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PARTNERSHIP SINCE 1590

MACRO NEWS 27/08/19

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GERMANY: RECESSION RISKS AND STIMULUS HOPES

Berenberg Macro Flash

Has Germany already fallen into recession? In technical terms, the probability is close to 50%. GDP contracted by 0.07% qoq in Q2. Whereas we project stagnation for Q3, the risk that GDP will decline slightly further in Q3 is high. Two consecutive quarters of falling GDP would count as a technical recession. Data for Q3 GDP are due in mid-November.

Abstracting from the short-term volatility of quarterly data, the situation is still slightly different. The Q1 gain in German GDP by 0.38% qoq was inflated by special factors such as a mild winter that boosted construction and a late Easter that postponed factory holidays from March to April. The unwinding of these special factors subtracted almost 0.2 percentage points from Germany's qoq rate of GDP growth in Q2. If we take the first two quarters of 2019 together (and subtract a little from Q1 as it benefitted slightly from one-off effects after a bad Q4 2018), we find that Germany's average quarterly rate of GDP growth was just below 0.15% qoq in the first half of the year. No recession yet. The renewed escalation of the US-Chinese trade war, the Brexit turmoil, declining survey and sentiment indicators and the ongoing drop in manufacturing orders (-6.9% yoy excluding bulk orders in Q2) point to a weaker result for 2H 2019. Abstracting from potential short-term distortions, we thus expect stagnation in quarterly GDP in Q3 and Q4 2019, with an almost 50% risk of a mild contraction instead.

With a 23.5% share of industry (excluding construction) in GDP and a heavy focus on the production and export of highly cyclical goods such as cars, machine tools and base chemicals, Germany depends more on the global business cycle than all other major advanced economies. This shapes the outlook: bad news on trade or Brexit would probably push Germany into a genuine mild recession. In the same vein, Germany would be among the prime beneficiaries from reduced supply-chain uncertainty and a rebound in business investment across the globe if the US and China could defuse their conflict. For our base case, we assume that trade tensions will not be resolved before spring 2020 but will not escalate dramatically either. If so, the global and German manufacturing downturn will likely deepen for the remainder of the year. As companies gradually get used to the heightened level of tensions, confidence and activity could bottom out in early 2020 and recover slowly thereafter. If and when the US and China strike a pre-election trade deal some time next year, the recovery could gain momentum, propelling German GDP growth back to at least its trend rate of 1.5%.

THE STIMULUS QUESTION

Right after Trump and Brexit, the key issue clients are raising at the moment is that of a German fiscal stimulus. The answer has three facets:

1) **The stimulus is there already.** German public investment rose 10.6% in 1H in nominal terms. In addition, the 1.8% yoy gain in real public consumption was the major contributor to the 0.4% yoy increase in real GDP in Q2. After a fiscal expansion of 0.3%-0.4% of GDP

this year, we expect further expansions of 0.4%-0.5% of GDP in 2020 as well as 2021. This includes a pre-scheduled income tax cut of 0.3% of GDP in 2021 (partial abolition of the solidarity surcharge to the income tax). By 2021, the fiscal stance as measured by the structural balance will be about 1.2 percentage points of GDP looser than it was in 2018.

2) **The fiscal expansion has little to do with the current recession risk**. With its slow-motion stimulus, Germany is trying to spend its structural surplus caused largely by a boom in employment in sort-of useful ways. Long planning and court procedures and a lack of skilled construction worker rather than a lack of money set the pace at which public investment can go up.
3) **The direct response to the recession risk will remain modest.** Beyond letting the automatics stabilisers in the tax and benefits system do their job, we look for a number of small-scale initiatives. These could include more generous terms to keep underemployed workers on the job as well as incentives for a faster conversion to cleaner energy and a few similar spending initiatives.

The fiscal expansion and the overall resilience of domestic demand show up clearly in the national accounts. Backed by rising employment and faster wage growth, net incomes from wages and salaries rose 4.8% yoy in 1H 2019. Although employment growth is now slowing down significantly as the manufacturing downturn gradually spreads to those services that are closely tied to manufacturing, hourly wages will likely continue to rise at rates close to 3%. The domestic resilience shows up clearly in the external accounts: with a 2.4% yoy rise in real imports that is outpacing the 0.05% yoy change in exports, Germany is now contributing nicely to a global rebalancing.

Tongue in cheek: If the German government wanted to be too clever by half, it might want to call two press conferences: The first one in English to explain to the world that its ongoing fiscal expansion adds up to a sizeable chunk of money, probably around €70bn if we add up the stimuli we expect for 2019 through 2021. The second press conference would be in German to explain to a debt-conscious domestic audience that fiscal policy will largely stay the course that was set before, with some well-targeted initiatives to soften the impact of a potential recession.

For three reasons, political support for a major fiscal stimulus tends to be much weaker in Germany than in the US or the UK.

1) A recession typically hits the labour market in Germany much less than in many other countries. Amid a pronounced shortage of skilled workers, modest government subsidies to keep underemployed workers on the job with reduced hours prevent large-scale dismissals.
2) The average German rents his house or flat instead of owning it. She has probably never heard of the "negative equity" scare that often turns a recession into a major problem for home owners in the US or the UK.
3) In a similar vein, the income Germans expect to receive as pensioners depends largely on the state of the labour market and public finances in Germany's pay-as-you-go pension system, not on the value of equities tied up in a major pension pot. Concerns about potential drops in asset prices in a recession are thus far less widespread in Germany than in many other countries.

As a result, consumption growth is more stable throughout the business cycle in Germany than it is in the US or the UK. German private consumption did not fall even in the mega-recession year of 2009. Being less affected by a recession, German consumers and voters thus see less need for their government to go for a big stimulus in order to soften a recession if and when it happens.

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