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Core-Periphery in the Eurozone

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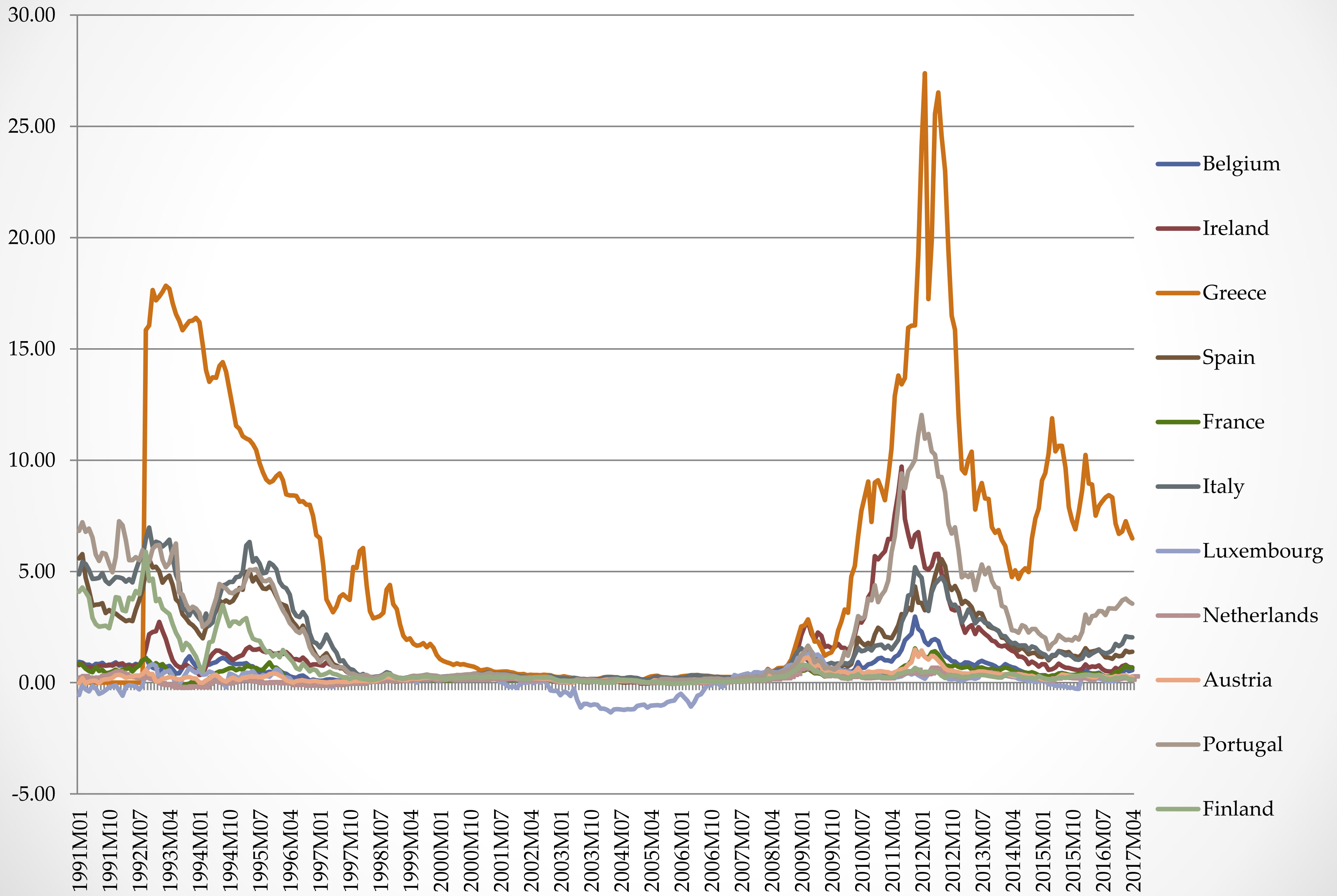
Presentation based on joint paper with Yuemei Ji

10-year Government bond spreads 1991-2017

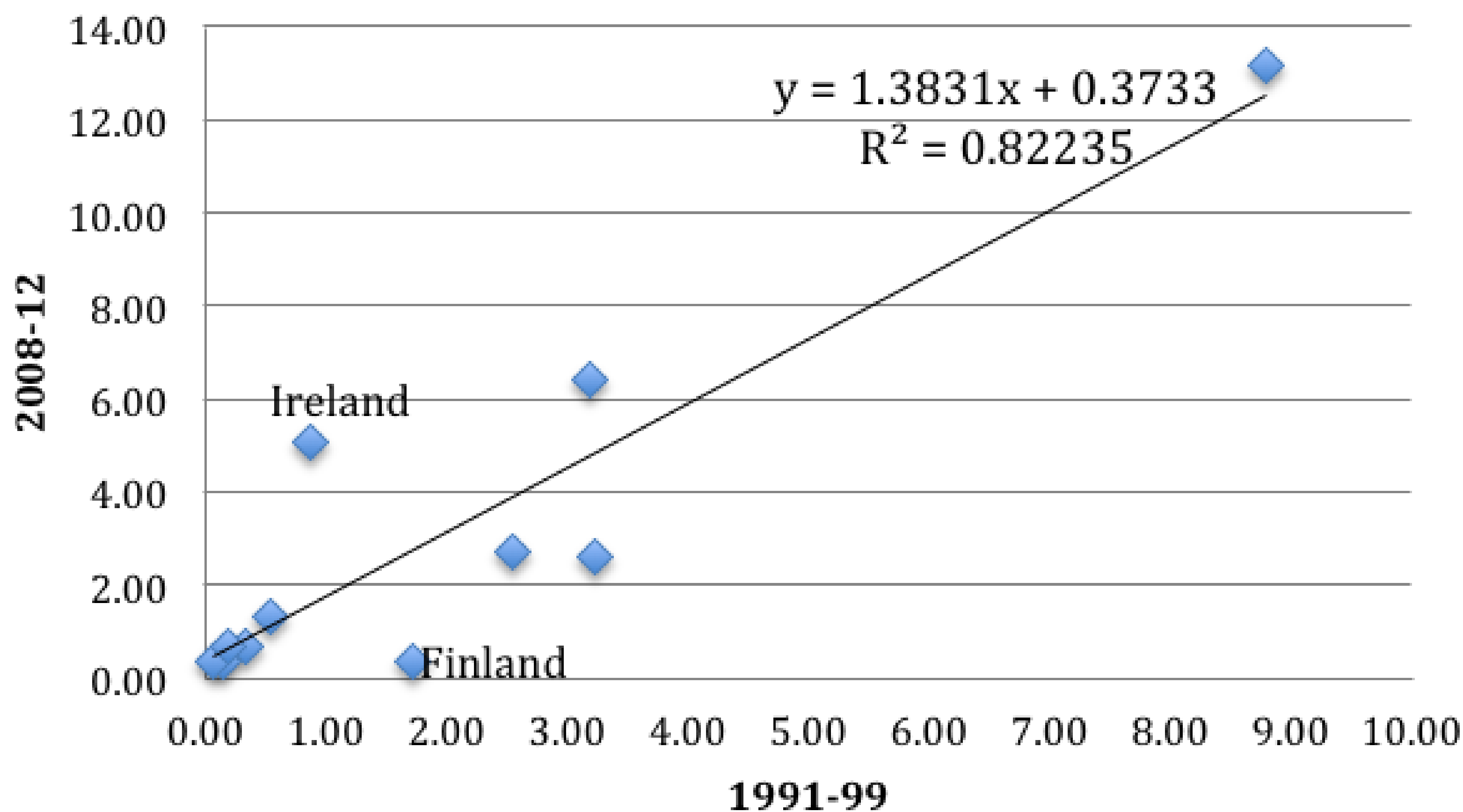


Source: Eurostat

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"?

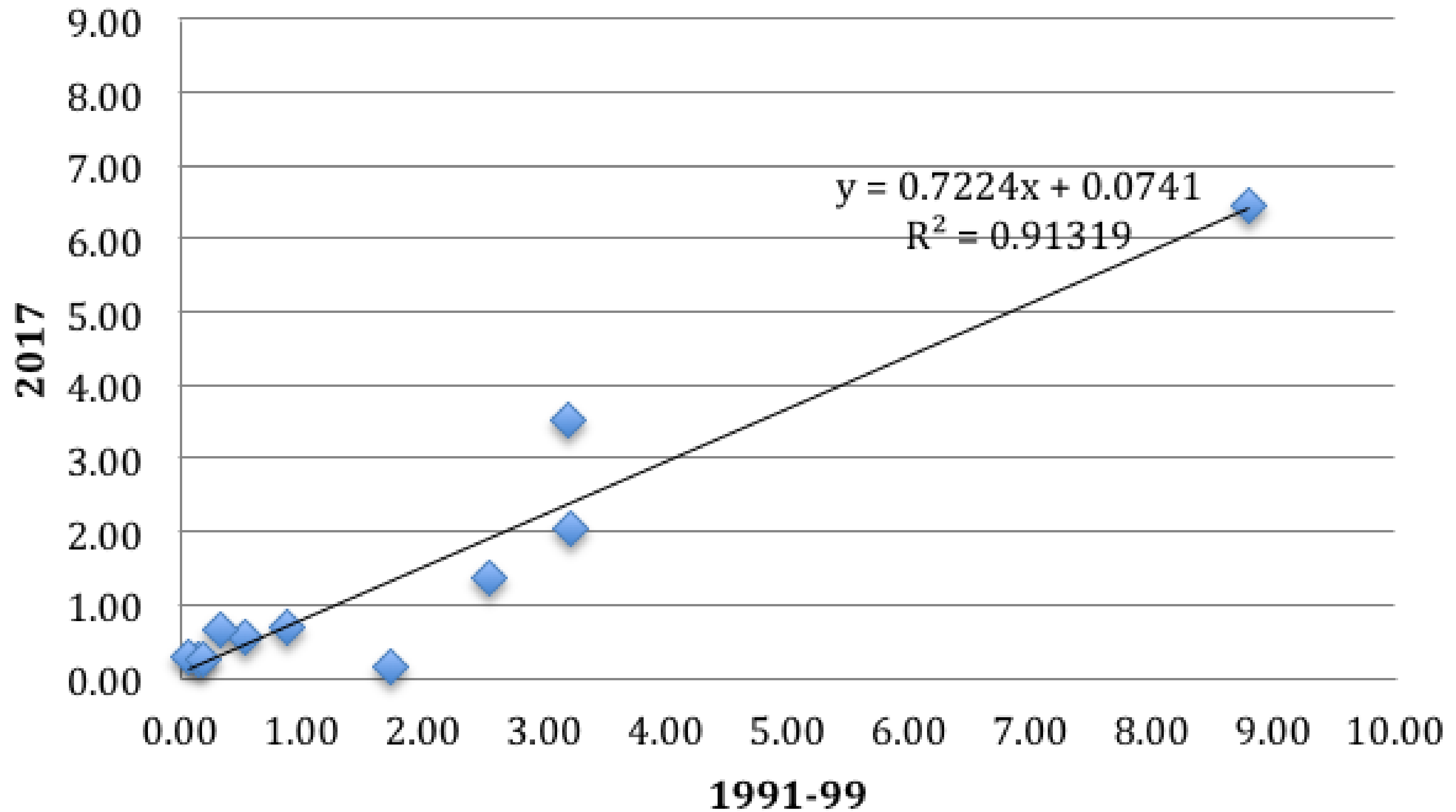
Foreign exchange crises of 1990s good predictors of sovereign debt crises of 2019-12



- Spreads of the 1990s are good predictors of spreads during 2008-12.
  - 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.
  - 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
  - Ireland: No original sin, yet got involved in sovereign debt crisis (role of doom loop with banks)
  - Finland: escaped from original sin
- Does original sin continue to do its work after 2012?

Effect of original sin also after 2012



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

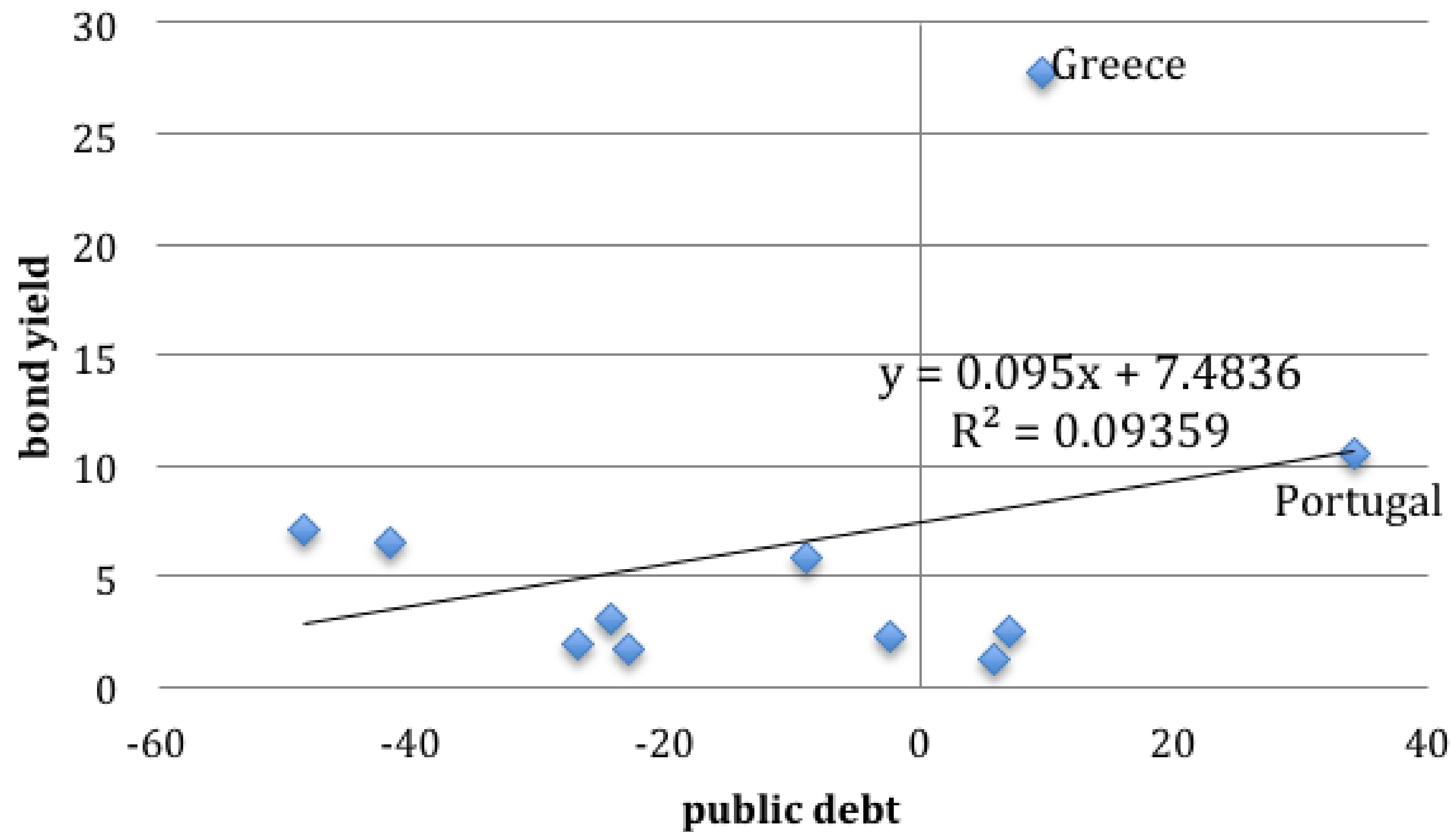
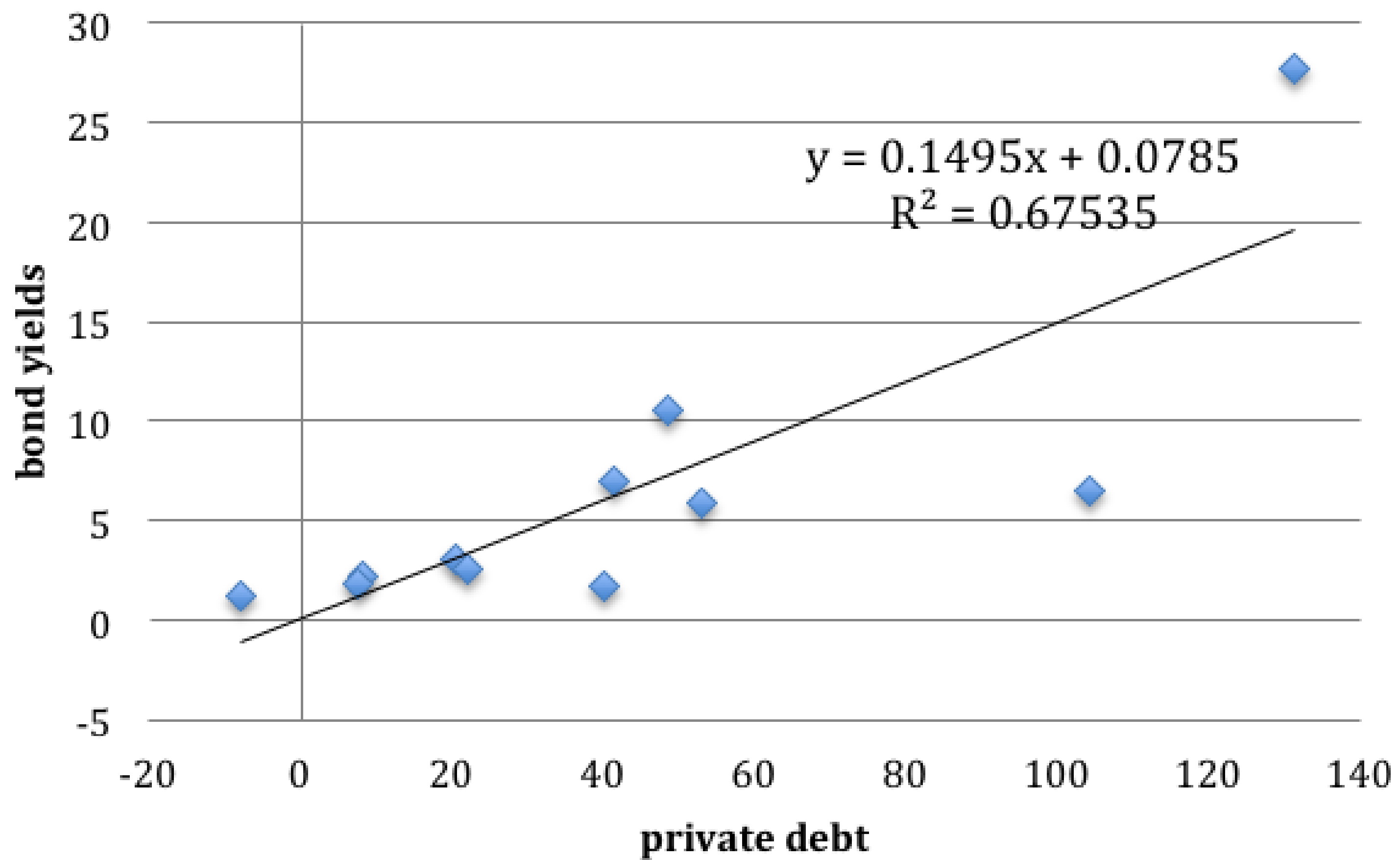


Figure 4: Government bond yields (2012) and increase government debt (1999-2007)
30
25
20
15
10
5
0
-60
-40
-20
0
20
40
bond yield
public debt
Greece
Portugal
y = 0.095x + 7.4836
R² = 0.09359

Private debt accumulation prior to crisis much better predictor of subsequent sovereign debt crisis



- 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
  - Some countries (Ireland, Greece, Spain) experiencing wild swings
  - While others (Germany, France, Netherlands, Belgium) experiencing mild swings

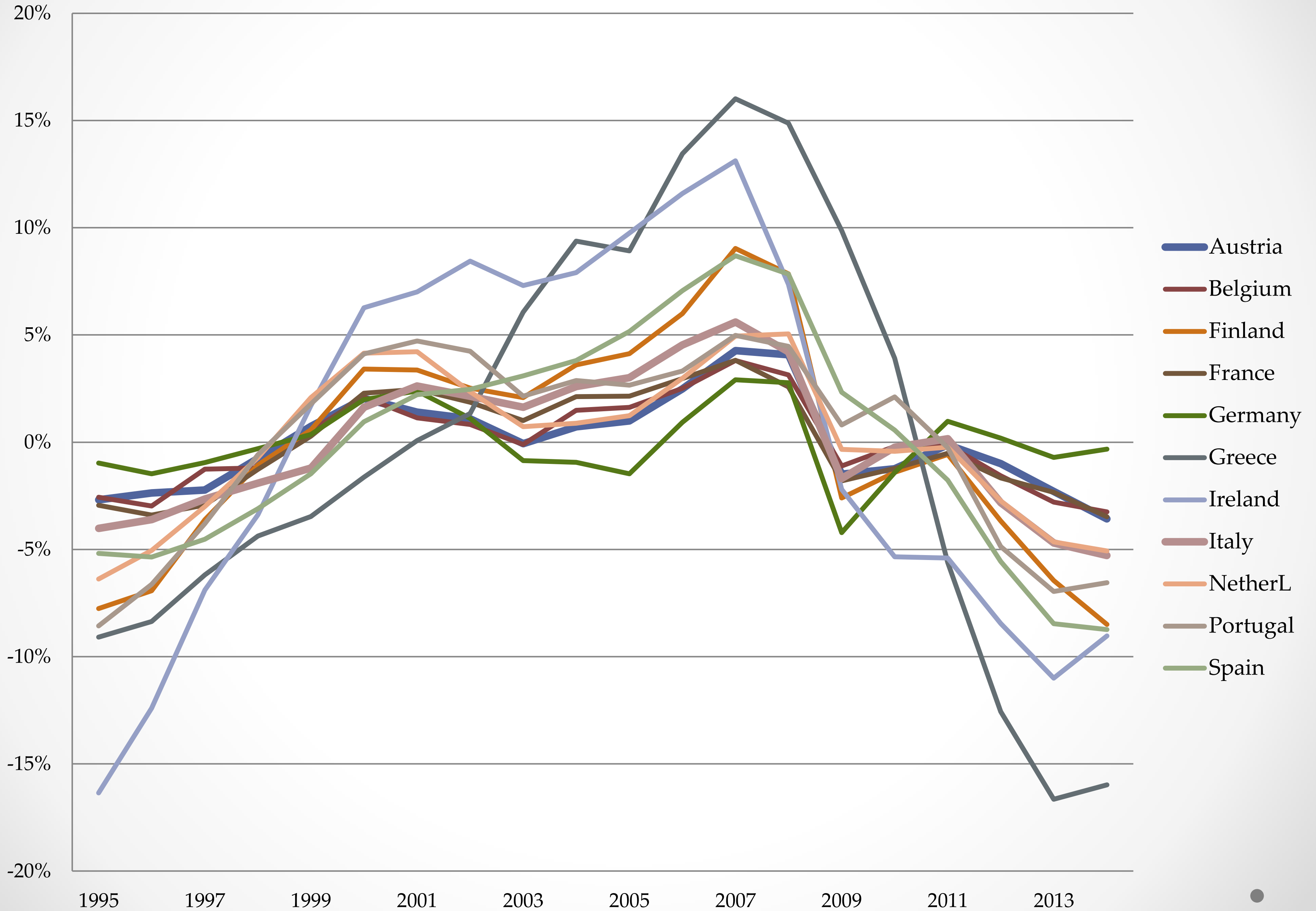

Business cycle component of GDP
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
NetherL
Portugal
Spain

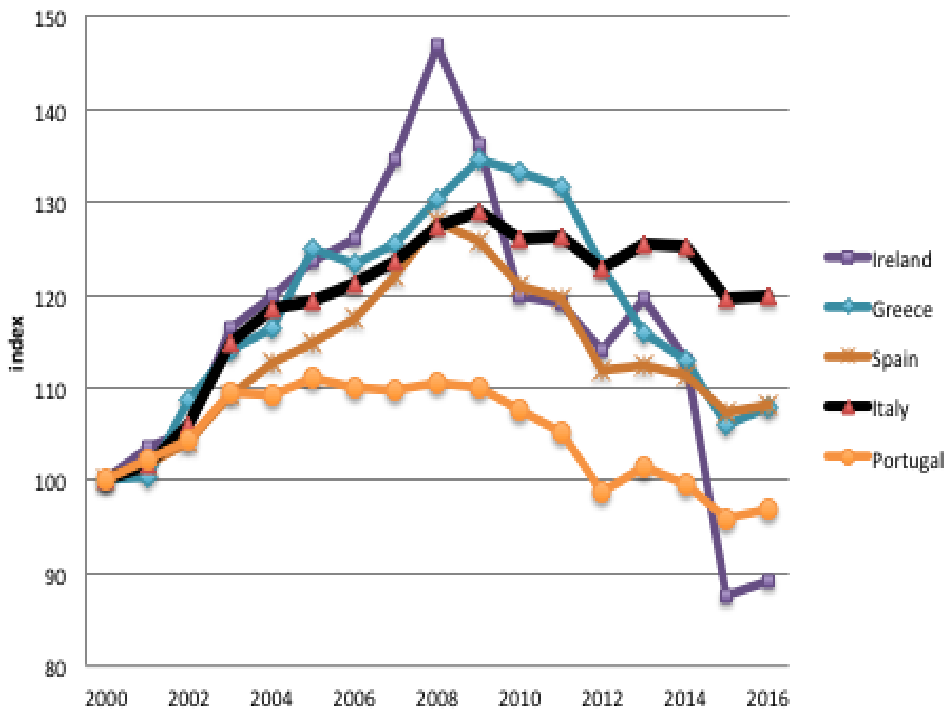
Table 3. Slope of regression domestic cycle on euro-cycle

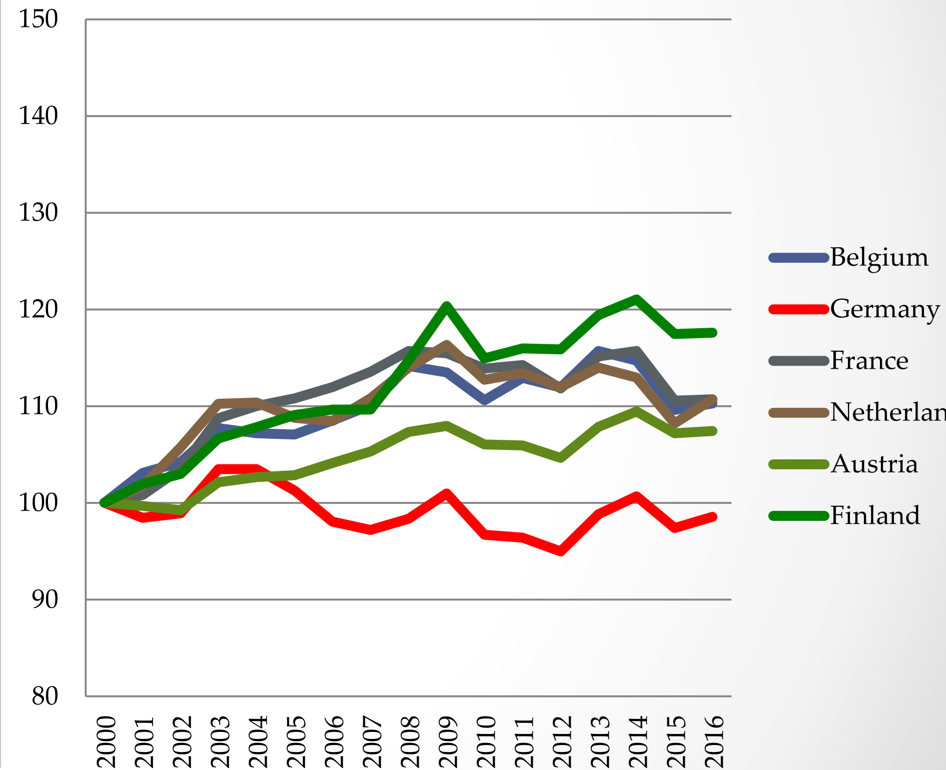
	slope
Germany	0,21
Belgium	0,48
Austria	0,49
France	0,55
Italy	0,77
Netherlands	0,80
Portugal	1,02
Finland	1,21
Spain	1,22
Ireland	2,07
Greece	2,18

Source: Own calculations.

- Monetary union had great difficulties in dealing with the asymmetric occurrence of these boom-bust scenarios, for two reasons.
  - Build-up of large divergences in competitive positions and external imbalances during boom phase
  - 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:
  - Countries of the periphery (high inflation countries) were hit by a large decline in real interest rates.
  - Which boosted their economies.
  - In some of these countries this created an unsustainable boom,
  - 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
  - It pushed the periphery countries into an extreme boom-bust dynamics and
  - 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.
  - The first one: it has poor instruments to deal with asymmetric shocks. We will call this the OCA-problem.
  - 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:
  - member countries of monetary union should do structural reforms so as to make their labour and product markets more flexible.
  - By increasing flexibility the costs of adjustments to asymmetric shocks can be reduced
  - 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

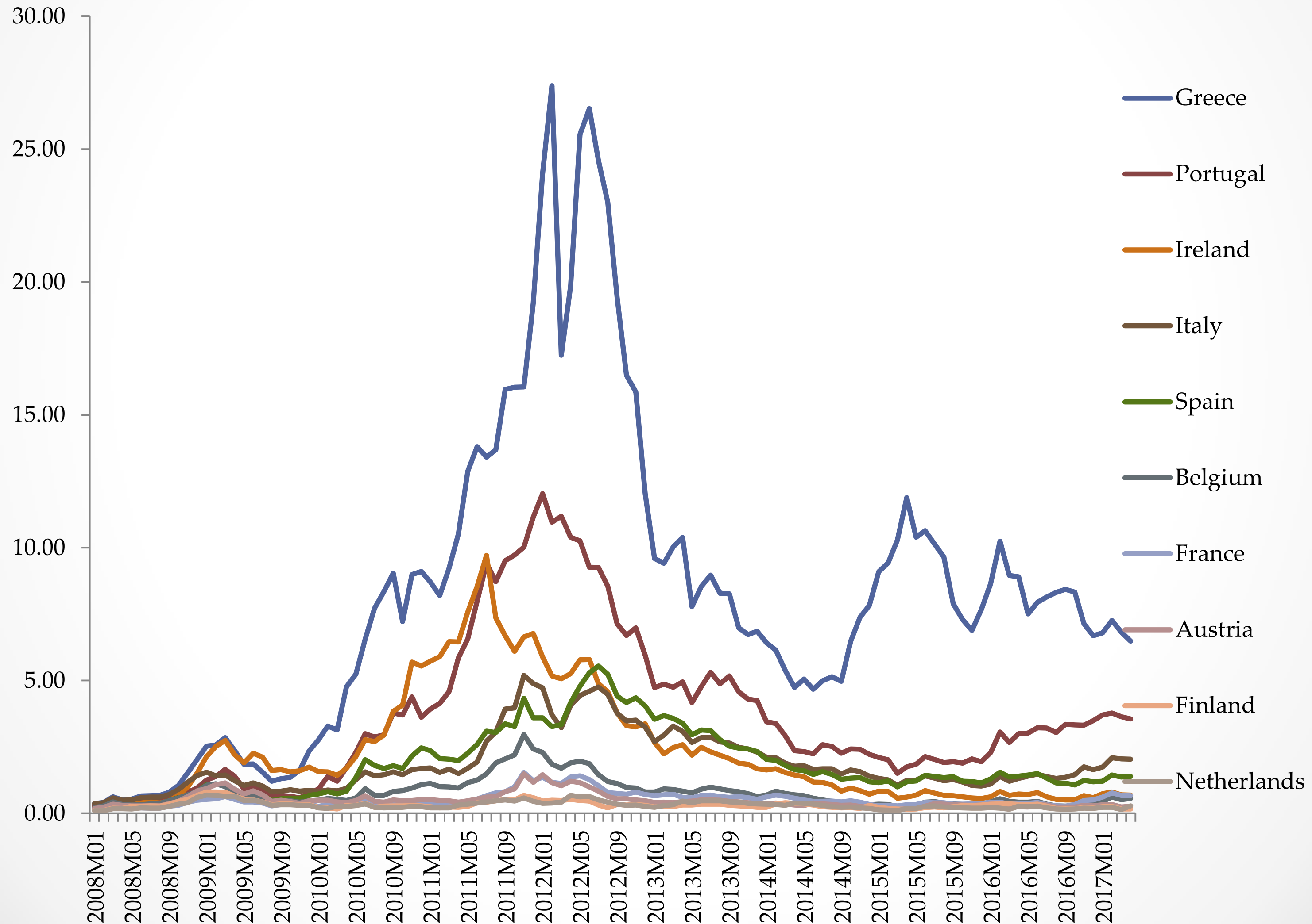
How to deal with the instability of the government bond markets?

- 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



- 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.
  - Such a consolidation mimics relation between central bank and government that exists in standalone countries.
  - It makes the credibility of liquidity support of the sovereign watertight
  - and eliminates the danger of destabilizing capital flows within the union.
  - such a consolidation can only occur if it is embedded in a political union,
  - 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