

Are we seeing 'peak' Germany?

Why we should be cautious before recommending Merkel and Gerhard Schröder to other countries

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There is a well-known phenomenon called the “skyscraper index” that relates the number and height of skyscrapers to the economic cycle.¹ At the peak of a bubble, ground is broken for the start of construction of the most ambitious projects. In the same manner, one can observe a tendency in the international community of policy-makers, journalists and academics to advocate policies akin to those adopted by countries that display all the signs of enduring success, just prior to taking a major stumble. This is particularly worrying if this tendency leads other countries to undertake similarly radical changes in their own policies that might not have the expected salutary effect.

As a Central European, I have observed this phenomenon first hand in the context of the post-Communist transition. After 1989, the Poles were the first to be celebrated – with the ‘shock therapy’ practised by the Solidarnosc government. In the mid-1990s it was the Czechs’ turn, with their mini-Thatcher in the person of Vaclav Klaus and one of the lowest unemployment rates in Europe, in what was prematurely hailed as the “end of the transition”. In the late 1990s, Hungary was subsequently feted as the country that overcame 40 years of high-spending, stop-and-go, muddling-through policies to finally and decisively deliver reforms that would ensure the country’s long-term success. And around 2004, it was finally Slovakia’s turn, with its flat tax, deep welfare reforms and ranking among the highest growth rates in Europe.

The merry-go-round never stops. During the Great Recession, Poland came back to the top as the only country in Europe to weather the crisis without succumbing to a recession. While it is understandable why these success stories attract so many admirers and champions, it is worth recalling and heeding certain caveats.

¹ Andrew Lawrence, "The Skyscraper Index: Faulty Towers", Property Report, Dresdner Kleinwort Wasserstein Research, 15 January 1999.

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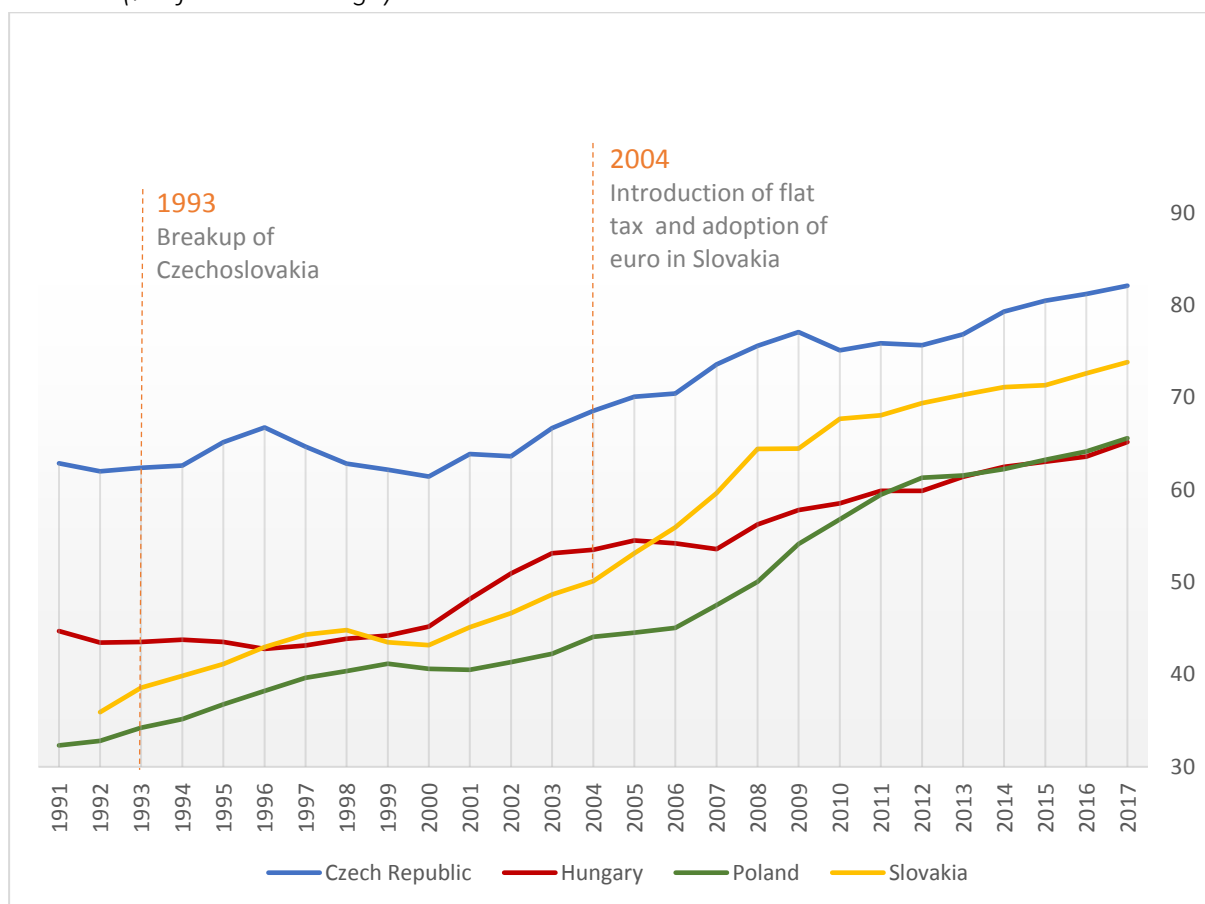
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One such caveat is that such narratives inevitably but brutally exaggerate the ups and downs of individual countries' development. Things are usually not as bad at the bottom as they appear to outside observers (perhaps with the exception of Greece over the last decade). But conditions are also not as great or as different when the country appears to be doing particularly well (except for possibly Ireland in the 1990s).

Additionally, there is an important element of luck, which is often ignored or only mentioned as a footnote in the literature. As Easterly has shown for developing countries, there can be and frequently is a significant divergence between two countries in economic performance over a period of several years that is purely random and cannot be attributed to policies.² A natural tendency to ascribe deep causes to such developments can easily mislead.

What really matters are developments in the long run – measured in decades. Over the 26-year period since 1991, as shown below, we have seen that each of the Central European countries has experienced its own 'peak' period, but their long-run performance has varied significantly. Slovakia and Poland managed to grow the fastest, with the Czech Republic barely retaining its economic primacy in absolute terms and Hungary gradually falling behind.

Figure 1. Growth in GDP per capita in Central European countries, 1991-2017
(% of EU-15 average)



Note: Gross domestic product at current prices per head of population (Purchasing Power Standards: EU-15=100).

Source: Author's own elaboration based on data from Ameco.

² W. Easterly (1992), "How much does policy affect growth?", *Cuadernos de Economía*, Vol. 29, No. 87, pp. 295-305.

Some of the highest accolades were bestowed on these countries' leaders for their economic acumen and foresight shortly before the deficiencies of their particular model became evident. In that sense, their models resemble the skyscrapers referenced at the beginning of this commentary as possible harbingers of economic downturn.

Such speculation might be intellectually interesting, but does it really matter? I would respond in the affirmative, for two reasons.

One is the potential for hubris in the leadership of the country in question. It is difficult to continue advocating reform if the situation looks reasonably good to your voters. But when everyone else is proclaiming that you have already made your country great again, it emboldens both 'small-c' conservatives and those who are happy to literally give away your country's future in pre-election hand-outs.

Even more dangerous is the nearly irresistible temptation to prescribe your way of life to others and to believe that if they only became more like you, their problems would be solved.

Germany is an excellent illustration of all these risks. And unlike in the case of Ireland, Greece or Slovakia, Germany's importance makes this phenomenon a major, or one could even say, a systemic risk.

Germany's story is well known. From the sick man of Europe that lost its way in the 1990s, it came roaring back thanks to its long-term strengths (tight fiscal policy, close links between employers and education, etc.), the reforms of Gerhard Schröder and the shrewd leadership of Angela Merkel.

In a recent column by the well-known American economist Tyler Cowen, it is even lauded as "the Silicon Valley of political innovation", with German unification and the response to the eurozone crisis elevated as prominent examples of political wisdom.³ When the German establishment's handling of these two challenges is assessed in such glowing terms, it is obvious that we are close to 'peak' Germany: nearly anything done by its government can appear worthy of emulation, regardless of its actual merit.

In reality, the German resurgence has been due less to Schröder's reforms (as necessary as they were) and more to trade unions' self-restraint in collective bargaining,⁴ the emergence of China and other developing countries as top markets for German capital goods⁵ and the fact that eurozone membership held down the exchange rate compared to what would have been the case under the Deutsche Mark. Since the turnaround was due in large part to a mobilisation of the least productive part of the labour force, it can result only in a one-time boost, but not in permanently higher growth rates.

³ T. Cowen, "Germany Is the Silicon Valley of Political Innovation", *Bloomberg*, 30 May 2017.

⁴ The Australian, "[Germany's surplus based on union-backed wage restraint](#)", *The Economist*, 8 July 2017.

⁵ German Chamber of Commerce in China, "[German Business in China: Business Confidence Survey](#)", 2015.

More importantly, Germany is facing severe challenges to its long-term economic success, partially due to troubling demographic trends,⁶ but also due to low public investment⁷ and emerging inequalities, which its state is not traditionally accustomed to handling.⁸ More immediately, a key element of Germany's strength over the last few years is that in a financial crisis 'cash is king'. But in a world of low-risk premia and excess savings everywhere, the external surplus is no longer a source of strength. The current pre-election debates are not primarily concerned with these issues, nor does one either a clear plan to address them or a sense of urgency from Chancellor Merkel or her challenger Martin Schulz.

Exporting Germany's model of success is also something to approach with caution. This warning concerns in particular two of the country's most visible 'achievements' – a balanced budget and low youth unemployment.

As economists have pointed out, if the entire eurozone had followed German fiscal policy, it would have been self-defeating, not to mention the fact that the German model led to significant underinvestment in public infrastructure and education even during 'good times'. This latter oversight does not bode well for long-term growth.⁹

The German 'dual' system of formal and vocational education is also seen at the moment as an appealing model that deserves to be emulated and exported.¹⁰ Proponents of its export overlook two important points, however. In the first instance, it only makes sense to export the German model to countries with strong corporatist structures and manufacturing-driven economies, neither of which is present in most countries struggling with high youth unemployment. Secondly, the German model has serious drawbacks in terms of equity and preparing workers for the knowledge-based service economy.

The foregoing discussion is not to denigrate Germany and its successes. However, analogous with the 'skyscraper index' theory presented at the start of this commentary, the current 'peak' Germany should be seen as a warning for both Germans and others that while every country has something to teach us, internal policy-making should not be driven by fads. The stakes are simply too high.

⁶ S. Wagstyl, "Germany's demographics: Young people wanted", *Financial Times*, 24 August 2015.

⁷ *The Economist*, "Germany's low investment rate leaves its infrastructure creaking", 17 July 2017.

⁸ M. Muller, "Wachsende Nachfrage nach Hochqualifizierten lässt Einkommen ungleicher werden" [Growing demand for highly qualified people makes income more unequal], KfW Research, No. 121, 16 March 2016.

⁹ S. Dullien, "A Missed Chance: The Grand Coalition and Public Investment in Germany", *Transatlantic Perspective*, American Institute for Contemporary German Studies, John Hopkins University, Washington, D.C., 19 December 2013.

¹⁰ D. Euler, "Germany's dual vocational training system: a model for other countries?", study commissioned by Bertelsmann Stiftung, 2013.