Germany's economic and political generals are fighting the wrong war

(Article by Saul Eslake, Director of the Productivity Growth Program at the Grattan Institute, published in the Melbourne Age*, and in the online edition of the* Sydney Morning Herald*, on Wednesday 25th November 2011)*

The most recent attempt at a comprehensive solution to the European sovereign debt crisis – the package of measures announced on 27th October after a week of summitry – appears, like others before it, to have failed. Secondary market yields on Italian and Spanish government ten-year bonds have risen by around one percentage point since the latest 'deal' was announced. Governments whose financial position had hitherto not been seen as vulnerable – such as France, Austria and Belgium – have seen their ten-year bond yields rise by between one-half and two-thirds of a percentage point. The 'spread' between French and German government ten-year bond yields (a measure of the additional 'risk' that the markets perceive to be associated with lending to France) has widened by almost 90 basis points (hundredths of a percentage point) to around 180 basis points, which is where the spread between Italian and German ten-year bond yields was in June (it's now 500 basis points). And the euro has fallen by more than 4% against the US dollar.

One of the key elements of the 27th October package was a proposal to 'leverage' the European Financial Stability Facility – established last year to provide financial assistance to euro zone governments in financial difficulty, including by buying their bonds – up from €440 billion (A$595 billion) to €1 trillion (A$1.35 trillion), by enticing investments from China and other developing countries. *Prima facie*, it seems odd for the euro area, whose per capita GDP the IMF estimates at around US$33,600 this year, to be passing a 'begging bowl' around countries with per capita GDPs of one-quarter of that amount, or less. And now that these countries have politely declined Europe's requests, financial markets sense that Europe still hasn't been able to erect a credible 'firewall' around Italy and Spain.

The only European institution which can credibly promise to purchase the bonds of highly-indebted but nonetheless solvent governments in whatever quantity is required to ward of the deepening market panic is the European Central Bank. But Germany, whose willingness or otherwise to shoulder a disproportionate share of the cost of any bail-out of other euro zone member states gives it a *de facto* veto, is implacably opposed to any suggestion that the European Central Bank use its balance sheet in this way. The European Central Bank itself, located in Frankfurt and deeply imbued with the culture of the German Bundesbank, feels much the same way.

Germany's implacable opposition to anything that smacks of the 'monetization' of government debt stems from its fear that such measures would inevitably result in higher inflation. That fear is deeply rooted in Germany's historical experience. Twice during the first half of the twentieth century, Germany experienced hyper-inflations that are almost impossible for those who haven't lived through such episodes to understand.

Between 1921 and 1923, the value of bank notes in circulation in Germany rose from 120 billion marks to 400,000,000 trillion. By November 1923, a kilo of butter cost 250 billion marks; a ride on a Berlin tram cost 15 billion. According to one account[1], such was the effect of dealing with such astronomical numbers on a regular basis that 'perfectly sensible people would say they were ten billion years old or had forty trillion children'. It was against this background that many German people, their lifetime savings wiped out, began losing their faith in democratic institutions, and that extremists first began to attract broader public support.

[1] Cited in Liaquat Ahamad, *Lords of Finance*, Windmill Books, London, 2010, p. 122.

As David Marsh records in his 1992 history of the Bundesbank, 'at the height of the inflation, a young man named Adolf Hitler was arrested in Bavaria, two days after he attempted to lead his stormtroopers on a march on Berlin'[2].

Germany experienced another bout of hyper-inflation – albeit not as serious as the first – in the aftermath of the Second World War, following a more than five-fold increase in the amount of currency in circulation under the Nazis between 1939 and 1945.

Yet despite those terrible experiences, which remain seared in the memory of the German people to this day, it is an egregious mis-reading of history to argue (as Angela Merkel's government does) that large-scale purchases of government bonds by the European Central Bank would inevitably result in something similar.

Those hyper-inflations, and similar episodes in other countries occurred not simply or solely because central banks printed enormous quantities of money: but rather because they did so in order to maintain demand in circumstances where, for very different reasons, the supply side of their economies had been massively eroded.

In the case of Weimar Germany, the Reichsbank began printing money in order to pay the reparations imposed by the Treaty of Versailles. And those money-printing operations were dramatically stepped up after January 1923 when, after Germany failed to deliver one hundred thousand telegraph poles to France, forty thousand French and Belgian troops invaded and occupied the Ruhr Valley, Germany's industrial heartland, dramatically curtailing Germany's export income (and hence its capacity to earn the foreign exchange needed to pay reparations to France).

The post-WWII inflation resulted not simply from the Nazis' inflationary financing of its war machine, but also from the destruction of Germany's physical infrastructure under Allied bombing and the loss of so much of its human capital.

Similarly, the hyper-inflation experienced in Nationalist China under Chiang Kai-Shek in the 1930s and 1940s resulted from his Finance Minister's TV Soong's recourse to central bank financing in circumstances where the most productive parts of China's economy were increasingly captured by Imperial Japan. The hyper-inflations experienced throughout Eastern Europe in the late 1980s and in the nations which emerged from the ashes of the former Soviet Union and Yugoslavia in the early 1990s were the combined result of central bank money-printing *and* the collapse of the centrally-controlled 'supply side' of these economies. The hyper-inflation experienced more recently in Robert Mugabe's Zimbabwe resulted from his government's printing of huge amounts of currency to pay for the continued activities of his government while simultaneously destroying the productive capacity of Zimbabwe's agricultural sector by handing it over to his cronies.

All of these situations are worlds away from that facing the euro zone today. Japan's experience of the past twenty years demonstrates that it is actually very difficult to generate inflation by expanding the central bank's balance sheet, even when that is an explicit objective, in circumstances where potential supply exceeds aggregate demand by a wide margin. Nor have the US Federal Reserve's substantial purchases of US Government debt in recent years, in the aftermath of the deepest recession since the 1930s, resulted in higher inflation.

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[2] David Marsh, *The Bundesbank*: *The Bank that Rules Europe*, Heineman, London, 1992, p. 100.

There is no want of potential supply in Europe. Unemployment is stuck at 10%. 20% of the euro zone's industrial capacity lies idle. The imposition of ever-more-stringent austerity measures on highly-indebted governments isn't working. On the contrary, it is pushing Europe back into recession, which is in turn making it harder to reduce budget deficits and reverse the upward trend in the level of public debt. And, as this month's 'silent *coups d'etat*' in Greece and Italy (in which democratically-elected governments have been replaced by unelected technocrats) suggest, it risks undermining the principles on which the European Union claims to be founded.

In any event, the role which the European Central Bank needs to be allowed to play in resolving the European sovereign debt crisis needn't amount to sustained financing of government deficits. It is perhaps better conceived of as being akin to central bank intervention in the currency markets.

When, in moments of one-sided speculation, or panic, foreign exchange markets push a currency to what by any reasonable yardstick appears to be extremely over- or under-valued levels, it's not unusual for central banks to sell or buy that currency in sufficient volume to push it back in the opposite direction. If the central bank concerned is perceived as 'credible', the volume of purchases or sales required to achieve its objective will often be quite small. And if its judgement as to what constitutes 'reasonable' is correct, it will usually end up making a profit.

Arguably, financial markets have, in their panic, pushed yields on Italian and Spanish bonds to levels that seem hard to justify, so long as those governments have credible plans to put their public finances on a sustainable footing. ECB intervention could reverse that panic.

Germany's economic and political generals are re-fighting the wrong wars. In so doing, they are risking the whole 'European project, and more besides.

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