

Euro-promise fades for the German economy. Any way out of the mire ?

20, July 2002

The promised single currency

Throughout the fifteen years that Helmut Kohl was Chancellor of Germany the eye of the whole country was on the single currency - that was the political target. The German view of the euro was that it was extremely important politically but on a more personal note they were suspicious. Suspicions could be allayed so long as the euro and the European Central Bank (ECB) were just the Deutschmark and the Bundesbank by different names. However the ECB is not a renamed Bundesbank and the monetary policy line it has followed has taken into account the exigencies of the whole euro zone and not just German needs. In all sorts of subtle ways this is creating unfamiliar pulls and tugs for German society and German industry and German ways. Germany is faced with having to make changes that few ever realised might have to be made, and mostly controversial ones at that.

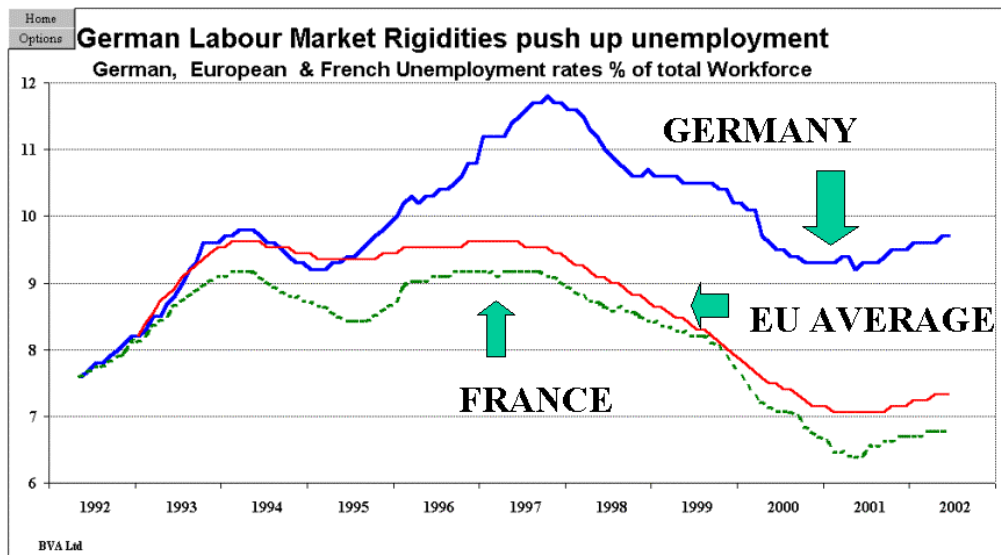
Faced with a monetary policy stance imposed by the ECB that is noticeably tighter than the German economy needs, German firms and businesses are fighting in a way that they have not done for a long time to maintain productivity and market share. To achieve this firms want three things : less red-tape, lower taxes on business, and most importantly, much greater flexibility in working practices. For so long the German model of capitalism seemed pretty good. society. The growing sense that perhaps this is not the case is increasingly disquieting.

.... in an election year

And this is an election year. More importantly, Gerhard Schröder, the leader of the SPD party, who ousted Kohl, is now facing an electorate who are weighing up how well he has met the promises made when he came to power four years ago. In the wake of Kohl's departure all sorts of financial shenanigans came to light concerning his party, the CDU, so that it looked as tattered as the Tories did in 1997 in the UK. It looked as if a lot of new policies designed to rebuild confidence and credibility would be needed before the right could hope to get back into power in Germany. Schröder's position then seemed as strong as any politician could hope for. Schröder ought to be facing the near certainty of a victory at the polls. Today he most certainly is not.

Schröder promised to tackle unemploymentand hasn't

Schröder's big promise, the one that Germans seized upon, was to bring down unemployment. When Schröder took over some four million people were out of work, more than 10% of the workforce and not far off the post-war record. The number out of work did fall in 2000 but is now rising again and is almost back to where it was when Schröder made his original promise. Unemployment remains the intransigent problem for Germany. But rather than tackle this energetically, Schröder has rather played to his supporters, the Trade Unions, and further increased the rigidities in the labour market.



Even when growth picked up across the continent it initially failed to bring down unemployment in Germany. One strong reason for this was that Schröder had decided to tinker with the taxation of so-called DM650 jobs. These were very low-paid jobs that almost entirely fell outside the tax and social security net. DM650 (325 Euros) a month was the ceiling for these jobs, hence the name. But Schröder decided that these jobs should be made liable for social security contributions, which imposed deductions upon the worker and raised the cost for the employer. This was one of the few areas of flexibility in the labour market, where working hours were variable, and where people moved in and out of such jobs with an ease. In the months following the decision large numbers of people with DM650 jobs decided that it was no longer worth the effort, and they registered for unemployment benefit instead. During the summer of 1999 this led to a one-off effect, so that despite an economic upturn unemployment continued to rise only starting to fall about a year later.

In another move that reduced labour force mobility, Schröder increased the power of workers' councils where employers have to consult their workforces over major decisions that affect employees. The change that Schröder brought about in 2001 was to make it easier for workers' councils to be set up in small and medium-sized companies, especially in the new economy. Any business with more than 51 employees is required to run a works' council, either paid or part-time, with a minimum of 5 elected members. Companies with 200 employees or more are required to pay for one member of staff to work full-time for the council. Companies are finding that they cannot hire or fire without the agreement of the workers' council and the government can fine them if they do - instead of adapting, businesses are going bankrupt. Business leaders calculated that these extra costs would put an extra 1.4 billion euro burden on businesses.

Labour market rigidities have contributed to a greater number of corporate bankruptcies, with businesses going to the wall at a record rate with each year's total higher than the last. In 1991 there were some 9,000 corporate insolvencies, most of them small and medium-sized companies; ten years later the number had more than trebled and from 32,000 last year it is expected to rise to 40,000 this year. In 1991 around 112,000 new companies were set up; ten years later only 98,000 companies were set up. According to Bürgel, a business research company in Hamburg, 5,000 companies filed for bankruptcy in the first three months of last year but in the same period this year a record 14,500 filings for bankruptcy occurred, many of them belonging to Germany's *Mittelstand*, the important group of small and medium-sized, and largely family-owned businesses. It has been estimated that around 7% of *Mittelstand* companies are in the red.

Government to the rescue?

Labour market inflexibility is causing difficulty not only for the Mittelstand, but for larger companies too. The government's reaction tends to be to "rescue" the big, high-profile companies. Schröder intervened to prevent the closure of a railcar subsidiary of Bombardier, to nationalise a subsidiary of Dasa, the aerospace company, to prevent the tyre manufacturer Continental from a takeover by Italy's Pirelli, and to "rescue" Philipp Holzmann, the construction company, which went bankrupt anyway. The Bavarian government also tried to "rescue" Kirchgruppe whose core, KirchMedia has gone bust spectacularly. The ill-fated "Alliance for Jobs", a forum for employers, unions and government to work out how to create more jobs, was a Kohl initiative that Schröder sought to rescucitate, but since the unions were convinced that this was their opportunity for government and unions to tell employers what to do, the "Alliance for Jobs" never had a chance.

Some positive reforms

Trying to breathe some more life into the German corporate scene, the government decided to lift the capital gains tax that is incurred when financial holdings in other companies are sold. Previously this had prevented companies, and particularly banks, from selling their long term "strategic equity" positions in other companies. Those with longer memories may recall the problems this called during the so called Flick affair. The changed law now means that companies can sell their holdings in others, often for huge book profits, and without having to pay any capital gains tax. Good business if you can get it !

Early optimism that the new arrangements would improve the efficiency of the German capital market have been thwarted. Partly by the downturn in equity prices that means the shares can be sold less profitably, and partly because of a new political fear. The "reforming" shadow administration of Herr Stoiber (CSU) has said it may reverse the tax cuts. As with past disputes in the UK on de-nationalization, there are few ways of more effectively sabotaging a reform as when the opposition says it will review it.

The reform on the capital gains side has been picked up the German banks, themselves struggling to meet the challenge of increasing shareholder value for their own investors. One very good way of doing this is to sell the "strategic" shareholdings, a point not missed by the Deutsche and Commerz banks.

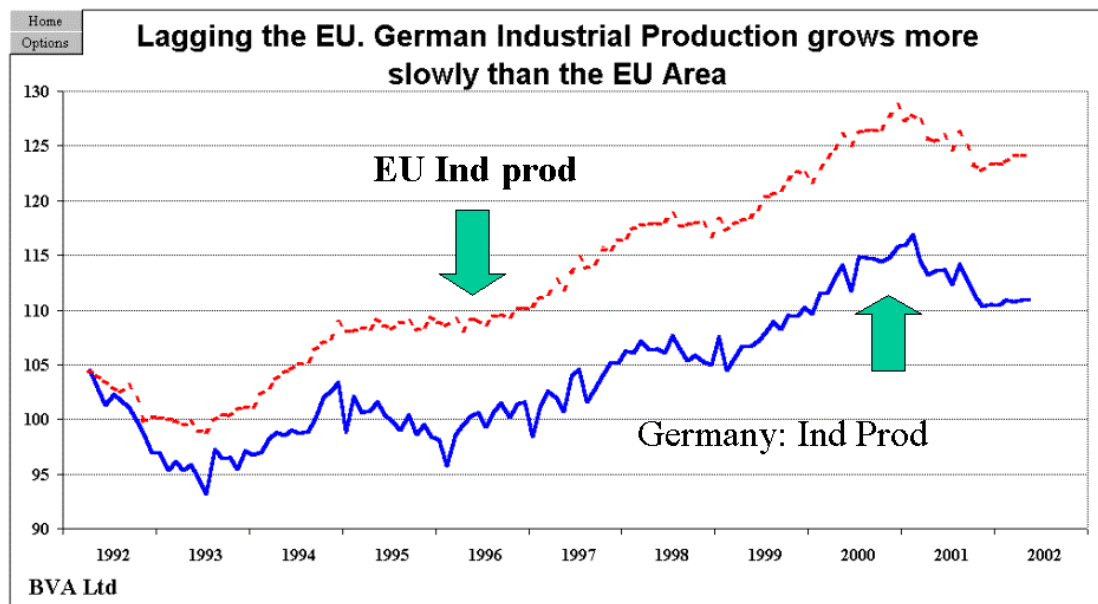
Although the reforms have not been as successful as expected, it is fair to say that there is a "wind of change" running through corporate Germany. The demise of Babcock being a particularly good sign that business is not going on "as usual".

Is Germany ready for a Mrs. T ?

It is easy to blame Schröder but some Germans panic at the word reform. Voting behaviour suggests that they would rather live with an average growth rate of only 1.5% a year (which is what they have had for the last ten years), or four million out of work (unofficial estimates put it closer to five million), or dream on that their government can deliver on its pension commitments when the pay-as-you-go system is underfunded and the birthrate has fallen to 140 babies per 100 women - oh, and an unprecedented number of Germans are now seeking work abroad, so much so that the federal labour office is now setting up a special "Euro-jobs" bureau. This spring has seen widespread strikes. IG Metall, the most powerful union, started the confrontation and has won a 4% settlement for its members which is likely to be well above productivity growth in the sector. It has spread to Verdi, now Germany's largest union, affecting workers in post offices, banks, insurance companies and the retail sector. In Q1 2002 the retail sector saw the largest decline in sales for 15 years and retail businesses face consumers who believe that the euro has brought higher prices. Then, in the middle of

June IG Bau, the construction union, with 98% member support, called for strike action. With the employers threatening lock-outs, this is likely to see tough negotiations.

There is a temptation to blame the euro for at least some of Germany's economic woes. There is a widespread conviction that the new currency has been used to push through surreptitious price rises. This view is not supported by the official figures though, which show that Germany's inflation performance remains good by EU standards. But consumers are voting with their wallets and sales have fallen sharply. Many Germans speak now of the "Teuro", a play on words since "teuer" means expensive in German. A survey by the European Commission showed that some 65% of Europeans blame the euro for price rises. The government insisted for a long time that the euro had not brought about price rises, but is now siding with consumers and blaming businesses and retailers. A Bundesbank report said that the euro had played a role in 20% of price increases since January. The Finance Minister, Hans Eichel, admitted that the government should have introduced legislation as other euro nations did to freeze prices during the transition period. Part of the problem is that consumers were told that the euro would bring price transparency and lower prices. It probably will – one day – when competition has bitten and firms have had to become more productive but that process will bring job losses before it starts creating new jobs.



The outlookSo is it all gloom?

The enthusiasm for the dot.com bubble in Germany showed that there was an appetite for new ideas, new products, and new ways for making money. It is easy to assume that there is no dynamism in the German economy – this is but one example showing that there is. In fact, it also indicates where the improvements are likely to come from. It is likely to be new sectors or new business activities that blow away the cobwebs.

There is another area this might come from. Mild reform of German pensions (not enough to resolve the whole pensions problem) has stimulated the savings market and there is a race now to provide private pensions and savings business. The savings market is estimated to reach between 20 and 40 billion euros by 2008. Since the tentative reform of German pensions is insufficient it is likely that further steps will be taken, so this is an area which could show increasing possibilities. These are thin ends of wedges and the opening up of markets in Europe is likely to provide more opportunities. German business is pragmatic; it may not produce fireworks but often produces top-class products. The problem is that shaking up a sclerotic dinosaur is not going to be an easy matter.

And will Gerhard Schröder win the elections on 22nd September? A few months ago few would have doubted it, but now the worries are building up. But whoever wins in September may well find that the changes that are being pushed through at the European level will force a much faster pace of reform than any German government has been willing to undertake so far. There are signs that the EU Commission wants to step up its fight against impediments to competition in order to bolster the euro. Germany wanted the euro but in many ways had no idea what it was pressing for. It may well yet be that it is those aspects of the euro that Germans like the least, that will do the most good for Germany in the longer run.

Elizabeth Legge and Andrew Black,

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BUILDING VALUE ASSOCIATES Ltd

Office phone **0208 287 9442**
Direct line **01892 835 177**
Mobile phone **077 646 04780**
E-mail (office) enquiries@bvaltd.com
E-mail (personal) elizabethlegge@yahoo.co.uk

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