GERMANY AND THE EUROLAND CRISIS: THE MAKING OF A VULNERABLE HAVEN

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AIM & STRUCTURE OF PRESENTATION

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

- STRUCTURE
  1. Euroland in global perspective
  2. A look inside Euroland
  3. Causes behind divergences & imbalances
  4. From crisis management to crisis resolution?
  5. Germany’s ‘euro trilemma’ & vulnerability
  6. Conclusion: Misdiagnosis, ill-medication & ill-guided reforms
1. **EUROLAND IN GLOBAL PERSPECTIVE**

**General government net lending/net borrowing**

- **US**
- **Japan**
- **UK**
- **Euro area**

Source: IMF WEO October 2012
PUBLIC DEBT

Source. IMF WEO October 2012
CURRENT ACCOUNT POSITION

Source. IMF WEO October 2012

How about G-20 commitment???
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 failure of Maastricht EMU regime

- €land crisis and rising external surplus poses a serious threat to global recovery & rebalancing!
  - In euro authorities’ imagination “the euro is ...a pole of stability for the global economy” (Almunia 2008).
2. **Inside Euroland: Government Balances**

Source: IMF (WEO October 2012)
PUBLIC DEBT

Source. IMF (WEO October 2012)
CURRENT ACCOUNT POSITIONS

Source: IMF (WEO October 2012)
ASSESSMENT

- Crisis countries (GIIPS) both externally and fiscally challenged (Spain only since crisis!)
- Creditor countries fiscally in better shape too
- No surprise here:
  - Private sector + public sector + external sector = 0
    - Union externally balanced but large intra-area imbalances!
  - 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

- Confirms massive failure of Maastricht EMU regime indeed!
3. Causes behind intra-area divergences & 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 ensure 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!

IRONY: While Euro was meant to ban ‘beggar-thy-neighbor’ ER devaluations forever, reneging on ‘golden rule’ did it!

Cumulative wage inflation

Source: OECD Economic Outlook no. 91 (May 2012)
**Golden Rule of Monetary Union**

- **MU** = commitment to common inflation rate
  - National unit-labor cost (ULC) trends must be aligned with common inflation norm (ECB: 2%)
  - As divergences are *cumulative*, they lastingly distort competitiveness positions, causing current account imbalances
    - And *persistent* CA imbalances involve debt buildups

- Myth that Germany had to ‘restore’ its competitiveness
  - If ‘restoring competitiveness’ means ending up with an 7.5% current account surplus, good luck with rebalancing Euroland! And world economy too!
NASTY CONSEQUENCES!

- As Germany turns “über-competitive”
  - Internally, Euroland seriously unbalanced
  - Externally, euro exchange rate too weak for Germany, too strong for rest
  = asymmetric shock!!

- One-size-does-NOT-fit-all ECB policy
  - Too tight for Germany ... domestic demand flat
  - Too loose for periphery ... ‘hello’ bubbles ...

“Today, in light of the evidence gathered so far in the euro area, I am more confident in saying: ‘One size does fit all!’” (Issing 2005, May).
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 Spain (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
‘SICK MAN OF THE EURO’: GERMANY 2001-5

THE ART OF FLYING ON ONE ENGINE

Cumulative GDP growth and its sources

Source. OECD Economic Outlook no. 91 (May 2012)
GERMAN EXPORT DESTINATIONS (% SHARES)

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

Source. Deutsche Bundesbank
GERMANY’S IIP

NET FOREIGN ASSETS PEAKED AT 40%

Perpetual current account surpluses boost net IIP
Euro & financial integration inflate gross IIP

Source: IMF IFS (June 2012)
NIIPs of GIIPS (plus France)
Spain’s net foreign assets peaked at -100%
4. From Crisis Management ...

GFC = crisis trigger ... as homemade bubbles burst

- Fiscal policy
  - Brief ‘Keynes moment’ in 2009
- Fiscal support to financial sectors
  - Guarantees, recapitalizations, deposit insurance etc.
- ECB monetary policy
  - Foolish hikes, delayed easing (i.e. business as usual)
- ECB as LOLR to banking systems
  - Various, culminating in LTROs
- ECB as LOLR to governments (indirectly)
  - SMP, OMTs
... 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)

- **Precondition:** robust GDP growth
Convergence to Germany’s historical norm not good enough!
Even France forced into debt deflation
2) ... **Magnifies need for Debt relief**

- “The more the debtors pay, the more they owe” (I. Fisher 1933).

- Recent deal on Greek OSI only the foretaste!
  - More in pipeline (Portugal, Ireland, Spain ...)

- EMU partners share *mutual responsibility* for setting up a rotten EMU regime and failing to make it work
  - German strategy to hold out until regime reforms are agreed costly for Germany, and hopeless too ...
3) … AS “MORE-OF-THE-SAME” STYLE REFORMS MEAN PERPETUAL AUSTERITY

- SGP/Fiscal Compact imply public debt ratio converging to zero (or even debt paid off), which can only work if:
  - Either private sector seizes to be net saver
  - Or ROW tolerates perpetual, large CA surplus of Euroland
    - *Repeating Germany’s feat inside union for union as a whole externally*

- Macroeconomic Imbalance Procedure
  - Placebo. Primary aim was acquittal of Germany, turning key blunder into virtue (to justify more structural reform)

- Structural reform NOT a growth strategy though
  - As distributional impact further undermines domestic demand … now continent-wide …
IN NUTSHELL, FROM BAD TO WORSE

- Asymmetric rebalancing by lethal mix of mindless austerity and structural reform = debt deflation

- While still taboo, need for debt relief rising

- ‘More-of-the-same’ regime reforms guarantee eventual € breakup

- Suffocating growth by area-wide austerity means breakup will come sooner rather than later
  - Perversely, markets are rewarding Germany while German austerity medicine is slaying Europe
5. Germany’s ‘€ trilemma’ & vulnerability

The ‘€ 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
- As private flows reverse, something has to give …
A RATHER VULNERABLE ‘SAFE HAVEN’

- Buildup of Germany’s foreign assets concentrated in Euroland
  - ‘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)
  - Originally, German banks! (50% of foreign A & L)
    - Damage partly parked in German state-backed bad banks
    - And partly passed on to Euro bad bank (aka ECB)
  - Plus: Other financial institutions (portfolio flows)

- Germany’s foreign liabilities little more global (bunds)
  - German banks have also cultivated sizeable ‘USD gap’
As German banks decline rollover, ECB steps in as LOLR; ‘hello’ TARGET2 imbalances

End-2008, Germany’s (net) IIP vis-à-vis Euroland nearly equal to its global IIP
OFFICIAL FLOWS REPLACE PRIVATE FLOWS

- Private exposures turning into official exposures
  - Bilateral loans (Greece bailout no. 1 etc)
  - EFSM/EFSF (... ESM)
  - ECB bond holdings (SMP ... OMTs ...)
  - Intra-Eurosysterm (TARGET2)

- So-called ‘bail-outs’ and Buba’s TARGET2 position are NOT new net exposures

- Measures just allowing banks to pull out
  - Actually, as ECB turning into giant ‘bad bank’, debts are – at least temporarily – mutualized

- All comes to nothing as debt deflation unfolds ...
A BREAKUP SCENARIO

- Exiting country (or countries)
  - Government(s) makes creditors among nationals whole, acting as counterpart to debtors among nationals; national debt relief as *net foreign debt nullified*
  - While new national currency restores competitiveness

- Last euro man standing (say, Germany)
  - Loses (ex-)€land part of IIP (incl. TARGET2)
  - Bailout of banks, insurances, pensions etc leads to surge in German public debt (well beyond 120%!)
  - As surging new also wipes out German export industries, causing severe recession & mass unemployment

- NOT a recommendation! Just reminder of a truth …
  - “If you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has” (JMK)
6. **Conclusion: Misdiagnosis, Ill-Medication, & Misguided Reforms**

- Maastricht EMU regime deeply flawed
- Germany reneged on ‘golden rule’ of MU
  - Not ‘sovereign debt crisis’, but banking & BOP crisis
- No crisis resolution in sight anywhere, for now euro remains firmly on track for breakup
- Germany ignored its ‘euro trilemma’, for the time being markets ignore Germany’s vulnerability
  - Draghi’s liquidity bluff will be called

*Ultimately, only a EURO Treasury will do!*
THANK YOU!

Background to ‘Germany and the Euroland crisis: The making of a vulnerable haven’

- ‘The Euroland crisis and Germany’s euro trilemma’,

- ‘At the crossroads: The euro and its central bank guardian (and savior?)’
  - Forthcoming in Cambridge Journal of Economics.


- See my homepage http://www.skidmore.edu/~jbibow/research.htm
- At Levy Economics Institute http://www.levyinstitute.org/scholars/?auth=20