

CENTRE FOR EUROPEAN REFORM

THURSDAY, FEBRUARY 19, 2009

Germany: Between a rock and a hard place

by Simon Tilford

Twelve months ago it seemed inconceivable that any member of the EU could face a sovereign debt crisis. It would have been the stuff of fantasy to argue that Ireland or Austria could be among those at risk. Such an outcome is now well within the realms of possibility. If one country suffers a crisis, that will not be the end of it. It would almost certainly trigger a wave of crises, plunging the EU, and especially the eurozone, into turmoil. There is nothing inevitable about this. But a way out requires Germany to show more vision.

Some eurozone member-states – Italy and Spain – are vulnerable because they have lost so much competitiveness and investors are sceptical they will be able to regain it. Others – Austria and Belgium – have disproportionately large banking sectors and/or banks with huge exposures to crisis hit regions such as Eastern Europe. For their part, Ireland and Greece have lost competitiveness and have very exposed banking sectors.

What is the way forward? One option might be for governments to start issuing eurozone sovereign bonds, rather than their own national bonds. This would help address the problem of poor liquidity that has bedevilled many of the smaller eurozone financial markets. And it would reduce borrowing costs substantially for most eurozone countries.

There are, however, a number of obstacles. German borrowing costs would rise, as it shared its credibility with the rest of the eurozone. Such a move would arguably let profligate countries off the hook. And, it might be difficult to ensure budgetary discipline in the fiscally weaker countries. Curbing the budgetary autonomy of individual governments would require a far greater degree of political integration in the eurozone.

These concerns highlight what many economists have always believed to be the inherent contradiction in economic and monetary union: the absence of a political union. However, the German government's objection to the pooling of bond issuance – that it would cost Germany too much money – is a parochial one. The alternatives threaten to cost Germany (and Europe) much more.

The German finance minister, Peer Steinbrück, has indicated that there may be a case for support for hard-hit members of the eurozone. But he is mistaken if he thinks a fiscal crisis in one member-state would be a cleansing experience, with the chastened country receiving a highly conditional IMF-type bail-out, and the others learning the lesson of their errant ways. First, one sovereign crisis would almost certainly lead to others. The direct costs of the bail-out

could be surmountable in the case of an Ireland or a Greece, but would pose a much bigger challenge in the case of larger member-states. Second there would be indirect costs to the German economy, which is enormously dependent on exports to the rest of the eurozone. The last thing the German economy needs is a further collapse in external demand.

Nor is this the worst case scenario. If Italy or Spain defaulted on their sovereign debt – perhaps as a result of the rest of the eurozone failing to agree a bail-out or attaching excessively onerous terms to one – the repercussions for the eurozone could be dramatic. For inflexible and sizeable economies, it is far from clear that default within the currency union is more plausible than a default and a move to leave it. A member-state could decide that having defaulted (and in the process cut itself off from most sources of capital, at least for a time) it may as well devalue, which would at least help to restore competitiveness and get the economy growing again. If one country were to leave, pressure on others to follow suit would be intense.

Germany cannot afford to be sanguine about such an outcome. German companies have spent years holding down costs. The result has been improved competitiveness versus the rest of the eurozone, but at the expense of chronically weak domestic demand. If the eurozone were to unravel, Germany would experience a huge real appreciation, reversing almost overnight the competitiveness gains it has painfully ground out.

A move to issue eurozone bonds would not mean Germany sacrificing its own interests for the good of Europe. A country as export-dependent as Germany and as politically reliant on the EU cannot afford to be blasé about economic crises in neighbouring countries. Germany is going to have to show solidarity one way or another, so it should do so in a way that imposes the fewest costs on itself and maximises its political capital.

Simon Tilford is chief economist at the Centre for European Reform.