Economic conditions in Germany

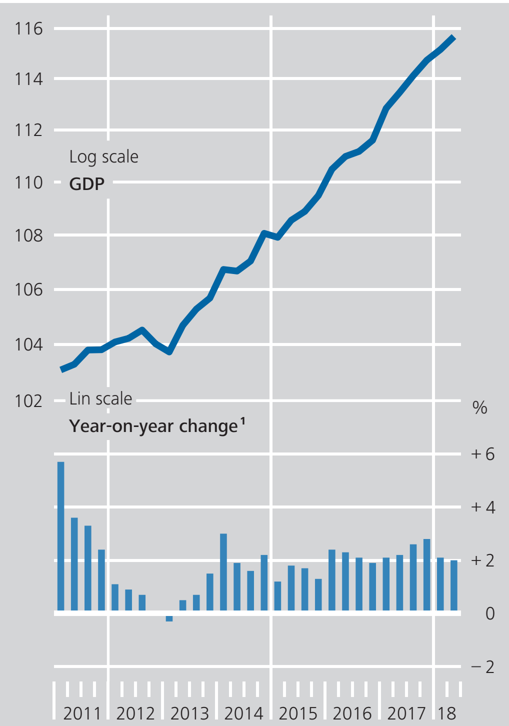
Macroeconomic situation

German economy back to stronger growth in second quarter

After the year got off to a moderate start, aggregate economic activity rebounded quite strongly in spring 2018. According to the flash estimate by the Federal Statistical Office, the growth rate of real gross domestic product (GDP), after adjustment for seasonal and calendar effects, rose slightly on the first quarter of 2018 to 0.5%.[1] 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 second quarter. 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 business investment in machinery and equipment.

Overall output

2010 = 100, price and seasonally adjusted



Source of unadjusted figures: Federal Statistical Office. **1** Only calendar-adjusted.

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Industry lacking momentum; 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 the role as the key economic driving force that it had in the previous year. For business-related services, the upturn continued. In spite of capacity constraints, construction output increased once again.

Exports back in positive territory

In real terms, German firms' export business expanded again in the second quarter of 2018, after declining significantly in the winter months. According to the seasonally adjusted figures available up to May, the recovery was due primarily to a countermovement in exports of goods to non-euro area countries, which had previously declined. Exports to the newly industrialised economies in Asia, the south and east Asian emerging markets and the United Kingdom rose particularly strongly. German exporters were also able to considerably boost their export sales to central and east European countries. In terms of value, exports to the United States remained at the level of the pre-

1 GDP growth in the first quarter of 2018 was revised upwards by 0.1 percentage point to 0.4%. Following the usual mid-year revision of previous years' data, GDP growth at the beginning of 2017 was even stronger. By contrast, the pace of expansion throughout the rest of the year was somewhat more moderate. Furthermore, GDP growth was revised upwards by 0.3 percentage point in 2014 and 2016. On the whole, the upswing is therefore stronger and probably also more mature than previously reported.

vious quarter. By contrast, business with China declined again slightly. Exports to Japan, Russia and the OPEC countries even fell considerably in the quarter under review.

Enterprises' investment activity probably showing little momentum

Business investment in new machinery and equipment is likely to have increased only moderately in the second quarter. This was probably because of an overall decline in demand impulses for industry in the first half of the year and because corporate sentiment was also no longer as euphoric as before. Capital goods imports rose strongly in the second quarter. Even excluding the very considerable rise in imports of other transport equipment, the increase was still strong. However, domestic sales of capital goods manufacturers declined considerably. Car manufacturers, in particular, suffered a sharp decline in domestic sales. Furthermore, the drop in the number of commercial motor vehicle registrations suggests that enterprises did not further expand their vehicle fleets in the reporting period.

Construction investment still pointing upwards

Construction investment probably expanded further in the second quarter of 2018. The turnover figures for the main construction sector available up to May indicate that more was invested in commercial and public buildings in particular. Following the strong growth in the previous quarter, private housing investment probably rose much more moderately.

Foreign trade

Seasonally adjusted, quarterly

Source of unadjusted figures: Federal Statistical Office. **1** Adjusted using the price indices for foreign trade.
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Marked rise in private consumption

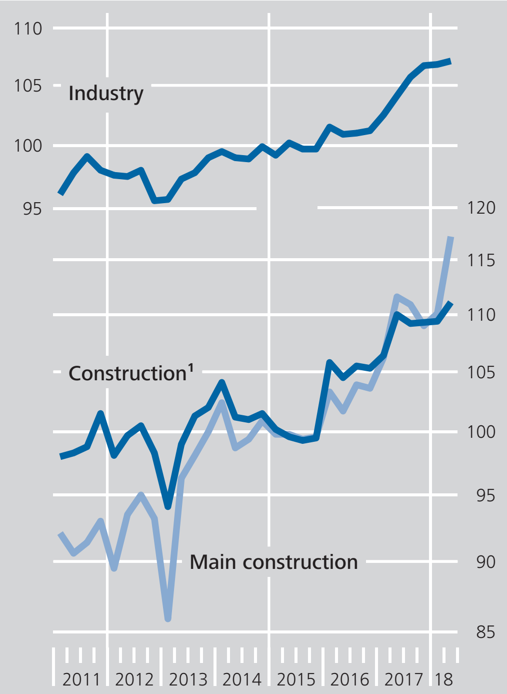
Household consumption expenditure again made a distinct contribution to overall economic growth in the second quarter of 2018. This can be seen above all in the significant increase in retail sales. Sales growth was strongest in online and mail order trade. Retail sales of information and communication technology (ICT) equipment also flourished, and sales of do-it-yourself (DIY) and home improvement goods likewise grew quite substantially. By contrast, sales of electrical household appliances, furniture and furnishings were down significantly on the previous quarter. The hotel and restaurant sector was again able to perceptibly increase its turnover, which was probably due in part to the comparatively warm and sunny weather in the spring. By contrast, households were clearly holding back on purchasing new motor vehicles following the extremely buoyant activity in the automotive sector in the previous quarters.

Steep rise in imports

Imports in the second quarter of 2018 rose considerably on the level of the previous quarter in price-adjusted terms. This was attributable to the increase in domestic demand and the marked rise in exports. That said, some of the imports were probably used to restock warehouses. The increased uncertainty about greater restrictions on international trade in

Output in industry and in construction

2015 = 100, seasonally adjusted, quarterly, log scale



Source of unadjusted figures: Federal Statistical Office. **1** Main construction sector and finishing trades.
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future may have played a role in this. In regional terms, imports from the euro area – according to the seasonally adjusted value-based figures available up to May – increased only slightly. Imports from non-euro area countries rose strongly, however, and also on a broad basis. This was due mainly to very substantial growth in imports from the United Kingdom. However, this was attributable to orders from the aircraft and aerospace industry and is therefore likely to represent a one-off special effect. Manufacturers from the newly industrialised Asian countries and the United States also benefited strongly from buoyant domestic demand. The strong increase in the value of imports from the OPEC countries was probably the result of the considerable rise in crude oil prices in the reporting period.

Sectoral trends

Slight increase in industrial activity

Industrial output went up again slightly in the second quarter of 2018 by a seasonally adjusted ¼%, after virtually stagnating at the beginning of the year. The development across the economic sectors was very heterogeneous, and the muted growth in output was driven by just a few industrial sectors. The production of pharmaceutical products rose particularly sharply, which meant that the consumer goods sector recorded the strongest overall growth in output among the main groups. By contrast, the output of capital goods was only slightly up on the level of the previous quarter. Here, too, the increase was attributable to just one important industrial segment, the automotive sector. German mechanical engineering firms, meanwhile, were forced to cut production sharply. The output of intermediate goods did not exceed the average of the first three months of the year.

No change in industrial capacity utilisation

According to Ifo Institute data, the level of capacity utilisation of tangible fixed assets in manufacturing remained at the high level of the previous quarter. This is likely to be related to the fact that business investment in machinery and equipment rose only slightly. The modest growth in industrial output was probably accompanied by correspondingly weak capacity expansion. Capacity utilisation changed only slightly across the individual sectors of industry.

Strong growth in construction output

Construction activity rose steeply in the second quarter of 2018 after adjustment for seasonal variations. The main reason for the growth in construction output by 1½% was a substantial increase in production in the main construction sector, where exceptionally strong growth was recorded in both general building and civil engineering. Activity in the finishing trades, by contrast, contracted considerably. There is still much evidence to suggest that the construction sector is working at full capacity. According to the Ifo Institute, for example, equipment utilisation in the main construction sector remained very high, and the share of construction firms reporting production hold-ups owing to the shortage of skilled workers reached a new record high in the second quarter. There was a sharp rise in construction prices. The fact that seasonally adjusted construction output still increased considerably compared to the winter months could be attributable in part to the wave of influenza and the unfavourable weather conditions in February and March. This is suggested, in any case, by the circumstance that the number of hours worked in the main construction sector rose considerably slower than employment at the beginning of the year, whereas the opposite was observed in April and May. Enterprises also sought to expand their potential output, with the number of employees in the main construction sector rising distinctly after the turn of the year.

Services sector still showing marked growth

All in all, the services sectors are likely to have expanded perceptibly again in the second quarter of 2018. Price-adjusted wholesale sales increased significantly. Enterprises in the retail trade sector (excluding motor vehicle trade) likewise managed to increase their sales in real terms. Furthermore, growing activity in the hotel and restaurant sector provided a boost. Positive impetus probably also came from motor vehicle trade, where total sales rose significantly despite a clear decline in motor vehicle registrations. This was due in particular to strong growth in the sales of motor vehicle parts and accessories as well as motorcycles. Business activity in the other services sectors is also likely to have expanded. This is suggested by the fact that the business situation in this sector is viewed very optimistically despite a slight downward revision.

Labour market

Labour market situation very good, but improvement not as strong as in previous quarters

In the second quarter, the labour market in Germany was again in very good shape, characterised by high employment and low unemployment. However, the situation did not improve as strongly 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 achieved in the spring. 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.

Slowdown in employment growth

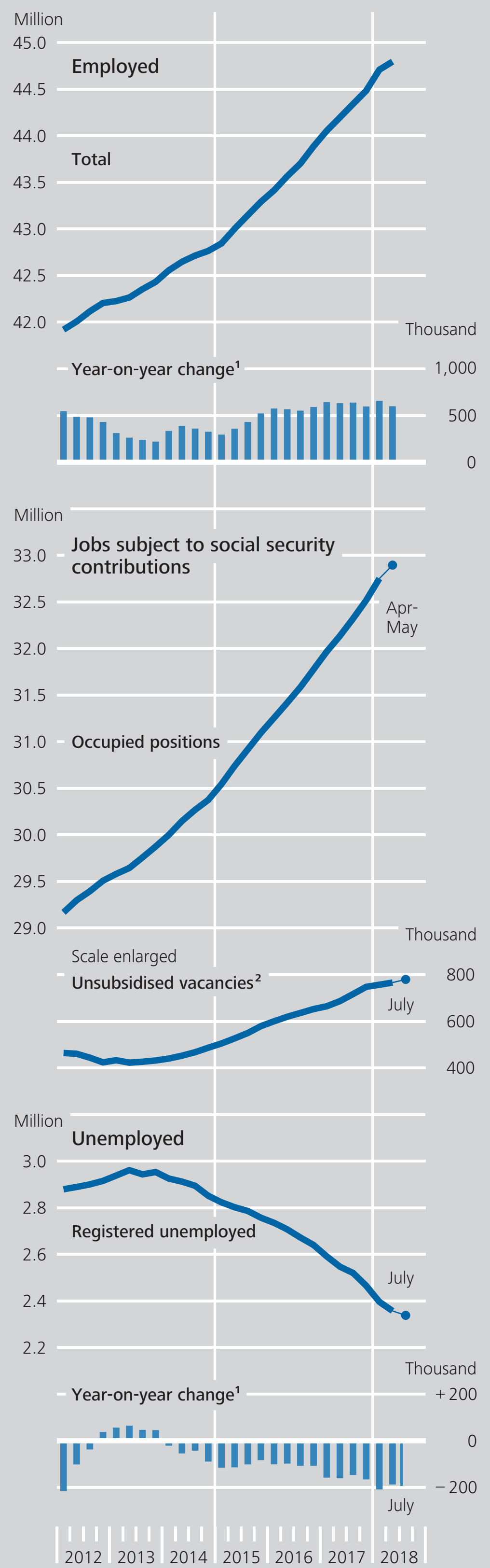
Employment in Germany rose more slowly in the second quarter of 2018 than it had done beforehand. It went up by a seasonally adjusted 86,000 persons, or 0.2%, after a revised +0.5% in the first quarter. The slowdown in the pace of expansion is likely to be due to the extensive hiring of new workers immediately beforehand and the weaker underlying pace of growth since the beginning of the year. In addition, the fact that it is becoming increasingly difficult to find suitable skilled labour may have had a negative impact on employment growth. The vacancy periods for open positions, for instance, have been rising significantly across all sectors for quite some time.

Growth in jobs subject to social security contributions broadly based across sectors, but strong decline in temporary agency work

The considerable increase in jobs subject to social security contributions continued to drive the rise in employment. According to initial estimates by the Federal Employment Agency (BA), on an average of April and May, the number of positions filled rose by just under 0.4% compared with the average for the first quarter. Services such as IT and logistics recorded the highest growth rates. Employment in the manufacturing sector also experienced above-average growth, as did business-related services if temporary agency work is excluded, where the number of jobs fell relatively sharply. One possible explanation for this is that the reform

Labour market

Seasonally adjusted, quarterly



Sources of unadjusted figures: Federal Statistical Office and Federal Employment Agency. **1** Not seasonally adjusted. **2** Excluding seasonal jobs and jobs located abroad.

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of the Act on Labour Leasing *(Arbeitnehmerüberlassungsgesetz)* of 1 April 2017 introduced a maximum period of labour leasing of 18 months. This could now be having an effect as the first people would shortly have to be given permanent positions. Employment in the health and social services sector enjoyed predictably robust growth. In construction, in the wholesale and retail trade, and the hotel and restaurant sector, the number of positions filled was up only slightly in the first months of the second quarter.

Number of unemployed persons down, particularly those receiving basic welfare allowance

Registered unemployment fell distinctly in the second quarter after seasonal adjustment, although taking the average of the reporting period, the decline of 39,000 persons was not as steep as in the preceding quarter. The unemployment rate fell by 0.2 percentage point to 5.2%. However, this was partly attributable to the adjustment, which takes place every spring, to the labour force measure used by the Federal Employment Agency to calculate the unemployment rate. The number of registered unemployed continued to decrease slightly in July. While unemployment covered by the statutory insurance scheme has been very low for some time and did not fall appreciably, the number of unemployed persons receiving the basic welfare allowance went down. This is mainly due to a significantly smaller risk of receiving the basic welfare allowance, as the current high demand for labour means that fewer persons are long-term unemployed or in need. By contrast, the rate of people no longer needing the basic allowance was up only slightly. The Federal Employment Agency's more broadly defined measure of underemployment, which also counts those participating in active labour market policy measures, fell even more strongly than registered unemployment. Significantly fewer people are currently receiving support through short-term labour market reintegration measures, further professional training or one-euro jobs than a year ago.

Leading indicators remain high

According to the leading labour market indicators, employment is likely to expand over the next few months at much the same rate as during the period under review. The most important leading indicators, including the Ifo employment barometer, the employment component of the IAB labour market barometer and the Federal Employment Agency's BA-X job index, remained virtually unchanged over the last few months and are still at an exceptionally expansive level. Nonetheless, the number of vacancies continued to rise, albeit somewhat more slowly. The leading indicator for unemployment in the IAB labour market barometer was down again slightly and is only just in positive territory. This suggests that registered unemployment will probably not decline appreciably in the next few months.

Wages and prices

Negotiated wages up more sharply in spring than before

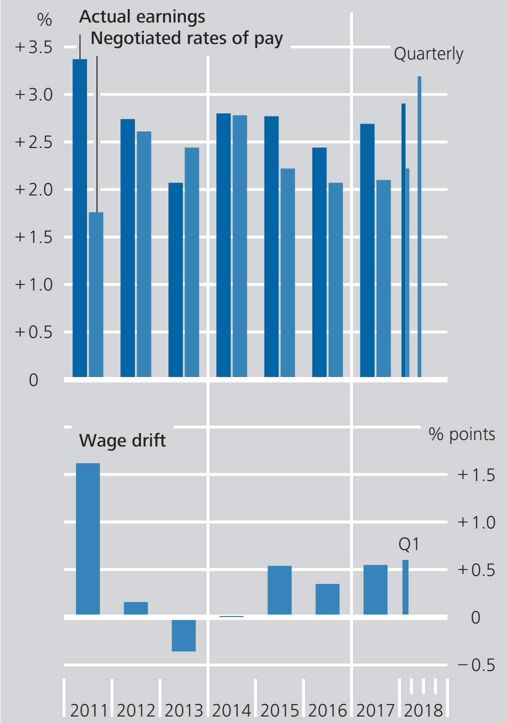
Negotiated wages rose sharply in the spring quarter, reflecting the fact that recent wage settlements were higher than in the last pay round given a healthy economy and a tight labour market. The rise in negotiated rates of pay including all additional benefits in spring 2018, at 3.2% on the year, was significantly higher than just three months before (2.2%). 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.

Substantial two-stage increase in general statutory minimum wage

At the end of June, the independent Minimum Wage Commission unanimously decided to recommend to the Federal Government a rise in the general minimum wage by a total of 51 cents, or 5.8%, over the next two years.[2] The minimum wage will therefore rise in an initial stage as of January 2019 from the current €8.84 to €9.19 per hour and in a second stage as of January 2020 to €9.35 per hour. The Federal Government announced that it would implement this proposal. The last rise in the minimum wage in January 2017 was lower, at 4% in total. The general statutory minimum wage tracks past negotiated wage developments with a lag and is intended to have the smallest possible impact on future wage rounds. The suggested rise in the minimum wage will probably have a significant impact on wage negotiations only in individual low-wage sectors.

Rates of pay and wage drift

Year-on-year percentage change, on monthly basis



Sources: Federal Statistical Office (actual earnings) and Deutsche Bundesbank (negotiated rates of pay).
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Sharp rise in consumer prices in spring

Consumer prices (as 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% increase was attributable to energy prices, reflecting the distinct rise in crude oil prices denominated in US dollars, an effect which

2 The Minimum Wage Commission's resolutions base the size of the statutory minimum wage on past developments in negotiated hourly earnings, excluding special payments, according to the negotiated wage index of the Federal Statistical Office. The latest decision to raise the minimum wage was based on the trend in negotiated wages for 2016 and 2017 and the first half of 2018. The rise in negotiated wages in the first half of 2016, which was already factored into the increase in the minimum wage at the beginning of 2017, has thus obviously been taken into account twice when raising the minimum wage.

Import, export, producer and consumer prices

2010 = 100, seasonally adjusted, quarterly

Source of unadjusted figures: Federal Statistical Office. **1** Producer price index for industrial products in domestic sales. **2** Harmonised Index of Consumer Prices. **3** Not seasonally adjusted.
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was amplified by the depreciation of the euro. Food products likewise became markedly more expensive, which was due in part to higher prices for 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. Prices for industrial goods excluding energy were barely up on the quarter, but began to accelerate over the course of the second quarter. One of the reasons for this may be that import prices for the relevant goods rose markedly owing to the euro's depreciation. 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%.[3] It passed the +2% mark in May and in 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 capacity overutilisation, remained above its longer-term average.

Inflation still above 2% in July …

In July, consumer prices remained unchanged in seasonally adjusted terms. Consumers had to pay just as much for energy and food as in the previous month. Prices for industrial goods excluding energy went down distinctly overall due to exceptionally strong discounts for clothing, although prices for other industrial goods excluding energy rose moderately. Prices for services including rents also rose somewhat. Annual headline HICP inflation was unchanged at 2.1%,[4] and it was also more or less constant at 1.2% when excluding energy and food.

… and is not expected to change substantially over the next few months

Headline inflation is likely to stabilise at around 2% over the next few months. Energy and food price inflation is likely to slow somewhat. However, the rate excluding energy and food should edge up as prices for clothing are likely to be raised as new collections are introduced. Furthermore, the reductions in motor vehicle insurance premiums in October 2017 drop out of the annual inflation rate calculation in the autumn.

Orders received and outlook

German economy stays on expansionary course

The German economy will probably remain on a sound growth path in the summer of 2018. The pace of growth could end up being somewhat slower than the average for the first half of the year, however. Industry, for instance, is not expected to make any meaningful contribution to aggregate growth. Although the stock of orders still being processed remains

3 The headline CPI figure was +2.0% compared with +1.5%.
4 The CPI figure was +2.0% from likewise +2.1%.

exceptionally high and short-term output expectations in the manufacturing sector have stabilised at an elevated level, new orders received by industry were down again in the quarter under review. To exacerbate matters, problems encountered during the transition to a new emission test cycle are likely to markedly constrain motor vehicle production in the summer months. By contrast, private consumption is likely to benefit from the excellent labour market situation and the current strong wage growth, thus maintaining its role as a key driver of German economic growth.

Scarcely any further deterioration in sentiment of late

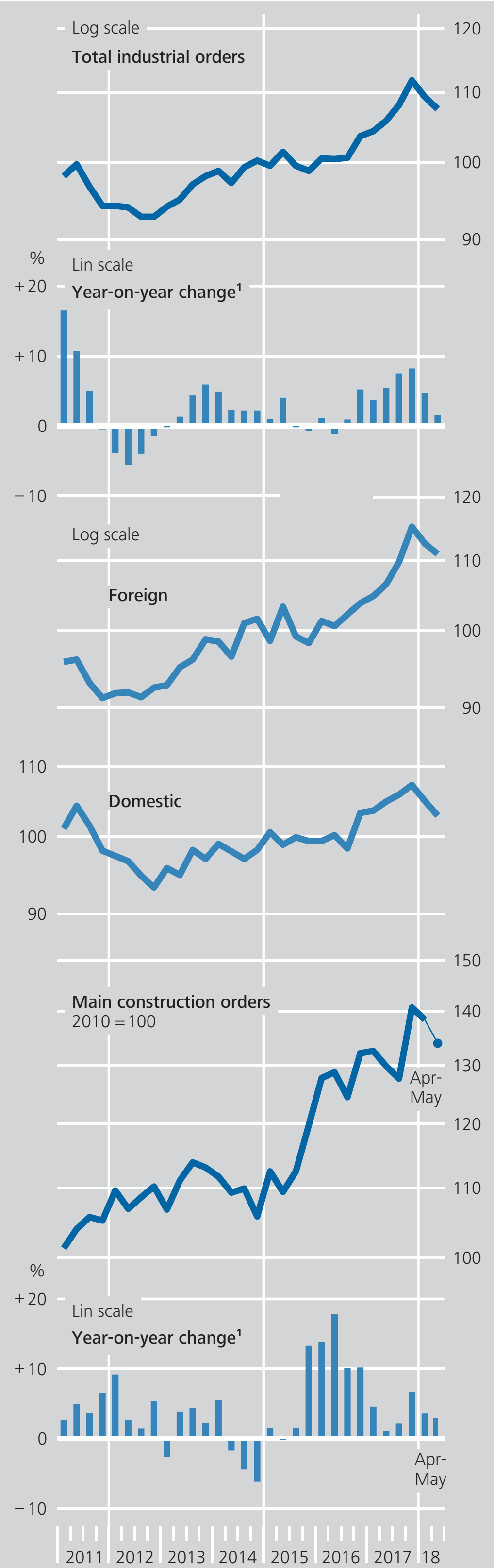
Sentiment in the German economy, having hit new record highs in the second half of last year before deteriorating markedly during the first few months of 2018, stabilised somewhat in the period under review. While the business situation was still considered to be very positive according to the Ifo surveys, business expectations fell to their longer-term average. This was mainly because enterprises in the wholesale and retail trade were taking a more cautious view of the future. By contrast, expectations in the other service sectors brightened slightly. The business outlook in the manufacturing industry has been stable in recent months, and the sector's assessments of short-term output and export expectations also remained largely unchanged. Developments in the main construction industry stood out positively, however. Not only did the assessment of the business situation jump to a new record high, expectations also brightened distinctly.

Order situation still favourable

German industry's order books are still well filled. The decline in industrial orders since the beginning of the year must be viewed in the context of the exceptionally strong inflow of orders in the second half of 2017 and the only subdued growth in output in the first half of this year. In regional terms, businesses received considerably fewer orders in the second quarter particularly from the euro area and Germany. By contrast, the inflow of new orders from non-euro area countries increased substantially. However, order backlogs in the

Demand for industrial goods and construction work

Volume, 2015 = 100, seasonally adjusted, quarterly



Source of unadjusted figures: Federal Statistical Office. **1** Only calendar-adjusted.

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manufacturing sector were still viewed as being well above average, according to the Ifo Institute surveys. The reported range of orders also remained close to its historical record high in the reporting period. Moreover, the order backlog in June was significantly higher than the average of the first quarter. The orders situation in industry can thus still be considered positive overall.

Demand for construction services remains high

The construction boom in Germany is likely to continue in the third quarter of 2018. Construction firms generally continue to enjoy very buoyant demand for construction services. On an average of April and May – the most recent months for which statistics are available – the order intake in the main construction sector went down steeply on the previous quarter. However, the inflow of new orders in the first quarter was exceptionally high and also, for the most part, characterised by large orders, which are often processed over longer periods of time. The brisk construction demand was also reflected in considerable and broad-based growth in the number of building permits granted. In view of the capacity constraints in the sector, however, it remains to be seen how quickly and strongly high demand will push up production.

Buoyant consumption continues

The prerequisites for private consumption to continue as a mainstay of solid economic growth remain in place in the third quarter of 2018. The recent improvement in the labour market situation was not as marked as that seen in 2017 but the outlook is still favourable. Moreover, significant price-adjusted wage growth is also likely to further increase households' scope for expenditure. In line with this, consumer sentiment is optimistic according to the consumer climate index compiled by the market research company Gesellschaft für Konsumforschung (GfK). The same applies to consumers' income expectations.