European Daily: Is Germany in Recession? (Durré/Fawcett)

- Industrial production has declined sharply in Germany and, following negative real GDP growth in Q3, has raised fears about a technical recession. We have marked down Q4 growth notably (and now look for only 0.8% annualized) but see three reasons not to worry too much about a German recession.
- First, industrial production is a noisy indicator and a number of distortions have likely weighed on industrial activity in recent months. These include continued problems in the autos industry (related to a change in environmental standards) and potential seasonal adjustment issues (stemming from a bridge holiday in November).
- Second, the broader dataflow remains consistent with moderate growth in Germany. Our current activity indicator (which includes consumer and labour market data in addition to industrial indicators) has slowed markedly over the last year but is still consistent with moderate growth.
- Third, a number of domestic macro drivers should support growth in 2019. Fiscal policy is set to boost growth significantly this year, strong wage gains should continue to support household income and bank lending conditions remain favourable. We therefore still expect a return to above-trend growth i n 2019.

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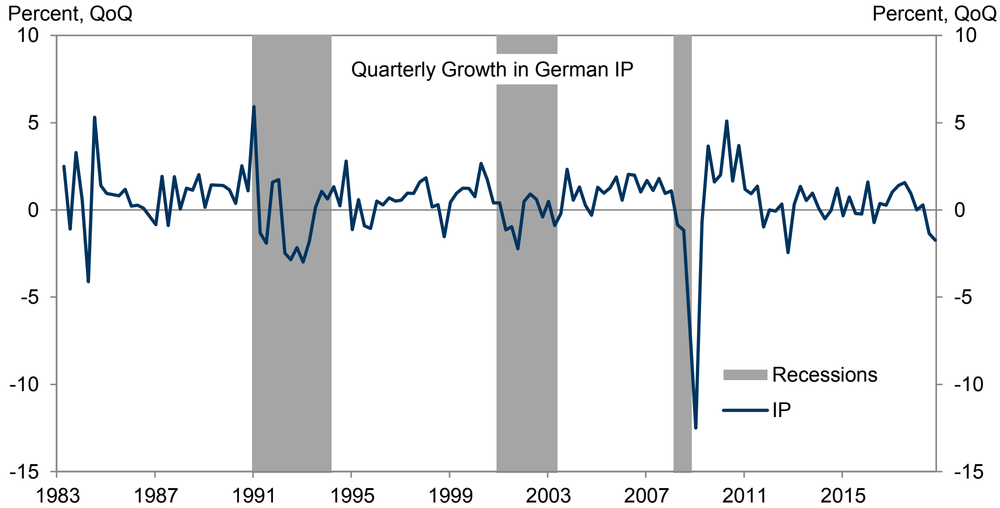
Is Germany in Recession?

The fall in German industrial production in November—coming after negative real GDP growth in Q3—has raised fears that Germany is in technical recession. The average level of production in October and November is now down 1.7% relative to Q3 and Exhibit 1 shows that sharp declines have often gone hand-in-hand with recessions in Germany.

Exhibit 1: Germany on Recession Watch?



Source: Destatis, Haver Analytics, Goldman Sachs Global Investment Research

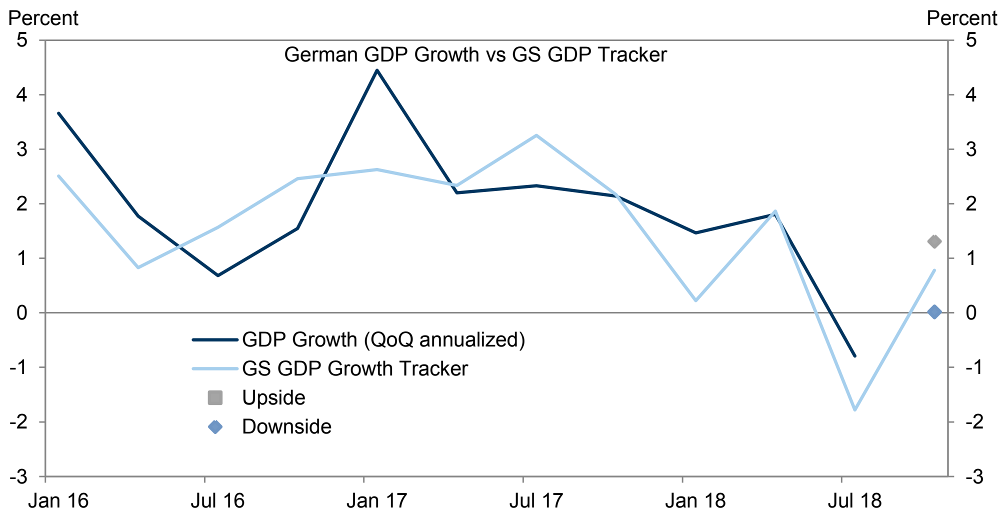
We therefore mark down our expectations for Q4 real GDP growth notably. We use our GDP tracker to derive three scenarios for Q4 GDP growth based on different assumptions for the December indicators.[1]

In the baseline case we assume that industrial production recovers the November decline in output, and some other key indicators—manufacturing orders and retail sales—also partially recover from recent weakness.[2] This delivers a nowcast of 0.8% quarterly growth (annualized) for Q4 (Exhibit 2). Even assuming a particularly strong set of December data in an upside scenario (grey diamond), the impact of weakness earlier in the quarter weighs on the overall growth rate, with 1.3% sequential annualized growth. A purely statistical forecast (which uses data already published in December alongside historical data) points to a downside scenario of zero growth in Q4 (blue diamond). We use the baseline scenario and revise down our 2018Q4 GDP forecast to +0.8% (from +3.6% previously).

1 See Alain Durré, Nicholas Fawcett and Michael Cahill, "A German Rebound Roadmap", *European Views, December 6, 2018.*

2 In the baseline case we assume that IP grows by 2% month-on-month (mom) in December, manufacturing output by 0.5% and retail sales by 0.5%. In the stronger scenario we assume growth rates of 3.5%, 1%, and 1% respectively.

Exhibit 2: We Now Expect a Very Weak Q4



Source: Destatis, Haver Analytics, Goldman Sachs Global Investment Research

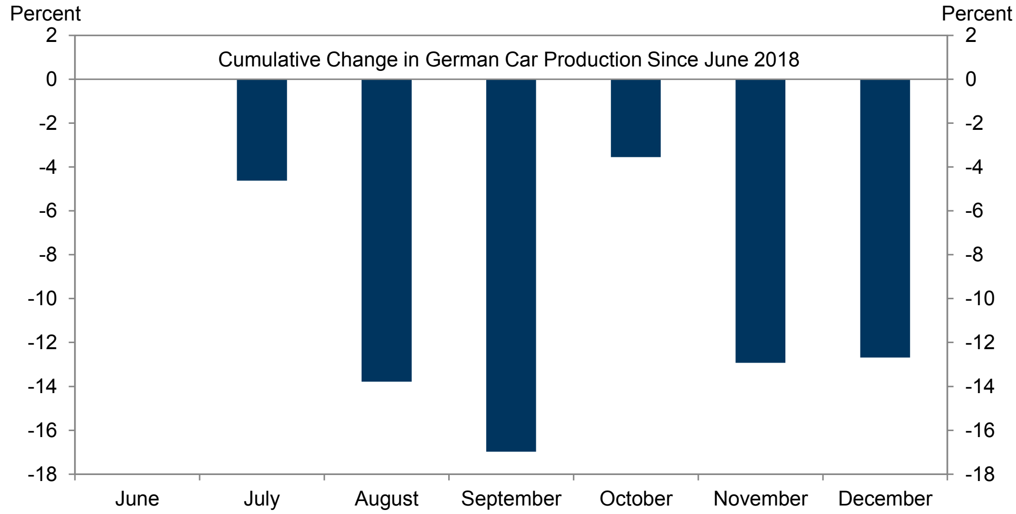
But we see three reasons to expect a return to above-trend growth in 2019.

First, industrial production is a noisy indicator and a number of distortions have likely weighed on industrial activity in recent months. While it is unusual to get two large consecutive falls in IP, it does not mean that the economy is in recession. Exhibit 1 shows that German recessions have always gone hand in hand with sharp falls in quarterly production, but the reverse is not true.

Moreover, we see evidence that the signal from recent production data has been distorted by temporary factors. The primary disruption in Q3 emerged from car producers as they adjusted to new emissions regulations.[3] We continue to think that these effects will pass but recent data suggest the recovery will be more drawn-out; German car production in December was only 0.3% higher than in November (on a seasonally adjusted basis), and remains 12.7% below its level in June (Exhibit 3). We have therefore also shave one tenth of our 2019Q1 forecast and now look for 2.0% (annualized).

3 For further background see Alain Durré, Nicholas Fawcett and Michael Cahill, "A German Rebound Roadmap", *European Views, December 6, 2018.*

Exhibit 3: Car Production Slowly Recovering Lost Output



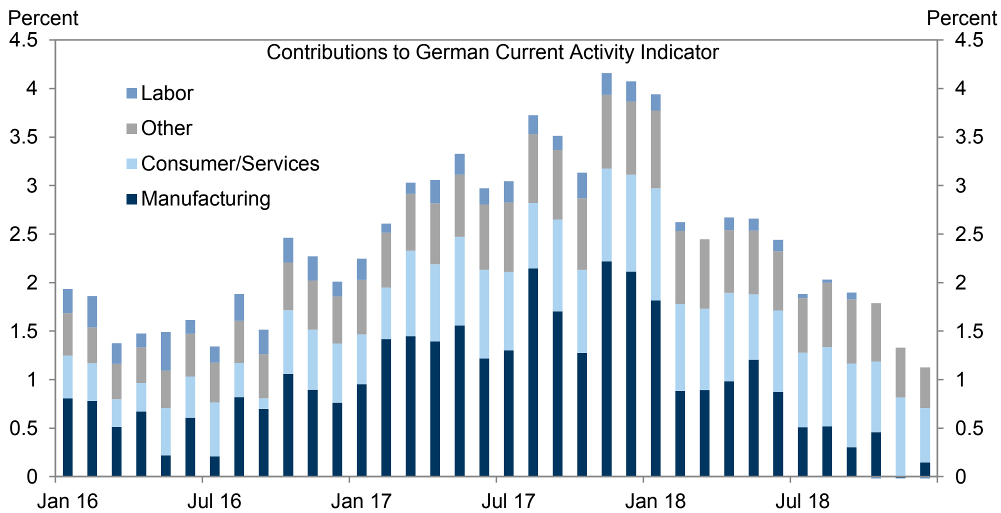
Source: Destatis, Haver Analytics, Goldman Sachs Global Investment Research

Other distortions may also be at play. For example, unusual holiday patterns around All Saints' Day in November might have artificially depressed output, thereby overstating the sequential fall in seasonally adjusted data. Estimates of residual seasonality suggest that the holiday timing might have reduced industrial production by 1% in November, although this estimate is not statistically significant and thus only tentative.[4]

Second, the broader dataflow remains consistent with moderate growth in Germany. Our Current Activity Indicator (CAI) has decelerated markedly over the last year, but is still running a bit above 1% in November (Exhibit 4). The CAI shows that the contribution from the manufacturing sector has fallen notably over the past year, but other sectors such as services have held up better.

[4] In regressions of month on month IP growth on changes in working days (not shown), an indicator of whether All Saints' day was on a Thursday, and month dummies, we find that IP growth is one percentage point weaker in affected years. But this effect is not statistically significant.

Exhibit 4: Broader Activity Still Holding Up



Source: Goldman Sachs Global Investment Research

Third, a number of domestic macro drivers should support growth in 2019.[5] We expect the fiscal stance in Germany to be supportive this year—boosting growth by 3/4pp—with room to expand further should economic conditions deteriorate.[6] The pickup in wage growth points to firm household income gains, which should support consumer spending. Moreover, bank lending conditions remain favourable for firms and households. Following a weak 2018H2, we therefore still expect a return to above-trend growth in 2019.

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[5] See Alain Durré, "Germany's Outlook 2019-2022: Rotating but resilient growth", *European Views, December 28, 2018.*

[6] See Lasse Holboell Nielsen and Roxane van Cleef, "A Larger Fiscal Boost", *European Daily, January 9, 2019.*

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