The world has a Germany problem

The debt obsession that ate the economy

By Paul Krugman
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You might think that recent events — market turmoil, weakening growth, declining manufacturing production — must be producing some soul-searching in the White House, particularly over Donald Trump's view that "trade wars are good, and easy to win." That is, you might think that if you haven't paid any attention to Trump's past behavior.

What he's actually doing, of course, is attributing the economy's troubles to a vast conspiracy of people out to get him. And his recent remarks suggest, if anything, that he's preparing to open a new front in the trade war, this time against the European Union, which he says "treats us horribly: barriers, tariffs, taxes."

The funny thing is that there are some aspects of European policy, especially German economic policy, that do hurt the world economy and deserve condemnation. But Trump is going after the wrong thing. Europe does not, in fact, treat us badly; its markets are about as open to U.S. products as ours are to Europe's. (We export about three times as much to the E.U. as we do to China.)

The problem, instead, is that the Europeans, and the Germans in particular, treat *themselves* badly, with a ruinous obsession over public debt. And the costs of that obsession are spilling over to the world as a whole.

Some background: Around 2010, politicians and pundits on both sides of the Atlantic caught a bad case of austerity fever. Somehow they lost interest in fighting unemployment, even though it remained catastrophically high, and demanded spending cuts instead. And these spending cuts, unprecedented in a weak economy, slowed the recovery and delayed the return to full employment.

While debt alarmism ruled both here and in Europe, however, it eventually became clear that there was a crucial difference in underlying motivation. Our deficit hawks were, in fact, hypocrites, who suddenly lost all interest in debt as soon as a Republican was in the White House. The Germans, on the other hand, really meant it.

True, Germany forced debt-troubled nations in southern Europe into punishing, society-destroying spending cuts; but it also imposed a lot of austerity on itself. Textbook economics says that governments should run deficits in times of high unemployment, but Germany basically eliminated its deficit in 2012, when euro area unemployment was more than 11 percent, and then began to run ever-growing surpluses.

Why is this a problem? Europe suffers from a chronic shortfall in private demand: Consumers and corporations don't seem to want to spend enough to maintain full employment. The causes of this shortfall are the subject of a lot of debate, although the most likely culprit is demography: low fertility has left Europe with a declining number of adults in their prime working years, which translates into low demand for new housing, office buildings, and so on.

The European Central Bank, Europe's counterpart to the Federal Reserve, has tried to fight this chronic weakness with extremely low interest rates — in fact, it has pushed rates below zero, which economists used to think was impossible. And bond investors clearly expect these extreme policies to last for a very long time. In Germany, even long-term bonds — all the way out to 30 years! — pay negative interest rates.

Some analysts think that these negative interest rates hurt the functioning of the financial sector. I’m agnostic on that point, but what’s clear is that with monetary policy stretched to its limits, Europe has no way to respond when things go wrong. Indeed, much of Europe may well already be in recession, and there’s little if anything the central bank can do.

There is, however, an obvious solution: European governments, and Germany in particular, should stimulate their economies by borrowing and increasing spending. The bond market is effectively begging them to do that; in fact, it’s willing to pay Germany to borrow, by lending at negative interest. And there’s no lack of things to spend on: Germany, like America, has crumbling infrastructure desperately in need of repair. But spend they won’t.

Most of the costs of German fiscal obstinacy fall on Germany and its neighbors, but there are some spillovers to the rest of us. Europe’s problems have contributed to a weak euro, which makes U.S. products less competitive and is one reason American manufacturing is sliding. But characterizing this as a situation in which Europe is taking advantage of America gets it all wrong, and is not helpful.

What would be helpful? Realistically, America has no ability to pressure Germany into changing its domestic policies. We might be able to provide a little moral suasion if our own leadership had any intellectual or policy credibility, but, of course, it doesn’t. There’s a sense in which the whole world has a Germany problem, but it’s up to the Germans themselves to solve it.

One thing is for sure: Starting a trade war with Europe would truly be a lose-lose proposition, even more so than our trade war with China. It’s the last thing either America or Europe needs. Which means that Trump is probably going to do it.