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Michael Heise\*

## The German Economy in International Competition with other Locations

*The deterioration in the supply conditions and competitiveness of the German economy is being increasingly bemoaned at present. Are the fears about Germany as a business location justified?*

Now that the temporary boost deriving from German unification has faded and increasingly large sections of the economy are being gripped by recession, the long-running public debate about the virtues and shortcomings of Germany as a business location is intensifying. The main complaints are about high costs, overregulation, excessively strict environmental requirements and above-average taxes. Criticism about economic conditions is being put forward not only by firms and business associations but also by politicians, academics and the press. Some critics paint a lurid picture of crisis. For example, "Der Spiegel"<sup>1</sup> proclaimed Germany's relegation to the second division of industrial countries and prophesied that the showcase engineering and automobile industries would suffer the same fate as the optical and consumer electronics industries in the seventies. German products were much too expensive and had fallen far behind the international competition, and German firms were investing increasingly abroad rather than in Germany itself.

The question is whether such fears are justified because large sections of the economy really have become uncompetitive owing to bad supply conditions and locational disadvantages, or whether concern about Germany as a business location rests partly on a misinterpretation of Germany's present cyclical problems. This question will be considered in the first part of the article. The second part discusses the action that needs to be taken and makes possible suggestions for economic policy in order to improve Germany as a business location.

Unquestionably, the German economy's position is still very good in international comparisons (Table 1). Germany's per capita GDP is one of the highest in the world, the world market share held by its exporters is only slightly smaller than that of US firms and far higher than that of its Japanese counterparts. In terms of the overall investment rate, Germany is not in the forefront, but in the upper middle range. Regarding the negative indicator "unemployment", the West German economy certainly does not come badly out of the international comparison – indeed, the unemployment rate is significantly below the EC average.

The sensible question about Germany's attractiveness as a business location is therefore not why Germany has fallen behind other countries but whether changes are appearing that could relegate it from its high-level position and cause a lasting deterioration in productivity and growth trends. In this regard two developments are often cited to support claims of declining competitiveness and waning attractiveness as a location, namely the weakness of German export growth and the net outflow of direct investment.

Let us address direct investment first. It is indeed striking that German manufacturing and service companies greatly increased their activities abroad during the eighties. Direct investment, which comprises not only the purchase of equities and other capital investments but also reinvested profits, totalled about DM 65 billion in 1991 and 1992 together, more than three times the figure for 1981 and 1982.

The growth in German direct investment abroad is often seen as a sign of the deterioration in locational quality in

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Germany itself. Such an interpretation seems rather exaggerated. First, it should be realised that part of the investment was carried out in order to penetrate foreign markets and improve companies' competitiveness internationally. This was particularly important and desirable in view of the integration of European markets and is clearly evident in the sharp increase in intra-European direct investment in the second half of the eighties. Moreover, a substantial part of direct investment abroad in recent years was due to the acquisitions and investments by German banks and insurance companies. This does not point directly to disadvantages of domestic locations either. There has, however, also been some proper relocation of production sites. The sharp increase in direct investment by the chemical industry in recent years is particularly noticeable; this partly reflects the transfer of research and development capacity, in biotechnology for example.

More worrying than German firms' commitments abroad is the low level of direct investment by foreign companies in Germany. According to balance-of-payments statistics, in the two years 1991 and 1992 foreign companies invested only DM 12 billion in Germany, whereas German firms transferred more than five times as much capital abroad (Table 2). In many cases, international groups investing in Europe have chosen cheaper locations in other EC countries. A greater commitment by foreign companies in Germany would have been desirable in view of the high capital requirement

and the massive privatisation programme in the Eastern part of the country.

The balance-of-payments statistics are of only limited value in assessing the attractiveness of Germany as a business location. It should be borne in mind that the figures on direct investment do not take account of all investment by foreign subsidiaries in Germany, such as IBM, Opel and Ford. The Bundesbank's statistics on the stock of direct investment show that between the end of 1989 and the end of 1991 the assets of foreign companies in Germany also increased substantially.<sup>2</sup> The small capital inflows shown in the balance-of-payments statistics should be viewed against this background, although the stock figures also indicate that the most permanent and important part of direct investment by German companies abroad, namely equity capital, increased at a far more rapid rate than the capital of foreign companies in Germany.

### Loss of Market Share

The slow growth in German exports in recent years could also indicate locational disadvantages or low competitiveness. Since the beginning of 1990, for more than three years now, the inflow of orders has shown a falling trend. The value of exports has increased only very slightly in real terms over this period. This poor performance is often interpreted as indicating that unfavourable conditions in Germany – especially

**Table 1**  
**Western Germany Compared with Other Countries and Country Groups**

	Period	Per capita GDP at current prices <sup>1</sup> (in standard purchasing power units) EC of 12 = 100	Unemployment rate <sup>2</sup>	Investment rate <sup>3</sup>	Share of world exports by OECD countries <sup>4</sup>
				in %	
Western Germany	1982-91	118.3	6.0	20.2	15.6
	1992	118.7	4.5	21.5	15.8
France	1982-91	112.6	9.5	20.3	8.1
	1992	111.5	10.1	20.0	8.7
United Kingdom	1982-91	100.2	9.7	17.5	7.7
	1992	95.3	10.8	15.6	7.1
EC of 12	1982-91	100	9.7	19.8	52.9
	1992	100	9.5	19.8	54.4
United States	1982-91	143.4	6.9	18.2	16.7
	1992	134.9	7.3	15.4	16.8
Japan	1982-91	107.2	2.5	29.3	13.0
	1992	116.9	2.2	31.1	12.7

<sup>1</sup> Source: Commission of the European Communities, Annual Report on the Economic Situation in the Community, 1993. <sup>2</sup> Standardised rates. Sources: for EC countries, Eurostat; for Japan and the USA, OECD. <sup>3</sup> Gross fixed capital formation at current prices in relation to GDP at market prices, whole economy. Source: Eurostat. <sup>4</sup> Ratio of exports to total world exports of OECD countries; special trade in US dollars. Source: United Nations.

Figure 1

Economic Developments in Selected Countries<sup>1</sup>— Gross domestic product, real<sup>2</sup>

... Private consumption, real

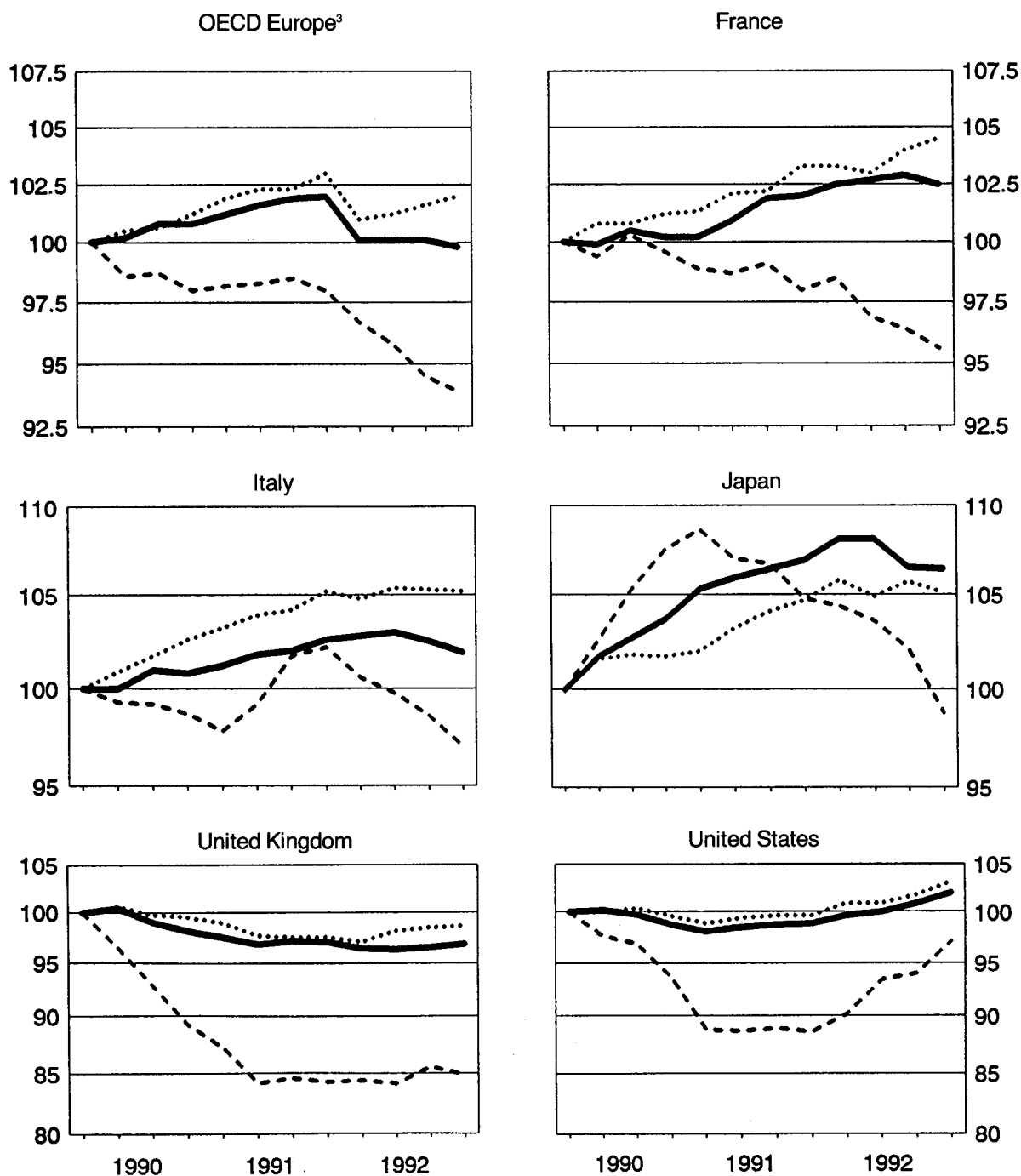
- - - Fixed investment, real

Log scale

1st qtr 1990 = 100

Log scale

1st qtr 1990 = 100

<sup>1</sup> Seasonally adjusted data. <sup>2</sup> For Japan, gross national product. <sup>3</sup> At 1985 prices and purchasing power parities.

Source: OECD.

excessive costs and too many rules and regulations – are making an increasing number of German firms uncompetitive. Indeed, the weakness of exports in recent years cannot be attributed solely to the sluggishness of economic activity worldwide, for although most of the industrial countries were undergoing a period of weak growth, the volume of world trade has been increasing slowly but steadily. German companies were not able to share fully in the growth of the world market.

What are the reasons for this loss of market share? Excessively high wages and social charges, the appreciation of the Deutsche Mark in Europe, or unexploited potential for rationalisation and wrong corporate strategies? In analysing the causes, it is helpful to distinguish between three important effects. First, the fact that economic growth in the main European markets for German goods was particularly weak in the last three years has worked against German exporters. The expanding markets in Asia and North America, on the other hand, are of less importance as markets for German exports, a competitive disadvantage that must be accepted as a fact in the short run but which can be altered

in the medium term. Secondly, this “regional effect” was compounded by an adverse “product range effect” which has similarly been observed in earlier cycles. During a recession, firms reduce investment severely. The demand for capital goods declines much more sharply than overall demand (see Fig. 1). This is particularly damaging for the German economy, whose exporters specialise strongly in capital equipment. Thirdly, in recent years exporters have had to cope with a powerful cost-push; combined with an underlying appreciation of the Mark, this has reduced their price-competitiveness in relation to foreign competitors and narrowed their profit margins.

It is not possible to quantify precisely the strength of each of these three effects. Their combined explanatory power is quite strong, however, so that it would clearly be wrong to attribute the loss of market share observed in recent years entirely or even largely to existing long-term structural problems in Germany’s exporting sector. A large part of the reduction in Germany’s share of world trade is

<sup>1</sup> Der Spiegel, No. 19, 1993.

<sup>2</sup> See Deutsche Bundesbank: Monatsbericht, April 1993, pp. 43 f.

Hans W. Micklitz (ed.)

## Post Market Control of Consumer Goods

The Community has defined the objective of achieving the Internal Market by 1992. Efforts to open up markets by harmonizing divergent technical standards and regulations have involved the Community in product safety matters. This is now manifested in the Draft Directive concerning general product safety. The present study on post market control, conducted on behalf of the European Commission, looks at two ways in which the „Europeanization“ of the rules governing this area might take place. First, the post market control systems in selected Member States, in Australia, Sweden, and the United States are analyzed, so that the consequences and perspectives for the establishment of a European post market control system may be examined. Secondly, the findings of the comparative analysis of post market control in the Member States and non-EEC countries are contrasted not only against the mechanisms proposed for the harmonization of the Member States’ legislation but also against the mechanism proposed to monitor product safety on a European level in emergency situations.

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undoubtedly due to particularly weak economic growth in Europe, the disproportionate decline in demand for capital goods and the real appreciation of the Deutsche Mark.

### Sectoral Structural Problems

This is no reason for complacency, however. A look at the export structure and the production of different branches of industry gives a more problematical picture of the present and future competitiveness of German firms. Viewing the issue from this angle reveals some of the "structural" problems that are repeatedly being cited in the current debate. The following points are important in this connection:

- Although the world market share of German firms as a whole is still impressively high, it is undisputable that firms have lost considerable market share in sectors that are growing particularly rapidly and have a strong growth potential.<sup>3</sup> These include many high-technology fields such as the markets for automated data-processing machines, parts and accessories for ADP machines and communications equipment.
- The car and motor vehicle industry, a sector of great importance for the German economy, is in a difficult situation. Considerable structural problems have emerged, now that the strong economic stimuli of German unification have dissipated. Despite rising sales, profits have decreased sharply in recent years, costs are too high and productivity is too low. This in turn is due to a combination of corporate management problems and locational disadvantages.
- Serious challenges also face the renowned German engineering industry. The savage cuts in output and

shortening of orderbooks in recent quarters have focussed attention on structural problems here too. Some engineering firms themselves, their advisers and the employers' associations have issued clear warnings that the sector's medium-term prospects are bleak unless corporate strategies and general economic conditions change.

The example of the engineering industry illustrates that the poor economic performance of the manufacturing sector in recent years is not due to a single cause – solely adverse locational conditions, for example – but to a combination of corporate, cyclical and locational factors.

In the current recession engineering companies are once again making the painful discovery that the demand for machinery and equipment reacts strongly to cyclical developments in Western Germany and in important export markets. For more than two years the demand for capital goods in the leading Western European industrial countries has displayed a sharp cyclical decline.

At the same time the German engineering industry had to cope with a strong cost-push caused mainly by rising wage and ancillary labour costs and to a lesser extent by rising interest rates. The effect of this cost pressure was reinforced by last year's appreciation of the Deutsche Mark, particularly against other European currencies. As a result, profit margins in the industry declined sharply.

However, it is not only weak demand and high costs that are to blame for the poor business situation, but also specific problems within the companies themselves. Opportunities for rationalisation and corporate renewal have clearly been ignored in recent years, because poor profit margins were offset by high volume sales thanks to German unification, at least until mid-1992. Studies of the machine-tool industry, for example, show that the cost advantage enjoyed by Japanese manufacturers is due partly to entrepreneurial factors, such as differences in the organisation of production and research and in corporate structures. This suggests a number of measures for firms to take: efforts to reduce costs, new production strategies, relocation of labour-intensive operations to low-cost countries, new forms of organisation, market-oriented innovation strategies, and so forth. Here too, Germany clearly has ground to make up.

The macro-economic relevance of the structural problems described above is not easy to assess. Those who attach great importance to the sectoral developments have to counter the argument that a dynamic economy

**Table 2**  
**Direct Investment<sup>1</sup>**  
(in billions of DM)

	German investment abroad (Capital outflows: -)	Foreign investment in Germany (Capital inflows: +)	Balance of direct investment (Net capital outflows)
1983	8.095	4.533	-3.562
1984	12.492	1.573	-10.919
1985	14.142	1.727	-12.415
1986	20.885	2.585	-18.300
1987	16.364	3.417	-12.947
1988	20.074	2.114	-17.960
1989	27.351	13.406	-13.945
1990	37.377	3.770	-33.607
1991	37.102	6.176	-30.926
1992	28.095	6.042	-22.053

<sup>1</sup> Net. From July 1990 including the new Länder. Based on the balance-of-payments statistics of the Deutsche Bundesbank. For further explanation, see Deutsche Bundesbank, Sonderdruck No. 8, pp. 80 ff.

Source: Deutsche Bundesbank.

<sup>3</sup> Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 1992/93, para. 76.

capable of change will always have some contracting branches, even if the general locational conditions are outstanding. Structural change – and that includes the decline of industries – is of crucial importance for the growth of an economy. Less profitable and productive activities must decline; capital and labour must move into new activities with higher productivity and higher profits. This is one of the reasons why subsidies, which preserve the status quo, are so often criticised.

### Behind in Key Technologies

This reference to the importance of structural change is certainly right but it in turn raises a series of other questions. Are there not “strategic” sectors of importance for the innovative capacity and technological know-how of an economy as a whole? And what should be done if they are among the contracting sectors? In addition, the question arises as to which sectors of the German economy will expand in order to compensate for the contraction of others in the course of structural change.

On its own, the fact that the services sector undoubtedly still has considerable scope for expansion is not a sufficient reply to the latter question, for unless Germany also maintains a strong position in tradable industrial goods its prosperity cannot be sustained in the long term.<sup>4</sup> But which are the high-growth sectors of manufacturing? The predominant opinion is probably that the future of German manufacturing industry will depend on success in innovative (high-tech) activities with a high human capital content. With the present pattern of relative costs, it is impossible to see how standardised and possibly labour-intensive mass-produced goods can be manufactured on an increasingly competitive basis.

A particularly prominent advocate of this thesis is Konrad Seitz, the former Head of Planning in the Foreign Office and now Ambassador in Rome.<sup>5</sup> He fears that the German economy's backwardness in key areas such as genetic engineering and micro-electronics could have devastating and lasting effects. Germany (and Europe) is in danger of becoming dependent on other industrial countries for technology. It is in the high-tech sectors, he claims, that the strategic industries are developing that will

also determine the competitiveness of “mature” industries and services. If the semi-conductor, computer and consumer electronics industries are in danger of extinction, it is questionable “whether it will be possible to save the machine-tool and telecommunications industries”.

In evaluating this proposition, it has to be acknowledged first of all that the retention of first-class research and development capabilities in Germany is of almost inestimable importance. However, it is questionable whether Germany's backwardness in specific fields such as micro-electronics will really lead to general technological impoverishment and complete reliance on other countries. Studies of the semi-conductor market, for example, show that market leadership is fiercely contested in this field. Companies in the semi-conductor industry can certainly create temporary monopolies, but as the life cycle of individual chips is only three years, all companies in the semi-conductor market repeatedly have to compete under new and equivalent starting conditions.<sup>6</sup> It therefore seems doubtful whether a country can establish an uncontested and exploitable dominant position in this field. Even if it were so, would they then have an incentive to harm other economies by exploiting this position? This would reduce sales and retaliatory measures would almost certainly follow. In the light of these considerations, individual technologies should not be subsidized just for the reason of a suspected dependence on other countries.

This is not to deny that the German economy has lost its technological lead or fallen further behind its competitors in many areas. The structural weaknesses in exports outlined above and the studies carried out by the Ifo-Institute in the context of the Innovation Test do indeed point to shortcomings in innovative sectors.<sup>7</sup> The causes of this are too numerous and complex to be described properly here. The often still inadequate level of competition in product markets, the conscious or unconscious obstruction of technological development by official regulations and permission procedures, general attitudes towards technology policy, especially the general “technology acceptance level”, and the technology policies of firms themselves all play a role. This brief list indicates a number of points on which economic policy could take action. Moreover, firms have to make up for past omissions as regards the speed of R & D work and its orientation towards output and customer requirements.<sup>8</sup>

<sup>4</sup> This is not to deny the potentially great significance of high-value services as an export product. However, only in a very long-term view is it conceivable that exports of services will reach a volume comparable to the present volume of merchandise exports.

<sup>5</sup> See for example K. Seitz: *The Case for a Federal Government High Technology Policy*, in: *INTERECONOMICS*, Vol. 27 (1992), No. 3, pp. 103-107.

<sup>6</sup> Cf. G. Bletschacher and H. Klodt: *Braucht Europa eine neue Industriepolitik?*, in: *Kieler Diskussionsbeiträge*, Institut für Weltwirtschaft, Kiel 1991, p. 22.

<sup>7</sup> Cf. Ifo-Schnelldienst, Vol. 46, No. 13, 1993.

<sup>8</sup> For greater detail, see for example H. H. Henzler: *Europreneurs – Europas Unternehmen melden sich zurück*, Frankfurt and Wiesbaden 1992, pp. 231 ff.

What is the result of all these considerations? Germany continues to be a good and competitive business location among the highly developed industrial countries, but there are unmistakable signs that Germany's attractiveness as an investment location is diminishing and key branches of industry are falling behind in competition with other countries. It is perfectly possible to close the gap, however. There is no cause for panic, although the "Economist" recently praised the Germans' ability to gain a lead by means of "panic". According to this theory, it is only when German society is in danger of falling behind other countries economically that it is prepared to make the changes needed to ensure its economic success. In this sense the critical debate about Germany as a business location is undoubtedly useful and hopefully beneficial.

## Tasks of Economic Policy

What changes must economic policy bring about, and how important is its contribution to solving the problem? By its actions in many areas, economic policy exerts a great influence on whether the German economy is attractive as an investment location and whether business in Germany is internationally competitive. Economic and fiscal policy sets the parameters not only as regards taxation and social charges but also by determining the entire framework of relevant business law. Incomes policy has a decisive influence on companies' costs and monetary policy determines the stability of the currency and the level of interest rates, both important factors in corporate investment.

A new policy concept to enhance locational quality is not required, however. Efforts to constantly improve and develop the conditions in which economic activity is conducted have always been one of the primary tasks of economic policy. It entails a good regulatory policy, a predictable fiscal policy, a monetary policy geared towards stability and an incomes policy designed to boost employment. All this will also preserve and reinforce Germany's existing strengths as a business location and eliminate or mitigate its weaknesses. Urgent action is currently required in the following areas.<sup>9</sup>

## Germany's Locational Advantages

Germany's locational advantages include a mature and functional infrastructure, a dense road and railway network, generally adequate telecommunications facilities, and a good social infrastructure of schools, cultural establishments, sports facilities and the like. Among its strengths it also counts its qualified labour force and its established system of training. But for firms, which benefit directly or indirectly from this infrastructure, its cost

in the form of taxes or charges is also important. In this respect Germany is probably one of the less attractive places to invest. Not only are taxes high by international standards, but some supplies of public state infrastructure are not cost-effective and hence are unnecessarily expensive. German Railways are a blatant example of this; they are simply no longer affordable in their present form and under the current regulatory conditions. In the future, far greater emphasis than in the past must be laid on offering an infrastructure that is not only reliable and of high quality but also cost-effective. This applies not only to the railways but also to telecommunications, the postal service, local utilities and energy supply.

It remains to be seen whether the planned reform of the postal service and the railways will entail more than a change in their legal structure. More tangible results can be expected only if competition is intensified and if the cross-subsidisation of unprofitable activities is eliminated. For example, it is quite conceivable that German Telekom will offer communications services in competition with other domestic and foreign providers. It is equally conceivable that ownership of the rail track network could be separated from its operation and third parties could be given easier access to the lines. In my opinion, there are many examples which show that the advantages of competition in this area are not just an article of faith. For instance, the liberalisation of the markets in telephone handsets and mobile telephones has increased product diversity and brought considerable price advantages. The importance of cheap transport, telecommunications and other infrastructure services for the competitiveness and hence growth potential of enterprises is often underestimated.

Other locational advantages that Germany offers are the high levels of social protection in the event of unemployment, illness or accident. Here too, the financial aspect must be considered, however. Ancillary wage costs, consisting partly of contributions to the statutory social security scheme and partly of voluntary but by now customary social benefits paid by firms, increased slowly but steadily during the eighties and then soared again in the early nineties. The recent increase was partly attributable to the fact that the social costs of the transformation process in the new Länder fell mainly on contributors to the unemployment insurance fund. The continuing rise in social security contributions, however, also reflects flaws in the design of the social security system. This is true of the health insurance scheme, which

<sup>9</sup> The list that follows is not exhaustive; in particular, questions of education policy and research policy have been omitted and the order in which issues are discussed does not imply an assessment of relative urgency.



despite a succession of new laws to curb costs and repeated cuts in the range of benefits has become more and more expensive. It is also evident in the unemployment scheme, where benefit fraud amounting to billions of Marks was apparently tolerated for years. The aim of reforms in the health sector, for example, should be to create inherent incentives for providers, patients and health insurance organisations to reduce costs.<sup>10</sup> This could be achieved without sacrificing the solidarity aspect. The Government's proposed arrangements for insuring against the need for health care do not adequately meet these requirements; they are seriously flawed and are not the best of the possible alternatives. Let it be emphasised once again that targeted and efficiently organised social insurance is an important factor in the attractiveness of a location. In this regard there is still room for improvement in Germany.

## Need for a More Flexible System of Pay

Labour market conditions should also be examined to see whether they take sufficient account of the demands imposed by intensified worldwide competition. German working hours are the shortest in the world, but recently firms have complained particularly about the insufficient flexibility of working hours, which puts them at a disadvantage in relation to foreign competitors. As examples from the metal industry in the early nineties have shown, more flexible working hours can actually increase productivity. This need not harm the interests of the workforce; indeed, in certain circumstances they would be better served. For these reasons wage negotiators on both sides should consider whether collective labour agreements should not define ways of making working hours more flexible.

Greater differentiation in the system of basic wages and salaries would also be desirable. As wages in Germany are not generally profit-related, marketing difficulties such as those we have been witnessing in most manufacturing areas for some time now lead to large-scale redundancies or a fall in profits and a corresponding curtailment of investment. The introduction of a more profit-related element of pay or worker participation in the firm's equity would make it easier for companies to weather recessions or temporary marketing difficulties due to other factors with smaller reductions in their workforce and it would give employees above-average wage increases in times of prosperity. Greater wage flexibility is also possible within the collective bargaining system. Here too, collective agreements could offer a range of options for a combination of basic remuneration and profit-related pay. Negotiators should recognise that pressure for far-

reaching changes in the system of collective labour agreements – such as the possibility of cancelling collective agreements and lower wage rates for the long-term unemployed – will steadily mount if they are not prepared to leave more scope for solutions tailored to companies' individual situations.

## Importance of Fiscal Policy

Last but not least, sound macro-economic conditions are an important factor in locational quality. Germany can no longer claim unqualified compliance with this requirement. Erosion of the value of money is more rapid than in many other industrial countries, government borrowing in the capital market has increased sharply and unemployment is at a dangerously high level, owing partly to the serious structural problems in the new Länder. In view of the large wage increases of recent years, it seems especially important that a policy of wage restraint improve the conditions for greater employment and support the stability objectives of monetary policy.

Fiscal policy, whose significance as a determinant of locational conditions is often underestimated, is also of special importance. Predictable financial conditions – especially as regards the level of taxes and charges – belong to the determinants of a country's attractiveness as a location for investment or production. Fiscal policy in Germany has not followed a clear and credible fiscal policy course in recent years; on the contrary, the uncertainty that has prevailed has seriously impaired the attractiveness of the country to investors and manufacturers. Government borrowing, which according to Bundesbank estimates could reach a total of DM 230 billion in 1993 and absorb a large part of total domestic saving by the private sector, is not a good precondition in the long term for a stable exchange rate and low interest rates in Germany. It is therefore time for the ambitious medium-term budget consolidation plans finally to be implemented, partly in order to maintain Germany's locational conditions.

If the problems that I have described in economic policy and in the corporate sector are tackled, then there is a good chance that in the years to come the German economy will remain on a growth path that will allow top-level wages and per capita income by international standards. On the other hand, if these tasks are left largely undone, wage and salary earners will painfully feel the consequences over the long term, as they will have to curb their share of national income by even more than will be necessary in any case as a result of the foreseeable additional burden of taxes and charges.

<sup>10</sup> Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 1992/93, para. 377 ff.