The Political Economy of Eurozone Austerity

Marcello de Cecco

Professor of Monetary and Financial History, Scuola normale di Pisa, Emeritus

In the last few weeks we have received a veritable shower of bad numbers about the world economy, and in particular about the European economy. The numbers about the Eurozone are the worst of the lot. We have become used to that.

The rest of the world, however, does not fare much better than we Euro area citizens do. The more successful among the Euro countries, signally Germany, cannot therefore entertain reasonable hopes to be able to have a reasonable growth rate by exporting what they do not sell, or do not want to sell, at home.

It was only a few months ago that prospects for the successful Euro countries, especially for Germany, looked much better. And it was as recently that the Euro looked to a present and a future of strength vis a vis the US dollar.

The euro, however, looks very different today. It has weakened considerably against the dollar and the main reason for this radical change of course and prospects is the state of open warfare in Eastern Ukraine, which erupted with the heavy involvement of the EU and Russia on the sidelines. A fragile truce has been reached a few weeks ago. It is unclear how effective it is and how long it will last. Monetary policy in the US and Europe, of course, also plays a role, but the Fed is not really set on a course of serious tightening yet.

I therefore think it is mandatory that an assessment of the economic state of the European Union give foreign political factors pride of place even in economic affairs. Political and military affairs are a large factor in determining and changing the expectations economic agents at all levels entertain about the future, When a huge problem like the Ukrainian civil war explodes, both

investment and consumption tend to be directly reduced in the countries of Europe, and especially in Germany, which was heavily involved in Ukrainian affairs even in tsarist times and again since that country became independent from Russia. Moreover, Germany is now the core of a new edition of *Mitteleuropa*, an area which has become deeply integrated with the German economy, so that it can now be considered as one huge production and export area.

Germany, of course, is an export giant. It is the main source of automobiles and investment goods absorbed by the rest of Europe, but also by huge importers like the United States and China, and more generally by all people who need complex machines or luxury cars. Granted that Europe seems to be affected by a durable slump of GDP growth because of flagging internal demand, German exporters have been so far able to rely on demand from China, the US, Brazil, and Russia. None of these countries seem likely to have an investment boom in the proximate future. In China growth prospects have been reduced and in Brazil the boom is over. The US economy still shines, when compared to Europe . It will be probably somewhat affected by the beginning of the end of the decade long very easy monetary policy, although we can rely on Janet Yellen waiting at least until the results of the midterm political elections before taking any monetary policy initiative. The stock exchange boom must not be stopped before the elections. Every American, through his or her pension fund, has a stake in it.

If US elections yield bad results for the Democrats, as it is likely, the Obama administration will certainly react by trying to make sure growth remains vigorous in the coming two years, in order to go to the Presidential election with a strong economy and an even stronger stock exchange. However, if relations between Russia and the West take a sharp turn for the worse, possibly a sudden one, in the next two years leading up to the Presidential election, it will be extremely difficult to insulate the US stock exchange from the negative consequences that will emanate from the international situation. We shall then watch the Fed's reactions to, say, a thirty per cent fall in the Dow Jones, a very realistic hypothesis, since it has happened no less than six times in the last few decades. My personal guess, again an extrapolation of past behavior, is that, like after nine-

eleven 2001, and especially after the invasion of Iraq in 2003, the Fed will initiate a new episode of extremely cheap money, and keep it going as long as the acute phase of the international political crisis lasts.

In spite of even such an accommodative forecast for US monetary policy, a continuation of the European slump is likely, with the German economy slowing down, too, because of the effect of the situation in Ukraine on the saving and consumption decisions of German citizens. An additional negative factor for Europe is the continuation of Abenomics in Japan, the most notable result of which has been a large fall in the exchange rate of the Yen. Germany and Japan thus compete again for a less ebullient Chinese market, as the Chinese government tries to steer the economy away from investment and into greater consumption, thus relatively reducing the demand for investment goods produced in Germany and Japan. Germany and Japan also compete fiercely on the American market, which is still much larger than the Chinese and larger than the European.

If a forecast of the world economy evolving in the next months in the way we have just depicted is reasonable, even if problems in Ukraine do not come to the boil again, a realistic economic policy would be for Europe one of continuing monetary accommodation and innovative fiscal push.

Draghi keeps repeating that he is not going to let the ECB swerve from its accommodative stance. But he also insists that it is time for governments, especially in the surplus countries, to introduce fiscal measures that will spur internal demand and imports.

It is necessary, at this point, to note, however, that, if one compares the growth in the size of European Central Bank (ECB) assets in the years since the start of the great crisis to the size of Federal Reserve assets, it is possible to see that, in the case of the ECB assets, after growing as fast as those of the FED and even faster, they have declined in the last years, while the Fed has carried on adding to its assets. This means that, after all, the ECB stance has been less accommodative than that of the Fed, and the reason is that the European banks borrowed from the ECB at rates that, as things calmed down in the international markets, became higher than the rates those banks could find on the international market. Thus banks started repaying the loans they had received from the

ECB, especially because demand for loans from the economy was very low and, in any case, banks, as just noted, could get very cheap funds from the international markets.

No positive macroeconomic effects seem to have come thus far from the expected introduction of the European Banking Union on November 4. Banks, in the course of the present year, seem to have been mesmerized by the need to prepare their balance sheets for the asset quality review that the European Banking Authority is making of the largest 120 banks in the Union, whose results will be out on the occasion of the start of the really important innovation in European money and banking which is the transfer of supervision to the European Central Bank. The awareness of their weak capital position has led most large banks to strengthen their capital positions, by issuing new shares, but especially by deleveraging, with obviously depressing results on their lending activity. In addition, banks, especially in the weaker countries, have preferred in the last years to lend to their governments, rather than to risky firms, even in spite of the possibility of having to take large haircuts if crisis breaks out again.

In this particular field, the position of Germany appears very peculiar. Germany is the strong brother of the European family and it behaves in a way that seems to be inspired more by traditional economic nationalism than by European cooperative spirit. It is thanks to unrelenting German opposition that the action of the ECB and of the European Commission to effectively face the great crisis in the European economy with prompt and adequate measures has been seriously retarded and slowed down in the course of the last decade.

The German power elites, however, know very well that the strength of Germany stops at the financial sector. Banks in Germany cater to the needs of the German Mittelstand, which is the protagonist of the strong German economic performance and receive the savings of the German public, under the form of time deposits and equally simple instruments. The German banking system is still extremely weak, after it was the negative protagonist of the speculative excesses of the last five years before the great crisis broke out. This involved the *Landesbanken* in particular, whose balance sheets were reduced to ruins by speculation in derivatives and even by rash lending

to extremely cyclical sectors like shipbuilding. In spite of receiving the largest amount of government funds in Europe in the course of the crisis, the balance sheets of German banks are not seriously repaired even today. Commerzbank, still owned in part by the German government, is among the 10 banks Mediobanca and Goldman Sachs indicate as likely to fail the Asset Quality Review. Even Deutsche Bank, which is one of the real protagonists of world finance, has to be as highly leveraged as its peers in the international senior league to be able to compete with them. German government action in the shaping of European economic policy thus suffers from the contradiction between a strong productive sector, equally strong public accounts, with even a balanced federal budget, and a still extremely weak banking sector. The most glaring example of this is that while they talk about severity and austerity, the Germans have managed to convince their partners to exclude no less than 1697 of their banks from the asset quality review.

This unbalanced situation has led the German authorities to strive, in the last years, to insulate their banking sector from common action at the European level. They have much preferred, since as early in the crisis as October 2008, to look after German banking problems at the national level, moving at a very slow pace to solve the sector's problems, also because of close ties between bankers and politicians. In the process, they have sunk or slowed down European solutions and tried in every case to get low level compromise outcomes, which allowed banking problems to remain national.

Given the power of Germany in Europe, this has meant that, for instance, Germany has managed to borrow money from abroad on very favourable terms, compared to those at which other countries of Europe, like the Latin ones, except France, borrow.

The secret of German success in controlling its borrowing rates, which would have been unfavourably influenced if other European countries had compelled Germany to adopt European level measures like Euro bonds, has to be found in the behavior of the French authorities. The latter's overwhelming policy aim has been, in recent years, to keep a very low discount for their bonds compared to German ones. French authorities have thus been constantly on the German side

in all European decisions or non-decisions with the aim of convincing the world markets that theirs would be the country the Germans would unfailingly support if need be.

The long run effect of this choice of alliances has been that the German steady retardation of ECB and European Commission action in the course of the crisis has yielded too high an exchange rate of the Euro. This had extremely negative effects on the French economy. The latter is much less competitive than the German economy and by trying to keep a high credit rating the French have been able to finance this state of affairs for a long time, without having to take drastic measures to increase their competitiveness. French big banks have been able to finance their international operations at very low rates, but the high exchange rate has punished French exporters whose products do not enjoy nearly the same relative market power German products have.

Summing up, the economic state of the European Union is lamentable, even if compared to that of other countries, like the US and China. It has been like that for some years now and it is going to remain the same in the near future. There seems to be no chance of seeing the German surplus with the rest of the world decline from the pathological level at which it has been in recent years. German surplus with the rest of Europe has disappeared, but only thanks to the slump of demand in the weaker countries, which has meant drastically lower imports.

In spite of constant nudging from Mario Draghi , the IMF and now even Jörg Asmussen, an important member of the German Social Democratic Party, the German Christian Democratic leadership is adamant in restating, especially through the voice of Wolfgang Schäuble, who has enjoyed the Kanzlerin's full support, the precepts of the *Soziale Marktwirtschaft*. They are the rules that have been imposed on the members of the Euro System to force on them the austerity which was and still is considered necessary for them to be able to stay in the Euro system on their own and without needing help from the stronger members of the Eurozone. No chance, therefore of seeing issues of Euro bonds.

SMW means governance by rules rather than by discretionary policy measures. Two years ago all Euro member countries agreed to include in their constitutions the balanced budget rules first

approved by the German Parliament and even automatic deflationary rules that kick into action if certain precisely defined limits are reached in public deficits and public debt. Schäuble recently announced that the German budget would be balanced earlier that expected, in the present fiscal year. Other countries are showing a much weaker desire to do the same, in spite of having accepted the fiscal compact, but most of the deficit ones have been compelled to adopt tough austerity measures, with results on their public expenditure, internal demand and unemployment rates which have not been significantly reduced by export growth.

Austerity is based on a *Weltanschauung* which is the opposite of that which inspires modern economic policy making and in general macroeconomics.

Austerity, which is a practical application of the *Soziale Marktwirtschaft*, sees an external surplus as the natural outcome of the international competitive process. A more competitive economy's external surplus is thus seen as a situation which requires no corrective policy on the part of the surplus country's government. External deficits, on the contrary, are pathological manifestations of a lack of competitiveness which depends on misalignment of wages or rents with those prevailing in the surplus country. Deficit countries governments must therefore adopt deflationary measures and structural reforms which will realign wages and reduce rent factors.

This looks like new stuff, but students of economic history know that it is the stance traditionally adopted by surplus countries. At Bretton Woods, it was the United States that took it to prevent an effective rebalancing method which weighed equally on surplus and deficit countries from being written into the Agreement. Keynes' efforts were thus in vain. The US was still suspicious the view that the world economy did not naturally tend to full employment balance and that balance had to be achieved by international agreement about policies of reflation to be adopted by surplus countries, so that the world economy would not reduce its growth rate and the maintenance of full employment could be secured in most countries.

The US, to its credit, after having seen the deflationary effects of the working of Bretton Woods in Europe, launched in 1948 the Marshall Plan, prompted by the new bipolarity in foreign policy. It

was a gigantic aid program to help deficit European countries avoid the consequences of deflation on employment and political equilibrium.

Germany, therefore, and other surplus countries, are just repeating the arguments used by the Americans against Keynes. They have no sympathy for the Keynesian approach adopted by Mario Draghi, by the IMF and by the US government. All try to convince Germany to boost internal demand and reduce its huge external surplus. By signing the Treatise introducing the Fiscal Compact on March 2, 2012, all the countries of the Euro Area have accepted the German *Weltanschauung*. The *Soziale Marktwirtschaft* has therefore been accepted as the correct theoretical basis which rules over the behavior of the Euro countries. Its consequences have already taken effect: deficit countries have had to adopt austerity, drastically reducing internal demand by severe cuts in public expenditure and drastic wage and employment policies. Surplus, on the contrary, being a sign of virtue, Germany did not have any obligation to boost internal demand. And, sure enough, the European imbalances disappeared because of the austerity measures adopted by the deficit countries. The question to ask is why did deficit countries agree to voluntarily introduce the German Weltanschauung in their economic policy making and even in their constitutions.

My answer is an articulate one: nothing inspires imitation more than success. The German economy has been successful, judging by its growth rate, its unemployment rate, the achievement of a balanced budget, the drastic reduction of public debt. Germany attracts skilled labor from all over Europe and pays high wages for it, while in other countries even young engineers cannot find jobs. Youth unemployment is extremely low, while in Southern Europe it reaches formerly unthinkable heights. And Germans have paid for their labor market reforms with their blood, by creating no less than seven million German workers who earn less than 400 euros a month.

However, what prompted the Treaty was the grave and imminent danger that the Euro might dissolve as a result of massive international speculation and rejection by the German people, politicians and law courts. Would Mario Draghi be allowed to pronounce his famous "whatever it takes" speech on July 26, 2012 that killed speculative attacks against the Euro and allayed the

dissolution of the Currency Union fear, had the Fiscal Compact not been signed a few months before?

Thus, in addition to admiration for the German Way, there was in the deficit countries of the Euro the consciousness that the fiscal compact was the pound of flesh they had to pledge to make their deflationary intentions credible to German eyes. And, of course, what was decided in the famous Deauville walk taken by Sarkozy and Merkel in October, 2010 had created the perturbation in the markets which led to everything else.

Once again, we see the French government playing along, accepting anything to show the special relationship with Germany still existed and was the basis for the French public debt's triple A rating.

There is no tradition in France to associate high finance interests to government decisions, as for instance is commonly done in the UK for the City. On several occasions, however, we got the distinct feeling that French government action in the European field was strongly influenced by the need of the large French international banks to have a high national debt rating on which to be able to base their international financial operations.

Some people say this is all changed since the return of a Socialist to the Élysée Palace. They see the dawn of a new special relationship between France and Italy capable of formulating a policy stance to oppose the German one. This opinion is not well founded. It ignores the new love story between Germany and conservative Spain. It also forgets that Matteo Renzi has been a Merkel protégé long before he became Prime Minister and that he keeps repeating that his policy model is Germany.

I conclude these short remarks by saying that until the German public does not see deflation hitting their own welfare, they will remain unsympathetic even to Jörg Asmussen's moderate criticism of Wolfgang Schäuble's dour policy stance. Especially after the recent depreciation of the Euro has given further wind to the sails of German exporters, the chances of a change in German policy rest solely on a drastic worsening of the situation in Ukraine which may darken the outlook for the German economy, especially because of the saving and investment reactions of German consumers

and entrepreneurs. The very recent declaration by the head of German industrialists may be a sign in that direction.

This is, however, a counsel of despair. Do we really want a dark situation like the one that sees renewed indirect warfare between Russia and the European Union in Eastern Ukraine help to mollify the German stance on European economic policy? Let us remember that, if a situation like that comes to pass, Germans may react in the opposite direction, by increasing the numbers of Alternative fűr Deutschland sympathizers and by becoming even more rigid in their demand for respect of the Fiscal Compact Treaty.

I am sorry to say I do not see a very bright future for Europe. And I do not think sanctions will make Putin more reasonable. His popularity in Russia increases the more nationalist he becomes. Can he be taken by hunger, i.e. by the sanctions causing food prices to jump to the sky in Russia, since so much food is imported and has been blocked by Russian countersanctions? Traditionally this has never happened. But never has Russia relied so much for its essential imports, like food, on foreign producers. Only a bumper wheat crop has balanced these numbers somewhat, but slumping oil prices have worked in the opposite direction, to reduce Russian oil revenues.