

THE GERMAN ECONOMY DURING THE FINANCIAL AND ECONOMIC CRISIS SINCE 2008/2009

AN UNEXPECTED SUCCESS STORY REVISITED



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Lothar Funk

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KONRAD-ADENAUER-STIFTUNG



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Cover picture: © Gerd Altmann / pixelio

Layout: SWITSCH KommunikationsDesign, Cologne.

Printed by: Druckerei Franz Paffenholz GmbH, Bornheim.

Printed in Germany.

This publication was printed with financial support of the Federal Republic of Germany.

ISBN 978-3-944015-27-9

FOREWORD

Only one decade ago, Germany was called *the sick man of Europe*. Nowadays, the same comments speak about Germany as *Europe's engine*. What are the reasons behind that considerable change in the performance of the German economy and its public observation abroad?

Lothar Funk from Duesseldorf University of Applied Sciences explains in his report some of the main reasons behind that change with special respect to the situation of the German labour market. It not only highlights the driving forces of ongoing structural reforms in economy and social systems. It explains the strong influence of what we call Social Market Economy (SME) as the cultural background of German economic and social order that combines economic competitiveness with social balance. That model helped especially in the middle of economic turmoil since the Lehman crises of 2008 to stabilize economic expectations and to create the framework of fast economic recovery.

Our report is not thought as a blueprint for others to be copied, but to better understand some of the insights behind that actual German economic strength and its way to tackle the acute euro zone challenges. We hope that you enjoy the reading.

Berlin, in November 2012

Matthias Schäfer
Head of Team Economic Policy
Konrad-Adenauer-Stiftung

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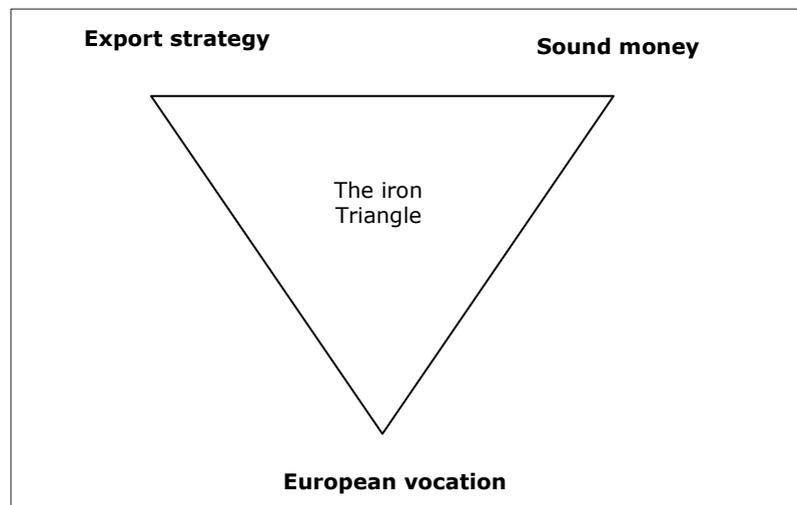
AN UNEXPECTED SUCCESS STORY REVISITED

Lothar Funk

THE GERMAN SOCIAL MARKET ECONOMY: A QUICK REFRESHER

The (West) German Social market economy (SME) has been trying to merge an approach to pursue open markets with functioning competition wherever possible with a concern to preserve price stability and social justice in society (cf. Funk 2000). In retrospect, the SME-approach has proved more or less compatible with three key principles, namely maintaining a large share of exports and imports, an unwavering commitment to price stability and a European vocation of the governing class at least. Recently, these features of the (west) German prosperous economy were named a "self reinforcing iron triangle", because "the key principles were derived from the traumatic failures of earlier German polities, notably the Great inflation of 1923 and murderous and ultimately self-destructive Nazi regime" (Paterson 2011, pp. 48-49).

Diagram 1: The iron Triangle of the German Model



Indeed, the (West) German economic performance very often benefited from the pick-up of economic growth in the rest of the world: "Traditionally, in the German case an upswing in the business cycle is stimulated by an increase in export demand, which is then followed by a pick-up of investment and eventually leads to less uncertainty, in terms of employment, and to higher income, so that consumer demand increases as well." (Siebert 2005, p. 7). Furthermore, Germany benefited particularly from the access to a widening European market (cf. Neal 2007, pp. 221-229)¹ as well as its comparatively hard-nosed counter-inflationary policies. Amongst other things including its geographical position as well as the German incremental innovation and high quality system (see Hütner 2011, pp. 13-18; Simon 2011, pp. 18-28), these factors contributed to a persistently high external competitiveness and ongoing trade surpluses with the exception of an adjustment period after German unification had occurred and which slowed the surge in German exports.

The remarkable West German early post-war economic success – popularly coined *Wirtschaftswunder* (economic miracle) – was partly attributed to temporary factors (positive supply-side factors such as a pool of motivated and skilled workers) and the incentives set by the early SME economic order conducive to catching up, namely above all the introduction of a stable currency based on independent central bank as well as

the lifting of most price controls in 1948 (cf. a short overview Funk 2002). Starting already in the mid-1970s and increasingly after the 1980s, however, the German model performed worse because its traditional institutions proved to be rather inflexible to the adaptation needs of structural changes, globalisation and reunification for quite a while. "In this view, the retardation of economic growth experienced by West Germany after the first oil prices in 1973 as well as rising unemployment are the consequences of institutional changes that have focused too much on the word 'social' and that have hampered economic activity" (Funk 2002, p. 149). The facts of longer-term decreasing real economic growth and an almost ever rising trend of unemployment since the mid-1970s until the financial crisis on which the general public became aware in September 2008 when the Lehman brothers Bank collapsed support the decreasing steam of the German power engine, as table 1 and diagram 2 (see p. 10) demonstrate.

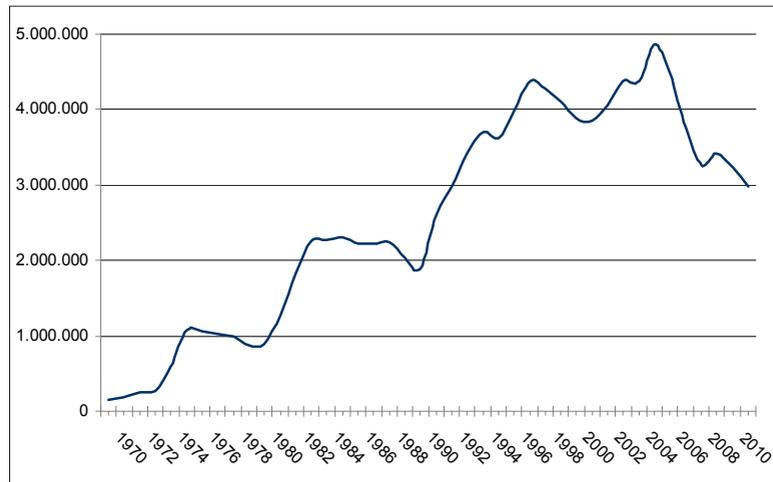
Table 1: Real growth of gross domestic product (GDP) 1951-2008 in (West) Germany (since 1991 united Germany)

| Time period | Average growth of real GDP in per cent |
|-------------|--|
| 1951-1960 | 8.3 |
| 1961-1970 | 4.3 |
| 1971-1980 | 2.8 |
| 1981-1990 | 2.3 |
| 1991-2000 | 2.1 |
| 2001-2008 | 1.5 |

Source: Eissel 2011, p. 84 based on figures from Federal Statistical Office.

Indeed, in a very broad-brushed and in important respects too superficial analysis "neither the Kohl government (1982-1998) nor the first Schröder government (1998-2002) were able (or willing) to overcome this inertia. Germany seemed to be a victim of its own success in the post-war period, having failed to renew its economy and society. Critics saw Germany as the sick man of Europe and analysts predicted the end of the German model" (Uterwedde 2011, p. 22).

Diagram 2: Registered unemployment stocks in Germany 1970-2010 (1970-1990 West Germany only)



Source: German Federal Labour Agency

In truth, however, already the Kohl-led government implemented policies that potentially rather unconsciously reshaped the German economy in the longer term away from the previously inflexible system towards new economic strengths and a more flexible but probably much more sustainable Social Market Economy, namely by the decisions how to shape the economic restructuring of eastern Germany and to replace the *Deutsche Mark* by a new joint currency of selected member states of the European Union that were expected to fulfil enduringly strict economic stability criteria (cf. Becker 2012, p. 6).

In spite of the initially harsh resistance in large parts of the German public and the remaining reservations up until now which have obviously risen again recently (cf. Bagus 2010, 51-62, Ifo-Institut 2011, p. 4), the Euro, if successfully implemented, was understood by its political proponents as beneficial for Germany as a whole at least in the longer term. Taking such a point of view, "Germany accepted the euro to avoid a repetition of the situation in the 1990s when, after reunification and the break-up of the European Monetary System, the real appreciation of the mark had disastrous consequences [...] on industrial production, manufacturing employment, growth, foreign trade and wages, which had to be squeezed for 15 years to restore competitiveness" (Artus 2010,

p. 7; Schwarzer 2011, p. 13 and the balanced survey by Owen Smith 2008, pp. 258-284).

Moreover, both the opportunities of globalisation (new markets and lower cost abroad) as well as improved transportation and information and communication opportunities first of all challenged and after a period of adjustment benefited the many world-open German companies by allowing them to take advantage of diversifying and cheapening their supply chains as well as opening up new export and production markets in Eastern Europe and Asia (cf. Hamilton / Quinlan 2008, pp. 156-158).

Additionally, and complementary to these changes, after a period of zigzagging in domestic economic policy which was accompanied by an increasing feeling of lagging behind against the rest of Europe. The reason was that Germany's economic record was at the lower end of league tables for quite a few years due to difficulties in transition from central planning in the East to a market based economy as well as due to adjustment difficulties when the Euro had been introduced, sweeping reforms were implemented also by the government. The courageous political efforts to improve Germany as a business location by the *Agenda 2010* reforms of the second Schröder government changed the German economy's adjustment trajectory considerably. The most important elements of the reform package were announced in 2003 (cf. Funk 2003) and became effective especially since 2005. They proved to be a trigger for the surprisingly large adjustments afterwards (cf. Funk / Allen 2013, pp. 317-320).

From the point of view of many mainstream economists, these reforms appeared often still moderate or even insufficient (cf. e.g. the recent evaluation of the "moderate" package and the succeeding reform efforts by Uterwedde 2011, pp. 23-25). Nonetheless, from a political point of view, the package was an extremely controversial reform programme which cut supposed entitlements of quite a few people hitherto (almost) entirely depending on the German welfare state. The reforms aimed particularly at improving the incentives to supply labour and more generally at increasing the flexibility of the labour market as well as product markets. Above all, one may argue that the measures jointly implemented a new labour market regime of "Promote and demand" (*Fördern und Fordern*) with a stronger emphasis on the component to create market incentives to work.

Simultaneously with the adjustment pressures of globalisation and the Euro, which both increased the power of companies to threaten with relocations to cheaper business locations abroad, the resulting increased pressure on the labour force in the light of still very high registered unemployment in Germany. That left a rather strong effect on the attitudes and behaviour particularly of the employed (considerably more threatened than hitherto to be substituted either by a cheaper supply of deregulated temporary workers within Germany or by workers in German subsidiaries abroad) as well as on short-term unemployed people and their representatives, the trade unions. Thus the measures combined with the other trends affected mainly the supply side of the economy and contributed to a prolonged period of very modest increases of labour cost only and the accompanying strong performance of the labour market since 2005. On the demand side, however, Germany's economic performance has been supported by strong exports. The latter fact also contributed to on-going controversies regarding Germany's allegedly insufficient domestic demand performance (cf. Whittock 2008; cf. Hüther 2011, p. 32).

The big question was how successful the reshaped economy would adjust to the challenge of the financial crisis since 2008. Before analysing this in more detail, the report, firstly, surveys the achievement of macroeconomic goals during the last decade and, secondly, sketches the causes of the recent interrelated crises of financial markets originating in the USA and then spreading to Europe as well as the current problems in the euro zone. Thirdly, the paper then surveys why – and in contrast to quite a few other countries – Germany proved comparatively resistant against the recent interrelated crises problems. Finally, the short report concludes with an overview of current dilemmas and future challenges that Germany is facing.

ACHIEVEMENT OF MACROECONOMIC GOALS DURING THE 2000s

The traditional SME governance model consisted of a set of general guidelines for economic policy rather than precise goals and instructions for policy. This changed, however, during the 1960s when also in Germany Keynesian thinking gained some influence. Despite of the fact that this influence lasted only few years, the goals included in the German economic "Law on Stability and Growth" of 1967 still often serve as a

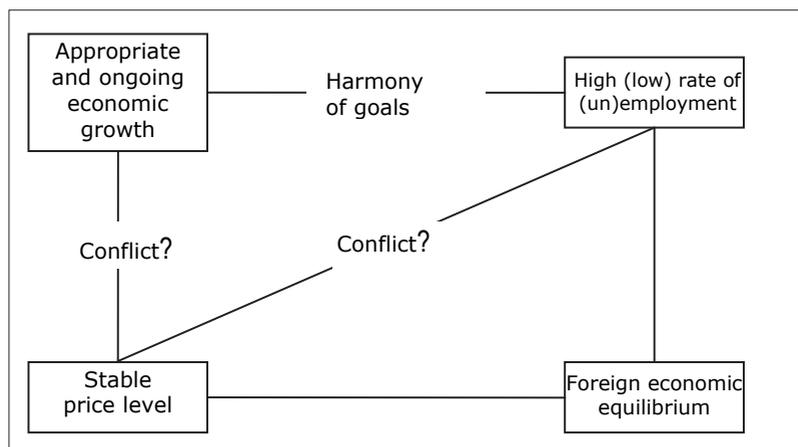
means to structure economic policy debates in Germany (cf. e.g. Beeker 2011, pp. 16-17, and Suntum 2011, pp. 177 and 227) despite of the fact that the law was hardly applied in practice after the 1970s. The law was passed after the first cyclical economic crisis had occurred during 1966/67 in West Germany and was meant to start a shift to Keynesian demand side strategy. Above all, the law for promoting stability and growth gave the government the obligation to smooth out the business cycle (cf. Eissel 2011, p. 79).

A high level of employment (measured in practice often by low unemployment) as well as price stability, steady economic growth and balanced foreign trade are the four principal economic policy objectives of the government, the so-called "magic quadrangle". Additionally and amongst certain other issues (e.g. ecological goals), as a rule it has also been considered the government's task to ensure an equitable distribution of income and wealth – a "magic polygon". These goals will serve here as a framework to assess the German economic record of the last decade. Apart from the habit to use this framework still in many textbooks, this may be justified also by the fact that during the last recession Keynesian demand management attained at least "a brief moment in the sun" again (cf. Funk 2011a,b and Tilford 2001).

In this report the focus will be on the traditional "magic quadruple" or rectangle which is called magic due to the short-term target conflicts arising in this context (cf. diagram 3). For example, according to the traditional Keynesian trade-off/target conflict-view, it was assumed that economic policy could choose between a combination of lower unemployment plus higher inflation, on the one hand, or vice versa on the other. However, such a choice proved wrong due to the dynamics of the wage fixing process, since when trying to take such a choice in the longer-term the price level and wage cost will rise at a similar rate. As a rule, in the longer term expansionary monetary and fiscal policies will only affect the price level, but not employment, as was wrongly assumed by many Keynesian economists during the 1960s as a simplifying assumption (cf. Funk 2013). Empirical evidence based on the theoretical criticisms against this approach demonstrated, however, that employees will build inflation forecasts into their expectations and, therefore, the price level and the cost of labour will - everything else the same - rise at a similar rate at least in the longer term in competitive labour markets. Thus there is no longer a trade-off between inflation and unemployment. More

inflation is no longer-term solution to fight (structural) unemployment (vertical as opposed to the assumption of the traditional negatively sloped Phillips curve). In other words, one cannot choose between unemployment and the inflation rate as the bargaining parties to a wage agreement will anticipate a state's readiness to drive up inflation and the employees or the trade unions, respectively, will base their wage demands on this anticipation (cf. Funk / Voggenreiter / Wesselmann, 2008, pp. 32-34).²

Diagram 3: Economic stability goals in Germany – a magic rectangle



Source: based on Beeker 2011, p. 17

Table 2: Development of consumer prices and real gross domestic product since the 1990s, selected figures

| Years | 1990-2000 | 2000-2010 | 2008 | 2009 | 2010 | 2011* | 2012* |
|-----------------|-------------------------------|-----------|------------------------------------|------|------|-------|-------|
| | Growth rates, annual averages | | Percentage change to previous year | | | | |
| Consumer Prices | 2.4 | 1.6 | 2.6 | 0.4 | 1.1 | 2.3 | 2.0 |
| Real GDP | 1.8 | 0.9 | 1.1 | -5.1 | 4.2 | 3.0 | 0.8 |

*=estimates

Source: IW 2011, pp. 138, 146 (annual average growth rates), since 2008: Advisory Group of Leading Research Institutes, October 2012, (Projektgruppe Gemeinschaftsdiagnose 2012, p. 18), and German Council of Economic Experts 2012, p. 2.

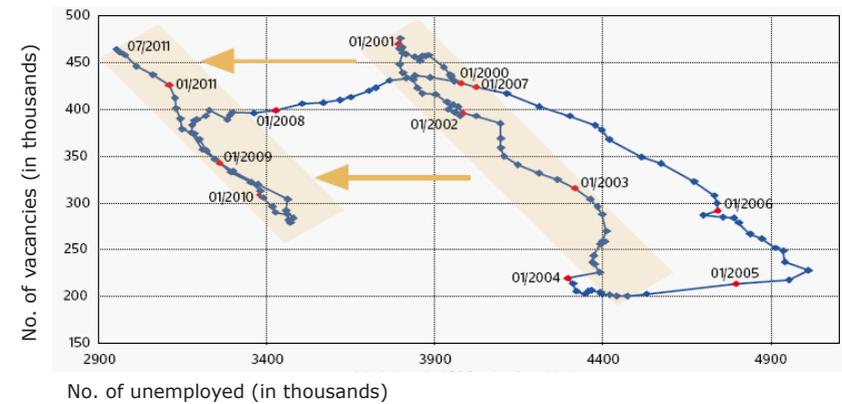
Harmony of achieving two goals simultaneously can be normally observed in reality with respect to employment and growth in the short-term because rising economic growth and increasing employment go hand in hand (cf. further relationships Beeker 2011, pp. 16-17). However, in the longer term this may again not be true if higher economic growth is accompanied by similarly high labour cost increases which entirely exhaust the economic distributional margin. Indeed, such a pattern of productivity and labour cost increases can explain to a large extent the development of persistently high unemployment in the western part of Germany since the mid-1970s. Thus, in contrast to the Keynesian short-term interpretation the longer-term view became particularly influential in this part of Germany. This happened after the independent advisory council to the Federal government (*Bundesregierung*), the "Council of Economic Experts", altered its stance moving away from a partly demand-side influenced view towards a rather strict supply-side interpretation of the economy in 1976 (cf. Donges 2004, p. 8). According to the supply-side school of economic thoughts which has been influencing (West) German governments dominantly especially since the early 1980s when the Christian-democrat Helmut Kohl became German chancellor, "the best economic measures for raising income opportunities is the implementation of policies, which help in letting the supply-side operate flexibly and efficiently" (cf. this statement and a further elaboration Trichet, p. 47).

Briefly evaluating the performance of the German economy in terms of achieving the mentioned macroeconomic goals leads to the following results:

- A high and sustained level of economic growth could not be achieved when taking the early experience of the 1950s until the 1970s as benchmark (see table 1). The gradually decreasing economic growth has to be seen, however, also compared to the experience of other highly industrialised economies, such as the United Kingdom, France, the European Union or the Euro area in general or the United States. All of these areas often did better in terms of economic growth than Germany until about the midst of the last decade (cf. e.g. Whittock 2008). Since then, however, the German growth performance has improved considerably apart from the exceptional recession of 2009 as table 2 above shows.

- Full employment has not been achieved since the mid 1970s when taking account of the stepwise increases of registered unemployment in (West) Germany (cf. Funk 2001 and Funk 2007b). Moreover, in no upswing it has been possible since then until only a few years ago to entirely reduce the additional unemployment which had increased during the previous downswing. In other words, a basic residue of unemployment rose cycle-by-cycle and became a core “structural” problem. This core of unemployed persons remained after each cyclical downturn and also does not fade away during the succeeding upturn. However, a marked improvement in terms of the German labour market performance can be detected since the second half of the 2000s (see diagram 1). A particular feature of the German upswing between 2005 and 2008 was that for the first time for about three decades it proved possible to decrease unemployment lastingly more than it rose in the previous downswing. This was mirrored also in the higher economic growth during that period. Furthermore, in spite of the large economic problems with respect to financial markets, the German labour market was hardly affected and appears to be heading towards a rather low level of economy-wide unemployment and at the same time also high employment rate (cf. diagram 1). Such behaviour of the labour market indicates the effectiveness of the rather far-reaching supply-side-oriented reforms implemented earlier as the observable facts of an above-average decline of unemployment and can by no means be explained by just a temporary cyclical recovery on the labour market. This is mirrored also in changes in the so-called Beveridge curve which helps to differentiate between cyclical unemployment and (more long-term) core structural unemployment components (cf. Funk 2009a, pp. 1316-1320; Sesselmeier / Funk / Waas 2010, pp. 51-62). Recently available data suggest a clear rise in the relation of vacancies to the unemployment figure (see diagram 4). In graphical terms, if the curve shifts inward, a sustained decrease in the structural level of unemployment has been achieved. However, this does not rule out that the ongoing actual improvement of the German labour market until summer 2012 has not been caused in parts by an unsustainable cyclical improvement caused by, above all, very low interest rates that have triggered domestic demand in Germany.

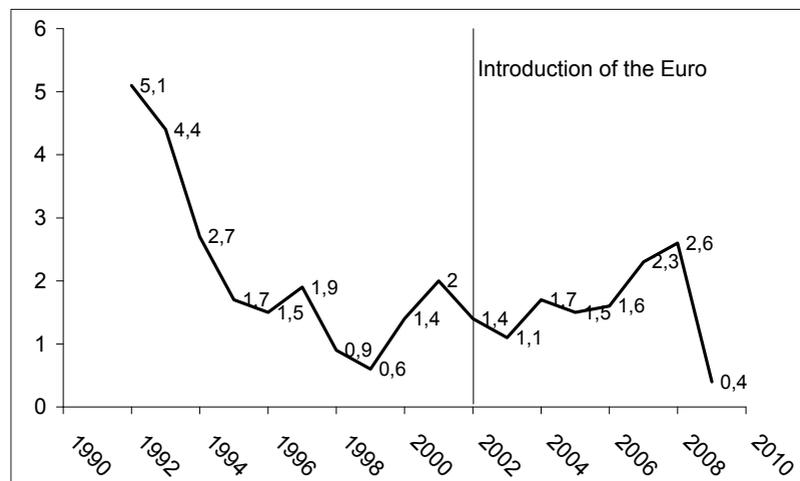
Diagram 4: The German Beveridge Curve – ratio between unemployed persons and registered vacancies



Source: Liebenberg 2011, p. 8.

- Regarding low and stable inflation, a heated debate has characterized Germany since the Euro became the new regular currency. The Germans had developed a rather emotional relationship to their beloved *Deutsche Mark*. The DM was, indeed, during its existence the most stable currency in terms of purchasing power jointly with the Swiss Franc. Despite of a feeling of a faster pace of loss of purchasing power since the adoption of the Euro in 2001 among many German citizens, in truth the statistical facts run counter to such observations (cf. diagram 5, p. 18). Indeed, the annual average growth rate of inflation has declined from 2.4 per cent during the 1990s to 1.6 per cent in the 2000s (cf. table 2).
- With respect to the goal of achieving foreign economic equilibrium, namely a sound balance in foreign trade, the national and particularly the international debate is rather controversial. Many people and particular Germans appear to believe that the more goods and services a nation exports the better off it will be. “This is because exports are said to create new jobs and because money seems to be pouring into the country, increasing the prosperity of its inhabitants” (Suntum 2011, p. 159). For example, according to this point of view, a country should strive for high export surpluses in order to boost domestic employment and economic growth. The truth, however, is much more complex. One important effect of the fundamental change towards a

Diagram 5: Development of index of consumer prices



Source: Beeker 2011, p. 32 based on German Federal Statistical Office.

supply-side orientation of economics – as explained above – was that trying to balance the value of exports and imports in the medium term has been no longer a goal of economic policy since that time. In the words of the current Federal government while defending the ongoing German current account surpluses during the last decade (and prior to German unification): “These surpluses are justified if, as in Germany, they result from competitive enterprises in viable markets and are related to structural conditions that determine the rate of savings and investments. The current account is not a political target for the Federal government.” (*Bundesregierung* 2012, p. 30). In other words, in this view increasingly positive current account surpluses prior to the crisis of 2008/2009 foremost reflect sound market reactions based, above all, on two factors: firstly, the fact that the products in which Germany specialises (e.g. capital equipment) have been in high demand particularly from rapidly expanding emerging economies; secondly, improvements of Germany’s supply side which were simply a side-effect of badly needed labour market-related reforms to get rid of persistently high and increasing unemployment for decades (cf. Meier 2012).³ In other words: On the one hand, rather than pursuing actively increasing trade or current account surpluses, the latter may be explained to a large extent as side-effects of necessary internal reform measures to fight high unemployment and the seemingly ever decreas-

ing trend of economic growth as well as adjustments to the incentives resulting from the adoption of the Euro both in the surplus and in the deficit countries. At the same time Germany also benefited from the expansion in the euro zone (triggered to a large extent by falling real interest rates for countries with hitherto higher rates) and worldwide (OECD 2010, p. 3; cf. Artus 2010, p. 7; Belke 2005, p. 129, Whittock 2008 p. 10). In this context it has to be acknowledged that “Germany was exporting goods and lending capital to countries where domestic demand was partly on an unsustainable track”. On the other hand, however, the rather widespread neglect of the current account deficits of the euro zone’s “Southern” countries that more or less mirrored the surpluses of the “Northern” countries while the current account of the euro zone as a whole was more or less balanced (cf. table 3) and of potential insolvency risks before 2008 proved dangerous. With the uncomfortable emergency in the euro area already since the end of 2009, we have learned the hard way, that both for surplus countries as well as deficit countries the situation may become very uncomfortable if chronic trade deficits of the trading partner become too large⁴ (cf. also Paterson 2011, pp. 49-50).

Table 3: Current account balance in the euro area 1990-2010, Germany and other selected countries (in per cent of GDP)

| Years Country | 1990-1995 | 1996-2000 | 2001-2005 | 2006-2010 |
|------------------|-----------|-----------|-----------|-----------|
| Germany | -0.51 | -0.95 | 2.74 | 6.20 |
| France | 0.12 | 2.26 | 0.86 | -1.43 |
| Greece | -1.74 | -4.57 | -6.72 | -12.23 |
| Ireland | 1.46 | 1.43 | -1.15 | -3.33 |
| Italy | -0.43 | 1.56 | -0.94 | -2.92 |
| Netherlands | 3.74 | 4.10 | 5.04 | 6.61 |
| Portugal | -0.57 | -7.01 | -8.23 | -10.12 |
| Spain | -2.19 | -1.68 | -4.66 | -7.78 |
| Euro area | n.a. | 0.48 | 0.53 | -0,02 |

Source: Advisory Board at the Federal Ministry of Economics and Technology (*Wissenschaftlicher Beirat beim BMWI* 2011, p. 13).

- Finally and very briefly, we shall discuss the issue of fair distribution. This question can hardly be analysed with measures such as, for example, the average GDP per capita only. Obviously, however, many other possibilities for measuring and assessing this issue exist. The most well-known concept for evaluating the distribution of income (and assets) is probably the Lorenz curve and as a concept built on it the Gini coefficient. The values of this coefficient can vary between zero (equal distribution of income) and one (extremely unequal distribution of income). In an international comparison, in 2010 Germany displayed according to this measure with a value of 0.27 a more equitable distribution of disposable income than, e.g. the European Union as a whole (0.31), Japan (0.38) or the United States (0.45). However, several countries including Sweden and Slovenia with values of 0.23 and 0.24 did somewhat better in this respect (cf. Beeker 2011, p. 189-190). Germany's market income distribution – that is prior to redistribution by the state – has been more unequal among persons of working age in the late 2000s than in most other countries with a lower Gini-coefficient. Thus the German redistribution efforts can be regarded as rather effective in transforming very unequal market incomes into more equitable ones after public redistribution (cf. e.g. OECD 2011, pp. 227-228). Nevertheless, critics complain that one of the side-effect hidden behind the so-called "New *Wirtschaftswunder*" (Koch / Rees 2010) is a labour market 'dualisation' which encompasses an 'under-class' of low-paid employees whose incomes have in parts shrunk in real terms over the last decade and who more often than in earlier times appear to be trapped in less than full-time jobs (cf. e.g. OECD 2011, pp. 281 ff.; Brenke 2010; cf. a more positive assessment of these developments, however, Germany Council of Economic Experts 2011a, p. 20 and 2011b, pp. 268-281; Funk 2010, p. 97 and Peters 2012).

ORIGINS OF THE INTERRELATED CRISES SINCE 2008

The Great Financial Crisis hit the world economy in the aftermath of the bankruptcy of the investment bank Lehman in the midst of September 2008. The immediate disastrous aftershock was the most severe fall of real GDP in 2009 among many high income countries. Quite a few mistakes by interventions of policymakers and by economists that too often overestimated the efficiency of financial markets contributed to the largely unexpected crisis (cf. Funk 2009b). All this led, in the final analysis, to an abuse of the state as a lender of last resort by the financial

sector according to the slogan "profits are privatised and financial losses are socialised". "As long as the financial industry gains profits out of their risky business the employees and shareholders achieve benefits, but if the system is overheated and creates incredible losses then the taxpayers have to bail out them in order to save the system" (Paesler 2011, p. 119; cf. also Franz 2011 and Schäuble 2012).

An important cause of the emerging problems was a partial under- or at least wrong regulation of some segments of financial markets. This made it possible to grant ever larger amounts of risky securitized mortgage loans to households with a dubious credit record in the United States where the crisis originated and which further fuelled an existing bubble – steadily rising average prices to some extent unrelated to fundamentals at least in retrospect – on the US real estate market. A trend fall in the US home market prices since 2006/2007 triggered the beginning of the financial crisis. As the price for securities backed by mortgages – which were held in large numbers by numerous international banks – started to collapse, the banking crisis became acute. In August 2007 banks began to lend less money to one another because they realised the problem of an unknown number of potentially worthless papers in their safes that may threaten the existence of quite a few commercial banks. The central banks' provision of more liquidity could not avoid the immediate spread of the financial crisis around the world after the fall of Lehman Brothers. Numerous banks had to be saved by the governments. These measures could not avoid, however, that hand in hand with a dramatic fall of the share prices at stock markets a world-wide economic downturn suddenly occurred in late 2008 which also implied the largest collapse of world trade since World War II.

The year 2009 in many countries marked the most severe collapse of real GDP during the last decades. All this initiated the authorities to implement, amongst other measures, massively expansionary and fiscal policies which helped to overcome the recession in numerous countries. However, these measures often lead to fragile upswings only which in addition often started from a considerably lower level of real GDP due to the recession. Furthermore, as unemployment is still high and government debt has piled up considerably in numerous countries (in some nations particularly in the euro area to such an extent that their sovereign default threatens), in quite a few countries a new recessionary period has already occurred or has to be expected again.

Although the euro area was regarded for a long time as a protective shield against the problems that piled up and partly burst during the early phase of the great financial crisis (cf. Schwarzer 2011, p. 13), gradually the credibility of the European single currency itself came under pressure. Starting with Greece in early 2010, the still ongoing financial crisis has been destabilising the Euro area itself to a previously unexpected extent by spreading to other member states and remains to be resolved by changing the existing architecture rather fundamentally. One of the basic lessons the German government has drawn from these events – “eurozone members must be recast in their mould of fiscal orthodoxy” (Plender 2011)⁵ – is, in the final analysis, also accepted by leading mainstream US-economists when they discuss their own problems: An ongoing policy of “stimulus spending to prop up the aggregate demand for goods and services comes with its own risks. The more we rely on deficit spending to keep the economy afloat, the more we risk the kind of sovereign debt crisis we have witnessed in Greece over the past year. [...] In the long run, we have to pay our debt – or face dire consequences (Mankiw 2011, p. 9, cf. also Rajan 2012 and Spence 2012).”

Major common causes of the interrelated crises problems since then can be seen particularly in the “flooding of markets with idle money, not only by the FED, but also by the ECB” (Suntum/Ilgmann 2011, p. 337; cf. also Mayer 2011b) and probably the large imbalances between current account surplus and deficit countries due to increased savings in countries such as China and Germany which contributed to the bubbles in different housing markets in the US as well as in several euro area countries (cf. Gerber 2010, pp. 296-297, and cf. for details of both the US-initiated great financial crisis and the so-called ‘public debt crises’ in the Euro area Spence 2011, pp. 172-173 and Baldwin / Wyplosz 2012, pp. 523 ff.).

A causal analysis of the current euro area problems relates these observations with the architecture of the euro and regards “at the root of the euro upheaval ... a balance of payment crisis caused by the cumulative effects of a 13-year-old one-size-fits-all monetary policy and a fixed exchange rate for a collection of disparate countries in very different stages of economic and structural development” (Marsh 2011, p. 1-2). In other words, a joint cause of both the great financial crisis originating in the United States and current euro zone problems has been the availability of artificially cheap loans (cf. Schäuble 2012).

The details of the responsibilities and the potential solutions of the “hidden balance-of-payment crisis in the eurozone” (Mayer 2011a) will not be addressed here; only the conclusions will sketch a few points. Instead the next section will highlight the main factors contributing to the surprisingly stable labour market developments in Germany despite the sharp fall of GDP and the other external challenges.

SUCCESSFULLY COPING WITH THE DOWNTURN: THE UNIQUE GERMAN MIX

Germany was called “the sick man of Europe” only few years earlier due to its below-average performance. Nevertheless, as opposed to most other countries affected by the great financial crisis and its after-effects, Germany did unexpectedly well during this period. Some additional facts can easily prove this assertion (see diagram 6 and table 4).

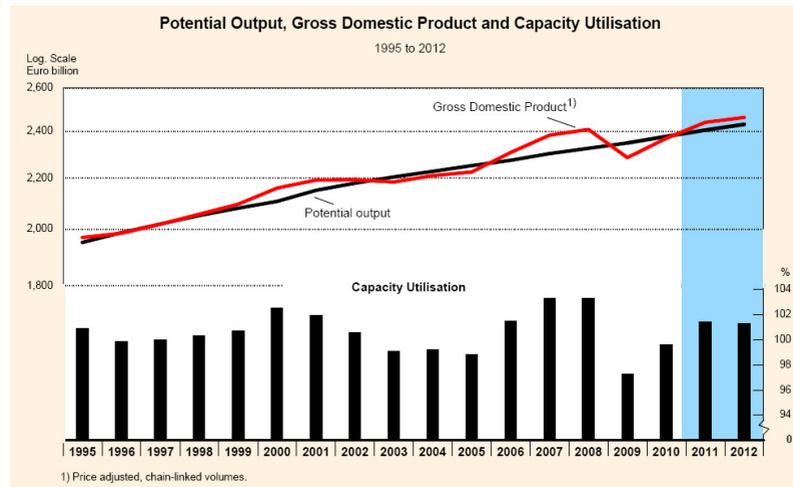
The losses sustained during the recession of 2009 could be recouped during the succeeding process of strong recovery (cf. Hielscher 2012). However, the upturn is expected to slow down somewhat according to recent economic forecasts due to external cooling factors, such as the sovereign debt crisis in the euro area and the accompanying tensions in the financial markets as well as the consolidation efforts in many countries including Germany (Knaus 2012). Risks also loom due to the reversal of German energy policy (cf. German Council of Economic Experts 2011a, pp. 13-16; cf. also Klein 2012). However, Germany is well-placed compared to other countries with its production still more in manufacturing goods than in other highly industrialised countries and if emerging countries will continue to expand as they are increasingly the destination countries of German exports.

Moreover, a rather positive German short-term „economic outlook of a slumbering boom that will awake during 2013 and fully unfold in 2014 is based on the assumption that the ECB and politicians in the euro area will do whatever is necessary to save the euro, and that the ECB in particular can convince investors through its actions that its readiness to act is unconditional. We are convinced of the former, because none of the parties involved have any interest in a break-up of monetary union – although a political accident cannot be ruled out” (Solveen 2012, p. 11). Such an assessment appears justified because despite of still existing huge controversies among economists especially in Germany at least the leading advisory economic research institutes with the task

to jointly forecast economic growth and cyclical developments twice a year agree with the German government's European policy approach in principle. Assuming as given that a national bankruptcy has not been regarded as a political option by the euro member states until now, the research institutes regarded in mid-October 2012 the current German-inspired euro zone strategy of growth-friendly structural reforms combined with credible consolidations of public budgets as the 'royal way' to regain trust and confidence to ensure sustainable 'business models' for these nations with previously unbearable imbalances in the future (cf. *Projektgruppe Gemeinschaftsdiagnose* 2012, p. 2).⁶

Diagram 6 demonstrates that the German economy utilised its production capacities above its average use (100) considerably during the boom between 2005 and 2008 and slightly again in 2011. Due to the strong economic upswing in Germany, working hours, employment and hourly productivity increased. The present characteristics include the comparatively low and decreasing budget deficits (cf. table 4). This is partly related to favourable current financing terms⁷ and especially the buoyant state of the labour market (cf. *Bundesregierung* 2011, pp. 3-4; German Council of Economic Experts 2011a, pp. 13-16 and 2011b, pp. 268-281).

Diagram 6: Potential output, real GDP and capacity utilisation, 1995 to 2012



Source: German Council of Economic Experts 2011a, p. 12.

Total employment reached record levels in 2010 and again in 2011 with the highest level of persons employed since reunification and has been still increasing in 2012 according to projections of the Federal Ministry of Economics and Technology on an annual average (cf. Knaus 2012, p. 11-12 and *Bundesregierung* 2012, p. 6). The registered unemployment level fell to new lows not equalled since 1991 while simultaneously the number of jobs fully subject to social contributions rose at a figure of 28.4 million in 2011 – with a further rising trend – to the highest level within the last 15 years (cf. table 4). The Council of Economic Advisers particularly emphasised the “remarkable [...] almost continuous rise in employment since the middle of the past decade and [...] the fact that the situation is actually better than before the crisis.” (German Council of Economic Experts 2011a, p. 19). International institutions such as the International Monetary Fund and the OECD even congratulated Germany on its impressive performance: „In 2005, the German unemployment rate was the 6th highest among OECD countries at close to 11 per cent. By 2011, the German rate had almost halved and was among the ten lowest rates in the OECD” (Gurria 2012; cf. also Barkbu et al. 2012, p. 13).⁸ This begs the question: What were the main drivers of the surprisingly stable labour market developments in Germany despite sharp fall of GDP and the other external challenges (and in contrast to many other countries)? In other words, what were the ingredients of the unique German mix apart from the bailout and guarantee packages for the financial industry?

Table 4: Additional key indicators for Germany

| Year Indicators | 2008 | 2009 | 2010 | 2011 | 2012* |
|--|-------|-------|-------|-------|-------|
| Persons employed (domestic), mn. | 40.35 | 40.37 | 40.60 | 41.16 | 41.57 |
| Employees covered by social insurance, mn. | 27.51 | 27.49 | 27.76 | 28.44 | 28.95 |
| Standardized unemployment rate in per cent | 7.6 | 7.7 | 7.1 | 6.0 | 5.3 |
| General government balance (per cent of GDP) | -0.1 | -3.2 | -4.1 | -0.8 | -0.1 |

* estimates; mn. = in million

Source: Advisory Group of Leading Research Institutes (*Projektgruppe Gemeinschaftsdiagnose* 2012, p. 22), German Council of Economic Experts 2012, p. 2 and International Monetary Fund (IMF 2012).

On the one hand, the Federal government not only allowed more or less in line with mainstream economic thinking the stimulation of the decreased aggregate demand by passive automatic stabilisers such as the unemployment aid system when the economy went into recession (and thus accepting resulting deficits). On the other hand and more controversial, however, the government also pursued active stabilisation policy measures after hesitating initially.

“Two economic stimulus packages with the total amount of € 82 bn. were parliamentary approved; mainly for infrastructure projects, new investments and a quite popular car-scrap bonus program. These measures softened the economic downturn noticeably and are even future-oriented investments; so the taxpayers’ money is in this regard not wasted” (Paesler 2011, p. 119).

Table 5: Dimensions of stimulus programs in selected countries of the EU

| Year Country / Area | 2009 | 2010 |
|------------------------|---|------------|
| | Discretionary impulse in percent of GDP | |
| Finland | 1.6 | 2.7 |
| Sweden | 1.7 | 2.7 |
| Germany | 1.7 | 2.4 |
| Austria | 1.5 | 1.8 |
| Denmark | 0.7 | 1.5 |
| EU-27 | 1.5 | 1.4 |
| France | 1.6 | 1.4 |
| Spain | 0.0 | 1.2 |
| Ireland | 0.7 | 1.0 |
| Netherlands | 0.9 | 1.0 |
| United Kingdom | 1.9 | 0.5 |

Source: Brügelmann 2011, p. 2.

Despite of the generally very large reservations of German mainstream economists against a demand management approach to stabilise and revitalise public and private demand as well as employment (cf. Beeker 2011, p. 17 and pp. 132-133),⁹ quite a few of them regarded the measures in principle as rather appropriate in the extreme situation of 2009 when a large negative demand shock due to the financial crisis originat-

ing in the United States hit the then prospering German economy (cf. Funk 2011a, 932-934 and diagram 6 which shows the much above average capacity utilisation in Germany during 2007 and 2008 and its succeeding short-term steep fall). The extent of the German stimulus programs in the EU were among the largest ones in the European Union and empirical evidence showed the effectiveness of the 2009/2010 recovery packages in overcoming the crisis (cf. Brügelmann 2011, p. 1).

On the other hand, based on previous reform efforts particularly the private sector including the trade unions and the employers’ associations contributed considerably to the German success story (cf. Gurría 2012). This has been achieved by uniquely combining the increased flexibility through the recent labour market reforms which contributed also to the ongoing employment-friendly wage policy with traditional German strengths of collaboration of social partners. This last point allowed for an “increased use of working time accounts which permit employers to avoid overtime premia ... [and] did provide disincentives for employers to lay off workers in a downturn” (Burda / Hunt 2011, Abstract).

In other words, the stable labour market and its further recovery after the financial crisis is based on an interaction of several factors. The most important components included – apart from certain direct fiscal policy measures (car scrapping subsidies) – a large amount of labour and thus skills hoarding and the use of short-time work foremost by the large export-oriented manufacturing sector. In spite of the fact that these instruments have been used traditionally especially since the 1970s in western Germany for labour market adjustment purposes, the wide use particularly in 2010 was unseen in the last decades. The approach worked well because its use was based on expectations by employers of a short recession only that proved to be true. Many of the most affected companies correctly anticipated to have a fundamentally appropriate structure of their products to meet the future demand in global markets as well as within Europe and Germany. Last but not least, the increased flexibility of the strategically restructured German labour market (cf. Funk 2010, pp. and Funk 2003, 2001) also contributed considerably to the success, due to the elevated profitability of production prior to the 2008/2009 downswing and the accompanying decreased uncertainty for successful entrepreneurship in Germany.

One may summarise that the “labour market in Germany goes along with a mix of more external flexibility (due to labour market reforms) and more firm-specific internal flexibility (in the course of crisis management).” (cf. Walwei 2011, Abstract).

Table 6 gives some more details based on data published foremost by the Institute for Employment in Nuremberg which confirm this basic evaluation and the resilience of the German labour market in spite of the fact that Germany was heavily affected, above all, by the steep decline in international trade due to the great financial crisis which decreased especially German exports in the core area of the German production model, that is machinery and automobile manufacturing. However, the previous upswing combined with the accompanying wage moderation and increased flexibility as well as the resulting high profits in these sectors before the breakdown of demand allowed for this rather unique German way of adjustment (cf. Eichhorst/ Marx/ Pastore, p. 48; cf. more details Zimmermann/ Wey 2010).

Table 6 provides important facts of adjustment in the German labour market during the crisis period and related to the fluctuations of real GDP in column 3. Important characteristics of the ‘labour market miracle’ include the consistent fall of registered unemployment and the missing decrease of the number of persons in employment on an annual average despite of the largest fall of real GDP in post-war Germany in 2009. In general, important indicators of the German labour market are lagging negative GDP-changes three to six months because enterprises hoard skilled employees to ensure their availability when the upswing returns. During the crisis year 2009 the average amount available in the time savings accounts of workers decreased by 9.1 hours per employee while the amount of overtime hours fell by 8.5 hours on average. Simultaneously, in 2009 companies decreased their demand for temporary agency workers and the amount of employees in short-time work increased tremendously by more than eleven times compared to 2008. All in all the fall in total hours worked (-2.7 per cent in 2009) can explain to a large extent why a decrease of employment in terms of persons could be avoided. At the same time, productivity per hour worked fell while the affected companies accepted strong unit labour costs in 2009. However, as expected by the Federal government and large parts of the affected manufacturing industry, the indicators improved fast again due to the fast return of economic growth in 2010 and 2011 (cf. table 6).

This kind of adjustment was possible because underutilised capacities could be employed again productively and profitably due to a fast recovery of the German economy given the basically sound supply side of the economy. Basically this kind of adjustment can be related also to the lack of skilled workers that was developing already prior to the crisis and which will accelerate due to the future ageing of German society. In order to stay strong when the upswing returns and in the future, German enterprises that expected to operate successfully in the medium term had an incentive to avoid dismissals of employees with scarce skills whenever possible – particularly in a crisis which was expected to be short-term (cf. IW 2012). The rather stable figure of employment in the manufacturing sector soon after the crisis compared to 2008 at around 7.6 million (cf. table 6) also demonstrates that this sector (and related industry services) is still the most important backbone of the German economy. Indeed, Germany still contributed 29.6% of all industrial production of EU-27 in 2011 (cf. Nikolai 2012, p. 5).

Table 6: Selected indicators on labour market adjustment in Germany

| Year | 2007 | 2008 | 2009 | 2010 | 2011 | 2012* |
|------------------------------------|------------------------------------|-------|-------|-------|-------|-------|
| Indicators | Percentage change to previous year | | | | | |
| Real GDP | 3.3 | 1.1 | -5.1 | 4.2 | 3.0 | 0.8 |
| Total employment (in persons) | 1.7 | 1.2 | 0.0 | 0.5 | 1.3 | 0.0 |
| Total hours worked | 1.6 | 1.2 | -2.7 | 2.3 | 1.8 | 0.3 |
| Productivity per hour worked | 1.7 | -0.1 | -2.5 | 1.8 | 1.6 | 0.2 |
| Unit labour cost | -1.0 | 2.3 | 6.2 | -1.5 | 1.2 | 2.8 |
| Total numbers / stocks | | | | | | |
| Short-time workers, 1.000 | 68 | 101 | 1,144 | 503 | 148 | 118 |
| Temporary agency workers, 1.000 | 614 | 612 | 560 | 742 | 775 | - |
| Employment in manufacturing, 1.000 | - | 7,642 | 7,454 | 7,328 | 7,46 | 7,562 |
| Registered unemployment, 1.000 | 3.760 | 3.258 | 3.415 | 3.238 | 2.976 | 2.892 |

* estimates

Source: Fuchs et al. 2012, pp. 6 and 10-11; IWD 2012, p. 4, and Advisory Group of Leading Research Institutes (*Projektgruppe Gemeinschaftsdiagnose* 2012, p. 22).

Finally it has to be noted that in contrast to other countries Germany entered the crisis not only with comparatively solid domestic fundamentals such as flexibilised labour markets, the absence of a construction and housing boom as well as solid household and corporate balance sheets, but succeeded also soon in overcoming its initial lack of a specified strategy for fiscal consolidation:

“As the previous fiscal rule had failed to sufficiently restrain the build-up in government debt over the past decades, the government introduced a new – also constitutionally enshrined – fiscal rule in 2009, constraining the structural budget deficit to 0.35 per cent of GDP by 2016 for the federal government and requiring balanced structural budgets for the *Länder* by 2020. [...] Based on sound forecasts, the new fiscal rule is likely to help bring public finances back to a sustainable path [...]” (OECD 2010, p. 6 and cf. also p. 3).

In other words, the combination of a fundamentally good shape of the German economy, the initial fiscal stimulus as well as a still rather strong foreign demand for German products particularly outside of the euro zone and the credible commitment to consolidation struck the right balance for recent German economic successes.

CONCLUSIONS

As opposed to many other countries and despite the largest fall of real GDP in the country since World War II, the German economy proved particularly resistant against recent crisis pressures. Obviously, above all the supply-side reforms during the last decade combined with more traditional elements of its Social Market Economy are responsible for Germany's recent boom while much of the euro area's peripheral countries sink back into recession in the struggle to overcome their macro-economic and structural imbalances. Such a situation that was regarded as hardly possible only few positive years before the great financial crisis started. As the acute current crisis in the euro area demonstrates, member states have to find a renewed and more sustainable balance between as much national economic autonomy (and political sovereignty) as possible and as much centralization of economic governance as necessary. This new balance is needed to finally get rid of the current system's weaknesses of which the crisis in the euro zone is to a large extent a symptom only. Economic theory, empirical results and, not least, the idea

that the German experience does have structural policy lessons also for the countries currently in crisis may serve as the basis for some final observations:

Firstly, even if the countries with ongoing current account deficits could not set their optimal interest rates and exchange rates after entering the euro which benefited these countries with much lower real interest rates, their governments could have done much more to avoid the present emergency (cf. Mattich 2011). “[...] the balance of payments current account is the inverse of the capital account. If Germany saves, it then exports capital and thus creates a potential for investment in other countries, so that opportunities for more growth and employment occur there. Similar opportunities arise from unilateral transfers [...] On the whole, [in most current crisis countries] this capital has not been put to productive use” (Hüther 2011, p. 32), , i.e. reasonable investments to create lasting economic growth and employment.

Secondly, at the brink of the break-up of the current euro zone it has to be understood by all member states that saving this area “requires more than a blank check” (WSJ 2011; cf. also Blinder 2011). What is actually necessary is “a new political commitment to better economic policy” (*ibidem*). The recent German successes and their preceding reform efforts can be a guide for at least some of the structural reforms that are needed to lastingly increase the competitiveness of the current ‘sick countries’ in the malfunctioning euro zone.

Thirdly, however, despite of all the merits and lessons, the German experience of the last decade does have, it cannot be a blueprint that could be easily copied in all its respects and, furthermore, has future problems of its own, as the mounting cost of ageing or to pursue ambitious greenhouse-gas reductions while closing down German nuclear plants (cf. e.g. Tilford 2011, Klein 2012 and Johansson et al. 2012). The structural differences among economies with respect to their alternative longer-term comparative advantages, for example, in manufacturing (Germany), financial industry (Britain) or tourism (e.g. Greece) can explain this fact (cf. e.g. Funk 2009a, p. 1310; Hamilton / Quinlan 2008, p. 158; Rürup 2011). Additionally, unless the euro zone starts to build up large surpluses with the rest of the world (which most likely would contribute to new other tensions, e.g. “currency wars” with the United States and China), not all member states of the euro zone can run an

export-oriented growth model simultaneously (cf. Mattich 2011). In other words, the burden of adjustment, i.e. reversing the current imbalances within the euro area at least to some extent, can be distributed in different ways. The adjustment needs by no means be placed entirely on the countries with acute imbalance problems by pursuing extreme deflationary policies. A German policy to raise its future growth with greater reliance on domestic demand than up until now can also contribute to a sustainable rebalancing (cf. Mayer 2011a). What would, above all, sustain economic growth in Germany and trigger it in the rest of the euro area and the European Union, respectively, in the medium term are more pro-market structural reforms. If they will take place in a consistent and credible way, this will be mutually beneficial for economic growth of Germany and the euro zone as well as other nations (cf. Barkbu et al. 2012).

Nevertheless, some of the basic lessons not only of the often positive effects liberalising economic reforms but also of the German experience of pursuing such supply-side orientated measures in practice should – better: have to – serve as a guideline for national reform efforts in the crisis countries of the Euro area to make it acceptable for the Germans not to refute such a rebalancing. A basic precondition for such a German policy change definitely includes that, as suggested by German conventional economic wisdom, ‘reckless’ national fiscal policies have to be monitored and sanctioned in a more credible and effective way than until recently; with the aid of the recent turbulences, finally steps in the right direction have been taken.

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- 1] *The deepening of European Integration also helped to increase German exports especially since the introduction of the Euro: "Germany's export volume grew between 1996 and 2008 twice as fast as that of other members in the Eurozone, while the domestic demand of German private households declined 1.5 percent per year against the rest of the Eurozone" (Young/Semmler 2011, p. 10). In other words, the European vocation of Germany – with Europe being still Germany's largest export market, while the rest of the world increasingly becomes more important – has been particularly important because losing open markets means great risks for Germany precisely because of its strong European and international economic involvement. Even prior to the sharp cyclical breakdown of the German current account surplus as a result of the recession of 2009 (cf. Young/Semmler 2011, p. 9), it was well-known: "A world economy collapse has possibly dramatic consequences for many branches. Many of them could not live with their present size just on their local sales" (Eibner 2006, p. 14).*
- 2] *It can be noted in this context that the independence of the central bank of the government – a basic ingredient of the traditional SME to achieve low inflation – is supposed to ensure that the bank's governors are not tempted to reach better employment figures with lower inflation, only to find out after some time that the improvement was short-term while the social cost of higher inflation will last.*
- 3] *Furthermore, recent research has detected empirical evidence according to which the popular belief that labour market reforms imply a beggar-my-neighbour policy appears to be misleading. Felbermayr, G./Larch, M./Lechthaler, W. (2012, p. 5) find "that domestic labour market reforms reduce not only the domestic unemployment rate but also the unemployment rate of trading partners. ... Thus, our analysis does not confirm the view that the Hartz IV reforms hurt Germany's European trading partners".*
- 4] *This is because, by whatever the case in detail, the export of goods and services is accompanied by a similar export of capital and thus the revenues from the German export surplus will have to be invested in the importing countries with the export deficit. If such a process is ongoing, there may not only emerge a situation of too low investment and a resulting shortage of jobs in the exporting country. Even worse, the countries with chronic balance of trade deficits will pile up ever more debt and interest payments against the exporting trading partner. This may end up in insolvency of the country with chronic deficits which is neither in the interest of the former nor of the creditor country because the investors of the latter country would ultimately be stuck with their bad loans. (cf. Suntum, pp. 177-83).*
- 5] *The rule that too large budget deficits will have to be punished is regarded as a return to the basic principles of a functioning euro area by a large majority of German mainstream economists (cf. a basic analysis of the stability and growth pact Owen Smith 2008, pp. 293-297; cf. a recent debate of the German-inspired "stability culture" in the euro area Schäfer/Gregosz 2012).*

However, apart from the looming future resource crunch due to, above all, the rising costs related to the ageing of society (cf. e.g. Paterson 2011, p. 48) especially the recent public debt emergency put pressure on the euro area members to implement "debt brakes" which will allow only marginal budget deficits in the future which is in line with the German mainstream view. The additional German mainstream point of view that "financial innovation is to be throttled by regulation" (Plender 2012) is based on a core idea of German Ordnungspolitik (economic governance of framework conditions) that an indispensable counterpart of the freedom of contract is the principle of liability for one's actions. This principle may be hurt when financial institutions are bailed out by the government despite of huge losses to avoid negative externalities on the economy as a whole ('systemic risks') (cf. Hüther 2009; cf. also Funk 2011b, p. 44). Furthermore, one must not forget that the rule that we must stop excessive risk-taking by appropriate measures is by no means limited to German mainstream economics but accepted also by many economists in the English-speaking world (cf. Wren-Lewis 2010, pp. 73-75).

- 6] *In order to ensure overcoming the currently still unbearable imbalances in the euro zone, it is necessary to ensure the future sustainability of public debt in all member states. If debt sustainability is endangered, only four possibilities exist to mend the situation. First, consolidation of budgets combined with sweeping structural reforms to increase the flexibility of a previously often strictly regulated supply side to achieve higher economic growth lastingly. Three further options to resolve the basic problems if the optimal option one cannot be implemented appropriately are: Second, transfers of other states to pay foreign debt at the expense foremost of tax payers in creditor countries. Third, bankruptcy of a state that cannot repay sovereign debt which implies that foreign investors will have to bear the resulting cost. Fourth, increased inflation (or 'financial repression') which, amongst other things, effectively lowers real interest rate returns for savers. This last option decreases public debt in a way that spreads the costs mainly onto consumers and tax payers of the countries with (unexpectedly) increased inflation rates relative to returns on savings (cf. Projektgruppe Gemeinschaftsdiagnose 2012, p. 2 and pp. 66-68).*
- 7] *This effect of Germany being perceived as a "safe haven" for foreign investors especially from euro area countries in crisis has led to low yields for its sovereign bonds as a result of significant capital inflows which is, however, by no means entirely positive in economic terms. This is despite of the fact that borrowing costs have fallen for the government, companies and home buyers. Because at the same time, for example, the savers in Germany have suffered big shortfalls in real income due to very low real interest rates. The latter appears to have provoked "a 'hunt for yield' among German investors that could sow the seeds of future instability in the financial system" (Smith/Lawton 2012).*
- 8] *Details will not be discussed here as the focus of this paper is foremost on factors directly related to Germany's labour market (cf. OECD 2012, p. 14). It has to be noted in this context, however, that "the crisis in the real economy was accompanied by a banking crisis, not least due to earlier investments by German banks in foreign assets linked to the US housing market, requiring substantial government intervention to safeguard financial stability" (OECD 2010., p. 3). Despite of the fact that other fundamentals appeared to be comparatively solid, the solidity of external lending was in doubt among several commentators within Germany and especially abroad. Furthermore, official deficit figures do not include implicit public debts such as, for example, future payments resulting from entitlements based on longer-term contributions to social security systems and potential future German risks due to implicit financing of peripheral countries by the European Central Bank (so-called Target debt). In*

other words, the official deficit figures in table 4 hide several economically important facts. The leading German economist Hans-Werner Sinn estimated the actual figure of 2010 at 12.8%, for example. "Why is this figure so large? Basically as a result of the bad banks that were set up to rescue the German banking system and because so-called toxic assets were taken over by the government in exchange for government bonds. It is claimed that these toxic assets have the same value as the government bonds, so they do not contribute to the deficit" (Sinn 2011, p. 14).

- 9| Based on past experience the effectiveness of such recovery programs often is poor only, amongst other things, because of small expansionary effects (small fiscal policy multipliers; see on this in general Funk/Voggenreiter/Wesselmann 2008, pp. 179-188), because such programmes often do not resolve the problems they are supposed to tackle and because they may create new problems (e.g. through piling up public debt over time).

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