

FEATURE ARTICLE II:

GERMANY:

FREE MARKET FRIENDLY?®

By Ausra Tallat-Kelpsa Di Raimondo

As the most powerful economy in Europe, the fourth largest economy in the world (nominal GDP), largest exporter and second largest importer of goods, third biggest trading nation, and a scientific and technological leader, Germany exerts great influence on the political and economic world stage. With the last obstacles falling away from the signing of the Lisbon Treaty by the European Union’s 27 member states (the Czech Republic’s only request is the addition of a footnote), Germany stands to be the leader in a union nearly equivalent to the U.S. in population and economic power, and soon to become one of the most important players in the global balance of power.

“Europe is the great response of peace to a long history of war.”—Westerwelle (FDP)

Because of its internationalist outlook and support of the EU—as well as being its driving engine, Germany is depended upon as the nation designated to shake the EU into a global power replete with a president, a strong mandate to influence foreign policy, and a united defense policy including an army. Because of its past history, it will be a challenge for Germany to fulfill this role in all its aspects, although the formula of the European Union is consistent with the way Germany chooses to act upon the world stage. For instance, it prefers government by consensus as exemplified by its own Chancellor. Still, events may require Germany to engage in areas or ways it and its colleague nations may find uncomfortable.

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Prior to Zacks and CRSP, Ausra has broad overseas experience with international business practices in Italy, Germany, Greece, France, Lithuania, Switzerland, Turkey, Monaco, and Spain. She’s lived in Germany for 14 years and has visited it periodically since returning to the U.S. Fluent in German, Italian, Spanish, Lithuanian, Turkish, and French, Ausra, the global citizen, shares her perspective regarding the recent changes in Germany.

Germany has been experiencing the greatest amount of upheaval and change since the unification of Germany, whose nineteenth anniversary is to be celebrated this next month. The financial crisis and its repercussions have had ramifications for the German economy, people, and government. Germany had already been working through the issues resulting from unification and had nearly balanced its budget when the financial crisis occurred. Additionally, with the FDP back in a power position as part of the conservative coalition with the CDU/CSU for the first time in 11 years, the political landscape has changed immensely.

A little history: the unification, which was not well thought out, occurred upon the heels of the peaceful revolution of 1989 under a euphoric state of mind. East Germans, who had been fighting for greater democracy and freedom and were less euphoric, advised leaders to take the great differences in economic, social, and educational structures into consideration and proceed in a planned and thoughtful fashion in order to minimize negative effects, primarily on the East German population. This approach was not to be. The effects of a quick unification, and subsequent

currency conversion to the West Mark on a one-to-one basis, had deleterious effects on the East. East German products rose by 400% in price and could not find a market while state run businesses were sold to private owners and promptly shut down. Nearly overnight, East Germans lost jobs in massive amounts; lost their state-subsidized homes, state-subsidized day-care and other services; and lost much more of their infrastructure support.

The East German population was not educated in the western mind-set nor was it acclimated to the structure and psychology of the freer, individualistic western society. One can draw an analogy to people who have never seen an ocean yet are thrown into the water without knowing what swimming is, let alone learning how to do it.



Progress in solving some of the issues resulting from unification has been slow, even after two decades. The subsequent 18 years have seen the migration of 2 million workers to the west. Currently twice as many East Germans are likely to face poverty, four and a half times as many single parents in East Germany depend on aid, and a much greater percentage proportion of East Germans are unemployed than West Germans.

The situation has improved somewhat in the last 16 years. In 1992 East Germany produced only 3.4% of GDP—this percentage has now risen to 10%; gross value added by each employee was less

than 25% of West Germany, which has now risen to 78%; and East Germany's per capita output has risen to 71% of West Germany's per capita output. Interestingly enough, the global financial crisis that threw Germany into the deepest recession it had experienced since WWII, had a lesser effect on East Germany. This lesser impact was due to the greater number of smaller, more flexible businesses that were less dependent on exports.

After nearly two years of hard work and government assistance via stimulus packages, the situation brought on by the global financial crisis has improved. The German Economic Ministry reported some positive numbers for the third quarter of 2009. Economic growth increased by .3% in the second quarter due, in part, to the measures that had been taken to soften the blow of the crisis. Domestic consumption rose by .7%, construction grew by 1.4%. Exports rose by 2.3% to 68.5 billion euros in Q3, a 7% increase over Q2. Consumer prices remained stable, helping to keep the inflation rate at zero. Industrial orders rose by 4.5%. The IFO's business sentiment indicator rose to 90.5 in August, the best results since 1991. Predictions are that growth will increase by 1% (Kiel Institute for the World Economy).

For 2009, the Federation for German Wholesale and Foreign Trade foresees an 18% slump in exports for 2009, and a growth of 5-10% in 2010. Economists predict a 5.3% contraction overall 2009 and .2% 2010. The first green shoots of recovery are beginning to grow, providing vestiges of hope. Increasingly favorable economic conditions and increased customer confidence caused the increase in orders, along with demand from emerging markets in Asia.

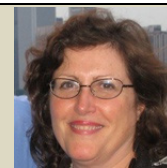
The high number of firms expecting a rise in business activity reflects an optimism that economic conditions will continue to improve. This hope is reflected in the rebounding DAX, whose benchmark index has reached the highest level in a year, and by the GfK AG's index, which

measures consumer confidence, and which rose by .5 points to 4.3 in October. Unemployment levels were down by .3% from 8.3 percent in August.

Germany's version of the social welfare state essentially adjusts government expenditures automatically to suit the economic situation, thus maintaining stability. However, challenges remain. On September 3rd the Federal Statistical Office stated that the deficit had increased to 57.2 billion euros in the first six months of 2009, as spending rose by 8.1% and revenues declined by 1.7%. This scenario may be further exacerbated if solutions are not found to create liquidity. Currently a vicious cycle is being perpetuated in which banks, although being provided "cheap" money, are not lending as much as deemed necessary; businesses are suffering and floundering; and the government continues to intervene. Its actions such as the recently ended "cash for clunkers" program and the support for short-hour labor may not be sustainable over the long term.

The 5 billion-euro "cash-for-clunkers" program affected a 23 percent increase on spending on vehicles during the first six months of 2009, which in turn affected the Q2 rebound. Predictably, it is estimated that a million less vehicles will be sold next year affecting the industry from production to the dealerships.

The Federal Labor Agency, has been subsidizing employees on short-time hours, by paying 60 percent of the net wage lost due to the reduction in hours. This program allows companies to function without engendering massive layoffs, and not having to rehire and retrain employees once the economy turns around. The program, extended in May from 18 to 24 months, includes close to 1.5 million employees. Still, the IWH expects the unemployment rate to increase to 10.3% for 2010 from 8.1% in 2009.



KATHY'S TAKE AWAY:

Three to five years from now, I'm going to be making a lot of money as a recruiter because of a choice the U.S. has made versus Germany's approach. The reason: the unemployment rate of the fresh college graduate has almost doubled (Business Week, *The Lost Generation*, 10/8/09). Without financial institutions hiring the usual number of recent graduates for their wide array of training programs, there will be way less available talent at the middle support level in three to five years, which will force companies to hire recruiters to find those scarce resources.

Every recession that I've seen to date has created the same scenario. Searching for people that don't exist because they weren't hired three to five years previously is tough. The people that are available are priced—like any scarce commodity—at a compensation that their skill level doesn't deserve. Their overpricing causes pressures on the wage scale for the people above them and for employers.

Individuals that aren't qualified but are willing to enter the field from a similar yet different field have a higher failure rate than those that come up the ranks. People who would've been encouraged to move to other employment will be retained—and at a premium wage—even though their productivity is substandard.

Perhaps instead of paying unemployment, a new policy similar to Germany's Federal Labor Agency's policy that would enable firms to keep "x" number of trainees employed as subsidized interns might be one way to break this ugly cycle?

The situation would be eased if lending to businesses would be increased. According to Creditreform, 16,650 companies with 250,000 employees have filed for bankruptcy since the crisis. Creditreform expects that banks will be hit by 170 billion euros in loan defaults by the end of next year. Lending to these businesses could minimize these issues. Although the European Central Bank and the German government (through its two stimulus bills) have taken steps to offer liquidity to get economic activity moving again, banks are not “biting”. There are two reasons for this, one being that the banks’ need for funds has decreased, which is not likely; the second being that banks are impeded by Basel II regulations, and by not wanting to seem weak.

Bailout money was not forced on banks; thus, banks have shied away from accepting funds. Banks participating in the “bad bank” (moving of now 800 billion total in toxic assets to a separate entity) program must pay the government 10% of the book value of the transferred junk securities; all other potential losses are estimated and must be paid in installments over 20 years. This payout can restrict banks in such a way as to make them freeze activity. Additionally, no matter how much liquidity is pumped into the market, banks’ required capital ratios remain a limiting factor when issuing credit. Core capital ratios of many German banks have declined but banks are reluctant to get federal funding due to the restrictions that would be placed on them. Those who have accepted the federal funding are not passing the funds on to businesses.

Basel II had been created to prevent the issuing of reckless loans by banks, but its restrictions are compounding the current crisis. Banks must increase equity reserves to satisfy requirements for existing loans. Under current conditions they can only do so by not extending expiring loans.

Although not much can be done regarding Basel II, the government is currently investigating whether

banks who accept support are operating legally as, according to the law, banks cannot set variable interest rates and fees at their own discretion. An option being considered by the government is the circumvention of banks with central banks going directly to the customer.

Given the above, the new conservative coalition faces a difficult task. It has to plan an exit strategy from the stimulus packages and to work towards a more balanced economy. It has to address the health care and pension time bombs that are already showing signs of stress. The coalition also needs to ensure a growth-friendly environment for consumers and companies. These tasks will not be easy due to the debt ceiling, under which the German constitution limits federal government borrowing to 0.35% of GDP (by 2016.)

Chancellor Merkel will continue to govern by consensus in her own pragmatic and temperate fashion, thus no extreme spending cuts (that would allow this adjustment to happen quickly) will be made. But some tax cuts will occur: from 14% to 12% for the lowest rate; the ceiling will be raised for the highest rate from 52K to 60K; and tax exemptions for children will be raised. Pensions will not be cut although they are pegged to wages, and, therefore, should actually see a reduction.

GERMANY AND THE US

Merkel warned fellow world leaders not to make the discussion about global imbalances the central issue of the G-20 summit. She diplomatically pointed out that the US and Britain were focusing on the export-oriented economic policies of Germany and China rather than on developing greater financial market regulation and global limits on bonuses for bankers.

The US has prevailed upon Germany to contribute more to resolving the financial crisis due to its strong export economy, which it feels benefits at the expense of other nations, and due to its relative economic strength and stability. Germany, on the

other hand, opines that it is not to blame for the crisis and that it has done as much as the US. In fact, Germany will have spent 3.5% of its economic output on its stimulus package by next year, which is comparable to the US at 3.8%. Given the size of its stimulus package, Germany wants to wait to see what the concrete results of its first two economic interventions will be.

Both countries understand that their policies affect each other's economies as they heavily invest in each other. The US is Germany's second largest trading partner and top investor destination. More than 6500 companies on both sides fuel trade, employ 1.5 million people, and invest 230 billion euros. American investments in Germany are its highest in Europe, amounting to 100 billion euros, and are often located in East Germany. German investments in the US are about 100 billion euros, and include manufacturing, technology, and highly skilled workers. Germany employs nearly 800,000 Americans through its US businesses.

The new Berlin administration is set to continue and grow its investments in the US, and to compromise on some of the issues that occupy the two nations at this time. The redefined European Union that is expected to emerge in the next year as a result of the Lisbon Treaty will define the conditions under which non-EU businesses will operate within the EU, including Germany, so the landscape may change somewhat for American investors.

FREE MARKET FRIENDLY?

Have these changes in Germany resulted in a more free market friendly economy? By Wikipedia (and others') definition, "a free market describes a market without economic intervention and regulation by government except to regulate against force or fraud." Given the vast amount of government intervention globally in response to the Fall of '08, few governments—if any—qualify as free markets today. However, before answering that question, a glimpse into the author's notes

from her stay in Berlin from 1980 to 1993 will provide a proper perspective from which to address that question:

"Berlin 1980 – 1990

A few years later I was on my way to Berlin for medical school. In Berlin, the creative, artistic, unusual, gregarious, and politically left merged with the hard-working, orderly, disciplined, and pragmatic. We all lived in a cage that faced outwards yet was subtly threatening to us all. I could see the towers manned by GDR military snipers every morning and so could much of Berlin...During those years East Germans were not allowed to travel into the west without a visa, which was very difficult to get, and could not travel with their family unless they were ranking party members. Nearly 140 persons were shot at the Wall trying to escape.

The later 80s saw the resistance that was growing in Lithuania and the Baltic states spill over into the "satellite" nations. Between August and November of 1989, tens of thousands of East Germans fled the GDR via Hungary and Czechoslovakia. GDR citizens began to protest openly, culminating in a 1,000,000 strong demonstration at the Berliner Alexander Platz.

Then on November 9, 1989, we watched East German news, expecting the usual propaganda. Instead Gunter Schabowski, the East German Minister of Propoganda, announced that East Berliners would be allowed to cross the border with a same day visa they could get at the checkpoint, effective immediately. We were certain that it had to be a mistake (we found out later that it was).

Living next to one of the famous border bridges...[we could see] throngs of people pushing through the checkpoint en masse, the guards having given up on providing visas. There was screaming, laughter, and dancing in our little working-class neighborhood...The day became an impromptu holiday and Berlin gave the biggest "block" party ever: champagne and food flowed freely... in every corner of the city. Strangers hugged, discussed, and expressed their joy and hope."

It's been a long road but, yes, Germany is more free market friendly and more unified internally.