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GERMAN GDP: SOLID TREND, TECHNICAL RECESSION AVERTED FOR NOW

Berenberg Macro Flash

Amid all the news about a serious cyclical downturn, do not forget the underlying fundamentals. With a 1.3% rise in employment and a record fiscal surplus of 1.7% of GDP in 2018, Germany continues to enjoy its golden decade which started in 2010. For the time being, the trend remains solid. With a rising participation rate and the successful integration of – mostly European – immigrants, Germany continues to cope well with its demographic challenges. The "Agenda 2010" and other reforms of around 2004 are still paying off nicely.

The good times will not last forever. Amid series of small-scale reform reversals and a propensity to raise entitlements instead of focussing on new pro-growth reforms, Germany looks set to gradually lose its edge as one of the world's top-performing advanced economies in the next decade. But this is a slow erosion of Germany's position. For now, Germany's fundamentals remain solid enough to allow its highly cyclical economy to bounce back nicely from the current downturn if and when the mostly external shocks and risks such as trade wars, the Chinese correction and the hard Brexit risk fade. We expect that to happen from spring 2019 onwards after a grey winter.

German real GDP expanded by 1.5% in 2018, the same rate as in 2015 in calendar-adjusted terms. As real imports (+3.4%) rose faster than price-adjusted exports (+2.4%), net exports subtracted 0.2ppt from growth. The turnaround on the external side after a 0.3ppt net export contribution to growth in 2017 explains half of the slowdown in calendar-adjusted real GDP growth from 2.5% in 2017 to 1.5% in 2018.

All components of domestic demand supported growth in 2018, with machinery investment (+4.5%) outpacing the gains in construction (+3%), public consumption (+1.1%) and private consumption (+1.0%). Inventory building added 0.4ppt to aggregate demand. While this may suggest a need for an inventory correction in 2019 after a potentially involuntary build-up in inventories in 2H 2018, the inventory data need to be taken with a large pinch of salt as they are largely the residual of the GDP calculus and subject to heavy revisions.

Relative to elevated expectations at the start of last year, the result for 2018 is disappointing. A series of shocks (trade tensions as of late February 2018, the crisis in some emerging markets, a temporary spike in oil prices and – in late 2018 – the serious slowdown in China and the hard Brexit risk) all weighed on confidence and demand. For example, Germany's exports to the Brexit-stricken UK fell by 3.6% in the first eleven months of 2018. In addition, some short-term factors such as the belated adjustment of car manufacturers to new emission testing standards and low water levels on the Rhine that impeded the transport and production of chemicals during the autumn took their toll on GDP in the second half of 2018.

According to Germany's statistical office Destatis, Germany narrowly avoided a technical recession with a slight quarterly gain in Q4 2018 GDP after a 0.2% qoq contraction in Q3. Destatis will publish a first set of Q4 GDP data on 14 February. The data could be in line with our forecast of a 0.14% qoq rebound in German Q4 GDP.

For the next few months, we have to brace ourselves for a very grey winter. Although some snap-back in car and chemicals output should boost Q1 GDP a little, the underlying tone in German and Eurozone data will likely be very soft. The risks to our below-consensus forecast of 1.2% German – and Eurozone – GDP growth for 2019 are heavily tilted to the downside. For example, after a 10% yoy rise in German exports to China in the first 11 months of 2018, we will likely see a sharp correction in upcoming data as the rush to trade now in order to beat potential new tariffs seems to be over.

The best fiscal news is over: In the last few years, an surge in tax revenues has outstepped the gradual increase in German public spending. This will likely be over soon. While Germany once again administers a small fiscal stimulus of roughly 0.2% of GDP in 2019, the current cyclical downturn will dent tax revenue growth. As a result, we look for Germany's fiscal surplus to fall from 1.7% of GDP in 2018 to 1.2% this year. Unfortunately, there seems to be little political appetite for a major tax cut, which Germany could still afford easily. For example, the centre-left SPD is likely to thwart CDU/CSU attempts to fully abolish the "solidarity surcharge" to the income tax. At the same time, the lack of qualified labour and long planning processes make it difficult to step up the pace of public investment spending significantly.

For the two sides of the current German story, an industrial recession coupled with solid trends in employment and real incomes, see also Growth or recession? Two sides of the German story

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