Europe's Keynesian Dream

A neo-classical recipe for a neo-classical problem.

By Hans-Werner Sinn

A prominent view among Anglo-Saxon economists is that Europe's ailing economies are suffering from a temporary lack of demand that requires classical macroeconomic policy measures such as those implemented by the United States in recent years. If this view were correct, Europe should now be out of the woods, given that its crisis-stricken countries have been showered with fresh money from local printing presses and allowed to boost their debt-to-GDP ratios. Alas, it isn't. The truth is that Europe is suffering from a distortion of relative prices that burdens southern Europe with mass unemployment and northern Europe with bad terms of trade. This assessment does not only follow from a German ordoliberal and old-fashioned view of the world, as is often maintained, but also from plain neoclassical economics.

True, a Keynesian demand crisis prevailed in 2008–2009, when banks and financial intermediaries were hoarding liquidity and the interbank market seized up. But when the recovery of the global economy brought some relief to the southern European economies, it became clear that the financial crisis simply had exposed the above structural problem.

The distortion resulted from the euro itself. Interest rates in Europe converged quickly after the Madrid Summit of 1995 set

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the timing for euro introduction, triggering inflationary credit bubbles in southern Europe that ultimately deprived these countries of their competitiveness. The credit inflows were used to raise the wages of both government employees and construction workers beyond productivity, and beyond the level of comparable competitors. Wages in Greece are today twice as high, and in Spain three times as high, as in Poland, for example. From the beginning of 1995 to the third quarter of 2008, when Lehman Brothers collapsed, Spanish prices increased by 23 percent more than the rest of the eurozone's prices. Similarly, Italy revalued in real terms by 25 percent, Greece by 16 percent, and Portugal by 17 percent. In contrast, Germany, which was suffering from an exodus of investment capital, devalued by 22 percent.

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As long as private investors were willing to finance the southern countries' funding gap, this situation was sustainable. However, as soon as the U.S. crisis spilled over to Europe and private capital shunned the south, the crisis hit.

Since early 2008, southern Europeans have been allowed to borrow and print themselves out of the pain, but this has not prevented the collapse. Portugal's manufacturing output has so far fallen by 13 percent, Italy's by 25 percent, and Spain's and Greece's by nearly 30 percent. Italy is now in a triple-dip recession, with unemployment trending upwards. Italian youth unemployment is at 42 percent. Spain had a double-dip depression, and it is unclear what comes next. In 2013, there were signs of recovery, but 2014 showed only a sideward movement in manufacturing output. Spain's and Greece's unemployment rates are around 25 percent, while youth unemployment hovers around 50 percent. By January 2010, when the first debate about Grexit flared up, Greece had received €48 billion, or 22 percent of its GDP, in extra credit from the printing press (Target credit). Now, five years later, Greece's stock of net credit from foreign public institutions (Target plus fiscal) stands at €267 billion, which is 145 percent of GDP. (This is, incidentally, equivalent to twenty-nine U.S. Marshall plans for Germany, given that the Marshall aid that Germany received in the post-war era added up to 5 percent of Germany's GDP in 1952. The Marshall aid was part of the forgiveness of German debt, amounting to 20 percent of GDP, mentioned in the London Debt Agreement of 1953.) Greek finance minister Yanis Varoufakis is right when he says that all this help was useless, given that the country's rate of unemployment now is more than twice as large as five years ago and that the Greek state is bankrupt.

What is more, the loose budget constraints have worked against the re-adjustment of relative prices. By escorting capital and hence investment demand from north to south, the ECB's Outright Monetary Transactions program and other rescue operations have dampened both the inflationary forces in the north as well as the deflationary forces in the south.

Even after six years of crisis, the realignment of relative prices of Italy, Portugal, and Germany has been tiny. In terms of the GDP deflator, only Greece and Spain have devalued by 7 percent or 6 percent, respectively, relative to the rest of the eurozone, but that is clearly not enough. Spanish relative prices, for instance, would have to decline by 19 percent from the time of Lehman to regain their relative position of early 1995. And to make sustainable the huge foreign debt of €1.003 trillion accumulated in the meantime, they would have to come down by no less than 34 percent relative to the rest of the eurozone.

The only country that managed the trick was Ireland. Its bubble burst in 2006, two years before Lehman. As no rescue program was on hand at the time and the ECB kept the local printing press under control, Ireland was forced into austerity, resulting in a real devaluation of 13 percent since the peak in the first quarter of 2007. It hurt, but Ireland's economy has emerged from the crisis. In 2014, its manufacturing output increased by 21 percent.

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For the eurozone, there are now only four dismal options. First, Europe could move into a transfer union to compensate for the south's lack of competitiveness. The risk would be a permanent Dutch disease, with southern prices up and the economies down. The second option is deflation in the south through austerity. However, deflating is grievous in countries that have had a credit bubble, as it drives debtors into bankruptcy. Germany's experience towards

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the end of the Weimar Republic tells a bitter lesson. The third option is inflation in the north, Germany in particular. But that is easier said than done when interest rates are zero, the ECB is running out of ammunition, and fiscal policy suffers from the inefficiencies evident in Japan. Inflation would also have to be huge: if no country deflates, from the third quarter of 2014 onwards German prices would have to go up by 62 percent, or 4.9 percent yearly, for ten years. The average eurozone price level would increase by 29 percent, equivalent to 2.6 percent annually for ten years, even if all other inflation rates stayed at zero, thoroughly violating the ECB's mandate. The fourth option would be for the eurozone to allow exits and open devaluations. Capital controls such as those in Cyprus would be required to counter capital flight and bank runs. Greece is very close to this.

As none of these "solutions" is attractive, politicians will have to make unpalatable choices. In my opinion, burden-sharing calls for a combination of all four options: transfers, moderate deflation in the South, more inflation in Germany, and temporary exits, facilitated by substantial debt relief. If the ECB stopped luring savings capital from north to south and gave up its "whatever it takes" philosophy, markets would by themselves bring about the necessary realignment by inflating the northern European countries. In particular, the current German construction boom, a result of investors' attempts to shield their wealth in turbulent times, would be rekindled and lead to higher wages and prices in Germany, boosting German imports and undermining the competitiveness of its exports, thus driving the eurozone back towards a sustainable equilibrium of relative prices. That is a neoclassical recipe for a neoclassical problem. Let the Keynesians dream their ideological dreams, and let the rest of us turn to the real problem. ◆