

## ECONOMICS | Eurozone

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## Two tales of one economy

### Benchmarking the German economy at the start of the election campaign

In slightly more than five months, Germany will go to the ballot boxes. Even though the German economy is the showcase model for the entire Eurozone, we expect the economy to become an important topic in the election campaign. While Angela Merkel's CDU is likely to emphasise strong economic fundamentals, the SPD and front-runner Martin Schulz will probably try to criticize shortcomings of the current growth performance. To many observers, the campaign could sound like two tales of one economy. Let's have a sneak preview.

While financial markets are still keeping close eyes on France and the upcoming presidential and parliamentary elections, Germany is getting off the starting blocks for its own exciting election year. As probably the last national election of the year in a core Eurozone country, the German national elections had been widely regarded as an example of political stability and hardly any excitement – a view which could be proven wrong. The German elections are not very likely to deliver a populist surprise, which could hit the heart of the Eurozone, but an outcome, which sees a new government coalition and possibly even a new chancellor, is clearly a possibility. This is a possibility financial markets have not yet priced in.

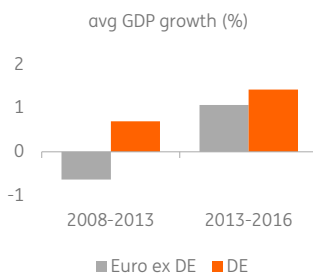
Germany is preparing for a much more exciting election campaign than previously expected as former president of European Parliament, Martin Schulz, has awakened the social-democratic party (SPD). Since the announcement of Schulz running as the SPD's front-runner, the party has gained some 10% percentage points in the opinion polls, rising from all-time lows of around 20% to almost being on par with Angela Merkel's CDU. As regards individual popularity Martin Schulz has even passed Angela Merkel. Obviously, with more than five months to go, it is far too early to give any guesstimates on the possible election results. We will revert to the political landscape, possible election outcomes and possible coalitions in a later report.

In our view, the main topics deciding the elections will probably be internal security, the refugee crisis (although ebbing away), social justice and the economy. Also, the personality and popularity issue (likeability, fatigue and appetite for change) between Merkel and Schulz could in our view be more important for the election outcome than in previous elections.

As regards the economy, Germany will probably experience an almost ironic controversy on the reforms of the 2000s during the upcoming election campaign. Merkel and the Christian-democrats will defend the reforms and point to the current strength of the economy, even though they were in the opposition back then. At the same time, Schulz and the Social-democrats will have to explain the voters why they now want to reform the reforms, even though they have been part of the government in 16 out of the last 19 years.

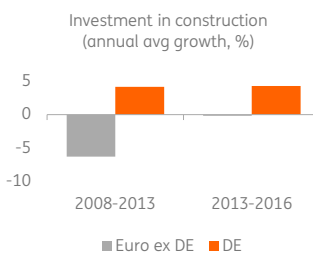
Despite the fact that the reforms of the 2000s have become an issue of the political discussion, up to now the biggest political parties have not yet addressed the economic issues which probably matter most, ie, investment and structural reforms, Bill Clinton's "it's the economy, stupid" could dominate the German election campaign this year.

#### Strong growth performance...



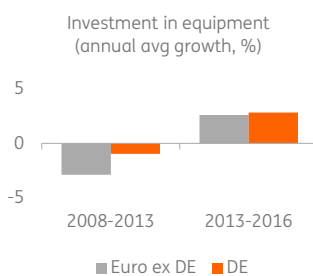
Source: European Commission

#### ...built on bricks...



Source: European Commission, ING estimates

#### ...while investment still lags behind



Source: European Commission, ING estimates

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# Golden cycle that does not want to end

The German success story...

The German economic success story has been told so often over the last years. Still, as good stories cannot be told often enough, here it is again. It is a story of a successful transition from a pure export-driven recovery towards a much more balanced growth model. The success formula consisted of structural reforms, accommodative monetary policy and a good portion of luck in the form of the emergence of China as a global player.

...has continued despite a series of external risks...

Currently, the German economy is the showcase of the Eurozone. Even in the 9th year of an almost non-stop expansion with only three quarters of negative growth since 2009, economic growth is still amongst the highest of all Eurozone countries. The unemployment rate is the lowest of all Eurozone countries (according to Eurostat data) and employment is at its highest level ever. Euro crisis, financial market turmoil, Chinese slowdown, Brexit or Trump – none of the recent major global events was able to derail nor even to slow the recovery. The transition towards more domestically-driven growth came at the right time to shield the German economy against external events. Since 2012, private consumption has on average contributed around two-thirds of total GDP growth. Now, although the structural reforms of the past have long been worn off, the ultra-loose monetary policy of the ECB with low interest rates and a weak euro combined with higher government consumption on the back of the influx of refugees are artificially extending the current golden cycle.

...benefiting from the ECB's ultra-loose monetary policy

Still, the economy could become an important topic during the upcoming election campaign

Against the background of a strong economy, one could think that the economy is very unlikely to become a dominant topic during the upcoming election campaign. Wrongly so. Angela Merkel's challenger, Martin Schulz, has already suggested reversing parts of earlier reforms. Schulz has also started to criticize the downsides of the current recovery. So, before the election campaign in Germany gathers pace, we take a look at the German economy, preparing ourselves for two tales of one economy.

## 1. Benchmarking the *Wirtschaftswunder*

How strong has the recovery really been?

Showcase of the Eurozone. New *Wirtschaftswunder*. Strong man of Europe. Germany has been awarded many unofficial titles in recent years. How miraculous is this *Wirtschaftswunder*, this "economic miracle"? How impressive is the recovery of the last years when put into perspective?

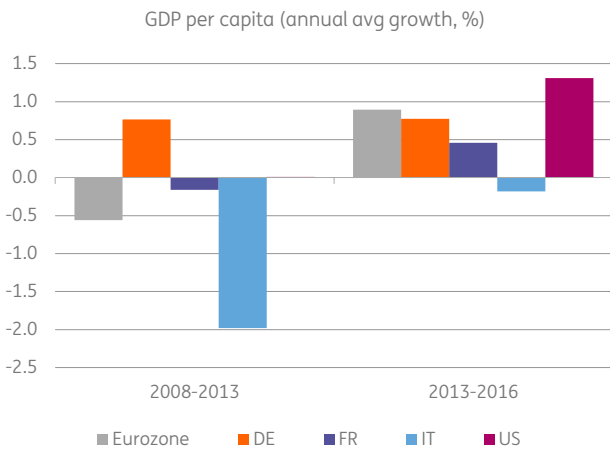
The head start after the crisis years explains biggest part of economic success...

The biggest difference vis-à-vis the rest of the Eurozone took already place during the first years of the crisis. Mainly due to the lack of significant domestic imbalances or bubbles and due to several public stimulus packages, the German economy recovered much quicker and stronger from the crisis than the rest. In the last four years, however, some normalisation has taken place.

...as well as solid fundamentals...

The most noteworthy feature of the current recovery is strong domestic demand. For the first time since reunification, both private consumption and the construction sector have become important growth drivers. The cyclical strength has also improved Germany's absolute strength in many international comparisons. The country has been a permanent Top10 country in the World Economic Forum's international competitiveness ranking, the unemployment rate is the lowest of all G7 economies and the participation rate is the highest in the Eurozone.

**Fig 1 German economy took head-start in crisis years...**



Source: European Commission, ING estimates

...with the only problem being “why is growth not even stronger?”

Low wage sector was first secret to success but has not yet transformed into full-time employment...

In sum, the current *Wirtschaftswunder* is the result of earlier structural reforms, a bit of good luck and the successful transition towards more domestic growth. However, given historically low interest rates and a relatively weak euro exchange rate, the fact that German growth is no longer outperforming the rest of the Eurozone is a clear indication that the current golden cycle is in its final stages.

## 2. The dark sides of the *Wirtschaftswunder*

Even though the macro numbers look excellent, there are weaknesses in the German economy. Let's start with the labour market. The improvement on the labour market started with the introduction of a low-wage segment. Prior to the structural reforms of the mid-2000s, Germany's low wage-sector did hardly exist. Between 2003 and 2016, the number of employees in the low-wage sector increased from around 5.6 million to almost 8 million. Admittedly, this increase has mainly been driven by a sharp increase in part-timers or moonlighters (from less than 1 million in 2003 to around 2.6 million in 2016). The idea that the longer the recovery lasts, the more people would move into full-time employment has not come true yet.

**Fig 2 ...and the labour market is still benefiting from sound fundamentals**



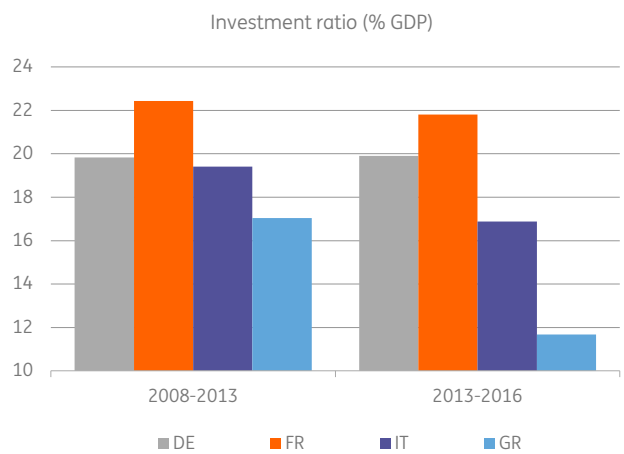
Source: Thomson Reuters

**Fig 3 Low wage sector still big...**



Source: German Labour Agency

**Fig 4 ...with widening investment gap**



Source: Thomson Reuters, ING estimates

...leading to discussion on social inequality

Even though the Gini-coefficient has slightly increased since 2008, there is little evidence for a widening income gap. However, a Gini-coefficient estimated based on capital income shows a wider income gap. Also, according to Eurostat data, the share of people at risk to fall into poverty is still higher than in nine other Eurozone countries.

Investment ratio remains low...

Another dark side of the current recovery is the lacklustre investment performance. With austerity, the share of investment in the GDP has dropped to below 20% in the second half of the 2000s; far below Eurozone average. Despite strong fundamentals, private investment has also not picked up in recent years. When looking at the details, the investment ratio without the latest upswing in the construction sector would have been even more disappointing.

...leading to continued underperformance

In sum, probably the darkest economic sides of the current *Wirtschaftswunder* are the lack of further evolution in the labour market and continued investment underperformance.

### 3. What should and could be done?

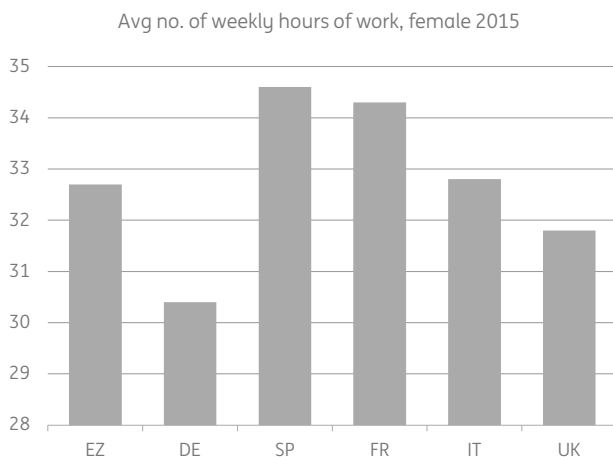
Keys to new success are: ...

In our view, there are a couple of areas which the next German government could and should tackle. The most outstanding ones are the labour market, the educational system and investments in modern infrastructure.

...Labour market reforms aimed at higher participation rates...

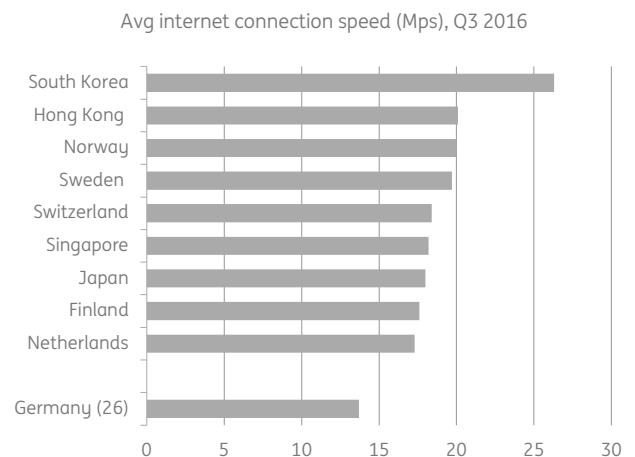
While the labour market is one of the showcases of the current growth performance, some adjustments to the low-wage sector in order to get a broader base for domestic demand does make sense; not necessarily via transfers but possibly also by further reforms. Currently, the labour market still has several built-in hurdles to further employment. Just think of tax disincentives for second earners and mini-job holders to expand labour participation. Particularly, female labour market participation has been a continuous problem, particularly low average working hours. Additional childcare facilities but also a lowering of the tax burden on the second earner could help. However, the latter touches upon a very sensitive point in the German tax system, which still has built-in incentives for one partner in a family to stay at home.

Fig 5 Female labour market participation remains low...



Source: Eurostat, ING estimates

Fig 6 ...and digitalization needs improvement



Source: Akamai, ING estimates

...improvements to the educational system...

According to the OECD, education outcomes remain closely linked to socio-economic background and education spending on disadvantaged students remains relatively low. Although the German educational system in theory offers plenty of opportunities for all kind of backgrounds and skills and does not have a public and private school system, better transitional paths to open different educational levels and streams at several stages during a school career could improve the educational system.

...and more investment

Another issue is the above mentioned investment gap. While government spending on infrastructure has increased since 2015, more will be needed. Not only to improve an ageing logistical and traffic infrastructure but most of all to face the challenges of digitalization. Currently, digitalization or Industry 4.0 (as it is called in Germany) is mainly a means to provide new technologies and improve cost efficiency but to a much lesser extent a means to explore new services or distribution channels. Investments in for example the roll-out of broadband internet but also further high-speed technologies will be needed to safeguard Germany's leading role. Let's not forget that a higher investment ratio does not necessarily have to come from more public investments.

First dress rehearsal in three weeks from now

So far, only few parties have released their election platforms. The CDU and SPD plan only to present their official platforms in June. It seems as if Germany's biggest parties are following the current political Zeitgeist, which has moved from political content to political selling. In the absence of concrete new economic and political plans and proposals, the state elections in North-Rhine-Westphalia on 14 May will be the "dress rehearsal" and popularity test for Merkel and Schulz.

Established parties are likely to return to their original profiles and platforms, with Merkel going for the well-known...

Nevertheless, judging from official statements in public, it looks as if all parties will try to return to their traditional profiles, at least to some extent. The CDU will focus on internal security, families and family values, sustainable public finances and generally claiming the current economic strength for itself. In early March, Angela Merkel announced an Agenda 2025 to prepare Germany for the era of digitalization, increasing public spending on education, R&D and other infrastructure investment. However, nothing has been presented on paper, no details or numbers have been given so far.

...while Schulz is likely to move the SPD to the left...

On the other hand, the SPD could become the German answer to populist trends around the world, campaigning for more social justice, higher wages, some reversals of the previous labour market reforms and extended worker rights. Interestingly, neither the CDU nor the SPD seem to be willing to address the issue of too few new reforms over the last years.

...in a campaign which could also be dominated by "soft factors"

As regards Europe, we don't expect Europe to win the German elections. Still, the candidate Schulz could force Merkel and the CDU to give more insights in their plans for the future of Europe and the Eurozone. In our view, the main topics deciding the elections will probably be internal security, the refugee crisis (although ebbing away), social justice and the economy. Also, the personality and popularity issue (likeability, fatigue and appetite for change) between Merkel and Schulz will in our view be more important for the election outcome than in previous elections.

Past reforms are likely to be a hot item....

In the upcoming election campaign, Germany will now probably experience an almost ironic controversy on the reforms of the 2000s. Merkel and the Christian-democrats will defend the reforms and point to the current strength of the economy, even though they were in the opposition back then. At the same time, Schulz and the Social-democrats will have to explain the voters why they now want to reform the reforms, even though they have been part of the government in 16 out of the last 19 years.

...while new reforms, unfortunately, will not

Even though up to now the biggest political parties have not yet addressed the economic issues which probably matter most, ie, investment and structural reforms, Bill Clinton's "it's the economy, stupid" could dominate the German election campaign this year.

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