CEPS COMMENTARY

Thinking ahead for Europe

Is Germany the model to follow?

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Ten years ago Germany was considered to be the sick man of Europe. Its economy was mired in recession while the rest of Europe was recovering. Germany's unemployment rate was higher than the euro area average, it was violating European rules on excessive deficits and its financial system was in crisis. Today, however, Germany is held up as a model for other countries to follow.

In considering this turnaround one has to distinguish between what can be done by a government and what remains the responsibility of the social partners and society at large.

The one area where the government is clearly in charge is that of public finance. In 2003 Germany ran a fiscal deficit of close to 4% of GDP. This does not seem high by today's standards, but back then it was higher than the EU average. Today, the country has a balanced budget whereas most of the rest of the euro area still has deficits higher than those of Germany ten years ago. The turnaround in public finances was mostly due to a reduction in expenditure. In 2003 general government expenditure amounted to almost 46% of GDP, above the euro area average. But expenditure was cut by five percentage points of GDP over the next five years. As a result, on the eve of the 'great recession', Germany had one of the lowest expenditure ratios in Europe.

But the government could not really do much about Germany's main problem, namely its perceived lack of competitiveness. It is hard to imagine today, but during the first years of the euro Germany was generally thought to be uncompetitive because of its high wage costs. When the euro was introduced it was widely feared that this problem could not be resolved because Germany could no longer adjust its exchange rate. But, as we now know, Germany did become competitive again. Today the country is even viewed as having become too competitive due to a combination of wage restraint and productivity-enhancing structural reforms. But a closer look at the data reveals that the former was decisive, not the latter.

Wage restraint was the key element, but it could not be imposed by the German government. It happened essentially because the German labour market was working. Persistently high unemployment between 2000 and 2008 forced workers to accept lower wages and longer working hours, while wages continued to increase by 2-3% p.a. in the booming peripheral countries. It is thus not surprising that until 2008 unit labour costs in Germany fell relative to those in the rest of the euro zone.

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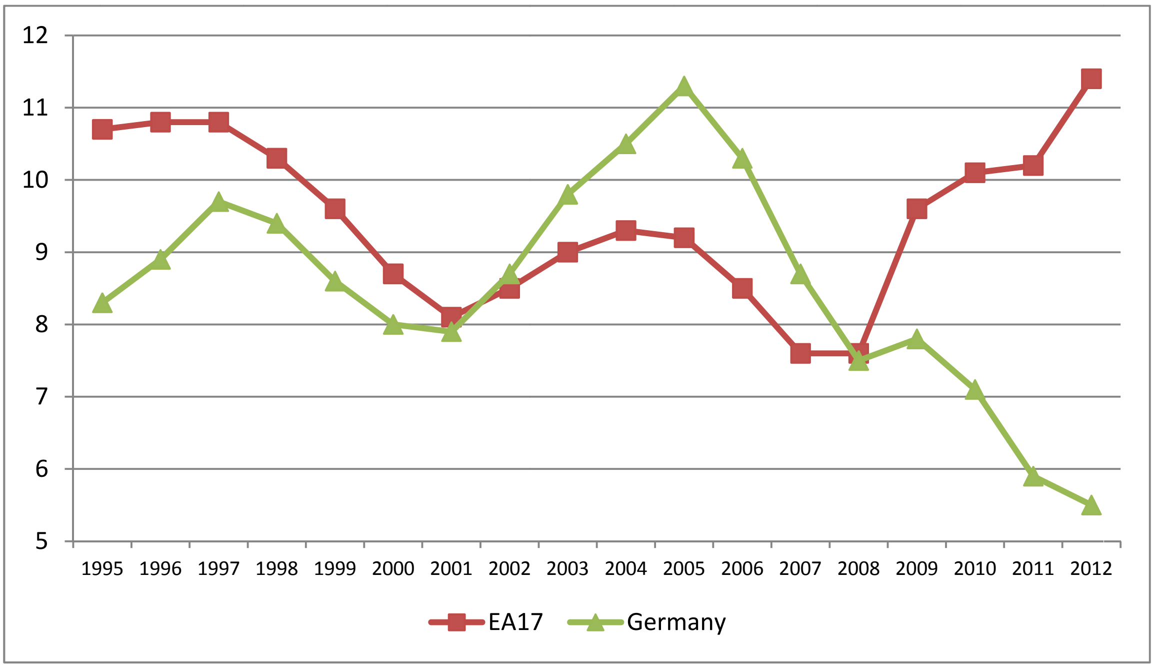
Figure 1. Unemployment rates

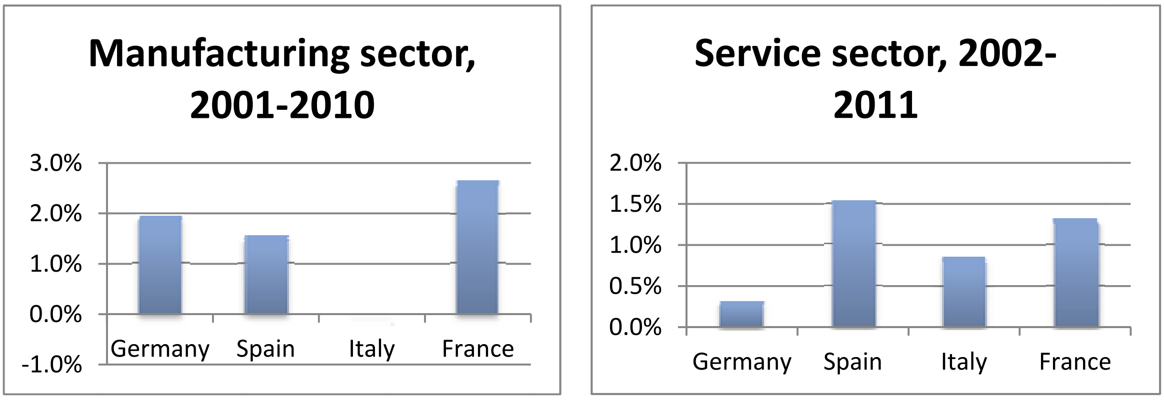


Source: Ameco, 2012.

But what about productivity and reforms? A number of important labour market reforms were indeed enacted about ten years ago, but apparently they had no impact on productivity. All available data show that Germany had one of the lowest productivity growth rates over the last ten years. This is not surprising if one considers that there were no reforms at all in the service sector, which is widely seen as over regulated and protected. Productivity growth rates were higher in manufacturing because it was subject to intense international competition, but even in this sector Germany's performance was not the best among the large euro area countries.

Even in Germany the service sector remains twice as big as the industrial sector. Deep service sector reforms would therefore be necessary to generate meaningful productivity gains in the German economy. But this did not happen, even in 2003, because all attention was focused on international competitiveness and industry.

Figure 2. Average annual change in hourly labour productivity



Source: Ameco, 2012.

The overall conclusion is that there are certainly some elements of the German 'model' that are useful for the embattled peripheral countries of the euro area today. In the first instance, long-term fiscal consolidation requires expenditure restraint, and labour market reforms can, over time, bring marginal groups into employment. But the biggest challenge for countries such as Italy or Spain remains competitiveness. The periphery can grow again only if it succeeds in exporting more. Wages are already falling under the weight of extremely high unemployment rates. But this is the most painful way out of the crisis and generates intense opposition. A much better way to reduce labour costs would be to increase productivity. Unfortunately, Germany is no model in this respect.

Fortunately, however, some peripheral countries are now being forced by their creditors to undertake drastic reforms, not only of their labour markets, but also of their service sectors. The reforms, even if initially implemented only under duress, actually represent the strongest grounds for optimism. Over time they should foster productivity and flexibility and the countries that implement them thoroughly will gradually become more productive and more competitive.

The one lesson to emerge from the reversal of fortunes that has taken place within the euro area over the last ten years is that one should not extrapolate from the difficulties of the moment. The reforms undertaken in some peripheral countries are much deeper than those undertaken by Germany when it was facing problems. Those peripheral countries that persist with these reforms could well emerge much leaner and more competitive. Those that do not (Italy appears to be heading in this direction) will be stuck in a low-growth trap for a very long time. Where individual countries will end up in ten years' time is highly uncertain, but Germany's pole position is not guaranteed forever. The pecking order within Europe's economy could change at any time.