Asymmetric shocks and monetary disintegration: the case of the eurozone

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Abstract 1

• Establishing a state of play of the issues concerning the long term stability of EMU

• Two main modern schools of thought are singled out: the views represented by Eichengreen and De Grauwe, respectively

• The former argues that the high costs of withdrawing can prevent a country to secede
Abstract 2

• The latter warns of the dangers of instability arising from the poor political governance of EMU
• Both however admit that political factors play a foremost role in the setting up and disintegration of monetary unions
• At present dangerous asymmetric shocks of national origin which could derail EMU are nurturing in Germany, where some decisions concerning the constitutional level could block any development towards forms of political union complementing the economic one
Divergences and asymmetric shocks

- The global economic crisis translated in a country specific way into the different economies included in the eurozone
- OCAs theory says that the monetary authority of the union, the ECB, could not offset the negative consequences of a country specific disturbance, which had therefore to be adjusted by other mechanisms than the monetary and exchange rate policies
- Since in the case of EMU such mechanisms were weak or even straightforwardly absent there was the risk to foster divergences among member countries, putting in jeopardy the eurozone survival in the long run
Divergences and asymmetric shocks 2

- One of the clearest alarm bells signalling the danger was the widening in the spreads on bonds issued by governments of peripheral countries in comparison with the German bund, which could be in part interpreted as a warning sign of a possible default by them.
- And since the Maastricht rules expressly state the no bail out clause, the default of some countries could in principle not be excluded.
- Under these circumstances the issue of a potential break up of the euro area came anew to the fore.
Initial econ. criticism on EMU: 1

• The attempt to set up a European monetary union via the Maastricht treaty was accompanied by a lot of scepticism by the economic profession.

• With the noteworthy exception of Mundell (1961, 1973), Mc Kinnon (1997) and Kenen (1995), the fathers of the OCA theory, the bulk of mainstream economists belonging to the Anglo-Saxon area deemed the EC to lack of the basic features of an OCA and hence to be doomed to failure: Milton Friedman (1997), Eichengreen (1993), Krugman (1993), Feldstein (1997, 1998) and Mussa (1997)
Initial econ. criticism on EMU: 2

• In the ranks of European economists supporters of the EU’s attempt were more frequent: De Grauwe (1992), Sievert (1997), Padoa Schiopppa (1994), Bini Smaghi and Vori (1993)
Initial econ. criticism on EMU: 3

• In particular the position of Mundell: whereas Mundell (1961) could be interpreted as the justification for considering sceptically the prospect of a European monetary union, due to its lack of optimality, Mundell (1973) showed that entering a monetary union did not imply a cost in terms of loss of the exchange rate adjustment mechanism but a benefit thanks to the abolishing of a source of asymmetric shocks.
Initial econ. criticism on EMU: 4

- Strictly speaking concerns on the scanty characters of optimality of the European market are justified only in a Keynesian context, where economic rigidities prevail and anti-cyclical policies have an outstanding role.

- For orthodox monetarists this issue is less relevant, since economic policies are useless and the clearing of markets depends on the free interplay of market forces or possibly by the institutional arrangements which offer the right incentives to the latter.
Initial econ. criticism on EMU: 5

- A surprising contradiction: the harsh negative judgment delivered by authors belonging to the neoclassical heritage, such as Milton Friedman and Martin Feldstein
- Perhaps their assessment was affected by the understanding they had of the functioning of one of the largest monetary union in the world, with a number of adjustment tools against asymmetric shocks, which in the case of the EU were cruelly absent
Friedman’s criticism 1

• Friedman (1997) argues that a common currency for Europe would be a poor monetary arrangement and that the euro project, being not economically but politically motivated, will have actually divisive political consequences

• European countries, with the possible exception of the economies belonging to the German mark area, are too different from the economic and political standpoints, having scarcely flexible markets, no common language, no European loyalty and a too small common budget managed by the European Commission.
Friedman’s criticism 2

• Under such circumstances for them the best adjustment tool is the exchange rate mechanism: instead of changing thousands of wages and prices as it would happen in a currency union, maintaining their monetary independence they could change the only price of exchange rate.

• Friedman believes that the true driver for euro is a political one: the need to link Germany and France so strongly together for making a future war in Europe unthinkable and establishing a pre requisite for a federal United States of Europe. However the currency union will have the contrary effect.
Friedman’s criticism 3

• “Political unity can pave the way for monetary union. Monetary union imposed under unfavourable conditions will prove a barrier to the achievement of political unity”.
Feldstein’s criticism 1

- Along similar lines Feldstein delivers a strong negative judgement on both European monetary union’s economic and political outcomes (Feldstein, 1998).

- The straitjacket of a common interest rate and of an inflexible exchange rate regime put on countries which have a lot of structural heterogeneities and are lacking of sufficient cross-border anti-cyclical transfers would result into higher unemployment and average inflation rates.
Feldstein’s criticism 2

- As to the political consequences of European monetary union, Feldstein (1997) goes well beyond Friedmans’ conjecture that EMU will foster tensions among European countries.
- For him too, the drive to political union as a way to reduce conflicts could have a contrary effect. Economic disagreements on goals and measures of monetary policy could cause some member countries damaged by higher unemployment to leave the union.
Feldstein’s criticism 3

• Political tensions could translate into risks of war, reigniting distrust among European nations and reinvigorating the struggle for leadership between France and Germany.

• One of main aim of European integration, the safeguard of peace in Europe will be put in jeopardy
Criticism in the aftermath of EMU 1

• Doubts as to EMU viability, mainly by mid 2010s, when the Stability and Growth Pact (SGP) was rendered more flexible as a result of fiscal policy difficulties incurred by a number of countries,

• Among them Italy took a foremost place as an example of a member country that could be obliged to leave the monetary union (Roubini, 2006).
Criticism in the aftermath of EMU 2

• In this period and in the following one, up to the first EMU decade, the arguments levelled in order to underline the flaws in the EMU setting up were similar in their essence to those advanced by Friedman and Feldstein.

• However complemented by the remark that the monetary union working was causing divergences among member countries, which could translate into a likely disintegration of the eurozone.
The hypothesis of EMU breakup: historical vs analytical approach

• Under what circumstances the European common monetary building could really break up?

• An inquiry into the possible future collapse of EMU can focus on historical experiences of monetary unions in the past or on an analytical identification of strengths and weaknesses of the present eurozone setup.

• The historical approach as in Bordo and Jonung (1999), along with Bordo and James (2008).
The hypothesis of EMU breakup: historical approach 1

- Successful national monetary unions such as those in the US, in Italy, Germany, or of monetary union dissolutions like in Austria, Russia or Soviet Union, Yugoslavia and Czechoslovakia and eventually collapsed multinational organizations such as the Latin and the Scandinavian monetary unions.
Historical approach 2

- The main insights derived from past examples: the political factor plays a crucial role both in the setting up and in the dissolution of monetary unions and that the latter can also fail not only when the political drive is lost or reversed, but also when monetary union member countries or regions decide to follow divergent monetary policies.

- Hence a possible lesson to be learnt from history is that EMU will survive up to the point where the political drive that supports it wanes and its member countries revert to their monetary autonomy.
Analytical approach: Eichengreen’s vs De Grauwe’s views

- To date the most convincing and detailed investigations on the subject have been carried out by Eichengreen and by De Grauwe.
- The two interpretations of the strengths and weaknesses of EMU share a number of common features, but in their essence lead to opposite conclusions, with Eichengreen highlighting its resilience and De Grauwe emphasising the risks of disruption.
- In addition, whereas Eichengreen focuses explicitly on the break up issue, De Grauwe derives his possible negative prognosis from an extensive inquiry into the EMU flaws.
Eichengreen’s view: 1

• Eichengreen’s (2007) view is that the abandon of the euro area by a single country deciding to reintroduce a national currency would entail too high costs for it to be economically and politically bearable, even though in principle this cannot be excluded.

• A country experiencing a competitiveness loss and slow growth or a rising debt accumulation could be tempted to withdraw and re-establish a national currency for following a monetary cum exchange rate policy aimed at producing inflation, reducing the debt burden and starting a short run growth cycle.

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Eichengreen’s view: 2

• Such a country could be confronted with possible banking and financial market disruptions with bank runs and immediate transfer abroad of bank savings, high exchange rate depreciation and a likely denial of single market privileged access by other member countries.

• Cases in point could apply to countries such as Portugal or Italy.
Eichengreen’s view: 3

• However exit could be decided also by countries such as Germany, under circumstances in which economic and political developments could imperil the anti-inflationary stance or reputation of the ECB.

• However the issue of the economic consequences for the defecting country is not clear cut and economic barriers to exit could prove not to be prohibitive, since reforms and other circumstances quoted in Eichengreen (2007) could reduce substantially the costs of leaving.
Eichengreen’s view: 4

• In any case technical and legal complexities linked to reintroduction of a national currency such as redenomination of wages, contracts and credit relations, reprogramming of computers and vending machines and the like are in all probability to be redoubtable.

• Widespread litigations and a loss of bargaining power on other EU issues

• Generally speaking, if a defector shares with other member countries the same economic issues, the latter could have strong incentive to follow, producing a union-wide collapse
Eichengreen’s view: 5

• But if the leaving country is an outlier its departure could strengthen the cohesion or remaining countries
• If a country such as Germany left, a group of others could follow suit
• However decision to exit could depend not only on economic but also on political issues or on extraordinary big asymmetric shocks such as those due to natural events, earthquakes, floods and the like
Eichengreen’s view: 6

• Hence, a general failure of monetary integration among EU countries following the departure of relevant EMU subgroups could not be ruled out, albeit difficult to come about.

• In short, Eichengreen (2007) is confident enough not so much of built-in stability mechanisms of EMU but of interests of member countries not to withdraw from it due high costs of exit mainly in political terms.

• Forecast that in a generic future ten year span no member country will likely defect and the overall disintegration of the eurozone will be still more unlikely.
De Grauwe’s view: 1

- Based on a deep inquiry into the links between monetary union and political union

- A political union is a multi dimension construction: the EU, despite being similar to a modern democracy, from the functional standpoint has been endowed with powers transferred from the national level only in some areas

- National states have maintained large competencies in fields such as taxation and spending, social security or wage policies
De Grauwe’s view: 2

- Furthermore, he identifies a number of essential flaws in the EMU institutional design, among which the most salient one is perhaps a deep contradiction between means and responsibilities of different players.
- National governments are held responsible for growth and employment by their national parliaments but are lacking the necessary tools to fight unemployment.
De Grauwe’s view: 3

• The European institutions have the necessary powers but lack of accountability.

• As a result, whenever a conflict between European and national policy makers arise the second ones do not respect the rules, as in the case of national deficits sanctioned by the SGP, or are tempted to reduce ECB’s independence when it comes to monetary policy.

• Such a contradiction alongside possible asymmetric shocks deriving from the remaining powers of national governments could put in jeopardy the EMU survival.
De Grauwe’s view: 4

• Contrary to what is happening in the US, where the federal government has enough political power to restrain states to secede from monetary union, in Europe the decision to stay in EMU depends solely on the perception that relative benefits are larger than costs

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De Grauwe’s view: 5

• It follows that withdrawal of a country in the case of EMU could clearly occur and that the euro area could break up when member countries stop considering membership to be in their national interest.
De Grauwe’s view: 6

- The crucial role played by political integration:
- A political union can increase the optimality of a monetary union by providing a centralised union-wide budget absorbing asymmetric shocks and by reducing asymmetric shocks generated by left over national competencies
- De Grauwe (2006, a) admits that his analysis derives from Keynesian foundations such as those of animal spirits, demand side factors and self fulfilling prophesies, implying a stabilisation task assigned to monetary and fiscal policies,
De Grauwe’s view: 7

• By contrast the Brussels-Frankfurt consensus on which EMU has been devised and implemented on the basis of monetarist and new classical elements has no room for stabilisation policies, beyond the central bank’s assignment to maintain price stability. It follows that withdrawal of a country in the case of EMU could clearly occur and that the euro area could break up when member countries stop considering membership to be in their national interest.

• However after the severe recession following the bursting of the property bubble, macroeconomic neoclassical ideas based on the tenet of self equilibrating markets have been discredited, giving his approach a new appeal.
De Grauwe’s view: 8

• His investigation on the manifold flaws of EMU and on the means to overcome them by further political integration can be deemed to be relevant in order to understand why European monetary union could disintegrate.

• In conclusion De Grauwe’s view on the viability of the European monetary integration maintains that EMU is a flawed construction, which in the absence of further progress towards political integration can push member countries to secede and EMU going along a path of instability that could result in its break up.

• In the long run without a higher degree of political union the Eurozone is doomed to failure.
Asymmetric shocks of national origin

- Asymmetric shocks could put in jeopardy the survival of monetary union, since flexibility in the labour markets within member countries, above all in the form of labour mobility, could not be enough and trade integration for some of them could be too low in order to create sufficient benefits from the use of the single currency.

- Under these circumstances since the “one size fits all” monetary policy carried out by the ECB cannot by definition adjust the asymmetric shock, the damaged member country experiencing a fall in growth and an increase in unemployment may see the costs of monetary integration to surpass the benefits, being tempted to leave.
Asymmetric shocks of national origin 2

- Asymmetric shocks can be of national and federal origin

- Among the former: economic asymmetric shock of pure national origin, such as those put into being by divergent fiscal, social and wage policies

- In addition: disturbances due to a common shock which translate however into different effects within member countries, due to diversity in their national structure, and asymmetric shock of pure political kind:

- Italian minister Maroni, belonging to the Northern League party, who in 2005 advocated the secession from the euro area and the reintroduction of the Lira, being supported in that by prime minister Berlusconi, who defined the single currency as a disaster.
Asymmetric shocks of federal origin

- The old debate between the Commission’s (EC, 1990) and the Krugman’s (1993) views about the frequency of asymmetric shocks in the aftermath of monetary integration has perhaps not been really settled and should the latter prove to be right, the regional concentration of activities due to economies of scale could heighten asymmetric shock probability.

- Therefore in the long run it could not be excluded that the functioning of the monetary union in the federal frame will ripen the seeds of its own destruction.

- However, with De Grauwe (2009), we tend to consider that the Commission’s (EC, 1990) interpretation, according to which trade integration will render the member countries economies more homogeneous by means of intra industry commerce, is likely to be the right one, not least because due to the working of mechanisms identified by the theory of endogeneity of OCA

- This will probably increase the degree of EMU optimality in the long run
More on asymmetric shocks of federal origin

• In addition, the federal level gives origin also to asymmetric shocks in the short run, which are easily found in the statistics of economic divergences among member countries.

• An economic explanation of internal divergences observed in the aftermath of EMU has been delivered by Blanchard (2006), with his theory of revolving slumps.

• Thanks to joining the eurozone, member countries, whose anti-inflationary credentials were low, experience in the short run a decrease in interest rate, an increase in capital inflows and eventually an economic expansion linked mainly to the residential construction sector development, with high wages, positive wealth effects on consumption and shrinking unemployment.
More on asymmetric shocks of federal origin

- However, when the capital stock has reached a new equilibrium, the economic boom runs out and, provided in the meanwhile labour productivity has not improved, growth subdues and a loss of competitiveness comes into view, which cannot be offset through the exchange rate depreciation.

- As a result, compared with core eurozone countries, such as Germany or France, peripheral countries record divergences in terms of growth rates and employment levels.
Divergences among national cycles

- Returning to the issue of divergences, as a matter of fact data on discrepancies induced by the combination of asymmetric shocks originated at both the federal and national levels show that a potentially risky backlog of dangers for the survival of monetary integration has been already brought into being in the first EMU ten years.

- In the aftermath of monetary union, in the period 1999-2007, GDP growth, compared with a 15 per cent rise for Germany, reached 39 and 45 percentage points respectively in Spain and Greece, whereas inflation increase figures were 15, 32 and 33 per cent, in that order. At the same time trade competitiveness improved by 7 for Germany and worsened by 14 and 13 per cent in the other two countries.
More on divergences among national cycles

- As a result current account balance recorded a surplus of 7 for Germany and a deficit of 10 and 14 per cent in Spain and Greece (Matthes, 2009).
- Moreover, during the recent economic downturn markets started betting on a possible default of some member countries, with sovereign bond spreads jumping to 310 basis points over German bunds in February 2009 for Greece and 220 basis points for Ireland (Oxford Economics, 2009).
- Interesting enough, a couple of months later an online prediction market assessed at 20 per cent the probability that a member country could leave the euro area by end-2010 (Eichengreen, 2009, b).
Asymmetric shocks of national origin in Germany: 1

- A number of potential asymmetric shocks of national origin, which could develop within the main member country of the eurozone, Germany, with a negative drive that could derail EMU frail foundations.

- German policy makers have accepted with some reluctance to keep up domestic demand mainly in form of interventions in favour of private sector wages, as a transitional measure to stave off downturn, but just when recovery seems to be at hand they are behaving as not having learnt any lesson from the economic crisis and being slaves to some defunct economists, in this case the Chicago school scholars.
Asymmetric shocks of national origin in Germany: 2

- This is the reason which explains why they have been initially wary of launching a co-ordinated EMU-wide fiscal plan in front of the common downturn and have resorted only to national measures. Such an intellectual weakness makes clear also why they have in mind to go back early to their policy of strong fiscal discipline, reducing in a short time span public deficits. The danger is that a premature fiscal retrenchment risks repeating the mistakes made during the second phase of Roosevelt’s policies against the Great Depression, with the result of producing a new recession in 1937-1938.

- At the same time, in the longer term they seem not to be available to reflate their economy, by abandoning their beggar-thy-neighbour policy of wage restrictions and export-led (slow) growth model. As a result EMU member countries will be pushed to become more alike to Germany, but in the process of transition will be confronted with difficulties linked to structural reforms and quite slow growth rates, which could induce fiscal crises, giving rise to tensions within EMU (Tilford, 2009).
Asymmetric shocks of national origin in Germany: 3

• Such state of affairs could become explosive when a recently passed law introduced into the German constitution and obliging to reduce federal public deficits to 0.35 per cent of GDP in 2016 and to nil beginning in 2020 will come into effect. One wonders how it will be possible to co-ordinate fiscal policies within EMU if Germany and France, not to mention the minor member countries, seem to follow conflicting stances as to the role of public deficits as a means to smooth business cycles. Could the resulting strains be attuned with the stability of eurozone?

• A last point to underline by considering possible asymmetric shocks building up in Germany has to do with the decision of the Federal Constitutional Court of Karlsruhe on the approval of the Lisbon Treaty. The judgement has identified a juridical path allowing the German legislative to give its assent to the treaty, but at the same time has definitively stated the supremacy of the German law, as decided by the Parliament and interpreted by the Court itself, over the European juridical order.
Asymmetric shocks of national origin in Germany: 4

- This means that in the future any progress on the way of European integration will be in practice dependent on the veto of the German legislative. Of course in order to establish new advances towards an ever closer union, for instance new co-ordination powers given to the European Commission, the say of Germany is essential, as it is the agreement by other member countries, but with the Court’s judgement it risks to be subordinated to the defence of German national interests.

- As a case in point of the dangers of policies putting in jeopardy EMU stability, following the new assertive stance of Germany on economic governance of the eurozone, we can refer also to the recent debate on launching common Euro bonds for fighting the downturn and strengthening growth prospects within EMU.
Asymmetric shocks of national origin in Germany: 5

- The initial suggestion of Jacques Delors in 1993 to issue union bonds in view of financing a European-wide plan of infrastructures has been freshly relaunched by a number of policy makers and scholars, among whom De Grauwe and Moesen (2009).

- In particular the latter argue that distortions and externalities caused by recent increases in spreads of sovereign debt within the eurozone could be offset either by quantitative easing interventions by ECB targeted to government bonds of peripheral member countries such as Ireland, Greece, Spain and Italy, or by issuing euro bonds endowed with the collective guarantee of EMU governments.

- Adopting the second option could be Pareto optimal, provided some technicalities were respected in order to avoid free riding by high risk member countries, for instance by setting the bond interest rate at a weighted average of yields on the bonds issued by the different member countries and asking the latter to pay their share of the common yield on the basis of their national interest rates.
Asymmetric shocks of national origin in Germany: 6

- The proposals of a joint euro bonds issue have traditionally raised opposition by German policy makers, who fear to be damaged by two possible developments: the immediate increase in interest rates on borrowing over and above the domestic level, on the one hand, and a later high cost due to bailing out of member countries from default, should such an occurrence materialise, on the other hand.
- Arguments against euro bonds prevailing in Germany are well summarised in Koesters (2009). In a nutshell the issue of common bonds would violate the basic European economic constitution, putting at risk the BCE independence and could lead EMU to disintegration. After having described the lines of the Maastricht rules, which he defines as a kind of rudimentary political union, Koesters (2009) maintains that issuing euro bonds in favour of a country on the brink of bankruptcy would represent a violation of the no bail out clause, according to which debts pertain to single member countries, without any liability by the EU or other member countries.
Asymmetric shocks of national origin in Germany: 7

- As a result, moral hazard problems would emerge, allowing fiscal policies to diverge and braking the built-in process of structural reforms forecast by the Maastricht treaty in order to improve the adaptability of national economies. In addition if the spending of resources devoted to bailing out defaulting member countries would be controlled by a new European body such a new institution, the latter could develop into a “gouvernement économique”, imperilling ECB independence.

- Against this background, the recent developments within the German constitutional area we have shortly described, with the no deficit rule included in the Constitution and the interpretation by the Karlsruhe Court stating the primacy of national legislation over the European one, are preparing a dangerous ground for the survival of EMU in the long run.
Final remarks 1

• This paper has been mainly devoted to setting up a state of play concerning the stability of EMU by taking into account the most recent developments of OCAs theory and the most influential interpretations as to its possible break up.
• We have seen that the costs of withdrawal from the eurozone by a single country could be huge enough to refrain therefore it normally from secession, but that a self interested political class could well decide to take an adventurous decision with huge damages for the citizens.
• Once a member country gets out of the union, specific circumstances could be identified, leading to a general collapse of EMU.
• We have extended on the different kinds of asymmetric shocks, singling out those of federal or national origins.
Final remarks 2

- As a case in point of such state of affairs we have commented on recent developments in Germany, where the no deficit clause has been included in the country constitution and the Karlsruhe high court has in practice subordinated future developments in the European integration process to the defence of national interests as interpreted by the legislative or the court itself. All that could create a backlog of future instability, putting in jeopardy the continued existence of EMU in the long run.

- In order to prevent the different dangers we have encountered in our analysis to deteriorate the viability of monetary integration some political innovations are necessary in order to mend flaws in the design of EMU.
Final remarks 3

• In the short run a more effective coordination of national economic policies left to the responsibility of member countries would be welcome, but in the long run what is needed is a complete overhaul of the monetary integration by setting up a European body responsible for the fiscal policy, or a fully fledged European government.

• In the meantime we are observing the reactions by the European institutions to the downturn following the bursting of the property bubble, which is the real acid test for the survival of EMU, as Friedman had famously anticipated. Apparently the crisis has not produced institutional advances towards political union as many European integration supporters had expected.
Final remarks 4

• However as far as the EMU rules are concerned something new is emerging. Confronted with the real risk of a member country default EMU policy makers have unmistakably stated their will to bail it out, through a financial emergency plan.

• It seems that the way out from a possible crisis in monetary union due to the violence of some future asymmetric shock might not necessarily be the secession of some member countries with a likely EMU break up. An alternative solution in shape of possible advances towards experiences of political union seems also to be at hand.

• Perhaps Monnet, contrary to what Feldstein believed, was right.