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The economics of external debt: a Damocles' Sword hanging over the Emergent and the Virtuous (Germany)

Abstract

Economic crises have become increasingly frequent, enduring and severe. Central bankers' and economists' focus has progressively moved from keywords like 'inflation' (70s and 80s of the last century) to 'debt', especially foreign indebtedness, which has emerged initially in the developing economies (Cline, 1984) and is nowadays plaguing the Eurozone. The article aims at matching some *micro-* with *macroeconomic* insights. The first one arising from authors like Anton Korinek (2008 and 2010) or Carmen and Vincent Reinhart (2008) and the second one from Quantum Economics, i.e. a pure *analytical-theoretical macroeconomic* treatment of economic matters. The paper compares the foreign indebtedness (and composition) of emerging countries in 'the' leading European economy *par excellence*, i.e. Germany. What do these country groups have in common? And what are their main differences? To answer these questions, it is indispensable to understand the nature of external debts, which roots are even today interlinked with their forerunner, i.e. reparation payments. The idea is that, no matter how sophisticated crises are today, their macroeconomic roots go back to the pathological international payments system, which has never been duly reformed.

Keywords: external debt, reparation payments, international payments system.

JEL Classification: B22, E42, E44.

Introduction

In recent times, numerous academic studies have emphasized the need for a *microeconomic (behavioral)* approach to the regulation of financial flows to emerging markets. Why is it so? The reason is that in the past emerging countries have repeatedly been afflicted by: (1) financial turmoil; (2) sudden capital reversals; and (3) drops in exchange rates.

In this specific regard, Reinhardt and Reinhart (2008) and Korinek (2010) claim that fast growing countries are mostly subject to an overtaking process of systemic risks. The idea is that several (not inter-linked) economic agents take *macroeconomic prices* (like exchange rates) as given, which in turn leads them to overinvest and, conversely, overexpose their countries to financial instability. As a result, the full social cost of capital inflows is often underestimated, since decentralized economic subjects belonging to crisis countries tend to give liquidity a significantly lower value than social planners do ($\mu^{\omega,SP} > \mu^{\omega,DE}$). To put it another way, the legislator is likely to prefer a more affordable repayment schedule or to reduce financial exposure (setting aside *macro-precautionary resources*) or to prepare himself for economic slumps. More precisely, the analyzed externality is a consequence of huge capital *outflows* during financial turmoil, but it is not imputable to *inflowing* foreign capital *per se*. According to this economic stream, agents are induced to underestimate the heaviness and social costs of not well-founded expectations, while the

financial accelerator mechanism blows up the negative consequences of people's misallocations. In actual fact, "[...] *some countries face interest payments that are so high relative to their ability to pay* [...]" (Corden and Dooley, 1989). After having constructed a stylized model of a small open emerging market economy in infinite discrete time ($t = 0, 1, 2, \dots$) which is also dependent from financial collateral constraints (Mendoza, 2002, 2006) – Anton Korinek (2008, 2010) represents the difference between the *social* and the *individual* preference for liquidity as follows:

$$\begin{aligned} \tau_1^\omega &= \frac{\mu_1^{\omega,SP} - \mu_1^{\omega,DE}}{E[\mu_1^{\omega,DE}]} = k\sigma \cdot \frac{\lambda_1^{\omega,SP}}{E[\mu_1^{\omega,DE}]} = \\ &= \frac{k\sigma}{1 - k\sigma} \cdot \frac{u'(C_{T,1}^\omega) - \beta R u'(C_{T,2}^\omega)}{E[u'(C_{T,1}^\omega)]}, \end{aligned} \quad (1)$$

τ_1^ω is the externality kernel; superscript *DE* and *SP* are the decentralized agent and the social planner respectively; ω is a constrained State of the world; $E[u'(C_{T,1}^\omega)]$ is the marginal private value of liquidity, $u'(C_{T,1}^\omega) - \beta R u'(C_{T,2}^\omega)$ is the marginal increase in utility from weakening the constraint; $\frac{k\sigma}{1 - k\sigma}$ is the factor maximizing the financial constraint $k\sigma$; λ_t^ω is the shadow price, $\mu_1^{\omega,SP}$ is the shadow value of period 1 wealth.

Consequently, *unconstrained* States show a perfect coincidence between private and social pricing kernels so that the externality kernel is equal to zero. On the contrary, in *constrained* States the externality kernel τ_1^ω is not only higher than zero, but it also grows in step with tightening financial constraints.

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Now, it is particularly interesting to analyze the same questions with regard to an industrialized European country, which is nowadays considered as the most virtuous in economic terms, namely Germany¹. Undeniably, the Federal Republic of Germany is far from being subject to sudden capital outflows and loss of confidence. There are nonetheless several macroeconomic monetary aspects, which are likely to affect the future of the German economy. International monetary macroeconomics cannot ignore the need for a *structural* analysis of payments systems, crises and economic variables. The *microeconomic* approach looks for the source of economic diseases in (human) behavior, expectations and contingent factors: what if financial, employment and debt crises were also the result of *macroeconomic* – i.e. *structural, not man-made* – fallacies in the international system of payments itself? Sadly, there is a pronounced human tendency to blame the origin of crises only on people's conduct (*microeconomic approach*). As we will see, *microeconomic science* has a lot to say on human investment decisions and behavior, although economists can get down to the deep fundamentals only by coupling it to a sound *macroeconomic*, i.e. *structural*, analysis.

1. The 'theorem' of Germany's alleged debt immunity as compared to the emerging economies²

Especially in the light of the Greek debt crisis, many commentators, economists and politicians have pointed out that the German macroeconomic external position should be regarded as an example of economic virtue and sustainability. Following Korinek's (2010) footsteps, let us focus our attention on the Gross External Debt Position (GEDP) of the Federal Republic of Germany. As shown in Table 1,

Germany's gross external liabilities have worsened by USD2,457.33 bn. from 2002 to 2010, but Germany's Gross Domestic Product (GDP) has also grown since then. What do these first data suggest? On the one hand, the gross amount of German foreign liabilities (USD5,674.19 bn. 2011 data) is becoming *unsustainable* over time (Shymanovic, 2012). Furthermore, the (unexpected) *doubling* of Germany's external obligations between 2002 and 2010 is all the more alarming. In fact, since a sustained *positive* current account balance should imply a *reduction* in a country's financial exposure (and this is clearly *not* yet the case), what if such trend in the German balance of payments became *less* marked? What consequences in terms of accumulation of external liabilities should be then expected? Most probably, Germany's foreign indebtedness would balloon (cf. debt ratios as calculated by the International Monetary Fund (2003)). Consequently, its foreign liabilities are now the world's third largest in absolute terms, right after the United States (USD15,047.66 bn. 2011 data) and the United Kingdom (USD9,928.07 bn. 2011 data). Economists are perfectly aware of the fact that some numerical macroeconomic expressions – especially expressed as percentages – are subject to a 'magic' threshold represented by '100'. In this respect, everyone agrees that Italy's (1,883.74 bn. Euros (119.6 per cent) (Eurostat, 2012)) or Japan's public indebtedness (USD13,089.60 bn. (220 per cent, 2010 data) (Economywatch, 2012)) has reached an unsustainable level. In addition, if we consider that the European Treaties prescribe a public debt-GDP ratio of 60 per cent, a 100% rate should set off all possible alarming bells, even if the country involved is Germany. On the contrary, emerging countries' external liabilities have been stationary over time and significantly below the German rate. The same is also true for all the other data.

Table 1. Some macroeconomic variables: Germany (D) versus the emerging countries (EM)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
GEDP _D (bn USD)	2,749.86	3,326.74	3,775.70	3,578.20	4,219.21	5,117.73	5,124.19	5,124.91	5,207.19
GEDP _{EM} (bn USD)	1,694.51	1,858.74	2,007.58	2,082.11	2,329.25	2,877.46	3,050.93	3,193.06	3,621.34
GDP _D (bn USD)	2,006.59	2,423.81	2,726.34	2,766.25	2,902.75	3,323.81	3,623.69	3,298.64	3,280.53
GDP _{EM} (bn USD)	5,875.21	6,675.31	7,857.90	9,261.25	10,837.72	13,249.40	15,358.29	14,892.70	18,021.60
GSEX _D (bn USD)	714.97	871.24	1,055.29	1,147.01	1,324.28	1,577.77	1,756.48	1,393.58	1,541.14
GSEX _{EM} (bn USD)	1,733.66	2,062.06	2,666.15	3,176.87	3,835.60	4,592.31	5,365.11	4,435.83	5,584.07
GEDP _D -GDP _D ratio (as %)	137.04	137.25	138.49	129.35	145.35	153.97	141.41	155.36	158.73
GEDP _{EM} -GDP _{EM} ratio (as %)	64.27	63.77	63.18	62.60	62.29	61.57	61.75	62.54	63.60
GEDP _D -GSEX _D ratio (as %)	384.61	381.84	357.79	311.96	318.60	324.36	291.73	367.75	337.88
GEDP _D -GSEX _{EM} ratio (as %)	58.46	58.15	57.89	57.67	57.46	57.04	57.05	57.51	58.43

Source: United Nations Economic Commission for Europe (2012) and the World Bank (2012).

¹ Richard Meyer-Eppler (2011) has disproved the supposed virtuousness of Germany's economy.

² As classified by the *Morgan Stanley Capital International* (MSCI) the list includes 21 countries: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey.

As pointed out by Anton Korinek (2010), there is another source of fears with specific regard to every countries' external indebtedness, i.e. the *typology* of capital inflows (Nowzad, 1990). Let us, therefore, analyze some common forms of capital flows like: (1) dollar debt; (2) GDP-indexed dollar debt; (3) Consumer-Price-Index (CPI) linked debt in local currency; (4) debt instruments in national money; (5) portfolio; (6) foreign direct investments (FDI), where the latter does not create any externality. Category (1) is at the origin of large repayment difficulties in emerging countries, while, although GDP usually fluctuates less than exchange rates in developing countries, typology (2) also presents a very similar externality problem. On the contrary, portfolio investments (5) are risk-sharing, since the value of foreign investors' shares is likely to drop without being at the origin of any (at least, *social*) cost. Local-currency denominated debt (4) also implies a small effect in terms of social externalities, although small emerging countries are not likely to be allowed to borrow in local currency. By looking at Germany's International Investment Position (IIP), it manifestly appears that there are some categories of liabilities incurred by (widespread) economic agents, which can give rise to repayment difficulties during financial crises as compared to more risk-diminishing forms of capital inflows (Table 2).

Table 2. The deterioration in Germany's IIP

Germany (bn. Euros)			
	2002	2011 (3 rd quarter)	Variation (as %)
Monetary and financial institutions (MFIs)			
Portfolio Investments – Bonds and notes	451.37	715.06	+58.42

Table 4. Debt securities versus equity securities: Germany and the emerging markets

	Debt securities (millions USD)		Variation (as %)	Equity securities (millions USD)		Variation (as %)
	2002	2010		2002	2010	
Germany	1,088.48	2,489.30	+129.70	212.68	598,75	+181.53
Brazil	110,106	226,051	+105.30	27,249	430,234	+1,478.90
Chile	8,223	21,169	+157.44	2,304	21,754	+844.18
China	14.25	15,483	+108,552.63	79.29	206,123	+259,860.90
Colombia	12,001	22,193	+84.93	325	25,197	+7,652.92
Czech Republic	2,423	31,014	+1,179.98	4,250	10,837	+154.99
Egypt	584	2,351 (2009)	+302.57	1,946 (2004)	1,757 (2009)	-9.71
Hungary	17,126	42,961	+150.85	3,784	15,125	+299.71
India	12,154	33,279	+173.81	19,885	138,216	+595.08
Indonesia	7,881	57,841	+633.93	6,452	88,847	+1,277.05
Korea	40,535	174,411	+330.27	75,666	316,366	+318.11
Malaysia	1,963	62,629	+3,090.47	13,882	65,902	+374.73
Mexico	82,572	138,120	+67.27	44,564	135,025	+202.99
Morocco	463	-	-	613	3,574	+483.03
Peru	4,554	10,035	+120.36	2,990	28,260	+845.15
Philippines	15,980	27,295	+70.81	1,863	9,021	+384.22
Poland	19,643	96,138	+389.43	4,399	32,853	+646.83
Russian Federation	31,149	45,486	+46.03	35,762	232,846	+551.10

Loans, currency and deposits – short-term	635.52	796.66	+25.36
Enterprises and individuals			
Portfolio investments – bonds and notes	20.30	60.96	+300.29
Loans, currency and deposits	181.84	425.58	+134.04
Trade credits	58.66	112.77	+92.24
General government			
Trade credits	14.25	114.11	+700.77

Source: Deutsche Bundesbank (2012a, 2012b).

The increase in debt securities, which are subject to correspond interest payments and/or are characterized by a short-term nature, is a factor of great concern. From 2002 to 2010, Germany has corresponded 414.86 bn. Euros as *interests on portfolio investments – bonds and notes*, which add on to the category of interest payments on credits being equal to 367.74 bn. Euros over the same time period (Deutsche Bundesbank, 2012a, 2012b).

Table 3. Emerging countries and their interest payments on external

Interest payments on emerging economies' external debt (bn USD)		
2002	2010	Increase (as %)
68.39	116.77	70.74

Source: The World Bank (2012).

On the other hand, the emerging countries considered in this paper excluding Taiwan and the European economies (4 countries out of 21), for which complete data are in turn not available, have paid almost *doubled* interests on their external obligations (Table 3). During this eight-year time span, such payments accounted for the *cumulative* amount of USD772,78 bn corresponding to approximately 590,75 bn. Euros.

Table 4 (cont.). Debt securities versus equity securities: Germany and the emerging markets

	Debt securities (millions USD)		Variation (as %)	Equity securities (millions USD)		Variation (as %)
	2002	2010		2002	2010	
South Africa	12,369	41,686	+237.02	23,308	138,098	+492.49
Taiwan	-	-	-	-	-	-
Thailand	5,490	15,268	+178.11	12,260	69,405	+466.11
Turkey	20,433	56,884	+178.39	3,450	61,497	+1,682.52
Average amount	76,861	58,963	+5,808.97	93,987	125,223	+13,275.37

Source: International Monetary Fund (2010, 2011).

Why are these figures ale the more *alarming* (Table 4)? Of course, because of the trend to replace *equity* with *debt securities*, i.e. *medium-* and *long-* with *short-term* participation in a country's economy, which adds on to the fact that debt securities increase the risk of bankruptcy, since they imply (regular) interest payments. On the contrary, equity securities correspond to ownership stakes in an economic activity and, as it is commonly known, shareholders are entitled to receive dividends *only after* all creditors have been remunerated. In this regard, it is particularly interesting to note that European emerging countries as well as Germany have experienced a sky-scraping increase in debt securities holdings. In fact, the average amount of the highlighted countries has ranged from USD14,285.9 (2002) to 218,088.3 (2010) millions, which is significantly huger than the general average amount (USD 58,963 million).

With regard to Anton Korinek's *microeconomic* analysis, sceptics are likely to claim that Germany's economy cannot be compared with emerging countries, which are more subject to an innate lack of confidence

by foreign investors. Furthermore, it has adhered to a monetary agreement called 'European Monetary Union' (EMU) and potential capital flights from Germany cannot (significantly) influence the exchange rate of the Euro, which is a *common* currency and bases its worth on the fundamental variables of the remaining 16 member countries. Last but not least, the German Federal Republic benefits from a large degree of confidence offsetting the risk of future sudden capital outflows. No doubt there is some truth in it, but such conclusions do not reproduce the complexity of comparing the set of emerging countries with an industrialized country like Germany. With specific regard to CPI-indexed debt instruments, Germany is out of harm's way. Thus, if CPI- but also GDP-indexed bonds were already relatively unusual in the European Monetary Union (EMU), nowadays they are extremely *rare* (De Broeck and Guscina, 2010). Nonetheless, a good proof of Germany's vulnerability risk is represented by the ballooning external debts. As formulated by Rudiger Dornbusch (1984), they vary according to their structural composing parts.

Table 5. Dornbusch's GEDP formula: the German case

	Δ Gross External Debt	=	Current Account Deficit	+	Δ Official Reserves	+	Short-Term Private Capital Outflows	-	Long-Term + Direct Capital Inflows
Germany (2002-2010, USD bn)	2,457.33	=	-1,393.12	+	126.84	+	x	-	348.28

Source: United Nations Economic Commission for Europe (2012) and The World Bank (2012).

Thus, "[...] *currency account deficits, reserve accumulation, and short-term capital flows [...] must be financed either by long-term capital movements and direct foreign investment, or by accumulation of external debt*" (Sachs and Collins, 1989).

As a matter of fact, the unknown variable *x* (*Short-Term Private Capital Outflows*) corresponds to at least USD4,071.87 bn. (UNECE, 2012 and The World Bank, 2012), since other any long-term capital inflow except of net FDI inflows have been disregarded. In other words, Short-Term Private Capital Outflows stemming from banks, enterprises and households combined with a *negligible* increase in official reserves numerically offset a *huge* current account surplus and the inflowing FDI causing a skyrocketing rise in Germany's GEDP, i.e. the European country with the second-largest current ac-

count (surplus) worldwide! If we consider that *x* represents nothing else than *short-term*, i.e. *speculative*, capital *outflows* from Germany, there is enough empirical evidence to claim that Germany is *potentially* exposed to financial crises.

Let us reformulate Anton Korinek's intuitions, which we know to be of a *microeconomic* nature, so that we can link them with a *macroeconomic* (*behaviour independent*) approach looking at the *structural* causes of economic disorders leading to external *over-indebtedness*. According to Korinek, the decisions of atomistic economic agents to incur liabilities with the rest of the world are often at the origin of adverse consequences for the *country as a whole*. Actually, since they have no incentive and/or innate predisposition for optimizing their private financial instrument portfolio, we can legitimately

infer that they can cause *systemic* financial crises and huge social economic losses. The domino effect is now complete: private risks and losses spill over to other economic actors and, if these effects become widespread and persistent, the downward trend and the capital outflow become more exacerbated (The Economist, 2012a and 2012b). Since Korinek's analysis is focused on concepts like 'human behavior', 'human decisions' and 'expectations', it has *microeconomic* roots as opposed to a *macroeconomic* approach, which looks at *structural* aspects of the economic system. Anyway, Korinek's intuitions are ultimately correct, though only for *macroeconomic* reasons. Now, if we accept the

Quantum theoretical demonstration developed by Bernard Schmitt (2007) and Alvaro Cencini (2005), which unmistakably shows that the country's debt *adds on* to the liabilities incurred by its residents, Anton Korinek's (2008 and 2010) findings are verified but if they are true, they are true because of *macroeconomic* reasons. External debt's (growing) unsustainability is imputable to the *intrinsic* shortcomings of the (inter)national system of payments. Hence, the remedy for the root causes of this *pathological* process has to be found in a way of reforming the whole international payments system, which has not (substantially) changed since the Genoa Conference (1922).

Table 6. The Emerging, the Virtuous and their (common) risks

	Emerging countries	Germany
Externality-creating financing forms	Dollar debt; GDP-indexed dollar debt; CPI-indexed debt in local currency; debt issuances in national money units.	Portfolio investments – bonds and notes; loans, currency and deposits – short term.
Other intrinsic sources of externality	Absolute and relative amount of gross external liabilities; payment schedule of financial instruments; currency denomination of debt issues; principal and interests of/on the external indebtedness.	
Economic agents responsible for socially costly financing forms	Atomistic agents, who do not internalize that servicing incurred external liabilities can be at the origin of a downward pressure on the local exchange rate, if capital outflows become <i>unsustainable</i> and <i>uncontrolled</i> .	Banks and bank-like actors, who bet on their rescue by the local Government. In fact, the social planner generally aims at preserving financial institutions from insolvency, since this scenario would have costly spill-over effects on national savers, investors and retirees.

Once again, the reader should not think of Germany as immune from being subject to *erroneous* and/or *socially inefficient* decisions taken by widespread economic agents. As the recent (and enduring) financial crisis has clearly revealed, the 'too-big-to-fail rule', which bank institutions claim to be due to, has prevented several actors from really taking care of their portfolios, investments and/or the loans received. In fact, public capital measures to the benefit of the German banking system accounted for more than 50 bn. Euros and 'risk shields' for more than 30 bn. Euros, while liquidity guarantees exceeded 140 bn. Euros (Bundesministerium der Finanzen, 2011).

It comes as no surprise that bank institutions, but increasingly also enterprises and households are likely to replace the generic category of 'atomistic agents' initially referring to emerging countries. The German Federal Republic has experienced the effects of *risky* forms of financing to be attributed to various institutions, which are subject to a latent 'moral hazard' due to their 'too-big-to-fail status' (e.g. banks, insurers, funds) or the awareness of benefiting from a pervading social security system (e.g. enterprises and households). Sure enough, although Germany seems to have turned the corner, it would be naive to claim that not only the *consequences*, but also the *source* of the financial crisis have been removed. On the contrary, the German IIP is massively charged with risky liabilities (and also assets), which can be easily turn out to be toxic for the system's recovery itself and lastingness itself.

2. Economic history's turnarounds: from reparations to interests on external debt

History's recurrence has become proverbial and economics is no exception (Steinbeck, 2007). For instance, let us look at reparation payments as compared to interests payments on external debt, which represent in our theoretical framework a significant source of externality and social costs. Now, what are reparation payments *intrinsically*? The answer is straightforward: they are *external obligations* of some economic agents (e.g. the State), which have to be paid to some external creditors usually represented by the Governments of the winner countries.

Setting up a link between (modern) external debts and (past) war indemnities, article 4 (*Debts to be settled*) of the *Agreement on German External Debts* (London, February, 27, 1953) states that foreign "*debts [...] are (a) non-contractual pecuniary obligations [...], (b) pecuniary obligations arising out of loan or credit contracts [...], (c) pecuniary obligations arising out of contracts other than loan or credit contracts [...]*" (Department of External Affairs, 1997), while (a) clearly corresponds to *reparation payments* (b) and (c) are equivalent to the item(s) *private/public external debts + private/public interests due on foreign obligations*. Taking a further step, the mentioned debt typologies are nothing else than the composing parts of what is nowadays called (*gross*) *external debt position*. The etymology of the noun *reparation* (Online Etymology Dictionary, 2011) is also an additional proof of the profound *economic similarities* subsisting be-

tween war and (more) ‘common’ foreign debts. Nonetheless, one remarkable difference is that war indemnities originate *ex nihilo*, i.e. they are imposed *ex abrupto* without the debtor country having benefited from capital inflows (i.e. a corresponding or matching credit) in the past (cf. Angell, 1930).

The most discussed case of reparation payments pertains to Germany after World War I (1925-1933) (singularly enough, the German Federal Republic is today reputed to be the ‘creditor country’ *par excellence*). Although not entirely serviced (Staley, 1935), Germany’s war debt was the object of a stimulating debate in 1929, as John Maynard Keynes, Jacques Rueff and Bertil Ohlin began discussing about its consequences. In the words of the British economist, it subsisted a “[...] *Budgetary Problem of extracting the necessary sums of money out of the pockets of the German people [...], and [a] Transfer Problem of converting the German money so received into foreign currency*” (Keynes, 1929, 1978). “*The latter is a question of foreign trade: the former is primarily a question of national resources and income, when viewed from the standpoint of their government*” (Williams, 1922).

Generally speaking, we claim that economic literature regarding the German ‘reparations problem’ can be divided into three different *currents of thought*. To begin with, (1) there are those who deny the existence of any *prejudicial* economic consequence. (2) There are also scientists who think that war indemnity payments will cause a deterioration in the terms of trade and/or an unstoppable currency depreciation. (3) A few economists try also to explain why reparation service is subject to an *economic pathology*, which unaccountably *duplicates* the total amount of the repayment due by the debtor country.

According to this last stream of thought, the *Government*, which collects the internal resources [→ ‘Budgetary Problem’], is not coterminous with the *Nation as a whole* [→ ‘Transfer Problem’], which comprises the set of economic residents as well as the *State*.

Interestingly enough, some economists of the past (cf. Taussig, 1920; Graham, 1925; Angell, 1926) were implicitly cognizant that every country servicing external obligations has to generate two different resource flows (the first one in local and the second one in foreign currency), which leads to a double loss in terms of domestic resources. Now, what if war reparation payments were the economic forerunner of payments on external debt? If so, then (at least some of) the same mechanisms, fears, concerns would apply to these international transactions characterized by *unilateralism*. Furthermore, if war indemnities are unilateral transactions contributing to the GEDP (Ritschl and Sarferaz, 2006), is the discharge of modern foreign obligations subject to (the same) constraints?

Conclusion and remedies

Microeconomic (non-structural) approach to external indebtedness: emerging countries versus Germany. The question posed by Anton Korinek (2010) is innovative, but the adopted approach is clearly *microeconomic*. There is also no doubt that the main contribution of this kind of economic literature consists in approaching sudden drops in the exchange rates of emerging countries by starting from the typology of the liabilities incurred by national economic agents. These models aim at depicting particular cases in a highly simplified way and are also set in a rational expectations framework. In particular, their main accent lies in supposing that capital outflows put downward pressures on the exchange rate.

With specific regard to the remedies proposed by this stream of thought, one of the best options is represented by *unanticipated* Government transfers as bailout measures in case of financial troubles, while *expected* bailouts are likely to be fully undone by atomistic agents. Furthermore, an expected rescue by the State authorities, which does *not* occur, would aggravate the economic situation, since decentralized agents would take on more risky liabilities in anticipation of the transfer. Trying to defend an exchange rate peg in the case of small economies implies also that (1) these countries should have huge amounts of international reserves at their disposal to counteract speculation and/or capital outflows and (2) the economic loss in case of exchange rate drops would be all the harsher in terms of affordability. What is a buffer of foreign reserves if not a stock of national *wealth* (painfully) gained through international commerce? In the author’s opinion, some second-best policies during crises would consist in (1) taxes aiming at holding economic agents from making use of socially risky financing instruments *a priori* and (2) temporarily suspending any capital outflow during financial crises and/or pre-defining quota on capital outflows. In our opinion, such kind of approach is likely to *socialize* the effects of the ‘Damocles’ Sword’ originally imputable to a *minority* of economic subjects. From a mere *microeconomic* perspective, it would be more effective to (1) *abolish* specific types of liabilities incurred by decentralized economic agents (2) after having tested such instruments for their potential prejudicial social costs. Although conceived as a policy of last resort, suspending capital outflows during financial turmoil and/or fixing quota on it are not the best conceivable policy measures, since the first destroys confidence in the local economic system and the second discourages investors *ex ante* from allocating their excess resources in these local emerging countries. Thus, who would put considerable funds into an economy knowing *in advance* that (at least, some) investors will not be allowed to *freely* disinvest part of their savings in case of financial instability? It is not re-

mote to imagine that people who will nevertheless opt to invest under these conditions will cause a *preventive* and massive capital flight and/or run on the local banks as soon as they will at least *presume* that financial instability will increase leading rapidly to exceed the pre-defined quota. Hence, either there will be less investors *ex ante* or there will be a bigger capital flight (than in the absence of quota of capital outflows) *even before* the financial crisis becomes acute. Therefore, it would be preferable to replace quota on capital *outflows* with (reasonable) taxes on capital *inflows* without limiting the investors' exit strategies. For example, these incoming funds should be put into a pool, which would be activated in an anticyclical way during financial turmoil, since investors are more prone (1) to pay in advance to invest in a foreign country than (2) to know that there is some probability that capital outflows quota will prevent them to save their invested funds by withdrawing them.

Very similar conclusions also apply to the German case, although we should remark that sudden drops in the exchange rate of the *common* currency (Euro) due to capital flight from Germany are very unlikely. Nevertheless, if German *debtors* would become (semi-) insolvent toward European *creditors* causing financial difficulties for them (or making them illiquid/insolvent), there would be severe spillover effects on the exchange rate of the Euro currency. Although Germany is nowadays considered to be a 'safe haven', there is *nonetheless* urgent need for action in order to reduce the amount of risky liabilities, which are doubling and almost tripling even in times of good economic conjuncture.

A macroeconomic (structural) approach to external indebtedness: a common solution to a shared problem. Other than in the case of *microeconomic*

(*contingent*) approaches, which aim at analyzing and/or preventing some particular human behaviors, expectations and fears, a *macroeconomic* one cannot abstain from looking at *structural* solutions directly interrelated with the system of functioning of (inter)national commercial/financial transactions leading to external indebtedness. A good beginning for establishing a new international economic order could consist in rediscovering some forgotten contributions of non-mainstream economists of the past centuries like many (disregarded) German thinkers (cf. Beretta, 2012).

With specific relation to the growing world's indebtedness, once economists will have agreed on the *logical* and *factual* similarities between external war and 'normal' foreign obligations, it will become easily understandable that similar reflections on reparation payments also apply to 'modern' external liabilities, i.e. the principal of debt and the interests lasting on it. Hence, it is of little importance that economists seem not to be aware of these matters of fact: the *de facto* equivalence between the two international transactions is for sure not determined by economists' acknowledgment, but only by the (1) unilateralism, (2) the accounting procedure in the balance of payments and (3) the intrinsic characteristics of both economic operations. In that case, what if the discharge of international obligations is responsible for (1) a deterioration of the terms of trade of the debtor's country – no matter if provided with 'strong' or 'weak' currencies, (2) an increasing devaluation pressure on its exchange rate and/or (3) a 'secondary burden' lasting on the *nation as a whole* causing an unjustifiably plethoric loss in economic wealth? Then, there would be no doubt that the 'Damocles' Sword' of external liabilities is even now taking its toll.

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