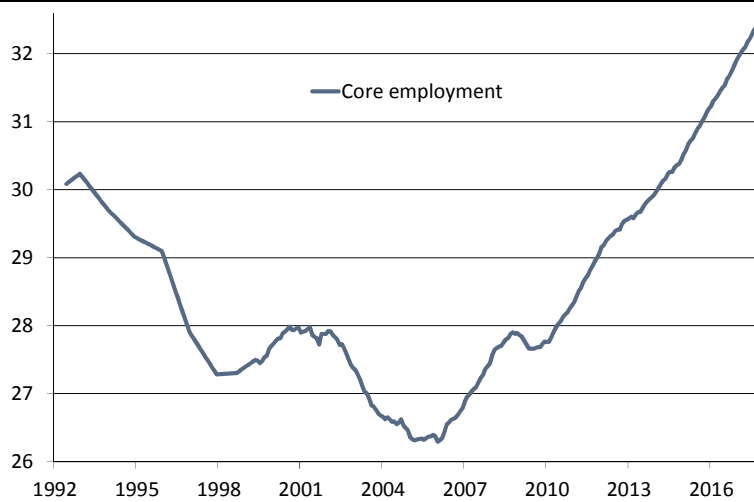


12 January 2018

Germany: how long can the good times last?

Reforms pay off: German core employment has surged since 2006



Core employment: jobs subject to social security contributions, in million. Source: Bundesbank

- Enjoying the good times:** Reaping the rewards of a wave of structural reforms introduced around 2004, Germany's economy remains in excellent shape. With a 2.5% gain in real GDP, a fiscal surplus of 1.2% and record employment, 2017 was arguably the best year the re-united Germany has had so far.
- Can it last?** Upon proclaiming a "golden decade" for Germany in 2010, we had warned that success would eventually breed complacency. Over time, the drive to reform would be followed by reform reversals that would bring the period of exceptionally strong trend growth to an end after a decade or so. How close is Germany to the end of its fat years – and would the policy changes which Chancellor Angela Merkel's CDU/CSU and the centre-left SPD have outlined in their deal to renew their current coalition hasten or slow down the process?
- It's the labour market:** Just like Margaret Thatcher had once cured the UK by fixing its labour market, Germany's success stems from policy changes that turned its labour market around. Reforms included more labour market flexibility, less generous jobless benefits as well as welfare, health care and pension changes that arrested the rise in burdensome payroll taxes on employers. The chart shows the spectacular turnaround that set in thereafter.
- Assessing the "GroKo" impact:** The draft deal which Merkel has now struck with SPD leaders to renew their current "GroKo" grand coalition for another four years continues the process of small-scale reform reversals. If the SPD rank and file approve the deal, the new government will remove the cap on employer contributions to the mandatory health insurance for employees, thus adding to labour costs. Pension entitlements will also become more generous, for instance by changing the pensions formula to prevent a drop in the ratio of the standard-pensions-to-earnings ratio below the current 48% until 2025. Financing this will require higher payroll taxes and more public subsidies. Over time, this will make it less attractive to invest capital and hire workers in Germany.
- The bill will be served later:** Near term, the changes to pension and health-care schemes and the labour market will not constrain Germany's economic performance. Judging by initial SPD demands, the draft deal to form a coalition could have been worse. Reflecting the strong labour market, the payroll tax to finance the unemployment insurance will be cut by 0.3 points. This partly offsets the rising burden on companies to fund health insurance. Also, the government wants to keep overall payroll taxes below 40%. For now, Germany can afford some measures that raise costs for businesses over time. After the next recession, however, when balance sheets are less strong, companies are likely to hesitate longer before they hire again. In the 2020s, German trend growth will no longer be as stellar as it is today. But until the next cyclical downturn, due perhaps in 2020 or 2021, the good times can last.

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