18 August 2019

Harr's View

Why Germany should ease fiscal policy

Thomas Harr, PhD, Global Head of FI&C Research, +45 45 13 67 31, thhar@danskebank.com

Good evening all

Today, I argue why Germany should immediately ease fiscal policy. In recent weeks, speculation has intensified that the German government is mulling fiscal stimulus. In my view, it might take some time before policymakers act, but it would make so much sense. **First, I believe the timing is right.** Data this week showed that the German economy contracted in Q2 and it has worsened in Q3. I expect Germany to weaken further in coming months due to the contraction in global manufacturing, trade and non-residential investments. In my view, Germany is likely to face a technical recession in Q3, defined as two quarters of negative growth. Meanwhile, manufacturers report they are cutting employment. The German labour market is tight, but employment growth in Q2 was the weakest since Q1-13. I expect Germany's labour market to weaken further in coming months. Fiscal easing could mitigate the downturn. It is crucial the German government acts now given the usual legislative and implementation lag of fiscal policy.

Second, the secular decline in interest rates provides the policy space for a permanently looser fiscal policy. Since 2010, the average yield on German government debt has been below nominal GDP growth rates. Currently, the average maturity of German debt is 6.9 years with an indicative yield of -0.89%. Meanwhile, nominal Q2 GDP growth was 1.03% y/y. I expect German interest rates on average to be below growth rates for a long time. Most estimates suggest that the real neutral interest rate in the Eurozone is around 0% to -1%. We expect the ECB to maintain negative policy rates for the next 4-5 years, anchoring the short-end of the German yield curve. In my view, the scarcity of safe assets due to the limited supply of AAA-rated government bonds, risk aversion and financial regulation will continue to put downward pressure on German yields in coming years. Low interest rates relative to growth rates will tend to lower Germany's debt-to-GDP ratio. The IMF estimates that its gross debt-to-GDP ratio will drop to 44.7% in 2024 from 60.9% currently, while the primary surplus will average 1.73% during this period. I believe this is too optimistic as the economy slows. However, the risk that investors suddenly view German debt as unsustainable is extremely low even with a permanent fiscal loosening. Germany faces a substantial demographic challenge over coming decades, which should raise ageing related spending and dampen growth. However, in my view the solution is not to prefund future spending with larger government surpluses today, but instead to provide workers the incentives and skills to extend working lives.

Third, German fiscal stimulus could lift the neutral rate in the Eurozone, which is of the essence. The current low neutral rate necessitates a very low policy rate in the Eurozone. This constrains the space for monetary policy to react to the next downturn due to the lower bound, and cripples the banking system. We expect the ECB to announce a comprehensive package of easing measures next month, including measures to mitigate the cost for Eurozone banks. (See the piece by our ECB strategist Piet Christiansen *here*, which explains how a tiering system could be constructed). However, I believe that the costs to Eurozone banks of negative rates will still increase over time due to rising excess liquidity, flat yield curves and limited transmission to depositors. (A *recent ECB study* finds that only 5% of total deposits in the Eurozone face negative rates). Instead, I believe that German policymakers should have a greater tolerance of a looser fiscal stance, as well as focusing on measures which promote private investments. **Empirical studies suggest that a permanent 2% worsening of the fiscal deficit in Germany could perhaps raise the neutral rate in the Eurozone by 25-50bp.** This implies that interest rates in Germany would still be below growth rates, which will tend to lower the debt-to-GDP ratio.

Fourth, a looser fiscal stance will support short- and long-term growth prospects. Public investment in Germany has been very sluggish over the last 20 years, while corporate tax rates are relatively high. The German government could focus on measures such as raising public infrastructure and digital services and reducing the corporate tax rates, which would boost the economy over the short- to medium-term. Germany should also focus on public investments and expenditures such as education and green transition, which are crucial to securing long-term sustainable growth. A loosening of Germany's fiscal stance will be especially powerful now when monetary policy is likely to be very accommodative for a long time. Moreover, a permanent loosing of the fiscal stance, which is not financed by an increase in taxes at a later stage, will make it more powerful in lifting domestic demand.

Over the last week, euro swap yields continued to collapse with a modest spike on Friday triggered by a news story that the German government will raise debt in case of a recession. This suggests that the market remains focused on the worsening slowdown and recession risk, forcing capitulation among investors. I expect the market would like to see more concrete evidence of a shift in the German stance before it might have a lasting impact. We might receive more concrete evidence in coming months. That was all for today. I wish you a great Sunday night and coming week, best regards, Thomas

Disclosures

Danske Bank A/S ('Danske Bank') has prepared this research report. The author of this research report is Thomas Harr, Global Head of FI&C Research.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Weekly.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 18 August 2019, 17:04 CEST

Report first disseminated: 18 August 2019, 19:00 CEST