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## **POLITICAL ECONOMY LECTURE**

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### **CREDITORS UNINTERESTED IN GETTING THEIR MONEY BACK: DISSOLVING THE EUROZONE PARADOX**

**Yanis Varoufakis**

I welcome this opportunity to reflect on the lessons arising from the short period of time during which I led the negotiations between the Greek Government and our international creditors. Before I explain why those creditors don't want their money back - and the kind of disaster that emanates from being indebted to creditors who don't want their money back - I should give some context.

When you bind together different national economies monetarily, you join their monetary systems. Their exchange rates become fixed, as happened when Mexico and Argentina did that some time ago, disastrously, and during the Gold Standard in the inter-War period, under the Bretton Woods System after the Second World War, and in the exchange rate mechanism of Europe in the period prior to 1991 – 1992. Or you go the whole way and you replace currencies with a single currency that is then shared by a number of countries.

What happens when you fix exchange rates is really quite basic. There is an acceleration of imbalances in trade and imbalances in capital movements, and the reason for this is simple. Every country, every monetary union - whether this is New South Wales, Australia, Europe, Britain, the United States or any other macroeconomic entity - comprises areas that have trade surpluses with the other areas that have trade deficits. So in Britain, for instance, the London area is always in surplus in relation to Wales and the North of England, while Wales and the North of England are always in deficit in relation to London. Similarly in Germany - East Germany, West Germany. In Greece - North Greece,

South Greece. In Italy - North Italy and South Italy. Similarly, California is always going to be in surplus in relation to Arizona next door. For decades, even centuries, these patterns of surplus and deficit for regions have remained.

### **Financing Trade Deficits**

How do the perpetual trade deficits get financed? It's very simple - by recycling of capital as goods flow asymmetrically from the surplus to the deficit country or regions. Then what happens is that the profits that are being made through the sale of these goods and services and which accumulate in the surplus parts migrate to the deficit parts. They are recycled. There are many ways in which this can occur.

One way is through bank loans: banks that are in London accumulate all the idle cash and then lend it to people in Wales or North England.

Another way is through the welfare state. If unemployment is higher in Northern England and Wales than it is in London, then almost automatically through the tax system, funds go from London to Northern England and Wales as welfare payments to the unemployed people.

Third, there are political elements. The most impressive surplus redistributing mechanism on Planet Earth is the military industrial complex of the United States of America. So when Lockheed or Boeing canvass with the Pentagon that they should be given the contract to build a new fighter jet that will cost zillions, there is a tacit agreement with the Pentagon that, yes, we will give you the contract on condition that you build a factory to manufacture the wings of the aircraft in Arizona, and the engines in a new greenfields development in Missouri - in other words, in deficit regions - so that those deficit regions receive investment coming from California or from New York. This is not philanthropy. It's just pragmatic management at the macroeconomic level, because these investments create jobs and incomes in Arizona and Missouri, and then the residents of those regions can carry on purchasing the products of California and New York so that those surpluses can be recycled and be reproduced.

So surplus recycling is an essential part of any monetary union. The trouble with the European monetary union, also known as the Eurozone, is that what I just said never emerged as an important fault in the mind of

its designers. If you read the documents that led to the creation of the Euro, you will find that there's no mention of the surplus recycling problem.

How will the surpluses of Germany, the Netherlands, or Austria - surplus countries within the European Monetary Union - get recycled to the rest of Europe? The implicit assumption was that it would happen through the financial system. Indeed, this is what happened between 1998, when effectively the Euro came into being, and 2008, when the great financial collapse - the GFC as we call it here in Australia - struck.

The problem is that creating a monetary union is a little bit like invading Russia. At first, there is rapid progress, as the French troops, Napoleon or the Wehrmacht found when they stormed the country, taking large tracts of land without much resistance. Then slowly, as the heavy winter sets in, the Cossacks and the Russian partisans start blowing up your convoys. Eventually you end up with blood on the snow and a hasty retreat. Recall the 1920s – after the Great War the Gold standard had created ‘the Roaring 20s’. Similarly, when Mexico and Argentina pegged their currency one to one on the US dollar, there was a flood of capital coming from the major surplus country - the United States - into Mexico and Argentina, creating the feeling of triumph, growth and investment. It was exactly the same in the Eurozone.

I remember I was on an aeroplane in 2011 from Frankfurt to New York City, sitting next to a German traveller - his name was Franz - and we started talking, as you do when travelling for 12 hours on a plane. He said to me that he used to be a banker and now had retired. He worked for Deutsche Bank, one of the major banks in the European Union. ‘I had a feeling’, he said, ‘that my life was totally charmed until the Euro was created. But when the Euro was created, it became a complete nightmare.’ I asked him why that was. Why did the life of a banker deteriorate in quality so rapidly under the Euro? He said that up until 1998/1999 he was a master of the universe. ‘I would fly to Paris, to Lisbon, to Athens in your country, and I would be received by CEOs of large corporations, local bankers, and government officials who feted me, took me to the opera and their best restaurants. They were effectively trying to convince me that they should be given a billion Euros here, another billion there and so on. They were seeking loans. There was a dearth of credit in the periphery of Europe before 1998, and I would take their business plans, their track records with me back to Frankfurt. I

would pore over them for about a week and then I would decide whether I should recommend to the board of directors that these large loans go ahead. It felt like I was doing a decent job, I was an important person, I was respected both by my superiors and the potential creditors. Then the Euro came and, suddenly, the frenzy began. Suddenly we had quotas. I had to lend one billion, two billion, three billion a week and if I didn't my bonus wasn't safe; and if I didn't reach those quotas in two or three consecutive weeks, my job was on the line. So the situation reversed. The balance of power was completely altered. I would fly into Athens and I would have to act as a predatory lender. I would have to beg government officials to take loans off my bank. It was a bit like the sub-prime industry in the United States during that period. Now why was this happening? It was the Euro.'

You see, before the Euro, the French and German banks were in two minds before lending to the Greek State, to the Portuguese State to a Portuguese bank or a Spanish bank. Why? Because they feared devaluation of the local currency. If you take 10 million Deutsche Marks from Frankfurt and you give it to a Spanish, Greek or Italian firm or bank - and that is prior to monetary union - and then suddenly there is a substantial devaluation of the currency of Spain, of Italy or Greece - something that was happening at regular intervals prior to monetary union - then you know that the capacity of the creditors to repay the loan shrinks. Because their income comes in the local currency, they will not be able to repay when the local currency is devalued. So banks were very careful before unloading Deutsche Marks to the periphery of Europe prior to the creation of a common currency. But the moment everybody had the Deutsche Mark - because that's what the Euro is, the Deutsche Mark with different clothes - everything changed.

The purpose of the Euro was for France in particular to get its hands on the Deutsche Mark - to get rid of the Franc and to replace it with the Deutsche Mark. Also for other countries, but France was the main player. That was the Faustian bargain between Germany and France and the rest: we'll give you the Deutsche Mark but we will write the rules. So the moment that happened, the managers of the Deutsche Bank felt that it doesn't matter whether we lend to a German company or a Greek company because now we're all one currency area. All incomes are denominated in Deutsche Marks. The only concern is: do the creditors have any collateral?

## **Increasing Regional Stresses**

In Greece – and this is something that surely will astound you - when we entered the European Union we had the lowest level of debt in Europe. Yes, the lowest, both private and public. Private debt in Greece is the lowest even to this day. Most people own outright their own homes. I grew up in a country where the idea that you would borrow 90 per cent of the price of the house and think of yourself as a ‘houseowner’ was laughable. Indeed, it is laughable.

The Greeks - and Spaniards, Portuguese and Irish too - had very low levels of debt and collateral for houses and land. Deutsche Bank looked at that and thought: ‘my goodness, this is amazing. These people have Deutsche Marks and they have collateral and they have low debts. This is the dream of a banker. Pile that on there: this is how you make money.’

Now, every time a Volkswagen is sold in Greece - let's say for a Volkswagen costing 20,000 Euros - 20,000 Euros goes from a Greek bank account to a Frankfurt bank account – perhaps to Deutsche Bank. Greece doesn't make cars, so the balance of trade is rather asymmetrical, as you can imagine. How many oranges or olives can you sell in Germany in order to ameliorate for the Mercedes Benz's and the Porsches that are exported? So there's always going to be a deficit - a trade deficit that Greece has. What then happens is the Deutsche Bank has to lend to a Greek Bank, so that the Greek can carry on purchasing the exports from Germany.

This is precisely what the German banks wanted to do. Why? When you have a major trade surplus, it means that you have net exports and a net flow of capital from the deficit countries to your banks. So there is a flood of cash coming into your banking system. The Germans, both households and the State, simply didn't have enough demand for all this cash that was piling up there. There's one thing that the banker hates more than anything and that is idle cash - cash that's just sitting there and not being lent - because it's a wasted opportunity for a banker to profit.

So the oversupply of capital in Germany was pushing down the value of money in Germany. That affected interest rates in Germany, pushing them very low. So there was no incentive for the banks to lend that money in Germany and there was not sufficient demand. But in the periphery of Europe where there was an exodus of capital going to places

like Germany and the Netherlands to facilitate the purchase of the net exports of those surplus countries, this exodus of capital created a scarcity of capital - of money - in Greece and Portugal and Ireland, which pushed up the effective price of money.

So if you were a business person and you wanted to borrow money in Greece to invest, you would have to pay a much higher interest rate than the equivalent German businessperson, even though the official interest rates were the same. The commercial interest rates were not the same because of this imbalance. So, if you were a banker sitting on a pile of cash in Frankfurt, where the effective interest rate is one or two per cent, but you can lend the same money to a Greek businessman or woman for five per cent, what would we do? Lend it in the latter place, of course. You're going to take the pile of cash, go there and say: 'please take it'.

So the Greek debt prior to the debt crisis in 2008 was the flip side of the coin of German net exports, which had been accelerating as a result of the currency union. That is something that happens inevitably in the history of capitalism: it has happened every time a monetary union has been created.

The problem with this is the reason why Germany is a surplus economy relative to Greece or Portugal. It is because of well-developed industry and high capital utilisation intensity in Germany, coexisting with very low utilisation - low production of tradable goods - in places like Greece. You have a lot of souvlaki and a lot of nightclubs producing services in Greece. But these are not internationally trade goods. You cannot sell them directly in Germany. You have to go to Greece - which is also very nice. So the imbalances are underpinned by asymmetries in capital utilisation.

This means that in places like Germany, because of the capital intensity of production, profit margins are very high, and companies like Volkswagen make a mint. In other words, the difference between the prices they charge and their costs of production is high and there is also excess capacity. They can produce a lot more Volkswagens than they're currently producing, which acts as a deterrent to competition, because if you know that the main player in a market sector has excess capacity, you hesitate to compete against them. Thus, competition is lowered in the surplus parts of the monetary union as a result of the same economic factors that create trade imbalances.

## Monetary Unions

In a proper monetary union, what happens is that this recycling would be rationalised in two important ways. Firstly, a federal government, like you have in Australia, should ensure that these loans go from the surplus parts, like New South Wales, to deficit parts like Tasmania. Because there is a common industrial policy, development policy, environmental policy, and social policy, transfers by the state to the deficit areas should bolster the capacity of those deficit areas to do useful things. However, when you don't have that, this flood of capital simply pushes up house prices, for instance, creating bubbles in the real estate. This happened in Spain, in Greece and in Ireland, which gave the house owners this illusion of being richer. So they took on more debts, using credit cards and personal loans. The first few years look like a startling success story. Greece consistently outperformed Germany in terms of growth rates. We had about four and five per cent annual growth rates in Real GDP between 2000 and 2008, while Germany was only growing at one per cent. There was convergence. Because our income was growing faster than either of the Germans, that was being presented by Brussels as testimony to the success of the monetary union. However, it was all a bubble. It was Ponzi growth - unsustainable debt-fuelled growth.

The problem with these kinds of monetary unions, as we know from 1929, is that at some point something pricks the bubble. It could be a meteor; or it could be fear of a bankruptcy of some large firm like Enron in the United States. Then suddenly the bankers will realise that they have lent so much money, especially to one another, that they themselves have become insolvent. So many of the debts that they created have gone bad because the debt cannot be paid and then they panic. As Keynes said, they resemble fair weather sailors who abandon the ship that they are supposed to be commanding, the moment that dark clouds emerge. But in their haste to get ashore, they also sink the lifeboats – when they stop lending.

But in a place like Greece, Portugal or Spain - where bubble economies have been created which need constant refinancing - developers who had been developing by borrowing began going bankrupt when suddenly faced with a situation where the debts that they already had were not refinanced by the bank. When the new loans didn't come the developers went bankrupt. In 2008 the whole of the private sector started deleveraging - in other words saving or not spending. The moment that

happened, the States' regulators collapsed, economic activity shrunk, everybody started owing to everyone else and no one could pay. That's what had happened in Mexico and in Argentina, as it had throughout the world in the late 1920s leading to the great depression, the rise of fascism and the onset of the second world war.

So there was nothing new in what happened in Europe. However, it was unlike the case of Mexico, Argentina or the Gold Standard, where the national currency in people's pockets remained the same - except that it was pegged to another hard currency. In the case of Argentina, the peso was pegged to the United States Dollar: so you still had pesos in your pocket but every peso was worth one US Dollar. But you still had the pesos in your pocket. Now why is this important? Because ending this regime when the going gets tough takes a simple decision by the Minister of Finance. Overnight he could say that the exchange rate of one-to-one doesn't exist anymore. Severing the peg and floating the currency effects an instant devaluation. Through this devaluation, suddenly a large chunk of your debt in dollars has disappeared. In Europe, by contrast, all the currencies had been replaced with a single one.

So how can you devalue when you don't have a distinct currency to devalue? How was the Greek crisis to be dealt with? Well, in 2010, the Greek State became well and truly bankrupt. Think of these two mountains. One is the mountain of national income and the other is the mountain of national or public debt. Public debt was 120 per cent - 1.2 times - national income. But, up until 2008 to 2009, national income in nominal terms - in Euros - was rising by 7 or 8 per cent every year, due to the Ponzi growth. The debt mountain was rising by 4 per cent. If your income is rising at 7 or 8 per cent and your debt is rising by 3 or 4 per cent, it's sustainable.

But then the GFC caused our nominal income to fall by 10 per cent. The country went from 8 per cent annual growth to minus 10 per cent. So we lost 18 per cent at this point. Investors and bankers thought: 'oh my God, we have a new Lehmann Brothers disaster in the form of Greece'. They demanded huge interest rates in order to carry on refinancing the existing debt mountain. The Greek State became bankrupt - well and truly, irreversibly. What was the response of the European Union and the Greek Government to this? Denial - pure, undiluted denial.

I wrote an article in 2010 saying: let's embrace our bankruptcy because if we don't, it will kill us. I was considered a national traitor. How dare you



say that the Greek State is bankrupt, even when it is? So when you're bankrupt, what do you do? If you pretend that you're not bankrupt - there's only one way - to borrow more. When you can't repay your mortgage, you get a credit card from which you draw money to make the payments every month, pretending you're not bankrupt. How old do you need to be to understand that this cannot end well - eight, six, seven? But making this point in Europe in 2010 was regarded as subversive and dangerous talk by a radical left looney person. Okay, so what did Greece do? We took the largest loan in human history, about 110 billion Euros - approximately 190 billion Australian dollars - in one go, on condition of implementing austerity measures that would cause the Greek national income to shrink further.

Now we have a choice here. We can say that our creditors were stupid. Imagine if you went to your bank and you said: 'dear manager, I can't repay my mortgage because I've lost my income - I lost my job or I lost overtime or I had to take a pay cut or I'm sick and I need to pay all this money for medical treatment - I can't repay my mortgage. Please can you give me a second mortgage from which I'll repay the first mortgage?' Imagine your banker saying: 'yes but under the condition that you will agree to shrink your income further'. Of course, no banker would say that. No creditor would sensibly impose on debtors conditions that guarantee that the creditor will not get their money back. Because I never believe an explanation based on the assumption or presumption of stupidity, something else must be going on. What was it? The fact of the matter was that a year before the bankruptcy of the Greek State, Deutsche Bank was deeply bankrupt. When Lehmann Brothers went bankrupt, it had a leverage ratio of 1 to 38 - that is, for every one dollar it had, it owed 38. Deutsche Bank in 2009 had a leverage ratio of 73: it was clearly *kaput*.

So Mrs Merkel, the German Chancellor, and Doctor Schauble, her Finance Minister - the paragons of parsimony and fiscal rectitude who claimed that you should never live beyond your means - suddenly had their aides come into their office and say: 'you know what, all our banks are bankrupt - and we have to pay them money'. 'What? How much do they need?' 'Oh, 500 billion, and we have only a few hours before they blow up'. So Merkel had to bite the bullet and go to the Bundestag - the Federal Parliament in Berlin - and face her own parliamentarians who had spent their political lives nit-picking over 100,000 Euros here and 100,000 Euros there - for example, should we give a million to this state

or to the health service - to tell them that in a very short space of time that they will have to give 500 billion Euros to the bankers who had been rolling in money for decades. It was very difficult for them to hear this, but within a few hours they had voted for a bail-out of the banks of Germany by 500 billion Euros. Now what they hadn't been told was that the black hole of German Banks was actually much greater. 500 billion Euros was not enough, because of the derivatives and the loans that France was giving to the banks that were not counted in the 500 billion. When, a year later, Greece went bankrupt, we owed something like 200 billion Euros to the German and French banks: only this.

Then there was Portugal, there was Spain, there was Italy, and a domino effect was in the making. So you can imagine the Chancellor thinking: 'oh my God! I may have to go back to the Bundestag and say, remember that 500 billion - it wasn't enough'. So a different solution had to be found.

Remember Aesop's fable of the Ant and the Grasshopper? The ant is working hard throughout the summer - he's a protestant - while the Greek grasshopper is sitting under a tree, singing and playing the *bouzouki*. Winter comes, so the grasshopper goes to the ant and begs for assistance. Everyone had to help the grasshoppers. Now the problem was that the array of grasshoppers seeking help included - as my friend Franz on that international flight was relating to us - the Northern banks.

It takes two to tango. For every irresponsible borrower, there is an irresponsible lender; and for every irresponsible lender there is going to be an irresponsible borrower. This is not a moralistic tale: this is a problem of the architecture of the Eurozone. So, to cut a long story short, the first bail-out was not because the creditors wanted to get their money back, but because the creditors were trying to find some way of saving the German and the French banks - that this bailing them out a second time, without the parliamentarians and electorates of Germany and France realising that this was what was going on.

So how was it presented? It was presented as a bail-out of Greece, rather than a second bail-out of the Deutsche Bank. Of that huge amount of money that Greece got in May 2010 - 110 billion Euros - how much do you think was retained by the Greek State? It was just eight per cent. Moreover, it didn't go to the pensioners or anything like that: 91 or 92 per cent went to the banks. The reason why I'm not the Greek Finance Minister any more is because I refused to sign another such a loan

agreement on the 12<sup>th</sup> of July last year. That loan agreement entailed another 85 billion Euros. Do you know how much of that was going to go to the Greek State? Zero. It was new money to pay off the older debts but in a manner that would sink Greece deeper into bankruptcy. That was the real situation.

Since 2010, Europe is in denial of the causes of Ponzi growth and then what I call the Period of Consolidation after 2010, I refer to as Ponzi Austerity. Yes, there's nothing wrong with belt tightening during the tough times if you or I have a problem balancing our household accounts because we spend more than we earn. We have a moral duty to ourselves and to rationality to tighten our belts - not go on that holiday, not to buy a new car, but to save. This is just common sense. But this is not helping in Greece. We have borrowed 400 billion Euros since we became bankrupt in 2010. This is not parsimony: this is profligacy. Remember, Ponzi growth is growth based on unsustainable debt. Ponzi austerity is belt tightening based on unsustainable debt. This is what is happening in Europe now.

Ponzi austerity is a result of the capacity of the European periphery to purchase Germany exports. That has created deflationary forces that afflict Germany and Holland. You can see that the rate of inflation has collapsed to zero. Interest rates in Germany are negative. Pension funds in Germany are in dire straits because they have negative interest. What does it mean to have negative interest? You have to pay people to take your money. Why do you do that? Because you fear that prices are going to fall. So if somebody takes your money and charges you one per cent interest you perpetuate the cycle of recession.

The only thing that kept Germany and the North of Europe alive after 2008 was the positive impact of China's economic growth - also impacting here in Australia. We can discuss how positive it is in the long run, but at least in the short time it was clearly positive. China decided, quite wisely I think, to buy time for itself and for Europe and the United States, hoping that the Europeans and the Americans would get their act together within three or four years. It pushed the rate of investment from an already high 32 per cent to 51 per cent of GDP. In other words, out of every 100 dollars of output in China, 51 per cent was invested. This is the largest percentage in history. It was based on Ponzi growth - on developing real estate at the regional government level, creating bubbles in the real estate that would support collateral credit creation. The fastest

credit growth episode in the history of capitalism has been in China. But that was all done in full knowledge of the dangers of what they were doing, hoping that, by 2011 or 2012, Europe would have picked up the slack and consolidated.

### **Concluding Observations**

Look, Greece is not important except to us Greeks. We're two per cent of the Euro economy. If New England in northern New South Wales was constantly in the news for six years because its economic instability threatened financial failure for the Commonwealth of Australia, that would signify not a problem with New England but a problem with the Commonwealth of Australia as a whole. So the only reason why it makes sense to focus on Greece is because what it reflects. It is 'the canary in the mine', an indicator of the fact that European capitalism is ungovernable. There remains a kind of denial that condemns Europe to constant fragmentation and to a process which leads to the deconstruction of the European community.

When, on top of that, you have some crisis which cannot be anticipated, like the current refugee crisis, the European union has no solid foundation upon which to build a common security and refugee policy. Every national government has succumbed to asking 'what's in it for me?' and seeking how to avoid taking responsibility for the common problem. This does not auger well for establishing or dealing with humanitarian issues or the threat from geopolitical ruptures like the conflict over Ukraine, like ISIS, like Libya.

Europe has given us no evidence that it is in the hands of a political class capable of achieving that which its name proclaims - a European Union. Ghandi was once asked what he thought of European civilisation: his answer was 'it would be an excellent idea'. The same applies to the European Union: it would be a splendid idea, but we don't have it and, increasingly, we're moving into the realm of European disunion. Many Europeans could quite understandably respond to this fact, and to the sights and sounds of an inane political class stumbling from one debacle to another fiasco, by saying: 'let's just abandon it and go back to our nation status'. I warn against this.

We should not have created the monetary union. I was an opponent of this when I was a lecturer here at the University of Sydney. I penned feisty and fiery articles in Greek which were published in Greek

newspapers in Athens, opposing Greece's entry to the monetary union. However, it's one thing to say we should not have entered - that we should not have created a European Union the way we did - but it's quite another to say that we should disband it. Once you follow the path towards a European Union, that path no longer exists. Retracing it backwards - reversing - will cause you to fall in an abyss, because that path is no longer there. Similarly, with institutions of political union. Fear is created over the way Brussels and Frankfurt operate. But if we allow the terrible European union we have now to fragment, we're going to go back to a worse situation. With a highly deflationary Germany and surrounding area - Poland, Slovakia, the Czech Republic and with Greece attached there somehow - high unemployment will occur. This will be terrible for Australia, terrible in the United States, and it will be appalling for China. Europe has managed to drag the world into the mire of world wars twice in the last 100 years. Could it do so again?

I leave you with just one simple thought: why is this political economic debacle happening in Europe? My answer is because the EU is not operating as a democracy. Democracy is not a luxury to be afforded to the rich or credit rich nations. The reason why democracy is important is because it is essential to good economic policy. So the economic crisis now evident in Europe is the result of all the important decisions being taken in a democratic vacuum. Either we are going to democratise the European Union or the European Union is going to perish.

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