ASCENDANT GERMANY -- IS IT DESTINED TO DOMINATE THE EUROPEAN UNION?

For several decades Germany has seen its economy rise to the point where there's little question it clearly dominates the EU. And over just the last few years Germany's political clout has also been on the rise, and it looks like Germany is starting to dominate Europe politically as well. Today Mike and I will trace how this ascendancy has evolved, and, importantly, discuss whether it is sustainable.

First I'll look at the purely economic aspects and then Mike will focus on how Germany is getting more assertive on political and foreign policy issues, with particular emphasis on the German party structure.

As to the German economy, I have to apologize to those who thought they'd find out how much pig iron Germany produced last year or how many pounds of wienerschnitzel is eaten every year in Duesseldorf. I'll spare you the statistics and look at the broad picture.

About 25 years after the end of WWII, what was then West Germany was already starting to emerge as Europe's leading economy. Today, 40 years later, following the unification of East and West, Germany's economy is clearly dominant, which really isn't surprising given its population of 82 million is by far the biggest in the EU. With a GDP of close to $3 trillion, which is about a fifth the size of our GDP, Germany now ranks as the 4th largest economy in the world, behind 3rd place Japan, which just lost its #2 spot to China.

In evolving out of the ashes of WWII in to a major world player, Germany went through three postwar phases. The most dramatic was its initial acceleration, called the Wirtschaftwunder, or economic miracle. Between 1950 and 1960 West Germany doubled its GDP, growing an average 8% per year. There were four key catalysts that combined to propel that resurgence.

The first was the well known stimulus provided by the Marshall Plan. The second was the creation of the European Coal and Steel Community, the predecessor to the Common Market and later the EU, which provided a solid foundation for German heavy industry.

The third was stable political leadership, for which the 14-year stewardship of Conrad Adenauer has to be given credit. And the fourth was a mix of factors, including an ingrained German focus on quality workmanship, education, intensive vocational training, apprenticeships and engineering skills, and, at the end of the day, good old-fashioned elbow grease.

With the fall of the wall in 1989 and formal reunification of East and West the next year, the economy lost steam for several years as the huge challenge of bringing together two very disparate economies and societies took a big toll.

The integration of the two Germanys was both highly ambitious and very troubled. It was surprisingly hard to mesh a free market, capitalist economy led by a democratic government with a rigid, state-run socialist economy where entrepreneurship was in very short supply. If we could find a domestic analogy, it would probably be a bit like trying to merge North Dakota and New Jersey.

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Not only was the cost of unification enormous – estimates are it totaled over $2 trillion over the first ten years alone -- the fact is that even today the process hasn't been completed. The former East Germany still significantly lags the West in output, worker productivity and income levels. By most measures the East has only reached about 80% of the living standards of the West, a full 21 years after reunification. And in some pockets of the old East Germany today the jobless rate is close to 20%.

The burdens of integrating the two economies were exacerbated by labor strife and rising wages in the '90s and early 2000's. For a while Germany was called the "sick man of Europe", suffering from sluggish growth, uncompetitive wage levels and high unemployment.

The current resurgence really got off the ground 6 or 7 years ago, when the so-called "German model", a new compact between labor and management, started to bear fruit. The concept was largely the brainchild of Gerhard Schroder, who was Chancellor from 1998 – 2005. Schroder saw Germany's export edge getting chipped away by lower-cost producers and pushed hard to win wage and work rule concessions from labor unions in exchange for more flexibility and job guarantees from managements.

The results were dramatic, and today Germany is enjoying an absence of labor strife, more competitive wage rates and improving productivity. The "model" helped Germany get through the recent financial crisis with moderate damage – millions of workers were kept on shortened work weeks through the worst of the downturn and were ready to go when business picked back up. Bottom line, Germany's jobless rate is now relatively enviable 6.7%, noticeably below our own 8.9% and way below levels in the weaker EU countries.

The recent comeback has also been accelerated by Germany's success in taking full advantage of booming growth in the emerging markets and Eastern Europe over the last decade to rack up big export sales.

Another big catalyst was the advent of the Euro. From its launch in 1999, the Euro was a Godsend for German exporters, since it brought currency stability to their transactions and eliminated the competitive devaluations that had always made life unpredictable for European exporters. Germany had already lived for decades with a strong DM, which it had skillfully maneuvered into a position as one of Europe's most stable currency, on a par with the Swiss Franc. So it could use the Euro's stability along with its established export savvy to gain market share in the EU.

The whole saga of the birth of the Euro is yet another story. The concept of a "one size fits all" currency was a contentious one from the beginning, and is even more contentious today.

Early on, many economists felt the idea of a single currency union for Europe was absurd and destined to fail in the end. They saw the weak sisters of Europe like Spain and Italy as no match for the Germans and the Dutch, and felt the big disparities in their economies could never be reconciled. But the idealists prevailed, arguing that the weaker members could be jawboned to implement fiscal and monetary reforms that would eventually move their economies up to par.

Well, obviously that hasn't happened. If anything the gulf between the haves and have-nots has widened as even less developed countries like Greece and Portugal have joined the Eurozone. Now its conceivable the Euro could unwind because of a lethal mixture of lax fiscal discipline, questionable accounting, irresponsible spending and the budget deficits caused by the world financial crisis.

For evidence, you don't have to look farther than the collapse of Portugal's government last week when it resisted accepting tough financial austerity measures. Germany has clearly emerged as the big player in trying to get the Portugals of the Eurozone to shape up their economies, and I'll get to more of that in a few minutes.

Getting back to Germany's rising economy, there was really a lot more than elbow grease and the Euro to its success. One key factor was the seemingly inherent bias on the part of German businessmen to mimic their government's fiscal conservatism and aversion to inflation. Certainly distant memories of the hyper-inflation of the 1920's may play a part here. Whatever the reason, there's no doubt Germany has run a more orderly financial ship than most of its EU peers in recent decades.

Its debt as a % of GDP has most stayed around 3 or 4%, a real model of rectitude compared to the excessive debt loads in the Greeces and Portugals, and well below the current 8% level in France. Of course I don't have to remind you what that number will be this year and for the next few years here in the U.S. By the same token, though German banks and industrial companies didn't get through the financial crisis unscathed, they did a much better job than their American counterparts in

avoiding excessive leverage and overexposure to subprime real estate lending.

To put a number on Germany's fiscal conservatism, the Institutional Investors' recently published annual rankings of global sovereign debt are revealing. Measured by perceived quality, the study shows Germany in third place, just behind Norway and Switzerland, and well ahead of the U.S., which not surprisingly fell from 6th to 9th place last year.

A second key factor was and is Germany's strong export orientation, which has turned it in to a real export juggernaut and making it the second largest exporter in the world. Currently Germany runs a fat trade surplus, a term that hasn't been heard in the US for decades, if ever. Their trade surplus as a % of GDP, which is 5%, is close to the flip side of America's well publicized trade deficit.

To make those sales, Germany zeroed in on the spectacular growth of China, India and Eastern Europe better than any other exporter, as I mentioned earlier. It doesn't hurt, either, that the domestic export sector gets strong backing from government sponsored R&D organizations, which have helped Siemens, BASF, Daimler Benz and other big exporters penetrate new markets.

Another enabler for the export surge has been Germany's success in controlling labor costs. This restraint contrasts sharply with the fat wage and benefit hikes, usually indexed to inflation, that Germany's competitors in the EU have doled out in recent years. Specifically, over the last decade, German unit labor costs have risen just 6%, versus much bigger increases of 25% in France, 36% in Spain and 41% in Greece. No wonder much of the rest of Europe can't compete.

Speaking of competition, a recent analysis by the World Economic Council of how different countries stack up in overall competitiveness puts the Germans way ahead of their peers in the EU. Germany ranked 5th in the world, just behind the U.S., and well ahead of France, which came in 15th, Italy, at #42, and Greece, in 83rd place.

Another plus for Germany was its early recognition that it faced a future shortage of unskilled workers. So starting in the 1950s the government actively encouraged immigration from less developed countries, especially Turkey, which until recently has seen millions of unskilled workers emigrate to Germany in search of better jobs. Those emigrants filled out the low-wage sector of the labor force and are a big part of the reason unit labor costs have stayed under such tight control.

An interesting part of Germany's export thrust has been the big growth in its trade with Russia, which has been equally profitable and pragmatic. As we know, Germany has a lot of coal in the ground but its crude oil reserves are about on a par with Westchester County's. So as a major importer of non-coal energy, Germany has long been a big buyer of Russian natural gas. The gas is piped in by Gazprom, the Russian energy conglomerate, whose current chairman just happens to be Gerhard Schroder, the former Chancellor. This connection, no pun intended, has solidified both political and economic ties between Berlin and Moscow.

We all recall how Gazprom made life miserable for the Ukraine several winters ago by cutting off gas supplies. That episode left Western Europe feeling vulnerable to the whims of

Russia, and has led the Germans to promote alternative pipelines from Russia that skirt problematical countries like Ukraine.

While Germany works to develop alternative energy sources, it knows it will be highly dependent on Russian gas for years to come. So its as strategic for them to stay cozy with Moscow as it is for the US to keep close ties with our Arab “friends” in Saudi Arabia.

A final note, or question, on Germany’s economy -- while it is clearly in ascending mode, can we assume Germany’s next door rival, France, is probably destined to lose relative position to the Germans? While the direct interaction between the two isn’t one-for-one, the short answer seems to be yes. Although it certainly isn’t in serious decline, France is showing signs of losing some of its edge in the EU’s economic pecking order.

For one, its basic work ethic has long been a bit suspect, witness among other things its continuing adherence to the famous 35- hour week rule. Then there was last year’s near meltdown over the government’s efforts to increase the retirement age from 60 to 62, which speaks for itself. In sharp contrast, by the way, Germany’s current retirement age is 67.

As well, France has made much less use than Germany of low-cost immigrant labor, does less outsourcing from Eastern Europe and suffers from much higher social benefit and pension costs than does Germany. Benefit costs per worker are a hefty 70% higher in France than Germany, a factor that’s going to be hard to reverse.

As a result of all of the above, France's exports as a percent of Germany's fell from 55% in 2000 to just over 40% last year. So while maybe we can't say Germany is eating France's proverbial lunch, it is certainly nibbling on the appetizer. It certainly seems like the weaker France gets, Germany probably gets stronger.