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VW Beetle in production 1955. By the early 2000s the famed German-efficiency economy was in desperate need of reform, which it got from chancellor Gerhard Schröder (below). PHOTO: KEYSTONE / GETTY

TONY ABBOTT'S GERMAN MOMENT

Reform Once a model of 20th century efficiency, Germany's economy stalled a decade ago. Gerhard Schröder's tough medicine turned it around. Tony Abbott should take note, writes **Oliver Hartwich**.

If Australia's new government needed a reminder of what economic challenges lie ahead, the recent *Global Competitiveness Report 2013-2014* delivered it. For the first time since the World Economic Forum started gathering data on the economic attractiveness of different countries, Australia dropped out of the global top 20 and is now in 21st place. To add insult to injury, its poorer New Zealand cousin edged ahead and is now ranked 18th in the world for competitiveness.

Such rankings should, of course, always be taken with a grain of salt. However, it is hard to deny that over the past years Australia has lost its mojo. The great reform era which had started with Hawke and Keating ended sometime during the Howard years. Arguably, the last major economic reform worthy of the name was the introduction of the goods and services tax. But that was way back in 2000.

Coinciding with the end of reforms, Australia's exports-driven mining boom took off. Amplified by extraordinarily favourable terms of trade, it masked an underlying deterioration in Australia's competitiveness.

Now that this boom is fading, the structural weaknesses of the Australian economy is coming to the surface. Public finances have deteriorated markedly; the labour market is rigid and inflexible; the tax system is a complicated mess; housing is severely unaffordable in all major cities; and the persistently strong dollar weighs heavily on exporters.

With the exception of housing affordability, all of the above could have been said about another country about a decade ago. Back then that country was dubbed "the sick man of Europe". Plagued by high unemployment and running substantial budget deficits, Germany was in the doldrums. Its bookstores were full of titles such as *Can Germany Still be Saved?*, a best-selling tome on the country's malaise written by prominent economist Hans-Werner Sinn.

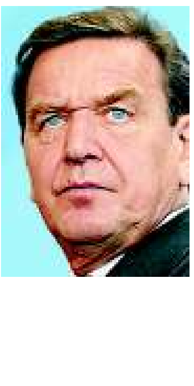
The *Frankfurter Allgemeine Zeitung*, a leading conservative broadsheet not usually engaged in revolutionary activities, published an essay by political scientist Arnulf Baring under the headline, "Citizens! To the barricades!" It ended with strong words: "We must not allow everything to continue going downhill as hapless politicians are letting our country rot."

That was a decade ago – when Germany's inevitable decline looked like a foregone conclusion. Today, it is hard to believe that the country which was about to lose hope in itself now ranks as the most competitive large country. Only Switzerland, Singapore and Finland scored better overall in the aforementioned report by the World Economic Forum.

What happened to German competitiveness in such a short period of time? And what are the lessons that Australia, now dealing with its own economic challenges, can learn from the Germans?

For a start, it is useful to keep perspective and not to indulge in widely shared exaggerations. Germany a decade ago obviously was not as doomed as most commentators believed. It probably is not quite the economic superpower it now appears, either.

The German business model looked distinctly old-fashioned in the early 2000s. It was an old economy country, with a large manufacturing sector and not much of the glitzy world of financial services and property speculation that had come to dominate the post-modern economies of the Anglo-



sphere. After the shock of the financial crisis, the old economy has come back into fashion – and with it, an appreciation of Germany as one of the world's most successful manufacturing and engineering nations.

Though the German pessimism at the beginning of the century may have been exaggerated, there is no doubt that the country faced serious problems. The unemployment rate stood stubbornly above 10 per cent, and total unemployment approached the 5 million mark. The average economic growth rate for the German economy from 2000 to 2005 was a paltry 0.6 per cent. From 2001 until 2005, budget deficits of between 3.1 and 4.2 per cent of gross domestic product were recorded. Employers were saddled with high contributions to a generous social security system – one that had grown since the 1950s when companies like Volkswagen, with its iconic Beetle, were driving Germany's post-War economic miracle..

Germany's economic crisis was the result of two factors. First, it was caused by decades without any meaningful economic reforms while the rest of the Western world experimented with Thatcherism, Reaganomics, economic rationalism and Rogernomics. Second, the introduction of Europe's common currency, the euro, had painful short-term implications for Germany's competitiveness within the euro zone.

From the 1970s until the early 2000s, the absence of economic reforms had become such a fixture in German politics that a word

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Don't trust online comments

The "wisdom of crowds" has become a mantra of the internet age. Need to choose a new vacuum cleaner? Check out the reviews on Amazon. Is that restaurant any good? See what Yelp has to say. But a new study suggests that such online scores don't always reveal the best choice. A massive controlled experiment of web users finds that such ratings are highly susceptible to irrational "herd behaviour" – and that the herd can be manipulated.

Sometimes the crowd really is wiser than you. The classic examples are guessing the weight of a bull or the number of gumballs in a jar. Your guess is probably going to be far from the mark, whereas the average of many people's choices is remarkably close to the true number.

But what happens when the goal is to judge something less tangible, such as the quality or worth of a product? According to one theory, the wisdom of the crowd still holds – measuring the aggregate of people's opinions produces a stable, reliable value. Sceptics, however, argue that people's opinions are easily swayed by those of others. So nudging a crowd early on by presenting contrary opinions – for example, exposing them to some very good or very bad attitudes – will steer the crowd in a different direction.

To test which hypothesis is true, you would need to manipulate huge numbers of people, exposing them to false information and determining how it affects their opinions.

A team led by Sinan Aral, a network scientist at the Massachusetts Institute of Technology, did exactly that. Aral has been secretly working with a popular website that aggregates news stories. The site allows users to make comments about news stories and vote each other's comments up or down. The vote tallies are visible as a number next to each comment, and the position of the comments is chronological. He wanted to know how much the crowd influences the individual, and whether it can be controlled from outside.

For five months, every comment submitted by a user randomly received an "up" vote (positive); a "down" vote (negative); or as a control, no vote at all.

The team then observed how users rated those comments. The users generated more than 100,000 comments that were viewed more than 10 million times and rated more than 300,000 times by other users.

At least when it comes to comments on news sites, the crowd is more herdlike than wise. Comments that received fake positive votes from the researchers were 32 per cent more likely to receive more positive votes compared with a control, the team reported online last week in *Science*. And those comments were no more likely than the control to be down-voted by the next viewer to see them.

By the end of the study, positively manipulated comments got an overall boost of about 25 per cent. However, the same did not hold true for negative manipulation. The ratings of comments that got a fake down vote were usually negated by an up vote by the next user to see them.

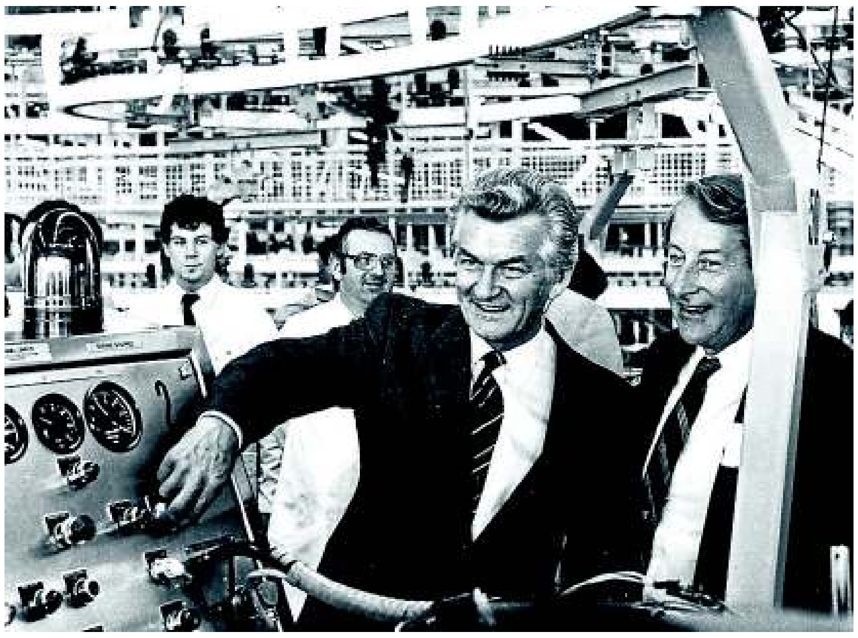
"Our experiment does not reveal the psychology behind people's decisions," Aral says, "but an intuitive explanation is that people are more sceptical of negative social influence. They're more willing to go along with positive opinions from other people."

Will companies be able to boost their products by manipulating online ratings on a massive scale? "That is easier said than done," Watts says.

If people detect – or learn – that comments on a website are being manipulated, the herd may spook and leave entirely. R

SCIENCENOW

This is adapted from ScienceNOW, the online daily news service of the journal Science. John Bohannan



Prime minister Bob Hawke (top) at Ford's Geelong plant, 1983. Fortescue Metals CEO Andrew Forrest (left) with Tony Abbott in August. PHOTO: BRUCE POSTLE, ALEX ELLINGHAUSEN

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German moment

was coined for it. *Reformstau* (literally: reform congestion) even won the German Language Society's "word of the year" award in 1997.

The roadblocks to reform could be found at the top of consecutive German governments. Chancellor Willy Brandt (1969-1974) was passionate about foreign policy and sought to improve relations between East and West Germany. But Brandt was fundamentally disinterested in economic affairs.

His successor Helmut Schmidt (1974-1982) regarded himself as a star economist. However, his Keynesian macroeconomic recipes left only a legacy of debt, unemployment and inflation. The unwillingness of Schmidt's party to tackle microeconomic reforms was one of the main reasons why the liberal Free Democrats ended the coalition with the Social Democrats.

The new liberal-conservative government under Helmut Kohl (1982-1998) also failed to deliver on reforms. Kohl wanted to be the political visionary who first united Germany and then Europe. For him, economic considerations always came a distant second. Kohl famously said that he wanted to win elections, not the Ludwig Erhard prize (Erhard's free-market policies had kick-started Germany's postwar boom). Consequently, Kohl mismanaged Germany's economic unification and led it into a poorly designed monetary union.

Initially, the social democrat chancellor Gerhard Schröder (1998-2005) was disinterested in economic management as well. "Governing is fun" was his motto, and in his first years as chancellor he enjoyed appearances on light entertainment television, smoked Cohiba cigars and displayed his collection of Brioni suits. He was a "cashmere chancellor", as news magazine *Der Spiegel* put it.

It is ironic how, of all people, this happy-go-lucky chancellor should turn out to be the greatest reformer Germany had seen for half a century. But at the start of Schröder's second term, economic circumstances had deteriorated so much that his back was to the wall. It just could not go on as it had.

Fighting for his political life, Schröder tried a political gamble. In March 2003, he went to parliament and gave the speech that had been decades overdue: "We have a duty not to rob following generations of their chances by our own inertia. This is why we need to have the courage to change." He went on to proclaim that his government would "cut state funding and promote individual responsibility, and we must ask all individuals to make an increased effort".

It was a shock announcement. Schröder's so-called Agenda 2010 curtailed the welfare state, reformed the federal employment agency, and liberalised temporary work. The greatest change, however, was the effect on people's expectations. Where previously the state provided a generous safety net, welfare recipients now received a clear signal they had to sort out their own affairs.

The most important, and most controversial, change was reform of so-called unemployment aid. Previously, job seekers could claim relatively generous benefits indefinitely. Schröder's reform meant that after one year out of work, the available benefits were reduced to a bare minimum. This increased the pressure on the unemployed to find a new job even if it did not match their previous salary or their qualifications.

Schröder's reforms tore his own party apart and gave rise to a populist movement, which later merged with the remnants of the East German communist party. The Social Democrats suffered a crushing defeat in the 2005 election and have not fully recovered.

And what about the current Chancellor, and leader of the Christian Democratic Union, Angela Merkel? When still in opposition, she criticised Schröder's reforms for being too timid and campaigned for a radical overhaul of tax and welfare laws. She hoped this would get her close to an absolute majority, but in the 2005 election she ended up only narrowly ahead of Schröder's Social Democrats and had to form a coalition government with them. The voters apparently do not value tough reforms – and Merkel has not spoken of them ever since.

The Agenda 2010 program had a double result. On the one hand, it contributed to Germany regaining its competitiveness and led to the creation of 2.7 million new jobs since. On the other, it scared off all parties from reforming further. In this year's election campaign, no party dares to speak the language of economic liberalisation although there remains much unfinished business, particularly in the areas of taxation, pensions and health.

The reform backlog was a major cause of Germany's crisis a decade ago, but an equally important factor was the introduction of the euro. For the past few years, Germany has benefitted from a euro exchange rate and interest rates that were too low for its economy. However, in the first years of the euro, it was the other way around. Germany had entered monetary union at an unfavourable exchange rate. The old deutschmark was valued too highly and left German businesses uncompetitive when the euro started in 1999.

Schröder's reforms were painful but eventually they paid off. Except for the politician who started them.

The crisis that ensued can be interpreted as a process of internal devaluation. For years, German wages barely increased in real terms. The bargaining power of unions was limited due to rising unemployment, and companies reacted to the high exchange rate as they had always done in the past: by cutting costs, streamlining processes and becoming more efficient.

Exchange rate pressure was nothing new to German businesses. Throughout postwar history, the old deutschemark had been one of the strongest currencies in the world. It kept appreciating against all other major currencies for decades.

In January 1960, you needed to pay DM4.17 for $US1. In December 1998, on the eve of the euro's introduction, the exchange rate had fallen to just DM1.67 – a depreciation of 60 per cent over 39 years.

The depreciation of the United States dollar against the deutschemark was not actually too bad when compared with other currencies. It was even worse for the British pound sterling (76 per cent), the Italian lira (85 per cent), the Spanish peseta (83 per cent), the Greek drachma (96 per cent) – and also the Australian dollar (78 per cent). However, the German response to such exchange rate pressures had always been to claw back competitiveness by becoming more productive. It certainly worked. Since 1953, Germany has been in the top three global exporting nations.

If Australia wanted to draw any conclusions from the German turnaround of the past decade, there are a few. To trigger a wave of economic modernisation, it either takes a conviction politician such as Margaret Thatcher or it takes an economic crisis to force it onto the agenda, as happened to Gerhard Schröder.

So far, Tony Abbott does not appear to be driven by a coherent economic strategy but deteriorating circumstances may well force him to do a Schröder. The lesson for Australian businesses is to stop moaning about the high exchange rate. Instead, they should accept it as a challenge to improve their operations and get better. A strong currency never stopped Germany from securing its international competitiveness.

Finally, the German reforms undertaken by the Schröder government, limited as they were, had a major effect on growth and employment. They were painful but eventually they paid off for the country. Except for the politician who started them.

What are the chances Tony Abbott will be as selfless? W

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Go to tv.afr.com Oliver Hartwich weighs the benefits of reform against the costs.