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CIO Viewpoint

Reinventing the German economy in a post-Covid world

Investment Solutions

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Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Germany's assumption of the European Union presidency comes at a pivotal moment for bloc's largest member as the region tackles recovery from the economic and social damage of Covid-19. Its motto for the presidency, "Together for Europe's recovery", signals not only the scale of ambition for Europe during Berlin's six-month tenure but also the challenge for Germany itself in remaking its economic model to make it fit for purpose in a post-Covid world.

The backdrop for such ambition is tougher than had been anticipated when the first economic readings from the pandemic came through in May. Longer lockdowns are likely to cause a "significantly" deeper recession in the eurozone for the rest of the year, the European Commission (EC) said in its latest forecast for the bloc.

Gross domestic product is set to fall by as much as a record 8.3%, with growth in 2021 seen at +5.8%. We see the euro area experiencing a 7% GDP contraction this year, recovering to +5% growth in 2021.

Germany faces a significantly less severe contraction than other major EU economies, with GDP falling by 5.5% this year, recovering to grow by 4.5% in 2021. The EC forecasts inflation this year at 0.3% for the euro area, and 0.4% for Germany.

Avoiding a twin-track recovery within the eurozone will be key. That is at the heart of German chancellor's support for the EC's proposed EUR 750bn economic recovery fund, unveiled in May. Together with French president Emmanuel Macron, Merkel - a "chancellor reloaded", in the words of one German official in reference to domestic support for her handling of the pandemic – has thrown her weight behind two things: tapping the capital markets in order to raise the bulk of the funds, and that they be largely disbursed in the form of grants to member states.

The aim is clear: by showing solidarity with countries worst affected by Covid, there is a fighting chance of weaving a robust new fabric that will bind all EU member states together with renewed collective purpose.

Opposition to the grants element of the EU's recovery fund from the so-called "frugal four" – Austria, the Netherlands, Sweden and Denmark – remains a stumbling block. But there is a good chance that Merkel and Macron will succeed in bringing them on board by the time member states vote at a two-day summit on 17 and 18 July. Central to the EUR 500bn Merkel-Macron proposal is a recognition of a linkage between solidarity and the threat posed to the EU itself by the pandemic's economic effects.

Key takeaways

- Germany assumes the EU presidency at a critical moment for its own economy, as well as for Europe
- Policymakers face an uphill task remaking the economic model of the EU's largest economy to one less reliant on manufacturing and more on innovation
- Sustainability and a "green recovery" are big positives in the German government's domestic pandemic recovery stimulus
- The leadership that Chancellor Angela Merkel has shown in managing the Covid crisis and breaking with fiscal orthodoxy bodes well, but her successor must maintain the momentum.

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Data as of 13 July 2020 unless otherwise stated.

Behind that lies an equally profound shift at home in Germany, where a long-held fiscal stance of balancing budgets and tight spending – *Schwarze Null*, or black zero – has had to give way to the reality of massive spending needs. It is hard to overstate the significance of this as a decisive break with a long-standing consensus approach. "We're doing whatever is necessary," Merkel had already signalled in March, "and we won't be asking every day what it means for our deficit."

Yet while increased public spending will help reduce reliance on exports, a broader re-invention of the German economic model is needed too. A change in the growth profile heavily based on manufacturing as a proportion of GDP (see chart 1) and an embrace of disruptive technology should be priorities. Germany has made a virtue of its entrepreneurial *Mittelstand*, which sells high-value products globally. But big tech is showing that developing an ongoing relationship with a customer via data is where true value is being created. Big tech is making inroads into healthcare, with predictive health solutions that rely on data replacing a treatment and patented-medication model that had driven business models until now. Little wonder that Apple's market capitalisation is larger than that of the top 30 constituents of the Dax index – many of them storied German manufacturing names - combined.

Automotive accounts for 5% of GDP, with more than two-thirds of production exported, yet is facing wholesale disruption as a result of e-mobility and automation. Efforts are being made to turn the ship around. In a EUR 130bn fiscal stimulus package for Germany unveiled on 29 June, Berlin allocated around EUR 46bn, according to Bloomberg calculations, in sustainable investments for a "green recovery". A significant share of that is to go towards e-mobility and research and development in battery technology.

Pulling on these two levers to improve the German economy would have positive implications for the whole region. But it remains to be seen how these radical shifts can be implemented at pace in an economic model that has relied for so long on consensus, with unions represented on boards and regulatory and oversight gaps that need to be addressed, as the Wirecard saga has highlighted.

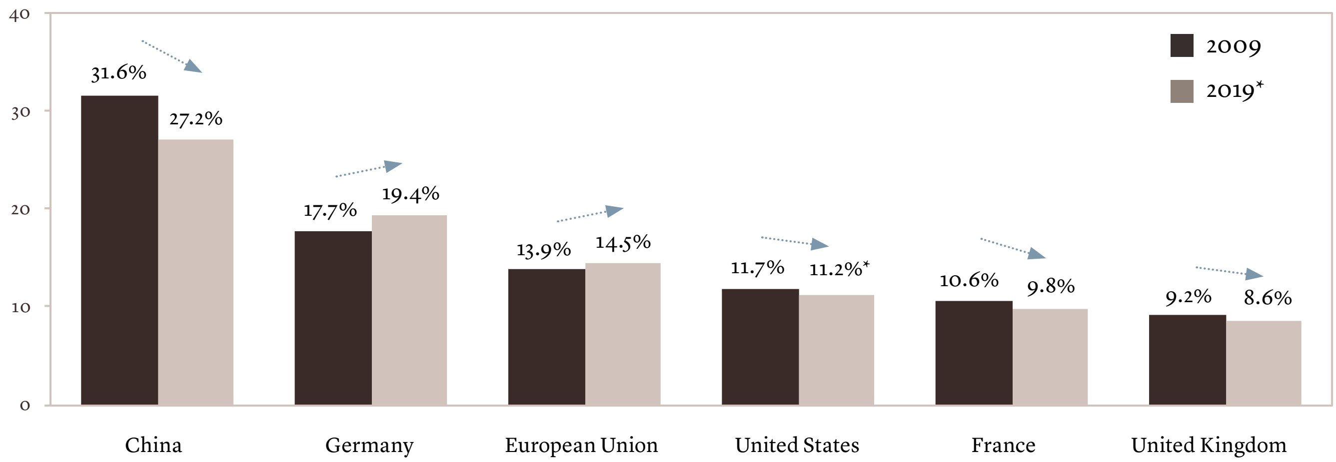
Yet the task is difficult and urgent, for another reason: competitiveness. The German economy fell to seventh place globally in the latest WEF competitiveness rankings, down by four places – the most of any country except Indonesia in the first 50 countries in the ranking.

Public investment will play a large role. Germany's gross fixed capital expenditure has been significant and steady, albeit nowhere near as China's levels (see chart 2). But public investment cannot do the whole job. Berlin last year promised to spend EUR 3.5bn on installing 1m charging points across Germany while raising subsidies to encourage people to buy electric vehicles. The UK experience of charging infrastructure has shown that while government grants have been vital to encouraging early adoption of electric vehicles, it is increasingly falling to the private sector to build out the network on a commercially viable basis, according to a recent report by consultants at PwC.

Germany also needs to raise its digital game – specifically on broadband connectivity. The country's biggest weakness in the WEF competitiveness rankings was a relatively low level of information and communications technology adoption, placing Germany behind a number of Gulf states, China and Russia. Encouraging signs came in the 29 June package, which included EUR 5bn for the build-out of a national 5G network by 2025.

1. Germany relies on manufacturing

Manufacturing, value added (% of GDP)



*latest data available for the US 2017
Source: World Bank

Such leadership as has been shown by Merkel will now be required of whomever succeeds her to make the corporate and economic reinvention of Germany a reality in the post-Covid era.

The contest to replace the chancellor when she stands down next year looks very different from even six months ago. Armin Laschet, prime minister of the state of North Rhine-Westfalia, had for months been widely expected to succeed Merkel as Christian Democratic Union (CDU) leader in December. But a recent TV poll propelled Markus Söder, prime minister of Bavaria, ahead of Laschet as the preferred CDU candidate for chancellor, based on his tough handling of the coronavirus.

That does not appear to have changed Laschet's front-runner status and Söder, who also leads Bavaria's ruling Christian Social Union (CSU) party, has since tacked towards the more liberal lockdown approach taken by his rival, notably by allowing Munich's beer gardens to re-open in May.

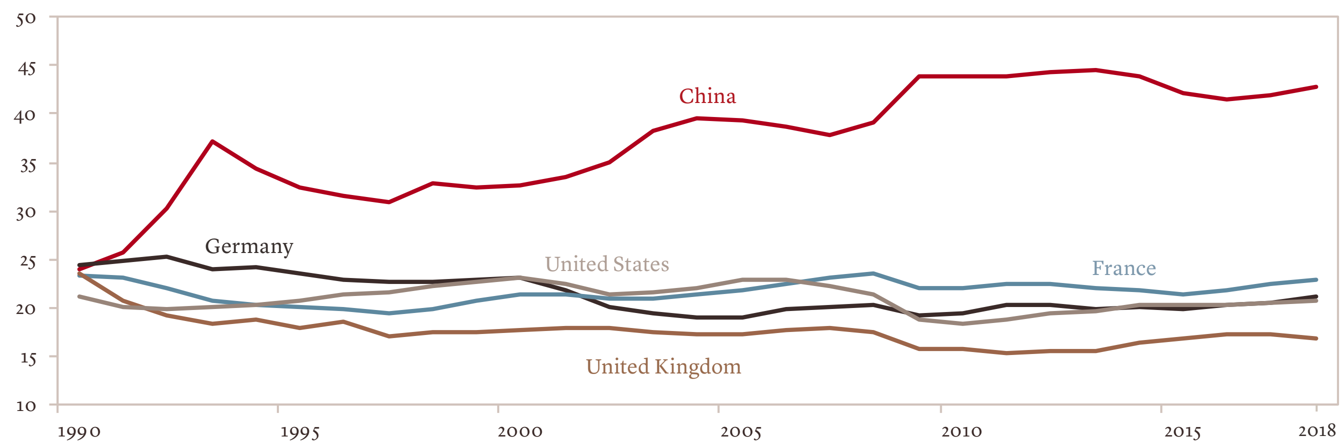
Whoever ends up in the Chancellery in Berlin will be drinking a long draught of challenges. Investors will be watching closely.

They will be particularly interested to see how Germany's Dax stock market index reflects global growth prospects, given how German corporates' performance is closely linked to the global economy through the materials, financials and industrials sectors – sectors to which the Dax is heavily weighted. The index underperformed the MSCI World Index during the March sell-off, before recouping losses in early June when sentiment rose.

Meanwhile, German 10-year Bund yields have been trading between -0.75% and -0.20% over the past 12 months. This reflects the European Central Bank's negative deposit rate of -0.5%, expectations of accommodative monetary policy for the next three years, and limited-to-no risk of inflationary pressures. German yields are therefore likely to stay negative and stable for longer.

2. Gross fixed capital formation in major economies

% of GDP



Source: Bloomberg

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

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Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom ·
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
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Lombard Odier Funds (Europe) S.A.
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Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
Paseo de la Castellana 66, 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
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MOSCOW
Bank Lombard Odier & Co Ltd · Representative Office Moscow
Letnikovskaya st.2, bld.1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
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Lombard Odier (Europe) S.A. · Succursale en France[2]
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dubai@lombardodier.com
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
140 West Street · Sandton · Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

MONTEVIDEO
Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305
11300 Montevideo · Uruguay
montevideo@lombardodier.com
Supervised by Banco Central del Uruguay.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
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Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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Lombard Odier (Singapore) Ltd.
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Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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