

# Stagnation in the Eurozone and the Future of the Euro

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# Outline of presentation

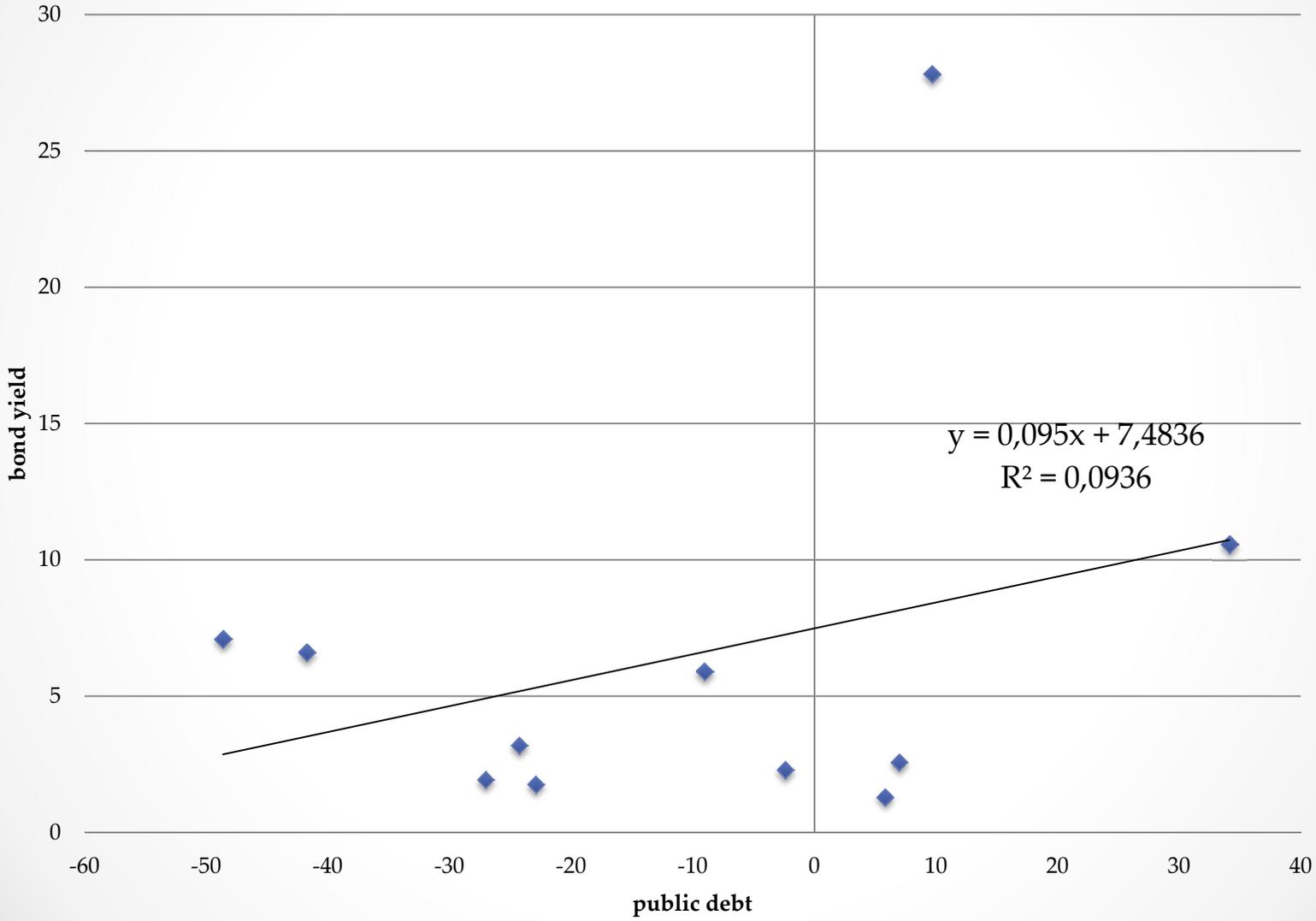
- Diagnosis of the Eurocrisis
- Design failures of Eurozone
- Redesigning the Eurozone:
  - Role of central bank
  - Macroeconomic coordination
  - What kind of budgetary and political union?



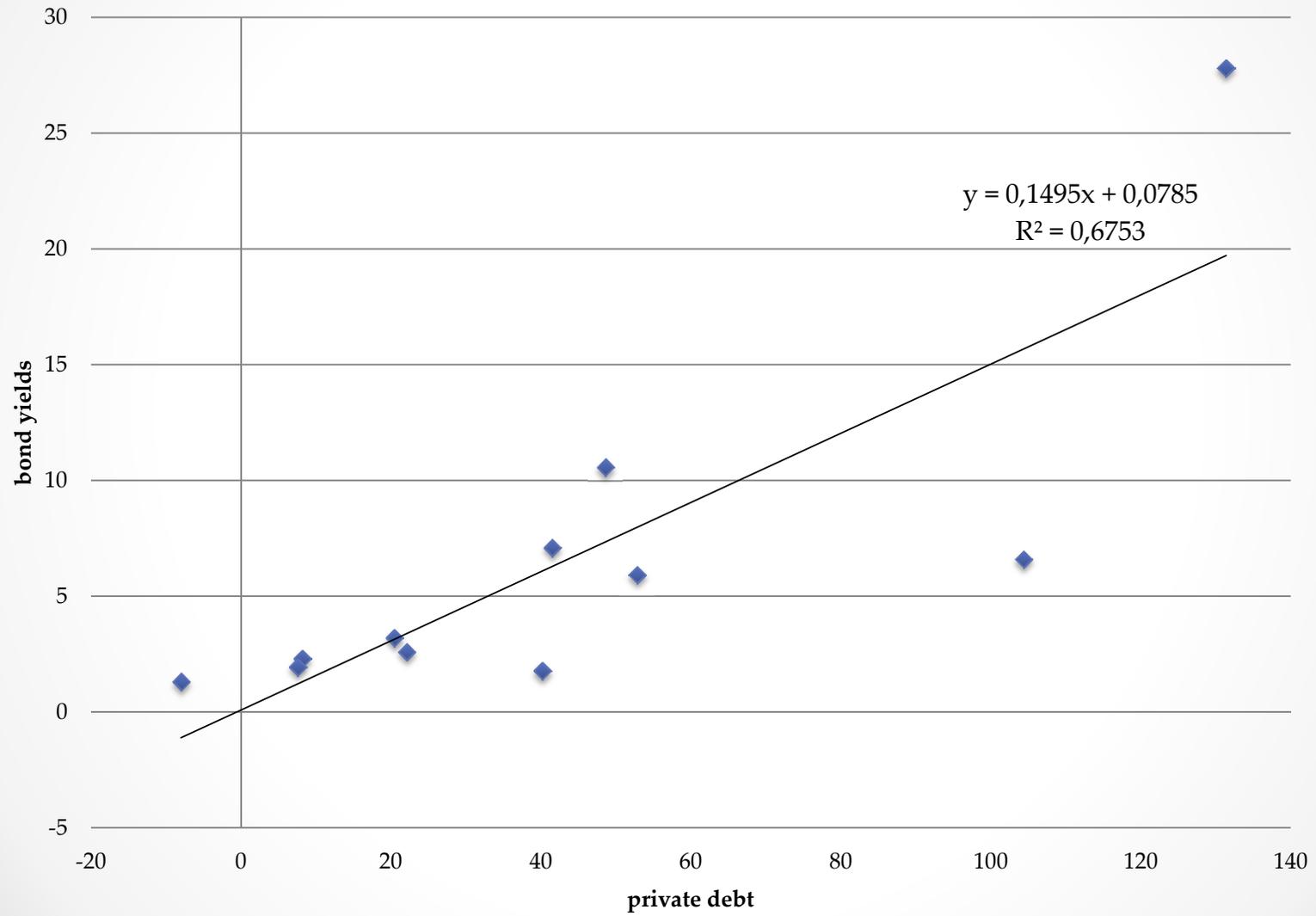
# Diagnosis of the crisis

- What explains sovereign debt crisis of 2010-12 better?
  - Public debt accumulation prior to crisis?
  - Or private debt accumulation prior to crisis?

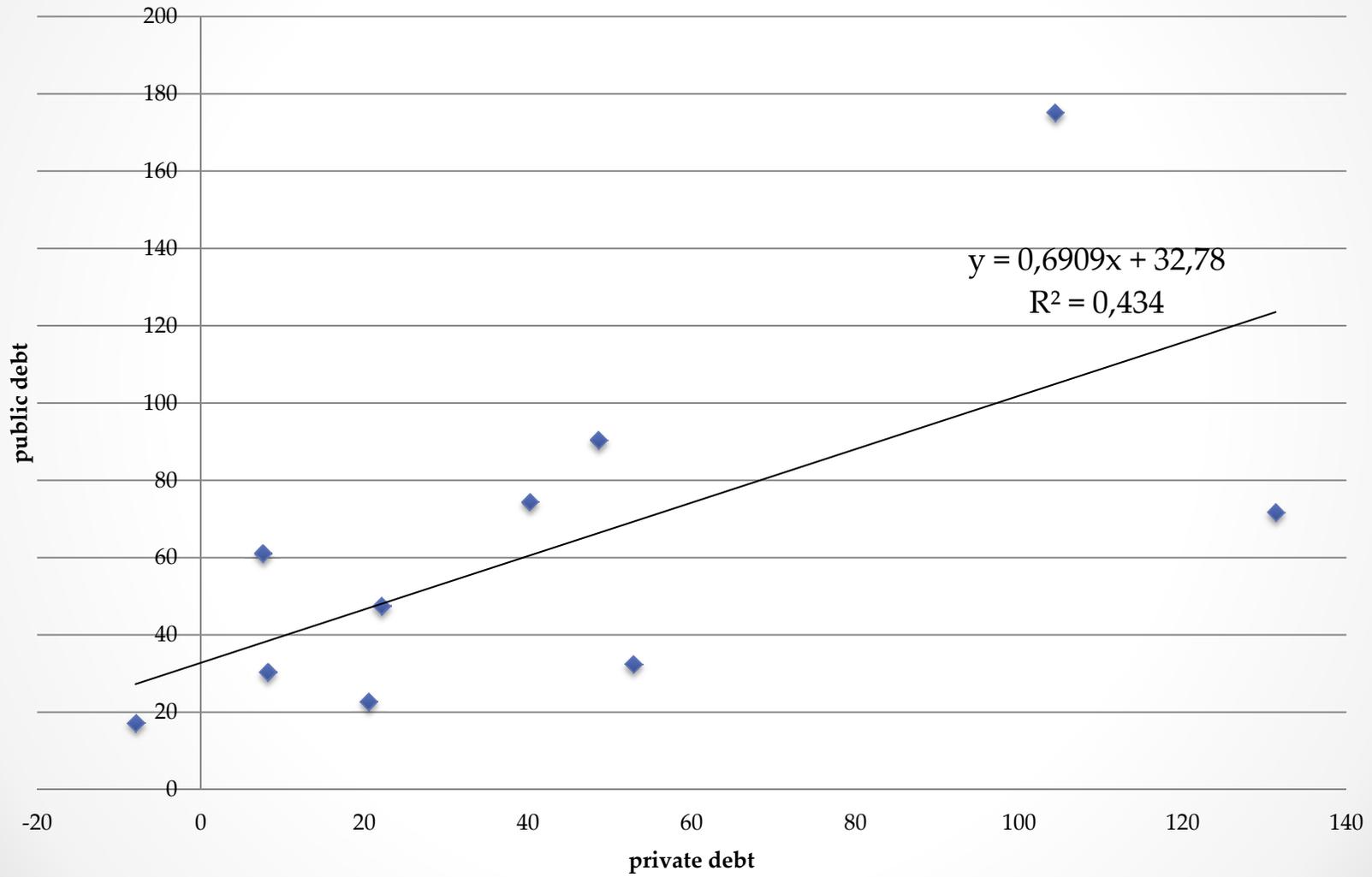
Government bond yields (2012) and  
increase government debt (1999-2007)



### Government bond yields (2012) and increase private debt (1999-2007)



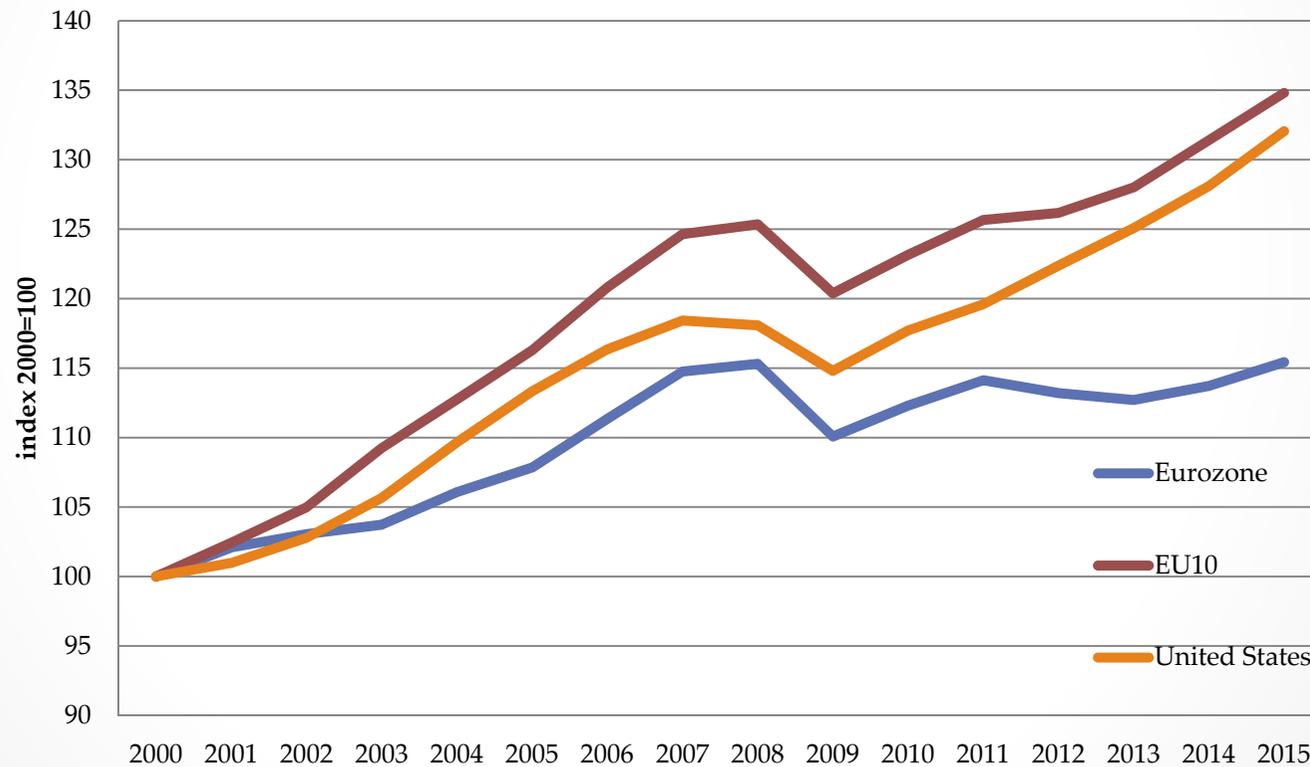
**Increase private debt (1999-2007)  
and public debt (2007-14)**



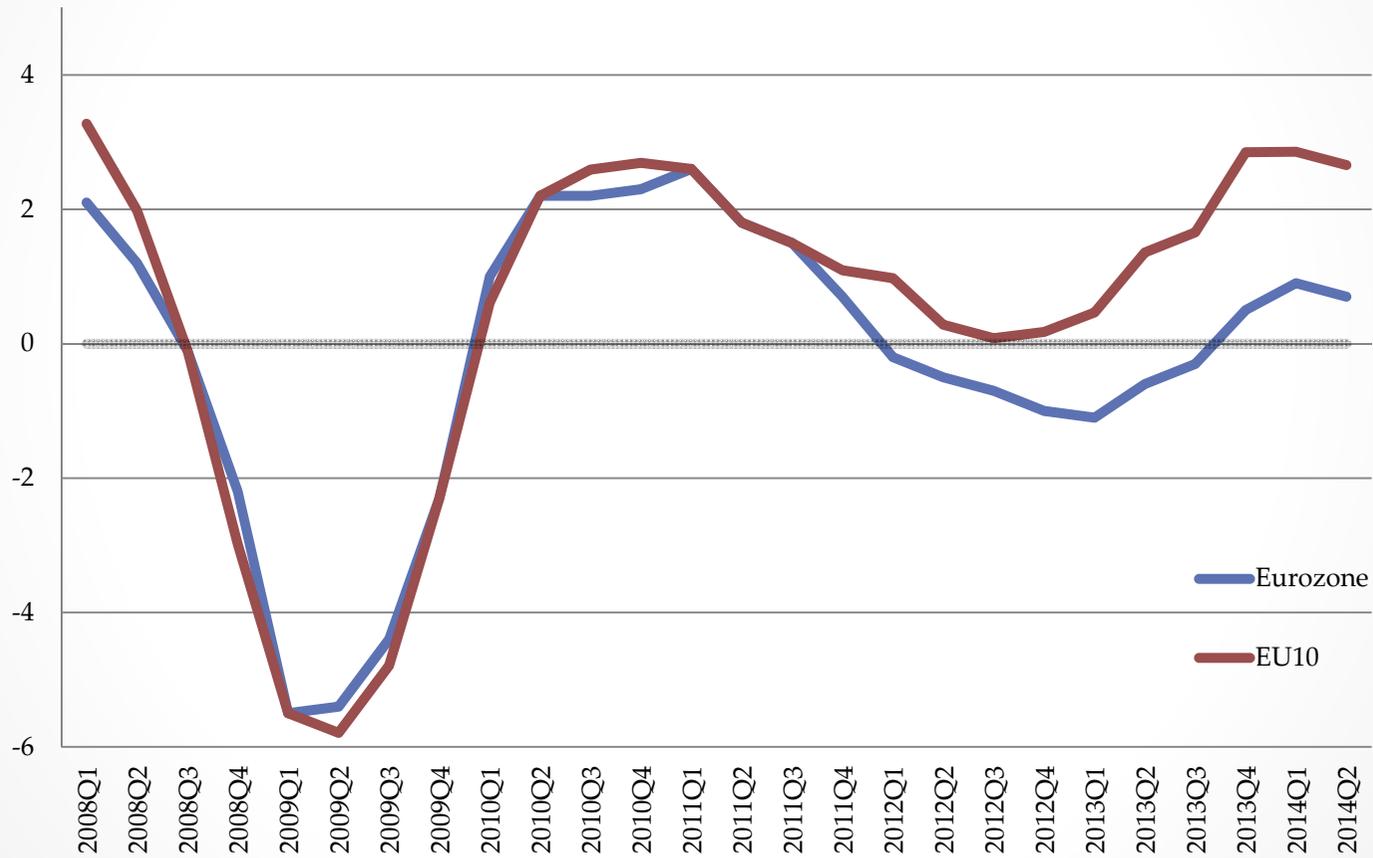
- We find that origin of crisis is a classical boom bust story
- However policies have been influenced by another diagnosis: it is governments' profligacy
- This has led to applying wrong medicine,
  - i.e. excessive austerity in periphery
  - without fiscal stimulus in center
- Result: economic stagnation in Eurozone

# Stagnation in Eurozone

Real GDP in Eurozone, EU10 and US (prices of 2010)

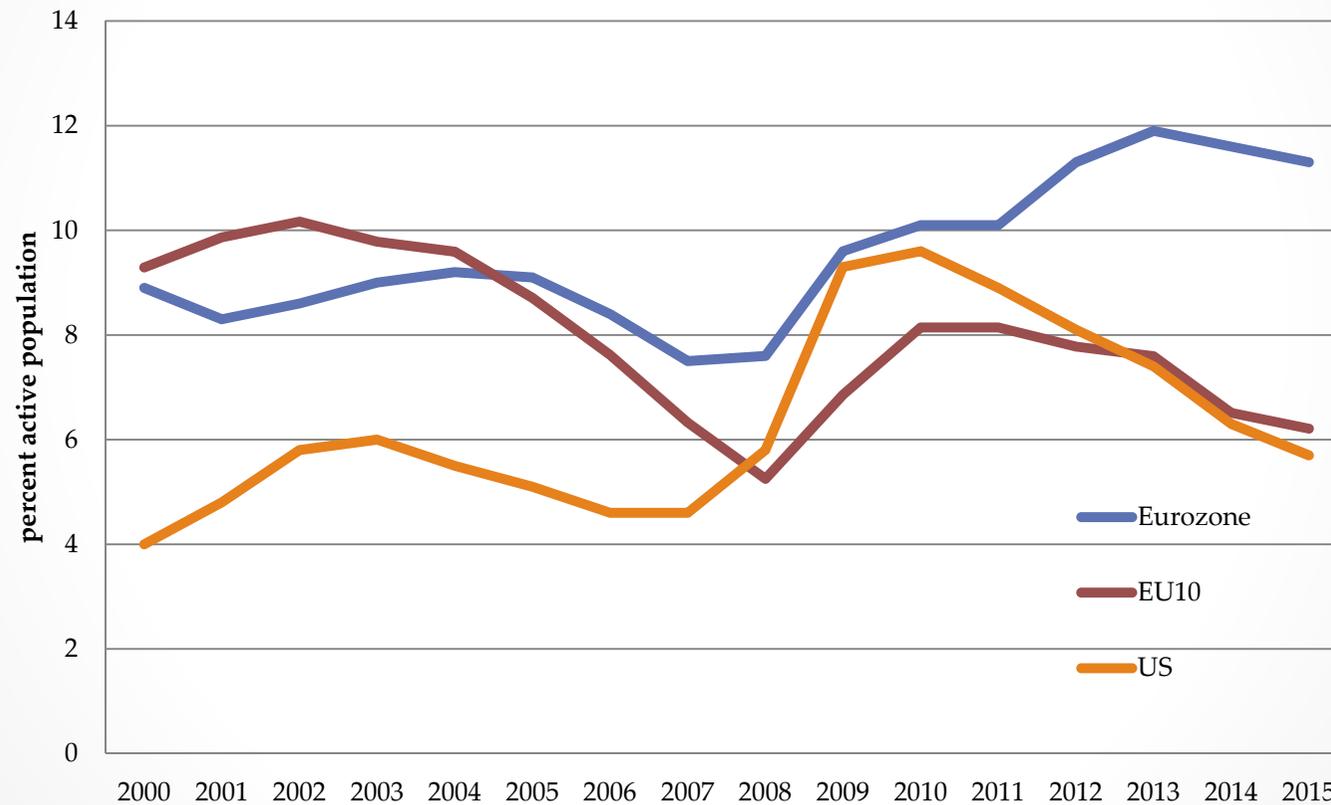


Growth GDP in Eurozone (EU18) and EU10 (percent)

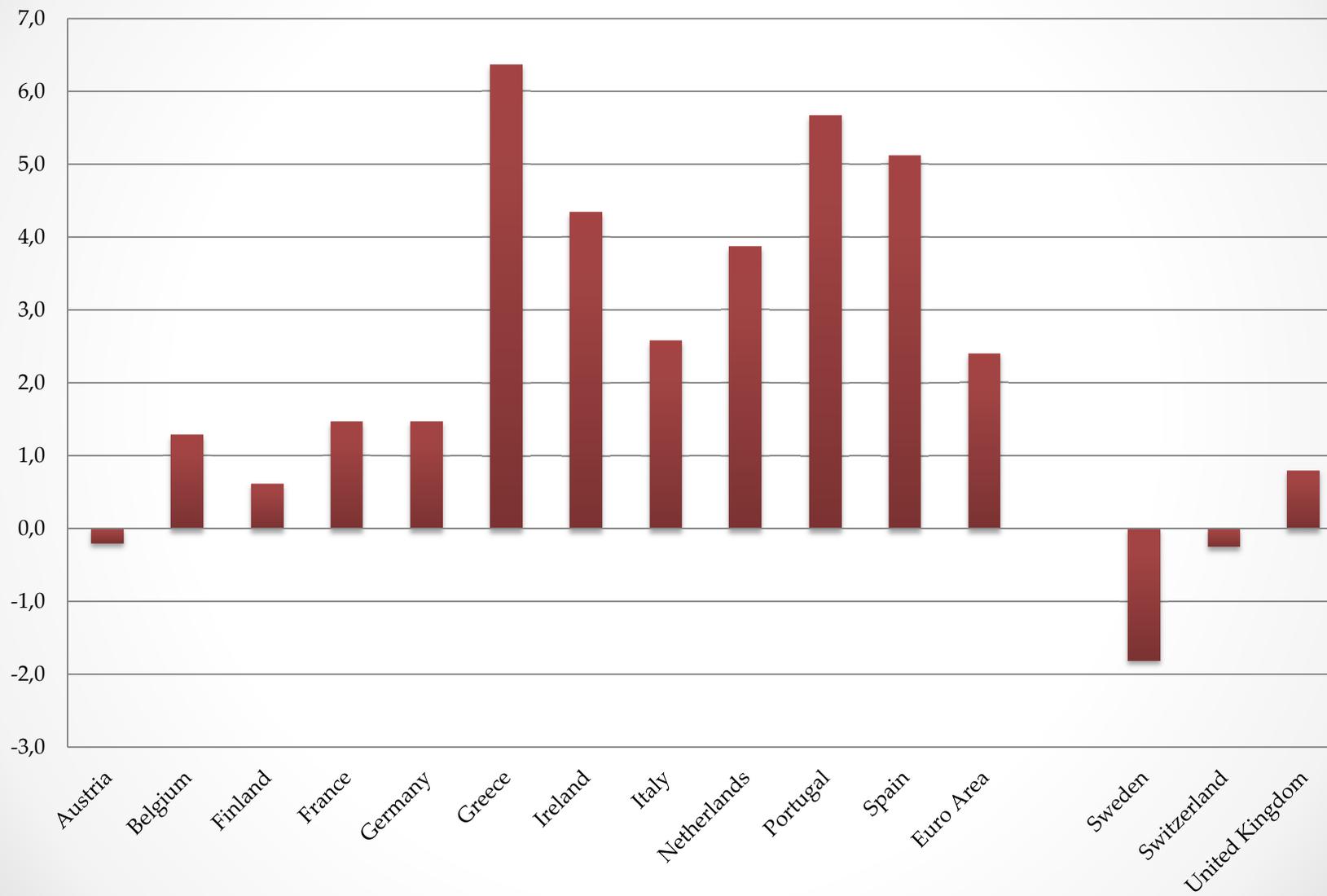


# Increasing unemployment

## Unemployment rate in Eurozone, EU10 and US

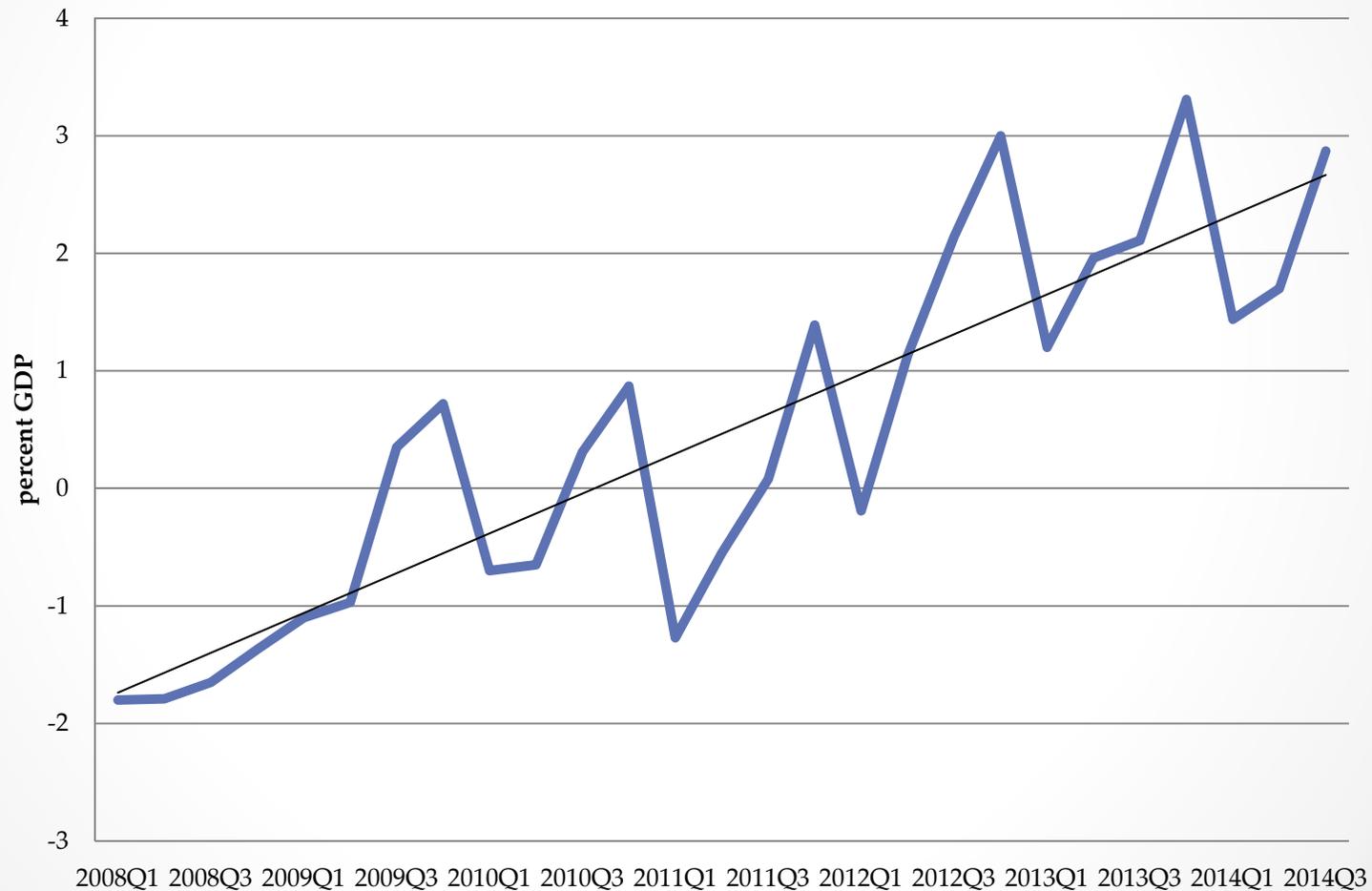


### IMF Fiscal Impulse (2011-14)



# Increasing savings as a result of austerity

Figure 6: Current account Euro area



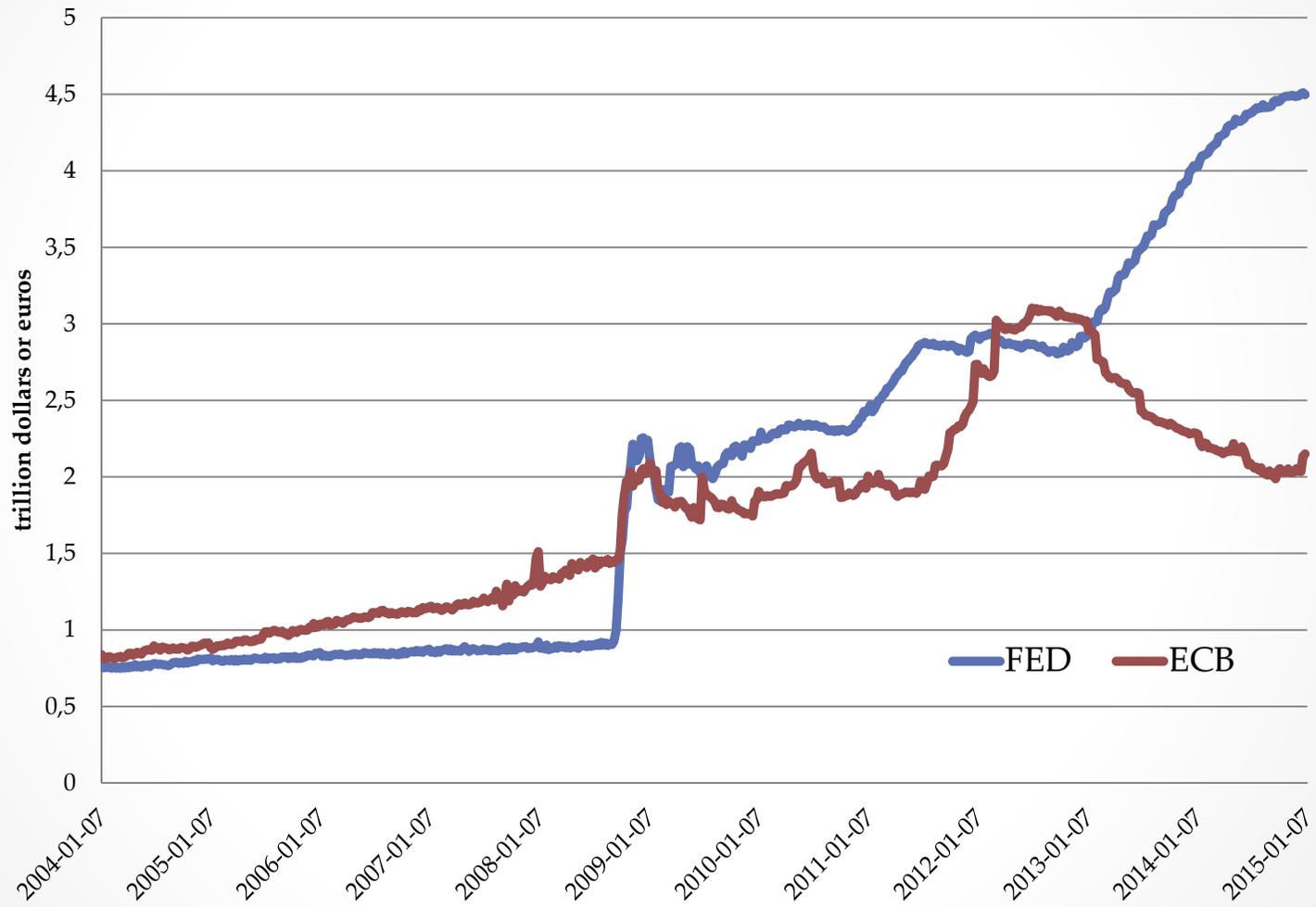
# Interpretation

- The sovereign debt crisis that emerged in 2010 led to panic both in financial markets and in Brussels
- Leading to the imposition of austerity measures
- Mostly in the problem countries
- While the core countries also were led to engage in austerity
- These austerity programs reinforced each other in a system that is highly interdependent
- This led to double-dip recession in 2012-13 and slow recovery since then
- Monetary policy did not help either

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Figure 2: Balance Sheet FED and ECB (2004-14)



# Deflation threat

Figure 7: Inflation in US and Eurozone



- What austerity programs in Eurozone illustrate is failure of conducting fiscal policies that are right for the system as a whole
- At the same time monetary policy was contractionary
- This led to wrong policy mix of fiscal and monetary contraction
- There is therefore no surprise in the stagnation of the Eurozone

# Design Failures of Eurozone

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# Eurozone's design failures: in a nutshell

1. Dynamics of booms and busts are endemic in capitalism
  - continued to work at national level and monetary union in no way disciplined these into a union-wide dynamics.
  - On the contrary the monetary union probably exacerbated these national booms and busts.
2. Stabilizers that existed at national level were stripped away from the member-states without being transposed at the monetary union level.
  - This left the member states “naked” and fragile, unable to deal with the coming disturbances.
3. Deadly embrace sovereign and banks

• Let me expand on these points. •

# Design failure I

## Booms and bust dynamics: national

- In Eurozone money is fully centralized
- Rest of macroeconomic policies organized at national level
- Thus booms and busts are not constrained by the fact that a monetary union exists.
- As a result, these booms and busts originate at the national level, not at the Eurozone level, and can have a life of their own for quite some time.



## Design failure II: no stabilizers left in place

- Lender of last resort existed in each member country at national level.
- Absence of lender of last resort in government bond market in Eurozone
- exposed fragility of government bond market in a monetary union

## 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
- Contrast with stand-alone countries that give this implicit guarantee
  - because they can and will force central bank to provide liquidity
  - There is no limit to money creating capacity

# Self-fulfilling crises

- This lack of guarantee can trigger liquidity crises
  - 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
  - Producing deep recession and Debt/GDP ratio increases
- This leads to default crisis
- Countries are pushed into bad equilibrium

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- This happened in Ireland, Portugal and Spain
  - Greece is different problem: it was a solvency problem from the start
- Thus absence of LoLR tends to eliminate other stabilizer: automatic budget stabilizer
  - Once in bad equilibrium countries are forced to introduce sharp austerity
  - pushing them in recession and aggravating the solvency problem
  - Budget stabilizer is forcefully switched off

# Redesigning the Eurozone

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# How to redesign the Eurozone

- Role of ECB
- Coordination of macroeconomic policies in the Eurozone
- Budgetary and Political Union

# The common central bank as lender of last resort

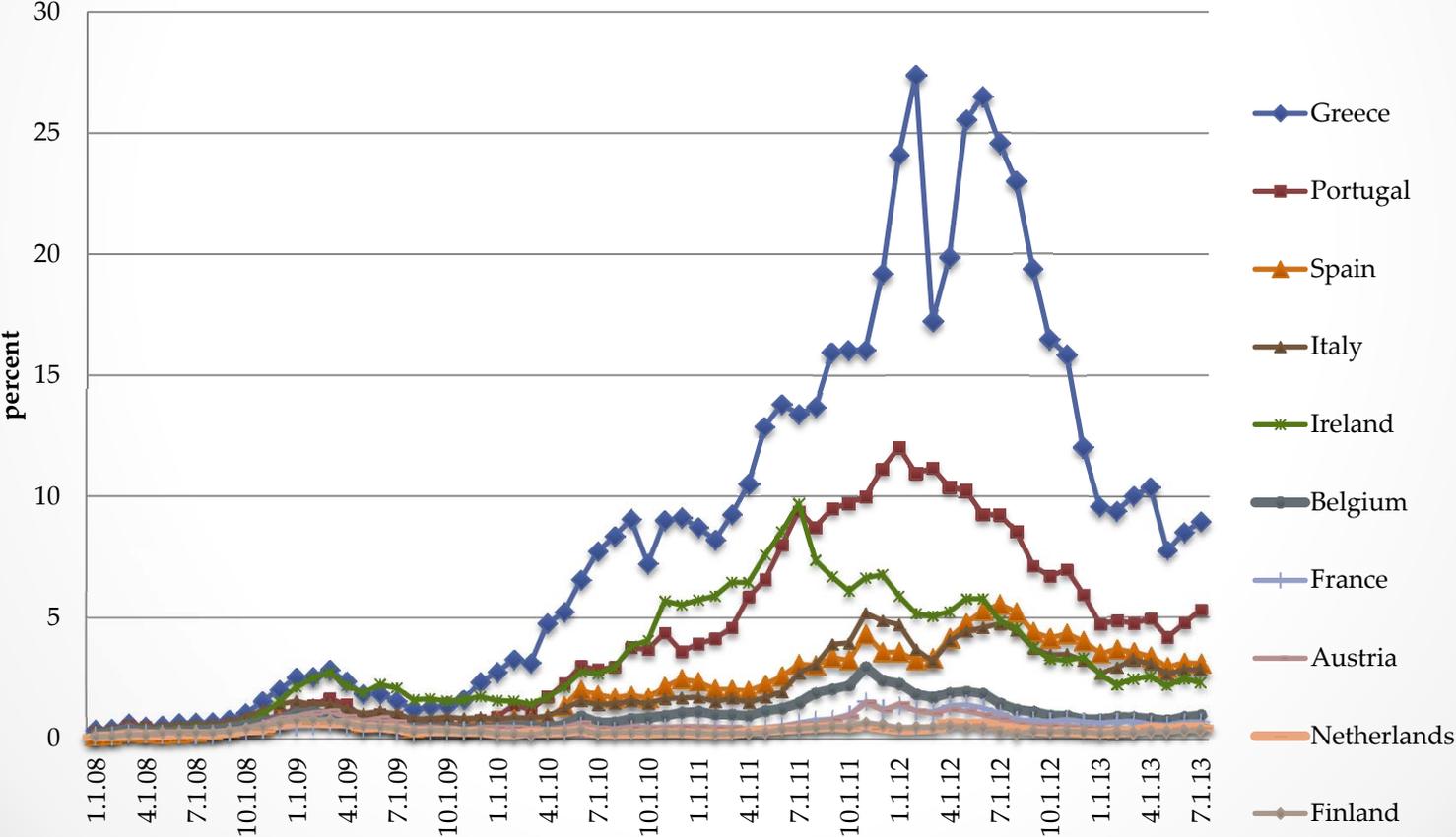
- Liquidity crises are avoided in stand-alone countries that issue debt in their own currencies mainly because central bank will provide all the necessary liquidity to sovereign.
- This outcome can also be achieved in a monetary union if the common central bank is willing to buy the different sovereigns' 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

# Success OMT-program

Figure 7: Spreads 10-year government bond rates eurozone



# Coordination of macroeconomic policies

- Macroeconomic imbalance procedure strengthening the coordination of macroeconomic policies are being put into place.
  - the monitoring of a number of macroeconomic variables
    - current account balances,
    - competitiveness measures,
    - house prices
    - bank credit
  - aimed at detecting and redressing national macroeconomic imbalances;



# However

- This procedure is implemented in asymmetric way
  - Deficit countries experience much more pressure to act, i.e. to reduce spending than surplus countries
- Competitiveness measures have same problem
  - This leads to downward pressure on wages
- Deflationary bias is not solved

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# Towards a political union

Most important component of political union is budgetary union



# Budgetary union has two dimensions

1. consolidation of national government debts.
  - A common fiscal authority that issues debt in a currency under the control of that authority.
  - This protects the member states from being forced into default by financial markets.
  - This restores the balance of power in favour of the sovereign and against the financial markets



## 2. Insurance mechanism

- mechanism transferring resources to the country hit by a negative economic shock.
- Limits to such an insurance: **moral hazard** risk,
- But that is problem of all insurance mechanisms

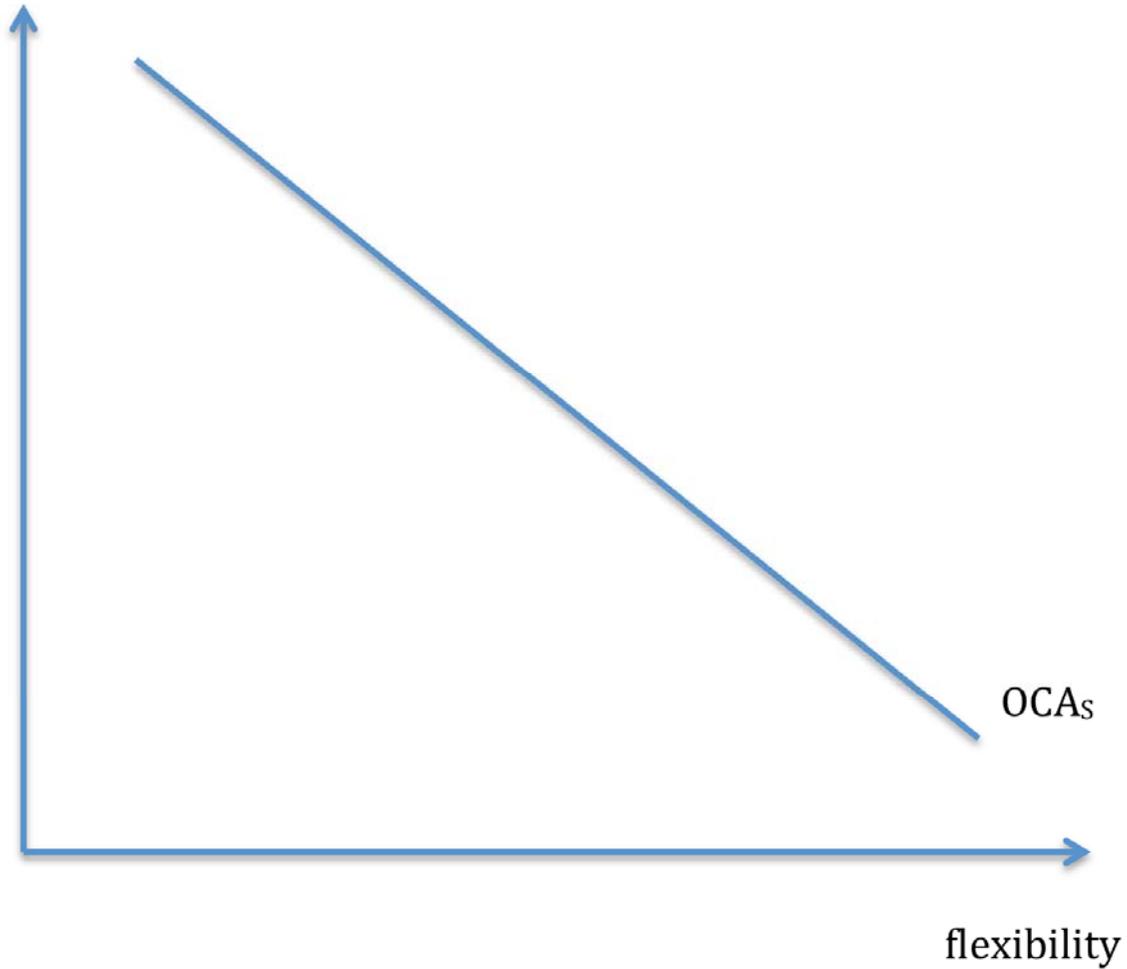
# The case for a budgetary union

- The case for a significant budgetary union is a strong one
- Let me develop the case



**Figure 1: Tradeoff between budgetary union and flexibility**

Budgetary union



# Implications

- Flexibility may sound great for many economists and central bankers. It is, however, costly for most people that are forced to be flexible.
- Flexibility means that these people may have to accept a wage cut or may be forced to emigrate.
- We learn from previous Figure that a movement towards budgetary union alleviates the (painful) need to be flexible.
- It may also make a monetary union more acceptable to large segments of the population.

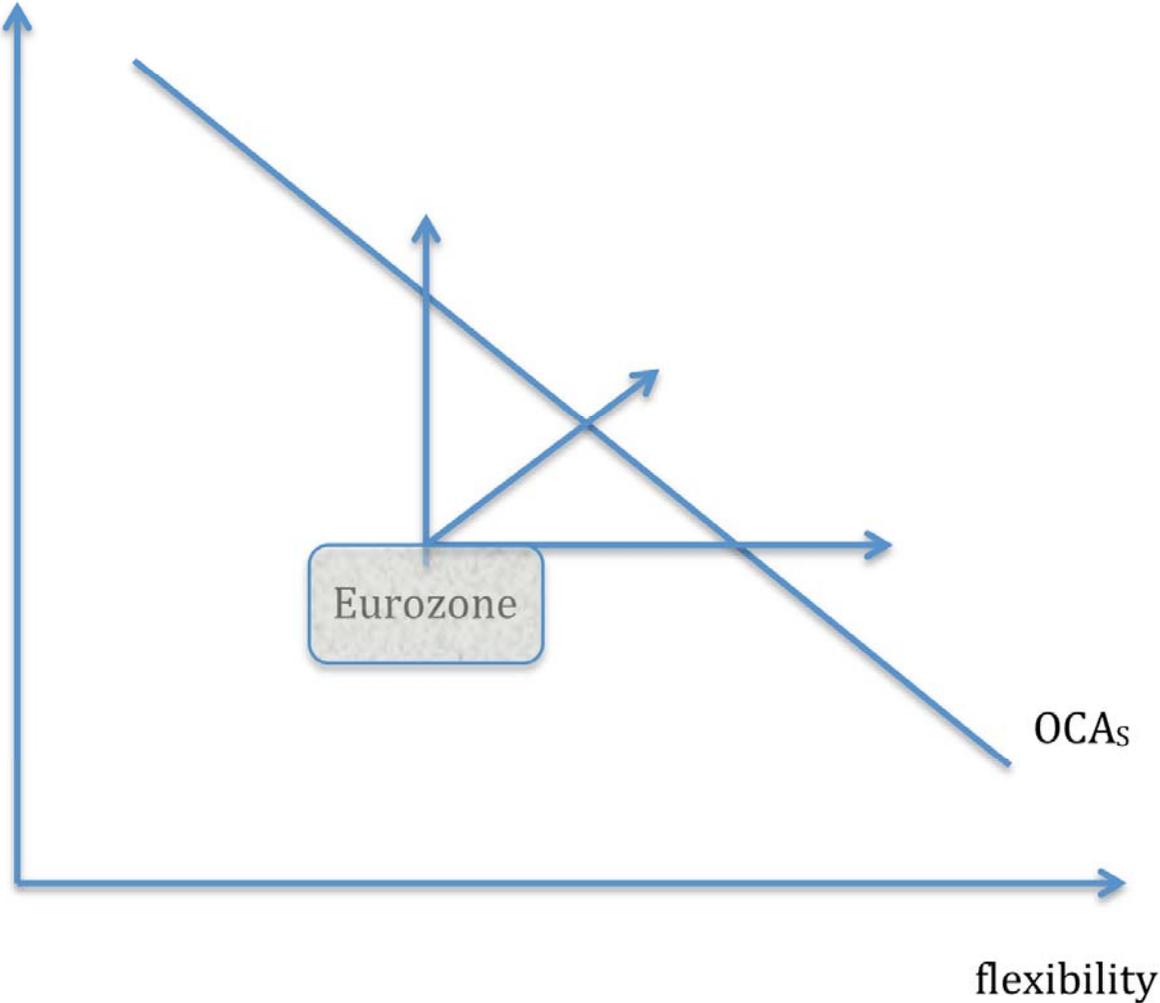
# Nature of shocks

- Two types of asymmetric shocks:
  - Exogenous asymmetric shocks: permanent shocks like productivity shock; mostly supply shocks
  - Endogenous shocks: they are result of unsynchronized business cycle movements. Driving force: animal spirits that lead to booms and busts

- When a permanent (exogenous) supply shock occurs flexibility is only option to adjust to shock.
- When asymmetric demand shocks occur it is not optimal to use flexibility.
  - In that case fiscal transfers (insurance) is appropriate response.
  - This is provided by a budgetary union.

**Figure 2: How to move the Eurozone towards the OCAs-area?**

Budgetary union



- Previous figure suggests that the present Eurozone is not an optimal currency area.
- When exogenous asymmetric supply shocks prevail, the Eurozone will have to move along the horizontal arrow to become optimal. (more flexibility is needed).
- If endogenous asymmetric demand shocks prevail (booms and busts), Eurozone must move along the vertical arrow to become optimal.
  - In this case flexibility does not help.
  - Instead a common insurance mechanism (provided by a budgetary union) becomes necessary to deal with these shocks.



# Additional insight

- Flexibility in labour markets is something national governments can do. There is no need to further integration to increase flexibility.
- Budgetary union, however, is of a different nature. It requires political integration.
- In other words while flexibility is in the realm of national governments, budgetary union is a European affair (Sapir(2015)).



# Empirical evidence about nature of shocks

- We compute trend and cyclical components of GDP of Eurozone countries
- Using HP-filter
- and then compute correlations
- And relative variance of cyclical and trend component



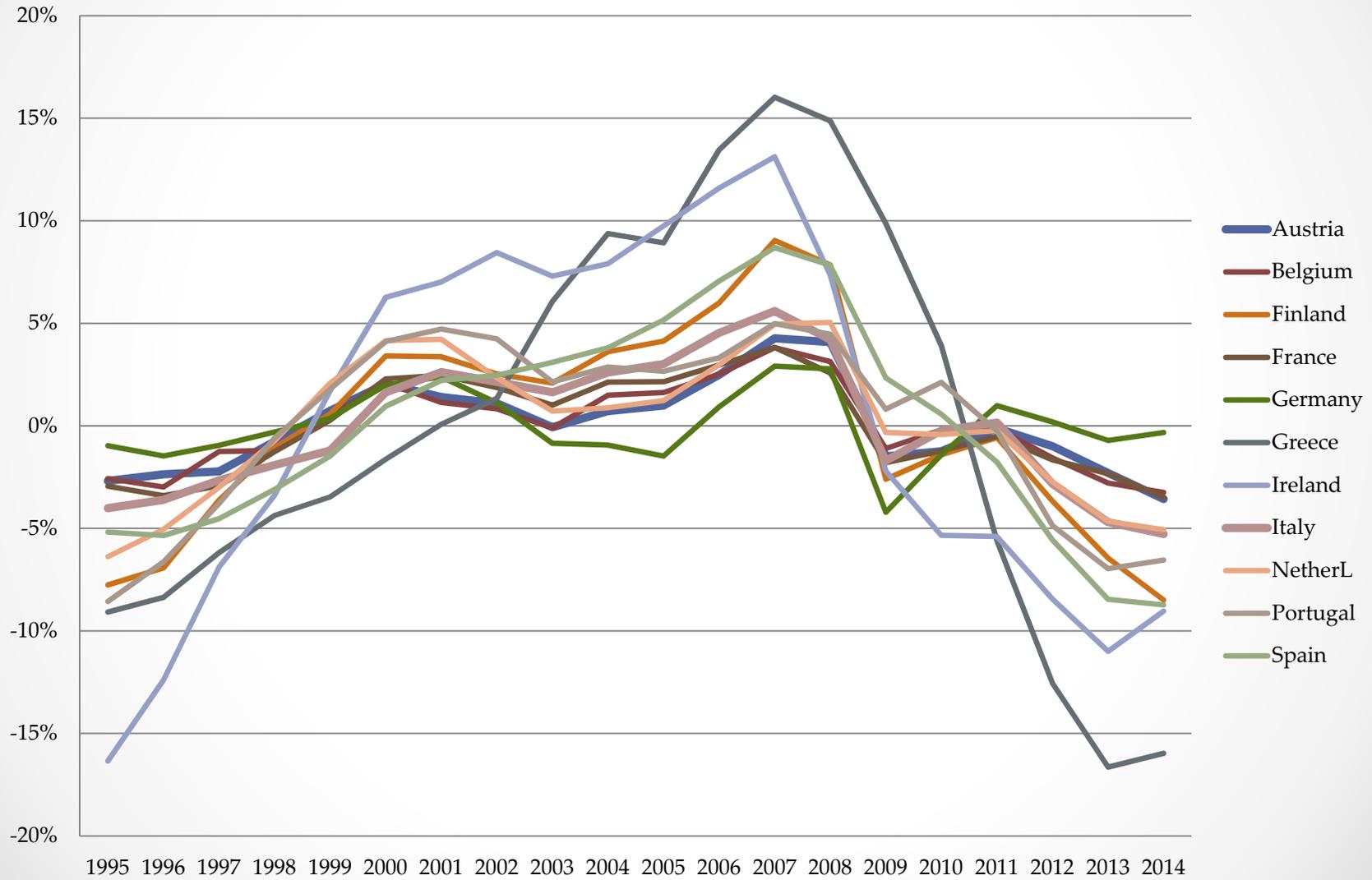
## Correlation coefficients cyclical components GDP

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Netherl	Port
Austria										
Belgium	0,97									
Finland	0,97	0,98								
France	0,93	0,95	0,97							
Germany	0,69	0,57	0,55	0,59						
Greece	0,73	0,82	0,84	0,74	0,09					
Ireland	0,85	0,89	0,92	0,95	0,41	0,81				
Italy	0,91	0,96	0,98	0,96	0,50	0,86	0,93			
Netherlands	0,93	0,94	0,93	0,91	0,60	0,75	0,86	0,90		
Portugal	0,98	0,89	0,89	0,87	0,37	0,82	0,87	0,90	0,94	
Spain	0,85	0,91	0,94	0,87	0,27	0,97	0,90	0,95	0,86	0,90

Mean trend growth and mean (absolute) business cycle change in GDP  
(in percent) during 1999-2014

	Mean cycle	Mean trend	ratio
Austria	1,79%	1,77%	1,01
Belgium	1,72%	1,67%	1,03
Germany	1,55%	1,23%	1,26
France	2,15%	1,49%	1,44
Netherlands	2,66%	1,66%	1,60
Finland	4,35%	2,02%	2,15
Spain	4,58%	2,07%	2,21
Ireland	8,01%	3,35%	2,39
Portugal	3,67%	0,81%	4,53
Italy	2,86%	0,41%	7,05
Greece	9,09%	0,90%	10,11

Business cycle component of GDP growth



# Interpretation

- Since start of Eurozone, cyclical (temporary) movements have been the dominant factor of growth variations in GDP.
- Cyclical movements of GDP are highly correlated in the Eurozone.
- Asymmetry between Eurozone countries
  - not so much to be found in a lack of correlation in growth rates
  - but in the intensity of the boom bust dynamics of growth rates.



# Implications for Eurozone governance

- Implications for ECB:
  - when setting interest rate ECB should not only watch the mean Eurozone-wide movement of output growth, or output gap,
  - but also the variance (across countries) of the movements of output growth.
  - When this variance is very large it should be a signal for the ECB that a boom in one or more countries risks being unsustainable,
  - leading to large problems later when crashes occur.



# Implications for budgetary union

- We found overwhelming importance of the cyclical component of output growth
- This leads to conclusion that efforts at stabilizing the business cycle should be strengthened relative to the efforts that have been made to impose structural reforms.
- In terms of Figure 3 this means that one should pursue efforts along a relatively steep upward sloping path
- This calls for budgetary union



- We have also found that business cycles are well synchronized but that intensity of booms and busts is not
- This makes standard proposals to create fiscal space at Eurozone level (e.g. unemployment insurance schemes) problematic
  - These work well when business cycles are desynchronized
  - Then: Countries in boom contribute to countries in recession
  - But when all countries experience boom and bust at the same time but with different intensities such an insurance scheme is not optimal
  - It dampens cycle in one country at expense of making it more intense in other country
- ◦ And it creates political problems

- Put differently: most countries are likely to experience a boom and a recession at about the same time,
- But with different intensities and amplitudes.
- There is therefore relatively little need for inter-country smoothing of business cycle movements.
- The more pressing need is to smoothen volatilities over time.



- In principle, this kind of smoothing (over time) could be done at the national level
- However, the large differences in the amplitude in the business cycle movements makes a purely national approach impractical
  - it leads to large differences in the budget deficits and debt accumulation between countries.
  - These differences quickly spillover into financial markets when countries that are hit very hard by a downward movement in output experience sudden stops and liquidity crises (see De Grauwe(2011)).

- This is likely to force them to switch off the automatic stabilizers in their national budgets (De Grauwe and Ji(2013)).
- This can push countries into a bad equilibrium.
- To avoid all this a common approach is necessary.
- Budgetary union is only way to deal with this.

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# Integration fatigue

- Willingness today to move in the direction of a budgetary and political union in Europe is non-existent.
- This will not only continue to make the Eurozone a fragile institution
- It forces a hegemonic political union by default
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# Hegemonic political union

- Absence of institutional steps towards political union has introduced a political system where creditor nations impose their rule
- It derives from fragility of Eurozone
  - When distrusted by financial markets (rightly or wrongly) countries cannot defend themselves
  - They can be pushed into illiquidity and insolvency
  - They are at the mercy of the creditor nations



- De facto and by default we land into a political decision mode at the level of the Eurozone where creditor nations call the shots.
- This is an hegemonic political union
- Such a union will be rejected
- It is unsustainable
- That's why we have to move to a political union based on democratic principles

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# Objection

- Some will object: all this is not necessary
- All what is needed is disciplining national governments
- This view overlooks the nature of capitalism with its booms and busts
- These will regularly push some countries (even the disciplined ones) into crisis mode (illiquidity and threats of insolvency)
- We have to create a political union that is fit to deal with these booms and busts
- This can only be through budgetary union
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# 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 cannot last
  - The eurocrisis is not over
-