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What Ptolemy tells us about Germany and Greece

By Stephen King

Ptolemy's theory of the universe held that the earth was at its centre. All other celestial objects – including the sun – rotated around it. It was, of course, nonsense. Aristarchus had more than 300 years earlier come up with a heliocentric model of the solar system. And much later Copernicus came along with his far superior system. Luckily, he died before anyone could be offended by his theory. Galileo, a supporter of Copernicanism, was not so fortunate, ending up under house arrest under suspicion of heresy.

Now, the eurozone is in danger of shifting towards a Ptolemaic system with Germany at its centre. Like Ptolemy's theory, a German-centric eurozone may wilt under scrutiny. It requires economic adjustment by others to protect the interests of German taxpayers and voters. That, however, makes the system as a whole increasingly unstable.

Consider, for example, the need for the so-called peripheral nations to improve their competitiveness. What does this actually mean? Presumably, the likes of Italy and Spain would have to have inflation rates – both of prices and of wages – significantly below the eurozone average. That, in turn, would require countries such as Germany to accept inflation rates well above the average.

In a Ptolemaic system, however, the good men and women of Berlin, Bremen and Bonn might simply dig their heels in, refusing to tolerate what they could regard as an unacceptable loss of price stability in Germany. The competitive adjustment within the eurozone would then either fail to materialise or, instead, be associated with excessively low inflation, particularly in those peripheral nations desperately trying to improve their competitiveness.

The Ptolemaic version of the eurozone also requires lopsided adjustment of so-called imbalances. It is more important, apparently, that the southern European nations reduce their current account deficits than that the northern European nations reduce their surpluses.

Perhaps the idea is that the eurozone as a whole should run a bigger surplus with the rest of the world (in which case, the terms under which the rest of the world runs a bigger deficit with the eurozone have yet to be enunciated). If, however, the adjustment in the eurozone is to take place via shifts in competitiveness, it follows not only that the real exchange rates of southern Europe should decline but, that the real exchange rates of northern Europe should rise. We are back to the need for different inflation rates in north and south.

The Ptolemaic system also requires a skewed view of bond markets. High yields in the periphery and low yields in Germany and other core nations are two sides of the same coin. A flight to "quality" has both punished the periphery and rewarded the core. This is as much a reflection of concerns about the euro's survival as it is an indication of excess borrowing in individual nations. Yet those who benefit from the euro's systemic weaknesses – Germany, with its remarkably low borrowing costs is surely a prime example – choose instead to talk only about the potential costs associated with bailing out others.

The Ptolemaic system ultimately condemns the peripheral nations to a life of weak activity and low inflation – possibly even deflation. In turn, this makes the servicing and repayment of debt all the more difficult. Already, activity in the peripheral nations is shrinking rapidly: Italian gross domestic product was down 0.5 per cent year-on-year in the final quarter of 2011, while Portugal's fell 2.7 per cent and Greece's by 7 per cent. Should inflation also drop like a stone – as now seems increasingly likely – there simply won't be enough nominal GDP around for the periphery's fiscal numbers to add up.

Germany, at the Ptolemaic centre of the eurozone, is in a far more comfortable position: growth may be fading but, thanks to its Ptolemaic advantage, interest rates are low enough to enable Berlin to keep on the fiscal straight and narrow.

The Ptolemaic system needs to be replaced. This is not an issue concerning Greece alone, even if investors remain focused on the minutiae of austerity, bail-outs and debt haircuts. It is, instead, about the need for adjustment by those who appear to be in a strong financial position.

Germany can play its part: encouraging domestic demand to grow more quickly; allowing its real exchange rate to rise with a more tolerant approach to inflation, ensuring that its current account surplus is invested not in potentially worthless chunks of peripheral debt but, instead, in factories in southern Europe and welcoming migrants from southern Europe as they try to escape from unemployment.

In other words, we need to drop Ptolemy and come up with a theory of eurozone relativity.

The writer is HSBC Group's chief economist and the bank's global head of economics and asset allocation research