

## Germany: The end of a golden decade

The economy shrank by 0.1% QoQ in the second quarter. Inevitably, the discussion about fiscal stimulus will get more heated



It's official: the German economy shrank by 0.1% quarter-on-quarter in the second quarter of the year, from +0.4% QoQ in the first quarter. On the year, the economy still grew by 0.4%, calendar and seasonally adjusted. GDP components will only be released at the end of the month, but available monthly data and the press release of the Statistical Agency suggest that private and government consumption were slightly up but trade and the construction sector were a drag on growth.

### End of golden decade

Today's GDP report definitely marks the end of a golden decade for the German economy. Since the end of the 2008/09 recession, the economy has grown by an average of 0.5% QoQ every quarter. In fact, the economy grew in 35 out of the last 40 quarters. However, under the surface of these impressive headline numbers, a worrisome trend has emerged. Since 3Q 2018, the economy has been in a de facto stagnation, with quarterly GDP growth at an average of zero percent.

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## *for the German economy*

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Trade conflicts, global uncertainty and the struggling automotive sector have finally brought the German economy down on its knee. In particular, increased uncertainty, rather than direct effects from the trade conflicts, have dented sentiment and hence economic activity. Who remembers that one year ago, the biggest problem for the German economy was supply-side constraints? Last summer the entire economy was close to overheating; now the lack of demand has become a pressing issue. Even worse, this transition has taken place without the expected boost to investments. While the slowdown of the industry is not really new, recent developments show that the resilience of the domestic economy to external shocks is crumbling. Profit warnings, first lay-offs, an increase in short-time work schemes, falling consumer confidence and weaker activity in the service sector have sounded the alarm bells.

Let's be clear: the fact that the German economy is currently in stagnation is not the most disconcerting message after a long period of strong growth. It is the weakening of the domestic economy that is most worrisome.

### **What's next? Worsening, external relief or fiscal stimulus?**

There is no need to panic, but instead to act. Looking ahead, the future path of the German economy highly depends on external events and government action. Obviously, any relief in the ongoing trade conflicts would benefit the German economy. Companies could still use extremely favourable financing conditions and invest. However, the principle of hope is not enough. The pressure on the German government to act will increase. However, any fiscal policy reaction will be more complicated than in 2008/09, when a typical Keynesian stimulus package kick-started the economy. At that time, state measures such as bank bailouts, scrapping and short-time working were successful because the economy was fundamentally sound. This time around, there are structural problems or at least challenges. Just think of digitalisation, infrastructure or the automotive industry. Therefore, Germany needs a two-pillar stimulus package: a short-term stimulus and an increase in the long-run growth potential. The buzzwords are well-known: digitisation, climate protection, energy transition, infrastructure and education.

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*Germany needs a two-pillar stimulus package: a short-term stimulus and an increase in the long-run growth potential*

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But will it happen? Even though it's still the end of summer and not every single media report implies policy changes, there seems to be growing support to agree on measures to tackle climate change in September, reduce the so-called solidarity tax and discuss additional investments into digitalisation. Don't forget that there is ample fiscal room for manoeuvre. The government's interest payments have dropped from 2.7% of GDP in 2008 to some 0.8% of GDP this year. The government could run fiscal deficits of some 1 ½% of GDP and the debt-to-GDP ratio would still stabilise at 60%. Running deficits instead of surpluses is currently still more than one bridge too far for the government. But some fiscal loosening looks in our view more likely than many might think. Otherwise the outlook of the German economy will basically be determined by external

factors.

Today's GDP data marks the end of a golden decade for the German economy. It was a decade of strong growth on the back of earlier structural reforms, fiscal stimulus, globalisation at its peak and steroids provided by the ECB in the form of low-interest rates and a relatively weak euro. This decade, in which strong German growth looked so effortless, is coming to an end.

However, like every end, there is a new beginning. The next months will show whether it is a beginning for the better or the worse.

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