

CHANCELLOR MERKEL AND  
GERMANY'S ONGOING  
UNIFICATION-STRUGGLE:  
IMPLICATIONS FOR EUROPE  
A European and Spanish  
Perspective

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**CHANCELLOR MERKEL AND GERMANY'S  
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With Europe standing at a crossroads in many regards, the role that Germany will play and the policies it will pursue in the coming months and years will be decisive in shaping the continent's future.

Before we examine why Germany's attitudes will have such a important impact on the rest of Europe, let us first analyze the current mood in Europe's biggest economy.

Fifteen years after reunification, Germany is still undergoing somewhat of an identity crisis. As has been extensively described and analyzed by numerous authors<sup>1</sup>, the reunification of the old Federal Republic of Germany (FRG) and the German Democratic Republic (GDR) has been a painful and often confusing experience for many Germans, especially those who were brought up in the former Communist East Germany.

## **East Germany's continuing woes**

Indeed, life for the so-called *Ossis*<sup>2</sup> has proven difficult in the new and unified Germany. Popular disenchantment with reunification is partly a result of the inflated expectations that East Germans –like other peoples who endured several decades of Communism in eastern Europe– held at the outset of the transition to democracy and a market economy. Many East Germans had a distorted and unrealistic picture of life in the West, one they had acquired by watching Western and specifically West German TV programs and through limited contacts with relatives in the

1. Sasha Vondra and Michael Werz: "German Reunification Provides Lessons for EU Expansion", VOA News, January 28, 2005.
2. It is symptomatic of unified Germany's inability to heal the wounds of the 44-year division of the country from 1945 to 1989 that the terms Wessis and Ossis, in the latter case having somewhat derogatory connotations in some instances, continue to be extensively used in the political discourse.

FRG. They thought that they would enjoy the consumption levels, higher standards of living and freedoms of the West without surrendering any of the certainties of life under central planning: cradle-to-grave free health care, free kindergarten, free education through university, a secure job for life, etc.

In essence, East Germans had an idyllic view of what life under capitalism would turn out to be: a combination of the security provided under Communism with the freedoms and prosperity prevalent in the West. There can also be no doubt that, in their sincere desire to rapidly achieve reunification, many West German politicians (especially Chancellor Helmut Kohl) significantly contributed to these inflated expectations. During his 1990 drive to achieve reunification on an accelerated time-schedule, Kohl famously promised East Germans that “blühende Landschaften” (blooming landscapes) would soon come to the GDR.<sup>3</sup>

In addition to these unrealistic expectations, discontent over reunification among *Ossis* has other explanations. The economic situation of the Länder that made up the former GDR is genuinely troubling. Unemployment stands at an average of 20% in the East. Entire sectors of the former GDR's economy have been practically wiped out or severely downsized: among others, coal mines and steel mills in Saxony or shipbuilding in the Vorpommern region. Although these activities were economically unfeasible, the impact on the communities that have lost thousands of jobs has been brutal and obviously generated resentment against reunification.

There is no disputing the fact that many unproductive East German factories would have had to be dismantled irrespective of the way that the

3. For a detailed description of the international negotiations that led to German reunification see: Alexandre Muns: “The end of the Cold War: German reunification”, doctoral thesis presented at the University of Barcelona, 2005.

economic union of the two Germanies had been handled. These factories were churning out goods that most people did not want (many were being exported to hapless Soviet consumers) and using vast amounts of energy and natural resources in order to do so. But there is near-consensus among economic experts that economic union among the two Germanies—which went into effect in July of 1990, three months ahead of formal political reunification—was a botched affair. The most irresponsible measure taken by the Kohl cabinet in 1990 was the decision to fix the conversion rate of East German marks into DM at one-to-one. This was obviously an attempt to curry favor with East Germans by artificially inflating their purchasing power. They were able to exchange their East German Ostmarks (with which they could not buy many quality goods in the GDR) for DM at a one-to-one ratio which obviously did not come close to reflecting the respective economic fundamentals of the two countries. Several West German policymakers warned about the dangers of the one-to-one conversion, most notably the then head of the Bundesbank, Karl Otto Pöhl. But Kohl was intent on achieving reunification as quickly as possible and making East Germans happy by allowing them to purchase West German goods was part of his plan. So he announced the economic union between the FRG and the GDR in early February of 1990 directly to the press and did not bother to even give advance notice to Pöhl, who on the previous day had met with his counterpart in the GDR and agreed that economic union was a long way off.

In Kohl's defense it could be said that, after the fall of the Berlin Wall on November 9<sup>th</sup>, 1989, and during the first months of 1990, tens of thousands of East German citizens emigrated to West Germany. In some of the rallies held in the GDR in late 1989 to demand immediate democratic elections and reunification with the FRG, demonstrators chanted: "Either the DM comes to us, or we will go to the DM", meaning that unless the DM were quickly turned into their currency they would join the tens of thousands of East Germans moving to the FRG.

Even though the need to curtail the emigration from and potential depopulation of the GDR was an overriding priority for the Kohl cabinet, one can hardly argue that the one-to-one conversion was indispensable to achieving that goal. By the spring of 1990 free and fair democratic elections had been held in the GDR and a timetable for reunification was being worked on. The East German CDU had won the parliamentary elections on March 18<sup>th</sup>, enabling Kohl to coordinate with and almost dictate policy to the GDR. Therefore, the one-to-one conversion cannot be portrayed as a last-ditch attempt at stopping massive emigration from the GDR. The decision was made at a time when the political and social situation in the GDR had stabilized. Moreover, it is not so much the conversion that should be criticized but rather the rate at which it was carried out. In this regard, the Bundesbank, which had already been outflanked on the matter of the economic union in February, urged Kohl not to offer a one-to-one conversion rate but rather a two-to-one rate (two Ostmarks for every DM). In the end, the pressure exerted by the Bundesbank only yielded minimal results: the one-to-one rate was applied to East Germans' first 4,000 Ostmarks in savings, with a two-to-one rate kicking in after the first 4,000 Ostmarks. But salaries were entirely converted at the one-to-one rate.

As many had forecasted, the artificial revaluation of the East German currency was a terrible blunder. After the initial buying spree undertaken by East Germans flush with DM and eager to satisfy a decades-old pent-up demand for high-quality Western goods petered out, the costs of the one-to-one conversion to the East German economy became evident. East German companies' productivity was only a fraction of that of West German firms but, due to the conversion, their costs suddenly mushroomed. Labor, energy and other costs expressed in DM at the one-to-one rate were prohibitive for East German companies and quickly forced many out of business.

In the final analysis, East Germany's productive apparatus was highly inefficient by Western standards, but the irresponsible one-to-one

conversion doomed any chance that the more productive sectors and companies had of surviving in the new competitive environment.

The elimination of much of East Germany's production apparatus and the ensuing high rates of unemployment have much to do with the *Ossis'* disgust and discontent with reunification. East Germans may not have liked the Communist system that oppressed them for more than 40 years, but they also were opposed to witnessing the wholesale dismantling of the industries they had painstakingly built up over the years. East Germans were by and large not happy under Communism, but the fact that the new reunified Germany swiftly and without compassion swept away what they had managed to create and develop in forty years was undoubtedly a heavy psychological blow. Paraphrasing Harry Truman's comment about a pro-US dictator, the east German economy may have been a mess, but it was the East German population's mess. Suddenly, in the wake of reunification, it was taken from them.

To be sure, huge financial transfers (€ 80 billion a year, over € 1.3 *trillion* to date) soon began flowing from the FRG to ease the former GDR's transition to a market economy and build modern transportation and energy infrastructures. To West Germans, these transfers have entailed a rise in their taxes and have bred resentment against easterners, whom many in the former West Germany regard as complacent, incapable of adapting and often outright lazy. It was certainly not very smart (and definitely cost the CDU votes in the eastern Länder) of Bavarian Premier Edmund Stoiber to remark that the "East Germans should not be allowed to determine the fate of the next government", but these comments uttered during the campaign for the September 18<sup>th</sup>, 2005, parliamentary elections reflected the opinion of many Wessis.

The one comparative advantage that the East German economy could have enjoyed in the wake of forty years of ruinous central economic planning was lower costs, especially pertaining to wages. But the one-to-one conversion did away with that potential advantage in one stroke. Currently East German labor costs are four times higher than those of

Czech or Polish companies. So while those countries (along with Hungary and Slovakia) continue to attract substantial amounts of FDI –€ 20 billion in the automobile sector alone– from multinationals eager to exploit the low wages and high skills of their work forces, it is hard to think of many multinationals which have relocated or set up new production facilities in the former East Germany.

On the other hand, East Germans are materially better off than their colleagues from former Communist countries in central and eastern Europe. Their per capita GDP and consumption levels are higher and the € 80 billion in yearly transfers from the Western Länder since 1990 allow them to drive their cars on brand-new highways, attend concerts in new theatres and enjoy modern municipal infrastructure. Many no longer live in the dreary apartment buildings that dotted the landscape of Communist countries such as the GDR. But this relative prosperity and increased consumption has not completely compensated for the loss of a country, identity, consciousness and way of life which East Germans experimented beginning in 1989. And being relatively well-off (compared to other eastern European countries) but unemployed or on training schemes is hardly a recipe for high self-esteem and an entrepreneurial spirit. As Professor Michael Werz of the University of Hannover puts it, “It was a mistake to believe that if one invests enough money, these two societies would somehow get used to each other and would be economically productive again. That has not been the case”.<sup>4</sup>

East Germans, therefore, are in a rut. They mostly continue to believe that life under Communism was miserable but at the same time do not feel they have a stake in the new system. Capitalism and democracy have not brought the benefits which they expected. They don’t want to go back to the old days but are turned off by the political parties,

4. Quoted in Sandra Vondra and Michael Werz: “German Reunification Provides Lessons for EU Expansion”, *VOA News*, January 28, 2005.

institutions and many customs from the Western Länder. Except for those who have clearly benefited economically with the transition, most East Germans regard the post-reunification German national identity and social model as a West German imposition.

## **West Germany's structural problems**

While East Germans feel unappreciated and have difficulty coping with the new system, West Germans are not at ease either. First of all, they chafe at the higher taxes they have had to pay to finance the modernization of the East German economy. West German angst, however, runs much deeper and is the result of factors that have nothing to do with the difficulties brought on by reunification, although they have coincided in time and thus aggravated the sense of gloom that has pervaded Germany in the last years.

Increasingly during the 1990s, Germans have come to realize that their generous social welfare system is threatened. Germany's ageing population, the financial burden of reunification on state finances, the increasing competition unleashed by globalisation and the unwillingness to implement far-reaching structural reforms in the 1980s have all combined to cause a serious underperformance of the German economy. Thus, the political victory that Germans achieved with reunification in 1990 has turned into an economic defeat as the once greatly-admired German juggernaut has dramatically slowed down.

For quite a few years, both the German population and the political class ignored the many symptoms of Germany's deep-seated problems. During the 1980s and until 1998, the governments led by Chancellor Kohl made only half-hearted attempts at addressing the structural causes of Germany's economic problems. There are several explanations of why this occurred. First of all, German economic growth during much of the 1980s was quite impressive and helped to mask the underlying structural weaknesses. Most

governments are quite reluctant to take painful measures if the general economic situation is good, and Kohl's administration was no exception. Moreover, Kohl himself, a historian by training, was little interested in economic affairs. In fairness to the CDU-led governments which ruled Germany from 1982 until 1998, some economic reform attempts were blocked by the Bundesrat (upper house of Parliament), which was often in the hands of the opposition SPD. The most significant reforms adopted in this period were the increase in the retirement age and the extension of the opening hours for stores. However, Germany's progress in implementing structural economic reforms by the time voters kicked the CDU-FDP government out of office and voted in the SPD-Green coalition in 1998 were clearly insufficient.

## **Economic colossus, political midget**

The onerous and expensive process of modernizing the East German economy, added to the underperformance of the overall German economy brought about by the inability to address the aforementioned structural deficiencies, have prevented reunified Germany from taking on a bigger role in international affairs after 1990. Post-unification Germany, as we shall examine, has certainly shed its timid and constrained foreign and security policy of the Cold War after 1990 and begun to play a role in internal affairs which corresponds to its economic weight in the world. But the economic stagnation experienced during much of the past 15 years has limited Germany's blossoming into a true global power. With the third largest economy in the world and the first in Europe, Germany continues to punch below its weight in the international arena.

A prime example of this inability to fully capitalize on reunification to enhance Germany's role in the world is the German government's failure to garner the consensus needed for the country to become a permanent member of the UN Security Council. Japan and Germany, the second

and third economies in the world, respectively, should have been shoe-ins for permanent status in the Council in the ongoing process to revamp the UN's premier security institution. But whereas Japan's travails are easily explained by China's uncompromising opposition to Japan's permanent membership, it is harder to explain why Berlin has not managed to become a consensus candidate to be permanent member of the UN Security Council. To be sure, Chancellor Schröder's total opposition to the war in Iraq has strained relations with the US and prompted Washington to withhold its support. But even within the EU (partly due to Italy's competition), Berlin has not been able to obtain unconditional backing for its bid.

German foreign policy underwent a profound transformation as a result of the electoral victory of Gerhard Schröder's Social Democrats in 1998, who teamed up with the Green Party in order to form a stable government coalition. That the change in government would bring about such a marked shift in Germany's foreign policy was something of a surprise. Schröder and the SPD had not campaigned on a platform that emphasized a change in foreign policy. Schröder himself did not appear to be a radical who would steer German foreign policy in a new direction. The cigar-puffing Schröder had nurtured very close ties to several of Germany's leading businessmen and as the premier of the *Land* of Lower Saxony had sat on the board of Volkswagen. He was perceived by analysts as being a moderate and pragmatist who would not radically alter either Germany's internal or external policies. The conventional wisdom as Schröder took office in late 1998 was that he would enact the groundbreaking environmental measures demanded by his junior coalition partner (the Greens) but would otherwise not sharply deviate from the policies pursued by the CDU-FDP governments. Although Schröder was a self-made man who had worked hard to pay for his university studies, he had not taken part (as opposed to Joschka Fischer, his Foreign Minister) in radical student activities during the late 60s and early 70s.

Despite the expectation that German foreign policy would not be significantly altered under Chancellor Schröder, in actual fact since 1998 Germany's foreign policy has undergone a remarkable transformation. The FRG's foreign policy from 1949 until 1989 was viewed as being too subservient to Washington's interests. In the past 15 years Germany has developed a more mature and balanced foreign policy, and this trend (which was hardly perceptible before 1998) has accelerated during Schröder's two terms in office.

First of all, ties with Russia have become especially close. This has happened in part due to the good chemistry existing between German Chancellor Gerhard Schröder and Russian President Vladimir Putin, who spent much of his career as a KGB officer based in the former GDR and speaks fluent German. The strengthening of political bonds has gone hand in hand with an expansion in bilateral trade and increasing German investment in the Russian economy. The recent signing of a big contract to build a pipeline under the Baltic Sea to supply Germany with Russian natural gas was the latest in a long series of important business ventures between German and Russian companies.

The camaraderie between Schröder and Putin has been so close in recent years that it would not be an exaggeration to claim that Germany's relations with Russia were at times better than those with the US (at least at the governmental level). Indeed, the warming of ties between Moscow and Berlin has coincided with a deterioration in the traditionally close US-German relationship.

The key event in the rift between Berlin and Washington was of course Chancellor Schröder's decision to use opposition to the impending US attack on Iraq in his successful bid for re-election in September of 2002. In fact, Schröder resorted to criticizing US foreign policy under the George W. Bush administration quite often during the campaign. Some of his attacks were aggressive and fierce, especially when measured against the traditional respect shown by post-World War II German chancellors towards Washington. Schröder was the first head of a Western government to specifically rule out sending his country's troops

to invade Iraq in the months prior to the US invasion of Iraq in March of 2003. This became one of his campaign pledges.

US officials openly voiced their displeasure at what they viewed as Schröder's opportunistic tirades against the Bush administration. A nadir was reached when a minister in Schröder's government compared Bush's tactics on the Iraq matter with those of Adolf Hitler. Even though the minister was forced to resign, the damage had been done, and when Schröder's SPD pulled off a come-from-behind victory against the CDU in the September 2002 general elections, there wasn't even a perfunctory congratulatory call from the White House to the German Chancellery.

If official Washington had expected Schröder's vitriol against the war plans to subside after he secured re-election, it was sorely disappointed. Schröder in fact took a quite active (if not leading) role in the meetings that were set up to openly challenge the Bush administration's war plans. Schröder, Chirac and Putin famously met in St. Petersburg in a public display of defiance to Washington.

To be sure, the greatest animosity in official Washington during the 2002-03 period was reserved for the French and their government, which was perceived to have stabbed the US in the back by persuading the non-permanent members of the UN Security Council to vote against the resolution authorizing the use of force against Saddam Hussein's regime. But discontent and even anger at Germany were not far behind.

While Germany was openly criticizing Washington over the Iraq war, it was also heavily involved in the development of an independent European Security and Defense Policy (ESDP), an initiative which the US has always viewed with distrust. Although the French government was the principal force behind the attempt to craft a European foreign and defense policy that would act as a counterweight to the US hyperpower<sup>5</sup>, Germany under Schröder and Fischer went along with

5. As applied to the US, an expression first coined by former French Foreign Minister Hubert Védrine.

many of the proposals, measures and even structures (such as the EU's command headquarters outside of Brussels) that France, Belgium, Luxembourg, Spain and in some instances Italy and the UK also supported. Even though Berlin was not as adamant as Paris on the need to create European defense structures and capabilities that would rival NATO, it nonetheless went along with the aforementioned countries in attempting to shape an independent ESDP, a position which obviously did not help its standing in Washington in light of the deeper disagreement over Iraq.

We can therefore conclude that Germany's foreign-policy shift beginning in 1998 was caused by both long-term trends and one-off circumstances. With the end of the Cold War and reunification, it was inevitable that Germany would be less dependent on its security partnership with the US. The US no longer needed to protect the FRG with its nuclear umbrella (Pershing II and Cruise intermediate-range nuclear missiles) and hundreds of thousands of Allied (US/British/French) troops on German soil to defend against a hypothetical Warsaw Pact attack. After the disappearance of the Soviet and Warsaw Pact threat with the dissolution of the USSR in 1991, Germany obviously became much less reliant on NATO and US/Allied security. Many Allied military installations in West Germany were shut down and US, British and French soldiers returned to their home countries. With the signing of the 2+4 treaty on the international aspects of German reunification in September 1990, Germany recovered its full sovereignty. As a result of the intense pressure exerted by the US during the 2+4 negotiations, the reunified Germany remained a member of NATO (US diplomacy made Washington's support for German reunification conditional on continued German membership in NATO). But Germany post-1990 was a sovereign country without foreign forces on its soil (Soviet troops were also evacuated during the first half of the 1990s from the

GDR by virtue of the 2+4 agreement). Thus, its foreign and security policy was bound to change. Until 1998, due to the fact that the CDU-FDP government remained in power and Kohl, a staunch Atlanticist, owed a debt of gratitude to the US for its support of German reunification, German-US relations remained very close. The normal evolution which should have begun in 1989-90 was thus stalled during the remainder of Kohl's tenure.

The one-off circumstance that led to the rift between the US and Germany was the Bush administration's desire to invade Iraq and overthrow Saddam Hussein. Prior to the cooling of relations in late 2002 as Washington's saber-rattling over Iraq grew louder and Schröder's protestations more forceful, the Schröder and Bush governments had had no serious spats. The major irritants in US-German relations between 1998 and 2002 derived from the Bush administration's rejection of the Kyoto protocol, its refusal to join the International Criminal Court and insistence on securing immunity from possible ICC prosecution to US military personnel. The Pentagon's obsession with ensuring its military forces could not be tried by the ICC prompted Washington to exert very intense pressure on several countries (including eastern European EU accession countries) to agree to bilateral agreements guaranteeing immunity for US forces. At one point, the Bush administration threatened to withdraw its peacekeepers deployed in NATO- or UN-sponsored missions around the world unless it received sufficient guarantees regarding the ICC matter.

Although the Kyoto and ICC disputes certainly did not help US-German relations, they can be described as bumps in the road. Relations between Washington and Berlin were becoming more contentious and certainly not as smooth as in the pre-1990 era. But the real fork in the road, the point at which the US and German governments and to some extent their populations took completely divergent paths, was the crisis over Iraq.

## **How Germany will affect Europe**

On many issues that affect European integration, Germany's position in the coming months and years will prove decisive in determining the EU's final posture. This is not only because of the fact that Germany holds the biggest number of votes in the Council and has the most MEPs of any member state of the EU. On key issues, Germany has traditionally taken a middle-of-the-road stance, but will in the end have to lean one way or another.

Turkey's prospects for someday becoming a member of the EU will depend to some extent on the position that Germany adopts during the coming years. The SPD-Green governments of 1998-2005 staunchly backed Turkey's eventual full membership and pushed for the Council to set the 3<sup>rd</sup> of October of 2005 as the date for the start of accession negotiations between the EU and Turkey. The CDU now unequivocally stands against Turkey's accession to the EU and favors only a privileged or special partnership between Brussels and Ankara. There is growing opposition among Germany's population to the prospect of Turkish EU membership (shared also by many French, Dutch, and Austrians). Although the CDU's opposition is buttressed by the even more anti-Turkish stance of its Bavarian wing, the CSU, there are two factors which might exert pressure on the CDU to reconsider, depending also on developments in Turkey. The first is the importance of the Turkish vote in German elections. Even some German citizens of Turkish origin harbor doubts about their native country's current suitability for the EU given the wide cultural differences. But in the medium to short-term (and especially if Ankara is perceived to be doing its most to implement the reforms demanded by Europe) the CDU will alienate Turkish voters in Germany if it sticks to opposing Turkish membership in the EU. The second is the

FDP, the CDU's traditional preference as a coalition partner, which advocates full Turkish membership of the EU.<sup>6</sup>

Germany's position regarding Turkey's EU prospects is especially crucial given the current alignment of EU members with regards to this issue. While the UK, most eastern European new members, Italy and Spain remain in favor of Turkish accession (albeit with declining popular support), France, the Netherlands, Denmark and Austria are decidedly against. Germany's shift to the "No" camp would decidedly tilt the balance in favor of those who reject Ankara's bid. During her first months in office Merkel is unlikely to want to confront the SPD on the Turkey issue, especially considering that the focus of the new government will be on domestic economic reforms. But when Germany takes over the EU presidency in the first half of 2007, Merkel's government will inevitably have a higher-profile role in terms of the EU-Turkey accession negotiations. Supposing that her poll ratings are high and that she has made progress on domestic reforms, the Chancellor might opt at that point to take an active stance against Turkish EU accession even at the risk (or, depending on her intentions, as a way of) of causing a crisis in her coalition government. But this scenario will certainly not come to pass during 2006.

One of the big question marks moving forward is to what extent Germany's gradual shift away from a staunch pro-Atlanticist and pro-American foreign policy will continue in the coming years or be partially reversed under the new government. The early signals being put out by

6. Hans-Dietrich Genscher, former vice-chancellor and Foreign Minister under both chancellors Helmut Schmidt (SPD) and Helmut Kohl (CDU) and one of the most respected elder statesmen in the FDP has publicly and repeatedly expressed his support for Turkey's EU membership.

the new government are mixed on this score. Foreign Minister Steinmeier quite assertively demanded that the US government clarify the numerous press accounts which have appeared in US and European media alleging that secret CIA flights carrying terror suspects landed in –among other countries– Germany and that the CIA operated secret detention facilities for terror suspects in eastern European countries. Moreover, Merkel herself publicly stated that the detention centre at Guantánamo Bay should be closed down. But the new chancellor completed a successful trip to Washington during which President Bush lavished much praise on her. There is no doubt that, on both a personal and substantive level, Bush and Merkel will get along much better than Bush and Schröder did (indeed, the latter two were hardly on speaking terms). Atlanticists, however, should not be deceived by the warmth of Merkel's welcome in Washington and conclude that under the Grand Coalition US-German relations will revert to their pre-1998 status. The days of unquestioning and staunch German loyalty to Washington are over for good. They were largely, as we have discussed, a product of the Cold War.

The divergence of values on either side of the Atlantic make it impossible for the US and Germany to enjoy the kind of close alliance they had between 1947 and 1990. On the one hand, the German population views war as a last resort, supports the primacy of international law and a leading role for international institutions, opposes capital punishment and nuclear energy, advocates gay rights and is very environmentally-conscious. On all of these scores, German society has evolved considerably and is not on the same wavelength as a considerable part of the US population. Thus the US-German rapprochement can only go so far. It is very likely that the atmosphere of US-German relations will improve dramatically and that the two countries will coordinate their actions and policies with regards to such matters as Iran's nuclear program. But there will be no return to the status quo ante. Opposition to President Bush's unilateralism in waging the war on terror in general and the Iraqi invasion in particular is so

widespread in Germany (among both left- and right-wing voters) as to preclude Merkel from embracing Bush's tactics.

With regards to Germany's foreign policy in general and relations with the US in particular, the coalition treaty worked out between the CDU/CSU and SPD states the following: "We deem Europe and the US to be a part of the same community of values. For the coalition partners there is no contradiction between the strengthening of the foreign policy role played by the European Union and the deepening of ties with the United States."<sup>7</sup>

### **After the September 18<sup>th</sup> elections**

Almost six months after Chancellor Gerhard Schröder called early elections following the SPD's defeat in regional elections in the federal state of North-Rhine Westphalia (NRW), Germany's two main political parties, the SPD and the CDU, formed the first grand coalition at the federal level since the 1966-69 period. The electoral results of September delivered a hung Parliament. Merkel's CDU failed in its attempt to obtain a strong pro-reform mandate. German voters were clearly not ready for more painful medicine and rejected Merkel's reformist agenda, which included the economically-sensible but politically-naïve proposal of raising VAT by two percentage points in order to finance a reduction of payroll taxes and thus stimulate job creation. Moreover, Merkel and the CDU also favored a radical overhaul of Germany's cumbersome and loophole-ridden tax system, which currently features relatively high income tax rates (not as high

7. "Gemeinsam für Deutschland - mit Mut und Menschlichkeit (Together for Germany - with courage and humanity)". Coalition treaty between CDU/CSU and SPD, 11 November 2005

as those of the Scandinavian countries but certainly higher than in southern and eastern Europe) but numerous exemptions and deductions which effectively make the system unfair. Some of the deductions are given to employees who work night shifts, those who have long commutes to work or to people who build or renovate their homes. Although such deductions individually make sense, the tax system is so bloated with them that wealthier Germans who can afford good tax lawyers who figure out ways to best take advantage of the deductions are those that mainly profit from the system. There is consensus among the main German political parties on the need to revamp and simplify the tax code, but of course the devil is in the details. The FDP has always staunchly supported lowering income- and corporate-tax rates as a matter of principle, and feel their case for lower taxes is bolstered by the need to revive internal demand. The CDU's onus is more on a simplification of the system and the closing of tax loopholes and elimination of deductions, although Merkel's party also campaigned in this year's elections on a platform of lower income taxes.

The German electorate, however, was not persuaded by Merkel's prescriptions for revitalizing the German economy: lower income taxes, a two-percentage point hike in VAT to finance a cut in payroll taxes, an overhaul of the tax system to eliminate loopholes and deductions for employees doing night shifts or long commutes, and a loosening of the regulations that determine how small companies can fire employees. The fiscal, budgetary and labor-market package that Merkel ran on was certainly not ultra-liberal. In many ways, it could be considered a continuation of the reforms that Schröder had undertaken in his second term.

But Schröder is a masterful campaigner who is at his best when coming from behind and when others count him out. The former chancellor pulled off a rare feat: he prevented the CDU-FDP from gaining a majority with a campaign that basically featured him criticizing the

CDU-FDP for their desire to continue the reforms which he himself had started. Having lost the battle to convince the German population and his own SPD about the inevitability of reforms, Schröder decided to go down fighting and did his country and its future economic prospects much harm by running a populist and demagogic campaign aimed at scaring German voters into thinking the CDU-FDP would demolish the welfare state and introduce Thatcher-like reforms. Schröder knew fully well that the CDU did not pose a danger to Germany's welfare system and social market economy, and that a CDU government would not have implemented much more radical reforms than the ones he himself had to struggle so hard to push.

Schröder's demagoguery and charisma allowed him to scare enough voters to prevent the CDU-FDP from obtaining a majority in the Bundestag. But now that his party must work together with the CDU in a grand coalition, the leftist wing of the SPD feels emboldened by Schröder's rhetoric and will do everything in its power to block the new government's attempts at further reform. While Merkel, Hesse's CDU premier, Roland Koch, Schröder and SPD chairman Franz Müntefering were busily working out the details of the grand coalition's government program in early November, the left wing of the SPD temporarily sabotaged the operation –willingly or not– by rejecting Müntefering's proposed candidate for the post of Secretary-general of the SPD and instead selecting Andrea Nahles, a radical left-wing member, thereby prompting Müntefering's resignation as SPD chairman.

The SPD Executive's selection of Nahles may be only a foretaste of things to come in the grand coalition. A substantial part of the SPD's parliamentary caucus in the Bundestag is made up of deputies who will block the grand coalition government's proposed reforms. Merkel might face considerable hostility in the Bundestag to any proposed laws that seek to implement the more liberal and reformist measures that the SPD leadership has agreed to include in the coalition agreement. Even before the government had been sworn in, thousands took to the streets of

Berlin (on November 7<sup>th</sup>) to warn the grand coalition not to lower social benefits or wages.

Apart from the possibility of street protests (which Schröder also had to face), the key issue that will decide the longevity of the new government is whether the SPD leadership will be able to keep significant numbers of its own parliamentarians from breaking ranks with the government. To be sure, the grand coalition between CDU-CSU and SPD will muster a considerable majority in the Bundestag (432 out of 614 deputies). It can mathematically survive having several dozens of SPD deputies belonging to its leftist wing consistently voting against government proposals. But the political effects of such consistent SPD sniping are difficult to gauge. If and when leftist SPD deputies vote against the government, the SPD leadership will be put in a tight spot. Inaction against the rebellious MPs will reveal the extent of the divisions within the SPD. On the other hand, if consistent defiance by left-wing SPD deputies in the Bundestag show up the SPD's inner divisions to a point where the SPD leadership is forced to abandon the grand coalition, early elections might result in the population punishing the party –in this case the SPD– that will have been perceived as divided, obstructing reform and ultimately bringing down the government. In this regard, the current constellation of forces is more of a predicament to the SPD leadership than to that of the CDU. Since the CDU is not nearly as riven by internal strife as the SPD is, it can enter the grand coalition safe in the knowledge that it is the SPD left wing which poses the greatest danger to the survivability of the government. Merkel's situation is in some regards similar to the one that SPD Chancellor Helmut Schmidt had to deal with after he succeeded Willy Brandt in 1974. The one major difference is that Merkel can feel quite assured that if left-wing SPD deputies bring down her government, the electorate is more likely to punish the SPD. Indeed, the latest polls (February 2006) reveal that Merkel's approval rating (80%) is extraordinarily high. If a scenario of a crisis in the grand coalition were to develop, the other three parties

represented in the Bundestag (FDP, Greens and Left Party) can be counted on to watch from the sidelines. None of them is very likely to want to team up with the CDU (in the case of the Greens) or the SPD (Greens or Left Party) if the grand coalition founders. The small parties represented in the Bundestag (with the exception of the FDP<sup>8</sup>, which does not have enough deputies to form an absolute majority with the CDU) will figure that they will increase their share of the vote if early elections are called. They will therefore not do anything to stand in the way of early elections, least of all lending parliamentary support for the passage of unpopular measures. The German political system is thus caught in a sad paradox. Even though all polls indicate that a majority of the population wants a strong and decisive government, the current hung Parliament and the internal divisions in the SPD make it almost impossible to create one.

However, the conventional wisdom in February of 2006 indicates that the grand coalition will at least serve out its term. Since Merkel and the CDU's popularity have increased since November of 2005, the SPD leadership has no reason to want early elections and therefore will have no choice but to continue to implement the coalition agreement even as it seeks to water down its more liberal measures.

At the time of writing, the possibility of implementing economic reforms as envisaged in the CDU-SPD coalition agreement has not generated significant opposition within the ranks of the SPD. But in her first few months in office Merkel has concentrated her attention and energies on European affairs (helping to broker an agreement on the EU's financial perspectives at the December 2005 summit) and on foreign policy (with high-profile trips to Washington and Moscow). Maybe Merkel's tactic is to focus on foreign affairs while she sizes up the

8. The FDP would be very unlikely to improve on its outstanding election results of September 18th if elections were called anytime in the next few months.

SPD's willingness to undertake the agreed reforms. Indeed, the new chancellor is extremely cautious and does not like to rush into situations she does not control. It remains to be seen, however, whether the SPD's left wing will toe the official party line when the government starts to submit its more painful economic, social and labour measures to the Bundestag.

On non-economic issues, the grand coalition headed by Angela Merkel with Franz Müntefering as her deputy is likely to pursue policies quite similar to those that the SPD administrations carried out between 1998 and 2005.

With regards to the phasing-out of nuclear power plants (NPPs), the CDU vehemently opposed the decision made by the SPD-Green coalition government in its first term to shut down all of Germany's NPPs and vowed to reverse the measure if and when it was voted back into office. Given the lack of a CDU-FDP majority in the Bundestag after the September 18<sup>th</sup> elections, this is an issue over which the CDU is unlikely to put up much of a fight. Indeed, the information emerging from the coalition negotiations indicates that the CDU leaders have capitulated on this matter and basically accepted that the status quo cannot be altered. In addition to the CDU's lack of a majority, another reason why Merkel has probably chosen to back down on the nuclear issue (despite the protestations to the contrary coming from the Economics Minister, a member of the CSU) is her desire not to alienate the Green Party and thus make it possible that someday in the future the CDU and the Greens might team up at either the regional or federal level.<sup>9</sup>

9. There are some leaders within the CDU, such as the Interior Minister Wolfgang Schäuble, who have often spoken in favor of a coalition between the CDU and the Greens. To date the two parties have never formed a coalition government, even at the Länder level.

On European matters, there is also little likelihood that the coalition under Merkel will radically alter the course set by Schröder in the past eight years. And this for several reasons.

First of all, the Foreign Minister in the grand coalition is Frank-Walter Steinmeier, who has served as head of the Chancellery during the last years and has been at Schröder's side since former Chancellor was premier of the state of Lower Saxony. It will be hard for Merkel to completely set her own foreign-policy course with Schröder's right-hand man at the helm and SPD appointees occupying the top positions of the Foreign Ministry. This assertion must be somewhat tempered by the consideration that Steinmeier has already been weakened by the revelations regarding the support that German intelligence services allegedly provided to US military forces in Iraq. At the time of writing, the opposition (Greens, FDP and Left Party) had failed in its attempt to create a parliamentary inquiry to investigate exactly what kind of information German intelligence offers passed on to the US forces (Steinmeier claims it was only on "non-targets" such as hospitals and schools). But there is no doubt that any further revelations about the German government's alleged support or blind eye towards unpopular US military or intelligence operations related to the war on terror in general and the war in Iraq in particular will undermine Steinmeier.

Secondly, the positions respectively held by the SPD and the CDU on European affairs are not very divergent to begin with. Both agree that Germany's future contributions to the EU budget should be cut. The days when Germany was the EU's unwilling but acquiescent paymaster are over. Germany has already been pressuring its EU counterparts hard since the late 1990s in order to get a reduction in its net contribution to the EU coffers. Such pressure resulted in Germany (along with some of the other net contributors) getting a discount on the amount it pays to finance the British rebate (worth € 5.5 billion annually).

The failure of the EU member states to agree on the financial perspectives at the Brussels summit in July of 2005 can certainly not be

blamed on Germany. Tony Blair refused to budge at all on the British rebate, and the Netherlands and Sweden also scuppered the proposed agreement by demanding to lower their contributions to the EU budget. But some years ago an impasse such as the one experienced last July might have been overcome by the generosity of past German leaders, who at the last minute often ponied up the amounts necessary to reach agreements and keep the EU on course. But this is no longer the case. Germany's generous contribution to EU coffers since 1957 has enabled its current generation of leaders to shed any remaining guilt derived from World War II and refute the notion that Germany must somehow shoulder a bigger burden of the EU finances.

Shortly after taking office on November 22<sup>nd</sup>, Merkel ruled out an increase in Germany's EU budget contribution as a means to break the deadlock over the EU's financial perspectives for 2007-2013. Although she traveled to London and met with British Prime Minister Tony Blair, on the matter of the financial perspectives the new chancellor has announced her willingness to mediate but placed her country at an equidistant position with regards to Paris and London. Indeed, at the summit in December of 2005 which finally produced an agreement on the financial perspectives, Merkel played a key role in mediating between the French and British positions. She was widely credited with having contributed to bridging the gap between London and Paris. It must be noted, however, that this success came at the price of Germany having to employ its checkbook diplomacy once again (albeit in a smaller degree than in the past) in accepting to provide financing for the EU's newest members.

A development related to the EU budget tussle is the opposition of the previous government led by former Chancellor Schröder to the "shock-absorber" fund proposed by the EU Commission and strongly backed by France. This fund would provide financing to retrain workers laid off as a result of companies outsourcing their production to non-European countries. Even though Germany has been one of the

main victims of outsourcing during the past few years (due to its astronomical labor costs) and the SPD leaders have often lambasted the effects of globalization, Schröder quickly distanced himself from the shock-absorber fund and in this case was joined by nordic and eastern European members of the EU. Schröder may have railed against globalization, but he clearly was not willing to support an EU fund (worth € 7 billion over 7 years) that would retrain those workers affected by the violent market forces unleashed by globalization. This is one of the few cases during the past few years of Germany and France standing on opposite sides of a significant debate within the EU.

Unless she is very keen on pleasing French leaders, Angela Merkel will have absolutely no reason to change Germany's stance on the shock-absorber fund. First of all, German voters are in no mood to see their country display its traditional largesse towards the EU. Secondly, Merkel had already indicated during her campaign that she would try to rebalance Germany's relations within the EU in order to take more account of the wishes of the smaller and eastern European member states. That is code word for not trying to run the EU alongside the French, as Schröder often did. Merkel's campaign manifesto and themes often accused Schröder of having unnecessarily alienated and snubbed the central and eastern European countries (CEECs) which joined the EU in 2004 in his desire to strengthen Germany's ties to Russia and maintain the French-German engine as the driving force in the EU integration process<sup>10</sup>. Two examples of his pattern under Schröder were the exclusion of Polish and Lithuanian government representatives

10. It is well known that France and its leadership has had rocky relations with several pro-American eastern European EU member or accession states, especially following the declaration that several signed supporting the Bush administration's policy in the lead-up to the US invasion of Iraq and French President Jacques Chirac's subsequent public remark that these countries had missed a good opportunity to keep quiet.

during the ceremony marking the 750<sup>th</sup> anniversary of the foundation of Kaliningrad, at which Russian President Vladimir Putin and Schröder fêted each other, and the signing of the agreement between Germany and Russia to build a gas pipeline under the Baltic Sea which will supply Russian natural gas to Germany but bypass Poland.

Merkel has repeatedly expressed her desire to get the middle and small member states of the EU more involved in the running of the Union. She specifically mentioned Poland as a country with which Berlin wanted to coordinate EU policies more closely. One of the new Chancellor's first trips took her in fact to Warsaw.

Chancellor Merkel is cautious and gradual in her approach to problems. What *The Economist* has dubbed the "Merkel method"<sup>11</sup> consists of first taking stock of a situation, analyzing the different elements and actors which determine a particular problem, and only at a later stage taking a pro-active stance and trying to influence them. It is very probable that Merkel will also apply this method to Germany's European policy. She will first wait to see how public opinion evolves in the EU member states<sup>12</sup>, how the EU Commission's brainstorm over the Constitutional treaty unfolds and what emerges from the combined EU presidencies of Austria (first semester of 2006) and Finland (second semester of 2006) before actually advancing specific proposals of her own. Merkel has already alluded to the need to revive the EU Constitution in some form, but her government will most likely not take the lead on this matter until it takes up the presidency of the EU in January of 2007. This does not entail,

12. For a detailed analysis on the state of public opinion in the EU and its individual member states with regards to the future of the Constitution, further enlargement and general concerns see Eurobarometer 64: Public Opinion in the European Union, European Commission, Brussels, December 2005

11. *The Economist*, January 14th, 2006, page 31

however, that Merkel's government will sit on the sidelines and not get involved at all in the debate on the future of Europe's constitutional treaty. Indeed, Merkel has signalled on several occasions that she is intent on reviving the constitutional treaty. On this matter at least, she will not be drawing closer to the position espoused by Tony Blair.

### **Germany can tilt the scales on many issues in the EU agenda**

As with the shock-absorber fund and the prospects for reviving the EU Constitution, there is a wide range of issues and conflicts within the EU which the new German government will have a tremendous influence over. Whether it is fiscal harmonization, directives to foster the liberalization of cross-border supply of services, measures to stop governments from preventing takeovers of national companies by companies from another EU member state, reforms of the regulations affecting state aid, possible cutbacks to the Common Agricultural Policy, the EU's position at the Doha round of WTO trade-liberalization negotiations or any other matter confronting the EU, the stance adopted by the new German government will have a big impact on the intra-EU debate.

On most of the aforementioned issues, the new government headed by Merkel is probably going to move closer to the position defended by the more market-friendly governments in the EU (UK, Ireland, Netherlands, CEECs). But this will only be a gradual and small shift. In some ways it may be hard to notice. And Merkel is unlikely to want to antagonize the French leaders by openly siding with Tony Blair in his quest to restructure the EU budget. The future Chancellor may have wanted to do so prior to September 18th, but in light of her need to govern with the SPD she is unlikely to pursue European policies which will put her at odds with Paris.

A key test of Merkel's vision for the project of European integration is the Austrian proposal to tax speculative capital flows. This idea has been floated before, both at the international level (the famous Tobin tax) and within the European Union, with the French as its foremost champions. The tax on speculative capital flows is being touted as a means to provide independent (of the member states) financing for the EU budget, especially after the long and complicated negotiations over the financial perspectives highlighted the excessive attention being paid to each member state's net position with regards to the EU budget. The tax on speculative capital flows could thus become a "European tax" not linked to specific member states and therefore similar to the traditional own resources which the EEC developed in 1970 (percentage of customs duties, tax on European sugar production). But this proposal, as is always the case with any new tax, has run into the opposition of the UK. And the British government can count on the support of the Irish and some eastern European member states when it comes to blocking the adoption of a new European tax, which requires unanimity from all 25 member states. Despite the requirement for unanimity, the position adopted by the German government will be crucial, since it will likely have an influence over the stance taken by the eastern European member states and could thus eventually help to isolate the UK. In Germany there was much criticism in 2005 in the media and by government officials (including the current vice-chancellor Müntefering) of the supposedly destructive role played by foreign hedge funds, which often invested in German companies at the price of demanding their restructuring (with subsequent layoffs). Given the widespread feeling in Germany that speculative capital flows are part and parcel of the excessively liberal and wild capitalism which is ravaging Germany's *Mittelstand* and contributing to Germany's economic and social ills, it would probably suit Merkel to come out and support the tax on speculative capital flows. Another method for raising revenues for the EU budget

which has been on the table is a tax on air travel. This measure is supported by France (and pushed by the Transport Commissioner, Jacques Barrot) but staunchly opposed by the Mediterranean members of the EU (Spain and Greece), who fear it would hurt their tourist sectors. Germany's stance on both proposals will be crucial.

Another defining issue which will determine to what extent Merkel can set her own foreign-policy course is Turkey's accession negotiations. As stated before, the CDU leader has been unrelenting in her opposition to Turkey becoming a full member of the EU, preferring instead that Brussels offer Ankara a privileged partnership short of full membership. The SPD, on the other hand, are staunch supporters of Turkey's EU accession. This is one issue that has the potential to tear the coalition apart. The SPD will not compromise its pro-Turkey position, among other things because it is the party of choice for the majority of Germans of Turkish origin. Merkel, for her part, cannot be seen as caving in to the SPD on every single issue. Given her previous fierce opposition to Turkey's accession to the EU, Merkel will have a tough time changing her stance on Turkey without losing face. The one silver lining regarding Turkey and the EU from Merkel's perspective is that the decision to start accession negotiations between Ankara and Brussels was already made on October 3<sup>rd</sup>. There is no looming decision on whether to continue Turkey's negotiations or not. True, the opening and closing of every chapter in Turkey's negotiations with the Commission will require a unanimous vote in the EU Council. But considering the pressing economic problems facing Germany, the population is unlikely to notice that its representatives in Brussels will not use their veto to prevent the opening or closing of a particular chapter. As pertain the EU accession negotiations with Turkey, the coalition treaty between CDU/CSU and SPD declares that this is an open-ended process whose result cannot be preordained, and that should the EU or Turkey not be in a position to carry out Turkey's accession at the end of the negotiating period,

Germany will support measures and mechanisms to strengthen Turkey's privileged ties to the EU. In other words, the CDU/CSU managed to include in the declaration language to the effect that Turkey's EU membership will not be automatic.

With the conclusion of the coalition agreement between the CDU and the SPD, there are already several areas where common ground between the two parties has been found and specific measures have been agreed upon. These are mostly related to finance and economic policy, reforms of the labor market, and distribution of powers between the federal government and *Länder* governments.

The coalition program which the SPD and the CDU have hammered out after several weeks of intense negotiations will include the following provisions to revive the German economy and plug the holes in Germany's finances<sup>13</sup>:

1) Raising VAT by 3 percentage points (from 16% to 19%) beginning in 2007. Most of the revenue generated by this tax increase will be directed at lowering Germany's level of public debt. About one third will fund a small decrease in the unemployment insurance premium, a payroll tax funded by employers and employees and which, as a non-wage labour cost, makes German workers among the most expensive in the world to hire. The CDU had campaigned on a pledge to use the revenue raised by the VAT increase mostly for the cut in the payroll tax but has had to settle for the more fiscally-conservative position as a result of its agreements with the SPD. There is also some reason to believe that in the course of the coalition negotiations between the CDU/CSU and the SPD after the elections, the CDU leaders have been appraised of the disastrous state of German finances (worse than had been officially expected) and therefore accepted that the extra revenue must be

13. Germany has breached the EU's Stability and Growth Pact every year since 2002 and its budget deficit this year is expected to reach 3.7% of GDP in 2005.

employed to cut the budget deficit. Some leaders among the CDU's more liberal wing (such as the former parliamentary leader Friedrich Merz) have bemoaned this concession and criticised that Merkel has reneged on her pledge to substantially reduce payroll taxes. Although it is beyond debate that the grand coalition must do something to bring down non-wage labour costs, the SPD and CDU must nonetheless be commended for taking the responsible and politically not attractive step of using the revenue generated by the VAT increase in order to plug the hole in Germany's finances. Thus, the grand coalition will be making a real attempt at lowering Germany's budget deficit and public debt. This move will not earn them any praise from the opposition parties or the public but is in the long-term interest of Germany.

2) Extending the trial period (during which they can more easily be fired) for new employees from six months to two years. This is what little is left over from the much more ambitious labour-market reform package which Merkel ran on. It can be argued that, in addition to personal factors such as Schröder's great campaigning skills and Merkel's lack of charisma, the centrist voters that the CDU did not manage to win over in the September 18<sup>th</sup> elections might have been turned off by what they perceived as the CDU candidate's excessively radical labour-market reforms. Given the electoral result, labour-market reform is an area where the CDU basically yielded to the SPD's position during the coalition negotiations. The SPD categorically refused to accept any loosening of the regulations which make it difficult to fire workers or which enable employers and trade unions to work out wage and general labour deals which all companies in a particular sector must abide by. Labour-market reforms is thus an area where the SPD did not make any significant compromises and Merkel's negotiating team, given the electoral results and Germany's traditional consensus-based labour reforms, felt they did not have the electoral mandate to pressure the SPD on this topic.

3) The coalition commits to reducing general contributions to Social Security paid by employers and employees to below 40%. These

contributions are the single-biggest factor why German employees are among the most expensive in the world. Specifically, beginning in January of 2007 the contribution paid towards the financing of the unemployment-benefit scheme will be lowered from 6.5% to 4.5%. Critics point out that the contribution to finance the pension system will be raised from 19.5% to 19.9%.

4) Gradually increasing the retirement age from 65 to 67 years beginning in 2012 (the transition period for the introduction of the higher retirement age will last until 2035). Employees who have paid Social Security contributions for at least 45 years will be able to retire at 65 without any cut in their pension.

5) Eliminating some of the deductions in the current tax code. Germans who drive long commutes or those who build or renovate homes will no longer be able to get tax deductions. The extra revenue will also contribute to reducing Germany's budget deficit and is in line with both the SPD and the CDU's pledge to simplify the tax code by eliminating loopholes and deductions. Some of these deductions are nonetheless perceived as socially progressive (people driving long commutes, doing night shifts) and, despite their inclusion in the coalition program, their elimination will not be popular. Again in this instance the two parties must be praised for doing what is good in the long-term despite the political cost they will incur.

6) Making it easier for companies with less than 20 workers to fire workers (under current law only companies with less than ten employees have more freedom to fire).

7) Raising the top income tax rate by three percentage points (from 42 to 45%) for single persons earning more than 250,000 and couples earning more than 500,000 annually. This was largely a demand put forth by the SPD during the negotiations which the more liberal wing of the CDU rejected. In the end, however, Merkel and her advisers understood the need to come up with additional revenue (the planned extra revenue from the VAT increase will not occur until 2007) in order

to begin to improve the calamitous state of Germany's finances and therefore yielded to the SPD's demand. This "tax for the rich" is the single most important revenue generating measure included in the coalition's program. The FDP has predictably come out against this tax hike, but given the SPD's desire to implement it and the CDU's understanding that it is a non-negotiable item for the Social Democrats, it will be approved by the Bundestag.

8) Increasing the work week for federal employees from 40 to 41 hours.

9) The coalition intends to reduce Germany's budget deficit by € 35 billion by 2007 and thus comply with the EU's Stability and Growth Pact after having breached the 3% ceiling for budget deficit/GDP since 2002. The reduction of the deficit will supposedly be achieved through the increased revenue derived from the higher VAT rate and the hike in income taxes for the top bracket. If the German economy can pick up steam, it is estimated that every additional half-percentage point increase in GDP growth generates € 2.5 billion in revenue.

10) A symbolically significant measure is the announcement that Christmas bonuses for top government officials will be cut. Although this will amount to a small quantity, it marks the first time in recent years that the government has shown the public that politicians should also suffer some of the pain derived from the need to reduce Germany's budget deficit and debt. If nothing else, this measure should lend credibility to the government's reform package.

### **The grand coalition: a prescription for the status quo or for real reforms ?**

The measures which the SPD and the CDU have agreed upon in their coalition negotiations are a clear prescription for a continuation of the policies pursued during the past eight years. The grand coalition will

attempt to plug the holes in Germany's budget by raising taxes and eliminating tax deductions as well as lengthening the work week for federal employees and planning a future increase in the retirement age. These are necessary but probably insufficient measures to address the German economy's long-term structural ills. Beyond the agreed measures, the SPD will block any CDU attempt at liberalising the labour market. The hike in VAT has been severely criticized not only by the FDP but also by both trade unions and employers' associations, who fear it could dampen already weak consumer demand (the grand coalition retorts that internal demand will have been revived by the time the tax increase goes into effect in 2007).

The SPD and the CDU have agreed to disagree on reforming Germany's indebted health system. They plan to tackle this matter in the second half of the legislature, provided their coalition survives that long.

There is one intriguing scenario that might unfold. If the recent signs of an upturn of economic activity in the Eurozone in general (GDP growth at an annual rate increased by 2.6% in the third quarter of 2005) and Germany in particular are not a one-off phenomenon and economic growth intensifies, the government's reform measures might actually be perceived as working (regardless of whether this is really the case or not) and might thus raise its popularity. If this were to happen, Merkel might be tempted to launch bolder reforms –such as those included in the CDU's original campaign program- at which point the SPD leadership would be placed in a difficult position. Oppose further reforms at the cost of being perceived by part of the population as blocking further progress on Germany's road to recovery or go along with the measures at the risk of alienating a significant amount of deputies in the party's left wing, thus exposing the divisions within the SPD.

Germany's foreign and European policies, as we have seen, will not suffer major modifications under the new government. The German people basically voted on September 18<sup>th</sup> for a continuation of the status quo, both in domestic affairs and in foreign policy. The SPD and CDU

coalition agreement is a minimum common denominator designed to implement further reforms but avoiding some of the matters on which the two parties disagree (labour-market reform, health-care reform, Turkey's potential membership in the EU). Unless popular opposition to the planned reforms stokes divisions within the SPD, the grand coalition might last much longer than analysts expect. The coalition program lays a basis for government action in the next years and the SPD-CDU have a huge majority in the Parliament. They will probably shy away from radical economic reforms, and the German public is not going to demand them. Both the CDU and the SPD are not eager to contest new elections to the Bundestag anytime soon since they would likely be punished by voters for their failure to implement their coalition program. For all polls confirm that the German public strongly accepts and demands the implementation of reforms; unfortunately, this consensus breaks down when it comes to individual, specific measures.

The grand coalition might thus prove a recipe for a certain stable continuation of the policies pursued during the last eight years.

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