



# Germany – the sick man of Europe?

*By Katinka Barysch*

- ★ The main reason for Germany's poor economic performance is a severe hangover from reunification. The cure – economic restructuring and reform – is taking effect slowly.
- ★ The foundations of the German economy remain strong. The country does well in terms of competitiveness, innovation, infrastructure, public services and social equality.
- ★ The EU can help Germany to get going again, for example through strengthening the Lisbon reform agenda, improving its macro-economic framework and shaking up the EU budget.

Germany was once the economic motor of Europe. Its large domestic market offered business opportunities for its smaller neighbours. Its high-quality machines powered manufacturing all across Europe. Its sound budget policies set the standard for the other EU countries. In the 1980s, however, the German motor began to sputter. It has since come to a standstill. In the second half of the 1990s, German GDP grew by a paltry 1.6 per cent a year, a full percentage point less than the other EU countries. Since 2000 the German economy has hardly grown at all. Unemployment has risen relentlessly and now stands at 4.4 million. Add those taking part in job creation schemes (0.5 million), those on income support (almost 3 million) and those taking early retirement (2.4 million), and it becomes clear that Germany has a problem to get its people working. A rising social security bill has pushed up the federal budget deficit, way beyond the 3 per cent of GDP permitted under the EU's stability and growth pact. Germany, quips the British press, is Britain in the 1970s. Germany is heading for a Japan-style quagmire. Germany is the sick man of Europe. Some even pronounce the patient dead.

Many commentators blame high taxes, an inflexible labour market and a tangled web of

red tape. Others think that the euro is behind Germany's economic woes. Britain's anti-euro 'No' campaign suspects a link between the introduction of the euro and the loss of 650,000 German jobs since then. Such analysis is short-sighted and superficial. Germany is not an economic basket case, nor is its future entirely bleak.

## **A hangover from reunification**

Germany's main problem is that it is still nursing a severe hangover from its reunification party in 1990. The shock of absorbing an economy with 16 million people, thousands of outdated smokestack factories and a 50-year legacy of central planning would have brought any economy to its knees. But in the case of German reunification, a series of grave policy mistakes made matters worse.

Contrary to widespread perception, the Kohl government's decision to exchange East Germany's sickly Ostmark for the sturdy D-mark at 1:1 (when the official exchange rate was 4:1 and the black market rate 20:1) was not the main problem. The currency swap bankrupted some East German companies by increasing the value

of their debt. But it also inflated East Germany's purchasing power, thus giving a massive boost to the entire German economy.

The deal that brought the German economy to its knees was that struck between the West German employers' federation and the newly created East German trade unions, egged on by their western colleagues. Fearing competition from low-cost workers within their own borders, as well as an influx of 'Ossies' in search of high West German wages, the two sides agreed to equalise wages as quickly as possible. Since productivity in the East was only one-third of the West German level, the deal priced most East German workers out of the market. East German industry shed almost half of its workers during the 1990s. The unemployment rate rose from an official zero during communism to well over 20 per cent in most of the eastern *Länder* today. Meanwhile, in the western part of the country, unemployment stands at 5.7 per cent, only marginally higher than in the UK.

### 'Equal pay for equal work'

In the name of equality and fairness, West Germany also quickly exported its generous social security system eastward. The combination of lengthening jobless queues and costly benefit entitlements was a double whammy for Germany's federal budget. Even today, transfers amount to a staggering 4-5 per cent of West German GDP each year (or 50 per cent of East German GDP), making the eastern *Länder* one of the most aid-dependent regions in the world.

Initially, the gaping hole in the state budget was plugged through borrowing – with the result that public debt more than doubled between 1989 and 1995. Then the government started to hike taxes, in particular payroll taxes, which pushed up the wage bill. By the late 1990s, German labour costs in manufacturing were the highest in the world, and companies were forced to downsize ruthlessly to stay competitive in an increasingly difficult international climate. The European Commission estimates that the tax hikes needed to pay for reunification explain one-third of Germany's growth under-performance *vis-à-vis* its European neighbours in the 1990s. Another third is explained by the collapse of the construction boom that followed reunification. Worried about the East's crumbling tower blocs and pot-holed roads, the German government decided to give generous tax breaks for construction and renovation. When the subsidies dried up in the mid-1990s, investment spending collapsed, leaving the region littered with half-built bridges and more than one million empty apartments.

With people dancing on the ruins of the Berlin Wall, boundless optimism superseded Germany's

proverbial prudence and diligence in 1989-90. But the country is now paying a heavy price for its reunification policies. "The economic reunification of Germany", concludes Hans-Werner Sinn, head of the IFO economics institute, "has been a disastrous failure. A fateful mixture of economic policy naivety and selfish abuse of power by the unions and employers' organisations has heavily mortgaged Germany's economic future."

### A freebie from the euro

The hangover from reunification is at the core of Germany's economic trouble – and it will eventually be cured. The euro may have played a role in Germany's economic underperformance since the mid-1990s, but not in the way that most eurosceptics believe. Germany has clearly profited from the increase in cross-border trade and investment that has resulted from the introduction of the single currency. But the rest of the eurozone has profited even more. Through the euro, Germany spread the benefits of its rock-solid currency and very low borrowing rates across the continent. Italy, Spain and other eurozone countries received an economic freebie in the form of lower interest rates. Germany's position remained unchanged.

Similarly, the single market has been a boon for Germany, Europe's number-one trading nation. But it may also have reduced the country's attractiveness as an investment location. Previously, foreign companies had to set up shop within Germany to sell into its large domestic market. But since the creation of the single market, they can effortlessly supply Germany from anywhere in the EU.

Many German companies have also taken advantage of the single market by shifting labour-intensive production processes to lower-cost locations. This trend will continue after enlargement, when countries such as Poland and Slovakia, with a fraction of Germany's labour costs, will join the EU. Germany, with its high skill and wage levels, cannot and should not try to compete in labour-intensive industries. It can and does compete in high-tech sectors and investment goods. Fears that a rigid labour market and high taxes have undermined Germany's international competitiveness are overblown. Despite the sluggish economic climate of recent years, German exports have grown by 30 per cent since 2000, generating a trade surplus of more than €100 billion in 2003 and making the country once again the world's largest exporter.

What distinguishes Germany from most of its European peers is the weakness of domestic demand. Since the mid-1990s, consumption in

France and the UK has grown by roughly twice as much as in Germany. Sluggish wage growth (the lowest in the EU according to some measures) and uncertainty about the future have led Germans to save an unusually high share of their income. In 2002 alone, the private sector squirreled away the equivalent of 6 per cent of GDP, or €120 billion. This is good in view of the country's rapidly ageing population and unsustainable pension system. But it is bad for domestic demand. However it also means that Germans have ample cash available for shopping trips and investment projects, once confidence picks up again.

### **Cheer up and go shopping**

There are at least three reasons to be cheerful. First, on many indicators Germany does rather better than its gloomy news coverage would suggest. High-tech industries in Germany employ a larger share of workers than in most other EU countries. Companies use the internet more widely than in, say, the UK or France. Spending on research and development (R&D) is above the EU average. Public services are famously efficient. There are no waiting lists for hospitals. Trains run on time. The state-run education system remains solid. The road system is among the best in the world. Telephone costs are now below those in the UK. The generous social security system may be a burden for the public purse, but it also brings benefits such as a low incidence of poverty and crime.

The second reason to be cheerful is that Germany is better placed than most other West European countries to take advantage of EU enlargement. Germany is already the biggest trading partner for most of the accession countries, selling well over €50 billion worth of goods to them in 2002. German companies have invested billions of euro in Eastern Europe, which leaves them well placed to take advantage of future catch-up growth. Tens of thousands of East Europeans are living and working in Germany. Germany has already digested many of the adjustment costs that resulted from opening up to its eastern neighbours. It is now ready to reap the benefits.

Germany can only do so if it remains willing and able to embrace change. Here, the news is also good. The Schröder government is currently pushing through one of the most ambitious reform programmes in the country's post-war history. To improve the functioning of the labour market, the government has shaken up the stuffy Employment Office and reduced eligibility for unemployment benefits. It is loosening rules for fixed-term employment and making it easier for companies, especially small ones, to lay off workers. In addition, the government is trying to push through tax reforms, cut some subsidies,

shake up the expensive healthcare sector, further liberalise shop opening hours, and ease restrictions on crafts such as plumbers and tailors.

### **Thatcher? Nein Danke**

Many economists say that these measures do not go far enough. Most foreign commentators agree, especially those from more 'liberal' countries such as the UK and the US. Germany needs a Thatcher, they say, someone who can break the country's powerful trade unions and push through radical measures. But a softly-softly approach is more in line with Germany's consensus-oriented political system. Britain's first-past-the-post election system produces tight-knit governments with strong leaders and a clear parliamentary majority. In Germany, proportional representation, coalition politics and the strong role of the *Länder* mean that governments must seek compromise *before* they act. It is true that this often waters down sensible reforms. But the need to bring everyone on board before decisions are taken also means that implementation is usually swift and easy. In a country like the UK, on the other hand, reform measures are often pushed through quickly – only to meet with bewilderment and hostility from those concerned.

Without doubt, the Schröder government will have to reinforce its reform efforts if it wants to restore the country's excellence. The reform agenda includes such controversial measures as streamlining decision-making in the complex system of federal government; raising the retirement age; finding a new way to fund healthcare; modernising the education system; phasing out the privileges of public sector workers; simplifying the tax code; and allowing companies to opt out of the rigid wage bargaining system. With the German population largely in favour of reforms, the opposition coming up with ever more radical proposals of its own and the economy finally picking up speed, Chancellor Schröder should be able to continue his current reform drive. This would not only improve the foundations for future growth in Germany. It would also increase the pressure on countries such as Italy and France to match German reform efforts.

### **With a little help from its friends**

The other EU countries have legitimate reasons to worry about Germany's economic health – not only because Germany alone accounts for one-third of the eurozone economy, but also because the enlarged EU needs a self-confident and vibrant Germany for its political health. Germany has traditionally provided the glue that the EU needs to stick together. It managed to combine the Franco-German alliance ('the motor

of EU integration') with strong transatlantic ties. It bridged Western and Eastern Europe. By financing the bulk of the EU budget, it also often helped to grease difficult negotiations and so drove EU integration forward. More recently, however, a weak and insecure Germany has been clinging too closely to France. It has used domestic problems as an excuse to break EU rules. It has threatened to cut its contribution to the EU budget. Germany's more assertive, but ultimately defensive, stance in the EU appears closely related to its internal weakness. Rather than criticising Germany for its performance, the other EU countries should ask how they can help their neighbour to get going again. The EU could:

#### ★ reinforce the Lisbon agenda

Many of the reforms that Germany is pursuing at the moment are part of the EU's Lisbon agenda of structural reform. For example, Germany and the other EU countries have committed themselves to open up their telecoms, energy and transport sectors, integrate their financial systems (which in the case of Germany meant an end to archaic state guarantees for the *Landesbanken*), and reduce industrial subsidies. Another key part of the Lisbon agenda is a continuous process of benchmarking and spreading best practice in areas such as employment, education and innovation. Progress towards Lisbon targets has often been slow and patchy. But rather than dismissing the Lisbon process as ineffective, the member-states should think about how they can improve it to help Germany and other slow-growing countries regain momentum.

#### ★ encourage the ECB to rethink its targets

ECB interest rates are not the reason for Germany's slow growth. In fact, real interest rates in Germany are now close to historic lows. Nevertheless, the ECB should ask itself whether its inflation target of just under 2 per cent is too strict. In countries such as Greece and Portugal, but also in the new member-states, higher inflation is part and parcel of catching up with the more mature European economies. If the ECB tries to push *average* eurozone inflation below 2 per cent, it may well end up with interest rates that are too high for the eurozone's slower-growing core economies, in particular Germany.

#### ★ reform the stability and growth pact

Germany's insistence on 'suspending' the excessive deficit procedure has robbed the stability pact of what little credibility it had left. The EU should now start debating a thorough overhaul of the pact. For the sake of sound fiscal management, not only in Germany but also the other eurozone countries, the EU needs to come up with fiscal rules that work more symmetrically, forcing governments to save while the economy is strong. The EU also needs to continue shifting its focus from short-term budget numbers to the long-term sustainability of public finances, particularly in view of rapidly ageing populations.

#### ★ shake up the EU budget

Germany is the main paymaster of the EU's common budget. Its net contribution (payments minus receipts) amounted to around €10 billion a year in the second half of the 1990s, or €130 for each German. By comparison, the UK's annual net contribution amounted to €35 per head and France's to €25. During the next budget period (2007-2013) the burden needs to be spread more evenly among the rich member-states. More importantly, the EU needs to rethink its spending priorities radically. Most EU money goes to farm subsidies and regional projects of dubious economic value. The European Union should redirect spending towards two major objectives, namely helping the East European countries catch up, and improving the EU's performance in research, education and innovation. Germany would benefit from both.

The main responsibility for Germany's economic future lies with the Germans. After a promising start, the Schröder government needs to sustain and broaden its reform programme. However, the EU can contribute through its various policies – not only the EU budget, but also the Lisbon agenda, EU competition policy, subsidy controls, research co-operation, employment guidelines and external trade policies. The other EU countries can also help to cheer up the Germans by reminding them that Germany's foundations for economic growth remain strong.

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