OPINION

Is Germany the Euro's Big Winner?

By Hans-Werner Sinn

Germany has profited from the euro just as all other member countries of the euro zone have. The euro created an area of stability in Europe and protected its member countries from currency exchange turbulences. It boasted a lower inflation rate than the mark had enjoyed over its 50-year history. It also stimulated trade and represented a major step towards further political integration in Europe. But did it help Germany more than the other countries?

Many think so, when they consider Germany's export surpluses. Timothy Geithner recently argued in a letter to the G-20 that surplus countries such as Germany should carry out structural reforms so as to reduce their surpluses. The EU even contemplates forcing Germany to raise its wages. But the fact should not be overlooked that, by definition, export surpluses in trade are actually net capital exports. Capital is the life elixir of the capitalist system. Wherever it flows to, the economy flourishes; wherever it flows away from, the economy flags. It is therefore misguided to interpret export surpluses as a trading gain.

Germany bled capital in the years before the crisis, capital that fueled the economies of Europe's southwestern rim, but also the Anglo-Saxon countries and France. The blood transfusion helped to bring about an unprecedented economic boom in those countries, a boom that spread out from their real-estate markets to the general economy, while Germany slumbered.

Germany became the second-largest capital exporter, after China, in the years following the euro announcement in the mid-1990s. The lion's share of its savings flowed to other countries, instead of being invested at home. On average, from 1995 to 2008 no less than 76% of aggregate German savings (private, governmental and corporate) were invested abroad, while only 24% found their way into the domestic economy. Germany exhibited the lowest net investment rate of all OECD countries, together with the second-lowest growth rate among all European countries. The performance of a euro-winner ought to look a bit different from this.

The domestic economic boom that the capital flows brought to countries such as Greece, Spain, Portugal, Ireland and to a lesser extent even France resulted from an explosive growth of the construction industry. Construction workers had no problem finding jobs and had money to spend on consumption goods. Property owners, in turn, could look forward to steadily rising wealth, which encouraged them to acquire further credit-financed real estate. This all added up to high real economic growth, but also to an inflationary overheating that reduced competitiveness and led to huge trade deficits. These deficits were the unavoidable counterpart of the capital imports.

Many seem to think so, considering its large trade surplus. But the truth is more complicated.

The opposite occurred in Germany. The capital outflows made the domestic economy lose impetus and led to a slump in real-estate prices. Consumer prices and wages rose only marginally, much more slowly than in neighboring countries. From 1995 to 2008, Germany underwent a real internal devaluation of 18% compared to its EU partners. This devaluation made Germany's export surpluses possible. Such surpluses were a welcome substitute for the deteriorating domestic economic activity. But they were not an indicator of economic strength; instead, they were the result of an internal weakness brought about by years of bleeding. This is the crucial misinterpretation of those who assert that Germany was the big winner from introduction of the euro.

The German capital outflows were not the result of the euro alone. In the past few years, I have repeatedly raised the issue of Germany's weaknesses as a location for business and industry, in particular its excessive regulation of the labor market and its welfare policies. These weaknesses were exacerbated after the introduction of the euro, since it created a single capital market in Europe and wiped out the hitherto large interest rate differences. Capital could now flow unhindered across borders, and apparently free of risk, in order to finance higher-yield projects abroad. That brought an enormous advantage to the capital-importing countries. German investors profited as well, or so they thought at least. But the German workers, whose productivity and wage levels depend crucially on domestic capital investment, suffered painful losses that placed enormous strains on German society.

Now the European debt crisis shows that some of the promised yields will not materialize. Many German investors will never see their money again. This has led them to think again. Interest-rate spreads are rising, and savings are being invested at home once more. A construction boom is just starting in Germany, and the country's economic growth, after a long time, again tops the league in the euro zone. Now the opposite of what happened in Europe's southwestern rim over the past 15 years is occurring. While the former capital importers stagnate, Germany booms. However, wages and prices will, as a result, rise faster in Germany in the coming years. This will decrease Germany's competitiveness and reduce the country's export surpluses, with no need for prodding by the EU or the U.S. Treasury secretary.

There is only one major obstacle against such a development: a potential prolongation of the €750 billion EU rescue package for countries at risk, which was agreed in May and currently is meant to expire in a little more than two years' time. Should this package be extended, capital will continue to flow out of Germany, and the trade surplus will persist. Thus, the most important structural reform, to use Mr. Geithner's words, that Germany can make to reduce trade imbalances is not to agree to an extension of the European bailout package.

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