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Recovering from an Economic Hangover: Lessons and Prescriptions for Transatlantic Cooperation

BY KIRSTEN VERCLAS

What was Germany's response to the Greek crisis?

How have the economic crises impacted the political dynamics within the EU?

How can the U.S. and EU overcome the weak economic outlook?

Two years after the financial and economic crisis began in the United States and shortly thereafter spread to Europe and Germany, the subsequent economic downturn continues to cause problems around the globe. A crucial challenge to the European Union (EU) is the case of Greece: In the spring of 2010, Greece succumbed to its own severe fiscal crisis and threatened to default on its sovereign debt. The members of the euro area, confronted with the possibility of the crisis spilling over to other states, struggled to agree on a unified policy. Different economic, political, and domestic interests influenced European policy choices made by the member states. Germany and France, who would have to bear the brunt of the financial assistance to Greece, were especially hesitant to support a financial bailout package. After lengthy negotiations, the European Union, the European Central Bank (ECB), and the International Monetary Fund (IMF) agreed to provide Greece with the needed financial assistance. In turn, Greece began to implement a severe austerity package, triggering massive protests by its population.

Even though economic indicators in Europe—and especially in Germany—are rebounding, rising deficits and global imbalances continue to threaten the economic recovery. In the U.S., the economy is giving mixed signals and analysts fear that a double dip recession is still possible and that a potential recovery could be jobless.

This Issue Brief will provide a short overview of the current economic picture in Germany, Europe, and the U.S. It will then turn briefly to the political implications of the economic crisis for the three actors and for transatlantic relations, with a special emphasis on the EU, before turning to policy recommendations for an improvement of the economy and dealing with the fallout.

The Current Situation in Germany, Europe, and the U.S.

After the financial and economic crisis rocked the U.S., Germany, and Europe in 2008 and 2009, 2010 offers a more positive picture—at least in Germany and Europe. Recent economic forecasts by the German Institute for Economic Research (*Deutsches Institut für Wirtschaftsforschung*, DIW) have predicted a growth rate of 3.4 percent for the German economy in 2010 and 2 percent in 2011. While initially estimating a growth rate of 1.9 percent and 1.7 percent in 2010 and 2011, respectively, the DIW updated its forecast at the end of the summer to take into account Germany's unexpected, record high growth rate of 9 percent in annualized terms in the second quarter of 2010.[1] The strong German growth rate has positively impacted the German labor market. With an unemployment rate of 7.6 percent (or 3.188 million workers) in August 2010, the unemployment rate has almost returned to its pre-crisis figures and experts are hopeful that the number of unemployed persons will drop under 3 million in the fall.

While the strong showing of the German economy in 2010 is a result of Germany's increased exports, analysts predict that positive numbers from the labor market will also result in rising domestic consumption, making the economic recovery more sustainable. However, vulnerabilities remain from Germany's continued dependence on exports as its economic driver. Some German companies' export share is more than 80 percent,[2] which is much higher than American companies. Even an increased domestic consumption is unlikely to be able to make up for potentially significant shortfalls in the export share should the global economy stall on its way to recovery.

German economic growth in 2010 has been the motor of the European economic sector; however, European economic news in 2010 has been largely overshadowed by the Greek sovereign debt crisis. In early 2010, Greece's public deficit and debt began to spiral out of control, amounting to almost 13 percent of its gross domestic product. Consequently, the country's credit rating was downgraded and analysts warned that the financial crisis in Greece could spill over to other European countries. The Greek crisis impacted not only the European countries: Fears of consequences for the euro area led to a devaluation of the euro; the euro fell from $1.5120 at the beginning of December 2009 to $1.1942 at the beginning of June 2010. The decline of the value of the euro makes European exports cheaper and American exports, a key factor in the American economic recovery, less competitive.

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The causes of the Greek financial crisis are twofold: The Greek government was unable to rein in its spending and kept the true extent of the crisis from the European Union. As economic numbers are self-reported by EU member states, an objective scrutiny of these numbers is infrequently undertaken. Additionally, the EU member states are still divided into groups of rich northern and poor southern states. Germany, together with France and the Scandinavian states, are net-exporting states, relying on the southern states' purchases for their economic growth. The southern states—Spain, Italy, Portugal, and Greece—have significantly overspent their budgets and allowed their debts to continue to rise.

Addressing the Greek crisis proved challenging for the EU. During the spring of 2010, debates among the euro area members of whether they should provide financial assistance to Greece and what preconditions Greece would have to fulfill to qualify for such aid dominated Europe. Some states, fearing the spread of the crisis to other countries, argued for significant aid for Greece, lest it jeopardize the European economy as a whole. They also pointed to the fact that the economic imbalance in Europe had enabled the northern states to run up their export surplus, thus profiting from Greece's increased spending. The euro is seen by many political analysts as the "crowning jewel"[3] of European integration, making the currency's success of as much political importance as economic. However, France and Germany, fearing that they would have to provide the bulk of financial assistance, balked at unconditional assistance to Greece, as they also faced their own rising national deficits and debts.

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Domestic political pressure increased their reluctance. German chancellor Angela Merkel faced a critical state election in May 2010: The election in North Rhine-Westphalia was widely regarded as a test for the CDU/CSU-FDP coalition government in Berlin. Polls in spring 2010 indicated that a majority of the German population was against providing financial assistance to Greece, which was perceived as having caused the crisis internally by uninhibited spending and mismanagement of the national budget. Chancellor Merkel feared that a German decision to help Greece would negatively impact her party's performance in this critical state election. After lengthy negotiations, however, the EU, the ECB, and the IMF agreed to a $140 billion rescue package for Greece in May 2010. The

country, in turn, unveiled a severe austerity program to curtail its budget costs, aimed at decreasing the debt to 7.6 percent of GDP. The measures combining an increase in taxes and cutting government-funded programs were met by fierce resistance from the Greek population in protests that even turned violent at points. Over the summer, protests have subsided and it appears that the austerity measures as well as the financial assistance from the EU and IMF have led to a stabilization of Greece's financial situation. Still, analysts fear that repercussions of the Greek crisis as well as potential budget woes in other European states, such as Spain, Portugal, Italy, or Ireland, will continue to test the EU politically and economically.

Originating in the U.S., the economic and financial crisis hit the U.S. the hardest. Two years after the beginning of the crisis and after a change in the U.S. administration, the economic outlook in the U.S. has improved but data for key economic indicators has been mixed in 2010. While the National Board of Economic Research (NBER) has determined that the recession officially ended in June 2009 and although September 2010 saw the largest U.S. stock rally since 1939, the housing market and the unemployment rates have not recovered. August 2010 was the second slowest month on record for sales of new homes in the U.S. and the unemployment rate was 9.6 percent for the same month. Although the U.S. economic growth rate picked up in the first quarter of 2010, to 3.7 percent, the U.S. economy grew only by an annual rate of 1.7 percent in the second quarter of 2010. Forecasts predict only a modest growth in 2010 and 2011 and do not expect the unemployment rate to fall under 9 percent until the end of 2011. The soaring deficit, which was expected to hit $1.47 trillion by the end of September 2010, is an additional concern for the U.S. economy. The pace of the economic recovery will certainly play a role in the U.S. midterm elections in November 2010, where the Republicans are predicted to threaten the Democratic majority, at least in the House of Representatives.

It's the Economy, Stupid – Political Implications in Germany, Europe, and the U.S.

As the reverberations of the economic and financial crisis continue to be felt, the European, German, and American political leadership continues to be tested. In a globalized world with a globalized economy, policy decisions are no longer purely of domestic relevance. Yet domestic implications and influences have a great impact on policy decisions that take place in an international realm. The Greek economic crisis exposed how much influence domestic policy concerns still have in the European Union. Germany's hesitation to provide financial assistance to Greece was largely determined by domestic concerns and polls showing the German population's opposition to any aid to Greece. Although the EU has made tremendous strides in unifying European policies, the division of monetary and fiscal policy tools for members of the euro area has made policies reacting to the financial and economic crisis more difficult for the European Union.

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Furthermore, national parliaments are still eager to blame the European Union for inconvenient policy decisions that are unpopular with their own voters. The economic crisis has exacerbated national debt concerns in Europe and the U.S. A stringent austerity package implemented in Greece has already drawn the ire of protesters there. Germany is currently in the midst of a discussion of how much the social welfare rate should increase. The question of how much the state should provide for its citizens—and what can and should be cut in light of falling revenues during the economic crisis—will become increasingly pertinent, especially in Europe. The crisis has highlighted two different view of social assistance. In Germany, the state is viewed as essential for regulating the economy, for providing for people who are unable to contribute to the economy, and for giving each citizen the same chance to succeed through subsidized education. In the U.S., the majority of citizens is rather skeptical of the state and government and believes that national regulation harms the economy more than supports it. The economic crisis has served to underscore this difference among the transatlantic partners, which has also informed their policy choices in addressing this crisis. Even though the U.S. implemented stimulus packages to help the banking and automotive industries and alleviate the worst consequences of the economic crisis, these bills have been controversial among the population, especially as a turnaround on the job market has not yet been achieved.

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Following the Greek debt crisis, the European Commission outlined a plan to "reinforce economic policy coordination in the EU and the euro area."[4] The Commission proposed three measures: increase economic surveillance of member states; coordinate budgets of European Union member states before they are passed; and establish procedures to address financial crises in euro area member states. All of these are sensible proposals, which are included in the policy recommendations below. Yet they do not address the most important question: How can these changes be implemented and then enforced? As long as countries in the EU, and especially in the euro area, are not willing to surrender more of their economic sovereignty to the EU, all sensible policy proposals will not be implemented or enforced since the member states will have to be the ones doing so. As the Lisbon Treaty is intended to increase greater political integration in areas of foreign policy, the Greek financial crisis has shown that the integration of economic policy, once considered the most advanced policy area of European integration, will have to be deepened to withstand economic and financial crises in the member states.

While the economic crisis might be nearing its end, the political consequences of the responses—that is, the large questions of how much state is needed to regulate the economy, how much international cooperation is feasible and desired, and how much welfare state should each individual state provide for its citizens—are still unanswered.

Policy Recommendations

The debate about how to address the global economic and financial crisis has continued throughout European and U.S. policy circles. Even though some economic indicators have turned positive, unless the U.S. truly overcomes the crisis, as evidenced by a substantial decline in unemployment figures and addressing the rising national debt, the long-term economic outlook is weak. EU member states will have to address the imbalances within the euro area and their own rising public deficits. Global imbalances will also have to be taken into account and addressed. Additionally, both the U.S. and Europe will have to grapple with several long-term issues—issues recently obscured by the economic crisis but whose solution remains important. First, states need to determine the desired relationship between the government and the economy, decide how much government oversight is needed, and determine the size of the social welfare net. Second, states, especially in Europe, will have to address the issue of demography. The population in Germany, for example, is forecasted to shrink from 82 million in 2006 to 69-74 million in 2050.[5] In addition to an aging population, countries will have to decide what kind of immigration policy is needed to counter their shrinking populations and, thus, their shrinking labor force. Third, the economy's environmental costs and consequences will also have to be taken into account. This includes the fact that many industrialized countries, such as Germany, are resource-poor, which could threaten their economic independence and stability. Fourth, as Europe and the U.S. are transforming increasingly from manufacturing states to countries dominated by service sector jobs, education policy will become more and more important to produce an educated workforce.

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While these issues are debated with different intensity in Europe and the U.S. and are emphasized differently, aspects of all issues will have to be solved in order to avoid a long-term economic decline. Several policies and changes to the political system could help Europe and the U.S. to address their economic weaknesses in the short and long run.

Increase Oversight and Enforcement of European Policies

Lack of oversight and enforcement were two primary reasons why the Greek crisis was able to spin out of control. In a monetary as well as a political union, transparency, oversight, and enforcement are paramount for success. The EU relies on its

member states to self-report their economic data to Eurostat, the statistical office of the European Union. Voluntary financial reports can no longer be enough, especially for members of the euro area. Each EU member state should therefore be obligated to allow Eurostat to control and verify the reporting of economic data. In addition, the European Monetary Union lacks enforcement mechanisms. The European Stability and Growth Pact (SGP) stipulates that members of the euro area cannot have a national debt higher than 60 percent of their GDPs and that their annual budget deficits are no higher than 3 percent of their respective GDPs. However, as the countries (including Germany) who initially insisted on implementing the SGP began to fail its criteria themselves, the EU weakened the SGP's requirements in March 2005, on Germany's and France's request. Critics had alleged that the criteria were too inflexible and did not allow countries enough maneuverability to address economic crises and consequent budget shortfalls. Additionally, many experts point to Greece as only the latest example of using accounting mechanisms to obscure the true fiscal situation of a country.

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The members of the euro area continue to be hampered by the division of monetary and fiscal policies, the fact that the SGP is not fully enforced, and the lack of independently verified economic data by their members, which are all necessary to fully enforce the SGP and anticipate economic and financial problems within the member states. The euro has significantly decreased costs for businesses to undertake transactions with the members of the euro area, and despite the political tug of war centered on the Greek crisis, an end of the euro or member states leaving the euro area is highly unlikely.

While a European budget with a European tax system might be proposed by some as a solution, this is politically unfeasible as national parliaments will be unwilling to relinquish their fiscal control. Yet the financial crisis in Greece has shown that the EU lacks transparency and a process by which problems can be addressed. Countries that have a strong stake in the European Union and the euro area, such as Germany, will have to decide domestically what the role of the European Union will be in economic policy. Where does national sovereignty end when a state is a member state of the euro area? Should national budgets be controlled by the EU? If so, who decides what is reasonable spending and what measures should be cut? While the Lisbon Treaty has given the EU more sovereignty and rights in terms of foreign policy, economic policy will have to be coordinated further as well, especially for members of the euro area.

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Germany, as one of the leading nations in the EU and an economic driver, will have to become one of the nations pushing for further economic integration and control. This will not be possible without explaining to its domestic audience why the European Union is necessary for Germany's economic growth. Currently, the EU—and especially the euro—is not very highly regarded in Germany; more than anything, Germans consider the EU a transfer union that drains Germany of money. In order to increase integration, strengthen the European regulatory framework, and boost transparency, Germany and other European nations will have to gain the support of their respective populations. The European Union is important not only within Europe, but will have to continue to also become a global economic player.

Strengthen the Transatlantic Economic Council (TEC)

The most important lesson from the economic and financial crisis is certainly that domestic responses and economic policies have a larger impact on the global economy. In a globalized world domestic policies matter more than ever; consequently, so should international cooperation. The Transatlantic Economic Council (TEC), implemented in 2007, has largely been sidelined when it comes to improving transatlantic economic coordination. Yet transatlantic trade is an area where sensible economic policies could have a very positive impact on the U.S. and European economic recoveries. Although transatlantic trade is not a political priority on either side of the Atlantic, the TEC could be a venue to continue to reduce non-tariff barriers (NTBs, sometimes referred to as non-trade measures or NTMs) between the U.S. and Europe. A recent study commissioned by the European Commission found that "[f]or the EU, removing all actionable NTMs would translate into an increase in GDP (€122 billion a year) and exports to the U.S. (+2.1%). Sector wise, EU benefits would come mainly from gains in motor vehicles, chemicals, pharmaceuticals, food and electric goods. For the U.S., benefits from removing actionable NTMs are estimated at €41 billion per year for GDP and 6.1% for exports to the EU. U.S. benefits would mainly accrue to the electric goods, chemicals, pharmaceuticals, financial services and insurance sectors."[6]

Thus, removing non-tariff barriers between the U.S. and Europe in times of economic uncertainty is an important step both economically and for the deepening of transatlantic ties. As the

TEC was founded during Germany's EU presidency in 2007, Chancellor Merkel as well as President Barack Obama should show political leadership and increase the importance of the TEC in negotiating the removal of non-tariff barriers. Negotiations between Europe and the U.S. to harmonize their accounting standards have been delayed and meeting the goal of achieving common standards by June 2011 seems unlikely. As both sides' standard-setting boards have not succeeded in negotiations,[7] the TEC could play a mediating role in achieving a common set of standards, which would strengthen the financial market as well as decrease costs to businesses having to provide different sets of accounting. The TEC should, furthermore, increasingly serve as a permanent forum for the U.S. and Europe to discuss and coordinate policies both will pursue vis-à-vis third countries, such as China, or in international organizations (such as the G20 or meetings of the IMF or World Bank). As the U.S. has increasingly called on China to undertake a currency reform and accused the country of artificially keeping its currency value low in order for its exports to remain cheap, the EU has begun to echo the U.S.' calls. Coordinated efforts between Europe and the U.S. elevate a bilateral dispute to an issue of international concern. Yet, as Europe is not always able to coordinate its economic and financial policies even among its member states, transatlantic cooperation will not be easy. However, with a forum such as the TEC, issues are not discussed in an isolated fashion but rather in a strategic context, opening the possibility for trade-offs between Europe and the U.S.

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Develop a Sustainable Economy

The rising national debt is a primary concern in the United States and in Europe. Germany, for instance, is in the process of implementing a national austerity program, which is intended to save €10 billion per year from 2011 onward to comply not only with the European Stability and Growth Pact but also with the "debt brake" passed into law by the previous German government. In the U.S. concern about the national debt is also rising. On both sides of the Atlantic the question of how to implement austerity measures without threatening the still fragile economic recovery are being debated contentiously.

While the need for austerity measures is clear, it is important for the U.S. as well as the EU to use the occasion of an economic crisis to spur development of an ecologically sustainable economy and infrastructure and lay a sound basis for future economic growth. A recent report conducted by a bipartisan U.S. panel concluded that the lag in investment in U.S. infrastructure will lead to "a steady erosion of the social and economic foundations for American prosperity in the long run." The report further "advocated the adoption of a distinct capital spending plan for transportation, empowering state and local governments with authority to make choices now dictated from the federal level, continued development of high-speed rail systems better integrated with freight rail transportation, and expansion of intermodal policies rather than reliance on highways alone to move goods and people."[8] Increasing infrastructure spending, especially for rail systems, will decrease the West's reliance on imported oil while countering climate change, thus increasing national security and decreasing economic costs in the long run.

Even though spending on infrastructure might run counter to austerity measures demanded to decrease the deficit, the costs of investing in a country's infrastructure have never been so low.[9] In the U.S., for example, due to the recent recession costs for construction labor, supplies, and borrowing money for infrastructure projects are very low. Thus any investment in infrastructure is currently comparatively cheap. The U.S. government used the American Recovery and Reinvestment Act in 2009 to provide states with several billions of dollars for infrastructure projects, but should continue to provide money for smart investments in needed infrastructure projects that, first and foremost, establish a sustainable economy. Furthermore, any investment in a greener economy will translate into job growth in the long run, as Germany has demonstrated with 250,000 new jobs created in its green economy, a sector that will employ more people than the automotive industry by 2020.

Infrastructure investment cannot be limited to just include transportation. The U.S. and Germany currently rank fairly low in international educational comparisons, such as the PISA study. As developed countries—including Germany and the United States—transition from a manufacturing economy to service economy, education will be vital to transform the workforce accordingly. Education policies should thus be another focus of developing a sustainable economy.

Conclusion

Even though economic indicators in Germany, Europe, and the U.S. show improvement, the economic recovery is still ongoing. The fall-out in Europe and the U.S. is not yet certain. While the Greek financial crisis has likely been overcome, other European states are still struggling with their economic recoveries and domestic problems are threatening to spill over to other members of the euro area. Furthermore, Greece's austerity package, which was implemented in the spring, continues to draw protests. The Greek crisis also revealed that the members of the euro area lack sufficient policy tools to deal with economic and financial problems of one of their fellow member states. Domestic concerns factor into policy decisions, as seen when it took nearly four months for a financial aid package to be agreed upon for Greece and domestic concerns continue to play a large role in Germany's policy decisions on Greece. The members of the European Union, and especially the euro area, have to increase their transparency, their enforcement, and their coordination policy tools to prevent a similar crisis from happening again.

The United States is facing a potentially decisive mid-term election in November 2010, which is certainly influenced by the economic outlook in the U.S. While economic data has been improving, so far positive signals have not translated into a real job growth and experts predict the unemployment rate will stay over 9 percent until the end of 2011. If, as political analysts have forecasted, Republicans win at least the majority in the House of Representatives, it will remain to be seen what economic policy direction the country will take after November 2010.

In a globalized world, however, it remains imperative that Europe and the United States continue to improve their cooperation on economic policies. The TEC, which was implemented under the German EU presidency, remains one of the best vehicles to do so. In addition to increasing transatlantic economic cooperation by agreeing on regulatory policies and minimizing non-tariff barriers, the U.S. and Europe should also use the TEC to coordinate economic and financial polices vis-à-vis third countries and in international organizations. The most recent pressure from Europe and the U.S. on China to devaluate its currency is one example of what kind of policy issues could be coordinated in the TEC. The economic and financial crisis should also be used to implement economic policies designed for the long run. Although both Europe and the U.S. are burdened by large national deficits, implementing austerity measures should not require neglecting investments in vital infrastructure, greening of the economy, or education. Austerity for austerity's sake will burden the transatlantic economy in the long run. Smart investment in growth areas will strengthen it for generations to come.

NOTES

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The ramifications of the financial and economic crisis reached Europe and Germany in 2008 and 2009, and especially during the Greek crisis in 2010. Although hesitant in the beginning, German politicians have committed to national stimulus measures as well as to their participation in a €257 billion EU economic stimulus package. Stimulus and Greek bailout decisions did not come easily, with France and Germany initially at odds over the structure and size of the stimulus package and measures for Greece. This Issue Brief analyzes the impact of the economic crisis on Germany, the EU, and the United States and offers policy recommendations for promoting greater cooperation in the future.

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