The current economic situation in Germany
Overview

Industrial downturn; domestic economy remains resilient

As was already the case in the final quarter of 2018, the global economy probably expanded at just a moderate pace at the start of the year. Developments were fairly varied from region to region, however. In the euro area, real gross domestic product (GDP) grew more strongly again. GDP also saw clearer growth in the United States. In both currency areas, though, favourable one-off factors are likely to have played a part in the pick-up. The Japanese economy seems to have weakened. In China, GDP rose at a similar pace as in the previous quarter, according to official data.

The current assessment contained in the April World Economic Outlook (WEO) published by the International Monetary Fund (IMF) reflects the fact that global activity has persisted at a moderate level. In the Outlook, the IMF made another downward revision to its forecast for global economic growth (based on purchasing power parity weights) this year – to the new level of 3.3%. Nonetheless, the IMF regards the recent slowdown in global economic activity as a temporary blip and expects to see a gradual recovery in the second half of 2019. It therefore left its global growth forecast for 2020 unchanged at 3.6%. As things stand, however, the outlook for the global economy appears extremely uncertain. This is partly down to the unresolved trade disputes, in particular.

Starting in the beginning of the year, the international financial markets have been influenced by the mixed economic signals set against a monetary policy that is still predominantly accommodative. Following the monetary policy decisions taken in March 2019 by the Eurosystem and the Federal Reserve System, market participants for the most part no longer expected key interest rates to rise in the euro area or the United States this year. Downward revisions to growth forecasts for this year are also likely to have played a part in this. As a result, the yield curves for both US Treasuries and Federal bonds dipped at the long end; they are now perceptibly flatter than at the end of 2018. On the stock markets, reduced capital market rates, which are associated with a lower discount factor for future expected corporate profits, played a role in major price rises, despite the economic uncertainty. Growing risk appetite among investors and a temporary increase in confidence in at least a partial resolution of the global trade disputes gave an added boost to equity prices. Moreover, financing terms on the market for European corporate bonds improved. Towards the end of the reporting period, renewed tension in the trade dispute between the United States and China subdued prices worldwide, especially on the stock market; compared with the previous large price gains, however, these losses were limited. Volatility on the foreign exchange markets was low for the most part. Only the Argentinian peso and the Turkish lira recorded stronger movements, and these currencies had already experienced severe price swings last year. Overall, on a weighted average against the currencies of 19 major trading partners, the euro slipped slightly on balance compared with the end of December 2018.

Given a slower convergence of inflation to its target, the Governing Council of the ECB adjusted the calendar-based element of its guidance on future key interest rate developments (“forward guidance”) after its March meeting. It now expects the key ECB interest rates to remain unchanged at least through the end of 2019. Additionally, the rates are to remain at their present levels 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.
At the same time, the Governing Council decided to launch a new series of targeted longer-term refinancing operations (TLTRO-III). They are intended to help to preserve favourable bank lending conditions and the smooth transmission of monetary policy. The Governing Council will announce further details on the precise terms of these operations at one of its upcoming meetings. It also extended its policy of full allotment, stating that all refinancing operations would continue to be conducted as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the reserve maintenance period starting in March 2021.

The robust increase in the broad monetary aggregate M3 continued in the reporting quarter, even though the Eurosystem had ceased its monthly net asset purchases at the end of 2018. Lending to the domestic private sector and inflows from abroad remained the main drivers of monetary growth. Demand for credit in the private sector was supported by the ongoing favourable financing terms and the healthy labour market situation in the euro area. Lending to non-financial corporations was more moderate, on balance, but at the same time enterprises raised more funds on the capital market during the reporting quarter, including from euro area banks. The associated increase in banks’ securitised lending meant that net flows to bank loans to the private sector, adjusted for loan sales and securitisation, grew slightly on the quarter.

The German economy got off to a good start in 2019, after economic output had largely stagnated in the second half of 2018. According to the Federal Statistical Office’s flash estimate, real GDP was 0.4% up on the quarter after seasonal and calendar adjustment. Temporary factors played an important role in this marked increase, however. For example, expansionary fiscal measures that entered into force at the start of this year probably gave added impetus to private consumption, which is likely to have received a further boost from car purchases that had earlier been deferred: in the second half of 2018, a considerable share of car purchases had been put off because of supply shortages due to the introduction of a new emissions testing procedure, the Worldwide Harmonised Light Vehicle Test Procedure (WLTP). Construction activity was brisk over the winter months, facilitated primarily by favourable weather conditions. Disregarding these one-off factors, the underlying cyclical trend nonetheless remained weak overall, as it has been since mid-2018. This is likely to be true of the current quarter, as well. Following the decline in the preceding six months, aggregate capacity utilisation stayed at what is still a significantly above average level.

The construction, hospitality and retail sectors were clear sources of impetus, flanked by the one-off effects. Commercial services are also likely to have increased markedly in the reporting period. By contrast, the broad-based downturn in industry continued. On the demand side, the key driver of growth was probably private consumption, which thus shrugged off the slump it went through in the second half of 2018. Despite anaemic industrial activity, business investment in new machinery, equipment and plants probably saw a distinct increase. Construction investment also expanded significantly. Exports likewise rose.

Despite the slowdown in economic activity in the second half of 2018, banks’ lending business in the reporting quarter was exceptionally dynamic. Loans to households accounted once again for the largest net inflows in lending to Germany’s private sector, although loans to non-financial corporations were also a key driver of growth in lending business. According to bank managers responding to the Bank Lending Survey, the higher level of funds needed for fixed investment was the main reason for the rise in demand in this credit segment. At the same time, the results of the Bank Lending Survey indicate overall that the period of expansionary adjustments in lending policy...
was no longer ongoing for loans to households for house purchase or for loans to enterprises in the reporting quarter.

In the first quarter of 2019, the labour market continued to improve despite the slower underlying cyclical trend, which has been ongoing since mid-2018. This meant that employment creation continued and unemployment declined, even if only slightly. As before, the rise in employment was mainly due to the increase in new jobs subject to social security contributions. By contrast, the number of self-employed persons and persons working exclusively in low-paid part-time jobs continued to go down. The number of job vacancies has remained at the high level it reached a few months ago. Leading indicators suggest that gloomier recruitment plans have so far largely been confined to manufacturing. On the whole, labour demand is continuing to trend upwards.

Negotiated wages also rose sharply in the first quarter. This was mainly due to the previous year’s wage settlements, which were higher than before on account of the pronounced tightness in the labour market. Likewise, the new agreements concluded in the 2019 pay round mainly envisage steeper wage rises than in the years from 2015 to 2017. The wage demands for sectors where an agreement is still pending in this year’s pay round are slightly higher than in the previous year. The growth in actual earnings may have again surpassed that of the negotiated pay rates in the first quarter of 2019.

The rise in the price of processed products was offset by a countermovement in unprocessed food prices. Increases in upstream prices of non-energy industrial goods were passed on to consumers. Services also became noticeably more expensive. Annual HICP inflation excluding energy and food saw a rise to 1.4%, which, in comparison to the previous year, was less sharp than in the fourth quarter of 2018, however. This was because, due to the relatively early date of Easter that year, price developments in the first quarter of 2018 had been similarly as high as in the reporting quarter. Consumer prices went up significantly in April, buoyed by higher energy prices and the effect of Easter on travel services. The headline rate rose to 2.1% on the year.

The pattern of a two-tiered economy that has been impacting on economic activity in Germany since the summer of 2018 will remain in place in the second quarter of 2019. While the downturn in industry will continue, the expansionary forces in the more domestically-oriented sectors are still intact. The overall result of this will continue to be a weak underlying cyclical trend. Given this setting, German economic output in the second quarter of 2019 is not very likely to exceed the level reached in the first quarter, which had been boosted by a number of one-off effects. The effects, which had largely driven growth after the turn of the year, are expected to lapse or even reverse themselves. To wit, the additional stimulus to private consumption from fiscal measures could dip temporarily in the second quarter before other measures to boost purchasing power pass through to households in the second half of the year. On top of this, it is likely that the processes for catch-up car purchases are largely complete. Last but not least, a dampening rebound effect can be expected in the construction sector following the very strong weather-related increase in the first quarter. Moreover, downturn forces continue to be prevalent in industry, and they may even intensify somewhat. This can also be seen, amongst other things, in the number of new orders in industry,
which have declined significantly and on a broad front from the start of 2019. The business climate index in manufacturing declined for the eighth consecutive period, too. Output and export expectations were also scaled back again. In line with this, the number of passenger cars manufactured in April dropped quite considerably, after seasonal adjustment, according to data provided by the German Association of the Automotive Industry (VDA). A gradual rebound in economic activity is only expected for the second half of the year alongside a global economic recovery.

Public finances will perceptibly bolster the economy throughout the year. The general government fiscal balance is likely to see a distinct deterioration, though it will clearly remain within positive territory as things stand today. The main reason for the declining surplus is the fiscal accommodation, which can primarily be seen in accelerating spending hikes. The macroeconomic slowdown also means that tax revenue is growing more slowly. The debt ratio is likely to fall below the 60% threshold.

Fiscal policy is expected to become more accommodative in the coming years owing to a wide range of projects. Steep spending increases are envisaged in the areas of pensions and long-term care. In addition, more funding is also set to be made available in areas such as infrastructure, education, and internal and external security. On the revenue side, the coalition deal still essentially plans to partially abolish the solidarity surcharge in 2021.

Overall, however, general government is still expected to run a surplus as things stand today. This holds even if the lower revenue expectations following the May tax estimate are factored in. That said, it looks as though government budgets will come under pressure in the coming years. With the measures agreed so far, this mainly applies to central government as well as the statutory pension and health insurance schemes, which, as of late, have still been running relatively large surpluses. As from the middle of the next decade, demographic change will once again weigh considerably on government budgets.

A severe deterioration in the Federal budget balance is expected this year and next year. However, the current decisions are adhering to the target of balancing the budget without net borrowing until 2023. The refugee reserve is expected to be used for this purpose. As things stand, this target appears at first glance to be highly achievable – even if the priority coalition agreements are implemented and the less favourable tax estimate is applied. A distinctly more favourable Federal budget balance than planned and growing reserves lie ahead in the shorter run. Going forward, however, pressures will increase considerably, and even an initially larger refugee reserve will only be able to plug budget gaps temporarily. It is not just the costs of new measures that need to be considered. Demographic trends will sharply increase the grant towards statutory pension insurance schemes even without any additional increase in benefits. It is therefore recommended to set stricter priorities and to secure funding in the longer term to cover the high costs of additional measures.

Reduced government surplus this year given fiscal accommodation

Further fiscal policy accommodation in coming years and...

Wiggle room left in Federal budget but considerable pressure expected looking ahead

...gradually lower surpluses