Before the German giant falls on his sword

Bob Hancké*

This article will appear in German in the September 2005 issue of *Die Mitbestimmung*

Reading a newspaper, listening to the news, talking to German students, friends in government and the trade unions, or flipping through the pages of a document from the European Commission, the OECD or the ECB, you get the impression that Germany is a country on its knees. Economic growth is lower than ever before, everyone seems to agree that there is an innovation crisis, and against the background of soaring government debt that made the country break the Stability and Growth Pact, unemployment refuses to fall. If you were looking for evidence of economic collapse, you are not wasting your time.

But few observers –political, academic and otherwise—take the time to enquire what's behind these tragic data and how they square with other facts. Export figures are fine: Germany has been the world's largest exporter in volume for a few years now, and there is no sign that this enviable situation will deteriorate any time soon. The recent claims that Germany is a 'bazar-economy' that puts a *Made in Germany* label on inferior imported goods and exports those, are the type of nonsense that can only come from economic observers who have clearly never seen a German company from the inside: export success means nothing less than that German firms still produce the high-quality products and services that are wanted everywhere else on the globe and have got better at doing so over the last decade. True, unemployment is high on aggregate, but what many ignore is that unemployment rates vary widely across different regions in Germany, in the east as well as the west of the country. In fact, the regions in the south of the country, where the old German model of high-quality products made by well-paid, highly-skilled workers, consistently have an enviably low unemployment rate, even by British or American standards. And the trade unions, often held up as the culprit in the story of the German demise, have been very careful in setting wages and negotiating more labour market flexibility to accommodate companies. Since the mid-1990s, they have accepted that the old standardised collective agreement (the *Flächentarifvertrag*) may not be the best way to set wages in an economy

* The author thanks his colleagues Manuel-Palazuelos-Martinez, Waltraud Schelkle, David Soskice and Sotiria Theodoropoulou for discussions on the topic of this paper.

where international competitiveness matters, and have started to introduce local variation to reflect the different positions that companies may be in.

How do we make sense of these different facts? The dominant interpretation among politicians of Left and Right, central bankers, economists and the financial press is simple: what still works well does so because it has not started to go wrong yet. Fundamentally, the German economy is hamstrung by a set of institutions, primarily in the labour market, and at some point in the near future, the entire German economy will inevitably collapse as a result. If the country does not deregulate its labour market institutions today, it will pay a big penalty tomorrow.

Yet deregulating the labour market may not be the panacea that it is held up to be. First of all, institutions such as labour law, trade unions, and centralised collective bargaining have been around for a long time, and many of them have been at the root of economic success in Germany in the past. The changes that have taken place in the last decade, such as globalisation and economic integration in Europe, should not have undermined but helped the German economy: if you produce for an expanding market, you export more products and services; if you export more, you need more workers and your employment rises. The counterargument to this is that under the wage cartel organised by the trade unions, everyone who wants to work is priced out of the market: many unfilled positions and few takers for the jobs. Looking across the border demonstrates why this argument is so weak. Unemployment is low in many European economies that have a broadly similar type of labour market regulation as in Germany: Denmark, the Netherlands, Austria, Sweden may have very low unemployment figures but these economies are by no means close to the textbook ideal of the deregulated labour market that figures so prominently in the prescriptions to solve Germany's ills. Wages are set by strong trade unions, workers have strong legal rights exercised on their behalf by unions, and unemployment benefits are high. In fact --a puzzle very few economists who advocate deregulation care to address-- if labour market institutions were at the basis of the economic problems in Germany, export performance would show a similar downward trend, because they would both reflect the same underlying problem of rigid supply-side institutions.

One of the best-kept secrets in contemporary economic analysis is that the link between unemployment performance and labour market institutions is tenuous at best, and probably so weak that it should not figure as prominently in the list of policy advice as it does. We increasingly realise that for labour market reforms to have any effect, lots of other changes in economic policy need to take place as well, particularly in the macro-economy. Without an expansion of aggregate demand, unemployment is bound to stay high for a long time. Look at the UK: it took that country almost ten years after the Thatcher reforms of the mid-80s, a significant devaluation of the Pound, and a reorganisation of the macro-economic framework to stabilise aggregate demand, before the unemployment rate began to fall. Unemployment in the Netherlands fell primarily because the country adopted a broad strategy to make unit labour costs rise more slowly than in its biggest trading partner (Germany) in the 1980s and 1990s. The boost in Dutch competitiveness translated into more exports, of goods, of services …and of unemployment. Labour market reforms were at best a side show to improved employment performance in these two countries, and what may be a feasible strategy for a small open economy like the Netherlands is probably less feasible for a large one like Germany.

If the standard story is, despite the virtual consensus among policy-makers and academics, not that convincing after all, how then can we make sense of the German predicament? There are two mutually reinforcing candidates for that: one that explains the high unemployment rate through low private demand in Germany, another that looks at the shifts induced by EMU as an explanations.

An interpretation of the problems in the German economy that is gaining currency, tries to understand the issues in terms of the interaction between the skills of the typical German employee, and the increased uncertainty as a result of rising unemployment and deregulation policies. German workers have skill profiles that are bound to an occupation in a specific industry. Career structures in German companies reflect the need of employers to hold on to these skills: the longer you work in a company, the higher your wage, and the more social rights you have. On the whole, German workers therefore rarely move to take up jobs in other companies. At the same time, rising unemployment in Germany and government policies such as Hartz IV that reorganise the unemployment system, increase the uncertainty of these workers. If they lose their job, the chances of finding a similar job with the same wage and benefit levels are small. Thus, faced with the need to hold on to their job in order to maintain their standard of living, and an increased risk of becoming unemployed (and facing harder sanctions if they do), employees and households save more, inducing, in Keynesian textbook fashion, a sharp drop in domestic consumption and economic growth, and increasing unemployment.

The EMU-related argument has different sides to it. The sustained restrictive macro-economic policies since 1991 are one: the Bundesbank after unification and the Maastricht criteria in the run-up to EMU produced a monetary and fiscal contraction at a time that the German cycle was, to put it mildly, not at its strongest. The effect was a sharp rise in unemployment.

EMU and the Stability and Growth Pact 'constitutionalised' this restrictive macro-economic regime, leaving little hope for a fall in unemployment in the short term.

More importantly, perhaps, EMU also robbed Germany of the advantages it had over the other European countries with whom it trades most. Before EMU, Germany had one of the lowest real interest rates in Europe. Because of the high productivity in the economy and the anchor position of the Deutschmark in the Exchange Rate Mechanism, it also had the lowest real exchange rate in Europe. After EMU that changed dramatically: the ECB's interest rate is the same for all, but inflation rates in EMU member-states are significantly higher outside Germany. The implication is that the real cost of capital is considerably lower outside Germany today –in fact, given the ECB's interest rate policies, countries with inflation rates around 3% frequently face *negative* real interest rates. Something similar happened to the cost of labour. Many countries discovered that one of the fastest mechanisms to bring domestic inflation in line with the Maastricht criteria was to shadow German unit labour costs. The effect of this was simple: as the Maastricht process drew to a close, wage-setting everywhere in Europe reflected German wages, thus undermining the labour cost (and real exchange rate) advantage of the German economy entirely. Moreover, as if to add insult to injury, companies in EMU member-states have adapted by moving up-market, often in market niches where German companies were alone only a decade ago. In short, the Germans are discovering a simple but painful lesson: if you force everyone to become like yourself (as EMU seems to have done), you lose the advantages you may had over them.

The problems in the German economy today are an expression of the slow adjustment to this new, partly self-inflicted situation, and it is not easy to think of ways to get out of it. What is obvious is that looking at the labour market alone is not going to solve the German problems. But you cannot realistically deregulate the banking system so that people can borrow more easily and thus prop up demand either, and leaving EMU is, at least for the time being, not a particularly wise idea given the political implications for European integration. Before we throw up our arms in despair, however, we should remember that this is, in the recent history of the country, not the first time that Germany faces a profound challenge. As in the past, the country will reappear wiser and stronger. And as in the past, the institutions at the basis of German economic success will probably prove sufficiently flexible and strong to steer that adjustment –again.