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The significance of ESG

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The significance of ESG

Illegal dumping of waste, manipulating emission standards, use of child labour, sexual harassment, fraud, corruption, are all instances of unfortunate incidents that we have experienced in the past years and may be fresh in our minds. For the companies and people involved, we also generally know what this leads to: fines, arrests, employees quitting their jobs either forcefully or out of protest, lower share prices, consumer and supplier boycotts leading to a decline in revenues and profits etc. Some organisations involved in these incidents have even ceased to exist. Three letters i.e. 'ESG' capture these kinds of events and have increasingly gained importance, not only in corporate governance, but also among providers of capital. ESG stands for Environmental, Social and Governance.

Regardless of the seemingly obvious connection between particular incidents and damage caused, it took years and much research to build a convincing case for the value of Corporate Social Responsibility (CSR) to which ESG belongs. In recent years, supported by research outcomes and practical experience, there is a growing consensus that corporate responsible behaviour is leading to higher performance, more stability and a better reputation or more trust. This all leads to sustainable economic growth and a more pleasant world for us to live in. In this article, we will explain the significance of ESG and how we can use this to gauge corporate responsibility.

Companies as societal entities

A common, but increasingly negative view is that companies exist to make money for their shareholders. The shareholders brought in the capital that laid the foundation for the company. In return for their investments, shareholders receive rewards in the form of dividends or future growth, generated by reinvested profits. Management's role is to make sure everything functions well in order to provide these rewards.

A relentless focus on earning profits, without regards of e.g. the environment the company operates in, workers employed or rules established, can eventually lead to detrimental effects, such as depletion, exhaustion and transgressions. These on their turn will affect corporate performance as discussed above. Obviously, it also works the other way around, if a company looks after the environment it operates in, it can continue to do so well. Taking care of workers leads to a fitter and motivated work force, that is more productive and creative. Abiding laws will benefit credibility and trust, making it easier to do business and leading to efficient transactions.

These insights, which are arguably as old as entrepreneurship itself, led to theoretical frameworks referred to as Corporate Social Responsibility or just Corporate Responsibility, for those who were less keen to include 'social'. A general discussion about the theory of CSR is not part of the scope of this article. What we wish to address here is that corporate responsibility nowadays has been widely adopted by companies, and is not exclusively enforced by means of laws and regulation.

Gauging corporate responsibility
What constitutes responsible behaviour? In other words, how can one measure this and its impact? ESG is helpful, as it offers concrete aspects with which the degree of corporate responsibility can be assessed. Each letter in ESG forms a pillar, Environmental, Social and Governance, which encompass multiple dimensions (see box 1). We can for example assess the environmental pillar along the lines of emissions, water use, recycling and risk management. Most of these aspects can be quantified or scored. To add value to such observations, it is recommendable to look at changes in time, and/or to compare with other companies that have similar business activities or a comparable business model. The reason for this is that it generally does not make sense to compare the environmental measures of an oil company, with those of a business services company.

Mounting evidence
Before we discuss in more detail were ESG data comes from and in what forms it is used, we will return to companies' acceptance of corporate responsibility. This acceptance is to a significant degree driven by research results based on ESG data. Such results increasingly demonstrate that companies doing well along the lines of ESG, also perform better. Performance can be measured in various manners. For example, share price developments, changes in financial indicators such as revenue, net profit, cost of equity, but also credit ratings or the quality of relations with stakeholders.

The number of research studies concerning ESG factors has reached levels that allow for meta-analysis of these studies. One meta-analysis carried out by Arabesque and Oxford University in 2015, covered more than 200 different sources[2]. This analysis showed that "88% of reviewed sources find that companies with robust sustainability practices demonstrate better operational performance, which ultimately translates into cashflows."[3] Another outcome was that 80% of reviewed sources show that share price developments are positively influenced by good sustainability practices.[4] A meta-analysis conducted in the same year by Friede, Busch and Bassen,

Box 1: The three pillars of ESG

The three letters ESG stand for Environmental, Social and Governance. What belongs to each of these 'pillars' is not commonly defined. Different organisations use different ESG factors, and even evidently similar aspects can be defined differently. For example, various units can be used to gauge emissions or the use of resources. In the table underneath, we show some commonly used ESG factors. These factors are also considered to be of greater significance for explaining corporate performance.[1] It is however not a complete overview of factors that can be taken into account for each pillar. For instance, one could add ESG factors such as travel and transport impact, use and reuse of packaging materials and environmental risk management to the Environment pillar.

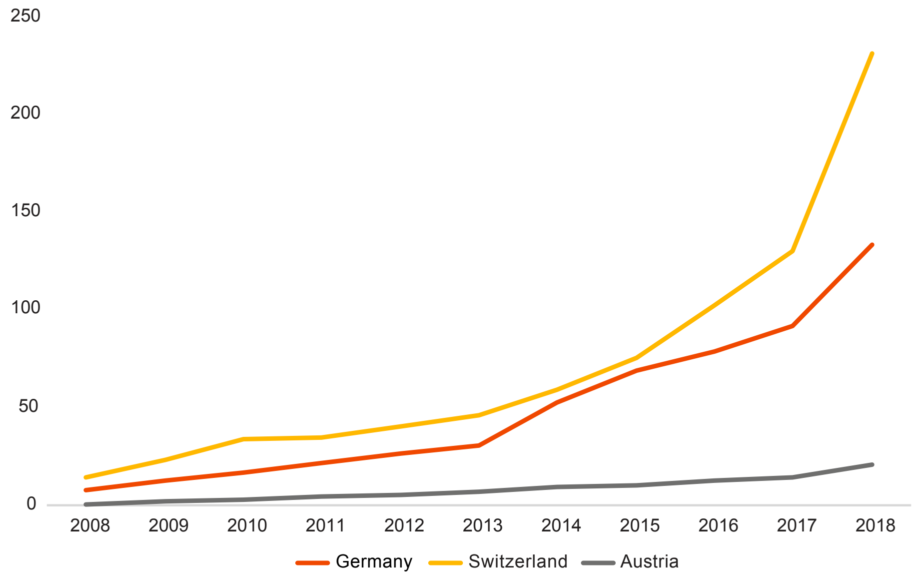
Selection of ESG factors for each pillar

E - Environment	S - Social	G - Governance
- Biodiversity/land use	- Community relations	- Accountability
- Carbon emissions	- Controversial business	- Anti-takeover measures
- Climate change risks	- Customer relations/product	- Board structure/size
- Energy usage	- Diversity issues	- Bribery and corruption
- Raw material sourcing	- Employee relations	- CEO duality
- Regulatory/legal risks	- Health and safety	- Executive compensation schemes
- Supply chain management	- Human capital management	- Ownership structure
- Waste and recycling	- Human rights	- Shareholder rights
- Water management	- Responsible marketing and R&D	- Transparency
- Weather events	- Union relationships	- Voting procedures

Source: Arabesque and Oxford University.

1 Arabesque, Oxford University, "From the Stockholder to the Stakeholder; How Sustainability Can Drive Financial Outperformance", 2015, page 12.
2 Arabesque, Oxford University, "From the Stockholder to the Stakeholder", page 10.
3 Idem, page 8.
4 Idem, page 9.

Figure 1 Sustainable investments by funds and mandates in Germany, Switzerland and Austria, 2008-2018, billion euro



covered more than 2,000 studies released since the 1970s.[5] The overall finding of this analysis was that approximately 90% of the studies reviewed showed a non-negative relation with corporate financial performance and 63% of the studies a positive relation.[6]

Providers of financial services have also contributed to a growing body of research concerning the relevance of ESG for companies. Merrill Lynch analysed companies on basis of their ESG rankings, and concluded that "an investor who only held stocks with above average-ranks on both Environmental and Social scores would have avoided 15 of the 17 bankruptcies we have seen since 2008"[7] They further concluded "ESG appears to isolate non-fundamental attributes that have real earnings impact: these attributes have been a better signal of future earnings volatility than any other measure we have found."[8] MSCI too analysed company performance based on their ESG-rankings and along three 'channels' i.e. cash-flow, idiosyncratic risk and valuation. MSCI concluded "high ESG-rated companies tended to show higher profitability, higher dividend yield and lower idiosyncratic tail risks" in addition to "high ESG-rated companies tended to show less systematic volatility, lower values for beta and higher valuations, which verifies the valuation channel."[9]

More conscious investing

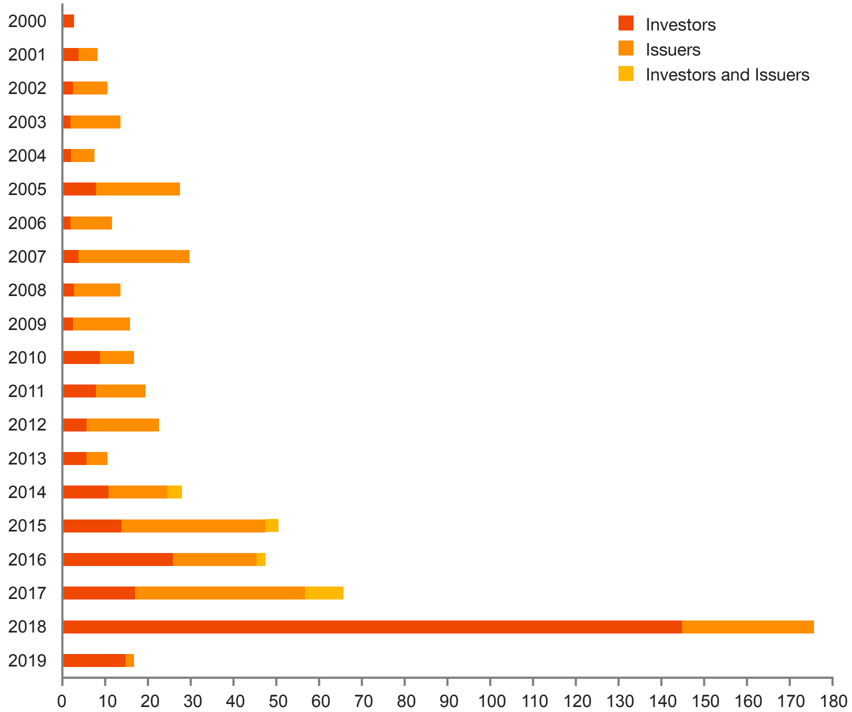
Partly because of research outcomes, institutional investors increasingly do no longer need to be convinced of the relevance of ESG. This as they seek stable returns on their investments and strive to align investments better with their own views, and those of their clients. Private Equity (PE), a type of investor that is even notorious for its focus on financial performance, is increasingly taking ESG serious, as a recent PwC study has made clear. Of PE houses surveyed by PwC, 81% indicated that they have adopted a responsible investment policy, and the same percentage reports ESG matters to their boards at least once a year.[10] Natixis surveyed 500 institutional investors globally and found that 56% "believe ESG mitigates governance and social risks, such as loss of assets due to lawsuits, social discord, or environmental harm."[11] Of the same group, 59% says the reason for ESG investments is "to align investment strategies with organizational values" and 38% says "it is to help minimize headline risk."[12] In the Netherlands, more than seventy pension funds, representing €1,180 billion in assets under management, signed the Dutch Agreement on International Socially Responsible Investment at the close of 2018. The pension funds agreed to collaborate in gauging the impacts of investments and to use their influence to solve issues related to society and environment.

Because of these developments, investments that take into account ESG aspects have increased considerably. In Germany for example, these investments increased more than 17 times in the period 2008 to 2018 (see figure 1).

5 Gunnar Friede, Timo Busch, Alexander Bassen, "ESG and Financial Performance: Aggregated Evidence from more than 2000 Empirical Studies, 2015.
6 Friede, Busch, Bassen, "ESG and Financial Performance", page 9.
7 Merrill Lynch, "ESG Part II; A Deeper Dive", 2017, page 2.
8 Merrill Lynch, "ESG Part II", page 1.
9 MSCI, "Foundations of ESG Investing, Part 1", 2017, page 3.
10 PwC, "Older and Wiser; Is Responsible Investment Coming of Age?", 2019, page 2.
11 Natixis, "Looking for the Best of Both Worlds", 2019, page 3.
12 Natixis, "Looking for the Best of Both Worlds", page 5.

Increased attention for ESG is also driven by legislation and demand. As more and more organisations pay attention to ESG, concerns rise about the extent these factors are truly taken into consideration by companies and their leaders, or the quality of information provided that make assessments of ESG accountability possible. Investors, suppliers and customers want to know whether companies or providers of investment products, have policies in place concerning ESG, what they do to incorporate these or how they avoid particular risks related to ESG factors. In response to this need, the number of rules and guidelines related to ESG disclosure has grown significantly in the past years (figure 2).

Figure 2 Number of ESG regulations since 2000



Source: MSCI. Note: the legend refers to groups that regulations target. 'Issuers' concern issuers of financial products.

ESG information

In order to assess whether companies take ESG factors into account and to what extent, information is required. Contrary to financial reporting frameworks such as IFRS or US GAAP, there is no framework yet for non-financial information including ESG aspects, that has a comparable obligatory weight. This means companies, investors and other types of stakeholders largely determine themselves what ESG aspects need to be disclosed or are relevant.

Currently several frameworks related to ESG do exist, which are also internationally recognized. These are for example guidelines provided by the Sustainability Accounting Standards Board (SASB), Global Reporting Initiative (GRI), the International Integrated Reporting Framework, Climate Disclosure Standards Board (CDSB), United Nations Global Compact (UNGC) and CDP (Carbon Disclosure Project). In the EU, companies are required to include non-financial statements in their annual reports from 2018 and in line with Directive 2014/95/EU.[13] Under this Directive companies need to disclose the policies they have implemented regarding:

- Environmental protection.
- Social responsibility and treatment of employees.
- Respect for human rights.
- Anti-corruption and bribery.
- Diversity on company boards (in terms of age, gender, educational and professional background).[14]

The Directive does however not cover all companies, it only applies to public-interest companies with more than 500 employees.

Apart from governments and international bodies, stock exchanges too, promote or even demand the disclosure of ESG related information. In the first quarter of 2018, there were 38 stock exchanges globally providing voluntary guidance on ESG disclosure, and there were 14 exchanges with ESG disclosure as a mandatory rule.[15]

13 European Commission, *https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en*
14 Idem.
15 UNCTAD, "World Investment Report 2018", 2018, page 22.

ESG rating agencies

Publishing ESG related information is the beginning, rather than the end. After all, how to make sense of all this information? What is relevant and not, and how can you assess companies based on the ESG data? This is where ESG rating agencies come into play.

ESG rating agencies collect ESG data, and use this to classify companies by means of a score or by identifying the best in class companies, and add these to an index or a short-list. One major advantage is that the ESG rating agencies facilitate comparisons between companies on basis of ESG topic categories, such as resource use, workforce and CSR strategy. Each category can consist of multiple indicators, e.g. water use, CO_2 emissions, green buildings, salary gap, fatalities, signatory of international agreements etc. Depending on how companies score on indicators and topic categories, they get a rating or rank, which can be used as a selection criteria or classifier.

Another advantage is that ESG rating agencies frequently use multiple sources in order to derive a rating. They do not only use corporate

Figure 3 Characteristics of ESG rating agencies

Rating agency	Target market	Coverage (nr. of firms)	Ratings				Nr. of topics	Nr. of indicators	Rating scale (best to worst)
			ESG	E	S	G			
Market									
Bloomberg	Investors & Companies	> 10,000	√	√	√	√	120	700	100-0
FTSE Russell	Investors	> 4,000	√	√	√	√	125	350	5.0-1.0
MSCI	Investors	> 6,000	√	√	√	√	37	1,000	AAA to CCC
Refinitiv*	Investors	> 6,000	√	√	√	√	178	400	A+ to D-
ESG Exclusive									
Arabesque	Investors	> 4,000	√	√	√	√	--	200	100-0
Covalence	Investors & Companies	> 3,400	√	√	√	√	50	--	100-0
CSRHub	Companies	> 17,000	√	√	√	√	--	--	100-0
Ethos	Investors	> 1,650	√	√	√	√	--	--	--
Inrate	Investors	> 2,600	√	√	√	√	--	--	A+ to D-
Oekom Research	Investors	> 3,500	√	√	√	√	37	100	A+ to D-
RobecoSAM	Investors & Companies	> 2,400	√				120	survey**	Gold, Silver, Bronze
Sustainalitics	Investors	> 6,500	√	√	√	√	21	70	100-0
VigeoEIRIS	Investors & Companies	> 3,200	√			√	38	330	++ to --
Specialised									
CDP	Investors	> 2,000		√			2	175	A to D-

Source: Douglas, Van Holt, Whelan, “Responsible Investing; Guide to ESG Data Providers and Relevant Trends”, 2017, pages 11 and 15.

Notes: “Markets” refers to agencies that offer ESG ratings as a subset of products and services, “ESG Exclusive” agencies focus on ESG ratings, and “Specialised” focusses on one ESG pillar. * New name of Thomson Reuters. ** Surveys with 80 to 120 questions.

Box 2: ESG controversies

Refinitiv complements its ESG score with an assessment based on so-called controversy measures to create an ESG combined score. These controversies are negative ESG events as reported in global media “which materially impact the corporations.” A company could for example be in the news because of a bribery scandal or discrimination. Refinitiv collects such news reports to count controversies for the companies it covers. As a result, ESG combined scores are adjusted for such controversies on a more continuous basis, whereas the ESG scores are updated less often, due to dependence on corporate reporting.

The table on the right shows as an example the controversies count for the 600 companies that are part of the Stoxx Europe 600 index and the ten most recent book years. The ‘business ethics’ controversy count of 520 for the financial services sector was relatively high in this ten-year period compared to other sectors. The total controversies count of 1,166 for the same sector was relative high as well, which will largely be a reflection of the aftermath of the global financial crisis. If one considers the average number of controversies per company, the energy sector does not stand out very well in comparison to other sectors. From the perspective of controversies, the technology sector is the best scoring sector, although it has some issues related to intellectual property.

Sum of controversies by type	Basic Materials	Consumer	Energy	Financials	Healthcare	Industrials	Technology	Telecom	Utilities	Grand Total
Customer Health & Safety	3	127	5	1	86	25	0	0	5	252
Responsible Marketing	4	97	6	119	51	12	2	28	16	335
Product Access	0	3	1	4	8	5	0	1	3	25
Consumer Complaints	1	62	14	94	13	32	12	34	33	295
Privacy	2	21	1	50	1	11	3	30	2	121
Responsible R&D	0	3	0	0	15	1	0	0	0	19
Intellectual Property	6	38	0	6	64	6	48	9	1	178
Public Health	18	10	24	0	4	7	0	3	9	75
Business Ethics	52	193	107	520	98	150	17	52	22	1,211
Tax Fraud	2	19	13	73	10	6	5	12	1	141
Anti-Competition	88	196	60	242	89	126	10	99	59	969
Environmental Controversies	46	69	42	1	8	2	0	0	15	183
Critical Countries	5	4	8	19	3	6	2	1	0	48
Human Rights	9	15	22	2	0	9	0	1	0	58
Freedom of Association	3	18	3	1	0	3	0	2	0	30
Child Labour	1	15	1	1	1	0	1	1	0	21
Wages, Working Conditions	55	103	58	25	5	88	4	10	13	361
Diversity and Opportunity	6	17	3	8	8	22	2	1	0	67
Employees Health & Safety	78	45	51	0	7	44	3	3	8	239
Total controversies	379	1,055	419	1,166	471	555	109	287	187	4,628
Controversies per company	7	8	14	9	9	5	3	12	7	8
Number of companies	54	136	29	135	52	112	32	24	26	600

Source: Refinitiv Eikon, PwC Analysis.

18 Thomson Reuters Eikon, “Thomson Reuters ESG Scores”, 2018, page 6.

responsibility reports, but potentially also news reports, surveys, interviews, information from non-governmental organisations (NGOs) and government reports. Rating agencies collect and analyse this data in an uniform manner, and can capture a greater breadth of ESG indicators this way. Obviously, it also saves users time and effort in trying to accomplish something similar. This is why approximately 70% of institutions use ratings to evaluate ESG performance.[16] This convenience benefits the integration of ESG factors into decision-making and may put pressure on companies with low ESG ratings.

ESG ratings data does have its challenges for users. To begin with, ESG ratings of agencies are very difficult or impossible to compare, because virtually each provider uses its own methodology, with differing topic categories, indicators and rating scales (see table 1). The rising number of ESG rating agencies further complicates this. Already in 2016, there were more than 125 ESG data providers.[17] Besides this, not all ESG rating agencies are transparent with respect to data processing and methodology used, as they often consider the exact methodology proprietary information. This makes it difficult to assess the strength, weakness and usability of the ESG data and ratings provided. Further, not all rating agencies provide an overall rating for all ESG pillars for a company. Some ESG data providers even cover only one of the pillars e.g. Environment as in case of CDP (see table 1).

The scope of companies covered can also be an issue. ESG data providers tend to focus on companies for which a relative large amount of data is available, in order to be able to rate such a company properly. In practice, this means agencies mainly cover exchange-listed companies that need to meet regulatory demands for the disclosure of information and are under larger public scrutiny to do so. Many private companies, or smaller listed companies, are not covered by rating agencies as a result. Another motive for the focus on listed companies is likely the kind of customers the ESG agencies tend to serve i.e. investors that use the ratings for their investment decisions (see 'target market' in table 1). This may change as other kinds of stakeholders, such as suppliers, customers or future employees become keen to find out how a company is assessed on ESG factors. Finally, not all ESG ratings are freely available. Some providers offer these ratings as part of other products, like financial information that require payments.

ESG in the future

We expect ESG to become more and more accepted as factors to take into account for gauging corporate responsibility and performance. This will extend beyond the financial services sector and NGOs, as the significance of ESG indicators will reverberate elsewhere too. As long as generally accepted principles for the collection and communication of ESG related information remains to a high degree noncommittal, it will be challenging to collect and interpret ESG data in a coherent manner. This will especially be the case for those who do not have good access to the ESG data that the rating agencies provide.

Companies can enhance trust if they are transparent about the way they deal with ESG matters. Increased transparency leads to credibility and a greater ability to assess future developments or outcomes. A condition is that the information is sufficiently reliable, by means of alignment with international standards and potentially enforced by means of an audit or certification. Information about ESG matters can further demonstrate how companies take responsibility for the environment they are active in and people they work with.

16 Natixis, "Looking for the Best of Both Worlds", page 7.
17 State Street, "The ESG Data Challenge", 2019, page 2.

Macroeconomic Update Europe

In the Eurozone, the pace of economic growth has stabilised at a relatively low level slightly above one percent. A decline in economic growth in important export markets is affecting manufacturing through trade channels. Domestic demand remains comparatively solid against the background of low employment and inflation, benefitting real incomes and consumption. Nonetheless, current economic conditions are such that the euro area is more vulnerable for demand or supply shocks. The economic situation in Turkey is more precarious, as the country struggles with recessionary conditions. Although the worst seems over, a period of challenging adjustments is still to follow.

GDP growth

In the first quarter of 2019, Eurozone GDP increased 1.2% compared to the same period last year. This GDP growth rate remained unchanged relative to the last quarter of 2018. Although GDP growth was stable in the last two quarters, it has reached the lowest level since the second quarter of 2014, and is well off its third quarter 2017 peak of 2.8%. Private consumption and investment in capital goods supported economic growth in the first three months of this year, while the negative change in inventories formed a drag. The contribution of net trade was positive for the first time in two quarters, but weak with 0.1% points.[19]

We expect growth in the Eurozone to remain sluggish, as a slowdown in trade negatively affects manufacturing activity. Economic growth is still supported by consumer expenditure, low unemployment and wage increases. Consumer sentiment is however indicative of a more cautious consumer. Although consumer sentiment improved slightly this year, it has shown a steady decline since the end of 2017. The European economy is vulnerable to adverse events, such as a trade conflict, Brexit without a deal, political unrest and heightened risk aversion on financial markets.

The Turkish economy shrank for a second quarter, as first quarter 2019 GDP growth came in at -2.6% compared to the same period last year. Economic growth was dragged down by a 13% decrease in fixed capital expenditure and a 4.7% decline in private consumption. Government expenditure rose with 7.2%, partly due to elections earlier this year, and net trade counterbalanced some of the negative impact. The Turkish economy remains in a precarious position, as temporary stimulus related to the elections will fade, and private consumption continuous to suffer from a high inflation rate, increasing unemployment and elevated uncertainty.

Private consumption

After three quarters of relatively low increases, private consumption's contribution to Eurozone economic growth rose again in the first three months of this year. Consumption in this period was supported by lower energy prices and higher automobile sales in Germany. On a structural level, private consumption remains supported by higher real wages and low employment. In April 2019, unemployment in the Eurozone was 7.6%, the lowest rate since August 2018. The number of people employed in the Eurozone increased by 1.3% in the first three months of 2019 and compared to the same period a year earlier. Employment has again reached the highest level ever recorded. Hourly wages rose with 2.5% in the first quarter of 2019 on an annual basis.

Capital investments

Gross fixed capital formation was comparatively robust in the Eurozone with an annual growth rate of 4.8% in the first three months of 2019. In the previous three quarters, the average growth rate was 3.3%.

19 Eurostat, "GDP main aggregates and employment estimates for first quarter 2019", 6 June 2019.

Net exports

Exports from the Eurozone rose with 3.2% on an annual basis in the first quarter of 2019. An increase in the growth rate compared to the 2.0% print in the last three months of 2018. Imports rose with 4.0% in the first quarter of the 2019, reflecting solid domestic demand.

Government expenditure

Government expenditure growth in the first quarter of 2019 remained unchanged at 1.1% in comparison to the previous quarter. Its contribution to economic growth on an annual basis was only 0.2% points, remaining very stable in the past four quarters. Government consumption is not a driver of economic growth in the Eurozone.

Inflation

Inflation in the Eurozone and May 2019 was 1.2%, down from 1.7% in April 2019. In May 2018, the inflation rate was 2.0% and in October 2018, it stood at a recent high of 2.2%. Since this month, inflation has gradually declined to a level far below the 2% target of the European Central Bank (ECB). At its meeting of 6 June, the ECB reiterated its expectation that key policy rates will remain at present levels until the first half of 2020. The declining inflation rate and market interest rates, in particular negative yields on e.g. German and Dutch sovereign bonds, are confronting the ECB with diverting trends from its target inflation rate. At the ECB's annual symposium in June, Mario Draghi suggested that the ECB could expand its quantitative easing programme again if the inflation outlook fails to improve.[20] This triggered a 0.5% decline of the euro versus the US dollar, and annoyed comments from president Trump accusing the ECB of currency manipulation[21].

Inflation in Turkey is quite a different story. In May 2019, inflation was 18.7%, down from 19.5% in the previous month. The high inflation rate and market pressures on the lira, forces the Turkish Central Bank to hold back on interest rates cuts in the short term, until the inflation rate drops further. Producer prices remain elevated compared to inflation, indicating companies are still reluctant to completely pass on higher costs to consumers, this to the detriment of companies' profit margins.

Figure 4 Key economic indicators, selected European economies

	GDP growth (% change)	Industrial production (% change)^	Consumer spending (% change)	Capital investment (% change)	Unemployment rate (%)^^	Consumer prices (% change)^^^
Eurozone	1.2	-0.5	1.0	2.8	7.6	1.2
Austria	1.6	-1.8**	1.7	2.8	4.7	1.7
Belgium	1.2	-2.5**	-2.0	3.5	5.7	1.7
France	1.2	0.4	1.5	2.2	8.7	1.1
Germany	0.7	-2.3	3.1	3.0	3.2	1.3
Italy	-0.1	-0.7	-0.9	0.1	10.2	0.9
Luxembourg	1.7*	2.1	2.8	-2.4	5.5	2.2
Netherlands	1.9	-1.7	2.7	3.6	3.3	2.3
Spain	2.4	-1.2	0.3	4.6	13.8	0.9
Switzerland	1.4	0.3**	0.9	-0.8	2.2	0.5
Turkey	-3.0	1.0*^	-8.9	-12.9	12.7**	19.7
United Kingdom	1.8	-2.7	-1.4	-1.4	3.7***	2.1****

Note: Figures are the latest available values i.e. the first quarter of 2019, unless specified differently. Figures are further reported quarterly, unless otherwise stated, and on basis of year-on-year change (where applicable). Consumer prices are reported according to the HICP methodology, except for Turkey.
^ Month-on-month change, April 2019 ^^ Seasonally adjusted, April 2019 ^^^ May 2019
* Q4 2018 ** March 2019 *** February 2019 **** April 2019 *^ Seasonal and calendar adjusted
Source: Thomson Reuters, Eurostat, Turkstat.

20 Financial Times, "Trump hits out at Draghi over fresh stimulus signal", 18 June 2019.
21 Idem.

Country Update: Germany

- **After five consecutive years of solid growth, the German economy is showing signs of a slow-down.**
- **Global protectionism poses a threat to the export reliant manufacturing industry.**
- **A shortage of skilled workers is limiting the growth potential of firms.**
- **Reluctant digitalization may harm competitiveness in future.**

After two quarters of slowdown following its prolonged boom, German economic growth – while back in positive territory – continues to underperform expectations[21]. In the first quarter of 2019, real GDP increased by 0.4% in comparison to a 0.2% decrease in the third quarter of 2018 and stagnation in the last quarter of 2018.[22] Growth remains just below the EU28 average, which increased from 0.3% in the last quarter of 2018 to 0.5% in the first quarter of 2019. German companies remain pessimistic about current and future business conditions – since its all-time high in 2017, the ifo Business Climate Index[23] has been on a downward trend, signalling a cooling of business conditions, predominantly in the manufacturing and wholesale sectors.

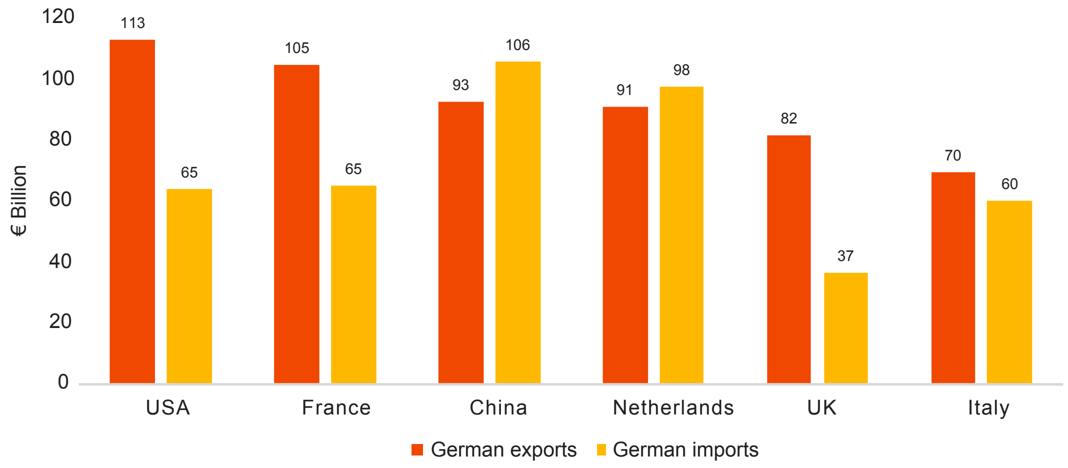
The German labour market remains in good shape. In November 2018, the unemployment rate of 4.8% was at its lowest level since the German reunification. Nonetheless, increased uncertainty about economic conditions has begun to reveal fissures here too. In spring 2019, the unemployment rate slightly increased to 4.9%, and the number of vacancies posted dropped substantially compared to previous years, which is considered to be a direct consequence of the cooling German economy.[24] Combined with low inflation rates, the strong German labour market has led to increased real income levels of German households in recent years. In 2018, household real income grew 1.3%, boosting consumer spending.

Simultaneously, general government revenue increased significantly, with an all-time high of €58 billion in fiscal surplus in 2018[25] and a reduction in government debt by 2.7% despite increased public spending. Here too, the official forecast of tax revenue already foresees a more moderate increase in the coming years. The dollar-euro exchange rate is still favourably low for the export heavy German economy, following a downward trend from $1.15 to $1.12 per euro since the beginning of 2019. The German year-on-year inflation rate has been oscillating between 1.4 to 2.1% in the first five months of 2019, remaining slightly above the average EU rate.

21 International Monetary Fund, "World Economic Outlook: Growth Slowdown, Precarious Recovery", April 2019.
22 Federal Statistical Office, "Growth rates are adjusted for price, season and calendar effects", May 2019.
23 The ifo Business Climate Index is a large-scale monthly survey among German companies, assessing their evaluation of current and expected business development.
24 *https://www.arbeitsagentur.de/presse/2019-17-der-arbeitsmarkt-im-mai-2019-konjunktur-bremst-fruehjahrsbelebung*
25 *https://www.destatis.de/DE/Presse/Pressemitteilungen/2019/02/PD19_065_813.html*

As the world's third largest exporter, the German economy is highly reliant on open markets and a prospering global economy, with every fourth workplace in Germany directly linked to the export industry.[26] The recent slowdown of global growth[27] therefore poses a substantial threat to future German economic growth and employment. The protective stance adopted by the US government is particularly detrimental for Germany, due to a potential decline in global demand. The looming trade conflict between the US and China further threatens to weaken the economic outlook of Germany's biggest trade partner and global economic powerhouse, with 8% of German trade conducted with China (see Figure 5). In addition, internal woes of the EU or EU trading partners contribute to the overall environment of economic uncertainty: in particular, the pending Brexit and the debt crisis in Italy may lead to a further economic downturn in the EU.

Figure 5 The six biggest German trade partners by export and import in 2018



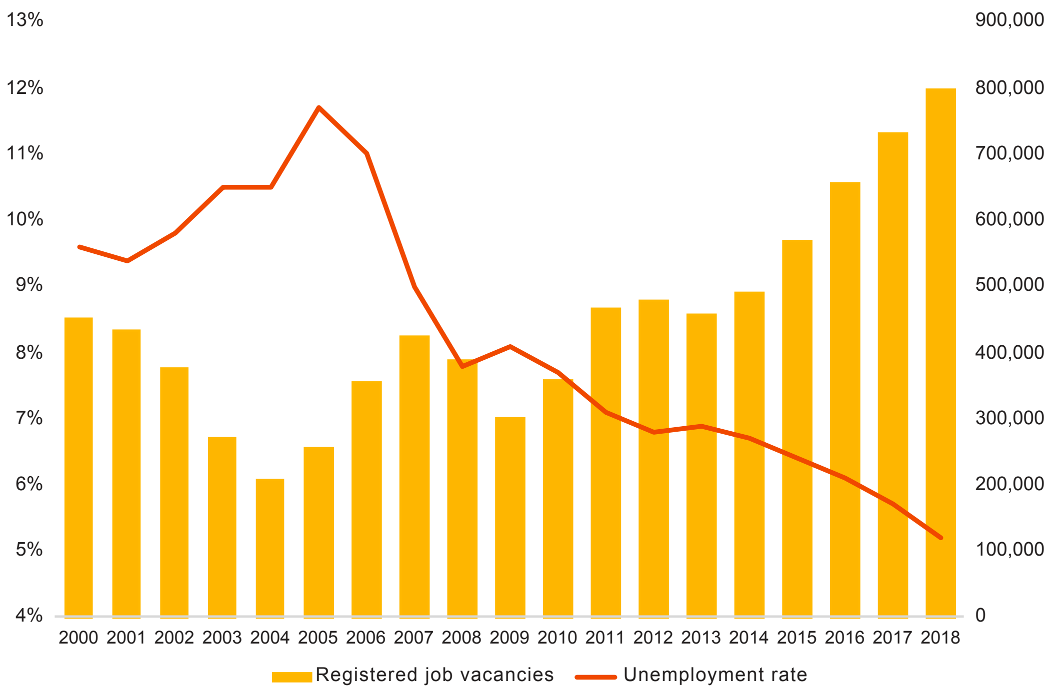
Source: German Statistical Office, Fachserie 7 Reihe 1: Außenhandel: Zusammenfassende Übersichten für den Außenhandel, 26 February 2019.

Further efforts are necessary to address the shortage of skilled labour

German companies consider the scarcity of skilled workers to be the biggest current risk for business development.[28] The average number of registered job vacancies almost doubled in the last four years (see Figure 6). The labour shortage is likely to be exacerbated further by demographic change, with an expected decline of the German workforce by 3.5 million workers by 2030, leaving every tenth workplace vacant.[29] To address this shortage, experts have argued for the promotion of immigration in the skilled labour segment. The German government intends to reduce barriers to immigration for skilled non-EU workers, by, among other measures, removing the requirement of EU-residents to be prioritized over non-EU residents, and by facilitating job searches for foreigners with foreign vocational qualifications.[30] Since the equivalence principle of the foreign qualifications remains unchanged i.e. individuals with qualifications from non-EU countries undergo a lengthy process to prove adherence to German vocational standards, experts estimate that these changes are insufficient to stimulate the required extent of skilled immigration, however.

26 Federal Agency for Civic Education: *http://www.bpb.de/nachschlagen/zahlen-und-fakten/globalisierung/52842/aussenhandel, 7 May 2019*
27 International Monetary Fund, "World Economic Outlook", April 2019.
28 PwC,"European Private Business Survey", 2018. *https://www.pwc.de/de/mittelstand/european-private-business-survey-2018-de-final.pdf*
29 PwC,"Demografischer Wandel. In Deutschland werden Arbeitskräfte rar", 2016.
30 Bundesregierung, "Eckpunkte zur Fachkräfteeinwanderung aus Drittstaaten", Oktober 2018. *https://www.bmi.bund.de/SharedDocs/downloads/DE/veroeffentlichungen/2018/eckpunkte-fachkraefteeinwanderung.pdf?__blob=publicationFile&v=1*

Figure 5 Unemployment rate and job vacancies in Germany between 2000 and 2018



Source: Federal Employment Agency.

Slow adoption of digital infrastructure and digital business models

Compared to the most digitally advanced Asian countries[31], Scandinavian countries and the US, the progress of digitalization in Germany is lagging behind. One reason for the hesitant adoption of new technologies is the lack of a reliable mobile network infrastructure with nationwide coverage. As of June 2019, the auction of 5G frequencies in Germany is still ongoing. The auction value has, as of the beginning of June 2019 exceeded €6 billion, sparking concerns among experts that the high initial capital costs will decrease further investments by the providers and increase consumer prices for the new frequencies.

At the same time, German companies have been particularly slow to adopt artificial intelligence and cloud technologies in their business processes, or to develop digital products. While scientific research in the field of artificial intelligence in Germany has an excellent reputation globally, the business sector, and above all the powerful German 'Mittelstand', i.e. medium-sized companies, have largely refrained from investing in digitalization projects. This because of the high initial costs as well as continued reservations about data security and the performance of the new technologies.[32]

31 *https://www.imd.org/wcc/world-competitiveness-center-rankings/world-digital-competitiveness-rankings-2018/*
32 KfW Research," KfW-Digitalisierungsbericht Mittelstand 2018", April 2019.

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