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Who's to blame for slack euro zone? Not Germany

Critics are quick to charge Germany's fiscal strength as the villain, but careful analysis points to monetary austerity

By: Steve Hanke – December 11, 2013

The economic talking-head establishment has declared war on Germany.

The opening shots in this battle were fired by none other than the United States Treasury Department, which had the audacity to blame Germany for a weak euro zone recovery in its semi-annual foreign exchange report.

The Treasury's criticisms were echoed by the International Monetary Fund's David Lipton, a first deputy managing director, in a recent speech in Berlin – a speech so incendiary that the IMF opted to post the "original draft", rather than his actual comments, on its website.

Things were kicked into a full blitzkrieg when Paul Krugman penned his latest German-bashing *The New York Times* column.

The criticisms of Germany revolve around nebulous terms like "imbalances" and "deflationary biases". But what's really going on here?

The primary complaint is that German exports are too strong, and domestic consumption is too weak. The country is producing more than it consumes.

Critics argue that "excess" German exports are making it harder for other countries (including the United States) to recover in the aftermath of the financial crisis.

While a review of international trade statistics is all well and good, the ire against Germany actually comes down to one thing: austerity.

Despite Germany's relatively strong recovery, the international economic establishment is none too happy about the country's tight fiscal ship. If only Germany would crank up government spending, then Germans would buy more goods, and all would be right in the euro zone, and around the world – the argument goes.

Yes, the anti-austerity crowd has found a convenient way to both slam austerity and scapegoat one of the few countries to successfully rebound from the crisis.

I would add that it is hardly a coincidence that this line of argument fits nicely into the fiscalist message of Germany's Social Democratic party, with whom Chancellor Angela Merkel is currently trying to arrange a governing coalition.

In recent years, the fiscalist crowd has advanced the one-dimensional argument that fiscal stimulus is the only way to save struggling economies in the wake of the crisis.

This follows the standard Keynesian line: to stimulate the economy and expand the government's deficit (or shrink its surplus) or to rein in an overheated economy, shrink the government's deficit (or expand its surplus).

Unfortunately, this is nothing more than a factoid, which is defined by the *Oxford English Dictionary* as "an item of unreliable information that is reported and repeated so often that it becomes accepted as fact".

A careful examination of the money supply shows why the euro zone economies have been on the brink of recession

Rather than diving into the weeds of this rather convoluted argument, we ought to focus on what really matters: money.

To do this, we revert back to John Maynard Keynes at his best.

Specifically, we must look at his two-volume 1930 work, *A Treatise on Money* – a work that no less than Milton Friedman wrote about approvingly in 1997. Indeed, Friedman concluded that much of the Treatise "remains of value". I agree.

In particular, Keynes separates money into two classes: state money and bank money.

State money is the high-powered money (the so-called monetary base) that is produced by central banks. Bank money is produced by commercial banks through deposit creation.

Keynes spends many pages in the Treatise dealing with bank money. This isn't surprising because, as Keynes makes clear, bank money was much larger than state money in 1930. Well, not much has changed since then.

Today, bank money accounts for 91 per cent of the total euro zone money supply, while state money accounts for only 9 per cent, measured by M3.

A careful examination of the money supply, broadly measured, shows why the euro zone economies have been on the brink of recession ever since Lehman Brothers collapsed in September 2008.

From 2002 until Lehman, the money supply was growing at an 8.7 per cent rate. Since then, it's slowed to 1.07 per cent.

At first glance, this might seem rather surprising. After all, hasn't the European Central Bank (ECB) been pumping out state money?

Well, yes. But, state money is only a small part of the total money supply.

The big elephant in the room is bank money. And banks have not been producing much bank money in Europe. This can be seen by looking at credit to the private sector, which is an important counterpart to bank money. Credit to the private sector in the euro zone is actually lower now than it was when Lehman collapsed in September 2008.

Faced with intense regulatory pressures, banks in Europe have been deleveraging big time.

Credit is the lifeblood for business in Europe, and excessive bank regulations like Basel III have made it scarce.

Sadly, things are only going to get worse. Over the next year, the ECB will be scrutinising the balance sheets of more than 120 euro zone banks, through its so-called “stress tests”.

This promises more mandatory bank deleveraging, which will result an even tighter squeeze on bank money and private credit in Europe.

Indeed, this monetary austerity might just push Europe from anaemic growth into a recession.

Forget fiscal austerity, the real villain here is monetary austerity.