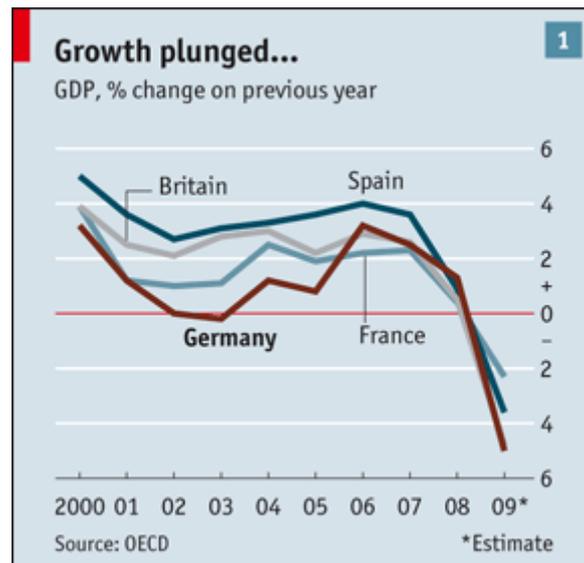


Older and wiser

For all its stolid reputation, Germany has become surprisingly flexible, says Brooke Unger. But it needs to keep working at it.

ULM, like many German towns, is arrayed around a central church like an expectant congregation. Its Gothic spire is the tallest in the world. The city is also famous for being the birthplace of Albert Einstein. But Ulmers do not live in the past. They are too busy making things, or working out how to make them better, and dispatching them to the rest of the world. The family-owned Mittelstand firms that cluster in and around this modest town alongside the Danube river were among the prime beneficiaries of Germany's export boom, the main source of growth until the world economy slumped in late 2008.



That disaster has not shaken Ulm's self-confidence. Since the financial crisis Germany's economy has shrunk more than most, by around 5% in 2009 (see chart 1). That of Baden-Württemberg, Ulm's home state, dived by as much as 8%. But the region around Ulm itself held up better than the rest of the state because its economy is diversified, reckons Otto Sälzle, managing director of the region's chamber of industry and commerce. Some local firms are in hard-hit industries like cars and machine tools but many are not: Ulm also makes pharmaceuticals and James Bond's favourite firearm, the Walther PPK. The region's unemployment rate rose from 3.3% to 4.6%, still well below the national rate. "We are the strongest region in Germany," crows Mr Sälzle.



Feistiness is an all-German trait these days, bolstered rather than subdued by the crisis. Although Germany's economy has plunged, its unemployment rate has so far barely budged, a "German miracle", economists proclaim (see chart 2). As the global economy recovers, Germany's will do better than the rest by selling cars, chemicals and capital goods to markets such as China, India and Brazil. "Germany is still outfitter to the world," says Bert Rürup, a former head of the government's council of economic "wise men".

The crisis seemed to discredit the "Anglo-Saxon model" of growth based on financial wizardry and property bubbles—and vindicate the German one, in which workers co-operate with bosses, managers invest for the long term and manufacturing holds pride of place over services. The chancellor, Angela Merkel, is promoting a "charter for international economic management" based on Germany's "social-market" principles. Crisis-prone members of the euro zone could cure their woes by becoming more like Germany, many Germans think. Its hottest export could be the German model itself.

Repeat after me

Germany does have some important lessons to teach the world, as this special report will explain. But the idea that Germany has got everything worked out requires some big qualifications. It has an ageing population, a growing share of which is either of non-German origin or poorly educated, or both. And Germany's towering export surpluses are at risk because its trading partners cannot sustain deficits for ever. Strikingly, too, the German model is no longer all that German. Over the past decade the country has rewritten its recipe for success, incorporating many foreign ingredients, including some from the much-maligned Anglo-Saxons.

Ulm shows that a springy economy makes the challenges easier to tackle but does not remove them. People with a "migration background"—immigrants, their children and grandchildren (including ethnic Germans who arrived after the fall of the Berlin Wall)—account for 37% of the city's 116,000 inhabitants and a majority of its children under ten. Those who came as "guest workers" in the 1950s and 1960s quickly adopted Swabian habits of thrift and hard work, says Ulm's mayor, Ivo Gönner, but "the kids have problems." Many are unsure where they belong; some have not mastered German.



Ulm and Neu Ulm, its Bavarian sibling across the river, became briefly notorious in 2007 when police captured would-be terrorists who were on the verge of blowing up American installations in Germany. Two of the suspects, one a convert to Islam, belonged to radical outfits in the twin towns. These have nothing to do with the established immigrant community, Mr Gönner insists. But foreigners are often associated with the threat of terrorism.

A bigger worry is what will happen as ageing Swabians retire. By 2025 a quarter of the workforce will be older than 55, compared with 15% now, and the number of school-leavers will shrink by a third. Within ten years the region will be short of 60,000 workers, 7,500 of them engineers, the soul of the Mittelstand. Mr Sälzle wonders whether the next generation is ready to step in. "We've imported the educational problems of Turkey and Italy," he says. Integrating young immigrants into the workforce is the "biggest challenge by far".

Much therefore depends on how gracefully Germany becomes greyer and browner. Other countries have even fewer babies, but none "has such long-term experience in low fertility", notes Reiner Klingholz of the Berlin Institute for Population and Development. The number of children per woman dropped below the replacement rate of 2.1 in the 1970s. The women born then in relatively small numbers are in turn having small families. Until 2002 Germany let in enough immigrants to stave off demographic decline, but the influx has slowed. In 2008, for the first time in a quarter-century, more people left the country than came in.

The newcomers are not as well educated as the native Germans, but they have more babies. Ulm is not unusual. In some towns in the Ruhr region the share of under-fives with migrant backgrounds tops 60%. Overall, they account for a third of the youngest children. By mid-

century half the population will have non-German origins, says Klaus Bade, head of the Expert Council for Integration and Migration in Berlin.

By then Germany will be a different sort of place. It will have 8m-14m fewer people than it does now, and perhaps a smaller population than Britain and France. If Turkey joins the European Union Germany could be pushed into fourth place, the spot Italy occupies now. Germany's economy will shrink relative to that of its neighbours. If it is not careful, so will its living standards. It will have more pensioners and fewer workers. One possible future is that it will become less innovative and less productive, and indeed less German in ways it would not welcome. But that is not inevitable.

The great thaw

Germany strikes people as being set in its ways. Revolutions, whether of the Thatcherite sort in Britain or the spasms of discontent in France, hold little appeal. From history's convulsions Germany has learnt to prize a quiet life. The fall of the Berlin Wall in 1989 and unification a year later was excitement enough for a while. Change, if it must happen, is painstakingly negotiated by everyone concerned, from political parties to the governments of the 16 Länder (states) to the "social partners" (trade unions and employers' representatives).

Yet the country has spent the past decade smashing its own taboos. In 1999 it sent its armed forces into battle for the first time since the second world war as part of a NATO operation to protect Kosovo from Yugoslavia. In the same year Germany reluctantly surrendered the D-mark, an anchor of its post-war identity, in favour of the euro, with notes and coins appearing in 2002. In 2000 the government changed the definition of what it is to be German, which had been based on bloodlines since imperial days, by giving non-ethnic Germans born in the country a right to citizenship. Meanwhile "Deutschland AG", the clannish system of cross-shareholdings among banks and enterprises, was killed off by Anglo-Saxon notions, and no one wants it back. That brought "more shareholder democracy into the real economy", says Frank Mattern, who heads the German operation of McKinsey, a consultancy.

More contentious than all of these was a series of economic reforms prompted by stubbornly high unemployment and intimations of demographic decline. Agenda 2010, the handiwork of a left-wing coalition of Social Democrats and Greens in 1998-2005 led by Gerhard Schröder, tried to tackle many of Germany's economic maladies. It made joblessness more painful but provided more support for jobseekers. That, along with buoyant world trade, seemed to help. Unemployment dropped from 5m in 2005 to 3m in 2008; in the last two years of the upswing long-term unemployment fell by 40%.

But Agenda 2010 both symbolised and contributed to changes in economic and social relations that Germans find unsettling. New forms of work and welfare spread: "mini-jobs", temporary employment and, most menacingly, Hartz IV, the handout that awaits anyone who does not find a job quickly. Workers in western Germany were already scrambling to compete with more flexible eastern Germans and cheap labour on Germany's doorstep in central Europe, and Agenda 2010 increased the pressure. This did wonders for competitiveness, sharpening Germany's dependence on exports, but wages stagnated and the middle class shrank even as high-income earners enjoyed a tax cut. Germany's income distribution was fast becoming less equal.

Punishing the messenger

In the 2005 election voters evicted Mr Schröder from power and demoted his Social Democratic Party (SPD) to second fiddle in a grand coalition led by Mrs Merkel's conservative Christian Democratic Union (CDU). Disgruntlement with Mr Schröder's reforms fuelled the rise

of the ex-communist Left Party, largely at the SPD's expense. Mrs Merkel proved to be more social democratic than her combative predecessor. She avoided giving offence, sought consensus, inched reform forward when she could and back when she thought she had to. In last September's elections she was rewarded with a victory that allowed her to boot out the SPD from her government and form a more coherent, supposedly more reform-minded coalition with her preferred partner, the liberal Free Democratic Party (FDP).

Germany may not need another abrupt shake-up. It no longer suffers from an arthritic labour market, an obese state or a suffocating tax burden. As the labour force shrinks, the number of jobs is likely to become less of a worry than the number and quality of people available to fill them. But this special report will show that plenty of problems remain to be solved. Between 2000 and 2009 the share of Germans who considered society unfair jumped from 54% to 71%. The state is better at supporting idle citizens than preparing them for today's world of work. Social welfare is not yet ready for the coming demographic storm. The economic recovery is still shaky and, if it lasts, will be followed by years of fiscal belt-tightening. Unless export surpluses keep rising, Germany will need to find new sources of growth. Mrs Merkel's job is not to haul Germany out of a ditch but to retune the engines of its success—in some ways a harder task.

Inside the miracle

How Germany weathered the recession.

"THIS is what we love," exclaims Jan Stefan Roell, presenting an intricately worked ingot of gleaming steel as though it were a piece of jewellery. It belongs somewhere in the innards of a testing machine made by Zwick Roell, the firm he owns. One model rips the eyes off teddy bears (to see if children can), another pokes computer keyboards. Mr Roell wants the visitor first to admire the part, next the Swabian craftsmen who fashioned it and then the German genius for making expensive and indispensable things. His customers expect German thoroughness, he says.

Ulm-based Zwick Roell, which has 950 employees and sales of €150m (\$202m) a year, is a typical Mittelstand firm. Until the 1930s it made buttons from cow horn imported from Argentina, but when plastic took over it switched to testing machines. Like many Mittelstand enterprises Zwick works backstage, making things that are used in making other things. The thousands of Zwick-like firms that constitute the engineering sector are a cornerstone of Germany's industrial economy. They employ nearly 1m workers, more than any other industry, and export almost 80% of their production. Often the product is not merely a machine, but also a panoply of services that go with it.

Last year they took a beating. Sales plunged by a fifth to €160 billion; Zwick fared no better. The wonder was that engineering firms shed a mere 40,000 jobs. "In narrow commercial terms we can't justify that," says Hannes Hesse, head of the Association of German Machine Builders in Frankfurt. His members are betting that demand will bounce back, but it is a gamble. Three possible misfortunes could scupper recovery, he reckons: another terrorist attack, another tremor in the banking system and a failure by banks to supply enough credit to his members or their customers. The jobs miracle could yet falter.

The last time Zwick made a regular employee redundant was in 1992. That is because the workforce reacts to economic shocks like a well-engineered suspension system. When the crisis hit, Mr Roell shed some workers on temporary contracts and cut the working hours and pay of regular employees. When such a deal is negotiated with the works council it is binding

on the workforce, a “huge advantage”, he says. He invites the council’s chairman to every management meeting.

This symbiosis owes something to the intimate scale of a Mittelstand enterprise, but it also relies on an institutional machine as intricate as one of Zwick’s testing contraptions. Mr Roell recruits skilled workers through an apprentice system with roots in medieval guilds. He manages labour relations within a framework set by negotiations between employers’ associations and trade unions. This arrangement survives because Germans have a knack for changing the way something works yet keeping its basic structure intact.

Slowly but surely

Twenty years ago it was a byword for rigidity. Wages and working conditions were set in sector-wide negotiations that allowed individual firms little scope for variation, tying employers’ hands. Outwardly little has changed, but the contracts have changed character. In the 1980s “they were like the Bible,” says Martin Wansleben, chief executive of the German Chambers of Industry and Commerce. “Now they provide important guidance.”

This was not a bloodless coup. Many East German enterprises, caught between low productivity and paying D-mark wages, shunned sector-wide labour contracts. High unemployment, the threat of production moving to central Europe and Mr Schröder’s reforms cranked up the pressure. As unions lost members, employers defected from the industry federations. Only half of west German private-sector workers are covered by sector-wide contracts, against two-thirds in 1998, says Reinhard Bispinck of the Hans-Böckler-Stiftung, a think-tank close to the trade unions.

Give and take

And even when they do, the contracts are riddled with “opening clauses”. At firm level bosses and works councils formed “alliances for jobs” under which workers sacrificed pay to secure employment. Working-hours accounts allow companies to adjust the amount of work done to peaks and troughs in production without paying overtime. This flexibility powered exports, lifted economic growth and fattened profits. It enriched everyone, the unions grumble, except workers. Wage rises have lagged behind productivity gains and inflation since 2000, driving down unit labour costs relative to those of Germany’s competitors (see chart 3).



Though bosses readjusted the settings in their favour, they did not smash the machine. In some ways Mitbestimmung, workers’ rights to influence decision-making, was strengthened.

Job alliances, for example, draw works councils into company strategy. In December workers at Mercedes's Sindelfingen factory near Stuttgart went on strike after the company said it would shift production of its C-Class cars to Alabama, so Mercedes promised to maintain employment at the plant until 2020. That pledge "would be worth nothing without new products and investments", points out Jörg Hofmann, head of the Baden-Württemberg branch of IG Metall, the trade union for the industry. Top of the reformers' hit list is Germany's rigid regime for protecting workers from dismissal. But without that protection workers would not allow hours to pile up in working-time accounts, says Alexander Herzog-Stein, also of the Hans-Böckler-Stiftung.

The crisis has drawn the two sides closer together. Both are determined to defend Germany's export success. It helps that they can blame the recession on outsiders and bankers rather than on each other. More important, employers have so far kept their side of the flexibility bargain by keeping up employment.

Much of the credit for Germany's jobs miracle goes to Kurzarbeit, a scheme under which government hands out subsidies to firms that retain surplus workers, but there is more to it. Joachim Möller, head of the Institute for Employment Research (IAB), part of the Federal Employment Agency, argues that flexible working hours have been an important factor in holding up employment. When the recession hit, workers had built up a large number of extra hours in their working-time accounts that could be wound down as work dried up. But firms were also looking ahead to a prospective scarcity of labour.

In 2009 the number of people of working age in western Germany shrank for the first time. The firms hit hardest by the crisis were precisely those that had the biggest problems recruiting skilled labour before it. "Most companies will see a significant impact" from a shortage of qualified labour by 2014 or 2015, says Harald Krüger, head of personnel at BMW, a Munich-based carmaker. Despite the crisis, BMW was careful not to cut its annual intake of 1,000 apprentices.

All this provides a perfect setting for Mr Roell to indulge his passion for profitable perfectionism. His machines are four times as expensive as competing testers made in China, his second-biggest market. The company actually makes its own boxes so that the gear arrives in perfect condition. Although Mr Roell has competitors, he acknowledges no peers. Where his main American rival prefers standard solutions, Zwick's engineers go for a tailor-made approach. The complexity-loving culture on the factory floor is shaped by Germany's "dual system" of vocational training, which combines classroom learning with hands-on experience. At Zwick Roell it is reinforced by a Swabian passion for inventive tinkering, or tüfteln. "I can delegate things that in other countries need supervision," he says.

It is a pact that depends partly on the owner not appearing to be too greedy. Mr Roell reinvests two-thirds of the firm's profits. The Mittelstand survives "because families don't want the money", he says. "They want the business to continue." And they are not easily put off: "If people tell you tax is a big issue they haven't done their homework." Bureaucracy is a bigger problem. Mr Roell grumbles that he has to install internal safety doors on his lifts, "ridiculous stuff which keeps me from doing my job". All in all, though, he feels that Germany's skilled workers and its infrastructure make it "a wonderful place to do business".

But the success of firms like Zwick Roell is not synonymous with Germany's. Manufacturing's share of output and employment has dropped, though it remains larger than in most competitor countries (see chart 3, above). Workers with permanent factory jobs have done relatively well recently. Since 2005 the pay of IG Metall's members went up by a total of 14%, says Mr Hofmann—less than the rise in productivity, but still "satisfactory". The price of

flexibility was higher for workers in weaker sectors or with “atypical” contracts. Schlecker, a chain of discount chemists, recently shut down some shops and sacked the workers, but at the same time opened bigger ones with temporary staff at lower pay. Public outrage forced a retreat.

Let’s have a party

Stagnant pay and domestic consumption have increased Germany’s dependence on exports. Between 2004 and 2008 its net exports accounted for nearly 40% of GDP growth. Its trade surpluses are the mirror image of deficits run by countries now no longer able to afford them, including several of its partners in the euro zone. Germany may not have been responsible for the headlong rush into consumption that caused the imbalances but, says Thomas Mayer, Deutsche Bank’s chief economist, “we were caterers to the party.” It is still in progress. Between the mid-1990s and 2007 current-account imbalances rose from 2% of global GDP to 6%. They have since eased back to 4%, but with public rather than private spending fuelling demand. That cannot last, Mr Mayer thinks.

Germany, he feels, should therefore throw its own party by rebalancing growth away from exports and towards domestic demand. Unusually, this puts the Deutsche Bank economist in the same camp as the trade unions, though their remedies differ. The unions want higher wages, backed by a statutory minimum wage, which would boost domestic demand and suck in more imports. Mr Mayer would encourage more low-wage jobs, which would beef up Germany’s services.

But not that many Germans are worried about the current-account surpluses. The country is getting older, so it makes sense for it to accumulate investments in more youthful places. The surpluses could be smaller, perhaps, but the main concern is keeping Germany in medal position among world exporters. If America and Europe buy less, China, India and Brazil will buy more. The next generation of export blockbusters is already coming up, as the next section will show.

The green machine

A second wind for German industry?

THE Roding Roadster, a sports car unveiled at last September’s Frankfurt motor show, has a powerful motor and lightweight construction that promise a thrilling ride. But at Munich’s Technical University (TUM), which the Roding’s designers attended, there is even more buzz about the Tesla, a battery-powered car from California. It shows that electro-mobility “could be fast and fun”, says Markus Lienkamp, who teaches car technology at TUM. Annoyingly, Tesla opened a dealership in Munich on BMW’s doorstep.

Germany invented the modern internal-combustion engine and intends to be a leader in any future automotive technology. It has helped to spread the idea that modern life can be transposed into planet-friendly technology. The government’s promise to put 1m electric cars on the road by 2020 is one of many initiatives to ensure that Germany cashes in. So Tesla’s brash entrance into the green enclosure was met with a mixture of derision and fear. Surely slapdash American engineering will be put to shame by the inventive perfectionism of the German Tüftler, car folk mutter. But that is a hope, not a certainty. Mr Lienkamp welcomes the threat. “When a German engineer gets angry,” he advises, “watch out.”

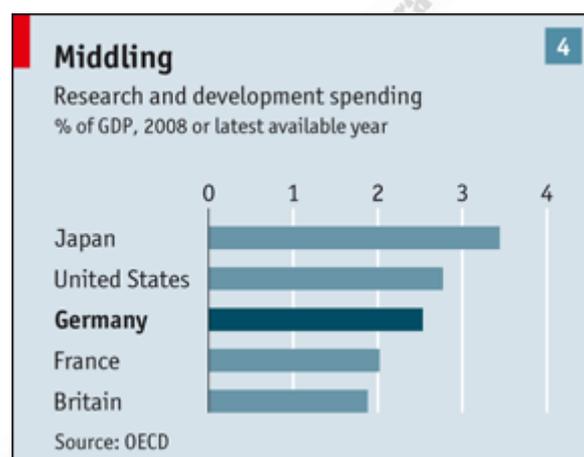
Germany is confused about its technological identity. On the one hand it embraces the new. It ranks fourth among countries in the number of patents filed per person and comes close to the

top in international surveys of innovation. On the other hand it has few enterprises emerging from garages to wreck everyone else's business model. The closest German equivalent to Google is SAP, a software firm that is pushing 40. Germans who want to convert bright ideas into riches go to America, says McKinsey's Mr Mattern. Only 4% of the working-age population is engaged in early-stage entrepreneurial activity, according to the Global Entrepreneurship Monitor, against America's 8%.

How much does that matter? Germany has done pretty well with cars, machines and chemicals, medium-tech products as measured by the share of turnover invested in research and development (R&D). Just because innovation is hidden does not mean it is not there. "A BMW has more software than the space shuttle," says Manfred Broy, a professor of information technology at TUM. Germany is in pole position in several fast-growing "green tech" areas, including renewable energy and automotive efficiency. But the arrival of the Tesla shows that Germany could still lose the race.

Sharpen up

Decision-makers are haunted by the thought that the country's only marketable raw material is brainpower and that the number of brains is shrinking. Germany underspends on education and R&D (see chart 4), and just a fifth of scientists and engineers are aged 25-34, the lowest share in the EU. As catalysts of new ideas, German universities lag behind American and British ones. Venture capital had a late and inauspicious start, just before the dotcom bubble burst in 2000, which stunted its subsequent growth.



Mrs Merkel, herself a physicist, has attended to these deficits with methodical doggedness. Her 2005-09 grand coalition stepped up support for government-funded research institutes and launched an "excellence initiative" to promote elite universities and programmes. Her new coalition plans to spend an extra €12 billion on education and to offer a big tax break for R&D. "We've sent a signal on education and research that no one else has sent," says the education minister, Annette Schavan.

Much of this money will flow into realising Germany's biggest idea: that German engineering and environmentalism will join forces to provide industry with a second wind. "Whoever is first to conquer green-tech markets will have an enduring export advantage and create jobs," Mrs Merkel has declared.

Green tech is a broad and slippery concept. Just about anything can be done more cleanly, and it would be surprising if Germans were not the first to do it in industries they lead. The German government has been sending steady green signals to the market for years. It passed a trend-setting recycling law in 1991 and was a pioneer of "feed-in tariffs", obliging utilities to buy

power generated by renewable sources at prices that reflect their higher costs. Now renewables account for 15% of electricity and German manufacturers of solar cells and wind-power turbines are among the world's leaders.

The place to be

In energy-saving fixes for cars with traditional engines, such as lightweight materials and stop-start brakes, "Germany is worldwide absolutely in front", says Christian Malorny of McKinsey. Even the Mittelstand has joined the general green mobilisation, in part because its German customers demand it. Licon, which makes machinery for the car industry, puts energy-storing brakes on its own machinery.

Using a broad definition, Roland Berger, a consultancy, reckons that the global green-tech market was worth €1.4 trillion in 2007 and is likely to grow to €3.1 trillion by 2020, outstripping vehicle production. Germany is well positioned, with market shares of 30% in power generation and 20% in "sustainable mobility". Green tech could create 1m new jobs by 2020. "This is a good and growing story," says Roland Berger's Torsten Henzelmann.

But Mrs Merkel's hopes of conquering green markets are optimistic. Competition there is as hot as anywhere else, as the solar industry is already finding out. The Chinese have jumped in with lower prices. Last year demand slumped along with prices of silicon, the main raw material for solar cells, dealing a double blow to firms locked into higher-priced silicon contracts. Now the government wants to accelerate the cuts in the feed-in tariff for solar power, which is four times the going rate for electricity. Q-Cells, the biggest firm in "Solar Valley" in the eastern German state of Saxony-Anhalt, has already shifted some production to Malaysia. High-value-added photovoltaic products will be made in Germany, says Q-Cells' Marko Schulz, but simple products will move abroad.

It might seem odd that makers of fast cars for people unfazed by the cost of fuel should worry about retooling them for a greener age, but the Germans reckon greenery plays to their strengths. Besides, they have little choice. Under EU law carmakers have until 2020 to reduce CO2 emissions significantly. BMW is determined that this should cause no loss of Fahrfreude (driving joy). They use the catchphrase "EfficientDynamics" to describe their efforts to reconcile the two. These are mostly "easy things" like fiddling with aerodynamics or pumping coolant "on demand", says Hans Rathgeber, BMW's head of vehicle architecture. Improvements to conventional cars will go most of the way towards meeting the EU emissions targets, says McKinsey's Mr Malorny. The final stretch will require adoption of radically new technologies, such as battery power.

Will German carmakers master a technology that came of age as a power source for video games? The answer matters not only to the industry but also to the country's future as an innovator. BMW says that electric vehicles will not replace conventional cars or hybrids for the foreseeable future: their range is too short and they take too long to charge. But the company will be ready. It is developing new "mobility concepts" for large cities. Last year it signed an agreement with Bosch, a German parts-maker, and Samsung, a Korean electronics firm, to buy batteries for an urban electric car. What makes a BMW is not the fuel source or even the engine. According to Ulrich Kranz, the company's resident futurologist, cars are "a huge interactive system" that BMW manages.

But even futurologists can be surprised. Profitable ideas can come from anywhere. That is why Mr Lienkamp at TUM leads a team that is developing its own ideas for a commercially viable electric car. An innovative society is one that hedges its bets by having as many thoughts—and thinkers—as possible.

Much to learn

Germany's education system is a work in progress.

GERMANY invented the modern university but long ago lost its leading position to other countries, especially America. These days the land of poets and thinkers is prouder of its "dual system" for training skilled workers such as bakers and electricians. Teenagers not bound for university apply for places in three-year programmes combining classroom learning with practical experience within companies. The result is superior German quality in haircuts as well as cars. Dual training "is the reason we're the world export champion", says Mrs Schavan, the education minister. Azubis (trainees) acquire not just a professional qualification but an identity.

But the dual system is under pressure. The number of places offered by companies has long been falling short of the number of applicants. Almost as many youngsters move into a "transitional system", a grab-bag of remedial education programmes designed to prepare them for the dual system or another qualification. Often it turns out to be a dead end, especially for male immigrants.

And given that Germany produces far fewer university graduates than many comparable countries, some wonder whether the dual system is producing the right qualifications for the knowledge-based professions of the future. "The dual system is for 200 years ago," says Alexander Kritikos of DIW, a research institute in Berlin. "You have to ask: is it still the right system if we want to be innovative?"

The system is governed by a consortium representing almost everyone who counts: the federal and state governments, the chambers of commerce and the unions. It regulates access to 350 narrowly defined trades. You can train to become a goldsmith, or if you want to manage a McDonald's you learn Systemgastronomie. Baking bread and pastries are separate disciplines. Schools outside the system may not train Azubis for a reserved trade.

It makes sense to combine theory and practice, says Heike Solga of the Social Science Research Centre in Berlin, but the dual system is rigid and discriminatory. And because the trades are so specialised, getting a job at the end can be hard. In 2005 more than a third of graduates were unemployed a year after completing their course. Ms Solga thinks the number of trades should be greatly reduced, the early stages of training made more general to make switching easier, and the right to train Azubis opened up to a wider range of schools. "It should not be about where you learn but what you can do," she says.

Once a scholar, always a scholar

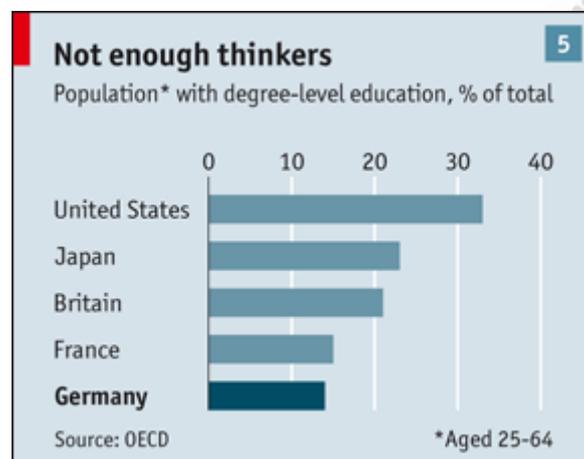
The type of secondary school a German attends, the degree he obtains and the exams he passes classify him for life. The distinctions are made earlier and more rigidly than in other countries. "Nowhere are credentials as important as in Germany," says Stefan Hradil, a sociologist at the University of Mainz.

Many children are typecast at age ten, which is when most German states decide which of three kinds of secondary school he or she will attend. Traditionally the Hauptschulen, the lowest tier, were the main suppliers of recruits to the dual training system, but they gradually became dumping grounds for children who could not keep up. Upon leaving (sometimes without passing the final exam), nearly 40% of these students find themselves in the precarious transitional system. The dual system now draws its intake mainly from the middle-grade Realschulen, the traditional training ground for white-collar workers, and even Gymnasien (grammar schools), the main route to university.

The state bureaucracy acknowledges four career paths: the simple, middle, elevated and higher services. Bureaucrats in one category can rarely aspire to careers in a higher one. Teachers in Gymnasien enjoy a higher status than those at other schools, and have their own trade union, the grandly named Philologenverband. A Meisterbrief, the highest vocational credential, is not just a badge of competence but in some trades a keep-off sign to competitors.

Germans are now asking themselves whether this way of doing things is fair, and whether it is working. Although income is distributed relatively equally, opportunity is not. "Germany is one of the most rigid among the relatively advanced societies," says Karl Ulrich Mayer, a sociologist at Yale University.

Germans remember the economic miracle years of the 1950s and 1960s nostalgically as the era of the "rising generation". But that growth lifted everyone without changing their relative positions much. And with inequality rising, that rigidity seems less acceptable. Renate Köcher of Allensbach, a polling firm, says that lower-class Germans are afflicted with "status fatalism", hopelessness about prospects for improvement for them and their children.



Teenagers' performance in international tests is more strongly correlated with family background than in almost any other country, says Ludger Woessmann of Ifo, a research institute in Munich. Even with the same marks, a child whose parents went to university is four times as likely to attend a Gymnasium as one born into a working-class family.

But social exclusiveness has not produced excellence. The 2001 "PISA shock"—a set of OECD figures which revealed that German 15-year-olds scored in the bottom third among schoolchildren from 32 countries in tests of reading and maths—has not worn off. Overall, Germany's performance remains mediocre. More than a fifth of 15-year-olds cannot read or calculate properly; 8% of teenagers drop out of school.

A war of ideologies

There is "no consensus on the content and goals of education", says Mrs Schavan. The arguments extend from primary schools to universities and are as much about tradition and status as about learning. Many Germans are loth to scrap a system so closely identified with the country's economic and cultural success.

A controversy now raging in Hamburg, a port city and one of Germany's smallest states, illustrates the strife. In 2008 the Christian Democrats, normally champions of the three-tier high-school system, formed their first state-level coalition with the left-leaning Green Party. The Greens won agreement for a radical school reform, mainly by extending primary schooling (and thus shortening secondary schooling) by two years. The idea was that if streaming

children by ability is done later, the slower ones will have a better chance of doing well and the brighter ones will at least fare no worse.

Middle-class parents of Gymnasium-bound children rebelled. The "Gucci protesters" collected more than enough signatures to get the reform put to a referendum. The parents fear that their children will be dragged down by academic laggards in the name of social justice, although such evidence as is available points in the opposite direction. The rebellion evokes wider sympathy. In conservatives' eyes, Hamburg's government is laying siege to a noble and ambitious idea of education that is still possible within the state school system.

Almost any education reform offends somebody. In a move to strengthen federalism in 2006, the federal government was banned from investing in areas reserved for the 16 Länder (including education), which makes serious reform even harder. But the immovable object is being battered by irresistible forces, including demographic change and the demands of the economy. Progress is halting but the direction is fairly clear: the system is being streamlined, schools are being made more accountable and the hierarchy is becoming less rigid. As with so many things in Germany, change proceeds by sleight of hand.

The 2001 PISA results, which not only compared Germany with other countries but individual German states with each other, put state education ministers under pressure. The states that performed worst narrowed the gap with the best performers by half within six years, says Mr Woessmann. Both states and the federal government are sharpening their instruments for measuring schools' performance. Starting in 2005, the states for the first time submitted to binding quality standards for secondary schools. "For Germany this is a paradigm shift," says Jürgen Baumert, head of the Max-Planck-Institute for Human Development in Berlin.

Paradigms in the way schools are managed do not suddenly shift, but they do evolve. School leaders in some states are gaining a modicum of autonomy, including the freedom to choose their own teachers. Though half-day schools are still the norm, the proportion offering an afternoon programme of some sort doubled between 2002 and 2006.

The three classic tiers are coalescing into two, as is happening in Hamburg and in Schleswig-Holstein, partly because the number of children is shrinking. All Hamburg's second-tier schools will offer the Abitur. North Rhine-Westphalia's CDU-FDP government last year enacted a law requiring teachers in lower-tier schools to be trained to the same standard as Gymnasium teachers.

With the number of young people shrinking and the demand for skills rising, states are making it easier for dual trainees to get bachelor's degrees, eroding the caste distinction between vocational and university training. BMW now sends a quarter of its apprentices to universities of applied science, the practice-oriented junior siblings of traditional universities, which account for about a quarter of students in higher education. More than 40% of the students at such universities come from schools other than Gymnasien.

The universities are embroiled in a row of their own. They have given up the revered Diplom to comply with Europe's Bologna process, which mandates (mostly shorter) bachelor's and master's degrees. This is meant to make the German system compatible with others in Europe (and encourage students to move around), and to award more useful degrees. Hard-core traditionalists oppose the reform in principle, but the main objections are its sometimes sloppy implementation and the scant resources available to universities in general.

Too much of German education remains hidebound. "The rule is still the teacher standing in front of a class of 30 and the kids taking notes," says Kaija Landsberg of Teach First, an education charity. Immigrant children suffer most.

What a waste

Germany scandalously underuses immigrants and women.

HEINZ BUSCHKOWSKY, the mayor of the Berlin district of Neukölln, is famous for being blunt. He is in charge of an ethnic goulash: 140,000 of his 305,000 constituents are Turks, Arabs, Yugoslavs or other migrants. The local unemployment rate is 26%, and probably twice that among the immigrants. Work disappeared when subsidies to industry were withdrawn after the fall of the Berlin Wall. But Neuköllners are all too willing to live off Hartz IV social-security benefits, which provide a family with children with enough to get by. "Long-term welfare paralyzes people," Mr Buschkowsky observes, sounding more like an American Republican of the 1980s than a leading member of Berlin's Social Democratic Party. Children grow up thinking "money comes from the state," drop out of school and then raise children who repeat the cycle.

Neukölln's problems loom large partly because it is in Berlin which, unlike Paris or London, is poorer than the country it governs. In Ulm, which has more factories, Hartz IV is a less appealing option. Still, Mr Buschkowsky's message matters anywhere in Germany. He lambasts not only welfare dependency but also conservative shibboleths like the three-tier high-school system ("once at the bottom, always at the bottom") and paying women to stay at home with their children (he thinks the money would be better spent on pre-school education so that immigrant children could learn proper German). He is equally impatient with liberal multiculturalism. Immigrants have a chance, he says, "when they not only live in Europe but become European".

Neukölln may be untypical, but it raises questions that preoccupy the whole country. How much welfare is too much? When should the state assume responsibility for looking after children? How can an ageing society make the most of underemployed immigrants and women? Should immigrants become Germans, and if so, what sort? These questions are interconnected.

For different reasons, immigrants and women play a disproportionately small role in Germany's labour force. Many immigrants never recover from their start in an "education-free monoculture", as Mr Buschkowsky puts it: a home where family members and cartoon characters speak a language other than German, a spell in a Hauptschule followed by the transitional system and a life on the dole. Nearly one-third of Germany's Turks, the largest group of immigrants other than ethnic Germans, have no secondary-school diploma, and just 14% qualify to go to university. Some 16% are dependent on welfare, twice the share of native Germans. In 2005, the last year for which data are available, the unemployment rate among Turks was 23%, compared with 10% for native Germans.

Underworked, underpaid

Women take a different route to underemployment. Their problem is not education: they make up a majority of those who pass the Abitur as well as of university students. The trouble starts afterwards. The wage gap between men and women is 23%, among the widest in the EU. That is partly because though women's participation rate is above average for Europe, many of those women work part-time (see chart 6). The "one breadwinner model" of family life—now updated to 1½ breadwinners—remains the cultural norm in west Germany. In a 2006 survey 27% of women aged 15 to 39 in that part of the country agreed with the statement that "family life suffers when the woman has a full-time job." In east Germany the figure was only 9%; in France 13%.



Institutions have not caught up with the majority of west German mothers who would contemplate full-time work. Child care remains scarce. Just 8% of German children aged two or younger are in crèches for more than 30 hours a week; in France the proportion is 17%. For slightly older children the difference widens. Unsurprisingly, in Germany only 17% of mothers with two or more children work anything like full time, whereas in France more than half do.

Germany as a whole is underemployed. Germans in work put in an average of 1,430 hours in 2006, the third-lowest rate in the OECD. Even after the labour-market reforms, long-term unemployment remains well above the OECD average. More than half a million immigrants cannot do the jobs for which they trained because Germany does not recognise their qualifications, a case of credentialism gone wild. A country in demographic decline cannot afford such waste. By 2035 Germany's GDP per person will fall by 8-15% relative to that in other rich European countries and in America, calculates Axel Börsch-Supan of the Mannheim Research Institute for the Economics of Ageing.

To head off such relative decline, Germany needs to re-engineer not only the welfare state but its attitudes towards immigrants, women and people over 60. Against its conservative instincts it has made a start. In the past ten years it has done more to integrate minorities than in the previous 40, says Klaus Bade, the immigration scholar. When "guest workers" from Turkey, Italy and Greece flooded in to alleviate labour shortages in the 1950s and 60s, Germans thought they would eventually leave again; during the 1980s the government tried to pay them to go. Now it accepts that Germany is an "immigration country". A citizenship law passed in 2000 which said that people not born German could become so was followed in 2005 by an immigration law that inched open the doors for skilled foreigners.

The government has maintained a cautious momentum, balancing welcome with a demand that immigrants adapt to German ways. Under a "national integration plan" orchestrated by the grand coalition, language training for immigrants and their children is being expanded and businesses have promised to create extra training places for migrants. The coalition set up a standing "Islam Conference" to negotiate relations between the religion and the state. Its main successes, according to Mr Bade, were to establish that Muslims see no contradiction between their faith and Germany's constitution, and to agree in principle to teach Islam in state schools, as Judaism and Christianity already are.

In 2008 Cem Ozdemir, a Swabian of Turkish origin, became co-chairman of the Greens, the first hyphenated German to lead a big party. The first Turkish-origin police inspector debuted on "Tatort" (crime scene), a popular television series, in the same year. When Mrs Merkel

named Philipp Rösler, who was born in Vietnam, as health minister in her new government, there was little comment. Second-generation immigrants fare better than their parents. Ethnic Turks born in Germany are twice as likely to pass the Abitur as those born in Turkey itself, though still only half as likely as native Germans to do so. Those who manage to obtain professional qualifications generally prosper in their careers, but this progress is partially masked by new arrivals of unskilled immigrants, often for marriage.

Neither side is sure where all this is leading. Germany lacks the republican assertiveness of France, which bars schoolgirls from wearing headscarves, and the populist self-confidence of Switzerland, which voted to ban minarets in a referendum last November. But that does not mean that it is more relaxed about migrants. In some ways it is less so. For example, citizens of non-EU countries cannot hold dual citizenship, which they are able to do in France and the Netherlands. When Thilo Sarrazin, a former Berlin finance minister, last year put forward the claim, which many saw as bordering on racist, that most of the city's Turks and Arabs were "neither willing to integrate nor capable of it", polls found that a majority of Germans agreed with him.

If integration means a willingness to embrace German identity, he is right. Only a third of Turks have given up their passports to become German citizens, and even the most successful among them have reservations. Ufuk Topkara, a young naturalised German perfectly at home with his Turkish-German identity, maintains that "the moment you speak German you are German," but explains that many of his Turkish friends disagree: "They go on about being Turks living in Germany." If on the other hand integration means speaking German, belonging to the middle class and obeying the law, then his friends are already there. The problem is that too many do not recover from a poor start in life. About half of young children in Neukölln need remedial German classes before they go to school. There is no sanction if their parents refuse to take them.

Now the government wants to make it easier for mothers to go back to work after childbirth. The grand coalition introduced "parents' pay", a benefit linked to the new parents' salaries that allows either of them to take up to 12 months off. This has started to make a difference to family life. The share of fathers taking paternity leave—normally for an extra two months—has jumped from 3.5% to more than 20%; the most dotting ones, surprisingly, are in conservative Bavaria, where more than a quarter of new fathers take the benefit.

By 2013 crèche places will be available for a third of children younger than three, and children over one will be entitled to a place if the parents want it. That may be difficult to achieve in practice. Local governments, which foot part of the bill for day care, are in dire financial straits. The expansion in most states remains "grossly underfunded", says Gisela Erler, owner of Familienservice, a company that operates crèches. She reckons it will take 20 years before the promised number of decent-quality places can be provided. But what has been put in motion, she notes, is nonetheless "a huge step".

No politician openly opposes that, but conservatives in Mrs Merkel's CDU have persuaded her also to accept a benefit called Betreuungsgeld, made to mothers who prefer to stay home with their children. For people like Mr Buschkowsky, this is a disastrous departure from the progressive policy of encouraging women to work and young children to attend German-speaking pre-schools. The conservatives invoke freedom of choice. "People know what's best for them," says Stefan Mappus, the premier of Baden-Württemberg. "It's sad that when you want to strengthen the family people accuse you of defending an obsolete model."

In business, pragmatism reigns. BMW supports four kindergartens in Bavaria and is trying to make the work culture more family-friendly. "The best worker isn't always the one who stays

till 8pm," says Mr Krüger, the personnel chief. BMW now lets workers take sabbaticals and up to 20 days' extra holiday a year in return for lower pay. He wants to arrange things so that working part-time does not mean dropping out of professional life. But family friendliness alone will not shield BMW from the coming demographic storm. By 2016, says Mr Krüger, "we won't make it without engineers from other parts of the world."

Getting closer

But eastern and western Germany may never quite meet.

THE capitalist West had Kodak, Agfa and Fuji. East Germany snapped its photos on ORWO film, which had drawbacks. The images were easily smudged and the colours were weird. In Wolfen, where ORWO was manufactured, people said you could develop the film by dipping it in the river Mulde. Neighbouring Bitterfeld, a hub of the East German chemical industry, was known as the "dirtiest city in Europe".

Since German unification in 1990 the federal and state governments have spent €230m on detoxifying the area. ORWO no longer makes film. Bitterfeld still produces chemicals, but hundreds of well-groomed firms have replaced the cheerless Kombinat (industrial conglomerate), and the chemical park now looks out over a nature reserve. Next to Wolfen is Solar Valley, a cluster of renewable-energy companies.

But Bitterfeld and Wolfen, now one town, have not yet recovered from the shock of unification, and may never do so. The super-efficient successors of the old socialist enterprises need far fewer people to work for them. The town has lost 44% of its population, says its mayor, Petra Wust. The young headed west to jobs and better pay. In the east the celebration of the 20th anniversary of unification next October 3rd will be tinged with melancholy.

For western Germany unification was a national triumph. It restored full sovereignty to the whole of Germany, both legally and psychologically. It removed the oddity of a separate East Germany, a thorn in the Federal Republic's flesh. But the cost was mind-boggling. In the past two decades about €1.6 trillion has flowed from west to east to pay for pensions and public-sector salaries, build roads, smarten up cities and encourage investment. Last year alone the net transfer was €80 billion, about 3% of German GDP.

Unification is no longer new and exciting, but it remains incomplete. Few doubt that it was inevitable, or question the basic political principles of the unified republic. In a recent poll by Forschungsgruppe Wahlen, a research outfit, 91% of east Germans ("Ossis") and 85% of west Germans ("Wessis") said unification was the right choice. Another survey, by Infratest dimap, found that 91% in the east support democracy as a form of government, though less than half are happy with the way it actually works. But Ossis and Wessis still have different perceptions of history and politics and of the way the burdens of unification were apportioned. Easterners are acutely conscious of what the merger has done to them. For most westerners the consequences have been more remote, so they tend to underestimate them.

Unification was bound to be expensive because of the way it was done. Once the border was open, West Germany had to offer some semblance of its own prosperity to the east or face mass immigration. So it exchanged D-marks for Ostmarks at a rate that had no basis in economic reality. Pensions were brought close to western levels. Trade unions, fearful that eastern workers would swamp western factories, insisted on rapid wage increases in the eastern states. Even the electricity supply needed an immediate upgrade: east German power

plants fell foul of EU rules and were switched off, so the region was wired into the western grid.

The west's nervous generosity sealed the fate of thousands of overmanned eastern firms making goods that had become unsellable in any part of the country. Between 1990 and 1992 they shed some 2.3m industrial jobs. Talent drained away. Since 1989 about 4.3m easterners have left the region, to be partially replaced by 2.7m westerners. All in all, eastern Germany lost a tenth of its population. Eastern Germany's unemployment rate is nearly double that of the west, though that is partly explained by a higher female participation rate.

Worth it, despite the pain

But these disruptions do not negate the huge gains in material and political well-being that unification brought about. The gap in living standards has shrunk: GDP per person in the east has risen from 40% of west German levels in 1991 to nearly 70% in 2008. Life expectancy is six years higher than before. Infrastructure—roads, telephone lines and so on—is so good that westerners are envious. Nor has it all been bought with western handouts. Manufacturing accounts for about a fifth of eastern GDP, not far off western levels, and unit labour costs are lower. The recession hit the west's export-oriented industry harder than the east's.

In North Wolfen, a collection of prefab apartment buildings put up in the 1960s, the losses seem to outweigh the gains. Once coveted, the apartments are now being abandoned. Once in a while a building is demolished. In the old days Kita Buratino, the neighbourhood's kindergarten, used to take care of nearly 200 children. Now there are 80.

The teachers there understand that communist East Germany was doomed. Rosemarie Krämer has not forgotten that the wait for a new car was 15 years and that to get your own apartment you first needed a husband. She realises the party was wrong to demand ideological compliance from kindergarten teachers. "We wanted a new system," says Mrs Krämer, "but what we have now is not what we wanted."

Most of the mothers, who under communism would have gone out to work as a matter of course, now spend their days in tiny apartments up several flights of stairs and collect Hartz IV. The children get little guidance at home and the teachers have to treat them with kid gloves at school, so they flounder. Kita Buratino's carers mourn the loss of subsidised bread, field trips to the Baltic and holidays to celebrate women and teachers. Solidarity among people is disappearing from the new east Germany, Mrs Krämer thinks: "It has become a society with sharp elbows."

The western eagle's embrace has left most Osis feeling bruised. Nearly two-thirds think they are treated as second-class citizens and three-quarters feel disadvantaged compared with Wessis. But resentment is not rejection. Large majorities of both groups see the peaceful revolution—an eastern achievement that led to unification—as a fortunate event and think it has been a success, according to a poll by the Konrad-Adenauer-Foundation, which is linked to the CDU.

Adenauer, the first post-war chancellor, thought that "east of the Elbe the Asian steppes begin." The steppes have now advanced to the Rhine. Unification led to an "economic cleansing" of the west, argues Ulrich Blum of the Institute for Economic Research in Halle. It was partly financed by a rise in social-security contributions, which made labour more expensive and indirectly led to the Agenda 2010 reforms. Post-communist labour practices in the east inspired greater western flexibility. And the east is already providing models for coping with demographic decline.

The move to more liberal shop-opening hours started in the eastern state of Saxony, in part because east German women spend more time at work. In 2007 three-quarters of them were in the workforce, against two-thirds in the west, and their pay was much closer to that of their male colleagues. They are happy to park children in crèches, which remain more plentiful than in the west. Eastern mothers work 12 hours a week longer than western ones. Although the overall birth rate in the east is low, highly educated women do not have fewer babies, as in the west. Eastern Germans see themselves as leading the way. "What's behind us faces west Germany now," says Wolfen's mayor, Mrs Wust.

Parity with western Germany is the wrong benchmark, argues Mr Blum. Eastern Germany may never overcome some of its disadvantages, such as its relative lack of big cities and the exodus of its elite. The biggest investors are firms from outside the region, so there are few highly paid jobs in company headquarters. Eastern companies innovate and export less. Even so, the forecasters say that within a decade or so eastern Germany as a whole should be as rich as the poorest western Länder. That will be unification of a sort.

Steady as she goes

Angela Merkel and the art of the possible.

IT IS hard to think of another big country where a recent election was such a non-event. Both America and Japan responded to the economic crisis by electing governments of a different colour, and Britain may do the same in a few months' time. In Germany, after a flaccid campaign last September, voters made a judicious adjustment. Angela Merkel was re-elected as chancellor but the grand coalition she had been heading did not survive. Her conservative union—the CDU plus its Bavarian sibling, the Christian Social Union (CSU)—acquired a new coalition partner, the liberal Free Democratic Party.

The result was both an endorsement and a rebuke. Voters rewarded Mrs Merkel for her deft handling of the economic crisis. Polls show that Germans' trust in government rose during the crisis. Yet turnout in the election was a record low of 71%, and the two big parties that have dominated post-war politics were humiliated. The SPD's 23% of the vote was a disaster, and the CDU and CSU's combined 34% was their worst result in 50 years. Only the strong showing of the FDP, which won a record 15% of the vote, spared Mrs Merkel from having to continue a grand coalition that her party did not want.

Guido Westerwelle, the FDP's leader and now Germany's foreign minister, proclaims that the election result will bring about a "spiritual-political transformation". His party is Germany's most forthright defender of free enterprise and a smallish state. It returned to power after 11 years in opposition by promising to slash taxes and "make work pay again". If Mr Westerwelle has his way, the new coalition will begin to move Germany out of the shadow of "father state".

Keep it mellow

But such transformations are not Mrs Merkel's style. Her four-year partnership with the SPD, normally a political foe, was a soothing blend of measured progress and opportunistic retreats from Mr Schröder's reforms (which many Social Democrats had come to regret). She sat out factional fights, making the course she eventually chose look Solomonic. Her stewardship of the new alliance is likely to be similarly cautious. She operates best behind the scenes and above the fray.

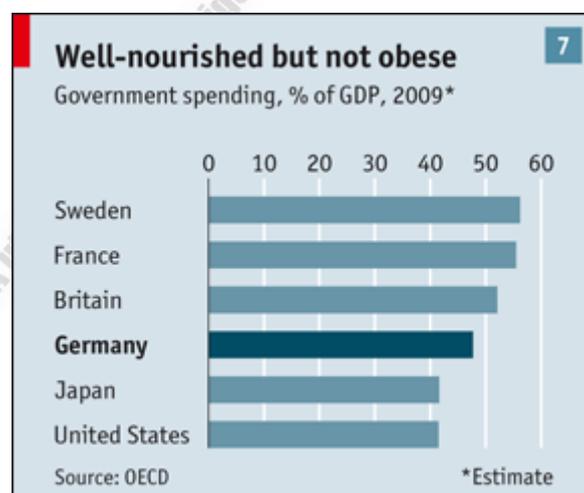
Nor are the voters in the mood for adventure. The FDP's surprisingly strong showing during capitalism's worst post-war crisis does not look like a mandate for less state and more market.

Its campaign emphasised tax cuts rather than a leaner state. In a poll conducted for the German Banking Federation, 61% of voters wanted more social protection and just 23% favoured more market. The political middle, which Mrs Merkel intends to colonise, wants a balance between social sensitivity and economic responsibility, says Klaus-Peter Schöppner of TNS Emnid, a pollster. Mrs Merkel's mandate is to reassure.

Her style makes sense for many of Germany's problems. It worked in the crisis, to which she reacted pragmatically and flexibly. It seems right for issues that require the patient pursuit of long-term solutions, such as education and the integration of ethnic minorities. But some of the hard choices now facing Germany may need a different approach.

The new government has had a muddled start. The coalition agreement is specific mainly about two issues, taxes and education, notes Andreas Pinkwart, an FDP leader and vice-premier of North Rhine-Westphalia, Germany's most populous state. There is to be extra money for education and research, €24 billion of annual tax relief and a simpler income-tax system. This will have to be reconciled with a recent amendment to the constitution obliging the federal government to get close to eliminating its structural deficit by 2016, and the Länder to do so by 2020. As the anchor of Europe's currency, the euro, Germany has an interim target of bringing its budget deficit below 3% of GDP by 2013. That is "an absolute must for Germany to be credible in the European context", says Axel Weber, president of the Bundesbank, the central bank. This year and next the deficit is likely to exceed 5% of GDP. In appointing Wolfgang Schäuble, a tough-minded elder statesman of the CDU, as finance minister, Mrs Merkel signalled that she has every intention of meeting the deficit targets.

The government has not yet explained how it hopes to reconcile these goals. Deep spending cuts would fit with Mr Westerwelle's ideas for a transformation. But the liberals have not made a consistent case for shrinking a state that is not particularly big by OECD standards (see chart 7), so attention has focused on the demand for tax cuts which, faced with record deficits, even most FDP voters now reject.



So far Mrs Merkel has contained the clashes. She managed to keep down a rebellion by state premiers from her own party against the coalition's first big initiative, an €8.5 billion package of tax cuts called the "growth acceleration law". The next round is likely to spark further insurrection. The coalition's approval rating has sagged, along with support for the FDP. Mrs Merkel's strategy will become clear only after North Rhine-Westphalia's own election in May, which will decide the survival of the state's CDU-FDP coalition as well as the federal government's majority in the Bundesrat, the upper house of the legislature.

The more important battleground is the modernisation of Bismarck's welfare state, which pays for pension, health and other benefits by taxing employment. According to one calculation, the unfunded future cost of these programmes pushes up public debt from 65% of GDP in 2007 to an implicit 250% of GDP. While investing more in the young, Germany must brace itself for ageing.

Some progress has been made on pensions. The grand coalition decided to raise the pension age, gradually, by two years to 67. But it also rolled back reform, for example by issuing a pre-election pledge that pensions would never drop even if wages did. "The next generation will pay dearly," says Friedrich Breyer of the University of Konstanz. Partly because of the reforms so far, says Hans Fehr of the University of Würzburg, by 2030 pensioners "will experience a dramatic drop in income". That argues for a further shift from state to private financing. The Bundesbank calculates that to keep pension contributions at their current rate of 20% of wages, the pension age will have to rise to 69 by 2060.

Doctor, doctor

Reform of health care may be the government's most ambitious undertaking. Germany is already the fourth-biggest spender on health after America, France and Switzerland. It does not have America's uninsured millions but suffers from un-German inefficiency. Germans are Europe's most dedicated patients, visiting their doctors an average of 18 times a year. Dr Rösler, the FDP health minister, wants to decouple health and employment costs and encourage patients to economise. His main idea is to convert part of workers' contributions into a fixed monthly payment that would act as a sort of insurance premium. More efficient insurers could charge lower fees. To lighten the burden for low earners, Dr Rösler would subsidise them through the tax system.

Hartz IV, though only five years old, is also ripe for reform. Some 5m people considered capable of working collect the welfare benefit but only 1.4m are actually employed. Activating the economically inert group would pay multiple dividends: it would spur growth, channel immigrants into the labour market and, some economists believe, give a fillip to the underdeveloped service sector, easing Germany's dependence on exports. Currently people with low-paid jobs can keep part of the benefit, which ought to encourage work, but the settings are skewed. Once income exceeds €100 a month, benefits quickly tail off, in effect imposing a tax rate of 80%.

All of this is highly contentious. Unions howled at the increase in the retirement age to 67. Dr Rösler's idea of a flat fee for rich and poor alike is vociferously opposed by the CSU, and the subsidy plan fits ill with the FDP's enthusiasm for tax cuts. The constitutional court recently told the government to rip up its formula for setting Hartz IV benefits and start anew. Most reforms imply a shift in responsibility from state to citizen. With more than 40% of German voters receiving a state transfer of some kind (including pensions), politicians tread carefully.

Mrs Merkel wants to introduce reforms, but whether and when she does so will depend on her keen sense of what is politically possible. The calculation will not be simple. Germans have a low tolerance for measures that widen inequality. The Agenda 2010 reforms tested that tolerance, alienating the SPD's core supporters and fuelling the rise of the ex-communist Left Party. More than two-thirds of Germans disapprove of earlier reforms to pensions and health care, according to a 2007 poll by the University of Stuttgart. Even the FDP now takes pains to show a social conscience, which is one reason why during the election campaign it said so little about slimming down the state.

Yet as pensioners tug one way, upwardly mobile young voters pull another. They "don't want to be spoon-fed" by the state, says Peer Steinbrück, who was finance minister in the grand-

coalition government. Mr Westerwelle recently tapped into popular resentment against Hartz IV beneficiaries by complaining that in Germany "there seem to be only people who get tax money but no one who earns it." Heinz Bude of the Hamburg Institute for Social Research detects a middle-class disenchantment with welfare, akin to America's before Ronald Reagan.

The North Rhine-Westphalia election will not settle the matter, but it will give Mrs Merkel's government its first firm indication of whether it is on the right track. Jürgen Rüttgers, the state's CDU premier (and the party's most vocal defender of "social" policies), is likely to be re-elected. But his coalition with the FDP could lose its majority, which could force the CDU to form either a grand coalition with the SPD or a partnership with the Greens. That would be a rebuff to Mrs Merkel's government and perhaps a fatal blow to Mr Westerwelle's transformation agenda.

Colour combinations

But Mrs Merkel might sense an opportunity. The CDU and the Greens already govern jointly in two small states, in Hamburg by themselves and in Saarland as part of a "Jamaica coalition" (named for the colours of the country's flag) that includes the FDP. Such exotic alliances are bound to become more common. The rise of the Left Party makes it more difficult for traditional coalitions such as CDU-FDP to build majorities in the Bundestag. A CDU alliance with the Greens in North Rhine-Westphalia could pave the way for something similar at federal level after the 2013 election.

The CDU's origins are in the Catholic Centre Party of pre-war Germany, the Greens' in the protest movements of the 1960s. But the CDU has embraced environmentalism, and today's Greens are mostly prosperous burghers with a liberal bent. Entrepreneurs in Baden-Württemberg, another candidate for such a coalition, vote CDU but their wives are often Green, says Winfried Kretschmann, the party's parliamentary leader in the state. Such a partnership would be harder to forge at federal level, but Mrs Merkel might like to have a go. Whatever the colour of the coalition, she intends to head it.

A muted normality

United Germany is becoming more comfortable in its skin.

"GERMANY is plagued by a severe economic malaise and by uncertainty about its place in the world," wrote The Economist in a special report in 2002. A lot has changed in eight years. These days Germany lectures other countries on economic management and sends troops to Afghanistan. It may still not be a "normal" country. But now that the Federal Republic is a matronly 60 and unification is approaching a post-adolescent 20, the likely shape of normality is becoming clearer.

Germany has become more at ease with itself. That became obvious during the football World Cup held in Germany in 2006, when its black, red and gold flag fluttered above cars and balconies as though patriotism had never gone out of fashion. Atonement for Germany's awful past is woven into the constitution and still shapes foreign and domestic policies; it is one reason why Germany is Israel's best friend in Europe. But now it is invoked less often as an excuse to avoid doing something that would otherwise make sense. The economic crisis, ironically, has been a psychological boost; to Germans, the social-market economy looks more like a solution than a cause.

This portends a Germany that can be both more assertive and more useful to its allies. Its armed forces get involved in conflicts in the Balkans, the Middle East, Africa and Afghanistan,

to which Germany is the third-largest contributor of troops. In January, under pressure from America, it agreed to raise the maximum number of soldiers it could send to Afghanistan from 4,500 to 5,350 and to double its aid for civilian reconstruction.

Germany now defends its national interests more frankly, especially in Europe. Helmut Kohl, the chancellor who guided Germany to unification, was responsible for the last great act of self-denial, the surrender of the D-mark. The tone changed with his successor, Gerhard Schröder, who made it clear that Germany would not reach for its cheque book every time the European Union put out its hand. He also signed a deal to build a gas pipeline from Russia that bypasses Poland and the Baltic states (and now works for the consortium that is constructing it), suggesting that a more self-confident Germany would also be a more selfish one.

This marks a generational change. Responsibility is passing from the '68ers, moral prosecutors of the crimes committed by their parents, to the youth of 1989, notes Joschka Fischer, whose progress from radical street fighter to foreign minister sums up the arc of his generation. The next one has less need of the EU to keep it on the straight and narrow, or of NATO to protect it from attack. Last summer Germany's constitutional court ruled that the EU lacked the democratic legitimacy to push European integration further.

Yet the '89ers face new anxieties that keep them hanging on to the old structures. Germans were the biggest beneficiaries of the post-war bargain under which Europe outsourced its security to America and used the money it saved to build the welfare state, notes Jan Techau of the NATO Defence College in Rome. But Europe is no longer the front line and America's focus is shifting to the Pacific. Europeans fret that China and America will make global decisions over their heads.

The answer to that is for the Europeans to speak with a more coherent voice and to strengthen their partnership with the Americans. Terrorism, climate change and the rise of China are probably best faced by investing more in the main alliances, not less. But the alliances themselves are under strain from a variety of causes. It falls to Germany to help.

Angela Merkel, a more self-effacing character than Mr Schröder, has sent mixed signals. She was instrumental in securing the passage of the Lisbon treaty, which strengthens the EU's role in justice, migration and foreign policy. Yet when it came to picking the first holders of the top jobs created by the treaty—the president of the European Council, which represents heads of government, and the high representative for foreign affairs—she joined her fellow leaders in choosing figures too puny to compete with them. In European emergencies Mrs Merkel has been watchful of German treasure and national prerogatives. Like her predecessor, she wants a permanent seat for Germany on the UN Security Council. Germany is coming to resemble France in balancing European cohesion with the pursuit of national status, says Gunther Hellmann of Johann Wolfgang Goethe University in Frankfurt.

Once burned, always shy

Yet unlike the victors of the second world war it remains, in the words of Constanze Stelzenmüller of the German Marshall Fund, a "self-shackled republic". Germany's NATO partners see it as passive, reactive and foot-dragging. Post-war pacifism remains vigorous. Germans respect their armed forces but a 2007 survey by the Bundeswehr found that only 42% of the population were proud of their achievements, compared with 87% of Americans. Most want Germany to pull out of Afghanistan as soon as possible.

What is striking, however, is how little the Germans protest. Even though they disapprove of the Afghanistan operation, 60% accept that such missions are unavoidable, according to Allensbach, a polling organisation. Germany's most popular politician is Karl-Theodor zu

Guttenberg, the aristocratic defence minister. Similarly, the EU inspires little enthusiasm, but few people doubt that Germany's destiny lies within it. National pride is partly linked to a sense of international duty.

Germany's friends no longer worry much that pride will ever become hubris again. A federal state with a declining population embedded in democratic alliances is unlikely to be a threat. But they do fear that its sense of duty will flag. As Germany comes of age, it seems unsure whether to assume more responsibilities or merely more prerogatives. Its allies are depending on Germany to become wiser with age.

Sources and acknowledgments

In addition to the people quoted in this report, the author is grateful to the following: Jutta Allmendinger, Reinhard Pollak and Wolfgang Merkel, Wissenschaftszentrum Berlin für Sozialforschung; Jörg Dräger, Bertelsmann-Stiftung; Sebastian Dullien, HTW Berlin; Jeanne Fagnani, CNRS; Clemens Fuest, University of Oxford; Matthias Gabriel, ChemiePark Bitterfeld Wolfen; Markus Grabka, DIW; Christine Grunert, Stadt Ulm; Ulrike Guérot, European Council on Foreign Relations; Wolfgang Herrmann and Bernhard Rieger, TU München; John Kornblum, Noerr LLP; Cornelia Kristen, Georg-August-Universität; Roland Manger, Earlybird; Paul Nolte, Freie Universität Berlin; Lothar Probst, Universität Bremen; Kai Peter Rath, Anja Hartmann and Eckart Windhagen, McKinsey; Holger Schäfer, IW Köln; Hilmar Schneider, IZA, Bonn; Daniela Schwarzer, SWP Berlin; Dennis Snower, Institut für Weltwirtschaft, Kiel; Werner Tillmetz, Zentrum für Sonnenenergie- und Wasserstoff-Forschung; Ingrid Weinhold, MABA.

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