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German economy at a crossroads

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Hardly a day goes by without the media raising alarms about the troubled state of the German economy, using terms such as "sick", "hungover", and "fatigued"[1]. In August 2023, The Economist posed the question of whether Germany had once again become the "sick man" of Europe. These concerns are echoed by businesses, research institutes, and international organizations[2]. The International Monetary Fund (IMF) predicts that Germany will be the only advanced economy to experience a drop in GDP in 2024. This raises the question of whether the current weakness in the German economy is merely a temporary issue or if it stems from deeper structural problems that necessitate a fundamental shift in its current developmental model. The former option is supported by the fact that Germany was already labeled the "sick man" of the eurozone in 1999, yet it went on to become the economic powerhouse of the region for decades. Up until 2018, Germany was seen as a major beneficiary of globalization. The latter option, however, is suggested by the growing disparity between the German and U.S. economies, a trend that has been unfavorable to Germany for more than a decade.

GERMAN ECONOMIC PERFORMANCE

Opinions within the co-ruling Social Democratic party on the state of the German economy are divided. Chancellor Olaf Scholz likened Germany to a proud sailing ship navigating through unique challenges, including the pandemic, the war in Ukraine, strained relations with China, climate change, energy, and digital transition. These problems stem from the sheer scale of the challenges, which is why harsh criticism from industry and experts is exaggerated and overly pessimistic in this context. On the other hand, the Chancellor's party colleague Sigmar Gabriel, former foreign minister, former economy minister, and former

[1] J. Nagel, Deutschlands Wachstumspfad mit Investitionen pflastern. Hindernisse abbauen, Finanzierung erleichtern, Bundesbank, Frankfurt am Main, 2024.

[2] https://www.kreis-anzeiger.de/wirtschaft/harte-kritik-an-olaf-scholz-hat-sehr-eigene-sicht-auf-die-dinge-zr-93117931.html, https://www.wiwo.de/politik/deutschland/mittelstand-scholz-ruft-familienunternehmen-zu-zuversicht-auf/29771744.html (accessed July 22, 2024).

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SPD chairman, takes a much more critical view of the situation[3]. Gabriel contends that the state has failed in its core responsibilities, such as education and ensuring internal and external security. Despite this, society seems to accept the decline in the quality of life, as evidenced by indicators that includes only 75% trains running on time, 75% completion of school curricula, a 75% vaccination rate, and the actual use of 75% of scheduled working hours, including two to three days of remote work. According to Gabriel, this complacency stems from a lack of awareness among Germans that their current high standard of living, relatively strong social security, and high standards of environmental protection and climate change response result from high-quality work and exceptional efficiency.

Undoubtedly, technological changes have shaken the foundations of Germany's current development model, which relies heavily on a significant share of industrial production and related services in GDP generation, as well as substantial export surpluses. This raises the question of whether Germany can find new competitive advantages in these altered conditions that would sustain its current economic position and the level of prosperity it has achieved.

The answer to this question is crucial not only for Germany but also for countries of Central and Eastern Europe, including Poland, for whom Germany is the leading and dominant trading partner. Germany accounts for nearly 28% of Poland's trade turnover. Naturally, Germany's economic difficulties also affect the broader European Union economy.

GERMANY COMPARED TO THE UNITED STATES

The reason behind the European Union's slower economic growth compared to the United States is undoubtedly linked to Germany's economic weakness. What is concerning is that this gap in development did not just emerge due to the pandemic or Russia's aggression against Ukraine – factors that could be attributed to the higher costs of Europe's energy transition. This trend actually began much earlier. In fact, the EU's economic growth compared to the U.S. has essentially stalled since 2010, despite the development of the common market and the introduction of a single currency[4]. Currently, DGP per capita in the U.S. is twice as high as in the EU[5]. In 2013, the EU economy was 91% of the

[3] S. Gabriel, Wie das demokratische Zentrum vor der AfD kapituliert, *Frankfurter Allgemeine Zeitung*, August 11, 2023.

[4] Tragedy of Europe so Cranach in Beyond the obvious, May 21, 2023, Podcast, Europe's relative decline, https://ecfr.eu/publication/the-art-of-vassalisation-how-russias-war-on-ukraine-has-transformed-transatlantic-relations/ (accessed July 22, 2024).

[5] Compared with per capita GNP in individual states of the USA, see. https://ipsr.ku.edu/ksdata/ksah/business/percapGDP.pdf (accessed July 22, 2024).

size of the U.S. economy in dollar terms, but by 2023, that figure had dropped to just 65%. A similar widening gap can be seen between Germany and the U.S. In 2011, Germany's GDP per capita was 75% of that in the U.S. Now, it has fallen to 68%. "If Germany's economy had grown at a similar pace to the American one, Germans would have an additional €4,000 in income per capita[6].

There are no signs that these differences will narrow. On the contrary, when looking at the top companies, universities, and producers of microprocessors, German and European companies are notably absent from the top ten in rankings. American companies dominate the IT sectors, where the highest profits are made. Leading U.S. companies earn twice as much as their EU counterparts[7]. American stocks make up 70% of the MSCI World index, and the combined m value of the top 10 companies in this index – all of which are American – exceeds the total value of the stock markets in Japan, the UK, France, Canada, and Germany combined. It is important to note that this level of dominance by the American stock and capital markets is a relatively new phenomenon, driven by the internet boom that began around 2000, giving rise to companies such as Amazon, Alphabet, and Microsoft, which have no equivalents in Europe[8] .

REASONS FOR TECHNOLOGICAL LAG

In German debates, the government is primarily blamed for the country's technological lag. The general consensus is that public investment in infrastructure, education, and digitalization is inadequate. Critics argue that the period of negative interest rates from the European Central Bank was not used to boost infrastructure spending, which requires substantial financial commitment. According to the German development bank KfW, achieving climate neutrality by 2045 along will require investments of €5 trillion[9]. Migration policy, excessive bureaucracy, and tax policies that discourage full-time employment are also criticized.

When analyzing Germany's economic situation through the lens of traditional production factors, i.e. labor, natural resources, and capital, it is clear that with different state policies, the growth potential of the German economy could be better harnessed.

Germany has been grappling with a shortage of skilled workers for many years, especially in emerging technologies, partly due to political neglect. For example, the relatively low

[6] D. Stelter, Deutschland ist ein Sanierungsfall – und muss so behandelt werden, *Handelsblatt*, August 13, 2023.
[7] https://www.faz.net/aktuell/wirtschaft/abstand-zu-usa-und-china-waechst-wohlstandsmuseum-eu-19792736.html#?cleverPushBounceUrl=https%3A%2F%2Fwww.faz.net%2Faktuell%2F&cleverPushNotificationId=q4B4nCZLxMvNCbfWk (accessed July 22, 2024).
[8] V. Romei, C. Smith, US poised to power ahead of Europe for years, *Financial Times*, October 20, 2023, p. 4.
[9] J. Nagel, Deutschlands Wachstumspfad mit Investitionen...

participation of women in the workforce is attributed to challenges in balancing work with childcare, as well as tax policies that discourage full-time employment. Furthermore, the educational system fails to meet the needs of the economy, particularly in STEM fields. Research shows that the education system inadequately prepares students in these areas. In 2022, nearly 30% of students tested under PISA failed to reach the basic level in mathematics[10]. Additionally, the education system struggles to fulfill its role in social integration, with school success strongly correlated with parents' education attainment. This poses a challenge, particularly with the need to integrate migrants. Germany has faced labor shortages before, but after 1990, these were partially mitigated by an influx of well-educated workers from Central and Eastern Europe, who accepted lower wages and were eager to succeed in a new environment. Today, however, the composition of incoming migrants has changed, with many either not participating in the workforce or not working in low-paid sectors[11].

Germany's relative lack of natural resources has not been an obstacle to its development, thanks to its technological leadership. However, the technologies that once gave Germany an edge are now being obsolete. Fossil fuels need to be replaced with low-emission alternatives, and combustion engines must give way to electric ones. Germany lacks a compelling strategy to address these challenges, which is surprising given that German society has long been aware of the need for change to protect the climate, and there has been broad public approval of these changes. This awareness, however, has not been translated into specific business actions. Germany has failed to develop comparative advantages in these areas and, like other European countries, is poorly prepared technologically for the necessary transitions.

In terms of capital market development, Germany and Europe are falling behind. They lack the legal frameworks to mobilize private capital for digital or climate transition, as seen in the U.S. After Brexit, the push for a capital union lost momentum. Peter Altmaier, the Economy Minister in Merkel's administration, once highlighted the negative consequences of capital weakness, noting that German startups are primarily funded by American investment funds. These funds not only take over ownership, but also transfer know-how, further widening the technological gap between the U.S. and Europe. Both traditional European companies and startups are increasingly opting for American stock exchanges to issue shares. The value of the American S&P500 index has tripled since the post-pandemic economic crisis, while

[10] PISA-Studie: Die wichtigsten Ergebnisse und Reaktionen (deutsches-schulportal.de), (accessed July 22, 2024).

[11] D. Stelter, Deutschland ist ein Sanierungsfall...

the Euro Stoxx50 has grown by less than 75% in the same period[12].

In conclusion, an appropriate economic policy could significantly improve the German economy. Reforms in tax regulations, a more targeted migration policy, and an education system better aligned with technological advancements would positively impact the labor market. A more balanced climate policy and longer adaptation periods would help industry maintain its technological leadership. A capital union would create better financing conditions across Europe.

THE ROLE OF BUSINESS

However, focusing solely on the government's shortcomings is not enough to fully grasp the extent of German business's lag behind the U.S. economy, a gap that became starkly apparent after Russia's invasion of Ukraine. It is surprising that German companies have not introduced new technological solutions that address the digital or green transitions, especially since Germany had previously planned to replicate its success from the 1970s. Back then, it was among the first to prioritize green production processes, which gave it a competitive edge. The example of the 2000 Lisbon Strategy also shows that both Germany and the EU were aware of the potential of digital technologies and the importance of European companies participating in this shift. This raises the question of why Germany has not been able to produce its own equivalents of American Internet giants. How did German companies transition from being rule-makers to rule-takers in these technologies?

It appears that the main reason for the decline in the dynamism of the German economy is the departure from the ordoliberal principles that once underpinned the German model of capitalism.

The principle of balancing the interests of all economic participants to create conditions for open and fair competition was not upheld during the process of German unification. The transformation weakened potential competitors from the former GDR and Central and Eastern Europe to the point that they posed no real challenge to West German companies. In exchange, these companies gained access to a market of nearly 100 million consumers, who were less technologically demanding. This significantly reduced the pressure and incentives to build competitive advantages through innovation or openness to new technologies. Instead, profits were generated by selling existing products and services. The integration of Central and Eastern European economies into the German production chain helped offset the decline in Germany's competitiveness after the adoption of the euro. Alongside the reforms under Gerhard Schröder's government,

[12] Ph. Augar, How the US is crushing Europe's domestic exchanges, Financial Times, September 26, 2023, p. 17.

this was one of the key factors in regaining competitiveness – not through innovative solutions by reducing labor and energy costs, but by leveraging the advantages of Central and Eastern European markets. As a result, economies in eastern Germany and Central and Eastern Europe became dependent on external financing and are now at risk of falling into the middle-income trap, which generally hinders the development dynamics of both Germany and the EU.

From an ordoliberal perspective, Germany's economic woes stem more from the unequal treatment of participants in the economic process, particularly in solutions that favor big business. The diesel emissions scandal, dependence on Russian gas, and the Wirecard scandal – along with the financial losses of its bankruptcy – are just a few examples of the close ties between politics and business. The fact that these scandals were only addressed due to external intervention goes to underpin the dysfunctionality of the institutional order, which is incapable of self-correction.

It is concerning that business and its analytical foundations mainly blame the state for technological backwardness, while also viewing the state's active industrial policy as the primary tool for rebuilding competitiveness. Measures such as closing markets, protecting them from more technologically advanced producers in Asia or the U.S., and providing state aid, are seen as ways to help German and European companies regain their competitive advantage. However, public aid is a double-edged sword. During the pandemic, the rules for granting such aid were relaxed, leading to a significant increase in spending across the EU – from €102.8 billion in 2015 to €334.54 billion in 2021. Between March and August 2022, the EU authorized public aid totaling €733 billion, with more than half of that amount allocated to Germany[13] . This imbalance in public aid distribution, driven by the differing budgetary capacities of Member States, threatens the cohesion of the European common market. Moreover, this aid does not seem to be delivering the desired results. Advocates of state aid often point to China as an example, but they overlook the fact that Chinese companies face fierce internal competition. Take BYD, for instance: it was founded in 1995 as a battery supplier for Nokia and evolved into the largest electric vehicle manufacturer by competing with over 400 other Chinese companies. In Germany and the EU, however, the approach is to designate "champions" from the top down, typically selecting companies that have been in the market for a long time, and often focus on the EU market, which only serves to reinforce their monopolistic positions.

[13] H. Foy, I. Johnston, The EU's plan to regain its edge, Financial Times, November 6, 2023, p. 19.

CONCLUSIONS

Relying on state interventionism contradicts Germany's historical experience. The ordoliberal tradition, which underpinned Germany’s post-World-War-II development model, deliberately avoided direct state intervention in economic processes. France was often cited as a cautionary tale to justify this approach. Germany's economic success was driven by well-educated workforce and high productivity, supported by modern infrastructure, machinery, and technological resources. The state’s role was to ensure fair competition, while businesses were expected to seek their competitive advantages in international markets. There is no compelling reason to depart from this model, which has provided Germany with technological leadership and prosperity after World War II. The alternative – greater state interventionism, where the government picks winners, subsidizes certain industries, or excludes specific producers and technologies – fails to address the core issue: the technological stagnation of German businesses due to weakened competition in Europe. German companies need to find competitive advantages in new technologies that will enable them to thrive without relying on protectionist measures such as tariffs and public subsidies. This process is already underway, and it would be a mistake for state interventionism to reward those who do not take risks on their own.

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