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Inside the miracle

How Germany weathered the recession

"THIS is what we love," exclaims Jan Stefan Roell, presenting an intricately worked ingot of gleaming steel as though it were a piece of jewellery. It belongs somewhere in the innards of a testing machine made by Zwick Roell, the firm he owns. One model rips the eyes off teddy bears (to see if children can), another pokes computer keyboards. Mr Roell wants the visitor first to admire the part, next the Swabian craftsmen who fashioned it and then the German genius for making expensive and indispensable things. His customers expect German thoroughness, he says.

Ulm-based Zwick Roell, which has 950 employees and sales of €150m ($202m) a year, is a typical *Mittelstand* firm. Until the 1930s it made buttons from cow horn imported from Argentina, but when plastic took over it switched to testing machines. Like many *Mittelstand* enterprises Zwick works backstage, making things that are used in making other things. The thousands of Zwick-like firms that constitute the engineering sector are a cornerstone of Germany's industrial economy. They employ nearly 1m workers, more than any other industry, and export almost 80% of their production. Often the product is not merely a machine, but also a panoply of services that go with it.

Last year they took a beating. Sales plunged by a fifth to €160 billion; Zwick fared no better. The wonder was that engineering firms shed a mere 40,000 jobs. "In narrow commercial terms we can't justify that," says Hannes Hesse, head of the Association of German Machine Builders in Frankfurt. His members are betting that demand will bounce back, but it is a gamble. Three possible misfortunes could scupper recovery, he reckons: another terrorist attack, another tremor in the banking system and a failure by banks to supply enough credit to his members or their customers. The jobs miracle could yet falter.

The last time Zwick made a regular employee redundant was in 1992. That is because the workforce reacts to economic shocks like a well-engineered suspension system. When the crisis hit, Mr Roell shed some workers on temporary contracts and cut the working hours and pay of regular employees. When such a deal is negotiated with the works council it is binding on the workforce, a "huge advantage", he says. He invites the council's chairman to every management meeting.

This symbiosis owes something to the intimate scale of a *Mittelstand* enterprise, but it also relies on an institutional machine as intricate as one of Zwick's testing contraptions. Mr Roell recruits skilled workers through an apprentice system with roots in medieval guilds. He manages labour relations within a framework set by negotiations between employers' associations and trade unions. This arrangement survives because Germans have a knack for changing the way something works yet keeping its basic structure intact.

Slowly but surely

Twenty years ago it was a byword for rigidity. Wages and working conditions were set in sector-wide negotiations that allowed individual firms little scope for variation, tying employers' hands. Outwardly little has changed, but the contracts have changed character. In the 1980s "they were like the Bible," says Martin Wansleben, chief executive of the German Chambers of Industry and Commerce. "Now they provide important guidance."

This was not a bloodless coup. Many East German enterprises, caught between low productivity and paying D-mark wages, shunned sector-wide labour contracts. High unemployment, the threat of production moving to central Europe and Mr Schröder's reforms cranked up the pressure. As unions lost members, employers defected from the industry federations. Only half of west German private-sector workers are covered by sector-wide contracts, against two-thirds in 1998, says Reinhard Bispinck of the Hans-Böckler-Stiftung, a think-tank close to the trade unions.

Give and take

And even when they do, the contracts are riddled with "opening clauses". At firm level bosses and works councils formed "alliances for jobs" under which workers sacrificed pay to secure employment. Working-hours accounts allow companies to adjust the amount of work done to peaks and troughs in production without paying overtime. This flexibility powered exports, lifted economic growth and fattened profits. It enriched everyone, the unions grumble, except workers. Wage rises have lagged behind productivity gains and inflation since 2000, driving down unit labour costs relative to those of Germany's competitors (see chart 3).

Though bosses readjusted the settings in their favour, they did not smash the machine. In some ways *Mitbestimmung*, workers' rights to influence decision-making, was strengthened. Job alliances, for example, draw works councils into company strategy. In December workers at Mercedes's Sindelfingen factory near Stuttgart went on strike after the company said it would shift production of its C-Class cars to Alabama, so Mercedes promised to maintain employment at the plant until 2020. That pledge "would be worth nothing without new products and investments", points out Jörg Hofmann, head of the Baden-Württemberg branch of IG Metall, the trade union for the industry. Top of the reformers' hit list is Germany's rigid regime for protecting workers from dismissal. But without that protection workers would not allow hours to pile up in working-time accounts, says Alexander Herzog-Stein, also of the Hans-Böckler-Stiftung.

The crisis has drawn the two sides closer together. Both are determined to defend Germany's export success. It helps that they can blame the recession on outsiders and bankers rather than on each other. More important, employers have so far kept their side of the flexibility bargain by keeping up employment.

Much of the credit for Germany's jobs miracle goes to *Kurzarbeit*, a scheme under which government hands out subsidies to firms that retain surplus workers, but there is more to it. Joachim Möller, head of the Institute for Employment Research (IAB), part of the Federal Employment Agency, argues that flexible working hours have been an important factor in holding up employment. When the recession hit, workers had built up a large number of extra hours in their working-time accounts that could be wound down as work dried up. But firms were also looking ahead to a prospective scarcity of labour.

In 2009 the number of people of working age in western Germany shrank for the first time. The firms hit hardest by the crisis were precisely those that had the biggest problems recruiting skilled labour before it. "Most companies will see a significant impact" from a shortage of qualified labour by 2014 or 2015, says Harald Krüger, head of personnel at BMW, a Munich-based carmarker. Despite the crisis, BMW was careful not to cut its annual intake of 1,000 apprentices.

All this provides a perfect setting for Mr Roell to indulge his passion for profitable perfectionism. His machines are four times as expensive as competing testers made in China, his second-biggest market. The company actually makes its own boxes so that the gear arrives in perfect condition. Although Mr Roell has competitors, he acknowledges no peers. Where his main American rival prefers standard solutions, Zwick's engineers go for a tailor-made approach. The complexity-loving culture on the factory floor is shaped by Germany's "dual system" of vocational training, which combines classroom learning with hands-on experience. At Zwick Roell it is reinforced by a Swabian passion for inventive tinkering, or *tüfteln*. "I can delegate things that in other countries need supervision," he says.

It is a pact that depends partly on the owner not appearing to be too greedy. Mr Roell reinvests two-thirds of the firm's profits. The *Mittelstand* survives "because families don't want the money", he says. "They want the business to continue." And they are not easily put off: "If people tell you tax is a big issue they haven't done their homework." Bureaucracy is a bigger problem. Mr Roell grumbles that he has to install internal safety doors on his lifts, "ridiculous stuff which keeps me from doing my job". All in all, though, he feels that Germany's skilled workers and its infrastructure make it "a wonderful place to do business".

But the success of firms like Zwick Roell is not synonymous with Germany's. Manufacturing's share of output and employment has dropped, though it remains larger than in most competitor countries (see chart 3). Workers with permanent factory jobs have done relatively well recently. Since 2005 the pay of IG Metall's members went up by a total of 14%, says Mr Hofmann—less than the rise in productivity, but still "satisfactory". The price of flexibility was higher for workers in weaker sectors or with "atypical" contracts. Schlecker, a chain of discount chemists, recently shut down some shops and sacked the workers, but at the same time opened bigger ones with temporary staff at lower pay. Public outrage forced a retreat.

Let's have a party

Stagnant pay and domestic consumption have increased Germany's dependence on exports. Between 2004 and 2008 its net exports accounted for nearly 40% of GDP growth. Its trade surpluses are the mirror image of deficits run by countries now no longer able to afford them, including several of its partners in the euro zone. Germany may not have been responsible for the headlong rush into consumption that caused the imbalances but, says Thomas Mayer, Deutsche Bank's chief economist, "we were caterers to the party." It is still in progress. Between the mid-1990s and 2007 current-account imbalances rose from 2% of global GDP to 6%. They have since eased back to 4%, but with public rather than private spending fuelling demand. That cannot last, Mr Mayer thinks.

Germany, he feels, should therefore throw its own party by rebalancing growth away from exports and towards domestic demand. Unusually, this puts the Deutsche Bank economist in the same camp as the trade unions, though their remedies differ. The unions want higher wages, backed by a statutory minimum wage, which would boost domestic demand and suck in more imports. Mr Mayer would encourage more low-wage jobs, which would beef up Germany's services.

But not that many Germans are worried about the current-account surpluses. The country is getting older, so it makes sense for it to accumulate investments in more youthful places. The surpluses could be smaller, perhaps, but the main concern is keeping Germany in medal position among world exporters. If America and Europe buy less, China, India and Brazil will buy more. The next generation of export blockbusters is already coming up, as the next section will show. ■