GERMAN ECONOMY

At the crossroads

The labor market rigidity has resulted in increasing output gap for the German economy, despite the inflation rate remaining more or less stable, says Kunal Kumar Kundu, Senior Economist, Indo-German Chamber of Commerce.

The German economy, the third largest economy in the world and the largest in the European Union (EU), has been experiencing conspicuously lower growth rate since the second half of the 1990s, thereby dragging down the overall growth rate of the EU. In fact, in 2003, the German economy actually contracted by 0.1%, first time since 1993.

A laggard in Europe

This is symptomatic, not just of the general global economic slowdown, but of a deeper malaise that afflicts the economy. In the past eight years, cumulated German growth has been 7% below the EU average.

In fact, since the middle of the 1990s, Germany had the lowest growth among all the European nations and there is no sign of change. So much so, that German per capita GDP, which used to be the highest in Europe, has been surpassed in recent years by the UK, Finland, the Netherlands, Ireland and Austria. That is despite the German population hardly growing. In fact, only four EU nations—Spain, Portugal, Italy and Greece have per capita GDP lower than that of Germany (see Figure 1).

Growth busters

Labor cost

The most important factor explaining the growth decline in Germany is the relative growth in wage rate. In fact, not only is the average compensation highest in Germany (here figures are available for former West Germany), but also the growth rate in wage rates is among the highest. This can be seen from Figure 2 which shows the change in hourly compensation (in US$) cost for production workers in manufacturing in EU during the period 1990 to 2002.

Inadequate productivity gains

The rising wage rates are also not being compensated by productivity gains, adding further to the cost of doing business. The bottom line in Figure 3 shows the movement of the hourly wage rate and top line the movement in hourly productivity in Germany. As seen, the difference (shaded area) is virtually constant (actually shrinking marginally), while the wage is on the rise.

In fact, while the average hourly wage cost in the whole of Germany rose by 3.75% between 1991 and 2002, the hourly productivity during the same period rose by only 1.99%.

Labor participation rate

According to the European Central Bank (ECB), the Euro area has a lower labor participation rate. As per their study in 2002, the labor force participation rate in the Euro area (68.2%) was significantly lower than in the US (76.4%). The difference is starker in case of females, where the participation rates are 58.8% and 70.1% respectively.

This can be extrapolated to Germany. While the Germans generally enjoy longer and healthier lives, ironically they spend fewer years at work and the effective retirement age has fallen, rather than rising.

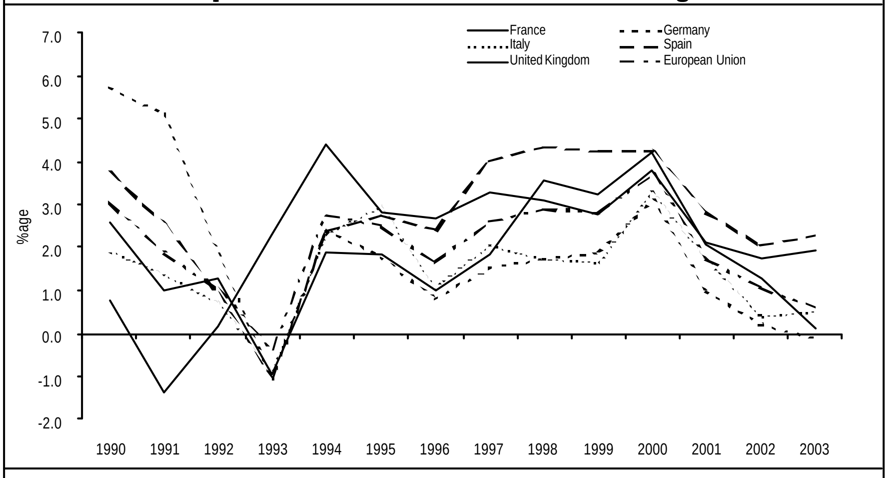
The lower participation rate combined with the higher unemployment rate results in lower employment rate.

Why ....

Labor laws

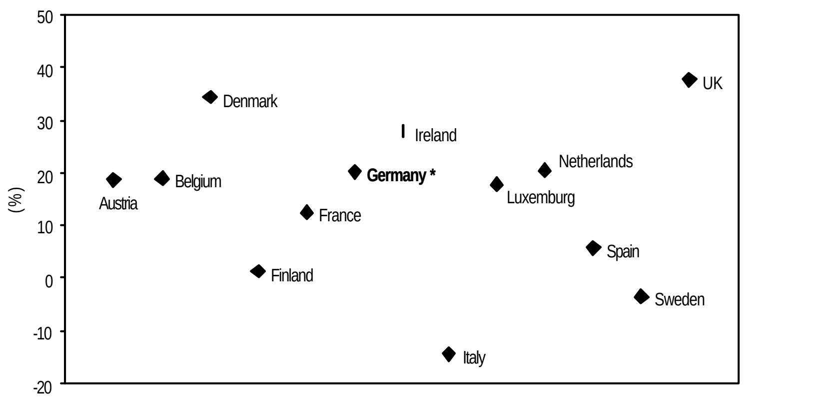
One of the causes of Germany's problems is the legal structure of

Figure 1: GDP Growth Rate of the Top Five Nations in EU and the EU Average



Source: OECD

Figure 2: Growth in Wage Rates



Source: CESifo – DICE

Note: * Former West Germany.
Information on Greece and Portugal not available.

the labor market in terms of tenure rules and the way negotiations are conducted. Germany has relatively extensive labor protection rules, which practically result in lifetime employment after only a few years of work. Moreover, the country has a system of centralized wage bargaining that results in uniform wages for industry sectors that are virtually the same across regions. This system makes it impossible for firms that are on the verge of bankruptcy to settle for lower wages with their employees, even if the solution is acceptable to the employees. Consequently, German economy suffers from substantial labor market rigidity.

Social security

Germany has one of the most generous social security systems anywhere in the world. The state funded system derives its funds from both the employers and the employees. Generous replacement incomes (in terms of unemployment benefits, early retirement schemes and social aid) result in high real wages. Replacement incomes are paid under the condition that people do not work and earn no income and these are reduced if recipients earn income. Replacement income creates high reserve wages i.e., minimum wages at which workers accept job offers. In many cases, these reserve wages are so high that it does not pay for a private firm to create jobs.

Resulting in ....

Increasing output gap

The labor market rigidity has resulted in increasing output gap (deviations of actual GDP from potential GDP as a percent of potential GDP) for the German economy, despite the inflation rate remaining more or less stable.

As shown in Table 1, the output gap in the German economy has not only been higher than average since 1998, but also has actually been deteriorating since 2000.

Losing competitiveness

Substantially high cost of labor has slowly eroded away the global competitiveness of the German economy. A study conducted by the Köln based Institut der deutschen Wirtschaft clearly brings out the fact that rising relative cost of labor (for the processing and finishing industry) has resulted in lower export performance over the years. This has adversely affected the German economy for which exports have been the engine of growth (see Figure 4).

Rising insolvency

The number of companies declared insolvent has also been rising steadily in Germany (see Figure 5).

The appreciating euro

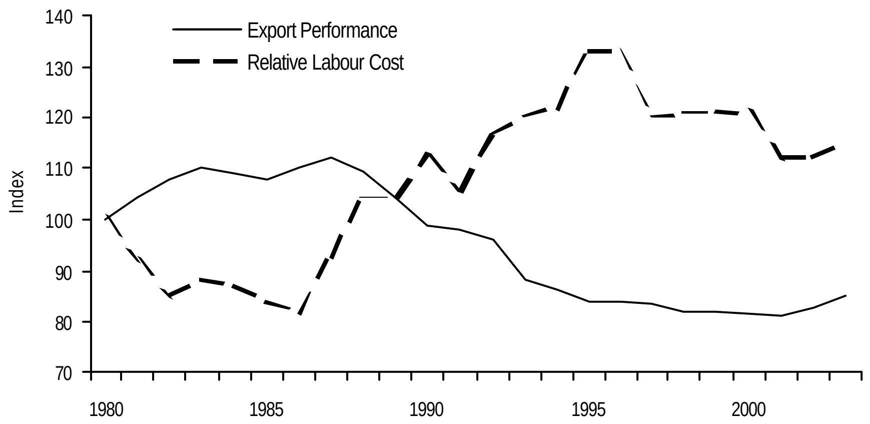
Added to their woes of rising cost, is the appreciating euro vis-à-vis US dollar which further reduces the competitiveness of the German products (see Figure 6).

Moreover, with the US clearly following a weak dollar policy to facilitate its exports growth, the euro is expected to strengthen further. The Economist Intelligence Unit forecasts an appreciation of euro to US dollar 1.35 by end 2004 from levels of US dollar 123 in

Figure 3

Source: FSO

Figure 4



Source: FSO

December 2003. A faltering economy like Germany facing a strengthening currency (not because of inherent economic strength, but because of the weakness of another major economy) will surely find the going tough.

Nascent economic recovery

With the likely signs of global economic recovery, there is increased optimism for the German economy as well. The IFO index of German business confidence rose for 9 continuous months till January 2004. Added to that is the fact that the month of December 2003 saw German exports rising by 7.1%. Also, while employment was not rising, at least there has been a slowdown in loss of jobs. It is being felt that while global economic recovery will fuel German GDP growth initially, a pick-up in domestic demand will lead to sustained recovery.

The question that needs to be answered is whether the global economic recovery is sustainable. The US, for example, has been experiencing a jobless recovery. The US manufacturers experienced 42 straight months of layoffs. The Federal Government deficit was as high as US$500 bn by the Q3 2003, which has certain implications for the economy. The GDP growth slowed down substantially during Q4 2003 to 4.1% from a growth of 8.2% during Q3 2003 resulting in the overall GDP growing by around 3.1%, as per the data provided by the Bureau of Economic Analysis. Moreover, the productivity gains that are driving the US economy are coming from outsourcing to low-wage countries. Also, the increased US consumer spending hasn't come from jobs, but from military spending, tax cuts and increase in money supply associated with negative real interest rates.

On the other hand, the Japanese economic recovery may finally be on its way.

Sustainable or not, on balance, though, 2004 is expected to be a better year vis-à-vis 2003. According to OECD estimates, the GDP growth rate of the OECD countries would be 3% as compared to 2% in the previous year. Even the growth rate for the EU would treble from 0.6% to 1.9%. The German economy is also expected to grow by 1.4% this year.

Will the lost glory be regained?

That is a million dollar question. In this connection, it should be realized that Germany's problems are structural in nature and not cyclical. Hence, more than the global economic recovery, a lot would depend on how the set of reforms of the labor market, pensions and healthcare, dubbed Agenda 2010 are sincerely carried through.

These structural rigidities will pose an even greater threat as Germany grapples with the following issues.

Expansion of EU

The immediate challenge is posed by the impending expansion of the EU (ten countries are set to enter the union by May 1, 2004). A number of new entrants have lower corporate tax rates than Germany (current rate is 25%) and are lowering it still. Slovakia, for example, lowered corporate tax rates from 25% to 19%. Poland also has a tax of 19% (reduced from 27%). Latvia reduced its rates to 15% in 2004 from 19%. Hungary, which is also slated to be a new member, has reduced its tax rates from 18% to 16%. Estonia, on the other hand, does not tax corporate incomes, but only the distributed profits. In fact, it ranks much higher than Germany in Heritage Foundation's *Index of Economic Freedom*. There will, therefore, be enough temptations for the MNCs to relocate their manufacturing facility out of Germany to take advantage of not only lower labor costs of these new member-countries, but also the potential tax savings they offer. Samsung, for

Table 1: Output Gap

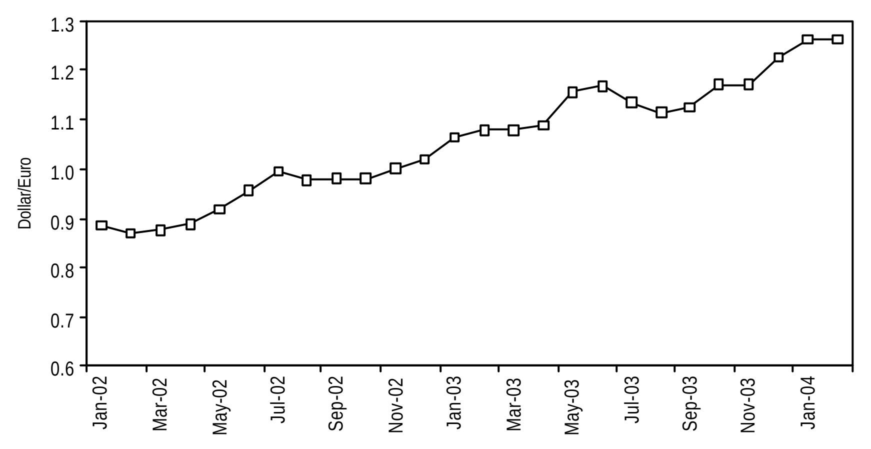
	1998	1999	2000	2001	2002	2003
Germany	–1.6	–1.1	0.3	–0.4	–1.7	–3.3
Euro area	–1.3	–0.6	0.9	0.3	–0.8	–2.2
European Union	–1.0	–0.4	0.9	0.4	–0.7	–2.0
Total OECD	0.1	0.5	1.2	–0.5	–1.2	–1.7

Source: OECD

example, has decided to close down plants in the UK and Spain to cut cost and shift production to Slovakia this year.

Germany will find it very difficult to match the new entrants in this area, what with expensive welfare and health system and a substantial budget deficit (as it is overshooting the deficit target of 3% under the Maastricht Treaty for the last couple of years and is expected to breach the target this year as well).

Figure 6



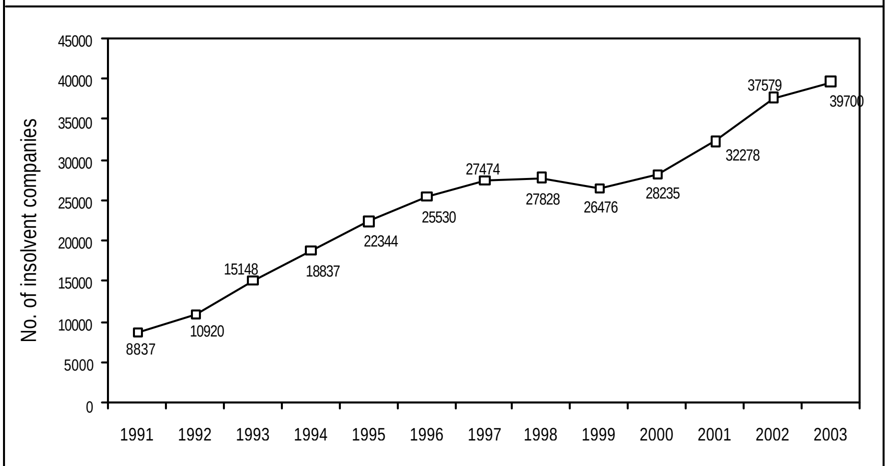
Source: CESifo - DICE

Ageing population

A greater challenge will be posed by the ageing population. According to FSO, the ratio of people over 60 to those between 20 to 59 i.e., the dependence of older people will rise from 45 to 78. In 1950, almost every third person was still under the age of 20 and only 1 in 7 were above the age of 60. In 2002, the group of retirees already amounted to 25%, whereas only 20% were 20 years or younger. By 2050, the young age group will comprise only 16%, while the group of 60 years and above would account for 37% of the population. The number of births in Germany has been declining since more than a century.

The burden of this on the German welfare system would be enormous. A study conducted by the Center for Strategic and International Studies (CSIS), the US finds (paradoxically) that countries with generous state-funded pension system such as the German one has the largest share of old age pensioners in their society than does countries with more modest system and rely more on private provisions like Australia, the US and Great Britain. The latter countries will face less financial burden, both as a result of lower pension payments and lower dependence ratio. It is believed that if adequate reforms are not carried through, then approximately 25% of German GDP will be required to fund the pension system in 40 years.

Figure 5



Source: FSO

The ageing society not only poses serious implications for public finances, but also for the economy as a whole. One important issue, for example, would be the ability to (at least) sustain the level of productivity, given the growing number of older employees. The impending shortage of labor would lead to higher wages and subsequently negative divergence between wage rates and productivity, thereby affecting company profitability. Even from the stock market point of view, the implications are quite serious. As the number of retirees rise, more and more individuals will start selling shares, which will dampen the stock markets.

The need of the hour is to ensure that Germany does not fall short of employable workforce.

Clearly, the ability of Germany to bring about drastic reforms in its labor policy (including possible incentives for higher labor force participation, greater flexibility in labor movement etc.) and the social security system will eventually decide whether the German economy can regain its lost glory.

Views expressed are those of the author and not of the organization.

Reference # 1-2004-04-07