AUSTERITY and its ALTERNATIVES

Internal Devaluation in Germany and the Crisis in Europe

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ABOUT US

Austerity and its Alternatives is an international knowledge mobilization project committed to expanding discussions on alternatives to fiscal consolidation and complimentary policies among policy communities and the public. To learn more about our project, please visit www.altausterity.mcmaster.ca.

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Abstract

This paper identifies the causal mechanisms linking public policy developments in Germany to the broader political economic environment of the Euro-zone. I argue that Germany's bold internal devaluation approach, based on the weakening of collective bargaining and the deregulations of "Agenda 2010," prepared the ground for the ongoing European crisis by triggering a mutual reinforcement of unsustainable growth models, pitting a surplus core against a deficit periphery. Tracing how German policymakers implemented "Agenda 2010" after having pushed the neoliberal construction of the European Monetary Union (EMU) in the 1990s, I show that the comparatively positive economic and labour market developments in Germany since 2009 are not to be attributed to "Agenda 2010," but to more recent reforms aimed at limiting the damage caused by precisely those deregulations. While the German "success story" is used to justify the dominant austerity approach in the EU, this article suggests that the stabilization of the Euro-zone depends on a more sustainable reorientation of Germany's socio-economic model toward strengthening its domestic market based on massive public investment in infrastructure and social services.

The present paper is a shortened and updated version of my contribution to Myant/Theodoropoulou/Piasna (2016).

Introduction

The European Monetary Union continues to be extremely vulnerable due to the economic policy approach based on a set of rules enshrined in the Maastricht Treaty of the early 1990s and the more recently established 'new economic governance' at EU level. The outbreak of the Euro-zone crisis gave way to the 'silent revolution' that, as predicted by former EU Commission President Barroso, lead to 'a quantum leap of economic surveillance in Europe' (EUobserver 2011). It institutionalised a dogmatic and aggressive austerity and deregulation approach in the EU in general, and its Monetary Union in particular. German governments have played a crucial role in the establishment and the reinforcement of these rules. For this purpose, they could dwell upon an authority based on the comparatively positive economic and labour market developments in Germany. The latter are attributed in large parts of the German and European public to the so-called 'structural reforms of the labour market' in the early 2000s. Thus, the so-called 'sick man of Europe' in the late 1990s/early 2000s has been turned into a role model for the rest of the EU.

In the present paper I present a contrasting line of argument to this mainstream view. I will sketch the main elements of the upheaval of the 'German model' since the 1990s and analyse its importance for the European Monetary Union (EMU) and its ongoing crisis. My conclusion will be that we are facing a paradoxical situation as the relatively successful development of the German economy and labour market since the Great Recession is to attributed primarily to the fact that in recent years the ill effects of the 'Agenda 2010' policy on the labour market have modestly begun to be curbed. That is, the alleged role model benefits from the opposite of what is currently being advertised as the 'one best way' for Europe. As a consequence, the effects of this 'one best way', which have proved to be disastrous both economically and politically for the European Union and have contributed substantially to demolish its foundations of solidarity, can only be overcome by a new policy approach both at EU and national levels, with particular importance of a social, ecological and economic policy turnaround in Germany.

Paving the Way into the Euro-Zone Crisis

The core of what was long described as the German variant of 'coordinated' or 'Rhenish capitalism' was a combination of economic dynamism and relatively low social inequality. Its main economic base has been the persistent strength of its exports-oriented manufacturing industry. Its performance and success is based primarily on the high specialization and product quality especially of capital goods, the strong orientation towards customer service, the flexibility and qualifications of the employees as a basis of incremental product as well as process innovation. Given this product-based competitiveness, the soaring current account surplus with the Euro-zone countries in the 2000s until the financial crisis is striking. It would be difficult to explain this sudden and dramatic rise primarily by an overnight re-gaining of product and process innovation capacities allegedly lost over the preceding decades. There must have been much more than this. It is more than obvious that the establishment of the EMU with its abolition of national level monetary policies and potential exchange-rate adaptations had created a substantially different playing field for competing economies. Within this new framework, a revived and high-performance German export industry in a domestic environment of social and institutional disintegration and fragmentation could become both fully effective in a destructive way (for what follows see Carlin et al. 2015; Lehndorff 2015).

Key elements of the upheaval of the German model included, first, a renewal of the production model since the 1990s: changes in ownership structures (opening the doors for a greater importance of 'impatient', rather than — what was typical for the traditional German model — 'patient capital'), in the international re-organization of supply chains, in a modernization of the production model, and in the role of the banking system. The second key element was the impoverishment of the state through privatisations and tax reforms to the benefit of large companies and capital owners which had to be matched by continuous and aggravating underinvestment into the public infrastructure and social services (Rietzler et al. 2017). The collateral damages included the fragmentation of, and an enormous pressure on, collective bargaining in the public sector, which have been part of the third key element: the weakening of the collective bargaining system (for details see Dribbusch et al. 2018; Haipeter 2017; Bosch 2018). In western Germany, sector level collective bargaining coverage fell from 70% of workers in the mid-1990s to 49% in 2017, and from 56% to 34% in eastern Germany (Ellguth and Kohaut 2018). While in principle this process was fostered by the structural change in the economy accompanied by a decline in trade union density, it was accelerated by the broad abolition of earlier extension practices of sector-level collective agreements by the government, under the pressure of the employers' organizations. This trend, in turn, contributed to a substantial weakening of pattern bargaining of unions across sectors, thus giving way to an overall negative wage drift and increasing dispersion in the development of both collectively agreed and actual wages in particular between manufacturing on the one side and major private, including recently privatised, service industries on the other. What came on top of this were local deviations from collective agreements which had gained momentum since the 1990s.

The fourth key feature of change have been the so-called 'Hartz reforms' in the early 2000s (Bosch 2014; Knuth 2014a; Weinkopf 2012). They brought about changes in the architecture of labour market regulation which included the partial replacement of unemployment insurance by a means-tested benefit system with intimidating ripple effects in broader segments of the labour market, the abolition of many formerly existing restrictions for temporary employment, an additional strong impetus for the extension of atypical employment triggered by public subsidies for low wages within the framework of Hartz IV and by the promotion of mini-jobs with pay of up to 450 Euros, and several pension reforms which abolished previously existing pathways into early retirement and increased the statutory retirement age gradually from 65 to the age of 67 until 2029.

If later than in other EU countries, GDP growth picked up from 2005, employment started to rise again and registered unemployment began to drop. Given the widely shared belief that the 'Agenda 2010' is the reason behind this jobs growth it is important to note that these 'labour market reforms' had no discernible effect on the employment intensity of GDP growth (Herzog-Stein et al. 2013; Knuth 2014b). What is more, growth rates were lower than in most other EU countries. What did change, however, were the sources of additional labour input, that is short-term unemployed persons in close interaction with the rise in precarious and low paid work. This happened against the background of the almost continuous rise in employment of women, both in persons employed and in percentage of the working age population. This long-term trend was closely linked with the soaring part-time and mini jobs employment, giving rise to a disconnection (until recently) between the number of persons in employment and the total number of hours worked (Wanger 2015; Jaehrling 2017).

The only effect of the 'labour market reforms' which is not controversial in the political and academic debates is its importance for wage developments (Bonin 2013). Average real wages per employee dropped until the crisis. While the domestic market almost stagnated, between 2001 and 2008 three-quarters of the

— modest — German GDP growth was attributable to the export surplus, while domestic demand contributed a quarter only (Priewe and Rietzler 2010), which reflected in the impressive rise in current account surpluses with the countries of the Euro-zone in particular during the short growth period 2004-2008.

In previous decades the exchange rate adjustment mechanism would have made it possible for economies with rising labour unit costs and higher inflation rates to react on dropping labour unit costs and a modest inflation rate in Europe's strongest economy. Since the founding of the monetary union two-fifths of Germany's foreign trade now no longer had to fear such action. In fact, this was one major economic rationale of German elites in the making of the EMU in the 1990s (Scharpf 2011). Now, the German economy became the forerunner of internal devaluation within the EU.

In the German case, and in contrast to some other EU countries, internal devaluation meant in practice that from the early 2000s the product- and process-based strengths of the German manufacturing industry were combined with, and supplemented by, the decline of unit labour costs in comparison with competing economies. The European Central Bank (ECB 2011) estimated the improvement in Germany's price competitiveness compared with the major global trading countries in the period 1999 to the beginning of 2011 at 16 per cent (basis: GDP deflator).

How does this relate to the widely shared observation that the price elasticity of demand for many German export products is relatively low? In fact, average export prices rose from 2003 to 2008, if at a slower pace than in other Euro-zone countries, while (until 2007) nominal unit labour costs dropped (Schulten 2015). As a consequence, profits of German firms increased on average (IG Metall 2010). As Deutsche Bundesbank (2011: 33) summarised, part of the relevant cost benefits 'were apparently used to increase profit margins'.

The weak wage development, in turn, impacted on the demand-side of the economy. What happened was an almost stagnation of the domestic market. Therefore, the widely shared criticism that the German economy 'exports too much' tends to divert attention from the core problem: The key outcome of the prevailing economic and social policy approach of internal devaluation in the first decade of the Euro-zone (and to some extent until now) has been the 'import deficit' of the largest EU economy.

Under these circumstances, trade surplus must go hand in hand with soaring capital export. Due to weak economic growth, only a small part of rising profits was used for domestic investment (Ma and McCauley 2013). Thus, German profits participated actively in the booming global financial market bubble and in particular the financing of strong growth driven by mostly private debt in Europe's deficit countries. German investors were among the largest foreign creditors of the indebted US private sector, and German banks were the largest creditors of partly public, but primarily private debtors in Greece, Ireland, Portugal and Spain

(Bofinger 2010; Lindner 2013). Hence the common denominator that sums up the German business model that dominated the first decade of the EMU which can be labelled as 'Making profits without investing'.

This is how the widely hailed 'structural reforms of the German labour market' contributed to pave the way into the almost breakup of the European Monetary Union in 2010 ff. The German economy was driven into a process of internal devaluation within the Monetary Union, while the economic policy approaches in other countries did not follow the same logic. The outcome up onto the crisis was a growing cleavage between Germany and a few other 'core' countries with high current account surpluses and low GDP growth rates on the one side, and a 'periphery' group of deficit countries with high growth rates on the other.

The almost collapse of this house of cards in 2008 ff opened the doors to the 'silent revolution' referred to above, and German governments played a decisive role in the implementation of the 'austeritarian regime' (Dufresne/Pernot 2013: 4), that is, austerity imposed in an authoritarian manner. To a large extent, they could play this role because they received a powerful economic and political tailwind due to the fact that after the burst of the bubble the German economy turned out to be an island of (relative) stability. What is behind this alleged proof of the benefits of the painful 'structural reforms' in the early 2000s?

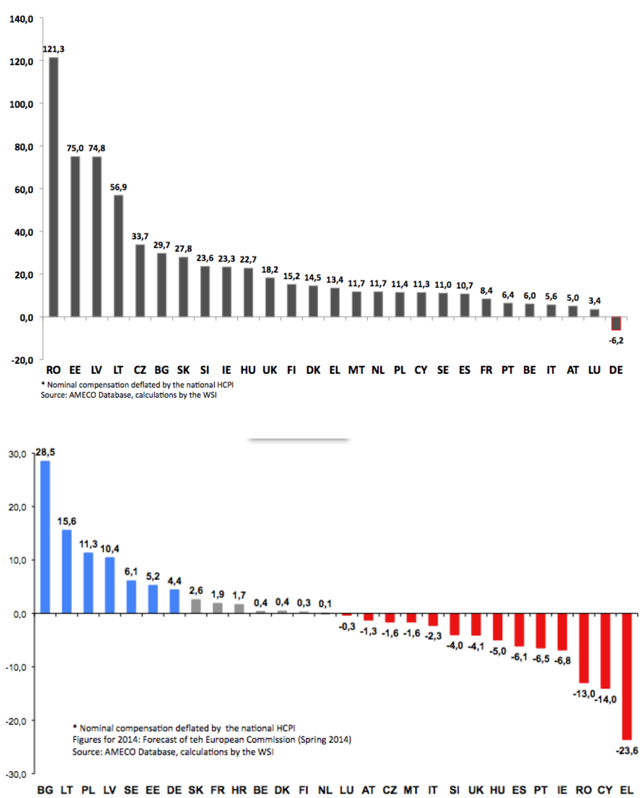
A Mislabeled Success Story

The beginning of the success story was the truly astonishing stability on the German labour market during the financial crisis which was the main condition of the rapid economic recovery from the third quarter of 2009 and the ensuing growth in employment in the following years. Almost overnight, counter to the relentless mantras that had previously prevailed, extensive economic stimulus programs were implemented in 2008 and 2009. The biggest direct effect of this recovery was the prevention of a massive fall in employment in crisis-ridden manufacturing. A similar turnaround happened with respect to external vs. internal flexibility. Since the mid-1990s increasing external flexibility had been one of the core neoliberal dogmas of employment policy and one of the guiding principles of the 'labour market reforms'. What rescued the German labour market in the crisis, however, was precisely the opposite: the reactivation of internal flexibility based on cooperation of employers and trade unions at eye-level. Now many companies accepted considerable productivity losses in the short term in order to retain skilled staff. Key to the revival of internal flexibility were short-time working and other working-time measures geared to reduce the volume of hours worked (Kümmerling and Lehndorff 2014).

The overall positive experience of safeguarding employment by a reactivation of precisely those elements of the German social model that had survived the neoliberally inspired zeal for demolition triggered a fresh political dynamic – tolerated by Merkelian adaptability – that could not easily be dismantled again as economic recovery set in from the second half of 2009. The policies of internal devaluation could not be carried on as easily as in the years before the crisis. This gave rise to a paradoxical situation which continues to dominate the European scene.

The paradox is reflected in the new trends in wage developments in Europe since 2010 as compared with the period before the Great Recession (Figure 1). The contrast is striking not just due to the dramatic wage cuts in the most crisis-ridden countries, but also due to the overall more favourable development of wages in Germany. Apart from the Baltic states Germany has had the highest wage increase of all Euro-zone countries since 2010. This shift is largely attributable to the experience of 2008/2009 and the broad public criticism of the increasing social inequality which has given tailwind to a more active wage policy of trade unions who have been, in many cases, more prepared to engage in conflicts. Furthermore, the public debate inside Germany has triggered new labour market regulations (most importantly the introduction of a statutory minimum wage) which more recently have supported these positive wage trends. It is a trend change which Horn/Watzka (2018) call a 'secret paradigm shift'.

Figure 1: Changes in real wages per employee, EU 2001-2009 (upper graph) and 2010-2014 (lower graph) (in per cent)



Source: Schulten and Müller (2015) (AMECO)

True, if balanced economic development is to be achieved in Germany and Europe this shift is still much too weak and the import deficit remains at a high level.

Nevertheless, the stabilizing influence of consumer demand on the domestic market should not be underestimated. In most years after 2009, domestic demand contributed much more to growth than the export surplus (Herzog-Stein et al. 2017). As a consequence, the wage rise in Germany after the crisis fostered a growth rate of GDP which has been higher than in the first decade of the EMU, while the German export industry continues to benefit from the drop in labour unit costs before the crisis (Horn/Watzka 2018).

Ironically, public-sector demand comes on top of that. Because of the increasing employment and rising wages and salaries tax revenues are also increasing. What comes on top of this positive sum game is a kind of crisis dividend, namely the interest benefits arising for the German budget from the Euro crisis. The so-called 'safe haven effect' made German government bonds such a desirable form of investment that their average overall interest rates fell from just under 5 per cent before the crisis to 3 per cent in 2012 (in 2017, 10-year bonds have been hovering around 0.5%). As a consequence, despite a higher public debt, the savings on German government interest payments from 2007 to 2018 add up to 368 billion Euros (Deutsche Bundesbank 2013; Handelsblatt 2019).

Irrespective of these more favourable economic dynamics, 'the long shadow of the 2000s' (Bispinck 2012) still lies on the German labour market. The proportion of employees and households on low incomes and, more generally spoken, income inequality continues to hover around their high pre-crisis levels (Bosch and Kalina 2017). The significance of temporary and agency employment has not diminished but most recently the number and share of full-time workers with open ended contracts has gone up for the first time in this century. The recent introduction of the statutory minimum wage has contributed to this more positive tendency as it has triggered a certain shift from mini jobs to regular employment (Amlinger et al. 2016; Bosch 2016). Nevertheless, these shifts in emphasis are still too tentative to enable the German economy to give a powerful impetus to help overcome the Euro-zone crisis.

Conclusion and Outlook

The paradox of recent developments in Germany and Europe can be summed up as follows: Before the crisis internal devaluation entailed by 'Agenda 2010' in Germany had contributed actively to the emergence of European economic imbalances. The comparatively positive economic and labour market development since the Great Recession, in turn, is not to be attributed to the internal devaluation before the financial crisis, but rather to the first attempts at limiting the damage caused by these 'reforms'. At the same time, the present 'jobs miracle' has served as a justification for the German government to push for internal devaluation in other countries, while the drivers behind the relatively positive development at home have been exactly those which are being forbidden to other countries.

It should be kept in mind that the logic of internal devaluation in Germany up until the financial crisis could only work, in terms of improved price competitiveness and higher profitability of firms, because policy approaches in other countries did not follow the same logic. If all economies take the same route there will be a race to the bottom. Arguably, if this had happened earlier, the Euro-zone would have experienced its first deep crisis already some years before the global financial crisis.

Now, as internal devaluation has been made the guideline for macroeconomic policy in the EU and its monetary union, it becomes evident that the shortcomings in product based competitiveness existing in many EU countries will not be overcome by this policy approach. Rather, social inequalities have been aggravated which reinforces the devaluation of the ultimately most crucial productive resource of any national economy, that is, human labour.

The moderate turn of events within Germany could already have positive side-effects for Europe if it were not used — or misused — to legitimate the alleged need for an institutionalised austerity approach in the EU and its monetary union. Thus, the potential minor stabilizing effects have been disabled by the economic and social outcomes of austerity and labour market deregulations in many EU countries, most dramatically in the so-called periphery of the EMU. Hence the need for a reorientation of German policy approaches at both the EU and the domestic level. To conclude, I give a brief sketch of the latter.

The limits of German economic policy to date are most discernible when looking at public infrastructure. The proportion of public investment in GDP, which has been for many years far below the EU average, had fallen to its lowest level so far by 2007, and after rising slightly it dropped to its lowest level ever in 2014. Net public investment has been negative in most years since 2004 (Rietzler 2014).

Over half of public investment is carried out by municipalities, where the woeful state of public finances is most evident. In 2017, German cities and municipalities estimated their investment gap at around 159 billion Euros (KfW 2018). What is more, the future development of the potential of the German economy and society depends on investment in people, rather than just capital goods. Germany is to be found in the lower midrange in the EU with regard to spending on such labour-intensive services (OECD 2011), while a viable education and training system and social services in general are crucial for qualified women to participate in the labour market. According to recent estimates it would require an additional annual spending of 6 billion Euros to close the staffing gap in child care, schools, police and other public services (Vesper 2016).

The German government and the great majority of the Bundestag have severely encumbered themselves with the 'debt brake' and played a decisive role in bringing it about that an even narrower constitutional limit was imposed on public debt across the EU. There is much evidence to suggest that turning away from this policy approach will require even more of a struggle than the one that made possible the recent tentative efforts to mitigate the damage caused on the labour market by Agenda 2010.

Particularly important elements of such reforms (without quotation marks) would be:

- A boost for public investment and services in conjunction with a gender-policy modernization of the welfare state and a turn towards a resolute energy and environmental policy (DIW 2013);
- A substantial increase in taxes on profits, higher incomes and, in particular, capital needed to finance this public investment and services programme (Godar et al. 2015);
- Support for the weakened collective bargaining system beyond the statutory minimum wage by a fresh approach to the extension of collective agreements and to the requirement of adhering to collective agreements in public procurement (Schulten and Bispinck 2013; Jaehrling 2015);
- Re-regulation of the labour market by an extension of the scope of protection by unemployment insurance; linking the notion of 'reasonable' employment conditions to be accepted by job seekers to the criterion of payment of collectively agreed or customary local wages; re-regulation of fixed-term and temporary employment (including equal pay); and the abolition of special regulations for mini-jobs (Bosch 2015; Bäcker 2018; Arbeitskreis Arbeitsmarktpolitik 2018).

Such a turn would be decisive for Europe, too: a more balanced socio-economic development in the biggest EU economy would reduce the constant pressure to lower wages and to dismantle the welfare state on the other countries in the region and in particular within the monetary union.

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