Will Hollande go to Germany?

In Triple Crisis, August 14, 2012

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The crisis of the Eurozone shows no sign of resolution and indications of intensification. W.B. Yeats's image of 'turning and turning in the widening gyre', formulated in another period of clouds over the European continent, is as apposite as any other. Is there a way out for Europe from the foreseeable disaster of a disorderly collapse of the euro?

The current approach demands austerity from crisis-hit countries as a quid pro quo for support. It is failing for three reasons. The first is that austerity is having a counter-productive consequence, leading to economic contraction which makes debt-burdens all the more difficult to bear. The second is that austerity-oriented policies are perceived as unjustly punitive and distributively blind, leading to social and political resistance that makes them difficult to implement and sustain. The third is that austerity cannot succeed, by itself, at restoring the confidence of the 'markets'.

The first of the two reasons are plain for all to see and are evident in the trajectory of the crisis to date. The third reason requires the most explanation. The countries experiencing sovereign debt crises in Europe are of two types. The proximate source of the crisis in the first set of countries, which include Spain and Ireland, was not a failure of international competitiveness but the absorption by the state of heavy and unsustainable private debts deriving from the collapse of inflated property values. The proximate source of the crisis in the second set of countries, which includes Greece, Portugal and arguably Italy, was the failure of international competitiveness of the countries concerned. This failure was directly related to the money flows the euro triggered (inflows of euros against the collateral of sovereign debt of peripheral countries accumulated elsewhere by banks, investors and the ECB, or against no collateral at all – via Target2 balances reflecting promises to pay between national central banks within the Eurozone). These flows both masked existing weaknesses in competitiveness and caused them (by bidding up the cost of the inputs needed to produce tradable goods relative to what they would otherwise have been). Austerity will not save the first set of countries because it is a medicine for a disease they do not have. Austerity will not save the second set of countries because it does not directly address the underlying sources of their lack of international competitiveness. Even if it succeeds in (painfully) depressing wages it will not do so to a sufficient extent to counter the cost based advantages of their primary non-European trading partners (e.g. China) and the productivity based advantages of their primary European trading partners (e.g. Germany).

What is the answer? The sovereign debt overhang in the first set of countries can be adequately addressed only through debt relief (or write-downs). The sovereign debt problem in the second set of countries also requires that creditors absorb losses, but in these countries especially that is not enough. An alternate strategy must be reflationary rather than deflationary. It must address the long-term structural difficulties in three ways. First, it must contain a European effort simultaneously to raise productivity and expand demand in these countries through a substantial program of strategic investment. This must involve not only an infusion of capital but also a wide effort to introduce more advanced techniques into the lagging sectors of the peripheral economies. Second, it must involve the abandonment of the policy of the strong euro to permit an increase in external competitiveness. This would be best achieved by allowing the ECB to play the role of an ordinary central bank, taking the support of full employment in the peripheral economies through greater external competitiveness to be among its objectives, or acting as a lender of last resort to governments (whether or not alongside the mutualization of some debt). Third, it must involve the correction of the internal imbalances within the Eurozone through increases in demand and through real exchange rate appreciation in the so-called core countries. This is best achieved by sufficiently increasing wages and social benefits in Germany, which have in recent times been repressed. The effect of such an increase in the German real exchange rate on Germany's trade balance with non-Eurozone countries can be partially or wholly counterbalanced by a deliberate depreciation of the euro.

All of these measures require the consent of the Germans. This is why it is necessary for France's Francois Hollande, as the President of the country which has been Germany's closest partner in Europe, to go to Germany. He must be willing to tell the German people directly what Angela Merkel is not: Your fate is not only now intertwined with that of other Europeans but there is moreover a way out. You must accept the (literal) wages of your own success. This is not the solution preferred by German business but it is that which can best save Europe. Moreover, it can serve the Europeans, including the Germans themselves; the interests of the Germans are not opposed to those of the Italians but are one and the same. You must eat your cake to have it too.

The French philosopher of science, Pierre Duhem, caricatured 'German Science' as flawed because it lacked *bon sens*, the recognition that truth is best arrived at 'by the practice of history, by our becoming more aware of the failures and successes of previous theories, by thinking about the trajectory of scientific theories, rather than by considering a single theory frozen in time' (Stanford Encyclopedia of Philosophy).   It is time for Germans to repudiate this caricature and Francois Hollande must urge them to do so. The alternative was foreseen in the widely cited subsequent lines of Yeats's poem: 'Things fall apart; the centre cannot hold; Mere anarchy is loosed upon the world'.