GERMANY IN THE POSITION OF LEADER

OFCE-IMK

Given the size of its economy, Germany has always played a leading role in the construction of Europe. The country's recent economic performance has bolstered its position so much that Germany is now the undisputed leader of the euro zone, giving it additional influence on Europe's political scene, in particular relative to France and Italy, the second and third largest economies. The analysis by the German government of the crisis in the euro area and with respect to both the current and future state of European governance is clearly decisive.

Germany's economic success story is based on three elements. First, Germany is in a situation of almost full employment, even though the global economy has experienced the deepest recession since the 1930s. After the sharp blow to Germany's economy in 2009, it quickly recovered to match and then surpass its pre-crisis state. Second, Germany has been spared the sovereign debt crisis. German bonds have benefited from their status as risk-free assets, with interest rates falling so much that they are now negative on maturities up to seven years. Finally, since 2001, Germany has accumulated current account surpluses, reflecting its industrial and export strength and relatively subdued import growth. The recent acceleration of wages has not had any impact on the current account up to now.

Under the apparent success, however, Germany faces a number of structural challenges. These include demography, low public and private investment and sluggish productivity growth, inequality and qualitative labour market issues, and the vulnerability that comes with a large export surplus. Finally the issue of how German adjustment can be rendered compatible with that in the Euro Area as a whole needs to be resolved. Ultimately Germany cannot prosper if its neighbours remain mired in economic difficulties. It can neither unilaterally impose its strategy nor can it generate recovery on its own. We address these issues in turn in this chapter.

7.1. Why / in what way has Germany been doing better than its euro area partners since 2007?

The collapse in global trade that accompanied the beginning of the Great Recession in 2008-2009 engendered fears of a long-term downturn in German growth and a rise in unemployment (Blot & Kooths, 2010). The fall in GDP was in fact more marked in Germany than in the rest of the euro area (-5.6% in 2009, compared to -4.6%), due mainly to the negative impact of foreign trade (-2.6 points against -1.3 for domestic demand). So although the acceleration of Germany's growth between 2004 and 2007 had been based on its dynamic export industries, the growing share of exports in GDP (up from 23% in 1996 to 43% in 2007) seemed at first to be its Achilles' heel.

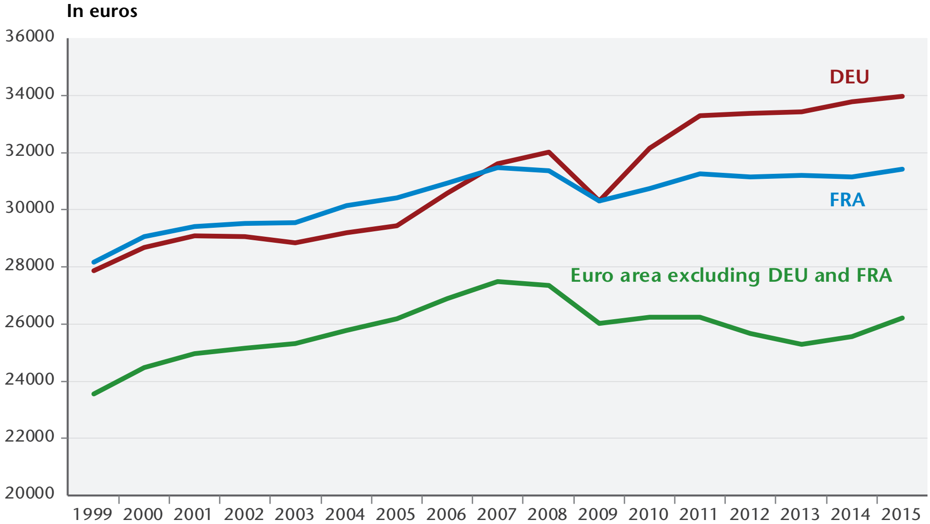
But this soon changed. On the one hand, the rebound in world trade starting in 2010 boosted Germany's recovery through the channel of foreign trade. On the other hand, growth gradually became more balanced due to domestic demand, which strengthened after the crisis (Table 1). Germany's growth picked up sharply in 2010 and 2011, and it remained a locomotive for the euro area, with GDP per capita rising faster than in the other countries (Figure 1). Furthermore, unemployment barely budged and then came down, and at the end of 2016, in November, stood at 4.1%, according to Eurostat, the lowest level of any euro area country. By cutting its budget deficit to below 3% of GDP in 2011 and then balancing the budget the next year, Germany was able to exit the excessive deficit procedure relatively quickly. Finally, Germany continued to set records for its current account surplus, which was over 266 billion euros in 2016, i.e. 8.5% of GDP.

Table 1. **Factors contributing to German growth**

	Internal demand	Consumption	Investment	External trade	Inventories	GDP growth
2000-2007	0.7	0.6	0.1	0.9	0.0	1.6
2008-2009	-1.0	0.8	-0.9	-1.3	-0.9	-2.4
2010-2015	1.4	0.9	0.5	0.6	0.0	2.0

Source: Eurostat.

Figure 1. **Change in GDP per capita**



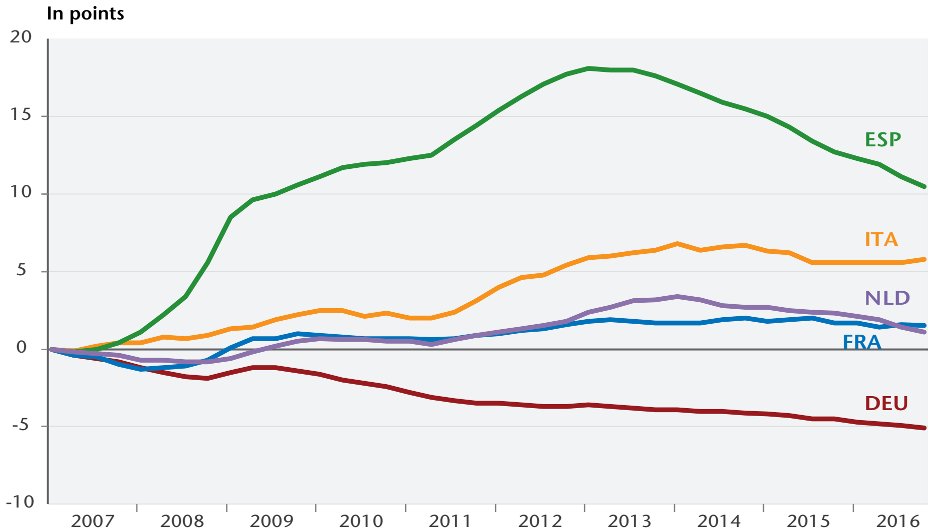
Source: Eurostat.

a) The German labour market during the crisis

Despite the worst recession since World War 2, Germany's unemployment rate increased only slightly, by 0.7 percentage point, at the beginning of 2009. For the euro area as a whole, the level rose by two points between the first quarter of 2008 and the second quarter of 2010. Furthermore, while higher unemployment persisted in most of the other euro area countries, in Germany the rate began to fall in the third quarter of 2009 (Figure 2). Between the first quarter of 2007 and the end of 2016, unemployment fell by almost 5.1 percentage points in Germany, whereas it rose by 1 point in the Netherlands, 1.2 points in France, 5.2 points in Italy and 11 points in Spain. This contrast in the unemployment rate is undoubtedly linked to Germany's better performance in terms of growth but it also reflects population dynamics as well as the job-rich character of German growth.

Around the years the crisis hit, Germany's unemployment rate had benefited from slower growth in its labour force, particularly relative to other European countries, such as France, Spain and the United Kingdom. Between 2007 and 2010, its labour force grew by only 0.1% on average per year. The working-age population was declining over this period, but the labour force expanded due to an increase in the participation rate (of women and seniors). The labour force has been growing faster since 2011, with an annual growth rate from 2011 of 0.5%, and even reaching 0.7% in 2016.

Figure 2. **Changes in the unemployment rate in selected euro area countries**



Source: Eurostat.

The labour force participation rate is continuing to rise, but immigration has pushed up the working-age population once more (+ 0.5% between 2011 and 2015). After restrictions on the free movement of workers from the new EU Member States came to an end (mainly Poland, Romania and Hungary), the leading source of immigration has been Eastern Europe, followed by the countries in the crisis-ridden south of Europe, and then finally the Balkans and more recently countries torn by war (Syria, Iraq and Afghanistan). In this recent period Germany has needed to create more jobs than before in order to absorb this increase in the labour force while continuing to hold down its unemployment rate.

In addition to the impact of labour force trends, the reduction in the unemployment rate is greater when, for a given rate of economic growth, productivity growth is low. During the crisis period, in Germany an active strategy of safeguarding employment supported by the social partners and the government was part of the policy response. As a consequence, German business hoarded labour by resorting to several measures of working-time flexibility to temporarily reduce working hours like short-time work, a policy that was also supported by government subsidies, working time accounts and temporary reductions in collectively agreed working hours. There was therefore no net job destruction during the heart of the Great Recession. As a result, per capita productivity fell sharply, by almost 6% in 2009 and on average by 0.04 % per annum between 2007 and 2011. So the slight pick-up in employment from 2011 (+0.8% on average between 2007 and 2011) was enough to bring down the unemployment rate. In the more recent period (2012-2016), per capita productivity rose by 0.58 % per year on average, accelerating since 2014 growing by 0.8 % in 2014 and 2015 and by 0.9 % in 2016.

Over the period 2007-2016 as a whole, economic growth has been more job-rich compared to the previous decade since per capita productivity grew by an annual average of 0.2%. As for the labour force, it increased only a little faster over the period 2007-2016 (0.4%) than from 2000 to 2007 (0.3%). The average increase of 0.8% in employment between 2007 and 2016 was therefore sufficient to lead to a rapid reduction in the unemployment rate.

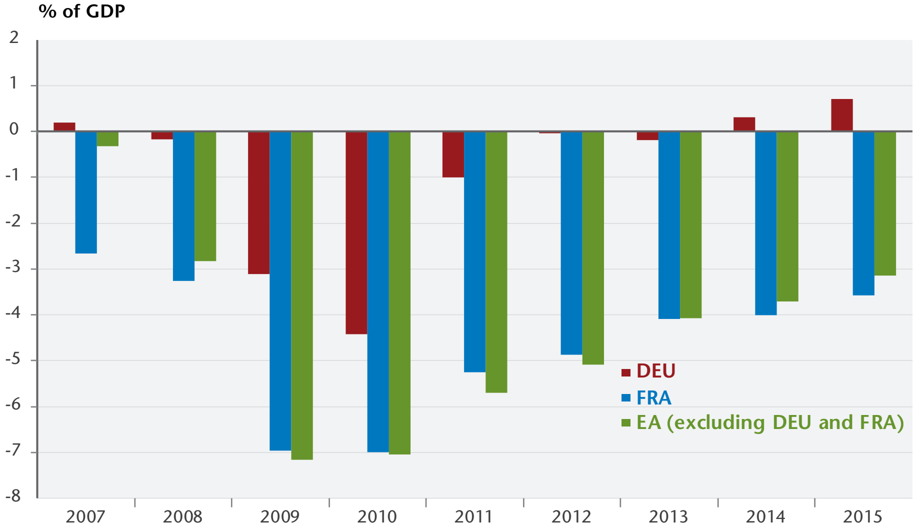
On the other hand, in the most recent period, with productivity growing at 0.8% and the labour force up by 0.7%, growth needed to hit at least 1.5% in order to continue to push down the unemployment rate. This was achieved in 2016, when the rate was 1.9%. But this remains an important challenge in the current period when substantial numbers of immigrants must be integrated into the labour market.

b) **The public finances: Respect for the rules?**

Like many European countries, Germany's public deficit deteriorated rapidly during the crisis. Germany started with a budgetary surplus of 0.2 GDP point in 2007, but three years later ran a deficit of 4.2%, and so found itself, like many other European countries, with an excessive deficit according to the EU's fiscal rules.[1] Due to the automatic stabilizers, the recession reduced tax revenues and pushed up public and social expenditure. Additional measures to boost the economy as well as plans to support the financial sector led to a further worsening of the public accounts. However, the deficit was subsequently quickly cut and then a surplus of 0.3% generated in 2014, at a time when France's deficit still exceeded the 3% threshold (Figure 3). After peaking at 81% in 2010, Germany's government debt also began to decline, by almost 10 points in all by 2015.

1. Under the Stability and Growth Pact, a country is considered to have an excessive deficit when the budget deficit exceeds 3% and when this situation is not justified by exceptional circumstances. A decision to put the country on notice is taken by the European Council at the recommendation of the European Commission.

Figure 3. **Government balance 2007-2015**



Source: Eurostat.

This improvement has enabled Germany to meet the requirements of the Stability and Growth Pact as well as those of the new "debt brake" in the country's Constitution.[2] This rule requires the federal government to ensure that the structural deficit does not exceed 0.35% of GDP.[3] The law, passed in 2009, provides for a transition period with intermediate targets starting in 2011, and with the 0.35% target to be met from 2016. In so far as it is the structural deficit that is the constraint, the annual indebtedness can vary according to the country's position in the cycle; however, the use of statistical filters as the estimation tool suggests a significant cyclical element and thus a strong risk of inducing pro-cyclical fiscal policy (Truger and Will 2013). Finally, the law also introduces a clause that allows exceptional circumstances to be taken into account. This "debt brake" rule introduced by the German government is in line with the Fiscal Compact,[4] which requires EU Member States to enact national legislation requiring a balanced budget—limiting the structural deficit to 0.5% of GDP[5]—as well as correction mechanisms in case the target is not met.

2. See Truger and Will (2013) for a critical overview of the debate on the debt brake and Paetz, Rietzler and Truger (2016) for a recent analysis.
3. The limit is set at 0% for the Länder from 2020 onwards.
4. Fiscal chapter of the TSCG adopted in 2012 and ratified by 25 Member States.
5. This limit is lifted to 1% for countries with a debt of less than 60%.

Between 2011 and 2016, the German federal government more than respected its commitments, as the annual debt was consistently lower than the intermediate targets. While the rapid improvement in the federal government's fiscal position does coincide with the adoption of this compulsory rule, Paetz, Rietzler and Truger (2016) show that the reduction in Germany's deficit was due mainly to favourable circumstances. A breakdown of the budgetary balance using the following relationship sheds light on this point:

$$NLG(t) = Interest\ payment\ (t) + Cyclical\ balance\ (t) + Primary\ structural\ balance\ (t) + one\text{-}offs\ (t)$$

Between 2010 and 2016, Germany's fiscal position improved by 4.5 points (Table 2). How much of this was the result of decisions taken by the government to improve the public finances? According to the OECD's estimate of the output gap, which indicates the improvement or deterioration in the deficit due to the cycle, discretionary measures contributed 1.2 percentage points to the deficit reduction. This contribution is close to that of the cyclical balance (+1.1 point). The fall in the interest rate is another important factor in the reduction in Germany's deficit. In effect, the debt service burden was cut by 1.1 percentage points of GDP, with the nominal rate on the debt also falling by 1.1 percentage points. Finally, exceptional measures have also contributed to deficit reduction, in line with the deterioration observed between 2007 and 2010.

Table 2. **German fiscal policy from 2003 to 2016**

Gdp points

Cumulated change	2003-2007	2007-2010	2010-2016*	2007-2016*
Net government lending	4.4	-4.4	4.5	0.1
Interest payment	0.2	0.2	1.1	1.4
Δ nominal rate	-0.3	-1.1	-1.1	-2.3
Cyclical balance	1.9	-2.0	1.1	-1.0
Primary structural balance	1.7	-1.6	1.2	-0.4
One-off measures	0.6	-1.1	1.1	0.1

* The figures for 2016 correspond to an OECD forecast.
Source: OECD, Economic Outlook n° 99.

Thus by the end of 2016, the government balance was once again at its 2007 level, i.e. in surplus, suggesting that the improvement in the balance between 2010 and 2016 (4.4 points) offset the deterioration experienced during the recession. It should be noted, however, that a breakdown of the deterioration in the balance between 2007 and 2010 shows a somewhat different picture, with a 2-point increase in the deficit due to lower growth and to discretionary measures, which accounted for 1.6 points. The exceptional measures (in particular support for the financial system) came to 1.1 points, as indicated above. The debt service burden played a positive role, falling by 0.2 point between 2007 and 2010.

It is clear, therefore, that, looking at the crisis as a whole, Germany managed to master its budget deficit despite the sharp deterioration during the worst part of the crisis. Fiscal policy played a counter-cyclical role during this period, with an expansionary fiscal policy during the recession and a policy of fiscal consolidation once growth picked up. However, this consolidation phase was much less pronounced than in the other euro area countries. For example, in France an estimate based on OECD data for consolidation measures indicates that the primary structural balance improved by 2.8 points between 2009 and 2016.[6]

Furthermore, Paetz *et al.* (2016) suggest from counterfactual simulations that if Germany's performance in terms of growth had been less favourable, the debt brake rule would have forced the government to take pro-cyclical measures that would in turn have undermined growth. In fact, fiscal consolidation in Germany was essentially carried out prior to the crisis: there was an improvement in the primary structural balance of 1.7 points, which made it possible to once again generate a fiscal surplus in 2007, whereas the deficit was 4.2% in 2004. But the macroeconomic situation, in particular the international environment, was completely different in the 2004-2007 period compared to the 2010-2016 period. The average annual growth rate in the euro area (excluding Germany) was 2.7% between 2004 and 2007, compared to 0.6% between 2010 and 2015. Germany therefore carried out the bulk of its fiscal adjustment in a favourable climate, which helped to mitigate the cost to the country in terms of lost output. In contrast, the synchronization of tight fiscal policies in the euro area from 2010 onwards generally contributed to amplifying their negative impact on the area's growth.[7]

One important lesson can be drawn from this analysis of the evolution of Germany's budget balance:

6. The choice of 2009 rather than 2010 for France is due to the fact that the figure for the deficit was observed in 2009 in France and in 2010 in Germany. In addition, according to the OECD the period of German fiscal consolidation was shorter. If we look only at fiscal consolidation measures, these come to 1.8 points in Germany between 2011 and 2014 and 3.2 points in France between 2011 and 2016.
7. See IMF (2010) and the iAGS 2013 report.

Fiscal consolidation is most successful in a favourable environment. An important factor is labour market performance. With rapid employment and wage growth tax revenues and social security contributions increase sharply while spending on unemployment is reduced quasi automatically. The German example is in sharp contrast with the developments in the European crisis countries, where wage cuts and falling employment made budget consolidation almost impossible.

In addition Germany benefitted from falling interest rates intensified by the country's function as a "safe haven" in the euro crisis.

c) **Current account: A country with excess savings**

The large and growing trade surplus is often considered to be a sign of the German economy's good health. The balance of goods and services reached 243 billion euros in 2016 (7.8% of GDP), making a significant contribution to the current account surplus (266 billion, or 5.5% of GDP). These record surpluses contrast with the current account deficits recorded by Germany after reunification and up until 2001, and they are widely seen as bearing witness to Germany's renewed status as an industrial and export "hyperpower". Changes in the real effective exchange rate since 1999 show that Germany has gained in cost-competitiveness relative to its European partners, and it proved its resilience in the 2000s when the euro appreciated on the foreign exchange market (Figure 4). Germany actually gained export market share during the 2000s. These trade performances not only stem from an improvement of the cost-competitiveness of Germany relative to trade—and notably other euro area members—partners but it also results from an advantage in terms of non-cost competitiveness, which evokes the idea of high-quality production and the benefit of a good image, enabling its companies to hold their demand captive.[8]

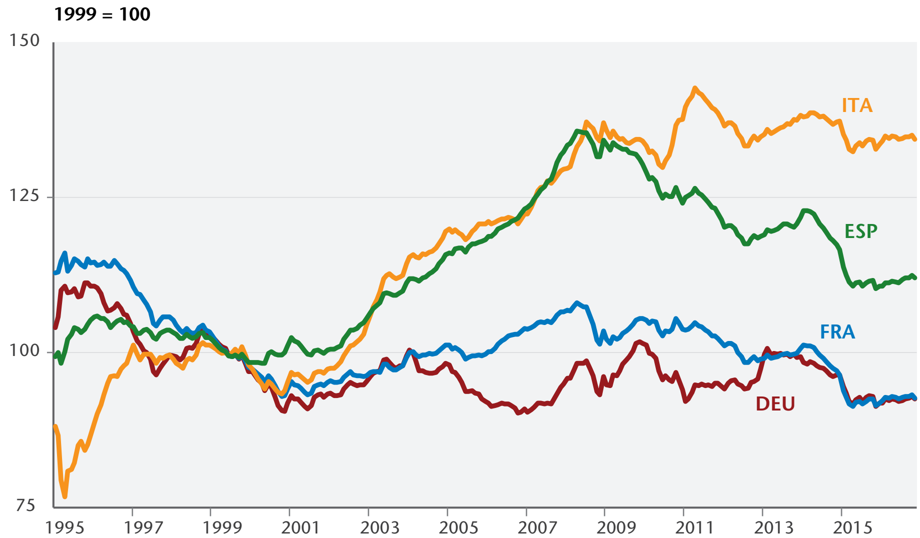
However, price competitiveness mostly applies to exports only while the current account is the balance between exports and imports. Many authors find that the development of exports did not account for most of the difference in current accounts but that the main difference were developments in imports.[9] Crisis countries like Greece and Ireland had even higher percentage increases in their nominal exports between 1999 and 2007 than Germany (Horn and

8. See ECB (2012) for an analysis at the euro area level and Le Moigne and Ragot (2015) for an analysis of the France's bilateral external trade deficit relative to Germany.
9. See for instance European Commission (2010), Feigl and Zuckerstätter (2012), Gaulier and Vicard (2012), Wyplosz (2013) and Horn and Lindner (2016).

Lindner 2016). What led to the current account surplus in Germany were low imports due to a weak internal demand. In the 2000s, labor market reform and austerity depressed domestic demand and thereby import demand. In many crisis countries credit financed real estate bubbles drove domestic demand and thus imports, thereby leading to current account imbalances.

Thus, a working group on the competitiveness within in the European System of Central Banks finds that: "From the start of the euro until the crisis, export growth adjusted for geographical and sector specific effects was only weakly correlated with changes in the current account or deviations in ULCs. This suggests that the negative correlation between the two latter variables was partly driven by common shocks rather than current account imbalances resulting from heterogeneous cost competitiveness. The data are consistent with demand shocks in peripheral euro area countries moving resources from the traded sector to the non-traded sector, with price and wage increases concentrated in the nontraded sector."

Figure 4. **Cost-competitiveness of 4 euro area countries**



Source: IMF. Indicators of real effective exchange rates weighted by unit labour costs.

Between 1999 and 2007, Germany's current account went from a deficit of 1.4% of GDP to a surplus of 6.8% mainly due to an improvement of nearly 6 percentage points in the balance of trade in goods and services (Table 3). By 2016, the trade surplus was 7,8%. The bulk of the improvement was actually achieved before the crisis. The gains were nevertheless consolidated during the crisis, even though several factors could have eroded Germany's export performance. First, the global trade shock in 2008-2009 and the slowdown in trade between 2012 and 2012 cut down demand for exports.[10] Second, the current rebalancing of current accounts within the euro area is partly being achieved by a relative gain in competitiveness of the countries running deficits before the crisis, and hence by a relative deterioration in Germany's cost-competitiveness (see Figure 4 and above). However, the major part of the adjustment of the crisis countries is achieved by austerity induced falls in imports which has also decreased European demand for German exports.

The evolution of a country's current account reflects not only the dynamics of its competitiveness but also its position in terms of the balance of savings and investment. In accounting terms, a current account surplus corresponds to an excess of domestic savings relative to investment, whereas a deficit reflects an excess of investment relative to domestic savings. An analysis of the savings and investment rates of households, business and government provides a complementary understanding of the dynamics of current account surpluses. In the pre-crisis period, the improvement in the current account coincided with a rise in savings and a fall in total investment by agents (households, financial and non-financial corporations and general government—HH, FC and NFC, GG). Expressed as a percentage of GDP, business savings rose by 3.6 points between 1999 and 2007 and government savings by 1.3 points. With respect to household investment, the fall in the period 1999-2007 needs to be seen in relation to the sluggishness of the German housing market. In fact, the recent rebound

Table 3. **Germany's current account since 1999**

Change in GDP pts

	1999-2007	2007-2015
Current account	8.2	1.6
Balance goods & services	5.9	0.9
HH savings	0.6	0.0
HH GFCF	-1.7	0.2
FC + NFC savings	3.6	-0.3
FC + NFC investment	-0.6	-0.6
GG savings	1.3	0.4
GG investment	-0.4	0.2

Source: Eurostat.

10. See IMF (2016) for a recent analysis of the slowdown in world trade.

in the period 2007-2015 has been reflected in a modest increase in household investment. Government investment is also picking up, although it is still low (2.1% of GDP in 2015, compared with 3.5% in France). As for business investment, it has continued to decline since 2007 despite the recent improvement in financial conditions. Thus, the record current account surplus is not only a sign of a healthy economy, but also reflects the weakness of investment, which is the engine of both short-term and long-term growth, in particular investment by business and general government.

7.2. What are the challenges facing the German economy?

The economic successes of Germany should not hide the challenges facing Germany. The reduction of the unemployment has benefited from the slow growth of the labour force. However on the long run, it will raise important issues. Besides, even if recently growth was less determined by external factors than during the years 2000, the question of public investment in Germany has been raised in the public debate. Finally, inequalities have significantly increased despite the reduction of the unemployment rate. This has been a major concern and has led to the introduction of the minimum wage.

a) The challenge of an ageing population

As of 1 January 2017, Germany's population stood at 82.8 million, up 0,7% from the previous year, nearly the highest since 1992. This increase has occurred even though the natural balance (number of births minus number of deaths) was still negative, by about 150,000 to 190,000 people according to the first estimations of Statistisches Bundesamt (2017). It was thus the migration balance (at least 750,000 in 2016), which was similar to the levels observed following the fall of the Berlin Wall and the opening of the Iron Curtain, that has recently made it possible to reverse the trend of a declining population.

Recent trends should not, however, be allowed to obscure the long-term tendency. Indeed, demographic projections generally follow well-identified trends, at least with respect to the fertility rate, which, although rising slightly in the last two decades, was still only 1.5 children per woman in 2015, which is much too low to ensure population renewal. According to the latest population projections by Statistisches Bundesamt (2015), the working-age population will fall sharply as the baby-boomers retire and the cohorts entering the labour market are much smaller. At the beginning of 2016, Statistisches Bundesamt indicated that the current high immigration levels would have only a limited impact on long-term population trends, even if this pushes back and limits the extent of population ageing in the short and medium term. In order to stabilize the population aged 20 to 66 by 2040, the net immigration of this age group would have to be 470,000 annually. But total net immigration (i.e. including those under age 20) has exceeded this level only in four years since 1991. The large-scale immigration observed recently is thus not sufficient to avoid a fall in the working-age population.

Measures to promote a better work-life balance have been implemented in recent years (reform of parental leave in 2007, the 2008 law introducing the right to a childcare place for children aged 1 to 3), and the level of women's participation in the labour market has risen, from 69.2% in 2007 to 72.7% in 2015 (compared with 81.8% for men in 2015). However, these measures will not be sufficient to reverse demographic trends, and this will have important consequences for the public purse, mainly *via* social spending. Population ageing will lower the ratio of workers to pensioners and will have an impact on the funding of pensions, which could increase by 2.6 GDP points by 2060 according to European Commission calculations.[11]

These factors undoubtedly explain why Germany has introduced measures to extend lifetime working hours, particularly provisions for raising the retirement age. Demographic ageing will also lead to higher funding needs for health and dependency. According to the European Commission's calculations, aggregate spending related to population ageing is expected to rise by more than 5.2 GDP points in Germany by 2060, compared to 3.7 points for the European Union as a whole.

The prospect of an ageing population suggests a possible alternative, and more sanguine, interpretation of the accumulation of current account surpluses since the early 2000s. As illustrated above, the current account reflects the gap between domestic savings (private and public) and investment. According to some theoretical approaches, positive net savings (a current account surplus) is justified whenever an ageing population and a slowdown in long-term growth can be expected. Germany should therefore export more in anticipation of a slowdown in its long-term growth and a future structural increase in its imports. As a corollary, the current account surplus would subside with falling growth and the concomitant reduction of the savings rate. However, this would not explain or justify surpluses of the magnitude we have seen.

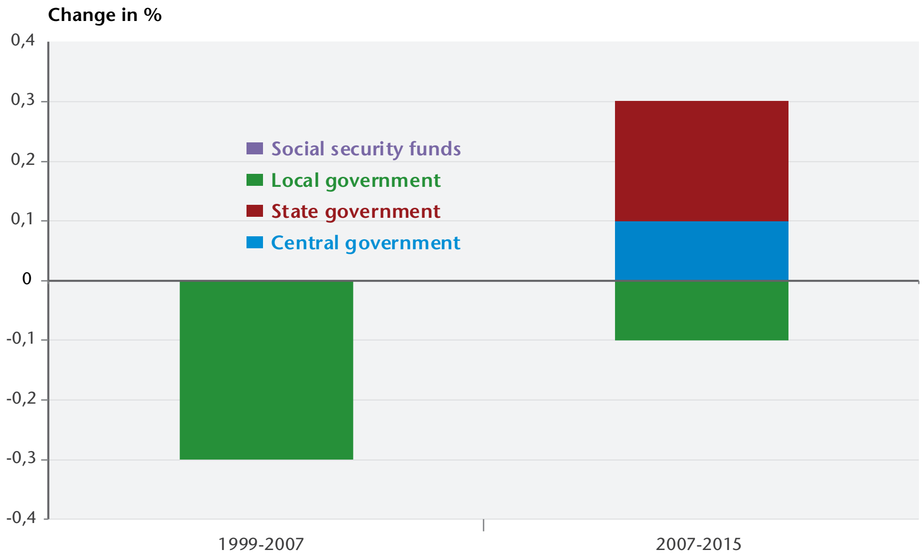
11. See European Commission (2015).

b) Does Germany need to invest more?

This analysis of the current account has also highlighted the weakness of German investment, particularly on the part of business and general government. But investment is needed, whether this is a matter of financing the energy transition, education or the country's infrastructure. The public authorities play a critical role with regard to investment. While the early 1990s were marked by a sharp increase in public investment due to reunification, the level of gross public investment flows since 2003 has not been sufficient to compensate for the obsolescence of capital, which is leading to lowering the quality of the public infrastructure.

There has been a clear lack of engagement by the public authorities in Germany (Rietzler 2014). This is due in particular to the withdrawal of the municipalities (Figure 5), which accounted for 35% of investment expenditure in 2015. From 2007 onwards, the central government and the Länder raised their level of investment by 0.1 and 0.2 percentage points, but the municipalities cut theirs again by 0.1 point. The number of reports focusing on the need for public investment, especially in infrastructure (bridges, roads), has multiplied since the late 2000s.[12]

Figure 5. **Public Investment in Germany**



Source: Eurostat.

12. See DIW (2013) for instance.

While since 2004 the German government has regularly announced support measures, in particular in response to the European Commission's recommendations with respect to the imbalance in the current account, this has not yet been reflected in the statistics on public investment. The authorities' manoeuvring room could also be limited in the future by the "debt brake" rule (Truger and Will, 2013). First, the rule adopted does not provide for an exclusion of capital expenditures when determining the yearly debt ceiling. Moreover, in the event of a cyclical downturn, the rule does not give the budgetary authorities sufficient room for manoeuvre, forcing them into pro-cyclical policies, which could in fact result in further adjustments in investment expenditure.

c) Labour market: Grey zones

From the early 1990's, wage setting became progressively more decentralized to the firm level. The number of enterprises not covered by a collective bargaining agreement increased and trade unions loosed power in the collective bargaining at the branch level. It triggered a significant increase in the share of low wages, employees earning less than 2/3 of the median gross wage, which accounted for 24% of German employees in 2013 (compared with 9% in France according to Eurostat[13]); 5 points higher than in 1995 (Kalina and Weinkopf, 2015). In the absence until 2015 of an interprofessional minimum wage, hourly wages remained very low and 1.6 million people earned a hourly wage below 5 euros at the beginning in 2013 (Kalina and Weinkopf, 2015).

The development of part-time work, related to the increase in the female participation rate (62.1% in 1991, 72.9% in 2015 according to Statistisches Bundesamt), and of temporary work (liberalized during the Hartz reforms) has also heightened wage inequalities: employees who worked less hours were also those for which the hourly wage was often weaker compared to a full-time job.

A reduction in the level of redistribution (taxation and transfers) has also contributed to widening income inequality (Schmid and Stein, 2013). Moreover, the unfavorable evolution of income at the bottom of the distribution in the period 1991-2010 has led to an increase in the risk of poverty in Germany, that was not mitigated by the redistribution system. A German household's risk of being in poverty rose from 11% in 1991 to 14% in 2012 (Goebel and Grabka, 2013; Goebel, Grabka and Schröder, 2015). The risk of poverty exploded particularly among the unemployed (56% in 2010, compared to 37%

13. Structure of earnings survey

in France).[14] As the Hartz reforms have restricted the conditions for qualifying for compensation and its duration, those who are unable to re-enter the labour market receive lower benefits. For people in employment, the risk of poverty increased slightly, to 10% in 2010.

In the face of these widening inequalities, there has been a growing awareness among social scientists, trade unions and some politicians that the collective bargaining system is no longer able to protect society's weakest workers from wage dumping and to ensure them a decent wage. So a little more than 10 years after the Hartz reforms were enacted, the question arose of correcting some of the excesses in a now more favourable macroeconomic context. In the 2013 legislative elections, the minimum wage was included in all the major parties' programmes. The principle of a generalized statutory minimum wage was, as the Social Democrats (SPD) wished, ultimately endorsed in the coalition agreement between the SPD and the Christian Democrats (CDU). The minimum wage has gradually come into force from 2015 and has helped to reduce wage disparities between the old and new Länder and between the most qualified and the least qualified employees (Amlinger, Bispinck and Schulten 2016, Chagny and Le Bayon, 2016).[15]

Firms have apparently limited the impact of the minimum wage on their costs by flattening the wage scales at the minimum wage level and by increasing the labour productivity of the employees concerned (cutting their working hours and / or intensifying the work effort). They have also passed on the higher costs in prices, especially in the new Länder. This is clearly reflected in the prices of certain services in these Länder (hairdressers, taxis, etc.). On the other hand, the impact has been small at the aggregate level, with the former Länder accounting for only 20% of Germany's consumer price index. Furthermore, the fall in oil prices had a disinflationary impact that helped to mask any possible inflationary effect of the minimum wage.

14. Allegre (2013).
15. Gross monthly wages (excluding minijobs) rose by 3.4% in 2015 in the new Länder, compared to 1.6% in the old Länder. Moreover, the rise in hourly wages in the new Länder was 8.6% for the unskilled and 5.8% for the semi-skilled, while for those with an average skills level it was 4%.

7.3. Germany and Europe: Reflections on European governance

Germany is emerging from the crisis in an unquestionably stronger position, and it is more than ever playing the role of leader of the euro zone. Even though there are imbalances and problem areas behind these apparent successes, the German model has become a benchmark for the euro area, since it showed the possibility of reducing unemployment while generating budget surpluses and remaining highly competitive, that is to say, while respecting the rules of European governance. This situation has given Germany a hegemonic economic and political position within the euro area, which enables it to defend its interests and propose its vision of governance (Wyplosz, 2016). At the same time, the other Member States are also tempted to ask it to assume the position of being a locomotive for the euro area so as to drive the growth of its partners through its stimulus policies.

a) Can the euro area use the same recipes as Germany?

The German government is interpreting its success as being the fruit of a form of orthodoxy and of respect for the existing rules of European governance. So if Germany is now running a budgetary surplus, this is because the country has made the efforts needed to reduce its deficit and ensure the sustainability of its public finances. Likewise, the current account surplus is viewed as the result of mastering competitiveness and controlling wage costs, in particular through the Hartz labour market reforms implemented in the early 2000s. Having identified the supposed keys to success, other European countries merely have to follow the same path.

However, although the Hartz reforms were an important turning point in the functioning of the German social welfare state, profound changes were already underway. Wage moderation had begun in the mid-1990s, reflecting the introduction of greater flexibility into the German social model (Chagny, 2008). Moreover, Germany's situation is due not only to the functioning of its labour market, but also to the existence of a set of complementarities that relate to the way that agents and institutions are coordinated, which define the German "model". However, these characteristics—industry specializing in quality goods produced by highly skilled employees, autonomy of the social partners, long-term governance, a state guaranteeing regulated liberalism, price stability—are unique to Germany and cannot be replicated by other countries (Hall, 2015). Given this, there is no guarantee that the same reforms will produce the same effects.

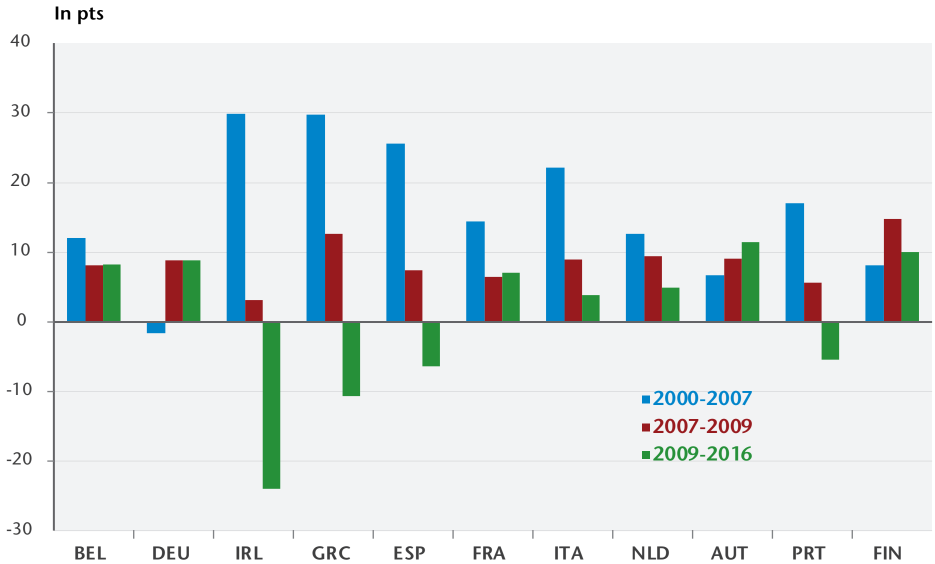
Herzog-Stein, Lindner and Zwiener (2014) show that for many years the structural reforms depressed domestic demand, with an overall negative growth and employment impact, in addition to helping to fuel the competitive disparities that led to the implosion of the common currency.

It should also not be forgotten that Germany's fiscal consolidation and labour market reform were undertaken before the 2007 financial crisis, i.e. in a much more favourable economic context. When Germany undertook its fiscal adjustment, it was able at that time to benefit from the more dynamic growth of the other euro area countries, which enabled it to offset at least partially the negative effect of its fiscal consolidation. Starting in 2010, it is the euro area as a whole that has pursued a fiscal consolidation policy. The synchronization of these policies has greatly increased their recessionary effect. In these circumstances it has been much more difficult and costly for the euro area countries to reduce their post-2010 deficits than it was for Germany after 2004. The iAGS 2013 report shows that this strategy was a failure and that alternative solutions should have been contemplated and implemented. The success of fiscal consolidation depends heavily on the moment that it is undertaken. As has been suggested in Section I, Germany's return to budgetary surpluses is the result not so much of extra efforts it has made relative to its partners as to the fact that it has undertaken less fiscal consolidation, and thus not undermined growth. The bulk of the effort was undertaken earlier, in a different context.

Similarly, by definition, Germany's gains in competitiveness in the first half of the 2000s have had as their corollary a deterioration in the competitiveness of its trading partners, particularly those in the euro area. The real effective exchange rate is ultimately a measure of the relative price or cost. It follows that not all countries can become more competitive simultaneously. However, the one-sided strategy currently being adopted by many countries, encouraged by flawed mechanisms such as the Macroeconomic Imbalance Procedure , is based on the implementation of labour market reforms or measures to cut labour costs (Figure 6). This race for competitiveness will inevitably have an attenuated impact on growth, with the gains of some being made to the detriment of others. Furthermore, in a context of high unemployment, implementing a strategy like this at the level of the euro area as a whole creates and reinforces disinflationary pressures throughout the area.

Hence there is every reason to think that an approach that has worked in one place at one specific time will not work in the same way for other countries in other contexts.

Figure 6. **Change in unit labour costs**



Source: Eurostat.

b) **Don't expect too much from Germany.**

Due to Germany's macroeconomic situation and the weight of its GDP in euro area GDP, the economic policy decisions that it takes have an impact on other countries. Furthermore, Germany is the only large Member State that enjoys fiscal space under the Stability and Growth Pact, which would enable it to enact a fiscal stimulus that would boost demand in the euro area and thus benefit the countries that are currently constrained by the fiscal rules. This is the approach sought not only by the euro area Member States but, recently, also by the European Commission, which emphasised in its Annual Growth Survey (2016) that the orientation of fiscal policy in the aggregate euro area should be expansionary. Not only did this imply a German fiscal stimulus (because the aggregate orientation must be compatible with the budgetary rules in force which call for consolidation in other countries; the Commission explicitly called on countries with fiscal space to use it and to frontload public investment. What we see is that Germany's fiscal stance was mildly expansionary in 2015 and 2016, in particular as a result of the measures taken to receive immigrants. The prospect of the autumn 2017 elections could also see the emergence of stimulus proposals which, in the current state of the debate, would mainly focus on tax cuts.

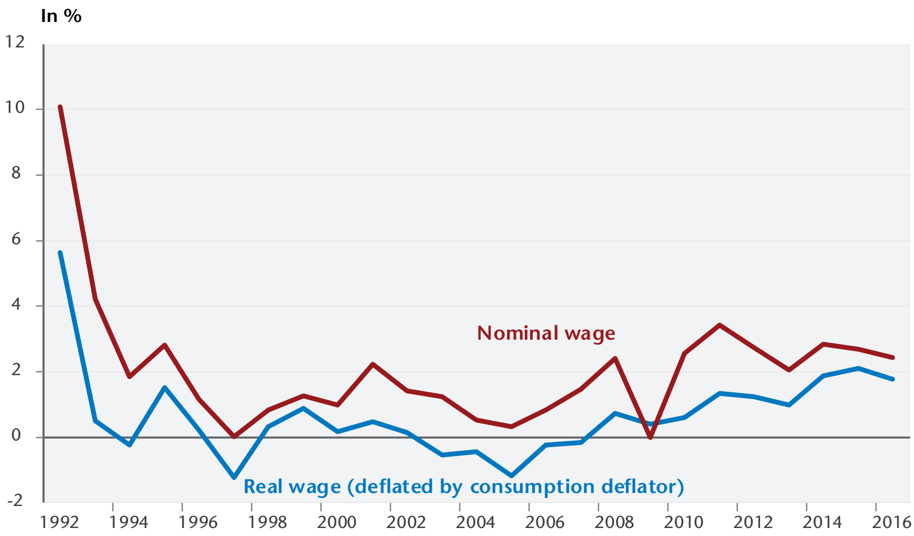
On the other hand, if a major fiscal stimulus were adopted, such as a public investment plan as suggested in Section 2, this would benefit Germany in particular and above all. Although the literature highlights the positive spill-over effects (Corsetti *et al.*, 2010; Blanchard *et al.*, 2016), their magnitude is probably limited. It does not therefore seem realistic to think that a German revival would solve the problem of low growth in France, Italy and Portugal. These limits should not however lead to giving up on the implementation of an investment programme in Germany. This is still desirable in order to consolidate Germany's growth in the short term and to boost its growth potential in the long term. This would also end up having a positive impact on demand for exports from other euro area countries. But this could not be the sole driver of growth in these countries.

The other factor supporting growth could be a more generous wage policy in Germany, which would help to reduce the euro area's current account imbalances, although here, too, the effects will be limited in magnitude. The iAGS reports for 2014, 2016 and 2017 largely support this idea. Indeed, they are based on the observation that up to now the correction of imbalances has been carried out mainly by the countries in deficit. The higher the inflation gap between the surplus countries and the deficit countries, the easier it is to rebalance the current accounts. The main aim would be to promote a method of coordinating wage policies that takes into account the externalities of these policies and prevents the euro area from falling into a deflationary trap. But even if adjustments in relative competitiveness help to reduce the imbalances, the euro area cannot rely on this strategy alone. This needs to be supplemented by a structural component, that is, by policies that favour the convergence of production capacities and living standards. As was pointed out in the iAGS 2017 report, restoring growth in the euro area as a whole cannot be accomplished by a single measure, but demands a comprehensive strategy.

It should also be noted that wages in Germany have been accelerating since 2011 (Figure 7). The reduction in the unemployment rate has been giving employees greater bargaining power. Furthermore, in 2015, German employees benefited from the implementation of the minimum wage (set initially at 8.50 euros per hour, before being revised to 8.84 euros in 2017), even though the macroeconomic impact has been relatively small. Yet, it is clear that the faster growth in German unit labour costs (Figure 6) since 2009 has not yet translated into a reduction in Germany's current account surpluses.

Horn *et al.* (2017) simulated the impact of a higher increase of average nominal wage growth per capita than was actually the case in Germany. They study the an increase of 2.7% between 1999 and 2015 (which is equal to the sum of pre-crisis productivity growth and the ECB's inflation target), i.e. 0.9 percentage points more than what actually took place over the period. They find that this would have led to somewhat higher prices but would not have prevented real wages from rising by 0.7 percentage points per year more on average. However, if only wages and nothing else would have changed, the trade balance would have decreased by only 0.7 percentage points between 1999 and 2015. Since higher wages lead to an increase in income and consumption taxes and thus higher public revenues, they use those extra revenues to increase higher public spending. In this scenario with an additional fiscal boost, the trade balance would have been 1.2 percentage points lower, i.e. it would stand at 6.3% of GDP and not at the actual value of 7.5%. Overall, those simulations show, that stronger wage growth alone is probably not likely to be effective to significantly reduce the German current account and that there would have to be a much stronger increase in public spending to stimulate Germand demand to such an extent that imports are significantly increased and the trade balance reduced.

Figure 7. **Changes in wages in Germany—See if the figure should appear earlier**



Source: Destatis.

7.4. Conclusion

From the sick man of Europe at the early 2000, Germany has now reached a position of leader in the euro area. The economic performance of Germany has shown a strong resilience despite a major financial crisis, a collapse of the world trade in 2008-2009 and the worst global recession since the Great Depression. During the sovereign debt crisis that hit euro area countries, Germany was considered as a safe haven in the euro area. Ten years after, the German unemployment rate is below its pre-crisis level, the current account surplus has increased and the net government deficit has rapidly been reduced. Even though, those economic successes should not hide important internal challenges, it seems that Germany has reinforced its political influence on issues regarding European governance emphasizing the importance of public debt sustainability and competitiveness. However, the recent evidence has shown that the strategy followed by euro area countries to improve competitiveness and reinforce sustainability has failed. All countries have implemented fiscal consolidation at the same time leading to a double-dip recession in the euro area. The synchronized consolidation is therefore more likely to be self-defeating. Besides, euro area countries should also avoid a race for competitiveness that will end in deflation rather than improving exports performance. The leader's position also implies expectations from other euro area members. However, even if Germany is the biggest country in the euro area and may contribute to reduce macroeconomic imbalances, it cannot alone tackle all economic challenges faced by euro area. More coordination is needed notably through the adoption of a fiscal rule more favourable to public investment and through the adoption of a "golden rule" for wages as emphasized in the iAGS 2017 report.

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