A German end to the Euro vision

by

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Once upon a time European leaders believed in a step-by-step approach of European integration. Each step would bring Europe closer to the target of closely related but still independent states. According to this vision states would be willing to relinquish more and more of their independence, in order to gain advantages of peace, global strength through political cooperation and economic strength as a result of a big common market. In this approach, the creation of a monetary union was just one of these consecutive and unavoidable steps on the path to strengthen political cooperation and to complete the common market with its indisputable advantages for all European citizens.

Unfortunately, a dozen years after the start of the European Monetary Union (EMU) reality tells a different story. EMU is in troubled water and captain Merkozy is steering the boat towards some dangerous rocks that could mark the end to a long and peaceful ride of a formerly war torn region.

Much has been said about the folly of pushing countries to cut public expenditure, increase taxes and put pressure on wages in the middle of one of the deepest recessions in modern history. However, even the outspoken critics of the Merkozy approach rarely go to the core of the matter and discuss the long established economic policy approach of the country that has come out of that recession like a phoenix from the ashes and is still celebrating its unique role and success. To the contrary, Germany is considered by many as the role model for the rest of the union. That is the biggest mistake and the real reason why Europe is committing economic suicide instead of tackling its problem at the root.

Since the end of Bretton Woods, Germany's economic policy has been based on two main pillars: competition of nations and monetarism. Both are irreconcilable with a monetary union. A monetary union is in essence a union of countries willing to harmonize their rates of inflation and to sacrifice national monetary policies. A country like Germany, fighting for higher market shares in international markets, tries to achieve the opposite. It has to undercut the cost and price level of its main trading partners by whatever means. A monetary union formed by already closely integrated countries becomes a rather closed economy and needs domestic policy instruments like monetary policy to stimulate growth time and again. German monetarism asks for the opposite, the absence of any discretionary action of central banks and relies solely on flexibility of prices, in particular wages.

Along these lines the story of EMU's failure is quickly told. From the very beginning of the monetary union, German politicians put enormous pressure on trade unions to help engender an increase of unit labour cost and prices that was less than in other countries. It got an easy harvest among the members of the currency union who could no longer escape by devaluing their currencies to maintain competitiveness as they had done hitherto. The domestic arm of that policy, the effort to stimulate employment creation through lower wages and restructuring of production towards more labour intensive modes, was a complete failure. Stagnating real wages resulted in stagnating domestic demand instead of what was expected, namely lower real wages per head multiplied by an increased number of heads, producing an unchanged domestic demand. But on the external side the effects got stronger as small annual effects accumulated over time and, after ten years, created a huge gap in competitiveness in favour of Germany. Germany built up huge current account surpluses and Southern Europe and France accumulated the complementary deficits.

The ECB, in good German monetarist tradition, celebrated the achievement of the target of two percent inflation on average, while ignoring the fact that her apparently successful steering of euro zone's monetary policy was built on two-sided violation of the inflation target. Without Germany's undershooting of the target the overshooting in Southern European countries would not have been compatible with two percent overall.

The result is disastrous for the southern European economies as they are losing permanently market shares without being able to successfully retaliate the German attack. With German politics refusing to move in terms of higher wages they would need a number of years with falling wages to come back into the markets. However, the time to do that is not available as falling wages mean falling domestic demand and recession in the first place in countries, like Italy or Spain, which have small export shares of some 25 percent of GDP. The resulting depression would not be politically bearable.

But even a political tour de force would be in vain as Germany is blocking the indispensible short and medium term relief measures. The deficit countries will remain in current account deficits and will not be able to reduce their budget deficits until EMU as a whole recovers strongly. But direct intervention by the ECB to bring down bond yields as well as Eurobonds to bridge the time till the deficit countries' competitiveness is restored is blocked by the German economic policy doctrine. If monetarism of the German brand is not explicitly abandoned, there is no way out.

To make a long story short: There is a solution but as long as no one openly challenges the consistency of Germany's economic policy strategy with the logic of a monetary union the boat approaches the rock at high speed.