

Austerity in Europe

Hans-Werner Sinn
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Summary of the argument

Austerity of a currency union
as a whole

versus

Austerity of a sub-region
within a currency union

- The Eurozone needs austerity in the south to realign relative prices
- Austerity comes from markets; policy softens the budget constraints
- Exits may be better than austerity

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The Euro Trap

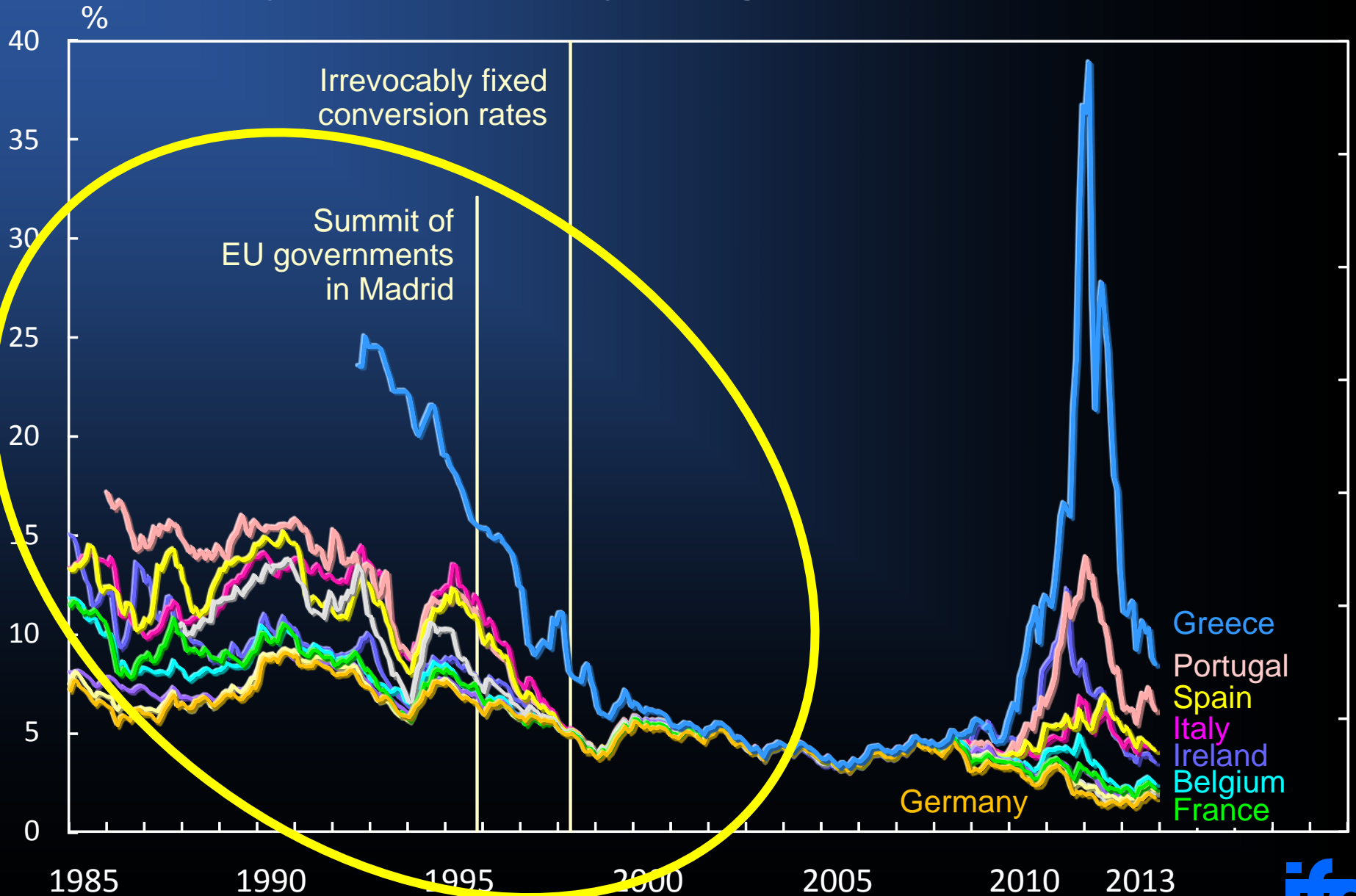
On Bursting Bubbles,
Budgets and Beliefs

2014
Oxford University Press

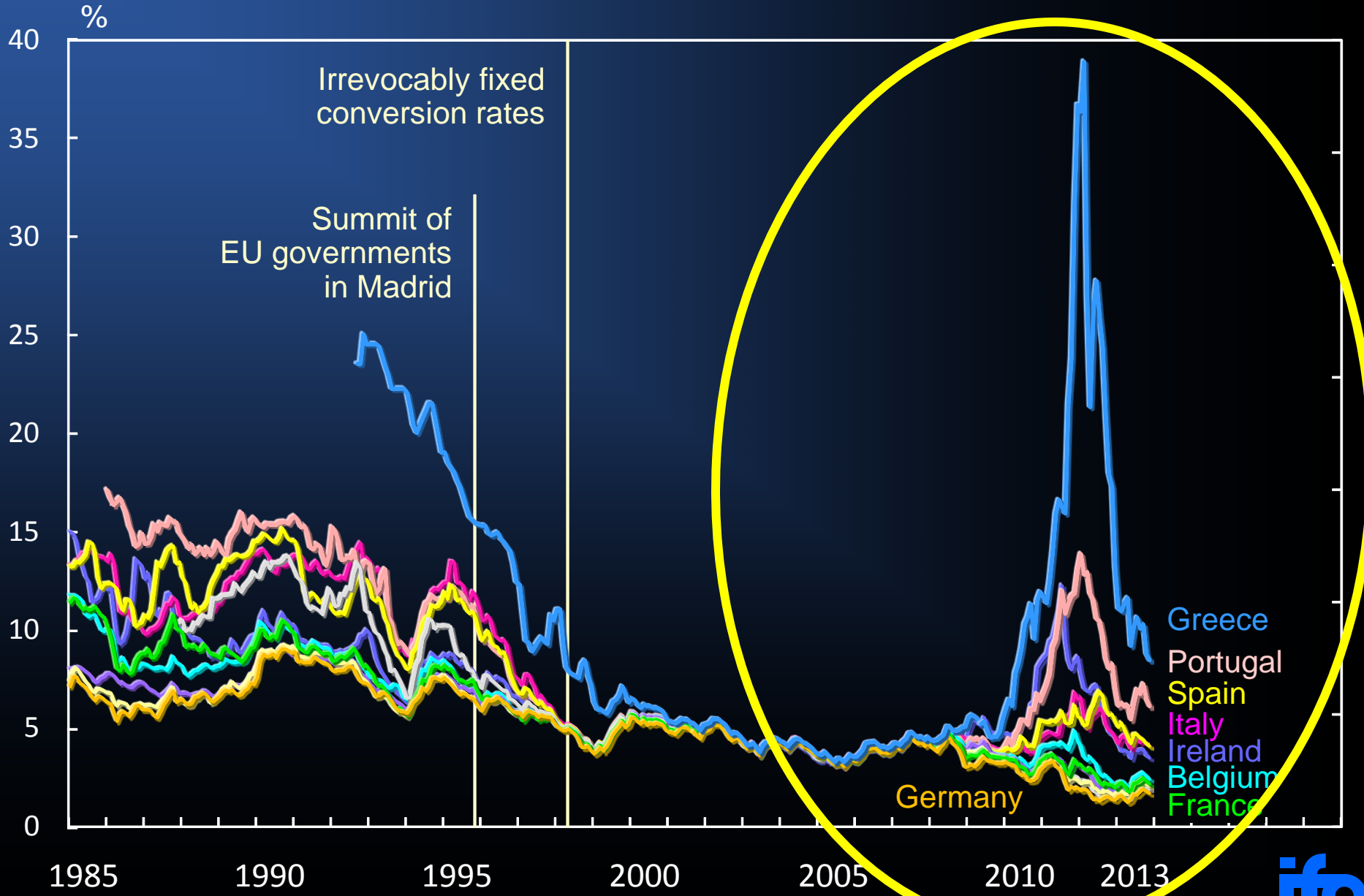
H.-W. Sinn,
„Austerity, Growth and
Inflation: Remarks
on the Eurozone’s Unresolved
Competitiveness Problem,“
The World Economy 36, 2013

The bubble

Net yields for 10-year government bonds

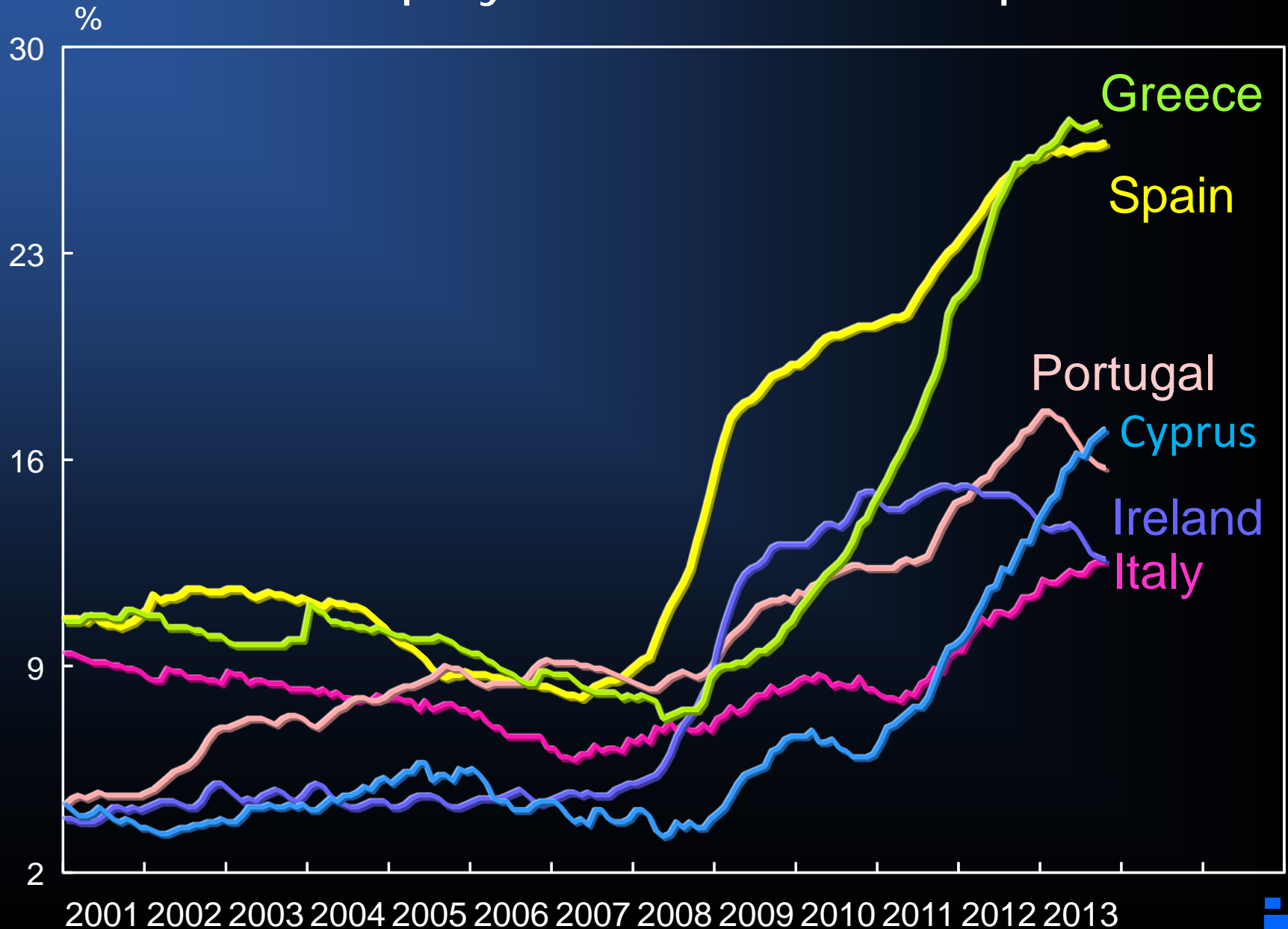


Net yields for 10-year government bonds



Source: Thomson Reuters Datastream.

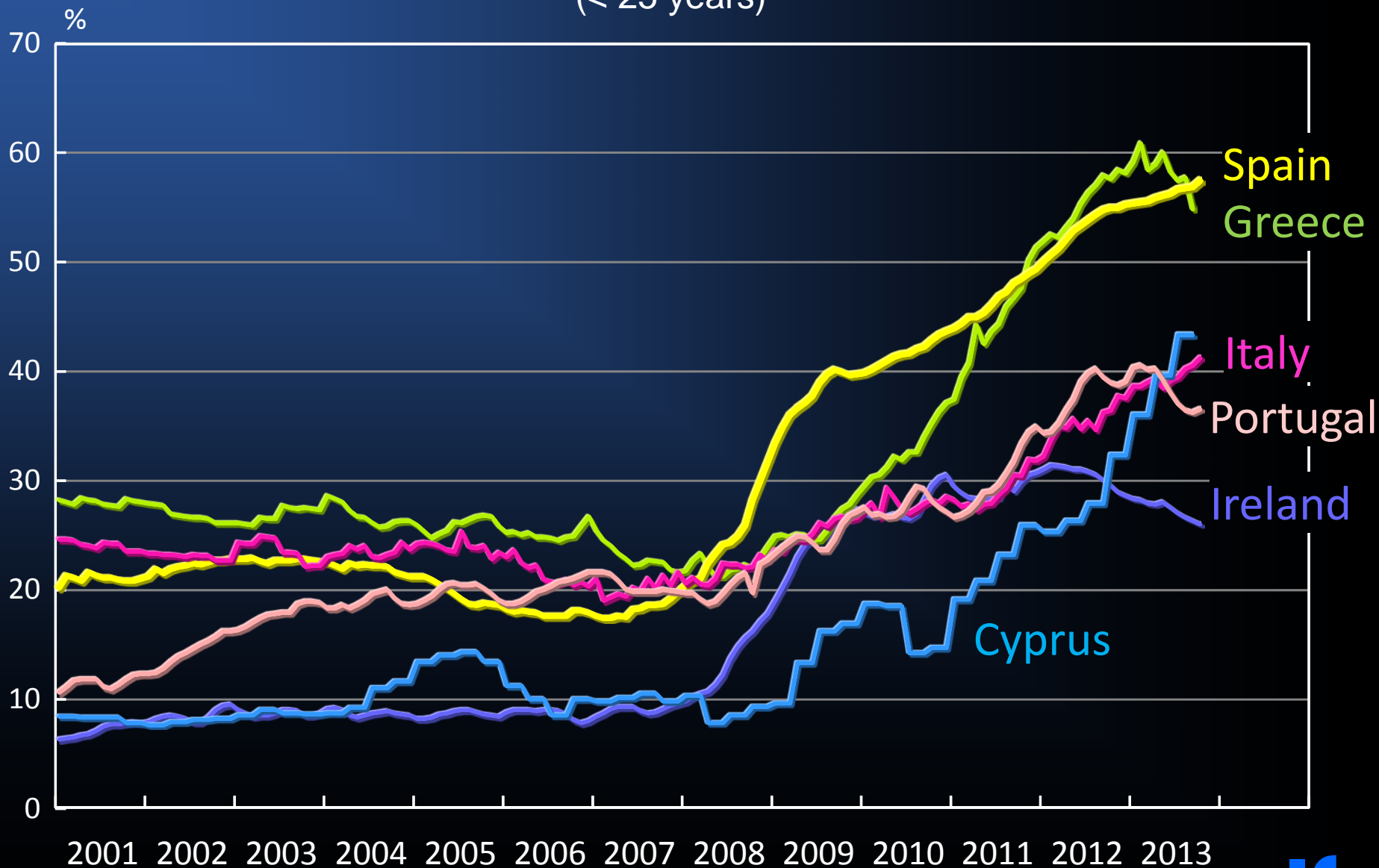
Unemployment rates in Europe



Source: Eurostat; December 2013.

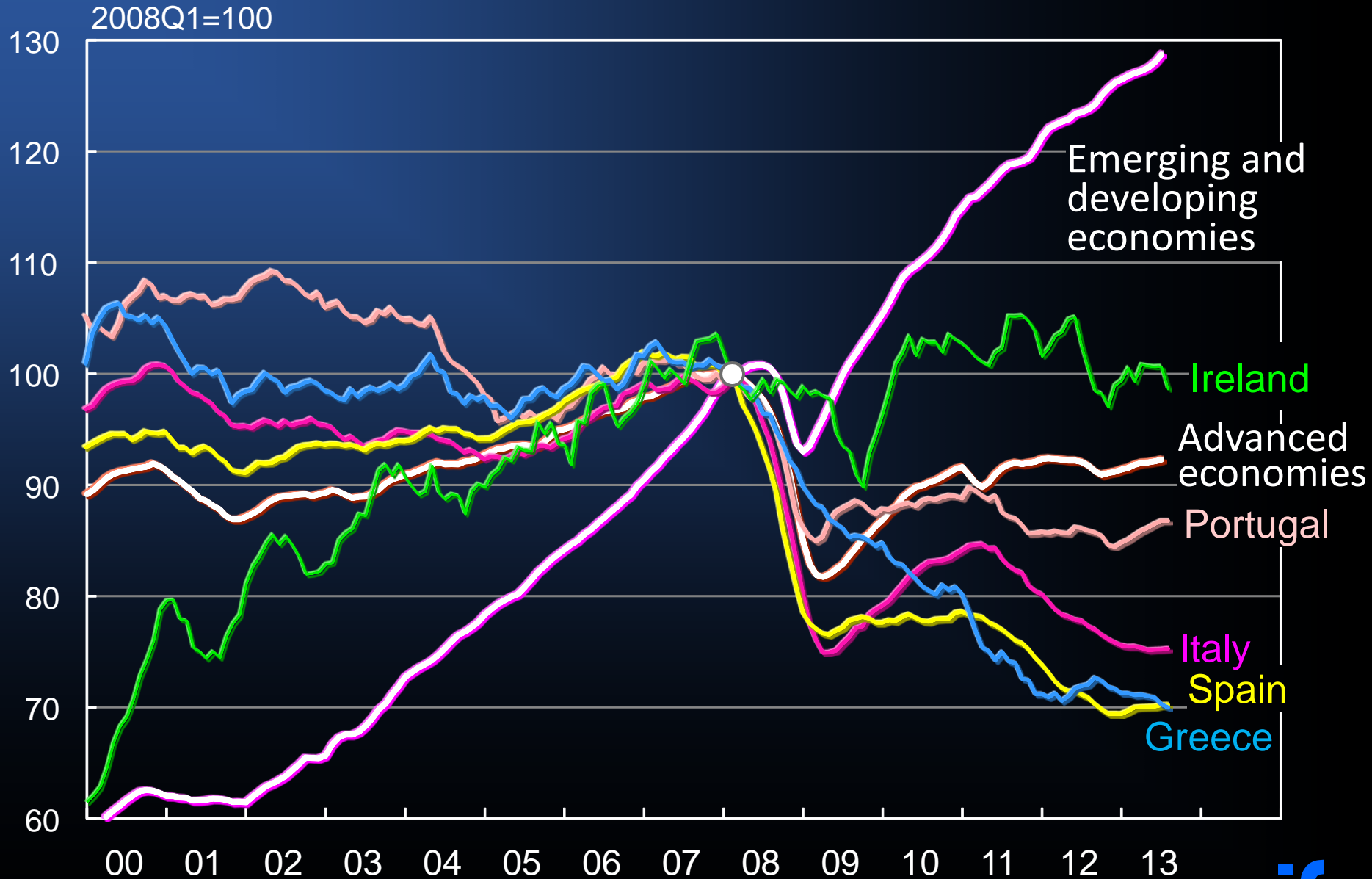
Youth unemployment

(< 25 years)



Source: Eurostat, December 2013.

Industrial production



Source: Eurostat; OECD; CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor.

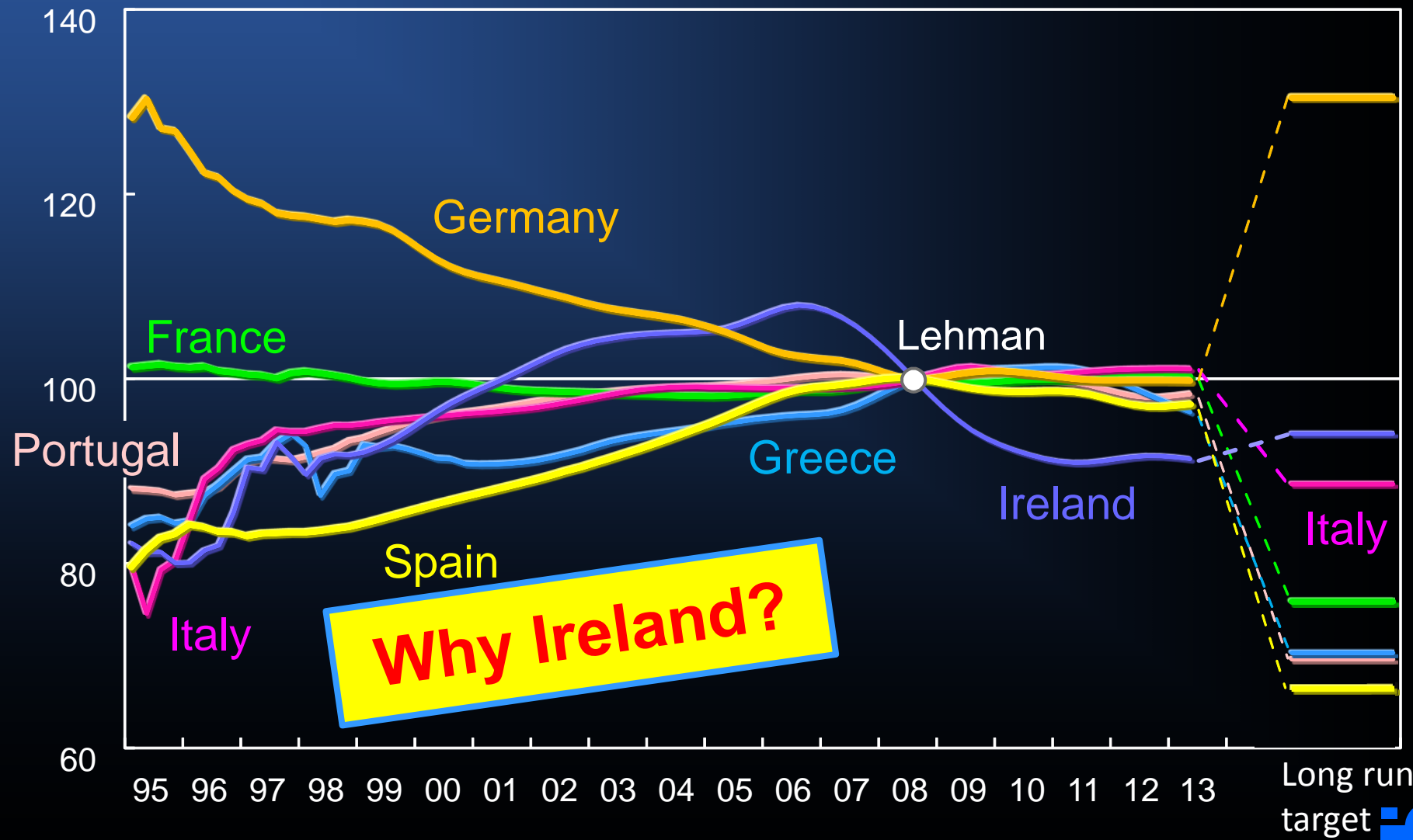
The realignment problem

Real exchange rates

(GDP deflator relative to rest of euro area)

& necessary realignment according to Goldman Sachs

Q3/2008=100



Long run target

Four dismal options

1. Transfer union

Dutch disease

Four dismal options

1. Transfer union

2. Deflation in the periphery (austerity)

**Mass unemployment and
bankruptcies**

Four dismal options

1. Transfer union
2. Deflation in the periphery (austerity)
3. Inflation in the core

**Violation of the central bank's
mandate**

Four dismal options

1. Transfer union
2. Deflation in the periphery (austerity)
3. Inflation in the core
4. Exits

**Bank run à la Cyprus
&
capital controls**

Austerity
or
soft budget constraints?

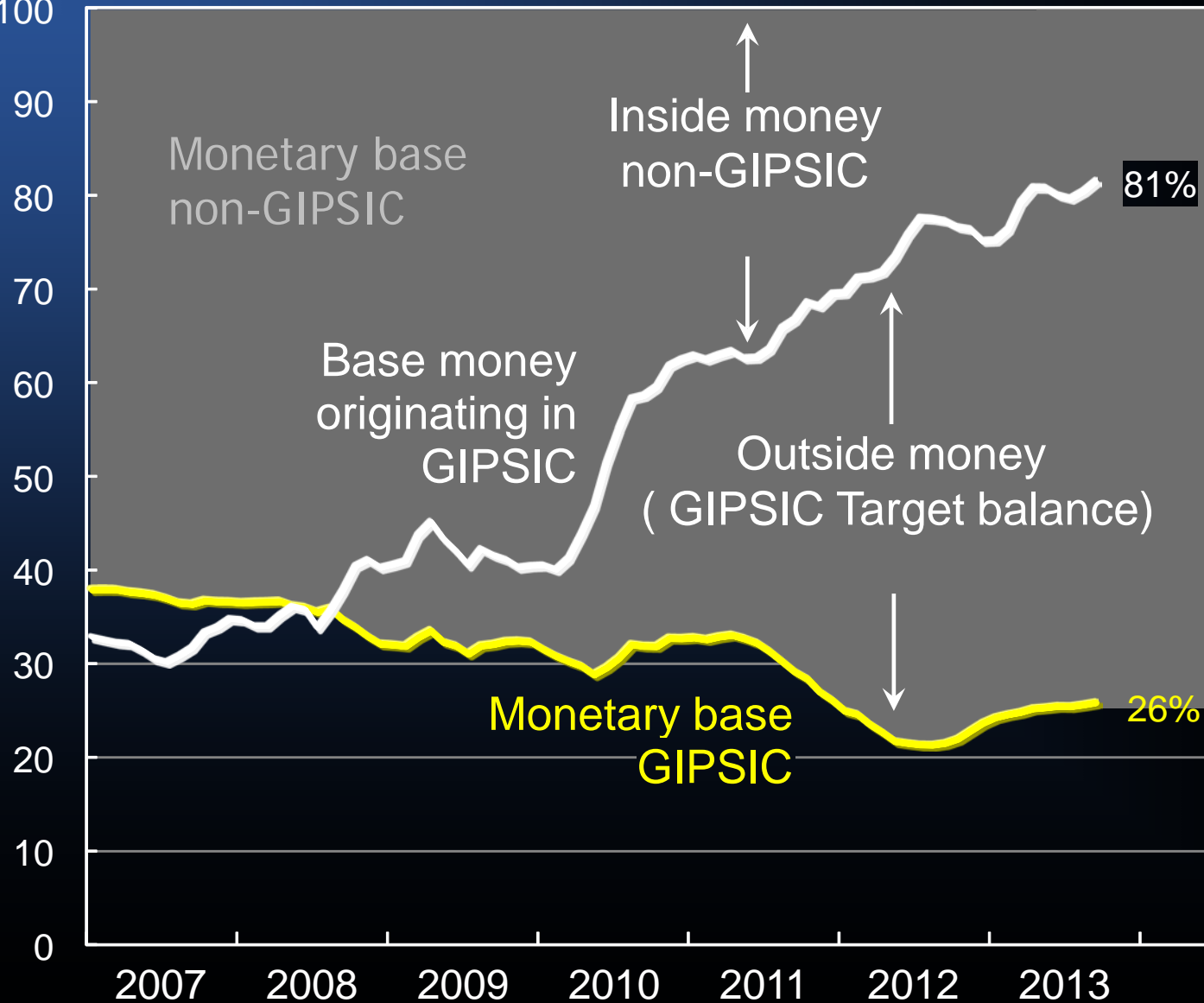
Bail out with the printing
press:

Non-investment grade
collateral for ECB refinancing
credit

Inside money and outside money

Monetary base
Eurozone

100 %



55%

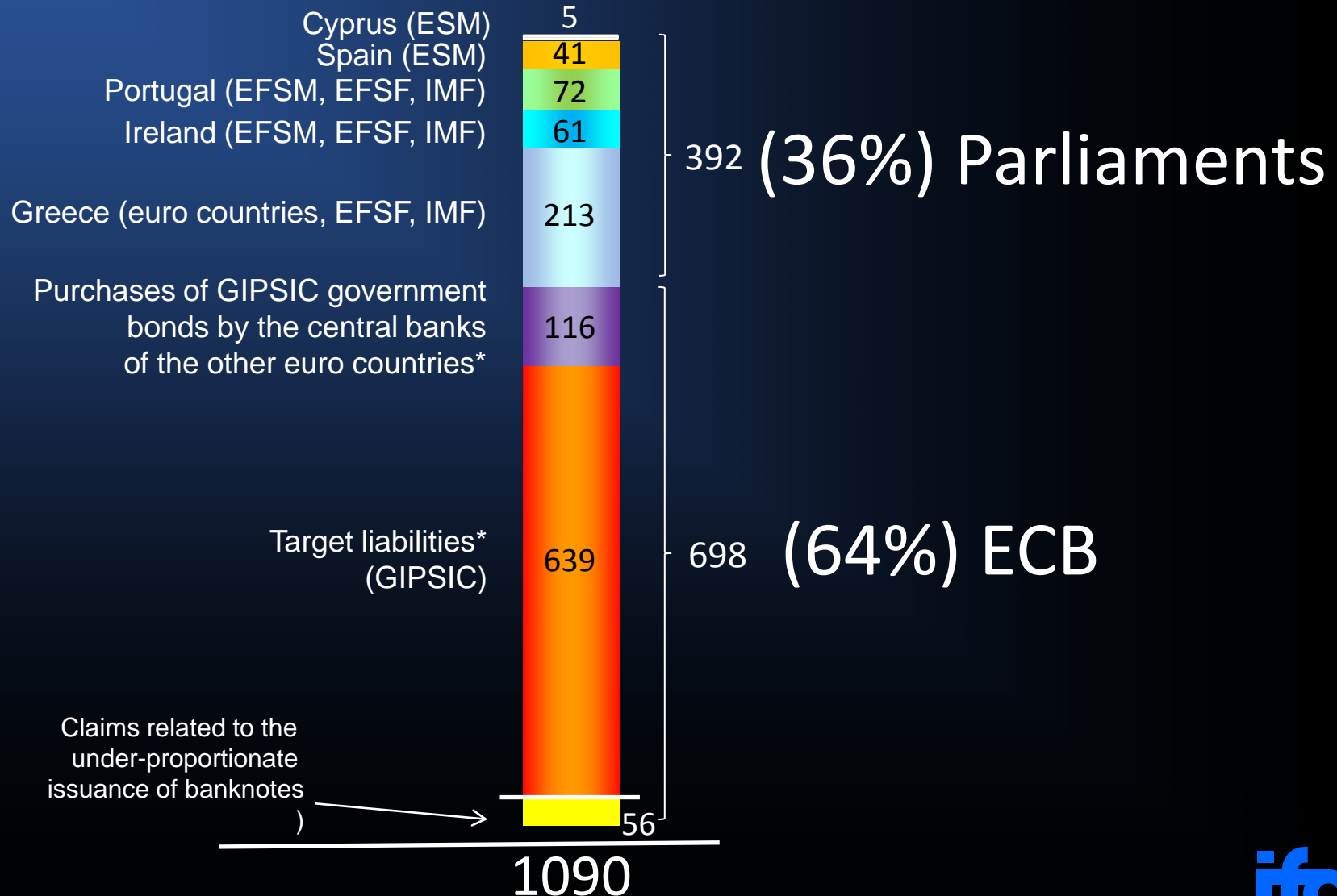
81%

26%

Lending funds to euro countries

(Billion euros)

Paid-out to date



* Updated 13 December 2013

Soft budget constraints

= abolishment of risk premia
ex ante

= credit bubbles and
overheating

= lack of reforms and
realignment efforts
ex post



Soft budget constraints are dangerous

Harold James, Princeton:

The Hamiltonian scheme of federal finance did not guarantee a peaceful commonwealth. “In fact the fiscal union proved to be explosive rather than cement.”



Unsustainable debt

Debt sustainability requires real devaluations, but real devaluations increase the debt-to-GDP ratios.

Actual and hypothetical public debt-to-GDP ratios (2012, %)

	Official public debt	Official public debt at competitive GDP prices
Greece	157	197
NB: without haircut	211	294
Ireland	118	114
Portugal	124	173
Spain	84	118
Italy	127	141

The way out

Three basic measures to rescue the EU and the euro

1. Debt conference to forgive part of the public debt, the bank debt and the Target debt
2. Temporary exits of severely uncompetitive countries
3. Harder local budget constraints for central banks (settlement of new Target balances, internal gold standard like US until 1975)

A “breathing currency union”
placed between
Bretton Woods and the dollar
until the
United States of Europe
is founded

