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Reform alone is no solution for the eurozone

Martin Wolf Author alerts

A policy that may work for Germany alone cannot work for an economy more than three times as big

Might the policies of the eurozone result in a robust recovery? My answer is: no. Since the eurozone generated 17 per cent of world output in 2013 (at market prices), that answer has global significance.

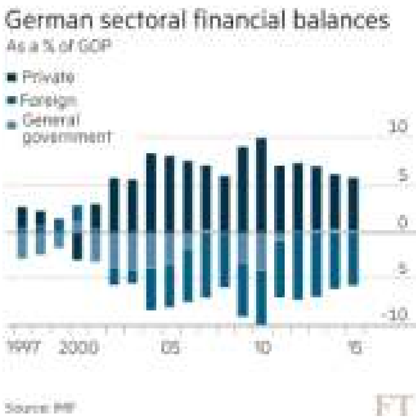
It is Germany that set the economic strategy of the eurozone. It consists of three elements: structural reform; fiscal discipline; and monetary accommodation. So far, this set of policies has failed to generate adequate demand: in the second quarter of 2014, real demand in the eurozone was 5 per cent smaller than it was in the first quarter of 2008.

Both France and Italy are being encouraged to accelerate "structural reforms" as a way to reignite growth in their own economies and so, given their importance, also in the eurozone. These two countries generate 38 per cent of eurozone gross domestic product, against 28 per cent for Germany alone. In both economies, the recommended programmes involve liberalising the labour market. They are both being encouraged to follow Germany's "Hartz reforms", introduced between 2003 and 2005, to which the country's relatively good recent labour market performance is often attributed.

Yet the one thing those reforms did not do is create dynamic aggregate demand. Between the second quarter of 2004 and the second quarter of 2014, Germany's real domestic demand grew 11.2 per cent, a compound annual rate of 1 per cent. It could have been worse. But this is hardly the performance of a "locomotive" (see chart below).

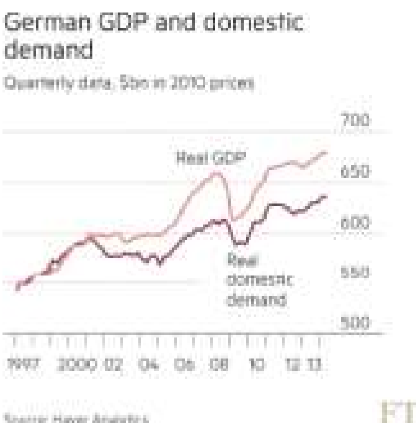
Examination of Germany's sectoral financial balances – the differences between income and spending of the government, private sector and foreigners – strengthens this point. The response of the German private sector to the reforms of the early 2000s was to increase financial surpluses massively: that is, to spend far less than their incomes. Since the fiscal deficit also shrank, the capital outflow soared. This is striking and significant. In brief, the response of the private sector to the labour market reforms and fiscal tightening was to become increasingly frugal and so accumulate large quantities of (often poor-quality) foreign assets.

In terms of raising private domestic demand, reforms achieved little. On the contrary, Germany became heavily dependent on foreign demand. Similarly, fiscal tightening did not unleash stronger private spending. Expecting similar labour-market reforms to promote demand in France and Italy is likely to prove highly over-optimistic.



This does not mean reforms achieved nothing. Germany has low unemployment despite quite weak growth. The UK also has relatively low unemployment despite still weaker post-crisis economic growth. In both cases, the labour reforms encouraged the sharing of a large negative shock across the population via stagnant or even falling real earnings. A symptom of this form of an adjustment is weak productivity. In German industry, productivity has not risen since 2007. Productivity performance has also been poor in the UK. But German unemployment was 4.9 per cent in July and the UK's only 6 per cent against 10.4 per cent in France.

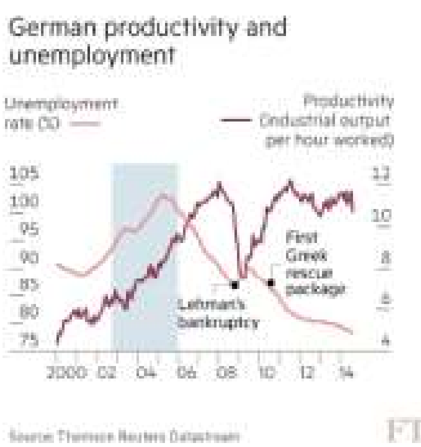
The upshot is that labour market reforms do little if anything to promote demand; in Germany's case, much of the demand has come from abroad. What might this mean for the eurozone as a whole? A theoretical possibility is that the eurozone would seek to generate a current account surplus that is as big relative to GDP as Germany's. This would mean a surplus not of $300bn, as in 2013, but of $900bn.



This could never be sustained: the rest of the world would not absorb it and an appreciation of the euro is likely to defeat it. The proper complement to structural reform is additional demand inside the eurozone. That is needed, in any case, to eliminate the difficulties being created by ultra-low inflation and the possibility of deflation. German core inflation of only 1.2 per cent is too low to let adjustment work satisfactorily.

With conventional monetary policy at its limits, the choices are between unconventional monetary policy or expansionary fiscal policy. Germany is extremely uncomfortable with both.

Yet, partly because of its haven status, Germany is also able to borrow at extraordinarily favourable interest rates. The 30-year Bund is now yielding 1.8 per cent. If one assumes the European Central Bank will meet its inflation target, this means a long-term real interest rate of zero. Such negligible costs of borrowing must transform views of the costs of fiscal deficits. Germany should both refinance its debt at such rates and borrow to finance additional public investment. Focusing on deficits and debts, without noticing the interest rate, makes no sense. In the same way, the focus on whether the French deficit breaks the rules is absurd. Even French 10-year bonds are yielding 1.1 per cent. The markets are screaming: borrow.



The big challenge for the eurozone is not to create institutions, but to promote adjustment and restore growth. The people of the eurozone cannot be expected to remain patient forever. Indeed, the dangers of continuing economic stagnation are obvious.

Germany is right that euro states need much long-term reform. But Germany is wrong to believe that this might, on its own, generate strong growth. The evidence from its experience with reforms is decisive on this point: it will not do so.

Nor does it make sense to rely on ever-greater external surpluses, instead. A policy that may work for Germany alone (a debatable proposition) cannot work for an economy more than three times as big as Germany's.

The eurozone needs to reach a bargain between more reform and extra demand. In doing so, it must recognise that persistent stagnation is a big threat to stability. The eurozone should risk expansion. That is now the safer course.

martin.wolf@ft.com

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