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Macroeconomic trends and reforms in Germany

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1. Introduction

This paper recounts the main developments in the German economy since the turn of the 1990s, and in particular the structural reforms enacted first to correct the disequilibria generated by national unification and then, with the inception of European Monetary Union, to enhance the flexibility of the productive economy and the fiscal system. The German performance is compared with that of the other euro-area economies, focusing in particular on the current account imbalances that have arisen since the turn of the century.[1] We retrace the recent debate on how to correct those imbalances, recalling the arguments for and against the thesis that the countries with a current payments surplus, above all Germany, must also play an active role in fostering the adjustment of the deficit countries. A possible synthesis is proposed, based on an analysis of the formation of national income and the use of resources according to the national accounts system.

The paper is organized as follows. The first section traces Germany's real economic performance in the 1990s, dominated during the first five years by the effects of unification and subsequently by the start of the correction of the consequent disequilibria. The second section describes the main macroeconomic developments from the launch of monetary union to the eve of the global crisis, recalling the role of the major structural reforms to the real economy during the first few years of the new century. The third section covers the steep global recession of

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[1] This study focuses on developments of the real economy and disregards the conditions of the financial markets; as for the banking system, see Hüfner (2010) and Brunner *et al.* (2004).

2008-09, describing the divergent course of events in the countries of the euro area and summarizing the ensuing debate on policy intervention to correct the imbalances of individual economies, and specifically on the proper role of countries with large balance-of-payments surpluses. The main theses are checked against the indications offered by national accounts data on the sources and uses of income. The last section concludes with a summary of the main implications deriving from the essay.

2. The German economy in the 1990s

2.1. 1991-95: Unification shock

From 1991 through 1995, the newly unified German economy grew at an average annual rate of 2.2 per cent, about half a point better than the future euro area as a whole (Table 1). This faster growth reflected a perceptibly larger contribution from domestic demand (2.4 percentage points each year, compared with 1.3 for the euro area), thanks to the massive mobilization of resources for the transition. Specifically, during these five years construction investment expanded by 4 per cent per year, against just 1 per cent for the euro area (Table 2),[2] mainly to modernize infrastructure in the eastern part of the country and build housing in the western regions for the expected massive internal migration.[3] The result was a rise of nearly 2 full percentage points in construction's share of GDP during these years to 14 per cent, in contrast with the downward trend observed in the other main euro-area countries. Household consumption also expanded faster in Germany than in the rest of the area (nearly 3 per cent per year against 1.7 per cent). Foreign trade, by contrast, was a drag on growth, as import growth outpaced exports by

[2] In the first ten years after unification, investment in the eastern regions is estimated at the equivalent of some 600 billion euros, two thirds of it in residential and industrial construction (Martinez Oliva, 2008).
[3] There had been a sharp acceleration of migration from the eastern part of Germany already in the late 1980s, contributing powerfully to population growth in the western regions.

Table 1 - *GDP, domestic demand and net trade*
(*chain-linked volumes; annual national accounts*)

Anno	GDP					Domestic demand					Net export				
	Euro	IT	FR	DE	ES	Euro	IT	FR	DE	ES	Euro	IT	FR	DE	ES
	Percentage changes on the previous year					Contribution to GDP growth (percentage points)									
1990	3.6	2.1	2.6	5.7	3.8	3.8	2.6	2.9	5.6	4.7	-0.2	-0.5	-0.2	0.1	-0.9
1991	2.5	1.5	1.0	5.0	2.5	2.5	2.4	0.5	5.1	3.1	0.0	-0.8	0.6	-0.1	-0.6
1992	1.6	0.8	1.4	2.2	0.9	1.7	0.8	0.6	3.2	1.0	-0.1	0.0	0.9	-0.9	-0.1
1993	-0.8	-0.9	-0.9	-0.8	-1.0	-2.1	-4.6	-1.5	-0.7	-3.4	1.3	3.7	0.7	0.0	2.4
1994	2.5	2.2	2.2	2.7	2.4	2.3	1.5	2.2	2.7	1.5	0.2	0.6	0.0	-0.1	0.8
1995	2.5	2.8	2.1	1.9	5.0	2.3	1.8	1.8	1.9	5.1	0.2	1.0	0.3	0.0	-0.2
1996	1.6	1.1	1.1	1.0	2.4	1.2	0.6	0.8	0.4	2.1	0.3	0.5	0.4	0.6	0.3
1997	2.6	1.9	2.2	1.8	3.9	2.0	2.5	1.0	0.9	3.4	0.6	-0.6	1.3	0.9	0.4
1998	2.8	1.4	3.5	2.0	4.5	3.5	2.8	4.0	2.3	6.2	-0.7	-1.4	-0.5	-0.3	-1.7
1999	2.9	1.5	3.3	2.0	4.7	3.4	2.6	3.7	2.6	6.6	-0.5	-1.2	-0.4	-0.6	-1.8
2000	3.9	3.7	3.9	3.2	5.0	3.3	3.0	4.2	2.1	5.5	0.5	0.7	-0.3	1.1	-0.5
2001	1.9	1.8	1.9	1.2	3.6	1.3	1.6	1.7	-0.5	3.9	0.6	0.2	0.1	1.7	-0.2
2002	0.9	0.5	1.0	0.0	2.7	0.4	1.3	1.1	-2.0	3.3	0.6	-0.8	0.0	2.0	-0.6
2003	0.8	0.0	1.1	-0.2	3.1	1.4	0.8	1.7	0.6	4.1	-0.6	-0.8	-0.6	-0.8	-1.0
2004	2.2	1.5	2.5	1.2	3.3	1.9	1.3	3.2	-0.1	5.3	0.3	0.2	-0.7	1.3	-2.0
2005	1.7	0.7	1.9	0.8	3.6	1.8	0.9	2.6	0.0	5.6	-0.2	-0.2	-0.7	0.7	-2.0
2006	3.0	2.0	2.2	3.4	4.0	2.9	2.0	2.5	2.3	5.9	0.2	0.1	-0.3	1.1	-1.9
2007	2.9	1.5	2.4	2.7	3.6	2.5	1.3	3.3	1.2	4.7	0.3	0.2	-0.9	1.5	-1.1
2008	0.5	-1.3	0.2	1.0	0.9	0.4	-1.5	0.5	1.1	-1.0	0.1	0.1	-0.3	-0.1	1.8
2009	-4.1	-5.0	-2.6	-4.7	-3.7	-3.4	-3.8	-2.3	-1.9	-7.1	-0.7	-1.2	-0.2	-2.9	3.4

Table 1 (*cont.*)

Table 1 (*cont.*)

Anno	GDP					Domestic demand					Net export				
	Euro	IT	FR	DE	ES	Euro	IT	FR	DE	ES	Euro	IT	FR	DE	ES
	Average yearly growth rate in the periods indicated					Average yearly contribution to GDP growth (percentage points)									
1981-1985	1.4	1.7	1.5	1.2	1.4	0.9	1.3	1.3	0.5	0.5	0.5	0.3	0.4	0.7	0.9
1986-1990	3.3	3.1	3.3	3.4	4.5	3.8	3.7	3.8	3.5	6.2	-0.5	-0.6	-0.6	-0.2	-1.7
1991-1995	1.6	1.3	1.2	2.2	1.9	1.3	0.4	0.7	2.4	1.5	0.3	0.9	0.5	-0.2	0.5
1996-2000	2.7	1.9	2.8	2.0	4.1	2.7	2.3	2.7	1.7	4.8	0.1	-0.4	0.1	0.3	-0.7
2001-2007	1.9	1.1	1.8	1.2	3.4	1.9	1.5	2.5	0.4	4.8	0.2	-0.1	-0.4	1.1	-1.2
1981-1990	2.4	2.4	2.4	2.2	2.9	2.3	2.5	2.5	2.0	3.3	0.0	-0.1	-0.1	0.3	-0.4
1991-2000	2.2	1.6	2.0	2.1	3.0	2.0	1.3	1.7	2.0	3.1	0.2	0.3	0.3	0.1	-0.1
2001-2009	1.1	0.2	1.2	0.6	2.3	1.0	0.4	1.6	0.1	2.8	0.1	-0.3	-0.4	0.5	-0.4

Source: Eurostat and national statistics.

Table 2 – *Uses of income in the largest euro area countries*
(*chain-linked volumes; percentage changes on the previous year; annual national accounts*)

Anno	Euro area						Italy					
	Gross fixed capital formation		*Consumption expenditure*		*Export*	*Import*	*Gross fixed capital formation*		*Consumption expenditure*		*Export*	*Import*
	Others	Construction	Households	Others			Others	Construction	Households	Others		
1990	6.4	4.4	3.5	2.6	7.2	7.8	4.1	4.5	2.1	2.3	6.9	9.6
1991	1.1	1.2	3.0	2.2	6.4	6.3	1.4	1.2	2.7	1.9	-2.1	2.2
1992	-3.2	3.3	2.1	3.3	3.3	3.5	-0.9	-1.9	1.7	1.0	6.8	6.9
1993	-11.0	-2.7	-0.7	1.4	0.9	-4.0	-16.2	-7.3	-3.1	-1.5	8.7	-11.6
1994	2.0	2.9	1.7	1.3	9.2	8.8	7.4	-5.1	1.5	-1.6	9.6	7.8
1995	7.4	-0.3	2.2	1.2	8.3	7.9	10.7	3.6	1.5	-3.3	12.4	9.3
1996	6.2	-0.9	1.7	1.6	4.9	3.9	3.3	1.4	0.9	0.8	1.5	-0.5
1997	6.7	-0.1	1.7	1.3	11.1	9.6	4.6	-1.4	3.2	0.5	5.1	9.4
1998	11.3	2.1	3.1	1.3	7.4	10.3	8.4	-0.2	3.5	0.4	2.5	9.4
1999	8.8	3.8	3.4	1.8	5.8	7.8	5.0	2.7	2.6	1.4	-0.4	4.9
2000	7.2	2.9	3.1	2.4	13.0	11.8	6.7	5.8	2.4	2.2	11.9	9.8
2001	0.5	0.6	2.1	2.1	4.0	2.3	1.3	4.4	0.7	3.9	2.6	1.8
2002	-2.4	-0.7	0.9	2.4	2.0	0.5	1.9	5.9	0.2	2.4	-2.9	0.2
2003	0.9	1.6	1.2	1.7	1.1	3.0	-4.6	2.4	1.0	1.9	-2.0	1.2
2004	3.5	1.3	1.6	1.6	7.4	7.0	2.3	2.2	0.8	2.2	4.9	4.2
2005	4.5	2.0	1.8	1.6	5.0	5.8	1.2	0.4	1.2	1.9	1.1	2.1
2006	6.5	4.3	2.1	2.0	8.6	8.5	4.8	1.0	1.3	0.5	6.2	5.9
2007	7.3	2.1	1.7	2.2	6.3	5.6	3.0	0.3	1.1	0.9	4.6	3.8
2008	0.5	-2.1	0.4	2.3	0.9	0.7	-4.6	-3.4	-0.8	0.8	-3.9	-4.3
2009	-15.0	-7.7	-1.1	2.4	-13.1	-11.8	-16.1	-7.9	-1.7	0.6	-19.1	-14.5

Table 2 – *(cont.)*

Table 2 – *(cont.)*

	France						Germany					
	Gross fixed capital formation		*Consumption expenditure*		*Export*	*Import*	*Gross fixed capital formation*		*Consumption expenditure*		*Export*	*Import*
	Others	Construction	Households	Others			Others	Construction	Households	Others		
1990	7.0	2.3	2.5	3.2	4.6	5.5	14.6	4.7	5.4	2.2	11.0	10.3
1991	-0.6	-0.3	0.6	3.2	6.2	3.0	11.0	2.6	5.6	0.4	12.6	13.1
1992	-2.4	-2.3	1.0	3.1	5.8	1.6	-3.2	10.4	3.3	5.3	-0.8	2.8
1993	-5.2	-6.7	-0.4	3.5	0.2	-3.3	-4.0	1.9	0.8	0.1	-4.9	-4.7
1994	6.2	-0.5	1.4	0.3	8.1	8.6	-0.9	7.1	2.0	2.7	8.0	8.3
1995	6.8	-0.7	1.7	0.0	8.4	7.1	2.9	-1.8	2.2	1.9	6.3	6.5
1996	5.6	-2.1	1.6	2.1	3.7	2.1	3.7	-2.7	1.3	2.1	6.0	3.5
1997	5.6	-2.7	0.4	1.2	12.9	7.9	5.4	-1.5	0.8	0.5	11.7	8.2
1998	13.5	3.0	3.9	-0.6	8.2	11.6	12.0	-0.9	1.5	1.8	8.0	9.5
1999	12.0	5.6	3.5	1.4	4.6	6.7	9.5	1.5	3.0	1.1	5.9	8.6
2000	7.9	6.6	3.6	1.9	12.4	14.9	10.4	-2.4	2.4	1.4	13.5	10.2
2001	3.5	1.5	2.6	1.2	2.5	2.2	-2.5	-4.6	1.9	0.5	6.4	1.2
2002	-3.7	-0.1	2.4	1.9	1.5	1.7	-6.4	-5.8	-0.8	1.5	4.3	-1.4
2003	1.9	2.5	2.0	2.0	-1.2	1.1	1.3	-1.6	0.1	0.4	2.5	5.4
2004	3.6	3.6	2.5	2.3	4.0	7.1	3.8	-3.9	0.1	-0.7	10.3	7.3
2005	4.5	4.3	2.6	1.2	3.1	5.9	5.0	-3.0	0.3	0.4	7.7	6.7
2006	2.6	5.3	2.4	1.3	4.8	5.6	11.0	4.9	1.4	1.0	13.1	11.9
2007	8.2	4.4	2.6	1.5	2.5	5.6	9.5	-0.5	-0.2	1.6	7.6	5.0
2008	3.4	-1.7	0.5	1.7	-0.5	0.6	3.6	1.2	0.7	2.3	2.5	3.3
2009	-8.0	-6.3	0.6	2.7	-12.4	-10.7	-7.2	-1.5	-0.2	2.9	-14.3	-9.4

Table 2 – *(cont.)*

Table 2 – *(cont.)*

	Euro area						Italy					
	Gross fixed capital formation		*Consumption expenditure*		*Export*	*Import*	*Gross fixed capital formation*		*Consumption expenditure*		*Export*	*Import*
	Averages yearly growth rate in the period indicated											
1981-1985	1.8	-2.2	1.1	2.3	4.2	1.5	-0.2	-0.3	1.6	2.9	4.1	2.5
1986-1990	8.2	4.2	3.4	2.3	5.2	7.4	7.4	2.6	3.6	2.8	5.2	8.3
1991-1995	-0.9	0.9	1.7	1.9	5.5	4.4	0.0	-2.0	0.8	-0.7	7.0	2.6
1996-2000	8.0	1.6	2.6	1.7	8.4	8.6	5.6	1.6	2.5	1.1	4.1	6.5
2001-2005	1.4	1.0	1.5	1.9	3.9	3.7	0.4	3.0	0.8	2.5	0.7	1.9
1981-1990	5.0	1.0	2.2	2.3	4.7	4.4	3.5	1.1	2.6	2.8	4.7	5.3
1991-2000	3.5	1.2	2.1	1.8	7.0	6.5	2.8	-0.2	1.7	0.2	5.5	4.5
	France						Germany					
	Gross fixed capital formation		*Consumption expenditure*		*Export*	*Import*	*Gross fixed capital formation*		*Consumption expenditure*		*Export*	*Import*
	Averages yearly growth rate in the period indicated											
1981-1985	2.2	-2.5	1.7	3.1	3.4	1.3	-0.4	-2.2	0.6	1.1	5.2	1.3
1986-1990	8.2	5.0	3.1	2.7	4.9	7.2	7.0	3.5	3.6	1.3	5.2	6.1
1991-1995	0.8	-2.1	0.8	2.0	5.7	3.3	-1.2	4.0	2.8	2.1	4.1	5.0
1996-2000	8.9	2.0	2.6	1.2	8.3	8.6	8.2	-1.2	1.8	1.4	9.0	8.0
2001-2005	1.9	2.3	2.4	1.7	2.0	3.6	0.2	-3.8	0.3	0.4	6.2	3.8
1981-1990	5.2	1.2	2.4	2.9	4.1	4.2	3.3	0.6	2.1	1.2	5.2	3.7
1991-2000	4.8	-0.1	1.7	1.6	7.0	5.9	3.4	1.4	2.3	1.7	6.5	6.5

Source: Eurostat

nearly 1 percentage point each year (Table 2). By contrast, for the euro area as a whole net foreign demand made a positive annual contribution of 0.3 percentage points to GDP growth.

Compared with the other main countries, the faster expansion of household consumption and the relatively more moderate growth of exports both reflected wage increases in the eastern regions that were considerably greater than productivity gains in the immediate post-unification years, a contributing factor in which was the one-to-one parity between the eastern Ostmark and the D-mark.[4] Unit labour costs in unified Germany rose by 3.2 per cent per year from 1991 through 1995, compared with 1.8 per cent in the euro area (Table 3).[5] Owing in part to the nominal appreciation of the mark in connection with the crisis of the European exchange rate mechanism, in the five years through the end of 1995 the price competitiveness of German goods, based on manufactures prices, slipped by 6 per cent (Figure 1), while France suffered a much smaller loss of 2 per cent and Italy, thanks to devaluation, gained more than 20 points. Germany's current payments balance turned negative, by as much as 1.5 per cent of GDP in 1994. One factor was the deterioration of the public finances: with the effort of unification, the general government deficit hovered around 3 per cent of GDP from 1991 to 1995, about twice as much as the Federal Republic's deficit over the previous five years, and the public debt rose from 40 to 56 per cent.

German unification accentuated the differences over economic policy priorities among European countries. While the inflation rate was falling throughout Europe, in Germany it rose from 2.6 per cent in 1989 to 3.8 per cent in 1992 (Table 4), leading the Bundesbank to tighten monetary conditions and raise the discount rate to its highest levels since World War II. This increased the cost of money in the other European

[4] Starting in July 1990, the parity was set at 1-to-1 for wages, pensions, and most savings, 2-to-1 for company debts. The aim of the dual parity was to sustain the purchasing power of wages in the east in order to stem the labour migration towards the west, discourage the relocation of firms eastward and alleviate the debt of eastern firms; and at the same time to limit the expansion of the money supply.

[5] Hourly earnings net of consumer price inflation rose by more than 2.5 per cent per year during the period, compared with 1.0 per cent in France and an average annual decline of 0.4 per cent in Italy).

Table 3 - *Unit labour costs and its component: total economy (percentage changes on the year-earlier period)*

(a) Euro area

	Hourly cost of labour	Hourly wages and salaries	Hourly productivity	of which: Value added (1)	of which: Hours worked	Unit labour costs
1992	7.6		2.7	1.6	-1.1	4.8
1993	2.7		0.9	-0.9	-1.8	1.7
1994	1.9		2.4	2.0	-0.5	-0.5
1995	2.7		1.5	2.0	0.5	1.2
1996	3.3		0.9	1.2	0.3	2.4
1997	-0.1		1.5	2.1	0.7	-1.6
1998	0.4		0.7	2.5	1.7	-0.3
1999	2.2		0.5	2.5	1.9	1.7
2000	2.1		1.3	3.9	2.6	0.8
2001	3.2	3.3	1.2	2.0	0.8	2.0
2002	3.4	3.3	1.2	1.0	-0.2	2.1
2003	2.7	2.4	0.7	0.7	0.1	2.1
2004	1.7	1.8	1.3	2.3	1.0	0.5
2005	2.4	2.5	1.1	1.7	0.6	1.3
2006	2.6	2.6	1.7	3.0	1.3	0.8
2007	2.7	2.9	1.3	3.1	1.8	1.3
2008	3.4	3.4	0.0	0.7	0.7	3.4
2009	2.7	2.4	-1.0	-4.2	-3.2	3.7
Averages yearly growth rate in the period indicated						
1991-1995	3.7		1.9	1.2	-0.7	1.8
1996-2000	1.6		1.0	2.4	1.4	0.6
2001-2005	2.7	2.6	1.1	1.5	0.5	1.6

Table 3 - *(cont.)*

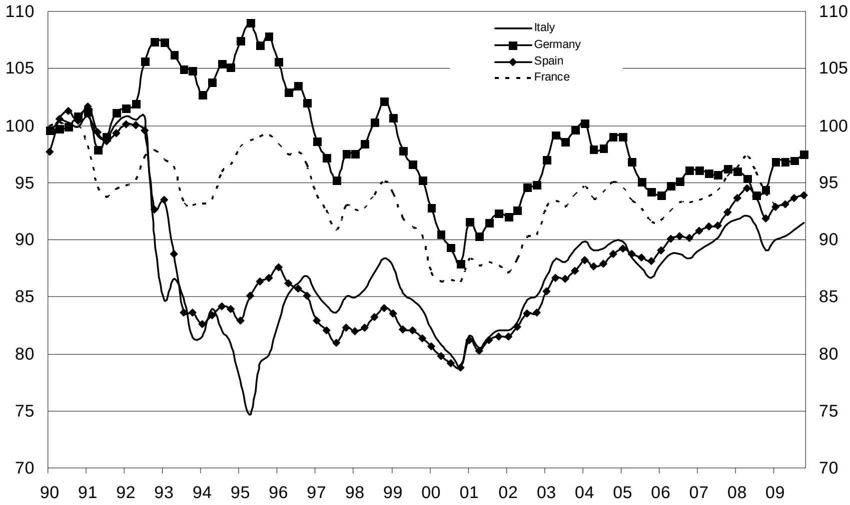
Table 3 - *(cont.)*

(b) Germany

	Hourly cost of labour	Hourly wages and salaries	Hourly productivity	of which: Value added (1)	of which: Hours worked	Unit labour costs
1990	4.7		2.5	5.6	2.8	2.1
1991	6.0		2.3	5.1	2.0	3.6
1992	9.0	9.0	2.5	2.2	-0.3	6.3
1993	5.4	5.7	1.4	-1.0	-2.4	4.0
1994	3.2	2.2	2.7	2.4	-0.3	0.5
1995	4.7	4.3	2.9	2.2	-0.7	1.8
1996	2.7	2.9	2.7	1.3	-1.3	0.1
1997	1.6	1.0	2.6	1.9	-0.7	-1.0
1998	1.3	1.3	1.2	2.1	0.8	0.1
1999	2.0	2.3	1.3	1.9	0.6	0.6
2000	3.3	2.9	3.1	3.7	0.6	0.3
2001	2.4	2.7	2.0	1.5	-0.6	0.4
2002	2.1	2.1	1.7	0.3	-1.4	0.3
2003	2.0	1.7	1.3	-0.1	-1.4	0.7
2004	0.1	0.4	1.0	1.6	0.6	-0.9
2005	0.6	1.0	1.5	0.9	-0.6	-0.9
2006	1.3	1.1	3.1	3.5	0.3	-1.8
2007	0.8	1.4	1.4	3.1	1.7	-0.7
2008	2.2	2.5	-0.1	1.1	1.2	2.3
2009	3.4	2.9	-2.8	-5.3	-2.6	6.4
	Averages yearly growth rate in the period indicated					
1991-1995	5.4	4.9	2.2	2.2	-0.1	3.2
1996-2000	2.2	2.1	2.2	2.2	0.0	0.0
2001-2005	1.4	1.5	1.5	0.8	0.7-	0.1

Source: Elaboration on Eurostat data. (1) Value added at base prices, volumes at chain-linked prices – reference year 2000.

Figure 1 - *Indicator of competitiveness based on producer prices of manufactured goods*
(*indices 1990=100*)



Source: Bank of Italy

countries as well, where in the absence of inflationary pressures there was a slowdown in economic activity. The central exchange rates within the EMS came under strain, and there were tensions in the coordination of monetary policies.

2.2. 1996-2000: Adjustment begins with concertation between the social partners

In the mid-1990s there was a brusque inversion of the macroeconomic situation by comparison with the immediate post-unification years. Between 1996 and 2000 average annual GDP growth slowed to 2.0 per cent, 0.7 percentage points lower than the area-wide average, owing to the sharp deceleration in the domestic components of demand (Table 1).

Table 4 - *Consumer Price Index*
(percentage changes on the year-earlier period) (1)

	Italy	Germany	France	Spain	Euro area
1980	21.2	5.4	13.6	15.6	11.5
1981	17.8	6.3	13.3	14.6	11.5
1982	16.5	5.2	12.0	14.4	10.2
1983	14.7	3.3	9.5	12.2	8.1
1984	10.8	2.4	7.7	11.3	6.7
1985	9.2	2.1	5.8	8.8	5.3
1986	5.9	-0.1	2.5	8.8	2.7
1987	4.7	0.2	3.3	5.2	2.5
1988	4.9	0.9	2.7	4.8	2.8
1989	6.0	2.6	3.5	6.8	4.0
1990	6.3	2.7	3.2	6.7	4.1
1991	6.2	3.7	3.4	5.9	4.1
1992	5.0	3.8	2.4	5.9	3.6
1993	4.5	3.2	2.2	4.9	3.3
1994	4.2	2.2	1.7	4.6	2.7
1995	5.4	1.3	1.8	4.6	2.4
1996	4.0	1.2	2.1	3.6	2.2
1997	1.9	1.5	1.3	1.9	1.6
1998	2.0	0.6	0.7	1.8	1.1
1999	1.7	0.6	0.6	2.2	1.1
2000	2.6	1.4	1.8	3.5	2.1
2001	2.7	1.9	1.8	2.8	2.3
2002	2.6	1.4	1.9	3.6	2.2
2003	2.8	1.0	2.2	3.1	2.1
2004	2.3	1.8	2.3	3.1	2.1
2005	2.2	1.9	1.9	3.4	2.2
2006	2.2	1.8	1.9	3.6	2.2
2007	2.0	2.3	1.6	2.8	2.1
2008	3.5	2.8	3.2	4.1	3.3
2009	0.8	0.2	0.1	-0.3	0.3
Averages yearly growth rate in the period indicated					
1986-1990	5.6	1.3	3.1	6.5	3.2
1991-1995	5.1	2.8	2.3	5.2	3.2
1996-2000	2.4	1.1	1.3	2.6	1.6
2001-2007	2.4	1.7	1.9	3.2	2.2
2008-2009	2.1	1.5	1.6	1.9	1.8

Sources: Istat, OECD and Eurostat.(1) HICP since 1988 for Italy and Germany, since 1991 for France and the euro area, since 1993 for Spain. For the remaining years, national consumer price indices.

The reduction in public support for the construction industry with the beginnings of fiscal adjustment and the attenuation in internal migration contributed to a contraction in construction investment, which slipped by an average of 1.2 per cent per year from 1996 through 2000, while in the area as a whole it recorded accelerated growth of 1.6 per cent, compared with 0.9 per cent in the previous half-decade (Table 2). By the end of the decade the share of German GDP going to construction investment had fallen back to pre-unification levels, while during those same years it was picking up strongly in the other countries, especially Spain and Ireland. These trends continued until the onset of the recent severe recession. Household consumption too, though still expanding in the second half of the 1990s (by nearly 2 per cent per year, about 1 point less than the area-wide average), slowed sharply.

The smaller contribution of domestic demand to German GDP growth was only partly offset by a sharp increase in exports, which grew at an average annual rate of 9.0 per cent during the five years, about half a percentage point faster than the area-wide rate. The contribution of net exports to GDP growth, which was practically nil for the entire area, was now positive again for Germany, at 0.3 points.

At this time the correction of the disequilibria generated by unification mainly involved the private sector and consisted chiefly in plant modernization and productive reorganization. These objectives were pursued jointly by management and labour unions, with the shared aim of wage moderation and more flexible use of manpower to maintain employment levels. Thanks to the pronounced moderation in hourly wages, between 1996 and 2000 unit labour costs for the German economy remained unchanged, while in the euro area they rose by 0.6 per cent per year (Table 3). Despite annual productivity gains of more than 2 per cent (about the same as in the previous five years), real hourly earnings (net of consumer price inflation) registered rises averaging just 1 per cent per year, nearly 2 points less than in the immediate post-unification period. The result was a recovery in the competitiveness of German goods that came to nearly 17 per cent over the second half of the decade as gauged by manufacturing producer prices, compared with 14 per cent in France and just 2.4 per cent in Italy (Figure 1).

At the same time, Germany also began the process of fiscal consolidation. The general government deficit began to decline in proportion to GDP in 1997, and in 2000 a surplus of 1.3 per cent was recorded, while gross public debt stabilized at about 60 per cent of GDP.

3. From monetary union to the eve of crisis: institutional reforms and the new picture of the real economy in Germany

In the face of mounting competitive pressures due to market integration – first global and then, with the single currency, European – at the turn of the decade the German economy suffered significant disequilibria: persistent labour redundancy in the eastern regions, with rising unemployment (peaking at over 5 million in 2003) in spite of wage moderation; a building glut; and progressive population aging.[6] Now, in the first half of the decade, the efforts of labour and management to modernize the productive structure and revise wage bargaining were flanked by a substantial policy agenda of structural reform designed to heighten the efficiency of the labour market and restrict social security both in order to prompt more active job search and to curb public spending.[7] This entailed a revision of the pension system, cutting benefits and increasing contributions, to make it more sustainable in the face of population aging. The new rules helped stimulate further innovations to collective bargaining, favouring greater flexibility in the modalities and schedules for the utilization of labour inputs at the level of the firm.

The result was increased job creation. From mid-decade until the deepening of the global recession at the end of 2008 the German employment rate rose steadily, reaching 70.7 per cent compared with

[6] The economically active share of the total population diminished steadily, falling by around 2 percentage points between the start of the 1990s and 2005; the downtrend has continued in the years since (Table 5).

[7] As part of the extensive reform programme set out by the Hartz Committee, between 2002 and 2005 fixed-term and temporary employment was facilitated, the social security contributions in respect of employment with income under 800 euros (mini-jobs) were lowered, employment services were reformed, and social welfare and unemployment benefits were unified, shortening their duration and stepping up means testing (see Magnani, 2008).

around 65 per cent in the first five years of Monetary Union. The unemployment rate came down to 7.3 per cent from its 2005 peak of 10.4 per cent. At the same time, however, there was a strengthening tendency towards low-wage jobs, which came to account for nearly 30 per cent of the total. Total wages declined steadily, by a total of nearly 5 per cent in real terms between 2000 and 2008, while working hours per capita fell by 3 per cent. And income inequality worsened more in Germany than in the other main European countries, increasing not only in the eastern regions, where the trend began with unification, but also in the western part of the country.[8]

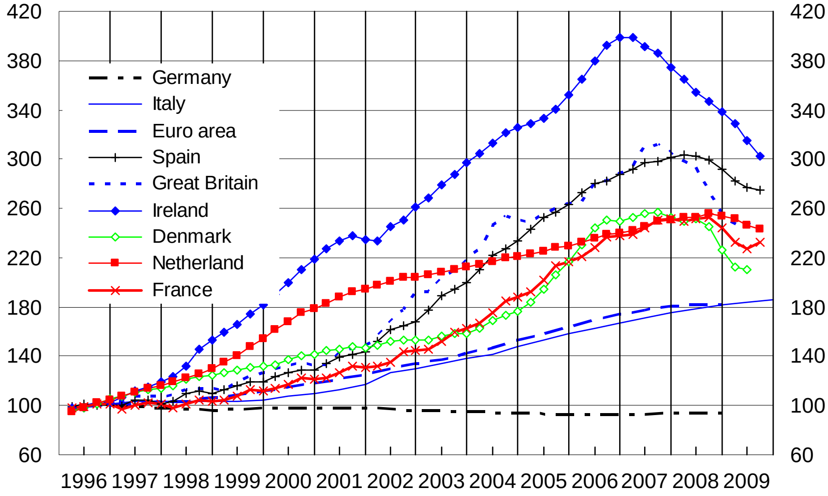
In these circumstances, the disparity between rapidly expanding exports and sluggish domestic demand was aggravated. Contributing factors were the steepening fall in construction investment and the sharp slowdown in household consumption (Table 2). From 2000 to 2007 the latter essentially stagnated (growing by just 0.4 per cent per year), as the slack growth of disposable income (0.6 per cent per year in real terms) was compounded by a rising propensity to save (from 15.3 to 17 per cent), presumably for precautionary reasons given the uncertain outlook during the transition to the new institutional framework.[9] The decline in house prices also held back consumer spending plans in Germany, whereas elsewhere in the euro area the rising real estate market helped to sustain consumption (Figure 2).

Thanks to wage moderation and rising productivity, over the period as a whole the price competitiveness of German exports, calculated on the basis of producer prices of manufactured goods, deteriorated by less than the nominal appreciation of the euro; and when calculated on the

[8] A standard measure of inequality is the Gini index (0 for perfect equality, 100 for perfect inequality). For the working age population (15-64), the Gini index for western Germany was practically stable at 60 through the entire second half of the 1990s but then rose progressively to 64 in 2006 (the last year for which data are available). In the eastern regions, where the index had already risen by 5 points between 1995 and 2000, it reached 66. There was also a sharp rise throughout Germany in the percentage of workers at risk of poverty (GSOEP, 2008).

[9] According to the data for the Federal Republic, the protracted weakness of domestic demand in western Germany has no precedent in the past fifty years. During the 1980s, despite the recession at the beginning of the decade, domestic expenditure contributed an average of 1.5 percentage points to GDP growth (3.4 points during the 1970s).

Figure 2 - *Residential house prices in Europe*
(*current prices; indices 1996=100*)



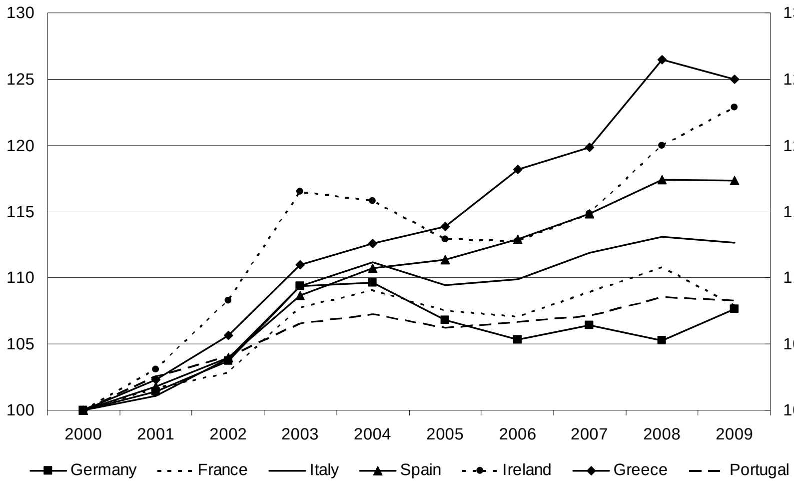
Source: Elaboration on data from ECB and, for Italy, Bank of Italy, Istat and Agenzia del Territorio.

basis of the GDP deflator it held practically unchanged, against significant losses of competitiveness for Germany's main European partners (Figure 3). Exports benefited, expanding by over 7 per cent a year, nearly twice as fast as in the rest of the area, and their share of GDP, just over 30 per cent in 2000, rose to nearly 50 per cent.[10] Meanwhile, import growth was much less rapid. The result was a mounting trade surplus, which at current prices increased threefold during the period. Geographically, a growing share of this surplus was with the rest of the euro area, which accounted for 34.5 per cent of the total in 2007, compared with 28.4 per cent at the start of Monetary Union. The current account in particular benefited: still in deficit at the end of the 1990s, it improved steadily to score a surplus of 6.6 per cent of GDP in 2007 (Table 6). This contrasts sharply with the substantial deficits that were run in the other area countries except for France, where the balance

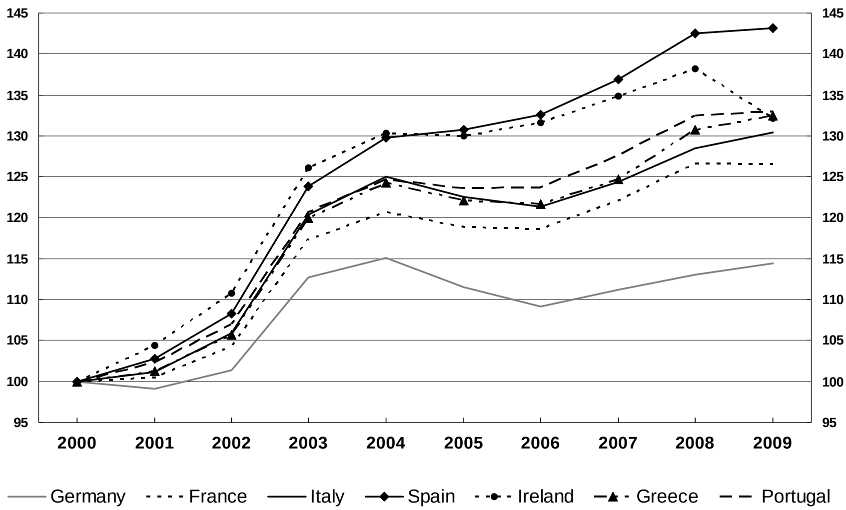
[10] In Italy and France, exports accounted for 29 per cent of GDP in 2007.

Figure 3 - *Indicators of competitiveness*
(*indices, 2000=100*)

(a) Based on producer prices of manufactured goods (1)



(b) Based on GDP deflator (2)



(1) Elaboration on Bank of Italy data for Germany, France, Italy and Spain and ECB data for the remaining countries. – (2) Based on ECB data.

Table 5 - *Per capita GDP and main determinants (percentage changes)*

	GDP/ Total population	GDP/ Hours worked	Hours worked/pers on employed	Person employed/ Labour force	Labour force/ Active popul.	Active popul./Total popul.	GDP
1992	1.5	2.5	1.2	-1.0	-1.1	-0.2	2.2
1993	-1.5	1.6	-1.0	-1.3	-0.5	-0.2	-0.8
1994	2.3	2.9	-0.2	-0.6	0.4	-0.2	2.7
1995	1.6	2.6	-0.9	0.3	-0.3	-0.1	1.9
1996	0.7	2.3	-1.0	-0.7	0.2	-0.1	1.0
1997	1.7	2.5	-0.6	-0.7	0.5		1.8
1998	2.0	1.2	-0.4	0.3	0.9	0.0	2.0
1999	1.9	1.4	-0.8	0.9	0.5	-0.1	2.0
2000	3.1	2.6	-1.3	0.8	1.2	-0.3	3.2
2001	1.1	1.8	-1.0	-0.1	0.7	-0.3	1.2
2002	-0.2	1.5	-0.9	-0.8	0.4	-0.3	0.0
2003	-0.3	1.2	-0.4	-1.0	0.3	-0.3	-0.2
2004	1.2	0.6	0.2	-0.5	1.4	-0.4	1.2
2005	0.8	1.4	-0.5	-1.0	1.4	-0.5	0.8
2006	3.5	3.1	-0.3	0.9	0.3	-0.5	3.4
2007	2.8	1.0	0.0	1.6	0.5	-0.3	2.7
2008	1.2	-0.2	-0.2	1.1	0.6	-0.2	1.0
2009	- 4.6	-2.2	-2.5	-0.1	0.6	-0.3	-4.7
	Averages yearly growth rate in the period indicated						
1992-1995	1.0	2.4	-0.2	-0.7	-0.4	-0.2	1.5
1996-2000	1.9	2.0	-0.8	0.1	0.7	-0.1	2.0
2001-2007	1.3	1.5	-0.4	-0.1	0.7	-0.4	1.3
2008-2009	-1.7	-1.2	-1.4	0.5	0.6	-0.3	-1.9
1992-2000	1.5	2.2	-0.5	-0.2	0.2	-0.1	1.8
2001-2009	1.3	1.3	-0.4	0.0	0.7	-0.3	1.2

Source: Elaboration on Eurostat data.

Table 6 - *Current account balances of euro area and selected member countries*
(*as a percentage of GDP)*

Year	Euro area	Belgium	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal	Spain
1999	-0.5	5.1	3.1	-1.3	-5.3	0.2	0.7	3.8	-8.3	-2.9
2000	-1.5	4.0	1.5	-1.7	-7.8	-0.4	-0.5	1.9	-10.0	-4.0
2001	-0.4	3.4	1.8	0.0	-7.2	-0.6	-0.1	2.4	-9.8	-3.9
2002	0.6	4.5	1.2	2.0	-6.6	-1.0	-0.8	2.5	-7.3	-3.3
2003	0.3	3.4	0.7	1.9	-6.5	0.0	-1.3	5.6	-5.3	-3.5
2004	0.8	3.2	0.5	4.7	-5.8	-0.6	-0.9	7.6	-7.1	-5.3
2005	0.1	2.0	-0.5	5.1	-7.5	-3.5	-1.7	7.4	-8.5	-7.4
2006	-0.1	1.9	-0.6	6.5	-11.3	-3.6	-2.6	9.3	-8.2	-9.0
2007	0.1	1.6	-1.0	7.6	-14.4	-5.3	-2.4	8.6	-9.0	-10.0
2008	-1.7	-2.9	-1.9	6.7	-14.6	-5.6	-3.6	4.8	-11.7	-9.7
2009	-0.6	0.3	-1.9	5.0	-11.3	-3.0	-3.2	5.1	-8.3	-5.5

Source: Elaboration on Banca d'Italia, BIS, ECB, Eurostat and Istat data.

turned slightly negative only at mid-decade, and Belgium, the Netherlands, Austria and Finland, whose balances, though narrowing, remained positive.

Despite the export stimulus, between 2000 and 2007 on average German GDP growth slowed to just above 1 per cent per year, compared with nearly 2 per cent in the second half of the 1990s, and was one percentage point less than in the rest of the area.[11] Per capita GDP also slowed, reflecting in particular slower growth in overall hourly productivity and a sharper decline in the population share of the economically active population (Table 5).

4. The crisis of 2008-09 and the debate on euro-area disequilibria

The impact of the deep global recession in 2008 and 2009 differed sharply from one European country to another both in severity and in transmission channel. Germany and Italy – the two countries most highly exposed to the collapse of world trade – registered particularly sharp contractions in GDP amounting to more than 6 per cent between the first quarter of 2008 and the second quarter of 2009, while their exports plunged by 18 and 24 per cent respectively. In France, meanwhile, a smaller fall in exports (16.5 per cent) helped limit the GDP loss to 3.7 per cent.

In Spain, as in Ireland, Portugal and Greece, the recession had a particularly heavy impact on the domestic components of demand, which had made the greatest contribution to the growth in economic activity since the turn of the decade, benefiting from the reduction in the cost of money in connection with the inception of Monetary Union. In these four economies, which account for more than 15 per cent of euro-area GDP, between the first quarter of 2008 and the second quarter of 2009 household spending contracted by 4.9 per cent and investment by 19.6 per cent, owing mainly to the steep decline in construction. The overall

[11] Including Germany too, average euro-area growth was 0.7 points higher than Germany’s (Table 1).

drop in GDP, which came to 4.5 per cent, was moderated by a fall in imports that outpaced that in exports. The payments deficit on current account came back down from the peaks of 14 per cent of GDP in Greece, nearly 10 per cent in Spain and Portugal and over 5 per cent in Ireland registered in 2007 towards the levels – still high – of the beginning of the decade (Table 6).

By comparison with the rest of the area – where since the summer of 2009 economic activity has gradually come back onto a growth path thanks to a pick-up in exports, followed by a moderate resumption of investment and improving consumer spending – according to the data for the first half of 2010 these four countries appear to have a less favourable outlook, with no clear sign of an end to the recession, owing in part to the serious cumulative loss of competitiveness since 2000.

4.1. The debate on adjustment measures

The persistence of markedly divergent macroeconomic performance between groups of countries within the area has become an especially serious problem in the context of global recession, both because the stimulus from world demand is not likely to match its exceptional strength of the first half of the decade and because of the risk that the financial strains in a few countries may infect other countries with large current external deficits. This has sparked an intensifying debate over the priorities for economic policy action for the gradual adjustment of disequilibria within the area. Attention has focused on the possible risks connected with the creation of large trade surpluses, raising questions over how desirable it is for the reforms enacted in Germany, which has Europe’s largest current account surplus, to serve as model for adjustment policies in the rest of the area.

Essentially, two distinct lines of analysis have been set out. The first holds that reform is urgent mainly in the countries with mounting external deficits on current account and losses of competitiveness and stresses that Germany’s achievement is the fruit of the sweeping restructuring of the productive system, of wage moderation and fiscal discipline already instituted by government, management and labour starting in the mid-1990s in response first to the imbalances engendered by national unification and then to the requirements of stability in order to reap the benefits of Monetary Union. According to President Weber (2010) "these structural reforms have paved the way for further necessary market-based corrections […] to take place. They have been painful, but the economy was in much better shape afterwards. In my view this is the core lesson that can be drawn from Germany's experience". The weakness of domestic demand, which has persisted since the turn of the decade despite the improvement in the job market, is due not so much to wage moderation, which serves to reduce the still excessive number of jobless, as to such exogenous factors as increased tax and social contribution pressure in the name of fiscal responsibility and, more recently, the rise in imported inflation. The conclusion is that the burden of correcting the area's disequilibria should fall mainly on the countries that have not yet attained the enhanced conditions of productive flexibility and efficiency needed to reap the benefits of Monetary Union and cope with the emerging global competition.[12] For these countries, it is argued, the German reform agenda is the right model to pursue to reverse the decline in competitiveness, regain export capacity and so shift the growth path upwards.

The other analysis also begins with the risks to sustainability inherent in the present state of the area's external accounts, observing that the state of overall balance stems from very large surpluses in one group of countries, notably Germany, and substantial deficits in other members, for the most part Mediterranean countries.[13] But this analysis emphasizes the mutual interest of the various countries in sharing adjustment costs broadly. And it recalls the potential role of domestic demand, in *tandem*

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[12] For instance, see O. Issing, "Higher German wages are not the solution," *Financial Times*, 19 March 2010. Similar arguments were put forward by A. Alesina and R. Perotti, "Non sparate sulla Germania", *Il Sole24ore*, 26 June 2010. Wyplosz (2010) challenged the idea itself that the high current account surpluses cumulated by Germany need to be adjusted as, according to the intertemporal approach, they match the quickly ageing population.

[13] For instance, see M. Wolf, "Excessive virtue can be a vice for the world economy," *Financial Times*, 24 March 2010, and S. Tilford, "Europe's economic reforms fall short on growth", *Financial Times*, 30 September 2010.

with structural reform, in the framework of the persistent uncertainty over the strength of the recovery in world demand and the resulting stimulus to euro-area economies. For one thing, if the deficit countries recoup competitiveness and restore fiscal discipline, this will very likely mean powerful recessionary pressures on domestic demand, which in view of the size of the deficits could be quite long-lasting. This could compromise their economic and financial prospects, with an adverse impact on the exports of Germany itself, more than a quarter of whose trade surplus is accounted for by the Mediterranean countries.[14] Second, spurring domestic demand in the countries with large surpluses on current account could offer a valid stand-in for the uncertain stimulus of world demand in sustaining the deficit countries' exports, alleviating the recessionary impact of the adjustment. To this end, these analysts prescribe a revision of the mechanism of wage determination to foster a fairer distribution of productivity gains and sustain households' purchasing power. Some observers have noted that since the inception of Monetary Union Germany is the only member country not to have lost competitiveness (gauged by the GDP deflator), and that the decisive factor has been the net reduction in real wages. In the rest of the area the trend in competitiveness has been less favourable, even where productivity has improved markedly, while the purchasing power of wages has risen. This implies two grounds for caution in endorsing the German experience: (i) a GDP growth rate lower, on average, than that of the area as a whole since 2000 and (ii) potential strains concerning the sustainability of the income distribution model, despite the reforms instituted, and concerning social cohesion.

4.2. A synthesis

The two contending theses share the acknowledgement of the benefits of the adjustment carried out in Germany beginning in the mid-1990s and of the need for structural reforms, especially in the countries with large current payments deficits, to enhance the competitiveness of

[14] Or, not counting Italy, almost a fifth.

markets and avert possible future strains to the Monetary Union. The main point at issue is the proper priorities for progressive correction of euro-area disequilibria in the view of the prolonged difficulties to resume a sound and sustainable global growth. For the advocates of the first thesis, adjustment must be principally the task of the deficit countries; for their opponents, the burden should be shared by the surplus countries as well.

The debate as currently framed would benefit of taking in due account of two aspects that tend towards a synthesis of the two positions.

First of all, Germany's aggregate performance conceals significant sectoral disparities that can help explain the poor transmission of the powerful export impulse to the other demand components. The progressive recovery in Germany export competitiveness, in fact, depended on the rapid productivity gains in industry as well as the large-scale internationalization of production, mainly to the bordering central and eastern European countries. From 2000 to the eve of the crisis, despite the pick-up in manufactures exports, labour input in industry contracted by about 7 per cent in terms of jobs and 9 per cent in terms of hours worked, while total real wages declined by 2 per cent.[15] Output per worker rose by 23 per cent, while labour's share of income was sharply reduced. Sectoral data indicate that this tendency was most marked in the core industries of the German model of product specialization, such as chemicals and transport equipment.[16] In the service sector total wages rose by 3 per cent in real terms, thanks entirely to the increase in the work force (heavily concentrated in finance): per capita earnings fell by nearly 4 per cent despite a 5 per cent gain in productivity.

[15] Extending the measurement through 2008 and 2009, the fall in labour input comes to 8 per cent in terms of jobs and 17 per cent in terms of hours, while total wages diminish by 1.4 per cent.

[16] According to EU Klems data, available through 2005, in these industries the share of wages in gross output has fallen below 20 per cent, from more than 25 per cent in the mid-1990s, while that of intermediate inputs rose from 71 to 75 per cent in transport equipment and from 66 to 70 per cent in chemicals. This confirms the increasing relocation of production to other countries by German exporters.

The other side of the picture is the widespread rise in the share of value added going to profit, which was more pronounced in Germany than in its main European partners. For non-financial firms the share of operating profit in value added rose by 5 percentage points from 36 per cent in 2000 to 41 per cent in 2008.[17] Households benefited only to a limited extent, as corporate saving rose progressively from 8.2 to 10.5 per cent of national income (Table 7). Nor was domestic investment significantly sustained, given the fall of gross investment as a share of national income. In the end, the bulk of the private sector saving was channelled into investment abroad.[18]

In this framework a valuable contribution by Germany in the mutual adjustment of the current account unbalances in the euro area would come from fostering the restructuring process towards sectors outside the core manufacturing activities whose performance in terms of productivity and job creation is lagging behind. Therefore, the reduction of Germany's large current account surplus could be attained by acting not so much on the wage formation mechanism as on the factors impeding domestic investment, especially in the non-tradables sectors, including the removal of barriers to competition that still weigh on such major areas of economic activity as retail trade and the professions, as the OECD has recommended (OECD, 2010). From this standpoint, a further progress in the structural reforms would help stimulate job creation and the growth of wage bill, benefiting German household spending and, ultimately, imports from the rest of the area.

Secondly, the position that the burden of adjustment measures should be shared between the different countries is gaining endorsement from European institutions. At its mid-March meeting the Eurogroup concluded that "the need for policy action is particularly pressing in

[17] In these same years the share fell in Italy (from 47 to 42 per cent) and Finland (from 45 to 43 per cent), held broadly unchanged in France and Spain (respectively, at 32 and 36 per cent in 2008); it did increase in Austria, Belgium and the Netherlands, but less than in Germany (respectively from 40 to 42, 35 to 38, and 39 to 40 per cent).

[18] According to the IMF, between the start of the decade and 2008 the value of German residents' outward portfolio investment nearly tripled to $2.15 trillion; a growing share of this outflow went to Spain, Greece and Portugal (13.5 per cent in 2008 as against 8 per cent in 2001).

Member States showing persistently large current account deficits and large competitiveness losses. [...] [A]ction is also needed in Member

Table 7 – *Savings and gross capital formation in Germany (percentage shares of national gross disposable income)*

Years	General government savings	Private sector savings	*of which: households*	National savings	Gross fixed capital formation	Current account balance
1991	1.4	21.5	*12.6*	22.9	24.2	-1.4
1992	1.6	20.9	*12.6*	22.5	23.5	-1.1
1993	0.8	20.6	*12.4*	21.4	22.4	-1.0
1994	1.1	20.2	*12.0*	21.3	22.9	-1.5
1995	-0.1	21.5	*11.7*	21.4	22.6	-1.2
1996	-0.5	21.4	*11.5*	20.9	21.4	-0.6
1997	-0.1	21.1	*11.2*	21.0	21.5	-0.5
1998	0.5	20.8	*11.2*	21.3	22.1	-0.7
1999	1.3	19.5	*10.8*	20.7	21.9	-1.2
2000	1.6	18.9	*10.7*	20.6	22.2	-1.7
2001	0.1	19.7	*10.9*	19.9	19.9	0.0
2002	-0.9	20.8	*11.3*	19.9	17.7	2.2
2003	-1.3	21.1	*11.5*	19.8	17.7	2.1
2004	-1.3	23.3	*11.4*	22.0	17.2	4.8
2005	-0.9	23.0	*11.5*	22.1	16.9	5.2
2006	0.6	23.4	*11.3*	24.0	17.5	6.6
2007	2.4	23.4	*11.4*	25.8	18.2	7.6
2008	*2.5*	*22.7*	*12.2*	*25.1*	18.4	*6.7*
2009	-0.5	22.0	12.1	21.5	16.5	5.0

*Sourc*e: Elaboration on European Commission data.

States that have accumulated large current account surpluses.” The importance of domestic demand in the adjustment process is now gaining attention in the economic policy debate in Germany itself, as is shown by the Government’s anti-recession measures early this year, which include support of households’ purchasing power (such as increased tax deductions for health contributions and insurance costs, the extension of tax exemption to family allowances, and income tax reductions). The Bundesbank itself considers the evolution of the German model to adapt to the new external context as a possibility; in his public address of 22 March President Weber called on German firms to redirect a part of their output towards the domestic market, given the persistent uncertainty of world demand. At the same time, however, he observed that “a political coordination of this process which goes beyond the purpose of setting a framework for a market-induced, smooth reallocation of resources is neither necessary nor helpful.”

5. Conclusion

We have traced the main developments in the German economy from national unification at the start of the 1990s to the global crisis of 2008-09 and compared them with those in the rest of the euro area. The focus is on the current account imbalances that have arisen since the turn of the century and the consequent debate over the priorities and economic policy measures needed to reduce them.

One of our main conclusions is the confirmation that Germany’s modest growth in the later 1990s – less than in the rest of the area – was due to the restrictive impact on domestic demand of the drastic restructuring and modernization of the production system, followed by sweeping reforms after the turn of the century. Rapid productivity increases and prolonged wage moderation, especially in industry, fueled a large and mounting current account surplus. While the external position of the euro area as a whole was broadly in balance, a sharp divide between Germany and the deficit countries emerged, with an implicit risk to market stability and the functioning of Monetary Union.

In the debate over the proper course of action to correct the imbalances, one side maintains that the burden of the adjustment must be placed principally on the deficit countries in order to close the gap with Germany in making the necessary structural reforms, while the other argues that it would be better if the surplus countries – Germany above all – also contributed to the adjustment by moving to stimulate domestic demand, including by revising the wage-determination mechanism to recoup the purchasing power of earnings. This debate neglects the sectoral disparities that are concealed by the aggregate trends in the German economy, in particular the efficiency gap between industry and the service sector and the unequal distribution of productivity gains in favour of profits. In any case, the rise in profit shares in recent years has not produced any broadening of the domestic productive base or job creation; rather it has mostly been channeled into portfolio and direct investment abroad, fueling Germany’s mounting current account surplus with the rest of the world.

The implication is that Germany can contribute to the correction of imbalances within the euro area not so much by altering the wage formation mechanism as by creating incentives for domestic investment, among other things by removing the barriers to competition that still weigh on significant portions of the service sector.

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