Opinion **German economy**

Germany must take care when throwing around stimulus

Two speed economy means that any spending must be carefully tailored

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Germany's auto sector is suffering through structural changes amid the shift to electric and self-driving cars © Bloomberg

Mohamed El-Erian 5 HOURS AGO

Now that Germany's leading economic institutes have slashed their growth forecasts, the pressure is on Berlin to adopt a major fiscal stimulus — not just to avoid a prolonged recession there but to boost regional and global economic growth. But there are also good reasons why many German policymakers are resisting. Finding a way forward is possible, but such budgetary expansion must be carefully tailored to address their legitimate concerns.

At first sight, the arguments for greater stimulus appear straightforward. The economy is already contracting and some indicators suggest that this will worsen. Inflation is low — 1.4 per cent — and more likely to fall than rise. There are obvious, productivity-enhancing opportunities, from infrastructure spending to an even larger package of spending aimed at meeting climate targets. And the country is one of the very few in the world that is not struggling with high debt and debt servicing burdens.

These domestic arguments are amplified by regional and international considerations. Europe can ill-afford to lose Germany as a regional locomotive in the short run. It would be even worse if the country becomes the caboose, pulling down the others, particularly those with high debt such as Italy.

Over the longer term, the sound health of the German economy is critical to Europe's wellbeing and, with that, the historic project of regional integration. Moreover, Germany continues to run one of the world's largest current account surpluses. There is a multilateral expectation, if not a moral obligation, for Germany to rebalance, lest it inadvertently contribute to placing excessive adjustment burdens on weaker, deficit economies.

No wonder German fiscal stimulus ranks among the first things, if not the only thing, that many experts suggest when asked how to help the world economy. Yet, as compelling as these arguments seem, they are subject to at least four important qualifications.

First, Germany's contracting gross domestic product masks two contrasting economies.

On the one hand, the export-oriented segment is suffering from lower global demand growth and uncertainties on account of Brexit and the China-US trade and tech wars. The situation is made worse by the fact that its big auto sector is suffering through structural changes amid the shift to electric and self-driving cars. On the other hand, the domestically oriented segment of the economy, including services, is still booming, resulting in very low unemployment and high utilisation rates.

Second, the lesson from years of ultra-loose monetary policy by the European Central Bank is that stimulus is not sufficient — and, some would argue, not even necessary — to lift the binding constraints on better German and European economic performance.

Negative interest rates and quantitative easing have failed to boost demand materially. Sceptics genuinely fear they could even end up doing more harm than good by encouraging excessive financial risk taking and distorting economy-wide asset allocation, including by propping up "zombie" companies and activities. It is not clear that fiscal stimulus will fare much better.

Third, maintaining fiscal flexibility appears more essential now. Monetary policy has run out of ammunition, so we will need something else to counter a deeper economic downturn later. Since there is little that stimulus can do to offset the impact of global trade uncertainty, it would seem prudent to keep fiscal powder dry for now.

Finally, premature German stimulus could discourage reforms not only in other eurozone countries but also inside companies. Such changes are a critical part of durable regional prosperity.

However these objections do not add up to case against fiscal stimulus. Instead they point to the need to design it very carefully. To work, a stimulus package should focus on areas most likely to prompt growth, such as infrastructure modernisation, digitalisation and enhancing human capital through education and training. The government should also supplement any package with further efforts to liberalise and reform the domestic economy. Government stimulus should avoid competing with the private sector and stay out of industries that face no funding constraints.

Germany would be right to make its efforts conditional on progress elsewhere in Europe. Other countries should also find ways to increase growth and strengthen the regional economic and financial architecture.

As appealing as it may seem, German fiscal stimulus is not a silver bullet. But it can, and should, serve as an important catalyst for a eurozone-wide effort to deal with longstanding challenges to high and inclusive growth.

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