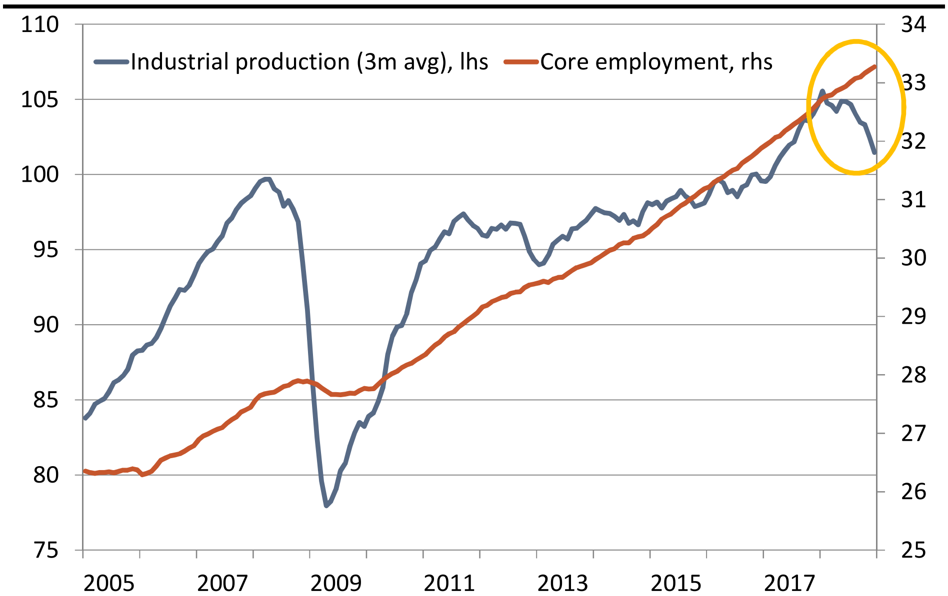
How weak is the German economy?

- **Not yet at the bottom:** Reeling from a series of external shocks, Germany's export-orientated economy fell into stagnation in H2 2018. Leading indicators project more weakness ahead. Further external shocks could even cause a recession.
- **Special factors:** A botched transition to new emission testing standards for cars and the Rhine's low water levels depressed output in the car and chemicals sector in H2 2018. Otherwise, German GDP would have been 0.5% higher in Q4 2018.
- **Looking for the circuit breakers:** The downturn has spread beyond exports. As businesses scale back their expectations for the future, investment growth will slow in early 2019. Households already reacted to rising uncertainty by raising their savings rate in H2 2018. It will take some easing of trade tensions, better news out of China and an end of the hard Brexit risk to end the downturn. We expect these three conditions to be met at some time this spring. Until then, German data can continue to disappoint. Our growth forecasts for 2019 remain well below consensus.
- **A split economy:** Germany's GDP fluctuates more with the ups and downs of global trade than that of other countries. However, the focus on the short-term cycle obscures the fundamental strengths of the German economy. Due to its solid and stable labour market and low levels of household and government debt, Germany's domestic economy is largely shielded from such global gyrations (see Chart 1).
- **Hidden strengths:** Although German politics have become complacent, the supply side remains in good shape. Faced with a dearth of qualified labour, companies are eager to hold on to their workers and to hire more of them even during a temporary downturn of demand. Employment and real disposable incomes continue to rise at a decent clip. Responding to a shortage of housing and fuelled by rising government investment at ultra-low financing costs, construction remains on a solid uptrend.
- **Ready for a rebound:** If and when the global uncertainties fade, German industry will benefit strongly from any revival of global trade. In addition, German households and companies have the means to step up their spending again significantly once they feel confident enough to do so. German growth could return to a pace around the 1.5% trend by spring or summer.

Chart 1: The split economy: German industrial output versus core employment



Three-month moving average for industrial output index excluding construction, monthly data for December 2018; core employment not subject to payroll taxes, in million, on right-hand scale. Sources: Destatis, Bundesbank

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Special factors reduce GDP by almost 0.5%

Bad luck: blame car companies and the weather

Two special factors depressed German industrial output in the second half of 2018.

- German car companies botched the transition to the World Light Vehicle Testing (WLTP) standards for fuel consumption and emissions last summer. As a result, they could not produce and sell some of their models for a while. Production, sales and exports of cars slumped. Output in the car sector declined 8% qoq in Q3. After a minor rebound in December, output in this sector in Q4 still fell 6.8% short of its Q2 2018 level. Cars and car parts account for 17.8% of German industrial output (excluding construction). In turn, this sector contributes 27% to overall gross value added in the German economy.
- The Rhine's low water levels impeded the transport of bulk chemicals last autumn. The production of the chemicals and pharmaceuticals sector plunged by 10% qoq in Q4, leaving output in Q4 some 9.4% below the Q2 2018 level. Chemicals and pharmaceuticals contribute 10.4% to German industrial output (excluding construction).

Excluding special factors, output declined by 1%

Outside these two sectors, industrial output declined by merely 1% from Q2 to Q4 despite a clear worsening of the monthly data for December (see Chart 2). To gauge the impact of these two special factors, we assume that car and chemicals production would have moved in line with the overall moderate downtrend in industrial output from Q2 to Q4 2018 instead of falling much more sharply. If so, German gross value added would have been almost 0.5% higher in Q4 than it actually was.

A hit to GDP of almost 0.5%

We can take this as a rough estimate of the extent to which these two special factors depressed German GDP late last year. Instead of declining by a cumulative 0.18% from Q2 to Q4 2018, German GDP would hypothetically have increased by 0.25% during this period without the special factors weighing temporarily on the car and chemicals sectors. Even correcting for these specific issues, we would still have to conclude that underlying German GDP growth slowed sharply from 2.5% in 2017 and an average quarterly annualised increase of 1.7% in H1 2018 to an average quarterly annualised gain of just 0.5% in H2 2018.

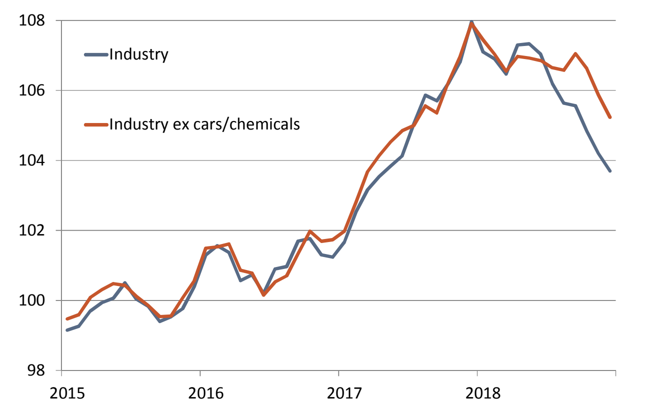
Special factors are temporary

We expect these special factors to fade in early 2019. The Rhine's water levels are back to normal. Helped by a big bounce in December, orders for German motor vehicles surged 9.8% qoq in Q4 (Chart 3). As ever more models comply with the new standards, customers place more orders for cars again. Of course, the strong December bounce in orders may be followed by a renewed correction in early 2019. Abstracting from the emission testing problems, the overall trend in the car sector remains weak.

Still on a downward trajectory

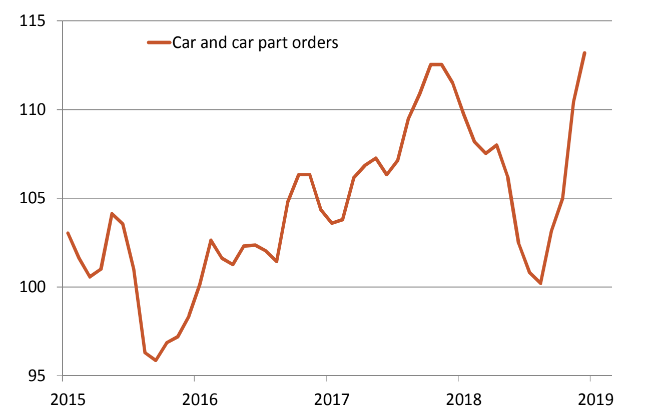
Although the underlying trend in industrial output remains negative, some rebound in output in the chemicals and car sectors will likely prevent a worsening slump in overall German industrial output in Q1 2019. Otherwise, we would have to project economic stagnation or even a slight decline in Q1 GDP instead of the small 0.15% qoq gain which we currently expect.

Chart 2: Special factors: output with and without cars/chemicals



Index levels, three-month moving average, last value is two-month average for November/December 2018. Source: Bundesbank

Chart 3: Car sector rollercoaster – orders for cars and car parts



Index levels, three-month moving average, last value is two-month average for November/December 2018. Source: Bundesbank

Near-term outlook: a grey winter with downside risks

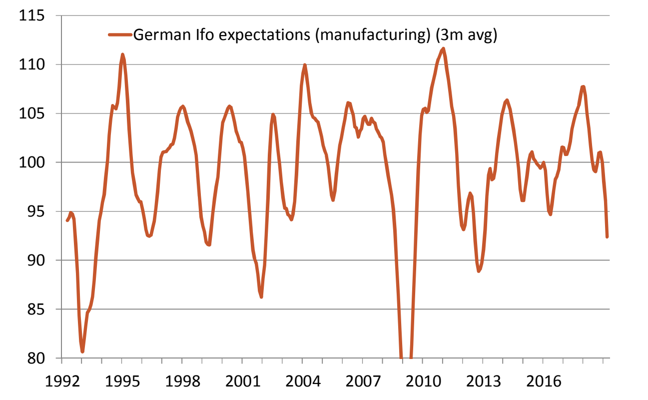
Manufacturing has not hit bottom yet

The German manufacturing sector has not hit bottom yet. In January and February 2019, German industry became even more pessimistic about the outlook for the next six months, as depicted in the Ifo survey (see Chart 4). As Chart 5 shows, the 10% yoy decline in orders for intermediate goods in late 2018 is in line with the decline typically seen at the start of a recession (ie in 1993, 2002, and 2008) or at least a pronounced soft patch (1996, 1999, 2012). In Markit's flash estimate for February 2019, the purchasing managers' index for German manufacturing hit a 74-month low of 47.6, well below the neutral level of 50. According to Markit, order books in German manufacturing suffered the steepest fall in 6.5 years largely due to weak export orders: "businesses continued to report lower orders from the autos sector, whilst also highlighting a fall in demand from Asia (in particular China) linked to ongoing trade tensions and growing competitive pressures within Europe".

Three conditions need to be met to end the downturn

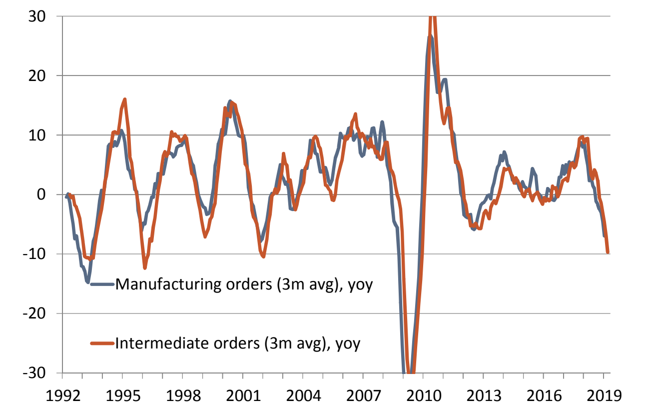
In our view, it will take some easing of trade tensions, better news out of China and an end to the hard Brexit risk to stop the downturn. We expect these three conditions to be met at some time this spring. Until then, German data can continue to disappoint. Our forecasts for 2019 German GDP growth of just 0.8% is well below the Bloomberg consensus of 1.2%. Risks to our call are tilted to the downside. If US-EU trade tensions escalate for a few more months and/or if the Brexit decision is postponed in a way that keeps the hard Brexit risk on the table and thus prolongs the period of grave uncertainty, Germany's manufacturing sector could continue to soften in Q2 instead of stabilising this spring, as we expect.

Chart 4: Close to recession levels: Ifo expectations



Three-month moving average, monthly data for February 2019. Source: Ifo

Chart 5: Manufacturing orders and orders of intermediate goods



Yoy change in %, three-month moving average, monthly data for December 2018. Source: Bundesbank

Export outlook: still some pain ahead

German GDP fluctuates with the global cycle

More than any other major country in the world, Germany specialises on the production and export of highly cyclical goods, notably top-notch cars and machines as well as chemicals. As a result, its industry and GDP fluctuate heavily with the global business cycle. Exports of goods and services accounted for 47.1% of German GDP in 2017, with exports of goods (38.7% of GDP) playing a much bigger role than services. Top export destinations for German goods are the other countries of the Eurozone (37.0% of total German goods exports), followed by the US (8.6%), China including Hong Kong (7.5%) and the UK (6.2%).

Confidence effects beyond the direct hit to exports

Germany's focus on exports (and imports) matters for the short-term business cycle in two major ways. First, any global trade issue affects German exports directly. Second, as German businesses and households know that almost half the country's output is sold abroad, they react more strongly to news from abroad than their counterparts in less globalised economies. In Germany, worries about, say, Donald Trump's trade wars or a Chinese slowdown thus tend to weigh on the propensity of businesses to invest and of households to spend more than elsewhere.

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Up and down: impact of net exports on growth

In 2017, net exports had contributed 0.3ppt to Germany's GDP growth of 2.5%. As export growth (including services) slowed from 5.3% in real terms in 2017 to just 2.2% in 2018 while import growth held up better (3.4% after 5.3%), net exports subtracted 0.4ppt from German GDP last year.

Exports: a bad finish to 2018

Charts 6 and 7 depicting the yoy changes in German goods exports show some of the key movers. After holding up well throughout most of 2018, exports to the US and China plunged in December 2018. Some of the temporary spike in exports to China in September and October probably resulted from the rush of companies to stock up on inventories ahead of a potential round of new punitive tariffs between the US and China. While the same factor may also have played a role in US-German trade in mid-2018, the overall loss of momentum of exports to the US probably reflects partly the gradual fading of the 2018 fiscal stimulus.

Brexit hurts

Charts 6 and 7 also bring out two specific issues: as **Turkey** descended into crisis, German exports to Turkey slumped by almost 30% yoy in the period September to November. The loss in exports equates to 0.2% of German Q4 2018 GDP. More importantly, German exports to the **UK** have contracted on trend ever since the UK voted in June 2016 to leave the European Union. Had German exports to the UK developed in line with deliveries of goods to the Eurozone (up 4.5%) instead of declining by 4%, the additional exports would have been worth 0.22% of German GDP.

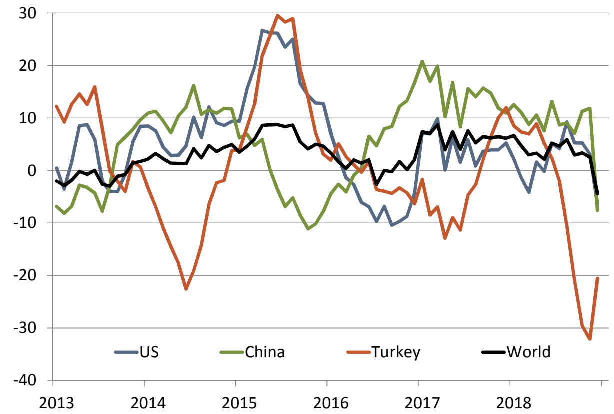
Estimating the hit to GDP

Of course, a look at export values does not suffice to gauge the potential impact of export losses on German GDP. First, exports incorporate imports. Close to 30% of the value added in German exports has been imported. This reduces the impact of any shortfall in exports on the value added and GDP generated in Germany. Hence, the impact of the Turkish crisis on German GDP in late 2018 was probably close to -0.15% rather than -0.2%. Second, the export data miss the potential confidence effects. Whereas confidence issues are negligible for small trading partners such as Turkey, they matter significantly for key trading partners that tend to be in the spotlight. As a result, the drag from the UK's Brexit mess on German GDP in 2018 probably exceeds the -0.2% which the comparison of potential and actual German exports would suggest.

China matters

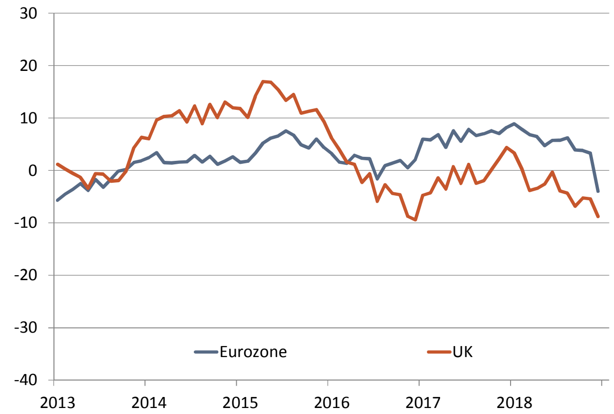
German exports to China (including Hong Kong) may well fall by 4% in 2019, in line with the decline in 2015. Relative to a baseline of flat exports, this would shave 0.1ppt off German GDP growth this year. Goods exports to China equal 2.9% of German GDP. However, China is big enough to matter significantly for overall business confidence. Through its repercussions on the propensity of German companies to invest at home as well as through the impact of China on Germany's other trading partners, the potential damage of a prolonged economic crisis in China could easily be 3-4 times as big as the mere look at the potential loss in exports to China would suggest. A hit to domestic consumer confidence and spending could add to that.

Chart 6: German goods exports to US, China and Turkey…



Yoy change in %, three-month moving average, last value is monthly data for December 2018. Source: Destatis

Chart 7: … and to Eurozone and UK



Yoy change in %, three-month moving average, last value is monthly data for December 2018. Source: Destatis

Hidden strengths at home

Short-term cycle is no gauge of the underlying strength

To discuss the strength and weakness of the German economy, we need to distinguish clearly between a temporary export-driven downturn in industry and the underlying fundamental state of the economy. We also need to assess how much Germany's domestic economy is shielded from temporary outside shocks that hit its export-orientated industry.

German fundamentals still in good shape

In fundamental terms, Germany remains one of the top places in the Western world to invest and create jobs. In our regular ranking for fundamental economic health, Germany has consistently achieved by far the best ranking of all major EU member states since we started the analysis in 2011. Germany is more exposed to the vagaries of the world than other countries. But it can also deal with temporary external shocks much better than most of its peers. While Germany's industrial output and GDP contract sharply in a global downturn, it also rebounds fast from such setbacks, as the experience of 2008-2010 clearly demonstrated.

A great place to invest and create jobs – if the workers can be found

With its 2004 reforms, German turned itself into a great place to invest. As companies want to hire ever more qualified workers, they rarely dismiss people even when demand drops temporarily. Chart 1 on page 1 shows that even the mega-recession of 2008/2009 did not dent the structural uptrend in employment for long. We expect employment and income growth to remain solid during the current downturn. At 805,000 in January, registered vacancies for unsubsidised jobs remain close to the 807,000 peak reached last September (see Chart 8). Across major parts of the German economy, the pace at which immigrants, who mostly stem from other European countries, can be brought up to speed and integrated into the labour market remains the key constraint on growth.

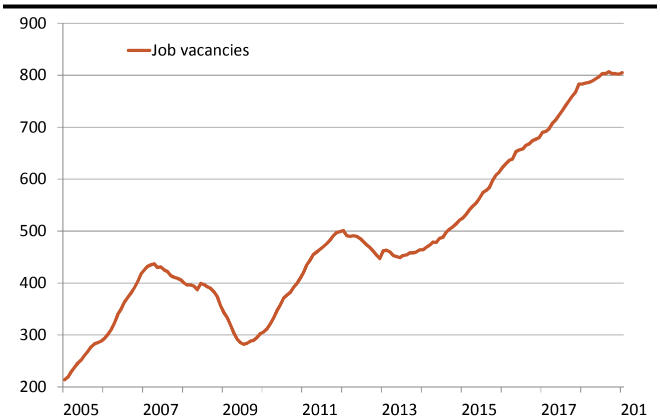
The grand bargain: wage restraint for job security

By and large, the grand bargain at the heart of German industrial relations still holds. In exceptionally good times such as 2017 and H1 2018, workers do not press their advantage to the fullest in wage negotiations. In return, companies do their best in lean times to avoid mass dismissals. With a dose of wage moderation, workers de facto buy some job security.

Healthy gains in wage incomes

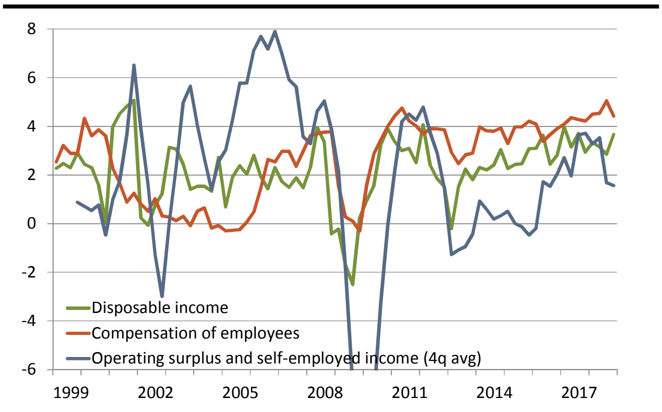
Supported by continuing gains in employment and a modest increase in wage inflation, overall compensation of employees in Germany rose by 4.75% yoy in H2 2018, the strongest gain since 1992 (see Chart 9). Although the pace will likely moderate slightly in 2019 due to the front-loaded nature of the two-year wage deals which many sectors concluded in 2018, compensation gains will probably continue to exceed 4% yoy this year. As consumer price inflation looks set to recede from 2.2% yoy in H2 2018 to an estimated 1.6% in Q1 2019 due to the return of oil prices to a more normal level, real disposable incomes will continue to post solid increases.

Chart 8: Stable at a record high – German job vacancies



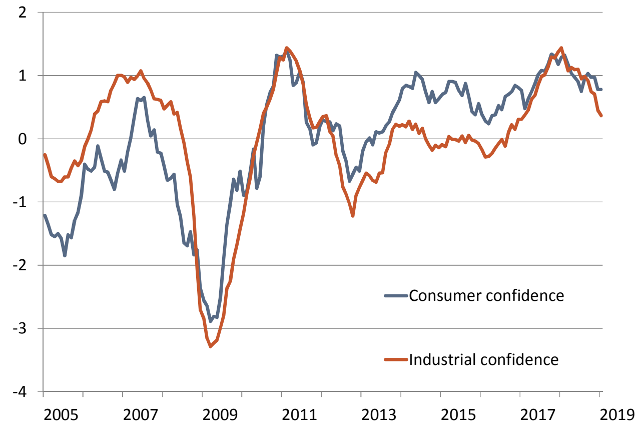
In thousand. Source: Bundesagentur, Bundesbank

Chart 9: Healthy gains – disposable income with key components



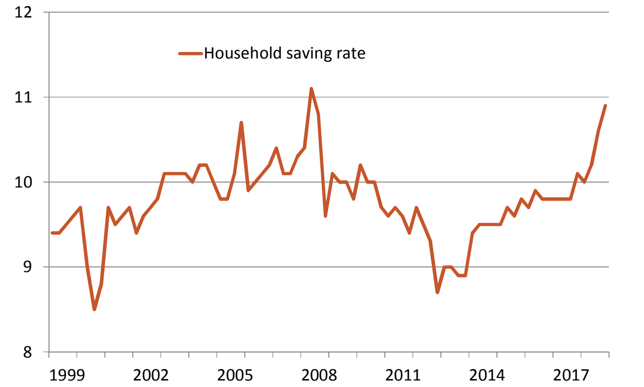
Yoy change, in %, in nominal terms. Four-quarter moving average for highly volatile operating surplus and self-employed income which also includes (net) property income, other current transfers. Sources: Destatis, Bundesbank

Chart 10: Softer – German industrial and consumer confidence



Adjusted for standard deviation from mean since 2005. Sources: European Commission; Berenberg calculations

Chart 11: German household savings rate: spike in Q3 2018



In % of disposable income, savings in net terms. Source: Bundesbank

Global shocks affect confidence at home

German consumers react to global economic shocks. Consumer confidence roughly tracks the ups and downs of industrial confidence, although in a more muted fashion (see Chart 10). Mounting concerns about trade wars, China and Brexit caused a dip in consumer confidence in H2 2018. Consumers decided to save rather than spend some of the significant rise in their disposable incomes in 2H 2018 (see Chart 11).

Hoping for a rebound after a grey winter

If and when trade tensions are defused, a hard Brexit is avoided and the ongoing Chinese stimulus starts to show up in a stabilisation of exports to China, German industrial sentiment will likely rebound. This should feed into a gain in consumer confidence and a renewed readiness of consumers to open their purses. With a rebound in exports going along with stronger business investment and consumer spending, German GDP could then recover from its current near-stagnation to a pace in line with the 1.5% trend rate.

Of course, if the external conditions (easing trade tensions, no hard landing in China and no hard Brexit) are not met, the German economy would likely weaken further, potentially slipping into an export-led recession in Q2 2019 from the near-stagnation now.

The trouble with the banks

Although banks are in trouble…

The widely reported profitability problems of Germany's big listed banks are sometimes seen as a potential sign or harbinger of a major economic weakness. Despite years of bad news about Germany's major listed banks, the economy shows no sign of a credit crunch or any other problem often related to banking issues, however. The profitability issues of Germany's major listed banks largely reflect the unusually competitive nature of the German banking markets. A panoply of local savings banks and co-operative banks, which do not always have to pay close attention to their profit margins, compete with the private banks for business. That German households and companies are mostly good risks with strong balance sheets adds to the inclination of banks to offer them loans at conditions that are more attractive for borrowers than for lenders. In addition, holding German government bonds is not exactly a way to generate interest income.

…the wider economy can still do well as banks offer excellent terms for loans

As a result, the big banks find it difficult to shine on the home market. However, German households and companies reap the advantage of a reliable supply of loans at generous conditions. Whereas Italy's banking issues are a major drag on its economic performance, Germany's banking issues are bad news for owners of banks but not for bank customers or the economy at large.

Under construction: the domestic economy

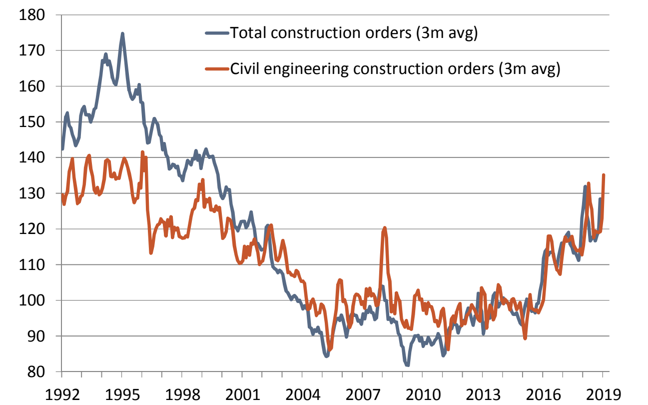
German construction: the times of misery are over for good

A key example of Germany's domestic strength that is neither affected very much by a temporary downturn in export-orientated industries nor suffering from any sign of credit crunch (or credit excess) is the construction sector. Construction contributes 5.4% to Germany's overall gross value added. After more than 10 mostly lean years, the construction sector has rebounded strongly since 2016. The trend in construction orders continues to point up amid significant short-term fluctuations (see Chart 12). The key constraint on growth in the sector is the time and effort it takes to recruit enough workers, mostly from other European countries, to do the work. The desire of government to step up infrastructure spending shows up in the strong rise in civil engineering orders (Chart 12) and construction orders placed by the public sector (Chart 13). Slowly but surely, Germany is delivering the boost to government spending that observers have asked for for many years. With lengthy planning procedures and a dearth of qualified labour, it simply takes some time until the money can be spent.

A pillar of strength for the foreseeable future

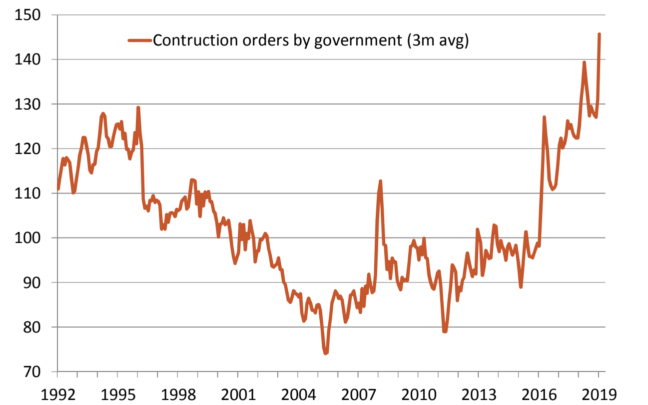
The temporary downturn in the business cycle will probably not affect the construction sector much. Even if business investment on construction were to decline – which we do not expect – the slack would be easily absorbed shortly afterwards by those companies in the construction sector that already have more orders than they can handle. Construction is likely to remain a pillar of stability and strength of the German economy for years to come throughout the ups and downs of the export-driven industrial cycle.

Chart 12: Total and civil engineering construction orders



Index levels, 2015=100, orders in real terms (volume), three-month moving average, monthly data for November 2018. Source: Bundesbank

Chart 13: Stimulus at work – government construction orders



Index levels, 2015=100, orders in nominal terms (value), three-month moving average, monthly data for November 2018. Source: Bundesbank

The big picture: beyond the temporary setback

From "sick man of Europe" to a continental powerhouse

Chart 14 on page 8 brings out key elements of the German story since the start of monetary union. Having turned itself into the "sick man of Europe" with the costly way in which the country had handled its re-unification in 1990, Germany lagged behind the remainder of the Eurozone until 2004. Courtesy of its supply-side reforms, Germany then recovered strongly from late 2005 onwards. Due to Germany's heavy exposure to the global cycle, GDP fell more strongly than elsewhere in the Great Financial Crisis of late 2008 and early 2009. But once the tide turned, Germany enjoyed a more V-shaped recovery than the remainder of the Eurozone. With no need for domestic austerity, Germany also suffered less from the euro confidence crisis of 2011/2012 than most other parts of the region.

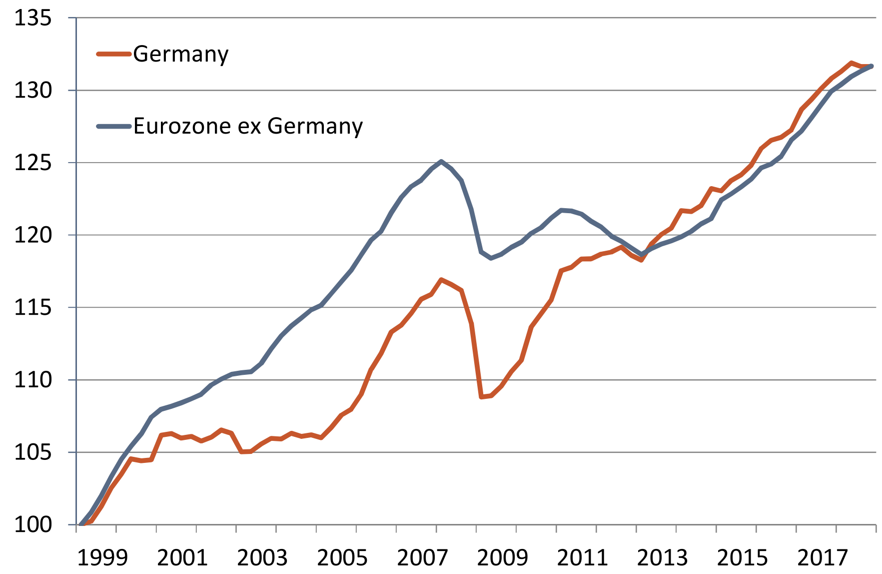
A temporary setback

In late 2018, the special effects weighing on German GDP (see page 2) and Germany's dependence on global trade pushed Germany into stagnation, whereas most other parts of the Eurozone (except Italy) continued to expand at least modestly. We look for German growth to rebound from Q2 2019 onwards, with a clear risk that the rebound could be delayed once again by continuing trade tensions, a lingering Chinese weakness or a botched Brexit. If the external shocks grow worse, Germany could temporarily fall into rercession before it rebounds.

France may soon overtake Germany on trend

On balance, we do not expect German growth to surpass the Eurozone average by a significant margin in the next few years. On the one hand, the follies of the current Italian government will remain a severe drag on the Eurozone average. On the other hand, the result of President Emmanuel Macron's reform drive and the continuing strength of Spain will support trend growth in the Eurozone. As Germany is slowly backtracking on pro-growth reforms, France may start to surpass the German growth rates in a few years' time – but that is a separate story with little bearing on the near-term outlook for the German economy.

Chart 14: Real GDP – Germany versus the rest of the Eurozone



Indexed at 1999-Q1=100. Source: Eurostat

German economic forecasts

Table 1: German economic forecasts

		2017	2018	2019	2020	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
GDP [1]	% y/y	**2.5**	**1.5**	**0.8**	**1.7**	2.1	2.0	1.2	0.6	0.4	0.4	1.0	1.4	1.7	1.7	1.7	1.7
	% q/q					0.4	0.5	-0.2	0.0	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4
	%q/q ann.					1.5	1.8	-0.8	0.1	0.6	1.6	1.7	1.8	1.7	1.7	1.7	1.7
Private Consumption	% y/y	**2.0**	**0.9**	**1.2**	**1.8**	1.6	1.1	0.5	0.5	0.5	0.8	1.6	1.8	1.8	1.8	1.8	1.8
	% q/q					0.4	0.2	-0.3	0.2	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Government Consumption	% y/y	**1.6**	**1.0**	**1.9**	**1.8**	0.7	1.1	0.5	1.7	2.1	1.7	2.4	1.3	1.8	1.8	1.9	1.9
	% q/q					-0.4	0.8	-0.3	1.6	0.0	0.4	0.4	0.5	0.5	0.5	0.5	0.5
Investment	% y/y	**3.6**	**2.7**	**2.5**	**2.9**	3.1	2.4	2.4	3.0	2.4	2.4	2.8	2.6	2.8	2.9	2.9	2.8
	% q/q					1.0	0.6	0.4	0.9	0.5	0.6	0.8	0.7	0.7	0.7	0.7	0.7
Final Domestic Demand [2]	% y/y	**2.1**	**1.2**	**1.5**	**1.9**	1.6	1.3	0.9	1.2	1.2	1.2	1.9	1.7	1.9	1.9	1.9	1.9
	% q/q					0.4	0.4	-0.1	0.6	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Net Exports [2]	% y/y	**0.3**	**-0.4**	**-0.8**	**-0.2**	0.3	0.3	-1.0	-1.2	-1.4	-1.2	-0.3	-0.4	-0.2	-0.2	-0.2	-0.2
	% q/q					0.0	-0.3	-1.0	0.0	-0.2	-0.1	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Stockbuilding [2]	% y/y	**0.0**	**0.6**	**0.1**	**0.0**	0.1	0.3	1.3	0.7	0.7	0.3	-0.6	0.0	0.0	0.0	0.0	0.0
	% q/q					0.0	0.3	0.9	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Account Balance	EUR bn	**262**	**253**	**229**	**217**	71	69	57	56	59	63	54	53	56	60	51	50
	% of GDP	**8.0**	**7.5**	**6.6**	**6.0**	8.6	8.2	6.6	6.5	7.0	7.3	6.2	6.0	6.4	6.7	5.6	5.5
Industrial Production [3]	% y/y	**3.3**	**1.0**	**-1.3**	**1.9**	4.0	2.8	-0.2	-2.6	-2.8	-2.6	-0.9	1.2	1.9	1.9	1.9	1.9
	% q/q					0.0	0.3	-1.3	-1.6	-0.2	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Unemployment Rate [4]	%	**3.8**	**3.4**	**3.3**	**3.0**	3.5	3.4	3.4	3.3	3.3	3.3	3.2	3.2	3.1	3.1	3.0	3.0
CPI [5]	% y/y	**1.7**	**1.9**	**1.5**	**1.9**	1.3	1.9	2.1	2.1	1.6	1.5	1.4	1.4	1.8	1.8	1.9	2.0
General Govt. Balance	% of GDP	**1.0**	**1.8**	**1.2**	**0.8**												
General Govt. Debt	% of GDP	**63.9**	**60.0**	**57.5**	**54.7**												

[1] Calendar-adjusted [2] Contribution to GDP growth [3] Ex construction, s.a., period averages [4] ILO measure, period averages, s.a.
[5] EU-harmonised, period averages

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