DEUTSCH-BRITISCHE GESELLSCHAFT

British Königswinter Committee:
Chairman: Sir Michael Arthur KCMG
Executive Director: Jackie Newbury

KÖNIGSWINTER

The British-German Conference

Report

TWELFTH ANNUAL ECONOMIC KÖNIGSWINTER CONFERENCE
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Schloss Landsberg

In the magnificent setting of Schloss Landsberg, the discussion ranged across three highly topical subjects: the role of British and German industry in growth, the future of European integration and how the burden of debt would weigh on economic prospects. These subjects were highly interrelated, and the three sessions inevitably overlapped, so by way of a summary it seemed helpful to slice the conversation in a slightly different way, by looking at the insights from a number of different time perspectives: the past, the present, the near-term future and the long-term future.

The past

It was hard not to be reminded of the past in the splendid surroundings of Schloss Landsberg. What would August Thyssen have made of the Königswinter gathering? Judging by what we learnt on the fascinating tour of the castle, one suspects he would have eaten only the soup and vegetables at the sumptuous dinner. But there were also some useful reminders of the not-so-distant past that helped to set the rest of the discussion in context.

First, we were reminded that a very different mood on our relative economic models prevailed before the crisis. It wasn't so very many years ago that "the British model" was in the ascendant. With only a little caricature and colourful exaggeration, it was remembered how the British could be insufferably arrogant about it, seeing "the German model" of heavy reliance on industry as hopelessly outdated and indulging in "Germany-bashing".

Second, there were reminders, both over dinner and during the general debate, of the decisions that put in place the conditions for the euro crisis. The flaws in the design were not ignored by those who pushed for the project; they were accepted as problems that would be sorted out over time.

Arguments of the sequencing of the building blocks for the euro were recalled between, for example, Hans-Dietrich Genscher and Otto Lambsdorff, and between Helmut Kohl and the Bundesbank. The logical sequence might have been to have economic integration, political union and then only at the end monetary union. But the experience of Europe to date, in particular the experience of German unification, was that of advancing by building the top part and the necessary supporting structure would be put in place in time. That was the conscious decision, and the current crisis is in a sense a logical consequence.

The present

Certainly the tables have been turned in terms of the prevailing view of economic models. “The German model” is all the rage, others look to emulate it, and Germans are rightly proud of the way it has held up through the crisis and serves as “an anchor of stability and a driving force of growth”. It was pointed out that 40% of Germany’s industrial export content comes from other European partners, so Germany’s success supports industry elsewhere. The sense of confidence, if not exactly “insufferable arrogance”, has shifted from the British to the Germans. The German model, far from being old-fashioned, is suddenly post-modern.

The strength of Germany’s performance has been particularly evident in the labour market. Despite the euro crisis and the recession that hit Germany and continues to plague other parts of the euro zone, German unemployment has remained strikingly low. Indeed, a record 41.6m Germans are now in employment, a remarkable achievement. Particularly striking is the low rate of youth unemployment – in stark contrast both to Germany’s angst-ridden recent past and to the experience elsewhere in Europe.

The broad assumption on the German side (and to some extent shared by the British) is that this strong performance has been helped by a number of factors: Germany’s continuing industrial strength, especially in products that have been in heavy demand in faster-growing economies, notably China; the robustness and niche expertise of the Mittelstand, Germany’s “hidden champions”; sound economic housekeeping; the brave reforms taken in easier economic times (which nevertheless cost Chancellor Gerhard Schröder); continuing investment in skills for the young; and active labour-market policies that softened the worst effects of the recession. British businesses have been very eager to see what they can learn, for example, from the German system of apprenticeships.

On the British side, overreliance on financial services, the industry at the heart of the economic crisis, has clearly been a problem. The search for a more balanced economy is on. The British economy has emerged from hits long double-dip but (in contrast to Germany) remains below its pre-crisis level of output. The employment picture has not been so bad, but not as impressive as Germany’s, and youth unemployment is far too high.

However, some important caveats emerged. For one thing, the German model is not so easy to copy even for those (including, it now seems, the French) who want to. It has deep cultural roots that are not readily replicated. Second, the contrast between the British and the German models may not be quite as stark as common caricature suggests: Britain, it was pointed out, has not “deindustrialised”; by some measures it has a bigger industrial sector than France, and it has significant strengths in areas such as defence, pharmaceuticals and even the automotive industry (with more carmakers in Britain than in Germany). Measurements of industry’s share in the economy vary: Germany’s is clearly significantly higher than Britain’s, but Britain’s share remains important.

The difficulty of pinning down the numbers pointed to a deeper debate of whether it really makes sense to draw such a sharp distinction between industry and services. Many of the activities that happen within “industry” are in fact services, not making things you can drop on your foot. Much actual manufacturing may happen in other countries, but the value-adding services that go into the design and business models happen at home. And many services are "high-end" in the same way that manufacturing can be "high-end". Britain has particular strengths not only in areas related to financial services but also in what might be called "abstract commodities" such as fashion, music and design. In general, on the British side there was a spirited questioning of what might be described as the new orthodoxy of "industry good, services bad".

The near-term future

If there were differences of emphasis and interpretation on the current state of the economy, in the discussion of what might happen over the next few years there was a wide chasm between the British and German perspectives.

All could agree that the European project is changing fundamentally. It is moving away from being a single project, albeit one in which different members went along at different speeds. Instead, it is becoming two projects: the euro zone, and the broader European Union. And within those two groups there are a number of sub-groups: the euro-zone core and periphery; the "outs" that aspire one day to be "in" and those that intend to stay out; and even "outs" that may decide to opt right out of the EU.

The broad direction of the euro zone over the next two or three years is now pretty clear: it is moving towards tighter integration. The pieces will be put in place for a fiscal union, a banking union and elements of a transfer union, with a permanent crisis-resolution structure through the ESM and perhaps a euro-zone budget. If once the European Union had seemed to the British to be "moving their way" with an emphasis on enlargement, now the core seems to be "moving Germany's way", with an emphasis on integration and closer union.

But if the general outline seems more or less settled, the crucial details still have to be thrashed out and big questions remain. One question is the speed at which the various building-blocks can be put in place. It is one thing to agree broadly on a banking union for the euro zone, another to have it fully operation. The structures for bank supervision, for example, are not something that in practice can be rushed.

Another question is what the implications will be for Germany. The former "French-German engine" has pretty clearly become a German motor, with France sometimes awkwardly in the back seat. Germany is not altogether comfortable in the leadership role; nor are the rest always happy to see it there. There is a risk that others gang up on it. It could find itself with a heavier burden as paymaster. In the core euro zone, too, the liberalising tendency is weaker; the statist urge stronger. Germany is also involved in a delicate game of wanting to keep the crisis at bay in the weaker euro-zone economies while also wishing to avoid the "moral hazard" of relieving the pressure and seeing politicians then put off necessary but difficult reforms.

A third question is whether the steady move towards closer integration might yet be disrupted by another dramatic turn of events. Even optimists who believe that the danger of a collapse of the euro zone is now much diminished do not put the chances of that happen at zero (as they might have done before the crisis): yet if the chance of a break-up is 10%, that's still not a negligible risk.

Others reckoned the chance of things going badly wrong remain rather higher. On that view, the crisis is far from over. Spain is in serious difficulty. France may go the way of Spain. Even Germany may eventually balk at the huge bill some think it will have to pay to keep the euro zone together. And the greatest threat to the euro zone may not be in the considered councils of the club, but on the streets and at the ballot boxes. Meanwhile, the politicians are moving far too slowly.

So far all these rather large questions relate just to the euro zone itself. But another disturbingly big area of uncertainty relates to the wider European Union – especially to Britain. In theory Britain is happy for the euro zone to proceed with greater integration; it is, after all, in Britain's interest to see the crisis resolved and dynamism restored in its main market. Yet the British also worry about the effect of tighter decision-making within the inner club of euro-zone members, and how this might affect both the single market in general and key British interests (such as the financial services industry) in particular.

Whereas the lesson of the crisis for the euro-zone core has been that there's a need to integrate more, for Britain the general mood is exactly the opposite. Any future treaty change would now require a referendum in Britain (the so-called "referendum block"), and it is hard to imagine a vote in favour of more integration.

On the contrary, a new treaty is seen by some in Britain as an opportunity to renegotiate terms of membership and to repatriate some of the powers ceded to Brussels. To Germans (and no doubt others), such a negotiation would look like a Pandora's Box. There is little understanding, let alone sympathy, for the predicament of British politicians who have to respond to a scepticism towards Europe that has always been strong but has grown more assertive with the crisis (you have only to look at the rise of the UK Independence Party). Instead, there irritation at what sometimes seems to be British Schadenfreude and cherry-picking when it comes to Europe.

There is a serious danger that these diverging dynamics eventually lead to a break-up. The elastic holding the EU together is pretty flexible, and it can no doubt stretch a bit more, but not indefinitely: one day it may snap. That would have big consequences, not least for the balance of pro-market forces within the EU as well as its aspirations to be serious about foreign policy and defence. Yet some believe that as the euro zone binds itself into a tighter club, Britain is inevitably moving towards a referendum on whether to stay within the European Union.

The long-term future

Hovering over the discussions was a sense of the importance of trends that will play out not so much over the coming few years but over the next few decades.

Over the longer term perceptions of what is a desirable economic model may change again. On one view, the Chinese will sooner or later themselves make the industrial goods that Germany has been selling to them; it has already started to do so in some cases (eg, Siemens trains). Then Germany might look again at Britain and see the charm of high-end services, and come to realise that it was "just dodging the transition to that stage". (Then again, maybe this was just British wishful thinking.)

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A more widely shared view is that over time the sustainability of the Western welfare model is in question. The role of the state will have to be rethought. Europe cannot go on accumulating debt. There was a sense that, in this respect, the post-war era is ending, and a new one will have to be invented.

Perhaps the most important of these long-term trends is demography. Europe is ageing, and becoming a smaller part of the world's population (moving below 10% and towards 5%). That can be seen both as a reminder of the need for Europe to act as a unit if it wants to have any serious influence and as a reminder of the need to pay greater heed to what is happening in the 90%-plus of the world that is beyond the European Union.

There was a sobering reminder towards the end of the discussion that, at a time when Europe should be vigorously adjusting to the historic rise of China and other emerging markets and preparing for what this will mean for the coming generations, it is once again engaged in introspection, distracted by its own institutional arrangements and complex negotiations. The world, meanwhile, marches on regardless.

Königswinter of our discontent

At the full Königswinter conference it had been striking and somewhat shocking to see how Germans and British were, as Michael Arthur put, not just drifting apart, but marching apart. At this economic Königswinter, there wasn't the same sort of shock, because we have become more used to this march in opposite directions, more an onging adjustment to this divergence. It seemed more important than ever to gather and debate – in a remarkably open spirit – in order to understand the different perspectives.

But there remains a great sense of uncertainty, and concern, about the final destinations.

Daniel Franklin