Germany and the Eurozone Sovereign Debt Crisis

The Lessons of History

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"The eurozone has decided that the losses of private sector creditors should be socialized and the ultimate burden fall on the taxpayers of deficit countries. The latter will then suffer first a slump and then years of fiscal austerity."— Martin Wolf, "The eurozone after Strauss-Kahn," *Financial Times*, 18 May 2011.

With pig-headed persistence, Germany is continuing to prioritize the rescue of German banks from their reckless lending to europeriphery banks and governments, over the wellbeing of millions of working people in the so-called 'deficit countries.' As financial journalists are now pointing out, the markets for Greek, Irish and Portuguese government bonds, and for the credit derivatives used to insure them, already show that the German obstinacy lacks any credibility. In the short term, forcing the repayment of debts through savage cuts in public expenditure is having exactly the consequences that Keynesian economics predicts: slashing public sector employment and incomes leads to a *worsening* of the public sector deficit, as tax revenues fall (from both incomes and consumer spending) and the state welfare bill rises. In the medium term, continuing austerity makes it impossible to undertake the investments, both public and private, that are essential if the indebted countries are to improve their international competitiveness. Sooner or later, sovereign bondholders are going to have to be forced to accept losses, and that means that ultimately banks all across Europe will have to do the same.

Exit Strategies?

The focus of current discussions is on finding a way out of this dilemma. According to Martin Wolf's data, originating from the IMF, German banks which have lent abroad are currently owed over 150% of their total equity capital by banks and governments in Portugal, Ireland, Greece and Spain. French banks are second with just under 100% of their equity exposed, banks in the rest of the Eurozone about 50%, and UK banks some 45%. The rankings reflect the relative positions of these countries in terms of trade and fiscal balances: Germany is noted for its permanent trade surplus, both with the rest of the eurozone and with the rest of the world as a whole, and for its high rate of domestic savings.

Demonstrators hold a banner depicting a big fish as IMF-EU-ECB during a protest in Athens, Greece.

The great dilemma facing German Chancellor Angela Merkel is that precisely because German banks could not make money, as their British counterparts did, by pushing high-interest loans upon a profligate household sector, they ended up lending abroad; and since they had neither the branch networks nor the local knowledge to lend directly to households and businesses in the europeriphery, they were happy to find that governments and local banks were only too willing to borrow from them. What is more, the local banks were all too often able to make easy money by using those loans to purchase bonds issued by their own governments.

What can we learn from economic and financial history that might help Mrs. Merkel and the eurobankers in their time of trouble? The obvious place to start might be the sovereign debt crisis that afflicted the Third World, and especially Latin America, in the 1980s. Here the present OECD Secretary-General, Angel Gurría, who has been a steadfast supporter of Chancellor of the Exchequer George Osborne's austerity programme in Britain, is particularly well-placed to advise them; for he was one of the small group of Mexican officials who negotiated the resolution of the Mexican debt during the great stand-off of 1982. The great money-centre banks of New York, London and Tokyo, as well as the IMF and oil-rich sovereign creditors like Saudi Arabia, were all persuaded to take what is now insouciantly called a 'haircut,' under the threat that the Mexican debt service moratorium would, if it became a complete debt default, lead to the collapse of the international financial system.

Unrepayable Debt

Of course, Mrs. Merkel's advisers, and especially the European Central Bank, will respond that the eurozone in 2011 is not the Third World in 1982. However, an unrepayable debt is an unrepayable debt, regardless of time and place. In the usual textbook case, unrepayable debts, whether private or public, can be socialized by the sovereign state imposing the necessary tax burden upon its citizens: this is precisely why in normal times government debt is regarded as the least risky. But however much we may have tried to ignore the fact, we have all known ever since its launch that the euro could not function in the same way as a textbook currency in the absence of a single European fiscal authority and unified budget. It is possible that this accounts for the unwillingness of monetary authorities around the world to accord the euro the role of a real alternative to the dollar as a reserve currency, although this might be crediting them with more intelligence than they displayed in other respects in the last twenty years of bubbles and busts. What is more, had we examined more closely the public finances of certain federal states, notably the USA and Germany but also more remotely Mexico and Nigeria, we might have realised how the diffusion of political authority in matters fiscal can also seriously undermine the textbook story.

In any case, applying the old adage of 'follow the money' – in this case, back from borrowers to lenders and thence to its ultimate source in savers of various kinds – we can see how frustrating it is for German high finance. It seemed to have had remarkable success in getting German workers to pay for the costs of the post-communist unification of Germany: the Hartz rounds of labour market 'reforms,' and the close cooperation – whatever their rhetoric – of the unions, enabled Germany to regain and then increase its competitive advantage in manufacturing. Within the newly-formed eurozone, this could only mean one thing: large trade deficits in the least-competitive member states, matched by capital inflows from Germany and the rest of the rich euronorth.

Just as China sustained U.S. demand by the loyal purchase of U.S. Treasury bonds, so Germany sustained europeriphery demand by its banks' willingness to purchase government and bank debt. But there is a vital difference: the dollar is the world's preeminent reserve and trading currency, by a very long way (over 60% compared to around 25% for the euro), and the U.S. monetary authorities therefore enjoy the privileges of 'seigniorage': in other words, the money markets will absorb pretty much as many dollars as they choose to issue. Indeed, paradoxically it is to the dollar that global investors flee for security in times of trouble, their herd behaviour confirming the dollar's uniquely privileged position. All the Fed has to worry about is opposition from monetary faddists in Congress; whereas the European Central Bank (ECB) has not only to convince the markets that they know what they are doing, but also has to get the 17 eurozone governments to agree. There are thus powerful reasons for institutional inertia and indecision.

Whatever transpires in the coming months, it seems increasingly clear that forcing complete debt repayment on schedule upon Greece, Portugal and Ireland cannot work. But this serves to highlight a lesson from history that takes us way back beyond the 1980s Mexican case. And the great irony is that the debtor country in question was not Portugal, Greece or Ireland, but – Germany. When the victorious allies enforced an impossible burden of war reparation payments upon Germany at Versailles in 1919, the outcome was disastrous, as the young Keynes warned at the time in his famous pamphlet *The Economic Consequences of the Peace*. To very many historians, it was the imposition of endless austerity upon the Germans that provided the economic and social conditions underlying the rise of Hitler. What is more, it was through absorbing the lessons of that disastrous policy that the USA was persuaded, after 1945, to take a completely opposite course of action in the Marshall Aid programme, which enabled the economic reconstruction of Germany and of Western Europe as a whole. Surely the political and financial élite of Germany today know enough of their own country's history to appreciate that austerity is not the answer? •

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