Kiel Institute
for the World Economy

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Growth in the EU - what can be done?

Germany – engine of the European Union?

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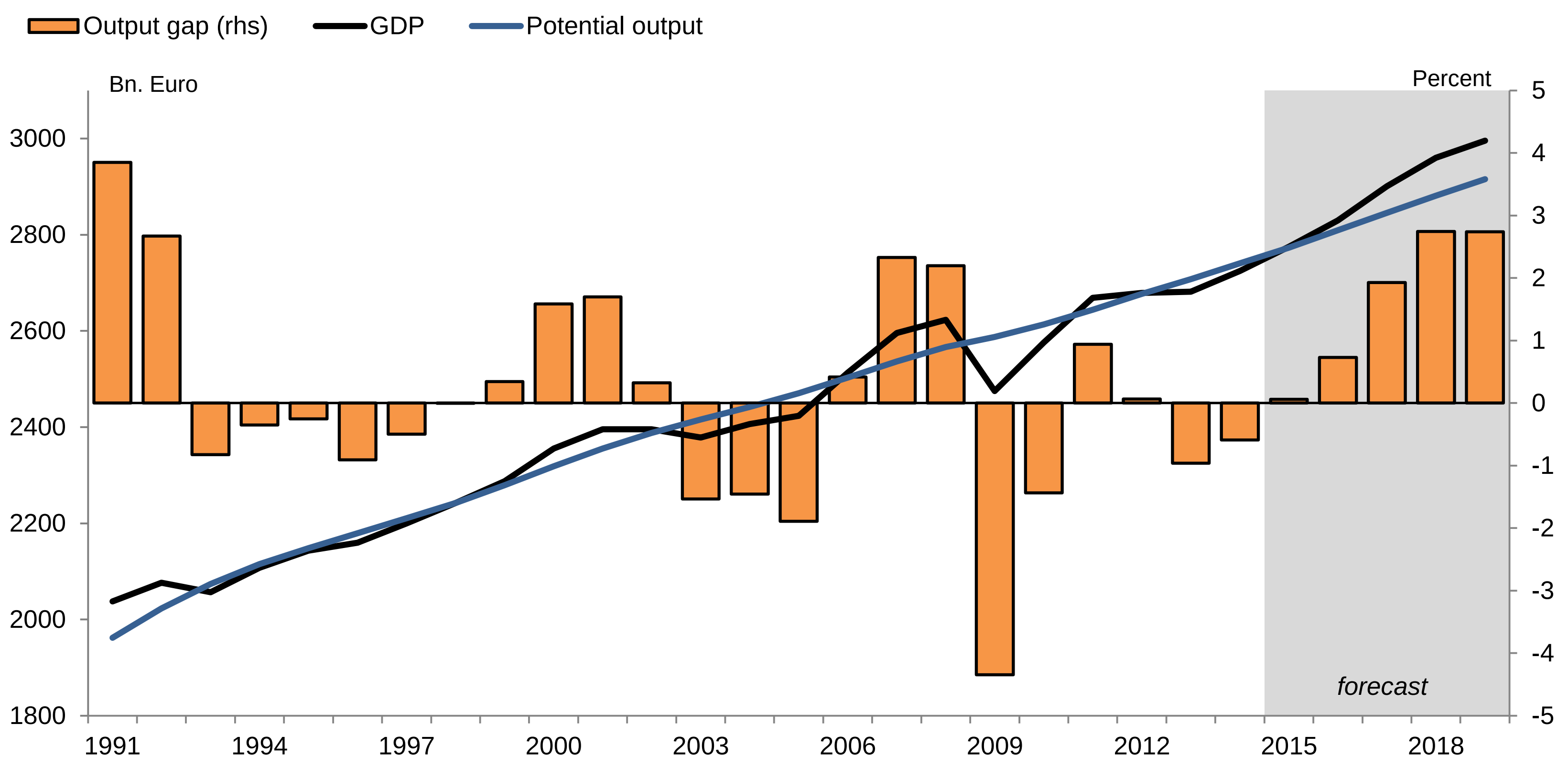
German economy: On the verge of overheating

Production and potential output



Yearly data; GDP, Potential output: price adjusted (chain index volumes, 2010=100).

European economy: Modest recovery is under way

- Diverse economic landscape in the E(M)U
  - » On aggregate, moderate expansion of economic activity
  - » Underutilization of production capacities in some countries and overheating in other parts of the euro area not to be misinterpreted as a macroeconomic equilibrium on the aggregate level
  - » Post-crisis sluggish growth is a typical pattern for countries suffering from severe capital stock distortions (= flipside of financial crisis)

- No destabilizing deflation
  - » Recent oil price slumps stimulate economic activity
  - » Core inflation is low, but there is no deflation spiral in sight
  - » Resolution of production structure distortions (mismatch-problems) dampens inflation pressure

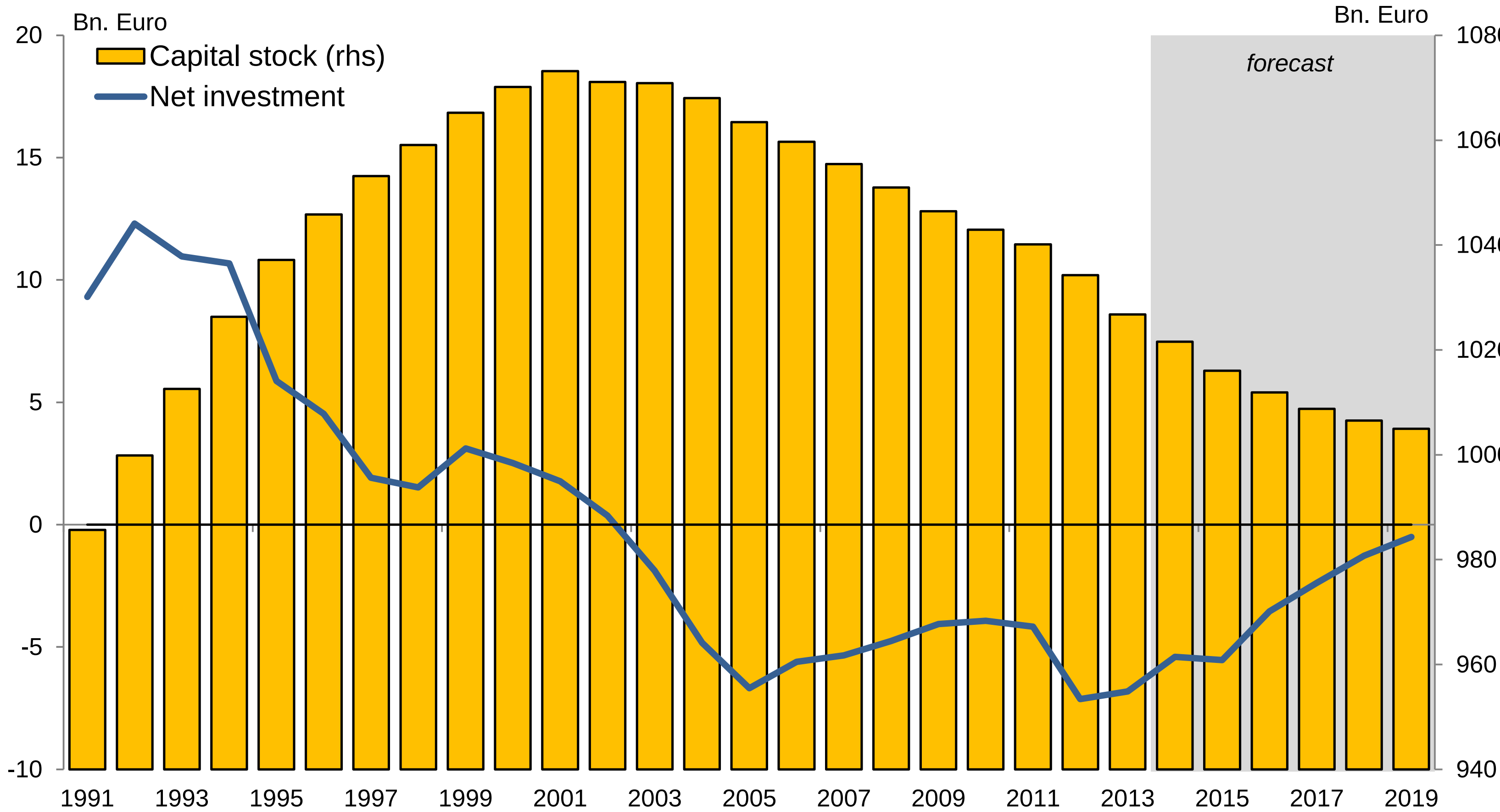
Germany in the driver‘s seat?

- „Locomotive“ picture is inappropriate (and always has been)
- Very modest spillovers
  - » Global VAR simulation:
    + 1 % GDP in Germany ⇨ + 0.15 % GDP in rest of EA
  - » NiGEM simulation
    + 1 % public investment spending ⇨ < + 0.1 % GDP in rest of EA
- Theory of idle resources
  - » Persistent deficient capacity utilization due to coordination failures on production factor and/or goods markets
- German openness to the rest of the world offers opportnities
  - » Linking value chains for market access
  - » Company level: Firms have no passport: truely European approach

Germany is not as strong/solid as it looks

- Economic activity fueled by ultra-expansionary monetary policy (overheating is not growth)
- Fiscal space?
  - » Massive relief from extraordinary low interest payments
  - » Social security systems benefit from small window of favorable demographics
  - » Negative net public investment spending (but some relief is on the way)
  - » Risk of overestimating potential production (= distorted structural fiscal figures)
  - » Tendency to roll back structural reforms of the past (labor market, social spending)
  - » Debt break ≠ investment break

Running down the public capital stock



Annual data.
Capital stock: Net stock of fixed assets, buildings and structures except for dwellings; price-adjusted (chain linked, reference year 2010).
Net investment: Current prices.

The European picture in a nutshell

- The labor market conditions are improving
  - Functional adjustments of wages in most crisis countries
- Fiscal consolidation comes to a stop
  - Further improvements of budget balances are cyclical or due to low interest rates, but not caused by further structural adjustments
- The economic situation in Greece remains extremely difficult
  - But: Little potential spill-overs to the rest of the euro area
- The ultra-low interest rate regime becomes increasingly risky
  - "Quantitative Easing" works in liquidity crises, not as a GDP booster
  - The longer the low rate of interest prevails the more the capital stock and the production structure as well as financial claims adopt causing new distortions and making exit strategies more difficult

Key messages

- Macroeconomic stimulus vs. structural reforms
  - » Deficit spending or ultra-permissive monetary policy are no viable substitutes for structural reforms to boost economic growth in Europe
  - » From the perspective of fiscal federalism, European programs (like the "Juncker investment initiative") are hardly a solution unless they address the provision of clearly identified public goods on the community level
  - » Mismatch resolving structural reforms: Ownership is key
- The MIP should stay focused on early crisis warning
  - » The European Macroeconomic Imbalance Procedure (MIP) is prone to divert from its key crisis prevention focus and expand to an overarching mechanism of policy coordination
  - » Serious conflicts with the principle of subsidiarity
  - » Weakening the early-warning mechanism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