



# Bundestagswahl Special 2017 The final countdown

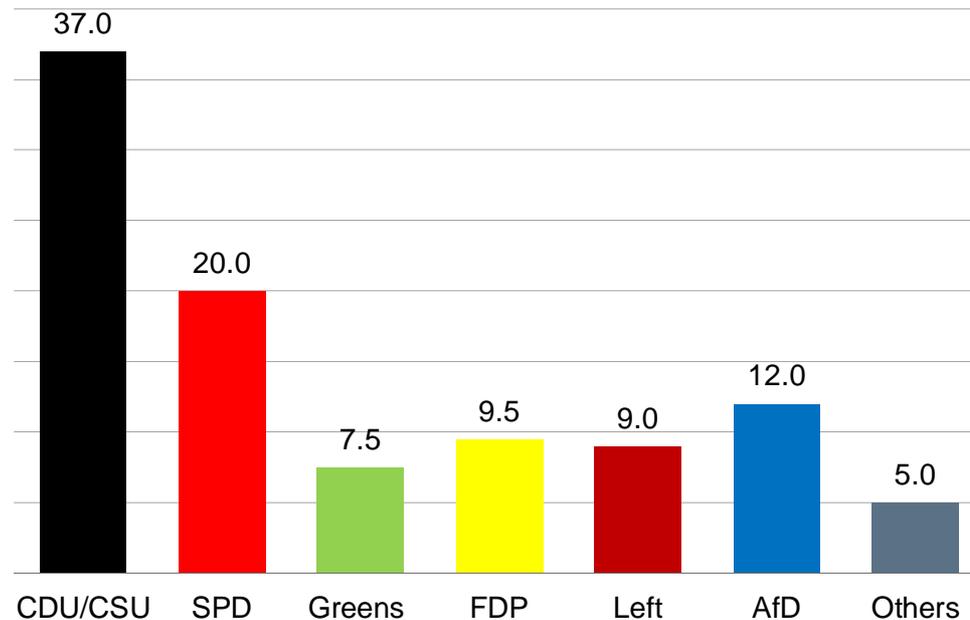
Frankfurt, September 19, 2017



# Latest polls: The winner seems to be clear, but not the next government!



## ARD Deutschlandtrend



Source: infratest dimap, Sept. 2017

- According to the ARD Deutschlandtrend (14.09.) only a renewed **Grand Coalition** or a coalition between Merkel's CDU/CSU, the liberals (FDP) and the Greens ("**Jamaica**") would be arithmetically possible.
- In other recent polls the CDU/CSU has scored 36,5%-38%, the SPD'S range has been 20%-24%. Left: 8% - 10 ½%. Greens: 6%-9%, FDP: 8-10% and the AfD: 8%-12%.
- However, polls show that a **substantial part of the voters** (some say almost half) is still **undecided**.
- The **usual margin of error** of these representative polls is about +/- 2 ½%

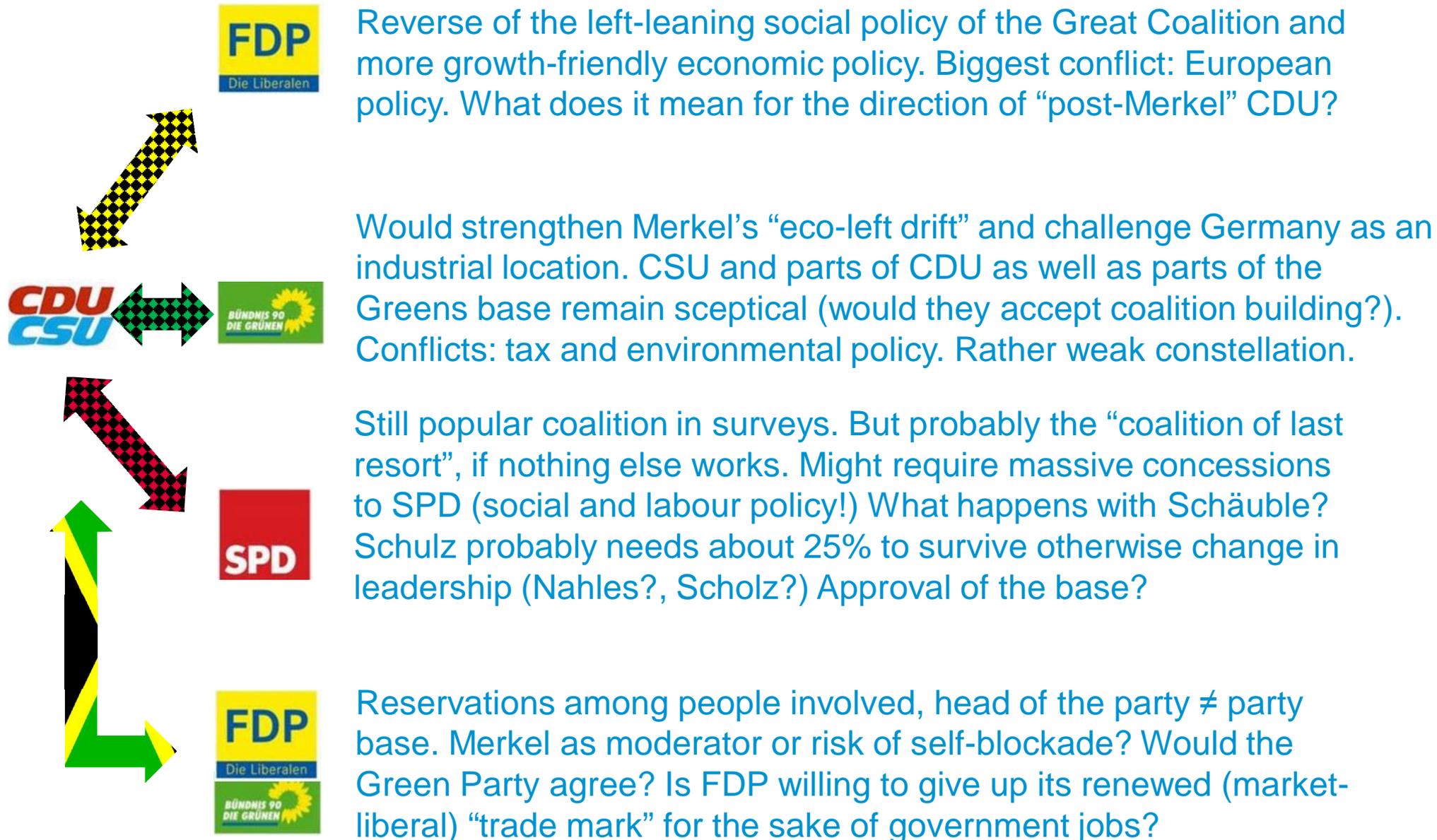
# And what is going to happen after September 24th?



## Disclaimer:

- We do not have a **crystal ball**.
- Our views on political issues are – like everyone else’s – based on a **subjective view** of the world which is influenced by **personal value judgments** and prone to **perception biases**.
- Election programs ≠ coalition programs ≠ government policy
- The **assignments** of certain **policy intentions** and the examples are necessary **simplifications** to highlight differences. The programs of the mainstream parties discussed here show **strong similarities** in many areas. Some statements are – probably on purpose – very vague, making it difficult to deduct / anticipate actual measures.
- Political developments have their own dynamics and are highly exogenous (e.g. refugee crisis 2015!)
- Considerations regarding **market reactions** are supposed to highlight potential implications.
- Given very **similar positions** of mainstream parties the **actual market outcomes might not differ that much!**

# Who with whom or why (not)?





# Likely implications: Economic, European and monetary policy



Less fiscal consolidation  
More redistribution  
More labour market regulation  
More EU(rope)

No fiscal deficits (intended)  
Social expenditure increase less likely  
More flexibility on the labour market  
Only conditional European transfers

**Fiscal policy:** Grand Coalition (GC) most expansionary – new gifts, like early retirement for 63+, “mother’s pension rise” 4 years ago (**fiscal surpluses for “growth-enhancing investments”**), but debt brake constrains room to maneuver  $\approx \frac{1}{2}$  pp of GDP. CDU, even more FDP: focus on consolidation, but see room for higher spending (**debt brake 2.0 -> long-term sustainability of new legislation**)

**Redistribution:** GC caters to their key constituencies (gerontocracy!), Greens even more determined than SPD (**higher top tax rate, pushing for unconditional basic income!**)

**Labour market:** SPD: bye, bye Agenda 2010 (**curtail fixed term contracts, contract work, service contracts, enhance co-determination, new unemployment pay Q, “improve welfare state further”**); CDU not completely averse (**prevent abuse**); CDU/FDP: chance for somewhat more market-friendly policies and more sustainable pension/social policies. (**reduce regulation, simplify law on working hours**)

**EU policy:** Left-leaning parties more in favour of enhanced EU institutions and more transfers (**broad EU investment program, EU economic government**) (**Euro bonds, “stop austerity”**); conservatives / liberals conditional support, rule-based institutions (**EMU exit procedure, reduce ESM, no debt socialization**)

**Growth:** GC = max. Keynesian impulse (**“pact for fair wages”**), negative for potential growth! CDU/FDP could boost animal spirits (private investment)

**ECB:** GC more fiscal spending & higher wage growth -> stronger domestic demand / inflation could make QE exit (somewhat) easier, stronger EU/EMU commitment could reduce concerns about financial conditions in case of new EMU trouble (Italy). FDP involvement, by contrast, might heighten concerns in times of crisis.

**Statements in brackets are key-phrases from party programs, color coding: CDU, SPD, Greens, FDP**

# How could markets respond?

What is priced in? Short-term (s), long-term (l) reactions might differ.  
Non-linearities? Feedback loops! Very uncertain!



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**Euro:** Left-leaning government (including GC) -> higher propensity to pay for EU/ Euro € (s). But more muddling-through, less structural reforms: € (l)

**10y bund yields:** GC , CDU / Greens -> less fiscal restraint yields € CDU/FDP: further debt reduction? Safe haven during renewed EUR crisis €

**Spreads:** Little impact due to principal EU commitment (“stop austerity”) **Exception:** CDU/FDP could cause spreads to widen, particularly in crisis times (Italy) (EMU exit procedure, reduction of ESM) €

**DAX:** CDP/FDP due to tax cuts / no further regulation and business-friendly policies € GC positive for domestic demand (consumption, public construction, infrastructure) € Green government involvement neg. for utilities, car industry (diesel back fitting) €

**Vola:** Tight outcome could make coalition talks very difficult (tail-risk: snap elections), Renewed EUR crisis could be a potential breaking point for a CDU/FDP government. € ; if AfD clearly > 12%€ (s)

GC bigger distance to the USA? FDP better relationships with RU?

# Important issues

Many of them neglected in the election debate



Slowing **trend growth** – largely unheeded!

Blind eye on **sustainability** – after us the deluge

**Fiscal policy:** Surfing the zero-rate wave

**Housing policy:** Rent cap unlocked?

**Labour market policy:** Wasting improvements of the Hartz reforms

**Industrial policy:** Energy transition, end of diesel?

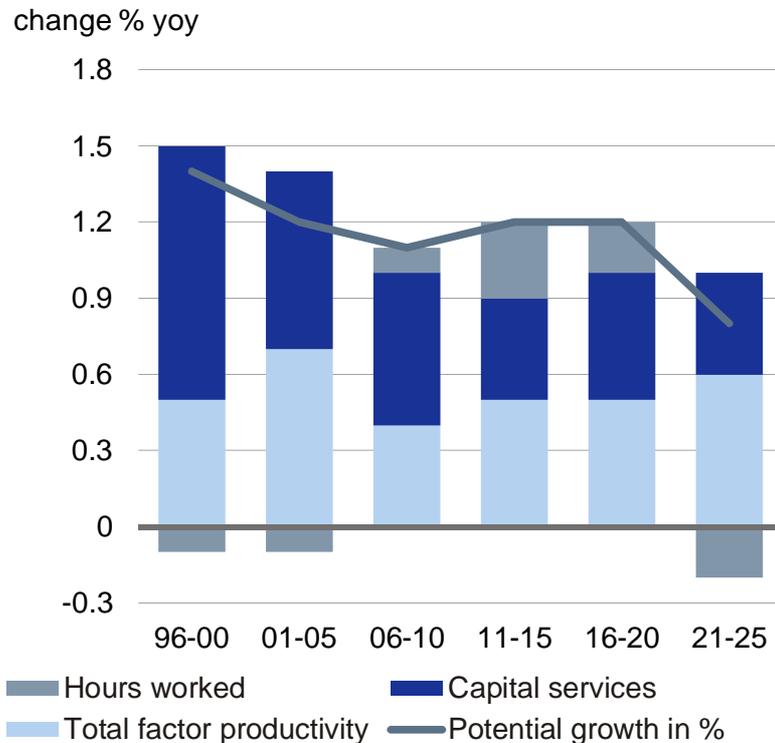
**Tax policy:** That is unfair!

**European policy:** More than gradual progress?

# Slowing trend growth – largely unheeded!



Medium-term projection of potential output



Source: Deutsche Bundesbank

## Cyclical upswing disguised slowing trend growth

- Trend growth looks set to halve by 2025 (0.75%)

## Productivity: key variable for trend growth

- Production technology + labour productivity + capital intensity
- Relative increase of service sector (lower productivity)

## Unclear impact of demographics on labour productivity

- Fluid v. crystalline intelligence
- Labour productivity rises on avg. up to the age of 55

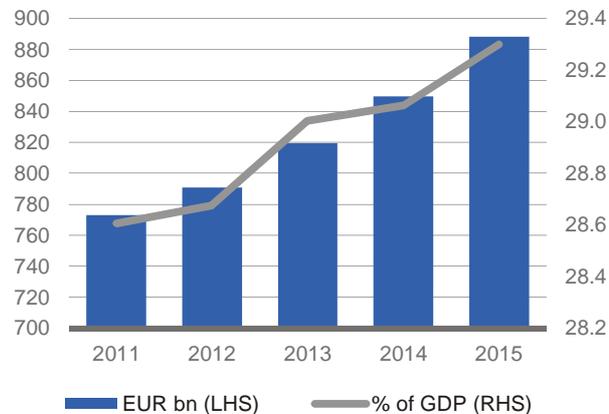
## Challenges & perspectives

- R&D, education, capital formation
- Process innovation vs. product innovation
- Education and further qualification on the job
- Flexible working time models
- Adjustments in fixed capital formation
- Changing consumption patterns
- **How can ageing work force adapt to digitisation?**

# Parties not focusing enough on sustainability



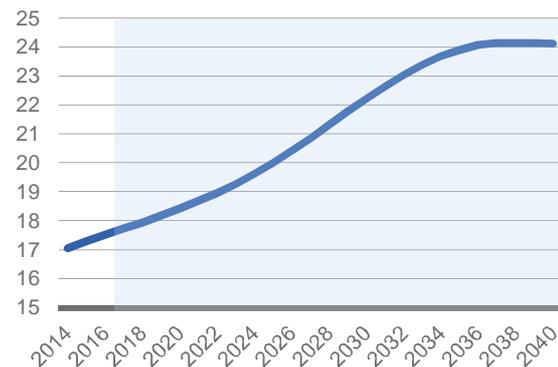
## Expanding welfare spending



Sources: Federal Ministry of Labour and Social Affairs, Federal Deutsche Bank Research

## Elderly people set to rise strongly

Population aged 65+ years\*, million persons



\* Assumptions: Life expectancy at birth by 2060: 86.7 years for males and 90.4 years for females.

Source: Federal Statistical Office of Germany

## Complaints about social imbalance despite strong expansion of welfare state

- Welfare spending per capita: EUR 10,900 (2015)
- Up to 29.3% of GDP 2015 (from 28.6% 2010)
- (Avoidable) welfare spending gifts (“retirement at 63“, “pensions paid to mothers“) have boosted expenditures, although adverse demographics have not yet kicked in!

## Planning for the future plays second fiddle, at best

- Political parties seduced by cyclically strong economy to increase government spending further / reduce taxes
- Many proposals aim at a further (unsustainable) expansion of the welfare state
- Reform backlog / standstill in the areas of pension, health and care – despite ageing population.

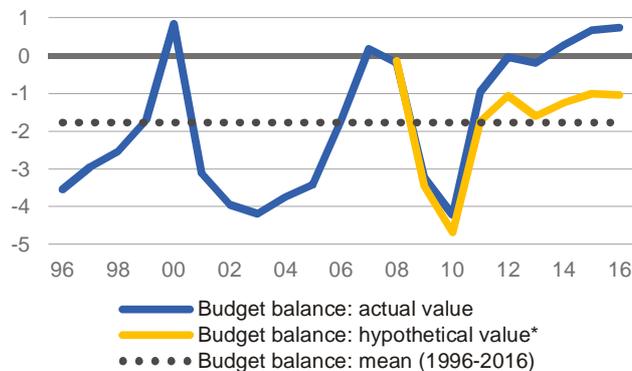
## Conclusion and outlook

- Demographic challenges of the current welfare state not adequately addressed by politicians
- Day of reckoning to come. Current (untenable) assurances will haunt parties and lead to further voter disenchantment.

# Fiscal policy: Surpluses thanks to full employment & zero interest rates but adverse demographics looming



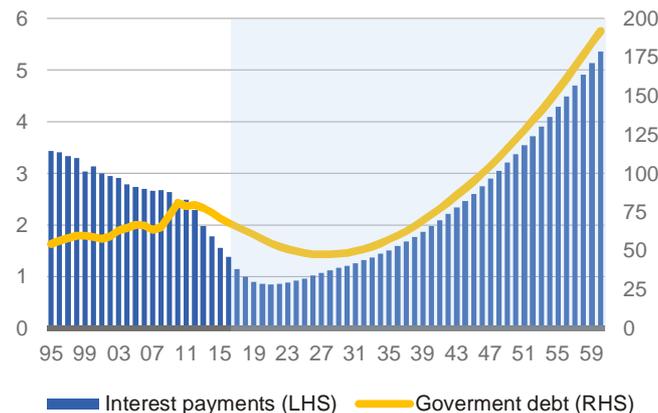
Surpluses only thanks to zero interest rates  
General government budget balance, % of GDP



\* Assuming constant interest rates (on the level of 2007), calculated for period from 2008 to 2016.

Sources: Eurostat, AMECO, Bloomberg, Deutsche Bank Research

Without counteracting measures debt trajectory could become unsustainable  
General government level, % of GDP



Sources: AMECO, Deutsche Bank Research

## Germany's interest savings over the period 2008-16 amount to almost EUR 260bn (8.2% of GDP)

- Without the steep fall in interest rates Germany would still have recorded a budget deficit of 1% of GDP, despite strong economy leading to record high revenues
- Future normalisation of the ECB's monetary policy is set to require retrenchment, at a time of more rapid population ageing, substantially lower GDP growth and the need for large investments (i.e. for digitisation)

## Adverse demographics will hurt public finances soon

- “Demographic respite“ to end by the middle/end of next decade
- The “old-age dependency ratio (65+ / 15-64) is set to rise to c. 50% by 2040 from 32% today (without stronger immigration)
- Public debt trajectory will become unsustainable in the absence of counteracting measures (containment of age-related spending)

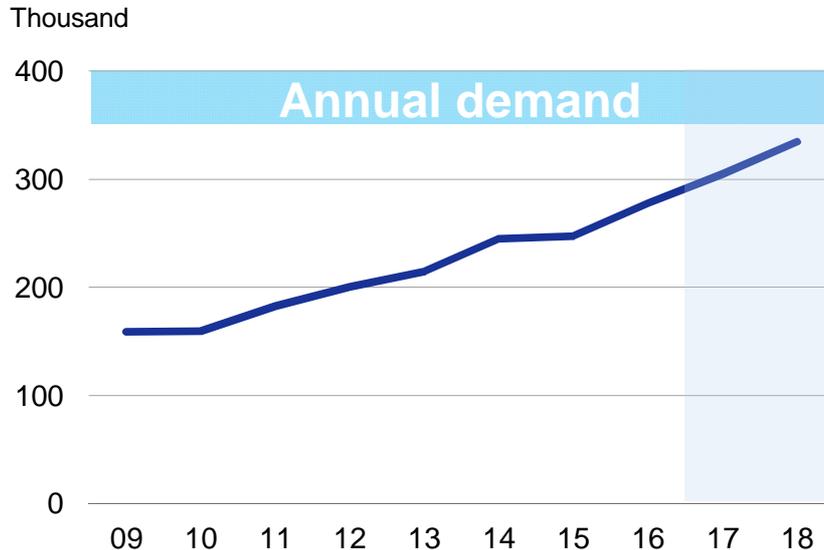
## Conclusion and outlook

- Fiscal space (for investment) will decrease further
- Public debt sustainability and macroeconomic stability endangered
- Containment of age-related expenditures (e.g. statutory pensions) are an economic order, but politically unpopular and increasingly difficult to implement (age of median voter > 50 years)

# Comeback of market-oriented housing policy?

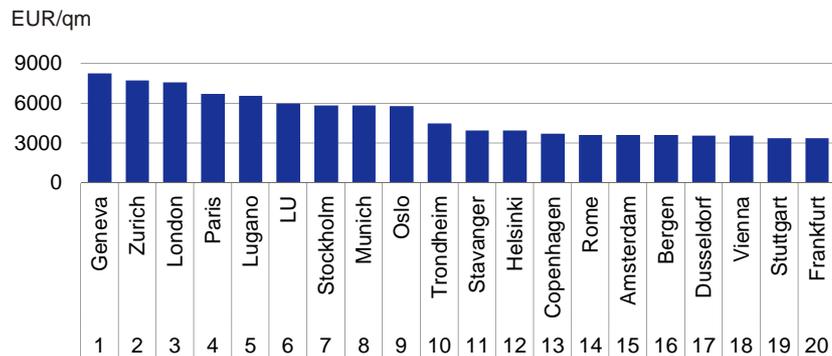


Germany: Completed dwellings per year



Source: Federal Statistical Office

Apartment prices outside the city center above EUR 3000



Download from numbeo.com on Sep 5, 2017

Source: Numbeo, Deutsche Bank Research

## Further price increases likely

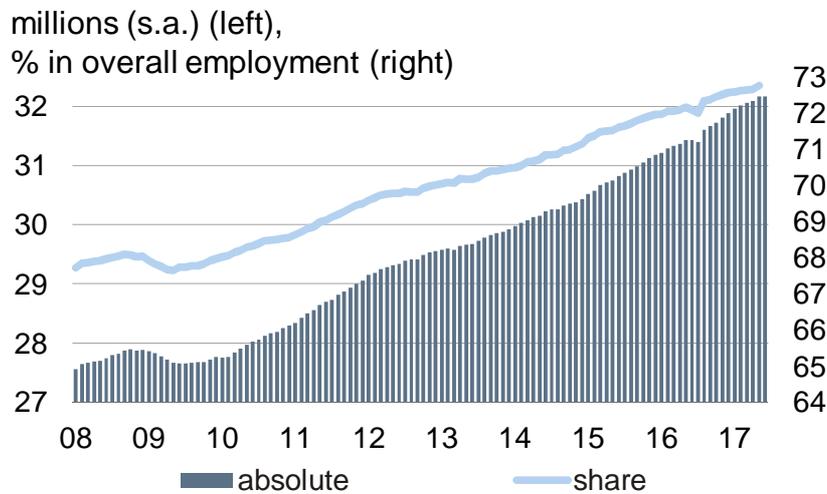
- Price drivers have not changed in recent years: Supply shortage, partly policy-induced, due to
  - § Scarcity of building land
  - § Stricter regulation: rent cap, energy reform
  - § Rising building costs, lack of qualified workers
  - § Complex political process
- Change of housing policy seems in the cards
  - § Merkel: “Rent cap is ineffective“
  - § CDU: 1.5 Mio. new dwellings until 2021
  - § FDP, CDU: Higher tax depreciations
  - § FDP prefers easing of EU mortgage credit directive
  - § SPD, Greens, Left: Prefer stricter regulation
  - § “A proper rent cap “ has to be implemented
- Conclusion
  - § Positive impulse for new building!
  - § Leakage effects as more incentives increase demand but also add to price pressure
  - § Price pressure should remain high

Additional topics: Property transfer tax, child allowance

# Labour market policy: Wasting improvements of the Hartz reforms

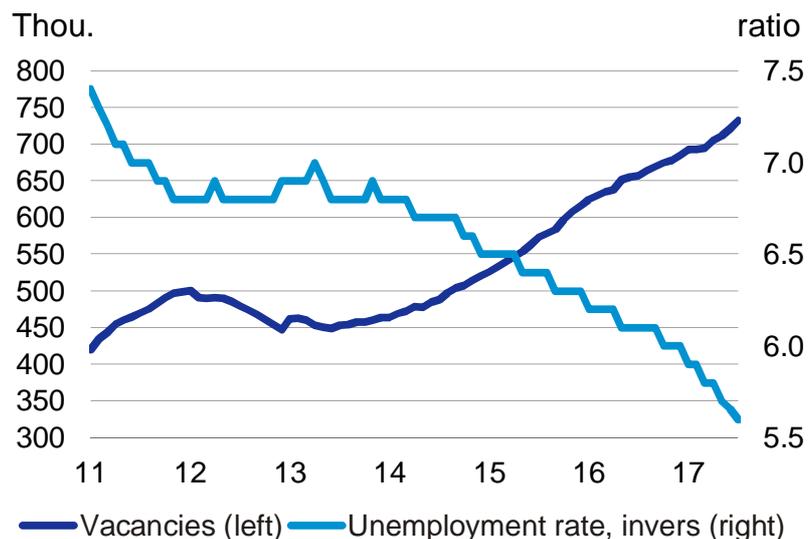


Strong growth in employment s.t. social security



Sources: BA, Federal Statistical Office

Labour market: Approaching full-employment



Source: Deutsche Bundesbank

## Labour market benefits from cyclical upswing

- Employment (44.2m) and vacancies at record levels
- Increased share of jobs paying social security (72.8%)
- Labour immigration from EU with positive impact (from IT, ES, PT and GR: 2013 to 2017: +0.6m)
- Regional labour supply shortages

## Sluggish integration of long-term unemployed

- Mismatch of job openings and qualification patterns
- Qualification, employability

## Demographics and digitisation require more flexibility and further training

- Vocational education and training (also pre-entry)
- Further qualification

## Integration of refugees & immigration policy

- Language & integration courses, vocational training
- Immigration law tailored to labour market needs

## Grand Coalition already (partly) reversed Hartz-labour reforms, i.e. increased regulation again!

- With the FDP the sole exception, all parties want to tighten labour market regulation further, although by different degrees.

# Industrial policy: General restraint commendable, but key areas are being neglected



## Cautious industrial policy in Germany was successful

- High manufacturing share (22.6%; EU: 16.1%), competitive companies
- However, it becomes increasingly difficult to maintain such a restrained policy approach as other countries show protectionist tendencies

## More public engagement in network infrastructure necessary

- Support for broadband expansion in rural areas
- Enlargement of electricity grid proceeds very slowly

Public influence in the **energy sector** will remain high, German ‘energy transition’ dependent on subsidies; **risks for long-term investments**

**Election campaigns concerning energy policy are based on wishful thinking**, political targets incompatible with actual developments and trade-offs

**Transport policy: diesel issue** could be a hurdle for a ‘Jamaica coalition’, **PPP projects** are generally viewed with **scepticism**

# Tax policy – how to balance growth and redistribution



## Unfavourable tax structure in Germany: tax burden above OECD-average

- 54% share of direct taxes in tax revenues, tax-to-GDP ratio close to 40%
- Since 2010, tax revenues increased by 33%, trend likely to continue → Reduction of inflation-triggered rise of marginal income tax rates needed (bracket creep)

## Relief focused on mid-range earning brackets and families

- Amount of relief for tax payers varies greatly across party proposals (EUR 6 – 20bn)
- Risk of higher tax rates for better-offs meet equality concerns (SPD, Greens)
- Solidarity surcharge (EUR 17bn p.a.) to be phased out

## Flat withholding tax of 25% under review

- Re-integration into income tax scheme but difficult question on how to treat dividends and avoid huge amount of red tape

## Company taxes no major issues for the mainstream parties

- R&D spending through tax deduction; relax depreciation rules for SMEs

## Franco-German initiative on BEPS and corporate tax regime by end-2017

- Risk of upward harmonisation (French effective tax burden  $\approx$  10ppts above German)

# European policy– numerous challenges, no (easy) answers



Economic recovery and ECB policy hide structural weaknesses of EMU

EU Commission's two-stage road map until 2025

- Banking union, budgetary rules, fiscal union, treaty changes

German mainstream-parties are pro-European, but differences not only marginal

- More investment and some sort of stabilisation mechanism favoured by SPD and Greens; Liberals insist on compliance with fiscal rules and demand a debt restructuring instrument; CDU/CSU less clear but signal support for built-out of EMU
- Brexit no campaign topic; all parties back EU position à unity of single market first

Franco-German cooperation is likely to facilitate reforms

- Next German government will make relations with France priority
- Same buzzwords often disguise different concepts (e.g. transforming ESM into EWF)

“Progress“ in Europe requires the Germans' willingness to pay more

- Migration deals, investment initiatives, Brexit, defence fund, EMU-budget...

Institutional changes only occur in the medium term

- Eurogroup Presidency + EU Commissioner = EU Finance Minister?

Market hopes for new asset classes are likely to be disappointed



# Germany Monitor

## Bundestag elections 2017

German industrial policy: General restraint commendable, but key areas that need to be addressed are being neglected  
September 12

Housing policy in Germany - Changing direction  
August 31

State or private, redistribution or growth - Who will be the winners according to the parties' tax proposals?  
August 28

Time to fully recognise the potential of digital start-ups  
August 22

German defence policy: Towards a more integrated security framework  
August 8

Packed European agenda for the next government: Numerous challenges, no (easy) answers  
August 3

Germany's fiscal situation: Full employment and zero interest rates result in budget surpluses – but demographic development might become a problem!  
July 19

Parties not focusing enough on sustainability  
July 17

Slowing German trend growth does not seem to be a major issue in the electoral campaign  
July 3



## Contact:

**Stefan Schneider**  
**Tel.: +49 69 910-31790**  
**E-Mail: stefan-b.schneider@db.com**

**Barbara Böttcher**  
**Tel.: +49 69 910-31787**  
**E-Mail: barbara.boettcher@db.com**

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