# 3. Germany: the real sick man of Europe. Why the 'German model' cannot – and should not – be a template for other countries

Thomas Fazi

Germany, written off as the 'sick man of Europe' when the euro was launched in 1999[3], is today considered by most to be the continent's most successful economy. But this is a dangerous misconception. As Matt O'Brien recently wrote in *The Washington Post*: 'It doesn't seem like it, but Germany is *still* the sick man of Europe. It's just that everybody else is terminally ill now'.[4]

Let's start by looking at the most recent economic data available. In August, the country reported its biggest tumble in exports since 2009, falling by 5.8 per cent.

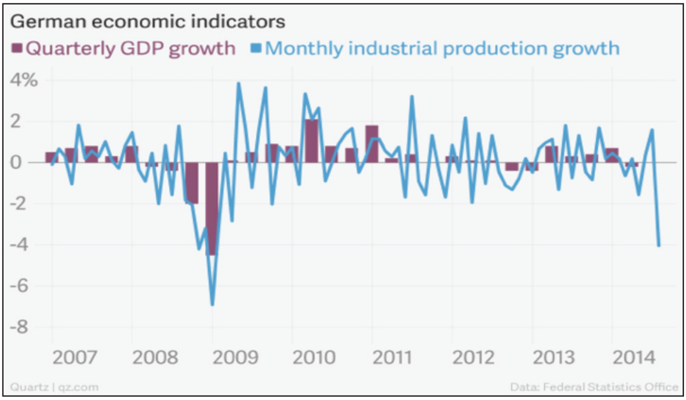
**Chart 3.1: Monthly changes in German exports 2008-2014**


Source: Quartz.

[3] *The Economist*, 'The sick man of the euro', 3 June 1999.
[4] Matt O'Brien, 'Germany is killing its economy – and Europe's too', *The Washington Post*, 9 October 2014.

That same month, a similar reading on industrial production collapsed, falling by 4 per cent, in its biggest monthly decline since January 2009.

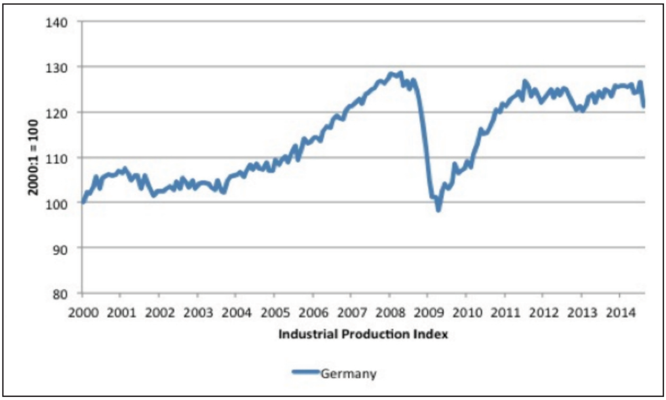
**Chart 3.2: German GDP growth rate and Monthly industrial production growth 2007-2014**




Source: Quartz.

This has put German industrial production back at December 2006 levels.

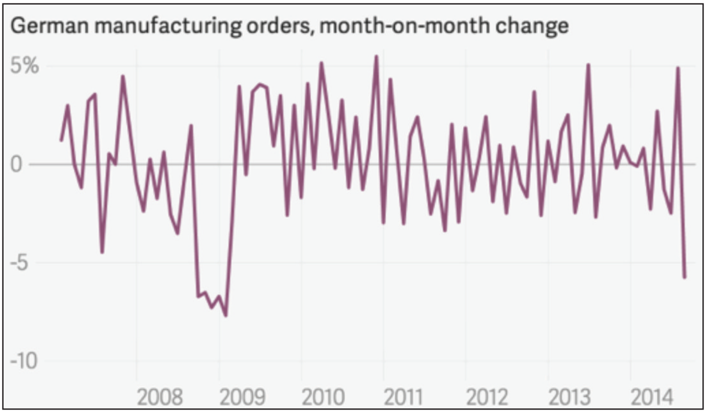
**Chart 3.3: German industrial production 2000-2014**




Source: Bill Mitchell.

Things don't look likely to improve over the short term either. German manufacturing indicators, a leading indicator for output, also fell sharply in August. The 5.7 per cent decline was, again, the largest drop since the worst of the global recession in early 2009.

**Chart 3.4: German manufacturing orders, month-on-month change, 2008-2014**




Source: Quartz.

Moreover, German inflation remained unchanged at 0.8 per cent – well below the ECB's target of 'below, but close to, 2 per cent'.

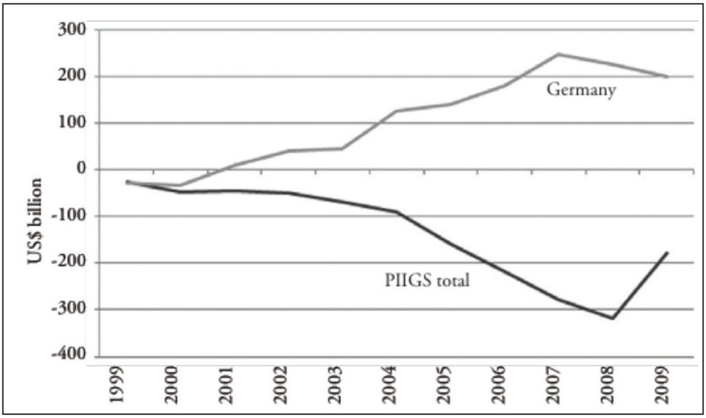
It's official: the German economy is flailing. In the face of such abysmal data, it's unsurprising that the German economy contracted in the second quarter of 2014 (for the first time since 2012), with the country's five economic institutes – or 'Wise Men' – stating in a joint report that the country is now in 'stagnation', and the president of the ZEW Center for European Economic research saying that he doesn't rule out a technical recession, defined as two subsequent quarters of shrinking GDP.[5]

Even more perplexing than the data itself – which is in fact not perplexing at all, as we shall see – was the response of the mainstream financial press, which largely reacted in shock and dismay to the dramatic slowdown of 'Europe's powerhouse', seen by the most as a model pupil for having escaped the crisis largely unscathed. This is rather ironic (not to say disheartening), considering that this outcome should have been perfectly predictable to anyone with a correct understanding of the true dynamics of the euro-crisis and a rudimentary knowledge of economics – and *was* in fact predicted by a number of non-mainstream economists and commentators.

5 Ambrose Evans-Pritchard, 'Eurozone on cusp of triple-dip recession as German exports crumble', *The Telegraph*, 9 October 2014; Catherine Bosley and Brian Parkin, 'Germany Cuts Growth Outlook as Recession Peril Mounts', *Bloomberg*, 14 October 2014.

To understand this, we have to take a step back in time. It's a well-known fact that following the introduction of the euro, the intra-euro balance of payments – which had been more or less balanced since the 1980s – started to drastically diverge, as the continent become increasingly divided into creditor and debtor nations. The following figure – which shows Germany's current account balance vis-à-vis that of the so-called PIIGS (Portugal, Italy, Ireland, Greece and Spain) – shows the rise of these massive imbalances form 2000 onwards.

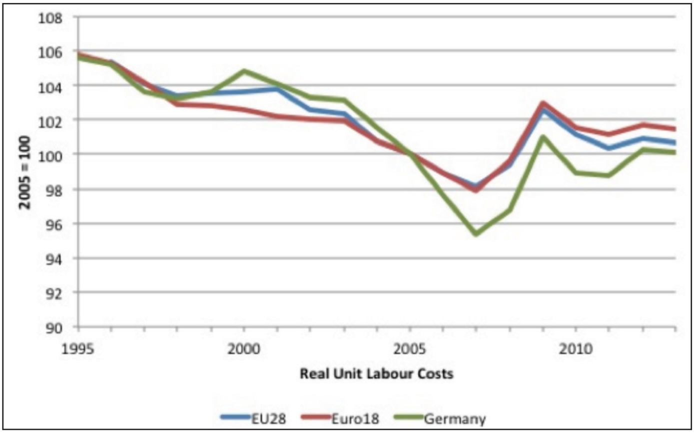
**Chart 3.5: Current Account balance, Germany and Portugal, Italy, Ireland, Greece and Spain combined, 1999-2009**




In short, Germany saw a huge increase in its trade surplus, while periphery countries saw an equally huge increase in their trade deficits. Of course, it is not a coincidence that the two trends are an almost exact mirror of each other. Although a significant proportion of Germany's impressive post-euro trade surplus increase is accounted for by trade with extra-EU countries, its trade surplus with the rest of the European Union almost tripled during those seven years, and a large proportion of this came from trade with the countries of the Mediterranean. The official story is that this was solely the result of the periphery countries letting their wages rise to excessive levels (in other words, paying their workers too generously) – or, as is often heard, 'living beyond their means' –, thus becoming less and less competitive, while Germany was one of the few countries to 'get it right', by keeping wages at a 'sustainable' level, thus becoming increasingly competitive (from a relative standpoint). At first glance it would indeed seem that this is the case – unit labour costs (ULCs) in periphery countries did indeed rise considerably relative to Germany's – and thus that the former are in effect responsible for their own post-crisis ills, and therefore should be the ones to adjust by cutting costs and lowering wages (which is what has happened).

Reality, though, is far more complex. First of all, when speaking of the supposed responsibility of workers in bringing about the crisis, we have to situate the argument in the right historical framework, which is one where during the past three decades the share of national income represented by wages, salaries and benefits – the wage or labour share (also known as real unit labour costs, or RULCs) – has been declining, and that of capital increasing, in nearly all OECD countries, and today stands at a historical low – a point which should always be kept in mind when we hear calls for the 'need' for wages to be cut to 'increase competitiveness'. A decreasing wage share means that productivity is rising faster than real wages, leading to a redistribution of national income to profits, which essentially means that in the past decades *workers have become more productive but also more exploited*. The following figure shows the decline of the wage share (or RULCs) in the EU, Eurozone and Germany between 1995 and today.

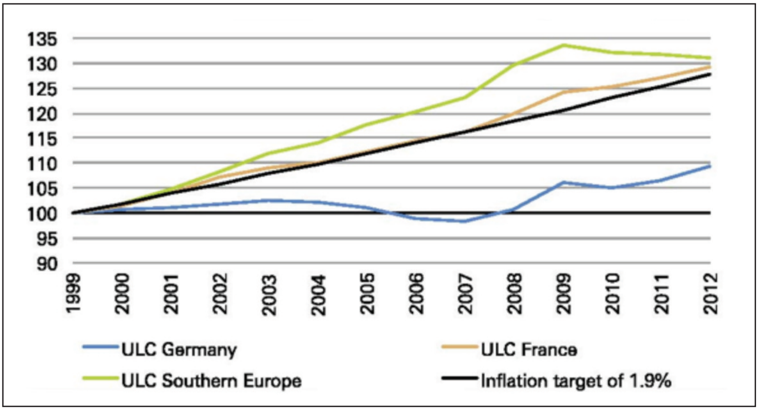
**Chart 3.6: Decline in wage share in the EU, Eurozone and Germany, 1996-2013**




Source: Bill Mitchell.

As the above figure shows, a more accurate assessment of the post-euro wage trend in Europe would be that Germany has simply compressed wages *more* than other countries. That said, in judging who did 'right' and who did 'wrong' in the run-up to the crisis, we should look at what the Eurozone as a whole decided was 'right' with regard to wage increases when the framework of the monetary union was created. Now, it is widely agreed that a system of fixed exchange rates can only work properly if unit labour costs converge and eliminate the need for exchange rate flexibility. The easiest way to achieve this is to ensure that in all member countries the ULCs increase in line with the commonly agreed inflation target, which – as we know – is 2 per cent for the EMU. In this regard, while it is certainly true that periphery countries overshot the EMU's commonly agreed inflation target of 2 per cent by letting their ULCs rise above that level, it is also true that Germany *undershot* its target by an even greater degree. If we compare Greece to Germany, for example, we note that in the post-euro years Greece experienced a 2.7 per cent ULC growth rate compared to a rate of just 0.4 per cent in Germany. In other words, Greece (and other periphery countries) violated the rule to a much lesser degree quantitatively than Germany.

**Chart 3.7: Unit Labour Costs Germany, France, Southern Europe and inflation target, 1999-2012.**




Source: Lapavitsas and Flassbeck.

As progressive economists Costas Lapavitsas and Heiner Flassbeck write, 'in view of this scale, the conclusion about wrongdoers and misbehaviour is obvious:... given this target and the overriding importance of unit labour costs for inflation, Germany headed towards a clear violation of the common target once its government started putting enormous pressure on wage negotiations to improve the country's international competitiveness, inside and outside EMU'.[6]

6 Heiner Flassbeck and Costas Lapavitsas, *The Systemic Crisis of the Euro – True Causes and Effective Therapies,* Berlin: Rosa-Luxemburg-Stiftung, May 2013, p. 12.

As is well known, this was the result of a set of decisions made by Schröder's social-democratic government (and continued by Merkel's conservative government) which emphasised the export sector as the main motor of the economy. The core of Schröder's 'revolution' was the 2003–04 'Hartz IV' labour reform, which merged unemployment benefits and welfare at a lower level and expanded the low-wage sector. It led to a proliferation of low-paid, low-skilled jobs, also known as 'mini-jobs'. Unemployment fell significantly – fuelling the myth of the so-called German 'job miracle' or *Jobwunder* – but this was achieved in large part by creating a huge number of 'precarious' jobs; as a result, total hours worked have barely risen, even as the number of unemployed has fallen.[7] A recent study by Klaus Dörre, professor of labour studies at the Friedrich Schiller University, for the Rosa Luxemburg Foundation emphasises the heavy price paid by German workers. As Dörre writes:

As a result in part of a deliberate policy strategy but also partly due to productive failure, Germany's economic and political elites have clearly managed to bring about the creative destruction of the institutions of erstwhile social capitalism…. However, the result has not been a renewed social market economy that could serve as a model for Europe and the world, but rather the establishment of a highly selective competitive society in which social services are provided to the classes without capital only in so far as is necessary to combine allegiance at home with a 'semi-hegemonic' policy of domination on the European stage. The price for this is being paid primarily by the victims of the reforms, namely precarious workers, the socially excluded and the jobless. *Behind the facade of the supposed 'job miracle' lurks the transition to a society of full but precarious employment*, where the spread of insecure working and living conditions disciplines even those social groups whose conditions remain relatively stable.[8]

The chief effect of the reform was to allow companies to compress wages through labour arbitrage, leading to a massive redistribution of income to profits. And, more importantly, allowing Germany to dramatically increase its competitiveness vis-à-vis its European trading partners, which were not able to impose the same 'discipline' on their workforce. Herein lies the

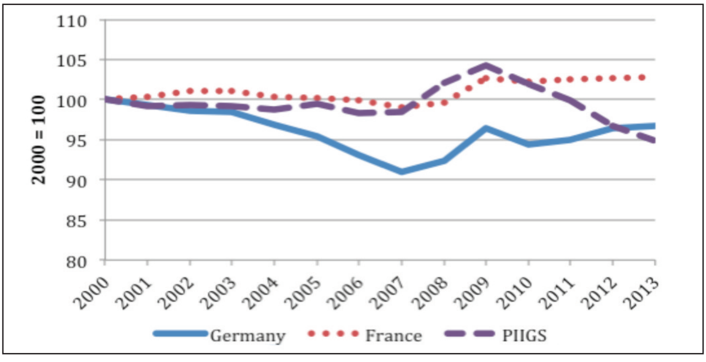
7 *The Economist*, ' Three illusions', 27 September 2014.
8 Klaus Dörre, *The* German Job Miracle – *A Model for Europe?*, Brussels: Rosa-Luxemburg-Stiftung, August 2014, p. 9.

explanation to Germany's post-euro export success, and not in the greater productivity or efficiency of the German economy, as is often implied or openly stated (as a matter of fact, Germany's productivity rate was actually lower than Greece's over the 2000-08 period). Moreover, by being part of the monetary union, Germany did not see its currency appreciate as a result its growing trade surplus, while deficit countries were prevented from pursuing currency depreciation.

This also underscores another obvious – but oft-omitted – point: that Germany was able to acquire such a massive trade surplus precisely because other countries (such as those of the periphery) were *not* following the same policy of drastic wage compression, thus sustaining internal demand (albeit through credit booms in some cases) and providing Germany with an export market, which in turn increased their trade deficit. Surpluses and deficits, in other words, are two sides of the same coin: it is economically impossible for all European states to be in surplus since they would all have to run a trade surplus with the rest of the world, which is clearly not possible (or even desirable).

In light of this, Germany's insistence, in the aftermath of the crisis, that the countries of southern Europe all develop a trade surplus of their own is at best naïve, especially considering that Germany and other northern countries, through their financial sectors, actively contributed to the bubbles in the countries of the periphery. By compressing wages, Germany severely stifled domestic demand up to 2005, as the following figure shows.

**Chart 3.8: Domestic demand in Germany, France and in Portugal, Ireland, Greece Italy and Spain combined, 2000-2013 (2000=100)**




Source: Bill Mitchell based on Eurostat AMECO data.

This meant that Germany could only grow through widening export surpluses. Which, as mentioned, required other countries running deficits – and, if necessary, helping them to do so. As a consequence of Germany's emphasis on exports, its banks accumulated huge amounts of euros – mostly from the countries of the periphery. Rather than using this money to increase demand in Germany (which would have stimulated not only the German economy, but the whole European economy), the German banks channelled their export earnings straight back into the countries of the periphery, in the form of debt. It was this that enabled those countries to keep on buying from the north. This amounted, effectively, to a sovereign version of what is known in retail as 'vendor finance', whereby a company lends money to be used by the borrower to buy the vendor's products (not unlike the way China and the US are bound together). In other words, to a large extent, 'Germany self-financed its own so-called economic miracle', as the American banker and economist Daniel Alpert put it.[9] That money directly contributed to the housing bubbles in Spain and other countries.

By the end of 2009, according to the Bank for International Settlements, German banks had amassed claims of $720 billion on Greece, Ireland, Italy, Portugal and Spain – much more than the German banks' aggregate capital.[10] Irresponsible borrowing, in short, was made possible by irresponsible lending. As Australian economist Bill Mitchell writes:

German government policy deliberately created widening imbalances in Europe by undermining the competitiveness of the other nations through the harsh attack on their own workers.... The suppression of consumption in Germany and the reliance on exports to maintain growth was very damaging to the peripheral states. The growth in employment in Germany in the lead-up to the crisis was not due to a well-functioning monetary union. Rather, *it reflected its malfunctioning because it depended on widening trade imbalances* – huge surpluses in Germany and some of its neighbours against widening deficits in the periphery, covered by unsustainable capital flows from the former to the latter.[11]

9 Daniel Alpert, 'Challenge to austerity deepens, the handwriting is on the wall', *EconoMonitor*, 6 May 2012.
10 Bank of International Settlements, *Quarterly Review*, March 2010, Table 9B, p. 76.
11 Bill Mitchell, 'Options for Europe – Part 62', author's blog, 8 April 2014.

Yet, despite its own responsibilities, Germany – along with the rest of the European establishment – was quick to blame the trade deficits of the PIIGS on their 'lack of competiveness'. The assumption underlying this was that Germany was the only country in the EMU that had got its policy right, so what was needed was for the other member states to improve their competitiveness by following the German wage-slashing model through so-called 'internal devaluation'. And wages have indeed fallen, to a degree that would have been considered politically impossible before the crisis. In Greece, for example, by 2012 cuts to nominal wages had reached 2.3 per cent, with the average salary down by 23 per cent and the minimum wage down by 30 per cent. This represented an 11 per cent drop in hourly labour costs over the 2008–12 period. To varying degrees, unit labour costs have been falling in all periphery countries except Italy over the 2009–12 period, as a result of nominal wages increasing very moderately compared with productivity, or even decreasing, as in Greece and Ireland. This has led to a drastic rebalancing of intra-euro trade balances, with periphery countries registering a sharp decrease in their pre-crisis intra- and extra-euro trade deficits (and Italy even gaining a small surplus in 2013). This, though, has been as much a consequence of increased exports as it has been of decreased imports, because of the drastic reduction in demand. This has meant that the benefits of increased exports for these countries has been offset by the devastating effects on the wider economy of stagnating or falling wages. This is especially so since the export share of periphery economies is rather low, amounting to 27, 32 and 39 per cent of GDP in Greece, Spain and Portugal respectively, compared with 52 per cent in Germany.

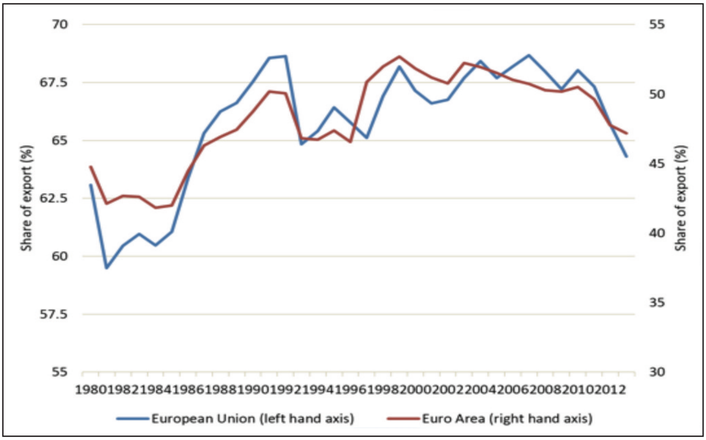
A 2012 discussion note by the European Commission pointed to the risks involved in boosting exports solely through cost cutting:

The scope for restoring competitiveness through wage adjustment is limited by the risk that this may trigger a deflationary wage spiral across the EMU – thereby simultaneously leaving their international competitiveness unchanged and depressing domestic demand in all Member States concerned and in the Union as a whole.[12]

[12] European Commission, 'Discussion note: tripartite exchange of views on wage developments', 20 December 2012, p. 3.

In other words, internal deflation is akin to killing the patients in order to cure them. The reason is that wage deflation policies are based on a fallacious and ideological reading of the crisis. As we saw, it is logically impossible for all EMU countries to follow the German pattern: to a large degree, Germany's export-led success story would never have been possible without the booms in the periphery, which provided customers for German products. Competitiveness, in other words, is a relative concept: if all countries, in the years following the creation of the euro, had applied the same wage moderation policies as Germany, the whole continent would have likely plunged into recession. Which is exactly what has happened, with the Eurozone as a whole today – as a result of the deadly combination of fiscal austerity and wage compression – on the verge of a triple-dip recession and a step away from deflation, and a number of periphery countries still in recession (and in some cases outright deflation) and burdened by record-high unemployment and public debt levels. As László Andor, EU Commissioner for Employment, Social Affairs and Inclusion, recently put it: 'Internal devaluation has resulted in high unemployment, falling household incomes and rising poverty – literally misery for tens of millions of people'.[13] The result, predictably, has been a collapse of intra-euro and intra-EU trade over the course of the last four years.[14]

**Chart 3.9: Intra-EU and Intra-Eurozone trade 1980-2012**



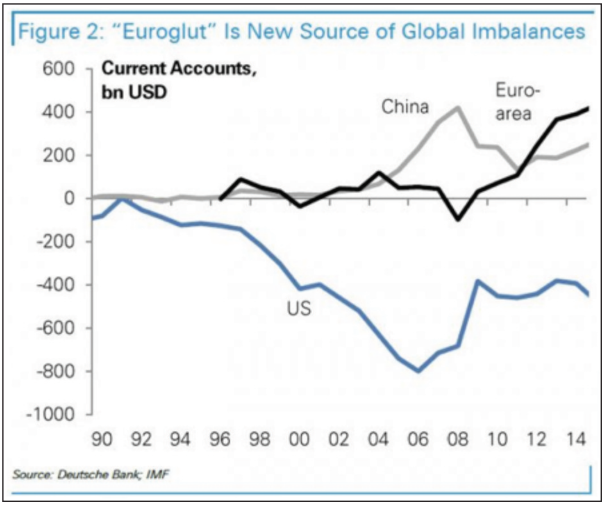

Source: Bruegel based on IMF data.

13 Nicolaj Nielsen, 'EU official says response to economic crisis is flawed', *EUobserver*, 14 June 2014.

14 Giulio Mazzolini, 'Chart: Sharp decline in intra-EU trade over the past 4 years', Bruegel, 27 August 2014.

As various non-mainstream economists number of economists had warned, given that EU nations account for about 57 per cent of German exports, killing demand across the entire continent through austerity would inevitably backfire on Germany. As Matt O'Brien put it, 'forcing your customers into a worse depression than the 1930s isn't good for you'.[15] A long-term, economically and socially sustainable solution to Europe's crisis would have required Germany to bear some of the burden, by boosting demand through increased wages and investment, and reducing its surplus (or even running a deficit). Instead, in recent years, Germany chose to keep pursuing its extreme mercantilist strategy, responding to collapsing demand in Europe by reorienting its exports towards extra-EU countries. As a result, it has managed to transform Europe's imbalances into an even more destabilising *global imbalance*, which a recent Deutsche Bank report termed 'Euroglut'.[16] The terms refer to the Eurozone's massive current account surplus (largely driven by Germany) – at around $400 billion a year, it is bigger than China's in the 2000s – caused by 'lack of European domestic demand' and 'an excess of savings over investment opportunities'.

**Chart 3.10: Eurozone current account surplus 1990-2014**




15 O'Brien, 'Germany is killing its economy – and Europe's too'.
16 *Zero Hedge*, 'Deutsche Bank's Shocking Admission: "QE In Europe Will Be Ineffective"', 7 October 2014.

‘If sustained, it would be the largest surplus ever generated in the history of global financial markets’, the report reads. The destabilising consequences of such a policy were the subject, in late 2013, of an unusually explicit report by the US Treasury Department, which openly accused the German authorities of pursuing beggar-thy-neighbour policies which were dragging down its EMU partners and the rest of the global economy:

Euro area deficit countries have sharply reduced their current account deficits, but euro area surplus countries have not reduced their current account surpluses.... Thus, the burden of adjustment is being disproportionately placed on peripheral European countries, exacerbating extremely high unemployment, especially among youth in these countries, while Europe’s overall adjustment is essentially premised on demand emanating from outside of Europe rather than addressing the shortfalls in demand that exist within Europe.... Germany’s anaemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro-area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment. *The net result has been a deflationary bias for the euro area, as well as for the world economy*.[17]

The implications of the report are clear: just like Germany’s policies are not sustainable on a European scale, they are not sustainable – especially when applied to the entire currency area – on a global scale either. Simply put, weak demand in the Eurozone means lower growth in the rest of the world, which means less imports of Europeans goods. And the economic data presented at the beginning of this paper proves it: in the face of weak global demand (see the whole debate on ‘secular stagnation’), Germany’s exports are taking a hit. The country’s share of global exports fell from 9.1 per cent in 2007 to 8 per cent in 2013 – as low as in the ‘sick man’ era, when Germany was struggling with reunification.[18]

The limits of the so-called ‘German model’ – and the folly of attempting to impose that model on the whole of Europe – seem to finally be dawning upon mainstream economists and commentators. Even in Germany.

17 US Department of the Treasury, *Report to Congress on International Economic and Exchange Rate Policies*, 30 October 2013, pp. 24–6.
18 Philippe Legrain, ‘Germany’s Economic Mirage’, *Project Syndicate*, 23 September 2014.

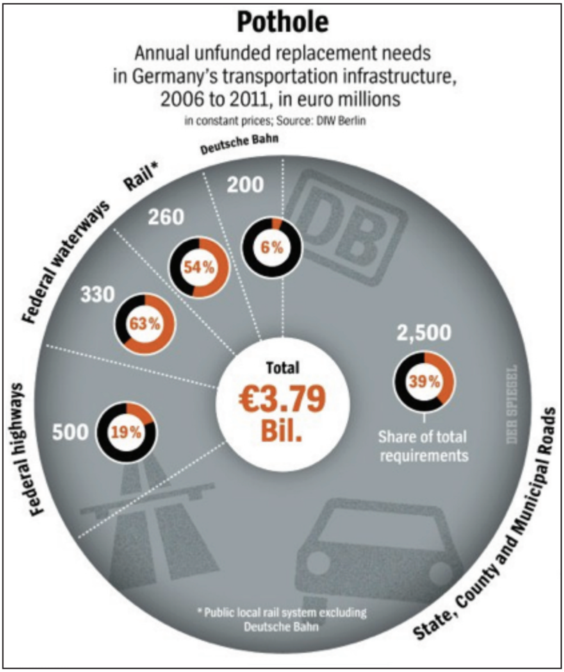
‘Germany considers itself the model for the world, but pride comes before the fall’, says Olaf Gersemann, *Die Welt*’s economics chief, in a new book, *The Germany Bubble: the Last Hurrah of a Great Economic Nation*. Gersemann says the second *Wirtschaftswunder* – or economic miracle – from 2005 onwards has ‘gone to Germany’s head’. The country has mistaken a confluence of exceptional events for permanent ascendancy. It cannot continue to live off exports of capital goods to China and the BRICS as they hit the buffers, or by stealing a march on southern Europe through wage compression, a zero-sum game. As Wolfgang Münchau recently wrote in the *Financial Times*,

One of the biggest misconceptions about the Eurozone has been a belief in the innate strength of Germany – the idea that competitiveness reforms have transformed a laggard into a leader. This is nonsense. The German model relies on the presence of an unsustainable investment boom in other parts of the world.... *The root cause of the problem is the age-old over-reliance on exports*.[19]

Marcel Fratzscher, head of the German Institute for Economic Research (DIW), goes even further in his new book, *Die Deutschland Illusion*, arguing that Germany’s export-led model isn’t simply unsustainable in the long run – it has been failing all along. He writes that Germany’s obsession for surpluses has resulted in chronic private underinvestment in the country’s economy, as the whole system depends on German capital fuelling demand abroad. This has resulted in investment falling from 22.3 per cent of GDP in 2000 to 17 per cent in 2013, less than most comparably rich countries, which – combined with one of the lowest levels of gross government investment in Europe (with net government investment negative in the past 12 years after accounting for wear and tear) – is responsible for low productivity growth (because it discourages workers from upgrading skills and companies from investing in higher-value production) and for what a recent *Spiegel* article described as ‘Germany’s ailing infrastructure’, with highways, bridges and even the Kiel Canal in desperate need of maintenance.[20] According to DIW calculations, the investment shortfall between 1999 and 2012 amounted to about 3 per cent of gross domestic product, the largest ‘investment gap’ of any European country.[21]

19 Wolfgang Münchau, ‘Germany’s weak point is its reliance on exports’, *Financial Times*, 12 October 2014.
20 Alexander Jung et al., ‘Germany’s Ailing Infrastructure: A Nation Slowly Crumbles’, *Spiegel*, 18 September 2014.
21 Jung, ‘Germany’s Ailing Infrastructure’.

**Chart 3.11: Annual unfunded replacement needs in Germany's transportation infrastructure 2006 to 2011 in Euro millions**




Source: *Spiegel*.

As Philippe Legrain, visiting senior fellow at the London School of Economics' European Institute and former economic adviser to the president of the European Commission, recently wrote, this is perhaps the best demonstration of the fact that Germany's export-led economic model (exemplified by the country's huge current account surplus), far from being an example of superior competitiveness, is actually highly 'dysfunctional':

External surpluses are in fact symptomatic of an ailing economy. Stagnant wages boost corporate surpluses, while subdued spending, a stifled service sector, and stunted start-ups suppress domestic investment, with the resulting surplus savings often squandered overseas. The Berlin-based DIW institute calculates that from 2006 to 2012, the value of Germany's foreign portfolio holdings fell by €600 billion, or 22 per cent of GDP. Worse, rather than being an 'anchor of stability' for the eurozone, as Schäuble claims, Germany spreads instability. Its banks' poor approach to lending their surplus savings inflated asset-price bubbles in the run-up to the financial crisis, and have imposed debt deflation since then. Nor is Germany a ‘growth engine’ for the Eurozone. In fact, its weak domestic demand has dampened growth elsewhere. As a result, German banks and taxpayers are less likely to recover their bad loans to southern Europe. Given how bad wage compression has been for Germany’s economy, foisting wage cuts on the rest of the Eurozone would be disastrous. Slashing incomes depresses domestic spending and makes debts even less manageable. With global demand weak, the Eurozone as a whole cannot rely on exports to grow out of its debts.[22]

And yet the European political establishment seems to be bent on transforming the monetary union into huge German-style, export-led economic machine characterised by stagnant wages, low demand and massive capital outflows. This is exemplified by the ‘free trade agreement’ currently being negotiated between the EU and the US, the Trade and Investment Partnership (TTIP). As Werner Raza, director of ÖFSE – Austrian Foundation for Development Research, writes:

The TTIP is an essential part of the Global Europe strategy, the latter linking EU trade policy explicitly with the ‘competitiveness agenda’ of the Europe 2020 strategy. In this sense, the new trade agenda is an essential element of an EU crisis policy that emphasises the need to increase external competitiveness in order to install an export-led growth model all over the EU, particularly in the Eurozone.[23]

According to Raza, there is a causal link between such a model and the regressive policies imposed on the peoples of Europe in recent years:

This export-led growth model is linked to the flexibilisation of labour markets, low corporate taxation and wage deflation as key elements of so-called ‘structural reforms’ – and thus to the wider dismantling of the welfare state which we have witnessed in recent years. The TTIP contributes to this by further shifting the balance of social forces in favour of the corporate sector, and by locking-in the neoliberal reforms of the last two decades, in particular the privatisation of public services.[24]

22 Legrain, ‘Germany’s Economic Mirage’.
23 Interview to the author.
24 Interview to the author.

The ‘Germanisation’ of Europe which the TTIP implies will not only pit the countries and workers of Europe against each other in a self-destructive race to the bottom – it will also pit Europe against the rest of the world, with potentially very destabilising consequences. As Adam Posen, president of the Peterson Institute for International Economics, wrote in the *Financial Times*: ‘Low wages are not the basis on which a rich nation should compete.... If Germany’s economic model is the future of Europe, we should all be quite troubled. But that is where we seem to be going’.[25]

[25] Adam Posen, ‘Germany is being crushed by its export obsession’, *Financial Times,* 3 September 2013