German success in a flawed European system

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ABSTRACT

This paper discusses the current flaws in the European Union as it exists today and addresses how Germany has succeeded within the flawed system. The purpose of this paper is to address the underlying fundamental issues with the European Union and explain how these issues have affected various European countries. It begins by discussing the foundation of the EU and the conditions upon which it was found. It goes on to discuss the reasons countries joined the EU and addresses why these conditions were ripe to create a crisis. The paper then discusses the asymmetries across Europe, how and why they occur, and the effect they have on Germany and the EU. The paper then focuses on how German society and German influences on the EU have enabled its continued economic success before concluding with an analysis and recommendation on how the EU should proceed from here. The paper finishes with a recommendation of further fiscal and political unification within the EU as the only means of success in the long run.

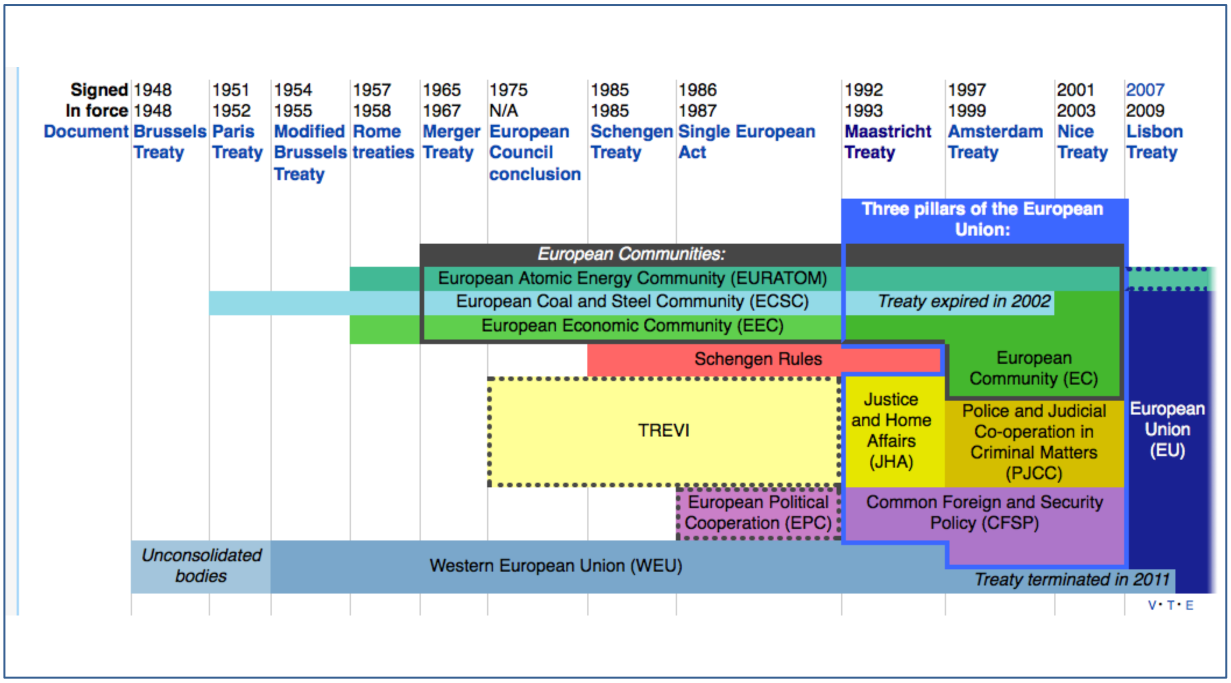
HISTORY OF THE EUROPEAN UNION

Limiting German Power in Europe

The foundation of what would ultimately become the European Union (EU) was based on a very interesting set of circumstances and occurred at a very unique point in history. At the end of World War II (WWII), political leaders across Europe were determined to establish a mechanism that would ensure the prevention of another large-scale European conflict. This effort was placed on the forefront by French President François Mitterrand who was determined to unite Europe through a monetary union (Bagnall, 2012). Despite not having a background in economics, Mitterrand recognized money and trade as the most important factors of success of a country. He believed that by beginning to establish a monetary union, Europe's economies would be too co-dependent for another European conflict to ever begin. Due to the historic tension between France and Germany, Mitterrand and the West German Chancellor Helmut Kohl knew that public opinion had to be changed if the union was to be successful. In an effort to begin changing public sentiment regarding the tensions between France and Germany, the political leaders came together to jointly mourn the victims of the world wars. This had a significant symbolic meaning as it began to display unification between historic rivals in an effort to move Europe forward together.

Following WWII, the western powers knew things had to be done differently when dealing with Germany and the treatment of Europe as a whole. The methods used to suppress German power and define international borders following WWI were obviously ineffective and are widely considered a major factor leading to the Second World War. The Allies in WWII determined that, rather than a divided Europe with clear borders and distinct territories, a focus on inclusion and unification must be sought to tie countries' individual success to one another, thereby ensuring no single country could gain significant individual power to start another armed European conflict. The political leaders chose to accomplish this task by creating strong economic ties between European countries through various treaties and agreements, the most notable being the European Coal and Steel Community that was established in 1951 in the Treaty of Paris (European Coal and Steel Community, 2013). This was the first step in unifying European nations and the first founding treaty that ultimately was incorporated into the European Union agreement.

Table 1: Founding treaties of the European Union
(Davis, 2013)



Monetary Union

The first attempt to create a single European currency and monetary union was during a meeting of the European Council in December of 1969 at The Hague. The council tasked Pierre Werner, Prime Minister of Luxembourg, with finding a way to stabilize exchange rates among member nations (Bagnall, 2012). His report, published in October 1970, led to the formation of the European Monetary system which established the European currency unit, an accounting currency that was designed to stabilize exchange rates and limit inflation (Bagnall, 2012). This, in essence, was the foundation of a monetary union between the European countries that many of the early proponents believed would ultimately lead to a full-scale political union. The problem of establishing a monetary union before the establishment of a political union carried enormous risks that were for the most part disregarded:

> "You cannot have a monetary union that works without a fiscal union. You cannot have a fiscal union without, in effect, a single finance minister which means you have to have a full political union. You can only have a full political union if people are prepared to go along with it, and the people quite clearly are not." *Nigel Lawson* (Bagnall, 2012)

While Europeans may have allowed the EU as a monetary union to form without resistance, they were nowhere close to being ready to form a political union and redefine the political landscape of Europe. This underlying sentiment preventing a political or fiscal union is the ultimate fundamental flaw of the European Union that virtually ensured an event like the European Sovereign Debt crisis would happen.

Benefits for Europe

In addition to limiting Germany's power within Europe, the establishment of a monetary union between European nations was thought to have the ability to bring wealth and prosperity to its member nations. The theory behind this supposed prosperity was underpinned by the strength of the collective European nations and the notion that as a group, the European Union would have the ability to compete with the world's largest economies.

In theory, this size and relative strength was supposed to allow each member nation the ability to compete on a world-wide scale much easier than if they were left on their own. In addition, with the creation of a single currency between nations, member countries would realize significant foreign exchange savings in inter-European trade in the amount of approximately 30 billion (Salvatore, 2002) and reduce unnecessary volatility between member nations. On a world scale, the relative size and strength of the Euro would potentially establish it as an additional reserve currency to rival the US dollar, ultimately lowering interest rates to member nations and lowering their costs to borrow money on the world market.

Table 2. Largest economies in the world by GDP (European Union and Eurozone treated as countries) (International Monetary Fund, 2013)

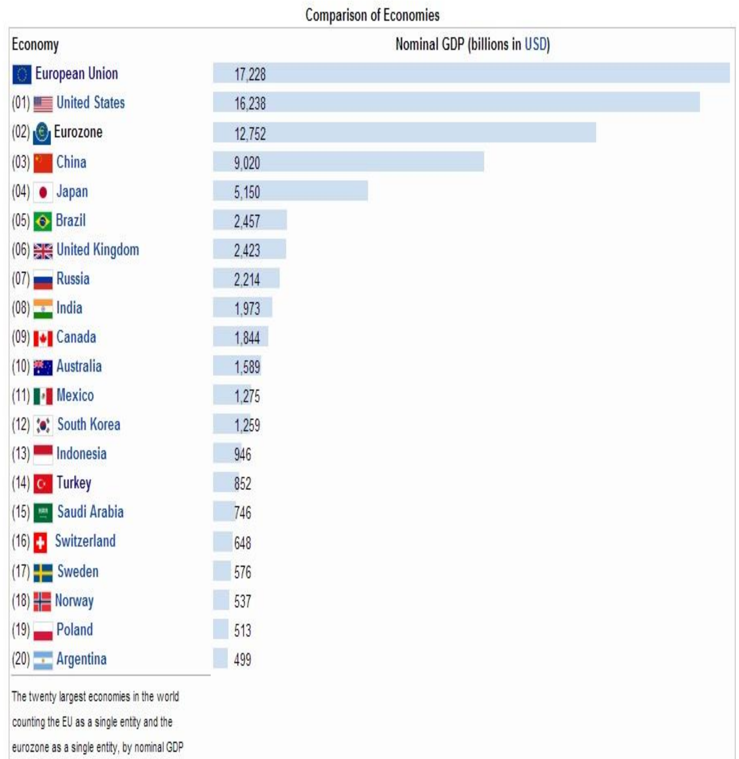
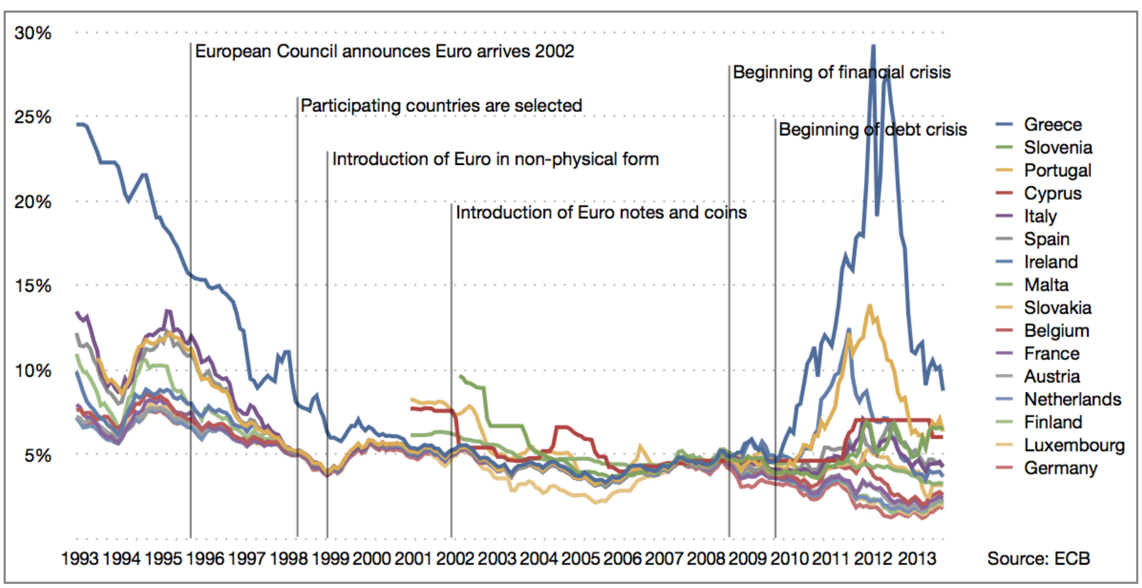


Table 3. Government 10 year bonds market interest rates (European Central Bank, 2013)



THE EURO: BOUND TO FAIL

Misguided Incentives

As discussed in a paper by Jeffry Frieden (1998), the creation of the Euro was attractive to many European nations for a number of reasons. For countries that had historically suffered from extreme levels of inflation and exchange rate fluctuations, adopting a single currency would eliminate these fluctuations by essentially fixing their exchange rate at the date of implementation. In addition, they would adopt a stable, trusted monetary policy similar to that of Germany which had been known for its strict austerity measures and tight policies designed to limit inflation. To ensure long-term financial stability within Europe, one of the principal goals of the European Union was to slowly shift member nations' fiscal policies towards those of Germany's. When the first eleven countries joined the Euro area, the non-member countries saw strong potential for strength and stability within the EU and were afraid to miss out on their opportunity to join. They were worried they would be considered 'second-class countries' within the European Union if they too were not a member of the Euro zone and feared they would not reap the same benefits the other 'first-class countries' had (Frieden, 1998). Large corporations and political leaders across Europe loved the idea of a single currency as they understood the benefit that would be available due to the elimination of exchange rate fluctuations. With the creation of a single currency, international corporations and government entities would no longer have to worry about exchange rate risk associated with international trade within the currency area. With a large percentage of trade occurring within the new currency zone, significant currency savings could be realized upon implementation of the Euro. With the aggregate pooling of economic power among member countries, the idea was the Euro would have the opportunity to be established as a major world currency that could eventually compete with the US Dollar in strength and stability.

Optimum Currency Area

Despite the benefits that were anticipated to come as a result of the adoption of the Euro as a single currency, there were many well-known risks associated with fixing the exchange rates of such a diverse set of countries. The Optimum Currency Area (OCA) Theory put forth by Mundell (1961) and McKinnon (1963) states that it is economically beneficial to use one currency when the economies are highly integrated and have the capacity to adjust quickly to asymmetrical demand. Prior to the formation of a currency zone, in the event of asymmetrical demand shift across various areas in Europe, countries could use monetary and fiscal policies in their home nation to counteract this demand imbalance. If a country such as Spain began to operate a large trade deficit, their currency would naturally devaluate through market mechanisms, making imported goods relatively more expensive, ultimately raising domestic GDP and reducing their trade deficit. This ability for the currency to adjust to the economic circumstances of a country acts as a natural stabilizer between nations. In addition, with control over domestic monetary policy, in the event of an economic crisis, Spain's government would have the ability to manipulate the money supply to spur economic activity and encourage growth. This control over the monetary system is one of the key levers a government has to manipulate the economy especially in times of crisis.

One Size Fits None

By establishing a central monetary union among Euro zone countries, governments essentially lose control over their economies and have a much harder time manipulating them in times of recession or crisis. This issue is compounded by the extensive differences between economies among member nations. Where countries such as Germany grow at an average of 2.6% a year, the southern periphery countries such as Greece struggle with high unemployment and recessionary economies (World Bank, 2013). These different economic states, coupled with a singular Monetary Union, led to a monetary policy that results in as a one-size-fits-none. In the EU's attempt to make every country happy, they ended up with policies that no country is truly happy with. The large asymmetries in the economies of Europe make the monetary policies enacted by the European Monetary Union inherently flawed for at least one area as the EMU can only establish one policy for all member states. In addition to these issues facing the EMU, studies completed by the International Monetary Fund (IMF) in 1998 indicate that a rise in interest rates took twice as long to have a significant effect in Austria, Belgium, Finland, Germany, and the Netherlands than in Spain, Portugal, France, and Italy (Salvatore, 2002).

Asymmetric Demand Problem

A major way geographically dispersed economies handle demand asymmetry is through the free flowing movement of labour. In the United States, for example, when localized unemployment begins to rise due to demand asymmetry, workers are able to move to other areas within the country to find work. This helps to balance out the entire economy as labour flows to balance out supply and demand ensuring a flowing but relatively consistent economic area. Knowing this, the European Union took measures to ensure this would be possible within Europe through the establishment of the Schengen Agreement which led to the creation of the Schengen Area, allowing any person from within the area to travel and reside in any other member nation. In theory, this agreement suggests that individuals from member countries would have the ability to move away from regions with high unemployment towards areas in the Schengen Area that have higher labor demands just as is done in the United States. Unfortunately, this theory does not work as well as anticipated within Europe. Due to language barriers, cultural differences, and inflexible housing markets, the Organization for Economic Cooperation and Development and the European Commission found that labour mobility among EMU members is two to three times lower than among United States (Salvatore, 2002). These significant differences between citizens of member nations make the prospect of crossing international borders a significantly larger undertaking than simply crossing state boundaries in the United States. Add on national pride and historical differences among individual counties within the EU and it is easy to see why individuals are reluctant or all together unable to move when the asymmetrical demand problem occurs. This fundamental flaw in the system must be addressed before widespread prosperity can return to the Euro region.

Prior to the existence of the European Central Bank (ECB), the Deutsche Bundesbank was the most powerful force within the European System of Central Banks due to its size and influence. However, its aggressive pursuit of low to zero inflation slowed growth and increased unemployment throughout Europe. This is one of the main reasons something less extreme like the ECB gained popularity so quickly (Frieden, 1998). However, just straying away from rigidity did not mean economic issues were solved for the European Union nations. While the ECB has clearly stated its mandate to increase growth level while keeping inflation rates down, it is evident that those two actions cannot be carried out simultaneously. Furthermore, the ECB answers to a diverse set of interested parties and must choose policies that are agreeable among the majority. Being conscious of 'monetary hardliners,' the ECB is unable to inflate their way out of a recession as these parties are very conscious of inflation rate fluctuations. The ECB must walk the very fine line of appeasing the countries that are struggling financially while not disrupting the current strength in the Euro. If they do too much, they risk losing stability in the Euro and reducing its strength as a reserve currency but if they don't do anything, they risk economic turmoil and political unrest among struggling nations (Frieden, 1998).

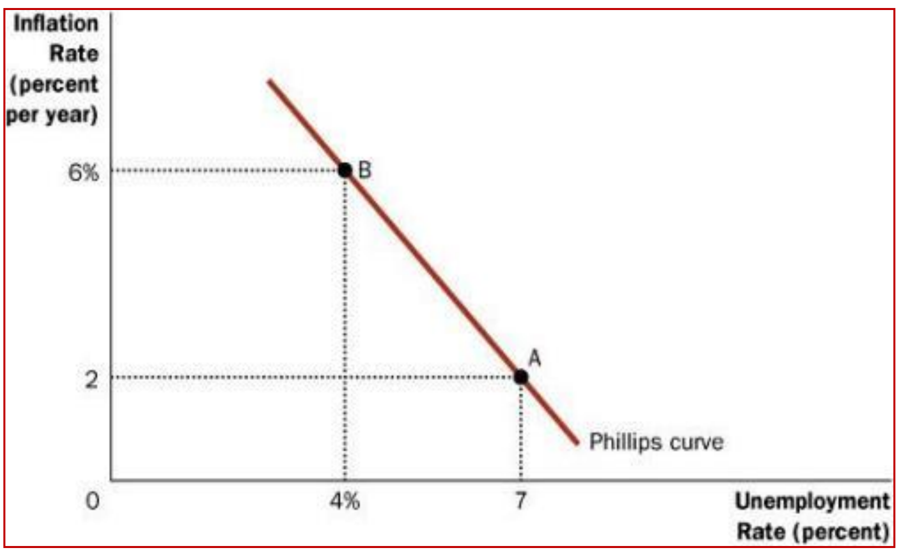
GERMAN SUCCESS FACTORS

Given the foundation of the European Monetary Union and the conditions under which it was created, one can begin to address the factors that led to German success within the system. The location of the European Central Bank in Frankfurt, Germany is an easily identifiable factor that can be addressed as a potential reason for German success within the Euro zone. During the establishment of the European Union and the creation of the Euro, Germany was extremely determined to ensure what would become the European Central Bank would be located in Germany (Reisenbichler, Morgan 2013). With the old Deutsche Mark being the most solid and reliable currency prior to the creation of the Euro and many central banks modeling their central banking systems on the Bundesbank, this stipulation lacked a sufficient counter argument to fail. This stipulation, however, had a direct impact on the success of the German economy during the financial crisis and the failures of the European periphery. Although the European Central Bank is technically an international central bank that currently has a non-German president, it operates as a profoundly German banking institution. Being located in Germany and managed by individuals who have spent a majority of their working life in the banking system has had a dramatic impact on the way the ECB is operated. It has had a profound impact on the role the ECB currently plays within the EU and has dramatically impacted the success of the German economy (European Central Bank, 2013).

Operational Goals

An operational goal is a goal that is definable, measurable, and enactable. Operational goals are particularly useful to bureaucratic institutions that cannot measure their success with an income or profit. Where private firms are able to judge their level of success through profitability and income, public organizations need clearly defined goals in which to measure their success. In the case of the ECB, their goal is stated as: "To maintain price stability in the euro zone, to achieve a low-level of unemployment and to facilitate economic growth with low inflation" (Davis, 2013). Upon first glance, this goal seems to meet the criteria for an operational goal: it is definable, in that it can easily be written down and understood; it is measurable, in that price levels, unemployment, growth and inflation can be tracked; and each portion is enactable, in that the desired outcomes can be targeted using the ECB's control over the monetary system. The ECB's goal breaks down, however, upon closer inspection of the individual elements listed. Taken individually, each element is relatively easy to achieve from a central bank's standpoint. The problem comes in the way the elements are combined. According to the Phillips curve in basic macroeconomic theory, the government can influence the unemployment rate in the short term but only by accepting a higher rate of inflation (Davis, 2013).

Table 4. Standard Phillips Curve (Davis, 2013)

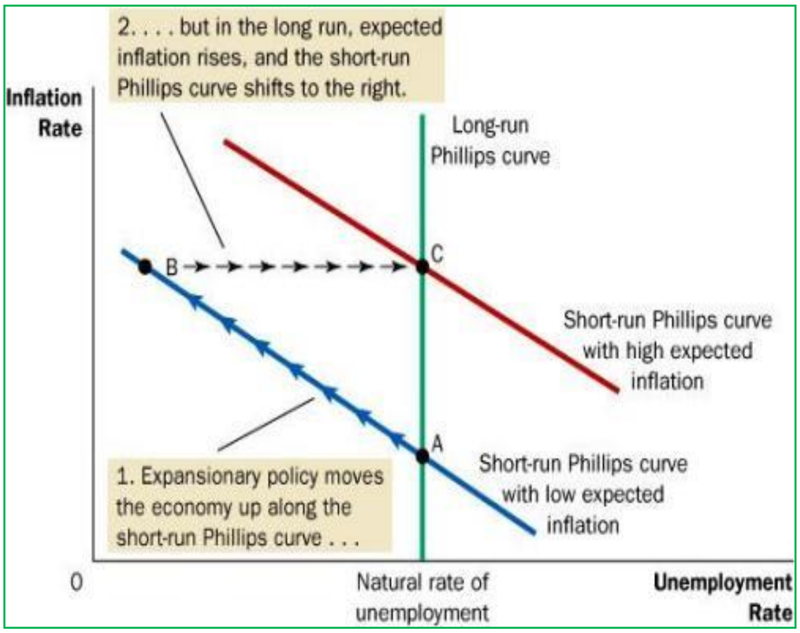


This fact makes the ECB's goal, fundamentally unattainable as it attempts to maintain a low level of unemployment while keeping prices stable and inflation low. This inherent contradiction can lead to large disparity in what the ideal course of action should be, especially in times of crisis.

Economic Differences

With the Spanish youth unemployment rate over 50% (Eurostat, 2013), Spanish people would gladly welcome a higher inflation rate in return for increased economic growth and a reduction in their unemployment rate. Germany on the other hand, whose economy is doing much stronger, would not tolerate a high level of inflation even if it lowered their unemployment rate as over 91% of their youth have jobs (Eurostat, 2013). This is where the location and mindset of the ECB plays a large role in determining the policy that shapes the Euro zone. Mario Draghi, along with the other executive members of the ECB, has chosen to pursue a goal of low inflation and price stability that is in line with historic German principles and traditional German practices. This so happens to be very well-suited to the current German economy that is displaying growth and relatively low unemployment. To a certain extent, this pursuit makes economic sense in the long run as macroeconomic theory further suggests that governments and central banks cannot affect the long run unemployment rate through monetary policy. As can be seen in the chart below, the long run Phillips curve is vertical and resides at a natural rate of unemployment. This natural rate is determined by other economic factors such as minimum wage laws and unions that are outside the control of the monetary policy. This means the use of monetary policy can only affect short term unemployment rates and both short and long term inflation rates. As can be seen in the graph below, the use of expansionary monetary policy can temporarily move an economy up the short run Philips curve, lowering unemployment and increasing inflation. In the long run, this theory suggests that with the new expected inflation, the economy with drift back towards the natural rate of unemployment at the new level of inflation.

Table 5. Long Run Phillips Curve (Davis, 2013)



With this economic theory in mind, the ECB is well justified to pursue a low level of inflation as it is the only economic factor it is able to control in the long run. By pursuing an expansionary monetary policy to spur growth in the periphery countries of Europe, the ECB could theoretically help to lower unemployment rates but at the cost of longer term higher inflation across the EU. As price stability and low inflation are two key objectives underpinning the ECB's existence, coupled with the distinct German influence, one can readily understand their choice to maintain policies to keep inflation low and sacrificing their ability to lower unemployment through growth.

German Employment Policies

While the Euro crisis put countries such as Greece, Italy, Portugal and Spain into turmoil, Germany's unemployment rate has declined from 8.5 percent to 7.1%, and it was becoming the world's leader in exports, exceeding the United States and just falling second behind China (Rattner, 2011). Germany can attribute its success to several key factors including: their rigid fiscal policy; the benefit of the relentless efforts by the ECB to keep inflation rates low on a manufacturing intensive country like Germany; and policies and strategies utilized by corporations and local governments to ensure German companies had the ability to keep their highly skilled employees. As the chancellor of Germany from 1998 to 2005, Gerhard Schroder proposed Agenda 2010 which managed to hold down wages with government subsidies, discourage unemployment, and increase organizations' ability to keep their skilled employees. With a short work scheme, the total number of hours worked were reduced but the scheme prevented layoffs due to the help of government subsidies which covered part of the workers' lost salaries. By May 2009, there were over 1.5 million Germans enrolled in this program, and although it cost the government 4.6 billion Euros that year alone, it saved over 500,000 jobs for Germans while citizens of other countries lost their jobs during this economic recession (Rattner, 2011).

The second contributing factor to Germany's success is the number of small- and medium-sized manufacturing firms that produce highly specialized goods, which are known as the *Mittelstand*. As these companies were privately owned by families, the focus is shifted more towards long-term growth rather than short-term profits, bringing stability to these firms and reducing the overall risk they were taking. Moreover, these medium-sized firms put a large emphasis on employing Germans, rather than giving away business to multinational giants overseas (Rattner, 2011). With the rise of these *Mittelstand*, German workers did not have to worry about their job security. In February 2011, Germany's exports were 21% higher than the year before. While other countries' cost of each unit of labour remained the same, Germany increased their competitiveness by 20% by increasing efficiency. It is important to keep in mind, however, that the success of the peripheral Euro countries are crucial to Germany's future success, as about 80% of Germany's trade surplus comes from its trade with the rest of the Euro area (Rattner, 2011). The combination of determined political leadership and the appropriate exploitation of Germany' comparative advantage allowed it to rise with outstanding performance amidst the Euro crisis. While Germany is currently stable and in a good financial health, it is beginning to change its focus towards encouraging new industries such as the alternative energy sector to grow. Recently, Germany has received 41 billion dollars in new investment for the green energy industry, whereas the United States has only received 31 billion dollars (Rattner, 2011).

Prior to the Euro crisis, with the help of government regulations, firms were able to develop policies and guidelines that accommodated fluctuations in working hours and pay according to economic conditions (Reisenbichler and Morgan, 2013). Ultimately these regulations and policies protected German skilled workers from losing their jobs and saved the firms large amounts of money and time on training new employees. The restraint on hours and wages for employees have become an "equivalent to currency devaluation," allowing Germany to continue to raise its gross exports and allowing the German economy to be more competitive in comparison to others of the Euro zone (Reisenbichler and Morgan, 2013).

German Household Strength

Just as German corporations maintain their productivity and profitability through efficiency, German households place a large emphasis on future planning and efficiency in the home. Germans prefer to live within their means rather than using debt to finance large purchases. Even with the historically low interest rates, when Germans purchase a car, 35% of them do so entirely in cash compared with 1% of Americans (KPMG, 2012). Many German households would even rather rent a house or apartment on a long-term basis rather than use bank debt to mortgage a house. This factor can be readily seen in the German economy by a small percentage of companies that accept credit card as a payment method. This is simply due to the fact that a large number of Germans simply don't believe in credit as a way to finance consumption. This is entirely foreign to a North American citizen where credit card transactions are a daily occurrence for both small and large scale purchases. Credit cards are a way of life to citizens in many debt-ridden countries as our different mindset views debt as a way to achieve our goals.

WHAT IS NEXT FOR THE EURO

The European Union is in a difficult situation and must face some challenging questions if they hope to survive in the long term. Being solely a monetary union was never meant as the final resting place for the EU, yet very little has been accomplished in moving closer to forming a fiscal or political union since its inception in 1993 as part of the Maastricht Treaty. As discussed in the opening section of this paper, a monetary union without fiscal or political integration cannot function indefinitely. There is a strong underlying need for increased fiscal and political integration among member nations that comes at high cost, each country's individual sovereignty.
With a difficult problem and no clear solution ahead, the European Union and its member nations are at a standstill. When the issues facing the EU are examined, three potential solutions must be considered. Firstly, the EU could remain in its current stagnant position with the notion of bringing in a tighter, unified fiscal policy on the forefront, but no significant change occurring. The second option is to abolish the Euro as a single currency for EU nations and allow each nation to regain control of their monetary policy. This would involve a high level of risk and uncertainty as there are no established regulations for the disbandment of the Euro on a small or large scale. The third and most beneficial option is for the member nations of the EU to come together and establish a fiscal union with a single finance minister, while working to creating a stronger sense of unity among nations.

As stated by Angela Merkel, Germany is facing a difficult predicament as they decide on whether they should keep supporting the peripheral EU countries through the use of bailout money, or to discontinue absorbing their liabilities until there is stronger political union in place (Charlemagne, 2012). Similarly, France is reluctant to relinquish any of its sovereignty until there is a more rigid unity between the EU nations where fiscal reforms can be enacted where necessary. For both of these economically strong countries, it is easy to understand why losing sovereignty would be a difficult notion to accept. Instead of being in economic turmoil like the southern periphery, Germany and France are financing these governments' sovereign debt obligations in order to maintain the strength of the Euro and ensure the continuation of monetary union.

Do Nothing – Status Quo

The EU has effectively maintained the status quo since its inception, without any major progress towards the formation of a fiscal or political union. The EU has essentially taken the easy way out by not enacting any major changes to the structure of the system and has simply maintained the status quo. This is obviously the easiest path for the EU to pursue as nothing needs to happen and things can simply stay the way they currently are. No major reforms need to be agreed upon and tough decisions need not be made. While the EU has been talking about their attempt to implement reforms and change the way the system has been operating, they have essentially been maintaining the status quo as nothing concrete has been accomplished. If countries with a strong economic foundation keep prospering, however, inflation will eventually begin to surface and interest rates will have to be adjusted upward. Without drastic changes to the current economic systems in the southern periphery, rising interest rates would demolish any chance these countries have of rebuilding their economies and cause further tension within the EU.

Disbandment of the Euro Currency

The possibility of a partial or full disbandment of the Euro as a unified currency among EU nations is a scary concept. There would be enormous difficulties if any country were to attempt to leave the Euro zone and re-establish a currency of their own. It would have drastic repercussions on the individual country and the remaining Euro zone nations. Because there were no provisions or guidelines established for how a country would leave the Euro, there is a lot of uncertainty as to the effect it would have on the EU. It would be a huge undertaking to re-establish a currency and each step would have to be carefully planned to minimize any adverse effects. Problems arise when discussing the implementation of a new currency in a former Euro zone country as exchange rates would have to be arbitrarily established and a significant depreciation of the new currency would be expected upon implementation. This would create a large scale 'run on the bank' in the affected country as all their citizens would attempt to hold their Euro bank deposits in paper form until the new currency is fully established and relatively stable. This would cause excessive strain on both domestic and foreign banks as the demand for physical Euros would increase dramatically causing shortages across the EU. The economic turmoil caused by a single nation abolishing the Euro as their currency could also lead other struggling EU nations to follow suit causing even more economic uncertainty. Ultimately, any form of dissolution of the Euro as the single European currency would cause a lot of economic strain on all the European economies and all the benefits initially sought in the formation of the Euro would be lost. Governments and corporations would face increased transaction costs during international trade, ultimately lowering European growth and reducing economic stability. Finally, as the second largest reserve currency in the world, the disbandment of the Euro would bring about a worldwide shift in currency holdings and would significantly affect governmental interest rates in Europe and abroad. In both the long and short term, the disbandment of the Euro would have dramatically negative effects on Germany, Europe and the entire world.

Further Fiscal Integration

In coordination with the Presidents of the Commissions, ECB, and Eurogroup, a report was drafted by the President of the European Council Herman Van Rompuy (2012) to establish ‘building blocks’ for further euro zone integration. The report focused on developing a high level plan to outline stages of integrating fiscal policies among member nations. This report is a good starting point of action needed to spark fiscal integration among EU countries, but concrete measures must be enacted for any of the plans to be successful. This proves to be much more challenging than simply having political leaders come together and superficially agree on changes outlined in a report. The process of enacting change will not be easy. However, difficult as it may be, one thing is for sure – “monetary union by itself cannot work indefinitely” (Bagnall, 2012). To make the EU sustainable in the long term, they must complete the necessary steps to become an Optimal Currency Area or risk continued financial instability and economic disparity for the foreseeable future. More rigid fiscal integration is needed to progress towards becoming an OCA at the expense of the loss of fiscal sovereignty for the individual EU nations. Simply continuing to provide bailout money and demanding reforms in the European periphery cannot be a long term solution. Real, visible steps must be taken towards fiscal integration to ensure the longevity of the European Union and the Euro as its currency. Financial integration among the European Union, if done correctly, could establish Europe as the largest economic power in the world with a sturdy foundation and strong growth prospects. However, without steps towards real fiscal union and continued financial integration, the Euro is destined to fail, bringing about significantly negative impacts on the European nations involved and Europe as a whole. With no easy way out, the European Union must proactively take action to move towards their original goal of fiscal and political unification.

CONCLUSION

With the European Union at a standstill and Europe’s economies drifting further apart, further fiscal integration is the natural course of action. Despite the relative economic success of Germany and the other larger economies of the EU, something substantial must begin to happen in the near future or the EU will face considerable economic issues. Further fiscal integration must begin to be established immediately for it to be effective in preventing another European crisis in the near future. Only a fully unified European Union will have the ability to rise above the current economic turmoil and maintain its strength and stability. The EU must ultimately take action to progress towards its designed resting place, as a fiscal and political union.

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