Germany

Nearing a turning point

Economic activity increased by only 0.6% in 2019, as the decline in manufacturing production was offset by increased activity in more domestically oriented sectors. In the coming two years, the economy will be supported by more accommodative fiscal policies. From Q2 2020, the pick-up in exports related to the partial lifting of uncertainties may more than compensate for easing consumption growth. Nevertheless, GDP growth is expected to remain below potential. The possible departure of the SPD from the ruling coalition forms a major political risk.

A prolonged period of virtual stagnation

According to the latest statistics and business cycle indicators, economic activity hardly increased in Q4 2019. Industrial production might even have further contracted as the manufacturing PMI, despite its hesitant improvement, remained firmly below the 50 mark. In particular Germany's large car industry was affected. In October-November, production in this sector was about 20% lower from two years earlier.

By contrast, activity in construction and services held up quite well according to the ifo surveys. In the service sector, the indicator even rose in December to its highest level of the past six months. In construction, companies remained upbeat of their current business situation, but became more pessimistic about activity in the coming few months.

Despite the economic slowdown, labour market conditions have hardly deteriorated. In November, the unemployment rate amounted to 3.1%, only 0.1% higher than in the previous month. Moreover, job vacancies have remained at a relatively high level. Even in the manufacturing sector, many employers still report labour shortages as being a limiting factor for their production.

Nevertheless, employers' organisations and trade unions have been adapting to the weaker business climate, as recent wage settlements have been less generous than those concluded one year earlier. The negotiated wage rate in the period August-October 2019 was 2.4% higher compared to a year earlier. In early 2019, the annual rate of change stood at around 3%.

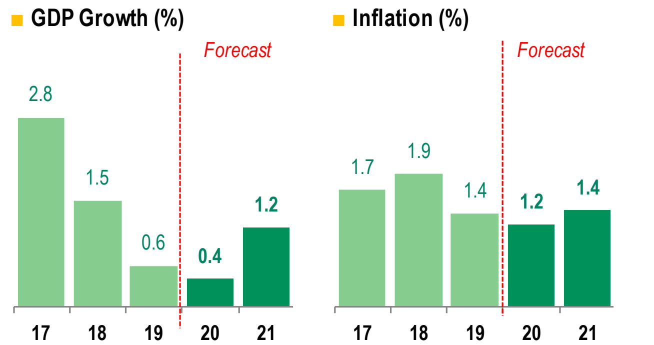
For the moment, the increase in labour costs has hardly affected consumption prices. In 2019, HICP inflation declined to 1.4% compared with 1.9% in the previous year, as the rise in energy prices slowed to 1.3%. By contrast, prices for services increased by 1.6%.

Fiscal easing

During the economic boom in the years 2014-2018, the government followed Keynes' advice to follow tight fiscal policies in order to restore government finances. The government indeed succeeded in reducing the debt-GDP ratio to 61.2% of GDP in 2019.

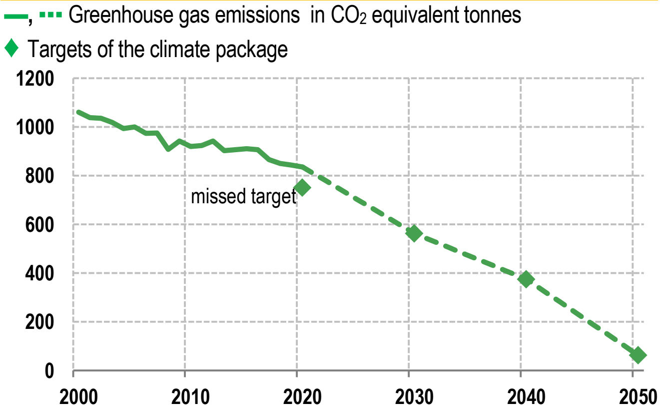
For 2020 and 2021, fiscal policy is set to be eased in line with the coalition agreement. Government investment will be stepped up in particular for transport and digital infrastructure and education. The

1- Growth and Inflation



Source: National Accounts, BNP Paribas

2- Growth and Inflation



Source: Umweltbundesamt, BNP Paribas

government also intends to increase spending in order to reduce the emission of greenhouse gases (see below). As share of GDP, government spending - excluding interest payments - is expected to reach a highest in 2021 since the reunification peak.

On the revenue side, income taxes will be lowered, in particular because of the partial scrapping of the solidary tax. On the other hand, additional tax receipts can be expected related to the rapid increase in wages and the progressiveness of the tax system. Moreover, energy taxes are set to increase. Overall, the tax burden will be virtually unchanged. Government finances are expected to remain in surplus during the projection period and the debt-GDP ratio could decline below 60%.

The political uncertainty has increased as the SPD members elected as chair persons of their party Saskia Esken and Norbert Walter-Borjans, two critics of the grand coalition. They are calling for renegotiating the coalition agreement. However, CDU and CSU are unlikely to give in. This places the SPD for a difficult choice. Pressing too hard for policy change could lead to a government crisis and new elections. Given the SPD's position in the polls, a severe defeat is likely, which could pave the way for a coalition between the CDU/CSU and the Greens.

Greener policies add to inflation

Last December, the German Parliament adopted a climate package, targeting zero CO_2 emissions by 2050 (Chart 2). The intermediate objective is to reduce greenhouse gas emissions by 55% in 2030 compared with 1990. However, the government has admitted that the country will miss the 2020 target, a reduction of 40% of carbon emissions from the 1990 level.

The main measure is the creation of a CO_2 tax for sectors that are outside the scope of the EU Emission Trading Scheme (ETS). In 2021, the tax should amount to EUR 10 per tonne CO2. It will steadily increase to EUR 35 per tonne by 2025. Tax receipts will be used to finance climate protection measures such as lowering electricity prices, increases in commuter allowances, and subsidies for green projects.

At a macroeconomic level, the consequences of the package are likely to be limited. The CO_2 levy will result in a rise in energy prices by 2%, thus raising inflation by around 0.2% in 2021. Core inflation will be hardly affected. The effect on activity will also be quite limited. The tax will reduce disposable income, but as the receipts are completely used for climate protection spending, the impact on activity will be neutral. Moreover, as the measure does not affect large energy users that are subjected to the ETS, the possible effect on price competitiveness is likely to be limited.

However, the measure will have an impact on the income distribution. It is well-known that carbon taxes particularly hurt low-income families and seniors. On the positive side, it will shift demand away from polluting activities.

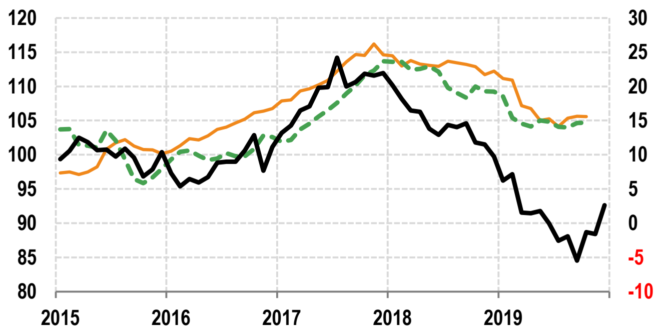
Exports prospects have improved

All business cycle indicators point to continuing subdued growth in Q1. Industrial production might even further contract, but this is compensated by a slight increase in activity in more domestically oriented sectors such as services and housing construction. Demand in these sectors is still underpinned by strong disposable income growth and robust labour market conditions.

However, the cycle may be about the turn. The ifo export expectations index rose significantly in December, underpinned by signs of an easing in the trade conflict and more clarity about Brexit after the UK general election (Chart 3). In particular, manufacturers of electrical products and pharmaceuticals are expecting a

3- Improving outlook for exports

Orders (2015=100, three-month moving average) :
Eurozone, Outside the eurozone
Export expectations (balance of opinions, RHS)



Sources: Deutsche Bundesbank, IFO, BNP Paribas

significantly higher number of orders from abroad. Even in the automotive industry, managers have become significantly less pessimistic. This will compensate for slowing domestic demand growth. Despite very accommodative monetary and fiscal policies, household disposable income growth is projected to increase at a slower rate than in previous years. This will weigh on consumer demand and housing construction. Moreover, investment demand could weaken, as capacity utilisation ratios have fallen below their long-term level. All in all, GDP growth is expected to increase by 0.8% and 1.2% (adjusted for calendar effects by 0.4% and 1.2%) in 2020 and 2021, respectively.

Although growth will remain well below potential in 2020 and 2021, the labour market is likely to remain very tight. On the one hand, manufacturers have resorted to reducing work hours and short-time working schemes to avoid dismissing their core workers. In addition, employment growth remains strong in particular in non-market services. Moreover, immigration is likely to slow as job opportunities diminish. The unemployment rate is projected to remain at very low levels. Negotiated pay rates may further ease in 2020 due to the downturn in the industrial sector, but may pick up next year. Inflation excluding food and energy is expected to rise slightly as past wage increases, in particular in services, are gradually passed onto consumers. Total inflation could edge down in 2020 to 1.2% and slightly accelerate in 2021 to 1.4% .

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