STEVEN BELL LOOKS AT THE FALL AND RISE OF GERMAN COMPETITIVENESS AND EXPLAINS THE IMPACT OF THE RESTRUCTURING PROCESS.

Germany: the sick man of Europe stirs

The regular meetings of Deutsche Asset Management's senior investors to discuss the issues affecting financial markets are not usually exciting affairs. But there was an exception two years ago. One of the big topics was the impact of the prospective new members of the European Union. I argued that this might be a massive event for the new members but that the impact on the existing members would be small. After all, the additional 10 countries would add only 5% to the EU's GDP and they were already well integrated in terms of trade and investment following the collapse of communism more than a decade ago.

But my Frankfurt colleague Georg Schuh, Head of Asset Allocation, disagreed. He said that my statistics might be right but that my conclusion was wrong, at least for Germany. I was ignoring the enormous psychological impact on the attitudes of workers and companies. The long and painful process of restructuring had already begun in Germany, he argued, but accession would give it a further big boost. Radical change was under way. I was genuinely surprised. I shared the consensus view that Germany was inflexible and slow to change. The extent of change at the corporate level, and the associated costs and benefits, is now clear. My colleague was right.

Germany used to be one of the most admired economies in the world. What went wrong? The basic problem was that the social welfare system was pushed too far even when unification required the opposite. East Germans had much lower productivity but were given similar wages and social security benefits to West Germans.

Unification was an extraordinary achievement but it involved enormous financial costs. As a general trend since the 1960s, German wage costs were raised by repeated reductions in the working week and increased taxes and social security contributions. Between 1980 and 1992 real labour costs per unit of output rose by 42% (see *Figure 1*). This led to a huge profits squeeze. Some companies went out of business and those that survived did so by closing marginal businesses, shrinking headcount, relocating abroad and outsourcing.

FLEXIBILITY More recently, some companies have negotiated an extension of the working week with their employees, reversing a 50-year decline. Siemens is the best-known example; the company made it clear that it would locate a new mobile phone plant in Hungary unless its German workers accepted increased flexibility and a longer working week. Other German companies, including household names such as Volkswagen and Daimler-Chrysler, have followed suit.

The effect of all this has been to reduce real labour costs per unit of output by 27% since the peak in 1992, and they are still declining by 3% to 5% a year.

Similar trends have been evident in other developed countries. Germany started restructuring later than the UK and US but has

Figure 1. German unit labour costs

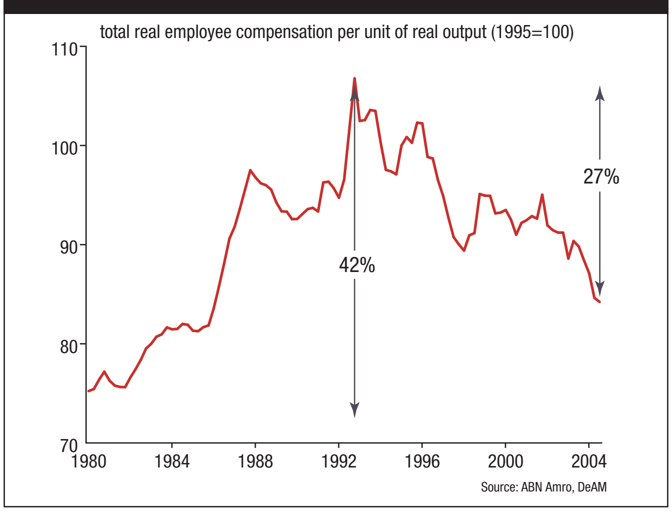


Figure 2. German consumer exports as a % of EU 12 total

recently been catching up and done much more than some other European countries, notably Italy. The impact of this on Germany's share of EU exports can be seen from *Figure 2*, which relates to consumer goods excluding transport (rather than capital goods or cars, which are normally seen as Germany's strong points).

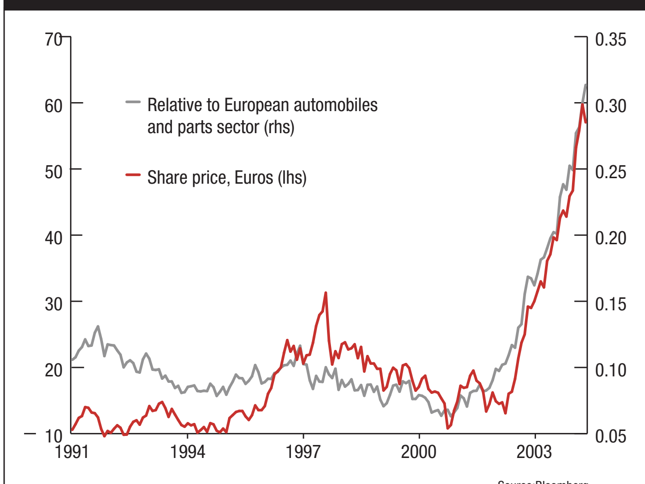
Germany's export success relative to other countries is also evident in the fastest growing market in the world: China. German exports to China have grown faster than those of the US, Japan and the UK on both a five-year and a 10-year basis (see *Table 1*). Germany supplies a remarkable 35% of China's car imports and its share of China's total imports in 2004 was 5.4% compared with a paltry 0.8% for the UK.

SHARE PRICES The fall and rise of German competitiveness may be clear from export data but the impact on the share prices of certain German companies has been even more dramatic. *Figure 3* plots the share price of tyre and car parts maker Continental AG in absolute terms and relative to its European sector. At the end of 1991 the company's shares were trading at the equivalent of €10. Fourteen years later they were at the same price. Since then they have risen more than fivefold. Continental's low point against its European sector was in 2001, when it was a third lower than in 1991, but it has since outperformed more than fourfold. Continental may be an extreme example, but many German companies exhibit a similar profile in qualitative terms.

This restructuring process has had its downside. Company share prices and exports may have been boosted but the cost in terms of weaker domestic demand, higher unemployment and wider budget deficits has been high. The political fallout has been heavy. Chancellor Schroder has pursued much needed reforms to the labour market and tried to reduce taxes and limit public spending. But he has lost much political support. Many commentators have taken a very negative view of German companies' focus on shareholder value and leading members of Schroder's party, the SDP, have criticised share buybacks and hedge funds. The party chairman even described private equity firms as "locusts", according to the *Financial Times*.

REALLOCATION To an economist, restructuring represents a more efficient reallocation of factors of production. Output and economic welfare should eventually improve after a period of temporary weakness. But even in countries such as the UK and US, which have

Figure 3. Share price of Continental AG



Executive Summary

- New members of the EU have had an enormous psychological impact on the attitudes of German workers and companies.
- Between 1980 and 1992 real German labour costs per unit of output rose by 42%.
- Germany started restructuring later than the UK and US but has recently been catching up and has done much more than some other European countries.
- The fall and rise of German competitiveness may be clear from export data but the impact on the share prices of certain German companies has been even more dramatic.
- Equity investors are now highly sensitive to any signs that a previously moribund company is set to initiate restructuring.

Table 1. CHINESE IMPORTS BY COUNTRY

	Average growth rate %	
	Last 10 years	Last 5 years
Japan	13.6	22.8
Germany	15.5	29.3
US	12.3	18.0
UK	10.4	9.7

Source: JP Morgan

more flexible labour markets and began restructuring many years ago, the temporary rise in unemployment lasted for almost a decade. Some redundant workers were only re-employed at lower wages and some older workers never secured employment again. Reduced job security and higher unemployment depress consumer spending, exacerbating the effect of Germany's ageing population. Germany's generous welfare system may have cushioned the effect on demand initially, but persistent high unemployment has meant higher taxes and social security charges. Eventually, restructuring should lead to a more dynamic economy and a virtuous circle as unemployment declines and the fiscal deficit improves. This turnaround does not appear to be imminent; German restructuring is far from complete.

The investment implications of all this are unclear. Equity investors are now highly sensitive to any signs that a previously moribund company is set to restructure. We at Deutsche Asset Management are neutral on the German stock market overall. The impact at the macro level in terms of low inflation and low growth is well established. Since the introduction of the euro, Germany no longer totally dominates European interest rates but it remains the largest economy and presumably ECB interest rates have been lower as a result. These forces are likely to remain for at least the rest of this year. If and when Germany enjoys a vigorous economic upswing, interest rates and bond yields could rise sharply. But both may fall before then.

Steven Bell is Global Chief Economist at Deutsche Asset Management.
steven.bell@db.com
www.db.com