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Putting employment security first will diminish demand: A warning from Germany

by Heiner Flassbeck

The current global recession and fear of increasing redundancies has shifted the emphasis of the German labour movement from one concerning pay claims to employment security. Employment security has become the name of the game. Even the metalworker's union IG Metall is openly putting employment security before pay claims in their demands. So wage rises and hour cuts can be foregone, so long as not too many heads roll in the workplace.

I would like to argue that this emphasis is a serious mistake and that employment security achieved through wage restraint is likely to have negative effects across the economy and retard Germany's exit from the recession. While wage restraint may preserve jobs within a firm, this has knock-on effects that will only serve to deepen the recession through their impact on demand. The current crisis brings into stark relief the failure of unions in Germany to examine seriously the impact of working-time reduction and the associated wage reduction, or lesser wage increases, on demand in the economy as a whole.

Take, for example, what has become a classic case. The Daimler company goes into the red. So, in agreement with the unions, it makes a 10 per cent uncompensated cut in the hours of those employees who are not already on short-time working arrangements. The positive trade-off is that there are no redundancies. In effect, Daimler's wage bill for the 90,000 employees affected is reduced by 10 per cent. At an average monthly wage of €4000, that means the firm saves more than €400m. This represents a very significant reduction in Daimler's expected losses!

But for the economy as a whole, the sums look rather different. Assuming that Daimler workers maintain relatively stable purchasing patterns, the 400 million saved by Daimler will reduce demand for other firms' products by the same amount, as Daimler employees tighten their belts. In effect, the expected losses of other firms will increase by the same amount as the reduction in Daimler's expected losses. This simple example shows how the savings measure taken by one company and its unions will not spell out improvements at all, even at the outset. Further, if other firms who bear an increased burden from falling demand associated with Daimler's cut backs follow suit, this could have a disastrous and far reaching impact across the economy. Suppose the wages of the ten million employees in all of Germany's industrial workplaces werereduced by 10 per cent over the course of the next year. Once again assuming that the employees' saving habits remained unaltered, this measure alone would cut demand across the economy by about €50 billion.

What are firms in general going to do when they notice that their loss predictions are systematically wrong, because demand is continually weaker than anticipated? Go back to the unions again in hopes of negotiating a 20 per cent reduction? Firms may also try to maintain their market share at a time of falling demand by passing on the cost reductions as price reductions. If only one firm does this, the situation of all the others will get even worse. If they all do it, prices may fall by so much that the workers regain their previous purchasing power. So in real terms, they will be pocketing as much as before for working less. The outcome will then be not a cost reduction, but deflation. This is turn will lead to sluggish consumption, as people expect prices to drop even further in the near future.

So what are the unions to do? It has become a common perception that unions cannot go on making the same demands as they had prior to the crisis. I disagree and would argue that they can. In fact, campaigning for and winning wage increases in line with productivity gains can lead workers to act together to overcome this crisis quickly. The great majority of consumers in Germany are workers or pensioners. Only if they can expect their incomes to rise at the normal rate despite the crisis, i.e. in line with the medium-term productivity growth trend of

around 1½ per cent plus the European Central Bank's target inflation rate of 2 per cent, only then can Germany pull out of the crisis under its own steam.

Such a campaign is likely to be met with great objection as firms face shrinking profits and find themslves at overcapacity. It should however be remembered that many firms' profits skyrocketed in the years just before the crisis, particularly as regards foreign trade. Nonetheless, the logic of macroeconomic theory informs us of no alternative solution to the one outlined above if Germany wishes to exit the crisis and get on to a stable growth path in the not too distant future.

In contrast to previous experiences, hopes of export-led growth prompted by falling costs ring hollow this time around. The euro has already risen strongly. It would appreciate even further if the biggest national economy in the Eurozone staked everything on a foreign trade surplus, as it did from 2005 to 2008, thus relying on the other countries shouldering new foreign debt. Also, both consumption and investment are very weak in Europe and the US, Eastern Europe is still in deep financial crisis, and the countries of Asia are themselves going all-out for export surpluses.

It follows that there is only one reliable way out of the crisis. The state must once again, by contracting even greater debts than already planned, give the economy a boost that will enable firms to do the right thing in terms of wage setting for the economy as a whole. This would be the most effective way of boosting demand and accelerating economic recovery. Tax cuts, as planned by the German government, are not an appropriate way of achieving this. 15 to 20 per cent of the money will simply vanish into savings accounts, and the much-hymned "performance incentives" are simply a liberal pipedream.

In contrast to debates in Germany, the issue of wage-induced consumption effects has been recognised in the United States. This is evident in the agressive deficit policy currently pursued by the American government. In order to sidestep the wage reduction trap, into which a market economy will automatically fall without state involvement, the American deficit this year will be proportionately around three times bigger than the German one – about 12 per cent of GDP. Over there, they have learned from the experience of Japan, which for almost 20 years now has been unsuccessfully striving to escape from the deflationary wage policy that came into being after a great speculative bubble burst at the end of the 1980s. For Germany, the choices ahead are clear: Either it will learn the Japanese lesson now, or it will have to learn it in face of stagnation and deflation later.

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