Group Economics

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What's up with Germany?

- **The German economy has slowed sharply and looks to be in recession**
- **The underperformance of the German economy reflects its heavy reliance on exports, particularly capital goods**
- **Meanwhile, households have stepped up savings, leading to a slowdown in consumer spending**
- **A much-needed transition towards domestic demand is badly needed for Germany and the eurozone**
- **The large current account surplus is the flip side of a domestic savings glut**
- **Germany has room to increase government spending, cut taxes and raise wages**

Germany's industrial collapse driving economy to recession

German industrial orders fell by 4.2% mom in February following a 2.1% decline in January. Even taking into account that this is a volatile series, the weakness is astonishing. Indeed, industrial orders are down by 8.4% over the last year, the weakest since the global financial crisis. Historically, declines of industrial orders of this magnitude have been consistent with periods of recession in the overall economy (see chart on the left). Germany has not recorded a technical recession yet (defined as two successive quarters of contraction). However, for all intents and purposes it is experiencing a modest recession. The economy contracted in Q3, was flat in Q4, and looks set to be contracting in the first few months of this year. Germany has been underperforming the eurozone as well as other advanced economies around the world. So what is going wrong in the German economy?

German industrial orders and GDP

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Export share of the economy

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

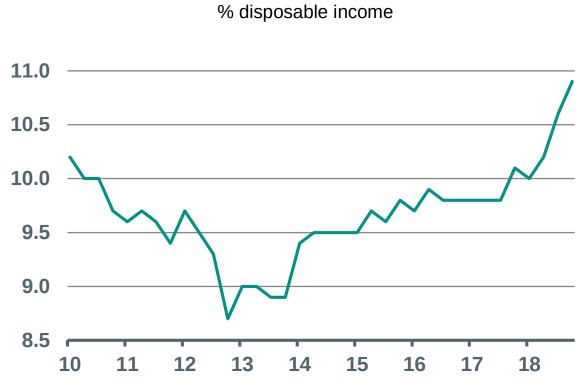
Germany economy hit by export downturn

The German economy is particularly sensitive to global demand, which has weakened significantly this year. Indeed, world trade is contracting year-over-year. In addition, the German economy is particularly strong in producing capital goods, and these have been hit by a slowdown in global investment spending (see chart on the left). Within industrial orders, capital goods are down by 9.8% yoy and foreign capital goods orders by 15.3% yoy. Investment spending is slowing in the eurozone, but has also been slowing significantly in the US, Japan and China.

Global investment slowdown hits Germany

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Germany household savings



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Domestic demand has also weakened

The slowdown in the German economy has also been exacerbated by weaker domestic demand. Although the employment has been expanding and wage growth accelerating, consumer spending slowed sharply during the course of last year. This reflects a jump in the household savings ratio. This may reflect precautionary saving given the slowdown in industry and concerns that worse might be to come, given the trade war between the US and China and worries that it might spill-over to the EU. In addition, there may also be worries about the impact of the UK leaving the EU without a deal.

Improvement later in the year

Since the start of this year, there has been improvement in surveys related to the domestic economy, such as the services PMI. That suggests that these concerns might by easing, although admittedly, we do not see signs of this yet in consumer confidence indicators. In addition, we think the global economy should improve modestly in the second half of the year, given the dovish shift by central banks and some easing of the uncertainties discussed above. So the German economy should improve in the second half of the year.

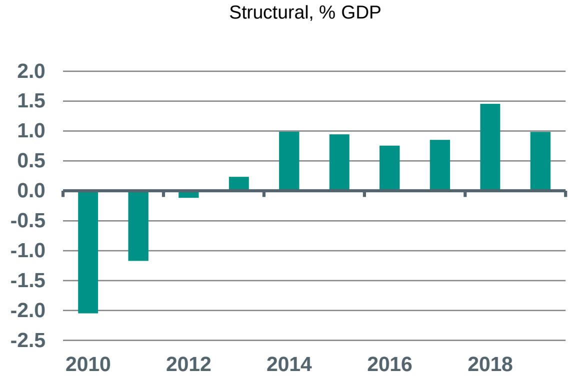
The elephant in the room

However, the global economic slowdown highlights a more structural problem in the economy. Its reliance on external demand and lack of a domestic growth engine. Germany has an enormous current account surplus. It has eased in recent quarters, but still stood at 7.4% GDP at the end of last year. The flip side of this is a large domestic savings glut. Who is saving? The short answer is everybody! The government, households and businesses have all stepped up savings over the last few years. The government has been building up budget surpluses, while public investment spending has floundered. In addition, households may be feeling less secure despite labour market developments. This may relate to concerns about future pension provision as well as the high number of temporary, mini-jobs. Meanwhile, Germany's competitiveness has improved over the years, helped by relative wage restraint. The labour share of income has gone down and companies have made large profits. However, business investment has remained relatively moderate, meaning that company savings have also gone up.

Germany current account surplus

Source: Bloomberg, ABN AMRO Group Economics

Germany fiscal balance



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Government has room for fiscal stimulus

The German authorities could do more to encourage a transition towards domestic demand, which would be good for Germany and the eurozone. The most obvious place to start would be step up fiscal stimulus. Indeed, even the ECB has started to hint at this. In the account of the March Governing Council meeting, officials called for 'jurisdictions that had fiscal space (to) stand ready to use it, given the downside risks to growth'. This could also reflect some recognition of the more limited scope for monetary policy to boost the eurozone economy and hence inflation compared to the past.

According to European Commission, Germany will have a structural fiscal surplus of 1% GDP this year. It is down compared to last year, because the government is putting a place a modest stimulus of just under 0.5% GDP. Even according to the government's own fiscal rules, it has room for an additional 1% GDP stimulus as it aims to be in balance once the impact of the cycle is taken into account. However, with borrowing rates low, it has arguably much more scope. A public investment programme would make sense, and tax cuts to encourage private sector demand could also be considered. In addition, an increase in minimum wages could also help to support domestic demand.

Main economic/financial forecasts

GDP growth (%)	2017	2018	2019e	2020e	3M interbank rate	28/03/2019	04/04/2019	+3M	2019e	2020e
United States	2.2	2.9	2.3	1.9	United States	2.59	2.59	2.60	2.60	2.50
Eurozone	2.5	1.8	0.8	1.3	Eurozone	-0.31	-0.31	-0.30	-0.30	-0.20
Japan	1.9	0.8	0.9	0.7	Japan	0.07	0.07	-0.10	-0.10	-0.10
United Kingdom	1.8	1.4	1.1	1.8	United Kingdom	0.83	0.83	1.00	1.00	1.25
China	6.9	6.6	6.3	6.0						
World	3.7	3.6	3.3	3.4						
Inflation (%)	**2017**	**2018**	**2019e**	**2020e**	**10Y interest rate**	**28/03/2019**	**04/04/2019**	**+3M**	**2019e**	**2020e**
United States	2.1	2.4	1.6	2.0	US Treasury	2.39	2.51	2.6	2.60	2.50
Eurozone	1.5	1.7	1.2	1.2	German Bund	-0.07	-0.01	0.0	0.20	0.50
Japan	0.5	0.9	1.1	1.6	Euro swap rate	0.47	0.52	0.6	0.80	1.10
United Kingdom	2.7	2.5	1.4	1.8	Japanese gov. bonds	-0.10	-0.06	0.1	0.10	0.30
China	1.6	2.1	2.5	2.5	UK gilts	1.00	1.09	1.7	1.50	1.80
World	3.0	3.5	3.8	3.2						
Key policy rate	**04/04/2019**	**+3M**	**2019e**	**2020e**	**Currencies**	**28/03/2019**	**04/04/2019**	**+3M**	**2019e**	**2020e**
Federal Reserve	2.50	2.50	2.50	2.50	EUR/USD	1.12	1.12	1.10	1.16	1.25
European Central Bank	-0.40	-0.40	-0.40	-0.30	USD/JPY	110.6	111.7	110	108	105
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.31	1.31	1.30	1.35	1.45
Bank of England	0.75	0.75	0.75	1.00	EUR/GBP	0.86	0.86	0.85	0.86	0.86
People's Bank of China	4.35	4.35	4.35	4.35	USD/CNY	6.74	6.72	6.65	6.60	6.60

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

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