Comment

A question of symmetry

- *Basic economic philosophy in Germany differs from that of much of the rest of the world*
- *The evolution and strength of the economy's productive base is viewed as paramount*
- *And external surpluses are seen as a symbol of economic success*
- *But not every country can run an external surplus in a currency union, or more generally*
- *Absence of symmetry in external adjustment could prove to be the euro's Achilles' heel*

Lingering question marks

The euro area's existential crisis is set to continue…

In our most recent *Comment*, entitled *Europe drags its feet*, we reviewed the prevailing macroeconomic and policy conjuncture in the euro area. Our conclusion was that, while the single currency is not in imminent danger of collapse, it remains beset by numerous challenges, with little immediate prospect of their being addressed in full. Hence, a further period of stagnation and additional bouts of financial turmoil are in prospect. Moreover, there is a strong likelihood that the social and political landscape will continue to leave the euro's existence over the long term open to question.

Philosophical differences

Evaluating the single currency's enduring prospects requires going beyond the immediate cyclical environment. And there lies the rub and what ultimately could prove to be a fatal flaw in the euro edifice – a fundamental, philosophical, difference between Germany (although it is also shared to some extent by some other members of the euro area core) and much of the rest of the world, including both the so-called Anglo Saxon economies and the European periphery.

…Germany prioritises its productive base…

In Germany, not just mainstream politicians and policymakers, but also much of society, believe instinctively and strongly that it is the evolution and health of the supply side of the economy, and in particular what can perhaps best be described as its productive or industrial base, that determines over the long run what can be delivered in terms of employment, output, living standards, and prosperity. Indeed, as can be seen in Germany's almost unrelenting focus on, and success in, the development and commercialisation of engineering and machinery, the economy has been built much in this image since its industrial development began in the nineteenth century.

What this means in practice is emphasis not on the primacy of free and unfettered markets, but on cost competitiveness, investment, education and training, and (often government sponsored) financing mechanisms with long term horizons. Germans are willing to make extended sacrifices to achieve their ultimate goal. There is rarely the clamour, so common elsewhere, for instant gratification in the form of higher wages and consumption, nor indeed for lower taxes.

…while elsewhere the focus is more on domestic demand

By contrast, in many other countries, including the US, the UK, and much of southern Europe, there has been a rather different attitude to the underlying sources and methods of securing longer-term economic success. There, the primary preoccupation has been with aggregate demand and its shorter-term manipulation to achieve a consistently high level of resource utilisation, the implicit assumption being that, if policy-makers get the demand side of the economy broadly right, the supply side will largely look after itself. And in turn this intense focus on short-term demand management has bred its own expectancies and perceptions of entitlements among populations.

The issue of improving supply side performance received little attention in this latter group of economies until the late 1970s. And even then, the impetus was more ideological than a practical desire explicitly to strengthen the industrial sector. The rise of "New Classical" economics and a rightward shift in the political centre of gravity brought with it less emphasis on "fine-tuning" demand via fiscal policy, and more emphasis on monetary policy, deregulation and a generally less intrusive role for the state. However, this "New Classical" revolution proved to be at most partial, often foundering on the rocks of political hyperactivity and the deeply embedded mentality of entitlement. The primacy of demand management, albeit with a few tweaks and nods in the direction of other priorities, endured.

Germans have little truck with this Anglo Saxon preoccupation. They see it as a potentially costly distraction and, even in the post-Keynesian era, all too often an excuse for fiscal laxity and monetary incontinence, reflecting, behind it, political and moral weakness.

Mutually exclusive

Not every country can run an external surplus

Unfortunately, these two divergent philosophies, grounded deeply in the history and culture of the respective peoples, and neither entirely unreasonable, lead, if taken together, to a false – and potentially dangerous – outcome.

To the extent that, by dint of fiscal and monetary rectitude, hard work, cautious consumption, a willingness to invest for the longer term, and all other such virtuous attributes, the German economy and the industrial dynamo at its core ends up running a persistent current account surplus, that is regarded as proof that the German model works. And in turn it is easy to glissade into the belief that the power that surplus confers is a reward for virtue.

It then becomes a short, easy, but fundamentally misconstrued step to urge every partner economy to behave similarly: "Do what we do and you will succeed as we do; and you will all move into surplus." (It is equally easy to adopt the corollary argument: "If you are in deficit it means that you are profligate, uncompetitive, and generally lacking in virtue and moral fibre".)

Unfortunately, however, this neo-mercantilist treatment of economics as a branch of moral philosophy, which celebrates external surpluses as true barometers of policy success, runs afoul of the laws of arithmetic. To the extent that one economy insists, through its actions, in being in current account surplus, at least one other will be forced into current account deficit. The counterpart, of course, is that to the extent that one economy insists, through its actions, in running a current account deficit, it obliges at least one other economy to be in counterpart surplus.

It does not follow, of course, that the counterpart of a surplus – be it German, Northern European, or whatever – has to be an Italian, or Southern European, deficit: the counterpart surplus or deficit could manifest itself outside Europe. But in all practical probability there will be at least some surplus/deficit reciprocity within Europe most of the time.

You scratch my back…

More policy symmetry is required…

What follows from this fundamental arithmetic truth is that Europe's economies can co-exist sustainably over the long term only if reducing inter-country imbalances is accepted as the joint responsibility of both sides, and if functional mechanisms operate to bring this about.

Keynes, or rather some of his more influential disciples, must take much of the responsibility for the way that demand management has come disproportionately to dominate economic policy-making in the Anglo-Saxon and southern European worlds. But on the matter of external imbalances, Keynes had it spot on. At the Bretton Woods negotiations in 1944, he pointed out the dangers of asymmetric adjustment, and in particular of putting the entire onus of policy adjustment on debtors rather than creditors. Unfortunately, however, with the dominant US economy at that time running a massive external surplus and reluctant to see its policies influenced at every turn from outside, his concerns were over-ruled by the chief American representative at the conference, Harry Dexter White.

The US post-war current account surplus did not last beyond the 1960s: but the logical error lived on, to bedevil the global monetary system ever since. And now Europe is suffering from its own, locally-grown, version of the problem. Having watched since then, more times than we would wish to remember, policymakers from the US (on occasion), Japan (sometimes) and Germany (almost invariably) deny this truism, we suspect that this could ultimately prove to be the Achilles' heel of a system that does not have an exchange rate mechanism as the ultimate safety valve.

…or the euro-area faces a permanent transfer union

Unless this notion of symmetrical adjustment is taken on board, the only means to sustain the euro is a permanent system of substantive transfers from the persistent creditors, at the core, to habitual debtors, in the periphery. And at some stage either the debts associated with these transfers will become politically unacceptable, or they will have to be written off.

Less than delicious irony

Consider the irony in all this: a country unwilling, or unable, to spend anywhere near to the limits of its income has, in order to keep the wheels of it factories turning, to give away its excess savings to countries that are willing to spend in excess of their income. This is Alice in Wonderland economics.■

Disclaimer