Auf Wiedersehen, German Competitiveness

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The release on Monday of data showing that the German manufacturing PMI fell to 44.1 in March, the weakest reading since 2012, emphasized how Germany's factory slump is likely to get worse before it gets better. The proximate causes of this slowdown are familiar: weaker demand growth from Asia, the fall in exports to Turkey following the lira's collapse, stalled demand from the UK since 2016's Brexit vote, and the slide in car sales following the introduction last year of new emission test standards. But behind these cyclical and one-off factors, deeper structural trends are eroding the vaunted competitiveness of German industry. Unfortunately for investors, the policy responses tabled to date are unlikely to remedy Germany's worsening malaise.

Just 15 years ago, Germany was still the sick man of Europe

It seems a long time ago now, but for much of the 1990s and early 2000s Germany was derided as the sick man of Europe. German exports were losing market share. Unemployment was in double digits. The government's deficit was well in excess of its Maastricht obligations. And German GDP growth consistently lagged around 1pp behind the rest of the eurozone. Germany's model—the social market economy—appeared to be failing.

Some 15 years on, and those bleak days seem a distant memory. A series of changes—some the result of deliberate reforms, others imposed on Germany by circumstances—altered the picture entirely. Today Germany's net exports are the largest of any major economy relative to GDP. At 3.2%, the unemployment rate is lower than West Germany's at reunification. Berlin runs a fiscal surplus equal to 1.9% of GDP. And in recent years growth, while unspectacular, has generally been ahead of Germany's eurozone peers—as has the performance of the German stock market.

Employment market changes led to a big increase in Germany's competitiveness

What made this turnaround possible was a series of changes that allowed the German economy to mobilize labor more efficiently. The consequences were a decline in real wages, even as the number of workers in employment rose steadily and output per worker increased. In short, labor market changes allowed Germany—and German manufacturing industry especially—to became super-competitive, with the result that for the last five years in a row, Germany has run a current account surplus greater than 7% of GDP.

Competitiveness boost runs out

Now reforms in other areas are needed

Now, however, the competitiveness gains Germany reaped from its heightened labor market efficiency appear to have run their course. This suggests that if Germany is to maintain its competitive advantages in the future, it must rely on mobilizing other factors of production more efficiently, in particular capital. If it succeeds, the long run results should be positive for investors. Unfortunately, the early signs are discouraging.

To appreciate why Germany's labor efficiencies are no longer delivering, it is necessary to recall the employment market changes that took place in the late 1990s and early 2000s.

In West Germany, wage settlements were negotiated at the industry level...

The first wave of change took place in the 1990s. Traditionally, wage bargaining in Germany had been conducted at the industry level between trade unions and employers' federations. For example, the powerful metalworkers' union IG Metall, representing workers across the country's industrial engineering sector including its automakers, negotiated an annual wage increase with industry employers' groups such as Gesamtmetall. The resulting settlement was then implemented across the industry by every employer that recognized the union—in effect by all the employers in the sector. In this way workers got favorable wage increases, and individual employers could be sure their competitors were not undercutting them on pay and conditions.

This began to change in the years following the fall of the Soviet Union in 1991. With the subsequent opening up of Eastern Europe, German industry had the opportunity to extend its supply chains eastward into cheaper neighboring countries which had both a long history of trade and deep cultural affinities with Germany. Not only was the historical structure of industry similar, but so were education systems, with an equally heavy emphasis placed on vocational training in countries such as Hungary and Poland as in Germany.

...but the opening up of Eastern Europe led to a fragmentation of pay bargaining and significant voluntary wage restraint

This opening up tipped the balance of power in wage negotiations away from Germany's trade unions and towards employers. Facing the prospect of lay-offs should production be shifted east, the unions were forced to accept a fragmentation of the collective bargaining process, with workers' representatives at individual companies increasingly opting out of industry-wide wage settlements in order to strike their own deals with company bosses to preserve jobs.

The result was greater flexibility over terms and conditions that in aggregate amounted to significant wage restraint, with wages remaining flat in real terms through the late 1990s and into the early 2000s. Meanwhile, the reduction in input costs achieved by outsourcing to Eastern Europe drove an increase in German productivity which, coupled with flat real wages, helped significantly boost Germany's competitiveness.

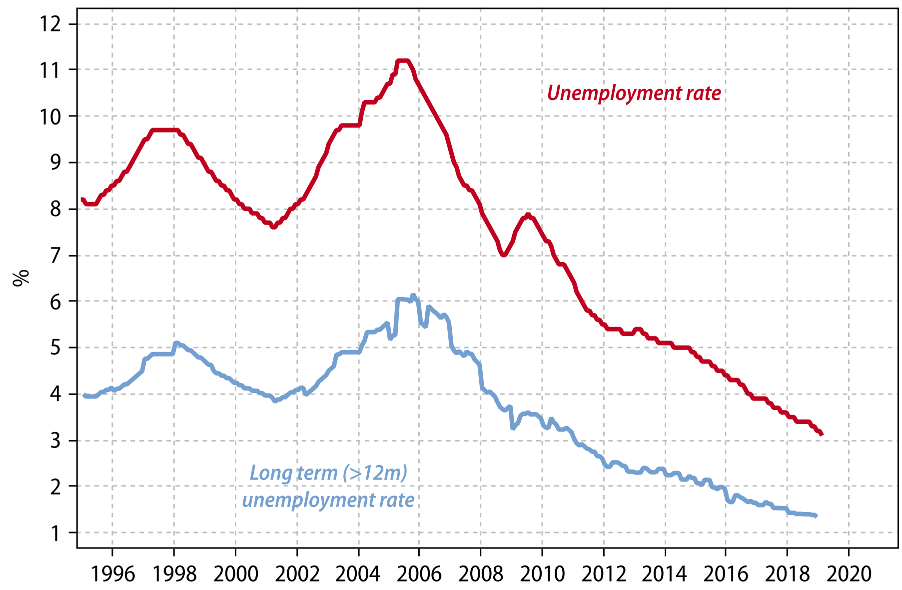
Welfare reforms

Until the mid-2000s, Germany suffered a high level of long term unemployment

The second wave of change came in the mid-2000s. For most of the time from the mid-1990s to the mid-2000s, the German unemployment rate had stayed stubbornly in double digits. What's more, around half of these jobless were long term unemployed—people who had been out of work for 12 months or more, and who in many cases were able to remain unemployed in relative comfort thanks to the considerable support offered by Germany's generous social welfare system.

Things began to change in 2005 when Gerhard Schröder's government implemented the fourth round of its Hartz reforms. This round merged unemployment payments with other social welfare benefits, and provided powerful incentives—including subsidies—for the unemployed to return to work. In the next three years 1.5mn unemployed Germans joined the country's working population. Over the same period, the long term unemployment rate fell from a high of 6.5% to 4.3%, with a further steady decline over the subsequent years to just 2% in late 2018 (see the chart overleaf).

The Hartz reforms got Germany's long term unemployed back to work



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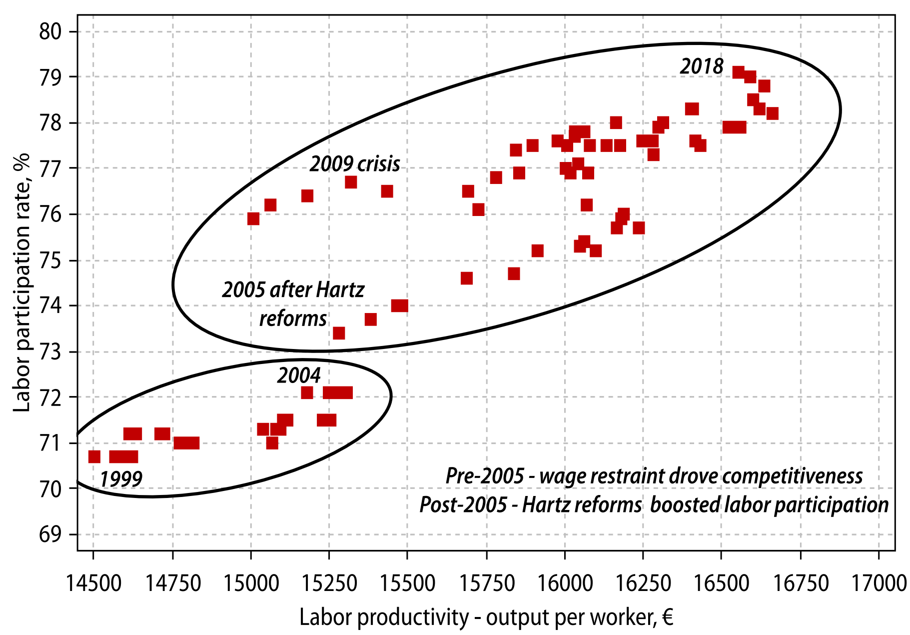
From the mid-2000s real wages went into decline, followed by stagnation

The influx of such large numbers of workers into the employment market exerted additional downward pressure on wages, which between 2004 and 2008 fell by -6% in real terms, further enhancing the competitiveness of the German economy relative to its international peers.

Shot in the arm

Together, these two changes—the decentralization of collective bargaining leading to wage restraint, and the back-to-work incentives of the Hartz reforms—delivered a large and sustained shot in the arm for German competitiveness.

Increased labor participation coincided with steadily rising productivity



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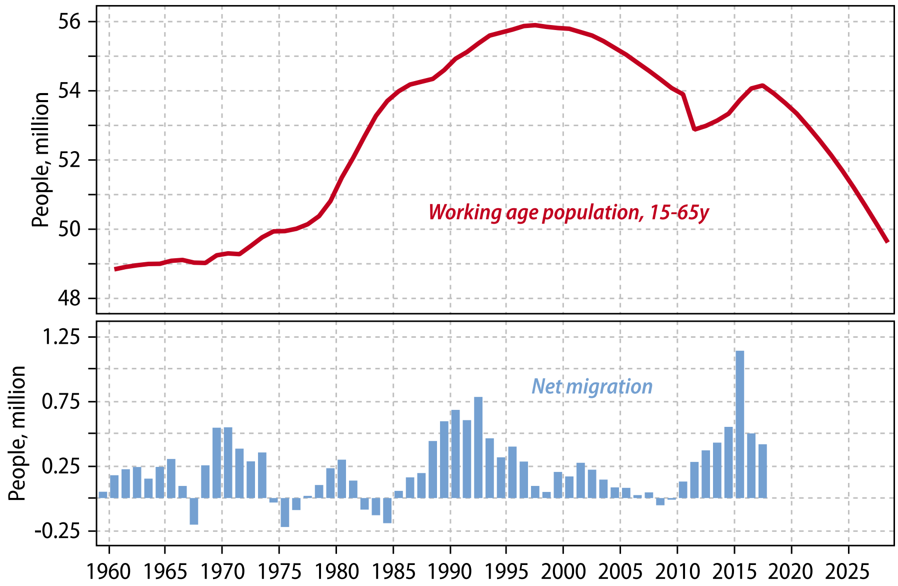
Now, the effects of that shot in the arm are wearing off. One reason is Germany's minimum wage. Introduced in 2015 at €8.50 an hour, it has since climbed to €9.19 (US$10.30). Equivalent to roughly €1,500 per month, Germany's minimum wage is now one of the highest in the European Union.

Now the pool of potential new workers has almost run dry...

On top of that, Germany's labor market is looking tighter and tighter. Not only has unemployment fallen to a post-reunification low, but the labor force participation rate has climbed to a record high of 79%. In other words, the pool of potential workers has almost run dry. Increased rates of immigration have slowed the process, but given Germany's demographic profile, not even a faster inflow of labor from abroad is likely to reverse the long term trend.

Inflows have not reversed the contraction of the working age population



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The increasing tightness of the German labor market has considerably strengthened the hand of workers and unions in recent wage negotiations. In March, for example, public sector workers secured a 3.2% pay rise for this year, followed by an additional 3.2% for 2020 and 2.4% in 2021.

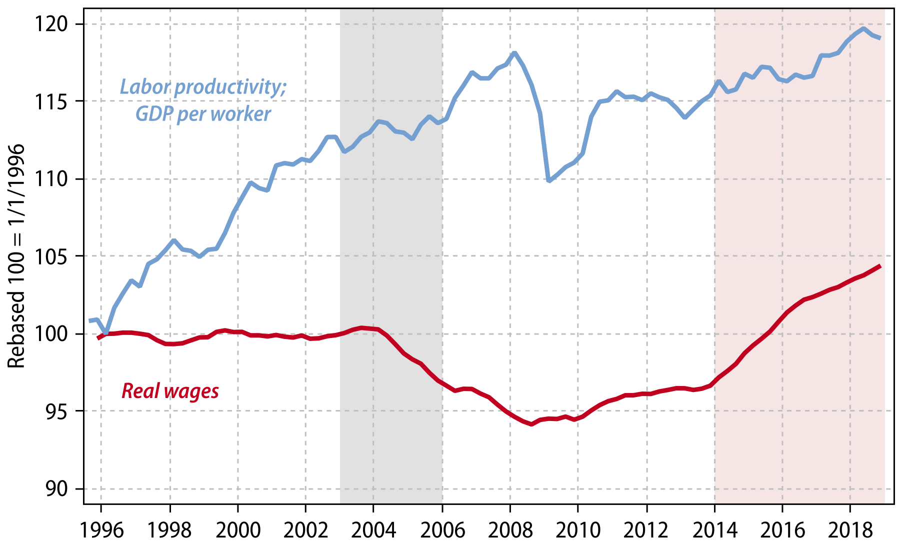
...and wages are rising again in real terms, and rising faster than productivity

The cyclical slowdown in the industrial sector is likely to ease the upward pressure on private sector wages this year. But that will not alter the structural picture, which is that after almost two decades of stagnation and decline, German wages are rising again in real terms. Moreover, real wages are now climbing faster than output per worker (see the chart overleaf), which suggests that the boost to competitiveness that accrued from the structural changes in the labor market in the late 1990s and early 2000s has now run its course.

If Germany has run out of the gains it can extract from mobilizing labor more efficiently, it will have to look for a different way to maintain competitiveness. The most obvious would be to mobilize capital more efficiently, boosting productivity through more and smarter investment. But the flipside of Germany's persistent current account surplus over recent years is that the economy's savings have far exceeded its domestic investment.

Real wages are now rising faster than workers' productivity

Grey bar = Hartz reforms | Pink bar = real wages rising faster than productivity



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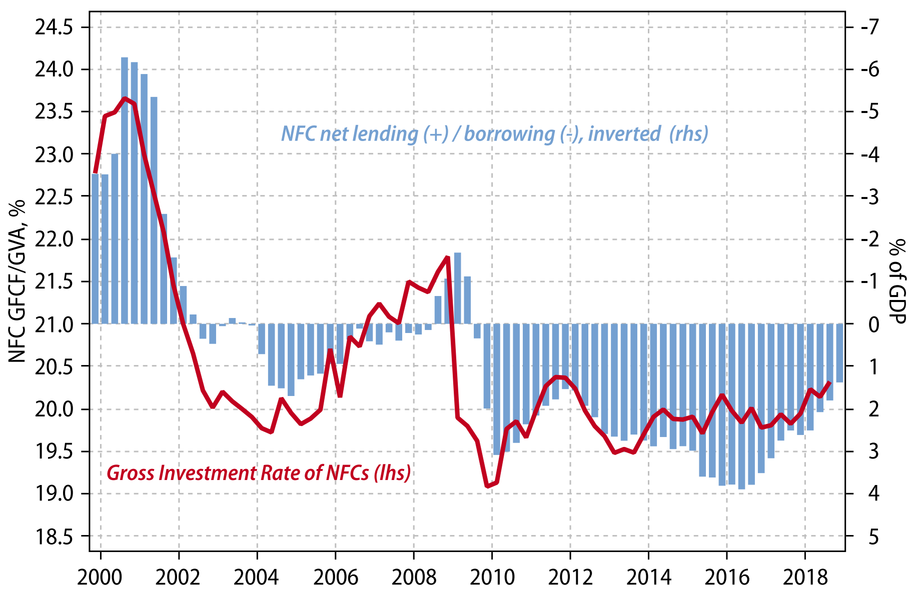
Tax reforms in the 2000s discouraged private sector investment...

Part of the reason is tax reforms introduced in 2000 that encouraged companies to use retained earnings to pay down debt. In response, businesses focused on deleveraging, investment fell steeply relative to value added, and Germany's current account swung from a small deficit to persistent surplus.

...while public investment has been insufficient

It's not only the private sector that has failed to invest. For years, government outlays have been constrained by ordoliberal ideas of fiscal rectitude, backed by the imperatives of coalition politics, a balanced budget law and a post-crisis focus on paying down debt. More recently, this official parsimony has been reinforced by fears that additional public spending would exacerbate labor market tightness and push up inflation. As a result, investment has barely kept pace with the depreciation of existing infrastructure assets.

Tax changes in 2000 led businesses to hoard cash and invest less



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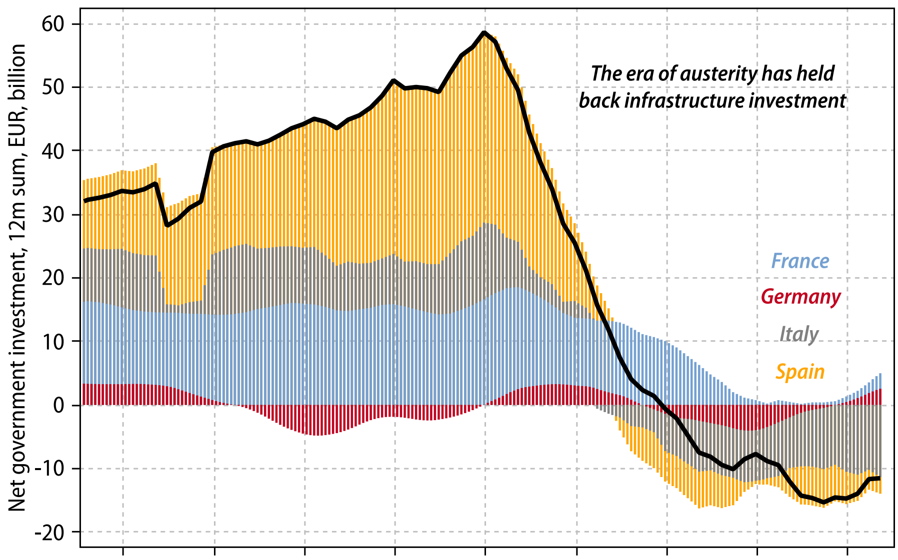
Germany's net public investment investment has been flat for 20 years



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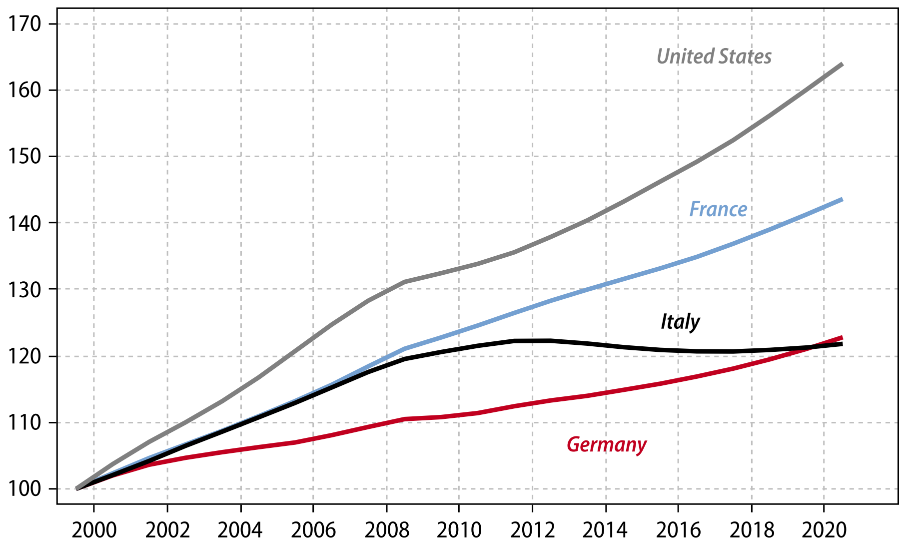
In macro terms, the upshot of this failure to invest is that the growth of Germany's capital stock has persistently lagged behind the growth of that in rival developed economies.

German corporations have not kept pace with investments in new technologioes

In more micro terms, Germany's manufacturing sector largely retains its reputation for engineering excellence. However, the emission test scandal of 2015 and its reverberations have emphasized how many of Germany's industrial giants have failed to keep pace with their emerging competitors' investments in new technologies. Meanwhile much of Germany's physical infrastructure is in need of modernization, while its digital infrastructure increasingly lags behind that of its economic peer group.

German investment has lagged behind international peers

Net capital stock, constant prices, rebased 1999 = 100



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Increased infrastructure investment and financial reform could help...

All of this bodes ill for Germany's future productivity growth and competitiveness, and the apparent direction of the authorities' policy responses is unlikely to improve matters. From the perspective of investors, the preferred policies would be greater public investment coupled with far-reaching financial reform. Increased public investment in both physical and digital infrastructure would help to lift productivity. Meanwhile, financial reform—in particular to incentivize venture capital investment—would allow the market a greater role in allocating the capital needed to facilitate creative destruction and establish the market leaders of tomorrow.

Trouble ahead

Neither policy track looks likely. The finance ministry continues to pursue debt reduction in preference to new investment, even though Germany's gross government debt is low by developed economy standards at less than 60% of GDP (with almost a third of that held by the European Central Bank). At the same time, European financial regulations effectively penalize institutional investors from holding assets other than government bonds, discouraging private investment in venture capital.

...but Berlin prefers to pay down debt and to try and promote national champions

And far from fostering creative destruction, government figures such as economy minister Peter Altmaier are talking in terms of promoting favored national champions, in emulation of China's state-directed industrial strategy. But while picking winners might play well politically, it seldom leads to superior returns on capital (see **The Trouble With Champions**). As a result, it is hard to be optimistic about Germany's economic future. Even if growth emerges from its current soft patch over the coming months, deeper structural trends point to a long term decline in German competitiveness. These suggest that the country's economic outperformance of the last 15 years may have been a historical aberration, and that in years to come Germany may find itself once again competing for the title of the sick man of Europe.