

| The current economic situation in Germany

Overview

German economy off to a flying start

Global economy starts year sluggishly, ...

The world economy's underlying dynamic is still sound, although the faster pace of growth seen in preceding quarters probably could not be maintained at the start of the year. In a number of industrial countries, for instance, growth in seasonally and price-adjusted gross domestic product (GDP) saw a marked first-quarter decline. Higher inflation dampened private consumption, as expected. But the lacklustre start to the year also owed something to the preceding dynamics. Thus consumers in the United States, for example, but presumably also in the United Kingdom raised their saving ratio, which they had scaled back in the preceding months. By contrast, real GDP rose fairly strongly in the euro area and Japan. The Brazilian economy, which slid into deep recession just over two years ago, may have actually started to grow again in the quarter just ended.

... but remains on track

In line with the stable underlying momentum of the world economy, the International Monetary Fund (IMF) expects global economic output to pick up by around 3½% both this year and in the coming year. In each case, this growth would be roughly ½ percentage point higher than in 2016. IMF staff have thus marginally lifted their forecasts for 2017 and 2018. These were the first upward revisions in a long while to the short-term growth expectations. However, the subdued start to the year suggests that the IMF staff projections could prove to be slightly too high in 2017, particularly for the United States. The outlook there hinges largely on the future path of economic and fiscal policy. At the end of April, the White House raised the prospect of extensive tax cuts for corporations and households. Bundesbank model simulations suggest that a package of measures like the one presented is likely to provide a considerable boost to the US economy initially, albeit at a high fiscal cost, but that the

positive effects will evaporate over the medium to long term, assuming there is a time limit on the measures. The short-term economic impacts on trading partners are less clear owing to offsetting effects. Even so, inflation would probably increase in the euro area as well.

Since the start of the year, the international financial markets have been caught between a basically stabilised world economy on the one hand and volatile political influences on the other. In particular, the lead-up to the French presidential elections saw market uncertainty mount distinctly for a time and led to increased demand for safe assets as well as to short-term share price losses on the European stock markets. However, market players' concerns were quickly allayed once the results of the first round of voting became known. The stock markets subsequently recorded major price gains, which were accompanied by rising yields on ten-year Federal Bunds, for example. The temporarily wider yield spreads within the euro area narrowed again during this period. In contrast, yields on long-term US Treasuries receded on balance in the course of the reporting period although the US Federal Reserve (Fed) raised its policy rate again in March. It seems that market players' more sceptical view concerning the implementation of economic policy measures in the United States, the announcement of which had earlier pushed up interest rates, has now led to declining term premiums. This is consistent with the fact that market-based forward inflation rates also contracted at the end of the reporting period in both the United States and the euro area. In Europe, the decrease may have been triggered mainly by market participants' preference for liquid nominal assets. In the foreign exchange markets, sentiment shifted in favour of the euro amid waning political uncertainty in Europe.

Financial market uncertainty temporarily heightened

The Governing Council of the European Central Bank (ECB) kept its key interest rates unchanged

Monetary policy: ECB Governing Council leaves policy rates unchanged

over the entire reporting period. In March 2017, the last of the four rounds under the second series of targeted longer-term refinancing operations (TLTRO II) was conducted. The participating institutions borrowed a total volume of €233.5 billion, thereby significantly exceeding market expectations.

The monthly volume of asset purchases under the expanded asset purchase programme was reduced to €60 billion in April, as planned. The Governing Council intends to continue purchasing securities until the end of December 2017, or beyond, if necessary, and in any case until it sees a sustained adjustment in the path of inflation consistent with its inflation aim. Although the ECB Governing Council perceives that the euro area's economic recovery has continued to strengthen in the past few months, it has so far considered the rise in headline inflation to close to 2% to be unsustainable, since no clear upward trend in core inflation has yet been observed. The Governing Council will review this assessment at the beginning of June, when the new Eurosystem macroeconomic projections are available.

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 first quarter of 2017 against the backdrop of the historically low interest rate setting and robust economic growth in the euro area. This was mainly attributable to lending to the domestic private sector as loans to households and non-financial corporations continued their upward trend. Monetary growth was additionally supported by securities-based lending to domestic non-banks, which was dominated by the Eurosystem's asset purchase programmes.

German economy showing strong growth in Q1

The cyclical upturn in the German economy gained momentum at the beginning of the year. According to the Federal Statistical Office's flash estimate, real GDP in the first quarter of 2017 rose substantially by 0.6%, after seasonal and calendar adjustment, against the fourth

quarter of 2016 in which the German economy had expanded by 0.4%. The pace of aggregate growth clearly exceeded the potential rate. As a result, overall capacity utilisation, which has been considerably above its longer-term average for quite some time, increased further. The acceleration of economic growth was due mainly to a marked expansion in construction activity fuelled by high demand, especially for housing, but also to a recent high inflow of new orders in the industrial sector which helped it to overcome its sluggish phase in the second half of 2016. Growth continued to be supported by buoyant business activity in the service sector. A breakdown of the GDP expenditure components likewise suggests that the upswing has become more broadly based recently. Investment in machinery and equipment also picked up again after the turn of the year in the wake of strong export growth, which continued the trend seen at the end of 2016, and the disproportionately high level of capacity utilisation in industry. The boom in the housing market continued. Although the inflation hike at the start of the year eroded consumers' real disposable income, private consumption remained on an expansionary course owing to the very strong labour market situation.

This impression is supported by the fact that banks again noticeably stepped up their lending to the domestic private sector in the quarter under review. The largest net expansion was recorded by loans to households, driven by their brisk demand for mortgages. Banks' lending business with domestic non-financial corporations, too, grew distinctly on balance.

The German labour market remains extremely resilient. As in the last three months of 2016, employment surged again in the first quarter of the year. Jobs subject to social security contributions continued to be the main driver of this positive development. By contrast, the low-paid part-time employment segment continued to contract. Registered unemployment fell quite significantly in the period under review. The leading labour market indicators suggest

Marked rise in loans to the domestic private sector in Germany

Labour market: situation and outlook still very buoyant

that this very favourable development will continue in the months to come.

Moderate wage trend persists

Although the increase in wages accelerated slightly in the first quarter of 2017, it remained subdued compared with the exceptionally strong labour market situation. Negotiated pay agreements to date in this year's "small" wage round have largely mirrored the level of last year's collective bargaining agreements. This applies both to the size of the wage increases, which have mostly been moderate so far, and to the normally two-year duration of the agreements. The wage demands of the trade unions in the case of outstanding pay negotiations vary between 4.5% and 6.5%, thus matching last year's range. However, the outstanding labour negotiations will probably not be limited to pay increases but will also feature other aspects such as pension arrangements or the impact of digitisation.

Consumer price inflation still driven by energy and food

Consumer prices as measured by the Harmonised Index of Consumer Prices (HICP) rose fairly sharply in the first quarter of 2017, as they had in the final months of 2016; in each case, they were up by a seasonally adjusted 0.5% on the quarter. Inflation was still mainly driven by energy and food. Prices of refined petroleum products continued to appreciate in line with crude oil prices. The unusually cold weather in large parts of Europe pushed up the cost of food. By contrast, the prices of industrial goods excluding energy rose only moderately, as in the previous quarter. The prices of services as a whole registered another slight increase despite a marked drop in patients' contributions to the cost of long-term care following the recent reform. Overall, annual HICP inflation jumped very sharply from 1.0% to 1.9% on a quarterly average. A key baseline factor in this was that energy prices had declined sharply at the beginning of 2016. The core rate excluding energy and food, meanwhile, remained at around 1%.

Strong growth set to continue in Q2

The German economy's strong growth looks set to continue in the second quarter of the year. Industrial activity is likely to remain on an

upward trajectory, buoyed by lively domestic and external demand. This is also suggested by the positive sentiment in manufacturing in conjunction with still optimistic export expectations. Given that utilisation of production capacity remains above average, this should support the ongoing momentum of private investment in machinery and equipment. The construction sector should continue to flourish, and the service industries are also likely to remain on an expansionary course. All this is likely to have a positive impact on households' income and labour market prospects, which should ensure that consumer spending remains robust in the second quarter.

Germany's public finances remain favourable. Nonetheless, the budget surplus could shrink somewhat this year. Fiscal policy is expansionary. Economic developments and a further decline in interest expenditure should ease the pressure on public coffers on balance, while other spending will continue to rise fairly sharply. Over the next few years, no major change to the fiscal balance is currently expected, and, overall, surpluses are anticipated. As things currently stand, the debt ratio looks likely to remain on its downward trend and could fall back below the 60% threshold towards the end of the decade, the first time it would have done so since 2002. There is uncertainty especially with regard to the international environment and new fiscal policy measures following Germany's general election this autumn.

Public finances: situation remains favourable

In recent years, the very positive underlying economic setting – such as the strong labour market performance, falling financing costs and the surging growth in tax revenue – has masked expansionary spending. However, zero interest rates, improvements in the labour market and an increasing tax ratio cannot continue forever, and fiscal policy will face major challenges in the future. Demographic change will take a toll on the social security funds, for instance, resulting in a clear rise in contribution rates. Central, state and local government, too,

Expansionary spending masked by positive setting

will have to prepare for additional expenditure amid lower growth in tax revenue.

Demographic challenges

A key component in preparing for these challenges is to bring the debt ratio down rapidly. It would also be advisable for central government and the state governments to factor structural surpluses into their fiscal plans as this would allow their budgets to absorb temporary shocks without needing to bend or breach the budgetary rules. With this in mind, the surpluses mapped out in the stability programme appear appropriate, overall. Looking at the Federal Employment Agency, it would make sense to lower the contribution rate given the exceptionally good financial situation and positive outlook, thus limiting the further increase in reserves. This would be a way of easing the burden on employees and enterprises alike.

The healthy budgetary position at central, state and local government level proves not least that the additional cost of absorbing the temporarily high influx of refugees can be funded without running up budgetary deficits. It would therefore make sound sense to release the reserve set up for this purpose in the Federal budget in order to repay debt. Moreover, relying on reserves to fund permanent spending would generate a risk of budget shortfalls in the medium term. Besides, such withdrawals would not be recognised as reducing the deficit under the European fiscal framework. Releasing reserves to pay down debt would therefore also prevent a potential conflict with the European fiscal rules.

Release reserves to repay debt