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Economy

About the German non-recession

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The German economy has been on the brink of recession for some time now without sliding into it, however. The current economic slowdown started almost two years ago, which is long. The correction is concentrated on industry (notably automotive), with little overspill to the rest of the economy. Some observers will see this as proof that Germany does not require a fiscal stimulus, with domestic demand holding up well. However, an economy of this size should not experience such jolts following a sector shock or uncertainties in external demand. This is the sign that its policy-mix is not the right one.

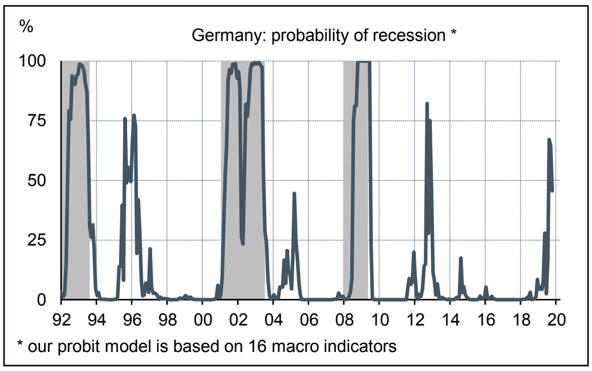
The probability of recession is beginning to decline

Since 2018, the German economy has recorded two quarters of contraction in real GDP, albeit not consecutively (Q3 2018 and Q2 2019). It has therefore averted a "technical recession", unlike Italy, which saw its GDP contract for two quarters in a row (Q2 and Q3 2018). On the basis of the most recent data available, German GDP now stands at +0.5% year-on-year, Italian GDP at +0.3%. Such a slight difference may only be due to the respective volatility of the national accounts. In both cases, this result is poor but for Germany, which has sounder fundamentals than Italy in many domains (labour market, government finance), it is particularly disappointing.

The "technical recession" concept is easy to measure but for analytical purposes, it is relatively useless, particularly as it is based on GDP which is subject to further revisions. To evaluate the risk of recession, it is better to gauge whether the economic slowdown is durable, deep and diffuse[1]. As GDP growth has slowed continuously since end-2017, peaking at +3.4% year-on-year, the **duration criterion** is certainly met. The conclusion is less clear for the **depth criterion**. Some activity data have corrected sharply, up to -5% for industrial production, but annual GDP growth remains marginally in positive territory (chart lhs). Regarding the **diffusion** criterion, it is not met. Industry aside, economic activity continues to progress; job creation is positive even though it has slowed; unemployment remains very low; household consumption is rising; and a highly cyclical sector such as construction is in robust health, to such an extent that some fear that it is overheating. **There is nothing here that fits an economy heading towards a recession, but these indications do reflect a severe industrial crisis, much of which is due to the automotive industry. The fact that a major economy like Germany is so dependent on a single sector of activity gives significant cause for concern**[2].

Germany: real GDP growth rate

Germany: probability of recession



Sources: Thomson Reuters, Oddo BHF Securities

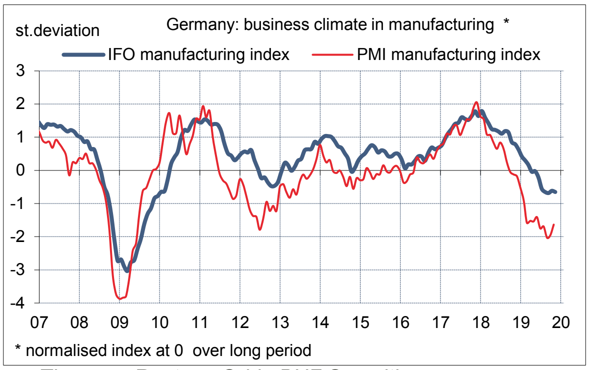
[1] *The 3D rule (depth-duration-diffusion) corresponds to the usual definition of recession used by the dating committee of the NBER in the US.*
[2] *See our* Eco Note *of 25 April 2019:* "What's Germany worth without the automotive industry?"

According to the dating used by the German Council of Economic Experts, Germany has experienced three recessions since its reunification[3]. At the beginning of these episodes, we can see the probability of recession[4] quickly shifts from 0% to over 80%, highlighting the disruptive nature of a recession. In the current situation, recession probability has risen to over 50%, but it has recently fallen back to below this threshold (chart rhs, p.1). The parallels are more accurate with two episodes of non-recessionary slowdown in 1995-96 and in 2011-12, which saw a surge and then a retreat in recession probability. In both cases, specific shocks with an immediate impact were to blame, with pre-EMU fiscal consolidation and a global growth slowdown in the first instance, and the Eurozone double dip in the second. There was no contagion in an economy operating above its capacity. **The present situation could end in similar fashion, on the threshold of a recession but no further, given that, for two or three months now, business climate indices suggest that the worst is over in the manufacturing sector** (chart lhs).

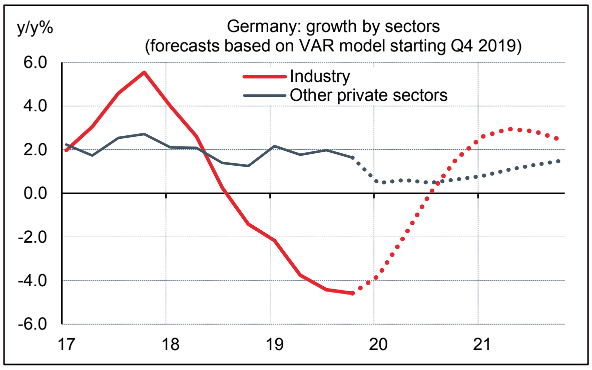
We arrive at a similar conclusion with a VAR-type forecasting model applied to the industrial and private-sector services sectors (chart rhs). Having reached its maximum intensity, the industrial recession will gradually end and manufacturing activity is set to return to expansion territory by mid-2020. On the services side, growth should remain in positive territory but could still slow slightly. This is also the conclusion of the recent surveys in this sector. All told, this points to real GDP growth at around zero in Q4 2019, and a recovery in 2020 towards a pace of +0.4% q-o-q. But it is worth noting that this type of model tends to forecast a return to the historical norm at a relatively slow rate.

The outlook for the German economy is contingent on the automotive sector, bearing in mind that it has driven a good portion of the weakening trend of the last two years. During this period, the sector has suffered something of a perfect storm, with the introduction of rigorous new anti-pollution standards, weakness in large export markets (UK, Turkey, China), and the overarching threat of customs tariffs in the US, to say nothing of the transition to electric vehicles, under pressure from government and EU regulators. The drop in automotive production alone accounts for around 40% of the decline in industrial output since 2018 (and probably more if we factor in the knock-on effects). By way of comparison, the automotive sector's contribution to the collapse in total production came to around 25% at the time of the 2008-2009 financial crisis and less than 20% at the height of the recession at the start of the 2000s. As long as there is no fresh shock, the stabilisation of the pace of global growth in 2019, the easing (to be confirmed) of protectionist measures and the avoidance of a no-deal Brexit are factors that are more favourable to the sector which, in turn, should help to boost industrial activity in Germany. That being said, the reorganisation of the automotive industry is a long-term affair, which carries a number of uncertainties in terms of supply (respecting norms vs sanctions) and demand (pace of the renewal of the existing stock of vehicles). **It would be imprudent to anticipate a V-shaped recovery, even though this scenario makes sense given the severity of the previous correction.** Until now it has, above all, been the adjustment to inventories which has enabled the industry to meet demand for vehicles in the face of sharply falling production. However, this type of adjustment is not limitless.

Germany: business sentiment in the industrial sector



Germany: sector forecasts (VAR model)



Sources: Thomson Reuters, Oddo BHF Securities

All told, a number of signals, still weak at this stage, suggest that the most acute phase of the industrial crisis, particularly in the automotive sector, is now over. The first step is to stabilize the business climate. The latest indicators, such as the PMI and Ifo surveys,

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[3] In 1992-93, 18 months with a cumulative decline in real GDP of 0.7%; in 2001-2003 (29 months, -1.6%); and in 2008-2009 (16 months, -7%).
[4] We estimate the probability of recession based on a model using 16 economic variables (various surveys, production indices, retail sales, employment, job creations, bank loans). The probabilities of recession from the German institute IMK are broadly equivalent https://www.boeckler.de/imk_38710.htm.

point in this direction. **In the absence of fresh external shocks, industrial activity in Germany should fall no lower and as long as employment and credit conditions remain positive, there is no reason that the decoupling of the rest of the economy vis-a-vis the industry should not continue.** In this context, German politicians will likely conclude that there is no reason to ease the fiscal policy, against the advice of a number of international bodies such as the IMF, the OECD, and the ECB. In the short term, they may be right, **but the fundamental question remains whether it is wise for a large economy that appears so dependent on external and sector shocks to continue to accumulate foreign trade surpluses, whilst making no effort to recycle these surpluses in the domestic economy. The debate on economic policy - in the domains of monetary, fiscal and banking policy - remains open even though Germany appears to have only just avoided a recession.** This is a subject that we will be examining shortly in another note.

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