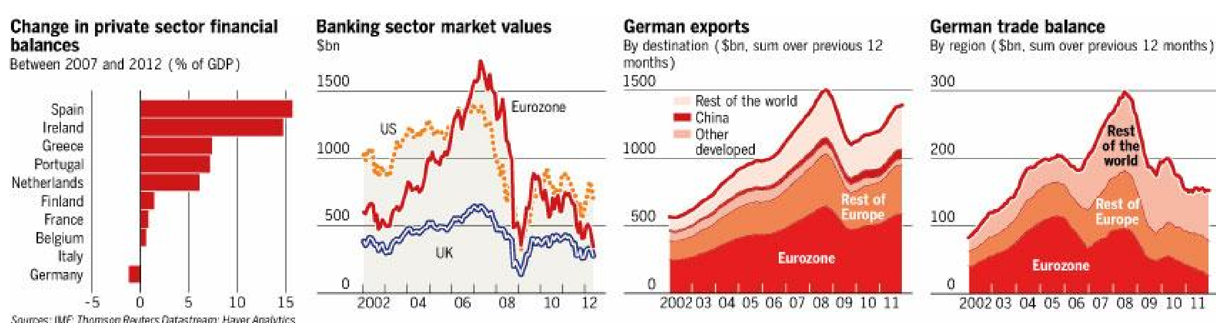
The riddle of German self-interest

Martin Wolf, May 29, 2012

How will the crises inside the eurozone end? Many people have asked me this question in the US in recent weeks. How, in particular, might the eurozone move from crisis into stability? To address this question, we need to distinguish three aspects of the turmoil: where the eurozone is going; where Germany wants the eurozone to go; and where the eurozone needs to go.

The eurozone's current position seems depressingly clear. A number of member countries, two of them – Italy and Spain – being large, already have, or are on the verge of having, governments unable to manage their public debt unassisted. Much of that debt is held by their banks. Many of these have been damaged, particularly in countries that experienced huge real-estate bubbles, large fiscal deficits or both. Governments with weak creditworthiness feel compelled to rescue fragile banking systems that are, in turn, expected to finance the governments trying to support them: the drunks are seeking to stay upright by leaning on one another.



Governments are also required to attempt fiscal austerity when private sectors are retrenching: between 2007 and 2012, the financial balance of the private sector shifted from deficit towards surplus by 16 per cent of gross domestic product in Spain (see chart). Austerity further weakens both economies and banks. This, in turn, raises unemployment and lowers government revenue, rendering fiscal austerity ineffective. Meanwhile, slack demand in the core reinforces economic weakness in the periphery, rather than offsets it.

With banks impaired, private demand damaged, government demand contracting and external demand weak, the fragile economies are likely to have smaller output and higher unemployment two or three years hence than now. The reward for pain today is pain tomorrow.

Whether or not Greece is "saved", for the moment it is hard to believe today's eurozone would survive this, particularly when the principal argument in its favour – that for economic and financial integration – is being destroyed. Businesses, particularly financial institutions, increasingly seek to match assets and liabilities by country. Equally, only the bravest business will plan production in the belief that exchange rate risk has been eliminated. With a rising share of cross-border risk now assumed by the European Central Bank, the way to break-up is becoming more open.

This looks like a long day's journey into night. It might take weeks, months or years. But the direction, alas, seems ever clearer.

Now turn to the second issue: how does Germany want the eurozone to be organised? This is how I understand the views of the German government and monetary authorities: no eurozone bonds; no increase in funds available to the European Stability Mechanism (currently €500bn); no common backing for the banking system; no deviation from fiscal austerity, including in Germany itself; no monetary financing of governments; no relaxation of eurozone monetary policy; and no powerful credit boom in Germany. The creditor country, in whose hands power in a crisis lies, is saying "*nein*" at least seven times.

How, I wonder, do Germany's policy makers imagine they will halt the eurozone's doom loop? I have two hypotheses. The first is that they believe they will not. They expect that life for some of the vulnerable economies will become so miserable that they will leave voluntarily, thereby reducing the eurozone to a like-minded core, and lowering risks to Germany's own monetary and fiscal stability from any pressure to rescue the weak economies. The second hypothesis is that the Germans really think these policies could work. One possibility is that the weaker countries would have so big an "internal devaluation" that they

would move into large external surpluses with the rest of the world, thereby restoring economic activity. Another possibility is that a combination of radical structural reforms with a fire sale of assets would draw a wave of inward direct investment. That could finance the current-account deficit in the short run, and generate new economic activity in the longer run.

Maybe German policy makers believe that it will be either harsh adjustment or swift departure. But "moral hazard" would at least be contained and Germany's exposure capped, whatever the outcome.

Yet the "exit of the weak" option looks very risky and the "painful adjustment and fire-sale" option so implausible as to lead swiftly back to exit. The danger, moreover, is not just to the weaker countries. Germany sends just 5 per cent of its exports to China, compared with 42 per cent to the rest of the eurozone, much of which would be disrupted by a meltdown. What has already happened has weakened its export-dependent economy: German GDP was only 1 per cent higher in the first quarter of 2012 than four years earlier. Beyond these narrowly economic dangers from damage to the "irrevocable" union would surely lie an enduring political disaster for the eurozone's economic hegemon.

In brief, the eurozone is now on a journey towards break-up that Germany shows little will to alter. This is not because alternatives are inconceivable. What is needed is to turn some of the Nos into Yeses: more financing, ideally via some sort of eurozone bond; collective backing of banks; less fiscal contraction; more expansionary monetary policies; and stronger German demand. Such shifts would not guarantee success. But they would give the eurozone at least a chance of avoiding the cost of partial or total break-up. To work in the long run, such shifts would also require greater political integration.

In October 1939, Winston Churchill said: "I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest." The key in Europe today is Germany's perception of its national interest. Once it becomes evident that their conditions will not work, German leaders will have to choose between a shipwreck and a change in course. I do not know which Germany will choose. I do not know whether its leaders know. But on that choice hangs the fate of Europe.

The German response

Martin Wolf, June 7, 2012

Last week I wrote a column entitled The riddle of German self-interest. To my surprise, it received a lengthy response from a senior and highly respected official of the German finance ministry. I am very grateful for this reply, because it clarifies the German finance ministry's position and raises a number of profound issues.

In the interests of clarifying these issues further, I comment below on some of the statements made in that letter.

From Mr Ludger Schuknecht:

> Sir, Martin Wolf ("The riddle of German self-interest", May 30) voices a fundamental critique of the European fiscal and economic policy strategy in the context of the current debt crisis. He argues that the "eurozone is now on a journey towards break-up that Germany shows little will to alter" given its many "neins" to anything that would break the "doom loop".
>
> Mr Wolf's solution for the current problems is risk transfer via eurobonds (of some sort), and demand stimulation via cheaper money and less fiscal consolidation in Germany. But the public and markets have been led to believe in short-term measures for far too long. And they know there is too much moral hazard already. Eurobonds would only make it worse and the healthier countries – mainly Germany and France – cannot even afford them.

Comment: At least three points are worth making here.

1. First, the aim is not risk transfer, but rather substantially to reduce the problems members of the currency union now have in retaining liquidity in their sovereign bond markets. Mr Schuknecht argues that such multiple equilibria are impossible. There is good reason to believe he is wrong, as the Belgian economist, Paul de Grauwe has written. I discussed this issue at length here .

2. Second, I do not know what "short-term measures", Mr Schuknecht is referring to. But the public presumably expects the eurozone at least to hit its inflation target. At present, there is good reason to doubt that it will.

3. Third, "moral hazard" is not the clincher Mr Schuknecht believes it is. We have fire brigades, despite moral hazard, because it is bad for the neighbourhood for a house to burn down. Nobody enjoys the experience of watching his house – or in this case, his economy – burn down. The idea that offering countries a cap on borrowing costs would encourage them to repeat the current experience is, to put it mildly, implausible. Governments really do dislike having 25 per cent unemployment rates (as in Spain today). The penalty is sufficient to discourage repetition.

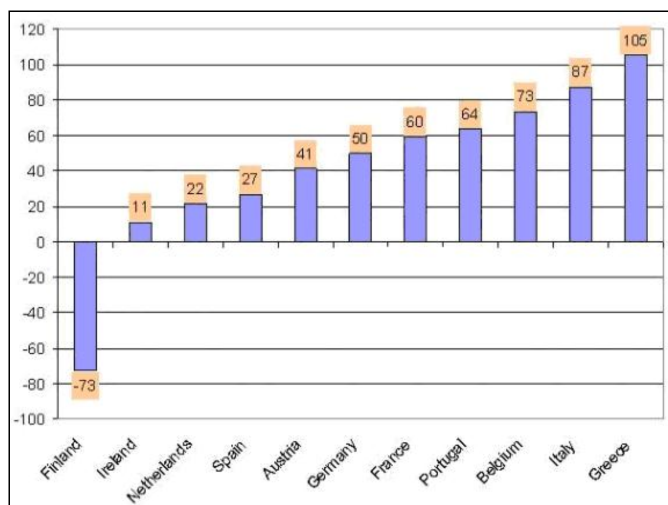
Mr Schuknecht:

I would rather believe that the public and markets want to see a credible path towards a prosperous, sustainable and competitive euro area. This is what they were promised at the start of the economic and monetary union. Indeed, it is expansionary policies and weak fiscal positions that created the current problems of high debt and low competitiveness in the crisis countries in the first place. This is why the European strategy to deal with the crisis seeks to regain confidence through a combination of fiscal consolidation and structural reforms that will improve competitiveness and growth prospects. Such reforms have invariably succeeded wherever they have been implemented.

Comment: Mr Schuknecht surely knows that "expansionary policies and weak fiscal positions" did not create "the current problems of high debt and low competitiveness in the crisis countries in the first place".

As the chart below (taken from the International Monetary Fund's World Economic Outlook database) shows, Ireland and Spain had exceptionally low net public debt before the crisis. Portugal's was close to that of France. Only Greece and Italy had relatively high debt. Italy's net public debt fell substantially, relative to GDP, in the period leading up to the crisis, though not perhaps enough.

Net Public Debt 2007 (relative to GDP)



What did cause the crisis were huge balance of payments deficits, induced by excessive private lending, most of it to private borrowers (with the exception of Greece). The responsibility for such lending and borrowing surely rests on the shoulders of both lenders and borrowers.

As to the claim that "Such reforms have invariably succeeded wherever they have been implemented", I can think of important cases where they failed: Argentina in the 1990s, for example. I fear this is a tautology: where such policies failed, they were not tried, by definition.

Moreover, "structural reform" is a woolly term. If by this Mr Schuknecht means that falling prices, induced by ultra-high unemployment, debt deflation and sovereign and banking insolvencies, will ultimately restore competitiveness, he is correct, provided the country is able to stick with such policies, for a very long period indeed (probably a decade, or even far longer). This is what is required if a country with a large private sector debt overhang and a sizable structural current account deficit is to eliminate its fiscal deficit, regain competitiveness and restore growth, particularly in a currency union whose core country has a structural current account surplus and low inflation. The question is whether democratic politics (or the eurozone) will survive the experience. I doubt it.

Mr Schuknecht:

Rebuilding confidence also entails making European Union institutions more credible. Fiscal and macroeconomic surveillance and banking regulation and supervision are being strengthened. Firewalls worth about €1tn euro have been erected and supplemented by International Monetary Fund money. Given what we have achieved, any decision to disregard the rules or introduce ill-suited tools such as eurobonds could undermine this effort to rebuild confidence.

Comment:Mr Schuknecht must recognise that the firewall he mentions is in conflict with his desire to eliminate moral hazard. So we are really just talking abut its size. The question is whether the available firewall is big enough to deal with likely crises. The answer is: no. I agree that eurobonds (which would need to be conditional) are only one way to provide a firewall. I agree, too, that long-run fiscal transfers are undesirable (and have said so). The whole of southern Europe must not be turned into a large Mezzogiorno.

Mr Schuknecht:

Moreover, just as the European Central Bank has a duty to focus on the goal of maintaining price stability, Germany must not undermine its role as an anchor of stability via inappropriate and ineffective fiscal stimuli. Incidentally, the social implications of Mr Wolf's recipe are highly problematic too. The short-term measures he puts forward focus on countering the deflationary tail-risks arising from financial instability. They would benefit those whose considerable fortunes were built or bolstered through excessive risk-taking during the pre-crisis boom. By neglecting the tail-risk of a destabilising loss of confidence in our money, his approach would put at risk the savings of those who have no way out: the cash-holding lower and middle classes.

Comment: I do not think an attempt at symmetrical adjustment inside the eurozone would undermine German stability. But it would certainly be helpful to eurozone stability if, during the lengthy adjustment period ahead, German policymakers focused on policies likely to expand domestic demand. It does not really matter to the outside world what those policies are. An investment boom or a rapid rises in real wages would also be excellent.

As to the question of benefiting those who created the crisis, may I point out that German lenders were part of the problem. Are they (and other creditors) paying the penalty for their mistakes or are taxpayers in debtor countries being forced to assume the bulk of the costs?

Mr Schuknecht:

"Finally, let me reflect on Mr Wolf's riddle of German self-interest. If one accepts the narrative that the risk of shipwreck comes from excessive "short-termism", then there is no riddle at all. German and European interests are indeed very much aligned and they are reflected in the jointly agreed strategy. Germany will play its full role in implementing it – in its own and Europe's interest."

Ludger Schuknecht, Director General, German Ministry of Finance, Berlin, Germany

Comment: I fear that austerity without end will bring about a return to the unstable populist politics the European Union was designed to prevent. That could shatter the eurozone and, with it, the EU, thereby ending the most successful attempt to build peace and prosperity in Europe since the fall of the Roman Empire.

Moreover, it is clear – and has long been so – that the responsibility for preventing that outcome rests on Germany, Europe's central power, in every sense. As Charles Kindleberger argued, in a panic, the creditworthy country has to lend freely if a fixed exchange rate system (or in this case a currency union) is to survive.

It is often forgotten, not least in Germany, that the rise of Adolf Hitler to power was preceded not by the great inflation, which occurred a decade before, but by the great depression and the austerity of Heinrich Brüning, in response. Thus, votes for the Nazi party jumped from a relatively insignificant 810,000 in 1928, to 6.4m in 1930, and 13.7m in July 1932. Deep economic collapses are dangerous.

Deep economic collapses are very dangerous. Mr Schuknecht, with his emphasis on the long term, completely ignores these dangers. If trying to avoid such a dire outcome is "short-termism", so be it. I think of it as trying to find a practical exit from the current trap. Without it, the eurozone may never reach the long term.

Fiat justitia, et pereat mundus (let justice be done, even if the world perishes) is a dangerous motto.