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Germany's Economic Performance: From Unification to Euroisation

Conference Report

Jens Hölscher and Rob Hayward

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Jens Hölscher and Rob Hayward, University of Brighton

Anglo-German Foundation for the Study of Industrial Society/
Deutsch-Britische Stiftung für das Studium der Industriegesellschaft
34 Belgrave Square, London SW1X 8DZ
Tel: +44 (0)20 7823 1123   Fax: + 44 (0)20 7823 2324
E-mail: info@agf.org.uk   Website: www.agf.org.uk

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Introduction

Keynote address by Professor Stephen F. Frowen, KSG

This conference was held at the Anglo-German Foundation on Friday 29th April and Saturday 30th April 2005. There were close to 30 participants at each of the sessions. The rationale behind the conference was to deepen the understanding of Germany's economic performance at the turn of the 21st century. The period under observation stretched from Germany's unification in 1990 to the death of the German Mark and first experiences with the Euro.[1] Particular attention was given to East Germany.[2] The performance of the German economy is under vigorous debate in Germany, but is less well known to an English-speaking readership. The conference aimed to bring together academics who had demonstrated their expertise in fields related to the subject. The speakers also represent the spectrum of the current academic debate as it is reflected in the public sphere in German politics and business. Speakers included representatives of research institutes associated with the trade unions, the employers' organisation as well as industry.

The aim was to produce a collection of essays based on the workshop, which will be published by Palgrave (Macmillan's Global Publishing). This publishing house approached the convener, Dr. Jens Hölscher, to produce a follow up of the books previously published with Palgrave. All speakers delivered a written paper of their workshop presentation and the editorial process of the book publication is going ahead with full speed. An evening reception was sponsored by the German Embassy and the conference participants were addressed by Martin Wieland, the representative of the Deutsche Bundesbank and Financial Attaché, as well as Anne Ruth Herkes, the Head of Economic Affairs Department of the Embassy.

Professor Stephen Frowen (KSG) summarised the dramatic economic developments that had taken place in Germany in the last 60 years. He highlighted the way that the monumental task of rebuilding the eastern part of the country had transformed the public finances, and the impact of the introduction of the European single currency and the replacement of the Bundesbank as the monetary authority by the European Central Bank. Professor Frowen argued that the task of bringing the two parts of the country together had proven to be too great to be mastered within the confines of the Euro system. This, he said, supported the arguments previously made in an open letter that he and other 155 German-speaking economics professors had published in the *Frankfurter Allgemeine Zeitung* and the *Financial Times* in February 1998. This letter called for a

[1] These events are documented by Frowen, S. F., Hölscher, J. (eds.): *The German Currency Union of 1990 – A Critical Assessment*, London and New York 1997 (Macmillan Press, St Martin's Press) and Hölscher, J. (ed.): *50 Years of the German Mark – Essays in Honour of Stephen F. Frowen*, London and New York, Palgrave (Macmillan's Global Publishing), London 2001.

[2] See also: Hölscher, J., Hochberg, a. (eds.): *East Germany's Economic Development: Domestic and Global Aspects*, London and New York 1998 (Macmillan Press, St. Martin's Press).

postponement of German entry into the Euro zone. Today, Professor. Frowen argued, Germany faces the difficulty of extracting itself from an accelerating decline. This problem, caused by structural barriers to economic growth, has been exacerbated by negative external shocks which include the high level of oil prices and the appreciation of the euro.

Professor Frowen asserted that, without the short-term interest rate tool, Germany had to find a new way out of its economic dilemma. Expansionary fiscal policy would be problematic if other European nations followed the German example, for it could prompt a monetary response from the European Central Bank that would make any actions by the government less effective. This scenario could create a crisis that would demand a break up of the economic union or the formation of a political union. However, Professor Frowen argued that a middle way to avoid this may be to strengthen the cooperation between fiscal and monetary authorities to overcome the inability of national governments to use interest rates to support economic activity.

Monetary issues

Chaired by Jens Hölscher, University of Brighton

Three papers were presented. The first by Dr. Iris Biefang-Frisancho Mariscal and Professor Peter Howells from the University of West of England; the second by Dr. Walter Heering from the University of Brighton; and the third by Dr. Jörg Bibow from Franklin College Lugano.

Dr. Iris Biefang-Frisancho Mariscal and Professor Peter Howells from the University of West of England addressed the issue of central bank transparency using a model that has been developed by Haldane and Read (2000). The paper looked particularly at the German Bundesbank and then the European Central Bank, together with the Bank of England in the UK, and raised the question of whether the Bank of England really is more transparent than the German-based institutions. Popular opinion, as well as research on those (often statutory) characteristics that should give rise to the transparent conduct of policy, suggests that the Bank of England is more transparent. Attempts to measure transparency through institutional characteristics of the central bank and surveys of money market traders' opinion have tended to indicate a relative lack of transparency for the Bundesbank and the European Central Bank. The institutional characteristics that are usually identified include things like publishing minutes and voting records, as well as providing public forecasts of inflation and economic growth. However, using the Haldane and Read model and looking more closely at the behaviour of money market interest rates in the days leading up to a change in official interest rates, suggests that traders have no more difficulty reading the Bundesbank and the European Central Bank than they do reading the Bank of England. Estimation of an equation that includes a term for monetary policy 'surprises' finds that, for the period since 1992, between 8% and 13% of policy rate changes by the Bank of England come as a revelation to traders on the day of the announcement. This compares to a policy surprise of between 6% and 9% for German interest rates over the whole period (January 1989 to July 2004).

The issue of whether money market traders feel more uncertain about Bundesbank and European Central Bank policy, while actually being able correctly to anticipate their actions, was tested with the use of interest rate forecasts by private institution as reported in *Consensus Forecasts.* The results suggest that uncertainty regarding the 3-month euro-DM rate has risen since the ECB conducted monetary policy. However, the one year ahead forecasting rage of the euro-DM interest rates produced more ambiguous results. For the UK there is no evidence that agents' unanimity over the money market rate has increased over time. Forecasting uncertainty, however, may not only be the result of transparency but also because it is easier to forecast the economy more generally. Results of a test for the uncertainty of forecasts for GDP and inflation in the UK and Germany over time show that there is a decline in forecasting uncertainty in the UK but no underlying trend for Germany. Indeed, in the period since the creation of the euro, there has been some increase in the uncertainty of forecasting German GDP and inflation. This is not really surprising given the large changes that took place at this time. This suggests that increased uncertainty over interest rate forecasts for Germany could be the result of increased uncertainty over forecasting macroeconomic variables rather than being due to a lack of transparency of the European Central Bank.

Dr. Walter Heering presented a paper on *Monetary Targeting by the German Bundesbank.* This paper used an IS-LM framework to highlight the importance of inflation expectations as a link between monetary targets and interest rate targets. Dr. Heering argued that, while the Bundesbank was successful in achieving price stability through its use of monetary targets, the relationship between money and prices is complex and depends crucially upon inflation expectations. The paper suggests that the success of the Bundesbank, which Dr. Heering discussed in some detail, was based on the fact that inflation expectations were anchored in Germany during the Bundesbank's reign. Dr. Heering asserted that this stability of inflation expectations greatly facilitated the German central bank's ability to conduct monetary policy. The risk that variations in inflation expectations could cause problems for the European Central Bank's monetary policy highlights the importance of maintaining a two-tier policy system combining inflation targeting and monetary aggregates. Indeed, Dr. Heering states the more difficult situation that the European Central Bank finds itself in with divergent economies and traditions argues for a firm theoretical bridging of the inflation and monetary targets so that the European Central Bank will be more able to cope with any shocks to the system.

Dr. Jörg Bibow from Frankin College Lugano presented a paper entitled *Bad for Euroland, worse for Germany – the ECB's record* This paper asserted that the 'tough' monetary regime adopted by the Bundesbank and the European Central Bank resembled the action of a car driver obsessed with using the brake and being very cautious about using the accelerator: the central bank was swift to tighten policy but was reluctant to embark on monetary expansion. With the Growth and Stability Pact providing a constraint on fiscal policy, Dr. Bibow makes the case that a series of policy blunders have been responsible for the German economic slump and that this is largely a demand-related issue rather than being the result of structural problems. Particular attention is paid to the inability of the European Central Bank to perceive that higher interest rates would not support the European Single Currency in the foreign exchange markets as interest parity theory would suggest. This, it was argued, was because of a time-inconsistency problem with the market believing that higher interest rates would be unsustainable and would merely increase the risk that interest rates in the Euro area would be lower in the future. The depreciation of the euro kept net export growth at the forefront of economic expansion in the Euro area and eventually, in conjunction with rising energy prices, caused some inflationary pressure. The Stability and Growth Pact did not allow automatic stabilisers to operate as the world economy slowed. Dr. Bibow says that this asymmetric type of monetary approach was successful in Germany before the introduction of the European single currency because other countries provided the economic stimulus to German growth. This allowed German exports to drive the economy forward in the face of this tight monetary stance. Now, however, with most of Europe having adopted the German position with the European Central Bank modelled on its German predecessor, there is less scope for external stimulus. Dr. Bibow argues for a change in policy that would bring non central bank and non EU nationals onto the Board of the European Central Bank and would look at alternative policies, such as nominal GDP targeting in agreement with the national governments, as a means of avoiding budgetary constraints leading to high indirect taxes and tighter monetary policy.

Dr. Khaled Soufani, University of Brighton, launched the discussion with a criticism of this very negative view of the European monetary authorities that had been offered. He said that while he liked the IS-LM framework presented by Dr. Heering, he questioned the definition of transparency provided by Dr. Biefang-Frisancho Mariscal and Professor Howells. He said that the uncertainty over workings of the ECB could not be resolved by showing that they could drop hints to the market a few days before any change in policy. Dr. Bibow argued that 'transparency' should be seen as being related to openness about the central bank policy reaction function. He said that the European Central Bank did not have this openness and that this was partly responsible for some confusion over monetary policy and the uncertain relation with the financial markets.

Macroeconomic performance

Dr. Horst Feldmann, University of Tübingen and Dr. Eckhard Hein from the Hans-Böckler-Stifung in Düsseldorf presented papers on Germany's macroeconomic performance.

Dr. Horst Feldmann, University of Tübingen presented a paper entitled *From Initiating to Breaching to Diluting the Stability and Growth Pact.* He outlined a comparative analysis of the German budgetary position with that of some of the other Euro area members. He argued that it was not the low rate of German economic growth that had caused Germany to undermine the pact that it had initiated. He argued that even in cyclically adjusted terms, there had been deterioration in the German budgetary position that required additional work by the German authorities. Dr. Feldmann contended that political economy can explain why the pact was breached: Germany, France and Italy each have 10 votes in the Council of Ministers and have enough power to provide a blocking minority when questions of sanctions were raised. Dr. Feldmann also suggested that the regional fiscal autonomy in Germany is not sufficient to explain the breach because there is similar autonomy in Spain that has not been allowed to affect the overall public finances. A comparison of the cyclically adjusted primary balance shows that fiscal loosening has tended to be pro-cyclical, suggesting to Dr. Feldmann that lack of political will has been the major cause of the breach.

Dr. Eckhard Hein from the Hans-Böckler-Stifung in Düsseldorf presented *Wages, macroeconomic policies and German stagnation.* He said that there is little support for the consensus view in Germany that structural issues are responsible for the weakness of the German economy and the relatively high level of unemployment. He argued that matters which are often cited as being of concern, such as employment protection, benefit replacement rates, benefit duration, bargaining co-ordination and the tax wedge, have all declined in Germany in recent years and that the difference between Germany and other nations has narrowed at a time when unemployment has risen sharply. Dr. Hein said that the German macroeconomic problems were largely due to policy being much tighter in Germany than in other countries. This was a result of low German inflation making the real level of interest rates relatively high and a result of the constraints of the Growth and Stability Pact ensuring that fiscal policy could not be used in a counter-cyclical way. He argued that wage policy was the main domestic policy problem in Germany, with the weakness of unions and the breakdown of collective agreements preventing income growing at a pace sufficient to foster domestic demand.

Dr. Waltraud Schelkle from the London School of Economics took issue with these two extreme views of the problems faced by Germany, arguing that the solutions that they proposed were too radical. She questioned the implication that policy makers were to blame for German economic woes. She contended that there were no quick fixes and said that Germany was adjusting gradually to its new position in a new world where there was increased competition and where many other countries had learnt from German success. Rather than being the 'sick man of Europe', Germany was suffering a 'mid-life crisis' with the proposed actions of more fiscal tightening or higher wages being the equivalent of a rash Ferrari purchase or an extra-marital affair.

Structural developments

Professor Lothar Funk from the Institut der Deutschen Wirtschaft, Köln and University for Applied Sciences Düsseldorf and Professor Jürgen Backhaus from Erfurt University presented papers.

Dr. Lothar Funk presented *Collective bargaining and labour markets.* He highlighted the need for the German economy to adjust to the changes wrought by globalisation, ICT and demography. Dr. Funk stressed the need for a more flexible style of life-long learning in an environment where risk for corporations had increased and demand for labour had become more diverse. Dr. Funk suggested that while demand for skilled labour had increased in Germany, that for lower skilled labour had fallen as a result of the increased competition from aboard. The demand curve for low skilled labour had become flatter and the level of real wages more important. This, he argued, could leave a large segment of the population caught without the skills necessary for many of the new jobs that were being created globally, but with a wage rate that was too high to be attractive for less-skilled activity. Dr. Funk presented figures showing that mining and quarrying employment had fallen 66% in the 1991 to 2002 period, with agricultural employment down 38% over the same timeframe. Jobs were being created in real estate and other more skilled service sector areas. The increased flexibility required more flexible real wages and greater labour mobility. Some of these changes were already taking place with a move towards individual wage contracts and with many more wage agreements now being effected at the plant level. The fact that wage drift had fallen sharply since the 1960s highlighted this phenomenon. Now the national wage agreements were often seen as a maximum that would be negotiated downward by individual firms.

Professor Jürgen Backhaus presented *Germany's public economy: Crisis and options.* He highlighted the fact that German public investment was negative and stated that there was flexibility in Germany but a lack of innovation. He surveyed historical German thought on innovation, highlighting the importance of knowledge and learning. Schumpeter, he argued, had emphasised the role of innovation in the public sector: hence it was important to ensure that disincentives to innovation were removed. The greatest disincentive, he argued, was the Federal equalisation programme. This gave no encouragement for states to innovate because they risked moving from being net recipients of the Federal government to being net contributors if they were successful.

Dr. Geoff Pugh began the discussion with a plea for a solution that would allow the collectivist features of the German labour market to be given the chance to work before neo-liberal solutions were tried. He said that he thought that the ability to reach consensus with a corporatist focus on the overall benefits of wage moderation had been part of the success of the economy in the western part of Germany before the unification. It had facilitated the high level of German productivity and it was important that this was not lost.

The fact that investment had as yet failed to respond to wage restraint was one uncertainty discussed by participants. Dr. Pugh argued that business would need to have confidence that wage restraint was going to be maintained for a number of years before it could successfully plan new capital projects. This, it was argued, would be particularly important in Germany where many medium-size firms depended upon retained profits to finance expansion. Dr. Pugh said that stability should be maintained in order to allow time for investment to support the contribution of net exports to economic growth. This stability could be undermined if more radical solutions were attempted now.

While Professor Funk's discussant (Dr. Eric Owen Smith) agreed in general with all of these observations, he contended that the German labour market was adapting to the megatrends more readily than some commentators conceded. Examples of dampers on wage growth seem to be replete: from the collapse of the east German engineering strike to the deals at Siemens, DaimlerChrysler, Opel, VW and Karstadt. Flexibility in both hours worked and money wage rates, with a consequent fall in labour costs, were achieved. In addition, federal-wide part-time employment has almost doubled since 1991 to reach 30 per cent of employees. Whereas the total number of employees remained roughly stable, at 34 million, full-time employment fell to 24 million. In the west, the number of part timers grew by 60 per cent, in the east by 175 per cent. Mini jobs with maximum pay of 400 Euro are, of course, included in this definition. Between April 2003 and April 2004 the number of such fringe workers increased by 1.3 million to 6 million. Indeed, minimum wage protection was required. The capital market was much more inflexible, especially as state-owned banks were no longer permitted to give cheap loans to the small and medium-sized business sector. A market for corporate control is only just beginning to emerge. Finally, some macro-economic policies have adversely affected employment. Unification was, of course, a political act with predictable and serious economic consequences. But it has also been suggested that French support for unification was gained at the expense of German entry into EMU, arguably at an overvalued nominal exchange rate. Moreover, the huge economic welfare burden of the CAP will continue to at least 2013 because of German support for the French policy stance.

East Germany

Dr. Johannes Stephan of the Halle Institute for Economic Research and Professor Michael Kaser of Oxford University and the Institute for German Studies, University of Birmingham, presented papers.

Dr. Johannes Stephan presented *Firm-specific determinants of the productivity gaps between East and West* that looked at firm-specific reasons for different productivity levels amongst west and east German firms. Dr. Stephan used a unique data-base created by fieldwork in selected manufacturing industries. Though productivity levels have clearly converged since the initial shock wrought by unification, productivity levels in the east remain below the level of the west and below the levels that would be accounted for by sectoral structures alone. Dr. Stephan took survey evidence from manufacturing industries in the east and west and used a matched pairs approach to reveal reasons for differences in productivity. The industries covered were machinery, furniture, cosmetics and electrotechnics. Dr. Stephan argued that management weakness, particularly the inexperience in strategic planning, was partly responsible for the lower level of productivity in the east of the country. Management factors that were designed to explain productivity differentials, such as strategic planning, marketing and communication techniques were generally significant in most of the equations that were estimated.

Professor Michael Kaser (KSG) presented *East Germany's economic transition in comparative perspective.* The paper highlighted the fact that, at a cumulative 1,200 billion, the unification of Germany represented the largest net transfer of resources from one region to another ever seen. This transfer, which accounted for one quarter of consumer demand in the Eastern Länder in 1998, could be assessed using the concept of 'psychic income'. This can be related to the benefit that a richer person receives in making a donation to someone poorer whereby the richer weighs the benefit received by the poorer against the opportunity cost of surrendering resources. A survey of households in each part of the country for the period 1990 to 1997 suggest that those in the West and those in the East consider that they have lost 'psychic income'. Those in the West do not feel good about 'giving' and those in the East have a sense of second-class citizenship. He went on to point out that the current Western relativity in wealth and income was a comparatively recent characteristic of the German economy, but that the post-communist recession in the East had been steeper than in both the West and the neighbouring states of the Czech Republic, Hungary and Poland. Despite continuing West-to-East resource transfers, GDP growth in the East remained slower than in the West and in the three ex-communist states, just as transfers had failed to accelerate the Mezzogiorno by comparison with Northern Italy.

Moreover, labour costs in the East were still higher with respect to relative labour productivities than in the West.

Ray Bachan from the University of Brighton started the discussion with some suggestions for modification of the regression techniques used by Dr. Stephan. He argued that fixed effects would be more effective and that this could involve the use of the Hausman test. There was some debate over whether fixed or random effects should be used or whether dummy variables could be included for sectors and for the areas of the country to improve the estimation.

Keynote speech

The final keynote speech was given by Professor Norbert Walter, Head of Deutsche Bank Research.

Professor Norbert Walter presented *Investment location Germany* in which he argued that despite broad near-term difficulties Germany remained an attractive country for investment and that this would start to become apparent after 2005. While German economic growth was weak and unemployment was high, the general scepticism was excessive. Market and cost attractions were limited in the near term, but structural reform of the economy was taking place. A new reform momentum would begin after the 2006 Federal elections. Small and medium size enterprises had refocused business strategies to concentrate on core competences. Profits were growing strongly; P/E ratios were relatively low while the earnings outlook was encouraging. Workers were more willing to accept lower wages and increased flexibility and the enlargement of the EU would maintain this pressure from abroad. Nonetheless, the public remained very sceptical about Germany's future economic performance and this was limiting the growth of personal consumption.

The conference concluded with a general discussion.