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Germany keeps dancing as the iceberg looms

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One must welcome the economic stimulus package decided by the German government last week. Germany has the potential to become a new motor of growth in Europe. Unfortunately, the structure of the programme poses the risk that Germany will recover at the expense of its European partners rather than helping all member states to grow.

The German stimulus amounts to €50bn ($66bn, £45bn) over two years. This represents 1 per cent of gross domestic product per year – a size slightly below, but comparable with, measures in other large countries. Of the spending, €18bn will be on investment. Given that public investment has been on a downward trend for years, most of it going to east Germany, there are huge opportunities to bring public infrastructure back to the standards of productivity that used to characterise the "German model".

However, the immediate effect on private consumption is weak. A person with an annual income of €25,000 will be able to spend an extra €136.67. A Keynesian stimulus alone was not palatable to supply-side-oriented German "ordo-liberals", the high guardians of the German social market economy. They sought to strengthen German competitiveness. Most importantly, payroll taxes and social insurance contributions were cut with the aim of reducing wage costs. In an economy dependent on manufacturing for the world market, that seems reasonable. However, there comes a point where improving one's competitive advantage becomes malign. Germany has now reached this point.

Unit labour costs are the most important factor in determining competitiveness. They measure average labour costs – that is, wages, social contributions and other statutory expenditures – per unit of output produced. A country with low unit labour costs is likely to export more, yield higher profits and attract foreign investment.

German unification and the European exchange rate crisis in the early 1990s caused a serious overvaluation: in 1996, German unit labour costs were 12 per cent above the eurozone average, while they stood in Ireland at 26 per cent and in Italy at 20 per cent below the average. Ireland used this comparative advantage for economic catch-up, Italy wasted the opportunity, Germany suffered. Subsequently, supply-side reforms did bring labour costs down. By 1999, when monetary union started, German costs were again at par with the euro area. But wage restraint continued. Today Germany is by far the most competitive economy, with unit labour costs 13 per cent below the eurozone average, while Portugal is the most expensive member (23.5 per cent above average), followed by Spain (16 per cent), Greece (14 per cent) and Italy (5 per cent). Ireland is average.

Germany has achieved this turnround by a mix of wage restraint, payroll tax cuts and a moderate increase in productivity. Southern eurozone countries have indexed wage increases to domestic inflation rather than the European Central Bank target, and have experienced a stagnation in productivity.

The consequences have been dramatic. Germany is growing again – but at the expense of its neighbours. Its trade surplus with partners in the European Union has more than doubled over

the past decade and amounts now to more than 5 per cent of GDP. At the same time intra-European trade balances have deteriorated for all of Germany's immediate neighbours.

This development must stop. Competitive tensions are increasing rapidly and could soon reach the tipping point where the euro and the single market fall apart. The gleeful policy consensus in Berlin ("We are world champions in exports") resembles the last dance on The Titanic, moments before it hit the iceberg. Wages are the missing variable in the economic rescue packages. Even the European Commission seems to be ignoring them. German wages must go up and stimulate consumption. That would benefit Europe. But in the south, wages must be restrained and investment must improve productivity.

Ten years ago, the German EU presidency set up the Macroeconomic Dialogue, aimed at making wage developments compatible with macroeconomic policies in the euro age. It brought trade unions, employers, finance ministers and central banks together. It has failed, probably because of its confidential nature. Openness and transparency are needed to "Europeanise" wage setting. It is high time to rescue and reform this policy tool, if Europe wants to avoid an even more severe crisis.

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