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German Elections: A Positive Result but Action Needed

Germany recently held parliamentary elections that resulted in a change to the balance of power. How significant is this election? And what are the ramifications for the German economy?

First, let's spend some time looking at the details. Earlier in this decade, Germany embarked on a number of reforms. With emerging market countries moving up the export value chain, labor market reforms became a necessity for Germany to remain competitive. Furthermore, future demographic challenges meant that the status quo for domestic spending on social services was unsustainable. These reforms, including a more flexible labor force and reduced pressures on pensions, were seen as signs that Germany was serious about remaining a global competitor. Most recently, reforms have slowed. Under a "grand coalition" between the center-right CDU/CSU and the center-left SPD, new minimum wage limits have been introduced for certain industries and unemployment benefits have been increased.

After recent elections, the center-right CDU/CSU and the pro-business FDP are forming a new coalition. Immediately, it can be said that further dilution of reforms is unlikely, which is definitely a positive as there were some concerns that another "grand coalition" would continue to see a reversal of past reforms. More importantly, the coalition could pursue more reforms in the future. A near-term stumbling block occurs in May of 2010, when regional elections in the important state of North Rhine-Westphalia will take place. Ahead of this election, the coalition is unlikely to introduce anything dramatic.

Looking past elections next year, the coalition partners agree upon a number of initiatives. Both want to see income tax cuts for individuals (such as cuts in income tax rates), as well as some adjustments to corporate tax rules. The FDP in particular is proposing even more in tax cuts than this. It is unclear as to how far the CDU/CSU is willing to go on the tax front, although recent indications are that initial tax cuts will be modest.

Another focus for the coalition is on education. A study by the Organization for Economic Cooperation and Development (OECD) shows that education inequality is an issue in Germany, as it identifies concerns in schooling with children from lower socio-economic

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Market Perspectives

OCTOBER 2009

and immigrant backgrounds. The study also points to a low level of education spending in Germany relative to other developed countries. The coalition partners both want to see education spending increase in the next few years to 10 percent of gross domestic product (GDP) vs. the current 4.6 percent.

One problem with these proposals is the present state of the government's finances. As with many other countries, the German government attacked the recent crisis via fiscal policy as well as monetary policy. Thus, Germany is likely to run a fiscal deficit of around 5 percent of GDP this year and over 6 percent in 2010. This, coupled with rising debt levels (which have jumped from around 65 percent to 75-80 percent), means that any new spending and/or tax cuts must be offset by spending cuts elsewhere.

So why is all of this important? The German economy is the fourth largest in the world and Germany is the most populous country in Europe. It is a major exporter in the world and (along with France) is at the core of Europe. Given the relative importance of the country, there are several issues that need to be dealt with.

As stated earlier, Germany is facing a demographic problem. According to population statistics from the United Nations, the working age population is already in decline, resulting in fewer workers supporting retirees. Further pension reform could be challenging, especially in the short-term given upcoming regional elections. However, any movement in this direction would be important for long-term fiscal sustainability.

The labor market will be important to watch. More labor market reform is necessary, but will prove difficult in coming years. The rate at which a country's economy can grow is determined by two inputs: Labor force growth and

productivity. The decline in the working age population has already been discussed. Without a large push for immigration, the labor force will decline over time. Thus, the impetus for future growth will fall on productivity. One of the ways to increase productivity is to increase the efficiency of the labor market. However, in its rankings of global competitiveness, the World Economic Forum ranks Germany's labor market efficiency 70th out of 133 countries. More labor market reforms are needed for Germany to remain competitive.

Despite being a large country, Germany has a relatively high savings rate, which has risen over the last 10 years or so. Thus, the German consumer has spent little in recent years. The rise in real disposable income has been muted during this time period, in part due to higher taxes. Any type of individual tax reform could result in confidence being restored to the German consumer, which may help to increase the rate of consumption. However, a tax cut alone is not the only solution for consumption. It will be equally important to lower the debt burden of the federal government, as a high debt burden leads consumers to believe that taxes will rise in the future, thereby reducing consumption in the present. Accomplishing both tax cuts and debt reduction will be a challenge.

In general, the German election results were the best possible outcome for the economy and markets. If the new German coalition becomes serious about making Germany more competitive in the next few years, then German markets could outperform. Were this to occur, the Waddell & Reed Advisors International Growth Fund as well as the Ivy International Core Equity and International Growth Funds should benefit.



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