Europe's engine

Why Germany needs to change, both for its own sake and for others.

ELSEWHERE in the world, Europe is widely regarded as a continent whose economy is rigid and sclerotic, whose people are work-shy and welfare-dependent, and whose industrial base is antiquated and declining—the broken cogs and levers that condemn the old world to a gloomy future. As with most clichés, there is some truth in it. Yet as our special report in this week's issue shows, the achievements of Germany, Europe's biggest economy, tell a rather different story.

A decade ago Germany was the sick man of Europe, plagued by slow growth and high unemployment, with big manufacturers moving out in a desperate search for lower costs. Now, despite the recession, unemployment is lower than it was five years ago. Although Germany recently ceded its place as the world's biggest exporter to China, its exporting prowess remains undimmed. As a share of GDP, its current-account surplus this year will be bigger than China's.

This feat gives the lie to the picture, common in America and Asia, of Europe as a washed-up continent incapable of change. And, for the rest of Europe, there is a lot to be said for having a strong economy at the continent's geographical and political centre. Yet Germany's success is paradoxically also causing problems for its neighbours—problems which they, and Germany, need to address.

The old and the new

Germany's impressive flexibility is the consequence of old virtues combined with new ones. The old consensus-building management system helped employers keep unions on side when costs needed to be held down. The famous Mittelstand (small and medium-sized firms, often family-owned) went through its operations, step by step, judging what to do in Germany, what to send abroad and what to outsource.

At the same time, economic policy took a new, liberalising, direction. The Schröder government introduced reforms to the labour market and welfare systems in 2003-04; spurred on by those, and by competitive pressures from Europe's single currency, German business ruthlessly held down real wages. Unit labour costs fell by an annual average of 1.4% in 2000-08 in Germany, compared with a decline of 0.7% in America and rises of 0.8% and 0.9% in France and Britain respectively. Although last year's recession hit Germany hard, its economy is in much better shape now than it was a decade ago—a point that should be noted in France, where President Nicolas Sarkozy has taken to railing against outsourcing, and in southern

Europe, which bends over backwards to preserve overgenerous wages and restricted labour markets.

Germany is rightly proud of its ability to control costs and keep on exporting. But it also needs to recognise that its success has been won in part at the expense of its European neighbours. Germans like to believe that they made a huge sacrifice in giving up their beloved D-mark ten years ago, but they have in truth benefited more than anyone else from the euro. Almost half of Germany's exports go to other euro-area countries that can no longer resort to devaluation to counter German competitiveness.

While Anglo-Saxons were throwing money around, Germans kept saving. Domestic investment has not kept pace. The result of Germans' prowess at exporting, combined with their reluctance to spend and invest, has been huge trade surpluses. Germany's excess savings have been funnelled abroad—often into subprime assets in America and government bonds in such countries as Greece. It would be absurd to maintain that a prudent Germany is responsible for Greece's profligacy or Spain's property bubble (though a few heroic economists have argued this). But it is true that, within a single-currency zone, habitual surplus countries tend to be matched by habitual deficit ones.

Give spending a chance

Imbalances cannot be sustained for ever, whether they are deficits or surpluses. Yet surplus countries tend to see themselves as virtuous and deficit countries as venal—the implication being that the burden of adjustment should fall on the borrowers. Germany's response to the troubles of Greece, Spain and other euro-area countries has followed just such a line. A bail-out for Greece, once taboo, is now being debated—and German ministers have even come out in favour of a putative European Monetary Fund (see article). But the idea that Germany should itself seek to adjust, through lower saving and higher consumption and investment, still seems unacceptable to Angela Merkel's government.

It is certainly true that Germany's neighbours have a great deal of work to do. France, Italy and Spain need to follow Germany in loosening up their labour markets; Italy, Spain and Greece need to tighten their public finances. But Germany also needs to push ahead with liberalisation. Its web of regulations is too constricting; its job protection is too rigid; its health, welfare and education systems still need big doses of change; its service sector is underdeveloped. You do not have to be a free-market zealot to think that it is too hard to start a new business in Germany, or to worry that a fat tax "wedge" to pay for health care and welfare reduces low-paid service jobs. Nor do all the changes Germany needs to make mean cutting government back. Too few women are in full-time work, partly because child-care support is lacking. The country's demographic prospects are dire.

A bold programme of German structural reforms would do much to boost consumption and investment—and, in turn, to raise Germany's GDP growth, which remains disturbingly feeble. Germany can also afford growth-boosting tax cuts without ruining its public finances. If only Germany would lift its head, it would see that this is in its own wider interest, both because it would be good for German consumers and because it would help the euro area to which it is hitched. Europe's single currency, like the European Union itself, owes much to past German leadership. When that goes missing, both the currency and the club tend to suffer—and Germany is foremost among the losers.

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