PIIE Debate: Germany's Role in Europe, Part II

Jacob Funk Kirkegaard and Edwin M. Truman say Germany needs to accept more inflation to help others in Europe, but the difficulties of such a step are formidable.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics with Ted Truman and Jacob Kirkegaard talking about Germany's role in the past, in the last few years in the Euro crisis. We just concluded Part I with Ted Truman discussing German, no doubt, reluctance to undertake more inflation to bring the total inflation rate up in the euro area. Jacob Kirkegaard, looking forward now that Chancellor Merkel has been re-elected, is there any possibility of Germany entertaining such an initiative?

Jacob Kirkegaard: I think the short answer is, unfortunately, no.

Steve Weisman: Why is that unfortunate?

Jacob Kirkegaard: I would agree with Ted that from a perspective of euro area rebalancing Germany running substantially higher inflations than the ECB's two percent or below target would be easier. I don't have any doubt about that.

Steve Weisman: What would Germany have to do to generate that level of inflation?

Jacob Kirkegaard: That's the problem. Generating inflation in Germany I think is not going to be very easy, because you're dealing with an economy that has had an essentially stable household savings rate for the last 40 years. Basically the German savings rate compared to savings rates in other countries is essentially noncyclical. You moreover have the lowest home ownership ratio among the industrialized country except Switzerland I believe, and you have very low levels of financial asset ownership among the German population. This is a country in which wealth effects basically don't exist or are very, very difficult to generate.

Steve Weisman: Explain what you mean by wealth effect?

Jacob Kirkegaard: I mean the effects to generate or create consumption in Germany by, for instance, a rise in the stock market, a rising in housing prices. It's very, very difficult to do. So the kind of scenario that we to some extent have had here in the United States or in other European countries, these measures basically, in my opinion, won't work in Germany.
And therefore even if—and this is obviously hypothetical—the German government wanted to create more inflation without getting personal consumption increases substantially in Germany, that will be very difficult. Germany actually suffers from an even more acute version of the lack of investment from the corporate side that we have also seen here in the United States.

And it is therefore quite difficult, again I would say from the perspective of even a willing German government to force German businesses to begin to invest more. Of course they could begin running very large fiscal deficits and thereby create an inflationary boom. But even if they did that, -- they would obviously never do it -- I think it would be very difficult to do unfortunately.

Steve Weisman: Yes, Ted.

Ted Truman: Two things, least in principle, could be done. Without running large fiscal deficits, they could have more in the way of investment tax credits or something like that to stimulate investment, some degree of fiscal stimulus. It would add to inflation through the aggregate demand channel which exists in Germany as well as elsewhere. And then the third area where one could imagine things happening would be in the area of wages in general.

Now Jacob will, I think, comment and should comment on what he thinks is going to happen in terms of the new minimum wage provisions. They are pretty complicated in the new agreement between the three major parties, and whether that will have a tendency to raise incomes.

But one could argue that to some extent stimulating income is presumably the easiest way to stimulate consumption. And thereby on the savings and investment side, to some degree, as well as on the relative bright side, [stimulating income] makes a contribution to correcting the imbalances within Europe and sustaining growth. To the extent that your intra-European imbalances have been reduced and the periphery countries, many of which are now in overall surplus, it's been a surplus that has been driven by contraction and it's a cyclical surplus rather than a secular surplus.

Steve Weisman: Ted before we conclude with the final comment from Jacob, what is your sense of growth prospects in Europe?

Ted Truman: I don't have a forecast. My fear is that over the next several years you're going to have a continued slow growth in the euro area as a whole, maybe 1 to 1 ½ percent real growth in the euro area as a whole. They may be slightly over that, but they have a lot of slack and you have to run 2 ½ to 3 percent or 2 ½ percent for several periods of time in order to absorb that slack. So my concern is that they'll be trapped in a very slow growth syndrome and that will feed on itself and may feed on the political economy of all the countries, Germany included.

Steve Weisman: Jacob, how much should Germany take responsibility for generating growth in Europe as a whole, and how much do you think Chancellor Merkel feels that responsibility?

Jacob Kirkegaard: Germany is today the undisputed political and economic leader of Europe and the euro area. That alone, of course, in my opinion should instill a certain responsibility in Angela Merkel. And I think actually to some extent that Germany is more of a locomotive to parts of the euro area than is often assumed. If you look at the German trade relationships with its neighboring countries in Northern Europe—Poland, the Czech Republic, Slovakia, Hungary, the Scandinavian countries, the Netherlands, etc.—most of these countries actually have a trade surplus with Germany.

Basically they provide intermediate goods into German industry that then uses those inputs to create exports sold outside the euro area.

In that sense Germany is actually more of a locomotive than often assumed. The problem of course is that this does not necessarily help those countries that are not part of these intra-European supply chains.

I think that there is room in Germany for higher wage growth. I agree with Ted that the new coalition agreement in Germany was disappointing in its commitment to increasing public investments. It's only about point 2.5 percent of GDP. I think you could have gone significantly more because the reality is that general government investments in Germany is running at only about half the levels that you see in comparable countries like France or the Netherlands. So Germany could afford and should for its own sake actually increase public investments.

Unfortunately, while I agree in principle that raising wages and income is the best way to increase consumption, I don't think that it is actually going to be that easy. One of the things that Germany is often criticized for is that it has had these very low increase in the so-called unit labor costs, whereas in other euro area countries, the unit labor costs have increased dramatically since the euro was introduced. The problem is that from a normative point of view, you actually want unit labor costs to be relatively stable. You would want wages to increase in line with productivity. And that's actually by and large what has happened in Germany where you have very decentralized wage setting today.

So even if the German government wanted to raise wages, they couldn't just go out and tell industry to raise wages significantly above inflation, because it is something that is dealt with among the social partners. And Germany, unlike other euro area countries where wages since 1999 have clearly outstripped productivity, has actually had labor market institutions that actually have been quite effective at creating the same level. So that too would be problematic.

Then the question is, "What effect will the minimum wage have?" I think the minimum wage, when properly phased in -- meaning that you should give time which the coalition agreement allows for – and I also think you should be careful with implementing a minimum wage that is designed for basically West German circumstances, because it's going to affect East Germany disproportionately, is going to be certainly affordable for Germany. But I think the reality is that it's not going to have much of an impact, for instance on German wage competitiveness in the manufacturing sector. In the manufacturing sector wages are already above eight-and-a-half euro, which is the new minimum per hour.

So it's really a measure that is politically astute by Angela Merkel and has the right social intent. But it is not going to do unfortunately very much to reduce the German external surplus or for that matter the ongoing imbalances in the euro area.

Steve Weisman: OK, Jacob and Ted thank you very much.

Ted Truman: You're certainly welcome.

Jacob Kirkegaard: Thank you.