Future Fiscal and Debt Policies: Germany in the Context of the European Monetary Union

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Conference: Fiscal and Debt Policies for the Future, The Cambridge Trust for New Economic Thinking, St. Catherine's College, Cambridge UK, 11 April 2013

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Overview

- **Requirements for fiscal policies in a currency union – a Post-Keynesian perspective**
- German fiscal policies in the macroeconomic context 1999-2007
- Fiscal policies during the crisis, the ‘debt brake’ and future perspectives
- Alternative strategies
- Conclusions

1. Monetary Policy

- Guarantee public debt of member countries
- Target low real interest rates

2. Wage/incomes policy

- Nominal stabilisation + stabilisation of income shares
- Wage norm: long-run productivity growth + inflation target
- Adjusting current account imbalances may require deviations from the norm

3. Fiscal Policy

- Real stabilisation, full employment, more equal income distribution
- Functional finance approach:
  $D = G-T = S-I – (X-M)$, with: $X-M=0$
  $B/Y = (D/Y)(1/g)$
- Coordination of fiscal policies: expenditure paths along functional finance lines
- Adjusting current account imbalances may require deviations
- Catch-up processes: $X-M > 0$ for mature countries, $X-M < 0$ for catching-up countries
  Precondition: stable financial transfers

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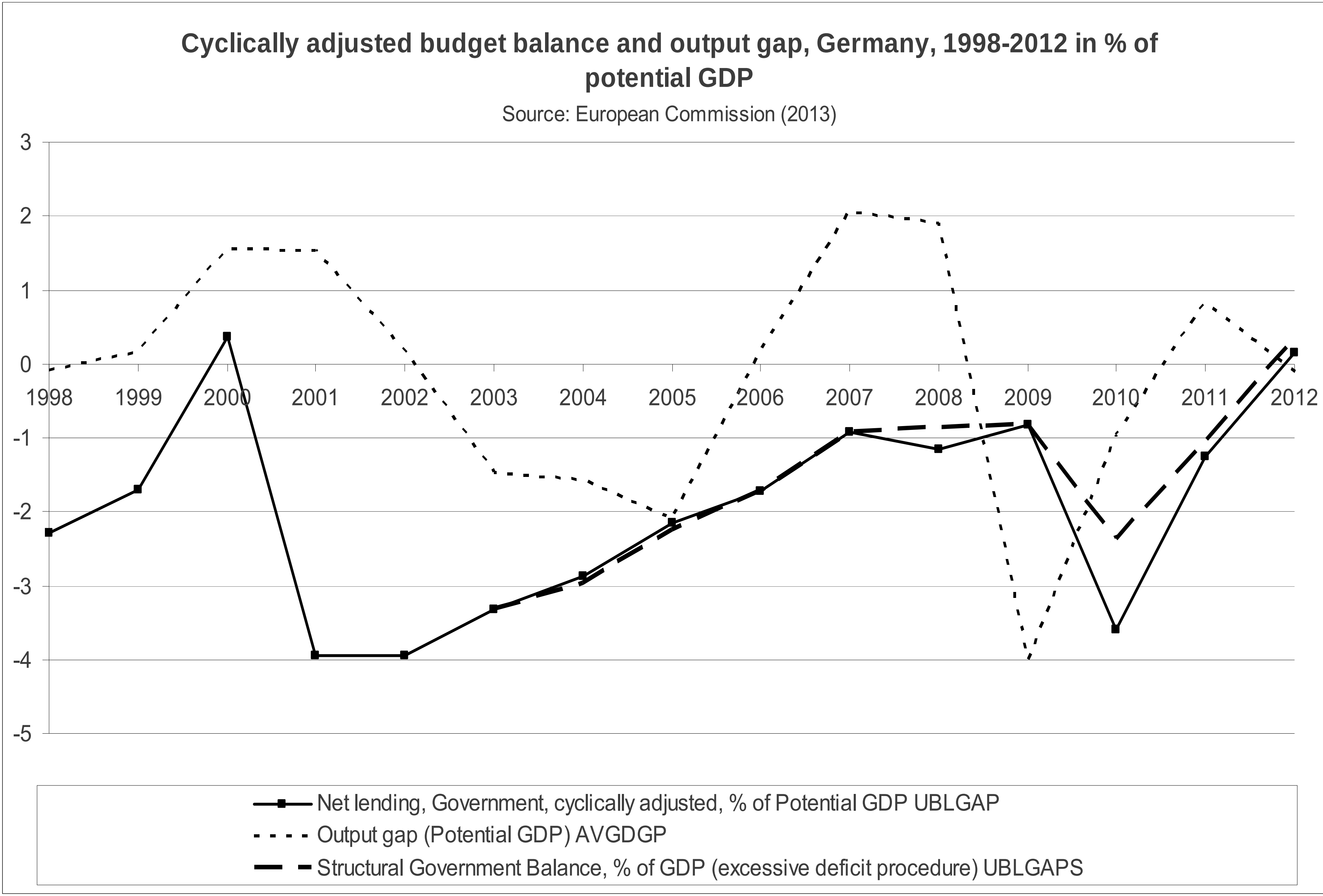
The German export-led mercantilist regime (1999 – 2007)

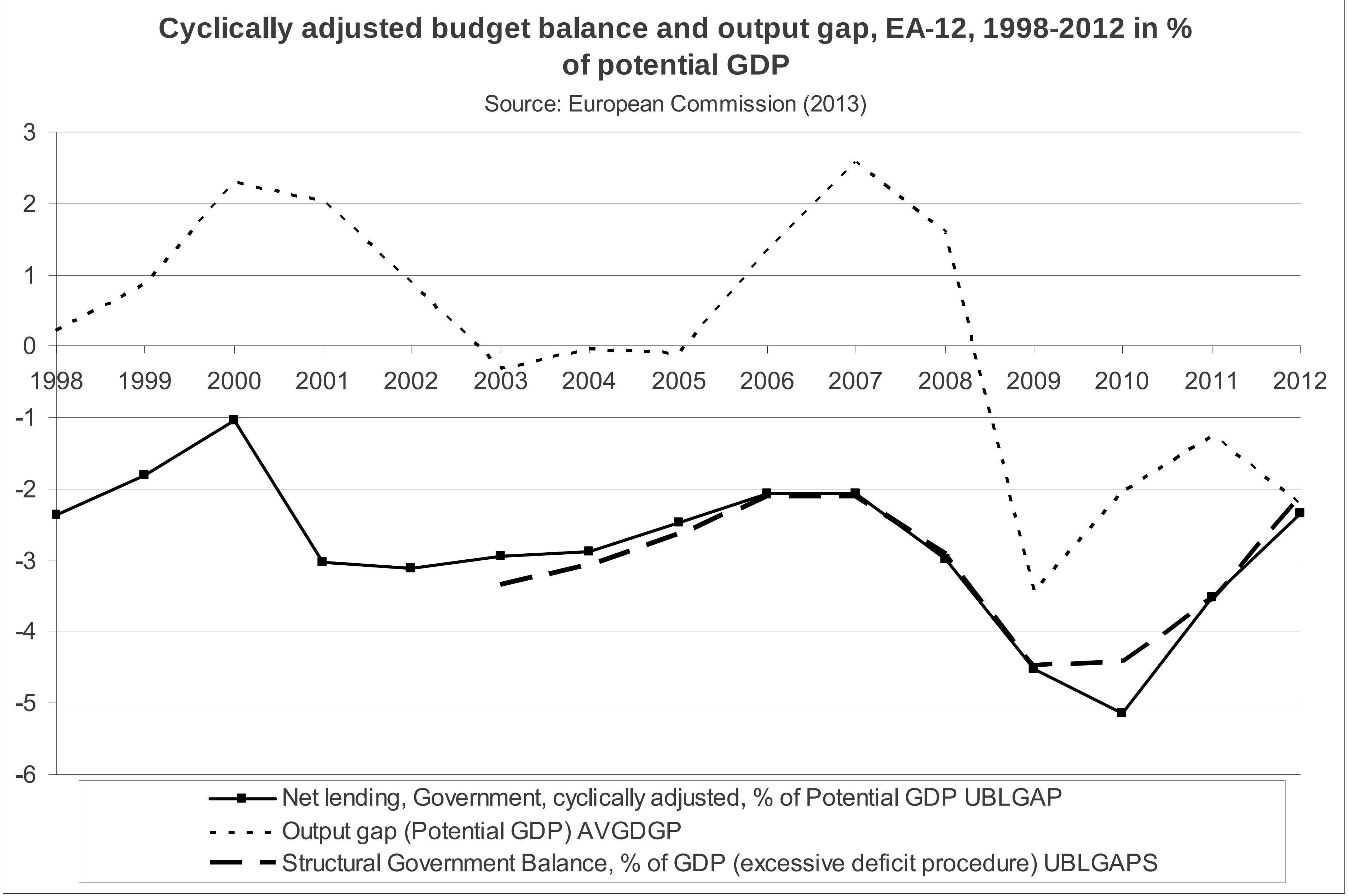
1. Significant improvement of price competitiveness by means of wage moderation
2. Weak domestic demand because of
   - wage moderation
   - no wealth effect on consumption
   - relatively higher real interest rates

   + inappropriate and restrictive fiscal policies (in the short and the long run)

Table 1: Key macroeconomic variables in Germany and the EU-15, average values for 1999-2007		
	Germany	**EA 12**
Real GDP growth, per cent	1.7	2.2
Growth contribution of domestic demand including stocks, percentage points	0.8	2.1
Growth contribution of private consumption, percentage points	0.5	1.1
Growth contribution of public consumption, percentage points	0.1	0.4
Growth contribution of gross fixed capital formation, percentage points	0.2	0.6
Growth contribution of the balance of goods and services, percentage points	0.9	0.1
Net exports of goods and services as a share of nominal GDP, per cent	3.8	1.6
Financial balances of external sector as a share of nominal GDP, per cent	-2.7	-0.5
Financial balances of public sector as share of nominal GDP, per cent	-2.2	-1.9
Financial balance of private sector as a share of nominal GDP, per cent	4.9	2.3
Financial balance of private household sector as a share of nominal GDP, per cent	5.2	…
Financial balance of the corporate sector as a share of nominal GDP, per cent	-0.2	…

	Germany	EA 12
Inflation (HCPI growth rate), per cent	1.6	2.1
Growth rate of nominal unit labour costs, per cent	-0.1	1.5
Growth rate of nominal effective exchange rates (Germany: relative to EU 15 + 9 industrial countries; EA-12: relative to 12 industrial countries), per cent	0.9	2.5
Growth rate of real effective exchange rates (Germany: relative to EU 15 + 9 industrial countries; EA-12: relative to 12 industrial countries), per cent	-1.3	0.3
Annual change in labour income share, as percentage of GDP at current factor costs	-0.5	-0.3
Short-term real interest rate, percent	1.6	1.2
Long-term real interest rate, percent	2.7	2.4
Short-term real interest rate minus real GDP growth, percentage points	0.0	-1.1
Long-term real interest rate minus real GDP growth, percentage points	1.1	0.1
Years with pro-cyclical fiscal policies	4	2
Pro-cyclically restrictive	3	2
Pro-cyclically expansive	1	-
Source: European Commission (2013), authors' calculations		


Cyclically adjusted budget balance and output gap, Germany, 1998-2012 in % of potential GDP
Source: European Commission (2013)
3
2
1
0
-1
-2
-3
-4
-5
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
Net lending, Government, cyclically adjusted, % of Potential GDP UBLGAP
Output gap (Potential GDP) AVGDGP
Structural Government Balance, % of GDP (excessive deficit procedure) UBLGAPS



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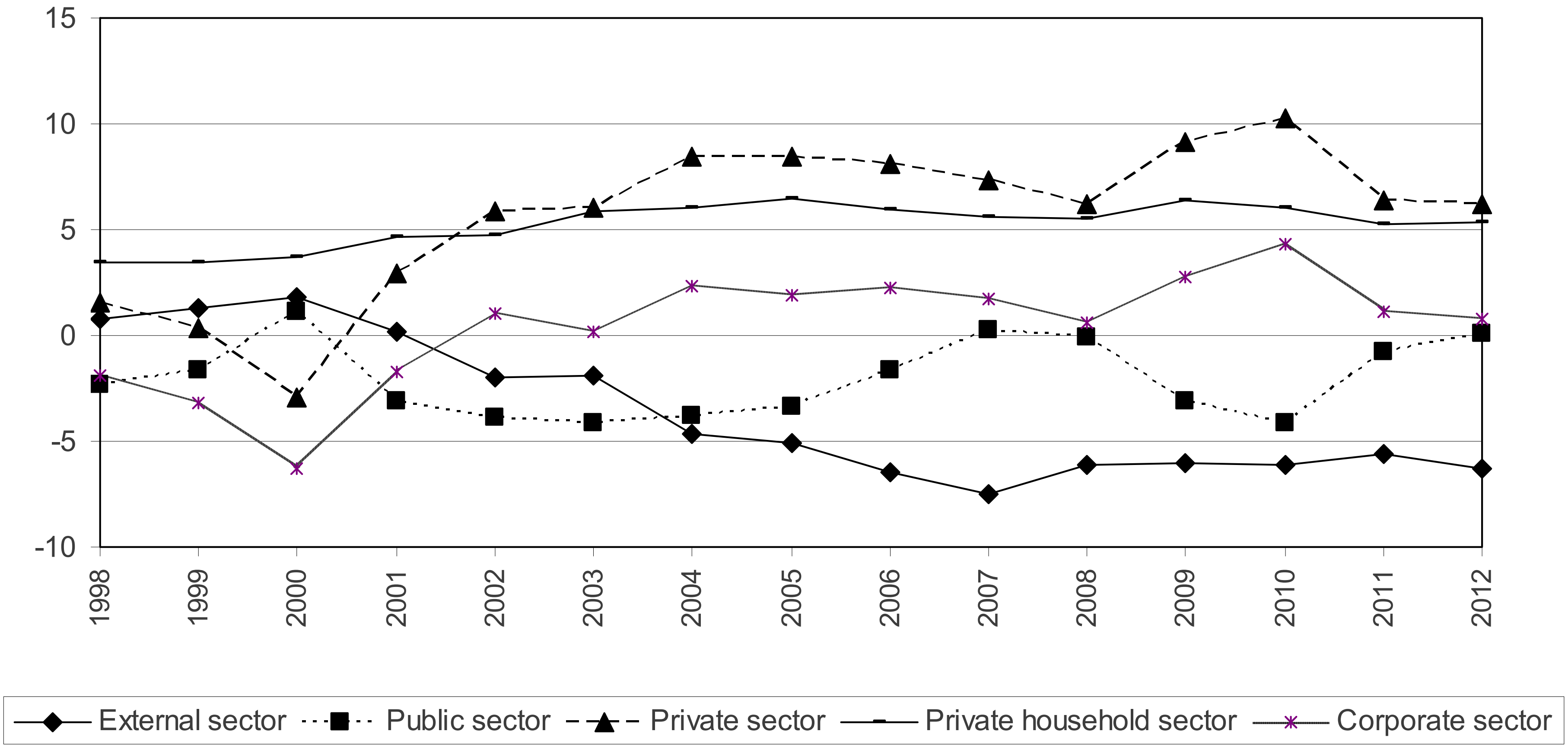
Germany: Sectoral financial balances as a percentage share of nominal GDP, 1998 - 2012
Source: European Commission (2013), authors' calculations



EA 12: Sectoral financial balances as a percentage share of nominal GDP, 1998 - 2012
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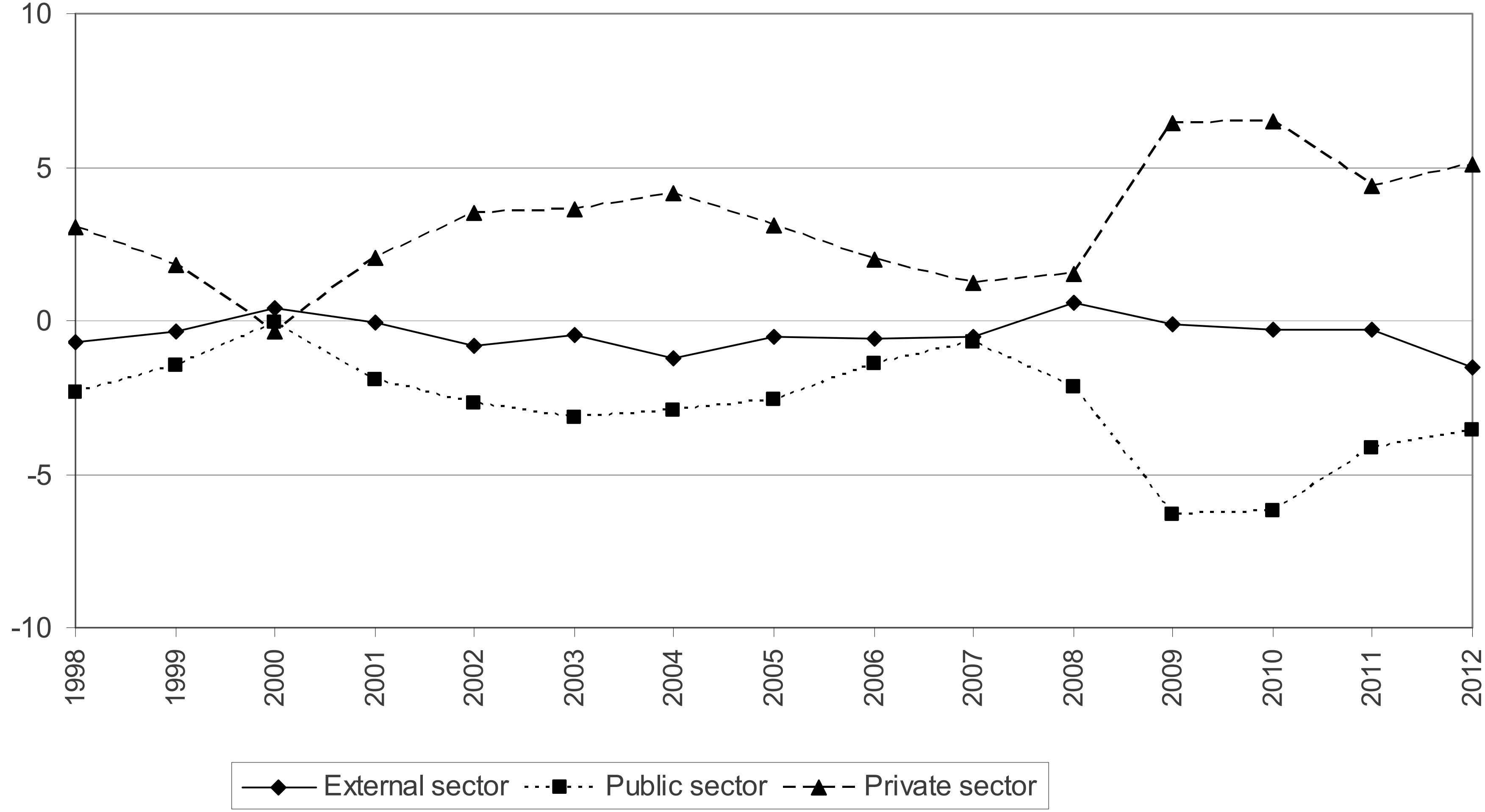

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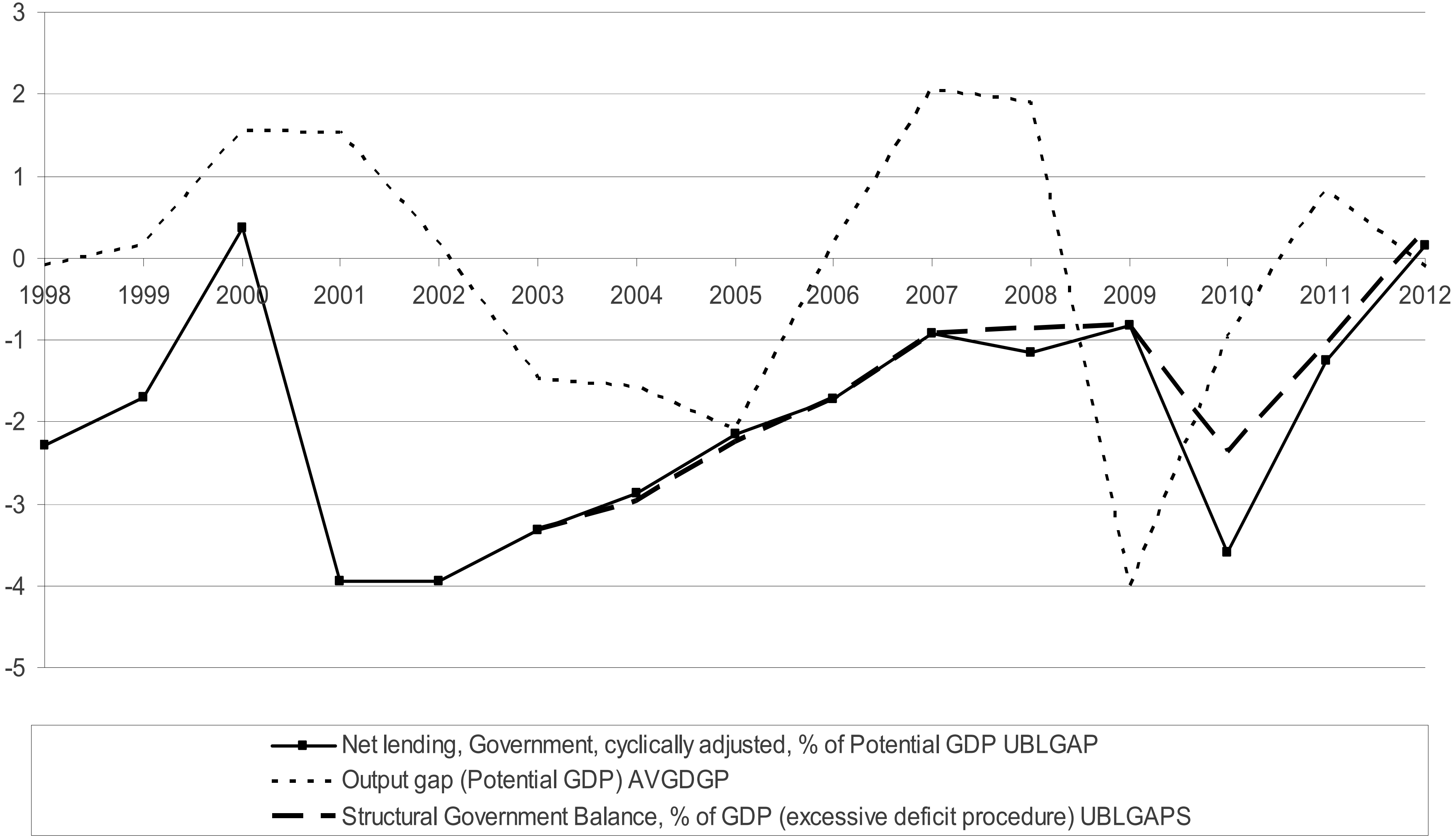
Budgetary effects of fiscal packages and additional measures in Germany, 2009 – 2010, in billions of Euros

Fiscal Package I	**2009**	**2010**	**09+10**
1. Investment Support	**1.3**	**1.4**	**2.7**
public infastructure (roads)	1.0	1.0	2.0
support for regions	0.2	0.1	0.3
credit programme for energy-efficient construction	0.1	0.2	0.3
further credit programmes	0.1	0.1	0.1
2. Tax Relief for Private Households	**0.4**	**1.0**	**1.4**
motor vehicle tax exemption	0.4	0.1	0.5
tax incentives for services in private households		0.9	0.9
3. Tax Relief for businesses	**2.3**	**4.7**	**6.9**
accelerated depreciation allowances (25%)	1.9	4.3	6.3
special depreciation for small and medium size enterprises	0.2	0.4	0.6
Sub Total	**3.9**	**7.1**	**11.0**
4. Measures by the Federal Labour Market Agency	**0.3**	**0.5**	**0.8**
Total	**4.2**	**7.6**	**11.8**
Fiscal Package II	**2009**	**2010**	**09+10**
1. Public Investment (local communities)	4.0	12.0	16.0
2. Support for Innovational Research	0.5	0.5	0.9
3. Support for motor vehicle demand	5.0		5.0
4. Reform of the motor vehicle tax	0.1	0.2	0.3
5. Support for Mobility Research	0.3	0.3	0.5
6. Employment			
a) subidies for short time work	1.6	1.6	3.1
b) activation programme	1.3	1.3	2.6
c) additional personnel for labour market agency	0.1	0.1	0.2
d) stabilising the unemployment insurance rate		1.0	1.0
7. Income Tax Cuts	2.9	6.1	9.0
8. Cuts Social Security Taxes (Health insurance)	3.0	6.0	9.0
9. expenditure for families			
a) transfer for children	1.8		1.8
b) higher social benefits for children	0.2	0.3	0.5
Total	**20.7**	**29.2**	**49.9**
Additional measures			
re-introduction of commuter tax relief	5.9	2.3	8.2
tax deductability social security contributions		8.1	8.1
Fiscal Packages I + II + additional measures			
Total	**30.7**	**47.2**	**78.0**
in % of 2008 GDP	1.2	1.9	3.1

Source: Federal Finance Ministry; Projektgruppe Gemeinschaftsdiagnose (2009); authors' calculations

Cyclically adjusted budget balance and output gap, Germany, 1998-2012 in % of potential GDP

Source: European Commission (2013)



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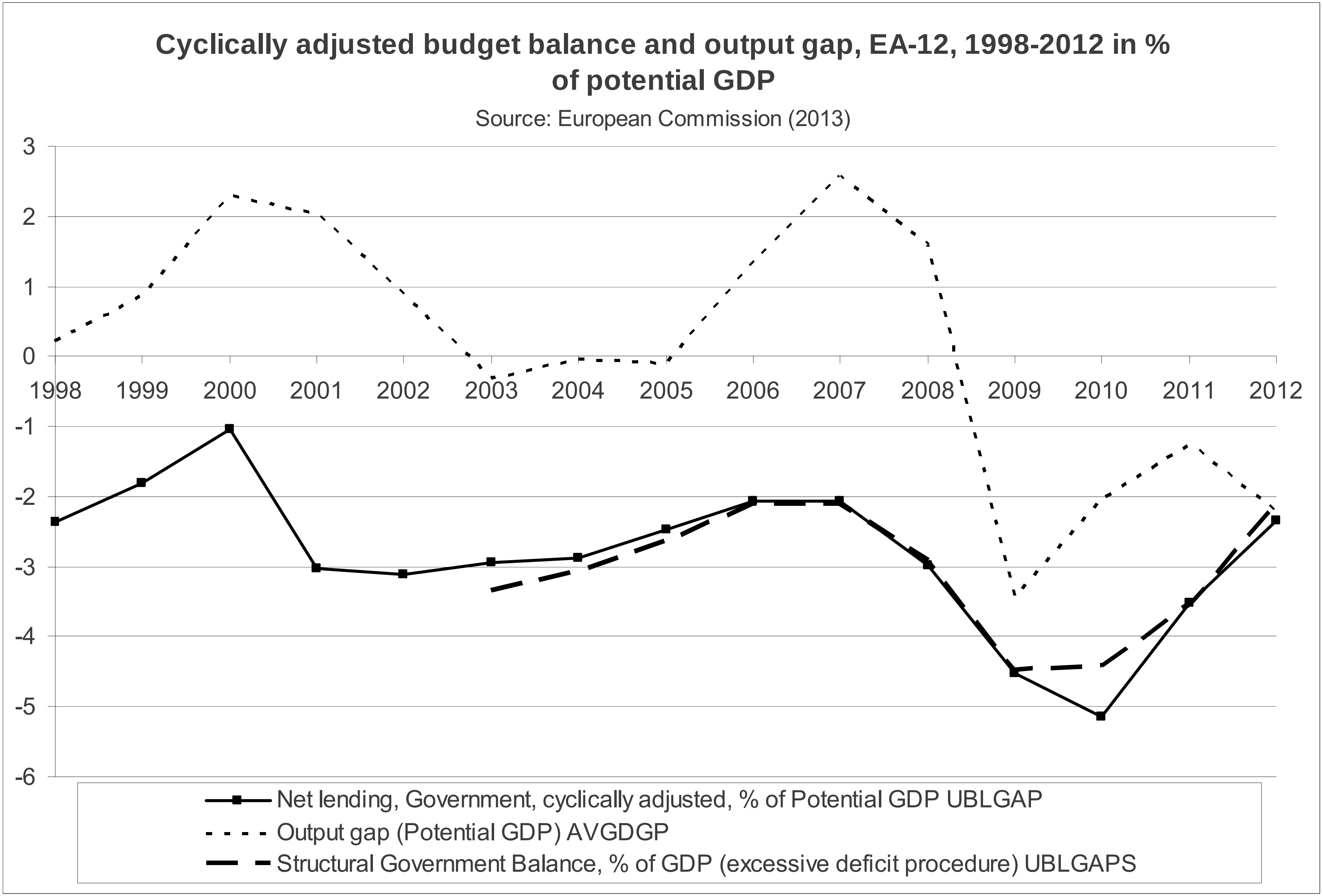

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The German debt brake comprised of 4 major components

The debt brake was introduced into the German constitution in Summer 2009 by the Grand coalition government

Components 1 and 2:

- **a “structural“ component:**
  - The Federal level‘s “structural“ budget deficit must not exceed 0.35 % of GDP by 2016
  - The federal states‘ (Länder) “structural“ budget deficit must be zero by 2020
  - Piecemeal reduction to target values during the transition period

- **a “cyclical“ component:**

  both the federal level and the states may run deficits in addition to the “structural“ component depending on the “output gap“, however, deficits in slumps must be symmetrically compensated by surpluses in booms

The German debt brake is comprised of 4 major components

Components 3 and 4

- **an exceptional clause**

  In the case of an emergency situation (exceptional situation like a natural disaster) deficits may exceed the ones resulting from components 1 and 2.

- **an adjustment account (for the federal level)**

  the account is to record deviations of deficits in the execution of the budget from the targeted deficits

  = control device

Debt brake = „structural“ deficit (close to) zero

„Structural“ deficit of zero (or 0.35 % or 0.5 % of GDP) difficult to justify

- implicit target of 11 % debt to GDP-ratio dubious
- Threshold for detrimental growth effects according to some (dubious) studies: 80 or 90 % of GDP.
- a deficit of e.g. 2 % of GDP may very well be „sustainable“
- What about discretionary fiscal policy?
- Who is going to absorb private sector surpluses?
- Who is going to play the role as a safe haven for financial markets?
- Total neglect of public investment („golden rule“), let alone functional finance considerations

Comparison: German Debt Brake (GDB) and Fiscal Compact (FC)

- GDB allows structural deficit of only 0.35 % of GDP (on the federal level) whereas FC allows 0.5 % (regardless on which level)
- GDB only applies to federal level and federal states whereas FC includes municipalities and social security
- FC may become binding earlier
- FC looks at general government deficits whereas GDB knows different rules for federal level and (potentially) each of the individual states
- GDB still lacks implementation in many federal states
- FC still lacks implementation as to role of different federal levels and social security

The rules framing future German fiscal policies

- Difficult to disentangle which of the numerous constraints on deficits and debt will become binding
- There is the EDP (deficit), the fiscal compact (structural deficit), the EDP (debt level) and the national debt brake(s)
- Currently it seems that Germany is meeting all the criteria

The rules framing future German fiscal policies

Currently it seems that Germany is meeting all the criteria

- the EDP (deficit) procedure has been closed
- the ‚structural‘ balance is in (small) surplus (+0.4 % of GDP)
- given the ‚structural‘ balance the ‚structural‘ primary balance is such that the EDP debt criterion will be met under even very modest growth conditions

➔ **Concentration on debt brake and structural balance warranted**

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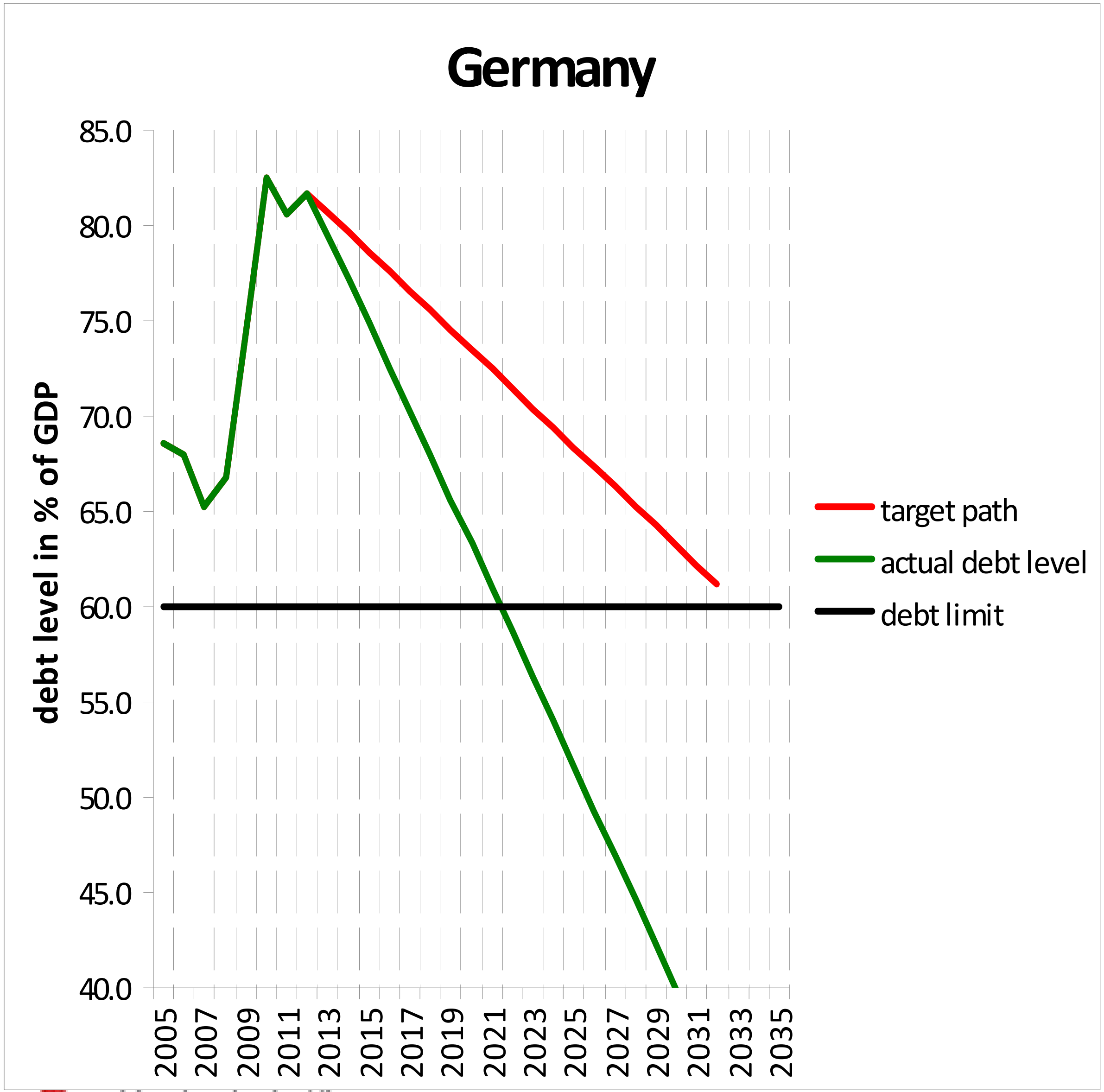
Compliance with debt rule in a ‚realistic‘ case



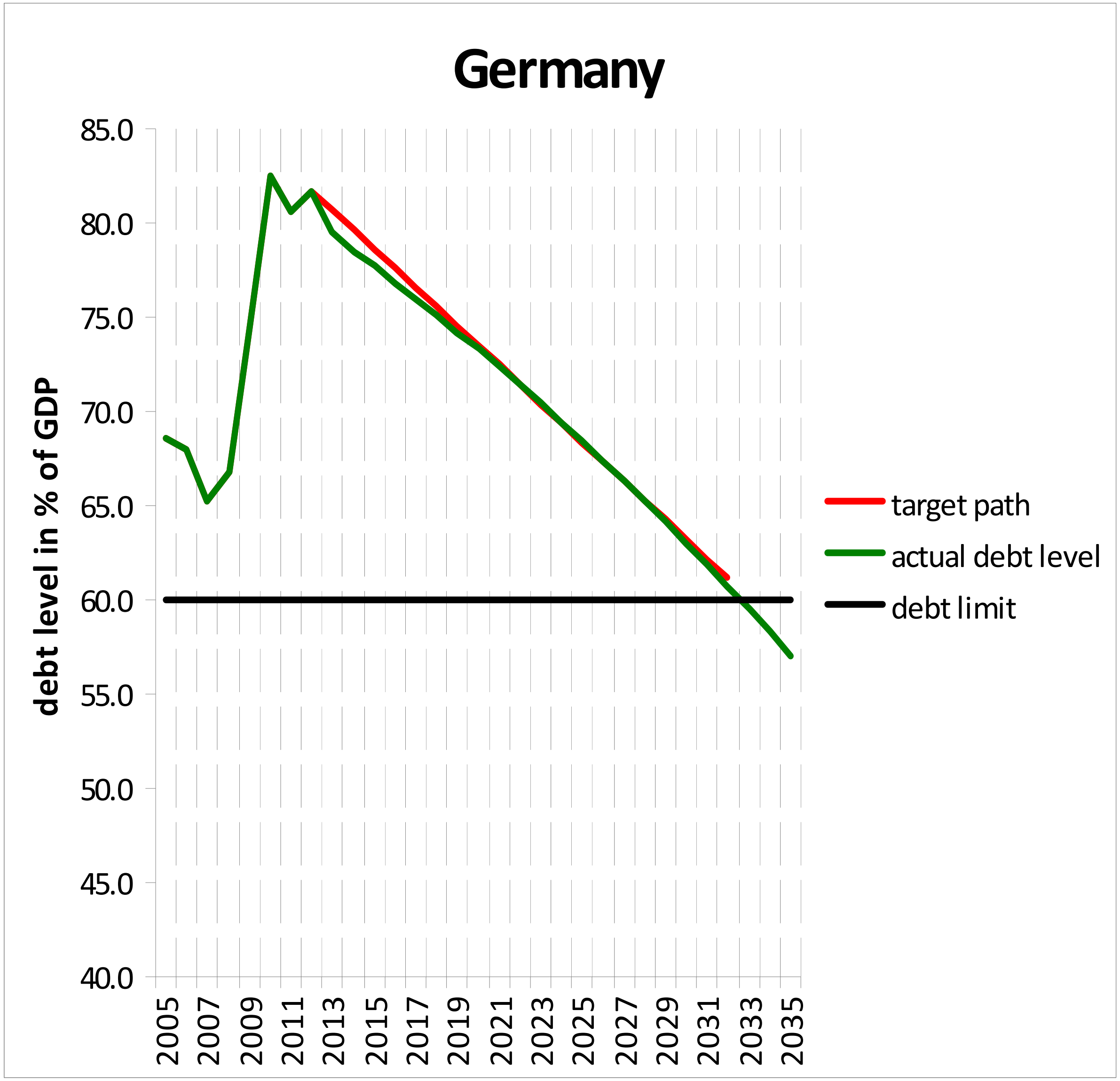
i = 3.2

pb = 2.5 % of GDP

gdp_n = 2.9

Overachievement!

…but even in a pessimistic scenario



i = 3.2
pb = 2.5 % of GDP
gdp_n = 1.1

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The rules framing future German fiscal policies

Currently it seems that Germany is meeting all the criteria

- the EDP (deficit) procedure has been closed
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➔ **Concentration on debt brake and structural balance warranted!**

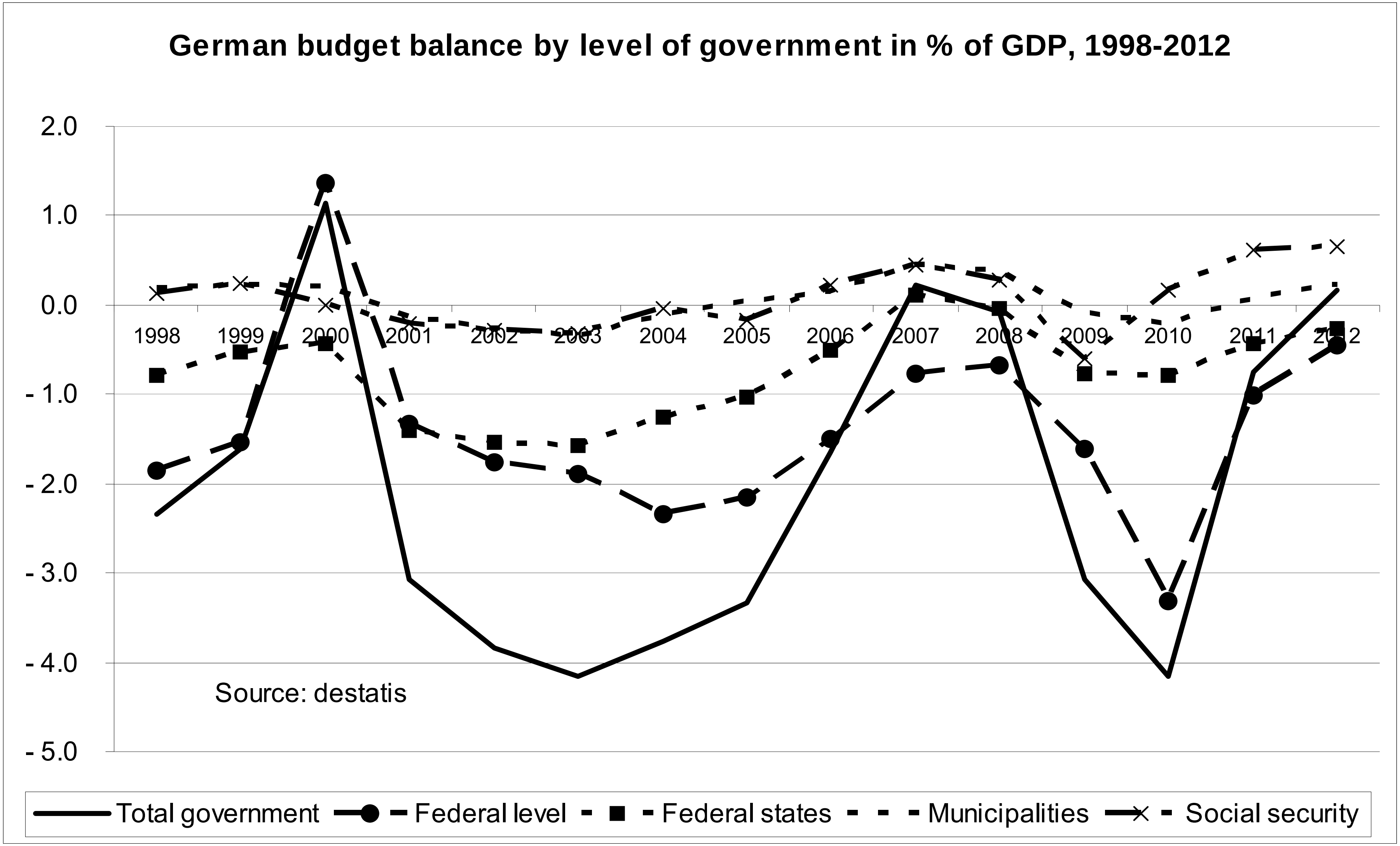
Focus on the structural balance

- **Will it be possible to keep the structural primary balance at around 2.5 % of GDP?**

- **How was it possible to ‚structurally' consolidate so fast?**

➔ **There are substantial risks!**

Risk No. 1: consolidation untypically relied on social security and the municipalities



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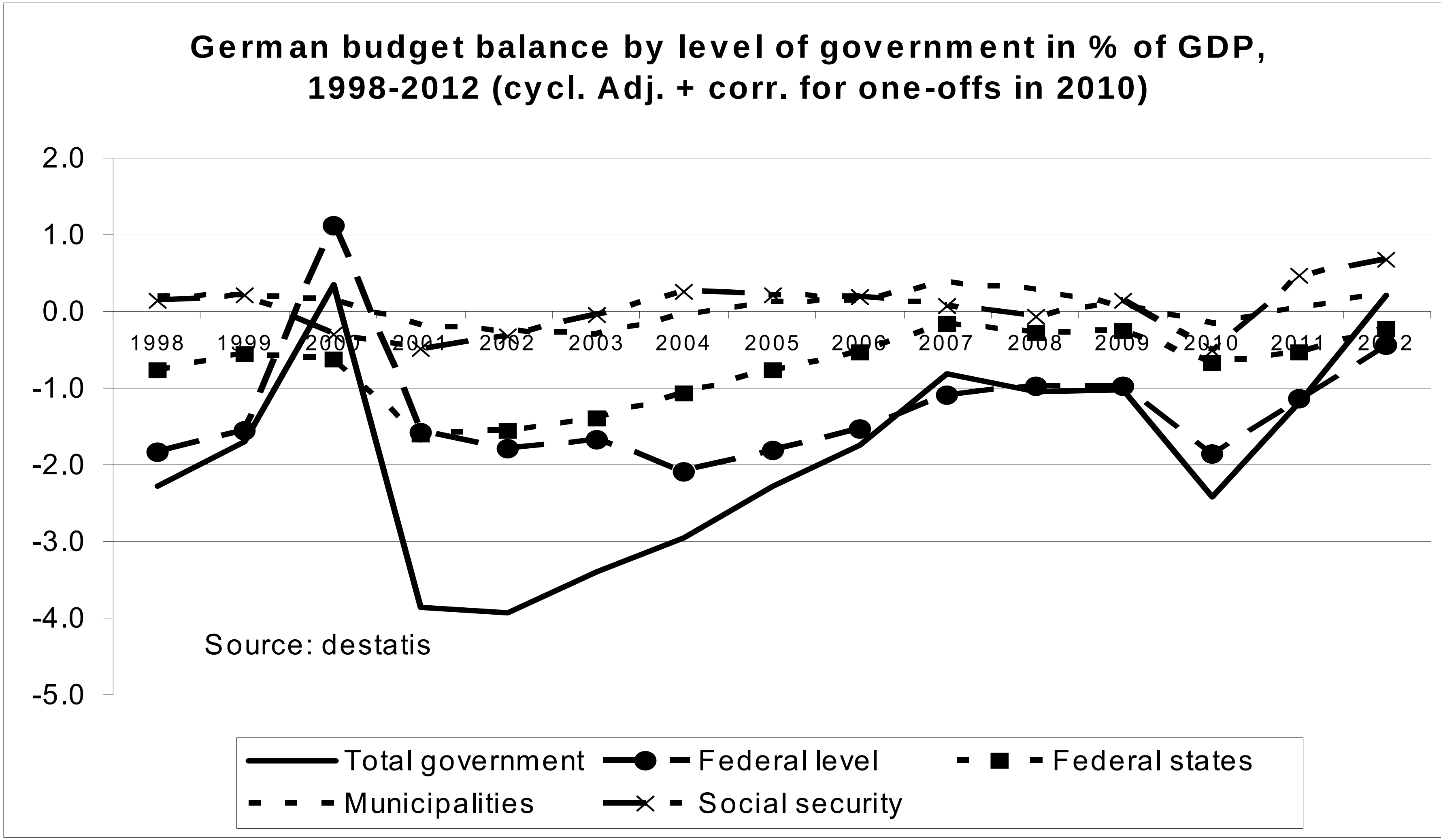
Risk No. 1: consolidation untypically relied on social security and the municipalities



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Risk No. 1: consolidation untypically relied on social security (and the communalities)

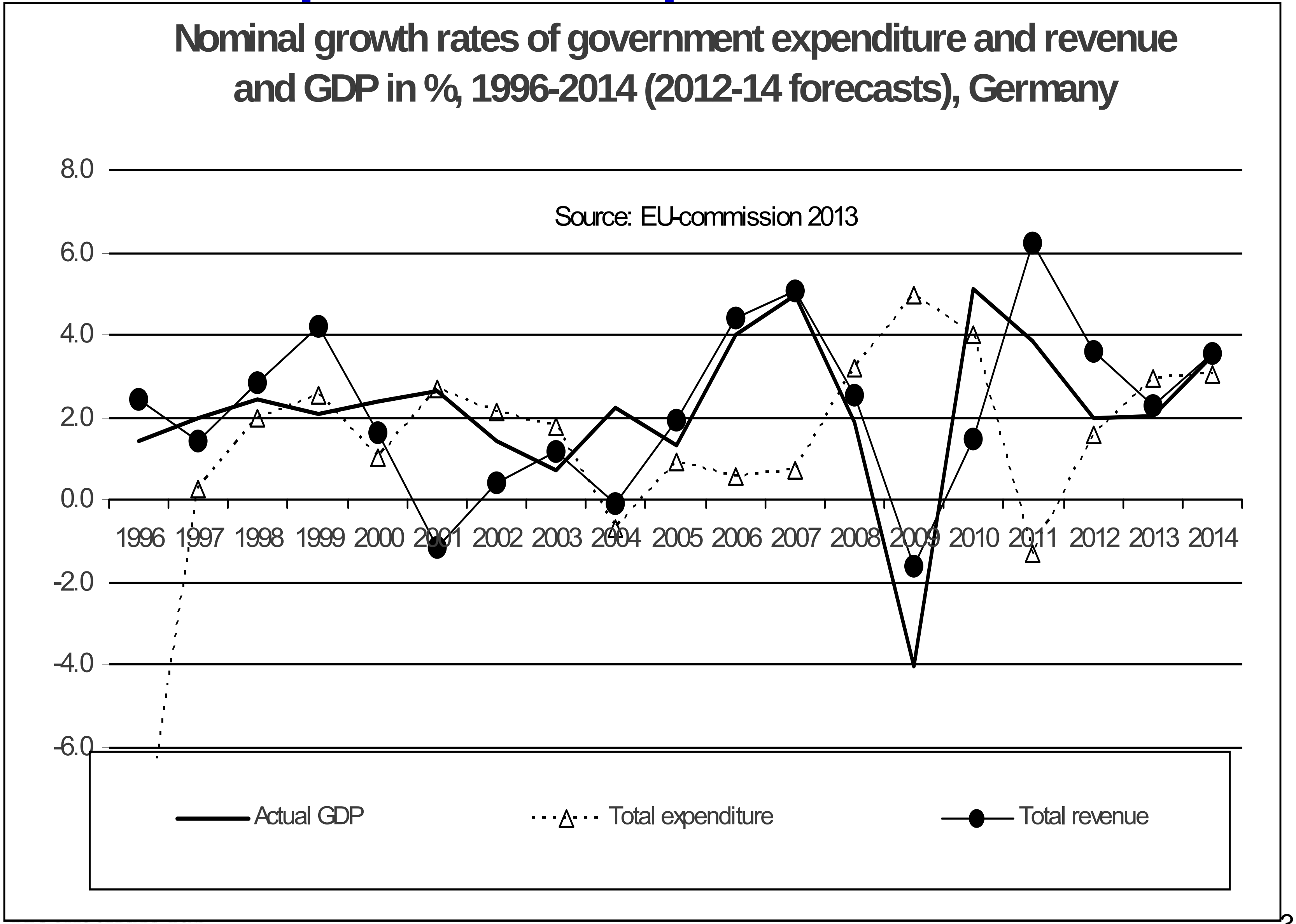
- **in the medium term social security will return to balance**
- **the consolidation needs for Federal level and states will increase**
- **Possibly negative stimulus if consolidation occurs mainly on the expenditure side**

Risk No. 2: the structural balance (was) is endogenous

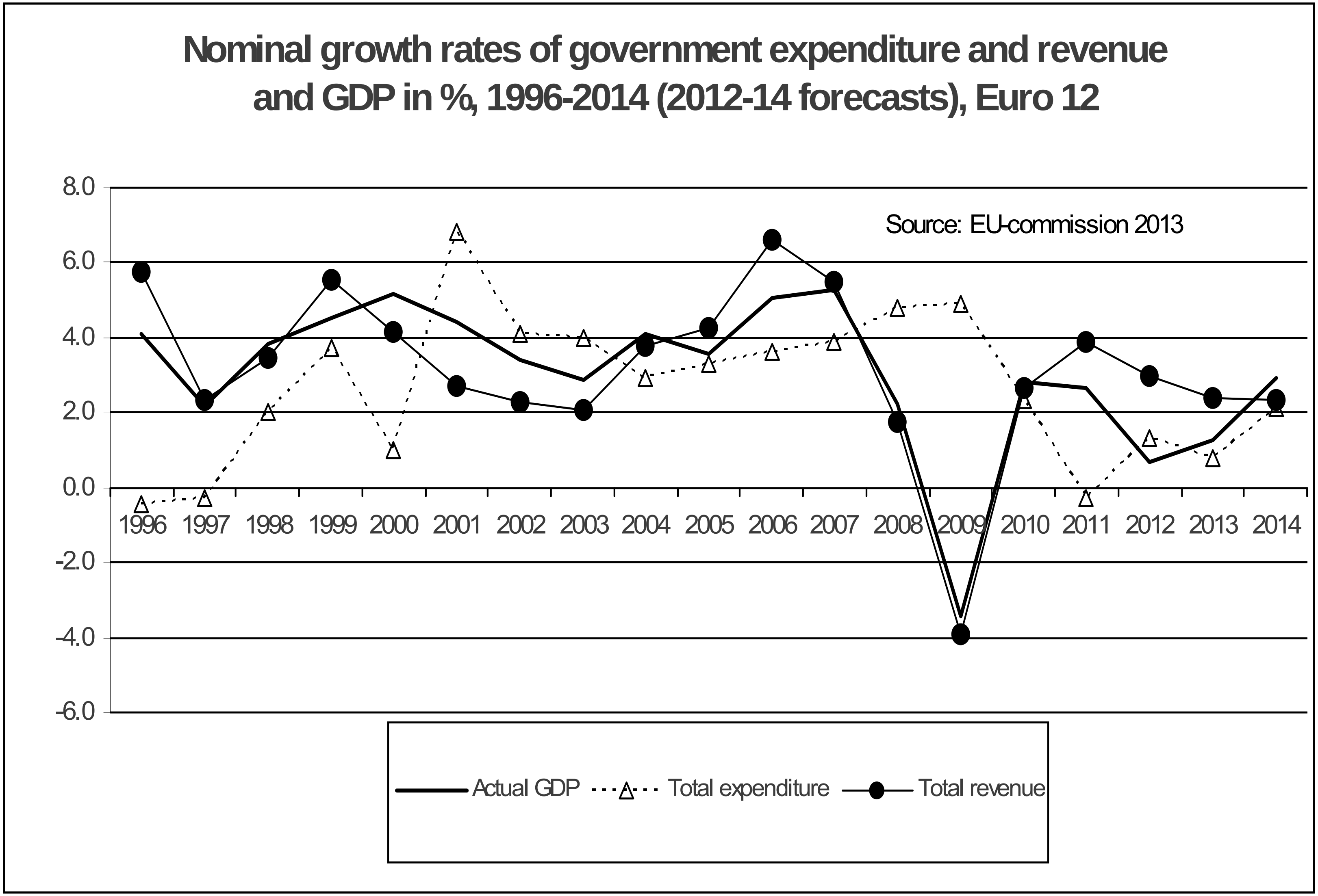
- **it depends on the cyclical condition of the economy!**
- for example from Spring 2010 to Autumn 2012 the EU Commission revised its GDP forecast for Germany upwards by 4.1 percentage points
- However, the estimate of the output gap was only adjusted by 2.6 percentage points.
- The difference of 1.5 percentage points led to a ‚consolidation present' of 0.8 % of GDP
- At the same time the budget sensitivity especially of taxes in the upswing seems to be way too small

➔ **It depends on future actual GDP growth whether it will be possible to stabilise the current structural balance!**

more expansion despite the debt brake…



The EU-12 taking over the former German path



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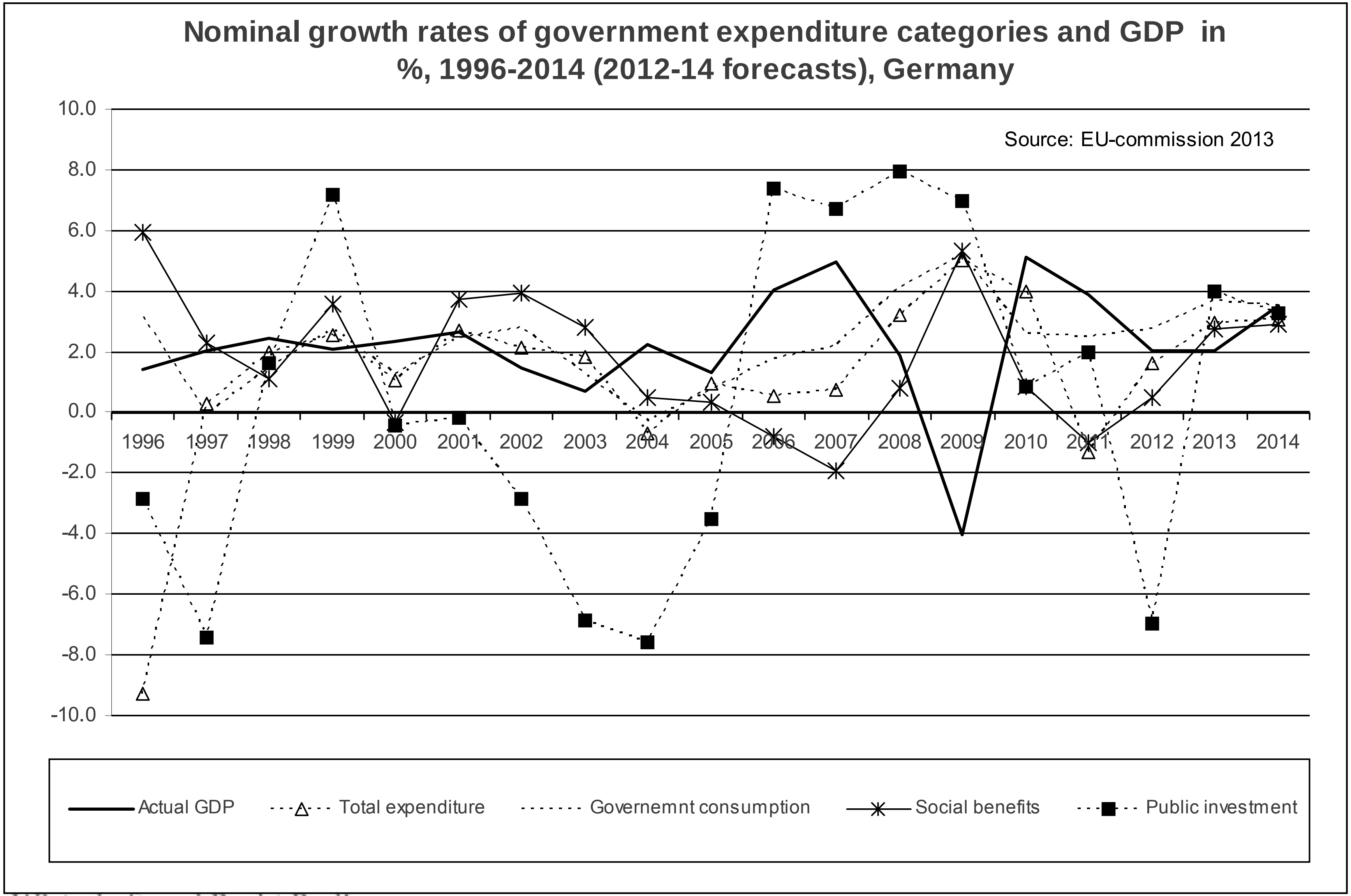
more expansion despite the debt brake…



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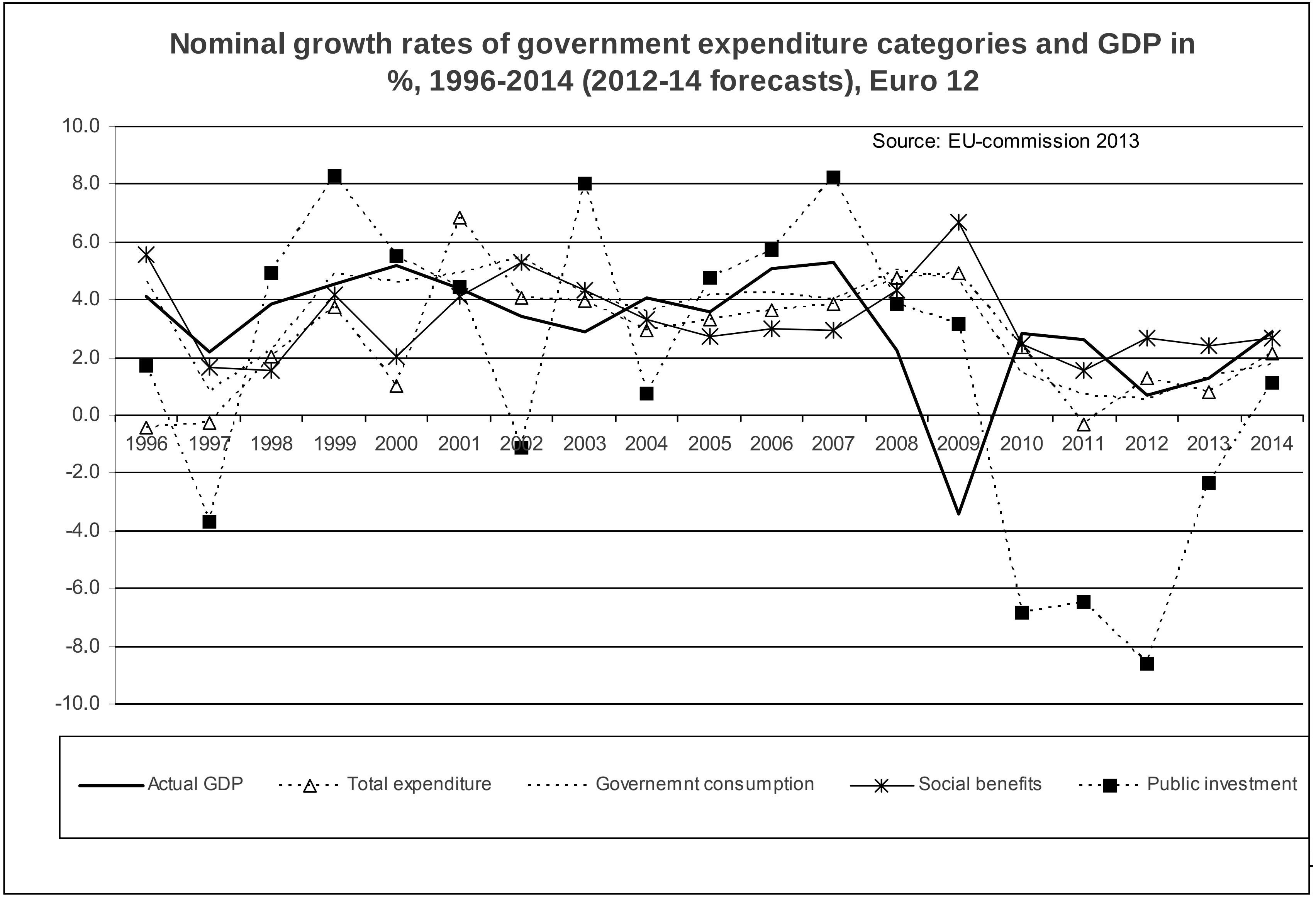

Risk No. 2: the structural balance (was) is endogenous

- It depends on future actual GDP growth whether it will be possible to stabilise the current structural balance!
- the Bund uses a version of the EU procedure of cyclical adjustment ➔ structural balance is endogenous (Truger/Will 2013)
- due to the earlier manipulation (Truger/Will 2013) the Bund still has some leeway that will disappear soon in a strong cyclical downswing
- most of the Länder are currently ill-equipped to counter a strong cyclical downswing

➔ in a strong cyclical downswing German fiscal policy will have to switch to pro-cyclical restriction, again

➔ therefore Germany may soon be in trouble, again

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1st best solution:

Allow for fiscal deficits of around 5 per cent of GDP

2nd best solution

Accept contraints of GDB and FC and adjust private sector financial balance:
D = G-T = S-I = close to 0,
so that X-M = close to 0
- stimulate private investment
- increase the propensity to consume
- redistribute income from profits to wages

Implications for functional income distribution
Profit share: h, wage share: 1-h

$$(5) \qquad S = s_W(1 - h)Y + s_\Pi hY = I + X - M + G - T\,.$$

$$(6) \qquad h = \frac{\frac{I}{Y} - \frac{T-G}{Y} + \frac{X-M}{Y} - s_W}{s_\Pi - s_W}\,.$$

Naastepad/Storm 2007; Hein/Vogel 2008, 2009; Stockhammer/Hein/Grafl 2011; Onaran/Galanis 2012:

Estimates for s_π (0.48 – 0.82) and s_W (0.09 – 0.46)

($s_\pi - s_W$): 0.3 – 0.5, average: 0.4

$$(7) \qquad s_W = \frac{I}{Y} + \frac{X - M}{Y} - \frac{T - G}{Y} - h\left(s_\Pi - s_W\right).$$

Average estimate of (s_Π – s_W) = 0.4 and average values from national accounts for (I/Y), [(X-M)/Y], and [(T-G)/Y] for the period 1999 – 2007

➔ s_W = 0.05

Scenarios	A	B	C	D	E
Gross fixed investment as a share of nominal GDP (I/Y), in per cent	19	19	19	21	19
Current account surplus as share of nominal GDP [(X-M)/Y)], in per cent	0	0	2	2	2
Government financial balance as a share of nominal GDP [(T-G)/Y], in per cent	0	-0.5	-0.5	-0.5	-0.5
Propensitiy to save from wages (s_W), in per cent	5	5	5	5	3
Differential between propensity to save from profits and from wages ($s_\Pi - s_W$), percentage points	40	40	40	40	40
Required profit share (h), in per cent	35	36	41	46	46
Average profit share (h) 1999-2008, in per cent	48	48	48	48	48
Required wage share (1-h), in percent	65	64	59	54	54
Average wage share (1-h) 1999-2008, in per cent	52	52	52	52	52
Redistribution requirements from profit share to wage share, percentage points	13	12	7	2	2
Source: European Commission (2013), authors' calculations					

Sticking to GDB and FC and contributing to rebalancing the Euro area requires

- Major re-distribution of income not seen in German history (highest wage share: 56.4 per cent in 1981 in West Germany, 58.7 per cent in 1991 Germany) and/or
- Major boost of investment to levels not seen since the German unification boom and/or
- Major decline in the propensity to save reversing the rising trend which had started even before the crisis

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- Strategies for improved fiscal policies
- **Conclusions**

- Fiscal policies were major contributor to German ‚export-led mercantilist' model before the crisis, violating the norm for fiscal policies in a currency union
- Sticking to GDB and FC is possible, but carries severe risks in the case of a major downturn and means continuous violation of the norm for fiscal policies in a currency union
- Sticking to GDB and FC and contributing to rebalancing the Euro area requires unrealistic re-distribution of income, improvement of investment and/or reduction of propensity to save

Thank you very much!