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Crisis and Renewal: International Political Economy at the Crossroad

Session 8:

Optimal Currency Areas and Governance: The Challenge of Europe

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In preparing this paper I have decided not to embark upon the decades-old issue of optimal-currency areas and governance as such. I assume that one of my colleagues on the panel will do that. Instead I will present an historical case of over-indebtedness of parts of a common-currency area somewhat similar to the present challenge of Europe, or rather of the Euro area with its common currency. My hope is that from a comparison of the two events we might gain further insights as well as perhaps an alternative perspective on and a new interpretation of the current Euro-zone challenge.

As we have witnessed during the decades-long and world-wide process of deregulation of financial markets that ended up in the recent financial crisis, decision-makers in politics often seemed to be captured by the financial industry. The latter sold the pursuit of its narrow profit-interests to the government as a contribution to the “general welfare” or the “national interest”. The purpose of financial regulation, namely to prevent a meltdown of financial markets of the recent kind, was largely ignored.

I have the impression that currently the financial industry is again pursuing its narrow profit-interests, after having reduced its own excessive indebtedness at the expense of government accounts. It “demands” of *its own* rating agencies (whose business – unlike that of government regulatory agencies – largely exists on purchase orders and payments by the financial industry) bad ratings for thus “over-indebted” countries like Greece, Ireland, perhaps also Portugal and Spain, and may be even Italy. Is this a conspiracy theory? Just look at how the U.S. financial industry "cooperated" with the leading rating agencies to induce them to rate "structured investment vehicles" containing mainly securitized subprime loans with AAA. The outbreak of the financial crisis in the summer of 2007, followed by the severest depression of the real economy since the 1930s after the Lehman crash of September 2008, revealed those AAAs to have been at best a grave misjudgment, at worst the outcome of willful deceit resulting from a collusion of the rating agencies with their customers in the U.S. financial industry. In any case the reputation of the leading Anglo-Saxon rating agencies has been so badly impaired that I hesitate to trust their bad ratings for Greek, Irish, Portuguese or Spanish government bonds. Couldn't it be that their ratings serve to push already elevated rates of return on government bonds of some countries more weakened by the depression than others even higher, and this precisely in a situation in which financial institutions can tap funds of their central banks at historic lows (Fed: zero percent, ECB: one percent)?

For the bad-rated countries there is, of course, the mechanism of self-fulfilling prophesy at work. In as much as capital investors still believe in the ratings, they demand higher rates of return for investing in Greek and Irish government bonds. And when, as a result of that, the spread between German and Greek or Irish government bonds rises to six or more percentage points, the bad ratings have fulfilled their prophesy and have served the profit-interests of the financial industry well. Prior to the outbreak of the financial crisis the AAA-rating for "structured investment vehicles" containing subprime loans over many years served the same purpose, but in the opposite direction: It was a misjudgment not toward the dark, but toward the bright side. All the while these were sold world-wide, and as I have read in Michael Lewis' recent book, to a great extent to "Duesseldorf"/Germany[1], namely to the Industriekreditbank (IKB) and the Westdeutsche Landesbank. These were and are still both in public ownership which might explain why both of them trusted the rating agency's AAA blindly.

If you think that I have fallen victim to a conspiracy theory, consider this: A market economy with the means of production in private ownership is always driven by

[1] Michael Lewis, *The Big Short. Inside the Doomsday Machine*, New York: Norton: 2010.

individual economic interests exploiting market opportunities. If these allow a company to build up and hold on to a profit-maximizing monopoly position, this will definitely emerge unless competition policy by a government agency prevents it. If such antitrust regulation would be entrusted to a private agency financed by the regulated business sector, it would inevitably create an incentive for collusion and kickbacks on both sides, because both are profit-maximizers. However, when the regulating function is entrusted to a government agency, only the regulated businesses are profit-maximizers. This provides a much weaker incentive for collusion and kickbacks, because on the agency side the temptation is restricted to individual civil servants who are willing to put their employment at risk on grounds of corruption charges.

The financial sector is unique in its degree of deregulation. New financial products, like those on the derivative market, which were outlawed before financial deregulation started in the 1970s, are nowadays not even screened for their safety by a government regulatory agency before they are marketed. Private rating agencies have taken over. Even legislative or central-bank statutes refer to their rating scales to define what financial institutions and central banks are allowed to hold in their portfolios.

Deregulation in other sectors of the economy has also taken place. But as opposed to the financial sector it did not go as far as throwing out the baby with the bath water. Supervising hygiene in restaurants is <u>not</u> an activity entrusted to a private business financed by restaurant owners. It is, of course, a public responsibility. Would you want to eat there otherwise? Or in aviation, would you feel safe traveling on an airplane, if the airlines themselves – as opposed to the U.S. Federal Aviation Agency (FAA) - had created and would finance their own regulatory agency for the inspection of their safety? What about the safety of house construction, of meat production, of toys etc. etc.? Would you feel safe, if private agencies, each one financed by the respective industry, rather than government agencies would inspect and rate them?

But by decades-long persistent “drilling of hard boards” (Max Weber) the financial industry, together with its rating agencies, has captured governments. Even in Germany, the social-democratic government of Chancellor Gerhard Schroeder

(1998-2005) fell victim to the birdcalls of the financial industry for more financial deregulation. International competition of financial institutions in our globalized world obviously triggered *a race to the bottom*.

Today we are steeped into a public discourse about government indebtedness that likewise seems to be shaped by the profit-interested financial industry. Therefore, it is all the more important to search for economic-history examples of similar events in order to be able to judge the consequences independently of what rating agencies and politicians assume these days. The similar historical case that I chose is the debt crisis of some states of the U.S. in the 1840s. This case is not dealt with in Kenneth Rogoff's and Carmen Reinhart's timely book *This Time is Different*.[2] As one of the earliest financial crises in the U.S., it is not only a part of standard U.S. economic-history textbooks. But since the 1990s it has also attracted the attention of some U.S. economic historians to test different explanations of sovereign debt crises. Research on the question why and under what circumstances sovereign states defaulted in the 1840s promised to shed new light on third-world debt crises of the recent past.[3]

I will draw on this research and some older literature to address a different set of questions with relevance to the subject of this panel: Do defaults of a minority of fiscally and financially (in terms of chartering, subsidizing and regulating banks) sovereign states within a monetary union endanger the stability of the common currency and the creditworthiness of the non-defaulting states (and of the central government) of that union? Is a rescue operation necessary to prevent harm from the non-defaulters? Whose interest is being served if the central government or the fiscally and financially sound member states rescue the debt-ridden states from default?

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[2] Carmen M. Reinhart/Kenneth S. Rogoff. *This Time is Different. Eight Centuries of Financial Folly*, Princeton UP, 2009.

[3] William B. English, "Understanding the costs of sovereign defaults: American state debts in the 1840's", *American Economic* Review 86 (1996), pp. 259-275. Arthur Grinath III/John J. Wallis/Richard E. Sylla, "Debt, default and revenue structure: the American state debt crisis in the early 1840s", NBER, Historical Paper 97, March 1997. Richard Sylla/John J. Wallis, „The anatomy of sovereign debt crises: lessons from the American state defaults of the 1840s", *Japan and the World Economy* 10 (1998), pp. 267-293 (This is a revised version of the preceding paper). John J. Wallis/Richard E. Sylla/Arthur Grinath III, "Sovereign debt and repudiation: the emerging-market debt crisis in the U.S. states, 1839-1843", NBER, Working Paper 10753, September 2004. An older article: Charles P. Howland, "Our repudiated state debts", *Foreign Affairs* 6 (1928), pp. 395-407.

I think it is needless to recount to this audience what happened to some members of the Euro zone and how the others reacted politically after the Greek debt crisis broke loose at the beginning of 2010 and the Euro allegedly moved into a danger zone. However, as to the American state defaults of the 1840s some information is apposite.

After "one of the longest and most severe depressions that this country has ever experienced" had started to develop in March 1839,[4] in conjunction with the cessation of British capital exports to the U.S.,[5] eight states (Arkansas, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, and Pennsylvania) out of a total of 26 states of the Union and the then still territory of Florida defaulted on their government bonds between 1841 and 1843. By 1841 19 states and two territories had issued bonds. This means that 50 percent of the indebted territories did, but that the majority of indebted states did not default. Borrowing was almost exclusively undertaken for the purpose of financing infrastructure projects in transportation, such as canals, turnpikes and railroads, or – especially in the Southern states – for the founding and financing of state-chartered banks.

During the depression the bond market dried up, in the U.S. and abroad. Therefore, many of the infrastructure projects remained incomplete and did not generate revenue. And many of the state banks failed.[6] State governments had supported their founding by purchasing a part of their stock in return for their own bond issues, which would be sold by the banks to investors in financial centers on the East coast or in London in order to raise the necessary liquid funds for running their normal banking operations. As these banks had been mostly land banks, the bulk of the assets had consisted of mortgage claims on plantation and farm land, at the start from selling stock to planters and farmers, thereafter from financing their current business and their investments in additional land purchases.[7] The depression had triggered a sharp and protracted fall in federal land sales and in the value of land as well as the prices of crops, which rendered mortgage debtors unable to service their debts.

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[4] Leonard P. Ayres, *Turning Points in Business Cycles*, New York: Macmillan, 1940, Reprint: New York: Augustus M. Kelley, 1969, pp. 18-19. For the causes of the depression in detail see Peter Temin, *The Jacksonian Economy*, New York: Norton, 1969, pp. 148-171.

[5] Leland H. Jenks, *The Migration of British Capital to 1875*, London: Nelson, 1963, p. 96; for an overview of the boom and bust of British capital exports to the U.S. see pp. 65-108.

[6] English, "Understanding …", pp. 261-264.

[7] Jenks, *Migration* …, pp. 75-76.

Expected property tax increases to back up the debt service on the bonds of state governments had also not materialized.[8]

A very large fraction of state-debt creditors were residents of other states and of other countries, primarily Great Britain, where especially Baring Brothers and Rothschilds had marketed such bonds to private investors.[9] Smaller amounts of state bonds were also held in Holland and France.[10] By the end of the decade four states and the then (since March 1845) state of Florida had repudiated all (Mississippi and Florida) or part of their debts (Arkansas, Louisiana, and Michigan). Of the other four states two (in the Mid-Atlantic: Pennsylvania 1845 and Maryland 1848) resumed their debt service fully including interest payments on their arrears, while the other two (in the Midwest: Indiana 1847 and Illinois 1846) reached settlements with their creditors who agreed to a cancellation of interest payments on arrears in exchange for resumption. State debt in relation to gross state product in 1840/41 averaged only 9 percent in the non-defaulting states, but 26 percent in those that defaulted temporarily and 36 percent in those that partially repudiated their debts. Of the two that repudiated completely only one fits into this pattern, namely Florida with its extremely high ratio of 77 percent, while Mississippi with only 16 percent is an outlier.[11]

The quotation of the bonds of the defaulting states fell dramatically. In the cases of Indiana and Pennsylvania their yield to maturity has been calculated as a proxy for their effective rate of interest. With nominal interest rates of usually six percent and effective rates mostly lower, the yield to maturity of Indiana bonds peaked at nearly 32 percent shortly after the outbreak of the crisis and the yield of Pennsylvania bonds at about 17.5 percent. Even after these had come down again by the mid-1840s, their spread over the yield of U.S. Treasury bonds during the second half of the 1840s remained at around 8 percentage points in the case of Indiana and at 4

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[8] This, in a nutshell, is the main explanation of the defaults in western und southern states in the paper of Wallis/Sylla/Grinath III, "Sovereign debt …".

[9] Reginald C. McGrane, *Foreign Bondholders and American State Debts*, New York: MacMillan, 1935, p. 9.

[10] For details on the structure of holders of bonds of the most indebted state, Pennsylvania, see McGrane, *Foreign Bondholders …*, p. 71, footnote 15. For this and other defaulting states' share of foreign bondholders and of the foreign currency denomination see: English, "Understanding …", p. 261. For the role of Baring Brothers and other London and continental banks see Ralph W. Hidy, *The House of 'Baring in American Trade and Finance. English Merchant Bankers at Work 1763-1861*, Cambridge, MA: Harvard UP, 1949, passim.

[11] Ibid., pp. 263-267. As to the reason for Mississippi's default with eventual repudiation see Wallis/Sylla/Grinath III, "Sovereign debt …", pp. 7, 14-15.

percentage points in the case of Pennsylvania, before they came further down since the end of the 1840s.[12] The yields of bonds of non-defaulting states, such as Massachusetts, or of local governments, such as Boston, were not affected by the financial crisis, U.S. Treasury bonds only slightly in 1842.[13]

In 1840 Baring Brothers in London and other European banks had urged the U.S. government to assume the debts of the states.[14] The federal government had done this in 1790 immediately after the U.S. had been founded. Acting in concert, European merchant and investment bankers tried again to exert pressure on Washington to assume the state debts by refusing to market U.S. bonds in 1842.[15] Thereafter, a Congressional House committee investigated the issue and also recommended the assumption of state debts in March 1843. The report was approved by the House and tabled for further legislation, but it failed in the Senate.[16] Neither did the U.S. government get involved nor the British government when pressured by British investors to do so.[17] After having generated copious revenue from the sale of Western land, the U.S. government had been debt-free 1835-1837 for the first and only time in history. It had even been distributing surpluses to the states on a per-capita basis in 1837. In 1841 its debt stood at only 5 million dollars. As against that the states had accumulated an aggregate debt of over 200 million

[12] English, "Understanding …", pp. 269-270. For a description of the sources of the data see ibid., p. 273.

[13] Sidney Homer/Richard Sylla, *A History of Interest Rates*, 3rd ed., New Brunswick, NJ: Rutgers UP, 1996, pp. 287, 304. The same data are also presented in Table Cj1192-1197: Long-term bond yields: 1798-1997, contributed by John A. James/Richard Sylla in chapter Cj of *Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition,* edited by Susan B. Carter, Scott Sigmund Gartner, Michael R. Haines, Alan L. Olmstead, Richard Sutch, and Gavin Wright. New York: Cambridge University Press, 2006. Available online. However, in states that narrowly avoided default, like New York and Ohio, bond yields did jump upward. See Sylla/Wallis, "The anatomy…, p. 269 and figure 4 on p. 285 showing the average monthly yields of New York, Ohio, and Kentucky state bonds, as reported by Ayres, *Turning Points …*, Appendix A and D.

[14] Jenks, *Migration* …, p. 105. McGrane, *Foreign Bondholders* ..., p. 23.

[15] Jenks, *Migration* …, p. 106.

[16] Benjamin U. Ratchford, *American State Debts*, Durham, NC: Duke UP, 1941, pp. 100-104. McGrane, *Foreign Bondholders* ..., pp. 34-40. Paul Studenski/Herman E. Krooss, *Financial History of the United States*, 2nd ed., New York: McGraw-Hill, 1963, p. 131. Margaret G. Myers, *A Financial History of the United States*, New York: Columbia UP, 1970, p. 145-146.

[17] Reasons for the refusal of the British government are given in McGrane, *Foreign Bondholders* …, pp. 53-54, 202. Jenks, *Migration* …, pp. 115-125.

dollars in 1841.[18] This is about 11 percent of an estimated U.S. GNP of 1.9 billion dollars.[19]

Did the state debt crisis endanger the stability, not to speak of the existence, of the U.S. dollar? It is true that the dollar in the 19th century was legally on a bimetallic standard. But the U.S. Coinage Act of 1834 changed the parity between gold and silver in such a way that – compared to their market prices – gold instead of silver was from then on overvalued. This – according to Gresham's Law - put the U.S. on an effective gold standard. The dollar was thus tied to the world's key currency, the British pound sterling, via fixed exchange rates (between the so-called gold points). However, during periods of a "paper standard" the gold points became inoperative and the exchange rate could fluctuate widely. One such period lasted from May 10, 1837 to March 17, 1842.[20] Thus the dollar-sterling-exchange rate was free to fall in 1841. It would have happened, if the state-debt crisis would have had any effect on the external stability of the dollar. But in 1841 the exchange rate was as stable as in the years before and after.[21]

This leads to the following questions: Are we really sure that the lowering (to use an appropriate neutral term in contrast to "weakening" or "depreciating") of the Euro exchange rate in the first half of 2010 was actually caused by the Greek and Irish debt crises? Or was it only attributed to or blamed on these crises by interested parties in order to urge EU governments to prevent default and repudiation at the expense of investors in bonds of those countries? Could the Euro-dollar exchange-rate changes not have been a reflection of the different fiscal and monetary policy mix in the U.S. and the Euro area in combating the financial crisis? Have a look at the

[18] This figure is given in English, "Understanding …", p. 272. For 1840 Sylla/Wallis ("The anatomy…, p. 269) report the sum of 171 million dollars. But this is close to the figure of 175 million dollars for 1838 as specified in the *Tenth Census of the United States*, 1980, vol. 7, p. 523, cited in Myers, *Financial History,…*, p. 143. Myers (p. 144) reports an "estimated 200 million dollars" for 1840. Slightly higher official figures as of September 1841 are reported in Ratchford, *American State Debts*, p. 80.
[19] The GNP figure was estimated as an average for the period 1839-1848 by Robert E. Gallman, "Economic growth and structural change in the long nineteenth century", in: Stanley L. Engerman/Robert E. Gallmann (eds.), *The Cambridge Economic History of the United States*, vol. 2: *The Long Nineteenth Century*, Cambridge UP 2000, p. 7.
[20] Lawrence H. Officer, "Exchange Rates", in chapter Ee of *Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition,* edited by Susan B. Carter, Scott Sigmund Gartner, Michael R. Haines, Alan L. Olmstead, Richard Sutch, and Gavin Wright. New York: Cambridge University Press, 2006. Available online.
[21] Ibid., Table Ee615-620: Dollar-sterling exchange rates: 1791-1914.

Euro exchange rate since January 2010 (Figure)! ECB president Jean-Claude Trichet has – in my view correctly - been denying until today that a Euro crisis exists.

In conclusion, what are the main differences and similarities between recent events in the Euro area and the American state defaults of the 1840s?

Differences:

- There was political union with a central government then, not in the EU today.
- The size of government and the share of tax revenue in GNP were much smaller during the 19th century than today.
- During the 1840s in contrast to today, the defaulting states were not rescued by the federal government or by other non-defaulting states. They either resumed debt service out of their own revenue or burdened their creditors with partial or even total losses by negotiating settlements or by outright repudiation.

Similarities:

- With relevance to the subject of optimal currency areas now and then, Wallis/Sylla/Grinath III asserted that around 1840 "The distinct regional patterns – northeast, northwest, and south – of the debt crisis and of regional responses to it imply to us that the United States at that time, although under one federal government, was less a nation or country in the usual sense, and more akin to an empire of different geographic and economic regions at different stages of development."[22] With arguably less economic diversity in the Euro area today, the centuries-old untouched existence of the U.S. dollar falsifies the proposition that the Euro area is not an optimal currency area.
- The public expenditure share of American state and local governments in the 19th century was larger than that of the federal government. It is true that the reverse holds for the U.S today. But with no central government and with rather small central funds on the EU level, the situation in the Euro area is similar to the 1840s in the U.S. with its fiscal federalism then. As the current

[22] Wallis/Sylla/Grinath III, "Sovereign debt …", p. 26.

debate shows, Euro-member countries defend their fiscal sovereignty tenaciously.

- The 1840s and the 2010 debt crises were triggered by very severe financial crises that led to deep depressions.
- In both cases investment bankers pressured governments to come to the aid of states in or close to default, 2010 successfully while in the 1840s without success.
- At the outbreak of the U.S. states' and Euro-member states' debt crises in 1841 and 2010 the exchange rates were free-floating to signal harm to the respective common currency.
- A counterfactual proposition: Had there been no rescue measures at the EU level for the sovereign debts of Greece and Ireland and had these countries defaulted, the path of the Euro exchange rate would not have been significantly different from its actual course since early 2010.

Why then did EU-governments commit large funds to the Euro "emergency parachute" (*Rettungsschirm*)? I have gathered evidence, for example from interview statements of Germany's finance minister Wolfgang Schaeuble,[23] that the financial crisis in general and the debt crisis of some Euro-member countries in particular are perceived as opportunities to deepen European political integration beyond monetary union. Mind you that monetary union as conceived in the early 1990s was planned to put pressure on the member states to integrate more fully not only in the economic-policy field, but also toward political union in terms of a United States of Europe.[24]

[23] Statements by Wolfgang Schaeuble, on the German television program ZDF "Minister Gnadenlos. Der lange Weg des Wolfgang Schaeuble", 9 March 2011.
[24] Resistance to progress toward this goal is widespread across EU member countries, but nowhere officially as pronounced as in Great Britain. That country begged for admission to the EU, but its government continues to defend its sovereignty to the last man. It is, therefore, useful for advances in European political integration that the Euro-member countries meet and take political decisions separately from the rest of the EU.