

GERMANY: ECONOMY

THE CASE FOR FISCAL STIMULUS STRENGTHENS

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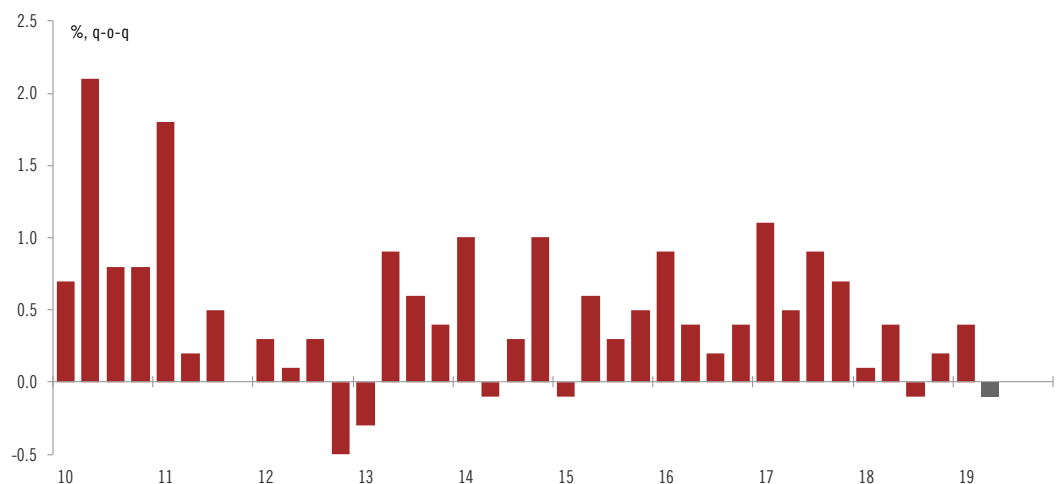
SUMMARY

- The German economy shrank by 0.1% quarter-on-quarter (q-o-q) in Q2. Today's report contained some positives news, notably regarding the resilience of domestic demand.
- Nevertheless, the ongoing trade disputes between China and the US, China weakness, the threat of auto tariffs and the threat of a no-deal Brexit to supply chains, in addition to the auto sector's own issues are all factors that make us much more cautious about the H2 economic prospects than before. As result, we have revised sharply down our 2019 GDP growth forecast for Germany to 0.5%.
- The pressure on the government to act will likely increase but abandoning the "Black Zero" has a big political cost that no party is ready to shoulder, especially ahead of regional elections in September and October.
- The trend in the latest German data will clearly ring more alarm bells at the European Central Bank (ECB), reinforcing our view of significant ECB action in September.

GDP shrank in Q2

German real GDP shrank by 0.1% q-o-q in Q2, decelerating from a 0.4% rise in Q1. Of note, H2 2018 GDP growth was revised up significantly. The numerical details are not yet available and will be not published until 27 August. Nevertheless, the statistics office made some comments. First, domestic demand remained resilient. **Consumer spending, government consumption and investment in machinery and equipment all rose in Q2.** In contrast, following the surge in Q1, investment in construction suffered some set-back in Q2. Second, **the main drag came from trade.** Exports recorded a stronger q-o-q decrease than did imports.

CHART 1: GERMANY – REAL GDP GROWTH



Source: PWM - AA&MR, Destatis

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The risk of recession is now elevated

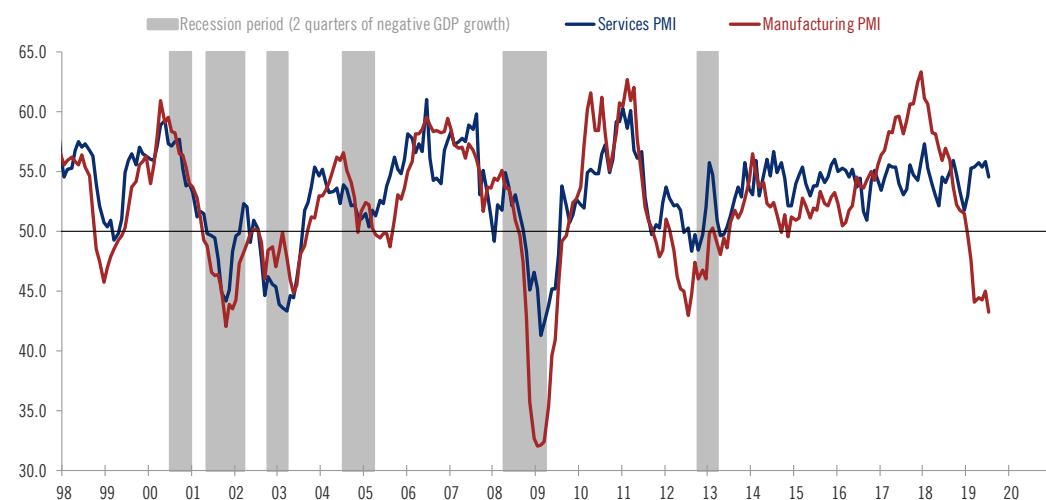
Today's report contained some positive news, notably the resilience of domestic demand. Nevertheless, the outlook for H2 2019 remains particularly challenging for Germany. **The structure of its economy being skewed towards the industrial tradable sector means that it is being hit harder than other economies by current environment.** The mix of ongoing trade disputes between China and the US, the global slowdown, China weakness, geopolitical uncertainties, the threat of auto tariffs and the threat of a no-deal Brexit to supply chains, in addition to the auto sector's own issues, are all factors dampening industrial sentiment and activity.

Early indicators point to another weak performance in Q3. Markit manufacturing PMIs for Germany recorded a seven-year low of 43.2 in July, down from 45.0 in June (*see Chart 2*). The IFO survey painted an equally gloomy picture. The business expectations sub-index declined to 92.2, the lowest level since June 2009, suggesting uncertainty continues to be a drag.

The more domestically-driven services sector has remained very resistant to external weakness up until now. Nevertheless, **the industrial slump has started to leave some marks on the Germany's domestic economy.** New orders have shrunk to levels that are forcing companies to reduce production capacity, as illustrated by the reduction in manufacturing jobs and the rise of shorter working hours. Fading consumer confidence is sending another warning signal about the German economy.

The tentative signs of a weakening domestic economy, the possibility of a no-deal Brexit, potential US tariffs on EU cars, the ongoing trade frictions between the US and China as well as the slow rotation of the Chinese economy are all factors that make us much more cautious about the H2 economic prospects than before. As a result, **we have revised down our 2019 GDP growth forecast for Germany to 0.5%.**

CHART 2: GERMANY - PMI SURVEYS



Source: PWM - AA&MR, Markit

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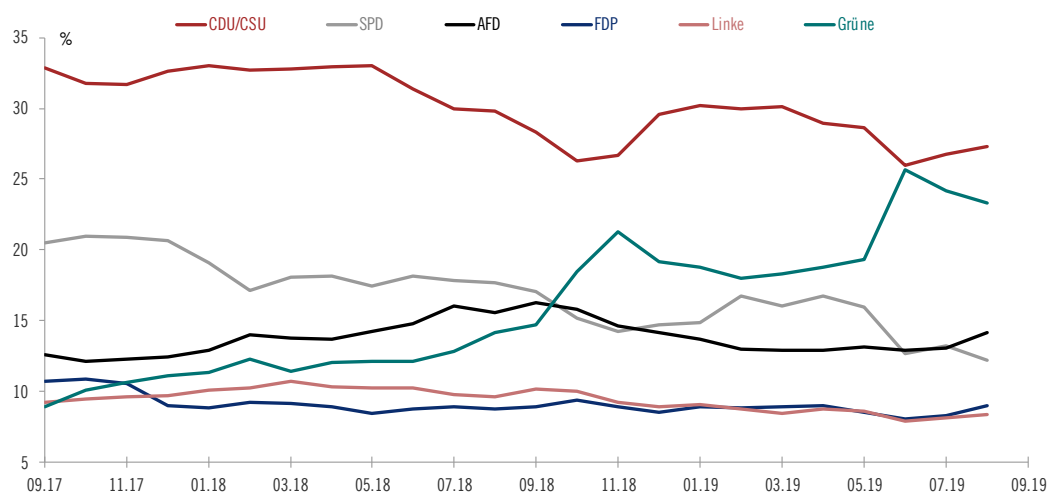
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A fiscal stimulus to address weaknesses?

The pressure on the government to act will likely increase. But while Germany has fiscal room, **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, Hesse State election as well as EU parliament elections. **Abandoning the "Black Zero"¹ has a big political cost that no party is ready to shoulder, especially ahead regional elections in September** (in Brandenburg and Saxony on 1 September) and October (Thuringia on 27 October).

Nevertheless, there seems to be growing support to agree on measures to tackle climate change and to reduce the so-called solidarity tax. The budget debate from 10 September may offer further clues as to whether pressure is really growing or not.

CHART 3: GERMANY – POLLS NEXT GENERAL ELECTIONS (MONTHLY AVERAGE)



Source: PWM - AA&MR, various polls

German data will ring more alarm bells at the ECB

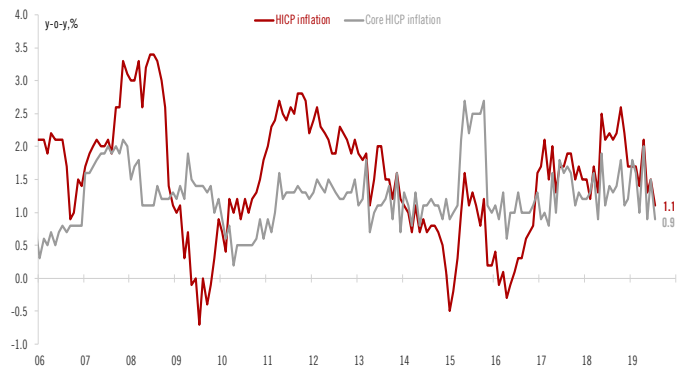
The trend in the latest German data will clearly ring more alarm bells at the European Central Bank (ECB), reinforcing our view of significant ECB action in September. **The key risk right now is to see German weakness generating spillovers to the rest of euro area.** We believe the ECB package will take the form of a 10bp deposit rate cut (along with tiering) as well as the launch of a new asset purchase programme (our best guess is EUR50bn of net monthly asset purchases over 12 months). **Risks are tilted towards a bigger package, namely a larger deposit rate cut (of 20bp) and/or a larger asset purchase programme.**

¹ The unofficial policy target of die schwarze Null ("Black Zero"), introduced in 2014 by then Finance Minister Schäuble, calls for a balanced nominal budget.

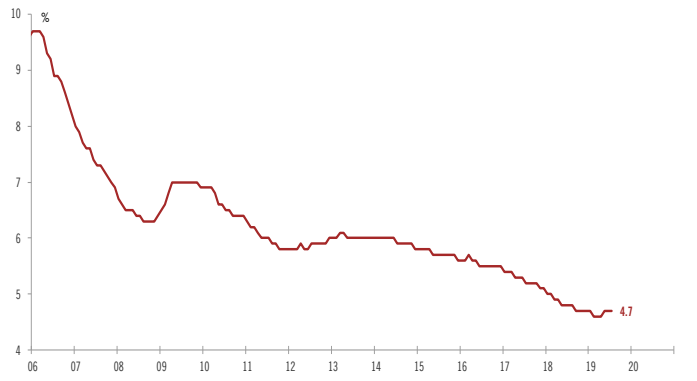
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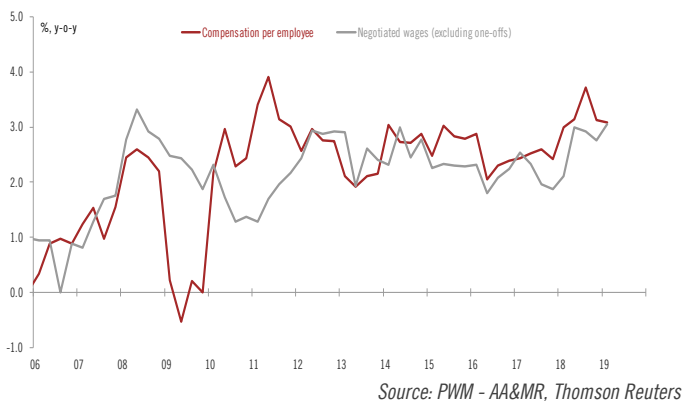
GERMANY: HICP INFLATION



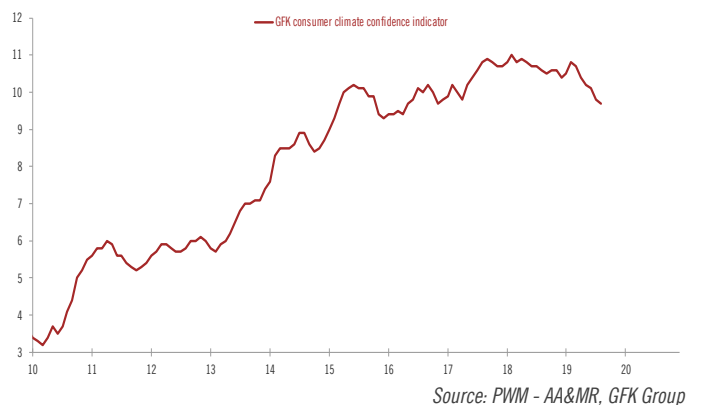
GERMANY: UNEMPLOYMENT RATE



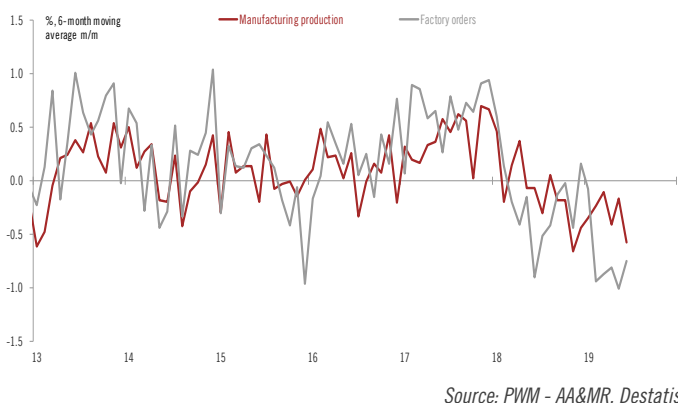
GERMANY: WAGE GROWTH



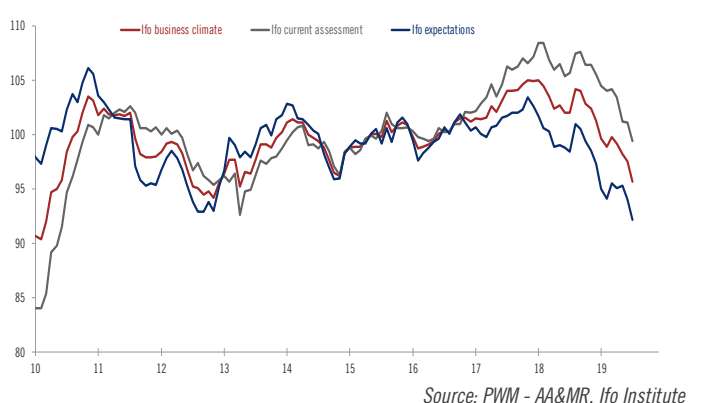
GERMANY: GFK CONSUMER CONFIDENCE



GERMANY: MANUFACTURING PRODUCTION AND FACTORY ORDERS



GERMANY: IFO SURVEYS



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