Core-Periphery in the Eurozone

Paul De Grauwe
London School of Economics

Conference “The future of central banking”, in honour of Vitor Constancio”, Frankfurt, 16-17 May, 2018

Presentation based on joint paper with Yuemei Ji

Source: Eurostat
Is there an original sin?

• In 1990s: exchange risk (devaluation risk) determined the spreads
• In Eurozone during sovereign debt crisis: liquidity and default risks of sovereigns determined the spreads in government bond markets
• Is the devaluation risk of the 1990s a good predictor of the sovereign debt risks during the Eurozone crisis of 2008-12?
• More provocatively: did the sovereigns that got into trouble during the sovereign debt crisis carry an “original sin”? 
Foreign exchange crises of 1990s good predictors of sovereign debt crises of 2019-12

Figure 2: Bond spreads 1991-99 and 2010-12 (percent)

\[ y = 1.3831x + 0.3733 \]

\[ R^2 = 0.82235 \]
• Spreads of the 1990s are good predictors of spreads during 2008-12.
  o Countries that got into trouble during the foreign exchange crisis in the 1990s are broadly the same as those that got into trouble during sovereign debt crisis.
  o And the intensity of the foreign exchange crises is highly correlated with the intensity of the subsequent sovereign debt crisis.
• This is quite remarkable because it took about 10 years for this correlation to appear. Everybody seems to have been sleeping
• Thus periphery countries seem to carry burden of original sin
• Are there exceptions?
• Yes: Ireland and Finland
  o Ireland: No original sin, yet got involved in sovereign debt crisis (role of doom loop with banks)
  o Finland: escaped from original sin
• Does original sin continue to do its work after 2012?
Effect of original sin also after 2012

Figure 3: Bond spreads 1991-99 and 2017

\[ y = 0.7224x + 0.0741 \]

\[ R^2 = 0.91319 \]
The nature of the original sin: the German School

- Weak political and legal institutions make it difficult to maintain fiscal discipline.
- That leads to macroeconomic and monetary instability.
- When countries with weak institutions peg their exchange rates, this leads to frequent speculative crises followed by devaluations.
- When these countries join a monetary union without strengthening their political institutions, the pressure will be mainly on the government finance.
- Ultimately, this will lead to a sovereign debt crisis.
- In this view; the crises have the same source: weak governance.
• Very influential analysis
• But is it convincing?
• If so, one should observe that public debt accumulation prior to the crisis is a good predictor of the subsequent sovereign debt crisis.
• We do not find this
Figure 4: Government bond yields (2012) and increase governent debt (1999-2007)

$y = 0.095x + 7.4836$

$R^2 = 0.09359$
Private debt accumulation prior to crisis much better predictor of subsequent sovereign debt crisis

**Figure 5: Government bond yields (2012) and increase private debt (1999-2007)**

\[
y = 0.1495x + 0.0785 \\
R^2 = 0.67535
\]
• With the possible exception of Greece and Portugal, the “low-discipline-original-sin” may explain the foreign exchange crises of the 1990s
• but fails to explain the sovereign debt crises that emerged in 2010.
• The latter may have little to do with an original sin condemning periphery countries to be hit by a sovereign debt crisis
• My interpretation:
• Sovereign debt crisis outcome of classical boom-bust dynamics of capitalism (Kindleberger, Minsky)
• Boom: euphoria, debt accumulation, bubbles
• Bust: crash, deleveraging, recession or depression
• Governments step in to save the system by increasing their own debt
• Sovereign debt crisis mostly result of responsible behaviour of governments faced with the collateral damage created by booms and bust
• This boom-bust dynamics creates special problems in monetary union
• A note of warning is in place here.
• The preceding does not mean that some countries of the periphery may not have deep-seated governance problems. They have.
• It means that these governance problems are not good predictors of the sovereign debt crises that erupted in 2010.
Booms and busts in the Eurozone

• These were strongly synchronized in Eurozone
• Asymmetry was in the amplitude of the booms and busts
  o Some countries (Ireland, Greece, Spain) experiencing wild swings
  o While others (Germany, France, Netherlands, Belgium) experiencing mild swings
Business cycle component of GDP
Table 3. Slope of regression domestic cycle on euro-cycle

<table>
<thead>
<tr>
<th></th>
<th>slope</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>0.21</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.48</td>
</tr>
<tr>
<td>Austria</td>
<td>0.49</td>
</tr>
<tr>
<td>France</td>
<td>0.55</td>
</tr>
<tr>
<td>Italy</td>
<td>0.77</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.80</td>
</tr>
<tr>
<td>Portugal</td>
<td>1.02</td>
</tr>
<tr>
<td>Finland</td>
<td>1.21</td>
</tr>
<tr>
<td>Spain</td>
<td>1.22</td>
</tr>
<tr>
<td>Ireland</td>
<td>2.07</td>
</tr>
<tr>
<td>Greece</td>
<td>2.18</td>
</tr>
</tbody>
</table>

Source: Own calculations.
• Monetary union had great difficulties in dealing with the asymmetric occurrence of these boom-bust scenarios, for two reasons.
  o Build-up of large divergences in competitive positions and external imbalances during boom phase
  o Instability in government bond markets during downswing
Diverging trends in competitiveness
• Adjustment through internal devaluation very painful
• Asymmetry in adjustment puts all the costs of the adjustment onto the deficit countries
• All this leads to political upheaval
• And dynamics of rejection
• That’s when second problem, instability of government bond markets in monetary union, steps in
Fragility of government bond market in monetary union

• Governments of member states cannot guarantee to bond holders that cash would always be there to pay them out at maturity
• Because they issue debt in a currency they have no control over
• And are not backed by central bank to provide liquidity in times of crises
• Contrast with stand-alone countries that give this implicit guarantee
Self-fulfilling crises

- This lack of guarantee can trigger liquidity crises
  - During recession, budget deficits increase automatically
  - Distrust leads to bond sales
  - Interest rate increases
  - Liquidity is withdrawn from national markets
  - Government unable to rollover debt
  - Is forced to introduce immediate and intense austerity
  - Intensifying recession and Debt/GDP ratio increases
Countries with largest booms and busts are singled out by financial markets
and pushed into bad equilibrium
Massive capital flows within the monetary union
Capital withdrawn from boom-bust countries channeled to “safe haven” countries
Intensifying asymmetry and conflict in the union
This problem is likely to reappear with each recession, as these recessions will vary in amplitude
And reinforced by doom-loop between sovereigns and banks
There is no original sin

- Why did we find high correlation between the foreign exchange crises of the 1990s and sovereign debt crises of 2010-12?
  - Countries that experienced foreign exchange crises in the 1990s were countries with a history of high and variable domestic inflations.
  - Result: High real interest rates, that incorporated a high risk premium.
  - When these countries were selected to enter Eurozone, real interest rates started process of steep declines.
  - Such a decline did not occur in the countries with low inflation.
• Thus, at the start of the Eurozone a major asymmetric shock occurred:
  o Countries of the periphery (high inflation countries) were hit by a large decline in real interest rates.
  o Which boosted their economies.
  o In some of these countries this created an unsustainable boom,
  o leading to a crash with all the consequences discussed earlier.
• This shock did not occur in the core countries.
• Thus, correlation we observed in Figure 2 and 3 is to a large extent a spurious one.

• Missing variable is: asymmetric shock in the real interest rate
  o It pushed the periphery countries into an extreme boom-bust dynamics and
  o forced the governments of these countries to increase their debts so as to save the market system in these countries.

• There is no need to invoke some dark force coming from weak governance

• that condemned these countries onto a path of sovereign default once in the monetary union.
• Again: this does not mean absence of governance problems in these countries, but these governance problems are not cause of boom-busts.
• There are no “original sins”.
• Capitalism will continue to produce booms and busts and the impact of these booms and busts will continue to be different.
• We do not know which country will be on the right side of the fence in the next boom-bust phase.
• It could very well be some core countries that turn out to become periphery countries.
• Previous discussion makes clear how unprepared the Eurozone was, and still is, to deal with boom-bust scenarios with different amplitudes.

• How should the Eurozone be redesigned to ensure it is better able to withstand such a dynamics?
How to redesign the Eurozone?

• We identified two problems of the Eurozone.
  o The first one: it has poor instruments to deal with asymmetric shocks. We will call this the OCA-problem.
  o The second problem: the instability of the government bond markets in the Eurozone.
How to deal with OCA-problem?

• The standard response derived from OCA-theory:
  o member countries of monetary union should do structural reforms so as to make their labour and product markets more flexible.
  o By increasing flexibility the costs of adjustments to asymmetric shocks can be reduced
  o the Eurozone can become an optimal currency area.

• This has been a very influential idea
• and has led Eurozone countries into programs of structural reforms.
• The traditional OCA-analysis is based on the assumption that asymmetric shocks are typically permanent and structural in nature (a change in preferences, a supply shock).
• Most of the shocks hitting the Eurozone have been temporary and the result of a boom-bust scenario.
• They are also typically demand shocks
Implications for the governance of the Eurozone

• Efforts at stabilizing the business cycle should be strengthened relative to the efforts that have been made to impose structural reforms.
• We are not implying that structural reforms are unnecessary,
• but rather that efforts at creating mechanisms aiming at stabilizing the Eurozone business cycles should be strengthened.
Common unemployment benefits scheme

- Many proposals have been made: e.g. Four Presidents report, Enderlein, et al. (2012), Beblavy, et al.(2015), Alcidi and Thirion(2015), Benassy-Quéré, A., et al. (2018)).
- As argued earlier business cycle shocks dominate
- We need smoothing over time (stabilization)
- Common unemployment schemes should be allowed to have deficit during recession compensated by surpluses during boom
- This means issuing common bonds
- First step on the road to budgetary union
How to deal with the instability of the government bond markets?

- Liquidity crises are avoided in stand-alone countries that issue debt in their own currencies mainly because central bank will provide all the necessary liquidity to sovereign.

- This outcome can also be achieved in a monetary union if the common central bank is willing to buy the different sovereigns’ debt in times of crisis.
ECB has acted in 2012

• On September 6, ECB announced it will buy unlimited amounts of government bonds.
• Program is called “Outright Monetary Transactions” (OMT)
• Success was spectacular
Spreads of 10-year government bond rates in the Eurozone, 2008–17

- Greece
- Portugal
- Ireland
- Italy
- Spain
- Belgium
- France
- Austria
- Finland
- Netherlands
• This was the right step: the ECB saved the Eurozone
• However, the second Greek crisis of 2014-15 casts doubts about the willingness to activate OMT in future
• There is credibility issue: will the ECB use OMT in future crises?
• Answer unclear
• OMT should only be used when liquidity problems arise
• In real time difficult to distinguish liquidity from solvency problems
• There will always be political controversy when ECB activates OMT
• Making it unsure the ECB will want to use it
• No such uncertainty exists in standalone countries where sovereign prevails over central bank in times of crises.
• Additional problem: OMT is loaded with austerity measures making it unsure countries will want to use it
Towards a budgetary and political union

- the lack of credibility of the ECB as lender of last resort in the government bond market can be solved
- by creating a budgetary union
- that includes the consolidation of a significant part of the national debts into one Eurozone debt.
• How? Issuance of Eurobonds that are backed by a joint liability of the issuing governments.
  o Such a consolidation mimics relation between central bank and government that exists in standalone countries.
  o It makes the credibility of liquidity support of the sovereign watertight
  o and eliminates the danger of destabilizing capital flows within the union.
  o such a consolidation can only occur if it is embedded in a political union,
  o characterized by a central government that has the democratic power to tax and to spend.
• These are very intrusive, if not revolutionary transformations of the Eurozone,
• There is little appetite today in official circles.
• These have now taken for granted that a further significant budgetary union together with a political union is out of reach for the foreseeable future (which undoubtedly is true).
• As a result, they tend to embrace technical solutions (e.g. “safe asset”) that promises to solve the problem while avoiding the need to create a budgetary and political union.
Conclusion

- Long run success of the Eurozone depends on continuing process of political unification.
- Political unification is needed because Eurozone has dramatically weakened
  - the power and legitimacy of nation states
  - without creating a nation at the European level.
- This is particularly true in the field of stabilization
Conclusion: Integration fatigue

• Budgetary union (and thus political union) is needed but is far away
• Willingness today to move in the direction of a budgetary and political union in Europe is non-existent.
• This will continue to make the Eurozone a fragile institution
• Its long-term success cannot be guaranteed