A global lesson from Europe

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"The Euro area is in crisis" is not the most thrilling way to open an article. The Euro area is seemingly *always* in crisis. The Euro area crisis resembles an opera by Wagner – very, very long, with lots of wailing and melodrama, generally conducted in German. The perpetual round of emergency summits and last minute deals is something investors have had to get used to.

The current manifestation of the Euro crisis, with tensions between Greece and the creditor nations of the Euro area, is a symptom of a deeper underlying problem in the Euro. The mess that the Euro area is starts with the structural flaws of the monetary union. However these flaws have been exaggerated by the severity of the *German* crisis today – and the German crisis dwarfs the wrangling over Greek debt terms.

The German crisis is simple. Germans have been forced to accept far too low a standard of living for far too long. Indeed, the German standard of living has fallen further and further behind its potential for a number of years now. The fact that the entire German economy is living in relative poverty (relative to the standard of living that Germans could enjoy) has compounded the wider problems of the Euro area.

This relative poverty is highly visible. The German current account surplus has risen with the rest of the world and with the rest of the Euro area. In 2001 the German current account was in balance. In 2013 the surplus was 7.5% of GDP. In 2013 the German economy had a standard of living that was 7.5% below that which it could sustainably achieve. Germans are being kept in a state of relative poverty (7.5% is a big number – Germans are essentially failing to enjoy a four weeks income every year).

Popular opinion tends to be uncomfortable with current account surpluses as a cause of crisis. Popular economic perceptions support a sort of macho mercantilism – a desire to gather as much gold as possible into a big heap and sit on top of it. The problem with sitting atop a big heap of gold is that it is rather uncomfortable and it does nothing to enhance living standards.

A current account surplus means a country is spending less than it earns – and therefore has a lower standard of living than its income would permit. There can be reasons why a *moderate* current account surplus may be desirable. If a country has an ageing population, then the need to live off investment returns in the future may suggest a desire to save today. Alternatively, if debt has been acquired in the past (through current account deficits) it may be desirable to repay some of that debt through current account surpluses. But the basic fact remains; running a current a surplus is a process of self-denial.

The desire to acquire a current account surplus is an anachronism of history – a legacy of the gold standard and the Bretton Woods currency systems. Both of these systems had correction mechanisms for current account imbalances. The problem was that although current account surplus nations were supposed to correct their imbalances, the *urgency* to correct lay with deficit nations. Surplus nations could continue to acquire surpluses without too much trouble, other than depressing domestic living standards. Deficit nations would soon run out of the gold or US dollars with which to acquire foreign goods. That meant deficits were associated with crises and a forced adjustment ("bad"). Thus, to run a current account surplus was seen as "good".

The German crisis is lowering the German standard of living *and* lowering the European standard of living. The Germans are denying themselves the lifestyle that they can afford. At the same time the Germans are forcing other countries in the Euro area to correct deficits. Some deficit correction may be desirable, but the scale of the German current account position is forcing large scale corrections elsewhere in the Euro area. The corrections are larger than is desirable, and gives the Euro area a negative growth bias that has generated political as well as economic consequences.

There is a lesson for the rest of the world in all of this – perhaps for Asia more than most. Low standards of living are not a good thing. An excessive current account deficit is a bad thing – it implies a dangerous dependence on credit. An excessive current account surplus is worse. An excessive current account surplus implies a deliberate lowering of domestic living standards while simultaneously creating deficit crises elsewhere in the world. A current account surplus should be seen for the dangerous signal of imbalance that it is. It is necessary that politicians understand the true nature of the German crisis if Europe's interminable Wagnerian drama is ever to come to an end.

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