How to Rescue the Euro: Ten Commandments

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There is no simple solution to the euro crisis, so expect just more muddling through. The peripheral countries are too expensive and should strive to become cheaper, but they will only do so if the flow of public funds gradually dries up, not if the EFSF is expanded.

The Economist argued in its editorial column on 17 September that the real cause of the crisis-stricken countries of the eurozone is a lack of credibility, that these countries need fiscal stimulus to grow out of their problems, and that voluminous rescue programs are needed to create a firewall around Europe's solvent governments (Economist 2011). Unfortunately, both the diagnosis and the recipes are wrong.

Why *The Economist* is wrong

The truth is that the cheap flow of credit for private and public purposes made possible by the euro until 2007 had fed an inflationary bubble that pushed prices for property, government bonds, goods and labour above the market clearing level and resulted in huge current account deficits and foreign debt levels that private investors have not been willing to finance and refinance since 2008. The eurozone suffers from a severe balance of payment crisis of the kind that ended the Bretton Woods system. Instead of merely lacking credibility, the stricken economies have lost their competitiveness. Instead of growing out of their problems, they need to shrink out of them (in nominal terms, to reduce their imports and boost their exports). And instead of a firewall, what the excessive rescue funds will create is a fire channel between the inflated countries and those that are still solvent, drawing them into a morass of debt.

It is surprising to see that *The Economist* does not even include the slightest hint regarding the problem of wrong, bubble-driven prices and the corresponding current account imbalances. It perceives the crisis as a temporary confidence crisis, but overlooks its deep structural roots. It focuses on a public debt problem, while entire economies, public and private sectors taken together, borrowed excessively from other countries, taking advantage of the demise of interest spreads once the euro was firmly announced. The current account deficits that the four GIPS countries (Greece, Ireland, Portugal and Spain) accumulated from 2002, the year the euro was physically introduced, to 2010 amounted to 932 billion euros, 7.0 percent of their joint GDP over that period. In the years 2005–2010, Greece's average current account deficit was 11.7 percent, Portugal's 10.8 percent, Spain's 7.6 percent, and Ireland's 3.7 percent of GDP. By the end of last year, the average net foreign debt position of the GIPS countries was 90.4 percent of GDP (95.3 percent for Greece, 90.9 percent for Ireland, 107.4 percent for Portugal and 86.6 percent for Spain). While the Portuguese and Greek debts resulted from government actions, the Irish and Spanish debt originated primarily from private borrowing, mainly in the construction sector. But that difference is irrelevant. In the end it does not matter whether the inflationary growth process originated with the government or the private sector. The cheap flow of credit unleashed by the euro pushed the prices in all four economies above their long-run equilibrium levels.

The balance of payment crisis

The bubbles that had built up in the GIPS countries burst when the American financial crisis deprived Europe's banks of substantial parts of their equity, forcing them to deleverage, and changed the market's risk perceptions. Private investors began to doubt whether the current account deficits were sustainable, balked at sending more funds to finance them and fled from those countries in order to safeguard their wealth. A balance of payment crisis erupted.

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In that situation, prices and wages should have fallen to reduce the current accounts and attract new capital from abroad. But that did not happen in most countries. Goods prices and wages got stuck at a level far above the equilibrium, cementing the current account deficits. From 1995, when interest rates started to converge in anticipation of the euro, to the crisis year 2008, the average price level of the GIPS countries increased by 23 percent relative to their trading partners in the rest of the eurozone. After the outbreak of the crisis, only Ireland underwent a sizeable real depreciation of about 12 percent, which is likely to result in a current account surplus this year, the first in a decade. Portugal depreciated by a mere 1 percent, and Spain and Greece did not depreciate at all. The relative price level of Greece increased by the amount of the VAT increase, while the level of net-of-tax prices grew in line with Greece's eurozone trading partners.

A reason for the failure to depreciate significantly can be sought in the ECB's explicit and implicit rescue actions that began in the summer of 2007. This was not just the much debated purchase of government bonds, which by now amounts to 157 billion euros. Much more important was the Target credit, a reallocation of ECB refinancing credit from the core, basically Germany, to the periphery beyond the credit necessary to endow these countries with a monetary base for internal circulation.[1] To be concrete: the mechanics of the Eurosystem implied that the Bundesbank gave credit to other euro countries at the expense of German banks to the tune of 390 billion euros (by August 2011) to allow them to crank up the money-printing press to finance their balance of payment deficits.

It was like in the Bretton Woods system. At that time, the United States had financed its current account deficit by printing and lending more dollars than the United States needed for internal purposes.[2] The dollars were flowing to, among other recipients, German exporters who had them exchanged by the Bundesbank for deutschmarks. The 'dollar-deutschmarks' crowded out the 'refinancing-credit-deutschmarks' stemming from the Bundesbank on a one-to-one basis, which meant that there was a public capital export from Germany to the United States *via* the central bank systems. At the time, it was assumed that the Bundesbank tolerated the process in order to help finance the Vietnam war. While the Bundesbank invested the dollars it received into US Treasury bills, the Banque de France insisted that the US government convert them to gold from Fort Knox. This destroyed the Bretton Woods system in the period 1968–1971. Today the Bundesbank converts the 'GIPS euros' into 'German euros', which then crowd out the 'refinancing-credit-euros' issued by the Bundesbank, and instead of foreign currency or foreign assets, the Bundesbank just receives claims on the Eurosystem that it will not be able to convert into anything.

Before the outbreak of the crisis, the Target balances were close to zero. But by June 2011 the four GIPS countries had built up a Target debt of 327 billion euros, while the Bundesbank's Target claims amounted to 337 billion euros in that same month. And the fast pace of that type of credit is breath taking. In August 2011 alone, the Bundesbank had to lend the ECB 47 billion euros for a further shifting of the stock of ECB credit to other euro countries.

In 2008, 2009 and 2010 no less than 88 percent of the aggregate current account deficit (capital import) of the four GIPS countries and 62 percent of Germany's current account surplus (capital export) was Target credit. While the Target credit was important in all four of the GIPS countries, there were substantial differences among them. In the three years mentioned, both Greece's and Portugal's current account deficits were entirely financed by Target credit. In Ireland the Target credit financed the entire current account deficit and, in addition, a huge capital flight, to the tune of 120 billion euros. By contrast, in Spain only about a quarter of the 200-billion-euro current account deficit was Target-financed.[3]

The credit provisions through the ECB system have not been deliberate policies insofar as they were endogenously induced by the GIPS countries' demand for funds which private markets were no longer willing to meet. However, the ECB has facilitated them through repeated lowering of the creditworthiness requirement for the collateral that banks had to offer for their refinancing credit. In effect, this was a rescue mechanism before the rescue mechanism.

[1] Cf. H.-W. Sinn and T. Wollmershäuser (2011), Sinn (2011a, 2011b and 2011c) and Wolf (2011). See also the special issue of ifo Schnelldienst (2011) with contributions of H.-W. Sinn, H. Schlesinger, W. Kohler, C.B. Blankart, M.J.M. Neumann, P. Bernholz, T. Mayer and J. Möbert and C. Weistroffer, G. Milbradt, S. Homburg, F.L. Sell and B. Sauer, I. Sauer, J. Ulbrich and A. Lipponer, C. Fahrholz and A. Freytag, U. Bindseil and P. Cour-Thimann and P. König, F.-C. Zeitler, K. Reeh.

[2] See Kohler (2011).

[3] See Sinn and Wollmershäuser (2011), Figure 14.

Opening or closing the tap?

The widely discussed open rescue mechanism being set up since May 2010 just came as a relief force helping the ECB to stem the tide, given that it was running out of ammunition. The rescue operations include the first package for Greece as well as the further help coming from the EFSM, the EFSF and the IMF, on the order of 332 billion euros. Together with the Target help to the GIPS until June 2011 (327 billion) and the current stock of ECB government bond purchases (157 billion), this amounts to a total of 815 billion euros. With the expansion of the EFSF to 780 billion euros decided on 21 July 2011, which will have to be ratified by the parliaments this autumn, the total volume of the planned and implicit rescue operations increases to 1.683 trillion euros, as shown in Figure 1. This is a bit more than half the 2011 public debt forecast for the GIPS and Italy by the end of this year, which amounts to 3.35 trillion euros.

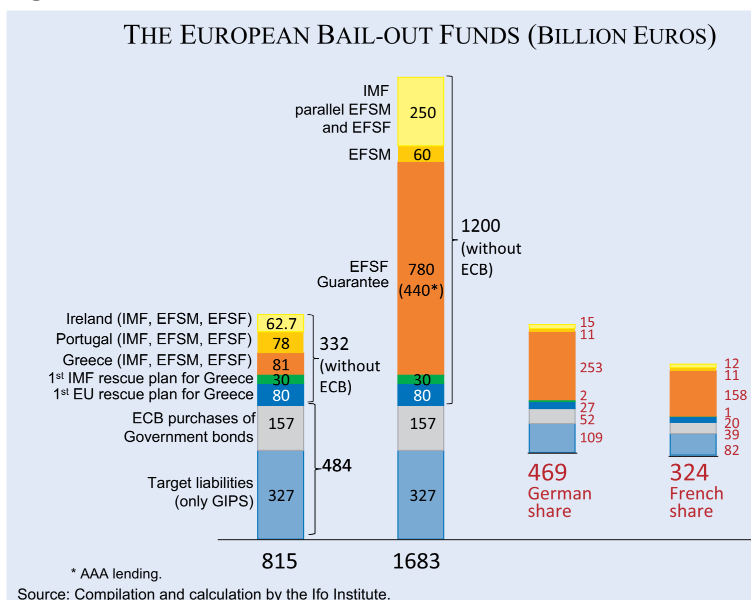
This is a huge sum, a multiple of what was on the table on 8 and 9 May 2010, when the first programmes were hastily put together over a weekend. If the GIPS countries go bust, Germany alone will be liable for 469 billion euros, and France for 324 billion euros. If, in addition, Italy defaults, the two countries will incur a liability of 522 billion and 364 billion euros respectively. If the liability materialises and is covered by public debt, the debt-to-GDP ratios of Germany and France would be 103 percent, in both cases, taking the Eurostat 2011 debt predictions as a basis. There can be little doubt that such sums would undermine the creditworthiness of the eurozone as a whole. What is called rescue programmes may, in fact, turn out to be incendiary channels through which the fire can expand and smother all public budgets in the eurozone.

Markets have already reacted by charging substantially higher premiums for credit default risks. The insurance for ten-year German Bunds now costs 1.2 percent per year, ten times the price before the crisis, and it has increased much faster than the British rate, overtaking it in August 2011, probably for the first time in history. While Britain has also been hit by the crisis, except for a limited help for Ireland, it has decided not to participate in the euro rescue operations.

It is not only that France and Germany may already have taken on more than they can bear. What is more, the rescue measures perpetuate the current account imbalances and slow down or prevent the necessary process of real depreciation. After all, in countries that are cut off from the capital markets, the flow of rescue funds is identical to the current account deficits.

The rescue measures also destabilise markets inasmuch as they try to support asset prices above their long-run equilibrium. This creates a permanent downward risk that causes renewed jitters whenever doubts arise regarding the depth of the rescuers' pockets. This aspect, too, reminds of the times when governments tried to maintain inappropriate exchange rates, or used up their reserves to temporarily stabilise them, causing even larger disruptions when they had to give up. A frightening scenario is therefore that each new flaring of the crisis will drain more money from the creditors' purses, until they run empty and the euro collapses. As long as public credit continues to flow, the deficit countries can continue to be financed, but when it stops flowing, some of them may prefer to leave the euro in order to try to bring back their finances to order through depreciation. Then both the euro and the core countries will be ruined.

Figure 1



THE EUROPEAN BAIL-OUT FUNDS (BILLION EUROS)

* AAA lending.
Source: Compilation and calculation by the Ifo Institute.

Given that this autumn public financing of the crisis countries has gone into its fifth year, the view that markets are merely dysfunctional and overstate the problems seems not well founded, and neither does the view that unlimited rescue funds should be provided to calm them. If stable countries like France, Germany, the Netherlands, Finland or Austria are not to become impoverished or the euro to collapse due to growing foreign debt levels, it is necessary to gradually but steadily close the tap for new loans rather than invent ever more channels and programmes to provide liquidity to insolvent countries.

If the tap is closed too quickly, this process could be accompanied by severe real contractions, but if it is sufficiently gentle, a mere real depreciation by cutting wages and prices relative to the trading partners in the eurozone will suffice to improve the current accounts and reduce the level of external debt. Germany before the crisis and Ireland after the crisis have demonstrated that this, though painful, is possible in principle.

European politicians argue that opening the tap and imposing a political debt constraint under common EU control, for example *via* the Euro Plus Pact, the new six-pack of the Commission or even a fiscal government for the eurozone, would be a sensible solution. While this view looks plausible at first glance, it seems to stem from the old days when markets were willing to finance the debtor countries and mere political debt constraints were necessary to discipline them. This is not the situation today. Given that private markets are no longer willing to finance the afflicted countries, such debt constraints are not only superfluous; they may even be counterproductive. What is called political debt constraints will, in effect, turn out to be entitlements to use the public debt machinery set up within the EFSF and the Target system. Europe does not need to place constraints on the demand for public debt if the supply constraints the creditor countries impose are sufficient.

What the eurozone needs is a crisis resolution mechanism, together with tighter constraints for the ECB that stop the self-service mechanism currently prevailing. It also needs to define how much help will be available under what conditions. The mechanism has to be specified before the respective funds for the new European Stability Mechanism planned to start in 2013 or earlier are set up, for otherwise the creditors will lose their bargaining chip. The '10 commandments' formulated below would lead the eurozone out of its crisis by gently tightening the budget constraints, turning it into a place where markets can better perform their allocative function.

Ten commandments for a renewed eurozone

The 'commandments' limit the scope for political *ad-hoc* actions and specify a crisis procedure that is a compromise between the goals of maintaining discipline and preventing panic in the case of a crisis. They balance out the need to help with the need to respect the stability and solvency of the rescuing countries. The crisis countries will themselves then be able to decide whether they see a possibility of managing the real depreciation process or whether they find the burden too large and prefer exiting the eurozone. The procedure gives them a fair chance and a safe option if they are willing and able to find the necessary internal consensus. It does provide much more solidarity than the Maastricht Treaty foresaw, without establishing a self-service shop for debtors.

In detail, the following measures could be taken:

1. No government bond purchases
Further purchases of government bonds by the euro rescue fund EFSF and the ECB are prohibited. Only assistance programmes that count on the participation of the IMF are allowed. Eurobonds are ruled out permanently. Even in a putative United States of Europe there is no place for them. Both the United States and Switzerland, two decentralized fiscal systems that originated through a long trial and error process, do not foresee this kind of help.

2. Paying back the Target credit
The credit given by the Bundesbank (Target) to the GIPS is not to increase further. The Target balances are to be settled once yearly with marketable assets bearing market interest rates, as is the case in the United States. Transition rules for the existing balances could be agreed upon.

3. New voting rights in the ECB
Voting rights in the ECB Council should be weighted by ECB capital shares.

4. Unanimity for credit policies
The ECB Council is to require unanimity and the approval of the creditor countries' governments for any inter-country credit transfers that it tolerates or induces.

5. Liquidity help for two years

The EFSF is to concentrate on liquidity assistance for crisis countries and limit such assistance to two years.

6. Slicing the problem in the case of impending insolvency

If a euro country cannot service its debts after the two years, an impending insolvency instead of a mere illiquidity is to be presumed. In such a case, and under exclusion of the cross-default rules, an automatic haircut is to be applied to the maturing bonds, and only to them. The depreciated old debt is to be replaced by new sovereign bonds guaranteed up to 80 percent by the EFSF, limiting such guarantees to 30 percent of GDP.

7. Full insolvency and exit for non-performers

A country whose guarantees are drawn or that exceeds the guarantee limit must declare insolvency. The country in question will be granted a haircut on its entire sovereign debt and it must leave the euro-zone.

8. Basel IV: higher risk weights for government bonds

After the Basel III system for bank regulation, a Basel IV system is needed in which the risk weights for sovereign debt are to be raised from zero to the level for mid-sized companies.

9. Higher equity ratios

Common equity (core capital plus balance-sheet ratio) is to be increased by 50 percent with respect to Basel III.

10. Bank recapitalisation

Weak banks unable to raise enough capital in the market to fulfil these requirements are to be forced to recapitalise and will be partly nationalised. The government is to sell its shares in them once the crisis has been overcome.

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