Western Europe: a new 1931 Kreditanstalt collapse?

by David Goldman and George Gregory

Western Europe's debt position has reached a breaking point identical to 1931, when the collapse of the German and Austrian banks brought down the entire world trading and financial system. The only difference is that Europe's debt is relatively much larger, and its vulnerability is much greater.

Europe has been in danger of bankruptcy since the First Great Oil Hoax of December 1973, and entirely bankrupt since the Second Great Oil Hoax of April 1979, during which time oil prices increased 16 times over. As we will show, Europe first avoided bankruptcy by running up public foreign debts of $330 billion, then by borrowing an additional $100 billion net from the interbank market. When the Mexico crisis of September 1982 shut off interbank lines, the West German central bank stepped in to support its trading partners. The end of this support signals the detonation of Europe's worst crisis in half a century.

In a limited sense the foreign debt crisis of the Scandinavians, Portugal, Spain, Belgium, Italy, and France is comparable to the developing-sector crisis. But the issue at stake is fundamentally different. The combined public and private debt, domestic and foreign, of the OECD nations is about $10 trillion. Of this, about $750 billion, as noted above, represents a potential detonator. Under conditions of relative economic and financial health, the three-quarter trillion of bad debt would not bring down the world credit structure. But the central-banking nations for the world—the United States, West Germany, and the special case of Switzerland—are themselves so overextended in domestic problems that the "foreign" trigger is sufficient to bring them down.

Let us take a bird's-eye view of the main categories of debt over the recent period (see **Figure 1**).

In themselves, the statistics in Figure 1 could be misleading. It is not the magnitudes per se that matter, but their reciprocal correlations: France's or Spain's domestic debts are fairly small, yet the counterpart is massive foreign indebtedness. Corporations in both countries have tapped the Euromarkets in huge proportions to escape credit controls. Similarly, the rate of growth of German or British state indebtedness appears to have been kept within reasonable bounds—but it started from very high levels. And, in all cases, the 1978-80 period witnessed an extraordinary acceleration of all debt ratios for all nations concerned, an acceleration which has essentially abolished differences in historical patterns.

On paper, the debt of Western Europe is $331.8 billion, just over that of Ibero-America's. That estimate is deceptive; the $390 billion foreign borrowings of Europe's banking system (almost entirely from the Eurodollar market) exceed its $317 billion foreign holdings by another $73 billion, putting the total debt at $404 billion.

For two reasons, even this staggering sum represents a wild understatement. First, the numbers are misreported in the International Monetary Fund's data; the foreign liabilities of French banks, in particular, garnered through their branches in offshore banking centers, are much larger than reported. The actual sum is probably over $100 billion, bringing the actual indebtedness to over $420 billion.

Much more important is the fact that the $390 billion total liabilities of the European banking system—its borrowings from the $2 trillion Eurodollar market—represent short-term debts with an average repayment period of 30 days. In a liquidity crunch, it does not matter, for example, if a French bank has dollar assets in the form of loans to Brazil, Poland, or French exporting companies; its liabilities are payable in days or weeks, and its assets cannot be turned into cash quickly, if ever.

Europe's real foreign exposure, therefore, is more than $700 billion ($331 billion of sovereign debt plus $390 billion of foreign liabilities), against only $300 billion for Ibero-America. More devastating is the short-term trigger in the form of about $400 billion of short-term banking system obligations. European nations have done precisely what Germany and Austria did in the late 1920s, after the weight of war debt put them into unofficial bankruptcy. They raised their interest rates and sought short-term money from all over the world.

Figure 2 shows the increase of internal government debt between 1975 and 1982, as well as the increase of foreign debt. In the most indebted countries, government debt has trebled, quadrupled, or quintupled, reflecting the erosion of economic growth and thus of the governments' revenue base.

West Germany's reversion to monetary austerity may be the blunder that brings the rest of Europe down.

While other nations cut back brutally, West Germany's central bank printed money during the past year, at an 11 percent annual rate by the August year-on-year measure, in order to support the rest of Europe. By importing more goods and making funds available for Germany's trading partners, West Germany kept the rest of the continent afloat. This pattern continued through the May-July 1983 period.

Figure 1

Sovereign debt, and banking system foreign assets, liabilities, and net liabilities of OECD nations

(in billions of U.S. dollars)

Country	Sovereign debt	Foreign liabilities	Foreign assets	Net foreign liabilities
France	70	110.7	113.0	−2.3
Canada	53.6	55.8	35.5	22.3
Italy	51	41.3	32.4	8.9
Spain	30	28.5	16.7	11.8
Sweden	27.4	14.3	7.0	7.3
Denmark	15.5	6.1	6.0	0.1
Portugal	14.2	5.6	1.4	4.2
Austria	14.0	25.8	25.2	0.6
Belgium	13.8	80.6	67.1	13.5
Norway	11.2	3.7	1.9	1.8
Finland	10.0	5.7	3.6	2.1
U.K.	7.3	n.a.	n.a.	n.a.
Ireland	7.3	7.1	6.3	0.3
Greece	6.0	4.3	1.3	3.0
Total	**331.8**	**389.5**	**317.9**	**73.6**

Figure 2

Debt expansion in European Community nations

	Increase of public debt 1975-82 in %	Increase of foreign debt in national currency in % 1975-82	Government debt per capita in 1982 dollars	Debt to GNP in %
West Germany	119	189	4,048	39
France	450	7,900	1,210	13
Italy	353	219	4,263	61
Spain	253	240	588	23.9
Holland	168	0	6,808	73
Belgium	245	9,560	10,204	107
Sweden	413	802	6,385	61
Denmark	300	900	6,078	47
U.K.	113	n.a.	10,357	111

Thus, exports to France declined in real terms 4 percent, to Italy 3.5 percent, to Denmark 1 percent, to Sweden 7 percent, to Norway 13 percent, while imports from these countries increased in real terms 5 percent.

Now, the West German central bank has announced that it is letting the rest of Europe go. Its most recent monthly report, published in September, makes two points.

First, it argues that there is too much international liquidity. Second, it says that it will stop "excessive" growth of German credit, and sets targets which amount to shutting down all credit growth during the fourth quarter of this year.

This marks the virtual merger of the West German central bank with the Swiss National Bank, its mugging-mate in most financial negotiations during the last six months. What may detonate the actual collapse is hard to tell; the Austrian Kreditanstalt failed in 1931 at the moment when one of its directors refused to certify the failing bank's balance sheet. Brazil's failure to pay its creditors, leading to a pullback of American banks' loans internationally, might blow up the European situation, just as a major European bank failure anywhere in the world might topple the structure, bringing down Ibero-America's debt as well.

The 1931 parallel

After the stock-market crash of 1929, American banks began to pull their funds out of Germany and Central Europe; the result, in the spring of 1931, was the collapse of the Austrian and German banking system, triggered by the Austrian Kreditanstalt institution's failure.

Germany declared a moratorium on its foreign payments. The Bank for International Settlements agreed, on condition that Nazi economic-czar-to-be Hjalmar Schacht was installed as central bank chief. The great French economist Jacques

Rueff, who was present at the negotiations, wrote, "When Hitler assumed power he found already established the system that would enable his regime to function and endure."

Europe has already suffered the equivalent of German Chancellor Heinrich Brüning's vicious austerity program in the Germany of 1929. In Italy, there has just been a radical cutback in the state-sector industries, costing over 150,000 jobs over the short term in steel and chemicals. In France, tax increases and fiscal cutbacks are going to be applied in the attempt to get the French balance-of-payment account into equilibrium. In England, the Thatcher government is shutting down military expenditures and selling off public-sector companies to raise money; and in West Germany, the Kohl government has introduced a new austerity budget.

How big was the debt that brought down central Europe in 1931? The totality of war debt was a mere $11 billion, and Europe's short-term obligations were under $3 billion—less than 1 percent of the short-term debt of the European continent! Even with the change in prices, real output, and world trade since then, the short-term debt burden of the European continent is *10 times worse than it was in 1931*.

The internal economies of Western Europe are not much better off than they were in 1931. Unemployment officially measured at 10 percent is not as grim as the one-third unemployment in Germany in 1931; but the capital structure and indebtedness of the continent have deteriorated drastically since 1974.

The German motor shuts off

The West German economy has functioned as a "motor" for the most vulnerable and highly indebted European partners via imports, financed primarily through recycling funds which flowed into Germany as a result of speculation around the European Monetary System currency realignments. As funds flowed into West Germany from other European nations, German banks relent these funds to the other EMS members, or West German consumers used them to buy goods from these countries. The combination of the West German import shift and the intentional weakening of the deutschemark on the part of the Bundesbank made possible the apparent success of austerity maneuvers throughout the rest of the continent through September 1983.

The Bundesbank itself explains that one of the reasons its "money volume" target of 4-7 percent per annum growth ran out of control (to 11 percent on a year-to-year comparison as of August) was this inflow, related to speculation on currency realignments. On the monetary side, the last drop in the Lombard rate (and discount rate) by a full percentage point to 5 percent on March 17 brought the Lombard down to half of what it had been in mid-1982, and served to fuel the housing/consumer goods boom.

We will show how artificially Europe's debt crisis was postponed, in terms of:

1) the dramatic changes in the import-export picture vis-à-vis Germany and its European partners;

2) the internal financial situation, which shows the untenability of maintaining the "import motor" function.

On an overall, non-adjusted basis, Germany ran a decline of exports by 2.2 percent and a decline of imports by 0.7 percent over the January-July 1983 period (for which the data is most precise). However, as **Figure 3** demonstrates, exports to France declined in real terms 4 percent, to Italy 3.5 percent, to Denmark 1 percent, to Sweden 7 percent, to Norway 13 percent, while real imports from these countries increased in real terms 5 percent. Needless to say, when Germany does not or cannot import like that any more, a lot of countries are going to be in trouble. The overall pattern accelerated in May-July 1983.

West Germany's credit picture

What the Kohl government has been doing is a "non-government" version of Helmut Schmidt's policy after the Bonn summit of 1978, when he agreed to balloon German imports. The internal "boom" has been led by housing and non-durable consumer goods, and is just as tenuous as in the United States. The housing/consumer goods bubble is the impetus for imports as well. The housing "boom," moreover, still leaves housing employment 4.5 percent below the level of last year, even with a 21.5 percent increase of housing construction, and a 41 percent increase of commercial construction.

In the first quarter of 1983, domestic credit to the private sector expanded over the stock of outstanding credit at the end of 1982 by DM 3.6 billion, which was a de facto standstill. It expanded, however, in the second quarter of 1983 by DM 32.7 billion, reflecting primarily housing and consumer credit. The German savings ratio dropped for the first time in postwar history! Two-thirds of the new credit went into hous-

Figure 3

Changes in West German trading profile

(in percent)

Country	Imports	Exports
Belgium/Luxembourg	+8.9%	−0.5%
Denmark	+13.4	−1.7
Ireland	+18.6	−1.6
Sweden	+1.4	−6.9
Spain	+10.1	−1.3
United States	−6.8	+2.4
USSR	−7.8	+24.4
Asia	−22.6	−1.8
Latin America	+14.0	−12.3
Iran	+76.0	+144.9
Saudi Arabia	−68.4	−10.8
Non-oil developing countries	−4.6	+0.8
Italy	+9.7	−3.4
France	−1.7	−8.8

ing, including modernization, new heating systems, and so forth. Consumer credit expansion in the first half of 1983 at DM 5.8 billion was already 75 percent of the total consumer credit of 1982.

In contrast, there was an expansion of long-term credit to the corporate sector in the first half by DM 6.1 billion, but some 70 percent of that was used to consolidate short-term credits, so that net credit expansion was only DM 3.1 billion. In 1978-82, the average first-half year rate of corporate credit expansion had been DM 12.3 billion, so that the German corporate sector was running on one-quarter of its "normal" credit flow. At the same time, foreign debt incurred by the corporate sector in the first half was DM 3 billion, compared to DM 17 billion for the first half of both 1980 and 1981.

Consumer credit is now flattening out, however, and so is the commercial building boom. Import demand is thus drying up, just at the time that the emergency conditions prevailing in steel, ship-building, and mining topple the industrial workforce. The wage total paid to operatives in mining and manufacturing in July was 4.8 percent below the level of July 1982; the number of hours worked was 5.9 percent lower. The workforce in mining was 3 percent lower, in investment goods 4.5 percent lower, even in consumer goods 5.7 percent lower. All of this is a function of cost-cutting against the labor force, while dishing out credit for consumers to buy at cutthroat prices.

The Bonn budget

The budget presented by Finance Minister Gerhard Stoltenberg on Aug. 23 is totally devoted to debt management à la Sisyphus (see **Figure 4**). The document is based on additional untenable projections:

1) It is assumed that the Federal Republic will have 11-13 percent growth over the five-year period 1982-87 compared to 8.2 percent growth over 1977-82. That means a 1982-87 average of 2-2.5 percent in real terms versus a 1.6 percent annual average for 1977-82.

2) Investments over the same period are projected to increase in current prices by 52.5 percent compared to 32.6 percent for the 1977-82 period, or 9 percent per year as opposed to 5.8 percent per year for 1977-82.

3) Private consumption is projected to decline to a growth rate in current terms of 27 percent during 1982-87, compared to 32.1 percent during 1977-82, or 5 percent growth per year, versus 5.7 percent.

4) Exports are expected to increase.

5) Employment is projected to grow, if only by 1 percent over 1982-87 as a whole, compared with 1977-82 growth of 1.9 percent.

In addition, emergency measures foreseen already include DM 500 million for "community tasks," which are always make-work projects; DM 400 million for city-renovation, also always make-work; DM 170 million for youth job training; DM 300 million for direct "job creation," such as cleaning up cemeteries; and DM 70 million for shipbuilding.

Cuts include a total of DM 2.6 billion from the budget of the labor office, which means making "job creation" schemes cheaper, and lowering the unemployment payments from 58 percent to 56 percent of previous wage rates. A billion marks will be cut from child-support funding, i.e., money paid to mothers ineligible for unemployment benefits but out of work because of pregnancy or related reasons. DM 0.7 billion will be cut from public service administration, and DM 1.7 billion in subsidies to industry. Areas not yet included in the official budget are:

- Reform of the pension system. Here Lambsdorff has laid out the following squeeze: by 2030 the proportion of pensioners to the total population will have doubled. Thus, if the level of pension contributions remains the same, pensions paid out would have to be cut in half; or, if the level of pensions remained the same, contributions, currently 18.5 percent of wage, would have to be doubled. A compromise is sought.
- How to distribute the cost of permanently laying off the workforces of the shipbuilding, steel, and mining industries. The difference between a worker's pension claims at 65 and forced retirement at 55 has to be made up somehow, shared between the government and the firm. "Social plans" for workers nowhere near retirement age, but foreseeably unable to find jobs in the collapsing basic industry, have to be financed somehow.

Here government medium-term projections claim to be cautious—they are planning on a temporary unemployed rate of 2.5 million, which is even more pessimistic than what Lambsdorff told the finance ministry to plan for.

As in Great Britain, where the Thatcher government is selling off large portions of private industry, a privatization wave appears to be coming. A number of government-linked firms are running huge losses, with no end in sight. Salzgitter alone DM 630 million in FY 82/83, the HDW ship-building operation ditto. So, federal participation in other firms not running losses will be cut down. Bonn will bow out of taking a cut when Lufthansa increases its capitalization by DM 300 million, and will also sell off shares in Veba, the state-controlled oil company. The Bundesbahn (national railroad) is ripe for a wave or partial privatization moves, as is Ruhrkohle AG, but nothing has been announced yet because Bonn is not prepared to weather a political explosion.

Figure 4

The West German federal budget

(in billions of deutschemarks)

	Debt service projection	New debt	Debt service/total expenditures
1983	27.8	40.9	10.9%
1984	29.2	37.3	11.6
1985	31.5	32.9	11.9
1986	34.2	27.6	12.5
1987	36.9	22.5	13.1