Germany's Unsustainable Growth: Austerity Now, Stagnation Later
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With the euro in crisis, Germany has come to seem like a lone island of fiscal stability in Europe. Its debt levels are modest, its government bonds are safe havens for investors around the world, and it has avoided the kinds of private credit booms and housing bubbles that have destabilized the rest of the continent. The German economy, fueled by record exports, has grown steadily, expanding by a quarter over the last decade.

But beneath the glowing headlines lies a darker story: Germany's economic position is simply unsustainable. For starters, much of its trade surplus has been earned at the expense of the corresponding current account deficits of the European countries in crisis. At the same time, this outsized surplus goes hand in hand with major imbalances within Germany's domestic economy. German businesses have invested their profits abroad, helping finance foreign imports. Meanwhile, as German money has flowed out of the country, domestic investment has languished at unprecedentedly low levels.

Germany, like other rich, polluting, and aging countries, faces enormous long-term challenges. Its workforce is shrinking, its energy sector needs to be remade, and its public infrastructure has gone too long without improvement. For all the talk of its financial strength, Germany has so far squandered the opportunity to secure long-term economic growth by addressing these challenges through badly needed domestic investments.

The financial conditions for such spending have never been more favorable: interest rates for public borrowing are approaching zero. And yet due to a 2009 constitutional amendment requiring both the federal and the state governments to maintain balanced budgets, the German public sector has denied itself the opportunity to borrow and invest. To make matters worse, rather than try to extricate itself from this self-inflicted trap, Berlin is insisting that the eurozone as a whole adopt this model, in the form of the European fiscal compact, a treaty that will mandate balanced budgets across the continent.

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That Germany is seeking to fashion the rest of Europe in its own image makes it all the more urgent to understand the fault lines that underlie its economic model.

**Austerity Starts at Home**

Germans are tempted to see the huge trade surplus they have enjoyed since 2000 as a return to the glory days following World War II, when West Germany rose from the rubble and "Made in Germany" first became a byword for quality. But the historical analogy is flawed. It is true that in the 1950s and 1960s, Germany sustained current account surpluses, which meant, as today, that the country was exporting capital. But in the postwar decades, the drive for domestic investment was huge. German household savings and public budget surpluses were large enough to sustain both a current account surplus and a roaring domestic reconstruction. These days, by contrast, the country is investing abroad rather than at home. In this sense, today's surplus is not a vindication of the tried-and-true postwar German growth model but a sign of its decomposition.

Since the millennium, net investment in Germany as a share of GDP has been lower than at any time in recorded history, outside the disastrous years of the Great Depression. The German corporate sector has invested its more than ample profits, but it has done so outside the country. The effect of this flight of private money has been compounded by Berlin's campaign to enforce balanced budgets, which has prevented meaningful investment on the part of the public sector.

For years, the depreciation in the value of Germany's public assets has outstripped new investment. In 2011, in towns and regions across the country, 100 billion euros' worth of needed public investment was backed up. Although Germany often flaunts its environmentalist credentials, the country's investment in a "green" stimulus from 2009 to 2012 was dwarfed by those of the United States and South Korea, not to mention that of China. Even though the German population is rapidly aging, the government has underinvested in human capital. According to Germany's most recent national report on education, its spending on primary and secondary education remains below the average for Organization for Economic Cooperation and Development (OECD) countries. German universities, which were the great intellectual powerhouses of the nineteenth and early twentieth centuries, now languish in mediocre places in international rankings. The 2011 Academic Ranking of World Universities, compiled by Shanghai Jiao Tong University, placed only six German universities in the top 100, with the highest-ranked German university 47th on the list. Over the last decade, as capital poured out of the country at rates of six to eight percent annually, Germany loaned far more to foreigners to buy German goods than it spent on the education of its own children. In short, Berlin may have secured a dominant place in Europe, but it has not made adequate provisions for the future.

Fortunately, although Berlin remains largely reluctant to consider the downsides of its export-driven growth strategy, German politicians, business leaders, and voters are starting to realize that the country's low level of domestic investment is a problem. Chancellor Angela Merkel and her government are often criticized for being too conservative and small-minded, but in recent years, they have...
come to understand that they must direct investment toward addressing Germany’s looming demographic shift and toward making the country a world leader in clean energy. Even in the face of the euro crisis and domestic political squabbles, these long-term imperatives continue to preoccupy the German government. Berlin has developed elaborate blueprints for national programs of investment in child care and energy, the costs of which will add up to hundreds of billions of euros.

These plans seem to be precisely the kind of stimulus that Merkel’s critics have been calling for. But because her government is constitutionally barred from increasing the public debt, she has no clear way to make them a reality. Her administration discusses the investment plans in vague generalities, without specifying exactly who will pay for them. With borrowing off the table, Berlin must be hoping either that the money will come from relentless cuts in public-sector spending or that a massive revival of private investment will address the country’s needs. The first possibility—that Germany will fund the investments by reallocating public-sector resources—would entail unnecessary pain. The second option—renewed private-sector investment—seems like wishful thinking given the lackluster corporate investment of the last decade and the prospect of far greater economic and political turbulence ahead. Unfortunately, then, Germany looks as if it will continue down an unsustainable path.
SENSIBLE PRIORITIES

Investment is needed, first, to prevent the German workforce from being hollowed out. Germany’s birthrate is low—in 2009, only three other countries in the OECD had fewer babies per woman—so its population is shrinking and rapidly aging, leaving a smaller workforce and a diminished tax base. This demographic shift will disrupt the balance between net contributors and net recipients within the country’s pay-as-you-go social insurance system, an inter-generational bargain that dates back to the 1950s.

One potential fix would be increased immigration, and Berlin has stepped up its efforts to recruit foreign workers. But the large-scale guest-worker programs of the 1960s and early 1970s, which brought immigrants in droves from Turkey and Europe’s Mediterranean periphery, carry a mixed legacy. Already, 35 percent of new children in Germany are born to immigrants, placing strains on an educational system that still has no coherent strategy for teaching German as a second language, let alone maximizing the potential of all students. Despite considerable attempts to integrate these immigrants, Germany remains uneasy about multiculturalism.

Another way to bolster the German workforce would be to enact child-care policies that would make it easier for women to raise children while pursuing careers. A major obstacle to such policies has been the conservative political culture of the Christian Democratic Union (CDU), Germany’s dominant political party for much of the last 60 years, which tends to disapprove of mothers working outside the home. The incorporation of formerly communist East Germany in 1990 helped cause these attitudes to shift, as it introduced to the country the experience of a radically different model of state-financed child care. Despite persisting and fierce resistance from the conservative wing of her party, Merkel has sought to continue to bring mothers into the workforce by building a comprehensive, high-quality child-care system that will cover all children up to the age of six. Between 2006 and 2011, Germany created 230,000 new places for preschool students, and local governments now face the challenge of creating a further 260,000 places by 2013. The bill for this project will come to billions of euros.

Even more imposing a challenge is Merkel’s proposal for an Energiewende, or energy transformation. Following Japan’s Fukushima nuclear disaster in 2011, Germany resolved to close all its nuclear plants by 2022. Rather than replace them with cheap but dirty coal-fired plants, Berlin envisions a huge investment in green technology, aiming to cover 35 percent of the country’s energy needs with renewable energy by 2020. In certain states, such as Bavaria, which generates 58 percent of its electricity from nuclear power, Germany will need to build massive amounts of new energy infrastructure. Vast offshore wind farms and an upgrade to the north-south transmission system are also on the drawing board. This energy transformation will likely end up costing over 200 billion euros.

These numbers should not be a cause for alarm. On the contrary, the priorities are sensible, and this scale of investment is precisely what Germany needs to grow sustainably. A boost to German domestic demand could also help rebalance the European economy, creating markets for
imports and jobs for migrant workers, thus helping offset the deflation that the crisis countries have endured. But Berlin has been unable to spell out exactly where the money will come from, and so the future of these projects is in doubt.

The question of how to pay for investment in Germany should not be hard to answer. Remaking the country’s child-care system and energy infrastructure are exactly the types of long-term projects that should be financed through borrowing, and Germany could hardly be better placed to do so. In June, the country was selling debt at negative yields. It can borrow for virtually nothing. A chorus of eminent economists from across the world, Larry Summers and Martin Wolf among them, continue to call for governments to bring forward all their essential spending plans to take advantage of the low-interest-rate bonanza. But Merkel and the German political class will have none of it. Over the last decade, a deep anti-debt consensus has taken root in Germany, and the country is now stuck with its 2009 balanced-budget amendment.

**TALKIN' 'BOUT THE NEXT GENERATION**
The rhetoric that inspired more than two-thirds of the Bundestag to adopt this radical amendment was a call for sustainability, once the slogan of the environmental movement. Supporters of the so-called debt brake claimed that a limit on government borrowing would ensure that the country’s finances would remain in order and leave a more equitable future for generations to come. But there are two types of intergenerational bargains that voters can make, one positive and the other negative. In a positive bargain, the current generation commits to leaving a better world for its children. In a negative bargain, the current generation vows not to leave its children with a large problem—in this case, a big public debt burden. The first model implies that the balance sheet should be left in a healthy state, with borrowing not exceeding productive investment. The second model implies simply that public debt should be reduced. Despite protests from a list of distinguished economists, trade unions, and public interest groups, in 2009, the negative model prevailed. As a result, even though Berlin recognizes the need to raise investment and the federal government faces favorable financial conditions, it is prevented from taking advantage of them by a legal obstacle of its own making.

What drove this decision was a sense of crisis, a sentiment that may baffle outsiders who see Germany as the picture of economic health but makes sense when one looks at Germany’s finances on the state level. Over the last 20 years, while Germany toiled to boost the competitiveness of its export sector, its politicians failed to keep public finances in balance. Now, although the federal government’s deficits are tolerable, and the finances of the rich southern states are in excellent shape, in much of the North and the East, public finances teeter on the edge of crisis. In 2011, the debt of the state of Berlin ran to 66 percent of state-level GDP. To contain this runaway problem, the affluent southern states agreed to bail out their bankrupt northern counterparts in exchange for a deal under which all new borrowing by the states would cease by 2020 and the federal government itself would restrict its new borrowing to no more than 0.35 percent of GDP annually. These
drastic provisions were the price paid for holding together the fiscal union of the Federal Republic.

The internal drama of Germany’s state finances sheds light on why Germany has taken such a conservative approach to Europe’s sovereign debt crisis. It is this same bargain—fiscal austerity in exchange for the preservation of a union—that Germany now proposes to extend to Greece, Italy, and Spain. But as critics of Berlin have consistently pointed out, any sustainable financial consolidation must have two components: a policy to contain profligate spending and a strategy for growth. And for both German states and similarly squeezed European countries, Merkel has failed to articulate a plan for economic growth. Berlin acknowledges the German economy’s need for domestic investment. But committed to a debt brake both at home and for Europe as a whole, the German finance ministry insists that growth can come only as a result of austerity.

Consider the implications of this model. With new borrowing frozen, Germany projects that its debt-to-GDP ratio will steadily decline. Yet since revenue from taxes on corporate and household income has been dropping as a share of GDP in Germany, as in much of the rest of the developed world, the government’s budget will be much smaller. If, faced with this squeeze, Berlin is to make good on its promises of investment in energy infrastructure, preschools, universities, and research and development, it will have to engage in relentless cutting of every euro of nonproductive public spending—a painful and politically unpopular proposition. German leaders must therefore be hoping that their strategy of shrinking and rebalancing the state will trigger a dramatic revival of private investment. What is remarkable about this model, which Merkel is now advocating not just for Germany but also for the rest of Europe, is how un-European it seems. The scenario sounds awfully like a 1980s-era supply-side utopia.

Even if Merkel’s government gets exactly what it wants—massive investment from the private sector alongside public investments financed without any increase in public borrowing—the pain will be real. The government will be forced to pay for these investments by raising taxes, clawing back exemptions, and, above all, charging consumers. Already, because of steep energy charges, Germans pay more than three times as much for electricity as Americans, and those costs will likely rise by at least 50 percent over the course of the Energiewende. What is more, relying on cooperation with the private sector to fund long-term strategic investment carries its own risks. Public-private partnerships may be efficient on a case-by-case basis, but they also breed conflicts of interest. This year, when the federal government tried to end an expensive subsidy it had enacted to steer private investment toward solar energy, it had to fight a protracted battle with interested state governments. The result was a messy compromise in which the federal government had to offer a guaranteed price for solar-generated power for 20 years. And this less-than-ideal outcome is the most optimistic scenario. Far more likely, given the massive fiscal pressure brought to bear by the debt brake, is that much-needed investment will simply slip further and further behind schedule. After all, even when the federal, state,
and local governments were allowed to borrow, they tended to neglect investment. If long-term spending can be financed only from current income, the prospects for renewed investment will surely be even more dim. Just look at Switzerland, which in 2003 was the first European country to introduce a debt brake and served as the model for the German initiative. Although its debt-to-GDP ratio has come down dramatically since then, its levels of public investment are among the lowest in the developed world. A debt brake may bring overall public expenditures in line with revenues. But it is naive to hope that it will get the public sector to shift its attention from short-term to long-term priorities.

UNTIL THE CASH COWS COME HOME

If Berlin does stick to its strategy of reining in the country’s finances, the challenge facing Germany’s leaders will be to reverse the collapse in domestic business investment. This will not be an easy problem to solve. For the last ten years, the German private sector has benefited from a remarkably favorable businesses environment. But even in these good times, it chose to direct its funds abroad, in order to develop markets for German goods elsewhere in Europe and in Asia. It is hard to see what more the German government could do to prevent its businesses from spending their profits outside the country. Meanwhile, the positive political and social climate of the last decade seems set to deteriorate.

Surely, the answer cannot simply be more cuts to the salaries of German workers. Between 2000 and 2009, while corporate profits soared, exports boomed, and capital fled the country, real wages
in Germany fell by one percent. According to the OECD, over the last 20 years, income inequality in Germany, as measured by the Gini coefficient, has risen only fractionally less than in the United States and twice as rapidly as the OECD average. How long can German employers expect their workers, faced with creeping tax increases and budget cuts, to continue to consent to this inequitable tradeoff? According to a 2009 poll conducted by the GfK Group, Germany’s largest market research institute, only 24.9 percent of Germans considered their society to be “fair”—and this was before the worst of the crisis had hit.

At the same time, Germany’s political system has become increasingly fragmented. Even during the economic and political turmoil of the 1970s, the two largest parties, the CDU and the Social Democratic Party (SPD), commanded 90 percent of the German electorate. Since 2000, their combined share has dropped to nearly 70 percent, requiring them to build complex and fragile coalitions with a roster of four other smaller parties. Most recently, the Pirate Party, an inchoate protest group of indeterminate ideology, has emerged as a real political force and is set to gain representation across the country. The anger of voters with the government’s response to the current crisis will only further strain the ability of the mainstream parties to channel and articulate public opinion.

One could imagine that the very incoherence of the German political landscape might, ironically, allow the country to escape its economic predicament. After all, it took an unusual coalition of the CDU and the SPD to put the debt brake into the constitution in the first place. It is more than likely that in the event of a severe shock to the German economy, perhaps brought on by a disorderly unraveling of the eurozone, an embattled coalition government would simply have to ignore the debt brake. No doubt, a truly comprehensive Europe-wide economic crisis might also lead German businesses to retreat into safer domestic investments. But to hope for such a catastrophic scenario is to play with fire. The political fallout would be incalculable. An outright abandonment of the debt clause would encounter fierce resistance from the low-debt states of southern Germany, provoking a crisis of Germany’s own fiscal union. It would also bring the government in conflict with Germany’s powerful constitutional court in Karlsruhe.

The best chance for Germany to emerge from the current impasse with a strategy for growth—for both itself and the rest of Europe—would be for it to treat austerity not as a permanent economic policy but as a form of shock therapy. After the market regains confidence in the euro, after German states and the rest of Europe pay down some of their debts, and after several years of fiscal pain, low investment, and low growth, Berlin can hopefully reconsider its course. If true sustainability is an attractive goal, then conceiving of it merely in negative terms, as the avoidance of long-term debt, is not only inadequate; it is also self-defeating. Germany must aim to leave future generations not only with fewer liabilities but also with the makings of a better world. For now, however, in the absence of meaningful investment, Germany’s long-term challenges continue to accumulate. The unprecedented opportunity presented by the current crisis—to put the global appetite for German debt to good use—risks being squandered.