Introduction

Since the introduction of the Euro at the turn of the century, nations within the Eurozone have enjoyed very different economic outcomes, reflected in disparate levels of growth and unemployment. The differing trade performance of the various countries has been a major factor in bringing this about particularly in the case of Germany.

To what extent has Germany (and also the Netherlands) benefitted from sharing an exchange rate with weaker economies such as Italy, France, Spain, Greece and Portugal and to what extent has southern Europe suffered from sharing a currency with Germany and some of its northern neighbors?

From a trade perspective, the free and fair exchange of goods and services requires currency flexibility if outcomes are to be fair. The exchange rate is supposed to act as a balancing factor, a safety valve if you like, to balance trade between nations in the absence of perfect price flexibility. The European currency union appears to dramatically inhibit the balancing of trade at the national level.

While the EU has become a firm supporter, if not an uncritical one, of existing multilateral trade institutions such as the WTO, is it the case that their own currency arrangements represent a significant part of the challenge that the global trading system faces today?
Diverging economic performance within the Eurozone

The Euro was introduced as an accounting currency in January 1999 and by March 2002 had replaced erstwhile national currencies in physical form as well. Using January 1999 as a starting point, it is clear that in terms of economic growth, Germany has outperformed some of its southern currency partners substantially. Furthermore, post the Global Financial Crisis of 2008 and the “Euro crisis” in 2012, with tighter credit conditions, and as the potential exchange rate misalignment has had time to develop, the disparity in growth performance has widened.

This is at odds with what one might have expected to happen. The poorer economies should have benefitted from their relatively low bases and undergone a “catch up”. Their lower cost base might have been expected to attract capital investment to enhance growth and productivity. Furthermore, the architects of the Euro hoped that with time, the underlying traits and structures of the various economies would converge, helping with the smooth functioning of the currency union and turning a politically motivated union into something that worked economically. The current environment in which the richest and largest economy seems to perform at or near its potential while others underperform their potential jars with both theory and the hopes of the Euro’s proponents.

Chart 1. Real GDP rebased to 1999: Germany, Italy, Portugal & Greece

Source: World Bank Open Database
A study by the Center for European Policy \(^{(1)}\), for example, found that in 2017, German GDP was EUR 3,390 per head higher than it would have been had the Euro not been introduced. Cumulatively, since 1999, the benefit to the German economy was estimated at EUR 1.9 trillion of EUR 23,000 per head.

In contrast, the impact on Italy has been very negative. The study found that in 2017 Italian GDP per head was EUR 8,700 lower that it would have been had Italy not joined the Euro and that cumulatively the cost to Italy amounted to EUR 4.3 trillion.

The German economy accounts for about 30% of the Eurozone economy with the Netherlands, the other perennial current account surplus country, accounting for another 6%. Thus, the economic circumstances of Germany and the Netherlands have a large but not dominant impact on the ECB’s interest rate policy and on the market’s interpretation of the value of the Euro – the exchange rate. The external value of the Euro, as reflected in exchange rates with Europe’s trading partners, reflects not just Germany’s and the Netherlands’ terms of trade and competitiveness but also that of the other weaker economies. By sharing the single currency with other economies, Germany and the Netherlands have benefited from a cheaper exchange rate than would otherwise be the case. The exchange rate is the mechanism by which the German economy’s external surplus should have naturally been brought back towards equilibrium, with both the rest of Europe and the rest of the world, were it to have retained the Deutschmark.

According to the OECD Purchasing Power Parity Model, there is about a 12% gap between the appropriate exchange rate for Germany and Italy. The IMF estimate that as of 2018, Germany’s current account surplus implied that its Real Effective Exchange Rate (REER) was between 15% and 30% undervalued. In contrast Italy’s REER was estimated to be between zero and 10% overvalued. The implication of these various estimates is that the single European currency has allowed large foreign exchange mis-alignments to develop over time.

**Unbalanced Trade**

This long-lasting currency misalignment is perhaps most evident in Germany’s external accounts. In 2018, for the third year running, Germany recorded the largest current account surplus in the world in nominal dollar terms. In the 10 years leading up to the Euro’s formation in 1999, Germany ran an average current account deficit of 0.7% of GDP. Between 2000 and 2018 it has run an average current account surplus of nearly 5.25% of GDP and post the GFC the surplus has averaged a whopping 7.2% of GDP.\(^{(2)}\) The Netherlands has run similarly large surpluses relative to GDP (larger in some years) but its smaller size as an economy limits the overall impact on global trade imbalances.
Furthermore, these huge surpluses, both relative to its own GDP and in absolute dollar terms have been recorded at a time when Germany has been running at close to full employment. This is the point in the cycle at which the propensity to import should be highest: when consumers are employed and spending, and companies are investing. At such a time, the current account should be at least tending towards deficit especially if one’s trading partners’ economies are growing below potential. Attempts to cyclically adjust the Germany current account surplus suggest that the underlying external position is in even larger surplus – perhaps as high as 8.5%.

**Chart 2. German & Netherlands current account as % of GDP**

It is not just the size of these current account surpluses that should be a cause for concern for those who want to see a sustainable global trading system but also their persistency. Germany has run a current account surplus in each of the past 17 years since 2002 with the smallest being 1.4% of GDP. The consequence of these continued surpluses, that cumulatively add up to USD 3.5 trillion, is that Germany’s net International Investment Position (IIP) has risen from zero in 2003 to 60% of GDP now.

There are two potential ways in which the single European Currency could be helping Germany’s trade performance. Firstly, because the Euro is made up of a plethora of economies with differing degrees of competitiveness, the external exchange rate, between say Germany and United States, is artificially low. Secondly, differing levels of productivity growth and inflation within the Eurozone mean that Germany could be increasing its competitiveness against those countries with which it shares the single currency. Since the exchange rate between say Germany and Italy is fixed, changes

In Germany’s case, since 2002, these surpluses add up to USD3.5 trillion.
in the relative competitiveness of the two countries’ exports boil down to inflation differentials and productivity differentials.

**Germany’s internal Eurozone surplus**

Using country of origin data for German imports, the share of Germany’s surplus coming from within the Eurozone has declined over the past 16 years to about 1/3 of the total now, but in nominal terms the absolute level has remained large. Given the relatively poor economic performance of the Euro area (ex-Germany), it is not a surprise the portion has declined but importantly, one could say that if ever there was a time for Germany to be running a deficit with its currency-sharing neighbors it has been in recent years when their economies have been struggling.

**Germany’s ex-Eurozone surplus**

The big growth in Germany’s trade surplus has come from outside the single currency area, namely the USA, UK and other non-Euro members of the EU. From the perspective of those wishing to see a sustainable global trading system this is problematic. There is an argument that the internal surplus is a matter for the EU and their member states, but the external surplus, its size and persistency raise questions of equity that impact the rest of the world. Specifically, are currency unions, particularly sub-optimal ones, a threat to the multilateral trading system?

**Chart 3. Germany & China current account surpluses in USD**

Source: World Bank Open Database
Despite having an economy that is just 30% the size of China’s, Germany’s current account surpluses have now surpassed China’s. China’s currency manipulation, particularly during the period of 1994-2014, manifested itself in the rapid growth of foreign exchange reserves that reflected central bank intervention to keep the exchange rate down. In the case of the Euro, the ECB does not intervene in the foreign exchange market, so the external value of the Euro is market determined. Germany’s advantage comes about because of the shared nature of the Euro and the fact its value is depressed by the other Euro economies.

The mechanisms through which this advantage runs are twofold. Firstly, in an attempt to stave off deflation in the Eurozone and to stimulate growth in countries with an overvalued exchange rate (such as Italy and Greece), the ECB has run an exceptionally easy monetary policy which in turn has driven the Euro down. While this is appropriate for Italy and southern Europe, it is not for Germany and the Netherlands. Using estimates derived from Taylor rules for the appropriate level of interest rates, for say, Germany and Italy, reveals that there is perhaps a 6% gap between the appropriate policy rate for each country. The “right” interest rate for peripheral Europe, given that they share an exchange rate with Germany is heavily negative while the “right” one for Germany is meaningfully higher than the current policy rate.

Secondly, the Euro area excluding Germany and the Netherlands has run near perennial cyclically adjusted current account deficits. The move into current account surplus by the southern countries in aggregate has only come about at the expense of collapsing domestic demand post the 2012 Euro crisis. In other words, the southern countries do not appear to be able to grow at potential and have a balanced current account at the same time given the current currency arrangement. They either have a large output gap and run a small surplus or they run deficits. These deficits in turn allow the north to run surpluses without exerting upward pressure on the Euro, or at least not as much as would be required to produce a balanced current account position in the North.

By sharing the Euro with weaker economies, Germany has garnered an unfair trade advantage. Southern Europe is locked into an exchange rate that makes it impossible to grow at potential and balance its trade position.
Why Does it matter?

By effectively locking some parts of the Eurozone into an overvalued currency, the single European currency project has produced extraordinarily high levels of unemployment and income stagnation in some Eurozone countries with the consequent squeeze on fiscal position and hence government indebtedness. The irony is that in order to undergo an “internal currency devaluation” the countries with an overvalued exchange rate need deflation and yet the indebtedness they already carry means such a downward move in price levels would most likely result in default.

If there is a purpose to economic policy making, it is surely to facilitate the realization of economic potential. If that is so, then the Euro has failed. Consider that unemployment in the Euro area seven years after the Euro crisis broke is still 8% and like so much else in the Euro area, the aggregate or average hides a large dispersion underneath. Unemployment in Italy remains above 10%, in Greece it is still at 18% and in Spain 13%. In Germany and the Netherlands, it is just 3.3% and 3.2% respectively. Consider also that in real terms, the economy of Greece in 2018 was the same size as it was in 2000 and in Italy the economy is the same size as it first reached in 2004. Not surprisingly, such poor economic performance has been accompanied by the rise of political extremism and the discrediting of the current economic system. The European elections were a reminder of the degree to which the population at large has lost faith in the European project.

Chart 4. Current account USD: Germany & Netherlands vs rest of Euro Area

Source: World Bank Open Database

High levels of indebtedness makes an “internal devaluation” through deflation incompatible with financial stability.

The huge human cost inflicted by the Euro is fueling populism.
Conversely, the part of the Euro area locked into an undervalued exchange rate continues to rely on the rest of the world to buy its exports for want of demand from within the Euro area, and here patience is wearing thin. While China, for geopolitical reasons as well as economic ones, is the current center of attention, the threat that the Euro area poses to a sustainable global trading system will likely draw more attention going forward. If southern Europe is to enjoy a monetary policy easy enough to let it grow, then northern Europe will likely continue to enjoy an exchange rate that is too weak to balance its current account.

This appears to point to three possible scenarios:

1) **Continued imbalance, rising socialist economics** – The rest of the world is compelled to accept continued and probably growing current account surpluses from Germany and the Netherlands that together constitute an outsized imbalance both in absolute terms and relative to the size of their economies. With the status quo comes the risk that populism continues to rise, and the political opponents of market-based economies gain power with the subsequent loss of economic welfare associated with alternative policies. Such a scenario would likely result in rising trade friction with the rest of the world and may well end up with countries opting to leave the Euro anyway. A disorderly break-up of the currency union will become more likely with time.

2) **Tighter monetary policy, stronger Euro, southern defaults** – The mechanisms that could correct the northern European imbalances are allowed to play out (i.e. tighter monetary policy and a stronger Euro) but at the cost of renewed stagnation in southern Europe. This comes with a high likelihood of sovereign debt default from Italy and perhaps others. Given Italy has EUR 2.35 trillion of debt, such a default would be potentially disastrous for the global financial system and hence the world economy.

Or,

3) **Euro disbanded, balance restored** – The single European currency union is disbanded in an orderly fashion with perhaps a southern and northern European bloc. This is politically unpalatable for proponents of the European project but it is possibly the least damaging outcome for the global economy and trading system.
Whichever of the three options policy makers decide to take, the European currency union continues to pose the greatest single threat to the global economy and the sustainability of the global trading system. Putting in place a currency union across such varied and diverse economies, with obvious price rigidities particularly in labour markets, was always going to put a strain on a multilateral trading system that depends on exchange rate flexibility among its largest players to ensure equity in outcomes.

While none of the policy options available are attractive, the break-up of the Eurozone might be the least costly in the long run.

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2. World bank open data base. Numbers often quoted by the IMF are slightly larger. All data is from the World bank unless stated otherwise.
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**Contact us**

Ms. Berenice Voets, International Trade Research & Media Enquiries
Tel: +852 2509-8662/+852 9081-8210 (Mobile)
Email: berenice.voets@hinrichfoundation.com