Overview

German economy growing at subdued underlying pace

Only moderate global economic growth in autumn

Global economic growth in the final quarter of 2018, too, is unlikely to have matched the pace recorded in the first half of the year. This is true of both the advanced economies and the emerging market economies, although very pronounced differences exist between the individual countries. While the previously strong macroeconomic growth seen in the United States was probably only slightly weaker in autumn, gross domestic product (GDP) in the euro area again increased by only a moderate amount. China's gradual slowdown in growth continued. On the whole, following a period of stronger growth from end-2016 to mid-2018, the global economy now appears to be on a more moderate expansionary path once more.

IMF reduces global growth projections only slightly; downside risks dominant

Against the backdrop of this slowdown, the International Monetary Fund revised its global growth forecast somewhat downwards in its January update to the World Economic Outlook, deeming the short-term prospects for the euro area to be less favourable than in October. On account of considerably lower oil prices, it also scaled back its growth forecasts for crude oil-exporting countries slightly. The outlook for most of the other economies, on the other hand, did not change significantly. Overall, therefore, the IMF anticipates only marginally slower global economic expansion than in 2018 for the current year and the year thereafter. In its outlook, however, risks are tilted to the downside. In addition, the recent continued deterioration of global sentiment and leading indicators suggests that the IMF's latest projection may overstate global economic momentum.

Economic downside risks shaping financial market developments

Potential downside risks to the global economy were also at the heart of international financial market developments. As a result, the markets were increasingly assuming that monetary policy in the major currency areas would turn out to be more accommodative than previously expected. This was especially the case for the United States, where there are now hardly any expectations of further policy rate increases by the Federal Reserve (Fed). Following the termination of net purchases under the asset purchase programme (APP) at the end of 2018, expectations of a first rate hike in the euro area were pushed further into the future. Additionally, financial analysts reduced their expectations for future corporate profits on both sides of the Atlantic more strongly than their growth forecasts. On the stock markets, which react particularly sensitively to changes in expectations and altered risk assessments, significant price losses have been recorded on balance as from end-September, although prices recovered slightly in the new year. By contrast – as is often the case in periods of heightened uncertainty – demand for safe government bonds increased and the yields on these securities declined worldwide. The developments described here had a remarkably minor impact on events in the foreign exchange markets. Exchange rate volatility between the major currencies thus remained relatively low. The exchange rate of the euro against the US dollar, for example, has moved within a comparatively narrow band since mid-October. Overall, on a weighted average against the currencies of 19 major trading partners, the euro slipped slightly on balance compared with the end of September.

Monetary policy: net asset purchases under the APP brought to an end

At its December meeting, the ECB Governing Council decided, as expected, to end its net purchases under the APP after December 2018. At the same time, it enhanced its forward guidance on the future development of reinvestment. According to its new guidance, the Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key interest rates, and in any

case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

Underlying monetary dynamics in the euro area still driven by loan growth

The broad monetary aggregate M3 saw continued robust growth in the euro area in the fourth quarter of 2018, although the Eurosystem further reduced its monthly net asset purchases. Among the counterparts, loans to the domestic private sector were once again the dominant driver of monetary expansion. Demand for such loans was bolstered by the still favourable financing conditions, high levels of capacity utilisation and the positive labour market situation in the euro area. However, as both cyclical momentum and economic sentiment deteriorated noticeably, flows in lending to non-financial corporations did not accelerate further in 2018. By contrast, the upward growth trend in loans to households continued into the reporting quarter. The bank managers responding to the bank lending survey (BLS) indicated that their credit standards for loans to the private sector had remained broadly unchanged in the fourth quarter of 2018.

German economy at a standstill in Q4 2018

Economic activity in Germany remained feeble up to the end of the year. According to the Federal Statistical Office's flash estimate, real GDP in the final quarter of 2018, after seasonal and calendar adjustment, remained at the level of the preceding quarter, in which it had dropped by 0.2% (primarily on account of a one-off effect in the automotive industry). It was up by 0.6% on the year in calendar-adjusted terms. The fact that the economy failed to pick up any steam following the setback in the third quarter was mainly due to persistently weak industrial activity. For instance, it took considerably longer than initially expected to overcome production stoppages in the automotive sector, which were linked to the new EU-wide standard for measuring exhaust emissions. In addition, output in other industrial sectors was reduced. Furthermore, there was probably no additional stimulus from the construction sector, either, which is operating close to full capacity. By contrast, the services sector probably bolstered the rise in economic activity in the final quarter of 2018. The degree of aggregate capacity utilisation declined once again, but is likely to have remained considerably above its longer-term average.

Demand impulses weak

Although in autumn goods exports offset the decline of the preceding quarter, no additional momentum was built up. Coupled with enterprises' subdued expectations, this is likely to have weighed on business investment, which probably expanded only slightly at best. In spite of robust employment growth and more steeply rising earnings, private consumption also remained largely listless. The strong upward price trend for energy products in particular may have dampened consumers' purchasing appetite. Government consumption, by contrast, is expected to have expanded markedly once more. Negative impulses are likely to have emanated from investment in inventories following a phase of substantial restocking around the middle of the year.

German banks' lending to domestic private sector less lively

Lending by German banks to the domestic private sector perceptibly lost momentum over the second half of 2018. This was mainly due to the slowdown in lending to non-financial corporations, which was a reflection of weaker economic activity. Loans to households, on the other hand, recorded similarly high inflows in the reporting quarter as in the preceding quarters. Again, this stemmed from lively demand for housing loans and consumer credit, driven by the still favourable financing conditions, persistently robust consumer confidence and the positive outlook for the housing market.

Labour market in very good shape

Despite a weaker economy, the labour market remained in very good shape at the end of 2018. The fourth quarter was marked by a solid rise in employment and a slight fall in underemployment. Employment went up primarily on the back of sustained growth in the number of new jobs subject to social security contributions. Unemployment continued to decrease noticeably in the reporting quarter. Although the number of job vacancies did not increase

further, it remains very high. The weak sentiment in a number of sectors was reflected to a certain degree in the leading indicators, although demand for labour remained expansionary overall.

Negotiated pay rates continuing to rise significantly

Negotiated pay rates remained on a clear upward trajectory at the end of 2018. Looking at the individual sectors, growth in the production sector (including construction) significantly outstripped growth in the services sector. The rise in actual earnings in the economy as a whole is likely to have been remarkably strong in the fourth quarter, as in the three preceding periods.

Another sharp climb in consumer prices in Q4 2018

In the final quarter of 2018, consumer prices (HICP) continued the distinct rise seen in the third quarter, climbing by 0.6% in seasonally adjusted terms. Despite the marked decline in crude oil prices, energy became considerably more expensive. Increased transport costs resulting from the low water level in the Rhine and other rivers probably played a key role here. By contrast, food prices, which had also risen significantly in previous quarters, largely came to a standstill. Prices for other goods, which had gone up sharply in the third quarter, accelerated further. Prices for clothing and footwear, in particular, were considerably higher. Finally, services prices continued to show a moderate rise. Annual HICP inflation, at 2.1% on average over the quarter, matched its level of the third quarter. However, it dropped to 1.7% in December as lower crude oil prices were partially passed on to consumers. Excluding energy and food, average inflation for the final quarter of the year increased from 1.1% to 1.3%.

Underlying cyclical trend likely to remain subdued for time being

The underlying cyclical trend will probably also remain subdued after the start of the new year. For instance, the decline in new orders in the manufacturing sector, with the exception of the automotive sector, indicates that industrial activity will barely pick up momentum again during the first quarter. The strong deterioration in business expectations in key economic sectors according to surveys by the Ifo Institute and the German Chamber of Industry and Commerce (DIHK) also lends weight to this. This will probably curb propensity to invest. Although this suggests that the underlying pace of economic growth is likely to remain subdued, at least in the first half of the year, there is no evidence that the deceleration will become a downturn. For one thing, some of the negative one-off factors from the third quarter of last year will peter out. For instance, looking at the automotive industry, after a dip in the summer, there are signs of at least a gradual return to normal activity in the production and export of motor vehicles. For another, the still very favourable labour market situation and the strong developments in wage growth suggest that private consumption will pick up again and counterbalance the dampening effects, in contrast to the second half of 2018. Further support will be provided by the fiscal measures introduced at the start of 2019.

Significant improvement in government finances in 2018

Germany's public finances improved significantly last year, with the general government surplus rising to 1.7% of GDP according to provisional data. This was largely due to dynamic growth in tax and social contribution receipts. In addition, interest expenditure continued to fall. The debt ratio declined to 61.0% at the end of the third quarter of 2018.

Shrinking surplus this year, accompanied by fiscal loosening

This year, too, public finances are likely to benefit from a reduction in the interest burden. The Federal Government anticipates a weaker but nonetheless favourable economic situation. By contrast, the looser fiscal policy will put noticeable pressure on the budget. Its impact on the expenditure side will be particularly pronounced. For instance, considerable spending increases are planned for pensions, internal and external security, education and infrastructure. On the income side, tax cuts will be offset by additional tax receipts due, in part, to bracket creep. Overall, the surplus is expected to shrink.

Loosening set to continue over medium term and safety buffer for unexpected negative developments likely to remain

Fiscal policy is subsequently set to remain loose and surpluses are set to fall. At the same time, as things stand, structural surpluses also appear likely in the medium term. The debt ratio is expected to drop significantly below 60%, meaning that the general government budget rules will be adhered to comfortably. Generally speaking, the rules permit cyclical burdens to have an impact on the budgets. However, flatter growth often leads to a reassessment of the structural budgetary situation, making corrections necessary. Buffers built up in good times therefore reduce the risk that procyclical consolidation will be needed in the next economic downturn.

Central government budget: After an improved outturn in 2018, …

The central government budget also ended 2018 with a large surplus. The refugee reserve was topped up further and the debt brake was undershot by a clear margin. The outturn thus clearly exceeded the budget plan, which stipulated that net borrowing was to be avoided by making withdrawals from the reserve.

… a better result for 2019 also appears possible, despite slower growth

The draft budget for 2019 likewise does not provide for any net borrowing. The growth forecast, which was scaled back slightly in comparison to the budget plans, will put pressure on the budget. However, as things now stand, the improved starting situation is likely to far outweigh this. All in all, it therefore appears that a balanced budget will again be possible without the envisaged withdrawals from the reserve.

Benchmark figures likely to be accompanied by further easing

In March 2019, the Federal Cabinet will adopt the benchmark figures for the 2020 budget and the fiscal plan up to 2023. At present, smaller revenue growth is expected here, too, as a result of a gloomier economic outlook. However, the government is likely to use up the additional funds in the refugee reserve and the favourable situation is set to continue. This means that central government, too, will still have room for manoeuvre in the medium term. However, the planned fiscal loosening is likely to gradually worsen its financial situation. In the longer term, this will be compounded, in particular, by growing burdens resulting from demographic developments which will require larger central government grants to the statutory pension insurance scheme.