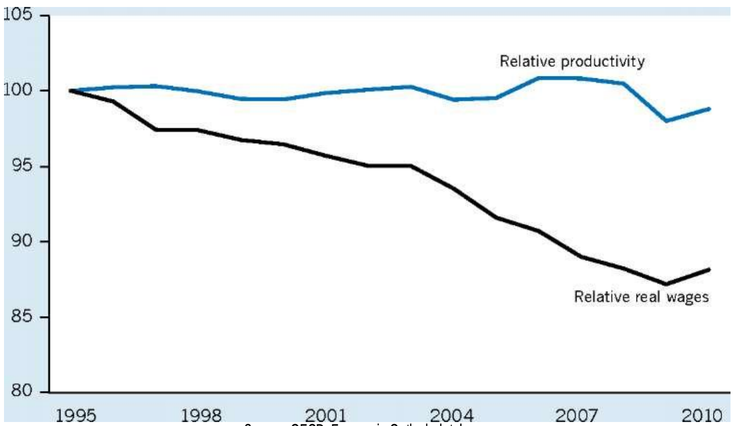
Box 4. German wage developments and euro area troubles

Rising competitiveness of German exporters has increasingly been identified as the structural cause underlying the recent difficulties in the euro area. As German unit labour costs were falling relative to those of competitors over the past decade, growth came under pressure in these economies, with adverse consequences for the sustainability of public finances. More importantly, crisis countries were barred from using the export route to make up for the shortfall in domestic demand as their manufacturing sector could not benefit from stronger aggregate demand in Germany. This box argues that the current problems are an inheritance from the past, when ill-designed policies during the period of German reunification led to a substantial increase in unemployment which subsequently was addressed by deflationary wage policies.

In the aftermath of German reunification, manufacturing industries suffered a substantial loss in competitiveness. Not only were East German companies less productive, the cash changeover rate was fixed at a rate 1:1 in comparison to an official exchange rate between the West and East German mark of around 1:4.3. As a consequence, inflation started to accelerate, in particular in the eastern part, pushing the Bundesbank to tighten monetary policy from 1991 onwards. In turn, the Deutschmark appreciated against the other European currencies leading to the demise of the European Monetary System in 1993 and a substantial loss in competitiveness with severe effects on Germany's domestic demand as well. In fact, German firms substantially reduced their investments during the second half of the 1990s, lagging the euro area average by almost 3 percentage points annually. At the same time, job creation fell dramatically, affecting wage growth and hence disposable income of households, who reduced their private consumption.

Under the impression of high and sticky unemployment, the Schröder Government initiated a series of labour market reforms starting in 2003, effectively reducing entry wages at the lower end of the labour market. Already starting in 2000, several tripartite negotiations had been undertaken in an attempt to lower wage growth and to restore price competitiveness. Partly, these reforms had been triggered by the fact that nominal exchange rates had been effectively fixed since 1995 in preparation for setting up the euro area three years later. This was also the year when the Deutschmark had reached a high point relative to currencies in main competing European countries as a result of the earlier policies enacted during reunification. Internal devaluation was, therefore, seen as the only means of restoring what was seen as a more equitable situation. However, most of the reforms essentially led to wage deflation in the services industries where new, predominantly low-wage jobs appeared. Such an approach substantially prolonged the adjustment period and until today, hourly wage costs remain among the highest in German manufacturing. At the same time, little was done to restore competitiveness through increases in productivity (see figure below). Indeed, productivity developments remained in line with other euro area countries.

Productivity and real wage developments: Germany versus the rest of the euro area (index, 1995 = 100)



Source: OECD, Economic Outlook database.

These wage deflation policies have not only impacted private consumption, which lagged behind that of other euro area countries by more than 1 percentage point over the period 1995 to 2001. They have also led to widening income inequalities, at a speed unseen even in the aftermath of reunification, when several million people lost their jobs in East Germany (see OECD, 2011). At the European level it has created conditions for a prolonged economic slump as other member countries increasingly see only even harsher wage deflation policies as a solution to their lack of competitiveness. This is all the more discomforting as it is unclear to what extent these wage deflation policies in Germany have contributed to higher employment levels, which in 2006 were barely higher than in 1991. As a matter of fact, recent export successes owe little to these wage policies and more to the geographical orientation of German exporters to dynamic emerging economies (see OECD, 2010). At the same time, low domestic demand has held back stronger services sector growth with adverse consequences for labour productivity in that sector and the aggregate economy as a consequence. Indeed, faster productivity growth in German services would not only allow an end to the current wage deflation policies - with positive spillover effects to the rest of Europe - it would also help restore a more equitable income distribution across wage earners.