

# GERMANY

10

## FOLLOWING IN MERKEL'S FOOTSTEP

After a strong recovery in Q2 and Q3, activity in the coming months could slow due to supply disruptions and sharp rising input prices. After his victory in the legislative elections, Olaf Scholz enters negotiations with the Greens and the liberals on forming a new coalition. The policies are likely to focus on protecting the environment and raising low wages. At the European level, the policies of the new coalition should not be very different from those of Angela Merkel.

## COMING OUT OF THE CRISIS

The economy recovered strongly in Q2, GDP rose by 1.6%, but fell short of eliminating the drop in Q1 (-2%). The main reason for the upswing was the easing of the Covid-19 related restrictions. Business surveys indicate a continuation of the robust expansion in Q3. The PMI composite index rose to 59.2 compared with 57.4 in the three months to June. In addition, the ifo activity index rose to 100.7 from 96.7 in the previous quarter. However, businesses have become increasingly concerned about business conditions in the coming few months. That is in particular the case in the manufacturing sector, where the ifo business climate index has been on a deteriorating trend since July. Businesses are not only worried about shortages of intermediate inputs but also about the stark rising input costs, which are weighing on profit margins.

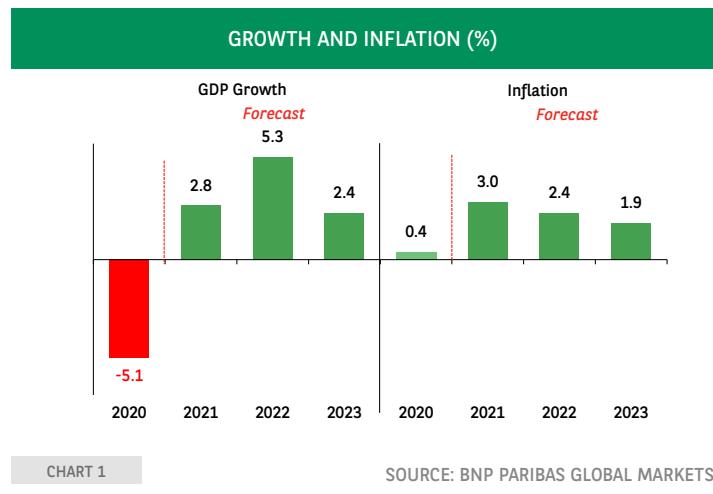
In the wake of strengthening activity, the labour market substantially improved. The unemployment rate has been on a descending trend since December 2020, reaching 3.6% in August, only 0.3 %-point higher than before the crisis. Moreover, the number of workers in the furlough scheme (*Kurzarbeit*) has been rapidly declining in all sectors. In August, only 2% of employees were in a furlough scheme compared with close to 20% in April 2020. As expected, the highest number was in the hospitality industry, 10% compared with 63% in April 2020.

At the same time, prices have been rising sharply. In September, consumer prices were 4.1% higher from a year earlier and we forecast inflation to rise to 4.6% in Q4. The *Bundesbank* attribute this mainly to temporary factors such as the return to the higher VAT rates on 1 January and the increase in crude oil prices. In September, energy prices were 14.3% higher from a year earlier. Moreover, businesses have charged higher prices to recoup some of the losses incurred during lockdown closures or owing to additional costs relating to safety measures. In addition, there is also a risk that supply bottlenecks might trigger additional price surges. If higher prices results in accelerated wage growth, the rate of inflation could rise perceptibly over the longer term as well.

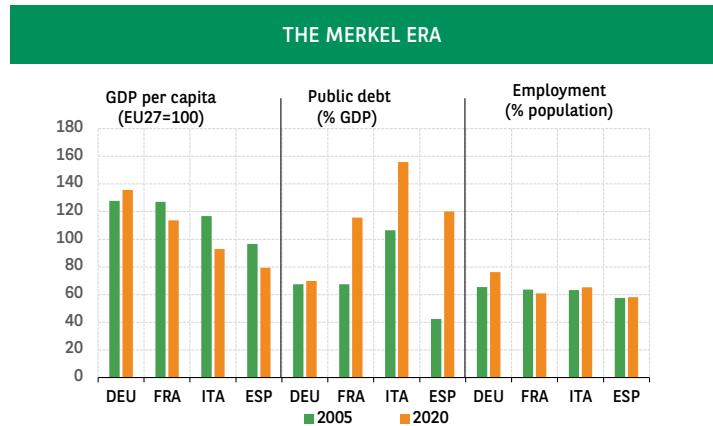
For the moment, basic pay rises have been moderate. Nevertheless, tensions in wage negotiations are rising. Recently, a dispute between Deutsche Bahn and the railroad workers union culminated in nationwide strikes. Given the uncertain inflation outlook, the *Bundesbank* is against committing the very loose monetary policy stance for a protracted period. The central bank pleads for a gradual winding down of the pandemic emergency purchase programme (PEPP), as soon as the pandemic crisis has been overcome.

## THE END OF THE MERKEL ERA

The German general election was narrowly won by the SPD (social-democrats) headed by finance minister Olaf Scholz. The party obtained 25.7% of the vote. The union parties CDU/CSU (Christian democrats) headed by Armin Laschet, the prime minister of Rhineland-Westphalia, ended second with 24.1% of the vote. It was the party's worst result in



SOURCE: BNP PARIBAS GLOBAL MARKETS



SOURCE: EUROSTAT

post-war history. By contrast, the Green party did quite well by almost doubling its score compared to the 2017 general election to 14.8%, and became the third largest political force. The next step is that the parties have to try to form a coalition that has the support of more than 50% of delegates in the Bundestag.

During the election campaign, Mr Scholz has put himself up as the candidate of the continuity. The wish to follow in the footsteps of Ms Merkel is not surprising. During her time at the Chancellery, Ms Merkel piloted the country through several crises. At the start of her mandate end 2005, Germany was considered as "the sick man of Europe". GDP per capita was around the same level as in France (chart 2). Fifteen years later, the income gap with the EU had widened to 46%, whe-



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reas the French income gap had further narrowed to only 14%. This remarkable turnaround can be largely attributed to the labour market reforms (*Agenda 2010*) undertaken under her predecessor Gerhard Schröder (SPD). As a result, unemployment declined from 11.3% in 2005 to only 3.8% in 2020. Moreover, changes in the wage bargaining process resulted in more moderate wage deals, which allowed the country to regain price competitiveness. Production costs were further lowered by shifting taxes from direct taxation to indirect taxation. In 2007, the VAT was increased from 16% to 19% and wage and company taxes were lowered.

The irony is that the *Agenda 2010* reforms have been a great disappointment among the SDP supporters. The party's score was halved between the federal elections of 1998 and those of 2017, from 40.9% to 20.5%. During the Merkel era, the SPD has always been in favour of softening some of the labour market reforms. In 2015, the party, as a junior partner in a grand coalition with CDU/CSU, was the main driving force behind the introduction of a national statutory minimum wage. The job losses that many observers had warned for did not materialise. One of the Mr Scholz's main election promises in the 2021 election campaign is to raise the minimum wage from EUR 9.60 to EUR 12 per hour.

In order to keep public finances in check, the government inscribed the so-called debt brake (*Schuldenbremse*) in the constitution in 2009. This mechanism, in line with the requirements of the Stability and Growth Pact, limits the Federal Government's structural net borrowing to 0.35% of GDP. It has been very effective in reducing Germany's debt-to-GDP ratio from 67.5% in 2005 to 59.7% in 2019. Starting from about a similar position as Germany in 2005, the French public debt actually deteriorated to 97.6% in 2019. Critics of the debt brake hold it responsible for the low level of government investment in particular for digitisation and education, and the bad state of the country's physical infrastructure.

Merkel's environmental record is more contested. After its sudden exit from nuclear energy following the disaster in Fukushima, Germany has invested heavily in renewable energies and yet achieved little on CO<sub>2</sub> reduction, as it delayed the exit from coal. The country achieved its climate targets for 2020, but that was due to the impact of the Covid-19 crisis on activity. Moreover, electricity consumers have paid a very high price for the transition.

During the Merkel era, female employment has substantially increased from less than 60% of the female working-age population in 2005 to 73.2% in 2020. However, many women work in low paid jobs or in so-called mini-jobs. An important disincentive for women to seek full-time employment is the joint taxation of married couples with full income splitting (*Ehegattensplitting*). As a result, the income gap between men and women is one of the highest in the EU (chart 2).

During the severe crises over the last 15 years, the German economy turned out to be much more resilient than that in the other European countries. At the European level, the Chancellor was often reluctant to give unconditional support to the other EU member states. However, at decisive moments, the Chancellor made the choice for Europe. She made sure that Greece could stay inside the Eurozone. In the case of the migration crisis in 2015, the Chancellor even took a serious political risk by opening the borders, in the first place for humanitarian reasons.

### GENDER WAGE GAP (2020)

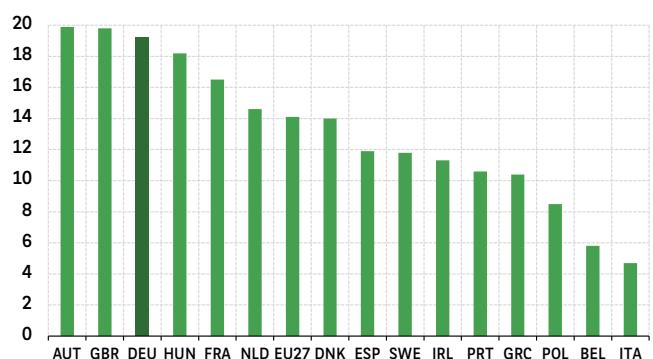


CHART 3

SOURCE: EUROSTAT

## PROTECTION OF THE ENVIRONMENT AND LOW-WAGE EARNERS

If Mr Scholz succeeds in forming a coalition, the emphasis of policy is likely to be put on the energy transition. The severe flooding in the western part of the country this summer has once more underlined the importance of more investment in flood prevention and a worldwide reduction in CO<sub>2</sub> emissions.

The SDP is likely to soften the labour market reforms. It has already announced its willingness to increase the minimum wage to EUR 12 per hour (from EUR 9.60 currently). Moreover, the party may like to slow the raising of the retirement age, which should reach 67 by 2029.

The new *Bundestag* will decide the Budget for 2022. As the Covid-19 crisis wanes and the Covid-19-related support to the economy is gradually reduced, the discussion on restoring budget discipline is likely to come again to the fore. The outgoing government, in which Mr. Scholz was the finance minister, planned to comply with the debt brake again in 2023, as foreseen in the country's constitution. Mr Scholz has certainly remembered the lesson from the Covid-19 crisis that thanks to a healthy budget, the federal government was able to support generously the economy in the crisis, without a dramatic deterioration of the public accounts.

At the European level, the policies of the incoming coalition should not be very different from the outgoing one. Each German Chancellor will act in the first place in what he or she perceives to be in the interest of the country. Germany is expected to defend a return to the European budget rules to instil confidence in the euro. Support to other countries can only be given conditional on the implementation of structural reforms.

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