Europe: How many Divisions?

The introduction of the single currency was at the origin of major distortions since capital flows could thus move from one member nation of the EU to another without regulation or control. It goes without saying that these liquidities seeking attractive returns gradually left the nations of the North with limited potential (Benelux, Germany and also France) to take up residence in the booming nations of the South and therefore thirsty for capital. Investors therefore did join in the auction and the returns in the economies of Southern Europe transformed into whirlpool projects under which these incessant capital flows would have been, in different circumstances, moderated by readjustments to the national currencies of these nations. However, the exchange rate could not play its essential role as regulator since all these countries shared a single currency. The masses of liquidities could therefore leave the rich countries to colonize the “emerging” member nations of the EU without the parity of the Euro being lowered for countries that invested or increased for those who benefited from these capital flows. These distortions also led to notorious inflation in the booming nations of the South which was royally ignored by Germany (only to cite it) which was thus happy to be able to invest in, and export to, these countries with great potential. As disastrous as these disparities in the inflation rate within the same zone were in the medium-term, they were not, however, fought since interest rates (like currency) were the same throughout this zone. These interest rates were maintained at an artificially low level for several years so as to support a lackluster German economy at the beginning of the 2000s with, for immediate and inevitable consequences, an overheating of peripheral economies. Indeed, these booming nations – that should have been contained by higher interest rates – were dropped as fodder for speculators who helped to inflate all kinds of bubbles which could have been partially avoided or lessened by an adapted monetary policy.

The famous excess of the PIIGS are therefore largely due to lax European interest rates sanctioned by the ECB and imposed by a Germany which then needed it! It was therefore Germany which dictated this policy to the ECB and not Greece, Portugal, Ireland or Spain… So many countries that were abandoned to their fate, and to their multiple speculative bubbles, as soon as these funds dried up in the aftermath of the
financial crisis. After largely investing in, and benefiting from, speculative development in peripheral Europe, Northern Europe thus did a turnabout and began to accuse the “grasshoppers”, yet once generously maintained by the Northern ants. It is certainly not a question of exonerating the irresponsible behavior of the national leaders of Ireland or Spain who closed their eyes to the excess of their countries, as it is important to condemn the Greek messengers. Just as it should deplore the guilty refusals or delays of the successive governments of these countries in vitally reforming their taxation systems and labor market. For all that, the lure of profit from businesses and finance from the northern countries, the tolerance of their authorities in the face of unjustified interest rates and their convenience vis-à-vis a circulation in capital which flooded the countries to the South were so many factors which helped to rush the PIIGS into the abyss.

The German position – which now pushes toward diametrically opposed excess consisting of imposing blind austerity on these highly affected countries – is even less understandable that budget deficits are not the roots of the financial crisis. Indeed, it is the advent of this crisis that breathed deficits into budgets of the states and not the reverse: Were not Spain and Ireland in surplus prior to the crisis? It makes sense also that all countries – a fortiori of a single currency group – cannot simultaneously benefit from surplus budgets. As it is evident that funds could not be invested in a balanced way among the members of the European Union. One of the priority EU projects should thus consist of monitoring and regulating capital flows among its members, a notorious sauce for imbalances in the balance of payments of each member within a framework of a common currency for all these nations. The collapse of Greece (citing only this country) is therefore entirely due to inconsistencies and gaps in the European construction. The members certainly benefited from a precious stabilization of their exchange rate in favor of introducing the Euro. In the same way they benefited greatly from the convergence of real interest rates (for cheap financing) which tended more and more toward those in Germany. They nevertheless forever lost the ability to define their monetary policy, that is to say, fixing their key interest rates. As such, they no longer have the privilege of a flexible currency which they could have possibly appreciated or devalued according to actual needs.

Today, these same peripheral European nations, which formerly masked their poor competitiveness and their high levels of public spending thanks to modest financing costs (due to this convergence which now firmly belongs in the past), are faced with an austerity which will certainly not allow their productive apparatus to recover. The increase in this competitiveness would of course likely bring them growth with the
Europe: How many Divisions?

key being a gradual repayment of their debts. Nevertheless, as measures aimed at improving this competitiveness are only effective in the long-term, only investment is immediately likely to feed growth. Austerity is therefore not an adequate solution when a country is hit by a financial crisis and that its private sector is depressed by debt, a fortiori if its banking sector is hyper weakened by the implosion of a property bubble as in Spain. The interdependence of European countries contributes further to exacerbating the depression, sentenced to spreading like wild fire due to this integration. The prerequisite for recovery – and of course to any lull – is introducing new common credible and realistic regulations, a sine qua non condition for rebooting the private sector. That is why the myth according to which a formula proven to work in one country would necessarily work in another – all the more reason in several others – will end up running through the EU. It is therefore necessary to diagnose separately each member country so as to implement different remedies to each one, or the same remedy according to a different degree. It is in this spirit of nuance, yet necessary if the goal is to significantly reduce deficits and reboot growth, which is sorely needed.

Since the German example is not easy to reproduce, despite the scorn of the German Chancellor Merkel deploring the “mediocrity” which had become the Euro “standard”! However, Germany could boost exports to such an extent only because it has depleted its poor ones! In any case it is what the employees in the Euro of the hour and the workers who earn EUR400 a month scream very loudly about… With its top priority of a long-term austerity policy, Germany can of course boast of unquestionable results in terms of putting its finances back in order. It would indeed react with determination in the face of its colossal reunification cost and in the wake of the very poor competitiveness of the factories in the former East Germany. As such, it followed Keynesian concepts and implemented a sound counter-cyclical measure, namely increasing VAT from 16 to 19% in 2007, i.e. after three prosperous economic years. If the collection of these new revenues necessarily paved the way for rehabilitating its finances, it is evidently much easier to undertake fiscal consolidation at a time of prosperity than during an economic and financial crisis. This increase in VAT was of course one of the milestones of a voluntary domestic devaluation policy whose most obvious manifestation was strict austerity in wages. The trade surpluses were somehow the natural secretion of this German that also resulted in a sharp surplus in the balance of payments. Indeed, impressed by these performances and always in search of solid investments, global investors rushed toward German Treasury bills, which mechanically contributed to establishing extremely low real interest rates in the country in a
general way – and permanently – without any impact whatsoever in favor of an increased in domestic consumption.

It remains no less than the ultimate example to follow was there: the country in difficulty had to prescribe strictly to a regime of halved wages and unemployment contributions, accompanied by substantially higher indirect fiscal pressure. Such was the magic formula that the peripheral European countries had to implement to boost their exports by adopting a recovery model of export-led growth. All in an effort to emulate the German model that was the poster child of perfection, not unreasonably as seen from the first European exporter. If only a country’s surpluses are simply for the deficits of others and the German dynamic was successful – by achieving substantial trade surpluses – due to European (and global) consumption of Germany’s manufactured products. German prosperity is actually wholly constructed on the economic activities of importing countries. So Germany feeds its own growth from the growth of other countries, somewhat parasitically. Therefore this serves nothing, and it would even be completely counter-productive if all European nations adopt these austere measures all at once to boost productivity in order to reboot their economies through exports. The one and only condition for success of such a business would be that Europe ceases consumption and that the rest of the world rushes to consume European products, which is hardly likely. In summary, how and why is Germany persuaded that its model can be implemented by all of its European partners which are ordered, in other words, to no longer buy its own goods? Germany, whose exports within the EU amount to 60% of its overall figure in 2011? Is it really convinced that the European Union will morph under its influence into a briskly gigantic export machine to the rest of the world? If a country alone can – of the same size and importance of Germany – implement domestic devaluations with a view to improving its competitiveness, an umbrella economy like the European Union having the largest GDP in the world, could not undertake such a revolution in its consumer and export habits without provoking a global disaster. This German attitude of imposing its standardized model of rebuilding reserves and inflating surpluses thanks to exports is therefore aberrant… and also totally unrealistic (in another registry of course) that unbearable reparations had been dictated to it after the First World War.

It is a pity that policies are not a little bit like historians! And that it is regrettable for all of us that they do not look back to 1931 – tragic for all – from which to draw parallels and precious information for today… From the bankruptcy of the very large Austrian bank, Österiechische Kredit Anstalt, over-exposed in East and Central Europe. To the general financial instability of Europe under threat from currency implosion due
to unpaid German reparations. To the U.S. intervention in the sense of debt restructuring for a Germany that was tied to a gold standard, yet one of the main reasons for the Great Depression. Only countries which abandon the first gold standards (Great Britain followed by the Scandinavian countries) are the first to pull themselves out of this terrible crisis without incurring too much damage. The unexpected rise in U.S. interest rates in 1928 was certainly the first sign of this crisis. As well, the deflationary global calamity, linked to a global economic contraction, is rooted in the gold standard, particularly due to the attitude… of France, presented by a number of experts as mainly responsible for the intensification of the Great Depression! It is actually the substantial increase in France’s gold reserves (from 7 to 27% between 1927 and 1932!), which, in creating scarcity for this metal, would undoubtedly contribute to an enormous deflationary spiral for all developed nations at that time. It is actually the substantial increase in France’s gold reserves (from 7 to 27% between 1927 and 1932!), which, in creating scarcity for this metal, would undoubtedly contribute to an enormous deflationary spiral for all developed nations at that time. With deflation as the distinctive sign of the Great Depression, it could have been avoided if the central banks at that time (and the French one in the first place) had maintained their 1928 gold bearing ratios… Indeed, it is this frenetic accumulation of the yellow metal by eminent central banks which fueled global deflationary pressure. However, maintaining gold reserves at their levels prior to the Great Depression would not have altered the historical correlation between consumer and production pricing and the quantities of gold held by central banks. It was Léon Blum, Prime Minister, who finally took France out of the gold standard in 1936, but the damage was done. Isn’t the parallel obvious in today’s Europe where austerity is the new gold standard? What a pity that policies are not a little like historians since the conjuncture of the 1930s strangely resemble our situation today, except that at that time it was only Germany which was in the same situation as peripheral Europe finds itself today. Entirely dependent on foreign capital, it had been steam rolled by unrealistic reparations stipulated in the Treaty of Versailles within a general framework of grossly under-capitalized national banks. Indeed, this is the whole problem relative to the reparations imposed on Germany, and their disastrous consequences, which have today been removed from the debate to make room for deficit obsession. The ardent defenders of austerity actually impose an absolute diktat on the media, opinions, public policy and academia by imbuing a climate of disaster where only hyperinflationary trauma seems worthy of interest. It is as if the disaster from the reparations imposed on Germany had been waned before the imaginary disease of deficits. Is it because Germans are perfectly aware of the multiple Treaties of Versailles that they dictate today to Greece,
Spain, Portugal and other nations forced to pay much more than their abilities and means allow?

Indeed, this is violent and unprecedented austerity that Germany had to implement at the beginning of the 1930s in favor of the drying up its international funding, which resulted in an unemployment rate that at one time was higher than 35% France – which at that time was the Germany of today – was doing well. Indeed, this is violent and unprecedented austerity that Germany had to implement at the beginning of the 1930s in favor of the drying up its international funding, which resulted in an unemployment rate that at one time was higher than 35% France – which at that time was the Germany of today – was doing well. It was one of the most prosperous and solid economies in the world at that time. It navigated these troubled waters by maintaining a single digit unemployment rate and enviable accounting surpluses. In a position to transform itself into a financial engine for the rest of Europe from the end of the 1920s and beginning of the 1930s, instead, France preferred to withdraw behind a wall of selfishness by refusing to adopt a conciliatory and expansionist monetary and economic policy, opting instead to ignore the plight of its neighbors. The financial collapse of Europe owes a lot to this navel gazing by France at that time. Just as the peripheral European nations can today, with reason, blame German intransigence for their intolerable end that they reached. From what remains, France could not escape this crisis which had rudely contaminated it since 1932. How is it that we fail to recognize that the France of so many years ago is today’s Germany, mired in missteps and which revels in mistakes that it will end up by paying – it also – a heavy price? Since if there is one country which, amongst all, is worried about retaining the teachings of the past, that country is Germany. So, why do we accord so much importance to the 1923 hyperinflation when we should instead be deeply concerned about avoiding 1933, the year which saw the extinction of democracy? That German leaders therefore return to school to relearn how a European bank crisis that set off in 1933 propelled their country – and Europe – into the horrors of 1933. It is no longer tolerable that leaders from this country declare (as the spokesperson for the German Ministry of Finance did in April 2010): “Just because we have extinguishers it doesn’t mean that we’ll use them to put out fires”. Gailbraith had understood well that “there are few areas where history counts so little as in the world of finance”… That is why it is no longer tolerable that political leaders declare (as the spokesperson for the German Ministry of Finance did in April 2010): “Just because we have extinguishers it doesn’t mean that we’ll use them to put out fires”. Identical instinct – or fears – which are at work in the face of its fear vis-à-vis inflation. The big – even single – European problem and the huge chip in its armor is the dichotomy between congenital monetary power
and budgetary authority of the respective members. For indeed only those who save – and who, therefore, fear or dread the future – is haunted by inflation, which has the effect of reducing the value of their savings. Each of these countries abdicated its monetary sovereignty (in favor of the ECB) while it could retain the power to levy taxes… without being in a position to stimulate its economy in the traditional way, like the U.S. did.

This essential German shift will, however only see the light when this country recognizes its financial debt toward the European Union that it will clearly never leave. Since such a possibility would immediately translate into a strengthening of the rediscovered national currency – the Deutsche Mark – and an inevitable deterioration of the standard of living of its citizens in favor of a dramatic decrease in its exports. Indeed it is the advent of the single currency which allowed Germany to more than double its exports from 469 billion Euros in 1999 to more than one trillion Euros in 2010, during which its economy grew twice faster than the European average during the same period. This impressive rise in German exports is undoubtedly inseparable from the quality of its manufactured products. There remains no doubt that its competitiveness was undeniably favored by a relatively weak currency. So this country benefits on several levels from the woes of hyper weak nations of the EU. By exporting more to these other member countries which, suffering from an endemic decline in their own competitiveness, end up with German imports less expensive than their own national products! By exporting more, of course, to the rest of the world due to a weakened Euro because it comprises nations like Greece, Portugal, Italy or Spain… Germany does not need to manipulate its currency to make its exports attractive: it is simply a bystander watching the fire engulf peripheral Europe and the South. In this regard, an interesting and revealing study from the Swiss bank, UBS, concluded that an exit from the Euro would cost Germany between 20 to 25% of its GDP, i.e. between EUR6,000 and EUR8,000 per capita the first year, which should reduce to EUR3,000 to EUR4,000 the following years. The same study indicating that the German citizen should only have to pay EUR1,000 in total if the European Union were to integrate half of the debts of Greece, Ireland and Portugal… the only reason for the much higher price to pay when exiting or breaking the EU is to be sought in its currency, which would suffer a simultaneous and lasting appreciation penalizing its exports. The ING Group estimates that a scission in the European Union would result in the Germany’s GDP falling by 9.2% with unemployment at around 9.3%, the price to pay for the surge in theis regained currency which would translate into a substantial collapse of the German export engine. In a sense, the German leaders are today faced with a tough choice since it would mean having to support financially an integrated
Europe by pooling the debts of member countries. The alternative, hardly more appealing, is to assume the potentially devastating social and financial costs of exiting the EU to which the massive recapitalization of German banks will be linked, heavily involved in the sovereign debt of the peripheral nations. In other words, the Germans are completely interested in remaining in the Euro zone, as they have everything to gain if the Euro remains at current levels. As a last resort, they will therefore do whatever is necessary to support “weak” nations like Greece within the EU.