THE VIEW

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Allianz

EULER HERMES

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- In the last quarter of 2018, both the German and French economies observed a significant deceleration of growth. According to our model, in Germany, one third of the drop comes from political instability and 20% from trade uncertainty – that is close to 50% which could be assigned to US-China trade tensions– and another third from the very specific regulatory shock in the auto industry. In France, 40% of the downward adjustment comes from trade, while 50% of the adjustment comes from political uncertainty related to the Yellow Vest movement.
- Going forward, both countries have three elements on the watchlist:
    - Households' saving ratio has increased beyond structural reasons (unemployment and ageing). Cyclical factors such as constrained residential investment and consumption of durable goods in Germany, and policy uncertainty and limited wage growth in France, will weigh on 2019 consumption outlook.
    - While trade talks between the US and China are still to experience a happy ending, attention seems to be on Germany's car exports to the US. We estimate the cost of a 25% tariff increase on imported European cars to the US at EUR 7bn in losses every year for Germany – EUR 190mn for France – and EUR 14 bn for the EU as a whole.
    - To calm social tensions in France, and make the pension system more progressive in Germany, fiscal stimulus will be at play. In Germany, the fiscal surplus is expected to decline from +1.7% of GDP in 2018 to about +0.8% this year. In France, the fiscal deficit will increase to -3.2% of GDP in 2019.
- All in all, the limited carry-over from 2018 growth (0.0pp for Germany; 0.4pp for France) and realistic expectations for savings patterns, trade and fiscal impulse led to significant revisions to our 2019 GDP growth forecasts: +1.0% for Germany and +1.2% for France, before a timid recovery in 2020: +1.5% in France and +1.4% in Germany.

Photo by Sarah Cervantes on Unsplash

2019 GDP growth forecast for Germany

+1.0%

2019 GDP growth forecast for France

+1.2%

DIFFICULT END TO 2018

In the last quarter of 2018, both the German and French economies observed a significant deceleration of growth. Quarterly GDP growth was flat in Germany in Q4 2018, and grew only timidly in France (+0.3%) with flat consumption and contracting residential investment. To understand the reasons behind such consumption and production shocks, we developed a model to disentangle the contributors to growth in industrial production in both Germany and France, based on total industry confidence index, economic policy uncertainty and global trade.

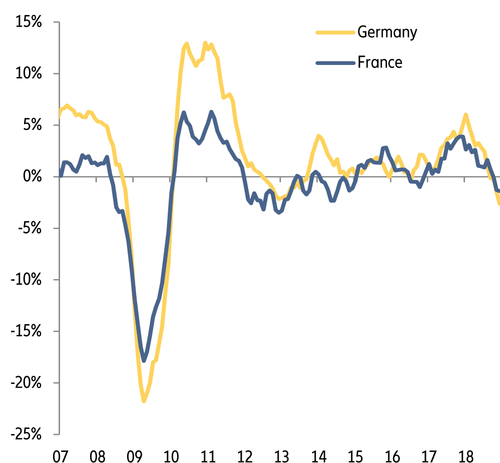
Figure 1 shows that in Germany, industrial production went down by -3.9% y/y in December 2018. In France, industrial production went down by -1.4% y/y in December. From its last peak in both countries in November 2017, the cyclical adjustment was visible but definitely got sharper for transient reasons in Q4 2018. According to our model, in Germany, one third of the drop comes from political uncertainty (US-China trade uncertainty and the domestic political standstill, presumably), another third from domestic business difficulties, certainly related to new norms in the auto sector, and 20% from actual trade deceleration. In France, 40% of the downward adjustment in industrial production is related to global trade, while 50% of the adjustment comes from political uncertainty, that is the Yellow Vest movement. In both cases, our models explains close to 90% of the variance. We therefore have a clear illustration of common causes explaining the deceleration of industrial production in these two countries (trade) and specific factors (political uncertainty in France and an industry-specific factor related to the car sector in Germany).

German car manufacturers were not prepared for a rapid implementation of new norms

In 2018, the German economy grew for the ninth year in a row. However, at +1.5% (working-day adjusted), it recorded its weakest GDP expansion since 2013. Domestic demand was the main growth driver in 2018. Investment in machinery & equipment and construction showed robust growth of +4.5% and +3.0%, respectively. Thanks to strong domestic demand, imports registered strong growth of +3.4%.

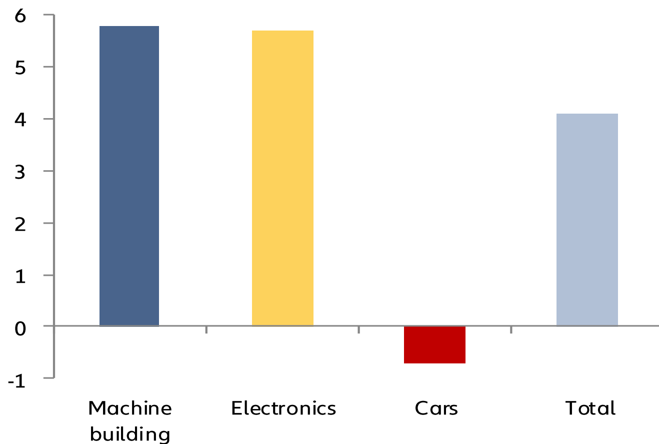
Exports disappointed with an increase of only +2.4%. In part, the relatively poor export performance is evidence for the negative impact of the smoldering trade dispute between the US and China, as well as the economic slowdown in China and other important emerging markets. Overall, net exports contributed negatively to real GDP growth in 2018 (-0.2ppt). Despite the fact that both nominal and real disposable income of private households increased only slightly less in 2018 than in 2017 (nominal: +3.2% vs +3.4%, real: +1.6% vs +1.8%), the growth of real private consumption almost halved from +1.8% in 2017 to +1.0%. in 2018.

Figure 1 Industrial production in France and Germany, y/y in %



Sources: Bloomberg, Allianz Research

Figure 2 Exports by usual top three export sectors: Jan-Oct 2018, nominal, percentage change over previous year



Sources: Destatis, Allianz Research

We assign a major part of the disappointing export performance to the problems in the auto sector (diesel scandal, problems with the certification of vehicles according to the new WLTP emissions test procedure):

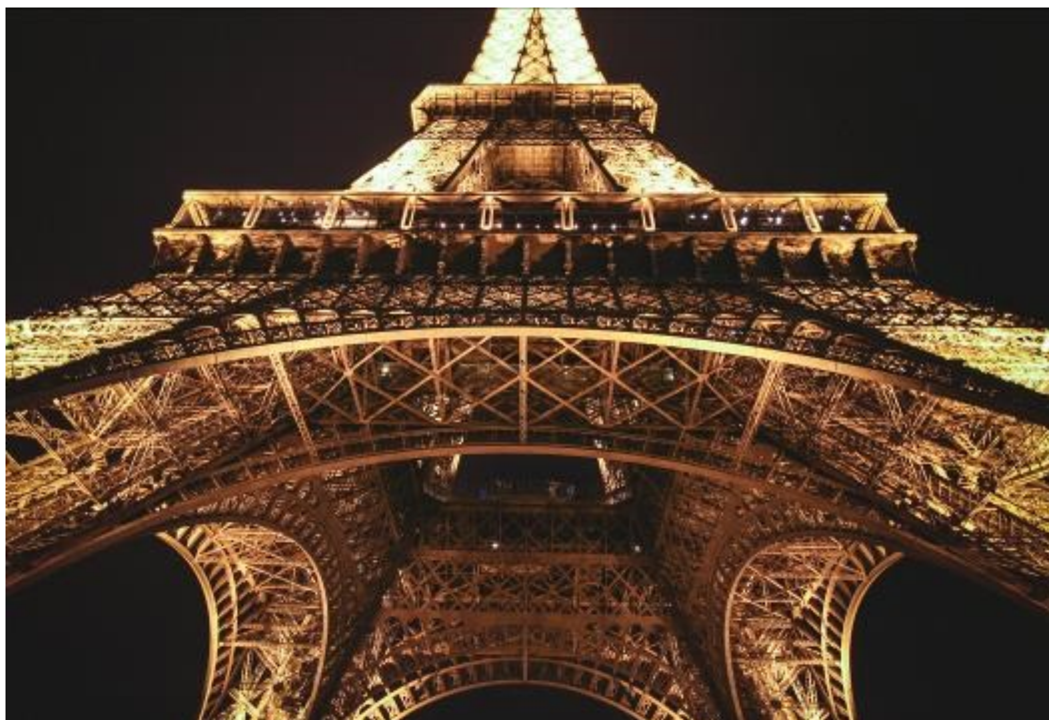
- The uncertainties linked to these problems made many private households postpone their car purchases, particularly in the third quarter. The result: At least a temporary significant increase in the savings ratio. For the sake of comparison, had the savings ratio in 2018 been at the same level as in the previous year, private consumption would not have risen by +1.0% in real terms, but by more satisfying +1.5%.
- Looking at sectors, the poor export performance observed in 2018 was explained by the sector "tractors, motor vehicles, motorcycles and bicycles" or, in a somewhat simplified way, the car industry. While the sectors machine building and electronics registered solid year-over-year growth rates in the period January-October 2018, exports from the car sector actually contracted.. China's shrinking auto market in terms of new car registrations and the already mentioned WLTP issue are the most important reasons for this.

France: Hastened reforms and the curse of the left behinds

Last year reopened some divides in the French economy observed after a lost decade (2007-16) in terms of income, jobs, insolvencies and profit margins. France still has a high unemployment rate (youth unemployment in particular is at 22%), low wage growth (+1.5% in 2018) and a high cost of pensions (14% of GDP). Government willingness to reduce the pension cost has started through the substitution of labor taxes by broader income taxes (levied also on pensions) and the end of pensions indexation to the CPI. But it came in a year where income growth was disappointing and returned to 2007-16 subdued levels.

France has registered several shocks in 2018. The first one was a price shock and was ignited through an oil-price increase, with the impact on prices intensified by an oil tax hike from January 2018. As a result, household savings were suddenly cut by -0.6pp in Q12018 to 13.7%. The second was a strike in Q2 with an impact of -0.2pp in terms of GDP growth and no catch-up effect afterwards. These two shocks were already enough to nurture a trend reversion of business insolvency dynamics, with a +2.1% increase from May to October 2018 (transport and construction showed the more noticeable insolvency growth). Adding to that, we observed a situation of overproduction in the manufacturing sector in H2 2017, since great demand expectations were missed by a wide margin. Manufacturers had to backpedal, triggering an industrial recession in H12018.

From September on, a new combination of shocks (fiscal consolidation plans, a new oil-price surge, car output slump) weighed again on household confidence and drove business confidence down, peaking in the Christmas season when the Yellow Vest movement hit mainly the retail and transport sectors. The strikes that have arisen from the impact of poorer income growth and purchasing-power issues particularly the Yellow Vest movement should also have an impact on 2019 as they triggered key changes. First, it seems that unemployment figures will also exhibit a small uptick (already in December, 60k people were laid-off) as a consequence of lower growth and higher insolvencies. Household unemployment expectations surged and so did their durable goods-purchases prospects, which should reverberate particularly on residential investment (-0.5% expected in 2019), car purchases and household-equipment spending. Now, households are worried about their income growth (in 2018, the worry was about purchasing-power issues driven by inflation and taxes).



THREE THINGS TO WATCH IN 2019: SAVINGS, TRADE, AND FISCAL IMPULSE

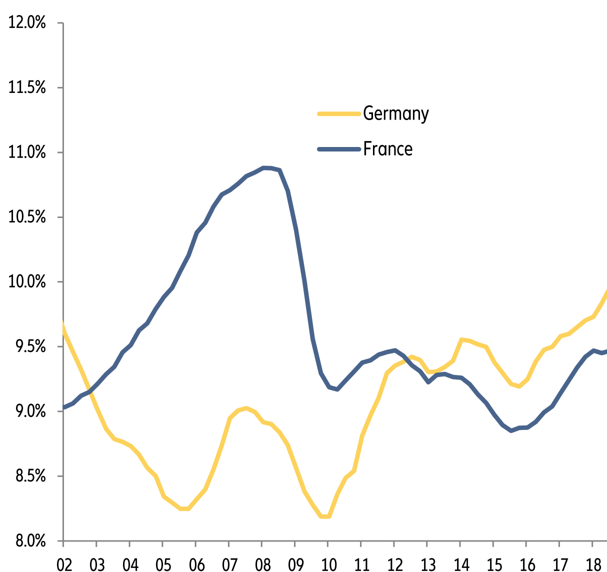
Higher saving ratios in both countries: A reason to worry?

In 2018, uncertainty led to a higher saving rate in both countries. The savings ratio of private households in Germany increased strongly by +0.4pp to 10.3%, the highest since 2008. It could increase again to 10.5% in 2019. At the same time, in France, we expect savings to increase by +1pp to 15.3% of disposable income from Q3 2018 to Q1 2019.

However, purchasing-power issues in France and the postponement of car purchases in Germany are not the only drivers of this trend. Both countries exhibited about +4% growth in housing prices over the last year, hampering real household investments in housing, and keeping the savings rate higher. When breaking down the households' savings ratio (in investment ratio plus financial savings ratio), we notice that higher real investment and higher prices were together responsible for increasing household investment ratios in the two economies by +0.8pp in terms of disposable income from mid-2015 to date. At the same time, financial savings were quite stable in Germany and were cut by a marginal amount in France (-0.2pp).

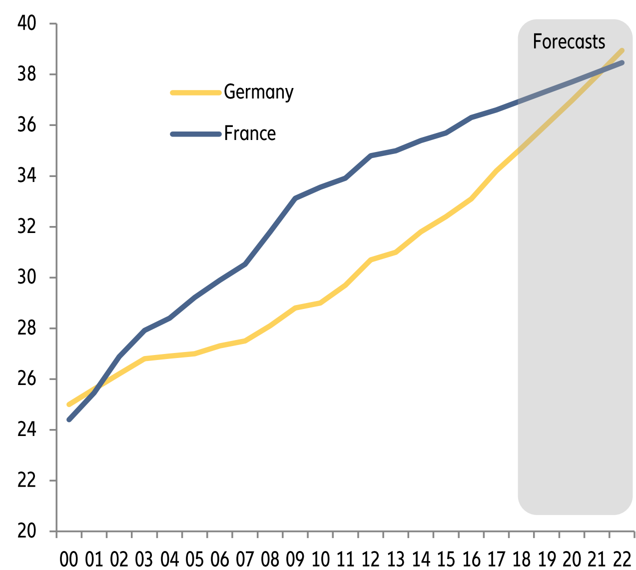
This propensity to save can also be explained by expected stabilization of wages around +1.5% growth in France (vs +2.5% in Germany). Under continued parallel tracks for wage growth, we expect wages to converge again between France and Germany by 2022 to close the gap that appeared in 2002. This also means that the share of compensation of employees in the value added will likely stabilize in France, a pressure that is likely to trigger high savings.

Figure 3 Household investment ratio (investment in % of disposable income, 4Q average)



Sources: ONS, Eurostat, Bloomberg, Allianz Research

Figure 4: Unit labor costs per hour worked (EUR): France vs. Germany



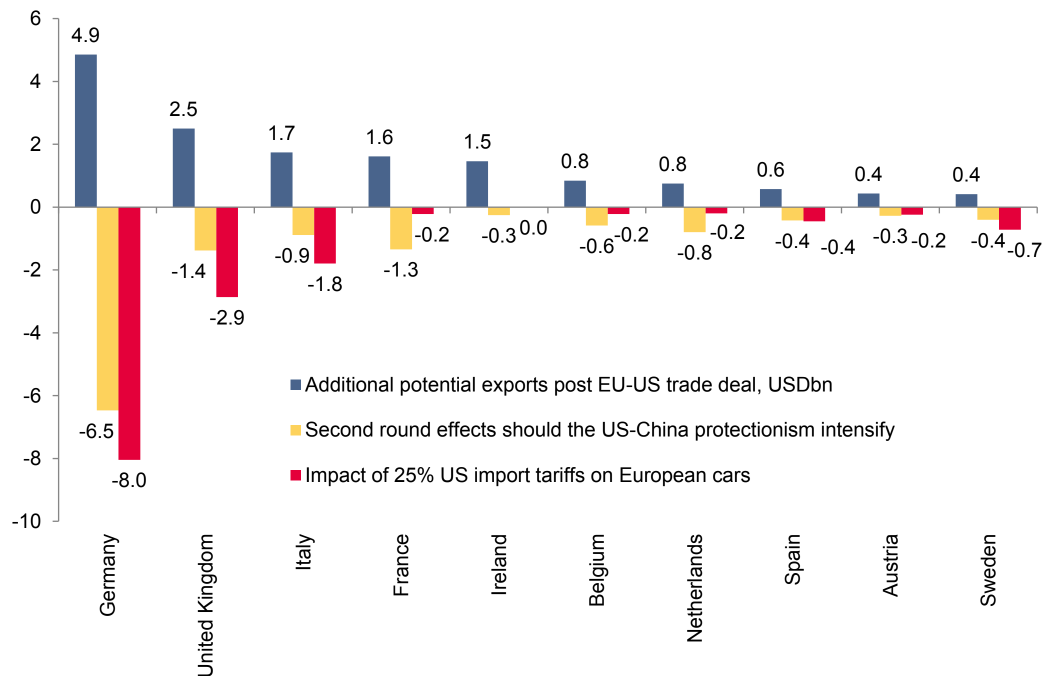
Sources: ONS, Eurostat, Bloomberg, Allianz Research

Structural reasons for higher financial saving ratios are still important to keep in mind: Unemployment in France, and ageing in Germany. Indeed, the unemployment level (and fears) are a major reason to save in France, where 8.8% of the population is unemployed (3.3% in Germany). The French unemployment problem is expected to improve gradually and the unemployment rate to converge to 8% by 2022. Ageing is a more obvious driver of long-term saving patterns in Germany since the country will have one employee contributing to social security per retiree by 2035 (according to the Bertelsmann Foundation); France is expected to keep 1.5 workers per pensioner (according to the French COR) in 2035.

A tentative trade shock on Germany… and France

The automotive sector is the second-biggest EU export sector to the US after machinery and equipment. In 2017, total automotive exports by the EU to the US stood at around EUR 50 bn (11% of total EU exports). Should the US implement a 25% tariff on its auto imports from the EU (Figure 5), Germany could lose as much as USD 8bn (or EUR 7 bn) every year, which is half of the total EU amount. This would translate into 270 000 fewer exported EU cars (out of the 1.15 million European cars sold into the US) and would mean an additional average cost of EUR 6 500 per EU car in the US. For France, the losses are less impressive - ~EUR 190 mn - but significant given the large trade deficit France has been running for the past fifteen years (today at –EUR 60bn).

Figure 5 Top 10 EU countries likely to win most from a USA-EU trade deal (CETA-type) vs impact from a Trade Feud scenario (USDbn)



Source: Chelem, , World Bank,, Allianz Research

Fiscal stimulus to the rescue in France… and Germany!

Fiscal policy will become supportive in both France and Germany in 2019, although for different reasons.

In Germany, the degree of expansion of fiscal policy will increase strongly in 2019. The budgetary impact of the fiscal policy measures will be more than EUR 22bn or 0.6% of GDP (after EUR 8.2bn or 0.2% of GDP in 2018). Public expenditure is set to rise significantly by about +4.5% (2018: about +3%). This is mainly due to pension policy measures, as well as investment measures and additional expenditure in the area of development aid. Changes to the so-called maternal pension (Muetterrente II) alone account for EUR 3.8bn in additional spending in 2019. With employment and wages continuing to rise, income from taxes and social security contributions will continue to increase in 2019 as well. However, lower economic growth momentum and policy measures such as the increase in child allowances and basic allowances (EUR 1.3bn in total) will have a dampening effect. Overall, revenue growth in 2019 will be considerably below last year's outcome (< +3%, after more than 4% in 2018). Thus, the fiscal surplus is expected to decline considerably from +1.7% of GDP in 2018 to about +0.8% this year.

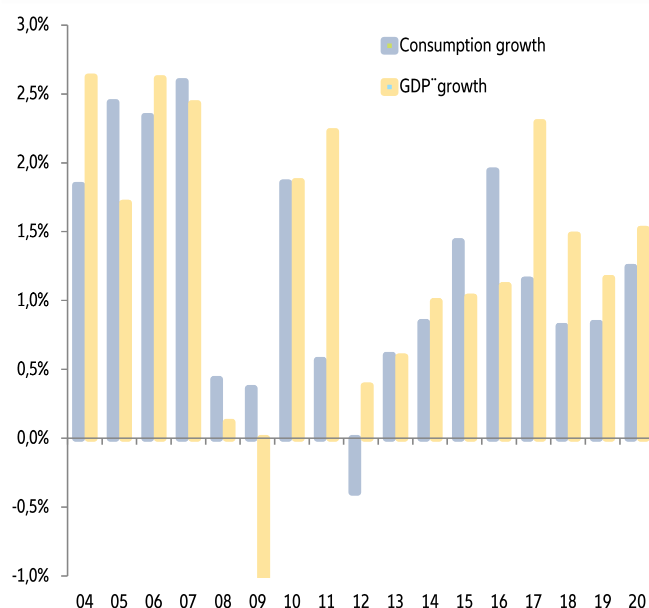
In France, the situation is different. The government announced a EUR 10bn policy package (mainly through higher public subsidies for lower-income wages) that will likely push the fiscal balance to -3.2% of GDP in 2019 (-2.7% in 2018), off-track compared to EU constraints. In our view, these measures are not shifting French government priorities. It shows a willingness to answer to the strikes in order to end the protests and then reignite the calendar of reforms, with the next topics being unemployment benefits and the pension reforms. However, this still means that the calendar of reforms will probably be lengthened. Fiscal spending (56% of GDP in 2018) will stay high for longer. This will not pave the way for stronger tax cuts (total corporate tax and contributions represent 62% of profits), considering that the tax on corporate value added are among the highest in Europe (about 3%).

2019: FIGHTING FOR +1% GROWTH

In France, we expect growth normalization from Q2 onwards (about +0.4% growth per quarter), based on lower inflation (+1.2% on average in 2019, compared to +1.8% in 2018) and voted tax cuts. Consumer spending will recover. However, the fiscal multiplier should be lower than expected since households turned more pessimistic about their financial situation (in 2018). Overall, this would put consumption growth at +1% in 2019, quite the same low growth as in 2018 despite better purchasing-power growth (+1.9% in 2019, compared to +1.1% in 2018). The likelihood that the government will revert to its reform agenda sooner or later will also trigger a short-run negative impact on household sentiment since pension reform is on its A-List. As a result, consumption will likely lag again in 2020 (+1.3% expected growth, compared to +1.5% GDP growth), putting even more pressure on consumer-related sectors' payment behavior.

Germany faces a combination of risks to its export-dependent growth model (slowing China, the trade dispute, political risks such as Brexit, Italy) but fundamentally the German economy is still solid. There was no negative income shock in 2018 and growth in households' disposable incomes is likely to pick up from +3.2% in 2018 to +3.6% in 2019, driven by employment growth (+0.9%), tax cuts and additional social benefits that will take effect in 2019. This will allow German households to increase their consumption (+1.3% in 2019). However, based on the less favorable-than-expected starting point for the current year, and the deteriorating external environment, we have revised downwards our real GDP growth forecast for 2019 from +1.7% to+1.0%. It now stands clearly below 2018 growth (+1.5%). The continuing uncertainty, particularly in connection with the trade conflict, is likely to weigh on investment activity. For 2019, we therefore expect a slowdown in growth in investment in machinery and equipment to +2.4% (2018: +4.5%). By contrast, construction remains on the upswing, even though capacity bottlenecks are limiting growth here. As in 2018, real construction should increase by close to +3% in 2019.

Figure 6 France, consumption growth vs. GDP growth



Sources: IMF, Euler Hermes, Allianz Research

Table 1 and 2 France and Germany forecasts in % (quarterly profiles are q/q growth rates)

France	2017	2018	2019	2020	12 17	03 18	06 18	09 18	12 18	03 19	06 19	09 19	12 19
GDP	2.3	1.5	1.2	1.5	0.7	0.2	0.2	0.3	0.3	0.2	0.4	0.4	0.4
Consumer Spending	1.1	0.9	1.0	1.3	0.2	0.3	-0.1	0.4	0.0	0.3	0.4	0.3	0.3
Public Spending	1.4	1.0	0.9	0.8	0.2	0.1	0.3	0.2	0.4	0.2	0.2	0.2	0.2
Investment	4.7	3.0	1.9	2.1	0.8	0.3	0.8	1.0	0.2	0.2	0.4	0.7	0.7
Construction	5.6	2.0	-0.6	1.2	1.0	0.5	0.2	-0.1	-0.4	-0.3	-0.1	0.1	0.2
Equipment	4.4	3.2	2.6	2.3	1.0	0.2	0.8	1.3	0.4	0.4	0.6	0.8	0.8
Stocks	0.2	-0.5	-0.2	0.0	-0.2	-0.1	0.2	-0.5	-0.1	0.1	0.0	0.0	0.0
Exports	4.7	3.1	2.9	2.8	2.2	-0.4	0.0	0.2	2.4	0.2	0.4	0.6	0.7
Imports	4.1	1.1	2.0	2.4	0.2	-0.5	0.6	-0.7	1.6	0.5	0.1	0.5	0.5
Net exports	0.1	0.6	0.3	0.1	0.6	0.0	-0.2	0.3	0.2	-0.1	0.1	0.0	0.1

Germany	2017	2018	2019	2020	12 17	03 18	06 18	09 18	12 18	03 19	06 19	09 19	12 19
GDP	2.5	1.5	1.0	1.4	0.5	0.4	0.5	-0.2	0.0	0.3	0.5	0.4	0.4
Consumer Spending	1.8	1.0	1.3	1.5	0.2	0.5	0.3	-0.3	0.2	0.5	0.5	0.4	0.3
Public Spending	1.6	1.1	1.5	1.4	0.4	-0.5	0.8	0.2	0.4	0.3	0.4	0.4	0.4
Investment	2.9	3.0	2.8	2.7	0.8	0.3	0.8	1.0	0.2	0.2	0.4	0.7	0.7
Construction	2.9	3.0	2.8	2.7	0.2	1.6	0.9	0.9	0.8	0.6	0.5	0.7	0.7
Investment in machinery/equipment	3.7	4.5	2.4	2.7	0.5	2.1	0.1	0.8	0.7	0.5	0.4	0.8	0.8
Stocks	0.2	-0.5	-0.2	0.0	-0.2	-0.1	0.2	-0.5	-0.1	0.1	0.0	0.0	0.0
Exports	4.6	2.4	2.3	3.1	1.7	-0.3	0.8	-0.9	0.8	0.8	0.8	0.7	0.7
Imports	4.8	3.4	3.9	3.1	1.4	-0.3	1.5	1.3	1.0	0.9	0.9	0.7	0.7
Net exports	0.3	-0.2	-0.1	0.0	0.2	0.0	-0.2	-1.0	0.0	0.0	0.0	0.0	0.0

Source: Allianz Research

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