

## After the Election: Germany Will Continue to Obstruct Global Economic Rebalancing

*By Sebastian Dullien*

*Over the past years, Germany has been one of the main causes for global imbalances and has not been very constructive in global economic cooperation. No matter who wins the upcoming elections, this obstructive stance will unfortunately not change.*

Global imbalances have often been quoted as one of the underlying reasons for the current financial and economic crisis. As parts of the world experienced extremely weak growth of domestic (and especially consumer) demand in the years after 2001, the U.S. was faced with an uncomfortable choice: Either monetary and fiscal authorities would try to expand domestic demand at home, thus mopping up excess savings in the rest of the world, or aggregate global demand would fall short of supply and unemployment would increase not only in the U.S., but also in the rest of the world. As we know, with a broad mandate including not only price stability but also high employment, the U.S. Federal Reserve chose the first option. It kept a very accommodative monetary policy stance and thus contributed to the credit over-expansion in the U.S. which is now corrected in the crisis. This imbalanced pattern of growth was reflected in large current account deficits in the U.S. and large current account surpluses in the countries with comparably weak domestic demand, such as Germany, Japan, and China. The U.S. had, in short, become the world's "consumer of last resort" which with its own demand kept the world economy ticking.

While China has featured heavily in the public debate on economic imbalances in the U.S., Germany has contributed almost as much to the global problem. Hitting a peak of \$250bn in 2007, Germany's aggregate current account surplus was not much smaller than China's. In the years from 2002 to 2008, Germany accumulated a total surplus of \$788bn while China accumulated a surplus of \$934bn and Japan a surplus of \$968bn. Those three countries (accounting between them for almost 22 percent of global GDP, roughly as much as the U.S.) have thus to be seen as the main culprits with weak domestic demand.

Consequently, a reasonably soft global rebalancing would not only require a solution of the U.S.-China dispute on the bilateral trade deficit and the Renminbi exchange rate, but also a solution of Germany's large surplus. Especially from a European perspective, this problem is pressing. After the housing boom and bust in Spain, a large part of southern Europe looks dangerously overvalued, as do the Baltic countries. If we go by the sad precedent of Portugal, Spain might be on track for a decade of economic stagnation. While productivity and real wages in these countries are still quite far away from the German level, nominal wages have increased strongly, which leaves unit labor costs at a level at which these countries are no longer overly attractive for production compared to Germany.

Part of this is the mirror image of the improvement in Germany's competitiveness. Since there are no nominal exchange rates within the euro area, the improvement in price competitiveness in Germany has directly translated into a real depreciation for Germany and a real appreciation for the rest of the European Monetary Union as well as for countries with a currency peg to the euro (such as parts of central and eastern Europe). This has increased Germany's surplus as well as the southern European

- How have German economic policies contributed to the global trade imbalances seen today?
- Could a different approach have softened the impact of the economic crisis on export-dependent Germany?
- Will the economic debate change after the federal elections?

countries' deficits.

Yet the rest of the world cannot discount Germany's large surplus as a purely European problem. If over-indebtedness in some European countries permanently hampers economic growth in Europe, this will reflect on the rest of the world, especially as the U.S. is not in a position to play global growth engine anymore. Europe can only contribute to global demand growth to its potential if domestic demand in Germany is increasing at a higher pace than in the past—a process during which its surplus would surely shrink and its relative price competitiveness would deteriorate at least slightly.

However, German politicians have been not very open to this line of argument even though it has become a very important issue of debate in other European countries, such as France. In the German public debate, unemployment was for a long time almost exclusively explained by a lack of competitiveness even when the country was already running large external surpluses. Consequently, for much of the past decade, economic policy was aimed at improving price competitiveness. The "Hartz" labor market reforms of the second Schröder government increased the already existing downward pressure on wages by increasing the workers' fear of unemployment and thus further weakening the unions' bargaining position. In addition, by stepping up the work requirements for recipients of welfare payments, they increased the supply of low-wage workers, lowering wages at the low end of the pay scale. As there is no legal minimum wage in Germany, wages fell as low as €3 to €4 an hour in the east. Since the beginning of the decade, low public pay raises also contributed to a stagnation of wage incomes. Reforms in the social and tax systems were always discussed under the heading of "lowering excessive labor costs."

Although the Grand Coalition did not continue labor market reforms along Schröder's "Hartz" line, they continued the strategy of improving German cost competitiveness: When they increased the value added tax (VAT) in early 2007, they used parts of the revenue to lower employers' contributions to the unemployment insurance. This move lowered labor costs for exporting firms while it made imports more expensive, further improving German price competitiveness relative to its European partners and increasing Germany's surplus.

While some of the reforms might have had their merits in making markets work more smoothly, all these policies have contributed to weak domestic demand and soaring exports and thus have contributed to global imbalances. These policies lowered real disposable income for the vast majority of German households, thus weakening domestic demand and lowered production costs to German firms, thus increasing their sales abroad. Similar to the exchange rate policies of the years between the two world wars in the first half of the twentieth century, German economic policy over the past decade can thus only be described as a beggar-thy-neighbor policy.

Even in this current crisis, Germany proved for a long time rather uncooperative when it came to contributing its share to counteracting the downturn. While the fiscal and external position in 2008 put Germany in an excellent position to run a counter-cyclical, expansionary fiscal policy, the German government was for a long time outright hostile toward that idea. Even as late as September 2008, when European partners begged Germany to work together on a coordinated stimulus package, the German finance minister Peer Steinbrück discounted the crisis as "mainly a U.S. problem" and rebuked any demands for fiscal stimulus.

Even now in German debates, after the government has made a U-turn on fiscal stimulus, officials from the finance ministry are still regularly making the point that a problem of any stimulus package is that a lot of the demand created will drain off to other countries. They thus completely deny the notion that some of the demand created in

Germany has to go to other countries in order to correct the global imbalances.

This strange stance has often also been reflected in Chancellor Angela Merkel's remarks on the crisis. She has repeatedly voiced criticism of the profligacy of the Anglo-Saxon economies and has resisted on the vices of a "Swabian housewife" who would not take on debt but would save first to possibly make purchases later, but at least to have a nest egg. At least until the whole impact of the crisis on the German economy became clear in late 2008, more than once the message was: The problems in the rest of Europe and in the rest of the world are that they have not behaved as prudently as the Germans, who have cut their wage costs and cut their public expenditure and now have these nice large surpluses as a cushion.

One famous financial journalist from abroad put it very nicely at a private dinner party a few weeks back in Berlin: Germany seems to be the only country where politicians do not understand that on a global level, trade deficits and trade surpluses have to add up to zero.

Even if one takes into account German interests, the distaste for international policy coordination in the current crisis can only be called irrational, as coordination might have helped Germany to weather the storm better than it now did: The brutal German downturn is mainly due to the contraction of export demand. An internationally coordinated response to the crisis could have helped stabilize economic activity abroad and could thus have helped to stabilize import demand abroad and consequently export sales for Germany. The advantage of a coordinated approach would have been that the protectionist measures now in some of the packages (like the "buy American" provision) could possibly have been avoided. Germany (along with Japan and China) as one of the world's largest exporters would probably have profited from such an approach most.

Unfortunately, the German debate and policy stance on global economic coordination as well as Germany's role in global imbalances is not likely to change even after the general election on September 27. Only two coalition options seem realistic given current polls and the parties' positions: Either Angela Merkel will be able to form a coalition between her Christian Democratic Union, its sister party, the Christian Socialist Union (which I will in the following refer to as one party under the heading Christian Union) and the Free Democrats. The alternative is that the Grand Coalition will continue. All the other options which would be in principle thinkable are extremely unlikely to materialize: The Greens have made a decision not to go into a three-party coalition with the Christian Union and the Free Democrats. Even if the Christian Union would have the option to rule with the Greens alone, both parties would be highly reluctant to enter into such an agreement as most of the rank and file of the two parties have strong aversions toward the other party. And after the debacle in Hessen, the Social Democrats will not take any risks and will not collaborate with the Left Party on a federal level.

Under both likely coalition outcomes, there will be no change for the better in the macroeconomic debates. If the Grand Coalition continues, the debates, the focus, and the policies of the government are not very likely to change as the same key policymakers will remain in office. Such a coalition might pass some minor tax cuts, but there would be no major policy shift and especially no shift toward a less export-oriented economic policy approach. The muddling-through in economic policy will just continue.

If the Christian Union enters into a coalition with the Free Democrats, there probably will be more tax cuts, as tax cuts are the main campaign issue of the Free Democrats and the Christian Socialist Union has also pushed for tax cuts for a long time. However, the approach toward global macroeconomic imbalances and international coordination will not change. If this is possible, the Christian Democrats have absorbed the cost-cutting logic more than the Social Democrats and the Free Democrats will be happy if labor

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costs can be cut as small business are a part of their constituency.

Even the new tax cuts from a conservative/liberal coalition would most likely not lead to more domestic demand. Given the already large deficits and the ideological aversion of large parts of the Christian Union against increasing government debt, it is very likely that such a coalition would try to make cuts in public expenditure to at least partly offset the costs of new tax cuts. Depending on the magnitude and specific details of tax and expenditure cuts, the net effect on domestic demand might even be negative.

Beyond these ideological considerations, there is now one very important factor that will hinder the next government in using fiscal policy in a way to support global rebalancing and try to kick-start Germany's underperforming domestic demand: the Bundestag just voted in late May to include a new budget rule into the Basic Law, the so-called "*Schuldenbremse*." According to this rule, the German federal level will only be allowed to have a structural deficit of 0.35 percent of GDP from 2016 onward. The German *Länder* will not be allowed any structural deficit from 2020 onward.

This means that the German constitution now forces a very harsh austerity stance on Germany for the coming years. Most recent forecasts include a structural budget deficit for 2010 of 4 to 5 percent of GDP. If the government wants to bring this down into the range of constitutionality before the end of the transition period, it would have to start rebalancing its budget very soon. As most of this structural deficit is now at the federal level and has thus to be all but eliminated by 2016, one can expect an extremely tight fiscal policy over the coming years. In order to reach this target, a consolidation effort of about 0.8 percent of GDP is needed each year from 2011 onward. Should there be more need for stimulus in 2009 and 2010 than forecast so far, the necessary consolidation effort will have to grow accordingly.

Both Social Democrats as well as Christian Democrats can be expected to try to stick to the rule. Even though a significant share of Social Democrats actually opposed the *Schuldenbremse* in principle, only nineteen of the SPD parliamentarians voted against the constitutional amendment. One of the arguments was that it would look as if the Social Democrats are in favor of even more debt if they vote against the proposal so late in the law-making process and that this would not fare well in the general election. Once the rule is there, they will try not to be labeled as the party that violates the constitution. Even if the rule will prove impractical and might be changed in the future (as has been the case with the European Stability and Growth Pact, which was supposed to limit public deficits at a EU level), it will take some years before the failure becomes evident. Up to then, Germany will again try to be more austere than the rest of the world.

German politicians have long lacked the understanding of the important issue of global imbalances. Now they have even given away some tools to support global rebalancing. The rest of the world needs to be prepared that the third (or fourth, depending on the estimation) largest economy will not be very cooperative for resolving pressing international macroeconomic issues over the next years.

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