# Wish list for the new German government

Ahead of a German parliamentary election, economic analysts usually deal with the campaign platforms of the various parties and explain in an unbiased report what announced measures will or might lead to what economic effects and market reactions. We are also going to publish such an analysis before the election. But in today's edition of Economic Situation and Strategy, we want to discuss, quite independently of political considerations and leanings, some matters that any future German government will have to address – and not because it seems politically opportune, but because it is simply and absolutely necessary regardless of politically motivated preferences or judgments. Our analysis below is thus a kind of economists' "wish list" and makes no claim to completeness. However, we may be able to demonstrate to some extent that political parties often appear to work on "processing" details without confronting the obvious structural problems and deficiencies whose solution is vital to the well-being of the economy in the long term.

*Wish No. 1: More government capital investment!*

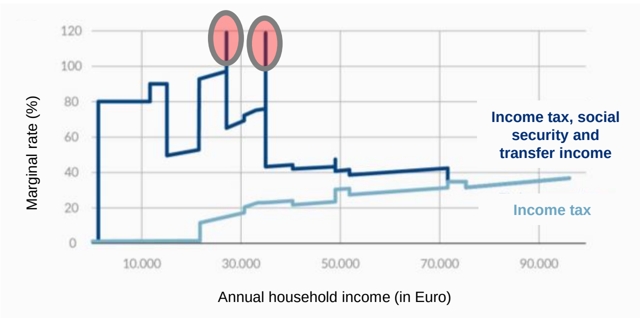
For many years, the German government has spent only a very small proportion of GDP on capital investment. It is comparatively constant at just over 2%, while other countries tend to invest 3%. At about 10% relative to total outlays, capital investment by the German government is also piddling in international comparison. To be fair, it must be noted that capital investment ratios of different countries cannot be perfectly compared because the government spending spectrum is not always comparable between countries. For example, German hospitals are often operated by churches or private institutions, while being almost completely public-operated in other countries – with corresponding effects on the capital investment ratio. However, considering that the government capital investment ratio has fallen from 6% in 1970 to about 2% in 2017 and write-offs on public capital investments are now higher than the actual investments, there is no need of an international comparison to see that Germany is living off its assets. The best and most topical example of that is the current closing of the Rhine Valley Railway. Of course, unplanned delays can always arise on construction sites, and temporary emergency solutions must be worked out. But when the closing of a single railway causes half of Germany's rail traffic to collapse because hardly any detour railways can be used due to lack of electrification, narrow tunnels, or insufficient track beds, that shows how thin reserves have become. And anyone still not convinced that a considerable investment backlog has accumulated in Germany in recent years should take a quick look at public offices, schools, and universities and then think again. Considered from any angle, it is a reasonable demand that the German government invests about EUR 30 billion more per year. If it does not, future generations will pay the consequences.

*Wish No. 2: Lower marginal tax burdens, especially for transfer income recipients!*

The German tax system is distinguished by a comparatively clear progression of the marginal tax rate. Up to almost EUR 9,000 every additionally earned euro is not taxed at all. Taxation begins at a marginal rate of 14%, which increases to 45%. This progression ensures that more than half of income tax revenue comes from the top 10% of taxpayers, while 90% of taxpayers account for less than half. This is desirable from the standpoint of distribution policy, and socially minded politicians "proudly" point to the associated redistribution effects. But it is completely overlooked that recipients of transfer income (housing subsidies, welfare, unemployment assistance, aid to families with children, etc.) do not benefit from a low or even non-existent tax rate, but rather suffer from an extremely high rate of transfer withdrawal. It sounds complicated, but in principle it is quite simple. When one receives transfer income in Germany (about 10% of the population), more or less every additionally earned euro is – in simplified terms – withdrawn from the transfer payments. In reality, this is more complicated because in Germany every social benefit is granted case by case and the individual effects can be different depending on the family situation and other contextual data. The Center for Economic Research (ZEW) in cooperation with the Ifo Institute on behalf of the Bertelsmann Foundation has therefore exactly calculated in a current study based on a large number of model households at what income level what marginal burdens arise including the transfer withdrawal rate.[1] The conclusion is definitely alarming and confirms many other studies published since the 1990s on this topic.

Finally, it emerges that marginal burdens of up to 120% arise at places in the income curve, with marginal burdens of 80%-100% being the rule. Only starting from a gross household income of over EUR 30,000 (in the case of a family with two children) does the marginal burden drop to 40%, and only at a gross household income of over EUR 70,000 does it drop below 40%.

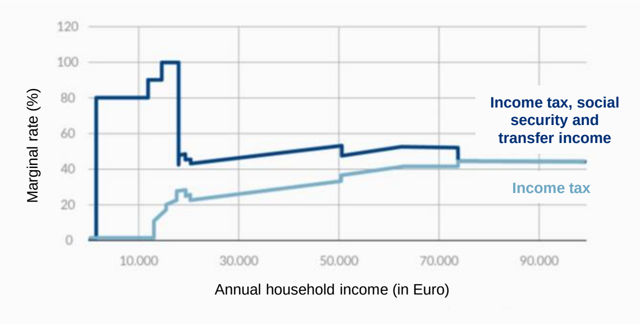
*Effective marginal burden of a married couple with two children (one spouse earning):*




*Source: Bertelsmann Foundation, ZEW, Ifo Institute*

[1] Peichel, Buhlmann, Löffler, Blömer (2017): Grenzbelastungen im Steuer-, Abgaben- und Transfersystem.

*Effective marginal burden of a single-person household:*

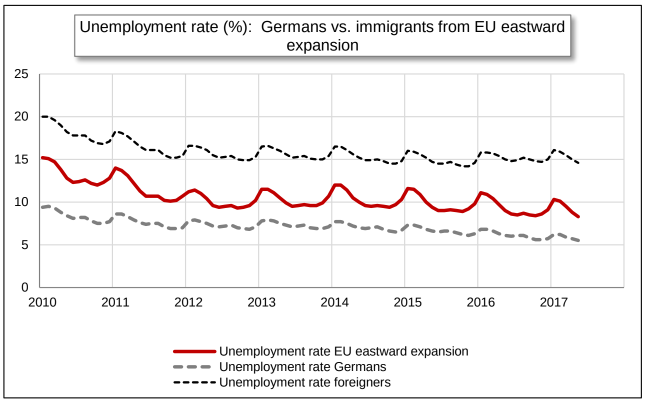


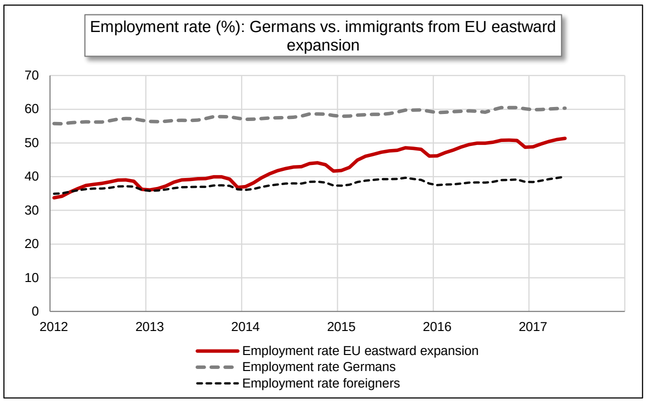

*Source: Bertelsmann Foundation, ZEW, Ifo Institute*

Now, the solution to this imbalance surely does not consist in further increasing the marginal income tax rate on high incomes, but in lowering the transfer withdrawal rate on low incomes, e.g., to 60%. Simplified, this would imply not lowering the transfer by EUR 100 when income rises by EUR 100, but rather only by EUR 60. Only this measure creates an incentive to work at all or somewhat more. Under the current social benefit system, the German government is (unintentionally) creating incentives to remain in the system instead of working one's way out of it. This is well-known among politicians. Nevertheless, nothing is changing since a reduction of the transfer withdrawal rate would presumably increase government expenditures somewhat in the first few years before this measure paid off in the long term. However, in terms of substance, there is no good reason not to tackle this problem.

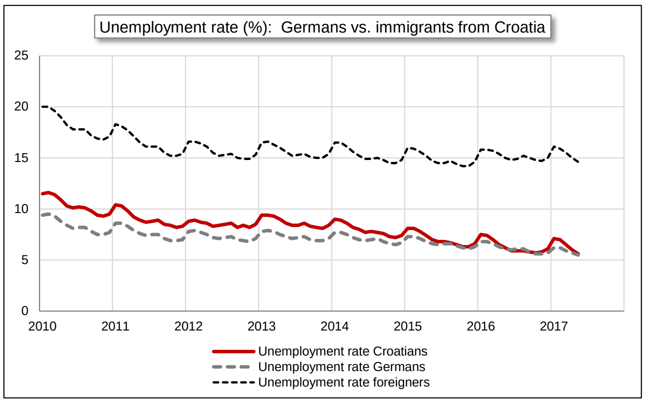
*Wish No. 3: Incentives for better integration of immigrants on the labor market*

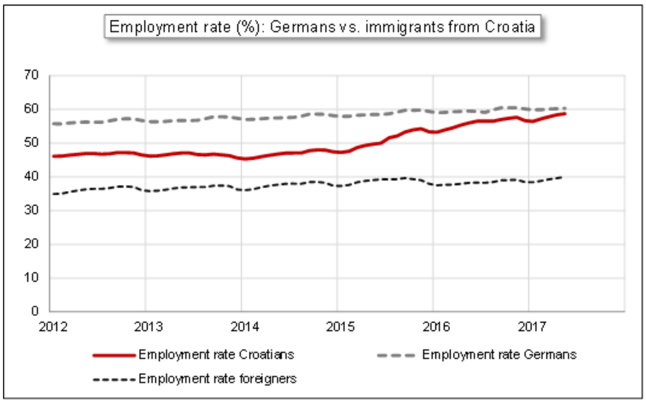
Germany is one of the world's most popular destinations for immigrants. In principle, that is good news because it confirms the country's attractiveness as a location and immigration can compensate to a certain extent for Germany's chronically low birth rate. If the trend of the last few years continues, it will become necessary to throw out all population projections for Germany due to immigration. However, immigration will only give the social state relief if persons with a migration background participate in the labor market to a similarly high degree as persons without such a background. That has definitely not been the case. For decades, the employment ratio of immigrants has been substantially below the average employment ratio of Germans, and the unemployment rate gap has been analogous. This situation has also not changed in recent years, although the economic upswing has created room for improvement. Moreover, since the average income of immigrants is in some cases significantly below average while social benefits from the government tend to be claimed above average, generational accounting studies regarding Germany based on micro-census data suggest that the German state is almost certainly not benefiting economically from immigration as it has in the past. And the situation is even a bit more complicated. For instance, it makes no sense to treat migration as a homogenous phenomenon. To understand what has happened in recent years, one must deal with the numbers. They show that immigration from the countries of the latest EU expansion eastward has been comparatively positive for Germany. The unemployment rate of these immigrants is only slightly above that of Germans, and the employment rate is gradually nearing the level of German workers.



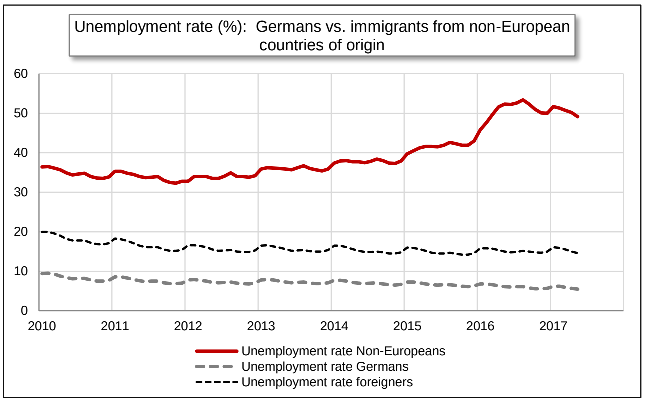



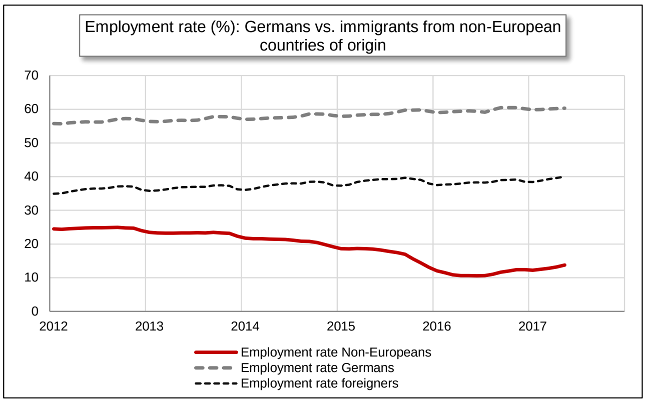

Immigration from Croatia has been especially "successful" from a German perspective. In comparison with German, we see no significant differences regarding integration into the labor market.



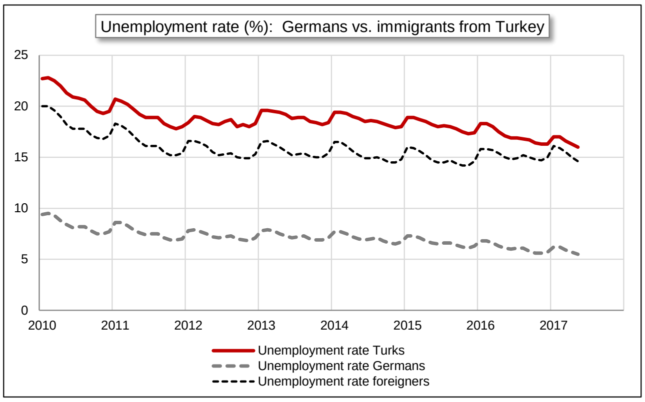



On the other hand, things look quite different when one analyzes the non-European countries generating asylum-seekers.




Even persons with a Turkish migration background are only integrated below average in the German labor market.




It is understandable that politicians like to steer away from this sensitive topic, since they would run the risk of entering a political minefield and being put in a context they would prefer to avoid. However, the trends depicted above contain explosive potential, and it would be misguided if politicians did not put the topic of integrating immigrants into the workforce on their agenda.

*Wish No. 4: Honest words about pensions*

The pay-as-you-go pension system can only work if every generation takes on two tasks: 1) to finance the pensions of the old generation through contributions and 2) to raise a new generation of contributors and educate them well. Since there are "problems" with fulfilling the second task in view of the low birth rate, an increase of the retirement age is mathematically unavoidable. Alternatively, one could switch to requiring contributors to pay amounts into a funded pension insurance upon reaching a certain age (e.g. 30) in addition to the "normal" contributions as long as they have no children. This ruthless solution is politically obviously not feasible. Future pensioners are voters, and therefore politicians find it hard to seriously consider this option. However, that does not alter the fact that a rude awakening awaits us in about 20 years unless honest and targeted steps are taken in the right direction now.

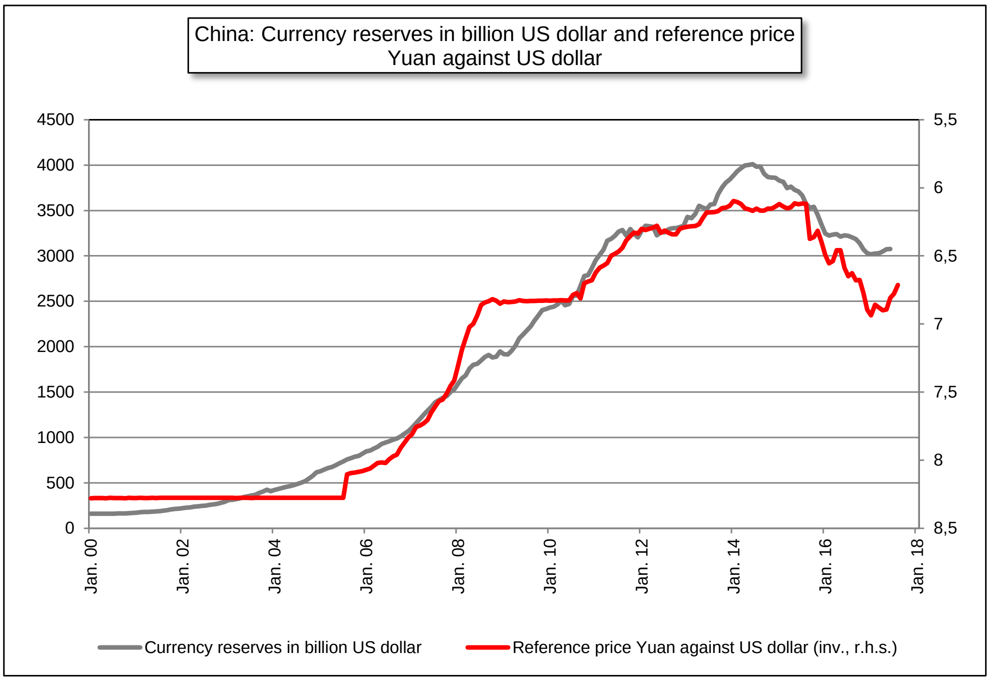
The above-mentioned perspectives and topics are only some examples of what a responsible German government with a longer time horizon would have to tackle. If the new government shows the courage to work on such issues right from the start, it will presumably nevertheless have good chances of being reelected. We therefore hope the coming government will have the fortitude to address the issues that may not bring in any votes at first, but are extremely important in the long term.

## Weekly outlook for August 28-September 1, 2017

| | Apr. | May | June | July | Aug. | Sept. | Release |
|---|---|---|---|---|---|---|---|
| DE: GfK consumption climate | 9.8 | 10.2 | 10.4 | 10.6 | 10.8 | 10.6 | August 29 |
| DE: Inflation rate, flash, m/m | 0.0% | -0.2% | 0.2% | 0.4% | 0.1% | | August 30 |
| DE: Inflation rate, flash, y/y | 2.0% | 1.5% | 1.6% | 1.7% | 1.8% | | August 30 |
| DE: Retail sales, m/m | -0.3% | 0.5% | 1.1% | 0.3% | | | August 31 |
| DE: Unemployed, change in k | -14 | -8 | 6 | -8 | -9 | | August 31 |
| DE: Unemployment rate | 5.8 | 5.7 | 5.7 | 5.7 | 5.6 | | August 31 |
| DE: PMI, manufacturing, final | 58.2 | 59.5 | 59.6 | 58.1 | 59.4 | | September 1 |
| EUR19: M3 money supply, y/y | 4.9% | 4.7% | 4.7% | 4.9% | | | August 28 |
| EUR19: Business climate | 1.09 | 0.9 | 1.16 | 1.05 | 1.03 | | August 30 |
| EUR19: Economic confidence | 109.7 | 109.2 | 111.1 | 111.2 | 110.5 | | August 30 |
| EUR19: Consumer confidence, final | -3.6 | -3.3 | -1.3 | -1.7 | -1.5 | | August 30 |
| EUR19: Business confidence | 2.6 | 2.8 | 4.5 | 4.5 | 4.1 | | August 30 |
| EUR19: Inflation rate, flash, y/y | 1.9% | 1.4% | 1.3% | 1.3% | 1.3% | | August 31 |
| EUR19: Core inflation rate, flash, y/y | 1.2% | 0.9% | 1.1% | 1.2% | 1.1% | | August 31 |
| EUR19: Unemployment rate, s.a. | 9.2 | 9.2 | 9.1 | 9.1 | | | August 31 |
| EUR19: PMI, manufacturing, final | 56.7 | 57.0 | 57.4 | 56.6 | 57.4 | | September 1 |

MMWB estimates in red

## **Chart of the Week**: China – reports of death greatly exaggerated




It has been almost exactly two years since the Chinese central bank decided to lower the reference value of its own currency, the yuan, against the US dollar by 2% overnight, a move described as "spectacular" by many market participants, after the yuan had continuously revalued upward in the preceding years. When the currency devalued in the two subsequent days, chaos broke out on stock exchanges worldwide. People thought then that if China was forced to devalue its currency against the US dollar for the first time in 20 years, its economy must be in bad shape. After all, the country had already reduced its currency reserves in the previous months, and it was standard practice to calculate when those would probably be used up. The yuan lost about 6% of its value against the US dollar between August and December 2015, and the trend continued in 2016 with a decrease of just under 7%. Considering annual fluctuations in some cases of 15%-20% in the euro/US dollar exchange rate, however, the panic at that time regarding the Chinese currency is difficult to understand and can only be explained by possible end-of-the-world scenarios. After all, many observers have long warned of China's economic collapse for a huge variety of reasons. But that has not happened – and probably will not in the near future. In 2017, the Chinese economy has again been growing faster than many had forecast. That is also in line with the currency's revaluation by over 4% against the US dollar since the beginning of the year and a recent increase of currency reserves.

| | As of | Change versus | | | |
|---|---|---|---|---|---|
| | 25.08.2017 | 18.08.2017 | 24.07.2017 | 24.05.2017 | 30.12.2016 |
| **Stock marktes** | 14:07 | -1 week | -1 month | -3 months | YTD |
| Dow Jones | 21783 | 0,5% | 1,3% | 3,7% | 10,2% |
| S&P 500 | 2439 | 0,6% | -1,3% | 1,4% | 8,9% |
| Nasdaq | 6271 | 0,9% | -2,2% | 1,8% | 16,5% |
| DAX | 12222 | 0,5% | 0,1% | -3,3% | 6,5% |
| MDAX | 24860 | 0,1% | 1,4% | -0,9% | 12,0% |
| TecDAX | 2274 | 0,7% | 0,7% | 0,8% | 25,5% |
| EuroStoxx 50 | 3454 | 0,2% | 0,0% | -3,7% | 5,0% |
| Stoxx 50 | 3057 | 0,5% | -1,7% | -5,6% | 1,5% |
| SMI (Swiss Market Index) | 8952 | 0,9% | 0,6% | -0,9% | 8,9% |
| Nikkei 225 | 19453 | -0,1% | -2,6% | -1,5% | 1,8% |
| Brasilien BOVESPA | 71133 | 3,5% | 9,3% | 12,4% | 18,1% |
| Russland RTS | 1053 | 2,5% | 3,9% | -3,2% | -8,6% |
| Indien BSE 30 | 31596 | 0,2% | -2,0% | 4,3% | 18,7% |
| China Shanghai Composite | 3332 | 1,9% | 2,5% | 8,7% | 7,3% |
| MSCI Welt (in €) | 1940 | -0,2% | -2,2% | -3,7% | -1,2% |
| MSCI Emerging Markets (in €) | 1082 | 1,5% | 0,3% | 2,0% | 12,0% |
| **Bond markets** | | | | | |
| Bund-Future | 164,46 | 10 | 192 | 366 | 31 |
| Bobl-Future | 132,88 | 11 | 78 | 128 | -75 |
| Schatz-Future | 112,21 | 3 | 19 | 6 | -9 |
| 3 Monats Euribor | -0,33 | 0 | 0 | 0 | -1 |
| 3M Euribor Future, Dec 2017 | -0,33 | -1 | -1 | -3 | 0 |
| 3 Monats $ Libor | 1,32 | 0 | 0 | 12 | 32 |
| Fed Funds Future, Dec 2017 | 1,21 | 0 | -3 | -2 | 0 |
| 10 year US Treasuries | 2,20 | 0 | -5 | -5 | -25 |
| 10 year Bunds | 0,40 | 6 | -4 | -1 | 29 |
| 10 year JGB | 0,02 | -3 | -5 | -3 | -3 |
| 10 year Swiss Government | -0,13 | -1 | -12 | -1 | 8 |
| US Treas 10Y Performance | 587,45 | 0,0% | 0,8% | 1,3% | 3,2% |
| Bund 10Y Performance | 612,47 | 0,4% | 1,3% | 1,1% | -0,1% |
| REX Performance Index | 483,59 | 0,1% | 0,5% | 0,3% | -0,4% |
| US mortgage rate | 0,00 | 0 | 0 | 0 | 0 |
| IBOXX AA, € | 0,69 | -2 | -10 | -8 | 1 |
| IBOXX BBB, € | 1,27 | -1 | -6 | -15 | -23 |
| ML US High Yield | 6,13 | -3 | 17 | 18 | -33 |
| JPM EMBI+, Index | 834 | 0,5% | 1,4% | 1,5% | 8,1% |
| Convertible Bonds, Exane 25 | 7164 | 0,0% | -0,2% | -1,0% | 3,6% |
| **Commodities** | | | | | |
| CRB Spot Index | 436,33 | -0,4% | -1,1% | 0,5% | 3,1% |
| MG Base Metal Index | 334,42 | 1,2% | 9,8% | 14,2% | 19,5% |
| Crude oil Brent | 52,50 | 2,4% | 7,9% | -3,1% | -7,4% |
| Gold | 1286,67 | -0,7% | 2,5% | 2,7% | 11,2% |
| Silver | 16,99 | -0,4% | 3,1% | -0,5% | 5,9% |
| Aluminium | 2106,50 | 1,7% | 11,4% | 8,4% | 23,6% |
| Copper | 6663,25 | 3,3% | 11,2% | 17,7% | 20,6% |
| Iron ore | 75,88 | 2,0% | 16,0% | 23,4% | -4,9% |
| Freight rates Baltic Dry Index | 1200 | -4,8% | 22,8% | 28,5% | 24,9% |
| **Currencies** | | | | | |
| EUR/ USD | 1,1814 | 0,6% | 1,4% | 5,5% | 12,1% |
| EUR/ GBP | 0,9209 | 0,8% | 3,2% | 6,6% | 7,9% |
| EUR/ JPY | 129,56 | 1,2% | 0,4% | 3,5% | 5,0% |
| EUR/ CHF | 1,1390 | 0,9% | 3,4% | 4,2% | 6,1% |
| USD/ CNY | 6,6530 | -0,3% | -1,5% | -3,5% | -4,3% |
| USD/ JPY | 109,56 | 0,3% | -1,4% | -1,7% | -6,3% |
| USD/ GBP | 0,78 | 0,2% | 1,7% | 1,0% | -3,7% |

Carsten Klude +49 40 3282-2572 cklude@mmwarburg.com
Dr. Christian Jasperneite +49 40 3282-2439 cjasperneite@mmwarburg.com
Dr. Jörg Rahn +49 40 3282-2419 jrahn@mmwarburg.com
Martin Hasse +49 40 3282-2411 mhasse@mmwarburg.com
Dr. Rebekka Haller +49 40 3282-2452 rhaller@mmwarburg.com
Bente Lorenzen +49 40 3282-2409 blorenzen@mmwarburg.com