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Policy

Strategy & Business ...Booz, Allen & Hamilton

Whither Germany? Whither Europe?

An Interview with Prof. Norbert Walter

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By Joel Kurtzman

A Conversation With Prof. Norbert Walter,
Chief Economist
Deutsche Bank Group

For nearly four decades, Germany was the miracle economy. Unemployment was low, inflation barely registered and growth was steady. With one tough central banker after another, and a Government that eschewed red ink, Germany was the world's benchmark with respect to monetary and fiscal policy. It was also something of a maverick economy. While multinationals took root in Britain, the Netherlands, Sweden and France, Germany--with its myriad high-quality, middle-sized producers--remained primarily an exporter. This was so much the case that in dollar terms, Germany sent more of its goods abroad than any other country, including the United States and Japan. About 60 percent of Germany's exports went to other European Union countries.

But beginning in the early 1990's, something changed. The German economy, as the saying goes, fell to earth.

One reason, of course, was the unification of the east and west portions of the country. Not only did people's savings have to be converted from East German marks to German marks--at very favorable terms--but factories had to be closed, workers had to be trained in the latest business practices and investment had to flow.

Then there was the global downturn that began around 1991.

Under the strain, the German economy sputtered. Unemployment rose to about 10 percent, budget deficits increased and growth went negative. In 1993, the economy contracted by 1.3 percent before becoming positive again in 1994. But 1995 was a lackluster year, with the G.D.P. growing at just under 2 percent, and most forecasters expect 1996 to be slower still.

All of this would be difficult enough--even for a powerhouse economy like Germany's--without the added pressure from the Maastricht Treaty. This treaty, which is to go into effect in 1999, calls for the establishment of the European Monetary Union. The EMU, as it is called, will do for the EU what the Federal Reserve did for the United States. It will create a single currency, the euro; establish a single central bank, to be based in Frankfurt, and require the coordination of the fiscal and monetary policies of all participating countries.

But unlike the Federal Reserve Act, which created a single currency for the United States through an act of Congress, the EMU is a membership organization with extremely high entrance requirements. Countries must meet those requirements beginning in 1997. No country may join, for example, unless its budget deficit is less than 3 percent of its G.D.P. Countries must also put their monetary houses in order. Their inflation rates can be no higher than 1.5 percentage points above the average rate of the three European countries with the lowest inflation numbers.

The clock is ticking on Maastricht and so far the only EU country that qualifies for entrance into the EMU is Luxembourg. All of the others that have expressed their intention to join, including Germany, have fallen short in some respect. In some cases, the problem is inflation. In others, it is the budget deficit. In fiscal 1995, Germany's deficit overshot the Maastricht criteria by seven-tenths of 1 percent, a significant miss for a country known for its fiscal discipline.

So whither Germany? And what effect will its future have on the rest of Europe?

To find out, the editors of Strategy & Business asked Prof. Norbert Walter, chief economist of the Deutsche Bank Group. Professor Walter, who is also managing director of Deutsche Bank Research G.m.b.H., is one of Europe's leading economic analysts and forecasters. He has written extensively about European economic integration, Germany's economy and the restructuring of the economies of eastern Europe. Before joining Deutsche Bank in 1987, Professor Walter held senior positions at the Kiel Institute of World Economics in Kiel, Germany. In 1986 and 1987, he was John J. McCloy Distinguished Research Fellow and resident scholar at the American Institute for Contemporary German Studies at Johns Hopkins University.

Professor Walter spoke to Strategy & Business during a recent visit to Washington.

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S&B: A decade ago, economists talked about "Eurosclerosis." By that, they meant that the continent was unable to solve its high unemployment and slow-growth problems. Now they are using that term once again to refer to the continent and specifically to Germany. Is Germany losing its competitiveness?

> **PROFESSOR WALTER:** A cynic would say that in Germany nothing is as cyclical or as predictable as the debate over the country's decline. The topic comes up about every 10 years. But this time the debate has taken only three years to re-emerge.

S&B: Why has the debate been rekindled so soon?

> **PROFESSOR WALTER:** Part of it has to do with the Maastricht Treaty. Complying with the treaty's criteria has produced a fiscal drag on the economy. This has created a dampening effect on demand in the short to medium term and has extended the cyclical downturn of the economy. This has brought to light some of the deep structural deficiencies in the German economy in general.

S&B: What deficiencies are you referring to?

> **PROFESSOR WALTER:** Most of Germany's economic wounds are self-inflicted. It has a social welfare system that is extremely costly and is clearly not sustainable at its present level. It has a system of supporting old economic structures through subsidies and Government guarantees. These are supported by the taxpayers. As a result, the tax and contribution system in Germany is actually taking money away from productivity. Price increases versus value-added are lower than they should be. This has very negative effects on productivity since the result of the subsidy system is that we are producing services and goods that are not really very much in demand on global markets.
>
> Let me give you an example of what I mean. In Germany we are subsidizing coal mining, shipbuilding and agriculture rather than helping build up the service sector in general or those segments of industry where we are really competitive, like pharmaceuticals, high-tech products, cars, machinery and capital goods and products oriented toward the protection of the environment.

S&B: These subsidies contribute to Germany's cost and productivity problems?

> **PROFESSOR WALTER:** Yes, but that is not all. There are other areas where Germany's costs are simply too high. Some of these result from overregulation, which has a limiting effect on productivity. For example, the construction sector is very expensive in Germany. The Government demands fire doors in houses and offices that could probably withstand a nuclear blast. Now that is just not necessary. It is what I call unnecessary quality. Engineers come up with standards and then there are Government regulations put in place and the consumer is never asked. That adds to the overall cost structure in Germany.

S&B: The Government, as service-provider and tax collector, accounts for a large share of gross domestic product in Germany. Is its share too high?

> **PROFESSOR WALTER:** Yes, it is. In the United States, the Government's stake in the economy is about 40 percent of G.D.P. In Germany, 52 percent of G.D.P. is accounted for by the Government. That is too high.

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S&B: What about the cost of labor in Germany?

PROFESSOR WALTER: Fringe benefits equal 80 percent of wage costs. In some companies, fringe benefits are even greater than the regular wage costs. Germany is in the top tier of countries in Europe when it comes to these costs. Denmark and Sweden have trimmed their costs. Switzerland has higher wage costs but lower fringe benefits. Other countries are beginning to move in the right direction, but Germany is on the top if you add the cost of fringe benefits and wages together. I don't have to tell you what that does to competitiveness.

S&B: Are you advocating trimming wages?

PROFESSOR WALTER: No. The wage component is not something I worry too much about. You can defend the present wage level. But you cannot defend the present wage and fringe benefit levels if you take them together.

S&B: So you are satisfied with the present wage levels in Germany?

PROFESSOR WALTER: Well, I would argue that the wage system for skilled workers is not sufficiently bonus-oriented. The way people are paid is part of the problem.

S&B: Unions are powerful in Germany. Would they go along with a new emphasis on bonuses?

PROFESSOR WALTER: Unions don't have a say over bonuses. They have power that transcends wage-level discussion because they are part of the political debate and the overall decision-making process. They are also part of business's decision-making through co-determination. It is very much of a consensus-oriented system and as a result there are few strikes and a very low level of labor unpredictability. Unions also have a say in what Government does. They have an important say in what the Social Democratic Party is going to do and with some factions in the Christian Democratic Party. They are listened to and they form one of the best lobbying bodies with respect to Parliament. They are very influential. But they don't have a say over bonuses.

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S&B: With the strength of the unions, can German companies trim their work forces?

PROFESSOR WALTER: There has been a shift because of the extreme economic pressure that is on Germany. For the first time, companies are exposed to international pressure and, as a result, considerable downsizing is now possible. We have also had a series of big experiments in eastern Germany so we now have experience in downsizing and in cutting off some production lines altogether. The production of the Trabant [a small-sized car made in the east] was discontinued, for example. The chemical industry in the east was slashed to something like 20 percent of its former size over the last five years. We have downsized the lignite coal industry to one third of its size.

So there is the possibility to downsize under very clearly defined circumstances. But if a problem is regionally concentrated--like coal, shipbuilding and steel--we will have difficulty. We will have much greater success where the industries are spread over the country.

S&B: Change is always difficult.

PROFESSOR WALTER: It is. Take, for example, retailing. There is a marvelous coalition between the trade union and the employers in this area. They lobby together to defend the shop-closing rules that limit the hours a shop can be open. This is clearly not in the interest of the consumer. But Germany is still--in some ways--very guild-oriented. There is a guild structure in retail trade, and there is a guild structure with respect to doctors and lawyers. The guilds determine the number of students allowed to study medicine, for example. This keeps prices high.

S&B:: You have described a very rigid system. Are there any challenges to the system?

PROFESSOR WALTER: There are several challenges to the system.

First, the EU is increasingly the provider of something that I believe is very good--competition. Without the EU and the courts, there would be even more protection than there is today. There would be no open-skies policy for European airlines, for example. Without the EU, there would be no allowances for competition with regard to electrical utilities. Without the EU, the level of subsidies would be far greater, I believe. Without the EU, entrance into the European telecom, government procurement and defense sectors would be even more limited. Since all politics is local, it is impossible for a German politician to speak out against coal subsidies. But the EU can do it. So it is important to have Brussels' influence in the economy.

Next, there is pressure for privatization of public services, which is coming from eastern Germany. Let me give you an example. There is still a huge job to do in eastern Germany with respect to the infrastructure. Our politicians have lots of work ahead of them. But they have limited tax revenue because the economy there is not fully functional yet. So they are unable to do their job without going in the direction of privatization, which is good. They must create public-private partnerships to repair the sewage system, for example. Because there is not much of a tax base yet, they must resort to public-private partnerships to rebuild the reservoirs and water system. Privatization in eastern Germany will come and it will be positive. Now if western Germany examines what is happening in the east and realizes that private firms can provide public goods, western firms will copy that model. I think that will be very good.

Finally, I think there is hope for a new political coalition in Germany. This will happen because many people are in fact being kept out of the system. You can't really fire people and there is also a need to downsize many industries because of labor costs. All of this comes at the expense of the young. This is true in Europe in general and it is also true of Germany. In Germany, there is a very long and inefficient apprenticeship program. The program really serves to park people rather than to give them the appropriate skills. Because of this program, youth unemployment is not as high in Germany as it is in France or Italy. Even so, young people find jobs only with great difficulty. These young people understand that the older generation is not taking care of their interests. My hope is that they will enter into the parties and unions and change things. They have no interest in preserving the present, rigid structure.

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S&B: Will some of these young people become entrepreneurs?

PROFESSOR WALTER: Some, but not many. It is still rare in Germany. When I was young, anyone considering becoming an entrepreneur was considered crazy. About the only entrepreneurial occupation at the time was to become a dentist. It has changed, but not by much. I mean you are not considered an outlaw anymore if you start your own business. But the numbers are small. It's not yet in the German mentality. I am in favor of it, however.

S&B: What has to be done to create an environment more conducive to entrepreneurship?

PROFESSOR WALTER: There are a number of obstacles in our society. As I said, there is the overregulation of society and there is also the notion that if you failed once, you are basically dead. As a society, we are very risk averse. In addition, the infrastructure of entrepreneurship is not there. Venture capital, for example, hardly exists. And the concept of risk-related investments is not a German concept. In Germany, investors try to have absolute guarantees for their investments. In addition, parents are not willing to give their children a start. So entrepreneurship is not very common. That stands in the way of a more vigorous economy.

S&B: What other forces will propel the German economy into the future?

PROFESSOR WALTER: Germany has a real competitive spirit. We don't appreciate losers and if it is demonstrated that what we are doing will make us losers, we will change. We have the "Boris Becker" mentality and we are very competitive. When you are down, you try much harder.

You know, the problems at Daimler-Benz, with its big losses, really shocked people. People in Germany just don't believe it yet. What I wonder about is whether this company's example will create the spirit of a new beginning. I don't feel it yet. But I think there will be very positive reactions.

S&B: Are there examples of adversity bringing out the country's competitive spirit?

PROFESSOR WALTER: Daimler is building a new sports roadster in Alabama. The project team in Alabama is not just important for its own sake; it is having a major impact on the company internally. For example, there is the perception that the people in Alabama are having a lot of fun. They are very forward looking, they are working like hell, but they have the sense that they are doing something that is very promising, very successful, very attractive for the company as a whole. They have a real spirit and everyone is watching them.

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S&B: Are there other examples of change?

PROFESSOR WALTER: Yes. BMW shocked people by setting up production in South Carolina. In fact, I remember in 1990, the chief executive of BMW said that he thought that you could not build a BMW elsewhere in Germany--only in Bavaria! Now they are building them in North America. That is quite a changed perspective from one of our flagship industries.

Of course, there is also negative fallout from these activities and there are conservative elements in the churches and in the Social Democratic Party that argue that these firms should not be allowed to close down at home and open up elsewhere. These elements have a lot of emotional support.

S&B: For decades, Germany was the economic engine of Europe. Is that still true?

PROFESSOR WALTER: Germany was the locomotive of Europe, but now it is a drag on Europe. It is dragging Europe down and probably will continue to drag it down for some time. The risk is that Germany's problems will endanger Europe's dynamism and integration efforts. It may endanger the enlargement of the institutional setup in Europe, such as the creation of the monetary union and other institutions like security arrangements and trade functions.

Therefore, I fear that the problems of the German economy may cause a call for renationalization that will spread throughout Europe. If that happens, and Europe loses its momentum, we could be on a dangerous course.

People now openly speculate whether Germany and France will make the Maastricht targets in '97. If they do not, what will other countries think? Will they keep their currencies strong if France and Germany don't? I don't think so. A great deal of progress will unravel.

If that happens, we will lose a decade, I am afraid, before the momentum of integration will resume.

S&B: What will enable Germany and Europe to regain their momentum?

PROFESSOR WALTER: I don't think that Europe will recover its momentum without external help. If the dollar remains strong, it will allow Europe to recover and that will put us back on track. Only then will we achieve the Maastricht criteria. The only scenario in which the European countries achieve convergence is if the dollar is high and Europe gets its act together.

So you asked if Germany is Europe's locomotive. The answer is no. The United States is Europe's locomotive.