

Euro Economy

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What can Germany learn from Thatcherism?

The following is an edited version of an address given by Jonathan Hoffman on 26 January to the 2nd Berlin Conference of the German-British Forum¹ and the British Chamber of Commerce in Germany². The subject of the Conference was “*What can Germany learn from Thatcherism?*”

Thatcher’s lessons have not been lost

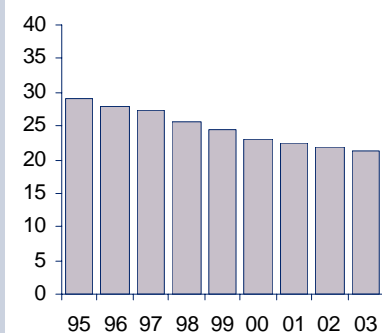
The lessons of the Thatcher era -- which brought deregulation, privatisation and a reduction in the powers of the trade unions to the UK some 20 years ago – have not been lost on other countries. Europe in general, and Germany in particular, have been attentive pupils. Europe’s Lisbon Agenda aims to boost growth via the classic Thatcherite methods of deregulation and greater economic flexibility. It stands in sharp contrast with previous European initiatives, notably some during the Delors era, for example with the 1989 Madrid Economic Summit which adopted the Social Chapter.

Moreover Germany has a radical (that’s not too dramatic a word to use) programme of economic liberalisation (Agenda 2010, including the Hartz reforms), including tax reform, cuts in pensions and entitlements for the unemployed and an increase in the minimum size of a business in order for it to be subject to the laws on the conduct of dismissals. In some respects, Germany has gone even further than the UK. For example from the beginning of this year, the public pension in Germany is numerically linked to the dependency ratio. If there are more old people in the population, the pension payment will fall automatically. Almost all countries face the same pensions ‘timebomb’ as Germany, but (to the best of my knowledge) no other country has made this direct linkage.

It is also the case that global economic trends are amplifying and reinforcing the German reforms. For example, Baroness Thatcher curtailed the powers of trade unions and successfully resisted the miners’ strike in 1984/5. But in Germany, the move within the economy away from industry, which is highly unionised, and towards services, which are much less so, has substantially reduced trade union membership. Since 1998 the membership of the DGB national union federation has declined by nearly 12% to 7.7m (Chart 1). In summer 2003 IG Metall – Germany’s largest trade union – admitted defeat in an industrial dispute for the first time since 1954 (the 4 week strike, in eastern Germany, was in support of a three hour cut in the workweek to 35 hours, the same as in the West. But many workers ignored the call to strike, because orders had fallen and unemployment in the east had risen to 19%). Another example is the length of the workweek, which is rapidly increasing to 40 hours, from 35. The cause is not Thatcherite legislation – rather, it is the reservoir of cheap labour within

Chart 1: Germany: Trade union members

(% of employees)



Source: Confederation of trade unions
 / RBS estimates

¹ www.gbf.com

² www.bccg.de

'In the last three years, cumulative eurozone growth has been just 3 per cent, Italy's 2.5 and Germany's just 1 per cent, compared with 5.5 per cent in the US and 6 in the UK. Latest data show domestic demand in the eurozone has all but stalled, with negative or stagnant growth in Germany, Italy and the Netherlands. ... It is the weakness of EU growth that lies at the root of the [global] imbalances. The eurozone has grown by 3 per cent or more in just one of the last 10 years, while the US has averaged more than 3 per cent. This EU growth problem makes a new commitment to urgent and fundamental reform essential. Reform of the stability pact is essential if the EU is to have the stability it needs and make its contribution to a more balanced and sustainable global recovery. But reform of the pact is not sufficient to sustain EU growth over the medium term. Nor will it be enough to respond to the new challenges of globalisation that are forcing economic reform as global restructuring gathers pace. That is why the EU must now also set a new and more urgent timetable for specific and credible reforms to complete the single market; ensure that competition policy becomes genuinely independent of politicians and pro-actively focused at driving up competition; set a new target for reducing state aids and for reorienting future aid to market-oriented causes - supporting research and development not loss-making subsidies; and break down the barriers to better trading relationships with the rest of the world. Only by rejecting the old trade-bloc Europe - inward-looking, inflexible and sclerotic - and wholeheartedly embracing a global Europe - reforming, flexible, outward-looking and competitive - will the EU respond to the new challenges of globalisation'.

- Gordon Brown, FT 13 Sept 2004

the EU, in Poland, the Czech and Slovak Republics and Hungary, to which German companies can easily shift production if onshore labour costs fail to fall.

Do they know how much has changed?

Those who are most vocal in urging further Thatcherite policies on Germany – they have been called the 'Anglo-Saxon triumphalists' – often do not seem to realise how much has already changed. They place the blame for global imbalances in Europe, omitting any mention of the huge US current account deficit or the heavy undervaluation of some Asian currencies.

Such expressions of 'Anglo-Saxon triumphalism' have drawn some robust responses. For example, the UK's EU Commissioner Peter Mandelson used his first public appearance as a Commissioner (CBI Conference, 8 November) to criticise what he called 'exaggerated gloating'. "Today Britain seems to offer its own distinctive model of economic success [and] I'm proud over the country's economic record and achievement," he said. "But let's have no exaggerated gloating about that." He warned of the risks in adopting the Anglo-Saxon model wholesale: "We do need more American-style dynamism in Europe but without emulating the raw divisions of America's more polarised society".

Those who urge further Anglo-Saxon policies on Germany are vulnerable to other criticisms too.

The first is that 'one size does not fit all', in other words there are limits in transferring the Anglo-Saxon model to non-Anglo-Saxon economies. One obvious difference in the case of Germany is that relations between the government and the trade unions remain good. They have certainly not deteriorated to the same extent as was the case in the UK in the 1980s. For the sake of the economy, Baroness Thatcher had no choice but to confront Arthur Scargill's NUM in the 1984 miners' strike, and the NGA in 1986-87 in the News International dispute over the introduction of new technology.

The second is that in their anxiety to squeeze Germany into the Anglo-Saxon mould, they forget the important aspects of Germany's Constitution - included for valid historical reasons – which mean that the model can be only partly valid. Especially important here are the large size of the trade unions and the power of the Länder, the 16 provinces into which Germany is divided. Both were deliberate features of the new post-War Constitution, drawn up by Ludwig Erhard and others. They were designed to prevent or at worst neutralise a new Hitler. History tells us that it was the pre-War fragmentation of workers which was one of the main reasons why it was impossible to form a united front against the Nazis, and it was reasoned that strong trade unions would prevent that paralysis being repeated. And the Länder were given substantial powers in order to make the Federal government as weak as possible, reducing the damage that could be done by any future tyrant.

Both large trade unions and a weak Federal government make structural reform more difficult. For example, there have been a number of cases where the Länder have blocked privatisation (eg Lufthansa, blocked by Bavaria). And the deliberately weak centre is a very expensive way of doing things, with each Land having its own Parliament, police force, publicly funded party system and the right to its own broadcasting system. Some two-thirds of national bills require the approval of the State premiers sitting in the Bundesrat.

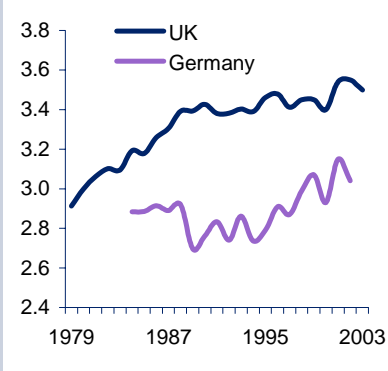
Unemployment and income inequality: two sides of the same coin

In their rush to dress Germany in Anglo-Saxon clothes, the 'triumphalists' miss other important points too. For example, they often observe how much lower unemployment is in the UK. Indeed, unemployment in Germany is more than double that in the UK: 9.9% (November) versus 4.5% (September) (on the ILO 'searching for work and available to work' definition).

However, high German unemployment is a sign of a problem which also exists in the UK, but which manifests itself in a different way. That problem is one of unskilled

Chart 2: Germany: Earnings inequality

(trends in wage rate dispersion D9/D1 ratio)



Source: OECD / RBS

workers. In Germany unskilled workers are unemployed, but in the UK they are likely to be 'working poor'. Look at this chart (Chart 2) which shows the difference between the 1/2 decile and 9/10 decile income borders in both economies. Income distribution in the UK has been consistently more unequal than in Germany. Which is better, higher unemployment or more unequal pay? It's impossible to say. It's a political judgment, to be decided at the ballot box.

It is also the case that Thatcherism did not solve the unemployment problem, though it did create jobs. Over the period 1982-90 for example, on average 9.7% of British workers were unemployed.

The 'triumphalists' also tend to forget the size of the burden of absorbing eastern Germany. Reunited Germany has successfully absorbed 18m people from the impoverished ex-communist east. Although the burden of bringing standards of living in the east up to those in the west still absorbs about 5% of GDP each year, Germany's economy has still grown by 23% since reunification in October 1990.

Das Übertreffen?

And even though annual German growth has been slower than that in the UK ever since 1993, production per hour worked remains much higher. GDP per hour in Germany in 2003 was 2.7% above the EU (15) average, while in the UK it was 11% below (Chart 3). That is, output per hour in the UK was 13% below that in Germany. **With hours in many plants drifting back up to 40 from 35, it should not be long before the gap in productivity per person is closed (in 2003 GDP per employed person in the UK was just 0.6% above that in Germany, whereas average annual hours, at 1707, were 18.2% more in the UK).**

Remember the excitement in Italy when per capita GDP overtook that in the UK? It was called *Il Sorpasso* (but it didn't last). Now we could get *das Übertreffen!* (see Chart 4).

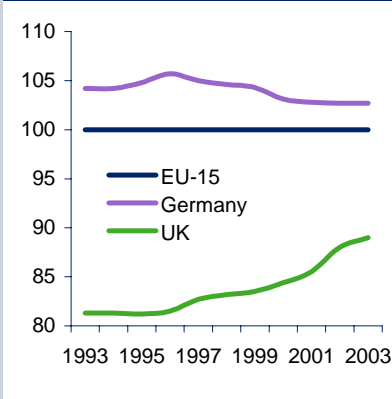
Germany's better human capital

Germany's higher output per hour is due to its higher human capital and greater physical capital per hour worked. The UK's physical capital per hour worked is 37% below Germany's³. Turning to human capital, Layard et al (*op cit*) estimate that approaching half the difference between British and German output per worker can be put down to differences in literacy and numeracy. Germany's vocational education remains well ahead of that in the UK. As Alfred Marshall, one of the founders of the economics profession, commented (1919, "Industry and Trade") "*All the world has much to learn from German methods of education*".

There has long been a legal obligation in Germany for all under 18, but not in fulltime education, to attend part-time vocational training. But in the UK it's voluntary. Ten years ago a series of studies (by some/all of Prais, Bierhoff, Jarvis, Steedman and Wagner) appeared in the Review of the National Institute for Economic and Social Research in the UK, comparing workforces in the UK and Germany. In one year – 1985 – the researchers found that the numbers qualifying in engineering and technology in Germany was double, at Master's level; 50% higher at Bachelor's level; 50% higher at technician level; and more than three times as high at craftsman level. They commented (NIER May 1993): '*when compared with the Continent it is the lack of training to craftsman-level – rather than a lack of University graduates – that forms the principal deficiency in Britain's education and training system.....there seems little doubt that the Continental approach to practical subjects at secondary schools remains more successful in preparing pupils of average and below-average attainment for subsequent specialised vocational training and for the practicalities of life.*' All in all, they found (Prais, NIER November 1981) that 60% of the German workforce had intermediate vocational qualifications, double the 30% in the UK.

Chart 3: GDP per hour worked

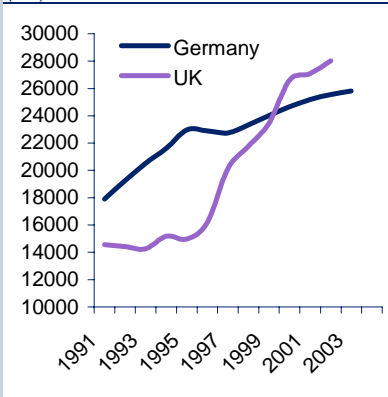
(GDP in PPS relative to EU-15)



Source: Eurostat

Chart 4: GDP per capita

(Eur)



Source: DataStream / RBS

³ Britain's Record on Skills, by R Layard, S McIntosh and A Vignoles, March 2001

The better qualifications of the German workforce were also detailed in Layard et al, *op cit* (Table 1).

Table 1: Qualifications

(% in 1998)

	At least degree	At least "A level"	At least "good GCSE"	Skills index (UK =100)
Germany	22	74	83	109
France	23	45	73	103
UK	24	36	55	100
US	22	29	50	97

Source: UK Department of Education and the Cabinet Office, note results for US are for 1994

Anglo-Saxon lessons for the Rhineland

So do the 'triumphalists' make any valid points? Are there remaining aspects of the Anglo-Saxon economies which Germany should emulate?

There are. For one thing, the ECB is less transparent than the Bank of England and the Fed in one important respect: it does not produce minutes. The risks of doing so, in terms of increasing pressure on Council members to vote according to national and not pan-European considerations, are far outweighed by the potential gains due to greater transparency.

For another, the Stability and Growth Pact needs reforming in the direction of the UK's 'Golden Rule', which makes the distinction between current and capital spending.

And the power of the Länder is an obstacle to necessary reforms, eg privatisation. It is surely time to move towards a directly elected Upper House, as in other European countries, and away from an Upper House comprising Länder representatives (the problem being, that the Länder representatives are never going to vote against themselves, as was shown in the collapse just before Christmas of the attempt at political reform). The sanctions regime of the SGP is currently under question, but if it is resuscitated, it would be sensible for the Länder to share in any financial penalty that is levied on Germany.

Finally corporate governance needs reforming in an Anglo-Saxon direction, notably to dilute or even terminate the *Mitbestimmung* system, by which all companies with over 500 employees must have one-third representation on their supervisory boards.

Possibly the main lesson for Germany from Thatcherism is that reforms can take time to produce results. Some of the Thatcher reforms took years to bear fruit, partly because in the UK macroeconomic stability was not achieved until well into the 1990s.

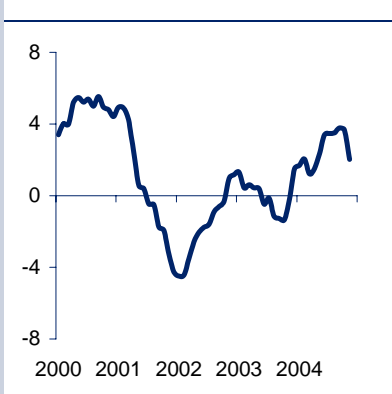
Conclusion

Structural reform in Germany is very much in the interests of other European economies. But there are limits to the extent to which Germany can become more 'Anglo-Saxon'. These limits derive from Germany's unique history which has shaped its institutions and from political choices. Attempts to squeeze Germany into a mould that does not fit properly will inevitably fail.

Major Data Releases

Chart 5: German IP

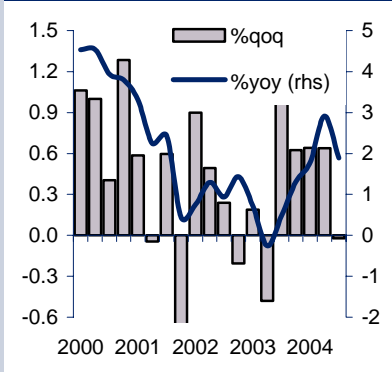
(% YOY)



Source: Datastream/RBS

Chart 6: French GDP growth

(%)



Source: Datastream/RBS

Germany: Industrial Production (December), Tuesday 8th February

Industrial production declined by 1.5% during November, led by a sharp drop in capital goods output. But survey evidence suggests that the downturn was temporary: the output sub-index of the PMI rose by 3.2 points in December, to 52.4, signalling a renewed firming in activity. Export performance remains very favourable (Germany was the world's biggest exporter - of goods - last year), despite the still relatively strong euro, thanks to a combination of offsetting cost cutting measures by companies (they have been particularly successful in containing wage growth) and the strength of overseas demand. As a result, exports remain a huge source of support for the industrial sector. Moreover, there is no sign of this fading: the export orders index of the PMI rose from 52.2 in December to 54.8 in January, the highest since September.

Germany: Trade Balance (December), Thursday 10th February

Export performance remains extremely favourable, despite the still relatively strong euro, for the reasons mentioned above. Exports rose by 9.0% yoy (3mma) in November, off the peak of 12% reached in mid-2004, but still at a healthy clip. This, and a reduction in the oil import bill (euro-denominated oil prices declined by 10% in December) should have led to a small increase in the trade surplus in December.

France: Industrial Production (December), Thursday 10th February

Industrial production rose by a paltry 0.1% during November, after falling by a revised 0.8% the previous month. However, the increase in the output index of the manufacturing activity PMI in December (and again in January), combined with positive anecdotal evidence from the auto sector, point to a renewed strengthening in manufacturing in December, even though some of the recent strength in retail spending was no doubt met from inventories.

France: GDP (1st estimate, Q4), Friday 11th February

Growth ground to a halt in Q3, after a very strong first half when it was fuelled by robust household spending and a buildup in inventories as well as some dynamism in public spending. But growth rebounded strongly again in the fourth quarter, thanks to renewed vigour in consumer spending (+2.1% qoq) and some recovery in business investment. Data and surveys released so far for 2005, and economic fundamentals, suggest that the economy's performance in 2005 will be similar to H2 2004, with growth expected to be close to 1.7%.

Time	Country	Indicator	Period	Adjust	Measure	t-2	Prev	Forecast	Median
Sunday 6 February									
	US	Fed. Chairman Greenspan speaks on "Adam Smith" at Adam Smith Memorial Lecture (Fife)							
	ASIA	Asia-Pacific central bank governors meet to discuss regional and global economic issues (Hong Kong)							
Sunday 6 February to Monday 7 February									
	GER	Public service union and government meet for first round of wage negotiations							
Monday 7 February									
09.00	ITA	PMI – retail	Jan	sa	Index	43.4	46.7	nf	nf
09.00	FRA	PMI – retail	Jan	sa	Index	47.8	49.0	nf	nf
09.00	GER	PMI – retail	Jan	Sa	Index	51.2	54.8	nf	nf
09.00	EUR	PMI – retail	Jan	sa	Index	48.0	50.6	nf	nf
	EUR	Chairman of EU Finance Ministers Juncker meets French President Chirac, EU budget rules on the agenda (Paris)							
	EUR	European Monetary Affairs Commissioner Almunia speaks (Madrid)							
	US	Budget for fiscal year 2006 released							
Tuesday 8 February									
11.00	GER	Industrial production	Dec (p)	sa	mom	0.4	-1.5	0.7	1.0
					yoy	2.3	-0.5	0.4	0.7
		Ex-construction	Dec (p)	sa	mom	0.4	-1.5	0.7	nf
					yoy	3.0	0.1	1.3	nf
		International Energy Agency monthly oil market report (Paris)							
Wednesday 9 February									
Thursday 10 February									
07.00	GER	Trade balance	Dec	nsa	Eur bn	12.6	11.9	12.0	12.0
07.50	FRA	Industrial production	Dec	sa	mom	-0.8	0.1	0.5	0.5
					yoy	1.3	2.1	2.3	2.3
07.50	FRA	Manufacturing production	Dec	sa	mom	-0.8	-0.3	0.4	0.5
					yoy	2.3	2.6	2.7	2.7
09.00	EUR	ECB: Monthly Bulletin							
12.00	UK	BoE rate announcement							
		International Energy Agency monthly oil market report (Paris)							
Friday 11 February									
07.50	FRA	GDP (1 st estimate)	Q4	sa	qoq	0.6	0.0	0.5	0.6
					yoy	2.9	1.9	1.8	1.8
13.00	EUR	ECB Governing Council Member Caruana makes closing speech at the New Economy Forum (Madrid)							
	US	Fed. Board Governor Bernanke speaks before the Stanford Institute of Economic Policy Research (Palo Alto)							

(US forecasts provided by RBS Greenwich Capital)

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