

Macro and Micro Economic Performance: the UK and Germany

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(based on work with Wendy Carlin, UCL and CEPR)

The question

How to explain persistently high & rising unemployment in Germany over more than a decade in face of weak real wage growth & implementation of supply-side restructuring & reforms? A comparison with the UK.

Structure of the argument

1. The 2 sides of supply-side restructuring
 - core economy: coordinated economy institutions
 - outsider labour market: government reformsBoth should promote lower unemployment ...
2. Aggregate demand & persistent unemployment
3. Political economic puzzles
 - large non-encompassing wage setters and the constraint on discretionary fiscal policy
 - consensual political systems and the nature of reforms

1. Supply-side restructuring using coordinated economy institutions

“Varieties of Capitalism” literature emphasizes co-evolution & complementarities among Germany’s institutions

- A. Vocational training & cooperative ind relns: heavy reliance on firm- & sector-specific skills → role of unions in wage-setting to contain ‘hold-up’ by skilled insiders
- B. Strong welfare state: to provide insurance for workers with specific skills (limited mid-career mobility)
- C. Consensus political system: in order to sustain investments (A) + insurance (B), institutional change requires wide agreement
- D. Blockholder ownership: permits works council role in management & provides commitment required for co-specific investments

Supply-side restructuring since early '90s – from below using coordinated economy institutions

In core tradeables sector, firms, unions, works councils ...
not government

- Increased consensus-based decision-making – management + works councils
- Unions still play major role in coordinated bargaining & vocational training but more oriented to specific company needs & dominated by chairs of important works councils
- Increased access to global financial markets but blockholder pattern intact

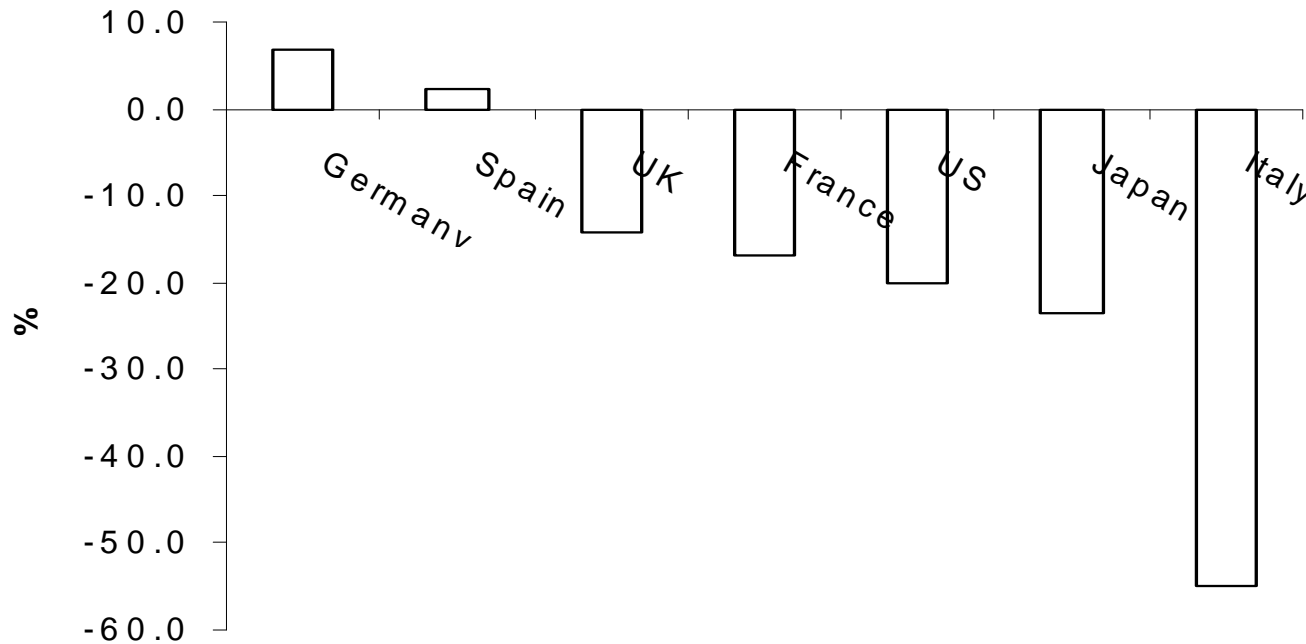
Average labour quality in services UK, US, France, Germany:

Market services	US	UK	France	Germany
Wholesale	2	4	3	1
Retail	3	4	2	1
Hotels & Rest.	4	3	2	1
Transport	3	4	2	1
Post & telecomm	2	4	3	1
Finance	2	4	3	1
Business services	2	4	3	1
Social & personal	4	3	2	1

(Mason et al. 2007)

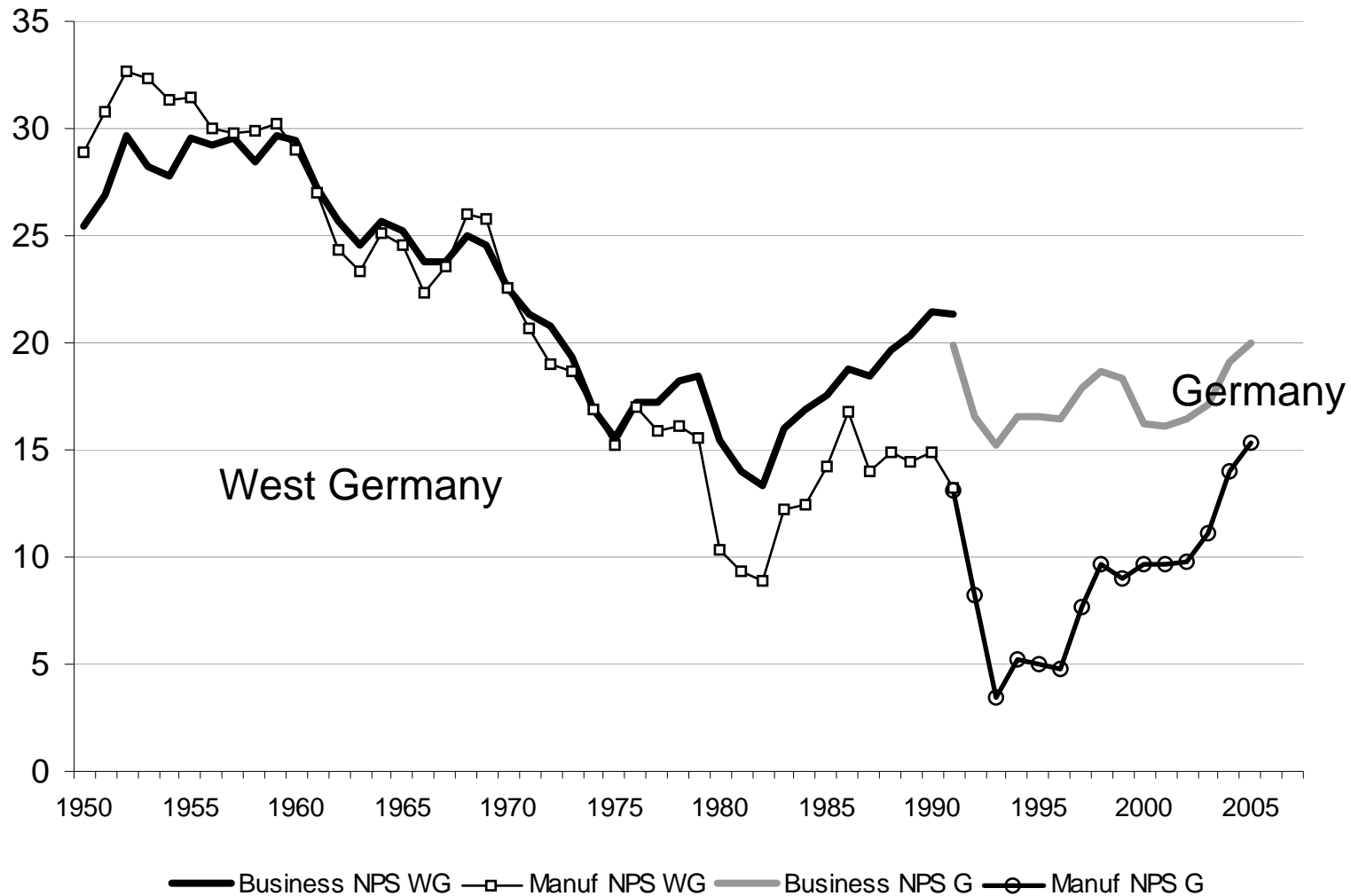
Private sector restructuring of core centres of comparative advantage

- Export performance – Germany unusual in OECD in increasing export market share in face of gains by China, India and post-communist economies; goods and services
- Econometric studies show role of both price & non-price factors



Export Performance of OECD Economics, 1995-2006

Long-run trends in net profit shares, Germany 1950-2005



Source: German National Accounts: various years..

Government supply side reforms

OECD-prescribed labour market & welfare state reforms: Germany ranked 4th highest in 30 OECD countries (1994-2004) in intensity of reform effort

- Direct effects: polarization of labour market
Increased poverty and inequality at the bottom

Incidence of low pay in Germany began to rise from 1995.

Data for 2005 (% employees with <2/3 median hourly wage):

Dk	Fr	Neth	UK	Ger	US
8.5	11.2	17.6	21.7	22.0	25.0

- Indirect effects: reduced incentives for children in lower school tracks (PISA results)

Puzzle “Correct” supply-side improvements yet unemployment rises

Typical cross-country econometric studies predict German unemployment poorly:

Post 93, Bassanini and Duval (2006) predict a fall in German unemployment, not the rise observed

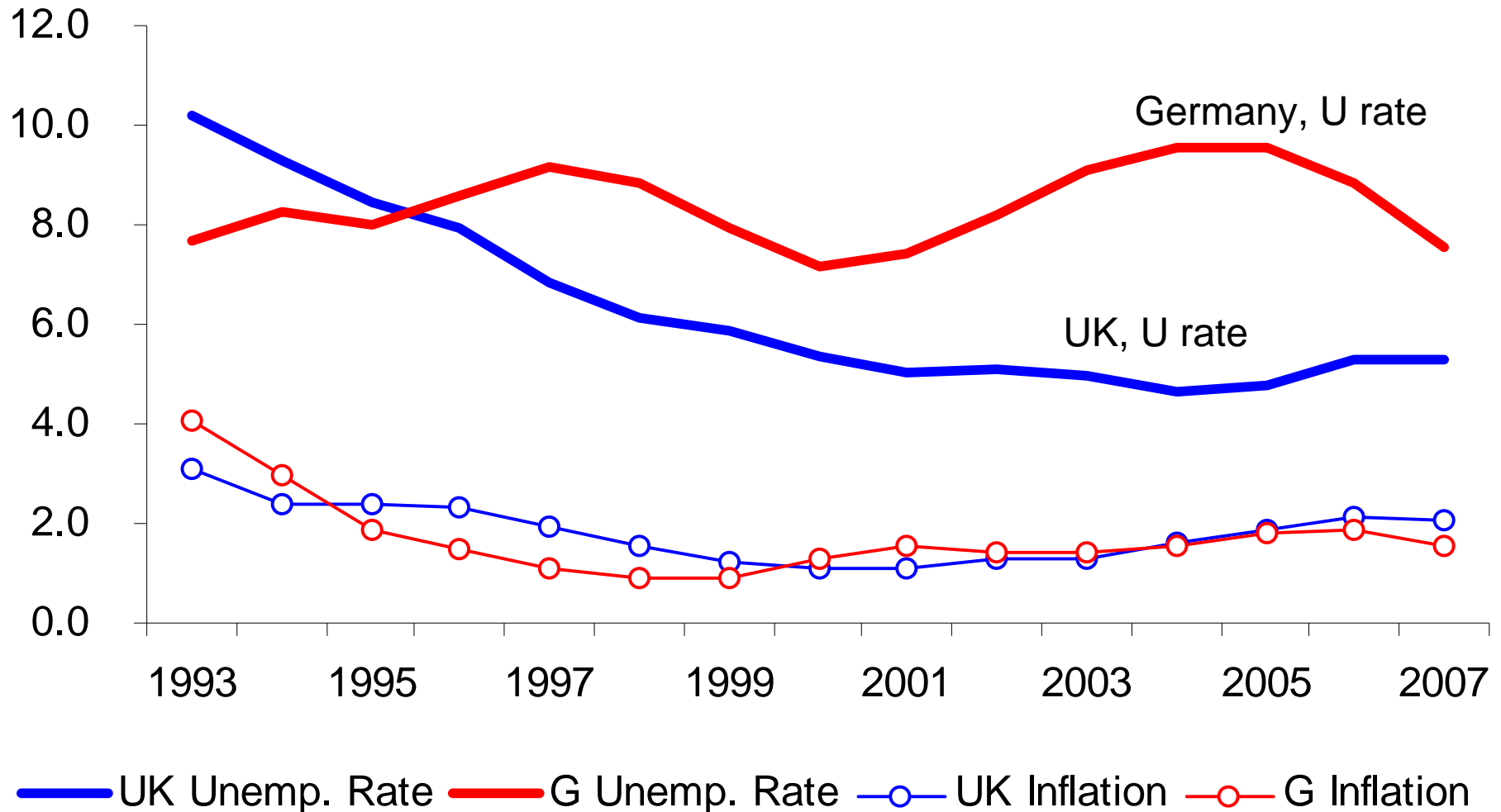
[Bassanini and Duval working within OECD; and OECD now revising its official views pro- Washington consensus, arguing that Nordic model works]

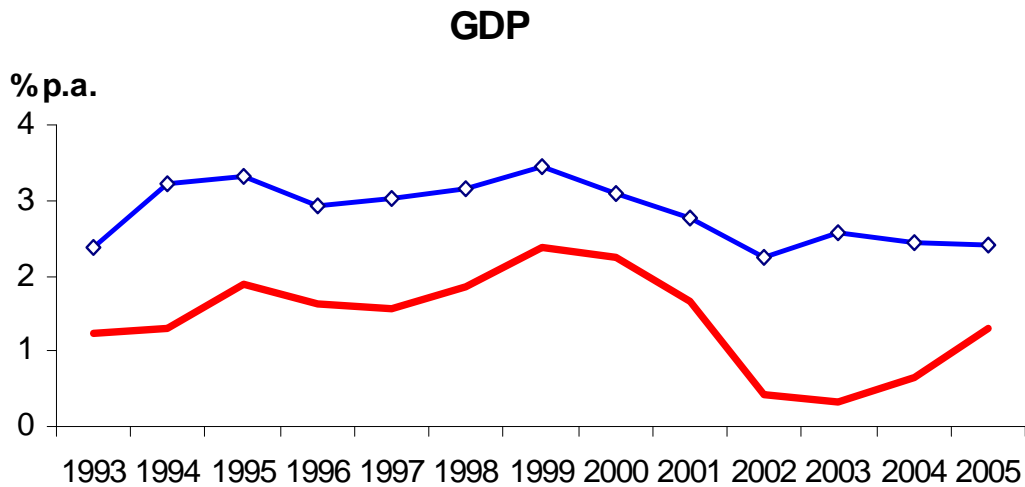
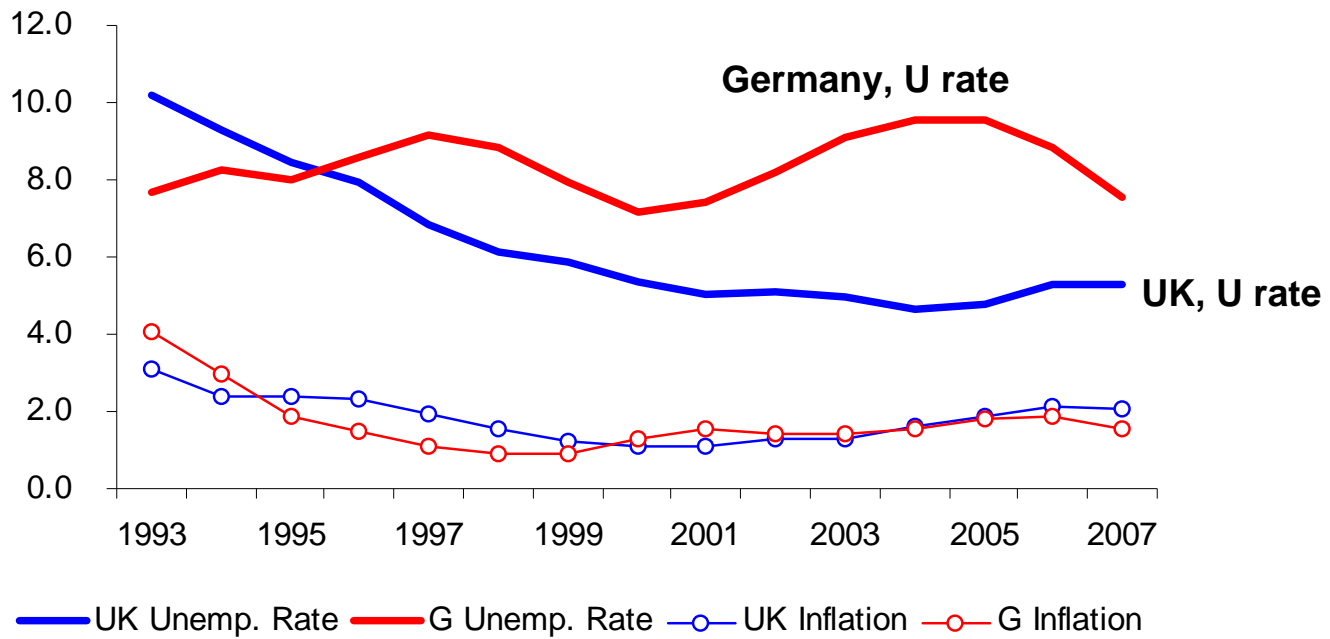
2. Aggregate demand & persistent unemployment

Accounts of buoyant UK v. sluggish German performance focus on successful British reforms & absent or unsuccessful German ones

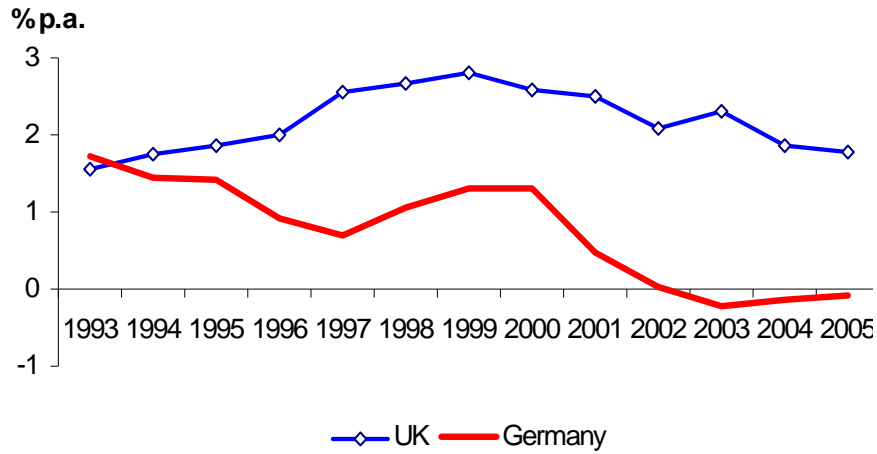
But performance differences appear related to specific patterns of demand ...

Unemployment & Inflation, Germany & UK

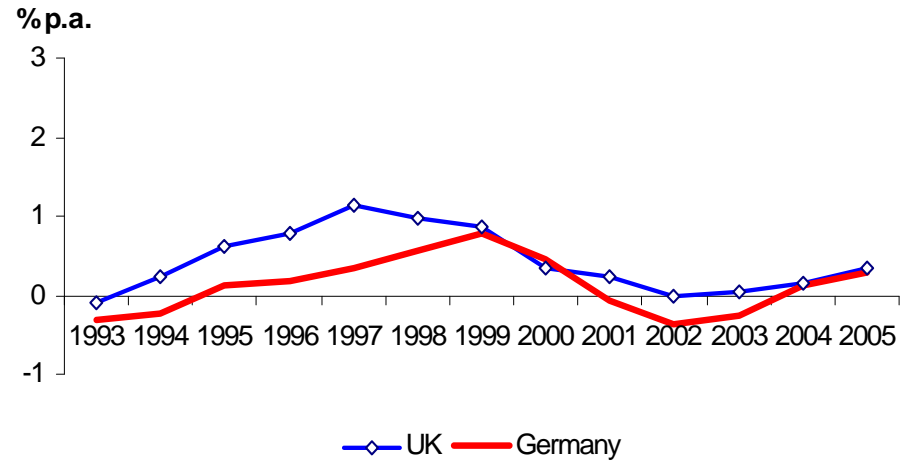




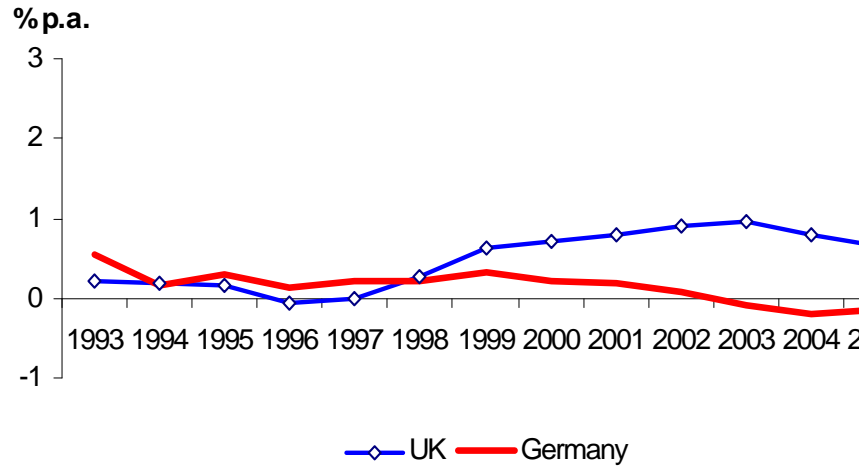
Private consumption and housing



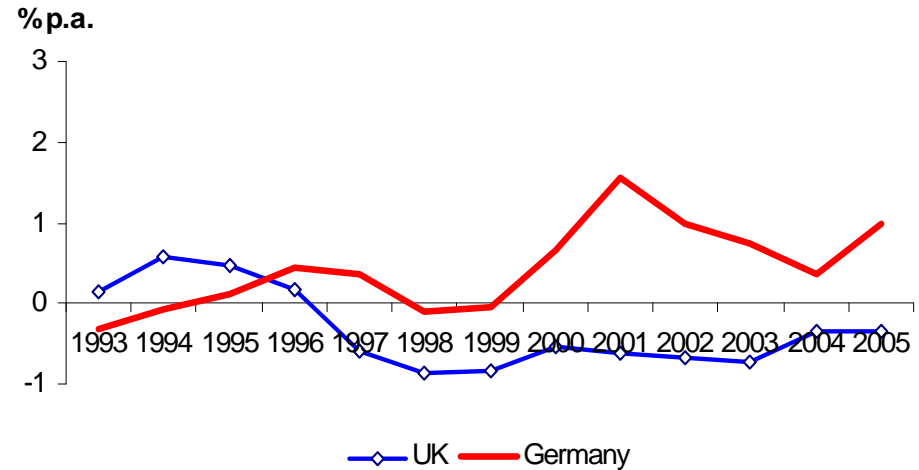
Private non-housing investment



Government consumption & investment



Net exports

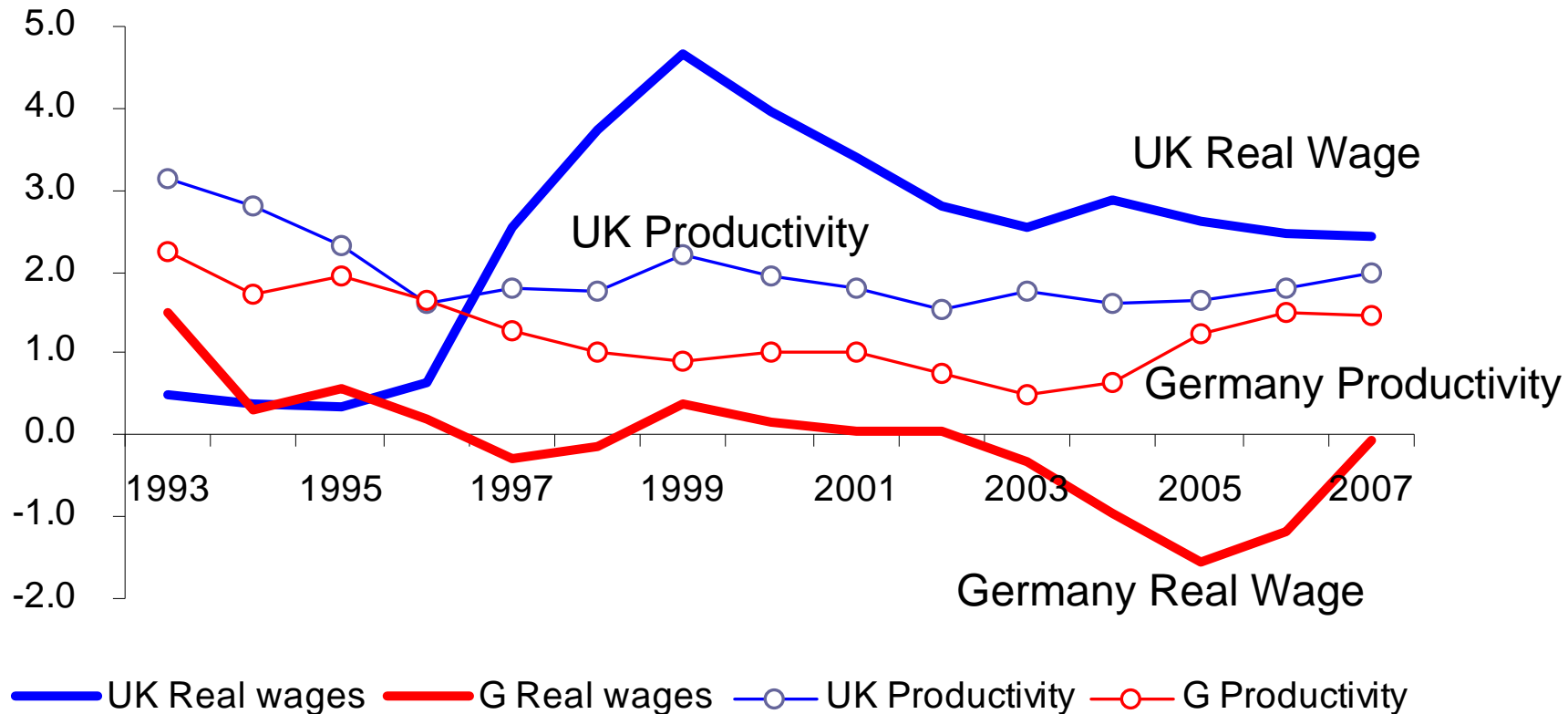


So: Unemployment worsened by slow GDP growth relative to UK

Slow GDP growth caused by slow consumption growth and government expenditure

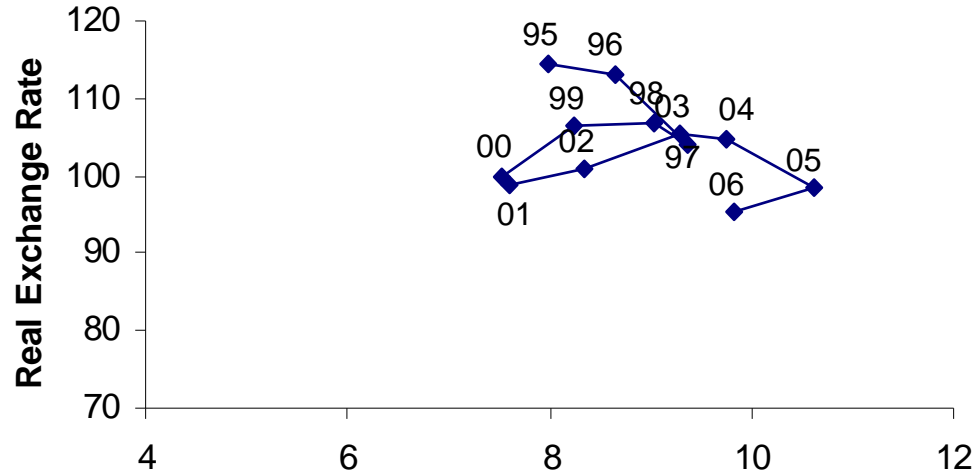
Slow consumption growth caused by??

Real Wage and Productivity Growth, UK and Germany

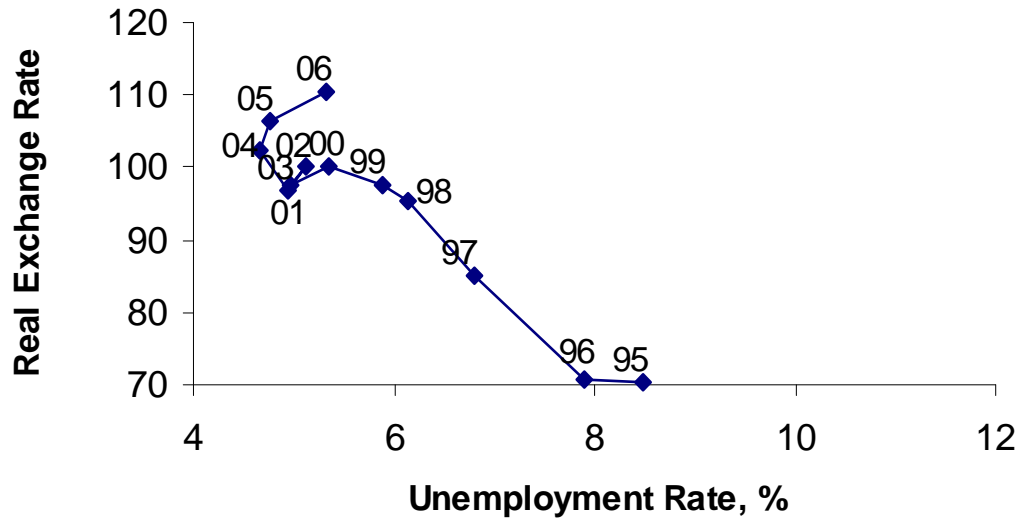


↑ Real appreciation

Germany



UK



Wage restraint and aggregate demand

Net negative effect on demand

Unlike small countries, +ve effect on external balance outweighed by –ve effect on consumption

Savings

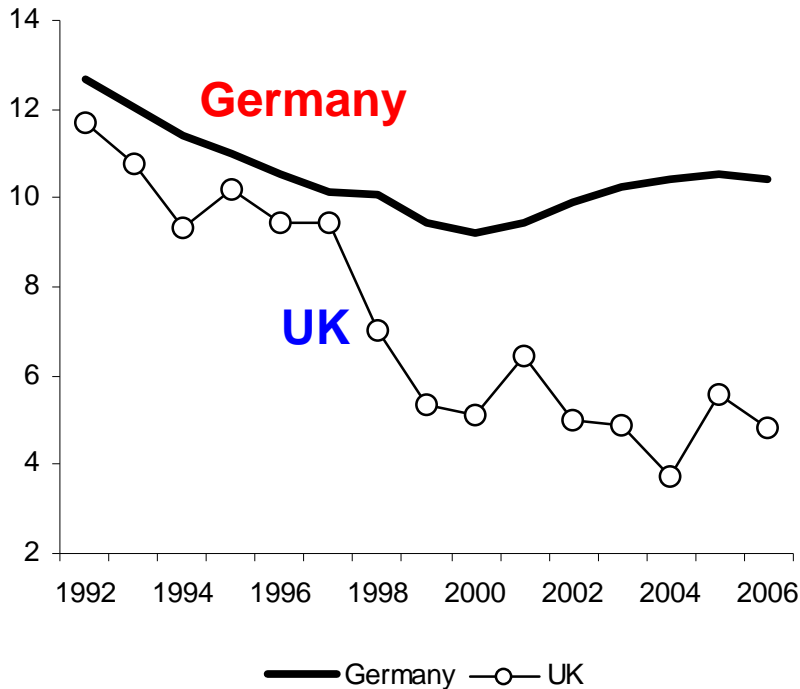
Employed sought to build up private wealth

***because* fears of govt contraction in pensions and unempl benefits**

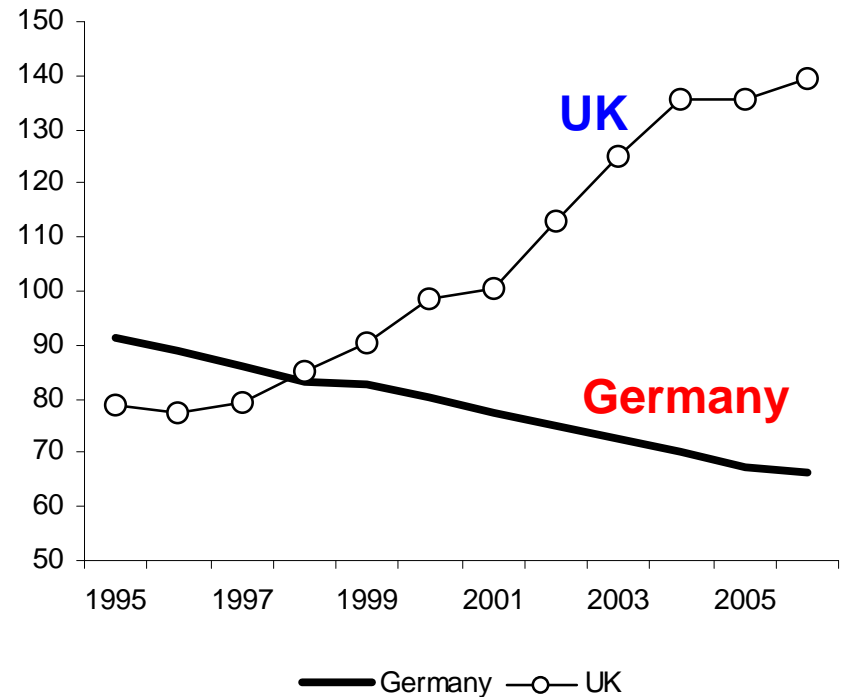
***especially* (a) long-employment tenure and limited mid-career job markets**

Savings behaviour in Germany and UK

Household Savings as % of Disposable Income



House price / income ratio
100 = long term average



(b) No easy entry to women's labour market (as in Nordic, Anglo-Saxon countries)

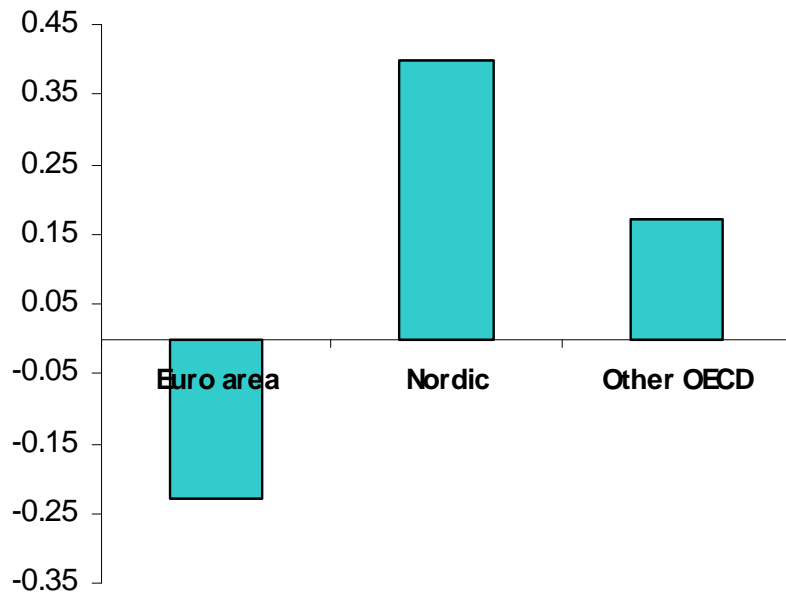
(c) Financial liberalisation didnt permit easy borrowing on property

Why didnt government counter the negative demand shocks in Germany as UK govt did?

What accounts for German fiscal policy cautiousness?

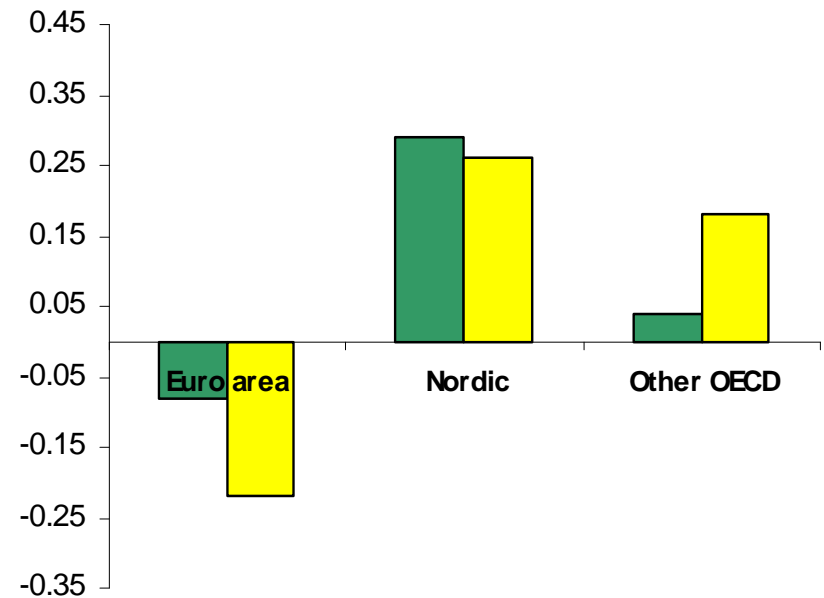
Discretionary fiscal policy ... Euro area countries, Nordic & other OECD, 1981-05

Cyclically adjusted primary balance



■ Cyclically adjusted primary balance

Expenditure and Revenue



■ Cyclically adjusted primary expenditure ■ Non interest revenue

Correlation with output gap: +ve sign implies counter-cyclical;
Finland is in 'Nordic'

Political economic puzzle

Puzzle : Why do countries differ in ability to sustain aggregate demand via discretionary fiscal policy

- large non-encompassing wage setters and the constraint on discretionary fiscal policy
- coalition governments & common pool problem

1. Large wage-setters set the inflation rate (out of equilibrium) & the real exchange rate
 - If unions act independently & if government pursues discretionary fiscal policy to respond to increased U , each union believes its actions will \rightarrow fiscal response of size $1/N$... by eliminating this possibility, government sharpens incentives for wage moderation

Compare with :

- large N labour markets as in UK, prospect of discretionary fiscal policy has no effect on wages
- encompassing unions (e.g. Nordic), where macro implications are internalized in wage-setting process itself and do not require constraint of non-discretionary fiscal policy

2. Coalition governments (Hallerberg, Strauch and von Hagen, 2001)

Coalition government → common pool problem if individual ministries from different parties independently decide on expenditure while taxation is general – i.e. G will be too high

- Hence incentive for all coalition members to agree a binding contract & this needs tough fiscal framework

Germany has both small N wage-setters & coalition governments ... hence non-discretionary fiscal framework.

Puzzle #3. How did consensual political system produce reforms that weakened protective labour market institutions?

Recall insurance role of welfare state when co-specific investments by workers matter & hence importance of consensus political system

Why not Nordic reforms? Plenty of scope (re-training; education; family policies)

- German political partisanship different. Unlike other consensus political systems, not mainly had centre-left governments
- Plus, unions more fragmented

Both made it easier for less egalitarian reforms to be adopted

Policy debate

- Generic labour market reforms may have counter-productive effects especially when co-specific investments are important
- Country comparative advantage interacts with appropriate reform design
- Germany – if coordinated economy institutions remain important for success of advanced sector, how to create a second labour market system complementary to rather than segmented from the core one? Efficiency as well as egalitarian issues are at stake