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Economy

Shocks on the German economic model

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If we were to describe the German economic "model" succinctly, we would speak of export competitiveness, industrial product quality, wage moderation, respect for budget equilibrium, etc. On all of these points however, this "model" has been turned on its head. Global trade is slowing. The VW scandal is tarnishing the reputation of "Deutsche Qualität". The introduction of a high minimum wage risks making the cost of labour more expensive. The massive influx of refugees will carry a cost for public finances, even though some claim that this factor will be a bonus in the medium-long term. Where is Germany headed?

Towards more robust domestic demand, slightly weaker exports

It was fashionable ten-fifteen years ago to give Germany the notorious "sick man of Europe" label. Reunification had sharply eroded the country's competitiveness. In 2002, Germany, as we tend to forget, breached the Maastricht Treaty's rules on the deficit and to avoid being sanctioned connived with France, all too pleased to find such an ally, to weaken the Commission. Its unemployment rate even exceeded France's! Then came the era of reforms (Chancellor Schröder's Agenda 2010), wage moderation, a return to fiscal discipline. The upshot is that the German economy has succeeded, after the global recession of 2008, in rapidly getting back on its feet and is now generating the strongest economic figures in Europe. The country is in full-employment. Chancellor Merkel is the dominant political personality in the continent, not without a degree of reluctance in assuming this role (the "Hegemon wider Willen" theme). This dominant position of Germany is illustrated at the macroeconomic level in the form of a double surplus, i.e. trade (8.3% of GDP) and budget (0.6% of GDP).

Several recent events nonetheless prompt us to question whether these economic performances are likely to encounter problems in the short term.

- The most emblematic shock is the **Volkswagen scandal** which has seriously tarnished the carmaker's reputation. By extension, the doubt could spread to the entire "made in Germany" concept. If this were the case, the competitiveness-quality (or excl. costs) of the entire German industrial sector would take a knock.
- Moreover, Germany, which is ranked amongst the Top 3 exporters worldwide, must deal with the **slowdown in global trade**, notably amongst its major clients (China, Russia for example).
- Germany is also at the forefront in terms of the **refugee crisis**. The inflow is massive. According to a number of unofficial reports, the figure could top the million mark in 2015. In addition to humanitarian and political aspects, which are undoubtedly a priority, a number of economic questions arise: the immediate cost for public finances, repercussion on the working population. From this standpoint, **the introduction of a minimum wage** since 1 January 2015 does not facilitate the integration into the job market.

To examine the scope of these concerns in greater detail, we recap in the present note on the factors which have underpinned Germany's economic success over the last decade: the flexibility of the labour market, tight control of wages, a high degree of non-cost competitiveness, successful integration in globalisation.

➢ **Export champion faced with the slowdown in global demand**

After its reunification, Germany underwent a profound economic transformation reflected in the rapid growth of its external trade, a phenomenon unparalleled in major European countries. The result is that Germany has climbed to the top of the export league worldwide alongside the US and China. As a percentage of GDP, the share of imports and exports rose from around 20% of GDP towards the middle of the 1990s to over 40% at the time of the global crisis in 2008. This figure is now approaching 50%

(chart lhs). The positive reading of these developments is that Germany has more effectively adapted to globalisation than other European countries thanks to its range of high-quality products and a geographic positioning which enables it to benefit from robust demand from emerging markets hungry for capital goods.

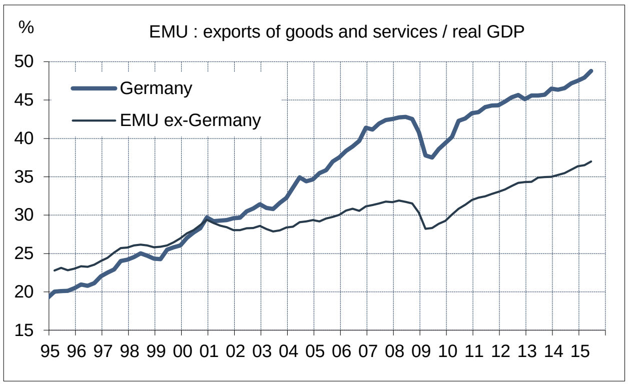
A negative interpretation quickly emerged nonetheless, in Germany, aimed at explaining the paradox which the German economy presented ten years' ago: the coexistence of a booming export sector and a domestic economy lagging the rest of Europe. This illustrated the existence of an overly rigid labour market and excessively high wages. To overcome this kind of constraint, companies have had to reorganise their production by transferring labour-intensive activities to low-cost countries (*offshoring*) or by buying intermediate products abroad (*outsourcing*). The only activities maintained locally have been capital-intensive ones, implying the destruction of unskilled jobs and a rise in unemployment. Germany began turning into an assembly point for products sold subsequently at very high prices under the "made in Germany" label, generating a sharp increase in trade surpluses. In provocative mode, some have described this situation as a "bazaar economy"[1]. All told, Germany's export success masked serious shortcomings on the domestic front.

As is often the case, the truth lies somewhere between these extreme descriptions. In any case, **a growth model of this kind is exposed to two weaknesses. It assumes that external demand remains robust and that wage discipline will be maintained. What happens if these conditions no longer hold?**

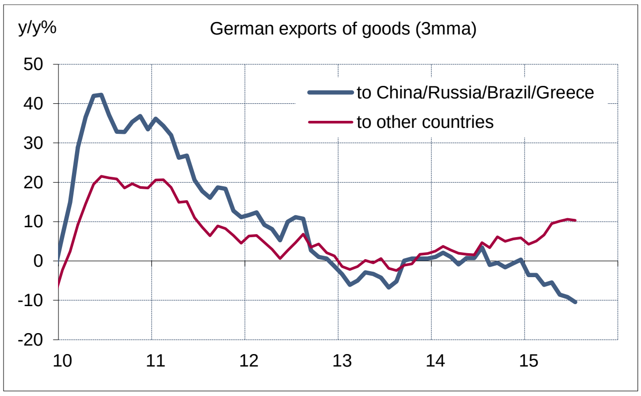
Global trade has slowed in recent years linked to the deceleration in economic activity. Real global GDP growth slowed from 4.2% per annum over the 1997-2007 decade to 3.3% over the last three years. Moreover, the elasticity of trade to GDP was halved following the crisis of 2008, falling from 1.9 to 0.9, partly due to the streamlining of the global value chain and partly following a rise in protectionism[2].

Have German exports been penalised by this new global trade regime? The answer, at this stage, appears to be mixed. The volume of exports has admittedly slowed (4.5% per annum over the last five years vs 7% in the pre-crisis decade), but slightly less than the pace of global trade. Germany has therefore maintained and even slightly increased its market share. Moreover, geographic diversification helps offset markets in decline by markets in expansion. Over the past year, exports of goods are down in around 10% of end-markets, mainly China, Russia and Brazil; but the strength of exports towards the US, helped by the decline in the euro, and the rebound of demand from other countries in the Eurozone has pushed the German trade surplus to new record levels (chart rhs).

Germany/EMU: exports to GDP ratio



Germany: exports of goods by destination



Sources: Thomson Reuters, Oddo Securities

All told, the slowing of growth in emerging countries will indubitably act as a drag on German exports. But exposure to the countries currently deemed the most risky appears bearable as long as demand coming from the rest of Europe continues to firm.

➢ Wage discipline and introduction of a minimum wage

The start of the 1990s had been marked by a deterioration in cost-competitiveness, partly caused by the shock of reunification and by an appreciation of the DM.

[1] This expression was popularised by the analyses of Hans-Werner Sinn, one of Germany's most influential economists, in several articles published in the middle of the last decade. See Sinn (2005), "The pathological export boom and the Bazaar Effect. How to solve the German puzzle", CESifo working paper.
[2] See ECB (2015), "Understanding the weakness in world trade", Economic Bulletin, n°3.

Businesses responded by reorganising the production chain (see above). The government responded by a series of reforms aimed at increasing labour-market flexibility, notably the reduction of jobless claims (Hartz IV law), the creation of mini-jobs (Hartz II) and the reorganisation of the federal employment agency (Hartz III). All told, wage moderation was the order of the day. Consequently, in the decade preceding the financial crisis of 2008, unit labour costs (wages/productivity) remained stable in Germany whilst they rose by 2% per annum in France and exceeded 3% per annum in Italy or in Spain. These different reforms, added to population ageing, helped Germany return to full-employment. Massive recourse to partial unemployment measure helped, moreover, to absorb the fall in demand after the financial crisis without triggering a durable rise in unemployment.

Unit labor cost in Germany and the Eurozone

EMU: unit labor cost (ULC) and components*

	Compensation (+)			Output (-)			Employment (+)			Nominal ULC (=)		
	from Q12000 to Q2 2008	from Q2 08 to Q3 13	from Q3 13 to date	from Q12000 to Q2 2008	from Q2 08 to Q3 13	from Q3 13 to date	from Q12000 to Q2 2008	from Q2 08 to Q3 13	from Q3 13 to date	from Q12000 to Q2 2008	from Q2 08 to Q3 13	from Q3 13 to date
Germany	1.2	2.0	2.8	1.5	0.5	1.5	0.3	0.7	0.7	0.0	2.2	2.0
France	3.0	2.1	1.3	1.8	0.3	0.5	0.8	0.0	0.3	2.1	1.8	1.0
Italy	2.8	0.5	1.2	1.1	-1.7	0.0	1.3	-0.8	0.2	3.0	1.4	1.4
Spain	3.7	1.0	0.0	3.4	-1.6	2.4	3.3	-3.4	2.4	3.5	-0.8	0.0

* annualized rate, do not sum exactly due to roundings

Sources : Thomson Reuters, Oddo Securities

Everything is therefore getting better? The reality of the situation is more subtle. The decline in unemployment has gone hand-in-hand with job insecurity, segmentation between mini-jobs and more conventional employment and a decline in the effective number of working hours. **In addition, with the low level of unemployment (<5% on the harmonised measure vs 11% for the Eurozone), it is more difficult to sustain wage moderations. Over recent years, we have seen wage increases accelerate, with the pace exceeding productivity gains** (see table). From the viewpoint of adjustments in the Eurozone, this development can be viewed as favourable since it has helped to restore price-competitiveness in other countries, but this has been at the cost of a relative deterioration in Germany.

To this should be added, on 1 January, the introduction of a universal minimum wage at a high level (€ 8.50/hour). This is not so much a problem for the export sector (industry) where jobs tend to be skilled and average wages well above this level. The negative impact is expected in those sectors that are protected from outside competition (services). **The minimum wage will diminish the flexibility of the jobs market, if only because the number of hours for which mini-jobs are eligible has been reduced.** To reconcile these two objectives - flexibility on the one hand and support for low wages, on the other - the government could introduce subsidies at the minimum wage level. The topic has been raised on numerous occasions. However, judging by the French example, this is costly for public finances and has no positive impact on the functioning of the jobs market. It would be preferable, as called for by the European Commission in its regular reform reviews, to lower taxation and the cost of labor[3].

➢ A shock on the quality of the "Made in Germany" brand?

The cost of production is a major factor for export firms, but in the case of Germany, non-cost competitiveness plays an even greater role[4]. The quality of German products is well known, to the point of becoming an advertising slogan. This is particularly true of the automotive sector, currently embroiled in the VW scandal. To take the measure of this shock, we should look at the weight of this sector in the German economy.

In 2014, Germany produced 5.6 million vehicles, three-quarters of which were exported. **The automotive sector represents around 4% of German GDP, 18% of exports and directly employs close to 800,000 people. In the rest of Europe, the share of the automotive sector in GDP stands at 1.7% and the share of exports is 10%.** In the premium segment in which German carmakers have a global market share of close to 80%, production is primarily carried out in Germany, which contributes to the trade surplus. Over the past twelve months, the automotive sector has generated a shade more than half of the total surplus, i.e. € 126bn. The US, where Volkswagen's fraud was uncovered, represented 10% of automotive exports, and a trade surplus of around € 25bn. These figures show that the weight of the automotive sector is disproportionate

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[3] See http://ec.europa.eu/europe2020/pdf/csr2015/csr2015_germany_en.pdf, Council recommendation on the 2015 German Reform Programme.
[4] *See Marin, Schymik & Tscheke (2015), "Europe's export superstars – it's the organization! », Brugel working paper May 2015, or Danninger & Joutz (2007), "What explains Germany's rebounding export market share?", IMF working paper 24 July*

compared with other developed countries. After the automotive sector, the chemicals sector is the other major contributor to the trade surplus, with the remainder split between the different segments of the capital goods sector (table)

Germany: external trade by category of good

bn€	All products					Autos					Chemicals					Machinery ex autos					Other				
	TOT	o/w				TOT	o/w				TOT	o/w				TOT	o/w				TOT	o/w			
		to/from EMU	UK	US	China		to/from EMU	UK	US	China		to/from EMU	UK	US	China		to/from EMU	UK	US	China		to/from EMU	UK	US	China
Exports	1178	406	88	109	74	207	53	27	29	20	185	68	13	19	7	366	109	20	38	33	420	177	28	22	14
Imports	935	332	40	54	87	81	35	4	6	1	121	54	6	13	4	240	66	11	18	44	493	177	18	18	38
Balance	244	74	48	54	-13	126	17	22	23	18	64	14	7	7	3	126	43	8	20	-11	-73	0	10	4	-24

Sources: Thomson Reuters, Oddo Securities

Since the revelation of the VW scandal, a number of alarmist comments have been printed regarding Volkswagen's future, which is understandable given uncertainty on the cost of the affair (penalties, legal action, vehicle recall, etc.), but also, more surprisingly, on the future of the "Made in Germany" brand as a whole[5]. These extrapolations leave us somewhat bewildered. **The Volkswagen scandal is a specific shock, not a systemic one.** Assuming that all German cars are not suddenly demoted to the ranks of low-quality vehicles, it would be exaggerated to think that demand for them will simply dry up. More generally, it is difficult to see why buyers of machine-tools or chemical products from German firms would modify their purchasing behaviour as a result of the Volkswagen scandal. We know that "accidents" in the financial sector can rapidly spread to the real economy, leaving behind lasting damage (the Lehman Brothers' bankruptcy), but there have been no similar examples when other sectors are responsible. The very different examples of Parmalat, Enron, BP and TEPCO suggest that any impact on the confidence or business climate indices would be modest and temporary[6].

➢ Costs and opportunities linked to the "refugee crisis"

The question is not primarily an economic one but could have repercussions on the economy nonetheless. Any estimate at this stage is extremely risky. The number of refugees in Germany was forecast at 450,000 last spring, then revised up to 800,000 this summer, but the figure of 1.5 million has been mentioned in recent days by the press without being firmly refuted by the German government. The accommodation costs per person and per annum are estimated at € 12,000. On this basis, consumption could increase by € 10bn-€ 18bn and lift GDP by around 0.3-0.6% (without a multiplier effect). Public finances can absorb such spending as the 2016 budget was forecast at a surplus of 0.5% of GDP. Amongst the positive effects often mentioned, the massive influx of refugees would improve potential growth in the long term (rise in the working population offsetting the ageing effect) thereby facilitating the financing of pensions. Some even spot an opportunity to introduce tighter wage discipline. Setting aside the "dehumanised" nature of this type of calculation, we see that the key point is that of integration into the labour force, the educational system, the housing market (where certain overheating exists) and, beyond these factors, into German society as a whole. The barriers of language, culture and skill-sets cannot be overlooked. These questions are stoking fears amongst the German population and political class. No one knows how many refugees will stay in Germany or for how long. **Beyond the short-term effects which are equivalent to a mini-stimulus to the budget, we would be careful to avoid reading into this "refugee crisis" a calling into question, for better or for worse, of the German model**.

➢ Conclusion

In recent years, we had fallen out of the habit of wondering whether Germany could be a source of economic risk. Unlike its European partners, its economy was robust enough to combine full-employment and substantial external surpluses. The German "model" has experienced various shocks in recent months, all of a different kind. The greatest of these has been the slowdown in global trade. But given the upturn in domestic demand in recent years, we think that Germany's economic outlook remains amongst the most solid in Europe in the coming years.

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[5] *One example amongst others is David Bach, "Seven reasons Volkswagen is worse than Enron", Financial Times, 28 September 2015.*
[6] *The recall of 11 million vehicles (around 3 million in Germany) would be an additional expense in GDP paid on Volkswagen's profits.*

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