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GERMAN MIGRANTS, A SHOCK FOR THE EURO-AREA

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AT THE BEGINNING OF SEPTEMBER, German chancellor Angela Merkel took everybody by surprise, announcing that Berlin would open the country's borders to all Syrian refugees. German vice-chancellor Sigmar Gabriel, leader of Merkel's coalition partner SPD, added that Germany is ready to host 500 thousand immigrants each year, for the years to come. Beyond its highly relevant ethical and political implications, the scope of the new migration policy in Germany is also bound to transform the economic landscape of the euro-area.

Millions of new workers represent a significant change in the labor force of a country that is commonly described as the European power engine. Given the relatively young age composition of the migrant population, the wave of newcomers will also change the demographic profile of the host country and the sustainability of its pension system. Overall, the new flow of workers represent a significant supply shock that may affect the German external position. In this regard, it may have a direct impact on the level of activity and on the competitive positions of other countries in the euro-area vis-a-vis Germany. In particular, the supply shock may affect both the size and trend of the German current account surplus. For the euro-area, which is just emerging from a disruptive crisis, coping with the new challenge offered by migrants in Germany may become an existential task.

In general terms, an increase in the labor force should accelerate domestic growth and decrease the marginal cost of labor. The two effects represent countervailing forces as far as the German external position is concerned. On one hand, stronger domestic demand should also increase German imports from euro-area partners and reduce the German surplus; on the other hand, lower labor costs could increase the competitive position of German firmsand improve the country's trade balance. In fact, it is possible that the impact of a larger German labor force on the relative external position of euro countries may be dwarfed by the indirect effect of migration on the German pension system.

More precisely, I endorse the opinion that the surplus in the current account is determined by the reluctance of German households to spend their income, a result of the perceived uncertainty over the stability of the German pension system in a rapidly aging society. The contribution provided by the influx of a large number of young workers might change the sustainability profile of the pension system and provide German citizens with more certainty

over their future income. In this case, the German anomaly of low consumption, and subsequent low investment, might be reined in, leading to a more balanced external position vis-a-vis the component of the euro-area that will be able to compensate for the worsening of their labor costs relative to Germany. Against this backdrop, Merkel's decision to open the borders to a migrant labor force represents a challenge for other euro-area countries, necessitating the reinforcement of their effort to regain competitiveness vis-a-vis Germany.

The Supply Shock

In order to assess the direct impact of a stronger labor force in Germany, one should be able to understand the relation between the labor component of the German competitive position and the current account. Since the early 2000s, price and cost competitiveness have increased significantly, building high current account surpluses and a positive net foreign asset position. Recent estimates point to a surplus in the 2015 current account reaching an astounding 10% of German GDP. The IMF has repeatedly expressed concerns over the German external surplus, arguing that "stronger and more balanced growth in Germany is critical to a lasting recovery in the euro area and global rebalancing." In November 2013, the persistent German current account surplus triggered an "In-Depth Review" by the EU Commission under the Commission's "Macroeconomic Imbalances Procedure." The review concluded that the German surplus constitutes an "imbalance."

The idea that structural reforms from 1999 to 2008 in Germany, especially the Hartz reforms on the labor market, are the root of the positive developments in Germany and the subsequent observed imbalances in the euro-area is not unequivocal. A paper published by Brookings Institution[1] showed that even before the Hartz reforms, wages declined and international competitiveness of firms rose in Germany. This evolution was a result of the delocalization of German firms and the consequent overhaul of industrial relations. In particular, the German economy's adjustment to a new competitive environment in Eastern Europe resulted in a decentralization of the wage-setting process, shifting it from the industry level to the firm level.

The Hartz reforms affected employment more than it did wages. They intervened a few years after the beginning of the spontaneous transformation of industrial relations in Germany and magnified a trend that had already begun. Hartz III and Hartz IV were put in place in 2004 and 2005, respectively. The goal of Hartz III was to increase the corresponding efficiency of the labor market by restructuring the Federal Employment Agency. The goal of Hartz IV was to increase incentives for the unemployed to search for jobs. It comprised a decrease in the entitlement duration of unemployment benefits for the short-term unemployed and a merger of unemployment assistance for the long-term unemployed into social welfare assistance. The merger led to lower unemployment assistance for the long-term unemployed but slightly higher social welfare assistance. Once enacted, the Hartz reforms contributed to the wage moderation observed since the beginning of the euro.

Notoriously, nominal wage growth has been markedly lower in Germany than in the aggregate euro-area during most of the Euro-era. Between 2002 and 2010, real wage growth has also been lower in Germany than in the other European countries. In fact, the German labor share (share of wage income to GDP) fell steadily, from 57% in the early 1990s to 49%

1. Carlo Bastasin, "Germany: A Global Miracle and a European Challenge," *Global Working Papers,* No. 58 of 80 (May 2013), Brookings Institution.

in 2008. Nominal unit labour cost (ULC, ratio of nominal compensation per employee to real GDP per person employed) was essentially flat between 1995 and 2007, falling slightly but risingby about 10% after the financial crisis. By contrast, nominal ULC rose steadily in the rest of the euro-area between 1995 and 2008, but has remained constant since then[2].

However, since the increase in employment overcompensated the decline in real wages, German aggregate disposable income rose in conjunction with aggregate consumption. This observation is relevant because the expected inflow of new workers seem to reproduce the same economic consequences as those that took shape in Germany between 1995 and 2005, i.e. more employment and lower average labor costs.

In the past, the link between lower labor costs and higher employment was influenced by the concurrent fiscal reforms that were enacted at the same time as labor reforms. Between 1999 and 2003, Germany raised indirect taxes and, at the same time, decreased social security contributions in order to decrease the price of labor. To boost price and cost competitiveness, growth, and employment, Germany decreased corporate taxes in 2001 and labor taxes between 2001 to 2005. Average real wages were positively affected, mainly because social security contributions were decreased and unemployment fell.

Although lower unemployment increased workers' demand for higher wages, reduced social security contributions entailed lower unit labor costs for German firms and lower producer prices. This improved the terms of trade persistently. The labor and capital income tax rate reductions in 2001 augmented net income for households, making them more willing to accept lower wages. The combination of labor and fiscal reforms thus wound up in a significant increase in German terms of trade. However, the impact on the current account was dampened by the effect of the reforms on the "quantities", i.e. on the increase of total employment and its impact on aggregate income.

Against this background, one should construe that, given the current strong German fiscal position and abundance of capital, the coming supply shock resulting from the huge influx of migrant workers intothe labor force could still be accommodated through fiscal incentives and new investments, bringing higher growth and domestic demand, without further destabilizing the German external position.

The causes of the exorbitant German current account surplus may not be dependent on the cost of labor, and they need to be identified and contrasted. According to a study published by the Bundesbank[3], a possible candidate could be higher savings preferences in Germany. Higher savings could be the result of an aging society realizing that expected pensions may be lower than previously anticipated, or of increased income uncertainty due to massive cuts in the unemployment benefit system.[4] According to this view, the depressed German domestic demand and consequent high savings partly reflect German households' concerns over rapid population aging, pension reforms (2001-2004) that markedly lowered state-funded pensions and created tax incentives for private retirement savings. This trend was aggravated by the

2. Robert Kollmann, Marco Ratto, Werner Roeger, Jan in't Veld, Lukas Vogel. "What drives the German current account? And how does it affect other EU member states?" ECONOMIC POLICY (Vol. 81), January 2015.

3. Niklas Gadatsch, Nikolai Stähler, Benjamin Weiger. "German labor market and fiscal reforms 1999 to 2008: can they be blamed for intra-euro area imbalances?" *Discussion Paper* (29/2015), Deutsche Bundesbank, 31 August 2015.

4. Deutsche Bundesbank, ibid.

cuts in social benefits and by fiscal consolidation in Germany in the wake of the financial crisis.

It is generally acknowledged that projected aging speed has a strong positive impact on current account surpluses. The IMF finds that a 1% increase in the old-age dependency ratio (defined as the number of people aged 65 and above, relative to the working age population) relative to the country average increases the current account balance by 0.2%. According to estimates published by Kollmann et al., in Germany, the dependency ratio increased by 10% between the mid-1990s and 2012. Projections by the German Council of Economic Advisors point to an increase of around 20 % within the next 20 years, a result of retiring post-war 'baby boom' cohorts.

Higher future old-age dependency ratios imply lower future per-capita pension entitlements or higher future financing costs in a pay as you go (PAYG) system, which both reduce future disposable income and provide an incentive to increase private savings. This aging trend is markedly stronger in Germany than in other euro-area countries, causing a divergence in the relative levels of consumption and strength of domestic demand, one of the main determinants of the current account. In Germany, the pension replacement rate (ratio of average pension to average wage income per employee) has fallen by 13% between the late 1990s and 2012. Public pension reforms enacted in Germany between 2001 and 2004 stipulate a rise in mandatory public pension contributions and retirement age, as well as a reduction of pension benefits. Demographic pressure became an important topic in the political debate in Germany and raised awareness among the German population regarding looming demographic problems.

The successful integration of a huge number of migrants is exposed to unknown political risks, which are almost impossible to gauge at this time. However, the arrival of millions of young workers can dramatically change the perception of the sustainability of the German pension system, leading German households to revise their time-preference profile and anticipate consumption, potentially stabilizing the external positions of euro-area member states. Ofcourse, other member states need to domestically compensate, perhaps through consumption tax increases accompanied by a decrease in social security contributions, in order to combat the competitive impact of a cheaper labor force in their most powerful competitor.