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Economy

About the German economic mythology

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On the subject of economic policy, some opinion makers in Germany peddle myths, i.e. imaginary tales without a factual basis aimed at pleasing the crowd. We have the myth that the ECB is robbing German savers to the benefit of the Italians or the French; or that calls for fiscal stimulus are there only to make up for the economic shortcomings of the rest of the Eurozone; or that the banking union project aims to make the Germans bear a risk concentrated outside Germany, etc. There is nothing to be gained by letting these myths flourish. And that is why we criticise them....

Myths and reality

In a previous note[1], we examined the German economy from a cyclical perspective and saw how the resilience of non-industrial sectors allowed the economy to narrowly escape recession in 2019. We focus, in the present note, on structural issues and the way in which the economic policy debate is most often presented by politicians, central bankers, economists and the press.

A parallel spontaneously springs to mind between the image of prudence, rigour and stability embodied by Angela Merkel, who has been the country's leader since 2005, and Germany's situation. **The Chancellor did not initiate any major economic reforms, unlike her predecessor, but under her "reign", Germany seemed to be almost the perfect country. The one that avoided real estate bubbles before 2007, that quickly restored its public accounts after the Great Recession, accumulated trade surpluses year after year, returned to full employment, all this after having to overcome the shock of reunification. Such results may justify a leaning towards the status quo but also a sense of superiority.** Why should such a system need to be changed? Why don't other European countries more actively try to emulate Germany? Why should Germany always have to "pay" for its neighbours or suffer from the actions of others, such as the ECB? These are questions that are inevitably raised, often in a clichéd way, sometimes aggressively. We recently saw the CDU, Chancellor Merkel's party, say (with humour, one would think) that the commitment to balanced budgets was our "little fetish" (image lhs). A curious choice of vocabulary for talking about economic policy. A few weeks ago, the widely read German newspaper *Bild* presented Mario Draghi, then president of the ECB, in the guise of a vampire literally sucking the savings accounts of the Germans (image rhs).

CDU: "We have a little fetish" ("the black zero")

Bild: "Count Draghila is sucking our accounts dry."

Sources : twitter, Oddo BHF Securities

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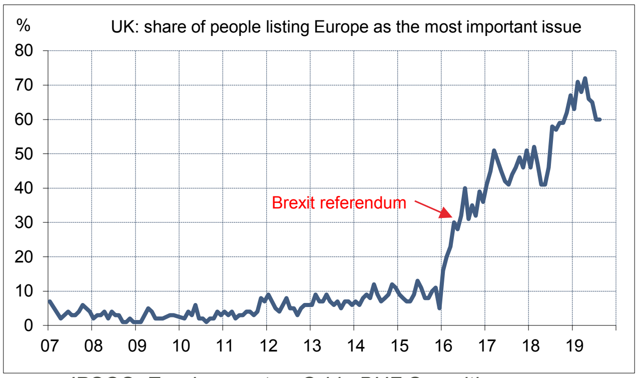
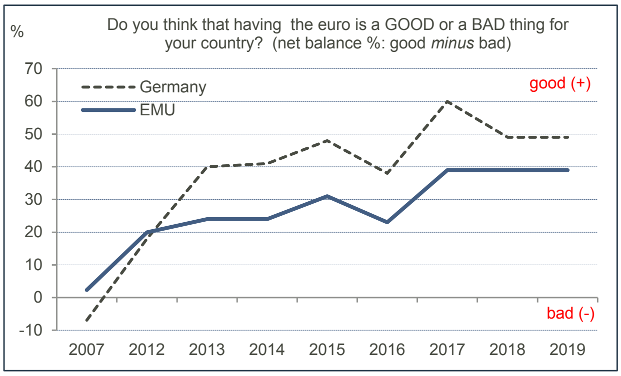
[1] *See our Economic Note dated 26 November 2019: "About the German non-recession".*

Economic patriotism is not a German monopoly. Donald Trump championed it in the US, but who will claim that it is a model to follow. Moreover, as a member of the Eurozone, Germany's economic situation and that of its neighbours are highly interdependent. **To claim that the euro has become a monetary regime that penalises Germany for the benefit of other countries is illusory[2].** However, this is what is more or less openly communicated by part of the political class and the press. **The risk is clear: if this idea continues to spread, the misunderstanding could one day reach the point where divorce becomes inevitable. This is exactly what happened in the UK.** Until David Cameron's government found a political interest in making Europe the central problem, public opinion did not think too much about it, then everything changed with the Brexit referendum (chart lhs). **Fortunately, there is no question of such a referendum in Germany, public opinion is not eurosceptic and its support for the euro has increased significantly over time** (chart rhs). Nevertheless, the economic policy debate deserves to be examined in terms other than those currently used. To do this, we examine one by one the myths too often conveyed about fiscal and monetary policies, banks and the German economy's relationship with Europe.

The UK and its relationship with Europe



Germany and its relationship with the euro



Sources : IPSOS, Eurobarometer, Oddo BHF Securities

➢ Germany and fiscal stimulus

The myth: There is no more optimal fiscal policy than to aim for a balanced budget year after year (as mentioned above, the CDU considers the "*schwarze Null*" as a fetish). Cleaning up public finances is within the reach of any country provided that it scrupulously complies with the relevant rules in the treaties or the constitution. These rules should not be amended or risk an immediate loss of credibility. The sacrifices made for fiscal restraint are paid back since a virtuous country has a better rating and lower interest rates. We must also consider the "counter-myth", quite popular outside Germany, which claims to solve all problems, cyclical or structural, by setting up a large public investment programme.

The reality: In 2019, Germany will reduce its public debt ratio to below the 60% of GDP threshold set in the Maastricht Treaty almost thirty years ago! This ratio had risen to over 80% by 2012 after the Great Recession. Debt reduction is often presented as the result of a "virtuous" mechanism where unproductive expenditure is tracked down in order to improve economic and employment conditions, which in turn reduces deficits, etc. In practice, the improvement in public finances also came from an increase in the tax burden. In Germany, net household taxes[3] increased by the equivalent of 3% of income between 2012 and 2019. Those who criticise German budgetary orthodoxy are wrong when they exclusively focus on spending. In practice, public spending has increased in recent years in line with potential growth, following the European Commission's recommendations. It is true, however, that the country's decentralised structure (central government, Länder, cities) can act as a brake on the success of certain investments. The adventures for the construction and commissioning of the new Berlin airport, which have been going on for ten years, are a typical example.

Outlook: The marked weakening of economic growth over the past two years has made it necessary to re-examine how fiscal policy in Germany is conducted. It is difficult to understand why a country that has the means to relax its fiscal policy, without compromising its solvency in the slightest, refuses to do so. **The balanced budget obsession has no economic basis[4]. It is becoming a stumbling block in the**

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[2] *For a well-argued refutation, see Fratzscher (2018), "The Germany Illusion - Between Economic Euphoria and Despair", Oxford Univ. Press*
[3] *Measured as the difference between taxes paid and monetary social benefits received (excluding benefits in kind).*
[4] *See Banchard & Ubide (2019), "Why Critics of a More Relaxed Attitude on Public Debt Are Wrong", PIIE*

political arena. The SPD (CDU partner in the coalition at the time of writing) and/or the Greens are clearly more open to the idea of fiscal stimulus. Deciding whether this should involve an investment plan, a tax cut or a pension increase will be the challenge of the next election competition, normally scheduled for the autumn of 2021. **In short, there is no immediate prospect of a major stimulus plan in Germany, but many parameters - cyclical (stagnation), structural (climate, cars), political (forthcoming elections, Berlin's relationship with the ECB and the Commission), social (fight against inequality) - are pushing to move away from the strict orthodoxy that has dominated in recent years.**

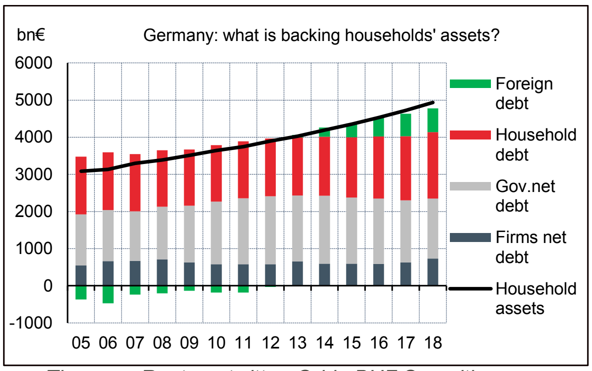
➢ Germany and the ECB

The myth: The ECB is conducting its rate and balance-sheet policies with the sole aim of making over-indebted countries, primarily Italy, solvent. These policies disrupt the hierarchy of yields to the detriment of German households, particularly savers who have a lower income than they had anticipated. In addition, low interest rates encourage the formation of a housing bubble, which increases housing spending and poses a risk to long-term financial stability. In short, the ECB is acting against the interests of the Germans.

The reality: In a previous note[5], we examined in detail the criticisms of the ECB. We will not recap on this here other than with regard to the accusation of expropriating savers for the benefit of foreigners, because this affects the degree of confidence or mistrust that the public expresses in its opinion of the ECB. By definition, there can be no financial asset without a liability. Demonising debt will not alter this accounting reality. According to the financial accounts, household savings appear to be the main counterpart of their mortgage debt and German public debt (chart lhs). A low interest rate policy modifies interest flows mainly within the country, but under no circumstances is it a transfer abroad. Whilst there are "winners" and "losers" with the ECB's policy, not all of the former are in Italy and the latter in Germany. The German government could correct the induced effect of the low interest rate policy, if it considers it undesirable, by increasing transfers to households to compensate for their loss on interest income - but this would require a review of its budgetary principles (see above).

Outlook: The low interest rate phenomenon is a global and durable one. The ECB contributes to it but cannot be held solely responsible for it. It is illusory to think that the Eurozone could escape low interest rates by pursuing a restrictive monetary policy, especially if fiscal policy also remains too tight (it is undoubtedly so in comparison with other developed countries). **It is fortunate that, on the myth of expropriation of German savers, Isabel Schnabel, who will soon be the German representative on the ECB's executive board, has clearly expressed diametrically opposed views** (image rhs). Tensions in the Governing Council are likely to abate.

Germany: financial accounts of economic agents



A fresh German voice at the ECB's Board

Sources : Thomson Reuters, twitter, Oddo BHF Securities

➢ Germany and banking union

The myth: Banks in peripheral countries are overloaded with sovereign debt from their country of residence and artificially survive only through the ECB's liquidity injections and its negative interest rate policy. To discourage banks from holding public debt, which should not be considered a risk-free asset (except in Germany), capital requirements must be raised. This will force banks to clean up their balance sheets. Once this is done, it will become clear that it is not necessary to create a European deposit guarantee scheme.

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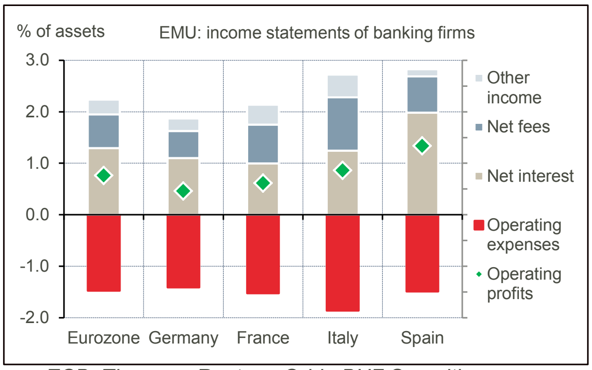
[5] *See our* Economic Note *dated 10 October 2019: "ECB: a critique of the critiques".*

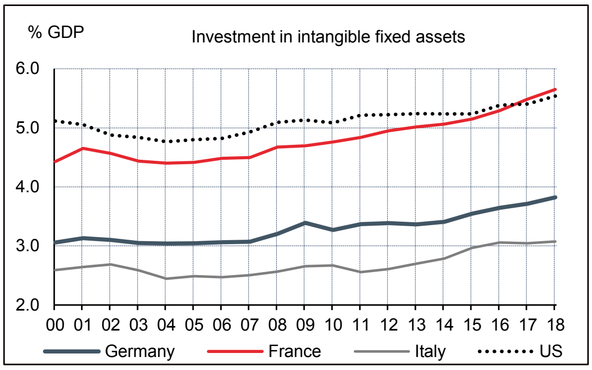
The reality: From 2010 to 2015, the Eurozone was hit by successive episodes of crisis in which sovereign risk and banking risk fuelled each other, the most dramatic of which was reached in 2012 with Mario Draghi's whatever-it-takes speech. In any case, the fact that the banking sector under pressure held debt in its own country was a *stabilising* factor which helped end the crisis. Forcing banks to get rid of their national debt portfolios would surely have the opposite effect, triggering a negative spiral - for what gain, do we even know? It is desirable that banks' exposure is not concentrated on a single type of asset and, ideally, that there is more cross-border exposure[6]. Without denying the weakness of some banks in peripheral countries, the situation in the German banking sector is far from perfect. According to ECB data, German banks have operating costs that are too high in relation to their revenues and a sub-optimal degree of concentration (chart lhs). **In a recent report, the ECB assessed a large panel of European banks and concluded that the share of "underperformers" is higher in Germany than elsewhere in the Eurozone, both in terms of the number of institutions involved and total assets**[7]. It is easy to blame negative rates for these poor results, but the main causes are elsewhere[8].

Outlook: The German banking sector has a complex, fragmented structure and generates low profitability. It implicitly benefits from a broad government guarantee - which places the low debt ratio of public administrations in perspective. It is unlikely to escape the sector's global consolidation movement indefinitely. The banking union is one of the major areas of efficiency gains in the Eurozone but, while significant progress occurred in terms of supervision, very little has been made as regards deposit guarantees due to the German veto. This position has changed slightly over the recent period at the initiative (at time of writing) of the German finance minister. Although this does not commit the entire coalition, it is a sign that some officials are now aware that there is an interest in encouraging the consolidation of the sector.

EMU: banks' profit and loss accounts



Intangible investments in Europe and the US



Sources : ECB, Thomson Reuters, Oddo BHF Securities

➤ Germany and Europe

The myth: Of all EU member-states, Germany is the most competitive country, most efficiently integrated into the global economy, specialising in high value-added goods, with a well-established tradition of social dialogue, constantly called upon to help when there is a crisis to finance bailout plans. It is therefore hardly astonishing that its economic growth has outperformed that of its neighbouring countries in recent years.

The reality: According to this myth, Germany would have almost nothing to gain from Europe. In fact, it is commonly acknowledged that the fixing of its entry exchange rate into the euro in 1999 was advantageous. The single currency has also eliminated the risk of competitive devaluation by its neighbours. The outperformance is, however, relative. Over the past 25 years, average annual real GDP growth has only exceeded that of the rest of the Eurozone on ten occasions, especially after 2010. Over the past two years, Germany moved below the European average. After the Great Recession, the country benefited from two major strengths: 1) a "safe haven" status because the risk of the euro disintegrating was perceived as very high; 2) a significant exposure to demand outside the Eurozone, particularly in Asia. The risk of the euro's breakdown now seems almost zero. Even the Eurosceptics like Salvini and Le Pen no longer include it as one of their respective watchwords. As for exposure to the external growth engine, it is an advantage that is shrinking due to the slowdown and the premiumisation of the Chinese economy. In contrast, the increase in trade uncertainty (protectionism, Brexit) weakens Germany more than others. Its weakening since 2018 has mainly been

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[6] *See the book from the Bruegel think-tank (2019), "Braver, Greener, Fairer – Memos to the EU leadership 2019-2024"*
[7] *See Andreeva & al. (2019), "Euro area bank profitability: where can consolidation help?", ECB Financial Stability Review*
[8] *See Coleman & Stebunovs (2019), "Do Negative Interest Rates Explain Low Profitability of European Banks?", FEDS notes*

an opportunity to point to other weaknesses such as its oversized automotive industry or the relative weakness of investment in new technologies (chart rhs, p. 4). Germany remains fundamentally a strong economy, there is no doubt about it, but its "growth model" is not foolproof.

Outlook: A country's productive structure cannot be changed with the wave of a magic wand and its shortcomings cannot be fully corrected by adjusting economic policy choices. In the foreseeable future, Germany will remain an export-oriented industrial economy. **Easing fiscal policy would be welcome to ensure that domestic demand does not falter in the short term and to facilitate some medium-term transitions (automotive sector, energy mix). Faced with these challenges, which are common to the entire Eurozone, it goes without saying that Germany has no interest in going solo, following the UK**. Somewhat paradoxically, Germany's recent weakness may be an opportunity to improve Europe's efficiency. The calming of the debate over the ECB policy – clearly one of Christine Lagarde's primary objectives, - and the few (timid) signs of openness towards banking union and fiscal policy in Germany illustrate how interdependent the Eurozone countries are. This de facto imposes some forms of mutualisation and solidarity. Translating them into action or institutions can take time, but there is little doubt about the direction being taken.

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