# Macroeconomics at the Service of Public Policy

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# 2

# The European Debt Crisis*

*Hans-Werner Sinn*

## 2.1 The European crisis

During the night of 9–10 May 2010 in Brussels, the EU countries agreed a €500 billion rescue package for member countries at risk, assuming that supplementary help, to the order of €250 billion, would come from the IMF.[1] The pact came in addition to the €80 billion rescue plan for Greece, topped by €30 billion from the IMF that had been agreed previously.[2] In addition to these measures, the ECB also allowed itself to be included in the new rescue programme. Making use of a loophole in the Maastricht Treaty, it decided on 12 May 2010 to buy government securities for the first time in its history, instead of only accepting them as collateral.[3] Literally overnight, the EU turned the no-bail-out philosophy of the Maastricht Treaty on its head. Though, at the time of writing, in October 2010 the crisis has not yet been overcome.

In this chapter I criticize the rescue measures because of the moral hazard effects they generate and I offer an explanation for the crisis that is quite different from the mainstream line of thinking. I do not want to be misunderstood. I am not against rescue measures, but I opt for different ones that also make the creditors responsible for some of the problems faced by the debtors. Neither do I wish to dispose of the

* The analysis in this chapter reflects the state of affairs at the time of writing in 2010.

[1] *The European Stabilization Mechanism*, Council Regulation (EU) 407/2010 of 11 May 2010 establishing a European financial stabilization mechanism, online at <http://www.eur-lex.europa.eu>, 7 July 2010; *EFSF Framework Agreement*, 7 June 2010, online at <http://www.bundesfinanzministerium.de>, 5 July 2010.

[2] *Statement by the Eurogroup*, Brussels, 2 May 2010, and *IMF Reaches Staff-level Agreement with Greece on €30 Billion Stand-By Arrangement*, IMF Press Release 10/176.

[3] *ECB Decides on Measures to Address Severe Tensions in Financial Markets*, ECB Press Release of 10 May 2010 (<http://www.ecb.int/press/pr/date/2010/html/pr100510.en.html>).





euro. The euro has given Europe stability amidst the financial turmoil of recent years, and it is an important vehicle for further European integration. However, I will argue that the euro has not been as beneficial for all European countries as has often been claimed. The euro has shifted Europe's growth forces from the centre to the periphery. It has not been particularly beneficial for Germany, for example, and because of a lack of proper private and public debt constraints, it has stimulated the periphery of Europe up to the point of overheating, with ultimately dangerous consequences for European cohesion. Obviously, the construction of the eurozone, in particular the rules of conduct for the participating countries, needs to be reconsidered. So at the end of this chapter I propose a new political design for a more prosperous and stable development of the eurozone.

## 2.2 Was the euro really at risk?

Politicians claimed and obviously believed that the bail-outs were necessary because the euro was at risk. There was no alternative to a bail-out over the weekend of 8 and 9 May, it was argued, for the financial markets were in such disarray that Europe's financial system, if not the Western world's, would have collapsed had the rescue packages not been agreed immediately, before the stock market in Tokyo was to open on Monday morning at 2 a.m. Brussels time. The similarity to the collapse of the interbank market after the insolvency of Lehman Brothers on 15 September 2008 seemed all too obvious.

The question, however, is whether the euro was really at risk and what could possibly have been meant by such statements. A possible hypothesis is that the euro was in danger of losing much of its internal and external value in this crisis. However, there is little empirical evidence for such a view. On Friday, 7 May 2010, the last trading day before the agreement, €1 cost $1.27. This was indeed less than in previous months but much more than the $0.88 which was the average of January and February 2002, when the euro currency was physically introduced. It was also more than the OECD purchasing power parity, which stood at $1.17. Amidst the crisis the euro was overvalued, not undervalued.

Neither were there indications of an unexpectedly strong decline in domestic purchasing power because of inflation. Most recently, in September 2010, the inflation rate in the euro area amounted to 1.8 per cent. That was one of the lowest rates since the introduction of the euro. It was also much lower than the inflation rate of the deutschmark

during its 50 years of existence, which averaged 2.7 per cent between 1948 and 1998.

In this respect as well there was no evident danger. In danger was not the euro, but the ability of the countries of Europe's periphery to continue financing themselves as cheaply in the capital markets as had been possible in the initial years of the euro. The next section will try to shed some light on this issue.

## 2.3 The true problem: Widening interest spreads

The decline in the market value of government bonds during the crisis was equivalent to an increase in the effective interest rates on these bonds. In Figure 2.1 the development of interest rates is plotted for ten-year government bonds since 1994. Evidently, the interest rate spreads were widening rapidly during the financial crisis, as shown on the

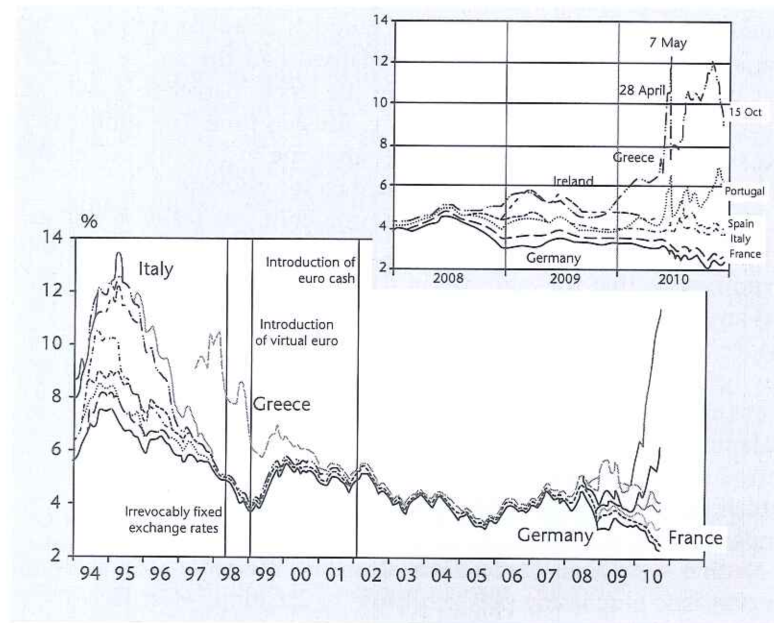


Figure 2.1 Interest rates for ten-year government bonds.

*Source*: Reuters Ecowin, *Government Benchmarks, Bid, 10 year, yield close*, 18 October 2010.





right-hand side of the diagram. No doubt, there was some danger, but it was a danger to very specific countries rather than a systemic danger to the euro system as such. Apart from France, which was indirectly affected via its banks' ownership of problematic state bonds, the countries at risk included Greece, Ireland, Portugal, Spain, and Italy (and to a limited extent Belgium), if the criterion was the increase in interest rates in the preceding months. The countries that were not at risk in terms of rising interest rates included Germany, the Netherlands, Austria, and Finland.

However, apart from Greece, even for the countries directly affected, the risk was limited. As the figure shows, interest spreads relative to Germany had been much more problematic before the euro was introduced. In 1995, Italy, Portugal, and Spain on average had had to pay 5.0 percentage points higher interest rates on ten-year government bonds than Germany.

The current crisis is characterized by a new divergence of interest rates. While the risk of implicit default via inflation and devaluation has disappeared under the euro regime, investors began to fear the explicit default of countries suffering from the consequences of the world financial crisis, demanding compensation by higher interest rates. Not only for Greece, but also for Ireland, Portugal, and Spain, and to some extent even for Italy, interest rates rose up to 7 May 2010, the day before the bail-out decisions of the EU countries were taken. After this agreement, the interest rate spreads did narrow for a while compared to the German benchmark, but after only a few weeks they were again on the rise with some easing in the weeks before the European summer holiday season.

Figure 2.1 shows why France and many other countries regarded the interest rate development as alarming. Before the introduction of the euro, they had suffered very much from the high interest rates that they had to offer to skeptical international investors. At that time, the interest premia on government debt that the investors demanded was the main reason these countries wanted to introduce the euro. They wanted to enjoy the same low interest rates with which Germany was able to satisfy its creditors. The calculation seemed to have paid off, because by 1998 the interest rate premia over German rates had in fact nearly disappeared. Nevertheless, now with the European debt crisis, the former circumstances threatened to return. The advantages promised by the euro, and which it had also delivered for some time, dwindled. This was the reason for the crisis atmosphere in the debtor countries, which was shared by the creditor countries' banks, fearing corresponding write-off losses on their assets.

## 2.4 The alternatives

Politicians claim that there was no alternative to the measures taken on 9 and 10 May 2010. This is, of course, not true. There are always alternatives, and it is a matter of choosing which one to take.

One alternative to the policy chosen by the EU could have been the American solution. As a rule, federal states in trouble in the United States are not bailed out. In US history, some states were even allowed to go bankrupt without receiving any help from the federal government. In light of the fact that Europe is a confederation of independent states rather than a union of federal states like the United States, it was not particularly plausible to organize a more extensive and generous bail-out than the USA would have done in similar circumstances.

Another, probably better, alternative would have been a bail-out procedure similar to the kind agreed, but preceded by a debt moratorium or haircut at the expense of the creditors. In private bankruptcy law, restructuring funds are not available unless a well-defined reduction of the creditor's claims is negotiated beforehand, so as to ensure that the help will benefit the troubled company rather than its creditors and induce the necessary caution in investment decisions. The risk of losing at least part of one's capital is essential for investors' prudence and for minimizing the risk of bankruptcy in the first place.

## 2.5 Trade imbalances

Many observers who have pointed to the imbalances in European development in recent years have obviously different theories in mind regarding the effects caused by the euro. They focus their attention on the goods markets rather than the capital markets and argue that countries that developed a trade surplus under the euro were winners of the European development. Germany, in particular, is seen to have profited from the euro. This view is often expressed outside Germany, but even inside the country it is shared by many politicians.

Recently, critics of the German development have even argued that the country should take active measures to increase its domestic demand instead of living on other countries' demand. French Finance Minister Christine Lagarde suggested that Germany increase its wages to reduce its competitiveness, because 'it takes two to tango',[4] and

[4] 'Lagarde Criticises Berlin Policy', *Financial Times Online*, 14 March 2010, <http://www.ft.com>.





IMF president Dominique Strauss-Kahn argued that in economies with persistent current account surpluses, domestic demand must go up, including by boosting consumption.[5] US Secretary of the Treasury Timothy Geithner wrote a letter to the G20 countries in which he proposed a rule, according to which countries with a current account surplus of more than 4 per cent of GDP (such as Germany and China) should take policy actions to increase their imports by boosting domestic demand.[6] While these statements are understandable, they only scratch the surface of the problem, demonstrating a misunderstanding of the forces that have produced the current account imbalances.

It is true that Germany has developed a large trade surplus that mirrored the trade deficit of other euro countries. This is confirmed by Figure 2.2 that compares the GANL countries, i.e., the former effective deutschmark zone consisting of Germany, Austria, and the Netherlands, with the rest of the euro countries. The GANL countries

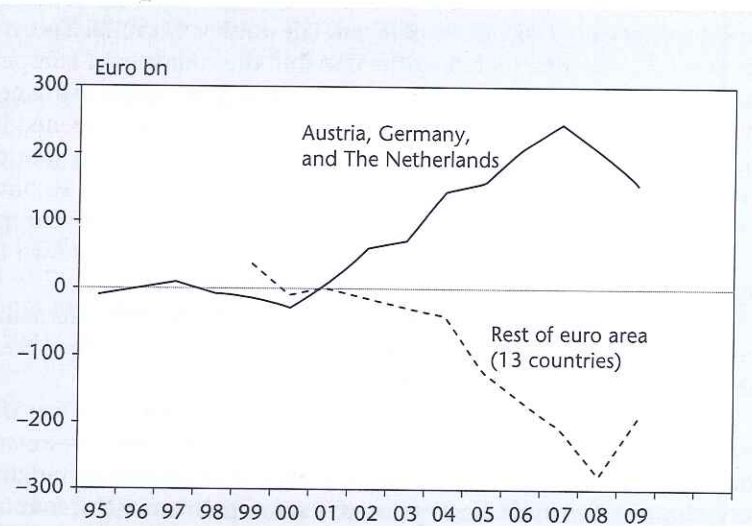


**Figure 2.2** Current account surplus = net capital exports.

*Sources*: Eurostat, Database, *Economy and Finance, Balance of Payments—International Transactions*; Ifo Institute calculations.

[5] *Closer Policy Coordination Needed in Europe*, IMF Survey online, 17 March 2010, <http://www.imf.org>.

[6] Reuters, 22 October 2010.

developed a current account surplus that culminated at a value of €244 billion in 2007, of which €185 billion was accounted for by Germany alone. By contrast, the rest of the euro countries accumulated current account deficits that peaked at €280 billion in 2008.

However, it is not true that this trade surplus has benefited Germany, at least not for reasons that have to do with demand effects. A trade surplus is basically the same as a capital export. Apart from a flow of money balances, a country's capital export equals its current account surplus, and the current account surplus is defined as the trade surplus minus regular gifts the country may make to other countries, for example via one of the EU's transfer systems. The terms 'current account surplus' and 'capital export' have different semantic connotations that tend to confuse politicians and the media, but for all practical purposes they mean the same thing.

Germany lost a huge amount of capital under the euro regime even though it urgently needed the capital to rebuild its ex-communist East. In fact, in recent years, Germany was the world's second biggest capital exporter after China and ahead of Japan. The outflow of capital has benefited other countries, including the USA and the countries of Europe's south-western periphery, all of which were sucking in capital to finance their investment and to enjoy a good life. The opposite happened in Germany. Except for Italy, Germany had the lowest growth rate of all EU countries from 1995 to 2009, and in fact, it had the second-lowest growth rate of all European countries regardless of how Europe is defined. The comparison with a selection of EU countries shown in Figure 2.3 illustrates Germany's meager growth performance.

In terms of GDP per capita in the period 1995 to 2009 Germany fell from third to tenth place among the EU15 countries. Even west Germany alone fell below France, for example.

Germany's low growth rate resulted from low investment. Over the period from 1995 to 2009, Germany had the lowest net investment share in net domestic product among all OECD countries, ranking very close to Switzerland that faced similar problems. No country spent a smaller share of its output on the enlargement of its private and public capital stock than Germany, after it was clear that a currency union would come and interest rates started to converge (see Figure 2.1).

Germany exported its savings instead of using them as loans for investment in the domestic economy. In the period from 1995 to 2009, Germans on average exported three-quarters of their current savings and invested only one-quarter. And once again, by definition, this was also identical to the surplus in the German current account.





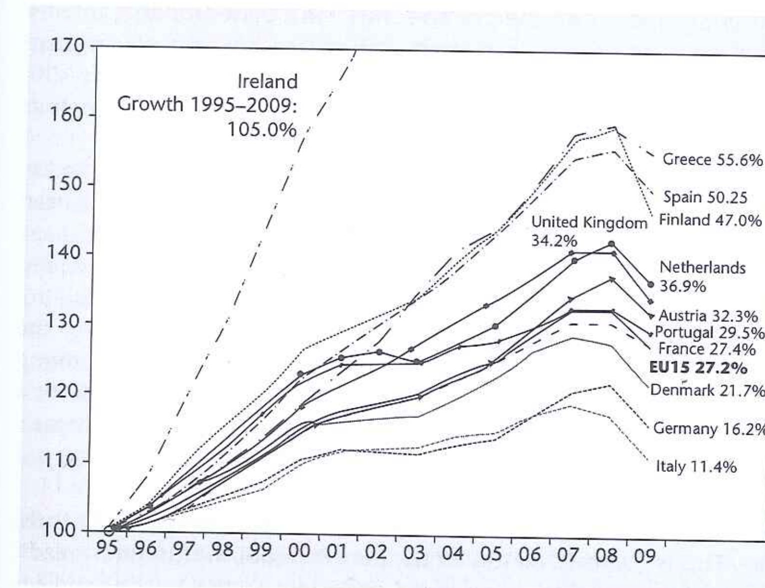


**Figure 2.3** Economic growth in selected EU countries. Chain-linked volumes at prices, 1995 = 100.

*Sources:* Eurostat, Database, *Economy and Finance, National Accounts*; Ifo Institute calculations.

If Germany is to reduce its current account surplus, it should take action not to export so much capital abroad but to use more of its savings at home. However, this would not be particularly good news for the countries of Europe's south-western periphery nor for the USA, whose living standard has relied to such a large extent on borrowed funds.

## 2.6 The future of the euro economy and the economic implications of the rescue programmes

Currently, the market seems to self-correct the current account imbalances. The previously booming countries of Europe's south-western periphery are caught in a deep economic crisis, and Europe is struggling to find a new equilibrium that fits the new reality of country risk. All of a sudden investors have given up their prior stance that country risks are only exchange rate risks. Investors now anticipate events they had previously thought close to impossible, and they want

to be compensated for the perceived risk with corresponding interest premiums. The increasing interest spreads for ten-year government bonds reflect this effect, although it has a much wider relevance, also applying to a large variety of private investment categories, such as company debt, private equity, shares, and direct investment.

In this light, the EU rescue measures must be regarded with suspicion. The €920 billion rescue packages agreed in early May 2010 have reduced the risk of country defaults and were designed to narrow the interest spreads and thus to soften the budget constraints in Europe once again. They have the potential of recreating the capital flows and refueling the overheating on Europe's periphery. If things go very wrong, the result could be an aggregate default risk for the entire system, pulling all euro countries into the vortex. What today is the default risk for a few smaller countries could end up in a default of the major European countries, with unpredictable consequences for the political stability of Europe.

Fortunately, however, the rescue packages were limited to only three years. This is the main reason for the persistence of the interest spreads. A month after the rescue measures were agreed, the interest spreads were even larger than on 10 May, the first day of the decision on the European rescue measures (Figure 2.1), and even in September 2010 there were many days with larger spreads.

If the rescue measures are not prolonged, this means that once again a toggle switch will have been flipped in Europe's development that will lead to a more balanced growth pattern, revitalizing the previously sluggish centre. The most plausible scenario for the Continent's future, from today's perspective (at the time of writing in October 2010), looks like this: Investors from the former deutschmark zone, including their banks, increasingly hesitate to send the national savings abroad, as they had done in the past to such an enormous extent. Due to the lack of suitable investment opportunities and heightened risk awareness, banks will seek alternative investment possibilities. They may try to invest in natural resources or new energies, but they will surely also offer better credit terms to domestic homeowners and firms. This will touch off a domestic boom in construction activity that will resemble that in Europe's south-western periphery during the previous fifteen years, if on a smaller scale. The two curves shown in Figure 2.2 will again be converging. This is what French officials and the US Secretary of the Treasury demanded so vigorously, but it comes endogenously as a result of the reallocation of savings flows and the resulting economic boom rather than exogenously through government-imposed measures.





## 2.7 A rescue plan for Europe

At the time of writing (October 2010), there are strong forces in Europe that press for a prolongation and strengthening of the rescue plan in order to complete the socialization of the country default risk and enforce a reduction in interest spreads in order to reduce the interest burden on public budgets in the countries of Europe's south-western periphery. Some even advocate going all the way to the issuance of eurobonds, i.e., replacing regular national issues of government bonds by Community bonds. However, this would be the end of European fiscal discipline and open a dangerous road where the debtors and their creditors could continue to speculate on being bailed out should problems arise. The European debt bubble would expand further and the damage caused by its bursting would be even greater. The risk of sovereign default would be extended to all the major countries of Europe.

Moreover, the current account imbalances would continue unabated. Thus, if the imbalances are to shrink, the rescue measures should not be prolonged unchanged, as many politicians demand.

This does not mean that Europe should fully return to the Maastricht Treaty without any rescue plan. But it does mean that the creditors would also have to bear some responsibility when sending capital to other countries, implying smaller capital flows and hence lower current account imbalances. A group of fellow economists and myself formulated a ten-point plan for a more stable institutional framework for the eurozone.[7] The following largely coincides with this plan.

1. Distressed countries can expect help only if an imminent insolvency or quasi-insolvency is unanimously confirmed by all helping countries and if the IMF helps, too.
2. Assistance can be provided in exchange for interest-bearing covered bonds collateralized with privatizable state assets, or by loans, the yield of which must be set at a reasonable amount (possibly 3.5 percentage points) above the European average. The accumulated credit thus provided must not exceed a given maximum percentage of the distressed country's GDP, say 20 per cent.
3. Before assistance is granted, the original creditors must waive a portion of their claims through a so-called haircut or debt moratorium. The maximum percentage to be waived must be

[7] W. Franz, C. Fuest, M. Hellwig, and H.-W. Sinn, 'A Euro Rescue Plan', *CESifo Forum*, 11(2) (2010), 101–4.

clearly defined beforehand in order to prevent a panic-fuelled intensification of the crisis. A reasonable haircut could be 5 per cent per year since the issuance of the respective government bond. This would limit the interest premium demanded upfront by the creditors to a maximum of around 5 percentage points.

4. The budget of the state facing quasi-insolvency must be placed under the control of the European Commission. Together with the country in question, the Commission would work out a programme to overhaul the state's finances, including reforms aimed at strengthening economic growth. Disbursement of rescue funds must be contingent on compliance with the conditions set forth by the rescue programme.
5. This quasi-insolvency process must in no circumstances be undermined by other assistance systems that could provide incentives for opportunistic behaviour, in particular by such mechanisms as eurobonds. A particular risk in the coming negotiations is that the capital exporting countries will be pressured to accept eurobonds in return for a quasi-insolvency procedure.
6. The deficit limit set by the Stability and Growth Pact should be modified in accordance with each country's debt-to-GDP ratio, in order to demand greater debt discipline early enough from the highly indebted countries. For example, the limit could be tightened by 1 percentage point for every 10 percentage points that the debt-to-GDP ratio exceeds the 60 per cent limit. A country with an 80 per cent debt-to-GDP ratio, for instance, would be allowed a maximum deficit of 1 per cent of GDP, while a country with a 110 per cent debt-to-GDP ratio would be required to have a budget surplus of at least 2 per cent.[8]
7. Penalties for exceeding the debt limits must apply automatically, without any further political decisions, once Eurostat has formally ascertained the deficits. The penalties can take the form of covered bonds collateralized by privatizable state assets, and they can also contain non-pecuniary elements such as the withdrawal of voting rights.
8. In order to ascertain deficit and debt-to-GDP ratios, Eurostat must be given the right to directly request information from every level of the national statistics offices and to conduct independent controls of the data-gathering procedures on site.
9. Finally, in case all the above assistance and control systems fail and insolvency approaches, the country in question may be asked to leave the eurozone by a majority of the eurozone members.
10. A voluntary exit from the eurozone must be possible at any time.

If these rules are respected, stability and prosperity of the eurozone will be strengthened, capital flows and current account imbalances will diminish, and the chances will improve that the European dream we have dreamt all our lives will become reality.

[8] A similar proposal was made by the EEAG. See European Economic Advisory Group at CESifo, 'Fiscal Policy and Macroeconomic Stabilisation in the Euro Area: Possible Reforms of the Stability and Growth Pact and National Decision-Making Processes', *Report on the European Economy* (2003), pp. 46–75.