

The German model as a blueprint for Europe?

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Confronting Italy and Germany“**

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# Program

1. What is the issue here?
2. Elements of the „German model“
3. What if everyone implemented these elements?
4. Why are the Germans so self-confident about their model?
5. Conclusions

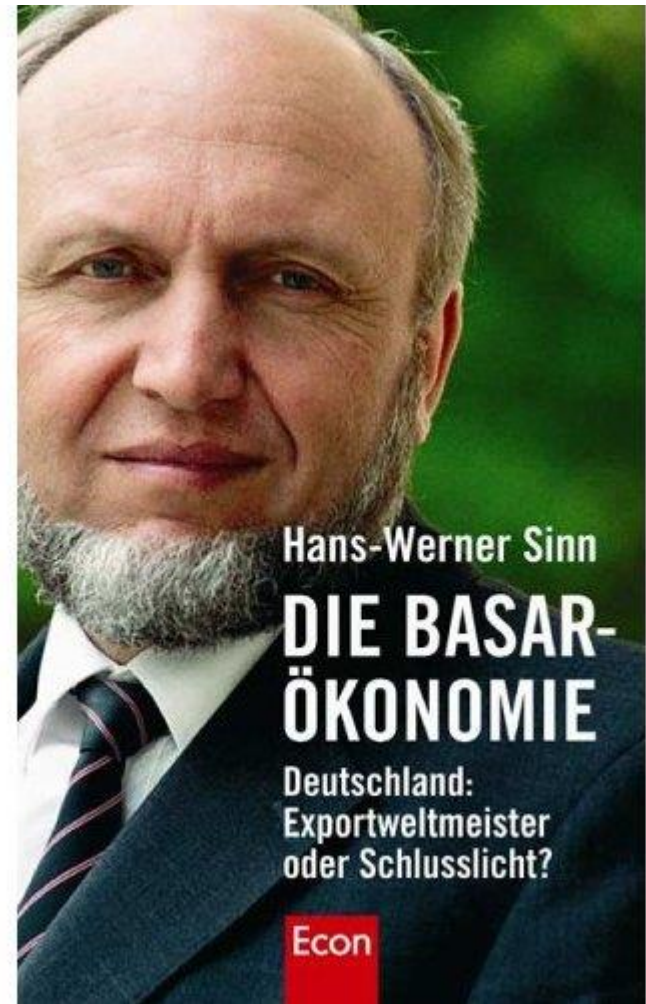
## The view at the beginning of the century in Germany... (I)

- „Can Germany be saved?“ (2003)
- By Hans-Werner Sinn, Ifo-president and probably Germany's most influential economist



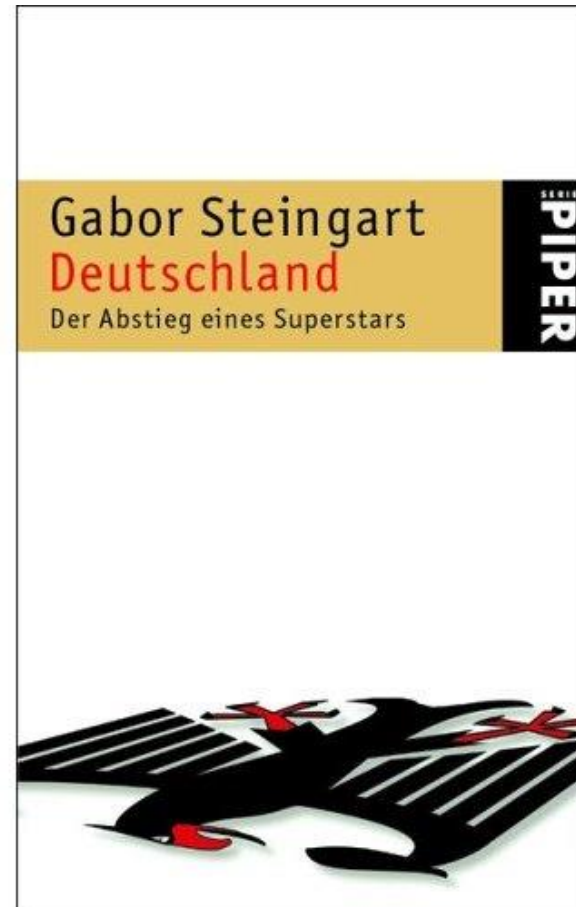
## The view at the beginning of the century in Germany... (II)

- „The Bazar economy “ (2005)
- Claiming that Germany was in terminal decline even though exports were soaring
- By Hans-Werner Sinn, Ifo-president and probably Germany's most influential economist



## The view at the beginning of the century in Germany... (III)

- „The decline of a superstar...” (2003)
- By Gabor Steingart, politics editor of „Der Spiegel“



# Outside Germany, the view started to change earlier...

- Goldman Sachs started to write more positively on Germany from 2003 onward
- Economist cover in August 2005



# The view in Germany today

- Today, Germans perceive themselves as **Superdeutschland...**
- While European partners perceive Angela Merkel as „Sicherheitsrisiko“ (security risk)



To summarize it in a German proverb

**„Am deutschen Wesen soll die Welt  
genesen“**

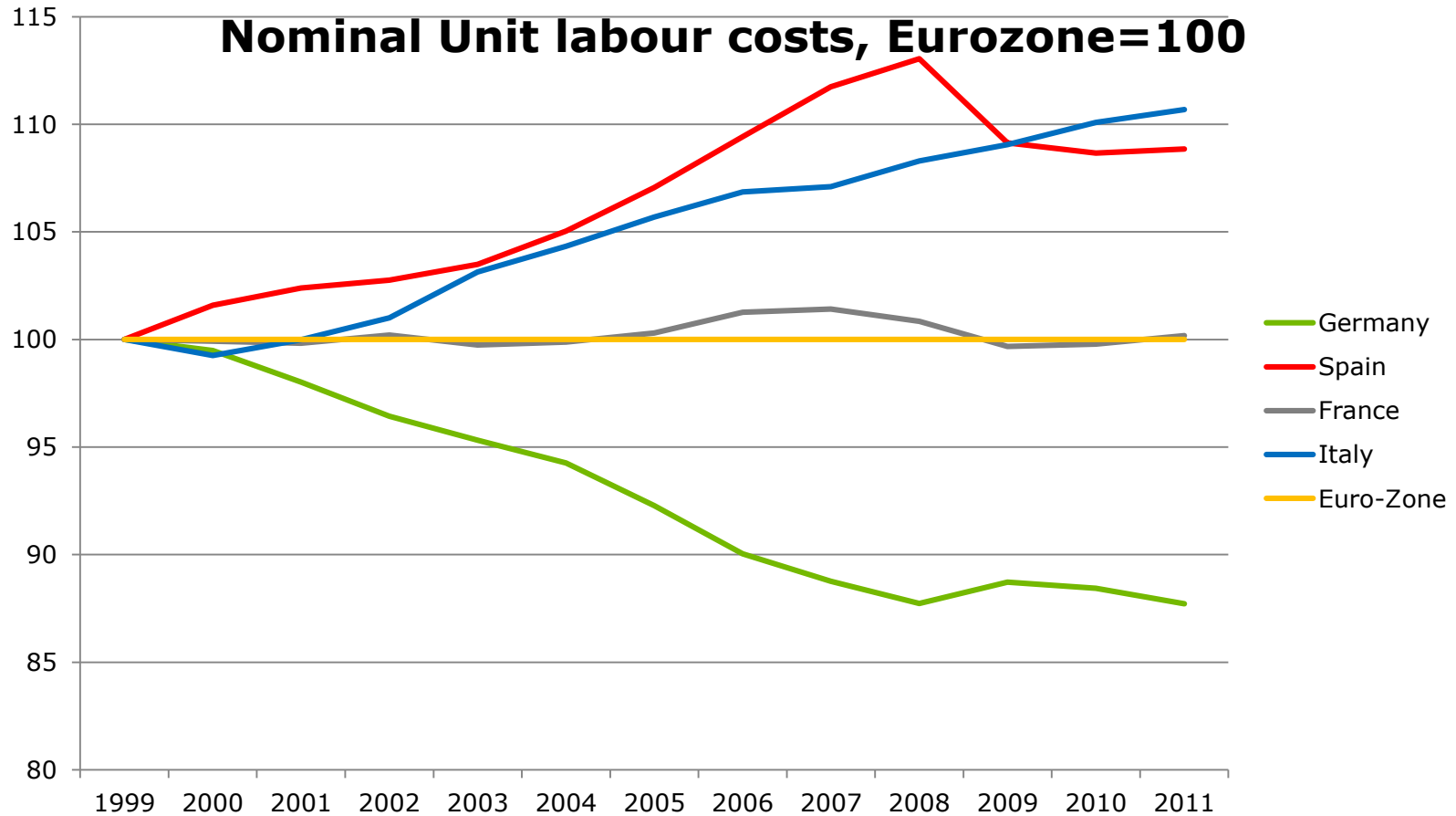
Emmanuel Geibel, *Deutscher Beruf*

Translated as:

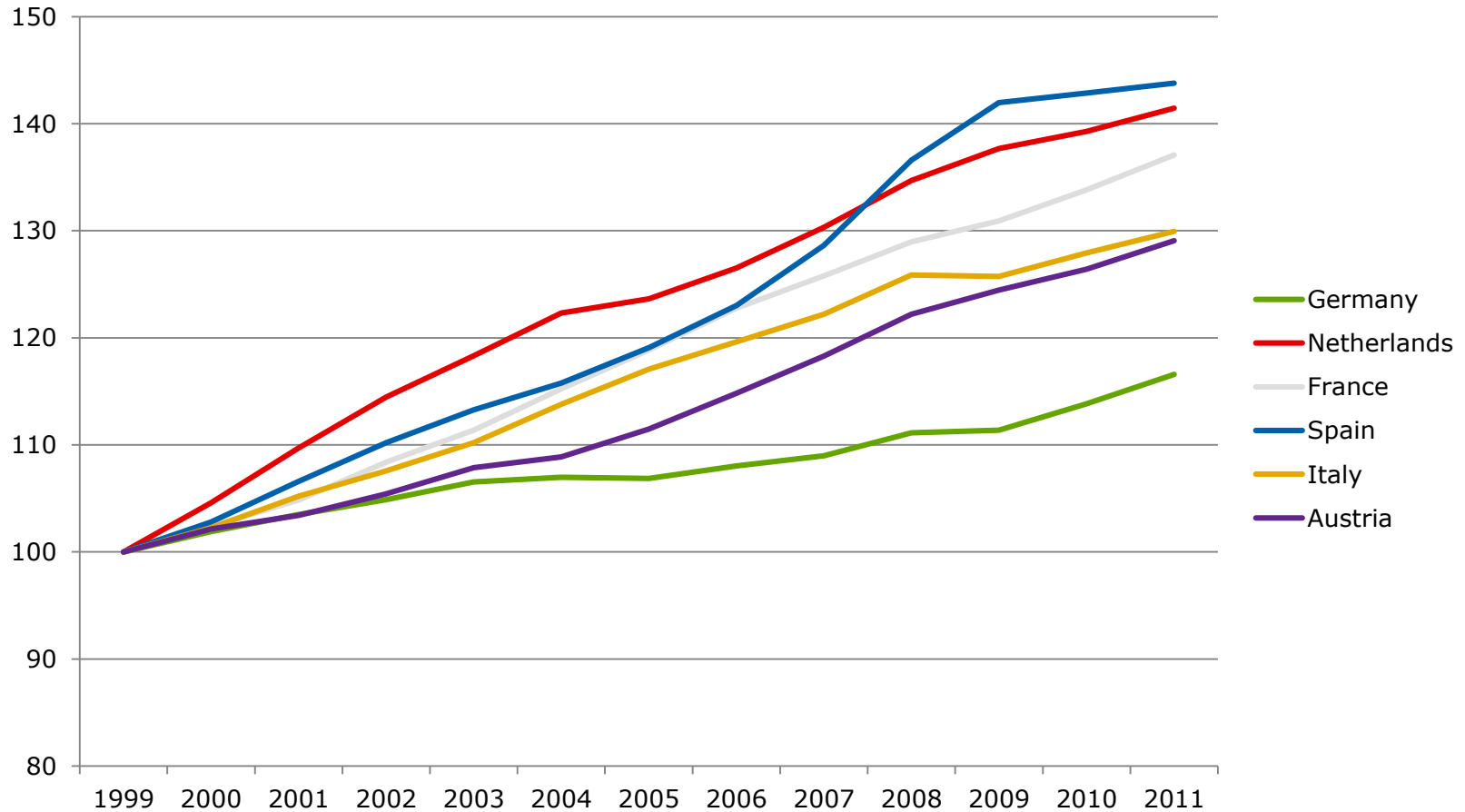
**„The world shall be cured by German values“**



# Elements of the German model (I): Unit labour costs

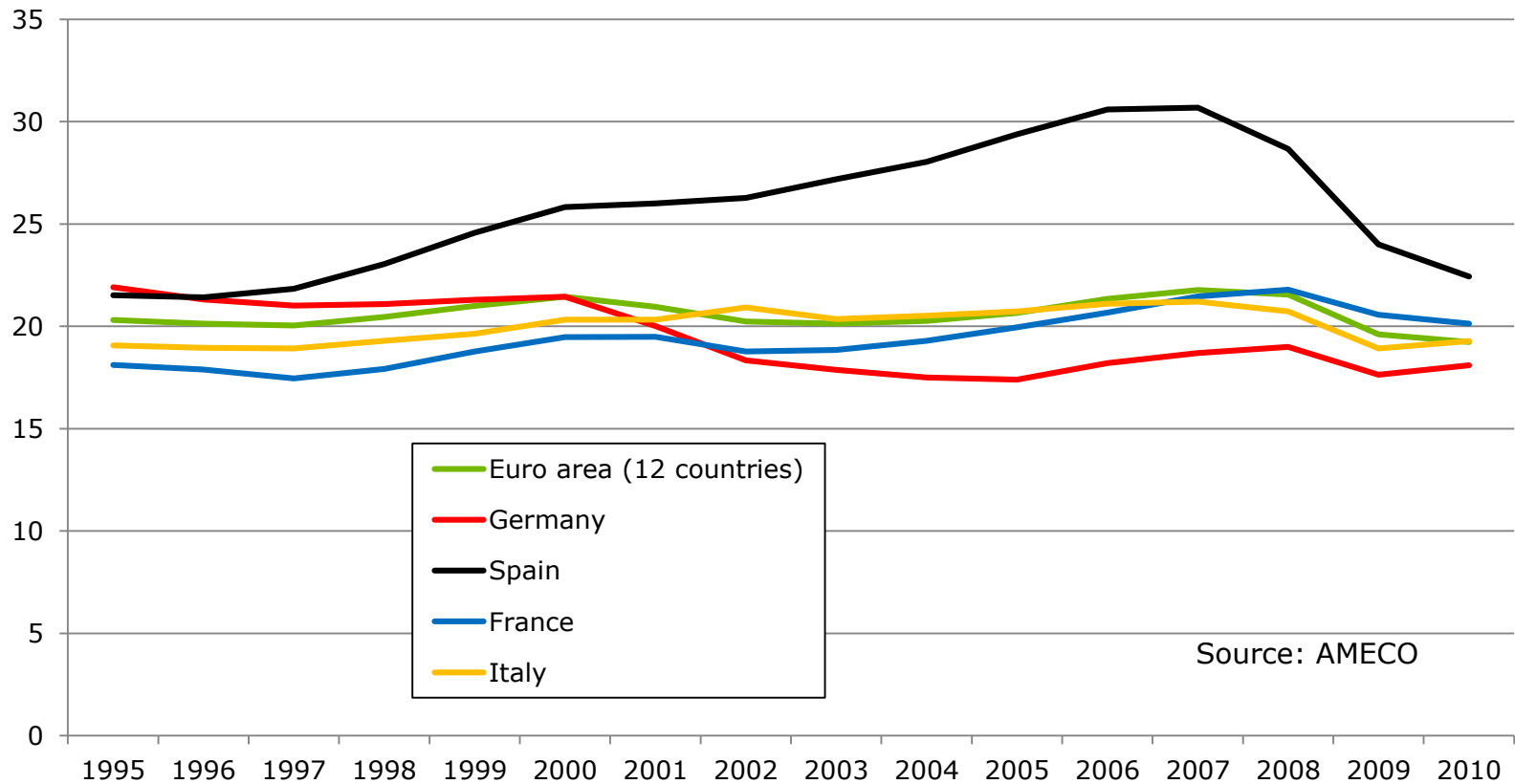


# Elements of the German model (II): Mainly nominal wage restraint



# Elements of the German model (III): Weak investment...

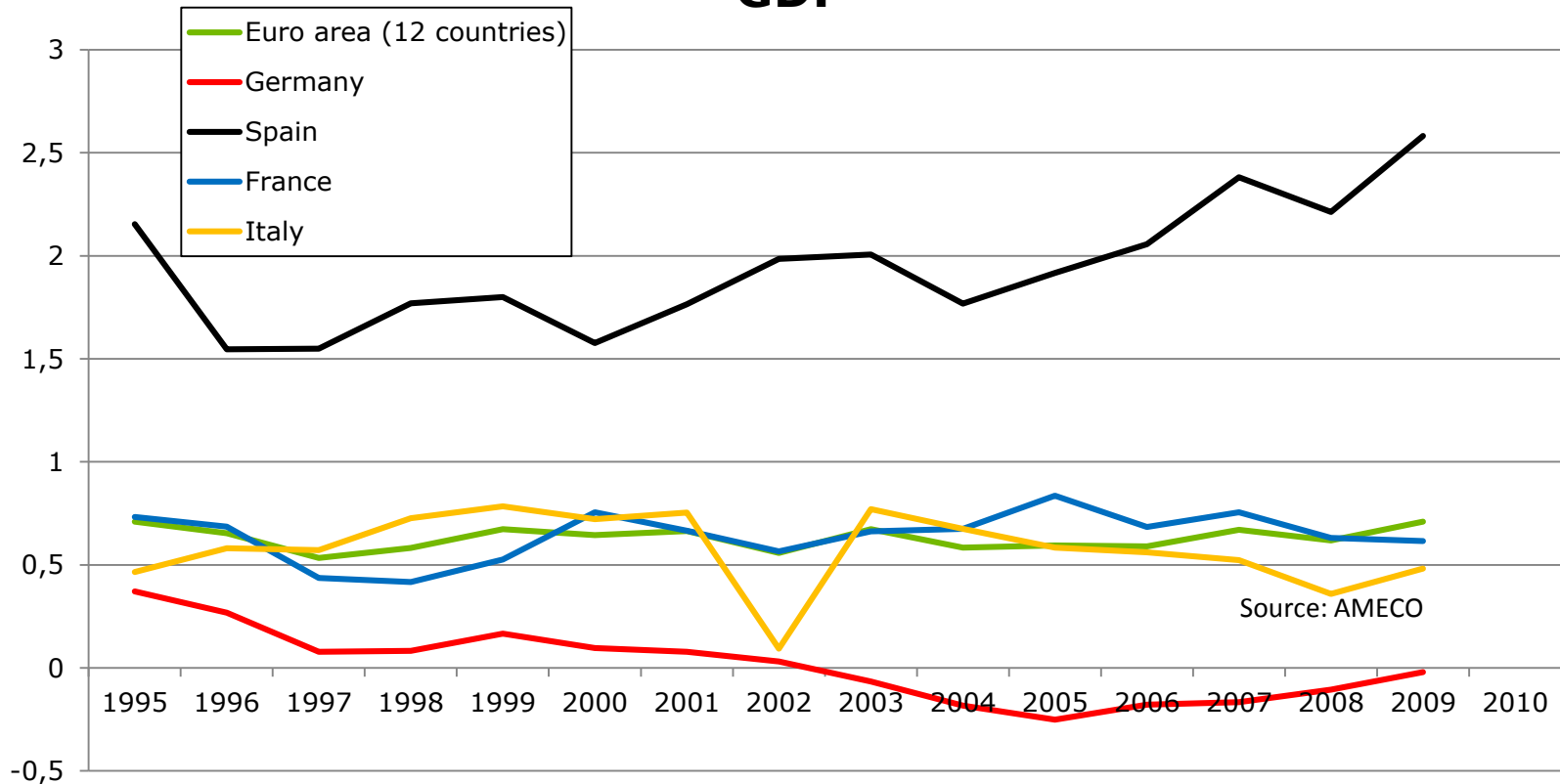
Gross fixed investment, total economy, in % of GDP



Source: AMECO

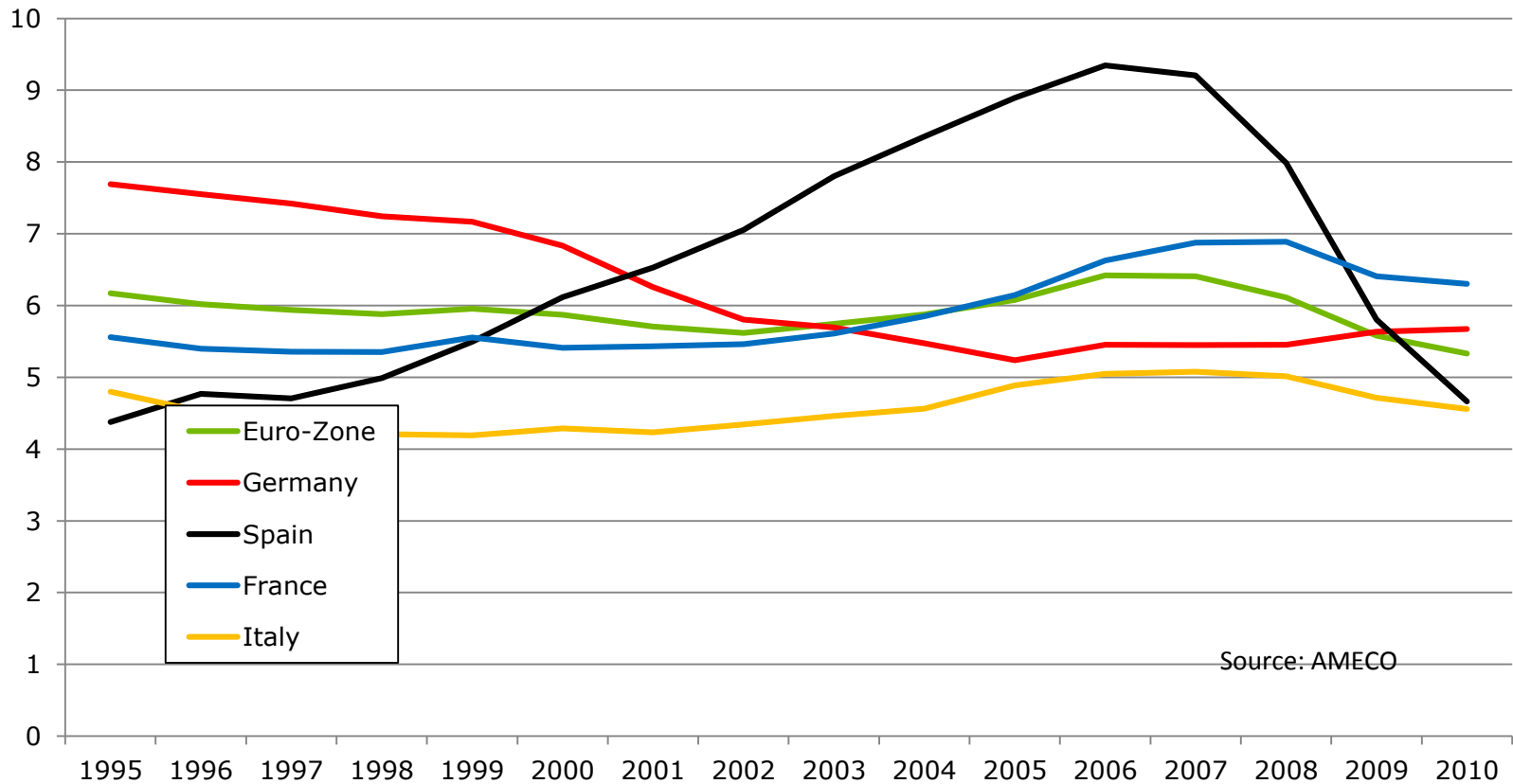
# Elements of the German model (IV): But mainly because of weak government investment

**Net investment, general government, in % of GDP**



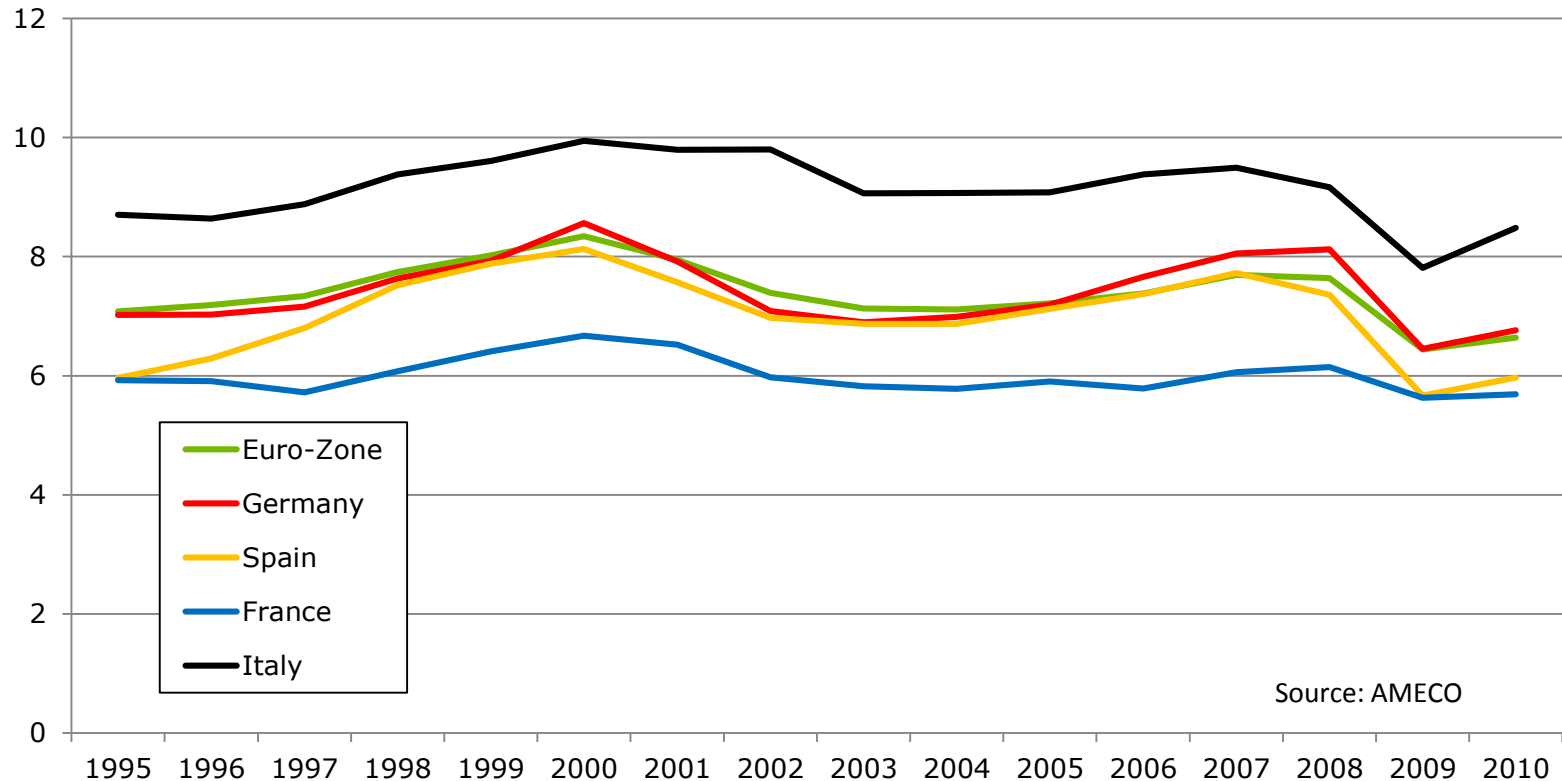
# Elements of the German model (V): ... and weak housing construction

## Gross investment, housing, in % of GDP



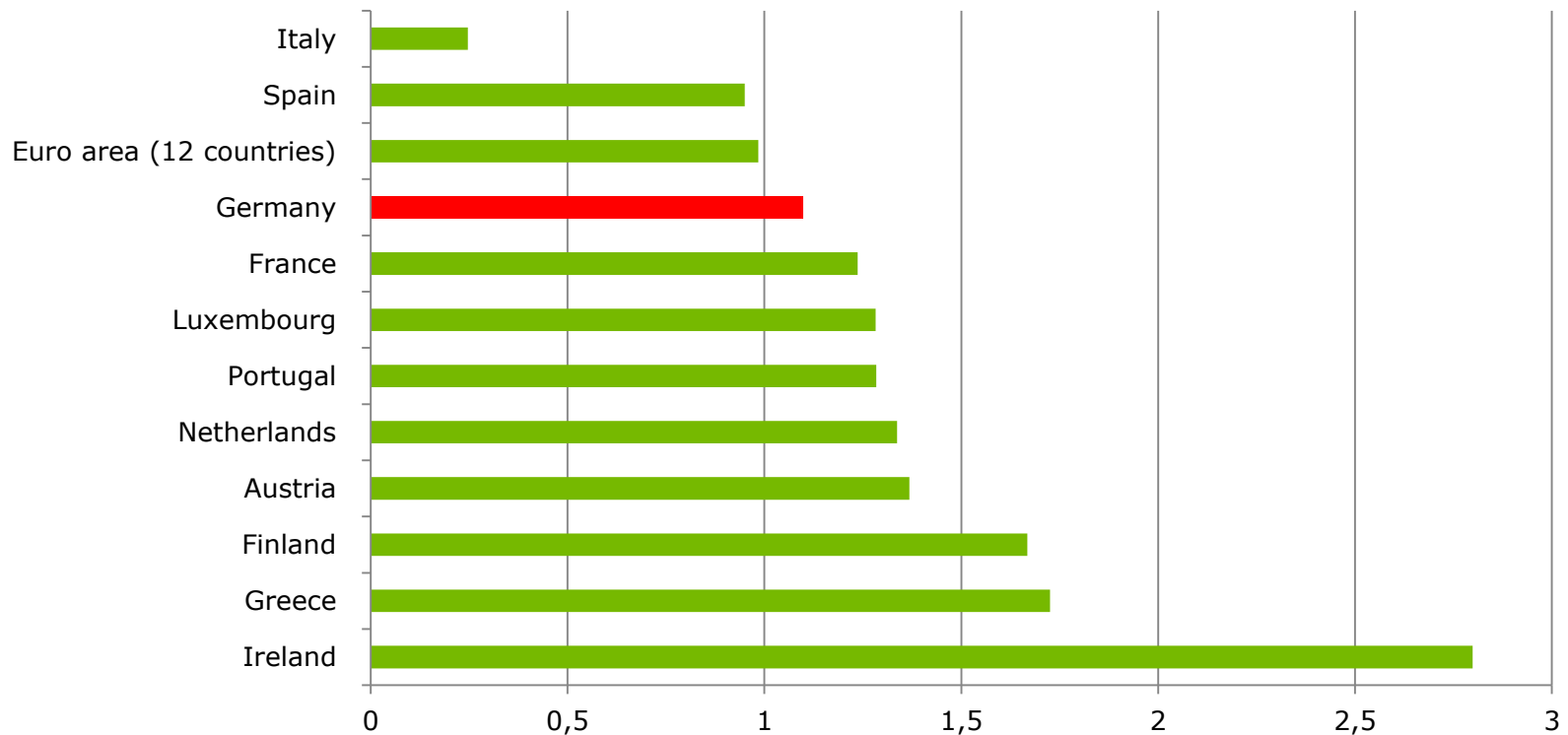
# Elements of the German model (VI): ... but rather decent corporate investment

## Investment in equipment, in % of GDP

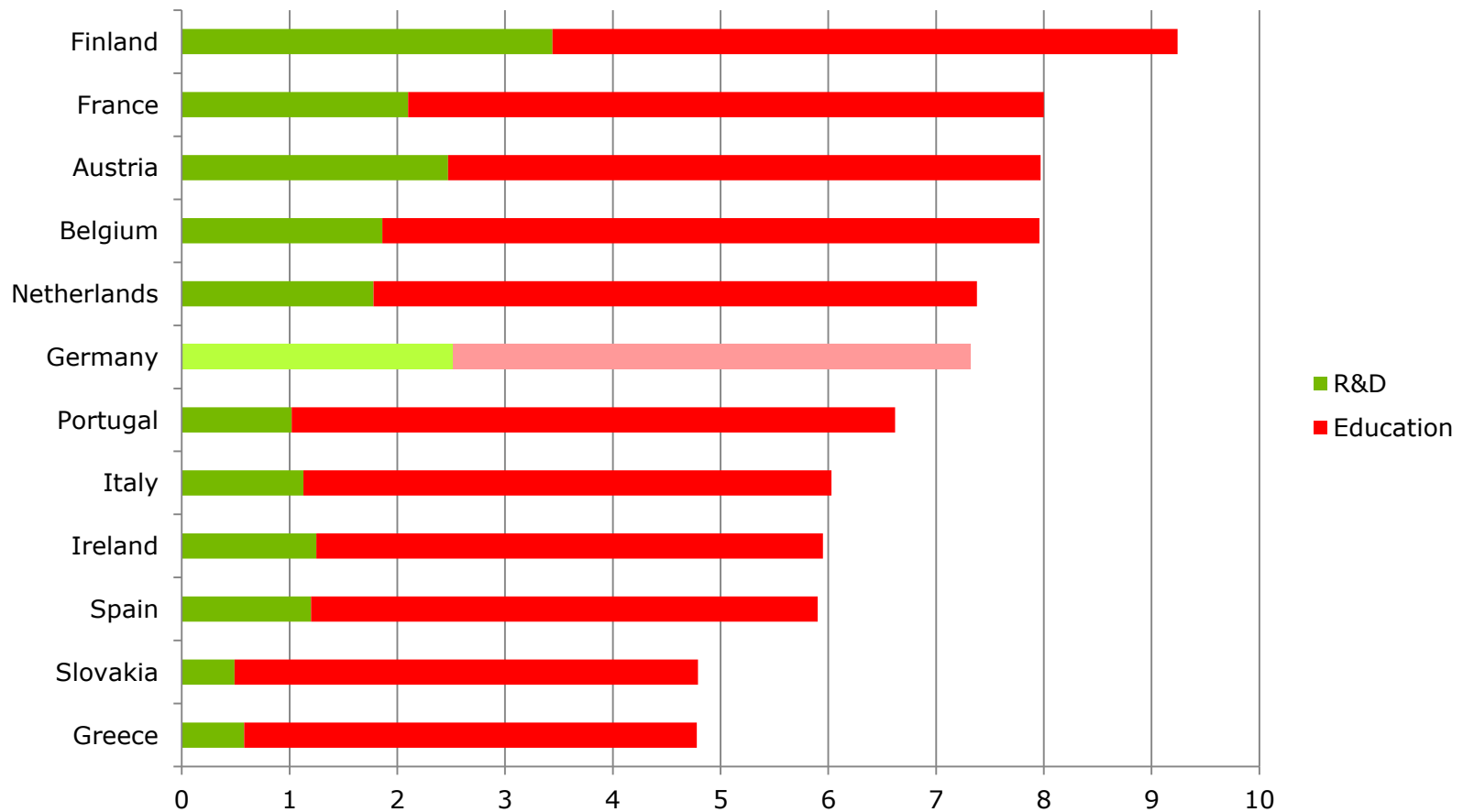


# Elements of the German model (VII): Rather weak productivity growth

**Average Annual Productivity Gain, 1999 to 2010, in %**



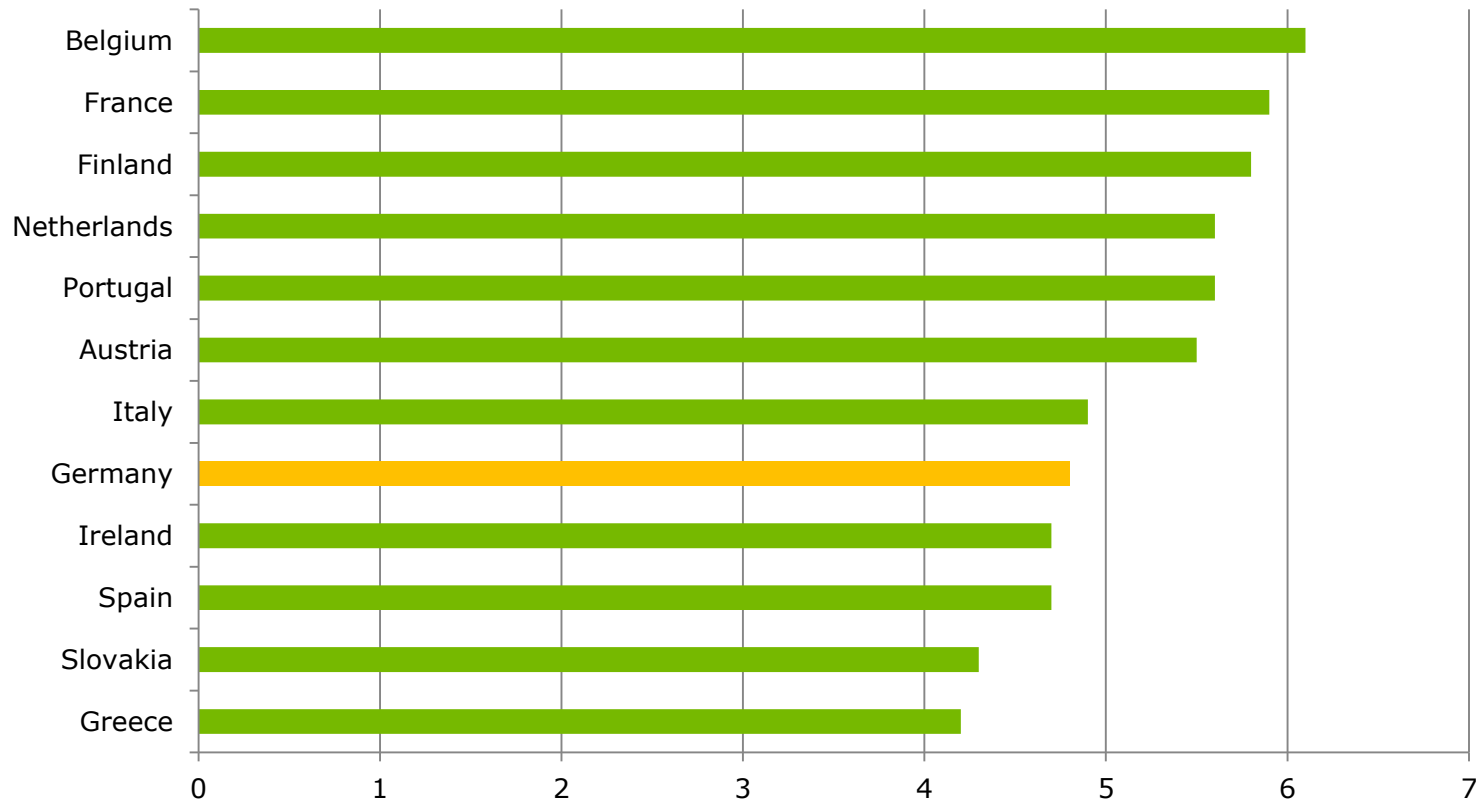
# Elements of the German model (VIII): Not overly much spending for R&D and education



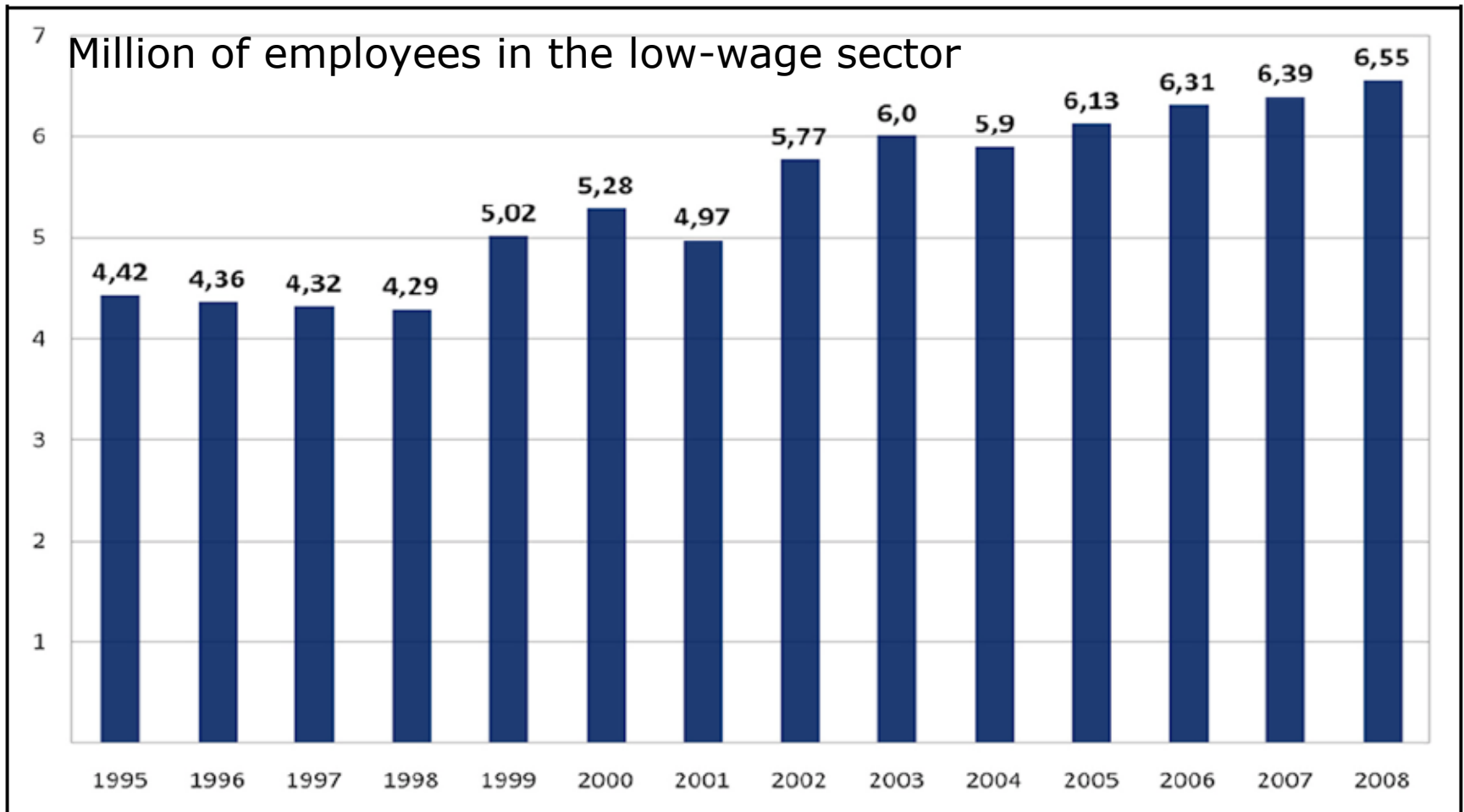


# Elements of the German model (IX): ...especially not on education

## Spending on education, 2006, in % of GDP



# Elements of the German model (X): The growing low-wage sector



# Size of low wage sector in Germany (2008)

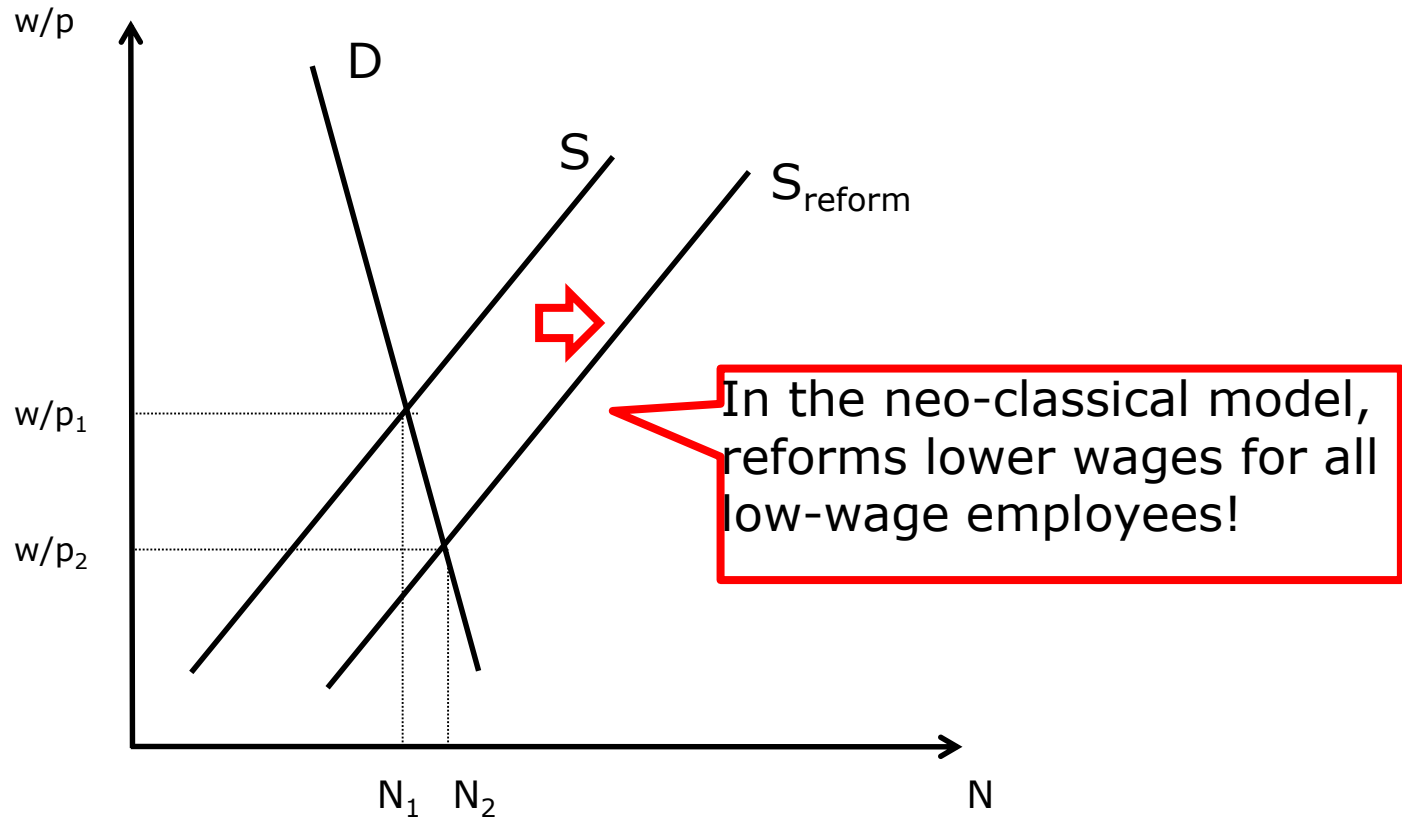
|                                                            |         | Differentiated low-wage threshold<br>West/East | Uniform low-wage threshold |
|------------------------------------------------------------|---------|------------------------------------------------|----------------------------|
| <b>Threshold low-wage sector (gross in € per hour)</b>     |         | 9.50 € (West)<br>6.87 € (East)                 | 9.06 €                     |
| <b>Share of dependent employment in low wage sector</b>    | West    | 20.8 %                                         | 17.9 %                     |
|                                                            | East    | 20.1 %                                         | 39.3 %                     |
|                                                            | Germany | 20.7 %                                         | 21.5 %                     |
| <b>Number of employees in low wage sector (in million)</b> | West    | 5.52                                           | 4.75                       |
|                                                            | East    | 1.04                                           | 2.03                       |
|                                                            | Germany | 6.55                                           | 6.81                       |

Source: Kalina/Weinkopf (2010)

# Labour market reforms (Hartz IV) and low wage sector

- Major changes in Hartz IV legislation
  - Long-term unemployed were forced to pick up employment even if work was low-qualified work
  - Unemployed were allowed to keep part of the unemployment assistance even if they were earning money (implicitly a low wage subsidy)
- Results
  - Fall in reservation wage
  - Increase of labour supply in low wage sector

# What happens in the neo-classical labour market model for unqualified labour?

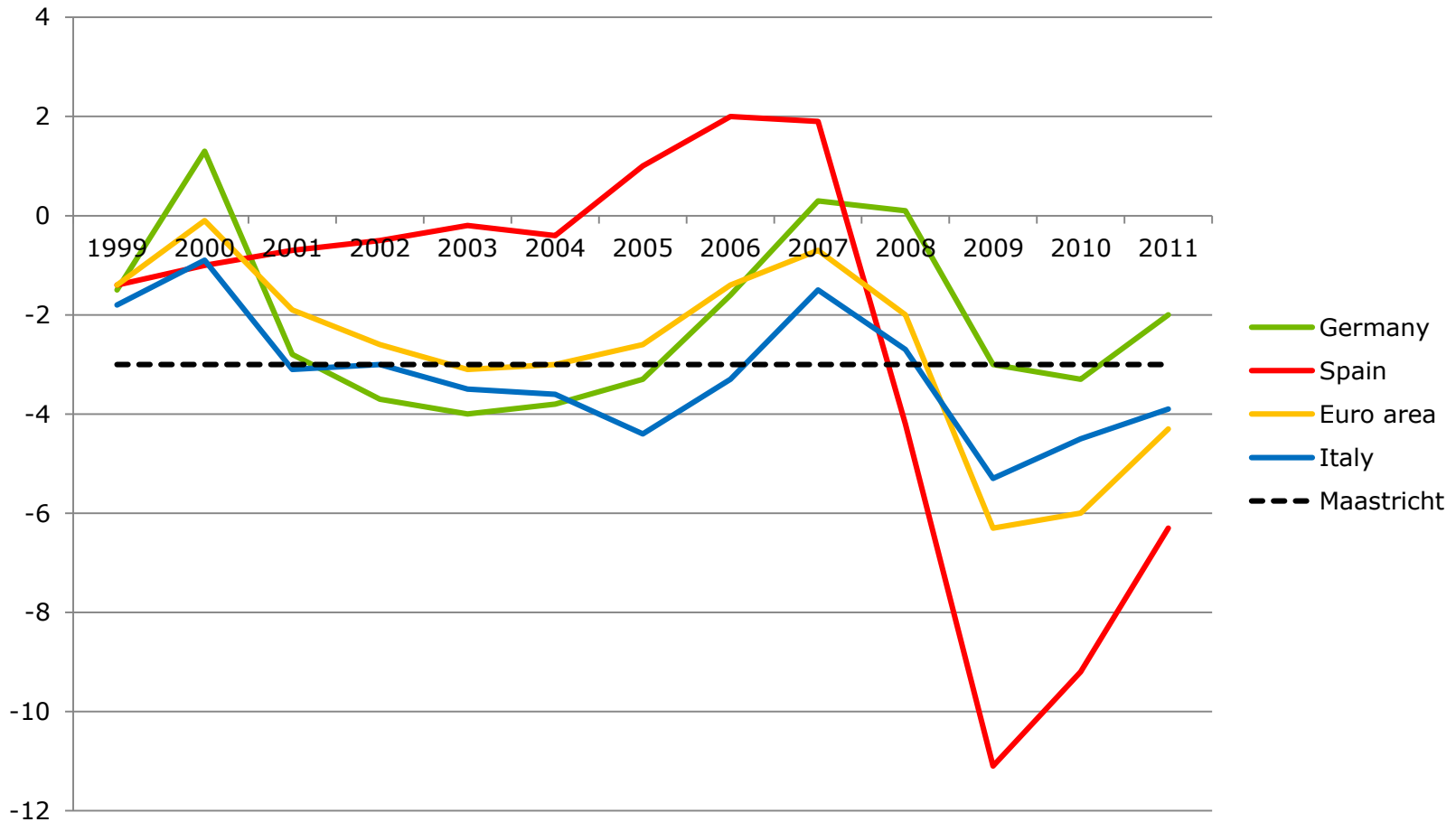


## Wage development in the low wage sector (Dullien et al. 2009)

- From 2000 to 2006, hourly wages for the lowest quintile have
  - Fallen by 4.8 percent in nominal terms
  - Fallen by 13.7 percent in real terms
- From 2000 to 2006, hourly wages for the second lowest quintile have
  - Risen by 5.2 percent in nominal terms
  - Fallen by 3.2 percent in real terms

# What about Germany's austerity path?

## Budget deficits in % of GDP



## Summary: Elements of the German model

- Wage restraint
- A growing low-wage sector
- Partly running down tangible/intangible capital stock
  - Public infrastructure
  - Education



# Can this be a blueprint?

## Elements of a blueprint

- Categorical Imperative (Immanuel Kant)
  - "Act only according to that maxim whereby you can, at the same time, will that it should become a universal law."
- Question: Would it be sensible if everyone in EMU tried to copy the German model?

## What would happen if everyone tried to follow the German model?

- Investment and spending on education is usually seen to be linked to productivity growth
  - Convergence on low German level would dampen productivity growth
  - → Conflict with Lisbon targets (even though they might be disfunct anyway)

## Other problems of low public investment/ growing low wage sector

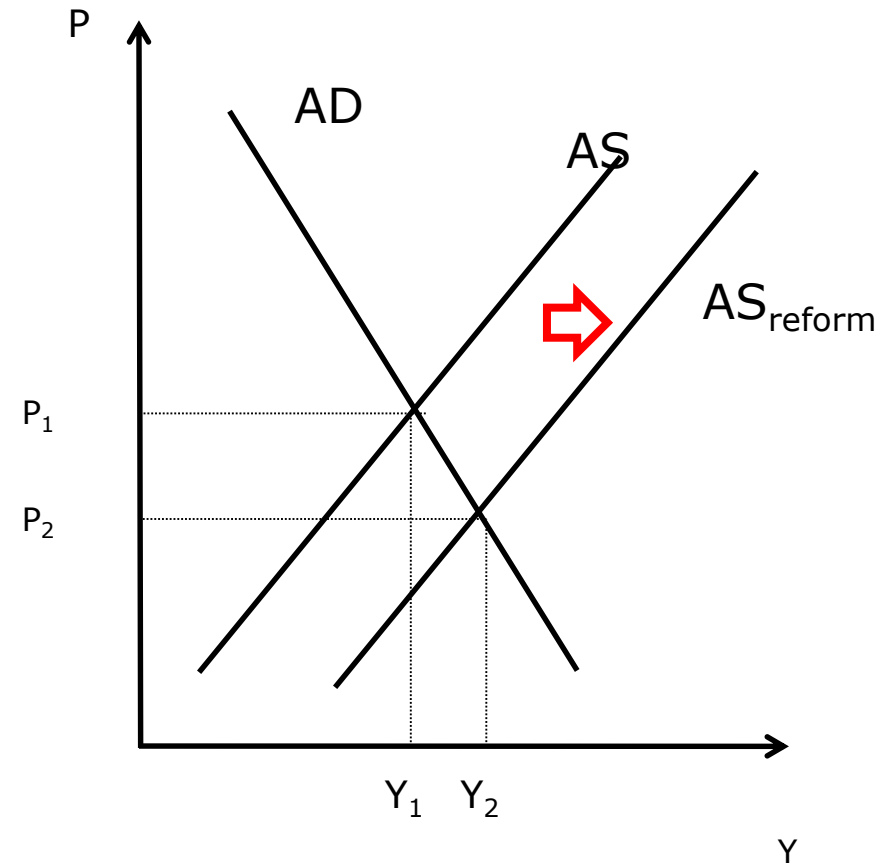
- Low aggregate investment and weak consumption demand translates into weak overall aggregate demand from Germany
- If everyone would follow this approach, there would be a **lack of overall aggregate demand** in the euro area!

## But aren't there benefits from lower wages? (I)

- Pure neoclassical or new classical textbook model would predict more employment if real wages fall
  - Substitution between labour and capital towards more labour input
  - More demand for labour by firms
  - More output

# But aren't there benefits from lower wages? (II)

- AS-AD model (neoclassical synthesis) would also predict an increase in output and employment from lower wages (at least if there is classical unemployment)
- AS-curve shifts downwards
- AD increases with lower prices
- If this were the case, German would do the rest of EMU a favor if it forces wage restraint everywhere



# Why isn't aggregate demand a problem in the neoclassical synthesis/new classical model

- Aggregate demand is increased through **real balance** effect if wages and prices fall
- Real money balances ( $M/P$ ) in the economy increase with falling prices
  - Lower interest rates  $\rightarrow$  more investment (Keynes effect)
  - More real wealth  $\rightarrow$  more consumption (Pigou effect)
- Assumption: Constant and exogenous  $M$

## A little more elaborated: The effect in models on interaction of wage bargaining/ monetary policy

- Similar outcome in Soscice/Iversen (2000) or Coricelli, Cukierman and Dalmazzo (2000)
  - Wage restraint leads in model with monopolistic competition to lower prices
  - Lower prices lead to higher real balances
  - Aggregate demand and output increases

## How realistic are these models?

- Money supply is to be seen as endogenous, rather than fixed
  - ECB targets the short term interest rate, not money supply targets
- Money is not net wealth to the economy
  - Money is borrowed by commercial banks from central banks
- Keynes and Pigou effects are unlikely to happen in reality
- Fall in prices might even exacerbate problems in banking sector and lead to **less AD**

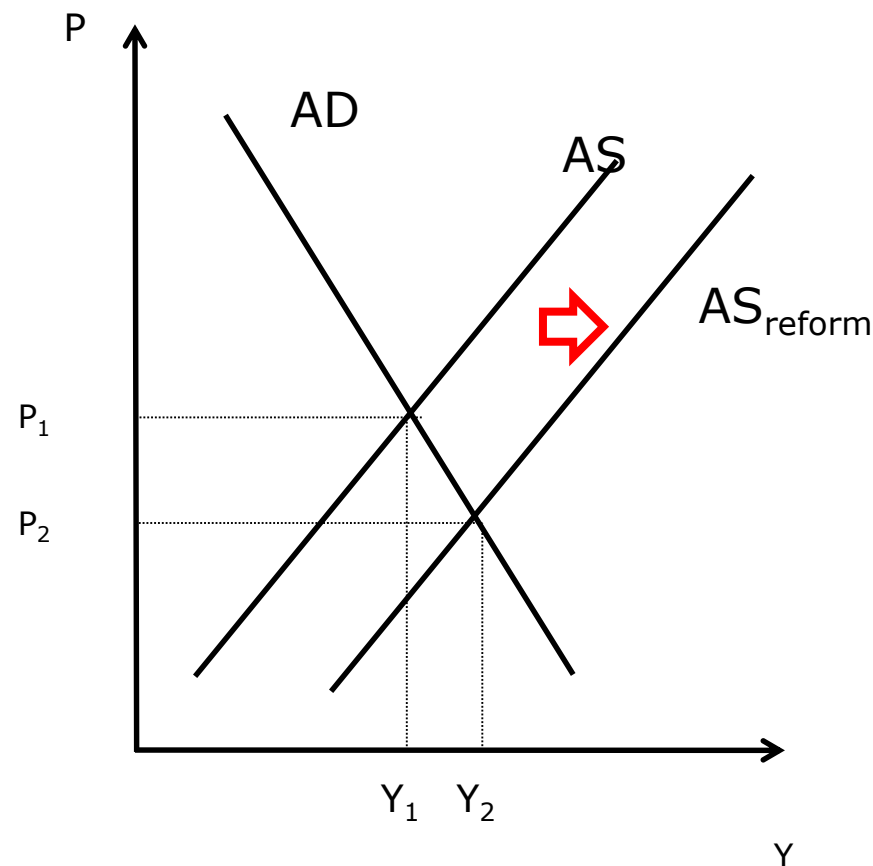


## But couldn't this just be a parable for the ECB reaction?

- Maybe ECB eases monetary policy if everyone does wage restraint and prices start falling?
- Possibly, but not very likely at current situation
  - Short term interest rates are already very low
  - ECB has hinted that it sees „normal level“ much higher than 1 percent
  - **Hence, under current circumstances, more wage restraint in the euro area will not have additional benefits**

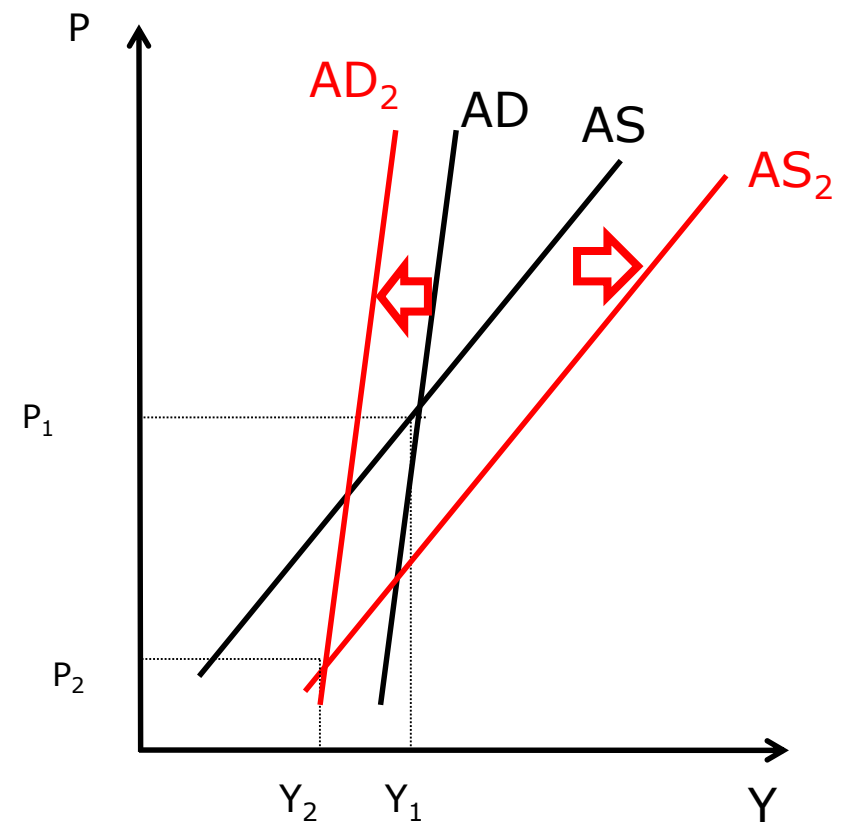
# Can we apply this model to one single country in EMU?

- Yes!
- Demand from other countries substitutes real balance effect (Dullien 2004)
- If German prices fall, but prices in the rest of eurozone remain constant, aggregate demand for German products increases



## So, what would happen if everyone followed the German model? A new AD-curve

- AD-curve can be seen as vertical or even upward sloping (due to effects of deflation on the banking sector)
- German policies would shift AS-curve right and AD-curve left
- Result: Deflationary scenario with less output and more unemployment



## Why are the Germans so confident about their model (I)?

- Merkel proposes „pact for competitiveness“
  - Focuses on elements of price competitiveness
  - Only some elements of more investment (spending on R&D and education)
- Berlin lobbies hard that only countries with excessive wage growth and current account deficits are forced to adjust

## Why are the Germans so confident about their model (II)?

- Under German economists, current account surplus is not seen as a problem related to wage restraint
  - Bundesbank (2010)
  - Sachverständigenrat (2010)
- The German Foreign service has sent around a paper how embassies are supposed to defend the German export-driven model

## My explanation

- Increasingly, there are different paradigms among German economists on the one hand and British/US/French economists on the other hand
- German economists are thinking very much in a new classical world without possible problems of insufficient demand...
- ...while the rest of the world uses New Keynesian approaches in which wage restraint might result in a beggar-thy-neighbor policy

## Conclusion

- The German model based on austerity and wage restraint is not suited to be copied by everyone in EMU
- The German position is based on an interpretation of underlying economics very different from that in other countries...
- ...and are very unlikely to change soon as the debate in Berlin is by now decoupled from that in London, Brussels, Paris or Rome

**THANK YOU VERY MUCH  
FOR YOUR ATTENTION**