

German Election Monitor #2

What important issues should politicians debate?

- **Angela Merkel is still on track to secure her fourth term in office, as polls have changed little since the TV debate. We continue to see another grand coalition of the CDU and SPD as the most likely outcome.**
- **However, in the current ‘sleepy campaign’, German politicians risk neglecting a thorough debate about measures to enhance future potential growth during times of economic strength.**
- **Initiatives to address the infrastructure backlog, deepen eurozone integration and solutions to demographic challenges should feature more prominently in the political debate.**

Sleepy election campaign lacks debate on structural reforms

As we have argued in *German Election Monitor No. 1*, the market impact of the upcoming German election will be limited as it is likely to result in a broad status-quo in terms of domestic policies and with negligible risk of a euro-sceptic government emerging. However, we think the future economic direction for Germany and more importantly further eurozone integration will be hugely important in the aftermath of the election.

The TV debate between Angela Merkel and Martin Schulz on 3 September centred mainly on immigration, inner security and Turkey. Economic and fiscal policy topics, on the other hand, remained broadly absent in line with a general complacency of politicians about the structural outlook for the German economy. **By neglecting a thorough debate about measures to enhance future potential growth during times of economic strength, German politicians risk missing opportunities to prepare the country for future social, economic and political challenges lying ahead.** Therefore, in this German election monitor, we look at some of the most pressing issues that politicians will have to deal with.

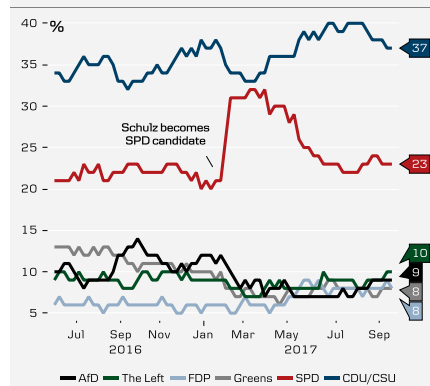
1. Infrastructure backlog

There have been repeated calls for Germany to raise its investment rates. *DIW*, a German think tank, estimates that the backlog in private and public investment is c.EUR75bn, roughly 3% of GDP, and argues that due to this lack of investment Germany foregoes growth of about 0.6% of GDP each year. **More investment in energy, infrastructure and education are particularly pressing**, in light of crumbling roads and schools. More broadly, inducing private investment is also seen as important to reduce the huge external surpluses and support recovery in the eurozone (see IMF Article IV report May 2017). The lack of infrastructure investment in the past few years has been more due to coordination issues between different public and private stakeholders and tight communal budgets, rather than lack of fiscal space: the general government budget surplus stood at 0.8% of GDP in 2016 and public debt is a mere 68% of GDP and has been on a declining path ever since 2012. However, the problem is that communal and federal budgets are constrained by the ‘debt brake’ (see factbox below), which historically has affected investment more than social spending.

Other research on Germany

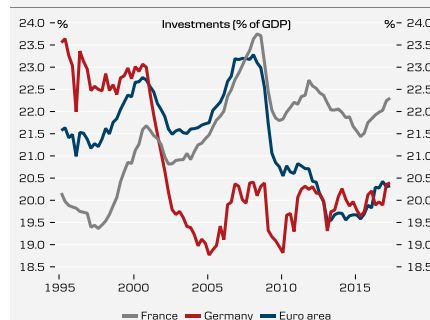
- *German Election Monitor No. 1: Next euro area election unlikely to rock the boat*, 29 August 2017
- *Research Germany - Status-quo after the 2017 parliamentary election?*, 6 April 2017

Chart 1: CDU still has comfortable lead in the polls



Source: OECD, Danske Bank

Chart 2: Germany's investment share still remains low



Source: OECD, Macrobond Financial, Danske Bank

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So **Germany surely has room for more fiscal easing** and given that it accounts for nearly 30% of euro area GDP, it will be difficult to achieve any significant boost to euro area growth from fiscal policy without Germany also ‘pulling its weight’ (see chart 3). Many of the mainstream parties have acknowledged that Germany’s investment backlog has to be addressed and the European Commission has already factored in an increase in public investment expenditure in its projections (see chart 4). But it remains questionable in what magnitude higher public infrastructure spending will actually materialise after the election, as most parties have also not specified their goals. Another question is whether an expansionary fiscal policy is appropriate under current circumstances as the German economy is already running at full speed, with business and consumer confidence as well as capacity utilisation at high levels (see chart 5). Pro-cyclical measures could hence risk the economy overheating in light of the still accommodative monetary policy of the ECB.

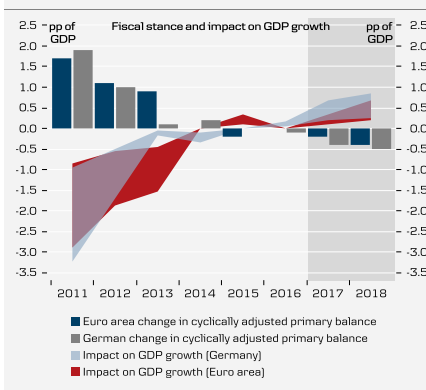
Chart 3: Considerable euro area fiscal easing depends on Germany

	Share of euro area GDP, 2016	Fiscal room, 2016		Expected fiscal stance, 2017*
		Public deficit-to-GDP	Public debt-to-GDP	
Germany	29.3%	0.8%	68%	-0.4%
France	20.8%	-3.4%	96%	0.2%
Italy	15.6%	-2.4%	133%	-0.3%
Spain	10.4%	-4.5%	99%	0.1%
Netherlands	6.5%	0.4%	62%	-0.5%
Belgium	3.9%	-2.6%	106%	0.4%
Austria	3.3%	-1.6%	85%	-0.1%
Ireland	2.6%	-0.6%	75%	0.3%
Finland	2.0%	-1.9%	64%	-0.5%
Portugal	1.7%	-2.0%	130%	-0.3%
Greece	1.6%	0.7%	179%	-3.0%
Slovakia	0.8%	-1.7%	52%	-0.1%
Luxembourg	0.5%	1.6%	20%	-1.6%
Slovenia	0.4%	-1.8%	80%	-0.6%
Lithuania	0.4%	0.3%	40%	-0.9%
Latvia	0.2%	0.0%	40%	-0.9%
Estonia	0.2%	0.3%	10%	-0.4%
Cyprus	0.2%	0.4%	108%	-1.1%
Malta	0.1%	1.0%	58%	-0.3%

*Change in cyclically adjusted primary balance (positive figure = tightening, negative figure = easing)

Source: Eurostat, European Commission, Danske Bank

Chart 4: Less restrictive fiscal stance will boost euro area growth prospects



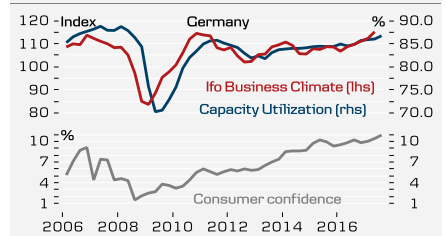
Source: European Commission, Macrobond Financial, Danske Bank

Factbox: German debt brake

- Requires central and state government to achieve balanced structural budgets without incurring new debt.
- Structural net borrowing limit of max. 0.35% of GDP for central government, but no such leeway for state governments (limit 0.0%).
- Exceptions to the rule in case of specific emergencies and cyclically induced burdens.
- Debt brake for state governments will only take full effect by 2020.

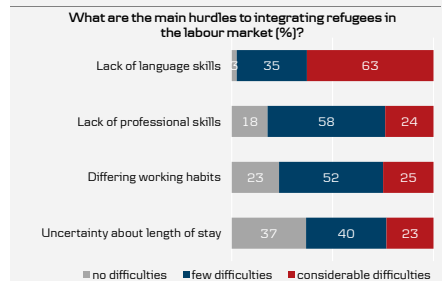
Source: Bundesbank

Chart 5: German economy is running at full speed



Source: Macrobond Financial, Danske Bank

Chart 6: German companies worry mainly about refugees' lack of language skills



Source: OECD, Danske Bank

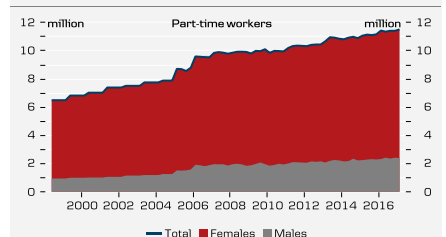
2. Successful integration of refugees

Although nearly all parties acknowledge the need for improved integration efforts for the 1.2m refugees who came to the country during 2015 and 2016, innovative policy proposals are still missing from party programmes. The experience with the Turkish migrant workers who came in the 1960s shows that Germany traditionally has struggled to successfully integrate immigrants into its society. In order to avoid repeating the same mistakes and **utilise the demographic dividend from the largely young migrant pool effectively**, creative initiatives to prepare them as active participants in the German labour market are required. Often the public administration itself acts as an impediment, as companies complain about increased bureaucratic hurdles and uncertainty around the employment of refugees. **Most parties acknowledge the need to improve language education and speed-up asylum procedures, but leave key issues such as access to jobs, professional skill gaps, lack of qualifications and rigid refugee worker schemes unaddressed.**

3. Demographic challenges

Among European countries, Germany is particularly affected by the adverse effects of a fast shrinking labour force in the future (see chart 7 on the next page). The successful integration of refugees into the labour market will be an important step to ease this burden, but **more needs to be done to increase labour force participation, especially among women**. Female part-time workers account for over 45% of total female workers. The main reason for females to work part-time instead of full-time still is still because they care for children and family, whereas for male part-timers the main reasons are either that they are

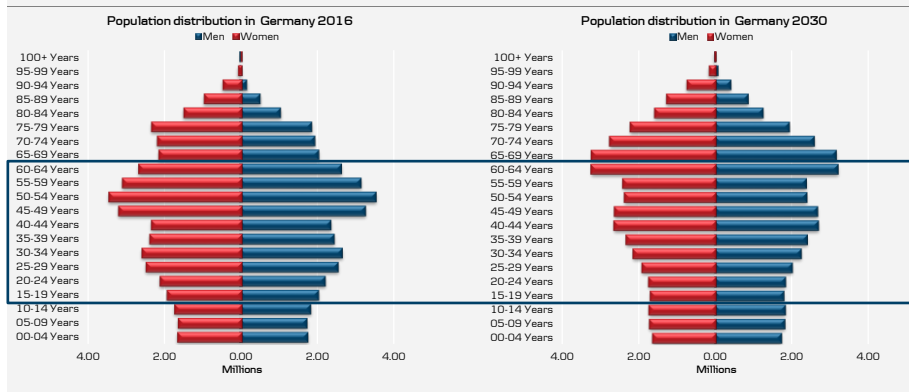
Chart 8: Females account for c.80% of all part-time workers in Germany



Source: Eurostat, Macrobond Financial, Danske Bank

in education or could not find full-time employment (see charts 9 and 10). Cheaper and more widely available child and elderly care facilities could hence unlock this unused potential and increase female labour participation. This would also have positive side-effects on the strained German pension system, reducing the need for further unpopular rises in the retirement age to 70.

Chart 7: German working age population shrinking rapidly by 2030

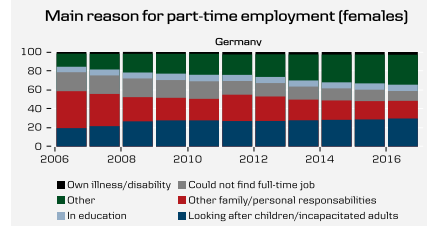


Source: United Nations, Danske Bank

4. Eurozone reforms

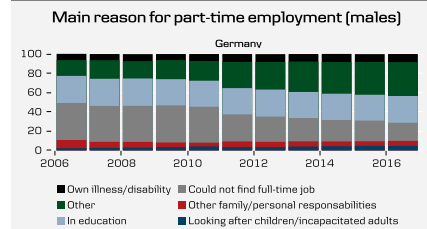
After signalling support following Emmanuel Macron’s election as French president, Merkel officially endorsed the idea of a eurozone finance minister and a ‘small’ eurozone budget on 29 August. This opens the possibility of a renewed push for deeper eurozone integration from a reinvigorated Franco-German alliance following the election. But three hurdles lie ahead. Firstly, the **window of opportunity to agree and implement these reforms will be tight**. Ideally a rough reform plan should already be in place at the beginning of October, so that it can be incorporated in the coalition agreement of the new German government, which would simplify reform implementation at a later stage. The reforms should then be pursued in H1 18, before the EU becomes too pre-occupied with the Brexit ratification process. **We think that the European council meeting on 22-23 March 2018 will be a key event with these questions gaining considerable market focus**. The second hurdle comes from the fact that **so far there is no agreement on what these reforms should be**. Whereas Merkel favours only a ‘small’ eurozone budget, Macron envisions country contributions amounting to ‘several’ percentage points of GDP, while European Commission chief Juncker has spoken out against such a separate eurozone budget. Macron will present his concrete ideas on 26 September. Currently the most realistic proposal comes from German finance minister Schäuble, of transforming the European Stability Mechanism (ESM) into a European Monetary Fund, which would also provide support for countries in times of recession in exchange for more budgetary powers. However, many open questions remain in terms of the magnitude of a eurozone budget, the possible creation of a common eurozone debt instrument or the nature of any enforcement mechanism in case of non-compliance with fiscal targets. The third impediment derives from **uncertainty about Merkel’s future coalition partner(s)**. A coalition with the liberal FDP in particular could derail the path for wide-ranging eurozone reforms. The FDP has spoken out in favour of countries such as Greece exiting the eurozone temporarily, and limiting the lending capacity of the ESM, while strictly opposing any kind of debt mutualisation or transfer union (see page 4). Hence, a CDU-FDP coalition government will make any fast and wide-ranging progress in terms of deepening eurozone integration even less likely.

Chart 9: Females looking after children or family...



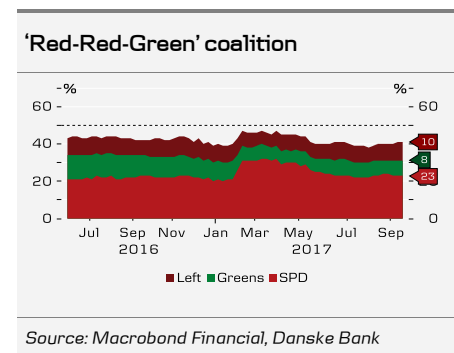
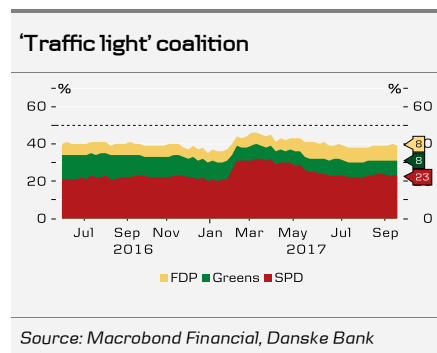
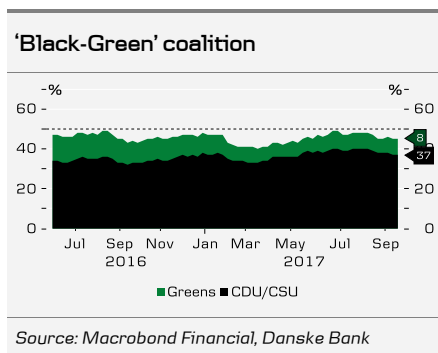
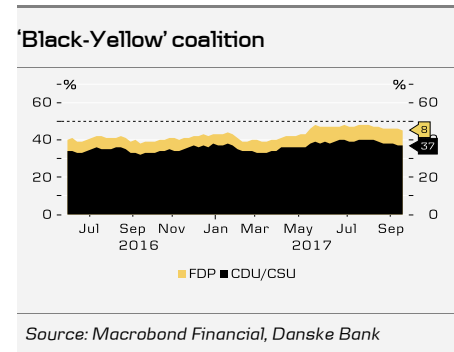
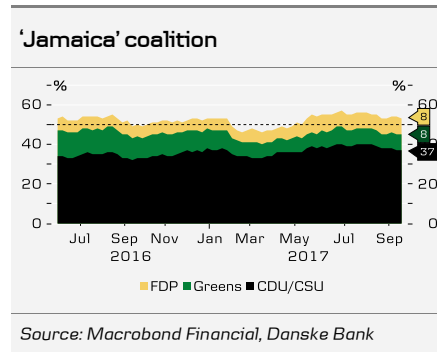
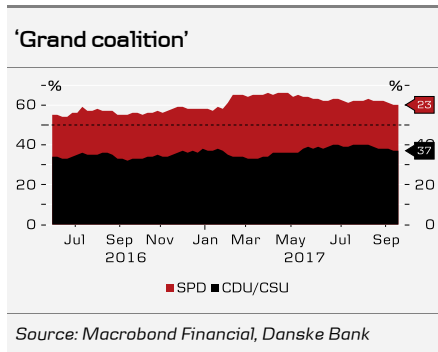
Source: Eurostat, Macrobond Financial, Danske Bank

Chart 10: ...whereas males are in education or could not find full-time work



Source: Eurostat, Macrobond Financial, Danske Bank

Coalitions tracker



Overview of party programmes

Few radical differences in mainstream parties' programmes

	CDU/CSU	SPD	FDP	Greens	The Left	AfD
Economic policy	<ul style="list-style-type: none"> Full employment (jobless rate <3%) by 2025 Pro free trade and globalisation Raise investment in education & infrastructure/broadband 	<ul style="list-style-type: none"> Focus on raising investments in education/infrastructure/broadband Invest 3.5% of GDP in R&D by 2025 Boost spending on child care, public housing 	<ul style="list-style-type: none"> Increase education spending Encourage entrepreneurship and venture-capital Invest in infrastructure and digitalisation Pro free trade 	<ul style="list-style-type: none"> Higher R&D and environmental spending Only green energy Debt brake for banks More infrastructure spending, sustainable investments 	<ul style="list-style-type: none"> Re-nationalize banking system to some degree; end investment banking Retirement at 65 Higher social benefits (min EUR1,050/month) Minimum wage of EUR12/h 	<ul style="list-style-type: none"> More direct democracy similar to Swiss model More protectionism (agriculture) Minimum wage Against FTAs and Paris climate agreement
Fiscal policy	<ul style="list-style-type: none"> Balanced budget No increase in public debt Income tax cuts of EUR1.5bn Boost government R&D funding 	<ul style="list-style-type: none"> Introduce additional type of unemployment benefits (ALG Q) EUR1.0bn tax cuts for small and medium incomes, raise taxes for the wealthy 	<ul style="list-style-type: none"> Cut bureaucracy and state subsidies Cut EUR 30bn in taxes and social contributions Reduce public debt 	<ul style="list-style-type: none"> Introduce tax on the "super-rich" 	<ul style="list-style-type: none"> Higher income taxes for the wealthy (75%) and corporate taxes More infrastructure spending (EUR1.20bn a year) Eliminate balanced budget 	<ul style="list-style-type: none"> Tax brake and reduce VAT to 12% from 19% Abolish wealth and inheritance tax. Balanced budget, reduce public debt
Europe	<ul style="list-style-type: none"> Ready to work with the new French government to develop the Eurozone step by step, but no debt mutualisation Pro EU defence union 	<ul style="list-style-type: none"> Create Eurozone budget, finance minister and parliament Transform ESM into European monetary fund Pro EU defence union 	<ul style="list-style-type: none"> 'Multi-speed' Europe; allow countries to leave euro Common EU foreign and defence policy End ECB's low-rate policy No debt mutualisation or transfer union 	<ul style="list-style-type: none"> Pro-EU stance Less austerity More power to EU parliament In favour of further EU enlargement 	<ul style="list-style-type: none"> More power to European parliament European parliaments (ECB accountable to EP) Against EU defence union European investment plan, end to German "hegemony" over EU 	<ul style="list-style-type: none"> Referendum and exit from the Euro More competencies for national states
Foreign policy	<ul style="list-style-type: none"> Reject full EU membership for Turkey Boost defence spending to 2% of GDP by 2024 US important partner 	<ul style="list-style-type: none"> Closer cooperation with France US remains important partner More engagement on global security issues US important partner Don't raise defence spending to 2% of GDP 	<ul style="list-style-type: none"> Stronger role for EU in NATO US important partner Tough stance on Russia Reject full Turkey EU membership 	<ul style="list-style-type: none"> Against CETA, TTIP (new, fair FTAs instead) More common EU defence and foreign policy Reject spending 2% of GDP on defence 	<ul style="list-style-type: none"> Anti-military stance Pro-Russian stance Against FTAs and against closer ties to Turkey Abolition of NATO 	<ul style="list-style-type: none"> Reform UN No EU army More influence in NATO Reject full EU membership for Turkey Stronger ties with Russia

Source: Danske Bank

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