Analysis

Germany – economic challenges for the new government

- *In a number of respects the German economy is in a good position after 16 years of Mrs Merkel*
- *But there are problems too, including slow growth that is unduly dependent on exports*
- *Securing good future performance will require that policy be made holistically, not piecemeal*
- *Particular emphasis warrants being paid to investment in human capital and infrastructure*

Is Germany in a good economic position after 16 years of a CDU/CSU-led federal government? By international standards, the answer may be 'yes'. But as well as positive elements in the economic balance sheet of the Merkel era there are also some negatives.

These negative elements will need to be addressed by its new government if Germany is to re-attain not only a satisfactory, but also a sustainable, growth performance.

The plus side of the balance sheet

A positive feature was the elimination of the budget deficit

Over the period since 2005 there has been significant growth in employment and a sharp drop in unemployment – from 11.7% in 2005 to 5.5% in August this year. That said, much of this success owes to the after-effects of the 'Agenda 2010' reforms introduced by a Red-Green government between 2003 and 2005.

On the positive side, the fiscal deficit was eliminated, and even turned into a slight surplus quite a few years before the COVID-19 crisis. This fairly solid budget situation enabled Germany to overcome, and relatively well, the effects the various crises during the Merkel years – the Global Financial Crisis, the Euro debt crisis, and the COVID-19 crisis.

The negative side of the balance sheet

Less impressive has been a lacklustre growth rate …

Less positive has been Germany's lacklustre economic growth, which has averaged only 1.1% per year since 2005, significantly slower than in previous decades. The growth in labour productivity too has left much to be desired, averaging only 0.7% over the period 2006-2020 (on an hours worked basis), significantly lower than in previous decades.

Along with this, real disposable household income averaged only 1% per year in the 15 years to 2020, the effects of employment growth being partially offset by a significant rise in the ratio of tax and social security contributions to GDP since 2005 – from around 39% to around 41% (according to national account statistics). The employment gains and falling unemployment rates of the past 15 years have not been used to reduce the burden of tax and contribution rates.

… weak investment and productivity growth …

Nor has the situation improved significantly in terms of investment and productivity growth over the past decade and a half. Although the rate of public investment has risen

Table 1: Economic summary of the Merkel era, 2005 and 2020

	2005	2020	
Employment	39.3m	44.8 m	😃
Unemployment rate	11.7%	5.8%	😃
Tax and contribution ratio	38.8%	41.3%	☹
Export ratio*	38.1%	43.4%	😐
Trade surplus*	5.2%	5.7%	😐
Public investment*	1.9%	2.6%	😐
Private investment, ex. housing*	12.1%	12.3%	😐

Table 2: Average values of the period 2006 to 2020

Fiscal position*	-0.6%	😃
Real GDP growth	1.1%	😐
Real disposable income growth	1.0%	😐
Labour productivity growth (per hour)	0.7%	☹

Source: Macroadvisors and Llewellyn Consulting
Note: *Proportion of GDP

somewhat, to 2.6%, it remains relatively low by international standards. Private investment (excluding housing) as a proportion of economic output is much the same as in 2005 (at just over 12%).

… and a serious savings-investment imbalance

Moreover, this has led to a macroeconomic and political issue. Altogether, investment in Germany is still well below domestic savings. The result is a high foreign trade surplus, which now stands at almost 6% of GDP, and meets with frequent criticism from abroad. Nor does this situation look likely to change on present policies. Germany's economy, long heavily dependent on exports, has become even more so: the export ratio, which had risen from around 38% in 2005 to 47% before the COVID crisis, is now at around 43%.

Policy challenges

Calls for higher productivity certainly cannot generate enthusiasm during elections but, as in so many countries, they are crucial for Germany's economic future. Productivity growth will determine how fast real (pre-tax) wages can grow. And, in turn, the rate at which public pensions, other social benefits and government revenues will increase depends very much on wage growth.

There needs to be a focus on innovation and investment …

Any economic policy of a new government will need to address these issues. In order to increase long-term growth potential and productivity and thereby secure the high-paying jobs in the long term, economic policy will need to focus in particular on investment, innovation, and the quality of human capital.

… including importantly in human capital …

Germany ranks only around mid-way (17th out of 35 OECD economies) in terms of the quality of its human capital.[1] Particularly at a time when the economy is undergoing a double transformation, toward zero greenhouse gas emissions and extensive digitisation, a well-qualified workforce, in combination with sufficiently high levels of investment and effective innovation, are prerequisites.

The importance of framework (supply-side) conditions

… requiring action on many fronts

How can the requisite changes be achieved? In the private sector, the extent to which capacity is built depends above all on the framework conditions and the attractiveness of Germany as an investment location. Criteria including tax burdens, wage costs, energy costs, bureaucratic burdens, the speed of planning and approval processes, legal certainty, a qualified workforce, and the quality of the public infrastructure in terms of transport, digital infrastructure, energy networks all play an important role.

Bureaucracy often proves to be a major hindrance

The coalition governments have tried in recent years to bring about improvements in various areas, for example by improving university facilities in education and innovation, providing more support for research and development and startups, and better equipping schools and kindergartens. Additional money has also been allocated to modernising public infrastructure in various areas, but often only very small portions of these monies have been spent, due to lengthy planning and approval processes and high bureaucratic requirements.

It is not easy to see major progress in this area. While reductions in bureaucracy are promised time and time again, there are more examples of areas where the bureaucratic burden has been increased than those where it has been significantly reduced. The argument of bureaucratic burdens for business is quickly pushed aside when 'higher' political goals are to be achieved, as in the case of regulations on the minimum wage, supply-chain law, or financial market regulation.

More environmental progress will also have to be made

A further, major determinant of Germany's economic future and the competitiveness of its companies and jobs lies in energy and environmental policy. The big task of achieving CO_2 neutrality as quickly as possible will need to be tackled more efficiently. Germany has made moderate progress in reducing CO_2 emissions through very high electricity prices, increased CO_2 taxes, an expensive coal phase-out, and high government subsidies. However the potential of renewable energies has not yet been fully tapped because of a lack of energy networks and storage media. This puts jobs at risk, rather than creating new ones.

The need for a holistic view

Over and above the need for action in many individual areas of economic policy, an overarching, holistic view is required for the future development of incomes and employment. When economic policy decisions are to be made that impose additional burdens on companies and employees, for example in social spending or energy costs, the effects on competitiveness should be assessed, and counter-balanced by improving framework conditions elsewhere – for example through first-class infrastructure or reduced tax burdens.

Otherwise, prosperity and growth are endangered. Burdens for the economy and employees accumulate because all branches of politics seem to have good reasons for higher charges, taxes, or stricter regulations. Germany has gone in this direction over the years and decades: high costs and tax burdens are offset by fewer and fewer outstanding strengths, such as once first-class infrastructure or highly efficient administrations.

Watch fors

For economic development that promotes prosperity and investment and innovation, the new government will need a reliable and holistic compass. So watch for:

- Signals that decisions involving higher burdens for companies and employees will be offset by improvements elsewhere, or relief.
- Measures to strengthen the competitiveness of the economy and its ability to invest and innovate.
- Willingness to streamline planning and permission procedures for investment.
- Tax hikes which would undermine growth.

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[1] Country rankings for three measures of human capital:

Human capital	Unit	Canada	Korea	Finland	Switzerland	Japan	United States	New Zealand	Slovenia	Netherlands	Estonia	Sweden	Australia	Ireland	Poland
% of adults with at least upper secondary and/or tertiary education	%	92	89	90	89	100	91	81	89	80	90	84	83	80	93
PISA test scores (reading, maths, and	Average score	517	520	516	498	520	495	503	504	502	525	502	499	505	513
% of employed adults participating in non-formal education and training	%	64	59	56	72	49	68	74	55	72	48	63	65	59	31
Average rank - Human capital		6.0	8.7	9.7	9.7	10.3	10.3	11.0	12.3	12.7	13.0	13.0	14.0	14.0	14.3

Human capital	Unit	Austria	Czech Republic	Germany	Norway	Hungary	Slovak Republic	United Kingdom	France	Latvia	Israel	Denmark	Lithuania	Belgium	Portugal	Luxembourg	Chile	Italy	Spain	Greece	Turkey	Mexico
% of adults with at least upper secondary and/or tertiary education	%	86	94	87	83	85	91	68	80	88	87	82	93	79	52	75	67	62	61	74	42	40
PISA test scores (reading, maths, and	Average score	491	495	500	497	479	469	504	494	487	465	501	480	500	492	477	438	477	482	453	463	416
% of employed adults participating in non-formal education and training	%	67	53	56	65	66	57	55	58	54	57	51	33	51	54	53	55	52	47	19	28	42
Average rank - Human capital		14.7	14.7	15.0	15.0	16.7	16.7	18.3	19.0	19.3	19.7	20.0	20.3	22.3	25.3	26.3	27.3	28.0	29.0	32.0	33.3	33.7

Source: Sepping, S., and Llewellyn, J, 2021. *The three 'R's: Recovery, reallocation, and resilience.* Llewellyn Consulting. Available on request.