Germany and the Great Recession

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(draws on joint and ongoing work with Bernd Fitzenberger, Steve Machin, Uta Schönberg, and Alexandra Spitz-Oener)
To understand why Germany emerged as one of the strongest economies from the Great Recession, one has to look back to the period preceding the Great Recession.

That was a period of dramatic challenge and change for Germany.

During that period Germany gained spectacularly in competitiveness.

Key to understand why that happened is the specific governance structure of German labour market institutions, with unions and works councils that collaborated with industry.
In the late 1990s and into the early 2000s Germany was "the sick man of Europe":

» Germany’s economic growth about 1.2 percent per year from 1998 to 2005, unemployment rose from 9.2 percent in 1998 to 11.1 percent in 2005

After the Great Recession, Germany emerged as "Economic Superstar"

» number of total unemployed fell from 5 million in 2005 to 3 million in 2008

» almost no increase in unemployment during the Great Recession, despite a sharp decline in GDP in 2008 and 2009

» exports reached all-time record of $1.738 trillion in 2011, roughly equal to half of Germany’s GDP, or 7.7 percent world exports
What happened?

- How did Germany transform itself from “the sick man of Europe” to an “economic superstar” in less than a decade?

  » One common answer: series of legislative market reforms that started in the mid 2000s, the so-called “Hartz labor reforms.”

  » Another explanation: the evolution of Germany’s trade balance in the context of the eurozone.
What really happened …

- Increase in competitiveness was driven by decentralisation of wage setting
  - Specific governance structure of the German labor market institutions allowed flexibility in time of extraordinary economic circumstances
  - This distinctive characteristic of its labor market institutions has been main reason for economic success Germany’s over last decade
Evolution of Competitiveness

Figure 1
Evolution of Competition-Weighted Relative Unit Labor Costs, Selected Countries, 1994–2012
Wage Trends and Wage Inequality

Figure 2
Indexed Wage Growth of the 15th, 50th, 85th Percentiles, West Germany, 1990–2008
Indexed Wage Growth by Sector

Figure 3

A: Nontradable Sectors

B: Tradable Manufacturing

C: Tradable Services
Unit Labor Cost, “Value Added” and “End Product”

Evolution of Real Daily Wages and Unit Labor Costs by Sector, 1995–2007

A: Nontradable Sectors

B: Tradable Manufacturing

C: Tradable Services
How did Germany’s Manufacturing Sector Improve Competitiveness?

- Inputs from domestically provided nontradables and tradable services, where real wages fell between 1995 and 2007.

- Productivity increases outpaced wage increases (decline in unit labor costs but increase in mean real wages).

- Increased use of trade integration with Eastern European countries through inputs imported from abroad (14.5% ‘95 ->21.5% ‘07).
What led to unprecedented wage restraint?

- **Institutions**: allowed for decentralization of wage setting process, from industry-region-wide level to the level of the single firm

- **Governance structure of the German system of industrial relations**: not rooted in legislation and not governed by the political process, but laid out in contracts and mutual agreements between trade unions, employer associations, and works councils
What led to unprecedented wage restraint?

- Driven by two main developments:

  » Sharp decline in share of workers covered by union agreements (‘95: 67%; 08: 41%)
What led to unprecedented wage restraint?

Driven by two main developments:

» Sharp decline in share of workers covered by union agreements

» Increase in opening clauses that strengthened the role of firm-based works councils in wage determination relative to trade unions

- Among industry-wide collective contracts in manufacturing, < 5% involved opening clauses in 1995, but 60 percent in 2004.

- 75 percent of all firms in 2005 with collective agreements use opening clauses
What Led to Greater Flexibility in the German Labor Market?

- Extraordinary cost of German Unification
- Opening of central and eastern European countries: unique opportunity for German industry to move production abroad
  - This “threat” changed balance of power between unions and employers and strengthened work councils
What was the Role of the so-called “Hartz Reforms”?

- Reduced and limited the benefits while unemployed, liberalized agency work, reformed “active” labor market policies, and reorganized the Federal Labor Agency.

- Did not induce any institutional changes in the wage setting process or impacted directly on competitiveness.

- Implemented in 2003, nearly one decade after process of wage decentralization and the improvement in competitiveness had begun.
Lessons for Europe

- Hartz Reforms: alone are not essential nor sufficient to improving competitiveness
- Important: Decentralisation of wage setting while keeping employees involved
- Far harder to achieve in many European countries, as changes can be made only through political process
Germany was improving its competitiveness during the mid 1990s, long before the euro started (1999).

Within the common currency area, and after 2001, Germany continued to gain competitiveness.

Euro has persistently appreciated against the US dollar.

Unlikely that Deutschmark would have appreciated much more against dollar before around 2008.
The Great Recession

- When the Great Recession started, Germany was in an unprecedented competitive position, with established trade links “ready to go”.

- Germany’s export markets were not much affected by the crash in the housing market, neither was Germany, and it was only a question of time for these markets to recover.

- That let to Germany to experience a deep but short recession: Germany was the first country to get out of recession (Q2 2008 - Q1 2009), long before e.g. the UK (Q3 2009 and Q2 2012).
The Great Recession

- A distinctive feature of Germany’s recession experience was that unemployment hardly increased.

- This was achieved through a tripartite deal to distribute the burden of employment reduction on workers, employers, and tax payers.

- Could only work if the recession is short.

- The key for these agreements were the unique collaboration between Policy Makers, Unions, and Industrialists.
Conclusions

- Germany is an interesting case study when evaluating the Great Recession.

- Its labour market institutions, characterised by independence from the political process, and strong collaborative tradition, were an essential feature for the development of Germany’s competitiveness.
Men, 20-60, Real Daily Gross Wages
Men and Women, 20-60, Real Daily Gross Wages