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With the country in the grip of a recession, economic issues have dominated Germany's federal election campaign.

The June 2009 European elections put Angela Merkel in a strong position. The liberals (FDP) also increased their support. The job of Chancellor will be attributed by a vote in the Bundestag, following the 27 September legislative elections. Angela Merkel (CDU-CSU), Frank-Walter Steinmeier (SPD), Guido Westerwelle (FDP), Renate Künast (Greens) and Oskar Lafontaine (Die Linke-The Left) are all in the running, and it will probably come down to a contest between Angela Merkel and Frank-Walter Steinmeier – no doubt leaving Germany with a coalition government.

Politically speaking, coalitions are always the focus of federal elections in Germany. The question is whether the Grand Coalition (CDU-CSU and SPD) will be renewed, or whether it will be replaced by another coalition (black and yellow for conservatives and liberals, or red and green for the SPD and the Greens). The most likely alliance – and the most ardently desired by the sitting Chancellor – would comprise the CDU-CSU and the FDP. The Christian Democrats and their liberal allies are therefore likely to hold on to power.

The campaign has focused on the economic and financial crisis – and how Germany can get over it – taxes and the funding of the pension system, military engagement abroad, the environment and energy policy, the introduction of a minimum wage, the accountability and compensation of corporate bosses, transport and infrastructure policy, and public health.

But, as the Chancellor acknowledged at a conference on 18 August, all parties agree on the basic issues. The differences lie in how they aim to achieve policy goals. The CDU-CSU and the FDP see economic salvation in tax cuts. The SPD is proposing a blend of tax increases and tax cuts, bringing the rate down from 14% to 10% in the lowest bracket and raising it from 45% to 47% in the top bracket. The Left agrees: it favours reducing the tax burden on households with the lowest incomes, and taking the top tax rate as high as 53%. The Greens advocate leaving the top rate at 45% but increasing death duties for the wealthiest people in the country.

The SPD, The Left and the Greens all support the creation of a minimum wage, along the lines of France's SMIC. The SPD and the Greens support an hourly rate of €7.50, while The Left has proposed €10. The FDP and the CDU-CSU are opposed to the creation of a legal minimum wage. The CDU has suggested defining a guaranteed income (Mindesteinkommen instead of a Mindestlohn). The FDP is also against the introduction of a minimum wage.

Environmental issues have also been given a good airing in these elections. The biggest split is on the issue of renewable and nuclear energy. The CDU-CSU sees nuclear energy as a transitional technology (Brückentechnologie) that should not be abandoned at this stage. It is nevertheless opposed to building new nuclear power plants. Its goal is to lift the proportion of renewable sources in Germany's electricity mix from 15% to 30% by 2020. The FDP is also against abandoning nuclear power. The Greens argue that the fight against global warming should become a national priority, and advocate enshrining this principle in the country's Basic Law (Grundgesetz). They would like to see all the country's electricity derived from renewable sources by 2030. The Left also has ambitious energy policy targets. It too would like to see all the country's electricity come from renewable sources, and has pledged to devote €2.5 billion to rail transport. The SPD continues to support the end to nuclear power by 2021. Its goal is to see renewable sources provide the country with half its electricity.

Despite these occasionally cosmetic differences, there is a relative consensus on the need to renovate the social market economy model to which Germans are so attached (for pensions, for instance, where opposition to lengthening the contribution period is fairly weak), to uphold fiscal restraint (except during periods of crisis, obviously!), to cut taxes and – to call a spade a spade – no doubt to accept only a fairly small measure of economic cooperation with the country's European partners (especially in fiscal policy). To put it another way, one could say that Germany's future economic policy is already pretty much in the bag.

The crisis that swamped the global economy in 2008 is the first in the contemporary period of globalisation: even in the emerging markets, only a handful of countries have avoided recession in 2009. Germany has not been spared, au contraire. Its reliance on exports left it highly vulnerable to the sudden downturn in international trade. Asterès, a consultancy, sees Germany's gross domestic product (GDP) falling by 6% in 2009, compared with "just" 2.5% in France. North Rhine-Westphalia, a highly industrialised state, is set for a 7% drop.

However, the year 2009 alone does not provide a reliable basis for assessing the strengths of an economy, whatever the country. After all, we could easily argue that the deep recession will be followed by an equally striking rebound. We could also contend that a severe recession will help "clean out" the economy, and prepare it for a fresh start. In reality, in Germany as elsewhere, we need to take a step back to fully grasp the social and economic transformation that is currently underway. Since the mid-2000s, this transformation has been a positive surprise. We should not forget that Germany, along with Italy, was long described as the sick man of Europe (an historical reference to a description of Turkey in the early 20th century).

On the face of it, a single number could be taken to illustrate Germany's loss of influence globally: its GDP, which stood at roughly $3,700 billion in 2008, according to the International Monetary Fund (IMF). A fairly abstract and meaningless number, except for those who know that it relegates Germany to fourth place in the global economy, as opposed to third place a year earlier, overtaken by China, with its GDP of $4,400 billion. This is a highly symbolic development, but it raises more questions about China's place in the global economy – specifically within multilateral institutions – than it does about Germany's. Germany is still an important and extremely rich country (economically, socially and legally stable), whereas China has become a major and influential country, despite remaining poor in terms of per-capita GDP. Moreover, China will overtake Japan to become the world's second-largest economy in a few years. Here again, this will say less about Japan's decline (even though the question deserves to be raised) than China's boom.

In per-capita terms, Germany's wealth has continued to increase over recent years, even though 2009 will temporarily interrupt the process (in Germany as in other countries). Between 1999 and 2008, Germany's per-capita GDP increased by 13.5%, below the eurozone average of 14.7%. In reality however, this period encompasses two sub-periods. Between 1999 and 2003, per-capita GDP increased by only 3.7% in Germany, compared with 5.8% in the eurozone. This was the time when it was fashionable to talk about the "old Europe", comprising a hard core of countries – Germany, France and Italy – that were deemed incapable of reform. But starting in 2004, the trend reversed: per-capita GDP increased by 8.2% in Germany, compared with only 6.9% in the eurozone. This is critical, as the surge in Germany's growth mirrors very precisely most of the reforms undertaken by the Schröder government, many of which (but not all) were part of the Agenda 2010 reform package that was hotly discussed in France, where economic policy comparisons with Germany are a national sport. It was at this time, following criticisms by the Council of Economic Experts, that the tax burden was lightened in Germany (for households as well as businesses) and the labour market was made more flexible (with the creation of "minijobs", extensions to short-term employment contracts, help for business start-ups among the self-employed and incentives to encourage unemployed people to return to work), within a framework of strict fiscal restraint (just before the crisis, the federal budget was virtually in balance, and public debt as a percentage of GDP was below the eurozone average).

The shift in Gerhard Schröder's policies (in relation to the past, but also compared with the early years of his government) is fascinating in three respects: because it paid off very quickly; because it cured the country of its collective blindness; and because of its method. For the first time, blame was not placed on external causes such as the integration of East Germany or immigration; rather, the decline was put down to the increasing cost of Germany's welfare state: increased public spending, higher taxes and social contributions, higher cost of labour, increased unemployment, ballooning social deficits, etc. The method gave a key role to the unions. On the face of things, the unions should have been reluctant to agree to policies aimed at restoring competitiveness in preference to Keynesian policies geared towards stimulating demand. However, after fierce internal debate, they agreed to modulate wages and working hours (in 2004, several companies adopted a 40-hour week again). More importantly, doubtless because it marked a break with a national tradition, the IG Metall union and its counterpart employers' federation, Gesamtmetall, agreed in the spring of 2004 to waive industry agreements in order to preserve the competitiveness of certain companies. The unions, despite grassroots resistance, moved into uncharted waters by accepting increased working hours without higher wages, in exchange for social benefits such as company pension plans. The results are there to be seen: unemployment began falling in 2005, helped along by the easing of demographic pressure. Interestingly, the severe recession sparked by the financial crisis has only pushed it back up slightly (see Appendices, Chart 1: Unemployment in Germany).

The economic policies of the coalition government led by Angela Merkel have continued this trend. Ms Merkel's term began with a big increase in value-added tax (VAT) in exchange for corporate tax cuts and lower social contributions. Once gain, policies have been supply-side oriented, and fundamentally anti-Keynesian: it is competitiveness that should drive consumption, and consumption that should drive growth. As Helmut Schmidt would have said, today's profits are tomorrow's investment and the jobs of the day after. The supply-side focus is clear: the goal is to attract corporate headquarters and to allow companies to keep a larger slice of their profits so that they can reinvest them and remain competitive, allowing the rest to follow. In return, German companies have offshored a large proportion of their manufacturing base, particularly to former Soviet Union countries. This restructuring, which dates back to the early 1990s, prompted a decade of economic and social upheavals (especially in East Germany, as well as in Western regions such as the Ruhr), but has now given rise to heightened competitiveness, in terms of costs as well as technological content, reliability and, accordingly, brand image. In overall terms, Germany's so-called "non-price" competitiveness is highly regarded throughout the world, allowing it to withstand the growing competitive pressure of the emerging markets. This is a characteristic it shares with Japan, but marks a striking difference with France.

The macroeconomic data offer an exaggerated picture of this view of the economy, as well as Germany's reliance on international trade. Between 1999 and 2008, German exports swelled by nearly 90%, despite the fact that the euro has tended to gain ground against the dollar in recent years, thereby undermining the price competitiveness of goods made in Europe. Over the same period, consumption increased by only 5%. By contrast, since the start of the crisis, consumption has remained stable, while exports have fallen by 20%. This shows that growth has been driven almost exclusively by external demand in recent years (see Appendices, Chart 2: Consumption and exports of capital goods in Germany).

It may be that the competitiveness strategy has been taken too far, and employers' federations may have been overly conservative: corporate profits are high in Germany, but purchasing power is not increasing. Between 1999 and 2008, it gained roughly 6%, one of the poorest performances among Organisation for Economic Cooperation and Development (OECD) counties. Looking beyond the economy, one may ask how long society can allow real personal income to stagnate. Once the crisis is over, a national debate on these questions would be extremely worthwhile. In other words, the German economy's growth potential is high, but muted internal demand is stopping it from reaching its full measure. This is a critical issue.

Policies designed to deal with the global financial crisis, in Germany and elsewhere, have blurred ideological lines. Angela Merkel, despite her fondness for citing Ludwig Erhard, the father of the social market economy, has made the state much more than just the provider and guarantor of a regulatory framework in which competition can flourish. State guarantees and recapitalisations in the banking sector have totalled €480 billion, and the Merkel government has introduced a generous car scrap bonus, a measure dictated by circumstances to avoid a collapse of the sector, but also a purely Keynesian response diametrically opposed to the policies that had been followed for more than ten years! Worse, the government had to modify the Constitution in order to help struggling businesses, by guaranteeing their debt for instance!

Does this mark an ideological shift in Germany, along the lines of the United Kingdom, where some people see Gordon Brown as a "nationaliser", or the United States, where Barack Obama is described as a "redistributor"? Not by a long shot. Germany's Social Democratic Party (SPD) has promised during the election campaign to create 4 million jobs by 2020, a pledge that has come up against strong criticism – and rightly so – from experts and the media, undermining the party's credibility to an extent. The rising star among Germany's political parties is the Free Democratic Party (FDP), which has the closest ties to the business world, and with which Angela Merkel hopes to govern in the aim of taking both economic and social parameters into account.

In reality, a vast majority of Germans believe that the economy is what determines the stability or instability of nations, but they still place great importance on social issues. During the crisis, the Christian Democratic Union (CDU) has managed the economy well, but – and this is a new feature – Angela Merkel has taken personal responsibility for promoting social harmony. Today, the CDU and the FDP dovetail well in this respect.

Germany's coming electoral campaign will be conducted against a paradoxical economic background. The recession has hit Germany harder than other industrialised nations, as opposition parties will be quick to point out. However, the biggest opposition parties are also members of the ruling coalition, which will mute their criticism to an extent. At the same time, Germany boasts significant capacity for a rebound, thanks to the competitiveness of its industry. Another positive factor for Germany is that the improvement in economic activity is being driven by Asia. For the first time since the Second World War, the recovery is spreading from East to West, and not from West to East. This is good news for German industry, which is a big exporter of capital goods to countries in Asia and Eastern Europe.

Public finances, which were under tight control prior to the crisis, are not a source of concern. German governments' fiscal rigour is a secret for no one. Projections for 2010 put public debt, in accordance with the definition under the Maastricht treaty, at 75.7% of GDP, as opposed to 82% for the eurozone as a whole. Yields on long-term government debt are lower in Germany than in any other European country. The capital markets are well aware of the importance the German elite attaches to fiscal rigour – and of the support from public opinion (Germany is not Greece or Italy). The latest proof of this is provided by the fact that the outgoing coalition, in its last weeks in power, pushed a constitutional amendment through Parliament capping the federal budget deficit at an average of 0.35% of potential GDP through the entire business cycle (i.e. theoretical GDP on the basis of the availability of factors of production) (see Appendices, Chart 3: Public debt as a percentage of GDP in Germany and the eurozone).

In reality, the biggest problem facing the German economy, and one that is not often alluded to, is demographic. The total fertility rate, which measures the average number of children born to women during their lifetime, is stuck at 1.3, well below the level needed to keep the population steady (this compares with 2 in France, which has the best results in Europe on this metric). Since 2004, Germany's population has been declining. By 2020, Germany's population could have fallen by nearly 800,000! (see Appendices, Chart 4: German population).The reasons for this catastrophe are clear. The institutional system (and possibly a measure of cultural inertia) makes it difficult for women to combine a career with motherhood. The ruling coalition has nevertheless broken with the widespread rejection of family policies, assimilated by some with Nazism and by others with Communism. A parental wage has been created, to top up child support. A total of 500,000 places in child-minding facilities are to be created by 2013, and more flexible working arrangements are now discussed within the collective bargaining framework.

APPENDICES

Chart 1: Unemployment in Germany. Percentage of the active population. Source: Feri

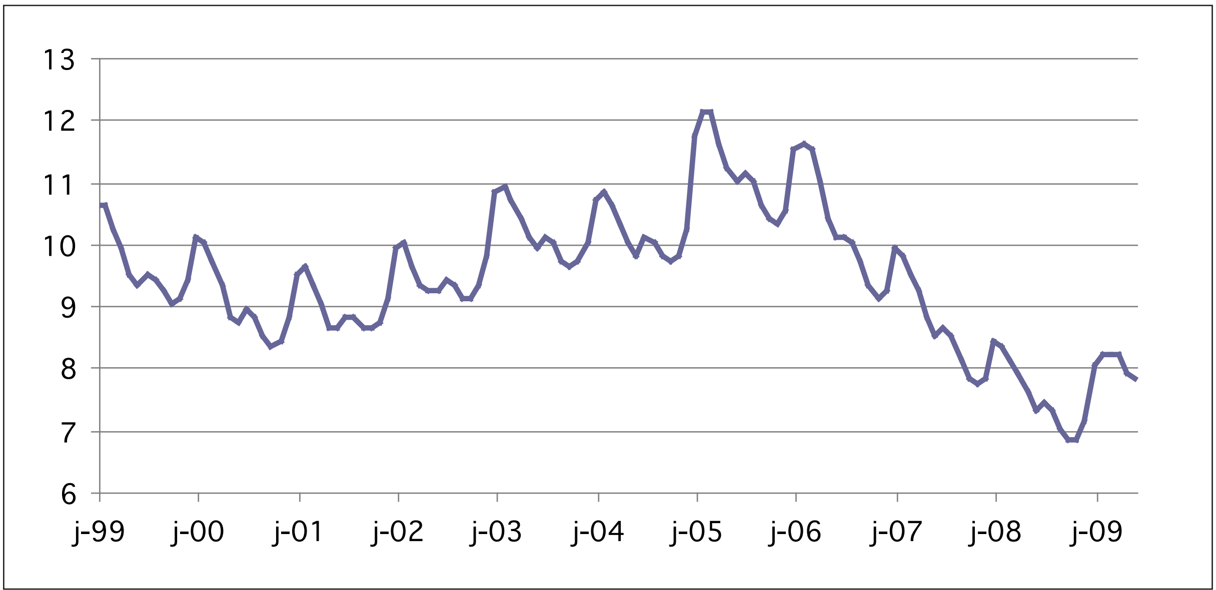


Chart 2: Consumption and exports of capital goods in Germany. Volume indices, 100 = Q1-1999. Source: Feri

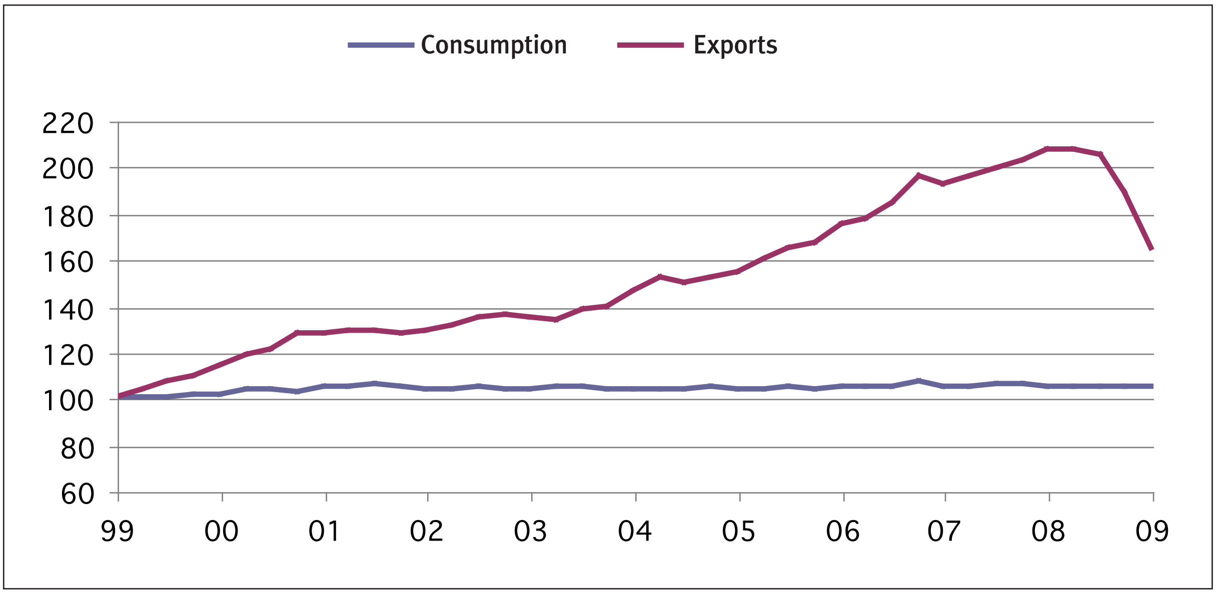


Chart 3: Public debt as a percentage of GDP in Germany and the eurozone. Source: Feri.

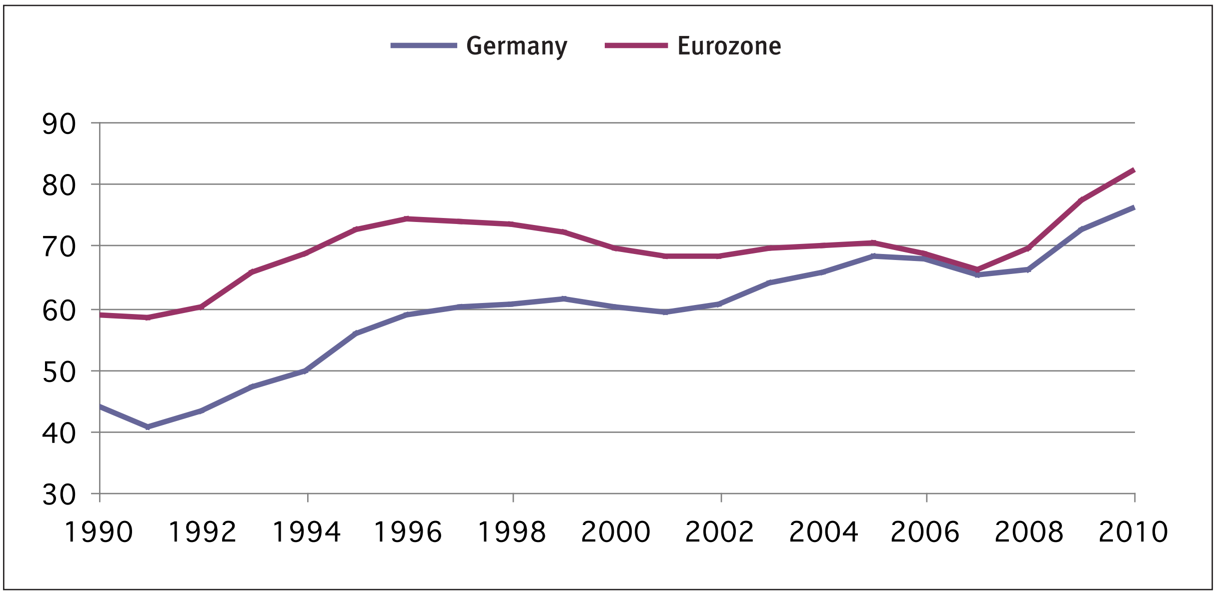
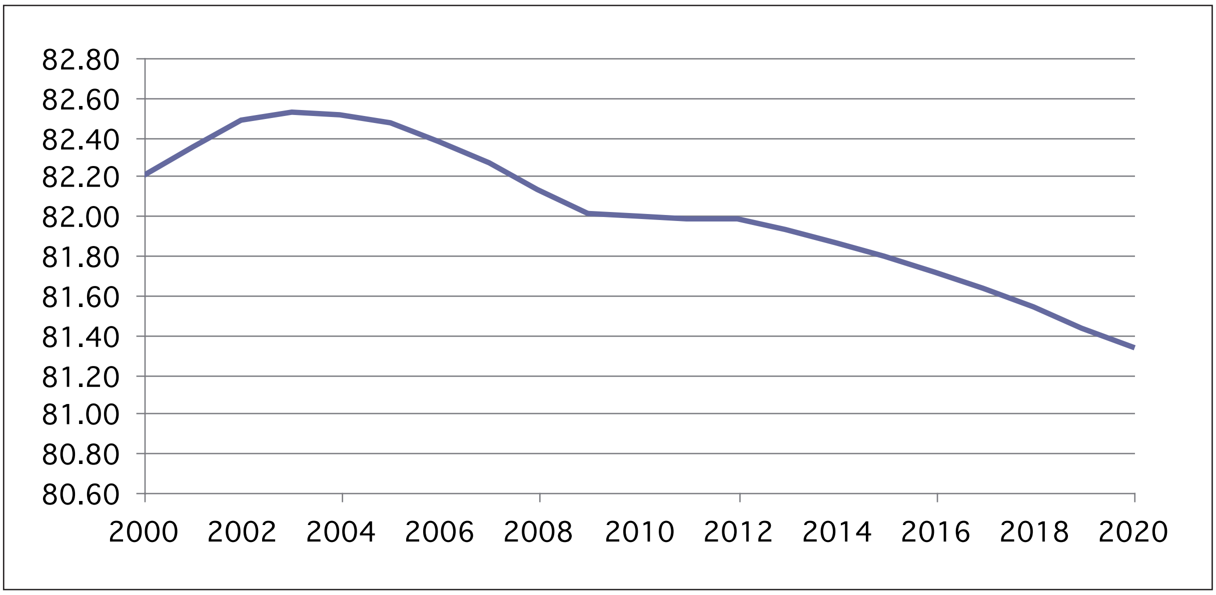


Chart 4: German population. Source: Feri.



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