Comments on Paul De Grauwe and Yuemei Ji

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A commendable aim:
Revisit the 2010-2012 crisis to learn how to prevent the next one

- Undisputable observations
  1. The crisis: not asymmetric *shocks* but asymmetric *cycle amplification*
  2. A private credit / balance of payment story rather than a fiscal profligacy story
  3. Public debt accumulation in the 2000s a poor predictor of 2010-2012 spreads
  4. But history matters: Spreads of the 1990s are good predictors
  5. Why? accelerated interest rate convergence triggered boom-bust cycle

- Disputable claims
  1. Institutional quality a second-order factor: core can become periphery and vice-versa
  2. Asymmetric cycle amplification is a permanent feature of the euro area
  3. Common budget the most effective way to address the problem
  4. Only consolidation of significant part of national debt into euro-area debt (hence political union) can help address sovereign bond market instability

An equal-opportunity threat?

- True, mid-1990s conditions were a major reason why some countries were hit
- True, today's losers can become tomorrow's winners (and vice-versa)
- But is the next crisis an « equal-opportunity threats »?
- Scars are there - 6 crisis countries (Irl, Gr, Es, It, Cy, Pt) account for:
  - 32% of GDP
  - 32% of bank loans
  - 42% of public debt
  - 64% of NPLs
  - 23% of manufacturing capital stock
  - 56% of unemployment

➢ Even assuming that institutions have been reformed, too soon to claim that core and periphery could trade places

➢ No veil of ignorance in the short run > need to recognise that solidarity mechanisms are likely to benefit these same countries

Asymmmetric cycle amplification

- Contradictory claims: crisis was contingent but amplification is permanent
- Disputable however: amplification may be contingent
  - Amplification was driven by financial cycle
  - No evidence of amplification in the current upswing
  - But resilience major issue
- Amplification in the US linked to structural factors
  - Share of manufacturing in output
  - Resilience of individual states

➢ Should policy reform be designed to address amplification?

Policy remedies to cycle amplification: A case for a common budget?

- Case for a common budget rests either on:
  - Randomly distributed country-specific shocks
  - Insurance-type support to risky economic activities (innovation, long-distance export)
  - Common shocks that call for aggregate fiscal response

➢ In a pure cycle amplification model, common budget not superior to:
  - Individual fiscal stabilisation (assuming it is feasible)
  - Common rainy-days fund

How to deal with instability of government bond markets?

De Grauwe (2011) rightly identified the roots of fragility: multiple equilibria

- ➢ Response: liquidity support conditional on sovereign solvency
- ➢ Compatible with no-bail out clause
- ➢ ESM liquidity facility possibly backed by ECB

De Grauwe and Ji (2018) go further and claim that in a standalone country, the commitment of the central bank is « *unconditional mainly because in times of crisis the sovereign prevails over bureaucrats at the central bank* »

- ➢ Need to « mimic » central bank-sovereign relation in standalone countries
- ➢ Only unconditional ECB support can protect against multiple equilibria
- ➢ Amounts to fiscal dominance

Problems

- ➢ Central bank in standalone countries can be overruled, does not mean they commit to unconditional support
- ➢ Liquidity support to solvent sovereigns, not unconditional support is required in euro area