Darrell Delamaide's Political Capital

German inflation obsession will keep euro strong

Commentary: Currency war impossible while Berlin is in charge

February 13, 2013 | Darrell Delamaide

WASHINGTON (MarketWatch) — To paraphrase the old saying about the key to a restaurant's success, Germany's top priority in maintaining a strong currency is inflation, inflation, inflation.

It is commonplace to say that Germany as a nation was traumatized by the hyperinflation of the 1920s, when it took literally a wheelbarrow full of paper money to buy a loaf of bread, and it is as true now as it has ever been.

So even though there may be a global currency war brewing, a German-dominated euro zone won't be a party to deliberately devaluing the joint European currency, whether openly as suggested last week by French President François Hollande, or under the cover of a domestic battle against deflation, as with Japan's new government.

Because of its single-minded obsession, a strong currency is for Germany the necessary bulwark against imported inflation. Likewise, a tight monetary policy is an essential hedge against inflation taking root.

European Central Bank President Mario Draghi used his bully pulpit last week to temporarily dampen the resurgence of the euro, talking down the currency just as effectively as he talked down the yields on Spanish bonds.

But the technical strength of the euro does not resolve its underlying contradictions, and in fact exacerbates them.

Germany, with the most productive workers in the euro zone, does not mind a strong euro. The common currency benefits Germany in two ways: it enables the country to run a massive current-account surplus with its less-productive euro-zone partners and it holds down the appreciation that a national German currency would experience.

In the meantime, of course, the southern European countries desperately need a weaker currency to stimulate their exports and balance their external accounts.

One of the new buzzwords in euro crisis management is "fiscal devaluation," an ingenious scheme proposed by Harvard professors Gita Gopinath and Emmanuel Fahri, among others, to mimic the effect of currency devaluation on the national level by simultaneously raising the value-added tax, which makes imports more expensive, and lowering the payroll tax, which makes exports cheaper.

Germany employed this scheme more or less intuitively in 2006, and France's Hollande in November announced a plan along these lines as a possible way to get the benefits of devaluation even while chained to the common currency.

This type of scheme can indeed stimulate manufacturing exports, but it may not deliver other benefits of currency devaluation — such as boosting tourism or encouraging capital imports — that the southern European countries need. These benefits still depend on the wrenching internal deflation from the austerity policies imposed by Brussels and Berlin.

In 1923, German banknotes had lost so much value that they were used as wallpaper.

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And the increase in VAT, which is only partially offset by lower domestic prices from the payroll tax reduction, could have the unwelcome side effect of further dampening consumption in general, not just consumption of imports.

Fiscal devaluation may be simple in theory, but the devil is in the details. The French plan, for instance, incorporated only some of the measures recommended by an expert panel and stretched out the implementation phase, so it's hard to know how significant its impact will be.

Moreover, as with currency devaluations themselves, fiscal devaluations can become a competitive sport, with the impact weakening as each successive country adopts it.

So far there has been no rush by Spain, Italy or Greece to adopt similar schemes. It seems like a clumsily interventionist way to achieve what markets would do naturally if countries retained their currency sovereignty and is another example of the artificiality of the monetary union.

But at least it is an option if voters in these countries decide they want to maintain the euro at all costs.

Voters in Italy, for example, according to the last polls published before a mandatory blackout ahead of national elections later this month, seem ready to stay the course by giving enough seats to the center-left parties of Pier Luigi Bersani and the centrist parties of outgoing Prime Minister Mario Monti to form a government supporting pro-euro policies.

A last-minute surge by former Prime Minister Silvio Berlusconi is likely to be cut short as news from the bombshell announcement of Pope Benedict XVI's resignation pushes the election campaign out of the headlines — surely the last thing on the pope's mind in timing his retirement.

As for currency wars, the G7 countries this week affirmed they would not target exchange rates and the Group of 20 finance ministers and central bankers meeting this week in Moscow are sure to echo this sentiment.

But that doesn't change the efforts of the U.S., Japan, Switzerland and other countries to ease monetary policy to fight domestic deflation, with the not-unwelcome side effect of depressing the value of their currencies.

The euro will remain "strong" — in the way someone remains tall standing in a room where everyone else has sat down — as long as the Germans call the shots in the euro zone and as long as the common currency can resist the economic strains threatening to tear it apart.

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