Transatlantic Relations Program

ISSUE BRIEF

THE ATLANTIC COUNCIL OF THE UNITED STATES

The German Locomotive:
Can It Drive The European Economy?

by Frances G. Burwell and Jan Neutze
with Richard Burt, Jackson Janes, Stephen J. Silvia, and Bruce Stokes

This essay is based on a series of programs recently organized by the Atlantic Council of the United States and focused on the German and European economies. In June 2006, the Council organized an expert delegation, led by Council Director Richard Burt, that visited Germany to assess the status of economic reforms a few months after the Grand Coalition took office. In October, the Council brought together experts on the German economy to update this assessment and to discuss the conclusions at a conference with a Washington audience. This essay also draws on an Atlantic Council workshop on "The European Economy: Challenges and Future Prospects."

This Issue Brief is part of an ongoing project on "Transatlantic Leadership in the Global Economy" which combines a series of efforts focused on analyzing the transatlantic economic relationship.

For more information on the project, please visit www.acus.org.

Chancellor Angela Merkel at the AMD micro-chip factory in Dresden, Germany

During the second half of 2006 and in early 2007, the German economic engine seemed to gain speed, moving into recovery after several years of stagnation. Whether this recovery is sustainable is still unclear, however. With its reliance on exports, Germany remains vulnerable to any downturn in the global economy. Nor is it yet clear that the recent upswing will result in long term job growth and increased consumer spending. To reinforce

April 2007

THE ATLANTIC COUNCIL
OF THE UNITED STATES
1101 15th Street, NW - 11th Floor
Washington, DC 20005
Tel. (202) 778.4968; Fax: (202) 463-7241

Mission

The Atlantic Council promotes constructive U.S. leadership and engagement in international affairs based on the central role of the Atlantic community in meeting the international challenges of the 21st century.

The Council embodies a nonpartisan network of leaders who aim to bring ideas to power and to give power to ideas by:

– stimulating dialogue and discussion about critical international issues with a view to enriching public debate and promoting consensus on appropriate responses in the administration, the Congress, the corporate and nonprofit sectors and the media in the United States and among leaders in Europe, Asia and the Americas;

– conducting educational and exchange programs for successor generations of U.S. leaders so that they will come to value U.S. international engagement and have the knowledge and understanding necessary to develop effective policies.

Transatlantic Relations Program

The Program on Transatlantic Relations promotes dialogue on the major issues that affect the evolution of the transatlantic relationship. At the heart of the program is the conviction that a healthy transatlantic relationship is an essential prerequisite for a stronger international system. The Council seeks to strengthen the transatlantic relationship by addressing specific areas of policy differences, identifying areas of potential cooperation, and building the personal networks and mutual understanding that form the basis of an effective partnership.

For further information on the Transatlantic Relations Program, please call (202) 778-4990. Information on Atlantic Council programs and publications is available at www.acus.org. Requests or comments may be sent to the Atlantic Council at info@acus.org this recovery, the chancellor should go beyond an economic policy based on balancing the budget and reducing corporate taxes. She should focus now on creating more flexible conditions of employment, so that more workers can be hired and companies can expand, and should work with German business to develop the successor industries to today's export champions. Her government must also rethink the failed policy of subsidizing the eastern Länder, and take steps to deal with the long term challenges of an aging workforce and an education system that does not produce workers with the right skills. Chancellor Merkel knows that coping with globalization will require a liberalized economy with more freedom and flexibility for its workers and its companies. To reach that goal she must:

— *Overcome the political stalemate imposed by the Grand Coalition.* The chancellor may have missed the early opportunity to push for greater change that was provided by her initial popularity and the buoyant national mood around the soccer World Cup. However, following a period of sinking approval ratings during the summer and fall of 2006, the good economic news toward the end of last year has given her more credibility. And stark criticism by the business community for not doing enough may even help her win sympathy, if not allies, on the center left, as demonstrated by a 14 percent increase in approval ratings from November 2006 to February 2007. Nonetheless, she will only succeed in pushing the Grand Coalition into action if she can win over a public that is largely unconvinced of the need for further liberalization. In Germany's consensus politics, she must use the recent economic successes to build wider support for more change.

Vital to Germany's export industy: container port in Hamburg

— *Position Germany as a leader in the European economy.* Germany is far from the days of the 1960s and 1970s, when it was truly the economic locomotive of Western Europe. But the size of its economy — Germany alone accounts for one third of the eurozone's GDP — makes its sluggishness or growth decisive. Despite economic success in some of the smaller states, the eurozone saw only modest growth until Germany began to move forward. Now the question is whether a few others, especially France and Italy, will be encouraged enough to launch their own reform programs. Only a German chancellor with a stronger, more liberal domestic economy will have the credibility to push her colleagues to reduce the regulatory barriers to a true Single Market, as envisioned in the EU's Lisbon Agenda. With Germany in the EU presidency for the first half of 2007, and leading the G-8 for the entire year, the chancellor has a "bully pulpit" for encouraging all member states toward economic policies that will fuel a recovery. But this moment will be brief — with Portugal, Slovenia, and France holding the next presidencies, it is up to Chancellor Merkel to put Germany and Europe on the path to a stronger economic future.

In short, this year is a critical one for Chancellor Merkel to set the economic tone not only for Germany but also for Europe. In some countries, continuing high unemployment will boost pressures to protect jobs from both outsourcing to Asia and immigrant labor. Across the EU, politicians and the public see foreign investors as "locusts" eager to close down non-competitive companies. Perhaps most important, the divide between those European countries that have liberalized their economies — especially Britain, the Nordics, and the Balts — and those that have not, will grow, making economic decision-making within the EU even more difficult.

Enthusiastic German fans celebrate the Soccer World Cup 2006

Chancellor Merkel's success in building a strong German and European economy is also crucial for U.S. interests. A weak European economy — or one overly reliant on vulnerable export sales — will not be able to cope with a serious slowdown in the U.S. economy or absorb the economic shocks that might arise from a precipitous correction in global currency markets or a serious disruption of global energy supplies. Nor will Europe have the credibility to contribute to the management of the global economy, especially as pressures grow for a larger role for China, Brazil, and others. Finally, unless Germans — and Europeans writ large — see a sustained economic recovery, they are unlikely to be sufficiently confident and outward looking to take an active role in rebuilding Afghanistan or stabilizing the broader Middle East. Only an economically strong Germany in a prosperous Europe can play such a leadership role, both in economic and foreign policy.

The Path of Reforms

During last summer's soccer World Cup, Germans partied in the streets, waving flags and rooting for the national team, which exceeded expectations by making it to the semi-finals. This optimistic attitude seemed to spill over into the economic and political arenas. With a new chancellor, strong export growth, and important indices (such as the "GfK Consumer Confidence Index" and the "Ifo Business Climate Index") at record-highs, Germany seemed ready to make political and economic reforms a priority. By the end of the year, the signs of recovery were clear:

— the official rate of economic growth for 2006 was pegged at 2.7 percent — a significant increase from the previous year's growth rate of 0.9 percent and well beyond German government expectations;

— the number of job seekers had fallen by 597,000 during 2006 — a drop that was described by the Federal Labor Agency as "extraordinary" and one that brought the unemployment rate down to 9.8 percent. That rate is still high, but clearly German workers are becoming more competitive, largely owing to a new willingness of unionized employees to work longer hours without pay increases;

— Germany's exports had risen to a record level of €893.6 billion ($1.117 trillion), compared to €786.1 billion ($942 billion) in 2005, due to strong performance from such industries as machine tools and automobiles;

— Even consumer spending, usually the weakest indicator of the German economy, rose by 0.6 percent over the previous year.

These positive developments were even more welcome since they came as a surprise to many. During the first few months of the coalition government, expectations for the German economy were extremely low. Despite the strength in exports, many analysts expected the unemployment rate to stay at over ten percent, and GDP growth to reach somewhere between 1.5 and 2.0 percent, with future years not looking much better. The demand side of the German economy was also weak, with the German consumer chronically reluctant to spend in a way that might boost the national income. This reflected the traditional tendency toward high savings in Germany (the national savings rate in 2006 was 10.6 percent in Germany, compared to about -1 percent in the United States), but also the lack of any real wage increases during the last ten years. Perhaps most indicative of the stagnant nature of the German economy was the fact that after 15 years, Germany was still dealing with the financial burden of reunification, transferring an average €80 billion ($104 billion) from west to east every year, with little noticeable improvement in growth or employment rates.[1]

After 15 years, Germany is still dealing with the financial burden of reunification, transferring around €80 billion ($104 billion) from west to east every year.

Faced with this stagnant economy, the Merkel government responded by seeking to boost short-term economic growth with a €25 billion package, ranging from tax credits for home modernization and child care to increased government spending on research and development. Despite their confidence that this package would increase consumer confidence and business investment, government officials still expected a growth rate in 2007 of only 1.5 percent. To achieve further economic growth, the Merkel government pursued a strategy with three key elements: balancing the budget; reducing corporate taxes; and cutting some labor costs.

Balancing the budget — A top policy priority for the Merkel government has been to reduce the federal deficits, as required by the European Union's Stability and Growth Pact. Under that agreement, Germany's government budget deficit should be no more than 3 percent, and the overall level of government debt should be below 60 percent of national GDP. Although it was the German government that insisted on these requirements as a way of keeping the new euro strong, Germany has been in violation since 2002. In its 2006 budget, the coalition succeeded in bringing Germany into compliance with a deficit rate of about 1.9 percent In an effort to continue reducing the budget deficit, the government undertook the very unpopular step of raising the value added tax (VAT) from 16 to 19 percent at the beginning of 2007.

Reducing corporate taxes — Tax rates on limited companies are currently higher in Germany than anywhere else in Europe, and are only second to Japan within the OECD.[2] This especially puts small and medium-sized companies — which are a major element in the German economy — at a comparative disadvantage. The coalition has proposed reducing the tax burden for corporations by some €30 billion by lowering the nominal tax rate for corporations to slightly below 30 percent, a 10 percent drop from the current rate. This tax-cut would take effect in 2008, but details are currently being worked out between the coalition partners. The final version of the proposed bill will be discussed in the Bundestag in late March and early April 2007.[3]

Cutting labor costs — This effort started very badly for the Coalition, with the Hartz IV reforms causing controversy almost immediately. Initially proposed during the government of Gerhard Schroeder, these labor market reforms were intended to reduce the state burden and encourage people to work. Yet they were so full of technical mistakes and loopholes that they ended up costing the government far more than anticipated. For Chancellor Merkel, the cost of this initial effort at reform was a serious hit on her previously high job ratings. Nevertheless, the government has continued to take some further steps toward reducing labor costs by raising the retirement age to 67 and reforming Germany's health care system. The first measure was voted into law in March 2007. Health care reform proved to be an extremely tough battle, as political infighting and wrangling over federal vs. Länder competencies stalled the initial effort. The coalition finally agreed on a compromise health care bill in January 2007, which has now passed the Bundestag and is expected to enter into law in April 2007. Yet, the core proposal, a so-called health care fund, will only go into effect in 2009. As for tackling the anti-dismissal protections that are thought to stifle employment, there seems little stomach among German policymakers for dealing with strong public opposition to any changes in this area, especially after the experience of Hartz IV.

> ***The [German] government should use the credibility it has gained in the recent recovery to [...] focus on building long-term economic growth.***

While the German economy looks much brighter than in the recent past, Chancellor Merkel still has some issues to confront. In particular, real incomes in Germany have declined in recent years - a major factor in making German industry more competitive. German industry is now likely to face new demands for higher wages. To reinforce the current recovery, Chancellor Merkel will not be able to depend on low wages. She must find other ways of stimulating long term economic growth. She and the Grand Coalition can best assure that the recovery gathers strength by taking on some difficult tasks:

— The labor market must be more flexible, and there must be a better match between the jobs of the future and the skills of those graduated by German universities.

— The success of Germany's export sector must not mask the need to identify and foster "sunrise" industries, and Germany must reduce the obstacles to starting a new business.

— Planning should begin now if Germany is to cope with its looming demographic crisis and the impact on its economy and social welfare system.

— Finally, the eastern Länder — the old East Germany — remain a significant drag on the entire economy; it is time to rethink the policy of subsidies that has had so little effect over the past decades.

The success or failure of the Merkel government in addressing these matters will determine whether Germany — and Europe — become more prosperous and dynamic.

Pushing forward won't be easy. Chancellor Merkel must address the inherent caution of the German public toward broader changes; a caution that has been reinforced by the many problems associated with Hartz IV. Moreover, the social welfare state continues to provide most Germans with economic comfort and security. In the absence of any deep economic crisis, the public is largely unconvinced of the urgency of economic change. Postwar Germany has never suffered the levels of inflation or unemployment that made Britain ready to give Margaret Thatcher a real mandate for change in the late 1970s. On the contrary, Merkel's narrow electoral victory in 2005 and the resulting Grand Coalition demonstrated the risk-averse nature of German voters and limited the scope for action by either party. Some political observers believe that by acting cautiously now, the chancellor may gain a greater mandate when Germany next votes in 2009. In this climate, convincing the German public that reforms are essential will be difficult. Nevertheless, the Merkel government should use the opportunity of the recent positive economic trends to build a case that Germany must now address some key challenges if it is to enjoy sustained economic growth and investment in the future.

Creating Jobs for the Future

So that economic growth will benefit the German people, the first challenge must be reducing Germany's structural unemployment. In recent months, employment in Germany has risen quickly after years of being among the lowest in the EU, but it is not yet clear that this rise will be sustained. Germany has for many years had particularly high levels of long-term unemployment. Labor union analysts estimate that up to 1.5 million people out of Germany's 4.5 million unemployed have been without a job for one year or longer. Also, among OECD countries, Germany has one of the lowest workforce participation rates (about 45 percent) for people 55 years and older. For comparison: in 2003, the unemployment rate for Germans 55-64 years old was 9.7 per cent while in Britain it was 3.3 per cent.[4] Few training programs exist for older potential workers who need new skills, at the same time that incentives for early retirement are plentiful.

Finally, despite the intentions of Hartz IV, Germany's labor rules, especially those concerned with hiring and firing, remain rather rigid. Employers are often reluctant to hire new employees unless the business can support that worker permanently. Germany's high non-wage labor costs also discourage employers from taking on more workers. Even though some of the VAT increase will be used to lower unemployment insurance, those non-wage labor costs will remain very high in Germany for the foreseeable future. The rigidity in the labor market also prevents workers from moving into new, growing areas of the economy. The largest group of Germany's unemployed – unskilled workers – has found it much harder to move into unskilled service sector jobs compared to other European economies. Highly skilled young Germans often find it more attractive to work in Austria, Britain, or even the United States, as these labor markets seem more dynamic and more flexible. According to the German Federal Office of Statistics, 144,815 Germans left the country in 2005, a jump of almost 25 percent over 2002. At the same time, fewer Germans are returning from abroad (128,052). Thus, for the first time in a generation, more Germans are emigrating than returning.[5]

> ***In tackling its structural unemployment problem, Germany should look beyond its own borders and learn from some of the economic reform experiences in other European countries.***

To tackle structural unemployment, Germany must make labor market reform a priority, and should push forward on two fronts:

— *Chancellor Merkel should support further labor market reforms* with the goals of: allowing flexible employment contracts so that companies, together with their work councils, might deviate from collective bargaining agreements; achieving a sensible overhaul of Germany's highly restrictive dismissal protection law; and closing the loopholes in Hartz IV that made this reform so expensive.

— *Germany should look beyond its own borders and learn from some of the economic reform experiences in other European countries.* It is unrealistic to expect Germans to adopt the so-called "Anglo-Saxon" economic model, but many of Germany's neighbors — including some that prize the social welfare model — are experimenting successfully with market-based approaches. In Denmark, for example, the "flexicurity" program uses a combination of carrots and sticks to retrain unemployed workers and place them in jobs. For example, while providing a substantial social safety net in case of unemployment, "flexicurity" mandates that after a year without a job, people must enter retraining in another field. If they refuse to seek work, their benefits are cut.[6] Not every program will be suitable for Germany, but this is a good time for the Merkel government, as president of the EU, to laud the diversity of European reform efforts – *i.e.* by creating benchmarks that show which country in Europe is doing best in which areas – while finding the most appropriate solutions for Germany.

Identifying New Growth Industries

German economic growth relies heavily on the country's export champions, especially the automobile and machine tool industries. These firms have been enormously successful, and operate in a truly global environment, with customers and operations around the world. Many are also very specialized, relying on German technical and engineering expertise to protect their comparative advantage. Although their headquarters remain in Germany, a significant portion of their increased profitability comes from moving production to cheaper and more flexible labor markets. The significant growth of its export champions has benefited the national economy in its recent upswing. But whether these export champions are positioned to fuel a broader economic recovery remains a matter of debate among economic experts. Moreover, these exporters of traditional industrial goods remain vulnerable to emerging competitors from China and India which will inevitably develop the expertise to challenge the German champions, and will do so with far lower wages.

In this fast changing-world of globalization, Germany must not rest on the laurels of its current export champions.

In this fast-changing world of globalization, Germany must not rest on the laurels of its current export champions. Yet too often German economic policy makes it difficult for entrepreneurs to explore potential "sunrise" industries, such as "green" energy technologies and biomedical research. The process of setting up a new company in Germany can be much lengthier and bureaucratic than elsewhere in Europe, and a tendency to want regulations in place before a new product can be sold can raise barriers to market entry. In the past, the conservative nature of German capital markets, dominated by banks with little interest in high-risk lending to new businesses, created a risk-averse lending culture. Even successful, but small, companies had difficulty in securing the capital to expand. As a result, Germany has seen a few successful large companies emerge in recent years — SAP is a prime example — but has not experienced the development of a "Silicon Valley" with many young start-ups.

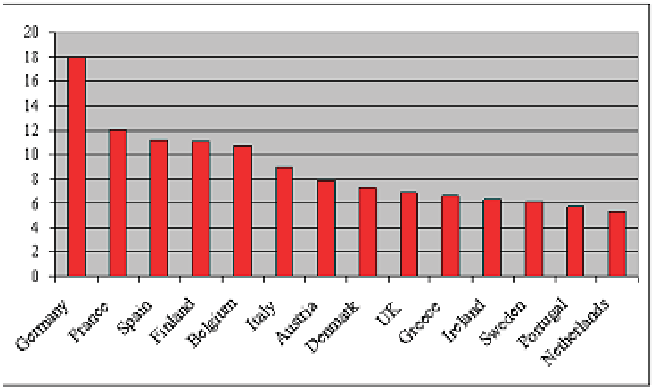
More recently, an increase in venture capital funds and larger flows of private equity may be slowly changing this picture. Now is a key moment for the Merkel government to take this opportunity and provide the encouragement needed if that capital is to lead to a new set of vigorous German industries. The government can play an important role in two areas:

— *Encouraging the flow of investment capital into Germany*, including private equity funds, and allowing them to compete with existing banks. During its presidency, Germany should take the lead in working to liberalize financial services and open capital markets across Europe. The government can also play a role by creating a welcoming atmosphere for investors; comments like those of former SPD head Franz Muentefering — who called private equity investors "locusts" — are politically savvy, but do little to advance a strong German economy.

— *Reducing the obstacles to establishing a new business.* According to the World Bank, it currently takes an average of 24 days to start a new business in Germany. In the United States the average is 5 days.[7] Improving this situation, would require reducing the bureaucratic burden of setting up a new company or office, including hiring staff.

Educating for the New Economy

Although Germany pioneered the idea of elite research universities, since the 1960s there has been a notable decline in Germany's educational system. In a recent ranking of the world's 20 best universities not a single German institution made the list.[8] The low ratings for Germany's mid- and higher-education institutions in the Europe-wide PISA study have caused alarm among many German politicians (and parents).[9] Not only is the quality of higher education under suspicion, but overcrowded classes and few time limits on finishing a degree lead students to stay at university for many years, thus delaying their entry into the workforce.



Unemployment rates for population 25 to 64 years[10]

When students do receive their degree, they often graduate with an expertise that is not in demand by employers. German high schools and universities are increasingly focused on social sciences and humanities, with interest in engineering, physics, biology, and chemistry declining. Yet, there is a growing need for technical workers, including engineers and scientists, despite high overall unemployment. In mid-2006, Airbus struggled to find qualified applicants for almost 1,000 high-paying engineering positions at its state-of-the-art factory in Hamburg.[11]

As Germans look for a response to this educational crisis, a new twist has been added — the recent federalism reform has put education matters almost entirely under the jurisdiction of the state governments. It is thus up to the Länder to overcome Germany's traditional aversion to competition among universities and develop centers of excellence for educating the inventors and workforce for the future German economy. The Merkel government must work with the Länder to upgrade the higher education system and foster closer ties between industry and government-funded basic research institutions. In particular, the Länder and the federal government must pursue innovative approaches to building a competitive educational system by:

— *Targeting government funding to support university-based centers of excellence and create links with private initiatives that fund research and innovation.* The federal government's five year, €1.9 billion ($2.4 billion) "Initiative for Excellence" is a first attempt at overhauling Germany's university system.[12] In a three-pronged approach, the initiative includes funding for up to 10 elite universities which will each receive about €100 million over 5 years, as well as up to 40 graduate schools with €1 million per year each, and up to 40 so-called "excellence clusters" awarded €6.5 million per year each. Three southern German universities were recently announced as the first German elite universities, with the remaining awardees to be announced in October 2007.[13]

It is time for a more radical program of reforms aimed at revitalizing the former East Germany, [such as] establishing a special economic zone for the eastern Länder.

While a step in the right direction, this initiative is merely a beginning given the modest amount of money involved. It must be supplemented by bringing in the private sector to provide additional support for research and innovation. Creation of public-private partnerships should also help ensure that German universities produce graduates with the skills needed to build a strong future economy.

— *Experimenting with educational reforms.* North Rhine-Westphalia was among the first of the Länder to introduce tuition for state universities (currently about $600 per semester). It has reduced the length of the secondary school system from 13 to 12 years and introduced an earlier start age for learning a foreign language. Such measures are intended to introduce some level of competition into the educational system — a measure that the state government is convinced will raise overall standards. If successful, North Rhine-Westphalia's experiment could be a model for other states in reforming their high school and university structures. Even though education policy is within the jurisdiction of the Länder, the federal government can play an important role by pushing for harmonized education standards, by encouraging them to undertake such experiments, and by establishing benchmarks for assessing and comparing different reform efforts.

Revitalizing the Eastern Länder

German officials repeatedly stress that a major reason for Germany's economic underperformance in recent years has been the huge cost of subsidizing the former Communist part of the country. This is true, and the dire economic situation in the eastern Länder should not be underestimated. Between the collapse of the old East German regime and German reunification in 1990, half of the workforce lost their jobs and industrial production sunk to only thirty percent of what it had been under Socialist rule. Yet, after 16 years of massive subsidies from the German government, totaling about €1.5 trillion, the eastern states have just managed to regain the level of output of East Germany before unification. The unemployment rate on average is around 20 percent and over 30 percent in some regions. Many of the remaining jobs are dependent on public funding, and the level of education among the workforce is generally low. The high-tech companies that committed to large-scale investments in the eastern Länder, such as the microchip producers in Saxony, require far less workers in their state-of-the-art, automated factories. With attractive, high-paying jobs still very few, many younger and educated workers leave for the West in search for better opportunities, and some parts of Eastern Germany are slowly becoming depopulated (German statistics indicate that since reunification in 1990, about 1.5 million East Germans have left their homes and moved west in search of jobs)[14].

It is time for a more radical program of reforms aimed at revitalizing the former East Germany. Instead of continuing to rely on massive subsidies, the federal government should consider:

— *Establishing a special economic zone in the eastern Länder*. This would allow these six states to experiment with less regulation and more business-friendly tax and employment policies in order to attract investments. Such a special economic zone would require a comprehensive package of economic measures, including tax-breaks for not only large corporations but also for small and medium enterprises. It would also require a special clearinghouse to ensure fast processing of bureaucratic requirements for large-scale investments, and a more targeted concentration of federal government subsidies on certain industries and locales.

Coping with the Demographic Challenge

Germany, like much of Europe, is facing a demographic time bomb. With a birthrate of only 1.39 children per woman[15] (compared to a needed replacement rate of 2.1 children), Germany will experience a significant decline in the number of available workers. According to experts, by 2050, there will be only 40 million active participants in the labor market, compared to 60 million today. Since Germans are living longer, there will be fewer workers to support each pensioner — a situation that will make sustaining the current pension system extremely difficult. Germany is hardly unique in the European Union in facing such a dilemma – an average EU fertility rate of 1.5 makes this an issue of relevance across the continent.

> ***By 2050, there will only be 40 million active participants in the German labor market, compared to 60 millon today.***

One reason that German women have far fewer babies than American women is the discrimination that faces mothers — and German women generally — in the labor market. Many German women feel pressured to choose either a career or a family, especially since government figures show that only one in five children under the age of three is able to be placed in a day care facility. Not surprisingly, the proportion of women working drops after the age of 30. According to the OECD, 58.8 percent of all German adult women worked in 2002, compared with more than 66 percent in Britain and 68 percent in the United States.[16] The labor participation rate of German mothers is even worse, with only 42.3 percent in the workforce compared to about 75 percent of mothers in the United States.[17] This under-representation of women persists throughout German industry at all levels; among the 197 executive board seats at the Dax 30 leading companies, only two are occupied by women.[18]

There is little the German government (or any government) can do to soften the impact of the demographic time bomb in the short term. But Germany can expand participation in its workforce in two important areas:

— *Increasing the participation of women in the workforce*. There must be adequate levels of day-care for families in which both parents have decided to pursue a career. Otherwise, German women will either opt not to have children or to leave the workforce. Along with making day-care easier to find, Germany should embark on a national conversation about the compatibility of work and family. Until German women are no longer forced by convention to choose between working and motherhood, Germany will find itself handicapped in meeting its demographic challenge.

— *Increasing immigration by qualified workers*. The issue of immigration is a difficult one for many Germans, and especially for CDU politicians. In contrast to parties like the SPD or the Greens, many in Chancellor Merkel's party find it difficult to accept that Germany is now an immigration country (although there is a downward trend, in 2004 more than 780,000 people migrated to Germany[19]). Yet, without attracting larger numbers of immigrants, especially qualified technical experts, Germany will not be able fill the gaps in its workforce, and there will be even fewer workers to support each pensioner. Even the Federation of German Industry (BDI), not usually known for left-of-center views, has advocated a pro-immigration policy for business reasons.

Moving Germany and Europe Forward

During Chancellor Merkel's first year in office, the German economy seemed to come back to life. But the sustainability of this recovery is far from assured. If Germany is to build on these initial positive developments, the government must move forward with some additional and far-reaching reforms.

The key question now is whether Chancellor Merkel can convince the German public and create the political consensus required for Germany to embark on the fundamental changes outlined here. She should use the opportunity presented by the current recovery to launch new initiatives designed to provide more flexibility in the labor market; attract new investment and grow new industries; link German higher education with the needs of the economy; jump start the economy of the eastern Länder; and achieve greater participation in the German workforce.

Chancellor Merkel's success will be essential for the long-term health of the German economy, but also for a strong European economy as well. Today, the German and European economies are tightly linked. Many of the challenges that Germany must surmount are shared across the eurozone and will determine Europe's economic health in the years ahead. In many ways, Germany serves as the locomotive for a European train — if that locomotive falters or stalls, the European economy goes nowhere; but if the locomotive is strong it will pull the European train along and gather speed. With Germany now in the EU presidency, and riding a wave of good news about its economy, Chancellor Merkel has an important opportunity to use that leadership role to push both Germany and Europe toward a stronger economic future.

Endnotes

1. "Transfers to Germany's eastern Länder: a necessary price for convergence or a permanent drag?," ECFIN Publication, Vol. 1, Issue 16, December 2004, available at: http://ec.europa.eu/economy_finance/publications/country_focus/2004/cf16en.pdf

2. Tax Policy Center "OECD taxation of corporate and capital income (2005)," available at: http://www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=479&Topic2id=95

3. "Unternehmenssteuerreform 2008: Korrigierte Pläne der Bundesregierung sorgen für Entlastung - dennoch sind weitergehende Reformschritte notwendig," Zentrum für Europäische Wirtschaftsforschung (ZEW), November 13, 2006 (http://www.zew.de/de/presse/presse.php?action=article_show&LFDNR=674)

4. "The aging workforce: Turning boomers into boomerangs," *The Economist*, February 16, 2006 (http://www.economist.com/business/displaystory.cfm?story_id=5519033)

5. "Bye, Bye Deutschland: More and More Leave Germany Behind," Spiegel Online, November 10, 2006 (http://www.spiegel.de/international/spiegel/0,1518,446045,00.html)

6. More background on the "flexicurity" program can be found in an article by Bruce Stokes "Europe Faces Glo balization – Part II", *YaleGlobal*, May 18, 2006

7. The World Bank - *Doing Business 2007*.

8. "The brains business" September 8, 2005, Economist.com.

9. Artel et al. "PISA 2000: Overview of the Study, Design Methods and Results", available at: http://www.mpib-berlin.mpg.de/pisa/PISA-2000_Overview.pdf, for the ranking, see page 7

10. All figures refer to the year 2003 (except the Netherlands and Italy: 2002). Trends in "Unemployment Rates by Educational Attainment for Population 25 to 64 Years of Age, 1991 – 2003", CES ifo DICE, cesifo-group.de

11. "Airbus findet keine Ingenieure in Deutschland," June 6, 2006, Handelsblatt.com.

12. See German Ministry for Education and Research at http://www.bmbf.de/en/1321.php

13. "Germany Chooses Munich, Karlsruhe as Elite Universities," October 13, 2006, Deutsche Welle.

14. Statistisches Bundesamt, July 19, 2006 http://www.destatis.de/presse/deutsch/pm2006/p2920021.htm; a "Berlin resorts to 'Ostalgia' to stem exodus from east," *The Independent*, March 17, 2006.

15. CIA *World Factbook*

16. "Women in the Labour Force: How Well is Europe Doing?" by Christopher Pissarides, Pietro Garibaldi, Claudia Olivetti, Barbara Petrongolo and Etienne Wasmer.

17. OECD Figure for Germany in 2004 http://www.oecd.org/dataoecd/15/35/37424318.pdf; U.S. Census Press Release, October 23, 2003 http://www.census.gov/Press-Release/www/releases/archives/fertility/001491.html

18. "Germany's career women look for a lifeline," October 13, 2005, *Financial Times*.

19. Migration Report 2005 of the Federal German Government, 06/2006. http://www.bundesregierung.de/Content/DE/Publikation/IB/Anlagen/migrationsbericht-2005,property=publicationFile.pdf

Acknowledgements

The authors of this essay wish to acknowledge the many individuals who contributed insights to this effort. The members of the expert delegation to Germany — Ambassador Richard Burt of Diligence LLC; Dr. Jackson Janes of the American Institute for Contemporary German Studies; Bruce Stokes of the National Journal; and Dr. Stephen Silvia of American University — were not only indefatigable in going to meetings, but identified key areas for further reform in the German economy. An early consensus of the group can be found in the op-ed by Ambassador Burt and Frances Burwell, which appeared in the Wall Street Journal Europe. Numerous experts helped us revisit the state of the German economy during our conference on the German economy, "Merkel's Moment of Truth: Restarting the German Economic Locomotive," held in October 2007. Foremost among the commentators at that gathering was the German ambassador to the United States, Dr. Klaus Scharioth, who spoke on the German government reform program. Finally, a number of U.S. and European economic experts participated in a Council workshop on "The European Economy: Challenges and Future Prospects" in December. Our discussions at that gathering made clear that Germany is part of a larger economy that faces many of the same challenges. We are indebted to all of these individuals for their observations and opinions. Some are reflected in this essay, but the authors alone are responsible for the content.

Support for these efforts came from many sources, including the Program for Transatlantic Encounters of the Federal German Ministry of Economics and Technology; the European Commission Delegation to the United States; and the German Marshall Fund of the United States. Although they bear no responsibility for our conclusions, their support and encouragement was essential to making this set of programs and this publication a reality.

Recent Atlantic Council Publications

Visit www.acus.org for these and other publications:

Transatlantic Relations

- The Indispensable Partnership: - Launching a New NATO-EU Relationship at Riga (11/2006)
- Transatlantic Transformation - Building a NATO-EU Security Architecture (03/2006)
- Ukraine's Euro-Atlantic Ambitions: Building an Effective Policy Coordination Process (02/2006)
- Germany and the Future of the Transatlantic Economy (08/2005)
- The New Partnership: Building Russia - West Coopeartion on Strategic Challenges (04/2005)
- Re-Engaging Russia: The Case for a Joint U.S. - EU Effort (02/2005)

International Security

- How Should NATO handle Stabilisation Operations and Reconstruction Efforts? (09/2006)
- Topics in Terrorism: Toward a Transatlantic Consensus on the Nature of the Threat Vol. 1 (07/2005)
- Global Futures and the Implications for U.S. Basing (06/2005)

Asia

- Taiwan in Search of a Strategic Consensus (03/2006)

Energy

- Clean Air for Asia: Update and Overview on China - India - Japan - United States Cooperation to Reduce Air Pollution in China and India (07/2006)

Senior Fellows

- Intelligence Sharing: Getting National Counterterrorism Analysts on the Same Data Sheet (10/2006)
- The Future of NATO - Russia Relations: Or, How to Dance with a Bear and Not Get Mauled (12/2005)
- Security Cooperation and Non-State Threats: A Call for an Integrated Strategy (10/2005)

THE ATLANTIC COUNCIL
OF THE UNITED STATES
1101 15th Street, NW - 11th Floor
Washington, DC 20005

ADDRESS SERVICE REQUESTED

Non Profit Org.
U.S. Postage
PAID
Washington, DC
Permit No. 8134