GERMANY: ECONOMIC ACTIVITY

HOW CLOSE ARE WE TO SEEING MORE GERMAN FISCAL STIMULUS?

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SUMMARY

- Germany's economy weakened significantly in the second half of 2018. External headwinds remain strong and, in an environment where monetary-policy ammunition remains limited, all eyes have shifted towards German fiscal policy.
- Beyond the already implemented 2019 fiscal stimulus, the country has fiscal space amounting to around 1% of GDP or EUR34bn according to various fiscal rules.
- Material fiscal easing would be a game-changer for us. This would support euro area and German demand growth. As things stand, the slowdown has not been severe enough to see the government upping its fiscal stimulus any further.
- Our view on the German economy is unchanged. Fundamentals supporting domestic demand, mostly private consumption, remain healthy, while most of the weakness is coming from external factors.
- We expect growth to remain subdued in H1 2019, before picking up somewhat in H2 2019, as some of the near-term risks come to a head. Nevertheless, we note that the balance of risks to our growth outlook remains angled to the downside. Particularly worrying in the near term is any potential escalation of trade tensions between the US and Europe.

Three key questions about German fiscal policy

The German economy avoided a technical recession in the second half of 2018 by the narrowest of margins. Several transitory factors dampened the economy in H2 2018 (see the Appendix). Moreover, Germany's overreliance on exports and broad exposure to China mean it has experienced a sharper downturn than most of its peers.

Recent indicators (Ifo expectations, Manufacturing PMI, industrial production, factory orders) suggest that external headwinds remain powerful, but domestic demand is looking resilient. **In an environment where monetary-policy ammunition remains limited, there has been plenty of focus on German fiscal policy**. How expansionary is German fiscal policy in 2019? How much fiscal space does Germany have? Is the government willing to do more should data deteriorate further? These are all questions that have been attracting ever closer attention.

How expansionary is German fiscal policy in 2019?

The government has planned fiscal easing worth 0.7% of GDP to the economy (worth around 0.3-0.4pp of higher growth) in 2019. **It is the most significant easing since the global financial crisis**. Some 0.5% of GDP of the easing is directed at households: tax cuts to families and low-/middle-income earners, cuts in unemployment insurance contributions and increases in pension benefits. The rest reflects planned investment spending and digital infrastructure. This is the 2019 budget plan approved last summer by the coalition. The stimulus was not designed to cushion a growth slowdown, but it has come at a timely moment and will help domestic demand.

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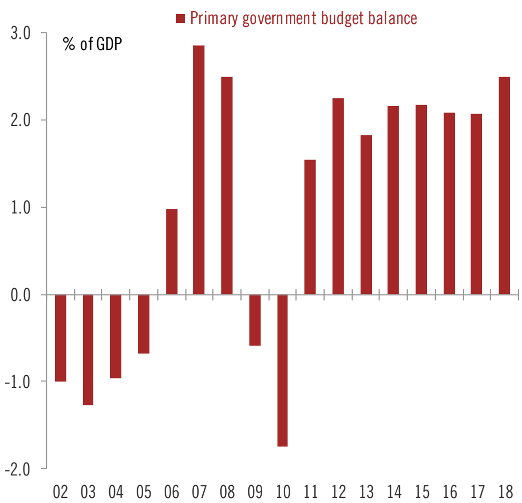
How much fiscal space does Germany have?

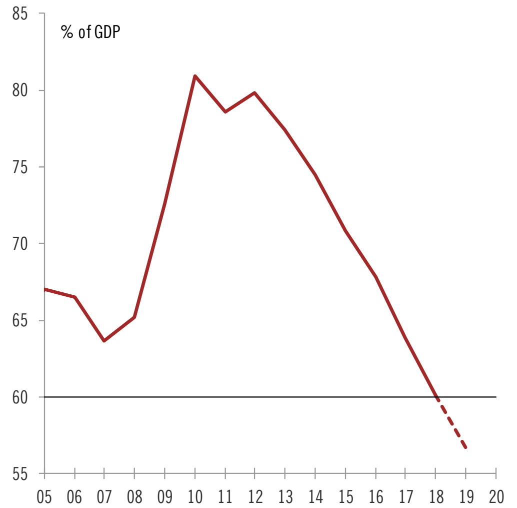
In recent years, the German government has been focusing on cutting debt. The debt-to-GDP ratio stood at 60% in 2018 and is expected to fall below the Maastricht Treaty threshold this year. Meanwhile, the country has generated significant budget surpluses since 2011 (see *Charts 1* and *2*).

CHART 1: GERMAN GOVERNMENT BUDGET BALANCE



Source: PWM - AA&MR, European commission

CHART 2: GERMAN GOVERNMENT DEBT



Source: PWM - AA&MR, European Commission

Over and above the 2019 fiscal stimulus already implemented, the question is how much fiscal space does Germany have according to various fiscal rules. Starting with European fiscal rules, Germany's obligation is for the structural deficit to be no greater than 0.5% of GDP (medium-term objective). According to the European Commission estimate, this year's structural surplus is projected at 0.7% of GDP. So, available fiscal space would be 1.2% of GDP. The unofficial policy target of *die schwarze Null* ("Black Zero"), introduced in 2014 by then Finance Minister Schäuble, calls for a balanced nominal budget. With an estimated government surplus of around 1.0%, this would allow for 1.0% more spending. Similarly, the German constitutional debt brake calls for a maximum structural budget deficit of 0.35% of GDP, but only applies to the Federal government, so there is room for flexibility.

Overall, therefore, based on the array of fiscal rules, **German fiscal space beyond the already implemented 2019 fiscal stimulus works out at around 1% of GDP or EUR34bn**. The government therefore has enough spending leeway to stabilise the economy. Nevertheless, fiscal space within the rules might be more constricted than that, as the slowing economy has translated into lower tax revenues. **Of course, if need be, both European and German fiscal rules allow for an overshoot in exceptional circumstances** (such as a major shock outside the government's control). Germany could also just break the rules, but the bar for this to be done is quite high. Abandoning the "Black Zero" has a big political cost that no party is ready to shoulder, especially ahead of European elections in May and regional elections in September and October.

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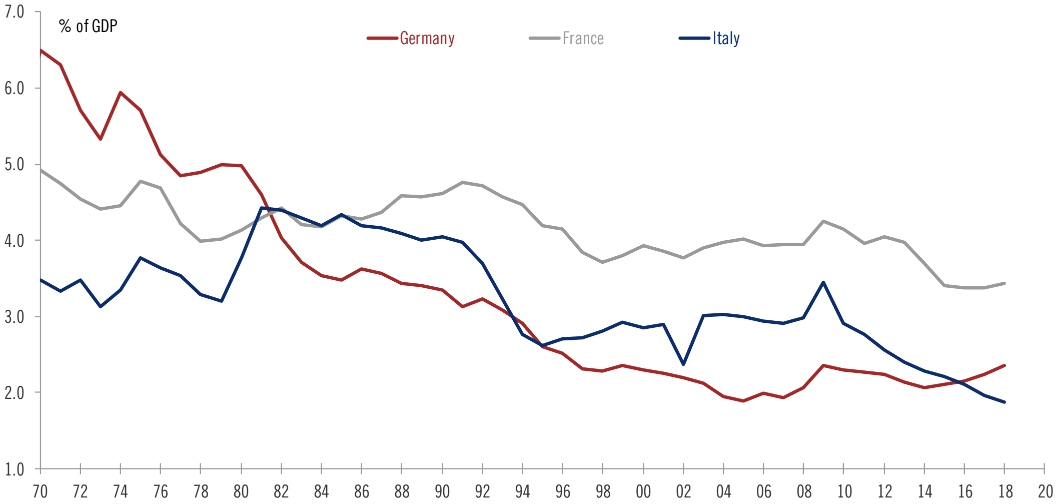
It is worth mentioning that discussions have been intensifying about the efficiency of German fiscal rules. To some extent, German fiscal rules contributed towards curbing public investment in recent years (see *Chart 3*) despite a low interest-rate environment and the country's crumbling infrastructure.

CHART 3: EURO AREA – GENERAL GOVERNMENT GROSS FIXED CAPITAL FORMATION



Source: PWM - AA&MR, European commission

Is the government willing to do more?

A new consensus for looser fiscal policy has been emerging among politicians, but the current political situation renders decision-making more complicated. The parties in Germany's 'Grand Coalition' – the Christian Democratic Union/Christian Social Union alliance (CDU/CSU) and the Social Democratic Party (SPD) – were the big losers in the 2018 Bavaria and Hesse State elections. The CDU's historic low score forced Chancellor Angela Merkel to step down as party leader in October last year (see here). The 'Grand Coalition' parties want to boost their support and demonstrate to their electorates that the centre-left and centre-right are not one and the same thing, even if they are governing together.

CDU leader Annegret Kramp-Karrenbauer (AKK) has suggested corporate tax cuts. The statutory Federal tax rate is currently 15% (30% including regional taxes and surcharges, the 5th highest among industrial economies). One way the CDU/CSU has been considering implementing these tax breaks would be by abolishing the *Solidaritätszuschlag* (the so-called "solidarity surcharge"). The current coalition deal envisages the '*Soli*' being removed for the bottom 90% of income earners by 2021. The CDU now seems to be in favour of getting rid of it altogether. The SPD made it clear that abolishing it completely would need to be counterbalanced by a rise in income taxes for the highest income bracket. This was rejected by the CDU. For its part, the SPD has turned towards higher social spending in a bid to re-engage with its working-class base. SPD proposals include an increase in the minimum wage, together with higher pensions and more generous unemployment and child benefits.

Material fiscal easing would be a game-changer for us. It would support euro area and German demand growth. But, even though a new consensus is emerging around looser

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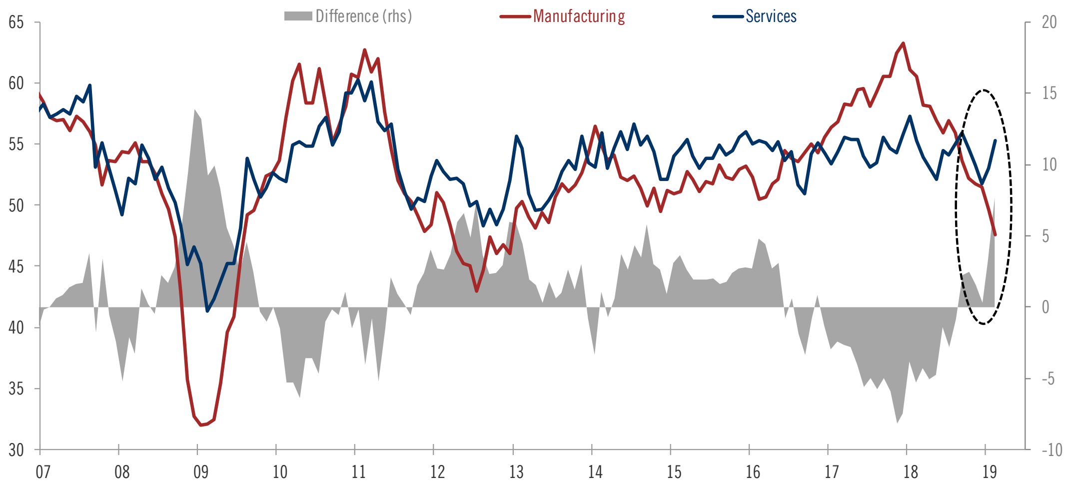
fiscal policy, we have not yet witnessed that much willingness to compromise from either side. **The Finance Ministry is said to have drawn up a contingency plan to stimulate the economy should recession risks mount significantly**. This would be achieved via income tax cuts and accelerating depreciation schedules for companies that are likely to be temporary (see here). As things stand, the slowdown has not been severe enough to see the government upping its fiscal stimulus any further.

Our view on the German economy in 2019

German domestic demand remains solid and underpinned by healthy fundamentals. Sustained jobs and wages growth, falling inflation due to lower oil prices and fiscal stimulus are all factors that should help private consumption to remain resilient this year. Fundamentals that have supported growing investment – tight capacity, easy financial conditions and strong cash flows – persist as well. However, deteriorating foreign demand and rising external uncertainties remain the most serious downside risks for an export-oriented economy like Germany's.

Recent hard and soft data have confirmed the resilience of domestic demand but have also highlighted how challenging the external environment is for the German economy. Increasing divergence between the domestically-driven services sector and the more export-exposed manufacturing sector is striking as well as worrying (see *Chart 4*). If it were to drag on for too long, weakness in the manufacturing sector could spread to the services sector.

CHART 4: GERMAN PMIS – A PICTURE OF DIVERGENCE



Source: PWM - AA&MR, IHS Markit

Overall, **German growth is likely to remain subdued in H1 2019**, before picking up somewhat in H2 2019, as some of the near-term risks come to a head. We expect the German economy to grow by 1.3% in 2019. Our baseline scenario relies on the following assumptions: a 'No Deal' Brexit is avoided; no auto tariffs are imposed by the US; a trade truce is struck between China and the US; Chinese stimulus gains some traction in Q2-Q3, helping to stabilise global demand. Nevertheless, the balance of risks to our growth outlook remains angled to the downside. Particularly worrying in the near term is the potential escalation of trade tensions between the US and Europe. Should President

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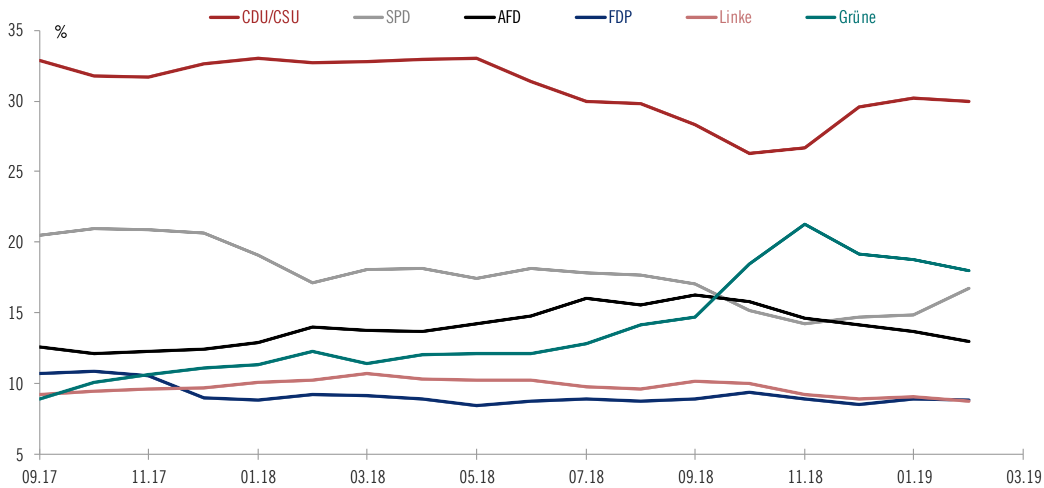
Trump decide to press ahead with auto tariffs, this would have a significant impact on German growth. According to our calculations, this would cut our annual GDP growth forecast for Germany by 0.4 percentage points at a minimum (see our *Flash Note* for further details here).

Last, **on German politics even though we have ruled out a snap 2019 election from our baseline scenario, the chances of one being called are significant enough not to be overlooked**. Results in European parliament elections in May and regional elections in Bremen (in May) followed by a string of regional polls in eastern Germany in the fall will be key to watch. A poor showing for the SPD at the ballot box in the coming months, could hasten the government's collapse amid pressure within the party to seek renewal in opposition.

CHART 5: GERMANY – NEXT GENERAL ELECTIONS (AVERAGE OPINION POLLS)



Source: PWM - AA&MR, various polls

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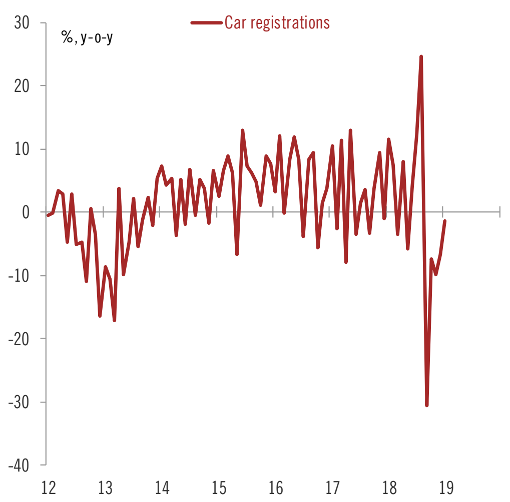
Appendix: Idiosyncratic events in German industry

Manufacturing output sank into deep recession in the second half of 2018, posting its steepest decline since Q4 2008-Q1 2009. The sector accounts for 23% of the economy, so contraction in German industry exerted a significant impact on GDP growth in Q3 and Q4 2018. Part of the downturn in manufacturing can be blamed on idiosyncratic events in some industries, notably the auto, chemicals & coke and pharmaceutical sectors. So far, January's hard data have been confusing. Industrial production contracted by 0.8% m-o-m, but the December print was revised up to +0.8% m-o-m from -0.4%. Meanwhile, new orders fell by 2.6% m-o-m in January, but the December release was revised up to +0.9% m-o-m from -1.6% m-o-m. So overall, the January round of hard data confirmed that headwinds from weak external trade persist, but also that the impact of transitory factors has not completely disappeared.

Vehicles – WLTP

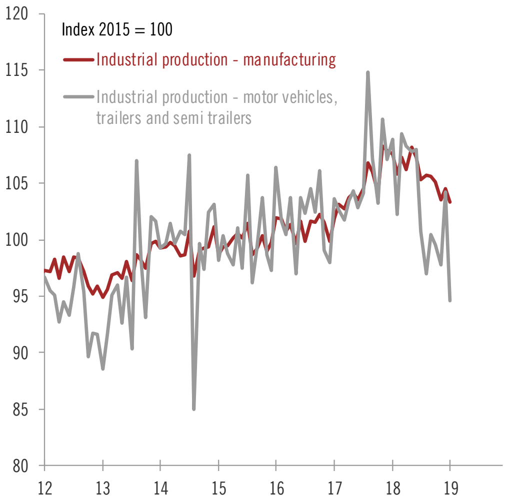
The new Worldwide Harmonised Light Vehicle Test Procedure (WLTP) for cars led to sizeable output declines in the German auto industry in Q3 2018. As new certifications for car models were not secured in time, car-makers had to cut production back temporarily. Production cuts were the key factors behind the negative German GDP figure in Q3 2018. According to official calculations, the slump in car production sliced 0.4pp off GDP growth in 2018.

GERMANY: CAR REGISTRATIONS



Source: PWM - AA&MR, Bloomberg

GERMANY: INDUSTRIAL PRODUCTION – MOTOR VEHICLES



Source: PWM - AA&MR, Destatis

In January, production fell sharply in the auto sector (-9.2% m-o-m). So far, a distinct rebound from the WLTP related production decline is thus not visible in the data. February may be more promising. Business sentiment in the car sector stabilised in February according to Ifo survey, with production expectations rising.

Chemicals and coke – Low Rhine levels

Below-average water levels on the Rhine dampened transport and production in the chemicals and coke/refined petroleum sectors in Q3 and Q4 2018. Water levels have

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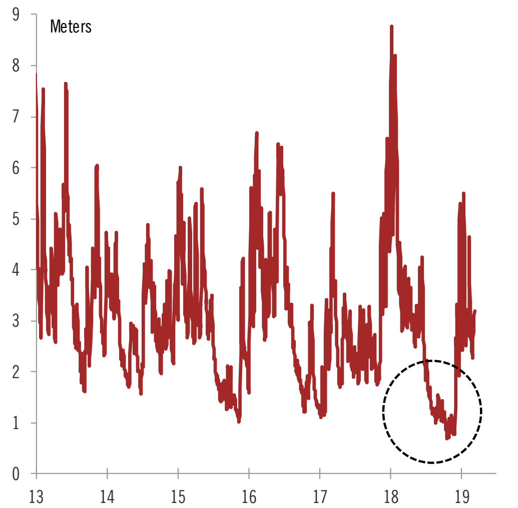
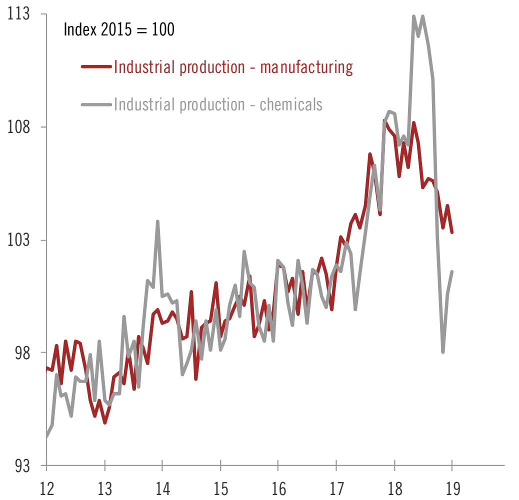
normalised this year, and accordingly production in chemicals and coke/refined petroleum sectors was up in January versus Q4 average

GERMANY: RIVER LEVEL – RHINE AT KOELN



Source: PWM - AA&MR, Bloomberg

GERMANY: INDUSTRIAL PRODUCTION - CHEMICALS



Source: PWM - AA&MR, Destatis

Pharmaceuticals – Statistical problems

Production in the pharma sector fell 27.5% from September to November, following on from a 30.1% y-o-y increase in July. The reasons for this are less clear, but, considering the severity of the decline, it had a significant impact on the headline number. January data was stable versus the Q4 average. Data revisions are likely in the coming months.

GERMANY: INDUSTRIAL PRODUCTION AND NEW ORDERS FOR PHARMACEUTICAL PRODUCTS

Source: PWM - AA&MR, Destatis

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