Investment Research
The Big Picture
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Section Germany

Germany

Cruising along, but vulnerable

- We think the current boom phase still has 'air to run' with growth to remain above potential at 2.1% in 2018E and 1.9% in 2019E, before moderating to 1.6% in 2020E.
- We expect domestic demand to rebound, not least due to higher public spending under the new government, while net exports would increasingly become a headwind to growth.
- Risks to the growth outlook for the export-dependent German economy stem mainly from the external side amid the ongoing US-China trade spat and its implication for global trade.
- The tight labour market has started to spill over to higher negotiated wages, leading us to expect a gradual rise in core inflation from H2 18 onwards.

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Smooth sailing as boom continues

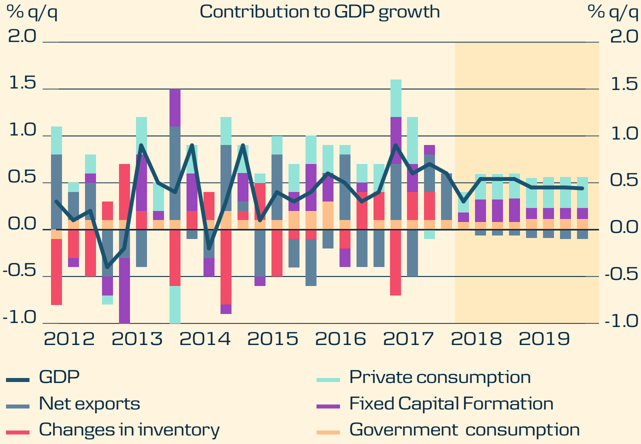
The German economy experienced strong growth of 2.5% in 2017 and we think the current boom phase still has 'air to run' in the next two years as capacity utilisation remains below historical peaks despite increasing labour shortages. Overall, we expect growth to remain above potential at 2.1% in 2018 and 1.9% in 2019, before moderating to its potential level at 1.6% in 2020. We expect the German economic momentum to be supported by continued employment gains, easy monetary conditions, solid global growth and not least, the more expansionary fiscal policy of the new government. Risks to the growth outlook for the export-dependent German economy stem mainly from the external side, where the euro appreciation and US-China trade conflicts could adversely affect business sentiment and investment activity.

Although economic activity lost momentum in Q1 18, with growth moderating to 0.3% q/q (from 0.6% q/q in Q4 17), this was partly due to temporary factors, such as an unusually severe flu season and several days of strikes in the metal industry during the - now resolved - IG Metall bargaining round. We look for slightly higher GDP growth rates of 0.5% q/q in the coming quarters, as some of these temporary headwinds fade. Following a weak spell in H2 17, we expect private consumption to become an important growth driver again, supported by positive real wage growth, low borrowing costs and simulative fiscal measures such as a lowering of unemployment insurance and pension contributions as well as the return to parity in the financing of the statutory health insurance. But as many of the coalition agreement's planned measures would take effect only at the turn of the year, we expect the boost to public and private consumption to be more pronounced in 2019. We project investment activity to remain dynamic in the absence of an escalating global trade war, not least because sentiment indicators such as Ifo remain at high levels, credit standards remain loose and increasing capacity constraints and labour shortages favour productivity-enhancing capital investments. In our view, the momentum in global growth will abate only slowly, meaning that robust foreign demand for German products would continue to fuel net exports in 2018. However, in light of the moderating global cycle and dynamic import growth, we expect net exports to become a drag on growth in 2019.

Core inflation rising gradually

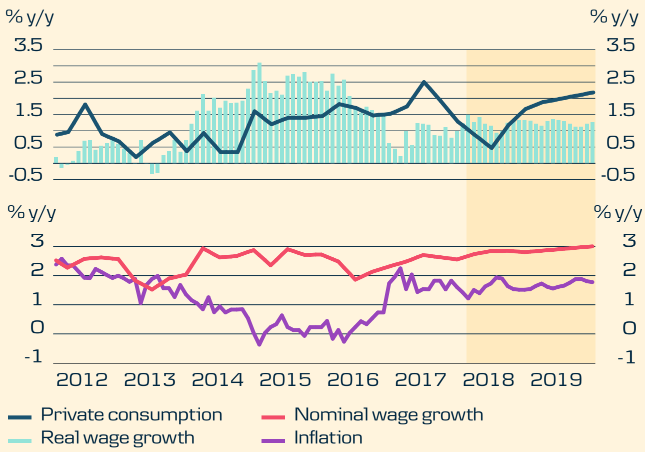
With growth staying above potential, we expect the unemployment rate to decline further to 3.3% in 2019. The tight labour market has started to spill over to higher negotiated wages and we expect wage growth in Germany to accelerate to 3.0% in 2019, also due to a possible increase in the minimum wage and falling net immigration from Eastern European countries (see Part 2: Eurozone Inflation - Upside risks from oil prices and rising wage pressures). Although we expect core inflation to increase to 1.8% in 2019, supported by rising wages, headline inflation should remain below the ECB's 2% target over the forecast horizon as global factors and a stronger euro will continue to be mostly headwinds.

Domestic demand set to rebound



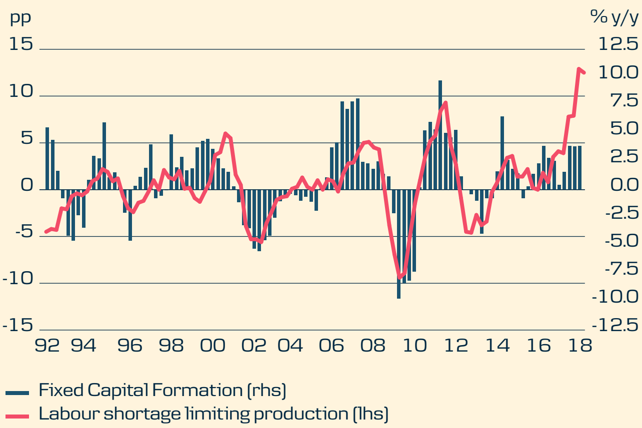
Source: Destatis, Macrobond Financial, Danske Bank

Positive real wage growth despite increasing inflation



Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Increasing labour shortages favour investment spending



Source: Eurostat, EC, Macrobond Financial, Danske Bank

Germany's trade vulnerability

The German economy is characterised by a high degree of openness, with exports accounting for roughly 50% of GDP. This makes the economy very susceptible to a deterioration in the global trade environment and especially recent protectionist tendencies from the US. President Trump plans to impose tariffs on European steel and aluminium, but the direct impact would be negligible for Germany: steel and aluminium account only for 3% of total German exports, of which the US' share is only 4.3%. Hence, only 0.13% of total German exports would be affected by such tariffs. However, the indirect effect of such measures should not underestimated in our view, as the lingering threat of additional tariffs on other sectors risks weighing on German business sentiment and investment activity. Many German companies are also highly integrated in global value chains and have set up subsidiaries and production facilities in China and the US. They would, hence, suffer significant collateral damage from either US or Chinese tariff measures. The important German car industry in particular could become a target in case of further escalation in the trade conflict, which would impair the German growth outlook significantly. BMW and Daimler are the largest vehicle exporters from the US by value and China is their number one market, making them among the prime victims of possible Chinese import tariffs on US cars.

Germany's car industry in a soft spot

Source: Destatis, Macrobond Financial, Danske Bank

Macro forecasts - Germany

% change q/q Annualised rate	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	Calendar year average 2017	2018	2019	2020
GDP	1.2	2.2	2.2	2.2	1.8	1.8	1.8	1.8	2.5	2.1	1.9	1.6
Private Consumption	1.6	2.0	2.0	2.0	2.4	2.4	2.4	2.4	2.1	1.3	2.3	2.0
Private Fixed Investments	4.1	4.9	4.9	4.9	2.4	2.4	2.4	2.4	3.9	3.5	3.3	2.2
Public Consumption	-2.0	1.6	1.6	1.6	2.4	2.4	2.4	2.4	1.6	0.8	2.1	2.2
Exports	-3.9	4.1	4.1	4.1	3.6	3.6	3.6	3.6	5.3	3.7	3.8	3.1
Imports	-4.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.6	3.5	5.3	4.5
Net exports [1]	-0.1	-0.2	-0.2	-0.2	-0.5	-0.5	-0.5	-0.5	0.2	0.3	-0.4	-0.4
Unemployment rate (%)	3.5	3.5	3.4	3.4	3.3	3.3	3.2	3.2	3.8	3.4	3.3	3.2
CPI (y/y)	1.3	1.9	2.3	2.0	2.1	1.7	1.7	1.8	1.7	1.9	1.8	1.8
Core CPI (y/y)	1.3	1.2	1.6	1.6	1.8	1.8	1.9	2.0	1.3	1.4	1.9	1.9
Public Budget[2]									1.3	1.2	1.4	1.0
Public Gross Debt[2]									64.1	60.2	56.3	54.0
Current Account [2]									8.0	7.9	7.6	7.3

1: Contribution to GDP growth, 2: Pct. of GDP, 3:End of period
Source: Eurostat, Danske Bank

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