

ECONOMICS: EUROPEAN PERSPECTIVES—FEBRUARY 12, 2010

Euro-Area Imbalances: Is Germany Part of the Problem?

■ **Darren Williams**

Senior European Economist—Global Economic Research

The elimination of intra-euro-area imbalances implies very high adjustment costs for countries on the euro-area periphery. A change in German philosophy could help ease the transition. If, instead, Germany chooses to maintain the status quo, it may have to get used to periodically bailing weaker nations out.

With Europe's leaders pledging to stand by Greece—provided it delivers on its fiscal promises—some stability has returned to peripheral euro-area bond markets. But very little has been done to address the fundamental imbalances that led to the upheaval in the first place. The conventional wisdom suggests that the fault for these imbalances lies with Greece and the other peripheral countries. In reality, it is not so simple. Indeed, it is not unreasonable to argue that Germany should accept some responsibility for the current predicament.

Since the introduction of the euro in 1999, the overall current account position of the euro area has never been very far from balance—it has ranged from a surplus of 0.8% of GDP to a deficit of 1.5% of GDP. But these numbers mask major imbalances within the euro area itself.

Digging beneath the surface, we find that Germany was actually running a small current account deficit in 1999 (**Display 1**). At the same time, the other core euro area countries (Austria, Belgium, France

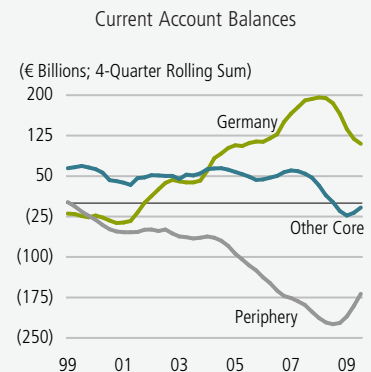
and the Netherlands) were running a modest collective surplus, while the periphery (Greece, Ireland, Italy, Portugal and Spain) was very close to balance.

Things have changed dramatically since then. In particular, there has been a huge deterioration in the combined current account position of the periphery. The counterpart of this has been the emergence of a large German surplus.

How can we explain this? A key factor has been very strong demand growth in the periphery countries, either as a result of credit-fueled housing booms or easy fiscal policy. But this has been exacerbated by developments in Germany, especially the stagnation of consumer spending and the, related, weakness of wage growth.

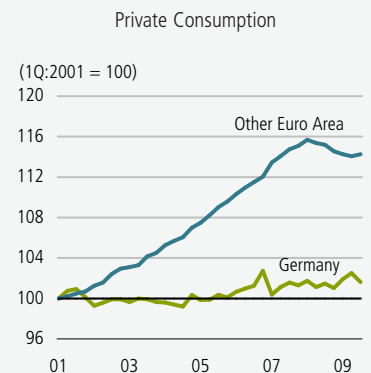
After a brief spurt of growth around the time the euro was introduced, German consumer spending has grown very slowly (**Display 2**). The cumulative gain since the first quarter of 2001 has been just 1.6% (equal to 0.2% per annum), depriving the

Display 1
Big Intra-Euro-Area Imbalances



Other core countries are France, the Netherlands, Belgium and Austria. Periphery countries are Italy, Spain, Ireland, Greece and Portugal.
Source: Haver Analytics and AllianceBernstein

Display 2
German Consumption Has Hardly Grown



Source: Haver Analytics and AllianceBernstein

other euro-area countries of support from their most important trading partner.

One reason why consumption has been so weak is that wage growth has been very subdued. Since 2001, compensation per employee has risen by just 7% in Germany, far lower than the 34% rise seen in the rest of the euro area (**Display 3**). It is worth noting that US compensation has also risen by about 30% over this period, making Germany a clear outlier.

The wage policy adopted by Germany is called competitive disinflation. The results, compounded by a rising euro, are plain to see. While Germany's real exchange rate is currently below its long-run average, the real exchange rate of every other euro-area country, except Austria, is now above its long-run average (**Display 4**). The periphery differs only to the extent that the problem is more acute there.

Before the credit crunch, the European Central Bank often warned of the dangers posed by a disorderly unwinding of global imbalances. The irony is that these same imbalances are clearly evident within the single currency itself. So far, the adjustment in the euro area has been born mainly by the debtor countries. If this continues, the costs are likely to be very high. A weaker euro can help ease the pain, but can do little to correct intra euro area imbalances.

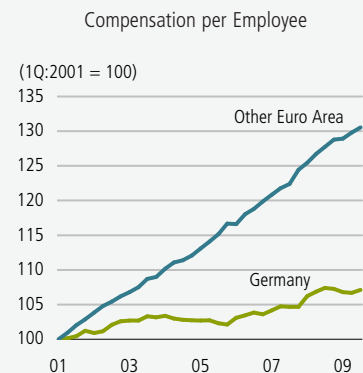
What would help is a change of approach from Germany. Faster consumption growth in Europe's biggest economy would lift imports in the rest of the euro area and provide an offset to fiscal consolidation. In addition, faster wage growth in Germany would allow other euro-area countries to regain competitiveness without the need for an extended period of deflation.

But is this likely to happen? The good news is that German fiscal policy remains highly expansionary, in contrast to the cutbacks emerging in other countries. However, the extent to which this will lift demand and have a positive impact on the rest of Europe is still uncertain.

As far as wages are concerned, it is crucial to realize that downward pressure stems in large part from the corporate sector's need to remain competitive against emerging-market producers. It is not clear why this should change—though a more vibrant domestic market would ease the pressure on German companies to cut costs.

Ultimately, Germany faces a choice. If it adopts policies to generate faster growth, it would make an important contribution to the correction of imbalances within the euro-area and help ease the adjustment costs for other countries. If, on the other hand, it chooses to maintain the status quo, it may periodically be forced to bail weaker nations out. ■

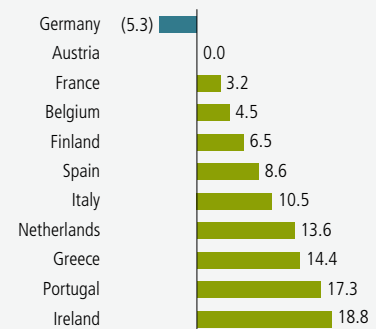
Display 3
Muted German Wage Growth



Source: Haver Analytics and AllianceBernstein

Display 4
Big Shifts in Cost Competitiveness

Deviation of Real Exchange Rate from Long-Run Average



Relative whole-economy unit labor costs. Long-run average is 1990 to 2007.

Source: European Commission and AllianceBernstein

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