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# Germany's Economic Prospects for 2014: A European Assessment

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*Germany entered the New Year with hopes of faster economic growth. At stake in 2014 is more than just the question of short-term domestic prosperity. A better and more sustainable economic situation in the region's largest economy would improve the recovery chances for the whole eurozone economy, as well as provide a model of domestic reform in policy fields from the economy to energy. The chances are good, even if the risk of negative shocks stemming from the unstable external environment are still significant. And yet, the implications for Poland of higher German growth rates are not solely positive.*

A few years ago, as the scale of the eurozone crisis was becoming clear, economic forecasts predicted 2014 to be a safe port after a long storm. The international environment was supposed to return to stability, the debt crisis to abate, and the economy to get back on track. But now that it is here, 2014 seems to less quiet than expected. The eurozone remains a massive challenge. It is true that the most troubled economies have achieved a degree of stability, but not of a wholly positive kind—high unemployment, debt and stagnation. The probability of political tensions and new aid packages, combined with debt cuts, remains high.

As for Germany, the new governing coalition is a sophisticated battleground not only between the CDU and the SPD but also the CSU, the smallest partner, which is already testing the boundaries of soft populism in the run-up to May's European elections. This Grand Coalition has heralded generous social reforms, notably a raise in the minimum wage to €8.50 per hour, but it is an open question how the economy will react: whether with higher consumption and growth, as left-wing economists expect, or with rising unemployment and companies shifting production abroad, as conservatives fear. The same uncertainty pertains to the reforms of the pension system which partly revert the successful reforms of the Schroeder years.

Challenges of a long-term nature are already making themselves felt. Germany badly needs more employees to fill demand, but due to the country's demographics they are in short supply. A campaign against immigration led by the CSU has been unhelpful. As to Germany's long-term *Energiewende*, or energy policy, industry may confirm the fears and move their production to cheaper destinations. Daimler's decision from December 2013 to start manufacturing the newest Mercedes C-class model in the U.S., even if the result of additional factors, fits well into the general anxiety that Germany will soon become too expensive a place for industries that demand a lot of energy, and the government has not yet taken the logical step of reducing business costs in other areas. The fundamentals are also poor. Germany, despite good headlines, is highly indebted. The current "no-new-debt" policy is sound but insufficient to bring the country below the current 80%-plus levels and into accordance with eurozone rules.

**Growth Prospects.** If there is something that could boost German resilience here, it is strong economic growth—something that would also boost the eurozone by increasing demand in favour of the troubled peripheries and giving a base for tricky reforms in both Germany and throughout the currency bloc. But how good are the chances of such a positive scenario? Many point at the driver being German exports, which according to the DIHK, the German Chamber of Commerce, should rise by 4%, to €1.45t. This is due to global economic improvements and the end of the recession in the eurozone. In comparison with 2013, in which Germany's exports rose at a rate of only 0.6%, which was much slower than the 3.6% recorded in 2012, this would count as a strong recovery.

Another predicted driver will be domestic consumption. In the last year, German consumers have become more optimistic, and spending on food, new smartphones, holidays, cars, etc. rose by 0.9% in total. Their good mood can be explained primarily by a very positive situation on the labour market. The unemployment rate rose only marginally by 0.1%, to 6.9%, and the number of people with a job in Germany climbed to 41.2 million—the highest level in the history of a united Germany. Moreover, salaries remained on a moderate growth path and were 11.4% higher than in 2008, just before the crisis. Most Germans thus remain very optimistic about their future, meaning there are strong signals that consumption will rise in 2014 as well.

Many reports on the economic prospects of Germany also argue that it is time for the third engine of growth to launch: investment. So far Germany has caused concern with its low rate of spending in this area (17–18% of GDP), lower even than crisis-ridden France or Spain. After two years of real shrinking (down 2.2% in 2013) the coming months should bring a turning point. Companies have probably reached their production capacities and cannot simply postpone their expansion. Rising labour costs, along with the planned minimum wage increase, should encourage them to invest in new machinery and technologies. The level of investment will also be driven by the state. The Grand Coalition has announced greater public funding for infrastructure and education, even if some economists expected greater ambitions here.

**Higher Growth Is No Given**. The German economy should therefore grow in 2014 between 1.5% and 2%. This is clearly better than in 2013, with its disappointing rate of 0.4%—the worst since the deep recession in 2009. Yet, this generally positive picture of the near-term future of the German economy cannot be taken for granted. Despite high hopes, the growth noted in the global economy still lacks firm foundations. This has become quite clear in the opening weeks of 2014. The end of quantitative easing in the U.S. exposed the vulnerabilities of emerging markets' currencies, which went into free fall. This fundamental weakness can reduce the likelihood that export-oriented economies such as Germany's will grow faster.

Another headache, of course, is the eurozone itself. It is not just that the recovery on the part of the bloc's southerners is at an early stage and collapses can hardly be excluded. The banking sector too is causing headaches. Speculation caused by the European Central Bank's so called autumn stress tests is the last thing a slowly recovering eurozone needs. Last but not least is the danger of deflation highlighted recently by the IMF. Such an eventuality would dent hopes for growth and trigger a longer period of stagnation (as in Japan in the 1990s). Of course, a "black swan" event that included all these risks is improbable, but this too cannot be excluded. In fact, an analysis from the financial sector has predicted that if things do go badly wrong, a recession that costs 2% of GDP in Germany is possible.

**Conclusions.** The implications of Germany's growth rates in 2014 stretch rather beyond the prospects of domestic consumers and companies becoming a little bit wealthier than the year before. A sound German economy has the potential to kickstart a Europe-wide trend of sustainable growth, which would bring this euro-crisis to its final end. An expanding German economy in 2014 would also create a safe run-up for the jump into the deep water of experimental reforms with labour and social insurance starting next year, not to mention the continuation of *Energiewende*. If Germany succeeds in these areas, its model will constitute an interesting template for other EU countries as well as provide an economic buffer for them as they try.

At first sight, faster growth in the biggest European economy can be only good for Poland. The European Union as a whole will become more stable, even if that also means becoming "more German" due to the rising political influence of Berlin. There are also chances for higher Polish export rates in general, which today amount to nearly 50% of Poland's GDP (more than one fourth of this is dependent on the German market). There is, however, one flaw in this argument. It is definitely not the dominant pattern that Polish companies sell their products directly to German consumers.

Much more often they deliver products that are part of a long production chain managed by German multinationals and that end up somewhere else in the global economy, such as China. In this sense, Polish exports to Germany are more exposed to the situation on the global market than is Germany itself. If Poland truly wants to enjoy the effects of German economic speed-ups it needs to develop its own palette of consumer end-products. Another ambiguous impact concerns the migration issue. Rising demand for labour in Germany, boosted by higher growth, can attract skilled workers from Poland. This would be a challenge for the competitiveness profile of Poland, which is still based on the low costs of labour. This risk could be partly abated by new FDI from companies escaping a more expensive Germany to new destinations. Whether they would choose their neighbour's economy is an open question as there are many locations that can beat Poland solely on labour costs.