CRÉDIT AGRICOLE S.A.

22 July 2019

GERMANY

2019-2020 SCENARIO

Philippe VILAS-BOAS

"Growth cropped by problems in industry"

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1 OVERVIEW
GROWTH CROPPED BY PROBLEMS IN INDUSTRY

The Q1 rebound in German growth turned out to be a short-lived respite. The fall in industrial activity dragged on through Q2 and is having a substantial adverse effect on the outlook for annual growth. Automotive production is at a record low and the other major industrial sectors are not picking up for want of sufficiently full order books. Fortunately, activity in the service sector is so far offsetting industrial activity but it will not be able to sustain growth on its own in the longer run. Germany still benefits from support factors allowing it to hope for low but positive growth in 2019 and 2020. Wages should still continue to see strong growth and support private consumption. Public expenditure is expected to rise in accordance with the coalition agreement. Investment looks set to fall but will remain the second largest contributor to growth. Conversely, net exports should continue to penalise GDP growth for the foreseeable future. We have revised our annual growth scenario down to +0.7% in 2019 due to a worsening outlook for recovery in industry. We feel that industrial activity should rebound more significantly next year, which is why we are forecasting a slight uptick in the pace of growth, to 1%, in 2020.

Household consumption should pick up on the strength of the robust wage increases expected this year and next. The labour market will be faced with new tensions, however. The job creation rate should be lower than that recorded last year due to lower activity levels but will nevertheless remain positive. Short-time working is likely to allay the lack of momentum in industry. Measures to regulate the labour market could also degrade the unemployment figures if the recovery in industrial activity were too long in coming. Inflation pressures should stay low, benefitting real incomes and consumption over the long term.

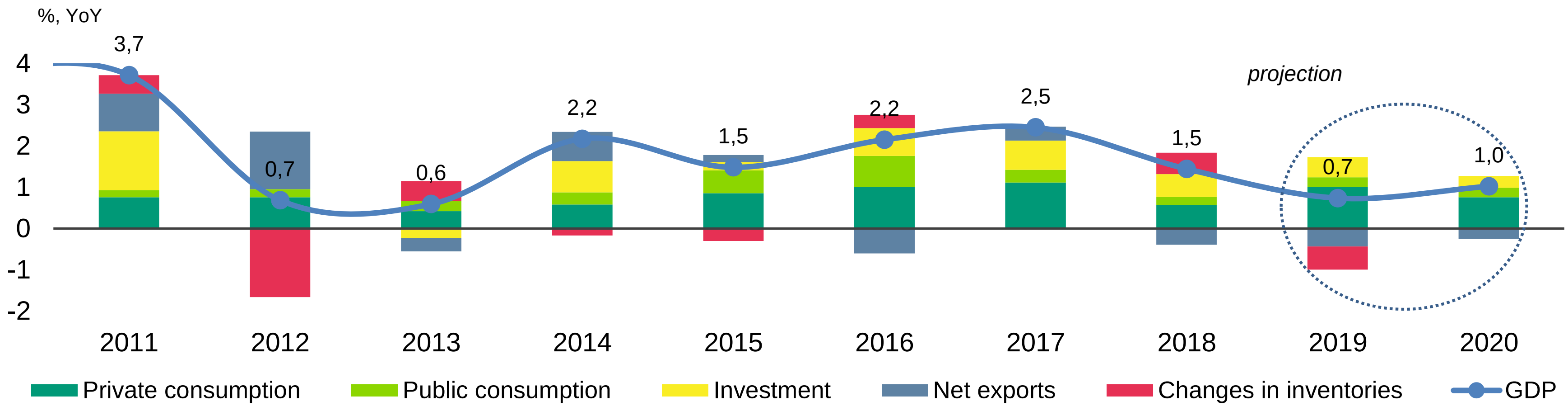
Public consumption seems to be picking up slightly in accordance with the deployment of the coalition programme to increase public investment and pensions, along with other family support measures. The fiscal surplus built up over recent years is helping to guarantee a downward trajectory for debt, which should fall to below 60% of GDP this year.

Investment should again be the second pillar of growth even if it is likely to decline gradually. It will still be able to count on a sustained contribution from investment in construction. Productive investment is slightly more at risk, not only due to the increase in unit wage costs, which squeezes corporate margins, but also to the fears of a more pronounced slowdown in world trade.

Germany's trade surplus will be more exposed to declining growth in the US and Chinese growth, its two main trading partners. The threat of higher US tariffs on the automotive sector has been pushed back six months, but has not been definitively removed. The probability of the UK's exit from the EU without a deal has risen, raising concerns of a greater deterioration in cross-Channel trade.

OVERVIEW
GROWTH CROPPED BY PROBLEMS IN INDUSTRY

Contributions to annual growth



Sources: Eurostat, Crédit Agricole SA / ECO

	Yearly average (YoY, %)				Quaterly growth (QoQ, %)											
Germany	2017	2018	2019	2020	2018				2019				2020			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	**2,5**	**1,5**	**0,7**	**1,0**	**0,4**	**0,5**	**-0,2**	**0,0**	**0,4**	**0,2**	**0,2**	**0,2**	**0,3**	**0,3**	**0,2**	**0,2**
private consumption	2,0	1,1	1,9	1,4	0,2	0,3	-0,1	0,3	1,2	0,3	0,3	0,3	0,4	0,4	0,3	0,3
investment	3,6	2,7	2,4	1,4	1,1	0,6	0,5	0,8	1,1	0,1	0,2	0,2	0,5	0,5	0,3	0,3
change in inventories *	0,0	0,5	-0,6	0,0	0,1	0,3	0,8	-0,6	-0,6	0,0	0,0	0,0	0,0	0,0	0,0	0,0
net exports *	0,3	-0,4	-0,4	-0,2	0,0	-0,3	-1,0	0,0	0,2	-0,1	-0,1	-0,1	-0,1	-0,1	-0,1	-0,1
unemployment rate	3,8	3,4	3,2	3,1	3,5	3,4	3,4	3,3	3,2	3,2	3,2	3,2	3,1	3,1	3,1	3,1
Inflation	1,7	1,9	1,4	1,7	1,5	1,9	2,2	2,1	1,6	1,6	1,2	1,3	1,8	1,7	1,7	1,5
Government net lending	1,0	1,7	1,2	1,0												

** Contributions to GDP growth*

Sources : Crédit Agricole SA, estimates

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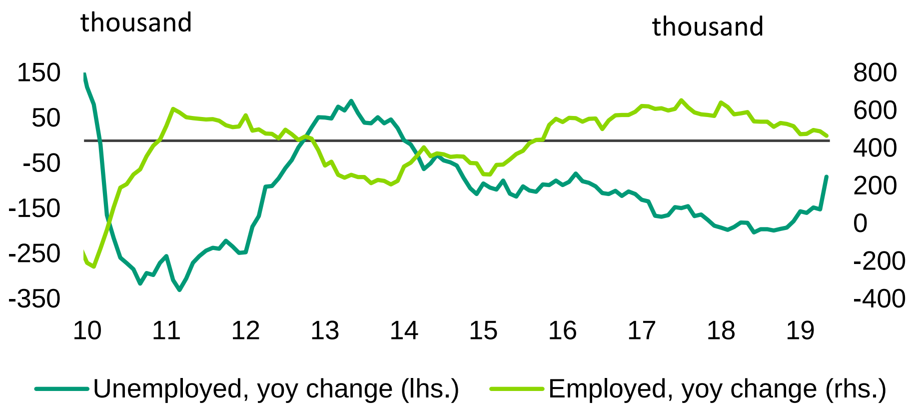
2 FOCUS 1: LABOUR MARKET DOWNTURN?

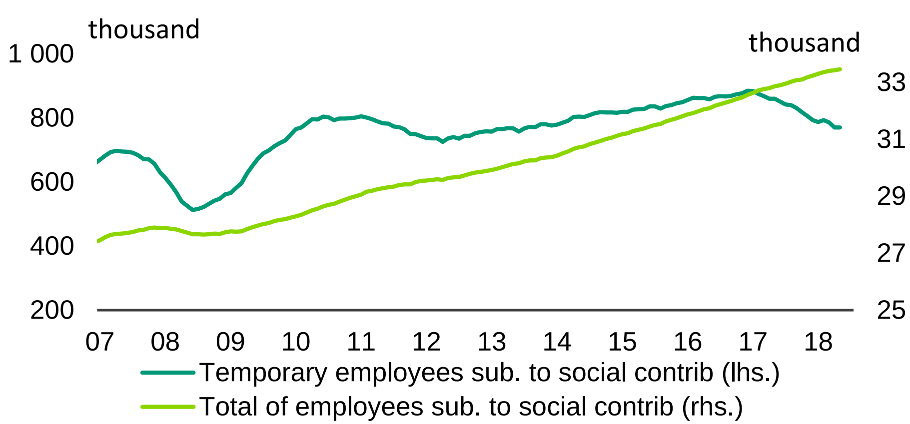
IS THERE SUFFICIENT GROWTH TO HEAD OFF A RISE IN UNEMPLOYMENT?

Labour market



Sources: DB, Crédit Agricole SA / ECO

Temporary work



Sources: DB, Crédit Agricole SA / ECO

- The number of jobless rose by 60,000 in May according to Germany's employment agency, the biggest increase recorded since April 2009. Job creation has been gradually slowing year-on-year since February 2018 but is nevertheless positive over the period. The number of job vacancies was also down in May compared with April and has been trending down since the second half of 2018.
- The deterioration in the economic environment is more visible in the labour market, with surveys suggesting that firms are loath to hire given their depleted order books.
- One recent Ifo survey flagged up a desire to rely more on short-time working: some 8.5% of industrial firms polled were considering this type of measure within the next three months, compared with the 3.8% already using it.
- Recourse to temporary work has been falling since end-2017 as it has become less attractive since new laws to regulate that market came into force. These include an obligation to pay a temporary employee the same as a full-time one after they have worked for at least nine months in the company (15 months maximum in the case of specific industry-wide agreements). The maximum term of temporary work is now set at 18 months.
- If we estimate stable labour force growth at around 0.8% per year (the average in 2011-2019) and low labour productivity of 0.4% per year, the rate of job-creating growth would then be 1.2% out to our forecasting horizon. However, given the hard data and survey findings at our disposal we feel that German growth is unlikely to rise above this threshold, which means that the unemployment rate could automatically increase. Yet it is reasonable to believe that in the event of a prolonged shut-down in the industrial sector, support measures for short-time working could be deployed to avoid the damaging effects on employment.

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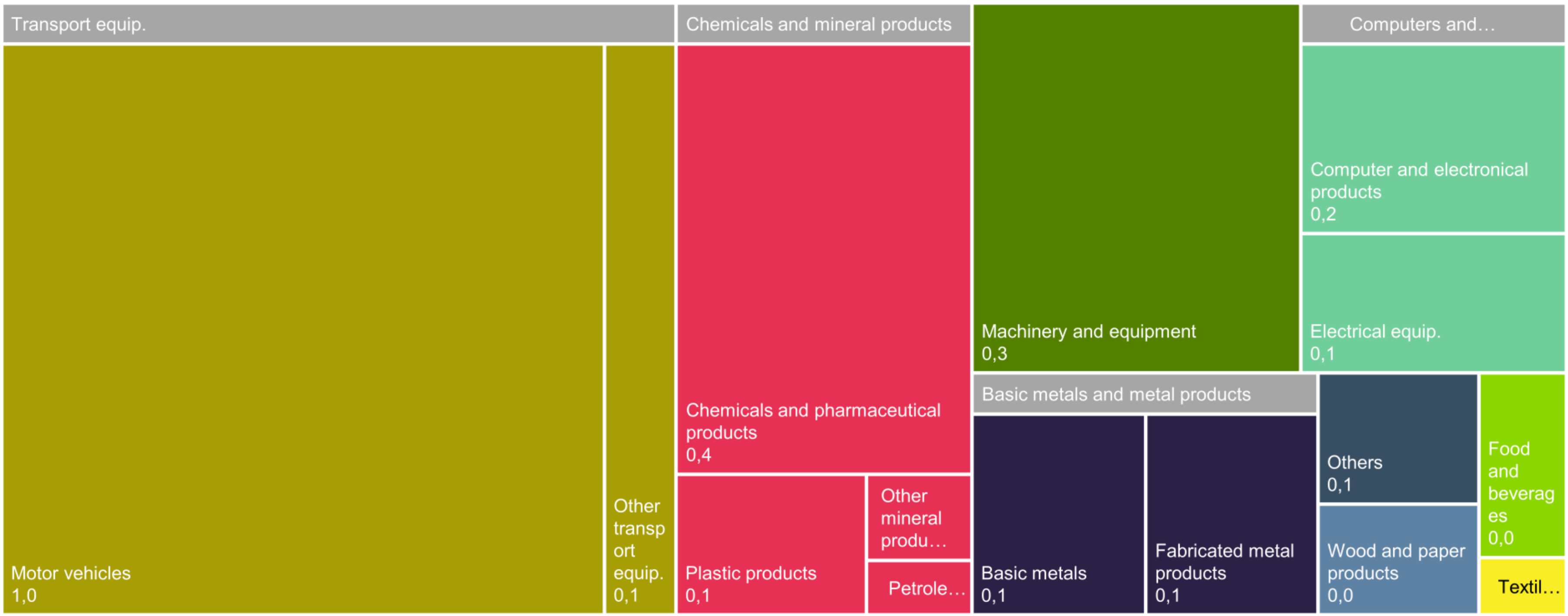
FOCUS 2: EXPOSURES FOR FOREIGN TRADE?
TO THE UNITED STATES

Added value in exports to the USA



Sources: OCDE, Crédit Agricole SA / ECO

German exports to the US are concentrated in three sectors: motor vehicles (1% of GDP), the pharmaceuticals and chemicals industries (0.4%), and machinery and equipment (0.3%). These three sectors concentrate added value equivalent of 1.7% of GDP. For the time being, the United States has deferred its decision to hike tariffs on motor vehicles until December. At that time, German car imports to the US could be taxed at an extra 25%, leading to a fall-off in sector exports that should have an adverse effect on growth.

3 FOCUS 2: EXPOSURES FOR FOREIGN TRADE?
TO CHINA

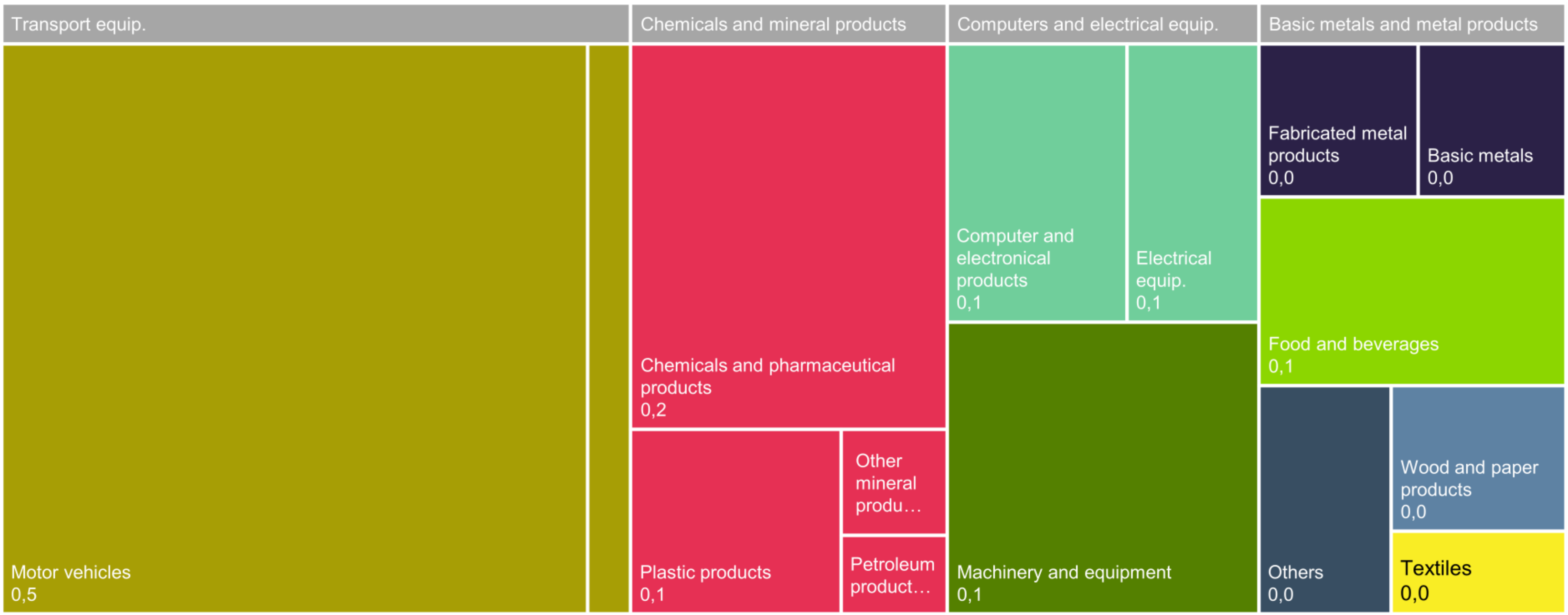
Added value in exports to China

Sources: OCDE, Crédit Agricole SA / ECO

The German automotive sector's exposure to China is half as big as its exposure to the United States (0.5%). Machinery and equipment is the second risky sector with a level equivalent to that of the automobile industry. Apart from these two sectors, exposure is modest. However, it is important to note that China has imported large quantities of machinery and equipment in recent years and that this trend is likely to disappear with the growing power and autonomy emerging as part of the "Made in China 2025" programme. Each new slowdown in Chinese imports inevitably knocks on into the level of German exports in the short term and penalises its growth.

3 FOCUS 2: EXPOSURES FOR FOREIGN TRADE? TO THE UNITED KINGDOM

Added value in exports to the UK



Sources: OCDE, Crédit Agricole SA / ECO

The main risky sector for exports to the UK is motor vehicles (0.5 of a point of GDP exposure). The UK's exposure is lower than that towards China; however, it is concentrated on a single sector. It is worth noting that exports to the UK have been falling steadily year-on-year since June 2016 (just after the Brexit referendum), which means that the country is contributing negatively to German export growth since that time. The possible impacts in the event of exiting the EU will above all depend on the exit arrangements which until now are unknown for lack of a political consensus on the subject.

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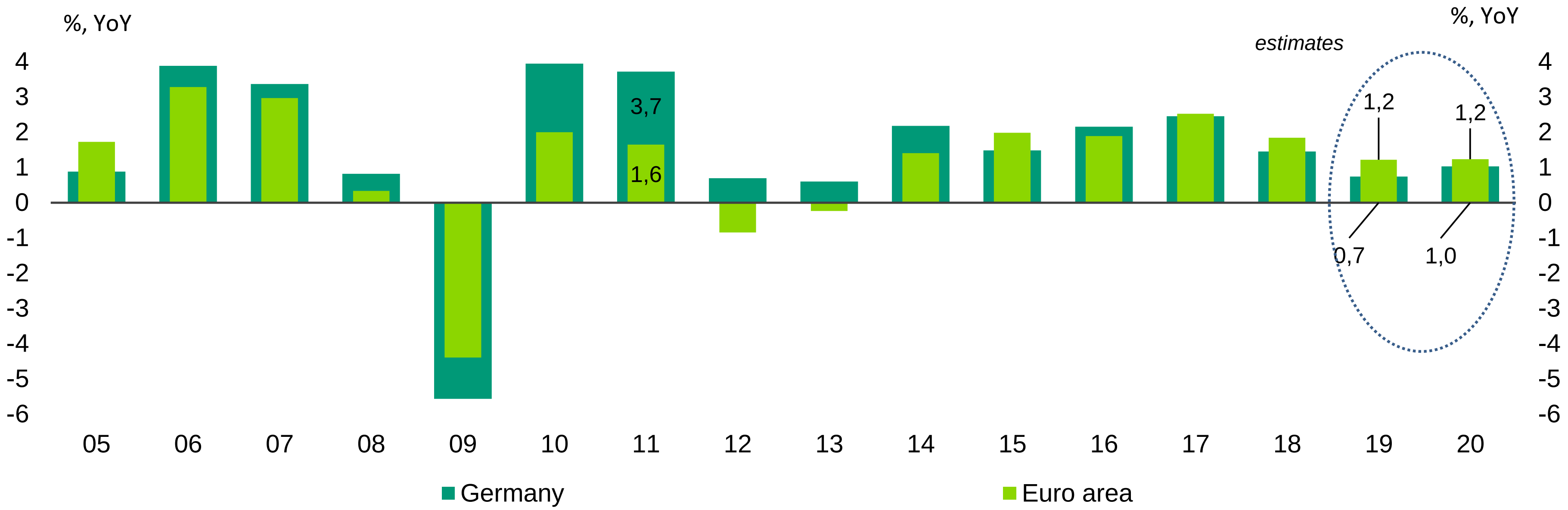
LATEST ECONOMIC DEVELOPMENTS

INDUSTRIAL SECTOR RECOVERY DEFERRED

Growth more vulnerable to the industrial downturn

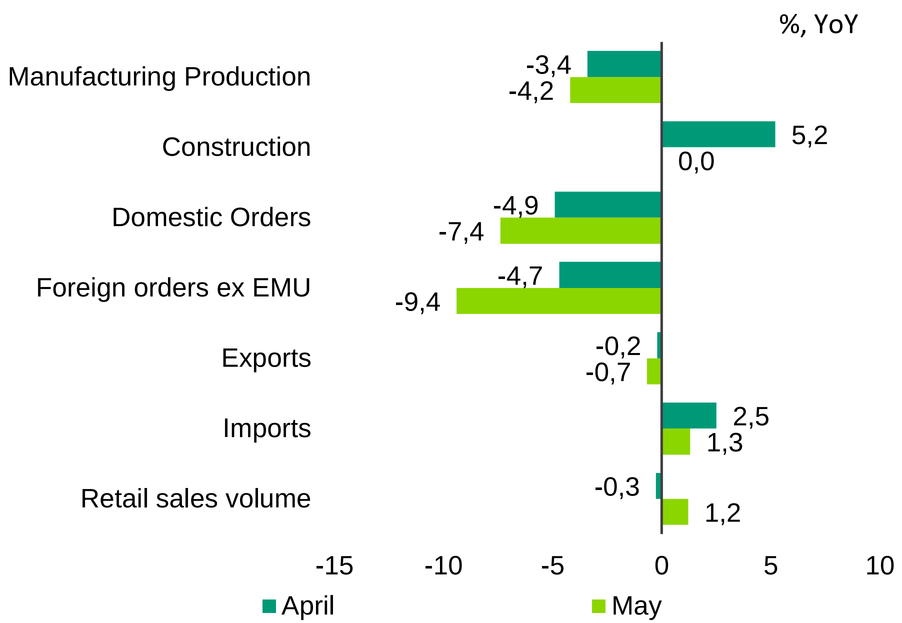


Sources: Eurostat, Crédit Agricole SA / ECO

Eurozone activity is still being disrupted by the sharp industrial slowdown in 2018. We are now expecting a more modest eurozone growth rate of 1.2% in 2019 and 2020. Domestic demand has retained its position as main contributor to GDP, while external demand will slice a few points off growth due to the fall-off in global growth. A resumption of tit-for-tat tariff wars between the United States and China is still driving a downside risk in our forecasts, and the absence of a Brexit deal between the United Kingdom and the European Union now seems more probable. The preponderance of the industrial sector in the German economy and its degree of openness exposa recovery in today's lifeless external demand. The situation of a recovery in industry delayed till year-end prompts us to forecast weaker growth of 0.7% this year and 1% next, ie, below the estimated potential figure of 1.2%.

4 LATEST ECONOMIC DEVELOPMENTS
NO PERCEPTIBLE IMPROVEMENT SIGNALS IN SIGHT

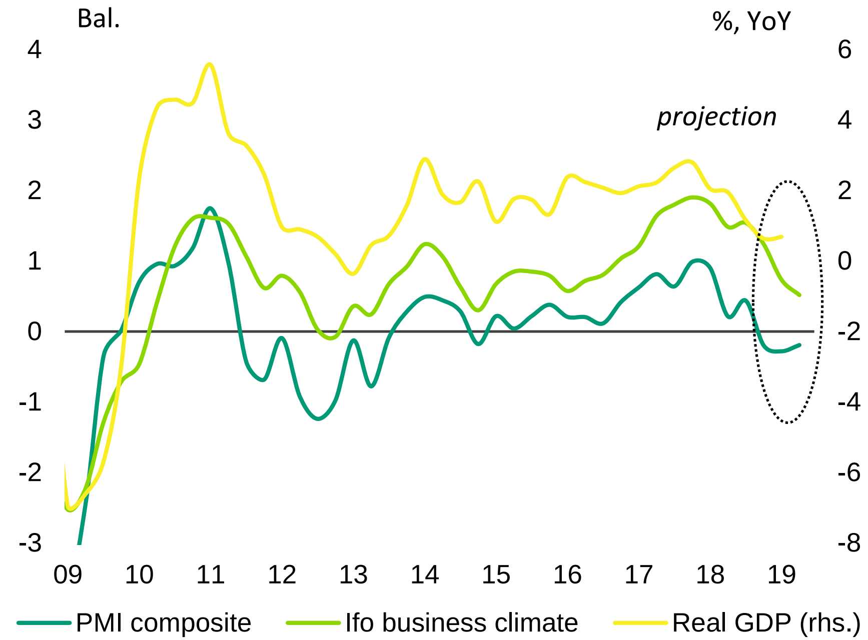
Direction of the main signals



Sources: FSO, DB, Crédit Agricole SA / ECO

Activity data showed a marked deterioration in growth in Q2. Industrial production continued to fall in the majority of sectors with the exception of pharmaceuticals. Domestic and foreign industrial orders continue to fall. Retail sales growth is still modest. The rate of growth in imports is higher than that of exports. The construction sector is also showing signs of flagging.

Activity surveys and real growth

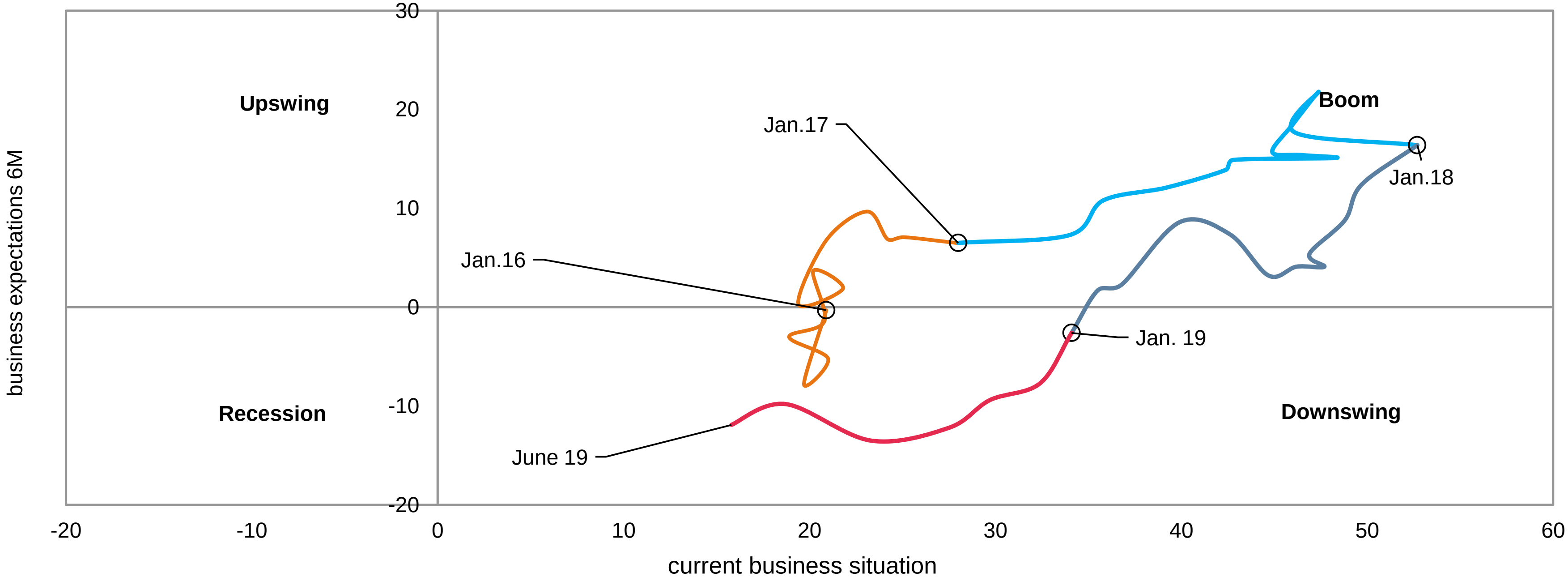


Sources: IFO, Crédit Agricole SA / ECO

Survey data provide a divergent view of activity. The composite PMI was signalling a very slight improvement in activity in Q2 thanks to the acceleration of service activities and despite a more pronounced fall-off in industry. The Ifo business climate survey has however noted a deterioration in the current situation and in the 6-month outlook, thus obviating any possibility of a recovery in the industrial sector in the short term.

4 LATEST ECONOMIC DEVELOPMENTS
INDUSTRIAL ENGINE STALLED

Trends in the industrial cycle (*IFO index*)



Sources: IFO, Crédit Agricole SA / ECO

The steady fall in the business climate index since its 2017 peak persists even today. All activity sectors (industry, services, construction, retail sales, wholesale sales) are affected by a deterioration in activity expectations out to six months. The degree of uncertainty about future business is on the rise among firms and the probability of any further economic expansion phase is very low (below 10%), suggesting an activity slowdown in the short term.

The figures for new car production as declared by the German association of car manufacturers in June are alarming, hitting their lowest level since 2009 and suggesting that a rebound in the automotive sector is highly unlikely in the short term. The pick-up in service activities has so far offset this recessionary effect, but there is no guarantee that it will persist throughout the year. We are now forecasting very weak annual growth of 0.7% in 2019.

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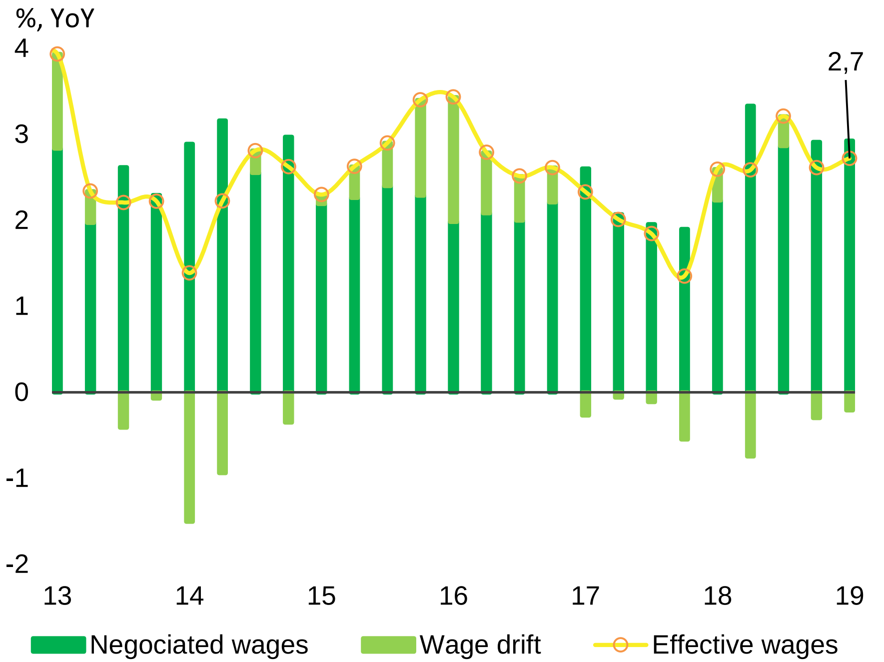
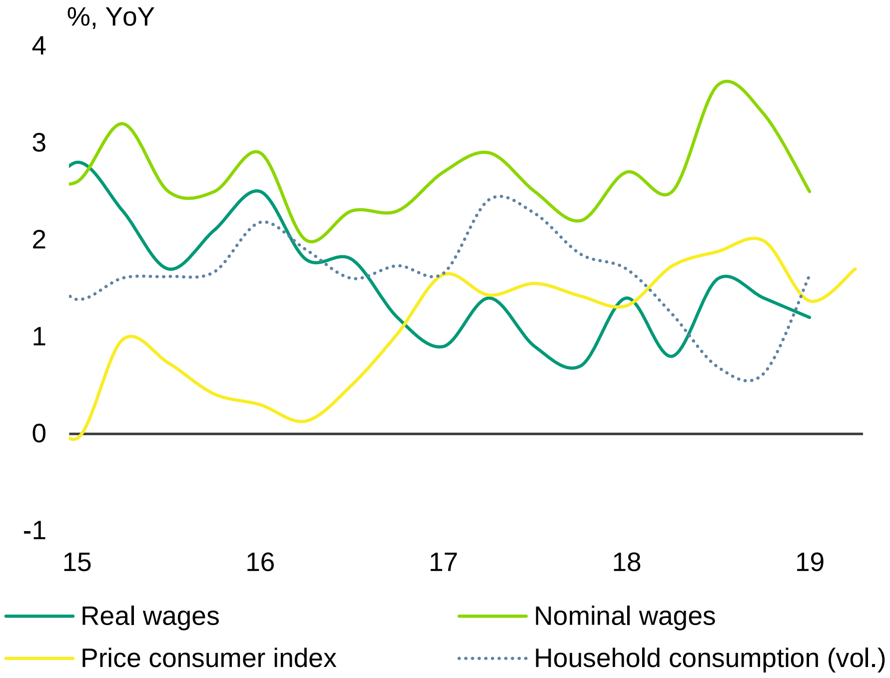
5 THE BASIS OF OUR SCENARIO
HOUSEHOLD CONSUMPTION AND WAGES

Wages



Sources: FSO, Crédit Agricole SA / ECO

Wages, inflation and consumption



Sources: FSO, Crédit Agricole SA / ECO

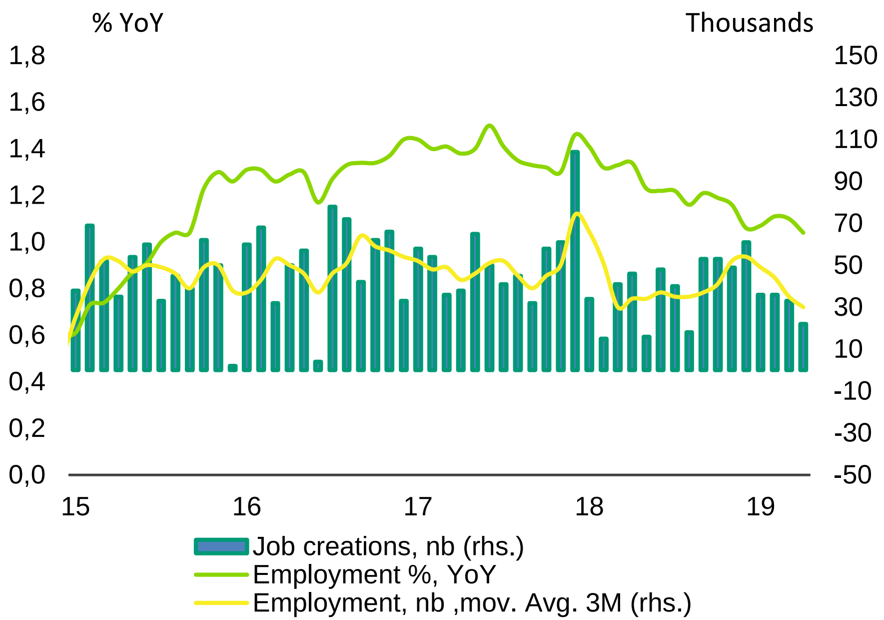
The latest industry wide negotiations (in the metallurgy and chemicals sectors) underpin robust growth in overall wages. According to Germany's Hans Böckler-Stiftung (Foundation), negotiated wages are likely to rise by an annualised 2.9% in 2019. By factoring in a positive slide in wages of 0.2%, effective wages should thus rise by 3.1% this year. As yet, we do not know what the outcome of the next round of negotiations for 2020 will be, but the proposals submitted argue for comparable levels once more.

That said, the activity slowdown suggests greater caution among firms for the upcoming collective bargaining talks. A 2.9% or thereabouts increase in effective wages in 2020 is still within the bounds of possibility. Low inflation, estimated at 1.3% in 2019 and 1.4% in 2020, is unlikely to eat into households' purchasing power or private consumption, which we expect to rise by 1.9% in 2019 and 1.4% in 2020.

5

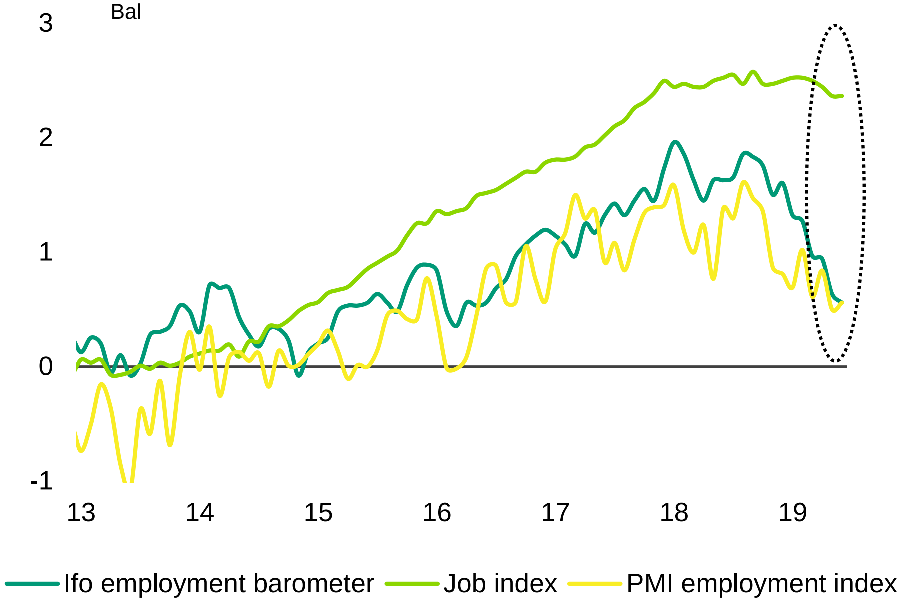
THE BASIS OF OUR SCENARIO
EMPLOYMENT AND WAGE PROSPECTS

Job creation



Sources: Bundesbank, Crédit Agricole SA / ECO

Employment indicators

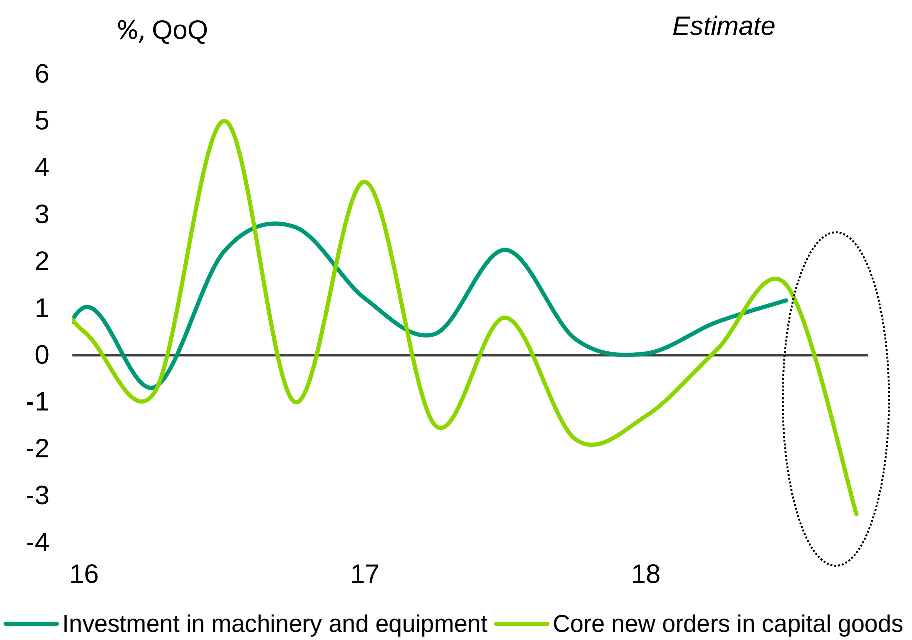


Sources: FSO, Crédit Agricole SA / ECO

The rate of increase in employment slowed to +1% year-on-year in May, compared to +1.3% a year earlier. It is still above its trend level, however, (+0.6%). The unemployment rate, harmonised by Eurostat, is below its equilibrium level (3.5%, according to the European Commission) and again fell, to 3.1% in May. That said, the job offer index is declining, while employment indicators from Ifo and purchasing managers suggest a fall-off in firms' hiring intentions, even if the dearth of skilled positions persists due to population ageing and greater numbers of workers retiring. The collapse in industrial orders, especially foreign orders, is prompting firms to plan for short-time working and to cut the numbers of temporary staff employed, who have become more expensive with the new statutory framework.

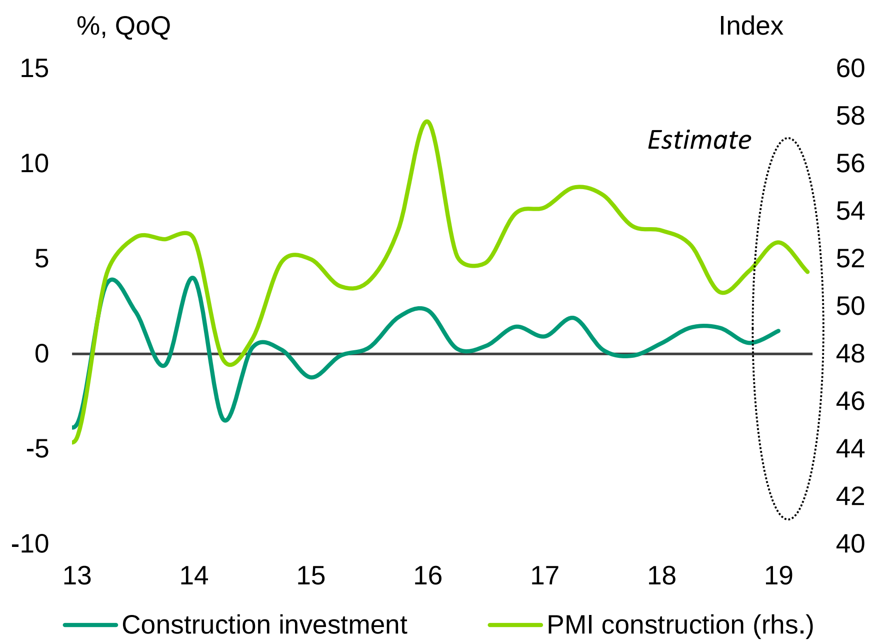
5 THE BASIS OF OUR SCENARIO
INVESTMENT: SHORT-TERM OUTLOOK

Productive investment



Sources: FSO, Crédit Agricole SA / ECO

Construction



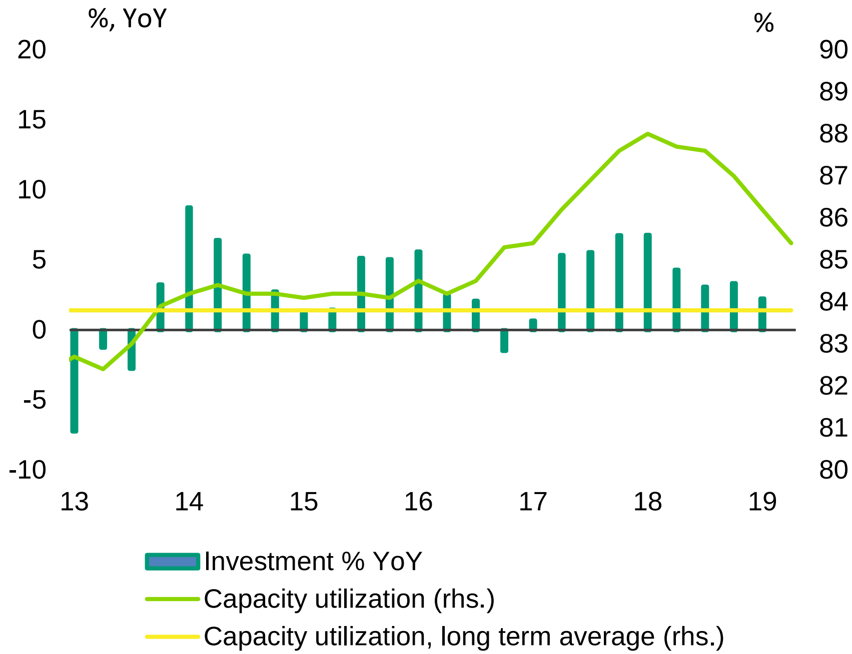
Sources: Markit, FSO, Crédit Agricole SA / ECO

The significant decline in orders for capital goods suggests a massive fall-off in productive investment in Q2. This is being driven by the drop in foreign orders and the marked deterioration in perceptions about the future of world trade. In the construction sector, we observed a slight deceleration in activity in Q2, as shown by the monthly PMI surveys. The combination of these two factors argues for a sudden halt in overall investment in Q2. However, construction investment is still sustained due to strong housing demand, continuing affordable prices, and lending conditions that are highly favourable to households, whose financial situation has improved since the 2011 crisis.

5 THE BASIS OF OUR SCENARIO

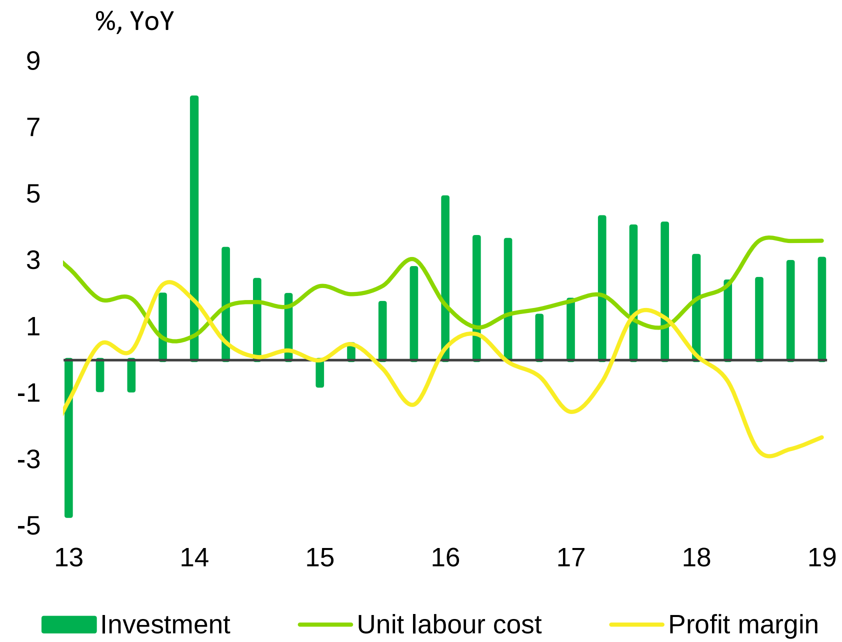
INVESTMENT: UNDERLYING TRENDS

Productive capacity utilisation rates



Sources: Destatis, Crédit Agricole SA / ECO

Margin ratios, unit wage costs and investment



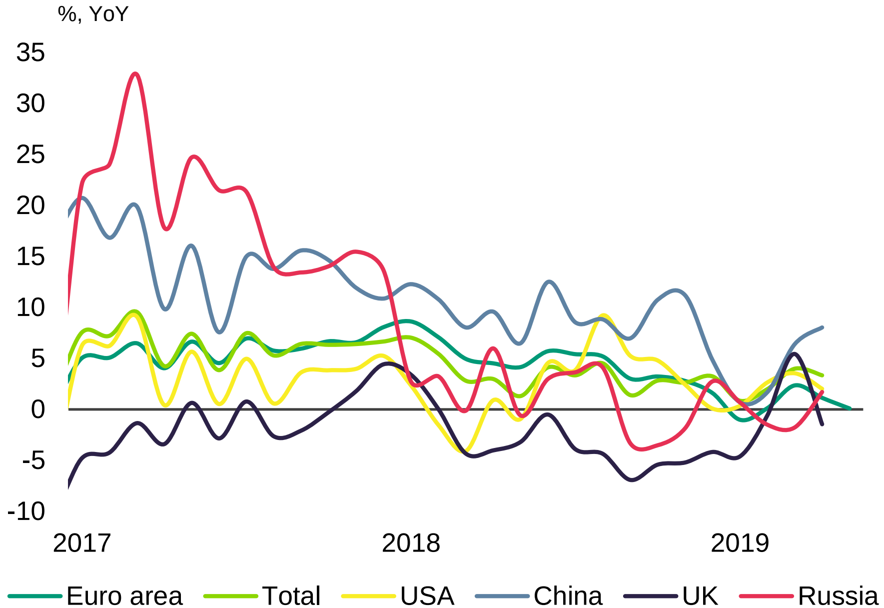
Sources: Destatis, Crédit Agricole SA / ECO

The productive capacity utilisation rate has fallen considerably since 2018 but is still above its trend and 2011 levels. Reduced use of inputs is proving necessary as demand addressed to firms weakens. Unit wage costs have stabilised since the start of 2019 and productivity has increased slightly, thus averting too big a squeeze on firms' margin ratios.

All these factors confirm the intuition that we will see greater caution in terms of investment over the next two years. We are now expecting investment to slow to +2.4% in 2019 (as against +2.7% in 2018) and then to +1.4% in 2020 due to wage pressures and a poor outlook for industrial sales that will adversely affect investment plans.

5 THE BASIS OF OUR SCENARIO
FOREIGN TRADE

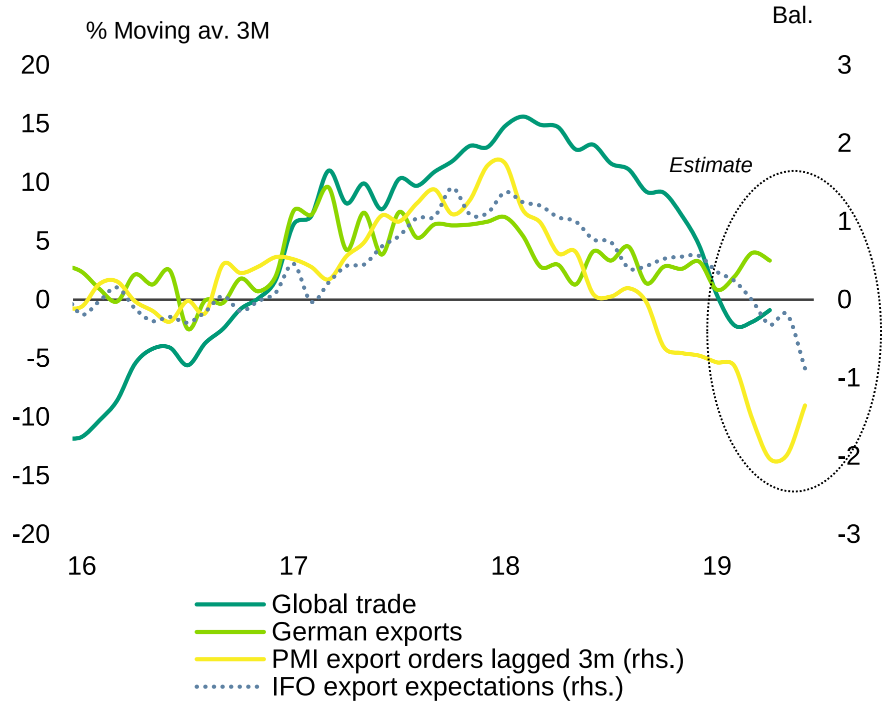
Exports by main trading partners



Sources: Bundesbank, Crédit Agricole SA / ECO

Imports grew faster than exports in Germany in 2018, leading to a negative contribution to GDP growth. This scenario will persist through 2019 and 2020. Trade (exports and imports) has weakened since the start of the year. The deterioration in German exports is due not only to the slowdown in trade with the United States and China, but also with its other eurozone partners. Exports to the United Kingdom saw a peak corresponding to a phase when goods were stockpiled but this has now stopped.

Export outlook



The PMI for export orders and the Ifo index both point to a drop in exports in Q2. Domestic demand should continue strong and lead to higher growth in imports than in exports, leading to a negative contribution to net exports of -0.4 of a point of GDP in 2019, and of -0.2 of a point of GDP in 2020.

Matrix of risks associated with our scenario

		Probability	Impact
↓	No short-term industrial rebound	High	High
↓	Deterioration of the trade balance due to an external shock (automobile tariffs, Brexit without agreement)	High	High
↓	Euro appreciating against the dollar	Medium	Medium
↑	Investment picks up	Low	Medium

Source: Crédit Agricole SA / ECO

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