Dieter Wermuth, consultant to UFJ Bank

1. As it turns out, **the ideas of the economic advisers of the next German government are almost the same as those of Mr Schröder's. There is not much in terms of stimulating growth** even though the main thrust of the manifesto that was released yesterday in Berlin is supposed to be growth and the creation of additional jobs. To the contrary, in the near term at least, the combined effects of the various proposals will be to slow down domestic demand further, increase net exports and thus the risk that the euro exchange rate will appreciate in a disruptive manner sometime down the road, and to keep budget deficits as large as they are today. This is good news for bond holders – and for all those who value stability more than economic expansion. The Stability and Growth pact will be taken more seriously again.
2. It is virtually certain that there will be a change of government on September 18, the likeliest election date. **The coalition of Ms Merkel's CDU, its Bavarian sister party CSU and the market liberal FDP would presently get 51% of the vote** while SPD and Greens, the government parties, could together hope for something like 35%. The new far-left party could get an additional 8 or 9% which is not enough to tip the scales. For the center-left Social democrats a coalition with them is out of the question in any case, and they would rather opt for a grand coalition a la 1966 to 1969 should there be a parliamentary deadlock.
3. Survey after survey shows that the conservatives will win by a landslide which in turn has emboldened them to make **a two-point VAT increase cum cuts in social security contributions the center piece of the election campaign**. Theirs is a blood, sweat and tears program: belt-tightening for a better future, no populist give-aways. The risk is less that the FDP who considers tax cuts as the solution to almost all problems will not play ball – they will, in the interest of a return to power – but rather that Gerhard Schröder has been handed an election topic which he will exploit to the fullest. His survival instincts are quite formidable.
4. **In January 2006, the main value added tax rate is scheduled to rise from 16 to18% which could yield an at least €16bn per year, the equivalent of 1.2% of private consumption.** About half of this money will be used to fund the government's payment into the public unemployment insurance agency which will receive less from direct contributions from workers and companies – their unemployment tax rate falls from 6.5% to 4.5% of eligible wages. Pre-tax profits rise by €4bn, and after-tax wages by €4bn as well. The remaining €8bn will go to the states which are eager to use the money for the reduction of their budget deficits.
5. These measures will have **two main first round effects**: a) household consumption and thus domestic demand will get another severe blow, b) wage costs for about 35

million workers who are covered by the state unemployment scheme will fall by 1% which will boost corporate profits (per unit of output) by about 2%.

6. German private consumption has been extremely weak – in volume terms, it has stagnated for an unprecedented three years and is still 1.1% below the last cyclical high in Q3 of 2001. **The loss of purchasing power by €16bn caused by the VAT hike is partly compensated for by the increase in after-tax incomes of workers by about €4bn which lessens the negative impact.**
7. There is also a distributional aspect to Ms Merkel's plan: the reduction of the rate of unemployment insurance benefits 35 million workers as well as the corporate sector whereas the increase in VAT hurts the whole population of 82 million, including pensioners, children and transfer recipients in general. **The income distribution shifts in favour of that part of the population which has a relatively low propensity to consume.** This exacerbates the initial impact of the rate hike. In other words, the new government proposes decidedly pro-cyclical policy changes.
8. The proposals are also **one further step in the direction of wage restraint designed to improve the international competitiveness of the economy**. Germany has the world's highest wage costs, but it also has the largest trade surplus, if only in absolute terms. Countries such as Switzerland and Sweden, both of them in the high-wage category as well, have even larger surpluses relative to the size of their GDPs. Competitiveness is certainly not an issue that should worry German policy makers. The main problems are slow productivity growth and high unemployment among the less qualified workers. Trying to beat China on wages is a hopeless strategy.
9. **Another misconception reflected in the election manifesto is that an increase in profits is regarded as a sine qua non for the creation of new jobs.** Lower labor costs are one important ingredient, no doubt, but sales prospects are at least as important. Strong profit growth, moreover, does not automatically lead to more jobs as we have learned recently. Over the past three years, earnings per share of the 30 companies in the DAX stock market index have risen by an annual average of no less than 28% while another increase of 21% is expected by market participants for the current year – yet the effect on jobs has been almost negligible. If rates of capacity utilization are as low as they are there is little incentive to hire new workers, given the excellent competitiveness and the bleak prospects for domestic demand.
10. The Christian parties also propose a number of labor market reforms which go beyond those already implemented by the Schröder government: it will become easier to fire workers, especially new hires, labor unions will lose some more of their influence by encouraging wage settlements on a micro level, and workers who have been unemployed for a long time can be paid 10% less than they normally would, with the

state making up the difference. **Labor markets will become more flexible and the incentive to take up work will be improved as well**, but this does not materially change the fact that there are presently twelve times more unemployed workers than job openings. The program does not address the core of the labor market malaise, the weakness of domestic demand.

11. There is the promise that **subsidies which do no longer make sense and which are quite costly will be either scrapped or reduced**, such as tax incentives to invest in commercial real estate, ship building or Hollywood films, to commute long distances to work, or to build own homes. The real estate market is still plagued by overcapacities and stagnating rents, after all, but home owners and high-income people who benefit from tax avoidance schemes are Ms Merkel's natural constituencies. So it will not be an easy job.
12. From January 2007, **the entry level of the personal income tax will be reduced from 15 to 12% while the top rate is to fall from 42 to 39%**, and there will be a tax-free allowance of €8,000 per year and person in a household. A family of four would thus start to pay income tax, at an initial rate of 12%, for incomes beyond €32,000. **The corporate income tax rate will be reduced from 25 to 22%.** At the same time, the new government will try to bring down the deficit of the federal government to zero by 2013. The 3% threshold for the deficit under the Stability and Growth Pact is to be reached by the end of the incoming parliament, ie by the fall of 2009.
13. The program is **vague about further health reforms** where so far mostly regressive proposals have been made which tend to hurt the lower income groups in particular. It is **equally vague about pension reform**, another hot potato. People who have raised children will get their pensions increased by €50 per month and child. But there is little about extending the working life and the financial future of the still-generous state pension system, the two key aspects.
14. **On balance, it is an uninspiring and cautious election manifesto, dominated by the fiscal constraints of the Stability and Growth Pact and the belief that the four-year stagnation can only be overcome by structural reforms on the supply side. The risk that Germany slides into a recession or deflation or both will rise if the opposition does indeed win the election which in turn may drag down the rest of the euro area as it may be forced to embark on a policy of competitive wage restraint as well. The only institution which can do something for the stimulation of demand is thus the ECB – and it can not do very much any more, and does not like the idea in any case.**