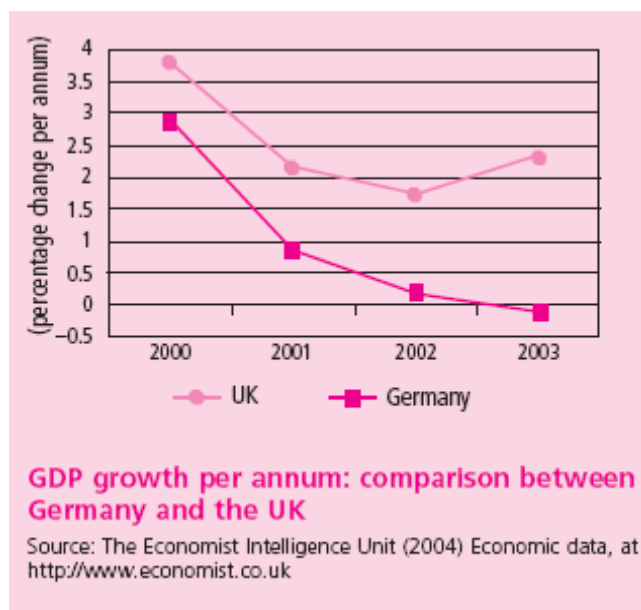


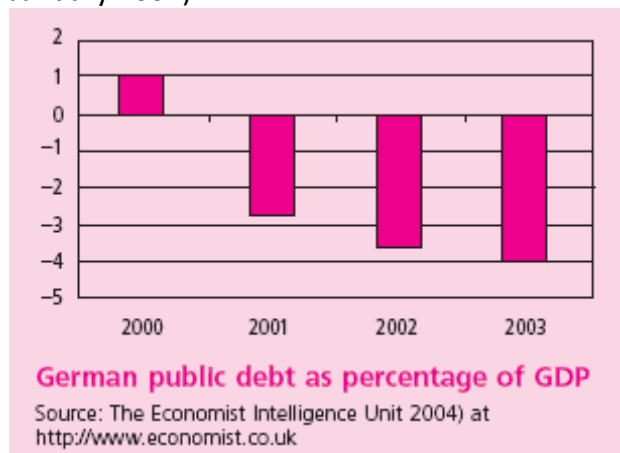
Is Germany back on track for economic growth?

Case taken from The International Business Environment, second edition (Palgrave, 2006), by Janet Morrison

While it was hoped that an upturn in the German economy would take place in the new millennium, optimism has been in short supply. The German economy has stagnated for three years. Its economic woes are highlighted by comparison with the UK growth rate, shown in the figure below. It was hoped that Germany, the EU's largest economy, would grow again in 2004, achieving a growth rate of 1.2 per cent, but growth prospects were slim.



The unification of Germany in 1990, uniting the former Communist East Germany with the more economically advanced West Germany, provided a new sense of optimism among Germany's 82 million inhabitants, despite the huge amount of economic catching up that was entailed in rebuilding the economy of the former East Germany. Despite huge injections of resources, unemployment has remained high in the East, at around 15–20 per cent, contributing to an overall unemployment figure of 9 per cent in 2004. The German government has been committed to social welfare spending, which accounts for 50 per cent of government expenditure. It has incurred the wrath of the EU for its budget deficit, which, hovering around 4 per cent of GDP, risks breaching the eurozone's budgetary rules (see figure below). The bill for social benefits in Germany is higher than in France, Italy, the UK, Spain, the US or Japan. These costs, including social security, healthcare and pensions, contribute to Germany's position as having the highest labour costs in the world, second only to the Norwegians. Clearly, Germany is in need of more job creation; one economist has said: 'you are seven times more likely to lose your job in the US as in Germany but 10 times more likely to get a new one' (Benoit, 7 January 2004).



Nearly 70 per cent of workers are employed in Germany's approximately 3.3 million SMEs, making up the Mittelstand, which is considered the backbone of the economy. In manufacturing, large firms of over 500 employees make up only 1 per cent of the total, while firms with fewer than 250 employees account for 45 per cent of manufacturing employment. Insolvencies among SMEs have run at record levels, while a parallel concern has been the low level of private sector investment in the economy, which fell a total of 12 per cent from 2001 to 2003. At the same time, consumer spending was weak and the rate of savings went up, both recognized features of an economic downturn. In these circumstances, economists would advise a lowering of interest rates, but the European Central Bank's modest easing of interest rates in 2003 had little impact, and Germany as a eurozone economy is unable to act unilaterally. The government of Helmut Schröder in 2003 put forward a comprehensive package of reforms called Agenda 2010 consisting of more than a dozen pieces of legislation. These were in areas of social security reform, the health service and labour market reforms. Labour market reforms, aiming to bring about greater flexibility, were seen as key to the structural problems which have made German businesses uncompetitive. Of particular concern was the worry that jobs would migrate to the new EU member states to the East, where costs are lower. Compromises had to be made in order to get the unpopular measures through the legislature and reforms were less sweeping than originally envisaged.


Unemployment benefits have been reduced, as have pensions, both deeply unpopular reforms. A reduction in both income and corporation taxes, brought forward from 2005 to 2004, has been the only universally popular reform. To further encourage employers, protection against dismissal has been relaxed, and employer contributions to the health service have been reduced. The hope is for export-led growth to generate economic recovery. However, the government still faces a budget deficit in public finances and people have little appetite for further reforms which trim Germany's social welfare system.

Sources: Barber, T. 'Economic downturn originates from home', Financial Times, 18 January 2002; Simonian, H., 'Troubles plague the powerhouse of Europe', Financial Times, 25 November 2002; Benoit, B., 'Schröder's unfinished business: why the reforms agreed for Germany's ailing economy leave the job half-done', Financial Times, 7 January 2004; Munchau, W., 'Grounded: why Germany's once soaring economy is failing to take off', Financial Times, 1 April 2004; OECD (2002) Small and Medium Enterprise Outlook (Paris: OECD).

Case questions

What are the main aspects of Germany's economic woes?

Assess the government's success in tackling them.

 Information on the German economy is on the country page of the OECD's website at www.oecd.org