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Germany Retreats

With national elections this fall, reform has stopped, and may now start to reverse.

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In Germany, as in so many other countries, the biggest political casualty of the financial crisis has been the easy distinction between left and right. Since the crisis first hit Germany in the fall of 2008, Chancellor Angela Merkel's Christian Democratic Union (CDU) and her Social Democratic Party (SPD) coalition partners have moved in lockstep to pass a €580 billion stimulus and bank bailout, which by some estimates could soon rise to €1.5 trillion. Amid worries that social-security payouts will get hit by the crisis, they agreed on a law to ban pension cuts forever. In May, leading pols from both parties pushed forward with a €1.5 billion bailout to Opel, General Motors' threatened subsidiary. In fact, it's as though the start of the financial crisis marked not the beginning of the debate over the proper balance between government and markets but the end.

Just a few years ago, Germany's main political protagonists agreed that the country's high-wage economy and elaborate welfare system were getting undercut by an aging population, global competition and a dysfunctional educational system. Years of debate led to some often painful reforms, mainly under Merkel's SPD predecessor, Gerhard Schröder, that Germany's politicians almost unanimously agreed could only be the start. Now the new zeitgeist of state intervention seems to have erased the need for such messy debates. While both parties imply they have a vision of what a post-crisis Germany will look like—Merkel calls for a "renewal" of Germany's "social-market economy"; the SPD talks about a "new start"—their proposals seem to come straight from the old, pre-reform textbooks: higher benefits here, more labor-union powers there, or a few more industrial subsidies. Thomas Petersen, a political analyst at the Allensbach polling institute, says the very idea of reform has become just about as badly discredited as what German commentators call "American casino capitalism."

The political calculus is easy to understand. With the campaign just beginning for national elections in September, neither party wants to be blamed for job losses and benefit cuts. Merkel, especially, doesn't want to risk her big lead in the polls by being branded as a heartless "reformer" or "market radical"—an epithet that almost cost her the 2005 election and would be even deadlier now. So both parties have reflexively gone back to pre-reform-era policies. In April, at their campaign-kickoff convention in Berlin, the Social Democrats unveiled an election platform that included a long list of higher benefits, a sales tax on financial-market transactions and a new 47.5 percent income-tax rate for "the rich" (defined as anyone earning more than €125,000 a year). Merkel has yet to unveil her platform, but it's unlikely she'll revive her 2005 proposals for deregulating labor markets or simplifying Germany's complex and bureaucratic tax code. Instead, she has made peace with the unions by expanding their powers to set wages, and in place of the promised cut, her administration put together the biggest tax hike in German history.

What's curious about the leap to policies once blasted as hopelessly leftist is not so much that it's happening—a similar shift has, after all, taken place in many countries—but that Germany's troubles so clearly upend the old left-right clichés of destructive markets versus the benevolent state and its protections. In Germany, it's the government-owned banks, not private "capitalist" ones like Deutsche Bank, that lost the house betting on toxic assets. And rather than hitting the poor and low-skilled workers, the crisis has mainly victimized globalization's winners: hypercompetitive German export companies in wealthy regions like Bavaria, struggling with the global collapse in demand. Half the 190,000 jobs lost over the past 12 months were in the engineering and technical professions, a layoff rate seven times higher than the national average.

But because the leftward shift fits neatly into the widespread narrative that government must now step in where capitalism failed, it remains largely popular. Virtually the only backlash to it has come from within Merkel's own CDU. An emergency "nationalization law" passed by the cabinet in April has sparked unease among family-owned *Mittelstand* companies, a traditional source of CDU votes. These medium-sized businesses, which make up the bulk of German manufacturing, trade and employment, are also furious about the special treatment they say banks and big carmakers like Opel are getting. Oliver Grün, owner of a software company and head of a national Mittelstand association, says the new flood of subsidies and stimulus favors politically connected big companies and bypasses the vast majority of Mittelstand firms.

Such concerns are unlikely to be enough to topple Merkel's coalition. But depending on the depth and length of the recession, the shift left could last. Jennifer McKeown, Europe analyst for Capital Economics in London, says Germany is poised for a strong and quick recovery once the downturn ends, thanks in part to those Mittelstand companies. But she says the election raises the risk that Germany's festering banking problem won't get resolved, as politicians try to avoid blame for sticking taxpayers with the €816 billion of toxic or otherwise impaired assets German banks are estimated to hold.

That a lingering crisis might also threaten an economic model that earns 47 percent of GDP from exports—and might require a new set of policies to boost the domestic part of the economy—is a topic no German party has in any way addressed. Should the recession deepen, avoiding these debates will turn out to be even less of an option.

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