

## Overview

### German domestic activity back on its feet in the third quarter

*Global economy remarkably robust*

Since the referendum in the United Kingdom, in which the country voted to leave the European Union (EU), observers perceived mounting political risks to the global economy. Attention was centred on the threat that the uncertainty regarding the way forward could encourage enterprises and households to restrain their investment and consumption. Against that background, the global economy turned out to be remarkably robust in the third quarter. In the quarter ended, the advanced economies even showed somewhat accelerated growth, a development due mainly to the perceptible acceleration of US and Japanese economic growth. Aggregate output in the euro area grew at a relatively constant pace. The considerable economic growth in the United Kingdom was striking, as it contrasts not only with diverse downward scenarios but also with the general expectation that the economy would sour following the Brexit vote. Within the group of emerging market economies, developments remained heterogeneous. The stable and relatively strong growth of Chinese economic output contrasted particularly sharply with the protracted problems faced by a variety of commodity-exporting nations.

*IMF confirms global growth projections*

Given the overall robust growth, the staff of the International Monetary Fund (IMF) has confirmed in the current issue of its World Economic Outlook its global growth projections for this year and next from the July round. It once again revised significantly downwards its estimate of growth in real gross domestic product (GDP) in the United States, especially for 2016. However, its assessment of the current US output gap is now considerably narrower than as late as April. The IMF staff recently assessed the outlook for some other economies a bit more favourably. It raised its growth projec-

tions for the euro area slightly for this year and next, and even revised its projections for Japan perceptibly upwards. Among the emerging market economies, Russia's outlook was less gloomy than before.

The UK referendum in the middle of the year impacted on the financial markets, too. Fears of an economic slump, primarily in the United Kingdom itself but capable of affecting other countries as well, and the associated expectation of long-term accommodative monetary policy drove down share prices and government bond yields. However, the swift real economic downturn expected for the United Kingdom in many quarters failed to materialise, and the markets subsequently recovered over the course of the third quarter. Towards the end of the period under review, expectations regarding future monetary policy on both sides of the Atlantic dominated yield movements. The financial markets were also affected by the outcome of the US presidential elections, which caught many observers off-guard. In the context of rising inflation rates and solid economic figures, the increase in expectations of a policy rate hike in the United States in December and of a more accommodative US fiscal policy are reflected in the rise in ten-year US Treasury yields (84 basis points to 2.3%) and the rise in German Bunds with the same maturity (37 basis points to 0.2%). On the other hand, financial market developments in Japan were dominated by the Japanese central bank's decision in September to change strategies. This means that not only is the central bank willing to allow inflation to temporarily overshoot the original target of 2% but that, moreover, yields on ten-year bonds will be stabilised at around the zero mark. There has therefore been no significant yield rise in Japan since the end of June. The effective exchange rate of the euro has remained unchanged on balance since the start of the second half of the year. Its appreciation against the pound sterling, linked to the

*Now that "Brexit shock" has died down, financial markets looking to monetary policy and US presidential election outcome*

referendum and the subsequent monetary policy measures taken by the Bank of England, were offset by losses against other currencies.

*Monetary policy: expectations of a gradual rise in inflation confirmed*

In the quarter under review, the Governing Council of the ECB left its policy rates unchanged and did not take any new non-standard measures. In September, it instructed the relevant Eurosystem committees to assess the options conducive to ensuring the smooth implementation of the purchase programme now and in future. At its monetary policy meeting in October, the ECB Governing Council stated that recently published information had confirmed the baseline scenario of a continued moderate but steady recovery of the euro-area economy and a gradual rise in inflation. The Council reaffirmed its commitment to preserving the substantial degree of monetary accommodation which is necessary for inflation to approach a level of below, but close to, 2% over the medium term.

*Second TLTRO II operation settled*

In the quarter under review, the Eurosystem continued its purchases under the expanded asset purchase programme (APP) as planned. As at the end of September, moreover, the second operation in the second series of targeted longer-term refinancing operations (TLTRO II) was conducted. Its allotment volume tended towards the upper end of market expectations. The third operation in the TLTRO II series will be conducted in December of this year.

*Continuation of monetary growth*

Developments in the monetary indicators per se continue to provide no indication of a growing need for monetary policy action. The broad M3 monetary aggregate rose considerably in the third quarter against the backdrop of historically low interest rates and the continued moderate economic recovery in the euro area. Monetary growth was particularly supported by the continuation of the recovery of lending to the non-financial private sector, though the rise in lending to non-financial corporations observed in the second quarter lagged behind that of the preceding quarters. It received a fur-

ther boost from securitised lending by banks to domestic non-banks, which was dominated by the Eurosystem's APPs. However, the positive effects of the asset purchases were partly offset by considerable 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.

The third quarter of 2016 saw the German economy temporarily lose some momentum. According to the Federal Statistical Office's flash estimate, real GDP rose by no more than 0.2% in the summer months after seasonal and calendar adjustment. However, different drivers were at play than in the preceding quarter. Exports, which had been making a key contribution to GDP growth in the second quarter, suffered a setback, which was not entirely offset by resurging domestic activity. The underlying cyclical momentum remains quite strong, though. For the final quarter of the current year, GDP growth can be expected to continue where the faster pace of the first half of the year left off. This is signalled by the strong improvement in the sentiment indicators. Aggregate capacity utilisation remains higher than average.

After the dip in the second quarter, domestic activity returned to the sustained strong level seen since the end of 2014. The more dynamic pace of domestic economic growth owed primarily to government and private consumption. Along with the particularly high mid-year pension increase and the delayed payment of the negotiated pay increase in the public sector, consumption received a strong boost from the ongoing advantageous income and labour market prospects and low energy prices. In the case of construction investment, the period of adjustment in the second quarter following higher-than-average production at the start of the year for weather-related reasons appears to have come to an end. Investment in machinery and equipment remained listless, but did not dampen economic activity to the same extent as it had in the second quarter.

*German economy lost momentum in 2016 Q3, as weak exports ...*

*... masked renewed increase in domestic activity*

*Robust credit growth in Germany*

German banks' lending to domestic customers once again rose significantly in the summer months. The largest net inflows were seen in lending to households, which, as in previous quarters, was chiefly driven by loans for house purchase. Banks also distinctly expanded their credit business with domestic non-financial corporations, on balance.

*Dip in favourable labour market developments, but outlook improved*

The very healthy labour market developments seen in previous quarters experienced a dip primarily between June and August. Unlike in winter and spring, employment grew only slightly in the third quarter. The reasons for this were twofold: weak growth in jobs subject to social security contributions and the renewed decline in low-paid part-time work. Nonetheless, the outlook for employment is favourable, as the leading indicators have recently improved considerably. Unemployment decreased only a little recently, but this was partly due to the increasing number of refugees registering as job seekers after their applications for asylum had been recognised. The expansion of labour market policy measures merely dampened this effect, but did not offset it in full. Over the next few months, official unemployment is expected to continue decreasing slightly.

*Negotiated pay rates only moderately higher in summer 2016 as well*

Negotiated pay rates moved onto a flatter growth path over the course of this year. Following on from a muted rise of 2.2% in spring 2016, the third-quarter increase was also no more than moderate, at 1.9%. Wage inflation was suppressed in the third quarter by both the low increases in negotiated wages from the second stage of earlier wage rounds and the new agreements concluded this year, which have been predominantly moderate. Furthermore, it was not uncommon for agreements to include months with a pay freeze, which led to delayed wage increases. It cannot be ruled out that a number of negotiated pay settlements were influenced not just by dominant determining factors such as the general economic situation, but also by the low inflation rate at present or the expectation of continued moderate price increases over the term of the wage

agreement. Actual earnings could recently have risen on a similar scale as in the first half of the year.

Turning to prices, the third quarter of 2016 saw a continuation of the previous quarter's upward trend at all stages of the economy. Energy mostly played a minor role in this, however, unlike in the second quarter. Instead, prices excluding energy, in particular, rose at the upstream stages. At the consumer level, however, the increase in prices excluding energy was somewhat less considerable than in the second quarter. Lower energy prices stood in contrast to higher food prices caused by weather-related factors. After factoring out these two volatile components, consumer prices continued their moderate increase. Pronounced price drops for clothing and footwear played a material role in the fact that the prices of industrial goods excluding energy barely rose. In contrast to this, rents grew somewhat more strongly than in previous quarters. Overall, prices rose by 0.5% year-on-year according to the national consumer price index, and thus at a considerably stronger rate than in the preceding quarter. According to the harmonised index, the increase strengthened to 0.4%.

*Consumer prices excluding energy and food up moderately*

In the final quarter of 2016, growth in the German economy is likely to pick up again considerably after the temporary slowdown in the third quarter. Sentiment has recently brightened substantially. This is especially true of the manufacturing sector, in which there was also continued clear growth in capacity utilisation and a rise in order intake. It is therefore assumed that industrial output will probably contribute more strongly to aggregate growth in the last quarter of the year. Moreover, high capacity utilisation is likely to stimulate the previously declining level of investment in machinery and equipment. Lastly, markedly higher export expectations in industry and the upward trend in orders received from abroad are indicating a return to rising exports of goods, following the third-quarter slump. In the construction sector, the indicators are still signal-

*GDP growth likely to accelerate significantly in final quarter of the year*

ling lively activity. The ongoing favourable income and labour market prospects combined with healthy consumer sentiment also suggest a distinct increase in private consumption expenditure.

*Budget surpluses  
despite looser  
fiscal policy  
stance*

Germany's public finances remain in a favourable position. As evidence of this, the surplus is likely to decline only a little this year (2015: 0.7% of GDP) in spite of the expansionary fiscal policy stance. Positive cyclical factors and further diminishing interest expenditure are easing the burden on government budgets. By contrast, the provision of support to refugees involves significant additional annual expenditure year-on-year, since most refugees only arrived in autumn last year. In addition, central, state and local governments are stepping up their spending on transport infrastructure, amongst other things, and the social security funds' benefits for healthcare, long-term care and pensions are clearly increasing. In the coming year, the surplus is set to remain practically unchanged on the back of a continuation of the moderately expansionary fiscal policy. Economic activity and falling interest expenses are likely to provide additional relief to government budgets. Expenditure related to refugee migra-

tion could initially more or less stabilise, provided that the number of (new) migrants stays relatively low, as is generally expected at present. However, expenditure increases in other areas are likely to remain fairly high.

The Federal budget will probably end the current year with another surplus and the refugee reserve is set to be topped up. There is to be no net borrowing in the coming year, as before. As in 2016, a sizeable withdrawal from the reserve is envisaged to balance out a planned deficit. In reality, however, the budget estimates seem cautious for next year, too, which means that such recourse to the reserve may be avoidable under certain circumstances, as long as no additional strains on the budget emerge. The reserve was established to temporarily cover the additional expenses, which were virtually impossible to calculate at first, arising from the very high levels of refugee migration at the time. Now, however, the expenses for central government can likely be estimated reliably enough and are evidently well covered by the budget, too. It is therefore advisable that the reserve be dissolved and the funds be used to redeem a portion of central government's still high debt in the budget.