The current economic situation in Germany

Overview

German economy booming

Continuing global economic upturn

The global economy remained buoyant at the end of 2017. Following its rapid pace in the second and third quarters, economic growth in industrial countries slowed only slightly in the final quarter of the year. In the United States, growth of real gross domestic product (GDP) was dampened by a very sharp increase in imports and a weaker build-up of inventories. Domestic final demand, on the other hand, saw its strongest growth in three years. Economic performance in the euro area also rose considerably again in the fourth quarter. Steady growth in the emerging market economies as a group – especially China – completes the picture of a largely synchronised upswing in the global economy. Overall, it is likely that global activity and international trade expanded much more strongly in 2017 than in the previous year, recording the largest gains since 2011.

Financial markets influenced by good economic outlook

Favourable economic conditions, US fiscal policy and monetary policy on both sides of the Atlantic shaped events on international financial markets in the fourth quarter of 2017 and at the beginning of the new year. Yields on sovereign bonds were initially mixed. One reason for this was the differing monetary policy stances in the euro area and the United States. Consequently, the interest rate spread between ten-year US Treasuries and German Federal bonds (Bunds) with the same maturity widened perceptibly. Yields then rose sharply worldwide as of mid-December. In this regard, stimulus was provided by the tax reform in the United States (Tax Cuts and Jobs Act), which was passed before the end of the year. Additionally, it was clear that the upswing was maintaining its great momentum not only in the euro area and the United States, but around the world. Not least in the light of market expectations of less expansionary monetary policy in the two major currency areas and higher term premiums, the yields on ten-year US Treasuries and German Bunds rose significantly. On the international stock markets, the positive economic outlook and the US tax reform were reflected in higher profit expectations and a greater appetite for risk amongst investors, causing stock prices to rise – in some cases, considerably – and new interim highs to be reached in both Germany and the United States. At the beginning of February, however, rising yields prompted a noticeable stock market correction, forcing the European markets to surrender their gains and end the period with net losses. On the foreign exchange markets, there were perceptible shifts in exchange rates to the detriment of the US dollar and to the benefit of the euro as of the fourth quarter of 2017.

Global economic outlook remains favourable

At the current end, indicators suggest that global economic activity has maintained its momentum. Sentiment amongst enterprises and consumers remained upbeat at the end of the year. The latest drops in prices on the stock markets are unlikely to fundamentally change this picture; they instead represent a correction to the, in some cases very high, valuation levels that had been achieved previously. Not only the economy's own momentum but also the continually supportive stance of macro policy are indicative that the global economic upswing will carry on. Monetary policy indeed still remains expansionary in many major economies and, in some countries, fiscal policy is being relaxed. In the United States in particular, the implemented tax cuts and announced spending hikes temporarily stimulated the economy.

ECB Governing Council leaves policy rates unchanged

The Governing Council of the European Central Bank (ECB) kept policy rates unchanged in the reporting period. Since January 2018, purchases under the expanded asset purchase programme (EAPP) have proceeded at a reduced monthly volume of €30 billion, as was decided in October 2017. The monthly net purchases are scheduled to take place until at least the end of September 2018 and in any case until the ECB Governing Council sees a sustained correction in the path of inflation consistent with its inflation target.

Ongoing monetary growth in the euro area

The positive underlying dynamics in the monetary indicators persisted in the fourth quarter of 2017. The broad monetary aggregate M3 again expanded considerably against the backdrop of the very low interest rate level and the strong, broadly based economic growth in the euro area. Once again, the mainstay of monetary growth was lending. Loans to non-financial corporations in the euro area saw a resurgence in the fourth quarter, while loans to households continued to grow stably and securities-based lending in the MFI sector to domestic non-banks, which was again mainly driven by Eurosystem asset purchases, likewise made a highly positive contribution.

German economy booming

Germany's economy is booming. After aggregate economic activity had surpassed potential output by a considerable margin in the first three quarters of 2017, economic performance also saw large gains in the last quarter, although with slightly less momentum than before. According to the Federal Statistical Office's flash estimate, real GDP increased by 0.6% from the third quarter after adjustment for seasonal and calendar variations. Aggregate capacity utilisation has since significantly exceeded its long-term average. Sentiment is extraordinarily good amongst enterprises and households alike, and the situation on the labour market has improved even further.

Industry remains key driving force

In the final quarter of 2017, industry continued to play its role as the main driving force of the upswing. In its wake, business-related service sectors are also likely to have maintained their dynamic upwards movement. On the other hand, the construction sector, which has been facing considerable capacity shortages for some time, was unable to increase production any further.

Demand-side growth driven mainly by exports and machinery and equipment

On the demand side, economic growth was driven mainly by exports and investment in machinery and equipment in the last quarter of the year. Flourishing global trade ensured strong growth in sales among German exporters. Commercial investment in machinery and equipment, which had already risen briskly in the first three quarters of 2017, was expanded much further in light of the high utilisation of production capacity. Following a lull in the summer, private consumption, which had been a mainstay of the upswing up until the first half of 2017, also only provided limited additional economic stimulus at the end of year. In the fourth quarter, investment in construction likewise remained lacklustre and lingered near the exceptionally high level that had been reached previously. Increasing capacity shortages could have been decisive in stifling further growth in construction activity.

Marked expansion in loans to the domestic private sector in Germany

In line with the strong underlying pace of growth in the German economy, banks in Germany again markedly increased their lending to the domestic private sector in the fourth quarter of 2017. The largest net expansion was recorded by loans to households in Germany, which continued to be driven by their brisk demand for housing loans. The rate of growth in consumer credit also accelerated noticeably over the course of 2017. On balance, banks' lending business with domestic non-financial corporations expanded further; the growth rate in this loan segment ultimately exceeded growth in loans to households by a significant margin.

Situation and outlook on labour market extremely favourable

Germany's labour market was again in excellent shape in the fourth quarter of 2017. As in the preceding quarters, employment rose sharply, especially in the case of jobs subject to social security contributions and among both German nationals and migrants. By contrast, exclusively low-paid part-time employment and self-employment followed a downward trend. Unemployment declined further from its already low level. The number of job vacancies also continued to grow during the reporting quarter. Other leading indicators promise a similarly positive outlook for the next few months. Nonetheless, it may become more difficult to fill vacant positions given the currently high demand for labour.

First major wage agreement in the 2018 pay round

In this year's pay round, the majority of the wage demands by the trade unions covering important sectors such as the metal-working and electrical engineering industries, the main construction sector, the central and local government public sector, and the chemical industry amounted to 6%, and were thus up slightly from the previous year's level. The macroeconomic conditions, which include strong economic growth and increasing staff shortages in the labour market, suggest that wage growth will accelerate to a more noticeable degree overall compared with previous years. This is supported by the most recent pay agreement in the metalworking and electrical engineering industries, which features a sustained increase of 4.3% in scheduled rates of pay from April 2018 as well as further significant improvements in remuneration in 2019. Other distinctive features of the agreement in this key sector of Germany industry are the, in some cases, innovative models put in place to allow more flexible working hours arrangements.

Another marked rise in consumer prices in Q4; core inflation rate significantly dampened by one-off effects

Consumer prices as measured by the Harmonised Index of Consumer Prices (HICP) rose considerably again at the end of 2017, recording a seasonally adjusted quarter-on-quarter increase of 0.4%. This was driven mainly by higher prices for energy, which were caused by the steep rise in crude oil prices, and for food. Excluding both these components, inflation was noticeably weaker. Substantial reductions in the price of travel services and car insurance policies had a dampening effect on services, which had previously become considerably more expensive. Although price pressures for non-energy industrial goods also eased, they remained positive despite a decrease in the corresponding import prices since the appreciation of the euro in the second quarter. Compared with the same period in 2016, the rate stayed more or less constant at 1.6%; excluding energy and food, however, it fell from 1.5% to 1.2%.

Strong economic growth continues

The burgeoning order books of industrial firms, along with the persistently positive sentiment in the economy as a whole, suggests that the rapid pace of expansion achieved in the course of 2017 will continue into the new year. Given the recent massive influx of new orders, the industrial sector probably remains the driving force behind the upturn. The continuing very high level of utilisation of tangible assets in manufacturing that this entails is likely to mean that enterprises' willingness to invest in new machinery and equipment will increase further. In addition, the framework conditions for private consumption, which experienced a lull in the second half of 2017 after strong growth in the first half of the year, remain favourable. These include the glowing outlook for employment and a perceptible rise in earnings. However, there are mounting signs that the German economy is increasingly facing shortages of skilled workers, which could stand in the way of significantly stronger growth.

Germany's public finances continue to benefit from favourable underlying conditions

German public finances remained in very good shape last year. Given the strong economic expansion and diminishing interest expenditure, the general government surplus increased further to over 1% of GDP. Growth in tax and social contribution receipts was again dynamic. At the same time, expenditure on items such as social benefits or one-off nuclear fuel tax repayments went up – in some cases significantly. As things stand, the underlying conditions look set to remain extremely favourable over the next few years with increasingly positive cyclical factors and further diminishing interest expenditure easing the burden on government budgets. Given the moderately expansionary fiscal stance of the financial plans up until now, after a surplus of around 1½% of GDP this year, a further slight increase in the balance could be on the cards. However, when it is formed, the new Federal Government – including the social security funds – along with state and local governments, is expected to use this favourable outlook for additional spending and tax cuts. As a result, the general government surplus is likely to be distinctly smaller, and fiscal policy considerably expansionary, going forward. The debt ratio declined to 65% by the end of the third quarter. Even though fiscal policy is expected to be more expansionary, it is likely to fall below the 60% mark again by 2019 at the latest.

Avoid short-term policy oriented to cash balance

The fact that the recently unveiled coalition agreement between the CDU, the CSU and the SPD retains the fundamental objective of a balanced budget and will thus continue to prioritise sound public finances is a welcome development. However, the aim of avoiding new net borrowing could also create problems. It allows the temporary funding of budget-consuming measures through cyclical surpluses and reserves. This can result in a procyclical and – once the reserves have been depleted – erratic fiscal policy, for instance. In addition, it must be ensured that the general government budget ceiling under the European budget rules is not breached. This ceiling is linked to the structural deficit rather than net borrowing. With regard to the coalition agreement, it is noticeable that new burdens for the central government budget will increase considerably in the final year, by which time the refugee reserve is expected to be used up. All in all, to achieve a steady, medium to long-term fiscal policy, it would remain advisable to aim for moderate structural surpluses in the financial plan.

Bear future demographic burdens in mind when using financial leeway

In the context of the budgetary rules, but also in terms of achieving modest structural budget surpluses, some financial leeway will be available over the next few years. The coalition agreement proposes a certain reduction in the tax burden, largely through the reduction in the solidarity surcharge announced for the year 2021. On the expenditure side, additional resources are to be used in areas such as education, pensions and digitalisation. Some projects will require coordination between central, state and local governments. Here, it will be necessary to prevent the lines of responsibility from becoming too blurred as a result of greater financial interconnectedness. When it comes to additional budgetary burdens, a long-term outlook should be taken given that Germany’s public finances are facing major challenges due to demographic developments. This is especially true for the statutory pension insurance scheme. The statutory retirement age should be raised further in line with increasing life expectancy, and, looking ahead, a lower pension level should also be considered in order to limit the significant increase which is already expected in the burdens generated by social security contributions and taxes. It appears appropriate to combat demographic developments with measures to counteract the shortage of potential labour supply.