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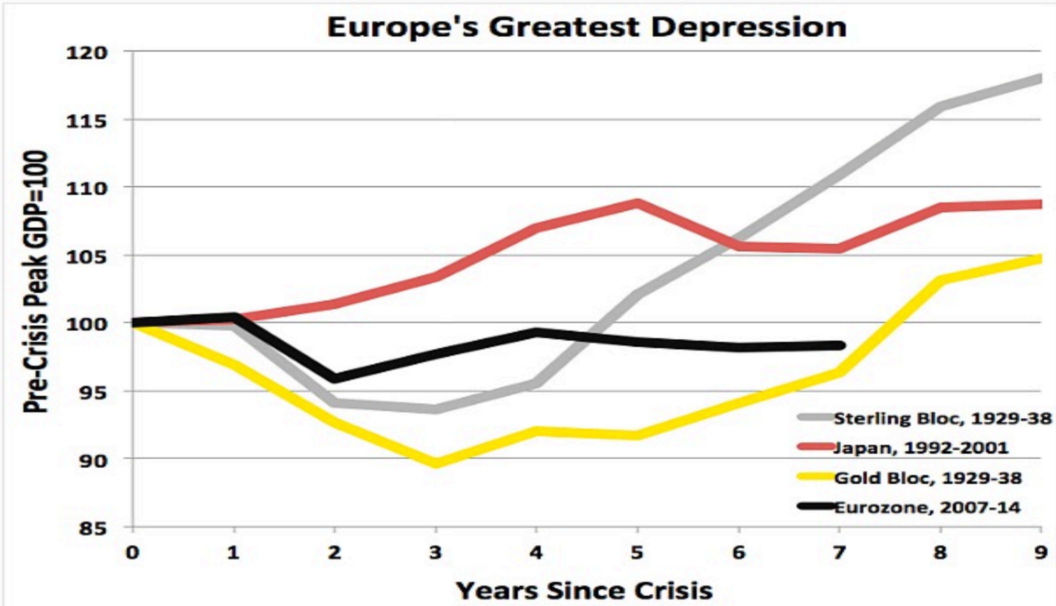
# The Clash of Powers: Draghi and Merkel on Diverging Paths

If one was still in need to understand Germany's political strategy to deal with the Eurozone crisis she could find the answer in Chancellor Merkel's speech at the Nobel Prize Laureates meeting in Lindau. In her lengthy speech she stressed the point that Germany has successfully demonstrated that the reduction of public debt can go hand in hand with an increase in employment, and that former is closely linked to latter. If we follow the official line then success is spreading. As a matter of fact, already tiny positive growth rates of GDP are used by the 'austerian camp' to stress the case that eventually austerity paces the way for strong growth and employment. Nowhere is this proposition more celebrated then in the UK where already the government easily deflects the fact that it needed eight years to return to the pre-crisis GDP-level.

Alas, austerity is the German recipe for the debt-ridden economies of the Eurozone. Can the German experience be generalized? The answer to this question must be a clear-cut: NO. And here is why.

This rosy picture is not the reality of the Eurozone. As a matter of fact, the more time passes the more it seems that the Eurozone has entered a phase of economic stagnation. The comparison of the normalized GDP growth of the Eurozone for 2007 and 2014 with the Sterling and the Gold bloc of 1929-38 as well as with Japan for the period 1992-2001 is revealing (graph 1).

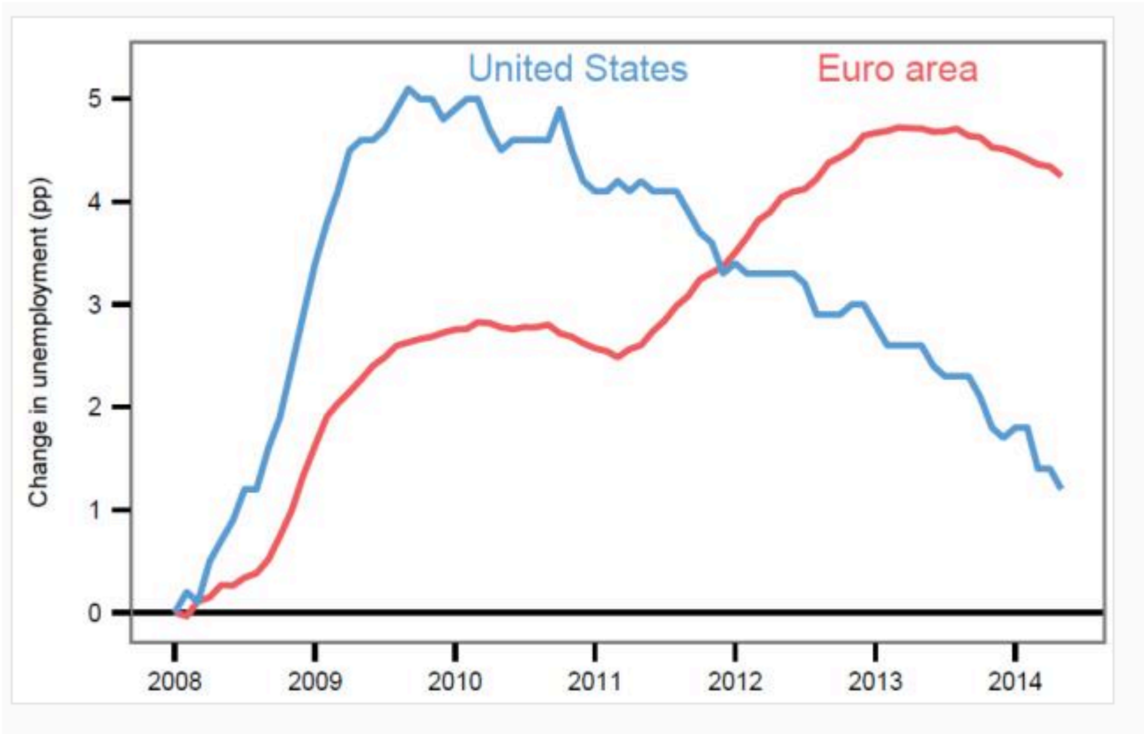



Sources: Maddison Project, Eurostat

*Notes*: 'sterling bloc' comprises Denmark, Norway, Sweden and UK, all of which left the gold standard and devalued in September 1931; the 'gold bloc' comprises Belgium, France, Italy, Netherlands and Switzerland, all of which stayed on the gold standard until autumn 1936 apart from Belgium which exited in March 1935.
*Source*: derived using Maddison (2010) updated with The Maddison Project (2013); OECD (2013).

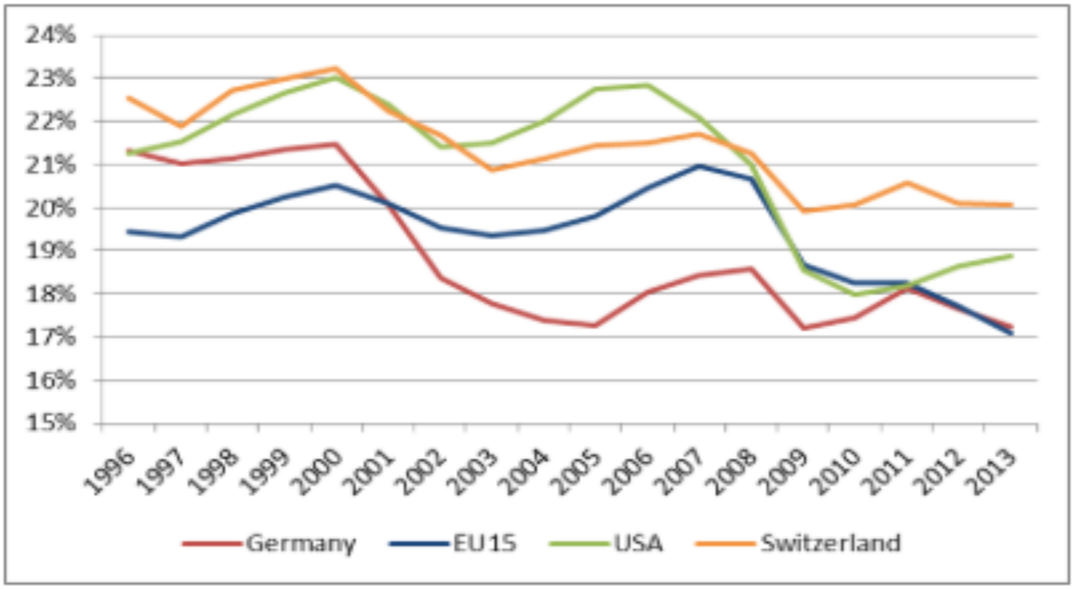
This comparison teaches mixed lessons, though. The Sterling bloc did best in terms of real GDP growth., probably due to the early depreciation of the Pound. The Gold bloc showed an inferior performance due to its insistence on keeping up the Gold Standard. Japan as a stand-alone economy with a currency of its own experienced quite substantial depreciations ns but never made it back to its former growth path.  The performance of the Eurozone looks devastating:. Not only did the Eurozone never see a full recovery back to the pre-crisis level of 2007, it actually moved onto a flat path in the last couple of years. Stagnation is written all over the common currency zone. This path is reflected in the development of the unemployment rate since 2008. It was Martio Draghi in his Jackson Hole speech from August 2014 who stressed the sad case of stubbornly high unemployment (see graph 2) and indicated that the established mode of austerity may need some re-thinking.

Graph 2: Unemployment rates USA and Eurozone




In comparison to Merkel's speech in Lindau Draghi's talk in Wyoming was much more substantial, and to some degree even courageous. The debate about the 'real meaning' of his talk has not ended yet but it seems that one can interpret his talk as an cautious reminder that fiscal policy needs to play a much more prominent role in the crisis management of the Eurozone. I don't think it should be read as a U-turn; the ECB still is a strict believer in supply-side reforms. However, it is also clear that Draghi is recognizing that monetary policy, even in its most heterodox version, can't move the Eurozone economies back to a sustainable growth path. Moreover, he fears that a radicalization of his 'whatever it takes'-approach may further stifle financial bubbles that can eaxh moment burst. His remarks that (i) existing rules of the SGP could be used better to address the weak recovery, (ii) that lower tax burden could be achieved in a budget-neutral way, (iii) that some member economies have greater fiscal space to move along then others and that (iv) the EU should start large public investment programs is nothing less then a appeal for an active fiscal policy in order to give the ECB some more policy space.

This statement is not revolutionary at all but it is light years apart from Merkel's approach. When two of the most powerful figures of economic policy making in the Eurozone come up with such divergent views, then we know something goes extremely wrong. And wrong it goes since the start of the Eurozone crisis. The German success story may not falter, even though the second quarter figures for economic growth were disappointing. And yet dark clouds are forming since quite a while. Private as well as public investment as share in GDP dived well below the level of other OECD-economies (graph 3).




Source: European Commission / Haver Analytics

*Graph 3: Gross Investment (Private and Public) as Share in GDP*

At the same time the profit share in GDP has reached new heights. The share of wealth and capital income was close to 29% in the early 1990s and grew since to close to 34% in 2013. Rather then financing domestic investment those funds are increasingly you used to finance investments abroad and, more so, to build up retained profits. Public investments decreased due to the emphasis on austerity that constrained fiscal policy to the point where it tends to undermine competitiveness.

Even though Chancellor Merkel enjoys in public the reputation of a 'scientific' politician who relies on facts rather then on ideology, it is obvious that this does not hold for her economic policy. She will very well be aware of the underlying causes of Germany's economic performance but then she also knows that that she would not politically survive a fiscal policy U-turn, not least because it was she in alliance with her finance minister who planted the German success and stability story into the DNA of German voters. I assume that the German Chancellor is very well aware of the dilemma. She may still have her apparitor Jens Weidmann in Frankfurt but this may not be enough to save her day. Her strong efforts to bring the right persons from the European 'austeritarian camp' into the right positions in Brussels speak volumes.

The day of reckoning will come. The longer the Eurozone remains on a stagnant path, the higher unemployment will stay and the higher the probability that the political disappointment in the common currency will get stronger. Draghi may eventually have to execute what has been indicated. Words alone will not suffice to calm down financial markets. Given the restrictions for the policy tools of the ECB one should not expect magic. It needs more efforts by Super Mario and his gang in Frankfurt to force the Merkel government to a U-turn. The stakes are high on all sides, and this is never a good  sign for a good policy outcome.

Tables are taken from:

1: wonkblog, Washington Post

2: Draghi speech, ECB

3: Odendhal, Center for European Policy Reform