



Current Issues Germany

Germany at the polls

The 2013 elections and the future of the euro

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Chancellor Merkel faces elections this autumn. She benefits from a solid economy and her stance on euro politics, reflected in her high popularity. Her centre-right coalition does not fare nearly as well in opinion polls as Merkel herself and her Liberal coalition partner is fighting for survival.

Chancellor Merkel has many options to remain in power. She will probably be able to continue with her current partner, the Liberals, build a coalition with the Social Democrats or accept the Greens as a junior partner. Since the change of tack on energy policy with the "Energiewende", nuclear power is no longer a stumbling block for a coalition with the Greens.

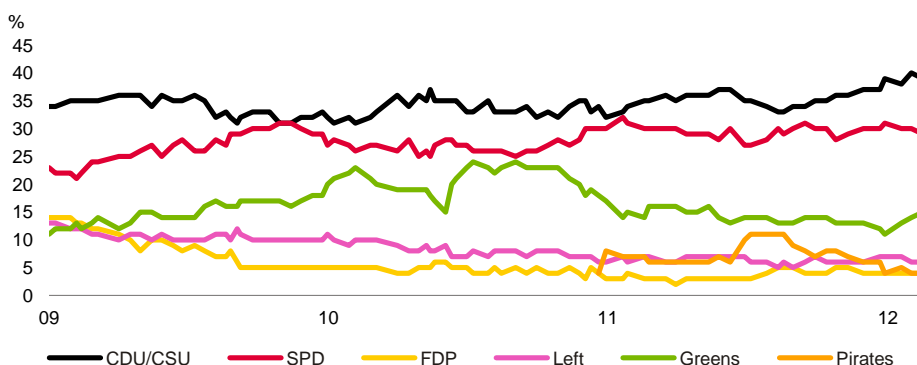
Peer Steinbrück, the Social Democrats' candidate, has only one and a half ways to power: a full-blown victory of the SPD/Green camp or perhaps a "traffic light" coalition with the Greens and the Liberals.

Germany's European policy will hardly change in substance regardless of the election outcome. Merkel and Steinbrück clash on transparency about costs or style but not on substance. Limited moves towards banking union, tighter economic union and fiscal union are likely. The Constitutional Court and public opinion will continue to constrain policy.

Tax and distribution issues will play a modest role in the election campaign but will show the policy differences separating the camps. The SPD and the Greens prefer higher tax burdens for the well-off and for companies along with higher spending on education, infrastructure and the environment. The CDU/CSU prefers tax cuts and modest increases in social spending.

Steinbrück and the Greens are outspoken on stricter banking regulation and a separation of investment banking from commercial banking. Merkel and her coalition have kept a low profile on this issue so far but the banks will remain under scrutiny.

Polls of party preferences ("Sonntagsfrage")



Source: Infratest

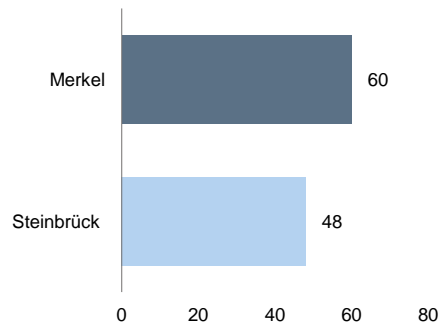


Germany at the polls

The 2013 German elections

Approval rating 1

%, December 2012



Source: ARD Deutschlandtrend

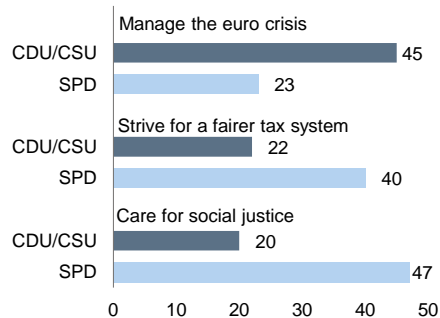
National elections will be held in Germany in the autumn of 2013 (September or October). Chancellor Merkel is campaigning for her third term. In her campaign, she calls for a continuation of her current coalition consisting of her Conservative party (CDU), its Bavarian sister party, the CSU, and the Liberals (FDP). Bavaria will hold elections most probably on September 15, and the current state premier and party chairman Horst Seehofer is running again; his victory is not fully certain, though. The Liberals are fighting to remain in parliament and pass the 5% hurdle in the second vote (see box on the new electoral law) and are clearly campaigning for a continuation of the current coalition, too. However, they might have outside options (see below).

The SPD, the major opposition party, nominated Peer Steinbrück as its candidate in December. The former finance minister was agreed as candidate since the party chairman, Sigmar Gabriel, refrained from running himself. Frank-Walter Steinmeier, the candidate in 2009 and current chairman of the faction in the Bundestag, also declared that he would not run.

The election campaign will be shaped, above all, by personality issues, second by the stance towards the euro crisis, and third by some modest domestic social policy issues.

CDU/CSU and SPD: Polls on policy stances 2

%, December 2012



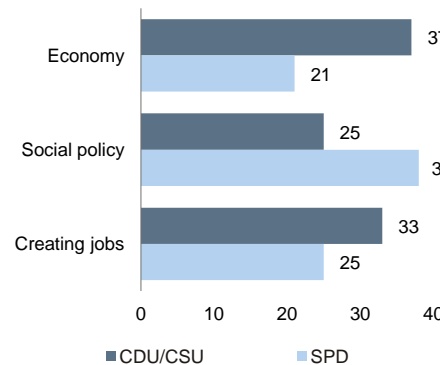
Source: ARD Deutschlandtrend

Personal popularity will be the most important factor. Chancellor Merkel's personal approval ratings and popularity are continuously strong, in particular her handling of European policies. She also tends to directly appeal to voters. Domestic misfortunes of her coalition do not affect Merkel's personal standing in the eyes of voters. Peer Steinbrück belongs to the group of most popular and well acclaimed politicians as well, but he suffered a bad start because he had to defend himself for accepting numerous honorary payments for speeches. This may well limit his appeal to the traditional rank-and-file workers, public employees, social groups and swing voters the SPD is targeting. On popularity, Merkel has held the lead so far.

Second, in the approach to European issues, a large majority of Germans polled on those issues has supported Merkel's gradualist approach towards the euro crisis. Steinbrück, and the opposition parties in general, have often criticised her policy but never argued for a radically different approach, instead voting in favour of all the rescue packages to date. This applies to the Greens as well but not to the Left Party which completely disagrees with government policy. On Europe, Merkel therefore holds the advantage as well.

Perceptions of party competence 3

%



Source: Forschungsgruppe Wahlen: Politbarometer, November 2012

Third, domestic tax and social policy issues play a modest role. Even though the Social Democrats try their best to make the case for higher taxation of the rich and businesses and for a general minimum wage, the suggested policy changes are rather small and do not materially alter the campaign. Steinbrück is a clear advocate of the "Agenda 2010" reforms pursued under Chancellor Schröder and, together with Gabriel and Steinmeier, has maintained party policy positions largely in line with those reforms. However, the SPD has moved considerably to the left on income distribution issues. It is not clear how this will play out electorally. Steinbrück receives good ratings for tax issues and leads over Merkel on social issues but on the euro issue and economic policy, Merkel holds the advantage.

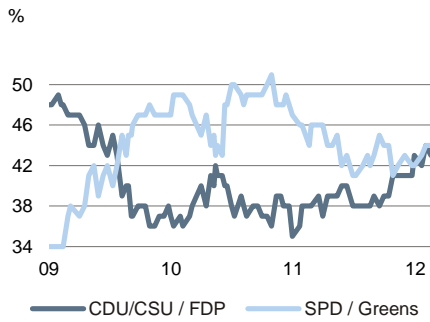
The traditional conservatism of the German population normally holds sway over an occasional appetite for substantial reforms. In addition, all-time high employment levels, all-time high tax receipts and a balanced budget at home are a case for continuity even though these results stem more from general economic adjustments over the last decade and policy decisions taken in 2005 and 2009 under the last government.



Germany at the polls

Strength of political camps

4



Source: Infratest

Any standard prediction of the elections would thus be another centre-right victory at the polls and a third Merkel term. However, long-term polling indicates that the two dominant political camps usually run neck-and-neck. The current coalition suffered through lows of only 35% support (see chart “Strength of political camps”) in early 2011 but has clearly recovered in the meantime. Recent polls since November 2012 show the centre-right camp is supported by 41-43% (CDU/CSU 36-39%, and the Liberals at 4%) of the electorate, whereas the centre-left is supported by 42-44% (SPD 26-31%, Greens 12-16%). The Left Party ranges at 6-8% and the recently established internet-oriented Pirates Party is supported by a stable 3-4% of those polled. The latter two parties are usually not regarded as potential coalition partners. They might win seats in parliament and prevent easy coalition building for a dominant camp, though.

New electoral law for upcoming federal elections

5

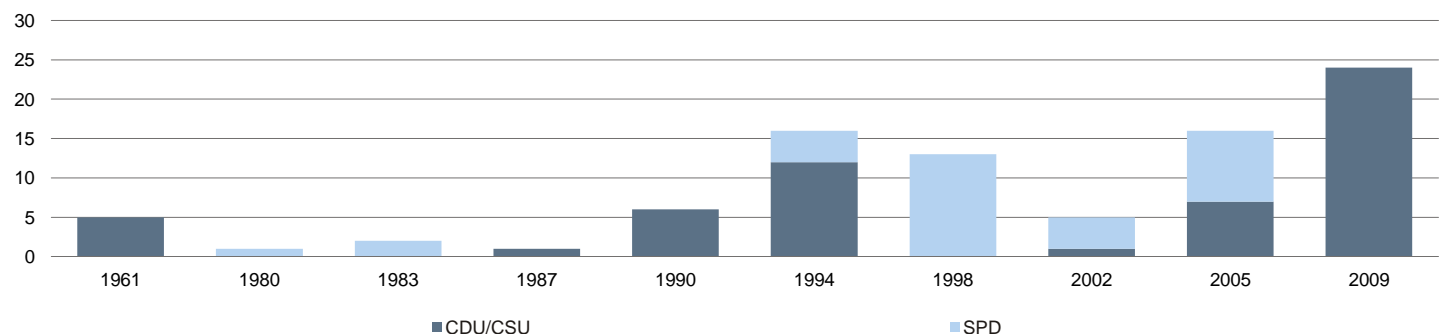
Parliamentary elections for the German Bundestag 2013 will be carried out on the basis of a reformed electoral law. So-called “overhang mandates” will be completely offset. This will terminate long-standing advantages of the two major parties, the CDU and the SPD, over minor parliamentary groups. The reform means that voters’ preferences will be reflected to a greater degree, but will lead to a significant rise in the number of members of parliament. Adjustments were demanded by the German Constitutional Court in 2008. It declared parts of the existing law unconstitutional because they contradicted the principles of equality and immediacy of elections. A cross-party compromise was struck in October 2012.

Reasons lie in the peculiarities of the German “personalised proportional” electoral system, as opposed to majority voting systems such as those in the US and the UK. It provides the voter with two votes at federal elections. With the first one, voters select a candidate directly in their constituency. With the second one, voters cast a ballot for a party in their federal state. If a party’s second-ballot votes exceed the five-percent threshold on the national level, the party enters the Bundestag. Initially, half the seats in parliament are filled by each vote. Since second-ballot votes determine party proportions, candidates directly elected on the basis of first-ballot votes are deducted from their parties’ respective regional lists. These lists – agreed on by the parties’ regional factions – then provide those additional candidates needed to fill up the parties’ remaining seats in parliament in order to reflect second-ballot proportions. If a party wins more direct mandates in a particular state than implied by the party’s second-ballot share in this state, however, it sends these additional parliamentarians to the Bundestag in Berlin as well. They are then said to hold “overhang mandates”. These “overhang mandates” are then offset by “equalisation mandates” for the other parties represented in the Bundestag so as to make sure that the overall composition of mandates correctly reflects the distribution of second-ballot votes.

With the Greens in the 1980s, the Left Party after German reunification and the Pirate Party possibly entering the lower house of the national parliament in September 2013, the occurrence of overhang mandates has been promoted (see figure below). This is because it has become more common for a major party, i.e. CDU, CSU or SPD, to win almost all the direct first-ballot votes in some states while, at the same time, receiving much less than 50 percent of the overall second ballot in the same states due to the strength of smaller competitors.

Increasing bias

Number of overhang mandates per party



Sources: ARD, Federal Elections Administrator

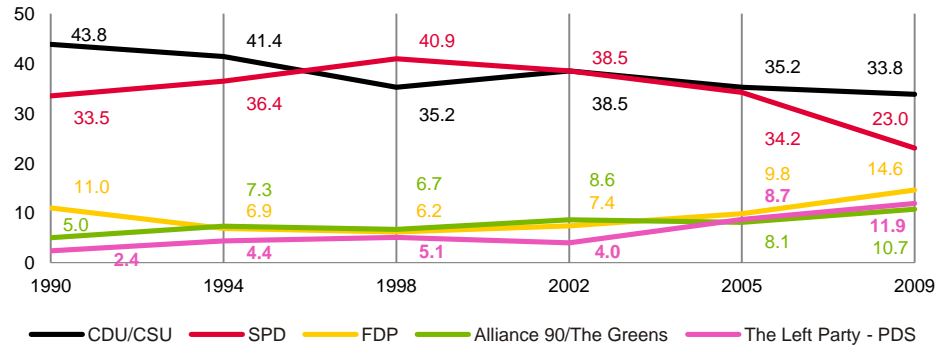


Germany at the polls

Elections to the Bundestag, 1990-2009

6

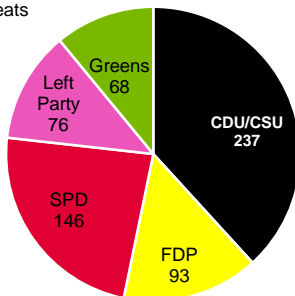
% of second votes



Distribution of seats in the 17th German Bundestag

7

620* seats



* incl. 22 overhang seats

Source: www.bundestag.de

Furthermore, the Liberals have been faring badly in polls at or below the 5% threshold since March 2011. Unless they improve their lot or conservative voters do tactically vote for the Liberals to ensure their representation in parliament, they might not enter the next Bundestag. An important milestone is the state election in late January in Lower Saxony, home state of the current Liberal party chairman and minister of the economy, Philipp Rösler. The Liberals must strive to pass the 5% threshold for re-entering the state parliament. If they fail, a 40%-plus result for the Conservative state premier, David McAllister, is unlikely to suffice to keep him in power, with the government then changing to an SPD/Green coalition led by Stephan Weil (SPD). In that case another change in the leadership of the Liberal party and/or a tactical opening to a centre-left government might occur, again adding even more uncertainty to the Liberals' success at the ballot box.

Scenarios for the next government

Due to the new six-party system, there are plenty of press commentaries about the ultimate outcome of the elections. There are many scenarios depending on the assumptions on who will pass the 5% threshold. We will limit the discussion to five.

1.1 No change: A third Merkel term with the Liberals

If the elections result in a victory for the Conservatives and Liberals, no major change in fiscal or economic policies is to be expected. If economic circumstances permit, the coalition would again try to lower income taxation and gradually strengthen social expenditure within the tight perimeters of a federal budget that must be structurally balanced by 2016. In European affairs, this would allow Merkel to hopefully oversee the transition of the euro area from crisis through adjustment back to modest growth. After the elections, Germany will continue with incremental steps towards fiscal union and promote economic convergence via national agreements of crisis countries with euro-area institutions and via a "solidarity mechanism" in the euro area co-sponsoring structural reform. While Finance Minister Schäuble has made bold proposals for stronger fiscal union this would require the establishment of a European Convention for which the EU Council in December did not give the green light.

1.2 Change: A Steinbrück victory and an SPD/Green coalition

If the SPD and the Greens were to win a majority of the seats in the Bundestag, they would easily agree on a coalition. If the Liberals fail to enter, this would most likely be the outcome. It could also occur if they enter but belong to the



Germany at the polls

smaller camp. Domestically, the new coalition would depart from the centre-right approach in taxation and modestly hike a few tax rates on income, wealth, inheritance and other items and refrain from raising federal spending materially but retarget it here and there. The new government would stick to a balanced budget policy. The most complicated matter would be the setting up of a comprehensive energy and environmental policy addressing shortcomings of the current state of play. In European affairs, much continuity would ensue. If anything, the Social Democrats would lean more towards supporting pro-growth policies and the Greens would push more strongly for deeper integration than the Social Democrats while both could agree amongst themselves to tighten financial regulation even further. In this scenario, an SPD chancellor and a presumably Green finance minister (Jürgen Trittin) would be quite a change from Merkel and Schäuble for Germany's European partners.

If the election result does not allow one traditional camp to govern, then matters become complicated. In that case, it depends on which party enters parliament and which potential coalition achieves a majority in parliament and can also reach agreement on a common agenda. There are numerous possible combinations (CDU/CSU + Liberals + Greens; CDU/CSU + Greens; SPD + Greens + Liberals; SPD+ Greens + either Left Party or Pirates, if they enter parliament).

1.3 Traffic light: SPD, Greens and Liberals

The Greens are the pivotal player in any case. Therefore, one can radically narrow those options down to three. The first one would be an SPD + Greens + Liberals ("traffic light") option which would be a first choice for the SPD and the Greens. The Liberals might look at it as a means of staying in power but would probably prefer to side with the opposition rather than confusing and alienating their voters with a switch of camps. If they were to enter a traffic light coalition, it would be difficult to negotiate and navigate since substantive policy positions are pretty far apart. Perhaps it could be managed as it would have a majority in the second chamber of the states, the Bundesrat. Building such a coalition would require major changes of heart on the part of the Liberals.

1.4 Eco-conservatism: CDU/CSU and the Greens

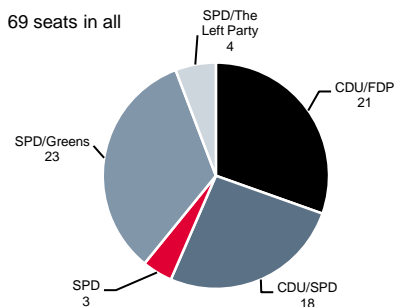
A second and rather more likely option would be a coalition of the Conservatives and the Greens. As the current government accelerated Germany's exit from nuclear power ("Energiewende"), this issue would not keep the parties at loggerheads any longer. However, positions on a broad range of social and foreign policy issues are pretty far apart in philosophical terms. Concerning specific policies, no insurmountable problems would occur. However, the Green party basis may not like a potential move of the leadership towards a coalition with the Conservatives. If it came about, it would also be a difficult coalition as common projects would essentially be limited to European integration and perhaps elements of energy policy. This coalition would likely never enjoy a majority in the second chamber and would have to cooperate extensively with the Social Democrats on issues in which the Bundesrat has co-decision rights, and there are plenty of them. However, this coalition could also be quite successful over the medium term, given the small overlap of constituents and of respective strengths or weaknesses at the polls.

1.5 A backflip to 2005: A third Merkel term with the Social Democrats

A possible course of action in this scenario would be a backflip to 2005, the formation of another grand coalition most likely led by Chancellor Merkel. Given current polls it would be a very big surprise if Steinbrück were to pull the SPD

Distribution of seats in the Bundesrat

69 seats in all



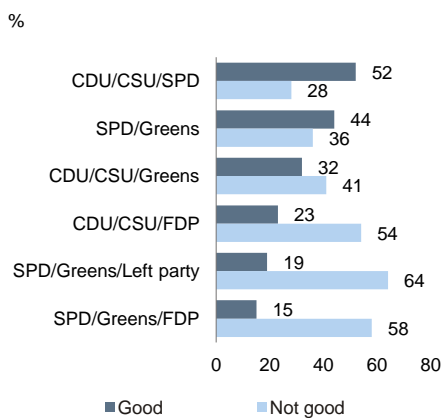
Source: Bundesrat

8



Germany at the polls

How do you view the following party coalitions?



Source: ZDF

past the CDU in the national vote. Germans polled on their preferred coalitions often indicate their support for this umbrella coalition which would probably enjoy a 65-75% majority in parliament. In that case, the Social Democrats would likely run finance, labour and foreign affairs once again. Peer Steinbrück stated that he would not join another Merkel cabinet. In that setting, majorities in both houses would be easy to achieve, but policy consensus is rather limited to European affairs, a balanced budget and more spending on educational and social issues. In taxation, a stalemate would ensue. In energy policy, the coordination between federal and state-level actions would be politically facilitated, but policy differences regarding renewables would have to be bridged. In a grand coalition neither the Conservatives nor the Social Democrats could pursue their desired course which will enshrine more conflicts than back in 2005 as the SPD has since moved to more “leftish” positions. Also, the SPD would want to ensure that it keeps its own profile in order not to suffer from the cooperation the way it did in the 2009 elections. However, such a coalition could prove stable enough to negotiate some complex domestic issues in fiscal federalism such as the distributional schemes involving the federal government, the states and the municipalities – not least because it would enjoy a majority in the Bundesrat, the second chamber, as well.

Euro politics – no promising issue for party profiling

Many – especially foreign – observers expect that European policy and the future course of integration will become a major campaign issue, something not even seen in the context of the introduction of the euro back in the 1998 election. And indeed, there is a great deal of controversy in society and within the political class on the right balance between fiscal solidarity and the extent of conditionality, the role of the ECB in euro crisis management and further steps for political integration. However, the parties will have a hard time playing this “euro-card” and presenting both coherent and distinctive positions to their respective electorates. In contrast to the parties’ substantial differences on taxation, social and labour market policy, their positioning on European policies is less distinctive (apart from the Left Party). The reasons for this are manifold.

First, despite all uneasiness about some aspects of euro crisis management the German public remains fundamentally pro-European. Downscaling European integration or positioning Germany as a regular naysayer has never been rewarded by the electorate. Given the extent of the euro crisis and the issues at stake there has never been a better time for the appearance of a euro-sceptical party, but even on a regional level attempts in this direction to date have failed. This implies that no major party will put forward an alternative model for Europe, but rather will focus on incremental steps forward as can be seen in terms of economic and fiscal coordination. While the tone of the major parties’ arguments may sound different, there is no real difference in principle between the mainstream parties, the government and the opposition on European matters. A look at the voting behaviour of MPs on euro crisis measures underlines this fact. If anything, the SPD and its candidate for chancellor, Peer Steinbrück, call for more transparent euro crisis management and to prepare the public for the “costs of Europe”. Greece is a case in point with the SPD openly talking about the need for another debt haircut – this time for the public-sector creditors – while the CDU is making this conditional on Greece achieving a high primary surplus in the medium term. For the time being it is working on other temporary solutions to meet Greece’s additional financing requirements.



Germany at the polls

Second, opinion seems to differ more within the major parties than among them. The coalition partners CDU/CSU and FDP harbour intra-party opposition to the bail-out approach, which has been reflected in the increasing number of dissenters in recent Bundestag decisions. But the numbers of dissenters within the SPD – which mostly supports the government’s course in parliamentary decisions – almost equals that of their Conservative counterparts. Representatives from both the ruling coalition and the SPD have challenged government decisions by appealing to the Constitutional Court. This can be expected in future as well, regardless of the government in charge.

Third, constitutional issues will likely constrain far-reaching political moves. Should EU leaders indeed agree to call for another European Convention to revise the EU Treaty, which requires changes to Germany’s Basic Law, a referendum might become a realistic possibility. Representatives from all parties have indicated that holding a referendum on EU issues deserves broad support. This is, however, further down the road and should hardly become an issue in the next legislative term.

As often, the smaller parties that might come in as junior partners in a coalition are more pronounced on their positions. The FDP tends to be more critical on euro crisis management than its current Conservative coalition partner. Its party leaders call for a more cautious bail-out approach, even stricter conditionality and advocate a change to the ECB’s voting rights (capital share-based voting weights and a veto for the Bundesbank) given the increasing importance of unconventional monetary policy. The Greens, in contrast, support the German Council of Economic Experts’ proposal for a European Debt Redemption Fund and a substantial move towards a closer political union including a substantial transfer of fiscal sovereignty as well as more federal control over national budgets. They also explicitly acknowledge that Greek debt is not sustainable and will require a haircut for public-sector creditors at some point in time.

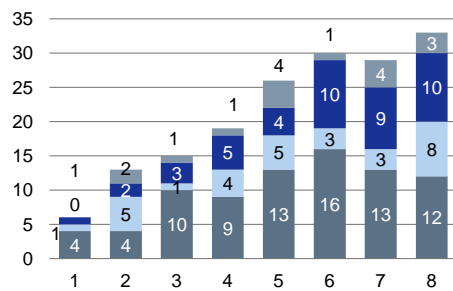
Will the election outcome substantially alter Germany’s political course in Europe? Not likely. The economic and funding crises in many euro-area member states are clearly not yet under control and will require additional crisis management measures. Most of the upcoming euro crisis decisions have to be taken by a majority of the plenary of the German Bundestag – think, for example, of approval for a possible Spanish ESM request. For reasons of political legitimacy, both the current and any new government would probably opt for broad approval of measures to be taken, even if formally not required. Given the high stakes involved, Germany is likely to stick to its course of providing as much financial relief and political support as is required to contain an escalation of the crisis in exchange for continued commitments to reform, adjustment and institutional improvements in the crisis countries. At the same time it will seek to carefully limit the upside risks to its financial commitments, which are already very large in both absolute and relative terms.

The elections might make a difference regarding the stance on building a stable EMU. While the Merkel government has been supportive of pillar one of banking union, namely a single supervisory mechanism, it confined itself to large banks only. It also supports a resolution framework for large financial institutions. It opposes, however, a common bank resolution fund and a joint deposit insurance regime. Steinbrück has clearly articulated that he favours a resolution fund financed by the industry but also dislikes common deposit insurance. Regarding economic union and structural reforms promoting competitiveness, there are no stark differences. Merkel also favours a separate “fiscal capacity” of the euro area, i.e. funds to co-finance structural reforms. She is openly rejecting treating debt stock problems by mutualisation and she has ruled out euro bonds (joint and several liability). The SPD tinkered with the idea of euro bonds and the bond redemption proposal but finally avoided the matter as polls indicated the electorate’s lack of enthusiasm for ex post risk sharing. Concerning

Voting on bail-out policy: Governing coalition

10

Abstentions and Nos in the governing coalition



- 1 = 05/07/10 Greece I
- 2 = 05/21/10 EFSF
- 3 = 09/29/11 ESFS upgrade
- 4 = 10/26/11 ESFS guideline
- 5 = 02/27/12 Greece II
- 6 = 06/29/12 ESM Treaty
- 7 = 07/19/12 Spanish banking programme
- 8 = 11/30/12 Greece II revised

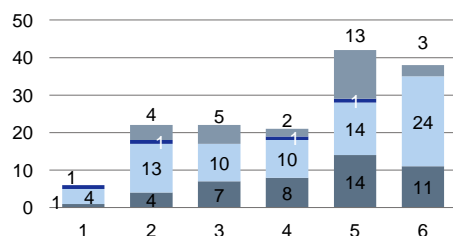
- CDU/CSU no
- CDU/CSU abstention*
- FDP no
- FDP abstention*

*abstention or not voted
Sources: Deutscher Bundestag, DB Research

Voting on bail-out policy: Opposition

11

Abstentions and Nos in the opposition



- 1 = 09/29/11 ESFS upgrade
- 2 = 10/26/11 ESFS guideline
- 3 = 02/27/12 Greece II
- 4 = 06/29/12 ESM Treaty
- 5 = 07/19/12 Spanish banking programme
- 6 = 11/30/12 Greece II revised

- SPD no
- SPD abstention*
- Green no
- Green abstention*

*abstention or not voted
Sources: Deutscher Bundestag, DB Research



Germany at the polls

structures of political legitimacy, both the Merkel government and Steinbrück have argued that it should be strengthened in principle, but without indicating how.

This is not to say that Germany's constructive course in euro crisis management cannot be put at risk. There remain certain, albeit low risks in economic and political respects. So far, the economic strength and the solid labour market performance support a compassionate attitude among German people towards the painful but necessary adjustments in the periphery. If the German economy were to plunge into recession – e.g. following a severe downturn of the world economy – with unemployment figures substantially rising, this might well alter the public's view on the costs of bail-outs and the risks attached to the high liabilities assumed by the German taxpayer. Attitudes might change and political reservations might also increase if euro-area partners fail to engage sufficiently in playing quid-pro-quo, i.e. sticking to their political reform commitments in return for fiscal support. In addition, there are some concerns over the balance in German-French relations and whether they will be able to constructively fulfil their role of bridge-builder between northern and southern Europe anymore.

Rebalancing the economy – a plea from the outside but no goal for German parties

Forecasts: German GDP growth
% yoy

12

	2011	2012F	2013F
Real GDP	3.0	0.8	0.3
Consumption	1.7	0.6	0.6
Gov't expenditure	1.0	1.0	1.0
Fixed investment	6.2	-1.9	1.1
Net exports, pp	0.6	1.1	-0.2
Consumer prices	2.3	2.0	1.7
Unemployment rate, %	7.1	6.8	7.0
Current account, % GDP	5.7	6.4	5.7

Sources: Federal Statistical Office, DB Research

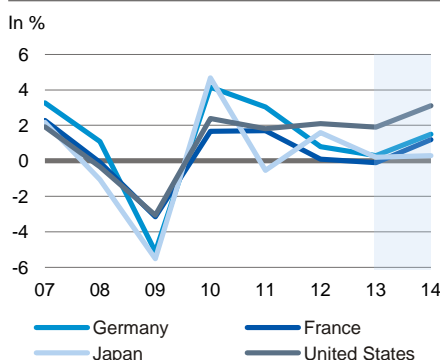
Throughout Merkel's current term, the economic indicators in Germany have been rather favourable and thus supportive for the ruling coalition. After the coalition assumed office in late 2009, which saw the steepest GDP drop in German history, the economy quickly recovered and GDP growth was around 2.6% on a three-year average. For the election year 2013, Deutsche Bank expects 0.3% GDP growth on a weak start into the year but an increase in the growth dynamics in H2. Even with the relatively weak figures for 2012/2013 Germany is still in a much better position than most of its euro-area partners. Nonetheless, this position – to a large extent – cannot be attributed to the Conservative-Liberal government. It builds on a financially sound corporate sector that is successfully targeting world markets as well as on the employment-friendly labour market reforms of the mid-2000s, a competitive tax system and a moderate wage policy which strengthened Germany as a place to invest.

In the course of the financial and sovereign debt crises, though, Germany has often been criticised for its relatively strong export performance and for a policy thrust that supports the export bias of the economy, thus preventing the necessary rebalancing from taking place. And indeed, compared to H1 2011 the current account surplus increased by 18% in H1 2012, to EUR 79 bn. In H1 2012, Germany had – for the first time – a current account surplus with all major regions. But already, within EMU, rebalancing is taking place. Especially the surplus versus the GIIPS countries dropped by over 40% yoy to EUR 17 bn in H1 2012 and rebalancing will continue as the economic outlook in GIIPS is set to remain subdued as will demand for German goods and services.

Would a new government assume a policy more directed at strengthening domestic demand? Probably not. Strengthening domestic demand is no political goal by itself but has to come, if at all, as a side effect of other political measures. The SPD and the Greens (and parts of the CDU) propose a minimum wage but empirical evidence is unclear on its contribution towards strengthening domestic demand. After the overall wage moderation of the previous decade, there have been relatively strong increases in unit labour costs since end-2010. In Q2 2012 unit labour costs increased by 1.2% yoy in Germany and only 0.2% yoy in EMU. The exit of the baby boomers from the labour market will probably push wages higher between 2014 and 2020. The increase in the retirement age

Real GDP growth

13



Source: DB Research

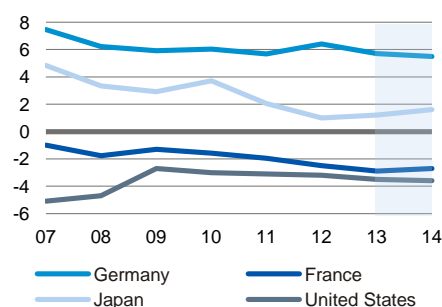


Germany at the polls

Current account balance

14

In % of GDP



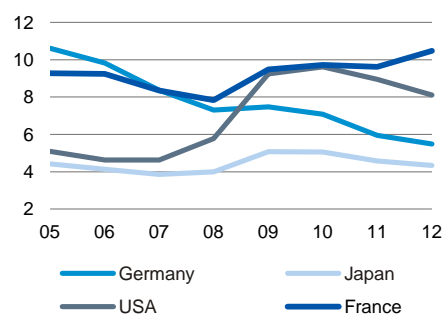
Source: DB Research

– also perceived to work in the direction of higher domestic consumption – is already above EU-27 and OECD averages as is the participation rate (72.6% in 2011 compared to the OECD average of 64.8%). More liberalisation in the services industry can hardly be expected from any of the possible coalitions. No major tax cuts (profit taxes are at the lower end of the international ranking) are foreseen – on the contrary: the SPD and the Greens envisage a higher tax burden for the well-off and corporates, but the centre-right wishes to lower income taxes for the middle class. A more expansionary fiscal policy runs counter to the German debt brake which foresees for the federal budget a maximum structural deficit of 0.35% by 2016. In the end, the current account balance whose figures prompt the complaints cannot be influenced by political decisions directly but rather it is the result of decisions of mainly the private sector not only in Germany but also in other countries (demand for German products).

Unemployment*

15

In %



*Number of jobless as percentage of civilian labour force; ILO definition

Source: OECD

Redistribution issues: The political divide

The policy area where differences between the ruling CDU/CSU/FDP and the opposition parties SPD and Greens are the most obvious is taxation. The renaissance of distribution issues can be observed – not only in Germany but also in other member states of the euro area – under the catchword of social inequality. The debate centres on the allocation of the costs of the crisis and the sometimes sharp contrast between private affluence and public debt that prevents the state from meeting the necessary investment requirements in education, health or infrastructure. Social benefits are called into question when strict consolidation is required.

Against this background the opposition SPD and Greens have presented detailed proposals to address this issue and increase tax revenues, i.e.

- increase the top income tax rate from 42% to 49% (plus solidarity surcharge) for incomes exceeding EUR 100,000
- increase the flat rate on capital income (Abgeltungssteuer) from 25% to 32%
- introduce a wealth tax of 1% or a similar one-off
- adjust (double) the inheritance tax
- introduce a financial transactions tax

The key reason for proposing these tax increases is a plan to substantially upgrade public spending at the local level, mostly on education and infrastructure. Steinbrück in particular justifies these demands by considerations of income distribution and corrections (by increasing the degree of progressivity) to the tax code. Of course, this is a party platform, and actually legislating these changes will be quite difficult given staunch opposition to most of these measures from many quarters. The easiest piece is raising the flat rate on capital income from 25% to 32% even though this would prompt many more savers to declare their investment income when filing their tax return. Being allowed to keep less of it after tax would prove unpopular. Introducing an FTT is materially difficult, and the current government is already trying to do so. Raising tax income on wealth once again sounds easy but is very complex. It can probably be done on financial assets but equality of the tax treatment of real estate posed so many constitutional problems in the past that it is unlikely to be done easily or at all. Hiking the inheritance tax was subject to numerous federal-Länder fiscal battles in the past, and is likely to remain so. The clearest case would be a hike in the top rate of the income tax, but the SPD and the Greens are well aware that the risks to small business profits and employment are substantial. Unless a clear-cut separation of corporate from personal income is legally instituted, it is very



Germany at the polls

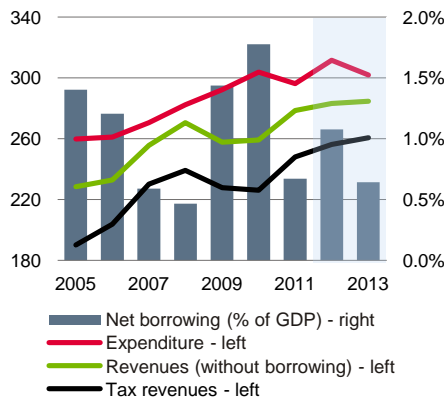
difficult to do. Numerous previous governments failed to get this done properly. The SPD might accept negative employment effects for raising the revenue and spending it elsewhere, partly compensating for it, but this would constitute a major battle with the business associations to win in the first place, to implement in the second and to defend in sluggish economic conditions in the medium run in the third.

Tax proposals by the parties of the ruling coalition are less clearly spelled-out. This is mainly due to the fact that fiscal adjustment came first and Merkel and Schäuble predominated among the tax cutters and spenders in their own ranks after initial concessions right after the 2009 elections. There are some ideas about reducing the tax burden resulting from the “cold progression” in income taxation, i.e. when income earners move on to a higher tax class simply because of inflation. The current coalition also prefers to keep rates where they are, but to increase the effectiveness of the tax system and close loopholes in the corporate world without alienating small and medium-sized enterprises. Most efforts to streamline the German tax system by abolishing special VAT rates, reforming the trade tax (third failed attempt in a row) and pushing through modest income tax cuts for the entry levels all failed or got stuck in the second chamber. This has reduced the traditionally strong appetite for grand tax plans of both the Conservatives and the Liberals. For the Liberals, the insistence on special tax cuts at the beginning of the current term proved disastrous as they seemed out of touch with reality at the time. Whether economic and financial conditions in the next term would allow positive tax-cutting ideas to emerge remains to be seen. It just does not seem to be very likely.

Development of federal budget

16

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



Sources: BMF, DB Research

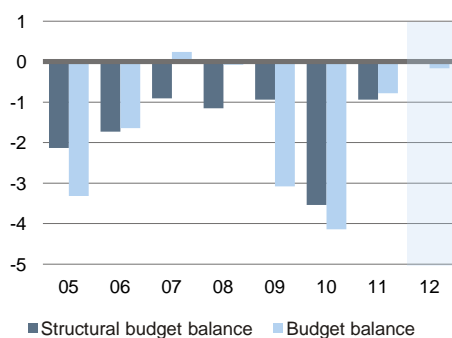
The budget: A matter of luck and skill

While most parts of the euro area are living through severe fiscal austerity, Germany is in a rather favourable fiscal position. There is almost no cause for serious debate about fiscal policy in the medium run. The opposition is arguing that the budget should have been balanced earlier, not later! Neither a new Merkel nor a new Steinbrück government would put the fiscal path at risk as big fiscal uncertainties stemming from the euro crisis might materialise. The clearest case is financial support for Greece and potential costs to the budget. The key reason why fiscal policy will stay the course is that the German parliament tied itself to the debt brake and now has zero leeway short of a change to the Basic Law to escape from that commitment – even if this were the preferred option. Between 2009 and 2012, the current government oversaw one of the strongest turnarounds of a federal budget ever. Both the cyclical downturn and successive improvements in output and budget data were staggering. Germany managed to turn the budget into almost a balanced position by playing safely on expenditure while letting automatic effects run their course.

Fiscal balance

17

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



Sources: Eurostat, DB Research

2012 should see a balanced budget with the structural deficit almost eliminated. A primary budget surplus of 2.3% of GDP is realistic in 2012. The good situation of public finances is due above all to substantial growth in tax revenues (2011: 8.1%; H1 2012: 5%) and surpluses in the social security system (thanks to positive labour market developments). However, a reduction of overall debt is not a given even in favourable times – the German debt-to-GDP ratio will reach 83% in 2012 with only about 10 pp due to banking rescue packages. Furthermore, Germany is profiting from its safe-haven role in the euro-area crisis and the continued low interest rate levels. Despite record-high overall debt, the interest-to-tax ratio (the share of tax revenues spent on interest payments) of 11.5% is at a level last seen in the 1980s.

This favourable situation will not last and budgetary risks have not been taken care of. For example, if the interest rate were to increase by 1 pp this would already result in higher federal interest payments of EUR 2.5 bn alone. Further-



Germany at the polls

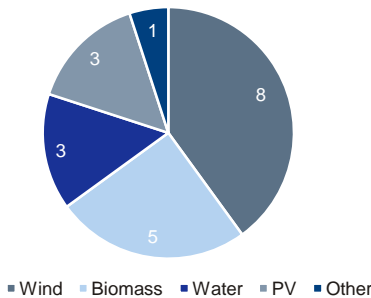
more, new social benefits just adopted by the ruling coalition will burden the federal budget with approx. EUR 4-5 bn p.a. The 2014 budget to be presented in summer 2013 – shortly before the federal elections – might have to tap new revenue resources such as KfW profits or transfers from the Federal Employment Agency in order to be balanced. The German debt brake requires the federation to limit its structural deficit to 0.35% of GDP by 2016.

“Energiewende”: The turn away from nuclear power

Renewables by type

18

%, 2011



Sources: AGEB, BDEW

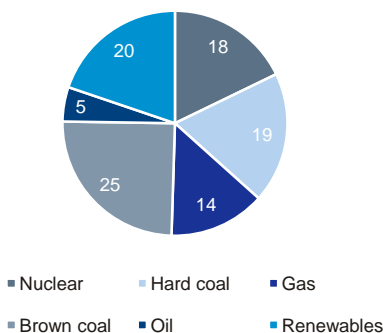
German energy policy is one of the few areas in which there is both broad agreement on the shift towards non-nuclear sources of power and appreciable differences among the parties’ policy positions. The field is too complex to carry much weight here but in terms of the electoral competition it might be an issue. There are two elements of importance. The current coalition made two U-turns in German energy policy within one year. First, it undid the exit from nuclear power that was negotiated by the Schröder government with the utilities in the early 2000s, and then, after the Japanese nuclear disaster, rushed at an even faster pace to the exit again. Seven nuclear facilities were immediately closed, and the youngest plants are allowed to run for another decade. By 2022, the use of nuclear power will end. This is now the consensus across all the political parties.

Second, the political management of the build-up of renewable power generation and heating capacity proved difficult as the subsidised push for renewables led to a strong market reaction. This again created operational and business problems for conventional power generation which in turn poses problems for both costs and reliability. Also, investments in conventional gas, offshore wind, grid infrastructure and other sectors were delayed. A good estimate is that EUR 30 bn is needed annually to cope with the transition.

Electricity by source

19

%, 2011



Sources: AGEB, BDEW

Whereas the centre-right government recently provided stronger incentives to invest in grid infrastructure and gradually reduced subsidies to renewables, there is still a lot of criticism regarding the management of the transition from nuclear power to other sources, in particular in some states which receive most of their electricity from nuclear plants. The opposition has many ideas on what to do, but it is by no means clear what a Social Democratic/Green energy policy would look like, nor that of a Conservative/Social Democratic coalition. Steinbrück has spoken out in favour of bundling energy policy competences now scattered across several ministries into one ministry and stressed the importance of comprehensive strategy. It seems clear, however, that competition for cheap energy sources will become a major business and political issue as prices in Germany are likely to rise while prices in the US will considerably fall in the medium term. Also, some social problems will become more severe. It is very likely that energy will become more expensive in Germany, and even more of a political issue. Energy, however, might also remain one of the most interesting innovation fields in Germany, as companies and households start taking conservation measures more seriously, become more energy-efficient and even tackle long-term investment in the energy efficiency of the housing stock. It seems that the euro crisis is distracting a lot of attention away from putting such a complex transition properly into place – both on the part of the government as well as on the part of the opposition.

Financial regulation: More, but of what?

The current government has supported tighter financial regulation from the start. In general, Germany has been a strong supporter of the G20 reform objectives and mostly worked within the EU to implement the many pieces of legislation



and rule-making. At times, it even pursued national regulation if and when global or EU policy processes took too long or did not move forward to its satisfaction. This happened with the introduction of a bank restructuring law and bank levy in 2011 in advance of an EU-wide system, the prohibition of naked shortsales, the ongoing legislation on the regulation of high-frequency trading and other matters. In the domestic arena, the government has maintained its equity investment in a large private bank and even re-opened the SoFFin – the national bad bank – recently to cope with further contingencies. There was no visible substantial involvement in restructuring the public-sector banks, which was left up to those banks, the state governments and the Competition Directorate of the European Commission. In the EU, the government embraced limited steps towards centralising supervision of big banks at the ECB and creating a resolution framework, but clearly spoke out against joint deposit insurance. Internationally, Chancellor Merkel and Minister of Finance Schäuble have been pushing for more aggressive regulatory tightening of the “shadow banking system”.

The Social Democrats (and the Greens) prefer an additional tightening of financial regulation. In September 2012, Steinbrück presented his detailed regulatory proposals to the Social Democratic faction in the Bundestag. He called for a legal and institutional separation of investment banking from commercial and retail banking and for a shift to bank holding companies for systemically important German banks. Furthermore, Steinbrück demanded a tight regulation of banks' proprietary trading, which is a matter of definition (a proper delineation of desirable market making and hedging activities from trading is difficult). He also supports the establishment of a European bank resolution fund for systemic banks. This fund would collect fees from the financial industry and from a financial transactions tax and issue debt which would have to be purchased by systemic banks. The fund should have a size of EUR 150-200 bn and act as a “banking ESM”. For smaller banks, national schemes are proposed. Comprehensive EU bank insolvency and resolution legislation is deemed necessary, too. Steinbrück supports the establishment of centralised banking supervision for systemic banks with ultimate systemic stability prerogatives over national supervisors which would retain day-to-day supervision of small and medium-sized banks at the national level. The political dynamics in an election year may well lead to a narrowing of political differences between the centre-right coalition parties and the Social Democrats (and the centre-left parties) on banking legislation. Of key importance are the elections in September or October 2013, however. If the SPD re-enters a governing coalition, complex negotiations on these issues will ensue. Until then, the future of universal banking in Germany is in doubt.

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