THE EUROLAND CRISIS AND GERMANY’S EURO TRILEMMA

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AIM & STRUCTURE OF PRESENTATION

- AIM: Investigate causes behind Euroland crisis, particularly Germany’s role, and crisis resolution

- STRUCTURE
  1. Euroland in global perspective
  2. Inside Euroland
  3. What caused divergences & buildup of intra-area imbalances?
  4. Germany’s ‘euro trilemma’
  5. Crisis management & crisis resolution
  6. Concluding observations
1. EUROLAND IN GLOBAL PERSPECTIVE

General government net lending/net borrowing

Source: IMF WEO October 2012
PUBLIC DEBT

Source. IMF WEO October 2012
CURRENT ACCOUNT POSITION

G-20 commitment: Global rebalancing?

Source. IMF WEO October 2012
**Assessment**

- Based on public finances and external balance, Euroland is not in particularly bad shape compared to peers.
- Suggests problems are internal/intra-regional.
- Suggests failings of Maastricht EMU regime.
- Also, rather than €land being held back by rest of world, it poses a serious threat to ROW.
2. **Inside Euroland: Government Balances**

![Graph showing government balances in percent of GDP for various countries from 1991 to 2012, Source: IMF (WEO October 2012)](chart)

- Germany
- Austria
- Finland
- Netherlands
- France
- Italy
- Spain
- Greece
- Ireland
- Portugal
PUBLIC DEBT

Source: IMF (WEO October 2012)
CURRENT ACCOUNT POSITIONS

Source. IMF (WEO October 2012)
ASSESSMENT

- Crisis countries (GIIPS) both externally and fiscally challenged (Ireland and Spain only since crisis!)
- Creditor countries fiscally in better shape too
- No surprise here:
  - Private sector + public sector + external sector = 0
    - All intra-Euroland imbalances, as union externally balanced!
  - While Germany’s balanced budget owes to foreign over-spending, Spain’s pre-crisis budget surplus cum external deficit owed to private sector over-spending
  - As flows change stocks, GIPS ran up huge external debts; Italy & France less so; while Germany’s net IIP surged
  - Conspicuously, German & French debt ratios rose in tandem; up from 40% to 80+% since ‘91 (= austerity start!)
- Signals massive failure of Maastricht EMU regime!
3. CAUSES OF INTRA-AREA DIVERGENCES & BUILDUP OF IMBALANCES?

Key features/flaws of Maastricht regime

- No one is ‘minding the store’, in particular:
  - No demand management in good times (asymmetry!)
    - On top, no LOLR foreseen in bad times
  
  *Hence: weak growth and export reliance*

- No proper policy coordination to assure convergence and cohesion of union, in particular:
  - Nothing keeping competitiveness positions balanced

  *Hence: divergences and imbalances*

- Instead, obsession with two numbers: 2% and 3%
Europe Converges to Germany’s Historical Stability Norm by Mid ‘90s

Source: AMECO, Destatis
Note: Nominal unit labor costs, total economy
But Germany itself diverges

Officially, everybody ‘lost competitiveness’ but Germany

Sources. Eurostat Ameco database; own calculations
Note. Nominal unit labor costs, total economy
PRODUCTIVITY?

Not the source of Germany’s super-competitiveness

Cumulative productivity growth

Source. OECD Economic Outlook no. 91 (May 2012)
It's Wages, Stupid!

I Irony: Euro was meant to ban ‘beggar-thy-neighbor’ ER devaluations forever; so Germany did it through wages, reneging on ‘golden rule’

Cumulative wage inflation

Source. OECD Economic Outlook no. 91 (May 2012)
GOLDEN RULE AND GERMAN MYTHS

- The ‘Golden Rule’ of monetary union:
  - National unit-labor cost (ULC) trends must be aligned with common inflation norm for common currency (ECB: 2%)
  - As divergences are *cumulative*, they lastingly distort competitiveness positions, causing current account imbalances
    - And *persistent* CA imbalances involve debt buildups

- Myth no. 1: ‘burden of unification’
- Myth no. 2: had to ‘restore’ its competitiveness

- #1 German tradition of macro policy blunders
- #2 If ‘restoring competitiveness’ means ending up with an 7.5% current account surplus, good luck with rebalancing Euroland! And world economy too!
‘Sick man of the euro’: Germany 2001-5

The art of flying on one engine

Cumulative GDP growth and its sources

- cumulative domestic demand contribution
- cumulative net trade contribution
- cumulative GDP growth

Source. OECD Economic Outlook no. 91 (May 2012)
MAASTRICHT REGIME AMPLIFIES RATHER THAN CONTAINS DIVERGENCES

- As Germany suffocates domestic demand through wage repression and mindless austerity, German macro conditions become relatively tighter
  - Financial conditions, credit, property prices ...
  - More SGP prompted austerity ... vicious circle ...

- Also undermines common monetary policy, as ECB stance becomes too easy for periphery
  - Financial conditions, credit, property prices ...
  - Fiscal ease as public finances seemingly healthy

- Feedback loops sustain divergences, smoothly financed by liberalized & integrated markets (equally wise as their dozing supervisors); fragilities build up
GERMAN EXPORT DESTINATIONS (% SHARES)

Source. Deutsche Bundesbank
GEOGRAPHY OF GERMAN MERCHANDISE TRADE SURPLUSES (% SHARES)

Source: Deutsche Bundesbank
4. Germany’s Euro Trilemma

- Germany can’t have all three:
  - Perpetual export surpluses, a no transfer / no bailout monetary union, & ‘clean,’ independent central bank
  
- Maastricht regime prohibits
  - CB financing of budget deficits (‘monetization’)
  - Fiscal transfers or ‘bailouts’ of partners
  - BUT NOT: beggar-thy-neighbor wage policies

- Alas, bankrupting the countries that buy your export surpluses not a smart idea, especially if you are also their lender
Germany’s IIP

Net Foreign Assets Peaked at 40%

Source: IMF IFS (June 2012)
NIIPs of GIIPS (plus France)

Source. IMF IFS July 2012
As German banks decline roll-over, ECB steps in as LOLR; ‘hello’ TARGET2 imbalances
A RATHER VULNERABLE ‘SAFE HAVEN’

Initially: German banks! (50% of foreign A & L)
  - ‘decreasing home bias seems to have been offset by an increased euro-area bias’; ‘Germany is .. more financially integrated in € area than .. in a real economic sense’ (Buba)
  - Damage partly parked in state-backed bad banks
  - Plus: Other financial institutions (portfolio flows)

Then increasingly taken over by official sector:
  - Bilateral loans (Greece bailout no. 1 etc)
  - EFSM/EFSF
  - ECB bond holdings (SMP)
  - Intra-Eurosistem (TARGET2)

Mainly, latter are not really new exposures, but just allow banks to pull out, while mutualizing bad debts and turning ECB into giant ‘bad bank’
5. Crisis Management

- Fiscal policy:
  - brief ‘Keynes moment’ followed by mindless austerity
- Fiscal support to financial sectors
  - Guarantees, recapitalizations, deposit insurance etc.
- ECB monetary policy:
  - foolish hikes, delayed easing
- ECB as LOLR to banking systems:
  - Promptly starting August 9, 2007, as euro banks exposed to U.S. subprime mess and ‘dollar gap’
  - Various, culminating in LTROs
- ECB as LOLR to governments(indirectly):
  - Securities Markets Program (SMP)
  - Outright Monetary Transactions (OMTs)
FROM CRISIS MANAGEMENT TO CRISIS RESOLUTION?

- Crisis resolution - and sustaining EMU - has three parts to it, and one precondition
  1) Rebalancing the currency union
     - Restoring intra-area equilibrium (transition; flows)
  2) Fair deal on debt legacies
     - Balance-sheet cleanup (past; stocks)
  3) Fixing (Maastricht) EMU regime
     - Establish viable EMU regime (future; flows & stocks)

- Precondition: robust GDP growth

- Alas, Euroland is failing dismally in every regard!
  - Perversely, markets even rewarding Germany
  - Hence, ever more of the same German medicine & economic ‘wisdom’ – that are killing the patient
FROM BAD TO WORSE

- Area-wide austerity suffocates growth
  - Sucking the air out of global recovery, too
- Asymmetric rebalancing forced upon debtors
  - Pushed into debt deflation by lethal mix of mindless austerity and structural reform
- Debt restructuring/forgiveness still taboo
  - Debtors drowning in legacy debts
- Regime reform features ‘more of the same’
  - Fiscal Compact and SGP on steroids
  - Macroeconomic Imbalance Procedure (MIP)
    - Asymmetric, as anything in (German) Maastricht think!
  - Banking union? Fiscal union?
    - Talks concern future crises, not resolving the current one!
      - Even Single Supervisory Mechanism (SSM) proving difficult
Symmetric adjustment or debt deflation?

- Convergence to Germany’s historical norm not good enough!
- Even France forced into debt deflation
ULTIMATE OBSTACLES ARE INTELLECTUAL

- German economic wisdom
  - Price stability and balanced budget cause growth
    - Well, only if others are kind enough to stimulate your exports sufficiently; assuming incomplete offset by currency appreciation
  - Germany scored own goal by exporting Buba ‘success model’ to Europe – only to then underbid its partners
- Small-country mindset afflicts euro leaders
  - Key motivation behind EU/euro was to join forces and be stronger globally as a union
  - Yet, euro policymakers continue to ‘think small’
- And now? Covering up key blunders as virtues
  - Follow German export model! The very problem!
THAT SINKING SOUND

HERE GOES THE ‘ISLAND OF STABILITY’ DREAM

1st Act: Greece
- GDP: 20% below pre-crisis; unemployment: 25%
- Budget deficit: -15.6% (2009) to -9.4% (2011)
- Fiscal retrenchment: >10%

2nd Act: Spain
- GDP: 5% below pre-crisis; unemployment 25%
- Budget deficit: -11.2% (2009) to -9.4% (2011)
- Fiscal retrenchment ongoing: >5%

3rd Act: France
- GDP: at pre-crisis level; unemployment 10.6%
- Budget deficit: -7.5% (2009) to -5.2% (2011)
- Fiscal retrenchment coming ...

Final Act: Germany
- GDP: up 2.5%; unemployment 5.5%
- Budget deficit: -4.1% (2010) to -0.8% (2011)
- Imported Swiss ‘debt brake’ will assure area-wide ‘expansionary’ fiscal contraction
FREELOADING ON EXTERNAL DEMAND

'Expansionary fiscal contractions' myth
Already undermining global recovery

Source. ECB, Eurostat (October 2012)
6. **Concluding Observations: Misdiagnosis, ill-medications, & misguided reforms**

- Maastricht EMU regime deeply flawed
- Germany reneged on ‘golden rule’ of MU
- Germany not facing up to its ‘euro trilemma’
- Instead, more wreckage through mindless austerity and structural reforms
  - Debt deflation, rising inequalities, destabilizing economies & nations ...
- Regime reforms do not address flaws; more myths
- Consequences for Europe? European integration?
- Consequences for global recovery? Global cooperation?
BACKGROUND TO ‘THE EUROLAND CRISIS AND GERMANY’S EURO TRILEMMA’


- See JB’s homepage http://www.skidmore.edu/~jbibow/research.htm