

Economic Policy

For decades, the German economy has been the locomotive driving the European train. Now it seems more like the **caboose**.



Germany Stalled

■ By Bruce Stokes

HAMBURG, Germany—On a sunny Sunday afternoon this summer, aging couples window-shop on the chic Neuer Wall Street at the center of this port city in Germany's northwest. Along the Jungfernstieg, against the backdrop of the picturesque Binnenalster Lake, teenagers with multiple body piercings and survivors of the 1960s with graying ponytails listen to a band playing American rock 'n' roll classics.

Thankful to be outdoors under a cloudless sky after a month of rain, the good burghers of Hamburg are enjoying the sun but seem oblivious to the retail opportunities that beckon all around them. The shops in this Neustadt neighborhood, which in years gone by would have been shuttered by law for the weekend, are open for business. But they remain largely empty. Even excitement about Germany's hosting the World Cup failed to fuel the buying frenzy that economists predicted would buoy the long-dormant economy.

Once the motor that drove European economic expansion, Germany has recently acted instead as the brake. Although the country's economy may perform better this year than it has for

■ Jobless
10%
of German workers were unemployed in June.

some time, growth is still anemic by American standards, and most economists here expect business activity to slow again next year.

This is bad news for Europe, the United States, and the world. With Germany accounting for 30 percent of the euro area's economy, Euroland can't grow if Germany is stuck in the doldrums. And with the American economy showing signs of

slowing, the world needs Europe to pick up some of the slack. If it doesn't, and if global expansion decelerates, the adverse consequences will reverberate from Jakarta to Sao Paulo.

Germans continue to suffer declining incomes and high unemployment rates. Although last year's election of the pop-

ular Christian Democratic-led coalition government of Angela Merkel raised hopes, economic reforms have been slow in coming. The problem, according to recent interviews with economic, business, and labor leaders in six German cities, is that Germans prefer stability over change. The zeal for reform, which was strong among German elites in recent years, is dissipating. After a few years of injecting greater flexibility into the country's rigid labor markets, Germans are in collective denial about the urgent need for more politically wrenching economic restructuring.

"The determinants of long-term economic growth are the efficient allocation of savings to the best projects and businesses, the promotion of competition, and the proper incentives for the investment in human capital," said Adam Posen, author of the forthcoming book *Reform in a Rich Country: Germany*. Berlin's continued failure to create such an environment for growth constrains Germany's economic prospects.

Posen contends that the nation's problems are as much political as they are economic. Specific reforms—such as the long-overdue privatization of public-sector banks and the deregulation of service industries—have been stymied because they directly challenge the interests of family-held businesses, local financial elites, and their political allies, who still dominate the German economic and political landscape.

These insiders have little interest in real reform, according to Posen and other experts. Instead, they point fingers, blaming Germany's woes on intransigent labor unions, the tightfisted European Central Bank, or Germany's dysfunctional federal system. And the insiders prefer silver-bullet solutions—such as cuts in health care costs and taxes—instead of structural change.

This establishment desire to muddle through rather than pursue the hard work of fundamental change is reminiscent of 1990s Japan, where society's accumulated wealth dulled the appetite for risk taking and made economic stagnation tolerable. Germany's preference for the status quo raises new doubts about its long-term economic prospects. "Will this country ever pursue policies that will lead it out of gridlock?" worried Norbert Walter, Deutsche Bank's chief economist. "I don't know."

In an integrated world economy, where Germany's underperformance resonates beyond its borders, muddling through is simply not good enough.

A Modest Recovery

After Germany's anemic 0.9 percent growth rate last year, 2006 is looking a bit better. Nikolaus Simon, head of the labor-funded Hans-Bockler-Stiftung, a Düsseldorf-based think tank, said, "We see the first signs of an economic upswing."

In June, the unemployment rate fell to 10.5 percent, from 10.8 percent in May, the largest one-month drop since German reuni-

fication more than a decade ago. The consumer confidence index is up sharply. Profits are rising. German business confidence climbed to a 15-year high in June, and private investment is up. And, thanks to recent cuts in government spending, the budget deficit, which has been above 3 percent of gross domestic prod-

uct for several years and thus in violation of European Union rules, is expected to be cut in half by 2009.

"This country is better than it looks," contended Klaus F. Zimmermann, president of the Deutsches Institut für Wirtschaftsforschung, or DIW, think tank, in Berlin.

As a result of these positive indicators, Dresdner Bank, the most bullish of prognosticators, forecasts 2.2 percent growth for Germany this year. "We will have the best Christmas sales ever in 2006," predicted Deutsche Bank's Walter. He expects consumers to buy appliances and other big-ticket items before the national sales tax jumps from 16 percent to 19 percent next year.

But some economic seers remain skeptical. HypoVereinsbank, in Munich, expects only 1.4 percent expansion this year, pegging Germany's recovery as weaker than that expected in the European Union as a whole. Moreover, economists are uniformly bearish about 2007, with Dresdner Bank foreseeing growth slipping to 1.9 percent and HypoVereinsbank forecasting only 0.6 percent growth.

The concern is that today's good economic news comes with too many caveats. Recent job creation, for example, primarily reflects the hiring of part-time workers. German wages and pensions are declining—by design. Recent economic reforms have been aimed at reducing Germany's high labor costs. But with declining wages and pensions, German consumers can't be counted on to fuel future growth, especially once they start paying a higher sales tax. Private investment, meanwhile, is up about 9 percent since its trough in the first quarter of 2004, but that is still about 3 percentage points less than is normal at this point in the business cycle.

Exports have fueled recent growth, reinforcing Germans' almost mystical belief in their destiny as suppliers of quality manufactured goods for the world market. "We have the right products for expanding markets, despite the fact that the euro is appreciating," Walter said. "This won't go away overnight."

But much of Germany's current competitiveness comes from the lower labor costs triggered by the last set of reforms. Falling wages can't continue indefinitely without smothering domestic consumer demand. Studies by DIW suggest that the quality of German exports is declining, raising new doubts about whether the world will always want what Germany produces. Posen said, "This whole export *weltmeister* [world champion] concept is complete self-delusion. Germans don't get that having the most exports has no correlation with productivity or economic growth."

At least one German finance ministry official agreed. "If we



GETTY IMAGES/SUTZ BONGARTS

- As Europe's largest economy, Germany is the key to boosting growth rates on the Continent and to expanding trans-Atlantic trade.

- Berlin's recent labor-market reforms aren't enough to jump-start the sluggish economy.

- Financial markets, as well as the tight family control of major German companies, need to be opened up.



German shops are now open longer and on weekends, but buyers were few and far between on Hamburg's main shopping streets on a recent sunny weekend. Most strollers were just window-shopping.

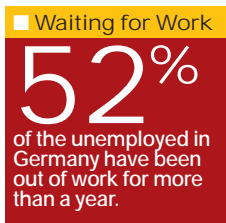
cannot move Germany forward toward a more dynamic economy," he said, "then we are in trouble."

The Engine, or the Brakeman?

Washington knows that Americans also need a successful German economy. As the largest European economy, Germany can be, and has been, the economic engine that leads all of Europe into faster growth rates and thus bolsters U.S. exports. Except for Germany's disagreement with the United States on Iraq, Berlin has been a reliable partner in Washington's European and global foreign-policy initiatives. And, looking forward, "Germany is the only dependable U.S. partner for the next 15 years," asserted Deutsche Bank's Walter.

But the growing divergence in economic performance between Europe and the United States is rapidly eroding the economic conditions that have nurtured trans-Atlantic political relations and fostered U.S.-European joint leadership of the world economy.

Absent major reform, Dresdner Bank officials think that Germany can hope for no more than 1.15 percent growth per year for the foreseeable future. The cumulative drag of such anemic economic activity has real consequences for Europe. If European growth does not improve, the E.U. economy, which was roughly the size of the American economy in 2003, will be at



least 15 percent smaller than the U.S. market by 2020, according to economic simulations done for the Atlantic Council of the United States.

Under these conditions, said Stefan Baron, editor of the German economics weekly *WirtschaftsWoche*, "I don't see any German locomotive around, not even in the station."

And Germany's economic circumstances could easily worsen. Rising oil prices have already knocked about 0.5 percent off growth this year, according to Dresdner Bank. Higher energy prices are a recipe for economic stagnation.

The euro is strengthening because of uncertainty about the U.S. economy. HypoVereinsbank thinks that a further 10 percent appreciation in the euro would take another half percentage point off European growth rates. That would drive up the price of German exports and slow demand for them in Europe and around the world. And one more bad sign: Germany's population of 83 million is expected to contract to 75 million by 2050. Fewer people will generate less demand for housing and cars, putting a drag on the domestic German economy.

Reforms to Date

The need for German economic restructuring reflects both the inherent shortcomings of the single European currency



Publicly owned local savings banks, like this one in Hamburg, control 40 percent of German banking assets and are politically powerful.

area and the rigidities built up over time in the German economy. Because the European Central Bank, not Berlin, controls interest rates, and because Germany has agreed under E.U. rules to constrain government spending, the nation's leaders are limited in what they can do to jump-start the economy. Domestic economic reform is the only policy tool they have left.

In a world where companies can easily move production to Eastern Europe or China, the difficulty in hiring and firing workers and the generosity of unemployment benefits puts Germany at a competitive disadvantage. So the public widely supported the previous Social Democratic government's extensive labor-market reforms. Thanks to those efforts, said Michael Heise, chief economist at the Allianz Group, "the incentive structure in the labor market has been significantly changed."

Today, Germans work more hours and take fewer sick days. Working arrangements in individual firms are increasingly flexible, regardless of what a union's national industry contract might require. And now that the government can demand that recipients of unemployment benefits do some menial community service to get their government checks, people tend to go back to work faster. "The labor market is now much more flexible than people think," said DIW's Zimmerman.

But some problems persist, and most experts say that further restructuring is necessary.

In most situations, for example, it is still impossible to fire someone in his or her first two years on the job. The Merkel government has proposed making layoffs easier, but business leaders are opposed unless the government also eases the current restrictions on firing disabled and other disadvantaged workers.

Recent unemployment reforms had the perverse effect of increasing the number of people on the dole rather than reducing the number of beneficiaries. As a result, costs rose even though individual monthly benefits were cut. This is not financially sustainable.

Germany's biggest labor-market problem is its long-term need for more workers as its population shrinks. Because all efforts to increase the birthrate have failed, increased immigration seems to be the answer. But the Merkel government wants to solve Germany's demographic problems without immigration—meaning that more Germans need to work.

Long-term unemployment—being out of a job for more than a year—is still relatively high: Fifty-two percent of the unemployed have been out of work for more than a year, compared with 42 percent in Western Europe as a whole. Those who have grown accustomed to the dole need to be retrained and put back to work.

The young and the old are another labor dilemma. Germans ages 25 to 54 are as likely as most other Europeans to be in the workforce. But only 42 percent of Germans under 25 are work-

ing, down from 56 percent in 1990. And only 39 percent of Germans ages 55 to 64 work, compared with 60 percent of Americans. The German retirement age will rise from 65 to 67, beginning in 2012, which should help. So should proposed educational reforms—such as higher fees at universities—that are intended to encourage young people to leave the classroom sooner for the job market.

Germany also needs to tap its force of stay-at-home women. Only three in five German women work outside the home, a relatively low rate compared with those in Scandinavia, the United Kingdom, and the United States. “We still believe women are on this earth to raise kids,” said Simon of Hans-Bockler-Stiftung. “This is a huge cultural and historical impasse.” The government is trying to change the culture by providing working mothers with more child care, but such societal shifts come slowly.

Financial Repairs

Germany’s labor reforms, although significant, have so far delivered only meager returns because the economy is just not growing fast enough to demand a lot of new workers. To enhance the nation’s long-term growth prospects, Berlin must find ways to create more job opportunities. That requires sweeping restruc-

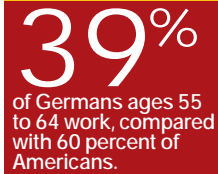
Angela Merkel



BONGARTS/GETTY IMAGES/ALEXANDER HASSENSTEIN

The Christian Democratic chancellor remains personally popular, but already three-quarters of Germans reject the government’s economic policies.

Idle Seniors



turing of the country’s financial and business practices.

“Germany’s lastingly poor economic performance results from the corporatist system in the German private sector, particularly the failure of Germany’s corporate governance and banking systems,” Posen said.

The leading candidate for a shake-up is Germany’s fragmented, highly state-controlled banking sector. In 2003, Germany had 2,232 separate banks, compared with only 445 in the U.K. Many are either publicly owned local savings banks, called *Sparkassen*, or *Landesbanken*, which are banks owned by Germany’s states. These public savings institutions control two-fifths of German banking assets. The five largest private German banks control only a fifth of such assets.

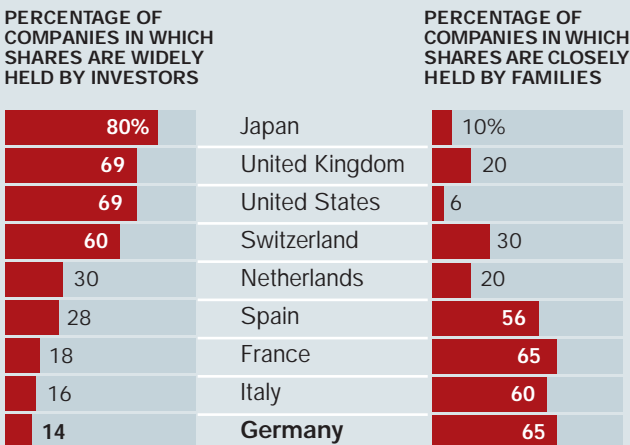
Moreover, the profusion of individual banks, each with its own headquarters and back-office operations, results in low efficiency and profitability. And, because the *Sparkassen* and *Landesbanken* are government-owned, local politicians use their leverage to channel funding to pet projects. As a result, banks are more apt to lend to established companies than to venturesome start-ups.

The German capital market is woefully underdeveloped for an advanced industrial economy. Relatively few German companies raise money by borrowing from pension funds or from individual investors. Stock market capitalization

Germany Inc.

Control of Large Corporations

Most German companies are still tightly held operations, with a majority of them owned by family groups controlling at least 20 percent of the outstanding stock shares.



SOURCE: Adam Posen

Stock Markets: Relative Size

In Germany, the ratio of the value of outstanding stock shares to the size of its economy is among the lowest in industrialized countries. So too is its ratio of initial public offerings for an economy of its size.

	STOCK MARKET CAPITALIZATION/GDP	IPOs/GDP
Switzerland	249.0	7.1
United Kingdom	157.7	11.3
United States	142.1	5.5
Netherlands	131.7	2.6
France	89.5	2.3
Spain	79.9	2.4
Japan	69.2	2.4
Germany	54.7	2.8
Italy	52.8	5.9

SOURCE: Adam Posen

(the total value of all German stock shares outstanding) as a percentage of the GDP, meanwhile, is just a third of what it is in the United States. The ratio of initial public offerings to GDP—one measure of entrepreneurial activity—is half that of the U.S.

Reform of the German financial sector to facilitate more-efficient allocation of capital nationwide has been an uphill struggle. Banks oppose it because they would lose business to the stock and bond markets. Established businesses fear that easier access to capital would boost potential competitors. Localities reject consolidation or privatization of the *Sparkassen* because it would mean fewer jobs and less local control over lending. And consumers worry that privatization would mean fewer convenient bank branches and higher fees.

Experience in other parts of Europe demonstrates that privatization of state-run savings institutions and the consolidation of banks improve productivity and profitability. “German banks would be considerably more successful,” concluded a 2004 Deutsche Bank study of European banks, “if the peculiarities of the German system were brought into line with standard international practice,” which would include allowing private investors to hold majority stakes in local savings banks. But fear of antagonizing local political sensibilities has kept the Merkel government, and its predecessors, from pursuing this long-overdue reform.

Adam Posen



Reforms are stymied because they challenge the interests of Germany's family-held businesses, local financial elites, and their allied politicians.

Family Values

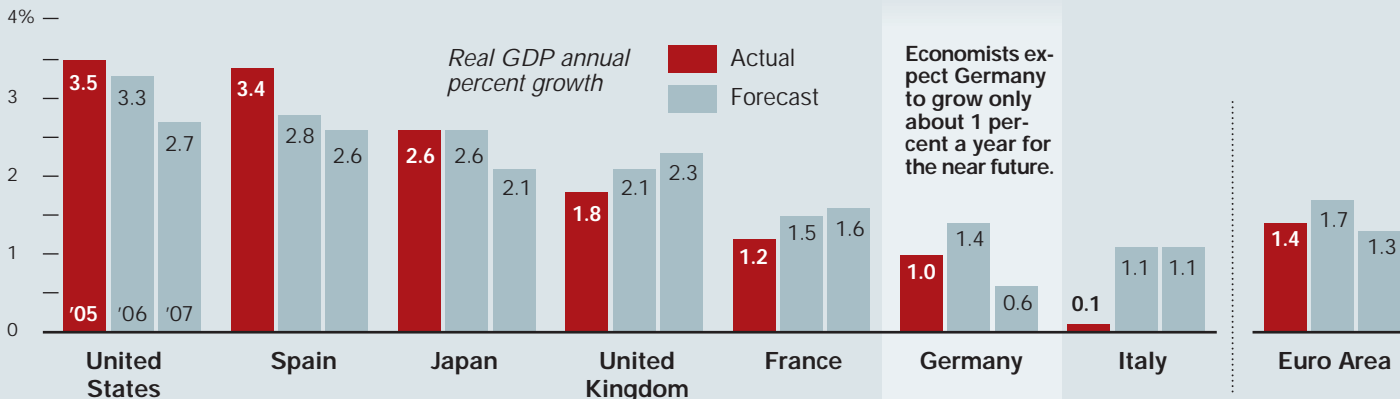
Germany Inc. is run by and for insiders, with outsiders paying much of the cost.

The incestuous nature of German capitalism starts in the boardroom. Only about 14 percent of German companies are owned by diverse groups of private and institutional investors. In America, that figure is 69 percent. In contrast, families control 65 percent of German firms. Under the weight of tradition and with few outside owners demanding corporate change, the German economy is led by the same industries—autos and machine tools—that predominated 40 years ago. While General Electric was transforming itself into a financial services company and IBM was moving from making computers

to offering consulting services, few German companies were reinventing their business model. The Germans' presumption that they will always be able to do what they do better than the Chinese or the Indians is a risky bet at best.

Germany need not break up its family-held firms across the board. But a more active and open capital market could loosen these bastions' stranglehold on the corporate sector and allow new firms to blossom. Unfortunately, Berlin has a history of opposing the European Union's trust-busting activities, which could prevent families from further consolidating their control over particular industries. The Merkel government could more actively support Brussels' efforts in this direction.

■ Growth Rates of Major Economies



SOURCE: HypoVereinsbank

Additionally, Germany must continue to deregulate its economy in order to spark greater competition, innovation, and productivity growth. The government has already opened the energy and telecommunications sectors to wider competition, with striking results. In recent years, productivity in mail and package delivery, air travel, and telecommunications has grown faster than in other sectors of the German economy. Competition pays off for consumers. In June, the promotional airfare on a discount airline's flight from Dusseldorf to Berlin—about 350 miles—was 1 euro.

Productivity is lagging, however, in finance, insurance, real estate, and business services because of bureaucratic obstacles to entrepreneurship. Richard Burt, the former U.S. ambassador to Germany, ruefully recounts trying to set up a Berlin office for Diligence, his risk-management consulting firm. It took six months to get the necessary permits. Opening a comparable office in London took a week.

German regulation of accountants, lawyers, and other professions, and the country's entry requirements for the crafts sector, are among the tightest in the world. To become a house painter or a baker, an ambitious young German has to obtain a *meister prüfung*, or master craftsman's diploma, from the local guild, a hurdle that effectively reduces competition because insiders try to limit newcomers. And the prices for some professional services are still set by law. If Germany would simply tailor its regulation of services to the "best practices" of other industrial nations, it could boost productivity significantly, according to the 2006 economic survey by the Organization for European Cooperation and Development, the rich nations' think tank in Paris.

The Political Economy of Reform

Liberalization of labor markets, absent a parallel freeing up of capital markets and other deregulation, has gotten Germany "very little economic bang for its buck," Posen said. As a result, growth prospects remain dismal.

On the plus side, labor reform has weakened the unions' clout in German society. Labor union membership accounts for barely 18 percent of the labor force today, compared with nearly 29 percent in 1991. Labor's share of national income, meanwhile, is at its lowest level in three decades.

Without a comparable increase in competition for the holders of capital, however, those who now control more of Germany's wealth have very little incentive to use the lower labor costs as an opportunity to change the way they do business.

Fewer Working Mothers



Only three in five German women work—a much lower figure than in Scandinavia, the United Kingdom, or the United States.

CORBIS/PAULINE GARTENEN

Tight-Knit



Although Merkel remains popular, doubts are growing about her credentials as a reformer. "The more the coalition is in power," Baron said, "the more tamed she will get." Already, three-quarters of Germans reject the government's economic policies and only a third think that the formation of the current grand coalition government of conservatives and socialists was the correct way to go, according to a late-May poll in the Sunday newspaper *Welt am Sonntag*. Among elites, talk is already rampant about when Merkel should engineer an impasse next year so that she can break the coalition and call a new election that might give her an absolute reformist majority.

If she gains that power, Merkel will have two choices, according to a forthcoming study by the Atlantic Council: "The Merkel government can pursue a program of modest reforms and allow the German economy to putter along at a comfortable rate. Or the chancellor can take advantage of her high popularity and undertake fundamental economic changes, making Germany once more the locomotive—perhaps even the 'bullet train'—of the European economy."

The United States has a very high stake in Merkel's accepting that challenge. Domestic economic policy is now a legitimate subject of discussion between allies. In that dialogue, Washington must help Berlin realize that labor-market reform was necessary, but not sufficient, for German economic success. In the trans-Atlantic marketplace, liberalization of German capital markets and deregulation of German business is not just a German issue—it is a global one, too.

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