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SNAPSHOT

Why Only Germany Can Fix the Euro

Reading Kindleberger in Berlin

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"Never did a ship founder with a captain and a crew more ignorant of the reasons for its misfortune or more impotent to do anything about it." This was Eric Hobsbawm's damning judgment of the policy elite's response to the Great Depression. As these leaders reached for the old truisms of balancing budgets, lowering tariffs, and restoring the gold standard, they merely worsened the crisis. The same judgment may soon be passed on Germany for its role in the ongoing European sovereign debt saga.

After watching the economies of Greece, Ireland, and Portugal founder, the world has now turned its attention to Italy, home to the world's eighth-largest national economy and third-largest sovereign bond market. The diagnosis is sadly redolent: Europe should deflate its way to growth by sticking with a gold standard of sorts: the hard-money German-dominated euro. Meanwhile, under enormous international pressure, the Greeks replaced socialist Prime Minister George Papandreou with Lucas Papademos, a former official of the European Central Bank, and the Italians placed economist and former European Commissioner Mario Monti, hailed "super Mario," in the stead of Silvio Berlusconi. Yet despite the EU's coup d'état, the yield on ten year Italian debt went back above seven percent within twenty-four hours of Monti showing up for work.

It is more than ironic that those two foundational Western civilizations -- the Greeks and the Romans -- who were among the very first to experiment with democracy, now have to let unelected Eurocrats run their economic affairs. There is even a whiff of the 1930s here, too, as weak democrats are pushed aside in favor of strong leaders at the behest of international creditors. As Hobsbawm noted, this did not end well last time.

What, we must ask, has driven Europe to this point? Since the beginning of the current economic crisis, analysts have offered multiple explanations. American economists call it a "crisis of design," arguing that Europe had it coming. Fiscal hawks the world over prefer the budgetary explanation, focusing on Greece's underreported public spending, bloated state, and generous pension system. They then generalize these problems to all of Europe (never mind that Italian private debt is relatively low, as is its public spending in comparison to most other developed countries). For their part, elites in Germany blame lagging competitiveness and "too-high" real wages in the Mediterranean countries. Still others point to intra-European macroeconomic imbalances. There is probably something to all of these explanations. But the depth and duration of this crisis call for a more complex, systemic, and historical account. After all, when explaining the collapse of a bridge, there is little point in blaming the last vehicle that crossed it.

This complex of causes does however have a common root: Germany's failure to act as a responsible hegemon in Europe. It is not that Germany should be unseating democracies and enforcing deflation, as it has attempted to do by installing Papademos in Greece and Monti in Italy. Rather, it should be stabilizing the eurozone by providing a set of public goods that the institutions and policies of the region have singularly failed to supply. To solve the European crisis and avoid repeating the mistakes of the late 1920s and the 1930s, those sitting in Berlin and Brussels should put down their Andrew Mellon and read Charles Kindleberger.

In *The World in Depression: 1929-1939*, Kindleberger argued that "the 1929 depression was so wide, so deep, and so long because the international economic system was rendered unstable by British inability and U.S. unwillingness to assume responsibility for stabilizing it." Indeed, Kindleberger's critique of the United States' role in that era's crisis summitry might well have been written about Germany today: "The World Economic conference of 1933 did not lack ideas ... [but] the one country capable of leadership was bemused by domestic concerns and stood aside."

In order to guarantee the strength of any international economic system, Kindleberger explained, a stabilizer -- only one stabilizer -- needs to provide five public goods: a market for distress goods (goods that cannot find a buyer), countercyclical long-term lending, stable exchange rates, macroeconomic policy coordination, and real lending of last resort during financial crises. The United States did not supply these things in the 1930s. Germany fails the test on all five items today.

First, rather than providing peripheral countries with a market for their distress goods, the Germans have been enthusiastically selling their manufactured goods to the periphery. According to Eurostat, Germany's trade surplus with the rest of the EU grew from 46.4 billion euro in 2000 to 126.5 billion in 2007. The evolution of Germany's bilateral trade surpluses with the Mediterranean countries is especially revealing. Between 2000 and 2007, Greece's annual trade deficit with Germany grew from 3 billion euro to 5.5 billion, Italy's doubled, from 9.6 billion to 19.6 billion, Spain's almost tripled, from 11 billion to 27.2 billion, and Portugal's quadrupled, from 1 billion to 4.2 billion. Between 2001 and 2009, moreover, Germany saw its final total consumption fall from 78.5 percent of GDP to 74.5 percent. Its gross savings rate increased from less than 19 percent of GDP to almost 26 percent over the same period.

Second, instead of countercyclical lending, German lending to the eurozone has been pro-cyclical. Indirectly (through buying bonds) and directly (by spreading its exchange rate through the euro), the country has basically given the periphery the money to buy its goods. During the economic boom of 2003-2008, Germany extended

credit on a massive scale to the eurozone's Mediterranean countries. Frankfurt did quite well for itself. "European Financial Linkages," a recent IMF working paper, reveals that in 2008, Germany was one of the two biggest net creditors within the eurozone (after France). Its positive positions were exact mirrors of Portugal, Greece, Italy, and Spain's negative ones. Of course, as the financial crisis began to escalate in 2009, Germany abruptly closed its wallet. Now Europe's periphery needs long-term loans more than ever, but Germany's enthusiasm for extending credit seems to have collapsed.

And what about the third public good, stable exchange rates? By definition, the euro gives the countries that choose to join it a common external float, the credibility that comes with banking in a potential global reserve asset, and the credit rating of its strongest member. This is both true and where the problems begin. At the core of the eurozone lies a belief that, if countries adhere to a set of rules about how much debt, deficit, and inflation they can have, their economies will converge, and the same exchange rate will work for all members. This is true in theory, but only so long as countries obey the rules. And, despite being the author of many of those rules, Germany showed a singular lack of leadership and responsibility when it came to following them. When it broke the Stability and Growth Pact (SGP) in 2003, it sent the signal to the smaller countries that fiscal profligacy would go unpunished. The result was heightened public sector borrowing and increased public spending. Germany's enthusiastic lending to the periphery only exacerbated the problem.

Fourth, economic health requires the stabilizer to coordinate macroeconomic policy within the system. In this domain, Germany failed spectacularly, by insisting that the rest of the world follow its peculiar ordoliberal economic philosophy of export-oriented growth. By ignoring long-established ideas such as the Keynesian "paradox of thrift" or the "fallacy of composition," Germany is advocating a serious dose of austerity in the European periphery without even a hint of offsetting those negative economic effects with stimulus or inflationary policies at home. German growth, after all, was partially fueled by demand in Southern Europe (made possible by excess German savings). By the iron logic of the balance of payments, one country's exports are another country's imports and one country's capital inflows are another's capital outflows. So, the eurozone as a whole cannot become more like Germany. Germany could only be like Germany because the others countries were not. Insisting on ordoliberal convergence is guaranteed to produce economic instability, not stability.

Finally, Kindleberger would want Germany -- or, rather, the ECB, which is dominated by Germany -- to act as a lender of last resort by providing liquidity during the current crisis. Germany instead insisted on IMF conditionality for the bailout countries and on severe fiscal austerity measures in exchange for limited liquidity, thus failing Kindleberger's final test. The most obvious example is German obstinacy against letting the ECB play the role that the Federal Reserve played in the United States in 2008 and 2009. By lending heavily, the Fed was able to arrest the United States' slide into despair. Only a couple of days ago, Jens Weidmann, the president of Germany's powerful Bundesbank, flat-out rejected the idea of using the ECB as "lender of last resort" for governments, warning that such steps "would add to instability by violating European law." It is hard to see how yet one more violation of European code will add significantly to the already horrendous levels of instability, when brushing democracy aside is considered good for the euro.

Throughout much of the twentieth century, the "German Problem" -- the fact that Germany was too strong, too powerful, and too economically dynamic for the rest of Europe -- bedeviled European elites. "Keeping Germany down" through NATO and European integration was seen as the solution. The problem today is not German

strength but German weakness -- a reluctance to take up its hegemonic role. It is not too late for Germany to change course. Even though they have profited handsomely so far from the current arrangement, they must realize by now that its model was always based on shaky foundations, cannot be generalized to all states, and has reached the limits of its sustainability. If the euro ends up collapsing -- and the European Union with it - Germany will clearly be much worse of. Many of its markets will disappear while the new deutschmark soars to unknown heights. In such a world, the 'old' German problem would be back at the heart of the 'new' Europe.

Former U.S. Secretary of State Dean Acheson once observed that the United Kingdom had lost an empire but had yet to find a role. In a way, by signing the Maastricht Treaty in the early 1990s, Germany has accidentally grown an economic empire. It has a role -- a leader, not a rule maker -- but is clearly not yet conscious of it.

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