Game over for the Euro?

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On September 8th a Polish Kaleckian economist, Leon Podkaminer, invited me to a round table at the XXI Economic Forum of the Central Eastern Economies in Krynica (Poland). The topic was: 'Thrifty North & Careless South: Are cultural differences in management going to break the EU?' Leon's introductory statement was the following:

"Europe is divided into Debtors & Creditors, not necessarily along the N-S axis. Debt crisis is unmanageable unless the creditors (Germany & Co) show 'mercy'. If not, a kind of a break-up is possible: first the euro area, then perhaps the EU Consequences: pretty nasty to ALL (Germany In the first place)"

and proposed 4 questions:
Set 1: Causes of the 'Southern Debt': "cultural?"
Set 2: Private thrift vs. governments' carelessness?
Set 3: The responsibilities of European Central Bank
Set 4: Un(sustainability) of trade/current account imbalances in the euro area
(at the bottom of this post you will find a further articulation of Leon's questions).

These are the answers I provided.

Set 1: Causes of the 'Southern Debt': "cultural?"

In May 2010, few days before I read Wolfgang Munchau saying the same on the *Financial Times*, I compared the European situation to the Tolstoy's families in the opening sentence of Anna Karenina: "Happy families are all alike; every unhappy family is unhappy in its own way." Similarly, core-European countries are alike; every periphery country is unhappy in its own way. In my remarks I will mainly refer to Italy.

The origin of the huge Italian public debt (120% of the GDP or so) is quite old. As is well-known, Italy was admitted in the European Monetary Union (EMU) in 1997 in spite of a public debt/GDP ratio well above the Maastricht Treaty limitation of 60%. With an economic manoeuvre implemented in extremis, the then Prodi Center-left government reached the other target of the fiscal deficit/GDP ratio below 3% (the expectation of the admission was also helped by lowering the interest rates on public debt). Officially Italy was let in because, otherwise, Belgium would also have to be excluded. A more likely truth is that France did not want to leave Italy – a strong manufacturing competitor – free to let the lira devalue against the Euro when she was signing a pact with the devil. The devil, Germany, seized a second opportunity – after the EMS - to get rid of a noisy competitor and of its ever-depreciating liretta.

Be as it may, the origin of the Italian huge public debt can be traced to the 1970s (the Italian "economic miracle" took place between 1958-1963; Italy is traditionally an export-led economy, but not on the same league with Germany although it has the second largest manufacturing sector in Europe after Germany). The social turmoil of the late 1960s and early 1970s was particularly intense in Italy. One (positive) result was the consolidation of a national welfare state in the early seventies. This caused an expansion of public spending. A second cause of expansion was the large support the state gave to public and private manufacturing enterprises hit by the difficult climate of the industrial relations (including Brigate Rosse terrorism) and by the global economic instability.[1] The constant climate of industrial conflict prevented Italian capitalism to react to the crisis by upgrading the quality of output. Large firms entered a process of decline, in spite of the State support, and capitalism based on small-medium enterprises producing traditional goods begun to characterize the Italian industrial landscape. Strong militancy that exists in Italy is a sign of backwardness. However, the Italian bourgeoisie has always accepted the conflict, never trying to meet the social demand behind militancy. Fascism and Berlusconi are creatures of the Italian bourgeoisie.

A deliberate mistake was made in the early seventies: the level of taxation and efficiency of the tax collection system was not adjusted to the new level of public spending that was, therefore, mainly financed by issuing public debt. The then ruling Christian Democrats could in this way placate the Trade Union request for a larger welfare state, without displeasing tax-payers. This choice was helped by the fact that the Italian financial markets was at the time quite unsophisticated, so that government bonds were almost the only choice for savers, the central bank was not independent and capital flows controls were in place (although not very efficient). So the State could issue bonds paying a negative interest rate (those were also times of double digit inflation): the Bank of Italy would buy any amount of treasuries that savers refused to buy.

Along with the other western countries, the economic climate in Italy changed in the early eighties. In 1979 Italy joined the European Monetary System (EMS), with the opposition of the Communist Party (that withdrew its support to an emergency government) and also of the then Governor of the Bank of Italy, Paolo Baffi (who worried about the consequences of this choice on employment). In 1981 the Bank of Italy acquired formal independence.[2] These two measures,

[1] The creation of the Regioni (Lands), with spending decided at the local level without any political accountability about its financing – sure that the State would write a check fixing any spending excess, was a third factor.
[2] Paolo Baffi was arrested in 1979 with futile motivations. His real fault was to have investigated the Calvi-Marcinkus-Vatican affair. He was later fully discharged of any guilt.

accompanied by the rise of the interest rates at the international level implied that the real interest rate the government had to pay on public debt become positive and very high. No measures to increase taxation and to fight tax evasion were taken. In the 1980s the Italian public debt exploded, mainly due to the high interest payments. At the same time, given fixed exchange rate system, with the Italian inflation systematically higher that German inflation, there was increased current account deficits and accumulation of foreign debt. The similarities with the present situation are striking.

Still, having its own currency, Italy got out from the EMS in 1992 with a big devaluation (about 30% against the DM). The foreign accounts were mended.

The 1992 crisis was not a financial crisis. Most of the Italian public debt was denominated in Liras and I cannot remember anybody talking of default at that time. It was a classical balance of payment crisis. Presently the Italian debt is denominated in a foreign currency, the Euro. This, plus the impossibility to recover competitiveness through devaluation, makes a fatal blend.

In the 1990s the discourse on the level of taxation and the fight against tax evasion were raised particularly by Center-Left governments - Berlusconi has always openly supported tax evasion. Major pension reforms were undertaken in that decade. From the early 1990s the Italian government budget has always displayed a primary surplus (the balance net of interest payments is in black). Since then, the deficit is entirely due to the payment of interests on the huge debt.

The arrival of the EMU helped Italy in so far as the interest rate on the Italian government bonds fell: the devaluation risk disappeared and everybody believed that the Italian debt was safer in the EMU. Very few noticed that the opposite was true: that, ceteris paribus, a public debt not backed by a sovereign bank is much riskier. I got this warning from Randall Wray, a heterodox economist at the Levy Institute, in the early 2000s. On the other side, in the EMU years Italy progressively lost competitiveness – as much as it happened in the EMS – due to the above European average domestic inflation and to a not-yet well understood negative productivity growth. The current account surplus and positive net foreign position acquired after the big 1992 devaluation slowly faded away.

Many mainstream (but sometimes open minded) economists, including Daniel Gross, Wyplosz, De Grauwe, Tabellini, now acknowledge Wray's warning that the absence of a sovereign bank backed indebted government is the key difference with the past: a government that has issued treasuries in its own currency can never default (of course, they do not concede that they arrived to this conclusion many years later). This is why these economists (but only lately) are supporting a serious ECB intervention (the present one is not serious). In a very nice review of the well-known book by Reinhart and Rogoff, Wray shows that all the cases of default considered in that study concern countries that gave up a full monetary sovereignty.

In synthesis, the Italian debt is not due to a profligate government spending; for example, social spending is below the EU-15 average. It has been due to the delay in the fight for adequate taxation and curbing tax evasion. Incidentally, tax evasion is high not just for the “amoral familism” (Edward C. Banfield (with Laura Fasano), *The Moral Basis of a Backward Society*, Glencoe, The Free Press, 1958), the presumed lack of sense of community in Italy, but for the larger share of self-employed, compared to foreign countries, in the Italian economy (only Greece, not surprisingly, has an higher share). In 2010 (source: Bank of Italy)

EU 15.6

Eurozone 16.2

Italy 25.7

Greece 35.5

I suppose that the self-employed tend to be tax evaders also in other countries. The diffusion of SME, black economy, and the missed repatriation of export revenues do the rest. In this situation neither the EMS nor the EMU helped. Certainly a major cause of the debt has not been some sort of profligate behaviour on the spending side.

We can say that the Italian holders of the Italian government debt are the past tax dodgers who have accumulated big financial and real estate wealth. Italians are famous for being big savers, but most savings come from tax evasion. Tax dodgers have financed the State by buying treasuries instead of paying taxes. They should be hit by a tax on wealth, and tax evasion must be seriously countered. The Centre-Left government have done something in this direction. Some measures to be adopted are electronic traceability of financial transaction, the use of banknotes should be forbidden barring small payments, the self-employed should keep an official record of their clients and suppliers etc. Centre-right governments have often reversed these measures and are not serious in this regard. The self-employed are indeed typical Berlusconi supporters (the other archetypal supporters are the Italian homemakers. Given low levels of female work force participation, they are a sizable section of society).

If I can use an “obsolete” expression, there is a class fight in Italy between the regularly employed against self-employed. I do not know how Europe could help, but certainly German moralism is not only fastidious, but superficial and useless to deal with these social problems that will only be aggravated by fiscal retrenchment.

Set 2: Private thrift vs. governments’ carelessness?

Thrift depends on income distribution, and as you can see, in Italy, tax evasion might support thrift. Would the Neoclassical fans of thrift then applaud Italy? From a genuine Keynesian point of view thrift is a negative factor.

Judging from its current account surplus and net foreign position, Germany is a thrifty country. This behaviour is not positive from a European and global point of view. Since the early 1950s Germany has pursued what a leading German economic historian has called "monetary mercantilism"[3], which consisted of domestic wage moderation within a fixed exchange system to pursue an export-led model. The involvement of trade unions in the export-led model (exports were defined in 1955 as the "sacred cow" of German economic policy), with the Buba as watchdog, assured the perpetuation of strict domestic discipline and external success.

(Note that in Germany the Buba played a unique role in wage bargaining. Everywhere, the so-called "independent central banks" are watchdogs of wage discipline, but this role was explicit in Germany. Unfortunately the ECB inherited this role: the inconsiderate raise of the interest rate in July 2008 when the world was sinking in the depression, or the two hasty raises this spring, were all dome with the German labour market in view.)

In Kaleckian terms (we are in Poland, and I consider myself a Sraffian economist but also a follower of Michal Kalecki, although not of neo-Kaleckian theories), wage moderation allows German capitalists to obtain a huge social surplus (the surplus value of Marx). The problem arises in 'realisation' of the surplus. The German, neo-mercantilist way is to finance the European periphery in order to sell their outputs. Recall the story of the order of the six submarines by the close Angela friend Karamanlis that was later cancelled by Papandreou which infuriated the Germans. Of course the main example is the Spanish house bubble that German banks happily financed. "Surpluses create debts" as very neatly our moderator put it in the introductory notes.

The American way to sustain aggregate demand has been to let the impoverished working and middle classes to have access to consumer credit. In both cases, neo-mercantilism and indebted-families-led growth. Once debts accumulate, the model meets troubles.

Incidentally, if everybody were as virtuous as Germany, where would we sell the output, since not all the world countries can be surplus countries at the same time? I admire Germans and Germany, but they should recognize there is a problem, not only for us, but also for them. The problem is that blinded by their moralism and of course by their affection to the ordoliberal export-led model (what I can understand) you find in Germany very few economists and politicians able to understand this. It is trivial, but the lack of mental flexibility by the German elite is a true obstacle.

Look at this quotation by the Schauble (FT 5 Sept. 2011)

"Whatever role the markets may have played in catalyzing the sovereign debt crisis in the eurozone, it is an undisputable fact that excessive state spending has led to unsustainable levels of debt and

[3] Cesaratto S., Stirati A. (2011) Germany in the European and Global Crises, *International Journal of Political Economy*, vol. 39, no. 4, Winter 2010–11, pp.56–87; working paper version: http://www.econ-pol.unisi.it/dipartimento/it/node/1267

deficits that now threaten our economic welfare. Piling on more debt now will stunt rather than stimulate growth in the long run. Governments in and beyond the eurozone need not just to commit to fiscal consolidation and improved competitiveness – they need to start delivering on these now."

These positions by Schauble have later been endorsed by the German President Wullf and by the SPD leader Gabriel, in a show of German conservative unity, and culminated in the resignation of the German member of the ECB executive board, Stark. This decision was taken on Friday, September 9th, with the financial markets still open and determined their (further) tumble. This shows the firm support of some German circles to a strategy of destroying any progressive exit from the crisis.

I am very glad the next President of the ECB will be Italian. He will (unfortunately) be a conservative governor, but at least with a flexible mind (Bernanke also is conservative, but he knows very well what a central bank has to do in troubled waters). There are of course clever German commentators: compare Wolfgang Munchau support of an ECB policy of zero interest rates and opposition to a collective fiscal retrenchment in the FT (4 Sept. 2011), but they seem to be isolated voices, at least in Germany.

Set 3: The responsibilities of European Central Bank

We all know the story of the role of the "one monetary policy fits all" in creating the housing bubbles in Spain and Ireland and their debts. In the case of Italy, as I said, the public debt was an older story, and the EMU has resulted in progressive lose of competitiveness for a country that has traditionally relied on its currency depreciation to sustain it.

The EMU is a gold standard system. The ECB is a foreign bank for every member country. In addition, the European philosophy is to put the burden of the adjustment on the shoulders of the countries with foreign deficit – at least in a classical gold standard the adjustment relies on deflation in the deficit countries and on inflation in the surplus countries!

Ideally, what the ECB should have done was to fully guarantee the public debt of the periphery and keep the interest rates at the same levels of the US or UK, practically zero. Periphery countries could then easily pursue policies to stabilise their public debt/GDP ratio. Without zero or negative interest rates a reduction is a useless contribution to the recession. (Incidentally, I believe that the proposal of the Eurobonds as an ultimate way to avoid the default of peripheral Europe is deficient, base much on the reasons adduced by its detractors: at the end it is Germany that must guarantee everybody; a burden that it cannot bear, even if it wished. Only the ECB, acting as a real European Central Bank with its infinite capacity to print money can guarantee everybody).

To stop the debt crisis would be the easiest thing to do, but German politicians and their economic advisers have a Tea Party mentality: only the punishment of the periphery can solve the problem or, at least, they should first show regret and mortification. They forget that the austerities they are imposing is making things worse and are rapidly leading to social instability in Europe and to the end of the Euro – and perhaps to the level of postWW2 Europe.

We all know Charles Kindleberger interpretation of the great crisis of the 1930s as due to the lack of a hegemonic country; of a country that has to take the honours but also the burden of being a leader. Either Germany decides to be this in Europe or we shall see a rancorous end of it.

Set 4: (Un)sustainability of trade/current account imbalances in the euro area

To relieve the debt crisis would have been (perhaps still would be) the easiest task. To address the European imbalances within the EMU/gold standard is the most difficult task. Punishment is not the right thing to do. Take the current manoeuvre that the ECB (sic) asked of Italy in exchange of the timid intervention to sustain the Italian treasuries (I do not discuss the insult to democracy of this procedure, the ECB was instructed to do that after an (informal) agreement between the Italian President Napolitano and Mario Draghi approved by Merkel-Sarkozy). Italy should of course adopt measures to cut useless public spending (which includes supporting an inflated and costly political class) and fight tax evasion but not in order to reduce the public debt. This target would worsen the recession and reduce tax revenues, rendering the austerity useless - another manoeuvre will be necessary, then another one, precisely like what it is happening in Greece. The guarantee and lower interest rate by the ECB should take care of public debts. Instead, the resources from “la manovra” should be used to improve competitiveness, education, R&D. This will not of course be enough, since such “supply side” measures act very slowly and must be accompanied by a recovery of aggregate demand.

Surpluses create debts as we argued above. Then, deficits, by core countries, would solve debts! An expansionary monetary policy by the ECB would avoid a recession in the periphery and, at the same time, support a recovery in the core countries where inflation must be left to continue. Many commentators see the end of wage moderation and a ‘nice touch’ of inflation in Germany as essential steps. This would be a dramatic passage for Germany: the passage from an export-led economy to one more based on the internal market (let alone the fact that high real wages means a lower profit rate); a passage from being a wagon of the periphery (or of the American) locomotive to be a European and global locomotive. There is a further passage: inflation should be moderate in the periphery, which is difficult to ensure. If a recovery does take place, employees would rightly ask for higher wages. They should be raised not through an increase of nominal wages (nominal wages are those relevant for the international competitiveness), but, for instance, by cutting taxes on wages by using the revenues from a serious fight against tax evasion or by taxing wealth.

I know the “moral hazard” objection by my northern friends: if “too much help” is given to the Southern friends they will never dismiss their bad habits.

I would reply to this that I will happily accept more European coordination of national economic policies - as long as full employment is mentioned as the main target along with moderate inflation (anyway not subordinate to low inflation). I also know too well some bad habits of my country. But I firmly believe that punishment is a useless way to deal with these problems. Bad habits are beaten by economic growth; they get worse with economic decline. Germans should know too well from their East Germany experience how difficult it is to change a society – and East Germany is not Calabria. Why does Europe not dictate a common policy to fight tax evasion?

Europe should say: you fight tax evasion and use the additional fiscal revenues to improve education, infrastructure etc. You promise to stabilise your public debt (we do not ask you to reduce it because this is deflationary for you and us) and the ECB will help you with her guarantee on all European public debts – i.e. it will become a true European Sovereign Central Bank. We shall contribute to common growth by sustaining our domestic demand.

The strategy of punishment will instead lead to two possible results:

- A dramatic social instability in the PIIGS first and later in France; possibly, the French will revolt against this Europe, Germany will do something different, or the UME and EU will break.
- Countries like Italy will progressively become more and more poor, but for some miracle the Euro will not break; organised criminality will take control of the country with serious business in North Europe; the country will elect another Berlusconi (Germany still does not realise that Mafia, especially Calabrese mafia, is well present in its territory).

Is this what Germany wants? Schauble’s article in the FT does suggest this. Perhaps <u>they</u> wish the rupture of the EMU.

For memory: the questions by Leon Podkaminer were so detailed:

Set 1: Causes of the 'Southern Debt'

Are the national debt-propensities inherent – i.e. 'cultural'?
Lax governmental policies responsible? Too high spending? Too low taxes?
Or an economic necessity, of a sort?
Attempts at "fiscal consolidation"?
Exogenous factors: Incorrect interest/exchange rates?
The other side of the "Northern Thrift'?

Set 2: Private thrift vs. governments' carelessness?

Are the private sectors more thrifty? More careless ?
What are the consequences of excessive private thrift? And of excessive private spendthrift?
Is the German private thrift increasing the German public debt?

Set 3: The responsibilities of European Central Bank

'One-Size-Fits-All': Applicable to the euro area?
Inflation the ONLY goal? No bail-out? No lender-of-last resort? Whence these ideas?
Alternative: Resort to 'Printing Press'?

Set 4: Un(sustainability) of trade/current account imbalances in the euro area

Surplus = increase in credit; Deficit=increase in debt → surpluses create debts?
Elimination of imbalances? How to achieve? Deflation in "S"?
Consequences for S & N? Alternatives?
Transfer Union? "N" stops repression of wages?