Preserving an Old Model in a New World: German Economic Policy

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Introduction

To describe the German economic and social system in a few words, only one term truly captures its essence: "social market economy." This means a system characterized by a combination of economic dynamism and social justice. The social market economy is based on the freedom of markets and private property, as well as competition among providers of goods and services, all of which are essential to facilitating considerable economic momentum and great material prosperity. The tax and benefit system is set up to distribute economic prosperity among all citizens in the most equitable way possible. Although some question how effective the German economy is at providing social justice, few have questioned the country's economic performance overall in recent years, particularly when compared to its neighbors. However, in the future, this model may be in danger.

A Look Back: From the "Sick Man of Europe" to "Economic Superstar"

In the early 2000s, Germany was still regarded as the "sick man of Europe,"[1] with a stagnant and at times shrinking economy, a decline in competitiveness, current account deficits and an increase in unemployment. At the time, the social market economy was thought to be approaching extinction, but today the German economic and social system is considered a model for other nations.

Gross domestic product (GDP) is a key indicator of an economy's performance, defined as the total value of goods and services produced by the people of a nation during one year. Economists are well aware that GDP is by no means a complete or ideal indicator for measuring human well-being. However, a high GDP is the basis for providing the material necessities to a nation's people and, in this sense, it contributes to maintaining nonmaterial living conditions, such as the environment and local amenities.

GDP per capita, rather than the total GDP for an economy, is typically used to draw international comparisons. Based on this indicator, Germany indisputably ranks among the wealthiest nations in the world. According to an International Monetary Fund (IMF) index that ranks 189 countries by their GDP per capita (measured in U.S. dollars), Germany is 19th with a projected per capita GDP of approximately $41,300. This puts the country ahead of France (about $37,700) and most European Union (EU) countries, as well as Japan (about $32,500). The per capita GDP gap between Germany and emerging markets such as Brazil ($8,800) and China ($8,300) is even larger.[2]

Germany's economic strength is also reflected in the country's unemployment rate: In February and March 2005, about 5.3 million people were registered as unemployed, with the unemployment rate reaching 11.2 percent (according to the unemployment definition of Eurostat, the statistical office of the European Union). In the following years, the annual unemployment rate was reduced to 7.1 percent in autumn 2008. Following the global financial crisis of 2008, a short-lived increase in unemployment was noticeable. But even in summer 2009, when the unemployment rate reached an intermediate high of 7.9 percent, Germany was still well below its

Table 1: Key Macroeconomic Indicators of the German Economy (2000-2015)

	2000	2005	2010	2015
Nominal GDP (in billion euros)	2,116.5	2,300.9	2,580.1	3,026.6
Number of people employed (in millions)	39.8	39.3	41.0	43.0
Unemployment rate (in percent)	8.0	11.0	7.0	4.7
Current account balance (in percent of GDP)	- 1.7	+ 4.6	+ 5.6	+ 8.5
Public debt (in percent of GDP)	58.9	66.9	81.0	71.4

Source: Statistisches Bundesamt 2016b and IMF 2015

2005 level. Ever since, the number of people out of work has fallen steadily, with an average of 1.95 million unemployed in 2015 (under 5 percent), the first time since German reunification that fewer than 2 million people were unemployed.[3]

Therefore, Germany has one of the lowest unemployment rates in the EU. While some EU states affected by crises, such as Spain and Greece, have struggled with unemployment rates of about 21 percent and 25 percent respectively, the overall average of all 28 EU member states was just above 9 percent in 2015.[4]

The low unemployment rate in Germany is due mainly to the economy's international competitiveness, with large and increasing current account surpluses that the country has maintained since the early 2000s. The main driver of this trend is an export surplus. Put simply, if a country exports more goods and services than it imports, there is a current account surplus. Since 2001, when the current account surplus was last negative, there has been a steady increase, and in 2015 Germany had a surplus of more than 8 percent of its GDP. Even in the crisis-stricken years after the global financial crisis, a time characterized by a severe decline in cross-border trade, Germany's current account surplus was at 6 percent of its GDP. In euro terms, in 2015 the surplus reached a new high of about 237 billion euros.[5] In contrast, between 2001 and 2015, the United States registered current account deficits that ranged from 3 to 6 percent of its GDP. In crisis-ridden states in the south of Europe, deficits accounted for 10 to 15 percent of GDP.[6]

Germany's economic growth of the last 15 years is illustrated by the indicators listed in Table 1. Both the export surpluses and low unemployment rate, even in the years of crisis, are signs of Germany's strong economic performance. As a result of these developments, perceptions of the German economic and social system have shifted dramatically over the last decade. In just a few years, the "sick man of Europe" has become what many perceive to be an "economic superstar."[7]

How Can this Economic Transformation Be Explained?

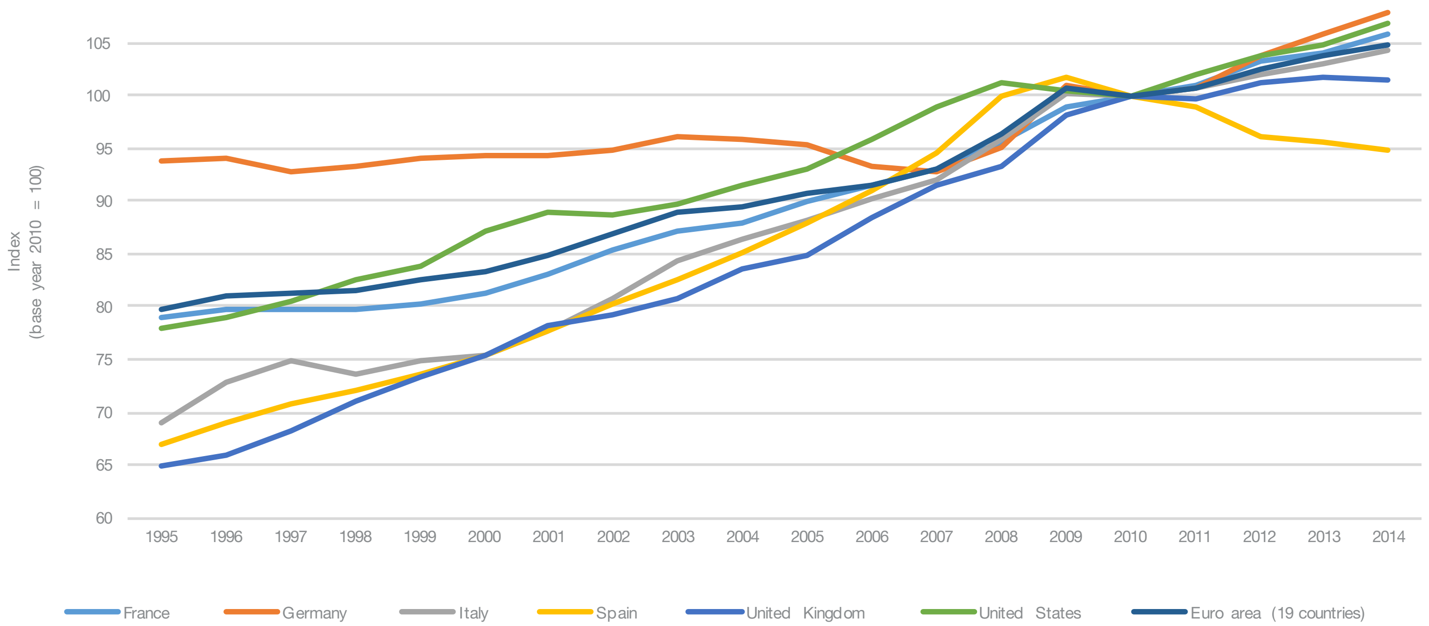
German economic growth has been predominantly export-oriented, and there are two main factors driving the country's international competitiveness and export surpluses: relatively low labor costs and the advantages of the European Monetary Union.

The unit labor costs of an economy are calculated as the ratio of total labor costs to the amount of goods and services produced (that is, GDP). They represent the average labor costs in a country per product unit produced.[8] Unit labor costs did not rise much in Germany between 1995 and 2009, but most other developed countries saw a 30 to 40 percent increase in unit labor costs in the same period (see Figure 1).

Why were increases in German unit labor costs so modest? The answer is a combination of technological progress that boosted labor productivity and labor unions' conservative wage policy. Low wage increases lead to small price increases, which in turn strengthen the international competitiveness of German products and help stimulate exports.

Usually, export surpluses lead to higher demand for the exporting country's currency, as importers must make payments in the currency of the exporting country. A high demand for a currency increases the currency's value. This revaluation causes prices to rise in the rest of the world for products from the exporting country, which in turn leads to a reduction in demand. At the same time, prices for products from other

Figure 1: Development of Unit Labor Costs in Selected OECD Countries (1995-2014), expressed as an index (base year 2010=100)



Source: OECD Statistics, accessed January 28, 2016

countries decrease in the exporting country. Thus the current account surplus is regulated by shrinking exports and increasing imports. However, with the introduction of the euro, this balancing mechanism does not apply. Germany's export strength is no longer reduced by the revaluation of its own currency.

A country with an export surplus produces more goods than it needs domestically. A current account surplus has a positive effect on the labor market because the country requires more manpower to create the additional goods than it would if it only produced goods to satisfy its own domestic demands. An export surplus thus leads to a decrease in unemployment, which improves the state of the public coffers, thanks to reduced public expenditure on supporting unemployed residents and an expanded tax base.

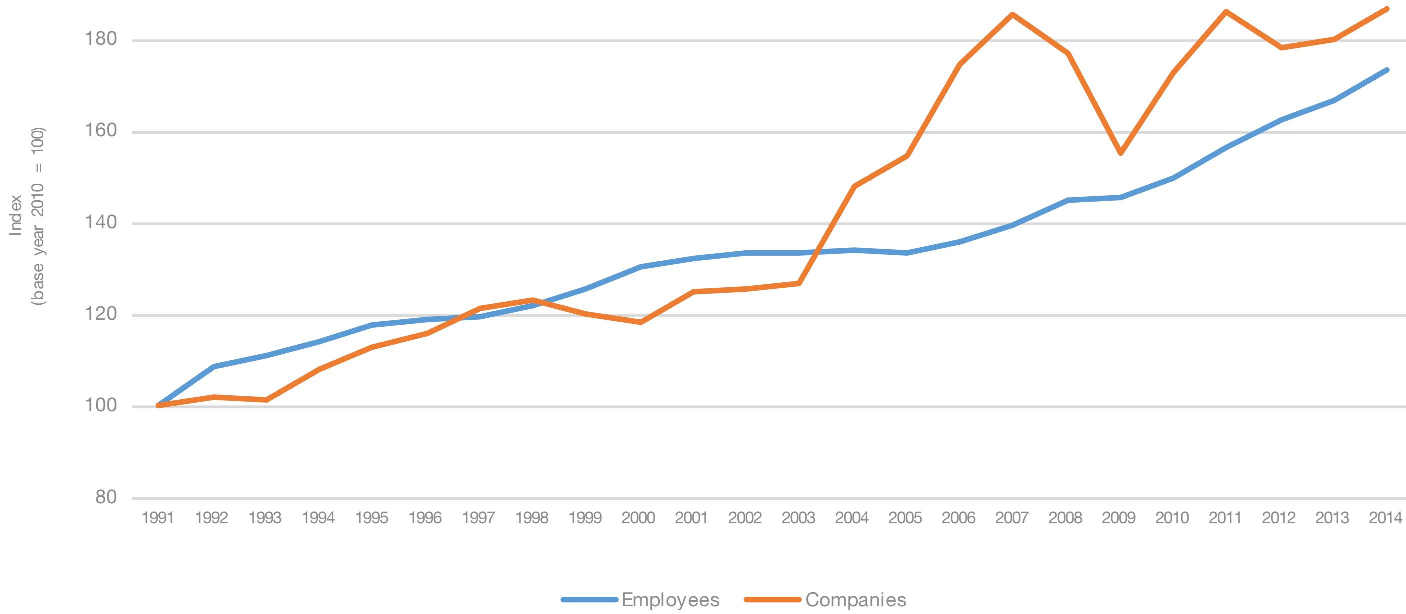
Thus Germany's booming exports have a positive effect on the national economy. The high level of employment in Germany is due to its exports—but some might argue that the country exports something else: its unemployment. Because of this and other adverse effects of a consistently high current account surplus, the European Commission criticized said surpluses in March 2014 and asked the German government to take measures to contain this development.[9] The European Commission is not the only source of criticism; critical voices from within Germany have increasingly denounced the nation's economic development during recent years because of the accompanying negative consequences for its neighbors.

Income Inequality

One major consequence of current economic development is rising income inequality. Globalization and digitalization in recent decades have led to a steadily increasing international division of labor. The significant growth of the working-age population in emerging markets has increased their international competitiveness in labor-intensive industries. In this global context, a well-developed industrialized country, such as Germany, can only sustain its competitiveness if productivity is increased through technological progress and greater investments. However, labor will become less important to GDP as a consequence of this investment and a greater use of technology.

As a country's production processes become increasingly capital-intensive, serious effects on income distribution are to be expected. Both the demand for capital and price for capital increase. At the same time, both wages and the demand for labor decrease. Low-skilled workers are the main, but by no means the only, group affected by this development. This change in income distribution is shown in Figure 2. Between 1991 and 2003, corporate and investment income grew at about the same rate as the income of individuals.

Figure 2: Development of Employee Income and Corporate and Investment Income in Germany (1991-2014), expressed as an index (base year 1991=100)



Source: Author's calculation based on Statistisches Bundesamt 2015b

Since then, however, the gap between the two types of income has widened.

In summary, the fruits of economic growth in Germany during the previous two decades have not been distributed equitably. Germany is not alone in experiencing growing inequality. Based on an analysis from 1985 to 2005, the OECD concluded that a continuous increase in income inequality throughout its member countries dates back to the mid-1980s or even the mid-1970s.[10] An update to that study, covering the period from 1985 to 2010, confirmed this development for most OECD countries.[11] In this context, Germany performed relatively well in terms of the gap between rich and poor. However, despite the low unemployment rate and economic growth, inequality is still increasing. Germans' tolerance of this trend can be expected to fade in the near future.

Germany now faces a major challenge for the social market economy as it works to shape the economic and social system in a way that will allow the nation to grow without undermining social cohesion. Only if this challenge is tackled successfully will the social market economy be able to deliver its most important promise: combining economic strength with social justice. At the moment, the issue is hotly debated and draws significant public and political attention.

In addition to inequality, however, Germany faces a number of other challenges with regard to its economic future that demonstrate a great need for economic and social systems to adapt. These issues, discussed in more detail below, have not yet attracted as much attention in the public debate.

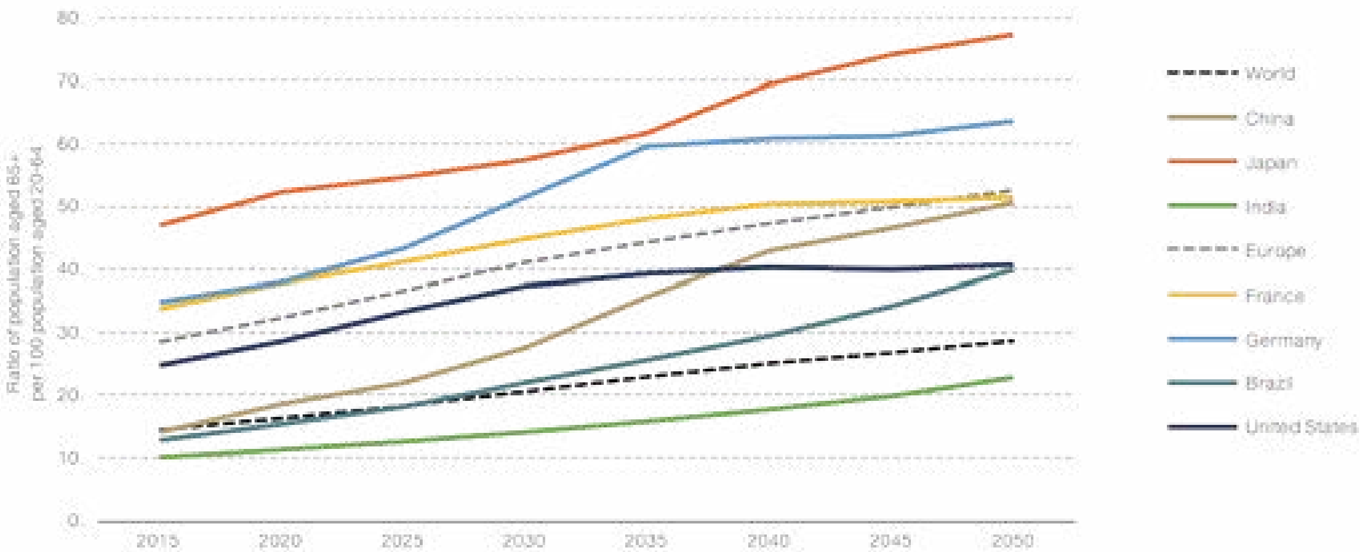
Looking Ahead: The Need for Adaptation in the Social Market Economy

Due to the economic upturn seen in recent years, economic development in Germany is currently more stable than it has been in a long time. At the same time, the country faces a number of serious challenges. Five central issues that could have a lasting effect on future economic developments in Germany are discussed below:

1. Aging Society

In the coming decades, Germany's total population is set to decrease. Depending on how many people immigrate, it will fall from 81.5 million to between 72 and 76 million by 2050.[12] As the population declines, it will also, on average, get older. Currently, 21 percent of the German population is at least 65 years of age, making Germany's population one of the world's oldest, ranking third behind Japan and Monaco. The proportion of over-65s is significantly lower in the United States, at 15 percent.[13] By 2050, the proportion of people in this age group in Germany will rise to between 30 and 32 percent.[15] The German population is aging quickly in relative global terms, as clearly shown in Figure 3.

Figure 3: Development of the Old-Age Dependency Ratio (ratio of population aged 65+ per 100 population aged 20-64) (2015-2050)



Source: United Nations Population Division 2015, accessed January 28, 2016

Even the current influx of refugees will be unable to reverse this trend; at best, it will only be slowed down. The aging of society will have far-reaching implications for economic development in Germany.

The consequences of societal aging are already becoming apparent in Germany's social security system. Since the 1880s, Germany has had a pay-as-you-go system in which pension contributions are used immediately to pay pension recipients. Due to the demographic changes discussed earlier, the ratio of people of retirement age to people of working age will almost double by 2050. In order to maintain the current system, either contribution rates will have to increase or pensions will need to be cut significantly. From a socio-political perspective, cutting pension benefits would be difficult to implement, and a major increase in contribution rates would have a negative impact on international competitiveness. Thus, Germany must find new ways of financing the social security system without undermining social cohesion or damaging the country's competitiveness. It is not enough, however, to modify the pay-as-you-go system. In the long term, there is likely no alternative but to switch to a tax-funded system that is based on national income, instead of solely tying it to labor.

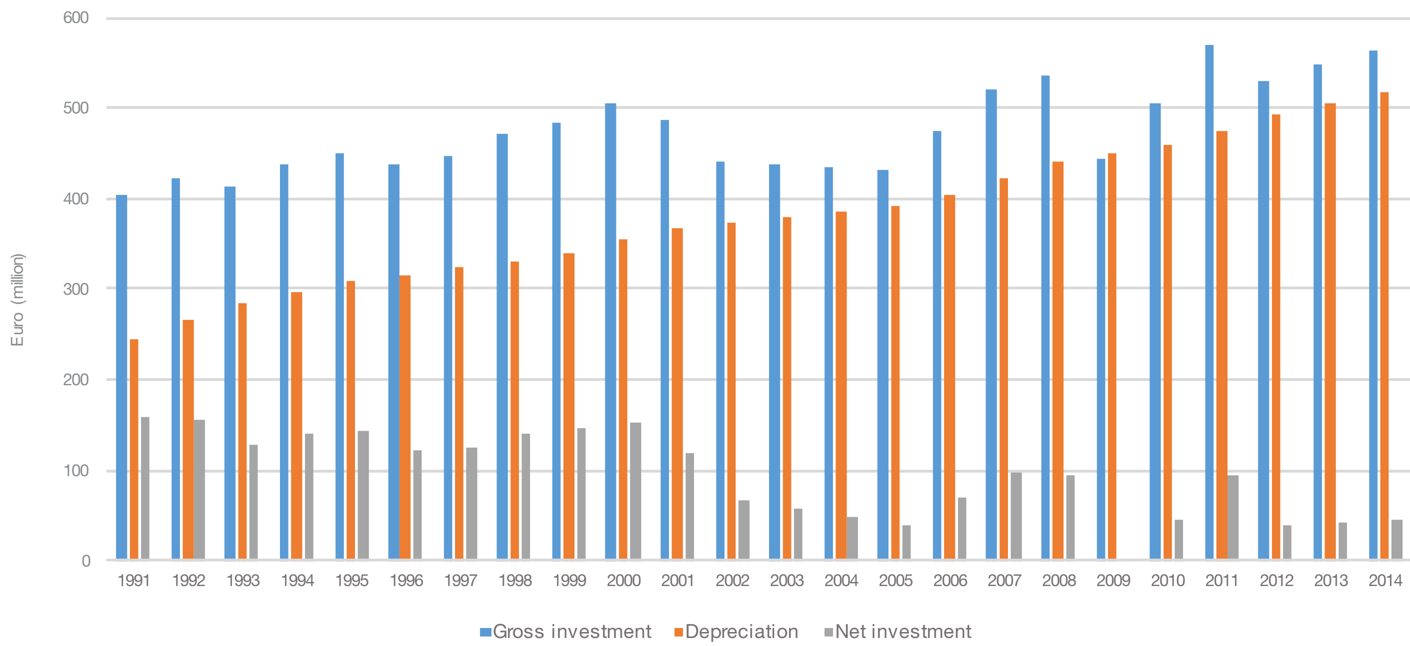
Societal aging also presents a great financial burden on the public budget. In a graying society, the shrinking number of taxpayers and contributors will collide with a growing demand for state benefits (including healthcare services and pensions). However, if an increasing share of state revenue is used for transfers, the government's capacity to act in the areas of education, research and development would be limited. R&D expenditure is currently less than 0.1 percent of German GDP. This share is three times larger in the United States (about 0.3 percent of GDP) and four times larger in South Korea (about 0.4 percent of GDP).[16] Internationally, Germany will lose ground to young and dynamic economies if R&D expenditure continues to shrink as a result of demographic shifts.

Finally, there is reason to fear that the current shortage of skilled labor will worsen in the future. At the moment, jobs in the scientific and healthcare sectors are most affected by the shortage. However, if there are fewer people of working age, it is to be expected that the problem will extend to other sectors as well, which would hurt Germany's international competitiveness and slow economic growth.

2. Declining Investments

For some time, investment has been a weak point in Germany's economic development. Net investment, meaning the difference between annual gross investment and annual depreciation, is critical to increasing production capacity. In the early 1990s, nominal net investment in Germany was about 160 billion euros a year. However, between 2012 and 2014 net investment decreased to roughly 40 billion euros (see Figure 4). As sustainable growth relies on sufficient net investment, economic growth in Germany is set to decline

Figure 4: Development of Gross Investment, Depreciation and Net Investment in Germany (1991-2014), all nominal (in euro million)



Source: United Nations Population Division 2015, accessed January 28, 2016

in the long term. Viewed this way, it seems that Germany is increasingly living on its capital.

In the public sector, this lack of investment is most apparent in run-down infrastructure. Financing necessary investment is proving to be problematic, given that in 2016 the German government introduced a debt brake, a constitutional amendment that only allows for annual net borrowing of up to 0.35 percent of GDP.[17]

3. Export Dependence

Because of the strong export orientation of Germany's economy, its development is particularly dependent on global economic trends. A booming global economy will benefit German growth and employment. Yet the high dependence on exports has its drawbacks too; an exceptionally strong downturn in the global economy would lead to below-average slumps in production. This became particularly clear in 2008, when the global economy crashed. According to the IMF, that year Germany and Japan, two export-oriented economies, registered decreases in GDP of 5.6 percent and 5.5 percent, respectively, whereas in the United States, real GDP fell by just 2.8 percent. If the global economy were to grow more slowly in the future (for example, if China ceased to be the main economic driving force), the subsequent low export demand would have a massive impact on the macroeconomic development of Germany.

Thus, building up domestic demand should be one of Germany's key objectives in order to reduce its dependence on overseas demand. However, this would mean making major changes to the status quo, which would face political resistance. The following strategies may offer a first step in the right direction:

- **Stimulating the highly regulated German service sector.** Removing existing barriers would allow for more investment and an increase in productivity. This should go hand in hand with increasing salaries and wages and strengthening domestic consumer demand. The necessary deregulation of professional services (like those provided by lawyers, architects and notaries) with regard to advertising, pricing and professional fees, however, would cause unwelcome heightened competitive pressure on these occupations.
- **Increasing German imports.** Customs duties and non-tariff barriers are traditional instruments for controlling imports. However, as a member of the European Union, Germany's scope for action in this area is limited. One option would be to phase out subsidies in the agricultural sector. These subsidies distort competition, with

foreign providers of agricultural goods bearing the greatest burden. For German farmers, however, eliminating such subsidies would make them far less competitive. Previous attempts to reduce such state assistance have failed because farmers opposed them. This position is unlikely to change.

- **Increasing charges for the use of natural resources and for CO2 emissions in order to internalize the associated negative externalities.** The resulting increase in prices would lead to a reduction in German exports and a growth in imports. In addition, it might provide an incentive for companies in Germany to produce in a more environmentally friendly and resource-efficient way. While the country would need to restructure its domestic economy and make significant investments in technology, these investments could foster domestic demand and thus successfully compensate for the fall in export demand. However, in the short term it seems likely that worsening price competitiveness would weaken economic growth and ultimately lead to an increase in unemployment.

4. Trouble in the EU

As the German economy is closely integrated in European value chains, its economic success depends heavily on stability within Europe and a functioning European single market. In various ways, the establishment of a common market has promoted economic growth in the countries involved and has led to increased growth and employment in Germany.[18] The euro, too, has had a positive effect on German economic development.[19]

However, these economic advantages may well disappear amid a series of developments that could result in the collapse of the eurozone and the common market. One of the developments that stands out in this context is the unresolved debt crisis in Greece. It is still uncertain whether the third rescue package negotiated for Greece in 2015 will sustain that country's public finances and economy. Doubts about Greece's ability to fulfil the financial reforms required for the bailout would negatively affect both investment sentiment on the part of companies and consumer sentiment in Europe. The ensuing slowdown in economic development in Europe would be particularly tough on export-oriented Germany.

An additional concern is the fallout from "Brexit," the United Kingdom's withdrawal from the European Union. The British exit presents serious economic disadvantages for the entire European Union: a decrease in economic growth, growing unemployment and dwindling international price competitiveness.[20]

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Although the risks of Brexit should be taken seriously, the cohesion of the European Union is currently most threatened by member state governments' isolationist tendencies stemming from the refugee crisis. With regard to integration in the European Union, an increasing number of national initiatives and the closing of borders would be a giant step backwards. The economic advantages that went hand in hand with increasing internal market integration would be a thing of the past. The result would be an economic downturn across Europe, again with a major impact on the export-oriented German economy.

5. Refugee Movement

At present, the major challenge facing the German economic and social system is undoubtedly the refugee movement and the resulting implications for public finances, the labor market and social cohesion.

As discussed in the chapter on migration, the influx of refugees has been particularly large in Germany. In the short term, such an influx increases consumer demand and thereby stimulates the economy. In the medium term, however, a large share of this consumer spending is financed by public transfer payments. As a result of the aforementioned debt brake, these expenses will need to be covered by cuts in expenditure and/or tax increases, both of which would cause demand to drop and opposition among taxpayers to rise. Thus it is fair to question whether the German government will change current fiscal strategies, especially with parliamentary elections approaching in the fall of 2017.

In addition, the integration of refugees into the labor market will take time. Studies show that employment rates among refugees only reach the level of other migrant groups after 10 to 15 years. Unemployment among refugees may be significantly higher than the German average, making transfer payments a necessity.[21]

In the end, uncertainty about future refugee migration to Germany and the integration of refugees into society and the labor market will foster uncertainty among German companies and employees alike. Both of these issues have the potential to adversely affect consumer and investment behavior and thereby stifle economic growth.

Thus, the rapid and successful integration of refugees into the German labor force and society is key to achieving economic success and social cohesion. This will be a significant challenge for the entire educational system. However, expenditure on the integration of those who have sought refuge in Germany is a sound investment in the future. In the long term, the migration of younger people will help to offset the aging of the population.

The Future of the Social Market Economy: Seeking Strategies for Inclusive Growth

The central tenet of the social market economy is "prosperity for everyone."[22] Although "prosperity" has been attained in Germany over the past two decades, its distribution among the population has become increasingly inequitable. In the long term, the era of growth may come to an end; in fact, there are several reasons to expect consistently low growth or no growth at all.[23] First, the decrease in population will also lead to a decrease in the number of consumers and thus demand for goods. This will cause a decline in the GDP. Second, as income inequality increases, demand for goods will decrease. High-income households possessing an increasing share of wealth in Germany are more likely to save their wealth than spend it, resulting in a decrease in demand for goods. Finally, the German government's lack of investment in infrastructure is detrimental to productivity and will have long-term negative effects on the economy.

As a result of these trends, tendencies toward secular stagnation—meaning negligible or no economic growth in a market economy—are already discernible in Germany. Until now, high and increasing export surpluses have compensated for the lack of domestic consumer and investment demand. However, if the number one export nation struggles with low levels of economic dynamism in emerging countries, an economic downturn is inevitable. Thus far, periods of extensive stagnation have not presented a real problem for Germany. This is why, politically speaking, the country is not prepared for a phase of secular stagnation.

Thus, the biggest challenge of the social market economy is boosting dwindling growth, but without a race to the bottom with respect to wages and social security standards, which would contradict the core promise of the social market economy. Germans' doubts about the current economic and social system are already growing: according to a poll from March 2015, 89 percent of Germans like the general idea behind the social market economy. However, only 46 percent believe that their country's economy is still functioning on the principles of the social market economy.[24]

Only 46 percent of Germans believe that their country's economy is still functioning on the principles of the social market economy

These doubts as to whether the promises of the social market economy can be kept have provoked a crisis of confidence in Germany. This lack of trust is further intensified by the level of global instability present at the moment: the state of economic development in China, the dispute between Russia and Ukraine, the Syrian conflict, political unrest in North Africa and the Middle East, the global terrorist threat and the ongoing standoff between North and South Korea. These and other uncertainties can easily lead to societal fears that would make the political implementation of necessary reforms more difficult, if not impossible. Good governance that seeks to reestablish lost trust is key to successfully adapting the social market economy to changing global circumstances.

The Global Effect of German Economic Development

Germany's economic stability has global implications. First of all, it is one of the United States' most important trading partners. In 2014, the United States exported about $50 billion in goods to Germany, making Germany the sixth largest importer of U.S. goods, behind Canada, Mexico, Japan, China and the United Kingdom.[25] Thus, a stable and growing German economy is a significant source of additional income for U.S. exporting companies.

More critically, Germany is Europe's largest economy. This status means any economic developments in Germany have a major impact on all of Europe. Many German exports are manufactured with material inputs that were imported from abroad. According to the most recent data from the OECD, in 2009 a quarter of all German exports consisted of such inputs. In vehicle construction, the share amounted to as much as 35 percent.[26] Geographical proximity increases trade with inputs, making Germany's European neighbors the main beneficiaries of this trade as they gain a growing value-added share in German exports.[27] In 2012, for example, German industrial demand for inputs created a total of about 3.5 million jobs in the European Union.[28]

A downturn in the German economy would have a negative effect on the economic development of the entire European Union. The ensuing consequences for U.S. exporters would be more severe than those of an isolated economic crash in Germany, as the United States exported goods worth more than $275 billion into the European Union in 2014. A sluggish economy in Europe would not only hit U.S. exporters, but the entire U.S. economy as well. However, this would not be solely because of a drop in exports to Europe, but also the impact a struggling economy would have on the value of the euro. Weak economic development usually leads to a devaluation of the ailing economy's currency. A devaluation of the euro can be equated with a revaluation of the U.S. dollar. The competitiveness of U.S. companies would hence decrease, not only in Europe but also in third markets in Asia and South America.

Thus, Germany's economic success is critical for the European Union, United States and beyond. Although it appears that Germany has gone from being the "sick man of Europe" to an "economic superstar," without the necessary investment, that track record of success may not be as sustainable as it currently appears. An economic downturn could have deep consequences beyond Frankfurt and Berlin. Therefore, policymakers around the world should be paying close attention to the more nuanced economic challenges that face the Federal Republic.

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