Europe

**Germany's economy**

# The export model sputters

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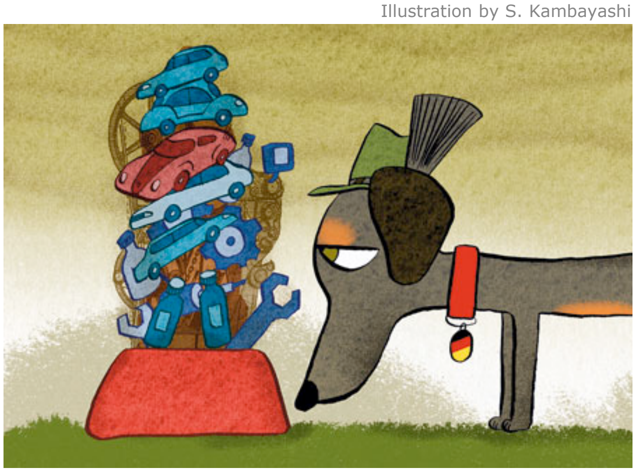
**The German habit of relying on export-led growth comes under fire**

Illustration by S. Kambayashi



IT HAD been purring along nicely, handling the twists and turns of the world economy, powering past rivals, inspiring envy. But in recession Germany's export-led model is sputtering more than most. The European Commission now expects German output to shrink by 5.4% this year, compared with a 4% drop in the European Union overall; the German government predicts a 6% plunge. Most of the contraction will be in exports.

Countries with similar models are thinking of trading them in. It is "no longer realistic to hope that Japan's growth can come back just by exporting the same products," the Japanese prime minister, Taro Aso, told *Handelsblatt* newspaper. Philipp Hildebrand, president of Switzerland's central bank, expressed similar doubts. Germany's economic press is peppered with articles asserting that the country "needs a new business model".

Most German leaders disagree. The two main parties in the grand coalition, Chancellor Angela Merkel's Christian Democratic Union (CDU) and the Social Democratic Party (SPD), are sniping before the federal election in September, but they are united in believing that exports must remain the foundation of German prosperity. Germany, unlike other rich countries, has avoided deindustrialisation, they point out. With a rapidly ageing population, it is also right to accumulate savings by



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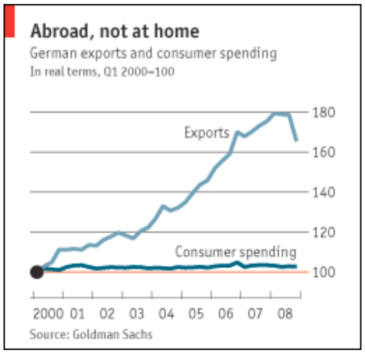
running a current-account surplus. Its scant natural resources and tradition of openness point the economy towards trade. Besides, Germany just isn't that into services, which have displaced industry in other countries.

This model could now change in one of three ways. The government could pursue an industrial policy that favoured production for the home market. To most Germans that would seem bizarre, though there is scope for creating service jobs in education or care for the elderly. Or the government could promote consumption by keeping fiscal policy relatively loose. But given German allergy to debt that is unlikely. Or change could come through a slowdown in world trade and a correction of international imbalances. This seems by far the most likely course. Germany will not deliberately surrender its position as the world's top exporter of goods, says Bert Rürup, a former head of the government's committee of economic "wise men" now at AWD Holding, a financial-advice firm. But its current-account surplus may fall as profligates like the United States and Britain consume less and export more.




Germany is export champion largely because it has done many things right. After losing competitiveness for years, industry clawed it back by holding down wage rises and shifting some production abroad. Germany now has "the lowest increase in unit labour costs of all its main trading partners," says Mr Rürup. The previous SPD-Green coalition sought to reduce joblessness by trimming unemployment benefits and deregulating the labour market. Its successor has slashed the budget deficit, partly by increasing value-added tax by three points. German consumers stayed thrifty as consumers from San Sebastián to San Francisco binged on debt.

The result of this self-restraint was that exports soared in real terms, whereas consumer spending barely budged (see chart). Between 2004 and 2007 net exports accounted for 60% of growth. Germany's current-account surplus reached a hefty 6% of GDP last year, irritating its trading partners within the euro area, which have been unwilling to hold down wages but can no longer resort to devaluation. Rather like China and Japan, virtuous Germany has made its living out of the overindulgence of others.

That was not a worry when times were good, but it is now. Exports will fall by nearly 19% this year, according to government forecasters. Germany's debt-free households, by contrast, will cut spending by just 0.1%. The export-led recession has hurt its most prosperous regions and better-paid workers, which may be one reason why the public outcry has been muted. But recovery will not be quick.

Some international trade "will disappear forever," says Marek Belka, director of the IMF's European department. Vehicles, machinery and chemicals account for nearly two-thirds of exports, a narrow base for the prosperity of the world's fourth-largest economy. Vehicle manufacturing is highly vulnerable. Too many factories and workers are making too many cars globally; Germany will surely be forced to close down some production.

When recovery comes, consumption is likely to play a bigger part than exports. By 2013, net exports will account for 3.25% of GDP, down from 6.3% in 2008, says a forecast by eight economic institutes. Consumer spending, meanwhile, will rise from 56.3% of GDP to 57.75%. This shift will occur amid sluggish growth and lower employment: the trend rate of growth between 2008 and 2013 will be 0.9%, compared with average growth of 1.5% in 1995-2008, say the institutes.

Do not expect the government to encourage the change, however. Even as they battle to save carmakers like Opel, the German arm of General Motors, politicians dream of the world champions that may replace them. The SPD's campaign programme rhapsodises about "climate and environmental technology" in which Germany supposedly has a competitive edge. IW Consult, part of the business-friendly Cologne Institute of the German Economy, thinks the growth industries will be pharmaceuticals, measurement technology and business services.

A government worried that growth is skewed towards exports could redress the balance by cutting taxes or raising spending. Dirk Schumacher, an economist at Goldman Sachs, says that the rise in VAT was a "big policy mistake" that squeezed consumption and also helped to undermine support for further economic reforms. He thinks the government should give low- and middle-income earners extra tax relief, even after the economy starts to recover. Ms Merkel may yield to pressure from the CDU's liberal wing to make this the centrepiece of her election platform.

In the end, fiscal prudence will win out. The contraction of GDP plus the government's two fiscal-stimulus packages will push the budget from balance in 2008 to a deficit of nearly 6% of GDP in 2010. The next government is likely to want to pare that back. Both governing parties back an amendment to the constitution to bar the federal government from running big deficits in most circumstances (and state governments from incurring any at all) after 2016. Tax will not be cut as a share of GDP, predicts Mr Rürup. The title of export champion may have lost its glitter, but Germany will not give it up lightly.

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