IS GERMANY TURNING JAPANESE?

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Germany, the world's third largest economy, has lagged the other eurozone economies in economic performance since the end of its reunification boom. That growth and employment gap has widened significantly during the current cyclical downturn. Germany's stock markets have suffered the largest losses of those in any major economy from the bursting of the IT/telecom bubble, and German real estate prices have been falling for nearly a decade. Germany flirted with deflation in consumer prices in the last six months of 2002, even while the eurozone's harmonized inflation rate has been above the European Central Bank's (ECB) target. The Schröder government has publicly acknowledged the severity of the situation and simultaneously committed to implementing a host of labor reforms and to bringing the Federal Republic's budget deficit down by 0.5-1.0 percent of GDP to adhere to the Stability and Growth Pact. And on February 20, 2003, Chancellor Gerhard Schröder met with the heads of Germany's leading banks and the chairman of ECB's banking supervision committee to discuss options for resolving financial fragility in the country's unprofitable banking sector. The apparent parallels between Germany's present troubles and some aspects of Japan's infamous "Great Recession" have become a topic of wide comment and concern.[1]

This attention is deserved. Japan's decade of decline is the worst fate suffered by an advanced economy since the Great Depression. Contraction in Japan, however, is not only Japan's problem; it is also a drag on the global economy. Japan's withdrawal of capital from Asia and a weakening yen contributed heavily to the Asian financial crisis of 1997-98. Since then, Japan's continuing slump has limited export earnings for emerging-market countries, thus strengthening the backlash in Asia and Latin America against globalization and the "Washington Consensus," and it is exacerbating rather than offsetting the current global slowdown.

Japan seems unable to halt its decline even though its problems are obvious, and effective, albeit painful, remedies are available. But Japan's very wealth and stability seem to be the sources of its inaction. In other words, there is little political pressure for change in Japan because it is still wealthy enough to allow a large number of Japanese citizens to travel the world and purchase luxury goods and also allow the government to buy off with programs those directly harmed by the recession, and it can still afford to put off the costs of this and other borrowing. Small wonder then that financial observers have wondered whether such a fate might befall other wealthy economies that got into trouble. When stock market bubbles burst and deflation appears

[1] We have identified 20 such articles published in the global financial press or released by leading financial firms. They are split roughly 50-50 on whether Germany will go down Japan's road, with a couple saying it is completely a matter of cyclical developments.

in prospect, the question "Who will be the next Japan?" takes on urgency for policymakers and markets.

Germany in particular has come under scrutiny for its potential to fall into a Japan-like trap. The apparent structural similarities and the parallel declines from being model economies to becoming long-term aging underperformers give some surface credibility to the analogy. As will be argued, these comparisons are too diffused and ignore many differences between these two industrial democracies and their economic behavior, and thereby fail to identify the core determinants of Germany's proclivity to the Japanese disease. At the same time, Germany has many longer-term structural problems and simply avoiding becoming 'the next Japan' will not be sufficient to fix these drags on growth and employment. Preventing Germany from turning Japanese, however, would preclude an extended period of stagnation and mounting public and private debt, with ongoing deflation and financial fragility. That fate of persistent stagnation would completely block meaningful long-term reform in Germany as it has in Japan.

Of course, the concern about any of the major economies "turning Japanese" begins with the recent collapse of the IT/telecom-fed global stock market bubble. But it takes more than a bubble to become Japan. Bubble economies can build up investment and industrial capacity in formerly overvalued sectors (like telecoms and IT) and then work it off in periods of slower growth—as the current US economic difficulties demonstrate. Mature economies can also reach the limits of technological catch-up or find themselves confronting choices about generous social welfare commitments made during times of faster growth and greater export opportunities—as the UK did in the 1980s, and the Netherlands and Sweden did in the 1990s. Corrupt or undercapitalized banking systems that misallocate credit have disrupted financial markets and growth in practically every economy— from the savings and loan debacle in the United States to the Credit Lyonnais affair in France to the widespread banking crises in the Nordic countries. In other words, it is possible for an advanced economy to have a bad time but still not fall into Japanese-style ongoing stagnation.

For an advanced economy to perpetually stagnate, its political economy must have the four elements of Japan's negative economic syndrome:

- incomplete financial liberalization;
- macroeconomic policy division and deflationary bias;
- financially and politically passive households; and
- a lack of openness to trade or capital flows or foreign ideas.

Of all the OECD countries, only Germany has increasingly begun to share Japan's political-economic profile. By the end of the 1990s, Germany had witnessed to a large degree the first three elements of the Japanese syndrome, and recent economic events and policies have made matters worse. But Germany had been spared by its long-standing openness and commitment to international economic integration.

However, the fourth element is newly threatening to surface because Germany now backs the increasingly intergovernmental or statist approach to the European Union's eastern enlargement taken by France and a few other member states in the constitutional convention. This approach would elevate the power and interests of the larger incumbent nation-states vis-à-vis Brussels and the accession countries. Transatlantic relations have been strained over Iraq, and this strain made evident the underlying divisions within the EU, both reinforcing Germany's recent political tendency to back its partnership with France as the main avenue of European decision-making. This is a switch from Germany's traditional role of being the large state advocating federalism in the EU and the voice of the smaller states. I argue that beyond its direct economic effects, such a switch in Germany's own attitude and approach to economic integration could well tip the country into a full-fledged Japan syndrome.

Reliance on the US economy as the engine of growth since 1995 has created major imbalances in the world economy and it cannot afford its third largest economy following its second largest down the path to economic perdition. A deepening of Germany's current economic weakness would not only add to the drag on world growth from a declining Japan, but would also compound it. Years of stagnation in Japan have made the global economy less resilient and weakened support for economic liberalization. Even looking solely at direct economic effects from potential stagnation in Germany, they will be disproportionately significant given Germany's geopolitical position. German output accounts for 23 percent of the European Union's GDP and 32 percent of the eurozone's. The Benelux countries sell over $90 billion in goods and services to Germany every year, making it the engine of west European growth. From the strategic emerging eastern Europe, Germany takes in 8 percent of Russian exports, 19 percent of Turkish exports, and 31 percent of the exports from the EU accession countries—primarily Poland, Hungary, and the Czech Republic—which is over 11 percent of the annual GDP of these NATO members. (See table 1.)

Germany is the third highest contributor of official development assistance (ODA), averaging $5.2 billion annually from 1999 to 2001 and accounting for 12.8 percent of the G-7's total net ODA, and without counting Germany's 25 percent share of contributions to the EU budget, that understates its role (see table 2). If Germany were to turn Japanese, the United States would be deprived of a critical partner in promoting economic liberalization and integrating developing democracies into the global economic system—a role Japan never played. That would also render even more improbable a significant increase in defense spending by the second largest member of NATO. For all of the Bush administration's criticism of German "pacifism" regarding Iraq, Germany does contribute 5.9 percent of total NATO defense spending, and has nearly 325,000 active military personnel (1997-2001 average; see table 3).

To prevent Germany from turning Japanese, the United States and the other G-7 countries must focus on shifting eurozone macroeconomic policy toward growth, encouraging international banking consolidation (particularly through application of international standards to Germany), strengthening of Brussels vis-à-vis the large nation-states in the EU constitutional design, and enhancing transatlantic economic integration and openness. The US government will have to recognize anew, even in the midst of military conflict, that its major foreign policy and security goals critically depend on the economic vitality of its largest allies such as Germany. The US government must be willing to compromise on less important political or military issues to get the needed changes in economic policies from high-savings, slow-growth countries such as Germany.

HOW THE JAPANESE MODEL BECAME JAPAN-THE-FATE-TO-AVOID

What a difference a decade makes. Over the last ten years, Japanese public debt and unemployment levels have doubled and average economic growth has fallen by nearly three-quarters to about 0.9 percent per year, the lowest of any industrialized economy. Bad debts in the Japanese banking system total an unprecedented $1 trillion (more than 20 percent of GDP) and are still rising. Projecting current trends, Japan will be unable to roll over its public or private debts and will ultimately fail to meet its internal pension and social security obligations, probably within just five years.[2] Even if an overt financial crisis is postponed indefinitely, more time with a dysfunctional financial system and therefore without sustained recovery will continue to erode Japan's wealth, stability, and world role. Japan has gone from being a soft power punching above its weight in international relations to being an aging society of declining significance even within Asia.

Worse, Japan seems unable to free itself from the tightening vise of fiscal erosion and debt-deflation in which its economy is caught. With each passing year of stagnation, tax revenues fall while public expenditure rises, limiting further the Japanese government's scope for constructive fiscal policy. Debt-deflation, meanwhile, is a vicious self-reinforcing cycle, last seen during the 1930s in the United States, where companies and individuals hit by falling prices and incomes are unable to service their outstanding debt obligations and so default or sell their

[2] Adam S. Posen, "The Looming Japanese Crisis," *Institute for International Economics Policy Brief* No. PB02-5, May 2002.

marketable assets. These defaults and fire sales further drive down asset prices and dry up bank credit, leading to another round of failures. The bank-dominated financial system in Japan offers little corporate access to stock and bond markets and the resulting credit crunch has starved the entire economy of new investment. It has also given aging savers little or no return on their assets, thereby sapping consumption as well. Japan, it seems, has fallen and is unable to get up.

Japan's economic troubles have been neither accidental nor inevitable. Instead, they are the result of politically driven and economically self-defeating policy decisions that turned a normal recession following an asset-price bubble in 1992-94 into a severe and accelerating decline.[3] I now briefly summarize the four interwoven aspects of the Japanese political economy before assessing the extent of the similarities between the German and Japanese economies in the last few years.

Incomplete Financial Liberalization

The seeds of the current crisis were sown in 1984 when Japan undertook to deregulate its financial markets. By 1989, most leading companies could exit their bank relationships and go directly to markets for capital (issuing bonds, commercial paper, and stock), thus depriving Japanese banks of their steady business of lending to near-zero-risk clients at high margins. Yet even as banks lost profitable opportunities, the Ministry of Finance equated financial-system stability to "no closure of banks," and financial incentives provided by a network of former financial officials placed in lucrative bank jobs after retirement (the famous *Amakudari*—descent from heaven) reinforced this belief.

Consequently too many unprofitable Japanese banks have stayed in business, retaining large amounts of Japan's lending funds. From the mid-1980s to the early 1990s, the banks shifted from funding creditworthy corporations to lending to small and medium enterprises solely on the basis of real estate collateral—a much riskier and more cyclical business. When the stock and real estate bubbles that their lending helped to inflate burst in 1990-92, the banks and their borrowers took heavy losses, and returns to Japanese savers began their long decline. The banks have since ceased lending to new businesses, while holders of savings accounts and certificates of deposit at those banks received little or no return on their deposits.[4]

Vast public sector banks and bank-like entities in Japan, such as the national Postal Savings system, designed to serve bureaucrats and politicians, compounded the problem. Public

[3] See Adam S. Posen, *Restoring Japan's Economic Growth*, IIE, 1998, and Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels with US Experience*, IIE, 2000.
[4] See Takeo Hoshi and Anil F. Kashyap, *Corporate Financing and Governance in Japan: The Road to the Future*, MIT Press, 2001, and the chapter by Shimizu in Mikitani and Posen, op cit.

banks, by definition, have a lesser need to make a profit, offer savers an implicit government guarantee, and have a mission to lend on non-market criteria. As a result, public-sector financial institutions put pressure on the profitability of private banks, by driving down their lending margins and driving up their cost of funds. Because overwhelming shares of both household savings and corporate finance are still intermediated by or held in banks in Japan, the resulting combination of undercapitalized private banks and bloated public banks has discouraged investment and distorted markets throughout the economy, thus devastating growth.

Uncoordinated Deflationary Macroeconomic Policy

In large economies, monetary and fiscal policies are usually employed to smooth out the business cycle. During normal recessions, the central bank cuts interest rates to make credit more readily available, tax revenues decline from those with declining incomes, and public spending on unemployment and other welfare benefits increases. In unusual circumstances, such as those following a stock market bubble when there is overcapacity and financial fragility, a more activist macroeconomic policy is undertaken: discretionary tax cuts are made, public works spending is often increased, and the central bank may purchase government bonds on a large scale.

Since 1990, however, macroeconomic policy in Japan has been on balance contractionary and has worked to deepen rather than offset the post-bubble recession.[5] The popular but incorrect perception of Japanese fiscal policy is that the government has been on a public-works spending binge. Properly measured, however, the Japanese government has provided little *added* stimulus as the economy has contracted. Over 80 percent of the increase in Japanese public debt is due to tax revenue shrinking with the economy. In fact, in April 1997, taxes were *raised* by 2 percent of GDP, cutting short of nascent recovery. Then, starting in July 1999, public investment has been cut month over month for more than three years now. Net public investment is lower now than it was in 1998. Meanwhile, the Japanese safety net for the unemployed and poor is the least generous in the OECD, even smaller than in the United States, so automatic stabilizers are small.

Monetary policy has been at least as contractionary and is perhaps even more misunderstood. The Bank of Japan was slow to cut interest rates after the bubble burst and

[5] Japanese macroeconomic policy is assessed in Kenneth N. Kuttner and Adam S. Posen, "The Great Recession: Lessons for Macroeconomic Policy from Japan", *Brookings Papers on Economic Activity,* 2001:2 and Posen (1998), op cit.

[6] See Alan Ahearne, et al., "Preventing Deflation: Lessons from Japan's Experience in the 1990's," Federal Reserve Board *International Finance Discussion Paper* No. 729, June 2002, and the chapter by Jinushi, Kuroki, and Miyao in Mikitani and Posen, op cit.

investment declined in the early 1990s.[6] By the time the Bank cut its overnight interest rate to zero in February 1999, it was too late—inflation had dropped below zero and the banking system broke down, making real interest rates high and credit conditions tight. Since then, the Bank has refused to undertake active quantitative expansion—i.e., printing yen and purchasing large amounts of government bonds, foreign currency, or other real assets—to increase liquidity outside the banking system. The result of the Bank's willful inaction has been the first extended period of deflation seen in any advanced economy since the Depression. Deflation not only reinforces the accumulation of bad loans and the contraction of credit in a vicious feedback loop but also deters consumer spending since individuals wait for prices to fall further.

The Ministry of Finance and the independent Bank of Japan have deepened the problem by playing a game of chicken with each other and with the financial regulators, each asking the other two to give in first—the Bank will not ease both until the bad loans are cleaned up and until the Ministry assures that clean-up funds will not be wasted on other projects; the financial supervisors will not close banks until the Bank of Japan and/or the Ministry of Finance provide a supportive macroeconomic environment in which to do so; and the Ministry will not reform the budget and the tax system until the Bank ends deflation and the supervisors put a limit on the bad loan problem. This game is in part simply a matter of not wanting to be the first to admit past mistakes. It also, however, reflects a lack of coordination on macroeconomic and financial policy, which creates a bidding war over who can maintain the most austere policies the longest.

Financially and Politically Passive Citizens

Obvious economic underperformance, fed by regulatory neglect and deflationary policies (not to mention overt corruption), would seem to be the cause for public outcry. But Japanese citizens have not yet demanded change. While prime ministers come and go, the Liberal Democratic Party retains leadership in the Diet and neither its members nor the bureaucrats making economic policies are held accountable. The selection by party caucus, not by popular election, of Junichiro Koizumi as prime minister in April 2001 was thought by many to signal potential reform, but nothing much has changed. In October 2002, Koizumi and his party gutted the first true bank clean-up proposal since the bubble and still *picked up* five seats in six by-elections. It may well be that Koizumi wanted to implement reforms and has been repeatedly defeated by interest group opposition, but clearly the Japanese populace has not punished Koizumi for that series of defeats.

The Japanese population appears to fear major changes in established relationships more than economic stagnation at their current high level of wealth. This net assessment, however, glosses over the raw political exploitation of the majority by powerful interest groups in Japan.[7] Indeed, for all the talk of social solidarity, Japan is a society in which the relatively wealthy old exploit younger workers, politically over-represented rural residents exploit urban populations, and incumbent businesses and workers exploit their current relationships to exclude new entrants. This pernicious system is enabled and reinforced by a process in which LDP politicians funnel public largesse and tax breaks to these older and rural voters in return for political (and personal) contributions and safe re-election. Bureaucrats, meanwhile, maintain their power by assuring that current business and regulatory structures reinforce each other.

Of course, all advanced societies have special interests, and farmers and pensioners often take advantage of the less-concentrated general public in government budget decisions. Only in Japan among wealthy democracies, however, among wealthy democracies, have such narrow interest groups so successfully snatched such a large share of national income and also managed to keep it coming in the face of obvious economic decline.

The same passivity pervades the Japanese financial system. Over 90 percent of Japanese household financial assets are kept in bank accounts, bank certificates of deposit, life insurance, or cash. It is often claimed that this reflects that the Japanese are extremely risk-averse; many macroeconomists would argue that Japanese savings have risen as a precautionary response to the possibility of losing one's job or pension as the recession continues. Whatever the source, the end result is that banks and life insurers in Japan effectively have captive deposits on which they can keep dropping the returns (now nearly zero on most accounts), while their management and shareholders keep their jobs and extract the dividends they can. Few households pull out their money in search of better investments, so banks are no more accountable than the politicians. This translates into little pressure to write off bad loans or lend to new businesses.

Lack of Openness

Some countries have no choice but to face their economic problems due to outside pressure, even if the day of reckoning is postponed for as long as possible by domestic politics. Even for large wealthy economies, openness matters: exit by domestic and foreign investors, regional integration agreements, migration, and/or expenditure requirements for national security usually force economies to respond to persistent economic underperformance. In Japan, though, government and established interests have eluded most pressures for change. Passivity is reinforced by the

[7] See Edward J. Lincoln, *Arthritic Japan: The Slow Pace of Reform*, Brookings Institution, 2001 and Leonard J. Schioppa, "Japan, the Reluctant Reformer," *Foreign Affairs*, September/October 2001, pp. 76-90.

closed nature of much of Japan's economy and society, as reflected by its discouragement of immigration and the virtual absence of regional security or trade integration—there is no East Asian equivalent of NATO, NAFTA, or the EU.

Japan's lack of openness is particularly felt in the absence of economic competition for the bulk of its domestic businesses and of its savings to invest. I refer here not to the standard US trade negotiator's demands for market access for American plate glass or apples. What is really at issue is the fact that 80-85 percent of the Japanese economy—particularly service sectors such as retail, transportation, and construction—is grossly inefficient, with thousands of politically protected small companies squandering Japan's stock of economic assets.[8] Also, many larger manufacturing companies are insulated from competition by tight business-government connections, particularly of bureaucrats to middle management, and by corporate boards of insiders from companies with cross-shareholdings. These companies secretly transfer the cost of the losses from bad investments, delinquent loans, and outright waste to the Japanese consumer and to the 15 percent of Japanese business that is internationally competitive.

Naturally enough, these inefficient companies have a strong interest in not only the substance of protection but also in maintaining the ideological pretense that Japan should have an economic model distinct from that of "the West." In the end, of course, it turns out that the maintenance of their privileges, and that alone, is what constitutes that "distinct" model. This environment is hardly conducive to spread new ideas; rather, it is one that encourages the scapegoating of foreign pressures as being a source of difficulty, an indulgence with implications that go far beyond economics.

GERMANY'S NEWLY JAPANESE WAYS

These four elements of an industrial democracy's proclivity toward the Japanese economic syndrome are all susceptible to independent observation and, thankfully, it appears that most OECD members have avoided them. But the notable and increasingly dangerous exception is Germany.

Many commentators have suggested that Germany is especially susceptible to the Japanese disease because of the apparent structural similarities of the German and Japanese economies. Both were beneficiaries of US reconstruction and open markets after World War II. Both are one-time exemplar economies whose growth rates slowed in the 1980s and fell on increasingly hard times in the 1990s. Both are self-described "consensus" or "stakeholder"

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[8] Agrawal, Raj, et al. (1996). "Capital Productivity: Why the U.S. Leads and Why It Matters," *The McKinsey Quarterly*, 3:38-55.

societies that organize much of their economic decision-making around tight business-bank ties and collaborative corporate governance. Both de-emphasize stock markets. Both are aging societies with high domestic rates of savings, high labor productivity, and low returns on capital. And both have been and remain critically dependent on exports for growth.

These longer-term structural similarities are misleading, for they do not and did not foreordain similar behavior by policymakers and citizens in Germany and Japan. Until the late 1990s, there were in fact significant differences in the functioning of the two economies. Postwar West Germany was always more market-friendly than Japan, even after the liberal architect of the *Sozialmarktwirtschaft*, Ludwig Erhard, left office in 1966. While certainly more regulated than the United States, in contrast to Japan, most individual German business decisions were not directly influenced by government intervention, and German civil servants tended to stay in government rather than join companies—direct business-government ties were limited. Germany also allowed more competition, both domestic and foreign: on the trade side, the value of Germany's imports and exports comprise nearly twice the share of its economy as in Japan, and foreign direct investment into and out of Germany is six times that of Japan (figures 1 and 2).[9] German banks did play a dominant role in corporate finance and savings, but were allowed occasionally to fail or be taken over; and German bank supervisors were strict.[10]

The electorate held German politicians accountable for economic performance, as well. The decentralized federal political system, installed by the occupying Allied powers, allotted a strong role in determining policy to the opposition in the *Bundesrat* and in the *Länder* (state) governments. This gave German citizens a sense of political responsiveness that never developed in the one-party, bureaucrat-dominated postwar Japanese political system. The generous distribution of government spoils to average German workers and consumers too, usually through universal welfare programs, reflected the fact that political power in Germany lay with the majority and not, as in Japan, with business management and select interest groups.

Most important, Germany was always more engaged internationally than Japan. This was in large part due to political geography, with West Germany in NATO and on the Cold War's

[9] The data used for the foreign direct investment figures are stock data from the international investment position statistics from the IFS. The first figure shows only the country's direct investment abroad as a percent of GDP whereas the second figure considers the sum of the country's direct investment abroad and direct investment in the economy as a percent of GDP.

[10] See the list of bank failures in Germany released by the Bundesbank in April 2002.

front line. A partial welcome to resident foreigners, from Turkish *Gästarbeitern* to US troops, added to the sense of openness. (Japan has also hosted resident US troops, of course, but they have been allowed much less social influence in Japan than their counterparts in Germany.) This was also because of enlightened leadership by a succession of German chancellors, strongly backed by a majority of Germans, who simultaneously pursued European integration and the maintenance of transatlantic ties. Membership in the EU, in turn, was then a force for economic liberalization, at least within the single market. In essence, Germany's postwar *Wirtschaftswunder* and reintegration into the West was a victory of globalization.

Nevertheless, as with Japan in 1990-92, Germany's main concern now is how to respond to a bubble and its recessionary aftermath. Germany has experienced a real stock market crash—on October 9, 2002, the DAX index was 68 percent off its March 2000 peak (as opposed to a 49 percent drop in the analogous US S&P 500 index over the same peak-to-trough period), and the Neuer Markt, Germany's NASDAQ market, will be completely shut down by year-end 2003 due to the collapse of the vast majority of its listed companies (see figure 3 that shows an identical path for the Nikkei, rising and declining nine-fold, ten years earlier). Germany also confronts a severe slowdown: since the post-reunification boom of 1990-92, Germany has beaten Italy for the distinction of being the slowest growing economy in the EU, growing at an average rate of 1.3 percent a year. In 2002, the German economy grew a mere 0.2 percent, and the government's own revised forecast for real growth in 2003 is only 1.0 percent, which is insufficient to keep public deficits and unemployment from rising further. This is the objective situation. How are German economic decision-makers likely to handle it?

To find out what policy decisions will be made, it is important to focus on the key elements of the Japanese syndrome, and not just reel off a laundry list of apparent long-term similarities between Japan and Germany. On the first element of Japanese-type stagnation--incomplete financial liberalization--there is real cause to worry about Germany. In theory, because Germany always had universal banks, there was little to deregulate in terms of bank activities, and banks were already well diversified and so better able to handle shocks. Banks' hidden reserves, comprised of unrealized capital gains on shareholdings of non-financial companies and retained dividends, were supposed to provide cushions to capital adequacy. However, German financial markets have been in a state of transition in recent years akin to that which preceded the US S&L crisis in the 1980s and Japan's banking problems of the 1990s. The interest rate spread for banks, a key marker of profitability and competition, declined from around 2 percent through 1985 down to 1.2 percent in 2001 (and has lowered since; see figure 4). For the

German universal banks, just as for the post-Glass-Steagall US bank-holding companies, diversified lines of business have not defended them against cyclical losses.

Like Japan, Germany is not only a high-savings country but also one where savers increasingly put their money into bank accounts even as returns decline. Germany's deposit-to-GDP ratio is the highest in Europe (rock steady at 1:1 over the last decade) and total deposits have grown sevenfold in the last 20 years, while the economy itself only grew by about 60 percent, and average interest paid on deposits declined from 4 to 2 percent.[11] German banks are now lending a growing, and now the largest, share of these ample loanable funds--totaling four times the amount lent in 1980--to the non-financial services sector comprising a set of less productive small and medium enterprises; these loans, as in Japan, are secured mainly by real estate collateral of declining worth (see figure 5).[12] Employment growth in services (from 54.9 percent of total employment in 1991 to 62.6 percent in 2000) and profitability in this sector were certainly far from suffic ient to justify such a credit expansion. This trend in lending patterns is consistent with a profit-chasing reallocation boom as seen in Japan in the 1980s and early 1990s.

Reminiscent of Japan, this lending growth has occurred while Germany's more stable and profitable export-oriented manufacturing sector has steadily raised a greater share of its funds by going directly to foreign markets with securities on offer. As a result, the profitability of German banks' loan portfolios has fallen and the riskiness of its loans has risen beyond cyclical changes. Figure 6 shows the declining ratio of bank liquid assets to liabilities in Germany, now having reached current Japanese levels at below 1.5:1 (in the 1980s, Germany averaged a ratio of 3:1). Germany's tough labor laws restricting the firing of workers limit the ability of the banks to improve profitability internally, much as the Japanese banks feel bound to retain their "lifetime employment" workforces. For private banks, times have been particularly tough. Table 4 compares average financial performance from 1997-2001 for the largest German banks with that of the largest private eurozone banks outside of Germany. The German banks are far below their eurozone competitors (let alone those in London or New York) in the key ratios of liquid assets to short-term funding, return on assets, and return on equity. Just as in Japan, the number of German banks has not declined to restore profitability in the banking sector. There are still over 300 commercial banks of various sizes, over 520 *Sparkassen* (public savings banks), and 1,500 cooperative banks (only the latter category has been noticeably shrinking). While the

[11] All data cited in this paragraph is taken from Deutsche Bundesbank publications.
[12] The Bundesbank's definition for non-financial services is: "Non-financial services include housing enterprises, holding companies, other real estate enterprises, restaurants and hotels, computer and related activities, research and development (plus other business activities (except investment companies)), health,

Bundesbank's published list of postwar bank failures in Germany is long, it lists only two failures since 1997. This number is strikingly low in a time when more than an average number of failures could be expected as a result of market discipline, pressures for consolidation (including across EU borders), and recent volatility.[13] The end result of persistent overbanking is to deprive Germany's big banks of any profitable retail franchise--less than 4 percent of all savings accounts are held at the *Grossbanken*, and 14 percent of corporate/household loans are channeled through them. The *Sparkassen* meanwhile account for more than 50 percent of savings deposits and 16 percent of lending.[14]

As in Japan, public banks and special credit entities—including the *Sparkassen*, their clearing banks (the half state-owned, half *Sparkassen*-owned *Landesbanken*), and the *Kreditanstalt für Wiederaufbau* (the one-time Marshall fund bank, with an AAA-rating and $250 billion in assets, which is now a means for the federal government to send more credit to the *Mittelstand* and to pursue chosen projects off-budget)—play a significant role in the financial system. These public banks carry the advantage of a state guarantee, and therefore a lower cost of funds, as well as non-profit criteria for lending. This puts them in unfair competition with Germany's private banks, further eroding the latter's profitability. The EU has recognized that this system is anti-competitive and has legislated that the *Landesbanken* gradually phase out their state guarantees starting in 2005. But that ensures at least another two years of eroding private bank capital and also assumes that the partial privatization of these popular government institutions will be implemented on time in the face of domestic resistance rather than be renegotiated by the German government.

Not surprisingly, then, adverse selection has become visible in the German financial system. As asset prices fall, new borrowers experience a credit crunch, collateral and balance sheets of current borrowers are impaired, and banks reduce lending. A standard marker of credit conditions is the spread between government bonds and corporate bonds of equivalent maturity—when this spread widens, borrowers have greater trouble getting loans. In Germany, the spread between ten-year government and highly rated corporate bonds averaged 0.3 percent between January 1980 and May 1998, and rarely went above 0.7 percent for more than a month, even during recessions. Since June 1998, when German banks began to incur losses from the Asian

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veterinary and social work (enterprises and the professions), letting of movables and other services. From 1999, this category has included finance leasing institutions."

[13] "Bankzusammenbrüche in Deutschland," Deutsche Bundesbank, *Monthly Report*, April 2002. The failures/closures since 1950 are listed chronologically. Since the failure of the German Herstatt bank in 1974, there have been 60 failures/closures but only 12 since 1989 (including the German branch of BCCI) and only four since 1995.

[14] Bundesbank data reported in "That sinking feeling," *Economist*, February 20, 2003.

financial crisis and then the Russian default, the risk spread has been steadily rising. As of September 2002, the spread was a hefty 1.7 percent, having averaged 1.3 percent in the preceding year. The comparable US risk spread also widened along a similar time frame but only went up by 58 basis points on a higher (0.72) initial base, whereas the German spread has increased by 138 percent.

This increase can be credibly linked to declining German bank capital. The national average bank financial strength rating, removing the effect of government guarantees, is now below C+ according to Moody's rating agency—in other words, sub-investment grade. Every other EU country's banking system except that of Greece has a higher average rating. Provisioning for the coming losses on non-performing loans in a time of declining profits will further erode German banks' capital base. A German banking leader remarked to the US press in October 2002, "We're not talking about a liquidity problem...What we are talking about is a lack of profitability."[15] Edgar Meister, the widely respected head of the ECB's banking supervision committee, was even more explicit following the February 20, 2003, meeting called by Chancellor Schröder to discuss whether public action was needed to deal with bad loans:

> *"I remain confident that German banks will be able to resolve specific weaknesses on their own. Anyway this is not at all the time to discuss the use of taxpayers' money. The stability of the German financial system as well as the banks' liquidity are [sic] out of question."*[16]

It is accurate to point out that the risk of a financial breakdown or even abnormal interbank liquidity problems in Germany is negligible in 2003, but the same thing could have been said of Japan's banks at the start of the post-bubble years. A few consecutive years of low profitability creates a lack of capital, ultimately leading to distorted credit decisions and the accumulation of bad loans. Germany today, like Japan circa 1992, has too many banks with too little capital but no significant exit of savers or public sector competitors. Similarly, it is entirely commendable to put the burdens of rebuilding capital on the large private banks themselves but if those banks are deemed to big too fail—and the means of rebuilding capital remain constrained by unfair competition from public-sector banks—the result could be unintentional forbearance while the situation worsens. Remember, for Germany in 2002-03 the appropriate comparison is to

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[15] Rolf E. Breuer, Chairman of the *Aufsichtsrat* of Deutsche Bank, quoted in "In Germany, Banks Mirror Wide Malaise in Economy," Mark Landler, *New York Times*, October 22, 2002, p. W1.
[16] "Statement by Edgar Meister on the current situation of the German banking sector," Deutsche Bundesbank Press release, February 24, 2003.

Japan in 1992-94, before the majority of Japan's private banks were insolvent or there was any significant accumulation of bad loans raising the need for a 'bad bank.'

In the past four years, German macroeconomic policy, the second indicator to watch, has also become distressingly parallel to that of Japan. Until 1999, German monetary policy was quite flexible and helped to stabilize the real economy, while German fiscal policy was well within G-7 norms for counter-cyclicality.[17] Since European monetary unification at the start of 1999, however, German monetary policy has been set by the European Central Bank, and German fiscal policy has been constrained by the eurozone's Stability and Growth Pact. With the ECB replacing the Bundesbank, Germany has suffered from a centrally set monetary policy aimed at the eurozone in general, rather than set to its own needs.[18]

While the German inflation rate has averaged 1.5 percent annually since January 1, 1999, and averaged just *below* zero percent over the last six months of 2002, the ECB has been reluctant to cut interest rates, referring to harmonized inflation rates above the 2 percent target. The impact of ECB monetary policy on Germany arguably diminishes as it approaches deflation while suffering from banking sector weakness. Under legitimate pressure to rebuild their capital, cash-strapped German banks have not passed the ECB's latest interest rate cuts to borrowers, another marker of Japan-like bank weakness.[19] Were Germany setting its own monetary policy, the Bundesbank might well seek to steepen the yield curve, much in the manner the Federal Reserve did to aid with the resolution of the US savings and loan crisis; for the ECB committed to an inflation target of 2 percent or less, and without a financial stability mandate, incurring such a rise in inflation expectations would be dereliction of duty.

There is an open debate over whether the ECB has ended up being more reluctant to ease credit for Germany than the Bundesbank would have been under similar economic conditions.[20] A UBS Warburg analysis, based on OECD data on output gaps and real interest rates, suggests

[17] For discussion of German monetary policy, see Thomas Laubach and Adam Posen, "Disciplined Discretion: Lessons from the German and Swiss Monetary Frameworks," *Princeton Essays in International Finance,* No. 206, 1997; and Richard Clarida and Mark Gertler, "How the Bundesbank Conducts Monetary Policy," NBER Working Paper 5581, May 1996. Posen (1998), chapter 2, op cit, compares OECD members' fiscal policy countercyclicality.

[18] Observing that macroeconomic policy set on an eurozone-wide basis could still exacerbate Germany's divergent growth path need not imply any criticism of the EU's policymakers evaluated in terms of their stated mission. One might consider, however, questions that divergence raises about that mission.

[19] "German banks ignore ECB cut," Andreas Krosta, *Financial Times*, January 14, 2003, p. 16; "Feeling the Crunch," *Economist*, February 1, 2003, p. xx; "Rate-Cut Row Shows German Bank Dilemma – Calls to Improve Margins Are Countered by Pressure to Lower Price of Credit," Marcus Walker, *Wall Street Journal Europe*, January 21, 2003, p. M1.

[20] Some estimates find that the ECB should have cut interest rates up to one hundred basis points more than it did since early 2001. See Michael Mussa, "Global Economic Prospects," IIE *Policy Brief*, No. PB02-5, September 2002.

that a Taylor rule-based neutral policy for Germany in 2003 would be a full point below that of the euro area as a whole.[21] JP Morgan economists David Mackie and Silvia Pepino claim that "since 1999, the ECB's policy rate has on average been almost 1 percentage point too high for Germany. But by the fourth quarter of [2002], the ECB's policy rate was almost 2 percentage points too high."[22] Noted monetary economists, however, including Jordi Gali, Jon Faust and their respective co-authors, have argued empirically that the ECB has erred on the side of ease in comparison to Taylor rules estimated on eurozone data with Bundesbank parameters; in fact, Faust, et al. argue that ECB monetary policy was closest to being in line with the rule for France and Germany, with the interest rate too low (by 200 basis points) even for those two member economies.[23]

Beyond the debate over current estimates, in terms of dealing with a member country with significantly divergent performance, the ECB's pursuit of an inflation target of 2 percent or less for a weighted average of eurozone economies has three inherent difficulties. First, the "or less" target, instead of a symmetrical one of around 2 percent, imparts an additional deflationary bias, leading the ECB to be more aggressive in offsetting price rises than declines so long as the average is above 2 percent; this may also instill an attitude of lower is always better even near or below the 2 percent target.

Second, the target level is set too low for a eurowide average. The smaller and the structurally reforming EU economies should be experiencing higher inflation as they adapt, and the larger and developed economies (like Germany) could have to therefore average substantially less than 2 percent on an ongoing basis (which in practice is actually deflation, given the positive bias of all inflation measures)—the range of European inflation rates over the last four years has been on the order of 3 percent, while that of the US states has been only 1 percent, and the European standard deviation of inflation rates has been twice as high.[24]

Third, given the lack of synchronization between the business cycles of eurozone economies and of fiscal transfers among the economies, some countries will always suffer from

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[21] UBS Warburg European Economics, "The Year Ahead in Europe," *Global Economic and Strategy Research*, December 20, 2002, pp. 12-18.
[22] David Mackie and Silvia Pepino, "Germany's stagnation is beyond its control," *Financial Times*, February 26, 2003.
[23] See Jordi Gali, "Monetary Policy in the Early Years of EMU," mimeo, CREI and Universitat Pompeu Fabra, May 2002, and Jon Faust, John H. Rogers, and Jonathan H. Wright, "An Empirical Comparison of Bundesbank and ECB Monetary Policy Rules," Board of Governors of the Federal Reserve System, International Finance Discussion Papers, Number 705, August 2001. The Faust, Rogers, and Wright data, however, ends in February 2001, when Germany's performance began to diverge more widely.

[24] UBS Warburg European Economics, "The Year Ahead in Europe," *Global Economic and Strategy Research*, December 20, 2002, pp. 12-18.

significant divergences between ECB policy and their own cyclical needs. Especially with countries like Ireland, the Netherlands, Spain, and (to a lesser degree) France on sustained trends of improvement in growth and unemployment, while countries like Germany and Italy are on secular growth downtrends, monetary policy will not simply balance out over time. It will be chronically tight for the slower economies and will reinforce their slowdown. Moreover, now that Germany is in a currency bloc with the majority of its trading partners, it cannot loosen its monetary conditions by adjusting its exchange rate either to make up for excessively high interest rates. Instead, deflation becomes the adjustment mechanism for relative national price levels.[25] The question is what the real economy suffers in that process if nominal rigidities are high (as they are in Germany) and the financial system is both bank-dependent and fragile (as also is the case in today's Germany).

Meanwhile, on the fiscal side, the Schröder government has proposed raising taxes during the current recession in the hope of bringing the budget deficit back down to the Stability and Growth Pact target of 3 percent of GDP. The EU's Stability and Growth Pact has a built-in destabilizing bias: the larger a recession, the more likely an economy is to breach the 3 percent cap on deficits; once it approaches that limit, meaning the more likely it is to exceed the deficit cap, the more tax increases or spending cuts must be pursued. Recent proposals to measure the deficit on a cyclically adjusted basis would offset this bias somewhat, but as long as the rule remains in place, mandating a rapid return to deficits of below 3 percents, fiscal policy will choke recovery by tightening policy as soon as growth and tax revenues pick up—repeating on a smaller scale Japan's mistake of 1997.[26]

Some countries, like France, have defied the Pact and simply put off meeting the deficit targets. The German government, however, has explicitly abjured such measures since its politicians were the ones who insisted upon having public debt and deficit limits built into the Maastricht Treaty and the EMU in the first place. They did so in order to (in their minds) prevent fiscal indiscipline from subverting the stability of the euro. The German government has thus painted itself into a corner of austerity, for it has echoed both the European Commission and the

[25] "Inflation must become Europe's target," Edwin Truman, *Financial Times*, December 17, 2002, p. 19
[26] More specifically, the SGP allows Germany to stay above 3 percent deficit in 2003, with the only penalty being the launch of a second 'excessive deficit procedure.' Germany will face financial penalties only if its deficit is above 3 percent in 2004. Still, that would require tax increases today, although only on the order of 0.5 percent of GDP, not the larger adjustment Finance Minister Hans Eichel has proposed.

ECB and characterized any loosening of the Stability and Growth Pact as an indication that markets should discount the euro's stability.[27]

Perhaps the most chilling parallel between post-EMU Germany and post-1992 Japan on macroeconomic policy is in the lack of coordination between fiscal and monetary policymakers in the eurozone. As with the Bank of Japan, the European Central Bank refuses to loosen monetary policy sufficiently or to believe that stronger growth is sustainable without inflation until elected governments pursue structural reforms. And the ECB is on record that it will view any loosening of or non-adherence to the Stability and Growth Pact as undermining monetary stability, and will be likely to tighten policy in response. In the eurozone, however, the ECB is playing chicken with not just one but twelve sets of politicians and bureaucrats. And the German Ministry of Finance alone, among those dozen national fiscal authorities, feels the need to self-impose austerity in order to set an example, even though its fiscal discipline alone will be insufficient to convince the ECB to ease policy in return. The result is that German fiscal policy discipline will not be rewarded with ECB easing of monetary policy.

TWO DOWN, TWO TO GO?

Today Germany already has in place the first two components of what fed Japan's decline a decade ago—incomplete financial liberalization and an uncoordinated deflationary macroeconomic policy—with the combined negative shock of a stock market crash, declining real estate prices, end of a credit boom, and global economic slowdown, which were needed to set the full "declinist" syndrome in motion. What, then, of the third element? Are German households sufficiently passive financially and politically to allow this process to gain momentum? Increasingly so, but not irreversibly.

On the political side, reunification has diversified and fragmented the composition of the German workforce, and both the pork-barrel benefits of government programs and the protections of government regulations have become more narrowly distributed as a result. Demands for protection due to the sustained growth slowdown, declining employment in some manufacturing sectors (as in Japan, these are the most efficient and export-competitive businesses in Germany, while backward sectors retain unneeded employees), and the rising number of long-term

[27] As various EC and ECB officials have noted, Germany and the other countries in violation of the pact could have cut their structural deficits during boom times and avoided the problem. In Germany's case, the push for tax cuts for structural reform reasons in 1999-2000 made this impractical.

unemployed people have reinforced a change in Germany from dispensing mostly universal benefits to more targeted interest-group rents.[28]

Notably, there are fewer traditionally unionized workers but the relative benefits of being such a worker versus working elsewhere or being unemployed have increased. This development allies long-term German employees and uncompetitive companies to maintain the status quo and protect specific businesses—and the protection of those businesses includes maintenance of their credit lines from either state-supported or uncompetitive banks, just as in Japan. Meanwhile, the long-term unemployed, particularly in the former East Germany, who have little hope of finding good union jobs, have no interest in challenging the system of protections so long as the unemployment benefits and regional public-works keep coming.

Thus, as in Japan, Germany now has special-interest blocs that exploit the average German and are capable of vetoing change. Meanwhile, ECB decisions on monetary policy, and decisions of the European ministers on the Stability and Growth Pact's fiscal rules, are so far removed from democratic control, let alone anything German voters can directly affect, that the decision-making process itself feeds political passivity about macroeconomic policy. Also in contrast to all the German national elections since the mid-1960s, the September 2002 election offered little choice to voters on economic and social policies between the two major parties' platforms. Unsurprisingly, turnout was down, the electoral shares of the SPD and the CDU/CSU differed by only tenths of a percentage point, and political cynicism rose sharply. The February 2, 2003, state elections in Hesse and Niedersachsen offer some hope, not so much because the Social Democrats lost ground but because they indicated a renewal of the German electorate's willingness to express frustration in politics and hold the government accountable. Yet, in these elections, too, voter turnout reached historical lows.[29] The next step depends on whether in practice, with a divided *Bundestag* and *Bundesrat*, this will result in policy change or deadlock (the latter of course will feed frustration anew if it happens).

On the financial side, too, recent events have taken a toll on German savers' willingness to move their capital out of German banks, or out of Germany altogether. The privatization of Deutsche Telekom in 1999 was meant to be the first step in the creation of an *Aktienkultur* (stock-holding culture) in Germany. The creation of the Neuer Markt and a unified Deutsche Börse were meant to take advantage of this increased demand for equities, thus deepening the market.

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[28] Mancur Olson was perhaps right to argue in *The Rise and Decline of Nations* [1978] that economies become sclerotic over time because rent-seeking groups accumulate.

[29] Turnout in the German national elections in 1994 was 79.1 percent, in 1998 82.3 percent, and in 2002, 79.1 percent. In Hesse, turnout was 70.8 percent in 1991, 66.3 percent in 1995, 66.4 percent in 1999, and

At peak, however, only 10 percent of German households held stocks or stock funds, even after these initiatives.[30] Unfortunately, the telecom collapse has imposed huge losses on Deutsche Telekom shareholders in a very short time, and for many Germans this was their first and major, if not only, stock holding. Those few who took speculative risks on "new economy" stocks in the Neuer Markt were similarly burnt and are now held up as cautionary examples.

Many wealthier Germans had moved savings abroad to secret accounts in Luxembourg, Switzerland, and other centers of bank privacy, but on December 16, 2002, Chancellor Schröder announced a new combined flat tax on savings interest and temporary tax amnesty to bring those funds home. Average Germans, particularly the elderly, share with their Japanese counterparts an aversion to risking their money abroad—or even any place beyond the neighborhood savings bank. Consumption growth has been on a downward trend for most of the last decade, outpacing the stagnation in real incomes (see figure 8; note the brief spike after reunification).

Corporate governance scandals in the United States have further reinforced popular longstanding German suspicions about financial speculation. This most inopportune increase in risk aversion and bank dependence in Germany happens to coincide with EU efforts to integrate Europe's banking markets, open Germany's corporations to hostile takeovers, and remove the privileges of the *Landesbanken*. Germany's uncompetitive public banks, and small businesses dependent on those banks for credit, are taking advantage of this fortuitously timed (for them) bad press for "Anglo-Saxon finance capitalism" to pressure their government to resist such liberalization.[31] Germany appears to be following Japan on the third step of the path to perdition--financial and political passivity in response to the first two steps (banking system breakdown and deflationary macroeconomic policy).

The pressing need for reform is now being acknowledged in the German public debate, but it remains to be seen whether that will translate into significant political pressure for painful and politically difficult changes. The key is Germany's openness. Germany--as a member of NATO, EU, and eurozone; as a major recipient and source of foreign direct investment (see figures 1 and 2), and as an immigrant-receiving country (despite some misgivings)--starts out much better prepared on this front than Japan. Market forces have always been pushed back to protect politically connected local companies, though in the last few years the bailouts, subsidies, and ownership protections have been particularly frequent and high-profile—for example, in the

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64.6 percent in 2003. In Niedersachsen, turnout was 73.8 percent in 1994 and in 1998, but 67 percent in 2003.

[30] Deutsches Aktieninstitut, e.V., *DAI-Factbook*, February 2003.

cases of Philipp Holzmann, Mobilcom, Mannesmann, Bankgesellschaft Berlin, and Volkswagen. But some form of such protection exists in all countries.

A more pressing question is whether this recent wave of domestic-company protection will interact with Germany's compassion fatigue, having given the *Neuen Bundesländer* and the converging EU states huge transfers through the years. Intra-Germany transfers from the west to the former DDR *Länder* have amounted to 4 percent of Germany's GDP a year. Net contributions to the EU budget have been another half a percent of GDP annually, the second highest contribution by share of GDP (after Sweden).[32] If the Germans view expansion to the transitioning low-wage east with alarm and cut back on their openness and net financial support of the EU, this could well feed greater protectionism and economic nationalism in the process.

Germany could on its own, perhaps in a de facto grand coalition between CDU and SPD, consolidate its banking system, push for looser fiscal and monetary policies, and revitalize consumption by its population. But policy capabilities and economic developments in these areas all depend critically upon the actions taken by the European Commission and EU ministers. While such openness and commitment through Brussels to multinational reform are Germany's key hope—which was absent in the Japanese case--EU policymaking trends are mostly heading in the wrong direction right now. The European Union's constitutional convention, led by former French President Valery Giscard d'Estaing, has sought to enhance the power of nation-states—particularly of the largest states in the EU, France, and Germany—vis-à-vis the European Commission and the Parliament in the face of EU's expansion to include ten new members from eastern Europe. Compounding this promotion of national identity in EU leadership is, of course, the divide within the European Union's foreign policy over the United States and Iraq.

Tending toward the statist/intergovernmental end (as opposed to the federalist end) of the constitutional spectrum increases the likelihood of German economic decline in four ways:

- first, by weakening the European Commission, it will impede Brussels' independent efforts to push liberalization (including of banking) on unwilling European governments;
- second, by making decision-making in the EU more akin to that in the US Senate, horse-trading and logrolling will promote national champions and bailouts rather than healthy compromises;

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[31] Consider the recent conflict between the EU and the German government over alleged discrimination against foreign investment funds. "Germany hit by legal action on foreign funds," Francesco Guerrera and Haig Simonian, *Financial Times*, December 20, 2002, p. 18.

[32] The UK's net contribution after rebate is 0.25 percent of GDP, France's (after CAP) is 0.10 percent, and Italy, Denmark, Spain, and Ireland are all net beneficiaries. Overall, 24.4 percent of the EU budget is financed by Germany. Source: http://europa.eu.int/comm/budget/pdf/agenda2000/report2001_en.pdf.

- third, by stunting the development of the European Parliament's competencies to promote rules by negotiations between national ministers instead, it will magnify the EU's democratic deficit, making citizens in Germany and elsewhere still more passive about economic policy;
- and fourth, by placing a premium on state leadership, with France at the forefront, the establishment of a distinct international EU identity—including a foreign policy divergent from that of the United States—will become the priority rather than the costlier internal development of the accession countries and less populist international integration.

Combine these effects with the likely combative response of the ECB to any political measures that the Council of Ministers would undertake to slow economic reform in Europe, and Germany ends up fulfilling all four determinants of Japan-style stagnation. Of course, Germany has traditionally advocated federalism within the EU, as illustrated by the speech of Foreign Minister Joschka Fischer in May 2000 calling for a single president as the EU executive.[33] With the recent French/German bilateral and exclusionary deals made on agricultural policy, and relations with Iraq, this historic German tendency cannot be taken for granted. Every time the economically strapped Germany of today is reminded of its disproportionate net funder (rather than recipient) status with regard to the EU budget, and with the smaller countries calling for more voice in EU decision-making propose to enhance or maintain their net receipts, Franco-German dominance becomes more appealing. Transatlantic foreign policy discord reinforces that feeling.

U.S. FOREIGN POLICY OPTIONS

There is room for the US government to forestall this development in Germany and in Europe, and there is good reason for it to do so. Expanding growth in the major economies should be a foreign policy priority. We have already seen the difficulties facing US foreign policy in East Asia caused by Japanese stagnation: withdrawal from the region of Japanese export demand, credit, technology transfers, and investment; economic contraction in 1997-99 throughout those markets, causing a decline in living standards and shifting of cheap exports to the US market; post-crisis political instability in Indonesia and varying degrees of anti-Americanism from Malaysia to South Korea as a result of scapegoating "failed" US/IMF policies; resistance to further multilateral trade liberalization and economic integration; Japan's withdrawal from leadership even as a donor with soft power; and the enhanced opportunities for China to cultivate dominance in the region as a result.

[33] "From Confederacy to Federation - Thoughts on the finality of European integration" , Speech by Joschka Fischer at the Humboldt University in Berlin, 12 May 2000. http://www.auswaertiges-amt.de/www/en/infoservice/presse/index_html?bereich_id=17&type_id=5&archiv_id=1252&detail=1

We can ill afford a similar destabilizing sequence taking place among the NATO members of eastern Europe, along Russia's border, and in Turkey and North Africa. That is, however, what will happen if the German economy does become the next Japan. And it is likely to be worse than what happened in East Asia for three reasons. First, global economic distress cumulates both directly and politically—if we add German decline and Eastern European or Mediterranean economic instability to that already experienced in East Asia in 1997-99 (and occurring at present in Latin America), the effects on global growth will worsen, and the political reaction against market economics will increase. Second, as previously noted, Germany is more geopolitically influential than Japan because its economy is more integrated with its neighbors, it has a significant military presence within NATO, and it has generally played a large role in supporting US multilateral initiatives (the obvious exception being treatment of Saddam's Iraq, but including deployment of troops in Kosovo and Afghanistan).

Third, the timing of Germany to potentially fall into Japan's trap is most inauspicious. The US economy is no longer growing at the same speed as it was during the Asian financial crisis, and cannot afford to take in a growing amount of imports indefinitely, let alone increase its current account deficit by importing more from emerging markets, especially while cutting public savings by undertaking a war budget. Yet formerly liberalizing, now economically frustrated, governments throughout East Asia, Latin America, and, if Germany goes, eastern Europe are looking for additional evidence they can use to blame their economic travails upon Western indifference or *laissez-faire*. Additionally, in a climate of transatlantic dispute, with unilateralism in the United States and a direct challenge from France and Germany, one can imagine extreme politicization of any export adjustments, movements in the dollar-euro rate, or of aid efforts either multilateral or in occupied countries.

Thus, while security goals may indeed be ultimately more important than economic ones for American national interests, as the Bush administration entered office proclaiming, the economic policies of the US and our major allies are critical to achieving those security goals. This is clearly underappreciated in current US foreign policy. Preventing Germany from going further down Japan's path should be our primary foreign economic policy priority, and one of our main security priorities overall. German economic underperformance has a direct negative effect on security relations even narrowly defined: some of Germany's declared pacifism and open conflict with the United States was induced by the inability to date of the Schröder government to deliver on its economic promises, increasing the need for an international distraction. The hectoring rhetoric of the Bush administration emphasizing perceived transatlantic differences and American superiority, accepting German economic troubles as the result of its being "Old Europe," rather than trying to bring the economy up, do not help. Finally, there are those who are ideologically or self-interestedly opposed to globalization associated with Americanization, who are taking advantage of the German slowdown to attack market economics and the United States for promoting it.

Given the importance of swinging German economic performance, and German views on EU integration, here are four steps that the United States can take to pursue this priority.

First, practice reverse linkage. Making better economic performance of Germany and other allies a security goal means practicing linkage of progress on this front to US cooperation in other issue areas, rather than artificially separating "high" and "low" politics. This reverses the famous economic linkage of US-Soviet détente, where political concessions by the Soviets were rewarded by trade deals. Japan has demonstrated how a country that runs a trade surplus and has vast national savings to start will not have any obvious barrier to continue running deflationary policies, and the United States has little direct economic leverage on such a country. US foreign policy under both Clinton and Bush has sometimes successfully moved Japanese economic policymakers to act when a broader front of public diplomatic and security pressures linked Japan's delivery on pro-growth policies to other things desired by Japan.[34] Such pressures proved almost uniformly unsuccessful when issue areas were not linked to broader foreign policy. The same would apply to a deflationary high-savings Germany.

Second, encourage a more federalist Europe. Giscard and the French statists have not yet won with their vision for a Europe led by national prime ministers, with influence weighted by state size. In fact, most of the smaller and the accession countries have favored a federalist Europe with a strengthened executive and European Parliament, and are against a big state dominion of intergovernmental EU decision-making. Of course, this is a matter of choice along a spectrum from federalist to statist/intergovernmental, not a zero-one decision, and the choice will be made by the elected representatives of the EU member states. Nonetheless, before the terms of European reorganization are set by the end of 2003, the United States can hold out the carrot for greater recognition of the EU in international organizations (the IMF, the UN Security Council, etc.) as well as the prospect of more extensive bilateral coordination, conditional on Europe moving in a more federalist direction. In so doing, the United States can support its many European friends among the small countries in this debate and change the incentives of those policymakers who remain swingable, with Germany foremost among them. It is a credible offer that the United States would deliver additional standing in international forums for a more federalist EU because then the EU would lean towards speaking with a single voice, but a voice forced to represent a responsible compromise position

[34] See "On U.S. Pressures for Improved Japanese Macroeconomic Policies," A comment to *Future Directions for U.S. Economic Policy Toward Japan*, Independent Task Force Report, Council on Foreign Relations, New York, September 2000.

(and not that of, say, neo-Gaullist France).[35] Put differently, if US economic and foreign policy were key to encouraging the initial development of European integration, why should the United States stand aside with so much at stake at the time of Europe's constitutional convention?

Third, play to Germany's traditional postwar values. Moving from the general precepts of means and relations with Europe to specifically German-American relations, American foreign policy can benefit from a call to Germany's recent past. Since the 1950s Germany has been committed to a federalist rather than a statist/intergovernmentalist Europe. Until its most recent economic troubles gave it assistance fatigue, Germany had championed the cause of European supra-national decision-making in response to first Mediterranean (Greece, Portugal, Spain) and then eastern enlargement, conditioning the entry of new members on sensible economic criteria. Germany also was repeatedly in consort with the United Kingdom to support liberalizing reforms on the continent. If the United States appeals to Germany's sense of historic responsibility to eastern Europe, to economic efficiency in the EU, and to wanting to transcend the nation-state by example—and gives the German government proper recognition for so doing—it can effect a major change in German policy toward internal EU arrangements. Obviously, managing this process from the nadir of German-American relations in the September 2002-February 2003 period is a matter of difficult diplomacy, but it is manageable. In fact, diplomacy can achieve more by emphasizing common ground and progress on the economic issues and by relieving some stresses around the world that will soon come to boil without growth and adjustment in the G-7, than by crying "Old Europe" and seemingly endorsing Germany's economic decline.

Fourth, encourage liberalization without being sanctimonious. US economic performance in the 1990s and its military predominance have converged with a moralistic tone in US foreign policy to make US-supported liberalization extremely unpopular. The United States would do better to pick specific areas in which economic reform will play a strategic purpose, particularly in saving Germany from stagnation, instead of being triumphalist about its superior "model." This has an additional advantage of being more persuasive to Germans and Europeans in general since this brings home that there are countries doing much better than Germany (Ireland and the Netherlands, for example) as a result of constructive reform without converging completely on some American ideal. This agenda would include encouraging free international competition for pension fund and investment management, reducing agricultural subsidies and barriers, creating non-aggression pacts between rich countries of no new trade protections or corporate bailouts (rather than encouraging their escalation as

[35] "They [the US and EU] need to start thinking of themselves as an informal 'G-2' steering committee for the global system…On issues where Europe speaks with a single voice, and has been able to translate its economic weight into negotiating leverage, a G-2 already exists…The European Union's current constitutional convention offers an opportunity that must be seized to consolidate its external representation." C. Fred Bergsten, "The Transatlantic Century," *Washington Post*, April 30, 2002, p. A19.

the United States did with its 2002 steel tariffs and farm bill), and pushing through some form of renewed international banking standards (a Basle II with teeth but fewer complications, for example). All of these would directly or indirectly lead to greater openness, financial stability, citizen risk-taking, and macroeconomic stimulus in Germany and in a more unified, less statist, European Union.

Table 1 Exports to Germany

Exporting country	**Exports as a percent of total exports**	**Exports as a percent of GDP**
United States	3.90%	0.30%
France	16.36%	3.63%
Benelux	24.09%	15.21%
Italy	15.60%	3.36%
United Kingdom	11.97%	2.26%
Russia	8.29%	3.21%
Turkey	19.00%	3.53%
EU accession countries	31.31%	11.11%

Source: IMF Direction of Trade Statistics, January 2003: Exports to Germany (line 70 DZD 134) and imports from Germany (line 71 DZD 134); and IMF, IFS, January 2003: Exports (line 70 DZF), imports (line 71 DZF), gross domestic product (line 99B ZF) and exchange rate with US dollar (AE ZF).

Table 2 Official development assistance to developing countries and multilateral organizations, 1999-2001

	Net ODA (US $ millions)	**Percent of gross national income**	**Percent of G-7 total net ODA**
United States	10176.50	0.10	25.23
Germany	5178.28	0.27	12.84
France	4647.36	0.34	11.52
United Kingdom	4168.83	0.29	10.34
Italy	1602.98	0.14	3.97
Canada	1660.88	0.25	4.12
Japan	12892.68	0.28	31.97
G-7 Total	40327.51		100

Source: http://www.oecd.org/xls/M00037000/M00037866.xls, Table 4: Net Official Development Assistance from DAC Countries to Developing Countries and Multilateral Organisations.

Table 3 Defense spending (average 1997-2001)

	Total defense spending (US$ billions)	**As a percent of GDP**	**As a percent of total NATO spending**	**Number of active military personnel** (thousands)
United States	301.99	3.16	64.74	1,499
Germany	27.46	1.52	5.89	324.68
France	33.66	2.72	7.22	421.36
United Kingdom	34.4	2.54	7.37	218.12
Italy	21.02	2	4.51	393.5
Turkey	7.36	4.98	1.58	798.48
Czech Republic, Hungary, and Poland	5.61	1.98	1.20	287.36
Japan	39.9	1	n/a	238.2
Canada	8	1.22	1.72	59.88

Note: The defense spending data was calculated in 2001 dollars in billions with 2001 exchange rates. For Czech Republic, Hungary and Poland, data were available only for 1999-2001.

Source: Report on Allied Contribution to the Common Defense, A Report to the United States Congress from the Secretary of Defense, June 2002, http://www.defenselink.mil/pubs/allied_contrib2002/allied2002.pdf, Table E-4 (Defense Spending), Table E-5 (Defense Spending as a percent of GDP) and Table E-8 (Active-Duty Military Personnel).

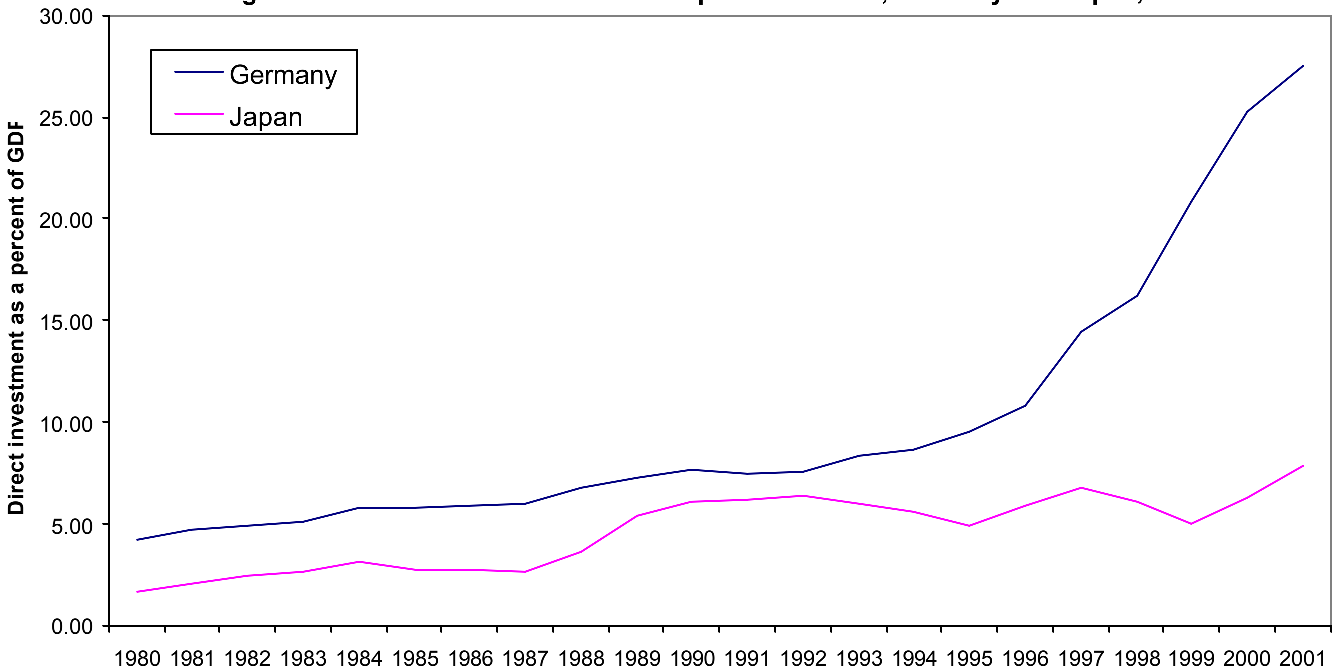
Table 4 Financial performance of German and eurozone banks (average 1997-2001)

	Cost to income ratio	Liquid assets / customer deposits & ST funding	Return on assets (ROA)	Return on equity (ROE)
Average of largest German banks	57.76	18.65	0.20	4.76
Average of largest non-German eurozone banks	64.36	30.43	0.66	14.18

Note: The unweighted average was computed for each group of banks from 1997-2001. The same 10 German banks are included in each column; due to data limitations, the sample includes 39 non-German eurozone banks in column 1, 28 in column 2, and 37 in columns 3 and 4.

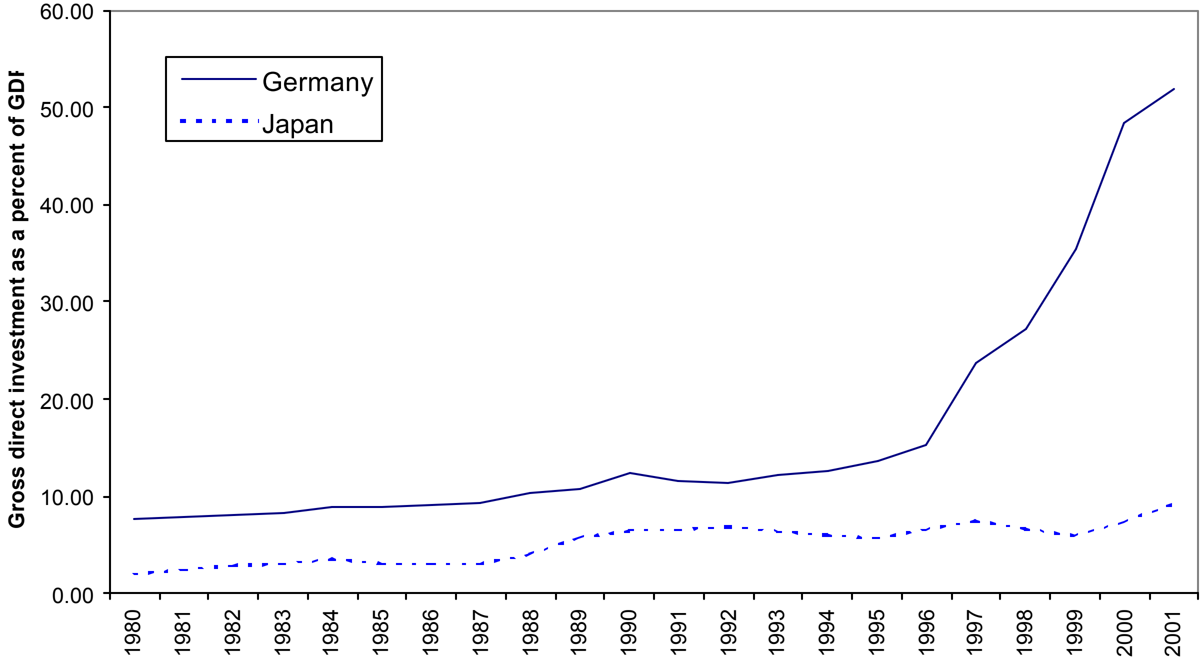
Source: European Central Bank, Monthly Report, "Indicators of the 50 largest euro area banks' liquidity, asset quality, profitability, and solvency," August 2002, Table 2, p. 58, http://www.ecb.int/pub/pdf/mb200208en.pdf.

Figure 1 Direct investment abroad as a percent of GDP, Germany and Japan, 1980-2001



Source: IMF, IFS, January 2003, International Investment Position. Direct Investment Abroad as a percentage of GDP was calculated from direct investment abroad (line 134 79 ABD ZF for Germany and line 158 79 ABD ZF for Japan) converted to national currency with IFS line AE (for Germany through 1998 and Japan) and EA (for Germany after 1998) and divided by national GDP figures (line 134 99b ZF and ZW for Germany and line 158 99b ZF for Japan).

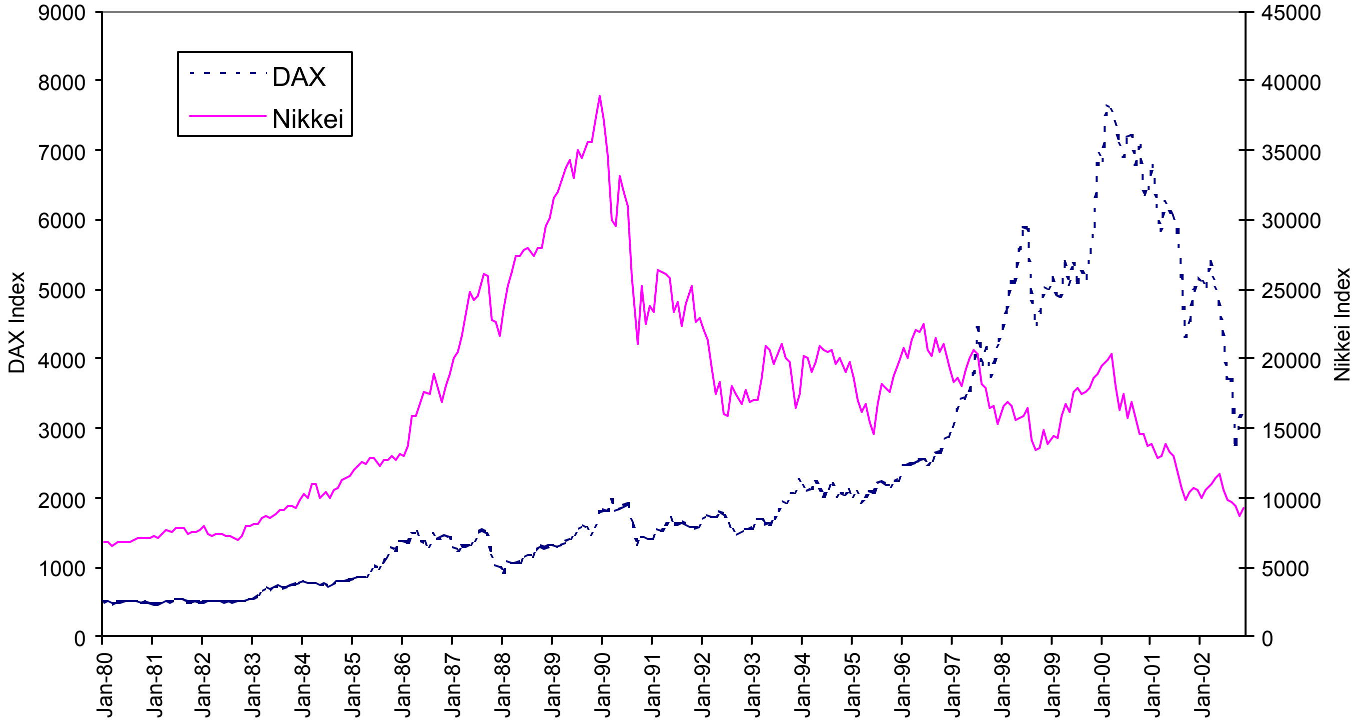
Figure 2 Gross direct investment as a percent of GDP, Germany and Japan, 1980-2001



Note: Direct investment includes equity capital, reinvested earnings, other capital and financial derivatives associated with various intercompany transactions between affiliated enterprises, but excludes flows of direct investment capital into the reporting economy for exceptional financing, such as debt-for-equity swaps.

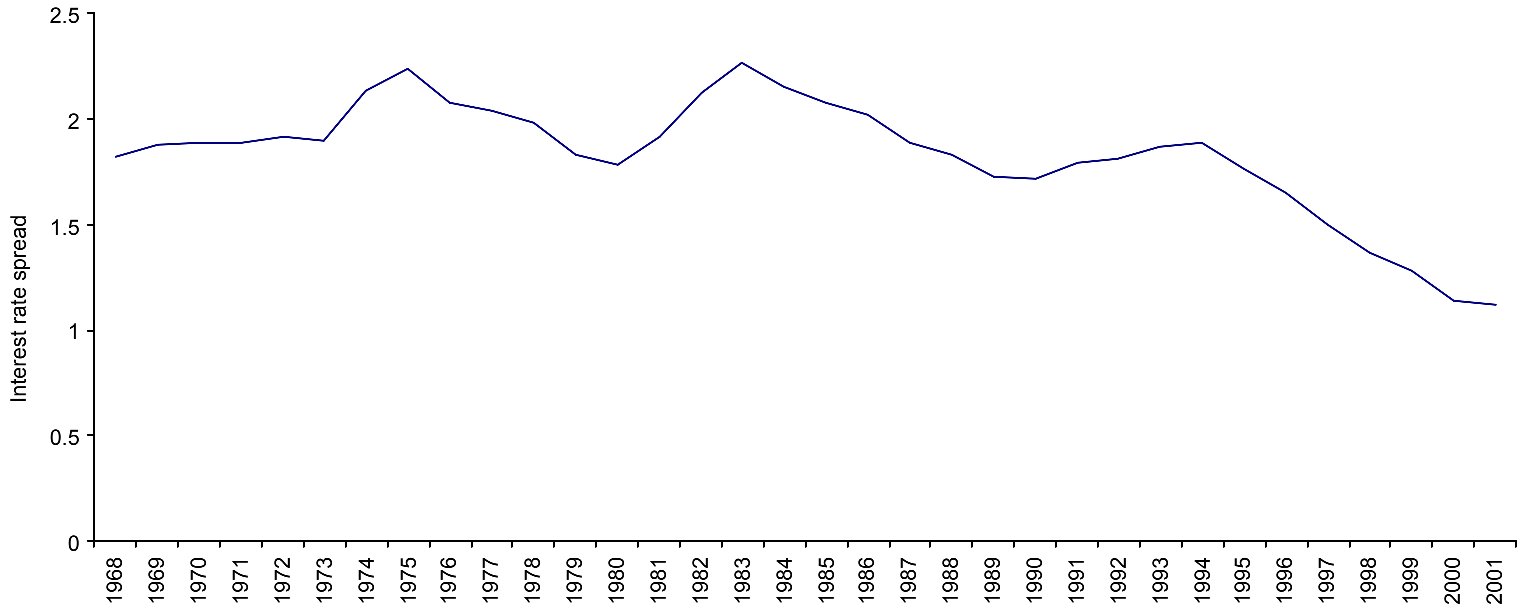
Source: IMF IFS, January 2003, International Investment Position. Gross Direct Investment as a percentage of GDP was calculated by taking the absolute value of the sum of Direct Investment Abroad (line 134 79 ABD ZF for Germany and line 158 79 ABD ZF for Japan) and Direct Investment in the Reporting Economy (line 134 79 LBD ZF for Germany and line 158 79 LBD ZF for Japan) converted to the national currency with IFS line AE (for Germany through 1998 and Japan) and EA (for Germany after 1998) and then divided by national GDP figures (line 134 99b ZF and ZW for Germany and line 158 99b ZF for Japan).

Figure 3 Equity prices, Germany and Japan, 1980-2002



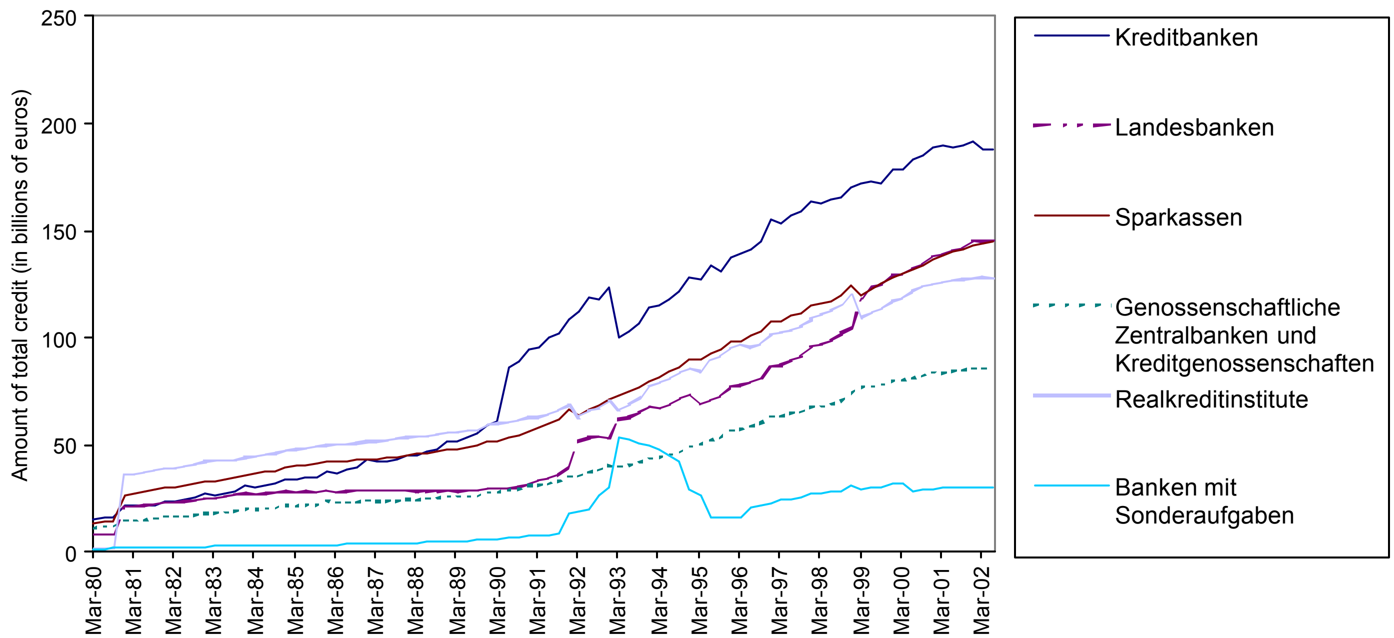
Source: Bundesbank at http://www.bundesbank.de/stat/zeitreihen/index.htm (WU3141, 1987=1000) and Bank of Japan at http://www.boj.or.jp/en/down/dlong_f.htm.
Note: The Nikkei is scaled on the secondary (right) axis.

Figure 4 Interest rate spread in Germany (all bank groups)



Source: Deutsche Bundesbank from *ECB Monthly Bulletin*, August 2002.

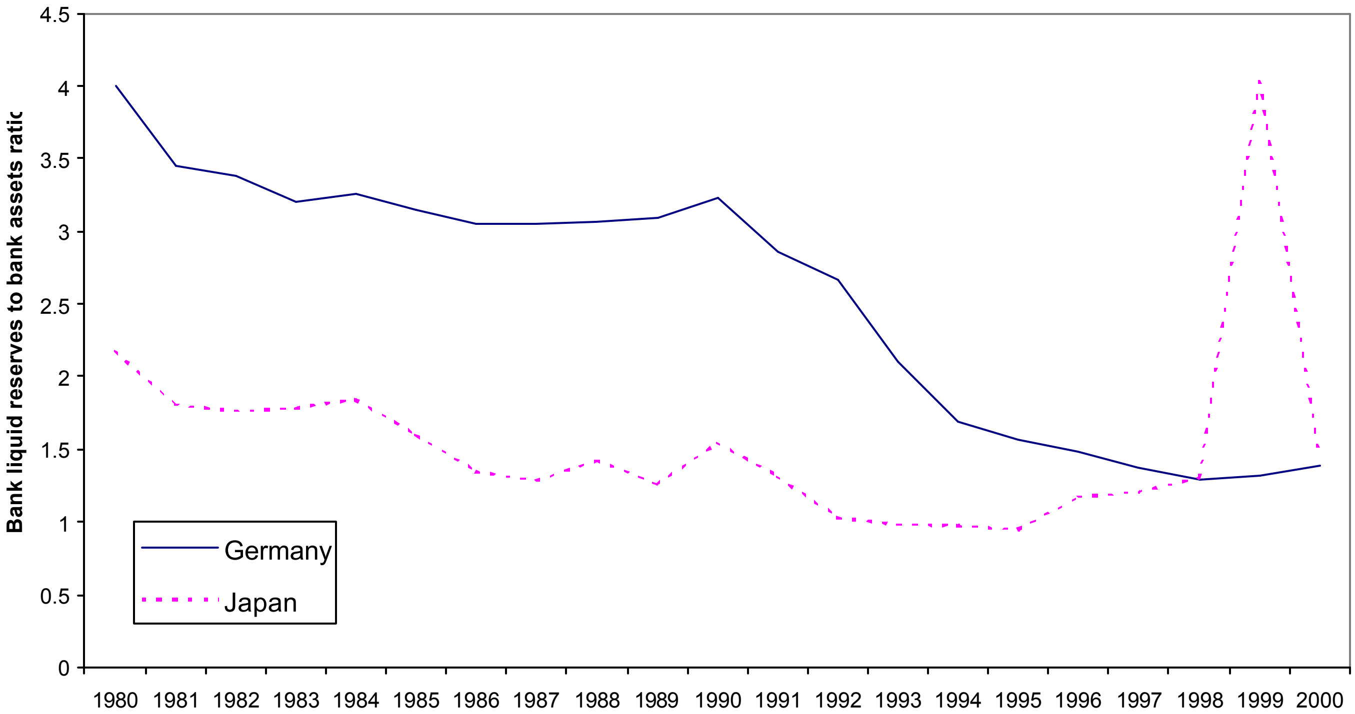
Figure 5 Amount of total credit by bank type to nonfinancial services industry in Germany, 1980-2002



Note: Data is quarterly. Non-financial services include "housing enterprises, holding companies, other real estate enterprises, restaurants and hotels, computer and related activities, research and development (plus other business activities (except investment companies)), health, veterinary and social work (enterprises and the professions), letting of movables and other services. From 1999, this category has included finance leasing institutions."

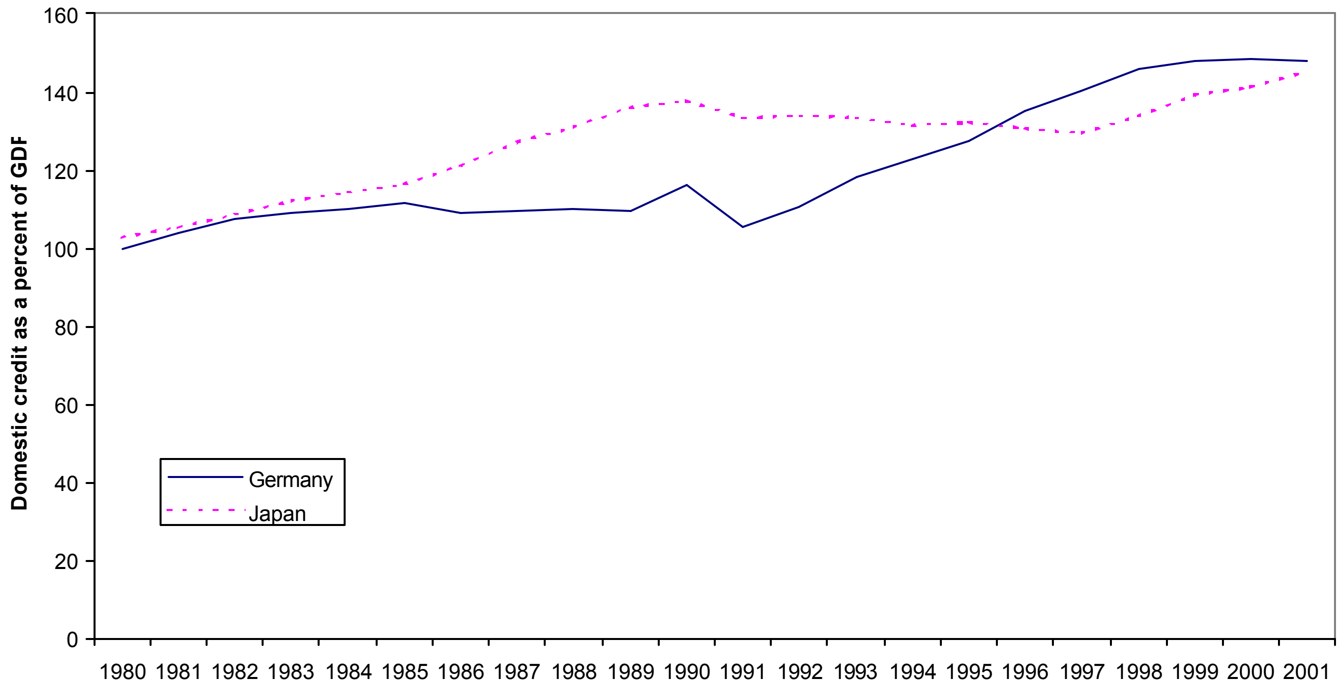
Source: http://www.bundesbank.de/stat/zeitreihen/index.htm.

Figure 6 Bank liquid reserves to bank assets ratio, Germany and Japan, 1980-2000



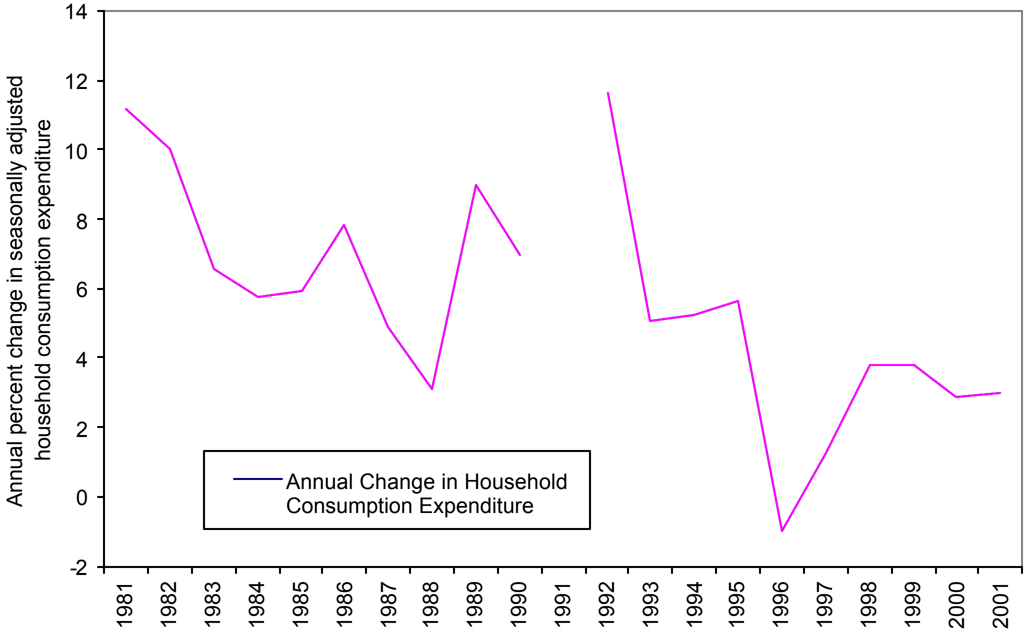
Source: World Development Indicators, http://devdata.worldbank.org/dataonline/. The ratio of bank assets to reserves is defined as the ratio of domestic currency holdings and deposits with the monetary authorities to claims on other governments, nonfinancial public enterprises, the private sector and other banking institutions.

Figure 7 Domestic credit as a percent of GDP, Germany and Japan, 1980-2001



Source: IMF IFS, January 2003, Monetary Survey and Country Tables for Germany and Japan. Domestic credit (line 134 32 ZF and 134 32 ZW for Germany and line 158 32 ZF for Japan) is defined as the sum of claims on central government, claims on state and local governments, claims on non-financial public enterprises, claims on private sector, claims on other banking institutions and claims on non-bank financial institutions. GDP was calculated from line 134 99B and converted to euros with the exchange rate on line AE for Germany and line 158 99B for Japan.

Figure 8 Year-over-year change in seasonally adjusted household consumption expenditure, Germany, 1981-2001



Note: Data is annual. The 1991 figure was excluded due to the effects of re-unification.

Source: IMF IFS, January 2003, National Accounts, Germany (Household Consumption Expenditure, Seasonally Adjusted, 134 96F.CZF and Market Rate EA to convert DM to ecu/euros).