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Angela Merkel's Moment of Truth

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During the recent football extravaganza, the world discovered a Germany that at last seemed confident and optimistic. Can this new self-esteem last? This is a key question, not only for Germany but also for Europe and the U.S., who depend on Berlin's willingness and ability to help defend Western interests around the globe. Only an economically strong Germany can play that role.

In a recent visit to Germany, we heard both government officials and private analysts make the case for cautious economic optimism. They pointed out that the country remains the world's export champion and argued that labor costs, while still high, were becoming more competitive, owing to a new willingness of unionized employees to work longer hours without pay increases.

Government officials also praised the coalition decision to increase the value added tax next year to meet the euro-zone's deficit targets. They pointed to other reforms on Chancellor Angela Merkel's agenda, including health-care financing, corporate taxation and redefining the constitutional relationship between the federal government and the country's 16 states.

The problem is that none of these steps gets to the root of what ails the German economy. Even the most bullish expert we interviewed acknowledged that, for the foreseeable future, unemployment is likely to hover around 10%. The so-called labor market reforms adopted by the previous government have yielded few results and turned out to be much more expensive than envisaged. But Ms. Merkel has steered clear of introducing flexibility into the nation's rigid rules for hiring and firing. And while consumer spending has modestly increased this year, the VAT rise in 2007 makes any sustained growth in spending unlikely.

With some luck, growth might approach 2% this year. But the estimates we heard for 2007 were all significantly below this. This is not only bad news for Germany. With signs of a slowdown in the U.S. and growing imbalances in Asia, a strong European economy -- which is only possible with a strong German economy -- will be essential in sustaining global prosperity. If Germany can't be a growth locomotive, the consequences of a downturn in the U.S. may have more severe consequences for Europe's export-dependent economies than the U.S. itself.

Hence, Ms. Merkel must press for more far-reaching changes, particularly in these four key areas:

• First, relying on Germany's current export champions -- automobiles and machine tools -- as the backbone of its economy is a big mistake. Rising competitors, such as China and India, are rapidly developing the technical expertise to challenge the German champions, and at far lower wages. Germany must now develop the new industries and services, such as biomedical and "green" energy technologies, which could serve as the economic backbone over the next generation. Coinciding with the World Cup, a large public-relations offensive advertised Germany as "the land of ideas." This is undoubtedly the case. The problem is that overregulated product markets, inflexible labor laws and a risk-averse financial sector often make it impossible for these ideas to get off the ground.

• Second, the government, together with the private sector, must build a competitive educational system. In the 19th century, Germany pioneered the idea of elite research universities. Since the 1960s, though, many of these institutions have fallen into mediocrity. In a recent ranking of the world's 20 best universities in the Economist magazine, not a single German institution made the list. If the Merkel government wants Germany to remain "the land of ideas," it must upgrade the higher education system and foster closer ties between government-funded basic research institutions and German industry.

• Third, it's probably unrealistic to expect Germans to buy into the "Anglo-Saxon" economic model. But many of Germany's neighbors -- who also prize the social welfare model -- are successfully experimenting with a range of market-based approaches. In Denmark, the "flexi security" program uses a combination of carrots and sticks to retrain unemployed workers and place them in jobs. Others, including the Baltic states, are using a flat tax to spur investment. Not every program will be adaptable to German conditions, but Berlin needs to be more attentive to the emerging European laboratory for economic reform.

• Finally, it is time for a more radical program for revitalizing East Germany. Officials repeatedly stress that a major reason for the country's underperformance in recent years has been the huge costs of subsidizing the former Communist part of the country. While true, the reality is that after about €1.5 trillion spent, the new states have just managed to regain the level of output the East German state had just before unification. No wonder that some regions, particularly in the northeast (where Ms. Merkel and U.S. President George W. Bush visited the other week), are becoming depopulated as the most talented are leaving in search for better opportunities.

Instead of betting on subsidies, though, Berlin should consider the establishment of a special economic zone there so that these six states can experiment with less regulation and more business-friendly tax and employment policies to attract investments. Over time, Berlin might even realize that this is not such a bad idea for the rest of the country either.

Ms. Merkel is rapidly approaching a moment of truth. She can pursue the current course of modest change and muddle through. Or she can seize on her own popularity and the recent World Cup euphoria to force through some fundamental changes. It won't be easy, but the results -- for Germany and the global economy as a whole -- will be well worth it.

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