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Welcome to the first 2013 edition of Creative Distraction!

You know the drill. With a new semester starting up, Creative Distraction is here to get your mind into gear! it is our aim in each addition to publish interesting and readable articles, essays and reviews submitted by your peers at UQ and in doing so showcase the work UQ students can do!

In keeping with the efforts of the publications team last year, we have included an interview with an academic in the School of Economics!

A huge thank you to those who contributed to this edition: Associate Professor Alicia Rambaldi for her interview; Samantha Wockner, Dan Mouat and Ben Jackman for their contributions; and the School of Economics and the BEL Faculty for their ongoing support.

Thanks must also go to those who submitted articles, it is unfortunate we could not publish more. Please keep an eye out towards the end of semester two for your chance to contribute an article to the second edition. You can also get your name in a coveted UQES publication in another way by submitting a course review for the 2013 BEcon Guide: head to our website (uqes.com.au) for the course review link.

Best of luck with the coming semester and hopefully this will aid you in procrastinating in a mildly relevant way!

Ben Jackman, Belinda McEniery, and Keaton Jenner
Publications Team

Upcoming Events

The UQES 25th Anniversary Gala Dinner is on in August!

The UQ Economics Society is pleased to invite all economics and non-economics students alike to celebrate our 25th Anniversary Gala at Southbank's Rydges Hotel. After 9131 days of maximising our members' surplus, a night of excitement, festivities and escalation is in order.

Just because the holidays will have ended and we will be back at uni, does not mean we have to stop enjoying ourselves. Featuring a two-course meal, a hospitable beverage package (including spirits), stunning Brisbane city views from the rooftop level of Rydges and a surprise after party, the 25th Anniversary Gala is set to restore your freedom in what is sure to be a night to remember.

Despite many peaks and troughs in the economy, since 1988 the UQ Economics Society (formerly, the Economics Society of Australia, UQ Chapter) has continually exceeded all rational expectations to surpass potential GMP (Gross Membership Product) and grow to record membership levels in 2013.

So cash in your Eurobonds, stuff austerity and embrace a night of animal spirits!

UQES 25th ANNIVERSARY GALA DINNER



7PM AUGUST 09 RYDGES HOTEL SOUTHBANK

When: 7pm, 9th of August 2013

Where: Rydges Hotel Southbank

Attire: Black Tie/Formal

Inclusions: 2 course dinner, drinks, after party

TICKETS:

- \$95 pp

- Table Booking (10 people): \$90pp

(+ \$5 for membership if you don't already have it)

- This is a strictly 18+ event

- This is a UQES Members event. Non members can purchase membership when booking online or organise to purchase membership in person - please contact t.connell@uques.com.au for further information.

- Further enquires please contact: events@uques.com.au

- For more information check out UQES on Facebook, and check out the UQES 25th Anniversary Gala Dinner Event page on Facebook!

Meet your Lecturer

Associate Professor Alicia Rambaldi

Courses taught in 2013:

ECON3350 - Applied Econometrics for Macroeconomics and Finance

Recent Publications:

Rambaldi, A.N, C.S. Fletcher, K. Collins, R. R. J. McAllister (2012), "Housing Shadow Prices in an Inundation Prone Suburb " Urban Studies. DOI: 10.1177/0042098012465904

Ganegodage, K. Renuka and Alicia N. Rambaldi (2011). The Impact of Education Investment on Sri Lankan Economic Growth. *Economics of Education Review*, 30, 1491– 1502, DOI:10.1016/j.econedurev.2011.08.001.

Question Time

If you were not an academic economist, what would you be?

If I had my time again, I'd probably be a physicist. I like theoretical physics, I don't know if I have the mind for it, but at the moment there is string theory, all these new issues, which are fascinating. So I would be interested in theoretical physics, or at least experimental physics if not theoretical.

Do you think there is enough experimental work in string theory that could be done?

Hah, well, as far as I can tell not yet. But let's hope one day.

How did you decide on economics or econometrics as a discipline over some of the other things you can be considering?

My first degree was in rural sciences, and for that degree we had to take a class in agricultural economics, which I really liked. So after that degree I pursued a Masters in agricultural economics, and while I was doing that, my supervisor said "You have a lot of talent for econometrics!" Thus, I started a PhD in Economics with major in Econometrics immediately after completing my Masters.

I should mention that agricultural economics is one of the disciplines from which econometrics came to be a discipline. In the US, econometrics came out of the need for agricultural economists (who dealt with large amounts of data) to deal with new problems they were facing, so the econometrics departments grew out of these agricultural economics departments. Many early famous econometricians were originally agricultural economists! In contrast, in Europe econometrics came more from a mathematical statistics background. So in these two ways econometrics became its own discipline.

In a contemporary sense the discipline is one of a number of applied statistics; these days the business statistics and econometrics falls under the umbrella of statistics. Nevertheless, my path to econometrics through agricultural economics is actually similar to how the whole discipline began (at least in the US).

What is the quality you like most in a student? And what is the quality you like least?

I think I value a willingness to work hard, obviously given a minimum set of necessary talents. One might be willing, but not have the minimum talent, which is a different problem. So assuming

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those minimum talents, I've always believed if you decide to put your mind to something, you will get there. For example, that is how you finish a PhD - anyone who has done a PhD will tell you it is more than your brain, it is your perseverance, as well as resilience, since failure is always a part of life. So I really value those things in a student.

What I don't like in students? When they are having trouble and they don't come and talk to me. When people wait until it is too late.

The day before the exam?

Well even after! Somebody comes to me and asks 'Why didn't I get a 7?' The answer to that is, 'Well, I don't know why you didn't get a 7!'

But if we look at the student's work during the course, and their marks haven't been what they wanted or expected, I say, 'Why didn't you come to me at that time and talk to me?'

Talking to teachers is important, they are teachers all the time, but they cannot be helpers all the time unless they are being asked for help. So, for students, not going to a teacher and asking for help when they need it is something that really irritates me, especially when they subsequently complain after the result.

What advice would you have for someone considering whether to go into the academic world or the private sector?

Well first of all, you should never make a decision because you think one option will give you the most money. I think that is misguided. Things will change.

The first thing that we all should do is whatever makes us happy. If you enjoy something, if you like it, it doesn't matter what it is.



If people think that they want to be challenged mentally, and like to progress science in whatever field, then a PhD is the best way to do it, because it is the only way you will end up in a research organisation. But if you want to apply things, or if you want to make contributions in other ways, then maybe the private sector is for you.

A PhD can be great if you are inspired by something another researcher is doing, but in general, I wouldn't say it is for most people; it is for a small number of people. And it doesn't pay that well!

I think the good thing about today is that we can all start one job or degree, and say 'this is not for me, I'm changing it,' which in the past was more difficult. So the extra freedom and flexibility is helpful these days, although you of course need to be responsible in your use of these things. Ultimately, pursuit of what you are passionate about is the best way to go.

What challenges do you think new economists face over the next few decades?

Economics is an interesting discipline, in that it is a social science. For most pure scientists, social sciences are 'imperfect' in some sense. But I think in economics we have gained some recognition over the past few decades. We are a 'Nobel prize' type discipline for instance, and these are good things for us.

I think the challenge for all of us is to try to treat

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and convey our discipline to others in a way that doesn't make us look like we are just commentators about the movement of interest rates. The generic idea about economics from the public is confused - they may see it as a mixture of accounting, business or finance... anything but what we actually do, especially at universities.

Economists are behavioural scientists, so we should try and move our discipline forward in that sense. We need to explain that we study the behaviour of consumers and producers, that we try to design mechanisms so that markets work correctly, and try to shape incentives rather than implementing inefficient rules or laws. Economists don't think markets are perfect, we know externalities exist, we understand these things, we are interested in designing systems that work properly and work best for everyone.

Such well-designed systems, with the correct incentives in the right places, create the best outcomes, and that is what economics can do best. That is what we should communicate about our discipline, and what every student of economics should remember.

I saw on your resume that you have done some work on commodity markets, especially wool and wheat markets in Australia. Given your experience dealing with markets like this, how do you feel about the efficient market hypothesis? The strong form? The weak form?

I feel about them, the same way I think we should all feel about any simplification of reality. In general, they both are (or might be) valid representations of realities at some particular point in time, and I don't think either one is the 'correct' one. Maybe a combination of them is.

I'm not a theorist in financial economics, but as an econometrician, I am a strong believer in models that adapt and change. I think one of the biggest problems has been the overuse of static models: you pick one hypothesis and you expect to observe it over the whole period of time you are studying as a non-evolving entity or parameter in your model, that is a bad assumption. In some periods you will

observe one hypothesis holding, in other periods you won't, so we should model such assumptions dynamically, rather than statically.

So in terms of the EMH, you might say they should inform our understanding of markets but are not sufficient and 'complete' explanations of markets behaviour?

As I said I am not a theorist in this area, but yes, I think they are not 'complete' in the sense you mean, but they are not 'wrong' either.

An American econometrician named Mark Thoma recently wrote about his experience as a grad student several decades ago, that he was optimistic that time-series econometrics could answer macroeconomic questions better and more accurately in future as datasets got bigger over time. However, he observed that big structural breaks in the datasets, especially due to changes in central bank behaviour, makes long run time-series data in macroeconomics difficult or impossible to work with. Do you think this problem is intractable? Or do we have tools to deal with it?

I think this is related to the previous issue (time-varying versus static assumptions in econometrics). More recently, people have been working on these adaptive or learning frameworks in econometrics. The problem is, if you run a regression with the 70s, the 80s, and the 90s in, and you try to get a single parameter out of that, you are getting an average over several different regimes and behavioural rule-sets of the central bank.

So I think anything that allows the flexibility of the model itself to change the basic parameters is the only way to deal with this problem. I do think time-series has a role here, but these fixed structure methods, for example having an underlying VAR that doesn't change over a large time period, is the wrong assumption to make. In fact these methods have been slowly but consistently abandoned in favour of the time varying parameter models, time varying VARs, and so on. There has been a clear recognition of this problem.

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But of course econometrics does not have all the answers! Macroeconomics and behavioural economists also have contributions to make. Behaviourally it is quite difficult to model central banks, considering they are entities that make decisions through the consensus of a board..

So this problem is a tough one, but not unbeatable?

I don't think it's an unbeatable problem, no.

I noticed one of your current research grants is related to climate change, with the CSIRO. Do you think climate change denial, or denial of the anthropogenic causes of climate change could be a problem?

I personally... well if I feel unwell; I go to a medical doctor for a diagnosis. In the same sense, I think that we should all respect climate scientists when they provide evidence, and I think the evidence is quite overwhelming. I don't think opinions on the internet, on Facebook, or in editorials, should be given the same weight as actual scientific data. Otherwise I would be saying anyone could dismiss what I or anyone else as a scientist does! Science is not a contest of opinion.

I am not a climate scientist, but I peruse the evidence, and considering the robustness of the results, putting it all together and doing a meta-analysis, I think you do find that there is a trend there. There is something happening, that is relatively clear.

What role does economics have in dealing with climate change? What are you doing in your research?

The work my team and I do is a small contribution to this area! What we are doing at the moment is basically looking at residential housing, land, and property, and examining whether the markets are pricing in (via people's willingness to pay) events like flooding that are obviously related to climate change. Can you capture from the transaction prices the effect of people considering the possibility of those events? Are markets beginning to price these

things in? With the physicist on the team, we are also simulating the responses to these events.

Economists have a very broad behavioural sciences background, in a sense this makes us very useful in teams like this. We have institutional frameworks in our head, we understand a little bit about political science, a little bit about human behaviour, a little bit about the structure of incentives, and so on.

I am not a climate scientist, but I peruse the evidence, and considering the robustness of the results, putting it all together and doing a meta-analysis, I think you do find that there is a trend there. There is something happening, that is relatively clear.

Are you familiar with Reinhart and Rogoff's paper?

The one with the mistake?

With the major mistake, yes.

I think the mistake doesn't change the sign of the result. It changes the interpretation of course.

I think I agree. Now at the time, the paper was not (and still hasn't been) peer-reviewed. Do you think that peer-review should be mandatory, in some sense? Or is there some other lesson to take away from this?

I always tell my research students when they first start: it is not the same to be quoting or using a paper published in some highly ranked journal, as it is to be using some working paper that is available but has not yet been peer reviewed and published. So I think we always need to be careful about these things. Of course even peer-review is not perfect!

But I think peer-review is mandatory, in an indirect way. Let me explain what I mean.

In academia, things that haven't been published in a peer-reviewed journal will not at the end of the day be considered, by promotions committees especially, as legitimate, in some sense. So work that is not peer-reviewed has less 'value' or credibility. It is still to be 'validated by peers'. But then again there are

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many working papers that have become completely famous without peer-review! But in becoming famous, they have been examined, cited and used perhaps hundreds of times, meaning they have been de facto peer-reviewed. So we should prefer papers or results that have been subject to the scrutiny of our peers in some way.

The user, then, should be careful. We shouldn't stop people from uploading working papers, but we should be cautious with how we use such papers.

Is there some onus on the authors as well? Should they bear some responsibility?

Well, everyone can make a mistake, obviously. The story is apparently that their result was used to design policy in Europe. If that story is true, then who was making those decisions in Europe? Certainly the authors should recognise they have made a mistake, but I find it hard to believe that their paper was the only thing driving these policy discussions in Europe. If people only used that paper, then they deserved what they got – that seems like such a non-robust way of making decisions! So the user of such a paper should certainly bear some responsibility.

If you were an international student, and you started an undergraduate degree in economics at UQ in 2012, the final cost for the three-year degree would be approximately \$88,800. Do you think there is good value there?

For this, I will revert to my willingness to pay argument. I think if we observe people that pay it, we have revealed their preference. If you are in a less developed country, and your tertiary education options are limited, then coming to here or to a place similar to this one would seem to be a logical thing to do.

I obviously haven't done an analysis of the costs that drive that figure, so I can only take this as a revealed preference question. I can imagine if nobody comes, then we probably have the wrong price. If they do, then the price might be about right!

Who would you most likely be stuck in an elevator with, if it could be anyone alive or dead?

Let's assume that we can take this opportunity to talk to a person that otherwise we wouldn't have the opportunity to talk to. There are quite a lot of people I would like to talk to!

I was reading a book last week about the history of mathematics. I read this story, of who is believed to be the very first female mathematician. She lived, somewhere around 496 BC, and she was Greek. She appeared, for what the records say, to be a very progressive person, and had a lot to do with what then became the more established early books of mathematics in Ancient Greece. But then, of course, she was burned alive as a witch.

I would just love to be able to sit with such a female, who was in a very male-dominated time, and sit and hear exactly what she thought about her life, and how she had tried to make a contribution to a society that wouldn't even have considered her a citizen. I think I would like to hear her story.

Final question, one we always ask Professors of Economics at UQ, if someone is at level 2 in the Colin Clark building, and they need to get to the top floor, should they take the stairs or the lift?

Well it depends! In principle, anybody that is physically able should try to take the stairs, because exercise of this type has been shown to be quite important. In this sense for your physical well-being you should be taking the stairs.

But sometimes, you might be carrying a whole lot of things, or you may be unwell, and so taking the stairs may actually be worse for your physical well-being! So of course, it depends. Given one set of assumptions, the stairs is best. But the answer depends on our assumptions.

The RBA and the AUD

Ben Jackman

This essay will appear in an upcoming edition of the Cornell Economics Society's bi-annual publication, "Visible Hand".

The Australian Dollar and the Reserve Bank

At the time of writing, the Australian Dollar was trading at parity or higher to the US Dollar, reflecting currency strength never before seen in the post-float era. Ben Jackman investigates if and how the Reserve Bank of Australia could respond.

In late 2010, the Australian Dollar surpassed the Swiss Franc to become the world's fifth most-traded currency. Trades in the dollar account for between 7 and 8 percent of the global daily foreign exchange volume, slightly higher than that of the Swiss currency. [10] The consensus among Australian economists and finance journalists is that the relative strength of the Australian economy, comparatively higher interest rates, political stability and deregulated exchange markets have all contributed to the high demand for the currency and hence an ongoing appreciation. [1] A similar story can be told of the Swiss Franc, including its own sizeable appreciation, although the Swiss story is more closely related to the crisis in the Eurozone. [11]

Despite their similarities, the handling of the two currencies by their respective central banks could not be more different. While the Swiss central bank (the SNB) has intervened to stabilise the value of their currency, the Australian central bank (the RBA) has been less forthcoming, committing only to intervention in times of 'market dysfunction.' [2] While there are some differences between the two cases, a comparison of the two is a good starting point for a short discussion of the RBA. Both nations are small open economies with their own currencies, managed under a flexible exchange rate and inflation-targeting regime. Comparing different policy responses and the rationale behind them gives context to a discussion of the RBA, its opinions on the strength of the dollar, what it perceives to be appropriate macroeconomic management,

and what actions it may take in future.

In the second half of 2011, the threat of a breakup in the European monetary union was provoking large-scale capital flight. In September 2011 the SNB announced it was pegging the value of the Franc to the Euro at 1.20 to halt the currency appreciation that was crushing the Swiss export sector, threatening recession and subsequent deflation. [3] The central bank announced that it would be willing to print an unlimited amount of Francs to defend the peg and accept higher domestic inflation if necessary. The total currency holdings of the SNB have increased to over 400 billion Francs (almost three quarters of GDP), with 188 billion Francs added to the bank's balance sheet in 2012. [12] It speaks to the power of a resolute central bank that the currency has not appreciated any further, despite the ongoing and elevated demand for safe assets in the Eurozone. [4]

The experience of the Australian dollar over the last few years has been similar, although the appreciation has occurred at a slower rate. The currency broke through parity with the US dollar in early 2011 and hit a record high of 1.108 in July of that year, from a recent low of just over 0.610 in late 2008. These levels are the highest sustained since the dollar's float in 1983, and are reflected not only in AUD:USD index, but across most major trading pairs and trade weighted indexes as well. [5]

The pressure imparted on certain sectors of the economy from the consistent and ongoing high levels of the dollar has led to calls for an intervention by the RBA, similar to the ongoing intervention in foreign exchange markets by the SNB. 20 percent of Australia's GDP is generated by the export sector, a large portion of which is threatened by the high value of the dollar. [6] The economy has been subject to a new carbon tax, an appreciating cur-

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rency, and ongoing wage pressures due to the mining boom, accelerating structural change that can be disruptive.[13][7] Some domestic commentators have argued that if it is possible for the Swiss to intervene without sacrificing macroeconomic stability, that same should be true of the RBA. The most notable commentator making this point is Warwick McKibbin, a former voting member of the RBA's monetary policy board. [7]

Despite these many concerns, and the Swiss experience, the RBA has been consistently playing down the possibility of a currency intervention. Several recent working papers by the bank that discuss previous currency interventions have found that while they can decrease volatility in the dollar, especially during market dysfunctions, their effectiveness at controlling the level of the dollar is low. In particular, a 2011 RBA Bulletin paper by Newman, Potter and Wright builds an econometric model of interventions by the bank and finds,

*... a recognition that when foreign exchange markets are deep and liquid (and the capital account is open), the effects of intervention on the **level** of the exchange rate are generally short-lived, (emphasis added).* [2]

Furthermore, the researchers were not confident about the robustness of their own results, stating,

"...it is not possible to draw strong conclusions, notwithstanding the use of an improved measure of RBA interventions. The well-known limitations of this type of analysis suggest that the estimates of the effect of intervention on the exchange rate are expected to be understated, and may even be perverse." [2]

The authors express concerns that the model may be inadvertently identifying a causal relationship from exchange rate movement to intervention, rather than from intervention to exchange rate movement. This identification problem is called endogeneity, and is a common problem facing econometric analysis of monetary policy. The normal method for

remediating such an issue is to lag the intervention variable by one period, given the fairly innocuous assumption that an intervention could not have been caused by an exchange rate movement in the future. The unfortunate result of this adjustment is that the model will not capture the intervention's effect from the day the intervention was implemented, hindering the identification power of the model. The researchers concluded that this problem is almost intractable, and is likely to affect all study of currency interventions, making the effects of small and moderate interventions difficult to quantify. *

Despite these problems, the consensus from this paper and others, and from several policy speeches made by RBA economists, is firstly that foreign exchange interventions today are reserved for 'market dysfunction;' secondly, that attempts to control the level of the dollar may be ineffective; and finally, that large scale interventions like that engaged by the SNB would conflict with the bank's inflation target. It is worth noting that while this consensus exists informally, no policy rule has been explicitly stated, and the Bulletin working paper quoted above goes at great length to avoid making specific policy statements about the future. This potential for future discretionary interventions is the reason why further information is valuable when attempting to understand the central bank's decision-making process. [2]

The RBA's thoughts on these matters have been illuminated by documents recently released under Australian Freedom of Information laws. The Australian Financial Review obtained documents from the RBA regarding its internal discussions of the strength of the dollar, its currency models, and its estimates of foreign central bank holdings. These documents expose more detail than what is found in the RBA's traditional communication channels, and give a clearer impression of the bank's internal consensus. [8] While the discussions are from August 2012, the dollar value at the time was comparable to the current value, and so the analysis re-

* Woodford's 2012 Paper, *Methods of Policy Accommodation at the Zero Lower Bound*, deals with this problem by using monetary policy 'surprises' to identify market responses in day zero of an intervention or policy change.

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mains relevant.

Of primary interest is the data from the RBA's in-house models, used to estimate an equilibrium value for the dollar. The two major models using samples from the post-float era indicate either a 6 percent or 13 percent overvaluation, given the economic fundamentals that are expected in theory to drive the 'fair value' of a currency. The researcher notes that in all models, the exchange rate lies "within or just outside" a range of one standard deviation around the equilibrium estimate, and critically, that no model suggests a "substantial overvaluation." [8]

Secondly, in a roundup of work from the Australian Federal Treasury collected for internal review by the RBA, the Treasury estimates an overvaluation range of between 11 and 35 percent, based on 'long-run' estimates of equilibrium. However, these models exclude cyclical factors like relative interest rates, and are subject to the usual caveats facing exchange rate modelling based on purchase power parity. [8]

Finally, an internal discussion paper from the Financial Markets Group of the RBA compares the case of the appreciating Swiss Franc to the dollar, pointing out that,

...while the extreme circumstances facing Switzerland last year presented a clear and credible case for intervention, the circumstances in Australia cannot yet be considered comparable. There is not strong evidence that the Australian dollar is posing an imminent threat of deflation or is highly contraction for the domestic economy. [8]

The paper highlights the difference in the two cases, noting that the Swiss 'traded sector' is 90 percent of GDP (compared to 40 percent for Australia), and that a large majority of that sector is exposed directly to the European Union. The Financial Markets Group explicitly states that the ceiling was warranted due to the 'massively overvalued' Swiss Franc and the "acute threat" it posed to the Swiss

economy. Clearly, the RBA considers the Swiss intervention a special case, warranted only by extreme circumstances, and does not believe the same applies for the Australian dollar. [8]

An overall estimate of the RBA's consensus on the dollar can be formed from both a combination of public statements, and information gleaned from internal document releases. While the 2012 Annual Report stated, "the bank retains discretion to intervene to address dislocated markets and gross misalignments of the exchange rate," [9] releases from September 2012 conclude, "most models... suggest the exchange rate is overvalued by 4-15 percent," and a key Treasury article circulated by the RBA states that "calls ... [to] take action directed at lowering the value of the AUD are misplaced." [8]

In summary, the RBA considers the Australian dollar overvalued, but not significantly enough to warrant an immediate intervention. The RBA consensus is that a small or moderately sized intervention would be ineffective, and that a large intervention similar to that enacted by the SNB would be incompatible with the bank's main policy goals, in particular the inflation target. It is thus possible to say with relative confidence, utilising both public information and document releases, that a currency intervention by the RBA in future would only be triggered by a severe appreciation in the dollar.

Nevertheless, it is unlikely that such high levels of the dollar will persist over the long-term, given the consensus estimate that the long-run equilibrium value of the dollar is significantly lower (although of course such long-run values give little weight to short-term prediction). Such a correction is more likely considering the decrease in Australian interest rates over the last 12 months, and improving economic conditions and sentiment in the United States. What is more certain is that unless there is movement in the currency unprecedented in scale and volatility, the RBA is unlikely to intervene.

[1] Debelle, G. Address by the Assistant Gov-

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Notes from the Blogosphere

The Rise of “Derp”

The term ‘derp’ has experienced a meteoric rise in the econ blogosphere and in common usage over the past few years. This rise recently culminated with Paul Krugman, the blogosphere’s fearless leader (or dastardly tyrant, depending on who you talk to) releasing a post in early July called “Regions of Derpistan,” in which he outlined the metaphorical lands of Derpistan from whence Derp and its proponents came. But how did it all begin?



The original Mr Derp

Urban Dictionary defines ‘derp’ as

“a simple, undefined reply when an ignorant comment or action is made. Brought to life in the South Park series, when Mr. Derp made a guest appearance at South Park Elementary as the chef for a day, followed by hitting himself in the head with a hammer and exclaiming “Derp!””

Derp enjoyed slow but consistent uptake as a mocking pejorative, most commonly in the phrase “derp derp,” and was sometimes joined by its slightly less popular etymological cousin, ‘herp’ (see graph).

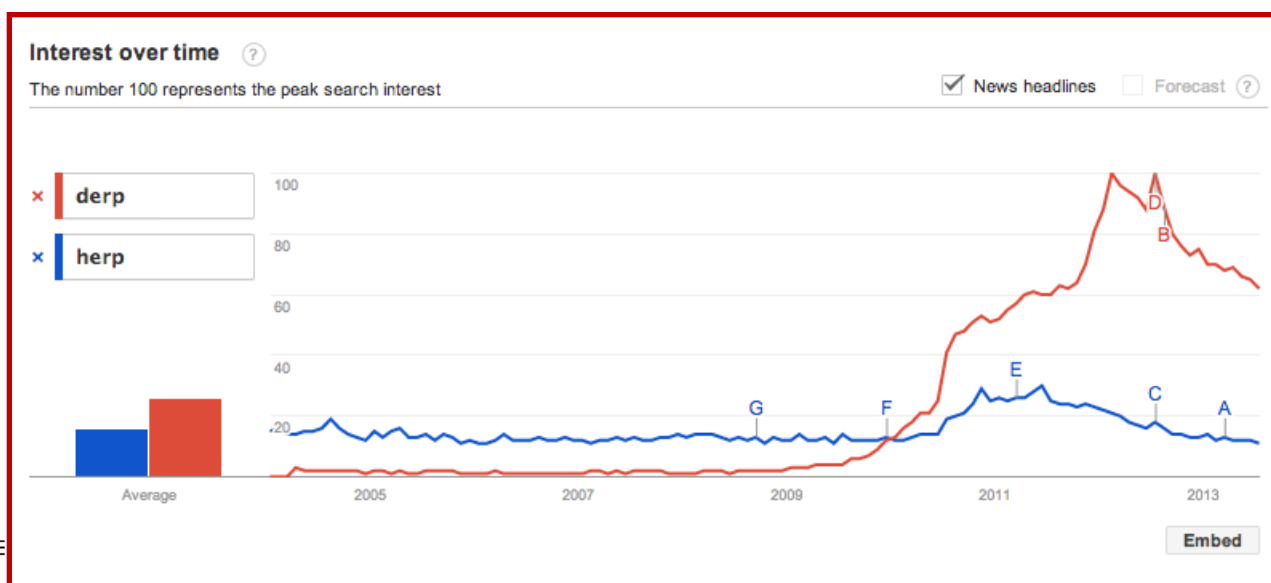
“Derpy,” “derpitude” and many other forms have subsequently been spawned.

Recently, many in the econ blogosphere have begun

to use derp with glee, while others have recoiled at what they see as a childish and unseemly utterance. Max Read on Gawker falls squarely into the latter camp,

“Seeing journalists talk about “derpy” things and “derpitude,” is a little like hearing your mom adopting slightly outdated slang. It’s almost sweet. At first. In small doses. But when an entire mini-debate, like this morning’s between Erick Erickson, Josh Barro and Krugman, is conducted entirely in terms of “derp,” it’s not cute anymore.”

Others still will rush to its defence, with Josh Barro coining a recent op-ed titled “Sorry, haters: “Derp” is a useful term, and here to stay.”



Notes from the Blogosphere

But how did derp go from being a throwaway gag by Matt Parker and Trey Stone to a staple of the econ blogosphere? At first, derp's biggest weakness was its frustrating ephemerality. Pulitzer prize winning author Nick Confessore explained in June,

"I can't define derp. I just know it when I see it."

No doubt all readers of Creative Distraction are uncomfortable with terms that are defined vaguely. How can our thoughts or models be clear if our words or parameters don't have well defined meaning?

The econ blogosphere needed a hero - one brave young blogger to cut through the confusion and set down, once and for all, the technical definition of derp. That hero was Noah Smith, a man who will no doubt soon receive the Nobel Prize in Econoblogonomics for his contributions to the field.

Using the framework of Bayesian probability, Smith came up with the following definition,

"Derp, verb. The constant, repetitive reiteration of strong priors."

Bayesian probability asserts that probability is in some sense subjective, or your 'best guess.' A Bayesian's initial guess (or belief) is her prior. Upon examining the evidence, she updates her belief, which is then called her posterior. The premise is that observable evidence that contradicts a belief should change a belief, which is quite intuitive. Unfortunately, not all people are so rigorous in their Bayesian inference.

Barro explains,

"...a policy commentator is "derpy" when his or her (usually his) prior assumptions about the world are so unwarrantedly strong that he is unswayable by evidence. Derpers have a faith-based approach to policy."

Those who hold beliefs in economics, and continually regurgitate them despite repeated evidence that their beliefs are incorrect, are thus engaged in the act

of derp.

With derp now well defined, the giants of the econ blogosphere and greater publications industry could embrace it. Krugman's "Regions of Derpistan" for the New York Times and Matt O'Brien's "The Derp and Fall of Inflation Fearmongers" for the Atlantic are fine examples.

As O'Brien outlines in detail, a textbook example of derp is the continued assertion by some that the US Federal Reserve's large-scale asset purchases (like QE) would (or even did!) lead to accelerating inflation. The constant and spirited repetition of the prior that QE will lead to runaway inflation, despite a half-decade of precisely the opposite, is the very essence of derp.

What now, then, for derp? Is it a passing fad, or here to stay? There is certainly no shortage of constant, repetitive reiteration of strong priors in the econ blogosphere, so the question is whether or not bloggers will continue to use derp to mock such bad behaviour. For what it's worth, I hope so. Derp has become a rallying cry against the nonsense the sometimes spews out of the deep dark parts of the econ blogosphere. May it take us further into the light. Praise be to derp.

Notes and Further Reading

<http://gawker.com/stop-using-the-word-derp-511316347>

<http://au.businessinsider.com/sorry-haters-derp-isnt-going-away-2013-6>

<http://cairnsbiz.blogspot.com.au/2013/06/the-war-on-derp.html>

<http://www.urbandictionary.com/define.php?term=derp>

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<http://www.google.ca/trends/explore#q=herp%2C%20derp&cmpt=q>

The Signal and the Noise by Nate Silver

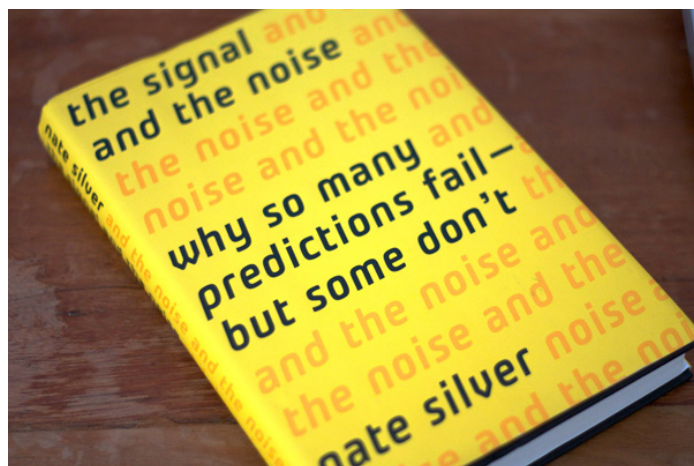
Reviewed by Dan Mouat

The ‘signal’ and the ‘noise’ of the title refer to the useful data that we seek and the irrelevant data that obscures it. It is a useful way of looking at the world, for it necessitates caution when dealing with big data and provides a reason for why many predictions fail.

It is worth giving a background on the author, Nate Silver, to show how he has used this approach to produce successful predictions and avoid the many mistakes of others. While employed as an economic consultant at KPMG where, “The job wasn’t so bad” he began putting together a spread sheet full of baseball statistics that would predict player performance accurately. Soon, he moved on from baseball to politics, an area he felt was underserved by quality predictions. Starting with the US Federal elections of 2008, his Web site FiveThirtyEight correctly predicted the presidential winner in forty nine states as well as the winner of all thirty-five US Senate seats up for election.

The methodology of his successful election forecasts, applied to a range of issues from terrorism to financial bubbles, forms the basis of Nate Silver’s book. His surprisingly simple approach consists of three steps: thinking probabilistically, updating forecasts in light of new information and looking for consensus among forecasts. In terms of electoral prediction, this meant articulating a range of possible outcomes, incorporating new voting polls into the current prediction and avoiding outliers. The author introduces Bayes’ theorem as a useful tool for evaluating probabilities and goes on to demonstrate its many applications.

The success of this book lies in looking at the application of statistics and forecasting to a multitude of fields without getting swept away by the success of some methods. In fact, the author says that while he set out to write a book about nerds conquering the



world, in the vein of Freakonomics, he found many predictions to be wanting. Often this is a function of our increasing reliance on Big Data, whereby models are over-fitted to existing information. The author goes on to look at the Global Financial Crisis and its likelihood of occurring, dynamic systems including the weather, a rare success story of better predictions over time, and earthquakes, which have so far evaded our predictive abilities. Sports like basketball and games like poker are presented as excellent opportunities for statistical analysis, given their predetermined outcomes, while the last chapters of the book conclude by looking at predictions surrounding terrorism and financial bubbles.

Many of Silver’s commentaries are insightful and fascinating, especially when he looks at the way terrorist attacks and earthquakes can be modelled on a logarithmically predictable scale in terms of their devastating potential. Some parts, including the long stretches about baseball and the detailed description of the GFC, are less riveting for those who are not fans of the American ball game or for anyone who has read an account of the GFC in the four years since it happened.

The Signal and the Noise does not maintain the pace of something like Freakonomics; it is more academic, although still easy to read. Those who are interested in finding out about statistical applications will find the book especially useful. For others, the book is recommended to anyone wishing to find the signal in an increasingly noisy world.

Crisis in the Eurozone

Short Term Solutions for Long Term Problems

by Samantha Wockner

The European Union's economic crisis began in earnest in 2010, and has continued on since that date. How are European political leaders and economic policy makers responding to this crisis? Are there responses effective, or ineffective? Samantha Wockner examines the issues.

In 2008, the global financial crisis had sent a shock-wave around the globe. In Europe, this crisis placed immense strain on the Euro, which was already faced with a number of ongoing structural issues. In response, European political leaders pursued a set of hawkish economic policies in an attempt to stop the Eurozone debt crisis from worsening. However, recession could not be avoided, and today a number of countries in the EU are dealing with high unemployment and political unrest. It is argued that this situation is unlikely to improve in the near future, and that evidence suggests that the policy decisions of the European Central Bank (ECB) will lead to at least ten more years of slow growth (Baimbridge, Burkitt and Whyman 2012: 96).

This essay aims to assess whether the European political leaders are pursuing the right policies amidst the euro crisis. European political leaders will be referred broadly as both political leaders of individual states along with members of the ECB who work conterminously to implement economic policy across all EU nations. The 'right' policies refer to policies that address both the short-term issues and long-term structural imbalances. Firstly, this essay will begin by outlining how the European crisis occurred. Then, it will analyse the major policies the EU enacted in response to the crisis, broadly encompassing austerity, the ECB's monetary policy regime, and unconventional actions like financing facilities run by the ECB. These policies will be critically analysed based on their ability to address the short and long term issues faced by Europe. This paper will argue that while the policies enacted may have resolved short-term issues such as the immediate threat of countries leaving the Euro and instabilities in government bond markets, they have not begun to address the long term structural issues to ensure a prosperous Eurozone and prevent a similar

situation occurring in the future.

The Euro Crisis: A Brief History

In 1999 following the Maastricht treaty, Europe introduced the Euro. It was celebrated because the introduction of a single currency would lower barriers to trade, lead to more open borders, increase mobility of labour and achieve a greater, unified Europe (Krugman 2011b). However, a single currency also came with risk. Joining the Euro meant countries were giving up their own currency and economic flexibility (Lane 2012: 49). For countries with vastly different economies, monetary union without fiscal union created vast structural imbalances that, as will be shown, had devastating and long-term effects on their economies. These structural imbalances were masked prior to 2008 by housing bubbles, boom times, and vast borrowing on the part of the peripheral nations. Furthermore, when the Euro was introduced, investors believed that Spanish and Greek debt was as secure as German debt. Additionally, interest rates on government bonds in countries such as France, Italy and Spain had been decreasing in the years leading up to the Euro and were approximately 3.25 % as the new currency was implemented (Baimbridge, Burkitt and Whyman 2012: 97). This led to a boom in deficit financing, especially for the European periphery countries. However, after the global financial crisis, it became clear that the level of government spending (especially in Greece, Italy, and Ireland) was unsustainable, and that those governments might default. This caused panic in investors, causing the interest rate at which these countries borrowed to increase, which in turn made borrowing more expensive, and thus even more unsustainable, and the crisis began to worsen in a cyclical pattern. The Eurozone thus became increasingly unstable and had

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to act quickly in order to recover.

In a dynamic market, economies are subject to boom times and times of decline. It is the role of the state to ensure a robust set of mechanisms to ensure efficient policies to adjust to both internal and external issues. Normally, a country that faces such a crisis will devalue their currency in international markets and engage in monetary easing, boosting their domestic economy, and making their exports cheaper for other countries to purchase. They continue this process until the problems causing the crisis abate, or until increased inflation helps them pay down their national debt. However, this is only possible if a country has its own currency. States apart of the European Monetary Union (EMU) effectively forfeited their ability to control monetary policies. This includes the inability for a sovereign state to devalue their currency. As a result, states were unable to address their increasing economic instability through monetary policy.

The inability for countries to individually control their economy threatened the stability of the Eurozone. In the fall of 2011, the Debt to GDP ratio of a number of states was dangerously large and increasing, indicating that a number of states were in danger of default (Feldstein 2012: 107). Countries were unable to write down or default on debt, partly because domestic European banks financed much of the debt and a default would leave them deeply exposed. For countries such as Greece it appeared as though they would have to leave the Euro. However, the consequence of this for Greece and other European countries would have been greatly damaging. For Greece, escaping the Euro would have been tricky because all the debts that their private citizens, corporations and banks owe were denominated in Euros. While switching all assets and wages to being denominated in the old currency would allow them devalue, such a move would cause nominal debt loads (denominated in Euros) to increase dramatically, critically destabilising an already weak financial sector. Overall, a return to the Drachma would probably cause systemic bank runs, national default, and full-blown depression (Lynn 2010: 329). Germany also looked unfavourably on Greece

leaving the Euro as it could possibly lead to the breakdown of the monetary union (Feldstein: 2012: 114). This would mean the elimination of the monetary regime status quo, generally favourable to the German economy. Therefore, it was not a policy option to allow states such as Greece to leave the Euro. Members of the EMU then aimed to implement policies to prevent a number of states leaving the Euro as a way to ensure stability in the region.

As discussed above, in the EMU countries no longer had the ability to control the macroeconomic tools of exchange rates and monetary policy. The Eurozone's Central Bank (ECB) is in charge of employing a common monetary policy, with a primary mandate of price stability, and the stability of the Euro as a whole (Engwerda, Aarle and Plasmans 2002: 451). The former German Central Bank (the Bundesbank) has heavily influenced this mandate, along with a taboo on purchasing bonds from member governments and an aversion for monetary aid for countries that became insolvent (De Grauwe 2013:156). With these policy constraints, the EU was faced with the major task of stabilising the Euro and ensuring that debt levels of periphery nations decreased. Their response was to implement two major policies. These were fiscal bailouts followed by putting pressure on governments to cut spending and unconventional acts from the ECB such as the European Stability Mechanism (ESM). The goal of these policies was to help governments by providing short-term stabilisation in the hope of market recovery.

Policy Action

In the wake of the global financial crisis, fears grew about the stability of the EMU. The crisis began to spread to other countries and there were growing concerns about the debt in other 'PIIGS' countries (Portugal, Italy, Ireland and Spain). These countries had failed to meet the rules of the Maastricht criteria that required government debt to not exceed 60 per cent of the overall budget and not surpass three per cent of GDP (Kitromilides 2011: 519). The resulting market pressure compounded fears that the euro would become destabilised. As a response,

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the EU and IMF made emergency funds available through the European Stability Financial System (ESFS) to countries such as Greece, Portugal and Ireland so they were able to pay back their loans and avoid default. As a condition the IMF, EU and the ECB pressured governments into draconian restructuring policies. In other words, the policy was a combination of delivering funds to struggling countries for short term finance in exchange for them implementing harsh austerity measures to reduce public deficits (Arestis and Sawyer 2011: 10). Despite these actions, interest rates remained high, reflecting the belief that the situation would worsen and large countries such as Italy and Spain would default (Baimbridge, Burkitt and Whyman 2012: 100). To counter this the ECB combined the ESFS with another financial mechanism (the EFSM) into the European Stability Mechanism, (the ESM). This body guaranteed that if governments had significant problem financing their deficits they would be financed via outright monetary transactions (OMT), as a precautionary program to make sure the crisis would not worsen further (ECB 2012; ESM 2013; Hodson 2011: 58-61). The aim of the policy was to stabilise interest rates on governments bonds and stabilise financial markets. In effect, this guarantee drastically lowered the risk of a nation being forced to leave the Euro because of sovereign default.

The Right Policies?

As discussed, the EU policy was to ensure stability through maintaining the survival of the Euro. If these measures were the overall goal of the EU then there can be little argument against their success. For now, no country has left the Euro. Furthermore, borrowing costs for governments have gone back down to acceptable levels. However, while these policies have addressed the EU's short term goals, they have failed to address the ongoing structural issues and imbalances that caused the crisis in the first place. This essay will now look at the policies of austerity and the ECB's monetary policy regime and identify the long term structural issues it perpetuates.

The implementation of austerity measures stemmed

from the belief that there was too much spending by the debtor nations and that in order to fix the issue, guilty nations had to undertake strict austerity measures (Krugman 2011a). While certainly the peripheral nations are somewhat responsible for their current state, the structural issues inherent to the Euro, and the ECB's monetary policy, make it extremely hard to run an effective government with fiscal restraint. Austerity measure in the EU have created an asymmetrical imbalance where northern European countries had retained a deficit while maintaining an increasing GDP while PIIGS states had seen a decline in GDP as a direct result of hard government cuts (Baimbridge, Burkitt and Whyman 2012: 100; Milios and Sotiropoulos 2010: 237). A Keynesian view of a nation's economy holds that during times of recession, the government must step in by increasing spending, to counteract the fall in private spending and return the economy to strength. This is called "counter cyclical fiscal policy" (Tanzi 2005: 60). In the Keynesian view, austerity in the form of large cuts to government spending during recessions will worsen the cycle, compounding the recessionary effect. As a result, these short term measures have done little to address the ongoing issue of large deficits (Arestis and Sawyer 2011: 10). In the Greek example, the debt to GDP ratio has increased but the ongoing recession has decreased GDP faster than the debt load could be decreased. Therefore, austerity measures are ineffective in stabilising states and placing them on the road to recovery. In fact, austerity is making things worse.

Furthermore, the story of a crisis caused solely by fiscal profligacy is not borne out by the facts. The premise of prescribing austerity to any EMU nation that sees its borrowing costs increase is that such a country must have been spending excessively, or had rapidly increasing deficits that were unsustainable. This is not the case for Italy, which actually had its budget deficit decrease from 2006 to 2008 from 4.3% to 1.5%, well inside the level required by EU policymakers (Trading Economics 2012). Despite Italy's fiscal responsibility in the years leading up to the crisis, they still experienced spiralling borrowing costs and recession. This has led some

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commentators, like Krugman, to hypothesize that in some cases rapidly rising rates reflected investor concerns that governments in the Eurozone could become insolvent during deep recession, and would not be financed by their central bank, like a country with an independent currency would be. This is in contrast to the story told by EU policymakers, that investors were effectively punishing countries for borrowing too much. Notably, Italian bond yields are approaching their lowest levels since 1999, reflecting that concern in the market has passed (Krugman 2013). The fact that interest rates spiralled both in countries that borrowed excessively (like Greece) and that were relatively responsible (like Italy) supports a more nuanced argument than that made by EU policymakers, and suggests a different prescription to blanket austerity would be appropriate. Even at its best, austerity provides only a short-term solution, as even though it may keep countries in the Euro (when paired with strategic bailouts and financing), the recessions that result from savagely cutting spending without the central bank doing anything to offset it are deep.

The ECB sets monetary policy so that inflation is low and stable in the Eurozone. While this target is 2%, the ECB has consistently undershot this target, implying that monetary policy has been too tight (Randow and Black 2012). Prior to the crisis, the price level (including wages) in the peripheral nations increased faster than in Germany and France, making the peripheral nation economies uncompetitive within the Eurozone and internationally. Under the previous European regime of different currencies, this structural imbalance would be addressed by the peripheral nations devaluing their currencies. When all nations are on the same currency, this structural imbalance can only be fixed via “internal devaluation” - relative price levels adjusting across regions within the single currency zone (Krugman 2011b). It would be possible to achieve this by allowing temporarily higher inflation in Germany and France and lower inflation in the peripheral countries. However, with the ECB maintaining very low inflation Eurozone wide, and therefore low inflation in Germany and France, this structural imbalance is manifesting as deflation in the peripheral nations,

worsening their recessions (Krugman 2011c; Laski and Podkaminer 2012: 256). Therefore, while the ECB may have postponed the short term crisis with its emergency stability mechanisms to fund deficits, its monetary policy is forcing destructive deflation as the only avenue for internal devaluation in the peripheral nations.

Overall this aggressive strategy of targeting inflation in favour of Germany means that the ECB policy does not accommodate for non-German EMU members. This is a symptom of a policy mismatch, whereby even if Eurozone countries were able to address the ongoing debt crisis, ongoing structural issues would persist. Specifically the stark differences in competitiveness would result in trade imbalances that would not to be compensated by fiscal transfers. The structural issue of mismatched countries on the same currency without fiscal transfers to compensate has not been adequately addressed. This highlights the fact that a ‘one size fits all’ policy fails to help periphery countries enact efficient reforms.

It appears that, for now, states such as Greece will remain in the Euro and borrowing costs for states has gone back down to acceptable levels. However, none of the underlying problems have been addressed. These policies are deflationary forces that further contribute to the long-term problems. Rapid austerity in places like Greece has caused such deep recessions that GDP has gone down more than the deficit levels have decreased, resulting in the debt to GDP ratio actually worsening. This is creating huge pressure in the Eurozone, between countries that would never allow such deep recession if they were in full control of their own economies, and the Euro political leaders who want to force Europe to come together. Furthermore, these policies are making richer nations better off, poorer nations worse off, and while they stop the crisis in the short run, they cannot ensure a strong European Union in the long run (Lucarelli 2012: 33).

As discussed the current policies have failed to address the long term structural issues that plague the EU. In addition to this, the structural constraint

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has created tension inside EU nations, which has echoed through to the political tension between EU states. Domestically, countries such as Greece and Ireland are becoming increasingly unable to be responsive to their citizens. In democratic capitalism, states are influenced and thusly pressured by capital owners, workers, citizens and the like through income claims (Streeck 2012). Greece has experience a number of riots and protests in regards to large public cuts and the rising unemployment (Featherstone 2011: 206; Kouvelakis 2011). Ideally, Greece would adopt policies in order ease these tensions to ensure political longevity. However, in order to correct its 'bad' behaviour, it is at the mercy of strict and aggressive austerity. What further worsens this structural imbalance is the lack of labour mobility, normally found in a currency union, driven by cultural and language barriers. Citizens are then unable to escape the crisis and essential have "to tough it out" by enduring high unemployment, lower wages and high taxes (Krugman 2011b). Overtime, these citizens will feel a growing contempt for domestic leaders as well as other EU member states for standing idly by while they face long term economic hardship.

As discussed, current policies have created political pressure domestically, especially for countries that have been forced to accept strict austerity. In addition to this the measure in which the EU has taken to ensure monetary unity has worked to created a political disunion internationally (Farrell and Quiggin 2011: 99). Voters in nations such as Germany feel contempt for supporting, in their view, undisciplined EU members. While struggling countries who are feeling the effects of austerity resent the EU for not doing more (Baimbridge, Burkitt and Whyman 2012: 102). An example of this is when in April, Greece asked Germany to pay its reparations for war damages from World War Two (Stamouli and Pangalos 2013). As a result, the current policy is creating disunion between EU member states, which highlightes the alarming fact that for a currency alleged to bring states closer together economically and politically, the Euro is in fact pulling them apart; the very thing the EU is trying to avoid.

In conclusion, political leaders of the European Union have not pursued the right policies in response to the Euro crisis. In the lead up to the crisis, all EMU nations accepted the same monetary policy by design, which led to vast structural pressures. Before 2008 these pressures were papered over by government borrowing and asset bubbles, but in the wake of the crisis the weakness of the monetary union was laid bare. EU policymakers responded to rolling debt crises with austerity, tight money from the ECB, and intermittent unconventional policy actions like financing guarantees. However, these policies have only acted as a band-aid on the deep structural imbalances besetting the Eurozone. In some cases, the program of austerity has worsened recessions so much as to actually increase the level of indebtedness. Furthermore, with the ECB maintaining low inflation Eurozone wide, the inevitable restructuring of competitiveness has manifest as deflation in the peripheral nations, worsening their recessions. This in turn has had profound negative impact on social factors, leading to depression-era levels of unemployment and tension between nations. The nation states within the monetary union are unable to act on these issues due to the limited ability of states to respond through fiscal and independent monetary policy. Overall, while EU policymakers may have decreased the risk of imminent break up, they have no plan for, and may have actually exacerbated, the long-term issues and structural pressures that were the ultimate genesis of the crisis.

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