Germans are wrong: the eurozone is good for them

By Martin Wolf
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Which country is the biggest gainer from the creation of the eurozone? My answer would be Germany. This view is hardly accepted in Germany itself. But such scepticism needs to evaporate. Not only is Germany a beneficiary, but it needs to recognise this far more clearly than now. Only then are Germans likely to support the reforms the eurozone needs.

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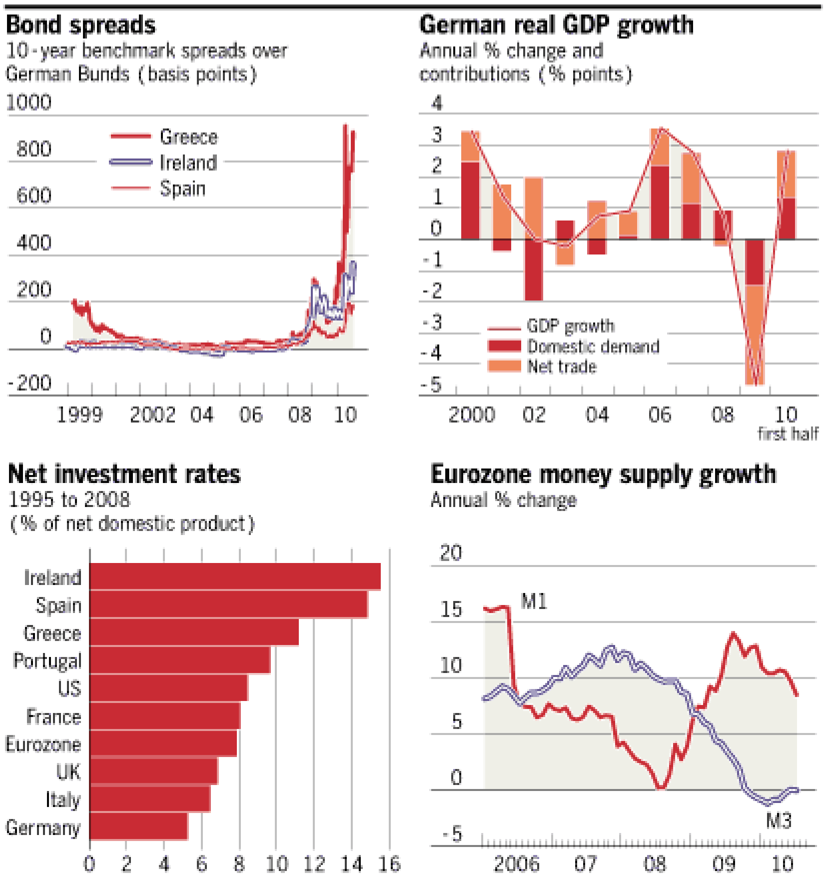
The starting point must be that the crisis is not dead, but sleeping. José Manuel Barroso, European Commission president, claimed in his "state of the union" speech on Tuesday that "the economic outlook in the European Union today is better than one year ago, not ... least as a result of our determined action". This is true. But confidence has definitely not been restored (see chart). Further shocks are likely.

So why, when confronting those shocks, should Germans accept that they have an overwhelming interest in the success of the eurozone? The immediate answer is that the economy is hugely dependent on exports for demand (see chart). From 2000 to 2008 external demand generated as much as two-thirds of the growth in overall demand for German output. Germany needs both captive markets and a competitive exchange rate. The eurozone has delivered both, to an inordinate degree: the crisis in the periphery has dragged down the value of the euro; and many of Germany's eurozone partners (who absorb two-fifths of its exports – nine times as much as China) are uncompetitive, after a decade of rising relative costs.



Source: Thomson Reuters Datastream; H-W Sinn (2010), OECD

More important, imagine what would have happened, in the absence of the euro. The exchange rate of the D-Mark would have exploded upwards, as currency crises savaged the European economy, as happened in the 1990s. In peripheral Europe, currency depreciations would have been at least as big as, if not bigger than, sterling's. The absence of such shocks has greatly enhanced the prospects for the German recovery. The creation of the eurozone was, for this reason alone, much more than a favour Germany did for its partners. It was also a big economic (not to mention political) gain for Germany. German industrialists are clear on this, as is the government.

Some German economists have a different view. My friend, Hans-Werner Sinn, president of the Ifo Institute for Economic Research, in Munich, provides an alternative story in a paper on the crisis. His starting point is with finance. Integration of the eurozone capital market and the mistaken view that risk had disappeared in the periphery drove convergence in interest rates. This provoked an investment boom, notably in Spain. It also allowed sloppy governments, notably in Greece, to spend madly. At the same time, he argues, the capital outflow – the counterpart of the current account surplus – starved Germany of investment: German net investment was, notes Prof Sinn, the lowest in the developed world between 1995 and 2008 (see chart). That, in turn, rendered German growth very slow: Germany had the lowest rate of growth in the EU, bar Italy, between 1995 and 2009.

I disagree with much of this.

First, the euro was not the crucial explanation for the weak German investment. My calculations suggest that German real interest rates also fell after 1999. True, those in peripheral Europe fell even more. But in a glutted world capital market, it is hard to believe that investment in Germany was crowded out. More plausibly, weak domestic demand, structural rigidities and globalisation kept investment down.

Second, the gains to the periphery were transitory, if not illusory. The inflow of capital went predominantly into construction and other non-tradeable activities. It also stoked unsustainable booms in consumption. Current account deficits became huge. Again, it is true that German investors and taxpayers will lose some of the money they have invested in economies that were far less safe than they realised. But the cost of this boom-bust pattern of development will be both larger and more prolonged in the periphery. The chances of a "lost decade" are high.

I conclude that Germany was (and is) a big beneficiary of the existence of the eurozone. It is in Germany's interests to push for a future in which the eurozone survives and peripheral countries adjust successfully. So consider two aspects: demand and institutional reform.

On the latter, Prof Sinn argues, rightly, that rescue packages must include "haircuts" for creditors. Indeed, he notes that the Greek rescue was more an attempt to hide the losses of banks, particularly French banks, than to save Greece. The principle that sovereigns never default is unacceptable. But I would add that reforms must not focus on fiscal discipline alone, but at least as much on mitigating the wild private sector boom-bust cycles.

On demand, two points seem clear.

First, rightly or wrongly (wrongly, in my view), the eurozone is set on fiscal retrenchment. Jean-Claude Trichet, president of the European Central Bank, gave strong support to this push at the Jackson Hole conference of monetary economists and central bankers. No surprise there! But monetary policy needs to be at least a partial offset. Yet the ECB is violating its own monetary principles, inherited from the Bundesbank, by allowing a collapse in the growth of broad money (see chart). What has happened to the "reference value" for monetary growth? Why do German economists not complain more about this egregious failure?

Second, Prof Sinn believes that a more balanced eurozone growth pattern is in the offing, now that German investors have learnt how unsafe their investments abroad are. German banks "may try to go into natural resources or Asia, but for sure they will also offer domestic homeowners and firms better credit terms". So can we expect a credit boom in Germany? I hope so. At least the German government should examine the disincentives to lending and spending at home. Without that, it is hard to see how the eurozone will make the needed recovery.

Germany has an enormous political and economic interest in making the eurozone work, however unpopular that view may be. The euro has been a stable currency: indeed, the rate of inflation has been lower than it was under the Bundesbank. The euro has also shielded the German economy from what would have been still bigger shocks. The challenge is to change the workings of the eurozone and reform its institutions in a way that makes the economy work for everybody. Change is painful. But Germany has no sane alternative.

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