Germany

Economic climate change

Economic growth has slowed markedly since the second quarter of 2018 and business surveys indicate that it is unlikely to change in the coming months. The exporting manufacturing sector is much affected by the slowdown in world trade. In the coming quarters, the domestic economy is likely to become the major engine behind growth thanks to an expansionary fiscal policy. More fiscal stimulus could be expected if the economy would slow further. This would also shore up the chances of the coalition parties at the next federal election set for 2021.

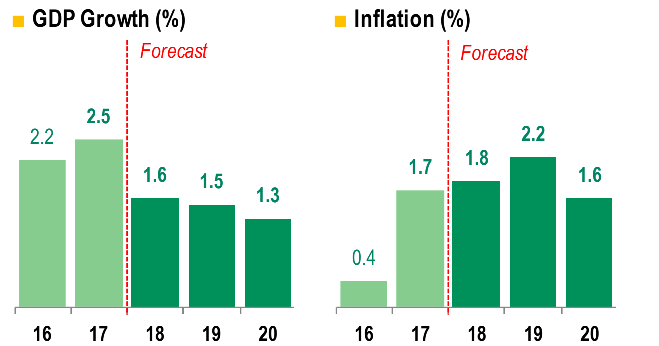
Slowing down

The business cycle has slowed substantially since the second quarter of 2018. Problems in the car industry following the introduction of new European emission standard resulted in substantial production losses. In addition, the banning of older diesel cars from city centres has also been affecting car sales in this segment. In November, automotive production was 12% lower from a year earlier. However, the problems are not only restricted to the car industry. Export demand in general has eased due to a slowdown in world trade. Furthermore, private consumption slowed, despite favourable developments in the labour market. As a result, the household savings rate is trending higher. The exception to the bleakness was housing construction, driven by shortages and rapidly increasing prices. Overall, Destatis estimates that GDP increased by 1.5% in 2018, i.e. a full percentage point less than in 2017.

Despite slowing demand, the unemployment rate has further declined to only 3.3% in November, the lowest in the euro area, while bottlenecks in the labour market have further increased. In the manufacturing sector, about one in four employers report recruiting difficulties. In the construction sector, 10% of builders report that it is even their main limiting factor. The German economy increasingly recruits foreign workers. In the twelve months to October 2018, the economy created as many as 700k jobs, of which 54% were occupied by foreigners. The German parliament recently adopted an immigration law to facilitate access to the labour market for workers from outside the EU.

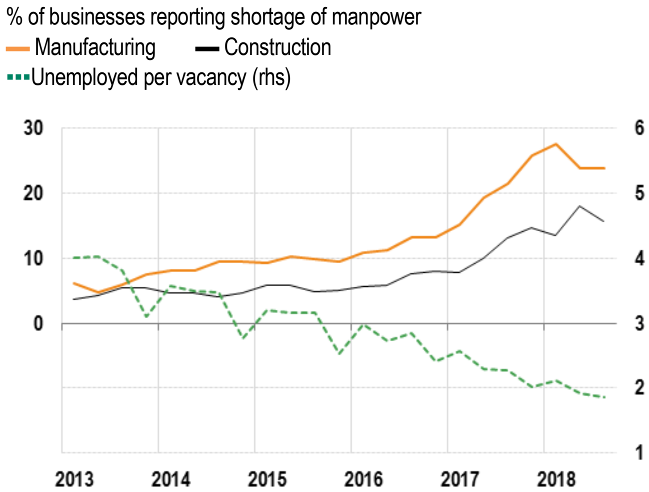
The favourable economic situation and growing labour shortages have resulted in a rise in negotiated pay rates. In the fourth quarter of 2018, basic pay was 3.2% higher from a year earlier. In the manufacturing sector, hourly earnings increased by 3.5%. These pay hikes have not yet resulted in a pick up in inflation.

1- Growth and Inflation



Source: National accounts, BNP Paribas

2- Increasing bottlenecks in the labour market



Source: IFO, IAB, BNP Paribas

Room for fiscal easing

Looking only at the economic results, the actual grand coalition between conservatives (CDU/CSU) and social democrats (SPD) should be doing quite well. The government finances are in rude health. For 2018, the government finances were again in surplus, estimated at 2% of GDP. Moreover, public debt declined to around 60% of GDP, for the first time since 2002.

Nevertheless, many voters are unhappy with the ruling coalition, as can be seen in the polls and the outcomes of several state elections. Following the disastrous results of the CDU/CSU in state elections in October, Chancellor Merkel announced to renounce the leadership of her party in December and to step down as chancellor at the next election to be in 2021. The CDU elected Annegret Kramp-Karrenbauer (AKK) as party chairman. This choice confirmed that the CDU wants to remain a broad people's party. The CDU/CSU is currently polling around 31%, slightly lower than at last year's federal election (32.9%).

The SPD is in a much more difficult position. In the polls, the party obtains the support of only 15%, compared with 21% at the federal election. Many party members would like the party to quit government at a suitable moment in order to rebuild the party from the opposition benches.

The Green Party profits most from the discontent. According to the latest polls, it would obtain 19% of the vote, a gain of 10 points compared to the 2017 federal elections. In eleven of the sixteen States, the Greens are already in the state government, mostly as junior partner. The populist right AfD is only doing slightly better than at the latest federal election. The next election is for the European Parliament in May. In autumn, several state elections will be held in the eastern part of the country.

According to the coalition agreement, fiscal policy should be mildly accommodative in the coming years. On the expenditure side, income transfers both at the federal level as the regional will be increased. This will be partly compensated by lower interest payments, as the government continues to borrow at extremely low interest rates. On the income side, tax reductions will be implemented even though the tax burden is estimated to decline only marginally. Pointing at the healthy budgetary situation, CDU leader Kramp-Karrenbauer has already called more tax cuts to head off an economic slowdown. By contrast, the SPD prefers stepping up spending on education, income transfers and digitalisation. Finance-Minister Scholz (SPD) remains cautious, warning that the era of windfalls in taxes is probably over.

Subdued growth in 2019-20

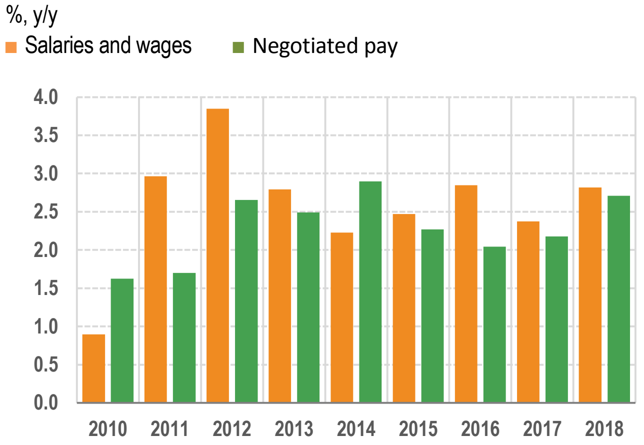
GDP growth is likely to be subdued in the coming quarters. The latest survey data is in line with this scenario of continuing weakness. The IFO climate index has been declining since September. It reached 101 in December, just above the average in 2015-16.

The activity slowdown is most obvious the manufacturing sector. The problems concern the new European exhaust norms are likely to be temporary and some catch-up should be expected in the coming months. The main problem for the sector is the slow growth of world markets. Both in 2019 and 2020, world GDP is projected to growth by around 3.3%, 0.5 percentage point lower than in 2017-2018.

By contrast, domestic demand is likely to remain rather strong thanks to the expansionary fiscal policy. This is likely to underpin household consumption in the coming quarters. Moreover, because of problems in the car sector, household have been delaying their car purchases. As a result, the household savings rate reached 10.7% in 2018, a highest since end 2005. This could give an additional boost to spending, in particular in the first half of this year.

Growth in government investment is likely to outpace GDP growth in 2019-2020, given the spending plans on transport infrastructure, childcare facilities and schools. However, administrative bottlenecks, the lack of building plots and capacity constraints might limit the execution of the programme.

3- Rising wage tensions



Source: Deutsche Bundesbank, Destatis, BNP Paribas

The lack of skilled workers is also likely to weigh on housing investment. Also other factors, such as the decline of the native-born German population and the increase in mortgage interest rates are likely to weigh on construction.

The downside risks to our projection are mainly related to the international environment, such as the undecipherable US trade policy and a possible disorderly Brexit. On the other hand, the domestic risks are on the upside; In particular, the healthy fiscal position gives the German authority some leeway in implementing a more expansive fiscal stance. This might also shore up the chances for the ruling coalition at the next federal elections in 2021.

Raymond Van der Putten
raymond.vanderputten@bnpparibas.com