January 2, 2020

°211

The Economic Legacy of the Merkel Era

14 years of Angela Merkel – an economic review: Merkel's chancellorship ushered in important reforms. Until welfare state expansion started to crowd out growth oriented policies.

Angela Merkel has served as German chancellor for 14 years. If she stays in office until the end of the current legislative period, she will draw level with Helmut Kohl, who was also chancellor for 16 years. Even so, one thing is clear: the Merkel era is drawing to a close. What is the economic legacy of her period in office?

A comparison between Germany's economic data in 2005, the year Merkel became chancellor, and the latest figures reveals a spectacular improvement. In 2005, Germany was ailing, with chronically weak growth. The economy was stagnant, having posted average growth of just 0.5 percent a year since 2001.

The public sector deficit equaled 3.3 percent of the country's economic output. Germany had been flouting the European public debt limits for years. The debt level stood at 67 percent and there was no end in sight to its rise. The unemployment rate had climbed to 11 percent; income inequality was growing. While the economy was booming in countries like Spain and the United Kingdom, Germany appeared to be in a state of paralysis: the sick man of Europe.

Today, some 14 years later, the picture is dramatically different. Despite the slump during the financial crisis, economic growth has averaged 1.6 percent since 2005 – in other words, approximately triple the rate over the previous five years. Over six million new jobs have been created and unemployment has dropped to 3.4 percent. At the very least, the income gap has not widened any further.

Government revenues have overtaken spending, while the public debt ratio has fallen below the 60 percent threshold set out in the Maastricht Treaty. This recovery has been achieved with little effort. Although bracket creep has led to a rising tax-to-GDP ratio, there have been no cuts in public spending. Falling interest rates and declining unemployment benefits were sufficient to make the budget deficit disappear.

Harvesting the Fruits of Agenda 2010

How did this success story come about, and what role did economic and fiscal policy play? Merkel has often been accused of merely reaping what the previous red-green coalition government had sowed under Chancellor Gerhard Schröder. Without doubt, the Agenda 2010 reforms paved the way for favorable economic development.

The increased pressure on the jobless to take up employment soon proved effective. Moreover, the reforms encouraged the collective agreement partners to keep wage increases to a minimum, thereby giving the German economy and jobs the competitive edge over other European economies.

Nevertheless, the Agenda 2010 reforms alone do not account fully for the economic upswing. First, adjustments on the labor market – especially a greater wage spread between higher- and lower-skilled work – had begun before the Agenda 2010 measures were introduced. Second, Merkel's government set other reforms in motion. In 2007, she lowered unemployment insurance contributions from 6.5 to 4.2 percent. This move was financed by an increase in VAT from 16 to 19 percent.

Company taxation was reformed in 2008, dropping the tax rate on retained earnings from 38 to 30 percent. Admittedly, the tax base was broadened to compensate; yet, overall, the tax burden on corporation was reduced. Both reforms sought to boost investments and create jobs in Germany.

Before these measures were able to take full effect, the global financial crisis shook the foundations of the world economy, heralding a period of crisis management. Merkel's joint press conference with Federal Finance Minister Peer Steinbrück, in which they assured depositors that their savings were safe, is engraved on the public memory. In 2009, the German economy was hard hit by the decline in growth around the world. Economic output shrank by 5 percent.

The fact that the export industry, the strongest sector in the German economy, was affected, proved to be a blessing in disguise. Despite the dramatic slump in sales, many companies refused to let their employees go. They were confident that the economy would recover quickly. The German federal government supported this strategy in a number of ways, including by extending the short-time allowance. This strategy paid off. The global economy picked up surprisingly quickly, along with the demand for products made in Germany.

Understandably, a policy of reforms with a long-term perspective was put on a back burner during the financial crisis, with one notable exception. In summer 2009, at the height of the crisis, the "debt brake" for federal and state governments was enshrined in Germany's constitution. It prohibited the federal government from running more than a very modest budget deficit after 2016, and requires the state governments to balance their budgets from 2020.

These debt rules are currently the subject of intense debate. Critics regard the introduction of the debt brake as a mistake because it gives fiscal policy too little room to maneuver. However, in 2009, there were compelling reasons for committing to medium-term budgetary consolidation. Given the soaring public debt in the wake of the crisis and the foreseeable pressure of demographic change, it was important to send out a credible signal that Germany was committed to sound public finances.

This resulted in improved financing conditions for the German government. Furthermore, without a limit on debt, subsequent years would doubtless have seen more pro-cyclical fiscal policy.

Throwing Out the Rule Book

In fall 2009, the next crisis reared its head in Greece, spreading to other euro countries in spring 2010. The euro crisis presented Merkel

with major challenges. She had to convince the German people and her own party that, in order to mitigate the crisis, Germany had to accept considerable liability risks. In so doing, fundamental rules imposed by the monetary union, particularly the no bailout clause, were thrown overboard. She justified these steps by repeating her mantra: if the euro fails, then Europe fails.

At the same time, Merkel insisted that the crisis states initiate reforms to overcome their economic problems and get their budgets in order. Although the right approach, it wasn't enough to restore confidence on the capital markets.

That confidence didn't return until the ECB pledged to purchase unlimited government bonds from crisis states if need be. This took the ECB to the limits of its mandate and beyond. Meanwhile, it was certainly opportune for Merkel that Mario Draghi saved her from having to enlist the support of the German Bundestag for a major expansion of the liability commitments in her rescue package policy.

The euro crisis affected the recovery of the German economy after the financial crisis, but didn't halt it. Above all, the favorable macroeconomic environment was conducive in this regard. In the United States and emerging markets such as China, demand for German exports rose substantially; meanwhile, interest rates continued to fall and the weak euro fueled the boom in German exports.

Goodbye Competition, Hello Welfare State

Germany's economic and employment policies underwent radical changes in the years following the financial crisis and the euro crisis. The objective of strengthening economic competitiveness took a back seat. Instead, the spotlight was on redistribution policies and expanding the welfare state. The SPD supported Merkel's chancellorship only on condition that the CDU made major concessions.

Taking office in 2013, the most important project for the second grand coalition under Merkel was to introduce a national legal minimum wage in the amount of EUR 8.50 per hour. Critics, including many economists, warned that the minimum wage could lead to job losses, particularly if the situation turned into a political competition to overpromise on the minimum wage.

As regards employment, there have been minor losses at most. Many companies have offset the extra costs by reducing working hours and increasing work intensity. Added to this, the minimum wage has been increased only moderately since 2015.

To date, the government has followed the recommendations of the specially instituted Minimum Wage Commission. However, it is not clear whether it will continue to do so. Calls for a significant increase in the minimum wage – a frequently quoted figure is EUR 12 – are becoming louder.

An extension of pension benefits has become a second priority. This includes making the pension available from age 63 onwards under certain conditions, expanding the maternal pension, applying the so-called stop line (to prevent pensions from falling below 48 percent of final net salary after 45 years of contributions), and upgrading the basic pension.

These benefits will all be paid to a growing number of pensioners, yet must be funded by a decreasing group of contributors. As the contributions will not be enough, increasing subsidies from general tax revenue will have to cover the shortfall. Financing pensions already accounts for almost one-third of the German federal budget. As a result, other expenditure – on defense or public investment, for example – is falling by the wayside.

Merkel's most controversial decision was to open Germany's borders during the 2015 refugee crisis. Supporters of this decision claimed that the influx of refugees would ultimately benefit Germany's economy as the country needs more workers. By contrast, critics advised caution in light of the high costs for the welfare state.

At no time did Merkel herself promise that Germany would stand to gain from the refugee wave in economic terms, stressing instead the humanitarian aspect, the costs of which Germany was in a position to bear. Today, it would seem that she was right after all.

The Misguided Climate Policy

If there is one area in which the politics of the Merkel era have taken a particularly unfortunate turn, then energy and climate policy wins hands down. Germany has spent more money than most industrialized countries on promoting renewables, yet has achieved very little. It will fall short of its climate goals for 2020. The hasty exit from nuclear power was even more ill-advised than the phase-out of coal. Uncertainty about the future framework is stifling investment in new power plants.

It wasn't until the Fridays for Future climate strikes and the growing electoral successes of the Greens that the German federal government was prompted to rethink its climate policy. The fact that the latest climate package focuses on a uniform CO_2 price for the first time is a step forward. All the same, a convincing overall concept is still lacking to show how Germany can combine climate protection with positive economic development.

Germany is inadequately prepared for the future not just in the energy sector, but also in other sectors of the economy. Even now, Germany is lagging behind in terms of digital infrastructure and digitalization in the public sector. The automotive sector, so crucial for the country, has gotten itself into hot water thanks to the "dieselgate" scandal.

Meanwhile, politics is creating further difficulties – for example, with European fleet-wide emission targets, which effectively take a planned-economy approach of dictating a sharp reduction in the number of vehicles with combustion engines. It would be better for both the fight against climate change and the economy as a whole to concentrate on CO_2 pricing and to let market forces establish what combination of drive technologies will prevail.

It is likely that the Merkel era will go down in history as a period characterized by prosperity and stability, despite the occasional crisis, but also as an era that where economic policy ran out of steam at the end. Time will soon tell whether the next government can approach the challenges ahead with renewed vigor and more inspired ideas for ensuring future prosperity.

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Published under the heading "Zeit des Wohlstands und der Bequemlichkeit" in Handelsblatt, November 15, 2019, p. 56.