Center on the
United States and Europe
at BROOKINGS

US – EUROPE ANALYSIS SERIES NUMBER 49
December 20, 2010

Waltzing with the Elephant: The Painful but Inevitable Convergence of Germany and the Euro-Periphery

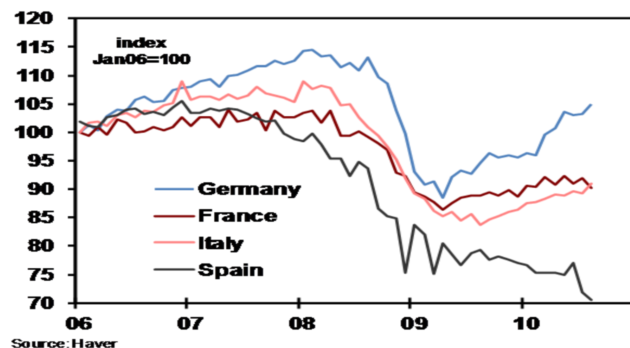
Carlo Bastasin

Despite an incredibly severe global economic crisis, the number of unemployed people in Germany has been shrinking: in January 2005 unemployment rolls in Germany topped five million, and today they number less than three million. Recently the OECD forecasted that in the next two years Germany will again overcome China as the country with the world's highest balance of payments surplus reaching 7.6 percent of GNP. For some eurozone countries, coping with Germany's economic stellar performance is becoming as difficult as waltzing with an elephant.

As indexes of industrial production demonstrate (see the graph to the right), there is growing separation between the industrial output of Germany and other leading European producers (including Italy, the second largest manufacturer in the eurozone). In the last 18 months, the indexes have started to yawn, and France and Italy have shown increases 15 percent lower than the Germans. It is still too early to assess all the dynamics behind this trend, but the crisis seems to have strengthened the correlation between Germany and its closest trading partners outside the euro area. German exports to China have increased by 80 percent since 2007, and those to India by 40 percent, while the German-French trade volume remained unchanged, and that with Spain declined by 20 percent. The German economic cycle, driven by industrial exports, seems to be correlated to the global cycle more than to the euro cycle, as is logical for a country whose share of trade as a percentage of GDP is double the average of the G7 countries.

Carlo Bastasin is a Nonresident Senior Fellow in Global Economy and Development and Foreign Policy at Brookings. His work focuses on European political and economic analysis.

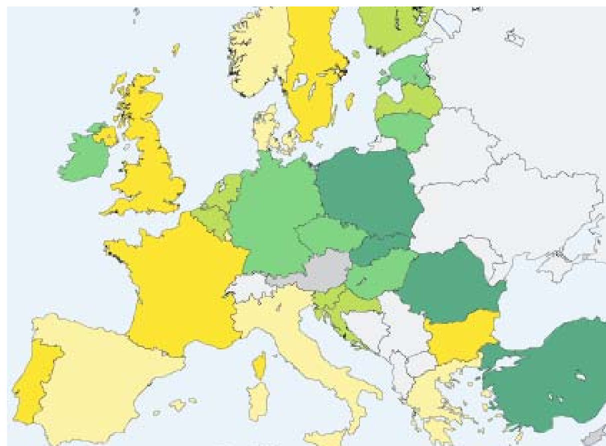
Industrial production



These developments are feeding into a feeling of scepticism about the future of the European Union. The debt crisis in the euro area is determined also by a sense of structural divergence between core and periphery countries. Furthermore, the political integration of the European Union had been built around the backbone of Franco-German trade. Now that the impulse driving German economic dynamism no longer comes from the West but from the East, some analysts are tempted to redraw the map. In this new map, Germany detaches from its European partners—with all their attendant problems—and turns alone towards the rest of the world.

Increase in industrial production since 2005

Industrial production – total industry (excluding construction)
Index (2005=100) and percentage changes – 2010M09



Legend

81.75 - 88.3 | 88.3 - 100.7 | 100.7 - 103.9
103.9 – 114.28 | 114.28 – 144.4 | N/A

Minimum value: 81.75 maximum value: 144.4 eu15:94.72

Source: Eurostat

As the map above shows, more than a few European countries are successfully keeping up with the German industrial pace: Benelux, Poland, Slovakia, Finland, the Baltics, Hungary, and Romania, for example. But for those other countries that are suffering through the rough winds of the euro crisis or are considered at the periphery of the euro area, there is a clear sign of detachment from the center of economic gravity in Europe. According to the latest statistical forecasts of the German Wirtschaftsweise (an independent technical body advising the government), Spain, Ireland and Italy are the three countries that stand to benefit the least from a German fiscal stimulus. An expansionary fiscal policy in Berlin would produce effects on Slovakia ten times greater than those on Italy. The effects on Hungary would be tenfold higher than on Ireland, and even France and Great Britain would receive a growth benefit twice as large as Spain. Italy has partially replicated the German model of subcontracting to Eastern Europe, and real trade flows may underestimate its trading capacity. Furthermore, the Italian figures hide the amazing correlation of the economic indicators with the geographical proximity to the Austrian - and indirectly German - border (wage increases are lower and income levels higher in the northeast of Italy, while wage increases are higher and income levels lower in the southwest). But for most of the periphery, geographical distance translates into economic distance from the world's most successful commercial actor.

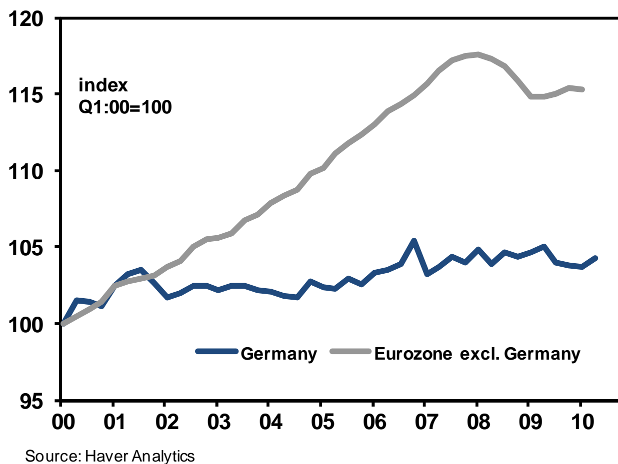
One day China will likely replicate the German level of quality for its products, and exports will be more difficult, as we have already seen in the case of office equipment and electronics. Furthermore Asia's growth and, for that matter, China's growth, may turn out less bullish in the next decade than generally estimated. Still this will not be an abrupt process; it will require years, and in the meantime, other markets will open up and ensure the benefits of an economic model driven by exports.

Many economists consider the structural divergences among countries to be an intrinsic dynamic of the euro area, and they conclude that the two Europes – the core and the periphery – will have to acknowledge their differences eventually, and then say "Auf wiedersehen" to each other. A less impressionistic analysis would assert that the two Europes complement each other. Until recently, they did so in a rather perverse way,

with Germany accumulating savings and the periphery exceeding consumption. But this unstable equilibrium will self correct—thanks to the hard lessons of the crisis—into a new model: more growth from Germany and more deflationary adjustment in the periphery.

While the change of paradigm may not occur spontaneously, it is inevitable. The second graph shows that while consumption in the rest of Europe has grown significantly over the past decade, it has remained stable in Germany. In fact, the disposable income of German households has remained stable. Gross wages have been burdened by taxes, which have grown between 2007 and 2009, and Berlin has advanced proposals to cut taxes only recently. Theoretically, this design goes in the right direction, though it is still doubtful that it will ever see the light. The consensus view in Germany is that the economic policy must continue along a path of wage moderation and fiscal restraint. Apparently, there is no way to shake the German obstinacy, even on the use of public investment: in 2011 they are expected to increase by only 0.5 percent, while in 2012, as a result of the measures of fiscal consolidation, they will drop by as much as 15.9 percent

Household Consumption



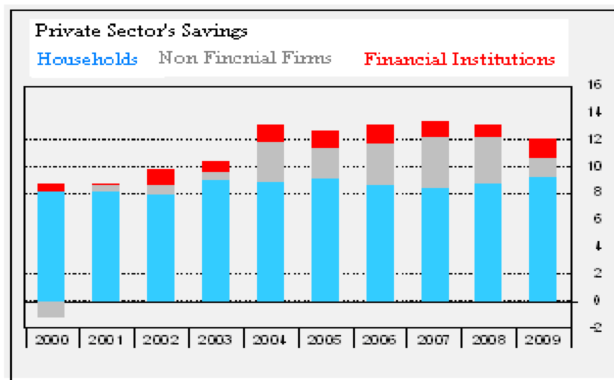
The German consensus view is supported by the estimates of the Bundesbank, according to which wage moderation increases employment and growth, and in this way contributes to the domestic demand and to foreign imports. Unfortunately, the results of the last ten years tell a different story. Wage moderation has not coincided with an increase in domestic demand over this period. The official version in Berlin is that wage moderation in the last ten years was only a compensation for the excesses of the 1990s, related to the shock of the German unification. But there is no evidence of this from the statistics. German wage development in the '90s was not different from the average across the rest of Europe. Only in the last ten years did the divergence build between Germany and the euro partners. While the latter followed exactly the same pattern as in the '90s (with average yearly wage increases hovering around 2.8 percent), Germany recorded increases below 1 percent. Was it the result of structural reforms and specifically of some courageous labor market reforms? It is likely to be so. But some analysts dispute this interpretation, pointing out that unemployment in the western part of the country did not recede during the last decade and remained unchanged in 2010 and at the same level as in 2000 (2.4 million people). What has changed, however, is the (overcoming of) unemployment in the eastern regions of former DDR. The real structural reform would be, in fact, the successful accomplishment of German reunification.

In fact, Germany's current stance on economic policy and its effects on domestic demand remain contractionary. However, full employment is very close to being realized, an adjustment of incomes may be under way, and we may see the expected recovery of the domestic demand in the next years. Furthermore, without the external demand coming from the rest of the euro area, the German economy will need to find ways to stimulate the economy or the whole of Europe will converge towards a deflationary status. The euro periphery urgently needs to bring labour costs back in line with productivity increases

(they lost competitiveness not only toward Germany but also the rest of the world), but so must Germany. Indeed, demonstrating that self correction is under way, Berlin's prognoses show that future wage increases will not underbid productivity rates, as it was the rule in the past decade.

But there is a major unknown along the route of self correction: until now German excess savings have not produced any adequate volume of domestic investments. In terms of supply-side policies, it is puzzling that the recent reduction of business tax rates, wage moderation, and the deep structural reforms have created no incentives to invest in the country, although they have certainly avoided the real risk of industrial desertification. In a global environment, structural reforms appear to be both indispensable and insufficient. In fact, statistics do not confirm that German excess savings result from low household consumption. On the contrary, the share of household savings marginally declined over the last ten years. This was probably affected by the uncertainty— or even the perception of political non-credibility— concerning the solidity of both the pension and the health systems. The increase in the savings rates becomes substantial only when banks and particularly non-financial companies are taken into account.

Composition of German annual savings



Source: Elaboration from the Wirtschaftsweise Annual report

Between 2004 and 2008, German non-financial firms have accumulated huge financial surpluses that have not brought investments to Germany but to capital flows abroad. German bank claims on euro area countries have increased fourfold between 1999 and 2008. Those capital flows—many of which landed in Greece, Ireland, Spain and Portugal—have made Berlin the biggest creditor of the euro periphery, and a *de facto* contributor to the current financial disequilibria. Even in the Irish banking crisis, German banks stood out by far as the largest euro investors in low-quality assets.

If there is a lesson in the euro crisis, it has to do not only with the irresponsible economic policies in the euro periphery (focused only on short-sighted rationale), but also with the wrong allocation of German excess savings in the last years. Both are destined to self correct. The first issue is being tackled at the European political level under the pressure of the financial markets. The second issue is a matter of self-interest even for the German investors and for the government itself: firms and banks can only take advantages from stronger domestic real investments stimulating growth across Europe. It will be surely better than shedding capitals in subprime loans or low quality real estate investments as they have stubbornly done in the last ten years. As for the Berlin government, it has a clear electoral advantage in setting the right incentives for domestic production, or for strengthened health and pension systems or improving citizens' education.

ABOUT CUSE:

The Center on the United States and Europe fosters high-level U.S.-European dialogue on the changes in Europe and global challenges that affect transatlantic relations. The Center offers independent research and recommendations for U.S. and European officials and policymakers; and convenes seminars and public forums. The Center's research program focuses on three key areas: the transformation of the European Union; strategies for engaging the countries and regions beyond the frontiers of the EU including the Balkans, Caucasus, Russia, Turkey and Ukraine; and European security issues such as the future of NATO, and forging common strategies on energy security and counter-terrorism. The Center also houses specific projects focused on Turkey, Russia, Italy and France.

The Brookings Institution
Center on the United States and Europe
1775 Massachusetts Avenue, NW
Washington, DC 20036
www.brookings.edu/cuse