



Germany's fiscal situation

Full employment and zero interest rates result in budget surpluses – but demographic development might become a problem

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In an international comparison, Germany's fiscal situation is very good – thanks to robust GDP growth and zero interest rates. Other important industrial countries, such as the US or Japan, are still struggling with high fiscal deficits and rising public-sector debt. Germany, however, is the only G7 country that has generated fiscal surpluses since 2014, helping to considerably reduce its debt ratio.

In the short to medium term, dynamic revenue growth should help ensure that Germany's fiscal situation remains comfortable, even though expenses look set to rise strongly as well. The budget complies with both national and European debt-limiting rules, and there is a considerable safety margin. The 2017 update of the Stability Programme foresees positive fiscal balances at the general government level for the years from 2017 to 2021, which means that – provided growth remains strong and interest rates low – the debt ratio might drop below the Maastricht limit of 60% of GDP by end-2020.

Public finances are currently benefiting from buoyant growth, low interest rates and a “demographic respite”. According to our calculations, the German government saved almost EUR 260 bn in interest payments between 2008 and 2016. However, the current fiscal surplus, which is to a large extent due to these special factors, should not be used to justify permanent expense increases or cuts in taxes and/or social security contributions.

Rising interest rates and the ageing society look set to put public finances under considerable pressure beginning in the middle of the coming decade. The ageing society will result in significant burdens for public budgets in the near future, as government revenues (taxes, social security contributions) will probably advance at a slower pace on the back of a shrinking workforce and lower potential growth, while government expenses boom at the same time (in particular for statutory pensions, healthcare and old-age care).

However, the long-term fiscal risks do not appear to play a major role in the current election campaign. Rather, politicians have included calls for tax cuts and expense increases in their parties' election programmes given the current favourable fiscal situation.

To prepare the economy and public-sector finances for the ageing of the population and avoid major abrupt fiscal adjustments in the future, the parties should not make increasingly more electoral promises that they will be hard pressed to pay for in the longer term.



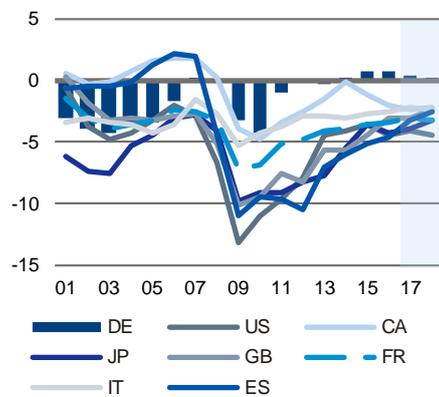
Germany's fiscal situation

In an international comparison, Germany's fiscal situation is very good – thanks to robust GDP growth and zero interest rates

Germany is the only G7 country that currently runs a budget surplus

1

General government budget balance, % of GDP



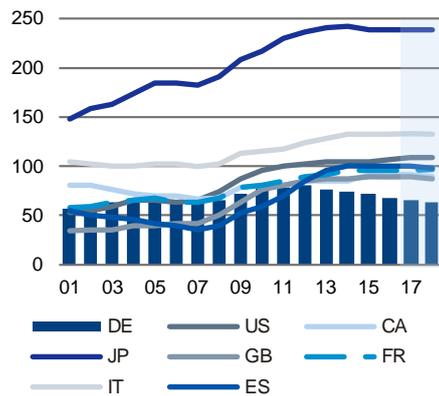
Germany, UK, France, Italy and Spain: budget balance according to Maastricht definition. US, Canada, Japan: budget balance according to IMF definition.

Sources: IMF WEO, AMECO, Deutsche Bank Research

Germany's debt ratio is declining against the trend

3

Gross general government debt, % of GDP



Germany, UK, France, Italy and Spain: debt stock according to Maastricht definition. US, Canada, Japan: debt stock according to IMF definition.

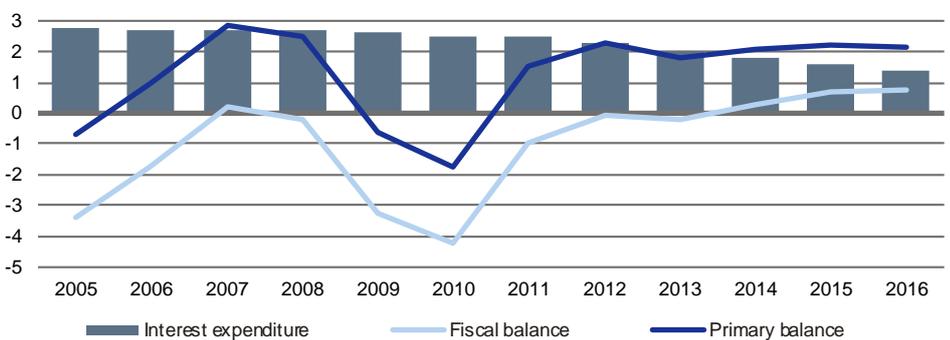
Sources: IMF WEO, AMECO, Deutsche Bank Research

Other important industrial countries, such as the US or Japan, and large European economies, such as the UK, France or Spain, are still struggling with high fiscal deficits and rising public-sector debt. Germany, however, is the only G7 country that has generated fiscal surpluses since 2014 (not least thanks to robust economic growth), helping to considerably reduce its debt ratio (charts 1 and 3). In fact, Germany's fiscal situation is better than it has been for a long time, mainly thanks to strong growth and zero interest rates. According to the Maastricht definition, the general government balance, which includes the budgets of the federal government, the federal states, the local authorities and the social security system as well as special budgets, was in the black for the third year in a row in 2016 (c. EUR 23,7 bn or 0.8% of GDP; chart 2).

Germany registered a general government budget surplus for the third year in a row in 2016

2

% of GDP

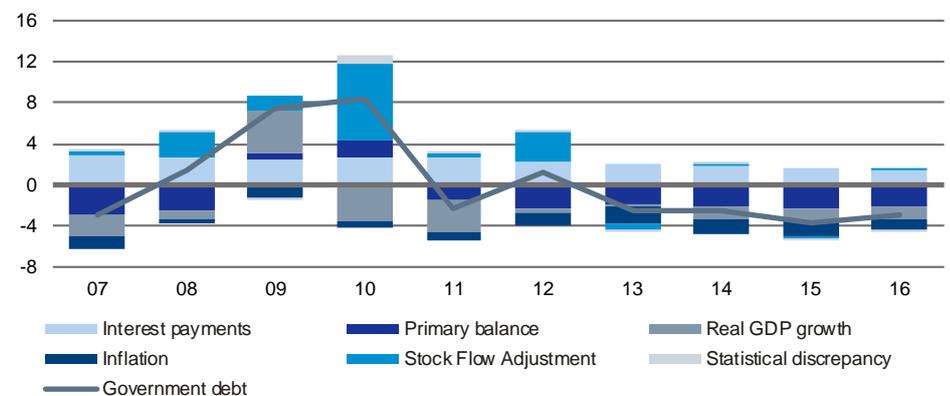


Sources: Eurostat, AMECO, Deutsche Bank Research

Decline in German government debt ratio thanks to primary surpluses and declining interest spending

4

General government debt ratio: yoy change in pp of GDP



Sources: Eurostat, AMECO, Deutsche Bank Research

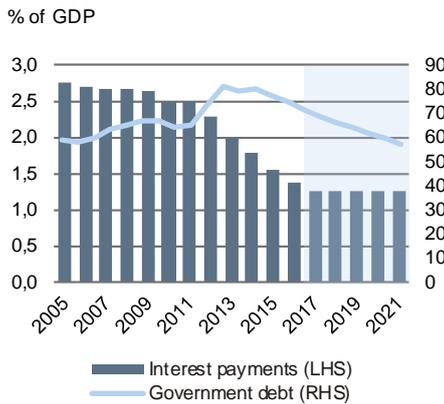
The spending side of the (general government) budget benefited from the further decline in interest payments, the revenue side from strong tax and social security revenues. Over the last few years, the tax ratio (as based on German fiscal statistics) has risen considerably thanks to bracket creep (i.e. "veiled" tax hikes) incorporated in the tax system, from 20.6% of GDP in 2010 to c. 22.5% in 2016.



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According to the draft budget for 2018 and the fiscal plan until 2021, the debt ratio might drop below 60% by 2020

5

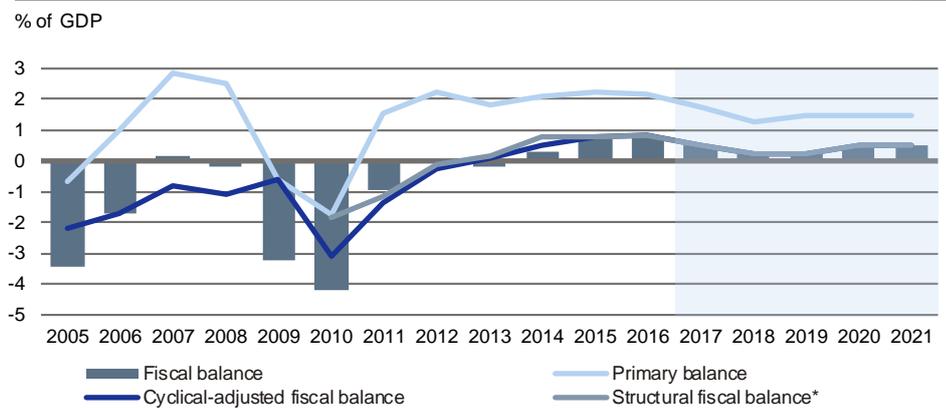


Sources: Eurostat, AMECO, Federal Ministry of Finance, Deutsche Bank Research

As a result, the government debt ratio has declined markedly in the last few years. At 68.3% of GDP at the end of 2016, it was considerably below its temporary peak of more than 80% of GDP registered at the end of 2010, if slightly above the level seen before the beginning of the global financial crisis (see chart 5). This decline in the German general government debt ratio is largely due to regular primary surpluses (i.e. budget surpluses before interest expenses) at the general government level, which are in turn the result of robust economic growth (which raises tax revenues and also increases the denominator of the debt ratio) and low interest rates (which reduce interest expenses; see chart 4).

Germany registered a general government budget surplus for the third year in row in 2016

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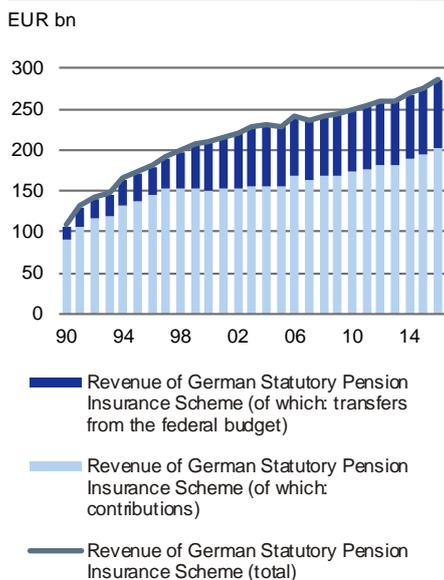


* cyclically adjusted, excluding special effects.
Forecasts: German Stability Programme (2017 Update).

Sources: Eurostat, AMECO, Federal Ministry of Finance, Deutsche Bank Research

German statutory pension system stabilised by high transfer payments from the federal government

7

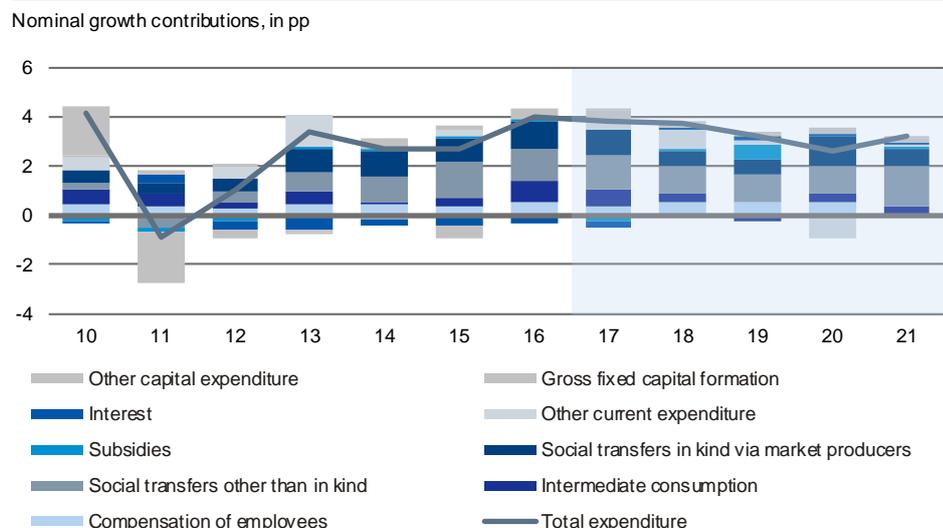


Excl. "Deutsche Rentenversicherung Knappschaft-Bahn-See"

Sources: WEFA, Deutsche Bundesbank, Deutsche Bank Research

Strong increase in overall spending foreseen in the fiscal planning until 2021

8



Forecasts taken from the German Stability Programme (2017 Update).

Sources: Eurostat, AMECO, Federal Ministry of Finance, Deutsche Bank Research



Germany's fiscal situation

In the short to medium term, dynamic revenue growth should help to ensure that Germany's fiscal situation remains comfortable, even though expenses look set to rise strongly as well

Still a large gap between contribution revenues and spending on pensions **9**



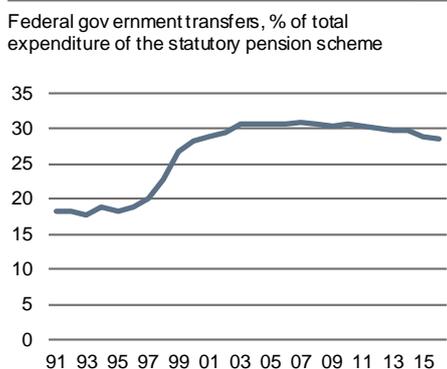
Excl. "Deutsche Rentenversicherung Knappschaft-Bahn-See"

Sources: WEFA, Deutsche Bundesbank, Deutsche Bank Research

Despite the significant increase in the general government's primary expenses (i.e. government expenses before interest payments), particularly for social security purposes ("retirement at 63", "pensions paid to mothers" etc), the fiscal situation looks set to remain comfortable, at least in the short to medium term, as public-sector revenues continue to grow at a strong clip. Even if the current, favourable macro outlook deteriorated unexpectedly in the next few years, national and European caps on public-sector borrowing would at least prevent a massive rise in the debt ratio.

The 2017 update of the Stability Programme foresees sustained positive fiscal balances on the general government level for the years from 2017 to 2021 (chart 6), which means that – provided growth remains strong and interest rates low – the debt ratio might be reduced considerably until the end of 2021. According to the federal government's projections, the general government debt ratio might drop below the pre-crisis level of 2007 by the end of 2019 and below the Maastricht limit of 60% of GDP by the end of 2020 for the first time since 2002 (chart 5). Even though such a decline in the debt ratio does not appear unrealistic, the strong increase in social spending (pensions, employment, healthcare) may result in immense fiscal pressure in the long run. This might, in turn, limit the scope for necessary future-oriented investments in education and public-sector infrastructure.

The German Statutory Pension Insurance Scheme depends on federal government transfer payments **10**



Excl. "Deutsche Rentenversicherung Knappschaft-Bahn-See"

Sources: WEFA, Deutsche Bundesbank, Deutsche Bank Research

Despite the good labour market situation, the German statutory pension system (excluding "Deutsche Rentenversicherung Knappschaft-Bahn-See") is the only social insurance scheme which currently runs a deficit. According to the Deutsche Bundesbank Monthly Report, it registered minor financing deficits over the past two years, which were offset from its reserves. These deficits generated by the statutory pension system despite a strong labour market are even more striking when considering the fact that a significant portion of the aggregate revenues of the pension scheme stems from transfer payments by the federal government. In fact, the budget for 2016 included a whopping EUR 82.6 bn (c. 2.6% of GDP) for financial support to the statutory pension system. This amount is equivalent to almost one-third of the statutory pension system's annual expenditure (chart 10). Assuming that contribution rates and the amount of federal financial support are unchanged and pension payments are raised further at the recent, generous pace, the statutory pension system will come under increasing financial pressure. In 2016, pensions were hiked by 4.25% in the western and by 5.95% in the eastern German states, even though the rate of inflation was only 0.5%. Future significant pension increases will increase the need for even more financial support from the government. In fact, the federal government forecasts in its budget draft for 2018 and financial planning until 2021 that overall federal government subsidies related to statutory pensions¹ will rise to EUR 94.0 bn in the fiscal year 2018 and climb further to more than EUR 100 bn by the end of the coming legislative period (2021F: EUR 103.4 bn). This means that the share of government support for statutory pensions in total federal expenditure could rise further, from 27.9% in 2018 to 29.0% in 2021. The financial situation of the statutory pension system, which has been stabilised by considerable amounts paid from the government coffers, will in the future depend more than ever on the support of the federal government, i.e. ultimately on tax payers.

¹ According to the German Federal Insurance Office ("Bundesversicherungsamt"), the federal government spent a total of EUR 87.5 bn (2.8% of GDP) on the statutory pension system (incl. Knappschaft) in 2016.

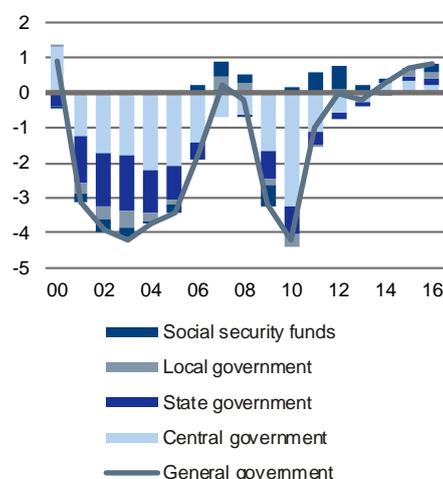


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German general government budget in the black since 2014

11

General government fiscal balance, % of GDP

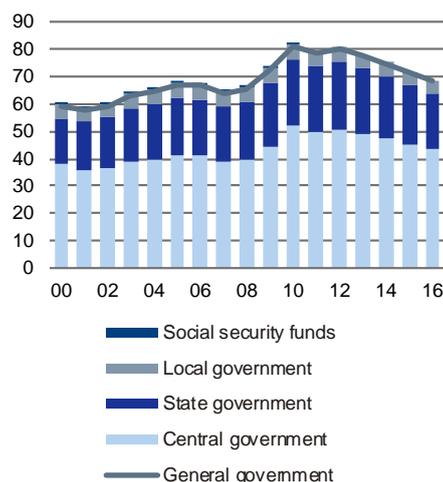


Sources: WEFA, Deutsche Bundesbank, Deutsche Bank Research

Germany's general government debt ratio has declined markedly

12

Gross general government debt, % of GDP



Sources: WEFA, Deutsche Bundesbank, Deutsche Bank Research

National and European rules to limit government debt

The “**debt brake**” introduced in 2009 and included in the Basic Law says that the structural fiscal deficit of the federal government (i.e. the deficit adjusted for cyclical and special effects) may not exceed 0.35% of GDP. In addition, it obliges the federal states to run a balanced budget. While the debt brake provisions became binding for the federal government in 2016, the federal states will not be obliged to comply with the fiscal rules until 2020. During the transition phase, the states will need to organise their budgets in such a way that they can function without raising new debt from 2020.

Besides this national debt brake, the **European Stability and Growth Pact (SGP)** says that a general government fiscal deficit may not exceed 3% of its GDP and that the debt ratio may not exceed 60% of annual GDP (the so-called “Maastricht limits”). While Germany has been complying with the deficit limit since 2011 (and is currently doing so with a comfortable margin), its general government debt ratio is still above the 60% limit. The SGP was extended in 2011 in order to oblige the EMU member states to re-balance their budgets in the medium term after the stress of the global financial and economic crisis. The so-called “1/20 rule” was introduced to make sure that the government debt ratio of a country is persistently reduced if it is above the 60% limit. Now that this additional provision is in effect, an excessive deficit procedure may be launched not only if the 3% deficit limit is exceeded, but also if it is not certain that a country will reduce its government debt to 60% of GDP in the medium term. Under the “1/20 rule”, countries shall reduce the excess debt (i.e. the difference between the actual debt ratio and 60% of GDP) by at least 1/20 per year, averaged over the most recent three fiscal years. Under the preventive arm of the SGP, the German government aims at a structural deficit of not more than 0.5% of GDP in the medium term. This target has been met since 2012.

In fact, there has been no new borrowing at the federal level since 2014. The consolidated state budgets have been in the black since 2014 and the local authorities’ budgets since 2015. The consolidated social security budgets (statutory pension system, healthcare, old-age care and unemployment insurance) have been running surpluses since 2010 (chart 11). Thus the federal government has clearly complied with the debt brake provisions, which have been in force since 2016. The aggregate budget surplus of the federal states amounted to 0.2% of GDP in 2016, which means that the states already comply with the new provisions as well, at least in the aggregate. Germany also meets its obligations under the European SGP with a comfortable margin. The 3% deficit rule has been met since 2011. Germany also complies with the 1/20 rule for debt reduction and has surpassed the medium-term fiscal target.

The budget is (currently) benefiting from buoyant growth, low interest rates and a “demographic respite”

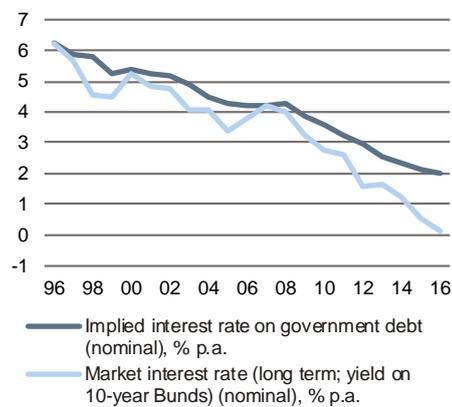
According to the latest fiscal planning, the fiscal situation should remain comfortable for the coming five years so that the debt ratio should decline further. However, this expectation depends to a large extent on a continuation of strong growth and dynamic increases in public-sector revenues (taxes, social security contributions). It is unlikely that the interest payments on government debt will continue to decline or remain at its exceptionally low level forever (chart 14). So far this year, yields of German government bonds have been negative for maturities far above five years (annual averages). And despite their recent increase, the yields of long-term German government bonds are still at historically low levels (charts 13 and 14). If monetary policy is normalised during the coming years (i.e. if QE is terminated and key rates are gradually hiked), German interest payments will rise again, both in absolute terms and relative to GDP. While the



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budget has regularly benefited from the decline in government bond yields in the last few years, there will be no further relief from this side in the future.

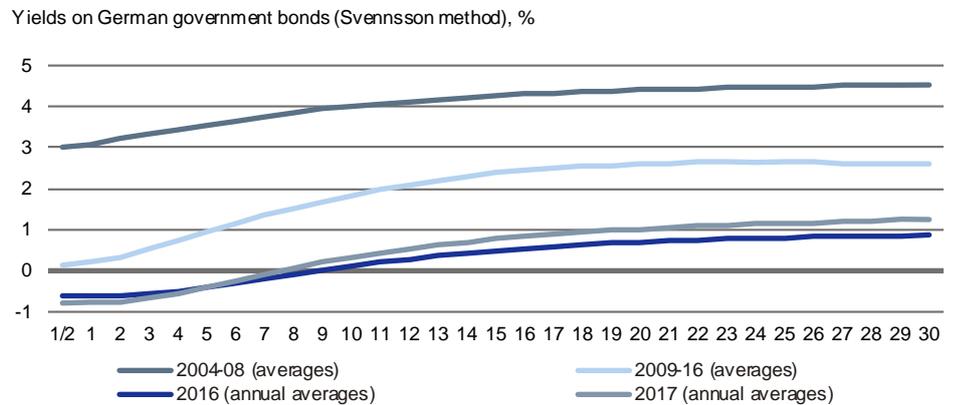
German fiscal policy currently benefits from low interest rates 13



The implied interest on government debt is calculated on the basis of the relationship between government interest expenditure during a given year and gross government debt at the end of the preceding year.

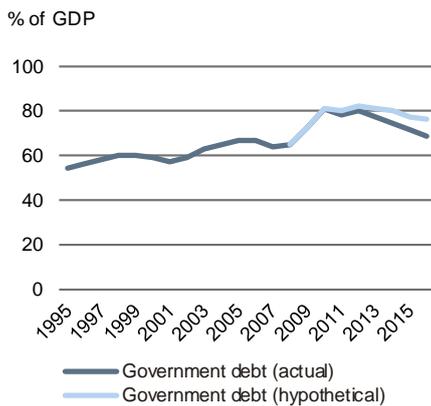
Sources: Eurostat, AMECO, Bloomberg, Deutsche Bank Research

Yield curve has steadily shifted to the downside during the past decade 14



Sources: WEFA, Deutsche Bundesbank, Deutsche Bank Research

Without the low interest rates, the level of debt would be higher today 15



Hypothetical interest expenditure calculated on the basis of an unchanged implied interest rate of 4.2% (level of 2007) from 2008.

Sources: AMECO, Eurostat, Deutsche Bank Research

A look at the implied interest rate shows to what extent the German public sector budgets have benefited over the past years and are still benefiting from negative or zero interest rates. This “average interest rate”, which is calculated from the overall interest payments (general government level) during a fiscal year and the debt level at the end of the preceding fiscal year (general government level), has steadily declined since the global financial and economic crisis and, indeed, more than halved from c. 4.2% p.a. in 2008 to only 2% p.a. in 2016 (chart 13). As a result, the interest service payments of the German government have slid rapidly, despite the rise in total debt after the beginning of the global financial crisis (chart 5 on page 3). Thanks to the significant drop in interest rates, the German government was able to save huge interest payments and enjoy significant fiscal relief. While, during the five years before the financial market crisis in 2007, the government had to pay c. EUR 64 bn per year in interest (c. 2.8% of GDP), this figure dropped to c. EUR 43 bn in 2016 (c. 1.4% of GDP). In other words: During the past fiscal year, the budget relief amounted to roughly EUR 21 bn or 0.7% of GDP (2016) according to this simple calculation.

The accumulated interest savings since 2008 are considerably higher. If the implied interest rate had not declined further since 2008, but remained at 4.2%, the German debt ratio would not have amounted to 68.3% of GDP, but to more than 75% of GDP at the end of 2016 (ceteris paribus, chart 15). Due to the considerably higher level of debt, interest payments would not have amounted to 1.4% of GDP (2016), but to more than double that figure, namely 3% of GDP (chart 16). While this rough calculation is admittedly highly simplified (it does not, for example, include the structural trend towards declining real interest rates since 2008), it shows that the German government could have saved almost EUR 260 bn in aggregate interest payments between 2008 and 2016. And the actual savings might even be much higher, as GDP growth would probably have been lower if interest rates had remained at the average level of 4.2% used for the simulation above. In turn, government revenues would have been lower and primary expenses higher. One thing is certain: If interest rates had not been low, the German fiscal situation would be considerably more difficult.

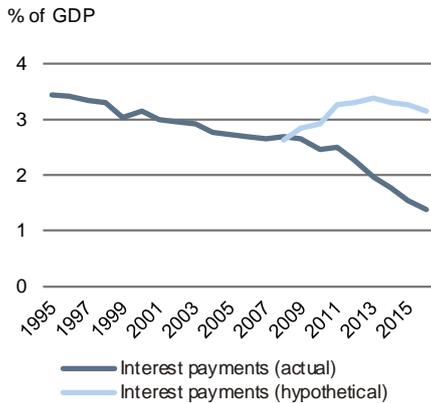
Admittedly, the average interest rate is likely to decline further in the coming years, towards the lower market interest rate (which we approximate on the ba-



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Low interest rates have helped the government to save interest to a significant extent

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Hypothetical interest expenditure calculated on the basis of an unchanged implied interest rate of 4.2% (level of 2007) from 2008.

Sources: AMECO, Eurostat, Deutsche Bank Research

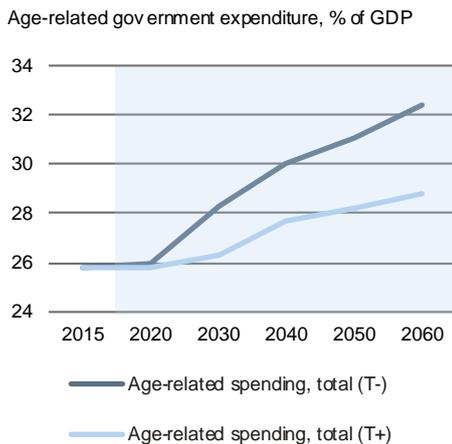
sis of 10-year Bund yields), as maturing old debt will be refinanced at lower interest rates.² However, in the medium term the implied interest rate looks set to rise again, as monetary policy is normalised and the general interest rate level is higher. The current fiscal surpluses, which are to a large extent due to the special factors described above (strong growth and low rates), should not be used to justify permanent expense increases or tax cuts.

Rising interest rates and the ageing society look set to put public finances under considerable pressure from the middle of the coming decade

Realistically, the general fiscal situation is unlikely to remain forever as good as it is now. First, interest service will again put pressure on the budget in the medium to long term, and second, the ageing of society will have an impact on economic activity and, in turn, government finances. The ageing society (unless there is more immigration) will progress noticeably and hence result in significant burdens for the public budgets in the near future, as government revenues (taxes, social security contributions) will probably advance at a slower pace on the back of a shrinking workforce and lower potential growth while government expenses will boom at the same time (in particular for statutory pensions, healthcare and old-age care). By the middle or end of the next decade at the latest, age-related government expenses (i.e. pension, healthcare and old-age care expenses) will rise considerably in comparison to GDP and thus put significant pressure on the budget.

Age-related spending to rise palpably according to the Federal Ministry of Finance

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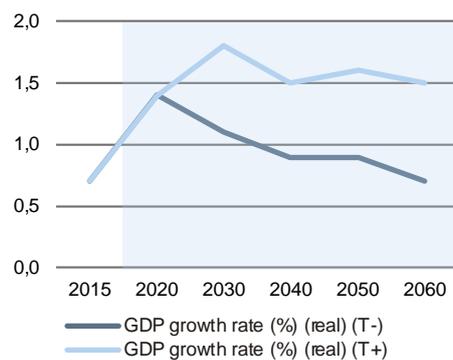


Projections based on the Fourth Report on the Sustainability of Public Finances (2016) by the Federal Ministry of Finance. Age-related expenditure includes (1) spending on pensions, (2) spending on healthcare, (3) spending on old-age care, (4) unemployment benefits, (5) spending on education and childcare and (6) family-related allowances.

Sources: Federal Ministry of Finance, Deutsche Bank Research

GDP growth assumptions in the Fourth Sustainability Report

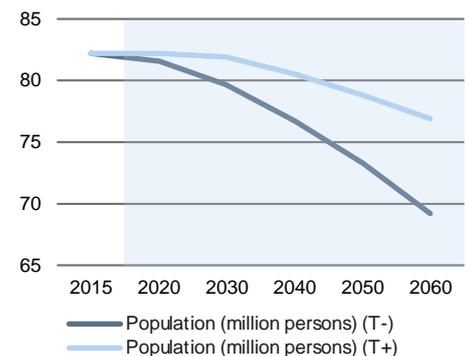
17



Sources: Federal Ministry of Finance, Deutsche Bank Research

Population growth assumptions in the Fourth Sustainability Report

18



Sources: Federal Ministry of Finance, Deutsche Bank Research

The Federal Ministry of Finance (see the Fourth Report on the Sustainability of Public Finances and the 2017 Update of the Stability Programme) believes that Germany is currently experiencing a “demographic respite”, which means that the full impact of ageing on the economy and the public finances is not yet being felt more noticeably and to the full extent. However, this respite will be over by the middle or end of the next decade at the latest, as more and more pensioners will claim money under the statutory pension system (i.e. put pressure on the public-sector budgets and/or contributors) and the declining workforce will re-

² The average maturity of German government debt was c. 5.8 years at the end of 2016 (ECB data). There is therefore some room for average interest rates to decline further in the coming years, as rates remain low and old debt is refinanced at lower rates.

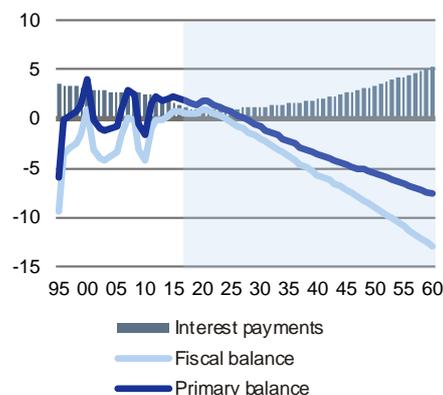


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Budget might get out of control in the long run if no counteracting measures are taken

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General government level, % of GDP



Sources: AMECO, Deutsche Bank Research

duce potential growth rates. In its pessimistic scenario (T-), the ministry of finance currently expects age-related expenses (e.g. for statutory pensions, statutory healthcare and old-age care, unemployment benefits etc.) to rise from 25.8% of GDP in 2015 (c. 60% of total general government expenses) to 32.4% of GDP by 2060 (chart 19).

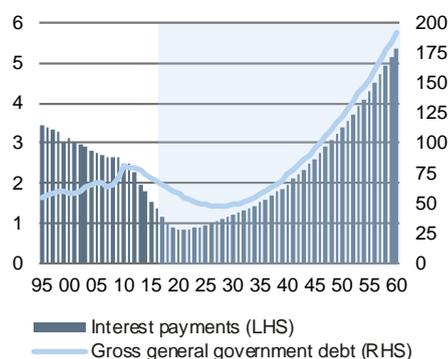
This pessimistic projection is based on the assumption that real GDP growth weakens to only 0.7% p.a. by 2060 (chart 17), that the population declines to around 69.2 million people (chart 18) and that the old-age dependency ratio³ (which measures the demographical changes in the population structure) doubles from 32.0% in 2015 to 64.1%⁴. Even under the optimistic scenario (T+), age-related government expenses could rise to at least 28.8% of GDP by 2060 (chart 19). This optimistic projection is based on considerably more favourable assumptions about real GDP growth (c. 1.5% in 2060), a smaller decline in population (c. 76.9 million persons by the end of 2060) and a less dramatic increase in the old-age dependency ratio (to 53.7%).⁵ The ministry of finance's simulations of the long-term sustainability of public finances have shown that the German debt ratio may rise to c. 220% of GDP by the end of 2060 under the pessimistic T- scenario, unless policymakers take measures to counteract this trend (which they would have to under both the national and the European rules to limit the level of public-sector debt). Even under the optimistic T+ scenario, the debt ratio would be higher than today, at about 76% of GDP (following a temporary decline to about 45% of GDP in 2035, according to the simulations).⁶

Assuming that the public finances (revenue, primary expenditure) develop as forecast by the federal government in its fiscal planning until the end of the next legislative period (they expect no recession for the coming five years), the debt ratio might decline to 56% of GDP by the end of 2021, provided that the economic situation remains favourable and there are regular budget surpluses.

German debt ratio might rise rapidly due to ageing society

21

General government level, % GDP



Sources: AMECO, Deutsche Bank Research

A possible scenario for the time after that might include

- real GDP growth of only 1% p.a. in the long run
- real interest rates near 1.2% by mid-2020
- government revenues and non-age-related primary government expenses rising in line with nominal GDP growth (i.e. c. 2.8% p.a.) every year
- and age-related government expenses rising in line with the median of the two projections by the ministry of finance, T- and T+⁷.

In that case, the general government budget might run a deficit again from mid-2020 and get out of control in the long run if no counteracting measures are taken (chart 20). In this scenario, the debt ratio (and, in turn, the interest burden) would rapidly rise again from end-2020 (chart 21).

³ The old-age dependency ratio measures the ratio between people aged 65 and more and people aged 15 – 64.

⁴ The complete assumptions (e.g. for the number of births, life expectancy, immigration, participation ratio etc.) are available on p. 6 – 10 of the “Fourth Report on the Sustainability of Public Finances” (2016).

⁵ See “German Stability Programme (2017 Update)”, page 47, table 19.

⁶ See “Fourth Report on the Sustainability of Public Finances”, 2016, p. 17 et seq.

⁷ The calculations are based on the long-term development of age-related government expenses as forecast in the “German Stability Programme (2017 Update)”, page 47, table 19.



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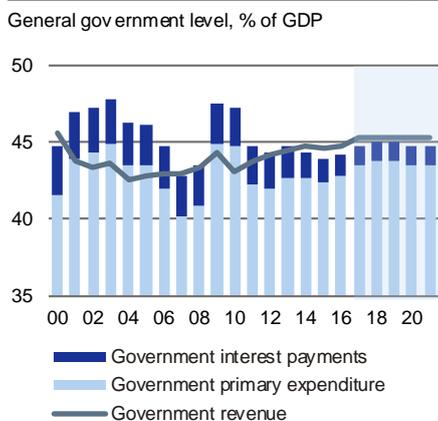
Estimate of fiscal leeway for tax cut **22**



*Necessary tax cuts to keep the tax ratio constant.

Sources: Working Party on Tax Revenue Estimates (May 2017), Deutsche Bank Research

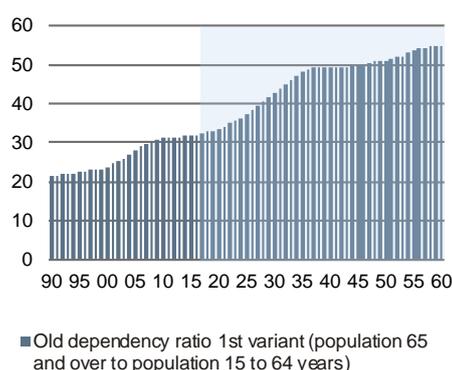
Revenues have exceeded expenditure since 2014, not least thanks to zero interest rates **23**



Projections: German Stability Programme (2017 Update).

Sources: Eurostat, AMECO, Federal Ministry of Finance, Deutsche Bank Research

Old-age dependency ratio to rise strongly from the next decade **24**



Sources: Eurostat, Deutsche Bank Research

However, the long-term fiscal risks do not appear to play a major role in the current election campaign, as the current cyclical situation is favourable

Since both the cyclical and the fiscal situations are quite favourable at the moment, the long-term risks for public finances do not appear to play a major role in the current election campaign. We argue in our latest German Monitor "Parties not focusing enough on sustainability" (17 July 2017) that planning for the future is playing second fiddle to another issue on the campaign trail and that many proposals are actually based on further expansion of the welfare state. For example, the CDU/CSU believe that, thanks to past reforms, the statutory pension system is currently sufficiently stable and there is no need for further amendments before 2030. In fact, politicians have included calls for tax cuts and expense increases in their parties' election programmes on the grounds of the current, favourable fiscal situation. For example, the CDU/CSU plan to cut income taxes. The current financial planning of the federal government includes freely disposable funds which amount to an accumulated EUR 14.8 bn (c. 1/2% of GDP) for the years 2019 to 2021. This sum has already been itemised as a global revenue shortfall.

The CDU/CSU election programme assumes that, thanks to the good cyclical situation, the government should be able to cut income taxes by a total of c. EUR 15 bn. The tax policy proposals of the CDU/CSU (hike of the tax-exempt amount for children and of child benefits, amendments to the tax bands, introduction of a children's allowance for young families who buy or build a home, introduction of tax allowances for acquiring property etc.) suggest, however, that the aggregate tax relief could come to more than EUR 15 bn. Moreover, the CDU/CSU promise that the tax ratio (22.5% of GDP in 2016) will not increase further. If the tax ratio remains unchanged, the fiscal scope might rise from EUR 5.3 bn in 2017 (0.2% of GDP) to up to EUR 27.5 bn (0.8% of GDP) in 2021 (own calculations, based on the tax estimate of May 2017; chart 22). This fiscal scope is equivalent to the difference between the forecast tax ratio and a tax ratio which remains at the level of 2016 (in relation to forecast nominal GDP).

The SPD promise to reduce taxes for lower and medium income earners and to offset the resultant revenue losses by higher taxes for higher income earners. In addition, they plan to abolish the solidarity surcharge for annual taxable incomes of up to EUR 52,000 (for single earners) by 2020. In 2016, this federal tax brought in revenues of c. EUR 16.9 bn (0.5% of GDP). The CDU/CSU intend to abolish the solidarity surcharge for all tax payers as quickly as possible in several steps from 2020. In concrete terms, they aim at relief worth roughly EUR 4 bn (0.1% of forecast GDP for 2017) during the coming legislative period. The SPD plan to introduce a "double stop line" in the pension system. In a first step, they aim to prevent a further decline in the pension level and keep pensions stable at least at their current level of 48% of working income until 2030. At the same time, contributions to the statutory pension system are not to rise above 22% (from currently 18.7%). A further hike in the retirement age is excluded. The SPD advocate additional tax money and an extension of the pension system to other groups of contributors ("citizens' insurance") for a period of transition to stabilise the pension system from the mid-2020s.

In order to prepare the economy and the public-sector finances for the ageing of the population and avoid abrupt major fiscal adjustments in the future, the parties should not make more and more electoral promises (tax cuts, expense increases) ahead of the elections in September which they will be hard pressed to pay for in the longer term. Rather, they should start a discussion about how to keep potential growth at least at the current level (or even raise it) in order to create new fiscal scope and stabilise the public finances despite the ageing of society. We already explained in our Germany Monitor "Slowing German trend growth does not seem to be a major issue in the electoral campaign" (3 July

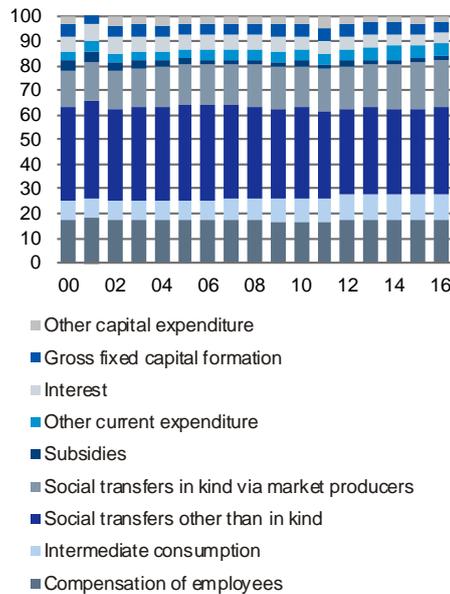


Germany's fiscal situation

Structure of general government spending

25

% of general government spending

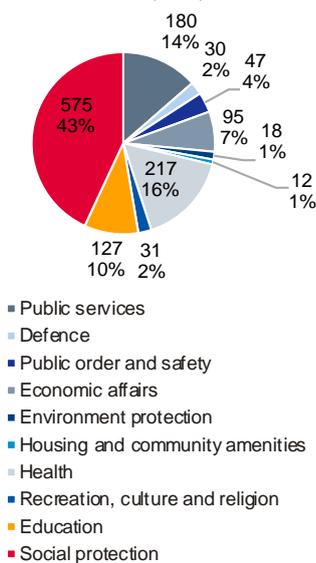


Sources: AMECO, Deutsche Bank Research

General government spending by policy areas

26

EUR bn and shares in % (2015)



Sources: Eurostat, Deutsche Bank Research

2017) that the current upswing veils the imminent slowdown in potential growth due to the ageing of society and that parties do not focus sufficiently on the issue of declining trend growth.

In principle, there is a broad social consensus that growth-promoting investment (in particular in education and innovative technologies) should be encouraged and have priority over other, non-growth-supporting expenses. It remains to be seen whether policymakers will heed this consensus in the upcoming legislative period (or will be able to implement it in view of their expensive promises in the fields of taxation and social security). Even today, non-growth-promoting expenses, particularly for social security, are weighing on the general government budget and reduce the scope for future-oriented investments considerably (charts 25 and 26).

Conclusion: Full employment and zero interest rates lead to high revenues, but (expensive) electoral promises and demographic developments might become risks

Overall, the fiscal situation looks set to remain very favourable in the coming five years (provided that growth stays healthy and government revenues continue to increase dynamically), but this state should not be regarded as permanent or as a given. In fact, the current growth rates are not sustainable the long run, particularly not if there are no further growth-supporting investments, in particular in education, and the number of qualified immigrants does not increase. Tax revenues will not boom forever either. In addition, actual government debt including implied debt (i.e. burdens which will materialise later on due to commitments made today) is considerably higher than the figures in the official statistics. An analysis by Stiftung Marktwirtschaft⁸ of March 2017 shows that current commitments, for example for civil servants' pensions or social security, will result in high future burdens on the budget (and hence fiscal deficits) if there are no amendments to current policies, as government revenues will not keep up with expenses in the longer run. Aggregate German government debt (including explicit and implied debt) currently amounts to 161% of GDP, according to the calculations made by the authors of the study, and is thus significantly above the official figure of 68.3% at the end of 2016.

If there are no amendments to current policies, e.g. in the areas of pensions or healthcare to limit age-related expenses, the overall financial situation and debt situation could become considerably more dire by the middle or end of the next decade at the latest, according to our calculations. By then, society is likely to have aged considerably – a development which will put a considerably larger burden on public finances than today.

The old-age dependency ratio, which measures the ratio between those aged above 65 and those aged 15 – 64, shows that Germany is in for a dramatic ageing of society. Based on the latest population forecasts by Eurostat, the old-age dependency ratio will rise considerably from the beginning of the next decade and the “demographic respite” will be over (chart 24). If the national and European provisions on limiting public-sector debt are to be complied with, fiscal policy, which is currently slightly, but increasingly expansionary (and thus pro-cyclical), will need to become considerably more restrictive.

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⁸ See Peters, Fabian, Bernd Raffelhüschen and Gerrit Reeker. “Ehrbare Staaten? Update 2016. Die Nachhaltigkeit der öffentlichen Finanzen in Europa.” Argumente zu Marktwirtschaft und Politik, No. 137 (March 2017).



Germany Monitor

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