The current economic situation in Germany

Overview

German economy held back by temporary one-off effects

Global economy still buoyant during the third quarter despite clear regional differences

The global economy is likely to have lost some momentum during the third quarter, particularly within the group of advanced economies. Whereas the strong economic upturn levelled off only slightly in the United States, growth in the euro area slowed markedly, and output even declined somewhat in Japan. However, in the latter two cases, temporary pressures played a role. By contrast, economic growth in the United Kingdom was distinctly more brisk. Among the emerging market economies, growth in the Chinese economy, whilst still high by international standards, dipped slightly. Overall, the global economy remains buoyant, albeit with significant regional differences.

Upswing continues according to IMF, although projections lowered slightly

According to current projections by the International Monetary Fund (IMF), the global upturn will continue at the same pace this year and in 2019, which would dash any hopes that may have arisen in the meantime of an acceleration in economic growth. The IMF substantially lowered its growth projections for a number of emerging market economies, in particular. It also factored in the potential repercussions of recent measures in the trade dispute between the US and China, thus reducing its growth projections for 2019 by 0.2 percentage point for each country. According to NiGEM simulations performed by the Bundesbank, if the trade dispute were to escalate further, its adverse effects could intensify and have a distinctly negative impact on the global economy. In addition to a sudden tightening of global financing conditions, the IMF staff see this as a major downside risk to the global upturn.

Rising government bond yields and falling prices in the equity markets

Developments in the financial markets have reflected the somewhat slower momentum in global activity since the middle of the year. In addition, negative political influences again became slightly more pronounced. These include, for example, the trade disputes between the US and China as well as the Italian government's disregard for the European fiscal rules. Given that economic growth remains solid, interest rates on government bonds picked up, especially in the US, which is still experiencing rapid growth and where the Federal Reserve continued to implement its policy of gradually increasing key interest rates as announced. In the euro area, higher risk premiums for individual countries played a role, particularly for Italy. On the other hand, since safe haven debt securities such as German Federal securities were in demand in this market environment, yields on Bunds remained practically unchanged. The equity markets initially moved sideways amid fluctuations. However, towards the end of the third quarter, the abovementioned stress factors exerted considerable pressure on prices. European stocks – notably bank equities – suffered particularly sharp price losses. In addition, amid higher risk aversion among market participants, measures of uncertainty in expectations, which had so far been at relatively low levels in the equity markets, increased markedly worldwide. Despite some distinct price drops in the equity and bond markets, overall, the euro recorded only moderate changes vis-à-vis the US dollar, the yen and the pound sterling from the end of June. Signs of a slight easing came from a few emerging market economies as their currencies, which had depreciated substantially until into August, recently stabilised against the euro and their bond yields fell – in some cases considerably.

Monetary policy: ECB Governing Council reduces monthly asset purchases

As indicated in June 2018, the Governing Council of the ECB decided at its September meeting to reduce the net purchases under the expanded asset purchase programme to €15 billion per month after September 2018. The Council also confirmed that it expects to discontinue net purchases after the end of December 2018 subject to confirmation of its current assessment of the medium-term inflation outlook by newly available data. The ECB Governing Council kept its policy rates unchanged during the reporting period and maintained the enhanced forward guidance on key interest rates given in June 2018.

Monetary dynamics in the euro area driven by loan growth

Growth in the broad monetary aggregate M3 in the euro area tailed off significantly in the third quarter of 2018 and was therefore markedly lower than during the last two years. This was mainly due to the scaling back of the monthly net asset purchases by the Eurosystem at the beginning of the year as well as to the subdued growth in enterprises' bank deposits. Looking at the counterparts, monetary developments were largely supported by the ongoing recovery in lending to the non-financial private sector. Against the background of high capacity utilisation and sound levels of consumer confidence, loans to non-financial corporations and households again recorded considerable inflows. The lively demand for credit was bolstered by the still favourable financing conditions for households and enterprises.

Slight decline in German economic output in the third quarter, mainly due to temporary one-off effects

Economic output in Germany dipped slightly in the third quarter of 2018. According to the Federal Statistical Office's flash estimate, real gross domestic product contracted by 0.2% in seasonal and calendar adjusted terms compared to the previous quarter. The main cause of this decline was a strong temporary one-off effect in the automotive sector. Major problems linked to the introduction of a new EU-wide standard for measuring exhaust emissions led to significant production stoppages as well as to a slump in motor vehicle exports. At the same time, private consumption was temporarily absent as a driving force of the economy. Besides the reduced supply of vehicles produced domestically – and potentially also the debate about bringing in a ban on cars with high emissions levels – the exceptionally hot, dry weather during the summer may have been another contributing factor. Despite these temporary one-off effects, the economic boom in Germany continues. Aggregate production capacity utilisation remains well above average. The German economy will probably expand quite strongly again towards the end of the year.

Sharp fall in output for industry caused by automotive sector

The manufacturing sector recorded a sharp fall in output as a result of the temporary production stoppages in the automotive sector, thus playing a major part in the decline in economic output during the third quarter. Moreover, the construction sector grew considerably more slowly than in the second quarter, when construction activity had expanded sharply. The upswing in the service industries may have continued. On the demand side, the weakness was quite broadly based. Only investment in new machinery and equipment and in new buildings as well as, to a certain extent, government consumption expenditure provided positive momentum. Large import volumes are likely to have been used to build up inventories in some cases.

Very high employment levels and low unemployment

In the third quarter, too, the labour market situation was one of very high levels of employment and low unemployment. Employment was somewhat more buoyant following moderate growth in the previous quarter. This was mainly due to the ongoing fairly strong increase in positions subject to social security contributions. Despite having already reached a low level, unemployment saw a notable decrease in the reporting quarter. At the same time, the already large number of vacancies continued to grow. Leading indicators show persistently high demand for labour over the next few months.

Continued high underlying momentum in negotiated pay rates

The economic situation, which has been favourable for quite some time now, and growing labour shortages were reflected over the course of the reporting quarter, too, in rising negotiated pay rates above the longer-term average. At 2.8%, the year-on-year increase in negotiated rates of basic pay in the third quarter of 2018 was significant, as in the second quarter. Actual earnings are also likely to have again picked up strongly in the third quarter. Following the conclusion of the latest pay agreement in the chemical industry, which will see wages climb sharply by around 3¾% in annualised terms, this year's pay round has all but come to an end. Pay agreements were characterised, in most instances, by markedly higher wage growth than in the past two years, and they were concluded for longer periods in many cases. Furthermore, it was often agreed that large hikes in negotiated rates of pay would occur at the start of the agreement period, followed by lower or no rises later on. In some industries, employees also had the option of choosing between wage increases or more leisure time in lieu thereof.

Inflation rate up further in Q3 from elevated level

Consumer prices (HICP) in the third quarter were again up markedly on the preceding three-month period, recording an increase of 0.5% in seasonally adjusted terms. Given the steadily mounting crude oil prices up to then, energy prices went up by roughly as much as in the previous quarter. As a result of abnormal weather conditions, food prices likewise continued to climb, albeit at a slower pace than in the second quarter. In the case of clothing and footwear, though, which are likewise subject to fairly strong price fluctuations, there were exceptionally large discounts. Overall, however, non-energy industrial goods prices grew at a markedly faster pace than in previous quarters. For instance, vehicle sales prices increased by 0.8%. The prices of services continued to rise moderately. The partial or full abolition of charges for day care facilities for small children in a number of federal states had a dampening effect here.[1] By contrast, far more had to be spent on other services. This was particularly the case for those services – cleaning being one such example – where wages represent a high share of costs. Compared with the previous year, annual headline HICP inflation increased from 1.9% to 2.1%.[2] Excluding energy and food, however, the rate decreased marginally from 1.2% to 1.1%. After factoring out the abolition of charges for day care facilities for small children and the volatile components of clothing and travel, it rose slightly.

German economy back on expansionary course by year-end

Having experienced a setback in the third quarter, the German economy is expected to see fairly strong growth again in the final quarter of 2018. Output and exports of motor vehicles are thus expected to return to normal before the year is out. The manufacturing sector as a whole likewise looks set for marked growth. For instance, demand for imported intermediate goods was very buoyant in the past quarter. Although new orders have not yet been able to break the steady downward trend that took hold at the start of the year, industry order books remain well filled. In addition, ifo Institute data indicate that short-term output expectations remain well above their long-term average. In addition, private consumption is expected to re-assume its role as a major economic driver following the dip in the third quarter. The still outstanding income and labour market prospects are expected to again provide a boost.

Renewed significant expansion in lending to domestic private sector

One indication of this is the continued high demand among households for housing loans and consumer credit, which was bolstered by still favourable financing conditions. Lending to non-financial corporations likewise increased significantly during the quarter under review, albeit to a slightly lesser extent than in the previous quarter. According to the banks surveyed in the BLS, corporate demand for credit was driven primarily by financing needs for fixed investment and the low general level of interest rates. The banks surveyed also reported that they had, on balance, further eased their credit standards for loans to enterprises.

Another significant improvement in public finances in 2018

Germany's public finances are continuing to benefit from the highly favourable underlying conditions. In light of this, a far larger general government surplus is on the cards this year. Revenue from taxes and social security contri-

1 This affected Lower Saxony, Hesse, Berlin and Brandenburg. With state-weighted fees accounting for 0.04% of HICP, this reduced the headline rate by around 0.05 percentage point.
2 The headline CPI figure was +2.1% compared with +2.0%.

butions is rising rapidly. In addition, the strain on public coffers is being eased by falling unemployment and dwindling interest expenditure. Overall, this represents only a moderate increase in spending. The debt ratio is still on a downward path and could fall below the 60% threshold this year already.

Lower surplus in coming years due to fiscal policy loosening

As things stand, the framework conditions for public finances will remain favourable in the medium term, too. At the same time, fiscal policy is to be eased by stepping up expenditure and lowering taxes. As a result, the surplus is expected to decrease as of next year, particularly in structural but also in unadjusted terms. In particular, there are plans to increase benefits for pensions, healthcare and long-term care. In addition, it is intended at the central, state and local government level to raise spending on, inter alia, childcare, education, transport and digital policy. Given the measures that have been provided for, the burden of taxes and social security contributions is set to decline only moderately in the medium term. Social security contribution rates will thus change little on balance – despite the still low level of demographic pressure and highly positive labour market performance. The envisaged tax cuts are to be partly offset by additional revenue from progressive taxation.

Fundamental reform instead of partial continuation of solidarity surcharge and expansion of mixed financing

With a view to providing tax relief, it was agreed, inter alia, that the solidarity surcharge would be partially abolished from 2021 onwards. The surcharge is received by central government alone and was explained by the heavy financial burden of German reunification. Amongst other things, central government awards grants to state government for infrastructure reconstruction in eastern Germany, but these are set to be discontinued at the end of 2019. During the period in which the solidarity surcharge is expected to still exist to a partial extent, central government intends to co-finance state government tasks (primarily education) on a larger scale. Mixed financing would experience a revival and responsibilities would thus be further blurred. In order to strengthen the individual responsibility of state governments and safeguard clear revenue and task structures, it would instead be worth considering a fundamental effort at reform. In this way, it would be possible to forgo the legally questionable partial continuation of the solidarity surcharge and avoid an increase in mixed financing. Objectives concerning tax revenue, burden-sharing among taxpayers and the distribution of taxes between the respective levels of government would then, if necessary, be met by reforming the regular tax system.

Decisions on sustainable statutory pension insurance scheme postponed

In view of the fact that public finances are currently in very good shape, it appears that longer-term challenges are, to some extent, being put on the back burner. In particular, demographic developments are putting significant pressure on the finances of the statutory pension insurance scheme. The new pension package will make it even more difficult to ensure sustainability. So far, how pension finances are to be balanced in the longer term remains to be seen. What is needed, ultimately, is a consistent combination of key parameters. Besides the pension level, contribution rates and central government grants, these also include the statutory retirement age. In future, it would be a logical move to tether this to rising life expectancy. Furthermore, even disregarding the pension package, substantial additional tax resources will have to be mobilised for the statutory pension insurance scheme. If an excessive levy burden is to be avoided, it will be necessary to bear in mind the mounting burdens of both taxes and social security contributions.