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Pushing Germany Off the Cliff Edge

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GERMANY IS CURRENTLY IN ITS WORST POSTWAR ECONOMIC CRISIS. After persistently sluggish economic growth since 1992, the 2000-2001 economic downturn has brought GDP growth to a virtual standstill as unemployment and bankruptcy rates move into uncharted territory. Germany was dubbed "the sick man of the euro" soon after the new currency's launch. The euro has since fully recovered from its humiliating fall in 1999 and 2000 (Bibow 2002), but the sick man may be at a tipping point: The International Monetary Fund (IMF), fearing the risk of deflation (IMF 2003), put Germany on high alert. The chance that Germany's economy might soon resemble that of Japan no longer seems all that remote.

Yet German public debate focuses on public finances, which, unsurprisingly, are also in a mess. Last year's budget deficit was 3.6 percent of GDP, leaving Germany struggling to meet the infamous Maastricht limit of 3 percent. Ironically, as some have noted with schadenfreude, the fiscal regime called the Stability and Growth Pact (SGP), which Germany forced upon its apparently untrustworthy European partners in order to protect itself from fiscal profligacy, is now posing an acute problem for the regime's originator. Following similar retrenchments last year, the German government continues to enact new discretionary measures that are meant to cut public expenditures and raise revenues.

Certainly the European Central Bank (ECB), the enforcer of discipline and another "made in Germany" product, approves of any fiscal austerity measure. It asserts that this is the right kind of "sound money" medicine to foster confidence and safeguard the euro's stability. As to its own monetary policies, there is no denying that the ECB has attracted an unusual amount of criticism from economists in recent years. In particular, many observers found that the bank's response to the 2000-2001 global downturn lacked timeliness and aggressiveness. When confronted with such criticisms, the ECB refers to its single goal of maintaining price stability. And it adds that, by strictly focusing on medium-term price stability, monetary policy automatically contributes to other economic goals, too.

While skepticism is riding high about the world's most independent central bank and its peculiar rearview-mirror obsession with inflation in today's deflationary environment, doubts are on the rise, too, about the wisdom of Germany's stubborn attitude in insisting on balancing its budget "no matter what." And as the SGP ensures that fiscal retrenchment will be not only Germany's but Europe's number-one economic policy priority for years to come, potentially wider ramifications cannot be ignored. Therefore, a fresh look at Germany's economic malaise is in order.

Germany's Economic Malaise

Conventional wisdom holds that Germany's poor record since 1992 was largely the result of the "unification shock" in 1990 when western Germany was brought to its knees by a collapsing eastern German economy that was merely 10 percent the size of western Germany's GDP. Another prominent conventional explanation features structural problems, especially Germany's famously "rigid" labor markets. German labor costs are simply too high, the argument goes, and the pitfalls inherent in firing workers deter firms from hiring in the first place. These explanations are endorsed by the Organization for Economic Co-operation and Development (OECD 2002).

I take exception to the conventional wisdom and popular conviction that these were the decisive factors in explaining Germany's crisis. Instead, my analysis of the crisis has revealed a peculiar and inappropriate German tradition and approach to macroeconomic policy making that has had a profoundly detrimental impact on economic performance (Bibow 2001a). In particular, my analysis shows that Germany's fiscal crisis cannot be attributed to unification per se, but that it arose as a consequence of ill-guided macroeconomic policies pursued in response to that event. Many structural problems that popped up along the way were mere symptoms of persistent macroeconomic mismanagement and protracted stagnation. 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.

Toward the end of the 1980s, on the eve of unification, the West German economy was performing strongly. Exports ignited demand-led growth, and fiscal and monetary policies contributed, albeit belatedly, to the recovery in domestic demand. When the Berlin Wall came down in 1989, economic growth was the finest in a decade, the budget was balanced, and the current account showed a surplus of 5 percent of GDP. During the initial unification process (1990-91), real GDP grew at a solid annual rate of 5 percent and there was rapid supply-side growth in capital investment, labor, and productivity. Significantly, this growth was noninflationary, as annual producer and market-determined consumer price inflation remained stable at approximately 2 to 3 percent, which was perfectly in line with the inflation trends of the 1980s.

Despite the fact that there was no second unification around any corner, Germany's famously independent central bank, the Bundesbank, feared that strong growth would inevitably lead to rising inflation. It strongly opposed the government's apparently too liberal recourse toward deficit spending in coping with the unification challenge. Reputed for its uncompromising inflation aversion, the bank was determined to slow down the economy at any price. Did unification pose any threat of unstable debt dynamics and runaway inflation?

According to my conclusions reached in Public Policy Brief No. 67 (Bibow 2001a), unification did not pose any immediate risk of unstable debt dynamics; the problem of unsustainable public finances arose only with the sharp recession of 1992-93. Also, quite perversely, government measures to reduce borrowing actually caused headline inflation to increase, while market-determined inflation remained remarkably stable.

The 1992 Fiscal Policy U-Turn

Initially, the German government deliberately relied upon borrowing to take up almost the whole of unification's fiscal brunt. Starting with a balanced budget in 1989, the budget swung close to a 3-percent deficit during the 1990-91 period and resulted in an overall budget deficit of DM 87 billion (44 billion) in 1991. The budgetary swing reflected the combined effects of fiscal transfers attributable to unification, previously decided income tax cuts that came into effect in 1990, and revenue increases related to the rise in tax and social security contributions. The initial recourse to borrowing was deliberate. Arguably, the sharp rise in deficit spending in 1990-91 was one aspect of fiscal policy that was both inevitable and not inconsistent with economic theory. The fiscal boost helped to stabilize growth in western Germany at a time when other countries were hit by recession.

Annual fiscal transfers from western to eastern Germany continued on the order of DM 120-140 billion (61-72 billion), roughly 4.5 percent of western Germany's GDP. While, initially, fiscal policy had been flexible, an abrupt shift in policy occurred in 1992, despite the fact that strong economic growth had allowed unification to finance itself in part, and actual financing requirements were well short of fiscal transfers. A stubborn focus on unconditional retrenchment (which continues to describe Germany's consolidation strategy today) was introduced by the government in light of the fiscal swing to deficit. Was the fiscal swing to a 3-percent budget deficit reason for panic?

Certainly the German authorities thought it was. Between 1992 and 1995, a cumulative fiscal tightening occurred (approximately DM 180 billion [Û92 billion] mainly through higher taxes and social security contributions) that was far in excess of initial borrowing requirements (Heilemann and Rappen 1997). Yet public finances deteriorated and resulted in protracted budget deficits and soaring public indebtedness, so that by 1996, Germany's deficit ratio was 3.4 percent of GDP, well above its deficit ratio in 1991. Clearly, something must have gone seriously wrong to produce this glaring fiscal paradox.

The Sustainability Issue

There is widespread concern that today's budget deficit will add to tomorrow's taxes. In a growing economy, however, the income from which to service the debt grows also. The real question is whether debt or GDP grows faster. As long as the public debt grows at a rate equal to or less than the nominal GDP growth rate, and even if the government borrows at a constant annual proportion of GDP each year, the tax burden for taxpayers on account of the debt would not rise. Instead, the higher the growth rate, the lighter the burden of debt. For example, internal consistency of the Maastricht criteria presupposes a 5-percent nominal GDP growth rate, since at that rate an annual budget deficit of 3 percent of GDP leads to a stable debt-to-GDP ratio of 60 percent.

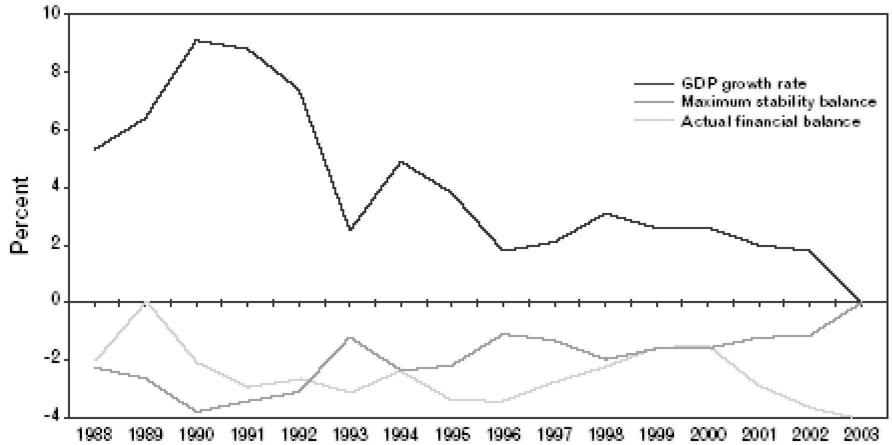
Unfortunately, the strategies of the government and the Bundesbank after unification did not heed the existing favorable alignment among Germany's key economic parameters (interest rates, deficit and debt ratios, and GDP growth rates). As a result, the German GDP growth rate collapsed and never recovered, owing to protracted stagnation of domestic demand. This raises the question, Why has domestic demand been so weak for so long?

Germany's peculiar approach to fiscal policy provides part of the answer. Even though there was no imminent risk of unstable debt dynamics following the unique historical challenge of unification, Germany embarked on fiscal retrenchment at the onset of recession in 1992. Fiscal tightening was not only untimely, but also inexplicably aggressive, relative to Germany's past experience and international standards (Heilemann and Reinicke 1995).

Manifold measures intended to reduce public borrowing were enacted by the government under mounting pressure from the Bundesbank, which argued that cuts in public borrowing were needed to prevent inflation. Paradoxically, rather than preventing inflation, government measures, such as hikes in indirect taxes and government-administered prices, caused further "tax-push" inflation, which drove up headline consumer price inflation and wage inflation. The effect of these measures, therefore, discouraged the Bundesbank from monetary easing and encouraged ongoing pressures for continued fiscal consolidation (Bibow 2001a). In fact, after briefly abating with the long-delayed recovery of 1997-98, public finances have sunk into a far worse state since the 2000-2001 downturn than at any time since unification (*see* Figure 1).

If Germany's fiscal policy had been more in line with economic theory and had followed the best-practices example of the United States, it could easily have achieved a more favorable economic performance in the 1990s. The same can be said of Germany's monetary policy.

Figure 1 Nothing Is Gained If Fiscal Consolidation Crunches GDP Growth: The German Case



Note: Actual financial balances (deficit ratios) less than the maximum stability balances imply public debt sustainability.

Sources: OECD, Economic Outlook no. 73, June 2003; and author's 2003 forecast

Monetary Policy and the Bundesbank

The Bundesbank never viewed the unification challenge as a chance to sustain growth in the context of a weak world economy. The bank viewed unification primarily as a risk to price stability with the threat of runaway inflation. Thus, unification brought the establishment of a tight monetary stance. As significant increases in indirect taxes and administered prices pushed headline CPI inflation up, the Bundesbank further tightened monetary policy in 1991-92. Thereafter, interest rate cuts were extraordinarily sluggish and, until the spring of 1996, fully offset by deutsche mark appreciation. In essence, the monetary condition established in late 1989 remained unchanged over the next six years. As a consequence, capacity utilization plunged with the recession of 1992-93 and remained stuck at severely depressed levels for several years. Rather than counterbalancing the deflationary consequences of procyclical fiscal consolidation, German monetary policy grossly magnified them. This contrasted starkly with the U.S. macropolicy mix of the 1990s (Blinder and Yellen 2002). In fact, it was only because of the "new era boom" in the United States and dollar strength that the German economy recovered somewhat after 1996 (Bibow 2001b).

Contractionary macrodemand policies, not unification, pushed Germany into a situation of unstable debt dynamics. Another striking fact is that the negligible rise in inflation in the beginning of the 1990s was the result of taxation policies that were enacted when the economy delivered robust GDP growth. Market-determined inflation was impressively stable, particularly when compared with the more flexible U.S. economy. A further truly striking fact is that these developments did not prevent the Bundesbank from pushing down headline CPI inflation from its 1992 western German peak of 4 percent to almost zero, while it appears that the U.S. Federal Reserve cautiously tried to avoid pushing inflation below 2 percent (Mankiw 2001).

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As opposed to rapid wage adjustments in eastern Germany, claims of greatly excessive wage increases in western Germany seem unjustified, as they were quite in line with productivity growth and headline inflation at the time, and barely exceeded a reasonable nominal GDP growth trend of 5 percent, even in the early years of unification. Sustained wage moderation in subsequent years helped to offset tax-push inflation and enhance the Bundesbank's anti-inflation credentials and maximize its prestige. It may also have boosted Germany's exports, but at the expense of domestic demand. Over and above the fiscal challenge posed by unification and huge job losses in eastern Germany, the Bundesbank's aggressive and single-minded pursuit of price stability has exacted a steep penalty in terms of high unemployment and low economic growth in western Germany, a penalty that has had stark consequences for public finances.

The Never-Ending Story about Structural Problems and All That

It is always popular to blame Germany's--in fact, Euroland's--malperformance on its allegedly manifold structural problems: a theme that was much in vogue in the 1980s, too. Although Germany's stunning performance around the time of unification put that theme to rest, the structuralist theme reemerged in the 1990s. Alas, this time, no myth-debunking experiment seems likely to occur anytime soon. The exception is that, despite often repeated difficulties in firing, German labor is currently being shed at a rather mind-boggling rate (the country's unemployment rate now exceeds 10 percent). Furthermore, given that German wage inflation has been persistently and significantly below trends in the United States and Europe since the mid 1990s, today's structural explanations focus on nonwage labor costs (*Lohnnebenkosten*). And, indeed, the gap between what workers get paid (consumption wage) and what businesses have to bear (production wage) shows a marked rise since the early 1990s. The trouble with this apparently compelling explanation is that it confuses mere symptoms with the underlying disease: protracted policy-inflicted domestic demand stagnation.

As noted earlier, increases in indirect taxes and administered prices (policy measures intended to stem borrowing requirements and inflationary pressures) had highly perverse effects by forestalling a timely easing of monetary policy. Other austerity measures included hikes in direct taxes and social security contributions as well as cuts in public investment. While cutting public investment spells long-run troubles for productivity growth, hiking direct taxes and social security contributions, apart from crushing disposable incomes and hence domestic demand, directly causes what is popularly referred to as "structural problems" (rising nonwage labor costs and disincentives to work and hire). These unpleasant supply-side by-products of contractionary demand policies lead to a vicious cycle of stagnation and fiscal squeeze.

Currently, and to much applause from the European Commission and the European Central Bank, "structural reforms" are under way in Germany. For instance, to halt the rise in nonwage labor costs, unemployment benefits and their duration will be reduced, while firing may be made easier too. Whatever the long-run supply-side effects under favorable economic circumstances, the immediate demand-side impact of such measures under today's recessionary conditions is clear-cut. In fact, the primary motive is to reduce public borrowing. As such, these structural reforms are part of yet another fiscal austerity package that is no different from all previous procyclical consolidation attempts since 1992. And further unconditional fiscal tightening is in the pipeline for years to come. 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.

Contrary to much excitement in the media of late, even if the government's latest plan--to bring forward by one year an income tax cut originally scheduled for 2005--finds parliamentary approval, this plan would not imply any fundamental shift in policy. The so-called tax cut, which mainly benefits the well-off, would be financed by offsetting cuts in subsidies and other expenditures (including public-sector wage cuts across the board), so that any net fiscal boost would be minimal at best. In fact, given that all budgetary planning for 2003-05 is still based on growth assumptions that look increasingly optimistic, the risk is of further contraction of disposable incomes by way of a new round of discretionary hikes in social security contributions and emergency savings throughout the public sector. This event might finally be sufficient to push Germany off the cliff edge and make the budget deficit rise further still.

According to economic theory, demand-side policies have only short-run effects, regardless of whether they are pursued skillfully or ineptly. Perhaps Germany's experience with persistently theory-hostile demand policies might invite some reflections on this conviction. Policy-making 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. 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.

To Follow or Not to Follow Germany's Lead: The Maastricht Regime in Crisis

A relevant concern today is that Germany is no longer in control of its macroeconomic policy tools. Monetary policy is under the control of the ECB rather than the Bundesbank, while Germany's fiscal policy is also constrained by the SGP in important ways. The Economic and Monetary Union (EMU) has fundamentally changed Germany's position and policy options. So far, Germany has been successful in underbidding its trade partners' wage inflation trends, improving its external competitiveness at its trade partners' expense, and creating internal trade imbalances within Europe. Unfortunately, this strategy has also left Germany with an inflation rate more than one percentage point below the Euroland average and, accordingly, with higher real interest rates. Given that the German inflation rate is close to zero, the ECB's remaining room for cutting nominal interest rates may prove insufficient and come too late to stop the German economy from slipping into a deflationary spiral--hence the

IMF's high alert. The question that arises here is whether or not Euroland could provide enough counterweight if Germany is pushed off the cliff edge.

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There is the equal chance that Germany could pull the rest of Euroland down with it. While inflation may still be somewhat higher in France and Italy, their fiscal positions are not fundamentally different from those of Germany a little while ago. They, too, are under pressure for additional procyclical consolidation. In terms of economic weight, the "big three" make up approximately three-quarters of Euroland's economy. Politically, however, the majority of smaller countries cling to the view that they still have some fiscal margin left because they have abided by the rules of the SGP. It is one thing when coordination of national fiscal policies is hampered by an apparent conflict of interest, but quite another when the kind of independence enjoyed by the ECB allows it to play a game of chicken with finance ministers. In fact, proclamations by the ECB seem to suggest that central bankers stand ready to inflict further punishment should finance ministers stray from what the ECB views as fiscal prudence--the basis, supposedly, of the euro's stability. One may contrast this situation with the smooth cooperation among U.S. fiscal and monetary authorities in response to the 2000-2001 economic downturn in America.

Essentially, the Maastricht regime is forcing upon Euroland those very policies that have wrecked Germany, the originator of that peculiar EMU regime. In the name of stability and growth, Euroland's finance ministers continue to experiment with procyclical consolidation attempts at any price. And because their declared sole goal is price stability, Euroland's independent central bankers notoriously fail to play the accommodative part that would be necessary to make their consolidation efforts successful.

Although some observers appear to appreciate the role of independent central bankers in dictating structural reforms to Euroland's democratically elected representatives, domestic-demand stagnation is the unsurprising consequence of this policy mix. And with unemployment on the rise again (and quickly declared structural by the ECB) there is the clear risk that the fiscal squeeze might turn into a vicious cycle, as has occurred in Germany. Interestingly, the ECB (2003) estimated that price effects due to indirect taxes and administered prices (tax-push inflation) may have at times added a little less than one-half of one percentage point to headline CPI inflation in Euroland between 1999 and 2002. This may sound trivial given that headline CPI inflation was only a little above 2 percent in recent years anyway. In view of the ECB's strict definition of price stability (inflation below 2 percent), however, this trivial amount played perhaps a crucial part in preventing the ECB from a more timely easing of interest rates in response to the 2000-2001 economic slowdown, even if domestic demand management (as understood by the bank) is not the ECB's business. But, then, whose business is it?

Global Imbalances: Shake-up or Implosion?

Massive fiscal and monetary policy stimulus measures were undertaken in the United States in response to the 2000-2001 global slump. These measures quickly pushed the nominal GDP

. . . the ECB continues Bundesbank traditions of benign neglect . . . .

growth rate above 4 percent and longer-term nominal interest rates below 4 percent, which, among other factors, has kept the U.S. interest burden in check. By contrast, recovery of the Euroland economy (approximately 70 percent the size of the U.S. economy) was not only frail and negligible in 2002, but also mainly export-driven as domestic demand merely stabilized at a depressed level (Bibow 2003). While net exports shaved more than one percentage point off the U.S. GDP growth rate in 2002, they were the source of roughly three-quarters of Euroland's negligible GDP growth.

Despite all this, the ECB has a penchant for referring to important imbalances "elsewhere in the world economy" that seem to hinder growth in Euroland. Strongly disapproving of the nonstability-oriented policies in the United States that have so far kept the world economy afloat, the ECB continues Bundesbank traditions of benign neglect of stagnating domestic demand and the habitual declaration that all unemployment is "structural" and, therefore, beyond its reach and duty. Germany may have been burdened with "structural" unemployment and become exclusively reliant on export growth, but these factors were not detrimental to the prestige of the Bundesbank.

Today that notorious free-riding strategy blocks one possible route to rebalancing global current account imbalances--that is, having Euroland's domestic-demand growth outpace that of the United States. Another possible route is via exchange-rate readjustment. Since April 2002 the euro has fully reversed its previous plunge against the dollar. U.S. authorities have signaled to the markets that this development was not unwelcome, particularly as the Fed's apt management kept bond markets calm in spite of the sea change in U.S. fiscal policy since 2000 (the U.S. budgetary swing as a percent of GDP has been approximately double that experienced during German unification).

From Euroland's perspective, euro appreciation has amounted to a significant tightening of monetary conditions, as the euro's rise has more than offset the ECB's "too little, too late" cut in interest rates (in contrast to the ECB's panicky hikes in 2000, which fostered the euro's earlier plunge in value [Bibow 2002]). Once again, the ECB's benign-neglect communications style appears to invite another one-way bet for the euro. Today, however, economic recovery in Euroland is no longer just an uphill struggle against a strengthening currency. Owing to the ECB's continued wait-and-see stance, a recovery is currently hampered by such major domestic headwinds as rising unemployment, an SGP-imposed fiscal squeeze, and some banking problems. Other important upshots are that dollar depreciation may fail to give U.S. growth much of a boost, and the world economy is unlikely to gather much speed when the main engine is sputtering and two brakes are being applied to world economic growth.

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