Economic analysis from the European Commission's Directorate-General for Economic and Financial Affairs

Volume 4, Issue 5

14.04.2007

ECFIN COUNTRY FOCUS

Highlights in this issue:

- **After a slow decade, Germany is enjoying a strong recovery**
- **Potential growth may benefit from the restoration of price competitiveness, the fading costs of reunification and structural reforms**
- **But further reforms are needed to lift potential growth substantially**

Upswing in Germany: how long will it last?

*By Heinz Jansen and Michael H. Stierle**

Summary

Following several years of low growth Germany is presently enjoying a strong recovery. With unemployment falling at record speed and fiscal consolidation progressing, the upswing is set to continue in spite of uncertainties surrounding the VAT increase of January 2007. This Country Focus analyses whether the strong outlook merely signifies a cyclical recovery or whether it heralds a return to higher potential growth from the estimated level of slightly above 1% in the first half of this decade. In recent years three developments have taken place that may have helped lift potential growth. These include, first, the restoration of external cost competitiveness by means of wage moderation; second, the lightening of the reunification burden, notably by cutting the bloated construction sector down to size; and, third, a number of reforms, especially in the labour market. On the other hand, the lengthy slowdown has taken its toll in terms of lower capital deepening and persistent structural unemployment. This weakness in providing labour and capital inputs means that Germany risks losing some of its still strong capacity to innovate, and potential growth is likely to remain subdued. Implementing a coordinated reform agenda, however, would lift potential growth substantially.

Cyclical or structural recovery?

At the beginning of 2007, economic sentiment in Germany is at the highest level since reunification. Demand and output are growing more strongly than in the last few years and have led to an impressive turnaround in public finances and unemployment. This contrasts sharply with the situation of entrenched pessimism until 2005, when Germany was frequently labelled the 'sick man of Europe' (Chart 1). Only once in the last 15 years – during the short ICT boom in 2000 – did the economy grow at more than 3%.

This Country Focus analyses whether the currently strong economic outlook might merely be a cyclical swing around a continuing weak trend of potential growth of presently only 1¼%, or whether it may be seen as ushering in a lasting period of stronger growth. It draws on the detailed country study entitled "Raising Germany's growth potential" published recently by DG ECFIN (European Commission 2007).

Germany is in its first recovery since the brief ICT boom

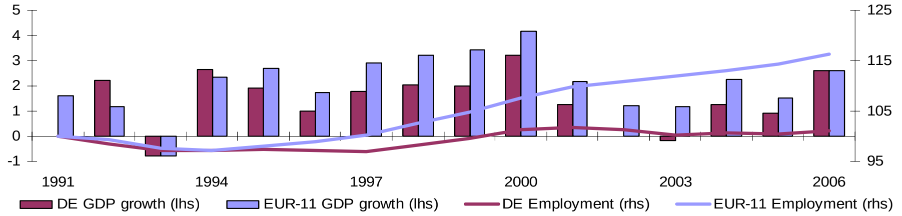
Reunification led to a brief boom in the early 1990s, but in its wake Germany's potential growth suffered a sharp fall. Reunification directly and indirectly left Germany with three significant imbalances. The first and most obvious was the need for a massive transfer of resources from the West to build up the East's crumbling infrastructure. However, not all the money was spent efficiently. Moreover, due to high unemployment, a significant share was directed towards social transfers rather than public investment. The cumulative transfer volume since unification exceeds

*** Directorate for the Economies of the Member States.**

€1000 billion and is the main factor responsible for Germany's increased debt and high taxes (Jansen 2004).

Ten years of underperformance

Chart 1. German GDP and employment growth have consistently been below that of other euro-area members (1991-2006)



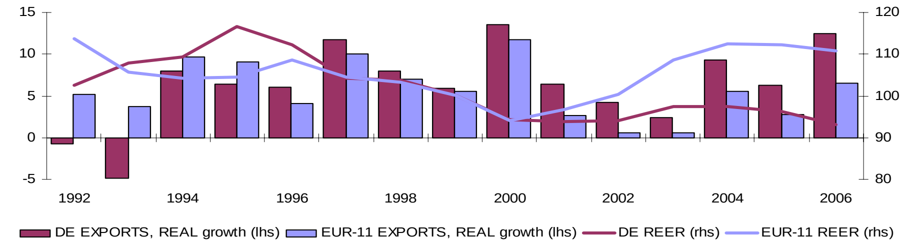
Source: Ameco

A second imbalance arose in the construction sector, which increased rapidly in size until the mid-1990s on the back of a building boom, particularly in the East, which was further fuelled by large-scale housing subsidies. The consequent adjustment took about ten years during which the sector fell by about one third in size. This adjustment alone reduced annual GDP by about ¼ of a percentage point over the entire period from 1991-2006. Indeed it may have reduced growth even more, if one takes into consideration that falling house prices have reduced consumption in Germany, while other countries in Europe have enjoyed a housing boom. Only in 2006 did the adjustment of the German housing market apparently come to a halt.

The third imbalance concerns the very sharp loss of cost competitiveness from which Germany suffered in the first half of the 1990s (Chart 2). High wage increases far in excess of productivity and a strong Deutschmark pushed up the real effective exchange rate until 1995. This, in combination with rising taxes and social security contributions, led to a slowdown both in investment and consumption, the latter also being affected by higher savings in response to concerns about future pension provision due to the ageing of the population.

Strong export growth as a result of wage moderation

Chart 2. Recently restored cost competitiveness and healthy export growth



Source: Ameco

Adjustment for the imbalances started in the mid-1990s, but was slow and far from complete when Germany entered EMU. External competitiveness was restored through wage moderation and labour-shedding over an extended period. German exports largely benefited from a booming world economy, greater exchange rate stability brought about by EMU and the gradual restoration of price competitiveness.

In contrast to exports, however, domestic investment and consumption failed to respond to the external stimulus as they were held back both by the wage adjustment that had become unavoidable and by a number of structural rigidities that had built up over the years (Jansen 2005). Moreover, although Germany's nominal and real interest rates were low by historical standards, higher inflation in partner countries meant that real interest rates in Germany were on average more than ½ percentage point higher than the euro-area average. This may have widened the growth gap with these countries further, as Germany may have benefited relatively less from generally favourable monetary conditions.

Factors influencing potential output

An analysis of longer-term growth trends needs to abstract from cyclical aspects of the current recovery, including temporary effects as a result of the several fiscal measures like the recent VAT increase, the unusually mild winter and upcoming changes in corporate taxation. The structural determinants of growth, however, are not constant. At the beginning of 2007, the prospects for potential growth are defined by two countervailing forces. Factors that could raise potential output compared with the situation of in the 1990s and the beginning of the current decade include:

- Regaining of cost competitiveness over the last ten years due to wage moderation, corporate restructuring and outsourcing.
- Reduction in the burden of reunification, notably though lower transfers to the East, as infrastructure gaps are now largely closed.
- End of the decline in the construction sector.
- A number of reforms, notably in the labour market.

Changes for the better and the worse

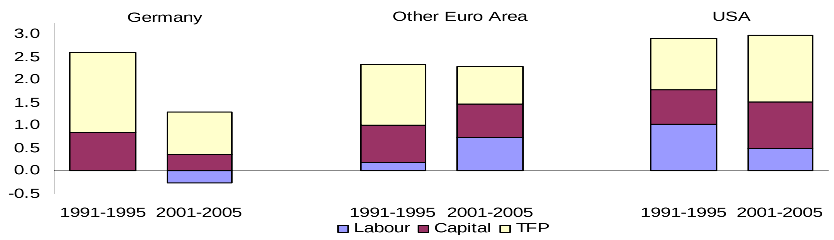
On the negative side, there are factors at work that have contributed to a reduction in potential output in recent years. Among them are:

- Lower capital deepening.
- Entrenchment of long-term unemployment.
- Increased competition for investment from neighbouring countries.

A production function approach provides a useful framework to analyse the net impact of the longer-term structural changes that have occurred over the past few years. The approach also allows potential output growth to be split into the constituent labour, capital and total factor productivity (TFP) contributions, the latter representing mainly the impact of technical progress and innovation (see Denis et al. 2006). Chart 3 shows the development of potential output since the early 1990s in Germany and compares it with the rest of the euro area and the United States, both of which have kept their potential growth unchanged. In the rest of the euro area employment growth has compensated for falling TFP growth, while in the USA TFP and capital growth have been able to counteract the fall in employment growth. Germany is the only area where there has been a significant drop in potential output. In stylised terms, in Germany, the capital contribution fell by half in 10 years; the labour contribution remained negative or was zero even in the best of times; and TFP growth is still relatively strong by international comparison, but is responsible for the largest decline in last 10 years. The following section briefly discusses the outlook of each component in turn.

Chart 3. Potential output is below that of the euro area and USA

Negative labour contribution, low capital contribution, falling TFP growth



Source: Ameco

Labour markets need continuing reforms

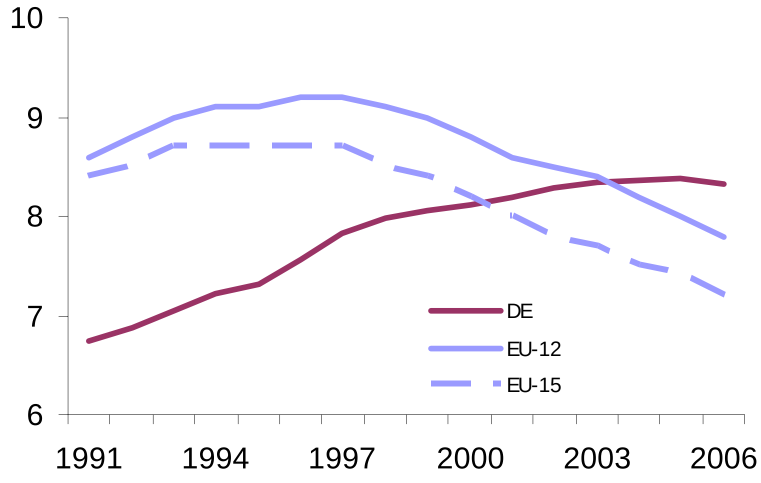
Labour market reforms have yet to show full impact

From a situation of virtual full employment until the mid-1990s, unemployment has been ratcheting up with each cyclical downturn, overtaking the EU average at the turn of the millennium and peaking in 2005 at above 5 million or 12% of the labour force. A number of indicators provide firm evidence that unemployment has become largely structural: for example, the non-accelerating wage rate of unemployment (NAWRU) is estimated to have increased from 7¼% in 1995 to almost 8½% in 2005, and has only recently started to turn around (Chart 4).

By long tradition, wage formation in Germany is relatively centralised, and although this facilitates wage moderation at the overall level, it inhibits wages from adequately reflecting differentials in labour productivity and companies' profitability. This not only deprives the low-qualified of job opportunities, but also leads to a brain-drain of the best-qualified, who represent the most innovative part of the labour force. Other problems relate to the social security system. By international standards, and also in relation to domestic earnings, social benefits have been relatively generous in terms of both level and duration, thereby also requiring high rates of social contributions, which drive a wedge between (high) labour costs for the employer and (low) take-home pay for the employee, creating strong disincentives for the former to recruit and for the latter to take up work, particularly where low-paying jobs are concerned.

This tax wedge widened considerably in the early 1990s as a consequence of reunification and has remained far above the EU average since then.

Chart 4. German structural unemployment until recently going up
(NAWRU as % of workforce)



Source: Ameco

In response to the growing imbalance on the labour market, and following the announcement in March 2003 of the so-called *Agenda 2010*, the government has introduced a series of important reforms designed partly to raise the efficiency of the labour exchange and placement services and partly to strengthen incentives for the unemployed to take up work. To facilitate their return to the job market, new forms of subsidised employment have been created. While the new measures need time to take their full effect and a final assessment would be premature at this stage, the latest developments signal a positive turnaround on the labour market that may go beyond a purely cyclical improvement. Yet some important causes of labour market rigidity, such as the set-up of the wage formation process or Germany's restrictive employment protection legislation, still need be addressed.

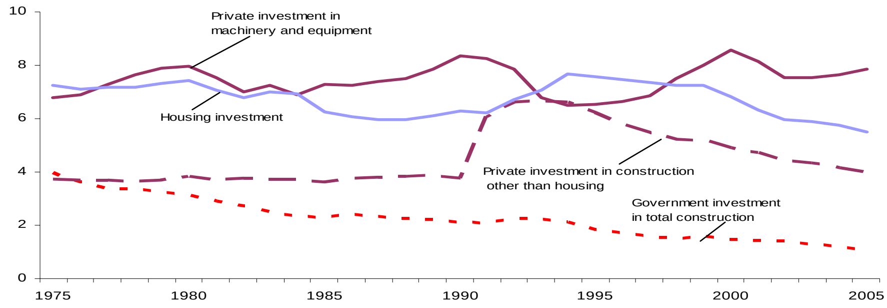
Investment held back by banking sector and corporate taxes

Construction is back to normal

Germany's investment ratio has fallen from 24% to 19% of GDP since the mid-1970s. The biggest single factor in the long decline has been the shrinking of the construction sector, where the necessary downsizing from the levels of the early post-war era, interrupted by the post-reunification boom, accelerated between the middle of the 1990s and 2005, stabilising only in 2006 (Chart 5).

Private investment in machinery and equipment, as a share of GDP, has been rather volatile since the late 1980s, with no clear trend (Kuhnert 2005). Yet the obvious response to reunification, the completion of the EU internal market, the introduction of the euro and the increasing momentum of globalisation, all calling for corporate restructuring, would have been an increase in investment. This suggests that there have been impediments to capital formation. The loss of external competitiveness after reunification and the need for balance sheet restructuring of companies at the beginning of the present decade may explain to some extent the hesitant pick-up in investment at the early stage of the current cyclical recovery. All this may be behind us and developments in 2006 suggest that corporate investment is now picking up pace.

Chart 5. Investment volumes dominated by construction (as % of GDP)



Source: Destatis, Ameco

However, it is likely that corporate financing and corporate taxation present more fundamental impediments to business capital formation. While large companies are increasingly resorting to capital market financing, established credit relations between borrowers and their "home bank" remain the dominant form of financing, notably for smaller and medium-sized companies. And although, with all its pros and cons, bank loan financing has proved efficient for established companies, it may be less so for the financing of new companies, including innovative, high-risk start-up businesses. Moreover, German banks' profitability is low by European standards, which points to operational and institutional inefficiencies, since the sector has been largely shielded from external competition; it will face stronger pressure for adjustment in the future (see IMF 2006). Corporate taxation, for its part, suffers from a relatively high nominal tax burden, a rather complicated tax code, and a narrow tax base. This leads to relatively low actual revenues. With the trend in neighbouring countries' tax rates heading clearly downwards, Germany risks losing out in the international competition for tax bases. In addition, the split in tax rates between retained earnings and distributed profits undermines the mobility of capital with regard to its optimal allocation for the financing of investment. The government has recognised the need for a competitive corporate tax system and a proposal has been made for reform, to take effect in 2008.

Plenty of innovations, but the application is lacking

Innovative capacity needs to be reinforced

Germany performs rather well on many of the conventional indicators for innovation efforts and spending on research and development, even though it regularly ranks behind the US and the European top performers (European Commission 2007). However, innovation appears to be concentrated in a relatively small number of large companies and geared towards rationalisation and cost reduction rather than developing and introducing new products. Small and medium-sized companies lag behind the industrial leaders and their position has weakened over time. It is not by coincidence that they are the most constrained in their access to venture capital. Furthermore, Germany has maintained its strong position in traditional sectors of manufacturing, such as the automotive, chemical and machine tools industries, but has been less innovative in frontier technologies and in the service sector, where lags in the adoption and diffusion of innovation may have contributed to the slowdown in productivity growth.

Results from the PISA studies (see OECD 2004) indicate that there is a need to improve the supply of highly-qualified labour. German schoolchildren score below the OECD average in mathematics and science, and there are no nationwide benchmarks for educational achievement. With the predominance of half-day schooling, early selection and low mobility between educational streams, Germany's education system is failing to mobilise its full human resources potential. At the tertiary level, the system is characterised by a lack of performance standards for and competition between universities, relatively long study periods and high drop-out rates. Finally, there is evidence that barriers to entrepreneurship are relatively high, notably the heavy regulatory and administrative burdens involved in starting up and running a business. These impediments need fixing for Germany to keep or even raise its high TFP growth.

Further reforms are needed to make the upswing durable

Whilst difficult to estimate the extent to which reforms could actually lift potential growth, indicative simulations carried out by the European Commission (2007) give a rough indication of the potential benefits of a comprehensive reform strategy. They show that Germany could, provided it continues to implement further reforms, catch up from potential growth currently estimated at 1¼% to the EU average growth trajectory over the next ten years. In an alternative scenario of bolder reform efforts, Germany could boost its potential growth to a rate comparable with that of the US economy in the first half of this decade. They thus give strong grounds to believe that Germany can indeed leave behind the sluggish growth experienced in the first half of this decade.

The best time to implement changes is now

Recent developments may support such optimism. It appears that Germany has finally emerged from the trough of the lengthy and cumbersome adjustment process, with external competitiveness restored the economic burden of reunification more manageable. Exports are providing strong forward momentum, accompanied by a rebound in investment. Unemployment has been brought onto a firm downward trend and, most importantly, the number of jobs covered by regular employment contracts is heading up for the first time since the beginning of the decade. Tax revenues rising even beyond the cyclical dividend and firm control over government spending have allowed the budget deficit to be brought under control, and put an end to the string of excessive budget deficits in 2006, one year earlier than expected. This benign economic outlook provides an excellent opportunity to implement the much needed reforms that could lead Germany emerging again as Europe's economic powerhouse.

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Coordinating Committee: Gerrit Bethuyne, Heinz Jansen, Stephanie Riso
Layout: Vittorio Gargaro, Johannes Kattevilder
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