Prepared Remarks

The Euro Trap

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It all seemed so remote, at the beginning: a queerly named crisis in the US, just a local affair of little import to such a booming economy as the EU's. But after it brought down Lehman Brothers in 2008, that queerly named crisis mutated into a full-blown global financial debacle. When it swept over to Europe, it not only swept the smug smile right off Europe's face. It also laid bare the shortcomings of the euro, the Eurozone's new-fangled currency. Countries in the common currency's periphery were battered savagely because they had lost their competitiveness, and there was not much they could do to fight back. Countries in the core had to bail out these countries' creditors, grudgingly, and there was nothing they could do about it. They were all trapped in the euro.

This is the story that Hans-Werner Sinn's new book, The Euro Trap, tells so masterfully. It answers all the many questions raised by the euro crisis: Why was the currency adopted at all, if it bore so many obvious flaws? Why were some countries pummelled so brutally, while others came through almost unscathed? What explains Germany's current economic buoyancy? Why has the crisis dragged on for so long? Is the crisis really, really over? And, no less important, what can we do to prevent a recurrence?

The euro crisis appears quiescent for now. But, as the book makes clear, it is just slumbering. Any number of factors could make it erupt again. It remains intractable, despite the massive aid provided by the ECB and through multilateral rescue packages to the countries in trouble. The dizzying sums rushed through parliaments and the ECB Governing Council in an attempt to defuse the mounting problems of the Eurosystem have not prevented sovereigns from faltering, caught in a deadly embrace with their respective banking systems. Instead of binding Europe closer together, the euro ended up creating more political tensions in western Europe than at any other time in the post-war period. How did things get this bad?

One problem is that the euro architects took the opposite path to a common currency than, say, the US or Switzerland. These two countries created first a strong political union, with all the attendant features it entails, including common defence a common foreign policy and a central government with significant domestic authority, before adopting a currency union equipped with suitable risk-sharing mechanisms. In the EU, the common currency came first, in the hope that it would in time lead to deeper political union.

Another problem is that the rescuers have been acting on the wrong diagnosis. There are two competing theories regarding the nature of the crisis. One is the money-in-the-display-window theory; the other, the bottomless-barrel one. According to the former, the Eurozone suffers from a loss of confidence of the capital markets; according to the latter, it suffers from structural deficiencies resulting from lack of competitiveness.
The troubled countries saw financing dry up because their creditors became increasingly sceptical about their future solvency. Up to that point, both theories agree. The difference lies in the reason suspected for the high premiums being demanded.

Advocates of the money-in-the-display-window theory believe that the capital markets were acting irrationally. Their thinking goes like this: The troubled countries are actually solvent, but if fear of a potential insolvency takes hold, creditors will demand higher premiums, and this will eventually lead to actual insolvency. But if the community provides enough rescue funds, the vicious circle will be broken. The countries will then regain their solvency and be able to service their debts, and everything will be ok. The money need only lie on the display window in order to elicit this reassuring effect; it won’t be drawn at all.

According to the bottomless-barrel theory, the capital markets have had every reason to be sceptical because the southern countries have lost their competitiveness and became dependent on foreign credit, being ultimately overwhelmed by the size of their private and public debts. Measures to mutualise debt simply encourage the troubled economies to take on even more debt, worsening the problem instead of solving it.

Eventually, more than one trillion euros worth of open public international credit, has been drawn from the display window, while under the security provided by common liability a big chunk of additional funds have been borrowed from private creditors. All this quashes the notion that the money merely needed to be displayed. The so-called Target credit, the extra refinancing credit provided by the national central banks to commercial banks in their jurisdictions, largely against poor-quality collateral, accounts for two-thirds of the sums drawn. This sort of refinancing credit, tolerated and supported by the European Central Bank, was in effect relocated from one group of countries to another in order to make up for the dwindling, or by then too expensive, private credit. This credit distorted investment decisions in Europe and entailed a significant exposure that does not differ substantially from the risks posed by the granting of public credit.

In a sense, the possibility of drawing Target credit has been available in unlimited volume on the display window since the very beginning of the monetary union, because the bail-out capacity of the ECB has always been an element encouraging private investors to go south. Over its first decade it did indeed stabilise the Eurozone at a low interest rate level. The cheap private credit that it encouraged, however, fuelled an inflationary boom in the Eurozone's southern and western countries, depriving them of their competitiveness and making them dependent on the supply of ever larger amounts of cheap borrowed funding. Seen in this light, the money in the display window had the effect of a drug that made the Southern European countries addicted, obliterating their competitiveness.

The argument between the display-window and the bottomless-barrel camps rages on, cutting straight across the economics profession. In Germany, nearly all economists (including Mr Sinn) want to keep the euro, establish a proper banking union, or at least common banking supervision, and hold private investors rather than the taxpayers liable for losses. The only differences concern the weighing up of the short- and long-term perils of the rescue policy and, consequently, the willingness to place more money on the display window than currently on offer.

The book shows that the policies currently pursued to solve the European crisis are wrong, because they are based on false premises and disregard the facts. Furthermore, they undermine both the
market economy and democracy, without solving southern Europe's competitiveness problem. They accord far too much weight to loss of confidence, and overlook the fact that it bears many features of the internal balance-of-payments crisis of the Bretton Woods system in the post-war period. Only a return to more stringent budget constraints, together with more political and fiscal integration akin to the USA or Swiss models, will make the monetary union fulfil its dream of bringing Europe closer together.

Julio Saavedra

Read what some personalities who have read the book have to say about it.