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German growth needs fresh capital

by Michael Heise

The numerous geopolitical hotspots and the risk of a sanction of spirals in the conflict with Russia have left their first scars on the German economic picture. But, despite this uncertainty in the business sector and the problems in trade with Russia, sentiment in the population and the earnings expectations of consumers are at a very high level. Germany is viewed as a pillar of the European economy, abroad we garner recognition and respect. That is positive.

But quite apart from the geopolitical risks we must ask the fundamental question whether the foundations are really in place for Germany to continue to thrive in the years ahead and not slip back into a weak phase. Unfortunately, all is not well. Germany suffers above all from inadequate capital accumulation. In the public sector there are clear signs of the damage caused by past consolidation, the industrial capital stock is shrinking and asset accumulation among savers is stalling. But the build-up of production capital and assets is urgently required in order to lift productivity and wages in the future as well, and safeguard financial prosperity and the social welfare systems. Many words are expounded about improving Germany as an investment location, but to date little has happened. Expedient steps would be: Higher priority for infrastructure spending in the public-sector budget, more openness towards private forms of financing, better tax allowances for equity-financed investments, more effective curbs on the costs of the energy transition, promotion of innovation and venture capital, to name but a few. With a combination of such measures it should be possible in a strong economy to halt the march of investors abroad and to make Germany attractive.

The current weakness of investment has its counterpart in private household asset formation. In Germany financial and real estate assets have recovered since the crisis, but both level and growth rank only in the middle of the eurozone league. A large portion of German household savings flows abroad where, contrary to popular opinion, substantial returns are indeed earned. The subdued growth in German financial assets has more to do with the fact that the upswing on the equity and other securities markets does not filter through directly because some 40% of financial assets are held in bank deposits. For this “liquidity preference” savers are willing to accept interest rates below the rate of inflation, resulting in an erosion of assets in real terms – a high price. But even safe longer-term bonds yield little more. This means that the compound interest effect, which allows assets to grow, is currently very low here in Germany.

Low interest rates are not bad news per se – as long as they are in line with the economic backdrop. Indeed, the decline in interest rates set in well before the financial crisis, in response to declining growth and inflation rates. However, since the financial crisis the game has changed: central banks are trying to push the interest rate level ever further down with everything in their power. While this was an effective reaction to the crisis given the vehemence of the economic slump, it is now threatening to become the monetary policy norm, above all in the eurozone. The longer this “new (ab)normality” persists, however, the more evident the costs of this policy become; costs that are having to be borne first and foremost by savers.

Low yields are making it difficult for savers to achieve their planned wealth targets. Rather than saving more, as would be required, they are tending to consume more. With interest rates so low it is indeed frustrating to put money in the piggy bank and forgo consumption. While this reaction is understandable in economic terms, in the long term it has extremely negative repercussions. An example: someone wishing to have saved an additional EUR 100,000 on retirement in thirty years’ time would need to put aside EUR 125 a month with interest rates at 5% after tax, EUR 175 with interest rates at 3%, and EUR 240 with interest rates at 1%. Mini interest rates push up savings requirements sharply. But who is prepared to do that? Many simply prefer to accept increasing reliance on public benefits.

What can be done? To generate better returns, savers will have little choice but to accept higher risks. This can best be achieved with long-term investment strategies. On the political level, several options are available to support asset growth. For instance, in today’s interest-rate environment taxes on capital gains are very high and undermine incentives for private pension provision. In the low-wage sector in particular there is a need to rethink the relatively low level at which taxes kick in or the relatively high deductions from the state pension of private retirement provisions. And pension products such as the Riester or Rürup pension or forms of company pensions should not be discouraged but promoted further.

Cushioning the huge social costs stemming from the retirement of the baby-boomers in the coming years, and which are set to rise further in the long term, requires growth in the capital stock and in the population’s financial assets. Neither is happening right now. Unless things change, current hopes for a golden decade will prove to be a bitter illusion. The conditions for investment and wealth accumulation need to be improved. Only then will the current upbeat mood in the country be maintainable in the longer term as well.