Working Paper No. 911

Twenty Years of the German Euro Are More than Enough

Jörg Bibow
Levy Economics Institute and Skidmore College

August 2018

The Levy Economics Institute Working Paper Collection presents research in progress by Levy Institute scholars and conference participants. The purpose of the series is to disseminate ideas to and elicit comments from academics and professionals.

Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan, independently funded research organization devoted to public service. Through scholarship and economic research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

Levy Economics Institute
P.O. Box 5000
Annandale-on-Hudson, NY 12504-5000
http://www.levyinstitute.org

Copyright © Levy Economics Institute 2018 All rights reserved

ISSN 1547-366X

ABSTRACT

This paper reviews the performance of the euro area since the euro's launch 20 years ago. It argues that the euro crisis has exposed existential flaws in the euro regime. Intra-area divergences and the corresponding buildup of imbalances had remained unchecked prior to the crisis. As those imbalances eventually imploded, member states were found to be extremely vulnerable to systemic banking problems and abruptly deteriorating public finances. Debt legacies and high unemployment continue to plague euro crisis countries. Its huge current account surplus highlights that the euro currency union, toiling under the German euro and trying to emulate the German model, has become very vulnerable to global developments. The euro regime is flawed and dysfunctional. Europe has to overcome the German euro. Three reforms are essential to turn the euro into a viable European currency. First, divergences in competitiveness positions must be prevented in future. Second, market integration must go hand in hand with policy integration. Third, the euro is lacking a safe footing for as long as the ECB is missing a federal treasury partner. Therefore, establishing the vital treasury–central bank axis that stands at the center of power in sovereign states is essential.

KEYWORDS: Euro; Euro Crisis; Banking Crisis; Debt Crisis; Monetary Policy; Lender of Last Resort; Fiscal Policy

JEL CLASSIFICATIONS: E30; E44; E58; E61; E62; F34; F45

1. INTRODUCTION

In the aftermath of World War II, maintaining peace by integrating economies and jointly organizing prosperity provided the original motivation behind European integration. In view of still-fresh memories of "beggar-thy-neighbor" competitive devaluations during the interwar period, stable exchange rates were part of this new collaborative European vision from the beginning. The Paris and Rome Treaties lent power to the former motive. The Bretton Woods global monetary order initially provided the backdrop to the latter concern. In the 1980s and 90s, Europe pushed its ambitions much further, deepening and widening market integration across the continent. In the (Maastricht) Treaty on European Union, the integration project even came to include currency unification. To some, Europe's common currency (the euro) was primarily an instrument to overcome German monetary hegemony in Europe. More generally, the euro was held to rid the continent of any threat of intraregional currency instability for good, with monetary stability by monetary unification seen as a means to accomplishing economic convergence and joint prosperity, political union, and lasting peace.

Twenty years later, Europe's common currency has come to play a prominent role in global financial markets and the majority of EU citizens continue to hold the euro in high esteem. Yet it is quite clear that the euro has failed to deliver on its promises. If the first decade was mediocre, the second was calamitous. Apart from dismal economic performance over the past ten years, the European nations living under the EU's "unity in diversity" motto seem more divided today than ever. Divergence rather than convergence of their economies is a sobering reality. Joint prosperity remains out of reach.

What went wrong? Why has the euro currency union proved so dysfunctional? Today, one might even ask: What needs to be done to rescue Europe from the euro without disaster?

In addressing these questions, the analysis begins in section 2 with highlighting that the German intellectual roots on which the euro policy regime is based are wholly unsuitable for Europe's common currency. Section 3 then briefly reviews the economic performance since the Maastricht Treaty, while section 4 zooms in on the Spanish case. Section 5 concludes and briefly delineates the required reforms that would turn the euro into a viable currency that could finally deliver on its promises.

2. HOW EUROPE ENDED UP WITH A GERMAN EURO

Few observers deny today that there is something fundamentally wrong about the euro regime. The official view is that the regime is “incomplete.” A more accurate description would be: flawed, dysfunctional, and wholly unsuitable for Europe. That begs the question of how Europe could end up with a policy regime for its common currency that has proved so highly inadequate. The quick answer to this puzzle is that Germany was in a position to set the conditions for its surrender of monetary hegemony in Europe and, as a result, the euro regime was essentially “made in Germany.” It was inspired by (West) Germany’s own postwar economic experience, by its “economic miracle” and famed record of price stability. But how, one is forced to then wonder, could a model that had provided the basis for (West) Germany’s success become the source of economic despair across Europe under the euro?

This section will answer this question and depict the “German model” and its historical background. It will prepare the ground for understanding how the model’s Europeanization under the euro turned the former German engine of prosperity into an engine of euro area impoverishment. Price stability and Germany’s central bank are central to how Europe ended up with a German euro—and in crisis.

It is a commonplace in the international media that Germans have a peculiarly strong preference for price stability. Along with their, allegedly, exceptional fears of (hyper-)inflation came a strong attachment to their former currency, the deutschmark (DM), and adoration for its central bank guardian, the Bundesbank. Former EU Commission President Jacques Delors pointedly observed that, while few Germans believe in god, all believe in the Bundesbank (see Issing [2008]; Bibow [2018]).

The deutschmark was launched in the currency reform of June 1948, which was more than a year before West Germany and its federal government were even established. Following an almost decade-long political struggle, the Bank deutscher Länder (BdL), established in 1948 by the Allied Occupation Forces, secured a status of independence for its successor, the Bundesbank, which was established in 1957. (West) Germany was thus far ahead of its time regarding “central bank independence,” an idea that only gained currency in the 1980s and 1990s. From early on, central bank independence and price stability became seen in Germany as two sides of the same coin—the DM coin of prosperity.

Arguably, economically, the most decisive event occurred in 1950–51, when the young West German republic with its still-unproven new currency, lacking gold and international reserves, suffered a balance of payments crisis. International experts advised the German authorities that to avoid a deep recession, they must focus on boosting German exports.

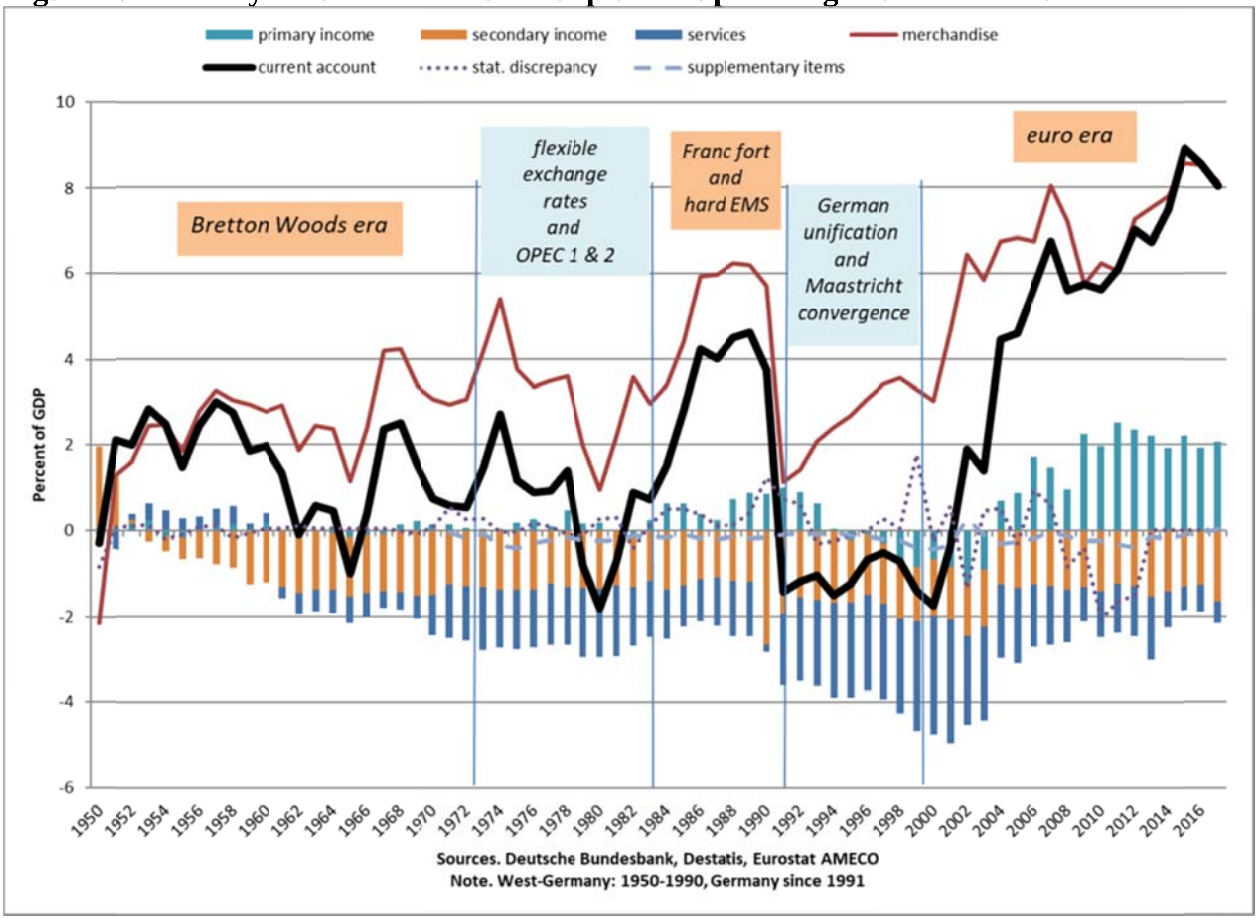
The German authorities happily obliged and came up with an ingenious strategy: boosting German exports through price stability. Economic minister Ludwig Erhard saw the crisis as a great opportunity for the future of German exports. He advised that, *through internal discipline*, inflation in Germany should be kept below inflation elsewhere, as that would strengthen exports.

The men at the helm of the BdL were fully in accord with Ludwig Erhard, the acclaimed architect of the economic miracle, and the central bank came to play a key role in achieving “internal discipline.” As the chief enforcer of wage and fiscal discipline, the Bundesbank’s own reputation and fame rests on its superior record of achieving price stability in Germany.

Price stability, or rather: German inflation that is lower than in main trading partners, achieved through superior internal discipline enforced by an independent central bank, stands at the heart of the “German model.” The international currency order provides the other key ingredient.

For in the context of the international Bretton Woods monetary order of pegged nominal exchange rates, West Germany would experience cumulative improvements in its competitiveness by keeping its inflation rate below inflation trends elsewhere. German exports received an extra lift in this way as the West German authorities always resisted deutschmark revaluation pressures for as long as possible. The first deutschmark revaluation only occurred in 1961, another followed in 1969 (Bibow 2018).

Figure 1. Germany's Current Account Surpluses Supercharged under the Euro



Note: West Germany, 1950–90, Germany since 1991
Sources: Deutsche Bundesbank, Destatis, Eurostat AMECO

As Figure 1 shows, Germany has a long history of persistent and sizeable trade and current account surpluses. From the beginning, West Germany became (over-)reliant on exports for its growth, successfully pursuing a model of export-led growth (Wallich 1955; Hölscher 1994; Holtfrerich 1998). As part of keeping with internal discipline, the government would balance its budget, or even run fiscal surpluses, and generally abstain from active fiscal stabilization policies. As chief enforcer of internal discipline, the Bundesbank built its reputation without standing in the way of growth or playing much of an active part in stimulating domestic demand.

In West Germany, price stability was perceived as causing growth. Moreover, growth was widely shared as wages rose in line with productivity.

The early 1970s saw the demise of the Bretton Woods system of pegged exchange rates. The deutschmark appreciated strongly until the late 1970s, undermining the German model. The economy faced a triple whammy of rising wage inflation, currency appreciation, and terms-of-trade deterioration. Unemployment soared and “stagflation” befell West Germany. Fiscal expansion was tried to some degree and with some measure of success while the Bundesbank was toying with a new monetarist mantra of monetary targeting (Giersch, Paque, and Schmieding 1992). Then the US authorities pressured the German government in 1978 to share the burden of acting as a “locomotive” by adding fiscal stimulus measures and limiting monetary tightening. Germany obliged to some extent, only to see inflation reaccelerate as the second OPEC oil-price shock hit.

Panic seemed to grip the authorities when the current account turned into deficit in 1979 and the deutschmark weakened. The Bundesbank tightened its monetary stance sharply. Procyclical fiscal tightening was enacted in the early 1980s. The new right-wing government, led by Helmut Kohl, embraced the idea of expansionary austerity (the “German view”) and adopted a single-minded focus on the supply side—denying any role for demand management.

Unsurprisingly, the recovery from the 1981–82 recession was very sluggish and unemployment stayed stubbornly high. (This foretold subsequent results in the 1990s and 2000s, when the same policy recipe was applied in even higher dosages.) Owing to the strong US dollar and US recovery, driven by Reagan-type “supply-side economics” featuring a strong Keynesian fiscal stimulus, there was some boost from exports in the mid-1980s, helping to offset some of the damage that austerity inflicted on domestic demand. In the second half of 1980s, the “hardening” of the European Monetary System (EMS) enabled a revival of the German model.

Even before the demise of the Bretton Woods system, Western Europe had started exploring ways to stabilize exchange rates regionally. Early attempts had failed, but at the end of the decade West German Chancellor Helmut Schmidt led the initiative that established the EMS.

The EMS included the Exchange Rate Mechanism (ERM) as the mechanism through which national currencies were meant to be stabilized, and the European Currency Unit (ECU), serving as (a politically neutral) anchor. There were still numerous "realignments" in the early years. Following a critical French macro policy U-turn in 1983, exchange rates "hardened" in the course of the 1980s. The project of completing Europe's "single market," featuring liberalized financial markets, got underway in the mid-1980s, with the Basel-Nyborg agreement of 1987 countries participating in the ERM essentially accepted Bundesbank leadership in Europe—at least for the time being.

At the time, pegging to the deutschmark was judged a convenient way to disinflate and achieve inflation convergence toward the low benchmark set by West Germany. As a result, West Germany, once again, achieved cumulative competitiveness gains under a system of pegged exchange rates—owing to the fact that its inflation rate was still lower than that of its partners. West Germany ran up sizeable trade and current account surpluses in the course of the 1980s (see figure 1), concentrated in Europe. Large external surpluses enabled the government to balance its budget. (Public finances were generally in poorer shape in other ERM member countries. Similar regional developments were later to reemerge under the euro.)

German unification may have accelerated Europe's push toward a common currency. There were fears that a united Germany might refocus toward the East or simply become too powerful if not tamed by deeper integration. There was also resentment in larger countries that Germany's central bank alone was calling the monetary shots in Europe. Monetary unification appeared to provide the solution to these issues. That put Germany in the position of dictating the conditions for its surrender of hegemony and the design of the new common currency. The EMU policy regime, agreed upon at Maastricht in 1991, largely followed the German rulebook (Dyson and Featherstone 1999; James 2012).

Essentially, the euro had to be as strong as or stronger than the beloved deutschmark. It needed to be guarded by an independent central bank focused only on price stability. Fiscal policies had to be disciplined so as not to challenge the guardian of stability. Disciplined macro policies should also tame wage developments as determined in free (liberalized) markets. It all seemed straightforward, because the recipe for West Germany's success seemed that simple: price stability causes growth. It had worked for Germany in the 1950s and 1960s, and again in the 1980s. The "Keynesian" experiences of the 1970s were not to be repeated. Very simple.

Alas, something important got overlooked here: the German model only worked because and as long as Germany's main trade partners behaved differently. A fallacy of composition is involved in assuming that the model could be exported to Europe—which is precisely what the Maastricht regime did—and still work for both Germany and its euro partners. Germany and Europe were in for a surprise.

3. FOLLOWING EARLY WARNINGS IN THE 1990s, APPARENT STABILITY BRED INSTABILITY IN THE 2000s

The euro's uneasy history may be divided into two parts. The euro's first—pre-2008—decade appeared to be successful to many observers. That proved an illusion, as growing intra-area divergences and imbalances were building up, creating the very vulnerabilities that erupted in the acute crisis of 2008—triggered, but not caused, by the Lehman event in the United States.

The trouble actually started right at the time of the Maastricht Treaty. The Bundesbank's overkill monetary policies pursued in response to German unification were a stark reminder that under German hegemony the EMS was not a sound monetary arrangement for Europe. As an asymmetric shock hit the EMS anchor currency, the fact that the Bundesbank had a price stability mandate for Germany but determined monetary policy for Europe (i.e., the "policy domain problem") caused havoc in European currency and economic affairs (Hefeker 1994).

The Bundesbank shock was not the only challenge. The other part of the problem was that, in the spirit of Maastricht, euro-aspirant countries were embarking on a joint fiscal austerity crusade at the time. Their spirited efforts provided a foretaste of things to come: growth crumbled, leaving countries struggling to squeeze deficits down to the holy 3-percent Maastricht mark that was to decide the fate of the euro-to-be. They failed and the initially foreseen start date in 1997 was missed since almost no country met the fiscal convergence criteria. It was virtually at the last minute that the US "dot.com" boom and US dollar appreciation then provided sufficiently strong global spillovers, thereby enabling 11 aspirant countries to meet the 3-percent mark in 1997—even if barely, as in Germany's own case.

The 1990s revealed another foreboding of things to come: divergence. Starting in the second half of the 1990s, and only getting worse in the 2000s, Germany performed more poorly than its (prospective) partners in the euro "periphery." There were two early causes of intra-area divergences. First, countries in the euro periphery received a boost to asset prices and economic growth owing to interest rate convergence (toward lower German levels), while Germany, traditionally enjoying lower interest rates than the rest, felt the full brunt of the Bundesbank's slow-motion monetary easing. Second, starting around 1996, in addition to persistent austerity embarked on in 1992, Germany ordered itself a drastic dose of wage repression. The ill-guided policy mix of fiscal austerity and wage repression was to lastingly undermine domestic demand in Germany.

Conventional wisdom in Germany has it that there was no alternative to "bringing its own fiscal house in order" and simultaneously "restoring" its competitiveness, which, allegedly, had been lost in the context of German unification and the ERM crises of the early 1990s. While it is true that the former East German economy suffered a drastic loss of competitiveness as wages—but not productivity—converged to West German levels almost overnight, jump-starting an ample intra-German transfer union, the same is not at all true for the West German economy. Owing to persistent inflation differentials in (West) Germany's favor in the "hard EMS" era, intra-EMS competitiveness positions had been seriously out of kilter at the time of Maastricht. DM appreciation effected through the 1992–93 EMS crises restored balance in Europe, at least for the time being.

For an economy used to operating with a competitive advantage due to its favorable inflation differential, losing this benefit as the rest of Europe converged to German inflation levels—as was required by the Maastricht Treaty!—may have felt like an undue loss in competitiveness. First under the Bretton Woods regime and later under the hard EMS, the German model of export-led growth had powered the West German economy. A persistent bias in aggregate demand shapes economic structures accordingly, leaving an oversized tradable goods sector as its legacy. The German model only worked because and as long as Germany's main trade partners behaved differently. Exporting the German model to Europe made Germany's export engine sputter.

Germany's knee-jerk and fateful reaction was to order itself an extra dose of discipline, of wage repression, and unconditional austerity. Providing the root cause of the later euro crisis, Germany thereby turned itself into the "sick man of the euro" in the run-up to the crisis (Flassbeck 1997; 2007; Bibow 2012; Dustmann et al. 2014)—before emerging from it as the supposed euro "powerhouse."

In fact, intra-area divergences and imbalances soared during in 2000s as Germany continued practicing relentless wage repression cum austerity. Following a brief boom toward the end of the 1990s—which ushered in the "dot.com bust" and "global slowdown'" of 2001—starting in 2002, euro appreciation was posing a fresh challenge to the German model.

The euro had plunged in its early years. And since (headline) inflation slightly exceeded the ECB's (original) "below 2 percent" price stability norm, the ECB was outstandingly slow in easing policy in response to the slowing euro area economy. By contrast, the US Federal Reserve quickly slashed its policy rate to record-low levels in response to deflation scares. In addition, the US authorities made it clear at the time that a weak dollar was rather welcome. As a result, the euro area authorities' previous years' wishes for a stronger euro soon came to haunt them.

US dollar depreciation from 2002 until the Lehman bankruptcy effectively cut Europe's EMU off from the global boom of the 2000s, stalling the German model with regard to extraregional net exports. In the first decade of its existence, the euro area's current account position was roughly balanced, providing a convenient excuse to the EU authorities in the context of heated debates about surging "global imbalances." They simply claimed that the euro area was not a party to those global current account imbalances and had to play no part in their resolution (Bibow 2007a).

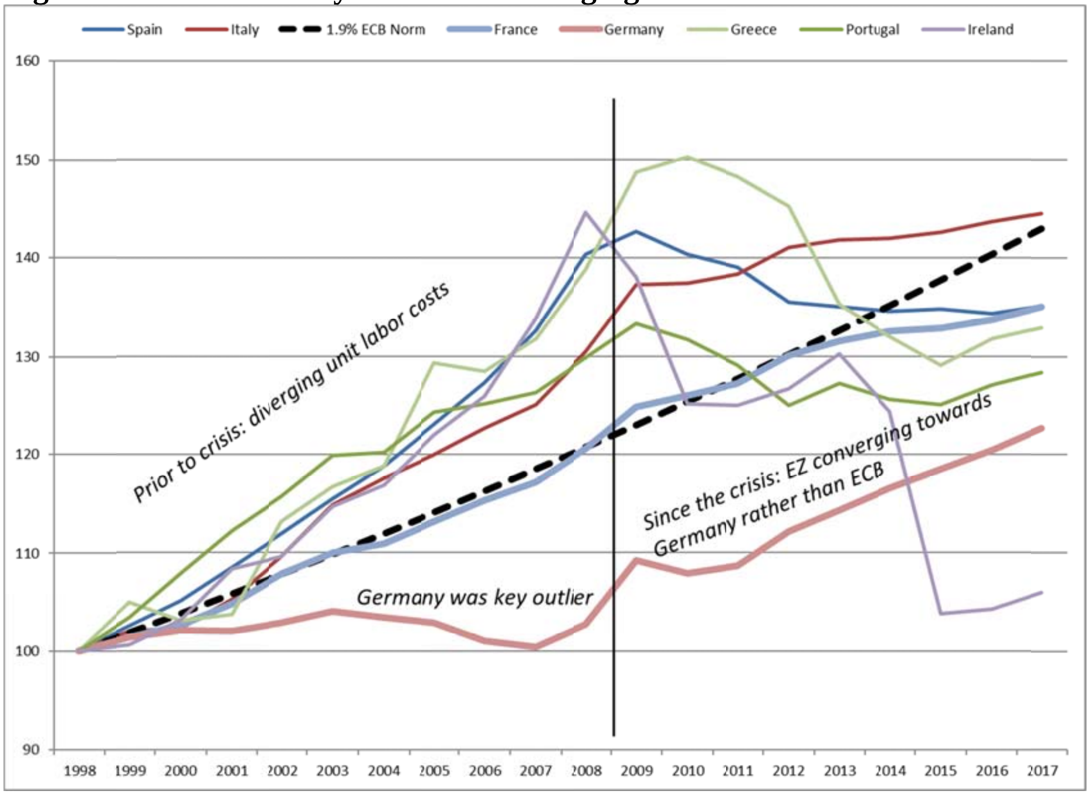
That excuse turned out to be flawed in at least two ways. For one thing, Europe's banks were playing a central role in enabling bubbles and imbalances both in the region and globally. For another, the euro area's inability to handle its own intraregional imbalances, homegrown bubbles, and resulting crises soon enough turned Europe's EMU into a massive global drag, hindering global recovery and more balanced global growth in the post–global crisis era and continuing until today.

In short, the German model has been in trouble right from the start and ever since. The German model relies on export-led growth. Euro appreciation after 2001 meant that Europe's currency union could not rely on external stimulus for its growth. Generating domestic-demand-led growth ended with very poor results indeed. Recovery from the 2001 global slowdown was a struggle. With Germany—the region's largest economy—sick and stagnant, the ECB's monetary stance, geared towards the area's "average," fired up credit and asset price bubbles in the periphery. Intra–euro area divergences and imbalances soared as a result, laying the groundwork for future crises (Bibow 2007b).

Mindless austerity and wage repression stoked domestic demand in Germany. But the country gradually also turned über-competitive as unit-labor cost trends persistently diverged downward from the rest (see figure 2). From 2002–6 Germany literally grew on (net) exports only. With flat domestic demand, even Germany's imports were solely driven by export demand. By implication, all the borrowing and spending that enabled German exports was done by Germany's trade partners, running up rising current account deficits and foreign debts in the process, particularly by Germany's euro partners (Bibow 2012).

The euro policy regime not only failed to prevent the buildup of fragilities, it also magnified any emerging intraregional divergences and emerging vulnerabilities. The ECB's monetary policy stance was too tight for Germany, but too loose for the bubbling periphery. The procyclical fiscal regime was a support act in this: persistent austerity held back Germany, while fiscal ease fired up the periphery (Hein and Truger 2007).

Figure 2: ECB's Stability Norm and Diverging Unit Labor Cost Trends



Sources: Eurostat, AMECO Database.
Note: Nominal unit labor costs, total economy

The failure of Lehman Brothers triggered a European banking crisis that exposed the euro area's lack of proper macro defenses. Some euro area countries, including Germany and France, had large direct exposures to US mortgage risks. Other euro area countries, such as Spain and Ireland, were facing banking problems caused by their own homegrown housing bubbles, with German and French banks' exposures to these countries' banks and bond markets once again featuring prominently. Further troublesome banking exposures showed up in the new EU member states.

Banking problems hit national public finances, proving too heavy for some countries' public finances to shoulder on their own. In the late 1980s, Europe had embarked on deep market integration, but forgot about commensurate policy integration. European banks felt encouraged to roam freely across borders. When troubles hit, banks turned out to be global in life, but national in death.

As banking losses weakened the fiscal outlook, any deterioration in the sovereign's credit rating, in turn, undermined the banks even more. Sovereigns depend on banks as lenders and buyers of their bonds. These—supposedly safe—sovereign bonds feature as critical collateral in banking business. Banks' and their sovereign's liquidity and solvency status are intensely connected.

A peculiar feature of euro area sovereigns is the fact that they effectively issue debt in a foreign currency and lack a central bank by their side that can act as lender of last resort. When the crisis materialized, the critical two-way dependency between banks and their sovereigns saw vulnerabilities quickly spread and escalate in Europe's EMU. The "bank-sovereign doom loop" destabilized more and more euro area countries, prompting large-scale flight-to-safety trades and threatening area-wide contagion.

Excessive private indebtedness that had built up during the euro's first decade was at the issue. Little fiscal stimulus was forthcoming in response to the unfolding economic collapse at the end of 2008. Germany, of all places, enacted a more sizeable stimulus package in 2009–10, but the Keynesian moment of reason was brief. The Greek crisis conveniently paved the way for a swift return to austerity across the continent. The ECB stuck with lending-of-last-resort (LOLR) measures in support of banking systems, while refraining from more aggressive experimental monetary policies applied elsewhere (known as "quantitative easing" [QE]) until 2015 (Bibow 2017).

The euro area's immediate crisis response proved insufficient. Disaster began to unfold in 2010 when the euro area embarked on joint fiscal austerity, paired in euro crisis countries with wage repression—the deadly mix that had gotten Germany sick prior to the crisis. Now the euro crisis countries were to try the same medicine jointly, and at a time when no growth impulses were forthcoming elsewhere in Europe. They were prescribed "internal devaluation" to restore their competitiveness, but no matching prescription for internal revaluation and domestic demand expansion was given to Germany. In fact, having included a "debt brake" provision in its constitution in 2009, Germany was joining the austerity campaign, aiming at a ("black zero") balanced budget as well. Worse, the so-called "Fiscal Compact" was pushed through, which essentially requires all countries to permanently pursue balanced budgets.

In 2010–12, the euro area sunk into another protracted recession. Rising exports were the only lifeline that kept the euro area above water. Mario Draghi's famous promise "to do whatever it takes" and the ECB's "outright monetary transactions" program broke the contagion and provided the turning point. The ECB was forced to engage in further policy experiments trying to compensate for euro regime deficiencies, including negative interest rate policies and finally a large-scale asset purchase program that included public debt securities. These improvised measures helped to stabilize Europe's currency union, at least temporarily, but regime flaws have not been fixed and the euro crisis remains ultimately unresolved, even by 2018. Figure 2, above, shows a deflationary convergence toward Germany, leaving the ECB struggling and persistently undershooting its price stability norm.

The essence of the euro's failure and its underlying regime flaws may be identified as the following three. The first mistake was to pursue market integration without commensurate policy integration. This flaw was most critically felt in the domain of banking. As the euro's launch unleashed another push to the single-market program's ideal of integrating Europe's financial markets, banks ventured across borders with forte, both regionally and internationally. Alas, a hazardous policy vacuum opened up as national policymakers were no longer in a proper position of minding the store. Europe's "banking union" initiative of 2012 was meant to heal this particular regime deficiency. It remains dangerously "incomplete" as of now.

The second mistake was to ignore intra-area divergences in competitiveness positions. The euro was meant to prevent "beggar-they-neighbor" competitive currency devaluations for good. But no safeguard was put in place to enforce the regime requirement of keeping national unit-labor cost trends aligned with the ECB's common price stability norm. Figure 2 shows that Germany's ill-guided mission to "restore" its competitiveness was in stark conflict with this norm. Germany's huge and persistent current account surplus proves the so-called "macro imbalances procedure" (MIP) wholly inadequate in looking after this issue, even a decade after the crisis erupted.

The third failure concerns macroeconomic stabilization in general and crisis management in particular. Already the 2001 global slowdown had shown that the euro area was lacking sufficient stabilization capacity for dealing with normal downturns. The global crisis of 2007–9 and subsequent euro crisis has proved the euro area's fiscal regime is utterly counterproductive: destabilizing in the short run and harmful to long-run growth, too. Even if the ECB grew sufficiently flexible and creative as LOLR to banks and banking systems, its support of sovereigns, ideology, and the Maastricht rules set bigger obstacles. Given the inherent interdependency between banks and sovereigns, just helping the former may prove ineffective.

At long last the ECB found cover for supporting sovereign debt under its monetary policy mandate, namely to counter acute deflation threats and to overcome defective monetary policy transmission. Its belated QE was not quite powerful enough to compensate for the currency union's inadequate overall fiscal stance and relentless wage repression. Instead, the euro area's fragile recovery since 2013 has seen Europe's currency union building up a 4-percent-of-GDP current account surplus by 2018. It would be rash to declare that the German model is working for the euro area after all. The next section will zoom in on the case of Spain before we return to the euro regime's persistent failure.

4. THE CASE OF SPAIN

Spain's crisis under the euro features all the critical ingredients that were identified above: first, the liberalization of banking that enabled an unchecked lending boom; second, a significant loss of competitiveness inside the euro area, particularly vis-à-vis Germany; and third, the amplification rather than containment of divergences and imbalances once these had got underway. Like in other euro crisis countries, certain national peculiarities played a role, too.

It is controversial how exactly the intra-euro area imbalances that imploded in the crisis came about (see Baldwin and Giavazzi [2015], for instance). One issue is whether financial account imbalances (net capital flows) or trade imbalances were driving the developments. Another issue is whether competitiveness imbalances were a cause or effect. Further issues concern the relative role of competitiveness divergences versus domestic demand growth differentials, as well as the role of productivity growth differentials, in this. In discussing these issues, we will aim at identifying the ultimate causes of the calamity.

Probably the most important confusion concerns the role of excess saving and capital flows. In terms of national income accounting, a country running a current account surplus features saving that exceeds investment by that amount. This neither means that saving can somehow precede and cause investment nor that a rise in saving, as a causal factor, is anything else but a drop in spending. Similarly, regarding capital flows—which in some discussions appear to be causally connected with some imaginary kind of “excess” saving—these are, in the first instance, nothing else but portfolio decisions: either concerning the reshuffling of existing assets or occurring together with a change in leverage of some kind, especially the expansion of balance sheets and creation of new liquid assets by banks (see Bibow [2009]; Borio, McCauley, and McGuire [2011]; Borio and Disyatat [2011, 2015]).

Banking liberalization inspired European banks to expand their balance sheets, sparking lending booms inside the euro area, but also with the United States and Eastern Europe as favored destinations (Shin 2012; Avdjiev, Berger, and Shin 2018). With the euro, highly liquid euro money and capital markets developed that greatly eased the recycling of any euro liquidity and funding imbalances across Europe—when times were calm. Relying on the liquidity of these markets, banks’ business expansions were only limited by what they perceived as profit opportunities under existing and expected financial conditions.

With the euro’s launch in sight, great profit opportunities were perceived in the euro periphery based on prevailing interest rate differentials and asset values. Presented such opportunities, assume a German bank expands its balance sheet by purchasing a Spanish government bond (or lends to a hedge fund that does so). The balance in the Spanish bond seller’s bank account in, say, Spain will go up accordingly. The balance sheet of the Spanish bank involved will increase. On the asset side, there may be a loan to the German bank that bought the Spanish government bond. The interbank lending may be direct or take place via some other bank in, say, London. Or the German bank issues bonds rather than (wholesale) deposits to fund its balance sheet expansion. Gross capital flows show portfolio flows toward Spain and other investment flows toward Germany. There is no change in net flows involved here as these transactions as such do not cause any change in the financial or trade account balances.

Rather, the portfolio decisions and related capital flows cause financial conditions to change: interest rate differentials will shrink and financial conditions ease in Spain. It is the easing of financial conditions in Spain that gets the lending boom proper going: willing borrowers will be enticed to take on more debt, with willing lenders happily going along (given the liquidity of wholesale markets). This stimulates spending and incomes in Spain. The stronger economy and rising asset prices validate the lending boom. Goods prices and wages, too, will be bolstered. The newfound liquidity of euro money and capital markets is key to sustaining the local lending boom. As Spanish imports surge, a trade imbalance and corresponding net capital flows become part of the picture. Banks do little lending in Germany, where wage repression and mindless austerity depress the economy. But German banks happily search for opportunities abroad (see Waysand, Ross, and Guzman [2010]; Milesi-Ferreti, Chen, and Tressel [2012]; Bibow [2013a]; Lane [2013]).

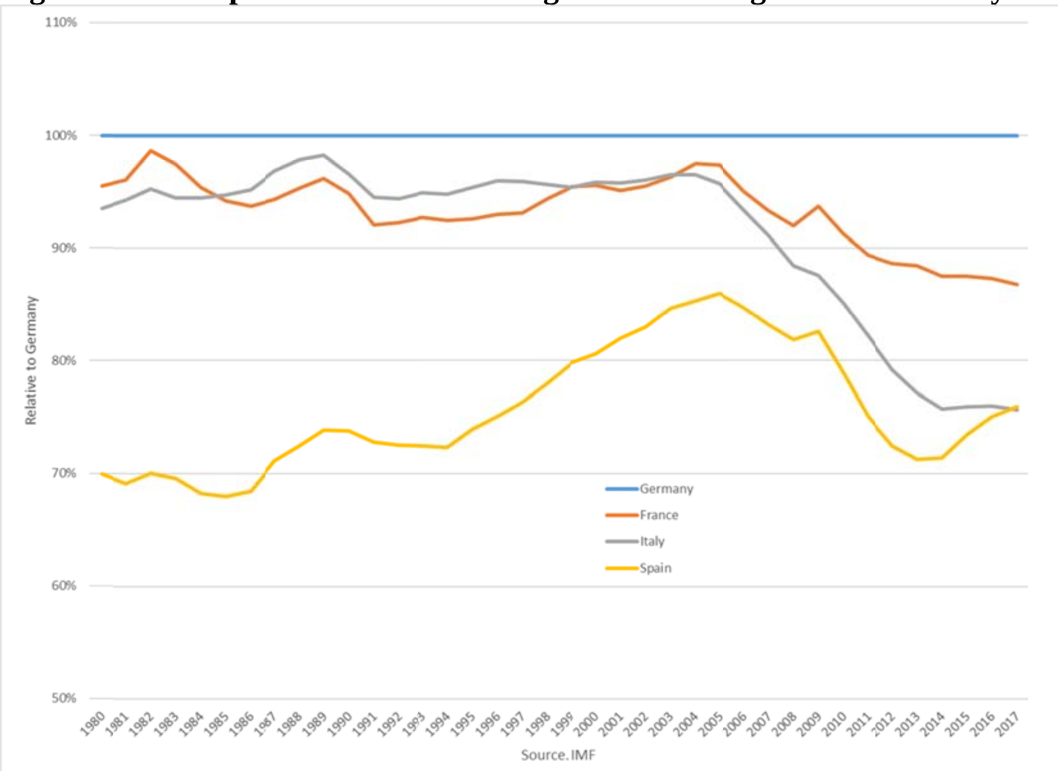
The ECB's common monetary policy stance and the Stability and Growth Pact magnify intra-area divergences and imbalances build up—both domestic and external imbalances. Domestically, Spanish households and corporations are seen to be on a debt binge. Much of the rising debt gets recycled externally. Spain's net international investment position deteriorates accordingly. Actually, gross external debts rise by even more since Spain's banks, too, are busy undertaking international adventures (see Febrero and Bermejo [2013]; Febrero, Uxó, and Bermejo [2016]; Veld [2014]; Fernández and Garia [2018]).

When Spain's lending and housing bubble turned from boom to bust many borrowers (household mortgagers, property developers, etc.) were quickly "underwater." As their lenders' solvency got questioned, liquidity—liquidity in those previously highly liquid euro money and capital markets—dried up. The phenomenon resembles a "sudden stop" featuring a "flight to quality." Essentially, the German banks (and others) got too scared to roll over their loans to Spanish banks. Prior to the euro, Banco de España would have acted as lender of last resort to banks, its foreign reserves would have dwindled, the peseta would have plunged, and German banks would have suffered losses on their foreign loans.

Instead, the ECB stepped in with emergency liquidity programs. The Eurosystem's balance sheet filled in for dried up euro money and capital markets, keeping Spanish banks above water and allowing German banks to get out largely unharmed, too. As German banks' foreign claims shrunk, their claims on the Bundesbank and the Bundesbank's claims on the ECB (TARGET2) rose accordingly. In this way, German banks' troubled risk exposures got mutualized/socialized on the Eurosystem's balance sheet (Bibow 2012). With exchange rate realignments no longer an option, asymmetric struggles with "internal devaluation" under adverse conditions got under way. Today, as banks in euro crisis countries are still working off their legacies of a deep and drawn-out crisis, Germany refuses to go along with more "risk sharing"—even as Germany got its own under-the-radar risk sharing deal done earlier thanks to the ECB.

The Spanish economy started recovering in 2013. To claim that austerity and wage repression (through structural labor market reform) did the trick is fake news. Instead, monetary easing and a weak euro have helped, and so has the pausing of fiscal austerity. A long tourism boom surely did no harm. Internal devaluation has contributed toward shifting from domestic to external demand, from producing nontradables to tradables, but mainly because Spain moved ahead of France and Italy.

Figure 3: Per Capita Incomes in the "Big Four": Falling behind Germany



Source: IMF

Looking at the "big four," the situation in Spain almost appears to be less unfavorable compared to France and Italy. The "big three" were not far apart in terms of per capita incomes prior to the euro, with Spain catching up fast since the mid-1980s until crisis struck. Spain suffered a heavy setback, though it appears temporary, as it is making up lost ground today. By contrast, France and especially Italy have fallen sharply behind Germany since the crisis. If non-German Europeans feel that the German euro has only served Germany but not Europe at large, this perception may not be too farfetched (see figure 3). Will Europe ever get a euro that delivers on its promises of convergence and shared prosperity?

5. THE UNRESOLVED EURO CRISIS: WILL EUROPE FINALLY GET A EUROPEAN EURO?

The euro crisis has exposed existential flaws in the euro regime. Intra-area divergences and the corresponding buildup of imbalances had remained unchecked prior to the crisis. As those imbalances eventually imploded, member states were found to be extremely vulnerable to systemic banking problems and abruptly deteriorating public finances. Debt legacies and high unemployment continue to plague euro crisis countries. Its huge current account surplus highlights that the euro currency union, toiling under the German euro and trying to emulate the German model, has become very vulnerable to global developments. The euro regime is flawed and dysfunctional. Europe has to overcome the German euro.

Three reforms are essential to turn the euro into a viable European currency.

First, divergences in competitiveness positions must be prevented in future. National unit labor cost trends must stay aligned with the ECB's common price stability norm. An effective MIP that deserves that name is essential.

Second, market integration must go hand in hand with policy integration. The belated banking union and capital markets union projects need to be completed. EMU urgently needs a common safe asset.

Third, the euro is lacking a safe footing as long as the ECB is missing a federal treasury partner, therefore establishing the vital treasury–central bank axis that stands at the center of power in sovereign states is essential (Goodhart 1998). The current regime leaves all players vulnerable. The lack of fiscal union is central to the euro's underlying ailments. The euro is a currency without a state, featuring the oddity of decoupling the monetary and fiscal authorities. This decoupling of fiscal and monetary powers is the ultimate euro flaw. It can only be fixed by pairing up the ECB with a common euro treasury (Bibow 2013b).

These key issues should have been addressed before 1999. It is so much harder to resolve them today because of pressing crisis legacies, rising political fragilities, and worsening distrust among the partners and euro nations. But kicking the can down the road is highly risky and will only work for so long.

REFERENCES

Avdjiev, S., B. Berger, H. S. Shin. 2018. “Gauging procyclicality and financial vulnerability in Asia through the BIS banking and financial statistics.” BIS Working Paper 735. Basel: Bank for International Settlements.

Baldwin, R., and F. Giavazzi. 2015. “Towards a consensus on the causes of the EZ crisis.” Voxeu.org, September 7.

Bibow, J. 2007a. “Global imbalances, Bretton Woods II, and Euroland’s role in all this.” In J. Bibow and A. Terzi (eds.), *Euroland and the World Economy—Global Player or Global Drag?* Basingstoke, UK: Palgrave Macmillan.

———. 2007b. “How the Maastricht regime fosters divergence as well as instability.” In P. Arestis, E. Hein, and E. Le Heron (eds.), *Monetary Policies—Modern Approaches*. Basingstoke, UK: Palgrave Macmillan.

———. 2009. *Keynes on Monetary Policy, Finance and Uncertainty: Liquidity Preference Theory and the Global Financial Crisis*. London and New York: Routledge.

———. 2012. “The Euroland crisis and Germany’s euro trilemma.” *International Review of Applied Economics* 27(3): 360–85.

———. 2013a. “Germany and the Euroland Crisis: The Making of a Vulnerable Haven.” Levy Institute Working Paper 767. Annandale-on-Hudson, NY: Levy Economics Institute of Bard College.

———. 2013b. “Lost at sea: the euro needs a euro treasury.” IMK Study No. 35. Düsseldorf: Hans Böckler Stiftung (IMK).

———. 2017. “From anti-growth bias to quantitative easing: The ECB’s belated conversion?” In R. Mirdala and R. R. Canale (eds.), *Economic Imbalances and Institutional Changes to the Euro and the European Union, International Finance Review*, Volume 18. Somerville, MA: Emerald Publishing.

———. 2018. “How Germany’s anti-Keynesianism has brought Europe to its knees.” *International Review of Applied Economics* 32(5): 569–88.

Borio, C., R. McCauley, and P. McGuire. 2011. “Global credit and domestic credit booms.” *BIS Quarterly Review* September: 43–57.

Borio, C., and P. Disyatat. 2011. “Global imbalances and the financial crisis: Link or no link.” BIS Working Paper 346. Basel: Bank for International Settlements.

———. 2015. “Capital flows and the current account: Taking financing (more) seriously.” BIS Working Paper 525. Basel: Bank for International Settlements.

Dustmann, C., B. Fitzenberger, U. Schönberg, and A. Spitz-Oener. 2014. “From sick man of Europe to economic superstar: Germany’s resurgent economy.” *Journal of Economic Perspectives* 28(1): 167–88.

Dyson, K., and K. Featherstone. 1999. *The Road to Maastricht: Negotiating Economic and Monetary Union.* Oxford: Oxford University Press.

Febrero, E., and F. Bermejo. 2013. “Spain during the great recession: Teetering on the brink of collapse.” In Ó. Dejuán, E. Febrero, and J. Uxó (eds.), *Post-Keynesian Views of the Crisis and its Remedies.* London: Routledge.

Febrero, E., J. Uxó, and F. Bermejo. 2016. “The role of gross capital flows in the great financial crisis. The case of Spain.” Unpublished conference paper delivered at the 20th FMM Conference, “Towards Pluralism in Macroeconomics?,” October, 20–22, Berlin.

Fernández, R., and C. Garia. 2018. “Wheels within wheels within wheels: the importance of capital inflows in the origin of the Spanish financial crisis.” *Cambridge Journal of Economics* 42: 331–53.

Flassbeck, H. 1997. “Und die Spielregeln für die Lohnpolitik in einer Währungsunion?“ Frankfurter Rundschau, October 31. Available at: http://www.nachdenkseiten.de/upload/pdf/FR_Dokumentation_DRS_Freitag_31-10-1997_2.pdf

———. 2007. “Wage divergences in Euroland: Explosive in the making.” In J. Bibow and A. Terzi (eds.), *Euroland and the World Economy—Global Player or Global Drag?* Basingstoke, UK: Palgrave Macmillan.

Giersch, H., K.-H.Paque, and H. Schmieding. 1992. *The Fading Miracle: Four Decades of Market Economy in Germany*. Cambridge: Cambridge University Press.

Goodhart, C. A. E. 1998. “The two concepts of money: Implications for the analysis of optimal currency areas.” *European Journal of Political Economy* 14: 407–32.

Hefeker, C. 1994. “German monetary union, the Bundesbank and EMS collapse.” *Banca Nazionale del Lavoro Quarterly Review* 47(191): 379–98.

Hein, E., and A. Truger. 2007. “Fiscal policy and macroeconomic performance in the euro area: Lessons for the future.” In J. Bibow and A. Terzi (eds.), *Euroland and the World Economy: Global Player or Global Drag?* Basingstoke, UK: Palgrave Macmillan.

Hölscher, J. 1994. *Entwicklungsmodell Westdeutschland. Aspekte der Akkumulation in der Geldwirtschaft*. Berlin: Dunkcer & Humblot.

Holtfrerich, C.-L. 1998. “Geldpolitik bei festen Wechselkursen (1948–1970).” In Deutsche Bundesbank (ed.), *Fünfzig Jahre Deutsche Mar: Notenbank und Währung in Deutschland seit 1948*. München: C. H. Beck.

Issing, O. 2008. *The Birth of the Euro*. Cambridge: Cambridge University Press.

James, H. 2012. *Making the European Monetary Union*. Cambridge, MA: Harvard University Press.

Lane, P. 2013. “Capital flows in the euro area.” *European Economy Economic Papers* 476: 1–54.

Milesi-Ferreti, G. M., R. Chen, and T. Tressel. 2012. “External imbalances in the euro area.” IMF Working Paper 12/236. Washington, DC: International Monetary Fund.

Shin, H. S. 2012. “Global banking glut and loan risk premium.” *IMF Review* 60(2): 155–92.

Veld, J. 2014. “International capital flows and the boom-bust cycle in Spain.” *European Economy Economic Papers* 519: 1–56.

Wallich, H. C. 1955. *Triebkräfte des deutschen Wiederaufstiegs*. Frankfurt am Main: Fritz Knapp.

Waysand, C., K. Ross, and J. Guzman. 2010. “European financial linkages: A new look at imbalances.” IMF Working Paper 10/295. Washington, DC: International Monetary Fund.