# Germany Q4: Cool runnings

With a difficult new government coalition in the making, the economy is still doing what it has been doing over the last nine years: growing strongly.


## A not-so-stable government

Germany is still digesting the outcome of the federal elections on 24 September. The election result was a strange combination of political earthquake and stabilisation. Angela Merkel will remain chancellor, but will very probably be a weaker chancellor in a less stable government than over the last twelve years. The rise of the AfD could increase pressure in her own party (and its Bavarian sister party) to move further to the political right, while a coalition together with the FDP and the Greens is anything but a done deal and is politically challenging.

After the regional elections in Lower Saxony on 15 October, all involved parties should make first steps towards the so-called “Jamaica” coalition. Despite political tensions and differences, Germany’s traditional craving for stable governments currently excludes other unprecedented options like a minority government. If – unexpectedly - the “Jamaica” option were to fail, pressure on the SPD to rethink its decision to move into opposition could increase again.

## A "Jamaica coalition": What would be in store?

What would such a government have in store for the German economy and for Europe? Regarding the economy, a "Jamaica coalition" could bring more investments, particularly in digitalization and education. Some tax relief could also be possible. However, there could be little in store to tackle increasing wage inequality, keeping German wage increases relatively moderate and consequently not making the ECB's life any easier. At the same time, topics such as energy transition and the future of the automotive industry are clearly potential stumbling blocks.

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As regards Europe, the new government could bring a cold shower to the current Macron euphoria. Even though any Merkel-led government will keep a pro-European stance, the FDP and the conservative wing of Merkel's own party are in our view clear brakes and limits to deeper Eurozone integration. We don't expect huge steps. It could be until the next severe crisis before we get further far-reaching steps towards more Eurozone integration.

The new German government will start with a strong economy. Even though it's entered its ninth year of expansion, there are still hardly any signs of a slowdown. On the contrary, the economy has actually regained speed; not only on the back of the still strong labour market, low-interest rates, higher wages and public spending, but recently also on the back of stronger investment.

## Investment and industrial production finally pick up

The weak spot of recent years – investment and industrial production – has increasingly and steadily shown signs of a revival. With capacity utilization back at levels last seen in 2007 and equipment being increasingly mentioned by the manufacturing industry as a limiting factor to production, investment should further pick up. With the expected investment programme of the new government, the current cycle should be extended by another couple of years.

> *The German economy could continue to grow above its potential growth rate.*

The biggest risks currently seem to come from the external side: geopolitical risks, the stronger euro, a possible slowdown in the US economy as a result of the continued absence of tax relief or investment programmes, a slowdown in the UK economy as a result of continuing Brexit uncertainty and China's ongoing transition from welcome export destination to serious competitor could spoil the German growth party in coming years.

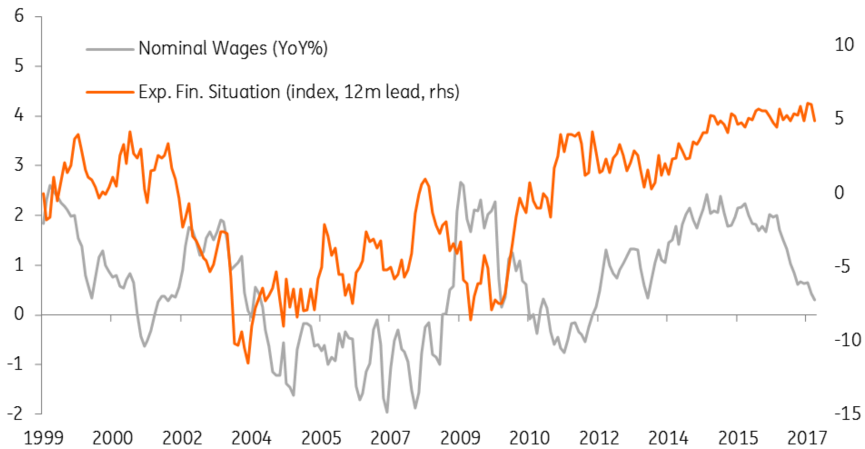
## The breakdown of the Philips curve

While German growth has become a welcome constant for the entire Eurozone economy, one of the most interesting issues is why wage growth has not picked up. As long as even the German labour market is not recording higher wage growth, despite record-low unemployment and still increasing employment, how could wages in the entire Eurozone increase? Since 2009, nominal wages have increased by roughly 2% pa on average. In real terms, wages have only increased by around 1% each year. Hidden unemployment, a still huge low-wage sector and the influx of refugees are probably the main reasons for sluggish wage growth.

Add to this the latest problems in the automotive industry, the threat of automatisation, globalisation and downward pressure on wages and prices from digitalisation (also in services) and it becomes increasingly unlikely we will see German wages spike anytime soon.

Later this year, the new wage negotiations in the symbolic and trend-setting metal and electro industry will start. With one of the most powerful unions, IG Metall, setting out its demands in late October. According to recent reports, however, IG Metall will call for a reduction of the 35-hour-week to 28 hours. Hourly wages should remain constant. It is an interesting trend, which in our view reflects the changing structure of the labour market and the changing preferences of employees, looking for more leisure time and not more money. This provides further evidence that wage developments in Germany could remain too "well-behaved" for the ECB.

## German wages and consumer's expectations




Source: Thomas Reuters

## What is in store for the future?

If the possible "Jamaica" coalition follows the example of other unprecedented "Jamaican" performances, the current mature cycle of the economy could easily be extended by a couple of more years and become "cool runnings". And maybe, possible reservations on further Eurozone integration could be tackled by Emmanuel Macron with famous Jamaican words: "Get up, stand up, stand up for your rights. Get up, stand up, don't give up the fight."

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