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essays

Why Germany is not a model for the eurozone

By Philip Whyte

★ An influential body of opinion across Europe believes that the eurozone should effectively turn itself into a larger version of present-day Germany. A eurozone built in Germany's image, the argument goes, would be more prudent, responsible and competitive.

★ Some countries, notably in the eurozone's indebted periphery, could do with a dose of German sobriety. But an unreformed Germany would be a poor model for the eurozone as a whole. Germany is not the 'world-beating' economy of current legend. It, too, needs to change.

★ Germany has numerous world-class manufacturers producing first-rate products for export. However, the massive external surpluses that the country generates are not evidence of 'competitiveness', but symptoms of structural weaknesses within Germany.

★ Germany is too export-dependent and needs more balanced economic growth. Rebalancing would not entail hobbling German 'competitiveness', but boosting productivity in the sheltered service sector and encouraging greater investment at home.

★ Turning the eurozone into a larger Germany would have adverse consequences – not just for Germany itself, but for Europe and the rest of the world. Europeans cannot pretend that the world economy can rebalance without parallel rebalancing in the eurozone.

Germany: a new benchmark for Europe?

Germany's economy has become the focus of renewed admiration across much of Europe. It is not hard to see why. Since the onset of the global financial crisis in late 2007, previously much-vaunted economies – Ireland, Spain, the US and the UK among them – have been exposed as fools' paradises built on reckless piles of private-sector debt. Germany, by contrast, looks to many observers to have been the very model of economic virtue. Its households have lived well within their means. And huge trade and current-account surpluses attest to Germany's economic prowess (or 'competitiveness'). The lesson, some conclude, is that while Anglo-Saxons and others went on debt-funded spending binges, Germany quietly got on with the more serious business of beating the international competition.

If this narrative is right, German economic policy and the values it embodies – thrift, discipline, and so on – have been vindicated by the global financial crisis. Profligacy is out, prudence in. Germany is Europe's benchmark, the country that all must now aspire to

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emulate. The direction of change is clear. Market doubts about the euro's long-term sustainability will only be removed once fecklessness and irresponsibility have been expunged from the zone's geographical periphery. Southern Europeans must therefore reform their economies to make themselves more 'competitive'. It is not for Germany to adjust. It is for the erstwhile dissolute to shape up. German leaders are clear on this point: they will not allow their country to become flabbier simply to give others a chance to compete.

The purpose of this essay is to examine whether this narrative really makes sense. The answer matters, both for the eurozone and the world economy more generally. Most people agree that over-extended households and governments in debt-laden countries must 'deleverage'. Most people also agree that countries in the eurozone's periphery urgently need to reform. The question is: does it follow that the eurozone should collectively turn itself into a larger version of present-day Germany? An influential body of opinion across Europe believes that it should. Indeed, for some Europeans, the answer appears to be self-evident. A eurozone built in Germany's image would, after all, be more prudent and 'competitive'. And how could anyone possibly object to a region displaying these twin properties?

This essay argues differently. There is much to admire about Germany. It boasts countless world-class firms producing first rate manufactured goods. But it is not quite the world-beating economy of current legend. The truth is that despite the extraordinary sacrifices that German workers have made for the past decade or more, the domestic economy remains chronically weak and in urgent need of reform. The massive trade and current-account surpluses that Germany generates are not reliable measures of economic prowess and speak of a country that has become structurally reliant on dis-saving abroad to grow at all. And turning the eurozone into a larger version of present-day Germany would have adverse consequences – not just for Germany itself, but also for Europe and the world economy.

Is Germany a 'competitive' economy?

Germany is often referred to as a 'super competitive' economy. Competitiveness is a notoriously slippery term when applied to a country, rather than a firm.[1] But the general impression that it is intended to convey is clear. Those with a penchant for sporting metaphors often liken Germany to a leading football team or to an elite athlete whose physique has been toned by years of hard exercise. Germany's reward for such discipline and sacrifice, according to one Bundesbank official, is its current position at the "top of the league". Those who prefer analogies drawn from business strategy prefer to compare Germany to a big corporation – a sort of Siemens or Volkswagen writ large. Like a firm, Germany is beating its international competitors and winning the battle for 'global market share'.

1 *Paul Krugman, 'Pop internationalism', MIT Press 1996.*

What evidence is there to suggest that Germany is leaving other countries trailing in its wake? The evidence usually advanced is the country's trade performance – a source of great pride to many Germans. On the face of it, the facts seem striking. Germany looks every inch an export *Weltmeister*. Over the past decade, it is one of the rare members of the eurozone to have increased its share of world exports. It has also been running vast trade and current-account surpluses. Its current-account surplus, for example, peaked at a staggering 8 per cent of GDP in 2008. Although that surplus has narrowed since then, it remains colossal. In absolute terms, it is the second largest surplus in the world after China's; relative to the size of its economy, it is, at 5 per cent of GDP, slightly larger than China's.

The question is: are huge external surpluses a reflection of the vitality and prowess of an economy? The answer is: not really. If a country's 'competitiveness' is measured by the size of its trade balance, then competitiveness must mean something quite different from productivity. Productivity in Germany is admittedly high. But labour productivity per hour worked is higher still in France – and it runs a current-account deficit. Nor has German productivity been growing more rapidly than elsewhere in the eurozone. Over the past decade, labour productivity growth has been around the eurozone average. In short, there is no link between a country's productivity and its trade position. Germany does not run external surpluses because it is a more efficient and dynamic economy than others.

If German competitiveness reflects anything, it is the heroic discipline of the country's workers, not the world-beating efficiency of its economy. Pay restraint in Germany since the introduction of the euro has been quite exceptional. In real terms, German wages are barely higher now than when the euro was launched in 1999. With pay settlements systematically undershooting the rate of productivity growth, real unit labour costs (wages adjusted for productivity) fell consistently between 2001 and 2007. The result has been a marked decline in Germany's real effective exchange rate (its exchange rate against a basket of currencies, adjusted for the effects of inflation). The decline in its real effective exchange rate has been a central factor behind Germany's rising share of world exports.

Chart 1: Labour productivity per hour worked, 2008 (EU15 = 100)

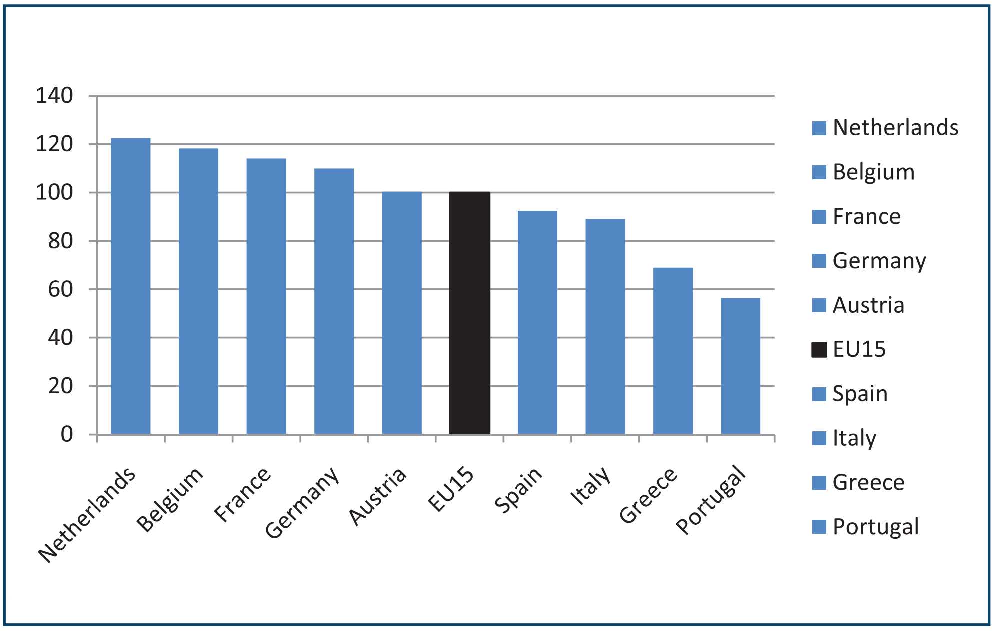
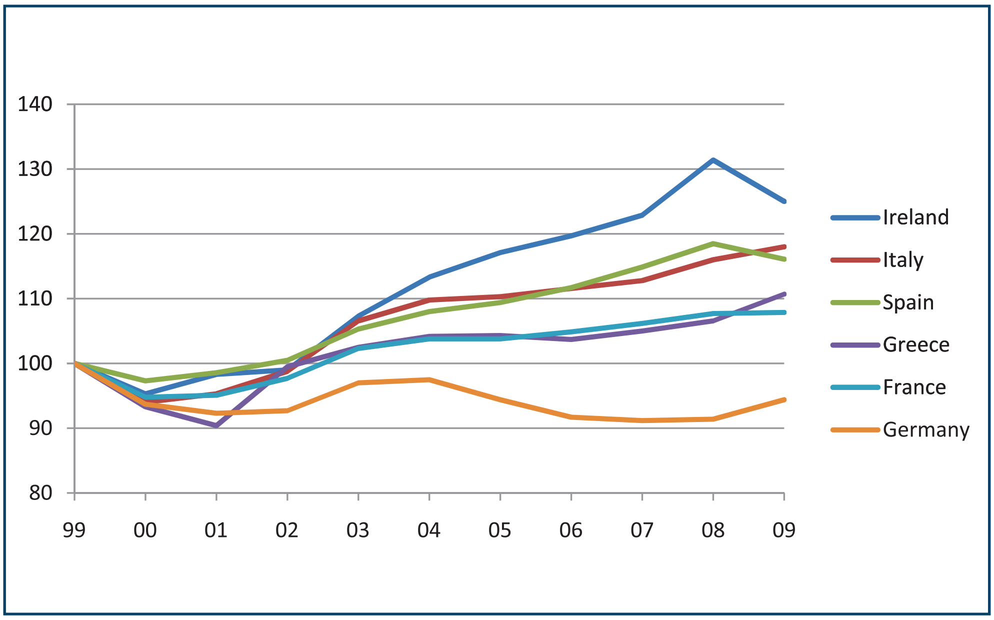


Chart 2: Real effective exchange rates (1999 = 100)



When people speak of Germany's competitiveness, then, they do so in a special and limited sense. Germany is not 'super-competitive' because it is uniquely productive or dynamic. In some respects, the reverse is true. Germany, which accounts for over a quarter of eurozone GDP, has contributed only modestly to the region's economic growth since 1999. For most of the period since the euro was launched, it is Germany that has slowed European growth – not the other way round. If Germany has been leaving others in the dust, therefore, it is emphatically not because living standards have been growing more rapidly than in other European countries. It is because stagnant real wages have driven down real unit labour costs at a time when they have increased elsewhere in the eurozone.

The causes of Germany's current-account surplus

What explains Germany's external surpluses since the early 2000s? Current-account positions reflect the difference between domestic savings and investment (or between aggregate spending and output). Germany has been running a current-account surplus because it has been saving more than it has been investing (or, which amounts to the same thing, because it has been spending less than it earns). The difference between Germany's domestic rate of savings and investment (or income and expenditure) has flowed abroad as capital to fund countries that have been running current-account deficits (that is, where spending has exceeded income). Have the out-sized external surpluses that Germany has generated since 2000 been the product of rising savings or weak investment at home?

The answer is: a mixture of the two. Between 2000 and 2005, domestic savings rose sharply. Note in passing that this was not because the German government was being more fiscally virtuous than its EU counterparts. Between 2002 and 2005, in fact, the German government consistently posted budget deficits in excess of the 3 per cent limit laid down by the EU's Stability and Growth Pact (during the same period, Spain was running largely balanced budgets). It was only between 2005 and 2007 that rapidly improving public finances contributed to Germany's growing current-account surplus. For much of the period after the launch of the euro, then, Germany's large and growing current-account surpluses were the result of sizeable adjustments in private-sector behaviour.

Since bottoming out at just over 9 per cent in 2000, Germany's household savings rate has steadily increased, reaching almost 12 per cent in early 2009. The reasons behind this increase are still a matter for debate. It is possible that part of it was 'structural' – that is, a long-term adjustment to a permanently higher level. One reason for thinking so is that the size of the age cohort most likely to save – that aged 35 and over – has increased over this period. But shorter-term ('cyclical') factors have almost certainly played a role too. Factors that appear to have pushed up precautionary savings over the past decade include growing uncertainty about future income and job prospects, falling house prices, losses in wealth resulting from sharp falls in share prices in 2001-03, and the global financial crisis in 2008-09.

Firms have also contributed to the rising external surplus. Net savings by German businesses increased because the sustained period of wage moderation boosted their profitability and shifted the share of income from labour to capital (between 2000 and 2007, the share of wages in GDP fell by four percentage points). Business investment spending at home, meanwhile, was weak. Between 2000 and 2005, Germany experienced a sharp fall in its investment ratio, with capital spending declining from 21.5 per cent of GDP in 2000 to 17.4 per cent in 2005. The investment ratio recovered slightly between 2006 and 2008. But at 19 per cent in 2008, it was still well below the eurozone average of 22 per cent. Weak investment at home was a leading cause of Germany's huge external surplus.

It is deeply misleading, therefore, to look at Germany's external surpluses through the prism of the country's 'competitiveness'. The way in which the savings-investment balance has evolved in recent years suggests that the scale of the trade and current-account surpluses is as much a reflection of the economy's domestic weakness as of its external strength. Households are saving more partly because their confidence in the future has fallen, while German firms have found it more attractive to invest abroad than at home. In short, the scale of its external surpluses points to the need for Germany to reform – a conclusion that is radically at odds with the now common view that improving 'competitiveness' in peripheral countries is all that is needed to reduce imbalances within the eurozone.

Germany and its foreign critics

Pleas that Germany reform and rebalance its economy face a sizeable obstacle: deep resistance in the country itself. Few Germans accept that the country's vast external surpluses are a problem. Many believe that their country's economic model has been vindicated by the global financial crisis. The lesson of the crisis, they argue, is that countries should 'live within their means'. Others resent being criticised by foreign officials and commentators, particularly when these are based in countries (like the UK and the US) that Germans blame directly for the crisis. And many harbour suspicions about the motives of foreign critics. Foreign pleas that Germany rebalance its economy are often seen as attempts to weaken it, or to shift the blame for the financial crisis on to prudent Germans.

Among politicians, a common reaction is to see foreign criticisms as a surreptitious assault on German exporters by countries that 'cannot compete'. Why, they ask, are Germans being criticised for making great products that others want to buy? Besides, what are they supposed to do? Should they, the economics minister, Rainer Brüderle, asked rhetorically, lower the quality of their goods to give foreigners a better chance to compete? Likewise, the finance minister, Wolfgang Schäuble, has said that he would never ask an opposition team to weaken itself to make life easier for the one he supports. And the chancellor, Angela Merkel, told the Bundestag in March 2010 that "we will not surrender our strength just because our exports are purchased more than those of other countries".

The Bundesbank, as one would expect, uses more refined economic arguments than politicians or the general public. But it, too, is reluctant to concede that large external surpluses are a problem, or that the country should seek to reduce its reliance on export-led growth. It rightly argues, for example, that domestic demand must grow more in line with potential output in countries with large external deficits such as Spain. But it sees no such need in countries with large external surpluses like Germany. It argues that wealthy, ageing countries should be exporting capital; that Germany's external surpluses reflect private-sector decisions that policy-makers cannot influence; and that even if they could be influenced, stronger demand in Germany would do little to reduce deficits in countries like Spain and Greece.

It is not possible to refute all these assertions in this brief essay. Much of the political rhetoric seems to reflect a mercantilist mind-set. The underlying assumption is that trade surpluses are markers of economic prowess; any proposal that would reduce them must therefore be designed to weaken the country running them. Many of the claims that flow from these assumptions are odd. Foreigners, for example, are not asking Germans to reduce the quality of their goods (a move that would actually lower the living standards of those who bought them). All foreign critics are suggesting is that domestic demand in Germany has been feeble and that the country has been too reliant on exports for its own growth: if other countries had not lived beyond their means, Germany would barely have grown at all.

The Bundesbank is right to argue that it makes sense for a wealthy, ageing country such as Germany to be exporting capital. What is less clear is whether it makes sense to do so on the scale that Germany was doing before the global financial crisis. The Bundesbank, moreover, under-estimates the extent to which more buoyant demand in Germany would help economic rebalancing in deficit countries like Greece. For one thing, the impact would not be limited to the direct effect on exports of Greek goods to Germany: it might well have a greater impact on the services balance (by increasing Greece's receipts from tourism). For another, stronger German demand would also have indirect effects (since a rise in German demand for, say, Dutch goods might later result in more visits by Dutch tourists to Greece).

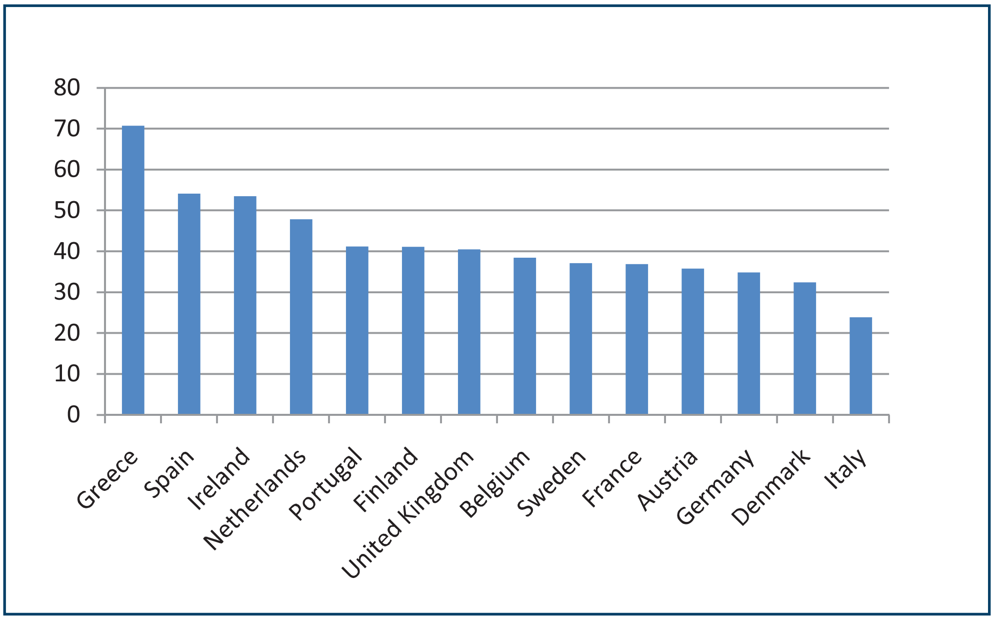
Is its economic model in Germany's interest?

It would be wrong to imply that no-one in Germany is calling the country's economic growth model into question. There are voices – notably on the Council of Economic Experts – arguing that it would be desirable for the country to reduce its reliance on export-led growth. In general, however, such voices are louder outside Germany than inside. The trouble is that policy-makers are unlikely to succumb to foreign exhortations for Germany to 'live up to its international responsibilities'. They will only see merit in re-balancing the economy if they conclude it is in the country's own interests to do so. And they are only likely to reach that conclusion if they can be persuaded that its heavy reliance on export-led growth has not served the country quite as well as many Germans currently believe.

Three things could push them towards that realisation. The first is that huge external surpluses have not coincided with particularly large increases in living standards. Over the past decade, real GDP has grown by 16.4 per cent in the EU27; by 14.3 per cent in the eurozone; and by 8.7 per cent in Germany. True, growth rates are adversely affected by Germany's demographic profile (it is the first country in the old EU15 whose population has started to decline). Germany also has less scope than poorer EU countries such as Greece and Portugal to benefit from 'catch-up' growth. But even if these factors are taken into account, Germany has not been in the European vanguard. Since 1999, income per head at purchasing power parity has grown faster in every other EU country bar Denmark and Italy (see chart 3).

A second factor that could encourage change is the realisation that much of the capital that Germany has exported has been poorly invested. True, an ageing, wealthy country should be a net exporter of capital. It is unquestionably more rational for Germany to be exporting capital to less prosperous countries such as Greece than it is for still

Chart 3: Cumulative growth in GDP per head (PPP, 1999-2009)



poor China to be doing so to the far wealthier US. But demographic factors alone do not explain the sheer scale of capital that Germany has been exporting in recent years. And it is hard to conclude that the colossal savings that prudent Germans have amassed at home have been profitably invested abroad: Germany, it turns out, supplied a sizeable share of the capital that funded housing booms and reckless spending binges by governments and consumers abroad.

A third factor, closely related to the second, is the parlous state of the German banking sector. German leaders have spent a lot of time over the past two years contrasting their own country's virtue with Anglo-Saxon and Southern European profligacy. But the prudence of firms and households at home has done little for the stability of Germany's banking sector, which is currently one of the sickliest in the EU. In truth, this is not a total coincidence. The huge exposures that German banks have built up to poor quality foreign assets like US sub-prime securities or Greek government bonds are a result of the sheer volume of capital that Germany has been exporting. At least in part, the fragility of Germany's banking sector is a by-product of the country's heavy reliance on export-led growth.

Many Germans believe that their economic model has been vindicated by the crisis. Looked at dispassionately, however, it is hard to argue that they have been that well served by it. Over the past decade, growth in income per head has been below the EU average. Employment has risen, but people in work have seen their living standards stagnate or even decline. And German thrift has been poorly rewarded: the capital that Germany has exported has been squandered on an epic scale on poor investments in other countries. Germans have expended huge efforts selling Porsches and Volkswagens to foreigners. Their reward for their industry and thrift has been over-sized exposures to junk foreign securities. Germans have fewer reasons to be attached to their economic model than they think.

Rebalancing the German economy

German domestic demand has been chronically weak for the best part of a decade: it was barely 3 per cent higher in real terms in 2009 than it had been in 1999. It is unrealistic of foreigners to expect German demand to grow faster than output for any sustained period of time: as an ageing, high-income country, Germany will probably remain a structural net exporter of capital. The real question is one of scale: the world would be better served if its fourth-largest economy were to start running smaller current-account surpluses than it became accustomed to doing in the run-up to the global financial crisis. To do so, German domestic demand would have to start growing somewhat faster than it has been doing over the past decade. What are the prospects of it doing so? And what would help it to do so?

Wherever else the impetus comes from, it will not come from government spending. Germany's brief flirtation with Keynesianism – the country provided one of the largest fiscal stimuli in the OECD in 2009 – is drawing to a close. It is joining the synchronised but unco-ordinated withdrawal of fiscal stimulus across Europe. German officials argue that tighter fiscal policy will boost private-sector spending and therefore growth. But if domestic demand is to gather pace, private-sector spending will have to grow sufficiently robustly to offset the government's withdrawal of fiscal stimulus. This could be a tall order in the short term. In any case, in the longer term, Germany will probably need more than improved public finances if spending by consumers and businesses is to grow more strongly.

The outlook for consumer spending is mixed. Rising employment could be a supportive factor. But German consumers may be reluctant to spend more freely if their real wages continue to stagnate. There was a strong case for freezing wages in the late 1990s, when unit labour costs needed to be cut following the post-unification boom. But the case for wage moderation is weaker now than it was then. Germany's real effective exchange rate is among the lowest in the EU; and suppressing wages is not a sustainable business strategy given the vast pools of cheap labour in countries such as China. Besides, the point of productivity growth is to raise living standards. For the past decade, productivity gains and wage restraint have boosted profits, but not incomes. German workers deserve a pay rise.

The prospects for business investment are equally uncertain. During the 'noughties', German companies found it increasingly attractive to invest abroad rather than at home. Factors encouraging them to invest abroad included the EU's eastward enlargement (and globalisation more generally), which pushed firms to boost their competitiveness by offshoring; and Germany's corporate tax regime which was one of the most onerous in the world. The corporate tax regime, which was reformed in 2008, is more attractive than it used to be. This has weakened one of the incentives pushing firms to invest abroad. But if the domestic investment rate is to be raised – and Germany's current-account surplus is to be reduced – the government will have to give companies further reasons to invest at home.

A major disincentive to investing in Germany is the economy's modest prospects for long-term growth. Much has been made of the strength of Germany's economic recovery in 2010. But it is important not to get carried away. Like a bungee jumper, Germany is rebounding faster than its neighbours because it fell further. Some of the factors that are propelling the economic rebound – recovering foreign demand and a more favourable position in the inventory cycle – are likely to weaken in 2011. The momentary strength of Germany's cyclical recovery should not obscure the longer-term story. Germany's trend rate of growth – the rate at which the economy can expand over the long term without triggering inflation – is just over 1 per cent (a percentage point lower than the average for the developed world).

The need for supply-side reforms in Germany

Like many other countries in the EU, Germany needs to improve the supply-side performance of its economy if it is to raise its long-term rate of growth. Charting a reform programme for Germany is beyond the scope of this essay. But two broad questions can briefly be touched upon. The first is whether Germany's modest long-term rate of growth reflects the country's failure to mobilise its population of working age, or a productivity problem in parts of the economy? In simple language: is the problem primarily one of 'perspiration' or of 'inspiration'? The second question is whether German policy-makers should worry most about raising productivity in the manufacturing sector, which is highly exposed to international trade, or the service sector, which is more sheltered from foreign competition.

Germany has made great strides in raising employment, thanks in part to the Hartz reforms which overhauled the tax and benefits system. Following a decade of almost uninterrupted rises, Germany's employment rate now stands at 71 per cent – 5 percentage points higher than in 2000 and 6 percentage points higher than the average for the EU27. The rise in the employment rate, moreover, has not coincided with a reduction in the working age population's participation in the labour force. Germany's labour force has actually increased over the past decade, because a growing share of the working age population has started actively to look for work. Germany, in other words, is mobilising its workforce far better than it did in the 1990s. In aggregate, it has created over 2 million jobs since 2000.

Does this mean there is no further room to increase labour utilisation? Not quite. A country can always do better. Germany's employment rate may now be above the EU average, but it is still below the levels notched up in Denmark, the Netherlands and Sweden. Germany could do more to encourage women to participate in full-time work (whereas 52 per cent of women aged 25-49 work full-time in France, only 34 per cent do so in Germany). Increasing the share of women in full-time work would make particular sense, given that more women than men now graduate from university.[2] Germany's previously much-admired vocational training system could also be reformed: it is not particularly well adapted to an age when demand for skills is changing more rapidly than in the past.

[2] *Klaus Zimmermann, 'Germany must make it easier for women to work', Financial Times June 3rd 2010.*

Germany's greatest challenge, however, is on the productivity front. Germany currently has a dual economy. In the manufacturing sector, productivity is high and growing faster than the OECD average. (In this sense, it is justified to describe German manufacturing as 'super-competitive'). But the reverse is true of the service sector. In many services – ranging from professional services, to retail and wholesale trade, the utilities, and so on – productivity is low and has been growing more slowly than the OECD average. One reason for weak service-sector productivity in Germany is that competition-restricting regulations are more extensive than in many other countries. Removing such restrictions would lower barriers to entry, increase competition and spur service-sector productivity growth.[3]

[3] *OECD, 'Economic survey: Germany', 2010.*

Politicians and businessmen often claim that productivity is crucial if countries are to compete successfully in the global marketplace. This assertion is deeply misleading. Productivity is important because it determines countries' living standards, whether they trade internationally or not. Germany – like most other countries – would be better served trying to raise productivity in the service sector, even though it is much less exposed to foreign competition than manufacturing. The reason is that Germany would get a 'bigger bang for its buck'. Since services account for a higher share of GDP than manufacturing (even in Germany), a one percentage point increase in productivity in the service sector would raise German living standards by three times more than a similar-sized increase in manufacturing.

The internal consequences of a more German eurozone

Europeans are currently holding critical discussions on how the governance of the eurozone should be reformed. Germany believes that the eurozone should be turned into a larger version of itself – a zone in which fiscal responsibility reigns and every country lives well within its means. Its view is supported by many 'core' countries in northern Europe (such as Austria and the Netherlands), as well as by the Nordics and some of the central Europeans. It is perfectly understandable, following the Greek sovereign debt crisis, that policy-makers should be preoccupied with restoring faith in the way that EU countries manage their public finances. However, they may be overlooking another risk: that a eurozone that becomes 'too German' could be as crisis-ridden as one that remains 'too Greek'.

The first reason is that an excess of national virtue could become a collective European vice. The countries in the eurozone's geographical periphery have no choice but to adopt the path of greater virtue. Over-indebted households in countries such as Ireland and Spain must pay down debt (even as their incomes fall), while their governments' room for manoeuvre will be constrained by tougher fiscal rules and more exacting bond markets. But if 'core' countries such as Germany and the Netherlands continue saving on the scale they have become accustomed to in recent years, the eurozone will be saddled with very weak demand. A more 'virtuous' eurozone would be wholly reliant on external demand to grow at all; and it would almost certainly worsen the plight of countries in the indebted periphery.

Another reason why a more 'German' eurozone would not be desirable is that policy would be asymmetric. A world in which macroeconomic imbalances are seen through the prism of 'competitiveness' pushes policy immutably in this direction: what, after all, could be more reasonable than to ask 'uncompetitive' countries to get into shape? The trouble, this essay has argued, is that large external surpluses can often be symptoms of domestic weaknesses that need tackling. And it is hard to see what incentives countries would have to tackle such weaknesses when their external surpluses are celebrated as measures of their competitiveness or economic prowess. Germany may face different challenges from those confronting Greece and Spain. But it is not exempt from the need to reform.

An asymmetric framework might do more than just lessen the pressure on Germany to reform. It could also have deeply pernicious consequences if Germany were to emerge as a benchmark against which other countries have to measure themselves. Consider unit labour costs. It is rational, over the long term, for wages to rise in line with productivity – that, after all, is the point of productivity growth. But this is not what would happen if an unreformed Germany were to emerge as a eurozone benchmark. If this were to happen, countries in which wages increased in line with productivity would be admonished for allowing their unit wage costs to deteriorate relative to Germany. Meanwhile, countries like Spain, where relative costs must improve, would be condemned to even larger wage cuts.

In May, the European Commission rightly argued that the optimal path for the eurozone would be for symmetrical changes to take place in all countries.[4] Countries with external deficits would have to free up their product and labour markets, lower unit labour costs (by cutting wages and trying to raise productivity), and reduce private and public sector debt. For their part, countries with external surpluses would need to do more to boost domestic demand and non-tradable sectors such as services. If the German government wins the political argument, however, the adjustment will be asymmetric, with little or no pressure on the surplus countries to change. This would hardwire deflationary policies in the running of the eurozone, and could end up worsening the very problems it is intended to resolve.

[4] *European Commission, 'Surveillance of intra-euro area competitiveness and imbalances', European Economy 1/2010.*

The external consequences of a more German eurozone

Turning the eurozone into a larger version of Germany would have adverse external consequences too. For the past decade, the eurozone's trade position with the rest of the world has been broadly in balance (surpluses in some parts of the region have been offset by deficits elsewhere). German leaders believe that the eurozone countries with external deficits can reduce these without Germany playing any offsetting role. The implication is clear: the unspoken assumption is that the rest of the world should accommodate a massive shift in the eurozone's external position. But the eurozone is not a small economy: it is the second largest in the world after the US. It is hard to see how the rest of the world could adjust to such a shift without an upsurge in trade tensions or destabilising flows of capital.

Imagine, by way of illustration, that all countries in the eurozone with external deficits succeeded in moving into surplus. Imagine, too, that countries such as Germany and the Netherlands continued to run current-account surpluses on the scale they have been doing in recent years. The result would be an economy that is two and a half times the size of China running a vastly larger external surplus (in absolute terms). It was hard enough for the world economy to accommodate China's external surpluses during the noughties. The way it did so – via an explosion of private and public sector debt in some of the world's wealthiest countries – planted the seeds of the global financial crisis. The world, it is safe to assume, would find it even harder to accommodate a large-scale shift in the eurozone's external position.

Which regions of the world would be able to offset a swing in the eurozone's current account position from broad balance to large surplus? No single region would be able to do so alone. At least three regions – Africa, Latin America and the Middle East – are too small economically, even collectively, to play more than a minor part in an adjustment on this scale. Asia could play a part. It would certainly be highly desirable for the region to contribute to global rebalancing. The trouble with Asia is that it displays many 'German' characteristics. Although most are emerging economies, a large number of countries within the region save vastly more than they invest. Many governments in the region, moreover, have been bent on running external surpluses since the Asian crisis in the late 1990s.

If much of the emerging world is too small, and parts of it are unwilling, to join in the sort of rebalancing that some eurozone governments seem to be conceiving, who does that leave? The answer, as ever, is the US. However, the world's traditional consumer of last resort is completely exhausted. It is mired in debt and must 'deleverage'. The only way the US could absorb a shift in the eurozone's external position would be for it to sink even further into debt than it already is. This would have two consequences. It would restore the very conditions that precipitated the global financial crisis (large-scale capital inflows into the US, irresponsible lending and borrowing, rising debt, and so on). And it would increase domestic pressure on the US government to take protectionist measures in response.

The German government sometimes points out that the current accounts of eurozone member-states do not have to sum to zero, because the eurozone is not the world. In practice, however, it is difficult to see how the world economy can rebalance without some rebalancing within the eurozone. The eurozone, after all, is not Luxembourg: the rest of the world can absorb large shifts in Luxembourg's external position and not even notice, but the same is not true of the eurozone. The rest of the world cannot ignore how the eurozone is run. A eurozone that lived well within its means might look prudent to its own policy-makers. But to the outside world it would look like a region pursuing beggar-thy-neighbour policies, to the detriment of global output, the international trading system and financial stability.

Conclusion

Many countries in Europe (and elsewhere) could do with a prolonged dose of German sobriety. But it does not follow that the German economy provides a template for all countries to follow. The reason is straightforward: Germany has only been able to be itself – an economy with chronically weak demand and vast external surpluses – because others have been the polar opposite. If Greeks and Spaniards must become more German, then Germans must become less so.[5] Some observers contest this conclusion. They accept that Germany's model cannot be universalised (since the world cannot run an external

[5] *Martin Wolf, 'The eurozone crisis is now a nightmare for Germany', Financial Times, March 9th 2010.*

surplus with itself). But they point out that it can be Europeanised (since the eurozone can run a surplus with the rest of the world). These observers are right in principle, but wrong in practice.

A eurozone that turned itself into a larger version of Germany would provoke intolerable strains at home and abroad. Internally, a more German eurozone would be afflicted by chronically weak demand, debilitating cycles of competitive wage cuts, and prolonged economic slumps in the deficit countries. The political fall-out could be poisonous – particularly if countries in the grip of debt deflation were then punished for struggling to consolidate their public finances. Externally, a more German eurozone would weaken the world economy. Not only would the world's second largest economy contribute little or nothing to global demand; it would put huge pressure on the international trading system at a time when too many countries across the globe are trying to export their way out of recession.

The world economy, in other words, will struggle to rebalance at a tolerable rate of output and employment without some adjustment in the eurozone; and the eurozone will not be able to rebalance without change in Germany. German policy-makers, however, will not be swayed by foreign appeals to 'save' the eurozone (or the rest of the world). They need to be convinced that change would be in Germany's own interest. This essay has argued that it would be. Its lop-sided growth model has served Germany less well than many observers believe. The country has enjoyed great success in creating jobs, and its households are not mired in debt. But workers have seen little financial reward for their sacrifices over the past decade, and much of the capital that Germany has exported has gone to waste.

One obstacle to rebalancing the German economy is the tendency of many of its politicians to see large external surpluses as signs of 'competitiveness' – that is, as markers of economic prowess. They are no such thing. There are higher productivity economies than Germany (such as France and the US) which run external deficits. And there is no reason why a lower external surplus should entail a decline in German living standards (the reverse may actually be true). Rebalancing the German economy would not mean hobbling exports, but boosting productivity in the sheltered service sector and encouraging firms to invest more at home and less abroad. In other words, it would mean recognising that large external surpluses can be a symptom of domestic weakness, rather than external strength.

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