The current economic situation in Germany

German economy still on strong growth path

Global economy gaining momentum

The global economy continued to expand briskly in the third quarter of 2017. Global economic output is likely to have accelerated at a similarly strong pace as in the second quarter. The United States, in particular, was able to maintain the fairly rapid pace of growth seen in the second quarter. Although economic activity in some US states was temporarily disrupted by two hurricanes, the dampening impact of this on the economy as a whole is – in line with past experiences – likely to have been small. Real gross domestic product (GDP) in the euro area continued to expand at a markedly faster pace than potential output in the third quarter, even though it did not quite match the strong pace of growth of the second quarter. The high level of growth in China remained remarkably stable compared to its international peers.

The robust global economic activity is attributable, not least, to the fact that the upswing has broadened to include more countries compared with the previous years. In 2012-13, the global economy was adversely affected by the debt crisis in a number of European countries and in 2015-16 by the recessions in major commodity exporters. This year, economic activity is declining in only a small number of countries. Not least the international exchange of goods is benefiting from the broadly based upward movement. At the beginning of the fourth quarter, the sentiment indicators were still not pointing to any significant change in the underlying cyclical trend.

Confident economic assessment and monetary policy expectations are shaping financial market developments

In addition to the favourable economic outlook, the expectations of market participants regarding monetary policy, in particular, were shaping the international financial markets in the third quarter. Government bond yields initially came under pressure on both sides of the Atlantic as investors firmed their expectation of a continued highly accommodative monetary policy for the euro area and lowered their expectations of interest rate hikes for the United States. Furthermore, the Eurosystem's decision to continue the asset purchase programme – at a reduced pace – beyond the turn of the year up until at least September 2018, and to lower risk premiums on the government bonds of peripheral countries resulted in declining yields in the euro area. In the United States, on the other hand, yields in the second half of the quarter were increasingly supported by expectations regarding the planned tax reform. Following the Fed's announcement that it would reduce its balance sheet, market participants were also again more confident that the Fed would pursue a less expansionary monetary policy course. As a result, US yields rose slightly on balance. On the international stock markets, the positive economic outlook was reflected in higher profit expectations, as a result of which prices increased pretty much across the board and new highs were reached temporarily in both Germany and the United States. In the foreign exchange markets, the euro was buoyed by the positive economic data for the euro area. On average, the euro appreciated against the currencies of 19 major trading partners by just under 2%.

Monetary policy: ECB Governing Council to reduce monthly asset purchase volumes from 2018

The Governing Council of the European Central Bank (ECB) has left the key interest rates unchanged. At its monetary policy meeting in October, the ECB Governing Council decided to continue the expanded asset purchase programme at the current monthly volume of €60 billion up until the end of 2017. From January 2018, the net monthly purchases of assets at the reduced volume of €30 billion will run until the end of September 2018, or beyond, if necessary, and in any case until the ECB Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. The ECB Governing Council justified its decision for reducing the purchase volume by saying that confidence in the gradual convergence of inflation rates towards its inflation aim has grown further on account of the increasingly robust and broadly based economic expansion. The principal payments from maturing securities purchased under the programme are also to be reinvested for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary.

Full allotment extended until end of 2019

Moreover, the ECB Governing Council decided to continue conducting the Eurosystem's regular refinancing operations as fixed-rate tender procedures with full allotment for as long as necessary, and at least until the end of the last reserve maintenance period of 2019.

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 third quarter of 2017 against the backdrop of the low interest rates and the broadly based economic growth in the euro area. Once again, the mainstay of monetary growth was lending. On the one hand, this comprised the continued expansion in bank loans to households and non-financial corporations. On the other hand, the Eurosystem's bond purchases again decisively supported the securities-based lending to domestic non-banks by the MFI sector.

German economy's robust upswing continued in Q3

The Germany economy continues to grow strongly. According to the Federal Statistical Office's flash estimate, real GDP grew by a seasonally and calendar adjusted 0.8% in the third quarter of 2017 compared with the previous quarter after very strong growth had already been recorded in the first half of the year. Aggregate output has therefore been expanding considerably faster than potential output since the beginning of the year, meaning that aggregate capacity utilisation levels are now likely to be significantly higher than the longer-term average. The sentiment in trade and industry, which is at a record high level, together with the excellent order situation in industry and the ongoing very high level of consumer optimism suggest that the strong upturn in the German economy will also continue in the fourth quarter.

Industry is the main driver of growth

The brisk industrial activity since the beginning of the year was the main driver of the strong upswing in the third quarter of 2017. The business-related services sectors are also likely to have shown marked growth in line with the vigorous developments in industry. In the construction sector, on the other hand, which had been a second major driver of growth in the first half of the year, it was probably not possible to increase activity further. However, given the high production levels, the exceptional mood and the well-filled order books in the sector, this should not be interpreted as the end of the current construction boom.

External impulses on the demand side more in the foreground

On the demand side, GDP growth was broad in scope. It was supported by both external and domestic stimuli, with the former coming more to the fore in the wake of the up-beat global economy. Favourable sales opportunities in the export markets, in combination with the growing utilisation of industrial capacities, contributed to the fact that along with exports, investment in machinery and equipment also saw a significant increase. Private consumption is likely to have persisted at roughly the same level as in the previous quarter after posting significant growth rates previously.

Marked expansion in loans to the domestic private sector in Germany

German banks again markedly expanded their lending to the domestic private sector in the quarter under review. The largest net gains were recorded in loans to non-financial corporations, the upward trend of which was driven by the favourable financing conditions coupled with enterprises' exceptionally positive business expectations. Moreover, banks' lending business with domestic households grew distinctly on balance, with the brisk demand for housing loans being primarily responsible for this.

Labour market: situation and outlook still very buoyant

Once again, the buoyant expansion of the German economy improved the already very positive labour market situation in the reporting quarter. Employment rose strongly in the third quarter, unemployment continued to decline from its already low level and enterprises reported an even greater number of vacancies. The employment growth was due predominantly to an increase in the number of positions subject to social security contributions. By contrast, other forms of employment, such as exclusively low-paid part-time employment or self-employment, declined slightly. The outlook for the next few months is favourable.

Wage growth still moderate

Wage growth remained moderate in the third quarter of 2017, as in the preceding quarters. However, the exceptionally good economic setting, staff shortages in the labour market and the impact of the rise in the minimum wage at the beginning of the year suggest that, as in the previous quarters, the rise in actual earnings was more pronounced than the increase in negotiated rates of pay.

Consumer prices excluding energy and food up significantly in Q3

In the third quarter, consumer prices as measured by the Harmonised Index of Consumer Prices (HICP) recorded stronger growth again after lower energy prices caused a temporary lull in the spring. The increase, which stood at a seasonally adjusted +0.5% on the quarter, was as sharp as in the final quarter of 2016 and the first quarter of 2017. Although energy prices continued to decline despite higher crude oil prices owing to the appreciation of the euro, at the same time, food prices rose again considerably. Prices of industrial goods (excluding energy) likewise rose markedly, meaning that the earlier appreciation of the euro, which was reflected in lower import prices, had probably not filtered through to the consumer level. The price of services rose substantially overall. This was mainly on account of travel services, but the price of other services (excluding rents) also went up distinctly, as in the previous quarter. By contrast, the increase in rents, which had been slightly higher than the long-term average since the beginning of the final quarter of 2016, weakened again. Overall, year-on-year price inflation increased from +1.6% in the previous quarter to +1.7%. Excluding energy and food, it also went up by 0.1 percentage point to 1.5%, meaning that, as in the second quarter, it was considerably higher than its average since 1999. Admittedly, this was also attributable to the steep rise in the prices of travel services, clothing and footwear, which generally fluctuate fairly sharply. However, even excluding these volatile components, the rate went up slightly to +1.3%.

Sharp upturn likely to continue

Buoyed by the boom in industrial activity, the German economy is likely to remain on a strongly expansionary path in the final quarter of 2017, too. The recent very strong inflow of orders in the manufacturing sector, in particular, suggests that industrial output will continue to make a significant contribution to aggregate economic activity. In line with this, the stock of industrial orders still being processed has reached its highest level for more than a decade according to data from the Ifo Institute. The business climate in the manufacturing sector has gone from record to record in the last few months. In addition, lively domestic and foreign demand and further increasing capacity utilisation are likely to make industrial enterprises significantly more willing to invest in new machinery and equipment. However, a growing shortage of skilled labour could place greater constraints on continued strong output growth in future. This is indicated by the Ifo survey results on production stoppages in the manufacturing sector. In the construction industry, too, a dwindling supply of skilled workers is likely to prevent output from expanding sharply. Construction activity is therefore no longer expected to drive overall economic growth as strongly as in the first half of the year. Ultimately, the extremely positive labour market environment and the fact that income prospects remain upbeat will ensure that private consumption stimulates domestic activity.

German government finances continue to develop favourably

German government finances continue to show a very positive development, with the surplus likely to remain at around 1% this year (having stood at 0.8% of GDP in 2016). Government budgets are benefiting from the strong economic upswing and the very good labour market situation, as well as the extremely favourable financing conditions and, once again, extraordinary growth in profit-related taxes. This more or less offsets the burdens caused by nuclear fuel tax repayments and the significant increase in expenditure on long-term care, healthcare and pensions, for example. As things stand, the framework conditions for public finances also look set to remain very favourable in the medium term. Without a policy change, the surplus could therefore continue to rise over the next few years and significantly exceed 1% of GDP. In structural terms (ie excluding cyclical and temporary effects), a relatively stable surplus amounting to 1% of GDP would ensue. However, as time progresses, it is to be assumed that at least some of the financial leeway at central, state and local government level under the budgetary rules will be utilised and that social security contribution rates could be lowered markedly overall. It may therefore be expected that the structural surpluses will shrink noticeably and that government finances will follow an expansionary path. Regardless of this, the debt ratio is likely to fall below the 60% mark in 2019.

Moderate structural surpluses and reduction of debt ratio to well below 60% appropriate

In principle, moderate structural surpluses for Germany's government finances appear appropriate as a means of continuing to quickly reduce the debt ratio. This will allow the prospective challenges posed by demographic change to be tackled more effectively as well as considerably enhancing the resilience of public finances. Moreover, moderate structural surpluses in central and state governments' fiscal plans create a budgetary buffer to cushion the impact of any unexpected negative budgetary developments within the debt brake rules. This would allow procyclical consolidation to be avoided in the event of an economic downturn.

Fiscal leeway available

Also with the aim of modest structural surpluses a certain amount of fiscal leeway opens up given the very favourable medium-term conditions. Even now, the Federal Employment Agency is already significantly benefiting from the continued healthy labour market situation, which suggests there may be a considerable cut in the contribution rate. Moreover, lower (additional) contribution rates for the statutory pension insurance scheme and the health insurance institutions currently appear plausible. Provided that the future Federal Government avoids new net borrowing in its central government budget plan and does not liquidate the extensive refugee reserve to finance new projects, central government will have a moderate amount of leeway at first, also taking into account the most recent official tax estimate. Only as time passes will a significant increase in this leeway probably be seen. Not least in view of the considerable surpluses expected for state and local governments overall, room for manoeuvre will be opened up here, too, meaning that they are unlikely to be in urgent need of additional transfers from central government.

Future burdens must be borne in mind when undertaking reforms

However, room for fiscal policy is not limited to using available surpluses. Regardless of the current positive environment, policymakers must not forget to consistently exploit efficiency reserves and to consider the possibility of budget shifts in order to fund the political priorities currently being debated in the areas of education, investment or national and international security, for example. With regard to taxation, relief measures on the solidarity surcharge and income tax seem plausible. It would be worth considering a more extensive approach to reform that additionally limits exemptions. In principle, this would provide funding for a more extensive cut in tax rates (after factoring in the solidarity surcharge). In the longer term, budgetary policy for central, state and local government and for pension, long-term care and health insurance needs to be geared towards tackling the additional burdens brought about by demographic change. Central, state and local governments will also have to weather less favourable financing conditions again at some point. At any rate, an additional expansion of benefits that are related to demographics would further increase the associated pressure on future budgets. In comparison, on the expenditure side, in the next few years it would seem appropriate to place greater emphasis on expenditure aimed at strengthening long-term growth, such as in the area of education or infrastructure.