CAN GERMANY BE AN EXAMPLE FOR THE CRISIS COUNTRIES?

di Fabian Lindner

Austerity, wage restraint and more competitiveness for everybody – this is the prescription of German policy makers to today's crisis countries like Greece, Ireland, Portugal, Spain and Italy. Germany has applied similar policies in the first half of the 2000s and now high growth rates and low unemployment seem to be the results of those polices. However, if one reviews Germany's economic policies since the euro's introduction in 1999, one finds that growth was strangled by austerity and labour market reforms. Further, the heavy reliance on exports due to Germany's high competitiveness meant (and still means) that Germany directly profits from the debt induced growth in its export partners, i.e. the exact policies that the German government now renounces as irresponsible. Further, Germany's good economic performance since the 2008 financial crisis is not due to austerity or labour market reforms but to expansionary fiscal policies and a reduction in hours worked.

In this article, it will be shown that German economic policies until the 2008 crisis did only work because Germany's European trade partners were pursuing the exact opposite policies. Germany's insistence that other countries have to copy German policies is based on the fallacy that all countries can increase their relative price competitiveness.

Austerità, moderazione salariale e competitività per tutti: questa è la ricetta dei decisori politici tedeschi per i paesi in crisi come Grecia, Irlanda, Portogallo, Spagna e Italia. La Germania ha applicato politiche simili nella prima metà degli anni 2000, e il risultato sembra oggi esserne alta crescita e bassa disoccupazione. Tuttavia, se si guarda alle politiche economiche seguite dalla Germania a partire dalla introduzione dell'Euro nel 1999, si constaterà che la crescita fu soffocata dall'austerità e dalle riforme del mercato del lavoro. Inoltre, la forte dipendenza dalle esportazioni dovuta all'alta competitività ha significato (e ancora significa) che la Germania si avvantaggia della crescita da debito dei propri partner commerciali, cioè proprio quelli che ora la Germania denuncia come irresponsabili. La buona performance economica tedesca dalla crisi finanziaria del 2008 non è dovuta dunque alla austerità o alle riforme del mercato del lavoro, ma a politiche fiscali espansive e alla riduzione delle ore lavorate.

Nell'articolo si mostrerà come le politiche economiche tedesche fino al 2008 hanno funzionato solo perché i partner commerciali europei della Germania hanno adottato politiche esattamente opposte alle sue. La insistenza della Germania nel pretendere che altri copino le sue politiche è basata sulla fallace convinzione che tutti i paesi possano incrementare la propria competitività relativa di prezzo.

1. Germany's economic performance under the euro

Let us begin with reviewing Germany's economic performance since the beginning of the Eurozone. It has been very weak. With average yearly growth rates of 1,7% between

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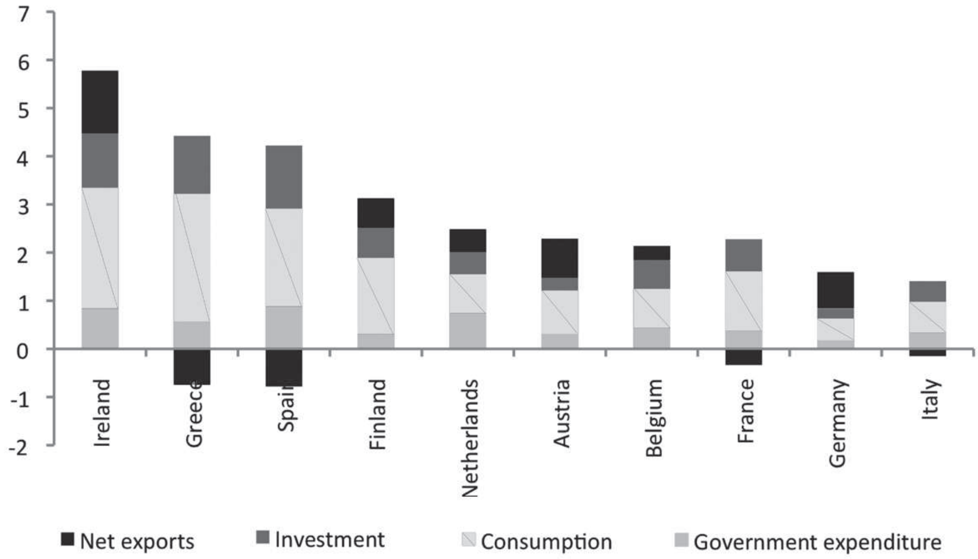
1999 and 2008, Germany had the second lowest growth among all Eurozone members, only followed by Italy with an average growth of 1,5%. FIG. 1 shows average growth rates and the contributions of the different GDP components to growth. One can see that Germany's economic performance stands out in that it is the only Eurozone country in which growth has mostly been driven by export surpluses and not by domestic demand (i.e. investment, government expenditures and consumption).

Figure 1. Average GDP growth rates, 1999-2008



Source: AMECO; own calculations.

With export surpluses an economy is constantly exporting more than it imports. However, in the world economy all imports have to be equal to all exports – there cannot be an export without an import and vice versa. An export surplus is thus only feasible if other countries have the balancing export deficits, i.e. a country or a group of countries can only export more than they import if other countries are importing more than they export.

This is exactly the root of the crisis: countries can only import more than they export if they get the credit to do so. Long lasting export deficits lead to increasingly higher foreign debts; on the other hand, countries that have constant export surpluses accumulate financial savings – which are the counterparts of their trading partners' foreign debts. This is why German banks are now one of the biggest creditors of today's crisis countries.

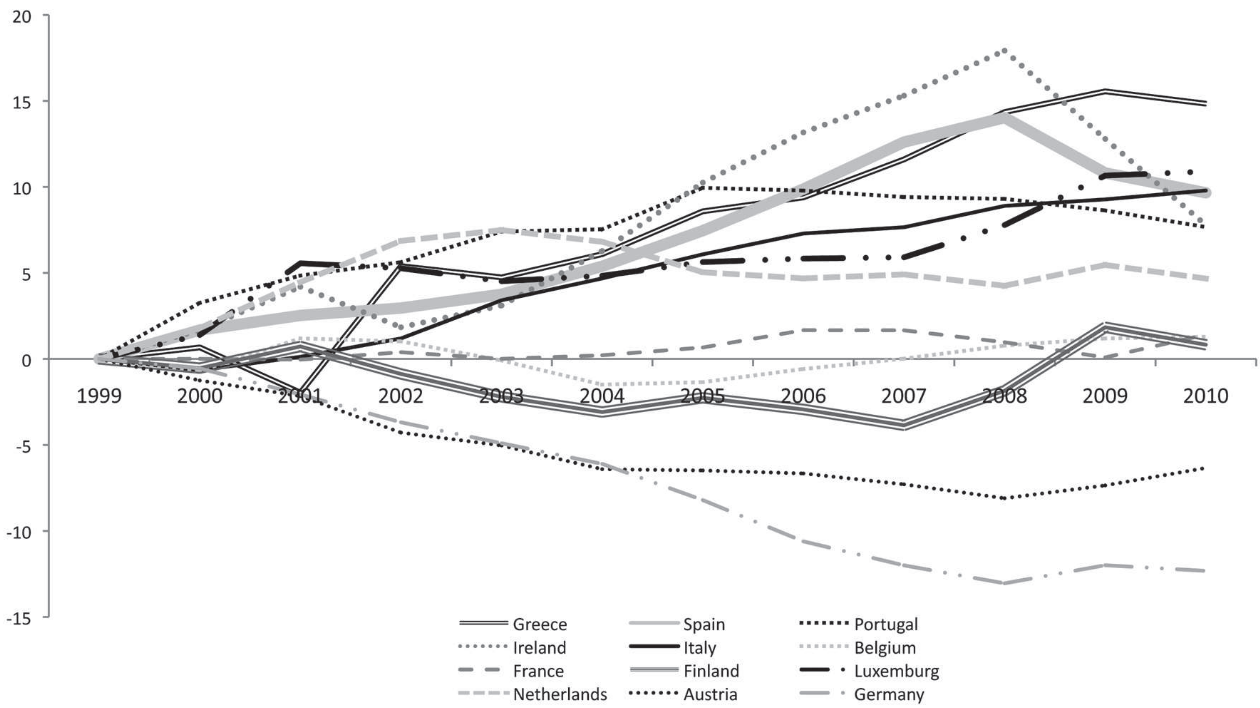
In German policy circles and public opinion, the crisis countries are blamed for their reckless spending. But it is often overlooked that their past trade deficits were only feasible because the German economy registered the balancing trade surpluses and German banks provided much of the financing for the deficit countries.

Like trade, financing and credit is a two-sided affair. A country can only export if others are willing and able to import; a country can only borrow if others are willing to lend. If a country imports and borrows at an unsustainable level, another country exports and lends on an equally unsustainable level. Why did Germany export and lend so much and imported so little?

2. Germany's increasing competitiveness

Germany's trade surpluses are due both to its weak internal demand – leading to low imports – and its strong exports. Both factors can be explained by the stagnation of German wages and unit labour costs. Unit labour costs are wage costs divided by productivity, productivity being the average amount of output produced by a worker. The more a worker produces relative to his labour costs, the lower are production costs per unit of output – i.e. unit labour costs decrease. Since labour costs are an important cost component of production, an economy's unit labour costs influence the economy's price level. Changes in unit labour costs lead to changes in price levels.

Figure 2. Nominal unit labour costs growth relative to Eurozone mean

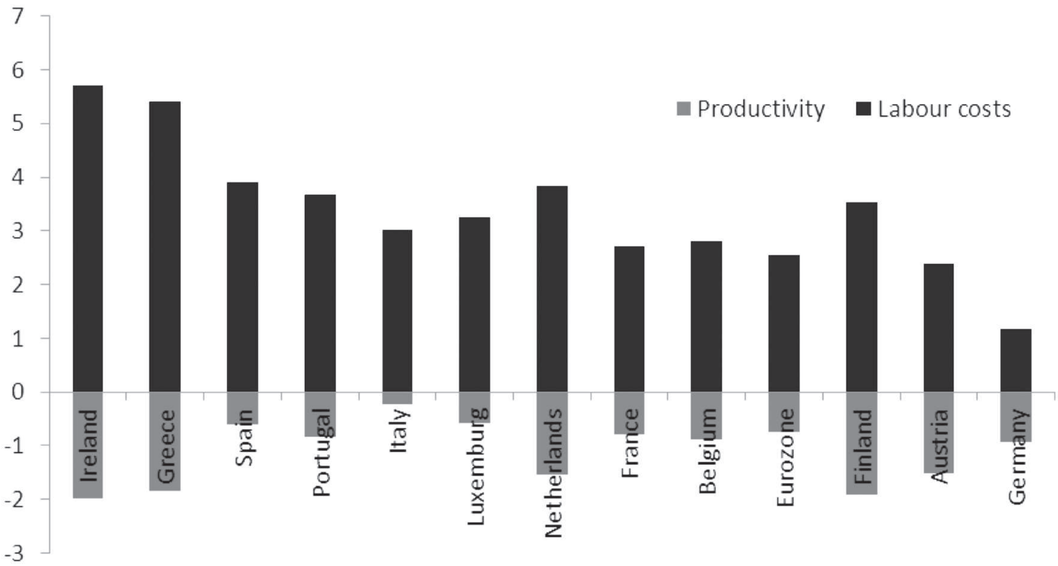


Source: ameco.

With the Euro as a common currency differences in unit labour costs directly influence price competitiveness among a currency union's members. Before the Euro, the adjustment of exchange rates between the different currencies could still counter divergences in national unit labour costs and price levels. As one can see in fig. 2, since the Euro's introduction, German unit labour costs have decreased strongly relative to the other Eurozone countries, thereby massively increasing its price competitiveness.

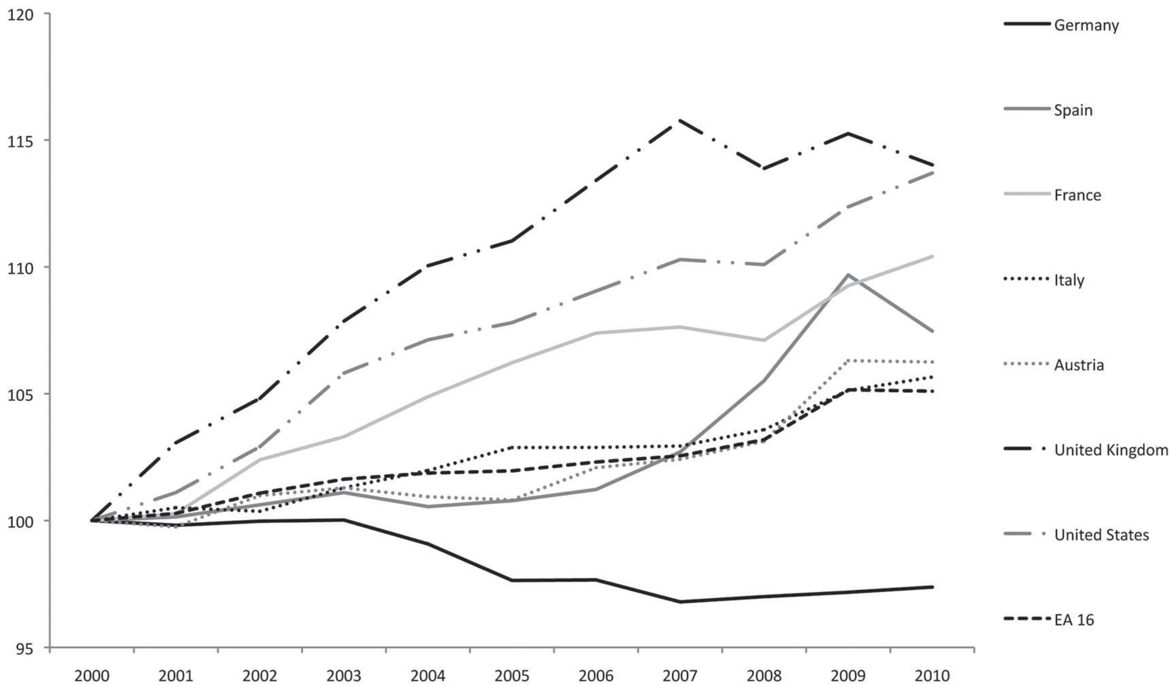
What drove the fall in unit labour costs? While it is possible that strong increases in productivity led to decreases in unit labour costs – e.g. due to a high of innovation – , this was not the case in Germany (fig. 3). While Germany's growth of labour productivity was a little below average, the main dampening factor on unit labour costs has been overall labour costs (labour costs are wages plus social security contributions). Indeed, from 2000 to 2010, average real wages have decreased by 2,6%. Germany is the only country among all OECD countries that actually saw a drop in real wages (FIG. 4). The low real wages in turn depressed consumption and thus imports.

Figure 3. Contribution of productivity and labour costs to unit labour cost changes, 2000-08



Source: AMECO; own calculations.

Figure 4. Real compensation per employee, 2000 = 100, deflated by private consumption deflator



Source: AMECO.

The central question then is what lay behind the fall in German wages? There are different factors at play. Those are the German labour market reforms, an eroding system of collective bargaining and government austerity. Both labour market reforms and government austerity in times of an economic downswing were being implemented under a social democratic / green coalition that governed from 1998 to 2005.

3. Labour market reforms without minimum wages

The German labour market reforms are called the "Hartz" laws, named after a former manager at the German car manufacturer Volkswagen (for more details on the reforms, see Kemmerling, Bruttel, 2006). Labour market reforms were explicitly aimed at increasing the low paid sector so as to give more "unqualified" workers jobs, albeit at very low wages. The reforms liberalised certain forms of employment and drastically cut unemployment insurance[1]. Employment protection was not directly weakened but more flexible forms of employment were strengthened, especially agency work and part-time so called "mini-jobs".

The use of agency work had been restricted before the reforms so that firms could use them only in emergency cases, i.e. peaks in production. After the reforms however, it became easier to employ agency workers also in regular production. This weakens core workers' bargaining position since they can be more easily replaced by agency workers. Indeed, since the reforms, agency employment is the form of employment with the highest growth rates.

Another employment form was also strengthened, the so-called "mini-jobs". Those are jobs that pay 400 € a month with reduced social contributions. While this is a flexible form of employment that was mostly directed at students or pensioners that want to gain some extra money, this form of employment is also widely used for part-time work, mostly for women in the service economy.

On the other hand, the access to unemployment insurance was massively tightened. Before the reforms, workers profited from a maximum of 32 years of unemployment insurance (depending on their years of contribution) at a replacement rate of 60% (somewhat more for families with children). Then they would fall into unemployment assistance at a replacement rate of 53%. Only those workers would receive social assistance that did not contribute to social security before their unemployment.

The Hartz reforms abolished the unemployment assistance altogether and shortened the time of unemployment insurance to only one year after which workers would fall into

[1] One has to add that the red-green government also implemented a pension reform that drastically cut benefits from the public pay-as-you-go pension system and introduced a subsidised private pension system, the so called "Riester"-pension. It is likely that the reform and the ensuing uncertainty about future pension levels led to a rise in the German saving rate which further depressed consumption. Further, the distributional consequences of the reform are dire: Since labour market reforms have massively increased the low pay sector, the cut in pension levels will hit future pensioners from the low pay sector double. Since they do not pay high contributions due to their low pay jobs and cannot save privately, they will be poor when they reach their pension age. Germany will then transform from a country that has almost eradicated old age poverty to the group of OECD countries with the highest levels of old age poverty. The OECD (2009b, p. 38) writes: «[…] net replacement rates are less than 60% in Germany, Japan, Mexico and the United States. Bearing in mind that this calculation is for a low earner, the earnings being replaced are already half of the economy-wide average: old-age safety-nets in these countries are relatively weak. Once a spell of late-in-life long-term unemployment or early retirement is also factored in, retirement incomes can be lower still. With weaker labour markets, many older workers may be forced to retire early or suffer long-term unemployment».

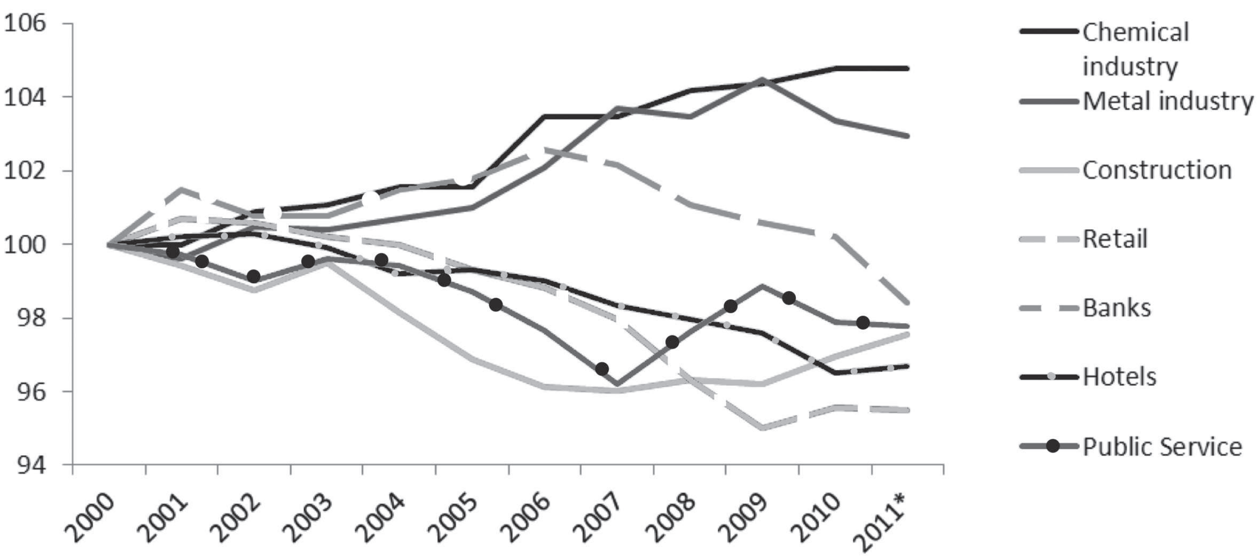
social assistance, thereby threatening the unemployed with poverty. All those reforms were implemented without introducing minimum wages. The high pressure on workers at the lower end of the pay scale means a strong pressure on their wages. Since there are no minimum wages, wages have no downward limit.

It is important to note however, that workers with very low wages receive additional social assistance to maintain a certain income minimum. But employers are using those rules to cut wages and let tax payers subsidise low pay jobs. This was intended by the reformers since they operated under the assumption that Germany's unemployment problem was mainly a problem of too high wages in the low pay sector.

Additionally, the conditions under which unemployed would get social assistance were tightened so that they have to take all jobs at almost every wage. Both the shortening of unemployment insurance coverage and the tightening of conditions for social assistance put massive pressure on the unemployed but also on the workers still employed. Those fear that they fall into poverty once unemployment hits them. Again, their bargaining position is drastically weakened by the reforms.

A third factor that put downward pressure on wages is the steady erosion of worker's collective bargaining coverage since German reunification. Today, only 63% of workers are covered by collective bargaining arrangements, compared to almost 100% in Austria, Belgium or France. This weakens unions who bargain for an increasingly smaller part of workers under the conditions of tightened welfare programs and liberalised forms of employment.

Figure 5. Negotiated wages relative to mean negotiated wages



Source: WSI Tarifarchiv.

The pressure on wages has been especially fierce in the domestic service economy where bargaining coverage is the lowest and the highest proportion of low-skilled workers are employed. Further, low domestic demand put pressure on the employment of workers in the domestic economy. On the other hand, workers that worked in the export sectors saw their wages increase. FIG. 5 shows negotiated wages by industry relative to the mean of negotiated wages.

One can see that workers in the chemical industry and in the metal industry had the highest increases in wages relative to all negotiated wages. Both sectors produce most of Germany's exports. On the other hand, service industries like retail, hotels and construction had very low increases in negotiated wages. The public service also saw a decrease of its relative wage position.

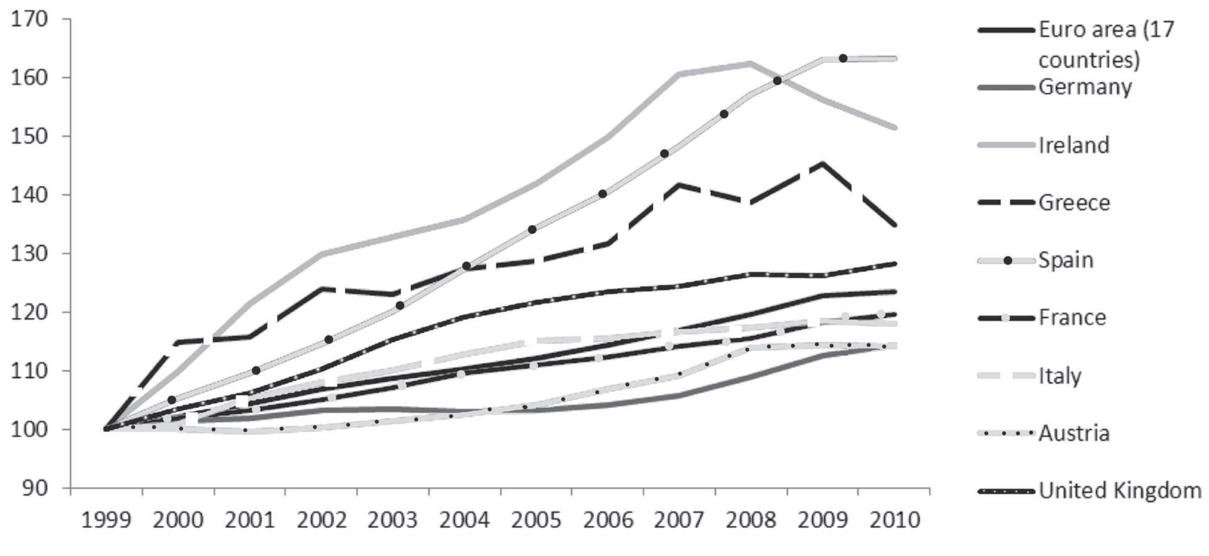
On first sight, the increase in negotiated wages in the export sectors could be interpreted as a refutation of the strong increase in German competitiveness. However, this would be a false conclusion. The export industry uses inputs from the service sector so that wage stagnation in those sectors leads to lower costs for exporters, thereby making it easier for them to lower costs. Further, the exports sector's productivity rose more strongly than wage costs so that this sector's unit labour costs also decreased (Niechoj *et al.*, 2011).

As one can also see in FIG. 5, public services – along with construction – had the worst development in negotiated wages. This already hints to another reason for low internal demand, namely restrictive fiscal policies by the government.

4. Cutting taxes and expenditures: German fiscal policy

In 2001, the red-green government drastically cut income taxes, the top rate dropping from 53 to 42%. Corporate taxes were also cut. This led to decreases of tax income by roughly 50 billion € or 2% of German GDP every year since the tax cuts. On the other hand, the government wanted to maintain the Maastricht criteria and thus began to cut spending in the face of falling tax revenues (Vesper, 2007).

Figure 6. Real government consumption, 1999 = 100



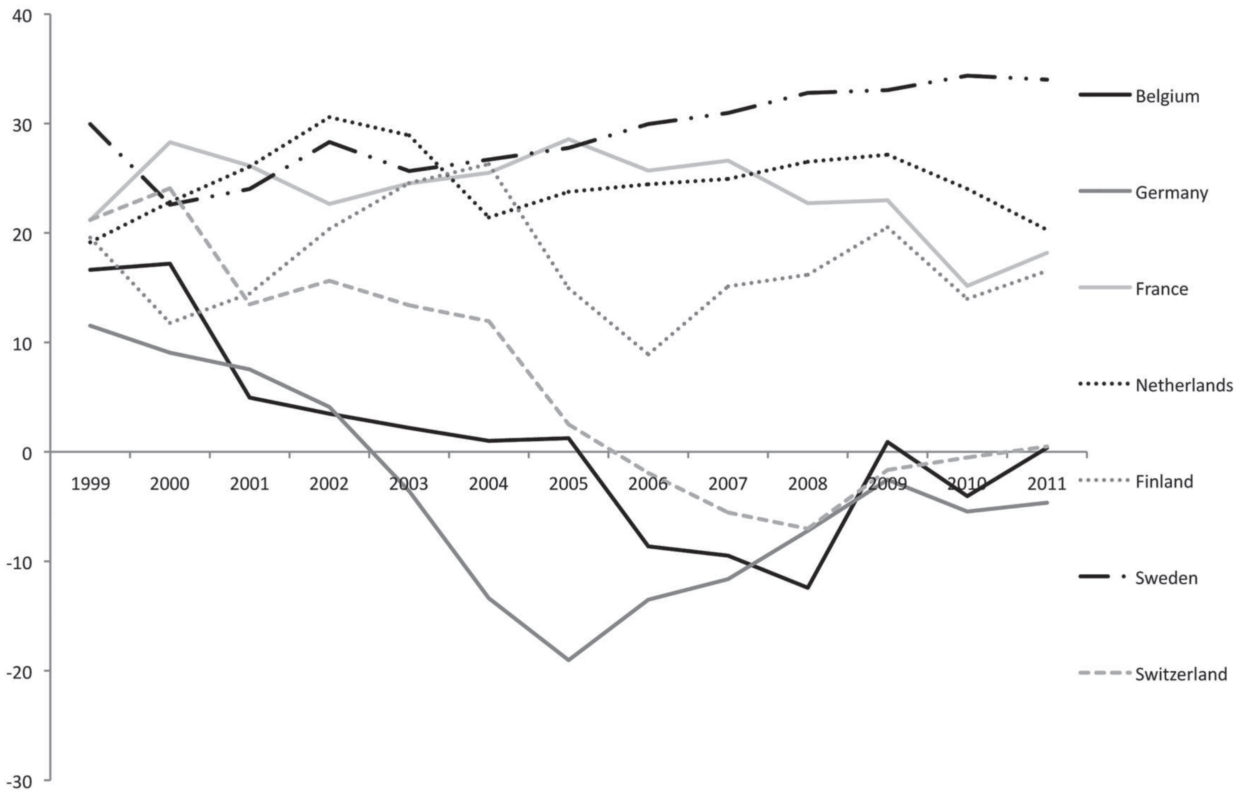
Source: AMECO; own calculations.

This deprived the economy of important demand by the government in a time when the German economy would have needed a stimulus most. In 2000 the internet bubble had burst all around the world, leading also to an economic downturn in Germany (Hein, Truger 2008). The tax cuts did not help to stabilise the business cycle since they were mostly directed at the top earners with high savings rates; the reduction in expenditures to reduce the deficit directly led to declines in growth. Hein and Truger (*ibid.*) show how that policy weakened German growth compared to other countries like the United Kingdom or France that did not pursue restrictive policies after the 2000 crisis.

FIG. 6 shows the development of real government consumption in comparison to other Eurozone countries since 1999. One can see that government consumption only rose very slowly, actually less than GDP. This led to a decrease of government expenditures in percent of GDP. The slow growth in government consumption was due both to the stagnation of public sector wages (FIG. 5) and a reduction in public sector employment (Holm-Hadulla *et al.*, 2010; Vesper, 2012). However, not only did government consumption virtually stagnate, government investment was heavily cut (Vesper, 2007). The cuts in government investment led to negative net government investment, i.e. a decrease of the public capital stock (FIG. 7).

Although the German government did strangle domestic demand by cutting government expenditures, the tax cuts from which mostly the rich profited made sure that Germany was nevertheless not able to fulfil the Maastricht criteria of a public deficit of 3% or lower from 2001 until 2005.

Figure 7. Net government fixed capital formation in Billions of Euro



Source: AMECO; own calculations.

5. The consequences: rising inequality

Contractive fiscal policy, tax cuts for the rich, labour market reforms without minimum wages and a decline in collective bargaining led both the fall of real wages and a massive increase in inequality. Since 1998, the poor have become poorer and the rich have become richer. The average fall in real wages is mostly due to the fall of the poors' real wages. The share of the low-pay sector (less than 9 € per hour) in overall employment has strongly increased from 15% in 1998 to 22% in 2005 and hasn't fallen since (Kalina, Weinkopf, 2010). It is now close to the size of the British low-pay sector but with one difference: without minimum wages, there is no bottom for German wages. This shows that people with low income have been most struck by the economic policies in the last decade. Tax cuts and pressure on the poor had their logical consequence: nowhere in the OECD did inequality increase as much over the last ten years as it did in Germany (OECD, 2011).

6. Germany's experience in the crisis

Many commentators now assume that the German policies described above are behind Germany's strong economic performance both in the financial crisis after 2007 and today's euro crisis. However, this is not the case. In the crisis, the German government – a grand coalition of social democrats and Christian democrats – pursued policies that were the exact opposite of the policies pursued up until the crisis and those now prescribed for the Eurozone crisis countries (Herzog-Stein *et al.*, 2010; Leschke, Watt, 2010). First, employment was kept stable by reducing working time and second, the government pursued very expansionary fiscal policies.

In 2008 Germany's GDP declined by 5,1% due to the financial crisis. This was the largest decline of GDP in Germany's post-war history. However, while employment declined drastically in all countries hit by the crisis, German employment staid stable and even increased a little. Was that due to German labour market reforms?

The German labour market reforms were aimed at making the labour market more flexible in increasing the employer's ability to hire and fire more easily ("external flexibility"), e.g. by increasing and reducing agency work when necessary. Indeed, in the crisis agency work has been drastically cut. If even more segments of the labour market would have been flexible in this sense, more workers would have been fired and employment would have fallen.

This was for instance the case in Denmark which until the crisis was hailed as a model country for "flexicurity", i.e. an employment model in which workers can easily be laid off but then receive high unemployment compensation. Low employment protection led to strong decreases in employment in Denmark but also in the United Kingdom and in Spain. Those countries also have labour markets that are highly externally flexible (Leschke, Watt, 2010; Tangian 2010).

In Germany however, instead of laying off workers, employers kept workers employed. To do so they reduced working time; workers staid employed but worked less hours. The flexibilisation of hours worked ("internal flexibility") was not an item of the Hartz reforms or other German labour market reforms. The reduction of working hours was due to three working time reduction instruments: government short time work, the reduction of regular negotiated working time and the use of working time accounts.

The government short time work program is a government program that exists since before the First World War. In economic downturns, the government subsidises the decrease in monthly pay due to shorter hours worked. The instrument has been used in almost all economic downturns in Germany's after-war downturns and was no topic whatsoever in the discussion leading to the Hartz labour market reforms (Herzog-Stein *et al.*, 2010).

However, both the reduction of negotiated working time and the use of working time accounts are relatively recent. Both are established by laws but negotiated between unions and employers. Before the crisis, unions and employers had negotiated that regular working time can be increased or decreased within a certain corridor depending on the state of the economy, thereby increasing working time in times of boom and decreasing it in times of lower economic activity. Working time accounts function similarly. Workers that work more in boom times can build up working time accounts which they can reduce in times of economic stagnation.

All those instruments facilitate flexible working hours and thus smooth employment over the business cycle. This allowed Germany to weather the crisis without employment losses. However, it is important to note that those instruments do only exist in the sectors of the labour market that are still strongly unionised, i.e. the export sector. Since the economic crisis mostly hit the export sector – due to the sudden stop of imports by other countries – those instruments of working time reduction could be easily used.

Additional to short time work, the government also pursued strongly expansionary fiscal policies by both cutting taxes and social contributions and by increasing cash transfers to households (for instance, the "cash-for-clunkers" program that subsidised the purchase of cars in order to strengthen the car industry that was hard hit by the recession and amount directly and indirectly for a large part of the German economy). Public investment was also increased (see FIG. 7 in which net government investment is still negative but less so than before the crisis; OECD, 2009a). Ironically, it needed a deep economic crisis to increase government investment in order to halt the depreciation of the public capital stock.

In sum, those policies were extraordinarily effective in maintaining employment and jumpstarting growth and thus overcome the crisis. Germany's good economic performance now is due to its maintenance of domestic demand when exports were hit by the crisis. But as is also evident, those policies were the exact opposite of what happened before the crisis.

7. Implications for other countries

Before the crisis, Germany lived off export surpluses and thus the willingness of its trading partners to run trade deficits that led to ever higher debts by those countries. Indeed, in the face of a stagnating domestic economy and a decrease in real wages, an economic and social collapse in Germany was only averted by other countries' willingness to keep purchasing German goods. The credit to do so was also extended by German banks (French banks are also among the biggest creditors of today's crisis countries). Due to the stagnating German economy, credit demand by German companies and private households was flat (Bundesbank, 2006). So banks readily lent to governments, households and companies abroad.

Thus, the only strong impulse for growth came exactly from those countries that German public opinion and the government now mark as over spenders; and from which the German government now demands to do what Germany did in its long period of economic stagnation – but in a much more radical way than Germany did. As has been shown by the evidence above, German policies did not lead to an economic boom but worsened the economic downturn that began in 2001.

However, there is a crucial difference between Germany's economic environment in the last ten years and today's crisis countries' situation. Whatever crisis countries now do to increase their competitiveness – and they are already drastically cutting wages and costs – there are fewer and fewer countries out there willing and able to buy those now more competitive goods and services. A high degree of competitiveness is worthless when demand for the products is simply not there.

The new European rules which demand every country simultaneously to save more and improve competitiveness will exacerbate economic and social problems in the crisis countries and drag the whole euro area into economic crisis. It is unlikely that the US or China will be willing or able to make up the loss of demand that Europe has inflicted upon itself. The US is still itself trying to reduce debts and thus will not grow as strong as it has done in the last twenty years; China on the other hand is similar to Germany in that its growth mainly comes from export surpluses.

The economic performance of Germany should be a warning to all other European countries. Not only did economic reforms strangle growth, they also worsened the distribution of income and thus led to a more polarised society. Indeed, many Germans are blaming the Euro for the stagnation of their incomes although those were mainly the result of the misguided policies of the red-green government.

The hostility of German public opinion towards today's crisis countries is likely to be driven by the higher insecurity in German society. But as is so often the case, those sentiments are not aimed at the true responsibles but on the weak who are themselves struggling, i.e. people in the crisis countries. Rising inequality and mounting fear have always been drivers of political instability.

Furthermore, German policy elites commit a dangerous fallacy: since competitiveness is relative, it is logically impossible to increase price competitiveness in all Eurozone countries as long as Germany and other countries with high competitiveness are not willing to deteriorate their relative position. If everybody tries to cut spending and prices at once, the effects will be decreasing income (since someone's spending is another one's income) and lead to deflation. Deflation means that the real amount of outstanding debt increases which already leads to a debt deflation trap in the crisis countries.

If German policy makers are not willing to rethink their policy prescriptions and/or other governments in Europe are not pressing for different policies – more in line with the successful German policies in the crisis – the Euro is likely to break up. This will have dire consequences for all countries involved, among them Germany, not only economically, but also politically.

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