

The
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Germany's economy

Message to the Bundesbank

If the euro zone is to survive, Germany must tolerate higher inflation

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HE IS not the best-known player in the euro crisis, but over the next couple of years Jens



Weidmann, who this week celebrated his first anniversary as president of Germany's Bundesbank, will be one of the most important. The euro zone's future hinges on when and how its peripheral economies can return to growth. And, put crudely, their ability to do so will depend a lot on whether Mr Weidmann and the Bundesbank will tolerate higher

inflation in Germany.

Asking a central banker to accept higher inflation may seem like asking a cardinal to accept more sin. All the more so in Germany, where the importance of price stability is etched on the collective psyche. Most of the time that German instinct is right. Tolerating higher inflation is risky. It can be hard to squeeze down again. Yet Germany will need to live with slightly frothier prices for the next few years. Both the arithmetic of euro-wide inflation and the mechanisms of rebalancing growth in the currency union demand it. If the Bundesbank resists, the single currency could come apart.

Consider the arithmetic. Inflation in the euro zone as a whole currently stands at 2.6% and in Germany at 2.1%. The euro-wide average is well above the European Central Bank's target of "close to but below 2%". But much of that inflation is temporary, the consequence of higher oil prices and increases in value-added taxes that formed part of many countries' austerity plans. Strip out these one-offs, and the underlying price pressure in the euro zone is much lower and probably falling. The IMF expects overall euro-zone inflation of only 1.5% in 2013, quite a bit below the ECB's target.

The drop in euro-zone inflation will be largely caused by disinflation in the peripheral economies, where fiscal austerity and a credit crunch will squeeze wages and prices. Since those economies together make up around one-third of euro-zone GDP, over the next few years the ECB will achieve its overall inflation target of 2% only if the healthier economies within the single-currency area (above all Germany) accept relatively higher inflation.

Higher German inflation would also help peripheral economies restore their competitiveness without deepening their debt crises. The main route to greater competitiveness in Europe's periphery is faster productivity growth, but shifts in relative costs will also play a role. If German prices rise by 3% a year and those in the periphery are flat, then countries like Spain, Portugal and Greece will gradually improve

their costs relative to Germany. If German inflation is much lower, the adjustment could require years of outright deflation in the periphery. That would be politically incendiary and, by raising the real burden of their debt, would make these countries' fiscal problems—and hence the euro zone's woes—even deeper.

To avoid this outcome, the ECB should loosen monetary conditions by cutting interest rates and, if necessary, printing money to buy bonds—even if German prices are rising faster than 2%. Instead of fighting against such easing, the Bundesbank's proper role is to welcome this outcome. Mr Weidmann should vote for looser policy at the ECB, and then focus on minimising the fallout from higher inflation at home.



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To do that, he has two tools: the bully pulpit and so-called macroprudential levers, such as requiring banks to boost their capital or tightening rules on mortgages. Like many other countries, Germany is developing rules that will allow its central bank and financial supervisors to dampen credit and asset bubbles (see [article \(http://www.economist.com/node/21554198\)](http://www.economist.com/node/21554198)).

Let the party begin

For the moment, Mr Weidmann should rely on the bully pulpit alone. He must be firm about the Bundesbank's commitment to price stability, but make clear that the relevant measure is price stability in the euro zone as a whole. He should put Germany's inflation in context: higher wages, after years of stagnation, are a good thing. And he must squash alarmist talk about asset bubbles. Yes, German property prices have started to rise, but it is hardly a bubble when house prices, relative to incomes and rents, are around 20% undervalued.

The absence of bubbles is also a reason for Mr Weidmann not to deploy

macroprudential tools too soon. With no obvious financial excesses, there is little need to rein in Germany's banks, particularly since any restrictions on them would make the euro zone's problems harder by cutting lending to the periphery faster. If the ECB's monetary policy stays loose for years, Germany will at some point have to worry about bubbles. But that point is a long way off. Central bankers are supposed to take the punchbowl away from the party. But not before the party has even begun.

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