CENTRE FOR EUROPEAN REFORM essays

Germany's brief moment in the sun

By Simon Tilford

Four years ago, Germany was widely seen as the sick man of Europe, beset by weak economic growth, a fast-ageing population and a pervasive sense of angst about the future. Now the talk is of Germany's unrivalled strength, even of its hegemonic status in Europe. Nowhere is this more obvious than in the case of the eurozone, whose survival – so the narrative goes – hangs on German benevolence. Germany is portrayed as the 'motor' or 'powerhouse' of the European economy, alone in Europe in having retained a manufacturing base worthy of its name and hence able to profit from the rise of emerging economies. Much of this new narrative is misleading – and ultimately damaging. Germany has its strengths, of course, but its economic might is exaggerated. Indeed, there are good reasons for thinking that its economic and political ascendancy will be short-lived.

At present, there is no missing the resurgence of German self-belief. Many German politicians, business leaders and economists like to compare Germany's economic performance and its alleged solidity – based on manufacturing and high savings – favourably with other European economies and the US. The subtext is that everyone must learn from the German example and put their houses in order. Countries must live 'within their means' and focus on sound forms of economic activity. German virtue and probity is contrasted with the irresponsibility and fecklessness of others. There is little sense that Germany, through its own domestic imbalances, faces serious economic challenges or is an obstacle to the resolution of problems elsewhere in the eurozone. True, there are dissenting German voices, but they are struggling to be heard.

Indeed, there is a sense within Germany that the country is outgrowing Europe. Booming exports to emerging markets (Germany accounts for almost half of total EU exports to China) are making some Germans question whether they still need the EU, especially when all it seems to do is present Germany with problems. Influential media, many business leaders and even some politicians from the ruling CDU/CSU and FDP parties imply that were it not for Europe and its sclerotic and debt-ridden economies Germany would be sitting pretty. Not only is there increasing frustration with the failures of other European countries, but also with the EU institutions. German politicians still pay lip-service to European integration – and portray themselves as good Europeans – but they have become increasingly hostile to the Commission and wherever possible prefer inter-governmental solutions to problems. Foreign critics of Germany's new assertiveness are generally given short shrift. Germany, one often hears, is simply doing what France or the UK do – putting its own interests first.

A new Wirtschaftswunder?

How, in the space of just four years, has Germany gone from being the sick man of Europe to experiencing a second *Wirtschaftswunder*, from being plagued by self-doubt to being full of self-confidence? The answer is that Germany was never quite the sick man of Europe that it appeared to be back then, and it is not as strong as is seems now.[1]

[1] *Katinka Barysch, 'Germany – The sick man of Europe?', CER policy brief, December 2003.*

The German economy has plenty of strengths. Even after a decade of weak economic growth, GDP per capita is around 20 per cent above the EU average, somewhat above the UK and considerably higher than in either France or Italy. Strip out the old ex-communist eastern Länder – which remain much poorer than the national average – and German per capita GDP is higher still. Successive German governments have taken steps to liberalise the labour market, with the result that Germany's employment rate – the proportion

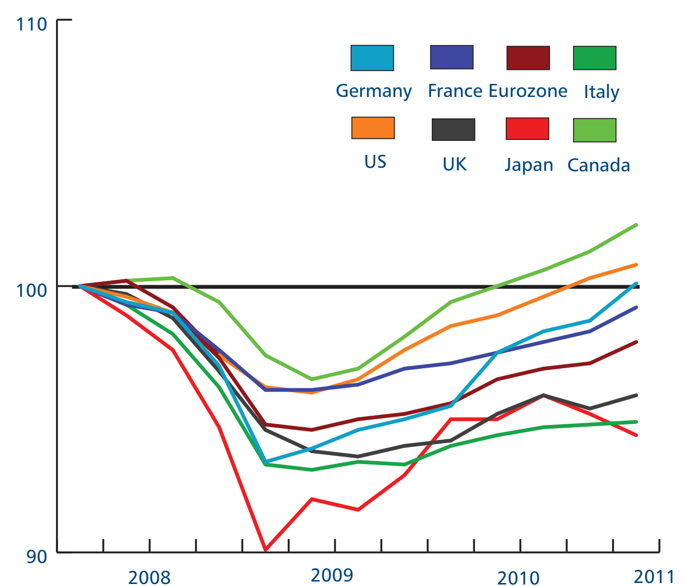
Centre for European Reform
14 Great College Street
London SW1P 3RX UK

T: 00 44 20 7233 1199
F: 00 44 20 7233 1117
info@cer.org.uk / www.cer.org.uk

of the working age population in employment – is now among the highest in the EU. Moreover, the country combines a high employment rate with relatively strong labour productivity: most EU economies have either a high employment rate or impressive productivity, but not both simultaneously. Although inequality has risen sharply in Germany over the last 20 years, it is still less acute than in France, Italy or the UK (let alone in the US), and social mobility, though declining, is still stronger than in any of these countries.

The German economy, moreover, has bounced back strongly from the downturn. Economic activity is now back to its pre-crisis peak. Of the G7 economies only Canada and the US have done better; Italy, Japan and the UK have fared much worse (see graph 1). German exports have rebounded strongly, driving a recovery in investment spending. After years of slump, the construction sector has strengthened as record low borrowing costs have kick-started the residential property market. Unemployment has fallen below 3 million, its lowest level since 1991. The economy expanded by 3.5 per cent in 2010, the quickest pace since unification, and could grow by as much as 3 per cent in 2011. That would be well above the expected eurozone average and probably the highest rate among the G7.

Graph 1 – Growth in real GDP (Q1 2008 = 100)



Source: OECD

But there are plenty of doubts about the sustainability of Germany's upturn and it is wrong to portray Germany as the motor of the European economy. So far, the economic recovery in Germany has been almost entirely down to a cyclical rebound in exports and investment. The principal impetus to investment has come from strong foreign demand for German goods and the recovery in the construction sector. Orders data suggest that German exports should rise relatively strongly for a while yet, but the pace of export demand is inevitably normalising as the recovery in world trade following the financial crisis slows. Indeed, there are mounting risks of a synchronised global slowdown, including in the hitherto booming Chinese economy. German export growth will weaken in this environment, notwithstanding the price competitiveness gains stemming from ongoing wage restraint.

German companies are certainly sitting on plenty of money – the share of profits in national income is at an all-time time high – but will they continue to invest and create jobs? Low interest rates should continue to stimulate the country's long depressed housing market. But a sustained recovery in investment will require firms to be confident about prospects for German domestic demand. Only if private consumption starts to recover from the unprecedented lows to which it has fallen will firms become more confident about investing in businesses that serve the domestic economy. A recovery in private consumption, in turn, requires steady employment growth and real wages to rise at least in line with the rate of productivity growth.

So far, consumers have played little role in the economic upturn. Private consumption grew by only 0.4 per cent in 2010, accounting for just 0.2 of a percentage point of the economic growth of 3.5 per cent. Private consumption could expand by as much as 1.5 per cent this year, but this will still only account for 0.8 of a percentage point of the forecast expansion of 3 per cent. There is no mystery why household consumption as a proportion of national income continues to decline. First, there has been no employment miracle. The German labour market has performed better than most other EU economies over the last three years, but not dramatically so. Indeed, over the year to April 2011, employment growth was no stronger in Germany than in France. Even the struggling British economy managed to create as many jobs as the German one over this period. The principal reason why Germany's unemployment rate has fallen is that the country's labour force is no longer expanding; by contrast the French and British labour forces continue to grow. Second, there is little indication that the tightening of the German labour market is pushing up real wages (wages adjusted for inflation). Wage settlements have risen in 2011, but are barely keeping pace with the rate of inflation. Third, despite improved consumer confidence the households' savings rate remains exceptionally high.

The mismatch between domestic savings and investment (or between aggregate spending and output) explains the country's current account surplus. The German economy cannot find enough useful investment

opportunities at home for domestically-generated savings. The current account surplus stood at 5.5 per cent of GDP in 2010, up from 5 per cent a year earlier. Moreover, the 2010 surplus would have been much bigger without an unfavourable 'terms of trade effect' – the prices of imported goods rose much more quickly than prices of goods exported by German producers, reflecting booming energy and commodity prices. The current account surplus is on course to be 5-6 per cent of GDP in 2011. This is lower than the peak of almost 8 per cent reached in 2008, but all this means is that Germany is exerting less of an economic drag on its trade partners in 2011 than it did in 2008.

The trading partners in question are mainly in Europe. Over half (52 per cent) of the German current account surplus was generated through trade with the eurozone in 2010, and almost two-thirds (65 per cent) of it with the EU. Adding in the rest of Europe lifted this proportion to almost three-quarters (73 per cent). The German surplus boosts output and employment in Germany; far from outgrowing Europe, Germany remains dependent on its European neighbours. Indeed, the current account surplus now poses a bigger problem for Germany than it did four years ago. It is aggravating the economic weakness and hence fiscal problems of the country's trading partners within the eurozone, which in turn poses serious economic and political challenges for Germany. It will only make sense to talk about Germany being a motor of the European economy once growth in German imports from the rest of Europe outpaces that of exports to the rest of Europe for a prolonged period of time, and ultimately if Germany runs a trade deficit with the rest of Europe.

Poor economic prospects

There is little reason to believe that Germany's underlying rate of economic growth is higher now than it was prior to the financial crisis. In fact, in some ways the economy's prospects have probably deteriorated:

Excessive export dependence

★ Four years ago there was widespread acknowledgement in Germany that the country's current account surplus was a problem. It left the economy vulnerable to external shocks and it reflected weak investment and private consumption in Germany. Now, the surplus is routinely cited as evidence of Germany's 'competitiveness' and as testament to the economy's solidity.[2] But a country with a large external surplus runs a number of risks.

First, foreign demand can weaken suddenly, as happened during the financial crisis, hitting economic growth. Second, it leaves the economy vulnerable to foreign competition. German manufacturers have a good record of maintaining their price competitiveness, but it is not as if everyone else is standing still. German producers face intensifying competition from Chinese and other emerging market producers, and most developed economies are now targeting higher-end manufacturing exports as a route back to economic growth. Third, countries with large external surpluses struggle to recycle their savings productively. High savings rates and low consumption are only possible because of the willingness and ability of others to save little and consume a lot, in the process accumulating debt. Over the medium to long term, this indebtedness tends to exert downward pressure on the value of the currencies of deficit countries. The German government resents the weakness of the US dollar, accusing the US authorities of engineering a competitive devaluation, but dollar weakness is the inevitable result of increased US indebtedness. No country can expect to be able to run large trade surpluses on an indefinite basis and be free from any exchange rate risk on the overseas investments made with those surpluses.

Running on-going trade surpluses within the eurozone carries different risks for Germany. The deficit countries can no longer devalue their currencies but they can default on their debts. Instead of being exposed to exchange rate risk, German savings are exposed to credit risk. For the time being, German savers are being bailed-out by EU governments, the IMF, and indirectly, the ECB, which is assuming the role of creditor to the deficit countries by lending unlimited sums of money to banks based in them. This means that all of the eurozone and contributors to the IMF will carry the costs of the inevitable defaults, not just the surplus economies which – along with the crisis-hit countries themselves – share primary responsibility for the eurozone crisis. However, this burden-sharing is hardly a risk-free outcome for Germany (or the other eurozone countries with excess savings.) The need to shoulder their share of the defaults threatens to erode the sovereign creditworthiness of Italy and Spain (and even France), increasing the likelihood of contagion from the currency union's periphery into its core.

Too much manufacturing

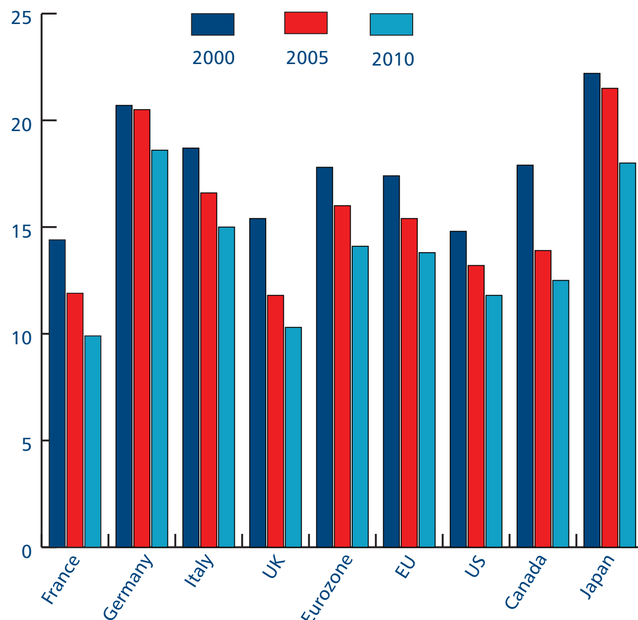
★ Four years ago the size of Germany's manufacturing sector was widely considered a problem, but policy-makers and economists now cite it as a strength. Other countries are advised to learn from how

[2] Philip Whyte, 'Why Germany is not a model for the eurozone', CER essay, October 2010.

Germany has retained such a large manufacturing industry. It may be the case that the proportion of economic activity accounted for by manufacturing has fallen too far in France, the UK and US (see graph 2). But a decline in the relative importance of manufacturing is the inevitable concomitant of rising living standards: as people get wealthier they spend a higher proportion of their income on services and a lower proportion of it on manufactured goods.

Manufacturing is not a unique source of wealth creation, and other sources, such as services, are not any less worthy. Wealth is created by producing whatever it is that people want to consume. If they want to consume services, then services are a source of wealth. The focus on manufacturing detracts attention from the big obstacle to balanced, sustained economic growth in Germany and across Europe as a whole – weak productivity growth in non-tradeable sectors. Even in Germany, services account for well over three-fifths of economic activity; manufacturing just a fifth. Higher productivity in retailing, finance and other service sectors, would help boost wages and hence consumption. This is not to say Germany needs an over-sized financial services industry like Britain or the US. But it is far from obvious that the current structure of the German economy will produce sustained economic expansion.

Graph 2: Manufacturing output
(per cent, GDP)



Source: OECD

A fast-ageing population

★ Germany's rapidly ageing population means that the need to raise productivity growth is especially urgent. The country's workforce is on course to decline rapidly, as more people retire than enter the labour market. Indeed, Germany is set to experience a relative decline in its economic weight within Europe. According to the UN, the populations of Germany, France and the UK are likely to converge in 25-30 years. Unless Germany manages to pull off a productivity miracle – and neither the OECD nor IMF expects it to do so – the three countries will by that point have similar-sized economies. Even if the Germans start having more children, population decline is all but guaranteed as the child-bearing cohort is now so small.

Closing Germany's demographic gap through immigration will not be easy. More people did enter the country than left in 2010, which was the first time this had happened since 2007. And this year's long-delayed opening of the German labour market to the new EU member-states should lead to increased net immigration. But Germany's record of attracting skilled immigrants is poor. Despite persistent skills shortages in various sectors, the proportion of immigrants educated to degree level is low. There is stiff international competition for such skilled immigrants, and Germany could struggle to attract them.

High public debt

★ In the teeth of an intractable sovereign debt crisis across a swath of the eurozone, it is easy to gloss over Germany's own fiscal problems. At 83 per cent of GDP at the end of 2010, Germany's public debt was higher than the EU average (80 per cent) and only slightly lower than the eurozone average of 85 per cent (see table 1). And with the population ageing rapidly, claims on the German government are set to mount.[3] The German government is currently running a smaller budget deficit – 3.3 per cent of GDP in 2010 – than the average across the EU (6.4 per cent) or eurozone (6 per cent). German borrowing costs are the lowest in the eurozone because investors believe there is only a minimal risk of the German government defaulting on its debt. But without Germany's trade surplus with the rest of Europe, its economy would be much weaker (because it would be producing considerably less), and hence its budget deficit bigger. One of the reasons other European countries have to run such large fiscal deficits is to offset the drag on their economies from their trade deficits. However, economic stagnation across much of the eurozone will hit Germany's public finances one way or another. There will inevitably be big losses on the loans that the German government has extended and will extend

[3] *'Medium and long-term developments: Challenges and risk', OECD Economic Outlook, 2011.*

to struggling eurozone economies through the European Financial Stability Mechanism and European Stability Mechanism. And the Germans will have to contribute their share to recapitalising the ECB, which has lent large sums of money to insolvent banks in the crisis-hit members of the currency union.

A troubled political legacy

Germany has no more outgrown Europe than has France. It is not an economic superpower, but a fast-ageing country, with modest growth prospects and a high degree of dependence on its European backyard. Germany has an acute national interest in the prosperity and political stability of the EU. Unfortunately, German policy-makers are pursuing policies that are damaging Europe, and with it Germany's own economic and political interests. Emerging markets are an important source of demand for German exports, but if anything, its economic and political stability is even more caught up with the rest of Europe than it was four years ago. Germany's economic future does not depend on exports to China, but on improving the performance of Germany's domestic economy and that of the EU economy upon which it depends so much. This requires a lasting solution to the eurozone crisis and a renewed drive to deepen the EU's single market. A loosening of the country's bonds with the EU is the last thing Germany needs.

Table 1: Public finances in 2010
(per cent, GDP)

	Government debt	Budget deficit
Germany	83.2	-3.3
France	81.7	-7.0
Italy	119.0	-4.6
The Netherlands	62.7	-5.4
Spain	60.1	-9.2
Sweden	39.8	0.0
UK	80.0	-10.4
Eurozone	85.1	-6.0
EU	80.0	-6.4

Source: Eurostat

Chancellor Merkel often says that the future of the euro and the future of the EU are inextricably linked. There is little doubt this is the case, but the eurozone crisis has been exacerbated by her leadership. The German government could have prevented the crisis – or at the very least mitigated it – by supporting the adoption of so-called 'euro-bonds': each eurozone country would be permitted to finance part of its debt by issuing bonds, which would be jointly guaranteed by all the member-states of the currency union. To prevent countries with low debts subsidising those with high debts, each country would only be allowed to issue debt worth a maximum of 60 per cent of GDP as euro-bonds. In times of crisis, countries could be permitted to issue all their debt as euro-bonds.[4] The introduction of such bonds would not save the eurozone in the absence of action to lessen trade imbalances between the participating economies. Unless these are reduced substantially, only a fiscal union – involving on-going transfers from the surplus countries to the deficit ones – will secure the future of the single currency. But there is no doubt that mutual guarantees of debt would be a big step towards getting the eurozone crisis under control.[5]

[4] *'The blue bond proposal', Jacques Delpla and Jakob von Weizsäcker, Bruegel, May 2010.*

[5] *Simon Tilford, 'How to save the euro', CER policy brief, November 2010.*

Merkel has consistently ruled this option out on the grounds that such a step would be unconstitutional and that it would impose higher borrowing costs on Germany. She does face domestic constitutional constraints: Germany's constitutional court could potentially rule against anything that violates its interpretation of article 125 of the Lisbon treaty – the so-called 'no bail-out clause'. However, it is far from clear that the adoption of euro-bonds would contravene article 125 and hence be incompatible with the German constitution. Moreover, the judges on the constitutional court do not make rulings in a vacuum; they are influenced by the prevailing political climate. If the German government were to back euro-bonds, it is unlikely the court would rule them unconstitutional.

The introduction of euro-bonds would probably increase German borrowing costs somewhat in the short-term, but would help to minimise the longer term damage to Germany's financial interests. Creditors such as Germany require solvent borrowers – Germany has a vested interest in the adjustment facing the countries in question being realistic and in the eurozone crisis being contained. By failing to recognise that the crisis in the periphery is as much about Germany and its imbalances as it is about the debtors, the German government has allowed a serious, but containable crisis, to morph into one that threatens to spread right into the core of the eurozone. Germany's vision of the eurozone as some kind of latter day gold standard, in which trade imbalances are addressed solely by the debtors cutting wages and deflating prices, is a recipe for economic stagnation and political dislocation. If one group of countries consumes less than their income in an attempt to pay down their debt, the other group have to save less relative to their income. If not, both will eventually slump, and it will prove all but impossible to bring about a sustained improvement in public finances.

Despite compelling evidence that the current strategy of imposing deflation and fiscal austerity on the periphery has failed, the EU together with the IMF is pushing on with it. This will do long-lasting damage to businesses and livelihoods in the crisis-hit countries as well as to creditors in the core, leaving a potentially fraught political legacy. One group of EU countries is forcing the impossible on another group of EU countries and even raising the prospect of a loss of sovereignty if they do not succeed. This is unjust and runs counter to the principles on which the EU was built. Political tensions within the crisis-hit member-states are set to rise, as well as tensions between the struggling member-states and the rest of the eurozone. Without a change of track on the part of Germany, a partial unravelling of the eurozone is all but inevitable. Full-blown contagion to Spain (and then Italy) would become almost unavoidable, at which point the future of the euro as a whole would be in doubt. Such an eventuality would have far-reaching implications for the single market and the stability of the EU. Every country would lose, but none more so than Germany. It would be saddled with a stagnant economy, losses on investments throughout Europe, and would have compromised decades of political investment in its neighbourhood.

The German government's failure to explain why greater fiscal supranationalism is as much in Germany's interests as the rest of the eurozone is symptomatic of a broader rise in populism. Three issues illustrate this trend. The first is the German authorities' attitude to the European Commission, in particular its work on the single market and its role in enforcing competition policy. As the biggest economy in Europe and one that relies heavily on trade with the rest of the EU, Germany benefits greatly from the single market and its effective policing. But increasingly German policy towards the Commission appears to be driven by the interests of its business lobbies – be it the car industry, the country's Landesbanken or the coal sector – and the political necessity of maintaining employment in Germany. Much as is the case in a number of other member-states, German politicians increasingly portray the Commission as an obstacle to German business and inimical to German interests. Criticism is not confined to the Commission. German officials have criticised the European Banking Authority for its attempt to subject European banks to strict stress tests.[6] The German authorities are worried that this will undermine the business models of German banks, some of which are under-capitalised. But it is essential that the German banking sector is strong enough to cope with a crisis brought on by default in one or more eurozone economies.

[6] *The European Banking Authority was established in November 2010, and assumed the responsibilities of the Committee of European Banking Supervisors (CEBs).*

The second issue is defence spending. The German government is cutting military expenditure from an already low base, casting further doubt over its ability to play a major role in providing for Europe's security. Defence spending is unpopular in Germany, where pacifist thinking is widespread and popular opinion sceptical of the efficacy of deploying military power. The German government's readiness to align itself with China and Russia in abstaining from a UN Security Council vote on military action against the Libyan regime of Colonel Gadhafi has sown doubts about its reliability. Indeed, Germany sometimes appears to have few military or strategic interests beyond protecting access to export markets and remaining on good terms with as many governments as possible. This stance has plenty of supporters in other EU capitals. But with the US signalling that it wants Europe to play a bigger role in providing for its own security, powerful European governments will not be able to avoid strategic thinking or difficult decisions indefinitely.

The third issue is nuclear energy. The German government's decision to shut half of the country's nuclear power plants in response to the Fukushima nuclear disaster in Japan and the rest by 2022 was taken in the face of an at times emotional popular debate about the risks of the nuclear industry. Germany relies on nuclear capacity for over a quarter of its electricity. Not all of this capacity can be replaced by renewable energy; Germany is now going to have to build a large number of new gas-fired power-stations. This decision comes at a crucial time for a host of European governments trying to overcome popular resistance to nuclear energy. In the aftermath of the German decision, Switzerland announced that it will not be building any new nuclear power plants and the Italians voted in a referendum against ending that country's moratorium on the construction of nuclear power stations. The retreat from nuclear means higher gas prices for everyone in Europe and greater dependence on Russia and North Africa. It also casts doubt over Europe's climate objectives, and Germany's leadership role in meeting them. Without an increase in nuclear capacity, Europe stands little chance of meeting its emissions reductions targets.

Conclusion

Germans and others are exaggerating Germany's strength. This does neither Germany nor Europe any favours. Of course, there are things that other EU countries can learn from Germany. But Germany is not the unrivalled power it is being portrayed as. Its current economic performance is built on vulnerable foundations and its relative economic power, even within Europe, is set to decline. France, in particular,

needs to wake up to this. France's fears that Germany could go its own way have led it to more or less cave in to a damaging German blue-print for eurozone reform. Germany may try to go it alone by cultivating closer bilateral links with countries such as China and Russia, and could be tempted to become more confrontational in its dealings with the EU. But it would pay a high price for doing so. Germany derives its strength from Europe, and cannot distance itself from it. And it lacks the strategic culture needed to be an effective independent player. In short, Germany needs the EU as much as the rest of the EU needs it, and this mutual dependence will endure. There are enough people in Germany who understand this. They need to speak out more loudly.

Simon Tilford is chief economist at the Centre for European Reform
June 2011

Recent CER publications

Thorium: How to save Europe's nuclear revival
policy brief by Stephen Tindale, June 2011

The EU and Russia: All smiles and no action?
policy brief by Katinka Barysch, April 2011

Surviving austerity: The case for a new approach to EU military collaboration
report by Tomas Valasek, April 2011

Europe's Parliament: Reform or perish?
Essay by Denis MacShane, April 2011

A new neighbourhood policy for the EU
policy brief by Charles Grant, March 2011

A chance for further CAP reform
policy brief by Chris Haskins, February 2011

Delivering energy savings and efficiency
policy brief by Stephen Tindale, January 2011

For further information, visit our website
www.cer.org.uk