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How Germany Won the Euro Crisis

And Why Its Gains Could Be Fleeting

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German Chancellor Angela Merkel must be in a mood to celebrate. Not only has the German economy bounced back from the 2008–9 financial crisis -- with revitalized export industries and record-low unemployment -- it has done so while most other European economies are still reeling. Where other countries see only economic hardship in their future, Germany sees an influx of skilled immigrants, low borrowing costs, a balanced budget, and a growing housing market. All of that is a boon for the German economy -- and for Merkel, who is up for reelection in September.

The common wisdom is that Germany's success is the hard-won reward for strict economic management. Yet fiscal conservatism and structural reforms alone do not account for Germany's export-led growth, which in fact is largely the product of adjustments in business and labor relations that reinvigorated German industries. The country also owes much of its economic rebound to the specific structure of the European Monetary Union and even to the labor and financial fallout of the eurozone crisis. Immigrants and investors' cash are flowing into the country from the rest of Europe, in order to escape the dire conditions that Merkel and EU technocrats helped create through their hard-line focus on austerity, structural reforms, and price stability.

Merkel's drive for austerity is a risky bet. Although it seems to be working to Germany's advantage, it has failed to lift up a recession-hit Europe. But Germany benefits from an economically healthy Europe, to which it exports roughly 40 percent of its products. Already, automakers such as Daimler and Volkswagen are starting to worry about weak European sales. A crumbling eurozone, therefore, both threatens the very existence of the monetary union and makes the German economy dangerously dependent on demand from emerging markets. Greater recognition of these vulnerabilities -- and of the ways in which the German economy has benefited from the status quo -- should budge reluctant German policymakers away from austerity toward growth-oriented policies for the rest of Europe.

MYTH AND MIRACLE

Answers to why the German economy thrived while other European economies have struggled often point to successful belt-tightening and government policy during the past decade. The Hartz reforms of the early 2000s -- a set of welfare and labor-market measures that cut benefits and made it easier for firms to create less well-protected and often temporary low-wage jobs -- are said to have reduced labor costs and encouraged more people to work. Meanwhile, fiscal responsibility, which the German constitution mandates, supposedly underwrote Germany's strong economic performance. German policymakers, in turn, have preached austerity and structural labor-market changes as the model for other European countries looking to foster competitiveness, boost growth, and increase employment.

Yet the sources of Germany's economic revival and continued success were not primarily labor-market reforms or fiscal conservatism but decade-long adjustments in business and labor relations coupled with Germany's place in the monetary union. Long before the Hartz reforms, German manufacturing firms, faced with growing global competition, started to impose wage restraints and adjust working time and pay while granting job security for skilled workers. With the grudging consent of labor unions, firms developed a series of flexible instruments [1] that allowed them to tweak working hours and pay to their economic needs, instead of touching workers' employment protection. Firms effectively granted job security in return for labor concessions. And they could now protect their investments in skilled workers -- by temporarily cutting wages and hours, for instance -- rather than shedding workers when production declined. These innovations increased productivity, reduced costs, gave firms room to maneuver during the recent crisis, and in general, reinvigorated German industries, which are once again admired around the globe.

In addition, Germany has been able to use its place within the monetary union to boost its exports. Given its highly coordinated collective-bargaining institutions, Germany has already had a clear advantage over other European states in restraining industry-wide wages. This form of internal devaluation -- an equivalent to currency devaluation based on depressing wages -- has fueled an export boom and made the German economy more competitive than other eurozone countries. A relatively weak euro compared to what it would be in better economic times -- or what a strong Deutsche mark would be -- further supported German exports. Another blessing for German exporters has been the German-engineered European Central Bank, given its obsession with low inflation and price stability.

Together, these adjustments in business and labor relations and Germany's place in the eurozone, along with growing demand for high-quality goods from emerging economies such as China, have helped Germany boost its exports and employment. And although exports tumbled a little last year, export firms have preserved their overall competitiveness, as a recent study [2] by the World Economic Forum confirms.

And Merkel appears to have even more aces up her sleeve. The first is the unintended and unexpected boom in the housing market, which is fueled by the current debt crisis in Europe. Until now, Germany's housing market had not been particularly interesting to investors, and house prices had stagnated in recent decades. Yet the debt crisis has spurred investment in German real estate, a perceived "safe haven" for investment in times of economic uncertainty and low interest rates. German workers may also be more willing to buy houses, as they have kept their jobs during the crisis and even received moderate wage increases. The Organization for Economic Cooperation and Development reckons [3] that house prices increased by 5.4 percent in 2011 -- and by much more in the major cities. This trend has carried over into the real economy, with substantial increase [4]s in building activity in recent years (4.4 percent in 2011 and 4.2 percent in 2012).

Merkel's second ace is that Germany's status as a safe haven has enhanced the country's ability to borrow money at very low interest rates (at times, even *negative* rates) during the debt crisis. Looking for secure investments, investors flock to the German bond market. According to the Kiel Institute for the World Economy, a German think tank, the bullish bond market has saved [5] the federal government roughly 80 billion euros between 2009 and 2013 (compared to pre-crisis interest rates), which now -- together with record tax revenues -- contributes to balancing Germany's budget and stabilizing its public debt.

Moreover, after decade-long shortages of skilled labor in the country's manufacturing sector and an aging and shrinking society threatening the welfare state, the debt crisis triggered an influx of skilled immigrants from crisis-ridden countries -- Merkel's third ace. This immigration spike is all the more surprising given Germany's reputation as a country that is not particularly welcoming to immigrants (put most succinctly in Merkel's 2010 remark that multiculturalism had "utterly failed"). Germany's Federal Statistics Office estimates that 2012 net immigration was around 370,000 -- a number last seen two decades ago. After eight years of contraction, Germany's population is growing.

RISKY BUSINESS

In short, for now, Germany enjoys the best of all worlds -- a competitive manufacturing sector and low unemployment, minimal borrowing costs in financial markets, a balanced budget within sight, a booming housing market, and a growing skilled workforce -- while many other advanced economies are suffering from declining competitiveness and staggering unemployment (France), high borrowing costs (the eurozone periphery), missed deficit targets (France and Spain), a job market that cannot match skills to needs (the United States), and the repercussions of housing bubbles (Ireland and Spain). With soaring public approval ratings, prospects look good for Merkel in the upcoming Bundestag elections, even if commentators across the political spectrum (and many EU citizens) bash her austerity platform, which has sustained Germany's economic success -- however perilously.

Convincing Merkel of the cracks in Germany's economic foundation and moving the country away from fiscal conservatism will be a tall order. But an export model that relies too heavily on emerging economies, weak domestic demand, and a further crumbling eurozone could bring down the entire monetary union and the German "miracle." The view that austerity contributed to Germany's postwar economic success thrives in mainstream economic thinking [6]. Given the relative unpopularity of the ill-defined plan to end austerity advanced by Peer Steinbrück, Merkel's Social Democratic Party contender, Merkel is unlikely to change her austerity platform much before the elections, whether at home and abroad. Steinbrück has only a slim chance of winning, after all, given his numerous political gaffes and his inability to communicate a left-of-center alternative for Europe and Germany.

Yet a shift away from austerity is necessary to help revive the eurozone and generate sustainable growth in Europe. It would give European leaders more time to focus on the eurozone's deeper problems, including the challenges of continuing to bring together very different models of capitalism and divergent levels of competitiveness. Major institutional reforms at the EU level, among them moving economic integration either forward or backward, will require extensive bargaining. Recession-hit countries need to find their own course toward increased competitiveness. All of these steps require time, a scarce commodity given the dire conditions facing many debt-ridden countries. Such a policy shift would help stabilize a crisis-ridden Europe and signal Germany's commitment to fix the continent's systemic problems instead of just muddling through.

Merkel's path ahead is precarious. Although Germany may seem insulated from what happens in the rest of the eurozone, a closer look reveals the fragility of this export giant. Merkel should be wary. If she wants to keep the German miracle alive, she needs to help revive the rest of Europe.

Merkel will have to allow for reduced austerity in the eurozone and for policies that generate more spending at home and abroad. A sluggish German economy in the last two quarters and pessimistic growth predictions should be warning signs that compel Merkel to adopt these changes. Otherwise Germany might soon rejoin the “sick men” of Europe.

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