27 January 2019

Research Germany

The epicentre of the euro area slowdown

- **The German economy had a tough start to the year, but we still expect activity to rebound in Q2 as consumers feel the boost to disposable income.**
- **A German growth slump is not a sufficient condition to rule out an ECB hike in 2019, but it increases the risk of a later move.**
- **A new fiscal stimulus programme to prop up growth will be politically contentious.**

Germany has seen a protracted slowdown in economic activity since Q3 18, leaving annual GDP growth at 1.5% in 2018, the lowest rate since 2015. Apart from Italy, Germany has become the epicentre of the euro area growth slowdown, leading analysts and forecasting institutes to slash their forecasts: The IMF in its new forecasts expects 2019 GDP growth only to average 1.3%, slightly below our own estimate of 1.4%, while the German government will *reportedly* (Handelsblatt, 24 January) lower its forecast even to 1% next week.

Part of the explanation of the revisions for economic activity in 2019 also derives from the fact that the expected growth rebound in Q4 18 did not materialise. Brexit uncertainties were added to the long list of companies' worries. Bottlenecks in the car sector showed no sign of easing up with industrial production contracting by 4.6% y/y in November, and low water levels in the Rhine river additionally hampered activity. The German economy might have avoided a technical recession (two consecutive quarters of negative growth), but recent leading indicators still paint a gloomy picture, especially in the manufacturing sector.

Is Europe's growth engine heading for a recession?

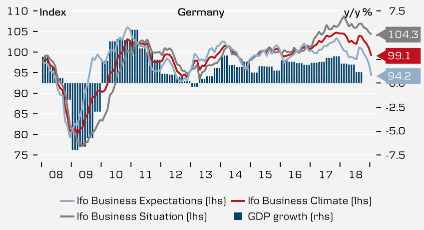
Global trade uncertainties have clearly taken their toll on German exports in 2018 and it has probably been one of the hardest hit economies in terms of the collateral damage from the US-China trade war and China slowdown. However, we still look for a US-China trade deal in H1 19 to drive the rebound in Chinese activity from Q2, which should also have positive repercussions for the German export sector.

Weak activity in the car sector will likely remain a headwind in the coming months. Many producers are still struggling to secure certification for new car models after new emission test standards came into effect on 1 September 2018 and weaker car production/sales are likely to remain a headwind during the course of H1 19.

Despite the many challenges for the German export sector, we still expect domestic demand to pick-up during 2019. Many income-boosting fiscal measures such as lower social security contributions and increased child benefits took effect in January 2019 and we expect to see some positive impact on private consumption, not least in light of the continued strong labour market situation and accelerating real wage growth. Furthermore, in the latest Commission investment survey, German firms again indicated a strong willingness to step up investment in 2019 by 10% y/y.

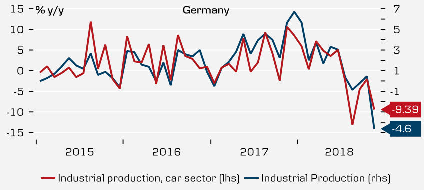
All in all, the German economy had a tough start to the year, but we still expect activity to rebound in Q2 as exports to China recover some ground, car sector bottlenecks slowly abate and consumers increasingly feel the boost to disposable income from higher real wages and fiscal measures.

A weak start to 2019



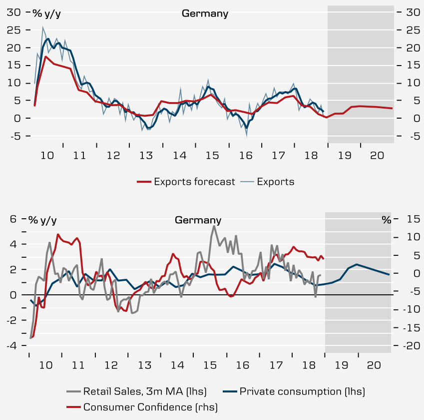
Source: Ifo, Macrobond Financial, Danske Bank

Car sector weakness remains a worry



Source: Destatis, Macrobond Financial, Danske Bank

Consumer spending to increase



Source: EC, Macrobond Financial, Danske Bank

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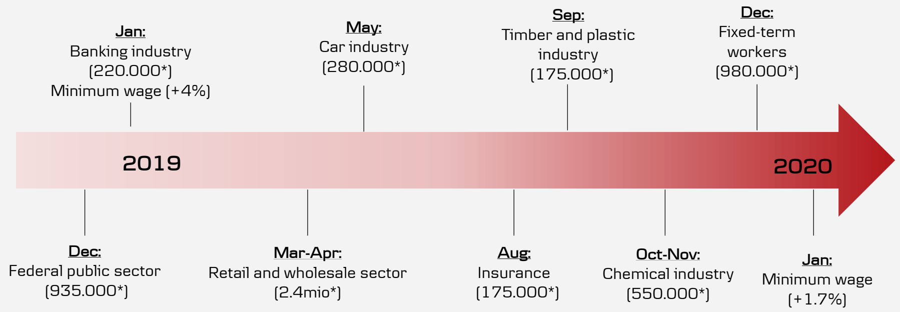
Will Germany's growth slowdown delay the ECB's first rate hike?

Should German growth in 2019 slump to 1% or below (significantly below our expectations), it will be difficult to see euro area growth staying around potential (which is important from a monetary policy perspective). Although a German growth collapse is bad news for the ECB, the key question will be what it implies for the expected wage-driven increase in core inflation. Usually, wage and inflation developments lag the economic cycle, so the ECB might well find itself confronted with a situation of rising underlying inflation pressures and a weakening economy.

Nominal wage growth in Germany is still expected to rise even further to 3.2% this year, helped by an increase in the minimum wage by 4% and further strong wage increases in many bargaining rounds coming up during the year. From the micro level there are already increasing reports that the tipping point of margin compression is close to being reached with many firms getting ready to pass higher wage costs on to consumers (see also *Euro Area Research: Is the Phillips curve finally coming alive in 2019?*, 18 December 2018). On the other hand, there is clearly also a risk that the growth slowdown could make producers more reluctant to pass on input costs to avoid losing market share.

All in all, we do not a think a German growth slowdown is a sufficient condition to rule out an ECB hike in late-2019, but it increases the risk that the translation from rising wages to core inflation will take longer and be more muted, with the balance of risks in this case increasingly shifting to a later rate hike.

Many wage bargaining rounds coming up again in 2019



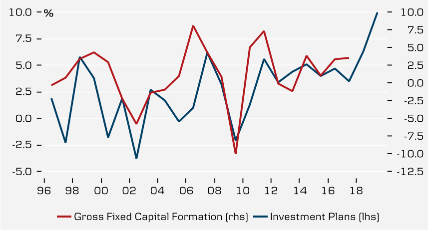
Source: WSI, Danske Bank **Workers affected*

Will the government launch another 'Konjunkturpaket III'?

During the global financial crisis the German government launched two 'Konjunkturpakete' (fiscal stimulus packages) totalling some EUR73bn. Although the packages helped to cushion the economic downturn, they also left sizable holes in state coffers, leading the debt to GDP ratio to jump to 81% by 2010. **In light of this we expect the threshold for a similar fiscal stimulus programme to be high, but should the German economy falter significantly to growth rates of 1% or below, we would be surprised to see politicians just sitting on their hands.**

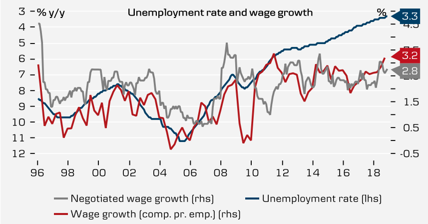
As part of the 2009 Konjunkurpaket II the government launched an incentive scheme for consumers to scrap old cars and buy new ones ('Abwrackprämie'), which proved very popular. Something similar could be introduced again to support the domestic car industry. Furthermore, new CDU leader Annegret Kramp-Karrenbauer has in a *recent interview* (Handelsblatt, 23 January 2018) already advocated corporate tax cuts to prevent growth cooling too much. Political discussions currently centre on scrapping the 'Solidaritätszuschlag' (solidarity surcharge – an additional fee on income tax, capital gains tax and corporate tax). This is already planned to be phased out for 90% of tax payers but only starting 2021, due to it being a very expensive measure, costing the state some EUR17bn in lost revenues per year. But the path to corporate tax cuts specifically will not

German firms plan to step up investment spending in 2019



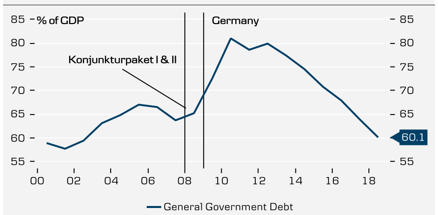
Source: EC, Macrobond Financial, Danske Bank

Strong wage growth ahead



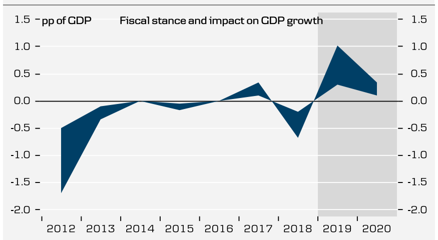
Source: Bundesbank, Macrobond Financial, Danske Bank

Fiscal stimulus packages had sizable impact on government finances



Source: Macrobond Financial, Danske Bank

Fiscal headwinds turning into a tailwind

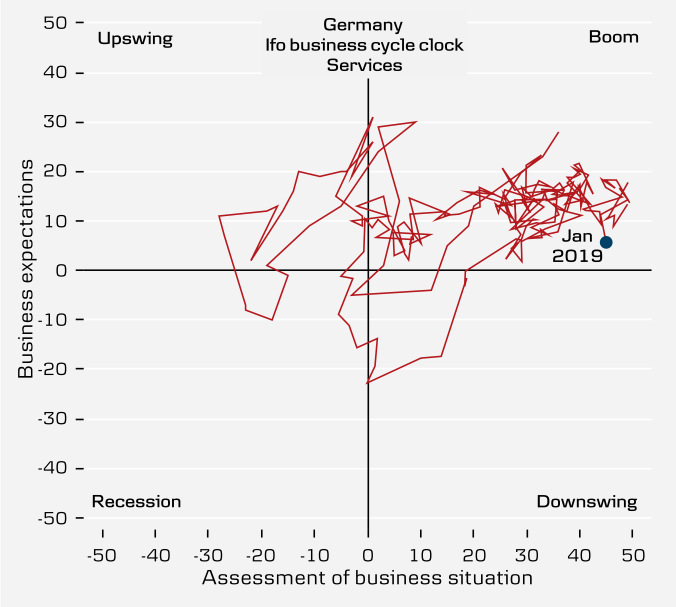


Estimated by using the change in the cyclically adjusted primary balance
Source: Gemeinschaftsdiagnose 2018, Danske Bank

be a smooth one with the SPD resisting any measures it sees as mainly benefiting high-earners. **Hence, getting such a tax cut plan through parliament might not be without difficulties in light of the already fractious state of the CDU/SPD grand coalition.**

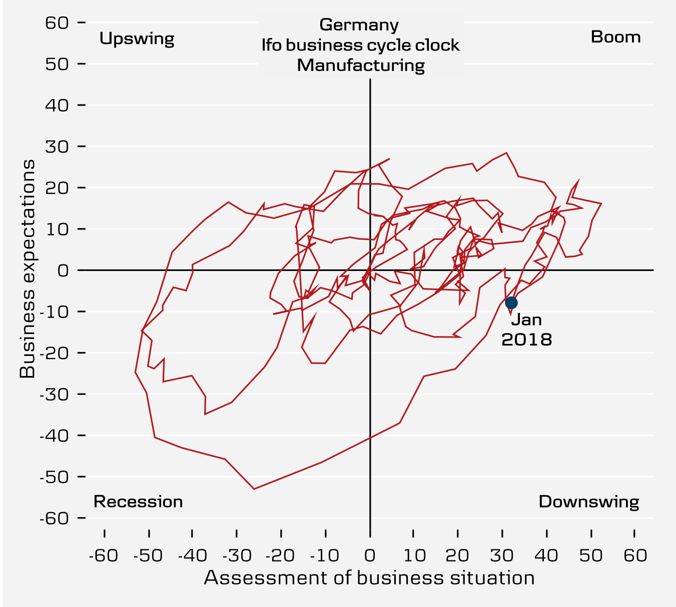
Ifo business cycle clocks (by sector)

Service sector still in boom quadrant...



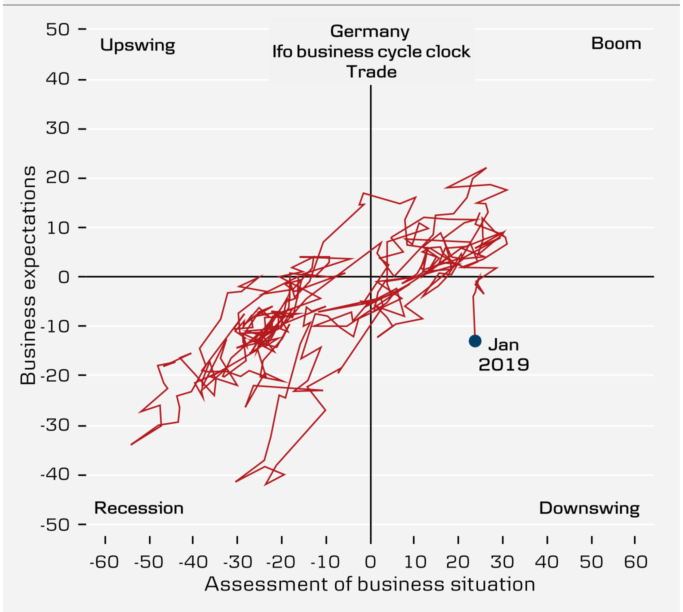
Source: Ifo, Macrobond Financial, Danske Bank

...while manufacturing sector has entered slowdown territory



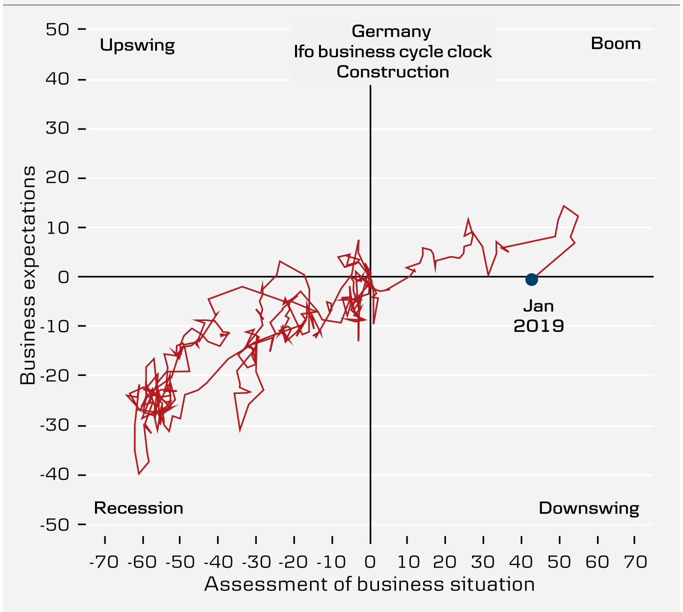
Source: Ifo, Macrobond Financial, Danske Bank

Trade sector has been hit by global and domestic headwinds



Source: Ifo, Macrobond Financial, Danske Bank

Construction sector is wringing with capacity constraints



Source: Ifo, Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Aila Mihr, Analyst, and Piet P. H. Christiansen, Senior Analyst.

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Date of first publication

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