

German wage moderation and the EZ Crisis

Peter Bofinger, vox.eu, 30 November 2015

The EZ 'consensus narrative' argues the Crisis should not be thought of as a government debt crisis in its origin. Instead it regards large intra-EZ capital flows that emerged in the decade before the Crisis as the real culprit. This column argues that while the narrative is correct, it is also incomplete. With its focus on the deficit countries, it neglects the role of Germany, by far the largest member state, and its contribution to the imbalances in the years preceding the Crisis. A narrative that does not account for the effects of the German wage moderation is incomplete.

In "[Rebooting the Eurozone](#)" (published on Vox on 20 November 2015) a consensus narrative on the causes of the Eurozone (EZ) Crisis is provided. The authors argue that the Crisis should not be thought of as a government debt crisis in its origin. Instead they regard large intra-EZ capital flows that emerged in the decade before the crisis as the real culprit. While this narrative is correct, it is incomplete. With its focus on the deficit countries, it neglects the role of Germany, by far the largest member state, and its contribution to the imbalances in the years preceding the Crisis.

In 1999, when the Eurozone started, Germany was confronted with an unemployment rate that was too high by German standards, although it was still below the EZ average. The solution to the unemployment problem was typical of Germany's corporatist system. Already in 1995 Klaus Zwickel, boss of the powerful labour union IG Metall, made the proposal of a *Bündnis für Arbeit* (pact for work). He explicitly declared his willingness to accept a stagnation of real wages, i.e. nominal wage increases that compensate for inflation only, if the employers were willing to create new jobs (Wolf 2000). This led to the *Bündnis für Arbeit, Ausbildung und Wettbewerbsfähigkeit* (pact for work, education and competitiveness), which was established by Gerhard Schröder in 1998. On 20 January 2000, trade unions and employers associations explicitly declared that productivity increases should not be used for increases in real wages but for agreements that increase employment. In essence, 'wage moderation' is an explicit attempt to devalue the real exchange rate internally.

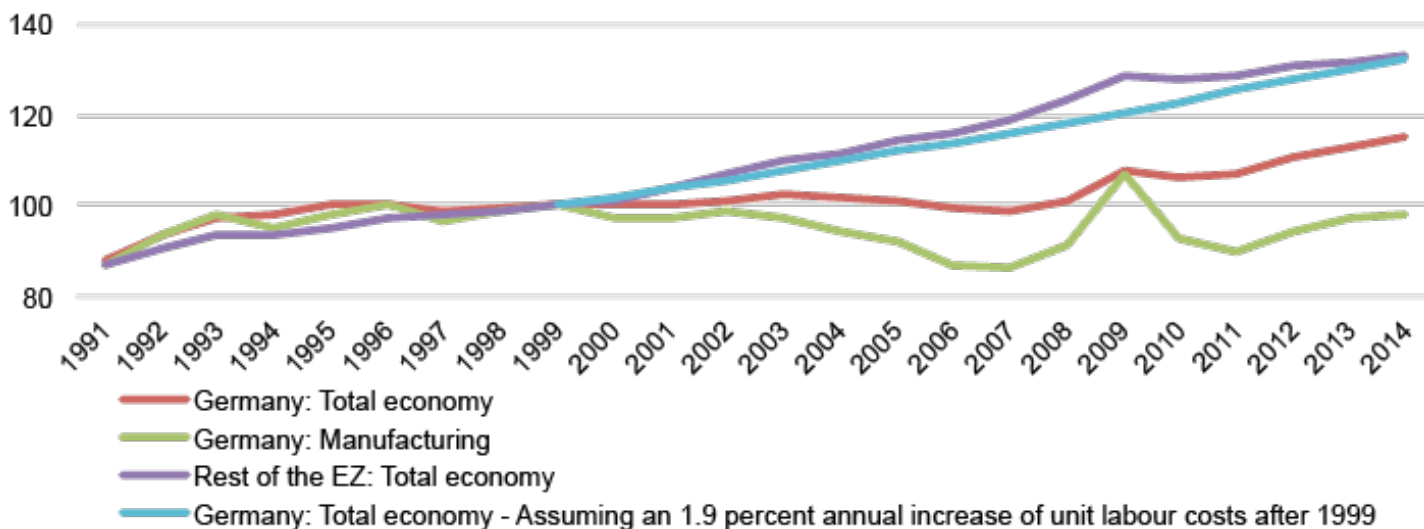
'Wage moderation' is not necessarily an expression of weaker bargaining power of trade unions. They were convinced that this would help to create more jobs. They also explicitly accepted firm-level deviations from collective agreements, when a firm experienced economic difficulties. The government contributed to wage moderation by reducing social security contributions in exchange for higher indirect taxes and by shifting a part of the employers' contribution rate for health insurance to the employees.

Wage moderation and the inflation rate of the EZ

The effects of wage moderation are mirrored in the development of unit labour costs. From 1999 to 2008, unit labour costs in the German economy remained more or less constant. In the manufacturing sector, which is characterised by a high degree of unionisation, unit labour costs declined by almost 9%.

For the ideal functioning of the EZ, unit labour costs of each member state should increase in line with the inflation target of the ECB. This would lead to national inflation rates close to the ECB target rate. Compared to this benchmark rate, which for the EZ is assumed to be 1.9%, wages in the German economy were almost 20% too low in 2008 (Figure 1). In the same period, unit labour costs in the rests of the EZ developed above this target rate, especially in Spain, Ireland and Greece.

Figure 1. Unit labour costs per employee (1999=100)



Source: AMECO, Destatis, own calculations

Wage moderation and EZ imbalances

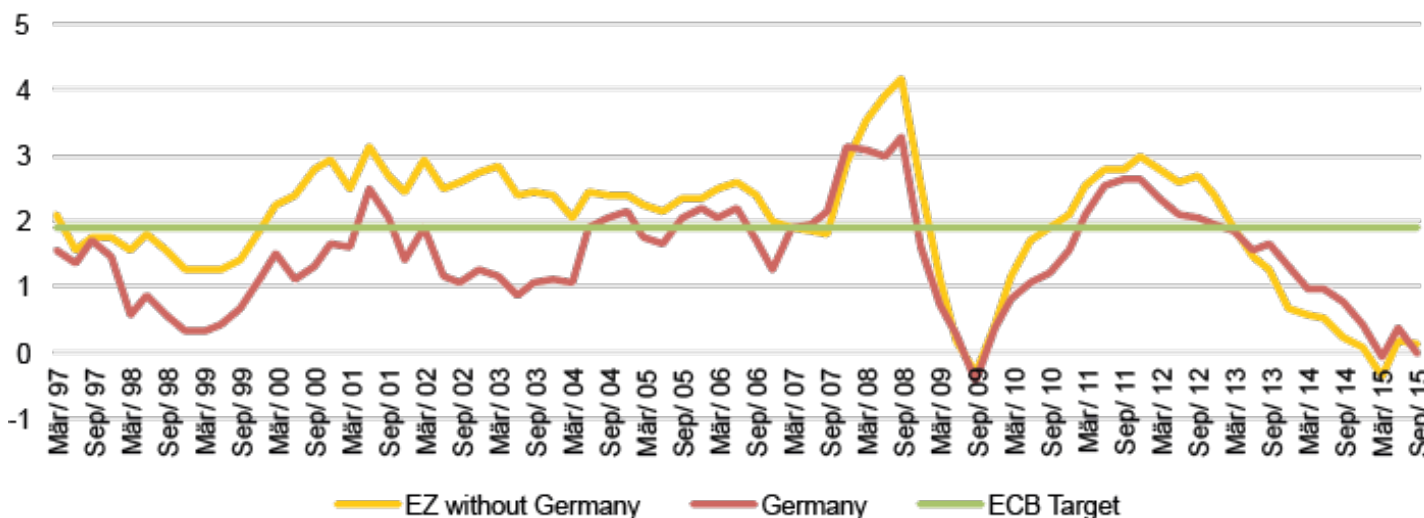
'Wage moderation' contributed to the EZ imbalances through several channels.

- First, the German HICP inflation was for many years below the ECB's target rate and also below the HICP inflation of the rest of the EZ.

A study by the ECB showed for the five largest Eurozone countries that a positive (negative) GDP deflator differential was reflected in relatively higher (lower) unit labour costs, profits and indirect taxes (ECB 2003). At the EZ level, the low German inflation rate compensated for the above target inflation rates, especially in Spain, Ireland and Greece.

As the HICP for the whole EZ was more or less in line with the target, the ECB held its policy rate constant from June 2003 until December 2005 at the then very low rate of 2%. With a single nominal interest rate, the real inflation rate in EZ countries with high inflation was low, while it was relatively high in Germany. Thus, inflation differentials can be amplified through the demand side (Angeloni and Ehrmann 2004).

Figure 2. HICP inflation rate



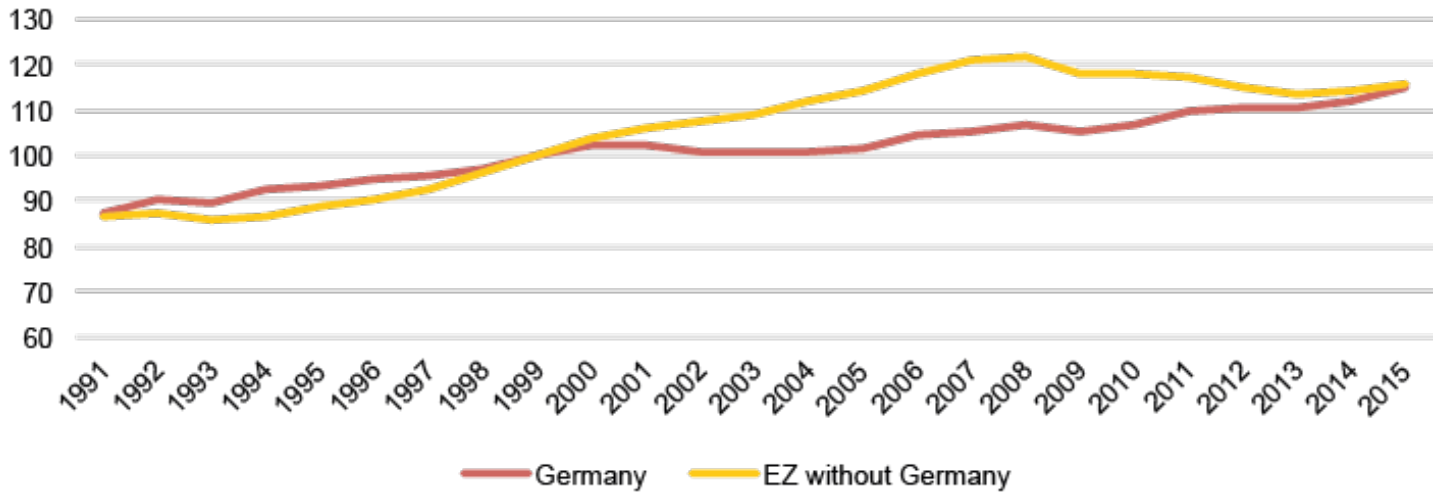
Source: Eurostat, own calculations

Wage moderation and stagnation of domestic demand in Germany

- A second transmission channel was the very weak real domestic demand in Germany, which strongly decelerated due to the wage moderation.

In the period 1995 to 2000 the average annual growth rate was 1.7%, in the period 2000 to 2005 it declined to -0.1%. In the rest of the EZ the growth rate of domestic demand was 3.2% in the first period and 2.0% in the second (Figure 3). For the rest of the EZ the weak domestic demand in Germany implied a strong deceleration of their export revenues for goods and services to Germany. The average annual nominal growth rate of their export revenues from Germany was 8.2% in the period 1995 to 2000 and 3.1% in the period 2000 to 2005. If Wyplosz (2013) argues that domestic demand lies at the root of the divergent paths of the EZ member countries, this view is compatible with a narrative that regards wage moderation as an important part of the imbalances within the EZ.

Figure 3. Domestic demand (at 2010 prices)



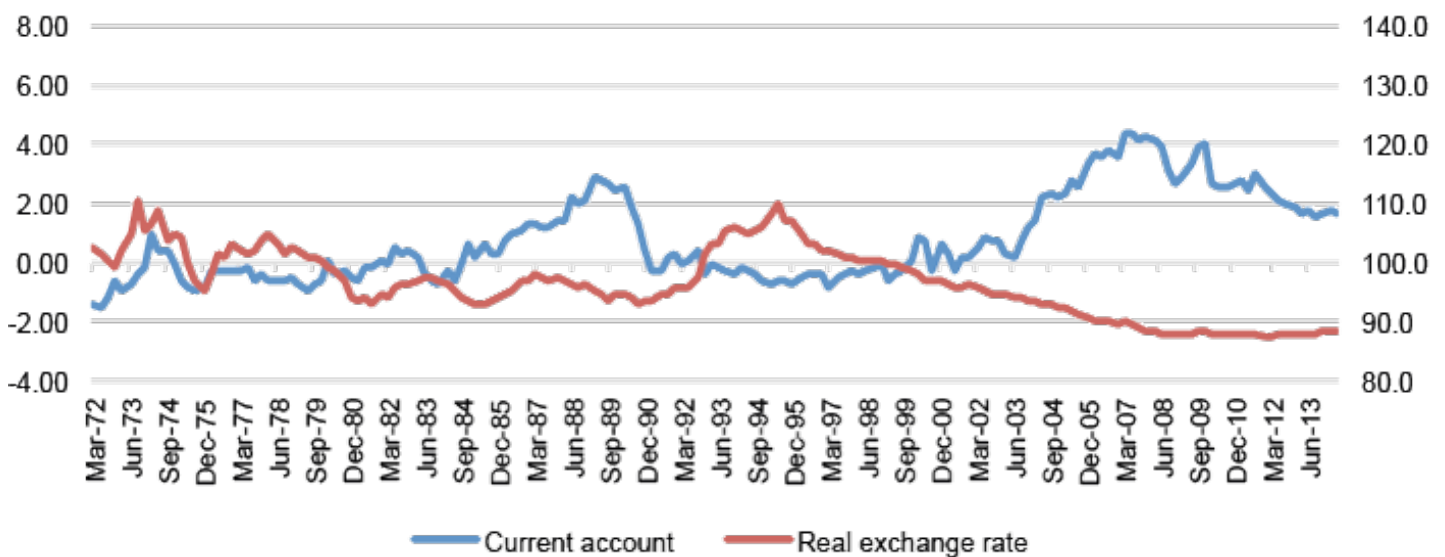
Source: AMECO, own calculations

Wage moderation and the current account

This leads to a third transmission channel.

- While wage moderation had an immediate effect on German domestic demand, it improved its price competitiveness and its exports over time (Figure 4).

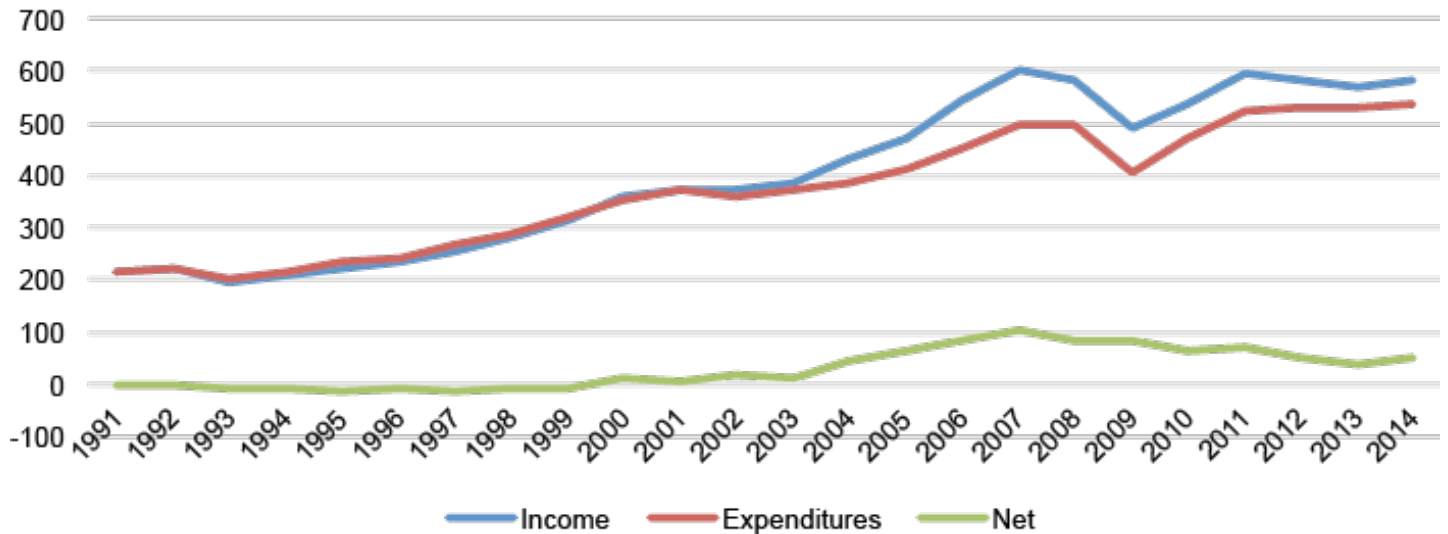
Figure 4. Germany: Real exchange rate vis-à-vis EZ and current account balance vis-à-vis EZ



Source: Sachverständigenrat (2014)

The improvement of the current account in the years 2000 to 2007 is due to the weak German import demand and to increasing exports to the rest of the EZ. This was different before 1999 when Germany's imports from and its exports to the rest of the EZ were growing in parallel (Figure 5).

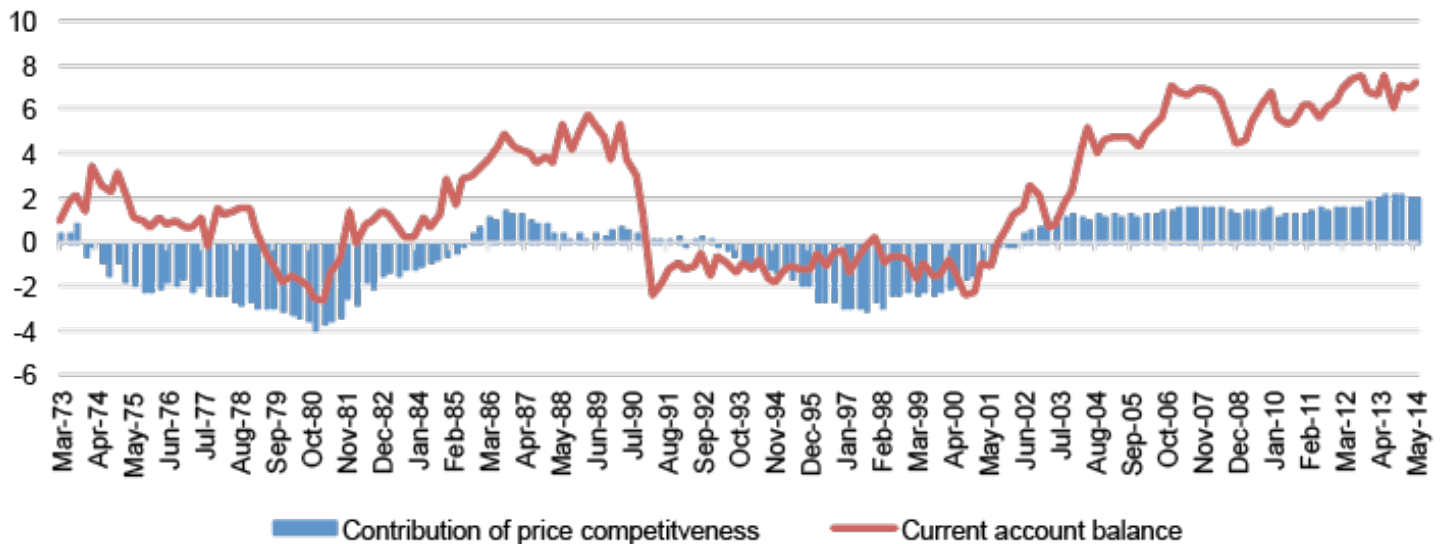
Figure 5. Bilateral current account between Germany and the rest of the EZ (in euros, Billions)



Source: Deutsche Bundesbank

The impact of the improvement in competitiveness on the German current account was estimated with a VAR analysis in the report of the Sachverständigenrat (2014). It shows that price competitiveness has a significant effect on the current account balance. It explains a swing in the current account from a deficit of 3.0% in 1997 to a surplus of 1.5% in 2007 (Figure 6).

Figure 6. Contribution of price competitiveness to the German current account balance (in %)



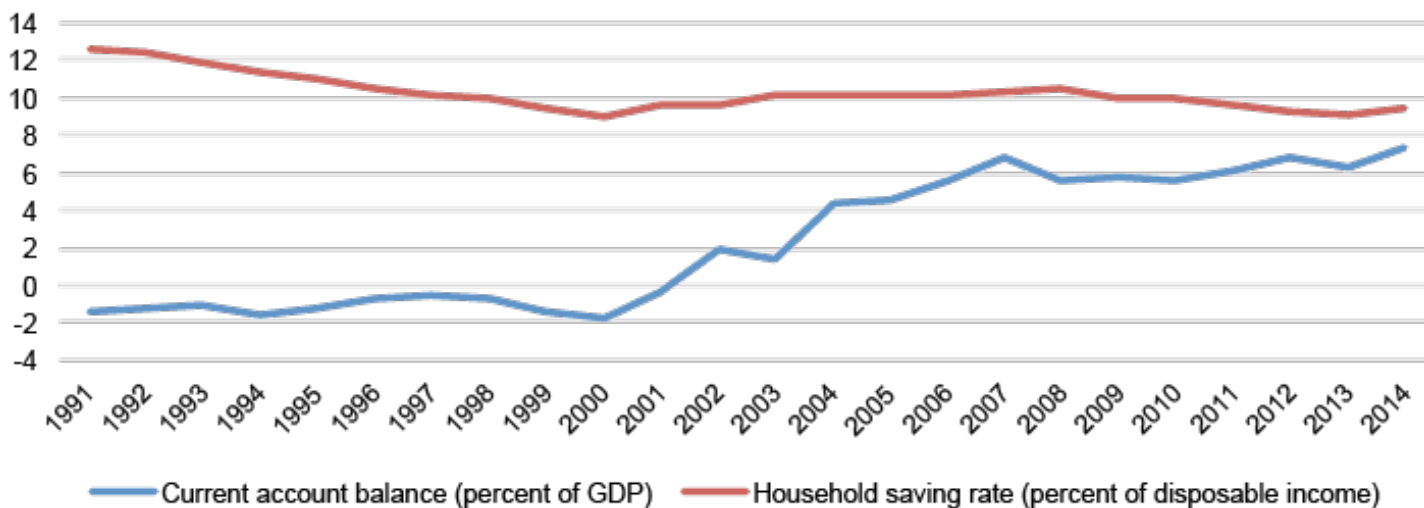
Source: Sachverständigenrat (2014)

A very strong impact of German wage moderation on current imbalances within the EZ is found in a paper by LeMoigne and Ragot (2015). Using a quantitative model of international trade, they find that the German wage moderation is responsible for roughly half of the divergence in terms of trade balance, and explain an increase of

more than 2% of the French unemployment rate.

A study by Kollmann et al. (2015) comes to the result that strong external demand and German competitiveness gains (wage moderation and technological improvements) are important sources of the German external surplus. According to this paper, positive shocks to the German saving rate have been especially important since the mid-2000s. However, as that the saving rate of private households remained more or less constant, it is difficult to explain the increase of the current account with the aging of the German society or with pension reforms. In addition, household saving was much higher in the 1990s when the current account even showed a small deficit (Figure 7).

Figure 7. Household saving rate and current account



Source: Destatis

The real saving shock happened in the sector of non-financial corporations. In the period 1991 to 2000 the average saving rate of non-financial corporations was close to zero, in the period 2001 to 2010 it was 2% (Figure 8). This was caused by growing profits especially in the years from 1999 to 2007. As wage moderation has contributed to higher profits, it can be regarded as a determinant of the saving shock in the corporate sector.

Summary

An EZ Crisis narrative that does not account for the effects of the German wage moderation is incomplete. Germany is by far the largest EZ economy and it is a very open economy with strong trade links to all other EZ member states. It would be difficult to explain why such a strong internal devaluation, which is regarded as a key determinant of Germany's success story in the 2000s (Dustmann et al. 2014), did not have significant repercussions for the rest of the EZ.

Wage moderation led to decline in unit labour costs and to a German HICP inflation rate below the ECB's target value. As this compensated for above target inflation in the rest of the EZ, the ECB was not able to increase its policy rate although there were signs of overheating in the deficit countries. Wage moderation caused stagnation in German domestic demand, which had a negative impact on the German demand for goods and services from the rest of EZ. Wage moderation improved the price competitiveness of Germany gradually which led to a deterioration of the bilateral current account of the rest of the EZ. Finally, wage moderation caused higher profits in the corporate sector, which led to a higher saving rate of this sector. Household saving in Germany has been more or less constant since 1999.

References

Angeloni, I. and M. Ehrmann (2004), "Euro area inflation differential", ECB Working Paper No. 388.

Dustmann C. et al. (2014), "From sick man of Europe to economic superstar: Germany's resurgent economy", *Journal of Economic Perspectives*, 28(1), pp. 167-188.

European Central Bank (2003), "Inflation Differentials in the Eurozone, Potential Causes and Policy Implications", September.

Kollmann et al. (2015), "What drives the German current account? And how does it affect other EU Member States?" *Economic Policy*, 2015, Vol. 30, pp.47-93.

Le Moigne, M. and X. Ragot (2015), "France et Allemagne : Une histoire du désajustement européen", Working Paper, OFCE, June.

Sachverständigenrat (2014), "Mehr Vertrauen in Marktprozesse", *Jahresgutachten 2014/15*.

Wolf, M. (2000), "Von der ›Konzertierten Aktion‹ zum ›Bündnis für Arbeit‹", *UTOPIE kreativ*, Heft 117, pp. 669-68, July.

Wyplosz, C. (2013), "Eurozone Crisis: It's About Demand, not Competitiveness", The Graduate Institute, Geneva, and CEPR, January