A Conversation with Peter Bofinger

Part of the 'Conversations with Re-Define' series

About Peter Bofinger

Dr Bofinger is currently a Full Professor of Economics, Money and International Economic Relations at the University of Würzburg, a position he has held since August 1992. Since March 2004, he has also been a Member of the German Government's Council of Economic Advisors, colloquially known as the 'Five Wise Men'. His most recent book, published in German, is called 'Can the Market Still Be Saved?'.

Dr Bofinger initially began his career in 1978 as an Economist at the German Council of Economic Advisors, Wiesbaden, before moving on in 1981 to become a Lecturer at the Department of Law and Economics, University of Saarbrücken. Between 1984 and 1990, he was an Economist with the Deutsche Bundesbank. Dr Bofinger has also been a Visiting Scholar in the Research Department at the International Monetary Fund and at the Federal Reserve Bank of St. Louis. From 2003 until 2004 he was First Vice President of the University of Würzburg.

Executive Summary

Dr Peter Bofinger and Sony Kapoor discuss the topical issues of the forthcoming German elections and the most recent developments in European economy. Dr Bofinger provides interesting insights into German domestic politics, and warns that great change of course in German politics is unlikely, as he believes the elections will bring both continuity of policies and leadership. However, he highlights that there is hope, as the idea of continued austerity policies is under increased scrutiny. Dr Bofinger also draws the attention to the fact that the calm in financial markets created by Mr Draghi's speech is deceptive, as the issues underlying the Eurocrisis have not been fully resolved. The criticism is aimed at national governments that have failed to use the breathing space to work on policies of fiscal integration. Dr Bofinger and Mr Kapoor discuss and analyse legacy debt and bank recapitalisation, assessing the progress on the creation of a banking union. Finally, the likelihood and potential scenarios for Euro exit are discussed.

Sony: So, Peter, how are things evolving in the Eurocrisis?

Peter: Well, the crisis is continuing and the recession is getting worse, especially as it is affecting more and more counties. It has spread from the peripheral countries into the core of Europe. It has affected France, which is in recession, and it has also affected Germany, which has seen a severe decline in output in the fourth quarter of last year and is more or less stagnating in the first quarter of this year.

Sony: When we were talking earlier you mentioned that this may bring new realisation in Germany and may change the debate in Germany somehow. Up until now the crisis has not actually been felt in Germany, it has just been on the TV. But is there not a danger that this may make a solution harder?

Personally, I can see it going both ways. On the one hand, Germans could realise that it is a systemic crisis and they are not immune, and therefore need to do something different. Or, on the other hand, 'oh my God, we are in trouble ourselves and here are these countries asking us for help; we cannot actually afford to help them'. This could make it less likely that Germany does anything to help them. Which way is it more likely to go?

Peter: Well, I think, first of all, German reaction will come if these negative economic developments have an impact of the labour market, and we can see the start of it affecting the German labour market. In my opinion, if the perception will be at the crisis starts to affect Germany, German politicians will come to a point where they realize that they have to give up this fiscal austerity for Germany (where there is also some kind of fiscal austerity)'. I am optimistic that this will pave the way for a paradigm change in Germany and from this, also for the whole Euro area.

So this crisis, in my view, has the potential to have a positive impact in the end for Europe.

Sony: There is a lot of commentary out there that seems to imply that just after the German elections things are going to change sufficiently or massively. Now, are things likely to change just because the elections have happened?

Peter: First of all, I do not expect that the elections will bring a major change of power in Germany. I see Angela Merkel remaining as the German chancellor after the September elections in 2013. There will not be a big change in Government in Germany. What I think is more important, is that there will be the perception that the paradigm that has been followed for the last three years is wrong and has an extremely negative impact on the Euro area and the Germany economy. This might lead to a change. The good thing with Merkel is that in the past she has shown astonishing flexibility in paradigms. I am optimistic that she will also show similar flexibility in this area.

Sony: Almost a year back the crisis looked very acute and the bond spreads were rising. There seemed to be potential runs on banks and Mr Draghi came and made a speech saying that the ECB will do whatever it takes. Since then things have, at least in terms of bond yields, immediate vulnerability of the banks and the markets (which have either gone to sleep or are giving the Europeans the benefit of the doubt), improved. But has this time been used well?

Peter: The impact of Draghi's speech shows that the financial markets are really behaving like sheep, because he had such a strong, lasting impact without buying one single bond in the last 10

months. I think this calm that has been created by his remarks is dangerous, because what has been improved has been the situation in financial markets, but the underlying problems in the Eurocrisis have not been addressed. Despite this period of relatively calm markets we still have a macroeconomic crisis, a recession going on, a continued banking crisis with more and more loans turning bad. Also, the government debt crisis is not improving, because Debt/GDP ratios are increasing all over.

So, these three main fields of crisis have shown no signs of improvement. I think it is a problem that politicians have not used this breathing space offered to them by Draghi to go ahead with fiscal policy integration. Politically, nothing has changed. If you want to get the ECB out of this role as an emergency supporter of the Euro, it can only be done by moving further ahead with fiscal policy integration and if you go ahead with joint and several liability, which in my view also requires a transfer of fiscal sovereignty to the EU level.

If you want a lasting change, and if you want a much more stable euro, we need to go ahead with fiscal integration. This takes a lot of time, is difficult, and it should have been started immediately in the summer of 2012. A whole year has been lost and that is not a good development.

Sony: Am I correct in thinking that the whole banking union discussion has come full circle from it being the panacea to all of our problems to essentially everyone gradually realising that this banking union discussion is effectively dead? Aren't all those aspects of the banking union that could actually help tackle the current crisis are essentially fiscal in nature?

Peter: Yes, of course. The problem is that we have all this legacy debt in the bank balance sheets that even now the quality of bank balance sheets are deteriorating as the recession continues. We have this nexus between banks and governments, and this is something that needs to be changed. The German approach of 'we do not want to have any responsibility for legacy debt' means that the banking union that has been built on this exact principle is of no help at all.

On the other hand, it is understandable that Germans have said that they do not want to be held responsible for past bad loans in Span. Therefore, in my opinion, the solution must be that it is, of course, a national responsibility for governments to restructure their banks, but if this overburdens the fiscal capacity of national governments, then they need support – the support of joining and several liability bonds, because that helps them to pay this burden.

Nevertheless, if the amount of debt created by the recapitalisation of banks is too high, I think one should think of one-time wealth taxes, especially in the countries that are responsible for that debt. As an extreme solution one could also consider a general European wealth tax to cope with these problems.

Sony: What about large-scale debt restructuring? Have we left it too late? Have the liabilities moved too much onto the public balance sheet, or is it still possible to have a one-time restructuring of clear un-payable debt, for both sovereigns and banks, and then move on from there?

Peter: I think that will lead to a catastrophe, because we know that many banks have equity rations of only 2%-4%, so there is not much leeway for bail-ins. If you start to bail-in bank bonds and deposits, it will lead to an extremely dangerous

chain reaction, because we know that there are a lot of inter-bank exposures, and if the bail-in effects banks which hold money with other banks that also only have 2%-4% equity, you will get a chain reaction. If you get bail-ins for say large bank deposits, you will affect pension schemes, municipalities, insurance etc. In my view, this is a completely wrong route to go.

It could also lead to large amounts of capital flight. If in Spain there is a discussion about bank bail-ins and restructuring, it is not difficult for Spanish bank depositors to switch all their money to Germany. It is the good thing with a single monetary union. I think it is a completely flawed approach and that we should really try to keep the banks solvent and try to solve the problem with the government recapitalising them, and, if necessary, financing it with wealth taxes.

Sony: Am I correct in understanding that the present approach cannot continue? That something significant has to change or else we will end up with the break up for the Euro?

Peter: The current approach, at least so far, has made things bad and is making things even worse. Just continuing this approach risks bringing the euro area deeper into recession and stagnation, while increasing unemployment. I think this is something that is dangerous economically and politically. I see the economic and political risks that some of these so-called problem countries face; their politicians may come to the conclusion that to exit the euro would be beneficial. They will decide that it is better to introduce their own currency rather than lower wages by 10 or 20%, which merely worsens the debt problems, banking sector problems and everything else.

The main risk of muddling through is that it might lead to countries exiting and a subsequent chain reaction with other countries following. In order to beat this, we need a paradigm change and to stop this austerity and restrictive policy measures in a recession (the most stupid things to do). It is not sufficient to give countries more time to reduce their deficits. It is important to say no 'additional austerity measurers' and then to ask 'how can we start some expansionary measures'? How do we get some money together to finance spending (because that is what is needed in a recession)?

Sony: Could we reach a point where either Germany decides it needs to leave, or other countries politely ask Germany to leave?

Peter: Well, I do not think that the political forces in Germany will ever envisage an exit from the Euro. I think that is something that we can almost exclude 100%. It is more likely that individual countries will decide to leave and I am not sure whether they may opt for a coalition to say 'we (Spain, Portugal, Italy and France) have decided to leave the euro and have our own monetary union'.

The most likely occurrence, in my view, is that one country decides to exit the euro and this would then create momentum, as other countries ask themselves if it would be better for them to get out of the Euro.

Sony: Thank you, Peter, for all the interesting and informative insights, it has been a great conversation.

Peter: Thank you, it is always a pleasure to talk to you.