

July 2009

Save jobs or drive structural change forward?

Ten theses on industrial policy in the economic crisis

In the face of the most serious economic crisis for 80 years, calls for state support for sectors of industry and individual companies are growing ever louder. The list of companies which have applied for state assistance is growing. Confronted by these developments, decision-makers are in a fundamental dilemma: Should they “save jobs or drive structural change forward?”. The working group on “Modern Industrial Policy” of the Friedrich-Ebert-Stiftung, led by Germany’s former Finance Minister Hans Eichel, has produced a short position paper with precisely that title. The authors, Alfred Pfaller and Philipp Fink, recommend careful consideration of any decision involving the issue of state assistance. The central point which must be faced is whether the struggling company could still compete in the market, irrespective of its current liquidity problem.

Alfred Pfaller and Philipp Fink*

1) The economic crisis represents an external shock for companies

The current economic crisis is caused by two complexes, which are affecting companies like electric shocks:

- the withdrawal of credit facilities, triggered by the bursting of the “bubble” which had formed in previous years on the American property and financial markets
- a drastic, self-reinforcing reduction in global demand, stemming from

drastic losses in assets as a result of falling prices in the shares and property markets, the withdrawal of credit facilities and a general pessimism about the future.

Companies are getting into difficulties because on the one hand banks were restricting the amount of credit they were offering, or charging a good deal more for it, and on the other hand, because the collapse in global demand led to a drying up of orders, sales and revenues. Both of these problems can bankrupt companies. If the production capacities are not then taken over by owners who are in a stronger financial position, the col-

*Dr. Alfred Pfaller works free-lance. Philipp Fink chairs the working group on modern industrial policy of the Friedrich-Ebert-Stiftung.

lapse may lead to a considerable destruction of capital and a corresponding destruction of jobs.

2) The economic crisis reinforces structural problems

Reductions in demand of critical importance are never distributed evenly across the entire economy. They always obtain a structural profile, in which, for example, competitive shifts and tendencies towards structural change find expression. Recession accelerate structural change, because they impose stricter criteria for survival. Thus the current macro-economic crisis is revealing companies' structural weaknesses.

3) Company closures caused by structural change are not a problem for the economy as a whole

Company closures do not necessarily represent a major economic problem. If a company has to cease production and can no longer satisfy the appropriate demand, this demand will at first shift to other offers instead. In this case, the more efficient competitors will profit from the bankruptcy of their competitor. Their turnover will rise, they can expand their production (or are confronted by less serious sales reductions during the crisis) and can therefore increase the number of jobs they offer (or now, during the crisis, make existing jobs safer).

It may also be the case that the demand turns towards other branches of the economy. Here too, the reduction of production and jobs in a single production area (accentuated by the closure of a large production facility) can also see an expansion in other areas.

4) However, bankruptcies are still a problem for the public

Two aspects nevertheless turn the collapse of a major industrial company into a political problem:

- **Lack of absorption:** The expansion in production and increase in jobs among competitors does not take place at the same time. As a result, the fall in demand and the economic crisis become more serious, the number of unemployed rises.
- **Transfer of absorption:** The demand is directed towards products manufactured outside the affected region. The new jobs are created elsewhere. As a result, the economic and social costs fall at the site of the company which has closed down.

The first aspect causes a **systemic interest** for politicians, especially in order to avoid if at all possible a massive corporate collapse, especially in times of crisis, and thus to preserve demand, and thereby also employment.

The second aspect is the interest of the affected regional bodies, to preserve their own production capacities and thus their own jobs irrespective of how well a corporate collapse is compensated for in other locations.

5) Support for struggling companies must be linked to their prospects of regaining competitiveness

In the view of a region or a federal state, it is therefore desirable in principle to keep alive companies based in the area which have got into difficulties.

But this raises two questions:

- Is it **possible in the long run** to rescue

the company from its difficulties, i.e. can the company in question survive in the market effectively in the long term?

- Are there **more sensible alternatives**, for using the resources necessary to save the company?

Costly experiments in the past (e. g. subsidies for the coal industry) have shown that it is not possible to maintain the status quo against the pressure of structural change. In spite of short-term successes, such plans are liable to fail in the medium or the long term.

Instead, the public body which seeks to help should ask the same questions as would banks and investors considering whether to take shares in the company: What are the chances that the firm can once again become competitive and profitable? Which measures can guarantee that this happens, and should therefore be imposed on the company as a condition?

These questions can only be answered on a case-by-case basis after careful analysis. Even then a risk remains that what seemed like well-founded confidence could turn out later to be false and that the jobs to be saved are still lost in the end.

6) Industrial policy must distinguish between three problems

Three main types of problem can be distinguished; each of them requires a different solution.

Shortage of liquidity

The twofold shock mentioned in the first thesis (shortage of liquidity + reduction in demand) does not necessarily demonstrate a lasting loss of the company's creditworthiness. If indeed it does not show this, then it is

extremely advisable to help the company get over its liquidity problems until the end of the general credit crunch.

Reduced competitiveness

It may also be the case that the twofold crisis reinforces specific company weaknesses, and that it cannot simply be assumed that the firm will have overcome its difficulties after the crisis. If this is the diagnosis, it raises the question of how and whether the company can be made competitive again. In this case, assistance from the taxpayer can only be supported if it is linked to the condition of a corresponding restructuring strategy (cost-cutting, development of more marketable products).

No attempt should be made to strengthen the company's competitive position "artificially", i.e. with subsidies, so that it can defend its sales figures in what is an overall shrinking market. This is not just against the rules, but also ultimately pointless, since its competitors would follow that example.

Shrinking sector

There is little sense investing a lot of money to rescue a company which is active in a market segment in which turnover is expected to shrink in the long run – whether because the markets are saturated, or because production is being transferred to cheaper locations, or where both factors apply together. That would only mean digging an even bigger hole for yourself. In such a case, a much better alternative is to invest the money necessary to rescue the company to develop production lines with a future (in manufacturing or services), which in the long run promise higher profits and higher aggregate wages.

7) Regional development strategies are the better way

If the diagnosis reveals that even after the macro-crisis has been overcome, the struggling company still has poor prospects, then there is nothing for it but to “face the music”, i.e. to force the pace in constructing new, competitive structures, preferably as part of a regional development strategy. Since what matters for the region above all is jobs for its working population, then they too must be prepared for the new structures – with the help of appropriate efforts to improve qualifications.

However, a regional development strategy cannot be produced “like a rabbit out of a hat”, whenever a large regional company gets into difficulties. It is better to keep a constant eye on companies and sectors and to steer them towards strategies for the future from an early stage. To ensure this, suitable processes of observation and decision-making should be institutionalised, involving all the important “stakeholders”. Institutions which “save” employees affected by closures and support them in their search for new jobs are also part of a forward-looking structural policy.

8) Supporting demand is the number one priority

The current crisis reveals a serious imbalance in Germany’s economic structure: its strong dependency on exports. It is precisely the crucially important demand for exports, so vital for German economic growth, which has fallen so dramatically. At the same time, internal demand cannot compensate for the capacities becoming free.

Therefore in the current recession, support for the collapsing domestic demand is advisable. In the present crisis this also means, above all: restoring credit facilities, whether by strengthening credit institutions which have got into difficulties, or by creating alternative facilities. Secondly, it means: generating demand (discouraging private saving, encouraging private spending, increasing public indebtedness).

However, the resultant problems of massive state indebtedness to the private sector, which is intended to compensate for the absence of private demand (irrespective of whether this is done through tax cuts not paid for from equivalent savings elsewhere, or through the expansion of public spending) must be taken into account. In this context, it would make better economic sense for the public sector to borrow from the central bank (in the sense of printing money). It is true that this can drive up inflation, if work is taking place at full capacity. However, the current problem is not an overheating economy but its “hypothermia” which is leading to a depression.

9) Measures to support demand must be coordinated internationally

Shrinking markets intensify competition, especially price competition. This provides a test for the financial stamina of companies. Measures of state support which allow your own companies to enter the market on more favourable terms, would distort this competition. They are essentially protectionist in nature. They attempt to pass on the consequences of the general crisis in sales to other people.

The same applies if state support is only given on condition that primary products are

purchased from the domestic market. Any possible direct advantages of such a procedure will soon be neutralised by countermeasures from trading partners, and overshadowed by the danger of a protectionist escalation process with fatal consequences, especially in the case of an exporting country like Germany.

Instead of involving the state in the struggle for market shares, it would be better to take international measures against market shrinkage and to rescue companies with a long-term future in the market. The danger is that measures by individual states or regions, even when these may be desirable in the sense described above, could lead to a protectionist maelstrom and thus ultimately prove ineffective.

10) When in doubt, try to save the firm

Because of its inherent escalation dynamic (the downwards spiral), the crisis requires quick actions, even when it is not possible to achieve internationally coordinated measures in time. But quick actions often must take place accompanied by a high degree of uncertainty about external conditions and consequences. In such a situation, you have to consider where the greater risk lies:

- In a **support or rescue action**, which ultimately turns out to be unsuccessful, because the company in question ends up being crushed by its competitors or which subsequently turns out to be a suboptimal solution, because there could have been more suitable ways to proceed;
- In avoiding any active **industrial policy**, which is desirable in a regulatory sense, but (a) accepts the insolvency of a com-

pany which is important to its region, even though it could have been allowed to survive with a financial bridging loan. This also would let the downward spiral of the economic crisis continue on its merry way.

In doubtful cases, the second risk should be assessed as the greater one, even if it is only a matter of gaining time until better solutions can be seen or become politically feasible.

In doubtful cases, the second risk should be assessed as the greater one, even if it is only a matter of gaining time until better solutions can be seen or become politically feasible.

This economic and financial crisis is not just a matter of economic key figures (gross domestic product/per capita regional product), but of life opportunities for human beings who are economically extremely vulnerable. The intensifying economic crisis can turn into a crisis of legitimacy for the economic and political system. That is why the world of politics must not refuse people the necessary assistance, whether out of incompetence, inability to take decisions or dogmatic ideologies.

Translation: The Language Technology Centre

The views expressed in this article are those of the authors and do not necessarily reflect those of the FES London.

ViSdP (Person responsible according to the German Press Law): Karl-Heinz Spiegel