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Germany's Economy Is Badly Exposed

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As the European economic crisis once again comes to a boil, many wonder how the Europeans put themselves in such hot water. This is a political crisis on top of an unemployment crisis, which bubbles on top of a fiscal crisis, underneath which is the critical element of an unsustainable imbalance in trade flows. While the trade imbalances within Europe have many causes, the prime culprit is the flawed foundation: the adoption of a single currency for all of Europe, the euro, without the political and economic trappings essential to make it work.

Each of these elements—the political errors, the unemployment, the fiscal calamities, the trade imbalances, and the euro—plays an important part in the daily evolution of the overall crisis. The collective effects highlight why every major initiative by Europe's leaders falls woefully short of a solution. Yet the proximate cause of the economic calamity is not the absence or presence of austerity, over which Europe is all abuzz. The proximate cause is the euro, which contributed substantially to the price signals that led to persistent trade and capital imbalances among Europe's members. At their roots, these imbalances are as straightforward as the solution.

Price Signals from the Euro at the Heart. The story of European trade imbalances begins with the euro. To simplify the story, the focus here is on the relationship between Germany and Greece, recognizing that Germany represents for this purpose all European countries running persistent trade surpluses, which is reasonable, as Germany is the biggest in every way. In turn, for this purpose, Greece represents all European countries running persistent trade deficits, which is reasonable, because Greece was the extreme case.

The adoption of the euro was predicated in part on the belief the euro would lead less competitive countries, like Greece, to converge in competitiveness with more competitive countries, like Germany. It was also largely understood that this convergence must occur for the euro to survive.

In fact, the opposite occurred, in part because Germany adopted useful reforms while Greece, if anything, went backward. In the early 2000s, Germany recognized it was becoming less able to compete on the world stage, so it adopted tough labor market reforms—the so-called Hartz reforms, named after the special committee established in 2002 and led by Chairman Peter Hartz. In short, the reforms worked, ensuring Germany's role as an exporting powerhouse, especially to the weaker countries of Europe trapped in the euro. Germany adopted many of the reforms Greece et al. needed—and are only now considering.

Matters were not all bleak for the Greeks, however. While the real purchasing power of Greek wages was falling, Greeks were still able to buy German products on the cheap. Had they kept the drachma, it would have fallen against the deutsche mark as Germany gained competitiveness. Locked inside the euro, price signals to the Greeks told them to buy abroad, and buy they did.

Further, this apparent prosperity in Greece eliminated all pressure on the Greek government to institute the economic reforms needed

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for convergence. On the contrary, it allowed the Greek state to balloon and Greek competitiveness to stagnate. No government would take on powerful labor unions to push through tough Hartz-like labor reforms under these conditions.

Germany, meanwhile, enjoyed the flipside of this currency distortion. Had it kept the deutsche mark, market forces would have caused the deutsche mark to appreciate against the world's currencies. Instead, locked inside the euro, Germany's hard-won advantages in competitiveness earned their due rewards.

This trade pattern was reinforced neatly by market prices relating to capital flows. Having joined the euro and by extension Germany's credit rating, the Greeks were able to borrow at much lower interest rates than before. Facing such a clear price signal to borrow, they happily obliged. And the Greeks needed to borrow to pay the Germans for all the stuff they were buying.

For their part, Germans are prodigious savers, to which was added all the profits from their export sales to the Greeks and elsewhere. The Germans needed an outlet for their saving, and so the cycle was complete. Facing a substantial currency misalignment in addition to the growing divergences in competitiveness between the countries, citizens of each did exactly what the price signals fostered by the euro told them to do: Greeks bought goods from Germany, and Germany was only too pleased to lend to the Greeks out of its surplus—all the money needed to buy German goods.

The Veil Is Lifted. It was all too good to be true, and the fly in the ointment was that the entire arrangement was predicated on a flawed economic edifice—the euro. Greece could not borrow indefinitely to buy far more than it produced. There had to be a reckoning, and the economic auditor ensuring the audit took place was, as always, the credit market. The first audit notice was sent in 2009, when the incoming Greek government of George Papandreou made known that the previous government had been cooking the nation's books. The budget deficit at 12 percent of gross domestic product was twice as high as previously advertised.

Jumping from past to present, little has changed in these trade and capital flow dynamics in the intervening years, yet much has changed elsewhere. Greece no longer has access to credit markets and must rely on the financial bailout sufferance of the rest of Europe as it plunges into depression. Meanwhile, Germany is deeply conflicted. On the one hand, having built an economic model centered on being a net exporter, it risks losing the economic benefits of having Europe's periphery as a ready market. Germany's prospects look bleak without massive trade surpluses.

Having guided its inception, Germany now also worries it will be blamed for the euro's demise. Germany is relatively rich. Its relatively poorer partners in the euro experiment expect it to fork over whatever is necessary to preserve the dream. And, not wanting to be blamed for waking the dreamer, Germany continues to pay.

The Germans also retain the smugness common to all net exporters and net savers. Set aside that much of its advantage is gleaned from tying its trading partners to a deal in which German exporters enjoy an artificial advantage. The Germans retain a certain self-assured moral superiority from hard work and saving. It is not entirely misplaced—just overdone—but not for long.

It takes two to tango, and this will be true in the German–Greek partnership in good times and in bad. Greece could not buy and borrow in the good times if the Germans were not so ready to sell and lend. Now, Greece cannot buy except through bailout funds. And the Germans? Before this is over, whatever currency Germany uses will have appreciated substantially relative to its trading partners, and much of the German trade advantage will vanish.

That is not the end of it for Germany. Both before and especially during the crisis, Germans have lent enormous sums to prop up a falling economic structure, buying time as Europe's leaders seek frantically for real, enduring solutions. They have not found those solutions yet, contenting themselves with bailout Band-Aids and ultimately toothless fiscal compacts. Nor will they find solutions until they address the most fundamental problems. No matter how it is resolved, the fact remains that Germany will have spent—not lent—those hundreds of billions of euros to buy time and avoid blame. That money is, or soon will be, mostly gone.

Greece, along with its cousins in the periphery such as Spain, Italy, Portugal, and perhaps others, has a long and painful road ahead.

In contrast, conventional wisdom is that Germany, the strong man of Europe, the prodigious saver, the powerful international competitor, will stumble a little but then just power onward. Conventional wisdom is almost certainly badly mistaken in this respect, much to the eventual chagrin of the Germans.

In Search of a Silver Bullet. Policymakers across Europe continue to seek in vain for the silver bullet—the magic policy pill that

will eventually make all things right again across the continent. There is no such policy. The bill for past policy mistakes cannot be waived; it can only be financed, and that only for awhile. Germany's fixation on austerity is a mild start at best toward correction, dampened by the tendency to meet fiscal targets through higher taxes.

"Economic growth" is the newest buzzword, as though Europe's leaders have discovered it for the first time, but it nevertheless remains little more than a campaign slogan. European leaders understand little more about what is needed for economic growth than does President Obama across the pond. This becomes abundantly clear when the focus of their efforts is to create a joint government fund for new infrastructure investments, the only merit of which is that the fund will be too small to exacerbate their debt problems materially. Even so, the emphasis on growth is correct, and one may be forgiven the hope that it will eventually lead to useful reforms in labor policy, environmental regulation, entitlements, and taxes.

Then there is the euro. News of its demise may have been premature, but not exaggerated. Monetary policy in good times is like a building's foundation—not something one thinks about much when it is sound. When it is cracked and shifting, however, little can go right until the monetary foundation is corrected. The crisis cannot end as long as the euro abides as is.

Difficult Decisions Ahead. The European leadership has not been entirely inert throughout the crisis. The European Central Bank has been very active monetizing sovereign debt. Numerous bailout packages have been constructed, first for Ireland and then Greece, and enormous bailout funds have been constructed to prepare for future efforts. Meanwhile, Europe has finally begun to rein in spending as part of a universal austerity drive—a drive that may stall out in light of recent elections in Greece and France. And the technocrats have been busy devising new capital rules to prepare for future crises after this one has passed.

But beyond slogans and a few tepid efforts Europe has yet to address the fundamental policy shifts needed to bring about stronger economic growth in the medium term. Unfortunately, there is almost nothing it can do in the short term, which is evident in that it really has not even tried. For starters, the rest of Europe can look to Germany's Hartz labor market reforms of a decade ago as a good initial template for growth. Again, the effects would not be immediate, but rather revealed over the following years.

And then there is the euro, which cannot continue in its current form. When it will morph is unknown; the longer Europe waits, the more economic damage will be done. How it will morph is equally uncertain. Perhaps ideally, all countries would return to their own currencies, but that may not be practical at this point. What is sure is that the strong must separate from the weak for either to prosper.

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