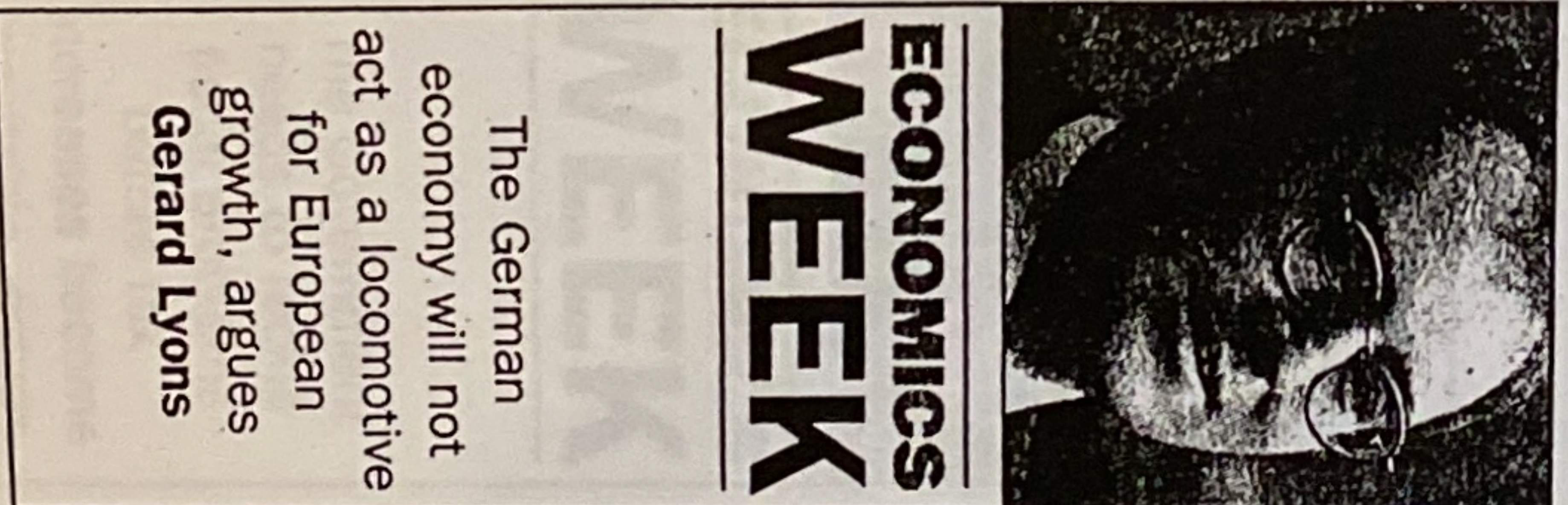
Germany suffers economic hangover



Germany pays the penalty for its good times. Don't be deceived by the recent improvement in the German economy. It may appear to be past the worst as it heads for economic recovery this year but all is not well. Germany faces deep-rooted economic problems. Industry has to cut costs and its government needs to cut spending. This points to a weak German recovery, with below trend growth and high unemployment.

It is necessary to distinguish between cyclical factors, which could allow the economy to improve in coming months, and the need for structural change.

Although GDP fell half a point in the first quarter, this was largely due to construction being hit by the harsh winter. Since then, construction has rebounded and growth looks set to bounce strongly in the second quarter. Recovery has been led by exports to eastern Europe and to South-east Asia. This has filtered through to the domestic economy, where low interest rates and the recent weakening of the Deutschemark have eased pressure on industry.

In recent months, business confidence, industrial production and retail sales have risen from low levels.

German recoveries are often led by exports and this is usually followed by a pick-up in investment. But not this time. There has been no investment boom to sustain this recovery, even though corporate profits are rising as firms cut costs. German firms are investing heavily overseas but not at home. A hollowing out of German manufacturing is underway, as firms move to lower-cost countries throughout Europe and further afield. This process of deindustrialisation will continue.

Germany's biggest problem is that it is not competitive due to high labour costs and the strength of the mark. Manufacturing labour costs are more than twice as high as in the UK and even 28% higher than Japan's.

There has been a sizeable appreciation of the DM throughout the 1990s. So much so that by last year it was causing severe strains to industry. Between 1991 and this spring the DM appreciated by 18.8% in real terms. Although less than the yen's 24.5% appreciation, it compared with a 10.3% fall for sterling and a 28.3% decline for the lira.

In the past Germany could cope with an appreciating DM because its productivity was high, outstripping its competitors. This is no longer the case. Other countries have raised their productivity — Germany therefore needs to cut its costs. Yet the extent of German cost-cutting that is required is high because the disinflationary global environment is forcing all countries to keep costs down.

Something had to give: either the DM or the economy. Hence the Bundesbank has encouraged a weaker DM since the end of last year and is now content with the currency's current level. Yet this has just touched the surface of the problem. Either the DM needs to fall sharply or German competitiveness needs to improve dramatically through radical cost cutting.

Unemployment is already high. The unemployment rate is 10.3% but the effective rate could be as high as 14% if one includes those on politically motivated training schemes which are simply keeping people off the unemployment register. UK unemployment is 7.7% and falling.

With German workers enjoying low working hours, long holidays and a low retirement age it is clear that, if firms are to restructure, then unemployment could rise sharply.

But change is imminent: Even though the German labour market is heavily regulated there are increasing instances of much greater flexibility at individual factories as firms agree not to lay workers off in return for dramatic improvements in working practices. If this continued it would allow the German economy to adjust much less painfully.

The fear of job losses explains a twist in how the government is trying to win the support of the German public for monetary union. While the public is not keen to lose its Deutschemark, the alternative it is told is for it to appreciate which would force more job losses.

Continued high unemployment will impose severe strains on public finances at a time when the government needs to squeeze spending.

This year, Germany will fail both parts of the fiscal convergence criteria. Government debt will exceed 60% of GDP for the first time. And the government deficit will rise to 4% of GDP, from 3.5% last year. With fiscal transfers to the old East Germany remaining high for some time, it will require more than a one-off effort to bring Germany's finances back under control. That inevitably means cutting government expenditure but no-one is prepared to shoulder the burden of the spending cuts. Transfer payments already account for a high 22% of disposable income, compared to 45% from net wages.

At a time of high unemployment it may be difficult for the government to achieve spending cuts and, if it does, it will weaken the economy.

While there is almost universal agreement that EMU will start on time, as the convergence criteria are relaxed, Germany's budget deficit remains the biggest potential hurdle and could still delay the process at the last minute.

The financial markets are therefore wrong to conclude that the recent improvement in the German economy inevitably means higher German interest rates. The need for cost-cutting and a softer DM alongside weak growth, continued low inflation and a tighter fiscal stance will compel the Bundesbank to keep interest rates low for some time.

Germany may not be able to act as a locomotive for European growth but it will enable European interest rates to remain low.

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