

| The current economic situation in Germany

Overview

German economy shows strong, broad-based growth

Global economic activity has stabilised ...

The impression that global economic activity has stabilised has been confirmed. Global economic output is likely to have risen significantly in the second quarter of 2017. In addition, the latest available data indicate that the dip in growth at the beginning of the year was less severe than originally estimated. In the United States, real gross domestic product (GDP) saw a resurgence of growth following a rather sluggish start to the year. The pace of growth picked up considerably in Japan. Moreover, economic activity in the euro area remained buoyant. China and other important emerging market economies also continued to experience relatively favourable economic conditions. However, economic output in the United Kingdom was subdued, growing at approximately the same rate as in the first quarter.

... and no immediate change of pace is likely

Although the quarterly GDP rates are volatile, the underlying pace of global economic activity is unlikely to change substantially during the third quarter. The global purchasing managers' indices (PMIs) for July again revealed marked growth in the manufacturing industry and in other sectors. Although alternative sentiment indicators suggest a further quickening of pace in the short term, the Bundesbank's leading indicator, which had signalled a cyclical upturn in the world economy since June 2016, has not risen further over the past few months. Low saving rates among households in the United States and the United Kingdom are raising doubts about the sustainability of private consumption growth rates in these countries.

Barely any progress on important initiatives in the United States

As yet, the US government and Congress appear to have made very little progress in implementing key economic policy initiatives. Although a number of measures have been taken in the area of deregulation, the healthcare reform has foundered for the time being. Plans

to introduce a comprehensive tax reform have not moved forward, either. Nevertheless, by abandoning the proposed border adjustment tax, a risk for international trade and thus for the world economy appears to have been averted. Even so, protectionist tendencies in general continue to pose a downside risk to the global economy. Furthermore, geopolitical tensions have become more prominent again of late.

Against the backdrop of firmer global economic activity, developments in the international financial markets in the second quarter were mainly determined by political factors and changing expectations about the course of monetary policy on both sides of the Atlantic. While political uncertainty in the euro area diminished as Eurosceptic parties failed to gain a foothold during elections in France and Italy, serious doubt surrounded the implementation of planned economic policy measures in the United States. By and large, the markets anticipated the Federal Reserve's policy rate hike in June 2017. Because further interest rate increases this year are seen as less likely than before, however, yields on ten-year US government bonds have declined on balance since the end of March. GDP-weighted long-term government bond yields also went down on balance in the euro area, although a speech by the ECB President at the end of June resulted in temporary market expectations that the Eurosystem's asset purchases might be phased out earlier than anticipated in response to the continued economic upturn. For a short period, this triggered a sharp rise in yields, which was particularly pronounced in the case of German bonds. As a result, yields on ten-year German government bonds have inched upward since the end of March 2017, thus also narrowing the spreads between German bonds and bonds issued by other euro area countries. Buoyed by rising earnings expectations, US equity indices climbed to new all-time highs at the beginning

Developments in the financial markets driven by political factors and monetary policy expectations

of August, while shares in the euro area have been burdened by the strong euro as well as by the spread of the diesel emissions scandal and anti-trust complaints against German car manufacturers. The euro recorded significant gains against the background of favourable economic data in the euro area. Measured against the currencies of 19 major trading partners, the euro appreciated by just over 5% compared with the end of the first quarter.

Monetary policy: ECB Governing Council leaves policy rates unchanged

The Governing Council of the European Central Bank (ECB) kept the key interest rates unchanged in the reporting period. The monthly volume of purchases under the expanded asset purchase programme has been reduced to €60 billion since April 2017. These purchases are scheduled to take place until the end of December 2017, or beyond, if necessary, and in any case until the ECB Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation target. The Governing Council believes that the euro area's growth prospects have improved of late and now considers the risks surrounding the growth outlook to be broadly balanced. On the one hand, the positive cyclical momentum increases the chances that the economic upswing will be stronger than expected, while on the other, downside risks relating to predominantly global factors continue to exist. However, the Governing Council considers that a substantial degree of monetary policy accommodation is still needed if price inflation is to meet the stability target in the medium term.

Ongoing monetary growth in the euro area

The positive underlying dynamics in the monetary indicators persisted in the reporting quarter. The broad monetary aggregate M3 again expanded considerably in the second quarter of 2017 against the backdrop of historically low interest rates and robust economic growth in the euro area. The mainstay of monetary growth was lending to the domestic private sector, with loans to households once again playing a major role. Moreover, monetary growth was also sustained by securities-based lending to domestic non-banks, which was

dominated by the Eurosystem's asset purchase programmes.

Germany continued to experience rapid economic growth in the second quarter of 2017. According to provisional data from the Federal Statistical Office, after seasonal and calendar adjustment, real GDP grew by 0.6% in the second quarter compared with 0.7% in the first quarter. GDP therefore grew much faster than potential output in both quarters, and aggregate overall capacity utilisation, which was already significantly above average in any case, rose again markedly. The fairly brisk underlying pace of economic activity seen last year owing to buoyant domestic activity recently accelerated further as the result of a more favourable external environment.

German economy continued to expand vigorously in the second quarter

As in the first quarter, the strong economic growth in the second quarter of 2017 was mainly attributable to the solid upswing in industry and construction. After some ups and downs last year, industrial output moved onto a clear growth path at the turn of the year. This also spilled over to business-related services sectors such as the wholesale market. The boom in the construction sector continued. Looking at demand, the recovery was broadly based. Exports continued to grow, mainly thanks to stimuli from the other euro area countries. In addition, investment in machinery and equipment expanded again. The fact that it has overcome its sustained period of sluggishness is probably mainly down to growing capacity utilisation in the industrial sector and positive sales prospects. Private consumption is also likely to have made a major contribution to the growth in GDP.

Industry and construction as key drivers

In line with this, German banks again markedly expanded their lending to the domestic private sector in the quarter under review. The largest net expansion was recorded by loans to households, driven mainly by their brisk demand for mortgages. Banks' lending business with domestic non-financial corporations also grew on balance; growth momentum here is still ham-

Marked rise in loans to the domestic private sector in Germany

pered by the abundant funds available to enterprises from alternative sources of financing.

Labour market: situation and outlook still very buoyant, ...

In the second quarter, the situation in the labour market remained very buoyant. Employment rose sharply, although the extremely rapid pace of growth seen in the final quarter of 2016 and the first quarter of 2017 could not be maintained. This positive development in employment continued to be driven mainly by the creation of new jobs subject to social security contributions. As in previous quarters, however, the low-paid part-time employment segment, as well as the number of self-employed, contracted. While registered unemployment fell significantly in quarter-on-quarter terms, the outlook for the next few months remains upbeat.

... but wage growth nevertheless subdued

Notwithstanding the positive labour market situation and the favourable economic situation, wage growth in the second quarter of the year remained moderate. Nor do recently concluded pay agreements in the services sector point to any significant boost in wage growth. With regard to upcoming wage negotiations, most of which affect the services industry, the social partners in some sectors will not just be campaigning for higher wages, but also addressing other aspects such as the impact of digitalisation or more diverse working arrangements to allow greater flexibility. Taken in isolation, this is likely to dampen wage growth.

Marked rise in consumer prices excluding energy and food

In the second quarter, consumer prices as measured by the Harmonised Index of Consumer Prices (HICP) rose further. At a seasonally adjusted 0.3%, this increase was, however, not as large as in the previous quarter (+0.5%), mainly due to the decline in energy prices caused by lower crude oil prices in euro terms. Moreover, there was no further increase in food prices. By contrast, prices excluding energy and food went up more noticeably than in the past. In particular, the prices of services rose more steeply, their upward movement having slowed down somewhat at the begin-

ning of the year following the recent reform in services provided under the public long-term care insurance scheme. Prices of industrial goods (excluding energy) rose at roughly the same pace as in the first quarter, whereby the depreciation of the euro in the final quarter of 2016 and the first quarter of 2017 is also likely to have had an effect, albeit with a time lag. The price increase as measured by HICP narrowed overall from 1.9% to 1.6% in year-on-year terms. This was partly attributable to a base effect arising from the surge in energy prices in the second quarter of 2016. Conversely, excluding food and energy, the year-on-year rate went up quite significantly from 1.0% to 1.4%, putting it above its longer-term average level of 1.0%, amidst above-average aggregate capacity utilisation.

The strong economic upturn in the German economy is expected to continue in the third quarter, with industrial output probably continuing to play an important role, thanks to a substantial expansion in exports. The all-time high degree of positive sentiment in manufacturing, the robust volume of new orders and the large stock of orders still being processed suggest that industrial output can be expected to grow significantly again in the current quarter. At least according to the survey data available to date, the discussion about imposing bans on older diesel cars in some German cities has hardly affected the sentiment among enterprises operating in the motor vehicle sector. Further developments remain to be seen. The good sales prospects and the increasing utilisation of capacity seen in the manufacturing sector are also likely to further sustain the momentum witnessed in business investment. Business-related services should likewise benefit from the ongoing favourable level of industrial activity. After recording very strong growth rates of late, recent developments in the order books indicate that the construction sector could generate considerably weaker momentum. All in all, the positive labour market environment and upbeat income prospects for consumers should, however, persist over the sum-

Economic activity likely to remain buoyant in Q3

mer months, from which private consumption will continue to benefit. The German economy in the current year could therefore perform even somewhat more strongly than forecast in the June projection.

German government budget in good shape

Germany's public finances continue to benefit from the highly favourable underlying economic conditions. Despite pursuing an expansionary fiscal policy, a marked surplus is therefore to be expected again in the current year. On the one hand, the positive economic developments, along with the extremely beneficial financing conditions, ease the strain on public coffers. On the other hand, the unconstitutional tax levied on nuclear fuel has had to be repaid and expenditure on pensions, health-care and long-term care, for instance, or on infrastructure and military is set to grow significantly. The debt ratio continues to narrow, but it will still be well above the 60% threshold. As things stand, the outlook for public finances will initially remain sound, and surpluses will persist so long as there is no change in policy. That said, the fiscal policy measures discussed in the run-up to the general election (such as tax relief or additional expenditure in various areas), all in all point to a more expansionary stance over the next few years.

Favourable environment suited to catering for demographic burdens and enhancing the resilience of public finances

In principle, moderate structural surpluses seem entirely appropriate for Germany. The debt ratio is still high, and the financial burdens that are set to arise from demographic developments will be factored into its public finances in the future and need to be absorbed. Most of these burdens will not materialise until some years down the road, when the baby boomer generation retires from the labour force. When assessing the shape of public finances or ques-

tions relating to pensions, it is therefore important to take into account significantly longer time horizons than those frequently considered in current political discussions or international recommendations. Overall, there is much to be said for taking advantage of the temporary relief due to favourable cyclical conditions and the very favourable interest rate level to swiftly reduce the debt ratio. This applies first and foremost to those state and local governments that have very high levels of debt. To this end, a more ambitious fiscal policy stance is particularly called for, not least in order to be equipped to deal with a normalisation in interest rates.

The central government budget is likely to develop more positively in the current year than planned. However, owing to the sizeable financial burden generated by the reimbursement of nuclear fuel tax payments, a deficit must be expected. To avoid net borrowing (ensuring a "black zero" or balanced budget), withdrawals from the reserve are likely to be necessary. Under the current implementation regime, withdrawals from the reserve increase the Federal Government's financial leeway in terms of complying with the national debt brake provisions. This methodology differs considerably from the European rules, which are based on the fiscal balance, which in turn is not affected by changes in reserves. This runs counter to the aim of ensuring that the national rules also ensure compliance with the European commitments. Furthermore, it would seem that the reserve is not needed to cover the costs of refugee-related spending for which it was originally intended. Against this background, it would be consistent to release the reserve set up for this purpose in the Federal budget by repaying debt.

Releasing the reserve in the Federal budget