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Grand coalition – poor policies

David Folkerts-Landau
Group Chief Economist

Editors

Gilles Moec
Head of European Economic Research

Barbara Böttcher
Head of European Policy Research

Stefan Schneider
Chief German Economist

Deutsche Bank AG
Deutsche Bank Research
Frankfurt am Main
Germany
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

www.dbresearch.com

The approval of the coalition negotiations by the SPD's membership has finally paved the way for a grand coalition. In our view, the agreement that is to be implemented over the coming years will take Germany in the wrong direction. It will likely result in the steady erosion of the major policy achievements that were instrumental in transforming Germany from Europe's sick man to its economic engine in the last decade.

The agreement will reduce trend growth in two broad ways: through the partial reversal of the successful Hartz reforms, as well as through increasing the fiscal sustainability gap through pension-system give-aways. Instead of making Germany a more competitive location for business and preparing its society for the demographic challenges ahead, the coalition is on course to implement policies that will be seen as errors in the years ahead.

There are other missteps. Fiscal policy has not been recalibrated for a stronger focus on growth. Moreover, the finances show a consolidation gap of roughly EUR 14 bn over the legislative period. Increased federal spending on education, research and development is not accompanied by cuts in less useful policy interventions. Furthermore, unexpected shocks or poor economic performance could force the coalition to break its promise of not raising taxes, which may even break the coalition itself.

Astonishingly, the demographic challenge is ignored and social and pension policy is being set on the wrong course. New social benefits will drive up expenditures by EUR 40-50 bn in the current term of the legislature and will be inappropriately funded by not cutting and ultimately increasing social security contributions. Pension policy decisions erode the sustainability of public finances. The sustainability gap, currently at 3% of GDP, will widen further. These measures send the wrong signals for an aging society and will weigh unnecessarily on the cost of labour.

The minor tweaks to energy policy will not correct its negative overall effect on Germany's competitiveness. The coalition completely fails to tackle cost-efficiency issues in climate policy and to seek overdue corrections of the subsidies for renewable energy sources.

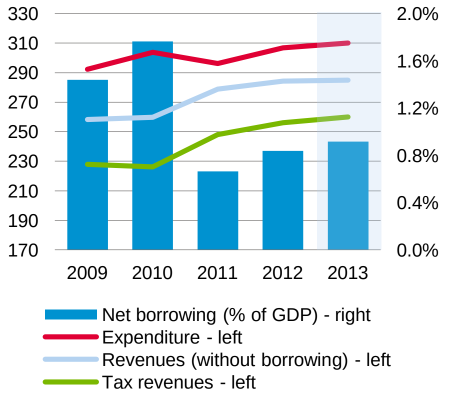
European policy remains caught in a catch-22 between a tangled mass of over-complex regulation and the lack of willingness – not only in Germany – to rapidly pursue a political union. Even worse, with the reversal of some Agenda 2010 reforms, Germany is undermining its own credibility in demanding much-needed structural reforms from other EMU countries.

David Folkerts-Landau,
Group Chief Economist

Grand coalition – poor policies

Development of federal budget 1

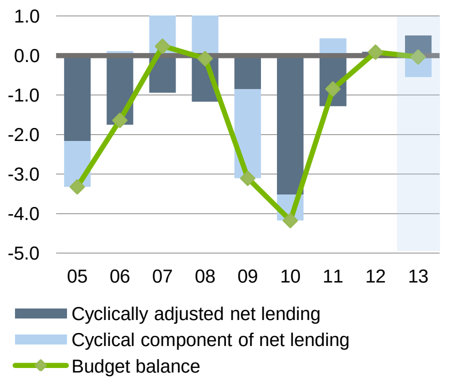
EUR bn, financial statistics (cash basis), actual and target according to federal budget plan



Sources: Ministry of Finance, Deutsche Bank Research

Fiscal balance 2

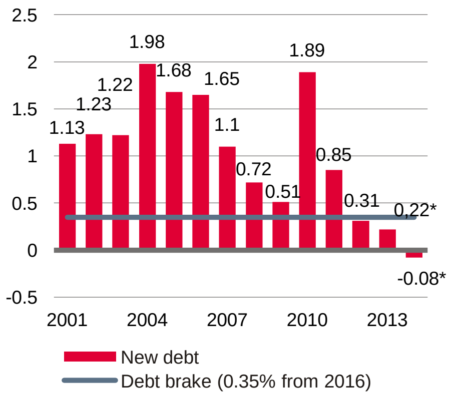
General government, % of GDP, budget balance and cyclically adjusted budget balance



Sources: Eurostat, Deutsche Bank Research

New structural federal government debt 3

Assuming the debt brake had kicked in before 2011 (as % of GDP)



* Expenditures of "Aufbauhilfe" special fund can lead to changes
2013: Target incl. supplementary budget

Source: Federal Ministry of Finance

The coalition is embarking on a regressive economic policy course that threatens to undermine the successes of the previous decade. The last major structural reforms aimed at improving Germany's prospects as a business location and the efficiency of its labour market were implemented almost ten years ago. These reforms were essential for Germany to shed the label of “sick man of Europe”. The current planned course of economic policy reveals a lack of understanding of the preconditions for growth in a globalised economy. Going down that road, Germany might end up assuming this label once again.

The coalition intends to hugely increase pension benefits, introduce a minimum wage and slightly expand public spending. There is as little provision for tax hikes (SPD campaign issue) as for tax relief (CDU/CSU pledges). Trend growth – especially in the labour supply – will suffer a blow. The sustainability of public finances will be weakened substantially. No economic priority has been attached to correct less important measures in the budget or misguided activities in certain policy areas. There are to be no structural reforms focusing on ossified goods and services markets. A better outcome that would have delivered a more sustainable equilibrium for growth, employment and climate protection would have involved further-reaching measures areas such as public-sector investment, the framework for private-sector investment and energy policy.

Fiscal policy: Trying to have their cake and eat it

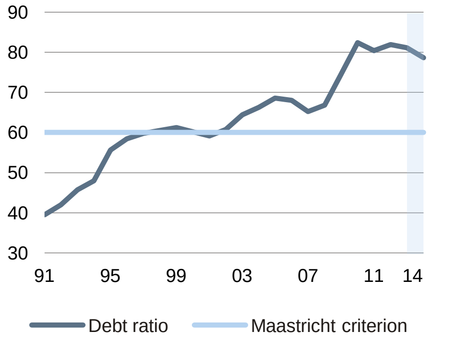
Despite the European crisis, Germany has followed a successful path of fiscal consolidation. According to the coalition agreement, the partners will adhere to the target of a structurally balanced budget in 2014 and a nominally balanced budget in 2015. The roadmap for the reduction of the general government debt ratio also ought to be maintained. This comes as a surprise given that it was decided to increase expenditures by roughly EUR 23 bn via tax instruments and by EUR 40-50 bn via contribution-funded social security schemes over the next four years. Nonetheless, there remains a notional funding gap of a minimum of EUR 14 bn over four years. Adjustments to individual budgets or curbing the growth of expenditure should enable the government to at least partially close the gap.

But already, medium-term fiscal planning is based on assumptions of continuously growing tax revenues on the back of a further improvement of the global and European environment. This is an optimistic view given the ongoing need for de-leveraging in all EMU countries. The risks for the budget are substantial, ranging from potential Soffin measures (Germany's Financial Market Stabilisation Fund), if the ECB's comprehensive review of German banks makes sovereign capital injections necessary, to higher bond yields following a stronger turn-around in the US interest rate cycle, or difficulties to implement planned taxes, in particular to raise the envisaged volume of EUR 2 bn annually from 2015 via the Financial Transaction Tax.

Should the coalition be faced with a weaker economic environment or other reasons for the deterioration of the fiscal situation, the coalition partners will have to make tough choices given their positioning in the election campaign. With the debt brake in place the coalition partners might be forced to break their promise of avoiding tax hikes or take back some of the most expensive social benefits. This will likely lead to severe tensions between the partners over the future course of economic and fiscal policy, encouraging the wings in the respective party which are sceptical about this marriage anyway. Ultimately, this could prove to be a final straw, especially if a successful CDU/Green government in Hessen and a more intensive flirting between the SPD and Die

Government debt ratio
Germany 4

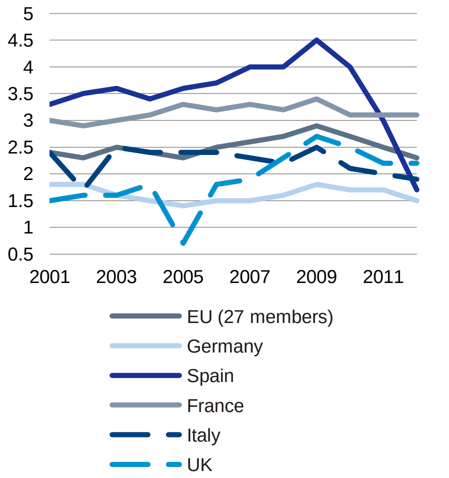
% of GDP



Source: Eurostat

Public investment 5

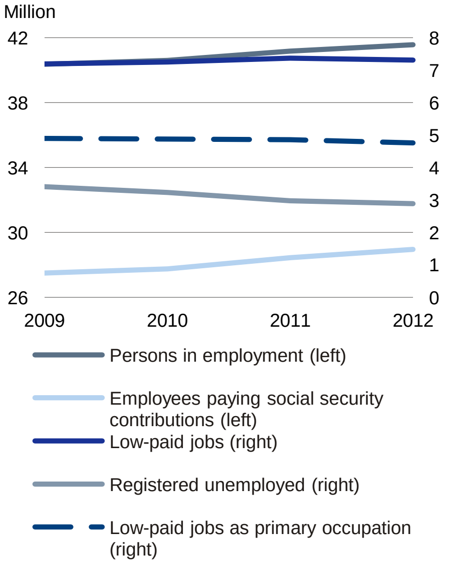
As % of GDP



Source: Eurostat

Labour market development 6

Million



Source: Council of Economic Experts, Annual Report 2013

Linke increases both partners propensity to look for greener pastures elsewhere.

The risks for the budget would be seen in a somewhat different light if the spending was directed at the right targets. But taken together, expenditure on social benefits are set to expand three times as much as those on "growth friendly" areas. A stronger focus on economic growth, public investment and a better framework for private investment would have been more preferable. After all, private and public investment has been developing slowly in Germany.[1] In education policy, the federal government and the Länder have failed to reach agreement on further-reaching reforms of financial resources and federal participation. Furthermore, the coalition partners did not manage in any single field to find funding from existing budgets even for these limited changes; instead, the new expenditures were simply added on top. A continually post-poned, long overdue review of family policy as well as a further decrease in subsidies across the board, would have offered the financial scope to engender forward-looking budgets that could and should have been exploited by a grand coalition in particular.

Demographic challenges brushed aside

Germany has one of the fastest aging populations in the world. The workforce too is shrinking. One would expect longer life expectancies to result in longer-working lives. Instead, the coalition is re-introducing the penalty-free retirement at the age of 63 under some conditions. This sends the wrong signal to an aging society. Also, disregarding the warnings of countless pension and financial experts the coalition agreed to expand the scope of statutory social-security benefits in five areas. They will add up to at least EUR 10 bn per year from 2015. The lion's share of expenditure is to be funded from pay-as-you-go contributions. Correspondingly, the contribution rates cannot be reduced as actually mapped out. In addition, contribution hikes for statutory long-term care are to be introduced. The consequences are twofold: First, the burden of social security contribution will continue to weigh on the cost of labour reducing incentives to work for above all low-income earners and for companies to create jobs. Second, the sustainability gap, which currently equals roughly 3% of GDP will widen further. This will be the case even if, in a few years' time, the social security contributions will have to be increased by one to two percentage points only on account of the reforms and by two to three points on the inclusion of the required rate changes in the statutory health insurance.

Labour market policy: Into reverse gear

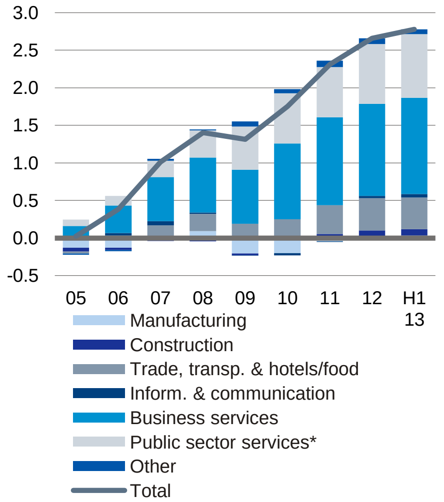
In the area of labour policy[2], January 2015 is to see the introduction of a nationwide minimum wage of EUR 8.50 per hour. In a transition period up to January 1, 2017 existing collective agreements that provide for wages below this threshold will remain valid; furthermore, new collectively bargained settlements may still have starting wages that undercut this level. During this

[1] See Deutsche Bank Research (2013). Standpunkt Deutschland. Criticism of Germany's CA surpluses largely unfounded. December 12, 2013. Frankfurt/Main. DIW (2013). Investitionen für mehr Wachstum – Eine Zukunftsagenda für Deutschland. Wochenbericht 26/2013.

[2] For a detailed discussion see Deutsche Bank Research (2013). Standpunkt Deutschland. Minimum wage at EUR 8.50: The wrong policy choice. November 1, 2013. Frankfurt/Main.

Business services and public sector lead employment build-up 7

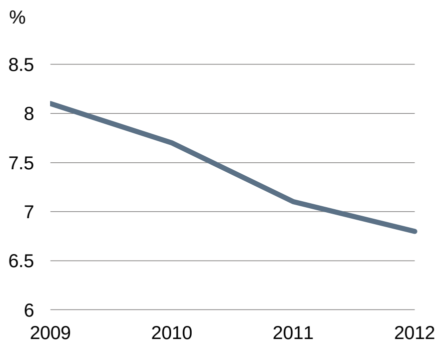
Cumulative employment increase since Q1 2005 by sector, m employees



* Public services including education and health care

Source: Federal Statistical Office

Unemployment rate 8



Source: Council of Economic Experts, Annual Report 2013

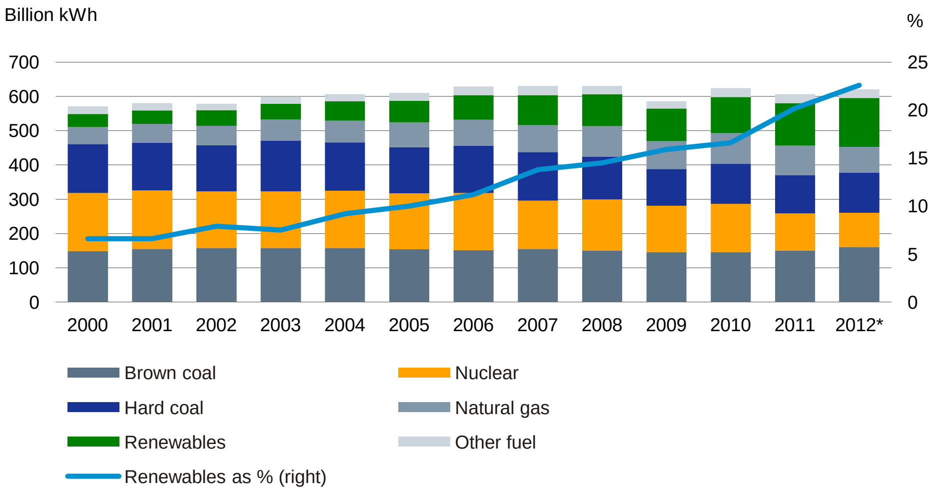
period, regional differentiation will also still be possible. Subsequently, there may still be exceptions for certain groups of labour market participants. On top of this, the labour regulatory framework is to be altered. In future, it is to become much easier for the government to declare collective wage settlements as universally binding, since they will no longer have to cover more than 50% of sector employees. There are going to be stricter arrangements for temporary employment agency work. Deployment of temporary workers is to be limited to a maximum of 18 months; such workers are to be granted the same conditions as regular employees after nine months, the common practice today. Moreover, the legislation covering contracts for work and labour (Werkverträge) is to be tightened. These measures are aimed at eliminating ways of circumventing the minimum wage. Also, the principle of allowing only one agreement in each company will limit the activities of specialised unions in large firms. Potential job losses can only be judged fully once all the details of the legislation are in place. However, the minimum wage will clearly worsen the employment situation of the roughly 6 million low-skilled workers earning less than EUR 8.50 per hour who are often among the groups with problems in the labour market. A rigorous introduction without any significant exceptions could lead to the loss of 450,000 to 1 million jobs in the medium term. Overall effects could be even more negative as the above listed measures will reduce the labour market's flexibility to adjust to such a high minimum wage.

Misguided energy policy will continue

The dramatic u-turn in German energy policy had (unintended) consequences. There is a high risk that Germany's status as an export powerhouse and its competitiveness against the US and the rest of the world is threatened by constantly rising electricity prices – compared with 2007, electricity prices for industry and households are up some 20%-40% in Germany, pushing them to the top ranks in Europe. Thus energy policy has to take a centre stage in the policy mix of the new government. Administrative competencies will be centralised in the Ministry of Economy. The coalition agreement falls short of addressing the deterioration of Germany as business location for energy-intensive industries. It only allows for very small and gradual adjustments to the current policy course. The numerous changes to the statutory and regulatory framework in energy policy are not sufficient to ensure the cost competitiveness of the German economy. This will become all the more evident with the investigations of the EU Commission into the scope of exemptions for energy-intensive industries under the Renewable Energy Sources Act (EEG). A "Energiewende 2.0,"[3] one that will improve the efficiency of the current system as well as introduce market mechanisms for future energy pricing, is not in sight. However, only with more efficiency and market orientation in energy policy will energy-intensive and globally exposed German-based companies be able to compete on a level-playing field with their international peers. The decisions on energy policy fall short of the required rethink.

[3] For a detailed discussion see: Deutsche Bank Research (2013). Standpunkt Deutschland. Energiewende 2.0 – don't risk competitiveness. November 26, 2013. Frankfurt/Main.

Gross electricity generation in Germany by source of energy 9



*Estimate

Source: AG Energiebilanz e. V.

European policy – no strategic vision

European issues did not play a major role in the election campaign or in the positioning of the three coalition parties. This is reflected in the coalition agreement, which contains virtually no specific statements on the current dossiers of the European agenda let alone a strategic vision on Europe's future and Germany's role in it. Not so much the German electorate but certainly Germany's European partners had no doubt expected more emphatic "forward guidance". How far would the German government be prepared to go for the stabilisation of the ailing euro area? Is the mindset more of a Maastricht 2.0 or expending the de facto already existing transfer and liability union? How prepared are German policymakers to transfer further sovereignty to the EU? And how to address the public fatigue for European integration in general which might fuel a good showing of eurosceptics at the upcoming European elections?

Admittedly, firm commitments in the coalition agreement might have placed restrictions on Germany's scope for action at the European level, at least for the current dossiers. The ongoing negotiations in the EcoFin and the preparation for the European Council on banking union are just a case in point. But the negotiations on banking union also show that, while Germany supports banking union in theory, it has its reservations on taking the appropriate decisions. To break the vicious circle between banks and their sovereign, there needs to be an element of cross-border fiscal transfer in the case of a crisis. This might be difficult to sell to the public but will be unavoidable should the financial crisis be resolved and the fragmentation of the single financial market stopped. A grand coalition with its far-reaching parliamentary majority could more easily assume responsibility to put a banking union into place.

Upgrading the Economic and Monetary Union, also seems to remain an uphill battle. The coalition rightly seeks to achieve better and more binding co-ordination of economic policy and a more effective fiscal policy. In earlier debates, Germany had supported demands calling for the Commission to be given the possibility of rejecting national draft budgets in the framework of the European semester. At the time, no majority was to be found. Therefore, it has been reasserted in the coalition agreement that national budget responsibility and supranational joint liability for debt obligations are incompatible. All in all, the new government, like its predecessor, wants to pursue a comprehensive political approach that combines structural reforms with budget consolidation and forward-looking investments as well as institutional changes. Given the compliance problems of a number of member states with EU rules and recommendations in this context, this approach will not be sufficient to set the euro area on a solid footing soon. Leadership on “re-thinking Europe” is required from its biggest economy.

Grand coalition – limited lifetime?

No doubt, the policies put into practice seldom match coalition agreements. In this respect, scope for improvement could emerge as could adjustment risks in the event of unexpectedly poor performance or shocks. However, this might bring the tensions which have been covered under an overly optimistic fiscal scenario back onto the front burner. Each party might then be worried about being outmanoeuvred by the other, making positioning for the 2017 (or earlier) elections the overruling objective. Even if this scenario can be avoided and the coalition governs through the whole term, it is disappointing that a country that has been lecturing its neighbours about fiscal prudence and sustainability for years is coming up with policies – and a budget in particular – which seems to follow the motto “après moi, le déluge”.

Klaus Günter Deutsch (+49 30 3407-3682, klaus.deutsch@db.com)

Barbara Böttcher (+49 69 910-31787, barbara.boettcher@db.com)

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