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GERMANY'S DEFLATIONARY FISCAL AND MONETARY POLICIES, MODELED BY THE EU, THREATEN EUROPEAN AND GLOBAL GROWTH

By Not Taking Significant Measures to Boost Domestic Demand, European Economies, as Exemplified by Germany, Are Taking a Dangerous Free Ride on U.S. Expansionary Policies, New Levy Institute Study Says

ANNANDALE-ON-HUDSON, N.Y. — In May the International Monetary Fund issued a warning that Germany was at a high risk of falling into a deflationary cycle. As Germany's economic woes continue to mount, from stagnant growth to surging unemployment and bankruptcy rates, so do the potential repercussions for Europe and the global economy. A new study from The Levy Economics Institute at Bard College explores the roots of Germany's current economic situation and argues that the country's continued pursuit of contractionary policies has serious implications for global growth.

In a public policy note, *Pushing Germany Off the Cliff Edge*, Levy Research Associate Jorg Bibow traces the history of Germany's current economic woes—10 percent unemployment, weak consumer demand, and stagnant GDP growth—to ill-guided macroeconomic policies enacted in the wake of reunification. Rather than viewing unification as a challenge to sustain growth in the context of a weak world economy, Bibow says, the German government, fearing inflation, cut spending while the Bundesbank raised interest rates. The German GDP growth rate collapsed and never recovered, which lead to weak demand and the chronic budget deficits the government had been seeking to avoid.

"Policymaking traditions in Germany may be best described as mixing the government's single-minded pursuit of fiscal consolidation with a single-minded pursuit of price stability by an independent central bank," Bibow writes. "The unpleasant supply-side by-products of contractionary demand policies lead to a vicious cycle of stagnation and financial squeeze."

Bibow asserts that, even after a decade of weak growth, Germany continues to blame its economic malaise on structural problems, such as rigid labor markets, and continues its efforts to reduce public spending. "With structural explanations providing a welcome excuse for anything that goes wrong, this regime's economic performance hinges crucially on export growth as domestic demand growth is not being looked after at all," he writes. "The sick man of the euro may be weak and wobbly, but the German government is determined to continue cutting its structural deficit by at least one half of 1 percent of GDP per year, no matter what, until the budget is balanced. This action might finally be sufficient to push Germany off the cliff edge and make the budget deficit rise further still."

While warning that Germany could fall into a Japan-like deflationary spiral, Bibow says a broader threat comes from the strict fiscal guidelines of the European Monetary Union (EMU) and the rigid monetary policies of the European Central Bank, both of which were modeled largely on German policies and institutions. "Since Germany provided the blueprint for Europe's stability-oriented macroeconomic policy regime, the risk is that the 'German disease' is spreading throughout the regime and, potentially, beyond Europe," Bibow writes. "Germany could pull the rest of Euroland down with it."

Furthermore, by not taking significant measures to stimulate domestic demand, Bibow says that Germany and the EMU are taking a free ride on the expansionary polices of the United States, which has acted aggressively to stimulate demand, dramatically cutting interest rates and boosting government deficit spending. Not only have European macroeconomic policies contributed to the record deficit in the U.S. account balance, they will keep it from easily correcting itself, which will ultimately undercut global growth. "Dollar depreciation may fail to give U.S. growth much of a boost. Given the twin deficits in the U.S. economy—the government and current account sectors—the world economy is unlikely to gather much speed when the main engine is sputtering and two brakes are being applied to economic growth."

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