Investment Managers

Research & Strategy Insights

Wind of change?

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Key points

- As the Merkel era is drawing to a close, we take a look at some key macroeconomic challenges ahead for Germany
- While last week's European Central Bank (ECB) announcements are not tapering, we detect some growing influence of the hawks

Maybe paradoxically given the ample policy space Germany would normally enjoy given its sound public finances even after the massive fiscal stimulus implemented to address the pandemic, the country is having to deal very quickly with some of the constraints which the entire European Union will have to navigate in the years ahead. Indeed, as the "Merkel era" is drawing to a close, on the occasion of the future coalition agreement, Berlin before most of its European partners will have to sketch out a comprehensive strategy to deal with the post-pandemic macro damage, decarbonize its economy and respond to the "pendulum shift" in public opinion towards more demand for government protection.

Decarbonization is in our view the key challenge, which transcends the parties – the Supreme Court is taking seriously the 1994 amendment to the Constitution which incorporates environment protection into the guiding principles of government action. Its transitory cost will collide with the other priorities of the parties, reducing inequality on the centre-left and improving competitiveness on the centre-right. This may make it tempting to allow some – moderate – drift from the pre-pandemic trajectory for the public deficit. The combination of European and national fiscal rules is a major hurdle, but we see some potential for a measure of flexibility there. We would expect a prudent inflexion though, not a revolution.

The next German government will also have to navigate treacherous waters when it comes to international trade. Germany has embraced the post-1990 globalization and remains reliant on the possibility to constantly count on new sources of "foreign traction". Still, the era of "politically blind" trade policies is over, and the changeover in the US administration has not altered this state of affairs. Germany is being asked to "choose sides" in the big US/China rivalry. The "bipolarization" of the world economy between US and Chinese areas of influence is not going to be comfortable for big "third party" players.

A reassuring point is that the current political debate in Germany is not obsessing about the ECB stance. While the ECB's paring back of Pandemic Emergency Purchase Programme (PEPP) announced last week is no proper "tapering", we detect a growing influence of the hawks in the details of the ECB's communication.

No plain sailing for Germany

Your humble servant recalls being probed at his university finals on how France could emulate the German economic model. Three decades later, it seems most of Europe continues to look up to Berlin. True, for a few years in the late 1990s Germany was dubbed "the sick man of Europe", but the apparent ease with which the Schroeder government addressed the country's rigidities still constitutes a reference for structural reforms across the European Union (EU) 20 years later. Admiration however is never far from envy and resentment. The European commentariat constantly oscillates between recommending other nations to be "more like Germany" and lamenting Berlin's shortcomings, in particular in EU affairs. While we agree that the German government's response to the sovereign crisis of 2010-2012 has been too slow and hesitant, symmetrically we are often surprised by the lack of recognition of the number of "red lines" which ultimately Berlin accepted to cross. We also suspect that many European governments would have in fact resented a German leadership on these policies. "Leading from behind" was possibly the only realistic approach.

Still, while Berlin rarely takes the lead, nothing much in the EU can happen without or against Germany. Germany's political life remains far less strident than in many European countries and its general prosperity would suggest that nothing essential is at stake in the elections on September 26th, both domestically and externally, limiting the potential uncertainty as the Merkel era is drawing to a close. However, maybe paradoxically given the ample policy space Germany would normally enjoy given its sound public finances, the country is having to deal very quickly with some of the constraints which the entire European Union will have to navigate in the years ahead. **On the occasion of the future coalition agreement, Berlin before most of its European partners will have to at least sketch out a comprehensive strategy to deal with the post-pandemic macro damage, decarbonize its economy, respond to the "pendulum shift" in public opinion towards more demand for government protection,** all of this while navigating treacherous waters when it comes to international trade. Whoever is the next Chancellor, it won't be plain sailing.

Over the last 10 years, to help keep the monetary union alive Germany has often allowed the rest of the EU more leeway on macro management than what the letter of the Treaty would have implied, while continuing to steer its own, more conservative course domestically. **What might change in the new configuration is that Germany may see an immediate domestic interest in even more loosening of the European rulebook.**

Strong starting point

Germany's economic performance since the beginning of the pandemic has been "average" when compared with the rest of the Euro area. Given the specialization of the country towards manufacturing, the initial shock was slightly more muted than in services-dominated economies further South, but over the course of 6 quarters, the GDP loss has been roughly the same as in France, smaller than in Spain but more pronounced than in Italy. Just like in the rest of Europe and in contrast with the US, the employment loss has been contained thanks to government schemes, but there again the German overall performance is unexceptional (see Exhibit 1).

Exhibit 1 – Middle of the pack

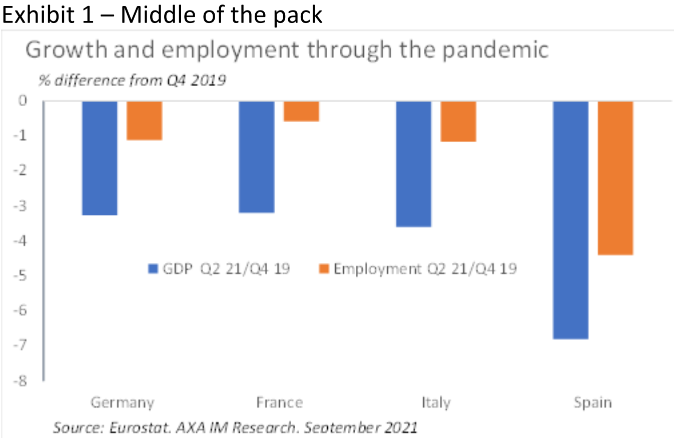
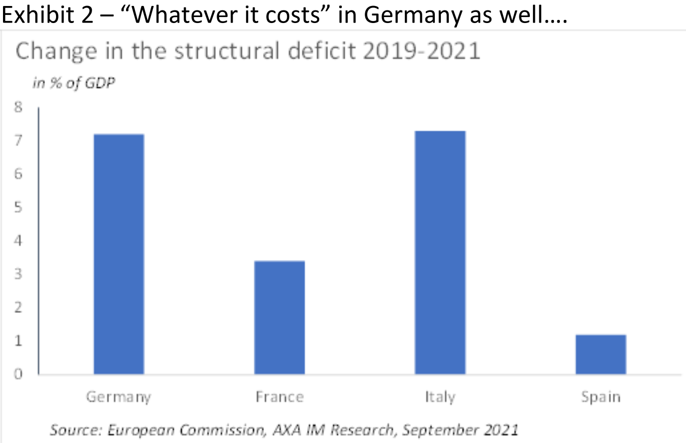


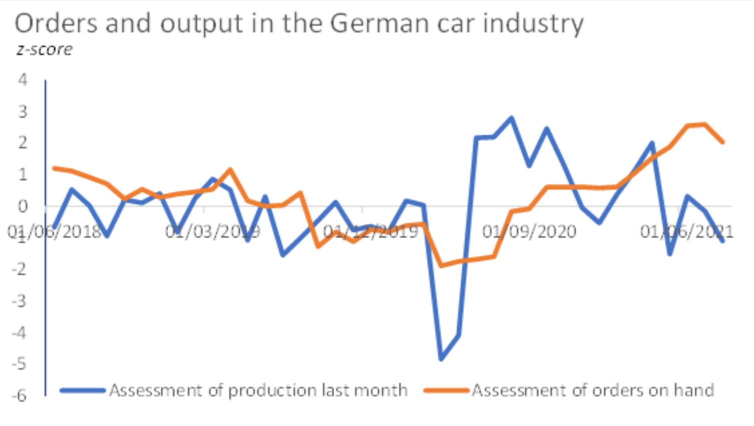
Exhibit 2 – "Whatever it costs" in Germany as well….



This "average performance" came out despite a massive fiscal cushioning of the blow. Disentangling in the change in the overall deficits what is directly the effect of the drop in GDP and what reflects the decisions of governments is particularly difficult in extreme cyclical conditions but judging by the European Commission estimates of the structural deficits, the fiscal stimulus in Germany has been on par with Italy's and bigger than in France and, even more clearly so, in Spain (see Exhibit 2).

The German economy may now be facing some of the adverse consequences of its reliance on manufacturing and intense integration in global value chains. Indeed, the bottlenecks – e.g., shortage in sea transport capacity or the shortage of microchips – are heavily impacting the German industry. In Exhibit 3 we focus on the car industry. The wide gap between the strong order book and production in the IFO survey is quite telling. Germany is missing some output.

Exhibit 3 – Unusual divergence



Source: IFO, AXA IM Research, September 2021

In these circumstances, "dropping the ball" and removing the fiscal stimulus too soon could well damage the recovery and **in principle, Germany can well afford this given its starting point on public finances**. In 2019, Germany was the only country in the "Big 4" where the fiscal balance was in surplus and public debt below 60% of GDP. The European Commission forecasts public debt to hit only 73.1% of GDP this year, far below the region's average (102.4%). This seems to support the strategy espoused by Finance minister Olaf Scholz – currently leading the polls as the Sozialdemokratische Partei Deutschlands (SPD) candidate to the Chancellorship. Indeed, until last year, when lambasted for Germany's budgetary prudence and his resistance to calls from the European partners for more active fiscal policy, Scholz argued that the country was saving to be able to respond in case of significant shock. This line helped him to defend a "whatever the cost" approach over the last year and half.

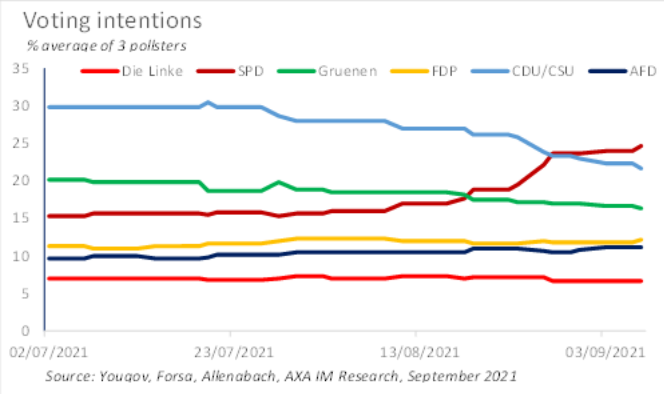
Given the width of the fiscal policy space left after the pandemic, in principle Germany should not have any difficulty to maintain an accommodative stance while the world economy deals with the supply-side legacy of the pandemic, while allowing for some funding for new structural initiatives, with the fight against climate change on the front row. However, **a complex combination of domestic and European fiscal rules drastically reduces the space**.

Squaring the "green transition" fiscal equation

According to the current polls, there are two viable options for coalitions comfortably exceeding 50% of the seats in the Bundestag: "traffic light" (SPD+Greens+ Freie Demokratische Partei (FDP)) and "red-red-green" (SPD+ Die Linke+Greens). In other words, while their hope of securing the chancellorship itself has waned over the last months (see Exhibit 4), the Greens would make it to the government anyway, which would suggest the decarbonization agenda will rank high after 26 September. But we would go one step further: **irrespective of the outcome of the elections, Germany has set itself on a "net zero" path which will in any case have a strong bearing on government policies.**

In April 2021, the German Supreme Court ruled that the Climate Action Law did not sufficiently protect the freedoms of the youth and future generations, drawing on a 1994 amendment to Article 20 of the Constitution which states: "*Mindful also of its responsibility toward future generations, the state shall protect the natural bases of life by legislation*" (see this precise Brookings paper on this issue). Merkel's government's response was swift, and in May 2021 duly announced more ambitious decarbonization targets, shifting up a gear with a 65% reduction in greenhouse gas emission by 2030 and reaching net zero by 2045 – 5 years ahead of the EU as a whole – from a previous target at -55% by 2030.

Exhibit 4 – SPD resurgence – Greens' slow erosion – CDU-CSU's drop



This ambition will come with a cost. A very recent paper by McKinsey (see here) argues that Germany will need to invest 1 trillion euros in new infrastructure and 5 trillion on upgrading existing capacity to reach net zero by 2045. True, McKinsey argues that this effort would ultimately pay for itself by boosting the development of new activities, but some measure of at least initially fiscally costly "pump priming" and painful "nudging" from the government would probably be needed. Such nudging is likely to take the form of further rises in the "carbon tax" and Germany has already moved ahead of the Commission's new proposals by extending on a national basis carbon trading to transport and building, on top of hiking the fuel tax at the beginning of 2021.

Down the road, the distributional and competitiveness effects of these moves could be very significant and collide with the parties' other priorities. The Greens and SPD are keen to address income inequalities in Germany (while judging by the Gini coefficient Germany is not a particularly unequal country among Organisation for Economic Co-operation and Development (OECD) nations, its poverty rate, at 9.5%, is slightly above the levels seen in some "big government" EU countries such as France and Sweden). Cushioning the blow of rising carbon prices for the most vulnerable would be on the cards. Squaring this equation without allowing the deficit to rise above the pre-pandemic trajectory would only be consistent with a rise in tax. Recent research by ZEW suggest the Greens' agenda to result in a *gain* for public finances of EUR18bn, a very similar figure for SPD's (EUR14bn). Unsurprisingly, given the FDP's usual business-friendly stance, government income would fall by EUR87bn, in particular because of their pledge to cut the corporate tax. Christlich Demokratische Union (CDU)'s cost would come to EUR32bn.

These model-based simulations are of course fragile by construction, but they have the merit to put figures on the constraints surrounding any coalition talks**. Bridging the gap between FDP's competitiveness priority and the two centre-left parties' inequality-busting agenda while still delivering on decarbonization will be tough. Allowing a bit more fiscal deficit may be a tempting solution.** But then the coalition would need to deal with both the German and European fiscal rules. The national debt brake limits the structural deficit to 0.35% of GDP in "normal circumstances". Germany can normally largely ignore the EU rules, but now that its debt has exceeded 60% of GDP, when the current Covid-related suspension will end (normally in 2023), it would normally have to reduce its structural deficit by 5% of the distance between its debt level and 60% annually (i.e., c.0.7% of GDP per year based on the latest Commission forecast).

The Greens are the only party explicitly proposing to change the German debt brake but given its constitutional nature no coalition is likely to reach the required majority threshold. Yet, there could be some technical solutions to circumvent the mechanism. An option would be to farm-out funding the decarbonization to an "off balance sheet" scheme, separate from the federal government's budget, which could issue debt with a government guarantee to fund the decarbonization. It is a grey area from a national legal point of view, but in any case, this would still fall foul of European rules. Relaxing them would thus be in the German domestic interest.

Some openness in Berlin towards a general overhaul of the EU fiscal surveillance rules to deal with the cost of decarbonization would meet similar ideas in Brussels. We read with interest the very recent proposal by the Bruegel think-tank to exclude decarbonization-related public investment from the calculation of the "excessive deficit" thresholds. Your humble servant is not humble enough to refrain from mentioning that we made the same proposal in November 2019 (combining common issuance to fund the green transition with an exclusion from the national deficits). While the technical details are likely to evolve, "there seems to be something brewing" along those lines, probably because of the very simple fact that a "pure and simple" return to the pre-pandemic fiscal surveillance framework is economically and politically unpalatable to most member states.

This is unlikely to be for immediate consumption though. At the risk of coming across as irremediably French, if not much in the EU can be done without or against Germany, the same applies to France. By the time the coalition talks in Berlin conclude (last time a deal was struck in February 2018 only, while the elections had taken place in September 2017), France is likely to be in the midst of the presidential campaign. Serious talks are unlikely to start before the summer of 2022.

We cannot conclude this fairly dry section without mentioning that, of course, there are other thinkable configurations than a compromise between FDP, SPD and the Greens in Berlin. Polls can still move, but there is also quite a bit of discussion around the "red-red-green" option. This is arithmetically possible (in the current state of opinion surveys), but it is also what may ultimately force FDP to compromise since their electorate may not forgive them to make a hard-left option the only workable solution. What may go against a "red-red-green" option "is that it would against the grain of what the Greens have been trying to achieve for years – moving towards the centre of the political arena as a "responsible party" – and Scholz' own positioning as a moderate within SPD. Besides, while such coalitions have been possible at state level, Die Linke's anti-Atlanticism (they are against North Atlantic Treaty Organisation (NATO)), at odds with its prospective coalition partners, could make their participation to the national government problematic.

But precisely, it is this overall moderation of SPD and the Greens, beyond the impact of FDP, which would make a relaxation of fiscal rules more like a gradual and limited shift under a "traffic light" coalition, and not a "revolution" in the European macro-management. Still, **a more flexible fiscal rulebook at the European level, coming on top of the debt mutualisation brought about by the Next Generation EU framework, would undoubtedly help support the standing of the periphery in the market.**

Thinking about the "de-globalisation risk"

Dealing with the cost of "net zero" is in our opinion by far Germany's (and the world's!) thorniest issue to tackle in the years ahead, but other challenges abound. Germany has embraced the post 1990s globalization. The potential EU-US trade war two years ago was a warning shot that clouds could be gathering on the international trade horizon, even among allies.

Their geographical position and industrial specialization made German exporters particularly well suited to reap the benefits of the integration of the old European socialist block, not only as a new market, but also thanks to the possibility to offshore production in highly skilled/(initially) low wage centres. Some of this externalized production found its way back to Germany as inputs into final exports. In 1990, the share of imports in GDP was similar in Germany, France and the UK. 30 years later, it has exceeded 40% in Germany, 10 points above the level seen in the other two countries.

While this strategy was at the beginning berated in some quarters as giving way to a "bazar economy" – an expression coined by Hans-Werner Sinn – which would gradually erode the substance of the German economy (he saw this as merely a response to excessively rigid domestic wages), the last 20 years have demonstrated that the country could maintain a decent pace of potential growth, save a large share of domestic industrial jobs and still maintain a very high current account surplus while gradually allowing real wages to rebound after several years of downward pressure in the late 1990s/early 2000s.

While domestic demand has solidified in the last 15 years, exports still continue to stand for a very high share of GDP for an economy of that size. **Germany remains reliant on the possibility to constantly count on new sources of "foreign traction".** Since the pace of demand in the Euro area has been lacklustre for decades, emerging markets had to be a point of focus, and over the last 10 years China has been playing a growing role. From this point of view, the recent focus in Beijing on inclusive, rather than extensive growth, is not necessarily good news for the German industry. Moreover, beyond the domestic developments in China, the era of "politically blind" trade policies is over, and the changeover in the US administration has not changed this state of affairs. **Germany is being asked to "choose sides" in the big US/China rivalry.** The "bipolarization" of the world economy between a US and a Chinese area of influence is not going to be comfortable for big "third party" players.

Angela Merkel had been a promoter of the Comprehensive Agreement on Investment between China and the European Union which has been "frozen" by the European parliament (EP) in May 2021, following sanctions by China against Members of the European Parliament (MEP) for denouncing human rights violations in Xinjiang. While the EP is very unlikely to change opinion any time soon, in any case political positions vis-à-vis China have hardened within Germany itself. A recent report by the Berlin-based Mercator Institute for China Studies has browsed through the main parties' manifestos for their approach to China. Sovereignty and security considerations dominate in the centre-right parties, human rights concerns on the centre-left, but interestingly **both CDU and the Greens explicitly advocate more transatlantic cooperation regarding Beijing.**

Lack of progress on trade deals is not necessarily a major impediment to export growth, but the perspective of more difficult relations with a major export market comes only 2 years after Germany was at risk of a major collision course with the US on trade, under Trump. This might lead to some re-think of the country's structural reliance on exports as its ultimate growth engine. Still, re-engineering a model which has proved effective for decades is no easy feat, and in any case, it is probably illusory to ask a country faced with demographic challenges to focus on private consumption in the long run. The usual attitude in Germany to threats on external demand is to react by preserving or improving competitiveness, often taking the form of wage moderation. We saw quite a few comments these last few days on Verdi (a services employees union) requesting a 5% hike in pay, but it is an opening gambit in a negotiation process, and it is actually *lower* than their initial demands in 2019, despite the recent rise in consumer prices. Just like in the rest of Europe, inflation in Germany is likely to continue to be boosted by supply-side shocks for a while, but it still takes a microscope to detect second round effects.

Meanwhile, at the ECB….

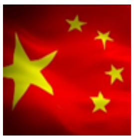
What is reassuring about the current political debate in Germany is that there is no obsession about the ECB policy, which is a key source of tranquillity for the Euro area as a whole. Still, while the central bank cannot steer its policy according to the vagaries of the political life of the member states, the "yearning for normalization" regularly expressed by the Bundesbank cannot be completely ignored.

The decision last week to pare back the pace of PEPP in the coming 3 months ("moderately lower than in the previous 2 quarters") was widely expected, and Christine Lagarde made it clear that it is not "proper tapering" (that would entail information on the landing zone for PEPP and the recalibration of Asset Purchase Programme (APP), which was entirely missing). Accordingly, the bond market was generally non-plussed by the decisions. Still, in the details of last week's communication the influence of the hawks is plain to see.

While the balance of risks around the (more optimistic) outlook for growth is neutral, it is tilted to the upside for inflation. This recognition of upside risks to inflation is new, even if the baseline has barely moved (the forecast for core inflation for 2023 moved up by only 0.1% relative to June to 1.5%, still significantly below the ECB's target).

Moreover, the ECB justified the reduction in the pace of PEPP by both the improvement in financial conditions AND the improvement of the inflation outlook. This matters. That the ECB fine tunes its pace of purchases according to the state of financial market is purely technical and contingent (these conditions can change), while linking the pace of buying to the inflation outlook implies a "directionality" and a proper message on the monetary stance.

Lagarde made several clear allusions to the December meeting as the key one for the "big decisions", as we have been expecting for a while. Our impression is with the hawks gathering strength, the link between the end of Quantitative Easing (QE) and policy rates will be severed (in the current forward guidance QE is supposed to continue nearly until the policy rate lift-off, which would not be before 2024 as implied by the ECB's forecasts) so that the Council can settle on a relatively short continuation of the APP once PEPP stops (normally in March 2022). Many details still need to be hammered between now and December (beyond the duration of APP, its flexibility and quantum also need to be discussed) and this will likely trigger bouts of volatility as hawks and doves openly debate in the press. All this makes us comfortable with the forecast of German yields moving up to a -20bps region by year end.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• President's Biden & Xi phone call • President Biden announces plans to mandate vaccines that will affect c. 100mn Americans • PPI inflation slows to 0.7%mom (from 1.0%), to 8.3%yoy (from 7.8%), 6.7% core. • Fed hawks Bullard and Kaplan make the case for an early and quicker taper • Beige Book points to moderation in growth is some areas amidst supply pressures • JOLYS survey (July) new high – still strong demand	• Fed in purdah ahead of FOMC following week • CPI (Aug) expect modest dip in inflation to 5.3% from 5.4% – tentatively past peak • Retail sales (Aug) are expected to fall again, in part a goods/services rotation, but a risk to Q3 • Congress reaches mid-Sept deadline for details of reconciliation spending bill – expect delays • U Mich consumer sentiment (Sep, p) – watch LR inflation expectations, stabilising <3% • Philly & Empire Fed surveys (Sep)
	• The ECB agreed to reduce net PEPP purchases at a "*moderately lower pace*". C. Lagarde postponed debate on PEPP/APP/TLTRO to Dec • Jul German IP rebound by 1%mom (5% below pre pandemic; factory orders 15% above) • Sept German ZEW sentiment cooled to 26.5	• Eurogroup to begin discussing changes to fiscal rules, green golden rule considered • Details on August CPI in EMU-4 to gauge inflationary pressure over items. • EMU Q2 wages to assess any upside pressure • July aggregated IP in EMU (cons: 0.5%mom)
	• GDP (July) rose by 0.1%, with services and mfg stagnating during the 'pingdemic' high • Government to boost health and social care by increasing Nat Ins by 1.25% – UK tax burden >35% – highest rate since 1950 • BoE Gov Bailey urges workers to return	• CPI inflation (Aug) to rebound to c.3% from 2.0% in July, in part on Eat Out base effect • Labour market (Jul/Aug), with July unemp watched as furlough scheme taper began • Retail sales (Aug) – expect +1.2% (+0.5% consensus) after sharp -2.5% in July
	• Kishida, Kono, Ishiba among the top contenders to replace Suga at the head of the LDP and PM • Q2 GDP growth revised up to 1.9%qoq ann / better capex and slightly higher pri consumption • Aug Economy Watchers poll down to 34.7(-13.7)	• Q3 Business survey index and September Reuters Tankan Mfg index to gauge Mfg sentiment • July Machinery orders • Aug trade figures will be important to monitor the impact of China slowdown.
	• August exports and imports surprise on the upside, driven in part by price increases • PPI rises further to 9.5%, but downstream price pressure remains muted	Domestic data is expected to show weaker activity in August due to the virus resurgence
	• Aug yoy inflation accelerated and remained above target in Brazil, Chile, Colombia, Russia. Slowed in Mexico but remains high. • South Africa Q2 GDP exceeded expectations and jumped to 19.3%yoy (Q1:-3.2%). • CB: Malaysia, Poland (on hold), Ukraine/Peru (+50bps) and Russia (+25bps) hiked.	• Retail sales (mom) in Brazil should recover in July after a negative print in June. • Inflation (August) releases in India, Argentina, Poland (final).

Upcoming events		
	US:	Tue: CPI (Aug), NFIB survey (Aug); Wed: Empire survey (Sep), IP (Aug); Thu: Retail sales (Aug), jobless claims (11 Sep), Philly Fed idx (Sep), business Inventories (Jul), TIC (Jul); Fri: Michigan consumer sentiment (Sep,p)
	Euro Area:	Tue: Sp inflation (Aug,f); Wed: IP (Aug), EC's Von der Leyen's annual 'state of union' , Fr & It inflation (Aug, f); Thu: Trade balance (Jul); Fri: Ez inflation (Aug,f)
	UK:	Tue: Labour market report (Jul); Wed: CPI & PPI inflation (Aug); Fri: Retail sales (Aug)
	Japan:	Wed: Private 'core' machinery orders (Jul); Thu: Trade balance (Aug)
	China:	Wed: Industrial production (Aug), Retail sales (Aug); Expected: Total social financing (Aug), New yuan loans (Aug), M2 (Aug)

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