



SPEECH AND DISCUSSION

PROFESSOR DR. HANS-WERNER SINN

September 16, 2014

Professor Dr. Hans-Werner Sinn, President of Ifo Institute for Economic Research, has a new book (in English) and gave a speech in the offices of Freshfields this morning. It was organized by the German American Chamber of Commerce. Professor Sinn did not say much new, but the speech was nevertheless a brilliant summary. His main points:

- The economic crisis in Europe is not over. The steps so far have moderated the symptoms but the root causes are still there.
- For 10 years, the marketplace did not act as a restraint on borrowing by weak economies. ¹ Southern economies borrowed at rates only before available to Germany. They used the funds to raise wages without increasing productivity. Correcting these mistakes will likewise take a long time and be painful.
- The problems of the southern European economies were compounded by cheap labor made available by accession of Eastern European countries to the EU. Polish labor is more productive than Greek or Spanish and much cheaper. German companies like VW profited greatly.
- The best of several bad solutions is to let countries leave the EU. Greece should have done this in 2010.
- The German Constitution prohibits the solution favored by the market place. This point of the Constitution cannot be modified without a referendum. This will not happen and the market has not yet recognized it.

DETAILS

The speech was supported by many slides with graphs and other economic details (all persuasive) than cannot be accurately repeated in a brief summary.

¹ Possibly the markets did recognize that the EU would ultimately stand behind these weak economies and so knew more than the politicians and economists.

The economic crisis in Europe is a crisis of competition in the South and of liability in the North. The worst is *not* past. The economy of southern Europe is stalling and the problems – a structural and competitive crisis – will continue for years.

The risk of country bankruptcy was not properly foreseen when the Euro was adopted. Prior to the Euro, countries could “print their way out of bankruptcy.”² This solution ended with adoption of a common currency. Countries newly free to borrow money at low rates did so to raise wages and build second homes in Spain and Ireland. Higher wages made the South uncompetitive. (Germany’s Hartz reform programs made the difference in productivity even greater.) This indulgence went on for ten years. It took the US financial crisis to shake the European confidence and bring on the Euro crisis, which had been building unnoticed.

European current account figures seem to show improvements in the southern countries but this is misleading. The improvement is a result of reduced imports by these countries, not increased exports. This is particularly true of Greece and Spain. Also clouding an accurate analysis of financial results is the fact that country debt which earlier had been in private investor hands is now held by governments. So there is an accounting shift, not a real one.³ No Greek sovereign debt is in private hands. Furthermore, Greek private wealth is invested outside Greece.

Italy’s ratio of debt to GDP has gone *up*. Italy would have no debt at all if the funds it saved by lower interest rates (a result of ECB support) had been used to pay off its sovereign debt.

Unemployment in France and Italy is a major problem. In Portugal unemployment is improving; also in Spain, but this is because young Spaniards leave Spain to find jobs. Germany is experiencing a real estate boom as rich Europeans flee to a safer environment. So the Euro has not been good for southern Europe.

France was a big supporter of the Euro, to get rid of the Deutsch Mark, but it is now also hurt. It is the largest lender to southern Europe, more than Germany or the UK.

Turning to industrial production results, they are generally not back to 2008 figures. Ireland has done well as have the emerging market countries. Numbers for Italy and France are not good. Germany is almost back to 2008 levels. Spain and Greece are much worse. They have experienced a double dip recession and a triple dip is possible.

² Prior to the speech, he noted to me that WWI Germany began inflating itself out of its war debts well before the war’s end.

³ I do not understand the accounting rules involved here.

The South has also suffered under the accession of eastern European countries to the EU. Southern European countries had raised their wages before 2004 when the East opened up.⁴ The new countries offered the same or better productivity at half the wages. Greece and Spain are simply not as productive as Poland and their wages are much higher.

Dr. Sinn then talked about effective price increases and decreases in various countries and a Goldman Sachs study (which I could not find on line).

The political and ECB support for the crisis countries has bought them time, but effectively prevented reforms.

Ireland did not have this support and took the needed steps when its bubble burst. It cut wages and prices and became more competitive.

Four courses could deal with the current situation, but none is a good one:

1. Transfer Union - Turn the EU into a transfer union, thereby making a gift to the southern countries. This “solution” does not deal with the lack of competitiveness. It creates a version of “the Dutch disease.”⁵
2. Austerity – The weakness of austerity is that it creates social disruption, including mass unemployment and bankruptcies.
3. Inflation – If the debt were inflated away, Germany would be the big loser, since it is the biggest creditor to the South.
4. Exits – Countries could leave the EU and reinstate their own currencies. Greeks would then (for example) stop importing (expensive) French food and start buying (cheap) food grown in Greece. Agriculture is one area where Greece is supposed to have a comparative advantage, yet it imports more food than it exports. The “exit” option too is destabilizing.

All of these solutions bring with them the prospect of increased influence of radical political parties.

Short term, the ECB has let countries print money and it has redeemed the debt held by foreign investors. It reduced the standards for the collateral it is willing to accept. So banks happily sold this substandard collateral to the ECB.

There followed a discussion of “inside money and outside money” that I could not follow.

⁴ Countries joining: Poland, Hungary, Czech Republic, Slovenia, Slovakia, Estonia, Latvia, Lithuania, Cyprus and Malta. In 2007 – Romania and Bulgaria.

⁵ http://en.wikipedia.org/wiki/Dutch_disease

Germany is restricted by Section 123 of the Treaty of Lisbon, prohibiting the purchase of government bonds. The ECB has bailed out private investors and then governments bailed out the ECB. The governments did not pledge enough so they then offered guarantees. The next step was OMT's – outright monetary transactions. The legality is questioned in Germany. Now the ECB wants to buy bundles of loans. Axel Weber is against this (as is Prof. Sinn). The ECB is not the same as the US Federal Reserve.

Of the funds committed to the rescue so far, 17% have been controlled by the various EU parliaments. 83% has been controlled by the ECB. This was improper. The Maastricht Treaty does not permit it. We now experience central government planning determining where funds should flow, thereby interfering with the market.

It is likely the German Supreme Court will determine that this action is improper. The EU Court could come down with a different decision, but then Germany would have to change its Constitution, a process which – as to this point – a new Constitution would be required, i.e. a referendum. Professor Sinn thinks the EU Court will know this and take it into account. This is a point the market generally has not recognized.⁶

Minor changes will not work. This crisis requires fundamental changes – and these are not politically possible. Ideally there would be a debt conference, covering all classes of debt, and a recognition that they cannot all be repaid. This would result in huge losses for creditor countries, i.e. Germany.

The EU should allow countries to exit. It was a big mistake to keep Greece from leaving in 2010. Italy would have seen the consequences and undertaken serious reforms.

The new system Professor Sinn recommends would be modeled on how the US Federal Reserve operated until 1975 – an internal gold standard. The various Fed district banks settled their accounts internally. It had once been accomplished by the physical transfer of gold among the banks. After 1975, the transfers were dropped. So the EU has a model. The EU should develop rules for an orderly country exit. After leaving, a country would have to pay higher interest rates and that charge would provide discipline.

The Swiss Confederation is another good model. Professor Sinn is strongly against debt mutualization. For example, the Federal Reserve would not keep California from going bankrupt if it could not pay its debts. American has two examples of the downside of debt mutualization. Alexander Hamilton mutualized state debt in 1791. It happened again in 1813, during the war with Great Britain. This process gave the states permission to borrow. A result was the Panic of

⁶ I THINK this is a point I reported at a German Marshall Fund discussion many months ago, so the market is again really slow – or it knows more than we do.

1837 when the resulting bubble burst. States which went bankrupt included Arkansas, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, Pennsylvania and Florida (then a territory). 18 states in all went bankrupt.

Q&A moderated by Jack Janes of the American Institute for Contemporary German Culture

Things will get worse before they get better. This is not a criticism of Mario Draghi (about whom Professor Sinn said some things off the record which were also not critical). He only reports what the ECB decides. A major weakness is that Malta has the same vote that Germany does. The debtor nations by their numbers have too much influence. The Bundesbank is marginalized.

Quantitative easing is fine for the US because it is a unified nation, but the EU is far from unified. He then made an analogy of Germany's relationship with France to a marriage between Ms. Merkel (a wealthy woman) to Mr. Hollande and giving him access to her money before the wedding.⁷ Leaving the EU would be like going to a hospital for recovery. Greece should certainly leave. Portugal and Spain are also candidates. The cure would be austerity for many years. Italy is not a candidate. However, austerity causes unemployment and turmoil. Marine Le Pen would be President of France today. If there is no improvement in Spain, Catalanian separatism will become more likely. Normal voters do not understand what has caused these problems.

The Alternativ fuer Deutschland is to be taken seriously. It is lead by a competent economist. (I presume this is Bernd Lucke.)

Ireland considers itself to be like the United States and its labor market is very flexible. Wages fell during the crisis. Germany's reforms under Chancellor Schroeder also amounted to wage cuts. The "reservation wage" - at which it made sense to try to work - dropped.

Asked why Professor Sinn supported the EU despite these problems, he cited the stability needed between France and Germany.

A yes vote in Scotland would have a major effect throughout Europe. The whole mood would change. People would begin to think seriously about the unthinkable. Nevertheless countries still want to join the EU.

As to why Germany has low investment levels, despite its competitiveness, he noted low public investment levels. German investments also do not promise good returns. Germans tend to invest in Eastern Europe, certainly not in the South. The fall of the wall had a huge effect. One

⁷ I suspect given Mr. Hollande's marital situation, Professor Sinn will use another analogy next time.

wonders if VW could have survived in Germany without the support of cheap, productive labor in Eastern Europe.

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In checking for background information, I found this pdf, which likely covers many of these points.

<http://www.google.de/url?sa=t&rct=j&q=&esrc=s&source=web&cd=5&ved=0CEsQFjAE&url=http%3A%2F%2Fwww.cesifo-group.de%2Fdms%2Fifodoc%2Fdocs%2Frts%2Frts-mitarbeiter%2FIFOMITARBSINNCV%2FCVSinnPDF%2FCVSinnPDFrefjournals2007%2Fcvsinn-world-econ-2014.pdf&ei=jU4YVNTcFoeQyASjo4GAAw&usg=AFQjCNFVhIOs9hB8A67I-VmHVZrbBisP0g>