

# Germany and the Great Recession

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(draws on joint and ongoing work with Bernd  
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# Germany and the Great Recession

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- ▶ To understand why Germany emerged as one of the strongest economies from the Great Recession, one has to look back to the period preceding the Great Recession.
- ▶ That was a period of dramatic challenge and change for Germany
- ▶ During that period Germany gained spectacularly in competitiveness
- ▶ Key to understand why that happened is the specific governance structure of German labour market institutions, with unions and works councils that collaborated with industry

# From “Sick Man of Europe” ...

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- ▶ In the late 1990s and into the early 2000 Germany was “the sick man of Europe”:
  - » Germany’s economic growth about 1.2 percent per year from 1998 to 2005, unemployment rose from 9.2 percent in 1998 to 11.1 percent in 2005
- ▶ After the Great Recession, Germany emerged as “Economic Superstar”
  - » number of total unemployed fell from 5 million in 2005 to 3 million in 2008
  - » almost no increase in unemployment during the Great Recession, despite a sharp decline in GDP in 2008 and 2009
  - » exports reached all-time record of \$1.738 trillion in 2011, roughly equal to half of Germany’s GDP, or 7.7 percent world exports

# What happened?

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- ▶ How did Germany transform itself from “the sick man of Europe” to an “economic superstar” in less than a decade?
  - » One common answer: series of legislative market reforms that started in the mid 2000s, the so-called “Hartz labor reforms.”
  - » Another explanation: the evolution of Germany’s trade balance in the context of the eurozone.

# What really happened ...

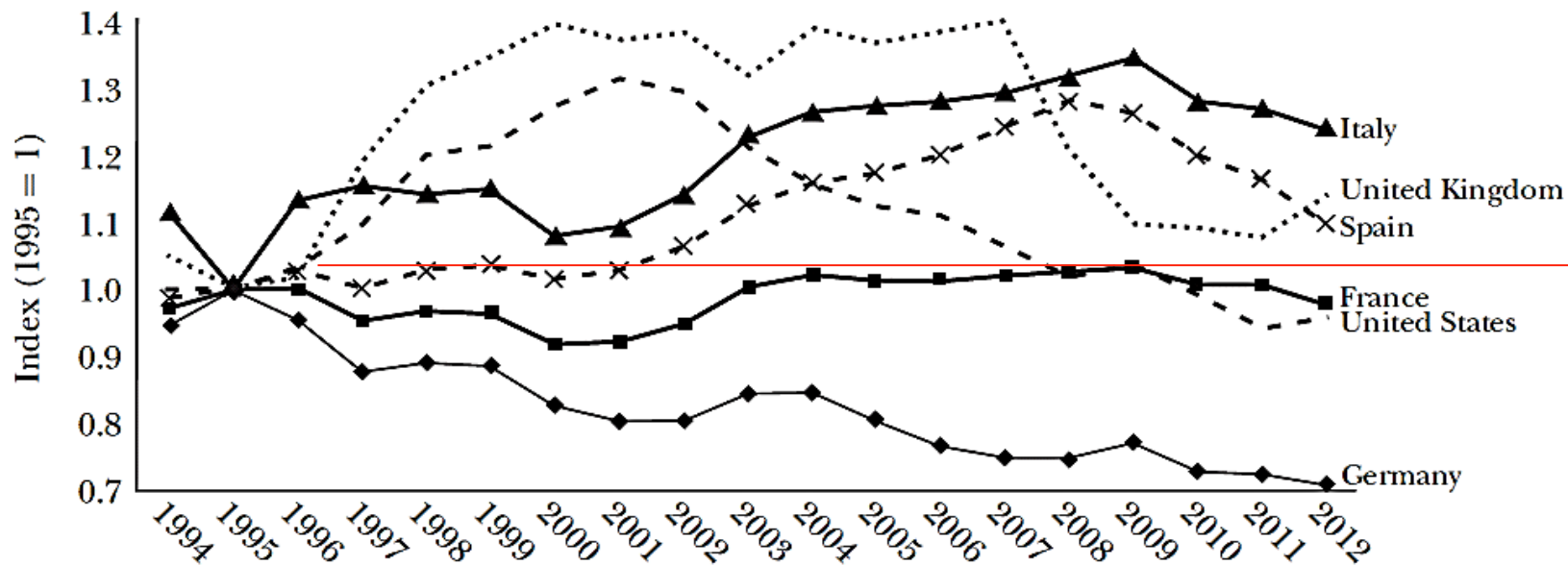
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- ▶ Increase in competitiveness was driven by decentralisation of wage setting
  - » Specific governance structure of the German labor market institutions allowed flexibility in time of extraordinary economic circumstances
  - » This distinctive characteristic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

# Evolution of Competitiveness

Figure 1

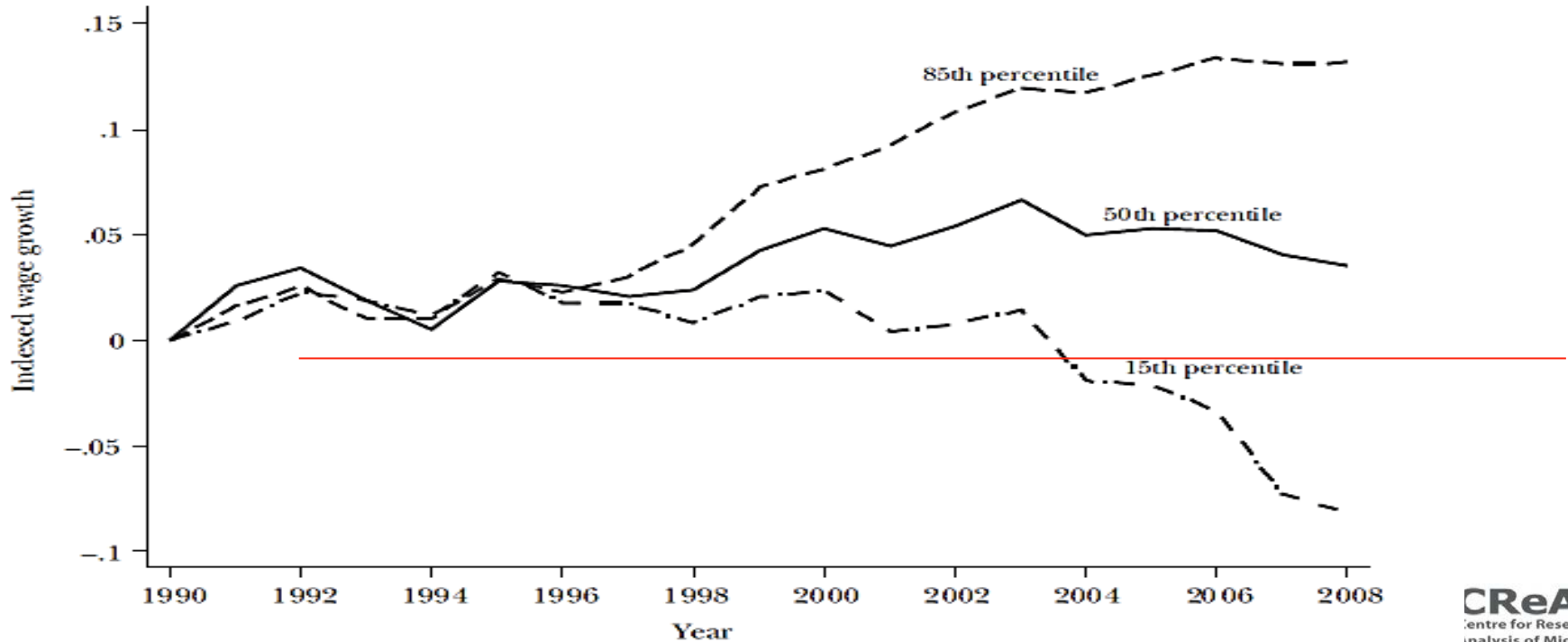
Evolution of Competition-Weighted Relative Unit Labor Costs, Selected Countries, 1994–2012



# Wage Trends and Wage Inequality

Figure 2

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

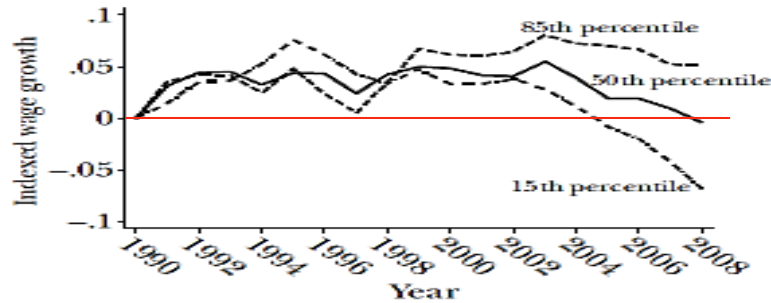


# Indexed Wage Growth by Sector

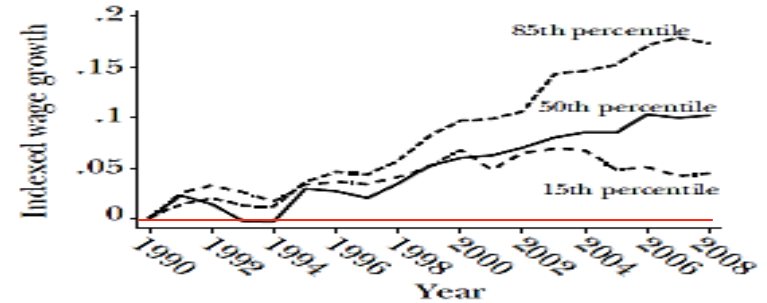
Figure 3

**Indexed Wage Growth of the 15th, 50th, 85th Percentiles, West Germany, by Sectors, 1990–2008**

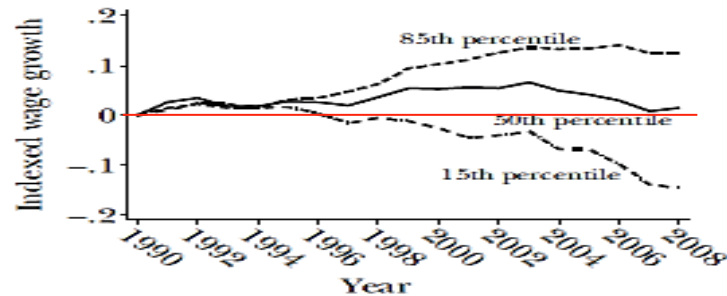
**A: Nontradable Sectors**



**B: Tradable Manufacturing**



**C: Tradable Services**

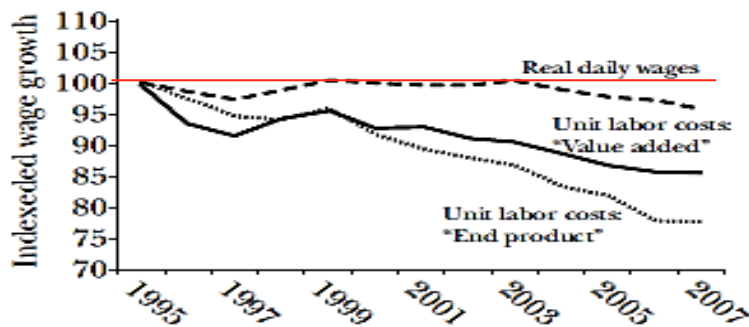




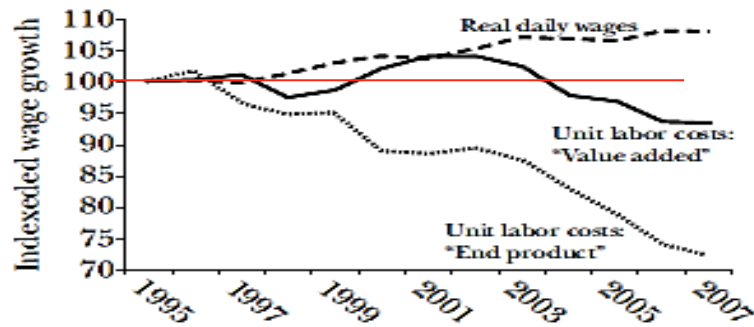
# Unit Labor Cost, “Value Added” and “End Product”

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

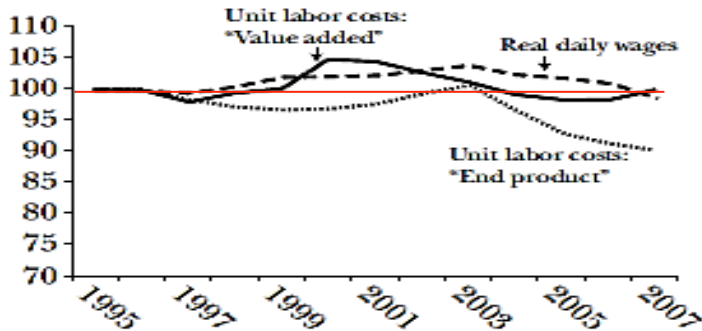
### A: Nontradable Sectors



### B: Tradable Manufacturing



### C: Tradable Services





# How did Germany's Manufacturing Sector Improve Competitiveness?

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- ▶ Inputs from domestically provided nontradables and tradable services, where real wages fell between 1995 and 2007
- ▶ Productivity increases outpaced wage increases (decline in unit labor costs but increase in mean real wages).
- ▶ Increased use of trade integration with Eastern European countries through inputs imported from abroad (14.5% '95 ->21.5% '07)

# What led to unprecedented wage restraint?

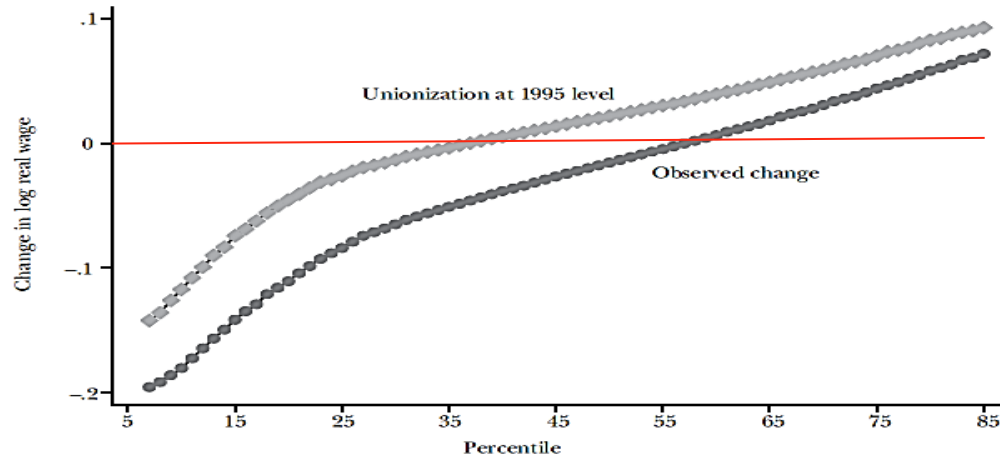
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- ▶ Institutions: allowed for decentralization of wage setting process, from industry- region-wide level to the level of the single firm
- ▶ Governance structure of the German system of industrial relations: not rooted in legislation and not governed by the political process, but laid out in contracts and mutual agreements between trade unions, employer associations, and works councils

# What led to unprecedented wage restraint?

- ▶ Driven by two main developments:
  - » Sharp decline in share of workers covered by union agreements ('95: 67%; 08: 41%)

Observed versus Counterfactual Wage Growth between 1995 and 2008 along the Wage Distribution: The Role of De-unionization



# What led to unprecedented wage restraint?

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- ▶ Driven by two main developments:
  - » Sharp decline in share of workers covered by union agreements
  - » Increase in opening clauses that strengthened the role of firm-based works councils in wage determination relative to trade unions
    - Among industry-wide collective contracts in manufacturing, < 5% involved opening clauses in 1995, but 60 percent in 2004.
    - 75 percent of all firms in 2005 with collective agreements use opening clauses

# What Led to Greater Flexibility in the German Labor Market?

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- ▶ Extraordinary cost of German Unification
- ▶ Opening of central and eastern European countries: unique opportunity for German industry to move production abroad
  - » This “threat” changed balance of power between unions and employers and strengthened work councils

# What was the Role of the so-called “Hartz Reforms”?

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- ▶ Reduced and limited the benefits while unemployed, liberalized agency work, reformed “active” labor market policies, and reorganized the Federal Labor Agency
- ▶ Did not induce any institutional changes in the wage setting process or impacted directly on competitiveness
- ▶ Implemented in 2003, nearly one decade after process of wage decentralization and the improvement in competitiveness had begun

# Lessons for Europe

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- ▶ Hartz Reforms: alone are not essential nor sufficient to improving competitiveness
- ▶ Important: Decentralisation of wage setting while keeping employees involved
- ▶ Far harder to achieve in many European countries, as changes can be made only through political process



# The Role of the Euro

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- ▶ Germany was improving its competitiveness during the mid 1990s, long before the euro started (1999).
- ▶ Within the common currency area, and after 2001, Germany continued to gain competitiveness
- ▶ Euro has persistently appreciated against the US dollar
- ▶ Unlikely that Deutschmark would have appreciated much more against dollar before around 2008

# The Great Recession

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- ▶ When the Great Recession started, Germany was in an unprecedented competitive position, with established trade links “ready to go”.
- ▶ Germany’s export markets were not much affected by the crash in the housing market, neither was Germany, and it was only a question of time for these markets to recover
- ▶ That let to Germany to experience a deep but short recession: Germany was the first country to get out of recession (Q2 2008 - Q1 2009), long before e.g. the UK (Q3 2009 and Q2 2012)

# The Great Recession

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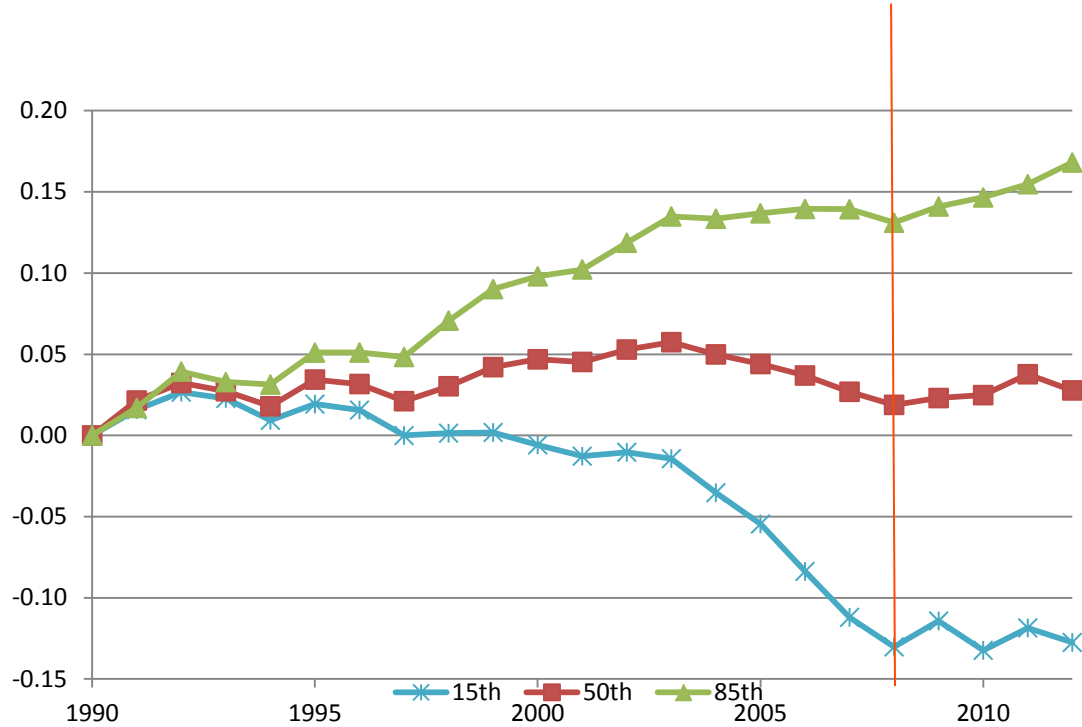
- ▶ A distinctive feature of Germany's recession experience was that unemployment hardly increased
- ▶ This was achieved through a tripartite deal to distribute the burden of employment reduction on workers, employers, and tax payers
- ▶ Could only work if the recession is short
- ▶ The key for these agreements were the unique collaboration between Policy Makers, Unions, and Industrialists

# Conclusions

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- ▶ Germany is an interesting case study when evaluating the Great Recession
- ▶ Its labour market institutions, characterised by independence from the political process, and strong collaborative tradition, were an essential feature for the development of Germany's competitiveness

# Men, 20-60, Real Daily Gross Wages



# Men and Women, 20-60, Real Daily Gross Wages

