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The Euro trap: on bursting bubbles, budgets and beliefs

Talk on 4th Dec 2014

Hans-Werner Sinn (Professor of Economics and Public Finance, University of Munich; President, Ifo Institute; President, CESifo Group, Member of the Advisory Council of the German Ministry of Economics) presented his latest book, 'The Euro Trap', in which he provides a critical assessment of the Eurozone crisis and details the policy failures in trying to solve it as well as potential ways out of the crisis. **Philippe Weil** (Professor at ULB and President of the Observatoire français des conjonctures économiques) was the discussant, while **Zsolt Darvas** (Senior Fellow, Bruegel) chaired the event.

Professor Sinn started out by a look at the recent good news regarding recovery in some crisis-hit countries. However, interest rate reductions explain a significant part of the current account reductions. Also, exports have not yet recovered to pre-crisis trends. Hence, according to Professor Sinn there is no recovery in sight for the crisis-hit countries and the problem is not a lack of demand (to be countered with fiscal stimulus and loose monetary policy), but a neo-classical problem of not aligned prices. A Goldman Sachs estimation shows that in real effective exchange rate terms relative to the EA, Spain appreciated by 25% up to Lehmann and depreciated by -6% since then, while Germany dis-inflated 31% over the same period, resulting in huge misalignments.

As a way out, Professor Sinn proposed four dismal options: (i) a transfer union, (ii) deflating the periphery, (iii) inflating the core, (iv) exits. All of them come with pro and cons, and according to Professor Sinn the transfer union will be chosen, because it is the easiest out (i.e. Target 2 is already a fiscal bail-out through the ECB, OMT is already a CDS insurance to invest). The measures proposed by Professor Sinn are a debt conference on public debt, temporary exits (with the possibility of a return to the EA) and budget constraints for central banks. The model of arrival should be the confederation one (i.e. Switzerland), where there is no debt mutualisation and on state level bankruptcy and bail-in are implemented.

Professor Weil, the discussant, stated that overall it is a good book on the Eurozone crisis, however, he was missing explanations regarding the transition period from one framework to the other. Also, Professor Weil attributed a more prominent role to market institutions, which are endogenous - temporary exits from the euro area might be in conflict with EU law on free movement of workers and the single market, something the book did not discuss at all. Moreover, the idea of temporary exits is in sharp contrast with the idea of structural reforms. Also, Professor Weil raised the left-out question of mass-migration in case of temporary exits. Considering these points, a debt-financed way out might be the preferred one.

In the Q&A session, the following points were raised:

- How would debt forgiveness work in detail? Professor Sinn argued that debt forgiveness would go in line with devaluation.
- When one person noted that wage versus price adjustment is not mutually exclusive, Professor Sinn argued that East Germany is a good example. Through re-unification, their living standard was lifted, but at the same time they lost their competitiveness. Convergence stopped since 1995. The Euro area is the same, countries experienced an increase in living standards, while their productivity lagged behind, which is an unsustainable development.
- Regarding a question why the third dismal option has not been discussed (inflating the core), Professor Sinn answered that a bit of everything would be the best. However, he believes that inflating the core will prove more difficult than one might think.
- On how to handle bank-runs following a "temporary" exit and the definition of "temporary" in general, Professor Sinn argued that a country could have legal right to return, while the exit should allow to reform and come back under ERM II. Also, when a country exits, bank-runs can be stopped through capital controls, which then can be lifted once the country devalued.
- A question on how a transfer union would look like, Professor Sinn answered that we are already in it (extending maturities and shift of interest rates to zero is already a sort of transfer). Also the unconventional monetary policy done by the ECB so far can be seen as a bail-out operation, and not really liquidity operations.

Event notes by Pia Huettl

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