



Economic Governance in the Eurozone and the EU: Drawing lessons from the crisis

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The role of Germany redefined?

Twelve years ago, before the heads of EU states took the final decision on starting the euro union, 155 German economists publicly warned: “The euro comes too early.” They pointed out that stability of a common currency required a lasting convergence and fiscal discipline by all participating countries. Specifically, they predicted that in the absence of automatic sanctions the ‘stability pact’ would achieve nothing. Unfortunately, the economists were right. Take Greece, whose governments have not played to the rules, running deficits exceeding 3 % of GDP year after year (with the exception of 2006: 2.9%); or take Portugal whose deficit as a rule has moved between 2.8 and 3 %, but jumped to 4.3 % in 2001, to 6.1 % in 2005 and to even 9.4 last year. In contrast it is noteworthy that the Italian deficit has been held below 3 % on average over the period 2000-07 and the Spanish budget has even remained at balance for most of the time.

In disregard of the no-bail-out rule of the EU Treaty, the euro governments (and the IMF) have put together a rescue package of € 110 bn for Greece and another € 750 bn package for other member countries, in case their debt comes into doubt. As regards the Greece-package, about 70 percent (€ 80 bn) serve to bail out international investors, among them French banks (holding € 50 bn) and German banks (holding € 28 bn). The package is based on the expectation that Greece will cut its deficit (2009: 13.6 %) by 7.5 percentage points this year, by 4 pp in 2011 and by 2 pp in 2012 and 2013. It is hard to believe that the Greek government will be able to fully enforce this impressive austerity programme. At the end of this year at the latest, we and the financial markets will know whether the Greek government has made headway as planned. Should it not have succeed, the rescue package, though large, will turn out to be too small. What then? Will financial markets remain calm or will they panic and flee the debt of other EU countries, too? How will the EU governments react? Will they be ready to stepping in again, pushing further up the bail-out levels?

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Given the current political mood in Germany – “ we wanted a currency union, not a transfer union” – , I doubt it very much that the German voter and his or her government will remain patient should signals arrive that promises cannot not be met and further resources are required. Hence one should not be too surprised if under those conditions Greece will be asked by its partners to face up to starting insolvency proceedings. As a matter of fact, it can be argued that Greece and its partners would be better off today, had Greece declared insolvency by the turn of the Year 2009/10. A defensible insolvency target is cutting the sovereign debt level (of about € 300 bn) drastically down to somewhere in the range of € 150 – 200 bn. In addition to that, the available indicators of competitiveness suggest that Greece needs a sizable devaluation. In principle, this can be achieved by ordering wage cuts. But a superior instrument would be currency devaluation because it affects all types of cross-border business to the same extent and meets less internal political opposition than nominal wage cuts. From an economic point of view, one should not flatly rule out that a country that needs serious economic restructuring returns to a currency of its own for an adjustment period of say 5 to 10 years. It is not clear why a country that seriously lacks competitiveness, hence faces stagnation under the regime of a fixed nominal exchange rate, should want to stay in the euro zone. It may hope to indefinitely receive financial aid from stronger partners but this is likely to be little in comparison to what the country may earn if it changes the economic conditions in favour of reaping productivity gains and flourishing markets.

In addition to the governments’ reckless breach of the EU Treaty, the European Central Bank’s most recent change of conduct is a matter of serious concern in Germany. In fact, the ECB tinkers with its credibility and independence from government. At least in Germany, a central bank becomes suspicious once it starts buying government debt outright at larger scale. All large inflations have been started by monetizing debt. It may seem that the ECB has abandoned the stability compass it had shared with the Bundesbank for more than a decade.

The ECB has defended its decision by pointing out that it will concentrate its purchases on specific market segments “which are dysfunctional”. Note that the ECB’s mandate is running monetary policy for the union of countries as a whole that have adopted the euro, not to the advantage of selected countries. Put differently, when the ECB engages in the stabilization of the prices of selected sovereign debt, it openly subsidizes selected governments. This is not compatible with the rules of the currency union.

To be sure, the ECB knows that it has to be careful as regards quantities as it can never resell the debt; because that would derange the selected sovereign debt markets. For that reason the ECB has promised to sterilize the impact of the debt purchases. Unfortunately, there are not many assets on the ECB’s balance-sheet that could be sold except foreign U.S. dollar denominated debt. Thus the ECB’s interventions in support of individual member countries’ government debt will need to be sterilized by interventions in the U.S. dollar-euro market, hence they will affect the dollar-euro rate.

As a final observation it is to be noted that the French obsession with ‘economic government’ flies high again in Brussels, notably with Jean-Claude Juncker (Luxemburg) and José Manuel Barroso (Portugal). They believe for long that such government must be installed in the euro union as a counterweight to the power of the ECB and its monetary policy. Since the times of Jean-Baptiste Colbert, French politicians and bureaucrats believe in the merits of centralisation, coordination and government intervention, while markets and competition appear to be suspicious. To be sure, the attempt at a closer coordination of national economic policies would provide functionaries with a new playing field but hardly lead to better economic outcomes. Moreover, it

In contrast, the German position as regards 'economic government' is structural in the sense that instead of trying to coordinate macroeconomic processes the community should focus on regulations and rules of conduct for markets as well as for economic policies. Naturally, this broader approach to policy making addresses all EU member countries, not just the countries belonging to the euro zone. Otherwise the danger is that incentives are set to stay outside the euro zone. Part of the broader approach will be establishing new rules as regards budget planning and automatic sanctions for countries running excessive deficits on a quasi permanent basis.

Germany redefined? Germany has introduced a 'debt brake' that reduces drastically the Federal government's capacity of borrowing. From 2016 the Federal government is permitted to borrow no more than 0.35 % of GDP on a regular basis. In case of an emergency it can take up extra borrowing, but will have to retire this extra borrowing within three years. Last year's total deficit was 3.1 % of GDP. This week the government has decided on a programme of budget cuts totalling € 80 bn. This will serve to consolidate the budget such that the budget becomes as lean as necessary to fit the 'debt brake'. Naturally, Germany is likely to propose that the debt brake will be applied by all EU countries.

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