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Revised

A PREDICTABLE PATHOLOGY*

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We meet at an unsettled time in the economic and political trajectory of many parts of the world, Europe certainly included. In Europe in particular, the setting is neither usual nor welcome. Germany's finance minister Wolfgang Schaeuble has called last month's elections for the European Parliament "a disaster," going on to conclude that "all of us in Europe have to ask ourselves what we can do better … we have to improve Europe." To be sure, an election is a political event. But just as surely, here and now as in other times and places, what underlies the politics is to a large degree the economics. What is happening in many parts of Europe today is not just a pathology, but the predictable pathology that ensues whenever the majority of any country's citizens suffer a protracted stagnation in their incomes and living standards.

The origins of this stagnation, in the parts of Europe where it is occurring, are broadly understood. More than half a decade ago, Europe imported the backwash of the financial crisis spawned in the American mortgage market and the U.S. banking system more generally. Factors idiosyncratic to one European country or another – fiscal imbalance, eroded competitiveness, an American-style construction boom, an excess of impaired bank assets, and the like – rendered

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some parts of Europe especially vulnerable. In the familiar way, both monetary and fiscal policies likewise played a role (although in this context it is not clear what one means by a European fiscal policy). But a large part of the story too bears on the subject of today's conference – "Debt" – and in particular the sovereign debt crisis that Europe has also now been confronting for more than half a decade.

The Euro-area constitutes a remarkable experiment in this regard. The fact that it is a monetary union without a fiscal union behind it is of course entirely familiar. But a seldom discussed implication of this anomaly is that the Euro-area economy has no government debt. By "government debt" I mean obligations issued by a public entity empowered to print the currency in which the obligations are payable. All other major economies we know – the U.S., the U.K., Japan, Sweden, Switzerland, and many others – have government debt in this sense. In the Euro-area, by contrast, public-sector debt is entirely what Americans call "municipals" – that is, obligations issued by public entities not authorized to print the currency owed. It is this feature that makes the bonds issued by Massachusetts, or New York, or Texas, subject to default in a way that U.S. Government debt is not. The bonds of all Euro-area states, even those currently regarded as most secure, like Germany's, are likewise subject to default in the same sense. It would be difficult to exaggerate how unusual an experiment this situation represents. I am unable to think of another modern example of a major economy with no government debt to anchor its financial structure.

A further unusual aspect of Europe's situation in this regard is that, following the various actions taken to date, what amounts to municipal debt issued by some of the entities whose fiscal condition is the weakest is, increasingly, owed not to market investors generally but to official lenders. This ownership matters because, unlike private market investors, official lenders in principle do not accept defaults. To a certain extent, of course, this is a fiction. But widely maintained fictions often guide actions, especially in public decision-making, and sometimes they do so with highly unfortunate consequences. This particular fiction also strengthens the commonplace European presumption – which strikes many Americans as bizarre – that sovereign default by a Euro-area member state would necessarily trigger the country's exit from the currency union. From time to time in America's history, U.S. states have defaulted on their general-obligation bonds, and it may happen again. In the recent financial crisis, the two states whose bonds the market deemed most at risk were Illinois (because of unfunded pension obligations) and California (because of the state's overall budget imbalance at the time). It would not have occurred to an American that if, say, Illinois defaulted on its GO bonds it would, on that account, have to exit the dollar currency union. But this principle seems to be the working assumption in much of the current European conversation.

The route by which Europe arrived at this situation is also well known. The governments of fiscally strong countries lent, or gave, funds to the governments of fiscally weak countries, allowing them to service their existing debt and to issue new debt. (This process also allowed the governments of the fiscally strong countries in effect to bail out their lending institutions without acknowledging doing so, thereby maintaining yet another fiction that may or may not be useful.) The fiscally strong countries provided these transfers and new credits mostly in exchange for imposition of contractionary fiscal policies – and, supposedly, structural reforms – in the fiscally weak countries, in both cases with the goal of rendering them better able to manage their debt. But the problem with the former is that, despite economists' ability to devise theoretical demonstrations to the contrary, contractionary fiscal policy actually is contractionary. The problem with the latter is not just that structural reforms are politically difficult to implement, but that even when implemented they take a long time to become expansionary. Moreover, even then they are often expansionary in a highly non-neutral way, exacerbating already unwelcome trends in income distribution.

In a group consisting mostly of economists, it is useful to recognize that this approach to Europe's debt crisis, and even more so the underlying attitudes it reflects, are counter-intuitive in yet another way. The standard presumption in economics, dating to the conception of "commerce" articulated by David Hume and Adam Smith and their contemporaries, is that market transactions involve two parties, each of whom acts voluntarily and with adequate information to make a choice. In the case of credit transactions, this means presuming that both borrowers and lenders acted voluntarily. Among borrowers there are familiar exceptions such as the inherited debt of deceased parents, or the "odious debt" issued by a country's prior regime, and for just this reason they are normally treated differently. Similarly, there is a stronger case for the presumption of informed voluntariness on the part of institutional lenders than individuals, and this difference in information and expertise provides a standard rationale (along with risk diversification) for financial intermediation. By contrast, today's public discussion surrounding the European sovereign debt crisis mostly presumes that when a bond is in trouble, the *lenders* – especially institutional lenders – are victims. In parallel, there is an almost religious presumption of guilt among the borrowers.

From a historical perspective there probably *is* something religious about these presumptions. Although Jews and Christians and Muslims long regarded lending with suspicion (and Muslims still do), by the beginning of the 19th century evangelical Protestants had mostly come to regard *borrowing* as sinful, even when the debt was serviced and repaid on a timely basis. Non-payment, of course, elevated the negative moral connotation to a whole different plane. As the 19th century moved on, in one European country after another (and in America too) the active frontier of this debate was often the movement to introduce limited liability for what we now think of as corporate borrowers and equity investors: limited liability represented a retreat from what historians often refer to as the "retributive philosophy" of 19th century evangelicalism.[1] By mid century public attitudes had begun to change, driven in large part by the new awareness of the possibilities for ongoing economic growth and waning ambivalence toward it. Even so, the lingering opprobrium attached to borrowing persisted, especially in the public-sector context. As one long-ago historian of H.M. Treasury described this development, "An ethic transmuted into a cult, this ideal of economical and therefore virtuous government passed from the hands of prigs like Pitt into those of high priests like Gladstone. It became a religion of financial orthodoxy whose Trinity was Free Trade, Balanced Budgets and the Gold Standard, whose Original Sin was the National Debt. It seems no accident that 'Conversion' and 'Redemption' should be the operations most closely associated with the Debt's reduction."[2]

Today a reversion to the "retributive philosophy" of the 19th century – to the view, in the words of another historian of that day, that "a just economy was more to be sought than an expanding one" – is clearly in evidence in Europe's approach to its sovereign debt crisis.[3] Whether Europe's economy has thereby achieved justice is a matter for a different discussion. It has clearly foregone expansion. The imposition of contractionary policies in the most heavily indebted countries has reinforced a perverse feedback between weak economies and questionable sovereign debt, with a further feedback between both of those and troubled banks. Cross-border lending has significantly contracted, and some countries face what amounts to a credit crunch despite the ECB's expansionary monetary policy. Nor are these simply isolated phenomena, with little bearing on the broader European economy. Back when I was first teaching economics, a plausible exam question was “Why is unemployment in Europe always so much greater than in the U.S.?” Then, for some years, asking the question in the opposite direction seemed more apt. Today, with the Euro-zone unemployment rate roughly double that in the U.S., we can bring out the old exams again.

The more fundamental consequence is ongoing stagnation of incomes and living standards for the majority of the population in many European countries. The median household income in the U.K., adjusted for what little inflation there has been, peaked in 2007 and has yet to regain that level. France, Italy and the Netherlands have not experienced complete stagnation by this measure, but the real median income in each has seen only a minimal increase. Ireland, Greece and Portugal have all experienced stagnation, or worse, in real median income over this period. Spain did too for a half-decade, only last year finally enjoying a solid increase.

A parallel stagnation of incomes has taken place in the United States as well, but America’s federal fiscal structure provides at least some built-in cushioning mechanisms that Europe lacks. Further, in Europe’s fiscally weak countries the usual frustration over stagnant incomes and living standards is today compounded by the sense of being dictated to, in many citizens’ eyes perhaps even exploited, by foreigners. Twenty-five centuries or so ago, if another city-state had conquered the Athenians the then-conventional tribute would have required some hundreds of Athens’s finest youth to trek off to the victors’ lands, to do forced labor, and an equal number of Athens’s fairest virgins to go as well, for purposes best left unspecified. Today’s political conventions are sharply different, but the resulting youth labor flows are similar.

And, as Mr. Schaueble has highlighted, the all-too-familiar consequence of this economic stagnation, together with the widespread absence of employment opportunities, is a turn away from (small-L) liberal values toward xenophobic populism of either the right or the left. The same pathology has emerged before, again and again, in one country after another around the world, whenever the citizenry has lost its sense of forward progress in its material living standard, and lost too the optimism that that progress will resume any time soon. Europe today increasingly looks to be on the verge of repeating key elements of the experience of the years between the two World Wars, with not only the ascendency of extremist political movements but cross-border communication among them. There are differences, of course: in the 1930s the central node of that communication was the rising Nazi movement and then government in Germany, while today it looks as if the facilitating vehicle will instead be the European Parliament. But the effects are parallel, and so are parts of these groups' programs, today including the campaign to roll back within-E.U. immigration and E.U. regulatory authority, not to mention the entire European Union project.

With European monetary policy already expansionary – with the introduction just last month of a negative redeposit rate, innovatively so – and since Europe as such has no fiscal policy, the urgent need today is for debt restructuring and relief for the fiscally weak European countries (and it is useful to recall that in real time it is often hard to tell the difference between the two). In a similar way, in the United States today there is need for relief for under-water homeowners whom the bail-out of U.S. lenders a half-decade ago largely neglected. But the need in Europe is more acute.

Again looking back to the interwar period, there is ample precedent, within Europe, for both debt relief and debt restructuring. Indeed, that experience is also the origin of our host institution this evening. The reparations due from Germany under the Versailles treaty were quickly transformed into the obligation to service two series of bonds, scaled to reflect the recovering country's ability to pay; but in the end neither bond was ever fully paid. Initially, the Weimar government serviced the bonds to foreign investors at the same time as German states and local governments were borrowing from abroad, so that on net the international flows were mostly recycling while within Germany there was substantial intergovernmental shifting of burdens. The 1924 Dawes Plan and then the 1929 Young Plan further reduced what Germany owed, and each arranged for yet a new foreign loan. The need to facilitate transactions under the Young loan is what led, in 1930, to creation of the Bank for International Settlements.

The Lausanne Conference in 1932 ended all German reparations payments, in exchange for which Germany deposited with the BIS bonds representing a small fraction of what was originally due; the bonds were never issued, and some years later the BIS burned them. By then Germany had acquired other foreign debts, however. The Nazi government initially serviced the debt but blocked the conversion of the Reichsmarks paid into foreign currency. It then began making payment half in Reichsmarks and half in nonconvertible Reichsbank scrip. After a series of further steps, in 1934 Germany defaulted on both the Dawes and the Young loans.

After the war, the 1953 London Debt Conference took up the matter of Germany's unfulfilled commitments, including government debt, state and local debt, and even private debt. The London agreement reduced the amount due by at least half (most likely more, depending on the calculation) and rescheduled the remainder so that no principal payments were due for five years and the rest strung out over thirty years. A significant part of the debt was further deferred, with no interest due along the way, until such time as reunification might occur – which turned out to be nearly four decades later. The U.S. also converted into grants most of the loans extended under the Marshall Plan, in parallel with treatment of the other recipient countries, and did the same for loans under the Government and Relief in Occupied Areas program.

As one historian summarized the approach taken to Germany's post-war debt relief, "at the time of the London conference most observers had in mind long years of what they viewed as Germany's irresponsible treatment of foreign debts and property owned by foreigners." Nonetheless, "The entire agreement was crafted on the premise that Germany's actual payments could not be so high as to endanger the short-term welfare of her people … reducing German consumption was not an acceptable way to ensure repayment of the debts."[4] The contrast to both the spirit and the implementation of the approach taken to today's overly indebted European countries is stark.

There is no economic ground for Germany to be the only European country in modern times to be granted official debt restructuring and debt relief on a massive scale, and certainly no moral ground either. The supposed ability of today's most heavily indebted European countries to reduce their obligations over time, even in relation to the scale of their economies, is likely yet another fiction – and in this case not a useful one. As the last decade's financial crisis fades into the past, and market interest rates move up to a more normal configuration, these countries and others too will find their debt increasingly difficult to service. In the meanwhile, the contractionary policies imposed on them are depressing their output and employment, and their tax revenues. And the predictable pathology that follows from stagnant incomes and living standards is already evident.

James Tobin often remarked that there are worse things than three percent inflation, and from time to time we have them. Indeed, we just did. In the same vein, there are worse things than sovereign debt defaults, and from time to time we have them too. They are in progress as we meet.

[1] See, for example, Boyd Hilton, *The Age of Atonement: The Influence of Evangelicalism on Social and Economic Thought, 1785-1865* (Oxford: Oxford University Press, 1986) p. 244.
[2] Henry Roseveare, *The Treasury: The Evolution of a British Institution* (London: Allen Lane Penguin Press, 1969) p. 118.
[3] Hilton, *Age of Atonement*, p. 248.
[4] Timothy W. Guinnane, "Financial Vergangenheitsbewaltigung: The 1953 London Debt Agreement" (Yale University, Economic Growth Center, Discussion Paper No. 880, 2004), pp. 22, 24, 31.