Economic Growth Program and World Economic Roundtable

The German Wages Problem – A World Problem

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2012-2013

Germany and Europe at large have suffered from chronically high unemployment for all or most of the time since the 1980s. The conventional wisdom of American economists and media commentators alike offers a clear-cut diagnosis of this long-standing malaise. Often repeated and never questioned, the verdict is that European labor markets are too rigid, the old continent's welfare systems overly generous, and wages too high. In short, European labor is simply too expensive, and employees are pricing themselves out of work as a result. Of course this conventional wisdom accords well with mainstream (neoclassical) economics more generally. On this view, if there is unemployment, wages must be too high almost by definition. By accepting lower wages, unemployed workers can always get themselves a job. Should institutions or social policies prevent this, structural rigidities are to blame, and structural reforms of labor markets and social policies are offering the straightforward route to salvation. If only the market mechanism were allowed to operate freely, and workers left free to choose, the labor market would always clear at the equilibrium wage and anyone willing to work at that wage find work without any problem at all.

Standard wisdom is quickly applied to the ongoing crisis in Europe, which is concentrated in Euroland, the subsection of the European Union that has adopted the euro as its common currency. Euroland member countries in acute crisis are bluntly described as uncompetitive, a deficiency gallantly associated with fiscal profligacy as the elixir that for long helped to cover up the underlying ailment of excessive labor costs (or, if a little more circumspection is harnessed, with private debt excesses that somehow achieved the same). For a mainstream economist it is utterly counterintuitive, if not perfectly inconceivable, that wages could ever be too low. But that is precisely the German wages problem in Europe today. The German wages problem is at the very heart of the ongoing Euroland crisis – a crisis with potentially devastating global repercussions. Therefore, the German wages problem is indeed a world problem.

After three decades of neoliberal groupthink and constant medial brainwashing, no doubt, any author suggesting that, especially at a time of high unemployment and subdued growth (at best), wages may be a problem not because they are too high but because they are too low, is surely at risk of being dismissed as foolhardy straight away. However counterintuitive or inconceivable the argument may seem at first, the simple truth is that wages are income – and income growth together with the expectation of continued income growth are critical for sustained spending and production growth. Should wage rises cease to be a source of income growth, and expectations sink in for this situation to persist, enticing the extra spending that is needed to buy the extra output which – potentially – enters the market owing to rising productivity becomes ever more challenging. Put differently, if wages lastingly decouple from productivity growth, this is putting a spanner in the works of capitalist production. Unless demand for what labor produces can somehow be found in other corners, relentlessly squeezing labor may not even be in capitalists' own best interest. For, in the aggregate, we cannot earn more than we spend.

I will first elaborate on this general proposition and its relevance in the U.S. and global context before zooming in on the crisis in Euroland. Investigating that crisis will require taking a closer look at the inner workings of a currency union of politically sovereign states. It will be easier to first consider the wages issue in a more general setting that includes exchange rates, reflecting the fact that countries generally have their own currencies in which wages and prices find their national nominal expression, with national central banks issuing the monetary liabilities accepted at the national treasury for meeting tax liabilities.

Ironically, what put that aforementioned spanner in the works of modern capitalism was market fundamentalism. Held responsible for causing all sorts of market "distortions," the essence of the neoliberal agenda was to push back government interferences, thereby unleashing the cleansing forces of market competition. In national labor markets neoliberalism meant a seismic shift in the balance of power in favor of capital. In product markets it meant exposing firms – and indirectly their employees – to global competition. In globalized financial markets it meant that institutional investors would henceforth meet only faint resistance from policymakers in shifting liquidity around globally, pushing currencies and asset prices up or down in accordance with short-term trading strategies. Neoliberal globalization thus significantly raised the vulnerability of labor vis-à-vis capital, of smaller local vis-à-vis larger global firms, and of smaller more open economies vis-à-vis larger ones. Unfettered global finance and large multinational corporations were placed firmly in the driver's seat. By contrast, labor and governments were seated in the back with no safety belts provided. Except for a few national governments of politically powerful nations, the latter found themselves on the defensive with only few pieces of armory left. In particular, at home, multinational corporations could hold labor at bay with the threat to "offshore" activities, while abroad playing off potential host countries of offshore production against one other. Lured by near-limitless rewards on offer in a supposedly self-regulating environment, global finance was complicit in punishing governments that would not play by the neoliberal rulebook. Euphemistically referred to as market discipline, unchecked market power and the law of the jungle were allowed to roam freely.

The stark increase in inequality over the last 30 years is conveniently attributed to globalization and technological change, apparently brought about by force of nature and wholly inevitable. Silence is observed on the fact that it was the neoliberal paradigm shift that provided the context and environment for this to happen in the way it did. It would be rather naïve to liken a freely competitive environment of grossly unequal powers to the economists' ideal of perfect competition. Instead, it was interest politics that empowered the most powerful to become even more so – and far more wealthy along the way too. Contrary to neoliberal promises, the outcome of letting the markets off the leash was not increased investment, faster growth, and a lifting of all boats – but rising incomes of the lucky few only, and by means of massive redistribution.

In the United States, global leader of neoliberal marching orders, wages have lastingly decoupled from productivity growth since the 1980s. Year after year U.S. workers' output per hour exceeded the level set in the previous year, but compensation would not keep up with the rising fruits of their efforts. The resulting deflationary bias was creatively met by a series of changing stimulatory factors. In the 1980s, sizeable government budget deficits under the Reagan administration owing to military spending and wealth-friendly tax cuts filled the national spending gap. The 1990s then saw monetary policy coming to the fore, enticing the well-to-do to raise their consumption propensity by creating lush "wealth effects", liquidized through business sector share buybacks. There was barely more investment resulting from increased saving though, as promised. Conspicuous consumption by the rich simply crowded out middleclass households' consumption instead. Finally, in the 2000s, as the wealthy were still licking their wounds incurred in the dot.com bust, Wall Street ingenuity was called upon in engineering the passing of the spendthrift baton to middleclass and poorer households, enabled to liberally boost their consumption spending well ahead of subdued wage income growth in a process also described as the "democratization of credit". The debt legacies of that experiment are today keeping household debtors as well as their financial sector creditors in deleveraging mode, restraining household spending more in line with subdued income growth. Coming full circle, sizeable fiscal deficits, reflecting the impact of the financial crisis, and sluggish recovery from it, on tax revenues, have – by default – taken over the part previously played by private sector deficit spending.

But U.S. economic performance in the era of rampant global neoliberalism cannot be fully appreciated without also taking the U.S.'s external position and the U.S. dollar's restored status as key global reserve currency into account. Regarding U.S. trade, the essential feature has been one of continuous U.S. trade and current account deficits, as national spending was generally running ahead of national income. In addition, apart from tight money episodes in the first half of the 1980s and at the peak of the dot.com boom, trade-related dollar outflows were generally augmented by bulging private U.S. capital outflows. While the general long-run trend for the U.S. dollar has been down, the fact that under conditions of unfettered global finance the rest of the world has developed ever greater appetite for holding dollar liquidity explains why the U.S. has been spared the fate that would have befallen any other country in such circumstances: currency crisis. In contrast to other countries, U.S. current account deficits and private capital outflows do not mean that the country is running out of foreign exchange reserves. Instead, the U.S. is merely providing global dollar liquidity which, beyond what might find its way into private portfolios, will end up as the official dollar reserves held by other nations' authorities.

Globally, there is thus another important power imbalance at play that has become far more acute with the freeing of global markets, an asymmetry between nations that issue a reserve currency and those whose vulnerability dictates them to hold such reserves for precaution. U.S. spending in excess of income allows other nations to grow more safely through export surpluses and reserve asset accumulation. For the U.S. as a nation, at least as long as the rest of the world is willing to hold low yielding U.S. liabilities as their safe assets, it is not too inconvenient to accommodate the demand for safety by providing the excess spending and any external deficit this might entail. Financially, being in this special position is made even more attractive if global demand for dollar liquidity allows for foreign asset acquisition on top of any surplus goods entering the country through trade deficits. Globalized finance thereby magnifies the distributional impact of production globalization. The benefits will largely go to whoever is in a position to extract the yield advantage obtainable from buying foreign assets, while the downside will be felt mostly by those whose wages come under pressure owing to an overvalued dollar that is the result of other countries' demand for safety in dollar liquidity.

This is not meant to put blame at the doorstep of countries that have supported the dollar. Developing countries' demand for safety in dollar liquidity is generally well-founded. As neoliberalism conquered the developing (and emerging) world under the Washington Consensus, recipient countries of capital inflows that tolerated uncompetitive exchange rates and external indebtedness learned the hard way that the adjustment following "sudden reversals" in capital flows can be brutal. They also learned that IMF adjustment programs following neoliberal prescriptions can make matters worse rather than better. The policy swing in developing countries since the late 1990s towards current account surpluses and reserve accumulation was a response to crisis experiences. China had avoided both the Washington Consensus as well as current account deficits and crisis, but the experiences of its neighbors brought home the same lessons. Indeed, the swing underlined a wider policy prioritization of competitiveness.

National competitiveness hinges on two factors: first, the growth of wages relative to productivity and, second, (real) exchange rate movements. A country can get itself into trouble for either of these two factors: wage growth in excess of productivity growth (by more than some low inflation margin) and/or nominal currency appreciation in excess of what may be warranted by any negative inflation differential vis-à-vis its main trading partners. Prioritizing competitiveness thus requires keeping a lid on wages while containing pressures for currency overvaluation.

Of course competitiveness is inherently a relative concept. If one country (or group of countries) gains in competitiveness, either through the exchange rate or a relative decline in unit labor costs, others will see their competitiveness deteriorating. A general policy prioritization of competitiveness will produce a general tendency for wage repression, but not every country can gain competitiveness at the same time. Equally, some countries may succeed in protecting their competitiveness through currency market intervention, but not all countries can have a competitive exchange rate at the same time. Pressures on U.S. wages will be magnified by U.S. dollar overvaluation. But at least the reserve currency issuer enjoys the liberty of providing excess spending to offset the global deflationary forces arising from a general policy prioritization of competitiveness.

With wage growth kept in check worldwide, multinational corporations and their financiers, not least those with a U.S. passport, are enjoying a field day, especially as U.S. monetary policy is greasing the credit wheels by lifting asset prices to offset the deflationary bias arising from wage repression and rising inequality. With global competitiveness positions twisted in this way as a result of the above-mentioned systemic asymmetry in currency arrangements, corporate investment will be attracted towards the developing world, fired by export-led growth. In the U.S. (and other rich financialized economies), residential investment and (credit and asset price-driven) private consumption are keeping the cylinders humming instead as the share of wages in national income is falling behind without abating.

The above analysis captures the essence of global developments in the neoliberal era as far as the U.S. and developing countries targeted by U.S. capital and responding by dollar reserve accumulation are concerned. As the U.S. played its part in tolerating its external deficits, the buildup of global current account imbalances featured two additional counterparts on the surplus side. One is something of a permanent factor and easily explained: oil. The U.S. is a large net oil importer. The gap this is leaving in the U.S. trade account is varying proportionately with the oil price – a rise representing a negative terms-of-trade shock from the U.S. perspective. The other missing contributing factor in global imbalances is more intricate, featuring Japan and Germany.

Defeated in WW2, both Japan and Germany successfully pursued export-led growth strategies in reconstructing their respective economies in the first three post-war decades. They have also both since struggled to wean themselves off that strategy and take on a more constructive global leadership role. The issue first arose in the second half of the 1970s in the aftermath of the OPEC I oil price shock. Following the breakdown of the Bretton Woods order of pegged exchange rates earlier in the 1970s, the U.S. authorities were as yet unsure of the dollar's position in the new global setting. The German deutschmark and the Japanese yen seemed to arise on the scene as serious competitors to the dollar's hitherto unchallenged global status as currency hegemon. In the context of the newly-found G7 the U.S. authorities actually pressed their Japanese and German counterparts to share in the U.S.'s burden to stimulate a global recovery by acting as "locomotives" too. Alas, the globally coordinated policy stimulus ushered straight into the OPEC II oil price shock at the end of the 1970s that saw to a further rise in inflation from its already elevated levels. In the German case, this inflationary experience with macro policy stimulus would cause the country to forever deny any role for demand management in future – a peculiar policy approach on which more will need to be said momentarily.

In any case, the recovery from OPEC II in the first half of the 1980s was solely led by the U.S. This was the time when large global imbalances first occurred. And the imbalances were essentially between the U.S. on the deficit side and Japan and Germany on the surplus side, the latter relying on exports for their growth, with imbalances being boosted by sharp dollar appreciation. Another G7 initiative in 1985 then delivered sizeable dollar depreciation while growth accelerated in both Japan and Germany in the second half of the 1980s and global imbalances briefly disappeared. This was however going to be the last time that these two countries would act as growth engines in the world economy. Following Japan's bubble economy in the late 1980s, the country has remained stuck in deflation and stagnation ever since, with large and persistent Japanese current account surpluses acting as a drag on global growth. In the German case, unification provided the policy accident that at first triggered a sizeable fiscal expansion and growth stimulus – to be choked off in due course by brutal monetary overkill on the Bundesbank's part. Germany's performance in the 1990s has been less than stellar, in the 2000s, Germany became known as "the sick man of the euro". That was until Germany miraculously recovered from the global financial crisis as Europe's re-awakened economic powerhouse – which leads us to zoom in on the German wages problem as the paramount cause behind the ongoing euro crisis.

The launching of the euro in 1999 was held to represent the "coronation" of a long process of European integration. At the beginning of that process was the German problem. The emerging power at the center of Europe had been at the center of recurrent conflict and warfare for the previous hundred years or so, with its French neighbor as the main opponent in the west. Responsible post-WW2 German leaders agreed with the general sentiment that also prevailed in other European capitals at the time that it would be to the benefit of all nations concerned if Germany were to forever forego the Fűhrer's goal to Germanize Europe and aspire a Europeanization – peaceful integration without domination based on mutual respect of cultural differences paired with some degree of economic solidarity – of Germany instead. The deal was a magnificent success in maintaining peace and bringing prosperity to the continent. But as the supposed coronation of the process is struggling in acute crisis, corrosion has befallen both mutual cultural respect and economic solidarity while German power is in the ascendance in ways that are harmful to the continent and its project of ever-deeper integration, and quite absurd in view of Germany's key role in bringing the current crisis about.

Germany's key role concerned both the peculiar design of the (Maastricht) regime of EMU and why that regime hit a wall, leaving the European economy stuck in recession and policy confronted with challenges that by design were never meant to arise in the first place. The German authorities are also responsible for Europe's largely ill-guided policy responses that have made the euro crisis worse rather than better until this point.

Germany's decisive influence on the EMU regime design stemmed from the hegemonic position that the deutschmark had attained in Europe. At the end of the tumultuous 1970s French and German leaders agreed to create the European Monetary System, which was to include an Exchange Rate Mechanism designed to stabilize European exchange rates and establish group-floating vis-à-vis the U.S. dollar. Reflecting the paramount concern not to establish currency hegemony, no national currency was to function as anchor. Instead, the European Currency Unit was to take on that role, as a weighted average of the national currencies. That was the theory. In practice, the deutschmark ended up in the anchor position in the course of the 1980s. The decisive event – a Franco-German economic policy battle – was in 1983. With the government change in the fall of 1982, the policy move in Germany to a "supply-side-only" vision was made official. Henceforth German fiscal policy would prioritize consolidation while the Bundesbank would focus on price stability only anyway. The socialist government in France had more Keynesian ideas and set out to fight mass unemployment by monetary and fiscal stimulus measures. It was forced to undergo a policy U-turn when the French franc came under pressure – given that the Bundesbank stayed its tight course. With France succumbing to the German monetary dictate, the rest of the pack followed. From 1987 until the 1992-93 ERM crises intra-European exchange rates remained fixed.

So the Bundesbank was pulling the monetary shots in Europe. As followers, other countries had effectively lost their monetary sovereignty – and without a seat on the Bundesbank's governing council, which had a mandate to maintain price stability in Germany while de facto setting monetary policy for Europe. For countries other than Germany monetary union thus held out the prospect of re-taking a seat at the policymaking board, a board that would take economic conditions in Europe rather than just Germany into account. Getting Germany to give up its leading position was the tough part. Essentially, the power imbalance left the Bundesbank in the position to lay down the conditions of its own abdication of monetary rule over Europe. Of course the

European Central Bank was to be modeled on itself, independent of any political control, and with a primary mandate of maintaining price stability. Furthermore, the central bank had to be protected from fiscal profligacy. Finance ministers would be denied access to central bank credit, the central bank forbidden to purchase government debt in the primary market. The Maastricht Treaty also included convergence criteria featuring limits for budget deficit and public debt ratios for that purpose, later strengthened as a balanced-budget rule in the so-called Stability and Growth Pact. To protect members from each other's fiscal sins, the "no-bailout" clause was to deny any room for fiscal transfers in support of ailing partners. Any sinners were to sweat in their own juice to find their way to redemption, but not infect and burden their partners too; so the (wishful) thinking went.

The EMU regime of German design features some fundamental deficiencies that were rather obvious to the Keynesian observer from the beginning. The regime created a large monetary union but left no one minding the store: there was no authority in charge of demand management in normal times, and no lender of last resort foreseen in times of crisis. In the German view, Keynesian demand management would be folly anyway. Abstaining from any such attempts was not a deficiency, but a piece of strength. Similarly, lending of last resort crisis management could be avoided by stability-oriented policies as crisis prevention. And that was what the regime was all about: stability by discipline. In particular, apart from supply-side policies, keeping inflation below 2 percent and budget deficits below 3 percent (while balancing the budget over the cycle) was held to be all that was needed to produce stability as well as growth.

In effect, Europe created a monetary union that would be reliant on fair-weather sailing but could quite easily capsize in a storm. In particular, any crisis requiring sizeable common fiscal backstops and/or fiscal transfers would be challenging to deal with. While even a purely national banking crisis might overburden the respective national fiscal authorities, in case of a cross-border banking crisis there is the additional complexity of splitting the damage – for lack of common backstops. In the event, both the national fiscal authorities as well as any common fiscal backstops, to be setup if such a need arises, would be cut off from central bank support by design. Not only is central bank support for governments prohibited, but inter-government support too. Europe set out to further deepen the common market by sharing a common currency. But economic crises were supposed to stay strictly national.

In practice, the need for fiscal transfers could most easily arise in case of asymmetric shocks, shocks that hit member countries differently causing intra-area divergence. If California were in recession with tax revenues plunging and New York in a boom with tax revenues surging, this would not matter at all for overall public finances and fiscal stance in case there were one unified budget. In actual fact, state finances would force California to consolidate while New York would enjoy fiscal leeway, but at least the U.S. federal budget and social security system would – quite invisibly – provide some automatic stabilization and risk sharing. Automatic fiscal stabilization and risk sharing are altogether absent in Euroland. Ad hoc transfers from the member in fiscal surplus to any member in deficit would achieve the same result, but are not supposed to happen either. Instead, the SGP will force the member country in recession towards fiscal austerity, with no such discipline applying to the booming member country.

Asymmetric shocks might not pose a serious problem if temporary and quickly reversed. But in case of long-lasting asymmetric shocks the fiscal regime reinforces divergence. Monetary policy cannot help in case of intra-regional divergences either, as the common monetary stance can only be calibrated to match the union average. In fact, monetary policy too would tend to reinforce divergence given that the booming region would likely experience higher inflation and hence easier financial conditions (lower real interest rates) – the opposite being the case in stagnant countries.

In the end, none of the usual suspects caused the euro crisis. The largely symmetric global financial crisis is widely blamed, but merely acted as the trigger. Nor can some other exogenous but asymmetric shock be identified for the ongoing malaise. Instead, the perfectly preventable buildup of internal imbalances that owed to persistent divergences in wages and unit-labor costs provided the root cause of a crisis that may still prove fatal since the EMU regime is peculiarly ill-equipped to handle it.

Agreeing on a currency union is essentially a commitment to a common inflation rate. For reasons that were explained earlier, the chosen inflation rate for the euro had to be a low one and the currency be guarded by an independent central bank; protected by fiscal safeguards. The ECB defines price stability as consumer price inflation "below but close to 2 percent". Except for temporary short-term influences the trend in unit-labor costs provides the main determinant of inflation. If nominal wages corrected for productivity growth rise at the target rate of inflation, the outcome may be described as inflation neutral. The outcome may also be described as neutral regarding income distribution, featuring real wages rising at the rate of productivity growth. Furthermore, the outcome would be neutral regarding competitiveness if all members of a currency union were to stick to the same rule. Further above we emphasized that competitiveness was a relative concept and that relative unit labor costs and the exchange rate were the macro determinants of competitiveness. In a currency union exchange rates do not exist anymore, so that relative unit labor costs become the sole determinant of intra-area competitiveness positions. What may be dubbed the golden rule of a currency union therefore states that national trends in nominal unit labor cost growth must stay closely aligned with the common inflation rate – or else, competitiveness positions will run out of kilter.

Historically, German wages (corrected for productivity) rose in line with Germany's low inflation record. Following the tumultuous 1970s, Germany re-established its two-percent norm in the 1980s. At that time, nominal unit labor costs and inflation trends in other European countries generally exceeded Germany's low standard. In the context of increasingly rigid intra-European nominal exchange rates, as stabilized within the ERM, this meant that Germany's competitiveness would improve in a gradual but cumulative fashion throughout the 1980s. At the end of the decade, just prior to unification, Germany's trade surpluses (largely vis-à-vis the rest of Europe) reached 5 percent of GDP. As unification at first boosted German imports and then provoked deutschmark appreciation in the ERM crises of 1992-93, Germany's trade balance swung into a small deficit of around 1 percent of GDP, where it remained for the rest of the 1990s.

Conventional wisdom blames the burden of unification for Germany's subdued growth in the 1990s. But that is missing the point by far. Essentially, Germany tried to repeat in the 1990s what it had done in the 1980s, fiscal austerity and "restoring" competitiveness through wage restraint. Only to find out that the strategy would not work anymore. And the reason is simple. The Maastricht convergence criteria for inflation had forced wage growth (corrected for productivity) to converge to Germany's

2-percent norm, while the fiscal criteria prescribed area-wide fiscal austerity. The strategy that had worked for Germany in the 1980s precisely because others were still behaving differently would not work anymore in the 1990s as Europe was being Germanized through the prospect of the “made in Germany” EMU regime of discipline and stability.

And this is when things went seriously off track and the ground was prepared for today’s euro crisis. Frustrated by the fact that its export engine would no longer catch fire when the country was following its established stability norms, Germany prescribed itself a super-dose of wage restraint under the euro. Starting in the late 1990s, German unit-labor costs would stay flat for a decade. In stark conflict with the golden rule of a currency union, Germany diverged from its own historical norm that had become the stability norm for Europe with the euro. The consequences were going to prove disastrous.

In Germany one immediate consequence was that private consumption would stop growing too. As wages decoupled from productivity growth and worker’s incomes stayed flat, protracted stagnation of consumption – roughly 60 percent of German GDP – set in. Needless to say this also put a damper on corporate investment. With GDP stagnating and unemployment rising, public finances came under pressure and Germany famously broke the SGP for several years in a row until 2005. As the SGP’s “excessive deficit procedure” was triggered, fiscal austerity further weakened domestic demand. The ECB’s monetary policy would bring no relief either. Set to suit the euro area as a whole, monetary stance was far too tight for the stagnant German economy (just under 30 percent of the euro area). With tight financial conditions, credit growth was meager and property prices on a slow decline throughout the decade. The only thing that held Germany above water were exports. The global boom certainly helped, euro appreciation did not as far as extra-euro area exports were concerned. However, as German unit labor costs stayed flat but where rising at two percent (France) or even higher (Spain, for instance), Germany experienced cumulative competitiveness gains within the currency union year after year; the opposite being the case for France and the soon-to-be-in-crisis periphery. Germany’s current account surplus surged, peaking at 7.5 percent of GDP in 2008. Almost 90 percent of this found its counterpart elsewhere in Europe.

For as Germany’s protracted stagnation dragged down interest rates across the euro area and beyond, financial conditions became far too easy for the rising-wage regions. These regions had higher inflation and hence very low real interest rates, and consumption spending was buoyant and residential investment booming. France and the periphery experienced continuous competitiveness losses and rising external deficits, but strong credit growth kept domestic demand on fire. Banks in Spain and Ireland, for instance, had no problem refinancing their expansion from German banks, desperate for business as the home market was stagnant, building up huge exposures to the periphery in this way.

Balances built up until 2008 and neither the authorities nor the markets paid any attention to the troubles that were brewing – until the Lehman Brothers failure brought things to an abrupt halt. As property price bubbles burst and cross-border credit stalled, borrowers in peripheral countries found out they were over-indebted. Greece is a special case in all this since fiscal profligacy actually did play a role in Greece. In other countries such as Ireland and Spain excessive private (nonfinancial) sector debt was the issue initially. But as loans turned sour, banks went belly up. And their national rescues in turn dragged down the respective governments’ credit ratings.

It is a mistake to diagnose the situation as a sovereign debt crisis. Instead, the euro area is experiencing banking and balance-of-payments crises the underlying cause of which featured wage divergences and intra-area debt imbalances. The crisis can only be overcome by restoring intra-area competitiveness positions, sustained GDP growth, and debt restructuring. The problem is that debt restructuring would hit German banks while restoring competitiveness would mean competitiveness losses for Germany. The German authorities therefore conveniently diagnosed the crisis as due to fiscal profligacy calling for unconditional austerity and structural reforms. Imposing continent-wide austerity, most brutally in the crisis countries, has pushed Europe back into recession. The situation of debtors is therefore getting worse rather than any better. Moreover, any attempt to restore competitiveness through "internal devaluation", i.e. falling wages and prices, will also raise the burden of the debt. But with exchange rates no longer existing and German wages rising at 3 percent (compared to 2 percent previously), internal devaluation and debt deflation are bound to continue.

For the time being Germany is even being rewarded by the markets for imposing policies that can only wreck Europe. As the traditional safe haven, German interest rates are at record lows, giving Germany extra leeway vis-à-vis the struggling periphery. The euro crisis is also depressing the euro's exchange rate, which is boosting German extra-area exports. This is one channel through which the euro crisis is having repercussions on the global and U.S. economies. But the potential fallout in case of crisis escalation or even euro breakup would be calamitous.

While U.S. commentators appear to be alert to the risks this is posing to the U.S., all sorts of misinformed justifications of German policies are conceived. Mainstream economists just can't understand that too low wages can be a problem. It just cannot be true that too-low German wages are the culprit of the matter. Instead others will have to cut their wages too, pull back their welfare states, and make their labor markets more flexible. There are many problems with this advice. One is that the debts will not go away but become far more burdensome in the process. In this way, the German wage deflation that started in the late 1990s will drive Europe into a full-blown debt deflation.

The German authorities and German policy traditions bear a high burden of responsibility for what is going on in Europe right now. The wholly unsuitable and dysfunctional euro regime is of German design, inspired by German beliefs in stability and discipline that suited Germany for as long as others were still behaving differently. Just as European partners were converging to traditional German stability norms, German wage restraint under the euro regime provided the root cause for the ongoing debt crisis. German austerity obsessions and blatant denial of responsibility for the crisis is making matters far worse and has pushed Europe back into recession. Matters can get far worse from here and global repercussions would be immense. By itself, Germany is too small for German wages to cause a global problem. It is through German influence on and leverage over Europe that the German wages problem is indeed a serious global problem today.

Post scriptum

In October 1962, Konrad Adenauer, West Germany's first chancellor, published an article in *Foreign Affairs* titled "The German problem, a world problem", in which he praised the new-found Franco-German solidarity as "the edifice of European unification", proclaiming that "Europe can only benefit if the two neighboring countries in the heart of Europe are closely united." For quite some time the euro crisis held both politics and the markets entranced with Greece as its supposed culprit. Since mid-2011 the far weightier Italy and Spain have moved center stage instead, raising the stakes accordingly. The point is that even France, after most truthfully upholding the euro's stability norm all along, will now be forced to embark on an austerity-ridden debt deflation course in order to re-converge to Germany's renegade trajectory of zero unit-labor-cost growth. Whether the France-German axis can withstand the pressures arising from the consequences of Germany's beggar-thy-neighbor wage repression and ill-guided austerity obsession will provide the ultimate test to the euro's longevity.

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