Fixing the European economic crisis

by Keith Rankin, 18 May 2012

All of the knowledge required to fix the Eurozone crisis is available now, and has been available since the 1930s. While the known solution is a growth solution, modified solutions that emphasise environmental sustainability are technically possible. Nevertheless, the simple growth solution is the most realistic immediate option.

Few economists are putting all the pieces together, however, and even fewer non-economists have the vision to do so. Economists, no less than others, are in the main ideological creatures, and tend to put their bits of knowledge together in ways that conform with their personal philosophies, or what they presume to be their employers' interests. Solutions are also obscured by nationalisms, in which each country looks for what is *relatively* good for that country (or at least for the elites of that country), even if it is absolutely harmful for the world economy as a whole.

One economist more prescient than most is Paul Krugman, and his just released book *End this Depression Now*, spells out the essence of the known growth solution.

The Eurozone crisis is a subset of a wider global crisis. The wider crisis is about the imbalances between private sectors running large and ongoing surpluses (spending much less than they are earning) and public sectors having to run equally large deficits. I say "having to", because the surplus-deficit game is a zero-sum game. Given that deficits are negative surpluses, by definition, the sum total of all the world's surpluses must equal zero, just as two minus two equals zero.

The Eurozone crisis, however, is a crisis of trade imbalances. The fiscal imbalances are a symptom, not the cause. The essential imbalance is the trade surplus of the northern bloc (dominated by Germany) and the matching trade deficit of the southern bloc (characterised most visibly by Greece and Spain). The problem is due both to inherent flaws in the fixed exchange rate system, and the refusal of those who are able to make such a system work (namely the northern bloc; the surplus bloc) to meet their obligations within such a system.

There are two currency systems that, if their rules are followed, economists believe enable the global economy to self-regulate. These are the fixed-currency system, and the floating-currency system. The Euro, as a fixed Eurozone currency, is also a floating currency, with respect to the rest of the world. The present crisis involves the flaws in both currency systems.

The problems of the floating currency system are familiar, but fixable. In the 2000s' decade we saw countries with trade deficits experience rising exchange rates, and countries with trade surpluses experience falling exchange rates, precisely the opposite of what is meant to happen within the floating currency system. The reason was that the various national monetary authorities manipulated interest rates - ostensibly to manage inflation - generating huge financial flows into trade deficit countries.

These transactions reinforced the trade imbalances, ensuring that deficit countries were accumulating private sector debts that could never ever be prepaid. The saving grace was that the creditor nations showed no signs of ever wanting to receive net inflows of goods and services from the debtor nations. In other words, their behaviour suggested that they never actually wanted to be repaid; rather they wanted to continue accumulating credits, by continuing to export more than they imported. These imbalances will, at some stage, be resolved through a process of global inflation, probably when the baby boomer generations seek to spend their retirement savings.

We are less familiar with the mechanism through which the fixed currency system is meant to work.

The fixed currency system is supposed to work according to rules self out by Scottish philosopher David Hume, in the 1750s. Under these rules, money (gold in his day) flows from countries with balance of trade deficits to those with trade surpluses. The shortage of money in the deficit countries was supposed to create deflation, and the excess of money in the surplus countries was assumed to create inflation. Falling prices (including wages) would restore the competitiveness of the deficit countries, and rising prices/wages in the surplus countries reduced their competitiveness, thereby restoring trade balance.

This is the principle that underpins the Eurozone; deflation in Greece and other southern European deficit countries, balanced by inflation in Germany and other northern European surplus countries. It was meant to be automatic; in Hume's enunciation there was no role for governments.

In practice the gold standard never worked like that, not even in its heyday before World War 1 (WW1), with some countries deflating while others inflated. However, the gold standard fixed currency system was widely believed to have been a stabilising factor, so the pre-war gold standard was restored in the mid-1920s, creating the circumstances that made the Great Depression of the 1930s unavoidable (especially in light of the debts imposed upon Germany in the Treaty of Versailles in 1919).

What really happened before WW1 was that the London-based financial system recycled the excess money in the surplus countries back to the deficit countries, undermining the monetary basis of deflation and inflation. In the 1920s when the imbalances were especially pronounced, the burden was placed on governments to pursue deflationary policies (in the event of a trade deficit) <u>and</u> inflationary policies (in the event of a trade surplus). In the 1920s, German and British governments obliged by running deflationary policies, but France and the USA did not oblige by pursuing inflationary policies. The result of the deflationary (read austerity) policy bias for the system as a whole was the Great Depression.

The system was flawed in other ways. Even if the classical monetary theory was allowed to work itself out (which would have required an absence of international financial flows), the surpluses would not have been eliminated, given the strength of will in some cultures to run perpetual surpluses.

More importantly, the monetary theory that underpinned the system doesn't work. There is not and has never been a simple inverse relationship between the quantity of money in circulation and the level of prices. It's actually very hard for policymakers to create deflation or inflation by turning the monetary taps off or on. On the basis of classical monetary theory, the massive money printing that has happened since 2008, especially in the USA and Great Britain, should have created inflation. Indeed, during the Great Depression in the 1930s, the monetary authorities in the leading economies tried to create inflation by monetary means, but could not.

At present all of the Eurozone economies are under deflationary pressure. In this scenario, rebalancing can only take effect if price deflation in Greece and Spain is larger than the price deflation that appears imminent in Germany and other northern Eurozone economies. Under the classical rebalancing rules of the fixed currency system, Germany should be trying to have inflation.

If the Eurozone is to survive in its present form, the policymakers have to find an alternative way of raising the competitiveness of Greece and Spain, and thereby *reducing* the competitiveness of

Germany. (Competitiveness is a relativist concept.) Thus the austerity (the modern word for deflationary policy) in Greece *must* be balanced by anti-austerity in Germany. Otherwise the austerity policy imposed on Greece cannot achieve its ostensible aim of raising Greece's competitiveness, the prerequisite for resolving Greece's debt problems. To eliminate the trade deficits of Greece and Spain, the trade surpluses of Germany must also be eliminated. Deficits and surpluses are a zero-sum game. This is the 'use it' solution; the surplus countries use their accumulated trade surpluses by spending them.

There is another solution to the European crisis; a solution which has two versions. Instead of resolving the trade deficits by reversing the trade flows of the past decades, the north can simply gift the required funds to the south. After all, if the surplus countries refuse to spend their surpluses, they must expect to lose them. Finance, like the human brain, works on a use it or lose it basis. 'Use it' is a growth solution whereby the rich spend more. 'Lose it' is a growth solution - like pressing the reset button on a stalled computer - whereby the poor spend more by having their debts forgiven.

The required transfers (gifts) can take place in a systematic way - as they do within any country with a federal structure (indeed as they did between West Germany and East Germany) - or they can take place retrospectively through debt default, whereby a debt eventually becomes an unintended gift.

In a fiscal union, such as the United States of America or the Commonwealth of Australia (or indeed the Federal Republic of Germany), transfers happen because federal government outlays are made on an approximate per person basis, while revenues are drawn principally from the richest provinces. This is the 'USE' solution (United States of Europe). While it would mean that there would be much less need for debt financing in the peripheral regions than there is in the presently configured Eurozone, it would also mean that there must be a commitment to paying the requisite amount of tax across the union. It is because this solution works (albeit underplayed in the USA where there is much tax resistance) that Tasmania or South Carolina or East Germany will never face the same kind of problem that Greece and Spain currently face.

In the event of a global depression worse than that of the 1930s - which is very probable at some stage over the next two decades - the growth solution that is known to work is a combination of fiscal stimulus (increased government spending in lieu of private sector non-spending) everywhere combined with temporary import controls in countries with substantial trade deficits. That is, simultaneous recovery and rebalancing.

The exemplar here is the Great Britain in the 1930s. Following a decade of deflationist austerity in the 1920s, with the greatest austerity under the watch of Labour Finance Minister Philip Snowden in 1929-31, and in the face of mounting speculative pressure arising from trade deficits, Britain jumped the gold standard in 1931, leading to the eventual decade-long break-up of the gold standard. From that point on, the British recovery was under way. While this devaluation of the British pound represented the key turning point, it was not sufficient to generate recovery, and the pound soon increased in value, especially when the USA left the gold standard in 1933.

What was most important in Britain in the 1930s proved to be the combination of fiscal stimulus and the introduction of import restrictions. It was only this that created the required 'multiplier effect' that generated a strong domestic recovery from 1933 to 1937. Certainly today, fiscal stimulus in all the world's shrinking economies, combined with temporary import controls in those countries with accumulated trade deficits, would return the world economy to economic growth, and would enable the young people of the developed world to gain employment without creating unemployment elsewhere.

Sustainable slower-growth solutions are also possible; indeed essential in the medium-term. Essentially, in addition to the recovery and rebalancing requirements, a sustainable equitable future requires reforms to the ways in which income is distributed. A key concept is that of 'public equity'; an unfamiliar concept to most economists. In essence, it involves both valuing the natural and social environments (public resources, by definition, and generally global in scope) much as we value businesses and their assets, and drawing public income from our holdings of these environmental assets. It's largely an accounting problem, and for the general reader, I highly recommend Jane Gleeson-White's book, *Double Entry: How the Merchants of Venice Created Modern Finance*.

Economic crises are not as complicated or incomprehensible as they often seem. They are caused by the pursuit of individual self-interest in ways that undermine collective self-interest. Solutions will not come if individuals simply rely on governments to solve these problems. We, as global citizens, need some knowledge of the history of these kinds of problems and the ways - both benign and malign - that these problems have resolved themselves in the past. Indeed the crises of the 1930s are still remembered by some people alive today.