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CIO Viewpoint

Can Germany take its foot off the brake?

Investment Solutions

26 August 2019

Calls for Germany to reverse its cultural aversion to debt and start spending its way to growth are getting louder as Europe's largest economy flirts with recession. The Bundesbank said this month that falling demand for cars and machinery would likely continue from the second quarter into the third, which would tip Germany into a technical recession.

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While it is important for the country to fix its own growth, it would also benefit the neighbouring eurozone and wider global economy. The International Monetary Fund, the European Commission and the US all want the country to make use of its budget surplus to lift investment and encourage higher wages. Politically there is pressure from within the eurozone for Germany to increase spending too. "We continue to see a case for eurozone countries that have fiscal space, like Germany, to increase spending or cut taxes to help boost potential growth," Poul Thomsen, head of the IMF European Department, said in April. French Finance Minister Bruno Le Maire was blunter: "Those with the means shouldn't hoard money for years and years, allowing growth to deteriorate."

Increased spending would make Germany's economy less export dependent and boost imports, improving growth in the eurozone and more widely. Germany's economic strength makes its performance key for the rest of the world as an exporter and, less so, as a consumer market. At the same time, with negative yields the length of the 30-year bond curve, investors are willing to pay the federal government for the privilege of lending it money.

Budget orthodoxy

However, Germany is officially wedded to a budget orthodoxy. The call for more spending is a direct challenge to Germany's decade-old constitutional commitment to a balanced budget. Known as "Schwarz null" or "black zero", the policy targets fiscal balance. Since 2012 Germany has built a budget surplus that is now edging toward 2% through a period of, until recently, healthy expansion (see chart 1). Income tax revenues and total tax income have risen and Germany's debt-to-GDP ratio has fallen from 81.8% in 2010 to 60.9% last year. At almost 8% of gross domestic product Germany also runs the world's largest current account surplus (the balance of trade and primary income) in absolute terms and enjoys a weak, export-friendly currency.

Key takeaways

- Germany faces increasing pressure to start spending to boost growth
- Europe's biggest economy is expected to tip into a technical recession while its infrastructure, including the transport and digital network, needs investments
- A stimulus package would be the first challenge in ten years to a constitutional commitment to a balanced budget
- Fiscal scenarios show that a 50 billion euro package may boost GDP by as much as 1.1% while keeping the German budget in surplus
- The threat of recession may be the catalyst needed for Germany to begin to use its fiscal strength to invest for the future, benefitting both the country and eurozone.

That focus on balance may have made sense in the aftermath of the financial crisis, but German infrastructure from roads to broadband is run-down. While the German economy places third globally in the World Economic Forum's competitiveness ranking, it is 31st in digital infrastructure while its road network slipped to 19th last year. In comparison, the WEF ranks Germany's 'debt dynamics' no.1.

Promised package

The German government argues that it is already investing more in its physical and digital infrastructure and is considering a spending programme. The last time it did so was in 2008/2009 with a 50 billion euro package.

In practice, there is room for Germany to both increase public spending and respect its commitment to a balanced budget. Our calculations suggest that a German package of 50 billion euros now, assuming a fiscal multiplier for government spending of 0.8 (in other words a relatively efficient 80 centimes increase in GDP per euro spent, as suggested in a 2014 IMF paper), would boost growth by 1.1% (see chart 2). That would still leave the German budget in surplus. It would also have a positive impact on the wider eurozone, with a boost of around 0.3% to the region's GDP.

The German government forecasts economic growth will slow to 0.6% for this full year, compared with a rate of 1.5% for 2018. That is slower than the eurozone, where the consensus forecast is for growth of as much as 1.1% in 2019.

Protectionism and cars

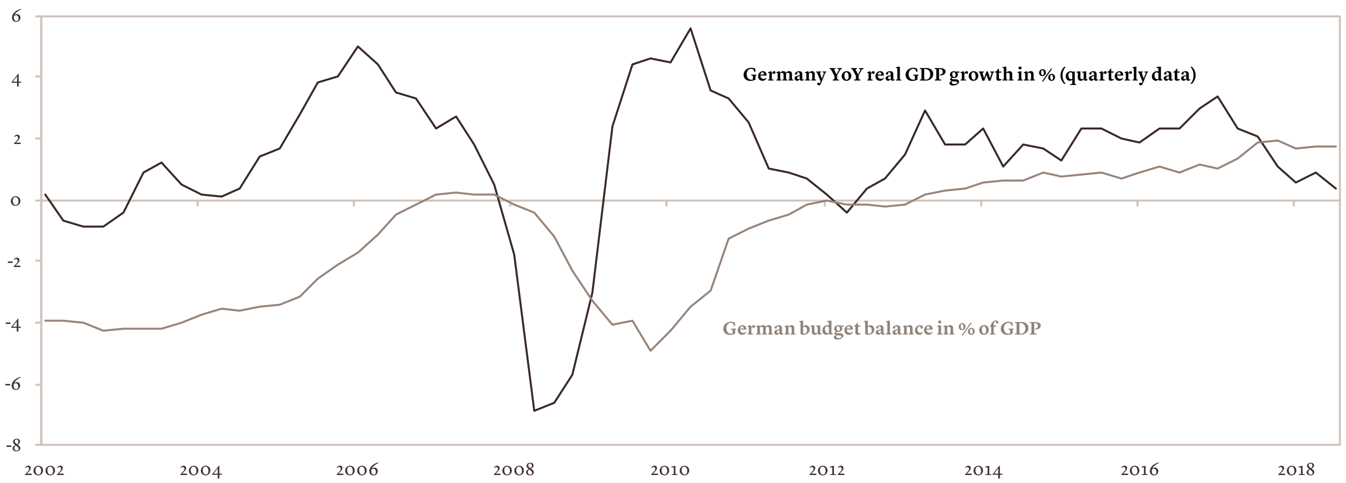
Trade remains the biggest economic theme of 2019 and Germany's economic slowdown tracks with the arrival of the US president's protectionist measures against China and threats to the European Union. The US administration has so far held off from imposing import tariffs on EU goods and services, but continues to reference its trade deficit with the bloc in general and the German car industry in particular. Germany accounted for 55% of EU car exports in 2018 while the second-largest exporter, the UK, shipped 17% of the total.

"Dealing with the European Union is very difficult; they drive a high bargain," Trump told reporters on 20 August. "We have all the cards in this country because all we have to do is tax their cars and they'd give us anything we wanted because they send millions of Mercedes over. They send millions of BMWs over."

Trump has threatened raising duties as high as 25% on car imports (a ten-fold rise) on national security grounds. Americans bought 1.34 million German cars and vans last year, of which 60% were US-built (and then in many cases exported to China).

It is worth remembering that US/EU trade is considerably larger than US/China trade. In 2018, the US exported goods and services worth USD574.5 billion to Europe vs USD 179.2 billion to China. The same year, US imported USD 683.9 billion from EU and USD 557.9 from China. Any impediment to trade between the EU and US, coming on the back of the US/China trade dispute, would be hugely damaging.

Chart 1 – German GDP growth and budget balance



Sources: Bloomberg, Lombard Odier calculations

In addition, the uncertainty of Brexit adds more potential downside. The UK is Germany's fifth-largest export market (buying almost 100 billion euros of German goods in 2018) and any disruption, compounded by weakening manufacturing at the same time as a hard Brexit, would further undermine the German economy.

Politics and a catalyst

In domestic politics, Germany finds itself in a sort of limbo. Support for Chancellor Angela Merkel's Christian Democratic Union party is falling after her almost 14 years as head of the German state. Protégée Annegret Kramp-Karrenbauer took over as party leader in December. In something of a coup, 'AKK' outflanked rivals in July to take on the role of Defence Minister (replacing Ursula von der Leyen who will become European Commission president). That may increase AKK's chances of succeeding Mrs Merkel as chancellor in 2021.

Unlike Italy's current political crisis, which has implications for the eurozone since it is capable of triggering yet another EU-level budget confrontation, Germany's self-imposed economic clouds and aging economic model have far wider consequences for the rest of the world. Fortunately, the spending tools to dissipate those clouds are already in the hands of the country's government.

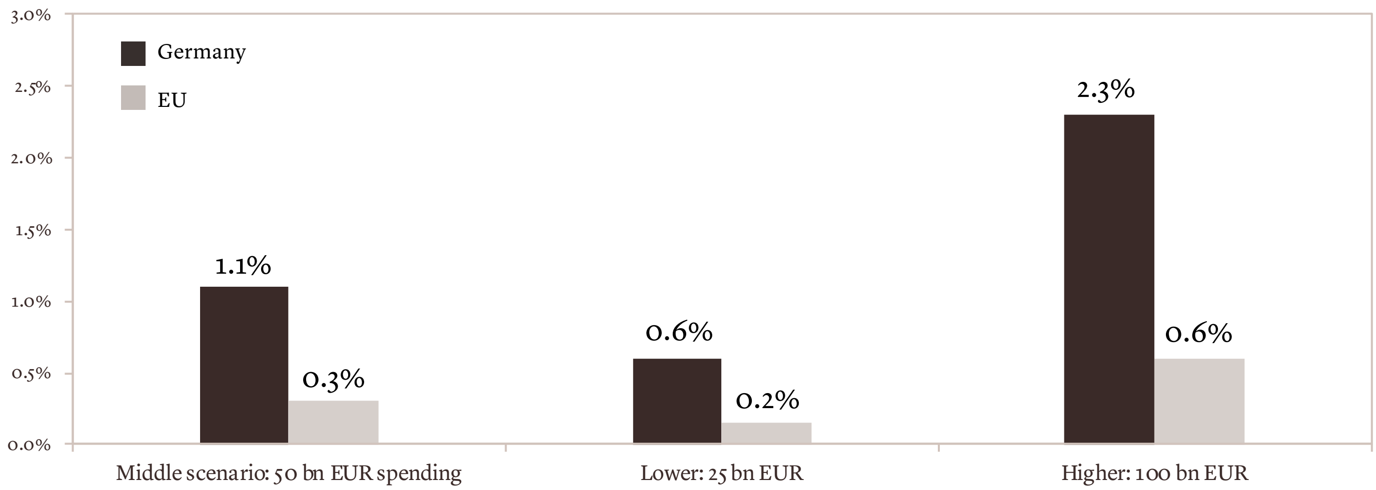
A German stimulus package, taking advantage of its significant fiscal cushion, would serve Germany well in decades to come. It would also calm critical voices within Europe and beyond.

In an increasingly protectionist trade environment, it may also be time for Germany to question whether it makes sense to continue with an economic model that depends on producing goods for export. More broadly, unless the EU's biggest economy can become a source of demand, the bloc will suffer as a whole.

In the very short run then, the threat of a recession may be just what is needed to jolt Germany out of its damaging obsession with balanced budgets and toward a more balanced economy.

Chart 2 – German spending package scenarios

Potential impact on GDP growth of various government investment spending packages



Sources: Lombard Odier calculations

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06.2019