# *The Euro Payoff*:
## *Germany's Economic Advantages from a Large and Diverse Euro Area*

**Adam S. Posen, Peterson Institute for International Economics**

*Being the anchor economy for a currency zone has been a boon for Germany over the last dozen years. Not just political good will, but coldhearted economic calculations should compel Berlin to step up for the euro. But Germany's preferred plan of imposing additional macro rules and austerity on troubled partners is not the way to a healthy, stable Euro Area.*

In a speech at Davos, German Chancellor Angela Merkel committed her government to the survival of the euro. Neither the euro's survival nor the German commitment to it should ever have been in question, but she took the opportunity to make a "competitiveness pact" for Euro Area countries the condition for German support. Whatever policy deal emerges from the current negotiations, the intent is revealing. Germany's leadership, as well as a large number of citizens in Germany and some neighboring countries, clearly feel that a lack of discipline on the part of the hard hit Euro Area economies caused the euro crisis, and that Germany is once again sacrificing its economic interests in the service of European unity by bailing out the malingering economies. Therefore, they also believe that the economic stability of both the euro and Germany are best served by forcing the other euro economies to be as much like Germany as possible in economic policy if not in structure.

This is exactly the wrong conclusion to draw about what is at stake for Germany in the euro, and leads to a self-defeating policy approach that will not increase the euro's long-term resilience. European monetary unification that included more than the self-proclaimed "core" countries has been to Germany's own great economic advantage. This assessment does not depend upon appeals to enlightened political self-interest in European unity (though that is sufficient justification in itself) and is not a stalking horse for American or other countries' interests (though a strong stable euro is to the benefit of the West as a whole). Whatever the balance of economic costs and benefits of euro adoption for other countries, for Germany itself there are many advantages to being the anchor economy for a currency zone from which it has benefited over the last dozen years. Furthermore, all of those advantages increase with the size and the diversity of the Euro Area. For that reason, the best German long-term response to the euro crisis in its own self-interest is to pursue greater fiscal integration and stricter bank regulation within the Euro Area, not to impose additional macro rules and austerity.

**The Benefits of Size in Monetary Unions**

Currencies have network effects like the Internet does, meaning the more people that use a given currency, the more useful it is and the more people want to use it. Meanwhile, the direct costs of setting up a currency, including founding a central bank, arranging payments and data gathering facilities, and so on, are small and largely fixed. A smaller member economy of a currency union might suffer from increased size, in that the monetary policy decisions made put too little weight on the conditions in that economy (which is arguably part of what happened to Ireland and Spain pre-crisis). For the anchor currency of a monetary union—the largest economy and the one that the other member economies' business cycles respond to most—monetary policy decisions will be largely the same as those that would have been made for the anchor economy itself, because of its economic and political weight. The larger monetary union does not imperil price stability in the anchor economy if the central bank is independent and committed to price stability, which of course the European Central Bank (ECB) is. (In fact, average inflation was lower and less variable in Germany in the twelve years of the euro than in the preceding twelve years. The difference is not worth trumpeting, but it certainly puts the lie to inflation worries.) Thus, for Germany, the benefits of the Economic and Monetary Union (EMU) show increasing returns to scale.

First of these advantages to Germany is seigniorage: the public revenues generated when actual currency issued is used outside of the originating area. Throughout Eastern Europe and the Mediterranean, as well as in some forms of illicit commerce globally, cash euros are in wide usage—and that translates into hard cash for the German government budget, as much as 0.2 percent of GDP (or 5 billion euros) a year, every year. This usage abroad is much greater with more potential for growth than deutschmark (DM) usage ever had.

Second, companies doing business in the Euro Area get to price and invoice most of their transactions in euros without having to worry about exchange rate fluctuations. That applies to both German companies exporting to other

Euro Area members and foreign companies doing business in Germany. Greater certainty reduces transaction costs, lowering costs to the consumer. It also expands trade, creating more variety and competition, also of benefit to the economy's productivity growth.[1] Germany, as the euro exportmeister, benefits most from this network of stability—and again has a wider and deeper range of trade in its own currency now than it did under the DM. And that means more transactions with producers outside of the Euro Area are denominated in euros as well, reducing costs and risks there, too.

Third, interest rates available for businesses borrowing have been reduced on average. Some of this benefit was felt much more in other Euro Area economies, since Germany already had the lowest risk premia on its borrowing. Still, the significant deepening of euro-denominated bond markets has paid off for many German businesses, and households as well, by expanding access to credit. Deepening of bond markets is a direct result of the euro's wide adoption. This attracts inflows of capital to Europe beyond what came in to just the DM-denominated debt market, which increases liquidity.[2] These gains dwarf any feared risk premia on German or overall euro debt, and such premia may not even be applied despite the pressures on the crisis-hit countries' bond yields.

Fourth, it is already the case and could become even more prominently so, that the euro provides a platform for Germany to stand with the Americans, Chinese, Japanese, and other rising economic powers in international negotiations. Yes, Germany was an original member of the G-5 then G-7, and had often spoken for continental Europe in the late 20th century. Increasingly, however, it will require the weight and legitimacy of the Euro Area as a whole to have a major voice at the G-20 or IMF table. In fact, this is an argument for Berlin to favor greater Euro Area membership in German self-interest, as well.

Fifth, the larger the union, the more resistance the monetary union as a whole has to currency shocks and devaluations abroad. The euro, being a large currency area, can retain its value amidst global and even internal financial turmoil without the exchange rate either shooting through the roof as a safe haven currency or tumbling due to worries about some of the members. Given a turbulent economic situation like the current one, capital inflows large in size relative to the economy, and thus potentially destabilizing, would have pushed the smaller, pre-euro DM up strongly and rapidly (as has happened to the small Swiss Franc of late).[3] Today's euro is large enough to be stable and attract such inflows (when the negative shocks are external to the Euro Area and to Germany) without being destabilized by them.

**Benefits of Diversity in Monetary Unions**

Of course, for the Euro Area to be a large monetary union it had to include economies beyond the hard core of Austria, Benelux, Finland, and possibly France, along with Germany. We all know that such economic motivations were not behind the membership decisions in 1999 and those since. The issue for the present discussion, however, is whether this more diverse Euro Area membership has imposed economic costs on Germany to offset the benefits to Germany from the increased size of its currency area. Though it will be difficult for some to accept, the reality is that the diversity of the Euro Area itself confers benefits to the German economy.

First, greater economic diversity in the Euro Area strengthens the forces for deeper European economic integration. It is the real integration of markets, which increases competition and choice while reducing costs, that is a major ongoing source of economic benefit to German citizens (and to European citizens more broadly). The existence of the euro has not advanced economic integration beyond interbank and bond markets to the degree some had hoped—but it has enabled many economies within Europe, like Italy and Spain, to keep up with the pace of growth in trade and financial integration at the cutting edge of globalization, rather than falling behind or dropping out.[4] This has yielded direct benefits to productivity and to real incomes in Germany that might not otherwise have been achieved. Despite the concerns expressed by Chancellor Merkel and other German opinion leaders regarding the relative lack of wage restraint in non-core Euro Area members, the evidence is that almost all Euro Area members have converged toward German standards of keeping pay growth in line with (or sadly below) productivity growth.[5]

Second, differences in economic structures, development, and business cycles within the Euro Area lead to diversification of demand sources for the German economy. This provides a stabler growth path for Germany than if it were in a Euro Area with only similar economies on similar cycles. There has long been a shortage of domestic demand, both consumption and corporate investment, in Germany (which thankfully is ending with the current recovery). During this period, the availability of closely linked markets which were booming offset Germany's domestic

drag. Germany's euro partners absorb 40 percent of its exports on average, which meant those exports constituted a quarter of total growth in overall German demand from 2000 to 2008.

In theory, this could have come at some cost to Germany because the ECB's monetary policy could have been tighter than suited a slow-growing Germany—in order to restrain excess demand and inflation in these other members (though the effect from tighter money would have had to have been quite large to offset this benefit). In fact, this is where Germany's anchor status came into beneficial play. There is no empirical evidence that the ECB's monetary policy was meaningfully different from that which would have been set for Germany alone by the Bundesbank[6]—if anything, the policy was too loose for the peripheral Euro Area members, ex post.

Related to this, and probably most importantly, Germany benefits directly from the stability of currencies that the euro provides to surrounding countries—and that includes southern Euro Area members. Germany gets to run a trade surplus with member countries that otherwise would not be able to afford so many of its exports. People should remember what happened in 1992 and 1995, the last time other European economies found their combination of demand growth and real exchange rates against the German economy unsustainable: massive abrupt nominal depreciations against the DM, which hammered German export competitiveness and then shocked the depreciating economies. Those were lose-lose situations, and a repeat of such is what the euro prevents.

Compare that to the current crisis when all of the adjustment for intra-Euro Area trade imbalances is being forced domestically on the deficit countries, with no currency appreciation for Germany. It is harmful for the deficit economies, and likely unsustainable.[7] But the distribution of benefits at present demonstrates just how large the economic gain is for Germany from the current situation of encompassing major trading partners into euro membership. It translates into great stability for Germany's export companies in both orders and prices. Nonetheless, the situation is far from ideal for Germany.

**Policy Implications for Euro Resilience in the Longer-Term**

The current crisis of the short-term funding needs for indebted euro economies can be dealt with, if, as is likely, some orderly debt reduction (by another name) is included in the financing package to accompany the adjusting countries' austerity programs.[8] The main barrier is the will of the German government to resolve the situation. As mentioned, Chancellor Merkel has made it clear that her government intends to do so, albeit grudgingly. The point of this article is to argue that it should not be so difficult to summon up the will and to build domestic German support because a large and diverse Euro Area is in Germany's narrow economic self-interest (though admittedly this reality will be a hard sell in some quarters of German popular opinion).

A better understanding of Germany's advantages from a large, diverse monetary union should not only ease immediate crisis resolution, but also inform plans for improving the long-term resilience of the Euro Area. The German economy gets a direct economic payoff from having a large monetary union, to its federal treasury as well as German businesses' and consumers' bottom lines. The German economy is protected against exchange rate instability, and likely sharp declines in competitiveness, by keeping its less stable neighbors viably in the Euro Area. Finally, Germany benefits from being able to run a sustained trade surplus with its European neighbors, particularly in times of global contraction.

Thus, it is in the Germans' own enlightened self-interest to provide financing to ease the process of real adjustment in those Euro Area economies that have overstretched on spending on German goods. That will keep the markets open and prevent contraction in growth on both sides of the transactions. And the trade surplus needs to be honestly addressed—long-term. The economic logic is the same as the "transfer problem" that Germany faced from the other side when it was left with unsustainable debt and reparations demands in a fixed currency under the Versailles Treaty. The Allies had to restructure the debt and allow Germany to sell enough to them to generate sufficient income to make the resulting lower payments—even as Germany undertook austerity measures. Beyond a certain point, just demanding that Germany save more was financially fruitless for the creditors (as well as being politically destructive). The same economic reality holds today for core European creditors of Greece, Ireland, Portugal, and Spain, even if the political situation is, one hopes, less dangerous. Some combination of expanded German domestic demand (including wage increases for workers), continued net capital flows into crisis-hit Europe, recognition of German Banks' losses on loans to borrowers in the periphery economies (meaning recapitalization of German banks), and fiscal transfers are required. Some of this is thankfully underway, but other parts need to be an ongoing response rather than a crisis response.

An expanded Euro Area remains so much in Germany's direct interest that it is worth financing, if not paying for. Trying to impose excessive conformity of economic policies and structures on supposedly errant Euro Area members is not only likely to backfire—to whatever degree it succeeds, such a program will diminish the benefits that Germany receives from Euro Area monetary membership as the anchor economy. Furthermore, a constructive positive approach, including greater (though still small) fiscal transfers and issuance of strictly controlled euro bonds would be an investment in the continued attractiveness of the Euro Area to future members. And more members with more diverse attributes would continue to accrue to Germany's economic benefit.

**Notes**

1. See Andrew Rose, "One money, one market: the effect of common currencies on trade," *Economic Policy*, April 2000; and Richard Baldwin, "The Euro's Trade Effects," ECB Working Paper No. 594, March 2006.

2. See the papers on financial integration in Jean Pisani-Ferry and Adam S. Posen, eds., *The Euro at Ten: The Next Global Currency?,* Bruegel and PIIE, 2009.

3. See Martin Wolf, "Germans are wrong: the eurozone is good for them," *Financial Times*, September 7, 2010.

4. See the assessments gathered in Adam S. Posen ed., *The Euro at Five: Ready for a Global Role?*, PIIE 2005; and Pisani-Ferry and Posen, eds. (2009), ibid.

5. It seems that that the euro provided the anchor that allowed these economies to keep up with global trends in this direction, as opposed to propelling greater wage restraint specific to the euro area (and not, say, in Sweden or the UK)—but that is still a major shift from Greek, Italian, or Spanish wage setting practices prior to EMU. See Adam S. Posen and Daniel Popov Gould, "Has EMU Had Any Impact on the Degree of Wage Restraint?" in David Cobham, ed., *The Travails of the Eurozone*, Palgrave 2007.

6. Various econometric studies have shown this result in formal terms, but the evident fact is that German inflation, GDP growth, and real interest rates stayed within a range around the sustainable averages of the pre-EMU levels, and that range was no wider than under the Bundesbank monetary regime (leaving out unification) until 2008.

7. See Barry Eichengreen, "Jaemmerliches Versagen," *Handelsblatt,* December 1, 2010; or Gabor Steingart, "Versailles ohne Krieg," *Handelsblatt*, November 19, 2010.

8. An emerging consensus on how to do this successfully, and the needed German policy actions, can be found in Zsolt Darvas, Jean Pisani-Ferry, and Andre Sapir, *Bruegel Policy Brief* No. 02/2011, or Jacob Kirkegaard, "How Europe Can Muddle Through Its Crisis," PIIE Policy Brief 10-27, December 2010; and Kevin O'Rourke, "Germany's Choices," The Irish Economy blog, December 15, 2010.