

## Germany: Entering the lost decade

The short-term prospects for the German economy aren't really that bad. With a bit of global tailwind and political will, a rebound in 2020 could well be on the cards. It's more the longer-term prospects which are concerning. While growth in the last decade looked effortless, the next ten years could easily end up as a lost decade



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The last decade was a golden one for the German economy, except for the last 18 months obviously.

Strong economic growth, record-high employment and record low unemployment combined with a record series of annual fiscal surpluses had all marked and contributed to the best economic performance since reunification. Unfortunately, this golden decade hasn't really ended in a golden way. The manufacturing slowdown since the summer of 2018 has become a slump, the labour market shows first tentative bruises and, even worse, disruption in one of Germany's key industries, automotives, do not bode well for the imminent future.

In fact, there is a risk that the German economy is almost seamlessly moving from a golden decade into a lost decade.

## Two sides of one economy

Headlines on the German economy have been dominated by speculation about whether or not the eurozone's largest economy would fall into recession.

The economy avoided a technical recession at the very last minute, with 3Q GDP growth coming in at 0.1% quarter-on-quarter. However, as exciting as this speculation about a technical recession might be, including relief, once the recession had been avoided, the hard reality is that the German economy has been in de facto stagnation since the summer of 2018. Under the surface of this stagnation, there is a two-faced economy: a weak manufacturing sector, which has moved from slowdown to slump on the back of trade conflicts, global uncertainty and disruption in the automotive sector, and a strong domestic sector, where private and public consumption are important growth drivers.

Let's look at this two-sided economy in more detail. As regards manufacturing, supply-side constraints have given way to demand-side ones. While in the summer of 2018, capacity utilisation was at record highs and the lack of adequate equipment and skilled workers argued in favour of more investments, demand as a limiting factor to production at the end of 2019 was back at levels last seen in 2012. Trade conflicts and the global slowdown are one reason for the manufacturing slump. On top of that, the structural challenges for the automotive sector, stemming from the transition to electric engines and car-sharing, are increasingly taking a toll. As regards consumption, one important reason why the economy has avoided recession is a long list of election gifts, often criticized as not increasing the long-term growth potential of the German economy. Over the last two years, the government has agreed to increase child allowances, pensions and study allowances as well as some tax relief and more money for health care, elderly care and schools. For 2019, all of this has amounted to a fiscal stimulus of some 0.5% of GDP. So much for the urban legend that the German government is completely averse to the idea of short-term fiscal stimulus.

Up to now, strong domestic demand has offset the manufacturing slowdown. Looking into 2020, it remains uncertain whether this balancing act can continue. In fact, in our view either the cyclical factors weighing on German industry will dissipate somewhat, with the entire economy rebounding, or the domestic part of the economy will also slow down. In our base-case scenario, global trade will rebound somewhat and low-interest rate and the weak euro should further support the export sector. Just in time to avoid a significant weakening of consumption and consequently pushing GDP growth close to 1%. Also, don't forget that more working days should increase annual GDP growth by some 0.4 percentage points.

## Structurally (much) less sound

Despite a minor cyclical rebound in 2020, the risk is high that the German economy will suffer from a series of structural challenges in the coming years.

Just think of demographic changes, the lack of structural reforms over the last decade, the loss of international competitiveness, mainly on the back of too little investments in conventional and digital infrastructure, a possible continuation of de-globalisation and further disruption in the automotive sector. Contrary to the recessions in 2008/9 or 2012/13, the German economy is currently structurally less sound.

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The risk that the German economy will experience a decade with much weaker growth than in the 2010s is high. Against this background, the debate on additional fiscal stimulus will continue. Not in the sense of a short-term recession-fighting package but rather in the sense of a long-term investment package, tackling the structural weaknesses of the economy. In this regard, it is remarkable that even the government business association, BDI, and the country's trade union federation, DGB, are teaming up to a plea for an investment package of 450bn euro over the next ten years.

Given the increasing public and electorate support for more investments, we continue to expect more fiscal stimulus than currently planned by the government in 2020 and in the years after. Ironically, the increasingly chaotic political situation in Berlin could help.

## **Turbulent politics could support more fiscal stimulus**

The new party leaders of the SPD Saskia Esken and Norbert-Walter Borjans, had been campaigning for an early end of the current coalition demanding more investments.

Since their official appointment at the SPD party convention, however, these calls have started to sound much less ambitious. Demands and threats have moved into calls to talk with the coalition partner. At least for now, the risk of an early end to the current government has been avoided. For the CDU of Angela Merkel, fiscal surpluses remain carved in stone and continue to be an important cornerstone of their political identity. Consequently, the fiscal room for manoeuvre has a natural lower bound, ie a balanced budget.

However, given that the government currently still runs a budget surplus of around 1% of GDP and off-budget investments have happened in the past, significant fiscal stimulus could still see the light under the current government. Don't forget that the government agreed on the climate change package amounting to some 50bn euro over the next four years and has increased its efforts to invest in digitalisation somewhat. In our view, the tensions within the government could lead to additional fiscal stimulus, advancing and upping elements of the climate package.

### **A lost decade on the cards?**

The short-term prospects for the German economy aren't that bad. With a bit of global tailwind and political will to engage in more investments, a rebound in 2020 is on the cards. It is rather the longer-term prospects of the economy which are worrisome. While growth in the last decade looked effortless, leading to a golden decade, without reforms and investments, the next ten years could easily end as a lost decade.

## The German economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP	1.6	0.6	0.6	1.2
Private consumption	1.2	1.5	0.4	0.5
Investment	3.5	2.7	1.9	3.1
Government consumption	1.4	2.1	2.4	2.6
Net trade contribution	-0.4	-0.4	0.0	0.0
Headline CPI	1.9	1.4	1.2	1.6
Unemployment rate (%)	3.5	3.2	3.3	3.4
Budget balance as % of GDP	1.6	1.8	1.1	0.9
Government debt as % of GDP	60.8	58.0	57.0	55.0

Source: Thomson Reuters, all forecasts ING estimates

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