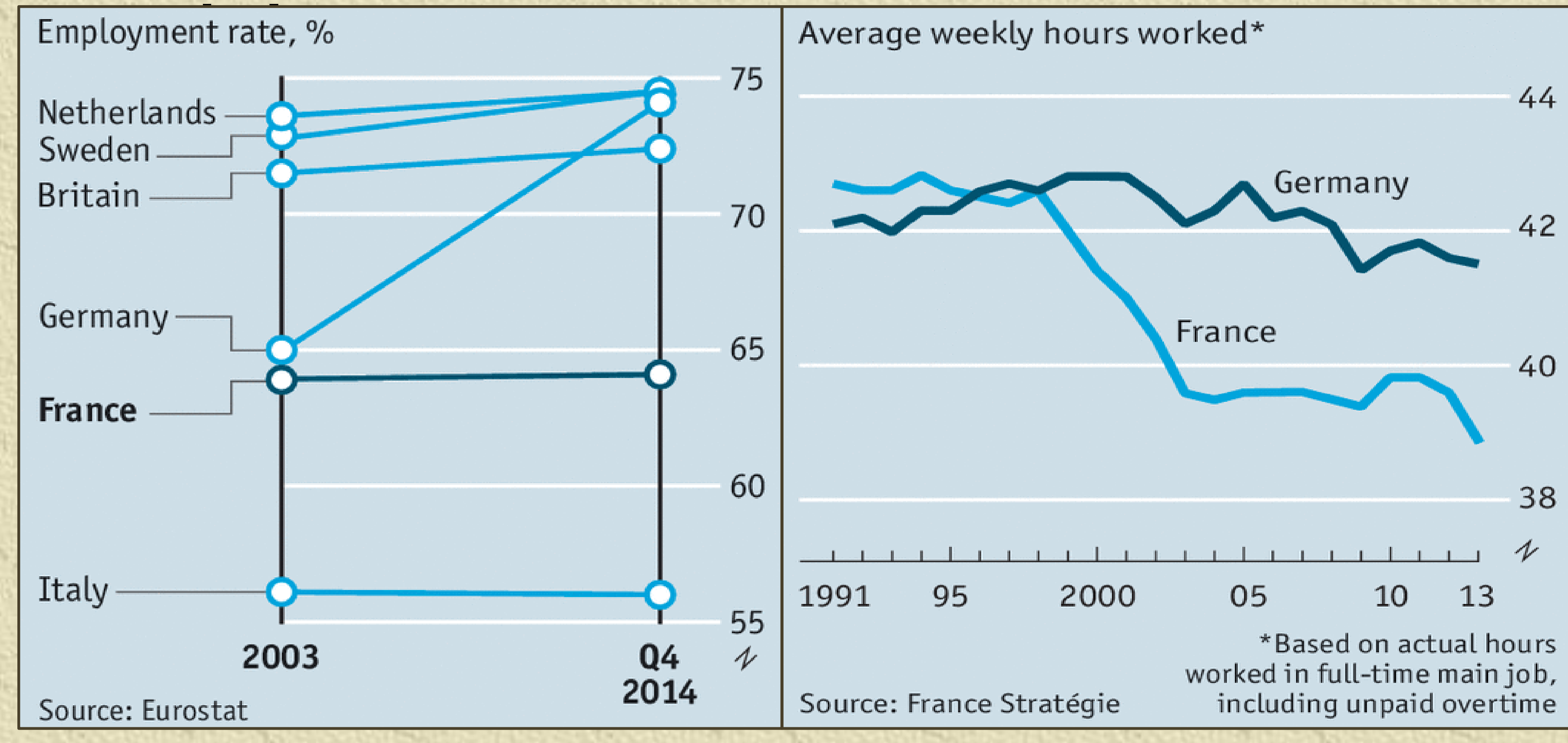




Economist, "Building euro-zone competitiveness", 28 Apr 2012 and "Brexit: An aggravating absence", 2 Jul 2016, p. 19-20.

European Monetary Union, continued . . .

- Employment patterns after EU L mkt reforms; average hours



In 2003, France and Germany had similar employment rates and both broke euro stability-pact rule not to exceed 3% budget deficit ceiling agreed in 1997. Germany used its fiscal space to become more competitive and loosen its labor mkt. France introduced a 35-hour work week.

Economist, "France and labour-market reforms: Holland's … journey", 25 Apr 2015, p. 23-4.

European Monetary Union, continued . . .

- Wage flexibility: unit L costs, internal devaluation and competition

German unit L costs fell in 2000. This helped Germany's competitiveness (at a cost to domestic demand).

In the wake of the 2008 crisis, workers struck deals that prevented job cuts in return for moderate wage increases or pay cuts.

Economist; *Fin Times*, "Germans in a bullish mood", 30 Jan 2018, p. 2.

European Monetary Union, continued . . .

- Tax wedge (% of labor costs) and unemployment rates differ

France's high tax wedge on employment reflects its costs of unemployment-insurance, social charges and costs-related to job protection, i.e., it is a measure of labor inflexibility. Different unemployment rates suggest immobility.

Economist, "Labour reforms in Europe: Slowly doing better", 25 Apr 2015, p. 24-5

European Monetary Union, continued . . .

- Employment protection indicator

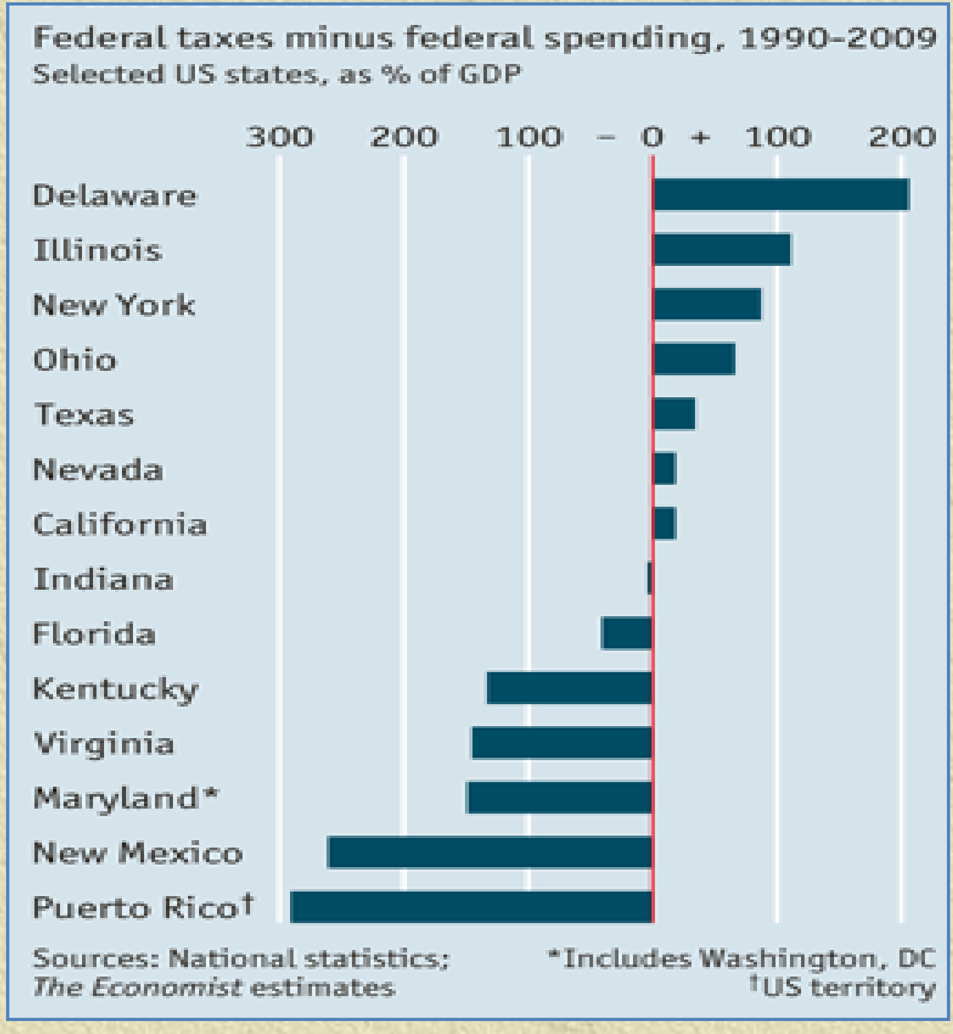
OECD job protection index shows southern European countries did most in response to the euro crisis to liberalize firing of workers. Flexibility matters. Despite Germany's high job protection score, its labour market functions because its collective bargaining has been adaptable – firms can strike deals with labor.

Economist, "Labour reforms in Europe: Slowly doing better", 25 Apr 2015, p. 24-5

European Monetary Union, continued . . .

- Fiscal stabilization in euroarea
  - Not envisioned
    - Small EU budget
    - No bailouts
    - Budget deficits, 3% GDP
    - Debt level: 60% of GDP

Federal transfers in US



European Monetary Union, continued . . .

12.2 Pre-crisis shortcomings – 1991 Maastricht Treaty

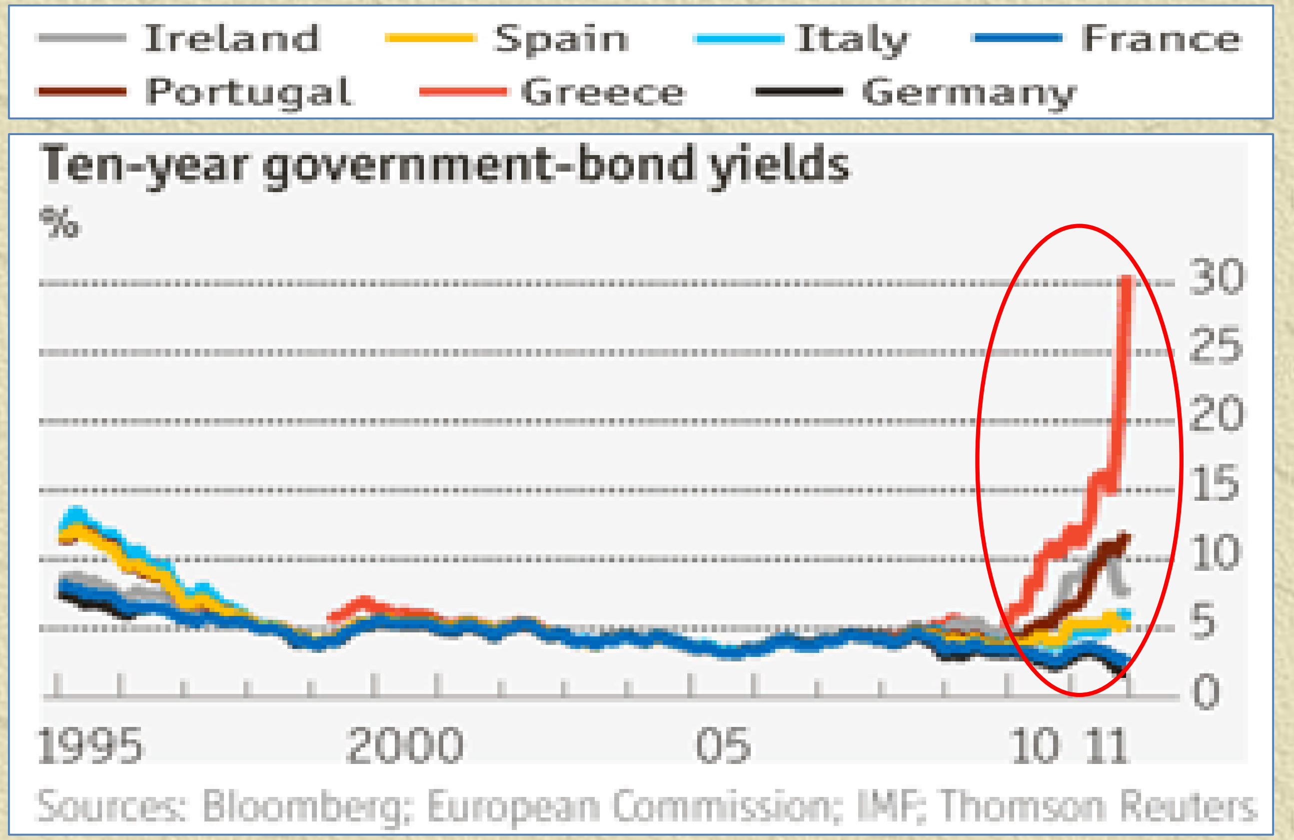
- Fiscal criteria restrictive and weak enforcement

- Institutional weaknesses
  - No political body to deal with BOT imbalances
  - No way out of euro
  - Treaty provisions prohibited bailouts
  - ECB not charged with lender of last resort

European Monetary Union, continued . . .

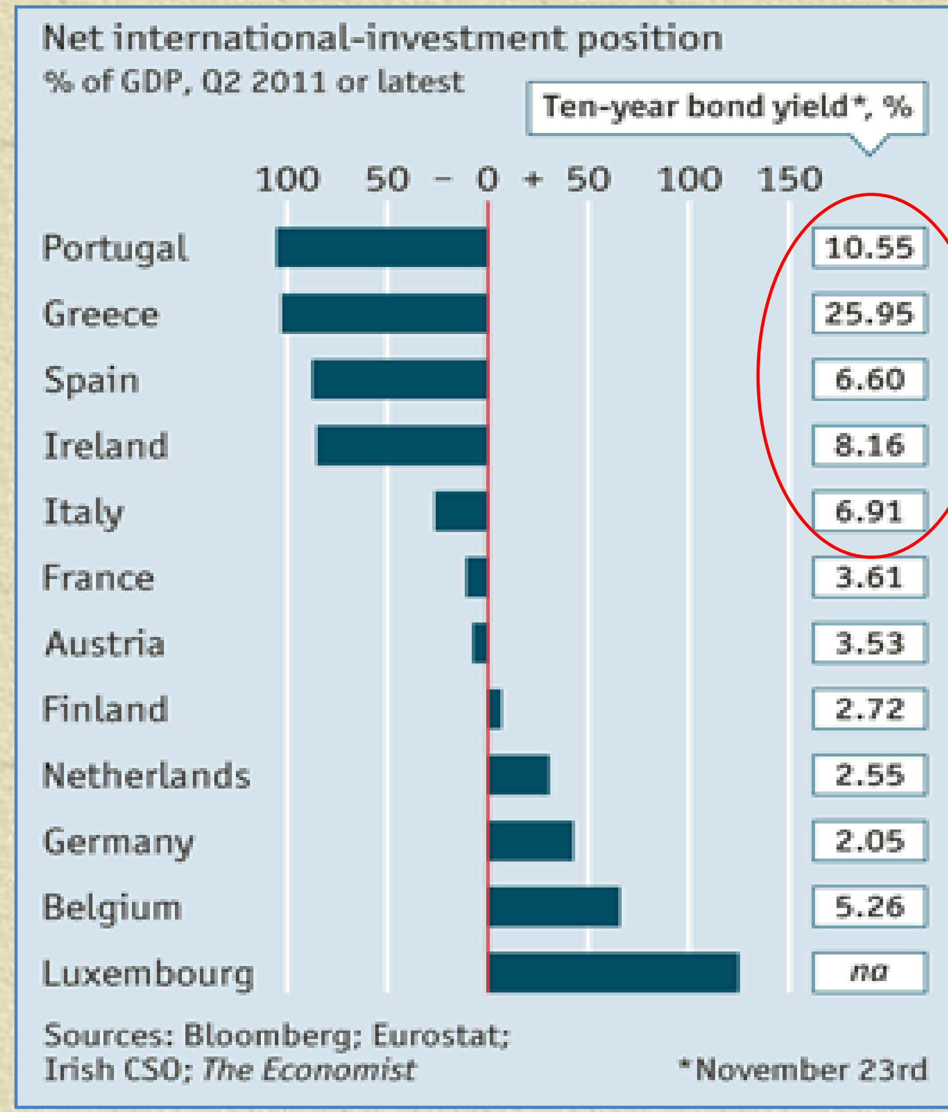
12.3 The euro crisis

- Problem seen as BOT or macro imbalance issue
- Slow to respond to a banking crisis
- Contrasts with US response
- Crisis begins
  - Bond yields



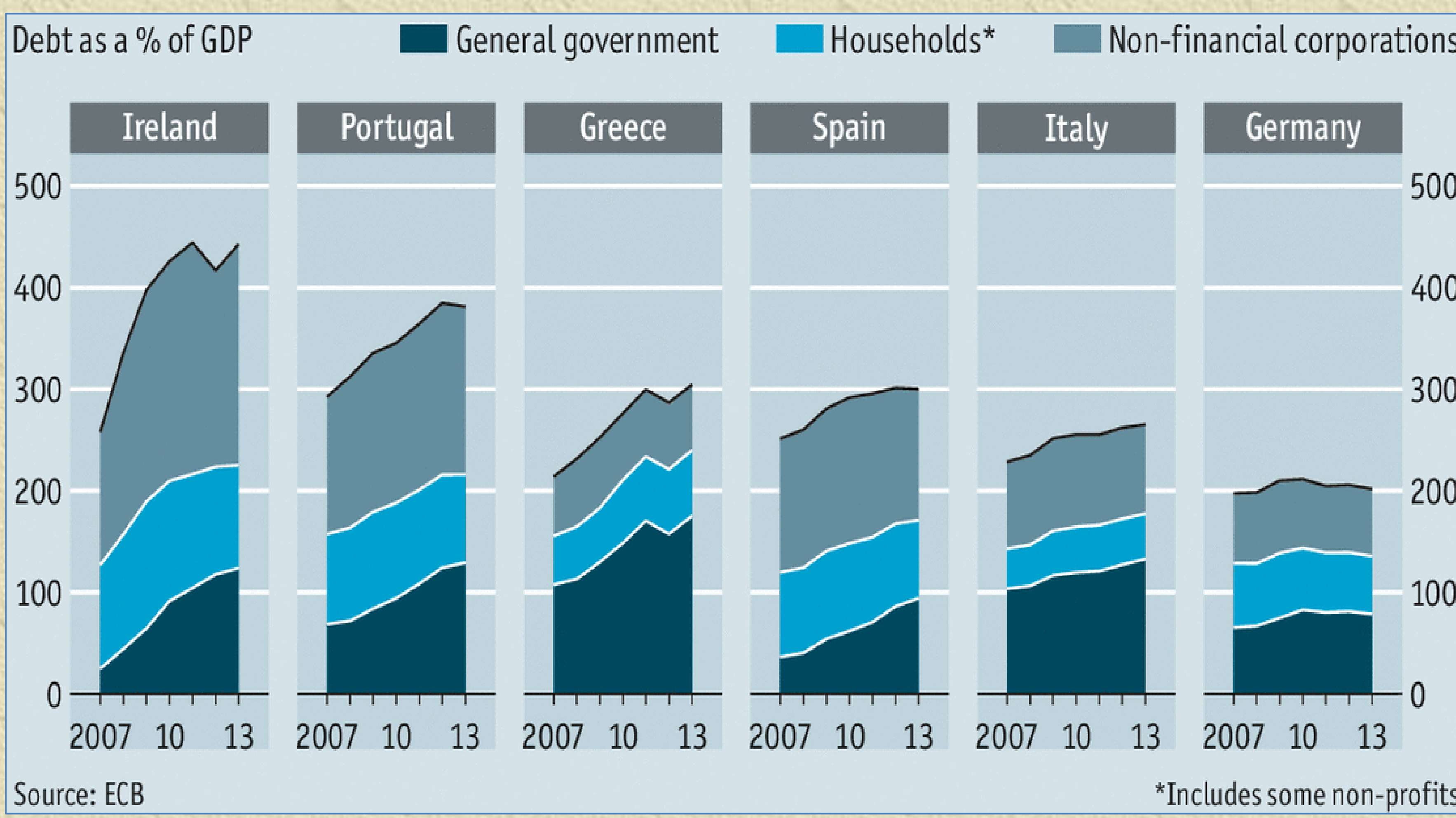
European Monetary Union, continued . . .

- Differing net int'al investment position



European Monetary Union, continued . . .

- Debt as % GDP



European Monetary Union, continued . . .

- Exposure of foreign banks to debt from PIIGS

The exposure to the debt shows how integrated K-mkts became interlinked in banking and finance. Solving the euro crisis became a necessity within and without the Eurozone.

European Monetary Union, continued . . .

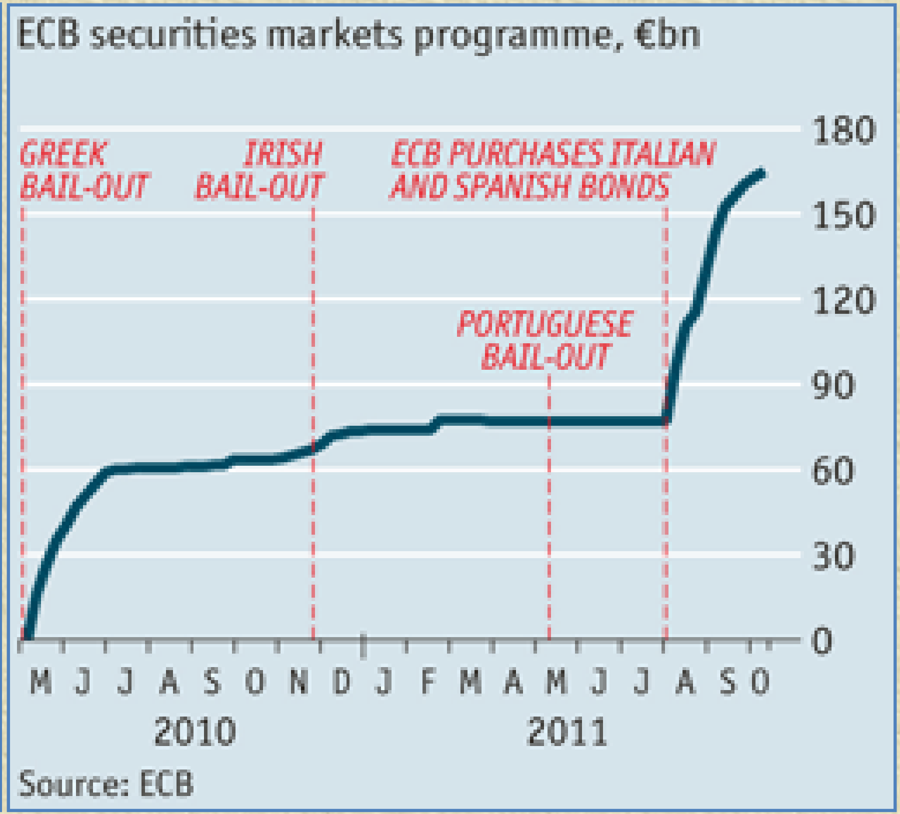
- Convergence – divergence: video, St. Louis Fed, 4:08 minute mark to 9:05 mark

http://www.stlouisfed.org/publications/ar/2011/index.cfm

European Monetary Union, continued . . .

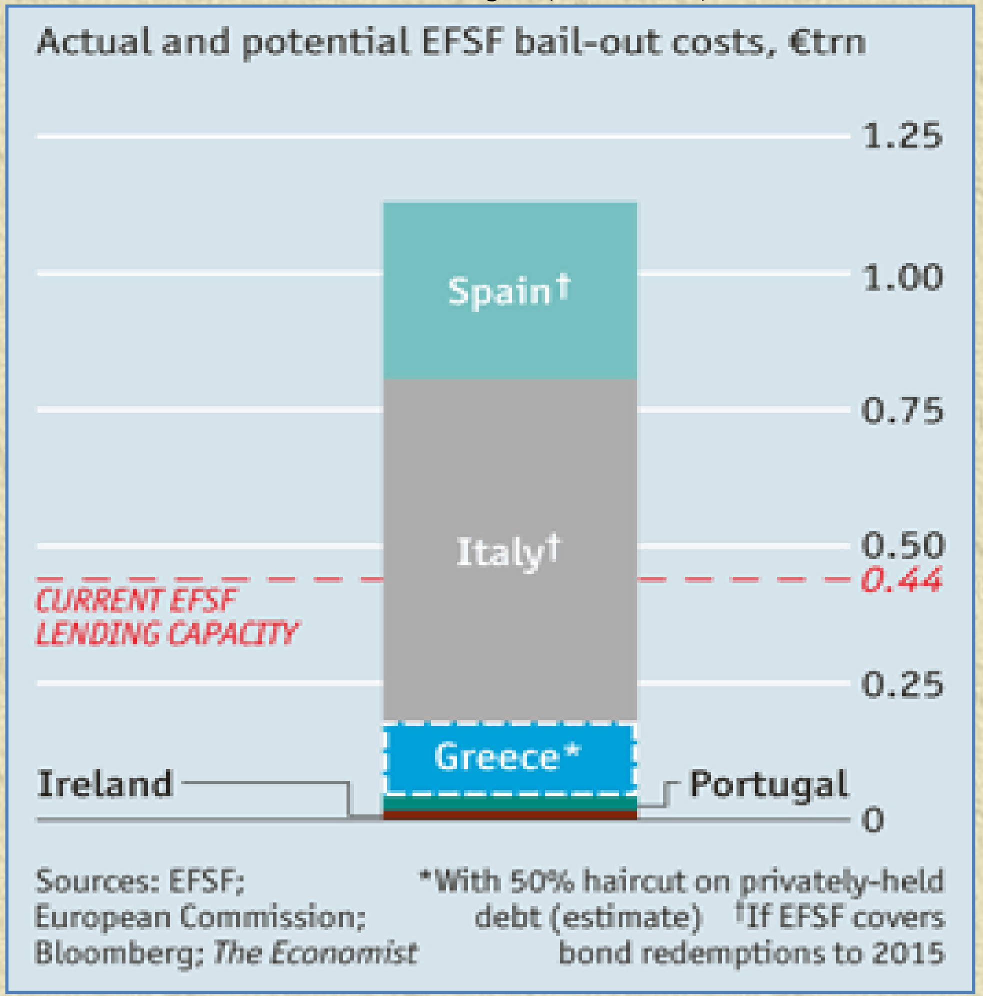
12.4 Chronology of EU’s response to euro crisis

- ECB only existing institution able to react
  - 2007: ECB’s credit easing light
  - 2010: ECB Securities market program



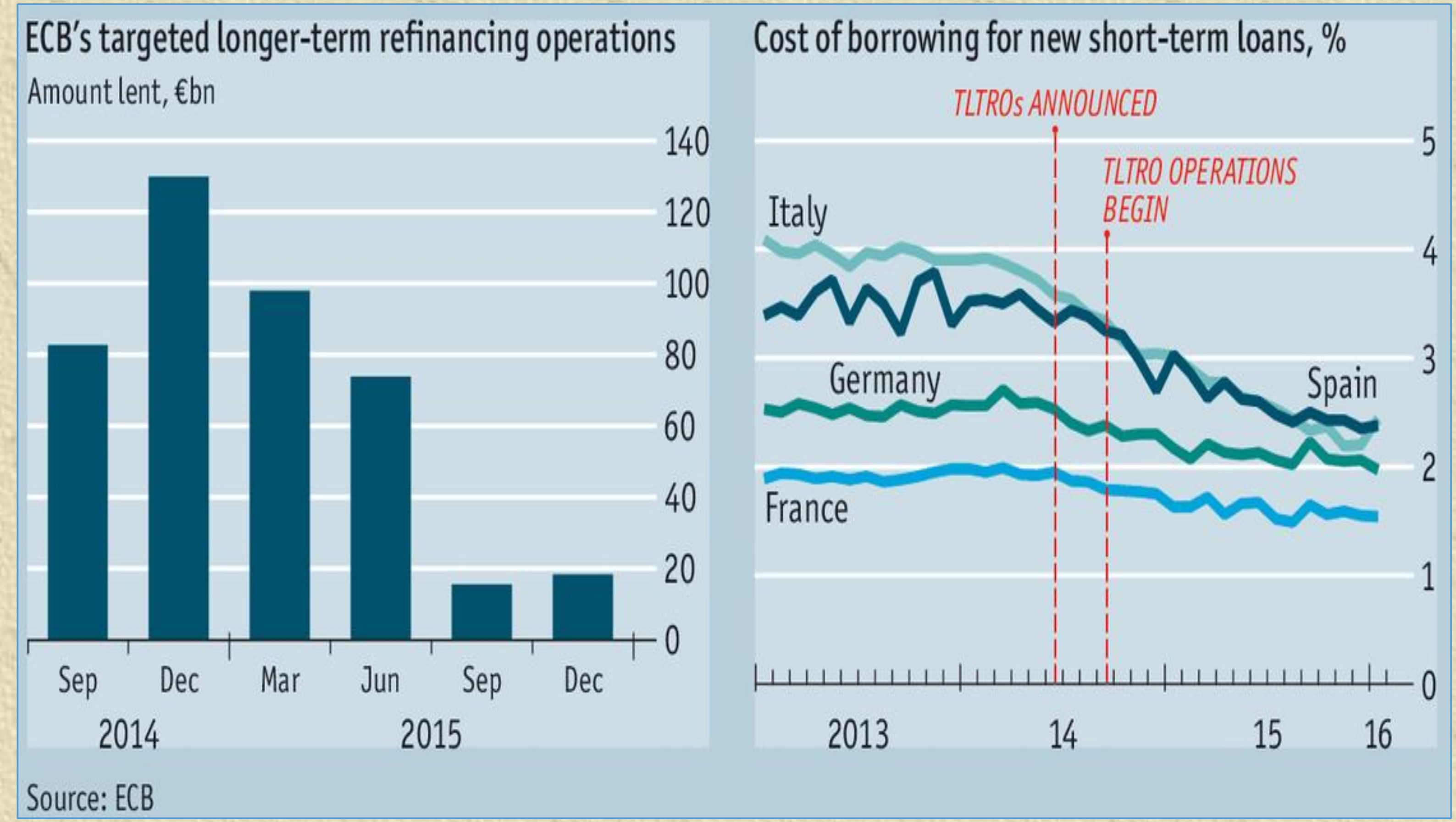
European Monetary Union, continued . . .

- Non-ECB financial stabilization mechanisms
  - 2010: European Financial Stabilization Facility (EFSF)
    - Issuing debt to raise funds
    - EFSF funds rose to €750bn from EC funds and EU guarantees and the IMF
  - 2012: European Stability Mechanism (ESM)
    - Permanent mechanism
    - ↑ lending capacity of €500bn + €700bn in guarantees



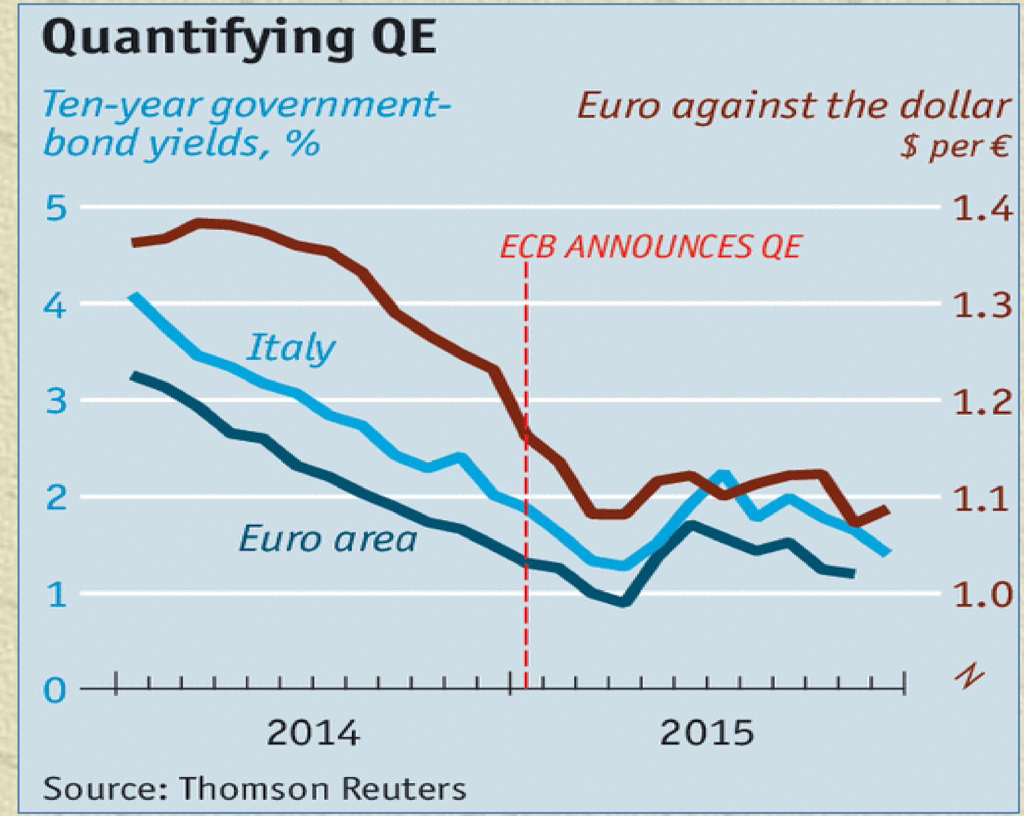
European Monetary Union, continued . . .

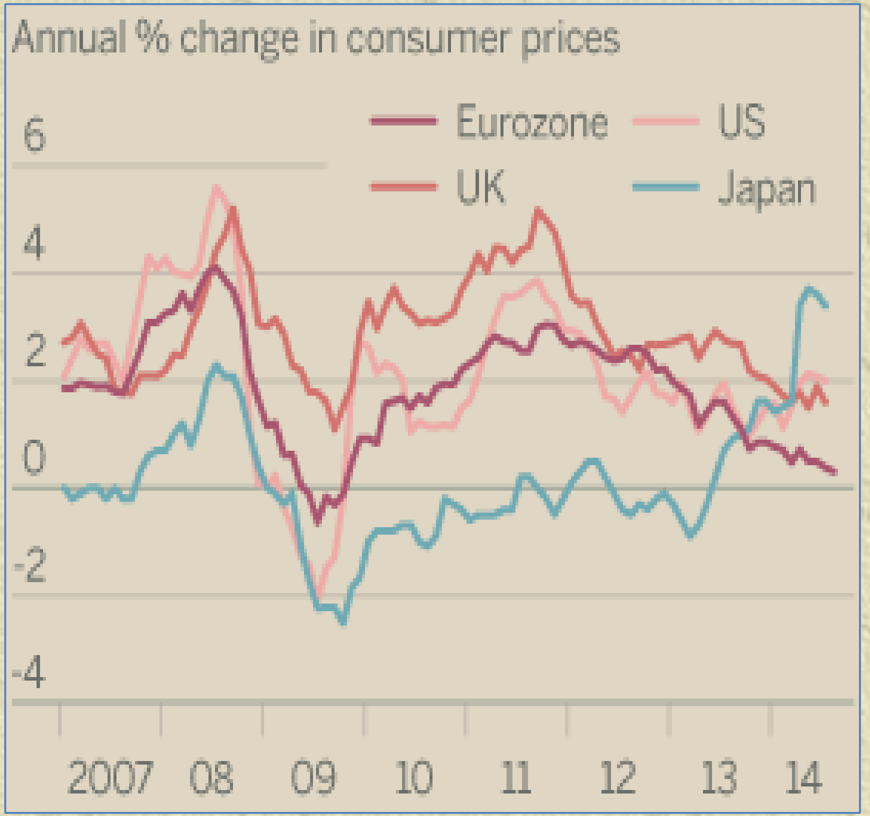
- ECB signals low long-term i-rates
  - Long-term refinancing operations (LTRO) by ECB
    - 2011-12: LTRO - cash injections to banks
    - 2014: Targeted LTRO to expand the program



European Monetary Union, continued . . .

- QE proper by ECB
  - 2014: Pursues QE aggressively despite critics
  - 2015: Purchases ↑ to €60bn/mo from €10bn/mo
  - 2018: ‘Tapering’ of purchases ↓ €80bn to €60bn no end date





European Monetary Union, continued . . .

12.5 Institutional mechanisms to prevent reoccurrence

- Mutualize debt: create a Eurobond
  - ESM necessary but not sufficient
  - EC Commission’s proposal: blue bonds and red bonds
- Fiscal union: Stabilization, Coordination & Governance
  - New rules on deficits, debt
  - Supra-nat’al surveillance on fiscal budgets
- Banking union: 3 pillars
  - Single supervisor
  - Single resolution authority
  - Joint deposit-insurance

- Three pillars

Fully-fledged banking union

Single supervisory Mechanism (SSM)	Single Resolution Mechanism (SRM)	Single Deposit Guarantee Scheme
* Homogenous supervisory stds across euroarea * ECB directly supervises 128 biggest banks, 85% of toal euro-area bank assets * Comprehensive assessment of banks (stress tests)	* Single authority responsible for resolution of euro area banks * Resolution financed by shareholders and creditors (bail-in = 8% of total liability (pre-defined liability * Bank levies (at nat'al level) to raise funds	* No single deposit scheme created * Harmonized deposit guarantee scheme as set out in Single Rule Book * Deposit guaranteed up to €100,000 everywhere in EU * Funds from deposits collected from banks over 10-yr period

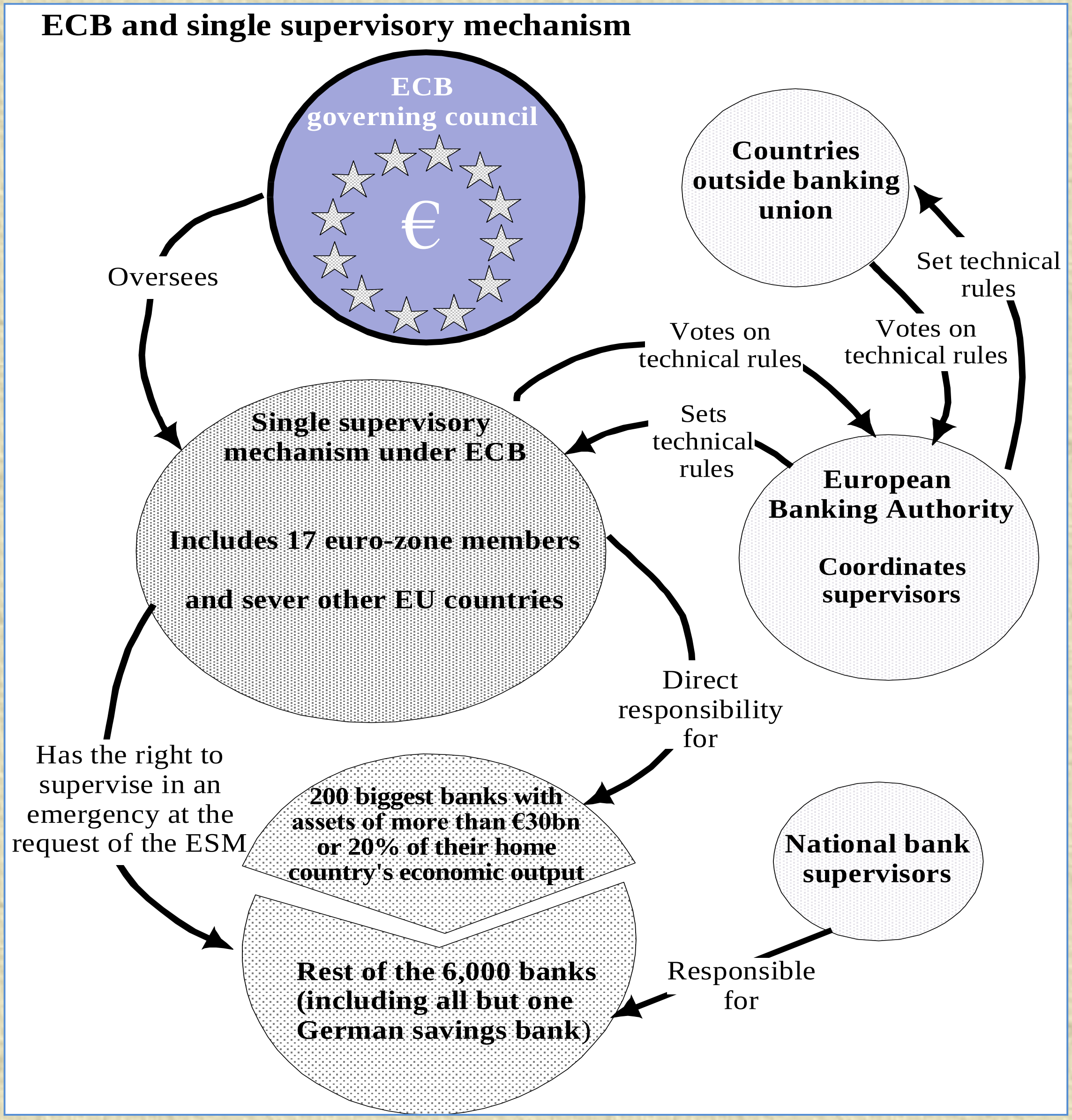
Based on EU-wide rules for banks, the Single Rule Book, e.g, Dir. On Capital Requirements (Basel III) since 2014, Bank Recovery and Resolution and Deposit Guarantee Scheme (DGS) starting in 2015.

Banks no longer "European in life, but national in death". Bail-in should become the rule, bail-outs the exception.

Source: Allianz GI Global Capital Markets and Thematic Research, May 2014

European Monetary Union, continued . . .

- ECB's supervisory role



European Monetary Union, continued . . .

- Video clip, *Financial Times*, “How the euro was saved”

http://video.ft.com/3567899112001/How-the-euro-was-saved/World