Germany ought to make an ”internal devaluation”

Stagnation and high unemployment have for a long time highlighted the need for far-reaching labour market reforms in Germany. Politicians have now finally embarked on such a path, involving a radical overhaul of federal employment services, reductions in the generosity of unemployment benefits, and tougher requirements on the unemployed.

The reforms will work by putting downward pressure on real wages, which will help raise employment. The downward wage pressure will also lead to a reduction of wage costs and prices relative to foreign competitors. Such a *real depreciation* will create the demand necessary to match the increase in output that will follow from higher employment.

But there is one great problem. In a low-inflation economy it takes time for labour market reforms to achieve the required real wage adjustments. This is evidenced by, for example, the UK and Dutch reforms in the 1980s, which both took more than a decade to deliver results. The main explanation is the difficulties of reducing *nominal* wage growth below 1-2 percent per year. In all developed market economies there appear to be strong social norms against nominal wage cuts also when reductions in real wages are accepted.

To speed up the effects of the reforms, they should be complemented with a demand stimulus. If Germany had not been a member of the EMU, this could have been achieved through lower interest rates than in the other European countries and a devaluation of the D-mark. But this option no longer exists. Nor does the option of fiscal expansion. Increases in the German budget deficit would further undermine the EU fiscal policy framework.

There is a need to consider other options. As an outsider, I am surprised that the possibility of a so-called *internal devaluation* does not seem to have been raised as a serious policy alternative. This measure has been much debated in the Scandinavian countries and has also been used there at times.

An internal devaluation implies a reduction in the payroll taxes paid by employers. To the extent that it cannot be financed through cuts in government expenditures, taxes falling on employees must be increased. In the case of Germany one should contemplate a significant reduction of employers´ social security contributions, say by 5-10 percentage points. To make up for this, the social security contributions paid by employees should be raised. A VAT increase could also contribute to the financing.

Such a tax shift would imply a reduction in real labour costs and a real depreciation in a similar way as a currency devaluation would have done. There would be an increase in net foreign demand for German output, which could compensate for low aggregate demand inside Germany. In the longer term, the resulting income expansion would increase also domestic demand. The associated increases in tax revenues would improve the government budget position.

An internal devaluation would be more effective in raising employment than other measures currently being discussed. For example, increases in working time at constant total pay do contribute to higher output, because wage costs per hour fall, but the effects on unemployment are uncertain.

The proposed tax shift would be much more controversial than a currency devaluation would have been in the absence of the EMU. An internal devaluation would amount to a politically decided real wage cut. In contrast, voters tend to view currency movements more as an outcome of market forces than as a consequence of political decisions.

A successful tax shift would have to be preceded by a long period of discussion, so that a consensus on the need for it can be reached. Needless to say, this may be very difficult. One important reason is the lack of an adequate debate in Germany on the policy requirements imposed by the EMU before the start in 1999. This is in stark contrast to the Scandinavian countries, where the decisions on whether or not to join the EMU were preceded by very thorough discussions on the need for new policy tools, such as internal devaluations, in the event of membership.

A successful employment strategy requires a *two-handed approach*, encompassing both supply-side and demand-side measures. A one-sided supply-side strategy may in the long run prove politically self-defeating, since there may be a backlash against the reforms if results take too long to materialise.

In my view, an internal devaluation, that is a shift of social security contributions from employers to employees, should be considered very seriously by German policy makers as a way of speeding up the effects of the labour market reforms. I do hope that this policy option can enter the German debate.

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