

A Glum 2015 Scenario—If...

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In examining whether Germany's less than stellar economic performance since the mid-1980s will continue, three questions must be posed:

- Will Germany be a force for intergovernmentalism and statism—or for federalism and liberalism—in the European Union?
- What will the economic agendas of the major German political parties look like?
- Will anything erect a hard budget constraint on—or prompt an exit of savings from—the German welfare state?

Without economic reform that goes beyond any now being sought, Germany is likely to pursue statist protections in the EU, suffer from an increasing vacuum of ideas in domestic policy debate, and thus sink into further stagnation. As a result, Germany in 2015 is likely to be a meaner, shrunken version of its current self. Outright economic crisis, however, is extremely unlikely—and this leaves the impetus of reform up to political leadership.

Until recently, Germany has been the swing vote on most economic issues in the EU between the more sta-

tist approaches (France, Italy) and the more liberal approaches (the United Kingdom, the Netherlands). This has reflected both Germany's middle position ideologically on economics and its status as the major net contributor to the EU budget. Americans often fail to appreciate how much of a force for internal liberalization the European Commission and Brussels-based decisions have been, and how dependent those measures have been on German backing. Lately, however, Germany has leaned the other way, for example on takeover rules and in perpetuating the huge subsidies of the EU's Common Agricultural Policy (CAP).

This approach reinforces, and is reinforced by, Germany's relationship with France. Germany's role in these Brussels debates holds a mirror to Berlin's willingness to sacrifice its national prerogatives for the sake of European integration: the more federalist Germany is, the more it tends to support liberal or standardizing economic policies; the more "intergovernmentalist" Germany becomes, the more it tends to support logrolling deals between national governments that preserve economic protections.

Over the next few years Europe will be making constitutional decisions, both formally and informally, as it goes through the process of ratifying the new EU constitutional treaty and adjusts to its enlarged membership of 25. If Germany chooses to go down a statist road, emphasizing its relationship with France as the "European en-

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gine,” it will most likely cut back on its net contributions to the EU, on the generosity of transfers (and, more importantly, degree of integration with the new entrants), and in general set back economic liberalization in Europe. Conversely, if Germany reverts to its tendencies of prior decades and supports a more federalist Europe (albeit with side-payments to France), integration will increase pressures for economic liberalization and constructive standardization—and also lead to a rationalization of the CAP. This would have critical implications both for the reform process within Germany and for the impact of last May’s EU enlargement.

The federalist/liberal course must be seen as the more positive one, since it would be more conducive to economic growth, stability, and support for international economic institutions. But either way, a clear tendency set up in the next two or three years would have lasting effect. By 2015 the trend will have decisively shaped European economic and political development. The choice is Germany’s.

Agenda 2010

The Agenda 2010 proposals for economic reform of Germany’s Social Democratic-Green government are significant and positive, taken on their own terms. Yet they seem to be petering out. Agenda 2010 could actually pass the legislature and improve economic performance in the next recovery, and still the public would only observe its adjustment costs. The conservative-liberal opposition’s proposals

seem to consist of the same reform policies, with a somewhat more anti-labor tinge. Despite the recurring statements of “crisis” in the German economy, however, neither coalition’s agenda has much support.

What is striking is the absence of an overall economic concept in any of the parties or coalitions. The Christian Democratic Union invokes memories of Ludwig Erhard’s *Ordnungspolitik* that backed Germany’s post-World War II “economic miracle.” But they are unwilling to take on real reform by addressing the serious impediments to competition and efficiency in the business and finance sectors that would trim their supporters’ privileges—and the CDU’s sister party of the Christian Social Union finds it even harder to cross its small-business constituents. In theory, the opposition Free Democrats could raise the banner for liberalization high, but their years of compromise without results in earlier center-right governments have largely discredited their promises, and they have no real constituency once international business discards them.

The Social Democrats talk about reform, but quickly hit the limits on how far they can drag their party loyalists toward a basically alien economic view. The Greens have the best shot at a consistent *Weltanschauung* that reconciles meaningful economic reform with core values. Their belief in sustainability (including across generations), their grudging experience with letting regulation replace outright environmental edicts, and their libertarian streak make them able to

tell a reasonable story about broad-based reform that extends beyond labor to guilds and banks. Yet they remain a small party.

This vacuum of economic ideas in the political debate is likely to become increasingly evident over the next decade, and there is genuine uncertainty about what will fill it. The outlook, even after any future change of government, is for increased awareness of Germany's relative decline—but a failure to respond to it, and rising domestic malaise and perhaps populism.

Still, No Outright Crisis

A wealthy country, even one with large ongoing transfers of income (internally and intergenerationally) and mounting government debts, can go a long time before confronting its economic problems, as Japan has definitively demonstrated. Discussions of sustainability and overly generous welfare states, motivated by aging populations, have relevance for today only if either markets or policymakers are forward-looking and take these far-off events into account. They are not and do not. Passive domestic savers can be counted on to finance such transfers until there is obvious direct expropriation, such as high and rising inflation levels, interference with access to savings, or major cutbacks in social programs. This gives politicians an incentive to maintain, if not increase, their programs and explains why markets can continue to make money treating the programs as given. For Germany in 2015, there is a high likelihood that this situation will persist.

The high likelihood is less than 100 percent, though. Thus, when forecasting Germany's future, one has to take into account the "peso problem" of the small probability that there could be a transformative event, and the uncertainty about what drives that probability. For Germany, such an event might be a loss of confidence in the German fiscal situation that led to a hard budget constraint and concomitantly a flight of savings from Germany. In real terms, the government might renege on a significant share of current social-expenditure obligations (since the European Central Bank would presumably foreclose any inflation option, were that to be considered). This would severely disrupt German economic performance and have a destabilizing political impact. It would most likely also have significant spillover effects on employment and trade with the rest of Europe and on global debt and currency markets.

In the narrowest economic terms, one would expect this probability to increase on average over time as the fiscal burden rises, debt accumulates, and outlays increase. Germany in 2015 is far more likely than Germany in 2005 either to have experienced such a crisis or to incur one. Even while the absolute probability of such a crisis will remain quite low, the higher the probability becomes, the more it will tend to influence contemporaneous economics and politics.

Going beyond the trends, one can list exogenous shocks that might suffice to induce such an event (or rather raise the probability that such an event might happen to the point where a

self-fulfilling logic kicks in, with money leaving). One such shock could be an increasing divergence of performance between Germany and other economies within the eurozone that tends to make monetary policy more inappropriate for German demand while attracting more capital abroad. Another could be a sharp inflow of migrant workers who were seen (justifiably or not) as burdening the welfare state without (as is more likely if properly handled) actually supporting older workers. A third might be a situation in which generational politics came to the fore as at times in the 1960s and 1970s, with direct challenges to the privileges of older workers and retirees. Yet another might be some form of catastrophe—natural disaster, terrorist onslaught, environmental collapse—that suddenly required a significant and sustained jump in public expenditure. These are admittedly unlikely, and serve to demonstrate how robust the German stagnation is likely to be to outside developments.

Robust Stagnation

Wealthy countries tend to stay on the track they are on. They are rich enough to avoid crisis—particularly if they are in balance or surplus on average rather than in current account deficit (and therefore are not borrowers from abroad). While Americans talk a lot about the unsustainability of the European and other welfare states, they tend to overlook two facts: 1) these welfare states have already been sustained in some cases for more than a century; 2) it is the US that is the out-

lier both in the relative paucity of its social transfers and the extreme variability of its economic growth rate. The safest bet for almost all developed economies other than the US is that tomorrow's structures and performance will look very much like today's.

For Germany in particular, the conjunction of actors having “veto points” over policy (as demonstrated in blockage of Agenda 2010) and the commitment to gradualism and collaboration in the country's economic and political structures tends to add stability. This is intentional; by design, the German political economy has been about transferring income to promote social stability, particularly in the postwar period. Despite all the contrary rhetoric of transformation, that was the goal of all western German decision-makers (government, business, and labor) for reunification, and it remains the underlying goal even of Germany's commitment to European integration.

There will be minimal further convergence between eastern and western German income levels. When German economic unification took place in 1990, the government of Helmut Kohl promised a prosperous and equal economic future for the “new *Länder*,” with incomes converging with western German levels within a decade. Income levels are ultimately what count in judging an economy's development: they represent purchasing power as well as productivity. If a region or economic system is backward, it will be defined as such by its income level, and within a unified welfare state any persistent gap in income level will have to be compensated for.

East-West Gap

That is, of course, what happened between the old and new *Länder*. The huge transfers (initially as much as 7 percent of German GDP, more recently around 4 percent) from west to east were motivated, though, by an unholy alliance of the Kohl government and west German unions against east German workers. The government did not want massive westward migration within its borders, and so had an interest in paying people to stay in their home regions; the DGB (umbrella labor association) and its member unions did not want low-wage competition against their jobs and employers. Thus, they agreed on the popular strategy of exchanging Ostmarks for Deutsche Marks at an unrealistic 1:1 ratio and reaching wage settlements that promised eastern workers more than 60 percent of western wages initially, with a rapid rise toward western wage levels through collective bargaining. In combination, these two factors completely overpriced east German production. The result has been persistently high unemployment and underinvestment in eastern Germany, with huge dependencies on government-funded work programs and social benefits.

This situation will improve only slightly between now and 2015. The only way for income levels to converge is for productivity in eastern Germany to rise to western levels – and that requires investment in and turnover of both human and physical capital. There has been some of that in the ex-German Democratic Republic (GDR),

with beneficial results. Some of the government funds that have gone into eastern Germany have been in the form of useful infrastructure projects (such as new telecom lines and transportation networks). Over time, some older east German workers have been retrained, and more have left the workforce or retired, while an increasing proportion of younger eastern Germans have received western standards of education and job experience. Nonetheless, this has been an uphill battle, given the huge gap in productivity levels; east Germans actually began 1991 with average productivity levels only one-third those of their west German counterparts, and the terms of monetary and labor market unification erected barriers to adjustment.

The current gap, with emptying regions in eastern Germany and income levels 60-70 percent of those in the west, will remain well past 2015. In recent years the growth rate in western Germany has even exceeded that in the east, widening the gap. Even if the most competitive parts of eastern Germany were to grow 2 percent faster annually than western Germany for the next 10 years (a very optimistic assumption), only half the income differential would be closed; in the more likely event that the east-west growth differential averages 1 percent, eastern incomes will make up only one-quarter of the difference.

We also know that the biggest jump in convergence tends to happen in the first few years of economic integration. That is when the largest gains are captured, through the release of labor and savings from inefficient uses; the

adoption of market incentives; the movement of capital to the most obvious investment opportunities; the higher marginal returns to the first re-employed pieces of capital and labor; the provision of needed infrastructure; and the introduction of new technologies. In other words, the biggest catch-up of eastern to western income and productivity levels has already occurred. But we know from the experience of the American South, the Italian South, the British Midlands, and the north island of Japan that the process is extremely slow, even when this initial burst is taken into account. The process is still slower, the less mobile a country's workers are. And the process is slowed still further—and labor mobility reduced still more—by the political responses of a government to provide social assistance. Obviously, both of these conditions are apparent in Germany.

Still an Exporter, But So What?

Germany in 2015 will retain export competitiveness, though this will not matter too much. To use Paul Krugman's terminology, competitiveness is a "dangerous obsession" for pundits and policymakers. No matter how many times economists try to point out that nations do not compete as units for economic benefits (even if in some specific arenas policies promote or restrict specific firms from specific countries), the old concern keeps reappearing. What is important to recognize is that neither export performance nor high-tech production is a sufficient statistic for economic well-

being. Economies can grow steadily even when they are net importers for extended periods. In fact, as the US and many developing countries demonstrate, there tends to be a positive correlation between growth and importing capital and goods. And economies can have businesses that remain at the top of various industries and export a great deal without generating growth (as in Japan in the 1990s).

It is a persistent myth that the German 1950s' economic miracle occurred because of the expansion of exports (which is partially the case at best), and that Germany's economic model succeeded by being export oriented (which is completely false). The bulk of German growth until the 1970s was the result of catch-up and rebuilding after the war, with physical capital accumulating to keep up with the human capital and savings on hand, particularly given price stability. It had nothing to do with export orientation, handworker skills, the *Mitbestimmung* say of labor in management, long-term investor time-horizons, or cozy relationships between firms and their banks. Thus, German economic performance is not determined by the rise or fall of this "German model," even if the alteration of specific parts of it may bring about various efficiency gains. Germany's famous performance as one of the world's great exporters really has little impact on anything that matters.

What is of critical importance is that Germany has been in current account balance or surplus throughout the postwar period right up to the present day. This results not from export

successes, but from the simple fact that Germans as a nation save more than they invest. Economists have no clue about how to explain national differences in savings rates, and so one has to take it as given (culturally or by deep institutions) that German savings have fluctuated around a high level. The excess of savings over investment, however, results in part from the low returns on capital in the German economic framework, which discourages domestic investment at the margin. So while Germany's excess savings represent an advantage in that the government has no foreign currency debt, little foreign ownership of its debt (outside of central banks), and no need for external financing, it also signifies a disadvantage in attracting investors. In something of a parallel to the situation in respect to the German welfare state, stability in the currency has been gained at the expense of shutting out productive factors (in this case, investment and new forms of corporate governance).

More Economic Feuds

There will be mounting contention between Germany and the US, and the EU and the US more broadly, however, about economic leadership by sector. This follows not from fundamental "imperatives" of competition or even the pursuit of national welfare by governments. This will occur because Germany, like the US and most other OECD economies, is moving its way up the value-added ladder in production. As a result, there is more and

more profit to be gained by erecting barriers of standards or accreditation or normalization or brands and the like.

With the rise of the sizable single European market, there is a rivalry to set standards to compete with the US; previously, having won the war and having the larger domestic market, the US was able to set standards in most areas, and its companies reaped the rents from monopoly or at least first-mover and/or tailored positions. Now, in areas ranging from Galileo navigational technology to environmental regulations to national champions in fast food to service sector preferences for locally accredited medical professionals, the EU is setting up standards to compete with the US.

To the degree that Germany pursues an intergovernmental-statist approach within the EU constitutional and policymaking processes, Europe will push harder against the US in this zero-sum manner. This will over time add to Germany's export share and profitability in various industries, while losing some (probably less overall) in others. The primary effect on Germany's overall economic performance is likely to be negative if business investment is driven by pursuit of protected markets rather than global competitiveness.

If one puts together these last two projections—that there will be no transformative boom in Germany from eastern German convergence toward western income levels, and that political attention will focus on sector-by-sector "competitiveness" transat-

lantically, while hurting overall German performance—it is clear that nothing is likely to raise German growth rates significantly by 2015. Meanwhile, the smaller and more backward economies in the EU have more low-hanging fruit to harvest in terms of reforms and catching up and also have more friendly demographic profiles, and should therefore attain higher average growth rates than the larger, more advanced economies (Germany, France, Italy). Even if the accession economies do not catch up in income levels through a boom, they will still grow faster than Germany for the foreseeable future.

Macroeconomic policy in the eurozone is likely to exacerbate this situation. The European Central Bank is constrained by international treaty to pursue a mandate of price stability, defined as a eurozone-wide inflation rate. Normally, transition or emerging market economies (like the accession countries and arguably, still, Greece and Portugal) will have higher inflation rates than developed economies as their traded goods sectors gain in productivity much faster than their domestic service (non-traded) sectors, driving up wages in the common domestic labor market. The present asynchronization of most current Eurozone's economies with the cycle in Germany—i.e., they are ready for monetary tightening (e.g., in Ireland) at the time that Germany needs easing or is in a recession—is likely to persist, since any tightening by the ECB now will cut off the current German recov-

ery. These two factors suggest that Germany on average will have consistently lower inflation than the mean eurozone rate, and so can be expected to have demand growth limited by a tighter monetary policy than is domestically appropriate.

The likely prognosis for 2015, then, is that the EU will have a statist hard core, and that Germany then will look a lot like Germany now—except that everything will be a little more run-down. There will be not many young people outside of Berlin and Munich, so the cities will seem less lively. There will be many illegal immigrant communities in suburbs around the cities. And there will be a lot of queues everywhere—particularly for medical care and for services—though still nothing to compare with the old GDR. The former GDR *Länder* will remain far behind the living standards of the west, twenty-five years after economic reunification. German businesses, particularly small- and medium-sized stores and companies, will remain ubiquitous; foreign brands and multinational companies will be no more common than in 2004.

If Schröder pulls off Nixon-goes-to-China on Agenda 2010 and extends that agenda, or if the CDU's Angela Merkel proves to be Thatcher, this fate could be avoided—but that is a lot to gamble on.

On present trends, think New York City in the 1970s as opposed to the late 1990s, and you have Germany 2015—but moving in the wrong direction.