Here's why Germany can withstand this rough patch

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Recessions rarely begin when people start warning that one is on the way. But the negative sentiments surrounding such banter can hurt markets and global investors, as is happening in Germany.

Germany's economy has slowed substantially since the second quarter of 2018, led by issues in the all-important car industry after the introduction of a European emission standard resulting in big production losses.

The problems, however, are not restricted to the car industry. Export demand in general has eased due to a slowdown in world trade, private domestic consumption is slower and, for trans-European investors, symbolic German bund yields fell back below zero for the first time since 2015.

The benchmark for comparison is the 2015 sell-off, when 10-year bund yields retraced almost 100 basis points (or 1 per cent) in a few weeks.

Continuing weakness

German GDP growth is likely to be subdued in the coming quarters, as the latest survey data is in line with this scenario of continuing weakness. The IFO business climate index has been declining since September, reaching 101 in December, just above the average in 2015-16.

Adding further woes, European banking stocks have been battered for much of the past four years by negative interest rates. With bunds now at or sub zero once again, these fears run deeper than at any time in Europe since the immediate aftershocks of Brexit.

Further, Brussels plans to impose market discipline through shareholder bail-ins rather than public bail-outs. This approach is in question as Germany embraces a new industrial strategy that will rely on strong state-backed banks taking political direction.

So the mooted merger of Commerzbank and Deutsche Bank has the potential to reset the relationship between banks and their sovereign.

The basic idea is for the German government to use its near 15 per cent stake in Commerzbank to organise a "bailout" for Deutsche Bank, whose problem is a large and risky balance sheet. Among European banks, it has the highest share of hard-to-value level three assets, at close to 50 per cent of CET1 capital.

Cause for hope

Before Australian global investors write off the euro bloc's central stabilising engine of growth, it must be remembered that Germany has deeper pockets to subsidise bad troughs and windows of malaise. Germany has posted substantial current account surpluses, well above the level justified by economic fundamentals for several consecutive years in a row.

Over the past decade, Germany has consistently been posting large current account surpluses on its balance of payments and since 2011, the surplus has been above 6 per cent of GDP, the threshold above which the surplus is qualified excessive by the European Union (EU).

Current account imbalances are not in principle bad but in the case of Germany, they are partly linked to the accumulation of savings by an ageing population which are invested abroad in younger and more dynamic economies.

Germany is clearly going through a rough patch as its industrial economy faces up to cyclical headwinds, unwanted structural change and the threat of protectionism.

The greatest risk of a permanent loss of capital in Germany – which for years has relied for its growth on a huge vendor financing scheme, lending money to people who cannot repay across Europe – lies in its car industry. This is where the biggest malinvestment has taken place, favoured by an undervalued exchange rate and a market interest rate that was kept low to maintain an unsustainable exchange rate.

From the 1970s until the Great Recession of 2009, the cost of capital in Germany was always well above the nominal growth rate, sometimes by as much as 700 basis points – capital wasn't misappropriated.

Waste of capital

Since then, however, the relative cost of capital has fallen by more than 500 basis points and this waste of capital in Germany has caught up with the national economy, as the performance of German bank shares would seem to indicate.

Japan witnessed a similar fate in 1988, which of course Australian investors remember representing the nadir of the 1987 to 1991 rolling recessionary years that crippled the Australian economy as we knew it then.

The Great Recession and the subsequent European sovereign debt crisis have drastically changed the perception of the role of the current account, in particular in a currency union. After all, a current account deficit needs to be financed even in a currency union.

Clearly, Germany is unique and unlike any other economy. But it must be remembered that what may present as recessionary flags elsewhere do not automatically transpose on to the German domestic experience.

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