GENERALI INVESTMENTS

Focal Point

German growth to stay solid

January 5, 2016

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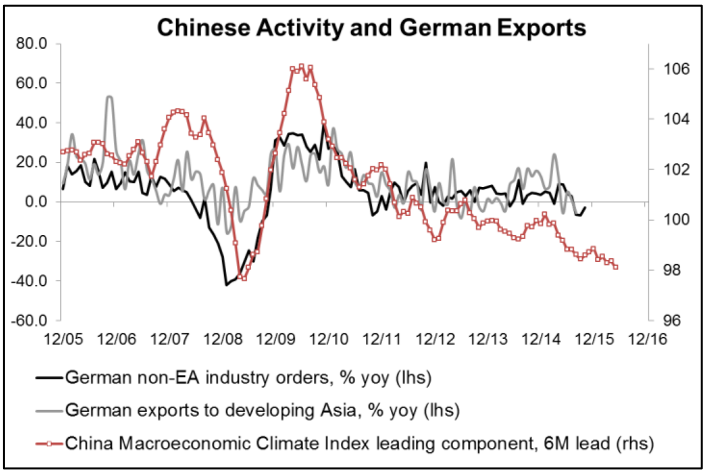
- Over the past months, the outlook for Germany has become subject to some market worries: The extent of the Chinese slowdown, the VW scandal and the refugee crisis.
- Despite these headwinds, we anticipate positive forces from a strong labor market, the broadening of the recovery across euro area economies and the highly accommodative ECB policy stance to prevail.
- Moreover, fiscal policy has leeway to cushion activity in case there are signs of a significant slowdown.
- Germany has likely closed its output gap in 2015 and is expected to grow by 1.7% in 2016, increasingly driven by private consumption.

Over the foregone years, Germany has become an engine of growth for the euro area. Over the past decade its annual growth averaged 1.4%, more than double of the corresponding euro area average of 0.6%, largely driven by exports. Behind this outperformance stand to a large degree the fruits of past reforms and restructuring since the start of the millennium. In 2015 the German economy also managed to grow healthily, quarterly growth was in the range of 0.3% to 0.4% qoq.

Over recent months, however, market concerns about the sustainability of the German recovery have emerged. Chinese activity has been moderating and there are concerns that this also dampens activity in the export-oriented German economy. Moreover, there is uncertainty about how far the VW-scandal also exerts negative macroeconomic effects. Another source of doubt is the refugee crisis given that Germany receives a huge share of the refugees.

Germany strongly exposed to Chinese activity

Over the past decade the German economy increasingly directed its trade towards China. In 2006, China ranked ninth among the German export destinations; in 2014 it was already number five. China is more important for Germany than for the other euro area economies as 6.6% of its total exports (intra+extra EU) go to China compared to the euro area average of 3.8%. Moreover, Germany's exports are concentrated on investment-related machinery and equipment goods. Its share in German exports was 48.4% in 2014, for the euro area as a whole the corresponding number was just 41.1%. As a result, German exports to China suffered significantly in 2015. For the first ten months of the year they were down by 4.2%, in the euro area ex Germany they were instead up by 5.1%. Exports to total Asia suffered too but to a lesser degree. This implies that demand from Asia ex China somehow buffers faltering exports to China. German industry orders are highly correlated to the cyclical development in China, albeit with a lag of about six months (see graph). German exports weakened significantly in Q3, to 0.2% qoq from 1.8% qoq before. A stronger-than-anticipated slowdown of China remains a downside risk to activity, to a higher degree to Germany than to the rest of the euro area.

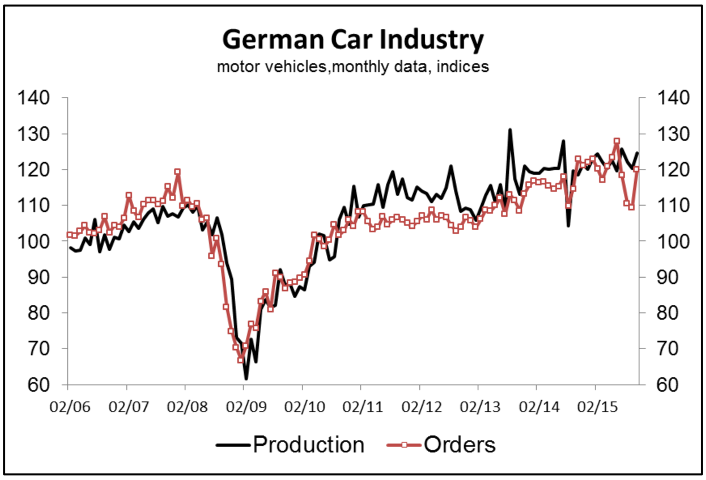


As it stands now the euro depreciation that started in mid-2014 and affects export activity with with a lag cushions weaker export demand and will support export activity also in 2016. Moreover, the rest of Asia does relatively better than China. As of December PMI export orders have recovered and are, with a reading of 53.2, in clearly expansionary territory. Looking further down the road, we do not expect China to fall off a cliff but to moderate in a controlled way (GDP growth down from 6.9% in 2015 to 6.4% in 2016).

Is the VW scandal of macroeconomic relevance?

The German car industry is of high importance for the German economy. According to the association of German car builders (VDA) one out of seven jobs in Germany is directly or indirectly related to the German car industry. Moreover, the car industry has generally been appreciated not only for its products but also a symbol for quality “Made in Germany”. Against this backdrop the VW-scandal that became public on September 18 is of potential relevance.

Orders to the car industry weakened over the last months. They were down by 4.5% yoy in September and 2.4% yoy in October. From the EC survey it becomes clear that faltering export orders played a role. They plummeted in October and November. This might among other things be related to the VW-scandal. However, domestic orders held up well and production expectations as well as confidence in the car industry weakened but clearly remained on a healthy level. This suggests that it might also have to do with the fact that the German car industry weakens relative to its euro area peers. Since 2013 its production expanded less than in the rest of the euro area. It has to be kept in mind that at least so far the scandal has been confined to VW. On the aggregate level, the production of motor vehicles accounts for 3.9% of German gross value added. While this for itself is not very high it ranks highest among the euro area economies and highlights that the car industry is much more important for Germany than for the rest of the euro area. At the moment we see no indication for the VW scandal to significantly affect the German outlook. Only the widening of the scandal towards other German carmakers or even branches could change this assessment.



The refugee crisis – a chance for Germany

The escalation of the refugee crisis lead to a surge of migration towards Europe. Germany has become a preferred destination country. Over 2015 965,000 refugees arrived in Germany. Although the monthly flows moderated as of late, the inflow of refugees is widely expected to continue in 2016. This development is also leaving its mark in the political arena. Some member states have reintroduced border controls. If this development were to continue it could jeopardize the Schengen-agreement with clearly negative political repercussions, especially on the European level but also economic effects, especially for the very much trade-oriented German economy.

From an economic perspective the overall impact is highly uncertain depending on the number of new arrivals, the question whether they will stay permanently or leave again, the qualification of the migrants, the age structure, the ability to integrate them into the labor market and the costs they constitute to the public. In a simulation exercise the European Commission assumes that 50% of the refugees are accepted as asylum seekers and that about ¾ of the accepted applicants are of working age. In this scenario the German population increases by 530,000 persons in 2016 and 255,000 in 2017. The public costs are assumed to be 12,000 € per refugee per year.

Combined effects of increase in spending and labour force for Germany

level difference in % compared to base-line scenario, source: European Commission 2015

	2015	2016	2017	2018	2019	2020
	First scenario: skillset as natives					
GDP	0.16	0.43	0.56	0.67	0.71	0.72
Employment	0.20	0.56	0.77	0.92	0.99	1.00
Real Wages	-0.23	-0.51	-0.61	-0.63	-0.60	-0.56
Gov. Balance (% of GDP)	-0.10	-0.25	-0.22	-0.21	-0.13	-0.05
	Second scenario: low skilled					
GDP	0.12	0.31	0.38	0.46	0.47	0.47
Employment	0.19	0.52	0.72	0.87	0.94	0.96
Real Wages	-0.13	-0.37	-0.55	-0.64	-0.68	-0.69
Gov. Balance (% of GDP)	-0.11	-0.27	-0.27	-0.27	-0.21	-0.15

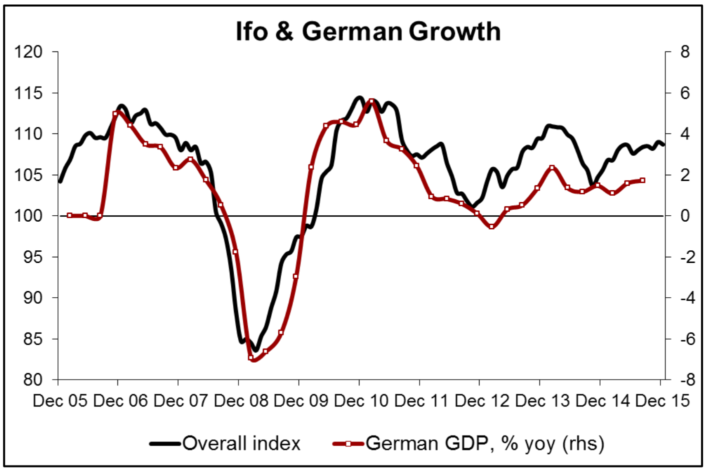
As can be seen from the above table an immediate effect is higher government expenditures for refugees giving rise to some fiscal stimulus in 2016. Growth is enhanced, also due to higher employment but wages tend to be affected negatively. Of course, the better the average qualification of the new arrivals, the more beneficial will the macro effects be.

These simulations are subject to very high uncertainty and in the light of the latest data for instance the refugee numbers for 2016 look too low. However, if the assumptions about qualification and labor market integration are halfway correct the inflow of people into Germany will alleviate the burden of ageing and lift potential growth at least in the medium term.

Solid Growth in 2016

There is no reason to be complacent about Germany. From a longer-term perspective there are also concerns at the horizon as for instance the reform-clock is now turning backwards (e.g. introduction of the minimum wage, weakening of past pension reforms) while infrastructure investment remains below replacement needs. Moreover, the European Commission rightly argues for already quite some time that Germany needs to liberalize its services sector more thoroughly. However these more idiosyncratic factors rather play out in the longer run than over the coming years.

Looking into 2016, uncertainties related to the Chinese economy and the effects of the VW-scandal are clear downside risks while we see the risks related to the refugee inflow more on the upside due to higher fiscal spending. The later view is also due to the fact that large-scale immigration into Germany takes place at a time where the labor market is in very good shape. In 2015, the unemployment rate fell to 4.7% (below an estimated natural rate of 5.0%) and employment likely expanded by 0.7% while wage growth gained momentum. From a broader perspective German activity also looks sound. As of Q3/2015, GDP was 5% above the pre-crisis level, the output gap narrowed significantly and has been closed towards the end of 2015 according to IMF calculations. At the end of the year, key sentiment indicators continue to paint a bright picture of German activity. The Ifo index, the composite PMI for Germany and the Economic Sentiment Indicator are all way above their long-term average suggesting ongoing solid growth. Yearly growth averaged around 1.5% in 2015.



In 2016, we look for the continuation of the good development with consumption remaining a key driver of German activity. Ongoing employment expansion and solid wage growth on the back of a labor market that is showing signs of tightness will keep the compensation of employees per head close to 3% while headline inflation will average only slightly above 1% yoy. Moreover, the latest renewed fall in the oil price will additionally help while financing conditions will stay very favorable thanks to the ECB's monetary policy stance. Hence, household spending will remain strongly supported. Also, the broad based recovery in the other euro area economies as well as the weak euro bode well for exports so that there is some cushion against a soft global environment. In this setting we also look for investment activity to strengthen somehow. As it stands now, German activity seems to be strong enough to weather downside risks. Furthermore, public finances are in a good state. In 2015, Germany likely reported a budget surplus of about 0.5% of GDP while the debt ratio is declining and – unlike to all other countries – below the 2010 peak (of 81.2% for Germany). This also gives the government fiscal leeway in case downside risks to activity materialize. All in all, we remain constructive on German growth for the time being and see growth at 1.7% in 2016.

Imprint

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Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

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