



Germany: No longer the island of the blessed

August 23, 2011

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www.
dbresearch.com

Authors

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

Bernhard Gräf
+49 69 910-31738
bernhard.graef@db.com

Stefan Schneider
+49 69 910-31790
stefan-b.schneider@db.com

Editor

Stefan Schneider

Technical Assistant

Manuela Peter

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

Managing Director

Thomas Mayer

The German economy almost ground to a halt in Q2 2011 (0.1% qoq) after expanding 1.3% in Q1. With quite substantial downward revisions in other industrialised economies, global growth could grow by just 3 ½% in 2012 – one percentage point lower than expected a few weeks ago. This would leave its imprint on Germany's export-oriented economy. We now expect the German economy to more or less stagnate in the winter half. GDP growth this year should reach 2.8% instead of 3.2%. Even with a modest recovery starting in mid-2012, the annual average would fall to a meagre 0.8% instead of 2.0%, given the low statistical carryover.

The unexpectedly sharp deceleration of the economy should also reduce the pressure in the upcoming wage round coming from unions' demands to catch up with the better-than-expected economic development over the last two years. Based on the concept of distribution-neutral wage policy, we find that catching-up claims are not justified when taking the year 2009 and its substantial labour hoarding into account. We expect that the increase in collective wages will accelerate only from around 2% this year to around 3%, with the settlement in the metal sector coming close to 4%.

Still, unions' bargaining position will improve in the medium and long term given the declining labour force, which will shrink by 12 million by 2060E. Demographic change will increase the share of services in private consumption. But the change in relative factor prices, which will probably be accompanied by higher expenditures for training and lower productivity growth, should weigh on profits of companies having a major part of their production in Germany.

The slowing economy will add to fiscal strains not only in the peripheral countries and probably not increase Germany's enthusiasm about bailing out its European neighbours. It will therefore remain under close scrutiny from financial markets, given pending parliamentary approval of EFSF reforms and the constitutional court ruling and the ongoing debate about eurobonds. We do not expect either of these decisions to throw a spanner into the works. While Germans and members of the ruling coalition have turned more sceptical regarding Germany's support for other countries and the euro in general, there is little sign of a grassroots movement that could trigger political change. We therefore expect the current federal government coalition to remain in office until the next regular elections in autumn 2013.

Economic Forecasts¹

	Real GDP			Consumer prices ²			Current account ³			Fiscal balance		
	% growth			% growth			% of GDP			% of GDP		
	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Euroland	1.8	1.7	0.8	1.6	2.7	2.0	-0.5	-0.5	-0.3	-6.0	-4.6	-3.5
Germany	3.7	2.8	0.8	1.2	2.1	1.5	5.7	5.4	5.1	-3.3	-2.0	-1.7
France	1.4	1.8	1.0	1.7	2.2	1.8	-1.8	-2.8	-2.6	-7.0	-6.0	-4.9
Italy	1.2	0.7	0.4	1.6	2.4	2.0	-3.5	-3.4	-2.1	-4.6	-3.9	-1.9
Spain	-0.1	0.7	0.5	2.0	3.0	1.6	-4.6	-4.5	-3.6	-9.2	-6.6	-4.9
Netherlands	1.8	2.2	1.4	0.9	2.5	2.2	6.7	7.5	8.5	-5.4	-3.5	-2.0
Belgium	2.2	2.3	1.1	2.3	3.4	2.2	2.4	2.0	2.0	-4.1	-3.7	-3.5
Austria	2.0	2.7	1.1	1.7	3.4	2.3	2.7	3.0	3.0	-4.6	-3.2	-2.3
Finland	3.6	3.6	1.3	1.7	3.4	2.4	3.0	2.5	2.5	-2.5	-1.2	-0.4
Greece	-4.5	-4.7	-1.8	4.7	2.8	0.7	-11.8	-9.0	-7.0	-10.4	-9.8	-9.0
Portugal	1.3	-1.9	-1.8	1.4	3.4	1.8	-9.9	-8.0	-6.5	-9.1	-6.1	-5.1
Ireland	-1.0	0.1	1.3	-1.6	1.2	1.2	-0.7	1.0	1.5	-32.4	-10.5	-8.5
UK	1.4	1.3	1.8	3.3	4.6	3.2	-5.1	-3.0	-2.8	-9.8	-7.9	-6.2
Sweden	5.4	4.6	2.8	1.3	2.6	2.0	6.3	6.5	6.0	-0.1	1.5	2.5
Denmark	1.8	1.0	2.0	2.3	2.5	2.0	5.0	6.0	5.8	-5.3	-4.0	-3.0
Norway	0.3	2.5	2.8	2.4	2.0	2.2	12.5	12.7	13.5	10.6	9.0	10.5
Switzerland	2.6	2.3	2.2	0.7	1.1	1.3	14.6	13.0	12.5	0.8	1.2	1.5
Poland	3.8	3.9	3.4	2.6	4.1	2.5	-4.5	-4.9	-5.0	-7.9	-5.8	-4.7
Hungary	1.2	3.0	3.2	5.0	3.9	3.2	2.0	0.7	0.0	-4.3	1.5	-2.8
Czech. Rep.	2.2	2.3	3.1	1.5	1.8	2.2	-3.9	-4.7	-5.0	-4.7	-4.3	-3.6
US	3.0	1.7	2.6	1.6	3.4	3.0	-3.2	-3.1	-2.7	-8.7	-10.4	-7.0
Japan	4.0	-1.5	2.5	-0.7	0.5	0.0	3.6	2.5	3.2	-8.7	-8.8	-9.3
World	4.9	4	4.4	3.2	4.2	3.4						

¹Forecasts are as of August 19, 2011, ²HICP figures for euro-zone countries and the UK

³Current account figures for euro area countries include intra regional transactions.

Sources: National statistics, national central banks, Deutsche Bank forecasts

1

Forecasts: Euroland GDP growth and central bank rates

Euroland and EMU3	2010				2011				2010F	2011F	2012F
	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F			
% qoq											
Euroland	0.4	1.0	0.3	0.3	0.8	0.4	0.2	0.3	1.8	1.9	1.5
Germany	0.5	1.9	0.8	0.5	1.3	0.1	0.3	0.1	3.7	2.8	0.8
France	0.2	0.5	0.4	0.3	0.9	0.0	0.2	0.2	1.4	1.9	1.4
Italy	0.5	0.5	0.3	0.1	0.1	0.3	0.2	0.2	1.2	0.8	1.0
Spain	0.1	0.3	0.0	0.2	0.3	0.0	0.2	0.1	-0.1	0.7	0.9
Central Bank Rates (eop)											
ECB refi rate	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.50			
US fed fund target rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25			
BoE bank rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50			
BoJ O/N call rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10			

Since the Statistical Office has not yet released detailed demand components following the revision, a quarterly break-down of our forecast cannot be provided at this time.

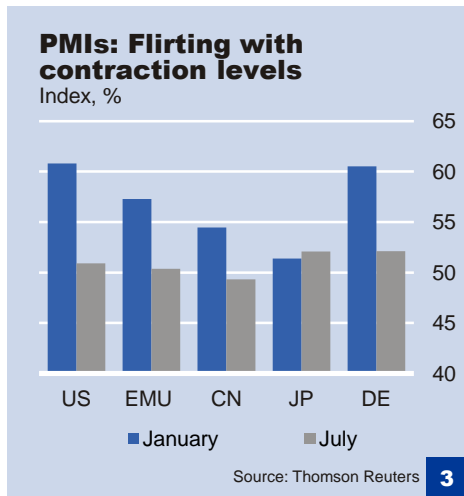
Sources: National statistics, national central banks, Deutsche Bank forecasts

2



Our view

The analysts' guide for eurozone politicians: Don't panic!



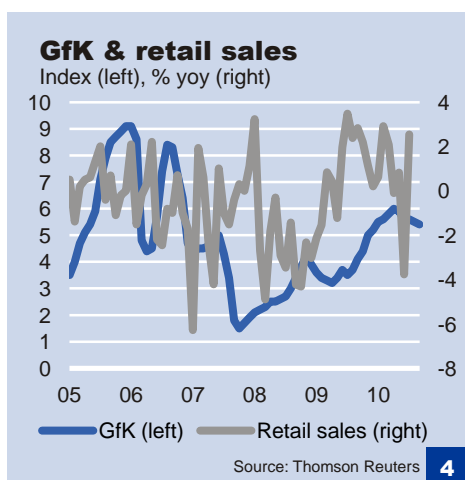
The latest PMIs show that industrialised economies are facing the risk of GDP stagnation or even contraction in the coming quarters. This can be attributed to debt crises on both sides of the Atlantic and the lack of fiscal and monetary policy options. The result has been increasing helplessness on the part of politicians and now even of central bankers – as indicated by the increasing number of dissenters in their decisions – as well as the shock brought about by the recent collapse in global equity markets. For Germany, weaker H2 growth means that the 2012 growth rate will likely come down to slightly below 1%, even with a recovery in the second half of next year.

We needed this turn of events about as much as a hole in the head. As a result, the debate about “what has to be done” has reached fever pitch. Unfortunately, it has become virtually impossible to predict direct and indirect impacts of suggested measures – let alone the market reaction. Therefore, proposals which promise certain rescue if adopted and certain disaster if rejected should be regarded with extreme caution. In addition, one should keep in mind where a given proposal originates. It would be naïve to believe that these suggestions only care about the benefit to the euro area. It is also a cheap shot to blame the German government for a lack of decisive action. At the end of the day, the government is responsible to the German people; it therefore has a genuine obligation to consider carefully measures which imply almost irreversible commitments of Germany's future fiscal means. This applies above all to the debate regarding eurobonds. As long as we do not have a truly European fiscal policy, nationally elected ministers of finance will always put their national interest first and fall victim to the implicit moral hazard of such bonds. This should be best understood by politicians, who out of national interest are requesting almost unconditional support from Germany and the other fiscally sounder economies. The behaviour of these countries in recent years has certainly not put them in a position to criticise Chancellor Merkel's position as anti-European. Ultimately, Angela Merkel's approach is probably more constructive to the European idea than many of the other proposals being floated on how to save Europe.

Stefan Schneider (+49 69 910-31790, stefan-b.schneider@db.com)

Germany: No longer the island of the blessed

- The German economy almost ground to a halt in Q2 2011 (0.1% qoq) after expanding 1.3% in Q1. Granted, the PMI's sharp correction during Q2 was a warning, but the extent of the deceleration was in part due to special factors.
- With quite substantial revisions in other industrialised economies, global growth could expand by just 3 ½% in 2012 (PPP-weighted), roughly 1 percentage point lower than expected a few weeks ago. This would leave its imprint on Germany's export-oriented economy.
- As the domestic components of demand, investment and private consumption, are to a large extent financed by profits and wage income generated in the export sector, they would be pulled lower, too.
- We now expect the German economy to more or less stagnate in the winter half. This year's GDP growth should then reach 2.8% instead of 3.3%. Even with a modest recovery starting in mid-2012, the annual average would fall to 0.8% instead of 2.0%, given the low statistical carryover.



The Statistical Office estimates GDP expansion of just 0.1% in Q2, while the consensus expected 0.5%. The Office revised Q1's 1.5% rise to 1.3%. It did not provide the statistical breakdown but indicated that exports and investment were behind the minimal Q2 expansion. However, a strong expansion in imports leading to an inventory build-up resulted in a negative contribution from net exports. Private consumption and construction investment subtracted from growth. Weak private consumption can be traced to the almost 1% qoq rise in the CPI and was evident in the quarterly decline in retail sales, but given the limited reliability of this statistic we discounted this information to a certain extent. The drop in construction investment was no surprise given the weather-related catching-up in Q1. Overall there might have been some temporary negative factors at work, such as the switching-off of nuclear power plants, which made themselves felt in energy output and net exports, given that Germany has probably turned into a net exporter of electricity. However, as the energy sector accounts for just 0.5% of total value added, the effects should have been less than one-tenth of a percentage point.



The Statistical Office has revised its national accounts data back to 1991. Similar to the US, the revision shows a sharper-than-expected GDP contraction in 2009 (-5.1% compared to -4.7% so far). Unfortunately, we do not know which parts of the economy performed worse than thought so far, as a revised breakdown of the components is currently unavailable.

2011 growth forecast lowered to 2.8%

The Ifo index saw a strong correction in July while the PMIs had already weakened through Q2 and continued to do so in July. In particular, the less favourable international environment is increasingly making itself felt in the assessment of export business (in the PMI the index for export orders dropped to 47.3 in July, to stand in contraction territory). Obviously, the recent slump in equity markets and increase in volatility are not reflected in these data, i.e., August should be even worse. Still, there might be a small counter-movement to the negative factors affecting Q2, allowing a small



rebound in Q3. But we expect a more or less stagnant winter half – not only in Germany but in most of the industrialised world. The combination of a weaker H1 and pretty soft H2 brings the annual average for 2011E down to 2.8%.

2012E GDP growth just ¾%, due to stagnant winter half

Since we do not have data for the components, it is difficult to produce a forecast for 2012. The numbers mentioned should therefore be treated as crude indications. Notwithstanding the jump in June foreign order intake, which was driven by some big-ticket orders, exports should continue to soften as already indicated in the various surveys, given the increasingly adverse external environment (fiscal consolidation and weaker growth pretty much across the industrialised world). We are sceptical regarding hopes that Germany's strong export focus on emerging markets, where downward revisions have been much smaller than in industrialised economies, will provide a substantial cushion. 80% of German exports go to Europe, the US or Japan. In addition, more than 1/2 of Germany's exports to China consist of machinery and pre-products and are therefore linked to China's external demand.

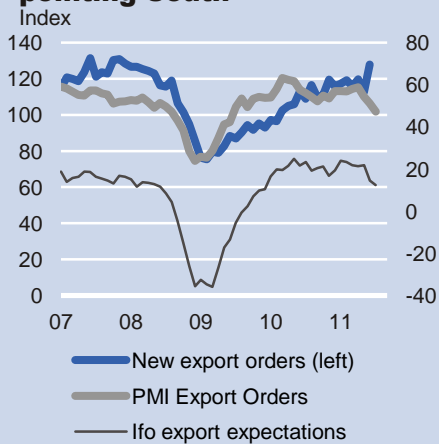
We have frequently pointed out that corporate investment spending in Germany is highly synchronised with exports. After all, DAX 30 companies generate some 70% of their annual turnover and most likely a similar share of their profits abroad and profit expectations are a major driver of investment spending. Add to that the general negative impact of increased volatility on corporates' animal spirits, falling capacity utilisation and most likely tougher financing conditions once the economic downswing is more clearly visible and investment spending should slow substantially in 2012. Labour market surveys indicated less optimistic hiring intentions even before the recent equities correction and the downward revisions to the internal outlook. The decline in the unemployment rate should come to a halt towards year-end. However, given the resilience of the labour market demonstrated during the 2008/09 slump, we do not expect a significant increase in the unemployment rate in 2012. Wage increases will most likely fall short of what unions had hoped for just a few weeks ago. In addition, fiscal policy will subtract from households' disposable income. Although lower inflation will provide some counterbalance, private consumption growth is unlikely to exceed 1% in 2012.

Assuming a quarterly profile of minimal growth in H1 2012, when recent financial market gyrations are likely to have their maximum impact, and a modest recovery in H2, although it currently might seem somewhat difficult to imagine its drivers, German GDP growth should come to just around ¾% in 2012. This contrasts with our forecast of 2% a month ago and a consensus forecast of 1.9% published in August Consensus Economics.

Inflation slowing noticeably

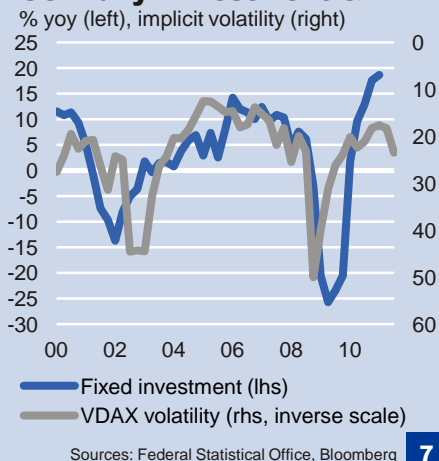
Based on the downward revisions to our forecast for Germany and internationally, output gaps in the industrialised world could be around 1 percentage point bigger than previously assumed. Weaker global demand has already left its imprint on oil prices. For 2012 we assume an average price for Brent of around 100 USD/bbl. Given the bleak US outlook causing the Fed to promise (conditionally) that Fed funds will stay at current low levels for the next two years, we no longer expect a substantial rise of the US dollar versus the euro. In combination, both factors will result in a clear decline in headline

Exports: leading indicators pointing South



6

Germany: Investment & DAX



7

Germany: Sluggish GDP growth



8



inflation from year-end onwards. We now expect average inflation slightly above 2% in 2011 falling to 1 ½% in 2012. The combination of very modest growth and low inflation rates could send 10Y Bund yields to new all-time lows in the coming weeks and does not suggest a substantial increase during 2012, unless Germany ultimately agrees to bail out the rest of EMU on its own.

Stefan Schneider (+49 69 910-31790, stefan-b.schneider@db.com)

Germany at a glance

	2010	2011F	2012F
Real GDP, % yoy	3.7	2.8	0.8
Inflation, % yoy	1.1	2.1	1.5
Budget balance, % GDP	-3.3	-2.0	-1.7
Public debt, % GDP	83.2	81.3	81.2
Current account balance			
EUR bn	141	140	135
% GDP	5.7	5.4	5.1

Sources: Federal Statistical Office, DB Research **10**



The 2012 wage round – heavy metal or damp squib?

- The tables are turning rapidly with regard to Germany's 2012 wage round. While until recently the booming economy seemed to be playing into the unions' hands, the sharper-than-expected slowdown is now strengthening the employers' bargaining position.
- There is still debate about whether there is ground to be made up given the much stronger-than-expected recovery in 2010/11. However, our analysis based on the cost-neutrality concept shows that employees actually did not end up with the short end of the stick, if 2009 is included.
- A simple model using core inflation, productivity growth and the unemployment rate as explanatory variables predicts a modest increase in average collective wage growth from close to 2% this year to around 3% in 2012.
- The IG Metall union, which is due to negotiate from March onwards, should probably achieve a settlement of around 4%. This will, however, include substantial one-off payments and probably have a duration of only 1 year.
- Overall, we expect that wage increases will slightly exceed the cost-neutral scope in 2012. Consequently the labour share, which peaked 2009 and has decreased strongly since then, will probably temporarily rise again.

Until a few weeks ago, the 2012 wage round seemed to be developing into a contentious issue. Some hoped that strong growth would finally make itself felt in employees' pockets and thereby put the domestic economy on a more solid footing. Others worried about the competitiveness of corporate Germany. The substantial darkening of the global economic outlook has probably reduced some of the potential for conflict, especially for such export-oriented sectors as the metal or chemical industries. Still, given the unusual developments in the German labour market during and after the 2008/09 slump, the 2012 wage round deserves close attention.

In this article we put the wage developments of 2009-2011 into economic context and try to assess the implications for the 2012 round. In addition, we devise a simple wage equation with the productivity growth, core inflation and the unemployment rate as explanatory variables. Due to its quite short estimation period, the model covers the developments since 2004 including the 2009-2011 bust/boom phase rather well. Based on our macro-assumptions, the model predicts that hourly wage growth in the total economy will accelerate to around 3% after slightly below 2% in 2011E. In the metal sector, where the existing agreement expires in March 2012, we expect a settlement worth around 4%, including considerable one-off payments, which will probably include some flexibility to take inter-company differences into account. In the domestic sectors (public sector, hotels and restaurants, banking), settlements should be lower. A 3% overall increase should be only slightly above the sum of productivity growth and inflation, creating at best mild headaches for the ECB.

The long overture to the 2012 wage round

Given that wages tend to lag the economic cycle by around one year, the real economy's ups and downs have kept wages out of

sync with fundamentals to a substantial extent. This factor will be one aspect discussed in the upcoming wage round and is therefore worth recapping briefly.

2009: Strong wage growth despite the recession

Wage negotiations in 2009 were influenced by deteriorating economic conditions and high uncertainty at the time. Despite the German economy sliding into a recession, labour unions entered the negotiations with strong demands based on high inflation rates during 2008 (2.8% over the year) as well as strong productivity growth in the previous years, but worsening business conditions undermined their case. Most unions aimed for an increase of around 6%, with notably higher demands in the metal industry (8%), the public sector (8%) and at Deutsche Bahn AG (10%). However, settlements were substantially below unions' wishes, mostly between 2% and 3% (normalized to 12-month growth rates over contract duration). On an hourly basis the increase in collective wages slowed from 2.8% in 2008 to 2.1% (measured by the Bundesbank's index of negotiated wages). With the benefit of hindsight, these settlements were definitely on the high side given a 5.1% contraction in GDP and a good 2% decline in productivity. Settlements were agreed for relatively long periods of 17 to 24 months to grant companies a secure long-term planning horizon given the increased economic uncertainty.

Settlements 2009

Sector	Union demands	One-time payments (EUR)	Wage increase*	Duration (months)
Construction	6.0%	60	2.3%	24
Metal industry**	8.0%	EUR 510+EUR 122	2.8%	18
Printing industry	5.0%	-	1.0%	24
Iron and steel industries	4.5%	350	1.4%	17
Retail	6.5%	150	1.8%	24
Wholesaling	8.0%	125 / 60	1.8%	24
Public sector (federal states)	8.0%	EUR 40+EUR 40 base increase	2.1%	24
Deutsche Bahn AG	10.0%	-	3.0%	18
Volkswagen AG	4.2%	710	2.8%	18
Transportation	-	-	2.7%	20

*Normalized to 12-months growth rates, w/o one-time payments

**Contract expired 2008, settlement in 2009

Sources: WSI-Tarifarchiv, DB Research

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The most important negotiations of 2009 were held in the metal industry (in fact, their contracts expired in 2008, but both parties could not come to an agreement until 2009). Unions and employers agreed on a 2.1% wage increase in February 2009 and another 2.1% increase in May 2009. In addition, employees received a lump-sum payment of EUR 510 to cover the period between the expiry of the previous agreement in November and the first wage increase in February and a one-time payment of EUR 122 in September 2009. The new agreement was reached for a period of 18 months. All in all, the metal industry's settlement was well above the year's average. Further above-average agreements were found at the company level at Deutsche Bahn AG (3%) and at Volkswagen (2.8% + EUR 710 one-time payment). In the public sector, the second-largest negotiations of the year took place. There, the wage increase was staggered, rising by 3% in March 2009 and 1.2% in March 2010. Also, employees received a EUR 40 increase in basic pay and a EUR 40 lump-sum payment, putting this settlement more or less in line with the year's average.



2010: Moderate wage growth and focus on job security measures

In 2010 agreements covering roughly half of the employees subject to collective bargaining were up for renewal, the other half was covered by earlier longer-term agreements. Given the experience of the 2009 slump, many unions went into the 2010 negotiations with moderate or not even explicitly quantified demands. The rather high wage increases of 2009 combined with very low inflation and rapidly declining productivity put a heavy burden on labour costs and fear of layoffs became prevalent. Consequently, the 2010 negotiations were to a large extent about introducing or extending job security measures. Wage increases were low and often completely replaced by one-time payments. For example, in the chemical industry, where settlements are traditionally above the average, the parties agreed to an 11-month extension of the existing agreement and a one-time payment of EUR 550 but no wage increase. In the metal industry, IG Metall, normally known for its high demands, went into bargaining without declaring a specific target increase in pay. The union agreed to a deferred 2.7% wage hike in April 2011, which combined with the long agreement duration of 22 months corresponded to a moderate 1.4% p.a. wage increase over the life of the contract.

Settlements 2010

Sector	Union demands	One-time payments (EUR)	Wage increase*	Duration (months)
Chemical industry	real +	550	0.0%	11
Metal industry	real +	-	1.4%	22
Iron and steel industries	-	150	3.1%	14
Public sector (federal and municipal employees)	5.0%	240	0.6%	26
Hotels and restaurants	4.5%	-	0.9%	33
Paper industry	4.5%	-	0.6%	28
Banking	real +	300	0.9%	22

* Normalized to 12-months growth rates, w/o one-time payments

Sources: WSI-Tarifarchiv, DB Research

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Most other industries agreed on marginal increases with a wide variation in the duration of the settlements. In the public sector, negotiations failed and an agreement could only be reached after arbitration. The arbitration committee suggested staggered increases of 1.2% in January 2010, 0.6% in January 2011 and 0.5% in August 2011, as well as a one-time payment of EUR 240 and a contract duration of 26 months, corresponding to an average 0.6% p.a. increase over the 3 years.

2011: Wage increases return to normal levels

Given the long duration of agreements reached in 2009 and 2010, the agreements that have expired in 2011 to date cover only 25% of employees subject to collective bargaining, with the bulk of the year's settlements being reached in H1. Negotiations have been shaped by unions' demands to share in the strong economic recovery, which turned out to be much more robust than anticipated a year ago. In 2010, GDP growth exceeded all expectations, climbing 3.6%, and is expected to stay close to 3% during 2011. As a result, demands have been higher than in 2010, with most unions aiming for a wage hike of around 6%. So far, most settlements have been around 3% p.a., with outliers in the chemical industry (3.8%) and the printing industry (0.7%), at Deutsche Bahn (1.6%) and in the public sector (1.7%). Duration of most contracts is again unusually long, with most contracts running for 2 years or even longer.

Settlements 2011

Sector	Union demands	One-time payments (EUR)	Wage increase*	Duration (months)
Construction (West)	5.9%	-	2.7%	24
Construction (East)	5.9%	-	3.2%	24
Chemical industry	7.0%	-	3.8%	13
Deutsche Bahn AG**	-	500	1.6%	29
Retail	6.5%	50	2.4%	25
Public Sector	3.0%	EUR 360+EUR 17 base increase	1.7%	24
Wholesaling	-	-	2.7%	24
Transportation	EUR 95	-	2.2%	26
Printing	5.5%	430	0.7%	33

* Normalized to 12-months growth rates, w/o one-time payments
 ** Contract expired 2010, settlement in 2011

Sources: WSI-Tarifarchiv, DB Research **13**

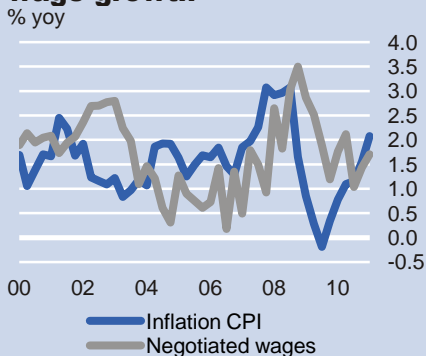
During the remainder of 2011, it is mostly smaller (by number of employees) agreements that will expire, covering only 4% of employees subject to collective bargaining.

Cost-neutral scope & negotiated wages



Sources: Bundesbank, DB Research **14**

Inflation and negotiated wage growth



Source: Bundesbank **15**

The long run: high increases in the 1990s, wage moderation thereafter

Negotiated wages in Germany grew at very fast rates during most of the 1990s. Average wage increases during that period were above 5%. This development was caused by the boom following German unification and by a strong catching-up of wages in eastern Germany, ignoring the productivity difference between East and West German workers. During the largest part of the decade that followed, German negotiated wages increased only moderately. This wage moderation was rooted in various factors: First, the wage policy during the 1990s led to a jump in labour costs and consequently high unemployment. This reduced unions' negotiating power and made them willing to accept lower wage settlements in order to keep jobs from being off-shored. In particular, even unions such as IG Metall endorsed improved flexibility of collective agreements, including opt-out clauses for company-level bargaining. This flexibility enabled companies to deviate from collectively negotiated standards, including by uncompensated increases in working hours and pay cuts in exchange for employment guarantees. In a nutshell, most employee representatives explicitly or implicitly accepted a decrease in real wages to improve the competitiveness of the German economy and thereby secure domestic jobs. As a result, from 2000 to 2007 average year-on-year increases of negotiated wages were only 1.6%, and from 2003 to 2007 they were just 1.2%.

One benchmark for the development of nominal wages is the concept of a cost-neutral wage policy, in which the sum of productivity growth and inflation rates provides the scope for wage increases. A cost-neutral wage policy keeps relative factor prices, as well as the functional income distribution between capital and labour income, constant. However, this yardstick should, in our opinion, be applied only when the economy and in particular the labour market are in equilibrium, i.e., if no involuntary unemployment prevails at the current wage rate.

From 2000 to 2007, negotiated wage increases were consistently lower than the cost-neutral scope would have allowed, with an exception during 2002 when both were roughly in line. From 2007 onwards, wage increases started to become more substantial again, driven by higher inflation rates and an impressive drop in the number of unemployed.



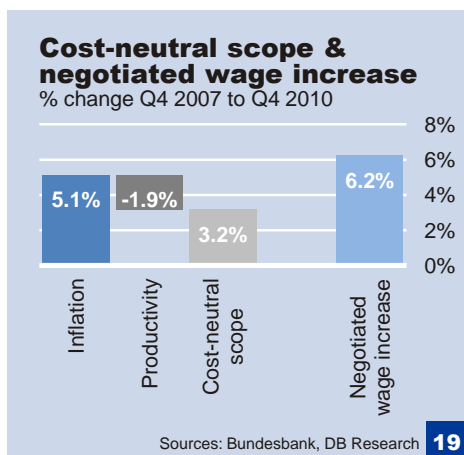
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Even though wage increases have been below the cost-neutral scope for most of the last decade, wage developments do seem to be driven by inflation and productivity growth. However, both influence the growth of negotiated wages with a time lag of various quarters, leading to a strongly backward-looking development of wages.

Furthermore, one should note that the downward response of wages to decreases in productivity or very low inflation is only limited. In other words, nominal wages are subject to downward rigidities, leading to cyclical behaviour in labour costs.

2009-2010: Wage increases exceeded the cost-neutral scope

After trending upwards during 2007, wage increases peaked in 2008, with an increase of 3.5% yoy in Q4 and a yearly average of 2.8%. For the first time in years, from Q3 2008 on negotiated wage growth exceeded the cost-neutral scope. This was partly caused by higher wage increases itself, but first and foremost by a slump in labour productivity, which began to decrease as the financial crisis started to affect the real economy. Over the whole year 2008 wage increases were 0.3pp above the cost-neutral scope.

Despite the contracting economy, wage growth slowed only slightly during 2009 and amounted to 2.1% over the year. Due to the global recession, labour productivity continued to decline strongly by about 2.2% over 2009 and consumer price increases were very low as well. Based on the above-discussed yardstick of cost neutrality, wages should have actually fallen by around 2%; instead, wage growth was 4.1pp above the cost-neutral scope for 2009 and 1.7pp above the years' inflation rate. The wage development of 2008 and 2009 caused a 3% increase in real wages (at a time of falling labour productivity) and nearly sufficed to reverse the decrease of real wages achieved from 2003 to 2007.

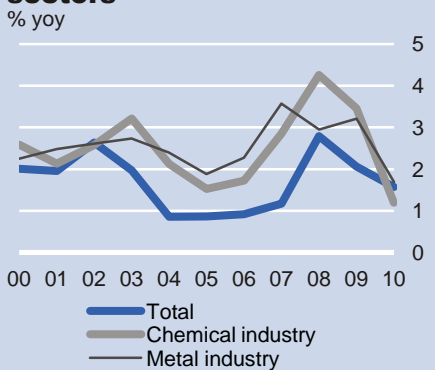
Labour productivity began to recover at the beginning of 2010. However, growth rates were far from allowing a quick recovery from the 2009 slump. Inflation stayed low, putting the cost-neutral scope at 2.1% for 2010. Due to the relatively high increases of the previous year and continuing tense economic conditions, unions were willing to accept only modest increases, leading to a wage increase of 1.6% over the year, slightly below the cost-neutral scope.

Over the whole period from Q4 2007 to Q4 2010 negotiated wages increased by 6.2%. Productivity on the other hand declined by 1.9%, and prices as measured by the CPI have increased by 5.1% since then. All in all, over the last 3 years negotiated wage increases have been 3pp above the cost-neutral scope, leading to a strong increase in real wages as well as unit labour costs and sacrificing – ceteris paribus – part of the competitiveness gains won by wage moderation from 2000 to 2007. This means that claims that employees had sold themselves short compared to the actual development, thus entitling them to some kind of catching-up, are actually not justified when looking at the 2009-2011 period as a whole.

Some scope for export-oriented industries

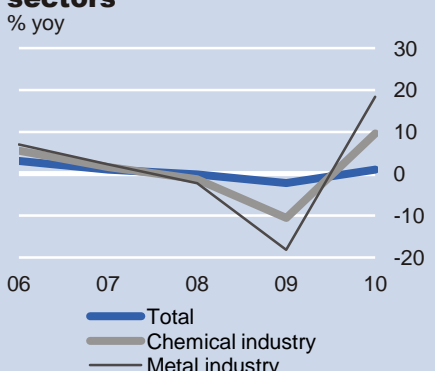
Traditionally the metal and chemical industries enjoy above-average settlements. These sectors are export-oriented and have achieved above-average productivity growth. For the last decade, negotiated wage growth in the chemical and metal industries – which are both highly unionized – has been on average about 0.8pp above the economy as a whole.

Negotiated wages in major sectors



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Productivity in major sectors



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Expiring contracts 2012

12/11	Deutsche Post AG
12/11	Industrial cleaning
02/12	Public Sector
02/12	Banking
03/12	Metal industry
03/12	Chemical industry*
03/12	Motor vehicle trade*
03/12	Hotels and restaurants*
08/12	Paper industry

*Regionally different expiration dates

Source: WSI-Tarifarchiv

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Over the period for which comparable sectoral data is available, productivity growth of the metal and chemical industries has been almost 1pp higher than in the economy as a whole. On the other hand, the slump in productivity during 2009 was more pronounced in both industries, but both have recovered most (but not all) of this productivity loss in 2010. Wage development in both industries responded to the economic downturn with very low wage settlements in 2010.

The metal industry's wage settlements are often seen as the top end of what is to be expected in the annual wage round. They should, however, not serve as a benchmark for other, less dynamic and less export-oriented sectors of the economy.

Wage increases will gain pace in 2012 ...

During 2012, collective agreements covering about 25% of employees subject to collective bargaining will be renewed. The first round of larger negotiations will be held at Deutsche Post AG and in industrial cleaning trade, whose contracts expire at the end of December 2011. In February, the contracts of federal and municipal employees, as well as those of the employees of various states (1.3 m employees in total) are up for renewal. February will also see the expiry of the agreement in the banking sector (258,500 employees). At the end of March, the contracts of the metal industry expire, where 3.2 m employees are affected.

As discussed before, negotiated wage increases from the end of 2007 to the end of 2010 were 3pp above the cost-neutral scope for that period. In addition, numerous companies had their employees participate in the strong recovery of the German economy during 2010 and 2011. For example, many companies in the metal and electronics industries brought forward the increase in collective wages by 2 months, from April to February 2011 (close to 50% of all employees enjoyed the increase already in February). In many firms, voluntary bonus payments were made to compensate employees for cuts in allowances during the crisis.

These factors have to be kept in mind when analyzing the 2012 wage round. On the other hand, the economic recovery in Germany has been – at least until recently – a lot stronger than anticipated. GDP growth should still be around 3% in 2011, although the prospects for 2012 have considerably worsened. The labour market has performed particularly well, with unemployment reaching its lowest level since reunification in Q2 2011. Also, inflation is currently running at 2 ½% and will likely fall to 1 ½ % in 2012.

In order to identify to what extent the parameters discussed above are likely to impact next year's wage round we have devised a simple model. In our model, the endogenous variable WAGE_YOY is the quarterly year-on-year change in the Bundesbank index of negotiated wages. The explanatory variables are the level of the unemployment rate (UNEMP_ILO), HCPI inflation excluding energy and food (INF_CORE), and productivity growth per employee (PROD_YOY)¹. The level of unemployment is a proxy for unions' negotiating power and hence enters the equation without a time lag. Inflation affects wages with a time lag of 6 quarters, reflecting the increasing length of collective wage settlements and backward-looking formation of inflation expectations. The fact that core

¹ This specification obviously ignores changes in average hours worked. However, due to the 6-quarter moving average used, short-term volatility in hours worked should have a small effect, if any.



inflation appears more significant than headline inflation suggests that the negotiating partners do not see temporary changes in food and energy prices as a relevant factor influencing wage negotiations. Productivity growth enters with a one-year lagged, 6-quarter moving average term. This reflects the fact that since nominal wages are subject to downward rigidities, employers are typically reluctant to raise wages in response to short run productivity increases. However, the long-term productivity development does affect wages. In addition, a dummy indicating quarters in which settlements in the metal industry went into effect is included.

Wage equation

Dependent Variable: WAGE_YOY

Sample: 2004Q1 2011Q1

HAC standard errors & covariance

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.7566	0.4501	8.3457	0.0000
INF_CORE(-6)	0.6487	0.1594	4.0700	0.0004
@MOVAV(PROD_YOY(-4),6)	0.2386	0.0313	7.6144	0.0000
METALL	0.5883	0.0957	6.1492	0.0000
UNEMP_ILO	-0.3622	0.0463	-7.8189	0.0000
R-squared	0.8054	Mean dependent var		1.4830
Adjusted R-squared	0.7729	S.D. dependent var		0.8301
S.E of Regression	0.3955	Durbin-Watson stat		2.4713
F-statistic	24.8272	Prob (F-statistic)		0.0000

Source: DB Research

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According to our model, a 1pp increase in unemployment reduces concurrent wage growth by 0.36pp. Core inflation affects wages with a time lag of 1.5 years, a 1pp higher core inflation rate increases future collective pay raises by 0.65pp. An average labour productivity increase of 1% during 2 years causes 0.24pp higher wage settlements one year in the future. The combined coefficients of inflation and productivity growth suggest that over our sample period, a 1pp change in the cost-neutral scope triggers a response of negotiated wage growth by around 0.45pp.

Our prediction of the development of the wage index is based on a scenario given by forecasts of the explanatory variables by DB Research. Our model predicts an accelerating trend for higher increases in the negotiated wage index during 2011 and 2012. The forecast for the remainder of 2011 is a moderate increase by 1.8% in Q2, and around 2% in Q3 and Q4. In total, this would make for a yearly index increase of 1.9%.



Assumptions & forecasts

Q	Unemployment	Core inflation	Productivity growth	Negotiated wage growth
11Q2	6.1%	1.1%	2.1%	1.8%
11Q3	6.1%	1.3%	1.0%	2.0%
11Q4	6.0%	1.3%	1.2%	2.1%
12Q1	5.9%	1.3%	1.1%	2.5%
12Q2	5.9%	1.4%	0.5%	3.3%
12Q3	5.9%	1.4%	0.5%	2.9%
12Q4	5.9%	1.3%	0.7%	3.0%
2011	6.1%	1.2%	1.6%	1.9%
2012	5.9%	1.4%	0.7%	2.9%
RMSE		0.3598		
Mean abs. Error		0.2945		

*ILO definition

Source: DB Research **25**

... but will be still manageable

In 2012, wage increases will accelerate somewhat further. After growing by 2.5% in Q1, high settlements in the metal sector (which could be still around 4%, with a considerable part coming from one-time payments) and the chemical industries will cause a spike in the wage development in Q2, with a year-on-year change of 3.3%. Wage growth will then return to the year's trend, growing strongly by 2.9% in Q3 and 3% in Q4. In total, our model predicts a wage increase by almost 3% over the whole year.

Given the recent worsening of global business conditions, we expect that employers will go for a short-term deal of probably 12 months. Against the backdrop of a cost-neutral scope of around 2.2%, we expect that the labour share, which has been declining since 2009, will moderately increase again.

Given that the estimation period of our model basically covers the start of the Hartz reforms and the period of deliberate wage moderation by labour unions as well as the global recession and its aftermath, the sub-par adjustment to productivity growth and inflation is not really surprising, and could even be interpreted as evidence that these reforms were indeed successful. Nevertheless, one has to question whether this wage restraint – driven by a combination of reforms and cyclical factors – can be extended into the future.

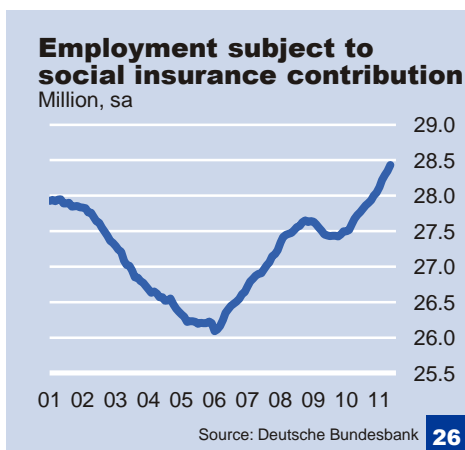
Tobias Renkin
 Stefan Schneider (+49 69 910-31790, stefan-b.schneider@db.com)



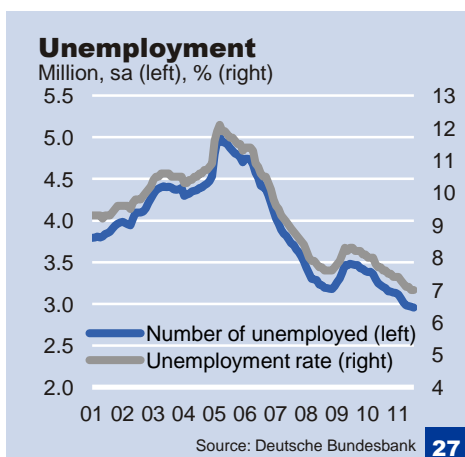
The German labour market

Demographic shift poses formidable challenges

- Employment numbers in Germany have surged over the past few years, with joblessness falling to its lowest level since the country's unification.
- Demographic changes will bring pressure to bear on the labour market in the coming decades, though, necessitating further reforms.
- The key to addressing this issue is to more effectively tap the labour potential of young people, women of child-bearing age and older workers. In addition, annual working times could be increased and incentives created to boost immigration.
- But even radical labour-market changes will probably not be able to fully offset the effects of an ageing and shrinking population on a realistic scale.
- The labour force is set to contract by 12 million members by 2060, accordingly.
- Fiercer competition for an increasingly scarce supply of labour is likely to drive up wages and, correspondingly, drive down returns on capital.
- The demographic shift is also going to accelerate structural change at the sector level. The beneficiaries will probably include the pharmaceuticals industry and, above all, services provided mainly to domestic consumers, for example, healthcare and long-term care, while the significance of industry will continue to decline.
- Higher wages and additional costs for in-house upgrading of older workers' skills in tandem with subdued productivity growth could weigh on the earnings of companies with production facilities in Germany.



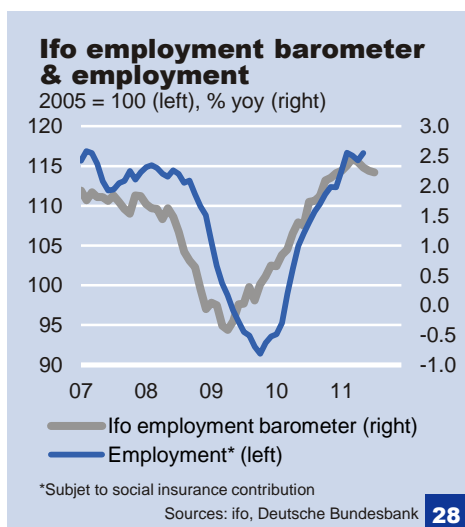
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Notable achievements in recent years

The German labour market has delivered a remarkable performance in recent years. In many industrial countries, there was a huge increase in unemployment in 2009, the year of the deepest recession in postwar history. In Germany, by contrast, unemployment edged up only slightly. The factors mainly responsible for Germany's performance were the extension of short-time work schemes, increased flexibility – particularly as regards collectively agreed working hours – and companies' extraordinarily good financial situation. In the course of the subsequent strong upswing, employment picked up substantially and joblessness fell to its lowest level since the country's unification. The number of workers subject to social insurance contributions has increased by a good 900,000 (nearly 3 ½%) since hitting its low in autumn 2009, and the number of jobless has fallen below the 3 million threshold (7% of the labour force). In spring 2005, when the roll-out of the Hartz labour-market reforms was all wrapped up, the jobless figure had still approached 5 million. This shows that many of the labour market reforms implemented under the then-ruling SPD-Green coalition led by Gerhard Schröder have indeed had an impact, but it took several years for them to feed through, since much of their thrust unfolded indirectly, by inducing changes in the behaviour patterns of those affected.



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Considering the sizeable jump in job vacancies, the improvement in the labour market should continue. Nonetheless, the slight fall in the Ifo Institute's employment barometer suggests there will be some easing of the upward momentum over the coming months. We expect the unemployment rate to decline to 6.9% by the end of 2011 (down from 7.4% at the end of 2010) and remain at this level in 2012. This – admittedly – unexpectedly good performance does not mean that further reforms to improve the functioning of the labour market are no longer necessary. Quite the opposite is true, in fact.

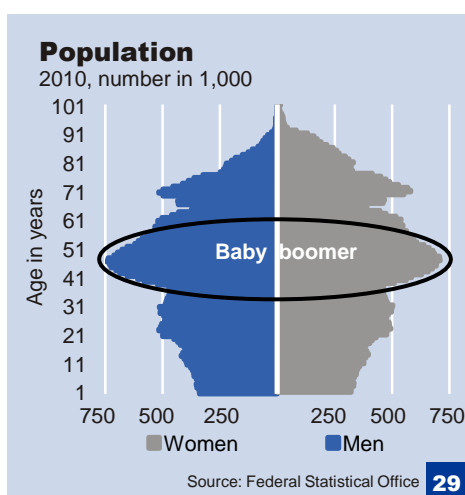
Disproportionate increase in atypical employment lately

Certain trends that will trigger societal problems are already emerging. Last year, for instance, there was a disproportionately strong increase in what is referred to as atypical employment; this is now the status of roughly 25% of all employees. Atypical employment comprises work on the basis of a fixed-term contract or “mini-jobs”, part-time work and temporary work agency services. True, the surge in these types of employment is a sign that companies are using them to be able to react flexibly to changes in economic activity. What this means is that there has actually been an increase in the flexibility of the German labour market – which is often criticised for having unduly rigid structures. However, atypical jobs entail considerable uncertainties for workers and they pay lower wages, particularly in the case of temping services, so the growth of household income, and thus of household consumption, is not able to keep pace with the increase in employment².

Demographic factors will exacerbate scarcity of skilled labour

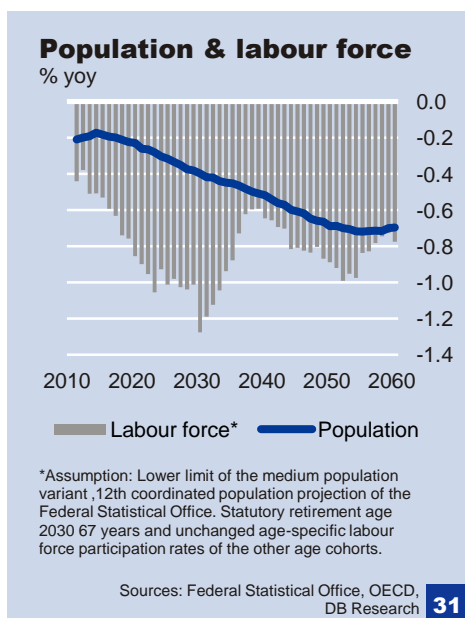
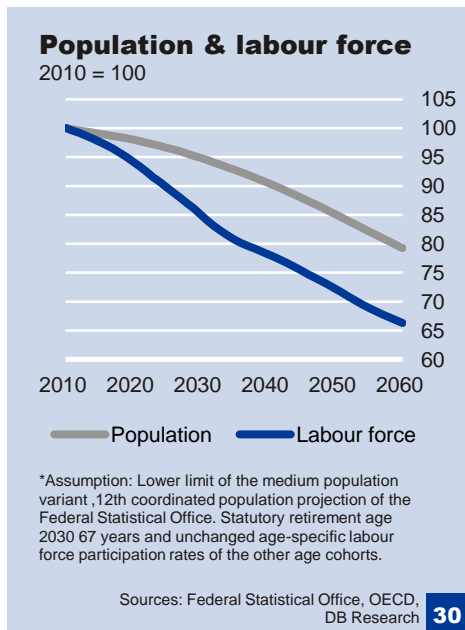
Furthermore, longer-term trends are materialising that will lead to serious changes in the labour market and that will need to be addressed early on. Initial signs of a scarcity of skilled labour are already in evidence. Some companies are already experiencing problems in their attempts to recruit such staff in the domestic labour market. This problem is probably more structural in nature than demographic.

However, the skills shortage will noticeably intensify over the coming years when the baby-boom generation reaches retirement age and can only be partially replaced by the cohorts born in years with low birth rates. For this reason, further reforms are necessary – ones which primarily focus on increasing the size of the potential labour force, i.e. the labour supply. This mainly includes incentives for people to join the labour force earlier, stay there longer and/or be available to the labour market at all. In what follows we depict the far-reaching repercussions of the demographic shift on the labour market and discuss ways in which they may be counteracted. Model calculations show that the negative effects of an ageing society and a shrinking population probably cannot be fully offset on a realistic scale even by using a combination of the most diverse measures. Besides, it is doubtful whether, and to what extent, society can even reach a consensus on which adjustments are necessary.



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² But this also covers jobs held by students, pensioners and second jobs. Moreover, in the past few years there has been a tangible decline in the number of long-term unemployed, who usually start their new job at below-average wage levels.



Inexorable demographic shift ...

According to the latest projections of Germany's Federal Statistical Office³, the shrinking of the population observed since 2003 is going to accelerate and according to the medium variant projection⁴ this will lead to a roughly 20% decline, from 81 $\frac{3}{4}$ million inhabitants at present to just over 64 $\frac{1}{2}$ million by 2060. The ageing of the population means that the share relevant to the labour market, i.e. the persons who are either gainfully employed or unemployed and thus potentially available to the labour pool, is going to shrink much faster than the population as a whole up to 2060. In figures, the decline translates to roughly 14 million workers or almost 35% of the labour force⁵. The contraction of the labour force should accelerate up to about 2030, peaking at around 1 $\frac{1}{4}$ % per year⁶. Subsequently, the decline should slow to about $\frac{3}{4}$ % p.a. until 2060. This model factors in the gradual increments to bring the retirement age up to 67 by 2030, moderating the decline in the labour force, as well as constant labour force participation rates⁷ for the other age cohorts.

... with various implications

Ceteris paribus, a decline in the labour force is tantamount to a fall in the growth potential of an economy, which is a function of potential labour input, i.e. the product of the number of workers and hours worked per worker, as well as of total capital resources and productivity growth. Moreover, the ratio of gainfully employed to recipients of statutory social-security benefits also deteriorates, which brings massive pressure to bear not only on the pay-as-you-go pension system, but also on the statutory healthcare and, above all, long-term care systems. Since older people have different preferences and needs than younger ones, the structure of the economy and thus employment will see changes in many sectors. Furthermore, the ratio of labour to capital in an economy also shifts towards labour. In an ageing and shrinking society it is thus generally to be expected that wages will climb and the macro-economic return on capital will fall when labour becomes scarcer and capital becomes more abundant, also given the greater propensity to save to ensure adequate provision for old age⁸. In this context the fall in returns is likely to be more pronounced in relation to low-risk investments because older people tend to invest in low-risk assets. This argument is backed by the shorter time horizon for

³ Federal Statistical Office (2009). Germany's population by 2060 – results of the 12th coordinated population projection. Wiesbaden.

⁴ Medium variant, lower limit – assumptions: nearly constant birth rate; basic assumption of life expectancy at birth in 2060: boys 85 years, girls 89.2 years; net immigration 100,000 per year; see Federal Statistical Office (2009).

⁵ This does not factor in what is referred to as the hidden reserve. This means persons who are fundamentally prepared to participate in the labour market, but because of a poor labour market situation or some other reason are not willing to take up a job. The IAB (the Research Institute of Germany's Federal Employment Agency) estimates that the hidden reserve has hovered at around 1 $\frac{1}{2}$ million in recent years.

⁶ The decline is slightly greater than in the IAB simulation, since the IAB also assumes an overall increase in the potential labour participation rates. See Fuchs, J. and G. Zika (2010). Arbeitsmarktbilanz bis 2025 – Demografie gibt die Richtung vor. IAB Kurzbericht 12/2010.

⁷ The labour participation rate is the number of people in the labour force (gainfully employed and unemployed) as a percentage of the total population of working age. In the following it is assumed that the working age spans the cohort from age 15 to 64.

⁸ See Gräf, B. and M. Schattenberg (2006). The demographic challenge – Simulations with an overlapping generations model. Deutsche Bank Research. Current Issues. May 19, 2006. Frankfurt am Main.

investments and the related focus on the availability and preservation of capital.

Three options

There are three ways we see to counter the looming decline in the labour force:

1. Tap the potential of the domestic working-age population more effectively, focusing on: young people, women and older workers;
2. Extend the length of annual working time; and
3. Encourage higher net immigration.

Option 1: Tap potential of domestic population more effectively

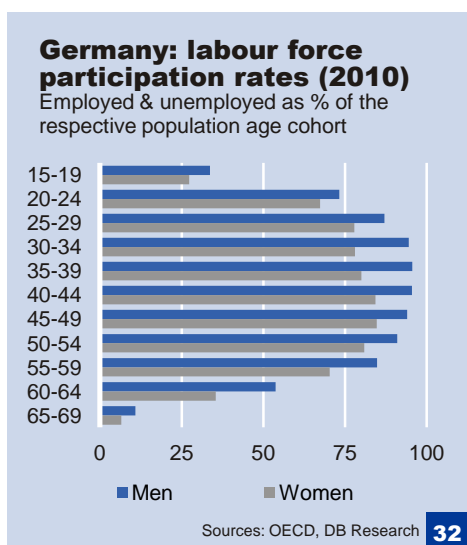
The key focal points for the first option are young people, women of child-bearing age and older workers. After all, an international comparison shows that the labour participation rate for German males aged 30 to 50 roughly matches the respective highest level among the industrial countries, while Germany's participation rates for young people, women of child-bearing age and older workers lag behind their peers. This means that other countries are much more successful in tapping the potential of their populations in these groups.

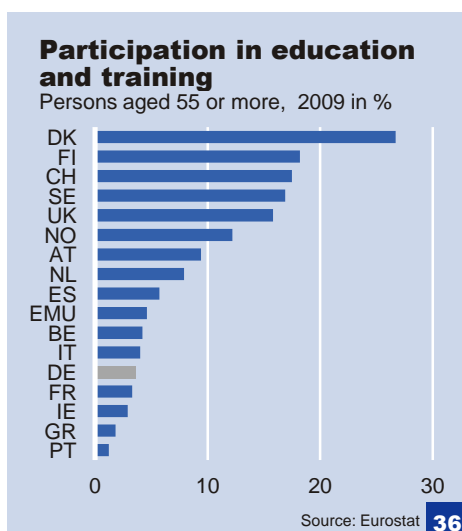
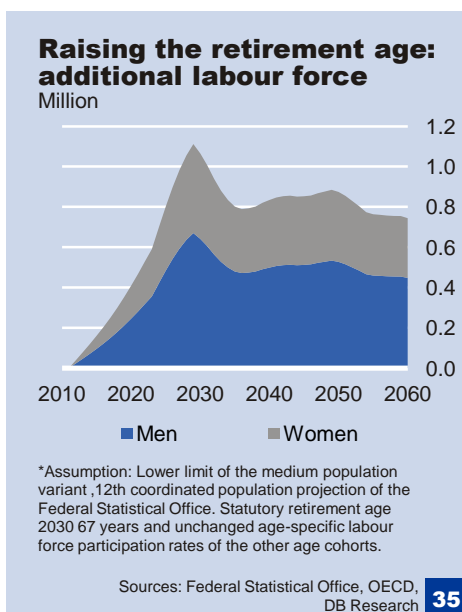
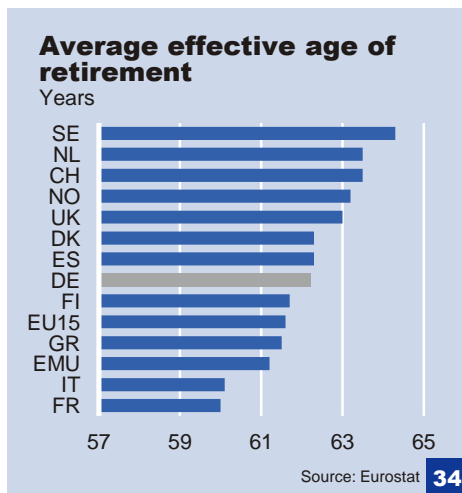
In Germany, merely almost 34% of the men aged 15-19 are available to the labour market as workers or job-seekers in the first place, while the percentages in the Netherlands and Denmark come to nearly 60% and in Switzerland to over 55%. The gap to the highest share of men aged 15-19 is thus 25 percentage points (pp). Among women of the same age bracket the gap is in fact nearly 34 pp, for only about 27% of the women in this age group in Germany are active members of the labour force versus about 60% in the Netherlands and Denmark.

The participation rate for men aged 20-24 also falls nearly 8 pp short of the highest value internationally, and for women likewise over 10 ½ pp. In this case, incentives need to be created for people to start working at an earlier age, for example by shortening the time devoted to schooling, training and university-level programmes. The reduction of school years from 13 to 12 and the launch of streamlined Bachelor degree programmes were steps in the right direction. All in all, raising the participation rate of the 15-19 age cohort to match the highest level internationally by 2030 would expand the labour force by about ¾ million. By contrast, raising the participation rate of those aged 20-24 would not suffice to compensate for the decline in the number of persons in this age group. Even if the highest participation rate internationally were matched, the working population aged 20-24 would fall by over ½ million by 2030.

Large personnel reserve in older cohorts ...

As among young people, similarly large gaps are to be found among older generations. In Germany, merely almost 54% of the males aged 60-64 are still available to the labour market, while the share of women in the same age bracket is no more than 35 ½%. This puts the participation rates for each of these two groups at around 23 pp below peak in the industrial countries. The leading country on the male side is Japan with a participation rate of 76%, while on the female side the ranking is topped by Sweden at close to 60%. Against this backdrop and given the prospective strong increase in





this age group in the decades ahead, there is a huge personnel reserve in Germany. The cohort of those aged 60-64, currently at 4 ¾ million, is similar in size to the 20-24 age group (close on 5 m) and much bigger than that of the 15-19 group (just over 4 m). By 2030, though, the number of 60 to 64-year-olds living in Germany is going to increase by over 1 million, while the group of 15 to 19-year-olds will shrink by ¾ million and of 20 to 24-year-olds by nearly 1 ½ million no less. This means an equally strong boost to the participation rate produces a more pronounced impact on the labour supply of older workers than on the supply of younger cohorts.

Germany is on the right track in intensifying its efforts to tap the potential of older age cohorts. The labour participation rate of those aged 60-64 has nearly doubled since 2000, and the average effective age of retirement in Germany has risen by a good 1 ½ years since 2001, mainly because of the curtailment of early-retirement incentives. In a European comparison, the German effective average of around 62 years is still a full 2 years short of the level in Sweden and nearly 1 ½ years short of the level in Norway and Switzerland, but it will continue to increase over the coming years as the statutory pension age rises from 65 to 67 by 2030 as legislated. This means the labour force will gradually grow by 1 ½ million members up to 2030, and the male participation rate of the respective age cohort would rise from about 54% now to 75% then, thus nearly closing the gap to the leader in the industrial countries (Japan: 76%).

... but this poses major challenges for business

The increasing share of older workers will pose major challenges for business, though⁹. Work processes will have to be adapted to older personnel and the skills of this cohort will have to be substantially upgraded. As education, comprising both school and job training, basically takes place at a young age, the knowledge gathered usually becomes outdated, which adversely affects labour productivity over time. In addition, faster structural change also means more rapid depreciation of job-specific knowledge, and acceptance of technological innovations is probably lower among older workers. Furthermore, there is considerable evidence that countries with a young, growing population are more innovative and risk tolerant than countries in which the average staff age is rising towards 50 and young workers are scarce. By contrast, older workers have more experience, often have better organisational skills and produce higher-quality work¹⁰.

Germany still poor in upgrading the skills of older employees

In terms of upgrading the skills of older people, Germany lags far behind the leaders by international standards. Only 3.6% of the population aged 55 or older participated in an education and/or training programme in Germany in 2009. The top ranks are held by the countries of Scandinavia and the United Kingdom with shares of 15-25% and more. This is an area where Germany still has lots to do in order to fully exploit the potential economic benefits of a larger labour force created by the increase in the statutory retirement age, despite the fact that a few companies have already seized initiatives to upgrade the skills of their older workers. For instance, one of

⁹ See also: Fuchs, J. (2006). Rente mit 67 – Neue Herausforderungen für die Beschäftigungspolitik. IAB Kurzbericht No. 16.

¹⁰ See Börsch-Supan, A., I. Düzgün and M. Weiss (2006). Altern und Produktivität: Zum Stand der Forschung. MEA Mannheim Research Institute for the Economics of Aging, now: Munich Center for the Economics of Aging.

Germany's large department store chains, Galeria Kaufhof, has conducted a training programme for older employees without any formal qualification in a commercial trade in order to equip them for the future in the retail sector, the aim being to further hone the employees' skills and thus secure their employability over a sustained period. Another example is the initiative on lifelong learning and skills upgrading launched by Sick AG in collaboration with the Chamber of Industry and Commerce (IHK).

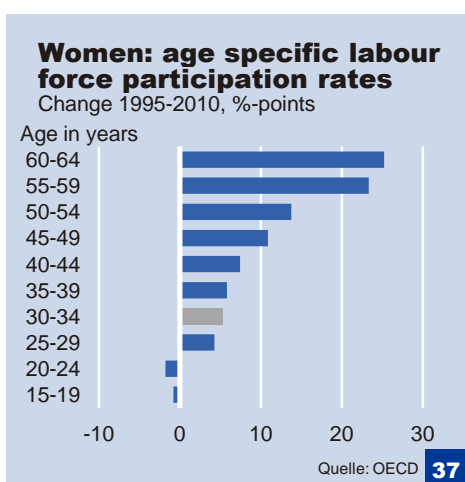
But skills upgrading must pay off for a company – something which is not always the case. For one thing, such training has to boost the productivity of the individual employee; for another, the employee also has to remain with the company long enough for the costs of upgrading his skills to be offset by a respective increase in productivity. There is empirical proof that companies offering programmes to upgrade the skills of their older staff also employ roughly three times as many older workers as companies without such measures. Nonetheless, definite confirmation that older workers do remain longer at a company following a skills upgrading programme can only be found in east Germany¹¹.

Change in work processes – problem identified

German industry has recognised the fact that work processes have to be adapted to an ageing workforce. The BMW pilot project in Dingolfing is a case in point. There, an assembly line has been adapted to reflect demographic conditions in 2018. In this context, only moderate, minor adjustments were necessary: additional lighting, larger writing, softer floor coverings to reduce leg strains when standing, special stools and company physiotherapists. However, it is not only work processes that can be re-engineered for older workers: the entire organisation and job conditions can be modified. While atypical types of employment still tend to have negative connotations today, this might change in future if older people remain a part of the labour force for a longer period of time, but want to be more flexible in terms of working hours, labour input and type of job. Expect structural change to boost the importance of the project economy, itself being likely to accelerate the pace of this adjustment process in the working world¹².

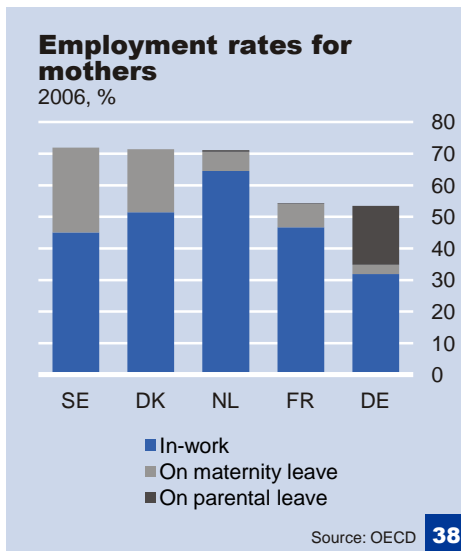
Work/life balance still unsatisfactory

Despite the improvements made in recent years, including the expansion of child care, the balance between work and family life in Germany is still unsatisfactory when compared with other countries. For example, female labour participation rates are much lower than the highest levels of other industrial nations. This is particularly pronounced in the cohort of women aged 30 to 34, whose participation rate has risen only very moderately over the last 15 years. The current level of 78% is still four points lower than in France and 10-12 percentage points lower than in Portugal, Sweden, Denmark and the Netherlands. In Germany women aged 30-34 are in the most active phase of child-bearing, as the average age at which they become mothers for the first time is just under 29, while the second child follows when the mother's average age is 31 and the third child is born when the mother is nearly 33 on average.



¹¹ See Bellmann, L., A. Pahnke and J. Stegmeier (2010). Betriebliche Weiterbildung und Beschäftigungsstabilität Älterer – Bleiben Geförderte länger? IAB Forum 1/2010.

¹² See Hofmann, J., I. Rollwagen and S. Schneider (2007). Germany 2020. Deutsche Bank Research. Current Issues. October 3, 2007. Frankfurt am Main.



Although working mothers as a share of all women of working age are almost the same in Germany as in France at 55-60%, there are, however, major differences in the make-up of these groups. For instance, almost half of the working mothers in Germany are on maternity leave or parental leave and are thus deemed to be in gainful employment, whereas in France the corresponding share is just 13%. Accordingly, in France there are far more mothers holding down a “real” job. Participation rates of mothers are even higher in Sweden, Denmark and the Netherlands.

Sharp decline in the number of mothers in full-time employment

In addition, there are far fewer mothers now working full time in Germany. In 2009 there were only close to 30% of working women in full-time employment compared with 50% in 1996. The findings of the last microcensus confirm that family considerations were the main factor in their decision regarding working time. According to the data, part-time working for most women is neither unequivocally their desire nor is it a temporary solution but rather a reflection of their familial or personal obligations¹³.

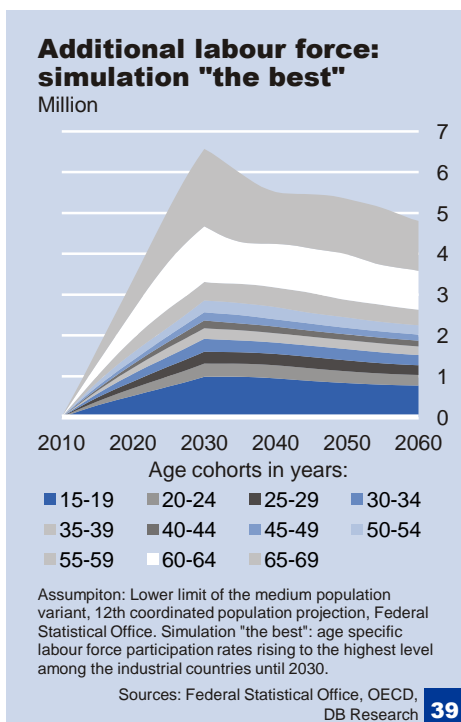
This shows that in Germany there is still a large number of women who could be in employment. Nevertheless, it should be noted that enabling a better work/life balance to be struck is a key precondition for boosting female labour participation rates. Germany is on the right track, for example, by introducing benefits for stay-at-home parents, expanding child care nationwide and increasing the flexibility of employment conditions. Nevertheless, the still prevailing mindset in Germany that looking after young children is the duty of the mother can only be changed in the long term, if at all.

Statistically speaking, raising the participation rate of women of child-bearing age to the highest international level until 2030 would add over 1 ½ million women to the active labour force.

But what would happen if participation in the labour market were to rise to the respective highest level in not only the areas where the gap is largest between Germany and other industrial nations, but also in all age groups?

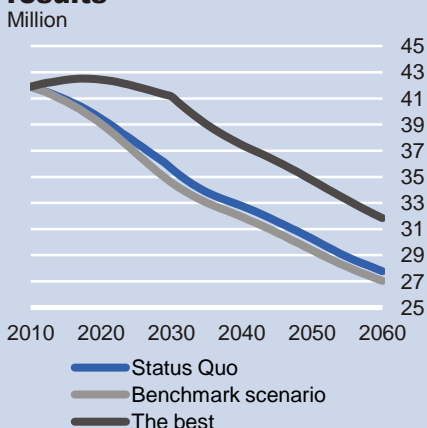
“The best” simulation: Demographic impact nearly offset until 2030

In order to answer this question we have carried out a simulation called “the Best”. We have calculated how the size of the workforce would develop if the age-specific participation rates of men and women in Germany were to rise to the respective highest level in the industrial countries until 2030, that is during the period when the impact of the demographic shift will be felt most keenly. This would swell the labour force by 6 ½ million people by 2030, which would largely offset the effects of demographic change. The workforce would thus shrink from nearly 42 million to just over 41 million by 2030, rather than dropping to the 37 ½ million derived in the “status quo” scenario, which factors in a retirement age of 67 but otherwise assumes unchanged participation rates for the other age cohorts. However, given the question of whether a social consensus can be found for such changes “the best” simulation appears to be relatively implausible and thus probably represents the upper end of the potential increase. Furthermore, it is shown that the impact of demographic change is only dampened during the period in which



¹³ See Puch, K. (2009). Frauendomäne Teilzeitarbeit – Wunsch oder Notlösung? German Federal Statistical Office. STATmagazin.

Labour force: simulation results



Assumptions: Lower limit of the medium population variant, 12th coordinated population projection.
"Benchmark scenario": Situation 2010 - unchanged labour force participation rates and unchanged retirement age.
"Status Quo": Statutory retirement age 2030 67 years and unchanged age-specific labour force participation rates of the other age cohorts.
"The best": Raising the labour force participation rates to the highest level among the industrial countries until 2030.

Sources: Federal Statistical Office, OECD, DB Research **40**

adjustments take place. When these adjustments come to an end the trend in the labour force figures returns to its old course, that is, the annual shrinkage rates after 2030 correspond roughly with those in the "status quo" scenario. However, the size of the workforce in 2060 would still be over 4 million higher than in the "status quo" scenario and would thus limit the decline in the potential labour force to around 10 million until 2060.

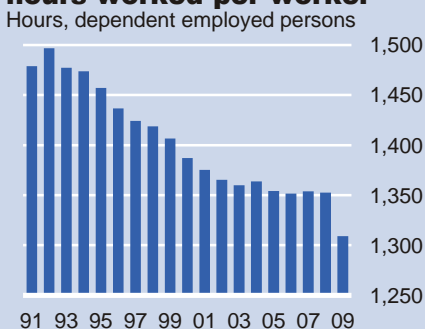
Labour supply: simulation results

Million	Population		Labour force ²	
	Total ¹	Aged 15-64 years	Scenario "Status Quo" ³	Scenario "The Best" ⁴
2010	81.5	53.9	41.9	41.9
2030	77.4	44.9	35.6	41.1
2060	64.7	34.9	27.8	31.8
Change in m				
2010-30	-4.2	-9.0	-6.3	-0.8
2030-60	-12.7	-10.0	-7.9	-9.3
2010-60	-16.9	-19.0	-14.1	-10.0
Change in %				
2010-30	-5.1	-16.7	-14.9	-1.8
2030-60	-16.4	-22.2	-22.0	-22.6
2010-60	-20.7	-35.2	-33.7	-24.0

¹Lower limit of the medium population variant, 12th coordinated population projection of the Federal Statistical Office.
²Employed and unemployed
³Raising the statutory retirement age to 67 years until 2030, unchanged age-specific labour force participation rates of the other age cohorts.
⁴Raising age-specific labour force participation rates to the highest level among the industrial countries until 2030.

Sources: Federal Statistical Office, OECD, DB Research **41**

Germany: average annual hours worked per worker

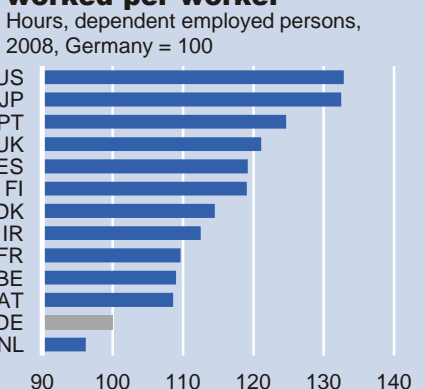


Source: OECD **42**

Option 2: Annual hours worked – Germany bottom of the rankings

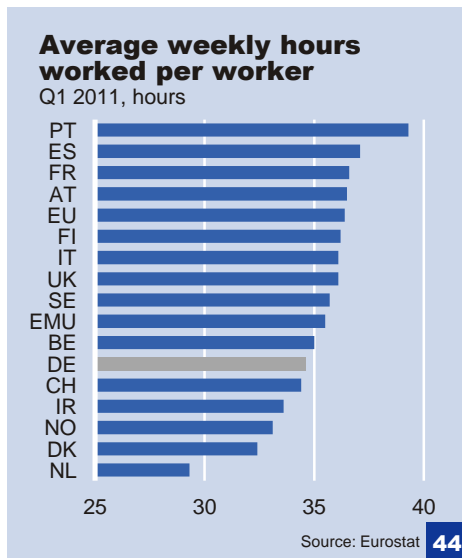
Another possibility for mitigating the demographic effects on the labour market is to increase annual working time. The demographically reduced headcount could via longer working hours stabilise the labour volume, that is, the product of employees and average working hours per employee. The average annual hours worked by company employees in Germany fell almost continuously between 1991 and 2003, roughly, and have been relatively stable since then. One exception was the year 2009, when during the deep recession working hours were reduced significantly to prevent a slump in employment.

Average annual hours worked per worker



Source: OECD **43**

An international comparison shows that in terms of the annual number of hours worked Germany ranks second from bottom – above the Netherlands – among the industrial countries. Even though it is difficult to compare the levels on account of the differing national methods of collating statistics it nevertheless shows that Germany does have scope to increase annual working time. This is also indicated by a comparison of average weekly working hours. The average number of hours worked per week in Germany is 34.6 and thus almost 1 hour less than the EMU average. In France, too, the average weekly working time of 36.6 hours is much higher, which is due to the higher average number of hours worked per week by part-time employees. Part-time employees in France work an average of 23.3 hours per week, whereas their counterparts in Germany work for only 18.2 hours.



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Using the average annual working time in industrial nations as a yardstick, annual working time in Germany could rise by around 15%. Spread across the years until 2030 this works out at an annual increase in working hours of $\frac{3}{4}\%$, which is roughly equivalent to the average contraction in the potential labour force. This would enable the effects of demographic change to be largely offset. This would mean that in 2030 the average working week would be 40 hours, which would definitely be the highest figure in Europe. However, such a development appears unrealistic as the 40-hour-week figure is the average for all employees, that is including part-time workers, whose share of the total working population has risen to more than 25% and who currently work an average of only slightly more than 18 hours per week. So, holidays and official holidays have to be shortened. Increasing working time would, moreover, probably conflict with the preferences of older members of the workforce who represent an important target group in endeavours to raise participation rates. Older employees will probably be more inclined to want a reduction in their working hours and a more flexible transition from the employment phase to the retirement phase.

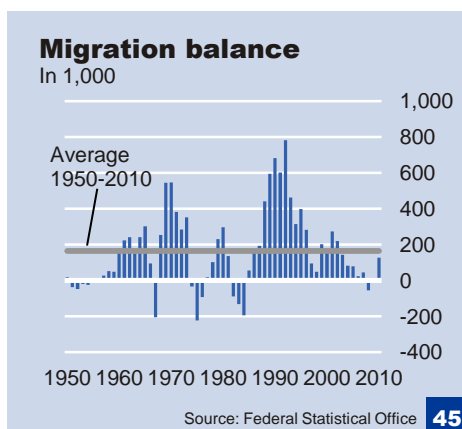
Option 3: Only increased immigration can mitigate the impact of demographic change

In recent decades net immigration to Germany has averaged around 160,000 people per year. This has occurred in different waves and for a variety of motives. Whereas in the 1950s and 1960s the reasons were primarily economic (recruitment of “guest workers”), in the 1990s it was mainly ethnic German repatriates, asylum seekers and refugees from civil wars who came to Germany. Following net negative migration balances in 2008 and 2009, which were probably due to the worsening of employment prospects for migrants caused by the economic downturn, last year saw a net migration inflow of 127,000 people.

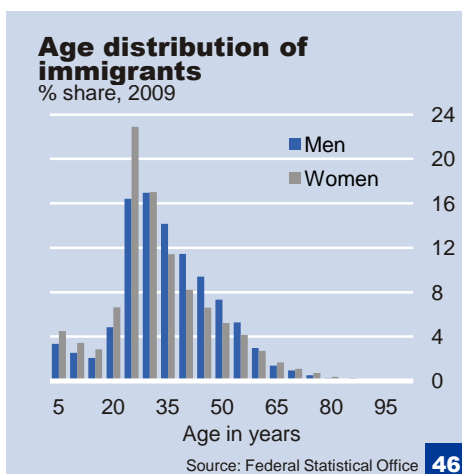
Given the age structure in Germany immigration is an ideal instrument for the labour market. Around 75% of immigrants are aged between 15 and 45, and the particularly economically active group of 20 to 30-year-olds make up nearly 40% of all immigrants. This hardly comes as a surprise given that economic considerations are the primary motivation for immigration. However, Germany's immigration law would need to be geared more closely to immigration by skilled workers in order to satisfy the demands of the labour market.

But can immigration on a realistic scale be sufficient to offset the impact of demographic change? In order to cancel out the contraction in the workforce of more than 6 million people in the “status quo” scenario by 2030 additional net immigration of over 300,000 people is needed each year. At its peak in 2030 this figure would be no less than 460,000. Since the population projection already factors in a net immigration of 100,000 persons p.a., total net immigration would have to total 400,000 per year, which is an unrealistic figure.

In our “the best” simulation, in which the age-specific participation rates rise to their respective highest levels of the industrial nations, only a few additional immigrants would be necessary until 2030. After the adjustment in labour participation has occurred the required additional immigration to Germany between 2030 and 2060 would need to total some 250,000 to 300,000 people per year – as in the “status quo” scenario. If annual working time were to be raised as described to the average level of the industrial countries between



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2030 and 2060, net immigration of only some 200,000 people per year would be needed to stabilise the labour supply.

Decline in potential labour force is inevitable

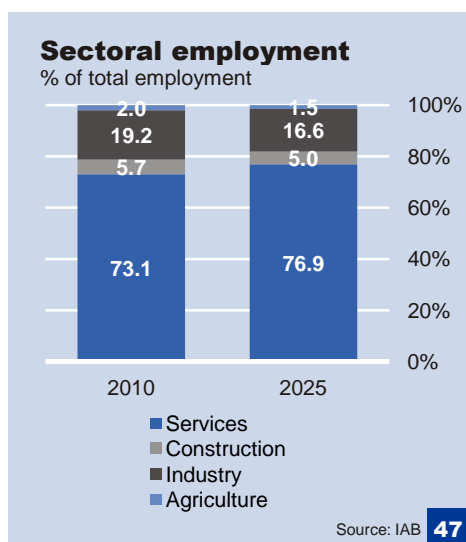
Only one-third of the impact of demographic change can at best be offset – based on realistic assumptions – and even then Herculean efforts and adjustments would be required in German society. Such adjustment processes cannot be ruled out since there are examples of industrial countries that fulfil the respectively selected upper limits for participation rates and annual working times. So nothing is impossible. Whether a consensus can, however, be found for this in German society appears more than doubtful as things currently stand. We therefore expect the workforce to shrink by 12 million by 2060, compared with about 14 million in the “status quo” scenario and about 10 million in “the best” scenario.¹⁴

Full employment forever?

Such a frightening contraction in the workforce does not, however, necessarily have to have negative consequences for society. On the one hand, the intense competition for skilled staff is likely to send salaries rising – to the detriment of the overall return on capital. On the other, the number of people in work will probably continue expanding until 2020 and will only decline slightly relative to the size of the labour force¹⁵. Accordingly, unemployment will fall significantly. This will apply primarily to skilled workers and the more highly qualified. However, the low-skilled will probably also benefit, among other things due to more attractive employment opportunities in domestic services if rising salaries for the more highly qualified increase the incentives to work full time and do overtime.

Change in sectoral employment – trend continues

Demographic change will also be accompanied by a shift in the structure of household consumption¹⁶. This will have a far-reaching impact on the sectoral structure of the German economy and thus on developments in sectoral employment. Transport, accommodation, healthcare and entertainment will in future probably account for a larger share of overall expenditure by households, with less therefore being spent on food, consumer durables and clothing. In this light and taking into account the contrasting productivity trends in the sectors this will lead to a considerable shift in sectoral employment. At the same time the already visible trend is likely to continue. The IAB expects that industrial employment (excluding construction) will fall nearly 15% on large productivity gains by 2025 and accordingly that the share of employed persons working in industry will decline from more than 19% to around 16 ½%¹⁷. The winners will be the service sectors of hospitality, healthcare and in particular housing and business services. In the healthcare sector



¹⁴ An IAB analysis finds that the potential labour force may contract by no less than 12 million or so by 2050 on net immigration of 100,000 persons per year and an increase in labour participation rates. See Fuchs, J., D. Söhnlein and B. Weber (2011). Projektion des Arbeitskräfteangebots bis 2050 – Rückgang und Alterung sind nicht mehr aufzuhalten. IAB Kurzbericht 16/2011.

¹⁵ The IAB estimates that the demand for labour will rise by about 400,000 persons by 2020 and then fall by around ½ million until 2025. See Fuchs, J. and G. Zika (2010). Arbeitsmarktbalanz bis 2025 – Demografie gibt die Richtung vor. IAB Kurzbericht 12/2010.

¹⁶ See Schaffnit-Chatterjee, C. (2007). How will senior Germans spend their money? Deutsche Bank Research. Current Issues. Frankfurt am Main. March 27, 2007.

¹⁷ See Fuchs, J. and G. Zika (2010). Arbeitsmarktbalanz bis 2025 – Demografie gibt die Richtung vor. IAB Kurzbericht 12/2010.



employment is set to rise more than 10% by 2025 and the share of total employment from more than 11% to nearly 13%. The IAB expects employment in the housing and business services sectors to rise even faster, so that this sector's share of total employment will climb by 4pp to 18%. There are also losers within the services sector, though. The IAB forecasts a decline in employment in the banking and insurance sector and in the distributive trade, for instance.

Demographically driven stronger focus on the domestic market

Demographic developments are likely to result in a stronger focus on the domestic market and bring about significant and sustained changes to the situation of businesses. A shrinking labour supply will probably lead to a shift in factor prices. Wages are set to rise, which will send up companies' labour costs, while at the same time the return on capital shrinks. On top of this, operating expenditure will rise in order to finance the skills upgrading of older employees so that they remain employable. Significant productivity gains can, however, hardly be expected given the ageing of personnel. Companies manufacturing in Germany are therefore likely to see their earnings squeezed. Skill shortages and a lower innovative capacity also suggest that the export industry, which has hitherto been the major driver of the German economy, will become less significant if its base in the domestic market is eroded. This is likely to apply primarily to the industries that provide innovative products for younger consumers. If a challenging domestic market does not exist then the international competitiveness of the industry could also suffer.

The shift in demand in an ageing society does, however, open up opportunities, especially in the pharma, healthcare and long-term care segments where demand is likely to grow sharply for demographic reasons. For instance, the number of people requiring long-term care should rise from 2 ¼ million at present to around 4 million by 2050 based on realistic assumptions, and even under very favourable conditions the increase should amount to at least 1 million¹⁸. This means that, for example, the market for care services, which still retains a strong national character, will become a "new" export success if it succeeds in delivering innovative and successful solutions to the problems that are looming.

Bernhard Gräf (+49 69 910-31738, bernhard.graef@db.com)

Note: The author would like to thank Manuela Peter for her assistance in researching and computing the extensive volume of data contained in this report.

¹⁸ See Blinkert, B. and B. Gräf (2009). Deutsche Pflegeversicherung vor massiven Herausforderungen. Deutsche Bank Research. Aktuelle Themen 442. Frankfurt am Main.

Germany's Euro-political mindset

As Germany is the largest economy in the euro area and has a major say in European policy, the markets focus squarely on this country's endeavours to solve the current eurozone debt crisis. This is why Germany's political decision-making processes, German popular opinion and the role of the guardians of its Constitution occupy the minds of many foreign observers. Here are the "top five" issues as well as our take on them.

1. How do Germans view the euro and current crisis management?
2. What positions do the political parties have on the euro crisis and the hot topic eurobonds, and is Euro(pe)-scepticism going to materialise in Germany's political arena?
3. Who has to agree to the EFSF II and the ESM, and can the required political majorities be gained to ensure their adoption?
4. What role is played by the Federal Constitutional Court, and what outcomes are to be expected in the cases now before the Court?
5. Can the euro crisis and the decisions being taken as part of crisis management efforts jeopardise Chancellor Merkel's government, or perhaps even trigger early elections?

July 21 decisions failed to calm market ...

On July 21, 2011, the eurozone heads of state and government took far-reaching decisions to stabilise the monetary union and provide further support for Greece. In this context, the resolutions on bolstering the EFSF in particular partially overstep the boundaries of the European policy pursued by Germany to date. The EFSF (and thus the ESM in turn) is to be given greater powers for conducting financial crisis management in the eurozone, partly via the possibility (under certain conditions) of intervening in the secondary market for sovereign debt, supporting individual countries in the framework of crisis prevention programmes and funding the recapitalisation of financial institutions via loans to the respective governments. The calming of the financial markets that was the purpose of these moves has been short-lived, however. In the meantime, financial market turmoils have returned and the ECB has even started to intervene in the Spanish and Italian bond markets via its securities markets programme. A major reason for the uncertainty in the markets is the risks linked with the legislative processes required in the national parliaments of the member countries, because social and political opposition to the extensive financial bailout measures is growing particularly in the key guarantor countries.

... not least because implementation risks remain

1. How do Germans view the euro and the current crisis in the eurozone?

Most Germans are familiar with a line from Heinrich Heine's poem "Germany: A Winter's Tale" (1843) which roughly translates to "Should I think of Germany at night, it puts all thought of sleep to flight". Expanding on this quotation, the substitution of "Europe" for "Germany" no doubt neatly captures the way many of them feel at present. Their reasons differ, though: while some of them are worried about the future of the eurozone and society's (decreasing) acceptance of the European project, others convey the impression in surveys that they long for the return of the D-mark and show absolutely no sympathy for the idea of "European solidarity".

There are two reasons Germans were reluctant to relinquish their national currency and accept the euro. First, the D-mark was a



Good international standing of the D-mark and respect of Bundesbank left no desire for a common currency

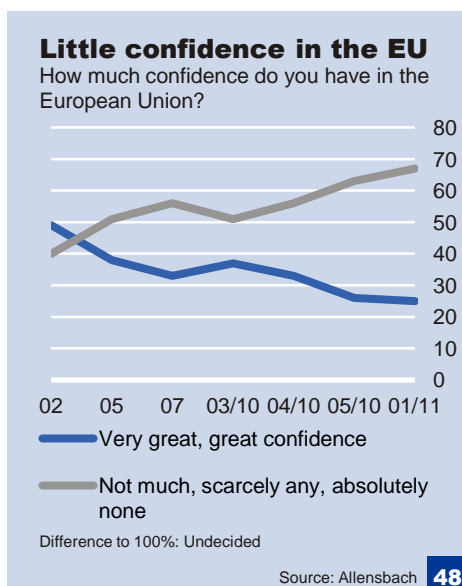
stable currency of international standing. Even at times of low inflation rates, price stability has invariably been one of the nation's key political priorities, partly because the perceived inflation at any given time is in most cases exceeding actual inflation rates. This is a reflection of the hyperinflation of the first half of the 20th century and the conviction that excessive government debt feeds inflationary trends. The second reason is the general respect commanded by Germany's Bundesbank, with its independence considered to guarantee monetary stability. It has never been easy for the (young) ECB to lay claim to a similar reputation, even though its record on price stability during the first 10 years of EMU was every bit a match for the performance of the Bundesbank in earlier decades. The way the ECB has acted during the euro crisis, in particular the launch of its securities markets programme (SMP), is regarded by many people as an indication that the ECB ultimately defers to the wishes of Europe's politicians and thus leaves its independence open to question – a view that has probably been reinforced yet again by the latest purchases of Italian and Spanish sovereign debt. **The Germans are perceived to lack solidarity with the debtor countries of the eurozone. This may be largely explained by Germans' fears of the internal and external value of the euro deteriorating and of the ECB's independence being jeopardised.**

Scepticism towards the single currency did not even change during EMU's "good years":

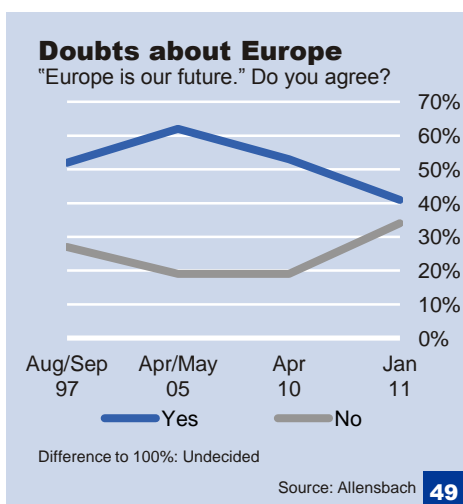
The scepticism towards the single currency did not even change during EMU's "good years": at the beginning of 2011 some 22% of all Germans said they had great or very great confidence in the euro, while 69% claimed to have little or no confidence in it. Throughout the years of the euro's existence the survey values have scarcely budged from the levels recorded in the first survey in 1995, that is some 16 years ago!¹⁹ Some 40% of Germans continue to wish for a return to their former currency. Granted, this reading can also be found in other eurozone countries and the responses differ sharply between generations. At the same time, however, the Germans are entirely realistic: a mere 9% thought in April 2010 – when the Greece crisis came to a head for the first time – that it made sense to abolish the euro and return to the D-mark.

The general and recently further increased lack of confidence in the euro, as we see it, presumably also results in the predominance of unbridled scepticism towards supporting debt-ridden eurozone members. Germans often feel their attitude is vindicated by the fact that the majority of German economists have heavily criticised the crisis measures and thus allegedly confirmed the nation's early doubts about the introduction of a common currency. However, the ambivalence on European issues emerges again in Germans' assessment of individual crisis management measures. Whether the issue is the suitability of a European rescue package or whether highly indebted countries should be excluded from EMU – those "for" and those "against" roughly balance each other out. A splitting of the eurozone, as demanded by some economists, is rebuffed though by nearly 50% of all Germans as not being a good suggestion; this signals both a sense of community as well as well-understood economic self-interest.

Despite the widespread unease over the eurozone crisis (and the ambivalence towards other decisions in the EU), **so far there has**



¹⁹ This is based on analyses conducted by the Institut für Demoskopie Allensbach, an institute for public opinion research, which regularly surveys Germans on their attitude towards European issues.



been little sign of rampant anti-Europe sentiment among the German population at large. However, current surveys (see charts 48 and 49) indicate that the fundamental pro-Europe stance is increasingly eroding. One aspect which may have bolstered these developments lately is that not everyone is still aware that Germany's strong economic and political role in the world is closely linked with its key position in Europe. But perhaps what is even more important is that in a country like Germany, which attaches such high priority to monetary stability, a progressive loss of confidence in the currency also has an influence on the general attitude towards Europe. This, however, may be more attributable to poor political communication on developments at the European level including the growing economic and political significance of the EU for Germany than to a fundamental popular abandonment of "Europe". Finally, the media's undifferentiated negative picture of the situation in Europe has also shaped public opinion.

In the German business community, which had committed strongly to the introduction of a single currency in the light of its heavy export bias, comments on the quality of euro crisis management go in both directions. The majority of leaders of organised business support the stabilisation measures and are seeking concrete ways to improve the investment situation in the affected countries.

2. What positions do the political parties have on the euro crisis and the hot topic eurobonds, and is Euro(pe)-scepticism going to materialise in Germany's political arena?

All of Germany's postwar governments and the respective constituent political parties have pursued a pro-European course, which mainly consisted in Germany's being a partner of France as the patient engine of the European integration project. Over the past two decades, though, Germany has increasingly become a "normal" country of Europe; in addition, in recent times it has regained a degree of economic clout that clearly sets it apart from its European partners. The difficulties facing some EMU member countries have reinforced Germany's convictions about its own economic priorities and principles. This has increasingly prompted some to question the political and economic benefits of European integration for Germany, a debate that has already raged for a long time in respect of Germany's (net) contributions to the EU budget, but the fire has now been stoked again by the latest decisions and the related foreseeable fiscal commitments to stabilise EMU. Some already fear that strong German interests might become a centrifugal force in the eurozone and thus in the EU. As things stand today this would seem somewhat far-fetched, but there is a growing risk that EMU countries with debt problems may interpret European solidarity too one-sidedly and thus hamper the room for manoeuvre even of the pro-European governments in the economically robust countries. In any event, there is likely to be more – and an increasingly public – dispute over the future course of European policy than has been the case so far – not only between the various political parties, but also within the parties themselves.²⁰ Furthermore, because of the already resolved agreements and the plans that Chancellor Merkel and President Sarkozy revealed at their bilateral meeting on August 16 – e.g. to progress with the long-debated harmonisation of corporate

Pro-European stance of Germany ...

... might be endangered by a too one-sided interpretation of solidarity by indebted members of the eurozone

²⁰ There will be a special convention of the CDU/CSU's Bundestag parliamentary group on August 23 to debate the eurozone crisis and the upcoming legislative procedure to implement the July 21 Council decisions.



tax bases and ranges for tax rates as soon as 2013²¹ – the crisis will probably require that decisions be made which will lastingly change the E(M)U institutional setting. Therefore, these cannot be taken without the backing of the populace. We think **the implications are that Europe will increasingly become an election campaign issue in Germany – at least at the federal level.**

Germans' increasing unease over the developments in the eurozone is mirrored in internal party discussions

Germans' increasing unease over the developments in the eurozone is mirrored in internal party discussions on the "right" way to stabilise the eurozone and deal with the highly indebted countries. In this context, the (centre-right/conservative) CDU/CSU and the (liberal) FDP view financial pledges – also in the form of guarantees – and related contingent liabilities for the federal budget more critically than the (centre-left) SPD or the Greens – which partly reflects the respective general party line on fiscal policy and certainly the fact that they are currently not in charge and hence not responsible to sell an union with unlimited liability to the people. The parties also have somewhat differing assessments of the increased risk that the ECB may mix monetary and fiscal policy in its crisis management and thus harm its credibility on a long-term basis, but they all generally take a more critical stand than the political parties in most of the other euro countries. The demand for private sector involvement in debt restructuring efforts is common to all the political parties in Germany, as is the call for stronger participation by the Bundestag in decisions pertaining to new support measures.

Eurobonds have recently topped the political agenda

The very recent vehement demands for **eurobonds** voiced by Italy, Luxembourg's Prime Minister Jean-Claude Juncker and also some factions of the European Commission **are highly contentious as far as German policymakers are concerned.** The ruling coalition's FDP and CSU members are fundamentally opposed to eurobonds for legal as well as economic reasons, while the CDU has adopted a very critical stance. Finance Minister Wolfgang Schäuble (CDU) has just reiterated his position that eurobonds can be ruled out as long as the member states have the option of conducting their own fiscal policy and the EU requires different interest rates to provide incentives and sanctions in order to secure fiscally sound policy. The SPD and Green opposition members speak about eurobonds in much more conciliatory tones than the ruling coalition. However, the SPD also says the introduction of eurobonds will need to be accompanied by corresponding measures: "Eurobonds will succeed only if complemented by new, far-reaching political reforms. This means empowering European institutions to establish tighter controls over fiscal and economic stability, alongside common minimum standards on wage and welfare policies, as well as capital and corporate taxation."²² Both parties also tend to put a ceiling on the national debt that could be refinanced by eurobonds.²³ However, even this assessment shows that eurobonds are not perceived as a silver bullet to solve the current eurozone crisis. Rather, they are regarded primarily as a measure to avoid necessary consolidation and structural reforms at the national level. Indeed, so far no economically convincing and practicable proposals have been put forward as to how eurobonds could be introduced without producing huge moral hazard problems. At the same time, not a single euro member

Eurobonds no economically and politically convincing solution to the eurozone debt crisis

²¹ The European Commission put forward a proposal for a Common Consolidated Corporate Tax Base, CCCTB, in May 2011 allowing businesses a one-stop-shop system for filing their tax returns and to consolidate all profits and losses they incur across EU members.

²² Steinmeier/Steinbrück: Financial Times. December 14, 2010.

²³ This refers to a paper by the Brussels Think Tank Bruegel "The Blue Bond Proposal", May 2010.

Strong resistance in the ruling coalition

country shows signs of having political and popular majorities which, in return for the introduction of eurobonds, would be willing to relinquish budget-making rights and a substantial share of economic policy sovereignty.

Within the party political spectrum, the FDP has the most obvious reservations about the road taken towards stabilising the eurozone and is most openly worried about the prospect of Germany inexorably slipping into a European transfer union²⁴. Some observers presume that the FDP could increasingly concentrate on the Europe issue in order to embrace and play to current popular fears. This raises the question of whether growing popular Euro-scepticism might not tend to lead to a change of position among the existing parties and/or whether in fact, like in other European countries, entirely new parties might be founded. Forecasting how this issue will play out is not easy. There is much to suggest that the CDU's pro-Euro(pean) loyalty is no longer as fundamental as it used to be, a fact partly attributable to the new generations coming up through the ranks. Besides, the potential for changes of tack was recently demonstrated in the field of energy policy. Unlike the exit from nuclear power, though, a potential exit from the euro currently still does not resonate with a large enough swathe of society. This would not seem to bode well for the prospects of a new party being founded that would attract sufficient voter support.

3. Who has to agree to the EFSF II and the ESM, and can the required political majorities be gained to ensure their adoption?**Related national legislative process is only in its infancy**

The related national legislative process is only in its infancy, since the new EFSF II Framework Agreement which fleshes out the decisions of July 21 still has to be finalised and signed by the finance ministers of the eurozone countries. The form in which the results of the July 21 summit are embedded in the already adopted ESM agreement will also require clarification at the European level. For this reason there are no plans for the Bundestag to convene during its summer recess for a special sitting on the euro crisis.

However, the German government is seeking to have the legislative process pushed through by September 23. Yet, to do so, the deadlines and consultation periods for the two chambers of parliament, the Bundestag and the Bundesrat, will have to be shortened and a host of important reform details presumably might not make it into the bill until the time of parliamentary reading. It remains to be seen, though, whether the Bundestag is prepared to charge ahead with a renewed parliamentary *tour de force* given the far-reaching changes to the EFSF II.

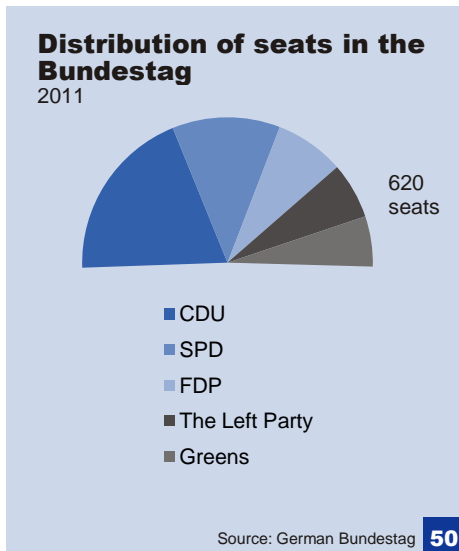
Four legislative bills will have to go through the mill to implement the European decisions taken in the course of this year. These will require differing majorities:

- Ratification of the amendment to the EU Treaty (Art. 136 III of the TFEU) as well as ratification of the international agreement to set up the ESM will require a two-thirds majority in the Bundestag and the approval of the Bundesrat.

²⁴ At its federal convention in May 2011 one-third of the FDP delegates voted for a resolution rejecting, among other things, the installation of the ESM. Ultimately, though, the lead motion put forward by the party leadership providing for approval of the ESM under certain conditions was carried by a large majority. How delegates vote at party congresses does not entirely dovetail, though, with how their respective members vote on the relevant issues in the Bundestag.



- The legislation accompanying the ESM as well as the amendment to the EFSF law (StabMechG) will require a simple majority of the members of the Bundestag.
- The agreement among the EMU governments to take recourse to the EFSF II for the new Greece package requires *no* legislative measures. However, government action is predicated on agreement being reached with the budget committee of the Bundestag.



The parties of the ruling coalition – the CDU/CSU and FDP – currently boast a 20-vote majority in the Bundestag (see chart 50). However, the government's European policy thrust is very much the subject of internal bickering; at the last vote on the Greece rescue package and on the EFSF in May 2010 a number of coalition members refused to toe the party line. Next time round, presumably not all of the CDU/CSU and FDP members of the Bundestag will want to vote for the EFSF II with its expanded scope of competence; a few CDU members have even called for an extraordinary party congress on the euro crisis. Back in February the parliamentary factions of the CDU/CSU and FDP had also already tabled a resolution expressly stating their reservations about interventions in the secondary market as well as to commonly funded or guaranteed debt purchase programmes – instruments that have now been conceded to the expanded EFSF. On the other hand, a key condition demanded by the FDP in particular was met in the shape of private sector involvement in the restructuring of Greece's debt. For this reason, immediately following the summit the party leaders and the heads of the parliamentary factions welcomed the decisions as being largely on target. Furthermore, the judgments of Germany's Federal Constitutional Court are likely to ensure that the cross-party demand for the right to parliamentary approval of budget-relevant decisions taken by the EFSF or the ESM is included in the acts of assent. **Therefore, as things stand today, we continue to believe that the various legislative proposals will find the necessary majorities in the Bundestag.**

German opposition has offered its parliamentary support

This holds all the more since ahead of the last EU summit the SPD had expressly offered its parliamentary support to the federal government in efforts to address the eurozone crisis. The other opposition party of relevance, the Greens, has also signalled its willingness to cooperate, suggesting that in cases where a two-thirds majority is required in the Bundestag the result of the vote will be positive. This provides evidence yet again that in situations which are critical for European policy decisions it is indeed possible in Germany to organise voting majorities that cross party lines. Of course, it would be an unfortunate political signal if the government had to rely on support from the opposition camp even to pass legislation requiring merely a simple majority of votes (i.e. the majority of the members present and participating in the vote). This would probably lead to substantial problems within the ruling coalition.

4. What role is played by the Federal Constitutional Court, and what outcomes are to be expected in the cases now before the Court?

Ever since the signing of the Maastricht Treaty in 1992, the main steps on the road to European integration (EMU, Lisbon Treaty) have been accompanied in Germany by appeals to the Federal

Federal Constitutional Court offers a forum for presenting positions and arguments that are more critical towards integration via the route of the constitutional complaint

Constitutional Court.²⁵ There have always been two main reasons for such complaints being lodged: one is that constitutional law specialists in particular demand a clear demarcation between German constitutional law and European law in order to underpin the shift towards closer European integration. The other reason is that in Germany – so far – there has not been any hard-hitting debate over the direction of European integration; Euro-sceptical positions are not to be found in any party manifesto. Thus, the Federal Constitutional Court offers a forum for presenting positions and arguments that are more critical towards integration via the route of the constitutional complaint. This last aspect in particular is probably going to play a key role considering the political decisions being taken during the eurozone sovereign debt crisis, because the individual steps, albeit easily justifiable, could ultimately change the structure of the E(M)U in the long run. So far, though, there has not really been any political debate on the matter.

The cases currently pending have had an impact on Germany's European policy almost from the start

The cases currently pending have had an impact on Germany's European policy almost from the start. To avoid contravening the so-called non-bail-out clause (Art. 125 of the TFEU), the German government took pains to ensure that the measures adopted in the first rescue package for Greece and later in the EFSF focused on the stability of EMU. The refusal to concede the EFSF competence to intervene in the secondary market for government securities was borne by this legal standpoint as was the desire to amend the Lisbon Treaty in order to make further eurozone stabilisation measures less vulnerable to attack on constitutional grounds. The amendment to Art. 136 of the Lisbon Treaty²⁶ should, as generally opined, now also cover the fact that the scope of EFSF II interventions may, in keeping with the decisions of July 21, no longer only be used as the "ultima ratio", but instead become a potential instrument for EFSF II to take pre-emptive action in the secondary market.

Economic considerations will play no role for the Constitutional Court

How is the Federal Constitutional Court expected to rule on the complaints pending? In the public hearing on July 5 the president of the Federal Constitutional Court made clear what was *not* at issue: he said economic considerations would not play a role and there would not be any proceedings on the future of Europe and the right economic strategy to cope with the sovereign debt crisis. He said this was the job of politicians and not of jurisprudence. However, the Federal Constitutional Court would have to gauge the limits set by the Constitution for policymakers when they address this task. This means that the widespread market **fears that the Federal Constitutional Court might possibly demand the "reversal" of crisis management decisions taken at the European level are probably largely unfounded.** By contrast, the focus is likely to be on the rights of the Bundestag to have a say on matters, particularly with regard to budget responsibility.²⁷ Quite a few parliamentarians consider the Bundestag's budget say to be undermined by the EFSF II and/or ESM fiscal aid measures, even though the deployment of

²⁵ For a more detailed discussion of pending constitutional complaints see Nicolaus Heinen. German Constitutional Court: Rejection of Rescue Packages Unlikely. Focus Europe. March 4, 2011.

²⁶ "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

²⁷ In a judgment on the Lisbon Treaty in respect of monetary union the Federal Constitutional Court had already warned back in 2009 that the information rights of the Bundestag had to be improved.



such measures may only be approved unanimously by the euro-area members. The Federal Constitutional Court will probably find that the Bundestag has to be granted greater authority to participate also in terms of content, e.g. in decisions on new aid programmes. Authorisation of individual credit tranches or market interventions could, by contrast, remain in the hands of the executive, that is, the ministries, for reasons of practicability alone.

Court's judgement expected for September

The Federal Constitutional Court has announced it will hand down its judgment on September 7. It would make sense for the German government to await the decision so it can include potential stipulations of the Court in the final version of the legislation accompanying the EFSF II and the ESM and thus create legal certainty. The Court decision may prove to be only of relevance at first for the ESM. However, the renewed flaring-up of the euro crisis around Italy and Spain has likely intensified the time pressure to equip the EFSF with powers and make its stabilisation instruments ready for deployment as rapidly as possible.

5. Could the euro crisis and the decisions being taken as part of crisis management efforts jeopardise Chancellor Merkel's government, or perhaps even trigger early elections?

Crisis management places substantial strains on the parties' political capital and eroding government credibility in almost all eurozone countries

The difficult decisions that have had to be taken in recent weeks because of the eurozone crisis are in some cases exerting substantial strains on the parties' political capital and eroding government credibility. This holds on the one hand for the governments of the countries that have launched huge reform programmes to consolidate their national budgets. The political majorities required to implement these reforms are thin on the ground, and the enthusiasm of the public to accept the painful adjustment steps is waning at the same time. Spain is a case in point: early elections have now been called there for November 20, 2011. And, on the other hand, in the euro-area countries that are key guarantors of the bailout measures, too, there is growing political and social resistance to the steadily growing (financial) commitments. There are even fears that incumbent governments could fall if they are unable to find majorities for the upcoming parliamentary voting processes on the EFSF II and the ESM and/or if the governments approve still further-reaching programmes to prop up the euro which do not enjoy the support of the nation or its parliamentary representatives.

Procedure for early elections is very complicated under Germany's Constitution

Are early elections a probable scenario for Germany? Not likely. Apart from the fact that we believe there is every likelihood of the ESM and EFSF II legislation being adopted (see point 3), the procedure for early elections is very complicated under Germany's Constitution. The Bundestag does not have the right to dissolve itself; an incumbent government cannot simply shorten the normal parliamentary term. Political stability and lessons of history are the reasons that a complicated procedure has to be triggered to allow early elections in Germany. Ultimately, there are only two ways to do so:

Vote of confidence

— The incumbent chancellor can call for a *vote of confidence* (Art. 68 of the Basic Law). If the motion fails because the majority of the Bundestag members refuse to affirm their confidence, the chancellor may request the federal president to dissolve parliament within 21 days and set an election date. This was the route taken by then-Chancellor Schröder on July 1, 2005, because following a series of SPD and Green party losses in

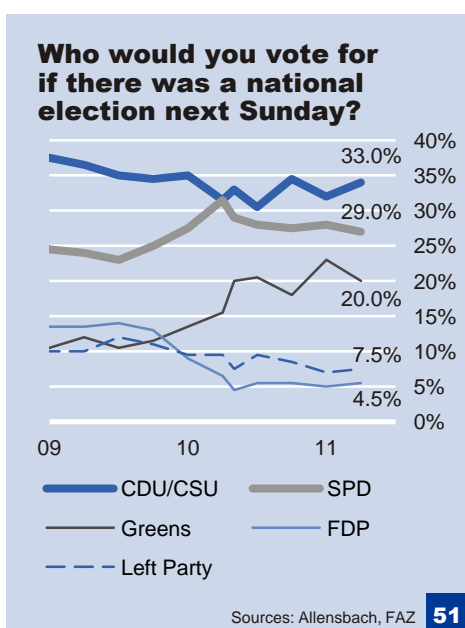
state elections he believed that his reform policies no longer had sufficient legitimate backing. The subsequent election in September 2005 culminated in a ruling coalition of the CDU/CSU and SPD parties under the leadership of Angela Merkel. In the current environment Chancellor Merkel could link a vote on the EFSF II and the ESM with a vote of confidence in order to bring greater pressure to bear on the deputies of the ruling parties to close ranks and produce a (positive) outcome reflecting the government's line. However, considering the currently existing majority conditions, such an approach seems very improbable.

Constructive vote of no confidence

- The other route to early elections would be by way of a *constructive vote of no confidence* and a related failure to elect a new chancellor (Art. 63 GG). This stipulates that the Bundestag has to vote out the incumbent by absolute majority (“chancellor majority”) and at the same time vote in a new chancellor. If this procedure is successful, the Bundestag retains its current composition; otherwise, it is dissolved. The constructive vote of no confidence paves the way for two further options, regardless of the objective of early elections. One is that the ruling parties represented in the Bundestag have the possibility of switching their head of government, so to speak, if they are dissatisfied with that person’s leadership. However, this is predicated on a new candidate being able to claim 100% of the votes – even in a situation in which the incumbent has poor popularity ratings and maintains political positions that run counter to the will of his or her party, this is a very difficult proposition. This has never happened before in the history of the Federal Republic of Germany. The other option is that a constructive vote of no confidence can trigger a “seamless changeover” between ruling coalitions. In October 1982, the then-leader of the opposition, Helmut Kohl (CDU), was elected chancellor, ousting Helmut Schmidt (SPD), because the FDP had left the ruling coalition with the SPD and teamed up with the CDU/CSU.

Comparisons can be made with the present situation insofar as the FDP is tending to have difficulties with the decisions on European policy being taken by the Merkel government, and so far the FDP has not been able to push through other demands from its own agenda (tax cuts, reform of the health system). By contrast, for some CDU/CSU deputies a revival of the grand coalition of CDU/CSU and SPD would appear to harbour fewer sticking points on content than has been the case in the current ruling coalition. What argues against such a “seamless changeover” today, though, is that, firstly, the SPD is scarcely likely to be interested and, secondly, the CDU is not really united on this issue – there is even considerable support for a CDU/Green option, no less. So, owing to the lack of politically viable majorities, these may all be regarded purely as talk.

Nonetheless, it is indeed impossible not to notice the dissatisfaction within the CDU/CSU over the course of policy, and this can be seen not only with regard to European issues but also with regard to the abolition of compulsory military service, the *volte-face* on energy policy and the general debate on tax policy. Going by the objectives set out in the coalition agreement, the Merkel government’s record as of the halfway point in its term is not really convincing, in our opinion. Opinion polls (see chart 51) show that the ruling coalition had lost its majority by last autumn at the latest. However, in our understanding this has nothing to do with public uneasiness with the eurozone crisis management. The polls primarily reflect domestic





No persuasive reasons for dissolving the Bundestag

policy issues and the overall impression of the government's performance.²⁸ More importantly: The weak scoring of the ruling coalition is mainly due to the poor ratings given to the liberal coalition partner, the FDP, and – in the opposition camp – to the advances made by the Greens. Chancellor Merkel will likely have to gird herself for a battle over her government's tack, on European policy in particular, at the CDU's party convention in November. Nonetheless, there are no persuasive reasons to be seen that the current government under Chancellor Merkel or the majority of the members of the Bundestag should want to shorten their term of office or feel compelled to call for early elections. **We continue to expect the next federal election to be held on schedule in autumn 2013.**

To sum up: Germany's implementation of the decisions already taken to stabilise the eurozone will probably be accompanied by a considerable political hue and cry, but ultimately the process is not likely to be truly jeopardised. But the more the character of the monetary union threatens to turn into a real transfer union – partly because highly indebted euro-area countries are unwilling to seize rigorous consolidation and structural reforms or else because the ECB gradually monetises sovereign debt – the greater the societal and political opposition in Germany is likely to become. It will probably be virtually impossible to push through eurobonds given the current majorities in the Bundestag. For the near future it appears that, for different reasons, hardly any of the EMU countries is likely to find political majorities enabling the quantum leap required to establish a real fiscal union that links current budget transfers with the surrender of national budget sovereignty. Thus, market hopes for a big-bang solution will likely continue to be disappointed. Instead, the step-by-step approach to improving eurozone economic governance and ensuring sound national fiscal policies – as just illustrated by the joint recommendations of Angela Merkel and Nicolas Sarkozy on debt brakes²⁹ being anchored in national constitutions by 2012 – is the only politically realistic avenue available.

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

²⁸ When the electorate starts to recognise the opposition's far-reaching willingness to bail out indebted euro members and introduce eurobonds, support for the SPD and the Greens is certain to decline.

²⁹ For the beneficial effects of eurozone-wide balanced-budget rules along the lines of the German debt brake, please refer to DB Research. EU Monitor 74. Debt brakes for Euroland.

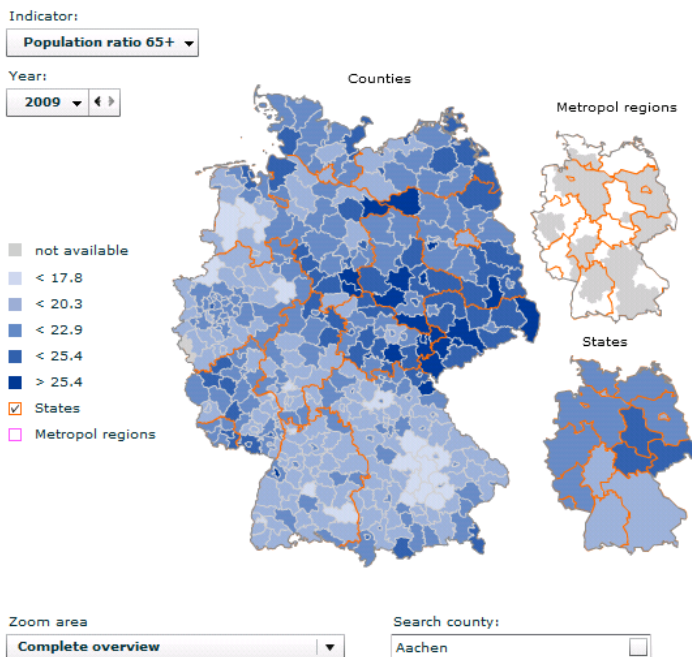


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