

GERMANY IS QUIETLY REBALANCING ITS ECONOMY – BUT THIS WILL NOT FIX THE EUROZONE'S FLAWS²⁷⁸

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Ever since the financial and sovereign debt crisis, the political and economic implications of Germany's unbalanced economy have lured the attention of academics, policy institutions, the public and politicians across Europe and beyond. Frequent are the pleas made to the German political establishment to rebalance its export-oriented economic model, increase fiscal expenditures and thus rein in the world's largest current account surplus. The issue has become so controversial that one reads economic commentators venturing into picturesque appraisals, comparing today's Germany to Nicolae Ceausescu's Romania.

But what is Germany being criticised for? In essence, the controversy revolves around macroeconomic policy making and what the German growth model implies for the rest of the world. There are four constitutive elements in this debate.

278 This piece has originally appeared, in the form of a blog post, on the *LSE Europ Blog* on 14/9/2018, available at: <http://blogs.lse.ac.uk/europpblog/2018/09/14/germany-is-quietly-rebalancing-its-economy-but-this-will-not-fix-the-eurozones-flaws/>, and on *Social Europe* on 20/9/2018, available at: <https://www.socialeurope.eu/germany-is-quietly-rebalancing-its-economy-but-this-will-not-fix-the-eurozones-flaws>.

The version presented here has been slightly modified with respect to the original blog post in order to incorporate critiques and suggestions.

279 I am grateful to Benjamin Braun, Sebastian Diessner, Martin Höpner, Fritz Scharpf and Jachim Truger with whom I had the chance to discuss these issues to refine my thinking. All mistakes are my sole responsibility. I am especially thankful to Dr. Paul Steinhardt who has written a thoughtful critique to my original piece. This has helped me substantially to refine my thinking and correct initial mistakes I had committed. His critique has appeared as a blog post (in German) on the *Makroskop blog* on 28/9/2018, available at: <https://makroskop.eu/2018/09/wissenschaftliche-sensation-deutschlands-stilles-rebalancing-wurde-entdeckt>.

Two pertain to the sphere of macroeconomic policy proper, i.e. wage and fiscal policy. One has to do with an empirical manifestation of macroeconomic policy in the German balance of trade, i.e. persistent current account surpluses. The last criticism is centred on the growth model itself and considers the implications of the German export *Weltmeister* for the European Economic and Monetary Union (EMU), as well as global imbalances). In what follows I focus *solely* on the EUROpean perspective and leave the issue of global imbalances to others.

Germany's 'unbalanced' economy and the EMU

German policy makers, the argument goes, should rein in the country's trade surplus and allow for symmetric adjustments in the EMU. Germany is accused of engineering economic growth at home by free-riding on other European countries' aggregate demand. Some even go as far as to argue that Germany is "artificially" and "purposefully" repressing domestic household consumption, government spending and private investments to sustain a *mercantilist model*. Germany allegedly refuses to correct trade imbalances and – given fixed exchange rates – grows at the expense of other EMU participants, which have to go through painful internal devaluations and fiscal austerity. What is thus being asked of Germany is to reduce its budget and trade surpluses to provide a more symmetric adjustment mechanism to the single currency via the expansion of its domestic demand for EMU exports.

In the eyes of the critics, Germany's increased imports are thus supposed to work as a functional equivalence for the lack of supranational adjustment mechanisms in the monetary union. In other words, Germany should act as a *fixer of last resort* in the Eurozone and, to fulfil this role, domestic macroeconomic policy should follow suit. Since participating in the EMU entails a loss of sovereignty over exchange rate and monetary policies, both criticism and policy advice focus on wage and fiscal policy.

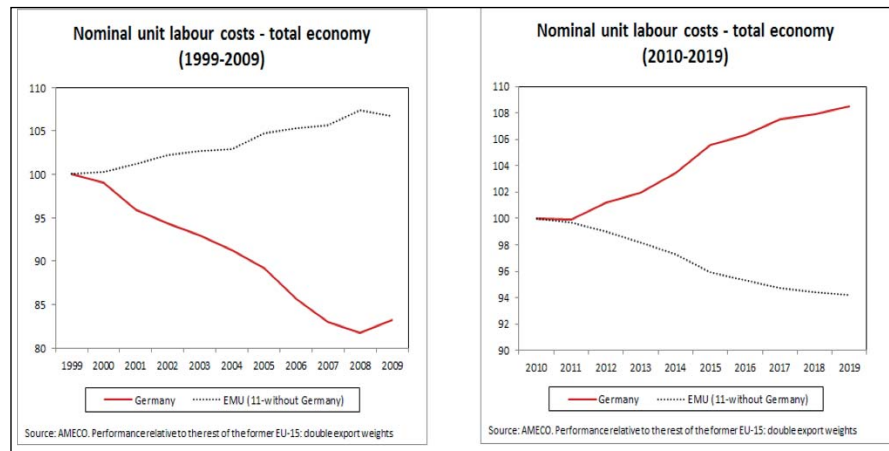
Let's start with the criticism. People concerned with wage policy argue that Germany has undergone a substantial internal devaluation of its unit labour costs (ULCs): wages have fallen behind the economy's productivity rates in both the private and public sector, thus yielding a cost and price competitiveness premium to the German export sector best captured by its remarkable ULC-based Real Exchange Rate (REER) depreciation. Those who point at fiscal policy stress the German budget surplus, bemoaning the lack of government spending. Deflationary wage policies (decreasing real wages) are said to deter household consumption at home and imports from abroad. An austere fiscal policy contains the government's final consumption and contributes to keeping imports artificially low. At any rate, the combination of a restrictive wage and fiscal stance represses total domestic demand (public and private), leads to relatively low inflation, REER competitiveness and trade surpluses – which prevent the possibility for other EMU participants of adjusting via an export-led recovery.

Now the policy advice: what should Germany do? Policy remedies follow consistently from the critiques. ULCs in Germany should rise faster than its competitors' so as to experience an appreciation of its REER and hence a loss of the competitiveness (unfairly) acquired before 2008. Additionally, the German government should spend more money. The effects of this policy mix would set in motion two complementary mechanisms for adjustment. On the one hand, the wage and price inflation deriving from higher wage rates and an expansionary fiscal stance will decrease (ULCs- and CPI-based) REER competitiveness and help rebalance the current account – allowing other EMU countries to “breathe”. On the other, increased households' purchasing power (due to higher real wages) and government consumption will increase domestic demand and imports from abroad.

What has Germany done since the crisis and what can it possibly do, given the institutional setting?

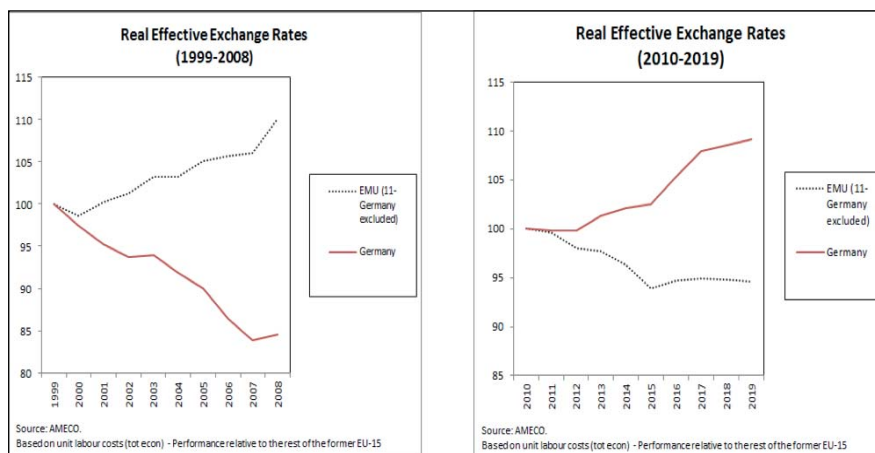
In general terms, the criticism on such a high current account surplus is certainly valid. Yet, what the critiques have in common is that they rarely ask what Germany has done since 2010 to address these issues. It thus seems appropriate to ask whether the trends of wage restraint and fiscal austerity, visible before 2008, have been reversed in the post-crisis era or whether Germany continues to “beg her neighbours”.

Figure 1: Unit labour costs: total economy (1999 and 2010=100)



ULCs in post-crisis Germany (figure 1) have increased steadily. Since 2010, the trend of internal depreciation so much pronounced during 1999-2008 has been reversed and Germany has undergone a substantial REER appreciation (figure 2) vis-à-vis its EMU peers, forced into a path of internal devaluation. The REER competitiveness gained in the pre-crisis period has not been fully reabsorbed yet. Still, the trend has clearly reversed.

Figure 2: Real Exchange Rates in Germany and the EMU (1999 and 2010=100)



Surely, criticising Germany for its own sake may lead to one always ask “how much is enough”. This would perhaps be a fair question given the remarkable pattern of wage restraint observable before the crisis. But a constructive and – *realistic* – critique should go beyond a mere numerical macroeconomic argument and include institutional structures in order to elaborate on the feasibility of an extraordinary internal appreciation, given the German wage setting systems.

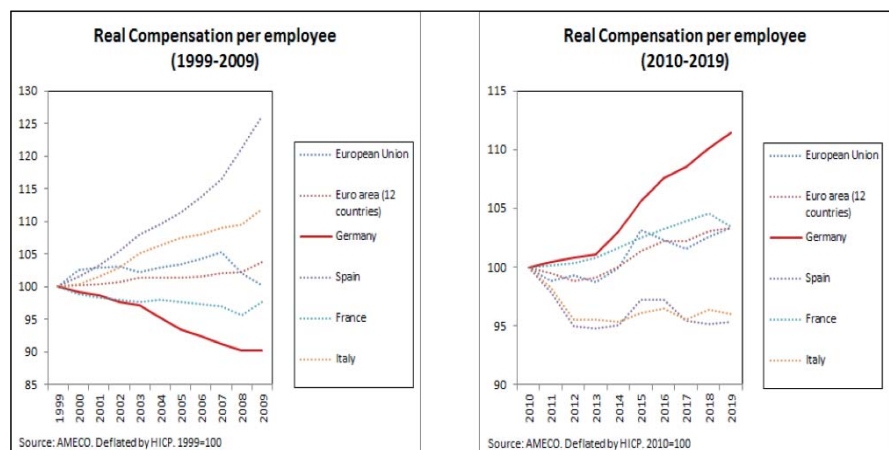
Tarifautonomie allows for no government interference in private sector wage negotiations and, frankly, it sounds quite absurd to expect the German government to ask the social partners to *price themselves out of the market* in order to purposefully lose competitiveness *vis-à-vis* its EMU peers.

Regarding public sector wage setting, after the reforms of the mid-2000s it is now the finance ministers of the *Länder* who are in charge of negotiating wage increases for the public employees they are in charge with, i.e. the majority. Given that the *Länder* lack the possibility to manipulate their marginal tax revenues - and that personnel pay is the most burdensome item in State administrations’ books

(approx. 45% of total expenditures)- it would be pointless to expect substantial wage increases in the TV-L contract without a fiscal federalism reform that attributes more money to subnational governments. Even more fundamental is that it is unclear why one should expect the finance minister of a German State to respond to Eurozone imperatives, while being accountable to their local constituency.

The only instrument the German government could use to intervene in wage-setting is to legislate for an increase of the minimum wage above inflation. This has already been agreed and the government is about to ratify an above-inflation increase of 4%.

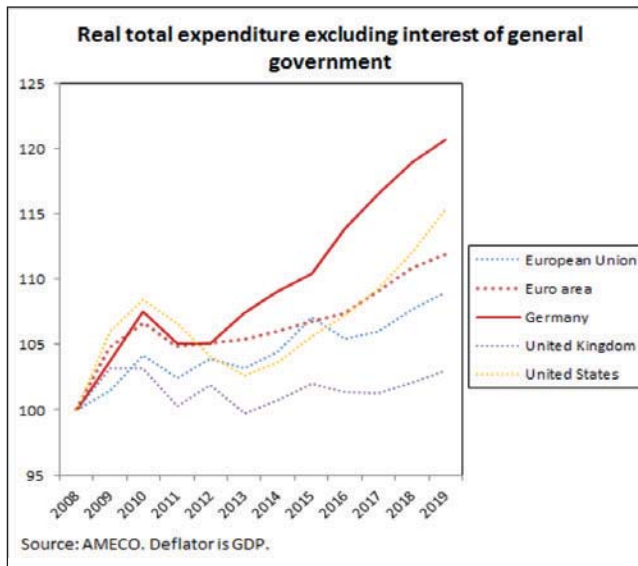
Figure 3: Real Compensation per Employee, deflator is HCPI (1999-2019)



Even assuming that it would be structurally possible to raise German price inflation far above the EMU average via wage push inflation, this is likely to create more damage than relief. Given Germany’s size in the EMU, it will rather put enormous political pressures on the soon-to-be new governor of the ECB to tighten monetary policy. The effect for the EMU would be the opposite of the desired symmetric adjustment: countries in the periphery would be pushed into even direr straits.

What about the German finance ministers, are they really so stingy? In terms of real government expenditures (net of interest payments), Germany has since the crisis spent considerably more than most other OECD countries, even more than the increase in spending in the United States – often praised for its post-crisis Keynesian stance.

Figure 4: Real total expenditure excluding interest of general government (2008=100)

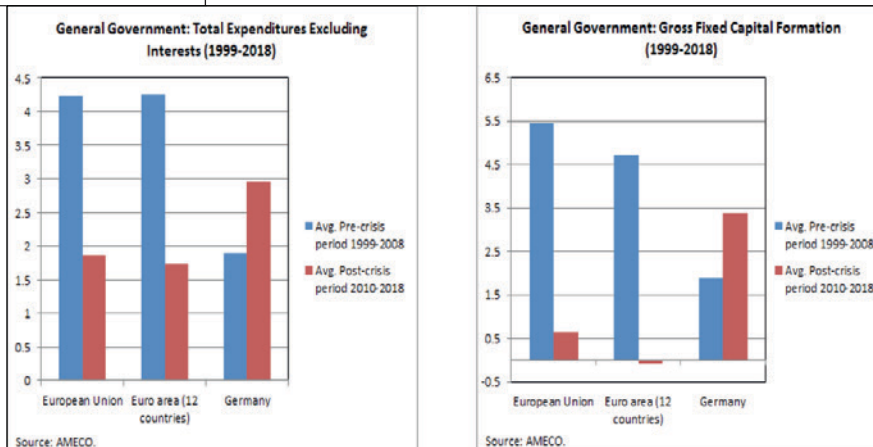


Calculations based on AMECO data also confirm a reversal of the trend: a moderate but steady expansion of Governments' expenditures. In the decade before the crisis (1999-2008), total expenditures in Germany (excluding interests) have increased at an average annual rate of 1.9% (4.2% in the EU – 4.2% in the EMU). After the crisis spending has increased at an annual average of 3%, while it has collapsed to 1.9% in the EU and 1.7% in the EMU. The same trend can be observed with regard to Government's gross capital formation. During the pre-crisis era, annual average growth of investment spending in Germany was 1.9% while it has increased at an annual pace of 3.4% during the period 2010-2018, while in the EU as a whole, in the post-crisis period it has been fallen to 0.6% (from 5.5%) and even negative in the EMU, -0.1% (from 4.7%).

Figure 5: Governments' total expenditures (excluding interests) and gross fixed capital formation (1999-2018)

Since gross fixed capital formation of general government does not consider the effect of capital

The fact is that focusing on the budget surplus may be misleading since, in a buoyant economy, it is relatively faster growth of revenues that drives the calculation up. It is thus perfectly possible to continue expanding investment spending at a moderate yet steady pace, while still remaining in a territory of surplus. It is certainly true that the public-investments/GDP ratio remains



below the Eurozone average and that there are innumerable fields in which Germany could (and should) invest more (e.g., in physical and digital infrastructure). I certainly agree with this plea. But one should also notice that, according to BMF data, since 2005 public investment spending in Germany has been increasing at an average annual growth rate of 3.8%, i.e., at a faster pace than both total expenditure and nominal GDP.

depreciation, a better measure to look at additional investment activity on tangible and intangible assets is *net fixed capital formation* (gross fixed capital formation – depreciation). Figure 6 shows the impressive decline in public fixed capital formation in Germany since 1991. Before the crisis, two periods are striking: 1993-1997 and 2000-2005.

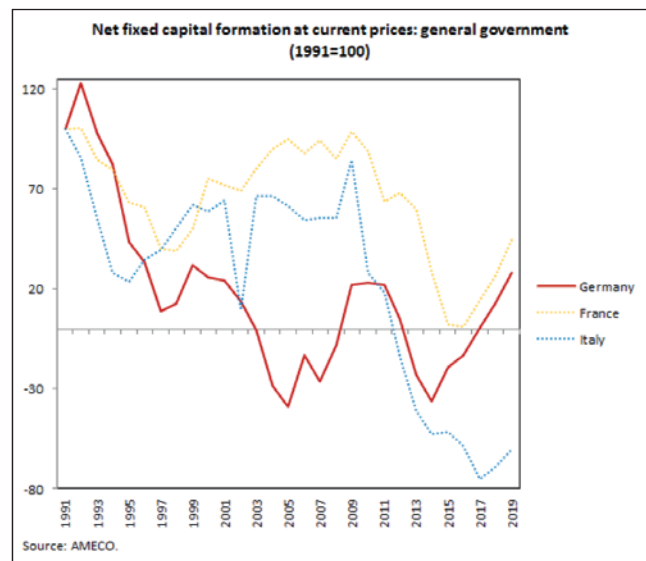
There are three ways in which this fall in public investment can be interpreted: (1) to read these shifts as the result of a conscious mercantilist strategy aimed at compressing domestic demand and price inflation to maintain export-competitiveness at the expenses of trading partners; (2) to read them as the fetishism for balanced budgets at all costs; (3) as lack of administrative capacity to plan and implement investments. I would argue that there is a fourth, more historical, interpretation.

On July 17th 1992, the *Bundesbank* raised interest rates to unprecedented levels in German post-war history (even higher than the June 1973 peak). This engineered an economic slowdown whose effects would be felt for fifteen years. The *Bundesbank's* policy had the precise purpose of punishing the expansionary fiscal stance of the Kohl government (meant to pay for reunification) and the wage setters' loss of discipline (both the private sector *IG Metall* and the public sector *ÖTV*) which ensued from the inflationary post-reunification period (in the 1991 and 1992 wage rounds). In this contingency, throughout the 1990s, the Kohl government *decided* to slash public investment, to reduce the size of the unified public sector and to force public sector wage restraint in order to rein in the budget deficit and comply with the Stability and Growth Pact (SGP) by the fiscal year 1997. Ironically enough, it was Mr. Theo Waigel who wanted the SGP which then haunted Germany until 2006. During the early 2000s, Germany (a then sick man) had hard disputes with the Economic Commissioner Pedro Solbes (in the Prodi Commission) to comply with the 3% fiscal rule which it repeatedly broke, unpunished. In a scenario in which the Commission barks at your back, the easiest way for a government to bring the budget deficit down in the short term is to cut/freeze public sector wages (and benefits) and slash public investment – this is, in fact, what also the countries of the EMU periphery did after 2010/2011. This is surely not a smart long-term strategy, but it does the job, if that is the political objective to be achieved in the short term, given the rules of the game at a specific point in time.

From a more historical perspective it becomes hard, in my view, to claim that Germany purposefully (and in bad faith!) neglected public investments. Germany could not spend more in the early 2000s because it had already fiscal problems due to high unemployment and low growth, hence weak revenues and high social expenditures for automatic stabilisers. My interpretation is rather that this was a contingent strategy and that now that times are good again, the trend of public investment (as well as of domestic demand) will gradually increase, as it has already gone back to the levels of the mid-1990s and is now line with the trend of public spending expansion in France.

It makes much more sense, instead, to argue that the countries which are desperately in need of public and private investments are those asymmetrically hit by the crisis – it is sufficient to look at Italy in figure 6.

Figure 6: net fixed capital formation at current prices: general government (1991-2019)



Surely enough, one can ask how much is enough. But, again, considering that approximately 2/3 of fiscal spending in Germany takes place at the decentralized level, we should ask ourselves why should local administrators respond to Eurozone imperatives while being accountable to their local constituencies?

German Federal and local administrators would be better off investing in the future of their citizens, especially given the cheap funding possibilities Germany enjoys today. This is an obvious statement with which it is easy to agree. But, realistically speaking, I don't see why one shouldn't also be open to the possibility that, more simply, the *timing* may be wrong to ask Germany for a Teutonic New Deal: it is perfectly conceivable, in fact, to imagine German local administrators to currently maintain a preference for a moderate (yet steady) expansion of investment rather than a massive fiscal stimulus.

In other words, there seems to exist an inconsistency in the very pre-conditions for the implementation of Keynesian economic policies in a system of multilevel governance: *i.e.*, a clear mismatch between the possibility – and the incentives – for German fiscal authorities to implement Keynesianism at home (in Germany) with the hope to engineer Keynesianism abroad (in the EMU). This is because of the asymmetric effects of an incomplete EMU. After all, to be completely honest: didn't Keynes also say that hoarding money in good times is functional to governments' counter-cyclical spending in hard ones?

What about Germany's current account surplus vis-à-vis its European partners in the single market? Ever since the crisis, German exports of goods to the EU have decreased substantially relative to its imports. The intra-EU export/imports ratio has been going down significantly. In fact, the core countries of the EMU, together with the Visegrád Group, show a higher exports/imports ratio than Germany.

It will be argued, perhaps correctly, that the bulk of this decrease is due to fiscal austerity and wage restraint in the periphery of the EMU. I am not in principle against this objection, but I would like to ask the reader to consider two qualifications. First, figure 6 shows that when the ratio for Southern European countries starts going up after the beginning of austerity measures in 2010, the German adjustment in the single market, which

started in 2008, is almost completed, *i.e.* lower imports from Southern Europe are not the whole story here. Secondly, the collapse of demand in the South could (and should!) have been avoided regardless of the German current account surplus: it is due to the lack of stabilization mechanisms at the supranational level and, especially, to bad policy choices.

So, where does the German current account surplus come from? Neither from the EU Single Market, nor from the Euro Area.

Ever since summer 2008, Germany's trade surplus with EMU partners has disappeared and the current account surplus has been driven solely by extra-EMU trade. In this sense, Germany quietly *exited the euro* in 2008 to then assail international markets in 2011. OECD statistics show that the driving markets behind export growth in Germany have been the US, the UK and the People's Republic of China - all of them outside the EMU.

It is exactly this that makes Donald Trump and his colleagues very angry. Global imbalances and the German extra-EMU current account surplus do constitute a serious political and economic issue in advanced capitalism, not least because the surplus makes Germany (and hence the whole EMU) fragile *vis-à-vis* exogenous shocks beyond her control. But in this essay - it is good to repeat - I leave this issue out of the analysis and only deal with the EUROpean perspective.

Here again, it will be argued that the closing of the intra-EMU surplus is due to the fall in imports from the Periphery. Again, I would subscribe to this objection if it weren't for the fact that reasoning in this way constitutes a *genetic fallacy*: the fact that since 2010 the German intra-EMU surplus has disappeared because of austerity and internal devaluations in the periphery does not make the intra-EMU rebalancing less true.

Figure 7: Intra-EU exports divided by intra-EU imports (2002-16)

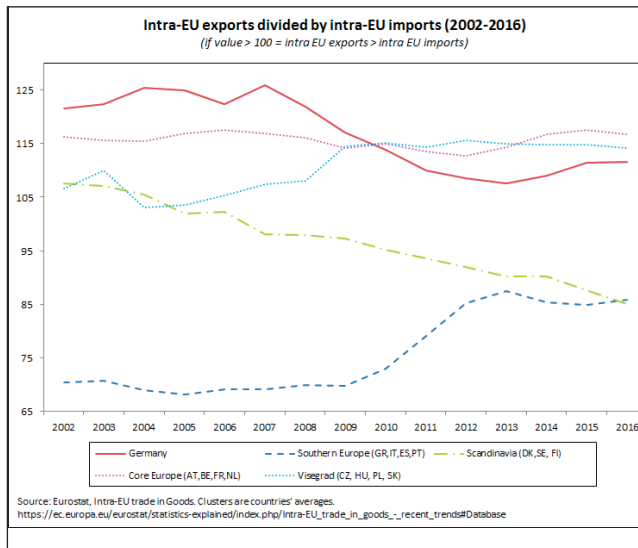
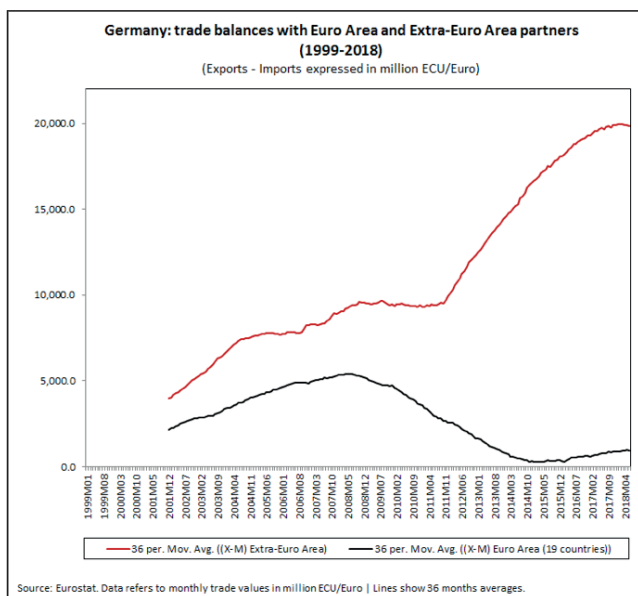


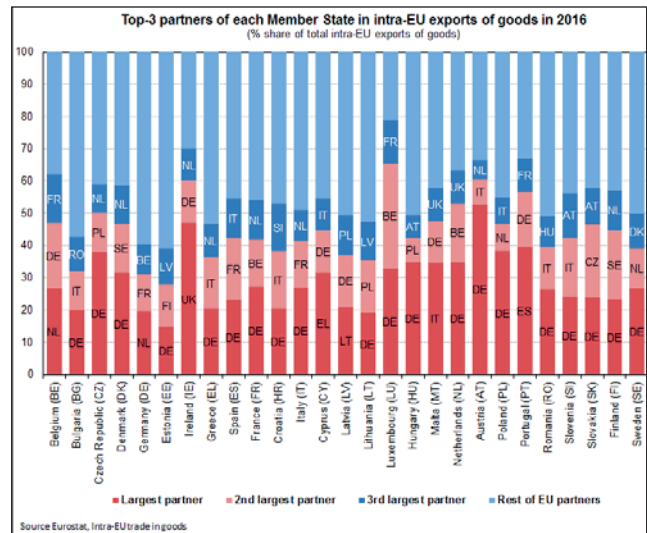
Figure 8: German trade balances with the Euro Area and Extra-Euro Area partners (1999-2018)



As far as the single market is concerned, Germany is virtually the largest importer for all its members. Germany, thanks to its size and industrial sector at the core of the EMU, already provides a very wide market for EMU exports. This will not come as a surprise to many, but it is simply taken to show that there will be limits to the extent that Germany can realistically expand its imports from its EMU peers – especially until these upgrade their productive structures (with smart investments –

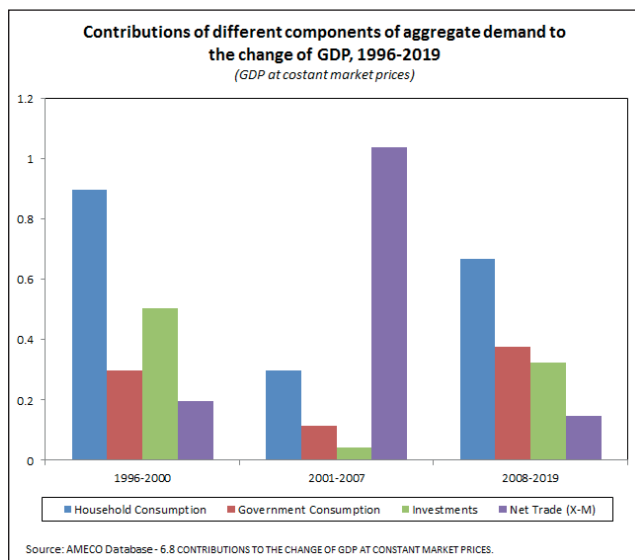
not via internal devaluations!). Will, on the other hand, asking Germany to slow down its extra-EMU export engine benefit the EMU? I think it is hard to tell. Possibly, it is instead likely to reduce German imports from its EU trade partners even further.

Figure 9: Top-three partners of each member state in intra-EU exports of goods (2016)



Is economic growth in Germany driven by exports, *i.e.* net trade (exports minus imports)? Or, in other words, does Germany “steal” growth from abroad? When decomposing GDP growth (Figure 10) in the aftermath of the crisis, we ascertain that export-led growth is an historical parenthesis rather than a structural feature of the German economy. GDP growth was strongly driven by net exports during 2001-2007. In the aftermath of the crisis, given increased real wages and government expenditures, GDP growth has been driven mostly by household consumption, public and private investment. Yes, the export share in total GDP remains high in relative terms, but data suggests that net exports have not been the main drivers of GDP growth in post-crisis Germany: the trend has been reversed.

Figure 10: Contributions of different components of aggregate demand to change of GDP (1996-2019)



CONCLUSIONS

Before moving to the conclusions I shall make clear what this essay does *not* argue, in order to avoid any misunderstanding. I am *not* arguing that the German current account and fiscal surpluses are good and desirable. Most importantly, I am *not* arguing that what documented here is enough for Germany and the EMU to cheer up, as well as I am *not* arguing that German wages should not rise further or that German authorities *shouldn't* invest in the future of their citizens. My aim was to play a bit the devils' advocate and ask two questions which seem to be forgotten in this very controversial debate: what has Germany done since 2010 to address its unbalanced growth? And, from a realistic and constructive perspective, what could Germany do given its institutional setting (i.e. wage setting structures and fiscal constitution)?

In so doing, I have attempted to go beyond a pure macroeconomic reasoning based on accounting identities and tried to push the reader into reflecting upon historical contingencies and the institutional constraints on a strategy of Teutonic Keynesianism that shall rescue the Euro from

itself. I would argue that, contrary to what is usually claimed, there are indications to maintain that the pre-crisis trend is being reversed and that Germany has made some important steps towards a "quiet" rebalancing. This is good news and should be kept in mind if we aspire to having constructive politics in the EU.

But does this mean that Germany, and the EMU, are safe and sound? No, not at all.

As for Germany's extra-EMU current account surplus, there is probably only one person realistically capable of tackling the issue. This person sits in Washington and we should expect him to sooner or later deal with it. It is likely to be nasty and the EMU should be ready when the next exogenous shock will arrive.

An incomplete EMU remains fragile and requires upkeep. German politicians are not immaculate in this story and, if they want others to stop teaching them how to run their fiscal and wage policies, they should stop opposing projects to fine-tune the EMU and venture into a serious reform plan that envisages *blühende Landschaften* for EUROpe as a whole and not for Germany alone. Whether they like it or not, they belong to a common project now.

There seems to be one priority around which accusers and defendants should come together before the next shock arrives: to avoid asymmetric macroeconomic adjustments based solely on the compression of wages and public investment. Two institutional changes could serve the purpose. Broadly speaking, a pan-European unemployment benefit scheme based on national (or better regional) PPPs would work as an automatic stabiliser to support household consumption when countries most in need are forced to switch them off in their budgets. Secondly, one could imagine an ECB that supports a European Growth Bond by the European Investment Bank in the context of a proper European Investment Plan. Unfortunately, the importance of both these reforms for the stabilisation of the EMU has been eclipsed by the attempts to create a Capital Markets Union to engineer a financial fix to the structural flaws of the EMU.

A complete monetary union is likely to relieve these conflicts and bring benefits also to the Germans. I may be wrong, but I do not seem to remember anyone in my life that has ever argued that Lombardy should undergo an internal appreciation *vis-à-vis* Sicily (or *vice versa*). We do not even seem to discuss publicly whether Sicily runs a current account deficit or a surplus (although regional finance is indeed a hot topic, I agree). To those who argue that an EMU with pan-European automatic stabilizers will turn into a permanent structure of uni-directional fiscal transfers to the South, one should remind two points.

First, Germany is a big country with relatively deprived areas as much as Italy is a big country with relatively rich and prosperous areas. Shifting the political discourse around fiscal transfers to the regional dimension (NUTS 1 and 2) would probably help to avoid poisonous nationalist discourses and would enable us to see how all countries would stand to benefit from a system of supranational automatic stabilisers calibrate on a regional basis - even the “Wessi” Germans and the Northern Italians, the “*non terroni*”. Secondly, had the EMU had a system of supranational automatic stabilisers in place since 1999, the Germans - or better parts of Germany - would have been net receivers for approximately half of the EMU’s existence. The simple intuition here is that insurance systems exist exactly because we live in an uncertain world and cannot foresee exogenous shocks. Indeed, if we could, we wouldn’t let them occur - I guess just like in that Tom Cruise movie, *Minority Report*.

Given its high current account surplus, Germany is, today more than ever, a very fragile country in a world in which free trade and liberal values cannot be taken for granted anymore. Since German authorities are now under the impression of being immortal, they think that a pan-European insurance system is not in Germany’s long-term interest. I wonder what the answer would have been, had one asked them about the merits of a pan-European unemployment benefits scheme in 2001/2004. This is, basically, a *time*

inconsistency problem. It is a short circuit which, to be solved, requires *today* an *irrational politician* in Germany to drive a process of institutional change which *tomorrow* will benefit also Germany and the People of Europe.

A big obstacle to a constructive debate remains, alas, the fact that German authorities have never bothered to acknowledge the issue of German responsibilities in the first place. This is regrettable and does not pay justice to the need to play cooperatively in a monetary union. Yet, it is also time for critics (me included) to face the fact that, while being *necessary*, an acknowledgment of the problem of Germany’s unbalanced growth will not be *sufficient* to trigger the supposed spectacular German expansion that shall cure the sorrows of the young Euro. In my view, it is a mistake to insist that Keynesianism in Germany will fix the Eurozone’s problems: Germany should not and cannot be the *fixer of last resort* for the single currency. Supranational adjustment mechanisms are needed for the stabilisation of the Eurozone in hard times - even if I am aware that this is easier said than done. But we should start from somewhere.