Revisiting the case for a proactive fiscal strategy for Germany

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Can Germany remain competitive in the fields they have been strong in and become more competitive in new fields of business?

On the 26th February our research explored the '***Case for a proactive fiscal strategy for Germany***'. Fast-forward to today and we see September IHS Markit Germany Manufacturing PMI fall to 41.4, missing its preliminary estimate of 44 and down from 43.5 in the previous month. Sentiment remains weak, given political uncertainty and trade war rhetoric, job losses have accelerated and new business has declined at the quickest pace in a decade. So, again, we ask the question—is there a case for a proactive fiscal strategy for Germany?

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Germany is not only under cyclical pressures from the slowdown in China, it will also likely experience new structural challenges in the years ahead. In this note, we make the case for Germany to adopt a proactive fiscal program to deal with both the cyclical and structural headwinds.

1. Germany can easily spend/invest more. This is the positive (descriptive) aspect of Germany's fiscal position. In contrast to much of the developed world, which has seen their public debt-to-GDP ratio rise by between 33-55% since the Global Financial Crisis in 2008, Germany's public debt-to-GDP ratio has actually shrunk (it is at 60% of GDP now, compared to 84% and 106% for the EMU and US, and of course 238% for Japan). After peaking at 81% of GDP in 2010, Germany's austerity has led to a EUR150 billion (19% GDP) reduction in its public debt.

2. The more controversial question is normative (prescriptive): should Germany adopt an expansionary fiscal stance? We believe Germany will likely suffer cyclically from the policy-induced growth deceleration in China, which accounts for 24% of Germany's extra-European exports, 20% of Germany's export growth over the past five years, and 12% of German FDI income. According to the Handelsblatt, the 30 companies on the DAX index have nearly 700 subsidiaries in China, where 15% of the sales are generated. Throughout 2018, Germany under-performed expectations, with quarterly GDP growth of 1.5%, 1.8%, -0.8%, and 0.1%. Each time growth underwhelmed, there were clear explanations, including the low level of the Rhine, diesel regulations, the weather, flu, and strikes. As parents of young children know, when there are too many different explanations for the same issue, probably the main cause is something else. That something else turned out to be China's weakening demand and the deceleration of its industrial complex, which was for a

time disguised by the flattered official data from China. If this trend continues, there seems to us to be a case for a counter-cyclical fiscal policy.

3. More importantly, we believe Germany is about to experience several important structural headwinds. First, the political tolerance for very large external surpluses is likely to be more limited in the years ahead than in the years past. Globalisation will no longer be dictated only by comparative advantages, which ought to translate into predictable trading patterns with free trade. Rather, fair trade will play a bigger role in our globalising world, and one measure of fair trade is whether countries consume products and services from others, just as much as they manufacture and sell to others. In this new political environment, Germany's high aggregate savings rate may no longer be tolerated by the rest of the world. Second, the advent of disruptive technologies may prove to be disruptive also for the German industrial complex. Have the German automakers already fallen behind international competition on electric and autonomous technologies? Can Germany remain competitive in the fields they have been strong in and become more competitive in new fields of business? Is there a role for industrial policies in Germany, given that they have worked so well in China, South Korea, and Singapore? What is Germany's long-term growth strategy and can a proactive fiscal program facilitate such a strategy? We believe the answers to most of the questions above are likely to be affirmative and not negative, and the debate on the appropriate fiscal stance should take into consideration these new structural dimensions that have arisen with the changing world.

With Germany facing structural rather than cyclical challenges, we believe that the moment is ripe to reorient itself with government guidance and assistance.

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