

**ECONOMICS FOCUS**

**Economics focus**

**Germany's euro test**

Jun 12th 2003

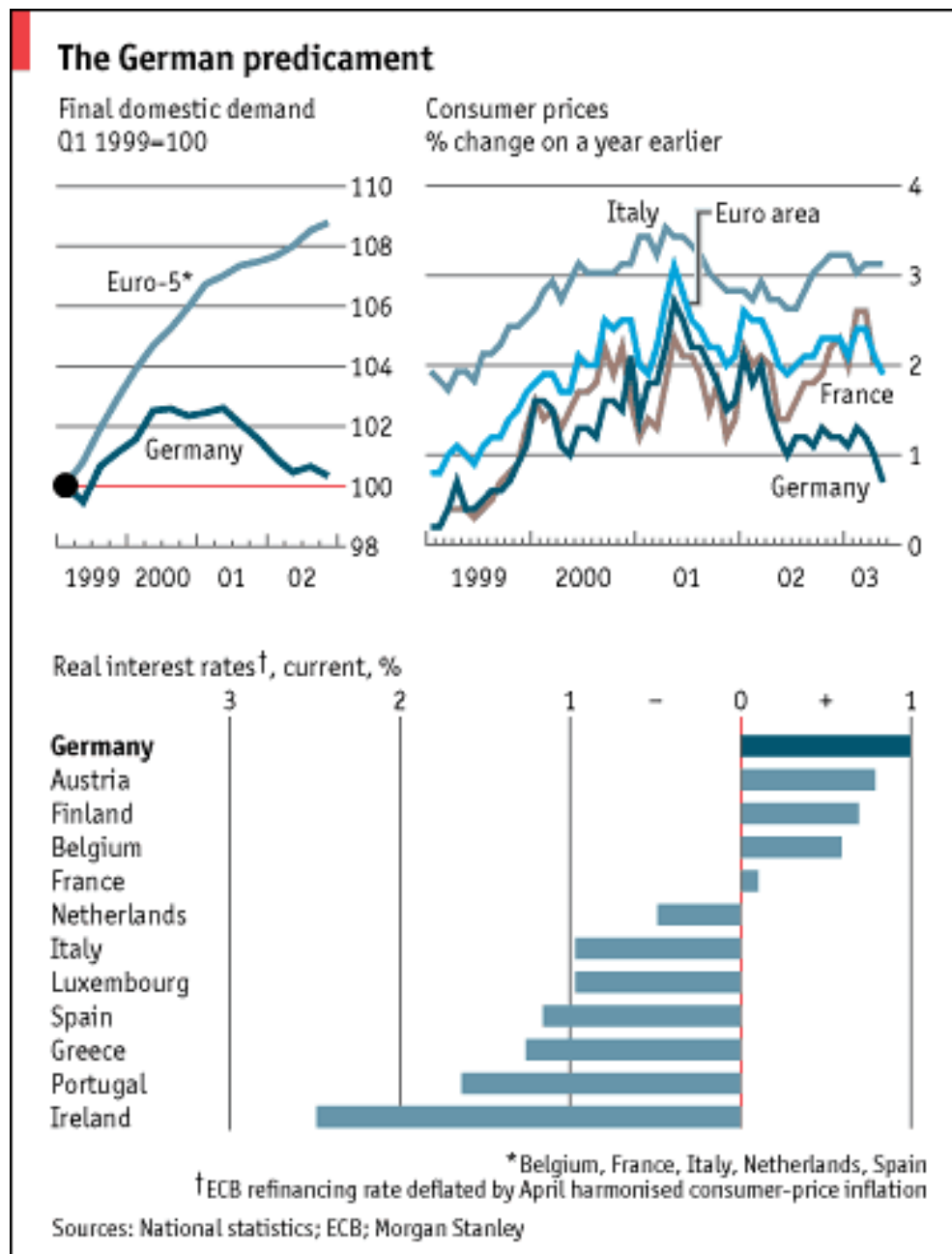
From The Economist print edition

**A half-serious proposition**

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THE interminable debate in Britain over whether to join the euro reached a new peak this week, when Gordon Brown, the chancellor of the exchequer, delivered his verdict. Mr Brown based his judgment on five economic tests, of which Britain, he announced, had failed four. Yet perhaps this is the wrong debate about euro membership. Only partly in jest, *The Economist* suggests that a better question is not whether Britain should join the currency zone, but whether Germany should leave.

Take Mr Brown's five tests and apply them to Germany. The first is convergence: are business cycles and economic structures sufficiently in step that Germany can live comfortably with euro-area interest rates? The clear answer is No. Since the euro was launched in 1999, Germany's GDP growth has been by far the slowest in the euro zone, causing its output gap (the difference between actual and potential GDP) to widen by more than anywhere else. Real domestic demand has barely risen at all in Germany since the start of 1999; in the rest of the euro area it has gone up by 9% (see chart). Germany is technically back in recession: many economists think that it is now in its third consecutive quarter of shrinking GDP.



Indeed, a study by HSBC finds that, although Britain's growth rate and output gap have converged with the euro zone in recent years, Germany's economy has diverged from other members. This suggests that Germany may be worse suited than Britain to live with a one-size-fits-all monetary policy. Since Germany has the biggest output gap within the euro area, it needs lower interest rates than its fellows. Instead, Germany has the highest real interest rates, because it has the lowest inflation rate. This, in turn, further depresses growth. Moreover, Germany's lower inflation rate is not just cyclical. Differences in productivity and price levels within the euro zone mean that inflation is structurally lower in Germany. This implies that real interest rates may be permanently too high.

The second test asks whether the economy is sufficiently flexible to deal with "asymmetric shocks", changes in the economic environment that affect some countries more than others. Flexibility matters because members of the euro zone cannot adjust national exchange rates or interest rates to cushion their economies, and fiscal policy is also

constrained. Again, the answer is No. Look, for example, at Germany's struggle to cope with the effects of reunification. For all the recent talk of reform, the labour market remains sclerotic. Levies on wages to finance social security, health care and pensions are painfully high. There are strict laws controlling the firing of workers, and wages are rigid.

Test three is: will the euro encourage companies, especially foreign ones, to invest, by eliminating exchange-rate risk within the zone? If Germany's economy remains weak, it should surely fail this test too, because firms will be wary of expansion. Mr Brown's fourth test, the impact of the euro on the financial-services industry, may be less important in Germany than in Britain. However, foreign banks have slimmed down in Frankfurt, even though the city is home to the European Central Bank.

## A failing economy

The fifth test is whether the euro will boost growth and jobs. Over the past couple of years, unemployment has increased by far more in Germany than in the rest of the euro area. Worse still, a recent study by the IMF warns that the country faces a serious risk of deflation, which could further depress output and jobs. Inflation is running at only 0.7% (well below the euro-area average of 1.9%), and increasing excess capacity and a stronger euro will push it lower still.

Deflation would be dangerous in Germany, given firms' heavy burden of debt and the fragile state of the financial system. Bank credit has already ground to a halt. Yet Germany cannot cut interest rates, because these are set by the ECB according to economic conditions across the whole euro area. Europe's stability and growth pact is forcing the German government to tighten fiscal policy too. Ironically, the rules for both the ECB and the stability pact were designed largely by Germany.

The IMF argues that monetary policy can prevent deflation, if it is pre-emptive and forceful. Those are not words that describe the ECB. At his May press conference, Wim Duisenberg, the bank's president, said: "In the 16 years that I was the governor of the central bank of the Netherlands, there were two years in which we had deflation of ½%. I publicly declared then that I lived in a central bankers' paradise."

Whatever the economic arguments for Britain's joining the euro, the case for Germany's quitting looks stronger. The idea that Germany will do it is, of course, the stuff of fairy tales. However, the country's present predicament also has a fairy-tale feel, with the ECB in the role of the wicked witch who lured Hansel and Gretel into her gingerbread home with the aim of eating them. In the story by the Brothers Grimm, Gretel pushes the witch into the oven. In the real world, Germany is being roasted, and risks living unhappily ever after.