Discussion of Hans-Werner Sinn

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“I don’t debate with myself”

George W. Bush

HWS: Framework of analysis

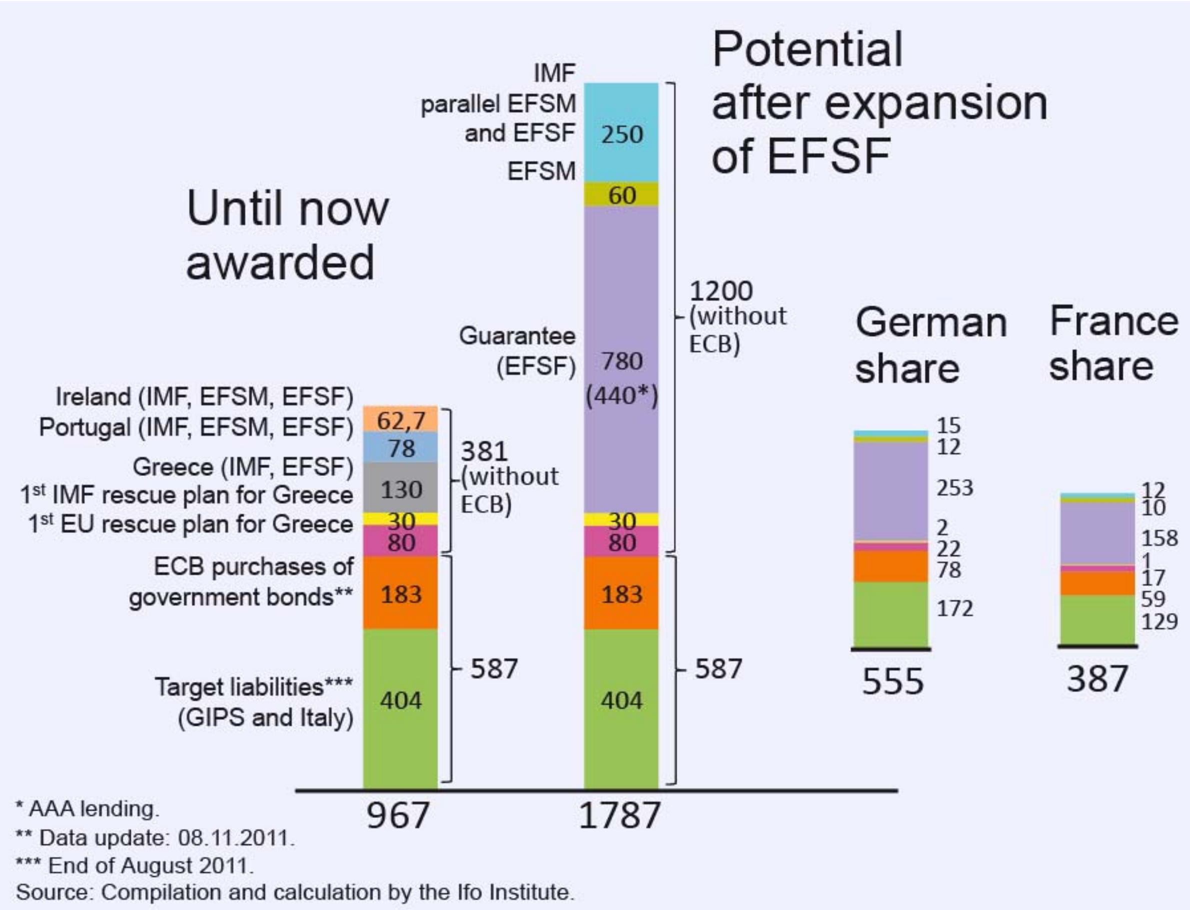
- Cheap flow of credit [to the periphery] made possible by the euro fed an inflationary bubble that pushed prices for property, government bonds, goods and labour above the market clearing level and resulted in huge current account deficits.
- Private investors have not been willing to finance and refinance [these CA deficits] since 2008.
- 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.
- A reason for the failure to depreciate significantly [was] the ECB’s explicit and implicit rescue actions. This was not just the purchase of government bonds. Much more important was the Target credit, a reallocation of ECB refinancing credit from the core, basically Germany, to the periphery

HWS: The role of Target 2

- [Target credit went] beyond the credit necessary to endow these countries with a monetary base for internal circulation
- It was like in the Bretton Woods system. At that time, the US had financed its current account deficit by printing and lending more dollars than the US needed for internal purposes.
- In 2008, 2009 and 2010 no less than 89% of the aggregate current account deficit of the four GIPS countries and 59% of Germany’s current account surplus wasTarget credit.
- The credit provisions through the ECB system have not been deliberate policies. However, the ECB has facilitated them through repeated lowering of the creditworthiness requirement for the collateral
- In effect, this was a rescue mechanism before the rescue mechanism.
- While the printing presses in the periphery overheat, the central banks in the core have replaced their printing presses with money shredders.

HWS: The numbers

The rescue funds (billion euros)



Agreements and disagreements with HWS's claims

Agreements

- ✓ Public debts are only part of the problem
- ✓ Property bubbles in the periphery were fuelled by capital inflows from the core
- ✓ Target 2 balances signal major problem in the functioning of EMU
- ✓ Real exchange rate adjustment is much too slow

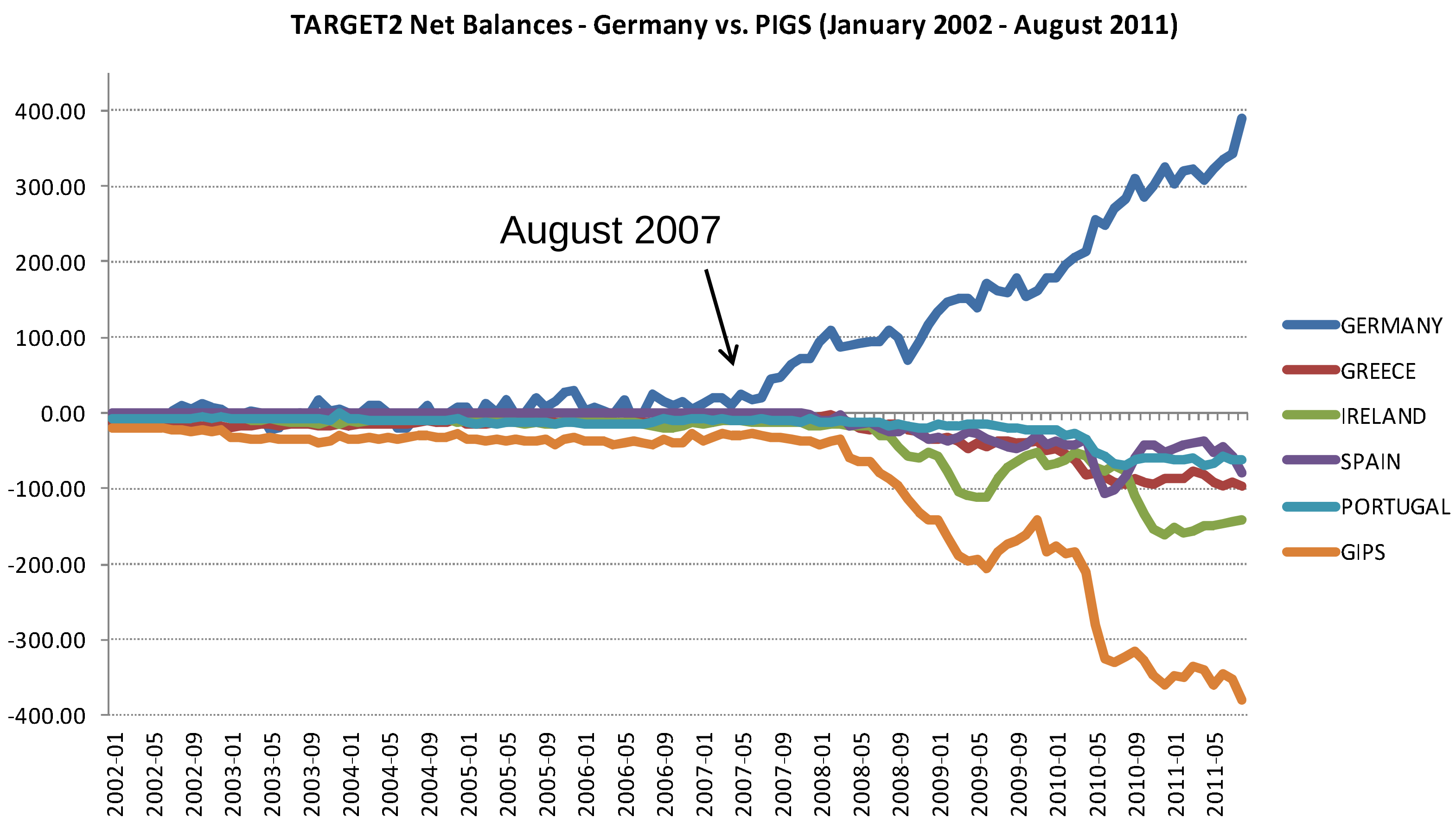
Disagreement

- ❖ The euro area suffers from "a balance-of-payments crisis of the kind that ended the Bretton Woods system"
- ❖ The printing press in the periphery is overheating while it has been replaced by money shredders in the North

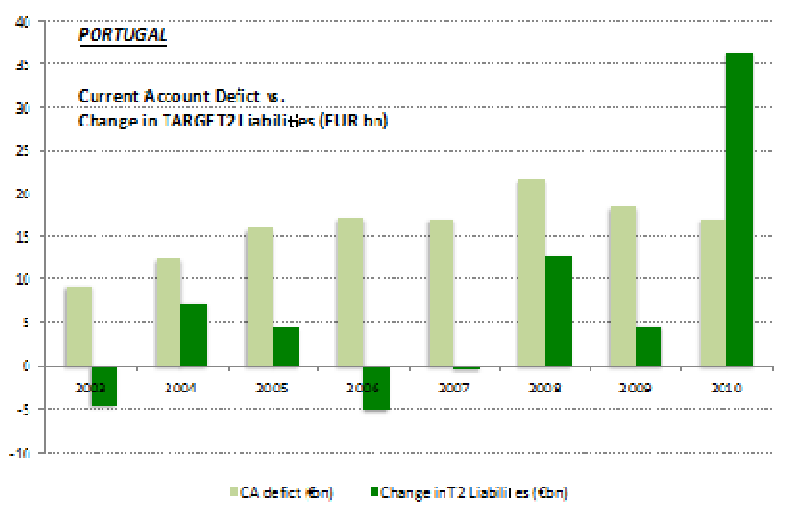
Rather,

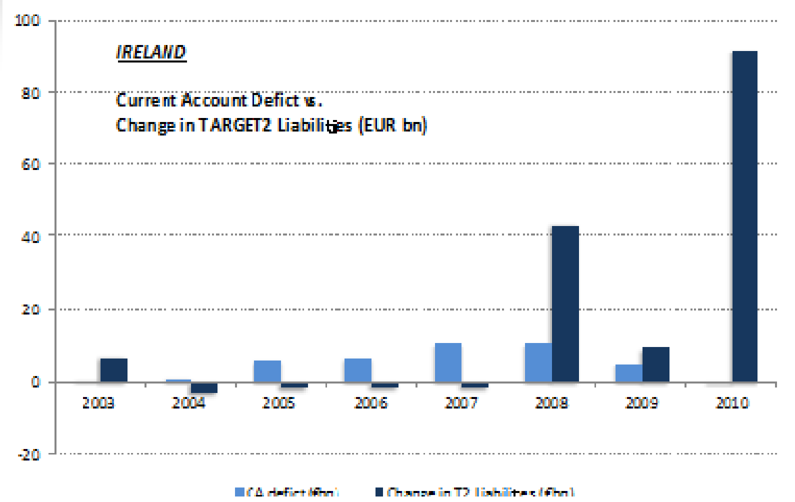
- Capital account crisis
- The Eurosystem has been facing a sudden stop and has performed its role of lender of last resort to the banking sector

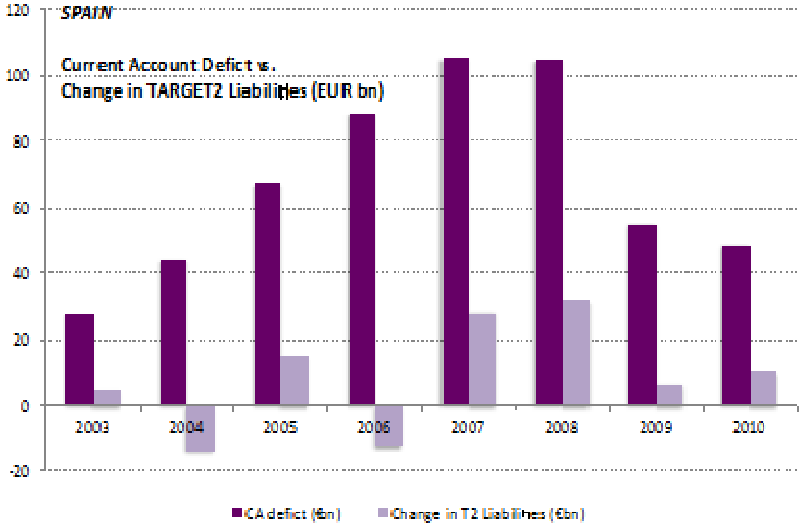
Target 2 balances

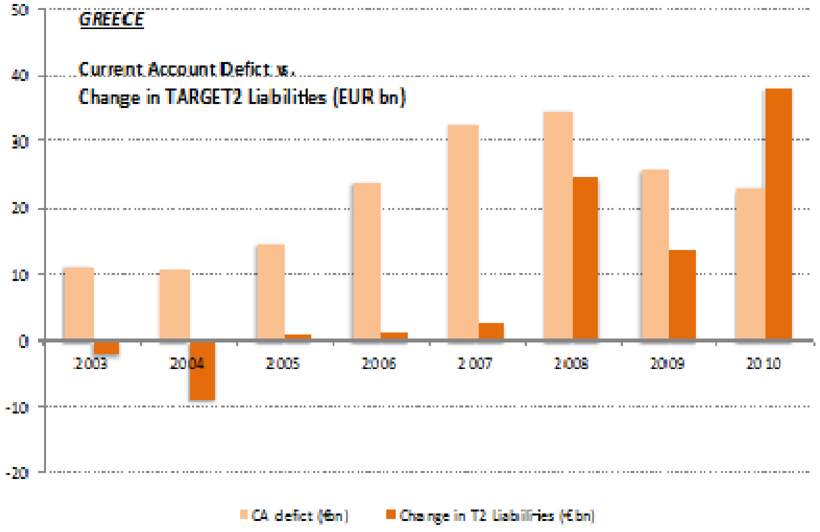


Target 2 and balances and current-account deficits









HWS: What NOT to do

- If the liability materialises, the debt-to-GDP ratios of Germany and France would be 103%, and 105% respectively.
- This would undermine the creditworthiness of the Eurozone as a whole. What is called rescue programmes may, in fact, turn out to be incendiary channels.
- European politicians argue that opening the tap and imposing a political debt constraint under common EU control would be a sensible solution. This view [stems] from the old days when markets were willing to finance the debtor countries.
- Today 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.
- What the Eurozone needs is a crisis resolution mechanism, together with tighter constraints for the ECB that stop the self-service mechanism currently prevailing.

HWS: 10 commandments

1. *No government bond purchases, no Eurobonds*
2. *Paying back the Target credit*

- Target balances are to be settled yearly with marketable assets.

3. *New voting rights in the ECB*
4. *Unanimity for credit policies*
5. *Liquidity help for two years (through EFSF)*
6. *Slicing the problem in the case of impending insolvency*
7. *Full insolvency and exit for non-performers*
8. *Basel IV: Higher risk weights for government bonds*
9. *Higher equity ratios*
10. *Bank recapitalisation*

What solution?

- Key issue is whether to cap Target 2 balances at current level and request annual settlement of Target balances

Right aim, wrong prescription - Target 2 imbalances are merely a symptom

My preferred prescription:

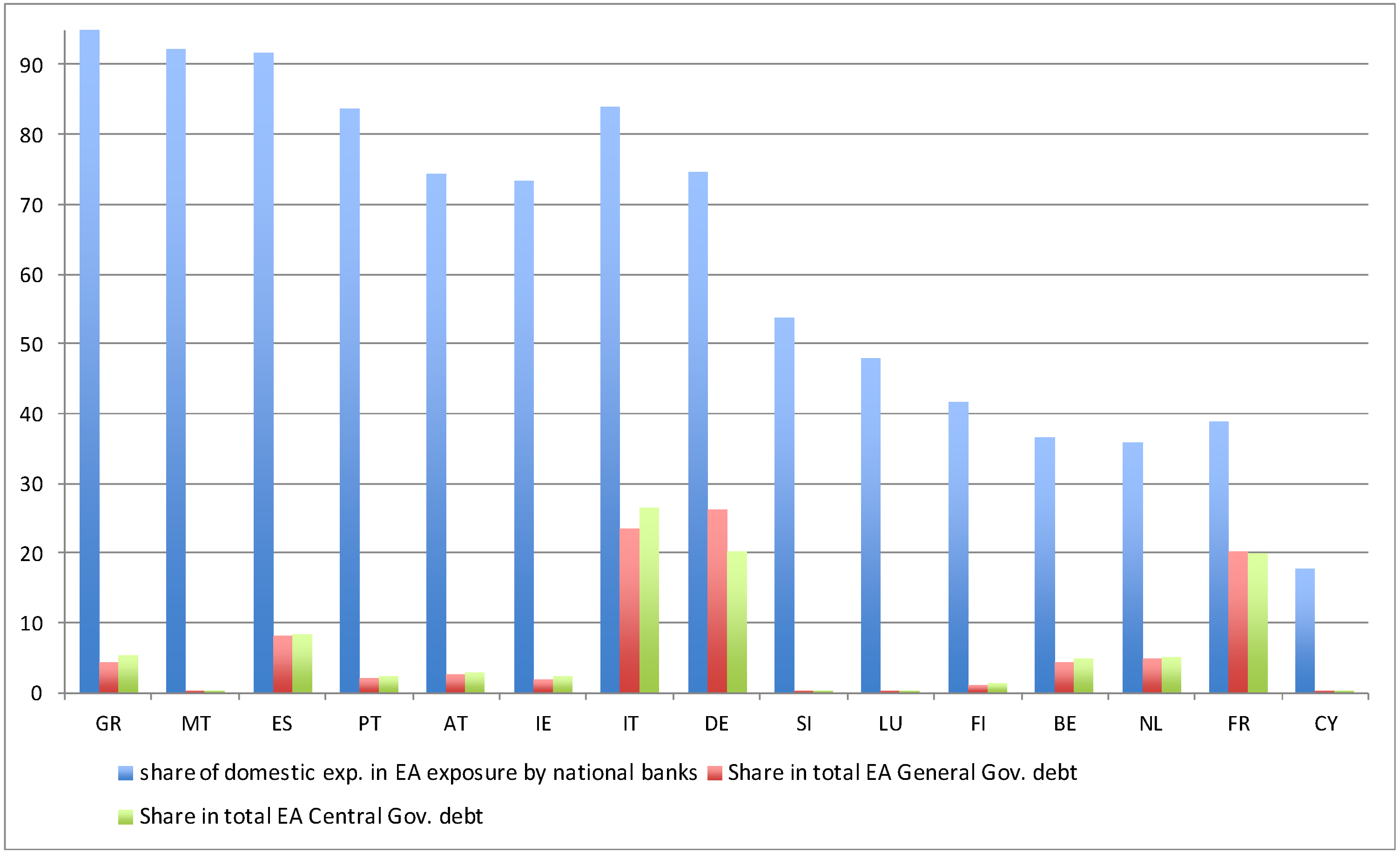
- IMF programmes
- Bank recapitalisation
- Common backstop for bank rescue
- Limit bank exposure to their own sovereign
- Eurobonds
- Bank M&As on pan-European scale

Other areas for discussion

- Liquidity / solvency
  - Rejection of purchase of government bonds
  - Near-automaticity of insolvency procedure
- Reform of voting rights in ECB
  - Not for monetary policy
  - Justified for policies with potential distributional consequences
- Slicing the problem in the case of impending insolvency
  - Risk of fragmenting bond market

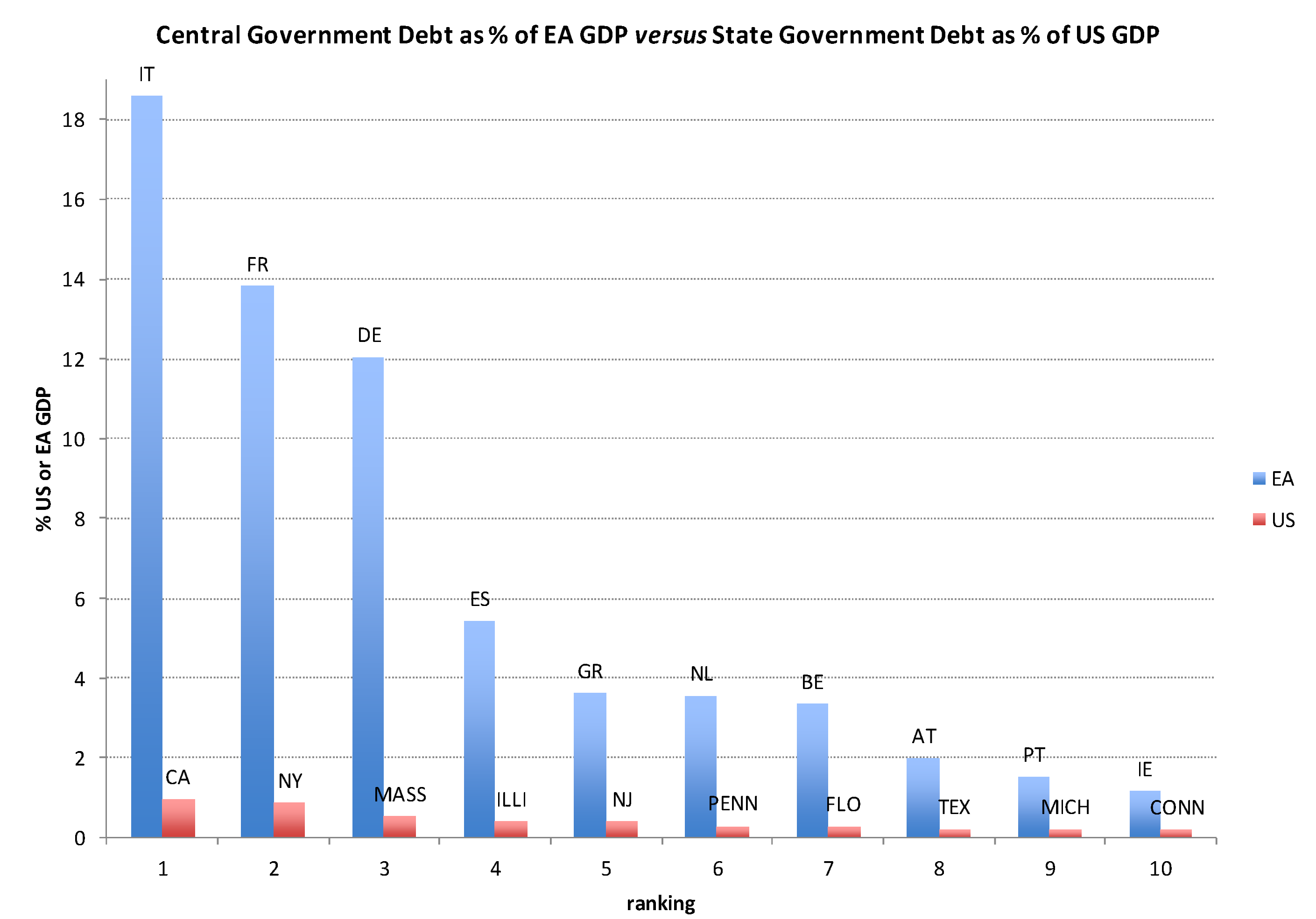
Banks exhibit strong home bias in holding of govt bonds

Share of own sovereign's bonds in EA government bonds held by banks, 2010



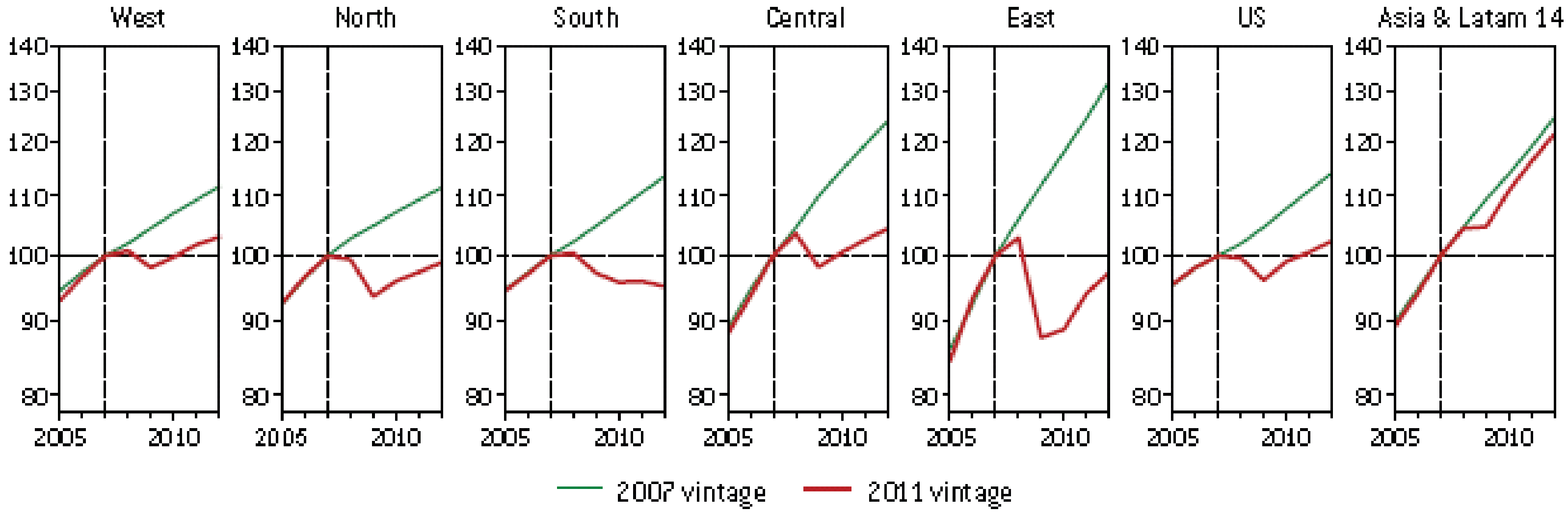
Source: EBA, Bruegel calculations

Government default unlikely to be a trivial event



Source: Eurostat, US Census, Bruegel calculations

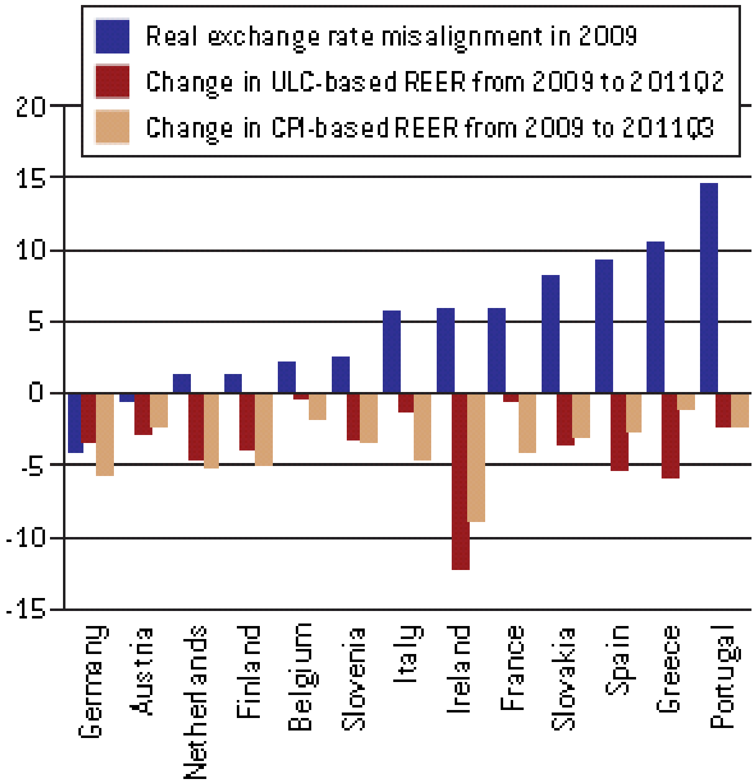
2005-2012 GDP: October 2007 and September 2011 IMF forecasts



Source: Bruegel calculation using IMF (2007) and IMF (2011d).

An important point

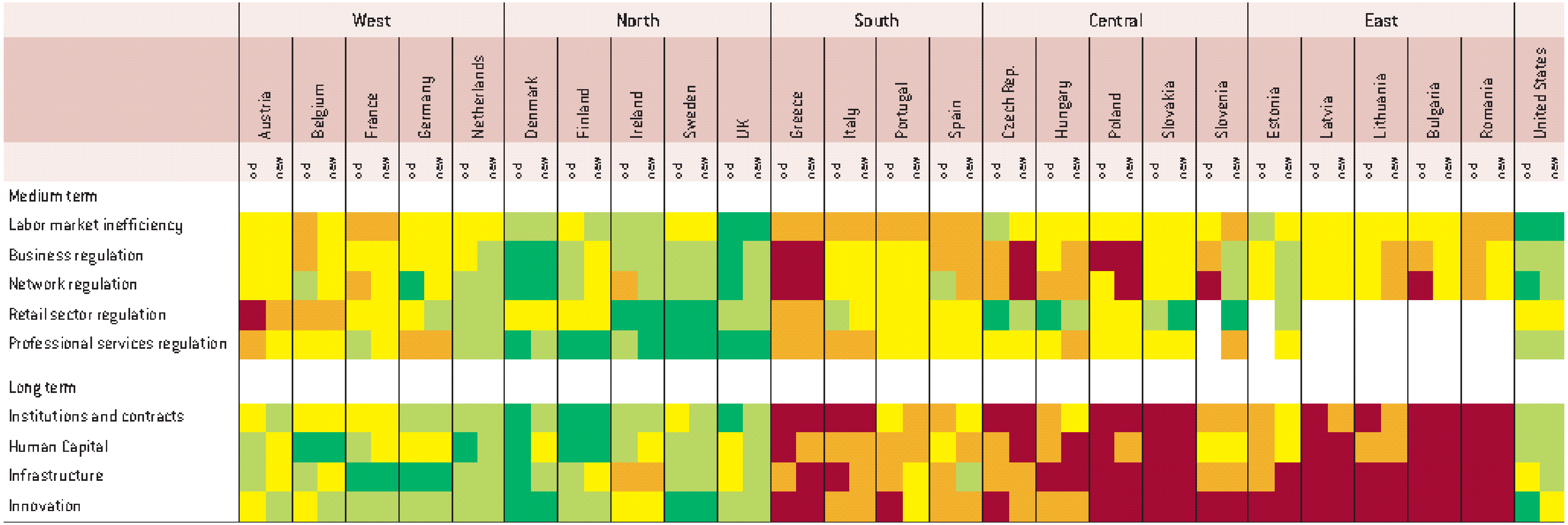
- Paper makes a very important point: adjustment in the periphery this far is a quantity adjustment, not a price adjustment



Source: Darvas and Pisani-Ferry 2011

What to do? The laundry list of structural reforms

Structural reform scoreboard



Source: Darvas and Pisani-Ferry 2011

What else?

- More aggressive real exchange rate depreciation strategies (internal devaluations)
- Better use of structural funds to serve the growth and competitiveness aims of programmes
- Incentives for private capital to return to Southern Europe, but this time to the tradables sector
- Project bonds
- Macro framework: 2 per cent inflation on average, less in South, more in North