

## **The Ifo Viewpoints 2007**

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### **Christmas Fear: Angela Merkel and Minimum Wages\***

As Christmas approaches pressure mounts to resolve the minimum wage issue in Germany. The conservatives weaken and agree to a comprehensive minimum wage of €7.50 an hour. This scenario is my Christmas fear.

Well-meant is not well done. Comprehensive minimum wages at the amounts being discussed will lead to mass unemployment. The alternative to minimum wages is not heartless neo-liberalism but a policy that ensures a minimum income via wage subsidies. If Hartz IV is reformed according to the proposal of the Ifo Institute, the German Council of Economic Experts, the Academic Advisory Council at the Federal Ministry of Economics and the Institute for the Study of Labor (IZA), there will be no one who can work, who is willing to work and who will fall below the Hartz-IV benefit level. And Germany will find its way back to full employment.

Minimum wages are of course harmless if they are low enough. If they are lower than the wage that is paid today for simple work, they have no effect on employment. Germany already has a minimum wage in the form of Unemployment Payment II (the former social welfare), since hardly anybody works for less than what the state pays for doing nothing. If the new minimum wage is under this level, it cannot destroy once more the jobs that have already been destroyed by the welfare state.

But such a low minimum wage is not what is under discussion today. If a minimum wage is introduced, the parties will debate how high it should be before every election. The left will make the highest bid, the social democrats will bid somewhat less and the conservatives will be constantly accused of heartlessness. Chancellor Merkel may succeed in closing the subject by making concessions. But this would mean that her successors would be confronted with this issue before every election. “Lost Leader”, as Newsweek called her, would be a fair evaluation.

That minimum wages that bind the market lead to major job losses is clear from international comparisons. In the United States, where only 4 euros is paid, the minimum wage is no problem because it is so low. Only about one percent of wage earners are affected. Similarly low (1.9 percent) is the share of wage earners in Great Britain that work to the minimum wage. Here too, the wage does not bind the market. It

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is very different with the high French minimum wage, which 15 percent of wage earners receive. It has ruined the labour market as much as the implicit minimum wage that the German wage replacement system creates. The burning French school busses have their origin in the minimum wage.

We also know about the job losses from the relevant studies for Germany. The Federal Statistical Office has calculated that one ninth of employees in the private sector in western Germany and a quarter of employees in eastern Germany earn less than €7.50 an hour. Thum and Ragnitz of Ifo Dresden and the Halle Institute for Economic Research (IWH) have used the official data to calculate how many jobs would be lost from the forced wage increases. Using the lowest empirically based coefficient for the percentage reaction of employment after a wage increase of one percent (-0.5), they reach the conclusion that in the medium term in western Germany 800,000 jobs would disappear and 300,000 in the east. These calculations are reliable, cautious and understandable for anyone.

And now there is also a study by Marion König and Joachim Möller, the new head of the Institute for Employment Research (IAB) in Nuremberg, which qualitatively says exactly the same thing (despite surprisingly defensive formulations, which have led to misinterpretation). The authors examined the effect of coverage extension of wage agreements in construction that was introduced in 1997. Since they could not examine the hours worked, they developed an estimation method that takes the resulting imprecision into consideration. While they found no significant effects for western Germany, they were able to show that the coverage extension led to a considerable loss of jobs in eastern Germany.

That the data for western Germany was insufficient for clarifying the issue is not surprising. Since the degree of unionisation was relatively high, the introduction of coverage extension did not lead to many more workers being bound by the wage agreement. And where nominally a few more were included, the coverage extension could easily be circumvented by an unobserved extension of working hours. This makes the results for eastern Germany all the more important. Since many employers left the employers associations – signers of the wage contracts – the effect of the coverage extension of binding wage agreements was greater and the drop in employment correspondingly higher.

This has clear implications for western Germany, since the other institutional features of the labour market are the same as in the east. The wage increase forced by the state was a unique, large-scale experiment on the effect wages have on employment under the

German legal conditions. The result of this experiment shows that without union wages, employment would also be higher in the west.

If Chancellor Merkel is not only interested in spreading Christmas cheer but also wants to do something truly positive, she should not agree to a minimum-wage compromise. Not Santa Claus but the devil is the instigator of minimum wages.

## How the Upswing Came About – Six Hypotheses\*

In the recent forecast of the economic research institutes, the German upswing will continue next year but will clearly weaken. The soft American economy is casting its long shadows.

The weakening of the German upswing raises the question of how this upswing came about in the first place. If we know the cause, we can perhaps keep the upswing forces going a little longer. Six hypotheses present themselves.

**Hypothesis 1:** The upswing is the work of Chancellor Merkel. This hypothesis is manifestly wrong, because Angela Merkel has completely reduced its budget deficit and has not pursued a supply-side policy. Whereas the deficit stood at 3.4 percent of GDP the year she assumed office, this year we expect a small surplus of 0.1 percent. The government has curbed the upswing, in other words. This, however, was the correct anti-cyclical policy, precisely as set out in the textbooks. The burden on future generations was not enlarged, and the government is in a position to respond when the next downturn comes.

**Hypothesis 2:** The trade unions displayed reserve, which led to the creation of new jobs. In fact, increases in nominal unit labour costs in recent years are clearly behind the rises in other countries. While the German unit labour costs increased from 1999 to 2006 by only 0.6 percent, the unit labour costs of the other euro countries increased by 15.9 percent, on average, which meant a relative lowering of labour costs in Germany of 13.2 percent. This has improved the competitiveness somewhat of the still very expensive German worker. However, credit for this is due less to the trade unions than to generally low inflation and to Agenda 2010. This leads us to the next two hypotheses.

**Hypothesis 3:** Germany has had a lower rate of inflation than the other euro countries and has become more competitive overall. Economists call this a real devaluation. In fact, measured in terms of the GDP price index in the euro area from 1999 to 2006, Germany experienced a devaluation of around 11.4 percent (10.9 percent on a trade-weighted basis). This is the main reason for the slow increase in German unit labour costs. It also means that only about 2 percentage points of the advantage from a

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decrease in unit labour costs vis-à-vis the other euro countries (13.2 percent) is explained by real wage restraints.

**Hypothesis 4:** Agenda 2010 is working. Schroeder eliminated Germany's second-tier unemployment assistance for one million people in the west and another million in the east, making the people essentially into social welfare recipients. In addition he reduced the duration of the first tier unemployment benefit for older employees from 32 to 18 months. This all lowered the implicit wage claims that were defined by wage replacements and brought some movement into the wage front, which also contributed to the job miracle of the past two years. We still cannot quantify the effects. An indication for the correctness of the hypothesis, however, is that employment of employees over fifty increased by 4.9 percent in 2006, whereas for all working-age groups the increase only amounted to 1.6 percent.

**Hypothesis 5:** The economy is driven by investment replacement cycles. This hypothesis is irrefutable if we look at the trend path of GDP demand components: Investments are the cycle-makers. They fluctuate much more strongly than other components of macroeconomic demand and generate the cyclical ups and downs. The German investment cycle has been about ten years long up to now but seems to have shortened. This explains a good portion of economic activity. That the economic cycle is driven by investments holds not only for Germany but for the whole world. This brings us to the last hypothesis.

**Hypothesis 6:** German economic activity parallels world economic activity because we export a lot. This hypothesis is also doubtlessly correct since the world economy has been expanding at a nearly unprecedented pace. This year for the fourth time in succession the world economy has grown at a pace of about five percent. This has not happened since the 1950s. Usually, in good times growth rates of 5 percent or more have only occurred for a maximum of three years.

There is no contradiction between hypothesis 6 and hypothesis 5, since the level of world economic activity is also explained by the investment cycle. In the German case, the two hypotheses complement themselves very well, since Germany has specialized in capital goods exports. Germany thus profits more from the upswing of the world economy than the other Euro-area countries did and exchanged its laggard status in the country growth rankings for a medium-range position. For the same reason, however, Germany could be more strongly hit by an economic downturn. The decades in which all efforts were focussed on exports to the neglect of the domestic sector has made Germany particularly vulnerable to cyclical change. During a boom Germany receives a stronger boost than the other euro countries, but it suffers all the more when the

economy is sluggish. For this reason it is important to further strengthen the forces that emanate from Agenda 2010, as stated in Hypothesis 4. In the long term they will contribute to an expansion of the more service-intensive domestic sector and thus reduce the cyclical dependency of the German economy.

### Should We Run Out Cars on Food?\*

Ban Ki-moon, Secretary General of the United Nations, recently visited the Antarctic and was impressed by the melting ice he saw. Then he was in Brazil, and he was impressed by the fact that in Brazil a quarter of automotive traffic runs on bio fuel. Oil pressed from rape seed can be used as diesel fuel, and from maize or sugar beets ethanol can be made, to replace gasoline.

Bio fuel is considered by the UN as one of the options to fight climate change. Many countries officially share this view. The USA generously subsidizes the production of ethanol from maize. The production of this type of fuel is currently growing at an annual rate of 12 percent in the USA and almost 10 percent worldwide. EU countries subsidized the production of bio fuels with 3.7 billion euros in 2006 and intend to cover 8 percent of their motor fuels from biological sources by 2015 and 20 percent by 2020. The Kyoto Protocol allows countries to meet their target reductions of carbon dioxide by substituting bio fuels for fossil fuels. This is all done to slow down global warming.

But is it really a wise and ethically acceptable strategy to burn food rather than eat it? If we allow food to be used for the production of bio fuels, food prices will be linked to the oil price, as the head of the German farmers association happily announced. Indeed, food prices are currently increasing in Europe because more and more farmland is being used for bio fuels instead of for food production.

This development is not sustainable. The so-called tortilla crisis, which led to protests in Mexico City in January this year, gives an impression of what we may expect. The price of maize, half of which is imported from the USA, more than doubled in the course of a year, primarily because of the maize used for the production of bio ethanol. Mexico tried to solve the problem by imposing a state-administered price ceiling for tortillas made of maize, combined with duty-free imports of maize.

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The Mexican tortilla crisis sarcastically demonstrates the deficiency in an environmental policy that seeks to reduce the greenhouse effect by promoting the production of bio fuels. The problem is that the advocates of this policy have not made clear where the land will come from that will be used for the production of bio fuels and other natural fuels. Until the answer is given, it is hard to see the logic in the promotion of bio fuels and other natural fuels.

In principle there are only three ways to procure land for the cultivation of bio fuels. Firstly, land can be withdrawn from the production of food (or fodder to feed animals to make food). Secondly, from the production of natural materials, wood in particular. And thirdly from nature. The perversity of the first course is manifest – it cannot be pursued with a clear conscience because there is no surplus food production in the world. Whoever wishes to grow bio fuels on land that was previously used for food production must realise that this increases food prices and burdens especially the poorest of poor. We are taught not to throw away food, but we shouldn't burn it either.

Only two alternatives remain, but these are also hardly convincing. To cultivate bio fuels on land that would otherwise be used for the production of sustainable construction materials drives up the prices of these materials and encourages their substitution by non-sustainable materials. Then less wood and more concrete and steel is used for construction. This is unobjectionable on ethical and social-policy grounds, but it does not help the environment.

Wood stores carbon, which is taken from the air by photosynthesis. The larger the stocks of wood on earth, in the form of living trees or in the form of wooden construction material stored in buildings, the smaller the portion of carbon dioxide in the air and the cooler the earth remains. Taking the land used for the production of bio fuels from forests means speeding up global warming, as the plants under consideration are all much smaller and hence store much less carbon than trees.

To be sure, in addition to the negative storage effect, there might be a positive effect on the world climate insofar as bio fuel may replace fossil fuel for combustion processes. But this assumes that the oil sheikhs will extract less oil because there is more bio fuel. If they don't, the bio fuel will simply come in addition to fossil fuel, and the positive effect is absent. World market prices of fossil fuels will simply be lower than they otherwise would be, such that the total consumption of fossil and bio fuels taken together rises by the extra production of bio fuel. The negative storage effect in this case prevails, and global warming accelerates.

The remaining alternative is land that has not been previously used commercially. But here too the analysis comes to the same conclusion because such land is usually

wooded. The substitution of forests by maize, rape and other oilseed cultivation reduces the stock of biomass and likewise leads to an increase in the concentration of carbon dioxide in the air. Brazil has cleared huge areas of its jungles in order to produce the bio ethanol that impressed the Secretary General. By doing so, the country has done a great disservice to the world climate.

Every year, the world loses a forest area the size of Ireland. This accounts for 18 percent of annual carbon dioxide emissions, more than from the world's entire transport sector. Deforestation must be reversed not accelerated.

The analysis shows that it makes little sense to take land in whatever form and use it for the production of bio fuels. Only the possibility of making bio fuels without the use of additional land is justifiable in terms of environmental and social policy. This would mean using agricultural waste, which would otherwise rot and produce nearly equal amounts of carbon dioxide and methane, an even more dangerous greenhouse gas.

These options should be explored and supported, also by the state. But it makes no sense to officially promote the production of bio fuels on land that would have been used for other purposes.

### **Stand Firm, Herr Mehdorn! –The German Railway Strike\***

The struggle between Deutsche Bahn AG and its union of train drivers (GDL) has intensified. Unlike the other two large unions that Bahn CEO Hartmut Mehdorn must negotiate with, Transnet and GDBA, the GDL has not signed on to the wage agreement of July 9, seeking to gain more for its members.

This would be fatal, since it would move Germany one step further in the direction of unions for individual trades which once dominated the labour market in England. The example of the stokers that rode along in electric locomotives and had to be paid is legendary. Germany traditionally had a great advantage over the English system in having industry unions, which represented all employees in a particular industry and which did not hinder the postwar Wirtschaftswunder.

Britain's economy, at the time, was decrepit. In the mid-seventies it had only just half of West Germany's per-capita income. The situation did not change until Margaret Thatcher was elected in 1979 and in bitter battles broke up the British trade-union system. In the meantime, Germany has fallen behind. Britain has again surpassed Germany in per-capita income, and the old British weaknesses are now becoming apparent in Germany. The behaviour of the train drivers (GDL) recalls unpleasant memories of the German flight-controllers' strike or the recent strike of hospital doctors.

Unions for individual trades are the worst thing that can happen to a country's labour market, since they tend to make aggressive wage demands that severely hinder the business of the affected industry and that even damage union members as a whole. The cake becomes so small that the workers together get less, even though they may manage to win a larger fraction of the cake. In this regard, Michael Sommer, head of the German Confederation of Trade Unions, is perfectly correct in criticising the maverick tactics of the GDL.

Why this dissent among union members? Competition among unions that represent alternative trades in the same industry is, for economists, a competition of monopolies

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that offer complementary goods. Such competition functions according to completely different rules than normal competition among suppliers of substitute goods. While the later form of competition is the lifeblood of a market economy, the former is more like a coffin nail. Competition between those who offer substitutes tends to lower prices and to increase the volumes sold on the market. Competition between those offering complementarities tends, in contrast, to raise prices and to decrease the volumes sold on the market. This aspect is fundamental to an economic understanding of competitive processes. The fact that this is not reflected in German competition and collective-bargaining law does not disprove this truth.

The impact of the two forms of competition is so different because the price changes of the one supplier have completely contrary effects on the other supplier. Under normal competition between suppliers of substitutes, a seller is happy when the other seller raises prices because this means the customers will run to him or he can raise prices himself without losing many sales. Under competition among suppliers of complementarities the opposite is the case. Here the one is happy when the other lowers his prices because now he can raise his prices without detrimental effects on turnover.

The differing effects between the suppliers imply that under competition totally different market equilibria arise. Competition among substitutes leads to lower prices and larger volumes than in the case of a complete monopoly; competition among complementarities in contrast leads to higher prices and lower volumes. If competition is replaced by a complete monopoly, this results in diverging price and volume reactions. To be sure, the amalgamation always leads to joint profits being maximised since the suppliers do more of that which they all benefit from. But in the case of substitutes this means rising prices and in the case of complements falling prices.

Monopolies are obviously not good for a market economy. Even worse is a chain of monopolies that offer complementary goods. It has such catastrophic effects that in comparison a total monopoly of all links in the chain is the better solution, both for the sellers and also for their customers.

This applies to the market for goods and also to the labour market. A monopoly union that represents all railway employees will negotiate lower wages than can be expected from independent negotiations with unions of the individual trades. In this way, a monopoly union will not damage employees, but on the contrary bring about more employment and a larger total income for employees. The additional, welcome benefit is that the railway and its customers also profit. So, stand firm, Herr Mehdorn!

### **The Same Old Mistake: How to Tame the Competitors\***

In his Agenda 2010 Gerhard Schröder lowered the German minimum wage. By eliminating Germany's second-tier unemployment assistance (*Arbeitslosenhilfe*) for a million western Germans and a million eastern Germans, he lowered the wage demands vis-à-vis potential private-sector employers, thereby improving the competitiveness of the affected employees. The wage restraint of recent years, which is responsible for a portion of Germany's much-cited job miracle of 2006, can also be attributed to Agenda 2010.

The current ruling coalition is turning Schröder's policies upside down by replacing the implicit minimum wage in the form of unemployment assistance by an explicit minimum wage. The good economic situation has fostered recklessness. When put to the test, the economy seems able to bear more than many thought possible.

Of course, this is an illusion. Germany's structural weaknesses are currently less apparent because of the booming world economy. If the forecasts are correct, in 2007 the international economy will grow by five percent for the fourth year in succession. This has not happened since the beginning of the records in 1950s. Once the boom is over, the fragility of the German labour market will become obvious again.

Fortunately, the worst has been just barely avoided in the coalition's recent decisions. A universal minimum wage of €7.50 will not be introduced. Of the 11 percent of private-sector employees in western Germany and 26 percent in eastern Germany that earn less than €7.50, it would have made about one quarter unemployed in both west and east. On the whole, 800,000 private-sector jobs in the west and 300,000 in the east would have disappeared.

But what will now come is bad enough. The generally binding character of collectively bargained wage contracts will be expanded to a non-specified number of industries. If at least half of the employees in an industry work in companies that are subject to collective wage agreements, i.e. companies that are organized in employer associations and thus pay collectively bargained wages, the employer association and the trade union can demand an extension of the negotiated wage rate to the other companies in the industry. Even if in these companies neither management nor workers wish to participate in the wage negotiations, they will be subject to the wage agreements

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dictated by the majority. A contract can be declared generally binding even in a situation where less than half of the employees work in companies subject to the wage agreements. In this case, a committee with equal representation of unions and employers association will decide on making the agreements generally binding. And what constitutes a majority is not even a true majority: of the employees that work in a company subject to the negotiated contract, hardly more than a fifth are likely to be union members and legally bound to the negotiated wage. In one way or the other, tiny minorities will be able to dictate market wages.

This is an attack on the market economy since it eliminates the mechanism of competition: this is the greatest sin committed by the coalition thus far. In future, organised companies can force their competitors to pay the same wages that they themselves must pay. It's not surprising that before this decision was made, not only union but also employer representatives were knocking on doors in Berlin.

It is no secret that the German postal service was also in on the act since, after the elimination of the letter-delivery monopoly, it fears being outbidded by United Parcel Service and other private, low-wage providers. It is particularly perverse when politicians sell this as protecting the interests of low-wage earners. This social cover-up only serves to hide the shame of naked political interests. The high postage for letters is only paid by those not yet familiar with e-mail, and they, as a rule, are the poorer groups of society.

This is all very familiar in Germany. As the western employers and the western trade unions moved to the eastern part of the country after German unification to establish their organisations, the motivation was similar. The self-appointed representatives of the eastern Germans negotiated in many districts a full convergence of eastern wages to the western level within five years. Under the mantle of brotherly concern for countrymen oppressed by years of Communism was also then coldly calculated political interests. Without these defensive measures, it would have been very tempting for the Japanese and other investors to establish themselves in eastern Germany, with wages at one third of those in the west, and to conquer the European markets from this base. This was what had to be prevented. The convergence of wages was slowed down, as eastern German enterprises emerged after privatisation, and in many cases not implemented as masses of eastern firms cancelled membership in the employer associations. But eastern Germany was never again able to go beneath the base of high wages created by the first collectively negotiated pay contracts. The investors went to Ireland, and the much-touted "self-sustained recovery" never came to be. The lead of fourteen years that eastern Germany had vis-à-vis its old friends in the ex-Comecon countries at the time of integration into the western markets was foolishly squandered away. The same old mistake is now unfortunately being made by the ruling grand coalition.

### The Green Paradox\*

The protesters have returned to their home countries, the injured are licking their wounds, the heads of state are back to business as usual, and Heiligendamm, the old spa on Germany's Baltic coast, is resuming its dream of imperial beauty. And German Chancellor Angela Merkel achieved a substantial diplomatic success. With charm and unassuming clear-headedness, she wrought a compromise from the G8 countries that may help save the world from the most severe devastations caused by global warming. The world's eight richest countries promised to "seriously consider" halving their CO<sub>2</sub> emissions by 2050.

The wording may sound vague, but, given the positions the countries held at the outset, the outcome was an important achievement. The United States, in particular, shifted its stance significantly since its rejection of the Kyoto Protocol, even accepting that the United Nations will have to organize the future negotiations.

But while the compromise is more than could have been hoped for at the outset, several important countries did not partake of it. To be sure, China, India, Brazil, South Africa, and Mexico signed on; but many countries, including the Asian tigers and most European countries, did not, despite their large contributions to polluting the world's atmosphere.

Moreover, the oil sheikhs and other producers of fossil fuels who ultimately control the amount of carbon released to the atmosphere were not part of the deal. If major consumer countries and most producer countries do not join the agreement to reduce CO<sub>2</sub> emissions, it could be useless.

Many believe that aggregate CO<sub>2</sub> emissions are the result of independent decisions in individual countries. Thus, if a group of countries decides to have lower emissions, worldwide emissions will decline by the sum of these countries' reductions. Sure, it

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would be better if all countries curtailed emissions, but it is already a great help if at least some countries do so.

Unfortunately, this view is too good to be true, because one country's emissions are not independent from those of another. If countries decide to cut their emissions, they will have to reduce their consumption of fossil fuels, in particular oil. This will reduce the world price of these fuels, inducing other countries to consume even more than they otherwise would. Countries that cut their emissions would, in effect, be subsidizing their competitors' growth, not necessarily reducing the speed of global warming.

The sacrifices of the participating countries would alleviate the CO<sub>2</sub> problem only if their restraint meant that some of the fossil resources they do not consume remain underground. They must succeed in inducing the oil sheikhs and other producers of fossil fuels to throttle their pumps. If the sheikhs are stubborn and continue to extract as much as they had planned to extract without the G8's restraint, the price of fuels will fall sufficiently to induce so much extra consumption among the non-participating countries that the net effect on aggregate CO<sub>2</sub> emissions will be nil.

Will the oil sheikhs reduce output of fossil fuels? At first glance, it seems natural to assume this, as most suppliers reduce production when the price falls. But the sheikhs are sitting on fixed stocks of oil. If they do not extract it today, they will have to do it in the future if they want to make a profit. At best, it seems that the time path of extractions can be tilted toward the future. This would not solve the CO<sub>2</sub> problem in the long run, but at least it would postpone the catastrophe.

The oil sheikhs would likely be inclined to postpone extraction only if they could reasonably assume that the demand reductions of the signing countries and the comparative price reduction that this implies are stronger today than they will be in the future. This is not plausible. Indeed, the sheikhs will know that, in all likelihood, concerns about global warming will increase over time. They will therefore speed up rather than reduce production, in order to avoid selling their oil when anxiety about CO<sub>2</sub> peaks and the artificial measures of the signing countries to reduce their consumption have dampened the oil price most. Thus, green policies will paradoxically accelerate rather than mitigate global warming.

Two lessons arise from these considerations. First, all polluters must sit at the negotiating table and be forced or induced to participate in reducing pollution. The commitments of single countries like Germany to reduce their emissions more than proportionately are useless. Germany has already contributed three-quarters of the aggregate EU-wide reductions of CO<sub>2</sub> emission from 1990 to 2008–2012 to which the

EU committed in the Kyoto Protocol. Such a policy simply subsidizes other polluters' CO<sub>2</sub> emissions but does not alleviate the problem of global warming.

Second, and more difficult, the oil sheikhs and other producers of fossil fuels must be talked into postponing their extraction plans or, better yet, not to extract some of their resources at all. The best policy against global warming is to keep the CO<sub>2</sub> imbedded in fossil resources deep underground.

The good news from Heiligendamm is that the UN will now have to organize a common solution. The bad news is that this is unlikely to happen in the foreseeable future, and that the owners of natural resources will therefore make every attempt to extract their resources and thus pump the fossil carbon into the atmosphere before the UN finds a way out of this impasse.

### France's Path not Taken\*

Nicolas Sarkozy will face a tough challenge when it comes to putting the French economy back on its feet. While the world economy is booming for the fourth consecutive year, with a historically unprecedented growth rate of about 5 percent, the French economy is limping.

In 2006, France grew by only 2.0 percent, and only a little more can be expected for 2007 according to a recent forecast of the Ifo Institute. This is significantly below the 2.8 percent, which is the average of the old EU countries for both of these two years.

France is currently one of Europe's laggards, only slightly ahead of Italy and Portugal. Even Germany is performing better. With a growth rate of 2.8 percent, the German economy clawed its way back towards the average of the old EU countries in 2006, and it can be expected to grow at 2.6 percent in 2007, far faster than France.

France's meager growth is surprising. Until recently, the economy was doing fairly well, outperforming many EU countries. While Germany grew by only 14 percent in the ten years from 1995 to 2005, ranking as Europe's "vice-laggard" next to Italy, France grew by 23.6 percent, which was nearly the old EU countries' average of 24.3 percent. In 2001, France's gross national income per capita overtook that of Germany, and is now 4 percent higher. And yet recent growth figures seem to have reversed this trend for the time being.

French employment data has been worrisome for even longer. In 2006, France's unemployment rate was 9.4 percent, a full percentage point higher than Germany's. By 2008, the French rate can be expected to decline only to 8.2 percent, while German unemployment is anticipated to fall to 6.3 percent.

A similar pattern holds for public debt. While Germany has resolved its debt problem insofar as it no longer violates the European Union's Stability and Growth Pact and can

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be expected to come close to a balanced budget in 2007 with a deficit rate of only 0.3 percent, the forecasts for France imply a deficit of 2.5 percent of GDP. If the boom in the world economy falters, France will again violate the Stability and Growth Pact, as it did in 2002, 2003, and 2004.

Why are France and Germany behaving so differently during this global boom? Among the potential explanations, the dissimilar specializations of each country stand out. While France has specialized in consumer goods such as food and pharmaceutical products, Germany is a leading exporter of investment goods. As the current boom in the world economy is largely fueled by investment demand rather consumption demand, only Germany profits from it to full measure.

Germany is the tool-shop of the world, with 450 world market leaders in niche products and another 500 companies in the top-three category. Fifteen of the world's 20 biggest trade fairs (measured by indoor exhibition space) are held in Germany, and the country tops the list in world commodity exports. Small wonder, then, that Germany's economy rockets when the world's demand for capital goods soars.

True, Germany has its share of problems. The country is gradually turning into an industrial bazaar that is relocating its workbench to low-wage, ex-communist countries. This is one of the reasons why the boom of 2006 was incapable of creating additional jobs in German manufacturing and why Germany still has the OECD's highest unemployment among low-skilled workers.

The French economy could be slightly more stable in the medium term insofar as it seems to have more solid internal sectors. But Germany definitely is partaking more of the current boom than France is.

Perhaps one French mistake was to neglect its small and medium-size firms and specialize too much on state-controlled mega-companies. Airbus, Renault, Cr dit Lyonnais, and Alstom are well-known examples of a mistaken industrial policy that has wasted French taxpayers' money – and that is partly connected with the name Sarkozy.

The true problem for France is the huge chunk of state-owned companies that go through the motions without being particularly successful in the market. In France, 25 percent of dependent employees work in the government sector, compared with 19 percent in the old EU and 12 percent in Germany. The French government share in GDP is 54 percent, while Germany's has been falling significantly in recent years and is approaching 44 percent.

In France, more than 7 percent of voters cast their ballots for Trotskyite and Communist candidates in the first round of the presidential election, and the Socialists,

who received 27 percent of the votes, are much more left-leaning than Germany's Social Democrats. Dirigiste attitudes are more popular in France than in most other European countries. To the extent that these attitudes may have led to a political system in which small and medium-size firms find it difficult to flourish, they may have contributed to France's problems.

It remains to be seen whether the new French president will be able to embark on a more promising course. Sarkozy will probably try to increase the flexibility of the French labor market so as to facilitate structural change and enable new firms to be created. However, he is likely to continue to support France's lumbering giants, as he has done so frequently in the past.

### **The Thirty-Billion Euro Deal: Seignorage of ECB\***

For Peer Steinbrück and Axel Weber 2007 is an important year, as the fifth anniversary of the euro in circulation also marks the end of the transition phase to the full socialisation of the Bundesbank's seignorage, i.e. its profits from money creation. The times when Germany could achieve special profits from exporting its currency are gone for ever.

Seignorage is generated when the central bank makes available the money it has itself created to the private sector in exchange for interest-bearing assets like bills of exchange or deposits of securities. Seignorage is the interest earned on the assets that the central bank has acquired with its money. The Bundesbank once had accumulated a very large stock of assets relative to the size of the country because the deutschmark was also used abroad for transaction purposes and store of value. Following the collapse of communism, the deutschmark became popular in Eastern Europe and beyond. The thousand DM notes under Turkish mattresses were legendary. One third of the stock of deutschmarks once circulated abroad. This is why the deutschmark had special status compared to other pre-euro currencies, and the Bundesbank was able to earn special profits, which Theo Waigel and Hans Eichel, former German finance ministers, were always able to anticipate. Since 2002 these good times have passed. The euro has replaced the deutschmark, and the interest earnings from the stock of assets have been summed up and distributed according to country size.

In Article 32 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank annexed to the Maastricht Treaty, it was stated that the degree of socialisation of the interest earnings was to amount to 40 percent in the first year of the currency union and would then be increased step by step to 100 percent within five years. What was meant by the first year was not clear, however: 1999, the year of the virtual introduction of the euro, or 2002, the year of its physical introduction. Otmar Issing was able to achieve acceptance of the later date. This saved the German taxpayer billions of euros. Nonetheless, since 2002 socialisation has occurred at rising amounts, and since the beginning of this year it has been completed. There are various reasons why the Bundesbank was able to transfer on average €8.8 billion p.a. to the treasury in the five years before the physical introduction of the euro (1997 to 2001) but

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only €2.7 billion p.a. in the five years after (2002 to 2006). Besides low interest rates and the collapse of money demand at the time of euro conversion, the reasons include the socialisation of seignorage.

At first glance, the Maastricht agreement on the distribution of the interest earnings looks good: If one shares a common currency, one might as well share the seignorage fairly. Therefore one could argue, as the Bundesbank did, that complete socialisation of seignorage was a natural implication of the currency union, to which there was no alternative at the negotiations of the Maastricht Treaty.

One could, however, also hold the view that Germany could have done better in those negotiations. The German negotiators could have argued that the rights to the interest earnings on the assets accumulated before euro conversion ought to stay with each country and that only the rights to the future growth of these assets would be socialised under the euro regime. Since the other countries were keen on getting rid of the deutschmark, such a position would certainly have been accepted. Based on the opening balance sheets of the euro countries on January 1, 1999, Holger Feist and I calculated ([www.cesifo.de](http://www.cesifo.de)) the wealth implications of such a result. Accordingly, Germany would have been richer by €29.3 billion net and France poorer by €31.3 billion. Finland would not have been able to increase its assets by €3.3 billion, and Austria would not have lost €1.8 billion. Spain, too, which relative to its size had a lot of currency in circulation due to its large underground economy and whose head of the central bank, Luis Angel Rojo, later fought in vain against the socialisation, could have avoided the permanent loss of interest earnings on a stock of assets worth €11 billion.

Of course, this does not mean that Germany has made a bad bargain with the euro. After all, the euro is doing very well. Euros in circulation have grown much faster recently than could have been expected from simply extending the trend of the pre-euro currencies. There are already more euros circulating worldwide than dollars. Although Germany is getting a smaller percentage of the cake than before, it may well be getting an absolutely bigger piece because the cake is much larger now.

That is cold comfort, however, as the socialisation of the rights to the interest earnings on the stock of assets that had already been accumulated under the deutschmark regime was nevertheless unnecessary. That Germany needlessly transferred about €30 billion to France in the Maastricht Treaty remains a portent that will be a reminder for Peer Steinbrück and Axel Weber when, at the end of 2007, they will add up the Bundesbank profits to be transferred.

### **Cars Buy Cars\***

Detlev Wetzel, the North Rhine-Westphalian representative of the metalworkers' union IG Metall, justified his demand for a 6.5 percent wage increase with a quote attributed to Henry Ford: "Cars don't buy cars". Hefty wage increases are needed to create purchasing power and boost private demand.

How moving it is to see IG Metall concerned about the welfare of the country. Unfortunately, however, the purchasing power argument is incorrect even for logical reasons: A wage increase is identical to a profit decrease, and to the same extent to which wage increases boost the purchasing power of the employees, they lower those of the employers. The existing purchasing power is simply distributed in a different way. Although the employees' consumption rises if, at the given employment, higher wages are paid, the willingness to invest declines because the wage increase pushes many investment projects below their profitability thresholds, and that reduces demand.

Investment also constitutes demand: You can eat up the gross national product, in which case it is consumption. Or you can put it on the pile that is called the capital stock, in which case it is an investment. Both constitute demand for the products of current output. Maybe cars don't buy cars, but investors buy machinery, equipment and buildings. A wage increase reduces this part of domestic demand. Mr. Wetzel ought to take this into consideration.

And investment is more than just one of many demand components that determine the pace of economic activity, it is a particularly important one. Investment fluctuates much more than consumption over the business cycle because it depends on the replacement cycle and on strongly fluctuating profit expectations, which in turn are significantly determined by wage costs. Since 1970, German unemployment has risen in cycles of about ten years and by chance was always at a cyclical low at the end of a decade. And this low always coincided with a peak in equipment investment: Investment is the cycle maker.

Union bosses usually counter this with the statement that the demand for consumer goods is the objective of all economic activity. The demand for capital goods is said to

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be only a derived intermediate demand, which in the end will only be realised if more demand for consumer goods is expected, and that is why wage increases are necessary.

The argument is partially correct, but it neglects the trade-off between short-term and long-term wage increases. A society that has low wages relative to its aggregate productivity and thus permanently invests a higher percentage of its national income and consumes a lower percentage builds up its production capacity faster and therefore grows faster, too. Its output and its wage income rise faster, which in the longer term is reflected in higher wages and a higher level of consumption despite the original wage restraint. The higher investment is itself the cause of the higher consumption for which it is needed.

High consumption is bad for economic growth and unnecessary for an upswing of the business cycle. The present boom of the German economy proves best that an economic boom does not depend on an immediate increase in consumer demand. Last year, in addition to export growth, it was once again primarily the increase in investment demand that was responsible for the rise in aggregate demand. Although consumption stagnated, the economy surged. Whereas consumer demand rose by a meagre 0.8 percent, investment demand grew by 5.6 percent and GDP by 2.7 percent. If the unions achieve their goal of high wage increases, they will smother the recovery very soon because they undermine the firms' willingness to invest. It is a game that has been observed time and again in Germany and elsewhere.

IG Metall in particular ought to reconsider. German industry workers are by far the most expensive of all big industrial countries. This is true not only in absolute terms but also in relation to overall labour productivity. As reported in the latest *Ifo Schnelldienst*, nowhere is there such a high ratio of wage costs of industrial workers to aggregate productivity as in Germany. And this is true whether only blue-collar industrial workers are considered or all industrial employees, including white-collar staff.

And contrary to conventional wisdom, Germany's top rank in labour costs has little to do with non-wage labour costs. Although these are high, they are still much lower than the average of EU countries. No, the explanation is clearly to be found in the extremely high gross hourly wages that in the 1970s and 1980s were pushed to the high level, from which they cannot now descend. That Germany's manufacturing employment is in free fall and even declined in the boom year of 2006 is primarily explained by this. The wage-bargaining parties bear the responsibility for a cooling industrial core and the fact that fewer and fewer people can warm themselves there.

### **Will Eastern EU Expansion Create Jobs in Germany?\***

The EU has expanded once again. After the 2004 enlargement, which added 75 million new citizens to the EU, Romania and Bulgaria are now adding 30 million more. What does this mean for the German labour market?

German Foreign Minister Frank-Walter Steinmeier voiced the opinion in a speech in the Munich Residenz that EU eastward enlargement will lead to net job creation in Germany. To be sure, some jobs will be lost as plumbers migrate to Germany or as companies relocate in Eastern Europe, but this will be offset by the expansion of German exports, which will create many more jobs. This argument is familiar. But is it correct?

The enlargement will certainly confront Germany with extremely low wage competition. Whereas a manufacturing worker in western Germany earns €27.90 an hour and a worker in eastern Germany averages €18.60 an hour, in Romania a worker is only paid €2.30 and in Bulgaria a mere €1.60.

If Steinmeier is correct, the Eastern European low-wage earners would complement German workers, and their presence would increase the demand for German workers. Indeed, this is partly the case. German engineers are needed to design sensible products to be manufactured by Eastern European workers, and those with managerial qualities can be sure that their abilities will be needed to integrate the Eastern European workers into the market economy. But for the great majority of those who only have their normal labour to offer, Eastern European workers are substitutes and not complements. They are confronted by low-wage competition from people that have similar skills and ambitions, and they are consequently the losers of enlargement. According to a study by the Berlin economists Geishecker and Görg, the group of losers in Germany extends from low-skilled up to skilled workers.

This has implications for the labour market. For the highly qualified in the German workforce, eastern enlargement will lead to an increase in labour demand but to a

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decrease for all the others. Since unemployment is low among the more highly qualified, the increased demand for their services will lead to an increase in wages rather than an increase in employment. In the case of the lesser qualified, whose services are now less in demand, a decrease in employment will result because their wages cannot fall. The scope for downward wage adjustments is limited by collective wage agreements and by the minimum-wage levels that the welfare state sets with its wage replacement benefits. The asymmetry in wage inflexibility combined with the substitutional labour performed by the great majority of German workers and their Eastern European counterparts leads to the inevitable conclusion that eastern enlargement will lead to a net loss of jobs in Germany, at least if the German labour market remains as inflexible as it now is.

Steinmeier's conclusions were certainly not based on complements and substitutes but on the assumptions made by observing exports, direct investments and migration. But in so doing he overlooks the two main reasons why most jobs are disappearing.

The first of these reasons is the structural change of the German economy. To be sure, eastern enlargement is leading to an increase in exports because more markets have been opened in which German firms can sell their products. However, if exports increase, the factors of production, namely capital, qualified workers and unskilled workers, must be diverted from other sectors of the economy, and this leads, on balance, to unemployment. Since the export goods are considerably more capital and knowledge intensive in their production than other goods, the structural change reduces the demand for unskilled labour. The capital and talents that move away from labour intensive to capital intensive sectors, cannot pull all unskilled workers with them whom they formerly employed, and they even prefer it that way since sectoral change is a way to defend themselves against the low-wage competition. The shrinking sectors include the labour-intensive preliminary stages of industrial production, the jobs of which have been unspectacularly outsourced to other countries, a phenomenon that is not apparent to customers nor registered in the statistics on foreign direct investment.

The second reason is capital exports. Steinmeier concedes that jobs can be lost via foreign direct investments. But much more important are the financial investments, that is the loans by which foreign firms are enabled to create jobs on their own. In 2006 Germany had a net capital export of €108 billion, whereas net domestic investment of all sectors together was only €75 billion. Of this net capital export, only €25 billion was for direct investments. Part of this capital export flowed to the new EU members in Eastern Europe, which had, relative to their size, gigantic capital imports.

No, taking all these factors into consideration, the remarks of the foreign minister are no more than empty rhetoric. Since German re-unification we have had more than enough of this rhetoric.