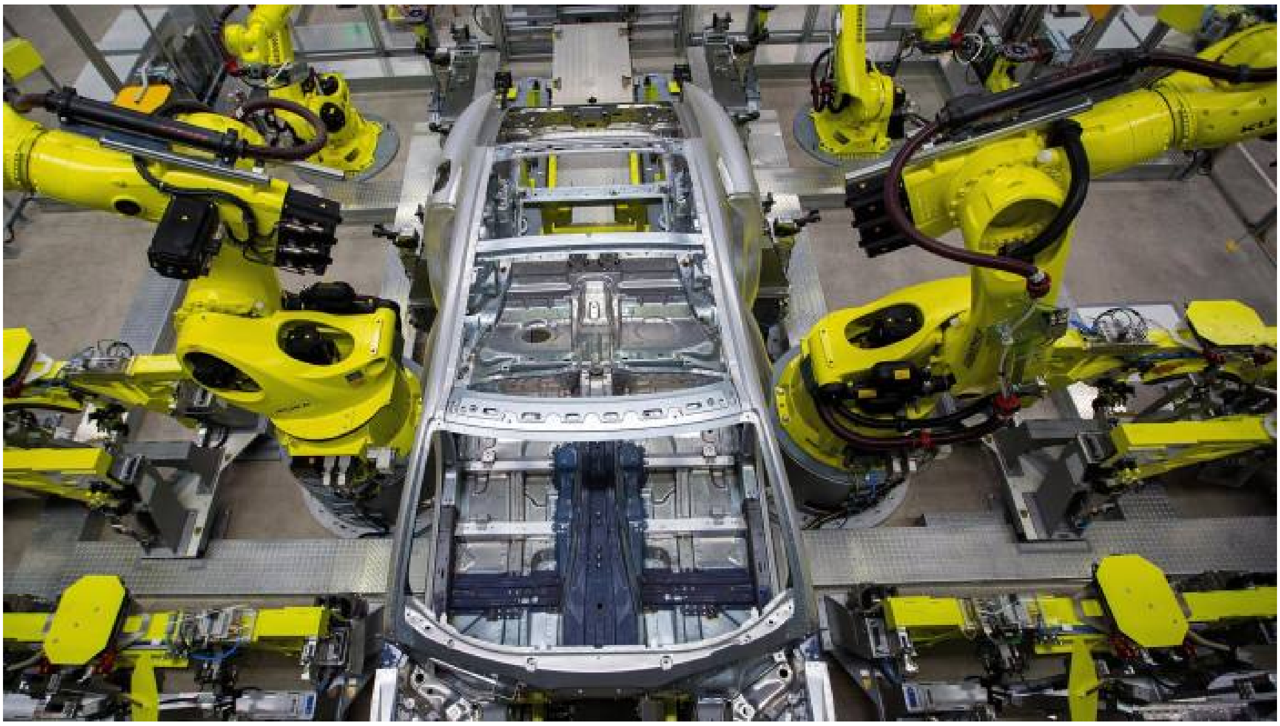
Germany's economic model is not the problem

17 June 2019

Marcel Fratzscher



Cars under construction at the Porsche factory in Leipzig. Germany's export companies are increasingly investing abroad and less at home, threatening the country's attractiveness as an investment hub © Bloomberg

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The German economic model has received some unusually harsh criticism of late, notably from French president Emmanuel Macron, who said in April that it "has perhaps run its course". Yet the problem for Germany today is not its economic model, but rather inadequate economic policies and two deep-seated illusions.

The German economy has slowed sharply, its dependence on industry is high and its automotive sector is slow to embrace new technologies. Germany's dependence on exports makes it vulnerable to a slowdown in global growth.

Yet the problem is not the country's economic model, which has been key to its success since the end of the second world war. The openness of the German economy and high degree of geographic and sectoral diversification of German exports which helped it to prosper for decades will be even more important for income growth and stability as the population ages and emerging markets catch up.

Mr Macron's criticism of the German model for not being compatible with his vision of a social Europe is misplaced. A particular strength of that model is the *Mittelstand* — midsized, often family-run companies, with hundreds of unsung champions. These are often flexible, highly innovative and specialised firms with solid balance sheets and stable global market shares.

Another traditional strength has been the social partnership between employers and unions and a strong social welfare state.

The real problem for Germany is that its political elite is 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. But Germany has implemented hardly any meaningful economic reforms during the past decade, despite mounting imbalances and vulnerabilities.

Low levels of public and private investment contribute to anaemic productivity in the non-tradable sectors and a current account surplus of 8 per cent of gross domestic product in 2017. Germany's export companies are increasingly investing abroad and less at home, threatening the country's attractiveness as an investment hub.

Low productivity and weakening social partnerships have contributed to the enormous expansion of the low-wage sector. Meanwhile, instead of implementing reforms — such as lowering labour taxes, simplifying the tax code, deregulating services, modernising 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.

Popular frustration with the political elite and the rise of the far-right Alternative for Germany party are not the result of economic weakness, the migrant crisis or an overreaching EU, but of a political failure to address some legitimate concerns about rising regional inequality and social polarisation. Germany failed to use the boom years to renew its economic model.

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. Ironically, however, Germany would be one of the greatest beneficiaries of some of the changes Mr Macron envisages: the completion of monetary union and the strengthening of European institutions. Yet for years, Berlin resisted such reforms.

Worse, it is showing increasingly protectionist tendencies, with proposals for the state to intervene much more directly in the economy and pursue the creation of "national champions".

Global trade tension and rising nationalism in the US and elsewhere mean the continued success of Germany's economic and social model will hinge on its ability to help create a strong, united Europe. The extent of political support in Berlin for further EU integration will be crucial in determining whether Europe can be a third partner at the geopolitical table alongside the US and China.

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. But it is not too late to change course — Germany's economic and political strengths mean it still has a chance to bring about change together with its European partners.

The writer is president of DIW Berlin, a think-tank, and professor of macroeconomics and finance at Humboldt-University Berlin

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