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Germany´s 2% boom

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Germany's 2% boom

The rising tide of global merchandise trade has finally started lifting the fortunes of the world's exporting champion in measurable ways. Germany's multiple chronic embarrassments with stunted economic growth, mass unemployment, sickly domestic consumption and Maastricht deficit ceilings have been shunted aside by sure signs of an economic recovery.

Germany is on course for a 2.2% real increase in gross domestic product in 2006, according to the September forecast of the EU Commission. Although that figure still lags the average 2.5% economic expansion that Brussels projects for all of Euroland, it is a big improvement from the commission's 1.7% growth estimate for Germany last May and vastly better than last year's actual 0.9% GDP rise there. "A very positive economic picture," was also the general assessment of Bundesbank President Axel Weber. But no such enthusiasm is being lavished by experts on 2007, the year of the great leap forward in value-added tax.

The country's industrial sector, meanwhile, made a convincing start in the third calendar quarter by booking 1.8% higher orders in July than in June, said the economics ministry in early September. Heavily export-oriented capital goods manufacturers led the way with 4.5% greater demand. Most notably the booming mechanical engineering branch, having already notched a heady 16% jump in output since the start of 2004, anticipates growth of at least 2% next year, backed partly by orders in hand.

In the financial services sector, major banks have put their 2001-02 crisis behind them year with fresh help from strong fee business, especially from corporate takeovers and a budding boom in property transactions. And recent stock-market hiccups notwithstanding, German blue-chip earnings in the second quarter were one-third higher than in the year-earlier quarter, making the April-June period of 2006 the most profitable in history for the 30 DAX corporations, a list dominated by big manufacturers and financial firms.

The general improvement in business earnings has been clearly reflected in higher German tax collections. Coupled with a long string of austerity budgets, this development finally allows Germany to comply this year with the 3% Maastricht ceiling on public deficits as a percentage of nominal GDP for the first time in five years. The anticipated 2.8% deficit for 2006 would also bring Germany's fiscal policy back into compliance with the country's own constitution, which gears deficit spending to public investment.

On the employment front, the Germany's official seasonally adjusted 10.6% jobless rate for August remained unchanged from July, although the jobless roll, currently with 4.45 million names, had shortened in previous months. Numerous changes in labor-market policy have increased the number of gainfully employed persons, currently 39.1 million, through alternative forms of employment that lack some of the protection of payroll jobs covered by full social insurance. But the decline in joblessness has been more closely related to such statistical effects than to the strengthening economy.

One apparent driver of the recent success of German merchandise exporters has been identified by the Federal Statistics Office in a new study -- "Was kostet Arbeit in Deutschland?"/What does labor cost in Germany? --which tracks the cost of German labor. German manufacturing, industrial production and production-related services have scored sustained gains in competitiveness because German labor costs in the period 2000-2004 had risen much more slowly than the comparable EU average, it found. “The weak increase caused an improvement in competitiveness against nearly all EU member countries,” said the federal statisticians said in this preliminary report.

Starting with the millennium year the annual increase in hourly labor costs in the whole production sector and supporting services has been 3.6% in the EU of 25 countries and 3.0% in Euroland but only 1.8% in Germany, this report said. For manufacturing alone Germany showed a rate of change of 2.1%, compared with 3.0% for all of Euroland and 3.5% for the EU-25.

Since 87% of all German exports fell into the category of merchandise during the record trading year of 2005, what happens in manufacturing is a good gauge of Germany’s international performance in increasingly globalized competition. Although only Sweden and Belgium had higher manufacturing labor costs than Germany in 2000, those lofty German costs have risen at the slowest rate in all Europe since then. Nowadays, Germany has descended to midfield in the old EU of 15 in terms of labor costs in all production and related services, making the country more competitive than France, the Netherlands, Belgium, Denmark, Luxembourg and perhaps a few others for which statistics were incomplete.

Of course, no conceivable suppression of labor costs can outweigh the low-wage advantage to be had next door in eastern Europe. And this study also says little about productivity, although other data have shown that real output per hour worked in Germany has recently been advancing faster than the employers’ total cost of obtaining that hour of work. This would then cause a real decline in unit labor costs, the quotient of labor costs and real GDP, where labor cost includes the wage or salary plus what the employer pays as his share of all associated benefits. According to the Federation of European Employers, real unit labor costs declined in 2005 by 0.3% in the EU-25, by 0.5% in Euroland and by 1.4% in Germany. Only Spain registered a steeper decline, namely 2.1% last year, while Italy showed a rise of 0.6% and France broke even. Germany’s federal statistics have also tracked a decline of the share of net wage in national income since the turn of the millennium, from 72.2% in 2000 to 67.0% in 2005.

“No wonder consumption has been stagnating for years,” Joachim Jahnke, author of the book Deutschland global? Mit falschen Rezepten in die Globalisierung, commented recently. “The domestic market is decisive and exports cannot make up for that. The loss of internal buying power through wage restraint has always been much greater than the gain from abroad. The macroeconomic result has been stagnant GDP.”

In view of the link to productivity, take-home pay, buying power and domestic demand, claims being made in the business press that the development of comparative labor costs strengthens the German business base may need some qualification. Germany’s new competitive edge is being measured in exports against other EU and Euroland countries such as France and Spain that are otherwise growing considerably faster than Germany. Using 2001 as a base, Commerzbank plotted the world export market shares of the four big Euroland countries. Despite the rise of Chinese exporting, Germany held its position in the period 2001 through 2005. After an initial gain in share, fast-growing Spain finished with a loss. The steepest and steadiest loss was suffered by Italy, where GDP growth has also fallen behind that Germany. And France, which is growing faster than Germany, lost market share moderately.

Supply-side economists insist that the same wage restraint which is clearly helping German exports will eventually attract more business investment to labor-intensive industries at home, putting people back to work. Demand-side economists argue that years of weakly rising wages and eroding real incomes are the cause of Germany's glaring weakness in consumption, which discourages job-creating business investment in the purely domestic economy, the main source of employment.

"The threshold of employment is closely tied to business investment," Jörg Krämer, Commerzbank's chief economist, told business journalists in late August. "We now need more investment to affect employment." But the outlook for that seems mixed, even though such export-driven branches as machinery have been investing and hiring vigorously. Considering only full-time payroll jobs with social insurance coverage, Krämer said, the bank's model projections show that employment is currently stagnating in spite of the sharp rise in business investment this year and that hiring expectations are already falling. The prospect of a positive trend reversal on the German labor market is therefore in doubt in view of the current economic situation.

Although the labor market has seemingly steadied, Ifo institute's leading economic indicator for Germany has now fallen twice and the indicator of ZEW has also dropped. Labor-intensive construction has merely stabilized and private consumption remains weak after having fallen in the second quarter. After having risen sharply in June, thanks partly to the World Cup soccer tournament in Germany, retail sales dropped sharply again in July. The domestic automobile market also ran out of gas in the month of August, leaving growth of only 0.6% in unit deliveries for the first eight months of 2006. For some of those reasons, Commerzbank is looking for considerably weaker GDP growth in the last two quarters than in the first half of 2006.

There are also external risks. European Central Bank has been tightening its interest rates and the U.S. economy, which has been driving global demand, has slowed considerably in recent months. "I'm reminded a lot of the year 2000," said Krämer, raising for Germany the possibility of a return to normal trend growth of 1% in 2007. But he said that Germany is no longer the "sick man of Europe" and would probably have closed the GDP growth gap to Euroland this year if it were not for austere fiscal policy. For next year, however, Krämer anticipated a "massive withdrawal of buying power," with private consumption just a shade above that of 2006.

The bank estimated that fiscal policy, starting with the three-point hiking of the value-added tax to 19%, would take €34.4 billion away from German private households, giving only €9.5 billion back. Businesses, meanwhile would approximately break even. Apart from the €18 billion lost to the sales tax increase, private households would lose €3.2 billion to heavier health insurance charges and €4.9 billion to various changes in income tax law. Smaller 10-digit euro raids on buying power would come from hikes in insurance tax, the retirement insurance levy, curtailed jobless assistance, labor policy changes and the phased elimination of house ownership grants. Buying power would be augmented only by the lowering of the unemployment insurance levy, a deferment of taxation of retirement income and the introduction of child-rearing money.

All that would certainly do wonders for government financing, temporarily. But the burden of public financing would apparently shift incrementally yet again from businesses to families, wage earners and consumers. And with signs of U.S. economic cooling that could crimp demand for exports, this German policy may prove to be a pro-cyclical growth flattener.

Asked whether export surpluses can serve as the appropriate yardstick for a country's economic success, the Commerzbank economist opined that the proper standard would be the general prosperity, namely GDP performance. In view of economic potential, however, he said Germany had no other recourse. But a number of foreign officials, including former U.S. Treasury Secretary John Snow last year, have urged Germany and other surplus countries to do something for their weak domestic demand -- in the interest of their own economic growth and the stability of the lopsided international balance of payments.

In an interview with the Frankfurter Rundschau newspaper the start of September, Heiner Flassbeck, chief economist of the Unctad, the UN Organization for Trade and Development, commented on the swelling German current account surpluses in the context of Unctad's annual report. By reverting to its old role from the pre-unification 1980s, he said, Germany was „hitching a ride on the running board of the world's economy“ that is powered by U.S. and Chinese demand and that it can now do this by „hiding behind the wall of the euro.“ German retailers, some purely domestic businesses and lots of wage earners might have cause to question such a national strategy, but the exporting industries can scarcely complain.

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