
**Special report:
Germany**

The economy
Dissecting the miracle**The ingredients of German economic success are more complex than they seem**

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THE NECKAR VALLEY, not far from Stuttgart, is the epitome of provincial Germany. A string of picturesque towns with quaint Swabian names—Tübingen (home to a famous university), Reutlingen, Nürtingen, Wendlingen, Metzingen—stretch along the river, separated by orchards and family farms and flanked by the hills of the Swabian Alb. But the small-town idyll is deceptive. The Neckar valley is also home to scores of Germany's small and medium-sized companies known as the *Mittelstand*, a highly successful component of the global economy.

Storopack, tucked inconspicuously down a side street in Metzingen, is a world leader in protective packaging. The firm is family-owned but thoroughly global, with 52 factories in 13 countries. The first Chinese facility opened in 2000. Now there are ten.

Rösch, a third-generation family textile firm in Tübingen known for upmarket nightwear, has also become one of Europe's biggest makers of specialist fabrics for the car industry. Its unassuming



buildings, down a small road by the river, contain vast computer-aided processing and dyeing machines that produce the synthetic materials for lining car roofs.

These small-town champions, along with industrial giants such as Siemens, Bosch and BMW, help to maintain Germany's manufacturing and export prowess. Manufacturing's share of GDP in Germany is bigger than in other rich countries and German exports, particularly to fast-growing emerging economies, are stronger. Half of Germany's growth over the past decade has come from exports. The external surplus, at €188 billion (\$243 billion), or 7% of GDP, is the world's biggest in absolute terms, one of the biggest relative to the size of the economy, and rising.

The working parts

In German eyes, strong exports and a big trade surplus are symbols of economic virility. But foreigners are more impressed with Germany's recent employment record. A decade ago Germany had one of the worst jobless rates in the rich world. Today its unemployment rate of 5.4% (using OECD figures) is one of the lowest in Europe. Youth unemployment, below 8%, is half that in America and a third of the European average. It is also the lowest Germany has seen for 20 years.

This is not the result of booming growth. Over the past decade Germany's economy has on average grown more slowly than America's and Britain's and barely faster than that of the euro zone as a whole. But Germany managed to avoid a surge of lay-offs after the financial crisis and has done far better than others at getting the young and the hard-to-employ into work.

How did it manage that? Most explanations heap praise on the *Mittelstand* model and the system of vocational training. Firms such as Storopack or Rösch take on apprentices, mixing practical training with classroom tuition. The German government also points out that the country "did its homework", introducing tough labour reforms from 2003 (known as "Agenda 2010") that freed up the job market. And the system of *Mitbestimmung* (which gives trade unions seats on company boards) encouraged wage restraint.

All these things helped, and the Agenda 2010 reforms, in particular, made a big difference. But they are not the whole story. A cheap currency, some dumb luck and a fair amount of fiscal pragmatism also played a part.

Germany had begun the 21st century in bad shape. Wages had soared after unification in 1990; the budget was burdened with big transfers to the former East Germany; excessive regulation was stifling the economy. To get away from all this, German firms, including many from the *Mittelstand*, shifted production to cheaper places in eastern Europe.

Shocked by high joblessness and the hollowing out of German industry, the SPD government under Gerhard Schröder introduced a set of sweeping tax, regulatory and labour reforms in 2003. The most important part of this package were the so-called Hartz reforms (after Peter Hartz, who headed the commission that drew them up), which brought fundamental changes to the low end of the German job market. They eliminated payroll taxes on earnings of less than €400 a month (recently raised to €450), thus encouraging the creation of part-time “mini-jobs”. A flat-rate benefit nudged the long-term jobless back into work. These and other reforms cost Mr Schröder the 2005 election, but they gave employers an incentive to create low-skilled and temporary jobs and the jobless a reason to take them.

They also made Germany more Anglo-Saxon. Some 20% of Germans now work in “low-wage” jobs, about the same share as in Britain, not much lower than in America and almost twice as much as in France. Germany’s employment boom had less to do with the *Mittelstand* than with this overhaul at the bottom, which pulled a lot of low-skilled people into work—though it also exerted a downward pull on overall productivity.

The reforms had big knock-on effects. In conjunction with a move east by many German firms, they persuaded Germany’s unions to accept years of tight wage restraint. Between 2001 and 2010 German wages rose by an average of just 1.1% a year in nominal terms, leaving them flat in real terms. Unit labour costs fell sharply relative to those in other countries.

The belt-tightening was impressive, but German firms were also lucky to be making the right stuff at the right time. German manufacturers have traditionally been strong in three big areas: machine tools, chemicals and cars. That proved a perfect combination in a decade when emerging economies were booming and China, especially, went on an investment binge. Almost half of German exports, and 72% of its exports to China, are machinery or transport goods.

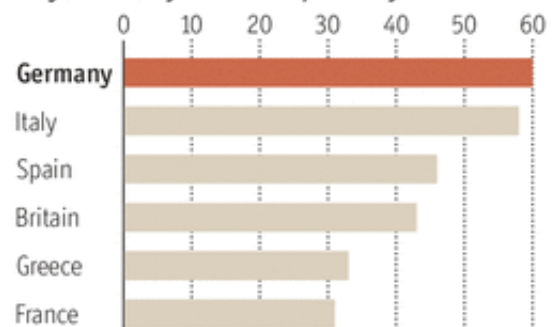
The 2008 financial crisis temporarily sent exports into a tailspin, and in the past three years

Dearly beloved

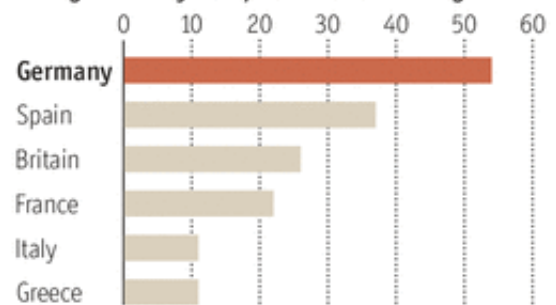
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Opinions on the EU and euro
% in agreement, polled spring 2013

Do you have a favourable opinion of the EU?



Do you think your national economy has been strengthened by European economic integration?



Source: Pew Research Centre

demand from the euro zone's periphery has collapsed. But Germany's manufacturers have been more than compensated by the weak euro, which allowed its export machine to whirr on.

Fiscal pragmatism lent a helping hand. The year when Germany pushed through its "Agenda 2010" reforms, 2003, was also the year when it ignored the "Maastricht" criterion of a 3% cap on its budget deficit, letting its borrowing rise rather than trying to bring it below the 3% limit. The Schröder government gave priority to structural reforms over fiscal consolidation, which today's Merkel government regards as an egregious mistake. But Frank-Walter Steinmeier, an SPD leader who was Mr Schröder's chief of staff, says he would do it again: "If we had dogmatically stuck to the Maastricht rules, we wouldn't have had an Agenda and we would be in the lower rung of Europe's economies."

The financial crisis prompted a more obvious whiff of Keynesian policies. As demand for exports collapsed, the German government came up with several schemes to stem unemployment, in particular *Kurzarbeit*, topping up the earnings of workers on shorter hours or paying for them to go on courses. As global car sales collapsed, Rösch, the *Mittelstand* company in Tübingen, sent a number of its workers for training at taxpayers' expense. It survived a 20% slump in sales without lay-offs, and the workers came back more productive.

If German success has more fathers than many Germans like to admit, it has also come at a price that few acknowledge. Most Germans' living standards have stagnated, wealth is highly skewed and national saving, embodied in the country's vast current-account surpluses, has been spectacularly badly invested. From American subprime securities to Spanish property loans, German banks recycled the country's savings surpluses into all manner of junk. A new study by Marcel Fratzscher of the DIW economic research institute in Berlin suggests that Germany has lost the equivalent of 20% of GDP on the valuation of its foreign portfolio investments since 2006.

Despite such losses, Germany as a country is rich, but a recent study from the European Central Bank suggests that the typical German household is not. Astonishingly, the median household's net assets, at €51,400, are less than those of the typical Italian, Spanish or even Greek household (see chart 4). These figures need careful interpretation. Households in Germany are smaller than in those countries, and their average is dragged down by the east, where 20 years ago no one had any assets to speak of. Moreover, the figures do not include pension promises. But the main reason for the poor showing is that far fewer people than in other European countries own their homes. Most households rent, and the housing stock is owned by a relatively small number of people, so Germany ends up with the most unequal distribution of household wealth in the euro zone. Moreover, a growing share of its wealth sits on corporate balance-sheets, particularly the family-owned

Mittelstand firms, which makes the overall wealth distribution more unequal still. For a country that likes to think of itself as middle-class and egalitarian, Germany's wealth disparities are huge.

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All this helps explain Germans' attitudes towards the euro crisis. German voters are sceptical of transfers to southern Europe not just because of their fear of inflation or their experience with pouring money into former East Germany, but also because the typical

German worker feels that he is no better off than the Spaniards he sees driving Audis when he holidays on the Costa Brava. After a decade of scant real wage growth, and given the unusually skewed wealth distribution, that perception is not altogether wrong.

What happens next? Outsiders, particularly Anglo-Saxons, have long argued that the German economy is dangerously distorted: too reliant on a few traditional manufacturing sectors, and with too little domestic demand. On this logic, if China's economy stumbles, or indeed as it produces ever more of its own high-end investment goods, Germany will be in trouble. It needs more innovation, more services and a better balance.

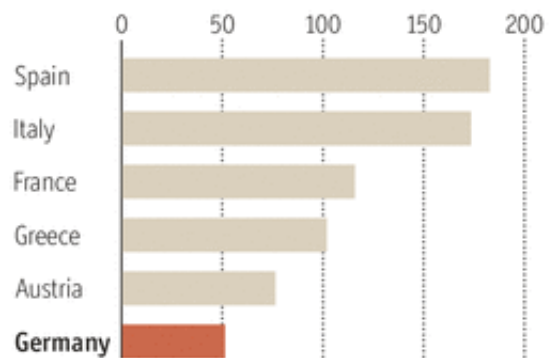
At first sight German industry does seem stolid. Its main components—cars, chemicals, machine tools—have been the same for decades. Although Berlin has become a bit of a European digital hub, and Germany's SAP is the world's third-largest software company, the country has no Apple, Facebook or any other household name of the new economy.

Look more closely, though, and German firms dominate some less obvious but crucial arteries of globalisation. From DHL to Kuehne & Nagel, the world's biggest logistics firms are German. And even in manufacturing, making things is increasingly bundled with a clutch of high-end services. Storopack's growth, for instance, depends ever more on the technicians who dream up whizzy solutions for specific packaging problems.

A new report from the German arm of McKinsey, a consultancy, predicts another decade of strong, export-led growth based on Germany's traditional sectors. It argues that industrialisation in emerging economies will keep up demand for machine tools, chemicals and the like, and that

Asset-poor

Median net wealth per household
€'000, 2010 or latest available year



Source: European Central Bank

German firms are innovating fast enough to maintain their dominance in premium niche markets. The report forecasts that between now and 2025 German exports will rise by 80%, pushing their share in the economy from 50% to 68% of GDP.

If McKinsey is even half right, German exporters have a rosy future. But it will be a future focused outside Europe. The euro zone now accounts for 37% of German exports, down from 46% in 2000. By 2025, reckons McKinsey, the euro zone's share of German exports is likely to be down to around 30%. That diminishing role will surely affect the attitude of German business. Sharing a currency with weaklings will be a fillip in global markets, but for business the euro zone will matter ever less. John Kornblum, a former American ambassador to Berlin, argues that "psychologically, German industry has already left the EU."

Yet becoming more indifferent to Europe is not in Germany's interest. The country is better off with the single currency than without; and the economic rebalancing that would help the rest of the euro zone is also what the German economy itself badly needs.

Spend, spend, spend

With a culture of thrift and, now, a fast-ageing society, Germany naturally saves more than it spends. (Barring a few years after unification, it has run an almost uninterrupted surplus since 1952.) But its current-account surplus, at 7% of GDP, is now more than three times higher than it was a decade ago, largely thanks to an artificially cheap currency and squeezed wages. It is unhealthy, both for Germans (who forgo higher living standards to pile up savings that are poorly invested abroad) and for others in the euro zone and beyond.

German economists recognise that this has to change. Hans-Werner Sinn of Munich's IFO economic research institute says the country is "too cheap". But how best to rebalance the economy: through less saving or more investment? As a share of GDP German investment has fallen sharply, from 22% in 2000 to 17% in 2012. Public investment has been squeezed, firms have been cautious about capital spending and in the absence of a property boom there has been little investment in construction.

Property is now beginning to look up. Ultra-low interest rates are pushing up house prices and spurring building. After a decade of stagnation, German property prices rose by 5% (in nominal terms) in both 2011 and 2012. Cities like Berlin and Munich have seen much bigger jumps. Taxi drivers offer tips on the best place to buy a flat. But there is a long way to go. Relative to income, German property prices are still 20% undervalued.

Wages have also started to pick up. In 2012 IG Metall, the biggest union, won a pay deal worth 4.3% over 13 months, the biggest jump in 20 years. Across the economy, wages increased by 2.7% last year, about 0.6% above the rate of inflation. Judging by the first agreements, this year's crop of wage deals will be slightly more generous.

Faster wage growth and a minor construction boom have yet to dent Germany's huge surplus, which increased further last year, but they have already fuelled German fears about asset bubbles and a loss of stability. The Bundesbank has given public warning about frothiness in the housing market. German politicians were furious at recent suggestions from France that higher German wages might be part of the solution to the euro crisis. The constant refrain is that "making Germany less competitive cannot help Europe become more competitive."

This gets to heart of the problem with Germany and Europe. The German government wants others to become more like them, but sees no reason for its own model to change. The Merkel government has done strikingly little to encourage an economic rebalancing towards more investment and consumption in Germany. The debt ceiling constrains public investment, but the government also brags about how fast it is reducing its deficit. Leaving aside minor measures, such as the deregulation of long-distance buses, there has been little in the way of structural reforms to encourage firms to invest. Mrs Merkel's 2009 election pledges to simplify the tax system and encourage entrepreneurship have gone nowhere. According to the Cologne Institute for Economic Research, the momentum for domestic reform in Mrs Merkel's second term has been much weaker than in her first. The OECD says that since 2007 Germany has brought in fewer pro-growth reforms than has any other of its members.

But it is not just a question of missed opportunities. Instead of making the right choices, Germany may be about to introduce counterproductive measures. Opposition parties are campaigning for increasing taxes sharply and rolling back some of the Hartz rules. The SPD and the Greens, for instance, want to raise the top rate of income tax to 49% (from 42%) and reintroduce a wealth tax. They also want to toughen the rules for employers creating mini-jobs and reduce the work requirements that benefit recipients must meet. So if the election were to result in a Red-Green coalition, German business would find itself in a less favourable tax environment. Even a grand coalition could bring some tax rises at the top—enough to deter investment and harm the economy. As one political insider quipped, "It's a good thing foreigners don't read German."

But all this is small beer compared with what Germany is doing as part of its *Energiewende*, or change in energy policy. The country's wholesale move to renewable energy betrays an ill-planned unilateralism.

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