The Other Side May 10, 2012

Learning from the past

It is well said that those who do not learn from history, are condemned to repeat it. Are we seeing yet another manifestation of this adage in what is happening in the euro zone?

First some parallels with what happened in the inter-war years: the parallel is very useful because, in many ways, the euro imposes some kind of a gold standard on members of the euro zone. After the First World War and its hugely inflationary impact on the European economies, and to a lesser extent, the U.S.A., the major countries took different macroeconomic paths. The United Kingdom restored in 1925 the currency to its pre-war parity despite the significant cost rises during and after the First World War: it tried to adjust internal costs to the external value of the currency as represented by the gold parity. In turn, this meant a sharp fall in the living standards of the working class, huge unemployment, strikes and riots. This was obviously not workable, particularly in a reasonably humane democracy, and the parity had to be abandoned a few years later. In the meantime, the people and the economy paid a huge cost for the sanctity of the exchange rate.

In many ways, the same medicine is being sought to be imposed on countries in the southern cone through fiscal austerity leading to cuts in wages, pensions, social services and the like: in other words, an internal devaluation since the countries have no control over the external value of the euro, and have been incurring huge deficits on the current account. Significant costs are being imposed on those least able to bear them, exactly what the U.K. tried to do in the 1920s. One manifestation of the deterioration in social conditions is that, in Greece, the suicide helpline which used to get five calls a day one year back, is now getting more than a hundred! GDP is likely to fall 5% in the current year, and unemployment has crossed 20% in both Greece and Spain: it is much higher amongst the young, and rising rapidly in other EU countries as well.

The defeated Germany followed an entirely opposite path, also given the absurd level of reparations imposed on it by the victors. Germany’s response was abandoning all macroeconomic discipline through galloping fiscal deficits and ultra-loose monetary policy. The result was hyper-inflation: at one point, you needed a cartload of currency notes to buy a loaf of bread! No wonder the Germans are petrified of inflation, given their experience of the 1920s, and prefer fiscal and monetary conservatism. Other countries in the euro zone, with no parallel experience and a different cultural background, are finding it extremely different to accept the fiscal austerity imposed on them by the EU treaty – even the dour Dutch, perhaps culturally closest to Germany in the zone, recently defeated a government on the issue!

Hyperinflation apart, one other consequence of the German policy of the 1920s was a galloping rise in unemployment. This led to significant electoral gains for both the extreme left (Communists) and the extreme right (National Socialists or Nazis). Nazi Germany undertook a huge program of rearmament, investments in infrastructure (the autobahns are a gift of the Nazis), and price and capital controls. It also repudiated external debts. In an eerie parallel to the Germany of the 1930s, in the last week-end’s elections in both France and Greece, it is the extreme left and right parties which have recorded maximum electoral gains. It is obvious that the fiscal austerity imposed by the European Union treaty is hated by the voter.

In another lesson from the past, in all the debates over austerity vs growth, one finds very little about the origins of the post-Second World War European Project. The *raison d'être* was political, not economic: to eliminate nationalistic rivalries, because of which Europe had paid a huge cost over the previous century and a half, by increasing economic inter-dependence. (This was where today’s EU and the euro zone were born.) And, lest we forget, this objective has been achieved spectacularly in the last 60 years.

One other feature of the post-war European economic revival is worth noting: the generous help provided by the United States to the war-ravaged European economies through the Marshall Plan. The Marshall Plan aid amounted to 2% of U.S. GDP, for several years. The recipients, including Germany, on the brink of economic collapse, mounted a strong recovery. Perhaps Germany needs to be equally, if not more, generous in now aiding the zone countries in difficulties. Like China, higher wages may also help increase Germany's domestic consumption and reduce external competitiveness and surpluses.

Coming back to the inter-war years, the remaining two major economies, the U.S. and France, followed far more pragmatic macroeconomic policies as compared to the U.K. and Germany – the result was that they suffered far less and emerged much stronger than the other two. Pragmatism rather than ideology, Keynes rather than Hayek, may well be the only solution, even if a split in the euro zone is unavoidable!

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