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A Currency Crisis Debate

'The Euro-Zone Bailout Programs Must Be Stopped'

How to save the euro? Some believe that the European Central Bank is the key to any solution. Others think that the euro zone should be contracted and the weak members squeezed out. SPIEGEL spoke with two leading German economists about the currency's future. Their one area of agreement? Something must be done quickly.

SPIEGEL: Mr. Starbatty, Mr. Bofinger, can the euro still be saved?

Starbatty: All of the measures that are currently planned take effect in the long term. But rescue measures are needed now. That's why many politicians want to pull out the so-called bazooka and inject money into the market through the European Central Bank (ECB) or introduce euro bonds. Both are deadly sins. It would be better to shrink the monetary union to a hard core that can sustain the euro.

Bofinger: That would be a disaster. But I agree with you that time is of the essence. The highly indebted countries must be able to borrow at moderate interest rates so they don't go bankrupt. This could be achieved with euro bonds. And if they can't be implemented that quickly, the ECB has to stabilize the system. In doing so, it would not create inflation but would in fact avoid deflation.

SPIEGEL: Aren't you worried that the pressure to push through austerity and reforms would subside as soon as the ECB unpacked the bazooka?

Bofinger: German politicians have not acknowledged that these countries have already reduced their deficits significantly. Compared to 2009, deficits have declined in all of the crisis-ridden countries. And Italy is the second-most solid G-7 member state, just behind Germany. The markets haven't even noticed this.

Starbatty: Politicians want to buy time for the debtor countries by lending them money, hoping to get it back when these countries recover. But this strategy doesn't work. The markets know that and are driving up yields.

SPIEGEL: Yields are going up because investors are selling the bonds. How can this investor flight be stopped?

Starbatty: Because the trouble spots in the euro zone are not being isolated, the sparks are jumping over to the healthy countries. Everyone knows that if the weaker countries are to be rescued, two countries -- Germany and France -- will ultimately be doing all the heavy lifting. So the most important question is: How long are the Germans willing to pay? And how long are the French in a position to pay? Investors believe that it won't be much longer, and so do the rating agencies.

Bofinger: You correctly describe how the euro zone behaves today, with 17 different countries trying to address the problems individually. In fact, the real question is whether Germany can be everyone's guarantor in the end. That's why we have to turn things around and say: We will now act as a unit. If Italy can go into debt through euro bonds, it will always be able to raise money, even it has to refinance €300 billion ($400 billion) in debt next year. This deprives speculators of the ability to play off individual countries against one another.

Starbatty: I'll say it again: I think this is a deadly sin. A community of liability always results in the careless handling of other people's money.

Bofinger: Of course, the bonds have to be tied to stricter requirements for fiscal discipline.

Starbatty: We had a fixed rule: the no-bailout clause…

SPIEGEL: …which states that no euro country can be liable for the debts of another.

Starbatty: But this rule has been pushed aside. Madame Christine Lagarde, the former French finance minister, says that we violated the treaty to rescue the euro. And that would happen again.

Bofinger: I don't think so, not if the rules are well made.

Starbatty: I think you're a little naïve. People will introduce new budget rules to get euro bonds, and as soon as they have them, they'll forget about the rules the next time there's a problem.

Bofinger: With euro bonds, it would be much more difficult to destabilize the system. Once everything is safeguarded, I can, if necessary, throw out all the countries that don't abide by the rules. For example, each country would have to have its budget approved by European Parliament. If the fiscal policy were viewed as inadequate, surcharges could be imposed on national taxes.

SPIEGEL: That would amount to a fiscal union.

Bofinger: We wouldn't even have to go that far. Temporary surcharges on income and value-added tax would be enough. This possibility would have to be enshrined in the national constitutions.

SPIEGEL: That, however, would require amending the national constitutions.

Bofinger: I believe that in return for euro bonds, most countries would be willing to agree to that.

Starbatty: You're always saying "could" and "ought to." Such normative sentences are unconvincing to an economist, who works with facts. So far, it has always been shown that rules haven't shaped behavior, but that in fact behavior has affected the rules.

Bofinger: If there is no confidence in the political process, then allowing the whole thing to blow up would be the logical next step. Because the market is not working as a tool of discipline. The market is chaotic. Up to 2008, it didn't see what was going on in Greece, and then it woke up. Now it hasn't noticed that countries have reduced their deficits; in fact, it is not differentiating at all.

Starbatty: You get into trouble when you try to eliminate the laws of economics. I can tell you what will happen when your euro bonds arrive. After two or three months, you'll face the same problems as before.

SPIEGEL: So the ECB will have to bring out the bazooka, after all?

Starbatty: Inflation is always the long-term consequence of government financing through the central bank. If the ECB takes the same amount of paper and simply prints larger numbers on it, it is tantamount to counterfeiting.

Bofinger: Where would money be printed? What are you talking about?

Starbatty: The bazooka means nothing other than printing money.

Bofinger: If the ECB buys bonds from a commercial bank, that bank receives a credit to its account with the ECB. Not a single euro is printed in such a case. Inflation could only occur if the bank, given the low interest rate on its deposit with the central bank, started issuing loans on a large scale. The way the economy is developing, banks are not about to start throwing around loans. But even if they do, the ECB can raise interest rates at any time to curb lending.

Starbatty: The central bank is forbidden by law to finance countries directly. Of course, it depends on the economic circumstances, but in the long run the counterfeiting will lead to inflation. In the past, if a ruler minted twice as many coins from a certain amount of treasure or gold or whatever, they were worth less. What the ECB is supposed to do is exactly the same thing.

Bofinger: You're talking about a growing money supply. But what the ECB is doing doesn't increase the money supply. It only increases when the banks issue more loans. Besides, what the ECB is doing isn't prohibited. These are classic open market operations, and not direct purchases of new government bonds.

SPIEGEL: If the investor flight from government bonds continues, the ECB will likely be unable to avoid underwriting government bonds directly.

Bofinger: The ECB only has to signal that it won't allow the interest rates on these bonds to go above 5 percent. It can control this through the secondary market.

Starbatty: I think the use of euro bonds and the use of the bazooka are dangerous. You think they're great.

Bofinger: No, I'm just saying that we're in a situation like the one we had in the fall of 2008. The financial system has to be stabilized directly, and then the rules have to be changed as quickly as possible. But tell me what it is that you want!

Starbatty: Consolidation of the euro!

Bofinger: Whom? How?

'It Will Really Blow Up in Our Faces'

Starbatty: The bailout programs, which are in violation of the treaties, must be stopped. Countries that believe they should be part of the group can make an effort. Those who would rather get out so that they can devalue their currencies and become competitive again, should do so. Otherwise the whole thing will blow up in our faces. I agree with you on that.

Bofinger: But in such a case, it really will blow up in our faces. When countries start withdrawing, there will be a chain reaction.

Starbatty: You should accept the reality that countries will not solve their problems in the monetary union.

Bofinger: But the problems aren't God-given. They result from the fact that Italy and Spain have to pay 7 percent in interest.

Starbatty: Because of their problems!

Bofinger: No, because the markets are in a panic. They aren't reacting to fiscal data, or else the Japanese and the Americans, who aren't trying as hard as Italy, would also be paying 7 or 8 percent. Investors are simply worried about their money, and they are adhering to a herd mentality.

Starbatty: No. Investors pay close attention to whether a country can manage its debt. And when they feel that it can't, they prefer to get out sooner rather than later.

Bofinger: But then it becomes a self-fulfilling prophecy: The more investors flee, the higher the interest rates go, and the more unlikely it becomes that a country can service its debts.

Starbatty: Before it joined the monetary union in 1995, Italy had a 6.2 percent share of the world market. In 2009 it was only 2.8 percent. How is the country supposed to generate the necessary surpluses? These problems will not be solved by euro bonds or by the money-printing press.

Bofinger: If countries like Portugal have a competition problem, it's also because they, to a far greater extent than Germany, have encountered new competition from countries like China and Russia. This would also have happened without the euro.

Starbatty: But if they had had their own currency they would have been able to devalue it.

SPIEGEL: So are the euro countries too different to be welded together in a single currency, as euro critics have claimed from the start?

Bofinger: There are also big differences in productive capacity in the United States. The problem is that we in Germany have tried to become even stronger by holding back wages. It is now clear that this was the wrong policy. We contributed to the decrease in competition within the euro zone, just as the Spaniards and the Portuguese did on the other end.

Starbatty: The mistake lies in the fact that the weak countries in the monetary union have not changed their policies. They have used the low interest rates to have a party instead of modernizing their economies. Germany has behaved differently, which is why we now have a large divide in the monetary union. Some are overly competitive, while others can't keep up anymore. The Greek euro is greatly overpriced, while the German euro is heavily undervalued. That's why we, like the Chinese, are in the dock.

SPIEGEL: Can the differences in the monetary union be reduced, or will the strong countries have to support the weak permanently?

Starbatty: Transfers are the automatic consequence when you have different economies within a monetary union. The weak import stability and export jobs. You see this in northern and southern Italy, as well as in western and eastern Germany. There will be more transfers unless this changes. And they won't amount to about €15 billion, as they have in the EU until now, but will be much larger. But this doesn't work without amending the constitution, because the euro zone will then take on strong federal characteristics. Otherwise we will be going before the Federal Constitution Court once again. There needs to be a referendum.

Bofinger: I see no reason for permanently high transfers. Countries are already in the process of reducing their current account deficits. The condition is that the economy doesn't collapse, that interest rates are reasonable and that growth potential is increased.

Starbatty: You're always talking in conditional sentences. As an economist, you ought to know that the consequence of a transfer union is not that the weak are no longer weak, but that the strong are no longer strong.

SPIEGEL: The only way to talk about the breakup of the monetary union is in conditional sentences. Mr. Starbatty, how do you imagine this in concrete terms?

Starbatty: Of course, it'll be a painful watershed moment if something breaks apart that took 12 years to grow together. But then again, there is the saying: It's better to have an end with horror than horror without end.

SPIEGEL: The withdrawal of Greece, Italy and other countries would have dramatic consequences, for the financial system, for example.

Starbatty: If Greece reintroduces the drachma, the markets will overshoot at first. But that isn't a problem for Greece. We've seen the same thing happen in Argentina, Thailand and Indonesia.

Bofinger: Devaluation was certainly not a delight for these countries.

Starbatty: No, but these countries are once again respected members of the global economy. Of course, the banks would have problems if Greece were to go bankrupt. You can't reach into the pockets of a naked man. But then Greece could start over again.

Bofinger: You talk about Greece, but you ignore the chain reaction. It's naïve to believe that we would just be tossing a little ballast overboard to allow the little ship to keep sailing. You're kicking the can down the road, and in the end we'll be all alone in this ocean of globalization. No, the only motto we should follow is this: all or nothing. If you let the genie out of the bottle, it won't come to rest until we've returned to the 1998 level.

SPIEGEL: Mr. Bofinger, Mr. Starbatty, thank you for this interview.

Interview conducted by Martin Hesse and Armin Mahler

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