International Review of Applied Economics ›
Volume 19, 2005 - Issue 1

Original Articles

What ever happened to Germany? Is the decline of the former european key currency country caused by structural sclerosis or by macroeconomic mismanagement?

ECKHARD HEIN & ACHIM TRUGER

Pages 3-28 | Published online: 16 Aug 2006

Cite this article https://doi.org/10.1080/0269217042000312588

Abstract

This paper challenges the institutional sclerosis view of the German crisis according to which rigid labour markets and generous welfare state institutions have driven Germany into its position as 'Europe's sick man'. In general, the view is not convincing, because the underlying hypotheses about the effects of labour market regulation and welfare state institutions on employment and growth cannot unambiguously be derived from modern labour market theory and are at least partially at odds with accepted empirical findings. In particular, the explanation is unconvincing, because in international comparison Germany's labour market and welfare state institutions are simply not as sclerotic as often supposed. In most of the aggregate indicators for structural rigidities Germany is not worse than the average OECD or EU country.

Moreover, there is a macroeconomic explanation focusing on the combined effects of restrictive and pro-cyclical monetary, fiscal and wage policies in Germany that is broadly consistent with modern macroeconomic theory and is supported by empirical data.

Keywords:

Labour market institutions
macroeconomic policy
employment determination
Germany
European Monetary Union

Acknowledgements

Very special thanks to Dean Baker, Andrew Glyn, David Howell and John Schmitt for generously supplying us with their complete data set from Baker, Glyn, Howell & Schmitt (2002). Earlier versions of the paper were presented at the 27th German Studies Association Conference, 18–21 September 2003, New Orleans, USA, at the International Conference 'Development in economic theory and policy, institutions and European integration', 15–17 July 2004, Universidad del Pais Vasco, Bilbao, Spain, and in research seminars at the Berlin School of Economics and the Technical University Darmstadt. We are grateful for helpful comments by the participants, by Wade Jacoby, Bernd Muelhaupt and Torsten Niechoj and by two anonymous referees. Any remaining errors are of course ours.

Notes

The main source for macroeconomic data in this paper is OECD (2003). Until 1990 the German data only covered the former West Germany. Since 1991 the data are related to the now united West and East Germany.

See for instance the annual reports of the German council of economic experts (SVR, 2002, 2003), the majority view in the semi-annual joint reports of the leading economic research institutes in Germany (Institute, 2002, 2003) and, in particular, an economic policy paper of the German central bank (Deutsche Bundesbank, 2003). The OECD and IMF reports on the German and European economy also aim at structural reforms (IMF, 2003; OECD, 2003). The same is true for the European Commission (2002). For a critique of the institutional rigidity view of European unemployment see recently Schettkat (2003b) and Stockhammer (2004).

See Bibow (2003) for an extensive discussion of the effects of German unification and the macroeconomic reactions by the Bundesbank and by German fiscal policies in the course of the 1990s.

In order to bring down the German unemployment rate, currently an annual GDP growth rate of slightly less than 2% is necessary.

Note that in this approach, contrary to what has been stated in the previous section, it is unemployment that lowers the growth rate and not low growth that is responsible for rising unemployment.

See for instance Blanchard & Katz (1997), Layard, Nickell & Jackman (1991), Nickell & Layard (1999), Schettkat (2003a), Snowdon, Vane & Wynarczyk (1994, pp. 292–318) and Stiglitz (1997a, 2002).

On the interaction of wage bargaining co-ordination with the Central Bank's monetary policy and the effects on unemployment see more extensively Hein (2002a, 2002b).

For a definition see Table 1.

It should be noted, however, that the results remain essentially unchanged when the whole period from 1960 to 1999 is studied.

They discuss Belot & van Ours (2001), Bertola, Blau & Kahn (2002), Blanchard & Wolfers (2000), Elmeskov, Martin & Scarpetta (1998), Nickell (1997) and Nickell, Nunziata, Ochel & Quintini (2002).

The study is based on updated data from Nickell et al. (2002).

See Snowdon, Vane & Wynarczyk (1994, pp. 286–330, 367–380) for textbook reviews of the two approaches.

A lot of papers have shown that a favourable coordination between monetary and fiscal policies rather than deregulated labour markets can be held responsible for the superior development of the US economy during the 1990s compared to Germany or the European economies (Flassbeck, Henry, Jacquet & Levine, 1997; Holtfrerich, 1999; Kalmbach, 2000; Palley, 1998; Solow, 2000).

On the lack of sound macroeconomic policy coordination in the euro area as a reason for slow growth and high unemployment see Hein & Truger (2004a, 2004b).

See Davidson (1994), Heine & Herr (1999) and Lavoie (1992) for textbook presentations of the post-Keynesian approach and Arestis (1996) for a survey.

See Auerbach & Kotlikoff (1998), Blanchard (2003), Mankiw (2002) and Stiglitz (1997b) for textbook presentations in the new Keynesian vain and Truger (2003) for a survey on macroeconomic policy implications.

The requirement of coordinated monetary and fiscal policy intervention increases considerably if hysteresis is taken into account. With hysteresis the NAIRU is not stable but rather depends on the past development of the actual unemployment rate, which can be affected by macro-policies (Ball, 1999; Blanchard, 2003, p. 283).

For a critique of the new Keynesian NAIRU approach from a post-Keynesian perspective see Sawyer (2001, 2002) and Hein (2004).

For an overview see Cecchetti (1995) and Bernanke & Gertler (1995). See Bondt (2000) and ECB (2000, 2002) on the monetary transmission mechanisms in the euro area countries.

See Arestis & Sawyer (2003) and Hein (2002a, 2004) for models of distribution conflict and inflation.

Empirical analysis for Germany and the EMU in the 1990s has shown, that the development of unit labour costs determines the development of output prices (Hein, Schulten & Truger, 2004). Falling unit labour cost growth rates, however, are not accompanied by proportionally falling inflation rates. Therefore, nominal wage moderation is also associated with a tendency of labour income shares to fall.

At least for Germany, long-term positive growth effects of public infrastructure investment should be uncontroversial. See Kitterer (1998).

It should be noted, that using the EMU average as a standard of reference does by no means imply that macroeconomic policies for the EMU have been optimal or adequate. On the contrary, EMU macroeconomic policies have in general suffered from the same problems as Germany: macroeconomic mismanagement and a lack of coordination (Hein & Truger, 2004). Unfortunately German macroeconomic policies have even been worse.

There is a fourth macroeconomic factor that is not explicitly addressed in the current paper, but that is nevertheless particularly suited to explaining the extraordinarily pronounced fall in relative German economic performance in 2001 and the subsequent years: The German economy depends considerably stronger on cyclical fluctuations of the US economy than the other EMU countries (SVR, 2001, pp. 251–266). This is true for the dependence of German exports on US demand, the stronger correlation between German and US share price indices and the transmission of cyclical fluctuations via direct foreign investment. Furthermore, the transmission of negative cyclical shocks from the US to Germany seems to be stronger than that of positive ones.

For a general critique of the ECB's 'anti-growth bias' see Bibow (2002) and Hein (2002a). This 'anti-growth' bias consists of a too restrictive definition of price stability for the heterogeneous currency area—as an annual increase of the harmonised consumer price index of below but close to 2%—and an asymmetric response to the expected deviation of actual from target inflation. The ECB has tended to tighten whenever inflation increased above the target without relaxing when inflation expectations came down.

The European Commission (2003) defines the labour income share as 'compensation per employee as percentage of GDP at factor cost per person employed'.

As is well known, labour income shares tend to increase in economic downswing and to decrease in upswings due to pro-cyclical productivity growth and time lags in nominal wage setting.

Also the growth rates of primary government expenditure have been below the EMU average since 1997. The same is even true for the growth rates of real social benefits.

This is not to say that there is no need for reforms or no scope for improving the existing institutions. For example ageing societies certainly pose a challenge for the welfare state that has to be addressed. However, this has nothing to do with the current crisis and is far from implying that deregulating the labour market, dismantling the welfare state or other supply side measures are automatically the best answers to these challenges.

See Hein & Truger (2004, 2005) for a more explicit discussion on this.

Related Research Data

Die NAIRU – eine post-keynesianische Interpretation
Source: European Journal of Economics and Economic Policies Intervention
Unemployment and Labor Market Institutions: An Empirical Analysis
Source: Journal of the Japanese and International Economies
Unemployment and Labor Market Rigidities: Europe versus North America
Source: The Journal of Economic Perspectives
Unemployment and the real wage: the economic basis for contesting political ideologies
Source: Cambridge Journal of Economics
Inside the Black Box: The Credit Channel of Monetary Policy Transmission
Source: The Journal of Economic Perspectives
Are institutional rigidities at the root of European unemployment?
Source: Cambridge Journal of Economics
What We Know and Do Not Know About the Natural Rate of Unemployment
Source: The Journal of Economic Perspectives

Related research