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Insight

Germany needs a new growth model

by Sander Tordoir and Shahin Vallée, 30 June 2023

Berlin should fundamentally reset its growth strategy, rather than clinging to a failing model of industrial export corporatism.

During the past decade, Germany's export-driven economic model underpinned its strength on the European and international stage. The country accumulated a large external surplus and used its deep pockets to cement its status a leading development aid donor, amplify its voice in the Bretton Woods institutions and, albeit hesitantly, backstop the eurozone and its bailout funds. Europe's largest economy has also proven to be more adaptable than previously thought and weathered the pandemic and the Russian gas cut-off better than widely anticipated.

But these shocks should not hide the fact that the German economic engine is facing structural headwinds, that are steadily weakening the country as geopolitical tensions mount. The exports that powered growth in the 2010s, propelled by Asian demand for German cars, machinery, and chemicals, ran out of steam in 2018, amidst former US President Trump's trade wars, growing Chinese production and '*Dieselgate*', with car-makers abruptly divesting from diesel vehicles after they had tampered with European Union emissions tests. Today, the German economy is roughly the size it was in 2019, as is its industrial output. Over that period, France added more than twice as many jobs as Germany, albeit many under apprenticeship schemes. The US economy, meanwhile, grew by 5 per cent and has returned to its pre-pandemic expansion path. Moreover, German growth is expected to lag behind the eurozone average until 2025, putting it closer to Brexit Britain than its peers.

Despite this, German policy-making does not seem set on long-term growth. Some in the governing traffic-light coalition of of Social Democrats (SPD), Greens, and pro-business Free Democrats (FDP) want to pursue a new form of industrial policy that uses lavish subsidies both to boost green tech and to limit the effects of rising industrial energy prices. Others clamour for higher interest rates and budget cuts. But the chokeholds on German growth stem from a deeper interplay between international dynamics and a domestic policy which are unfit for this decade. Germany needs to embrace a new growth strategy to avoid a further drift down the economic league table.

For decades, Germany's economic strategy was either agnostic to geopolitics or pursued ideas like '*Wandel durch Handel*', reducing political tensions through trade. Trade deficits prompted German support for

European fixed exchange rate mechanisms in the 1970s and 1980s, in order to prevent devaluations against the Deutsche Mark. Intensifying competition with the Asian tigers (Hong Kong, Singapore, South Korea, and Taiwan) in the 1990s and 2000s underpinned German support for waves of eastward EU enlargement, in search for cheaper markets and labour to establish its industrial supply chains. Securing cheap energy, and in particular gas from Russia, was a central pillar of Germany's foreign policy until Putin's full-scale invasion of Ukraine in February 2022 put an end to it. A domestic policy of restrained wages and tight budgets to keep German products competitive rounded off the strategy – a doctrine Berlin advocated as the blueprint for the rest of the EU during the euro crisis. Strategic dependencies on autocratic countries, like Russia and China, grew along the way, but were largely ignored.

In the span of three years, a perfect storm of a global pandemic, Russia's war against Ukraine, and an ensuing energy crisis, as well as growing Sino-American tensions, have exposed the risks of such dependencies being weaponised. Germany's heavy reliance on foreign demand for its products, and importing the fossil fuels to build them, has been exposed. Globalisation may not have gone into reverse, but it is surely changing – and not in Germany's favour. China's car exports are exploding, supplanting Germany as the runner-up and threatening Japan's spot at the top of the global auto market. Beijing is also upgrading China's machinery sector. Ironically, Berlin has exacerbated the competitive threat that it now faces with little regard for maintaining a level playing field with China. For years it let leading German companies plough foreign direct investment into China (FDI), enter joint ventures that were demanded by Beijing as the price of admission, and build factories to capture Chinese subsidies with local content requirements. This has fostered technology transfers that have raised the quality and competitive edge of Chinese cars and machines.

Prompted by growing pressure from Washington, European Commission President von der Leyen is now leading a charge to 'de-risk' from China, as laid out in its draft EU economic security strategy released in June 2023. But it is not yet clear how Berlin will translate this into action. German Chancellor Olaf Scholz has accepted that Berlin needs to diversify its supply chains. But Berlin is only marginally more dependent on incoming Chinese goods than most other G7 economies. In turn, Germany's export exposure to China is much higher than its peers, accounting for over 3 per cent of the country's GDP, and it has a very large stock of investments in China (just below €90 billion by late 2020). The emerging EU de-risking agenda would involve screening outward investment for risks of technology theft and clamping down on takeovers of technologically cutting-edge European companies funded by firms that benefit from foreign government subsidies. The German government has already capped government insurance for investments abroad that are at risk of expropriation at €3 billion per company per country. Such measures will help to limit future damage. But the trap has been sprung. Volkswagen's sales growth in China has fallen flat, and Chinese-built cars are now rolling into global and European markets.

The absence of coherent long-term economic plan is compounded by the lack of public investment or reforms during the sixteen years of former Chancellor Merkel's tenure. Germany's physical infrastructure has decayed after more than a decade of belt-tightening at the national, state, and local level. The railway network alone needs a €45 billion investment injection between now and 2027. Net spending on higher education grew by less than 1 per cent in inflation adjusted terms between 2010 and 2018, compared to 6 per cent in the Netherlands, 15 in the US, and a staggering 116 in Estonia. Germany also made little progress in cutting red tape or reducing unwarranted protections for professional service like tax or legal services, which both stifle competition and keep prices unnecessarily high. This makes it harder to start or scale-up a business. Lack of childcare and disincentives in the tax code continue to hamper women's labour force participation. Most importantly, Germany has lagged behind the US and other EU countries on digitalisation, from building out fibre-optic infrastructure to digitising government services. Despite a modest boom in start-ups, all of this has weakened innovation outside of the manufacturing sector.

Out of the 40 blue-chip companies listed in Germany's leading DAX index, 23 trace their corporate roots back to the 1800s or before and only two were founded this century. One notable exception, German fintech-darling Wirecard, turned out to be a farcical criminal fraud. None of this was inevitable. For example, the much smaller Netherlands, which is economically so integrated with Germany that it could be considered an 17th '*Bundesland*' (federal state), is home to ASML, the world's leading semiconductor manufacturing company, and Adyen, a cutting-edge payment provider.

The governing coalition has set its sights on tackling some of these challenges but also continues to crave the old 'cost-competitiveness' medicine. Chancellor Scholz and finance minister Christian Lindner are mulling on budget cuts, while economic minister Robert Habeck seems intent on deploying yet more subsidies to bail out the energy-intensive industrial sector. The medicine, however, may simply not work this time. Barriers to goods trade are rising and Germany is weak in services, where global trade continues to grow. Between 2010 and 2019, its exports of services grew by an annual rate of 3.4 per cent, compared to 4.6 per cent for all high-income countries. Meanwhile, the IZA labour market institute reckons more transparent and higher, not lower, wages are the best way to draw skilled workers into sectors and firms in which labour shortages are curbing growth.

The green transition alone is also not the answer to Germany's growth woes. It is vital for Germany's prospects and will help reduce dependencies on authoritarian regimes in Russia and the Middle East. But swapping brown capital stock for green may not lead to additional growth in the long term, even if the necessary investments may bump up growth during the transition. Renewables produce energy at virtually zero marginal cost, but also intermittently. Research on the Netherlands, which has a similar energy mix, suggests the total cost of the energy system will be higher as a result.

Yet Germany has strengths that can form a basis for renewed growth, but the government will have to act wisely.

Germany is at the heart of a promising EU green tech manufacturing base. China's share of global exports in 220 'low carbon technology' (LCT) goods - ranging from electric vehicles to insulation materials - has exploded, from 23 per cent in 2019 to 34 per cent last year. But the EU's sizable share has also grown from 19 to 23 per cent, with Germany accounting for roughly half of that share. In 2021, no other G7 country – or China – exported more LCT goods than Germany, as a share of GDP. Germany should continue to excel in these green technologies, because supply chains are shortening as technologies mature, and companies are expanding production nearer to consumers to reduce shipping costs. However, Berlin should avoid disrupting the EU single market by only subsidising domestic production when many other EU countries like Slovakia, Hungary and the Czechia are an integral part of the same clean tech value chains.

Nevertheless, a drop in the share of industry in the German economy is probably inevitable. The car sector will continue to serve the EU market and retain a global edge in high-value niches. But it will shrink in overall size under pressure from Chinese competition. The future of Germany's energy-intensive sector also hangs in the balance. Can it continue to lead in manufacturing while being structurally uncompetitive in energy-intensive sectors like steel, aluminum, and chemicals? Lavishing subsidies on firms that will succeed anyway, or be outcompeted, might prove to be a waste, when more targeted support could help sprout new sectors altogether. The German economy is flexible enough to create new firms and markets, but that process is held back by fraying infrastructure, remaining digitalisation gaps, and sluggish capital markets.

Thankfully, the country has more budgetary space to propel a long-term investment drive than almost any other major advanced economy. The 'Scholzonomics' doctrine to save up and then deploy a 'fiscal bazooka' in a crisis have successfully returned the economy to its 2019 size but but growth will be slow without a comprehensive reform programme. Germany should ditch the constitutional debt brake, which limits net debt issuance to 0.35 per cent of GDP and is unnecessarily strict compared to EU fiscal rules. To circumvent the brake, Berlin has rigged up off-budget vehicles worth nine per cent of GDP for the green transition and defence. But the debt brake holds back investment at the state and local level, which is critical, for example for infrastructure and education. The German Economic Institute (IW Köln) recently estimated that the state capital stock should have grown by about €25 billion more per year in the 2000s, and by €45 billion in the 2010s, to achieve the same productivity boost that it provided in the 1990s. The cumulative gap that needs to be closed is now staggering, but Germany has the means to do so.

To help its economy adapt to a more fragmented international economy, Germany must go back-to-basics by reforming conditions at home. The country leads in research and development, spending a full percentage point of GDP more than the EU average. But its research prowess does not sufficiently translate into firm dynamism. The country's banking sector is bloated and hamstrung by low profitability, hampering financing for a new economic model. The IMF, for example, has suggested that the country can boost the funding for young and innovative firms by reducing barriers to the participation of institutional investors in capital markets, and align the tax treatment of employee stock ownership plans with international standards to provide financing for a new economic model.

Even if the key to growth lies in reform at home, Germany should continue to use its economic openness to its advantage but in a more targeted way. Berlin should support the EU's efforts to negotiate new FTAs with booming Asian countries outside China, like India and Indonesia. Germany also has a strong track record of integrating migrants into the labour force. It should further embrace migration to offset a looming decline of 7 million people in the working-age population until 2035, building on the recent easing of immigration laws.

The German economy has essentially been flat for years and the growth outlook is measly. Energy prices will be structurally higher and Chinese competition is intensifying. But the government is contemplating doubling down on the industrial export corporatism that tipped Germany into stasis in the first place. Berlin will have to fundamentally reset its growth policies to emerge stronger. At home, more education spending and higher wages can help to close skills gaps, upgrading public infrastructure like railways will facilitate labour reallocation to growing sectors, while better capital markets can funnel capital to them. If Berlin embraces and shapes an EU industrial strategy instead of pouring subsidies only on its own firms, it has better odds of expanding the blossoming EU green tech supply chains, rather than disrupting them. Berlin should also use the EU as a shield from Chinese mercantilism and potential US pressure, and to open other markets. The country has the budget resources, innovation prowess, skills, and appeal for migrants to help its economy adjust. The question is whether Germany has the courage to leap forward by trying something different.

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