Germany *on the* Firing Line

Questionable economic judgment amidst a leadership crisis.

BY KLAUS C. ENGELEN

Ever since U.S. President Donald Trump started a global trade war, attacking high German current account surpluses and threatening penalty tariffs on German cars, Germany's economic model as the basis for the extraordinarily strong position of German quality brands on world markets moves further into the firing line.

Faced with the threat of a 35 percent tariff on imported cars in the United States, Sigmar Gabriel, then Germany's economic minister, hit back, saying, "The American car industry is getting worse, weaker and more expensive." If U.S. buyers are choosing German models, as Trump suggests, then "that's why the U.S. needs to build better cars," rather than penalizing competition.

The term "German model" is used to refer to the post-World War II system of organizing business and industry as a "social market economy" (*soziale Marktwirtschaft*) with close cooperation between company managers and unions.

The term was first coined in 1946 by Alfred Müller-Armack, economic advisor to Ludwig Erhard, the first economic minister of the young German Federal Republic, who is considered the father of Germany's post-war "economic miracle." Erhard's call for "prosperity for all" became the political underpinning for the long dominance of his party, the conservative Christian Democratic Union.

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"The outstanding economic development of Germany after the Second World War has been significantly influenced by the social market economy," argues Jörg Rocholl, president of the European School of Management and Technology in Berlin. "Its biggest merit is to balance work and capital in enabling competition."

Erhard advocated for a minimally regulated market economy free from government micromanagement, with prices, wages, and nature of goods determined by supply and demand. Private property rights and stringent antitrust laws were part of his agenda, along with codetermination—putting worker representatives on company boards in the hope of reaching consensus on wages, benefits, and working conditions.

British economist Wendy Carlin points out that the model of social market economy was the launching pad for Germany's unknown "hidden champions," supplying Europe and world market with high-quality mass products.

SOCIAL DEMOCRATS CHANGED THE MODEL

In 1998, after the sixteen-year reign of Helmut Kohl and his Christian Democratic Union governing in a coalition with the Free Democratic Party, Kohl lost the federal elections to Gerhard Schröder, leader of the Social Democratic Party. The German economic model was drastically changed, entering a long-term wage depression in order to create more manufacturing jobs and lower the high unemployment rate (12.6 percent of the working-age population people in early 2005), increasing the competitiveness of German manufacturing firms on European and international markets.

Schröder's government, in a coalition with the Green Party, instituted a series of drastic reforms of the German welfare system and labor relations under the heading Agenda 2010. The unprecedented reform program was adopted in reference to the EU's Lisbon Strategy of market liberalization.

On March 14, 2003, Chancellor Schröder gave a speech in the German Bundestag presenting the planned reforms in three main areas: the economy, pensions and unemployment benefits, and the position in European and world markets. The core welfare reform called Hartz IV came into effect January 1, 2005.

Under Schröder's reform agenda, reported *Deutsche Welle* at the time, Germany saw "drastic cuts to welfare budgets, tax breaks to workers and corporations, weakening the then-stricter labor laws to allow easier hiring and firing of employees, changing the rules to allow for more part-time and temporary work, creating the social benefit program called 'Hartz IV' that merged unemployment and welfare benefits, and reducing the amount of time a person could receive unemployment benefits."

These measures were intended to jump-start a sluggish economy and bring unemployment down.

While conservatives and business-friendly parts of German society supported Schröder's reform agenda, there was an upheaval among the Social Democrats, and a revolt by German's strong union organizations that had essentially paved the way for Schröder to the chancellorship. Facing wholesale defections of his own party members, Schröder triggered a loss of confidence vote and a new election in 2005, which he lost.

This brought Angela Merkel, then leader of the Christian Democrats, to office as the first female chancellor in German history, in a coalition government with the defeated Social Democrats. In her first speech to the Bundestag as chancellor, Merkel thanked her predecessor "for bravely and resolutely opening a door with Agenda 2010, so that our social systems could be adapted to a new era."

The Agenda 2010 reforms remain highly controversial to this day. Schröder's reforms created the largest low-wage and part-time labor market sector in Europe.

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Miracle Maker

Ludwig Erhard, the first economic minister of the young German Federal Republic, is considered the father of Germany's post-war "economic miracle." Erhard advocated for a minimally regulated market economy free from government micromanagement, with prices, wages, and nature of goods determined by supply and demand. Private property rights and stringent antitrust laws were part of his agenda, along with codetermination—putting worker representatives on company boards in the hope of reaching consensus on wages, benefits, and working conditions.

—K. Engelen

Ludwig Erhard

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Despite recent minimum wage laws, the wages paid are by far insufficient to raise a family and achieve old age pension security.

As *Deutsche Welle* sums up the reforms: "Some view them as a success story that reduced Germany's unemployment levels, other see them as an instrument that punishes those who are out of work. But there's no denying that Gerhard Schröder and the Social Democrats paid a heavy price for implementing these reforms. It cost them the support of the unions and many voters."

GERMANY'S WAGE MODERATION LED TO HIGH TRADE IMBALANCES

As Peter Bofinger, longtime member of the German Council of Economic Experts, points out, Germany is by far the largest eurozone economy, and a very open one with strong links to all other eurozone member states. Wage moderation, as pushed by the reforms, led to a decline in unit labor costs and stagnation of German domestic demand. This had a negative impact on German demand for goods and services from the rest of the eurozone. Wage moderation leading to an internal devaluation is considered a key determinant of Germany's economic success in the 2000s. The price competitiveness of Germany gradually was improved, which led to a deterioration of the bilateral current accounts with the rest of the eurozone. Finally, wage moderation caused higher profits in the corporate sector which led to higher savings in that sector, while household savings have remained constant since 1999.

Simon Tilford, a Berlin-based researcher who assessed Germany's growing dependence on exports, agrees with Bofinger. In a *Foreign Policy* article with the provocative title "Germany Is an Economic Masochist," he sees Germany with "a ballooning corporate sector and government savings, as Germany has been running a fiscal surplus since 2013. The United States, by contrast, consumes more than it produces; that is, domestic savings are insufficient to fund domestic investment."

For Tilford, "The principle reason why German savings have risen and investment has weakened is a big transfer of national income from households to firms, reflecting very weak wage growth for those on low to average incomes and tax policies that have favored the business sector over households."

Tilford points to a revealing statistic: "According to the IMF, German household consumption has fallen from around 63 percent of GDP in 2005 to 51 percent in 2018. He continues, "Germany produces far more than it consumes, because the country saves far more than it invests."

Tilford adds, "The biggest challenge facing the country comes from its own politics rather than the worsening international environment. Germany can easily take steps to boost domestic consumption and offset the weakening of external demand. The German government could reduce taxes on low to median incomes, raise public-sector wages, launch a major public investment program, and overturn the elements of the Hartz labor market reforms implemented in 2003 to 2005 that undermined the bargaining power of workers and helped to create a large low-wage economy."

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Paul J.J. Welfens, author of the recently published *The Global Trump: Structural U.S. Populism and Economic Conflicts with Europe and Asia* (2019) and *An Accidental Brexit* (2017), is worried that "Germany's economic model of a 'Social Market Economy' faces a phase of political instability, especially with the weakness in the automotive sector in context with the shift to electrical mobility."

In mid-February of this year, economist Michael Ivanovitch came down with an especially hard verdict in an essay for CNBC. "Sadly, instead of acting as a constructive member of the international community, Germany is running its own economy into the ground by allowing demand and output to stagnate for most of the year—and just barely managing to eke out a 0.6 percent growth rate. During that time, Germany continued to live off its trade partners, while lecturing all comers on economic policy, virulently denouncing the support by the euro area's easy credit conditions, and relentlessly attacking Washington's allegedly nationalistic agenda. All that because the United States' long-overdue decision to cut its excessive trade imbalances runs counter to Germany's mercantilism."

IS GERMANY'S ECONOMIC MODEL THE REAL PROBLEM?

Recently, French President Emmanuel Macron—who declared NATO brain-dead—also launched a broadside against his most important EU partner, claiming, "The German growth model has perhaps run its course."

He argued that the drastic belt-tightening reforms in the 2000s that were good for Germany allowed the country to benefit from imbalances within the eurozone, but that these imbalances created problems for the rest of Europe which are too large to ignore. Especially hit were the Southern economies such as Spain, Greece, and Italy, for which austerity was harsh and destabilizing. These imbalances have worsened and "run counter to the social project" Macron supports.

"Macron Puts Germany on Trial" headlined the *New York Times,* arguing "Cooperation between Paris and Berlin has long been a requirement for a unified Europe. But now they are at odds on fundamental policies."

In the *Financial Times,* Wolfgang Munchau cautioned that "The demise of the German growth model would not necessarily be a calamity. If all goes well, the slow erosion of German uber-competitiveness could even be the fortuitous accident that triggers economic convergence in the eurozone. But on a continent where not everything goes well all the time, it could pan out rather differently."

Munchau continues, "The German model has two interacting components—technological and macroeconomic. … Germany supported its model with an elaborate infrastructure: from skills-based, technical training to high-tech, applied research institutes, and industry-friendly government policies. … I would discourage readers from predicting the demise of the German growth model lightheartedly."

Marcel Fratzscher, who heads the German Institute for Economic Research (DIW) in Berlin, finds Macron's criticism of the German model for not being compatible with his vision of a social Europe "misplaced."

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Writing in the *Financial Times,* Fratzscher says, "A particular strength of that model is the *Mittelstand*—mid-sized, often family-run companies … with hundreds of unsung champions. These are often flexible, highly innovative and specialized firms with solid balance sheets and stable global market shares."

Another traditional strength supporting the German model has been "the social partnership between employers and unions and a strong welfare state." Fratzscher argues that the real problem for Germany is its political elite, "in the grip of two dangerous illusions. The first is the widespread assumption that it is not Germany that needs to change, but other European countries who need to follow the virtuous German path."

The second illusion is that "Germany does not need Europe and that the EU and eurozone are effectively a transfer union with a German paymaster. This attitude explains why many Germans are deeply suspicious of Mr. Macron's proposals for reforming the eurozone."

Fratzscher severely criticizes Germany's policymakers, saying "[I]nstead of implementing reforms—such as lowering labor taxes, simplifying the tax code, deregulating services, modernizing an inefficient bureaucracy and raising public investment in infrastructure, education and innovation—the past three governments have tried to appease vested interests through misguided handouts. … So it is not Germany's economic model, but the reluctance of its political elite to pursue economic and social reforms, domestically and in the EU, that is the main risk that Europe faces today."

STAGNATING ECONOMY, RECORD SURPLUSES

Germany entered 2020 with a flatlining economy and manufacturers in distress, leaving it ill-prepared for continued trade uncertainty and the new coronavirus threat, warns Bloomberg. "Europe's largest economy has been battered by multiple forces that have turned it from a growth engine to one of the region's weakest performers."

"Its vast industry is in recession, a victim of shifting consumer demand, China's economic rebalancing, and a global trade war. Investment spending is shrinking, sentiment is souring, job creation has stalled, and productivity growth looks to have turned negative," notes Balazs Koranyi, Reuters' Frankfurt correspondent.

In their most recent Annual Report, the German Council of Economic Experts came up with 0.5 percent real GDP growth for 2019 and 0.9 percent growth for 2020. Their key warnings: Germany is slow to adopt to new technology, investment is weak, and barriers to starting new businesses are too high.

How is it that Germany's business, political, and science elite missed the digital and software revolution?

Commerzbank's chief economist Joerg Kraemer predicts, "Germany is likely to remain in a zone between modest positive growth and slight GDP declines. Once the downturn is over, however, there is unlikely to be a strong economic recovery … the German export industry will suffer for a long time to come."

But there also is the global health and economic threat of the COVID-19 epidemic that started in China, about which IMF Managing Director Kristalina Georgieva warned at the Riyadh G20 summit: "We are also looking at more dire scenarios where the spread of the virus continues for longer and more globally, and the growth consequences are more protracted."

There remains the question of what is happening to Germany's external surpluses. For years, Germany has been under attack for ever-higher trade and current account surpluses and much too low domestic investment levels in infrastructure, education, and higher wages. The International Monetary Fund and the European Commission have been urging Berlin governments to help reduce these surpluses.

According to the Munich-based Ifo Institute for Economic Research, in 2019 Germany achieved, for the fourth year in a row, the world's largest current account surplus. This puts further political pressure on Germany's policymakers to help reduce global imbalances and stimulate domestic demand.

Ifo economist Christian Grimme told Reuters that last year's current account surplus—measuring the flow of goods, services, and investments—is $276 billion, compared to Japan's surplus estimate of $188 billion and China's of $182 billion. Far more German products and services are sold abroad than imported by Europe's largest economy, accounting for the high current account surplus.

In sharp contrast, the United States is expected to post the world's largest current account deficit of $480 billion in 2019, despite President Trump waging a trade war against China by imposing higher tariffs on imports and targeting Europe by threatening much higher tariffs, especially on German auto exports.

The European Commission recommends that EU member countries apply a mix of economic and fiscal policies to limit their current account surplus to about 6 percent of GDP as sustainable over the long-term when measured by the size of a country's economy. Germany has come closer to that threshold, reducing the record high surplus of 8.5 percent of the size of the economy in 2015 to 7.1 percent.

GERMANY MISSED THE DIGITAL TRAIN

How is it that Germany's business, political, and science elite missed the digital and software revolution? With a stock market valuation of $1.33 trillion, iPhone maker Apple was more worth than the entire Dax index of Germany's thirty leading companies in January 2020, and electric car maker Tesla—which plans to build a production factory close to Berlin—has overtaken Volkswagen in terms of market capitalization. Volkswagen sold about 11 million cars last year compared to Tesla's mere 367,500.

In a recent piece, the *Financial Times* conceded that "Germany is a special case. It is Europe's engine and the world's fourth-biggest economy because its brands mastered quality mass production and engineering, the key elements of 20th century industry, before software began 'eating the world'." The *FT* noted that while the Dax 30, including world-leading companies such as chemical manufacturer BASF, insurer Allianz, and logistics group DHL, rose 22 percent during the last twelve months to hit a record high, Apple's value has more than doubled over the same period.

The *FT* quotes Carsten Brzeski, chief economist for ING Germany, on the biggest concerns in German boardrooms. "The big picture story is that we have missed the train on technology—the sector that is dominating the 21st century. The next 20 years will be dominated by ecommerce, the internet of things, and artificial intelligence. In all these things, Germany is running behind."

As the *FT* also points out, "The risk is that the industries Germany excels at, such as machine building and chemicals, could see the same kind of disruption that ravaged sectors such as music and media, as digital technology overtakes the hardware-oriented, engineering-based model at the heart of what Germany calls its postwar 'economic miracle'."

This concern is also shared by Chancellor Merkel. In an earlier *FT* interview with Merkel, she noted software companies were inserting themselves into producer-customer relationships, becoming essential 'intermediaries' between businesses and their clients. German companies, she warned, had missed out on this development and were now at risk of falling behind. "It's no longer

enough to merely sell a product. One also needs to develop new products from the data on these products," she said. Merkel expressed the fear that without this expertise, Germany would end up becoming nothing more than an "extended workbench."

BETTER ECONOMIC MANAGEMENT

From the discussion about the German economic model, it is clear that policymakers are challenged as never before at a time when Berlin is in the grip of a leadership crisis.

Under President Trump's "America First" policy, the United States is withdrawing from the post-war rules-based multilateral system and threatening Europe, and especially Germany's important auto sector, with higher tariffs. As Washington pressures Europe to exclude Huawei and other Chinese 5G high-speed network suppliers from setting up new communication networks, Germany as leading exporter with a huge dependence on the Chinese market is caught in the middle.

A major challenge is how to cope with the political and economic uncertainties of the United Kingdom leaving the European Union after nearly five decades as the second-largest net contributor after Germany. Brexit is bringing enormous disruptions to firms and people on both sides of the English Channel.

Since Germany will assume the EU Council presidency in the second half of 2020, Merkel will need to play a key moderating role in the coming difficult negotiation of the exit terms. Considering the consequences, she will be pressured to avoid the catastrophe of a no-deal Brexit.

An elephant in the room—and a horror vision for German business—is the climate change movement with significant youth participation and the ever-stronger Green party hoping to take over the next German government. The mega-billion-euro "European Green Deal," set by the new European Commission under Ursula von der Leyen, and Berlin's "Climate Action Plan 2050"—agreed upon after a year of consultations and political wrangling—are costly and disruptive road maps to a nearly carbon emission-free economy with legally binding targets for individual sectors.

Berlin is in the grip of a leadership crisis.

Germany's economic and political vulnerability has undermined support for the governing centrist parties.

German policymakers also can no longer ignore the lack of investment, the lack of innovation, and the emerging skill shortages Germany will need to address to meet the growing digitalization needs. As the Cologne Institute for Economic Research found in a recent study, "Large German firms are currently suffering from a huge shortage of skilled labor which could see business losing out on £27 billion. To fill this gap, almost half a million workers need to move to Germany every year."

Germany's government and the democratic-oriented parties also must address the gaping holes in Germany's neglected security infrastructure. And above all, Germany's political elites must make sure that the European Union—and especially the eurozone—does not fall apart.

Germany's economic and political vulnerability has undermined support for the governing centrist parties and produced a political windfall for the far-right—and ever-more radical—Alternative für Deutschland party, especially in the Eastern federal states where generations grew up under a Communist regime. Because of the ongoing wars in Syria and Libya, there is the threat of a new refugee wave on the horizon like that Germany experienced in 2015.

Recently Guy Chazan, the *Financial Times* correspondent in Berlin, captured the current German leadership dilemma. "Merkel's political twilight sees Germany's influence wane. As the chancellor's final term ticks away, her ability to set the political agenda is diminishing fast." He adds, "Domestically, too, she is weaker. The coalition with the Social Democrats, which has ceded its status as Germany's leading left-of-center party to the Greens, is fragile. Her health has suddenly become an issue of public concern, following three—largely unexplained—trembling fits in the summer. With a recession looming, critics complain of a sense of drift and purposelessness, and a government that is out of ideas." This leads us to the conclusion that Germany—however one looks at the historic evolution of Germany's economic model—needs stronger leadership these days and a much better economic management. ◆