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Germany and the Future of the Transatlantic Economy

Ë Rather than assigning blame, it is time for the United States, the European Union, and key European countries — especially Germany — to work together in addressing economic weaknesses

Ë In Germany, there is a deep sense of pessimism about Europe's economic future

Ë The new EU member states are very unlikely to deliver a panacea in terms of greater economic performance or demographic stability

A senior delegation from the Atlantic Council of the United States, led by W. Bowman Cutter and Paula Stern, visited key government, parliamentary, and private sector stakeholders in Frankfurt, Berlin, and Brussels in spring 2005. The delegation presented the findings of the Atlantic Council report, "The Transatlantic Economy in 2020: A Partnership for the Future?" to numerous business, government, and think tank audiences. This report summarizes the delegation's discussions.

A Challenge to the Transatlantic Economy

A strong European economy is essential to an effective transatlantic partnership. Yet key European countries — especially Germany — are struggling to resolve deep-rooted macroeconomic problems. The future of important but admittedly unpopular economic and social reforms is in doubt. Linked with these difficulties in Germany is a deep sense of pessimism among both the public and the policy community about the economic future of Europe. Moreover, even though some European countries have maintained healthy growth and employment rates, Germany's lagging performance has slowed the EU economy overall, and there are now few analysts who anticipate a pan-European growth rate of more than 2.5 percent in the next few years.

If these trends continue, they may imperil the prospects of the European Union remaining an equal economic partner with the United States, according to an Atlantic Council delegation that visited Frankfurt, Berlin, and Brussels in spring 2005. Strong political leadership and the continuation of social and economic reforms will be essential to Europe's future economic health, just as it will be imperative that the United States address its economic deficits. Without a strong economic partnership, the delegation concluded, the political partnership between the United States and the European Union might well be at risk. (See Atlantic Council Policy Paper *The Transatlantic Economy in 2020: A Partnership for the Future?*, which argues that current growth, productivity, and demographic trends may lead to a serious imbalance in the economic parity between the United States and the EU, with a potentially significant impact on the political relationship.)

The United States needs Europe to maintain its historic role as a roughly equivalent economic power in order for the U.S. economy to flourish in the long-term

Although it is sometimes argued that a stronger Europe will act as a counterweight or rival to the United States, the delegation rejected the view that a weak Europe is good for the continuation of U.S. global dominance. On the contrary, the United States needs Europe to maintain its historic role as a roughly equivalent economic power in order for the U.S. economy to flourish in the long-term. Even though advanced developing countries such as India and China are emerging as powerful competitors on the global economic scene, it is Europe, with its compatible business culture and longstanding historical links, that will continue to be this country's preferred trading partner for some time to come. Thus it is in the U.S. national interest — and the interest of the U.S. business community — that European governments provide serious political leadership and pursue reforms designed to move their economies toward higher growth and employment levels.

German political leaders, policymakers and consumers alike seem overwhelmed by the burdens of Germany's domestic economic challenges

If the United States is to uphold its end of the transatlantic partnership, however, it must be acknowledged that the U.S. economy has some serious short- and long-term economic issues to address, including the budget and current account deficits, social security reform, health care costs, and significant security-related obligations. In particular, the current account deficit and the weak dollar are attracting increasing concern from foreign investors, as well as some domestic economic commentators. Over the long term, the twin deficits, as well as the conflict in Iraq and the burden of additional anti-terrorism security measures may affect the health of the U.S. economy. In general, however, there is more optimism about the U.S. economy, and U.S. growth and competitiveness remain relatively steady and able to absorb short-term challenges.

This is in strong contrast to the situation in Europe, where the delegation found little optimism towards long-term EU economic growth rates. Coupled with the debate over the EU's long-term political future — as seen in the recent failure of France and the Netherlands to approve the constitutional treaty — this has created a focus in the European Union's member states on the many obstacles to economic growth, both short- and long-term. Without a renewed commitment on both sides of the Atlantic to overcoming these challenges and building healthy economies, it will be extremely difficult for the United States and Europe to play a strong and positive role in leading the global economy over the next few decades.

The Transatlantic Economy in 2020: The Report and Discussions

The Atlantic Council Policy Paper *The Transatlantic Economy in 2020: A Partnership for the Future* (November 2004) concluded that if existing trends in economic growth, productivity, and demographics continued, there is a possibility of a significant imbalance developing in the transatlantic economy, with Europe becoming a much smaller part of the world economy than it is now, while the United States continues to maintain its position and China and India both become more significant economic players. These developments could not only hinder the vigor of the close transatlantic economic partnership, but might also have a long-term impact on the political relationship.

In presenting the report to European audiences, the delegation aimed to: (i) establish a common understanding of the likely long-term course of the U.S. and European economies, (ii) engage European (particularly German) analysts and decision-makers in a discussion of the implications of long-term U.S.-EU joint global leadership, (iii) assess the effect of the transatlantic economy on transatlantic relations in general, and (iv) examine the implications of the transatlantic economic relationship on future global governance. The delegation placed a special emphasis on Germany as Europe's largest economy, and one that faces deep economic challenges that will affect long-term growth prospects across the European Union.

Germany's Economic Debate

During the delegation's discussions with politicians, financial experts, business executives and federal government officials in Frankfurt and Berlin, members were struck by their lack of agreement as to how the German economy could be turned around, and whether the cautious reforms introduced to date were having a positive or negative effect. For example, two Bundestag members disagreed strongly as to whether Chancellor Gerhard Schroeder's Agenda 2010 reforms are too radical and removing essential benefits to those most in need of help, or are too modest and merely sustaining "big government." This debate will undoubtedly be central to the federal elections that will take place in September 2005.

Moreover, German political leaders, policymakers, and consumers seemed almost overwhelmed with the twin burdens of Germany's domestic economic challenges and the need to sign up to pan-European economic goals. The latter, which include the European Union's Lisbon strategy (see box on page 6), have been proposed by the European Commission to improve EU economic performance as a whole, reduce

barriers to trade, and complete the single market. In Germany there is particular concern about the introduction of the Services directive, which is intended to lower barriers to the provision of services within the EU. The governments of Germany, France, and many European trade unions oppose the directive, fearing it will give service providers from low cost countries in Central and Eastern Europe an advantage based on allegedly lower quality standards and employment conditions.

Among most of the German policy community, the current focus, understandably, is on solving Germany's own domestic problems before addressing the wider debate about the future direction of the European economy. Many European business representatives argued to the delegation that increasing domestic demand is a key factor in improving Europe's economic performance. But in Germany in particular, domestic consumption and poor economic performance seem in a "Catch-22" situation. Despite low, two percent interest rates, consumers are still holding back, which contributes to an unemployment rate above 12 percent, which in turn fuels consumer caution. Long-range economic forecasts suggest that Germany's current fiscal policies are unsustainable, when the country's demographics are taken into account. Even when economic indicators seem positive, German consumer confidence and expenditures seem to stagnate. Breaking this cycle will require a change in attitude as much as in economic policy. German consumers must become more confident that they are *employable*, whether or not they happen to be employed at any given time. Despite the priority German leaders give to the economy — German President Horst Köhler made a statement on the economy and Chancellor Schroeder held an "economic summit" with opposition leaders during the week of the delegation's visit — Germans seem to remain doubtful that greater growth and prosperity is within reach. Even if Chancellor Schroeder loses the forthcoming federal election, only time will tell whether a much-anticipated Christian Democratic government will be able to secure appropriate and effective economic reforms.

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DELEGATION MEMBERS AT A DISCUSSION IN FRANKFURT

In the meantime, Germany is making cautious progress towards economic reform in some specific areas, such as lowering corporate taxes. But even greater reforms, especially in the areas of increasing working hours and enhancing labor flexibility, could have a more significant impact. For example, in 2004, Germany's GDP increased by

0.5 percent simply due to the fact that, given the way federal holidays fell, there were five extra working days (according to official German government statistics). This demonstrates that there would be much to be gained in Germany from even a modest increase in working hours.

In addition to the frustration expressed about the lack of confidence among consumers and the faltering progress on reforms, some European audiences reacted to the suggestion of relative economic decline in Europe — compared with the United States — by noting the serious challenges facing the U.S. economy. In particular, they cited the current account and budget deficits, the weak dollar, and the economic implications of health costs and pension reform. Some argued that the high current account deficits were not being addressed by the U.S. administration, and that if foreign central bank investors decided that they no longer wished to invest in U.S. debt markets, the U.S. economic outlook may become weaker. European observers also pointed to high consumer debt and potentially overheated house prices, and repeated the view held by some financial investors that the U.S. equity market is over-valued. While it is certainly legitimate to raise concerns about the U.S. economic situation — and those concerns must be addressed — the delegation concluded that the priority for European policymakers must be to address the obstacles to future growth in the EU economy, and especially in Germany.

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This report is based on discussions among the delegation but does not represent a formal endorsement of specific statements or recommendations by individual delegation members.

Germany, of course, plays a large role in the broader European economy, including in the attainment of the Lisbon strategy and in establishing the global competitiveness of the EU. In fact, the rest of Europe looks to Germany to provide strong political leadership toward completion of the single market, since Germany is seen as one of the most powerful and most committed countries in the EU. But Germany's stagnant economic performance drags down the rest of the EU, and without Germany's economy improving, it is unlikely that the Lisbon strategy goals will be met. Although German stakeholders are clearly keen for the United States and Europe to show joint leadership in the global economy, it is increasingly clear that this will first require progress in the health of the German economy.

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The Lisbon Strategy: Towards European Growth?

European policymakers have struggled over the last two decades with a fundamental problem: how to reach a balance between the much-criticized U.S. economic model, which many European policymakers see as providing an insufficient safety net for the vulnerable in society, and the European social model of expensive welfare programs, shorter working hours, strong labor unions and family-friendly employment policies. The Lisbon strategy — a multifaceted program involving several areas of potential legislation — is at the heart of EU efforts to reconcile this balance while boosting growth and productivity throughout the Union.

This effort has been complicated, however, by the increasing complexity of economic policymaking in Europe. In particular, EU member states must now deal with the formulation of economic policies at both the EU and national level. Over the years, there has been a gradual shift in the management of macroeconomic policy in some areas toward EU institutions such as the European Central Bank and the European Commission. However, the Council of Ministers has retained a key role in detailed economic decision-making, giving the member states a very strong voice — often the dominant one — at the Brussels level. Member states retain control over many elements of economic policy, including fiscal matters and large areas of regulatory policy, making it difficult to implement pan-European policies. Moreover, laws promulgated in Brussels must still be implemented by the national governments, sometimes with varied results, as can be seen in the adherence to the Stability and Growth Pact that supports the European Monetary Union.

This piecemeal shift toward centralizing the formulation of macroeconomic policy in the supranational institutions has allowed some member states to absolve themselves of responsibility for their own stagnant economic performance.

The Lisbon Strategy

Initiated in March 2000, the Lisbon Strategy seeks to make the European Union "the most dynamic and competitive knowledge-based economy in the world" by 2010. The European Council formulated a set of 28 objectives focused primarily on economic, social, and environmental fields. Member states are expected to implement the necessary reforms to meet the goals outlined by the European Council. The Lisbon Strategy is heavily based on the economic concepts of:

- Innovation as the motor for economic change
- The "learning economy"
- Social and environmental renewal

The year 2005 marks the midway point for the Lisbon Strategy. According to the European Commission's assessment report, results thus far "are not satisfactory." In an effort to increase the commitment of European Union member states, the Commission proposed to establish a new kind of partnership with member states that will focus on two main areas: productivity and employment.

For further information, see: http://europa.eu.int/growthandjobs/index_en.htm

In recent years, European politicians have increasingly blamed "Brussels" for forcing them to take unpopular measures. When discussing economic policy with analysts and business representatives in Germany, the delegation found not only a willingness to blame EU institutions, but also a tendency to rely on the EU to resolve economic problems. Even in areas where the EU has little jurisdiction, some seemed to look to EU institutions to provide guidance and sometimes pressure on difficult economic questions.

If the Lisbon strategy is to succeed, the European Commission must make the European public aware of the strategy's aims, while the member states must commit to strategy's reforms at the national level

The delegation had extensive discussions regarding the Lisbon strategy, and its chances of success. Most Commission officials were willing to acknowledge that Lisbon had so far failed to achieve its intended goals, but spoke optimistically of its relaunch and ultimate success (perhaps not surprisingly, given the prominence of Lisbon in Commission President José Manuel Barroso's program). Other observers, however, are far more pessimistic, with some going so far as to pronounce Lisbon dead. Still others see the Lisbon strategy as achievable, but argue that most of the necessary reforms, along with increasing domestic demand and reducing unemployment, are the responsibility of national governments. If the Lisbon strategy is to succeed, even if after its original, unrealistic deadline of 2010, the European Commission and other supporters of Lisbon must not only make the European public more aware of the strategy's aims and significance, they must also do better at assigning responsibility for attainment of Lisbon's key targets. The member states in particular must commit to the reforms the Lisbon strategy requires at the national level.

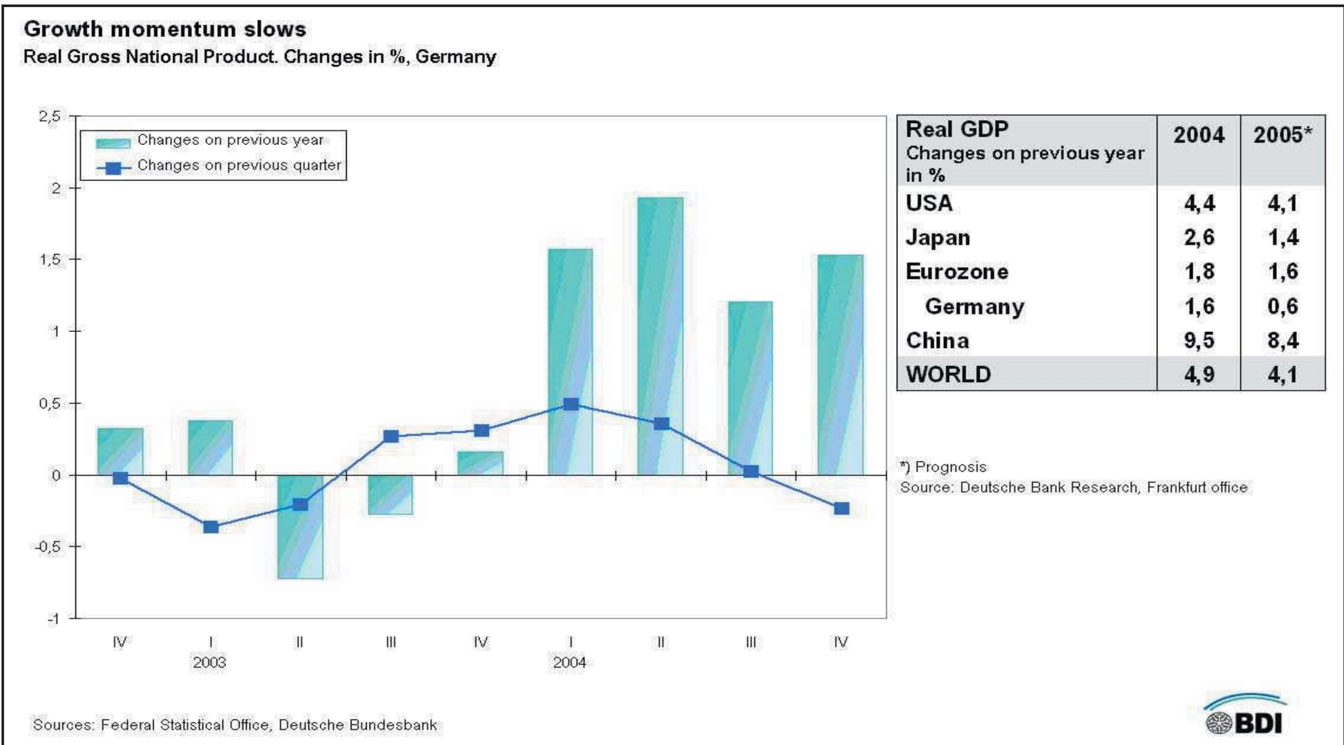
In both Brussels and Germany, observers underlined the importance of political leadership in Europe's battle to improve economic performance. As one U.S. government official put it, "the key to Europe growing is 90 percent in Europe's hands." But as the case of Germany made clear in the weeks before the North Rhine Westphalia election, domestic elections are always looming somewhere in member states, creating a serious disincentive for any European politician to undertake unpopular reforms. Germany in particular suffers from an almost continuous calendar of regional elections, many of which have political implications for the federal government (as demonstrated by the Social Democrats losing the North Rhine Westphalia election). Nevertheless, German political leaders need to take bolder steps towards improving their own national economic performance, rather than looking to the rest of Europe to help raise the EU's overall growth rate, and somehow lift Germany on that rising tide. Recent experience in fact demonstrates the opposite — without a stronger German performance, the overall EU economy will continue to lag.

Without a stronger German performance, the overall EU economy will continue to lag

Economic Contributions of the New Member States

It is well understood that Germany's economic problems stem, in part, from the financial burden of German reunification and that the eastern Länder of Germany in particular still face serious economic challenges. Nevertheless, some European analysts commented to the delegation that the new members of the EU would not follow in the footsteps of the eastern Länder, but would instead serve as a positive force for economic growth and reform in countries such as Germany. Indeed, the issues of Turkish accession to the EU and the contribution of the ten new member states towards higher economic growth in the European Union, were frequently raised during the delegation's visit. Some German commentators pointed to new member states as providing the key to long-term economic growth. Others saw Turkey's more positive demographics — including a younger population and higher fertility rates — as potentially compensating for the aging population in the current EU member states. But a closer examination of these two points indicates that their impact is unlikely to be significant enough to substantially increase European GDP. Even if the ten new member states all had dynamic economies, their total GDP adds only • 500bn to the pre-enlargement EU, or roughly five percent (Eurostat). In addition, Turkey can only provide enough youthful workers to support EU pensioners over the short-term, as its current fertility rate of 2.7 is forecast to drop just below the replacement rate by 2020 (UN Population

The economies of the ten new member states currently only add five percent to the EU's pre-enlargement GDP



Real GDP Changes on previous year in %	2004	2005*
USA	4,4	4,1
Japan	2,6	1,4
Eurozone	1,8	1,6
Germany	1,6	0,6
China	9,5	8,4
WORLD	4,9	4,1

Division). As for the fertility rates of the new Central European member states (*e.g.* Slovakia, Latvia, and the Czech Republic) these are lower than in most western European countries such as Britain, Ireland, and France, and thus actually fuel long-term aging in the EU as a whole.

AUDIENCE MEMBERS AT A PRESENTATION OF THE 2020 REPORT IN FRANKFURT

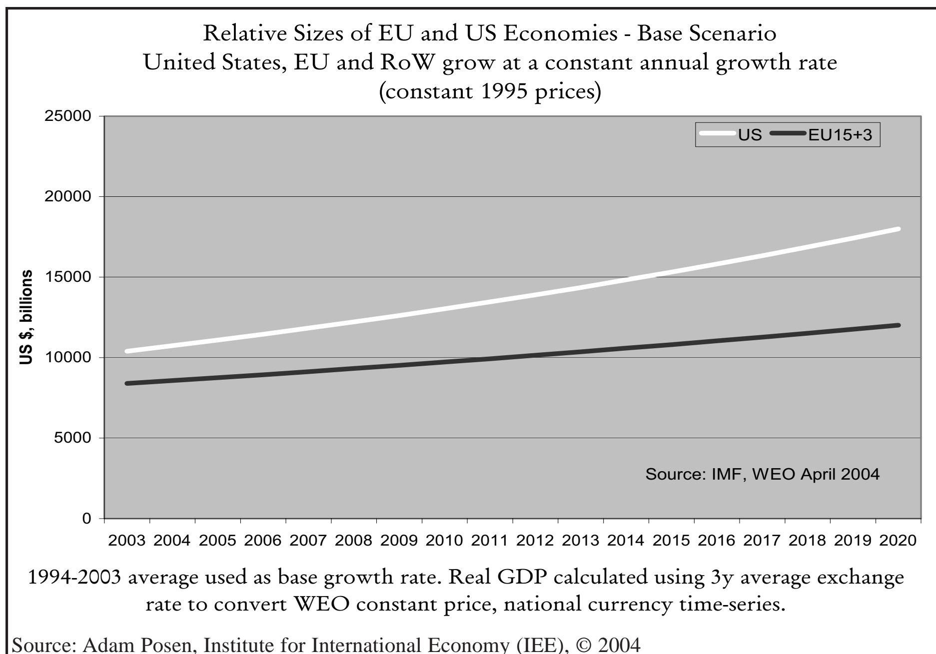
Discussions in Germany about the new and prospective EU member states' contribution to European prosperity also revealed that any optimism about these countries' contribution to healthier demographic balances or growth rates were tempered by concern over "unfair" economic competition from these countries. Turkey caused an even greater concern, given the increasingly apparent public resistance to the idea of Turkey as an EU member. One business representative claimed that no German politician intended to vote for Turkish accession to the European Union, as it would be "political suicide" to do so. In sum, the delegation concluded that the new member states are very unlikely to deliver a panacea in terms of greater economic performance or demographic stability.

The Way Forward

With contentious short-term issues such as the transatlantic response to terrorism, Boeing-Airbus, Microsoft, biometric passports and the Chinese arms embargo to distract EU and U.S. policymakers and regulators, it will be tempting to let the longer term problems of the transatlantic economy take a backseat in transatlantic policy discussions. Nevertheless, the delegation returned to the United States convinced that this should not be allowed to happen. To the contrary, discussions with European and especially German interlocutors made clear the value of one of the key conclusions of the Atlantic Council report *The Transatlantic Economy in 2020*: that the United States and Europe should recognize that domestic economic policy is a legitimate and important subject for transatlantic dialogue.

Policymakers in the U.S. and Europe should recognize that domestic economic policy is a legitimate subject for transatlantic dialogue

Throughout the delegation's travels, it heard increasing concern from European commentators about the decline of the dollar and the U.S. budget and trade deficits. Representatives of U.S. companies, and numerous Europeans expressed even more serious concern about the direction of the EU economy. As one EU official remarked, "We are no longer talking about getting Europe back to U.S. levels by 2010, but just as long as it takes." Given the potentially very different directions taken by the U.S. and European economies, one U.S. government official



Source: Adam Posen, Institute for International Economy (IEE), © 2004

predicted that "the next five years are going to be very troubling for the U.S. and Europe."

Rather than simply pointing fingers and assigning blame, however, it is time for the United States, the European Union, and key European countries — especially Germany — to work together in addressing economic weaknesses. This does not mean that there is only one set of answers; on the contrary, the transatlantic economy is big enough to include a diverse set of policy responses. Nor is there only one right economic model, but instead a range of possibilities from a pure market economy to one with significant social welfare protections. But it does mean an increased awareness among all governments of the importance of a healthy and balanced economy, not only for their own citizens, but also for others. Only those governments who can foster competition and create jobs in an integrated global economy should expect to be able to lead in that same arena.

To move forward in constructing a stronger transatlantic economy, based on an improved performance in national economies, the following measures should be undertaken:

- The U.S. and European governments should establish a regular dialogue on domestic economic policy, both within the framework of U.S.-EU discussions and in bilateral U.S. discussions with key European governments, including that of Germany. These discussions should include key policymakers involved in the setting of domestic economic policy, including legislators, when appropriate. These discussions should be aimed at enhancing understanding, and over time, a closer consensus on the policy priorities within domestic economies.

- The United States and European experts should undertake discussions on demographics and the related issues of pension reforms and immigration. Because these topics are relatively long-term, the discussions should involve both government officials

and outside experts who can bring in a wider variety of perspectives. The discussions should be aimed at building understanding of different approaches and perspectives but also at comparing best practices, especially in the areas of pensions.

- The United States should address its own economic weaknesses, especially the budget and current account deficits. Recent figures showing that the budget deficit will be less than anticipated will undoubtedly be viewed positively in Europe. Even if U.S. policy priorities require the continuation of these deficits, the United States should acknowledge the concerns of its economic partners.

- While recognizing that the implementation of specific elements of the Lisbon strategy is an internal EU decision and responsibility, the United States should make clear that it looks for a strong European economy as an international partner. It should reaffirm the desirability of transatlantic leadership in the global economy, but also note that the ability to lead in a diversifying international economy will inevitably be derived from a strong economic performance.

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