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The Logic Behind the German Euro Gamble

As Europe's economy continues to slide, the majority of member countries are seeking a more flexible interpretation of the stability pact. So, what's behind Germany's stubborn reluctance to give up its obsession with austerity?

Europe's current economic policy debate seems to highlight an increasing polarisation between the German mindset and the view of other member countries. How did we end up with such contradictory positions and what is the basis for Germany's apparent stubbornness when it comes to determining the right economic policies for the Euro area?

Here is my best attempt to explain the economic logic behind Germany's standpoint, and a critical view of their arguments.

1. Europe needs structural reforms. Correct. This has always been true and it will be true in the coming years or decades.

2. Some countries/governments will find any excuses they can to avoid reforms. Correct. Without external pressure or a crisis, change will not happen. This was also true for Germany in the post-2000 reforms.

3. Imbalances of spending and debt (and asset price bubbles) were a fundamental cause of the crisis. Correct.

4. The pre-crisis imbalances require post-crisis sacrifices. Correct but only up to a point. We understand that deleveraging can slow down growth, but this does not justify the extent of the Euro crisis. For example, the fact that pre-crisis growth was not balanced and required an adjustment does not justify the post-crisis downward revisions of potential output we have seen in many Euro members.

5. Competitiveness and low wages are the key to growth. Wrong. Prices need to reflect the balance of supply and demand and while it is possible that, in some cases, some prices or wages are above their optimal levels, the idea that reduction in nominal wages leads to growth is wrong. It just leads to deflation. And the idea that reduction in real wages is always good makes no sense. If this was true, let's all work for free to be more competitive. In addition, reduction in wages look a lot like competitive devaluations that we know are not possible everywhere.

6. Good behaviour, high saving and a surplus in the current account are a sign of strength. Wrong. Not every country can run a current account surplus. The world cannot save (net of investment).

7. Inflation is always bad. Wrong. Even the Bundesbank always understood that 0 percent inflation was not optimal. All central banks around

the world set inflation targets above 0 percent for a reason. Questioning 2 percent as a target and arguing for 3 percent or 4 percent (permanently or temporarily) is consistent with the framework central banks use to think about inflation.

8. Germany can live without the euro, it has only been a source of costs for the economy. Certainly Germany would be a successful economy without the euro but it’s worth noting that Germany is one of the countries that has benefitted the most from the creation of the euro.

9. Demand does not matter, the only thing that matters is supply and structural reforms. Wrong. Recessions are a reality and some of them are driven by a deficiency in demand. While it will still be true that reforms are needed (see point 1), in the short-term, policy should be focused on demand. And what matters for the short run (spending) might be different than what matters for the long run (saving and investment).

So that's how we ended up with a policy which is based on the idea that pre-crisis excesses justify any post-crisis suffering. A policy that assumes whatever output drops we see are the consequence of the imbalances that led to the crisis and the absence of reforms. A policy that refuses to enter a debate about inflation despite the agreement among central banks that 0 percent inflation is never optimal. And one that is willing to gamble with the political consequences of discontent in some Euro countries; even if they lead to yet another crisis and possibly a break-up of the Eurozone.

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