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Germany, the Euro and the Euro Crisis

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THIESS PETERSEN, AUG 5 2013

In a recent article, Alexander Reisenbichler and Kimberly J. Morgen argue that 'Germany won the Euro Crisis'[i]. I doubt that any country can be the winner of a major economic crisis, especially if we are talking about an exporting nation. Of course Germany does benefit from some economic developments of the current Euro Crisis—in particular the low interest rates for German government bonds which reduce public spendings for interest payments on public debt. However, as an exporting nation, Germany depends on stable economic conditions in Europe. Thus a sluggish economic situation in several European economies has a negative impact on German exports and thereby on Germany's real domestic product (GDP) and labour market. Hence I would argue that Germany benefits from the Euro, not from the Euro Crisis.

How Germany Benefits from the Euro

Being a member of the European Monetary Union (EMU) has three main advantages for Germany. First, a common currency reduces transaction costs for companies and consumers. With the Euro, German companies save on currency conversions, bank transfers between different currency areas, currency management and, perhaps most importantly, on potential exchange rate fluctuations. Secondly a common currency increases price transparency. Such transparency stimulates cross-border trade and enhances price competition. This competition causes significant price-cuttings and thus an increase in international competitiveness of German companies.

Whereas these two arguments work for all EMU member states, there is a third advantage of a common currency which applies only to those economies with a strong economic competitiveness and a current account surplus. According to economic theory, an export surplus causes an appreciation of the currency of the country with this surplus: The products of any exporting country have to be paid in the currency of the exporting country. Therefore high exports imply a high demand for the currency of the exporting country and thus an increase in the exchange rate of this currency. The rise of the price of the exporting country's currency increases the prices of its export goods and thus has a negative impact on the country's capacity to export goods and services.

In a recent study, we estimate that the German currency would have appreciated by roughly 23 percent if Germany still had a currency of its own whereas the currencies of the remaining members of the Eurozone would have been devaluated by nearly seven percent [ii]. Such an increase in relative prices would have had a negative impact on German exports. At the same time, German imports would rise. However, as a member of the single European currency, Germany does not suffer such an appreciation as the exports of all 17 countries using the Euro are more or less balanced to the imports. Hence in view of trade activities, the Euro stimulates German exports with resultant benefits for the domestic labour market.

From my point of view, this third advantage is crucial for the German economy. Without any doubt, the strong economic performance of Germany and the German labour market in particular are due to the low labour costs per unit. During the last fifteen years German wage growth has been lower than in other developed economies. The main reason for the low growth of labour costs per unit in Germany is wage restraints. Since the mid-nineties – and especially since the beginning of the new millennium – the growth of wages has been very low. The long-lasting wage restraint is caused primarily by the Hartz reforms and by a weakening of the bargaining power of the German unions. In 1990, more than 11 million people were members of a union. In 2012, the number of members dropped to 6.15

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million [iii]. Without the Euro, wage restraints would have resulted in an appreciation of the German currency. The competitive advantages due to low wage increases would have been counterbalanced by a revaluation of the 'deutschmark'.

Therefore, the German economy and the German labour market have certainly profited from EMU membership during the last decade. In our above mentioned study, we also demonstrate that Germany will profit from the euro in the future. Even if Germany must write off large parts of the loans and bail-outs given to crisis-ridden countries, the economic advantages of EMU would outweigh these losses.

How Germany Suffers from the Euro Crisis

According to Reisenbichler and Morgen, Germany seems to profit from the current Euro Crisis. They focus on three arguments to support this claim: the booming housing market, the very low interest rates and the influx of skilled labour from crisis-ridden countries. In my opinion, two of these arguments are not clear cut.

I do not believe that the booming housing market is that crucial for the German economy. The mentioned increase in building activities has only a small impact on the German labour market. From 2011 to 2012 the average number of employees in the construction sector rose by 11,000 [iv]. Compared to 41.8 millions persons in employment in May 2013 [v], the additional employment due to building and construction activities is relatively small and thus only of minor importance.

The influx of skilled labour from crisis-ridden southern European countries is increasing, but we have to bear in mind the relatively low starting point of immigration from these countries. From 2011 to 2012, the number of immigrants from Spain, Portugal, Greece and Italy to Germany grew by 40 to 45 percent. But in absolute numbers, this translates to an increase of 4,000 more immigrants from Portugal, 9,000 from Spain, 10,000 from Greece and 12,000 from Italy [vi]. Once again, compared to the entire workforce in Germany, this is of marginal magnitude.

Germany's low interest rates, however, are, in fact, a veritable ace of an argument. However, as Reisenbichler and Morgen correctly indicated, it is a fragile advantage. Sooner or later the European Central Bank must increase interest rates. In that case, government interest payments will rise. With a total public debt in Germany of more than two trillion euros, an interest rate hike of just one percentage point would increase interest payments in the long run by 20 billions euros.

Moreover, besides these advantages, an overall evaluation of the Euro crisis and its impacts on the German economy must consider the disadvantages as well. Most importantly, German exports suffer from an economic slump in the entire Eurozone. An economic downturn in the southern European countries reduces the imports of these countries and thus the exports of Germany. Consequently, in May 2013 German exports to the member countries of the Eurozone dropped by 9.6 percent compared to May 2012 [vii]. This was the largest reduction since December 2009.

Due to the strong dependency on exports, the economic harm generated by lower exports to other countries within the Eurozone, Germany suffers directly and indirectly from the poor economic development in crisis-ridden economies. Directly, because lower imports of Greece, Portugal, Spain and Italy imply lower exports of Germany and thus lower employment in Germany's export-oriented companies. Indirectly, because all other European economies suffer from lower exports to the four countries in crisis and thus have lower GDP, lower employment and lower income. Hence Germany must reduce exports to all these countries as well. Once sales expectations in Germany drop, the incentive to enlarge production capacities by further investments goes down. Therefore, in spite of the low interest rates, a reduction of private investments in Germany is imminent.

In summary, I believe it is more appropriate to characterize Germany as a loser of the Euro crisis. Obviously Germany is by far not the biggest loser. But if we had to decide between an economic healthy development in Europe—with higher interest rates for Germany and less skilled immigrants from southern European economies—and the current situation, my guess is that few in Germany would favour the latter.

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Economic Implications: Support is Needed

Concerning the essential economic implication of the previous arguments, I wholeheartedly agree with Reisenbichler and Morgen: Germany must assist the crisis-ridden countries in revitalizing their economies, because without the support of economically strong nations, these countries will not be able to solve their real economic problems or their public debt problems. Actually this finding is no surprise for those familiar with the “theory of optimum currency area”. According to that theory, distinct regions should only opt for a common currency if they have similar levels of productivity and more or less identical productivity growth rates. Without these prerequisites, a common currency needs a high mobility of labour between the involved regions or flexible prices—which means de facto wage reductions. Otherwise economically weak regions require their own currency in order to maintain international competitiveness by devaluating.

In reality, however, hardly any large region meets these conditions. Neither the United States (US) nor Germany can be referred to as an “optimum currency area”. Nevertheless the US and Germany are better in dealing with economic heterogeneity. Beside a greater labour mobility due to a common language and a common culture, the main reason is the fact that the US and Germany have a wide system of financial transfers between economically strong and weak regions. Thus struggling regions are supported by buoyant regions. Hence Germany is requested to transfer money to the crisis-ridden countries. In its 2011/12 annual report, the German Council of Economic Experts rightly claimed: “Yet Germany has been a principal beneficiary of monetary union up to now. ... Given the global interconnection of money and capital markets, the benefits of open product markets can only be had if, at the same time, it is ensured that the resulting instabilities pose no serious threat to the real sector. And this protection does not come for free” [viii].

How to create this protection is debatable: Germany and other countries that profit from lower interest rates due to the euro crisis could, for example, use part of their interest savings and transfer them to those countries with higher interest rates—a proposal made by the Centre for European Economic Research (ZEW) in Mannheim last summer [ix]. Another discussed proposal is the introduction of a European transfer system in the form of a European unemployment insurance system [x]. In any case, those kinds of financial transfers are necessary in order to stabilize the EMU. Such a stabilization is of vital importance for Germany’s exporting economy and hence is in Germany’s own best interests [xi].

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[i] <http://www.foreignaffairs.com/articles/139520/alexander-reisenbichler-and-kimberly-j-morgan/how-germany-won-the-euro-crisis>

[ii] http://www.bertelsmann-stiftung.de/cps/rde/xbcr/SID-3F092218-A947651E/bst_engl/xcms_bst_dms_37730_37731_2.pdf

[iii] <http://www.dgb.de/uber-uns/dgb-heute/mitgliederzahlen>

[iv] https://www.destatis.de/EN/PressServices/Press/pr/2013/02/PE13_069_441.html

[v] https://www.destatis.de/EN/PressServices/Press/pr/2013/06/PE13_215_132.html

[vi] https://www.destatis.de/EN/PressServices/Press/pr/2013/05/PE13_156_12711.html

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[vii] https://www.destatis.de/EN/PressServices/Press/pr/2013/07/PE13_224_51.html

[viii] http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_one_2011.pdf

[ix] <http://www.zew.de/en/presse/2051>

[x] http://www.diw.de/sixcms/detail.php?id=diw_01.c.410751.de

[xi] http://www.bertelsmann-stiftung.de/cps/rde/xbcr/SID-66416194-81A469AA/bst/spotlight_1202_EN_web.pdf

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