The current economic situation in Germany

Overview

German economy picking up momentum, inflation on the increase

Global economy gradually strengthening

The global economy appears to have strengthened at the end of 2016. Growth in global economic activity is likely to have contracted slightly in the final quarter of 2016 in seasonally adjusted terms. This, however, was due chiefly to the fact that the strong dynamics in the United States in the third quarter were being fuelled by special factors and were therefore unsustainable. No major change in pace was observed elsewhere, however, with a number of indicators pointing to an improvement in the global economic outlook. There were clear signs of an upturn in industrial activity and in the international trade in goods. Moreover, business sentiment brightened markedly and prices on major commodity markets went up. On the whole, there is therefore much to suggest that the gradual strengthening of the global economy, which has been anticipated for quite some time, is now underway.

Possible implications of a US policy switch

The expectation of a radical change in policy in the United States is seen by many as one of the reasons for the improved global economic picture and a number of different movements in the financial markets recently. Comprehensive tax cuts could stoke growth in aggregate demand and thus also in exports to the United States in the short term. Given the largely normal aggregate capacity utilisation of the US economy, however, this is also likely to perceptibly increase price pressures and therefore interest rates. Through the interest-exchange rate nexus, these effects would probably also tend to be reflected in the partner countries, where the dampening impact of higher interest rates and lower purchasing power might consequently be accompanied by an expansion of exports to the United States. The danger of a tightening of US trade policy would also have to be taken into account. Seen in that light, it is not only the upside risks to the global economy that have become more significant. It is more likely that such a change in policy would increase the general upward pressure on prices.

Financial markets under the influence of monetary policy decisions and the US elections

Political events and the monetary policy decisions of the Federal Reserve and the Eurosystem have been having a major impact on developments in the international financial markets since September last year. Added to this was the fact that rising energy prices over the course of the fourth quarter helped to allay the deflation fears of some market participants. In early November, the result of the US elections, in particular, led to a rapid surge in interest rates around the globe. The expectation of a loosening of US fiscal policy was a contributory factor in this; moreover, the Federal Reserve raised US key interest rates by a further 25 basis points and reaffirmed the possibility of a further tightening of monetary policy this year, if necessary. The interest rate linkage with the United States led to a rise in yields in the euro area, too, albeit to a lesser extent. One reason was that the ECB Governing Council decided in early December to further increase the extent of monetary expansion. Share prices rose significantly in some cases in this economic and financial market setting. The US S&P 500 index reached a new all-time high in mid-February. Financial stocks rose disproportionately in many cases – not least due to the expectation that the yield curve, having steepened again, is likely to have a positive effect on financial institutions' profitability going forward. However, bank shares also benefited from the fact that the new US administration intends to loosen regulatory requirements, which in view of the experiences gained during the financial crisis should be seen in a critical light. On the foreign exchange markets, the focus of interest was on the development of the US dollar exchange rate, which recorded significant gains against most of the currencies of advanced and emerging economies. On a weighted average, the euro fell slightly on balance (-1.4%) against 19 major trading partners. This was largely attributable to losses against the US dollar and a number of commodity currencies in particular, which benefited from the rebound in oil prices.

Monetary policy: ECB Governing Council approves adjustments to purchase programmes

The ECB Governing Council left the key interest rates unchanged throughout the reporting period, but decided at the monetary policy meeting in December to continue its purchases under the expanded asset purchase programme in the current amount of €80 billion per month until the end of March 2017. From April 2017, net asset purchases are to continue at a reduced monthly volume of €60 billion until the end of December 2017, or beyond if necessary, and in any case until the ECB Governing Council sees a sustained correction in the path of inflation consistent with its inflation target. The majority of the ECB Governing Council deemed the extension of the asset purchase programme necessary to secure a sustained convergence of inflation rates towards levels below, but close to, 2% over the medium term. The reversion to the initial monthly pace of APP purchases of €60 billion was attributed to the economic recovery firming.

In December, the third in the second series of four targeted longer-term refinancing operations (TLTRO II) was conducted. The demand volume of €62.2 billion was at the upper end of market expectations. The final operation in the TLTRO II series will be conducted in March of this year.

Continued monetary growth in the euro area

Developments in the monetary indicators *per se* continued to provide no indication of a growing need for monetary policy action. The broad monetary aggregate M3 again rose considerably in the fourth quarter against the backdrop of historically low interest rates and the fairly robust economic recovery in the euro area. Monetary growth was supported, in particular, by the ongoing recovery in lending by the banking sector to the non-financial private sector; lending to non-financial corporations, especially, resumed its upward trend after a weaker performance during the preceding quarter. Securities-based lending to domestic non-banks, which was dominated by the Eurosystem's APPs, gave monetary growth a further boost.

Pick-up in economic growth in Germany towards year-end

The pace of growth in the German economy picked up perceptibly towards the end of 2016. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) in the fourth quarter of 2016 rose by a seasonal and calendar-adjusted 0.4% on the quarter and thus considerably more strongly than in the summer months, when the increase had stood at just 0.1%. In 2016 as a whole, real GDP increased by 1.9% year-on-year (1.8% in calendar-adjusted terms). Stronger growth stimulus was generated on the demand side towards the end of the year, driven primarily by exports after they had managed to overcome their third-quarter lull and post strong growth. The expansion in exports was broadly based in regional terms. German exports to euro-area countries rose significantly, while demand from non-euro-area countries was even more buoyant. Construction activity also accelerated again in the final quarter of 2016. Private consumption continued to expand given that labour market and income prospects remained favourable. The loss of purchasing power resulting from the sharp rise in energy prices appeared to diminish households' strong appetite for consumption only marginally. By contrast, investment in machinery and equipment, which had waned in the previous two quarters, remained lacklustre. Although manufacturers of capital goods recorded significant domestic sales growth in real terms, the decline in the number of registrations for commercial vehicles suggests that investment in enterprises' motor vehicle fleets was very weak.

The fact that banks further stepped up their lending to the domestic private sector in the quarter under review is in keeping with this economic picture. Once again, this was mainly attributable to the rise in loans to households for house purchase. The volume of loans extended to domestic non-financial corporations expanded moderately in the quarter under review.

Slight increase in employment, unemployment continues to decline

Employment rose again during the fourth quarter, following a slight dip in the summer months. However, measured in terms of the developments during the first half of the year and the – in some cases very favourable – leading indicators, employment figures only showed a moderate increase. Employment subject to social security contributions went up only modestly in the fourth quarter, and exclusively low-paid part-time employment continued to decline. Demographic factors may go some way towards explaining the weaker employment dynamics. The reduction in the potential domestic labour force observed over the last few years is no longer fully offset by higher labour market participation. In addition, according to the Federal Employment Agency, the increased demand for labour is likely to have been covered for the most part by immigration. The outlook for employment remains favourable, although it is becoming increasingly clear that it will become more difficult to fill vacant positions. Unemployment figures fell significantly throughout the reporting period, despite the large number of refugees registering as job seekers after their applications for asylum were approved.

Moderate rise in negotiated wages continues

Once again, negotiated wages rose only moderately in the last quarter of 2016. Including additional benefits, they went up 2.2% on the year, thus showing just a slight increase on the third quarter. Actual earnings are likely to have risen more sharply, as was the case in the previous period. This year's pay round will affect fewer employees than in 2016 and mainly relates to the services sectors. Under the wage agreements concluded last year, 2017 will see low graduated increases of below 2½% in most cases. The figures published so far for trade unions' wage demands range from 4.5% to 6% and are thus on a par with last year's demands.

Sharper rise in consumer prices in the final quarter owing to higher energy and food prices

Consumer price inflation as measured by the Harmonised Index of Consumer Prices (HICP) rose fairly sharply in the fourth quarter of 2016, climbing by 0.5% in seasonally adjusted terms and thus outstripping its increase in the preceding quarter (+0.3%). Energy prices, in particular, rose significantly due to the rebound in crude oil prices. However, consumers also had to pay noticeably more for food owing to very steep increases in dairy product prices. Moreover, prices for industrial goods (excluding energy) picked up again after moving sideways in the third quarter. This was mainly due to a countermovement in prices for clothing and footwear, which had dropped considerably in the preceding period, probably due to the unusually warm weather in September. The prices of services, by contrast, went up only slightly owing to a remarkably sharp fall in the price of package holidays. Apart from this, services prices rose at roughly the same pace as in the third quarter. This was also true of rents, which once again went up somewhat more sharply than the longer-term average. Annual headline HICP inflation increased significantly from 0.4% to 1.0%. Over the course of the quarter, the rise from 0.5% in September to 1.7% in December was even more pronounced. The fact that prices for fuel and heating oil had fallen markedly at the end of 2015 played a role here. Excluding energy and food, the year-on-year rate remained at just over 1% in the fourth quarter.

Renewed stronger economic growth likely in early 2017

Growth in the German economy is likely to pick up further in the first quarter of 2017. Given the very dynamic intake of new orders, major impetus is expected to emanate from industrial activity, in particular. This is also likely to be reflected in exports, as indicated by enterprises' optimistic export expectations. Enterprises are also expected to invest more in machinery and equipment in view of the now significantly above-average capacity utilisation. Construction activity is also likely to remain exceptionally lively in the first quarter, as long as it is not heavily affected by unfavourable weather conditions. Finally, the sustained improvement in labour market conditions, employees' favourable income prospects and the healthy consumer climate all point to a continuation of brisk consumption, even though higher inflation is constricting consumers' scope for spending.

Public finances: third consecutive annual surplus

On the back of continued very favourable conditions for public finances, Germany last year generated a third consecutive general government surplus (+0.6% of GDP according to provisional data). On the one hand, pressure on government budgets was eased by favourable cyclical developments and by interest expenditure falling again. On the other hand, the underlying fiscal stance was expansionary. All in all, public finances benefited from significant revenue increases, especially from profit-related taxes. However, expenditure also rose fairly steeply in some cases, chiefly in relation to the provision of support for refugees, but also with regard to pensions and healthcare, for instance. A similar surplus looks set to be recorded for the current year. The fiscal policy stance remains moderately expansionary, although this is likely to be partially obscured by continued drops in interest expenditure. The debt ratio is likely to decrease further.

The average rate of interest on government debt fell from 4¼% in 2007 (pre-crisis) to 2% recently, resulting in budget relief of 1½% of GDP, in arithmetical terms, in 2016 alone. However, the very favourable interest rate level at present belies the long-term burdens of government debt. Rising social spending driven by demographics in Germany presents a continued argument for rapidly scaling back the government debt ratio. The current planning, which envisages moderate structural surpluses, thus does not appear too ambitious. At the same time, structural policies that strengthen the forces of growth are desirable. These include investment to maintain good infrastructure; this could be financed without having to increase debt, but it is chiefly a question of fiscal policy priorities.

Use Federal budget surpluses to repay debt

Looking at the Federal budget, it did not seem advisable to top up the refugee reserve again using the 2016 surplus. Using the entire reserve – which apparently is not needed to finance refugee-related burdens – to repay debt in the budget would have reliably ensured lower interest expenditure. The additional outlays that have already been specified elsewhere – for example, in the course of the planned new state government revenue-sharing scheme – are also an argument in favour of resolutely securing relief when it comes to debt servicing, at least.

Effective fiscal rules a key prerequisite for a stable euro area

In order to safeguard sound public finances, a debt brake was introduced in Germany and fiscal rules were agreed upon in the EU. However, the European fiscal rules are continuing to lose their binding force. With its recent call for a distinct loosening of the euro area's fiscal stance, the European Commission explicitly set aside the objective of sustainable public finances in favour of a coordinated economic fine-tuning approach. According to the European Commission's assessment, the modest economic slack in the euro area as a whole will also be reduced next year even without any additional fiscal stimulus. However, the debt ratios in various member states are still very high. In many cases, there is no sign as yet of these ratios being rapidly reduced as a precaution against a potentially resurgent interest rate level, amongst other reasons. Binding fiscal rules equally borne by all member states, not to mention a credible no-bail-out clause, remain a key prerequisite for a euro area focused on stability.