

**GERMANY AND
THE EUROZONE OUTLOOK:**

**Improvements for the Medium Term
Little Immediate Help**

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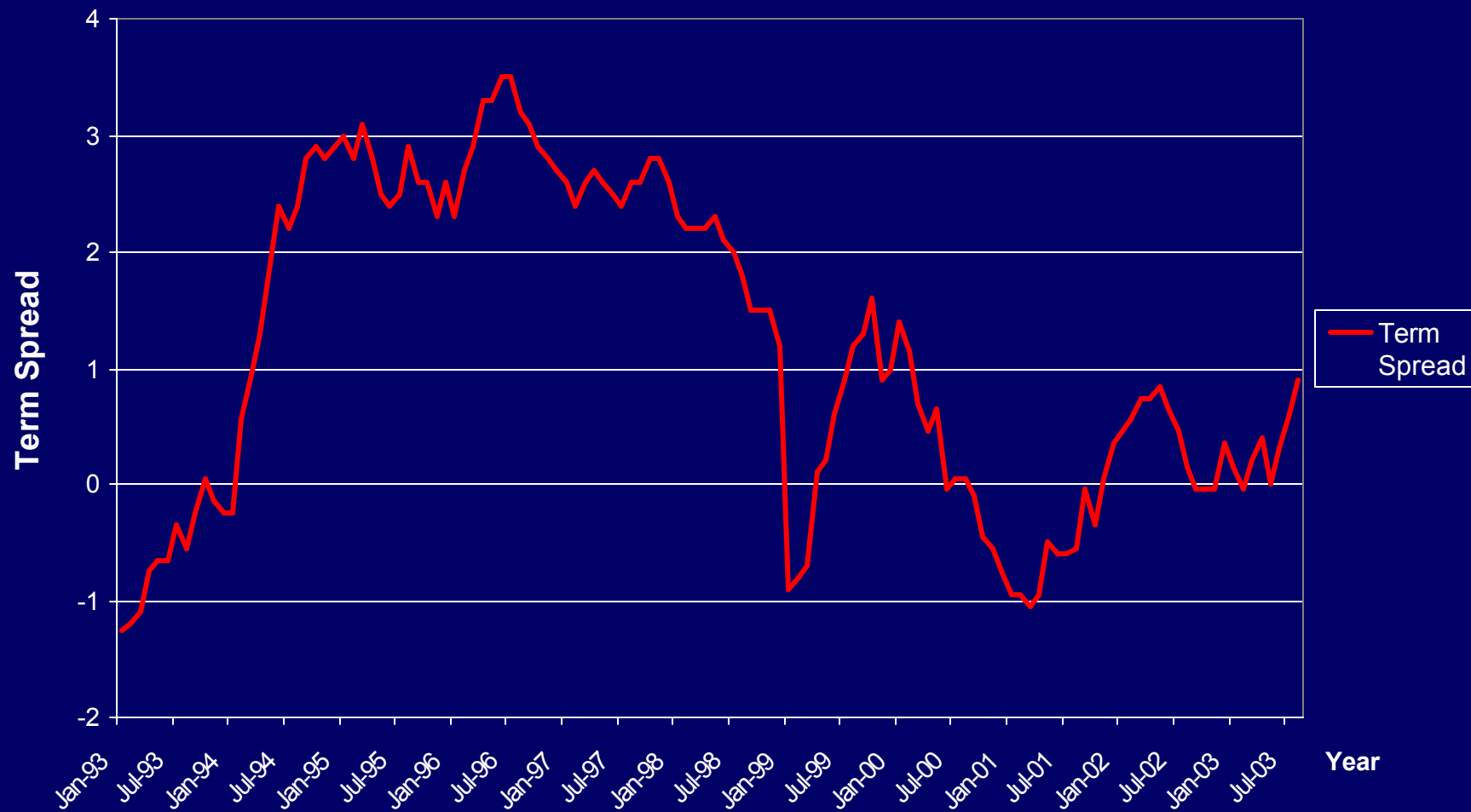
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Recovery is coming to the eurozone, but Germany will be a laggard and a drag

- ECB is looking for a recovery with upside risks.
- In 2003:Q2, only three eurozone countries grew. Working off the bubble has been an EU problem, too.
- Germany, 32% of eurozone GDP and recipient of a large share of members' exports (15-25%), has had three consecutive quarters of negative growth.
- Germany has been the slowest growing eurozone economy for the last five years. Unemployment is at 10.4%, over 4.3 million workers.
- Inflation differential between eurozone HICP and German CPI is much larger than intra-US differences, and recovery prospects are similarly dispersed.

- Some confidence indicators (Ifo, ZEW) are up in Germany, but they gave a false positive signal in 2002H1.
- Recent retail sales and IP numbers were much weaker. Markets do not expect the output gap to close.

German Term Spread



The Schroeder Government's Agenda 2010 Reform Effort is Ambitious and Beneficial

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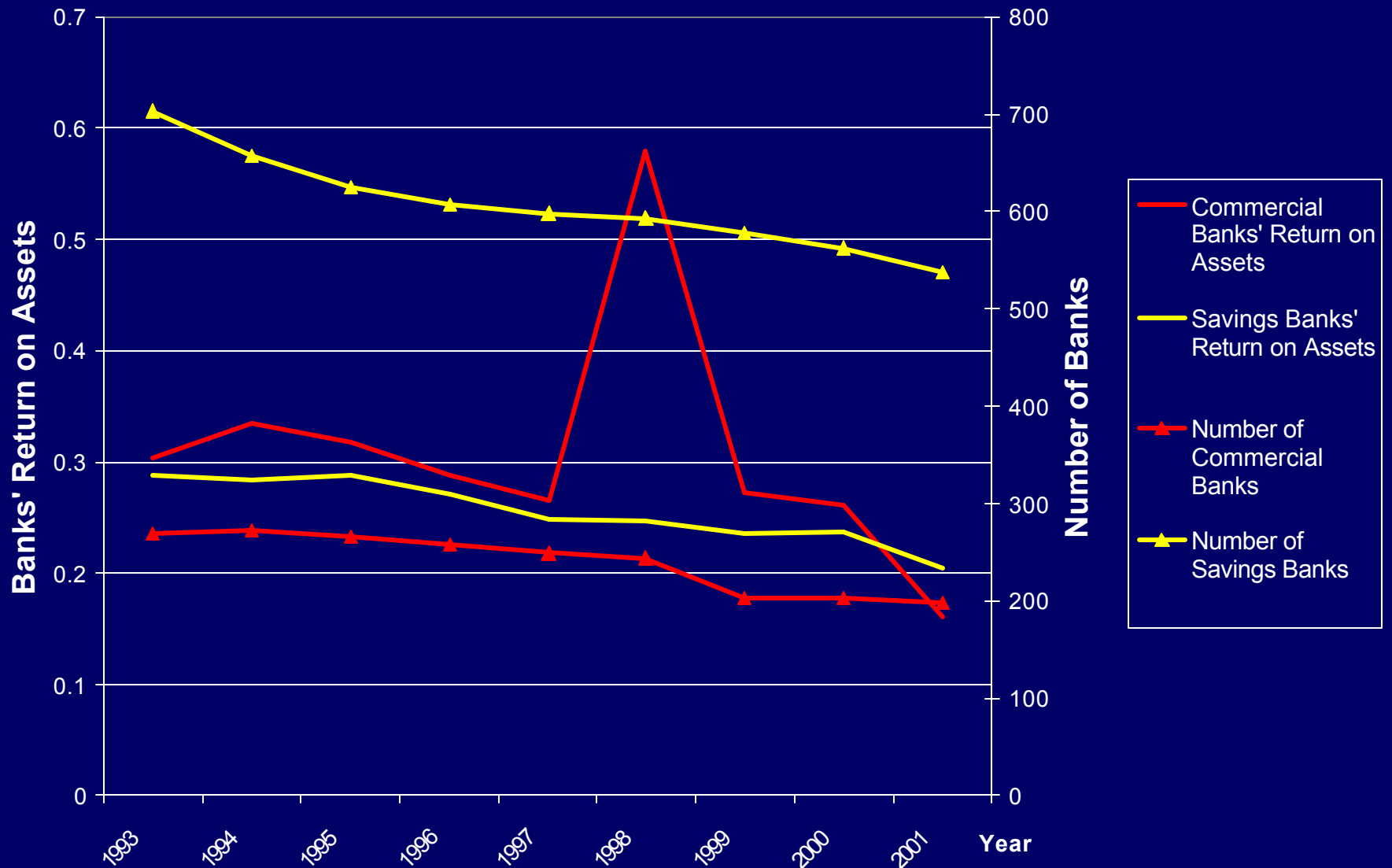
Area for reform	IFI's wishes (IMF/OECD/EU)	Agenda 2010 proposals
Labor market	Reduce work disincentives	Cut unemployment duration; reduce disincentives for low wage jobs (or founding <i>Ich AG's</i>)
Tax System	Lower tax rates; Non-wage costs	Brought forward income and corporate tax cuts
Health Care	Charge patients more; reduce demand	Increase co-payments; change doctors' payments from <i>Krankenkassen</i>
Pensions	Make sustainable	Not there yet; raise from 65 to 67 retirement age

Financial fragility is still an issue, but there has been improvement

- Germany's overbanking, with limited use of alternatives by savers, overlending to SME's on real estate, government subsidized banks, and partial liberalization could combine with near-deflation for difficulties
 - See *"Is Germany Turning Japanese?"* IIE, March 2003
- Three developments have improved the situation, reflecting the greater openness of Germany than Japan
 - Renewed commitment to privatization of the *Landesbanken*
 - "True Sale"* initiative to pool and securitize loans
 - Germany has imported some inflation
- Still, there are too many banks with too little profit, and therefore too little capital.
- The resulting adverse selection and evergreening of dubious loans remain a problem.

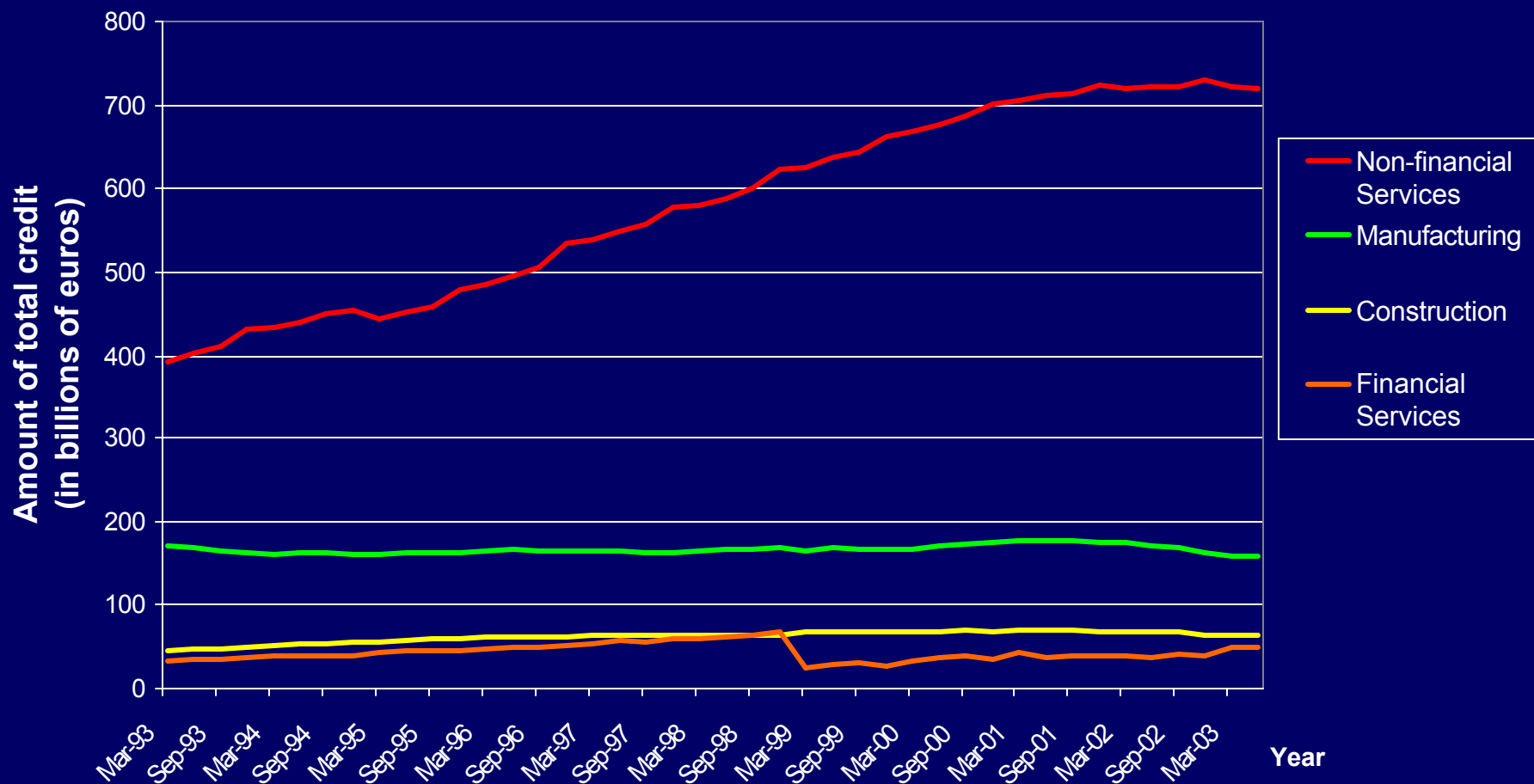
Too many banks, too little profit...

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...leads to evergreening to the *Mittelstand* and
little reallocation of investment.

Total Bank Credit by sector

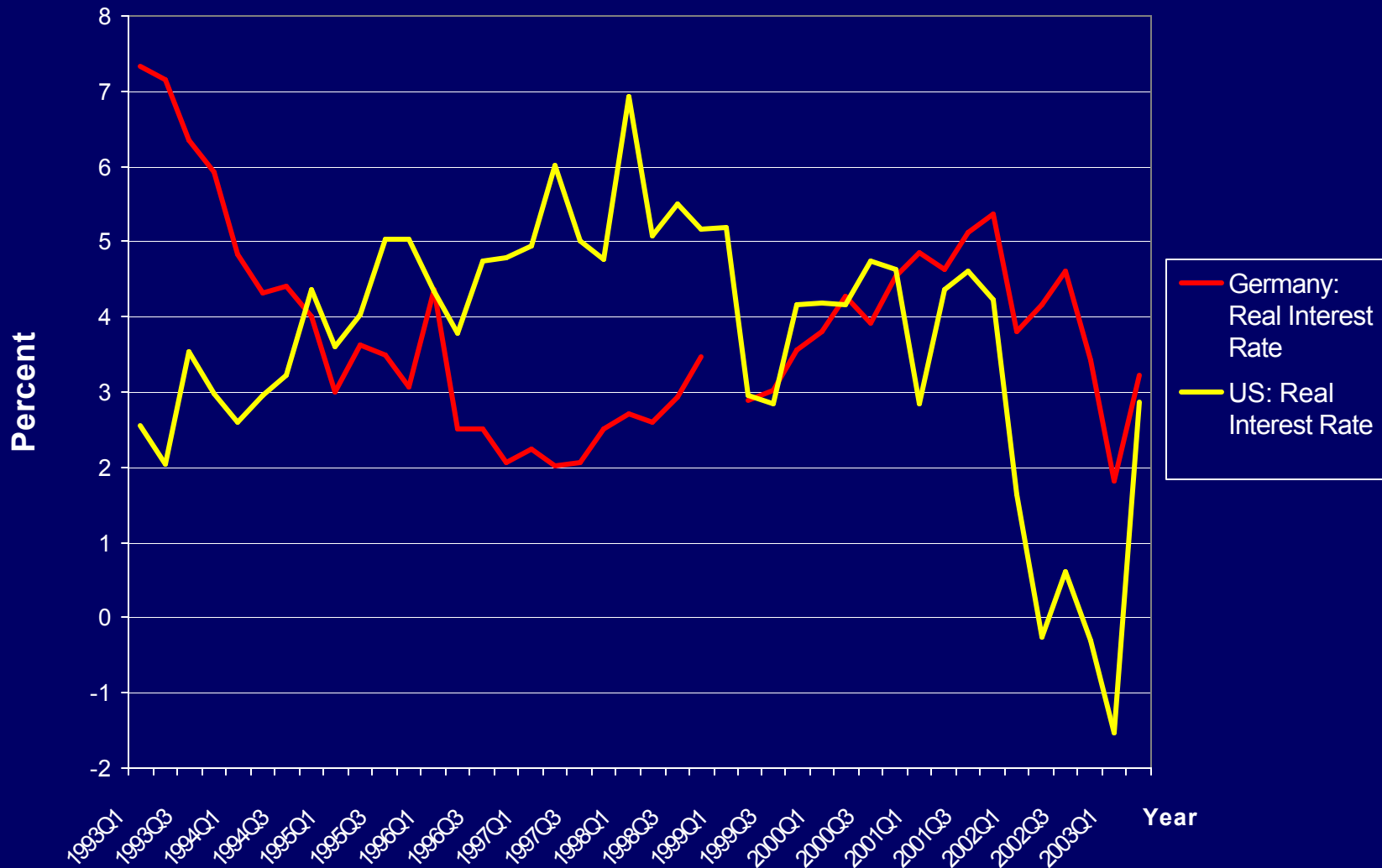


Eurozone macro policy has been insufficiently countercyclical, and has hit Germany hardest

- Stability and Growth Pact, though increasingly ignored, has constrained fiscal policy
- Dreams of expansionary consolidations (i.e., budget contractions that increase growth) are not relevant for large, low debt countries borrowing in their own currency, such as France and Germany
- The rise in the euro against the dollar has been an additional drag, but to date the manufacturing recession probably had a much greater effect
- Real interest rates in the eurozone have declined far less than in the US, and, given inflation differentials, have been high in Germany

A lack of proportionate monetary response

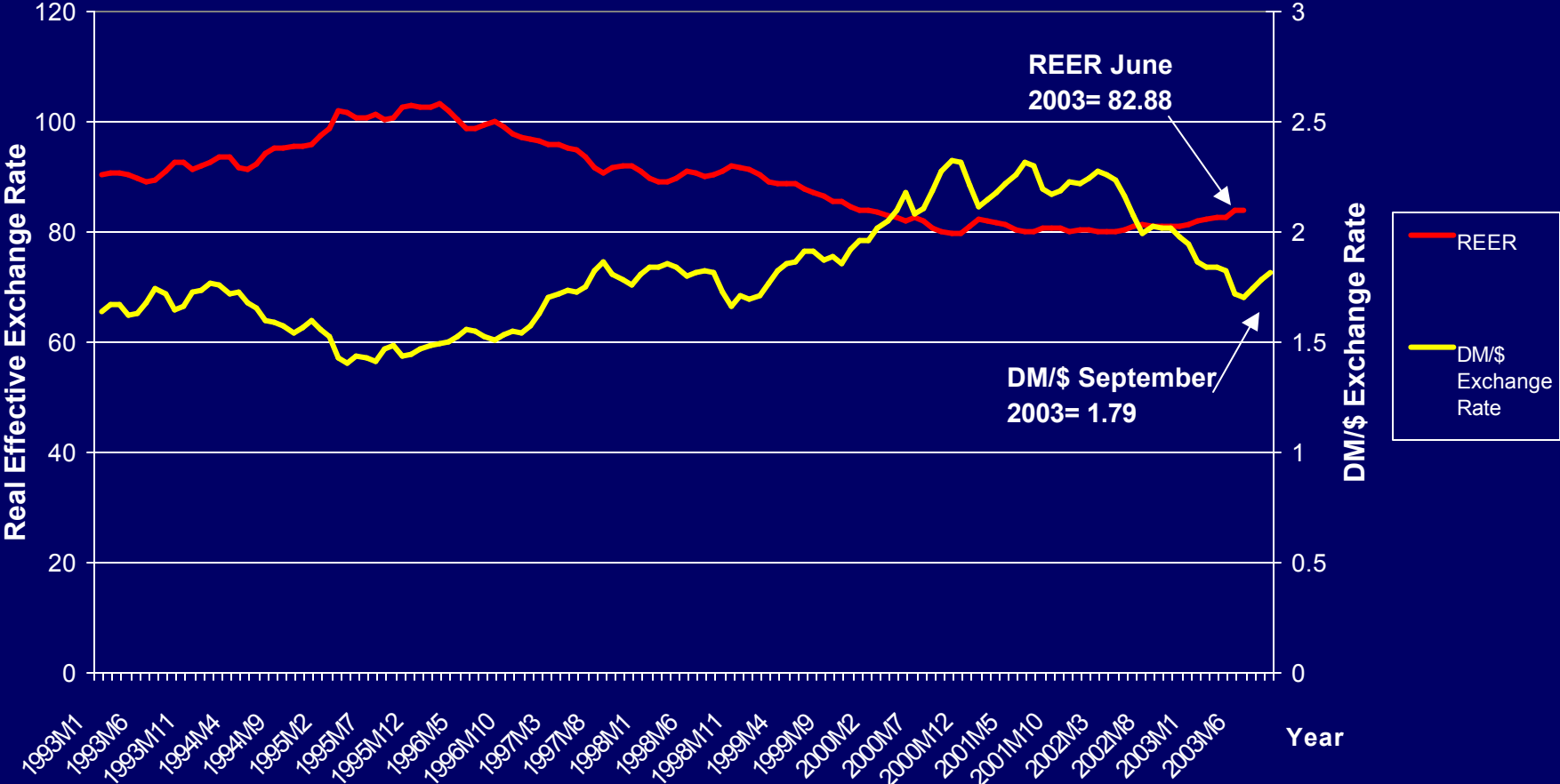
Germany and US Real Interest Rates



The current German recession cannot be ascribed to euro appreciation so far

Germany is heavily dependent upon capital goods demand, but nearly 50% of its export markets are in the *de facto* eurozone.

German real and dollar exchange rates



Eurozone – Getting better around all the edges

- For several years, reform and (with a lag) growth in the smaller economies has outpaced that in core EU.
- In the last few years, France has engaged in stealth reform, and the recent pension battle shows willingness to carry it through. Spain has continued to improve its competitiveness as well.
- Eastern enlargement will bring in higher growth economies and some competitive pressure, but these remain very small. A lot of investment has already occurred since integration is taken for granted.
- The eurozone “outs” (Denmark, Sweden, UK) are likely to remain out. They do not have a common economic agenda (e.g., on SGP), however, and little leverage unless bargaining to come into the eurozone.
- As a result, Germany’s domestic will to liberalize will be a key determinant of the EU’s economic agenda.

Conclusions:

- If the Agenda 2010 reforms are implemented, Germany will have significantly improved labor supply and the tax code, and made some progress on health care and pension sustainability. Financial fragility is being addressed as well, but only partially.
- These reforms may be somewhat contractionary over the next few quarters on net. Recovery in Germany will be weak (<1.3%).
- If the ECB and SGP continue to bind Germany excessively, the net drag from implementing reform will increase, and likelihood of full implementation will decrease. **This will be a further demonstration that macro tightness impedes reform.**
- Overall, the eurozone will come back, despite Germany, but weakness in Germany will suppress the strength of recovery.
- The Swedish decision and upcoming enlargement will not directly affect the forecast, but will limit the EU agenda.