The formidable challenges facing Germany’s new leader

Germany goes to the polls this Sunday, 26th September. Chancellor, Angela Merkel, will continue to run the country until a new government can be formed. Her successor faces formidable challenges. While there are a lot of positives as far as the German economy is concerned, much needs to be done to ensure the country fulfils its true potential

In this bundle

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Germany needs to be more than just mediocre

After more than 15 years leading Germany, Angela Merkel's time as Chancellor comes to an end this weekend when Germans vote in a general election. The...

Bye bye 'Mutti'. Angela Merkel with the French president earlier this month

A political era comes to an end. How will a new one face the many challenges?

Sunday's general election will mean a political era comes to an end in Germany. Angela Merkel's four terms in office have been accompanied by many global crises - financial, Greek, the euro, refugees and now the pandemic. Navigating the country through these crises has already been an enormous achievement, saving the eurozone from collapsing and getting the German economy out of every single emergency in relatively strong shape may be the most important. When it comes to more structural economic policies, however, the Merkel-era has rather disappointed and shows how complicated visionary policy-making can be.

The challenges and the urgency to address them have only increased

Looking ahead, the challenges and, above all, the urgency to address them have only increased in recent years. The topics are still the same as four years ago: it's still about demographics, too much dependence on exports, a lack of digitisation and high-tech industries, mediocre education and too little investment and climate progress. You can still find them all in the parties' election programmes, as was the case four years ago. The question is whether the next potential coalition will have the courage to actually deliver change.

So here's an overview of some of the most pressing economic issues.

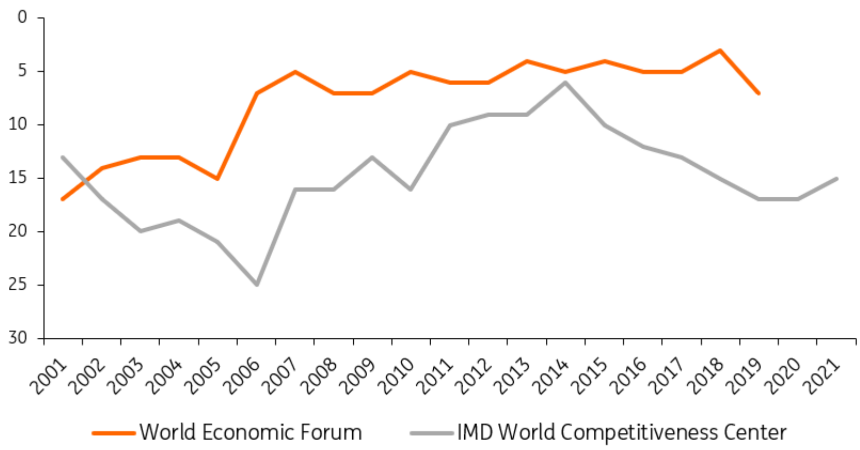
Germany's competitiveness isn't bad but structural weaknesses persist

Not everything is bad in the German economy. Far from it, Germany's importance is not only proven by its position in the upper range of international rankings but also, above all, by the hard economic data, which shows an economy close to full employment and public finances – before the pandemic – in a very healthy state. However, as one of the world's top export countries, the most important supply hub for Europe, a source of hidden champions and a strong research and development base, Germany is in a somewhat unfortunate place as far as global competition is concerned. And for that, we can blame inadequate digital infrastructure and a lack of attention to education, both of which have been lagging behind for years.

Germany's position in international rankings had already weakened ahead of the elections in 2017. Even if the positions slightly differ across rankings, one thing is for sure: Germany's economic position has not improved.

Germany's global competitiveness

Rankings



Source: ING Research

WEF ranking has been paused due to Covid-19

Traditional sectors are still in the lead

Germany's success is primarily based on traditional industrial sectors. "Traditional" does not mean outdated. But German corporations play a lesser role in the New Economy. The technology giants, in particular, have emerged stronger from crises. And even in traditional segments, Germany has a very strong competitor in China.

Germany lags behind internationally when it comes to education, digitisation and venture capital. But enabling risky ideas is vital to future economic success as it nourishes innovation and challenges long-established companies and corporate structures. The country's hidden champions are still a plus. But competition is coming here, too.

Issues that must be addressed

So let's take a look at the key areas where progress is desperately needed.

Lack of digitisation. This has become even more apparent during the pandemic. The digital infrastructure framework remains a major construction site. Germany still lags significantly behind its European peers when it comes to the integration of digital technology and digital public services. The fact is that Germany is still only in twelfth place in the European ranking, and doesn't make a splash in global ones either.

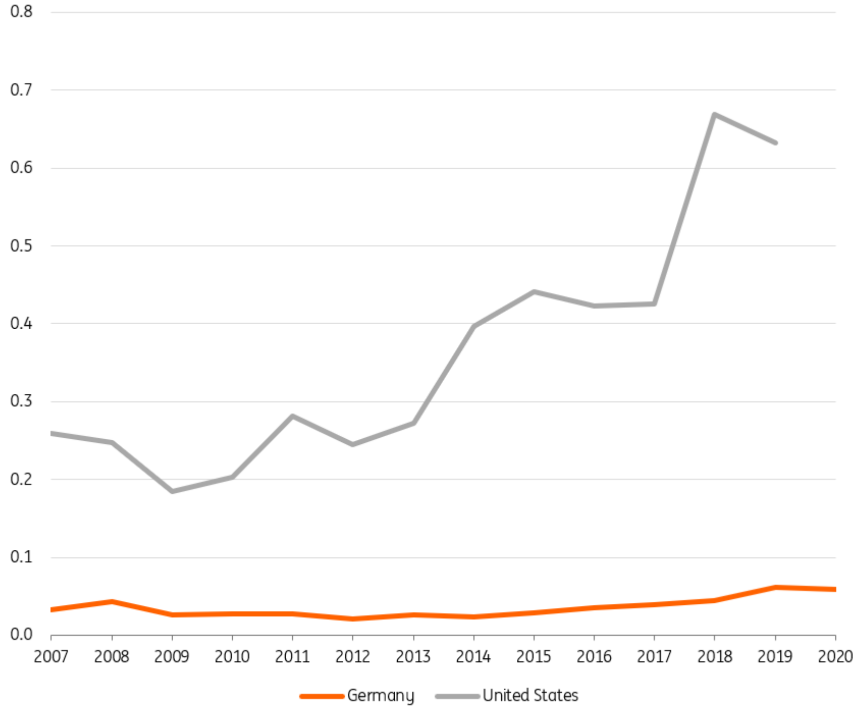
Education. This is an area where Germany rarely shines in international comparison and, again, it particularly suffered during the pandemic. Not only did an unclear school lockdown policy make teaching difficult, but there is also a lack of digital equipment. Education investment is a fundamental cornerstone of a thriving economy even if those investments don't pay off until years later.

Tax policy: It's complex and rates are high when you compare internationally, notably for corporate income and individual taxes. Regulation also doesn't make it easy for foreign companies.

Financing start-ups: Germany lags behind internationally when it comes to financing start-ups. In 2020, venture capital investments made up only 0.06% of GDP. It's 0.6% in the US. Start-ups are vital to future economic success as they bring in new ideas and challenge long-established companies and structures. Berlin, Munich and Hamburg have seen important start-up hubs established so yes, the picture is slowly changing. The 'dare to fail' culture is still somewhat absent in Germany, certainly when compared to what's going on in America.

Venture capital: Excess savings and low to negative interest rates have yet to trigger a new venture capital environment. The current federal government launched the 'Future Fund' in March 2021 to finance start-ups with high capital requirements. It is investing €10bn here while further private and public partners and existing instruments are supposed to mobilise another €40bn in venture capital for start-ups. This is sorely needed as the sum of the total venture capital investment in Germany in 2020 amounted to €1.9bn. Hopefully, this focus will also prevail with a new government.

Venture capital investment as a percentage of GDP



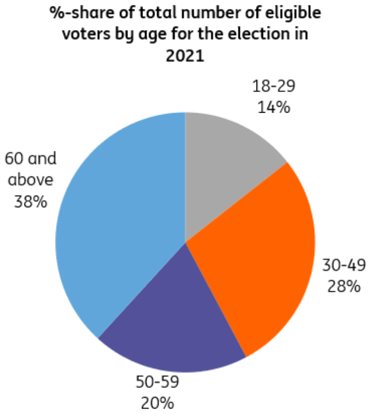
Source: OECD, ING Research

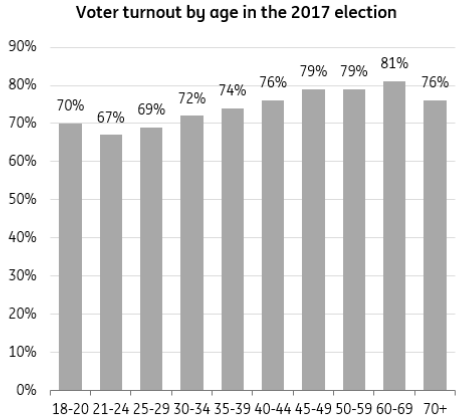
The baby boomers will be the kingmakers

Who will sit in the next government? The current election campaign and the possible coalition outcomes have rarely been as exciting as this year. The election could be the first to result in a three-party coalition, which by definition requires parties to cooperate with those who were perceived as being from the 'opposite' political camp. This creates not only room for new ideas, but also potential for conflict.

A majority of more than 1,000 people surveyed by the Bertelsmann Stiftung would like to see a realignment in the areas of refugee policy and integration, pensions, environmental and climate protection, education and housing, regardless of age. But while the young are more concerned with digitalisation and the environment, pensions and refugee policy top the concerns of the 50+ generation.

Voter demographics





Source: Bundeswahlleiter, ifD Allensbach (Survey period: 16.07.-29.07. and 23.04.-06.05.2021) on behalf of Bertelsmann Stiftung

The priorities of the older generation are significant as the political future of Germany essentially rests in their hands - the over-50s make up half of all voters and they're most likely to turn out. Developments over recent months, however, have shown that German politics, or at least voter support, has become more fluid. Larger swings in the polls have become normal. The changes that the German electorate really want to see will be revealed on 26 September.

A challenging future requires focus and commitment

The next German government still has the chance to turn the tide before it is too late. A clearly defined investment programme, not only aimed at digitalisation, climate change and education but also at social inclusion and identifying a few future-oriented key sectors in which Germany wants to excel in the coming decades, should be in any new coalition agreement. The polls, however, indicate that the German electorate is not really looking for change. The rise of Olaf Scholz and the SPD suggests a preference for continuity over something new. We fear that the next government will have to deliver more economic change than most voters are hoping for.

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How Germany responds to the changing face of trade is vital

Germany's export-based model has served it well but there's still a focus on traditional sectors. However, competition is growing, not least from...

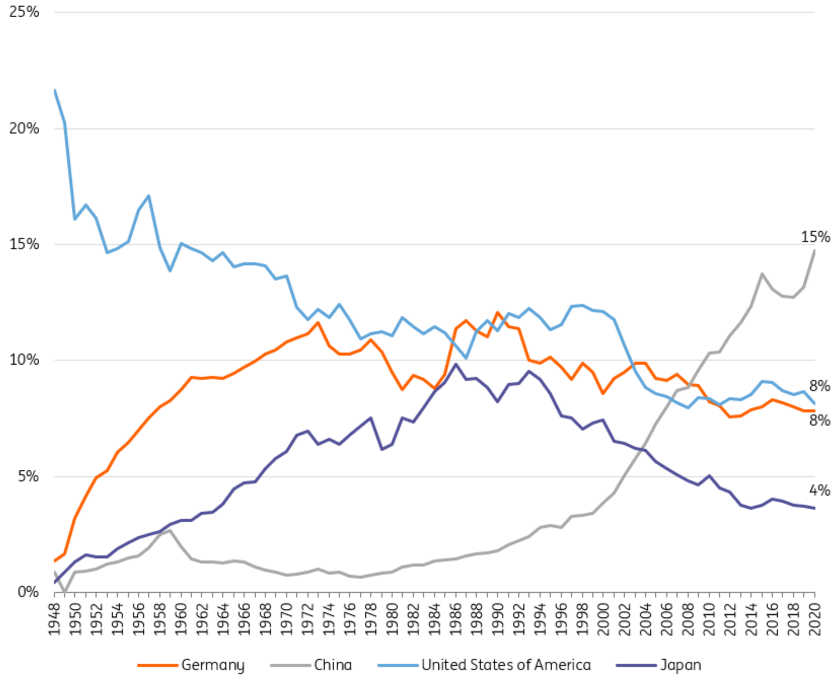
The changing face of Germany needs to face up to the changing face of global trade.

It's all about exports

The German export-based economic model has been subject to international criticism for years. It's always focused on large trade and current account surplusses, which have not really changed over the last decade. Compared to the peak in 1990, Germany's share in world exports has fallen by four percentage points. Exports of goods have tripled since 1990 as have imports.

Around every fourth job in Germany depends on exports. Measured as a percentage of GDP, exports of goods and services reached an all-time high of 47.3% in 2018, falling slightly to 44% in 2020. At the beginning of the millennium, this share was only at 30.8%, rising almost without interruption until last year, while in other countries there was a stabilisation or even a trend reversal.

Germany's share in world exports compared to the US, China and Japan



Source: WTO, ING Economic & Financial Analysis

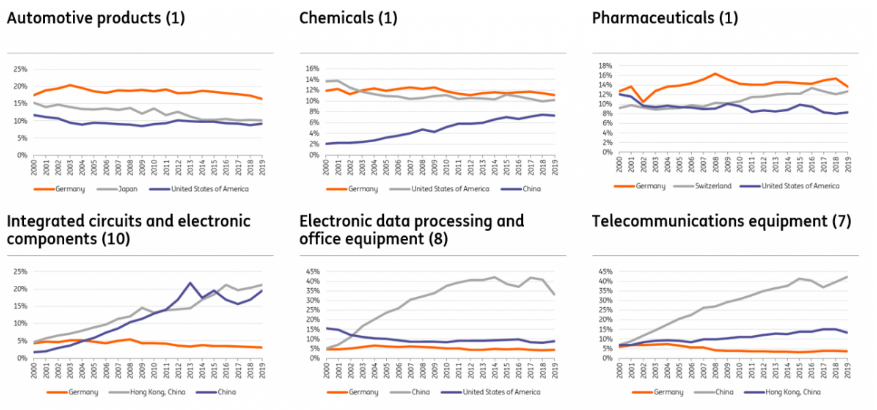
Traditional sectors are still in the lead

Germany's success story is built on traditional sectors. Germany ranks first in the global export of automotive products, chemicals and pharmaceuticals. The automotive sector, in particular, faces profound challenges given ambitious climate goals. With the automotive sector being by far the most important branch of industry in Germany in terms of sales, it is no wonder that a transition which secures its growth and employment contribution is needed.

The pandemic has shown, however, that traditional sectors should not be written off, as they can quickly become new future markets, as is the case for the pharmaceutical sector. It is estimated that Mainz-based biotech company, BioNTech, could alone lift the German economy by 0.5% in 2021.

Germany's share in world exports and other leading export countries per sector

Germany's world rank in brackets



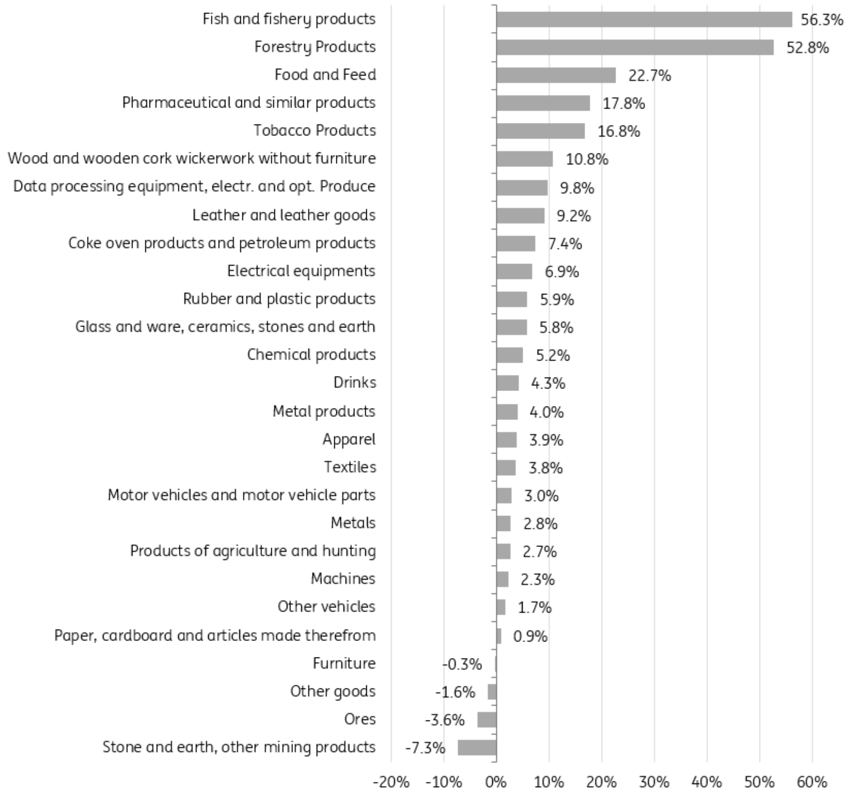
Source: WTO, ING Research

Surprising global growth markets

Although the German economy is characterised by traditional sectors, surprising growth markets have opened up in recent years in both the US and China. While some of these markets are very small in terms of value, the average growth performance over the past five years is impressive nevertheless. Demand for forestry products and wood and wooden cork wickerwork rose strongly. Pharmaceutical products (+17.8% in China, +8.1% in the US) were also in demand. Traditional products such as motor vehicles and parts only saw minor growth in China (+3%) and a decline in the US (-3.8%) over a five-year average period.

Exports to China

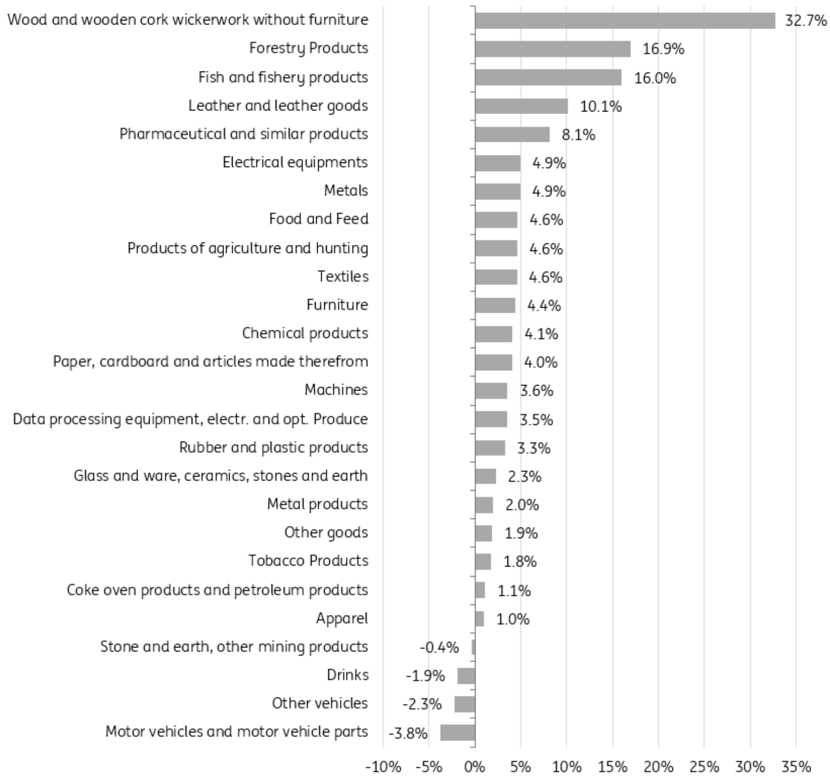
By product (percentage change 2015-2020)



Source: Destatis, ING Research

Exports to the US

By product (percentage change 2015-2020)



Source: Destatis, ING Research

Does company size matter for exports?

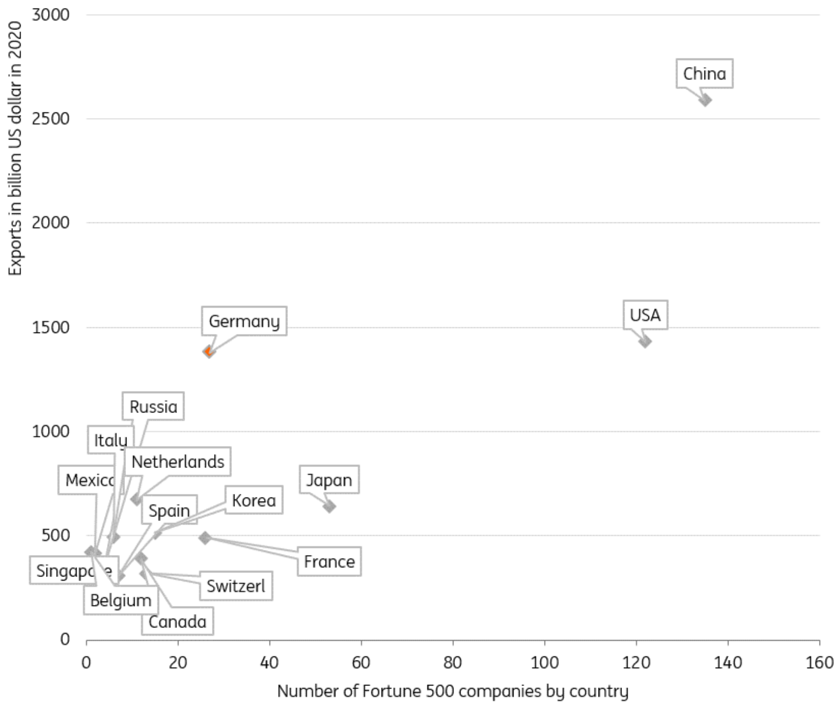
Although only a few German companies are among the largest in the world, the country still ranks third in terms of worldwide exports. Companies which operate in product niches, the so-called Mittelstand and its hidden champions, are largely unknown by the public and have a turnover of less than five billion euros, but they've been a major factor in Germany's export success for decades. Varying by estimates, more than 1,500 companies in Germany rank among the hidden champions, half of all those estimated in the world. A list of hidden champions conducted in 2019 up to 2016 shows that most companies are active in the manufacturing industry with a specific focus on machinery followed by electronics and optical products.

Yet, competition is coming. China's 10-year plan to transform China into a manufacturing leader and into a high-tech powerhouse by 2025 is moving at full speed. China targets 10 strategic industries, which will be detrimental to Germany's future. In addition to the 'Made in China 2025' strategy, there is a new guideline of developing 10,000 'little giants' for niche sectors and 1,000 enterprises that are market leaders in a single industry – mirroring, in a way, Germany's model.

At the same time, German companies are more dependent on foreign input. While in Germany the ratio of foreign value-added to the export volume of the manufacturing sector remained relatively stable between 2005 and 2016 (the latest available data in the OECD's TiVA databank) at around 25%, China's ratio fell from almost 30% in 2005 to 17%, driven by China's plans to reach selfsufficiency.

Number of Fortune 500 companies and exports

Billions of US dollars



Source: Destatis, Fortune

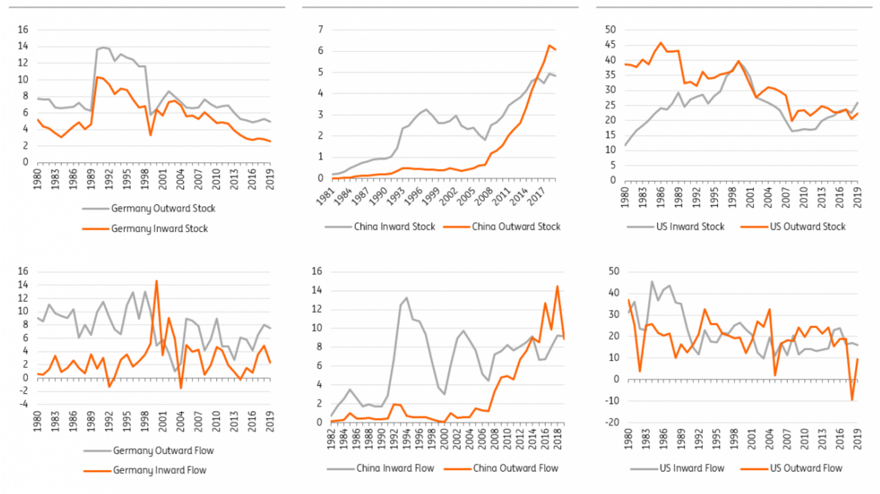
Calculated on the basis of Hermann Simon, CESifo Forum 3/2015, ZEW, Discussion Paper, The Distinct Features of Hidden Champions in Germany: A Dynamic Capabilities View, March 2019

How attractive still is Germany for foreign investors?

Even if large, well-known companies are building up new locations in Germany, worldwide FDI flows and stocks have declined over the years. While in 2018, Germany received a strong inward FDI flow, in 2019 inflows decreased by more than 50% measured as a percentage of total world FDI flows. When looking at the stock level, both inflows as well as outflows have decreased significantly over the years. In China, on the other hand, an almost continuous trend can be observed for the stock and flow level, while in the US FDI flows remain strong, overall.

Foreign direct investment in Germany, China and the USA

Percentage of world total



Source: UNCTAD, ING Research

Make Germany's core economic competencies fit for the future

Germany's success is built on its export strength coupled with an outstanding competence among others in the automotive industry, in healthcare and mechanical engineering. This export-based economic model will not change anytime soon and it doesn't necessarily have to. Since German corporations play a lesser role in the New Economy, one of the main tasks of the new government must be to make Germany's core economic competencies fit for the future. The pandemic has shown that traditional sectors can become new future markets.

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