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Germany's post-2000 stagnation in the European context - a lesson in macroeconomic mismanagement

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Germany's post-2000 stagnation in the European context – a lesson in macroeconomic mismanagement

Germany's post-2000 stagnation in the European context

—

a lesson in macroeconomic mismanagement*

Eckhard Hein, Achim Truger

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Abstract

In the present paper we question the mainstream diagnosis of Germany's post-2000 stagnation as well as the prescribed remedies. We show that the 'institutional sclerosis' view of Germany's stagnation is unfounded and that therefore the political measures proposed and actually taken are misguided. Instead, we claim that macroeconomic mismanagement explains the German absolute and relative stagnation compared with the Euro area as a whole and with the USA. If the problem of macroeconomic mismanagement is not addressed and solved, irrespective occasional cyclical upswings, we predict a continuing stagnation tendency for the German economy. And we argue that this is not only a German problem, but a matter of European concern, because the macroeconomic policies which have caused the German constellation will have major negative feedback effects on the other Euro area countries in the near future.

JEL classification: E58, E61, E62, E63, E64, E65

Keywords: Macroeconomic policy, structural reforms, unemployment, growth, inflation

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1. Introduction

Germany's economic performance with respect to GDP growth, the development of unemployment and also the budget deficit has been considerably worse than the Euro area average since the mid-1990s (Hein/Truger 2005a, 2005b). However, this relative economic weakness might have gone almost unnoticed if it had not been for the slowdown of the world economy after 2000. By the end of 2002 it had become obvious that Germany had been hit much harder by this slowdown and did not manage to recover. Unemployment rose for the first time above the Euro area average and the budget deficit exceeded the 3 percent limit of the European Stability and Growth Pact (SGP). Soon talk of Germany as 'Europe's sick man' began to spread.

Now, more than five years after the beginning of the slowdown – and perhaps on the verge of an uncertain recovery –, the whole extent of the German crisis can be evaluated: Real GDP growth more or less stagnated from late 2001 to 2003. 2004 then saw a mild recovery with a growth rate of 1.6 percent, but in 2005 growth staggered again and came down to below 1 percent. Unemployment rose to its post-war maximum. The budget deficit, though still not excessively high in international comparison, has been increasing despite strong consolidation efforts since 2001. In 2005 it has exceeded the 3 percent (of GDP) deficit limit of the Maastricht Treaty and the Stability and Growth Pact (SGP) for the fourth time in four consecutive years.

The economic crisis had serious consequences both for the economic policy debate and for economic policy itself. The debate that had been biased by a monetarist/new classical or simple supply side view, became even more radical. For most of the German – and to some extent also the international – mainstream economists, journalists and business lobbyists Germany seemed stuck in a deep 'structural' crisis caused by tightly regulated labour markets and an overly generous welfare state. In their view the long duration of the stagnation excluded cyclical, demand side factors as an explanation. Therefore, they recommended radical 'structural' reforms, i.e. a large scale deregulation of the labour market, a dismantling of the welfare state, together with an accelerated policy of fiscal consolidation by means of public expenditure cuts.

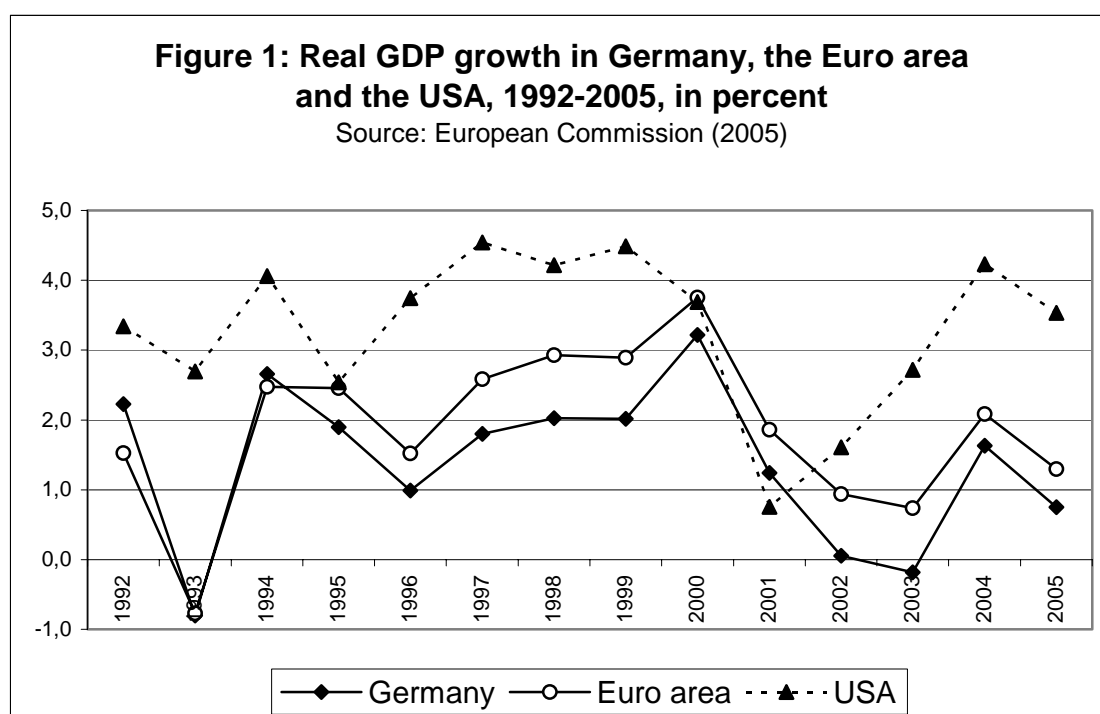
The proponents of radical reforms have been politically successful: Six months after the beginning of the red-green government's second term, Chancellor Schroeder's 'AGENDA 2010' presented in March 2003 has been the turning point towards the implementation of far reaching structural reforms to overcome the (perceived) institutional sclerosis (Schroeder 2003). Above all the duration and the level of unemployment benefits have been drastically reduced by 2005 ('Hartz IV' laws). And in November 2005 the newly elected grand coalition government formed by the conservative party (CDU) and the social democrats (SPD) under chancellor Angela Merkel, has made it very clear that it is determined to continue the way of 'structural' reforms and to tighten fiscal policy even further (Coalition contract 2005).

In the present paper we question the mainstream diagnosis as well as the prescribed remedies. We show that the underlying 'institutional sclerosis' view of Germany's stagnation is unfounded and that therefore the political measures proposed and actually taken are misguided. Instead, we claim that macroeconomic mismanagement explains the German absolute and relative stagnation compared with the Euro area as whole and with the USA. If the problem of macroeconomic mismanagement is not addressed and solved, irrespective occasional cyclical upswings, we predict a continuing stagnation tendency for the German economy. And we argue that this is not only a German problem, but a matter of European concern: The macroeconomic policies which have caused the German constellation might have major negative feedback effects on the other Euro area countries in the near future.

The paper is organised as follows. Section 2 presents the facts to be explained, namely the different economic performances of Germany, the Euro area as a whole and the USA after the economic slowdown in 2000/2001 to 2005. Section 3 sketches 'institutional sclerosis' and a lack of 'structural reforms' as the dominant mainstream explanation and shows that it cannot be reconciled with the standard empirical indicators for institutional sclerosis. Section 4 presents our macroeconomic policy explanation and demonstrates that macroeconomic mismanagement of the post-2000 slowdown is the key to understand the prolonged German stagnation. Section 5 concentrates on recent disinflationary developments in German wage policy and the danger of deflation in the near future. It shows why that danger might spread all over Europe. Section 6 gives some economic policy conclusions and a rather pessimistic outlook.

2. Germany's stagnation since 2000/2001

During the recent years the Euro area as a whole has been facing serious economic problems and has been doing considerably worse than the USA.¹ But in comparison to the Euro area as a whole Germany's performance has been even worse since the mid 1990s (Figure 1), and Germany has been hit much harder by the economic slowdown in 2000/2001 (Table 1). During the period 2001-2005 average annual GDP growth in Germany has amounted to only 0.7 percent which was only half of the Euro area growth of 1.4 percent.



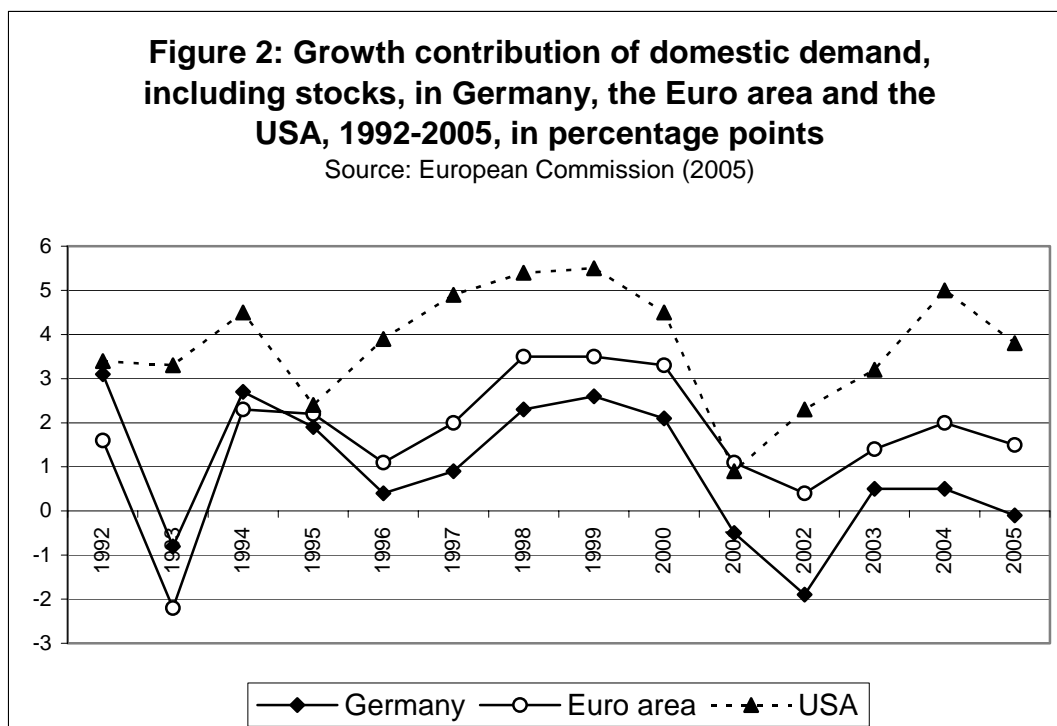
In contrast to the entire Euro area, Germany's weak growth is completely driven by export surpluses. The contribution of domestic demand to GDP growth has been negative on average over this period. Whereas private and public consumption in real terms have almost stagnated during the period 2001-2005, private and public investment have decreased and have negatively contributed to GDP growth. Without the huge growth contribution of export surpluses which amounted to 1 percentage point per year on average, Germany would not only face a period of stagnation but would suffer from a deep recession. Taken together, Germany's economy has performed very well on international markets and has gained

¹ See Hein/Niechoj (2006) and Hein/Truger (2005a, 2005b) for a detailed analysis of the long run trends and the macroeconomic policy causes for the differences between the countries or currency areas referred to above.

considerable export surpluses in the period 2001-2005, but has suffered from weak domestic demand (Table 1 and Figure 2).

Table 1: Real GDP growth, growth contributions of demand aggregates, unemployment rate and inflation rate, in Germany, the Euro area and the USA, average values for 2001-2005*			
	Germany	Euro area	USA
Real GDP, annual growth rate, percent	0.7	1.4	2.6
Growth contribution of domestic demand including stocks, percentage points	-0.3	1.3	3.0
Growth contribution of private consumption, percentage points	0.2	0.8	2.2
Growth contribution of public consumption, percentage points	0.0	0.3	0.5
Growth contribution of gross fixed capital formation, percentage points	-0.4	0.1	0.4
Growth contribution of balance of goods and services, percentage points	1.0	0.1	-0.5
Employment, annual growth, percent	-0.1	0.8	0.7
Unemployment rate, percent	8.7	8.5	5.4
Inflation rate (Germany, Euro area: HCPI, USA: national CPI), percent	1.6	2.2	2.5
Notes: *Forecast values for 2005			
Source: European Commission (2005), OECD (2005a), authors' calculations			

Between 2001-2005 GDP growth in the Euro area has been higher than in Germany but more than 1 percentage point per year below US growth. The growth contribution of external demand is positive but low. The USA has done well after the recession of 2000/1 and seems to have returned to the growth path of the second half of the 1990s. It is completely relying on domestic demand with external demand contributing negatively to real GDP growth. As in the 1990s, US investors and, in particular, US consumers, supported by public expenditures on investment and consumption, are again the world demand locomotive.



The willingness of the USA to spend beyond their means has been a welcomed source of world demand and has contributed to a quick recovery of the world economy from the 2000/1 growth slowdown. But the associated world imbalances, in particular the enormous US current account deficit and the rising indebtedness of US private households, question the sustainability of this constellation.²

Because of weak growth, German employment has even shrunken during the period 2001-2005, whereas employment in the Euro area and in the USA has increased by 0.8 and 0.7 percent per year. Therefore, German unemployment which had always been below the Euro area average until 2002 now exceeds this average. The unemployment rate in the Euro area is still more than 3 percentage points higher than in the USA (Figure 3). Inflation in Germany is well below the Euro area average, as it has been since the mid 1990s (Figure 4). And Euro area inflation is slightly below US inflation.

² See for a discussion Godley et al. (2005) and Papadimitriou et al. (2005, 2006).

Figure 3: Unemployment rate in Germany, the Euro area and the USA, 1992-2005, percent

Source: European Commission (2005)

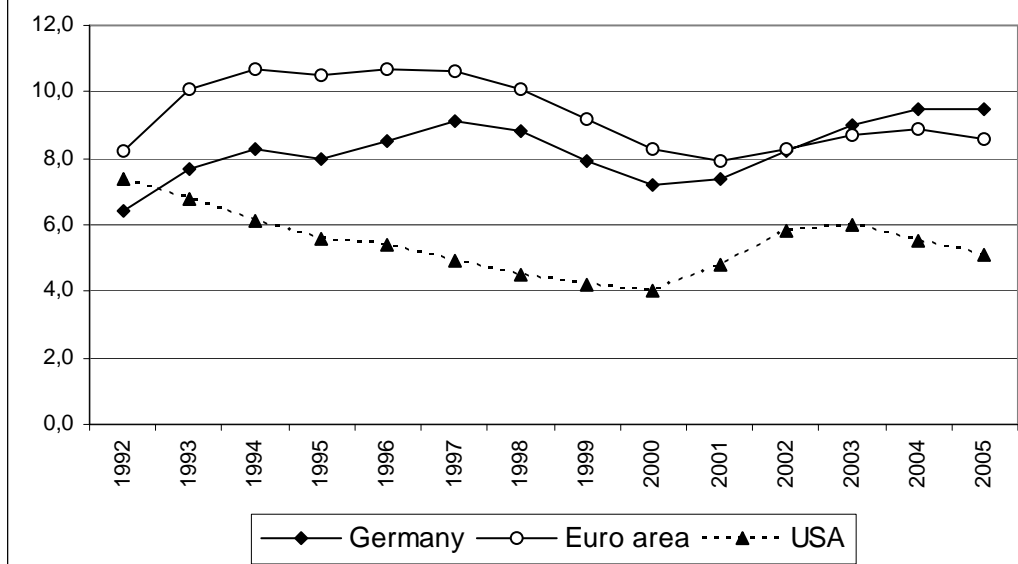
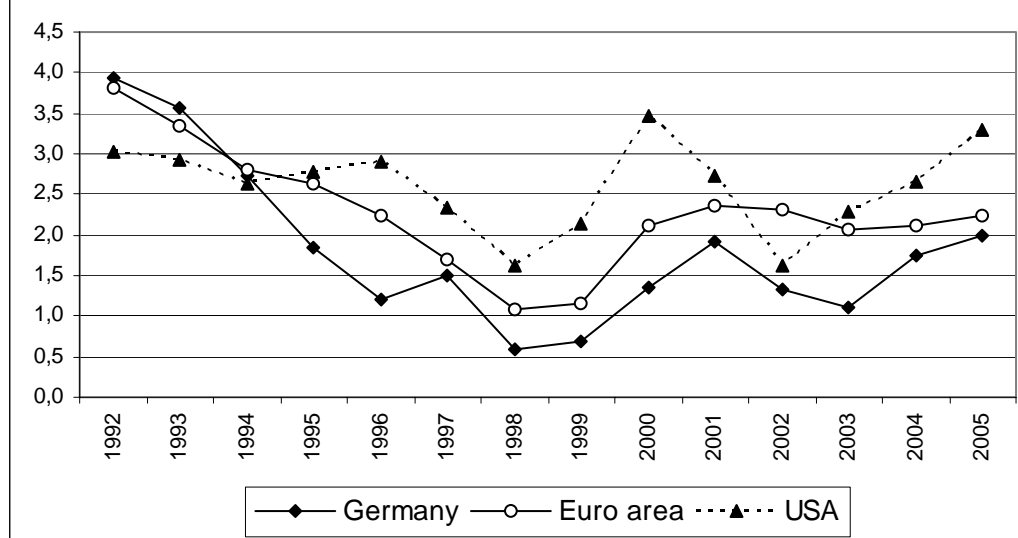


Figure 4: Inflation rate (Consumer price index) in Germany, the Euro area and the USA, 1992-2005, percent

Source: European Commission (2005)



Taken together, the development following the 2000/1 growth slowdown has made clear that Germany, the former key currency country of the European Monetary System (EMS) has indeed become 'Europe's sick man'. This is not due to a loss of international competitiveness

but rather to stagnating domestic demand. The reasons for this constellation remain to be explained.

3. The mainstream interpretation: lack of structural reforms

For most of the German – and to a somewhat lesser extent also the international – economics profession, the analysis of the German growth and employment problem is clear and simple: Institutional sclerosis, i.e. rigid and over-regulated labour markets and too generous welfare state institutions have driven Germany into crisis. This institutional sclerosis view is based on simple neoclassical labour market theory. With a complete and perfect neoclassical labour market as standard of reference unemployment can only arise because of market imperfections preventing a market clearing real wage at full employment (Siebert 1997). Institutions of collective wage bargaining (unions and employers' associations on the regional, sectoral or national level), labour market regulation (e.g. employment protection legislation, minimum wages) and the welfare state (unemployment benefits, social benefits and the 'tax wedge') are seen as creators of unemployment. From this theoretical point of view there is only one remedy to get the German economy going again and to fight unemployment: Reduce the imperfections of the labour market, i.e. impede collective bargaining, deregulate the labour market and dismantle the welfare state as far as possible. This is exactly the message that has been repeated over and over again by most of the national and international economic experts in recent years.³

We have argued elsewhere (Hein/Truger 2005a, 2005b) that the institutional sclerosis view in general suffers from serious deficiencies with respect to both its theoretical as well as its empirical foundations. What is even more important in the particular German case is that the empirical conditions for deriving an institutional sclerosis explanation of its absolute and relative economic weakness are hardly ever verified. On the contrary, most mainstream economists simply assume that there must be institutional sclerosis in Germany without even bothering to find any direct empirical support for that assumption. Instead they seem to rely on indirect 'evidence'. For example the German council of economic experts (SVR 2005) as well as the major research institutes (Institute 2004: 665-668.) decompose the economic data

³ See for instance the annual reports of the German council of economic experts (SVR 2003, 2004, 2005), the majority view in the semi-annual joint reports of the leading economic research institutes in Germany (Institute 2003, 2004, 2005) and, in particular, an economic policy paper by the German central bank (Deutsche Bundesbank 2003). The OECD and IMF reports on the German and European economy also aim at structural reforms (IMF 2006, OECD 2005a). The same is true for the European Commission (2002).

into a trend and a cyclical component with the help of modern time series econometrics. As trend growth has come down rather drastically as a result of Germany's prolonged stagnation in recent years, they 'observe' that long-term 'potential' growth has decreased and that 'long-term' 'structural' unemployment has risen, whereas the importance of the 'short-term' 'cyclical' component has decreased. Being strong believers in simple neoclassical labour market theory or simplistic NAIRU (Non Accelerating Inflation Rate of Unemployment) approaches, they therefore conclude that only 'structural' factors can be responsible for the long-term difficulties of the economy. Hence, they conclude that a lack of structural reforms both in absolute terms and in comparison with other 'more successful countries' must be responsible for Germany's crisis. As a corollary they also conclude that macroeconomic policies cannot explain Germany's stagnation, as they are only 'short term' in nature and can only influence the cyclical component which has been identified as being of minor importance before. Therefore, the mainstream experts see no serious problem in the ECB's monetary policy and they propose much more ambitious fiscal consolidation efforts to the German government. They are confident that 'short-term' negative demand effects of monetary or fiscal policy can not do much harm, as they simply see no serious demand-side problems in Germany. Symmetrically they do not believe that monetary or fiscal expansion can be very helpful in getting Germany out of its stagnation.

What happens, however, if one looks for direct evidence on institutional sclerosis in Germany? In order to convincingly apply the institutional sclerosis explanation to Germany's current economic crisis it would have to be verified, that German labour market and welfare state institutions have taken an unfavourable path both over time and in international comparison. The supposed 'lack of reforms' should be observable somewhere in the data. As we have demonstrated in greater detail elsewhere (Hein/Truger 2005a; 2005b), using the set of six institutional indicators (index of employment protection, benefit replacement rate, benefit duration, union density, bargaining coordination and tax wedge) compiled by Baker et al. (2004), this is not the case. Table 2 presents the most important results for our present purpose in a nutshell. It shows the total indicator of institutional sclerosis for Germany, the OECD, the European Union, the Euro-Area and the United States we calculated from the set of six single indicators for the first half of the 1980s and the second half of the 1990s. Higher values indicate higher levels of institutional sclerosis. Focussing first on Germany alone, it can easily be seen, that within the covered 20 year period, it has succeeded in reducing its institutional sclerosis by about 5 percentage points from 57 to 52. Obviously, in contrast to

popular wisdom, there has been a considerable reform activity. This becomes even more striking in international comparison, where Germany seems to have outperformed the OECD, EU, Euro-Area and the US with respect to reform activity: The average total indicator for the OECD, the EU and the US has been reduced by only 2 percentage points, the Euro-area average has even risen by 1 percentage point. Starting from above average values, by the end of the 1990s Germany had managed to bring down its level of institutional sclerosis to the average EU level and even below the Euro-Area average. Of course it still cannot ‘compete’ with the free-market USA.

Table 2: Total indicator of institutional sclerosis* 1980-84 and 1995-99		
	1980-84	1995-99
Germany	57	52
OECD[#]	49	47
European Union[§]	53	52
Euro area[§]	52	53
USA	20	18
<p>* Arithmetic mean of six single indicators for employment protection legislation, benefit replacement rate, benefit duration, union density, bargaining coordination and the tax wedge previously scaled to the interval [0; 100]. An exact definition and a documentation of the origin of the data is given by Nickell et. al. (2002) and Baker et. al. (2004). A more detailed presentation of the German data in international comparison is given in Hein/Truger (2005a).</p> <p># Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, USA.</p> <p>§ without Greece and Luxembourg.</p> <p>Source: Baker et al. (2004), authors' calculations</p>		

One might of course question the importance of rather favourable indicators from the late 1990s for Germany's current economic performance. German institutions might simply have become more sclerotic in the meantime. Although there is no complete data set comparable to that of Baker et al. (2004) for the more recent past, there are strong indications that there has been no reversal of the reform trend in Germany. The analysis by Mabbett/Schelkle (2005) on the basis of the Fondazione Rodolfo Debenedetti Social Reforms Data Base (Fondazione 2005) shows, that at least for employment protection legislation and the system of unemployment benefits, the earlier reform trend has continued until 2002. Table 3 displays indicators summarising the intensity of welfare state reform with respect to employment protection and unemployment benefits for 14 EU countries in the period 1986-2002 divided into two sub-periods. Positive (negative) values indicate a decrease (increase) in institutional sclerosis. As can easily be seen, Germany had a rather ‘bad start’ during the first sub-period 1986-1994, when welfare state institutions slightly ‘worsened’, whereas most of the other countries ‘improved’ them by small amounts. However, in the second period 1995-2002

Germany ‘improved’ its welfare state institutions by 17 points – more than any other country except for the Netherlands. Of course, for the very recent past from 2003 onwards a trend reversal might still be a theoretical possibility. This is almost impossible, however, since in 2003 the former red-green government started its ‘Agenda 2010’ which has been praised by most mainstream economists as an important step forward on the way of structural reforms.

Table 3: Intensity of welfare state reform¹⁾ in 14 EU countries			
	1987-1994	1995-2002	1987-2002
Austria	-1	13	12
Belgium	5	7	12
Denmark	4	10	14
Finland	4	16	20
France	-3	-12	-15
Germany	-2	17	15
Greece	0	9	9
Ireland	5	3	8
Italy	1	13	14
Netherlands	2	24	26
Portugal	0	-3	-3
Spain	5	0	5
Sweden	4	15	19
United Kingdom	5	5	10
¹⁾ Sum of the two single reform intensity values assigned by Mabbett/Schelkle (2005), i.e. the sum of reform intensity values of reform measures in employment protection and non-employment benefits for each country in the relevant period, on the basis of the Fondazione Rodolfo De Benedetti Social Reforms database (Fondazione 2005). A plus indicates ‘increasing flexibility’ (making systems less protective or generous). A minus indicates ‘decreasing flexibility’ (making systems more protective or generous). Mabbett/Schelkle (2005) measure the intensity of any reform package by assigning a value of ± 1 to reform measures the database classifies as ‘marginal’ and ± 2 to those classified as ‘structural’. Reform packages containing a series of measures get an intensity value of 2 if they contain two or more marginal measures and an additional 2 for including a structural measure (so ± 4 is the maximum for the intensity of any one reform package, ± 2 if it contains only marginal measures).			
Source: Fondazione (2005), Mabbett/Schelkle (2005), authors’ calculations			

In the face of this evidence it is difficult to understand how the overwhelming majority of national and international economists can still cling to the myth of extraordinary institutional sclerosis and a lack of structural reforms in Germany. In comparison with the Euro area average the indicators prove that Germany is less sclerotic and has shown above average efforts to improve its structural conditions in the recent past.

4. Another view: macroeconomic mismanagement

4.1 On the relevance of macroeconomic policy coordination for growth and employment

A macroeconomic-policy story of Germany's slump can both rely on Post-Keynesian as well as on New Keynesian approaches.⁴ In those two modern Keynesian views monetary, fiscal and wage policies have a common responsibility for employment and price stability. In order to attain these goals the three policies have to be coordinated at least at the national,⁵ better even at the international level, in particular in currency unions with a common monetary policy.

In the Post-Keynesian approach the development of aggregate demand determines growth and employment in the short as well as in the long run.⁶ Monetary policy's interest rate setting and firms' profit expectations essentially affect private investment which in turn is an essential determinant of effective demand and macroeconomic growth. Fiscal policy is also a central short and long run determinant of aggregate demand working both through the tax and the expenditure channel, in particular through public investment. And it is effective demand which via the level of aggregate output determines the level of employment realised in the labour market. The labour market, in this view, is a derived market because wage setting has no direct influence on employment. Instead, employment is determined by the interaction of the financial market where the interest rate is set – mainly by the policies of the central bank – and the goods market where total output is determined. Nominal wages set by labour unions and employers' associations, however, are the crucial determinant of the price level and inflation: With labour productivity given or following an exogenous trend and mark-up pricing in incomplete goods markets, the nominal wage rate determines the price level when the mark-ups are constant. Whereas monetary and fiscal policies are capable of affecting effective demand and hence employment, wage policies are in charge of preventing cumulative inflation as well as deflation. Therefore, rigid wages have to provide the nominal anchor for the whole system of a monetary production economy.

⁴ See Snowden/Vane/Wynarczyk (1994: 286-330, 367-380) for textbook reviews of the two approaches.

⁵ 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 (Fritzsche et al. 2005, Hein/Niechoj 2006, Palley 1998, Solow 2000).

⁶ See Davidson (1994), Heine/Herr (1999) and Lavoie (1992) for textbook presentations of the Post-Keynesian approach and Arestis (1996) for a survey.

In New Keynesian economics effective demand and hence monetary and fiscal policies have at least a short run impact on production and employment because prices and wages are assumed to adjust rather slowly to their long-run equilibrium values.⁷ In the long run equilibrium, however, unemployment is determined by the NAIRU, which may depend on those structural factors discussed in Section 3. In the short run, however, the exact duration of which is not clear, but which may be assumed to last at least a few years (Blanchard, 2003, p. 34), effective demand determines production and employment. From this it follows, that mainstream New Keynesian implications for monetary and fiscal policies in the short run are rather similar to the Post-Keynesian approach: Monetary and fiscal policies are capable of stimulating demand and employment when the economy is in a slump and unemployment exceeds the NAIRU. Utmost importance is assigned as well to the coordination of the two policies by some authors (Blanchard 2003: 101-4, 431-2).⁸

With respect to wage policies, however, the New Keynesian analysis differs substantially from the Post-Keynesian approach. In the short run, wage policy is strictly speaking not even a policy variable, because the short run is defined by exogenous and/or sticky nominal wages. And in the long run, wage policy is completely endogenous because mainstream models assume nominal wages adapting to the level consistent with the NAIRU (Blanchard 2003: 113-33). In contrast to the Post-Keynesian view, nominal wage moderation can be an effective way to accelerate the reduction of actual unemployment to the NAIRU-level. In New Keynesian models, however, it is not clear how effective demand determining unemployment in the short run can adjust to the level of production associated with the NAIRU in the long run.⁹ In order to have increasing effective demand when nominal wages and prices are falling in the face of unemployment above the NAIRU, either a real-balance-effect has to be assumed. This requires the dominance of exogenous or outside money which is not the case in modern monetary production economies. Or, if we assume the dominance of endogenous money coming into existence via credit creation, symmetric monetary policy interventions are required (Allsopp/Vines 1998). These may, however, not be sufficient to increase demand and employment when profit expectations are depressed and debt-deflation

⁷ See Auerbach/Kotlikoff (1998), Blanchard (2003), Mankiw (2002) and Stiglitz (1997) for textbook presentations in the New Keynesian vein and Truger (2003) for a survey of macroeconomic policy implications.

⁸ The requirement of coordinated monetary and fiscal policy intervention increases considerably if hysteresis is taken into account. With hysteresis the NAIRU is no longer exogenous for macro-economic policies but rather depends on the past development of the actual unemployment rate which can be affected by macro-policies (Ball 1999, Blanchard 2003: 283, Blanchard/Summers 1987, 1988).

⁹ For a critique of the New Keynesian NAIRU approach from a Post-Keynesian perspective see Arestis/Sawyer (2004: 73-99), Sawyer (2001, 2002), Stockhammer (2004) and Hein (2002, 2004, 2005).

works its way through the private sector. Because of these considerations we prefer the Post-Keynesian view of rigid nominal wages as a macroeconomic stabiliser rather than the New Keynesian view of nominal wages as an adjustment variable to the long-run equilibrium.

4.2 Restrictive and ill-coordinated macroeconomic policies in Germany

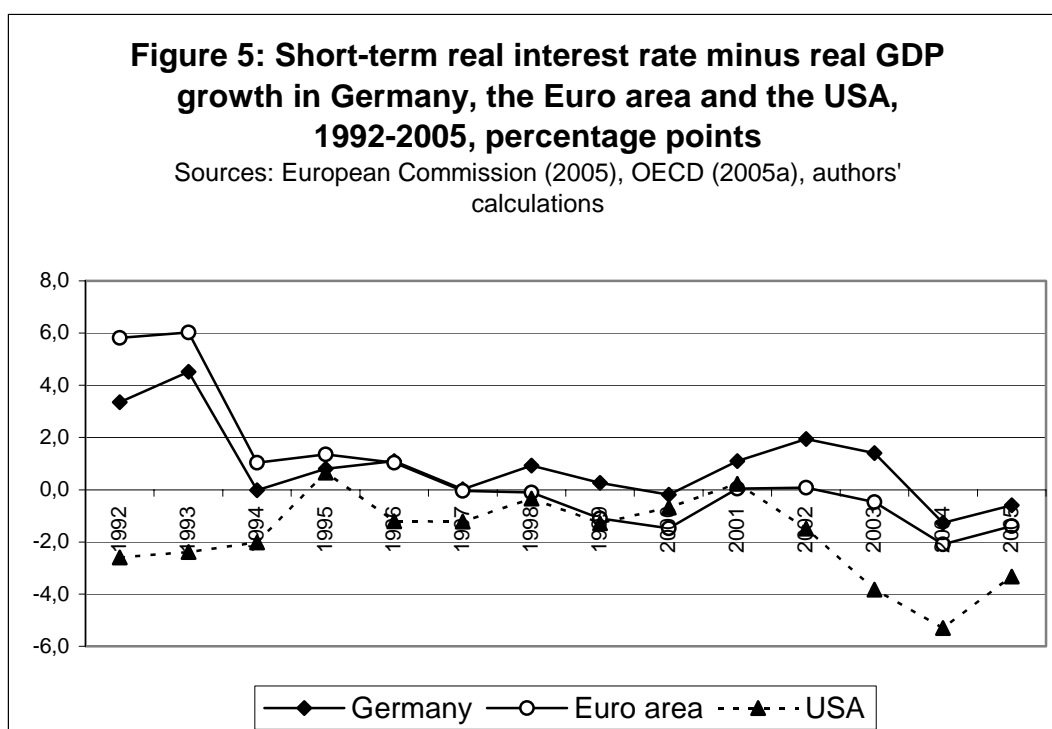
In order to provide a macroeconomic policy explanation for Germany's recent stagnation, it has to be shown that since 2001 monetary, fiscal and wage policies for Germany have indeed been less favourable than for the Euro area average or for the USA (Table 4).

Table 4: Indicators for monetary, wage and fiscal policies in Germany, the Euro area, and the USA, average values, 2001-2005*			
	Germany	Euro area	USA
Monetary Policy			
Short-term real interest rate, percent	1.2	0.6	-0.2
Long-term real interest rate, percent	2.6	2.1	1.9
Short-term real interest rate minus real GDP growth, percentage points	0.5	-0.8	-2.7
Long-term real interest rate minus real GDP growth, percentage points	1.9	0.7	-0.7
Fiscal Policy			
Budget balance (percent of GDP)	-3.6	-2.6	-3.5
Cyclically adjusted budget balance (percent of cyclical adjusted GDP), annual change, percentage points	-0.1	-0.1	-0.9
Output gap, (percent of cyclical adjusted GDP), annual change, percentage points	-0.8	-0.6	-0.3
Number of years with pro-cyclical fiscal policy during an economic slowdown	3 (2003-5)	3 (2003-5)	0
Negative fiscal stimulus in economic slowdown, cumulated (percent of potential GDP)	1.1	0.5	--
Wage Policy			
Nominal compensation per employee, annual growth, percent	1.7	2.5	4.0
Nominal unit labour costs, annual growth, percent	0.3	1.7	1.7
Labour income share [#] , percent	58.1	58.0	62.6
Change in labour income share to previous year, percentage points	-0.5	-0.2	-0.4
Notes: *Forecast values for 2005, [#] compensation per employee divided by GDP at current market prices per person employed			
Sources: European Commission (2005), OECD (2005a), authors' calculations			

Monetary policy

Monetary policy will be assessed by the development of the short-term real interest rate. It is now widely accepted that modern central banks use the short-term nominal interest rate as an economic policy instrument. But if central banks target inflation they have to set nominal interest rates with an eye to the ensuing real rate, as it is proposed in the famous Taylor-rule for example (Taylor 1993). In order to take into account the underlying economic situation, we consult the differences between the short-term real interest rate and real GDP-growth and also the difference between the long-term real interest rate and real GDP-growth. We expect a negative influence of real interest rates on economic growth working through different transmission channels (money, credit, asset prices, exchange rates) (Bernanke/Gertler 1995, Cecchetti 1995).

With respect to monetary policies, Germany has lost its former status as the key currency country within the European Monetary System (EMS) at the start of the European Monetary Union (EMU) in 1999. Since then it has no longer been in a position to reap the advantages of lower interest rates it used to have compared to the other EMS countries. During the process of convergence these countries gained from a considerable decrease of short- and long-term nominal interest rates towards the lower German level. This convergence and decrease in nominal interest rates was associated with a stronger decrease in real interest rates for the other Euro area countries than for Germany over the 1990s. And this has been conducive to relative growth in these countries and has established a more favourable real interest rate-real GDP growth relation compared to Germany since the mid 1990s (Figure 5). In the USA monetary policies have even been more conducive to growth with a negative short-term interest rate-real GDP growth-difference almost throughout since the early 1990s.



As the German inflation rate has been lower than the Euro area average and the nominal interest rates have almost completely converged since 1999, Germany's real interest rates have even been higher than the Euro area average since then. On average over the period 2001-2005 the ECB policies generated a short-term real interest rate of 1.2 percent in Germany which was now twice as high as in the Euro area as whole with 0.6 percent. Whereas the Euro area short-term real interest rate was positive on average over the period after the 2000/1 growth slowdown, the Federal Reserve managed to establish a negative short-term real interest rate of -0.2 percent in the USA. These expansionary monetary policies contributed to the quick recovery of the US economy. Already in 2002 the USA saw again – as in the years before 2001 – a negative short-term real interest rate-real GDP growth rate-difference, whereas in the Euro area this difference became negative only in 2003 and in Germany only in 2004 (Figure 5). On average over the recent years, the Fed established a favourable short-term real interest rate-real GDP growth-difference (-2.7 percentage points), and also a growth-friendly long-term real interest rate-real GDP growth constellation (-0.7 percentage points). The ECB has been much more reluctant to stimulate the economy by means of cutting interest rates in the face of the 2000/1 slowdown and has thereby contributed to weak growth in the Euro area, and particularly in Germany since then. Whereas on average over the period 2001-2005 in the Euro area as a whole the short-term real interest rate-real GDP growth-difference has been at least slightly negative (-0.8 percentage point), in Germany this difference has even been positive (0.5 percentage points). And the long-term real interest

rate-real GDP growth-difference has been positive in the Euro area as whole (0.7 percentage points) with the German value (1.9 percentage points) exceeding the Euro area average by a considerable amount.

Therefore, Germany has not only suffered from European monetary integration losing the interest rate advantage it has enjoyed before but it has also, in particular, suffered from the ECB's 'anti-growth bias' since 1999. This 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 percent (ECB 2003: 89) – and an asymmetric response to the expected deviation of actual from target inflation.¹⁰ Germany's weak performance since 2000/1, however, is only partly caused by the ECB's monetary strategy. It is also due to the fact that within the monetary union, the ECB can only address average inflation and cannot take into account Germany's special economic situation with both a higher output gap and lower inflation than the Euro area average.

Fiscal policy

As the ECB was neither willing nor able to take a more active part in stabilising the German economy after 2000, German national fiscal policy should have taken over the responsibility to counteract the macroeconomic shock. However, German fiscal policy did exactly the opposite by switching to a policy of pro-cyclical budget consolidation, thereby further worsening the crisis. On the one hand this was certainly attributable to political pressure imposed by the SGP, because Germany kept on exceeding the 3 percent limit for the deficit-GDP-ratio. On the other hand, it is highly probable that mainstream policy advice of the sort described in section 3 of this paper did also play an important role. As can be seen from Table 4, the German budget deficit over the period 2001-2005 averaged 3.6 percent of GDP, leading many professional observers to believe that fiscal policy was useless, as permanently 'high' deficits seemingly were not able to make the German economy recover. However, such reasoning is obviously simplistic. It ignores the fact that high or even growing deficits may well be the result of an economic slump rather than an indicator of active fiscal policy.

¹⁰ The ECB has tended to tighten whenever inflation increased above the target without relaxing when inflation expectations came down. For a general critique of the ECB's 'anti-growth bias' see Bibow (2002, 2005a, 2005b) and Hein (2002).

Therefore Tables 4 and 5 present some more adequate indicators for the macroeconomic impact of fiscal policy.

The extent to which fiscal policy exerts a stabilising or destabilising influence on the business cycle can be assessed by comparing changes in the output gap and the cyclically adjusted budget balance-potential GDP ratio (CBR).¹¹ The output gap serves as an indicator of the current state of economic activity. If it is positive, then capacity is outstripped, if it is negative, this means that capacity is not fully utilised. Consequently, a positive change in the output gap indicates a cyclical upturn, whereas a negative change points to a cyclical downturn. If there is a positive (negative) change in the CBR, then structural deficits fall (rise) or structural surpluses rise (fall), and fiscal policy provides a restrictive (expansive) stimulus to demand. If the CBR remains constant when there is a change in the output gap, then fiscal policy is neither expansive nor restrictive and the automatic stabilisers are simply left to take effect.

Measured in this way, German fiscal policy from 2001-2005 has been restrictive in three years in the face of a slowdown in economic activity, destabilising the economy and pro-cyclically worsening the crisis. The cumulative negative fiscal stimulus from this pro-cyclical policy amounted to 1.1 percent of potential GDP over the whole period, acting as a substantial brake for the recovery. For the Euro area as a whole fiscal policy was pro-cyclically restrictive, too. However, the negative fiscal stimulus amounted to only 0.5 percent. So, despite the fact that the economic slowdown was considerably worse in Germany than in the Euro area as a whole (0.8 percentage points average annual fall in the output gap as compared to 0.6 percentage points in the Euro area), German fiscal policy was more restrictive. In striking contrast to the European practice, US fiscal policy acted as a strong counter-cyclical stabiliser: During the observation period there has not been a single year in which US fiscal

¹¹ Of course, such cyclically adjusted measures can be criticised for a number of theoretical and empirical reasons and should therefore be interpreted with great care. Theoretically they are very close to the idea embedded in the standard NAIRU models that there is a long run equilibrium determined by structural characteristics of the labour market which is independent of the short run fluctuations generated by demand shocks or macroeconomic policy. We do not share this view. Empirically these measures are very sensitive to the exact method used and to the choice of observation period. Despite these serious problems with the measures we consider them as useful. Even more: If it can be shown that certain empirical findings about the stabilising or destabilising effects of fiscal policy can be derived even within such a mainstream framework, then this strengthens the point from a heterodox perspective. Of course, the results for a given set of countries and a given time period should be more or less robust to the method used and to additional observations due to new data over time. In order to ensure the first, in this paper we did some sensitivity analysis with regard to three different methods. With regard to the latter most of the results have proven to be very robust to new data, as we conducted this kind of analysis with almost every new edition of the OECD Economic Outlook data since 2001 (see Hein/Muelhaupt/Truger 2001, Hein/Truger 2005a, 2005b, 2005c, 2005d, Truger/Hein 2002).

policy reduced the CBR in the face of an economic slowdown. Quite the opposite, it boosted the US economy by reducing the CBR by 0.9 percentage points of potential GDP on average over the last five years. In both the Euro area and Germany the stimulus was only 0.1 percentage points on average.¹²

The restrictive and destabilising impact of German fiscal policy becomes even more obvious if one considers the growth rates of some fiscal policy aggregates in more detail (Table 5). Public expenditure growth has been weak, all the relevant numbers being far below average real GDP growth of 0.7 percent. Real total public expenditure actually declined by an annual average of -0.2 percent. Real public final consumption stagnated and public investment declined dramatically by an annual 3.7 percent leading to an historically low average share of public investment in GDP of only 1.5 percent (1.3 percent in 2005). The latter development is particularly distressing as public investment is not only an essential component of aggregate demand in the short run, but also a provider of public infrastructure making it a key condition for growth in the long run. Expenditure growth has not only been weak in absolute terms but also in comparison with the Euro area and the USA. The corresponding average expenditure growth rates for the Euro are in the range between 1.4 and 1.8 percent and therefore rather well in line with or even slightly above average real GDP growth. The same is true for the USA where all the relevant expenditure growth rates are above 3 percent. In both the USA and the Euro area with an average 2.7¹³ and 2.5 percent of GDP respectively the level of public investment is much higher than in Germany.

¹² Our results have been derived using the cyclically adjusted data and output gaps estimated by the OECD (2005a). As these estimates are considerably different from the two alternative estimates published by the European Commission (2005) based on a potential and a trend approach for Germany and the Euro area (there is no estimate for the USA), we checked whether our results still hold for these data. Qualitatively the results do hold, only the number of years with destabilising fiscal policy is reduced from three to two and the extent of the negative cumulative fiscal stimuli for both Germany and the Euro area are considerably lower.

¹³ In some of the earlier papers which we authored or one of us co-authored (Hein/Truger 2005d, Hein/Niechoj 2006) we displayed a substantially higher share of public investment for the USA well above 3 percent. The difference is exclusively due to different data sources. The OECD Economic Outlook which was used in the earlier papers has data received from the BEA (OECD 2005b: 70). The European Commission data which we used for the present paper subtracts the item 'gross investment national defense' from the primary US data, and adds it to government final consumption, hence the difference. This also has a visible effect on the growth rates of public consumption and investment calculated in Table 4. With the OECD data the growth rate of public investment would be higher by about 0.4 percentage points, those of public consumption would be lower by about 0.3 percentage points. We are grateful to Antonis Avdoulos and Noël Doyle from the European Commission for the statistical information.

Table 5: Annual growth rates of selected fiscal policy aggregates in Germany, the Euro area, and the USA, average values, 2001-2005* in percent

	Germany	Euro area	USA
Real total government expenditure [#]	-0.2	1.4	3.6
Real government final consumption expenditure	0.0	1.8	3.1
Real government gross fixed capital formation ^{##}	-3.7	1.5	3.1
Real government total revenue [#]	-1.4	0.6	0.3
Gross fixed government capital formation (percent of GDP)	1.5	2.5	2.7
Notes: *Forecast values for 2005; [#] deflated with the (harmonised) consumer price index; ^{##} deflated with the deflator of total fixed capital formation.			
Sources: European Commission (2005), authors' calculations			

Another striking feature of German fiscal policy over the last five years has been the remarkable decrease of real total public revenue by 1.4 percent per year, whereas both the Euro area and the US had at least a slow positive revenue growth. In the absence of any tax policy measures one would expect the revenue side to be growing somewhat faster than GDP due to a progressive tax system. It should be noted that there is a link between fiscal policy and wage policy through the revenue generation process of the tax system. In Germany the process of revenue generation and therefore also the process of fiscal consolidation is harmed by the extremely moderate wage development owing to the progressive tax system and also to the fact that the German social security system is mainly financed by wage based contributions.

Apart from such effects, the weak development of revenue in Germany and also the USA quite obviously reflects the effects of the substantial tax cuts by the former red-green government in Germany (Truger 2004, Truger/Jacoby 2004) and by the Bush administration in the USA. For Germany this, however, means that the small average expansionary effects of fiscal policy have almost exclusively come from the revenue side through tax cuts, while the expenditure side has been on a tight restrictive path. If one takes into account the fact that the usual empirical estimates for expenditure multipliers are about double the size of the tax multipliers (Arestis/Sawyer 2003), the German policy of fiscal consolidation additionally destabilised the economy by its particularly ill designed and counterproductive structure.

Wage policy

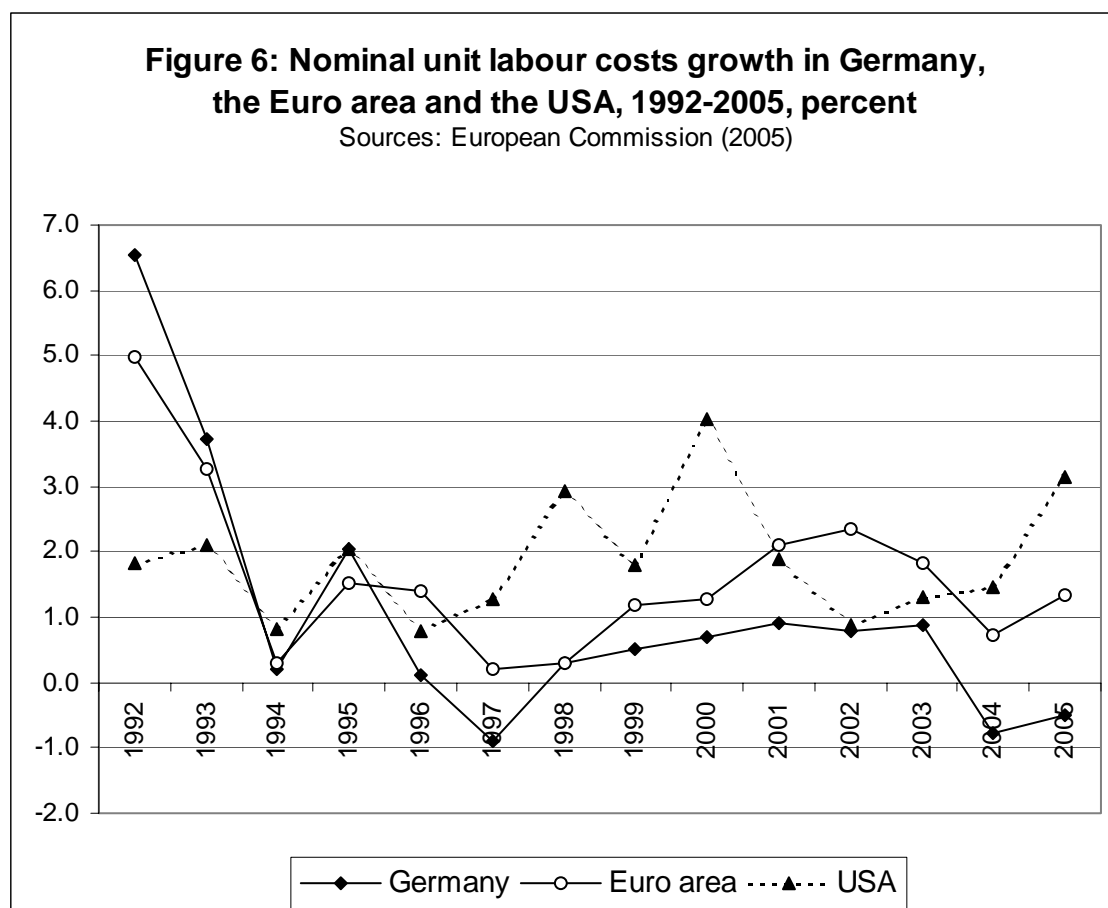
Wage policies can be assessed by nominal wage growth (compensation per employee), unit labour cost growth and the labour income share. Nominal wage setting affects unit labour cost growth and inflation. If nominal wages increase at a faster pace than productivity plus the price level do, unit labour cost growth and inflation will speed up.¹⁴ This will cause real interest rates to fall and may make the central bank increase nominal interest rates in order to reach its inflation target. If nominal wages increase at a rate below the sum of productivity growth and inflation, unit labour cost growth will slow down and cause disinflation. Finally, deflation may be the consequence. Deflation causes increasing real interest rates and rising real debts with potentially negative effects on investment and growth.¹⁵ If deflationary processes have started, monetary policies lowering interest rates may be ineffective.

Wage policies, however, may not only affect prices, but may also change distribution if firms do not completely pass unit labour cost variations to prices. Under these conditions nominal wage moderation causes the labour income share to fall. Empirical analysis for Germany and the Euro area since the 1960s has indicated, that the development of unit labour costs affects the development of output prices (Hein/Schulten/Truger 2006). The adjustment of the inflation rate to nominal unit labour cost growth, however, is incomplete. Therefore, nominal wage moderation is also associated with a tendency of labour income shares to fall. Hypothetically, the effects of income shares on GDP growth are ambiguous (Bhaduri/Marglin 1990). With the propensity to save out of wages falling short of the savings propensity out of profits, a falling labour income share means a cut-back in consumption demand and capacity utilisation with directly contractive effects on investment and GDP growth. A fall in labour income shares that is associated with nominal wage restraint would, on the other hand, improve international competitiveness and, therefore, stimulate demand for exports, investment and growth. With a slowdown in inflation, the central bank may also cut interest rates and stimulate investment and growth. Finally, a falling labour income share is associated with rising unit profits which may also improve investment and growth. Since the stimulating effects of wage moderation and declining labour income shares for investment and growth are rather indirect and uncertain, the direct and contractive effects will presumably dominate. And

¹⁴ See Arestis/Sawyer (2005) and Hein (2005) for recent post-Keynesian models of distribution conflict and inflation.

¹⁵ See Hein (2005, 2006) for the integration of real debt effects into Kaleckian models of distribution and growth with conflict inflation.

since nominal wage increases, which shift distribution in favour of labour income, will also trigger inflation and concomitant restrictive central bank interventions, nominal wage growth according to the sum of long-run productivity growth and inflation and hence constant labour income shares should be generally favourable conditions for growth.



Germany's too moderate nominal wage increases are the major cause for the below average inflation rate. Since 1995 unit labour cost growth in Germany has undercut the Euro area average growth (Figure 6). This is due to overly moderate wage development in Germany. On average over the period 2001-2005 nominal compensation per employee has only increased by 1.7 percent per year (Table 3). Taking into account inflation (Table 1), this means that real compensation per employee has stagnated in Germany since 2001. In the Euro area as a whole nominal compensation per employee has increased at a faster pace (2.5 percent per year) and real compensation has at least slightly increased (0.3 percent per year). The USA has witnessed a much higher average rate of increase of nominal compensation per employee (4.0 percent) and also of real compensation per employee (1.5 percent). Because of overly moderate wage increases nominal unit labour cost growth in Germany has on average

between 2001-2005 amounted to 0.3 percent, whereas the Euro area as a whole, as well as the USA, have seen an average annual increase of 1.7 percent.

Slower unit labour cost growth and lower inflation in Germany were also observed before European monetary integration when Germany's absolute and relative economic performance was much better (Hein/Truger 2005a, 2005b). But then unit labour cost growth and the resulting low inflation rates were the basis for the Deutschmark's status as the regional key currency within the EMS, allowing the German Bundesbank to set substantially lower nominal and actually real interest rates than in the other EMS countries. Since the beginning of the interest rate convergence process in the mid 1990s and with the completion of Euro area in 1999, however, lower inflation rates for Germany do no longer pay off in terms of lower interest rates.

The overly moderate wage setting in Germany did not only cause below average inflation rates. This wage policy also contributed to the acceleration of a tendency of declining labour income shares which had already started in early 1980s and continued during the 1990s (Figure 7). This redistribution at the expense of labour has contributed to the weak development of domestic demand and hence to Germany's weak performance, in particular since 2001 when the labour income share declined by 0.5 percentage points per annum. However, a declining labour income share trend can also be witnessed in the Euro area as a whole, but not in the USA since the early 1990s, so that on average over the period 2001-2005 the labour income share in USA (62.6 percent) exceeded the labour income share in the Euro area (58.0 percent) and in Germany (58.1 percent) by more than 4 percentage points. Redistribution at the expense of labour can hence only add to the explanation of Germany's *relative* performance compared with the USA but not compared with the rest of the Euro area.



On the other hand, moderate wage policies in Germany have improved price competitiveness and profitability of German firms which made German export surpluses almost quadruple between 2001 and 2005. But this extraordinary export performance was insufficient to compensate for the associated deficiencies in domestic demand, as has been shown above (Table 1). And since around 44 percent of German exports go to the Euro area, increasing German export surpluses cause major problems for the other Euro area countries: Whereas Germany has continuously increased its current account surplus, amounting to 4.1 percent of GDP in 2005, the other larger Euro area countries (France, Italy, Spain) are increasingly driven into current account deficits (Table 6). And also some of the smaller countries either see their surpluses decline (Belgium, Finland) or are not allowed to improve their huge deficits (Greece, Portugal).

Table 6: Current account balances as a percentage of GDP in Euro area countries and the USA, 2001-2005

	2001	2002	2003	2004	2005
Germany	0.2	2.3	2.2	3.8	4.1
France	1.6	0.9	0.4	-0.4	-1.6
Italy	-0.1	-0.8	-1.3	-0.9	-1.5
Spain	-3.9	-3.3	-3.6	-5.3	-7.7
Austria	-1.9	0.3	-0.5	0.3	-0.4
Belgium	3.4	4.6	4.1	3.3	1.4
Finland	7.2	7.6	3.8	5.3	3.5
Greece	-8.1	-7.5	-7.2	-6.3	-7.0
Ireland	-0.6	-1.0	0.0	-0.8	-1.5
Netherlands	2.4	2.9	2.8	3.3	5.8
Portugal	-8.4	-8.0	-0.9	-3.6	-6.7
Euro area	0.1	0.7	0.3	0.5	-0.2
USA	-3.8	-4.5	-4.7	-5.7	-6.5

Source: OECD (2005a)

A restrictive macroeconomic policy mix in Germany

In sum, macroeconomic policy variables have indeed been less favourable in Germany than in the Euro area as a whole and in the USA since 2001, as it has already been the case since the mid 1990s (Hein/Truger 2005a, 2005b). Macroeconomic mismanagement, therefore, can be considered to be the main cause of Germany's stagnation. This is partly due to the integration of a former key currency country into a monetary union and the associated loss of the interest rate advantage, and is insofar inevitable. But it is also caused by the restrictive macroeconomic policy mix implemented at the Euro area level, which is particularly affecting a slowly growing low inflation country like Germany: the too restrictive ECB monetary policy strategy and the SGP enforcing a restrictive stance on the member countries' fiscal policies. And a major contribution to macroeconomic mismanagement has come from German wage developments, which seems to be completely inappropriate for the largest economy in a monetary union.

5. German wage development: an increasingly severe problem for Germany and for the Euro area

One of the key problems derived in the previous section is Germany's below Euro area average inflation rate. Below average inflation has been caused by below average growth of compensation per employee and hence below average unit labour cost growth which was not

(and could not be directly) rewarded by the ECB's monetary policy. This has meant that German households and firms have had to pay above Euro area average real interest rates since 1999 and the German economy has been particularly hit by the too restrictive stance of the ECB monetary policy strategy, in particular since 2001. And overly moderate wage increases and too low inflation have also contributed to the budget deficit problems and the inability to stick to the deficit criteria of the SGP.

The particularly low wage increases in Germany compared to the Euro area average can be attributed to the following reasons (Table 7):¹⁶

First, there has been a lessening of the trade unions' bargaining power. Since 1996 trade unions' collective bargaining policy has been plunged into a major crisis, they have been forced to accept collectively agreed wage increases of below 3 percent and 2004 and 2005 even below 2 percent. The Euro area as a whole has also seen a decline in the growth of collectively agreed wages which has come down to slightly above 2 percent recently.

Second, wage trends in Germany since the mid 1990s have been mainly characterized by a negative wage drift. In particular since 2002 actual earnings have been growing even more slowly than collectively agreed wages. In the Euro area as a whole there is still a positive but declining wage drift.

Table 7: Collectively agreed wages, actual earning and wage drift in Germany and the Euro area, 2001-2005					
	2001	2002	2003	2004	2005
Germany					
1. Collectively agreed wages per employee hour, annual increase, percent	2.0	2.7	2.0	1.2	1.0*
2. Actual earnings per employee hour, annual increase, percent	2.6	2.1	1.6	0.2	0.9*
3. Wage drift (2. minus 1.), percentage points	+0.6	-0.6	-0.4	-1.0	-0.1*
Euro area					
1. Collectively agreed wages per employee hour, annual increase, percent	2.6	2.7	2.4	2.1	2.1*
2. Actual earnings per employee hour, annual increase, percent	4.0	3.3	2.8	2.3	2.3*
3. Wage drift (2. minus 1.), percentage points	+1.4	+0.6	+0.4	+0.2	+0.2
Notes: *Average of first 3 quarters					
Sources: Deutsche Bundesbank (2005), ECB (2006), Statistisches Bundesamt (2005), authors' calculations					

The negative German wage drift is a consequence of fundamental changes in the structure and operation of the German collective bargaining system. One clear indicator of this is the

¹⁶ See Hein/Schulten/Truger (2006) for a more detailed analysis and further references.

decline in the number of companies and employees covered by collective agreements that has been observed since the mid-1990s.¹⁷ The negative wage drift seems to suggest that wage increases in companies not bound by collective agreements were significantly lower. Furthermore, even within the German collective bargaining system there are numerous indicators which suggest that the binding nature of collective agreements is being eroded, making negotiated collective wage increases harder to implement in practice. There is now a significant number of companies that are formally bound by collective agreements but which in practice do not comply with them.¹⁸ In addition to the above, ‘hardship’ and ‘opening-clauses’ were introduced into virtually all of the major sectoral collective agreements in the 1990s, allowing companies to deviate from the terms contained in collective agreements under certain circumstances.¹⁹ One final significant cause of the negative wage drift is the reduction of payments that are above the collectively agreed rate. During the course of the 1990s, several companies began to use ‘company alliances for jobs’ to ‘compensate for’ the wage increases negotiated in collective agreements by cutting back on payments above the collectively agreed rate. This has led to the emergence of a new form of concession bargaining in which employees agree to give up established benefits in exchange for limited job security, thereby contributing to a substantial reduction in labour costs.

High unemployment, weak trade union bargaining power, the erosion of the German wage bargaining system, and the recent labour market reforms (AGENDA 2010, ‘Hartz’-laws) have increased the risk of deflation for the German economy.²⁰ In the long run inflation is mainly affected by the development of nominal unit labour costs, and in Germany unit labour cost growth has been negative in 2004 and 2005. This has not yet triggered actual deflation due to increasing import prices (crude oil and oil derivatives) and to increasing administered prices.²¹ But it has certainly increased deflationary risks if we take a look at the development at the

¹⁷ According to the IAB (Institut für Arbeitsmarkt- und Berufsforschung) figures for 2001, only 48 percent of all companies in western Germany and 71 percent of all employees were bound by collective agreements, while in eastern Germany the figures were as low as 28 percent of companies and 56 percent of employees (Bispinck 2003: 395).

¹⁸ According to the results of the 2002 WSI Works Council Survey, which probably only covers part of the problem, 10 percent of companies occasionally failed to comply with the terms of current collective agreements, and a further 5 percent did so frequently. In the majority of these cases, the non-compliance involved failure to pay the collectively agreed wages (Bispinck/Schulten 2003: 159)

¹⁹ Opening-clauses are now used by more than a third of all companies, although it is true that in the majority of cases these relate to the divergence of working time organization from the collective agreement, and the use of opening-clauses with regard to remuneration is for the time being still not very widespread (Bispinck/ Schulten 2003: 160).

²⁰ See the IMF (2003) on deflation risks in Germany. For a more extensive discussion of deflation risks in Germany and the Euro area see Hein/Schulten/Truger (2006).

²¹ See Bibow (2006a, 2006b) on the relevance of tax-push inflation in Germany and other European countries.

market determined core inflation (Table 8). And this risk threatens to be spreading to the Euro area as a whole. Here nominal unit labour cost growth has come down to around 1 percent in 2004 and 2005, and the market determined core inflation has also declined to close to 1 percent in 2005. Of course, this development is dominated by the largest Euro area economy, Germany. But German wage restraint, the increasing German competitiveness relative to the other Euro area countries and hence rising German export surpluses with the rest of the Euro area will increase the pressure on the other Euro area countries to reduce wage costs. And since the competitive price advantage which German producers have gained during the recent decade would be maintained even if unit labour costs in Germany and the rest of the Euro area would now start to move in step, this pressure will continue and deflationary risks for the Euro area will inevitably have to increase.

Table 8: Unit labour costs and inflation in Germany and the Euro area, 2001-2005					
	2001	2002	2003	2004	2005
Germany					
1. Compensation per employee hour, annual increase, percent	2.4	2.1	1.9	0.0	0.8
2. Productivity per hour, annual increase, percent	1.8	1.5	1.2	0.9	1.5
3. Nominal unit labour costs growth, percent	0.6	0.6	0.6	-0.8	-0.7
4. Market determined core inflation [~] , percent	0.7	1.3	0.5	0.8	0.3
5. Inflation rate (HCPI), percent	1.9	1.3	1.1	1.7	2.0 [§]
Euro area					
1. Compensation per employee, annual increase, percent	2.7	2.5	2.3	2.0	1.5 [#]
2. Productivity per employee, annual increase, percent	0.5	0.2	0.5	1.1	0.5 [#]
3. Nominal unit labour costs growth, percent	2.3	2.2	1.8	0.9	1.1 [#]
4. Market determined core inflation [~] , percent	1.7	2.2	1.6	1.3	1.1
5. Inflation rate (HCPI), percent	2.3	2.3	2.1	2.1	2.2 [§]
Notes: [#] average of first 2 quarters, [§] European Commission (2005) forecast, [~] without energy, food, alcohol, tobacco and administered prices according to Bibow (2006a)					
Sources: Bibow (2006a), ECB (2005), European Commission (2005), Statistische Bundesamt (2006), authors' calculations					

6. Economic policy conclusions

Since the main cause for Germany's absolute and relative stagnation can be found in macroeconomic mismanagement, the economic policy recommendations seem to be quite straight forward: apply more expansive monetary and fiscal policies and stabilising wage policies. However, such an approach faces serious institutional problems associated with the Maastricht economic policy regime dominating the Euro area: the ECB's monetary policy strategy and practice displaying a serious 'anti-growth'-bias, the SGP imposing a restrictive fiscal stance on the Euro area, and the focus on labour market deregulation which systematically undermines the ability of bargaining parties to establish wage settlements with an eye to macroeconomic requirements.²² Under these conditions, the combination of a pronounced trend towards stagnation and significant deflation risks caused by overly moderate wage developments in the largest Euro area country represents a major challenge:

First, reduction of deflation risks and nominal stabilisation in Germany requires nominal wage growth to rise in order to achieve the sum of long-term productivity growth plus the ECB's target inflation rate. However, given the deterioration of the German wage bargaining system and the weak bargaining position of the trade unions, an increase in nominal wage and unit labour cost growth requires improved employment and higher GDP growth as a precondition. But more expansive macroeconomic policies at the national level generating more employment are difficult to achieve given the restrictions by the Euro area policy mix, i.e. the ECB policies and the SGP.

Second, even if German trade unions – assisted by more expansive fiscal and monetary policies – managed to increase nominal wage und unit labour cost growth, and if inflation in Germany rose, such a rise would lead to a Euro area inflation rate above the ECB's target as long as other Euro area countries have inflation rates considerably above that target rate. Restrictive monetary policies will then be unavoidable if the ECB is not prepared to increase its inflation target substantially in order to allow the slowly growing larger economies more room to achieve a recovery.

²² On the Maastricht economic policy regime and European macroeconomic policies see the more extensive treatment in Hein/Truger (2005c, 2005d). On the interaction of the ECB's monetary policy with wage bargaining in Europe see Hein (2002).

Third, if the ECB is not prepared to raise its inflation target, it will be necessary to reduce inflation in the other Euro area countries in order to allow Germany to have more inflation. It is therefore important for the bargaining parties and in particular the trade unions to intensify their efforts towards European-level effective coordination of wage policies. The aim of this process should be for each country to increase wages on the basis of its long-term domestic productivity growth rates plus the ECB's target inflation rate.²³ There are, however, major obstacles for wage bargaining coordination across Europe arising from the different degrees of coordination within the national bargaining systems, from the overall weakness of trade unions in the larger Euro area countries, from the tendency towards decentralisation of bargaining imposed by labour market policies, etc. In addition, reducing inflation in the rapidly growing high inflation Euro area countries would mean higher real interest rates and lower growth for these countries.

If it proves impossible either to convince the ECB to raise its inflation target or to coordinate wage policies across the Euro area in the way described above, even more expansive fiscal policies would have to be undermined by restrictive ECB policies. Under these conditions Germany's stagnation and deflation risks will continue to spread to the other Euro area countries. Excessive wage restraint in Germany will not only fuel national economic stagnation but will also increase the already existing pressure on wage policies in the other Euro area countries. If wage policies are widely used to protect or improve price competitiveness, then further redistribution at the expense of labour, rising effective demand problems and the threat of deflation will spread accordingly. If this happens, then even a more growth-friendly monetary policy by the ECB might be ineffective when in the next cyclical downturn the deflation risks become actual deflation – in Germany but also in the Euro area as a whole, with serious consequences for the economic and political future of the Euro area.

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²³ For more detailed information on the various trade union coordination initiatives see Schulten (2003, 2004) and Traxler/Mehrmet (2003).

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