

## Germany is fading

*"Germany's effort to push through social policy goals against the laws of the market has hit the rocks."* (H.-W. Sinn, President of Ifo-Institute)

- **The political class and general public still underestimate the size of Germany's economic problems and prefer homeopathy to the required radical surgery. Political governance is ineffective and even the limited reforms favoured by politicians and accepted by the populace are very hard to implement.**
- **The consequences of the likely failure of comprehensive economic reform are labour costs remaining above market-clearing levels and continuing downward pressure on the return to capital. Despite near-term cyclical recovery, unemployment is likely to remain high and capital exports will probably continue.**
- **The moderate reforms of last year and the prospect of 14 elections this year have already scared some politicians so much that they have demanded "time-out" from the reform process.**

It is said that if you throw a frog in hot water it will jump out, but if you put it in warm water and turn the heat on it will die slowly. We shall argue below that the behaviour of German society is disturbingly similar to that of the frog dozing to its death (which in our case means relative economic decline).

But is our scepticism not based on a look into the rear view mirror? Surely, we must be aware that the international community of economic analysts has recently praised the new enthusiasm for economic reform in Germany. However, our closer look at the German debate of reform is sobering: The political class and general public still underestimate the size of the economic problems and prefer homeopathy to the required radical surgery. Moreover, political governance is ineffective and even the limited reforms favoured by politicians and accepted by the populace are very hard to implement. Hence, we can explain the analysts' present optimism only as an emotional reaction to their earlier exaggerated pessimism and the signs of cyclical upswing (on the latter point see also a further article in this publication). Less than a year ago, analysts warned of Germany's falling into a Japanese-style deflation and of an imminent collapse of the German banking system. They now seem to err on the other side.

### Germany's problems are still underestimated

Hans-Werner Sinn, a renowned economist and president of the Ifo economic research institute has recently given a lucid analysis of Germany's economic malaise.<sup>4</sup> In his view—shared by many other

economists—Germany suffers (among other things) from the following key deficiencies:

- A rigid labour market where wages are set by a cartel of unions and employers above market clearing levels and where job holders are protected by government regulations against lay-offs. According to Sinn, wages would have to be cut by 10%-15% on average to clear the labour market (with wages for low-skilled workers required to fall by about one third).
- An overly-generous welfare system that keeps reservation wages high (inducing people to claim unemployment benefits instead of taking on low-paying jobs) and financed by high payroll taxes (boosting the cost of labour). According to Sinn, a married welfare recipient with two children receives EUR1,550 per month in support, provided no family member works (with support being reduced when family members receive other income). At the same time, social security contributions for an average wage earner in industry (also with family) amounts to 30% of his value added (pushing his total marginal tax to 66.7% of value added).
- A pension system that is unable to secure future pension benefits for the present working age population and rewards people without children. To sustain present benefit levels, the effective rate of contribution to the public pension insurance would have to rise to 31% of gross wages from 20% today. Moreover, according to Sinn, the present value of future pension contributions of a child is EUR100,000 but the present value of additional pension benefits for mothers is EUR4,350. This is certainly one reason why Germany has one of the lowest birth rates and fastest ageing populations in the world.
- A complicated and inefficient tax system, which—together with the social security system—creates disincentives to work and invest, but incentives for tax avoidance and rent seeking. As a result, the black economy is estimated to have reached some 17% of German GDP.

Based on his analysis, Sinn has proposed a policy programme to prevent Germany's further relative economic decline. It is interesting to compare Sinn's proposals with those recently implemented or planned by the German government (the so-called Hartz-reforms and Agenda 2010, see accompanying table). In all areas, the Government's measures fail to tackle the key problems, suggesting that they are insufficient to stop or reverse Germany's trend decline. Notably, the government

- is shying away from breaking up the wage cartel (confining itself to an appeal to unions and employers to allow "opening clauses" in wage contracts);
- does not materially lower the reservation wage (hoping that "unconventional" labour market measures

<sup>4</sup> H.-W. Sinn, *Ist Deutschland noch zu retten?* München 2003.

- ("Ich-AG, "mini-jobs", "PSAs") would lower unemployment);
- has no agreed plan for a viable pension system (hoping that the Riester Pension will finally catch on and relying on muddling through otherwise);
- is unable to agree on a radical tax reform.

The weaknesses of the government's cautious approach to reform are already visible. Thus, IG-Metall (IGM), the metal workers' union, is demanding a 4% wage hike for this year and is presently staging warning strikes against the employers' demands for greater working time flexibility (allowing companies on a case-by-case basis to raise weekly working time by up to 5 hours to 42 hours). IGM is adamant about uniform working times and wage agreements and is threatening a full-blown strike over this. Moreover, the government's new "mini-jobs" appear to draw especially students and spouses, who are not eligible for unemployment or welfare benefits into the work force, as companies have an incentive to replace regular employees by "mini-jobbers". Incentives for private pension savings (Riester Pension) are failing to have the

expected effect, and difficulties in financing pay-as-you-go pension benefits through contributions are already emerging. Finally, the government's already implemented and planned tax reforms have (so far) failed to raise consumer confidence.

The sceptical assessment of the government's reform track record is shared by a group of independent economists established to measure reform progress. The group (which is supported by the foundation "Neue Soziale Marktwirtschaft", the Institut der deutschen Wirtschaft, and the economics weekly "Wirtschaftswoche") analyses all laws and cabinet decisions related to economic reforms taken through a month against the background of their effects on growth and employment. The results are compiled into a reform index taking the value of 100 in October 2002, when the government was re-elected. Increases from that level indicate progress, decreases set-backs in the reform process. Apart from an aggregate index, the group also compiles sub-indices for labour market, social, and tax policy. While of course not able to give completely objective results, the approach nonetheless

### The German reform agenda

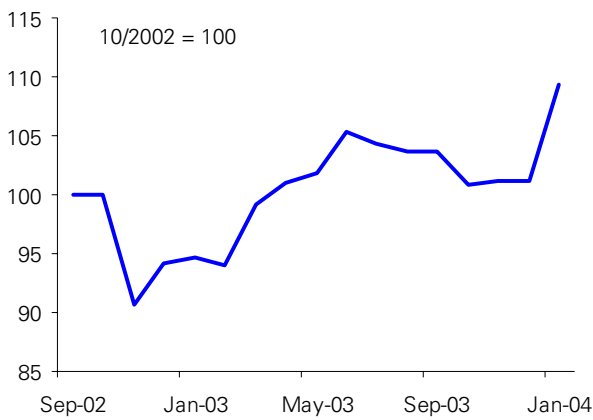
	Sinn	Schröder
<b>Labour market</b>	<ul style="list-style-type: none"> <li>• Break-up of wage cartel through opening clauses allowing wage setting at company level</li> <li>• Conversion of a part of cash wage into profit participation</li> <li>• Elimination of firing restrictions</li> </ul>	<ul style="list-style-type: none"> <li>• Temporary work agencies (PSAs)</li> <li>• Incentives for self-employment (Ich-AG)</li> <li>• Subsidies for low wage jobs (mini-jobs)</li> <li>• Tighter limits for unemployment benefits, making it harder for unemployed to reject job offers</li> <li>• Reorganisation of labour office</li> <li>• Easing of firing restrictions for firms with less than 11 employees</li> </ul>
<b>Social policy</b>	<ul style="list-style-type: none"> <li>• Welfare benefits cut by 1/3 and introduction of (modified) "earned-income-tax-credit"</li> <li>• Pooling of hard-core unemployed in Temporary work agencies</li> <li>• Rise of statutory retirement age to 67 and actuarial benefit discounts for early retirees</li> <li>• Delayed social benefits for immigrants</li> <li>• Substantial cut of benefits from PAYG retirement system with credits for parents of children and mandatory retirement savings for persons without children</li> </ul>	<ul style="list-style-type: none"> <li>• Incentives for private pension saving (Riester pension)</li> <li>• Demographic factor in PAYG system, and less generous early retirement benefits</li> <li>• No increase in pensions in 2004 and higher contributions of pensioners to old-age care insurance</li> <li>• Reduction in public health insurance benefits</li> <li>• Lower contributions to old age care insurance</li> </ul>
<b>Tax policy</b>	<ul style="list-style-type: none"> <li>• Simplified income tax system with rates of 0%, 15%, 25%, 35%</li> <li>• Flat tax on capital income of 20%</li> <li>• Company tax rate of 35%</li> <li>• Revenue losses to be financed by cuts in social spending</li> </ul>	<ul style="list-style-type: none"> <li>• Cut of entry/top income tax rates to 15%/42%</li> <li>• Cuts in subsidies and increase in tobacco tax, temporarily higher deficit</li> </ul>

Sources: H.-W. Sinn, *Ist Deutschland noch zu retten?* München 2003, DB Global Markets Research

seems to give a reasonably balanced assessment of the economic reform progress.

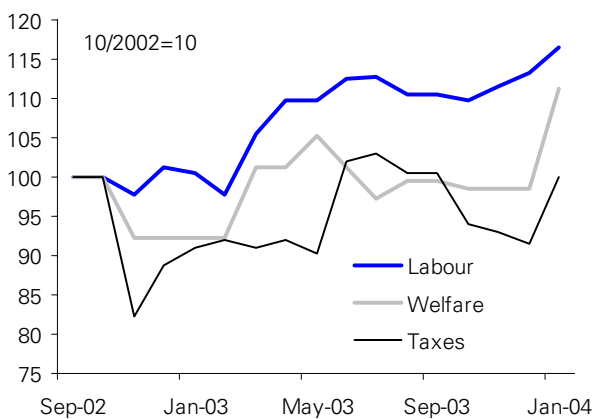
The latest available analysis puts the aggregate index at 109.3 in January of this year, up from December on the back of decisions in the context of Agenda 2010. This reading suggests that the government has made rather moderate progress in reform since it was returned to office in the autumn of 2002. Indeed, a number of recent measures simply corrected earlier mistakes and allowed the reform index to recover from its low reached in November 2002. Regarding the individual areas, some progress was made in the area of labour market and social policy, but tax policy has simply recovered from the earlier mistakes made at the beginning of the legislative period.

**Germany: Index of structural reform**



Source: "Neue Soziale Marktwirtschaft" ([www.chancenfueralle.de](http://www.chancenfueralle.de))

**Germany: Sub-indices of structural reform**



Source: "Neue Soziale Marktwirtschaft" ([www.chancenfueralle.de](http://www.chancenfueralle.de))

**Political governance is ineffective**

Optimists may interject that every beginning is difficult and the German reform train will gain momentum now that it has started to move. More likely, however, is that the German reform train is already losing traction because of Germany's clogged political decision making system.

The competences of Germany's two chambers of parliament, the Bundestag and the Bundesrat, overlap

to an extent that few reform measures can be passed without agreement of both houses.<sup>5</sup> At the same time, the distribution of federal and state elections over time has the effect that a loss in popularity of a federal government in the wake of its election strengthens the national opposition parties in the states and hence the Bundesrat. In turbulent times when painful reforms need to be launched by the federal government, the Bundesrat therefore tends to be dominated by the national opposition parties. Reform legislation can then only be passed when consensus can be reached.

The need for consensus among the parties of different political colour in a stealth grand coalition government that is in effect ruling the country is a serious road block to economic reform. Controversial policy proposals from either side have to be sent through the mediation committee of both houses, which is charged to merge them into laws acceptable to both sides. Obviously, the national opposition parties have an interest in presenting the federal government as impotent and incompetent to the voters. Even when they refrain from blocking federal government initiatives in deference to the electorate's love for consensus, they are loath to help policy to become effective.

Hence, legislation coming out of the mills of the mediation committee is often a torso of the original policy programme, suffering from inconsistencies and formal errors. The 2004 tax reduction package passed at the very end of last year is a good example for the political horse-trading common to German legislation. The federal government wanted to bring forward the 2005 tax package, consisting of a cut in the entry / top income tax rates to 15% / 42% with the revenue loss equally financed by subsidy cuts and a deficit increase. After much haggling through night shifts in closed session and in front of TV cameras, the mediation committee eventually produced a cut to 16% / 45% and less subsidy reduction than planned. But even that compromise was called into question for several days following its announcement after a night session as a mistake was found in the calculation of the implied tax revenue loss. Moreover, the opposition parties were quick to point out that the measures were insufficient to boost growth and kicked-off a debate about radical tax reform, thereby undermining any positive confidence effects that may have come from the tax cuts.

Apart from the overlapping legislative competences of the Bundestag and Bundesrat, the presence of vested interest groups in all important public institutions is a further road block to reform. This presence gives trade unions and employers' organisations an important say

<sup>5</sup> The Bundestag elects the federal government and in theory is responsible for policies at the federal level. The Bundesrat is constituted by representatives of governments of the federal states and in theory responsible for the states' affairs. However, the overlap in competences over time has muddled responsibilities, making it very difficult for a federal government to rule when the Bundesrat is dominated by state governments of the opposing political colours.

especially in social policy, which they often use to defend the status-quo. For instance, two years ago Chancellor Schröder appointed Florian Gerster as the new head of the Federal Labour Office, which—apart from being ineffective—was caught beautifying labour market statistics. Gerster's mandate was to reform the office, a task he pursued vigorously—perhaps too vigorously for groups with an interest in the preservation of the status-quo. Towards the end of last year, allegations surfaced that Gerster had not followed official procedures in hiring consultants. On the back of a public campaign against him, the supervisory body of the office—consisting mainly of trade union and employer representatives—expressed its lack of confidence in Gerster, forcing the Economics Minister to fire him. Immediately thereafter, the allegations proved to be immaterial.

The poor performance of Germany's system of public governance has caused the political parties to have a commission produce plans for a reform of federalism by the end of this year. Obviously, a better system of political governance is a necessary condition for a successful implementation of economic reform legislation. However, apart from coming rather late, the proposals of the commission are unlikely to establish effective channels for political decision making. With the members of the commission being the same politicians that have been responsible for the present dysfunctional system, agreement to do more than just repair the most glaring defects is unlikely.

### **Economic consequences of the German disease**

The most important consequences of the likely failure of comprehensive economic reform are labour costs above market-clearing levels and continuing downward pressure on the return to capital.

Germany's problems are not new and their effects can be traced in the economy's performance over recent years. As a result of high and rigid labour costs, the demand for labour has been weak and unemployment high. Bad labour market performance has depressed private consumption growth and, in turn, investment and GDP growth. Sluggish GDP growth—together with a tight regulatory and a still unfavourable tax regime—has depressed the real return to capital. This has led to a decline in the price of the existing capital stock relative to that of the capital stock abroad. German savings have financed direct and portfolio investments abroad instead of at home. Thus, Germany's current account surplus of recent years has reflected internal weakness rather than strong competitiveness abroad. Without radical economic reform, it is unlikely that these trends will change in the future (and monetary policy easing to boost growth—favoured by left-wing politicians and a few academics—will be like "spitting into the wind").

Regarding the performance of different asset classes, real estate—the least mobile asset—was most affected, with German real estate prices hardly changing during the last ten years compared to

considerable increases in all other industrial countries except Japan. Germany equities have underperformed (with the Dax returning an annual average 5.6% between the beginning of 1996 and 2004 compared to 7.3% for the DJ Euro Stoxx 50 and 8.6% for the Dow Jones Industrial index in euro terms<sup>6</sup>). Especially hard hit were (mostly private) small and medium-sized companies that had difficulties in building up production locations abroad. Insolvencies of these companies have reached record levels in recent years. Larger companies could reduce their dependence on the German market through increased international diversification (which brought their stocks closer in line with international developments).

Most likely, the relative price for existing capital in Germany has still further to fall as the domestic returns have not yet caught up with returns abroad. Hence, exports of new capital will continue or even increase. Larger companies will gain more purchasing power for foreign currency denominated capital as the euro rises and strong world trade growth compensates for any losses in market shares. Small and medium-sized companies will benefit from EU enlargement. These companies will be able to relocate production to neighbouring countries with plenty of cheap labour, an escape route from high German labour costs so far open only to larger companies with experience in more distant countries. With small and medium-sized companies joining larger companies leaving Germany—and immigrants from the new EU member states replacing some job holders in Germany—upward pressure on unemployment is likely to intensify on trend.

The experience of the UK has shown that the economic pain of relative decline may become so strong that the political system will eventually produce a radical reformer. However, for now Germany's economic pain appears to be far below this threshold. In fact, the moderate reforms of last year and the prospect of 14 elections this year (at the European, states, and local levels) have already scared politicians so much that they have demanded "time-out" from the reform process.

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<sup>6</sup> The Dow Jones Industrial index is a price-weighted stock price index for 30 US blue chip companies, the DJ Euro Stoxx 50 is a capitalisation-weighted stock price index for 50 major Euroland companies, and the DAX is a capitalisation-weighted total return index for 30 major German companies. To make return comparisons fully consistent, returns of the US and Euroland indices would have to be increased by the annual average dividend yield.

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