The current economic situation in Germany

Overview

German economy exhibiting robust growth

Global economy

The global economy probably expanded only modestly again in the second quarter of this year, as in the last three months of 2015 and first quarter of 2016. The pace of economic growth remained moderate, particularly in the advanced economies, with the dynamics shifting somewhat between individual countries. Real gross domestic product (GDP) in the United States grew barely faster in the second quarter than in the preceding three months, not least as a result of changes in inventories. In the euro area, the remarkable vigour with which the economy had begun the year waned. On average, growth in the first two quarters was roughly in line with the moderate underlying rate which has for some time now set the pace and which still suffices to bring unemployment down gradually. Despite the increased uncertainty surrounding the Brexit referendum, the economic upturn in the United Kingdom proved robust in the second quarter. In the emerging market economies, activity appears to be stabilising further. In China, this was probably primarily due to the authorities' efforts to stimulate growth. Additionally, there was increasing evidence in the first half of the year to suggest that the recessions in Brazil and Russia are easing.

Brexit not a significant risk for global economy

On 23 June 2016, the British public voted for the United Kingdom to leave the EU, an event which many market participants had previously identified as a significant downside risk for the global economy. According to first surveys among consumers and businesses, however, sentiment in the immediate aftermath of the referendum was noticeably depressed only in the United Kingdom. Yet weaker growth of the British economy alone does not pose a significant risk to the global economy. In fact, the strengthening labour market in the United States – after intermittent worries that the country could slip into recession – and the stabilisation of the emerging market economies suggest that the downside risks for the global economy have recently eased somewhat, if anything.

Financial market setting

Developments in the international financial markets in the second quarter were dominated by uncertainty surrounding the British referendum on whether to remain in or leave the EU. Another important factor was monetary policy in the industrialised nations which maintained an expansionary stance – not least because of the UK Leave vote and concerns about the downside risks for the global economy that it could entail. A lot of market participants were surprised by the vote and shifted funds into safe investments (safe haven inflows). Nonetheless, the turmoil that observers had feared such an outcome would cause on the international financial markets failed to materialise. Long-term government bond yields in the major currency areas continued to decline and temporarily reached historic lows. This was the case in Germany, Japan and the UK, for instance. Mirroring this, the stock markets initially also recorded sharp share price losses in response to the outcome of the referendum. However, as uncertainty eased, a counterswing fairly rapidly set in on the bond and, especially, the stock markets. Overall, the Euro Stoxx was trading slightly above its level at the end of March as this report went to press, and the US markets even marked new record highs. European bank shares significantly underperformed the market. They suffered from deteriorating earnings expectations and the fact that attention was increasingly focusing on the large levels of non-performing loans, especially in Italy. Funding conditions for enterprises in the euro area improved considerably. The euro's effective exchange rates against the currencies of 19 major trading partners remained virtually unchanged as compared to the end of March. While the single currency fell perceptibly

UK referendum dominant factor on financial markets against the yen, it appreciated strongly, especially against the pound sterling.

Monetary policy

Having agreed on a comprehensive package of monetary easing measures in March, the Governing Council of the ECB adopted no new non-standard measures in the reporting quarter and left its policy rates unchanged. At its monetary policy meeting in July, it discussed potential consequences of the UK referendum for the euro area and concluded that the baseline scenario of an ongoing economic recovery and a gradual increase in inflation rates in the euro area remained intact. Given the uncertainty resulting from the outcome of the referendum, the ECB's Governing Council did, however, announce that it would closely monitor the outlook for price stability and reassess the most likely path of inflation as well as the risks over the coming months based on newly available information.

Baseline scenario of rising inflation also intact post-Brexit

Borrowing allowances in the first TLTRO II only partially exhausted

The Eurosystem continued to make purchases under its expanded asset purchase programme (APP) in the reporting quarter as planned and in June started to implement the corporate sector purchase programme (CSPP), which was decided on in March. Moreover, at the end of June, the last transaction in the first series of targeted longer-term refinancing operations (TLTRO I) was carried out as well as the first of a total of four new such transactions (TLTRO II). In line with market expectations, banks did not fully exhaust their total allowances under the first TLTRO II, using lending in particular to replace earlier longer-term refinancing operations, which were now no longer as attractive. The second TLTRO II will be carried out in September of this year.

Monetary developments in the euro area

Developments in the monetary indicators continue to provide no indication of a growing need for monetary policy action. The broad M3 monetary aggregate rose considerably in the second quarter against the backdrop of historically low interest rates and the continued moderate economic recovery in the euro area. One growth driver was a marked increase in loans to the private sector; lending to domestic non-financial corporations and households especially thus remained on an upward trajectory. Nonetheless, the mainstay of monetary expansion was once again securities-based lending to general government by the MFI sector, fuelled largely by the Eurosystem's government bond purchases. However, the direct boost from the securities purchases on the money stock was partly offset by outflows of funds from the euro area as foreign investors offloaded euro-area bonds on balance and euro-area investors continued to purchase foreign debt securities.

Credit dynamics in Germany

In Germany, banks once again issued more loans to the domestic private sector during the quarter under review. In addition to lending to the private sector, banks also raised their holdings of privately issued securities, which they had reduced considerably in the preceding quarters. Lively demand from households for loans for house purchase was once again the key factor driving the ongoing expansion in loans to the private sector. By contrast, momentum in lending to domestic non-financial corporations sagged somewhat in the quarter under review following three fairly strong quarters. According to the banks participating in the Bank Lending Survey (BLS), this is probably because companies have ample scope for internal financing.

German economy

German economic growth slowed as anticipated in the second quarter of 2016, following an exceptionally strong first quarter. According to the Federal Statistical Office's flash estimate, real GDP in the second quarter rose by 0.4% on the quarter after seasonal and calendar adjustment. Aggregate capacity utilisation is still above average. The reduced economic momentum was mainly attributable to a clear drop in investment in both machinery and equipment and in construction, though private consumption growth was also weaker than at the beginning of the year.

Special factors notably depressed investment. The weaker demand for new machinery and equipment probably represents not least a natural rebound from the strong surge in investment at the beginning of the year. Another factor is likely to have been that industrial output has not yet picked up durably. By contrast, the fall-off in construction investment was largely weather-related, after exceptionally mild temperatures in the winter had allowed additional building output in the first quarter. Moreover, part of the additional building work carried out during the winter months was probably merely brought forward, meaning that this impulse was lacking in the second quarter. The slower pace of private consumption may also owe something to the turnaround from falling to rising oil prices, as this cancelled out previously realised gains in purchasing power. On the other hand, the very robust export momentum had a stabilising effect on overall economic activity.

The labour market situation continued to be very favourable. Both employment and the number of vacant positions continued to rise. As in the preceding quarters, this was due mainly to the very buoyant trend in jobs subject to social security contributions. The underlying unemployment dynamics were also positive. However, the growing number of asylum application decisions led to an increase in the number of refugees registering as unemployed. The fact that total registered unemployment nonetheless continued to decrease is attributable to the increased use of labour market policy instruments. The upbeat employment momentum should persist in the coming months, since the most important leading indicators of employment have remained very stable in the last few months. Unemployment could also continue to drop slightly, since the active labour market policy measures will probably be further expanded in connection with the influx of refugees.

The second quarter of 2016 saw negotiated rates of pay climb only modestly by +2.2% year on year, just as they had done in the first quarter. This was due not only to the moderate pay rises in the current pay round, which in some cases come into effect only after a several-month freeze at the old pay rates, but also to negative baseline effects owing to one-off and special payments in the second quarter of 2015, as well as to low graduated increases stemming from pay agreements negotiated in earlier pay rounds. So far this year, new wage agreements were concluded for just under 8 million workers and salaried employees. On an annualised basis, the agreed volumes translate into a moderate wage increase of just under 2½%.

Prices did not continue their downward trend in the second quarter of 2016; instead, higher crude oil prices resulted in steep increases across nearly all stages of the economy compared to the first quarter. Excluding energy, however, the underlying inflation dynamics remained muted, whereby the decline at the upstream stages tailed off noticeably. While the rate of price increases at the consumer level intensified somewhat, even after stripping out energy, this was mainly attributable to exceptional factors. Thus the surge in the price of commercial goods excluding energy can largely be explained by fluctuations in the prices of clothing and footwear, which have become significantly more volatile in recent years. Moreover, an adjustment to the minimum tax rate resulted in higher tobacco prices. As the rate of inflation had likewise increased sharply in the second quarter of 2015, the year-on-year increase as measured by the national consumer price index (CPI) dipped slightly to +0.1% and to 0.0% as defined by the Harmonised Index of Consumer Prices (HICP).

The German economy should continue to grow in the third quarter in line with the robust underlying cyclical upthrust. Despite the low level of new orders received in the second quarter, the mood in German industry has improved distinctly. Notwithstanding the intense public discussion about the economic implications of the UK's announced departure from the EU, German firms have so far only slightly moderated their positive expectations. This supports the assessment that the economic consequences of the Brexit vote for Germany are likely to be very limited in scope, at least in the short term. German firms' positive expectations regarding foreign sales suggest that exports, too, will grow solidly in the third quarter. Overall, production by industrial firms should once again make a stronger contribution to aggregate growth in the third quarter. Given that capacity utilisation is already above its average level, this should also mean more investment in machinery and equipment. Construction investment should also provide a greater impetus in the third quarter after the effects of the weather-related second-quarter rebound in building activity have petered out. In addition, private consumption should once more be a significant driver of domestic economic growth after faltering in the first quarter. Both employees' income prospects and the labour market situation remain favourable, and the preceding rise in crude oil prices has reversed.

Public finances

The setting for German public finances remains favourable; as things currently stand, a surplus and a declining debt ratio are once again on the horizon for the coming year. Given the robust economic and labour market situation, government budgets are profiting from further falling interest expenditure. However, the fiscal surplus is expected to be smaller than last year as it will be partly offset by additional structural outlays. First, expenditure on refugees and other immigrants will rise, particularly because in 2015 many immigrants only arrived in autumn, which meant that the bulk of the related expenditure only affected a few months. Second, the budgetary stance is expansionary in other fields, too. For example, spending is being increased in various areas, such as housing allowance, infrastructure and child day-care. In addition, the mid-year pension increases were particularly large.

The outlook for German public finances remains favourable over the medium term. However, recent experience of unexpectedly high fiscal burdens in connection with the influx of immigrants underlines the importance of creating safety cushions below the deficit ceilings that provide room for manoeuvre within the fiscal framework to cope with unexpected developments. In view of the requirements set by the national debt brake, this suggests that policymakers should generally strive to generate moderate structural surpluses in the future as well.

On top of this, it is important to seek to achieve a focused improvement in the structural framework, eg by exploiting efficiency reserves and giving greater prominence to growth-enhancing expenditure categories. Any sustained budgetary leeway available over and above the safety margins could be used in future to lower taxes and social contributions, rather than choosing as in the recent past to use positive fiscal shocks primarily to boost spending. For example, the Federal Employment Agency could consider lowering the contribution rate, thus dampening the additional increase in its reserves which is currently expected. Another option would be to reduce the solidarity surcharge. This add-on to various taxes imposed by the Federal Government generates extra revenue of ½% of GDP, whereas the special-purposes grants to the east German federal states, which were given as the reason for introducing the surcharge, are now low in comparison and will have been phased out by the end of the decade.

It would also be expedient to build up greater safety margins in the Federal budget below the budget ceiling defined by the debt brake – not only to ensure greater operational flexibility to deal with unexpected developments but also, for example, to make provision for the demographic challenges that are gradually emerging. It would also be better to use the reserves set up to cover expenses relating to refugee immigration costs in order to pay down public debt by the end of 2017 at the latest. By then it should then be possible to relatively accurately gauge future expenditures on refugees, and these should then be financed out of regular income streams. The current accounting treatment of the reserve in the context of the debt brake may lead to a conflict with EU rules, which state that changes in reserves – like financial transactions – should be disregarded when calculating the fiscal balance. The underlying rationale of the debt brake is to safeguard the EU fiscal rules, which is another reason why surpluses accumulated from previous years should not be used to plug funding gaps in the budget plans. In general, policymakers should resist the temptation to use windfall budgetary gains such as reserves to cover new, permanent additional spending in the short term since this causes a future cumulative consolidation requirement.

The current favourable situation of the statutory pension insurance scheme masks the fact that it will face substantial strains in future from demographic challenges. Official costing forecasts should extend beyond the year 2030 in order to identify long-term trends that will determine funding requirements. Public trust in the statutory pension insurance scheme could be strengthened and uncertainty about financial security in old age allayed if policymakers were to spell out the likely long-term rules for adjusting the pension scheme's key parameters of retirement age, pension level and contribution rate from today's perspective. The official calculations currently fail to take adequate account of the prolongation of the average working life induced by the progressive raising of the statutory retirement age to 67, with the result that the likely future pension-to-earnings ratio is increasingly understated along the time axis by current projections. In fact, policymakers wold be well advised to revisit the issues of a longer working life and a higher statutory retirement age. The incremental raising of the statutory retirement age to 67 by the year 2029 will largely stabilise the balance between the respective average duration of the retirement phase and of the contribution phase up to that time, albeit at an historically high level. It would make sense to extend this stabilisation concept beyond 2029. From today's vantage point, this implies a graduated increase in the retirement age to approximately 69 by the year 2060. Even on this basis the contribution rate would probably rise to around 24%, while the pension-to-earnings level provided by the statutory pension insurance scheme would fall to around 44%. However, supplementary savings under voluntary private pension plans could enable retirees to achieve a total pension income above the current level, even in the event of low market rates of return on investment.