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MARKET INSIGHTS

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# Germany and the euro

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## Introduction

*Some economists suggest that those eurozone countries which run current account surpluses, particularly Germany, helped to create the peripheral sovereign bond crisis. They point to Germany's growing trade surpluses within the eurozone over the last decade and to the reluctance of German policymakers to stimulate German and pan-European demand through macroeconomic and fiscal measures. Does this make sense? Or would the cause of eurozone economic stability be best served by focusing on lowering costs in the peripheral economies, perhaps aided by closer economic and fiscal union?*

## Summary

Germany and other eurozone countries, that run relatively strong public finances and trade surpluses, are not bound by the governance of the euro to run their macroeconomic or fiscal policy for the benefit of their neighbours and trading partners. This is perhaps a key weakness of the euro and something that needs to be changed for the long-term success of the single currency project, but member countries cannot be blamed for sticking to the interpretation of the euro as a purely monetary union since that is how it was established. Germany had every right to run deflationary policies in the years prior to the credit crunch, in order to ensure global competitiveness, while some of its eurozone neighbours inflated their economies on cheap borrowing.

The eurozone peripheral bond crisis will not be solved by forcing Germany to pay itself higher wages, since that will make German exports to non-eurozone countries uncompetitive and severely limit Germany's long-term growth prospects.

The peripheral eurozone countries need to bring their wage costs down relative to their trading partners and produce goods and services that are attractive to their trading partners at current prices. This will reduce intra-eurozone trade imbalances. However, as long as these countries are in the euro they cannot devalue, so to bring down costs they must either increase productivity or cut real wages. If the emphasis is on cutting real wages, a prolonged period of low growth and social unrest is possible in the peripheral economies.

Closer fiscal union, perhaps with direct transfers of cash from richer countries, may help to soften the blow and ensure the support of the bond markets. But with closer fiscal union comes the risk that competitiveness in the core region is 'levelled down', if such transfers actually delay structural reform in the periphery and become a large and permanent weight on the core economies. Nevertheless, closer fiscal union remains the most likely outcome of the crisis.

It is also possible that member states may seek to leave the euro in order to devalue if the political and social cost of economic restructuring is deemed too high (in the case of peripheral countries) or to avoid fiscal union (in the case of the core countries). However, this scenario is far less likely.

## What's the problem?

The dominance of Germany within the eurozone makes it the prime target for those who criticise member countries that run relatively strong government finances and have trade surpluses. Hence it is the criticism of Germany that we shall focus on.

**Criticism one: German fiscal policy is too tight and household savings rates too high, hindering the German and the eurozone economic recovery.**

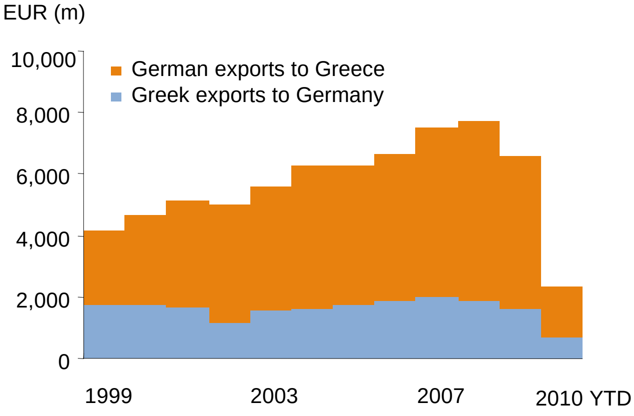
The German government has recently passed a budget containing EUR 80 billion of cuts. Wolfgang Schäuble, Germany's finance minister, contrasted his own budget cuts with the ongoing fiscal stimulus package in the US: 'While US policymakers like to focus on short-term corrective measures, we take the longer view and, therefore, are more preoccupied with the implications of excessive deficits and the dangers of high inflation' (1). The economic background is improving, with German unemployment falling steadily thanks to export strength that helped deliver GDP growth of an astonishing 9% at an annualised rate in the second quarter.

But for critics such as Paul Krugman in the US, the German government is cutting spending too soon. It should be continuing to stimulate the German economy, to bolster confidence, which will, in turn, unlock household savings, to the long-term benefit of the German and the broader eurozone economy.

**Criticism two: German trade surpluses are destabilising as they create trade deficits elsewhere.**

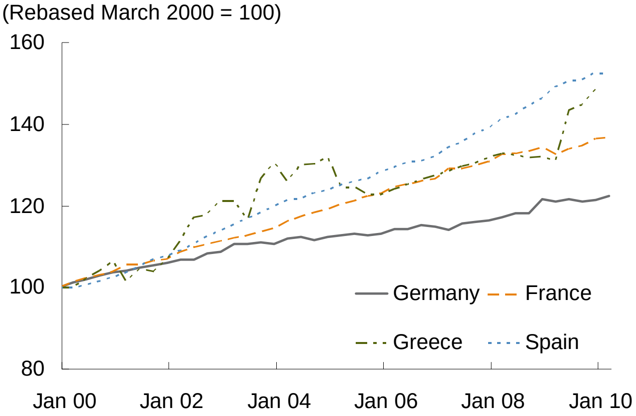
From 2000 to 2008 net export growth generated approximately two-thirds of overall growth in German output, thanks in part to the creation and membership of the euro, which locked in uncompetitive neighbouring economies who had relied on devaluation in the past to restore their trade balance. Around 40% of German exports go to other eurozone countries. Over the last decade Germany has seen its trade surpluses with other eurozone countries widen as it has sought to keep its costs down relative to its non-eurozone competitors.

Exhibit 1 – **Greek and German trade**




Source: Eurostat, J.P. Morgan

Exhibit 2 – **Europe labour cost index**




Source: Eurostat, J. P. Morgan

**Exhibit 1** plots the gap between Germany's exports to Greece and Greece's exports to Germany. This gap has doubled since the euro began in 1999, and large increases are to be found in Germany's trade surpluses with most of its eurozone trading partners over the same period. Much of the increase in Germany's trade surplus can be attributed to a relative difference in unit labour costs, to Germany's advantage. German industrialists have sought to keep wage growth to a minimum over the last decade, often with agreement from trade unions, in order to compete against non-eurozone economies. Nominal wages were cut for some workers at large industrial concerns such as Siemens and Bosch from 2004 to 2006, while real wages fell for most workers over those years. Meanwhile, as **exhibit 2** shows, other eurozone countries saw increases in wages. This was particularly so in the peripheral countries, as an investment-led boom absorbed labour.

Critics say that Germany's policy of relying on exports for growth, and of maintaining a high household savings rate and a low level of consumption, is inherently destabilising for the eurozone. This is because a trade surplus for Germany with, say, Greece necessitates a trade deficit for Greece with Germany. In this sense, Germany's export success comes at a cost to its trading partners, and Germany's success in limiting wage growth over the last decade amounted to a devaluation against its neighbours. Countries in the periphery cannot deflate wages to regain their competitiveness with Germany, it is argued, without creating a deflationary slump in their economies (2).

The belief that German policies pose a threat to the eurozone recovery, and to the long-term stability of the euro, was the subject of a much-publicised speech by the IMF chief, Dominique Strauss-Kahn, in March, to the European Parliament. It was followed up a few days later by comments from Christine Lagarde, France's finance minister, who urged Germany to focus more on stimulating consumption and so boost demand for imports (3).

## The German response

Chancellor Angela Merkel responded to the French criticism by telling the Bundestag: 'We are strong, we will not give up our strengths just because our exports are preferred to those of other countries' (4). The Bundesbank, in its monthly report in July, echoed this sentiment by quoting a recent European Commission report, which found that 'neither strong exports nor the fiscal policy situation in the surplus countries constitute the problem, and that it would therefore not be sensible to weaken Germany's price competitiveness or its fiscal policy framework' (5).

## Is the real problem the lack of a common economic and fiscal policy?

Perhaps the tensions that have been created within the eurozone by a country deflating its wages while others raise them stem from the way the euro was constructed under the Treaty of Maastricht. The member states made a conscious decision to have a monetary union without a fiscal union or a common economic policy.

A common economic and fiscal policy would probably have limited the extent of the divergence between core and peripheral wage costs over the last decade. For example, if Germany had run a bigger government deficit over the last decade, perhaps by cutting income tax to boost household spending, we might have seen higher growth and inflation in Germany and higher wage costs. Higher ECB interest rates would have followed, which would have limited the appetite for borrowing by peripheral eurozone banks, households, property companies and governments, and the current sovereign debt crisis may have been avoided. Meanwhile, transfers of cash from the core economies to the peripheral economies, in exchange for evidence of structural reform, might have helped raise the international competitiveness of the peripheral countries.

The drawback to a common economic policy and fiscal union, however, is that while such a policy would help reduce internal differences in growth and incomes, it may create a reliance by peripheral countries on handouts of cash from the core countries. The core countries' own long-term growth prospects would suffer as fiscal transfers kept taxes higher than they would otherwise be, while the urge to reflate core economies for the benefit of their trading partners would risk raising wages and reducing international competitiveness.

# Conclusion

The fundamental problem within the eurozone is a north/south divide that continues to be characterised by a sharp difference in competitiveness. In the past this was resolved through currency flexibility. Today, in the single currency, it has to be resolved through changes in prices and wages. Germany has increased its competitive position through wage restraint. To call this unfair is to wish that Europe's largest manufacturer sold a little less and was a little more inefficient. It is hard to see how this would benefit the region as a whole. Germany is not obliged to run macroeconomic or fiscal policies for the benefit of its neighbours.

A monetary union without a pooling of economic and fiscal policy was always going to be difficult. But greater policy union may be the only way to contain the two very different regions in one currency union. The manner in which the Growth and Stability Pact has been abused by many eurozone countries over the last decade suggests that enthusiasm for a pooling of economic and fiscal policy is limited. However, there is probably even less appetite for years of wage and price deflation with low or no economic growth, which appears to be the cost of inaction.

## Notes

1. Interviewed by the *Financial Times* 23 June 2010, 'Schäuble defends German austerity'. Schäuble's comments were intended to head off charges in the US – not least from the Nobel prize winning economist Paul Krugman – that his austerity measures will choke off the global recovery. Quoted by Bloomberg Businessweek, 22 June 2010, Krugman makes the claim that 'to short-change stimulus now [in the eurozone] just doesn't add up' and that German policymakers are 'crazy' to fear inflation.
2. The Financial Times has carried many articles on this theme. For example, see the *Financial Times* 30 March 2010 'Why Germany cannot be a model for the eurozone' by Martin Wolf, and *Financial Times* 29 August 2010 'Germany's rebound is no cause to cheer' by Wolfgang Münchau.
3. Interview with Christine Lagarde, France's finance minister, *Financial Times* 15 March 2010.
4. Angela Merkel quoted in the *Daily Telegraph* 17 March 2010.
5. Deutsche Bundesbank Monthly Report, July 2010 vol 62 no7 page 29.