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The Euro Has Yet to Produce Any Real Winner

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JöRG BIBOW, AUG 9 2013

It is almost conventional wisdom today to view Germany as the winner of the euro crisis. Reisenbichler and Morgan recently argued this case in *Foreign Affairs*, although cautiously adding that Germany's supposed gains may not last.[i] The miserable truth is, however, that the euro has yet to produce any real winner, while Germany's apparent gains from the euro crisis in particular are largely an illusion about to unravel. Ultimately only a fundamental re-design of institutions and policies in the Euro-zone would open up the prospect of creating a union of true euro winners. Misled by ill-conceived ideas and beliefs – and against its own national interest – Germany is adamantly blocking such a move. Actual policies pursued and regime reforms undertaken since 2009 under German dictate have made Europe progressively more vulnerable, and ever more of a threat to global stability as well. As of now, the euro remains firmly on track for eventual breakup – an event which would see Germany among the biggest losers.

The view of Germany as the winner of the euro crisis points as evidence at Germany's current low unemployment rate, balanced public budget, and low borrowing costs. The contrast with the situation elsewhere in the Euro-zone is so crass that Germany currently also enjoys an influx of skilled immigrants, providing further support to its economy and housing market. Yet the state of Germany's economy is far from stellar and the fact that Germany's current superior performance in relative terms has come largely at the expense of its euro partners should prompt alarm rather than awe. The euro's life expectancy was always dependent on convergence within the currency union. Instead, persistent divergences and the corresponding buildup of intra-zone imbalances have not only created the ongoing crisis, but also the illusion that Germany – its apparent winner – must have done everything right and should now be the unchallenged model for others to follow.

But to view Germany as the euro paragon is a grave misinterpretation of events. Not only should Germany's current performance be viewed in a broader perspective: Germany has grown at an average rate of little over one percent per year under the euro; hardly impressive. It must also be understood that Germany cannot be the model for others to follow, precisely because the workability of the German model depends on others behaving differently. It is in the essence of Germany's export-led growth model that it presupposes willing importers. The trouble is that the German authorities remain at a terrible loss when it comes to properly understanding the country's economic model and the sources of its success under specific historical conditions.

Stability Culture Breeds Instability

Deeply ingrained in the country's political-economic belief system and cherished "stability culture", Bundesbank mantra has it that price stability causes growth. Maintaining price stability did indeed work well for both Germany and the Bundesbank in pre-euro times when trading partners were locked into a system of stable nominal exchange rates. For under such conditions keeping German inflation lower than in key trading partners boosted Germany's competitiveness and oiled its export engine. With the Bundesbank keeping fiscal policy and the unions in check, the model worked well under the Bretton Woods regime of global dollar pegs. It was then re-ignited regionally in the 1980s with the European Monetary System. Belated deutschmark revaluation might temporarily restore trade balance, but only to start a fresh round of rising German competitiveness through relative price stability with Germany relying for its own growth on over-spending by its trade partners.[ii]

Europe's currency union was a joint commitment to keeping inflation below two percent across the union, a game changer. Alas, the German authorities missed the essential truth that exporting the German model to Europe through the Maastricht regime of Economic and Monetary Union (EMU) would undermine its working at home. A model the workability of which depends on others behaving differently cannot be made to work by forcing everyone to behave like Germany. Regional stability and cohesion requires that national unit labor cost trends stay aligned with the common two-percent mark. But general abidance by Germany's historical stability norm would put a spanner in the works of Germany's traditional export engine. On the other hand, persistent divergences in national unit labor cost trends would see intra-union competitiveness positions run out of kilter – with exchange rate realignments no longer an option to restore balance under the euro.

When its export engine failed to drive the economy in the usual way in the 1990s Germany embarked on wage repression to "restore" its competitiveness. Mass unemployment, widely blamed on unification, seemed to provide the perfect excuse. The "Hartz reforms" of the 2000s were merely the final leg in a journey that saw German unit labor costs stray systematically from the agreed stability norm in the downward direction, preparing the ground for the ongoing euro crisis.

Persistent wage repression joined by unconditional fiscal austerity in the name of stability and growth earned Germany the title "sick man of the euro" in the 2000s. Far worse, as Germany got sick and sicker, this undermined the European Central Bank's "single" monetary policy. For in a currency union "one size must fit all", presupposing roughly similar conditions. Attuned to fit the regional average, monetary policy became far too tight for Germany but way too easy for other euro member countries, nourishing property market bubbles in the euro periphery. While property prices were sagging in Germany, financial fragilities and bubbles building up elsewhere created the over-spending which Germany needed to fire its export engine, silently oiled through gradual but cumulative competitiveness gains.

Before the crisis Germany's growing external imbalance had its counterpart largely in Europe. This left Germany highly vulnerable to its over-spending European partners, both in terms of trade and finance. For German finance also sponsored the credit booms in euro crisis countries, through liberal refinancing of banks in Spain and Ireland, for instance.

Vulnerable Haven

Previously exuberant private lending flows ended with the euro crisis. Official lending and the ECB's balance sheet came to the rescue to some extent, but only by adding more debt to the burden of already struggling countries. Ultimately Germany can only fulfill its apparent wish for permanent trade surpluses by fiscal transfers. It is ironic that German mercantilism has made a transfer union inevitable – when a transfer union is what the country dreads most.[iii]

But Germany remains in denial, and so far the euro crisis has provided two important boons to the country: ultra-low interest rates owing to its haven status and a euro exchange rate that is far weaker than what external balance of the German economy would require. But the view that Germany may have won the euro crisis is an illusion. Germany's foreign assets feature huge exposures to its euro partners, including the infamous TARGET2 balances. A euro breakup would inflict massive wealth losses on the country together with a surging new deutschmark that would cripple the German export engine.[iv]

With so much to gain from avoiding the ultimate euro calamity, what kind of wakeup call will it take to lift the German leadership out of its intellectual trap? Just as wage deflation and mindless fiscal austerity made Germany sick in the 2000s, we are watching a blind repeat of that experience across the currency union today. Germany's freeloading on external demand provided the background to the ongoing and largely unresolved euro crisis. The current state of the global economy seems unfit to tolerate a similar effort on the part of a Germanized Europe. Europe's currency union must start managing – rather than systematically suffocating – domestic demand. The United States, not German mercantilism, provides the right model for Europe. Institutions and policies must be reformed accordingly.

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[i] Reisenbichler and Morgan (2013). "How German won the Euro Crisis", Foreign Affairs, June 20.

[ii] Bibow (2013). "On the Franco-German euro contradiction and ultimate euro battleground", Contributions to Political Economy 32: 127-49. (Levy Economics Institute, Working Paper no. 738, April.

[iii] Bibow (2012) "The Euroland crisis and Germany's euro trilemma", International Review of Applied Economics Online. Levy Economics Institute, Working Paper no. 721, May.

[iv] Bibow (2013). "Germany and the Euroland crisis: The making of a vulnerable haven", Levy Economics Institute, Working Paper no. 767, June,

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