



# The German Economy and U.S.-German Economic Relations

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## Summary

Germany is the world's fifth largest economy and the largest in Europe, accounting for about one-fifth of the European Union's (EU) GDP. Germany is also the largest European trade and investment partner of the United States. Mutually profitable and growing U.S.-German commercial ties historically have been facilitated by a strong German economy. The health and functioning of the German economy, as well as its approaches to international economic policy issues, thus, are of considerable importance to the United States as well as to the rest of Europe.

By most standards, post-war West Germany registered impressive economic performance in the first decades of its existence. But beginning in the mid-1990s, the German economy has been on a much lower growth path, averaging about 1.5% of GDP per year. Unemployment has also risen steadily. These trends, which have been exacerbated by a steep 5% decline in German GDP growth in 2009, raise questions about the long-term vitality and strength of the German economy.

A number of factors help explain Germany's declining growth rate. One factor has been the high cost associated with integrating the formerly communist East German economy into the Federal Republic since reunification in 1990. A second has been the growing cost of Germany's generous social security and welfare programs and associated regulations which some believe may undercut incentives for work and entrepreneurship. A third is an economy that is more geared towards exporting than domestic investment and consumption.

With few exceptions, German governments have generally been reluctant to advance what many economists consider necessary but unpopular economic policy reforms, including cut-backs in welfare programs and labor market protections. Some believe that Chancellor Angela Merkel's September 2009 reelection in coalition with the pro-business Free Democratic Party (FDP) could increase the likelihood of market-friendly reforms being enacted, but any radical restructuring of Germany's social market economy is considered unlikely.

With declining economic growth and rising expenditures on social protections, Germany faces significant budgetary and resource constraints. This resource crunch could limit Germany's flexibility in pursuing domestic and international policy goals, arguably making Germany less capable of compromise on matters of potential economic advantage. In this regard, Germany's domestic economic challenges could limit its policymaking flexibility. This has affected not only the economic and trade leadership role Germany has traditionally played in Europe, but also its position on issues that directly affect U.S. interests such as the global economic downturn and economic sanctions.

A prosperous German state remains critical to both the U.S. and European economies. Difficulties Germany may have in regaining a stronger economic position are important concerns, affecting the U.S.-German partnership's ability to mutually address and manage a range of bilateral, regional, and global challenges. This report elaborates on these themes in three parts: the first section examines Germany's economic performance in historical perspective and assesses some of the domestic factors that may be contributing to Germany's less than optimal performance; the second discusses the reform challenges facing Germany's political leaders; and the third section evaluates a few salient U.S.-German economic policy differences and strains that seem to be influenced by Germany's weakened economic situation.

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## Overview

With a population of 82 million and a GDP of \$3.6 trillion, Germany is the world's fifth largest economy (after the United States, China, Japan, and India) and the largest in Europe, accounting for about one-fifth of the gross domestic production (GDP) of the European Union (EU).<sup>1</sup> Based on a per capita income of around \$44,280 (2008), Germany is one of the world's high-income countries. Germany has also been the world's number one exporter of goods and the largest European trade and investment partner of the United States. Although its economic and commercial policies are increasingly determined within the EU, Germany plays a key role in influencing EU policies. The health and functioning of the German economy, as well as policy approaches adopted by the government, are not only of bilateral and regional importance, but also of global importance to the United States.

Since its founding in 1949, the Federal Republic of Germany has experienced a continuous rise in living standards.<sup>2</sup> GDP per person has risen by a factor of 6 since 1950. This increase in material well-being has helped create a very stable middle class. German firms remain competitive internationally and the work force tends to be highly skilled. The economy is heavily dependent on exports. In 2008 exports of goods and services accounted for 47% of Germany's GDP—more than three times the rate in the United States. Germany's strong export performance in goods or merchandise is also denoted by the term *Exportweltmeister* (world champion exporter). At the same time, relatively weak consumer demand is a consistent feature of the German economy.

Germany has been a driving force in European integration, including the creation of the European Monetary Union. Germany's EU partners remain its prime trade customers and suppliers. In 2008, 63% of German exports went to other EU member states and 64% of its imports came from other EU member states.<sup>3</sup> The United States is Germany's largest trading partner outside of Europe. In 2008, 7.2% of German exports went to the United States and 4.2% of its imports came from the United States. In turn, Germany is the United States' largest European trading partner and its fifth largest trading partner worldwide, accounting for 4.5% of U.S. total trade.<sup>4</sup>

The two countries also share strong foreign direct investment (FDI) ties. The United States in 2008 accounted for \$110 billion, or over 25%, of Germany's total stock of outward FDI and was the second most important provider of FDI in Germany. Germany's stock of FDI in the United States stood at \$212 billion in 2008, making Germany the fifth largest foreign investor in the United States.<sup>5</sup>

These investments drive trade and create jobs. In 2007, 62% of U.S. imports from Germany consisted of related party trade—trade between German parent companies and their own affiliates in America. German companies doing business in the United States employ about 670,000 people, or one in every 200 people in the private sector. U.S. companies operating in Germany

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<sup>1</sup> Country GDP rankings based on purchasing power parity measure. CIA, *The World Factbook*, 2008.

<sup>2</sup> Between 1949 and 1990, two German states, the western-oriented Federal Republic of Germany, or West Germany, and the communist German Democratic Republic, or East Germany, existed side-by-side. The East German regime collapsed between 1989 and 1990 and East Germany ceased to exist after German reunification on October 3, 1990.

<sup>3</sup> IMF, *Directions of Trade*, 2008.

<sup>4</sup> U.S. Census Bureau, *Foreign Trade Statistics*.

<sup>5</sup> Survey of Current Business, *Direct Investment Position for 2008*, July 2009.

employ nearly 800,000 people, which accounts for nearly one out of every 35 jobs in the private sector.<sup>6</sup>

Mutually profitable, growing, and beneficial U.S.-German commercial ties historically have been facilitated by a strong German economy. By most standards, West Germany registered an impressive economic performance in the 1950s and 1960s, the first decades of its existence. Powered by export-led economic growth based on low wages and high-level engineering, the Federal Republic of Germany grew at an average of 6.3% per year during this twenty-year period. The economy grew at a less rapid, but still strong pace of 3.6% per year in the 1970s and 1980s. But beginning in the mid-1990s, the German economy has been on a much lower growth path, averaging around 1.5% GDP growth per year (as compared to an OECD average growth rate of 2.7%). Unemployment has ratcheted upward since 1970, from virtually full employment to a situation where in some years 10% of the population is out of work and another 4% can't find work but are in government programs. These trends, have been exacerbated by a 5% decline in German GDP growth in 2009, raise questions about the long-term vitality and strength of this European powerhouse.<sup>7</sup>

A number of mostly domestic factors may account for Germany's suboptimal economic performance. These include the heavy and continuing costs of reunification with East Germany in 1990, escalating costs associated with generous social security and welfare programs, rigid labor market laws and perceived over-regulation, and an economy more geared towards exporting than consumption. Amidst the current global economic slowdown, questions have been raised concerning the impact that Germany's export dependency has on the domestic economy, particularly for growth.

Some of the aforementioned factors are at the same time valued by many Germans as essential features of the country's so-called social-market economy. Since the founding of the Federal Republic and reunification in 1990, German policymakers have consistently pursued parallel national goals of export-driven economic growth and social cohesion through a robust system of social welfare programs. Most Germans appear to continue to take pride in Germany's position as a leading exporter and to support government-funded programs aimed at reducing economic disparities within their society. In turn, German political leaders have displayed a willingness to sacrifice a degree of economic growth for what they perceive as social cohesion.

These preferences are evident in the reluctance of most German governments to pursue the kinds of economic reforms advocated by many economists. Most recently, from 2005-2009, a so-called *grand coalition* government of the center-right Christian Democratic/Christian Social Union (CDU/CSU) and the left-of-center Social Democratic Party (SPD) proved reluctant to advance unpopular cut-backs in welfare programs and labor market protections. Some believe that Chancellor Angela Merkel's (CDU) September 2009 reelection in coalition with the pro-business Free Democratic Party (FDP) could increase the likelihood of market-friendly reforms being enacted, but any radical restructuring of Germany's social market economy is considered unlikely. Failure to enact substantial reforms could mean that the problems posed by an aging population and Germany's system of social benefits will place an even larger strain on the economy in the future.

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<sup>6</sup> U.S. Embassy Berlin, *The German-American Partnership: Benchmarking Success*, November 2008.

<sup>7</sup> Economist Intelligence Unit data.

### **Germany's Political Parties: Overview and Key Economic Policy Positions**

**The Christian Democratic Party and Christian Social Union (CDU/CSU).** Founded by West Germany's first post-war Chancellor, Konrad Adenauer, the CDU runs in federal elections with its Bavarian sister party, the CSU. The parties jointly pursue a center-right policy platform, with the CDU generally more conservative on economic issues than the CSU and the CSU more conservative on social values associated with the Catholic church. During the previous government (2005-2009), Merkel was criticized by some within her party and by members of the FDP (see below) for being too reluctant to pursue free-market reforms such as a further liberalization of the labor market and reducing the tax burden on employers. In the face of the economic downturn, Merkel and her partners in the CSU have been cautious about pursuing such reforms and have emphasized the need to provide support to the poor and unemployed as well as to the business community.

**The Social Democratic Party (SPD).** Germany's oldest political party, the SPD has evolved from a socialist party to a social democratic party, but continues to see itself as the representative of the German working class and enjoys close ties to Germany's trade unions. Now in opposition for the first time since 1998, the party has been challenged to overcome internal divisions between its more centrist wing represented by some of the party's veteran policymakers and a left wing of younger lawmakers. The internal debate within the SPD has been exacerbated by the emergence of the Left Party, which has sought to distinguish itself as a left-wing alternative to the SPD. Under former Chancellor Schröder, the SPD championed stringent economic reforms that were opposed by most Germans and some of the party's base. In opposition, the party appears poised to oppose economic policies it perceives as too "pro-business" such as tax cuts for employers, and to seek to strengthen protections for German workers and the poor and unemployed.

**The Free Democratic Party (FDP).** The junior coalition party in the current government, the FDP considers itself a liberal party, advocating individual freedom and limited government involvement in economic and social issues. Since its inception in 1948, the party has governed in coalition with both the CDU/CSU and SPD, but is considered a more natural ally of the CDU. While in opposition from 1998 to 2009, the FDP distinguished itself by advocating free-market, pro-business policies and the protection of individual civil liberties. The FDP favors extensive tax cuts and a reform of Germany's social welfare structure, including its public health system. Some commentators speculate that a return to government could soften the FDP's calls for stronger reforms. Party leader Guido Westerwelle is Vice Chancellor and German Foreign Minister.

**The Left (Die Linke).** The Left Party was formed in 2007 as a merger of the Party of Democratic Socialism (PDS)—the successor to East Germany's ruling Socialist Union Party—and the Electoral Alternative for Labor and Social Justice (WASG), based in western Germany. The most left-wing party in the German parliament espouses a platform of social solidarity in the face of globalization. The party calls for redistribution of wealth through taxes on corporations and the rich, a minimum wage, curbs on privatization, and more self-determination for workers. The party enjoys strong support in eastern Germany and is considered a potential future coalition partner of the SPD. Should the SPD and The Left overcome existing differences, the grouping could represent a leftward shift in German politics.

**Alliance '90 / The Greens.** Founded in 1980 as an opposition movement, the Green Party has become a widely respected mainstay in German politics. The Greens have had continuous representation in the German parliament since 1983 and were a junior coalition partner in the Schröder government from 1998 to 2005. The party has long advocated enhanced environmental protection and sustainable development and has promoted achieving economic growth through such development. In the Schröder government, the Greens successfully pushed for a gasoline tax which channeled revenues to spur clean energy development. Although the party is on the left of the political spectrum, it has entered into coalition governments with the CDU at the regional level and is considered less beholden to trade unions and more open to economic reform than the SPD.

As a result of its declining economic growth, aging population, and the growing costs of maintaining generous social security programs, Germany, as many other industrialized countries, faces a resource crunch. This resource crunch arguably has limited Germany's flexibility to maneuver domestically and appears to have been a factor in the evolution of somewhat more assertive German international economic policies. With dwindling economic and financial resources, Germany arguably has become less capable of compromising on matters of potential economic advantage. This has affected not only the trade and economic leadership role that Germany has traditionally played in Europe and the world economy, but also its position on issues that directly affect U.S. interests. These include different approaches in dealing with the global economic downturn and economic sanctions.

In short, a prosperous German state remains critical to both the U.S. and European economies. Difficulties Germany may have in regaining a stronger growth pattern are an important concern, affecting the U.S.-German partnership in addressing a range of bilateral, regional, and multilateral challenges.

This report elaborates on these themes in three parts: the first part examines Germany's economic performance in historical perspective and assesses some of the domestic factors that may be contributing to Germany's less than optimal growth pattern in recent years. The second section discusses the reform challenges facing German political leaders. The third section evaluates selected U.S.-German economic policy differences and strains that may be influenced by Germany's economic situation.

## Germany's Economic Performance: Factors Explaining Declining Growth

In the first decades of its existence, West Germany experienced impressive economic performance. Powered by export-led growth and close collaboration between business, government, and labor, the Federal Republic of Germany was hailed as an "economic wonder" (*Wirtschaftswunder*) as it averaged 8.2% growth rates during the 1950s, 4.4% in the 1960s, and 2.8% in the 1970s. In the 1980s, Germany's economic performance began to slip further, falling to an annual average increase of 2.3%. As shown in **Table 1**, with only a few years of exceptions, the growth rate has continued to decline since 1990.<sup>8</sup> In the 1990s, Germany recorded an average growth rate of only 1.6% and a meager 0.6% between 2001 and 2005. The economy did bounce back in the three years from 2006-2008, with growth averaging 2.3%. But the economy was again hard hit in late 2008 and early 2009 by the global economic downturn. Germany's economy contracted by 5% in 2009, compared with a 3.7% drop in the Euro-zone overall.<sup>9</sup>

Once Europe's growth engine, Germany since the mid-1990s has had, along with Italy, one of the lowest growth rates in Europe. The aggregate output of the German economy, for example, increased by 7% between 2000 and 2009 compared to a Euro Area increase of 12.6%.<sup>10</sup>

**Table 1. Germany: Annual GDP Growth Rates for Selected Years**

(in percent change)

1950- 1960	1960- 1970	1970- 1980	1980- 1990	1991- 2000	2001- 2005	2006	2007	2008	2009
8.2	4.4	2.8	2.3	1.6	0.6	3.2	2.6	1.0	-5.0

Slower German economic growth, in turn, has been accompanied by high unemployment (see **Table 2**). In the 1960s, both West and East Germany had almost no unemployment. In 1970, about 150,000 people or 0.7% of the labor force were unemployed—compared to over 3 million

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<sup>8</sup> Growth rates over 4% were registered in 1990 and 1991, the boom years of reunification. The economy also grew at a much more rapid pace in 2006-2008. This was thought to be due largely to rising export demand but also to economic reforms implemented in 2003 and 2004.

<sup>9</sup> Economist Intelligence Unit data.

<sup>10</sup> OECD data.

today. But by 2005 unemployment reached 11.7% nationwide and 18% in the states of the former East Germany.<sup>11</sup> When the economy did bounce back in the three years from 2006-2008, with growth averaging 2.3%, unemployment also fell from nearly 5 million to around 3.3 million, but the unemployment rate barely dipped below 8%. The OECD also predicts that the number of unemployed will rise to 5.1 million and that the unemployment rate will increase sharply to 11.6% by the end of 2010.<sup>12</sup>

**Table 2. Germany: Unemployment Rate, 2000-2010**

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 <sup>a</sup>	2010 <sup>a</sup>
9.6	9.4	9.8	10.5	10.6	11.7	10.8	9.0	7.8	10.1	11.6

a. Projected.

**Source:** EIU database, OECD World Economic Outlook, June 2009.

Many economists argue that unemployment in the German economy is higher than the unemployment data indicate. This “hidden” unemployment is allegedly due to a large number of workers employed in government schemes or subsidized in early-retirement programs. In addition, the government funds a so-called “short-term working benefit” (*Kürzarbeit*) through which it subsidizes 60%-67% of lost income for individuals whose working time has been reduced by their employer. According to some estimates, the program has saved at least 400,000 jobs and 1.4 million employees are working shorter hours.<sup>13</sup>

High unemployment translates into underutilization of the German labor force and foregone production. The fact that the German labor force, on average, tends to work fewer hours than its counterparts in most industrialized countries, and enjoys more paid leave and holidays, could further impede more robust economic growth.<sup>14</sup> On the other hand, as noted above, many Germans appear comfortable foregoing potential gains in economic growth in order to maintain relatively generous social benefits.

A number of factors help explain Germany’s declining growth record. One factor has been the high costs of integrating the formerly communist East German economy into the Federal Republic. A second factor is Germany’s generous social welfare provisions which may undercut incentives for work and entrepreneurship. A third is an economy that may be excessively dependent on exports, and saddled with labor market rigidities and other barriers that make investment in the domestic economy less attractive than investing abroad. These trends are discussed below.

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<sup>11</sup> Andreas Falke, “The Internationalisation of Germany: Adapting to Europeanisation and Globalisation,” In *Germany’s Gathering Crisis: The 2005 Federal Election and the Grand Coalition*, eds. Alister Miskimmon, William E. Paterson and James Sloan, Palgrave MacMillan, 2009.

<sup>12</sup> OECD Economic Outlook, June 2009.

<sup>13</sup> Judy Dempsey, “Merkel Says Worst Still Ahead in Germany,” *New York Times*, November 11, 2009.

<sup>14</sup> Horst Seibert, *The German Economy*, Princeton University Press, 2005, p. 44.



## **The Costs of Reunification**

With German reunification in 1990, West Germany realized what had been its single most important national objective. Reunification also represented a major change in the country's economic condition. In practical terms, a relatively strong West German economy of about 63.2 million people took over a reeling economy of 16.1 million people which had been essentially isolated from the West for over 40 years. For the former East Germany, this meant a drastically new environment for its population. German policymakers set out to privatize state-owned firms, production was to be reoriented towards the markets of the West, and new roads, housing, and public infrastructure began to be constructed.<sup>15</sup> The results of these policies have been at best mixed and today, some estimate the total value of transfers from west to east since 1989 at upwards of \$2 trillion.

The West German economy was fairly strong when the reunification process began. Price stability had been achieved, the government budget was balanced, and the country's transactions with the rest of the world (i.e., its current account) were in surplus by almost 5% of GDP. The East German economy, on the other hand, had a per capita GDP just 40% of that of its western neighbor.

In hindsight, some observers think that the strong economic situation in the west perhaps led the government to underestimate the economic burden that reunification would entail and caused it to commit a number of policy mistakes in the process. One oft-cited example is the decision to exchange the East German currency at a one-to-one rate for the West German deutschmark. This action effectively quadrupled East German wage costs in terms of deutschmarks. While the one-to-one currency conversion raised East German wage costs to only 30 percent of the West German level, subsequent increases may have undermined the attractiveness of East Germany for investors.<sup>16</sup>

A second scrutinized policy decision was to extend West Germany's social welfare system, with its wage-replacement benefits in terms of early retirement, unemployment compensation, and social assistance, to East Germany. These benefits arguably prevented wage rates from settling at a level that would have made East German labor competitive, particularly given the lower level of productivity of East German workers.<sup>17</sup>

Proponents of the one-to-one currency valuation and the decision to extend West Germany's social welfare system east argue that these moves were both inevitable and necessary given the political context. One of the West German government's primary goals with regard to reunification was to avoid a mass migration of people from east to west and to ensure social and economic cohesion between east and west. In explaining the rationale behind the one-to-one currency valuation, then-West German Foreign Minister Hans-Dietrich Genscher has said, "If we had not brought the deutschmark to the east, the east would have come to the deutschmark."<sup>18</sup> West German leaders believed that their best policy option was to extend the West German

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<sup>15</sup> Ibid., p. 18.

<sup>16</sup> Ibid., p.19.

<sup>17</sup> Hans-Werner Sinn, *Can Germany Be Saved?*, MIT Press, 2007, pp. 164-165.

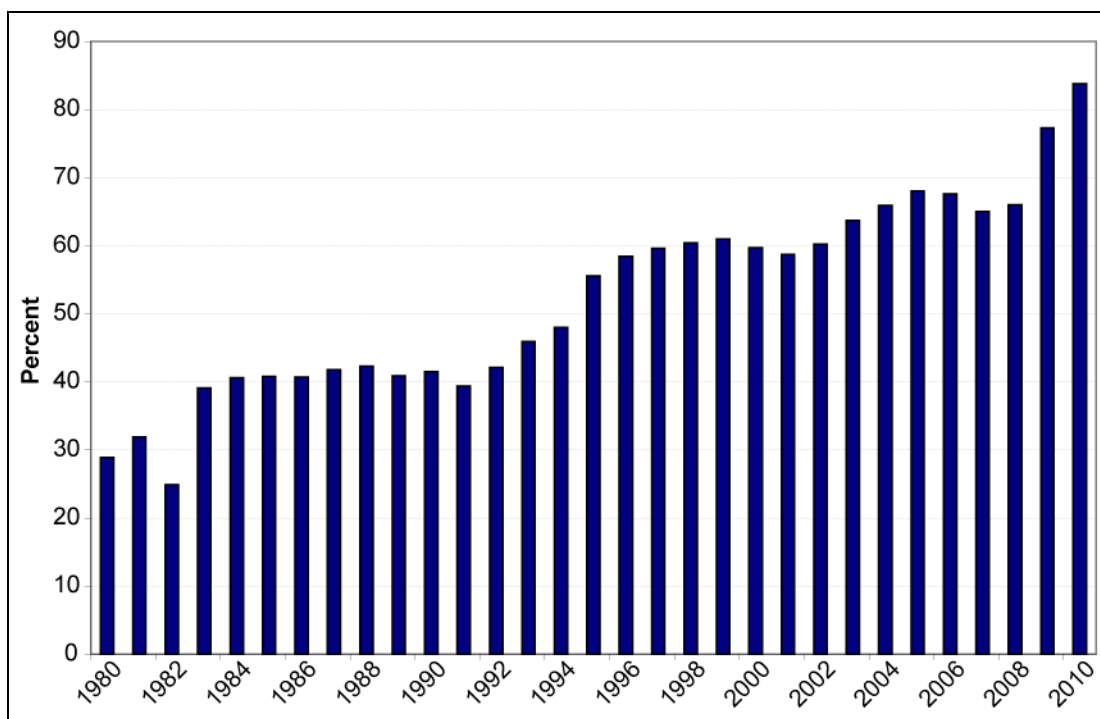
<sup>18</sup> Hans Dietrech Genscher, remarks at The German Marshall Fund event "Twenty Years After the Fall of the Berlin Wall: A Europe Whole and Free?," The Newseum, Washington, DC, November 2, 2009.

currency and its social market economy east despite the potentially negative consequences for the regional economy.

German reunification required, and still requires, large annual public transfers to the east, estimated to be roughly 3%-4% of western Germany's GDP and more than one-third of the federal budget. This sum has placed a heavy burden on the economy of western Germany.<sup>19</sup> It is also estimated that only one-quarter of total transfers to the east are used for investment, either in the private sector or for infrastructure. Most of the transfers are thought to go to public and private consumption.<sup>20</sup>

The budgetary transfers were financed to a large extent by issuing bonds rather than by increasing taxes, leading to a doubling of government debt. As shown in **Figure 1**, in the nearly twenty years since reunification, total government debt as a percentage of gross domestic product has doubled, rising from 39.4% in 1991 to a projected 83.8% in 2010. Debt service payments on this amount of debt has equaled in recent years around 15% of total federal budget expenditures, or between 2.2% and 2.4% of GDP (as compared to the OECD average of between 1.7% and 1.8% of GDP).<sup>21</sup>

**Figure 1. Germany's Public Debt as Percent of GDP**



**Note:** 2009 and 2010 figures are projections.

**Source:** EIU database.

<sup>19</sup> Ibid., pp. 148-149.

<sup>20</sup> Horst Seibert, *The German Economy*, p. 42.

<sup>21</sup> Wolfgang Streek, "Endgame? The Fiscal Crisis of the German State," In *Germany's Gathering Crisis*, p. 47.

The higher debt and interest rate burden has had an adverse impact on Germany's fiscal policy stance. Due to the rising interest payments on the new debt, the leeway for tax reductions has been severely reduced. In the process, tax rates for German firms have remained higher than those in other EU countries.<sup>22</sup>

Despite the magnitude of transfers from the west to the east, the challenge of bringing the economy of the east up to the standards of the west persists. The eastern German economy still depends upon resource transfers from western Germany for 45% of its total expenditures. While eastern German aggregate income has almost reached the western German level, aggregate productivity is only about 60% of the western German level. At the same time, in some areas of eastern Germany per capita GDP is less than half that in western Germany. Some eastern areas are also confronting population declines of 20%. Moreover, there are few indicators to suggest that the eastern German economy, after nearly two decades since reunification, is close to becoming self-sustaining. Continuing dependency on transfer payments could represent a heavy burden on western German businesses and employees in the years ahead.<sup>23</sup>

## **Social Welfare Costs**

After World War II, West Germany constructed the so-called "social-market economy" that remains the foundation of the current German economic model.<sup>24</sup> The basic idea was to create a competitive economy safeguarded by social protections with minimal government intervention in markets. At its core, the approach attempts to generate a more stable and equitable distribution of income than the outcome which market forces alone would achieve. It does so through a range of institutional arrangements that generally include market capitalism, strong protection of labor and unions, a relatively large welfare state, and tight regulation of markets. Born out of the traumatic experience of the economic and political chaos of the 1920s and 1930s, it was "an attempt to harness free market capitalism while simultaneously avoiding the social problems created by unfettered laissez-faire, on the one hand, and a centrally-planned economy, on the other."<sup>25</sup>

German social programs consist of old age pension support, nursing or long-term care insurance, health insurance, and unemployment insurance. These programs were greatly expanded in the 1970s to allow more citizens to share in the fruits of the then prospering West German economy. Unemployment compensation and social assistance benefits were raised, working time was reduced and early retirement options were created. The pension insurance system was expanded to the self-employed and public university tuition fees were done away with.

Despite recent reforms that have limited the scope and duration of benefits, German welfare programs remain quite generous compared to those provided by other industrialized countries. Until 2004, unemployment compensation, for example, provided for replacement of more than 50% of a person's previous net earnings and for an unlimited period of time.<sup>26</sup> The old-age

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<sup>22</sup> Horst Seibert, *The German Economy*, pp. 21, 42.

<sup>23</sup> Hans-Werner Sinn, *Can Germany Be Saved?*, pp. 148-151.

<sup>24</sup> The social welfare system originated in Germany under Chancellor Bismarck in the late 19<sup>th</sup> century and then spread to the rest of western Europe.

<sup>25</sup> Stormy-Annika Mildner and Mark Prentice, "Germany's Social Market Economy: Old Wine in Old Bottles?," in AICGS, *Germany's Founding Pillars at 60: Future Challenges and Choices*, p. 9.

<sup>26</sup> Hans-Werner Sinn, *Can Germany Be Saved?*, p. 108.

pension system provided a retirement income worth nearly 70% of the net average wage before retirement.<sup>27</sup> Moreover, an estimated 40% of Germany's adult population (pensioners, social-welfare recipients, unemployed, accident victims, and students) receive some form of state income transfer, with even higher percentages in eastern Germany.<sup>28</sup>

Most economists believe unemployment and welfare payments should aim to insure against hardship caused by unemployment or other life changing events without undermining incentives to work. Yet, there is evidence that some German programs have had an impact on incentives to work by granting much of this assistance on condition of labor income not being earned. That is to say that under some German programs, if labor income is earned, much of the assistance is cut. The so-called "wage replacement" incomes provided by these programs, thus, can contribute to unemployment by operating as wage floors. This is because people receiving state assistance could be unwilling to take a job in the private sector at a wage that is not substantially higher than the wage-replacement income provided for remaining unemployed.<sup>29</sup>

Offering incentives not to work may put upward pressure on private sector wages and thereby undercut the competitiveness of German workers. It may also saddle German businesses with added costs because the bulk of the expenditures of the social welfare system are financed by contributions paid half by employees and half by employers.<sup>30</sup>

The burden of taxes and social security contributions on German employees is high. Non-wage labor costs, in the form of social security contributions (pension, unemployment, and health insurance) have for years exceeded 40% of workers' pay. Many economists maintain that cutting these taxes on labor would be the most effective way to revive the labor market and reduce unemployment, particularly among workers with low-skills.<sup>31</sup>

Germany's population size has been declining since 2002. Against the backdrop of an aging population, social welfare costs continue to escalate.<sup>32</sup> Germany's share of public social expenditure in GDP today exceeds 30%.<sup>33</sup> Combined with the increasing numbers of pension and retirement claims forecast for the coming decades, the costs and job market consequences of the social benefits system could limit the maneuvering space for fiscal policy in the future and could continue to have adverse effects on incentives for work and entrepreneurship that many consider critical for stimulating faster growth.<sup>34</sup>

## **Export Dependency Costs**

Germany's strong export performance has been a constant feature of the German economy since the founding of the Federal Republic. A future Chancellor, Ludwig Erhard, set the tone for

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<sup>27</sup> Horst Seibert, *The German Economy*, p.114.

<sup>28</sup> Hans Werner Sinn, "The World Owes Germany Thanks," May 3, 2009.

<sup>29</sup> Hans-Werner Sinn, *Can Germany Be Saved?*, p. 107.

<sup>30</sup> Horst Seibert, *The German Economy*, p. 114.

<sup>31</sup> Wolfgang Streek, "Endgame: The Fiscal Crisis of the German States," p. 39.

<sup>32</sup> Among industrialized countries, Germany is projected to have the second largest percentage (22.7%) of its population over 65 by 2020. OECD data.

<sup>33</sup> Hans-Werner Sinn, *Can Germany Be Saved?*, p. 24.

<sup>34</sup> Horst Seibert, *The German Economy*, p. 261.

German trade policy when he was minister for economics in 1953 by stating that “foreign trade is not a specialized activity for a few who might engage in it, but it is the very core of our economic and social order.” Subsequently, it has become common to speak of the German “export mystique” and efforts to increase competitiveness. German diplomatic missions rarely make visits abroad without including select businessmen in their official delegations.

Various data illustrate the growing role that exports have played in Germany’s economy. In 1950, exports represented 9.3% of GDP. Once the postwar economic boom got under way, exports rose to 17.2% of GDP in 1960. The rise continued to 23.8% in 1970, to 26.7% in 1980, and to 33% in 1990. By 2008, German exports were accounting for 47% of GDP, compared to less than 20% in Japan and about 13% in the United States.<sup>35</sup>

Since 2004, Germany has been the world’s top exporter of merchandise or goods, surpassing the United States, Japan, and China.<sup>36</sup> The title of *Exportweltmeister* (export champion) is a source of great pride for many Germans. The main German exports—cars, precision machinery and chemicals—have come to symbolize a German identity based on skill, quality, and reliability.<sup>37</sup> In addition, many German small and medium-sized companies have also demonstrated exporting prowess in niche markets, including beverage-filling equipment, vacuum technology, surgical instruments, and binoculars and telescopic sights.<sup>38</sup>

What impact Germany’s exporting success has had on its overall economy over the past 10 to 15 years, however, is a matter of debate. One view is that Germany’s exporting success has not been as positive for addressing core economic problems such as production and employment. Under this view, Germany has maintained its lead in exports by systematically outsourcing and off-shoring the labor-intensive parts of production to low-wage countries, primarily in Eastern Europe. Consequently, the import content of German exports has increased dramatically over the last several decades from 15% to 40%. Thus, the increase in exports cannot automatically be equated anymore with a commensurate increase in domestic production and employment.<sup>39</sup>

A second view is that Germany has maintained its export competitiveness by pursuing a policy of systematic wage deflation, thereby reducing unit labor costs. From 2001 until today, Germany kept a tight lid on wages and, as a result, wages are still at almost the same level today as they were eight years ago.<sup>40</sup> In this way, Germany was able to raise its share of internal EU exports substantially, mostly at the expense of its EU neighbors who did not exercise similar wage restraint.<sup>41</sup> This bottom-up process of sustained wage moderation and unit cost reduction was reinforced by corporate-led changes to working conditions and time. According to one economist,

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<sup>35</sup> EIU Data Base.

<sup>36</sup> In 2007, the most recent year where data are available, Germany accounted for 9.7% of world merchandise exports, followed by China (8.9%), the United States (8.5%) and Japan (5.2%). Press reports have indicated that China overtook Germany in 2008 as the world’s top exporter of goods. Source: WTO Statistics.

<sup>37</sup> Andreas Falke, “The Internationalisation of Germany,” p. 208.

<sup>38</sup> Hans-Werner Sinn, *Can Germany Be Saved?*, pp. 33-34.

<sup>39</sup> Andreas Falke, “The Internationalisation of Germany,” p. 208.

<sup>40</sup> Yet, German manufacturing wages remain among some the highest in the world. Simon Taylor, “Rebalancing A Disrupted Economy,” *European Voice*, May 7, 2009.

<sup>41</sup> This is often referred to as a beggar-thy-neighbor or protectionist policy.

“this move lowered labor costs for exporting firms while it made imports more expensive, further improving German price competitiveness relative to its European partners.”<sup>42</sup>

German wage discipline may also have tilted demand in favor of exports and away from consumption. Even as exports boomed and jobs have been created, sluggish wages mean that the gains from national income growth go mostly to profits. In the process, consumer spending has suffered, falling to a low of 56% of GDP—well below the 65% of GDP level experienced in most western economies. The increase in the rate of the value-added tax (VAT), from 16% to 19% in early 2007 may have resulted in a further check on consumption.<sup>43</sup>

Observers raised concerns about Germany’s export dependency in 2008 and in early 2009 in the face of the global economic slowdown. With the collapse of foreign demand, German exports are expected to decline in 2009 by over 20%, making Germany’s deep recession export-led. Exports of cars, machinery, and chemicals can provide a narrow and potentially vulnerable base for prosperity in an integrated world economy.

To keep consumption from dropping even further, the previous grand-coalition government implemented a range of policies intended to stimulate domestic economic growth and to support the German private sector. In December 2008 and January 2009, the parliament passed domestic stimulus measures totaling EUR 71 billion (about \$100 billion) for 2009 and 2010. The so-called “short-term working benefit” (*Kürzarbeit*) through which the government subsidizes individuals whose working time has been reduced was expanded and the government also subsidized the sale of new cars through a “cash for clunkers” program. German economists and officials also emphasize the positive effects on domestic demand of so-called “automatic stabilizers,” public expenditures for guaranteed social welfare benefits such as unemployment programs.

When the economy has shown some signs of picking up (as it did in the second quarter of 2009), certain German policymakers have seen this as evidence that the German export-led growth model is indeed sustainable.<sup>44</sup> These proponents, contrary to G-20 pledges to correct current account imbalances, also tend to argue that other countries could benefit by reducing domestic consumption, increasing savings and by implication, running a current account surplus, as Germany does. As shown in **Table 3**, Germany has been running current account surpluses for the past decade.

Some economists counter that a large economy cannot run on “export fuel” alone and that German policymakers should look for ways to make the economy more balanced by encouraging consumption at home. This, in turn, would require Germans to spend and invest more at home, thereby running smaller current account trade surpluses. They argue that for a sustained recovery of the world economy to occur, trade surplus countries like Germany will have to run smaller surpluses to accommodate the smaller current account deficits that countries like the United States will have to experience by exporting more to the rest of the world.<sup>45</sup>

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<sup>42</sup> Sebastian Dullien, “After the Election, Germany Will Continue to Obstruct Global Economic Rebalancing,” *AICGS Transatlantic Perspectives*, June 2009.

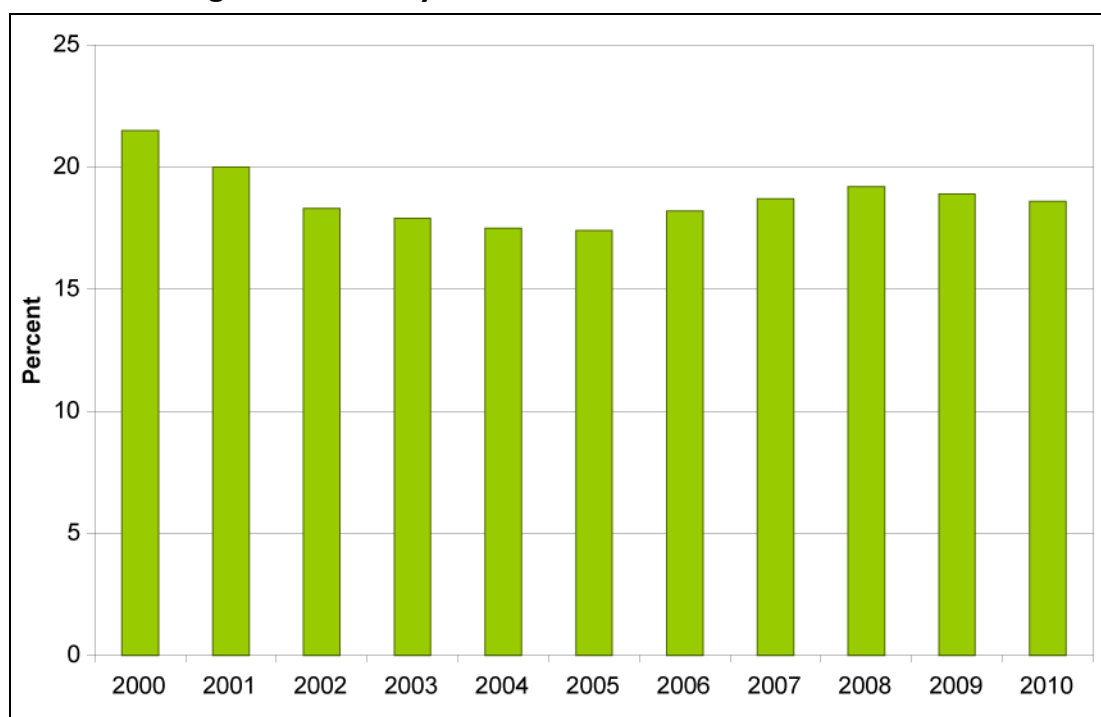
<sup>43</sup> *The Economist*, “Germany’s Economy: The Export Model Sputters,” May 9, 2009.

<sup>44</sup> Simon Tilford, “Germany will not drive a European recovery,” *Financial Times*, August 31, 2009.

<sup>45</sup> See, for example, Roland Berger, “How is Germany doing? Insights by Roland Berger,” Roland Berger Strategy Consultants, October 22, 2009.

From an economic perspective, Germany's large and enduring current account surpluses reflect a persistent excess of domestic savings over domestic investment. While Germany's gross national savings has increased from an average of about 21% of GDP from 1990 thru 2003 to an average of 24% of GDP between 2004 and 2008, its gross fixed investment share in GDP, as shown in **Figure 2**, has declined from 21.5% in 2000 to 17.4% of GDP in 2005 before increasing to 18.4% of GDP in 2008.

**Figure 2. Germany: Fixed Investment as Percent of GDP**



**Note:** 2009 and 2010 figures are projections.

**Source:** EIU database, OECD.

Germany's declining investment rate can also be viewed as the mirror image of net direct investment flows. As shown in **Table 4**, Germany has experienced rising direct investment outflows over the last decade. The largest net outflows of \$125 billion in 2007 and \$133 billion in 2008 occurred in the years of Germany's largest current account surpluses.

**Table 3. Germany's Current Account Position**

Year	Current Account Balance (\$ billions)	Current Account Balance as % of GDP
1995	-29.6	-1.2
1996	-16.8	-0.6
1997	-10.2	-0.1
1998	-17.1	-0.8
1999	-28.0	-1.3
2000	-33.9	-1.2

Year	Current Account Balance (\$ billions)	Current Account Balance as % of GDP
2001	0.3	0.0
2002	41.4	2.0
2003	47.9	1.9
2004	126.8	4.6
2005	142.2	5.1
2006	190.1	6.5
2007	265.9	8.0
2008	243.4	6.6
2009 <sup>a</sup>	90.3	2.8
2010 <sup>a</sup>	100.0	3.0

Source: OECD.

a. Projected.

**Table 4. Germany: Net Direct Investment Flows (\$ billions)**

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
150	-13	34	26	-30	-30	-70	-125	-133	-6	-36

Source: EIU Country Database.

In the view of some economists, Germany's declining investment rate and net capital exports are driven by domestic barriers or rigidities in the markets for labor and products. Among the most notable barriers or rigidities often cited are the wage replacement policies that serve to maintain a narrow gap between the best- and worst-paid employees. These policies may limit the earnings of the most skilled workers across all sectors, tempting many to find work abroad, and could be stunting the emergence of a low-wage service sector that could cater to the home market. If the wage replacement policies tend to prop up the pay of unskilled workers, services become more expensive and difficult to supply, thereby contributing to the pool of domestic savings going abroad.<sup>46</sup>

Other indications of rigidities that affect decisions to invest in Germany include barriers to starting a new business. Permits for building new facilities, limited shop hours, and regulations on new products tend to stifle competition and deter new investments. According to the World Bank's 2009 *Doing Business Survey*, Germany ranked 102<sup>nd</sup> out of 181 countries on these and other criterion.

## Reform Efforts and Political Challenges

As illustrated in the first section of this report, the economic challenges facing German policymakers include low economic growth, high unemployment, and a deterioration of public

<sup>46</sup> *The Economist*, "Rebalancing the World Economy: Germany," August 8, 2009.



finances. Also as shown, these problems are linked to the continuing costs of reunification, rising social welfare costs, and the dependency on export-led growth. Moreover, troubling demographic trends—Germany’s population has been shrinking since the 1970s and its birthrate is one of Europe’s lowest—are further exacerbating the strain on the social market economy.

German policymakers, politicians, and scholars have proposed or considered a number of reforms aimed at reinvigorating and strengthening the German economy. These include changes in social and labor policies that provide protections at the expense of a more efficient and dynamic economy, as well as reforms that would create an economy driven more by domestic demand than exports. Given the significant proportion of the German public that directly benefits from the status quo, political opposition to reforms has been and continues to be significant.

## **Past Efforts**

Successive German governments have recognized the importance of reforming the German economy to bring about increased economic growth. However, all have found it difficult to sell tough reforms to voters and vested interests. The most notable reform efforts since reunification were undertaken in 2003 and 2004 by the left leaning coalition government of the Social Democratic Party (SPD) and the Green party, under the leadership of then-Chancellor Gerhard Schröder (SPD). Schröder’s far-reaching reform program, known as Agenda 2010, aimed at boosting growth and employment and consolidating public finances through tax reforms, greater labor market flexibility, and limited cuts in state benefits and subsidies.

The cornerstone and most controversial aspects of Agenda 2010 were a series of labor market reforms, including the so-called Hartz IV reform, which sought to merge unemployment and welfare benefits.<sup>47</sup> One of the most publicized of these initiatives shortened the period for which unemployment compensation could be received by most people from 32 months to 12 months. The Hartz IV law abolished an existing program under which the long-term unemployed would receive up to 57% of their last regular net income and replaced it with less generous social assistance benefits already available to poor individuals, regardless of employment history. These changes were publically justified by the need to pare back government expenditures, but it was also hoped that the reforms would lower real wages and help create new jobs.<sup>48</sup>

Most experts agree that the Agenda 2010 reforms likely played a role in boosting GDP growth and reducing unemployment in 2006 and 2007. However, at the time of implementation, the reform program was broadly unpopular, caused deep rifts within the SPD, and arguably cost Schröder the Chancellorship. Once the reforms were implemented, political support for the SPD plummeted below 30 percent and he was forced to resign as chairman of the party. With his eroding mandate, Schröder was compelled to call an early election in 2005, which the SPD lost. Many observers believe the fall-out from Agenda 2010 also greatly affected the electoral outcome in 2005. The SPD remained in the governing coalition, but as a junior party to its long-time rival, Merkel’s center right Christian Democratic Party (CDU).

Both Merkel and the SPD appear to have taken a lesson from Schröder’s electoral defeat. Although Merkel campaigned in 2005 as a reformer promising to liberalize restrictions on

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<sup>47</sup> The so-called “Hartz reforms” were based on proposals made by a government-appointed committee of 15 experts chaired by Peter Hartz, then personnel director at Volkswagen.

<sup>48</sup> Hans-Werner Sinn, *Can Germany Be Saved?*, p. 108.

business and to unburden taxpayers, as head of a *grand coalition* government with the SPD, she adopted a cautious and modest approach to economic reform.<sup>49</sup> Merkel and her supporters argue that more ambitious reforms were not possible, given the coalition's reliance on the left-leaning SPD. However, others argue that Merkel was wary of championing unpopular reforms of the welfare system, regardless of her coalition partner. Ultimately, the CDU/CSU-SPD *grand coalition* government passed just one significant reform in the spirit of Agenda 2010, a gradual rise in the retirement age to 67. More often, with Merkel's help, the government rolled back reforms by lengthening the time for paying unemployment benefits to older workers, offering pensioners relief from rising prices, and introducing minimum wages in half a dozen industries, including postal and security services.<sup>50</sup>

## Future Challenges and Prospects for Reform

Germany's reform challenges at the broadest level include efforts to redesign the welfare state and encourage the development of a more balanced economy. Less equity and a lower level of worker protection may be needed if a higher growth path and a higher rate of employment are to be achieved. Given that Germany's population is expected to decline by 3.5 million by 2020, with a steady rise in individuals over the age of 65, the earlier the necessary adjustments are made, the more effective they may be.

Assuming that expenditures on social security programs need to be reduced, benefits may have to be redefined. This could entail a variety of changes such as increasing the retirement age or eliminating social security coverage for many small risks or conditions. Other reform suggestions to make German workers more competitive include working longer hours, substituting wage supplements for wage replacements, and shortening the period of university education before students enter the workforce.<sup>51</sup> To deal with distortions in the labor market, changes in governance have been proposed. Most of the proposals involve more decentralized ways of determining wages and job security in the marketplace.<sup>52</sup>

To deal with Germany's dependency on export-led growth, some experts believe that Germany must try to develop a more balanced economy by promoting service industries such as health care and education through tax policy and de-regulation. Yet, current political and business leaders appear united in the belief that exports must remain the foundation of German prosperity. This strategy hinges on the hope that world demand for German exports will eventually reinvigorate the German economy.<sup>53</sup> Indeed, some proponents of the German economic model challenge the notion that the economy is in need of sweeping structural reform. They point out that economists have been urging such reforms for decades during which time the economy has consistently proven its resilience and continued to sustain itself. Furthermore, the value most Germans place on the state's long-standing social welfare programs suggests that they may be willing to forgo a level of GDP growth in exchange for the increased social cohesion presumed to be brought about by such programs.

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<sup>49</sup> Alister Miskimmon and Walter E. Paterson, "Conclusion: coping with the Gathering Crisis," In *Germany's Gathering Crisis*, pp. 222-223.

<sup>50</sup> Economist, June 27, 2009.

<sup>51</sup> Horst Seibert, *The German Economy*, pp. 165, 369.

<sup>52</sup> Ibid., p. 375.

<sup>53</sup> Wolfgang Munchau, "Down and Out for the Long-term in Germany," *Financial Times*, June 8, 2009.

Despite a general consensus among economists that structural reforms to the German economy may be necessary to boost long-term economic growth, the short- to medium-term prospects for such reform appear slim. German politicians have been reluctant to advocate unpopular limits on social welfare spending at a time of economic contraction and increased unemployment. This reluctance was evident in the 2009 election campaign, during which there was very little debate over German economic policy and the need to revamp the German social welfare system or to deregulate the economy. Nor was there much debate about the need to stimulate domestic demand or nurture the growth of services.<sup>54</sup> Whether Merkel's newly elected center-right government will change this calculation remains to be seen. However, early signs suggest that an immediate need to stabilize a fragile economy, reduce record budget deficits, and cope with rising unemployment could take precedence over efforts to launch deeper structural reforms.<sup>55</sup>

### **The 2009 Election: Emerging fragmentation of the German political system?**

Since 1949, Germany's political landscape has been dominated by the country's two largest political parties, Chancellor Merkel's center-right Christian Democratic Party/Christian Social Union (CDU/CSU) and the left-of-center Social Democratic Party (SPD). One of these parties has been at the helm of every post-war German government. The CDU/CSU and SPD have, however, slowly ceded support to smaller political parties on both sides of the political spectrum—a fact illuminated by the 2009 election. Although Merkel's CDU/CSU won 33.8% of the vote, the most of any party, the CDU/CSU's total was 1.4 percentage points less than in 2005. More significantly, the SPD won only 23% of the popular vote, 11.2 percentage points less than in 2005.

The drop in electoral support for the CDU/CSU and SPD contrasted with gains for three smaller parties. The center-right, free market-oriented Free Democratic Party (FDP) and the far-left Left Party (*Die Linke*) each achieved their best ever electoral results, winning 14.6% and 11.9% of the vote, respectively; the Green Party won 10.7% of the vote.

Merkel and the CDU/CSU formed a government in coalition with their preferred and traditional coalition partner, the FDP. Nonetheless, observers believe the growing popularity of the FDP and the Green Party, and the emergence of The Left Party, a successor of East Germany's communist party, could signal an emerging fragmentation of the German political system.

In particular, the ascendancy of the populist Left Party appears to be putting pressure on the SPD to redefine itself, either as a center-left or more left wing party. The degree to which the FDP will influence the policies of the new government remains to be seen, but differences between the CDU/CSU and FDP, particularly on economic policy, have emerged. According to some analysts, this political realignment could potentially undermine German policy and leadership on a host of international issues, thereby making it more difficult for the United States and other countries to work with Germany on resolving mutual challenges.<sup>56</sup>

A number of factors may account for the decline in popular support for the CDU/CSU and SPD, including public dissatisfaction with the *grand coalition* government of 2005-2009, during which the traditional rivals governed together in an arrangement some might compare to a U.S. Administration run jointly by Democrats and Republicans.

In her first address to the German parliament since being re-elected in September 2009, Chancellor Merkel bluntly stated that she expects the German economy to face increasing challenges in the coming year, including higher unemployment. She said her government's primary goal in addressing this challenge is to spur economic growth: "without growth, no investment; without growth, no jobs; without growth, no money for education; without growth, no support for the weak."<sup>57</sup> The government's prescription for such growth appears to be a mix of

<sup>54</sup> Carter Dougherty, "Debate on Economy Muted As Germany Prepares To Vote," *New York Times*, September 25, 2009.

<sup>55</sup> *The Economist*, "A Black-Yellow (and purple) Triumph," October 3, 2009.

<sup>56</sup> Bruce Stokes, "German Elections Presage Troubles," *The National Journal*, October 3, 2009.

<sup>57</sup> "Deutschland zu neue staerke fuehren," address by Chancellor Angela Merkel, German *Bundestag*, November 10, 2009. Available, in German, at [http://www.bundestkanzlerin.de/Content/DE/Artikel/2009/11/2009-11-10-\(continued...\)](http://www.bundestkanzlerin.de/Content/DE/Artikel/2009/11/2009-11-10-(continued...))

tax cuts, continued government spending to keep unemployment down, and a longer-term effort to rein-in such spending. The Merkel government has extended the *Kürzarbeit* program by which it subsidizes employers to keep part-time workers and has said it will implement tax cuts worth EUR 24 billion (about \$36 billion) for companies and the middle class over the next four years. In advocating a balance between market-led growth and strong social spending, Merkel seems poised to continue to advocate economic policies based on the traditional social market economy model. Longer term structural reforms are not expected to feature prominently in the current government's plans.

## **U.S.–German Economic Policy Strains and Differences**

Given weak economic growth and the rising costs of maintaining generous social security programs, Germany faces budgetary constraints, as do many other industrialized countries. With dwindling economic and financial resources, Germany arguably has become less willing to compromise on matters of potential economic advantage.<sup>58</sup> In this regard, Germany's domestic economic challenges could limit its policymaking flexibility.<sup>59</sup> This has affected not only the economic and trade leadership role that Germany traditionally has played in Europe, but also its position on issues that directly affect U.S. interests. These include different approaches in dealing with the global economic downturn and economic sanctions.

### **Trade Leadership**

Germany in the past has been a key ally of the United States on international trade issues. Given its heavy export orientation and dependence on the international economy, Germany traditionally has been a strong voice for trade liberalization, both within the EU and the world trading system, as well as the decisive swing vote between French and British views on trade policy. Every successful multilateral trade round in the past has depended on Germany to use its bilateral economic clout to influence the policies of more inward-looking countries in Europe. German support for a liberal trade policy and generalized opposition to blatantly protectionist proposals, with few exceptions, has been provided by the major political parties and leading stakeholders in the private sector.<sup>60</sup>

Yet, in recent years, German leadership of the free trade bloc within Europe has weakened. It was first compromised in the 1990s' Uruguay Round of multilateral trade negotiations when then-Chancellor Helmut Kohl backed restrictive agricultural trade proposals the French government was advocating in an effort to advance European integration. The trend solidified in 2002 when then-Chancellor Gerhard Schröder agreed with France on setting parameters for agricultural liberalization within the EU. The same budget agreement on reform of the Common Agricultural

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regierungserklaerung-merkel.html; Judy Dempsey, "Merkel Says Worst Still Ahead in Germany," *New York Times*, November 11, 2009.

<sup>58</sup> Alister Miskimmon and James Paterson, "Conclusion: Coping With the Gathering Crisis," p. 223.

<sup>59</sup> Ibid., p. 220.

<sup>60</sup> Andreas Falke, "The Internationalisation of the Germany Economy," p. 210.

System (CAP) continues to serve as a constraint to achieving a breakthrough in the on-going Doha Round of trade negotiations under the World Trade Organization.<sup>61</sup>

Germany is also providing less unconditional support for European integration than it used to, particularly when the European integration under question entails international trade pressures from increased labor mobility and low-wage service providers. This was first evident in the Schröder government's decision to demand transition periods of up to seven years before granting full labor mobility to the citizens of new Central and Eastern European EU member states. Another instance of German opposition to further market liberalization in Europe involved rejection of the European Services Directive. This directive would have opened highly protected low-wage services (such as cleaning and transport) and high-wage services (such as public infrastructure and health) to competition from the rest of the EU—a proposal that was opposed by unions and the left-wing of the SPD.<sup>62</sup>

The German government announced in May 2009 that it was keeping labor restrictions in place on workers from the eight Central and European countries that joined the EU in 2004. The controls had been expected to be rescinded this year, but Germany invoked a clause allowing two more years in case of “serious labor market disturbance, or threat of them.” The idea that free movement of East European labor would threaten “serious disruption” is questionable given that Germany still has shortages of skilled labor in some areas.<sup>63</sup>

Chancellor Merkel and the previous *grand coalition* government faced criticism from within Europe and elsewhere for its role lobbying General Motors (GM) to sell a majority stake in its Opel unit to Magna International, a Canadian-Austrian group, and Sberbank, its Russian partner. In May 2009, the Merkel government approved EUR 4.5 billion (about \$6.7 billion) in loan guarantees to enable the takeover in return for which Berlin reportedly sought a pledge that Magna would not close factories in Germany where Opel employed some 25,000 workers, half of its 50,000 employees in Europe. The deal led to speculation that plants in Belgium, Spain, and the UK would be closed in order to keep the German plants open. This prompted critics, including the Belgian government, to cast Germany's action as “protectionist” and raised questions as to whether the sale would conform to the European Union's rules on permissible state aid to companies.<sup>64</sup>

On November 3, 2009, GM angered German officials by deciding to maintain its European business and pull out of the Berlin-backed proposal to sell Opel. Chancellor Merkel and others sharply criticized the decision, which they fear could lead to job losses in Germany. GM will reportedly seek financial support from European governments to realize its plans to restructure Opel. However, the German government is expected to show little support for any deal that involves significant job losses in Germany.<sup>65</sup>

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<sup>61</sup> Adam S. Posen, “The United States Needs German Economic Leadership,” *Peterson Institute for International Economics*, Policy Brief PB06-1, January 2006.

<sup>62</sup> Andreas Falke, “The Internationalisation of the German Economy,” p. 219

<sup>63</sup> *Economist*, “Those Selfish Germans, As Germany Becomes Normal, It Looks A Bit More National and A Bit Less European,” April 30, 2009.

<sup>64</sup> Matthew Saltmarsh, “Charges of Protectionism Great G.M.'s Deal on Opel,” *New York Times*, September 9, 2009.

<sup>65</sup> Andrew Ross Sorkin, “Germans Frustrated Over G.M. Keeping Opel,” *New York Times*, November 4, 2009; Chris Reiter, “GM Says Opel Reorganization Still Requires State Aid,” *Bloomberg*, November 13, 2009.

## Responding to the Global Economic Downturn

The United States and Germany have differences over the causes and appropriate policy responses to the global economic downturn. Obama Administration officials have criticized Germany for what some consider a relatively cautious response to the crisis. They have also taken aim at a perceived German reluctance to support common European approaches to fixing the banking sector, to join in coordinated cooperative spending programs, and to deal with the Central European financial crisis.<sup>66</sup>

German political leaders have vigorously defended their policy response to the crisis, arguing that they have taken substantial action to stimulate the German economy. They have also urged the United States and others to commit to an “exit strategy” from fiscal stimulus measures which they feel could lead to potentially debilitating deficits and dangerous inflation. Moreover, they have argued that such domestic spending measures will do little to address the root causes of the crisis, which they tend to view as inadequate regulation of global financial markets. Indeed, many in Germany view profligate consumption and unregulated markets in the United States and UK as having been the cause of the global crisis. These critics argue that the downturn could have been avoided had others behaved as prudently as Germans by cutting wage costs and public expenditures.

Many U.S. policymakers and politicians counter that Germany shares responsibility for the downturn because it has run-up large current account surpluses over the last six years. These surpluses, combined with those run by China and Japan, funneled excess savings to the rest of the world.<sup>67</sup> Under this view, if the United States had not decided to run an accommodating monetary policy in the 2001 to 2002 period, which contributed to the expansion of easy credit and the financial crisis, aggregate global demand would have fallen short of supply and unemployment would have increased worldwide. The imbalances in the global economy, according to this view, required that the United States serve as the world’s “consumer of last resort” to keep the world economy growing.<sup>68</sup>

Many U.S. observers have argued that a reduction of Germany’s large current account surplus could be a crucial component in the global rebalancing that will be necessary to bring the world economy back on a more sustainable growth path. As part of this process, domestic demand in Germany must increase faster than it has in the past. German leaders tend to reject this line of argument, citing concern that increased spending would impose long-term debt on a shrinking population and arguing that the basic features of their export-oriented and social market economy model are solid.<sup>69</sup> Even though Chancellor Merkel, at the September 2009 G-20 meeting in

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<sup>66</sup> The United States viewed the Central European financial crisis as primarily an internal European matter, leaving it to the Germans, French, Swiss, and Italians to bail-out their own banks. But Germany, which had somewhat less exposure than other European countries, reportedly helped block a European bailout, on the grounds that the IMF should be used for this purpose. Many in the United States interpreted this as a German effort to secure U.S. and Asian money to deal with a European problem.

<sup>67</sup> The top three current account surplus countries are China, Japan, and Germany. From 2002-2008, China accumulated surpluses totaling \$934 billion, Japan \$968 billion, and German \$788 billion. In a deep recession, some analysts maintain that failure of the current account surplus countries to increase domestic demand in a substantial manner is a form of beggar-thy-neighbor policy as they import demand from the rest of the world.

<sup>68</sup> Sebastian Dullien, “After the Election: Germany Will Continue to Obstruct Global Economic Restructuring, *AICGS*, June 2009.

<sup>69</sup> Stormy-Annika Mildner and Mark Prentice, “Germany’s Social Market Economy: Old Wine in New Bottles?” In (continued...)

Pittsburgh, signed the leaders' statement pledging to adopt the measures needed to "lay the foundation for strong, sustained, and balanced growth in the 21<sup>st</sup> Century," most German leaders appear to reject the idea that global economic recovery requires fundamental changes in the German way of doing business.<sup>70</sup>

Although it was widely criticized for an initially cautious domestic response to the global economic crisis, Germany has implemented a range of policies to stimulate economic growth and to support the German private sector. In December 2008 and January 2009, the parliament passed domestic stimulus measures totaling EUR 71 billion (about \$105 billion) for 2009 and 2010. German officials also emphasize the positive effects on domestic demand of so-called "automatic stabilizers," public expenditures for guaranteed social welfare benefits such as unemployment programs. In total, they estimate that Germany's fiscal stimulus measures amount to about 1.5% of German GDP.

Unlike the U.S. focus on increasing consumption, Germany's stimulus packages have been geared towards creating incentives for private investment and infrastructure projects, and for stabilizing exports. Germany's high household savings rate (11.4% of disposable income in 2008 compared to 1.8% in the United States) has provided the justification for not providing tax breaks to stimulate consumption. However, the new Merkel government has pledged a series of tax breaks for companies in the hope that this will decrease unemployment, among other things. Berlin has also focused on tightening financial regulation.

While most applaud Germany for adopting significant stimulus measures, there is still a view among some U.S. policymakers that Washington is shouldering the burden of getting the world economy moving again. Related to this concern is the perception that heavily export dependent Germany could use demand created by the United States and UK to surge German exports into these countries as demand rises. Germany would thus benefit from U.S. domestic stimulus as the United States adds to its domestic debt.<sup>71</sup>

Merkel has committed her new government to restoring growth to the German economy. The governing coalition has agreed to pass significant tax cuts for German businesses and the middle class in the coming four years. However, any additional and broader fiscal spending measures are considered highly unlikely because of a strong desire to prevent future inflation. The new government will also be hindered in any effort to support global rebalancing by increasing German domestic demand by new budget rules approved by the parliament this year. The new rules, written into Germany's constitution, the Basic Law, set a legally binding deficit ceiling to take effect in 2016. Under the constitutional amendment, the federal deficit will not be allowed to exceed 0.35% of GDP and individual states will be constitutionally barred from running deficits after 2020. Even if the rule proves impractical and needs to be changed in the future, in the interim, according to one analyst, "Germany will again try to be more austere than the rest of the world."<sup>72</sup>

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(...continued)

*Germany's Founding Pillars at 60: Future Challenges and Choices*, AICGS, The Johns Hopkins University, 2009, p.16.

<sup>70</sup> Bruce Stokes, October 3, 2009.

<sup>71</sup> George Freidman, "The United States, Germany, and Beyond," *Stratfor*, March 30, 2009.

<sup>72</sup> Sebastian Dullien, p. 4.

## **Economic Sanctions**

The United States and Germany have in the past had policy differences over the use of economic sanctions as a foreign policy tool. Germany has traditionally been reluctant to use economic sanctions, despite U.S. urgings. Those in Germany who oppose economic sanctions tend to question whether sanctions are the most effective means to achieve foreign policy aims. They argue, for example, that sanctions have at times proved counterproductive by serving to unite citizens in the targeted country against those implementing them. They add that without strong multilateral backing, sanctions are likely to fail; if only a few countries continue to trade with the targeted state, the implementing countries lose their leverage, the argument goes.

U.S. and other critics contend that Germany's position on sanctions is greatly influenced by commercial interests and the economy's strong dependence on industrial exports. German business groups often oppose calls for economic sanctions and their views are thought to carry considerable political weight, particularly with the right-of-center CDU and FDP parties. For example, industrial lobbies have reportedly played an important role in demanding that German foreign policy elevate commercial relations as a priority factor in Germany's policies towards Russia and China, two of its fastest growing markets.<sup>73</sup> Observers highlight German policy toward Iran as the most pertinent example of this influence.

As a member of the so-called EU-3 (France, Germany and the United Kingdom), Germany has been at the forefront of EU and U.N. efforts to prevent Iran from developing nuclear weapons. However, of the EU-3, Germany has reportedly been the most reluctant to endorse more stringent sanctions against Tehran. Berlin continues to face pressure from the United States and others to limit civilian commercial ties with Iran. Along with Italy and China, Germany remains one of Iran's most important trading partners. Although German exports to Iran dropped 25% between 2005 and 2007, they reportedly grew 10% between 2007 and 2008. Germany has in the past argued that sanctions without Russian and Chinese support would both be ineffective and hurt the German economy.

On the other hand, Germany's two largest banks, Deutsche Bank and Commerzbank AG, have withdrawn from the Iranian market and officials in Berlin report that new export credit guarantees to companies doing business in Iran have dropped by more than half since 2005.<sup>74</sup> While some interpret weakening German-Iranian economic ties as a sign that Berlin is intent on increasing economic pressure on Tehran, others argue that German-Iranian trade remains robust and that politicians in Berlin are unlikely to seek further cuts in commercial ties.<sup>75</sup>

Currently, German officials reportedly are more inclined to impose economic sanctions on Iran than they have been in the past, but simultaneously question their effectiveness. Public support for stronger actions if sanctions fail is also weak in Germany. According to one poll, only one in five Germans back the option of using military force to stop Iran's nuclear programs if diplomacy fails, compared to one in two Americans.<sup>76</sup>

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<sup>73</sup> Charles Grant, "Unilateral Germany Threatens to Weaken Europe", *Financial Times*, December 14, 2008.

<sup>74</sup> Interviews with German officials, June-July, 2009.

<sup>75</sup> See, for example, "German Business with Iran Said to Flourish Despite Trade Embargo," *Handelsblatt*, January 26, 2009. Accessed through OpenSource, EUP20090126085003.

<sup>76</sup> Bruce Stokes, *National Journal*, October 3, 2009.



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