The Target of German Economists

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Beyond any doubt, Hans-Werner Sinn is the most influential German economist. He exhibits a flawless, albeit conventional, curriculum. Revered by his dominantly priggish colleagues, he chairs Cesifo, a powerful group of research institutes in a country in which the economists' opinion is viewed in high consideration. Sinn's views are the most pro-German one can imagine and have the sole purpose of depicting it as the real victim of the rest of Europe.

It obviously makes little sense to blame Germany or any other country for the European crisis. Each dominant class joined the European Monetary Union (EMU) in its own interest or pretending to do so for its respective country. If the collective design of the EMU has failed, the responsibility is not of one single country: each national elite has made its own calculations and they should all have known that Europe was not an optimal currency area. We cannot know, of course, what would have happened to Europe or to single members of the Eurozone (EZ) without the EMU. Less excusable is, especially for major countries, not to appreciate and change national policies that are particularly inconsistent with the EMU. Unfortunately this is far from happening. The story told by Sinn is interesting in this respect, since the narrative of the crisis offered to the public by the German centre-right politicians particularly relies on that provided by their most favourite economist. I shall refer here to a recent long petition subscribed to by top exponents of the financial and political elite, including Sinn, who is clearly recognisable as the extensor.

1. The analysis begins with the recognition, generally shared by all analysts, that the EMU has favoured financial flows from core toward fringe Europe.[i] Those flows induced an ephemeral growth in the latter. Ephemeral because it did not lead to the development of national productive capacities and export sectors (as predicted by neoclassical theory), but to massive imports from the core. This also because growth was accompanied by an above European average inflation and consequent loss of competitiveness. Corresponding to the foreign disequilibria was the progressive indebtness of the private and/or public sectors. From here, however, interpretations diverge. According to many observers Germany prepared itself to win markets through a severe labour market reform undertaken by Chancellor Schroeder, a reform that imposed a moderate tone to the wage and domestic consumption dynamics in Germany. One is tempted to see here a continuity with, what an important German economic historian has defined as, 'Monetary Mercantilism', a strategy

inaugurated in the early 1950s under the auspices of Erhard, the father of the German economic miracle, and the then chief of the German central bank (called Bank Deutscher Lander until 1957). Wilhelm Vocke so summed up: 'we have consistently remained below [the competitors' inflation rate]. And this is our chance, that is decisive, for our currency and especially for our exports. Raising exports is vital for us, and this in turn depends on maintaining a relative low price level and wage level … As I have said, keeping the price level below that in other countries is the focal point of our efforts at the central bank, and it is a success of those efforts. That should be borne in mind by those who say to us: your restrictive measures are too tight, are no longer necessary' (see Holtfrerich 1999: 345). In summation, with fixed exchange rate, as during Bretton Woods, the German strategy was to maintain the inflation rate a little below that of competitors to sustain exports while enjoying a strong currency. This policy was widely criticised by the Keynesian-oriented Western partners during the 1950s. With the European Monetary System and later with the EMU, Italy, France and the other European peripheral partners wanted, unsuccessfully, to imitate Germany. In the light of Kaleckian theory, 'Monetary Mercantilism' is a perfect strategy for capitalists: domestic low wages (relative to productivity) imply a high surplus (i.e. capitalists' profits) that can be successfully sold in the uncompetitive periphery. The financial capital flows are functional to this circuit anticipating to the periphery the purchasing power necessary to absorb the core capitalists' surplus.

2. Sinn argues in quite different terms. In synthesis he maintains that the capital outflows from Germany impoverished the investment capacity of his country and this (and not the domestic consumption repression) would explain the German low growth in the EMU pre-crisis decade. After the crisis, capital outflows ended. The ensuing recovery of investment reinforced by wage moderation, so the argument goes, led to the German recovery in spite of the periphery troubles.[ii]

   It may, in the first place, be asked why the EMU favoured credit demand in the periphery and not in Germany. One may dare to think that, on the one hand, countries such as Spain and Ireland were already in a process of catching up, while suffering from financial repression - for instance, mortgages were available only at high interest rates and with short durations, the opposite happened after the EMU. This attracted foreign financial flows. On the other hand the German market was not promising for investment: wage moderation, traditional German household aversion for debts and the low propensity to home-ownership (only 43% of German households live in a house owned by them, one of the lowest in the

industrialised world) may explain the absence of a housing bubble.[iii] So credit went where the economic climate was more favourable to autonomous (credit financed) spending decisions. In no sense, however, could financial flows to the periphery have constrained credit availability in Germany. Sinn clearly argues as if a *given* amount of German saving was available to alternative uses, either in the core or in periphery. But, as we shall see, German savings are the final result of a financial circuit which starts from the purchasing power creation by core (or also peripheral) banks in favour of autonomous spending in the periphery. German savings are indeed the outcome of (actually by definition identical to) the German foreign trade surplus – more precisely of the current account surplus.

In the second place, the general opinion is that the German recovery in mid-2010 has been led by exports (who could guess otherwise?) to extra-EZ markets. This was the result both of the euro depreciation after the crisis and of the good performance of the emerging economies. So Germany profited both because of the European disgraces, that downgraded the euro, and of the support to domestic demand by emerging economies.[iv]

3. A big fuss was also raised by Professor Sinn in late spring 2011 when he accused the ECB of providing unlimited financial support to the periphery enduring current account deficits and even capital imbalances. The story has to do with a complicated mechanism through which the ECB manages in an ordered way the payments flow within the EZ, called TARGET2, that involves the Eurosystem central banks besides the ECB itself. As far as I could understand, Sinn is not wrong in calling attention to the role of the ECB in making the European imbalances financially sustainable – although he typically over-stretches his case to maximise the German role as a victim.[v] Simplifying, normally, whenever a Greek borrowed money from a Greek bank in order to buy a German commodity, eventually the German exporter lent to the Greek, through its German bank, the revenues received as payment for its export. Unsurprisingly, it is the shopkeeper that lends money to the old lady that lives out of her poor pension (perhaps expecting that some grandchild will eventually foot the bill). Ordinarily, the ECB is involved in this circuit only as an intermediate, as a clearing house. Since 2008 or so, however, Germans began to distrust the solvability of the peripheral European countries and stopped the recycling of their export revenues. These proceeds begun therefore to remain deposited in the German banks that re-deposited them, via Bundesbank, at the ECB. At this point, it was the same ECB that, as part of its normal duty as Bank of the (ordinary) banks, began to lend money to the peripheral banks. It would

of course be wrong to say that the ECB lent the export revenues that the Germans left with the ECB, as Sinn pretends. Indeed, if (say) Greece does not return the credit to the ECB, all the European Central Banks would suffer pro-quota the loss.[vi]

In addition, in order to finance the peripheral current account deficits, the ECB also has to make good the capital flights from the peripheral to the core Europe banks. Also in this case the capital outflows from the periphery that reach the German banks are re-deposited, via Buba, at the ECB. Nonetheless it is not correct to say that the ECB is lending these deposits (again, in case of capital losses, the Buba would be hit only pro-quota).

The main mistake by Sinn is not to admit that the ECB is just allowing the circuit not to collapse, that is, it is constantly re-financing German exports towards the periphery.[vii] As a German critic of Sinn sums up: ‘the counterfactual would be a breakdown of the euro where Germany’s claims would be against foreign commercial banks. In this case they would be just as worthless. The whole point of the rescue operations is to prop up the solvency of Germany’s export clients’ (quoted here). If Sinn doesn’t trust the long run reliability of this system – he would perhaps not be wrong to think so – why does he not ask for an embargo of German exports towards the periphery? Certainly fringe Europe would not oppose it.

4. As a digression, Sinn’s argument becomes really specious when he argues that with the capitals deposited at the ECB Germans might have bought real assets in the periphery. This reminds of the German refrain that German thrift and foreign trade surplus are necessary to collect foreign assets necessary into the future to sustain the ageing German labour force.[viii] Why did they not do so, then? Perhaps because foreign investment is not very profitable in an impoverished periphery. Blinded by his over-effort to present his beloved country as the victim of a profligate world, a refrain of previous generations of German orthodox economists, Sinn does also not clearly perceive that once a periphery country sells its capital assets – say its public utilities - to redeem its foreign debt, then its current account will be *forever* burdened by the interest payments on those assets (in practice, for instance, profits yield by the public utilities will go abroad). As Jan Kregel taught us many years ago,[ix] foreign investment is a sort of foreign debt for the country that receives it: it has still to pay interests on it. If Greece redeems the principal of the debt by surrendering to Germany a corresponding amount of real capital assets, it will nonetheless have to continue to pay – ad infinitum – the same or even higher interests.[x] Of course, in the short run the advantage for

Greece is that it will have not realize an enormous trade surplus necessary to repay the foreign debt while continuing to serve the interest payments. However, a general, German-led European recovery might help Greece and the other peripheral nations to obtain a trade surplus and slowly repay the debt without becoming, by selling the capital assets, forever slave of foreign reinters (see e.g. here and here).

5. All in all, the economic recipe of Sinn and his German orthodox fellows is just to say: if you are not capable of surviving within the EMU by cutting your wages and prices, leave it.[xi] It is an argument we expect from the *Build Zeitung*.

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[i] Core Europe includes Germany, The Netherlands, Austria and Finland. Fringe Europe includes Greece, Portugal and in some respect Spain and Ireland. Italy, traditionally a strong manufacturing country, cannot strictly be considered part of the periphery. Its public debt problem is older than the EMU, although the latter aggravated the foreign balance problems of the country.

[ii] "Germany was not the euro winner, as some politicians argue, but is benefiting from free trade. The massive flow of capital out of Germany and into the deficit countries ushered in by the introduction of the euro is a major reason why Germany had the lowest net investment rate of all OECD countries for a long time, lagged behind them in terms of growth and was hit by mass unemployment, which forced the Schröder government into implementing painful social reforms. From the start of interest rate convergence, triggered by the announcement of the introduction of the euro as early as 1995, until 2007, the year before the crisis, Germany had fallen from third to eleventh place in the ranking of EU countries by GDP per capita. In the light of these facts, the assertion that Germany has profited in any special way from the euro is untenable.

Germany was not able to achieve above-average growth until after the outbreak of the euro crisis in 2010 and 2011. However, that was partly because it had already survived its own euro crisis through years of restraint in terms of wages and prices accompanied by strenuous efforts on the part of businesses, and partly due to a revised assessment of foreign risks, which induced German investors to keep their money in their relatively safe home port. The economic recovery of the last two years was indeed primarily driven by investment. This enabled Germany to work its way up from eleventh to ninth place in the ranking of EU countries. So the current success is not achieved thanks to the euro, but actually despite it, and because of its crisis." (see here)

[iii] An informative article on why Germany has not had a housing bubble is here. We learn that this country had a bubble in Berlin and the East in the 1990s induced by tax-advantages for residential investment there that ended in tears.

[iv] Shamefully, in November 2008 the then German minister for the Economy declared: "We can only hope that the measures taken by other countries ... will help our export economy", (*Financial Times* 30 November 2008). George Irvin points that: 'In late 2008, when the OECD countries had only just been hit by the credit crunch and Keynesians were arguing for a large stimulus package to offset private deleveraging, the German Finance Minister Peer Steinbrück launched an unprecedented attack on Gordon Brown, accusing him of 'crass Keynesianism' and claiming that economic stimulus would merely 'raise Britain's debt to a level that will take a whole generation to work off'. A year later, Steinbrück helped draft the Merkel government's infamous debt-brake law (*Schuldenbremse*) effectively outlawing counter-cyclical deficit spending — which Ms Merkel currently wants applied to the whole Eurozone (EZ). One might dismiss all this as right-wing

madness, were it not for the fact that Peer Steinbrück was an SPD (German social democratic party) Minister and the party's Deputy Chairman. Not only does he have a degree in economics from Kiel University, but he may well be the SPD's candidate for *Bundeskanzler* (Chancellor) in the federal elections scheduled for late 2013'.

[v] See Peter Garber of the Deutsche Bank, who was the first to draw attention to the issue, and Whelan (here) for a criticism of Sinn.

[vi] It is of course arguable that Central bank can suffer capital losses, given the unlimited power they have to create money (see here). Interestingly, mainstream economist Lucrezia Reichlin contexts Sinn's contention that 'by shifting so much of the Eurozone's money creation towards indirect finance of deficit countries, the system has had to withdraw credit from commercial banks in creditor countries'. Indeed, she argues, 'in the euro system, under the fixed rate full allotment system of operations, liquidity is supplied at satiation at a fixed interest rate and there is thus no withdrawal of money creation from creditor countries.'

[vii] TARGET 2 shows that it is financial lending in support of spending in the periphery that generates, via higher German net export, production and income, the higher German savings. So it is not correct to say that German savings financed the Greek (presumed) profligacy, since it is the Greek profligacy, financed out of purchasing power creation by the financial system, that has generated German savings. This is not surprising for those who have fully understood Keynes. Without that spending, *nicht* saving.

[viii] 'In the three years from 2008 to 2010, Germany accumulated a current account surplus of 264 billion Euros vis-à-vis other Eurozone countries. But in net terms this did not translate into it acquiring titles to assets abroad, such as factories, real estate or securities. Instead, fully 255 billion Euros, or 96% of the entire surplus, was "settled" with Target claims of the Bundesbank on the ECB. …Trade surpluses are, of themselves, no badge of success, as politicians are wont to proclaim. They are only useful if they help it to acquire safe assets yielding market-driven interest that can in turn help to secure the standard of living in times of need, by running up current account deficits. If Germany had to write off all or part of its Target claims on the ECB, its export surplus vis-à-vis the other Eurozone countries would be for nought, mere donations that did not make the country any richer. The Germans would have then worked for nothing.' (here). Perhaps the time is now for Germany to carry on current account deficits!

[ix] "Some Risks and Implications of Financial Globalisation for National Policy Autonomy," *UNCTAD Review 1996*, March 1997.

[x] In short the exchange of peripheral capital assets with the debt those countries have with Germany is just a consolidation of this debt: the interest rates on it will have to be paid forever. Not to forget that these interest payments represent a negative entry of the current account.

[xi] "Euro countries that are not willing or objectively unable to take the necessary measures to reduce imbalances and debt should be allowed to withdraw from the euro area and revert to the status of EU countries that are not in the Eurozone. Exiting the Eurozone should be mandatory in the case of default, and the relevant procedures should be contractually set out. Only a monetary union that remains a voluntary confederation of states with respect for the mutually agreed rules has the hope of permanency." (see here)