# The Revenge *of* Helmut Schmidt

*Why I was right about the euro.*

BY C. FRED BERGSTEN

I was one of the very few prominent American economists who supported the euro. I predicted fearlessly that it would succeed, it would be a strong currency, and indeed over the years would join the dollar as a major world currency. All of those predictions, except perhaps the last, have already occurred, and I still think the last will occur as well.

Over the past few years, I predicted that the euro would successfully resolve its crisis, with no breakup of the eurozone, no exits, and no disorderly defaults. That is admittedly a low bar. I did not foresee a rapid return to growth, or rapid completion of the economic union. But the crisis was existential. Apocalyptic forecasts were prevalent. At least in the United States, a majority predicted that the euro would fail, so I feel justified in declaring at least partial and modest victory.

This record should qualify me as one of the strongest and most consistent supporters of the euro. But the interesting question is why the euro survived the crisis. Why were so many analysts wrong? The reason, I think, is simple. Most analysts, at least in the United States and Britain, were using the wrong analytical model.

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Virtually all economists have relied on the theory of optimal currency areas. This says that a monetary union could only work if countries met certain tests, such as having free mobility of labor, which Europe has to a large extent, but also having a regular fiscal transfer mechanism, which Europe does not yet have and certainly did not have at the onset of the crisis. The euro's founding fathers knew they were creating a monetary union that did not have all of the theoretical constructs. They thought that the creation of the monetary union would lead inexorably to further steps necessary to complete the economic union. But times were good in the early 2000s, there was no pressure from the markets to proceed, and when the crisis broke, the house was only half-full. Most experts, seeing the absence of the criteria for an optimum currency area at that point, felt confident that the euro would collapse.

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Using a political economy model, a few of us knew that the overriding postwar goal of all the major countries in Europe was to integrate the continent and avoid the repetition of past disasters. The euro had now become both the main substance and the main symbol of that project. And therefore it would not fail.

This overriding geopolitical determination was particularly prevalent in Germany. As the main source of historical disturbances, Germany would never again let itself be blamed for destroying Europe. According to recent accounts in the *Financial Times* of decision-making during the crisis, German Chancellor Angela Merkel apparently thought of it in exactly those terms, that the failure of the euro would mean the failure of Europe.

A critical but unpopular corollary of this logic was that Germany would pay whatever was necessary to preserve the euro. The European Central Bank would do so as well, with the support and approval of Germany.

For the first couple of years of the crisis, neither the German government nor the ECB was willing to say that they would pay whatever was necessary. That left the markets somewhat uncertain. In my view, the Germans and the ECB were correct to do that because it kept the pressure on the deficit countries to adjust. Also, a little less admirably, the Germans were trying to share the burden of financing with other surplus countries, the ECB, and even the IMF and the rest of the world. I always advised: "Watch what they do, not what they say." And what the Germans did, at every critical stage of the crisis, was to pay whatever was necessary and avoid the risk of failure.

**Helmut Schmidt,** *Chancellor of West Germany 1974–1982: He would complain, sometimes loudly, about the weakness of the dollar.*

Two years ago, ECB President Mario Draghi changed all that when he said for the ECB, "We will do whatever is necessary." That ushered in Phase Two of the crisis. During Phase One, they were doing the right thing, but not saying it. In Phase Two, they said it, so the markets settled and most people agreed the crisis phase had ended. I suggest it is time for Phase Three, where the focus is no longer on financing the imbalances but on achieving adjustment in real economic terms to bring down the imbalances, and thereby restore economic growth to Europe.

First, I want to emphasize that Germany has a second overwhelming reason for its unlimited support of the euro, including via the ECB. That is of course this country's overwhelming economic interest in the euro. Some analysts, such as Adam Posen of the Peterson Institute, like to put it in terms of the heavy exposure of the German banks to the countries in the periphery. Posen argues that bailouts of those countries are really the bailouts of German banks, and Germany maintains its own financial stability by providing support, even unlimited support, to the debtor countries. I prefer to focus on the real side of the economies, not the financial side. My view might be called "The Revenge of Helmut Schmidt."

Germany is the number-one exporting and surplus country in the world. More than China or the United States, Germany is the world export master. It has relied on export-led growth throughout the postwar period. Exports have been the only constant source of growth in the German economy over the last ten years. In seven of those last ten, domestic demand actually rose less than the economy as a whole.

Imports dropped in 2013. And the external surplus has stabilized at over 6 percent a year for the last three years. It actually rose to 8 percent at the end of 2014, almost as high as the Chinese surplus ever got. By comparison, the German surplus is almost $100 billion more in dollar terms than the Chinese surplus, despite being a smaller economy. Germany will soon be the world's number-one creditor country, like it was before reunification, as a result of this surplus.

With this heavy dependence on trade and exports, the German economy is very sensitive to exchange rate issues, especially the level of the exchange rate that governs its price competitiveness in the world economy. When Chancellor Schmidt was running this country, he and other German leaders would routinely express dismay at the typical cycle of the German economy. Germany would get into an export boom, which would lead the overall economy to a stronger position. Then the exchange rate of the deutsche mark would shoot up, undermining to some extent the competitiveness of the economy. Growth would slip. Job creation would not be as rapid or might even decline.

Chancellor Schmidt would then complain, sometimes loudly, about the weakness of the dollar. Now on some occasions there was generalized weakness of the dollar. And I will not pretend that the United States had any monopoly on good policies or international competitiveness. But sometimes we saw a general strengthening of the deutsche mark against virtually all currencies, including others in Europe. There were at least four Schmidt cycles, as I will call them, of that type in the mid-1970s, the late 1970s, the mid-to-late 1980s, and the mid-to-late 1990s, marked by strong exports, a booming economy, the rise of the deutsche mark, and some adjustment.

This time, there has been no adjustment. The German surplus has risen to an all-time record level, and it has stayed there now for an unprecedented period of time. The European Commission, which is not usually too critical of Germany, its paymaster, has said this surplus is structural, so it's likely to continue. The IMF predicts it will continue into the indefinite future. So what has changed?

*The German economy is very sensitive to exchange rate issues.*

This time, there is no deutsche mark to rise to achieve the adjustment of the German surplus. The euro is a very different animal. I'm suggesting that the advent of the euro is actually the revenge of Helmut Schmidt, because the German exchange rate now reflects the economies of the weak European countries as well as Germany itself and the other strong countries. Germany, in purely economic terms, now has the best of both worlds.

Germany runs the world's biggest trade surplus, and it does not suffer from a significant rise in the value of its currency. Whether the euro itself is overvalued or undervalued is a matter of opinion, but it surely has not risen like the deutsche mark or the neue deutsche mark would have had the eurozone broken up.

From a pure economic standpoint, we can predict that the deutsche mark, if it still existed, would have gone up at least 20 percent or more. Analysis at the height of the crisis suggested that had the eurozone broken up, a neue deutsche mark would have gone up at least 40 percent and probably more. That is the difference the euro makes for German competitiveness, the German trade surplus, and the strength and durability of the German economy, as opposed to the adjustment cycle experienced in the past.

I don't know if Chancellor Schmidt had this in mind when he and French President Valéry Giscard d'Estaing and a few others led the way to the creation of the euro, but I think that all German elites—in the government, in the private sector, in the labor unions—understand this phenomenon. That is the second reason why there is no chance that Germany would ever let the euro fail and the eurozone revert to national currencies.

But as usual, when things look too good to be true, it's time to take a closer look.

In this case, the risk is of political push-back from elsewhere in Europe to the growing perception that "the euro works only for Germany." Germany is an island of stability, growth, high employment, and dynamic advancement, while most of Europe languishes in high unemployment, slow growth, and unsatisfactory economic conditions.

Maybe this was an important factor in the recent elections for the European Parliament, where anti-euro sentiment began to arise. I don't suggest that anything dramatic is going to happen overnight. The center has held politically in all of the debtor countries through the crisis. But the potential risk of a continuation of this situation where Germany is isolated in its success is very risky for Europe as a whole, and particularly for Germany.

This anxiety about Europe working only for Germany takes several forms. One is the view that Germany itself is not generating adequate demand to support growth in the eurozone as a whole. A second is the asymmetry in European decision-making between the surplus and deficit countries. If a country runs a deficit above 3 percent, it gets penalized, while a surplus above 6 percent is merely monitored. That's a big asymmetry. Third, there's a lack of structural reform in the surplus countries, even to re-balance in the direction of more domestic demand growth, whereas the deficit countries are hammered every day to do structural reform.

And fourth, fiscal policy comes under increasingly rigorous discipline, whereas monetary policy, at the ECB, has not come under discipline for failing to meet its cardinal target of keeping the inflation rate at around 2 percent. Inflation has been a lot lower than that.

In purely economic terms, one has to acknowledge that Germany is the source of much of the euro crisis. So what are the sources of the underlying problem?

First and foremost are the dramatic unit labor cost differences which former ECB President Jean-Claude Trichet and many others have pointed to throughout the crisis. Unit labor costs in Germany have been unchanged for the twelve-year life of the euro. Unit labor costs in most of the other countries have gone up about 10 percent. A couple of outliers are higher, such as Greece, and maybe Portugal. But in economic terms, there is one outlier: not the deficit countries, but Germany.

*Germany does need to modify the debt brake in its Constitution, and adopt an investment budget separate from the current spending budget.*

German success has been at the root of the problem. This is unpopular to say in Germany, where surpluses are regarded as a great virtue, but that is in fact the economic case. When you look at data provided by the ECB itself, it clearly suggests that the real exchange rate of Germany, not the euro but of Germany within the eurozone, declined by almost 20 percent from the start of the euro until now. This decline strengthened the competitive position of Germany against its main trading partners, due largely to very low wage increases. Indeed, German real wages have been flat throughout the life of the euro. Wages in Germany actually declined in 2013, and this has led to very low inflation throughout Germany, thereby strengthening German competitiveness in a dramatic way. What this implies, of course, is that Germany has experienced a huge internal devaluation of its real exchange rate over this extended period of time.

*Germany has done a terrific job in steering the eurozone through the crisis to date.*

This internal devaluation of the euro period is usually justified by an alleged need to reverse the internal upward revaluation of the mark prior to the creation of the euro. In fact, recent studies, again using official data, show that the deutsche mark was already weaker in 1998, at the eve of the euro, than it was in 1980, almost twenty years before. And the result is a huge undervaluation of the real exchange rate of Germany in the European and world economy.

In short, Germany dramatically overdid its reaction to fears that it would lose competitiveness and economic strength in the wake of reunification in the early 1990s. But of course, Germany does not have its own exchange rate, so it cannot be directly criticized by the G-7, the G-20, or the IMF. The U.S. Treasury tries sometimes, but it's difficult to criticize the exchange rate of a country that does not have an exchange rate.

That is the dilemma that others face. It should be an issue for the eurozone itself, but Germany is the paymaster; it's hard to criticize your creditor. Former U.S. Secretary of State Hillary Clinton always used to say it's hard for the United States to criticize China too much. China is our banker, it finances us, and somewhat the same applies within Europe for Germany. As a result, when Europe set up its rules for monitoring imbalances, it required a 6 percent ceiling for surpluses to even come under surveillance, but Germany has now surpassed that for three years running, and the situation looks to continue.

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Thus, I regard this situation as completing the revenge of Helmut Schmidt. Not only does Germany have the best of all worlds, in economic terms, but it can't be criticized, because it is protected by being part of the eurozone.

Now the final and most crucial policy question: Is this situation desirable or even viable, for Europe, for the world economy, and for Germany itself? It is certainly true technically that Germany could run huge surpluses forever, and keep financing the rest of the eurozone forever, as it has for the last few years. But that of course would mean that the other countries would have to do all the adjusting, because they would, from time to time, inevitably come under financial pressure and internal political pressure as well.

If all of the adjustment comes via the deficit countries, that means reduced growth there, and that means continued very low, possibly zero, growth for the eurozone as a whole. Continued low German inflation means that the other countries have to deflate, because how else can they improve their price competitiveness? And deflation adds further to the risk of very low or zero growth for most of the member countries, and indeed for the zone as a whole.

Taking the view that maybe the eurozone does work only for Germany, such approaches would exacerbate that risk, threatening the sustainability of the euro over time. It's almost inevitable there will be push-back from others, both political and economic, particularly as historical memories of the geopolitical basis for Europe in the eurozone fade, and economic issues become more dominant and perhaps more deeply entrenched.

Incidentally, this situation would also dampen global economic growth. Europe is the largest single entity in the world economy, bigger than the United States, bigger than China. Continued stagnation, or worse, zero growth, in Europe will dampen the world economy—a legitimate issue for the G-7, the G-20, and the IMF.

The external position of the eurozone as a whole has already moved from -1 percent of GDP prior to the crisis to a 3 percent surplus now. That's a 4 percent swing in the biggest economic entity in the world, which is already a big drag on the rest of the world economy. And if that continues, as the IMF predicts it will, then the global implications are also poor.

The bottom line is twofold. First, Germany has done a terrific job in steering the eurozone through the crisis to date. It would pay whatever was necessary, directly or indirectly through the ECB. It did save Europe from another crisis. For that, Europe owes Germany an incalculable debt, as does the rest of the world.

But second, Germany now faces the same choice that any surplus country faces. It can either finance its borrowers and keep the imbalances going as long as they'll keep going, or it can promote more active adjustment of the imbalances to try to reduce the underlying source of the problem, and respond to the political concerns that all of this is primarily for the benefit of Germany.

I would urge Germany to undertake a major new effort to adjust and reduce its own imbalance, particularly in favor of its partners within Europe, but also for the world more broadly. The monetary easing steps that were announced recently by the ECB will help by spurring faster domestic demand growth in Germany.

*Germany is the paymaster; it's hard to criticize your creditor.*

I think the increase in the minimum wage by Germany's new coalition government should help to some extent. Income tax cuts would help, along with increased public investment by the German government. Germany now does much less than other major economies of the world, including the others in Europe, in terms of public investment. It could double or more the share of its economy going in that direction, with very favorable economic effects.

Germany does need to modify the debt brake in its Constitution, and adopt an investment budget separate from the current spending budget. Almost every other country in the world and every state in the United States does this, although the U.S. federal government is another outlier which does not.

There are many steps that could be taken as part of the new economic policy strategy of Germany's government to deal with these fundamental problems. These steps would help assure that the eurozone—in a third phase of response to the crisis, and under the continued and indeed reinforced leadership of Germany—will do more than just survive the crisis. They will put Europe back on a viable and sustainable path that would create, over time, an optimum currency area.

If all that can be done, the grand vision of Chancellor Schmidt and his colleagues will be fully realized and provide a permanent legacy to his wisdom and leadership. ◆