Germany should help to stabilize the euro area’s economic growth

Michael Zwahlen | EyeEm | Getty Images – The Brandenburg Gate in Berlin, Germany.

In spite of extraordinarily supportive monetary policy, the euro area economy is showing a considerable, and broad-based, loss of growth momentum since the beginning of this year.

The area’s gross domestic product growth in the first two quarters has slowed to an average annual rate of 2.3 percent from a nearly 3 percent pace of advance in the previous six months. Industrial production during the January to June interval has been in recession, and retail sales barely eked out a 0.9 percent growth.

Some German government officials see nothing wrong with that. They are alarmed, instead, by a strong monetary stimulus provided by the European Central Bank and an energy-driven euro area consumer price inflation of 2.1 percent in July. Inflation’s 0.3 percent monthly decline is conveniently ignored, and so is the fact that the core inflation (CPI minus food and energy) came in at only 1.3 percent — way below the medium-term objective of 2 percent.

Germany, of course, should have nothing to complain about: It has a fully employed economy, growing so far this year at a rate of 2 percent (considerably above its estimated 1.3 percent growth potential) and drawing nearly 40 percent of the total trade surplus from its hard-pressed euro area partners surviving on monetary life support.

Focus on growth

By contrast, France, Italy, Spain and Portugal — cumulatively accounting for nearly half of the euro area economy — are some of the countries that would be devastated by Germany's groundless advocacy for the euro area's rising interest rates.

Indeed, in addition to seeking tightening credit conditions, Germany is also putting unrelenting pressure on those countries to rapidly balance their public finances and to bring down their government debt. It all looks like Berlin does not care that a combination of fiscal restraint and rising credit costs would promptly throw half of the monetary union into an intractable recession.

At the moment, France, Italy, Spain and Portugal are facing a daunting task of fiscal consolidation under conditions of weakening aggregate demand. Their budget deficits range from 2.3 percent of GDP (Italy) to 3 percent of GDP (Spain and Portugal), and most of their fiscal progress so far has been made possible by monetary stimulus to economic growth.

The public debt situation is much worse. Their debt-to-GDP ratios at the end of last year were estimated in the range of 115 percent (Spain) to 155 percent (Italy) — a far cry from the 60 percent mandated by the monetary union's fiscal rules. To keep debt on a steadily declining path, they would have to consistently run large budget surpluses before interest charges on government liabilities. Only Portugal now meets that condition with a primary budget surplus of about 4 percent of GDP. Much smaller primary budget surpluses run by Italy and Spain will hardly make a dent into their massive public sector debt.

What we are seeing now looks like a replay of fiscal austerity that Germany imposed on sinking euro area economies earlier this decade. Berlin, it seems, remains unrepentant that its calamitous "austerity growth model" threw millions of people out of work, and that, as a result, 118 million citizens of the European Union are still at risk of poverty and social exclusion.

Italy will now be the first test case of the euro area fiscal policy run by Germany and its proxies at the EU Commission.

Don’t cut spending in cyclical downturns

The new government in Rome is poised to relax its fiscal stance in response to a number of problems: Economic growth has slowed to 1.2 percent in the first six months of this year, the unemployment rate is stuck at 11 percent, one-third of Italy’s youth is without a job, 18 million people (nearly a third of the country’s population) are facing poverty and social exclusion and crumbling infrastructure is in need of urgent repairs.

Italy’s budget process is still under way, but the damage has already been done. Speculations and public warnings from the EU Commission that the deficit could exceed the limit of 3 percent of GDP have significantly pushed up the cost of Italy’s public funding. Last Friday, Italy’s 10-year government bond closed with a yield of 3.14 percent, a sharp increase from about 2 percent at the beginning of this year.

France is the next in line. Budget decisions for next year are complicated by an apparently unexpected weakening of demand and output. That will significantly reduce government revenues and handicap the social welfare agenda that was supposed to burnish the image of an increasingly unpopular president. The EU Commission estimated that the French budget deficit in the first quarter of this year shot up to 2.5 percent of GDP, making any further progress on public finances highly problematic.

Meanwhile, Germany is reported to have run a budget surplus of 2.4 percent of GDP in the first three months of this year, continuing its fiscal nirvana since 2014. At the same time, during the January to April interval, Germany booked a trade surplus at an annual rate of 101.4 billion euro on the back of its monetary union partners — a whopping 12.4 percent increase from the year earlier.

Obviously, those huge wealth transfers that Germany gets from the rest of the euro area have a lot to do with Berlin’s overflowing government coffers and its export-driven economic growth.

Investment thoughts

If France, Italy, Spain and Portugal cave to German pressures to step up fiscal consolidation under conditions of an ongoing cyclical downturn, there is no way that the ECB could prevent more serious recessionary slippages within the monetary union.

Following the U.S. example, the current growth slowdown in the euro area can be easily reversed with a policy mix consisting of a fiscal stimulus and accommodative monetary policies. But that, one can safely say, is out of the question. So, the best those four countries could do is to refrain from any fiscal tightening in order to protect growth and employment creation.

Germany could help to stabilize and balance the euro area economy by stimulating its domestic spending. That would spur rising German purchases from its area partners. Unfortunately, the most recent data are showing exactly the opposite: Germany's soaring euro area trade surpluses are an increasing drag on the monetary union's economic growth.

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