Germany's Fiscal Contraction: Less Than Meets the Eye?

Jacob Funk Kirkegaard argues that reports of a drastic fiscal consolidation by Germany are exaggerated—and the cries of alarm in the United States may be overstated.

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Steve Weisman: A worldwide debate is going on about how quickly governments, especially in Europe and the United States, should proceed toward fiscal consolidation. This is Steve Weisman at the Peterson Institute for International Economics with Jacob Kirkegaard, research fellow, who's been writing about this especially from the European perspective. Jacob, thanks.

Jacob Kirkegaard: My pleasure.

Steve Weisman: The apocalyptic version of this holds that the Europeans are heading toward the exit of their stimulus programs—led, of course, not only by the Southern European countries but by Germany. Are the fears exaggerated?

Jacob Kirkegaard: I certainly think that there was a lot of exaggeration going on, just tied to the G-20 Summit. Something quite extraordinary happened [in Toronto]. The Chinese rhetorically declared their willingness to change their exchange rate policy. So the expected big clash between the Obama administration and the Chinese did not materialize. Quite naturally, in my opinion, the media particularly started looking for the next flashpoint, and that became the transatlantic clash on fiscal policy. But I think if you look at the actual data and what is actually in the pipeline on austerity in Europe, and particularly in Germany, it was inflated.

Steve Weisman: You mean the reports of Germany consolidating or reducing its budget were exaggerated?

Jacob Kirkegaard: Yes. Part of this was the German government's own fault because they came up with a headline saying: "Germany is going to do €80 billion of austerity up until 2015." But in reality that number is double counting. The actual austerity to be implemented in Germany over that five-year period is only €26 billion worth of austerity measures. A nontrivial part of that number is actually of, shall we say dubious austerity quality. Two billion of that, for instance, is supposed to be revenue coming from the introduction of a financial transaction tax in Germany. Of course everyone knows that nobody can impose a financial transaction tax unilaterally.

Steve Weisman: Because transactions will just migrate to another location.

Jacob Kirkegaard: Yes, they'll just migrate somewhere else. So, in reality, the German austerity measure is far below what meets the eye. But in a sense, you could say that the German government itself was guilty of a communications disaster by basically publishing this very large headline number that was obviously picked up by the media. Clearly had it been true, it would have been much closer to this apocalyptic vision of the Europeans basically sort of saving themselves into a double-dip recession.

Steve Weisman: But I wonder if the politics are actually rather different. Chancellor Merkel is more interested in reassuring her German electorate that she's taking these strong steps. What you're saying is that a politically mishandled communication might have actually been well-handled from her domestic point of view.

Jacob Kirkegaard: I think you're absolutely right. I mean, the fact that the German government chose to go with the double-counted—in many ways, inflated—number for the austerity package was clearly a reflection of the, shall we say, political mood in Germany right now, which clearly is one of, "We need to do belt-tightening, we need to basically save so that we can overcome this economic crisis."

I think one frequently overlooked aspect of this is that in the German debate, there is a very clear political link between the acceptance by the German government of the first agreed bailout and then the larger European financial stability facility, which in the case of Germany represents a potential commitment in excess of $230 billion if you add both the Greek program and the subsequent larger stability facility together. And the commitment clearly is there, [but Germans feel] well, okay, we have made this commitment—even though it's contingent and it's not actual expenditure—we really have to make sure that we put our own house in order.

And then they've also previously put in place in 2009 a balanced budget amendment that basically compels the country to run balanced budgets—in 2016 at the federal level and then 2020 at the state level—. Again in my opinion [this] is a reaction partly to the economic crisis and partly to the fact that Germany is facing a significant or accelerating demographic decline.

Steve Weisman: What is the demographic decline?

Jacob Kirkegaard: The German labor force is shrinking. The German population is aging very rapidly, and the population as a whole is going to start declining quite significantly. So what this means is something that's frankly quite alien to the American political debate, that America is always a growing nation, [with] its progress, its optimism, etc. I mean, these austerity programs and the German political debate really are a sort of internalization in my opinion of the idea that this is not something that we can grow our way out of. We basically have to do the savings to be able to afford all these things. Growth is not a realistic option in and of itself, which is something quite fundamentally different.

Steve Weisman: Except through exports.

Jacob Kirkegaard: Well, except through exports but even exports are only going to get them so far.

Steve Weisman: Right.

Jacob Kirkegaard: But again, I mean, that really separates the whole sort of German debate from what you are seeing in the United States at a very sort of fundamental concept.

Steve Weisman: Another fundamental aspect is the psychological factor addressed by Paul Krugman in the *New York Times* column where he quoted Jean-Claude Trichet, the head of the European Central Bank, as taking the traditional view that governments getting their own house[s] in order has a psychological effect on the population, on the citizens, that they will then spend and behave like good consumers and spenders because they have this feeling that the government is getting its house in order. I don't know that this applies to the United States.

Jacob Kirkegaard: No, I certainly don't think it applies to the United States. But I am much more sympathetic than Paul Krugman to this view that when you are faced with some sort of national perception that you are in decline, your numbers are shrinking and therefore growth is not an option, you will be reassured by the government taking the sufficient corrective actions. And these kinds of Ricardian equivalence arguments that German consumers are not going to spend more today because they know that they'll be taxed in the future, I really do think that there is a lot of truth in that in the case of Germany. And this is certainly the belief of the German government and part of the reason why they are conducting or they're implementing the kind of policies that they are.

Steve Weisman: But again, to conclude, those policies are not bringing the wrenching change fiscally that the media sometimes suggest?

Jacob Kirkegaard: Oh, no. I mean, this is not going to be a gutting of Germany as we know it. It is not the equivalent of the programs that we're seeing in Greece. Because in Greece it's going to be the end of the Greek social model as we know it. That's probably in many ways a good thing, but that's not what's happening in Germany. It is in fact a much more modest, gradually phased-in withdrawal of fiscal stimulus. So in that sense, again, the media picture of this has been vastly exaggerated in my opinion.

Steve Weisman: I'm shocked.

Jacob Kirkegaard: Yes.

Steve Weisman: Jacob, thanks.

Jacob Kirkegaard: My pleasure.