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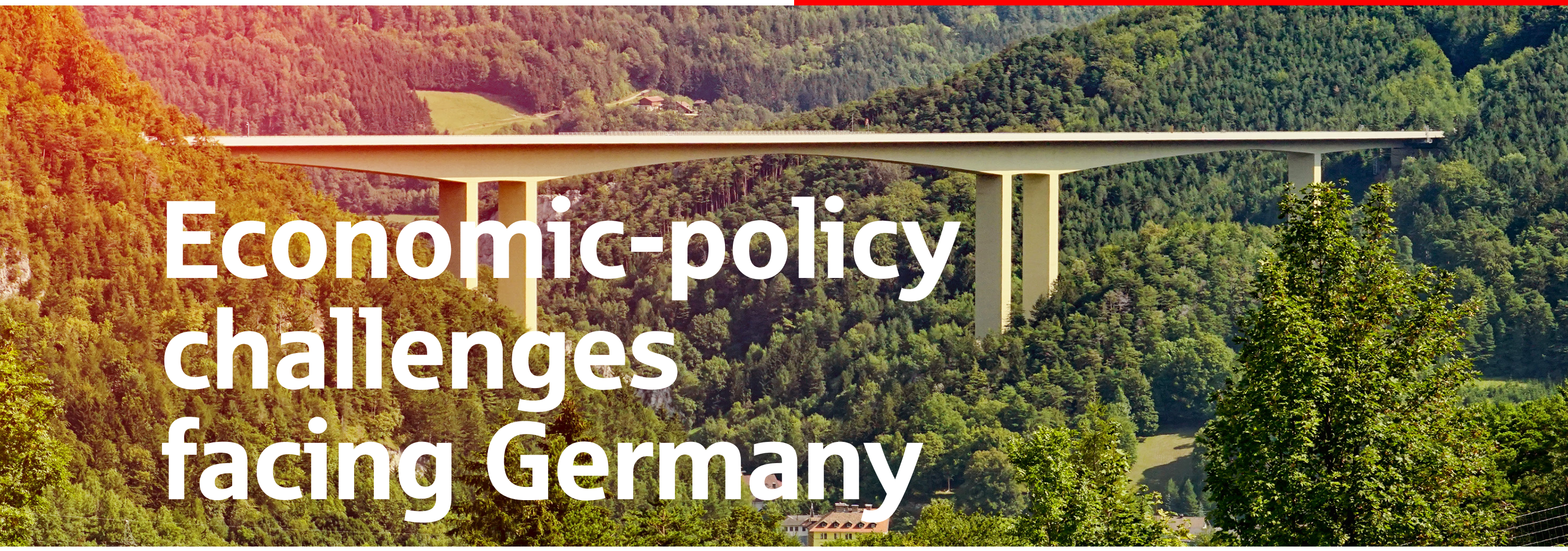

Economic-policy challenges facing Germany

Berlin, 21ST November 2018

The cyclical environment is clouding over while both interest rates and inflation rates are drifting upwards. In the light of this, the Chief Economists of the German Savings Bank Finance Group have engaged with selected economic-policy themes. They conclude that investment momentum has been unsatisfactory over the last few "years of plenty" and advocate the following remedies:

- → Targeting the goal of equal living conditions as a matter of urgency;
- → Bolstering local-authority investment in a broad manner (i.e. also taking account of the problem of scarce planning capacities);
- → Aligning the future EU financial framework more single-mindedly to the task of creating reliable framework conditions for investment;
- → Creating an innovation-friendly environment and focusing research funding more closely on the generation of marketable product and process innovations,
- → Rapid implementation of measures enabling fast-track recruitment of skilled workers from abroad.

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Germany is facing economic-policy challenges

When it comes to determining how the German economy is doing, the business-climate gauges are currently painting an ambiguous picture. On the surface, they are continuing to indicate that the situation remains highly favourable, but the fact that survey readings are now pointing downwards in most cases gives rise to certain dark presentiments about what is in store going forward.

A comfortable point of departure

Close to full employment

There can be no doubt that the German economy has been in a decidedly comfortable place during the past five years. Over this period, average GDP growth – at somewhat higher than 2 percent – has been half a percentage point higher than the medium-term to long-term growth path, and this has, moreover, been accompanied by a concomitant increase in employment subject to social security contributions. At 4.9 percent, the unemployment rate is currently half a percentage point lower than was the case last year, declining somewhat faster as the upswing has matured. Falling joblessness in combination with low oil prices has fed through to higher real incomes, which, in turn, has permitted private consumption to overcome its former sluggishness. It has also been possible to detect greater momentum again on the investment front over the past five years (an average growth rate of 4 percent), with the now higher profile for licences and software use in the national accounts reflecting the progressive digitalisation of the economy. Another piece of good news is that, on balance, no skid-marks are in evidence on the foreign-trade side in spite of the geopolitical and trade-policy imponderables that have frequently been a cause for complaint in recent years.

Investment is not looking dynamic enough

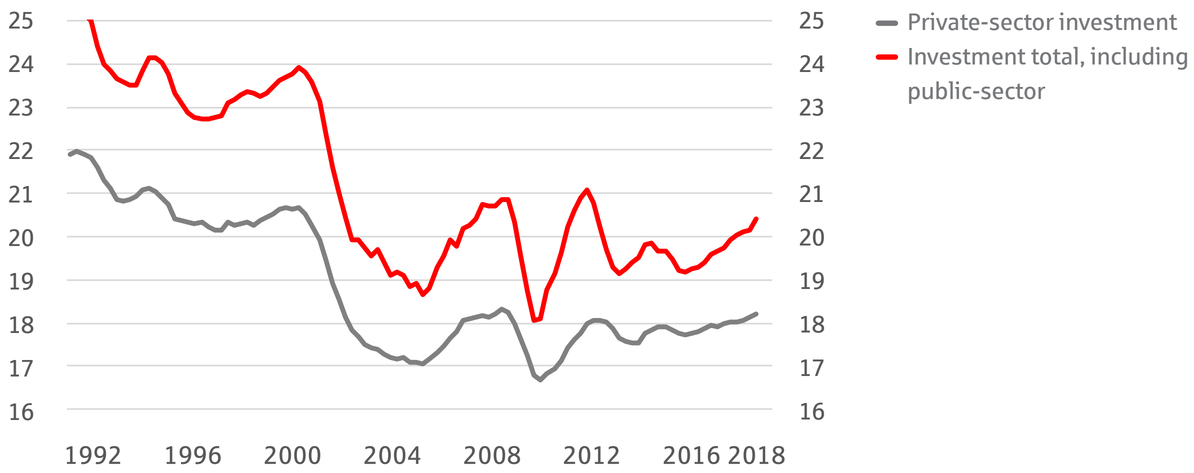
Regarding the three main components of macroeconomic demand referred to above, there appears to be no doubt, however, that the Federal Republic will now have to brace itself for more difficult times. This is particularly conspicuous in the case of the export industry, which is facing major challenges – the shaky situation in various threshold countries, the waning expansion in China, and the political imponderables concerning the future configuration of trade with the USA, or with the United Kingdom as well.

Yet there now also appears to be less residual room for improvement in the case of domestic demand as well. Now that cyclical unemployment has been reduced comparatively easily, future job growth is going to hinge to a greater extent on the tough struggle to eliminate structural obstacles to employment. Given, furthermore, that the upward drift in inflation rates has, so far, been predominantly attributable to external price factors, and only to a smaller extent to higher rates of wage growth, real incomes are only climbing to a rather modest degree.

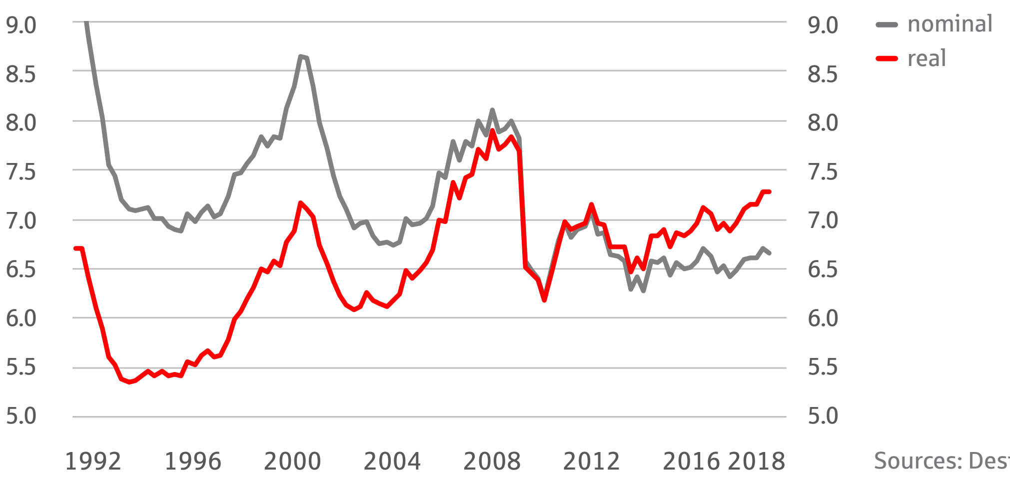
On the investment front, the latest movements in interest rates make one suspect that more difficult financing conditions could put a brake on capital-expenditure activity as well. The good news on this score is that this cyclical adjustment pattern is unlikely to prove particularly pronounced because corporate finances are, for the most part, decidedly solid and therefore, in large swathes of industry, scarcely vulnerable to rising interest rates. The bad news on the same score is that we have not witnessed a striking increase in plant-and-equipment spending over the past few years even though the cyclical environment would have definitely been conducive to an above-average growth rate in capital investment. More specifically, the ratio of equipment investment to the gross domestic product (GDP) only ticked up to a very marginal extent in the immediate aftermath of the euro crisis of 2012/13 and has since remained more or less unchanged at a shade over 6.5 percent. This ratio has thus invariably been more than one percentage point lower than prior to the structural break constituted by the onset of the financial crisis ten years ago

Little setback potential for investment as the recent trend was hardly exuberant

Germany: Investment-to-GDP ratios, annual moving averages in percent



Germany: Ratio of plant-and-equipment spending to GDP, in percent



Sources: Destatis, own calculations

Admittedly, these figures can partly be explained in terms of technological change, the shifts in the composition of the capital stock associated with this, and the comparatively moderate price trend for capital goods. However, this only relativises, rather than fundamentally contradicting, the insight that investment activity has been restrained. Such investment restraint does not only diminish growth opportunities; it also crimps technological progress in the medium term, thereby limiting the leeway for a transition to a more environmentally-friendly economy.

Bolstering local-authority investment and aiming to ensure equal living conditions

As a consequence, an economic policy designed to be viable in the future will have to remain geared to overcoming sluggish investment. Not the least important illustration of this finding is the need to expand and modernise infrastructure networks in the energy, transportation and communication spheres. It is true, of course, that bottlenecks regarding the implementation of construction measures are due less to the unavailability of financial resources than to a lack of planning capacities in the public-sector general-construction and civil-engineering administration field and to the fact that capacity utilisation in the building industry is very high in any case, with myriad regulatory requirements simultaneously spawning a drastic rise in construction costs. We are therefore calling for a Construction and Infrastructure Acceleration Act, which would need to entail considerable relief with regard to planning and implementation procedures. In the case of new construction projects, all resolutions adopted over the past five years ought to be suspended for five years. The rehabilitation of existing buildings ought to continue to be carried out and promoted, paying particular attention to the relevant ecological building specifications. After being approved, important infrastructure projects ought to be able to be implemented without being subject to any further stipulations. In this context, subsequent adjustments to existing requirements, as well as to those coming into existence in future, will help to ensure that large-scale projects can be realised on time and on budget and that they will yield the appropriate utility for the economy as a whole.

Relief measures are needed to accelerate infrastructure investment

In principle, it certainly cannot be denied that certain local authorities have been compelled in recent years to keep their fiscal position under control very largely by postponing or dispensing with investment. It is true that the pressure which such local authorities are under has at least eased for cyclically-related reasons, and the federal government has also provided financial assistance totalling EUR 7 billion for financially-weak local authorities in the 2015-2020 period by means of the Local Authority Investment Promotion Fund (Kommunalinvestitionsförderungsfonds). All the same, net investment in the local-authority sector as a whole so far remains negative, because eliminating capacity bottlenecks is evidently a long haul. It is important here to bolster Germany's cities/towns, municipalities and rural districts so that they are able to meet their fundamental responsibility, namely the provision of general public services. Paramount importance here attaches to expanding digital infrastructure, with special attention to "last mile" broadband access in rural areas.

Investment weakness is unequally distributed

The under-investment at local authorities is an all the more explosive issue because it is not a nationwide phenomenon in the Federal Republic but is rather concentrated in economically weak regions. Under-investment of this kind helps to entrench disparities between locational conditions. Such disparities frequently open up between rural areas and cities/towns heavily affected by structural change, on the one hand, and conurbations benefiting to a greater extent from international exchange, on the other. They must not lead to deep social rifts, of the kind which are already being foreshadowed by the increasingly irreconcilable tone in certain political debates. Given that the Savings Bank Finance Group is a network of institutions serving the common good and with deep roots in the various regions, this topic is definitely a matter close to our hearts. Endeavours to create equal living conditions – which are, we are glad to note, the task of a commission recently appointed by the federal government – ought to be given concrete form as soon as possible and ought to pursue the goal of enhancing development opportunities in all parts of the country.

The European financial framework and the digital tax: a reliable framework is the key factor

Strengthening regional roots is an essential undertaking, but more still is needed. Success will only materialise if Germany simultaneously broadens its international economic relations and stands up, along with its partners in the European Union, for the preservation and further evolution of multilateral agreements. It is by now a commonplace that the world – and therefore, by extension, economic life – is becoming ever more closely interlinked as digitalisation makes further inroads. This also means that interdependencies on an unprecedented scale need to be taken into account by economic policymakers. It is therefore imperative to come up with problem-solving approaches where all the gears mesh properly.

All the gears need to mesh properly

In this context, it is, in principle, to be welcomed that a facility to support growth-promoting public-sector investment is to be provided for in the EU's next Multiannual Financial Framework (MFF). Since many public-sector investment projects are likely to unlock "European added value," this can be regarded as a meaningful building block contributing to the planned realignment of the EU budget. On the other hand, the configuration of this instrument as a stabilisation facility for crises undermines the credibility of the simultaneous pledge to comply with strict eligibility criteria. This is because the member states, in the event of a crisis, would simply not have the time to identify eligible projects and then to subsequently put together complex project applications for what would presumably prove to be long-drawn-out approval procedures. What would make better sense here would be a permanent facility, which could partly be funded through the redesignation of existing cohesion and regional-promotion funds.

Questionable digital-tax strategy

On the public-sector revenue side too, a new EU-wide fiscal ruling is currently being propagated – the "digital tax." This is to be used to apply a higher tax rate to revenues generated within the framework of digital business models involving users from within the EU. In this connection, business models are reckoned to be "digital" which garner revenues from personalised advertising, data sales or the provision of platform-based intermediation services. Advocates of such a tax see it as a means of putting an end to the allegedly too low taxation of internet corporations and as a contribution towards creating a level tax playing field for the various players in the competitive stakes. However, it has to be doubted whether the digital tax can live up to such ambitions. One objection: since it is a (gross) turnover tax, it is – even methodologically – a questionable substitute for the efforts which are definitely needed to narrow the divide separating the various national states when it comes to the tax assessment of corporate earnings.

Higher tax rates would also tend to stunt the development of digital business models, thus turning into a locational disadvantage for Europe. By contrast, the big challenge when it comes to strengthening the ground rules for fair competition is to create a reliable legal framework to accompany the tectonic shifts in the market environment brought about by digitalisation. It is an incontrovertible fact that network effects in digital worlds lead to stronger supply-side concentration and to a tilt in in the competitive architecture towards competition between heterogeneous business models. Above all platform-based models are proving very assertive, regarding both the utilisation of data made available by users and the compensation of creators of intellectual property. The state also remains in demand as a market custodian in view of the strong incentives to exploit lock-in effects.

Would the wrong economic agents be affected?

Regarding the digital tax, we should not succumb to the illusion either that it would only affect the "data-collecting monsters" which are eyed critically by many in the public sphere. Conversely, introducing such a tax would undoubtedly sour the atmosphere of trade negotiations with the United States, and would also make it more difficult to achieve the close cooperation with the USA which is urgently required when formulating and enforcing ethical standards concerning the use of algorithms and in the domain of IT security.

Structural change needs to be organised in an innovation-based manner

In the context of unlocking development potential in rural regions, the latest technological disruptions could open up new options for action, especially regarding the decentralised (and frequently small-scale) provision of goods and services. A precondition here, though, is that there should be efficient energy, transportation and communication networks, capable of coping with the continuous change on the markets and, for example, helping to support the collective use of goods, new more family-friendly forms of work, local-production strategies, more efficient use of low-emission energy sources, or the flexibilisation, reduction or even avoidance of commuter and transport flows. What is imperative, then, is to engineer an innovation-based form of structural change, simultaneously capable of making the economy more ecologically correct while, not least, making a contribution towards defusing the strained situation on the housing market. If our guiding principle is to be sustainable economic management, such types of progress are part of the solution.

Prerequisites for innovation

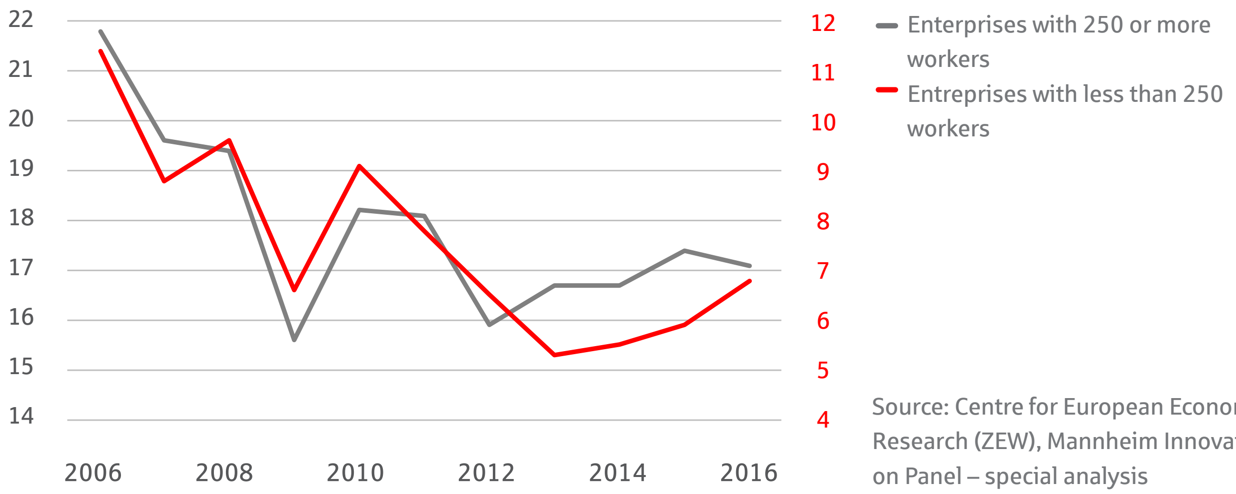
In the capital market too, investment strategies geared to sustainability are bulking ever larger. The latest developments here demonstrate that market opportunities not involving any additional regulatory obligations are being seized, with institutions from the Savings Bank Finance Group being outstanding examples (cf. the green bonds issued by Berlin Hyp and LBBW). At the pan-European level, a debate about whether or not to give preferential treatment to green financial products by means of graduated capital-adequacy requirements is taking place within the context of the EU action plan "Financing of Sustainable Growth." We are convinced, though, that the amount of capital that needs to be set aside must continue to be linked to the risk profile of a given investment. The examples of "Prokon" or "Solarworld" are graphic cases in point that sustainable revenues on investments classified as sustainable are anything but guaranteed. The point is that lower capital-adequacy ratios would tend to foster this misunderstanding and might ultimately indeed undermine the acceptability of such financial products.

Translating cutting-edge research into product and process innovations

The way has been paved

If technological innovations are to be harnessed as pacemakers spurring the transition to sustainable economic management, Germany must not let up in its efforts to reinforce research and development. Over the past ten years, pretty decent progress has already been made along this path, with the ratio of R&D expenditure to GDP climbing from slightly over 2.4 percent to very nearly 3 percent of the gross domestic product. Research intensity in the Federal Republic is thoroughly respectable by international standards (one percentage point above the EU average). And yet such success can be built on further: for instance, the number of patent applications in the high-tech sphere (ratio of R&D expenditure to revenues: up to 9%) is high on an international comparison, but the figure for the cutting-edge technology field (ratio of R&D expenditure to revenues: over 9%) is low. It would also be desirable for small and medium-sized enterprises to participate to a greater extent in this high research intensity, thereby putting it on a broader basis across the country. Yet the most recent ZEW Innovation Survey (2016) concludes that the share of revenues generated with product innovations is significantly lower in the case of Germany's midsize companies ("Mittelstand") at 6.8 percent than in the case of the country's corporate behemoths (17.1 percent). What is unsatisfactory is not how far behind the SMEs are in absolute terms but that no convergence has taken place in recent years. It is also somewhat lamentable that market use of research findings has, if anything, waned over the past few years across all company-size classes. The implication is that German industry needs to devote more attention to transforming new findings from basic research into marketable product and process innovations.

Germany: Share of revenues generated with product innovations,
as a percentage of agggregate turnover



Source: Centre for European Economic Research (ZEW), Mannheim Innovation Panel – special analysis

Facilitating inflows of skilled workers

Demand oriented migration

Macroeconomic growth has become more employment-intensive over the course of time. This development has also been aided by the arrival of immigrants on the German labour market. Economically speaking, such migration inflows have been advantageous for Germany, a country defined by immigration, because they have helped to bridge bottlenecks. However, the growth successes scored as a result of this are not felt to anything like the same extent by individuals at the micro level – after all, the additional revenues generated are distributed among more people. As far as economic considerations are concerned, the influx of workers should be mainly steered according to qualification requirements and in keeping with demand. The planned amendment of Germany's immigration law is designed to give skilled workers from non-EU states the opportunity of taking up employment within six months even without a priority review having taken place. Admittedly, we will have to wait and see whether this makes it easier to recruit specialised workers; much will depend on concrete implementation when it comes to recognising proof of qualifications. Admittedly, the option of a "lane change" in the policy for immigrants tolerated for humanitarian reasons would have made for more reliable human-resource planning at many companies.

It's getting harder to close the gaps

The high – and indeed still growing – number of vacancies demonstrates that Germany continues to face labour-supply shortages. However, it would be neither realistic nor desirable to wish to close such gaps for the most part by attracting (if possible, well-qualified) migrant workers. Immigration and return migration movements are seismographs for crises in other economies, and it would be wrong to rely on, or indeed hope for, these movements to escalate. It follows from this that immigration will always remain an inconstant variable, and cannot therefore be factored into the equation as a support for local social security systems. What is more, migration flows into Germany weaken the economic base in migrants' home countries, which are, after all, at the same time the export markets for German suppliers.

Promoting labour-force participation

Despite all the endeavours to make it easier for foreign skilled workers to gain access to the German labour market, ideas about how to strengthen the domestic labour-force participation rate therefore remain indispensable. Both employees and employers have to react to the shift in qualification requirements. Of course, changes in the world of work are not solely a burden: newly gained flexibility opens up scope for workers to turn their as yet unfulfilled job dreams into concrete professional reality. This, along with private precautionary saving measures, is the decisive parameter when it comes to making social security systems viable for the future. In the long term, it will continue to be crucial to stabilise the ratio between contributors to pension systems and beneficiaries in a lasting manner. The German pension package which was recently passed into law, providing for a "double protection" of the pension level and for a maximum contribution rate until 2025, will only be able to be financed with the help of higher tax subsidies. However, these tax subsidies themselves have to be found from government revenues and therefore presuppose value added and gainful employment.

Every pension guarantee has got to be worked for

Just as every form of immigration – be it for humanitarian reasons or due to labour shortages – has to be underpinned by manifold integration efforts on all sides in the socio-political and social-policy arena, raising the participation rate will also come with a price-tag attached. There is only space here to refer to three important aspects of this far wider theme. Firstly, the expansion of facilities for early childhood care needs to be pushed ahead with, not only to enable parents to return to professional life but also because this builds a stronger basis on a broad front for youngsters to have a better chance in life. Secondly, the new technological options in the world of work also need to be used to overcome obstacles to participation which have their origin in personal handicaps or in the home environment. Thirdly, a package of measures is required which resolves the timeworn dilemma entailed by the urgent need to extend people's working lives, on the one hand, while necessarily avoiding the social hardships bound up with this in certain professions, on the other.

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks or the DSGV.

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