Transcript

Germany and the Euro: The Revenge of Helmut Schmidt

C. Fred Bergsten, Peterson Institute for International Economics
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Introduction by Andreas R. Dombret, Member of the Executive Board, Deutsche Bundesbank

Edited Transcript

Andreas R. Dombret: I’m more than pleased to have been asked to introduce Fred Bergsten as today’s speaker, and I would like to say a little bit about him, and also a little bit about the Euro crisis.

Now Fred is--and it’s probably one of his most important jobs--is a member of the president’s advisory committee on trade policy and negotiations. He is a senior fellow and director emeritus of the Peterson Institute and many of you will remember Adam Posen, who spoke here not too long ago, where he served at the Peterson Institute for more than 30 years. And today he is also a member of the advisory committee of the Export Import Bank, and Fred is cochairman of their private sector advisory group of the United States India Trade Policy Forum.

Now, all of these positions have brought Fred for the circle, as he started his career in government service. By the way, as I just learned, Fred wrote 43 books on international economics and he is going to read them all to us tonight.

Now while he was in government service, his previous government posts include: Assistant Secretary for International Affairs of the US treasury, from 1977 to 81. (You have to correct me if I say silly things.) He was Undersecretary for Monetary Affairs from 1980 to 1981, and at the very beginning of his career, if I may add, he was Assistant for International Economic Affairs to Henry Kissinger which makes him a bipartisan, independent member of government because he worked both for Republican and Democrat governments.

It was actually Henry Kissinger who said, and I quote him, "If you don’t know where you’re going, every road will get you nowhere." And this is particularly true in times of crisis, and it kind of leads me to the topic of this evening’s lecture.

In March of 2010 the Euro crisis is considered to have broken out, and the
starting shot for the sovereign debt crisis here in the Euro area was fired when the Euro countries agreed to finally support stumbling Greece, as you will all remember. Today, more than four years later, we finally see a silver lining on the horizon.

The reforms that were undertaken have begun to bear fruit, and economic growth in the Euro area has picked up again, and we are no longer in recession, but we are growing in the Euro area. However, we are not out of the woods as of yet, there are still quite a number of risks to recovery. And I would like to name a couple of those risks I see. One of the major risks I think is complacency and reform fatigue. This is the real threat; because there are still quite a number of structural problems that remain unresolved not only at the national level, at the countries of the Euro area themselves, but also at the European level.

Let me cite something Fred wrote in 2012, which I think is very relevant for tonight’s lecture. And I quote him, "At its core the Euro area crisis is about national sovereignty and the process in which European governments can agree to transfer it to new required Euro area institutions, government banking sectors and fiscal policies."

In my view, this captures the central issue rather well. There are institutional imbalances in the setup of the Euro area. Now, having said that, the banking union is probably the biggest and most important step since the introduction of the euro as a single currency. And it’s the most logical step at the same time. A single currency requires integrated financial markets, and this of course includes an integrated harmonized supervision, and also potentially resolution of banks.

The upcoming European banking supervision regime, and the European resolution mechanism for banks would certainly help, we think, to re-balance the institutional setup of the Euro area. Nevertheless, another institutional imbalance remains, and is kind of active. Now while monetary policy is decided by the governing Council of the ECB in Frankfurt, and actually, the governing Council took a decision today, so monetary policy is conducted in Frankfurt, fiscal policies [inaudible 0:05:02] for national policy makers, each country, as you are well aware, decides itself on its own government revenues and expenditures.

Now, given such an imbalance of responsibilities, the individual countries actually do have incentives to borrow. And what we, as economists, call a deficit bias emerges. Now one option to realign this imbalance would be to transfer control over national budgets to the European level, thereby creating a fiscal union. I think this is what Fred meant by national sovereignty.
This option would require member states to transfer this national sovereignty to the European level. But such a change would be rather a radical change, and I think it would need a raft of amendments to national and European legislation, and more than anything, such a change would need the support, not only of the parliaments and of the policymakers, but also of the general public.

And on this point, I urge you all to be realistic. I don’t see anywhere, whether in Germany or in any other country in Europe, the will to give up national sovereignty right now. Again, neither in Germany nor in any other country of the Euro area, which means that it leaves us with the second option, leaving control over fiscal policies at the national level in the countries themselves, while at the same time, strengthening the rules on borrowing, as it was sent out in the Maastricht Treaty.

Actually for now this is the course that has been chosen, and the course we are walking. The rules of the stability and growth pact have been tightened. Now they have to be applied, and they also have to be complied with.

To sum up, the situation in the Euro area has certainly improved. As I would argue, but risks remain, and kind of a number of structural problems still need to be resolved. Against this backdrop, possible ways in which Germany, our country, could address these issues are being discussed frequently; I am therefore really eager to hear what Fred has to say on Germany and the Euro, the revenge of Helmut Schmidt, because it’s quite important to hear from the outside, how we as Germany, can contribute.

But let me make a final remark, USA Today once listed Fred as one of the 10 people who can change your life; USA Today. This certainly raises the bar for this lecture and for you. And I’m certain that Fred will rise to this occasion, thank you very much for your attention and Fred the floor is yours, thank you.

C. Fred Bergsten: Well Andreas, thank you very much for that very kind introduction, and also for some things you did not say. It is true; the USA Today once said I was one of the 10 people that could change your life, along with the guy who invented the Internet, not Al Gore, the guy who identified the ozone layer, and a few others. But the full quote one as follows: "These are the 10 people who could change your life that you never heard of." And I suspect that the second part is more accurate.

Andreas also mentioned that I once was economic deputy to Henry Kissinger. Once when I was introduced as having had that honor, my introducer said, "and that is like being military adviser to the Pope."
I made that comment on a program with Kissinger a couple of years ago, and he said, “Das ist korrekt,” he said, "And Fred went on to have a distinguished career in the Carter administration, something quite difficult to have achieved." So as usual Henry gets the last word.

I deeply appreciate this invitation tonight to speak here at the Academy, especially as the Kurt Viermetz distinguished fellow, I’ll be spending a couple of weeks here with my wife, Jenny, and Kurt to you into the Academy as a whole I want to say my deep appreciation.

Berlin is my favorite city in the world, I’ve been here 40–50 times in my life I suppose, and I actually had the great good fortune to attend the conference, I spoke to it, back in 1994, at which the Academy was launched, with Henry Kissinger, and particularly my close friend Richard Holbrooke. Jenny and I stayed with Dick Holbrooke at his residence in Bonn while he was ambassador.

He was one day younger than I am. We were colleagues on the softball field, as well as in the field of diplomacy. I know you had a memorial service for him here; I had the great privilege to attend the memorial service for him at the Kennedy Center in Washington, which was one of the most remarkable events that my wife and I ever attended. It was addressed by at least two presidents. Now I say at least two presidents, because it was addressed by Bill Clinton, and Barack Obama, but it was also addressed by Hillary Clinton. So, may be… That’s if you put the odds at 50-50, 2-1/2 presidents speaking for Holbrooke, which even by Holbrooke’s standards was pretty impressive.

I also want to say how deeply honored I am by the presence here of Chancellor Schmidt. I had the enormous privilege to both work with him, and sometimes to spar with him a little bit, over the years. As I think back over my career of many years in this business, I had the great great privilege to work with four people that I think are among the greatest statesman of the second half of the 20th century: my boss Kissinger in the White House; Paul Volcker, who licked inflation and the third world debt crisis; Lee Kuan Yew, with whom I had the opportunity to work out some of the economic architecture of the Asia-Pacific region; and Chancellor Schmidt, who, among many other things was, of course, the father or one of the fathers of the Euro, one of the architects of the evolution of the European Union. And who I can testify—from the hour-and-a-half that we spent together today—is in phenomenal shape at age 95, and truly one of the great statesmen of our time. And I would like to invite the audience to…

I suspect the Chancellor will not agree with everything I say tonight, but I
do want to dedicate my remarks to him, and I put his name in the title in a somewhat mischievous way that I will explain a little later.

As most of you probably know, all my friends here certainly know, I was one of the very few prominent American economists who supported the euro. I thought it was a good idea. I thought it would launch on time; there was a great debate about that you may remember. I predicted fearlessly that it would succeed, it would be a strong currency, and indeed over the years would move up alongside the dollar as a major world currency. All of those predictions, except perhaps the last, have occurred already, and I still think the last will occur as well.

Throughout the crisis of the last few years, I and a very few colleagues, very few, unswervingly predicted that the Euro would successfully resolve its crisis, defining that as no breakup of the Euro zone, no exits from the zone, no disorderly defaults. That is admittedly a low bar, but even though I did not--and I did not foresee a rapid return to growth, or rapid completion of the economic Union. But the crisis was existential, there were of course apocalyptic forecasts prevalent. I would say a majority, at least in the United States, predicted that the euro would fall, so I feel justified in declaring at least partial and modest victory.

But the point for tonight is just to remember all of you that this record should qualify me as one of the strongest and most consistent supporters of the euro. In short, I am with you here in Europe and in Germany in this fantastically important project. But the interesting question for tonight, the first important question is why did the euro survive the crisis? Why were so many analysts wrong? The reason, I think, is simple. Most analysts, at least in the United States and Britain, were using the wrong analytical model.

Virtually all economists have relied on what we called the theory of optimal currency areas, saying that a monetary union could only work if countries met certain tests. Like having free mobility of labor, which Europe has to a large extent, but also having a regular fiscal transfer mechanism, which as Andreas mentioned, Europe does not yet have and certainly did not have at the outset of the crisis. Now, Chancellor Schmidt and the other founding fathers knew they were creating a monetary union that did not have all of the theoretical constructs. They thought that the creation of the monetary union would lead inexorably to further steps necessary to complete the economic Union. But times were good in the early 2000s, there was no pressure from the markets to proceed, and so, when the crisis broke, the house was only half-full. So, when the crisis hit, most of the experts, seeing the absence of the criteria for an optimum currency area, felt confident that the euro would collapse.
By contrast, I and my few friends used a political economy model. We knew that the overriding postwar goal of all the major countries in Europe was to integrate the continent, avoid the repetition of past disasters, via the integration project, and that the euro had now become both the main substance and the main symbol of that project. And therefore it would not fail.

This overriding geopolitical determination was of course particularly prevalent here in Germany. As the main source of historical disturbances, which would never, never let itself be blamed for again destroying Europe. And according to the recent accounts of decision-making during the crisis, that appeared recently in the Financial Times, Chancellor Merkel apparently thought of it in exactly those terms, and went on to say that the failure of the euro would mean the failure of Europe.

Now there was a critical corollary of this logic, which was unpopular when I said it during the crisis, maybe it’s still unpopular here in Germany. The corollary I drew was that Germany would pay whatever was necessary, repeat, whatever was necessary to preserve the euro. And that the European Central Bank would do so as well with the support and approval of this country. I don’t want to tell tales out of school, but when I met today with Minister Schäuble, he did not deny that that was a correct interpretation of the evolution of policy during this period. And my conclusion, to repeat, was that there was zero chance of failure of the euro and the Euro zone defined in the way as I did.

Now of course, for the first couple of years of the crisis, neither the German government nor the ECB was willing to say that they would pay whatever was necessary. And that left the markets somewhat uncertain. In my view the Germans and the ECB were correct to do that, because it kept the pressure on the deficit countries to adjust, a little less admirably, the Germans were trying to share out the burden of financing with others like other surplus countries, and the ECB and even the IMF and the rest of the world, but they kept the pressure on. I always said: Watch what they do not what they say. And what they did, at every critical stage of the crisis, was to pay whatever was necessary to get over that hurdle and avoid the risk of failure.

Now two years ago, of course, Mario Draghi changed all that for the European Central Bank, when he then said, "We will do whatever is necessary." And in my view that ushered in phase 2 of the crisis. Phase 1 was the initial couple of years or so, where they were doing the right thing, but not saying it. Phase 2, now they’re saying it, and so the markets are settled, and most people agree the crisis phase has ended. What I will suggest tonight is that it is time for a phase 3 of the responding to the crisis. Where the focus is no longer on financing the adjustments, but on
achieving the adjustment in real economic terms to bring down the imbalances and the difficulties, and thereby to get restored growth in this continent which at the moment the great lacking variable.

Now before I suggest with the phase 3 could look like, I want to emphasize that, in my view at least, Germany has a second overwhelming reason for its unlimited support of the euro, including via the European Central Bank. That is of course this country’s overwhelming economic interest in the euro. Some analysts like my successor Adam Posen at our Peterson Institute, who said he would be watching this by live stream, hello Adam if you’re there. He likes to put it in terms of the heavy exposure of the German banks to the countries in the periphery. Adam argues that bailouts of those countries are really the bailouts of German banks. So that Germany maintains its own financial stability, by providing support, even unlimited support, to the debtor countries. I prefer to focus on the real side of the economies, not the financial side. And that leads to my subtitle: “The Revenge of Helmut Schmidt.”

Germany is of course the number one exporting and surplus country in the world. More than China, more than United States, Germany is the export world master. It has relied on export-led growth throughout the postwar period, going back to the time when we worked together. Exports have been the only constant source of growth in the German economy over the last 10 years. In seven of those last 10, domestic demand actually rose less than the economy as a whole.

Imports dropped last year, 2013. I sometimes chide my German friends that they seem to like external demand, but are not so keen to promote domestic demand. And the external surplus has stabilized at over 6% a year for the last three years. It actually rose to 8% at the end of last year, almost as high as the Chinese surplus ever got. And the German surplus is almost $100 billion more in dollar terms than the Chinese surplus, despite being a smaller economy. In Germany will soon again be the world’s number one creditor country, like it was before reunification. But it’s headed back to that position again, as a result of all these surpluses.

So the German economy, with this very heavy dependence on trade and exports in particular, is very sensitive to exchange rate issues, and the level of the exchange rate that governs its price competitiveness in the world economy. And that leads me to Chancellor Schmidt, because back in the day, when he was running this country so well, he and other German leaders would routinely express dismay at the typical cycle of the German economy.

What would happen is that Germany would get into an export boom, which would lead the overall economy to a stronger position. But then, the
exchange rate of the deutsche mark would shoot up, and that would undermine to some extent the competitiveness of the economy. Growth would slip back. Job creation was not as rapid or might even decline. And so, there was some unhappiness about the way it worked.

Chancellor Schmidt would then complain, sometimes loudly, about the weakness of the dollar. Now to be sure, there were some occasions all in which there was generalized weakness of the dollar. And I will not pretend that the United States had any monopoly on good policies or international competitiveness. But sometimes it was a generalized strengthening of the deutsche mark against virtually all currencies, including others in Europe. And there were at least four Schmidt cycles, as I will call them, of that type in the mid-70s, the late 70s, the mid-to-late 80s, the mid-to-late 90s. Strong exports, booming economy, rise of the deutsche mark and some adjustment.

This time, there has been no adjustment. The German surplus has risen to an all-time record levels; it has stayed there now for a period of time that is unprecedented. The European Commission, which is not usually too critical of Germany, its paymaster has said this is structural, it’s likely to continue. The IMF predicts that is going to continue into the indefinite future. And so there is a question of what has happened and what has changed.

Now of course this time, there is no deutsche mark to go up to achieve the adjustment of the German surplus. And the euro is a very different animal than the deutsche mark ever was. And so, what I’m suggesting is that the advent of the euro is the revenge of Helmut Schmidt. Because the German exchange rate now reflects the economies of the weak European countries as well as Germany itself, and the other strong countries. And so Germany, in purely economic terms has the best of both worlds.

It runs the world’s biggest trade surplus, and it does not suffer from a significant rise in the value of its currency. You can have views as to whether the euro itself is overvalued or undervalued, but it surely has not gone up like the deutsche mark or the neue deutsche mark had the Euro zone broken up. Would do so.

From a pure economic standpoint, we can analyze that the deutsche mark, if it still existed, would’ve gone up at least 20%, and probably more. And analysis that were done at the height of the crisis, suggested that had the Euro zone broken up, a neue deutsche mark would go up at least 40% and probably more. And so that is the difference that the euro makes for German competitiveness, German trade surplus, the strength of the German economy and its durability, as opposed to the adjustment cycle that I mentioned in the past.
I don’t know if Chancellor Schmidt had this in mind, when he and Giscard and a few others, led the way to the creation of the euro, but I think that all German elites—many people in this room—in the government, in the private sector, in the labor unions, all understand this phenomenon. And so, I would argue, there is a second reason, in addition to the traditional geopolitical and historical basis for European integration. There is a second reason why there is no chance, no chance that Germany would ever let the euro fail and revert to national currencies.

So, this reinforces my conclusion that Germany will pay whatever is necessary to hold the euro together, and to keep these advantages that it has achieved. But, as usual, when things sound too good to be true, they may be too good to be true.

In this case, the risk is of political push back from elsewhere in Europe to the perception, which I fear is growing, but I’ll be fascinated by comments tonight from all of you. My perception is that quote “the euro works only for Germany.” Because Germany is an island of stability, growth, high employment, dynamic advance, while truth be told, virtually all of the rest of Europe languishes in high unemployment, slow growth, and unsatisfactory economic conditions.

Maybe this was a key factor, at least an important factor, in the recent elections for the European Parliament, where anti-euro sentiment begins to arise. I don’t suggest that anything dramatic is going to happen overnight. The center has held politically, in all of the debtor countries through the crisis, amazingly so, although that was one of my predictions. But the potential risk, I think, of a continuation of this situation where Germany is so isolated in its success, and through a mechanism, these trade surpluses that we can clearly see, is very risky for Europe as a whole, particularly for Germany itself. As Andreas said, “one cannot be complacent.”

Now this anxiety about Europe working only for Germany, I think, takes three or four different forms. One is the view that Germany itself is not generating adequate demand to support growth in the Euro zone as a whole. A second is the asymmetry in European decision-making between the surplus and deficit countries. If you run a deficit beyond 3%, you get penalized. You have to run a surplus above 6%, twice as much to even to get monitored, and then not much happens, that’s a big asymmetry. Third, there’s a lack of structural reform in the surplus countries, even to rebalance in the direction of more domestic demand growth, whereas the deficit countries are hammered every day to do structural reform.

And fourth, fiscal policy comes under increasingly rigorous disciplines, whereas monetary policy, at the European Central Bank, has at least not
until now, maybe today changes it a bit. European Central Bank has not come under discipline for failing to meet its cardinal target of keeping the inflation rate at around 2%. It’s been a lot lower than that. So these asymmetries and differences, I think, fuel this concern.

In purely economic terms, I think one has to acknowledge that Germany is the source of much of the Euro crisis. I realize that’s an unpopular thing to say here in Germany. I’m trying to step back as an economist and analyze what are the sources of the underlying problem.

First and foremost are the famous unit labor cost differences which Jean-Claude Trichet and many others have broadcast over Europe all through the crisis. I don’t have a PowerPoint or a screen here tonight, but when you look at those charts, they’re dramatic. Unit labor costs in Germany have been unchanged for the 12 year life of the euro. Unit labor costs in most of the other countries have gone up about 10%. There are couple outliers that are higher: Greece, maybe Portugal. But in economic terms, what that says, of course, is that there is one outlier. That’s not the deficit countries, it’s Germany.

So German success has been at the root of the problem. Again, unpopular to say in Germany, where virtue is a great virtue, but that is in fact the economic case. When you look at data provided by the ECB itself, it clearly suggests that the real exchange rate of Germany, not the euro but of Germany within the Euro zone, declined by almost 20% from the start of the euro until now. A decline of 20% strengthening the competitive position of Germany against its main partners. And that of course was due largely to very low wage increases. Indeed, German real wages have been flat, zero change throughout the life of the euro. Actually declined last year, in 2013, and all this has led to very low inflation throughout Germany, and therefore, strengthening German competitiveness in this dramatic way. What this implies, of course, is that Germany has experienced a huge internal devaluation of a real exchange rate over this extended period of time.

Now this internal devaluation of the euro period is usually justified by an alleged need to reverse the internal upward revaluation of the mark prior to the creation of the euro. But in fact, recent studies, again using official data, show that the DM was already weaker in 1998, at the eve of the euro, than it was in 1980, fully 20 years before. And the result is a huge under valuation of the real exchange rate of Germany in the European euro world economy.

In short, Germany dramatically overdid its reaction to fears that it would lose competitiveness, lose economic strength, in the wake of reunification in the early 1990s, and the result was as I suggest. But of course, Germany
does not have its own exchange rate. So, it cannot be directly criticized by the G7 or the G20, the IMF. United States Treasury tries sometimes, but in fact, it’s pretty hard to criticize the exchange rate of country that does not have an exchange rate.

And so, that is the dilemma that others face. It should be an issue for the Euro zone itself, but, as I said before, Germany is the paymaster; it’s a little hard to criticize your creditor. Hillary Clinton always used to say it’s hard for US to criticize China too much. They are our banker, they finance us, and somewhat the same within Europe. As a result, when Europe set up these new rules for monitoring imbalances, it required a 6% ceiling for surpluses to even come under surveillance, but Germany is now surpassed that for three years running, looks like continuing. And so even that generous limit has been met.

So I regard this as completing the revenge of Helmut Schmidt. Not only does Germany have the best of all worlds, in economic terms, but it can’t be criticized, because it is protected by being part of the Euro zone. And so, there is no way to get at it the way people had at least tried to get at China and the other large surplus countries.

Now all that leads then to the final and most important question: Is this situation desirable or even viable, for Europe, for the world economy, and for Germany itself? That seems to me the crucial policy question that all of you in Germany need to be facing right now. It is certainly true technically, that Germany could run huge surpluses forever, and keep financing the rest of the Euro zone forever, as it has for the last few years. But that of course would mean that the other countries would have to do all the adjusting, because they would from time to time, inevitably come under financial pressure and internal political pressure as well.

If all of the adjustment comes via the deficit countries, that means reduced growth there, and that means continued very low, possibly zero growth for the Euro zone as a whole. Continued low German inflation means that the other countries have to deflate, because how else can they improve their price competitiveness? And it adds further, to the likely outcome of very low or zero growth for most of the member countries, and indeed for the zone as a whole.

And so, on the view that maybe the Euro zone does work only for Germany, such approaches would be exacerbating and, I’m afraid, underlining that risk. And all this could then threaten the sustainability of the euro over time, which would be hugely ironic if having come through the crisis, a failure to deal with the underlying problem would then lead to a failure over time. It’s almost inevitable there will be push-back from others, both political and economic, particularly as historical memories of
the geopolitical basis for Europe in the Euro zone fade, and economic issues become more dominant and perhaps more deeply entrenched.

Incidentally, all this would also dampen global economic growth. Europe is the largest single entity in the world economy, the EU as a whole, 500 million people, bigger than the US, bigger than China. And so, a continued stagnation or worse yet, zero growth in Europe will dampen the world economy, and that makes it a legitimate issue for the G7, the G20, and the IMF.

The external position of the Euro zone, as a whole, has already moved from minus its current account, (-)1% of GDP prior to the crisis to 3% surplus now. That’s a 4% swing in the biggest economic entity in the world, which is already a big drag on the rest of the world economy. And if that continues, as the IMF predicts it will, then the global implications are also poor.

The bottom line of all this, I think, is twofold: first, Germany has done a fantastic, terrific job in steering the Euro zone through the crisis to date. It would pay whatever was necessary, directly indirectly, through the ECB. And it did save Europe from another crisis. And for that Europe owes Germany and incalculable debt, as do all of us around the world.

But secondly, Germany now faces the same choice that any surplus country faces. It can either finance its borrowers and keep the imbalances going as long as they’ll keep going, or it can promote more active adjustment of the imbalances to try to reduce the underlying source of the problem, respond to the political push-back, respond to the concerns that all of this is really, primarily for the benefit of Germany.

And so I would urge my friends in Germany at closing, to undertake a major new effort to adjust and reduce their own imbalance, particularly in favor of their partners within Europe, but the world more broadly. I think the monetary easing steps that were announced today by the European Central Bank will help. It should provide at least a bit of a spur for faster domestic demand growth in Germany.

I think the increase in the minimum wage by the new coalition government should help to some extent. Income tax cuts would help; in particular, increased public investment by the German government would be extremely valuable. Germany now does much less than other major economies of the world, including the others in Europe, in terms of public investment. It could double or more the share of its economy going in that direction, with very favorable economic effects.

It does need to modify the debt brake in the Constitution, to adopt an
investment budget separate from the current spending budget, that almost every other country in the world has, and every one of the states in the United States has, although the US federal government is another outlier which does not have it.

So there are many steps that could be taken, and I think should become the new economic policy strategy of this government to deal with these more fundamental problems. If those steps can be taken, it would help greatly to assure that the Euro zone—in a third phase of response to the crisis, and under continued and indeed reinforced leadership of Germany—will do more than just survive the crisis. But will put Europe back on a viable and sustainable path that would create, over time, and optimum currency area.

If all that can be done, the grand vision of Chancellor Schmidt and his colleagues will be fully realized and provide a permanent legacy to his wisdom and leadership.

Thank you very much.

Claus Tigges: Well, ladies and gentlemen I’ll have the pleasure of moderating the Q&A session, my name is Claus Tigges; I’m the head of Bundesbank’s regional office here in Berlin. We do have a microphone, I would kindly ask that you wait for the microphone, and then briefly state your name and affiliation, so we all know who’s asking the smart questions. So who wants to make a start?

Rudolf Delius: Sir my name’s Rudolph Delius, I am from Bielefeld, I am one of the great benefiter of the euro. We are an industrial company who used to suffer from what you call the Helmut Schmidt cycle, whenever we had entered a market. Italy or France, they devalued and we were out of business again. I follow your thoughts completely, but I wonder looking at the AFD, looking at people who are not AFD voters, but the general public.

I don’t see support for what you are asking us to do for increasing deficit spending, for increasing public spending, for alternatively supporting the southern European countries at a stronger rate. I do think all that is necessary but I don’t see either a public debate in that favor nor the willingness of the German public to follow such ideas. So if my pessimism is right, how will the whole thing end?

C. Fred Bergsten: I suspect you’re right in your political assessment, but political assessments can change, actually quite rapidly, and we’ve seen that in many countries. But it only changes with leadership to promote the change. And again I’m looking at Chancellor Schmidt, who is one of the great leaders that this country and the world has experienced in the last 50 years.
In his leadership experience, it was necessary to educate the German public on some very important issues, and he did it. You have a powerful chancellor in office now, who I think has cautiously, but effectively led the positive response to the crisis that I described. And who I think, using stories like your own as case in point could begin to change opinion.

If I’m right, then the biggest loser from continuing the status quo would be Germany. For the reasons I outlined, the huge economic benefits to Germany, and the historical legacy could all really, really come into great jeopardy, if these more constructive adjustments are not made. And of course it would have to be put that way to the German public, that it was in Germany’s own interest to ease up a little bit on some of its traditional values and virtues, in order that there be a true Europe within which Germany was the leading part, but only a part, and was not just Germany for us Germans, but Germany and Europe for us Europeans; the famous statements from the past.

It would require, I think, an important educational job, but again, if I’m right, all German elites kind of understand the stakes. I would actually think leadership from the top could begin to mobilize the kind of support that would be necessary. In the media, in academic intellectual circles, and then transcribed into political circles to begin to change these policies. I put it in terms of a package, there are half a dozen things you could do; you don’t have to do them all at once.

I think if Germany begins to move in one or two areas that clearly demonstrated that it wanted to help its partners and neighbors adjust, reduce their deficits without forcing them into stagnation and high unemployment, then I think attitudes would begin to change and you have time to do it, you wouldn’t have to do it all at once. And even modest changes might begin to change these attitudes that could otherwise be so poisonous.

So, I would not despair. I give you one example from my long career. In 1986, you may remember, in 1985, there was a famous agreement on currencies called the Plaza Agreement. The dollar got way overvalued, the mark was way undervalued, but everybody agreed to that, so the G5, the G7 of the day, agreed. And so there was a big initiative to move the dollar down and the deutsche mark, yen and the European currencies up. That was working very well, but just at that time there were some major new players in the world economy, what we can call the NICs, the newly industrialized countries. This was Korea, Hong Kong, Taiwan, Singapore and they were not part of this Plaza Agreement. So they kept their currencies pegged to the dollar— I’m going to just intervene to say I know Chancellor Schmidt has leave to catch his train to Hamburg. Let me again
thank you, Mr. Chancellor, for having been with us tonight.

Now I’ll finish my story. These newly industrialized countries were not part of the Plaza Agreement. So they kept their currencies pegged to the dollar. The dollar went down 50%, they went down 50%, and all of a sudden they began running massive surpluses. Well I happen to go to Korea, which was the biggest of them at the time, and I met the senior advisor to the president on economic policy, the blue house as they call it, and I said you know you have to start thinking of yourself as a surplus country, and start adjusting to this new situation.

All the other Koreans in the room were horrified at the thought, you know, here’s Korea, a weak, developing country, low income, export-led growth for a couple three decades, “How can you say we should let our exchange rate go up?” The senior advisor to the president said, “You’re right, I’m going to stake out an hour on prime time television tonight, would you please come with me and explain that to the Korean people?”

Well, it’s pretty hard for me to explain to the Korean people partly because my Korean was not too good, but the point was that he wanted me to help launch that, and then he took the ball, and sure enough, over the next year or two they adjusted, let their exchange rate go up 30 to 40%, and adjusted to their new status as a surplus country. Now that’s a little more, more dramatic in one sense, not as dramatic in other senses. But, it was an example of where public opinion was changed, and a country’s policies changed diametrically, once it realized where its real interests lay in the longer run. So, I would not despair.

Rudolf Delius: Sir, can I ask you to talk shop once more? Are you going to appear on TV tomorrow night with Schäuble?

C. Fred Bergsten: He didn’t go quite so far as to ask me to do that. When I said that he did not, I do not want to be reported out of context, when I said he did not object, neither did he stand up and cheer. So…but I have a lot of faith in him actually. I think he’s been a hero in responding to this crisis. And so I have great faith in the leadership here in this country, it’s farsighted. There are a few historical hangups, but I think wisdom will prevail.

Claus Tigges: There are a couple of questions in the banquet hall.

Michael Boeda first

Michael Boeda: Michael Boeda, Humboldt-Universität, Berlin. You talk about the affairs of Germany; it’s interesting to think about the position here, which is more about the failures of southern Europe to perform their economies. So the view in Germany is that it’s not just demand, it’s also supply. And the
German solved the supply problem in 2003, when they did the Hartz reforms, and fixed the labor markets.

So what’s your view on the failures of southern Europe to get their act together, to get their labor markets moving again, because that’s part of the growth format, it’s not just demand. It’s got to be getting people to work again.

C. Fred Bergsten: I absolutely agree. In a longer version of this I would’ve dwelt on that to some extent. I wanted purposely to focus on Germany, German policy time, but you’re absolutely right, of course. The deficit countries have to do their part. I’ll mention the United States as well, but within Europe, certainly you’re absolutely right.

What I do worry about, is that putting total reliance on the supply response from the deficit countries, means: (A) a very long-term process, because we know that those structure reforms, even the Hartz reform, took quite a long time to play through to economic results, and secondly in the meanwhile--and maybe even at the end of the day, if the demand is still inadequate--you’re going to have very low growth. And then the reform process may even be discredited, because a country goes through all the anxiety and the costs of dealing with its structural rigidities, and it doesn’t get much payoff from it at the end of the day anyway, because the demand side is weak.

So, absolutely right. You have to do both, but there’s been a lot of stress on the need for the debtor countries to adjust and reform, including structurally, as I said, that’s exactly right. I think there’s been less stress on the need for the surplus side to bring down its surpluses and boost demand. That of course is nothing new, that’s been, in a way, the bane of the international monetary system since Bretton Woods. For understandable reasons there are rules that bite on deficit countries, and no rules that really bite at all on surplus countries, but that’s a formula for economic costs.

And even new crises and unsustainability. So fully take the point, it’s got to have that dimension, but that dimension alone, I think will not do it, and both the perception, in some sense the reality is that that has been--if not the totality of the policy response--at least a very large part of it. As I said, Germany to its credit has been willing to finance those countries, and put pressure on them to reform, but I just don’t think that will be enough for a viable and sustainable long-term outcome.

Claus Tigges: The last row. The gentleman in the dark suit.

Speaker: Hei Jodres, Institut pro Produktions Management, we work with Airbus,
VW and Deutsche Bahn in particularly in their procurement organization and their supply chains, and I found your story about Korea particularly interesting. And it leads to my question, because the people that we work with, particularly the procurement directors, very much think that the dollar is way too high in respect to the euro, and they are working actively toward, against, to offset that process with respect to globalization. And pushing to build plants and pushing their suppliers to build plants, if we look just at the United States, in order to offset that, especially with respect to Airbus.

And I wondered, at what point do companies realize that countries are driving the currency exchange rates as an advantage? As the Airbus versus Boeing, since all aircraft are sold in dollars, is very much aware of, and my question is: At what point do countries look at currency as a weapon in the process of globalization?

C. Fred Bergsten:  Well, nothing new. They have been doing it for a long time. And as you are probably aware, there’s been quite an outburst of debate over the last several years--it’s cooled down a little bit lately, but it’s been very hot for the last 10 years, about the issue of currency wars.

In fact that’s my next book I’m working on is currency wars in the world economy. China, to take the prototype, has for 10 years been carrying out the most protectionist, mercantilistic economic policy in the history of mankind, by intervening daily, against the dollar, to the average of $1 billion per day, over a 10 year period. That’s how their reserves have gotten to $4 trillion, in order to keep the dollar strong, and the renminbi weaker for competitive reasons.

It is a crime that they been able to get away with that. The US is mounting some efforts; the Chinese have let the rate move up significantly, though not nearly enough. Their surpluses have come down a lot, but they’re still way too high, and they’re going back up. That is the most extreme example of currency wars.

But, less than two years ago a new government came into office in Japan. Prime Minister Abe. His team, as he’s not even taken office yet, dramatically talks down the exchange rate in the yen. They say well you know, the yen should really be 25 to 30% weaker, and were going to carry on a monetary policy that will achieve that. Well, of course in retrospect, they say the monetary policy would’ve done it by itself, but what actually drove it down was the jawboning.

And so a lot of people, like the American auto industry, but others as well, got very excited about that, you can understand why. This is competitive currency depreciation. If there was one lesson for the world economy from
the 1930s, if there was one idea that underlay the creation of Bretton Woods system, it was to avoid a repetition of currency wars [inaudible].

But then of course, eventually the other guy always emulates and copies, and so at the end of the day, everybody turns out to be substantial loser. That rule, which was written very explicitly, into the charter of the international monetary fund, has never been implemented, because it had no enforcement tools, and because surplus countries come under no market pressure to deal with their currency problem. Therefore, the United States, on a couple of occasions, has broken a lot of crockery.

A long time ago John Connally and Richard Nixon devalued the dollar against gold, put on an import surcharge to enable them to negotiate a dollar devaluation. Because they felt that was the only way to do it, and they were probably right. In the mid-1980s Jim Baker [inaudible] the Plaza Agreement because the dollar had gotten so hugely overvalued, that time there was good international cooperation actually, to bring the dollar down. And those NICs came along a little later, as I said.

But the international system has failed dramatically to deal with that central problem. And therefore, the temptation for individual countries to try to unilaterally strengthen their competitive position by currency undervaluations is still very strong. And in periods of weak economic performance, like the great recession we’ve just come through, is when it really breaks out.

So the finance minister of Brazil in 2010 was talking about currency wars having broken out. We documented it in a study that I published about that time. Over 20 countries that were really systematically intervening, manipulating exchange rates in order to undervalue their currency. The issue is a little esoteric for many people, it’s politically of course, very sensitive for G7, G20. It has been addressed, but not yet effectively.

In the German case that I talked about today, there’s this additional layer of difficulty, namely that Germany does not have its own exchange rate. It’s part of the euro. So now you have to figure a way to determine whether the exchange rate of the euro is really truly reflecting the individual currencies and, whether internal adjustment, within the Euro zone, can take place on the same basis that the international adjustment between countries with their own currencies should take place.

Your suppliers have a valid point, a valid fear. If this issue, now I’m talking about today in Europe, the global issue that I now mentioned in addition, are not dealt with in a more constructive and cooperative way, I think we inevitably face the risk of very severe currency wars.
Countries will be sorely tempted to seek advantage through unilateral steps. We’ll get more John Connallys, and if we don’t deal with it in a more collaborative way, I’m afraid that’s one major risk, but not just your suppliers. But all of us will have to face.

Claus Tigges: Okay let’s move a little further, from Klaus Deutsch.

Klaus Deutsch: Yah, Klaus Deutsch from Deutsche Bank. If you compare the performance of the United States and the Euro area to the financial crisis, there is a stark difference in how you treat bad debt. On both sides of the Atlantic. And in Europe it’s often underrated how much the Federal Reserve actually intervened into the resolution of that crisis in the United States that of course came from real estate, but also affected households, banks, and property developers.

Now if you look at the European situation, we are pretty tough on these debtors, and the ECP hasn’t taken much off the balance sheet of these southern European countries, which is why they are not really moving ahead. And not having a lot of investment in the tradable sector.

What is your view, also given the experience of Japan and other over invested countries of the past, how one would deal with such a situation, even with five years into the crisis?

C. Fred Bergsten: Well I think it would be hard to underestimate the intervention of the Federal Reserve. Its balance sheet is up to $4 trillion, and it’s rising by another still $60 to $65 billion per month. Now we’re down 45. We’re now tapering. We’re only doing $45 billion per month that’s about a billion and a half dollars a day. It’s still more than small change. But it’s coming down. But the balance sheet is to $4 trillion and it’s huge.

So there’s been massive intervention by the Federal Reserve no question about it. And the Bank of Japan, which was also not doing too much of that, is now catching up with a vengeance with the monetary policy under Kuroda and the Abe administration.

In terms of trying to offer stimulus to its own economy, it’s definitely true what you say, and the European Central Bank has been the least aggressive. Rightly or wrongly one could argue it both ways, but I would say the European Central Bank has been the least aggressive. The steps today move, I think, significantly in the direction of strengthening our support, but it may well be that with the US having gone through much of what you said, and now tapering down, and the ECB coming along later in the process, and now easing, while the US is reducing its easing, we may get a very big exchange rate adjustment.
Now we could get a very large exchange rate effect. The euro could come down very substantially against the dollar, depending on the followthrough in Frankfurt, what happens in implementing the new strategy, how fast the US tapers through the Fed and all that. But I think we could have a very big exchange rate effect.

And some people, I can assure you, will regard that as competitive devaluation by Europe. Now I would actually not regard it that way, partly because our analysis show that the euro–dollar rate is not that far from equilibrium now, and the euro could actually come down a little bit, without violating equilibrium principles. But what happens at the margin is key, and if the euro does come down substantially, and the dollar would then go into generalized increase, some of our people would sound like Helmut Schmidt sounded back in the 1970s and 80s that we will be disadvantaged by the exchange rate.

When the Japanese did what they did, 18 months ago, there were screams from the American automobile industry, other manufacturers in the United States, who compete with Japan, screaming competitive devaluation. And it was ultimately done through monetary policy. So the risk that I mentioned is with us, and could happen again, though I do support, as I said earlier, a move by the European Central Bank to promote more domestic demand increase in Europe. Quantitative easing by the Fed, and the Bank of Japan has I think rightly been regarded around the world as a legitimate policy tool. It’s carried out basically to promote domestic demand. It’s carried out in domestic instruments. It’s very different from direct intervention in currency markets like the Chinese have done, but there is an effect on the exchange rate, and so that will lead to perception and criticism. I hope this does not lead to another round of currency war scares.

Claus Tigges: Why don’t you hand them out?

Donesch Meyer: Donesch Meyer of the Berlin Center of Finance, can I suggest to you that the task lying ahead of the German government is actually even more complicated than you sketched out? Now let me explain why. My reading of the Euro crisis is actually that it is a case of an abject failure of macroprudential policies, because in the initial years of the EMU, actually real interest rates were too low for the southern European countries. And they should have been running fiscal surpluses to counteract that in the spirit of macroprudential policies, with, which with the exception, laudable exception of Ireland and Spain, to some extent they didn’t.

Now I would argue that in some sense Germany finds itself in that situation at the moment where real interest rates really are too low for the strength of the German economy. And really what the German government
should be doing is trying to enforce fiscal surplus, if that was the case. Now that obviously runs counter to your idea of stimulating the demand in the German economy. So the policy response, if that line of argumentation was correct, would be that, yes there is indeed a need to stimulate domestic demand, but not by simply pushing up fiscal deficits, but rather by shifting demand structures towards domestic consumption, which obviously is a far harder task than simply pushing up fiscal deficits. Would you agree?

C. Fred Bergsten: Certainly I would agree that should be a major dimension of the program. I did say rather quickly in passing that there was an asymmetry between the pressure on the deficit countries in Europe to undertake structural reform, which we discussed, and what many would argue is an absence of structural reform of late in the surplus countries including Germany. Like the services sector, like some of the financial arrangements, various elements of the German economy, which if they were reformed, in the same spirit as the Hartz reforms of labor a decade or so ago, could stimulate, as you said, more consumer demand, more imports, more growth that would be imparted to the rest of Europe.

That would certainly be highly desirable and a vital part of any overall strategy of the type that I mentioned. So I fully accept your amendment to that. On your first point about the deficit countries and the origins of the crisis, macro prudential problems, again I agree in large part, but I would have one important difference in interpretation. The markets made huge errors in treating Greek debt like German debt. And that made interest rates in the other peripheral countries way below what they should have been, in light of the fiscal positions and the overall economies of those countries.

So the markets sent hugely misleading signals to those countries. And you of course are right, they should have used this to run fiscal surpluses and to invest in their infrastructure, and do all the right things. But it’s a little hard to attack people too strongly for living beyond their means when it’s so cheap to do so.

So the markets, the great, omnipotent, farseeing market sends some very, very perverse signals, and it’s in that sense, only in that sense, but in that sense I have some sympathy for the countries that got into this crisis. They should have known better, but they were misled and a lot of people were cheering them on to borrow that money and use it in ways that were not so sound.

Claus Tigges: Yes we will take the last question.

Bernard Malamud: Yeah, Bernard Malamud, University of Nevada Las Vegas, visiting one of
our favorite cities, right now. If expansion succeeds as you called for, and considering the interest rate issue that was just raised, mightn’t that lead to higher interest rates, that would put pressure on sovereign debt, and your back into another crisis that we sort of got out of recently?

C. Fred Bergsten: Well, if we got faster growth, sure it would put some upward pressure on interest rates. I’d be happy to take that trade-off right now, but in addition interest rates are coming from such a low level throughout Europe, also in the United States, Asia, Japan, around the world interest rates are at abnormally low levels. And we cannot view those as anything like equilibrium for the longer run.

Those distortions will lead to other big problems beyond the scope of today’s discussion. But we should not, I think, be reluctant to achieve, pick up in real growth, because it might lead to higher interest rates. There will be plenty of time—it’s the same as the fear that it will trigger inflation. And again inflation is nowhere to be seen. And there will be as Ben Bernanke repeatedly said, [inaudible 1:12:40] has said, all the central bankers rightly say, “There will be plenty of time to reverse gears and head off a new risk of inflation at higher interest rates if that were to happen.” So, of the things that keep me awake at night, that’s the least. And I would not be deterred by that concern.

Claus Tigges: Ladies and gentlemen thank you very much, I’d like to conclude the Q&A session now, let me thank Fred Bergsten again for an inspiring good few minutes, lecture, and for sharing your thoughts and your wisdom with us during the discussion. And if I’m not mistaken there may be drinks served outside. It’s getting increasingly warm. So thank you very much.