Germany faces more difficult road ahead

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A postcard from.... Germany.

Chief Economist Keith Wade travelled to Frankfurt and Berlin in mid-September to meet senior officials at the ECB, Bundesbank, Finance, Economics and Labour Ministries of the German government plus a think tank. Here, he reports back on the main themes of his discussions.

An optimistic assessment of the German economy and a sense of relief that the Greek crisis is back under control provided a positive backdrop to this visit, which took place just before the Volkswagen scandal broke. However, although no one wanted to say it, the longer term prognosis for Germany looks poor.

The slowdown in China and the emerging markets presents a major challenge when the growth model is based on a significant manufacturing sector which has benefited enormously from the emergence of China and growth in the emerging markets.

Germany is increasing its long-run fiscal commitments through: (a) support for migrants, which may prove to be a short-term boost but long run drag; and (b) the eurozone, through guarantees and the mutualisation of risk in the banking sector, not to mention Greece. These challenges come on top of a demographic deficit which will see the working population shrink in coming years.

It could well be the case that today proves to be the peak for Germany and it thereafter struggles as it seeks to meet its new obligations and keep a balanced budget.

Economy: near term optimism on growth and inflation

There was near universal agreement in my conversations that the German economy was performing fine and was set to grow by 1.8% this year and the same next year. Not surprisingly, the cloud on the horizon was the downturn in China which was expected to lead to some moderation in export growth. Generally, though, this was not seen as a major problem with just 6.5% of German exports (2.5% GDP) going to China, the same as to The Netherlands.

Most saw the problems in China as temporary and expected a government stimulus to lift the economy in 2016. There were offsets for Germany in the form of better demand from peripheral Europe where economies are strengthening, and from increased public expenditure on refugees (more below).

Nonetheless, it was recognised that the impact of recent events in China was not in the data yet, and many companies had significant sales in China (for example, it accounts for one in three cars sold by VW) and that the broad impact could be exacerbated by financial markets, particularly through the euro.

The higher trade-weighted euro combined with the recent tightening of financial conditions was expected to take about 0.2% off eurozone core CPI inflation next year and delay the closure of the eurozone output gap until later in the decade (2019). Downside risks had risen and these developments would seem to have increased the European Central Bank's (ECB) willingness to increase or extend quantitative easing (QE) beyond September 2016. Monetary policy remains the primary source of stimulus given the limits on the fiscal side.

Coming back to Germany, there was some surprise at the lack of inflation this year as a result of the fall in the euro over the past year. Most believed the output gap had closed and, as the economy continued to grow above trend, inflation would normally pick-up. Most welcomed this and none saw inflation as getting out of hand as there was a belief that the ECB had succeeded in stabilising inflation expectations at 2%.

Immigration

The influx of immigrants is seen as positive by all from an economic perspective, by helping to boost demand and address the demographic deficit. It is expected that at least 800k migrants will arrive this year and some 2 million in total over the next four years. Germany already has net migration of 400k p.a. but this would be a considerable step-up. It is estimated that it will take five months to process and settle each refugee. Each will then be offered a six-month German language course to be followed, if necessary, by a technical training course to equip them for the labour market. Initial estimates suggest that such training will be necessary, with unofficial surveys finding that 80-90% of refugees are not currently qualified for the German labour market.

Whilst it is difficult to criticise Germany's approach, there is also a cost which has been put at €10k minimum per refugee. German finances are strong and all we spoke to said "the money is not a problem". However, it may not take long to absorb the €10bn which can be spent before the balanced budget policy is put at risk.

Update: since my visit, Finance Minister Schäuble has asked government departments to prepare savings of up to €2.5bn to finance additional federal expenditure of €9bn for refugees. However, as some of this will be through lower-than-expected interest payments, the expenditure cuts will be correspondingly smaller. Consequently, the net increase in migrant spending so far is about €8bn on current plans. This amounts to about 0.3% of GDP, which – whilst not insignificant – will amount to the maximum effect unless Schäuble relaxes his budget policy.

As for the supply side, adding 2 million people will help address the demographic deficit, whereby the German workforce is set to shrink from 45 million to 36 million over the next 15 years. The impact on potential output though will depend on whether the new arrivals can be profitably employed. In addition to the need to boost skills, there were also warnings that the minimum wage and increased labour legislation would make it more difficult to absorb many migrants at the low skill end of the labour market. The short-term fiscal boost could well turn into a longer-term drag if migrants struggle to find work and fall back on benefits.

“EM export bubble is over”

German economists and policymakers still see the economy as being driven by a strong manufacturing sector which in turn drives the service sector. This traditional view has of course worked brilliantly in recent years as global trade has boomed. Now, the tide was turning as –although there was confidence that China would avoid a hard landing – it was admitted that the “EM bubble” was bursting as the period of extraordinary growth in China was over. Germany still has a strong niche in exports of luxury cars and capital goods, but the economy would have to find a new driver in coming years.

Eurozone

There was surprisingly little discussion on this subject. The Greek situation was seen to have been resolved and officials brushed off suggestions that by showing Greece the euro exit door Schäuble had crossed the Rubicon on the currency being irreversible: “he was only being tactical”, according to one person I met.

There was little appetite for allowing haircuts, although this was not universal, with one official saying “the money has gone and we should admit it”. This issue will come to a head when the IMF, which believes debt forgiveness is necessary, decides whether to renew its commitment to Greece in the New Year.

Schäuble’s balanced budget policy (rather oddly known as “the black zero”) was widely lauded and one got the sense that many would like it to be extended to the whole eurozone. There was significant frustration at the lack of fiscal discipline in the eurozone: there were too many get-outs and too much politics when it came to public deficits. The solution was seen as taking the EU Commission out of the process and bringing in an independent fiscal watchdog. This body would then report to the Eurogroup where finance ministers would have a binding vote. One official described this as his “dream”, but admitted it was unlikely to happen.

Brexit

This came up surprisingly frequently and as the only English person on the trip I was expected to give regular explanations as to why the UK might wish to leave the EU. Encouragingly, there was considerable support in Berlin for the UK remaining a member.

One official said it was “unthinkable” to have an EU without the UK. One who has been close to the process said that they were optimistic on the negotiations with the UK, but more pessimistic on the outcome of the referendum.

The optimism stems from common ground between Germany and the UK on how immigrants may use the benefit system. Freedom of movement remained a red line, but there was scope to do a deal. The pessimism came from the recent change of leader of the Labour party, although since the trip the Opposition has indicated support for remaining in the EU.

There should be a technical report out of Brussels on the UK’s demands in October, followed by a summit in December. That was likely to be followed by a political agreement in early 2016, but only after some “fireworks”. The referendum could then occur after the summer, towards the end of next year.

It was noted that should the UK choose to leave the EU there would be a prolonged negotiation period (up to two years) on unwinding treaties and making new arrangements (details of which have been notably absent from the anti-EU camp). The resulting uncertainty was seen as adversely affecting capital flows into the UK and the country’s international standing.

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