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Raising growth in the euro area

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The economic policy debate in Europe – or rather in the euro area – seems deadlocked. We would like higher growth of domestic demand and incomes, but monetary policy doesn't work anymore; fiscal policy is not available because of political constraints; and structural reform resembles the mythical phoenix, unable to rise from the ashes until someone gives it concrete content.

In this policy brief, I argue that the euro area suffers from a special disease that sets it apart from the US and the other advanced economies because its economic policies are constrained by the massive excess savings of its anchor economy, Germany. This is in turn the result of a single-minded export orientation of the economy for over two decades that, through the common currency, constrains growth in domestic demand in the rest of the area, and notably in the less competitive economies. Therefore, there is no way out of the present predicament of low growth and low inflation in the euro area unless Germany reduces its excess savings and raises domestic demand and incomes, clearing the way for other euro participants to follow suit. A thoroughfare to get there is offered by opening the services sector to integration and competition in the internal market and accepting the long-delayed consolidation of the network services industry in Germany and the entire euro area. My argument is based on four exhibits of evidence.

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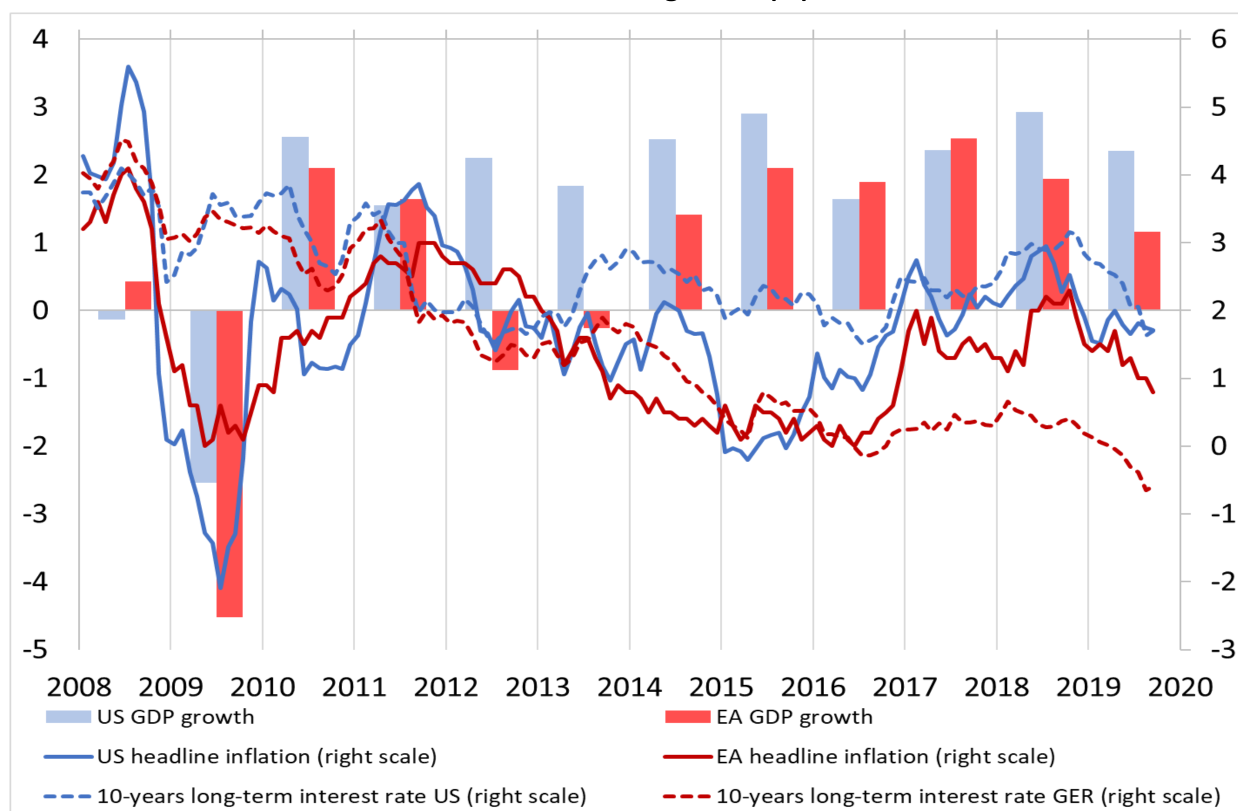
Lowflation in the euro area

The first exhibit is that in the general lowflation environment that has prevailed in the advanced world in recent years, the euro area seems to have suffered from a more acute disease – despite its increasingly aggressive monetary expansion with unconventional tools. Chart 1 shows that in recent years, GDP growth and headline inflation in the euro area have indeed fallen systematically below that observed in the US (except for GDP growth in 2016-17; see Chart 1), while long-term interest rates have been well lower. Eventually, since the end of 2018 interest rates have fallen below zero even on long maturities (ten years and beyond) in Germany, the Netherlands and France – a phenomenon unknown in the US (as well as in the UK, where the financial structure is in many ways more similar to that of the US).

Chart 1. Headline inflation (yoy % change), ten-year long-term interest rate and GDP annual growth (%)

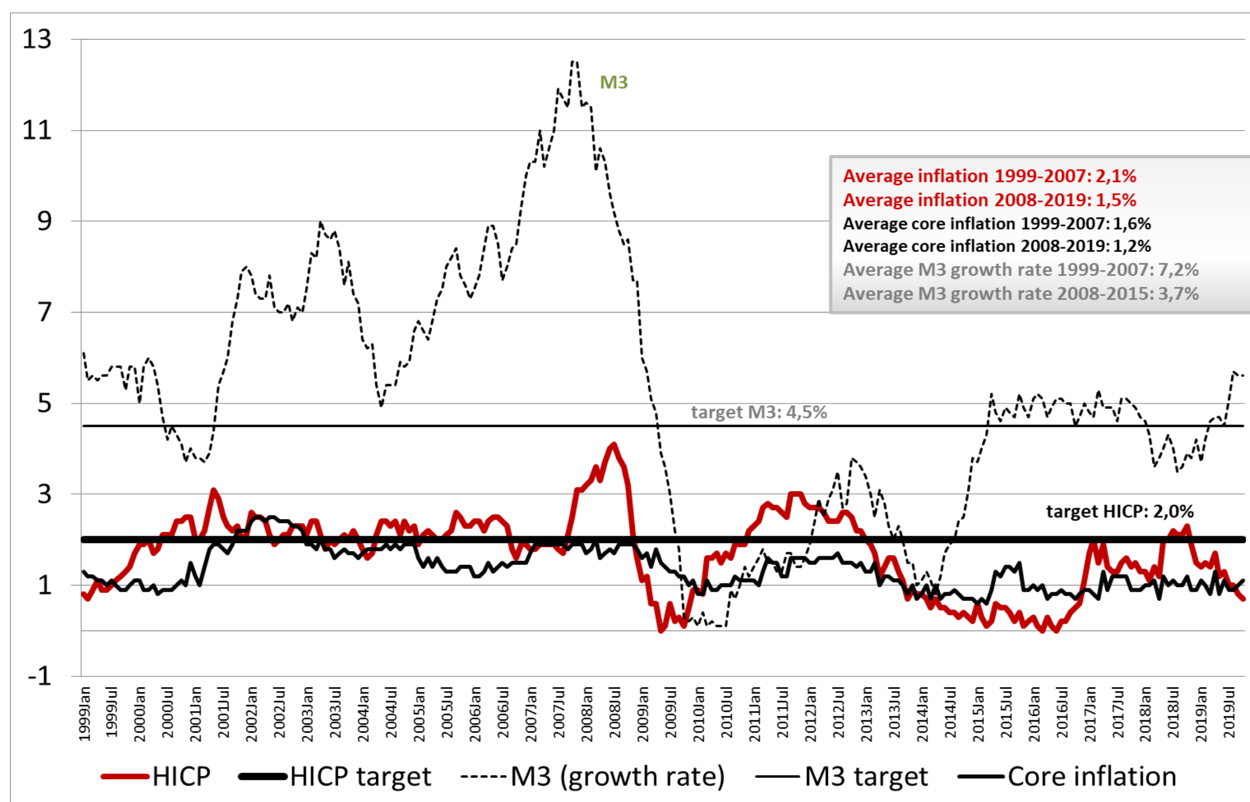


For inflation and interest rate monthly data, source OECD. For GDP growth annual data, source: IMF.

The current external surplus is the counterpart of massive excessive saving in the German economy, which must be seen as the principal cause of low interest rates. The ECB may have contributed marginally to lowering rates and flattening the maturity curve, but by established macroeconomic models cannot be held responsible for the bulk of the precipitous fall in rates since the financial crisis.

Meanwhile, the ECB has been failing in its inflation objective by increasing margins over the successive tenures of its three presidents, Wim Duisenberg, Jean-Claude Trichet and Mario Draghi. The shortfall from the (close to) 2% inflation target has risen in the Draghi years (2011-2019) to 50%, with headline inflation stubbornly hovering just above 1% and core inflation even lower (Chart 2).

Chart 2. ECB monetary policy: inflation, core inflation and money growth in the Euro area (January 1999-October 2019, %)



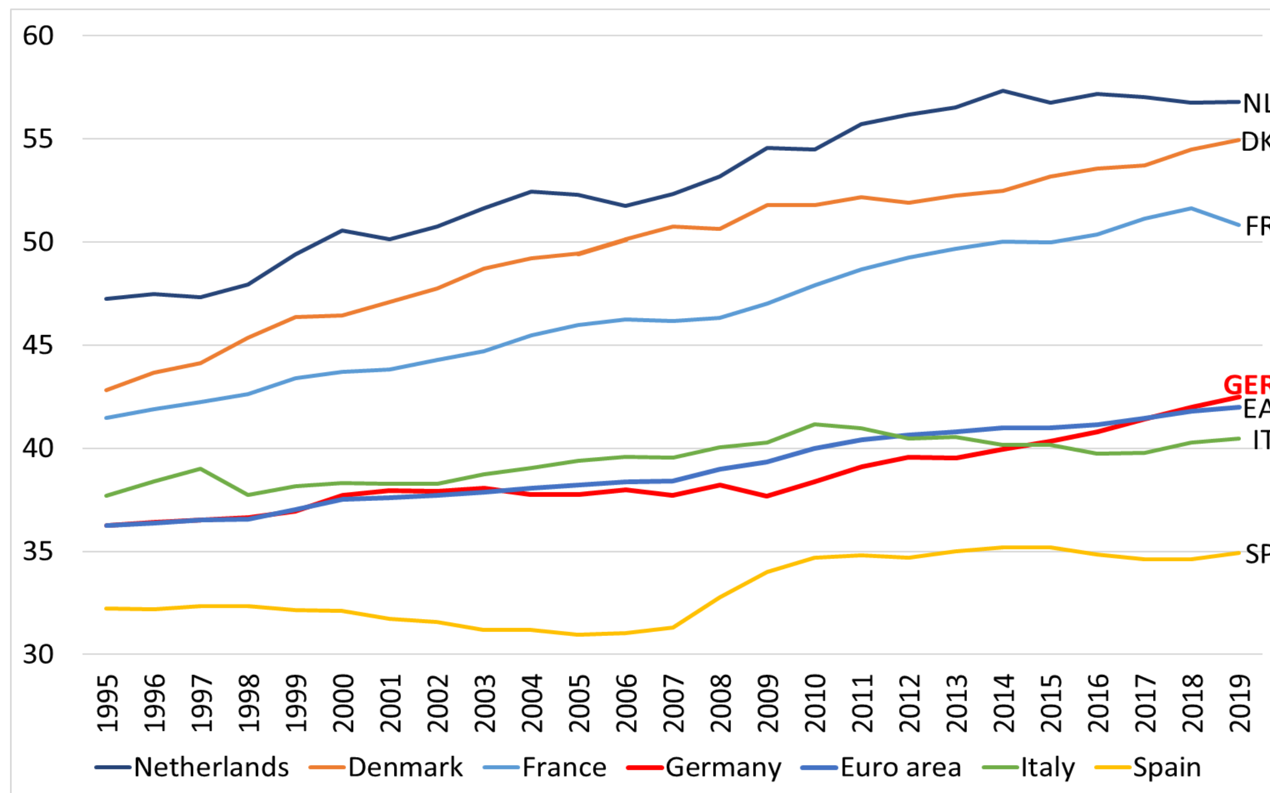
Monthly data. Source: ECB

Bini Smaghi (2020) has convincingly argued that the ECB monetary policy has remained too restrictive in the years following the twin financial crises in Europe, at all events most of the time more restrictive than in the US. However, this does not seem to offer a sufficient explanation for the unsatisfactory monetary developments in the euro area. This raises the question of the possible role played by structural factors at work in the German economy as well in its euro partner countries.

Export success in the German economy has come at a cost

The second exhibit concerns the export success of the German economy, which to an important extent was based on labour market reforms enacted in successive waves since the mid-1990s. Their main effect was to lower wage growth dramatically, most notably in the services sector. Following the Hartz reform of the early 2000s, over 7 million Germans found themselves employed with mini-job contracts paying €5-600 per month. Furthermore, wage increases fell systematically well below productivity increases (Micossi et al. 2018). Cheap labour has allowed the slowdown of the transfer of manufacturing jobs to low-labour cost areas, but has also entailed slower growth of domestic demand. The German economy has thus evolved into a rich manufacturing economy with poor workers. Chart 3 shows that the average hourly wage level in Germany has been aligning with that of Italy, a country with much lower labour productivity, and falling well below the high-productivity economies of the euro area.

Chart 3. Real compensation per employee (thousand €)



Source: Ameco

The resulting rise in the share of profits has not led to higher investments. After falling by some 4 percentage points of GDP after the financial crisis, corporate investments have barely returned to 60% of the pre-crisis years. Higher profit rates and reduced investment have been main factors in generating excess savings, together with the shift in the public sector balance from deficit to surplus (Micossi et al. 2018).

Low investment has left corporate Germany falling behind in the competitive race set in motion by the digital transformation (with especially severe consequences for its automotive industry; see Keohane et al. 2019). Meanwhile, massive reliance on exports has exposed the German economy to the adverse effects of slowing demand in China as well as to the protectionist backlash by the US administration.

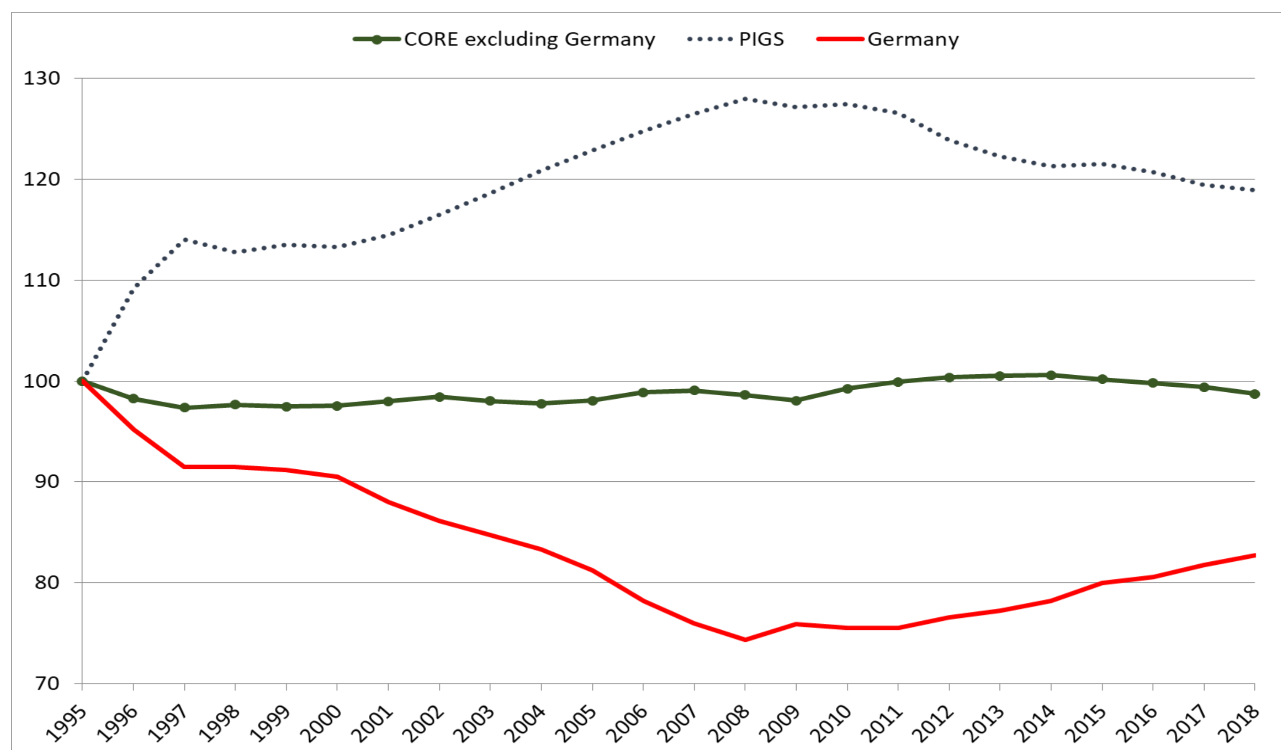
The deflationary impact on euro area partners

The third exhibit is that the German economy has systematically exported deflation to the rest of the euro area through two main channels (Micossi 2016b, Micossi et al. 2018). The first channel is the substantial fall of the relative price of German goods within the area, which has maintained strong competitive pressure on all euro partners (Chart 4), forcing lower wages and demand deflation throughout the area. This effect has been

reinforced in weaker economies by the balance-of-payments constraint that obliged them to turn their current external deficits into surpluses by further restraining domestic demand.[2]

The single currency has effectively eliminated the external adjustment mechanism for surplus countries, whose money supply is no longer put under pressure by capital inflows into Germany (Micossi et al. 2018). The latter, however, have been the key factor pushing German interest rates into negative territory, with mounting adverse consequence for domestic financial institutions and private savers.

Chart 4. Real effective exchange rate (1995=100)



Source: Eurostat; REERs deflated by unit labour costs in the total economy and computed with respect to EZ 19 trading partners. CORE countries are Austria, Belgium, France, Finland and the Netherlands.

Table 1 presents key growth data in the euro area since its inception. As may be seen, over time growth in the rest of the euro area was brought down to the German rate, while it had in general remained above it in the pre-euro years. Real wages in the euro area had outpaced those of Germany up to the 2008 financial crisis, but then fell under in 2009-18. This has not impeded higher growth in some participating countries, such as Ireland, as the deflationary impact has concentrated on the less-competitive economies.

[2] The balance of payments constraint was expected to disappear within the single currency, in analogy with the experience of the US. What had not been anticipated is that to each participating country the euro is in a sense a foreign currency, since its supply is under the control of an external independent actor, the ECB, and cannot be used to meet financial strains hitting individual participants.

Table 1. Value added, productivity and compensation per employee (average growth, %)

	1990-1999		2000-2008		2009-2018	
	Germany	Euro area excl. Germany	Germany	Euro area excl. Germany	Germany	Euro area excl. Germany
TOTAL ECONOMY						
Gross value added growth	1,5	2,8*	1,7	2,2	1,3	0,6
Productivity (GVA per hour worked)	1,9	1,0*	1,6	0,9	0,7	0,9
Real compensation per employee	1,1	1,0	0,4	0,7	0,9	0,6
MANUFACTURING						
Gross value added growth	-0,6	2,5	2,6	1,7	2,1	0,8
Productivity (GVA per hour worked)	2,5	2,3*	3,2	2,7	1,8	2,6
Real compensation per employee	2,7	1,4	1,2	0,8	0,7	1,2
SERVICES						
Gross value added growth	2,6	2,9*	1,8	2,4	1,1	0,9
Productivity (GVA per hour worked)	1,9	0,7*	1,0	0,5	0,4	0,5
Real compensation per employee	0,8	0,9*	0,3	0,7	1,1	0,5

Source: Ameco
*(1995-99)

The missing internal market for services

The fourth exhibit concerns the behaviour of the services sector. Table 1 highlights the different behaviour of growth, productivity and wages in manufacturing versus services. As can be seen, everywhere in the euro area the slowdown in growth is stronger in services, which also display lower productivity and wage growth (despite some recovery in Germany in the latest period). Since services represent over 70% of value added in the economy, the adverse impact on the overall economic performance of the area is clear.

The explanation for this underperformance of the services sector is quite obvious: the sector still is largely closed to competition and integration in the internal market, which has discouraged investment and slowed productivity gains, as extensively documented in OECD (2018).

Especially important in this context are the network services (energy, transport and communications), where the industrial structure still is highly fragmented, leading to higher prices and lower investment (Brons et al. 2018). This is true even in activities where regulatory policies have been effective in promoting competition, but cross-border consolidation has not taken place due to political resistance, weakening the incumbents and pushing them into high indebtedness (as in telecoms and air transport).

In the energy sector, large national champions have been effective at guarding their local monopolies or oligopolies and on occasion have thrived through their bilateral relations with large exporting countries outside the EU, hampering development of an integrated market for electricity, oil and gas. In all these areas there are enormous unexploited opportunities for productivity gains and private investment from opening the way to cross-border consolidation and the creation of a truly integrated European market.

In conclusion

The evidence that has been presented in this chapter indicates that lowflation and dismal growth assume special connotations in the euro area due, on the one hand, to Germany's excess savings and the single-minded export orientation of its economy and, on the other, to failure to open and integrate the services sector.

The development of the internal market for services offers a way out from the present predicament without hurting the competitiveness of manufacturing. It would foster the required reorientation of the European economy towards domestic demand, it would loosen the competitive pressure on the manufacturing sectors of weaker economies, and it would open prairies to private investment and the deployment of new technologies, including digital technologies. It would also help reduce the excess savings that are the main culprit for low interest rates and defuse the mounting protectionist pressures against European manufacturing exports.

The reorientation of demand towards its domestic components, in Germany and elsewhere, should be encouraged and fostered by more effective application of the Macroeconomic Imbalances Procedure (MIP), which so far has entirely failed in helping to correct excessive external surpluses in Germany and elsewhere in the euro area, as well as encouraging less restrictive budgetary policies in countries with strong budgetary positions.

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