Germany: There is ample room for fiscal stimulus but it is unlikely to be imminent

HENRY COOK
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1591
E: henry.cook@uk.mufg.jp

MUFG Bank, Ltd.
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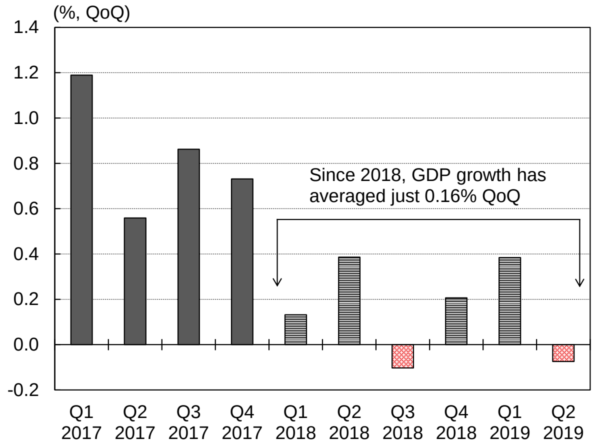
Germany is on the brink of a technical recession

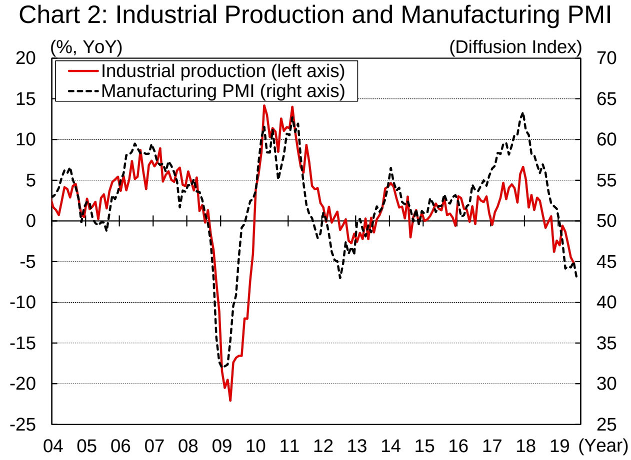
After a series of disappointing figures since the start of 2018 (Chart 1), German real GDP growth fell 0.1% QoQ in the second quarter of the year. There were some transitory factors in Q2 2019 – the boost from mild winter weather and the UK's Brexit stockpiling were unwound – but forward-looking survey indicators do not point to an immediate pick-up in activity in Q3. This leaves Germany on the brink of a technical recession (two consecutive quarters of negative growth). Its export-orientated economy has been buffeted by global trade tensions and auto-industry regulatory changes. The manufacturing sector has felt the brunt of the downturn. Industrial production fell by 5.1% YoY in June (Chart 2), and the number of passenger cars exported has dropped 13.4% in the six months to July.

Chart 1: German GDP Growth



Source: Statistisches Bundesamt, MUFG Bank Economic Research Office

Chart 2: Industrial Production and Manufacturing PMI



Source: Statistisches Bundesamt, IHS Markit, MUFG Bank Economic Research Office

So far, the services industry has been relatively resilient as consumer spending has benefited from an improving labour market and stronger wage growth (household disposable income increased 3.1% YoY in Q2). With this in mind, along with our expectations for some of the headwinds from inventory adjustment to start to fade by the end of this year[1], we think that

[1] See here: www.bk.mufg.jp/report/ecoeu2019e/monthly_we20190801e.pdf

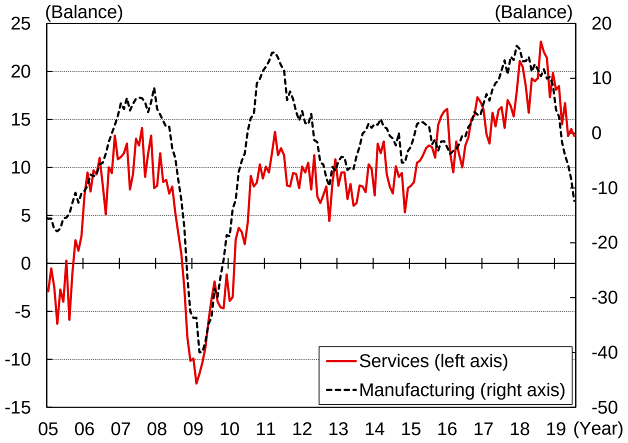
German GDP growth will improve to average 1.4% in 2020. However, the drags on the economy from factors such as global protectionism and political uncertainty are likely to remain. There is a clear risk that eventually there will be stronger pass-through to the services sector and a deeper economic slump. This has prompted renewed calls for the government to implement fiscal stimulus measures.

Policymakers have started to hint at additional stimulus measures

To a certain degree, Germany's current fiscal plans are already expansionary. The coalition agreement between Merkel's conservatives and the SPD in March last year paved the way for higher social spending and some tax cuts. The Bundesbank has written that "fiscal policy will continue to have an expansionary effect in the coming years" but it "will not fully counterbalance the domestic economy". This could change as policymakers start to take note of the weaker growth outlook. Angela Merkel, the chancellor, has said that Germany is "heading into a difficult phase", adding that the government will react "depending on the situation". Olaf Scholz, the finance minister, has hinted that Germany could muster around 50 billion euros (1.5% of GDP) to counter a crisis (without any details of a timeframe).

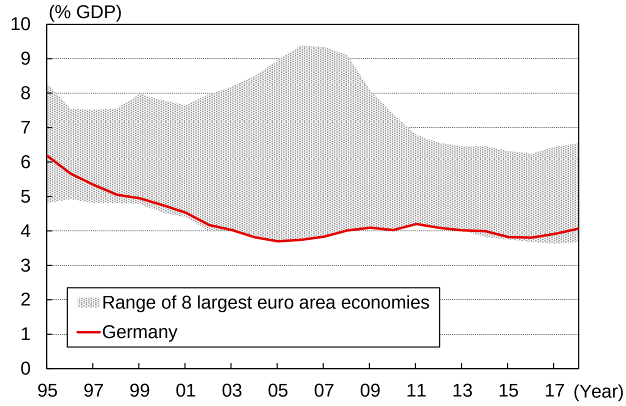
Whether this is the case or not, the recent period of economic weakness is likely to produce a mechanical (rather than discretionary) increase in government spending, which should not be confused with fiscal stimulus. So-called automatic stabiliser mechanisms will mean that transfer payments (such as unemployment benefits) are likely to increase, and tax receipts should fall. The labour market has so far proved to be resilient to the slump in manufacturing output – but cracks are appearing. The unemployment rate increased in May this year after 65 months of stable or improving figures. The ifo employment barometer for the manufacturing sector (which accounts for around 20% of total employment) has fallen to its lowest since 2010, and its service sector equivalent has also drifted lower (Chart 3). The Bundesbank has said there has been "a perceptible increase in the number of recipients of unemployment benefit under the statutory insurance scheme".

Chart 3: ifo Employment Barometer by Sector



Source: ifo, MUFG Bank Economic Research Office

Chart 4: Gross Fixed Capital Formation in Non-Residential Construction



Source: OECD, MUFG Bank Economic Research Office

However, automatic stabilisers are generally better at dealing with temporary consumption shocks rather than investment shocks, so may be less effective at supporting growth in an industry-led downturn. If the outlook worsens – and especially if unemployment increases –

there will be pressure on the government to change its discretionary spending plans. To our minds, a blend of short-term stimulus measures to support the economy as well as policies to ease longer-term imbalances (such as the historically low non-residential investment shown in Chart 4) would be appropriate. In the case of a serious downturn, short-term measures might include corporate tax cuts, a temporary VAT reduction, or incentives for car purchases.

Looking further ahead, a variety of long-term measures could help to raise the economy's supply potential. The European Commission has recommended that Germany "undertake additional expenditure for achieving a sustained upward trend in public and private investment, and in particular on education, research and innovation". There is also a need for infrastructure investment to address issues such as Germany's lack of speedy internet and the poor state of many of its roads. We also note the strong push to strengthen the country's climate protection efforts – specific 'green' government spending might be a suitable justification to circumvent the political constraints detailed below, while more stringent, legally-binding climate targets could spur private-sector investment and innovation.

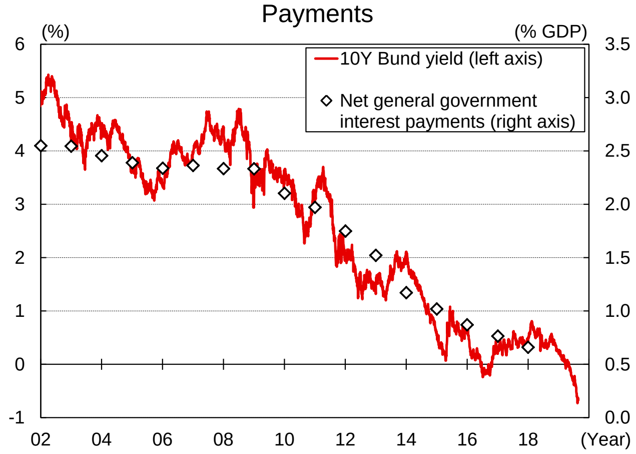
There is ample room to increase government spending

Germany certainly has plenty of fiscal leeway to implement these sorts of stimulus measures. The government has run a budget surplus since 2014 (Chart 5). The debt-to-GDP ratio has fallen steadily from over 80% in 2012 to around 60% now (the figure for the euro area, excluding Germany, is almost 100%). The shrinking debt burden and ongoing fall in bund yields have helped to reduce interest payments to less than 1% of GDP (Chart 6).

Chart 5: German Debt and Deficit

Source: Bundesbank, MUFG Bank Economic Research Office

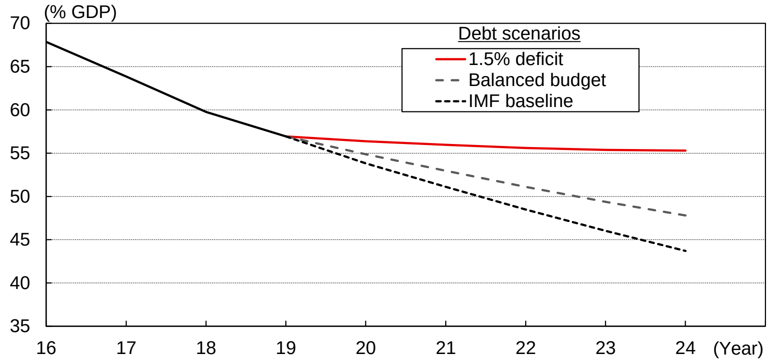
Chart 6: German 10Y Yield and Government Interest Payments



Source: Macrobond, OECD, MUFG Bank Economic Research Office

Using the IMF's projections, Chart 7 shows how the debt-to-GDP ratio might evolve under various budget scenarios. This approach suggests that debt would continue to fall fairly swiftly even if the current budget surplus was reduced to zero. The debt reduction path might even be sustained under a deficit of 1.5% of GDP. We would note that the IMF's GDP path from their July forecast update (0.8% in 2019, 1.4% in 2020) now seems optimistic after the Q2 GDP release. However, even with lower growth figures, we think that **there is certainly scope to open up a deficit of at least 1% of GDP while still reducing the government debt ratio**.

Chart 7: German Government Debt Scenarios



Note: Uses IMF GDP, primary balance and implied interest rate forecasts from July 2019. We apply the simplified formula $\Delta b = d + (r - g)b$, where b is the current debt-to-GDP ratio, d is the primary deficit as a proportion of nominal GDP, r is the real interest rate, and g is the real GDP growth rate.
Source: IMF, MUFG Bank Economic Research Office

The political hurdles are high and any eventual stimulus will probably be underwhelming

Despite this fiscal room, **a move to looser fiscal policy would be very difficult politically**. There is a 'debt brake' mechanism enshrined in Germany's constitutional law which states that the federal government's cyclically-adjusted deficit cannot exceed 0.35% of GDP. The German government actively pursues a balanced budget (known as *schwarze Null*, or black zero), and the approach was retained in the coalition agreement last year. There is also the notional constraint of the EU's Stability and Growth Pact which states that debt should remain below a ceiling of 60%, which Germany should reach this year after a half a decade of debt-reduction.

With these considerations, the bar is very high for a change of approach. We suspect that any significant move is likely to be reactive rather than preventative, and would require economic conditions to worsen (one quarter of growth at -0.1% QoQ is probably not enough). The GDP figure for Q3, released on 14 November, could be key: **confirmation of technical recession might be a wake-up call for policymakers to take more action**, especially if accompanied by signs of labour market weakness. However, despite Germany's favourable budgetary situation, any implemented measures might fall short of expectations in terms of both size and speed. Our suspicion is that, absent a serious crisis, the government's deeply held desire to cut debt will prevail. A balanced budget might be the best that can be hoped for; deficit spending may be too much of a shift (even if debt could continue to fall in such a case).

Overall, there is **a clear risk that market participants will be disappointed by any eventual fiscal spending in Germany**. We think that the ECB has some room to ease policy further (some measures are likely to be implemented in September)[2], but there is widespread hope that fiscal policy will start to take up the mantle. The 50 billion euros mooted by Schulz would be around 0.45% of euro area GDP, but, even if implemented, some of the more likely measures such as higher spending on education may not immediately spur higher German demand. If the downturn became a crisis, then there is a risk that any higher spending would be too late. Policymakers might rue their inaction – in terms of fiscal policy, prevention can be a lot cheaper than cure.

[2] See here: www.bk.mufg.jp/report/ecoeu2019e/specialreport_20190621.pdf