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German election: stability-led complacency

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- The German election will take place on September 24. Polls indicate a fourth term for Chancellor Merkel but it remains to be seen with which coalition she will govern. The booming economy has fostered cross-party complacency and prevented the necessary debate about how to ensure Germany's future prosperity.

- The robust cyclical upswing is masking the creeping erosion of growth. By 2025, trend growth looks set to halve to only ¾%. To promote growth, measures to increase the participation rate, improve education and support more technological specialisation should rank high on the political agenda. None has made it into the public debate.

- The sustainability of the welfare system has been eroded by the outgoing coalition. Already, welfare spending accounts for a growing share in GDP (29.3%) and general government spending (43%) while demographics suggest further cost increases. The widespread feeling of rising inequality – although less evident in actual data – makes promises of even more social good deeds a temptation for parties.

- German public finances are in a comfortable situation with a budget surplus of 0.8% of GDP and the debt ratio likely to drop below the Maastricht limit of 60% of GDP by end-2020. However, rising interest rates and the ageing society look set to put public finances under considerable pressure in the medium-term.

- The future of E(M)U is not dominating the election campaign. There is a general mood among the mainstream parties to move forward and to leverage Franco-German relations for joint initiatives. We remain sceptical, though, that the next German government would be prepared for a quantum leap in the institutional framework of EMU.

- With pressures to meet the 2% NATO objective and related European initiatives, parties are being forced to take a position on the international security framework. To reach the NATO target by 2024, defence spending would have to more than double to EUR 80bn. We consider this unlikely. While the centre-right parties pledge themselves to the NATO objective, the centre-left reject the increase in military expenses.

- Germany's ageing society appears happy with the "status quo" and is more than happy to believe politicians' promises that this can be maintained in the future without any bigger (and painful) changes.

Slowing German trend growth does not seem to be a major issue in the electoral campaign

We published a Special Report on 03 July 2017 and the key points are below:

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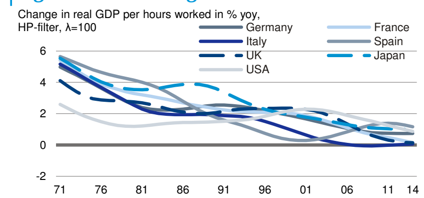
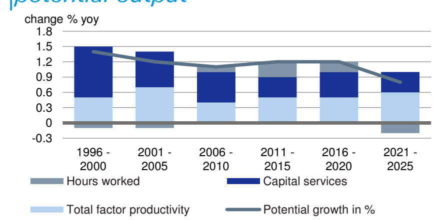
- **The developed industrial countries have experienced a steady decline in trend growth since the mid-70s – and Germany is no exception.** By 2025, trend growth looks set to halve again, to only ¾%.
- **The robust cyclical upswing is veiling this creeping erosion of growth.** The situation is rendered even graver by the fact that policymakers did not adopt significant measures to support growth during the past legislative period; indeed, they even scrapped some important reforms.
- **The performance of the German economy depends on three input factors: labour, capital and technological know-how.** Labour productivity growth is determined by capital intensity, the qualifications of workers and the pace of technological progress.
- **Labour, as an input factor, is suffering from the ageing and shrinking of the population.** Demographic changes will reduce the workforce.
- **The capital stock is currently growing at a subdued clip** and investment activity is moderate.
- **The current level of technological know-how is reflected in total factor productivity.** The growth contribution of total factor productivity has recently declined, possibly because the benefits of specialisation are shrinking and because input factors have been reallocated less efficiently.
- **It is absolutely necessary to raise the participation rate.** Against the background of accelerated structural change, this can be achieved only if the general level of qualification is raised and it becomes easier to reconcile a career and a family, particularly for women.
- **Better education and vocational training will also help to improve the quality (and thus raise the growth contribution) of labour.** More day schools are a step in the right direction. At the same time, digitalisation increases the need for regular professional training.
- **Specialisation helps to lift productivity.** That is only one reason why policymakers should support free global trade. If conditions for businesses are improved as well, Germany might see stronger capital stock growth and benefit from competitive advantages in the future.

Figure 1: Trend growth



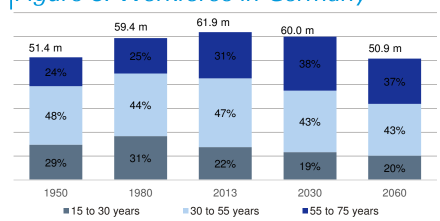
Source: German Council of Economic Experts, Deutsche Bank

Figure 2: Medium-term projection of potential output



Source: Deutsche Bundesbank, Deutsche Bank

Figure 3: Workforce in Germany



Figures 2030 and 2060 based on results of the 13th coordinated population projection (var. 2). Source: Federal Statistical Office of Germany, BiB, Deutsche Bank

Parties not focusing enough on sustainability

We published a [Special Report]() on 17 July 2017 and the key points are below:

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- **The debate over welfare policy in Germany appears to be paradoxical.** On the one hand, revenues and spending in the welfare systems have never been so high – and both are set to continue to increase sharply. In 2015, welfare spending per capita reached almost EUR 10,900 – some 9% higher than in the UK. Nevertheless, some critics believe that there is a social imbalance.

- **The welfare system is better than its reputation in Germany suggests.** Social security continues to have a positive impact. Welfare spending significantly reduces the number of people at risk of poverty (2015: from 25.1% to 16.7%). In particular, there is no reason to interpret the situation facing the elderly as dire. The number of elderly recipients of basic welfare benefits has fallen by 2.5% over the past year. By contrast, single parents and the unemployed are at higher risk of poverty. This shows how important integration into the labour market is to prevent poverty.

- **The welfare system operates under favourable conditions at the moment.** Not only is it benefiting from the positive economic trend, the impact of population ageing is (still) relatively low. The number of over-65s has only increased by roughly 0.2 million on average over the past few years, whereas this figure is expected to grow by double that margin annually over the next decade. This means that rising welfare costs are on the horizon.

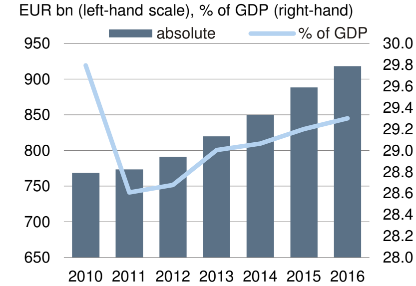
- **However, planning for the future is playing second fiddle to another issue on the campaign trail.** Instead, many proposals are based on further expansion of the welfare state, even though the current government has already burdened taxpayers with avoidable costs.

- **The Social Democrats (SPD) and the Left (Die Linke) in particular want to move away from consolidation of the public pension scheme.** A guarantee of the current replacement rate (48% of average income) and stable contribution rates can exist in the scheme only if there are no barriers to long-term economic growth and to labour market flexibility and if government subsidies to the scheme increase further. However, the former does not hold at the moment and would likely be thwarted by the latter.

- **In terms of healthcare, the Free Democratic Party (FDP) is one of the main proponents of increased competition.** The SPD, the Greens and the Left want to merge private and statutory health insurance into a single "citizens' insurance" system. However, it is doubtful whether this would lead to "greater equality" given the opaque and unmethodical distribution of costs through income-dependent contributions. Provisions are set aside for old age in private health insurances, so long-term sustainability in the healthcare system would be lost in the event of a merger.

Figure 4: Increased welfare spending

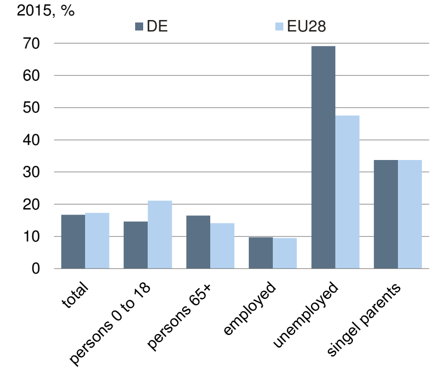
EUR bn (left-hand scale), % of GDP (right-hand)



Source: BMAS, Statistisches Bundesamt, Deutsche Bank

*Figure 5: At-risk-of-poverty rating**

2015, %



**At risk of poverty = less than 60% of the medianequivalent income of the population as a whole Source: Eurostat, Statistisches Bundesamt, Deutsche Bank*

Germany's fiscal situation

We published a Special Report on 19 July 2017 and the key points are below:

- **In an international comparison, Germany's fiscal situation is very good – thanks to robust GDP growth and zero interest rates.** Other important industrial countries, such as the US or Japan, are still struggling with high fiscal deficits and rising public-sector debt. Germany, however, is the only G7 country that has generated fiscal surpluses since 2014, helping to considerably reduce its debt ratio.

- **In the short to medium term, dynamic revenue growth should help ensure that Germany's fiscal situation remains comfortable, even though expenses look set to rise strongly as well.** The budget complies with both national and European debt-limiting rules, and there is a considerable safety margin. The 2017 update of the Stability Programme foresees positive fiscal balances at the general government level for the years from 2017 to 2021, which means that – provided growth remains strong and interest rates low – the debt ratio might drop below the Maastricht limit of 60% of GDP by end-2020.

- **Public finances are currently benefiting from buoyant growth, low interest rates and a "demographic respite". According to our calculations, the German government saved almost EUR 260 bn in interest payments between 2008 and 2016.** However, the current fiscal surplus, which is to a large extent due to these special factors, should not be used to justify permanent expense increases or cuts in taxes and/or social security contributions.

- **Rising interest rates and the ageing society look set to put public finances under considerable pressure beginning in the middle of the coming decade.** The ageing society will result in significant burdens for public budgets in the near future, as government revenues (taxes, social security contributions) will probably advance at a slower pace on the back of a shrinking workforce and lower potential growth, while government expenses boom at the same time (in particular for statutory pensions, healthcare and old-age care).

- **However, the long-term fiscal risks do not appear to play a major role in the current election campaign.** Rather, politicians have included calls for tax cuts and expense increases in their parties' election programmes given the current favourable fiscal situation.

- **To prepare the economy and public-sector finances for the ageing of the population and avoid major abrupt fiscal adjustments in the future,** the parties should not make increasingly more electoral promises that they will be hard pressed to pay for in the longer term.

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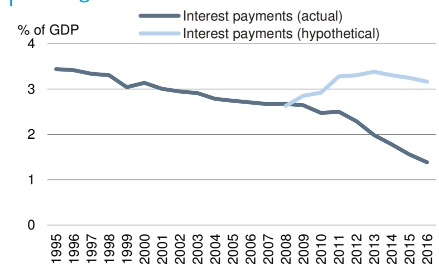
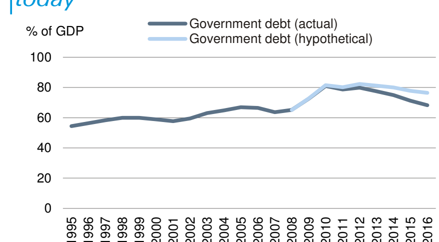
Figure 6: Low interest rates have helped the government to save interest to a significant extent



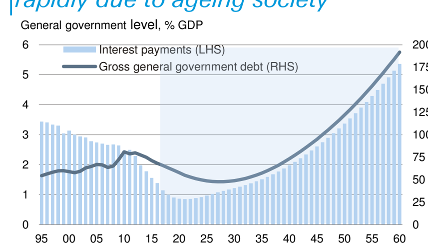
Hypothetical interest expenditure calculated on the basis of an unchanged implied interest rate of 4.2% (level of 2007() from 2008 .
Source: AMECO, Eurostat, Deutsche Bank

Figure 7: Without the low interest rates, the level of debt would be higher today



Hypothetical interest expenditure calculated on the basis of an unchanged implied interest rate of 4.2% (level of 2007) from 2008.
Source: AMECO, Eurostat, Deutsche Bank

Figure 8: German debt ratio might rise rapidly due to ageing society



Source: AMECO, Deutsche Bank

Packed European agenda for the next government

We published a Special Report on 03 August 2017 and the key points are below:

- **The now more benign economic and public environment in the EU allows it to fundamentally address shortcomings of the E(M)U.** The current backlash of populism, rising public support for the European project and the pick-up in the economy give politics more leeway to foster the debate on institutional and policy reforms.

- **The next German government's term is faced with numerous challenges that might turn into political risks for Europe and thus require sensible management:** (i) A deal on Brexit and future EU-UK relations (ii) negotiating the post-Brexit budget (iii) coping with the migration flows (iv) overhauling the framework of the euro area (EA) including Banking Union and institutional questions. Improving the EU's economic performance and coherence should be self-evident, though.

- **A revitalised relationship with France offers Germany the chance to mitigate the unwanted and unintended label of the "European hegemon".** It provides an opportunity for substantive steps to further stabilise the EA albeit Germany and France need to find common ground on many issues and seek the support of the other member states. The concept of a multi-speed Europe might be an option to move ahead with the EA but it has disadvantages in other regards. Balancing (financial) solidarity with (fiscal) solidity and (reform) conditionality will remain essential for selling changes in the EA to the German public.

- **European policy issues are still less of a topic for the German electorate.** Reflecting the general attitude of the German public, mainstream parties are all various shades of pro-EU. Both CDU/CSU and SPD are supporting a broader and deeper upgrade of the EA architecture but manifestos differ in terms of commitment and detail. The Liberals call for a strengthening of the fiscal framework, e.g. an insolvency regime for the EA, whereas SPD and Greens favour a deeper social union and further EU-wide investment. An EU migration policy or more cooperation in home and security affairs are common features in the parties' positions.

- **The next government's composition is likely to impact on Germany's European policy course.** While there is a general political mood to move forward just how much will depend on the partners in the government. The appetite for ambitious reforms of the EU might be larger in another CDU/CSU/SPD coalition given the overlap of their positions. A conservative-liberal coalition will not refrain from reforms but might alter both speed and scope of them.

- **An important signpost could be the German EU presidency in 2020.** Most of the proposals for the evolution of E(M)U require complex agreements or even changes to the EU Treaties as they would involve further loss of sovereignty. During its last presidency in 2007 Germany paved the way for the Lisbon Treaty. Given the need for referenda in some member states, though, any treaty changes in this respect remain a difficult endeavour in the by then EU-27.

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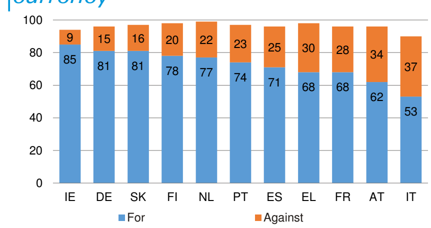
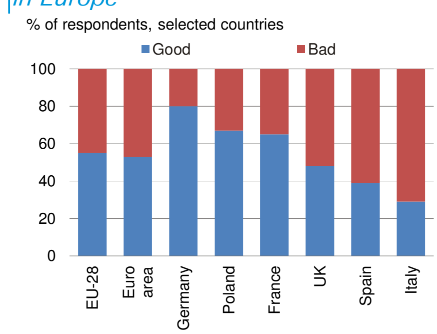
Figure 9: Popular opinion on the single currency



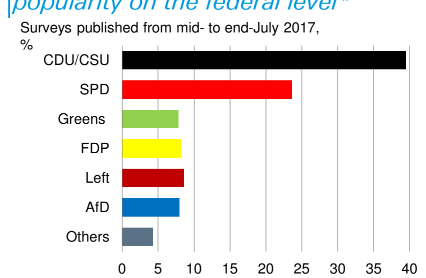
Source: Eurobarometer Spring 2017, Deutsche Bank

Figure 10: View on German Leadership in Europe



Source: IfD Allensbach April 2017, Deutsche Bank

*Figure 11: Major political parties' popularity on the federal level**



**Average of major surveys (Allensbach, Infratest Dimap, Forsa, Forschungsgruppe Wahlen, TNS Emnid) Source: Wahlrecht.de, Deutsche Bank*

German defence policy

We published a [Special Report](#) on 08 August 2017 and the key points are below:

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- **Defence up on the political agenda.** Usually rather an anathema in German electoral campaigns, defence policy and the question of defence spending have moved into the light of public attention ahead of September parliamentary elections. The debate is fuelled by the experience of the refugee crisis, US criticism of Europe's NATO spending but also regained momentum for European integration, including efforts towards a European Defence Union.

- **German public supports NATO membership and EU defence integration, majority against increased defence spending.** According to polls, most Germans favour a common EU defence and security policy while NATO membership is backed by at least two-thirds. At the same time, a majority of 64% opposes an increase of military expenses.

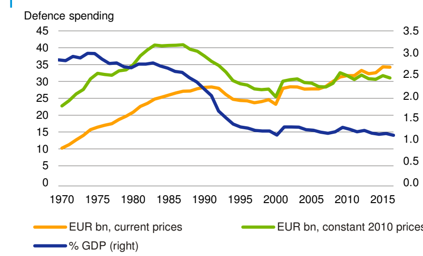
- **Current medium-term budget planning not towards 2% NATO objective.** The German government initiated a "turnaround in the financing of the Bundeswehr" to meet alliance commitments and adjust to a changing security environment. To reach NATO's 2% of GDP target by 2024, defence spending would have to more than double to c.EUR 80 bn. Spending increases planned by the FinMin suggest that the defence/GDP ratio might remain close to current levels of around 1.2%, but tweaks to the medium-term budget are common under a new government.

- **More fiscal leeway for spending increases than many NATO/Eurozone partners.** Germany is in a more comfortable fiscal position to reach the NATO target than many other Eurozone/NATO peers. France will cut its defence spending this year to stay in the Maastricht fiscal limit – but at 1.8% of GDP is closer to the NATO objective. More is demanded of other euro area members, such as Spain and Italy with limited fiscal space and defence spending at half the NATO target.

- **Spend 'better' rather than 'more' - European synergies in the focus.** Emphasizing national budget constraints, European initiatives for deeper defence integration pushed by France and Germany focus on better use of resources, interoperability and reduction of duplicity in military expenditures. But efficiency gains will not free Europe from the necessity of increasing spending on R&D and modern military equipment.

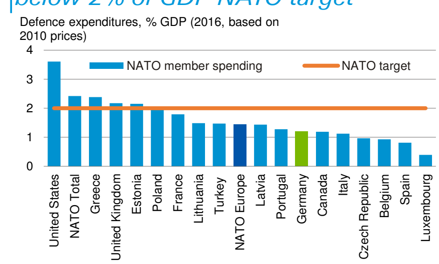
- **Mainstream parties agree on international security framework, not on the details.** Mirroring the German populace, most mainstream German political parties broadly agree in their commitment to NATO membership and European defence integration. There seems to be a consensus that a more holistic security framework is required, taking into account increasing interconnections between foreign, defence and development policy and even between foreign and domestic policy. Both sides stress the importance of strengthening German development aid towards the 0.7% of GNI OECD target. But while the centreright parties pledge themselves to the 2% NATO objective, the centre-left reject the implied increase in military expenses.

Figure 12: German defence spending down in real terms/share of GDP after cold war



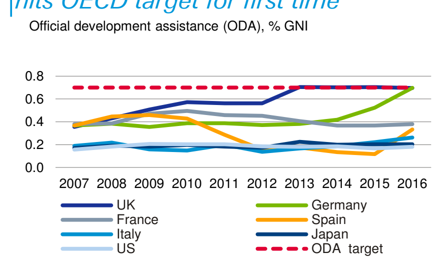
** Note: Break in GDP deflator/GDP series in 1991. Source: Finance Ministry, Statistisches Bundesamt, Deutsche Bank*

Figure 13: German defence spending below 2% of GDP NATO target



Source: NATO, Deutsche Bank

Figure 14: German development aid hits OECD target for first time



Source: OECD, Deutsche Bank

Appendix 1

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