Zeroing in on Germany

Executive Summary

The risks of a recession in Germany are rising, but the details underlying today’s GDP release show the situation is not quite as dire as the drop in headline GDP would suggest. Still, Germany’s economy is clearly struggling, with the uptick in unemployment in recent months perhaps the most concerning sign. Fiscal and monetary policy is set to become easier, but will that be enough?

Taking Stock of the Latest German GDP Numbers & Fiscal Prospects

Data released today offered more insight into what drove the 0.1% quarter-over-quarter drop in German real GDP in Q2—there is some good news and some bad news from the release. Let us start with the bad news. Private consumption was especially weak, as it rose just 0.1% quarter-over-quarter, while gross fixed capital formation (i.e., capital investment) unexpectedly fell 0.1%. On a more positive note, the Q1 capital investment figure was revised up to show a gain of 1.6% quarter-over-quarter, the strongest reading in two years. Moreover, the drop in GDP in Q2 seems to largely have been driven by a sizable negative contribution from net exports. On balance, looking at final domestic demand, the Q2 reading still looks quite weak, but a bit less concerning considering the strength in underlying demand exhibited in the prior two quarters, particularly Q1 (Figure 1).

Figure 1

Germany Final Domestic Demand
Contributions to Quarterly Percent Change

Source: Statistisches Bundesamt, European Commission and Wells Fargo Securities

Still, Germany’s economy is clearly struggling at present, in particular the manufacturing sector. The manufacturing PMI registered a dismal reading of 43.6 in August, while output in the sector has fallen roughly 7% from the peak in late 2017. In our view, the question is to what extent the manufacturing malaise spreads to the services sector. Retail sales have thus far been fairly resilient, but German unemployment has generally been falling at a slower pace, and ticked higher in July (the spike in unemployment in May was mostly due to reclassification of the data). We think the unemployment figures are among the most important numbers to watch in Germany, and if they continue to show rising jobless ranks, the chances of a more significant and widespread German recession would increase.

Final domestic demand has been more resilient than headline GDP.

Keep an eye on German unemployment numbers.

Together we’ll go far

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The extent of a possible German recession matters on a number of levels, including in the context of prospects for fiscal stimulus from the German government. Interestingly, Germany is already on track to ease fiscal policy moderately this year and next after tightening policy sharply last year (Figure 2, prior page). However, the government is somewhat limited in its ability to ease policy further by the “debt brake,” a constitutional rule which forbids a general government structural deficit of more than 0.5% of GDP unless there is a “strong recession” or natural disaster. Even within that rule, Germany has some more space to ease on paper, but government officials have said they would only implement a larger package of fiscal easing measures if there is a more severe recession (the size of the potential package was floated as €50 billion, or around 1.5% of German GDP). In the interim, Germany’s economy will likely thus have to rely on only modest fiscal easing and a package of ECB easing measures to find its footing.