Bubbles, Current Account Deficits and Rescue Operations

By Hans-Werner Sinn

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The convergence process caused by the euro was partly artificial and resulted in an inflationary overheating and bubble building. When the US crisis hit Europe's banks, they shied away from financing the periphery and the bubble burst. Now public capital imports are demanded to replace the private capital imports, but that may simply prolong the crisis because it maintains the artificially overdrawn prices of goods, labour and assets, preserving the current account deficits and keeping private capital away. Only a process of gradual depreciation within or outside the euro can restore the equilibrium and prevent mass unemployment.

Wrong interpretations of the crisis

Many politicians and journalists these days argue that the real cause of the crisis-stricken countries of the euro zone 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.[2] Unfortunately, both the diagnosis and the recipes are 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 many leading politicians do not even include the slightest hint regarding the problem of wrong, bubble-driven prices and the corresponding current account imbalances. They perceive the crisis as a temporary confidence crisis, but overlook its deep structural roots. They focus 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 929 billion euros, 7.0% of their

[1] This is an updated version of an article that appeared in Vox. See Sinn (2011d).
[2] See, e.g., Economist (2011).

joint GDP over that period. In the years 2005 – 2010, Greece's average current account deficit was 11.7%, Portugal's 10.8%, Spain's 7.6%, and Ireland's 3.5% of GDP. By the end of last year, the average net foreign debt position of the GIPS countries was 91.2% of GDP (96.5% for Greece, 90.9% for Ireland, 107.4% for Portugal and 87.5% 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 GIPS 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.

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 30% 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 a good 10%, which is likely to result in a current account surplus this year, the first in a decade. Portugal depreciated by a mere 1%, 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 183 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.[3] To be concrete: The mechanics of the Eurosystem implied that credit was drawn from the Bundesbank to the tune of 466 billion euros (by October 2011) by crank up the money-printing presses in the crisis countries to finance their balance of payment deficits.

It was like in the Bretton Woods system. At that time, the US had financed asset

[3] Cf. H.-W. Sinn and T. Wollmershäuser (2011), Sinn (2011a, 2011b, 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.

and goods purchases in Europe by printing and lending more dollars than the US needed for internal purposes.[4] The dollars were flowing to, among other recipients, German sellers 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 US 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 may not be able to convert into anything.

Before the outbreak of the crisis, the Target balances were close to zero. But by August 2011 the five GIIPS countries (including Italy) had built up a Target debt of 404 billion euros, while the Bundesbank's Target claims amounted to 390 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. Meanwhile the Target credits have wiped out the refinancing credit of the euro core central banks net of the banks' deposits with their national central banks. The Bundesbank as well as the remainder of the core central banks have become net debtors of their respective commercial banking systems. While the printing presses in the periphery overheat, the central banks in the core have replaced their printing presses with money shredders.

In 2008, 2009 and 2010 no less than 89% of the aggregate current account deficit (capital import) of the four GIPS countries and 59% of Germany's current account surplus (capital export) was Target credit. While the Target credit was important in all five 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 130 billion euros. By contrast, in Spain only about a quarter of the 200-billion-euro current account deficit was Target-financed.[5] In Italy, a huge capital flight starting in August 2011 has been financed which still is underway.

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.

Opening or closing the tap?

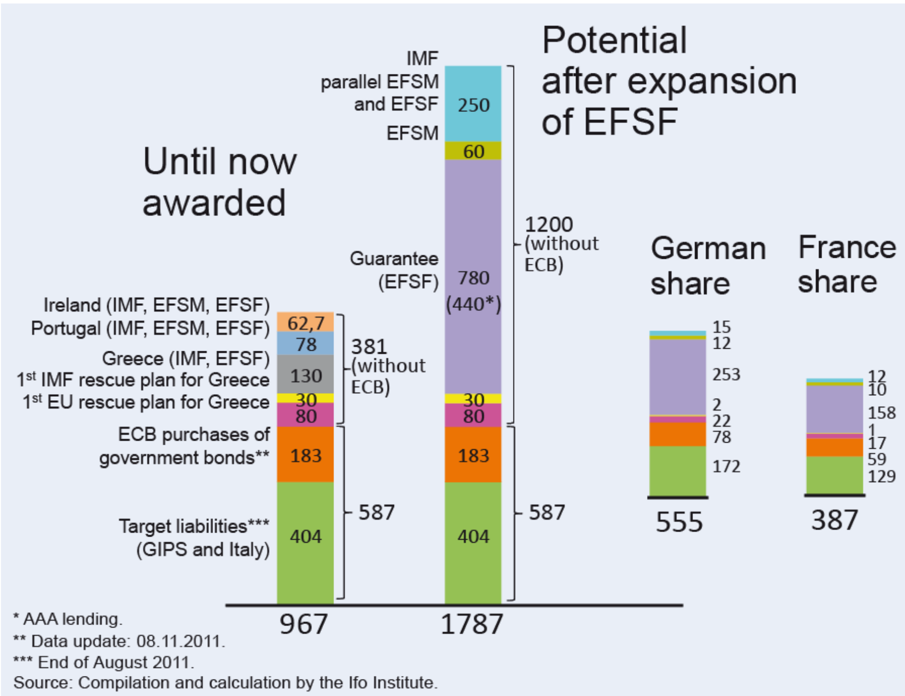
The widely discussed open rescue mechanisms being set up since May 2010 just came

[4] Cf. Kohler (2011).

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

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 381 billion euros. Together with the Target help to the GIIPS until August 2011 (404 billion) and the current stock of ECB government bond purchases (183 billion), this amounts to a total of 967 billion euros. With the expansion of the EFSF to 780 billion euros decided on 21 July 2011 and ratified by all parliaments by October 2011, the total volume of the planned and implicit rescue operations increased to 1.787 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 3.36 trillion euros.

Figure 1: The rescue funds (billion euros)



This is a huge sum, a multiple of what was on the table on 8th and 9th May 2010, when the first programmes were hastily put together over a weekend. If the GIPS countries and the collateral accepted by the national central banks go bust, Germany alone will be liable for 481 billion euros, and France for 331 billion euros. If, in addition, Italy defaults, the two countries will incur a liability of 555 billion and 387 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%, and 105% respectively, taking the EU 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 1.1% 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.

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 USA 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 that the GIPS national central banks have drawn from the Bundesbank (and the Dutch Central Bank) via the ECB system (Target) 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 USA. 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 of up to 50% 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 Eurozone.

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 (Tier-1 ratio and inverse leverage 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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