

| The current economic situation in Germany

Overview

German economy kicks off year with strong growth

Global economy

As in the final quarter of 2015, global economic output at the start of 2016 probably expanded at no more than a subdued pace, with clearer signs than before of a shift in expansionary forces. The emerging market economies appear to have emerged from last year's distinct lull to stabilise of late. In contrast, economic growth in key advanced economies remained muted. This may well have been triggered in part by the slump in demand in the emerging market economies. However, domestic factors were partly to blame for the virtual stagnation of the US economy in the first quarter. The euro area, by contrast, saw its macroeconomic recovery continue with increased momentum, boosted by mild winter weather.

The slowdown in global economic growth last year was notionally attributable to commodity-exporting regions, which were forced to digest considerable adjustment costs as a result of the fall in prices of their key export goods. Unsurprisingly, developments in the commodity markets in recent months have been regarded by many as a yardstick for the economic outlook, and not just for this group of countries. The latest stabilisation of commodity prices paves the way for the exporting regions to return to normality and thus also for the world economy as a whole to gather strength. A scenario of this kind underpins the staff projections in the World Economic Outlook, published by the International Monetary Fund (IMF) in April. The IMF's staff thus project that real gross domestic product (GDP) will bounce back in the Commonwealth of Independent States and Latin America in 2017, following two years of contraction. This reversal is the primary reason for the expected strengthening of global growth in the coming year.

The year 2016 kicked off in the international financial markets against the backdrop of lacklustre growth, at best, in the global economy and additional accommodative monetary policy measures in major economies. Oil prices, which fell sharply until mid-January before recovering their footing, weighed on stock markets for a time. The attendant shifts into safe haven investments sent yields tumbling in bond markets. Yet the lower yield level, at the same time, also reflected market participants' expectations of additional expansionary monetary policy measures in the euro area and Japan. The Bank of Japan had already unleashed further monetary policy measures in January and introduced, for the first time, negative interest rates for some of the deposits that commercial banks hold at the Bank of Japan. In addition, the period under review saw a consensus emerge among market participants that the Federal Reserve would raise its policy rate more slowly than the market had assumed at the start of the year. Whereas yield levels remained doggedly close to their historical lows up to the end of the period under review, equities on both sides of the Atlantic succeeded in part in recouping the losses they had sustained into February. However, bank shares, which faced particular challenges, were only able to claw back previous losses to a comparatively minor extent. In foreign exchange markets, too, alternating views on the pace of further interest rate hikes in the USA and the uncertainty surrounding the global economic outlook were keenly followed. Overall – despite fluctuating distinctly and fairly differently against individual currencies – the euro appreciated by approximately 3% in real terms.

Financial markets

At its monetary policy meeting at the beginning of March, the Governing Council of the ECB re-examined the degree of monetary policy accommodation – as it had announced in January – based on the submitted macroeconomic projections. The ECB Governing Council

Monetary policy

regarded an extensive new package of monetary policy measures as necessary to counteract the increased risks to price stability, to avoid any second-round effects on wage and price setting, and to reinforce the momentum of the euro area's economic recovery. As part of this package of measures, the Governing Council lowered its main refinancing rate and the rate for the marginal lending facility by 5 basis points each, to 0% and 0.25% respectively; it reduced the interest rate for the deposit facility by 10 basis points to -0.40%. Furthermore, the Governing Council stated that, taking into account the current outlook for price stability, it expects the key interest rates to remain at present or lower levels for an extended period of time, and past the horizon of its net asset purchases.

Another component of the package of measures adopted by the Governing Council was the expansion of the volume of the monthly purchases under the expanded asset purchase programme (APP) by €20 billion to €80 billion as of April 2016. These purchases are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. In addition, the APP is being expanded to include a corporate sector purchase programme (CSPP), under which investment-grade euro-denominated bonds will be purchased from non-banks domiciled in the euro area. The purchases under the CSPP, which will form part of the monthly purchase volume, are scheduled to begin in June 2016.

Furthermore, the ECB Governing Council adopted a new series of a total of four targeted longer-term refinancing operations (TLTRO II) to further strengthen the degree of accommodation of its monetary policy and to create additional incentives to encourage lending to the real economy. These operations will be carried out on a quarterly basis and are likewise scheduled to begin in June 2016.

The German economy grew strongly at the start of 2016. According to the Federal Statistical Office's flash estimate, real GDP in the first three months of the year was up 0.7% on the quarter after seasonal and calendar adjustment. Growth thus accelerated perceptibly and was noticeably up on the growth path of potential output. This drove up aggregate capacity utilisation, which reached its highest level since 2012. Economic growth was still being propelled chiefly by private consumption and buoyant construction activity, but, in contrast to the end of 2015, also by resurgent export activity and investment in machinery and equipment.

German economy

Private consumption demand mainly surged on the back of a fresh (quarter-on-quarter) decline in global oil market prices, which bolstered consumers' purchasing power in Germany. Furthermore, the upbeat outlook for the labour market and incomes was continuing to spur domestic activity. Construction investment showed a very sharp rise, buoyed by the exceptionally mild weather conditions. Another major factor in the strong growth was the renewed upturn in exports following the decline at the end of 2015, in which the sharp pick-up in demand from China of late played an instrumental role. In tandem with the increased level of aggregate capacity utilisation, this also boosted enterprises' willingness to step up their investment again.

German banks increased their lending to the domestic private sector significantly in the first quarter. In addition to a marked rise in loans to households – fuelled, as usual, by housing loans – lending to non-financial corporations also increased noticeably in the first quarter of 2016. According to the results of the Bank Lending Survey, the surveyed institutions saw demand among non-financial corporations for bank loans climb sharply in the first quarter of the year. Judging by the responses given by the participating banks, this is likely to have been driven by the keener demand among businesses for funds for investment and operational

purposes, say, as well as for refinancing, on the one hand, and by the low interest rates, on the other.

Employment saw very strong growth in the first quarter owing mainly to an upturn in jobs subject to social security contributions. New jobs subject to social security contributions were notably occupied in those services sectors which had already recorded particularly strong growth in recent quarters, namely business-related services and the health and social services sector. Employment growth also picked up significantly in the construction sector and is now likewise at an above-average level. As in previous months, the strong demand for labour was met to a very significant extent by labour market-oriented immigration, especially from within the EU. Although the influx of refugees is gradually starting to make itself felt in the unemployment statistics, the year to date has seen a further decline in unemployment. The leading labour market indicators suggest that the upbeat employment path might remain intact in the coming months, albeit at a somewhat more moderate pace than of late, and that registered unemployment will edge up slightly, probably in connection with the influx of refugees.

The first quarter of 2016 saw negotiated rates of pay climb much less substantially than they had done in the autumn quarter of 2015. This was driven chiefly by negative base effects owing to one-off payments in the same quarter of last year, but also, to an increasing extent, by the quite low increases in the second stage of a number of pay agreements negotiated in earlier pay rounds. In the first quarter of 2016, actual earnings may have marginally outpaced negotiated rates of pay.

In this year's pay round, the pay settlements for central and local government employees as well as in the metal-working and electrical engineering industries will raise negotiated pay rates by around 2½% both this year and next year. In the public sector, additional agree-

ments, such as guarantees regarding the supplementary pension scheme and the introduction of a new pay scheme for local government, are likely to have made the trade unions more willing to agree to these comparatively modest wage increases. The moderate pay settlement could, nonetheless, send out a signal to other wage bargainers currently in negotiations in other sectors. From a stability policy perspective, it is crucial that the currently low inflation rates do not lead to second-round effects, which would materialise if lower inflation rates or expectations were to be used as a benchmark in the current round of wage negotiations rather than a rate of inflation within the desired range of "below, but close to, 2%".

The price trend was still very much pointing downwards across all stages of the economy in the first quarter of 2016. This was largely a reflection of the drop in crude oil prices which continued up until mid-January. Furthermore, the falls in the prices of other commodities – in some cases with a time lag – and the slight appreciation of the euro since November 2015 are also likely to have had a dampening effect on prices (excluding energy), especially at the upstream stages. The quarter-on-quarter dip in consumer prices in the first three months of the year was more marked than in the two preceding quarters. This was due almost exclusively to the accelerated decline in the prices of fuel and heating oil. If energy is excluded, the upward price pressure of the past few quarters continued, albeit somewhat more moderately. Prices of services (excluding rents) went up almost as strongly as in the fourth quarter of 2015. However, this contrasted with food products becoming somewhat cheaper in seasonally adjusted terms, and, in the case of industrial goods, it became noticeable that price inflation for clothing and footwear was significantly weaker than is usual at this time of year, as it already had been in the final quarter of last year. Given the likewise fairly sharp decline in prices in the first quarter of 2015, the annual rate of consumer inflation in the first quarter of 2016 remained unchanged at +0.3% as meas-

ured by the national Consumer Price Index (CPI), and dipped slightly to +0.1% as defined by the Harmonised Index of Consumer Prices (HICP).

Growth in the German economy is likely to lose momentum in spring. It is true that private consumers have not channelled all of the additional financial leeway they gained from the oil price drop into higher consumer spending, but instead saved a portion initially. Nonetheless, growth in private consumption will probably not match the rate seen in the previous quarter. The strong pace of growth in the construction industry is also unlikely to be maintained in the second quarter, as beneficial weather effects have ceased. Even if fiscal policy essentially remains on an expansionary track, the boost provided by rising government spending related to the influx of refugees is likely to subside from the previous quarter seeing as the incoming numbers have tailed off significantly of late. The solid underlying cyclical trend will probably remain intact into the second quarter, however.

Public finances

The German government budget recorded a distinct surplus last year, which, once again, will probably largely be used up this year, however. This is because of a marked deterioration in the structural balance, although interest expenditure continues to provide relief. Spending related to the immigration of refugees will rise distinctly on the year, though the influx has decreased sharply in recent months. Last year, however, many refugees only arrived in autumn, which meant they needed support for just a few months. But even without this, the budgetary stance is already expansionary, and spending on pensions, health and infrastructure, amongst other things, is likely to rise significantly. All things considered, no major change in the budget balance is expected in the coming year. Given that the economy is on more of an upward trajectory and interest expenditure continues to fall, this would mean that the budgetary stance had become laxer still, though the funds for refugees could re-

main more or less stable as things stand today. The debt ratio is continuing its downward trend, chiefly because of nominal GDP growth in the denominator.

In its stability programme updated in April 2016, the Federal Government loosened its fiscal stance in comparison with earlier programmes, though this is partly masked by lower interest expenditure. According to the programme, the aim now is simply to achieve a structurally balanced budget, after previously attempting to generate a moderate structural surplus. As before, the government is aiming to avoid net borrowing in the Federal budget (balanced budget). To do so, it will first draw on the reserve created last year, and it has planned to make as yet unspecified savings in 2018. In view of the latest tax estimate, too, the outlook for both central and general government might now be brighter.

On the whole, the European fiscal rules and the national debt brake should thus be adhered to. However, it would be advisable to make renewed efforts, in the medium term, to generate the moderate structural surpluses for the general government budget that were previously planned and larger safety margins below the stricter national debt brake. This would strengthen the resilience of public finances, if interest rates rise again in future, for example. Germany's public finances are additionally faced with the considerable challenge of demographic change. By creating a more favourable starting point, the prospective need for consolidation in the future – putting a burden on future generations – can be reduced. In this context, the call to make greater use of the budget limits, partially directed at Germany, is not compelling. As it is, Germany is already running a considerably expansionary fiscal policy at present. Attempts at economic fine-tuning in the euro area by stepping up fiscal stimulus in Germany do not seem promising. Even so, economic and fiscal policy measures to improve growth conditions should be taken consistently, but be suitably funded.

As regards the current debate about the statutory pension insurance scheme, it would be key for Federal Government to make known the financial developments that it expects in the long term by publishing the relevant projections and to provide insurees with as good a planning basis as possible. Since the end of the 1980s, however, the projections have ended in 2030, which means that they now cover just 14 more years. Demographic change will have an especially strong impact on the statutory pension insurance scheme. In order to tackle the strains this is expected to create, there are ultimately the three main levers of benefit level, contribution rate and statutory retirement age. If the increase in the burden of contributions is to be kept in check and the pension level is to be reduced at least no more strongly than so far planned, a further increase in the statutory retirement age will probably be unavoidable. Various countries have since introduced indexing of the statutory retirement age, for example, as a rule-based method of preventing automatically increasing relative pension-drawing periods owing to longer life expectancy.

The financial situation of the Federal Employment Agency is currently shaped by fairly high surpluses and growing reserves. Irrespective of this, non-insurance-related payments should be financed with tax funds, otherwise tasks facing society as a whole would be borne by the contributors alone. This also applies to spending on the integration of refugees, for instance, which is undoubtedly a key government task. Should any financial scope be perceived at the Federal Employment Agency, this should be used to the benefit of the contribution payers. Generally speaking, the Federal Employment Agency's budget is highly cyclical, and it thus makes sense to run surpluses and build up larger reserves when times are good. However, if it is assumed that the current extremely favourable labour market situation, with low unemployment figures among contributors, proves to be sustainable, the option of cutting the contribution rate could be considered, given the associated increase in reserves.