Welcome and introduction to the
5th Munich Economic Summit 2006 by

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Dear Minister Glos,
Director-General Lamy,
Sponsors of the Summit,
Ladies and Gentlemen,

I would also like to welcome you to this year's Munich Economic Summit and extend my best wishes for an interesting and informative conference.

By way of introduction, let me say something on the division of labour as I see it. I want to remark briefly on the effects on the German economy of globalisation, the fall of the Iron Curtain as well as outsourcing and offshoring, and then make some comments on the welfare state.

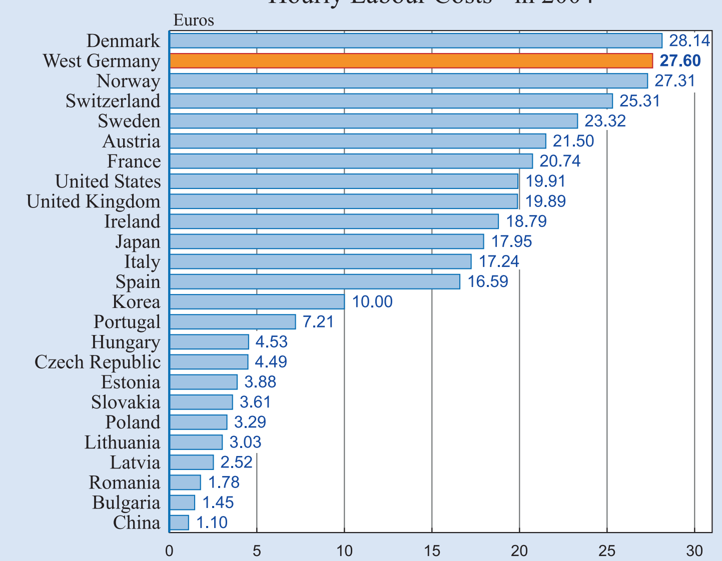
I think the most important thing to realise is that we are in the middle of an economic experiment in peace times. The world has never known such an experiment before, with the Iron Curtain suddenly falling and more or less changing an historical perspective overnight. No less than 28 percent of mankind has decided to participate in the market game. These people are well educated, but willing to work for an apple and an egg, as we say in Germany.

The wage differences are enormous: The Chinese work for €1.10 per hour, Norwegians for €27, the Germans for €28, the same as the Danish. That is an enormous difference of more than 1 to 25. Even if you take the eastern European countries, with the Poles working for €3.30 or so, you can see that on average their wage costs per hour are $^{1}/_{8}$ of the German ones.

These enormous differences in wage costs bring about economic reactions of all kinds. Capital moves to these low-wage countries. We are forced to specialise in capital-intensive activities. Labour migrates in. In the end, the gap will narrow, but it is difficult to say by how much. Our experience says that within 35 years the gap will be reduced by 50 percent (a sigma convergence rate of 2 percent per year), and that will make life difficult for the West. I believe personally that the world will not have reached its new equilibrium in the labour market in our lifetime. I think that it will take at least one generation, if not two.

Germany reacts by exporting a lot of capital. Germany invests 50 percent more capital abroad in net terms than it invests in net terms at home. But there is also an internal structural change and this is the topic of this Summit. There is a horizontal change and a vertical change. We are giving up entire branches of industry that are labour-intensive like textiles or leather goods. I am from Bielefeld – I know what it means when the textile industry dies. Instead we expand capital- and knowledge-intensive branches like the automobile industry or

Hourly Labour Costs[1] in 2004



1) Average labour costs in the manufacturing industry

Sources: Institut der deutschen Wirtschaft, Köln. For Bulgaria, Romania and the Baltic countries, the Eurostat figures for 2000 were extrapolated on the basis of the Eurostat press release no. 81 of June 21, 2005 or the ILO database Laborsta, respectively. China and Korea: 2001 estimated from the data of the ILO database Laborsta: Ifo Institute calculations.

Share of foreign intermediaries
in total intermediaries

Countries	Year	Share (%)	*)
Italy	1995 2000	17 19	**+ 2**
Denmark	1995 2000	22 26	**+ 4**
Finland	1995 2000	20 24	**+ 4**
Netherlands	1995 2000	29 30	**+ 1**
Austria	1995 2000	25 29	**+ 4**
Sweden	1995 2000	23 28	**+ 5**
Germany	1995 2000	20 26	**+ 6**

Legend: All numbers refer to total economy. Those countries are mentioned for which Eurostat data are available.
*) Change of share in percentage points.

Sources: Eurostat, Ifo Institute calculations.

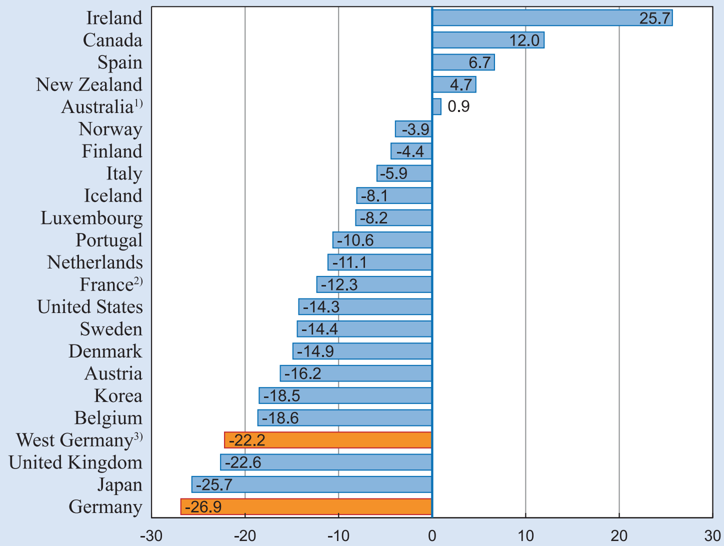
the chemical industry or high-tech branches. So that's horizontal specialisation. And then we have vertical specialisation: within the production chains the upstream activities, which tend to be very labour-intensive, are cut off and are shifted to other countries via offshoring or outsourcing. The final stages of production, which are human-capital-intensive and real capital-intensive, tend to stay and so the country just assembles the products it had produced abroad and ships them from here to the rest of the world. And this is not only true for Germany, it's the same thing for other countries. What are the figures? Well, we don't have very good data on all of this because this is a new way of thinking about phenomena, but EUROSTAT has provided data for a few countries. You see here how from 1995 to 2000 the share of foreign intermediate goods and total intermediate goods of these economies have increased. As you can see, the share has increased everywhere – here are European countries: Italy + 2 percent, Denmark + 4 percent, Finland + 4 percent, Netherlands + 1 percent, Austria + 1 percent, Sweden + 5 percent and Germany which is affected most, where this effect is stronger than in other countries.

And unfortunately or fortunately – we can discuss this –, the result is that employment in manufacturing is typically declining. There are few countries where, since the fall of the Iron Curtain, employment in manufacturing has increased: these are Ireland, Canada, Spain, New Zealand, Australia. But in most countries it has declined and enormously so: United States – 14 percent, Sweden also – 14 percent, West-Germany – 22 percent and Germany as a whole – 27 percent, which is partly the east German story. Germany, the UK and Japan have had the largest loss of manufacturing employment among all OECD countries. The production depth, that is the share of value added in manufacturing output, has declined – in Germany from 38 percent to something like 33 percent since unification, and a similar development has taken place in the other old EU countries, although there the share is lower. It is clear that it is lower because the smaller a country is, the less likely it is that the intermediate products are produced at home. That is nothing special, but the downward trend that we see here in Western Europe is remarkable.

And Germany is affected more because the gap to the other EU countries has narrowed. And if we compare Germany with the average of the United States, Japan, France and the UK, you see this enormous special development here in Germany where production depth has declined much more than in other countries. We used to be above the average of

Employment in Manufacturing

Change 1991 to 2003 in %



1) Australia 1991-2001. 2) France 1991-2002. 3) West Germany including Berlin.

Sources: OECD STAN Industry Volume 2005, release 03; Arbeitskreis VGR der Länder, Volkswirtschaftliche Gesamtrechnung, Ländergebnisse, Reihe 1, Band 1, February 2005; Ifo Institute calculations.

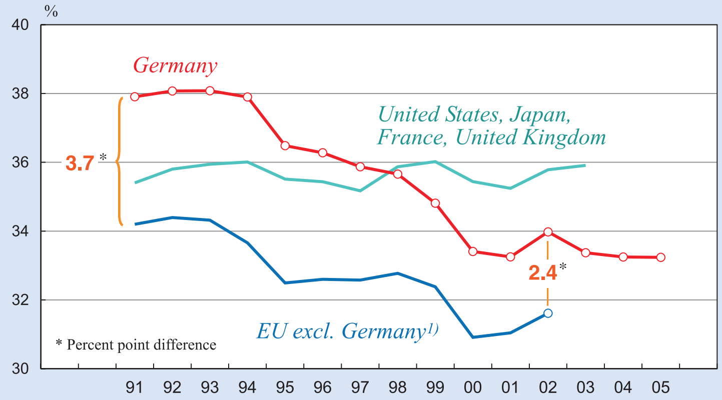
these countries in the early 1990s and now we are way below. This is what I have termed the "bazaar economy".

We are the bazaar anyway because I think we have the richest range of industrial products of the intermediate kind in the world. The tool making shop is located in Germany, not in Japan, not in the United States. We have 450 world leaders in some market niches. However, this bazaar is separating itself from the workbench. The workbench used to sit in the back yard and produce directly for the bazaar, but now this workbench is increasingly being shifted to the lower-wage countries. You don't realise that because the goods still go over the same counter and are distributed via this counter to the world, but the jobs are being lost. And the label "Made in Germany" becomes a relevant question. What does it mean? "Sold in Germany" it often means. It does not really mean that the value added is generated in Germany. I had a little debate with Porsche about this because they had claimed that more than 50 percent of the value added of their production cost is in Germany. Ferdinand Dudenhöfer, however, an expert on the automobile industry, has now looked into the details and arrives at just 33 percent. Two thirds of the value of a Porsche Cayenne is generated abroad. The question is: is that good or bad? What do we make of it? Do we like it or don't we? There is no clear answer. The answer depends on your level of abstraction. It depends on the angle from which you see it. If you see it from a business perspective, the answer is trivially: good because otherwise the clever managers wouldn't do it. It increases profits and it helps to run the business. Actually, Germany has been very successful because it has been able to outsource labour-intensive parts of the production chain to Eastern Europe. Otherwise there would not be the success story of Germany's manufacturing firms. The second point of view is economic rather than business, it is from a general economic perspective. Here we have to distinguish between second best and first best.

Second best is to take the world as it is, take our institutional setting as it is. Is outsourcing good or bad from an economic point of view? The answer is again: good. Why is it good? Because without outsourcing, industry could not survive at all and then you would lose even more jobs than you do now. So it is a rational strategy also from an economic point of view.

But now comes economic first best and that is a different question! That is the question posed by David Ricardo: Is it an improvement in the division of labour? If so, it would also be good. But here I have my doubts. Whether something is an improvement in the division of labour has to be reflected by the labour market, of course it can only be seen there. So, here is a sector where the jobs disappear and then there should be another sector offering new jobs, so that we have a structural change for the better. That means specialisation: you have as many new jobs in services, in construction, in high-tech as you lose in manufacturing. In that case the whole thing would make sense from an economic point of view. But the reality is different in Germany. I don't have the data for other countries, but it would be useful to look into this. In Germany, from 1995 to 2005, the manufacturing industry lost 1.21 million jobs in full time equivalent terms and the nice economic theory that we find in our textbooks would now say: OK, these people moved to the other sectors: to construction, to services, to high-tech industries to produce better things with higher value added in which we have a comparative advantage. Lets be happy about the Chinese and the Poles doing the dirty industrial work for us while we sit at the computer and do high value stuff. But the reality is – no new jobs! Virtually no jobs were created in the rest of the economy

Production Depth
Share of own value-added in manufacturing output



1) Belgium, Denmark, Finland, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, Sweden, Spain and United Kingdom.

Sources: Statistisches Bundesamt, Fachserie 18, Reihe 1.4; OECD, STAN database for Industrial Analysis; Deutsche Bundesbank; Ifo Institute calculations.

in net terms. Yes, services have gained, construction has lost, but in net terms the entire rest of the economy has not created a single job during the past ten years. In fact, there was a loss of 150,000 full time equivalent jobs in the rest of the economy. What has happened, where have these people gone? There is only one possibility – they have gone to the welfare state. That is the division of labour à l'allemande. We do the one half – we cut the industrial jobs here, but we forget about the other half – creating new jobs elsewhere in the economy. Why is this so? It is obviously the rigidity of the German labour market which brings about that result. We have strong unions that defend existing wages despite the worldwide competition of low paid labour, despite the fact that equilibrium wages in Germany have declined with the opening of the Iron Curtain, and in this way we are creating a lot of unemployment.

High and rigid wages, which do not react to the forces of globalisation, lead to pathological overreactions of the economy. There are two types of overreaction: the first is that the bazaar effect is too strong – that is, the part of the production chain that we cut off here is too large. In principle, outsourcing is a good thing. A well functioning economy would shift some of the labour-intensive activities to other countries. This would create more jobs elsewhere. Our economy is not well functioning, however, as the data on the labour market show. We cut off too many jobs and don't create enough jobs elsewhere in the domestic economy. And why? Because our wages are too high and sticky and are remaining there despite the Poles, despite the Chinese. And there is another pathological overreaction. Horizontal specialisation is also too strong. In fact, there is a landslide, as the labour-intensive industries are being killed and the factors of production, labour, real capital, human capital, are driven out of these industries into the capital-intensive export sector that can more easily withstand low-wage competition from elsewhere.

Normally, a well functioning market economy, opening up to international trade with low-wage countries, would react efficiently. It would also specialise in the same direction, but because this specialisation makes jobs redundant, wages would fall. And the decline in wages, which an efficient market economy would bring about, would impose a brake on this process. This brake is absent in Germany. Therefore we get excessive horizontal specialisation and we overexpand the capital-intensive export sector – so we get too many exports in value-added terms, not just in volume, and the bazaar effect, i.e. the fact that we specialise in downstream activities, reinforces the export boom, making export volume grow faster than value added. That explains why Germany is world champion in merchandise exports.

What can we do? We have to reinvent the German model. The old German model has come to its end. The welfare state, which fixes the lowest wages at the level of replacement incomes paid, that is incomes that are paid on the condition that you do not work, cannot survive in times of globalisation. It is impossible to withstand the forces of globalisation, which demand lower wages for simple labour, by keeping the welfare state in tact, by defending existing wages. This is what we have done for 35 years, and as a result unemployment has increased in west Germany along a linear trend despite the cycles. I believe that we cannot continue for another 35 years. The Federal Republic of Germany will have ceased to exist before these 35 years are over. So, something has to be done. We have to re-invent the welfare state – create a better welfare state – and then we will be able to efficiently integrate into the world economy and capture gains from trade and be winners of globalisation. I don't believe that Germany has been able to increase its gains from trade in the last ten years. Germany was a big winner in the postwar period, no doubt about that, at a time when it was the low-wage competitor whom the Americans allowed to participate in world trade. But that time is over. Now Germany is the high-wage country competing with Poland, China and so on and it is making many mistakes. And because it is making these mistakes, Germany is unable to further increase its gains from trade. Germany is the laggard in Europe in terms of growth. It is obviously doing something wrong, and I think not only Germany is doing something wrong. I believe that all of Europe is on the wrong track.

Thank you very much.