

# How Europe Ended Up Someplace Else



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*EuroTragedy: A Drama in Nine Acts*

New York: Oxford University Press, June 2018

**Thesis: monetary union would lead Europe into political union.  
Early warnings it would not.**

- **Nicholas Kaldor**, March 1971:
  - Single currency would *amplify* economic divergence, and
  - A house “**divided against itself cannot stand.**”
- **Robert Marjolin**, crucial catalyst of Treaty of Rome, in the 1970s:
  - Political efforts to counteract economic divergence would be impeded by the **sovereignty barrier**:
  - European leaders “**obviously not ready**” to give up core sovereign functions;
  - Change required was “**too profound.**”

## A flawed euro, which the French desperately wanted, on German terms.



- Chancellor Helmut Kohl—despite severe initial misgivings—pushed the euro, overriding German public’s deep opposition to giving up the deutsche mark
- Seeking the Bundestag’s authorization on April 24, 1998, he twice said:
- “According to the treaty rules, the community shall not be liable for the commitments of the member states and there are no additional financial transfers.” *Translation: Germany will not pay the bills of other member countries.*
- Kohl’s mantra: **euro would ensure Europe’s peace.**

**But there was no conception of *what* the end goal was  
...and, hence, no idea of *how* Europe would get there.**



“If you don’t know where you are  
going,

You'll end up someplace else.”

*Yogi Berra*

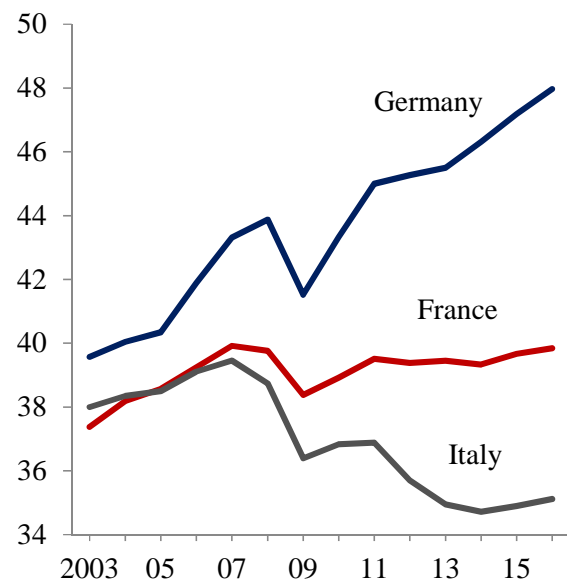
The tragedy: the euro inevitably  
pushed Europe into a “someplace”  
else that was not good.

**Kaldor's ghost stalks:**

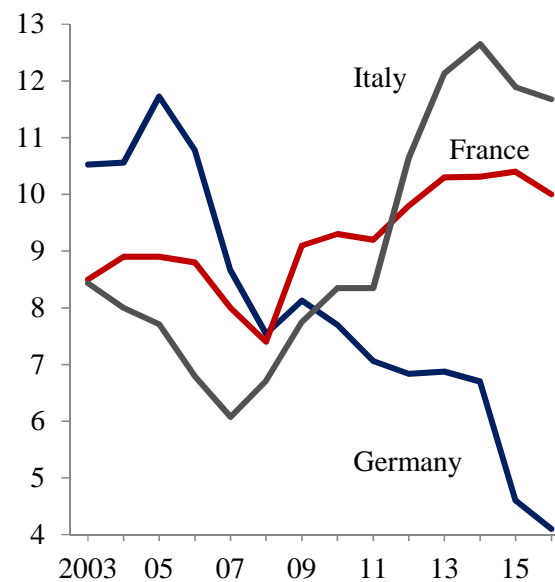
**The euro divides Europe**

# The great divergence in euro-area incomes and employment.

Per capita incomes  
(In thousands of US dollars, corrected  
for purchasing power parity)

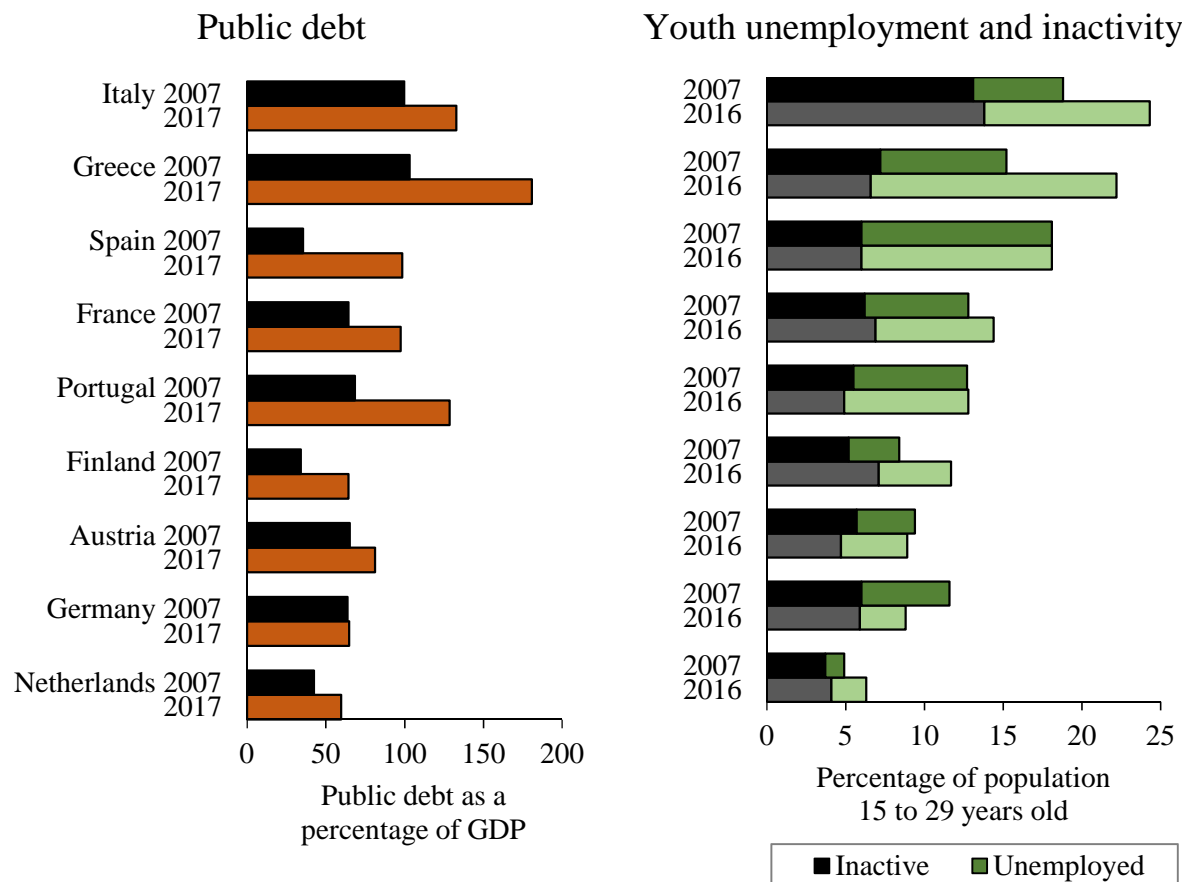


Unemployment rates  
(Percent)



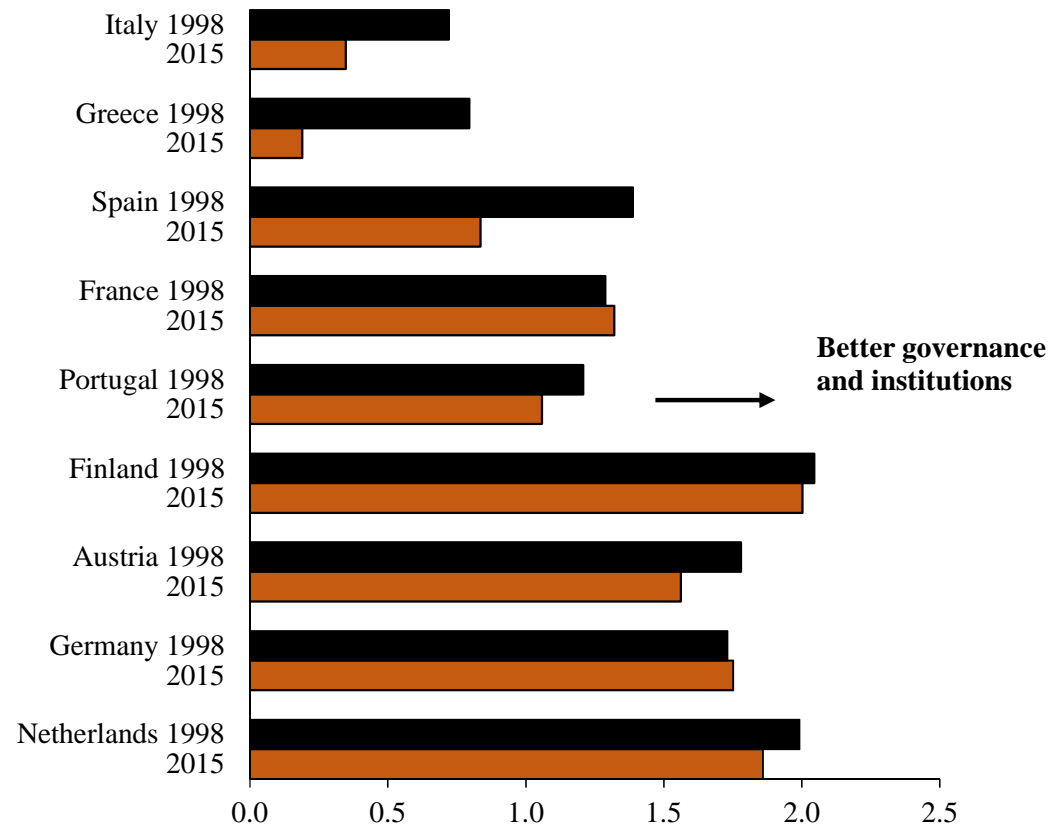
Sources: Conference Board, "Total Economy Database (Adjusted Version)," <http://www.conference-board.org/data/economydatabase/>; IMF, World Economic Outlook Database, <https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx>.

## The euro-area north-south divergence: public debt and youth distress.



Source: IMF, World Economic Outlook Database; Eurostat (edat\_lfse\_20). Note: Countries on the left side correspond to the countries on the right side. The “unemployed” are those who are looking for a job but are unable to find one; the “inactive” are not looking for a job and neither are they in an educational or training program. The sum of the unemployed and inactive is known as “neither in employment, education or training” (NEET).

**Divergence was predictable, not an accident: southern euro area suffers from weak governance and institutions, which weaken growth potential:  
The euro is cruel on countries with low growth potential.**

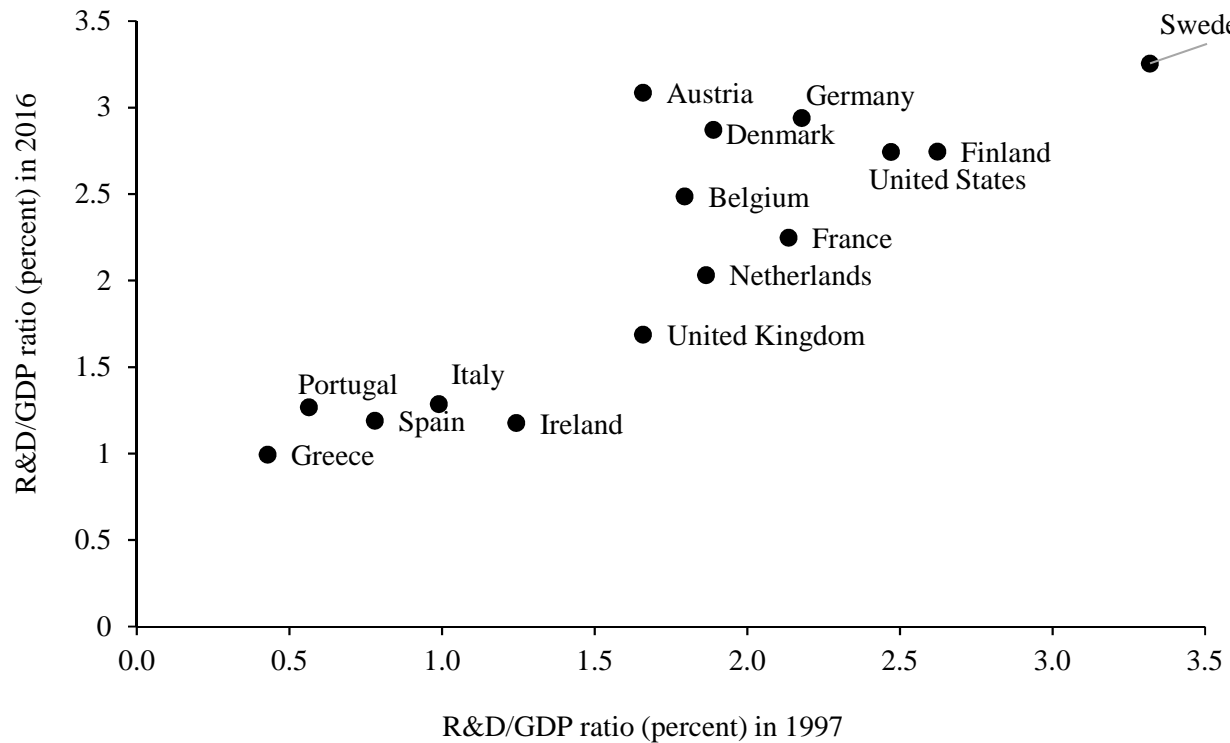


Source: World Bank, Worldwide Governance Indicator. Note: The overall index presented is an average of measures of government effectiveness, regulatory quality, rule of law, and control of corruption. Each individual measure is normally distributed, with a mean of zero, a standard deviation of 1, and an approximate range of -2.5 to 2.5. Larger values indicate better governance.



# Poorer long-term growth prospects a trap: persistently low R&D rates in the euro-area periphery, hence persistently low growth potential.

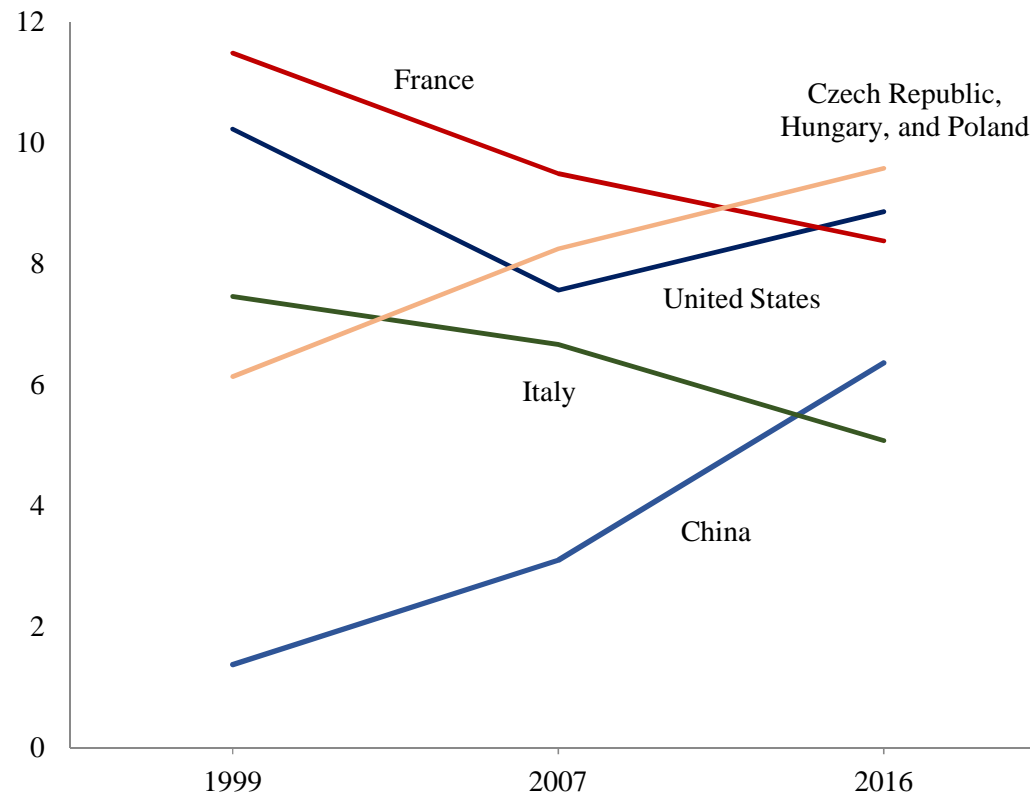
(R&D as a percentage of GDP, 2016 versus 1997)



Source: OECD Statistical Database.

## Predictably, German exporters shift their sights away from the euro area.

(Percent of total German exports to the various countries)



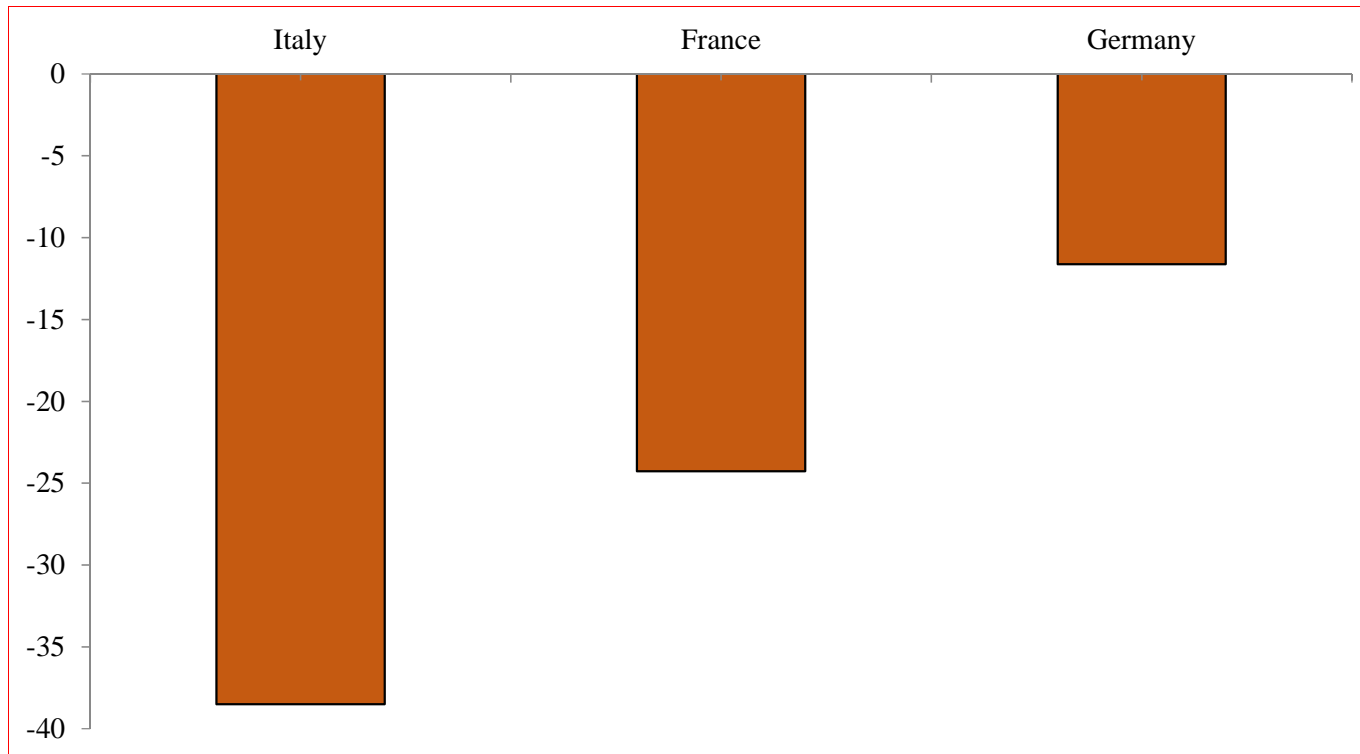
Source: IMF Data, <http://data.imf.org/regular.aspx?key=61013712>.

*Undercuts the idea that the euro would promote trade and, hence, growth.*

**Kaldor's ghost stalks also the eurozone's  
politics**

## Italians lost trust in Europe: economic wounds left political scars.

(Decrease in percentage of respondents who trust the European Union, 2016 relative to 2001)



Source: Standard Eurobarometer survey, available at <http://zacat.gesis.org>. Note: Respondents answered the following question: “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you (Tend to trust it; Tend not to trust it): The European Union.” The chart presents the change in share of people who said they trusted the EU. For each year, 2001 and 2016, responses for the two available quarters are averaged.

## “European chancellor” Merkel held eurozone together: Became polarizing force.



Between 2010 and 2016, Merkel was *de facto* European chancellor, a goal that Kohl had dreamt of.

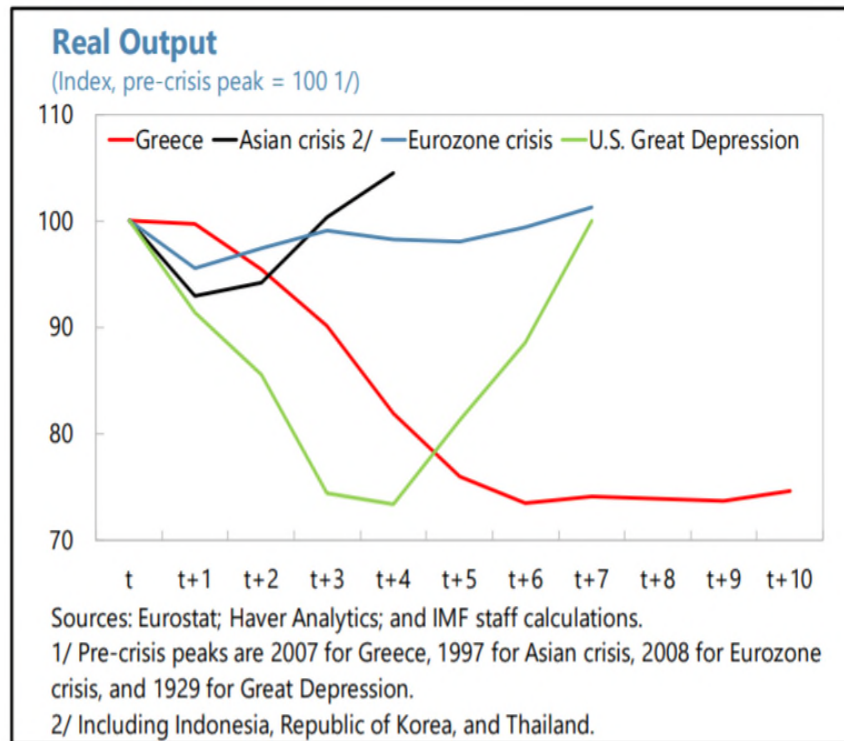
*Ipsa facto*, she became a politically polarizing figure, dividing Europe.

- In Italy, February 2013 election:
  - Rise of the anti-euro Five Star Movement
  - Silvio Berlusconi, whose party also performed well, asked at his rallies, “*Do you want a government that that is subject to the diktats of Europe?*”
  - Pro-European Mario Monti electorally humiliated.
- In Germany, starting in 2012:
  - Breakaway group from Merkel’s Christian Democratic Party (CDU) formed Alternative für Deutschland, initially as an anti-euro party and then as an anti-immigrant party.

**Looking ahead:**

**The future ain't what it used to be**

## For now, Greece has lost its democracy.



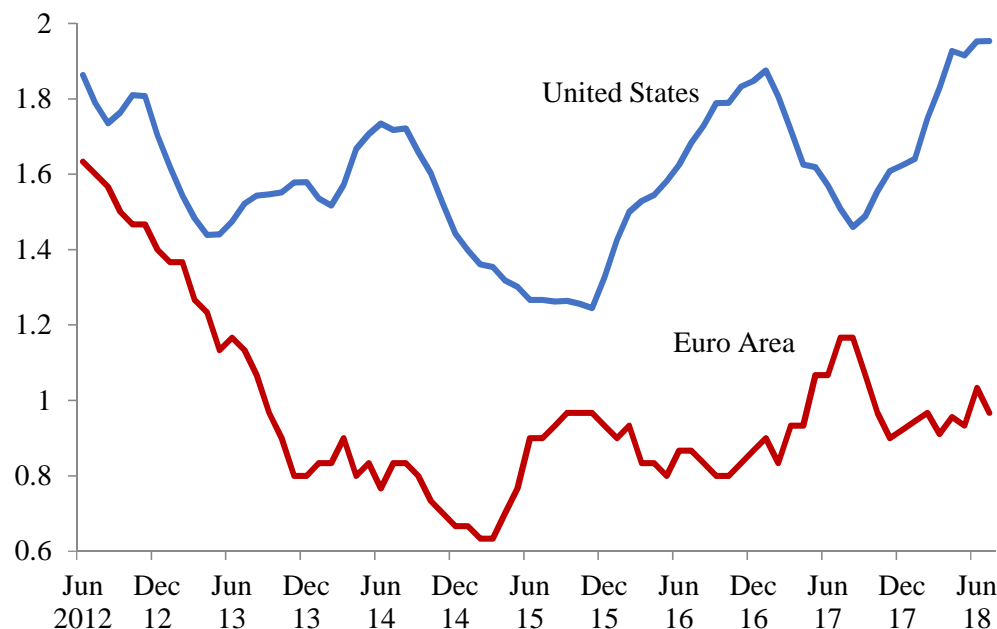
- Failure to provide *substantial and upfront* debt relief implies
  - Large primary surpluses
  - Historically hard to maintain
  - Will constrain government investment
  - Keep growth low
- More seriously
  - Greek parliament will mainly rubber-stamp decisions made in Berlin, Brussels, and Frankfurt.

**The ECB has reached its political limits**



**ECB tardy in initiating bond purchases:  
Euro-area inflation rate began dropping in mid-2013, delivering the  
lowflation wound.**

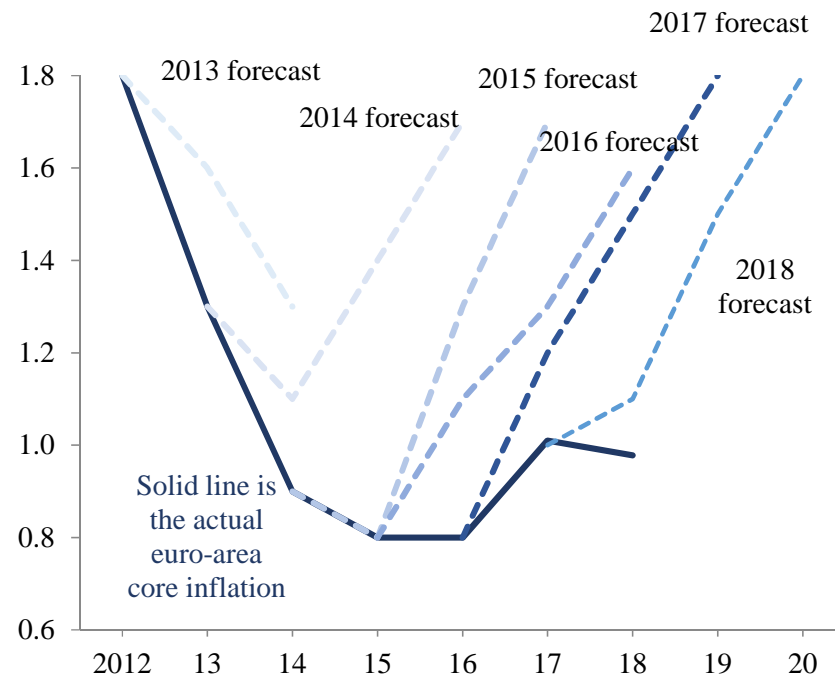
(Three-month moving average of “core” annual inflation rates, percent)



Source: Eurostat: “HICP—All Items Excluding Energy and Food”; St. Louis Fed, FRED: “Personal Consumption Expenditures Excluding Food and Energy (Chain-Type Price Index).”

## The ECB keeps forecasting a rise in inflation:

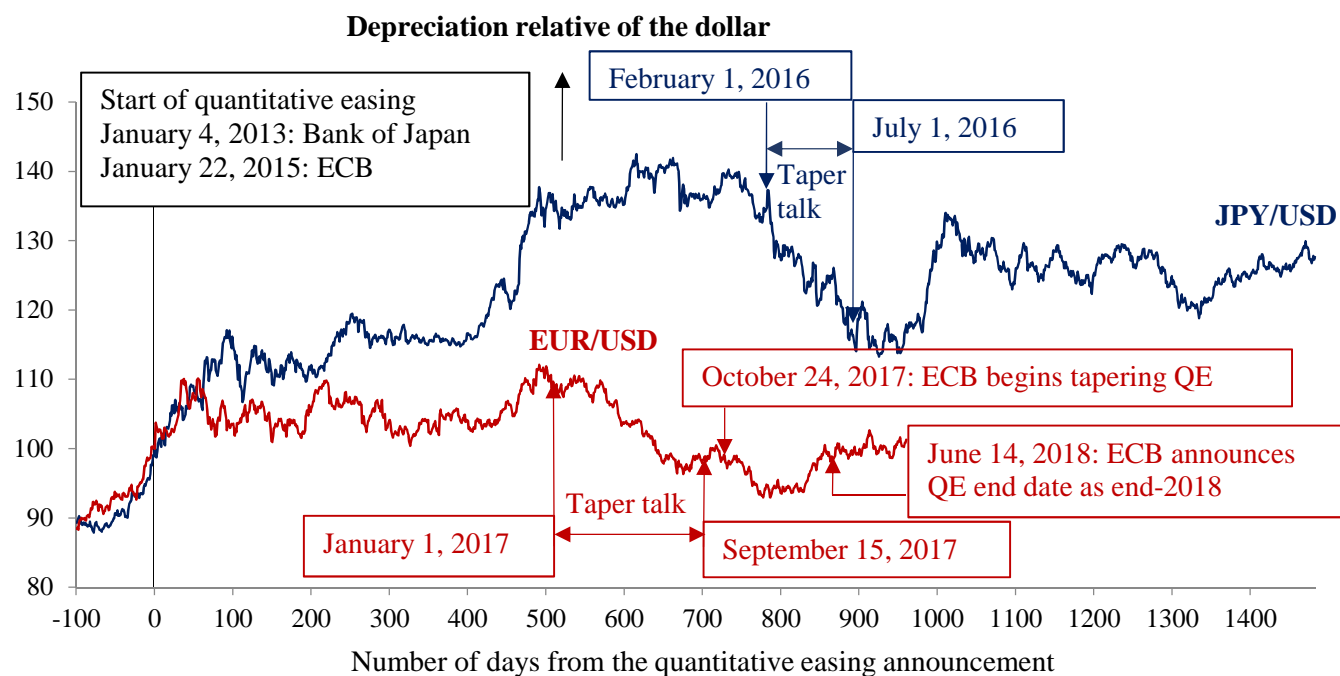
### Inflation remains stubbornly low.



Sources: ECB's Macroeconomic Projections made in March of the year,  
<https://www.ecb.europa.eu/pub/projections/html/index.en.html>.

Note: 2018 core inflation is the average of months January to September 2018.

## The ECB lacked commitment to bond purchases, even more so than the Bank of Japan.

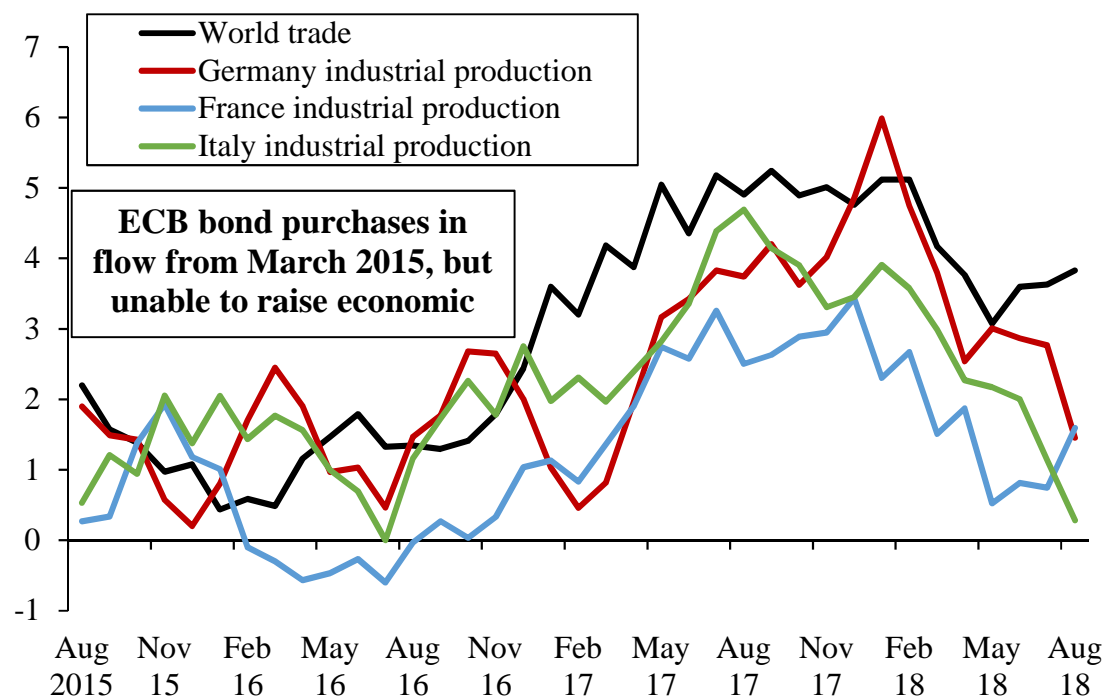


Note: Exchange rate for JPY/USD equals 100 on January 4, 2013 (date of the announcement of quantitative easing by the Bank of Japan) and exchange rate for EUR/USD equals 100 on January 22, 2015 (date of the announcement of quantitative easing by the ECB).

Source: For USD and Japanese Yen, <https://www.investing.com/currencies>, for USD and Euro rates ECB, [https://sdw.ecb.europa.eu/quickview.do?SERIES\\_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC](https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC).

## World trade rather than ECB's bond purchases moves eurozone growth.

(Annual growth rates, percent; three-quarter moving averages)

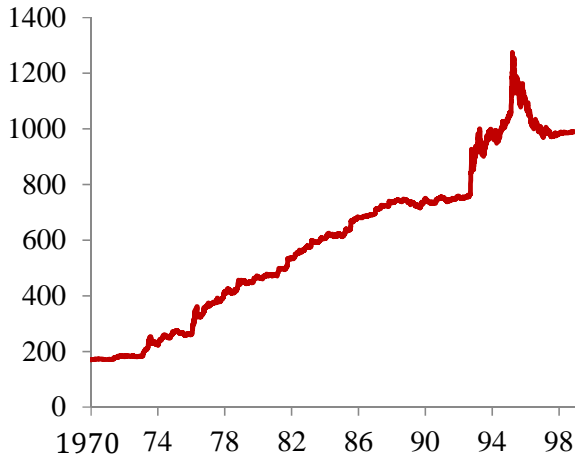


Source: For world trade growth data World Trade Monitor, <https://www.cpb.nl/en/data>; for the industrial production of Germany, France and Italy Eurostat, code [sts\_inpr\_m]. Note: The three-month average of growth over the same three months in the previous year.

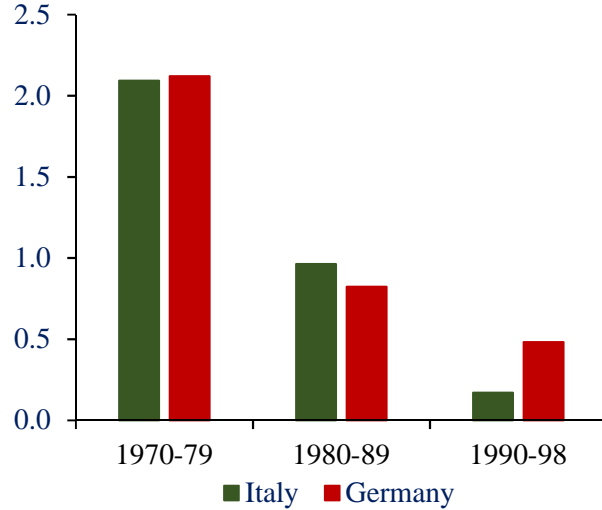
# **Italy: theater of EuroTragedy**

# Italy needed—and needs—the crutch of a depreciating currency to offset its abysmal productivity growth.

The depreciating lira  
(Number of liras for one D-mark)



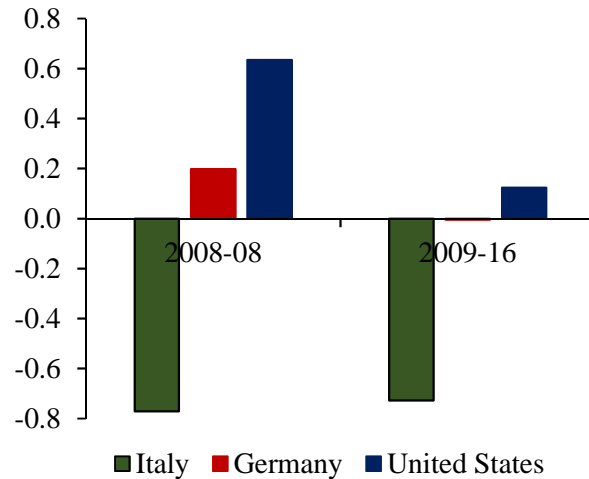
Italian productivity fell relative to German  
(annual total factor productivity growth)



US Dollar/Euro exchange rate is back where it began, 1999-2018

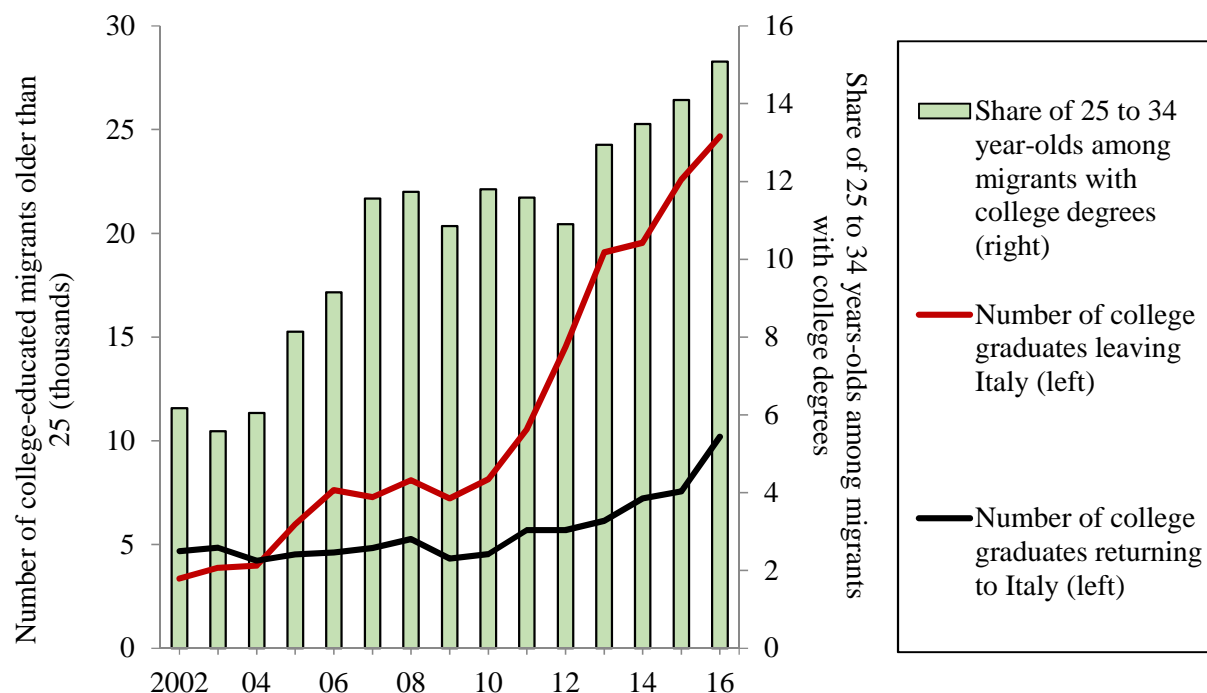


Italian productivity collapsed while even German fell behind the U.S.  
(annual total factor productivity growth)



Source: Top left panel: Banca d'Italia, <https://tassidicambio.bancaditalia.it/timeSeries>; top right panel: ECB data warehouse [https://sdw.ecb.europa.eu/quickview.do?SERIES\\_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC](https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC); bottom left and right panels: The Conference Board, <https://www.conference-board.org/data/economydatabase/index.cfm?id=27762>.

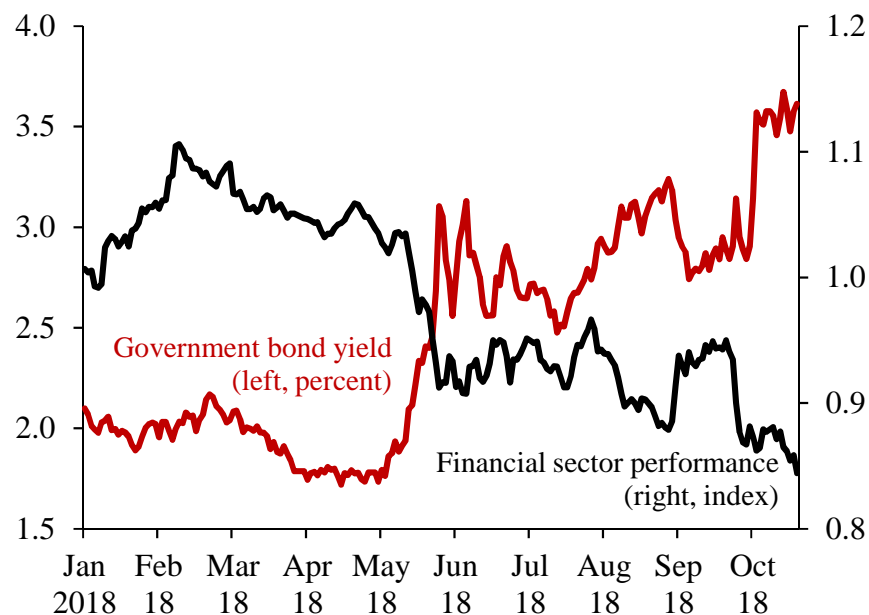
## Young college-educated Italians leave Italy in growing numbers.



Source: Italian National Institute of Statistics.

*Italy's low growth trap: poor opportunities, the educated leave, R&D remains weak, and opportunities remain poor.*

## Italy's financial problems: The government-bank “doom loop,” always latent, has reemerged.



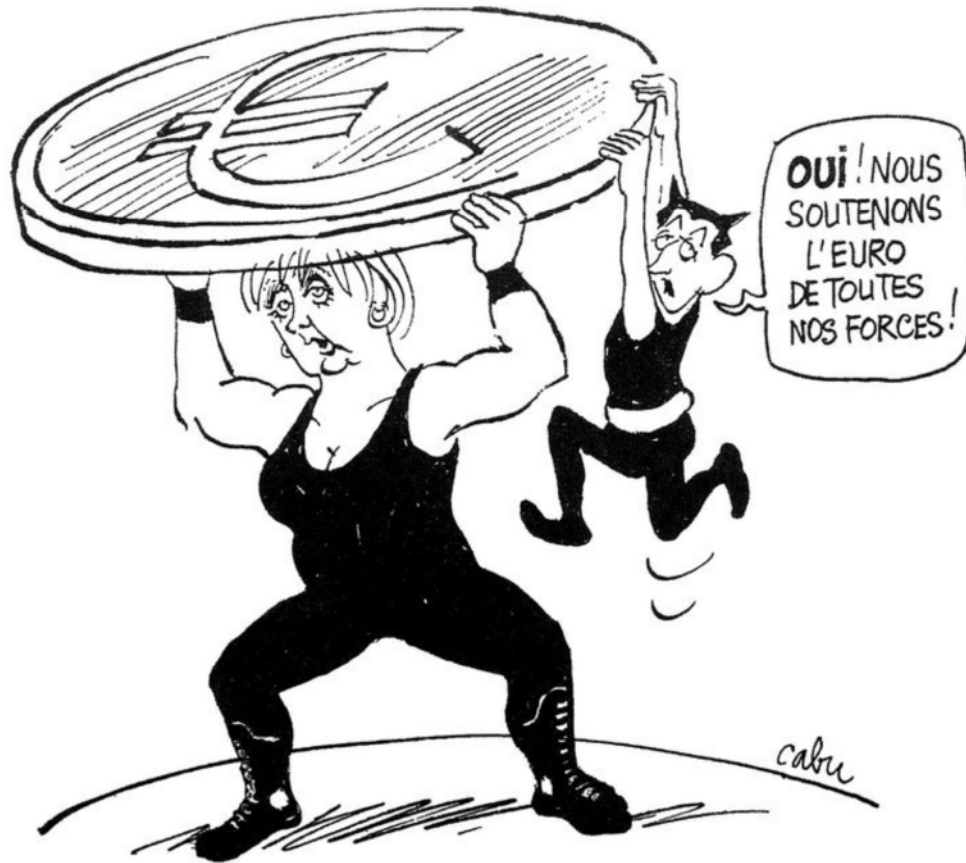
Sources: FTSE Italia All-Share Financial Index: Global Financial Data, ticker IT8300 Index; FTSE Italia All-Share Index: Global Financial Data, ticker FTSEMIB Index; Italy ten-year bond yield: Datastream International, code S310DT. Notes: The graph presents the relative performance of financial stocks and the Italian 10-year bond yield from 2 January 2015 to 18 September 2012. The relative performance of financial stocks for Italy is the ratio between the FTSE Italia All-Share Financial Index and FTSE Italia All-Share Index.

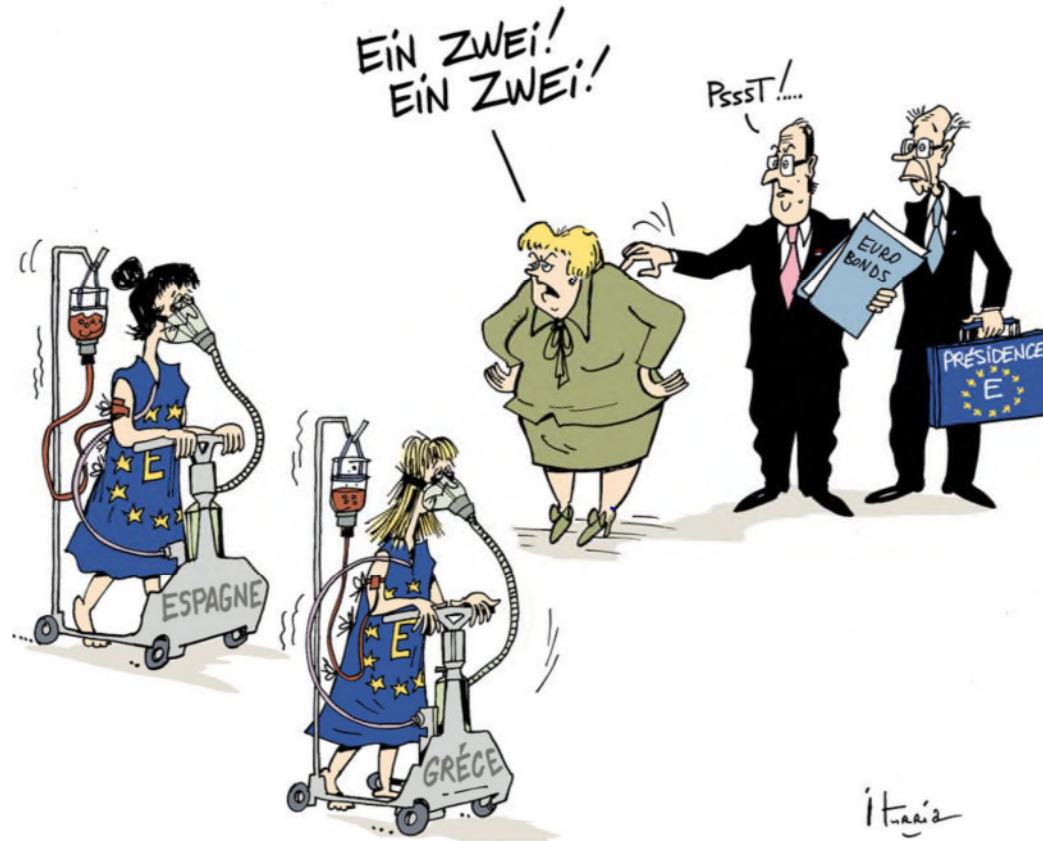


**Sovereignty barrier remains as strong as  
ever**

# The myth of Franco-German friendship.

SARKOZY SOUTIENT ANGELA



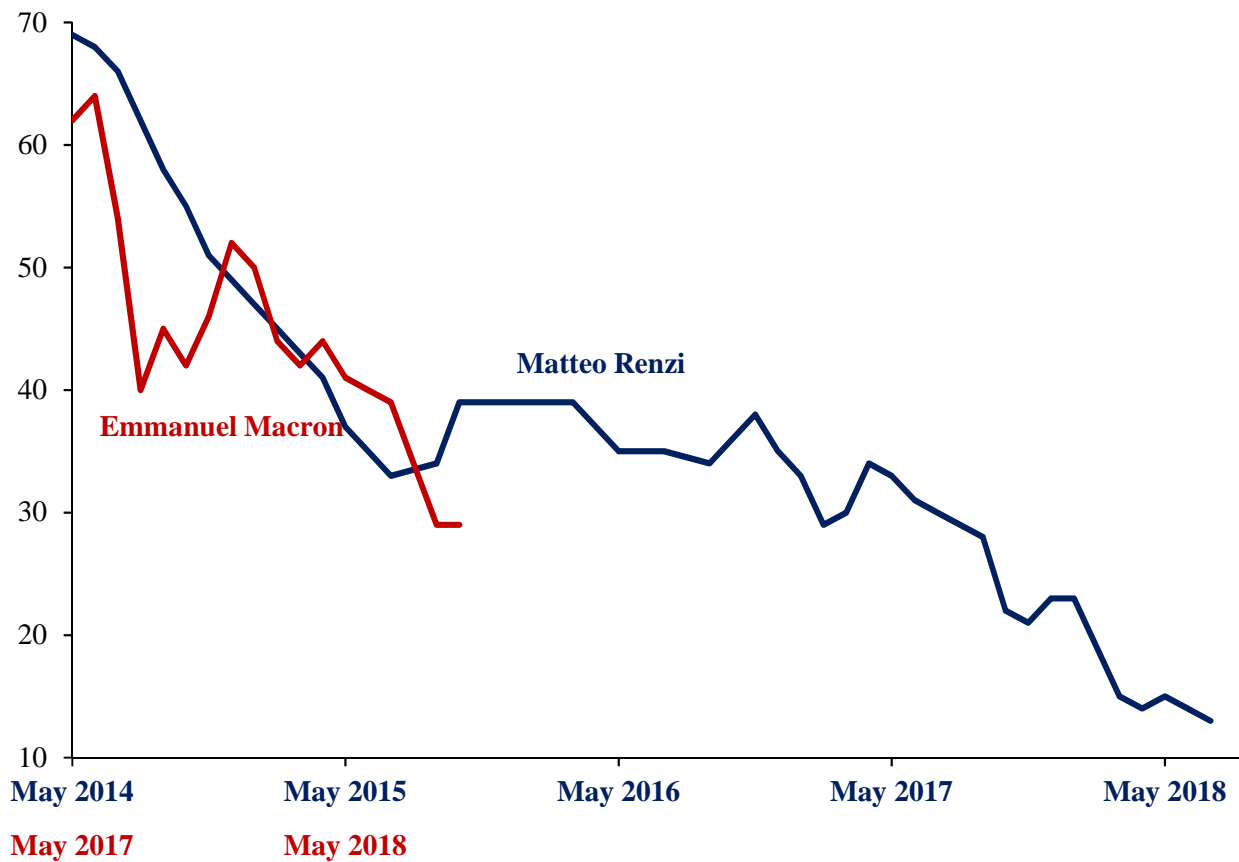


At the December 2012 European Council, Herman Von Rompuy proposed a eurozone budget. Merkel asked, “Where will the money come from?” French president François Hollande helpfully suggested to Merkel that she think of it as a “solidarity fund.” Again, Merkel coldly asked, “And where will the money come from?”

## The search for a savior.



## How the saviors fall: Matteo Renzi and Emmanuel Macron approval ratings. (Approval ratings, percent)



Source: Ipsos polls for Matteo Renzi, [www.ipsos.it](http://www.ipsos.it); Ifop for Emmanuel Macron, <https://www.ifop.com/wp-content/uploads/2018/08/Indices-de-popularit%C3%A9-Ao%C3%BBt-2018.pdf>.

Note: Percent "Don't know" excluded.

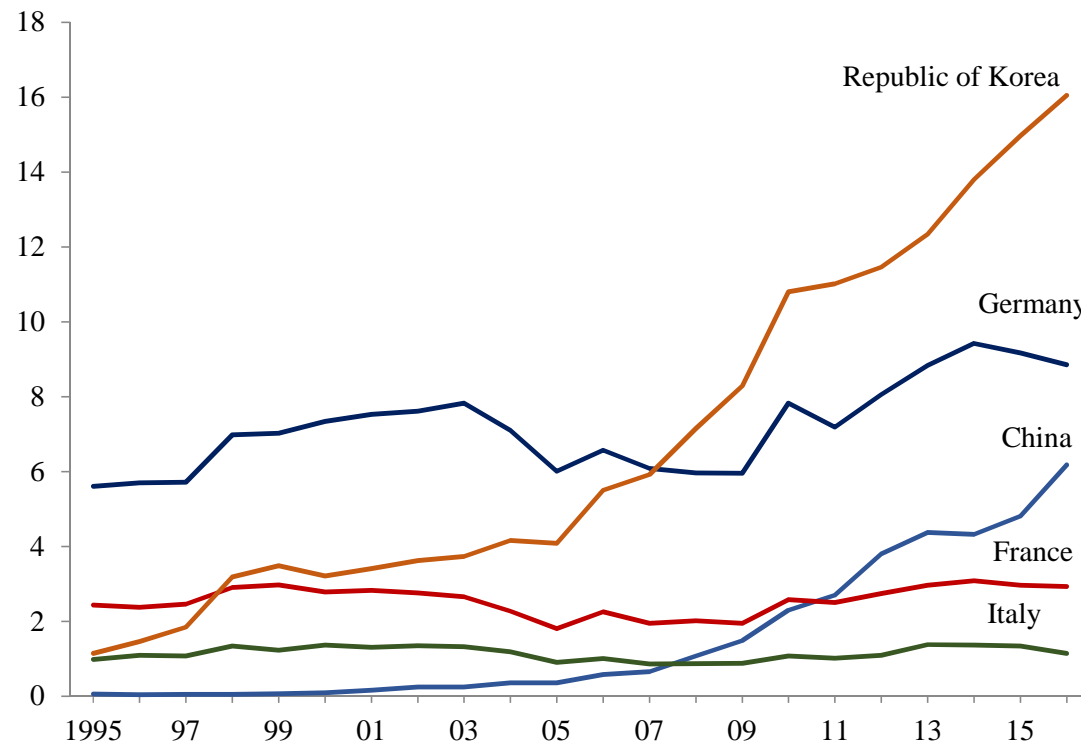
**There are no saviors.**



## Europe: a declining continent for over a century:

## The future does not look much better, as Asia surges ahead.

(US patents granted annually to companies in different countries, numbers in thousands)



Source: World Intellectual Property Statistics Database, <https://www3.wipo.int/ipstats/index.htm>.



The warnings were sounded. It need not have been. It almost was not. The rest followed. It could get worse, a lot worse.

- The euro has hobbled many of its member countries.
- It has created bitter political division among Europeans.
- If Aristotle were alive today, he would see how “eminently good and just” men and women enacted the *EuroTragedy*, “not by vice or depravity,” but by “error or frailty.”