GENERALI INVESTMENTS

Focal Point

Germany: Rock in the wind or blown into recession?

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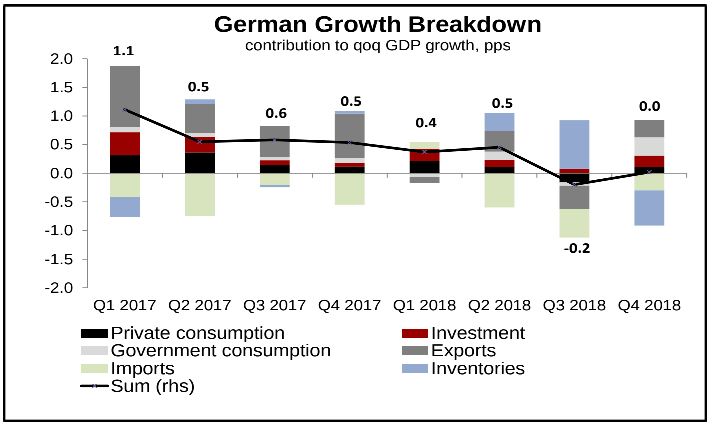
- German economic activity decelerated sharply in H2/2018 and is close to stalling at the outset of 2019.
- One-off effects like temporary car sector weakness can no longer be blamed. Instead, we find that the weakening of global activity plays a major role for the slowing of the very export-oriented German economy.
- Moreover, uncertainty arising from the looming risk of US tariffs in general and on EU cars specifically as well as the risk of a crash Brexit is weighing on sentiment.
- Looking ahead, indicators for domestic activity still look sound. Robust private consumption (thanks to solid wage and employment growth) and a supportive fiscal policy stance amid likely reduced uncertainty will support activity.
- Germany has plenty of leeway to stimulate activity further. However, we think that the situation is not yet serious enough to trigger additional fiscal policy measures.
- We expect no quick rebound of growth but look for improvement in H2. In 2019 we see annual growth at only 0.7 %.

Germany was a powerhouse for euro area activity in the recent recovery. In the 2007 to 2017 decade German annual growth averaged 1.4%, 0.5% pp faster than in the euro area as a whole. In 2018, the tide has turned. Germany's annual growth fell to 1.4%, 0.4pp below the euro area average. What is more, the euro area's largest economy posted a negative growth rate in the third quarter of last year and stalled in Q4/2018.

At the outset of 2019, the news flow surrounding the German economy continued to surprise on the downside, raising concerns that Germany will move from being a pillar of activity in the euro area to a drag. Looking ahead, it is critical to identify the reasons for Germany's economic weakness in order to assess whether a recovery or a further weakening of activity is to be expected.

Accounting for the sharp slowdown in H2/2018

Analyzing the reasons for the German growth slowdown from a national accounting perspective, the combination of weakening domestic demand (with private consumption even shrinking in Q3) as well as well as a strongly negative contribution from net trade pushed growth into negative territory in Q3. The latter was the result of receding exports and buoyant imports. Investment activity stayed sound over the course of the year (with quarterly growth averaging 0.7% qoq 2018). In Q4, exports (0.7% qoq, from -0.9% qoq) and consumption (0.2% qoq, from -0.3% qoq) recovered. However, the strong build-up of inventories that helped growth in Q3 largely unwound so that growth stalled.



German activity likely stalls at the outset of 2019

What actually spurred current concerns is not the past 2018 weakness but the fact that more weakness is on the cards. The decline of key sentiment indices continued. The Ifo, which has been weakening since August 2018, fell to the lowest reading since December 2014 in February with the headline now in line with the historical average. What is more, the expectations component gives an even bleaker outlook. Likewise, the monthly inflow of new manufacturing orders weakened at the end of 2018 and was 7% lower than one year ago, suggesting that the German weakness carries over into 2019. In February, the composite PMI improved but was still 0.3 standard deviations below average. However, taking a closer look at these indicators one observation is striking: Sentiment in the export-oriented manufacturing sector (with February PMI export orders of 42.3 at the lowest level since October 2012) is worse than in the more domestically-oriented service sector, construction or consumer sentiment. It is also worth noting that the EC Economic Sentiment Index (ESI), which is the only business climate index also covering consumers, was still half a standard deviation above normal in January.

That said, based on the data available so far for Q1/2019 – which is mainly sentiment indicators - our models suggest that growth continues to stall.

Special effects no longer to be blamed

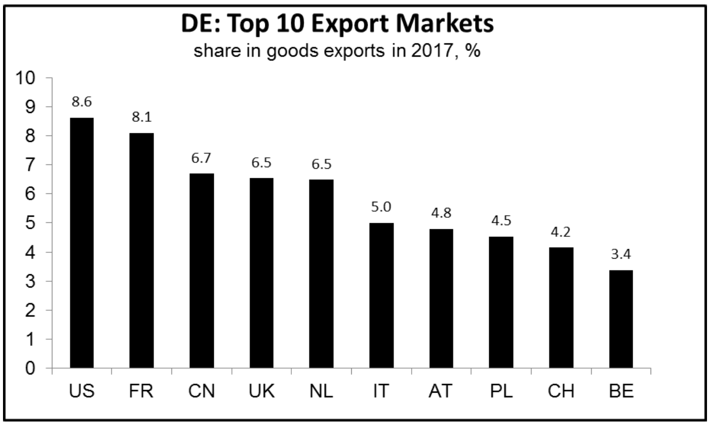
In 2018, various negative one-off effects were identified as reasons for slowing. At the outset of 2018, a strong flu season, strikes and unfavorable weather conditions were blamed. Later in the year low water levels on the River Rhine contributed to transportation bottlenecks and pushed petrol station prices up. In autumn, the introduction of a new, lengthy testing procedure for car emissions led to falling car production and rising inventories. However, in December car production recovered again and is now, by and large, back in line with the development of the whole manufacturing sector. Hence, the car sector can no longer be blamed for the poor industrial production data. Also, at the start of 2019 the Rhine water level normalized again. Another factor that dented real activity in the second half of 2019 was the oil price induced surge in headline inflation to 2.4% yoy in October. With these effects having run their course and given the expectation of broadly stable oil prices, lower inflation rates of around 1.5% yoy will instead be supportive to real income.

Weakness in top export markets

Longer term, German growth can well be explained by means of global growth. In fact, we find that over the past 15 years export activity determined (as measured by Granger causality) the development of GDP. Given the strong export dependence of the German economy this does not come as a surprise. Taking a look at the major German export markets it becomes clear that Germany is very much exposed to the US and China, two economies which we expect to decelerate. We forecast growth in Germany's top 10 (goods) export markets to recede from 2.8% in 2018 to 2.3% in 2019.

In order to take into account also indirect and third country-effects from weaker US and China growth as well as firms' expectations, a look at the responsiveness of German growth to the global growth as measured by the manufacturing PMI is useful. We find that an increase in the global manufacturing PMI by one index point implies an increase in German quarterly growth by about 0.2 pp. Since Q1/2018 this PMI receded by about two index points to 51.8 in Q4/2018 implying a 0.4 pp fall in the GDP growth rate. In January, the global manufacturing PMI receded to 50.7, below the long-term mean of 51.6. However, its level does not stand against an increase of the quarterly growth rates towards 0.2% to 0.3% qoq this quarter and the next when also taking other variables like employment, wage growth and the exchange rate into account.

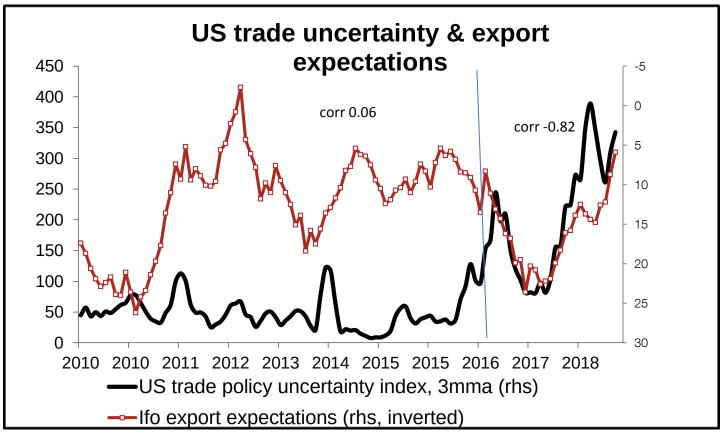
The upshot is that weaker global growth pushed German growth lower but does not explain the poor H2/2018 GDP readings and would also be consistent with still stronger sentiment indicators at the outset of 2019.



Uncertainty bites

When thinking further about the sources of German weakness the elephant in the room is uncertainty emanating from the threat of a trade war and the looming Brexit. But even with an escalation of US-Chinese dispute ebbing – as we expect – trade risks would remain. There is mounting indication that the US will start targeting tariffs on EU cars. As we have worked out before, a 20% tariff on imported cars would dent German GDP by 0.4% in the long term. Recently, a confidential report to the US President reportedly identified security risks from car imports giving him 90 days to decide whether to impose tariffs or not. Generally, the rise in US trade-related uncertainty that coincided with the election of Trump as US President (averaging a level of 216 since then, compared to 50 in the 2010 to 11/2016 range) also went along with faltering export expectations (see graph overleaf) and also turned out to be of statistical significance.

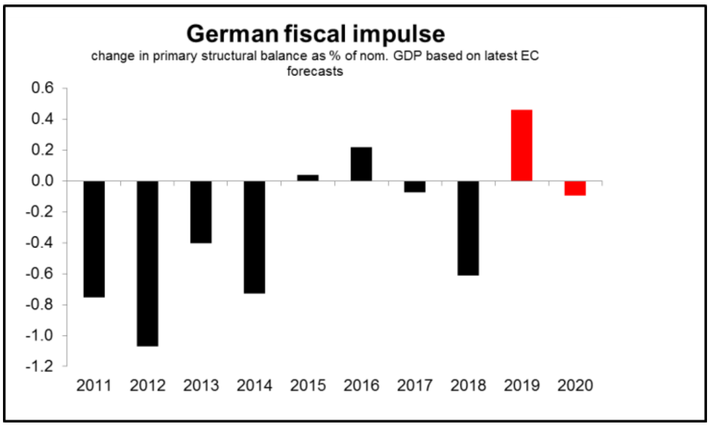
According to our assessment this uncertainty reduced quarterly growth by 0.2 pp. This number might be biased to the upside given that the Brexit referendum took place in June 2016 and as of late uncertainty on trade as well as on the Brexit rose significantly. If trade barriers to Germany's fourth biggest export market were suddenly implemented in a no-deal Brexit, trade would not only be hampered but new value chains would have to be built and with the UK falling into a recession Germany could also follow. We still look for a more benign Brexit, but against this backdrop it becomes clear why uncertainty bites so much in the current situation.



Resilient domestic economy

That said, the labor market is a big cushion for the German economy. The unemployment rate has been at just 3.3% since September 2018, a record low and even below the equilibrium (NAWRU) level of 3.5%. What is more, albeit employment growth has been moderating, it continued throughout the last year (2018: 1.3% yoy). This is set to last also in 2019 as the employment component of the composite PMI was still at 54.0 in January. Furthermore, annual wage growth has gained traction in 2018 (to 2.8% yoy, from 2.1%). We expect disposable income growth to maintain its 2018 rate of 3.5% yoy. Consumer confidence has been suffering but currently is still half a standard deviation above normal. While consumers' economic outlook has deteriorated, expectations about their own financial situation have stabilized at elevated levels. In sum, we expect robust German consumption in 2019 providing a cushion to activity.

Moreover, with German capacity utilization 0.6 standard deviations above average in Q1/2019, January production expectations still 0.3 standard deviations above normal and ongoing favorable financing conditions, we continue to see the way paved for solid investment growth. We assess the supportive effects from consumption currently stronger than the dampening effects from the external sector.



Lastly, fiscal policy turned slightly supportive in 2019 following a tightening in the year before (see chart). Moreover, in Germany there still is plenty of leeway for further fiscal policy expansion. We doubt that the German economy is yet at this point and the usual decision lag could be significant. That said, in case some downside risk materializes (e.g. crash Brexit) we would expect fiscal policy measures to be announced. The Minister of Finance said that he stands ready to launch a € 35 bn (or 1.0% of 2018 nominal GDP) package that reportedly consists of income tax cuts and improved and depreciation rules, if needed.

Conclusions

Bottom line, as it stands now we deem domestic activity strong enough to keep the economy on a positive growth trajectory. While German key export market growth will likely be lower than last year's, we expect a gradual recovery from a still weak Q1. Furthermore, while we are aware of the uncertainties and risks surrounding Brexit negotiations, we ultimately look for an orderly exit of the UK from the EU. Given the currently stuck Brexit situation an extension of the exit date into July looks likely thereby extending the period of uncertainty further. The threat of car tariffs will also stay at elevated levels given that the US President has 90 days time (starting on February 17) to decide, whether to impose tariffs or not. Although we expect that this threat will primarily be used to get concessions in other areas like agriculture, uncertainty will stay over the coming months. In the nearer term we only expect the risk of an escalating US-Chinese trade conflict to come down.

In terms of numbers, we expect quarterly growth to stay muted and to recover from the flat Q4/2018 reading into the 0.3% to 0.4% qoq region in the second half of the year. Due to the weak start in to the year, we expect annual growth to average a meagre 0.7% in 2019, thereby halving the growth rate of last year.

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Imprint

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