FIFTH THIRD BANK

INTERNATIONAL INSIGHTS

Germany and Angela Merkel's Election Win: What's Next

First elected German Chancellor in November 2005, Angela Merkel achieved a stunning victory through her second re-election on September 22nd. This is very important since Germany is the largest European Union (EU) economy, accounting for more than one-fifth of its gross domestic product (GDP), and the main bailout creditor to struggling European countries. As a result, many are wondering what's next in terms of German policy and its impact.

Angela Merkel Has a Broad Perspective

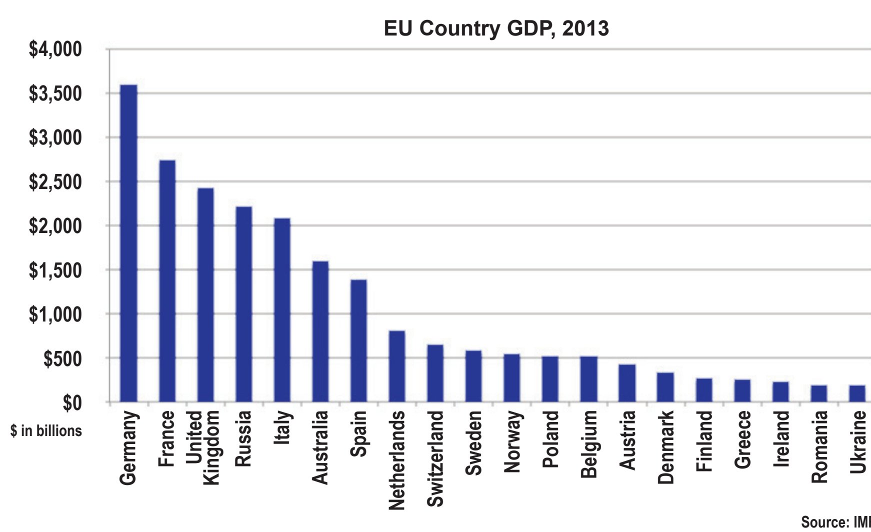
As leader of the center-right Christian Democratic Union party since 2000, Merkel, a physicist by training, has a very broad perspective. On November 9, 1989, when the Berlin Wall fell, Angela Merkel, then 35 years old, crossed from former East Berlin into West Berlin. Having grown up in former East Germany, Merkel thoroughly understands the limitations promulgated by Communism.

As demonstrated by the global recession, Capitalism is not without its flaws. However, for billions of people worldwide, including Merkel and former East Germans, Capitalism has delivered a remarkably higher quality of life than competing systems. From living under the constraints of Communism to fine-tuning Germany's brand of Capitalism, Merkel certainly has come a long way. Set to overtake Margaret Thatcher as Europe's longest-serving elected female leader, today Merkel is viewed by many as the world's most powerful woman.

The strong showing of support for Merkel in the September 22nd election is viewed by many as approval of Merkel's handling of the German economy and her position on the euro debt crisis. Still, not all agree with the outcome thus far. Her emphasis on fiscal discipline, for example, has divided much of Europe. Thus, analysts say Germany is even less likely now to forgive part of Greece's bailout loans even though Greece's debt may be beyond its means to pay.

Issues at Hand

Measured by output in GDP Germany is the economic powerhouse of Europe at nearly $3.6 trillion projected this year. Germany is followed by France, at $2.74 trillion, and the United Kingdom, at $2.42 trillion, according to the IMF. And in the second quarter 2013, Germany's GDP growth increased by 0.7 percent, compared with the zero growth rate registered in the first quarter, according to the OECD, an independent organization that promotes policies to improve global economic prosperity.



Although Germany has been relatively prosperous during the euro crisis as compared to other European countries in recent years, problems persist. Stated by Adam Posen, president of the Peterson Institute for International Economics, a Washington, D.C.-based think tank on economics and globalization, “If Germany’s economic model is the future of Europe, we should all be quite troubled.”

Posen argues that much of Germany’s success, which has been based on exports, has relied on cutting wages. “Make no mistake; that has been the basis of the nation’s export success in the past dozen years, and exports have been its sole consistent source of growth in that period. But low wages are not the basis on which a rich nation should compete.”

“Ideally, a wealthy country should stay competitive through research and development, and capital investment. Instead, total gross fixed investment has fallen steadily in Germany, from 24 percent to less than 18 percent of GDP, since 1991,” Posen continued. In fact, he says, the recent OECD Economic Survey of Germany indicates that German investment has been persistently well below the rate of the rest of the G-7 leading economies since 2001. In turn, he notes, Germany’s productivity growth has been low compared with its peers.

According to Eurostat, the statistical office of the European Union, exports were equivalent to nearly 52 percent of Germany’s gross domestic product in 2012. Europe is Germany’s largest customer, and as a result, its economy heavily depends on the strength of the European consumer base.

To promote exports, Stratfor Global Intelligence says “the Germans have used the institutions and practices of the EU to maintain demand for their products. Through the currency union, Germany has enabled other eurozone states to access credit at rates their economies did not merit in their own right. In this sense, Germany encouraged demand for its exports by facilitating irresponsible lending practices across Europe.” Others disagree with this perspective.

Nevertheless, to limit damage caused by the euro crisis, Germany has begun to diversify its exports away from Europe and toward the United States and Asia. This, however, may not provide the demand necessary to accelerate German growth to past levels. As a result, boosting domestic demand remains very important.

To achieve this, some suggest raising German wages. This, however, also would make German exports less competitive, says Stratfor Global Intelligence.

What’s Ahead
What is Germany likely to do moving forward?

Despite an election surge of an anti-euro party, Germany appears to remain fully committed to the euro. And Merkel’s past position on austerity measures and the euro crisis is unlikely to change, analysts say. According to Open Europe, an independent think tank with offices in London and Brussels, Merkel’s “resounding victory must also be seen as a validation of her eurozone policy – expect more of the same.”

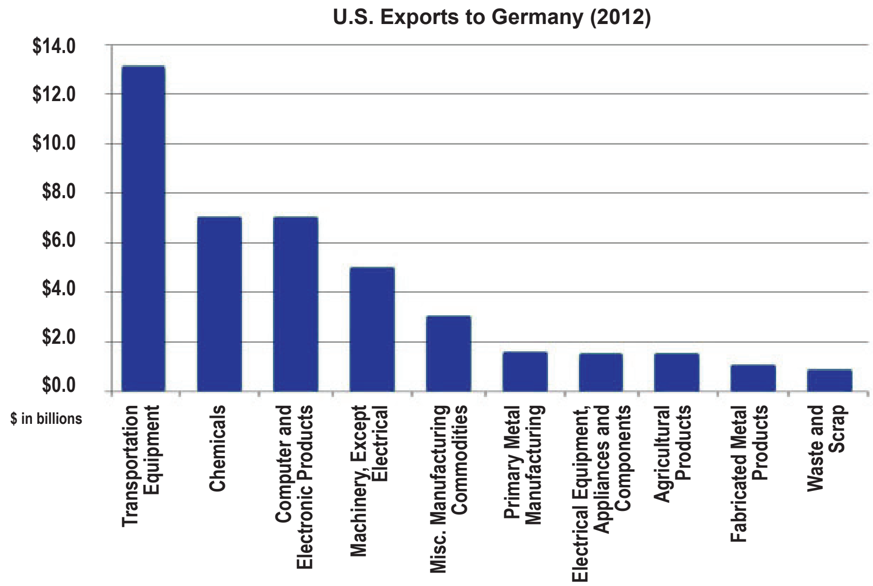
However, German domestic policy may shift. And this may include incentives to encourage more investment in Germany, especially in its infrastructure, according to analysts. In turn , these investments could establish a stronger base for German companies to expand and profit.

In a 2012 report, the OECD noted several related recommendations. It said “Reforms to foster domestic demand should focus on improving competition enhancing framework conditions for investment and innovation in Germany’s domestic sector. This includes lowering the strict regulation in some services sectors, notably professional services, and improving innovation support, for example by introducing a tax credit for R&D complementing direct R&D support.”

The direction Germany takes with regard to domestic reforms is very important, and somewhat dependent on the governing coalition Merkel is able to establish in coming months. Thus, the business-oriented Free Democratic Party, her former junior partner in her governing coalition, suffered a historic defeat and failed to win enough votes for seats in the Bundestag, the lower house of parliament.

Consequently, the new governing coalition will look different. And although it's not clear how long it will take to establish, "in 2005, when the country last had a grand coalition, it took the parties 26 days to agree the various posts and 2 months for the coalition to be officially formed and ratified by the Bundestag," says Open Europe.

There is much at stake. As the world's fourth largest economy, Germany is very powerful. And with a population of approximately 82 million, it's also the United States' biggest European trading partner and the sixth largest market for U.S. exports.



German Labor and Skill Shortages

Based on United Nations data, Germany has the oldest population in Europe and will have a median age of 46.4 by 2015. Furthermore, to the surprise of many, Germany also has the oldest population in the world, followed by Japan and Italy. In addition, Germany's population is in decline, the U.S. Census Bureau says.

As a result, "Germany is searching for ways to attract foreigners who can bolster its labor force. Germany has actually seen an uptick of immigrants over the past few years due to its resilience to the crisis, but historically it has trouble retaining them. Any new government will have to introduce policies to retain immigrants while allaying fears that foreigners will abuse the national social security system," Stratfor says.

The OECD 2012 report also made labor market recommendations. "The focus now needs to be on raising labour input and avoiding skill shortages. This includes notably increasing female full-time labour participation by lowering fiscal disincentives for second earners and further improving childcare supply. In addition, employment of older workers should be promoted by further removing work disincentives and fostering employability, including by continued reforms of the education and training system, aiming at a higher participation in lifelong learning."

The policies Germany follows are yet to be seen. Nevertheless, Europe's dominant player will have much to consider.

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