Hans Werner Sinn "The Euro Trap" Oxford UP.

Comments by *Massimo Bordignon*

The book is impressive for the level of the information that is provided. It is also very well written, understandable even by no specialists.

The main story before 2007 (flows of capital that created an inflationary boom in some countries, financed with the savings of the countries in surplus) is convincing. It is no obvious to me why the author insists so much in being capital movements (desired allocation of saving at international level) the "cause" of the budget current deficits/surplus in the Euro area and no vice-versa. No convincing evidence is reported on this point. A plausible alternative story is simply that Germany (or great Germany, adding Finland and Holland) managed to become more competitive- through the labor market policies explained in the book and perhaps for other structural reasons, not discussed in the book (sectorial specialization in capital goods, globalization, weak Euro, synergies with close Eastern European Countries etc.)- and the resulting surplus was lent to European countries in deficits to finance the latter. Not even clear why it should matter whether desired capital reallocations or budget imbalances were the starting point of imbalances. In terms of losers/winners the result is also unclear; clearly, German banks and German financial institutions made good money in the period out of these financial investments in GIISPI countries, or would not have done them. Surely, it had strong re-distributive effects inside Germany (not everybody invested in Spain); this could have been discussed more at length in the book. Where all the money for the returns of the capital investment went, and now that the bubble has burst, who is carrying the losses?

Also, why did Europe allow these macro-economic imbalances to happen? Competition between banking regulators, the (wrong) idea that external imbalances did not matter in a currency union or what ? Clearly, however, pre-crisis Maastricht rules on debt and deficits were not enough; before the crisis Ireland and Spain were the first of the class. This suggests that the Euro area should have focused more (should focus more) on banking regulations (banking union?) rather than, or only on, public finances.

The interpretation of what happened after the crisis is instead less convincing.

1. Leaving aside the issue whether target balances are o are not true fiscal transfers and if they are or are not a correct quantitative indicators of the risk for the surplus countries (debatable), the point that the currency union and the policies decided in the Euro crisis has generated and might generate moral hazard problems is well taken. But at the end the book becomes almost obsessive on this point .. banking union, target balance, OMT… everything is either illegal or produces moral hazard. The fact that there is potential moral hazard problem means that this problem has to be held in check, not that this is the only problem or perhaps even the most important for the Euro area. For instance, I find very implausible the idea that OMT is akin to full debt socialization. OMT can only be activated following a decision of the ESM in this sense, and one of the three countries having veto power on this decision even under the qualified majority rule is German, who should be, according to the book, the main payer.

2. The main economic argument of why all policy interventions decided during the Euro crisis were at the end damaging is because they distorted efficient allocation of capital, not letting debtors pay the "right" or correct price. This assumes an extraordinary faith in the ability of the financial markets to correctly assess the risks even in the context of a financial crisis, which in lieu of what we have witnessed in the financial markets in the recent years looks surprising. Issues of multiple equilibria, self-fulfilling expectations in the capital markets, and so on are no discussed in the book (and quickly dismissed in the introduction). All interventions by the Central bank or even by the countries themselves were "distortive" of an underground "correct" assessment of the risk involved.

3. Linked to the former, the analysis assumes that without the help of the other countries (directly or indirectly through the monetary policy of the ECB) GISPI countries would have adjusted faster and better. Possibly, although it would certainly have happened at higher costs for the population. But possibly, because of these same costs, countries might have not adjusted at all and left the Euro area inducing contagion effects and losses to all other Euro countries. Hard to say.

4. On this point, I do not think that public debt bankruptcy or debt restructuring was/is possible for a county inside the Euro area (without support from the others, which in the case of, say, Italy or any big country is impossible, because the debt is too large). The problem is the interaction between banks and sovereigns of the same country, as banks and financial institutions of one country typically hold most

of the public debt of that country. If a country fails, the entire banking system fail and vice-versa. Bankruptcy (inside the Euro) will become possible only when banking risk and sovereign risk are truly severed, i.e. if and when a banking union will be established. Without any support from the ECB in the midst of the crisis in 2011, even just the "announcement" of OMT, Italy would probably have been forced to leave rather than remain in the Union.

5. In terms of periodization, it is surprising that the focus of the book is only on the 2007 international crisis (before/after). As a matter of fact, there were two crises. The first was the international one (Lehman Brothers), where Europe coped not much differently from the US. The second, beginning in 2010, was the Euro crisis, which was ignited by the Greek problem and by contagion extended to the other countries with public debt/bank debt problems. The turning point was the Deauville declaration by Merkel-Sarkozy. This showed that 1) private holders of Greek debt would sustain all the costs of bankruptcy (nice principle in theory, but not the thing to say at the moment in which you want to convince people to keep Greek debt, and indeed the principle was not followed afterwards); 2) the Euro area had neither the political will nor the tools to face even the crisis of a small economy such as Greece; 3) exiting the Euro area by a member country was a serious possibility; that is, that currency union was not a union but in fact just a system of fixed exchange rates (and fixed exchange rates can always be changed). This created expectations of a breaking up of the union and hence the reintroduction of a re-denomination risk on countries in trouble that led to huge capital withdrawal and capital flights. This is in itself created target balances through adjustment inside the banking sector (Cecchetti). The "whatever it takes" declaration has removed the risk of redenomination.. as long as people believe it, which might not be long, considering Karlsburge's decision and pending the European Court of Justice decision.

6. The case of France seems to me to be very indicative of what went on. France never came under attack by financial markets during the Euro crisis, in spite of its banking system being much more exposed to the GIISPI countries and in spite of the fact that its economy was not doing particularly well. In terms of competitiveness versus Germany, France lost more than, say, Italy. A plausible explanation is that markets believed that Germany would never have allowed France to go (differently from Greece, Spain or even Italy) for political reasons.

7. The criticisms raised to the ECB in the book (technocratic and no democratic body that takes redistributive fiscal decisions) I found too heavy, although understandable in principle. Even assuming that the ECB choices had fiscal consequences and that therefore the ECB overstepped its mandate, the reality is that ECB never took these decisions alone. As a matter of fact, all relevant decisions taken so far by the ECB (expect, perhaps, the very last), including the OMT, have been taken in accordance with the leaders of the main countries, that is democratically elected leaders. Indeed many think that this is why ECB decisions often came too late and at too high a cost; Mario Draghi is not fully independent and needed the political support of the bigger countries and in particular Germany before being able to take any serious decision. Very often, as it was case with the OMT, only the German representative in the ECB council objected to them. Which of course is a problem, given the importance of Germany both in economic and population terms. But it looks more as an episode of the long conflict between the German government and the Bundesbank, than a problem with democracy.

8. Talking about democracy, there is no discussion in the book about how decisions about the Euro crisis (right or wrong) were taken. As a matter of facts, the decision were taken by the ECB for monetary policy and for fiscal policy by the countries in the European Council, where only the representatives of the different countries seat. Totally democratic legitimate leaders, of course, but accountable only to their national constituency and who at the end cared only for this national constituency. But there is also an European constituency and interests of the Euro area that go beyond that of any single country. In economic terms, there are externalities and spillover effects that were not internalized by national decision makers in the Council. The European Parliament, the only body that legitimately represents an European constituency, has never been involved in decisions concerning the Euro or the stance of fiscal policy in the Union. Notice that this is different from what happens for other European policies, where usually the communitary method, rather than the intergovernmental method, is used to reach decisions. Worse than that, for the dynamics of the Council and the relative importance of countries, who really mattered in the Council was the German Chancellor. This created resentments in the public opinions of the other countries, and also led to decisions who were untimely (too little, too late) and sub-optimal for the area as a whole (and possibly for Germany itself).

9. The book lacks a chapter, on how rules on fiscal imbalances and macro-economic imbalance have evolved inside the Euro area up to the fiscal compact. The author dismisses them in a paragraph, saying that nobody is going to follow them anyhow. Not the way it is seen in Italy or in the other GIISPI countries, where all discussion and fiscal policy have been concentrated on how to meet these constraints. Also, it would have deserved explaining the new role that now the Commission is playing.

10. In the book Italy is always grouped together with the GIISPI countries. But the dynamic was totally different as also shown in the book. Italy did not experience the capital boom that the other countries witnessed in the first period, while it suffered from GDP losses and capital flights in the second. There were very few direct capital investments in Italy before the crisis; the Euro for Italy just meant that now foreigners found convenient to hold a part of Italian debt. Using the book terminology, Italy was a loser like Germany in the first period and a loser like the GIISPI countries in the second, in spite of the enormous advantages that the Euro brought about to Italy in terms of reduced interest payments on the debt. The country suffers from a competiveness problem with preceded the Euro and has very little to do with it. The Euro perhaps worsened the situation, because Italy became more expensive, but I do not think this is the main problem, nor that just making Italy cheaper would by itself solve it. For instance, exports have not gone back to 2007 level, but it is hard to believe that this was due to the fact that Italy was massively less competitive in terms of relative price in, say, 2010 than it was in 2007. Structural problems, debt crunch and recession induced by fiscal adjustment are the most likely causes. (Talking about Italy, which is the only country I know well, I have problems with many numbers quoted in the book. Labor income compensations in the public sector did not increase as much as it is said after the 2007 crisis (public wages have been frozen since 2009 and public employees have been reduced by 8%); and potential losses in the banking system (crediti incagliati) are by far lower than those reported into the book).

11. This point may perhaps be elaborated further. The warranted adjustment in the book is just in terms of relative wages and prices; this is certain a point for many services and goods produced by the GIISPI countries. But what these countries really need it is to move their production towards higher value added products, where price and wage differentials are less important. This needs private investments and direct capital flows from above, no just fiscal restrictions. Also, no enough consideration is given in the book to the fact that devaluation and recession induced

by fiscal policy might make more difficult to achieve fiscal equilibrium, so conflicting with Maastricht rules and fiscal compact. Italy seems to be stuck in the middle of this dilemma. Taxes have been increased, in nominal (not just real) terms, current expenditure has been frozen for the the last 3 years and capital expenditure has been cut by half; but with falling nominal GDP this was not enough to stabilize public finance and the austerity policies made the economic situation worse. Tellingly, in spite of the increase in several tax rates, tax revenues was actually lower after Monti policies than it was the previous year. Austerity, credit crunch and falling expectations have reduced private and public investment thus making more unlikely that the country can get back to the sustainable growth.

Ways out

12. There is no doubt that the situation is a mess. Europe and the Euro area as a whole is doing much worse than the US in spite of the fact that the crisis had originally hit the US harder. On average, private consumption and investments (-20% in the area, -25% in Italy) have not yet gone back to previous crisis period. There are serious risks of another lost decade with deflation, high unemployment and structural output losses. A crisis that lasts so long has also structural effects; there is permanent human capital losses that cannot be recovered. Not sure that this is only a Southern Europe problem, the North doesn't seem to be doing much better. And in spite of all the importance being given on the necessity of restructuring public finance as a precondition for growth, the situation on public finance is now worse than it was in 2007. Italian debt is certainly by far less sustainable now than it was in 2007.

13. At the end the policy for the Euro area was grossly sub-optimal, because the Union is not a truly federal union. The book speaks for to need to move for a federal union, taking Switzerland and the US as example. I fully agree (although my model is more a Union of States, with a role being given to member country at the executive and not at the legislative level; but these are details). It should be noted however that these federations are not only characterized by strict budget and debt rules for sub-national units, but also by common federal policy in many areas, included fiscal policy. And implicitly, through federal policies, these sub-national units are partly insured by the federal budget. In the US for example, although there is no explicit redistributive transfer system in place for sub-units, the federal personal income tax plays this role at the personal level. In passing, it should also be noted in the US

during the crisis the federal budget increased its transfers to states and counties so as to compensate them for revenue losses (in the US these units largely finance themselves with property taxes on real estate, whose value fell during the crisis). A political federation is not only made up by fiscal constraints on local units. Common policies are decided by political bodies where representatives of all participate to decisions.

Given the Euro area situation, there then seems to be two options.

14. The first is recognizing that since Europeans do not want a political union, the Euro was a mistake to start with and we should peacefully agree to dismantle it. The problem is that this is unlikely to be possible, differently from what the author suggests. Any leakages that the countries are preparing to dismantle the Euro, would immediately generate huge capital flights, bringing down the Euro and inducing heavy losses to all ex members. And as these are democratic countries, a decision of leaving the Euro could not be taken "secretly", without involving Parliaments and public discussions, and therefore would obviously "leak" in advance. (In the book there are several references of Berlusconi having started secret consultations to leave the Euro; but, whatever the agreements, he could not have done it without Parliamentary approval and large country discussion). This means that the decision of a country of leaving the Euro, if it happens, would probably not happen peacefully, but in the middle of a financial crisis, with extraordinary measures being put in place, and in a political turmoil. And the univocal decision of a country to leave the Euro would perhaps force other countries to leave the Euro as well, in particular if the ECB , as the book suggests, was not allowed to take counteracting measure. This contagion risk was there even with the small Greece; one can only image what would happen if a big country, say Italy, was the one to take this route. And since any breakup of the Euro is going to have serious economic costs for everybody, it is only too easy to predict that a gigantic blame game would ensue; every national leader will immediately accuse other countries and other national leaders of the responsibility of the break-up. It is difficult to believe that in such a situation European countries could keep the common market and the European Union flowing. These are, in my view, the true costs of a break-up of the Euro; so much has been invested politically on the Euro that giving it up would probably mean give up the European Union as well. This is the true Euro trap.

15. The second alternative is moving gradually towards a political union and a true federation. With optimism, one might think that the Euro crisis was a growing crisis (not differently from the many that all federations have met during their history; even the US were not born like that) and that all steps taken so far (Banking union, Esm, new fiscal rules, Euro-plus, macroeconomic imbalances indicator, the proposal for a political union by the four presidents etc.) are all intermediate steps leading to a fully-fledged political union. The problem with this interpretation is that this can only happen if the Euro maintain its promises of growth and well-being for at least a majority of the population in all countries; if the Euro, with the complicity of national leaders that have already started the blame game, is only seen as a constraint by some, and as a way to steal their money by the others, Europe does not go anywhere. The low level of trust between member countries is by far the most dangerous development for the Euro crisis; it looks as if even problems which could be easily managed with a bit of common sense are becoming increasingly insurmountable.

16. Specifically, so far the adjustment has been mainly imposed on the GIISPI countries, with a bit of help from the ECB. But a solution to the problems can only come from a common economic policy. For instance, if the matter is relative prices, the core should accept more inflation for a period in order to help the devaluation of the others. Further, it seems obvious that the Euro area has both a supply and an aggregate demand problems; given the fiscal constraints on many countries, support for demand should come either from the common budget or from countries in better shape. And so on. It looks as a reasonable equilibrium is between reach, and it is frustrating that it seems so difficult to reach. To me, it is a further indication of the limit of the intergovernmental system.

17. If a reasonable solution is not found, the risk is that the economic situation degenerates so much that sooner or later anti-euro political forces will prevail somewhere (Italy, France, Germany..) and they will pull the plug, with the consequences discussed under point 14.