THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com

Are German Workers *Killing Europe?*

In other words, have their low relative wages created a "beggar-thy-neighbor real devaluation" policy highly destabilizing to the Eurozone?*

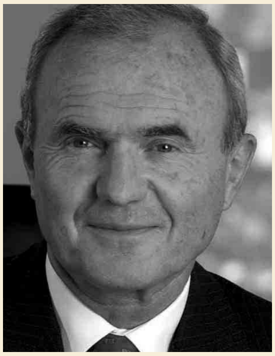
Background: To what extent are productivity gains at the expense of wage growth and consumption holding back the German economy and thus the entire Eurozone economy? In Germany, real incomes and unit labor costs have fallen in recent years and are expected to fall again next year. As a result, the export industry is booming while consumer demand stagnates. Not surprisingly, the IFO index and other confidence indicators for industry continue to soar even as consumer confidence drags. As some analysts have put it, household spending has become Germany's Achilles heel of economic development.

***The argument goes that this ongoing process has led to Germany undercutting the competitiveness of other euro-area countries, including Italy, Portugal, and Greece. The *Financial Times* has dubbed this a "beggar-thy-neighbor real devaluation" policy.**

Some argue that German industry is being increasingly delinked from the broader German economy as production and sales are increasingly geared more toward foreign buyers. Meanwhile, the argument goes, this ongoing process has led to Germany undercutting the competitiveness of other euro-area countries, including Italy, Portugal, and Greece. The *Financial Times* has dubbed this a "beggar-thy-neighbor real devaluation" policy.

Some analysts suggest higher German wage increases would rebalance this situation. Others argue that the main cause for Germany's continuing economic weakness is structural and thus greater market liberalization is the answer.

Can the German economy continue to be comprised of world-class export companies positioned well in the global economy sitting side-by-side with a disillusioned domestic household sector? To what extent is this dichotomy in the German system sustainable, for both Germany and Europe?



Germany's wage situation is to a large extent a correction of real overvaluation at the start of EMU.

OTMAR ISSING
Former Chief Economist and Member of the Executive Board of the European Central Bank

Germany is a country with wages among the highest in the world and a double-digit rate of unemployment for many years by now. Hardly a case to ask for higher wages. Germany being a member of European Monetary Union does not change the argument. What would you recommend if a region within the boundary of a country with its own currency were in such a situation? Higher wages? Certainly not.

It is true that Germany has regained competitiveness via wage constraint in relation to other members of EMU over the last years. But, one must not forget that this has been to a large extent a correction of real overvaluation at the start of EMU. In some countries unit labor costs have risen substantially due to strong increases in wages. It is high time that these countries reverse this process.

Continuous and growing divergences as a consequence of wage increases above productivity within EMU will create economic and finally also political tension. But this diagnosis should not lead to a prescription of the wrong medicine.

Stop lecturing Germany for overachieving.

SAMUEL BRITTAN
***Columnist,* Financial Times**

A wise inter-war Marxist once said that anti-Semitism was the socialism of the stupid. In the same way, artificially raising wages is the reflation of the economically illiterate.

Classical economists have normally insisted on the link between wages and employment. A wage is a price, and if it is too high workers are priced out of jobs. Keynes's supporters replied that wages are also a source of purchasing power and if wages are cut, the market for the product of business and industry would also be reduced.

A synthesis of the two positions is not difficult. Full employment does require a flexible labor market. But this will work best if monetary and fiscal policy aims to sustain final demand in nominal terms so that purchasing power is maintained. The aim can be described in different ways—whether a monetary target pursued with common sense or a policy aimed at maintaining nominal GDP.

This route is however not available to members of the euro monetary zone, as there is a single monetary policy applied to national economies with very different characteristics. And the safety valve of national exchange rate changes has been removed.

Enthusiasts for European monetary union hoped that its establishment would itself be a force for convergence of labor costs so that relative exchange rate changes within the zone could be abandoned. (This is at least how the aim should have been expressed.) They have been sadly disappointed. Since the union was established in 1999 German unit labor costs in manufacturing have risen in most years by a fraction of a percent and in the last two years they have actually been falling by around 1 percent per annum. At the other extreme, Italy has had labor costs rising by nearly 4 percent per annum and even faster in the last couple of years. France has been somewhere in between.

So long as the euro lasts, the only real exchange adjustments available to members have to work through wages. Instead of lecturing Germany for overachieving, it would be better if other members could work towards both lower labor cost increases and more flexibility between different sectors and corporations. The European Central Bank could also help by indicating that wage moderation would not be offset by lower final demand. It does not have to make unwise deals with national governments or unions to do this, but simply slightly adjust its oratory and show that it means it.

As for Germany, despite the improvement in overall labor markets, there are many other inflexible elements including nationwide wage bargaining and various corporatist deals and laws which make it very difficult for different sectors of the economy to move in their own way.

There is also a cultural factor regarded as politically incorrect to mention. This is that in the German tradition economic success is linked with manufacturing and exports, while services and consumption are regarded as somewhat sissy. This has now given Germany the dubious benefit of having re-established a current balance of payments surplus two-thirds as large in proportion to GDP as the American current deficit.

Despite all these pathologies I suspect that the OECD is right and that Germany is now taking part in a more broadly based European recovery. The dangers to it are mainly that the dollar could go into free-fall or that a real oil crisis could sabotage world activity. But my bet, on which I am not putting my own money, would be with the moderate optimists.

Yes, there's a dark side of wage restraint.

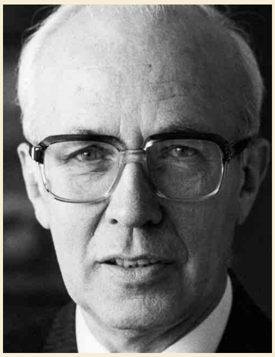
GUSTAV HORN
Director, Macroeconomic Policy Institute of the Hans Böckler Foundation

The answer is a resounding yes. Unit labor costs are decreasing and German wages in the private sector are only average in the European Union. The implication is clear. Germany's economy is facing a dramatic redistribution towards more profits at the expense of labor income. Supply-side conditions have improved accordingly. But is it a blessing or a curse for the German economy? Most German economists would say the former, because they think that wage restraint is exactly what Germany needs to get its economy going again. Only wage moderation could enhance employment and reduce unemployment. Strangely—in the view of the German mainstream—the employment record has not improved although the strategy applied is considered appropriate. The usual reaction is to recommend more of the same to overcome Germany's problems.

This advice is strange and dangerous at the same time. It is strange, because it neglects more than ten years of economic policy failure. And it is dangerous because it continues to build on a one-sided supply-side strategy while neglecting the demand side. And here you find Germany's real problems. Ten years of wage moderation have led to the most persistent weakness of consumption seen since World War II, because the unbalanced supply side approach has had two particular effects.

On the one side there is a brilliant export performance since no other country except Austria has emulated Germany's wage restraint in the euro area. The corresponding gain of competitiveness has given Germany's external balance sheet a high and rising surplus, while other countries—most notably Italy—are deeply in the red. However, this situation—as brilliant as it looks for Germany—is not sustainable. In a currency union, a real depreciation can only be of temporary nature. At some stage when surpluses and the corresponding deficits become too high, there must be a turnaround if the union should not blow up. Recent figures indicate that such a day is coming nearer. So "more of the same" is no option for the future.

The dark side of wage restraint is lower real labor income, the main source of private consumption and consequently investment. One should not be surprised that the costs of wage restraint are being predominantly paid by domestic demand. In Germany domestic demand was even more depressed during the last ten years than in the Japanese economy, which suffered from an extended period of deflation. Costs exceeded the gains from the export boom by far. So an appropriate strategy would aim at higher demand and higher wages. Underpaid workers are a curse and not a blessing for an economy.



Wages are not the only problem.

HELMUT SCHLESINGER
Former President, Deutsche Bundesbank

Germany is a country with five million unemployed (11 percent of the labor force) and a certain decline of the number of employed persons. Would anyone believe a stronger increase in labor costs would stimulate the economy and would bring higher profits, higher investment, more employment and higher consumption? This is not my understanding of the way the German economy would react. Unfortunately, wages are not the only problem. German total labor costs per hour are about 80 percent higher than wages alone. Non-wage costs such employer contributions to social security, thirty days of vacation leave plus twelve to fourteen other religious holidays, full compensation in the case of illness, and so forth are adding to this amount. The German total labor costs per hour are the highest in Europe excluding Denmark.

Confronted with this burden, the German enterprises try to increase productivity and shift production to lower-wage countries. In the total economy wage costs per product are stagnating or even declining a little bit. But in the manufacturing industry with its high productivity gains, labor costs per unit went down much more. This is one of the reasons for the increase of competitiveness in the export markets of industrial products. The second reason is the growing trend toward importing cheaper semi-finished goods.

With the variable rates of the past, the discrepancies between the competitiveness of partner countries in Europe were solved by a realignment of exchange rates. In the monetary union, this is no longer possible. From the beginning it was clear that member countries would need to try and keep pace with the competitive positions of their partners. Countries which have higher wage increases and less or no productivity growth develop high deficits in their balance of payments, and the end result is higher unemployment. This is the reality understood by many of the leading policymakers of these countries who are pleading for changes. (See the annual report of the Bank of Italy.) This year Germany saw some wage and salary increases. But the cautious attitude of consumers will linger. Consumers are continually confronted with rising tax burdens, such as an increase in the VAT from 16 percent to 19 percent beginning 2007 and proposals for a new solidarity surcharge on the income tax—quite contrary to the political promises before the last election.

The problem is monetary union.

BERNARD CONNOLLY
Global Strategist, Banque AIG

Germany is a problem for monetary union; monetary union is a problem for Germany and everyone else. The triumph of malign political will over economic logic that was the creation of monetary union left post-reunification Germany extremely uncompetitive in 1998. Germany then had four options:

- Depreciate the actual real exchange rate through German disinflation (the Issing route);
- Depreciate through loose ECB policy, euro depreciation, and induced inflation in euro area "partner" countries (the Tietmeyer route);
- Appreciate the equilibrium exchange rate through positive supply-side measures in Germany (any candidates?);
- Appreciate it by using the European Union to impose negative supply-side measures on "partners" (the Lafontaine route).

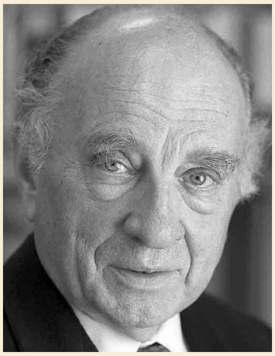
The first two were those that had an impact. Germany regained competitiveness massively and now has a trade surplus of around 4 percent of GDP, most of it with its euro area "partners." It would have been much better for everyone if Germany had followed the third route, which would—if Germany had been an "Anglo-Saxon" country—eventually have strengthened German domestic demand. It did not happen because positive supply-side reforms require acceptance of dynamic change, to the detriment of some established interests and "acquired rights," unacceptable in a country with a corporatist philosophy.

One of the routes actually followed induced the inflation in partner countries of which German officials now complain, uncomprehendingly or hypocritically. It also reduced real interest rates in those countries, and produced housing and domestic demand booms. The other—German wage disinflation—meant that, once the euro recovered, other countries lost competitiveness very rapidly.

That does not matter so long as low real interest rates there stoke housing booms and markets accept massive Club Med current account deficits without demanding sensible risk premiums. But if the European Central Bank increases rates as much as the German bloc in the bank wants and housing booms come to an end, the dreadful competitive positions of Club Med—and perhaps even of France—will force them into relative disinflation.

This will be much more difficult to achieve than it was in Germany. By construction, the ECB will not be helping out. In addition, the economies concerned are relatively closed and will require bigger gains in competitiveness, and they start with much worse public finances than Germany in 1998 (this is true in underlying terms even of Spain). It will require very deep and prolonged recessions creating unbearable strains.

Supply-side reform in Germany in 1998 would have reduced the required relative disinflation there, but now it would bring German relative inflation. That is the nub: any conceivable resolution of the strains in monetary union must involve Germany's inflation accelerating sharply. There is thus an inconsistent triad in monetary union and it is impossible to achieve all three parts simultaneously: reasonable stability in German inflation, the ECB's euro area inflation target, and continued southern-country euro participation.



The higher wage answer does not fit Germany.

OTTO GRAF LAMBSDORFF
Former German Minister of Economics

In Germany, leftists traditionally claim that workers are underpaid. They underlay their reasoning with statistics which show real incomes and unit labor costs having fallen in recent years. The political answer seems easy—at least at first sight: Higher wage agreements, lower interest rates, and far-reaching dismissal protection will stimulate household spending.

But the apparent correct answer does not fit to Germany.

First of all, it is true that exports have been booming and domestic demand has been lagging behind for the last few years. Nonetheless, it is also true that consumer confidence is picking up lately. And studies found that substantial wage increases hardly lead to more consumption, but to lower employment! According to economists' calculations, only €.60 of a €1 wage increase remain after subtracting taxes and contributions. And about €.20 are spent on import goods, resulting in marginal employment effects in the retail industry. Saving accounts for €.05. As a consequence, only €.35 is left over for domestic consumption.

Unfortunately, the expected positive demand effect is empirically likely to get completely neutralized as higher wages tend to cause lay-offs. Hence, the bottom line of the above described policy is not more buying power, but higher unemployment. This chain of cause and effect especially holds true for Germany, a country with a high saving rate.

What Germany really needs is a policy that attracts job creation. Of course, that does not mean lowering labor costs to compete with China. But certain structural business conditions on the supply side need to be in existence before postulated wage increases could have positive effects. One of these conditions is the flexibility of work force. Germany's extensive dismissal protection leads sometimes to cases where employees cannot be released until a company's insolvency.

Against the backdrop of global competition, German companies have without a doubt benefited from decreasing unit labor costs and years of restructuring and cost cutting in order to increase productivity. And a recent study by Ernst & Young revealed that Germany's economic attractiveness for foreign investment has lately improved again.

In this situation, drastic wage increases may choke the new international optimism: a dampening perspective for the seven million unemployed people in Germany.

Countries like Italy should pay more attention to the competitive requirements in a monetary union.

NORBERT WALTER
Managing Director, Deutsche Bank Research

The German labor market exhibits anything but a balance between supply and demand. An unemployment rate of more than 10 percent signals that the price of labor is too high to absorb the supply completely. I have not heard of any theory saying that excessively low labor prices create excess supply!

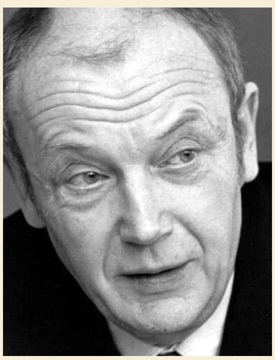
Of course I know there are still economists who are deeply convinced that demand management policies are key for employment trends. I do not completely negate such a—short-term—relationship. But the dear analysts and advisors for Germany should be willing to at least acknowledge the facts. And the fact is that Germany is a country with an explicit government debt of 70 percent of

GDP and—if obligations in the social security system take proper account of the demographic outlook—an implicit government debt of 200 percent of GDP. Such a country, presently with a government deficit of 3.3 percent of GDP (2005), has absolutely no fiscal leeway for expansionary measures. And these beloved commentators certainly know that Germany has no interest rate or exchange rate policy left to stimulate domestic demand. This was all transferred to the European Central Bank's hands in 1999.

In effect, the only means left to improve Germany's fate is to pursue efforts to improve cost competitiveness. Of course, further education and ensuing productivity increases are the very best option, but if such potential does not exist, wage restraint will have to fill the void. That Italy does not pay attention to the competitive requirements in a monetary union is a pity, but solely its own fault. The cure is obvious. If pursued, such behavior would ease the need for the ECB to raise interest rates and limit the euro's rise, thus helping the recovery in Euroland.

And before anyone gets overly excited about the *Financial Times'* dubbing Germany a "beggar-thy-neighbor, real-devaluation" country, one should look at Germany's wage levels today in an international comparison. They are still the absolute pinnacle (ex. Norway). Admittedly, over the last five years Germany has reduced its labor cost excesses and certainly has improved its relative position, particularly vs. Italy.

It would be nice if the international community accepted that a shrinking population needs less housing and fewer kindergartens. It would of course be helpful if other Euroland citizens lived up to their decision to be part of a monetary union.



I blame the political incompetence of Germany's economic administration.

KARL GEORG ZINN
Professor of Economics Emeritus, Technical University of Aachen

The long-term trend of German labor unit costs grew relatively moderately—below the international average (OECD, EU)—because the wages did not catch up with productivity growth. Thus the real devaluation of the German currency fostered export growth, a surplus of the trade balance, and recently again a surplus of the current account balance. But this favorite international position of the economy did not compensate for the deflationist effect of weak mass consumption and the comparatively high savings of the private households. The lack of demand in the domestic market is the main reason for the low growth of the German GNP and the terrible, long-lasting unemployment. Since the 19th century, Germany has not experienced such a long period—now more than twenty-five years—of rising mass unemployment.

Besides the lacking domestic demand there are two other important factors which darken the economic performance of Germany: tight money policy of the central bank—Deutsche Bundesbank and since 1999 the European Central Bank respectively—and the too-narrow supply side orientation of the German governments. The political incompetence of the economic administration seems to reflect a special mentality, a kind of anxious caution to continue in selected direction though it does not lead to the promised destination.

The new government, the coalition of conservatives and social democrats in office since last autumn, did not change the devastating course so there will be even more of the wrong medicine. Most of the German mass media, the majority of the political class, and the dominant economic commentators are clinging to neoliberal ideology and even parts of the German unions are strongly influenced by the belief in the healing powers of market mechanisms.

The argument is alluring but flawed.

MANFRED WEBER
Chief Executive, Association of German Banks

The situation in the German labor market is a cause for concern. Sensible proposals for tackling the problem are therefore welcome. Nevertheless, we should beware of strategies that seem simple, but—in the German environment—will actually achieve little.

The purchasing power argument is a good example of such a strategy—alluring, but flawed. The theory is that consumer demand will grow if wages go up; firms will expand their production and increase their investments. This will ultimately boost employment and, in turn, demand—a sort of *perpetuum mobile*.

But just as the *perpetuum mobile* ignores the laws of physics, so too does the idea of levering ourselves out of trouble with higher wages fly in the face of economic reason! Even worse, wage increases over and above what is warranted by productivity gains will ultimately drive down employment and domestic demand.

The strong savings ethic and the relatively high proportion of spending by households on imports mean that the boost given by higher wages is significantly less than the drop in demand of domestic producers as a result of higher costs. It is, however, above all high direct and indirect taxes and social security contributions which are responsible for this gap between additional consumption and additional costs.

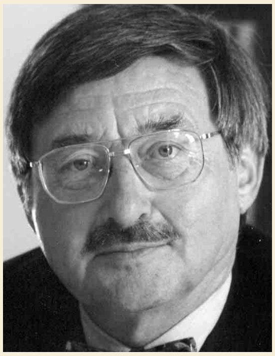
If we are to strengthen Germany's fragile upswing, it is undeniable that we need to stimulate domestic demand. The engine is investment activity; this must first start up. It is, after all, the capital goods industry which is the core of the German economy.

The best contribution to growth from the wage front would be increases that are in line with productivity gains. This has been borne out in practice: excessive wage agreements have been corrected, production costs cut, and the competitiveness of the German economy thus strengthened.

Investment is now rising and unemployment gradually falling. There can be no question of a "beggar-thy-neighbor" policy. German businesses have adapted to a changing global economy under difficult conditions and largely without support from policymakers. They have done so more rigorously than companies in other parts of the euro zone. Now they are reaping the fruits of their labor. Criticism of Germany is therefore misplaced.

Higher wages are not the right way to encourage growth. This does not exclude the possibility of higher wage increases in some instances if corporate earnings allow. Overall, greater flexibility in Germany's system of collective bargaining and wage increases which better reflect companies' individual circumstances and earnings situation would also boost consumption.

Also essential are a still more flexible labor market and benefits for the jobless which encourage job seeking. Bold reforms in this direction are an imperative that no one in a position of political responsibility in Germany can avoid.



The argument is quite strange.

HORST SIEBERT
President-Emeritus, Kiel Institute for World Economics

This is a strange question when you take into consideration that 13 percent of the German workforce is idle, if those who are in governmental schemes are included under the unemployed. It is true that domestic aggregate demand has been one of Germany's weak spots. However, it is a strange idea that increasing German wages would improve the situation. The weak aggregate demand is due to uncertainty. Job security would be reduced further and job uncertainty would dampen consumption demand even more. It is true that real net wage income (net after taxes and contributions to the social security system) has stagnated since 2002 and declined in 2005. However, this phenomenon is due to the increase in contributions for the social security system. With these contributions, the low annual labor productivity growth of about 1 percent is not strong enough to cover a rise in the net wage. It is also true that German unit labor costs are declining; but this is not surprising since fewer workers are employed which means lower unit labor costs.

The idea that Germany's low gross wage increase has negative effects on other European Monetary Union countries is also quite strange. Have we not learned from the criteria for an optimum currency area that it is the real exchange rate that has to help countries out of a problem in a monetary union since a nominal depreciation is ruled out due to the single currency. A real depreciation is the necessary instrument, and other countries cannot complain that Germany uses this instrument. Viewing this problem from the other side, take Italy as an example. Since 1999, it has experienced a real appreciation, reducing its competitiveness. What it needs is a real depreciation, that is, a drop in the price of non-tradable products relative to tradable goods. This has be done in Italy and it cannot be brought about by Germany also appreciating in real terms. Admittedly, such diverging developments in its member states represent a problem for the European Monetary Union. However, don't we economists know that there is a price for having a common currency?

The wage argument is fallacious.

KLAUS FRIEDRICH
Former Chief Economist, Dresdner Bank

It's a pity. Just as the German economy is beginning to show some signs of recovery from a long slump, the old purchasing power fallacy emerges again: Just pay out higher wages and the consumer will save the day. This argument is as old as political debate in Germany and it has been shown to be fallacious again and again. The old Bundesbank and (fortunately) the new European Central Bank will not monetize excessive wage increases. The result would therefore be a short burst of inflation followed by increased unemployment in the longer term. This lesson has been learned painfully several times in the past. But the unions continue to use the "Kaufkraft" argument and they are certainly entitled to use whatever argument they wish.

This is one thing. Quite another, however, are international demands of Germany to end wage restraint. The *Financial Times,* for example, is far off the mark with its characterization of a German "beggar-thy-neighbor real devaluation" policy.

Real devaluation can be conceded. But "beggar-thy-neighbor"? In the days before the euro, such policies were typically designed to deal with the devaluing country's inability to maintain wage restraint as well as fiscal and monetary moderation. In the pre-euro days, international differences in competitiveness would eventually be vented by exchange rate adjustment. In the euro era, those same differences are supposed to trigger adjustments in prices, wages, and real incomes. Note, however, that these adjustments should be brought about by market forces and not by international cajoling.

It should also be noted that the competitiveness of German exporters does not by any means rest on wage moderation alone. Low unit costs are entirely compatible with high wages as long as workers are highly productive. That productivity comes from investment and that investment comes from profits. All past recoveries in the German business cycle have been export-led.

If there is a common denominator for which European countries should strive, it is stability in prices and wages as the only proven long-term basis for real income growth. Trying to cajole a country into relaxing that standard is to play with fire, if only because compliance would be all too easy. Those who agree with the *Financial Times'* views would be right to stay out of the euro-kitchen, because it is obvious they can't stand the heat.

Germany is like Japan.

RICHARD COOPER
Maurits C. Boas Professor of International Economics, Harvard University

Rising productivity under competitive conditions should lead to higher wages and/or employment or to lower prices, in either case raising real incomes. If real incomes have not risen, either competition is not present—being reflected in higher corporate profits—or the lower prices accrue to foreigners through increasingly competitive German exports rather than to domestic residents, signifying an increasing separation between export markets and the domestic economy. We have observed this also in the case of Japan with respect to investment goods, although both countries also export and consume domestically high quality consumer durables, especially automobiles.

Germany is like Japan in another respect: its total population has begun to decline. More significantly, the number of young adults, those in their twenties, has been in decline for some time, and this decline is expected to continue in the coming decades at a rate of roughly 1 percent per year. These are the most educated and most flexible members—occupationally and geographically—of the labor force, permitting countries to respond readily to ever-present changes in the composition of demand. And they are the ones who form new households and whose need for both new productive capital and for new housing (including appliances and furniture) contribute to aggregate demand. In Germany the steady diminution of this group acts as a brake both on investment and on consumer demand. With limited investment opportunities at home, Germany needs to invest abroad—that is, to have an excess of exports over imports—to provide for its rapidly aging population.

The wage argument is rubbish.

GABRIEL STEIN
Chief International Economist and Director, Lombard Street Research Ltd.

After many years of weak growth, the German economy is accelerating. Output growth should be comfortably in excess of the country's 1–1.5 percent trend growth rate in 2006 and still above-trend in 2007. This is good news, not only for Germany but for Euroland and the rest of the world too. Yet German improvements have been meet with hostility. Germany is accused of pursuing a beggar-thy-neighbor policy. This is rubbish.

Data from the Federation of European Employers show that German labor costs last year were the second highest in the euro zone. The average labor cost in Germany was €53,278. That put Germany closely behind Belgium (€53,581), but well above the next country (France: €47,824) not to mention Italy and Spain (€36,011 and €34,545 respectively). So German workers are certainly not underpaid.

However, the argument against Germany rests more on relative labor cost developments, that German real incomes and unit labor costs are falling and that while this benefits German exports, it harms Germany's neighbors.

It is true that German labor costs have risen considerably less fast than those of other large euro zone countries. Over the period 1998–2005, German labor costs rose by about 3 percent. French labor costs rose by 9 percent, Italian and Dutch rose by 20 percent and Spanish by 25 percent.

This happened for three reasons. First, Germany entered the euro at an overvalued exchange rate. Second, globalization saw the entrance into the world economy of two giants with a seemingly inexhaustible supply of cheap labor. Third, Germany's structural problems helped erode the country's trend growth rate.

But by joining the euro, Germany abdicated the possibility of using monetary policy (and in practice also fiscal policy) to improve its competitiveness. The only way Germany could improve its situation was through relatively lower labor cost inflation and structural reforms. At great cost to its economy, it has done both and is now beginning to reap the rewards. And this highlights what is the true Euroland problem. It isn't that Germany is beggaring its neighbors. It is that those neighbors are unwilling to follow Germany on a true reform path. For most Euroland countries, structural reform is something that is spoken of but never undertaken. From a Belgian *et al*. point of view it would no doubt be preferable if Germany remained uncompetitive. That would spare Belgium and others from having to undertake their own reforms. But asking the Germans to remain the sick man of Europe for the benefit of its partners may be asking too much, even of that *communautaire* people.

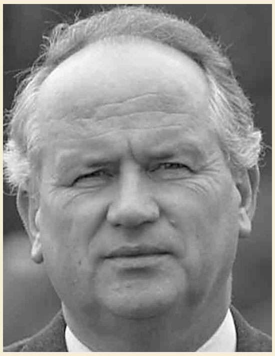
Germany needs more jobs, not higher wages.

JULIAN CALLOW
Chief European Economist, Barclays Capital

Market forces have been forcing down German unit wage costs and at this stage it would be impertinent to interfere with this process. German business hiring intentions, as measured by the very broad DIHK (chambers of commerce) survey, are now very close to the peaks recorded in 2000. This corresponds well to the improvement that is now very visible in German capital goods spending. Since German consumer confidence has been scarred for many years by high unemployment (particularly in the eastern Länder, blighted by persistent jobless rates of around 18 percent), it is much more preferable that Germany generates more jobs rather than higher wage inflation.

Germany has a large current account surplus, but we now seem to be at that point in the cycle when this finally translates into stronger domestic demand, implying that we shall be seeing a quicker pace of compensation growth during the next two years, which ought to begin to lower this surplus (via stronger domestic demand). Moreover, from a euro area perspective, the German current account surplus merely offsets large (and deteriorating) external deficits in southern Europe, and indeed the euro area is in a small external deficit as a whole.

One should not forget either that Germany faces a very large consumption tax increase next January, with standard rate VAT rising three points to 19 percent. International episodes of such large "big bangs" for indirect taxes increases are infrequent, but the consequences for domestic demand and/or inflationary expectations can be very disruptive (for example, Japan in 1997, France in 1995, or the United Kingdom in 1979). With this increase now approved by the German parliament, German wage settlements next year are bound to rise. Economists should rather save their exhortations for the German government to call off this unnecessary and potentially disruptive fiscal adjustment, and to focus upon improving government efficiency, which might be more politically challenging, but would prove much more economically desirable.



It is not Italy that has to change but Germany.

HEINER FLASSBECK
Officer-in-Charge, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

The European Monetary Union can only function if nominal wage increases in all member countries are in line with the inflation target set by the monetary authorities. Given the close correlation of unit labor cost growth (nominal wage growth minus productivity growth) and inflation, the implicit rule of the monetary union asks for real wage growth in each member state following strictly national productivity progress and for unit labor costs not exceeding and not undershooting a 2 percent growth path in each member state.

Violations of this rule will either lead to inflation or deflation in the union as a whole or to deviations of national real exchange rates and national levels of competitiveness bearing grave long-run consequences for the appreciating countries. This kind of aberration started with the beginning of the currency union in 1999—with Germany, due to its deflationary wage policy, being the main culprit. Without fundamental changes in wage policies throughout Europe, a deflation or a transfer union, comparable to the German transfer union after unification, is an imminent danger.

However, it is not Italy that has to change its policy but mainly Germany. Italy's unit labor cost growth is fully in line with the European inflation target, Germany's is too low; in Spain, Portugal and some smaller countries the unit labor cost growth is clearly overshooting the implicit European rule and has to be moderated. If Italy were to adjust downwards, as seems to be the intention of Mr. Prodi, that would set a bad prejudice for others to follow the deflationary German line and an overall deflation in the monetary union could not be avoided as monetary policy. Japan is a good example—a country unable to compensate for the effect of a drop in unit labor costs on prices.

The tragedy is that Germany, on balance, is not gaining from this kind of beggar-thy-neighbor policy. Domestic demand in that country is still more important than exports and private consumption is flat due to the fact that, since the mid-1990s, real wages are not rising and employment growth has not made up for the loss in real income, thereby proving false the forecasts of the orthodox economic thinking. ◆