



PISM

POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 6 (1077), 16 January 2018 © PISM

Editors: Sławomir Dębski • Bartosz Wiśniewski • Rafał Tarnogórski

Karolina Borońska-Hryniewiecka • Anna Maria Dynier • Aleksandra Gawlikowska-Fyk
Sebastian Płóciennik • Patrycja Sasnal • Justyna Szczudlik • Marcin Terlikowski • Tomasz Żornaczuk

Risks of the Boom: Prospects for the German Economy

Sebastian Płóciennik

Germany is in a period of exceptional economic prosperity. Although the prospects of it maintaining this state in the coming years are good, the risks associated with it, such as overheating the economy and loss of competitiveness, are increasing. The possibility of these problems depends on the stability of the incoming coalition government.

The year 2017 marked the eighth year in a row of positive German economic data. GDP growth amounted to 2.3% and unemployment fell to the lowest level since reunification (5.7%). Exports also improved by an impressive rate of 6.5%, as did the situation with public finances: the federal budget recorded a several billion-dollar surplus for another year in a row. Most analysts expect a continuation of the positive trends in the coming years. However, moods might be even better if there were not worries about risks and challenges emerging in the background.

Overheating the Economy. Germany's economic performance has coincided with loose monetary policy maintained for several years by the European Central Bank (ECB), which has become the focus of the debate. Access to cheap capital has made it possible even to profit from investments of low quality and consumers to significantly increase their level of spending. Euro area governments also have benefited, as their public finance deficits have become less costly.

This policy has undoubtedly contributed to the end of stagnation in the particularly crisis-ridden southern economies. In Germany alone, with its incomparably healthier economic foundations, the effect of this good run was an additional boost in growth. Not a few economists are concerned its economy is on the verge of "overheating," that is, producing more than its potential output (which is full use of resources), provoking inflation pressure. These fears are not unfounded. Many companies report they are not able to increase their production capacity to fill all orders. In addition, real estate prices have grown rapidly, and food and energy prices are around 3% higher. In general, inflation in 2017 reached the highest level in five years (1.8%). The predicted end of quantitative easing (QE) in September and the January minutes of the ECB on a possible change in monetary policy to a more restrictive one are viewed as possibly inhibiting the unfavourable trend in Germany. However, if doubts about the sustainability of the southern European economies, such as after the upcoming elections in Italy, the current expansion policy will remain.

The Challenge of Competitiveness. One of the strengths of Germany's economy in recent years has been its relatively low labour costs and increased participation rate. However, the effect of this factor is weakening. Companies report they are having more trouble finding enough employees: According to the Federal Employment Agency, in December 2017, the number of vacant posts exceeded 760,000. Wages are also growing, driven by competition between companies to hire good employees, as well as the labour market reforms of the "Grand Coalition" of the former government, especially the introduction of an hourly minimum wage. The problems on the labour market will deepen with the predicted age-based demographic changes. Hopes that the recent wave of immigration will ease the tight market a bit may turn out to be in vain: The refugees who have come to Germany often do not have the qualifications and language skills necessary to fill the needed positions.

There are further threats to Germany's competitiveness. Here, attention is being paid to the deteriorating condition of the country's road and railway infrastructure, as well as public services (including education). These areas were not favoured in recent years because of the cost-savings policy on public finances, known as "black zero," imposed under Finance Minister Wolfgang Schäuble. As a result, the record budget surplus was accompanied by negative net public investment. The next challenge is the revolution in transport, namely autonomous vehicles and electrification, as well as competition from upstarts like Tesla and new companies from China, which may disturb the German automotive industry's international position.

However, the greatest concern stems from the economy's adaptation to digitalisation. Germany is seriously underdeveloped in modern data-transmission infrastructure. As a consequence, many mid-sized companies based in provincial locations are unable to enjoy the benefits of e-commerce, cloud data storage services, remote management, or product promotions via social media. The changes also require an educational system that is unable to educate a sufficient number of IT specialists, and in the sphere of state services, it is still in an analogue era. If digital transformation fails, German companies will fall to the role of sub-suppliers of large platforms like Apple, Google, Amazon, and Microsoft.

External Threats. The condition of the German economy depends to a large extent on exports, comprising 46% of GDP. Among the challenges, it is thus impossible to omit potential external threats.

In 2017, these were apparently few: The global economic situation was good, and trade was developing faster than global GDP. This does not mean, however, that there will be no risks in the next few or subsequent years. Growth in the global economy is largely fuelled by expansionary monetary policy, pursued by many central banks since the worldwide financial crisis. Effects of this are that asset prices have risen to speculative levels (e.g., booming stock markets) and the global asymmetry in the distribution of savings and debt has deepened. A political-military event, such as the escalation of tensions on the Korean Peninsula or further action by U.S. President Donald Trump to protect the U.S. market from foreign competition, could trigger a quite sudden correction.

Europe itself may also be a source of uncertainty in the coming months. The spring elections in Italy may factor into the prosperity of the eurozone and the direction of its reforms. In addition, there are the ongoing negotiations with the UK on Brexit conditions, with Germany aiming to maintain its favourable trade balance with Britain. Another concern of business is the increasing political conflict with some countries in Central and Eastern Europe, namely Poland and Hungary, over such issues as mass-migration, the rule of law, or European integration. This is understandable since exports to the markets of the Visegrad Group (Czech Republic, Hungary, Poland, Slovakia) are higher than to the U.S. or France, and made more distinct by the many key investments of German industry in these countries.

Political Instability. Germany has sufficient resources to effectively address these challenges and threats. It has in its favour its excellent economic situation and the great chances of it continuing in the coming years. One limitation on this may be, however, a lower level of political stability than before. A harbinger of this was the September elections to the Bundestag, which weakened the big parties and gave seats to right-wing Alternative for Germany (AfD). The next sign was the fiasco of negotiations on the creation of the so-called "Jamaica" coalition of CDU/CSU, the Greens, and FDP. Now, talks are underway to continue the "Grand Coalition" of the CDU/CSU and SPD. Although this grouping is more likely after initial discussions in mid-January, it does not guarantee stability. The Social Democrats, weakened by the election, will be a more assertive partner, focused on forcing their own social agenda. The CDU also faces a difficult term. The party will want to regain voters who moved their support to AfD and will face the problem of finding a successor to Angela Merkel. It is not surprising then that business is afraid of a "long phase of uncertainty" (Erik Schweitzer, DIHK), the lack of reforms to maintain or improve competitiveness, and increasing social spending at the expense of investment.

Less political stability would not only have internal effects. An introverted and economically weaker Germany would probably be less interested in finalising eurozone reforms and more prone to protectionism. Central Europe, whose economies are very dependent on the situation on the German market, would be in a particularly difficult situation. Many of the region's companies are integrated into value chains created by German corporations, through which they see better chances for global expansion. Weakening competitiveness in Germany would mean—at best—the need for them to change their development strategies.