Germany

Manufacturing woes

Since the middle of 2018, economic activity has virtually stagnated largely because of a slowdown in world trade. The most recent surveys and hard data confirm that weakness in the manufacturing sector continued in Q1 2019. Spearhead of the economy, the sector can become a source of vulnerability when world markets are less buoyant. However, Germany is able to support domestic demand. In 2019, the government will return to households and businesses a part of last year's record budget surplus (more than EUR 50 bn).

Since the middle of 2018, economic activity has virtually stagnated. Initially, this was largely blamed on temporary factors such as the introduction of new exhaust regulations for cars. In the second half of 2018, car production was 7.1% lower than in the preceding six months. Moreover, a long period of draught resulted in record-low water levels of the Rhine, which seriously hampered freight transport on Europe's busiest waterway. In particular, the chemical industry was impacted.

A slowdown based on more than anecdotal evidence

However, throughout the second half of the year, it became increasingly obvious that the slowdown could not be explained by only temporary factors. The manufacturing woes can largely be blamed on the slowdown in world trade, against the backdrop of US-Chinese trade tensions and Brexit uncertainties. In Q4, world trade volumes were 1% lower on the preceding quarter, in particular due to an important import contraction in the for Germany important Asian markets (-5.6%). German exports in declined by 0.1% in the second half of the year.

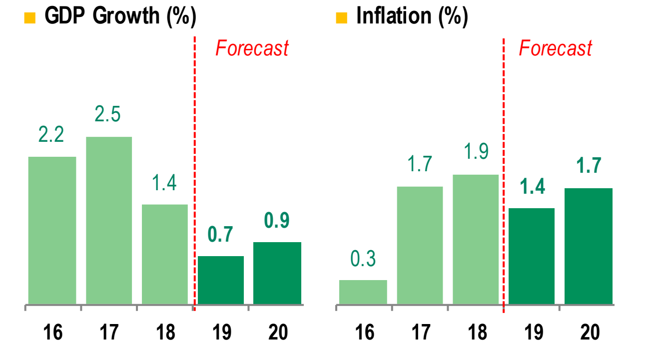
Also private consumption was more or less stagnant in the second half of 2018, despite strong wage developments, growing employment and high consumer confidence. A possible explanation is the increase in energy and food prices in Q4, which had a negative impact on purchasing power. Moreover, households may have postponed their car purchases, partly because of the production problems, but also because of increased tightening of exhaust regulations for diesel vehicles in several large German cities. As a consequence, the savings rate steadily increased during the year from 10% in Q1 2018 to 10.9% in Q4 2018, a highest since mid-2008.

Growth was mainly supported by government consumption and investment in buildings, both rising by 0.2% in H2 on the previous six months. Investment in equipment remained at around the same level as in H1. Nevertheless, it was 4.2% higher in 2018 on the previous year, a substantial increase compared with previous years.

The most recent surveys and hard data confirm that weakness in the manufacturing sector continued in Q1 2019. In March, the PMI manufacturing dropped to 44.1, a lowest since July 2012, as total order books and new business from abroad fell at the fastest rate since April 2009.

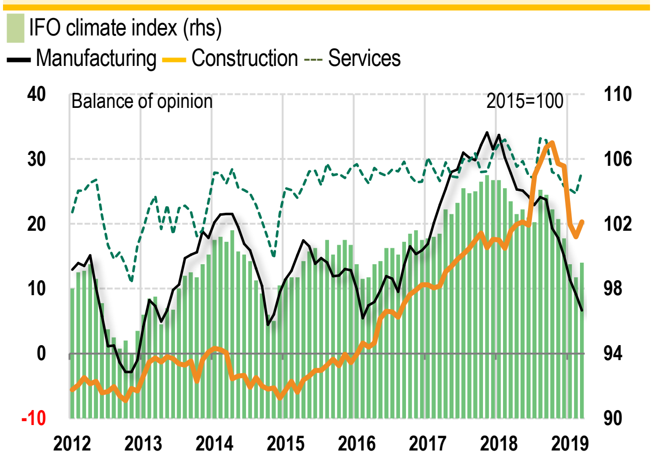
However, more positive signals came from the sectors mainly producing for the domestic market such as construction and services. The IFO climate index even strengthened in March after six consecutive months of decline, despite a further deterioration of the manufacturing component. This also explains why labour market data remain well oriented. Employment continued to grow, although at a slower speed and the unemployment rate inched down to only 3.1% in February, whereas job vacancies reached a historical high (807 000 in March).

1- Growth and Inflation



Source: National accounts, BNP Paribas

2- The Ifo climate index turned upwards in March



Source: IFO

The state coffers are bursting at the seams

Thanks to the rapidly incoming taxes in the context of robust consumption and wage growth, the government budget surplus reached 1.7% of GDP and public sector debt declined to 60.9% of

GDP in 2018. This would allow the government to pursue its expansionary policy as projected in the coalition agreement.

In 2019, discretionary fiscal measures will amount to 0.7% of GDP. They will include an improvement of pensions for mothers (*Mütterrente II*), and increased spending for defence, development aid, child care and investment. Moreover, the budget includes income tax reductions and research funding. For 2020, the stimulus plan will amount to 0.4% of GDP, in particular for health care and child benefits. Moreover, the basic tax-free allowance will be increased and the tax brackets raised. The budget surplus (in % of GDP) is projected to decline to 1.2% in 2019 and 1% in 2020. According to the German Council of Economic Experts (*Sachverständigenrat*), the structural deficit will decline from 1.7% in 2018 to 0.7% and 0.4% in 2019 and 2020, respectively.

Finance minister Olaf Scholz has already announced that he is prepared to use all the fiscal leeway available to stimulate the economy if a crisis hit. However, the government is unlikely to characterize the current slowdown as a crisis. Moreover, breaking open the government agreement might create new problems for the already fragile coalition.

Strong employment and productivity growth

Leading indicators and early hard data such as factory orders suggest that the slower momentum in growth is likely to continue in the first half of 2019. Growth could stabilise around the middle of the year, depending on the unwinding of tensions and uncertainties that are currently weighing on world trade. We expect the economy to recover gradually thereafter. GDP growth could gradually pick up from 0.7% in 2019 to 0.9% in 2020.

Compared to other industrialised countries, Germany has a relatively large manufacturing sector. The share of manufacturing in total gross value added amounted to 23% in 2017, compared with only 11% in France. That is the reason that the Germany economy is among those most affected by the current economic slowdown.

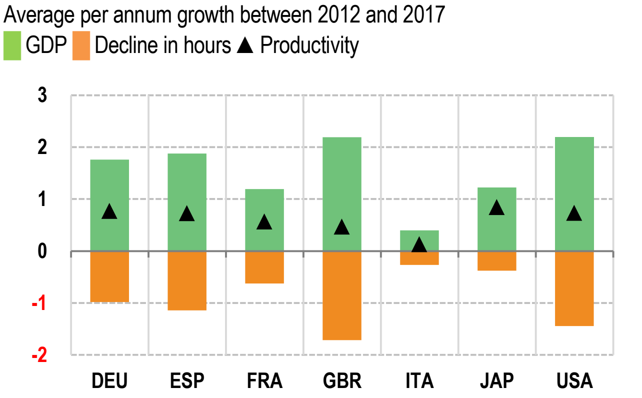
However, the large manufacturing sector has also brought major advantages for the economy. As the manufacturing sector has recorded much higher labour productivity increases than the services sector, Germany has outperformed most other advanced economies in terms of economic output per hour. In the period 2012-2017, productivity increased by 0.8% per annum in Germany, compared with 0.6% p.a. in France.

Moreover, Germany has succeeded in integrating many workers with low productivity into the labour force. They have found work mainly in the services sector. Between 2012 and 2017, total hours worked in the German economy increased by around 1% p.a., compared with only 0.6% p.a. in France.

It is true that many of the jobs that have been created in Germany were part-time jobs. Nevertheless, thanks to income support schemes, the number of working-poor has remained relatively low. The risk of poverty among employees, whose household equivalised disponible income is below 60% of the national median equivalised income, has actually declined from 10.4 in 2014 to 8.7%

3- Labour productivity and hours worked

Average per annum growth between 2012 and 2017



Source: OECD, BNP Paribas

in 2017. Among the major EU countries only France, at 7.5% in 2017, did better. In Italy and Spain, these rates were 15.5% and 13.4%, respectively.

The turnaround of the German economy is generally attributed to the implementation of the labour market reforms, the so-called Hartz reforms, in 2003-05. Overall, these reforms have delivered good results in terms of access to the labour market and equity objectives. However, the model has not yet been tested in an economic environment in which jobs are less numerous. If the current economic slowdown were to morph into a long lasting recession, it might be hard for the German model to achieve its equity objectives without corrective measures.

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