Europe’s Surplus of Stagnation

LONDON – While the rest of the world recovers from the Great Recession of 2008-2009, Europe is stagnating. Eurozone growth is expected to be 1.7% next year. What can be done about it?

One solution is a weaker euro. Earlier this month, the chief executive of Airbus called for drastic action to reduce the value of the euro against the dollar by about 10%, from a “crazy” $1.35 to between $1.20 and $1.25. The European Central Bank cut its deposit rates from 0 to -0.1%, effectively charging banks to keep money at the Central Bank. But these measures had little effect on foreign-exchange markets.

That is mainly because nothing is being done to boost aggregate demand. The United Kingdom, the United States, and Japan all increased their money supply to revive their economies, with currency devaluation becoming an essential part of the recovery mechanism. ECB President Mario Draghi often hints at quantitative easing – last month, he repeated that, “if required, we will act swiftly with further monetary policy easing” – but his perpetual lack of commitment resembles that of Mark Carney, the governor of the Bank of England, whom one former UK government minister recently compared to an “unreliable boyfriend.”
But the ECB’s inaction is not wholly responsible for the appreciation of the euro’s exchange rate. The pattern of current-account imbalances across the eurozone also plays a large role.

Germany’s current-account surplus – the largest in the eurozone – is not a new phenomenon. It has existed since the 1980s, falling only during reunification, when intensive construction investment in the former East Germany more than absorbed the country’s savings. The external surplus has grown especially rapidly since the early 2000s. Today, it remains close to its pre-crisis 2007 level, at 7.4% of GDP.

Now, however, previously deficit-stricken countries are moving into surplus, which means that the eurozone’s current account is increasingly positive; indeed, the eurozone-wide surplus is now expected to be 2.25% of GDP this year and next. The eurozone is saving more than it is investing, or, equivalently, exporting more than it is importing. This is strengthening its currency.

Back in October 2013, the US Treasury pointed the finger at Germany’s structural surplus as the source of Europe’s woes. Its argument was that if one country runs a surplus, another must run a deficit, because the excess savings/exports of the surplus country must be absorbed by another country as investment, consumption, or imports.

If the surplus country takes no steps to reduce its surplus – for example, by increasing its domestic investment and consumption – the only way the deficit country can reduce its deficit is by cutting its own investment and consumption. But this would produce a “bad” equilibrium, achieved by stagnation.

Something like this seems to have happened in the eurozone. Germany has retained its “good” surplus, whereas the Mediterranean countries slashed their deficits by cutting investment, consumption, and imports. Greece's unemployment rate soared to nearly 27%; Spain’s is almost as high; and Portugal faces a banking crisis.

In November 2013, Paul Krugman wrote that, “Germany's failure to adjust magnified the cost of austerity.” Though it “was inevitable that Spain would face lean years as it learned to live within its means,” Krugman argued, “Germany's immovability was an important contributor to Spain's pain.”

But Germany rejected this logic. Its current-account surplus was its just reward for hard work. Indeed, according to the German finance ministry, the surplus is “no cause for
concern, neither for Germany, nor for the eurozone, or the global economy.” Because no “correction” was needed, it was up to the deficit countries to adjust by tightening their belts.

John Maynard Keynes pointed out the deflationary consequence of this attitude in 1941. Deficit countries with a fixed exchange rate (as is the case in the eurozone) are forced to cut their spending, while surplus countries are under no equivalent pressure to increase theirs. Keynes’s proposed solution to this problem was an international payments system that would force symmetric adjustment on both surplus and deficit countries. Persistent surpluses and deficits would be taxed at an escalating rate. His plan was rejected.

Of course, a creditor country can always help a debtor by investing its surplus there. Germany is willing to do this in principle, but insists that austerity must come first. The problem is that stagnation ruins investment prospects.

China has shown that voluntary adjustment by a surplus country is possible. Until recently, the global imbalances problem was centered on China’s bilateral surplus with the US. China used its excess savings to buy US Treasury bonds, which drove down world interest rates and enabled cheap borrowing, permitting America to run a vast current-account deficit. The main impact of low interest rates, however, was to fuel the housing bubble that burst in 2007, leading directly to the 2008 financial crisis.

Since then, China has made great efforts to reduce its external surplus. At its peak of 10.1% of GDP in 2007, the surplus was larger than Germany’s; by the end of 2013, it had plummeted to 2% of GDP.

Why was China willing to adjust while Germany would not? Perhaps a key difference lies in the fact that Germany has significant political clout over the deficit countries with which it trades. Germany was effectively able to force austerity upon its neighbors.

That raises an important issue regarding the legitimacy of austerity. Its main proponents are creditors, who have much to gain from it (relative to the alternative of raising domestic wages and forgiving debts). Creditor-debtor conflicts have always been the stuff of monetary politics, and the persistence of austerity has set the stage for a new debtors’ revolt.

So we will have to rely on Draghi and quantitative easing to save the euro from Germany.
Money will have to fall from the proverbial helicopter before Germany shows any willingness to reduce its surplus.

http://www.project-syndicate.org/commentary/robert-skidelsky-takes-germany-to-task-over-its-refusal-to-address-its-massive-current-account-surplus

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