The current economic situation in Germany

Overview

German economy back to stronger growth in the second quarter

Global activity regains momentum in second quarter

Following a slight slowdown in growth over the past few quarters, global economic activity rebounded in the second quarter of 2018. The upswing stabilised in the advanced economies, in particular. The United States recorded its strongest growth in real gross domestic product (GDP) in nearly four years. After a setback in the first quarter, the Japanese economy returned to its path of growth, while in the United Kingdom the pace of expansion picked up distinctly. Euro area economic output, meanwhile, continued to increase at an unchanged moderate rate. The high level of growth in China also remained largely stable compared to its international peers.

As yet no major impact of further escalation of trade policy conflicts

Despite ongoing efforts to reach negotiated solutions, several trade policy conflicts escalated. However, this was probably not the main reason why sentiment in the manufacturing sector, while still fundamentally positive, has clouded over since the beginning of the year. Recent survey results have been less favourable, particularly among those economies which had benefited from particularly buoyant industrial activity in 2017. In those countries affected the most by trade-restrictive measures, the relevant purchasing managers' indices barely budged. Nonetheless, an escalation of these disputes could weigh considerably on global economic growth.

Differences in business cycle position and monetary policy stance impacting on financial markets

In the second quarter and the early part of the third quarter, international financial markets reflected the, on the whole, robust economic growth, the intensity of which varied from one currency area to the next, however. Monetary policy decisions, along with expectations of the future economic policy stance, also showed evidence of these differences. The Federal Reserve continued to gradually hike its policy rate. Whereas at the end of March only one interest rate move had been expected for the second half of 2018, the sound outlook for the economy meant that the most likely scenario at the end of the reporting period was two interest rate moves over the rest of the year. By contrast, at last report the euro area was not expected to see an initial interest rate increase until the second half of 2019. This was due in large measure to the ECB Governing Council's communication of mid-June, which was perceived as being accommodative. Concern about how the trade conflicts between the major economic areas would progress, uncertainty about the thrust of the new Italian government's policy, and the sharp depreciation of the Turkish lira led at times to safe haven flows. The (implied) volatility in the financial markets, however, rose only in isolated cases and remained, on the whole, near its long-run average. On balance, the yields on ten-year Bunds dropped, whereas those on matched-maturity US Treasuries rose. At times, the yield spread was at its highest level since the late 1980s. The GDP-weighted yield for the euro area excluding Germany picked up as well, particularly owing to the increase in the interest rate on Italian sovereign debt. The yields on euro area corporate bonds likewise inched up slightly. Equity markets largely tracked the positive cyclical movement, yet in the euro area the aforementioned political uncertainty dampened the dynamics of equity prices. On a weighted average against the currencies of 19 major trading partners, the euro slipped slightly, on balance. Significant losses against the US dollar were made up for in part by gains against other currencies.

Monetary policy: ECB Governing Council announces decision on asset purchases …

Given the considerable progress made in sustainably adjusting the path of inflation to its medium-term target, at its meeting in June the ECB Governing Council announced the time horizon for exiting its net purchases, which had begun in March 2015 as part of its extended asset purchase programme (EAPP). Subject to confirmation of its current assessment of the medium-term outlook by newly available data, the ECB Governing Council anticipates that it will reduce its current volume of monthly asset purchases from €30 billion to €15 billion after the end of September 2018 and discontinue purchases entirely after the end of December 2018. The principal payments from maturing securities are to be reinvested for an extended period of time after the end of the net asset purchases, and in any case for as long as necessary, in order to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

… and strengthens its forward guidance

While leaving policy rates themselves unchanged, the ECB Governing Council, at its June meeting, strengthened its forward guidance. It expects policy rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.

Monetary dynamics in the euro area increasingly driven by loan growth

Following two significantly weaker quarters, in the spring months the broad monetary aggregate M3 in the euro area returned closer to the robust growth from the previous year. This was mainly because lending to the private sector rebounded at an accelerated pace. With economic growth continuing to be sound, loans to non-financial corporations and to households again climbed considerably. The growing demand for credit was sustained by the low-interest-rate setting and a further easing of commercial banks' credit supply conditions. By contrast, the reduction in monthly net asset purchases by the Eurosystem effective as of January has had a dampening yet, to date, limited overall impact on monetary growth.

German economy back to stronger growth in the second quarter

After a moderate start to the year, aggregate economic activity rebounded quite strongly in spring 2018. According to the flash estimate by the Federal Statistical Office, the growth rate of real GDP, after adjustment for seasonal and calendar effects, rose marginally from the first quarter of 2018 to 0.5%. Diminishing one-off effects such as the extremely virulent wave of influenza, which had dampened economic activity in the winter months, are likely to have had merely a limited impact. This meant that the economic boom in Germany was still ongoing. However, the pace of growth in the first half of 2018 failed to match the high rates of the previous year, and the current underlying cyclical trend is probably only marginally above the potential rate. The already high degree of aggregate capacity utilisation is therefore only edging up. Private consumption – currently the linchpin of economic expansion – continued its ascent in the spring. Government consumption probably likewise rose significantly following a distinct decline in the previous quarter, the first in many years. Moreover, following a drop at the beginning of the year, exports grew moderately. The same is probably the case for commercial investment in machinery and equipment.

Industry weak; services and construction, by contrast, dynamic

In the second quarter of 2018, industrial activity remained largely listless. Although the manufacturing industry may well have contributed slightly to aggregate growth, it was unable to re-assume its previous year's role as the key driver of economic activity. The upturn continued for business-related services. In spite of existing capacity constraints, construction output increased once again.

Accelerated, broadly based expansion of lending to the domestic private sector

In Germany, too, the domestic private sector's demand for loans accelerated. This was consistent with the German economy's sound growth, the low level of interest rates and the continued easing of banks' credit supply conditions. For the first time since 2012, the non-financial corporations sector recorded the largest net inflows of loans in the reporting quarter; the annual rate of growth of these loans rose to 5.9% at end-June, its highest mark since 2008. Loans to households in Germany picked up significantly as well, particularly owing to brisk demand for housing loans.

Given the stable consumer climate, consumer loan growth likewise strengthened.

Labour market situation and outlook very favourable

In the second quarter, the labour market in Germany was still in a very good state of health, characterised by high employment and low unemployment. However, the situation did not improve as much as in previous quarters: although employment rose markedly, this growth was no longer as buoyant. Employment growth continued to be driven by jobs subject to social security contributions. Exclusively low-paid part-time employment, as before, fell slightly, while self-employment dropped more significantly. In the quarter under review, unemployment likewise did not fall as sharply as in the winter, yet given the low level achieved, this fall was still quite considerable. Over the same period, the number of job vacancies went up only a little from the exceptionally high level previously achieved. Other, survey-based leading indicators of labour market developments either fell slightly or remained virtually unchanged in the last few months. On the whole, the outlook for the labour market remains good.

Negotiated wages up more strongly in spring

Negotiated wages rose sharply in the spring quarter, reflecting recent wage settlements which, given a healthy economy and a tight labour market, were higher than in the last pay round. The rise in negotiated rates of pay including all additional benefits in spring 2018, at 3.2% on the year, was significantly higher than just three months before. Already in the first quarter of 2018, actual earnings had picked up somewhat more strongly than in earlier periods. This trend could well have continued in the second quarter. Following a unanimous decision, at the end of June the independent Minimum Wage Commission submitted a recommendation to the Federal Government to raise the general minimum wage from €8.84 per hour to €9.19 per hour. In a second stage as of January 2020, it should then go up to €9.35 per hour. The Federal Government announced that it would implement this proposal.

Sharp rise in consumer prices in spring

Consumer prices (measured by the Harmonised Index of Consumer Prices, or HICP) continued to rise sharply in the second quarter. Roughly half of the seasonally adjusted 0.6% quarter-on-quarter increase was attributable to energy prices, reflecting the distinct rise in crude oil prices denominated in US dollars, the effect of which was amplified by the depreciation of the euro. Food products likewise became markedly more expensive. This was due also to hikes in the price of tobacco products, which the HICP counts under food. Excluding energy and food, prices rose similarly moderately to the previous quarter. Prices in several sub-sectors of the services sector went up, including rents. The prices of industrial goods excluding energy barely inched upwards on the quarter, but began to accelerate over the course of the second quarter. One reason for this may be that import prices for the relevant goods rose markedly owing to the euro's depreciation against the US dollar. At the commercial producer level, too, prices continued their gradual climb. The headline annual HICP inflation rate rose clearly from 1.3% to 1.9%. It even passed the 2% mark in May and June owing to the sharp rise in energy prices. Excluding energy and food, annual inflation in the spring was more or less constant at 1.2% and, consistent with aggregate overutilisation, remained above its longer-term average.

German economy set to stay on expansionary course

The German economy will probably remain on a sound growth path in the third quarter as well. The rate of growth could end up being somewhat slower than the average for the first half of the year, however. Thus, industry is not expected to make any meaningful contribution to aggregate growth. Although the stock of orders still being processed remains exceptionally high and short-term output expectations in the manufacturing sector have stabilised at an elevated level, new orders received by industry were also down in the quarter under review. To exacerbate matters, problems encountered during the transition to a new emission test cycle are likely to have markedly constrained motor vehicle production in the summer months. Private consumption, on the other hand, is likely to benefit from the excellent labour market situation and the current strong wage hikes, thus maintaining its role as a key driver of German economic growth.

Favourable development of public finances in current year

German public finances are continuing to develop favourably. The general government surplus is likely to keep rising in the current year. The debt ratio has remained on its downward trend and is expected to come close to the 60% limit by the end of the year. Public finances are benefiting from the favourable economy. In addition, temporary burdens have declined because the effect of the nuclear fuel tax repayment in 2017 has expired. Revenue has been on the rise as well, even independent of the cyclical upswing. This is being supported by the structurally positive labour market development, which has also been dampening expenditure growth. While interest expenditure has been decreasing, expenditure in other areas has gone up significantly.

Fiscal loosening will cause surplus to decline in coming years

As things stand, the framework conditions for public finances also look set to remain positive in the medium term. However, the surplus could well decline since a significant fiscal loosening is in the offing. Measures to that effect are enshrined in the Federal Government coalition agreement and are currently being gradually fleshed out. State and local governments will likewise probably make greater use of their fiscal leeway.

Put pension finances on sound footing and …

The current situation, which is good now and will probably remain so in the years to come, should not detract from the long-term challenges, which include demographic trends. To that extent, the rapid reduction in the debt ratio, making public finances better prepared for these challenges, is a welcome development. This will also render budgets less vulnerable to rising interest rates. However, the current pension policy plans will increase the pressure already resulting from demographic trends. The vast majority of the additionally envisaged burdens on pension insurance are to be initially funded from contributions. Only as from 2025 would this impose a relatively heavy burden on the Federal budget. A more appropriate idea would be to use Federal grants, ie via general tax revenue, to fund the new non-insurance-related payments. This would, moreover, largely obviate the need for the planned limits to the long-term contribution rate and pension level up until 2025. According to the calculations presented, excluding the additional burdens, only for the pension level would these limits have become binding in 2025.

… improve planning certainty

The outlook for pension insurance post-2025 is currently uncertain. Demographic trends will exert an increasing burden from then on, and fundamental pension reform has been announced. Reaching a quick agreement would give all parties involved considerably more planning certainty. In the process, long-term projections should be conducted in order to make transparent the expected trends and burden-sharing. The currently sound economic and financial situation should not entice decision-makers to shift the adjustment pressure unilaterally to the central government budget. Given the tax burden going forward, domestic tax conditions should not be disregarded, either. Raising the statutory retirement age beyond 67 years could also contribute towards stabilising pension finances. As this would also dampen the decline in headcount employment, potential growth and the tax base could be supported in this manner as well. In other countries, the statutory pension age is pegged, for instance, to life expectancy.

Central government increasingly utilising its fiscal leeway

In early July, the fiscal planning for the central government budget as from 2019 was adopted. The Federal Government is sticking to its target of a balanced budget, which means it will continue its policy of no new net borrowing. It is making plans for considerable structural deficits, however. The only way it will be able to comply with the debt brake is by tapping reserves. Although the plans for this year and the next appear, on the whole, to be prudent, the room for manoeuvre is likely to be increasingly exhausted by 2022. The solidarity surcharge is set to be maintained in some places, which is legally contentious. Amongst other things, convergence towards international agreements regarding defence expenditure or development aid could entail an additional fiscal need.

Planning is not transparent

The Federal Government's plans are difficult to analyse. Copious use of reserves and off-budget entities is making them ever more complex. Relevant information on the debt brake, which should be one of the centrepieces of budget planning, is lacking as well. Thus, structural net borrowing as from 2020 cannot be gauged because there are no budget estimates for off-budget entities. In addition, risks cannot be readily assessed because the high global provisions for as yet unspecified additional or reduced revenues or expenditures, as a potential buffer, have not been explained in detail. The reserve withdrawals – which are probably only planned as an initial measure – mask the underlying structural fiscal position. It would be desirable to heighten the transparency of planning by providing timely, comprehensive information.