29 September 2014

Reply to a letter of Massimo Bordignon of September 2014

Dear Massimo,

Thank you once again for the invitation to Milano and the organisation of the book presentation. This was a very useful event. I received good comments.

I read your comment on my book with great interest. Please allow me to react.

You question the causality between capital movements and current accounts that I describe. My argument is the German slump, resulting from the low investment that itself followed from the emergence of seemingly better investment opportunities abroad (fall of the Iron Curtain, the euro, globalisation and previous aggressive wage policies in Germany). I had discussed that a decade ago in my book "Ist Deutschland noch zu retten?" (Can Germany be saved?). Had the current account driven the capital flows, Germany would have had to experience a boom resulting from foreign demand for German products. Schröder's reform was a reaction to the slump and it helped to widen the wage distribution, improving the economy's reactions to the various shocks. The reform was prepared in 2002 out a disappointment about a boom that was expected, but did not come. Ifo was instrumental at the time in demanding and defining the necessary reform.

I agree that Europe should have focused more on banking regulation early on. In 2003 I published my book "The New Systems Competition" making exactly that point by showing that systems competition would lead to competitive and harmful deregulation in the banking industry.

Your point 1:
I regret that you find my emphasis on the moral hazard problems obsessive. For me this is the most important aspect. If we cannot limit the moral hazard resulting from the artificial elimination of interest spreads due to mutual assistance programs we should get rid of the euro. The danger for European peace it too large. But I think we can save the euro by sticking to article 125 TFEU. Neither the US nor Switzerland would bail out their states or Cantons, and the central banks do not buy their bonds. The no-bail-out principle is the fundamental prerequisite for a stable federation. Interest spreads are essential brakes against excessive borrowing, and they only arise if investors would have to face the risk themselves.

According to the German Constitutional Court (preliminary ruling of February 2014) the Bundestag does not have the right to agree to ESM aid if it implies OMT actions, as this would undermine the budgetary autonomy of the state which is one of the fundamentals of the constitution with "eternal validity". Germany in this case would need a new constitution to be implemented by a referendum.

As I explain towards the end of my book I am willing to go the full way towards a new German constitution imbedded into the rules of a European state, if it really is a state with a common European army and a parliament based on the one-man-one vote principle.

Your point 2:
Article 125 TFEU was not meant to be for good times but for the crisis. It specifies that states would have to go bankrupt if they are unwilling to repay their debt and that the creditors would have to bear the losses. The IMF in 2013 agreed that it was mistake not to have a Greek haircut in 2010, i.e. not to let Greece default. If a country wants to avoid settling in a bad equilibrium with expected default it can tax its citizens or offer collateral to borrowers. I find the arguments for collective action to bring about the good equilibrium weak. International externalities that would legitimize such actions are conceivable, but highly theoretical. In my view, no compelling case has been made for them in practical terms. The ECB was asked by the German Constitutional Court to explain why it believed that there was a risk of settling in a wrong equilibrium and why this required collective action. The ECB's answer was ridiculously weak, and no one could understand what they really meant.

Your point 4:
I am not against temporary liquidity help by other nations in the case of a crisis. Insofar I accept the EFSF and ESM. They are compatible with the Maastricht Treaty. However, other states cannot and should not prevent insolvency. Italy is a rich, indeed very rich, country. It would have been easy to convince investors that Italy would service its debt had Berlusconi introduced a real estate tax. Italy would not have had to leave, and it should not have left even if the ECB had not introduced the OMT program. If the ECB wants to be a lender of last resort, it does require a new mandate.

Your point 5:
I fail to see why a re-denomination risk as such will create interest spreads. Such spreads result not from the risk (with zero mean), but from an expected devaluation, which in turn results from the loss of competitiveness in the prior inflationary credit bubble. Interest spreads that reflect the likelihood of a realignment of a currency are efficient according to basic economic principles (Dorfman, Solow ... early 1960ies). A central bank acting against such spreads will create allocative distortions and violate its mandate.

Your point 6:
I basically agree. But as you see in my Figure 4.8, Italy inflated much more than France and thus lost more competitiveness under the euro. Yes, the French spreads did not go up because markets believe that France is strong enough politically to always stay in the euro. This does not help France very much, as it is in deep trouble now. Not only the southern European countries fell into the euro trap, but also France, which was the driving political force behind the euro. It is a tragedy.

Your point 7:
The fact that Merkel backed Draghi is well taken. I also make it in my book. . However, in the opinion of the German Constitutional Court, Merkel did not have the right to back the ECB, as this meant she was circumventing the Bundestag. The Court's statement of February implicitly, but very bluntly, attacks Merkel because of this. According to the Court, the German government does not have the right to silently accept, let alone support ultra vires actions of European institutions, but has to take actions against them. If it does not, every citizen has the right to appeal to the Court forcing the government to act.

Your point 8:
I understand this point.

Your point 9:
Yes, I could have expanded more on that.

Your point 10:
Indeed Italy had a competitiveness problem before the euro. Perhaps the 1000 Lira should not have been brought back from 82 Pfennig to one deutschmark before the irrevocable fixation of exchange rates. You are right. Before 2007 Italy was a bit like Germany, and thereafter a bit like Greece. It needs fundamental labour market reforms and much higher taxes to redeem its debt.

Your point 11:
The policy of compensating for excessive wages with interest subsidies we observed in east Germany. That did not work at all, creating even more unemployment and mass emigration. The factor price ratios have to be right. Lowering the rate of interest is no compensation for excessive wages. Italy needs higher interest rates and lower wages. Basically wages and living standards have moved beyond productivity growth and will now have to return to reality as defined by productivity. This was the German problem a decade ago. Scaling down is the only solution. A period of nominal shrinkage is unavoidable. Keynesian "growth" will not be a solution, but exacerbate the problems.

Your points 12 and 13:
I agree, but repeat that we need more than just a common budget. Every confederation started as a defense union with a common army.

Your point 14:
Are you sure Europeans do not want the union? A majority of Germans including myself want it. The conditions are subject to bargaining. Italy or another big country should not be leaving. I hope you do not misinterpret me here.

Your point 15:
You miss the essential aspect of any political union, the common army. We have to start with that and then move on with the rest. So it was in the US and in Switzerland. Your sequencing is wrong.

Your point 16:
I deny that Europe has more than structural problems and needs Keynesian demand stimulus. Such stimulus would weaken the adjustment of relative prices. I accept, and said so in the book, that Germany needs more inflation as part of the solution.

Your point 17:
If we continue with Keynesianism and ECB bail-out actions the future will be as you describe. A breathing currency union based on the investor-liability principle is the only one that could work for the time being, and hopefully we will have the courage to dare a full European Union thereafter. There is no alternative to European Integration.