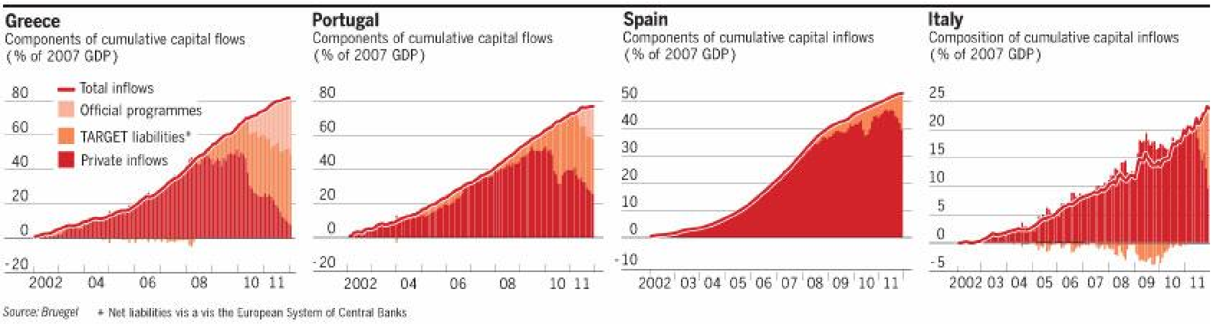
[Why the Bundesbank is wrong]


By Martin Wolf, April 10, 2012

How far has the eurozone come towards resolving its crisis? The optimistic answer would be that it has rescued itself from a heart attack, but must still manage a difficult convalescence, with a good chance of further attacks. It must also adopt a regime able to protect itself against future crises. This task, too, is incomplete. But the eurozone has secured time. The big question is how well it now uses it.

Arguably, the crucial step is to agree on the nature of the illness. On this, progress is now being achieved, at least among economists. It is widely accepted that the balance of payments is fundamental to any understanding of the present crisis. Indeed, the balance of payments may matter more in the eurozone than among economies not bound together in a currency union. Hans-Werner Sinn of CESifo, in Munich, has done much to explain, in his words, that "the European Monetary Union is experiencing a serious internal balance of payments crisis that is similar, in important ways, to the crisis of the Bretton Woods System, in the years prior to its demise." A special issue of the CESifo Forum, published in January 2012, is dedicated to this theme. In March, Bruegel, a Brussels-based think-tank, published a seminal paper on "Sudden Stops in the Euro Area". Then, in late March, Jens Weidmann, president of the Bundesbank, explored the issue in a speech in London on "rebalancing Europe".



In the years of euphoria prior to the financial crisis, private capital flowed freely, not least into countries in southern Europe. Greece, Portugal and Spain ran current account deficits of 10 per cent of gross domestic product, or more. These financed huge excesses of spending over income in private sectors, public sectors, or both. These economic booms also generated large losses in external competitiveness.

Then came the "sudden stops" in private inflows. As the Bruegel paper notes, such stops occurred during the global crisis of 2008 (affecting Greece and Ireland), in the spring of 2010 (affecting Greece, Ireland and Portugal) and, finally, in the second half of 2011 (affecting Italy, Portugal and Spain). In some cases, what happened went beyond a mere stop in inflows. Ireland, for example experienced large capital flight. Of course, when capital ceased to flow to the private sector, activity collapsed and the fiscal position worsened dramatically.

The eurozone was unprepared for such an interruption in cross-border finance: it was believed impossible. Once the stops had happened, the eurozone had two options: force external adjustment on countries shut out of the markets or finance them via official sources. The second was the chosen option, with the European Central Bank the dominant source of finance, in its role as lender of last resort to banks. The ECB has become the "European Monetary Fund" (see charts).

So what is to be done? Mr Weidman describes what he calls a “typical German position”. This is that “the deficit countries must adjust. They must address their structural problems. They must reduce domestic demand. They must become more competitive and they must increase their exports.”

What, in this, is the role of the surplus countries? On this, Mr Weidmann is clear: “it is sometimes suggested that rebalancing should be undertaken by ‘meeting in the middle’, that is by making surplus countries such as Germany less competitive. This suggestion implies that the adjustment as such would be shared between deficit and surplus countries. But the question we have to ask ourselves is: ‘where would this take us? ... [H]ow can Europe succeed ... if we ... give up our hard-won competitiveness? To succeed, Europe as a whole has to become more dynamic, more inventive and more productive.”

Alas, these remarks confuse productivity with competitiveness. Yet these are distinct: the US, for example, is more productive, but less competitive, than China. External competitiveness is relative. Moreover, at the global level, the adjustment must also be shared. Mr Weidmann knows this. As he says, “of course, surplus countries will eventually be affected as deficit countries adjust”. The question is by what mechanism.

The external competitiveness of the eurozone depends on the exchange rate. Yet that is not a policy variable. Members can only seek to improve their competitiveness vis a vis one another. That is exactly what Germany did in the 2000s. Now this must be reversed. Goldman Sachs has provided two excellent pieces of research on what this might imply (“Achieving fiscal and external balance”, March 15 and 22). It concludes that, to achieve a sustainable external position, Portugal needs a real depreciation of its exchange rate of 35 per cent, Greece one of 30 per cent, Spain one of 20 per cent and Italy one of 10-15 per cent, while Ireland is now competitive. Such adjustments imply offsetting appreciation in core countries. Moreover, with average inflation of 2 per cent in the eurozone and, say, zero inflation in currently uncompetitive countries, adjustment would take Portugal and Greece 15 years, Spain 10 years and Italy 5-10 years. Moreover, that would also imply 4 per cent annual inflation in the rest of the eurozone.

Might such an internal adjustment even occur naturally? Yes, it might. At present, the ECB is pursuing an expansionary policy. At the same time, German banks surely want to lend more at home. A huge lending boom in Germany would be a big help. But suppose that did not happen. Then today’s austerity-blighted eurozone would end up with a prolonged period of weak demand. It might, as a result, generate a large shift in its net exports. For the rest of the world, that would be a beggar-my-neighbour policy, impossible to tolerate in hard times. For the eurozone to pursue such a policy, while asking outsiders to increase their finance of its members in difficulty, via additional resources for the International Monetary Fund, would add insult to injury. The outsiders should just say no. They should insist, instead, that additional support must be predicated on two-sided adjustment inside the zone.

The good news is that agreement is emerging on the role in the crisis of the payments imbalances. The bad news is that the eurozone does not yet agree that competitiveness is necessarily relative. As soon as it does, the route to convalescence will at least be clear, however hard.