

Sinn, Hans-Werner

**Article**

## Introduction: relaunching Europe: problems, reform strategies and future options

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Introduction

## RELAUNCHING EUROPE: PROBLEMS, REFORM STRATEGIES AND FUTURE OPTIONS

HANS-WERNER SINN

Professor of Economics and Public Finance,  
University of Munich;  
President, Ifo Institute, Munich

Dear Mr. Chrobog,  
Mr. Quandt, Mr. Almunia,  
Ladies and Gentlemen,

Europe's main problem at present is the question of how it can resolve the euro crisis. Never in my lifetime has there been as much strife among the peoples of Western Europe as there is today. Twenty years after the introduction of the euro as a major peace project for Europe, the common currency has obviously fallen far short of its goals. In the words of Martin Wolf: "You have to be a masochist to think that the introduction of the euro was a good idea". Now that we have the euro, however, this does not mean that we can or should abandon it. On the contrary, our challenge is to turn the euro into a success story.

You may remember the frightening words of Jean-Claude Juncker, who said in April that the year 2013 reminded him of 1913, a year when nobody anticipated what was about to happen in Europe a year later. While this statement is a bit exaggerated, it reveals the tension that grips politicians. Frits Bolkestein, one of the EU's most successful commissioners

ever, advised his country, the Netherlands, to exit the euro. He argued that the euro was doomed and was not compatible with the prosperity of a common market.

I would like to look at a few key economic indicators to outline the current shortcomings of the eurozone economy before addressing the question of potential solutions. If we look at unemployment rates (see Figure 1), Germany is now doing fine after suffering its own crisis a decade ago, but the situation is very different in the other eurozone countries. In France unemployment is rising and has reached levels that exceed those seen during its last economic slump in the winter of 2005-2006. In Italy and Ireland unemployment is stabilizing at a high level, in Portugal it is slightly decreasing, and in the two problem countries of Spain and Greece overall unemployment rates are as high as 26 percent and 28 percent.

The situation is even worse when it comes to youth unemployment (see Figure 2). In Greece 62 percent, or two-thirds of the labour force aged 15-24, are unemployed. This is largely due to widespread protection of older workers' jobs, which makes it hard for younger workers to gain a foothold in the labour market, but the overall situation is nevertheless a catastrophe, as the overall rate of 28 percent starkly underlines.

Figure 1

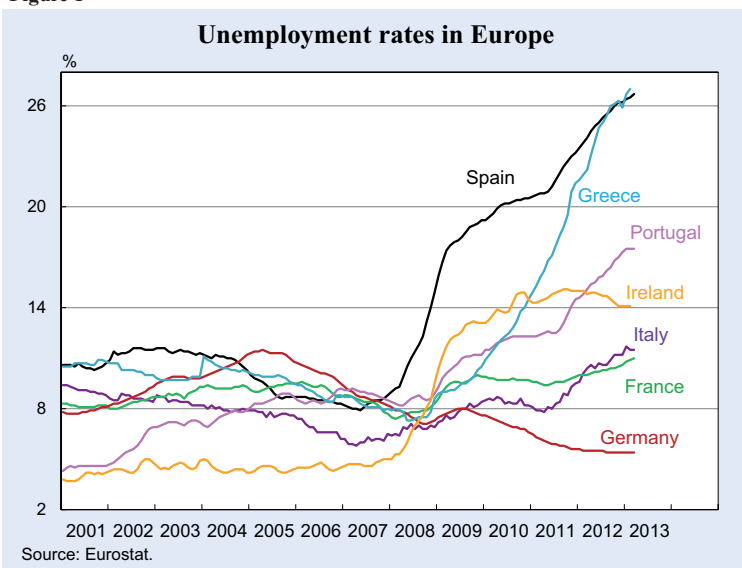
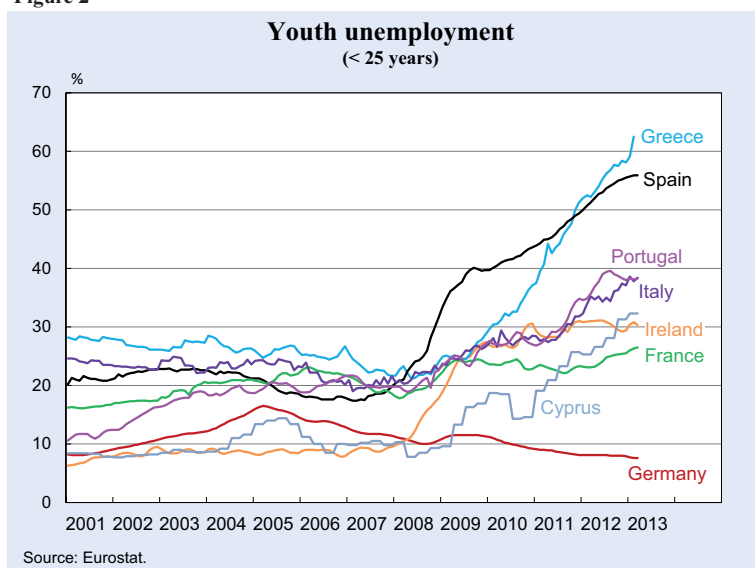


Figure 2



### Focus on competitiveness

The debate over austerity is still raging and tends to revolve around the following questions: should we have more Keynesian deficit spending to stimulate growth? Do we need a banking union with a common resolution fund? Should we even create an Outright Monetary Transactions (OMT) programme for companies, as European central bankers are now discussing, involving the issue of some structured securities composed of company credits, which the ECB may possibly guarantee in the same way as it guarantees government bonds?

Unfortunately, all of these options are merely painkillers and do not represent lasting solutions. The true problem of Europe lies much deeper than the financial crisis, which is merely a surface symptom of it. The true problem is one of competitiveness, and if we wish to relaunch Europe, we must begin by addressing this issue.

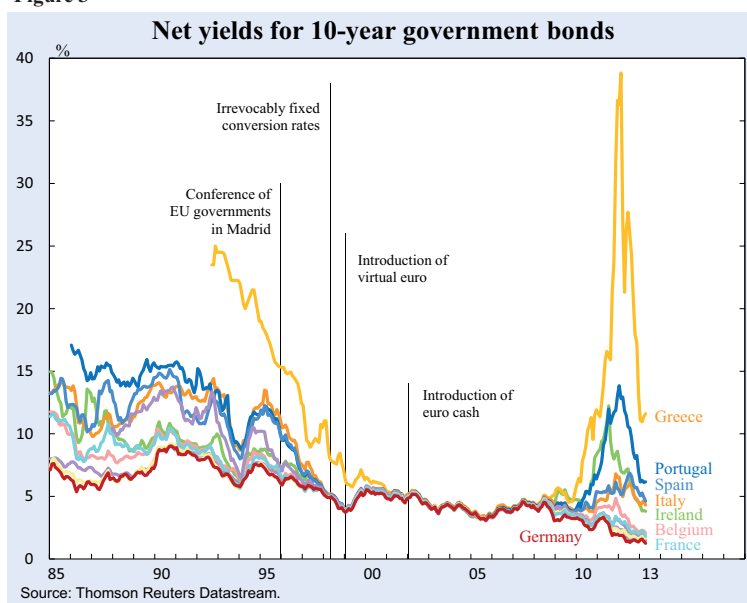
When the euro was introduced interest rates converged (see Figure 3). Key points in the euro's history are shown by the vertical bars on the chart. For me the most important point is the EU's Madrid Summit of December 1995, where it was

agreed that the exchange rates would be irrevocably fixed two years later in 1997 and that the euro would definitely be introduced. That was the point at which investment in any part of Europe was perceived to be safe and that capital began to flow across the borders in unprecedented volumes. The interest rates converged to the same level for a long period of time until crisis struck and the spreads emerged again, as shown on the right of the chart.

The chart raises a number of interesting questions: why did interest rates converge? Why was

there such reckless lending to debtors who would obviously have problems repaying, especially given that article 125 of the Maastricht Treaty (TFEU) expressly states that no country will be bailed out if it goes bust and creditors must bear the full loss? One answer is that the unlimited firing power of the ECB made state bankruptcies very unlikely in the Eurosystem. Another is perhaps that the EU undermined Article 125 with practical policies, such as allowing lending to governments and banks with no or only minuscule equity requirements. Whatever the true reason, the introduction of the euro encouraged capital flows beyond any reasonable level and created an artificial boom in Southern Europe. This boom

Figure 3



became inflationary, deprived Southern European countries of their competitiveness and made them dependent on foreign credit which, when it dried up, unleashed the balance-of-payments crisis.

A look at price developments during the period from the Madrid Summit to the Lehman crisis (see Figure 4) shows that the crisis-afflicted GIPSIC countries revaluated by 30 percent (trade-weighted relative to the rest of the eurozone), while Germany devaluated by 22 percent. These enormous relative price changes are the key problem facing Europe today, as they have fundamentally deprived the South of its competitiveness. We now need to rewind the price clock, but that is easier said than done. All reform programmes aimed at making economies

more competitive must operate *via* the price channel. Either relative prices fall because relative wage are implemented given the productivity, or productivity jumps up, given the relative wages. As the latter is a dream, relative wage cuts will be unavoidable. In my opinion, this is the only way of relaunching Europe if we do not want to allow exits from the eurozone followed by open devaluations. All of the various measures that we will discuss over the next two days are, in my view, part of this programme of realigning relative prices.

A great deal has happened in recent years and current account deficits have disappeared, so Europe could be said to be headed in the right direction. I would agree to a certain extent. The gap between imports

and exports has certainly declined, but why? This decrease is not due to exports exceeding their pre-crisis levels; it is merely due to the collapse of the economy, which has meant that people can no longer afford imports. That has nothing to do with an improvement in competitiveness of the economy.

While exports have risen a bit in Spain (see Figure 5) and Greece (see Figure 6) after the Great Recession of 2008, the collapse in imports resulting from plummeting domestic consumer purchasing power, which has been significantly weakened by mass unemployment, dominates the picture. So the improvement in the current account situation of Spain, for example, in no way indicates an improvement in its competitiveness. I do not wish to be overly negative: there are some signs of improvement in Spain, such as movement on the wage front, as well as greater flexibility, reforms and so on. Nevertheless, as is clearly visible from the graph, the improvement in its current account balances is mainly due to the effects of the

Figure 4



Figure 5

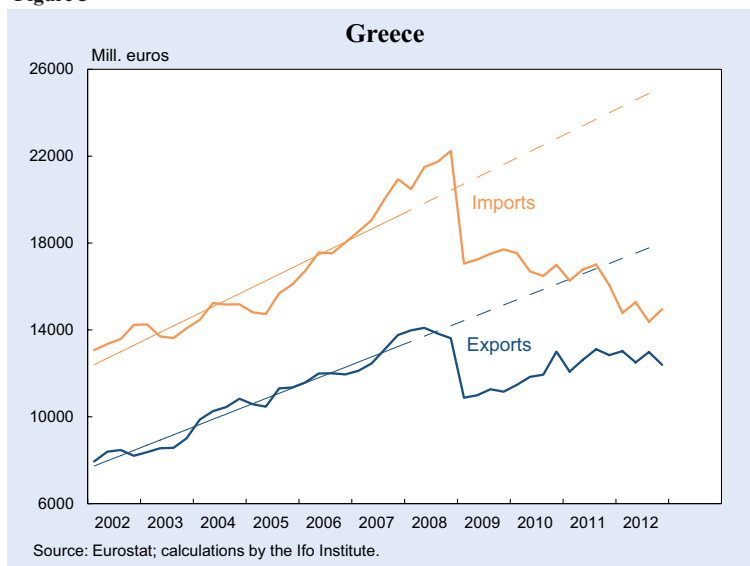
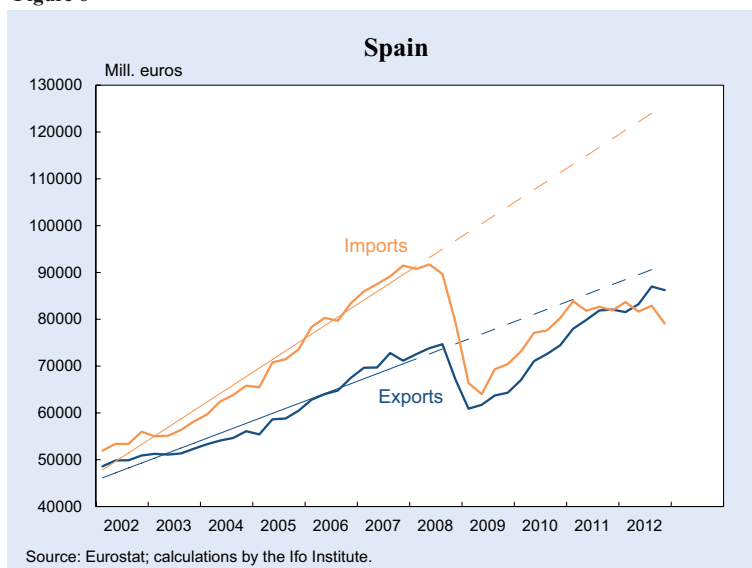


Figure 6



crisis. It is misleading to use current account balances as an indicator of competitiveness.

### Realign relative prices

A realignment of relative prices is required to achieve debt sustainability. In the old days, before the introduction of the euro, this would have involved a realignment of exchange rates in a fixed exchange rate system, but now such a realignment can only be achieved in the eurozone through relative price changes. How much progress has been made towards price realignment to date, as the crisis nears the end of its sixth year?

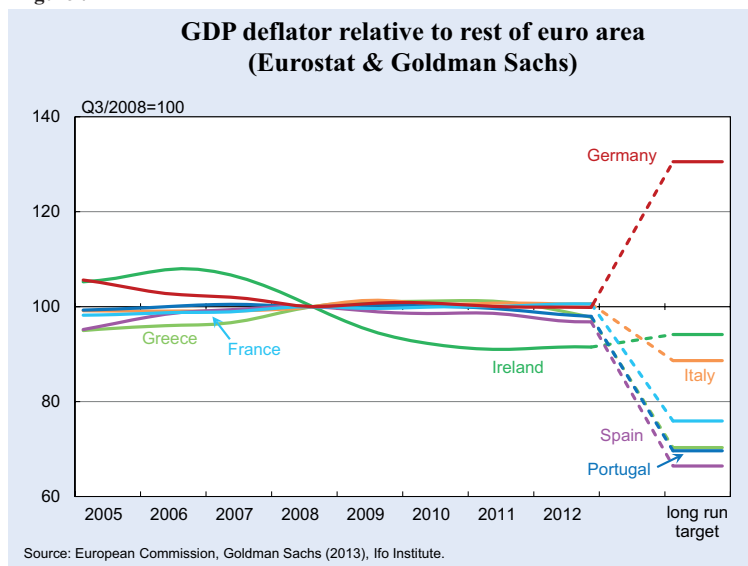
Europe's progress so far can be charted by the Eurostat GDP deflator relative to the rest of the euro area, normalized such that 100 is the point of the Lehman collapse (see Figure 7).

Let's take a look at Spain, which appreciated relative to its trading partners before the Lehmann crisis and deflated thereafter. At what level do its prices need to settle to achieve debt sustainability? This question is explored in a very useful study by the economics department of Goldman Sachs, which examines the realignment of prices that is re-

quired in the eurozone in order to achieve debt sustainability, which is defined as bringing the net foreign asset position below 25 percent of GDP in the long run. According to the Goldman Sachs study, Spain's goal should be a ca. 30-percent price reduction relative to the eurozone average which translates into a decline of 33 percent relative to the rest of the eurozone as shown in the figure. While some progress has already been made towards such goal, there is still a very long way to go.

In France property prices have exploded like their Spanish counterparts, the only difference being that the real-estate bubble in France has not burst yet. French industry has lost its competitiveness; manufacturing is declining and only accounts for 9 percent of GDP. The French have compensated by creating more jobs in the government sector (which has twice as many employees as Germany's public sector) and by indulging in high government spending (56 percent of GDP, 10 percentage points higher than in Germany). These Keynesian replacement measures have helped the French to alleviate economic pain, but they have not promoted its competitiveness. According to Goldman Sachs France would have to devalue by 20 percent relative to the eurozone average which

Figure 7



is 24 percent relative to the respective rest of the eurozone.

Italy, on the other hand, is doing much better than many other euro states, so the price devaluation required there is small, while Germany, according to the Goldman Sachs study, still needs to become more expensive to make Greece competitive. German prices relative to the rest of the eurozone would have to go up by 20 percent and relative to the rest of the eurozone by 30 percent.

The level at which realignment can be achieved remains an open question. Can the South cut its prices while the North increases its prices slightly? Should we increase the average so that no country has to cut its prices and the core merely inflates? The realignment process will in all circumstances be painful. Germany will not be willing to accept the necessary inflation and some of the GIPSIC countries will not accept the necessary deflation.

Ireland is the only country that has managed to carry out the necessary devaluation. It devaluated by 15 percent in real terms since 2006 by implementing the harshest austerity programme of all European countries. While Ireland helped itself, the other countries were hit by the crisis simultaneously after Lehman, nearly two years later than Ireland's crisis; and rather than following Ireland's painful austerity programme, they opted for a political solution in the form of local money-printing in their national central banks to replace the missing private capital.

### Three options for Europe

In my view, Europe has three options. The first option is that of a reform strategy with austerity and deflation in the South. Austerity is necessary because the money is simply no longer there and lenders are no longer willing to loan it; but austerity is also necessary to rebalance prices, which is necessarily a painful process. While moderate austerity stopping the inflation is possible, I personally do not think that a sizeable outright deflation constitutes a feasible option for all countries. An economy can be squeezed to the point that the country is pushed to the brink of civil war without bringing its prices down very much. The countries of Southern Europe have borrowed too heavily and now need to service their debts. Against this background, they cannot

achieve a real devaluation through price and wage cuts, because they would drive their citizens to bankruptcy. Thus, a reform strategy based on austerity and strong deflation would prove impossible.

The second alternative is inflation in the eurozone's core countries. According to the Goldman Sachs study mentioned above, Germany would need an inflation rate of 5.5 percent for 10 years to increase its prices by 70 percent. Realistically, this is not going to happen, for various reasons.

The third option is that of individual countries temporarily exiting the euro. Exits, however, are disastrous for the capital market, as they lead to bank runs and capital flight, as seen in Cyprus. On balance, there does not seem to be any clear-cut solution available to resolve the eurozone's underlying problems. Instead, the euro countries may have to muddle through using a combination of all of the strategies put forward above, namely a little bit of inflation in the core, a little bit of austerity in the South and a little bit of exit in isolated cases.

A fourth option is to give up austerity and just continue living on credit that is publicly provided or guaranteed by other countries. This option is preferred by many, in particular the debtor countries and their private creditors, who would like to safeguard their wealth. However, it obviously finds less support in the Northern countries and would not be a solution in the long run. It lifts private credit contracts to the public level, creating tensions between countries. It imposes huge risks on the taxpayers of the creditor countries and will in all likelihood deprive them of some of their wealth. It means that the allocation of capital in the eurozone is determined by political rather than market forces. And, last but not least, it turns the recipient countries' lack of competitiveness into a chronic Dutch disease, with permanent mass unemployment and a state of enduring dependence.

Europe is unfortunately trapped in a situation with no attractive solutions, forced to choose between ugly alternatives. If we want to rule out the fourth possibility, namely an exit, a realignment of relative prices is indispensable. While some countries' prices are sufficiently close to equilibrium to achieve the necessary realignment within the eurozone by keeping their prices constant and waiting for Germany and other northern countries to inflate, others would have to really cut them and undergo a very painful

adjustment. This process may be so dangerous and harmful for the society that it might be better for them to exit the euro.

In such a case, a programme of orderly exits should be defined for them which keeps them formally in the eurozone, allows for re-entry at a later point in time, and supports the exiting economies' banking systems. I personally think that we made a mistake with Greece three years ago, for if the country had been allowed to exit at that time, its troubles would now be over. However, continuing as we have done to date is definitely not an option for the future, as the current situation is one of terror without end. How long can the Greek population withstand a youth unemployment level of two thirds? The mistake that we are making is to place a financial crisis on the same logical level as a crisis in terms of risking the stability of society.

### Some conclusions

Discussions are needed of a new model for Europe that lies somewhere between the dollar and the Bretton Woods system. In my opinion, Europe cannot have a common currency without a common state. Realistically, however, I do not see a United States of Europe taking shape in my lifetime. In its absence, the eurozone needs a flexible system that gives its members the possibility to exit and re-enter the monetary union if necessary.

Our goal should be a United States of Europe, but at the same time we need to avoid the mistakes made by the Americans. One of their biggest mistakes was that of debt mutualisation when the United States was founded. Alexander Hamilton, the first US finance minister, mutualized state debt in 1791 arguing that this would act as cement for the new US state. In fact, however, the opposite proved true. In 1812-1813 there was a second round of debt mutualisation during the second war against Great Britain, but all this merely gave the US federal states the impression that they were better off borrowing if their neighbours did, as this would enable them to finance infrastructure development, the costs of which would be shared. These events led to the emergence of a major credit bubble in the United States that burst in 1837. From 1837 to 1842, nine of the US states went bankrupt and the result was a great deal of strife. According to Harold James of Princeton,

history shows that fiscal unions have proved explosive in the past, rather than acting as cement to strengthen newly formed states.

Europe needs to learn from the US experience by creating a United States of Europe with a strong power centre, but avoiding mutualising local debt, as this would poison relations between European countries by lifting debtor-creditor relations, which are currently largely private, to a state level. Since we do not have a legal resolution mechanism at a state level, debt socialization would therefore lead to endless quarrels in Europe and a repetition of the mistakes made in the United States.

The first step towards a true federation is to have a common foreign policy and a common army to defend the territory. Surprisingly, no one speaks about that. All the effort is directed instead towards fiscal transfers and loss mutualisation schemes. This is putting the cart before the horse and does not strike me as the right approach. Europe, in my opinion, does not mean reinventing the wheel: it means replicating the best aspects of the model from the other side of the Atlantic.