Germany

Ebbing confidence

As international trade slows, the economy is mainly supported by expansionary fiscal and monetary policies and real disposable income growth. After a mild contracted in Q2, the economy is expected to grow modestly in the second half of the year. In 2020, exports may strengthen again and growth could return to close to potential. Due to its deep integration in global value chains, Germany is relatively hard hit by the global trade slowdown. This integration has undoubtedly brought benefits by improving productivity and skill-intensity. However, it has also accentuated income inequality.

A disappointing second quarter

Early indicators point to a slight growth contraction in Q2, following a surprising strong performance in the preceding quarter (0.4%). The latter could be attributed to temporary factors such as mild winter weather which stimulated construction activity, the end of supply difficulties in the car industry related to the introduction of the WLTP, and increased demand from UK clients in the run-up to the Brexit deadline.

Meanwhile underlying business conditions have continued to deteriorate. In June, the ifo climate index fell once again. At 97.4, it has reached its lowest level since November 2014. On balance, companies remain satisfied with the current situation, but express concern about the coming months, as order books are thinning. Only in the construction sector, the climate index remains at a relatively high level. Moreover, uncertainty among firms is relatively high. Since Q4 2018, the ifo dispersion index, which measures the dispersion of firm's expectations regarding the six-month business outlook, have been at around 59, a level earlier observed in the wake of the financial crisis.

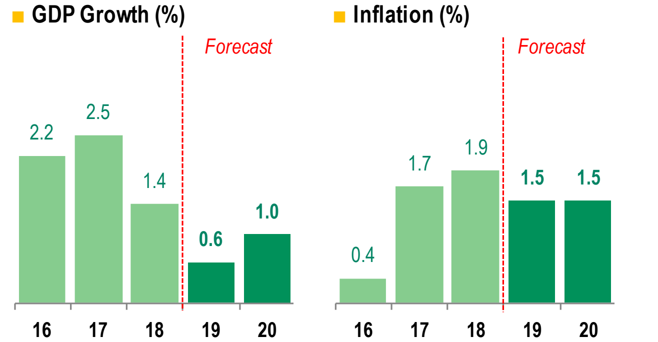
Nevertheless, the labour market remains well oriented. In April, employment was still about 1% higher from the previous year and the harmonised unemployment rate stood in May at 3.2%, the lowest in the eurozone.

Given the tensions in the labour market, negotiated wages have risen sharply in recent months. In Q1 they were almost 3% higher from a year earlier. Overall labour costs rose by 2.3% over the same period. However, this has hardly affected inflation. In May, consumer prices were only 1.4% higher from a year earlier.

An expansionary fiscal stance

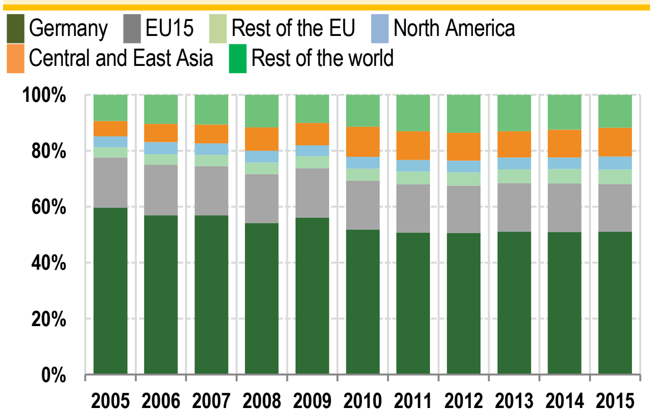
The coalition parties lost heavily in last May's European election. The CDU/CSU (conservative, Christian-Democrats) remained the largest party, but the SPD (social-democrats) ended third after the Greens. Many SPD supporters would like to quit the grand coalition. However, the prospect of crushing defeat and the upcoming election for a new chairperson do not make it a likely option for the moment. In the coming months, confrontations between the coalition parties are likely to increase, as the SDP would like to have more influence on government policies in areas such as the introduction of a basic pension or climate policy.

1- Growth and Inflation



Source: National Accounts, BNP Paribas

2- Value added by country of origin in final demand for the German manufacturing industry



Source: OECD TiVA statistics, BNP Paribas calculations

In accordance with the coalition agreement, fiscal policy will be loosened considerably, in particular on the expenditure side. Government spending on transport infrastructure, child care and education will be increased. Moreover, the pension entitlement for people who raised children will be improved (mothers' pension). Income taxes and social contributions will not change substantially. The income tax cuts are just enough to compensate for bracket creep. Moreover, lower unemployment contributions will be offset by increased contributions for the long-term care insurance.

Given the fiscal loosening, the general government surplus will probably shrink markedly from 1.7% of GDP in 2018 to 1% in 2019 and 0.75% in 2020. Moreover, tax receipts, in particular from the corporate sector, are likely to disappoint. On the positive side, interest payments continue to decline because of the exceptionally low interest rates. As a result, the debt ratio will continue to fall and will fall below the 60% of GDP mark, for the first time since 2002.

Growth may pick up in 2020

In the coming quarters, the economy will be mainly driven by expansionary fiscal and monetary policies. In addition, domestic demand will be supported by earlier concluded generous wage settlements and a well-oriented labour market.

Against this backdrop, only a slight increase in GDP is expected in the second half of 2019, mainly due to robust government and household demand. By contrast, manufacturing production growth will remain sluggish given the slowing of international trade. It is likely that this will also spill over to the rest of the economy. In particular, the uncertain business climate is not very conducive for investment. Assuming an orderly Brexit, some of the trade uncertainties may be lifted towards the end of the year, which will be favourable for German exporters. Moreover, construction activity will remain supported by low interest rates and the infrastructure projects. Growth is projected to be again close to potential, estimated at 1.4%.

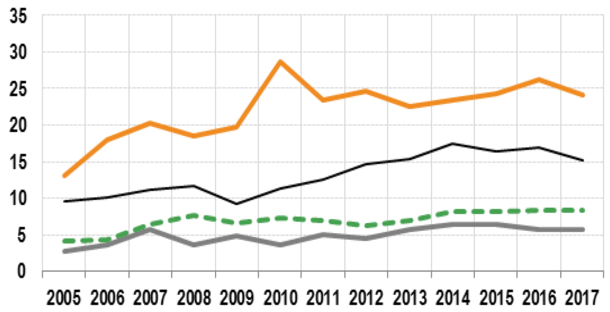
Integration in global value chains

At the moment, the large Germany's large manufacturing sector is very much affected by the slowdown in international trade. During the past decades, German manufacturers have become very integrated in global value chains. In order to remain competitive in world markets, they have off-shored low value added and labour intensive processes. As a result, the domestic share of value added in total demand declined from 60% in 2005 to 51% in 2015. Most of the value added is still produced in the EU (73% in 2015) but the share of China has substantially increased, from 1.8% in 2005 to 6% in 2015. Moreover, a shift to the former communist countries in central and Eastern Europe is observed, their share in the value added increasing from 3.7% to 5.2%. The trade in value added statistics also show that 4.1% of the value added of the German manufacturing sector came from the US in 2015, compared with 3.3% in 2005. It underlines once more that US trade sanctions may also indirectly affect US industry.
The manufacturing sector receives also inputs from other sectors, such as services. Its share in terms of value added has remained rather constant at around 33%. Against this backdrop, it is not surprising that business services are also impacted by the slowdown in manufacturing production.

The offshoring of low value added and labour intensive processes have had a profound effect on the German labour market. It is not that the number of jobs has declined. On the contrary, jobs have increased and unemployment is at a record low. However, the nature of the jobs has changed, as the economy has become more knowledge intensive. Between 1995 and 2009 (latest data available) the share of hours of worked by high skilled persons increased from 21.8 to 27.7%. This has been a contributory factor to the growing inequality. Although partly compensated by the redistribution of income through the tax and social security system, the risk of poverty among people in the working-age population has increased over the past 15 years.

3- The risk of in-work poverty has increased

% of employed people earning less than 60 % of the median equivalised disposable income after social transfers
Single person : with children, without children
Two or more adults: with children without children



Source: Eurostat

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