Blame Germany for Europe's Economic Nightmare

Christopher Ragan
The Globe and Mail, January 13, 2015

Germany is usually blamed for the two wars that devastated much of Europe during the first half of the 20th Century. And those wars were an important motivation for the European Union, a grand project to bind together many countries, both economically and politically. Future wars in Europe may now be unthinkable, but Berlin is nonetheless wreaking havoc on its neighbours – this time through its belligerent stance on economic policies.

Six years after the beginning of the global financial crisis, GDP in the euro zone is still almost 2 percent below its 2008 level. (In both Canada and the United States, GDP is 8 to 9 percent above 2008 levels.) As a result, there is loads of excess capacity in Europe, with the unemployment rate near 12 percent. As if that weren't bad enough, these aggregate statistics hide the tragedies occurring in Italy and Greece, where GDP has fallen since 2008 by 8 and 25 percent, respectively, and long-term unemployment is almost off the charts.

Since mid-2010, after the worst part of the global financial crisis was over, Europe has desperately needed two things to advance its moribund economy.

The first is that European countries have needed fiscal stimulus rather than fiscal austerity. Faced with the brutal combination of slumping growth and very high public debt, the best policy approach was for these countries to commit to future cuts in spending to improve their long-run fiscal positions, but to implement increases in spending in the short term. This unusual combination would stimulate the economy immediately, reduce the suffering from high unemployment, and reduce the governments' long-run debt-to-GDP ratios.

What happened instead was immediate fiscal austerity, driven largely by leaders from Germany and other northern European states, whose assistance came with severe conditions. Their view was that the high public debt required immediate and enduring spending cuts; some even argued that such cuts would drive economic expansion. Yet the result has been the exact opposite: very sluggish European growth (contraction in some countries), persistently high unemployment, and ever-rising public debt ratios.

These bad outcomes were entirely predictable. Indeed, for the past four years, German leaders have been pushing other countries to embark on fiscal policies directly opposite to the ones all G20 countries, including Germany, implemented in 2009 and 2010 – when they collectively agreed to avoid repeating the major policy mistakes from the Great Depression. It's almost as if these leaders don't want Europe to recover.

The second thing Europe has desperately needed since 2010 is for the European Central Bank (ECB) to follow the lead set by the U.S. Federal Reserve in massively expanding its balance sheet. From 2008 through 2014, the Fed's balance sheet expanded from $900 billion (U.S.) to $4.5 trillion, and this "Quantitative Easing" has greatly assisted what is now appearing to be a solid and sustainable economic recovery in the United States.

Mario Draghi, the ECB's president, said in 2012 that he was prepared to do "whatever it takes" to preserve the currency and put the euro zone's economy back on track. But all those people expecting him to start his own QE have been waiting in vain. In fact, since mid-2012, while the Fed's balance sheet grew by well over $1 trillion, the ECB's balance sheet actually contracted by the same amount. Now they're talking, again, about trying QE in earnest.

While Mr. Draghi appears willing to mirror the Fed's monetary boldness, there remains enormous opposition to such actions from the Germans. Their opposition appears to be based on a crucial misunderstanding. Like the Tea Partiers in the United States, they fear that massive QE will unleash uncontrollable inflation. The Germans rightly remember their history; their 1922-23 hyperinflation caused economic devastation.

But the fear of inflation in today's Europe is completely misplaced. With massive excess capacity, a serious threat of deflation, and commercial banks doing little lending, QE is exactly what the ECB should be doing, and on a large scale. As in the United States, sustained inflation will only emerge once the economy starts a solid recovery – and that's currently nowhere on the European horizon.

If Europe is committed to having a single currency, it needs to be willing to use its major macro policy tools when they are needed. And they're certainly needed now. But as long as Germany's leaders stick to their current views, these tools will remain unused and the European economic nightmare will continue.

*****

Christopher Ragan is an associate professor of economics at McGill University in Montreal and a research fellow at the C.D. Howe Institute in Toronto.