



Volume 2, Issue 6

Date: 11.04.2005

ECFIN COUNTRY FOCUS

Highlights in this issue:

- German competitiveness is improving
- Rising profits are not invested
- Low expectations are a worse problem than competitors from Eastern Europe

For wages the party ended ten years ago!

Domestic gloom and export boom: a look at German competitiveness

By Heinz Jansen*

Summary

Since 1995 Germany has barely managed to grow by 1.2% annually, with growth over the last four years averaging only 0.6%. In 2005, growth will again be below 1%. With these low growth rates Germany has clearly fallen behind all the other European countries. The German economy is suffering from a number of problems. There are the usual long-running concerns about Germany's high labour costs and taxes, and high levels of regulation. This has been exacerbated by new challenges over the last decade and a half, such as the high costs of German unification and the direct exposure to low-wage eastern and central European countries. With hindsight the four-year stagnation might therefore not be all that surprising. And what this paper shows is that structurally the country has made substantial progress and is in a better competitive position than before. What is needed now is an improvement in confidence and a pick-up in domestic demand.

History of wage moderation

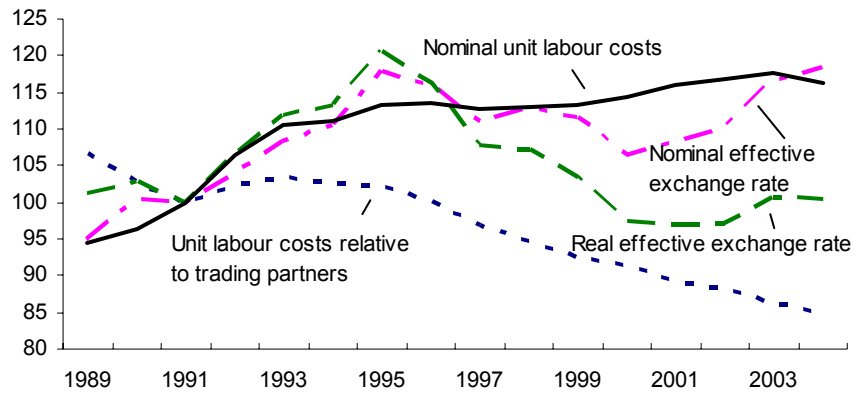
Until the middle of the nineties, wage bargaining played a fundamental role in determining the German business cycle. This is most evident in the early nineties, when wage increases of 25% in the four years between 1991 and 1995 stood out against a productivity increase of less than 10% over the same period. While they certainly supported higher private consumption, the wage increases (plus significant increases in social security contributions related to the financing of unification) severely aggravated the loss of competitiveness stemming from an increase of the nominal effective exchange rate by some 18%. Even though the increase in unit labour costs was just 3 percentage points higher than that of Germany's trading partners, the combined loss of competitiveness amounted to over 20% in the four years between 1991 and 1995 (Chart 1). High wages were thus partly responsible for the choking off of investment growth and, ultimately, employment growth, which has arguably had a negative impact on German growth until today.

Since 1995 this trend has been reversed (Chart 1). In 2000 Germany regained the competitive position it had held ten years earlier due to a substantial drop in the real effective exchange rate by 20% between 1995 and 2000. Half of this drop was due to a fall in the nominal exchange rate. The other half resulted from a fall in nominal unit labour costs vis-à-vis Germany's trading partners. With nominal unit labour costs continuing to fall by roughly 2% annually, Germany's price competitiveness has remained practically unchanged since 2000, despite the fact that the nominal effective exchange rate has come back up to its 1995 levels¹. In this context and in

contrast to most other EU countries, Germany could maintain or even gain in export market share.

Chart 1: Recovering the competitiveness lost in the early 1990s (compared with 23 trading partners; 1991=100)

Rising exchange rates? No problem!



Note: All except nominal unit labour costs compared with 23 trading partners; 89-90 West only
Source: European Commission services, Ameco database.

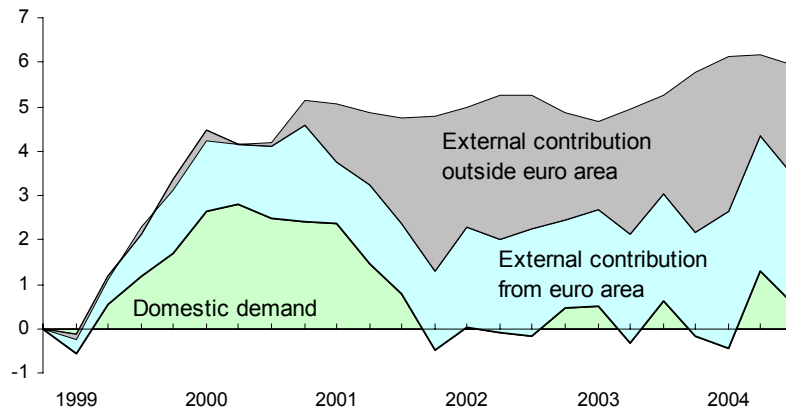
The two sides of wage moderation

If Germany has therefore clearly (re)gained its international cost competitiveness, why then has it remained stuck in a slow-growth trap? Chart 2 shows that practically all of the barely 6% cumulative growth in the six-year span from early 1999 to the end of 2004 is due to a rise in the external contribution, half of which was borne by other euro-zone countries, where trade is unaffected by exchange rate movements. Evidently the net impulse from abroad has not been translated into higher domestic demand, which rose until the year 2000 but has since then dropped off.

Chart 2: Contribution to real GDP growth (cumulative changes since 1999 Q1)

The world is buying German products.

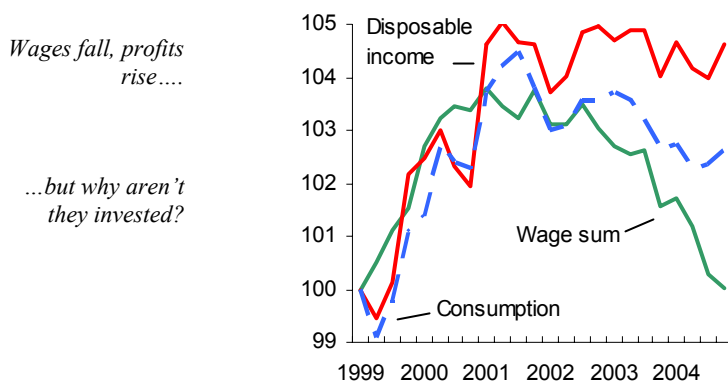
The Germans aren't.



Seasonally adjusted at constant prices; 1999Q1 = 100;
Source: Bundesbank, own calculation.

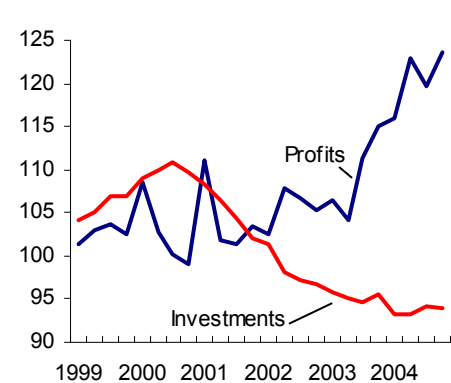
Underlying the weak domestic demand is a decline in both private consumption and investment. For private consumption, wage moderation combined with falling employment has led to falling earnings since 2001 (Chart 3). Even though disposable income held up better thanks to tax reductions and rising entrepreneurial income, consumption fell as uncertainty about employment prospects and, possibly, increased efforts to build a private pillar of retirement provisions, led to a rising savings rate. The latter aspect should not be overestimated, however: even with a constant savings rate, private consumption would not have increased, but left consumption at best constant.

Chart 3: Consumption constrained by stagnant incomes



All data seasonally adjusted and at constant prices; 1999Q1 = 100.
Source: Bundesbank.

Chart 4: Profits decoupled from investment



Seasonally adjusted quarterly figures in billion euros.
Source: Bundesbank.

A question that deserves more critical attention is that of why rising profits failed to trigger higher investment. Chart 4 shows that, while profits (as reported in the national accounts) rose from some €100 billion by the middle of 2000 to €125 billion by the end of 2004. Investment dropped by over €15 billion turning enterprises to sizeable net lenders rather than borrowers.



There is more to competitiveness than wages

Deregulation and tax reductions in Germany were matched elsewhere ...

Clearly, if companies had spent at least part of their extra profits on investment, employment, the wage bill and consumption would have risen, too, and the whole economy would be in better shape. There are several hypotheses as to why investment has not been forthcoming. One is that unit labour costs reflect only part of the picture and the functioning of Germany's product markets may not have improved as much as that of other countries. However, Conway *et al.* (2005) show that between 1998 and 2003 deregulation took place at the same speed in Germany as elsewhere in the OECD. As Germany's relative position remained practically unchanged, this factor is not sufficient to explain the fall in investment.

More troublesome than product markets might be the problem of Germany's financial market. While some companies are flush with cash, others, mostly smaller ones, complain about a credit crunch. Obviously, then, the mechanisms for matching financial investors with profitable investments appear not to be working properly. An overhaul of the tight financial regulation might therefore remove an important growth obstacle. Broadbent *et al.* (2004) also argue that in the past subsidised interest rates led to overinvestment and low capital returns. As structural changes in the banking sector have brought rising costs of capital in Germany, current investment is being reduced.



The lure of the East?

Low wages and low taxes in the New Europe

Another possible factor is that hidden behind a general gain in competitiveness lies the emergence of Germany's eastern neighbours as formidable competitors for new investment. Compared with Germany, the new EU Member States offer lower taxes and substantially lower wages and have gained improved access to the EU market since their accession.

Certainly there is anecdotal evidence of companies moving production to the new EU Member States, and German trade with them is growing relatively faster than that with any other country group. After all, in spite of the prolonged wage moderation, Germany still has the highest wage costs in Europe (Chart 5). The picture of high labour costs is only slightly moderated when hourly labour costs are adjusted for productivity (Chart 6). In spite of its high productivity (measured in GDP

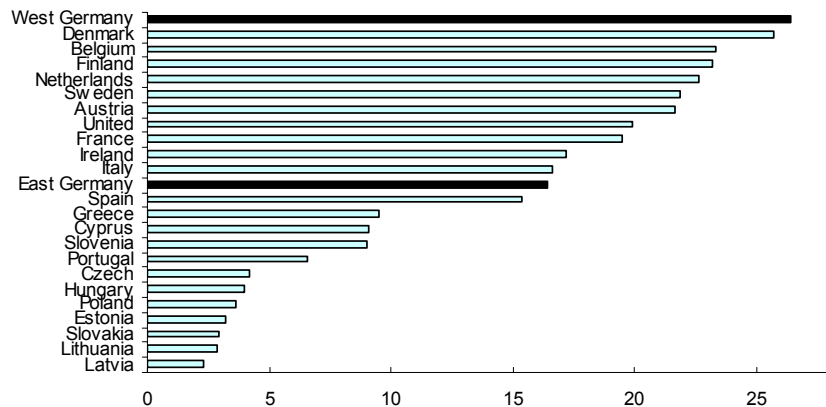
per hour worked), (West) Germany still comes out as one of the most expensive places to employ workers in Europe, while East Germany is in a mid-range position. A starting position with very low wages also explains why the new Member States have achieved high export growth rates, even though their real effective exchange rates vis-à-vis Germany have risen since 1995 by a cumulative rate of between 20 and 120%. Of course the figures must be taken with a pinch of salt: it is worth noting especially that the productivity figures do not reflect the important distinction between the tradable and non-tradable goods sectors.

Despite the obvious cost advantages of Germany's neighbours, it is surprisingly difficult to find data to corroborate the hypothesis that eastern and central European countries have had a substantial impact on Germany's economic development. In terms of German foreign direct investment in and outflows, these countries are barely visible. Moderate net FDI flows into the new Member States have dried up in the last few years. Since the 2000 FDI boom came to an end, Germans are even pulling out of foreign markets and foreigners are disinvesting in Germany.

Net trade flows also indicate that the new Member States have not had any negative impact on the German economy. They do, however, support the case for a differentiated view of the German competitive position. Clearly, the bulk of the gain in German net exports has been borne by the other euro-zone countries, while the new Member States have kept an unchanged net export position vis-à-vis Germany.

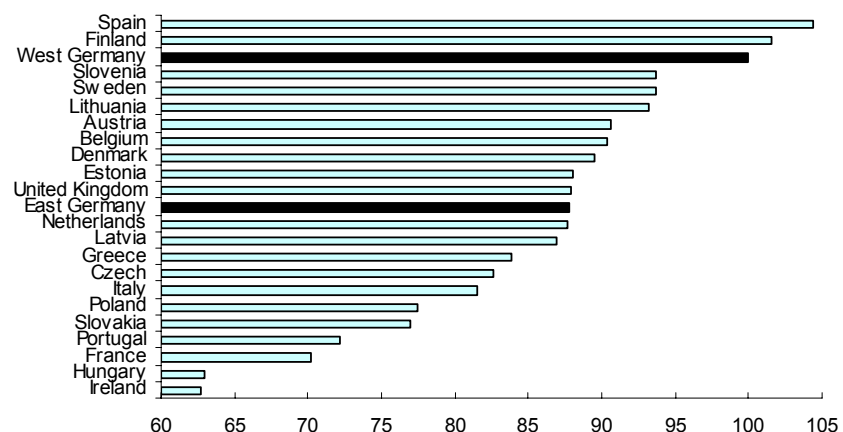
Germany is still expensive despite wage moderation

Chart 5: Hourly labour costs in Europe (2002; in €)



Source: DIHK (2004); East Germany: IFO (2005)

Chart 6: Labour costs per unit of GDP in Europe (2002; W. Germany = 100)



Note: Hourly labour costs divided by GDP per hour worked.
Source: DIHK, GGDC, Ameco, own calculations.

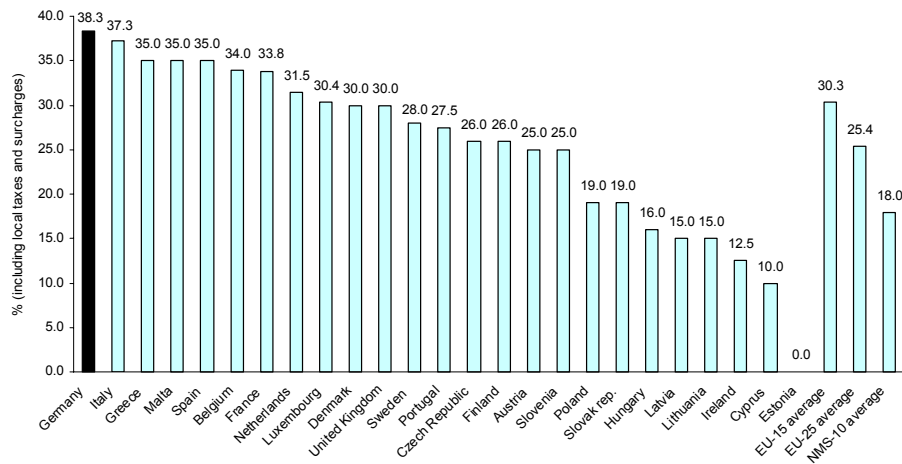
Sinn (2004) has argued that Germany's export success is based on the country becoming only a place for the transshipment of goods, where the value added takes place in the East while German value added declines (a so-called "bazaar economy"). However, while there is certainly a large increase in such outsourcing, a

negative net effect would presume that net exports would fall, which cannot be seen from the statistics. In any case, Sinn's hypothesis begs the question of how Germany's exports would have performed without the cost savings of international outsourcing. A more significant problem could arise from Germany losing its comparative advantage at the high value end of production – of which there is some evidence (European Commission, 2002). Competition here is, however, mostly to be feared from the western trading partners.

In this context, Germany's taxes clearly remain a burden. Chart 7 shows that, at 38.3%, Germany has the highest corporate tax rate in Europe. This compares with average tax rates of 30% in the old Member States and 18% in the new Member States. However, the German tax rate has actually already come down by some 6 percentage points from a level of 44.1% in the period 1995 to 2000 (Finkenzeller and Spengel, 2004). This means that German taxes have become more attractive compared with other old Member States where tax rates have remained practically unchanged over the same time span. By contrast, Germany's position deteriorated relative to the new Member States, which have lowered their tax rates by nearly 10 percentage points since 1995/2000.

Chart 7: Statutory corporate tax rates in 2005 (including local taxes and surcharges)

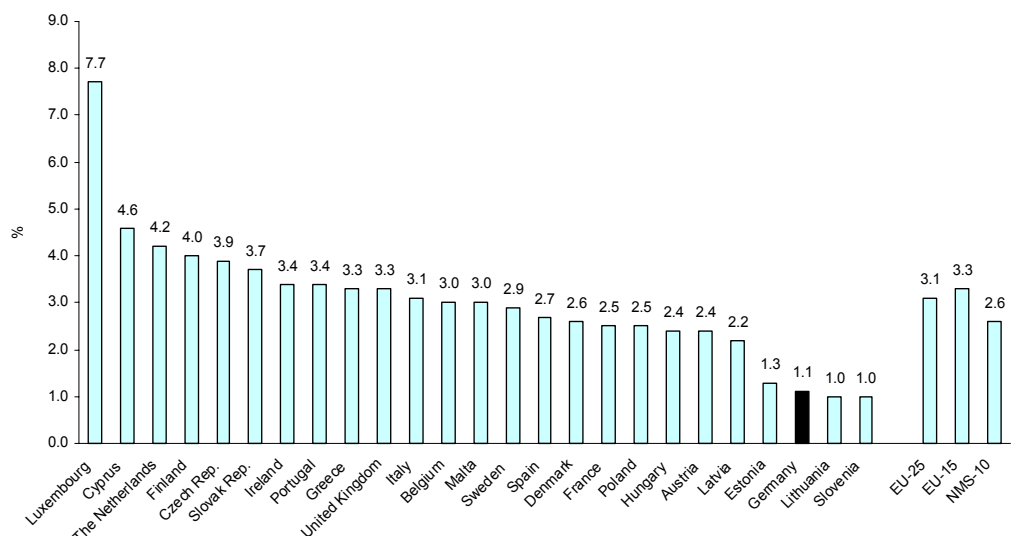
The highest corporate taxes...



Note: Estonia: rate on reinvested profit; 24% if distributed

Chart 8: Implicit corporate tax rates 1995-2002 (corporate income tax as share of GDP)

...yield the lowest revenues



Note: average for EE (2002), CY (1998-2002), HU (2001-2002), SK (1995-2001).
Source: European Commission, DG TAXUD.

The analysis of the practical importance of the tax burden is complicated, however, by the fact that Germany has practically the lowest effective tax collection in the EU due to exemptions and loopholes (Chart 8). Even if this picture is moderated somewhat by the fact that many companies are subject to income rather than corporate taxes, the tax system is clearly distorting and highly complex without delivering significant revenues. This points to blatant inefficiency, which acts as a deterrent to foreign investors and puts Germany at a disadvantage relative to other countries.

Conclusion: the problem is mostly at home

The lack of direct evidence does not prove that Germany has not become less competitive as an investment location for third parties. It is true that companies that might have considered investing in Germany are building their factories in Eastern Europe instead, as clearly shown by a survey of American companies, with wage costs being the East's decisive advantage (AmCham 2005). But what is more telling is the fact that these companies identify "low growth" as Germany's most serious problem – more important than high regulation, wage costs and taxes. One can assume that similar reasoning holds also for other investors, including the Germans themselves.

The German dilemma is therefore not its lack of external competitiveness, but a low expectations trap. German consumers will not spontaneously reduce their savings rate by much, as many expect the long-term trend of falling real incomes to continue. Investors will not spend their substantial profits unless they are convinced of higher growth. The fact that Germany's stagnation has now lasted for four years and that an expected upswing has been aborted twice since 2000 has made low expectations so entrenched that it is difficult to break the vicious cycle, particularly as high deficits preclude any significant government impulse. Objectively, however, with labour costs substantially down and significant structural reforms in the labour market implemented, Germany is better placed for a sustained upswing than it was a few years back.

References

- AmCham Germany (2005), Perspektiven zum Wirtschaftsstandort Deutschland, Ergebnisse des AmCham Business Questionnaire
- Broadbent, B., D. Schumacher and S. Schels (2004), No gain without pain—Germany's adjustment to a higher cost of capital, Goldman Sachs Global Economics Paper No. 103
- Conway, P., V. Janod and G. Nicoletti (2005), Product market regulation in OECD Countries, OECD Economics Department Working Paper No. 419
- DIHK (Cologne Institute for Business Research) (2004), *Deutschland in Zahlen 2004*
- European Commission, DG ECFIN (2002), Germany's growth performance in the 1990s, European Economy Economic Papers No. 170
- European Commission, DG ECFIN (2004), Quarterly Report on the Euro Area, Vol. 3, No. 4
- European Commission, DG TAXUD (2004), Structures of taxation systems, available from: http://europa.eu.int/comm/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm
- Finkenzeller, M. and C. Spengel (2004), EU Beitrittsstaaten: Effektive Steuerbelastung geringer als in Deutschland, ZEWnews, No 1
- Sinn, H-W (2004), *Ist Deutschland noch zu retten?*, Munich, Econ-Verlag

¹ There are a multitude of indicators for competitiveness and real effective exchange rates (European Commission, DG ECFIN, 2004). This Country Focus remains agnostic about the best measurement, as there are no qualitative differences in the general trends.

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.

Chief Editor: Marco Buti, Director of the Directorate for the Economies of the Member States.

Coordinating Committee: Ronald Albers, Natalie Darnaut, Jens Matthiessen

Layout: Vittorio Gargaro, Karl Gradinger, Johannes Kattevilder

E-mail: ECFIN-CountryFocus@cec.eu.int

Website: http://europa.eu.int/comm/economy_finance/publications/countryfocus_en.htm