



LESSONS FROM THE 2000-20007 GERMAN EXPERIMENT IN WAGE MODERATION

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Unemployment is now rising sharply and is projected to reach 11% in the EU-27 and 12% in the euro area by the end of next year. The spectre of mass unemployment brings with it the danger of 'economic nationalism': Confronted with a depressed internal market, individual member states will be tempted to restore demand, investment and employment by trying to gain a higher share of the European marketplace at the expense of other members. Pressure on workers and trade unions to deliver even more wage moderation will intensify in the period to come.

However, before engaging in such a policy, governments and employers should look at past experiences with competitive wage moderation, in particular at the developments in Germany between 2000 and 2007.

1. An experiment in wage moderation and flexibility ...

Wage moderation policy in Germany, known as 'competitive disinflation, already started in the 1980's and was only shortly interrupted in the aftermath of the German re-unification (1990-1993). However, between 2000 and 2007, this policy gained considerable momentum, and this

in a period in which the possibility of adjusting nominal exchange rates no longer existed because of monetary union membership.

In the early years of monetary union (1999-2000), which were also the peak years for the 1999-2000 business cycle, German workers did obtain wage increases that were robust enough to push the share of wages in gross added value up and the share of profits slightly down. The profit share for the whole sector of non-financial corporations fell from 37.3% in 1998 to 36.3% in 2000.

However, from 2001 on and after the bursting of the ICT bubble, the OECD economies went into a slowdown of growth. Germany reacted to this by opting for a policy of wage moderation with the aim of improving national competitiveness. The idea of job alliances at company level was forcefully promoted by the government. Trade unions were put under much pressure to keep wage demands low and accept company 'opening clauses' in collective agreements bargained at the sector level. A reform of unemployment benefits, cutting benefit duration back to one year and forcing unemployed to take up jobs paying below the collectively agreed wage, together with the liberalisation of

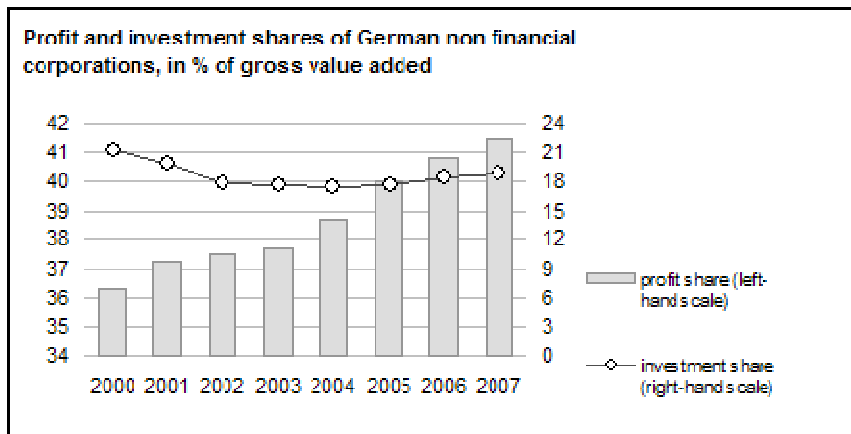
agency work, added to increase workers' insecurity and to weaken their bargaining power.

This policy of wage moderation certainly resulted in a rather spectacular increase in the share of profits for the sector of non-financial corporations. In 2000, the profit share in Germany stood at 36.3% of gross value added for this sector. Seven years later, the profit share had soared to 41.4% (see Graph I below).

2. ... which failed to lift investment

In serious contradiction with mainstream economic thinking, the increase in profits failed to lift investment rates. Instead, gross investments of German non-financial corporations as a share of gross added value fell from 21.1% to 18.7% (see Graph I). Wage moderation served to increase profits but undermined domestic demand dynamics at the same time, thereby actually depressing business investment in the end.

Graph I



Source: Eurostat, *Statistics in focus* 28/2009

One can also express these findings in absolute numbers (see next graph). From 2000 to 2007, German non financial corporations increased their total gross added value by some 243 billion euros. From these 243 billion, less than one third (70 billion) went into a higher bill for compensation of employees, leaving an increase of 159 billion in gross operating profits. Half of these 159 billion extra profits went into additional dividend payments, implying that share holders managed to improve their

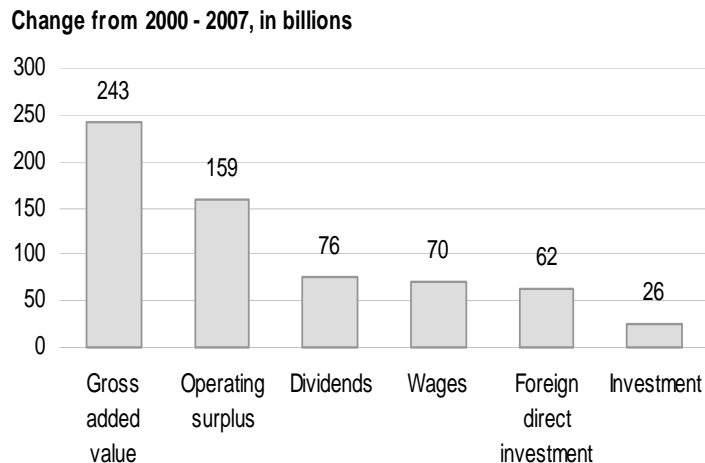
revenues by an identical amount as the total work force of non financial companies.

The other half of these 159 billions additional profits were kept inside the companies themselves. A minor part of this (26 billion) was used to undertake additional investment. The rest served to reduce the (net) borrowing needs of German companies, which did swing from a net borrowing position in 2000 (minus 12% of gross value added) to a net lending position

(0.7% in 2007). At the same time however, German companies doubled direct investment abroad from 61 billion in 2000 to 124 billion in 2007. It is likely that these foreign investment flows

were, at least partly, financed by the additional profits that were realised and kept inside the companies (see von der Vring, June 2009).

Graph II: Profits and dividends of the German non-financial sector



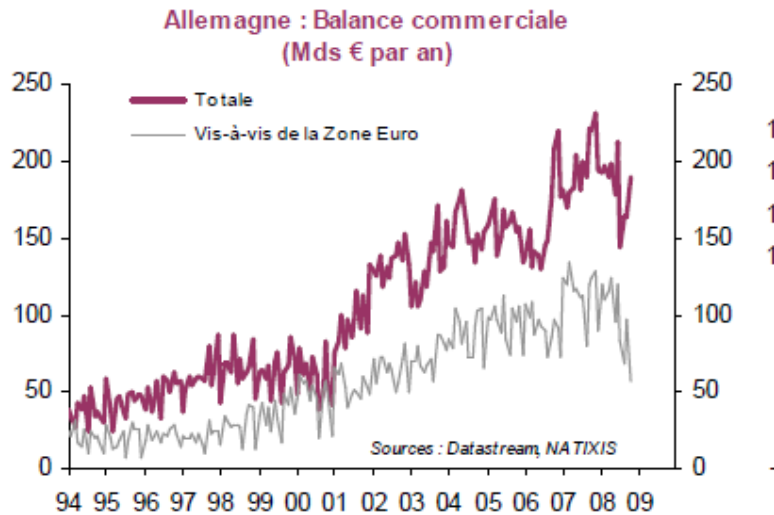
Source: Eurostat and von der Vring, „Bilanz der Lohnzurückhaltung 2000–2007 im volkswirtschaftlichen Kreislauf Deutschlands“, *WSI-Mitteilungen 06/2009*, June 2009.

3. while also 'begging the neighbours'...

Meanwhile, wage moderation also improved the cost competitive position of Germany. This can be seen from the robust improvement of Germany's trade surplus over that same period. In 2000 – 2001, Germany's trade surplus was limited to around 50 billion but it reached over 200 billions in 2007 – 2008. An important part of this improvement in the trade balance comes from other euro area members (see Graph III). Germany's trade surplus with the Euro Area moved from around 25 to 30 billion in 2000 to some 120 billion in 2007. With about 20

billions of euro equivalent to 1% of German GDP, this implies that around three quarters (!) of the (disappointingly low) expansion of economic activity in Germany over this period (some 9% over these 7 years or around 1.3% a year) has actually come from exporting more and importing less to the euro area neighbours and other trading partners.

Graph III: Trade balance of Germany (Billions of euros)

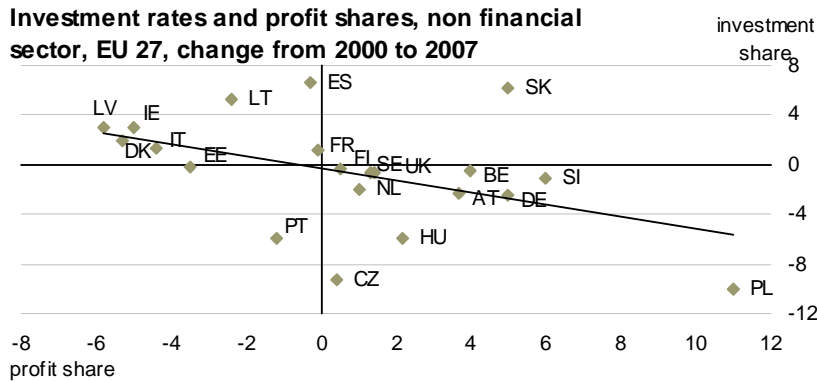


5. Investment and profit performances in the rest of Europe

What about the rest of Europe? A few other countries (Belgium, Austria, and Poland) followed the German lead and allowed profit shares of their non financial sector to rise as well. Italy, Denmark, Ireland and the Baltic's did the opposite and pushed profit shares down, sometimes from extremely high levels (for example, a profit share of 59% in 2000 and still 54% in 2007 in the case of Ireland, compared with 41% in Germany). France, Spain, the UK on the other hand kept profit shares rather stable.

Comparing these changes in profit shares over different countries with investment performance again testifies to the negative link between profits and investments: In those countries where the profit share was stable, investment performance was positive (France, Spain). This was also the case in countries where the profit share fell (Denmark, Ireland). Meanwhile, Belgium, Austria and Poland repeated the German experience with investment rates falling at the same time as profit shares were rising.

Graph IV



Conclusion

It is often said that today's wage moderation is the basis for tomorrow's profits and the investments of the day after tomorrow. Reality however does not confirm this. In the case of Germany, wage moderation triggered *less*, not more investment. Workers' sacrifices were used instead to hike dividend payments and finance investment abroad.

All of this confirms once again that investments are not determined by profits only.

Demand for the goods and services which are to be produced by the investment in machinery and networks plays a key role as well. In an economy that is as integrated as Europe is, policy makers need to keep that lesson in mind. Starting new rounds of competitive wage moderation and generalising this sort of policy throughout the entire internal market, will only serve to undermine the demand dynamics of the European economy as a whole and will get us deeper into the crisis.

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