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Economy

10 questions on Germany

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Germany today took over the six-month presidency of the Council of the EU with ambitions that would not have been thought possible even a short while ago. End-2019, it recorded the weakest growth rate in the EU, apart from Italy. It was suffering from trade frictions and the slump in the automotive sector. Deficits were banned, the ECB was held responsible for expropriating savers, European integration was not being widely lauded. Angela Merkel was criticised within her own party. Six months later, the situation has completely changed. The economy is devastated, but less so than elsewhere, and the Chancellor is once again the central figure in domestic and European affairs.

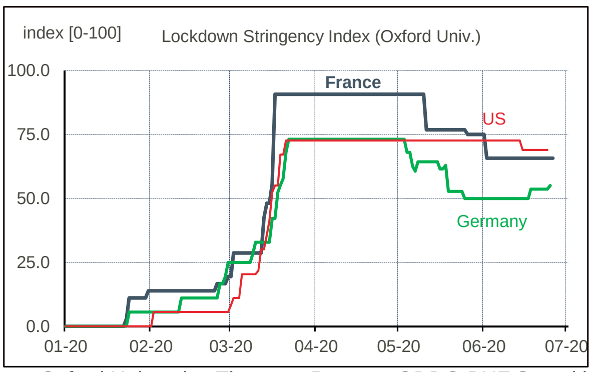
Germany takes the helm of the EU

The EU has a half-yearly rotating presidency in order to involve each member state, be they large or small, in the organisation of its affairs, but let's be honest and concede that people are rarely interested in the name of the country hosting the presidency. As a coincidence of the calendar, Germany, the biggest EU country, will occupy this position in exceptional circumstances. First, the EU has just experienced the greatest shock in its history. Second, with the UK's exit, the EU is losing one of its biggest member states and future relations between the two entities will have to be clarified between now and the end of the year. In the present note, we examine Germany's own situation and its relations with other EU member-states. For the sake of clarity, we have divided our presentation into ten questions.

① What is the (provisional) assessment of the pandemic?

At the time of writing, the pandemic has been clearly receding in all EU countries in recent weeks. This is a general relief, but the human toll varies from country to country. **According to the excess mortality, Germany looks like one of the countries that has "managed" the epidemic most effectively**[1]. A broad-based testing campaign was implemented as of March, which helped to rapidly circumscribe the main centres of the outbreak of the virus. This policy has been made possible in part through private sector initiative, often in a decentralised manner. At the same time, in France, the government was clumsily trying to justify its lack of preparation (shortage of masks). Germany adopted lockdown measures, but these were less severe than in other countries and were therefore able to be lifted more rapidly (chart lhs). A few more or fewer days of lockdown are important for the measurement of growth in Q2, and thus for 2020.

Lockdown Stringency Indices



Sources: Oxford University, Thomson Reuters, ODDO BHF Securities

GDP growth forecasts

y/y%	Real GDP growth	Ifo	BuBa	GCEE*	OECD**	IMF
Germany	2020	-6.7	-7.1	-6.9	-6.6	-7.8
	2021	6.4	3.2	4.9	5.8	5.4
	Total growth 2019-2021	-0.7	-4.1	-2.3	-12	-2.8
Rest of Eurozone	2020	-9.0	-9.6	-9.1	-10.0	-11.1
	2021	6.0	7.2	6.7	6.8	6.2
	Total growth 2019-2021	-3.6	-3.1	-3.0	-3.9	-5.5
USA	2020	-	-	-6.1	-7.3	-8.0
	2021	-	-	4.7	4.1	4.5
	Total growth 2019-2021	-	-	-17	-3.5	-3.9

*German Council of Economic Experts **single hit scenario

[1] *According to analysis by the FT (https://www.ft.com/coronavirusfree), the excess mortality rate during the coronavirus crisis was 6% in Germany, vs 24% in France, 25% in the US, 26% in Sweden, 43% in Italy, 49% in the UK and 56% in Spain.*

② What was the loss of activity during lockdown?

Activities involving physical contact or travel (catering, entertainment) suffered heavily as elsewhere in Europe. Uncertainty and the disruption of supply chains have weighed on the demand for capital goods. Automotive production was virtually halted (in April, with 10,900 vehicles produced, it was down 97% year-on-year). Industrial production fell by 29% between February and April, a figure comparable to that of France (-33%). Other sectors held up better, e.g. certain services and especially construction. During the period of strict lockdown, the decline in total activity was around 15% in Germany, compared with around 33% in France, Italy and Spain[2]. In Q2, which includes a phase of reopening of the economy, the Bundesbank expects real GDP to fall by 9.5% q-o-q, compared with around -15% in France. **All told, the contraction in German real GDP is considerable, around 7%, but less so than in other Eurozone countries or the US** (table rhs, p.1). **The expected rebound is admittedly weaker but the cumulative loss of activity over two years in Germany should be one of the more modest of the developed countries.**

③ What emergency measures have been adopted to make up for the shock?

For households, the main measure was based, as was the case during the financial crisis of 2008, on the short-time working system (*Kurzarbeit*) which helps preserve jobs. The amounts in question are of an entirely different magnitude. In March 2009, a peak of 1.4 million people was reached. In March-April 2020, the number of claims exceeded 10 million, for an actual use of 6.8 million. The support given to employees is broad, but less generous than in some countries[3]. **In any case, the *Kurzarbeit* system proved its effectiveness during the Great Recession, limiting the rise in unemployment. The same is expected this time round**.

In terms of businesses, priority was initially given to setting up loan guarantees (~€ 930bn) and direct equity investments (~€ 100bn). The conditions for this state support are demanding and may have aroused reluctance on the part of the companies concerned (the case of Lufthansa). By the end of May, the agency managing the state guarantees, KfW, had received applications for loans totalling just € 47bn.

④ What of the monetary support from the ECB?

The ECB is supposed to conduct monetary policy for the Eurozone as a whole, not for individual countries, but it is clear that if stress occurs in one place, the risk is that it will spread elsewhere. With the creation of the PEPP (Pandemic Emergency Purchase Programme), the ECB's objective was to alleviate the tensions arising in Italy and, in doing so, not to end up in the situation of 2012 with a splintering of borrowing conditions. In addition, other measures decided by the ECB may have had a more direct positive impact on the German banking sector (relaxation of collateral rules, liquidity injection). Note that the latest TLTRO was made with a negative rate of -1%, which may overcompensate for the -0.5% taxation of reserves. **In the present situation, the ECB has neutralised the undesirable effects of the negative interest rate policy on banks' profitability.** With loan guarantees, German banks have responded to the strong demand from companies drawing on their liquidity lines (in March-May, adjusted flows of new corporate loans amounted to € 44bn).

⑤ What is the impact on public finances?

Besides the emergency measures already mentioned, the federal government has instituted a stimulus programme. The main measures are a cut in VAT (-2 points from July to December) for a cost of € 13bn and help for families (payment of € 300 per child) for € 5.5bn. Unlike in 2009, the system of car scrappage premiums will not be used on a large scale but solely to encourage a shift to electric vehicles. According to the German Council of Economic experts, the fiscal stimulus measures will represent € 80bn in 2020 (2.3% of GDP) and € 45bn in 2021 (1.3% of GDP).

The budget surplus target is shelved for the moment (+1.5% of GDP in 2019). This year, the public deficit is expected to be between 6% of GDP according to the Bundesbank and 7.25% according to the stability programme. As some of the additional spending is a one-off, the deficit should fall to 3-4% of GDP in 2021. **Under the twofold impact of a bigger deficit and lower GDP, government debt would jump by around 15 points to 75% in 2020, before falling back. The Bundesbank forecasts a debt to GDP ratio of 70% in 2022. These figures would have caused outrage amongst the devotees of fiscal orthodoxy not long ago, but the severity of the coronavirus crisis has**

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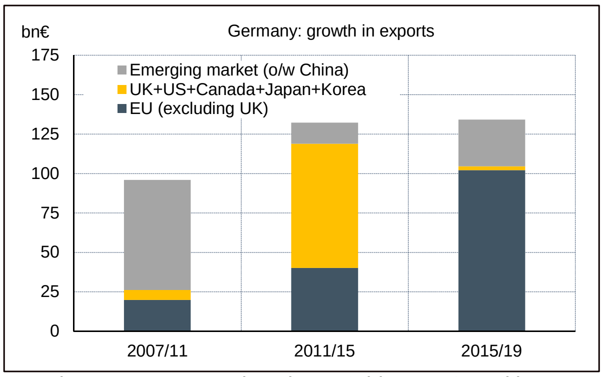
[2] See Ifo Economic Forecast 2020 Update (28 May 2020); INSEE Point de conjoncture (17 June 2020), Bank of Spain Economic Bulletin (June 2020).
[3] In Germany, 60% of net wages are paid initially, then 70% from the fourth month, and 80% from the seventh to the twelfth month (with a bonus paid to parents). Some company agreements complete the system. In France, the short-time working system covers 84% of the net wage (100% at the level of the minimum wage) and in the UK 80%.

changed priorities[4]. German public finances are nonetheless in a more enviable place than those of its neighbours. The increase in debt also has the advantage of reducing the scarcity of German bonds, which might have been a constraint on purchases of securities by the ECB/Bundesbank. Yet it is unlikely that yields will rise, particularly as inflationary pressures are non-existent.

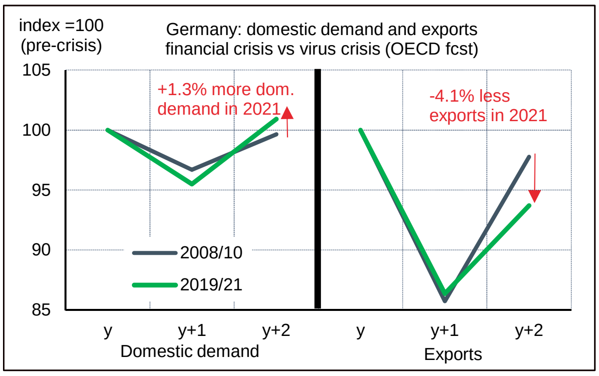
⑥ What shape might the recovery be (comparison with 2010-2011)?

In the 2008-2009 recession, the negative shock to activity was stronger in Germany than in the rest of the Eurozone[5], but the recovery was also stronger. As of Q1 2011, real GDP exceeded its pre-crisis peak (the same was true in France) but it was still more than 4% below the peak in Italy and Spain. At the time, the recovery in Germany had been driven by external demand, particularly from China. From 2007 to 2011, exports to China rose € 35bn (1.4% of German GDP), more than offsetting the fall in exports to countries on the periphery of the Eurozone (-€ 19bn). **In the current crisis, it is doubtful whether the German recovery will rely as heavily on exports as in 2010.** First, the growth model in China has changed. Chinese imports rose just 2% per year from 2011 to 2019 versus 20% from 2000 to 2011. In a number of sectors, China has become a rival to Germany rather than an export market. China was the main contributor to growth in German exports from 2007 to 2011. This role then went to the US and a few other developed countries from 2001 to 2015, but since 2015 the rest of the EU (excluding the UK) has been the most important driver of export demand (chart lhs). Second, international trade is less fluid due to the tariff tensions and uncertainty caused by US protectionist policies.

Contribution to German exports



Contribution to German growth



Sources: Thomson Reuters, Bloomberg, Oddo BHF Securities

Can the expected weakness of external demand in 2020-2021 be offset by higher domestic demand? In its most recent report, the OECD partly adopts this scenario, with recovery in 2021 being different to that in 2010, with a smaller rebound in exports but a stronger pick-up in domestic demand (chart rhs). Yet this scenario is open to criticism in that wage growth in Germany depends on export companies. It may seem more logical to envisage less strong domestic demand (Bundesbank), or to count on a stronger recovery in demand in the Eurozone (GCEE)[6].

⑦ What is the German stance vis-à-vis Brexit?

In 2019, German industrial companies exported € 79bn worth of goods to the UK (2.3% of GDP), including € 21bn of automotive exports. It goes without saying that a no-deal Brexit, implying tariff and non-tariff barriers, would be bad news for export companies[7]. In some models, the volume of trade between the EU and the UK could fall by one-third, which for Germany would represent a shock equivalent to 0.8 points of GDP. Taking into account shifts towards other markets, the final shock would probably be smaller, but the short-term consequences would necessarily cause disruption to production. Based on the principle that the party with the weaker hand in a trade negotiation is the one that has surpluses, for the last four years the UK has hammered away at the German government and industrial lobbies to emphasise just how important the UK market is. The sub-text is that Germany should be conciliatory in the negotiations. **The UK negotiating strategy is to try to divide the Europeans. For the last four years, this strategy has been a total failure. Angela Merkel has always placed the EU's fundamental principles (integrity of the single market, level playing field) before**

[4] *See our* Economic Note *dated 4 December 2019:* "About the German economic mythology*".*
[5] *In the Great Recession in 2008-2009, from peak to trough, real GDP fell 7% in Germany over four quarters and by 5.2% in the rest of the Eurozone over five quarters. Unlike other countries, Germany did not experience a double-dip recession in 2011-2012.*
[6] *See OECD, Economic Outlook (single-hit scenario), June 2020; Bundesbank, Outlook for the German Economy for 2020 to 2022, Monthly Report June 2020; German Council of Economic Experts, Economic Outlook for 2020 and 2021, June 2020.*
[7] *See our* Economic Note *dated 17 June 2020:* "Brexit, towards breaking point"

her country's short-term commercial interests. This is not about to change in the last six months of the transition phase.

⑧ What remains of the (absurd) criticism of the ECB?

It is an understatement to say that the ECB has been the subject of much criticism in Germany from the press, politicians, economists and, last but not least, central bankers at the Bundesbank or on the ECB Governing Council. Last year, at the end of Mario Draghi's mandate, one could almost have been forgiven for thinking that the ECB, having betrayed its mission, had only a single aim, to dispossess German savers of the fruit of their labours and make life impossible for German bankers and insurers. All, it goes without saying, for the benefit of other Eurozone countries. **At one point, the criticism had become so extreme, and it must be said so ridiculous, that it lost all weight as a result**[8].

Several appeals were lodged against the ECB with the German Constitutional Court. On 5 May last, this Court criticised certain aspects of the ECB's asset purchase programme launched in 2015, giving it three months to prove the proportionality of its action otherwise the Bundesbank would have to withdraw from the programme in question. This ruling is extraordinary in terms of its content (legal experts passing judgement on economic policy), its timing (the last day of the mandate of the court's president) and its form (it disregards a favourable ruling from the Court of Justice of the European Union, which has sole authority over the ECB). More importantly, this ruling was a headache for the German government and parliament, but both recently took stances asserting that the ECB's action was not open to criticism. It remains to be seen what form the response to the court will take.

We may be witnessing the end of the debate between two conceptions of what the ECB's monetary policy should be. One is represented by the Bundesbank and derives from the precepts of ordoliberalism (setting/compliance with immutable rules), the other is based on neo-Keynesian economic thinking and holds sway just about everywhere in the world. **When it was created in 1999, the ECB was designed based on the Bundesbank model, but in the various crises it has faced, its monetary practices have become closer to what one sees at the Fed. There will be no going back.** No neutral observer views the ECB's rate hikes in 2008 and 2011 (resulting directly from a dogmatic interpretation of its mandate) as anything other than serious mistakes, and, conversely, all consider that the actions taken under the influence of Mario Draghi after 2011 saved the Eurozone. **It is notable that the strongest and most effectively wielded arguments in defence of the ECB's policy come from the new German representative on the Governing Council, Isabel Schnabel** (who, it is worth noting, did part of her doctoral studies at Berkeley).

⑨ Why would Germany encourage the EU fiscal initiative?

Monetary union was created in 1999 on the basis of a decentralisation of fiscal policies. Each country is responsible for its own fiscal choices, on the condition that this does not undermine the euro, lead to a pooling of debts or a "union of transfers" (hence the deficit and debt criteria in the Maastricht Treaty, the stability pact, etc.). Here again, as is the case for monetary policy, the succession of crises has led to a need for flexibility with regards to respecting the rules. The coronavirus crisis is the most severe of all and the consequences are not uniform from one country to another. This is a situation that could likely accentuate the disparity between countries and ultimately threaten the integrity of the euro. At the EU summit on 24 March, two irreconcilable camps with opposing views on "coronabonds", Germany deemed this option to run counter to the existing Treaties[9]. According to the usual stereotype, Germany was the champion of the defenders of the orthodoxy against the lax southern states, championed by France.

Over the course of several weeks, the terms of the European fiscal debate have changed beyond recognition. Whilst the idea of "coronabonds" appears to have been completely abandoned, it has been acknowledged that surviving the shock will require, in addition to emergency measures, stimulus plans. On 18 May, Germany and France proposed the creation of a stimulus fund on top of the EU budget, a budget that will therefore need to grow. The proposal was picked-up and even expanded by the European Commission on 27 May[10]. The Chancellor is using all her influence to make sure that a political agreement is reached with the other EU countries at the summit scheduled for 17-18 July. The technical details, which are undeniably complex, could be negotiated in the coming months, so that the plan's implementation can begin in 2021. Several factors might explain the change in Germany's position. The most obvious is that we have a clearer view of the effects of the coronavirus crisis in

[8] *We discussed these arguments at length in an* Economic Note *of 10 October 2019: "*ECB: a critique of the critiques*".*
[9] *This has been Chancellor Merkel's unwavering position ("Eurobonds: not in my lifetime", Euractiv, 27 June 2012)*
[10] *See our* Economic Note *of 28 May 2020: "*A one-legged Europe no more?

July than we had in March, hence the more pressing need for fiscal stimulus. It is equally clear that in this time of trade tensions and Brexit, Germany's economic outlook depends on the health of the single market more than it ever has in the past. Finally, there a political dimension. **Over recent years, the main argument put forward by eurosceptical parties has been that the EU has failed in its mission to ensure the prosperity of its citizens. This will provide a good opportunity to prove the contrary, not only in Germany (where the AfD party is losing ground) but also elsewhere in Europe (here we are, above all, thinking of Italy)**[11].

⑩ What political situation after Merkel?

Political fortunes can change rapidly in troubled times. A number of leaders have been criticised for their irresolute management of the health crisis. The opposite is true of Angela Merkel who is once again her party's principal asset in the run-up to the elections in the autumn of 2021, after receiving much criticism for the way in which she organised her succession. It turned out that support for the choice of Annegret Kramp-Karrenbauer as head of the CDU was relatively weak. A fresh election for party leader was due to be held in April but this was pushed back due to the health crisis.

The Chancellor has said time and again that this is her fourth and final mandate. There is no reason to think that she is about to change her mind even in these exceptional circumstances. She has now regained the influence to weigh-in on the future direction of her party, to anchor it on a pro-European platform, whilst a number of her internal opponents have been more critical regarding integration (with some even straying into the territory of the AfD). **In any event, the rebound in Angela Merkel's popularity has had an impact on intentions to vote for the CDU, which currently stands at close to 40%. If this situation continues, it will once again ensure the CDU a role as the main player in any future coalition, with its choice of partners.**

[11] *See our* Economic Note *of 16 April 2020: "*Where is Italy headed?*"*

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