



## POLICYMAKING IN THE EUROZONE AND THE CORE VS PERIPHERY PROBLEM

STERGIOS SKAPERDAS\*

Starting with Greece in early 2010 the eurozone crisis expanded, with rescue packages required for Ireland and recently for Portugal. While it is uncertain whether other countries will be directly affected so as to require outside intervention in the near future, the implementation of the IMF/EU/ECB troika policies in Greece and Ireland is running into trouble. Greece's debt-to-GDP ratio is projected to reach 153 percent by the end of 2011 (IMF 2011) and its projected public financing needs for 2012 go beyond what could be provided by the original rescue package of 110 billion euros. Ireland's relative condition in terms of similar variables is better, but the exposure to losses by its banking system is uncertain and the absolute numbers are problematic as well.<sup>1</sup>

It is hard to imagine how either country could continue with the current austerity policies coupled with an undiminished debt burden. Naturally, discussion and rumors of 'lengthening' existing loan terms, 'restructuring', and even 'default' appear continually in the press, contributing to further uncertainty about particular countries but also about the future economic prospects of the eurozone as a whole.

In this article I provide a perspective on the different policies that are potentially available within the eurozone, with emphasis on the differences between 'core' and 'periphery'.<sup>2</sup> In particular, I will argue the following:

- The strategies followed and the existing institutions are not consistent with the long-term viability

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<sup>1</sup> The IMF projects its debt-to-GDP ratio to stabilize at 120 percent from 2012 and beyond (IMF 2010).

<sup>2</sup> In the periphery, we could differentiate an 'outer' one that includes in addition to Greece, Ireland and Portugal, the newer entrants of Slovakia, Malta, Cyprus and Estonia, whereas the inner periphery would include Spain, Italy and Slovenia.

ty of a multi-country currency. In addition to more well-known problems, especially significant is the neglect of developing a coherent framework for the supervision and ultimate responsibility for the eurozone's banking system.

- The periphery's problems have exhibited varied symptoms that could have been expected to test the eurozone during its first serious recession. The ultimate problems lie with the institutional structure of the eurozone and, despite the expectations of its architects, the absence of any significant change in its institutions since its inception.
- The Greek and Irish packages have favored the banking sector and creditors and imposed the highest costs on lower-income citizens in both countries. In the meantime, the threat of continual contagion has not abated and the ultimate long-term costs of the crisis to the eurozone countries are likely to keep increasing.
- One possible factor in the policies that have been followed is the absence of any serious bargaining on the part of the Greek and Irish governments, at a time that the game within the eurozone has become 'zero-sum' or even 'negative-sum'. This is an unhealthy state of affairs not just for the people of the peripheral countries but more generally for the citizens of the European Union.
- In the absence of much closer political integration or other long-term policies that recognize and attempt to remedy the difficulties of a multi-country currency, exit from the eurozone for some of the peripheral countries cannot and should not be ruled out. An orderly procedure for exit, instead of a forced, disorderly one, would be desirable for all. In turn, thinking seriously about exit from the eurozone might make both peripheral and core countries appreciate the benefits of a common currency enough to make it politically viable and follow through with needed institutional changes.

### Weaknesses of the eurozone's institutional underpinnings

The euro represents a unique experiment since it is the first fiat currency without the exclusive backing

of a single state. From the moment it was conceived many economists had doubts about its benefits and long-term viability for strictly economic reasons, especially since the burden of external adjustment would be transferred from the exchange rate to the price and wage levels of countries without flexible labor markets (see, for example, Dornbusch 1996). The hope and expectations of at least some of its architects, however, were that the euro would force greater political integration (Eichengreen 2001). That is, there was recognition that the original compromises – including the limited powers of the European Central Bank, no substantial increases in the EU budget or a system of automatic cross-country taxes and transfers – were undertaken in order to make launching the EMU politically feasible. Nevertheless, the expectation was that, given economic pressures, in the medium and long run the institutional framework would have to be revisited and closer political integration would be seen as necessary.

The absence of fiscal coordination is the most commonly mentioned institutional weakness of the euro, yet it is instructive to briefly compare it to the fiscal coordination in the country with the world's current dominant reserve currency. The eurozone is of comparable population and economic size to the United States, but with less labor mobility across states and greater heterogeneity of laws, cultures, and politics that make adjustments to shocks, other things being equal, more difficult in the eurozone in the first place. Of course, other things are not equal. When a US state faces an economic shock, automatic as well as discretionary transfers from the federal government cushion it and help bring the state back to economic health. That is one function of fiscal transfers as well as of common tax and labor laws is the insurance role they play. As with any insurance scheme there can be incentive problems but it would be hard to imagine how the heavily industrialized Midwestern US states, where the US losers from globalization were largely concentrated, would have coped without help from the federal government.<sup>3</sup> Louisiana after the destruction brought about by hurricane Katrina is a starker example of massive assistance to a state facing an enormous shock. It is difficult to conceive how such an event could be similarly accommodated within today's eurozone.

<sup>3</sup> See Orphanides (2010) for a discussion of the insurance role of fiscal coordination and the mechanisms that could minimize moral hazard problems.

There is a tendency to focus on the rent-seeking aspects of a fiscal union, but no serious economic analysis can deny the crucial economic role of insurance in a monetary union in which individual states no longer have the tools that sovereign states normally have to cushion against economic shocks.

One significant institutional weakness of the euro that, to my knowledge, was not foreseen or even discussed at all before the financial crisis of 2007–09 was the fragmented supervision of, and absence of clear responsibility for, the banking sector. In what sense is a bank chartered, say, in Ireland but which receives much of its funding from German or French banks 'Irish' and is effectively the sole responsibility of Irish supervisory authorities? How can ultimately the default guarantor of such a bank's deposits and other liabilities be solely the Irish state? In a common currency area with free capital movements and with the express encouragement of creating a level playing field for banks across the eurozone, how can one expect the individual states of origin of the bank to be solely responsible for their supervision and deposit insurance, and be the ultimate bagholder of its liabilities? It is as if individual US states were to be responsible (perhaps with the assistance of the regional Federal Reserve(s) within which the state belongs) for the supervision and deposit insurance, and be liable for the losses of banks that are chartered by its states.

The reaction to the Irish crisis shows there is little recognition by eurozone political and economic elites that there is any problem with such a state of affairs and nothing fundamental is planned to remedy it. As the bubbles in Spain and Ireland continue to unfold, the probable restructurings and even defaults of several sovereigns, and the interconnections that exist among banks, the exposures of banks throughout the eurozone to losses in the medium term are uncertain and of possibly high value. Is anyone considering possible scenarios that would minimize the impact of such losses on the continent's economy? How, under a bad but probable scenario, are individual countries that cannot print their own currencies going to prevent, all by themselves, their banking systems from collapsing?

Given the limited degree of fiscal coordination and the highly fragmented supervision of the banking system, one would have expected the ECB to fill at least some of the institutional vacuum. As far as central banks go, however, the ECB is by design a weak cen-

tral bank. It has few supervisory functions that it shares with each country's central banks or other authorities and it cannot buy eurozone country debt directly. Moreover, in contrast to the US Federal Reserve that has the dual mandate of inflation and unemployment, its sole mandate is inflation. Thus, not only is the ECB limited in filling any of the supervisory and policy vacuums that exist from other sources of institutional weakness, it adds to them by the absence of an unemployment mandate. Of course, repeatedly during both the financial crisis and the sovereign crisis, the ECB has gone beyond the spirit, if not the letter, of the law and its mandate to provide special lending facilities and buy indirectly sovereign debt. Nevertheless, the exclusive inflation mandate and other restrictions on its policies limit the scope of actions it can take. In some ways, it resembles the US Federal Reserve before the Great Depression with its fragmentation among the twelve regional Federal Reserve Districts (Ahamed 2009) which, though, had the ability to conduct independent monetary and supervisory policies that have been shown to have had significant effects across regions (Richardson and Troost 2009).

In discussing some of these institutional weaknesses of the eurozone and comparing them to those of the United States, I do not mean to imply that the US institutions are in any way perfect. On the contrary, the breakdown of the financial sector's regulation over the past few decades that resulted in the financial crisis of 2007–09 shows the serious US problems, for which the rest of the world has paid and is still paying. However, the existing institutions appear to have averted another Great Depression, even though the regulatory problems of the financial sector that developed especially over the past two decades still persist – see Johnson and Kwak (2010), for a credibly pessimistic view of the future due to the absence of reform. Moreover, at least some of the intellectual roots of the recent breakdown of regulation in the United States appear to be similar to those that promote within the EU lax supervision and find no need for any institutional change in the eurozone.

Indeed, the view that no fundamental changes are needed for the functioning of the eurozone appears to be the consensus, if perhaps default, view within the political and economic elites of the core (that is, primarily those of Germany and France, with the former providing the leadership role). The European Stability Mechanism (ESM), agreed to in March 2011, does not confront any of the institutional weaknesses I

have discussed. Instead, it continues the practice of the imposition of seemingly hard rules and quantitative targets, like those of the Stability and Growth Pact. When the time comes for such rules and targets to be enforced there will be difficulties because doing so is likely to be neither optimal nor realistic.<sup>4</sup> That is, such rules and quantitative targets can be time inconsistent. One can understand the political constraints imposed by the financial crisis, the recession, and the increasing dissatisfaction by the populations in most countries on making fundamental changes, but there is also an absence of strategic vision and the political constraints are at least partly endogenous, due to the institutional weaknesses themselves. Whatever the reasons for this state of affairs, the strategies followed by the players in the eurozone's core cannot be characterized in game-theoretic terms as *cooperative*, in the sense of leading to long-run outcomes that could be anywhere near Pareto-optimal.

#### Varieties of failure, common causes

Given the serious institutional weaknesses, the problems of Greece, Ireland, Portugal, and beyond should not be surprising. There were problems lurking in the background that surfaced with the financial crisis and the recession that followed. Greece's problem was its fiscal policy and external public debt. Ireland, judging from its pre-crisis debt-to-GDP ratio, was the most fiscally responsible country of the eurozone, but the culprits turned out to be private over-indebtedness and its property bubble that led to problems with its banks, followed by the guarantees its government gave to the banks. Portugal had moderate debt-to-GDP ratios but through contagion it was perceived by the bond markets to be the weakest of the rest in terms of size, low growth, and fiscal vulnerabilities. Spain was also nearly as fiscally responsible as Ireland and it also suffered from a property bubble and high private debt, but has avoided the latter's destiny thus far probably because of its size.

Greece was the biggest violator of the Stability and Growth Pact's budget deficit limits and had the highest public debt. The Irish and Spanish crises can be considered largely an outcome of the unclear supervision of, and gaps in responsibilities for, the banks. Portugal has been a victim of the general economic

<sup>4</sup> For a more detailed critique of ESM, see De Grauwe (2011). For an analysis of mechanisms that build on the ESM, see EEAG (2011). A useful way of thinking about the constraints faced by individual eurozone countries is in terms of the two 'trilemmas', an economic and a political one, as analyzed by O'Rourke (2011).

malaise that it has experienced since adopting the euro and the power of the bond ‘vigilantes’, perhaps more so than any of the other countries since there was nothing specifically that was done wrong. But all countries experiencing a crisis have had, since the inauguration of the euro, a large expansion of overall indebtedness, whether primarily public or private, that was accompanied by an increase in their current account deficits. Over the same time period, these deficits were matched by an increase in Germany’s current account surplus.<sup>5</sup>

The problem is not Greek government profligacy or Irish carelessness. If Ireland or Greece were not part of the eurozone, another peripheral country would get into trouble sooner than later. The problem is structural: the weakness of institutions for a monetary union that consists of such diverse and heterogeneous countries that have no independent economic tools other than wage and price adjustments that have been historically known to be crude instruments.<sup>6</sup> With banking systems across Europe (and the United States) still fragile and austerity being fashionable beyond the immediate neighborhood of the crisis, low growth and recessions would threaten not just Spain but other countries in the periphery and even the core itself.

### **Giving in without bargaining: the Greek and Irish packages**

The Greek and Irish rescue packages provide loans from the IMF and the other eurozone countries with high interest rates conditioned on fiscal programs that prescribe: budget cuts and tax increases; legal changes in labor market institutions, in financial regulation, in professional accreditation, in retail and other markets; as well as possible privatization of state assets. Whereas the fiscal measures have the objective of increasing the countries’ ability to repay their existing debt and return to the private bond markets, other measures, especially for Greece, were partly meant to hasten internal devaluation and change domestic institutions in ways that will ostensibly make the economy more internationally competitive.

<sup>5</sup> See Economist Intelligence Unit (2011) or Lapavistas *et al.* (2010, Fig. 14, 27). Lapavistas *et al.* (2010, 1) thus characterizes the eurozone as follows: “monetary union is a “beggar-thy-neighbour” policy for Germany, on condition that it beggars its own workers first”. Wage stagnation in Germany, a conscious policy decision, plays a prominent role in this argument.

<sup>6</sup> See Ahamed (2009) for a discussion of the Britain’s painful and persistent attempt to return to the Gold Standard at pre-World War I exchange rates.

Thus far, bondholders have been kept whole in both countries. The principal of retiring debt is fully paid and is being replaced by the IMF/EU loan disbursements. The burden of adjustment has fallen wholly on the taxpayers in the peripheral countries. In particular, for Greece, where the VAT and other indirect taxes are a high proportion of total taxes and wage and pension cuts have had the most impact on middle and low income earners, the burden of adjustment is falling on almost everybody else except for those who are most responsible for the country’s predicament: its political and economic elites, who also continue to evade income taxation and can most easily move their liquid assets outside of the country.

At the moment, the citizens of other eurozone countries providing the loan funds are enjoying a healthy return, despite a reduction in the interest rates charged, and these loans hold the most senior position in the debt hierarchy of Greece and Ireland. The risks to eurozone citizens lie elsewhere. First, there are contagion and systemic risks that the continued sovereign crisis has for their own economies. Second, there is some indication that at least some of the periphery public debt originally held by banks in the core countries has migrated into the balance sheets of the ECB and the banks of the periphery. In the event of restructuring or default of any peripheral country, the ECB’s losses could be sizable, something that will require its recapitalization by taxpayers. Of course, the systemic and contagion risks are of much higher importance than the potential cost of the ECB’s recapitalization but it is important to keep in mind that this is another implicit and indirect subsidy to bondholders, especially to the banks of the core.

Thus, so far the eurozone’s sovereign debt crisis has had the following distributional consequences: existing holders of the previously contracted debt, subordinate to the IMF/EU loans, continue to receive principal and interest although the market value of this debt has declined. In the event of restructuring or default, banks and pension funds of the periphery and the ECB are likely to face the most losses. The middle class and the poor of the periphery are the biggest losers, whereas the citizens of the other eurozone countries face contagion and systemic risk and the potential cost of ECB recapitalization in the future.

Such a distributional outcome was not the sole feasible one. Even without the more systematic measures one would have expected in a more politically inte-



grated monetary union, the initial package for Greece could have included a significant ‘haircut’ for existing bondholders, something that would have reduced the depth of the country’s recession, decreased the burden to those who can least afford it, made the remaining debt more sustainable, and, arguably, have reduced the threat of economic contagion to the rest of the eurozone. In the case of Ireland, even with the bank guarantee, having the bondholders of the private Irish banks take losses would have been politically easier than having haircuts on Greek public debt since the expectation that a country has any obligations towards the bondholders of banks that have made bad bets is absurd on its face.<sup>7</sup> In both cases, it is clear that the interests of bondholders on the one hand and the citizens of Greece and Ireland on the other were diametrically opposed, but the bondholders did not have to bear any costs as an outcome of negotiations, that is, if there were any real negotiations.

For it appears that the Greek and Irish governments acquiesced to the troika’s conditions without much, if any, bargaining.<sup>8</sup> Using just the threat of contagion of a banking crisis to the rest of Europe discretely but skillfully should have given some bargaining leverage to the two governments of the periphery. The language used itself that the packages were ‘rescues’ or ‘bailouts’ of Greece or Ireland, instead of primarily of the creditors and the elites of Greece and the creditors of Irish banks hints at the nature of the problem. Politicians and bureaucrats of the European periphery are subtly subordinate to those in the core and can sometimes believe their own press and internalize rhetorical proclamations of ‘European solidarity’ or ‘that we are all in this together’. Such proclamations do have their place but cannot be taken seriously in preparing one’s side. Without awareness of the different objectives, no further steps can be taken to create a strong bargaining position. Instead of being an independent actor, one becomes *cognitively captured* by models of the world that go against the interests of your country’s ordinary citizens.

Awareness of differences in interests and objectives between periphery governments and troika representatives is especially important for the citizens of the periphery in view of the abandonment on the part of

the core’s decision-makers of any semblance of cooperative, long-term strategies in the eurozone that we have already discussed. Only with awareness of the differing objectives, the bureaucratic apparatus of a government could be directed to produce data and arguments that would favor its citizens’ interests. If IMF experts want to apply their cookie-cutter approach used in other countries, the government should be able to come up with arguments about the harm that particular reforms could induce. For example, in Greece it is unclear how many of the proposed changes in labor market institutions serve the long-term interests of ordinary citizens, the country’s future growth, and therefore ultimately the ability of creditors to be paid back. As argued by Rodrik (2011), the idea of one-size-fits-all institutions can be very harmful. The IMF itself is gradually recognizing that allowing local variations in its institutional reform recommendations could well lead to better final outcomes for all. To do so, though, requires independent thinking, awareness of differences of objectives, and ability to argue and bargain on the part of target governments, something that may be lacking in both the case of Greek and Irish governments (perhaps including the newly elected government of Ireland).

Since part of bargaining is the presentation of evidence and the development of arguments, timidity in bargaining also prevents the identification of other problems down the road and the discovery of potential new solutions that is to the benefit of all parties. Timid bargaining by the periphery along with short-sighted choices made in the core, often influenced by yesterday’s tabloid headlines or next week’s special election, do not make for policies that serve the interests of either the periphery’s or the core’s citizens.

### Greater political integration vs exit

Under current scenarios, it is hard to imagine how Greece and Ireland can go back to the international bond markets after 2012. Conditions are unlikely to become easier for Portugal, Spain and beyond. Since there is no appetite for any closer political integration and substantial changes in the policies followed towards the periphery, the practice of ‘kicking the can down the road’ will likely be followed until a crisis cannot be averted any longer. Greece will most likely reach such a stage first. In a bad scenario, after repeated failures of Greek governments to meet the Memorandum of Understanding targets, an impasse

<sup>7</sup> In the case of the biggest commercial bank failure in the United States, that of Washington Mutual, the bondholders were completely wiped out as part of the deal that had the bank absorbed by JPMorgan Chase.

<sup>8</sup> For examples of such absence of bargaining on the part of Irish officials, relying apparently on some inside information, see Kelly (2011).

will be reached between the troika representatives and a Greek government that will not become bridgeable by the European Commissioners, the ECB, or the German Chancellor. The core's decision-makers, fed up with repeated unfulfilled promises by Greek officials, will demand collateral that no Greek politician could ever give. Under such a scenario, the country will default on its foreign obligations and enter into discussion with its bondholders. In response to a bank run, the government will impose ceilings on withdrawals and take other emergency measures, including possibly temporarily suspending the Schengen agreement. European officials' uniform message will be that Greece was a special case with clearly unsustainable public debt from the beginning and they did the most they could to help the country, that Greek debt is not that important for European banks, and there is no objective reason that investors should be worried about the debt of other countries with much lower debt burden. Greek officials will expand the practice of issuing IOUs to government contractors but the lack of cash will hamper ordinary market transactions. After a few days of chaos, on a Friday afternoon, the government could announce that Greece will be exiting the eurozone 'temporarily', effective immediately. Banks will be closed for a few days during the following week, until they are supplied with 'euro coupons' that will themselves be converted to 'new drachmas' after they are printed. The government also could well announce that all public debt contracted under Greek law will now be denominated in the country's new currency.

If such a series of events were to take place, the repercussions will likely be worse than the bankruptcy of Lehman Brothers, without the comparable powers of the Federal Reserve and the US government to provide deposit insurance to money market funds and to offer the slew of lending facilities and fiscal measures as mechanisms to cushion a downward spiral. Thus, the persistent question for the eurozone is how to possibly cushion against such an event, given the very limited political maneuvering room that exists in changing institutions. De Grauwe (2011) has argued for a strategy of 'small steps, including the evolution of the ESM to a European Monetary Fund, issuing 'Eurobonds', and greater policy coordination. These are sensible steps but there is still much political resistance to them, it would take time to implement them, and it is far from clear whether they would be able to forestall a bad scenario like the one described above.

To avoid uncontrollable scenarios that have some likelihood of occurring, some flexibility has to exist about a country exiting the eurozone, and at least some routines about doing so need to be planned out and become institutionalized in the long run, even though in the short and medium run the planning will have to be done behind tightly closed doors. In cogent thinking that reflects the experiences of globalization, Rodrik (2011) argues that 'opt outs' or exit clauses should be an integral part of international economic rules: "any tightening of international disciplines should include explicit escape clauses. Such arrangements would help legitimize the rules and allow democracies to reassert their priorities when these priorities clash with obligations to global markets or international economic institutions. Escape clauses would be viewed not as 'derogations' or violations of the rules, but as an inherent component of sustainable international economic arrangements" (Rodrik 2011, 244).

There is probably more political support within the eurozone for such an escape clause than there is for a single measure like the creation of Eurobonds. Exit is a technically and logistically very difficult task with unforeseeable contingencies. No country would ever do it lightly, especially since such a country would be more likely to be one from the periphery, with memories still fresh of inflation and exchange rate instability from pre-euro times. The upheaval that can be expected from a eurozone exit will be inversely proportional to the amount of planning that is undertaken before such an event occurs.

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