Germany

Unchanged policy despite stagnation

Weak data and business cycle indicators suggest that economy would be in a mild technical recession. The weakness is mainly in the manufacturing sector and has hardly affected the rest of the economy. Despite calls from different quarters, the government is unlikely to launch a fiscal stimulus, beyond what is in the coalition agreement and the climate package. Simulations show that spill-over effects of a fiscal boost to other countries will be limited. Moreover, the implementation might be hampered because of long planning periods and bottlenecks in the labour market. Political tensions could increase after the SPD congress in December.

A mild recession

Weak manufacturing data and business cycle indicators suggest that the economy contracted in Q3 for the second consecutive quarter, implying that the economy would be in technical recession. As the economy is currently operating close to full capacity, the current turbulence could for the moment be considered as a normalisation of the economic situation.

The weakness is in particular located in the manufacturing sector, against the backdrop of Brexit and elevated trade tensions. Germany's large manufacturing sector seems more affected than that in other countries. It is partly due to Germany's specialisation in transport and investment goods and its rather important exposure to the Chinese market. Moreover, several large firms listed on the DAX have been experiencing serious problems. The difference in price/book value between the S&P500 and the DAX is even at its largest for 18 years. By contrast, in the non-manufacturing sector, activity indicators, although weaker from a year earlier, remain at relatively high levels.

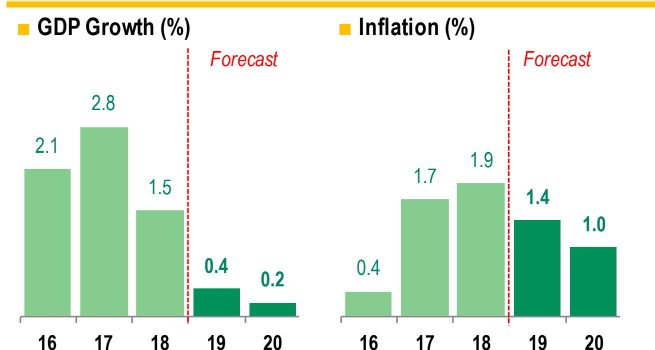
Despite the mild recession, labour market conditions remain extremely tight and vacancies remain at record high levels. In August, the unemployment rate stood at only 3.1%, the lowest in the eurozone. Given recent recruiting difficulties and the Germany's strict employment protection legislation, employers might prefer to hold on to their workforce by using short-time working schemes. The number of employees in these schemes has been increasing.

Government sticking to their fiscal guns

In September, Finance Minister Scholz announced the 2020 Budget. It will be mildly fiscal expansionary in accordance with the coalition agreement but the budget will remain in surplus (*Schwarze Null*). Policy will remain directed at increasing disposable income in particular for low and average income earners and families. This policy will continue in 2021 by increasing child benefits and the scrapping of the solidarity tax – a surcharge to help rebuild eastern Germany - for 90% of tax-payers. The authorities want to reduce the general government debt to close to 50% by 2023.

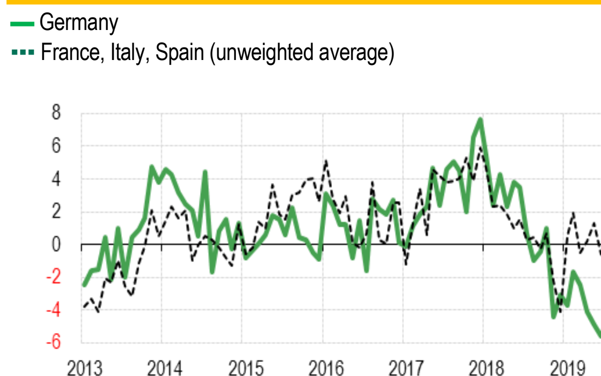
In addition, in the same month the government announced a comprehensive climate package in order to reduce CO_2 emissions by 55% from the 1990 level by 2030. From 2050, the economy should become carbon neutral. For the period 2020-2023, EUR 54 bn will be spent on incentives for climate-friendly behaviour and investment. This will be largely financed by the extension of the

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Manufacturing production (%, y/y)



Source: Eurostat

emission trading system to cover the transport sector and the heating of buildings. The climate plan completes the earlier announced phasing out of coal by 2038. The government has made EUR 40 bn available for the restructuring of the coal regions over the coming 20 years.

Given the favourable budgetary situation and negative borrowing costs, the German government has come under pressure from international organisations such as the IMF and the ECB to use the fiscal room to support the economy. Recently also the German employers' organisation DBI joined the chorus. For the moment, these appeals have fallen on deaf ears. The German government argues that the economy is still operating close to potential. Moreover, because of the long lags and uncertain impact, fiscal

stimulus, beyond the operation of the automatic stabilisers, is maybe not the most appropriate instrument for the fine tuning of the business cycle. In addition, the spill-over effects on the rest of the eurozone is rather limited (see Box). However, Finance Minister Scholz has declared that he stands ready to loosen the purse strings in the case of an economic crisis.

Prolonged stagnation and political tensions

GDP growth is forecast to slow to 0.4% in 2019 and 0.2% in 2020. The main driver is domestic demand, in particular supported by generous wages increases. In Q2 2019, contract wages were 3.8% higher from a year earlier. Inflation is expected to decline from 1.4% in 2019 to 1% in 2020. However, core inflation is likely to increase gradually in the coming years, as a result of domestic wage pressures. The Bundesbank estimates that an increase in wage costs would lead to an increase in consumer prices by 0.3% in the medium term.

Heavy losses in the European and state elections for the governing parties CDU/CSU and SPD have led to tensions within the coalition. An increasing number of SPD members would like the party to leave the government. The SPD congress in December should elect a new leader – Finance Minister Scholz is amidst the contenders – and may choose a new direction, which could increase tensions in the coalition.

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3- The effectiveness of fiscal policy

We have used the NiGEM model to simulate the effect of an increase in government investment by 1% in GDP maintained over two years. Assuming no change in interest rates, real GDP in Germany would be 0.5% higher compared to the base run after two years.

This is substantially smaller than the initial shock, as the increase in demand pulls in more imports. Moreover, the labour market is set to tighten further which will drive up wages and consumer prices. In the second year, consumer prices will be 0.3% higher than in the base run. The resulting loss in competitiveness will also be supportive for imports, whereas exports may decline. As a result, the current account surplus will decline by 0.7% of GDP.

The initial deterioration of the government balance will be softened by the increase in tax receipts and reduced social spending. All in all, the government balance is set to deteriorate by 0.9% of GDP.

The spill-over effects to other countries are limited. The main beneficiaries of a fiscal boost are the small neighbouring countries. In particular, production in Hungary & Slovakia (both 0.4% higher than base run after two years) and the Netherlands & the Czech Republic (both 0.3%) will benefit from a German budget stimulus. The effect on France, Italy and Spain is close to 0.1% after two years.

These results should be interpreted with care. As a consequence of the shock, government investment would increase by almost 50%. It is doubtful if sufficient projects can be found on this scale and within a short time span. Moreover, labour shortages in the construction sector may form a major obstacle in implementing the programme.

Effects of fiscal expansion in Germany of 1 % of GDP*

	Year 1	Year 2
% from baseline		
GDP	0.45	0.46
Private Consumption	0.14	0.22
HCPI	0.10	0.30
% point difference from baseline		
Current Account**	-0.73	-0.66
Gov. financial balance**	-0.88	-0.89

*exchange rate, interest rates exogenous ** in % of GDP

Source: calculations BNP Paribas with NiGEM