Social Europe

Restoring European Solidarity

by Marcello Minenna on 27 February 2018

Strange to say, but between the international debt crisis of the 1980s and the Great Recession of 2008, Europe has shown an overall GDP growth rate greater than the rest of the world.

In that period two major political events occurred: German reunification in 1990 and the birth of a single interest rate term structure for 11 countries of European Union – that is the right way to look at the birth of the Euro. Both events had a long-lasting impact on government debts.

The former was followed by the cancellation of almost all German debt arising from war reparations whose full repayment would have implied – as Chancellor Kohl once said – the third *default* of Germany in a century. The cancellation certainly helped Kohl to manage the sheer costs of reunification (€ 2000 billion on average, according to different estimates).

The latter brought the alignment of interest rate levels of the future Eurozone area to the German level, with long-term consequences especially for peripheral economies that were more attune to a higher level of interest rates. That phenomenon started well before the official euro entry date of January 1st, 1999 and derived from shifting market expectations that took the form of "convergence trades". A convergence trade is a kind of arbitrage manoeuvre which does not, however, involve identical financial products, but bonds that are believed to be similar. In 1996-1999, the European bond market bet on the fact that since peripheral countries would surely enter as part of the Eurozone alongside Germany, the bonds would be able to be considered as comparable and therefore be priced in a "nearly" identical way. Convergence trades were supported of course by concrete political and financial measures.

In fact, several EU directives enacted between 1993 and 1997 imposed equal regulatory treatment for the future Euro Area Govies (government/sovereign bonds). Moreover, the newly born ECB did not discriminate between Eurozone bonds when presented by banks as collateral in lending operations. Apparently, the Eurozone began to operate as if the risk were shared and the markets believed in this implicit guarantee of the ECB and of the European institutions.

This seemed at the time an ancillary feature of the Eurozone architecture; but what's happened since the debt crisis of 2011 has clearly demonstrated that a currency union cannot work on the basis of different interest rate term structures without huge consequences for the competitiveness and financial stability of peripheral countries.

For more than half of a century, therefore, principles such as solidarity and risk-sharing have been a propellant for the EU's economic and social growth. From 2009, in less than ten years, instead we have experienced a sudden reversal in this virtuous process that has unleashed a new wave of populism and nationalism. Solidarity, in all but name, has evaporated: before 2008, the Greek government would never have presented Germany with the provocative request of € 280 billion of old loans that Greece was forced to pay during the Nazi occupation. Of course, it had no legal basis but came from a government put on the ropes and alarmed by the devastating austerity imposed by the Troika.

The Contribution Of Italy To The Cancellation Of German Debt

Debt cancellations are not uncommon in Europe's history. With the 1947 Paris Treaty after WWII, Italy was obliged to forgive war-related claims towards Germany (Art.77/4), a significant sum of 700 billion lire, roughly €65 billion at 2018 values. The international community was not willing to accede to Italy's Prime Minister Alcide De Gasperi's complaints that claimed that the damages inflicted on Italy by the German army had occurred during the period when Italy fought on the same side as the Allies (1943-1945). A few years later on, in 1953, the treaty of London halved the German debt that was in existence at the end of WWII and deferred the remaining part (subsequently also cancelled) for 30 years. War damage, about 1.5 trillion dollars at 1990 values, was frozen until eventual reunification took place.

Further concessions were negotiated along the road. The deferred debt (roughly €300bn at 2018 values) was repaid in annual installments that were disbursed only in the favorable event of a Germany trade surplus. It was a reasonable mechanism that conditioned repayments to the presence of real resources available to transfer. Moreover, it was useful to avoid the misuse of foreign loans and currency reserves only to honor war debt, a perverse scheme with which new debt was issued (or money was printed) to pay foreign debt. In the past this type of mistakes had put Weimar's Germany in a spiraling hyperinflation. In 1958, the first year of repayments, government disbursements amounted to a relatively low 2.7% of total exports and would further decline in the following years. In this perspective, it seems odd that under the current IMF and World Bank regulation, debtor countries are forced to adjust their budgets at a pace that is ten times higher in terms of total exports.

The Value Of Solidarity

After the 2008 crisis we have seen a bold political shift by EU institutions and the Eurocracy towards a marginalization of the risk-sharing principle; the rise of spreads and a faltering, asymmetrical growth at the expense of peripheral countries has been the sole legacy of what we can really call a lost decade for European integration.

Of course, it would be politically unrealistic not to consider the financial turbulence induced by any debt forgiveness within the Eurozone in its current form. But, at the same time, any idea of debt restructuring, as envisaged by the German proposal of Eurozone reform (and in a weakened form also by the French-German counterproposal), should be dismissed as a form of ideological extravagance. I've suggested (here) a third path that would give priority to investments and growth under a progressive reshaping of the architecture of the Euro area towards embracing more fully *risk-sharing*.

As Europeans, we need to overcome any partisan visions by looking back to our shared history: the European Union prospered economically and socially as long as it was anchored to principles of solidarity. Hopefully, given enough time, a new political class with long-term objectives will gradually emerge to re-embrace and re-enact those principles in action.

About Marcello Minenna
Marcello Minenna is Head of the Quantitative Analysis Unit in Consob (the Italian Securities and Exchange Commission). He has also taught Quantitative Finance at Bocconi University and at the London Graduate School of Mathematical Finance. He is a regular writer for The Wall Street Journal and for Corriere della Sera as well as member of an advisory group that supports the economic analysis of the biggest Italian trade union CGIL.