China and Germany unite to impose global deflation

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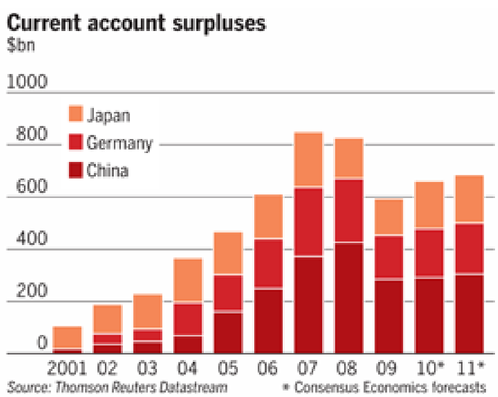
"Chermany" spoke last week and the world listened. Was what it said coherent? No. Was what it said self-righteous? Very much so. Was what it said dangerous? Yes. Will wiser views still prevail? I doubt it.

You may have heard of Chimerica – a neologism invented by Niall Ferguson, the Harvard historian, and Moritz Schularick of the Free University of Berlin, to describe a supposed fusion between the Chinese and American economies. You may also have heard of Chindia, invented by Jairam Ramesh, an Indian politician, to describe the composite new Asian giant. Let me introduce you to Chermany, a composite of the world's biggest net exporters: China, with a forecast **current account surplus** of $291bn this year and Germany, with a forecast surplus of $187bn (see chart).

China and Germany are, of course, very different from each other. Yet, for all their differences, these countries share some characteristics: they are the largest exporters of manufactures, with **China now ahead of Germany**; they have massive surpluses of saving over investment; and they have huge trade surpluses. (See charts.)

Both also believe that their customers should keep buying, but stop irresponsible borrowing. Since their surpluses entail others' deficits, this position is incoherent. Surplus countries have to finance those in deficit. If the stock of debt becomes too big, the debtors will default. If so, the vaunted "savings" of surplus countries will prove to have been illusory: vendor finance becomes, after the fact, open export subsidies.

I am beginning to wonder whether the open global economy is going to survive this crisis. The eurozone may also be in some danger. Last week's interventions by Wen Jiabao, China's premier, and Wolfgang Schäuble, Germany's finance minister, illuminate these dangers perfectly.

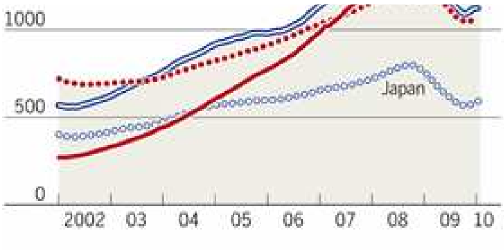


The core of **Mr Schäuble's argument** was not about the mooted European Monetary Fund, which could not, even if agreed and implemented, alter the pressures created by the huge macroeconomic imbalances within the eurozone. His central ideas are: combining emergency aid for countries running excessive fiscal deficits with fierce penalties; suspending voting rights of badly behaving members within the eurogroup; and allowing a member to exit the monetary union, while remaining inside the European Union. Suddenly, the eurozone is not so irrevocable: Germany has said so.

Three points can be drawn from this démarche from Europe's most powerful country: first, it will have an overwhelmingly deflationary impact; second, it is unworkable; and, third, it might pave the way for Germany's exit from the eurozone.

I explained the first point **last week**. If Germany gets what it wants, the world's second-largest economy would play an altogether negative role in the search for a way out from the global slump in aggregate demand. The eurozone would not be exporting the demand the world now needs. It would export excess supply, instead.

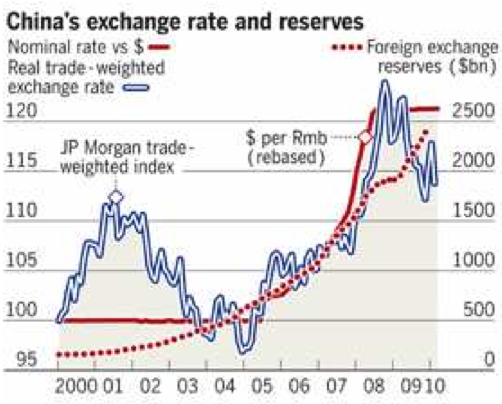
Imagine that weaker eurozone countries were forced to contract their fiscal deficits sharply. This would surely weaken the entire eurozone economy. But the result would also be fiscal deterioration in Germany and France. Imagine that Germany then did don the hair shirt. Would it instruct France to do the same? After all, France already has a general



government deficit forecast by the Organisation for Economic Co-operation and Development at close to 9 per cent of gross domestic product this year. Does Mr Schäuble imagine France could be fined? Surely not. Yet it is not Greek public finances that threaten the stability of the eurozone. These are a mere bagatelle. The threat is the public finances of big countries. Since Germany could not force such countries to behave and has no chance of expelling any member it disapproves of from the eurozone, it would have to leave itself. That is the logic of Mr Schäuble's ideas. This must be obvious to him, too.

Germany is in a supposedly irrevocable currency union with some of its principal customers. It now wants them to deflate their way to prosperity in a world of chronically weak aggregate demand. Mr Wen has the same idea. But the economy he wants to pursue this goal is the US. Fat chance!

Speaking at the end of the National People's Congress, **Mr Wen declared**: "What I don't understand is depreciating one's own currency, and attempting to pressure others to appreciate, for the purpose of increasing exports. In my view, that is protectionism." He also insisted he was worried about the safety of China's dollar investments.



What, I wonder, does Premier Wen mean by this, apart from telling the US to leave China's exchange rate policies alone? If the US desire for a weaker dollar is "protectionist", how much more so is China's determination to keep its currency down, come what may? There is nothing evidently "protectionist" about asking a country with a huge current account surplus to reduce it, at a time of weak global demand. If I understand China's declared position correctly, it wants the US to deflate itself into competitiveness, instead, via fiscal and monetary contraction and, presumably, falling domestic prices. That would be dreadful for the US. But it would be dreadful for China and the rest of the world, too. It is also not going to happen. China surely knows that.

Behind all this is a fundamental divide. Surplus countries insist on continuing just as before. But they refuse to accept that their reliance on export surpluses must rebound upon themselves, once their customers go broke. Indeed, that is just what is happening. Meanwhile, countries that ran huge external deficits in the past can cut the massive fiscal deficits that result from post-bubble deleveraging by their private sectors only via a big surge in their net exports. If surplus countries fail to offset that shift, through expansion in aggregate demand, the world is inevitably caught in a "beggar-my-neighbour" battle: everybody seeks desperately to foist excess supplies on to their trading partners. That was a big part of the catastrophe of the 1930s, too.

In this battle, the surplus countries are most unlikely to win. A disruption of the eurozone would be very bad for German manufacturing. A US resort to protectionism would be very bad for China. Those whom the gods wish to destroy, they first make mad. It is not too late to look for co-operative solutions. Both sides have to seek to adjust. Forget all the self-righteous moralising. Try some plain common sense, instead.

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