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WILL GERMANY REALLY STOP UNDERMINING EUROPEAN INTEGRATION?
By: Jörg Bibow

A glimmer of hope has recently emerged from Berlin with Angela Merkel’s pledge to cut income tax for "each and every taxpayer", arguing that only substantial tax cuts would guarantee the swift return to growth needed to bring Germany’s budget deficit back under control. It is not clear at this point how much of the meanwhile re-elected chancellor’s remarks will survive the coalition negotiations in the next few weeks. But it would practically turn German policy wisdom of recent decades on its head. It is almost as if Angela Merkel is belatedly applauding and embracing French President Sarkozy’s promise made at his parliamentary address at Versailles in June that he will not have a policy of austerity: “Because austerity policy has always failed.”
Germany certainly provides a sad example of failed austerity at huge costs, which may well have inspired Mr Sarkozy's observation, and perhaps Ms Merkel's recent enlightenment too.

Ever since Germany's budget deficit reached nearly 3% of GDP in 1991 balancing the budget "no matter what" has been the single-minded pursuit of German finance ministers. Yet while the deficit has never moved far away from 3% of GDP in all these years except for brief export-driven booms, trend nominal GDP growth has been crushed to a mere 2% and net public debt has shot up by some 40% of GDP. In real terms Germany has experienced a significant relative decline compared to its rich peers in both Europe and the US. In short, austerity squeezed the economy rather than the deficit.

Ignoring these austerity disasters since the 1990s, German policymakers cherish memories of the successful consolidation of the 1980s when balancing the budget attained policy priority with the change in government in 1982. The predictable result was domestic demand stagnation and rising unemployment. Yet, by the end of the decade Germany had indeed balanced its public budget, together with a current account surplus of...
some 5 per cent of GDP. In a way, Germany's mini-boom of 2006-7 brought a repeat of that experience on the back of the record global boom: Germany attained a nearly balanced budget just before the outbreak of the crisis, this time together with an 8% of GDP current account surplus.

The key patterns in German macro policy are clear enough: mindless strangling of domestic demand through austerity measures is paired with hopes to freeload on exports. The trouble is that the euro has fundamentally changed the conditions for this strategy to work successfully. In the past it worked for Germany as long as others behaved differently. In particular, in the 1980s, Germany had low inflation and a balanced budget, but the rest of Europe did not. Germany got away with budgetary discipline while ignoring domestic demand as others did not, thereby creating sufficient demand for German exports. Exporting the German model to Europe through the Maastricht regime meant inflation would be low across Europe, while all countries would try to balance their budgets at the same time. When German stability policy was jointly applied across Europe in the early 1990s, the predictable result was domestic demand stagnation and rising unemployment.
A colossal policy mistake then occurred when Germany embarked on underbidding wage trends in the newly formed euro area. Stagnating wages not only helped to depress private consumption directly. By driving down price inflation this strategy also gave Germany higher real interest rates than elsewhere in the euro area – turning Europe’s pre-EMU monetary world upside down.

Ms Merkel’s enlightened promise to forego austerity and go for growth instead is thus all the more welcome. At least if she meant growth of German domestic demand, as this would also help other countries in restoring their competitiveness and reducing intra-area imbalances. But we must not forget here that in a remarkable act of policy unilateralism bluntly ignoring the EU membership obligation to treat economic policy as a common concern Germany has in June this year constitutionally banned public borrowing both at the Federal and the Länder levels of government from 2016 or 2020 onwards, respectively. The window of opportunity to go for growth rather than austerity may thus not extend all that far beyond the election, and we must also take serious the possibility that any cuts in direct taxes might come along with hikes in indirect taxes.
And since Germany’s surprise emergence from recession in the second quarter was primarily driven by net exports, the ongoing revival in global trade will likely lift Germany’s boat faster than the rest of Europe, at least for the next couple of quarters. So German policy makers might even feel vindicated by this quick revival of fortunes – overlooking that they owe their luck to other countries’ stimulus measures.

Apparently the current crisis was not big enough to trigger a proper revision of Germany’s “export-oriented growth model”. The real trouble is Germany’s penchant for policies that depress imports; with trade surpluses serving its moral crusade at balancing the government budget. The next chance for that highly warranted public debate may not be all too far off though. Let’s hope it will take place under a German government that is not notoriously on collision course with European integration.

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