

## **NOT A VERY GREEK TRAGEDY**

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The financial crisis that now threatens to engulf the Eurozone, and for which present and past Greek Governments are now being blamed, is in fact mostly due to policy errors by the leaders of the European Union and the faulty institutional design of the Eurozone. In both of these Greek Governments have played only a minor part. Indeed, if Greece were not part of the European Union, then the faults would simply emerge elsewhere. Even if the European union were reduced to its northern fringe, say Scandinavia, Germany, Austria Benelux and France, then the crisis would break out in the Netherlands, where Government indebtedness relative to national income is not much below that of Greece (i.e., 99% of GDP in 2009, compared Greece's 108%). This is because the critical variable is not the absolute level of government indebtedness, or even the level of that indebtedness relative to national income, as put forward in the Maastricht Treaty, but the level of indebtedness that central banks refuse to refinance.

The principle that central banks should not refinance government borrowing derives from the central banking doctrines of Hjalmar Schacht, the President of Hitler's Reichsbank. (Schacht only escaped conviction at Nuremburg because Hitler had removed him from the Reichsbank after Schacht had protested when Hitler's Finance Ministry exceeded its agreed quota on borrowing.) The principle gave rise to the paradoxical operating framework of central banks in the European Union in which central banks may buy in corporate and other bonds, even the collateralised debt obligations made infamous in the U.S. financial crisis, but not bonds issued by governments.

It is this aspect of central bank operations that has given rise to fears of default on their debts by governments. In fact, given that their borrowing is in their domestic currency, the danger of default is easily removed by allowing governments to refinance their debts, in the same way that companies refinance theirs. Many central banks, such as the Bank of England, were originally set up to manage their government's debts, i.e., buying and selling government bonds, to keep a stable market in those bonds. This function was finally killed off when the European Central Bank was designed at Maastricht in 1992 by central bankers convinced that commercial banks and their interbank markets, and capital markets and their credit ratings agencies, are better at evaluating financial risks than central banks.

This touching faith in wisdom and foresight of commercial bankers and credit ratings agencies has survived despite the mounting evidence (from the emerging market crises to the Collateralised Debt Obligations revelations of 2008) that commercial bankers and ratings agencies are in fact very poor judges of financial soundness. There is a very simple reason for this. The financial success of commercial bankers and ratings agencies depends not on their prudence but on their judgement of financial market consensus at

any one time, *however senseless that consensus may be*. As Keynes wrote ‘a “sound” banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him’ (J.M. Keynes *Essays in Persuasion* 1931, p. 176). In the wake of the 1929 Crash, Keynes concluded with words even more appropriate today: ‘The present signs are that the bankers of the world are bent on suicide. At every stage they have been unwilling to adopt a sufficiently drastic remedy. And by now matters have been allowed to go so far that it has become extraordinarily difficult to find any way out.’ (op. cit. p. 178).

The Schachtian principle was just such a senseless consensus. It was partially remedied at the beginning of May when the Eurozone Governments finally agreed to set up a €720bn stabilisation fund for the Eurozone government bond markets. This can only be a first step towards a formal system for regulating the markets for government securities.

Default is therefore not a problem. A much more serious possibility is that of debt deflation. Debt deflation has already started. Businesses and households throughout Europe, but especially in Britain and southern Europe, are being squeezed by excessive debt. Their response to this is to use income to pay off their excess debt. This takes money, nowadays in the form of bank credit, out of normal circulation, where it would be spent on goods and services, and instead uses it to pay off debt. In the balance sheets of banks, both debits and credits are cancelled by this process, and bank balance sheets are reduced. The effect is falling bank credit and reduced expenditure in the real economy. Since the best (i.e., most liquid) borrowers pay off first, bank borrowing becomes concentrated more and more on worse borrowers, i.e., those who cannot pay off their debts.

In this situation, the best that governments can do is supply good quality assets to banks, in other words to borrow more from banks, and not less. If governments join in the deflation by cutting their expenditure, then the policy becomes self-defeating. GDP may then fall faster than the reduction in debt, so that the ratio of government debt to GDP continues to rise. Under the current IMF programme, the debt/GDP ratio of Greece is expected to rise to 145% by the end of 2011 (still well below that of Japan, currently at 192%). However, as a result of fiscal austerity, civil disorder and reduced business investment, the gross domestic product of Greece is likely to fall by 12% by the end of 2011. This would bring the government debt to GDP ratio up to 155%. In simple terms, it is just not possible to reduce the ratio of debt to GDP by cutting expenditure. The only way in which that ratio can be reduced is by economic growth: increasing the value (relative to debt) of economic activity.

Two principles should guide this fiscal manoeuvre. One is that total government expenditure in the real economy (that is apart from debt service payments) should not be cut back. Such a reduction would shrink the tax base and acts to increase the ratio of debt to GDP. The other principle is that where necessary fiscal balance should be restored by raising taxes on the better off. This is not because the rich necessarily deserve such treatment (although the justice of the distribution of income should always be on the

political agenda) but because their incomes can be reduced by taxes with minimum effect on total expenditure in the real economy.

The other crucial institutional factor in the crisis is the integration of banking and financial markets that has been going on in the Eurozone since capital controls were abolished at the beginning of the 1990s. Although the claims for greater economic efficiency that were made for banking and financial integration were always hugely exaggerated, there is no doubt that this integration has had the political effect of increasing solidarity with Greece among the governments of the European Union. Financial integration now means that banks in other countries hold Greek government debt and are prepared to exert pressure to ensure that their assets are adequately refinanced.

In the years before financial integration the surpluses that German business obtained through its foreign trade were accumulated in German banks. The system of foreign capital controls meant that German banks acquired foreign assets through markets controlled by the German Government. The trade deficits of countries such as Greece effectively drained the foreign currency reserves of the Greek banking system. But this too was managed by the government of the deficit country. Such foreign capital controls therefore interposed elements of government guarantee for the foreign assets of banks.

With financial integration, these government guarantees have been removed. Processes of competition in banking markets oblige German, French and Dutch banks to acquire as assets the weak debts of southern Europe. Therefore the commercial bank deposits of German, French and Dutch businesses and households are backed to some degree by the assets that their banks hold in Greece, Italy, Portugal and Spain. For the sake of their banks and the deposits of their businesses and households, the Governments of Northern Europe must refinance the debts of Southern Europe.

This does not mean that the corruption and tax evasion that is supposed to be widespread in Greece have not played a part in exacerbating the country's fiscal deficit. Corruption is a serious problem, but it has to be combated by transparency and democratic accountability. Nothing could be worse for Greek democracy, or for the sadly limited democratic institutions of the European Union, than for the Greek Government to become merely a debt collector for foreign banks and multilateral agencies such as the European Central Bank, the International Monetary Fund and so on. All governments have to meet their financial obligations although, as indicated above, this does not mean that they must immediately pay their debts. But beyond a certain point the notion that the first duty of a government is to pay massive rents to foreign interests can only strain the compromises on which democracy rests. This is how fledgling democracies of many developing countries were undermined by the international debt crisis of the 1980s. The outlook for democracy in Europe is grim if similar pressures are imposed.

Above all it is important that the Eurozone should not go the way of the Franc Zone. Designed by the French gold zealot, Jacques Rueff, whose opposition to Keynes blinded him to the way in which credit markets work, the Franc Zone an example for the whole

world of how low inflation may be obtained at the cost of economic backwardness and corrupt democracy, broken only by *coups d'état* and commodity bubbles. We need better solutions than this.

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The author has worked in fund management, international banking and central banking. His book *Theories of Financial Disturbance* was published by Edward Elgar in 2005. Another book, *Why the World Economy Needs a Financial Crash* will be published by Anthem Press later this year.