The Euro Crisis

JULIAN HODGE INSTITUTE OF APPLIED MACROECONOMICS

ANNUAL LECTURE

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He is a member of the Council of Economic Advisors to the German Ministry of Economics as well as former president of the International Institute of Public Finance (IIPF). Sinn holds honorary doctorate degrees of the universities of Magdeburg and Helsinki as well as HHL Leipzig Graduate School, and he has been honoured with the Maximilians Order. He is the author of more than 20 monographs and 135 scientific articles.

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In May 1999, Cardiff Business School and Julian Hodge Bank entered into a significant collaboration, resulting in the establishment of the Julian Hodge Institute of Applied Macroeconomics. The main aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. The Institute's research work further extends across international trade, money and banking, international finance and econometrics, in a collaboration between around twenty academics, mostly in Cardiff, and some thirty PhD students.

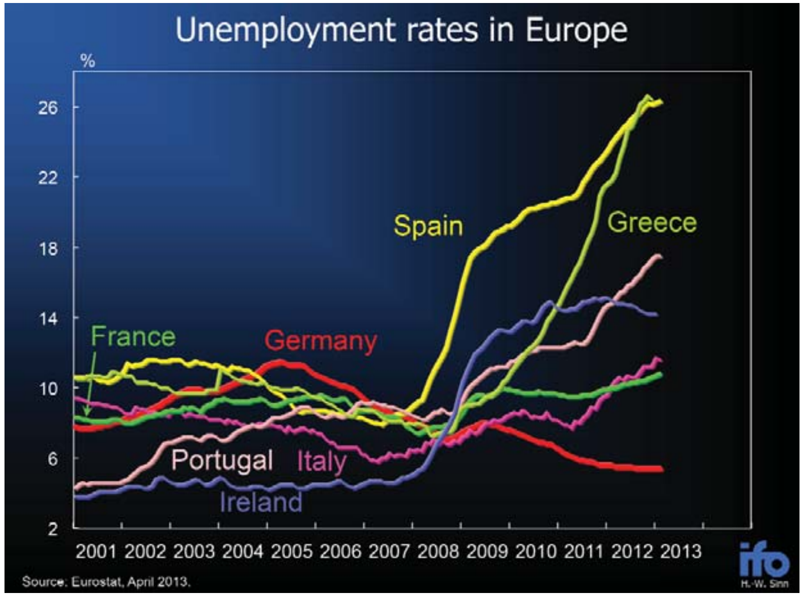
The institute's director since it was founded has been Professor Patrick Minford, of Cardiff Business School, who is also the Economic Adviser to Julian Hodge Bank. Apart from its research projects the institute carries on the forecasting and modelling work which Minford began at Liverpool University and has been based mainly in Cardiff for more than a decade, producing forecasts and policy analysis of the UK and other major economies.

The European crisis is a topic which interests us all. Twenty years ago the euro was introduced as a peace project for Europe. Alas, it has turned out to be the opposite. It's not war, of course, but it's not exactly peace either. There has never been as much animosity among the people of Western Europe in my lifetime. Southern Europeans are extremely frustrated with the situation, given their high levels of unemployment, in particular among the young; and Northern Europeans, Germans in particular, are also very frustrated, because they feel they are being swept into an uncontrollable liability spiral. So we are all trapped in a terrible situation. Martin Wolf recently said in one of his excellent columns that anyone who still thinks the euro was a good idea must be a masochist. I find very few economists in my country who still think the euro was a good idea. Some feel things are so bad that we should exit, while the majority thinks 'well, now we are stuck with it, we can't escape anymore': as with a marriage, the divorce is too costly, and that keeps you in. Very few would say it was a good idea. In theory, under different conditions, yes, they might. Indeed I too was a great enthusiast of the euro at one time. But if the question was: do we want this type of euro? Or no euro? Then I would guess most economists in Germany would say it would have been better not to introduce the euro.

If this is the opinion in Germany, the one major euro country that is doing well today, imagine what feelings about the euro must be elsewhere in the Eurozone, where an economic catastrophe is unfolding.

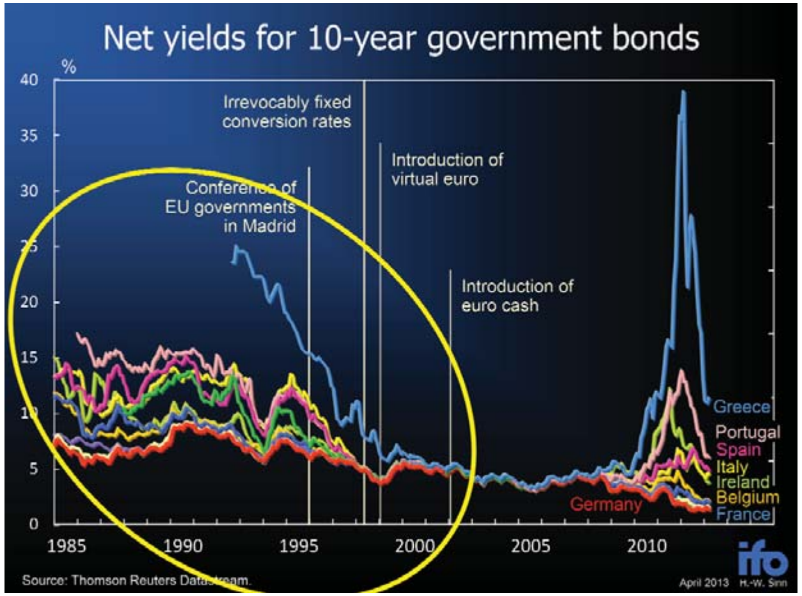
Germany did have its problems when the euro was introduced. Unemployment was very high, wages were too high, and two-thirds of Germany's savings were being invested abroad because conditions in Germany seemed so unpromising. Economic growth was the lowest of all European countries. Germany fell to 8th in GDP per capita, from second in 1995 when the euro was announced. Relative performance has improved since the crisis broke, so that Germany has climbed back to 7th place. Over the whole period, a rather bad performance.

But currently, the disaster is even bigger for the southern countries, in which I will include France because of its recent trends. Unemployment is on the rise, quite sharply in Italy, disastrously in Portugal (where the rate has reached 18%), and horrendously in Spain and Greece, with rates at about 27% and no end to the rising trend in sight, as shown by the chart below.



If you look at youth unemployment, the figures are even more catastrophic. Italy's youth unemployment is approaching 40%, Spain's 55%, and Greece's even 64%. Would even the most pessimistic economists have predicted such a mess 20 years ago?

How did it come about? To understand what happened under the euro, look at this chart for interest rates on ten-year government bonds; private bond rates would be similar. The red curve at the lower end of the spectrum is Germany. Notice the interest rate convergence of Portugal and Spain after the euro's introduction. The convergence was even stronger for Greece: for it, interest rates were 25% before the euro; afterwards, they came down more or less to the German level; now they have gone back up. This convergence did not result from the virtual introduction of the euro in 1999, but from the conference in Madrid in 1995 that announced its introduction and specified which countries would participate, and that in May 1998 exchange rates would be fixed. Greece joined a bit later, in 2001, and at once its interest rate came down.



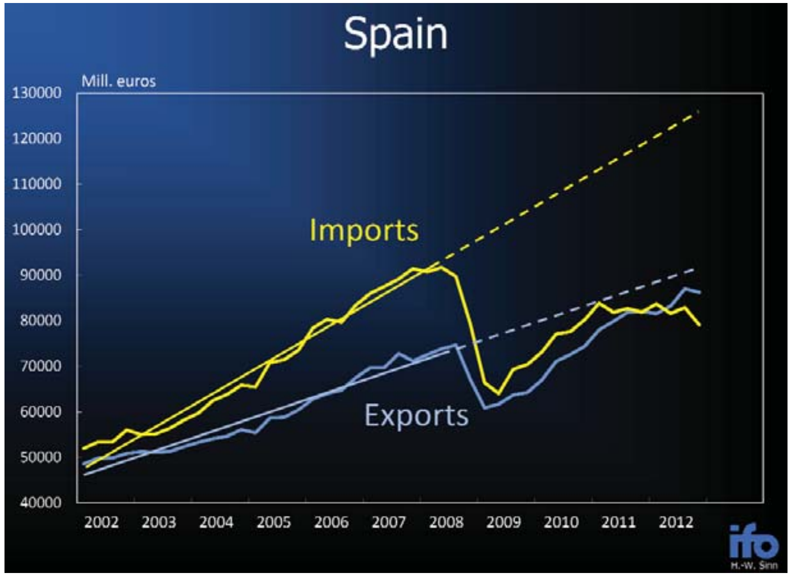
Why the convergence? Exchange rate risk disappeared with the euro, and no one thought that default was a possibility. Convergence was a big advantage for indebted countries: Italy, for example, devoted 12% of its GDP to servicing interest on its government debt before convergence. Afterwards, this fell to only 6.5%, and later to 4.5%. Had Italy saved all this interest rate advantage, its government debt-to-GDP ratio would not be 130% as it is today, but just 18%, well, adjusting for inflation, to 60%. But governments squandered it! While the existing debt became cheaper, there now was a new incentive to borrow. In Greece and Portugal, the governments financed excessive wage increases with money borrowed from abroad. In Ireland and Spain, foreign credit flowed through the banking sector to home owners, creating a bubble in the real estate and construction industry. In the end it did not really matter how the foreign credit entered these economies, whether via the government sector or via the construction industry, because in each case the other sector benefited as well. In Spain, construction workers paid taxes out of their credit-financed wages, enabling the government to spend more; in Greece, government employees bought homes with their credit-financed wage increases, boosting the construction industry.

Some say we have a sovereign debt crisis in Europe; yes, of course we do. But that is too narrow a focus. We have a sovereign and private debt crisis. There was a credit-driven growth process in those countries now in crisis. To be sure, productivity increased, but the inflationary process was significantly more relevant, with wages increasing far more quickly than productivity, such that prices went up too. Huge current account deficits developed. In Germany, meanwhile, the opposite occurred: it went into a slump that pushed up unemployment and drove down wages, so that imports fell against the trend and exports rose. The counterpart of these developments could be seen in capital flows: German savings, in the form of its current account surplus, flowed out to other countries as credit, financing their current account deficits.

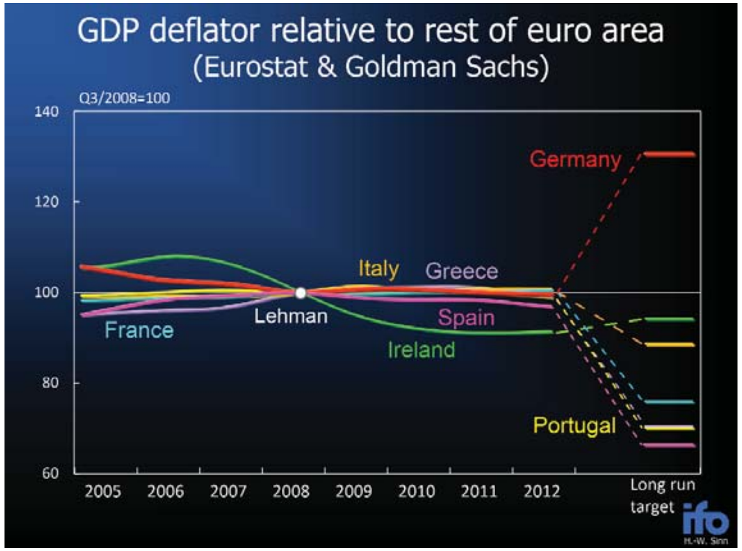
This was the period when for most countries the euro seemed to function well. Everyone in the south was happy because cheap foreign credit meant fast growth. The situation in the north, Germany in particular, was much less favourable, since unemployment was rising sharply, forcing the government to painful social reforms that made wages downward-flexible. The situation in the labour market gradually improved only after 2005, largely due to the boom in exports which partly compensated for the decline in construction and other non-trading sectors. But, as you can see, there was an inflationary credit bubble in the south.

From the Madrid summit in 1995 to 2008 and the crisis, all Southern countries experienced enormous price increases. In Slovenia and Slovakia inflation was also huge, but since they started from communism the numbers did not mean very much. At the lower end you have Germany, with the lowest inflation rate. Hence, the crisis countries appreciated in real terms relative to their trading partners, exactly by 30% over these 13 years, while Germany devalued relatively. These huge divergences led to today's difficulties, because the southern countries lost their competitiveness in the process. The problem for them now is how to reduce their massive current account deficits and restore their competitiveness.

You might think that the recent fall in these countries' current account deficits has solved that problem, showing light at the end of the tunnel in this euro crisis. If these deficits come down and turn into surpluses, the countries will be able to repay their external debts. Unfortunately, however, the progress so far is entirely due to the collapse of these countries' incomes; and such impoverishment is not a desirable solution to their debt problems. You can see this happening in the Spanish example.



What we need is not income effects, but what economists call substitution effects, whereby falls in relative prices reduce imports and raise exports, and therefore incomes.



The chart shows the size of the relative fall in prices needed, according to Goldman Sachs calculations, in all these countries (and how much German prices would have to rise relatively to them by implication) in order to restore competitiveness on a scale sufficient to permit these countries to return to growth but with current account surpluses large enough to enable them to repay their foreign debts.

We know from past experience, under the gold standard in the 1920s and 1930s, that austerity and deflation cause enormous problems. Being a member of a currency union such as the Eurozone means that competitiveness can only be restored by wage reductions and not by devaluation, and that does require austerity. The euro thus means that a solution is only available after a long extended period of pain, if it is available at all.

Germany had its own experience under the gold standard. Other countries had already exited or were about to exit. Germany was barred from exiting because the Dawes and Young plan forbade it. Thus, the country had to cut the prices internally to compensate: prices fell by 23% from 1929-33, and wages by 28%. This led to violent riots and brought the country to the brink of a civil war. What came in 1933 was, as you know, even worse. This tells us that realignments through price cuts are not really useful solutions.

One reason for the difficulties is that unions object to wage cuts, which is the old argument of Keynes. Another is that general price and wage cuts would drive highly indebted firms and households into bankruptcy. This is a particularly relevant argument in the Eurozone because their problems result from credit bubbles.

All the more amazing that Ireland did manage it. Why did it do it? If you talk to the people in Ireland you know that they suffered dreadfully. There were many personal bankruptcies, but still they succeeded in cutting their prices, up to 15% relative to the rest of the Eurozone. How did Ireland do it, while the others could not? My, admittedly speculative, explanation is that the Irish bubble burst earlier than the others, already in 2006, and that at that point the Irish had to cope alone. There was no perception of a general crisis among Europe's policymakers, no particular rescue programme from the ECB, nothing. So they had to help themselves. They were forced into austerity, into pushing down prices and wages, for lack of any alternative. Also, unions in Ireland seem to be less powerful than elsewhere.

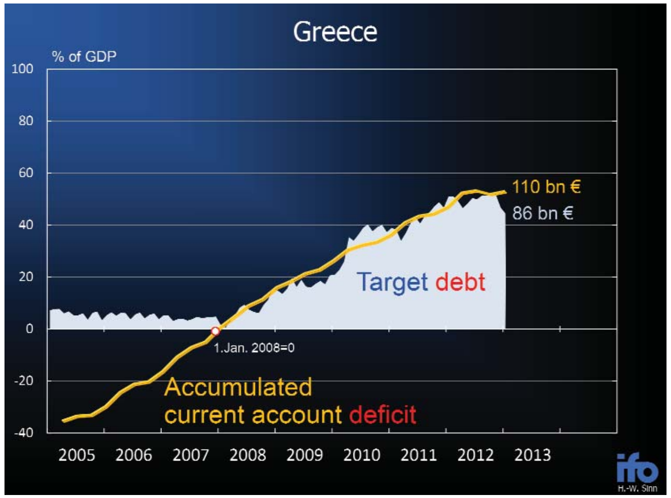
The other European countries came into similar difficulties together only after the Lehman collapse, two years later. They asked themselves, should we repeat the Irish austerity, or is there perhaps another possibility? They found one, in the form of their local central banks electronic printing presses. How can you gain access to it? By having the majority in the ECB Council agree to reduce the collateral requirements for refinancing credit. Indeed, these requirements have been reduced again and again to allow the southern countries and Ireland to provide more refinancing credit to their banks, replacing private credit at below-market conditions. In the case of Ireland, Portugal and Greece, the ECB Council even waived the rating requirement for government bonds that were used as collateral for refinancing credit from the printing press, after the rating agencies had given the government bonds of these countries' bonds a non-investment grade. Moreover, with only one-third majority, the national central banks could provide refinancing credit apparently at their own risk (ELA credit).

The Eurozone's national central banks are combined into the Eurosystem, which means that the ECB's electronic printing presses are local: it is a very decentralised system. So, if you have problems financing your business because the capital market shies away and demands excessive yields, the alternative option is to phone your central bank president and ask him to give you credit instead. That indeed was the solution.

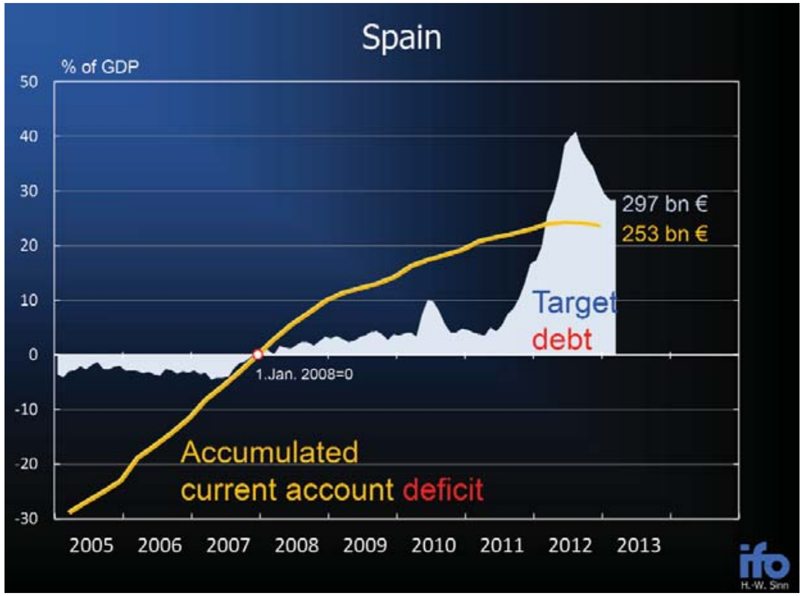
Chart 6 shows the extra money created in the GIPSIC countries as a result of this process of credit granted by national central banks, as measured by the so-called Target balances. The process started with the Lehman crisis in September 2008, when credit conditions imposed by external creditors on Southern countries began to tighten. To finance their external payments, that is, their current account deficits and debt redemptions, the banks in Southern countries turned to their own central banks for credit. The central banks lent them the funds, which they then paid to their external creditors in northern Europe and deposited in banks there; these banks, in turn, did not need this extra liquidity and deposited it at their central banks. Thus, in effect, the central banks of Northern Europe lent the central banks of Southern Europe large funds via the ECB's internal accounts. This credit is measured by the so-called Target balances in the central banks' balance sheets. Target is an acronym for 'Trans-European Automated Real-time Gross settlement Express Transfer system'. The amounts involved can be seen on the chart, rising by the end of 2012 to over 1 trillion euros and then falling back to around 800 billion euros in March this year.

The extra euros created in the South have been transferred to the North in exchange for goods and for the purpose of debt redemption. However, because the Northern banks have not lent on this extra liquidity but have deposited it at their Central Banks, no general expansion of money and credit around the Eurozone has occurred. This has led to the extraordinary phenomenon that today 80% of the stock of central bank money in the Eurozone had its origin in open market operations or refinancing credit provided by the national central banks of Greece, Ireland, Portugal, Spain, Italy and Cyprus. In Germany, for example, there exists no money that was created by refinancing or open market operations conducted in Germany. All money circulating was created by the Bundesbank by carrying out payment orders on behalf of other central banks of the Eurozone. One can picture the process as money being printed in the South that is then used for purchases of goods and debt redemption in the North, being effectively 'extinguished' in the North, where the extra inflowing liquidity through payment orders was not needed.

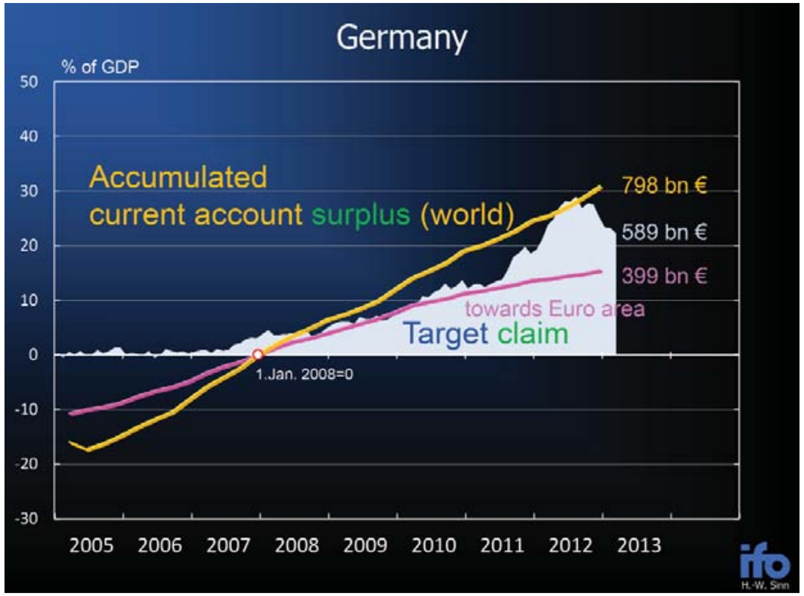
We can divide the process of money creation in the South, which results in Target2 balances, into two parts: one needed to finance the current account deficits, and another one needed to replace 'capital flight', typically in the sense of debt redemptions that became necessary as foreign investors were not willing to roll over their loans. The following charts depict this breakdown, with Greece and Spain as key examples, as well as Germany's as a key counterpart. The main component was clearly the current account deficit, but in Spain, for instance, capital flight came on top of that.



It can be seen that in Greece this process started gradually, from 2008, dictated largely by its current account deficit. Theoretically, the excess of Target liabilities over the accumulated current account deficit equals the net private and rescue fund capital export, but obviously there was no such excess. Thus, in net terms, the entire current account deficit was financed with the local printing press.



In the case of Spain, confidence started to erode seriously from the summer of 2011, with large-scale capital flight occurring in 2012. Since then confidence has been restored somewhat and capital has returned, helped along by official aid as well, so that by early 2013 the country's Target liabilities had fallen back towards the cumulative current account deficit. Public rescue funds did not play a major role at that time.



For Germany, it is the other side of the coin. The country accumulated current account surpluses with the rest of the Eurozone and with the world as a whole. The excess of German-held Target claims over its current account surplus with the rest of the Eurozone mainly measures the extent of financing by Southern central banks of their countries' deficits vis-à-vis non-euro countries. The southern countries print euros, buy Chinese textiles, say, with these euros, and the Chinese buy German cars. In the end it is the Bundesbank that pays the German carmaker for its sale to China, providing the necessary credit to the Southern Eurozone countries. The problem posed for Germany by these Target claims is that, if the euro were to break up, the claims it holds might not be honoured, or at least not in full. This risk, in turn, deprives Germany of its freedom to decide about its participation in further rescue operations to prevent the euro from breaking up.

To summarise the whole process, the aggregate stock of money balances in the Eurozone stayed more or less on a moderate trend. But the money was printed almost solely in the southern countries, enabling them to buy what they needed in other euro or non-euro countries and to redeem their private foreign debt.

I wrote a book on this in German, called the ‘Target Trap’, which came out last year. It sees Europe trapped: the southern countries are trapped with their high wages and prices, resulting from the credit bubble the euro caused, and the northern ones trapped in a liability spiral created by public rescue operations including those of the ECB. Europe stumbles along from one crisis to the next. The governments do something to prevent a big disaster and that helps for a while, until the next crisis comes around. And no one knows where this whole process will end up. Everyone is happy if the current crisis has been sorted out, praying that it won’t return.

The main way to keep the crisis from exploding has been via the ECB’s granting of credit to the Southern countries, through the printing of money that was then lent on to the banks. The banks often used this money to buy government bonds, which they handed in as collateral to their central banks. This was an indirect form of state finance, not forbidden by the Maastricht Treaty. In addition, however, the ECB financed the states directly by buying their bonds from the banking system. This may have violated article 123 of the Maastricht Treaty, which forbids the ECB from directly financing governments.

Policymakers in Germany found the ECB’s lending practices alarming, prompting them to agree to having the permanent rescue fund, ESM, buy the government bonds instead. But the ECB did not promise to stop buying government bonds after the rescue fund was set up. On the contrary, it even promised to buy unlimited amounts through its OMT programme. The German Constitutional Court in Karlsruhe is currently examining the matter.

The ECB system, as a result of its aggressive operations, is itself under risk today; it has an equity capital of 500 billion euros, but nearly 800 billion euros, as measured by the Target balances, in dodgy credit claims on the banks of southern Europe covered with low-quality collateral. Now the ECB wants the ESM to be able to recapitalise the banks of southern Europe, rescuing itself in the process. That is part of the banking union proposals being discussed. The next step might be Eurobonds, whereby European governments jointly guarantee the bonds issued by any member government to pay for its own expenses. A growing chorus is calling for Germany to ‘either accept euro-bonds or exit the euro’.

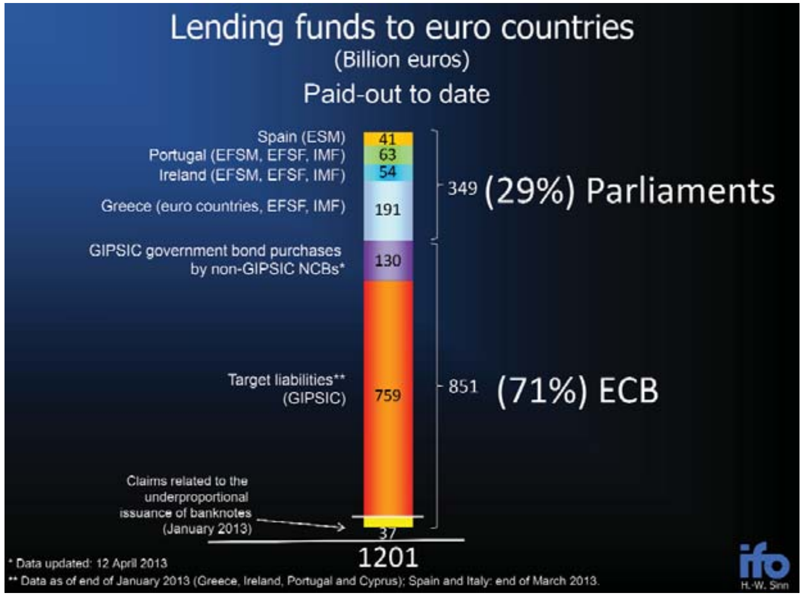
So it seems, if you will permit me a little joke, instead of the market we will now have two institutions allocating capital in the Eurozone: namely the ESM in Luxembourg, and the ECB in Frankfurt. They will determine at what rates of interest capital can flow from one corner of the Eurozone to another. It will no longer be the market. Thus far it has been the strength of capitalism that has made sure that behind each investment there is a wealth owner who has sleepless nights thinking about how to minimise his risk and whether he should relocate his funds. Not anymore.

WHY THIS POLICY IS FISCAL

1. Aggregate stock of money balances remains unchanged.
2. Electronic “reprinting” and “shredding” keeps regional distribution of money balances unchanged.
3. Pure credit shift across countries, very much like ESM credit.

COLLATERAL DAMAGE

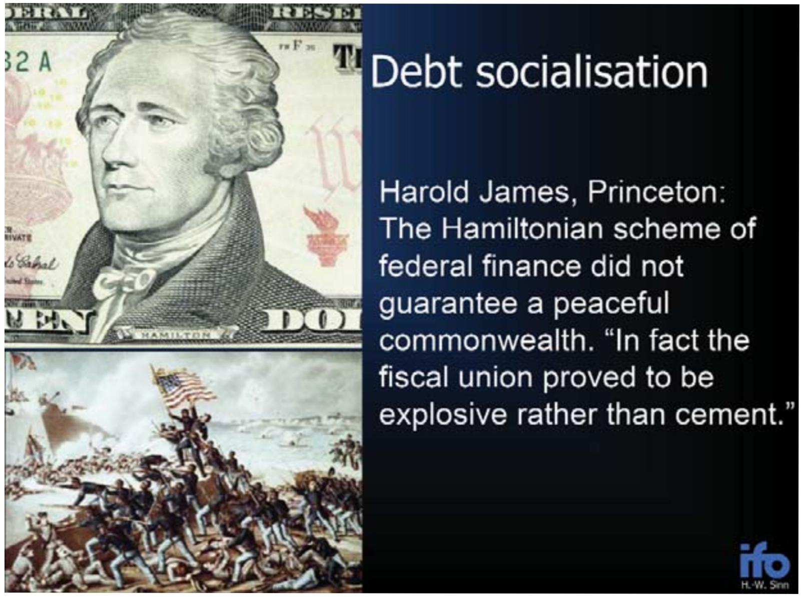
1. Wrong asset prices are supported artificially: capital stays away.
2. Wrong goods prices and wrong wages are supported artificially: structural current account deficits are perpetuated.
3. Revaluation of the euro undermines competitiveness: structural current account deficits increase.



No longer! Now the savings capital of the North is being escorted to the South to replace the capital market.

Some say this is right as the capital market is stupid. That has always been the argument of communists, but I do not think it is right. Experience has shown that government failure is much bigger than market failure when it comes to allocating scarce resources to alternative ends.

What I find most problematic is that private credit relationships are being shifted onto the public arena, out of the reach of civil law. With these rescue operations, private claims against southern creditors become public claims. The ECB has joined the ESM in creating a huge federal fiscal programme of debt socialisation across the Eurozone. Moving all these debts into the public arena is the recipe for strife and animosity across Europe. This is my greatest concern about what we are doing.



Do you know the person depicted above? It is Alexander Hamilton, the first finance minister of the United States of America; you will find him on the US ten-dollar note. In 1791 he socialised the states' debts. As these debts arose because of the war against the British, and because depending on where the fighting occurred there was more or less debt, he argued that it should be socialised and made into federal debt. This, he said, will serve as cement for the new American state. But did it?

Harold James, the historian from Princeton University, argues that it did not. Rather it acted as an explosive. Why? Debt mutualisation encouraged the single states to borrow even more afterwards. There was a second war against Great Britain, in 1813, followed by another debt mutualisation round. Everyone thought you could borrow freely, since the debt would be lifted to the federal level. You would be a fool if you did not borrow like everyone else!

A credit bubble built up in the United States that burst in 1837, and from 1837 to 1842 most of the American states went bankrupt, while the remainder were severely damaged. That was the end of debt mutualisation, since it had brought nothing but hassle and strife, its strains contributing to the other tensions that led to the civil war of 1861. According to Harold James, the unresolved debt problem was the second reason, after the slavery problem, which gave rise to the civil war.

EUROPE HAS THREE OPTIONS

1. Price cuts in periphery
2. Inflating the core
3. Temporary exits from the Eurozone or two separate currency areas

Europe now has three options.

The first is to cut wages and prices in the periphery countries through deflation. As mentioned earlier, this looks impossible. The resulting unemployment would impose intolerable strains on society.

The second is to create inflation in the Eurozone's core. If you believe the Goldman Sachs estimates shown above, Germany would have to inflate by 5.5% for 10 years to make Greece competitive without cutting Greek prices. I can assure you that Germany won't even entertain the idea. Even if the ECB tried to, official interest rates are already at rock bottom (a 'liquidity trap'), so that it is unclear whether they could do it. The Bank of Japan has tried for more than one-and-a-half decades, flooding the economy with money. What do they have to show for it? Deflation of many prices. The GDP deflator now is the same as in 1980. So this second option too is a non-starter.

The third and last option is for temporary exits from the Eurozone until the exiting countries recover fully. People rightly worry about bank runs and capital flight under such a scenario. We have seen the mess in Cyprus. Capital controls and limits to the amount of money to be drawn from bank accounts had to be put in place. While this is a terrible signal for the coherence of the Eurosystem, it means that Cyprus could exit today without further bank runs and capital flight. Of course there is a risk of contagion to other countries, but if so, an exit might also be to their benefit. They would return to competitiveness and be able later to re-join the Eurozone. In that case we would need a two-tier European system; maybe the exiting countries can even remain attached to the Eurozone, so that they do not have to exit legally. There are all sorts of models we can discuss, but after six years of crisis we cannot just continue with the palliatives and short-term measures we have used so far, hoping that everything will work out. We need to have a more fundamental approach to solving this problem.

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