The current economic situation in Germany

Overview

Bifurcation of German economy continues

Global economic growth still moderate

The global economy likely expanded in the third quarter of 2019 at a similar rate to the second quarter. This means that the upturn in economic activity predicted in a number of forecasts has not yet materialised. Of the major economies, the third quarter in the United States was once again characterised by robust aggregate output growth, and the UK economy recovered from its second-quarter setback. The euro area saw another period of muted economic growth. In China, the gradual moderation of growth continued, and in other large emerging markets economic activity remained mostly subdued.

Protracted sluggishness in industry, with risk of spillover to services sector

The ongoing moderate growth in the global economy was chiefly attributable to the sluggishness in global industry, which has barely expanded its output since the first quarter of 2019. The underlying trend of global trade likewise remained weak despite a marginal rebound in July and August. Although the global Purchasing Managers' Index for the manufacturing sector has picked up again somewhat in recent months, it has not reached the expansion threshold. At the same time, there have been growing signs that this slowdown in industrial activity is spreading to the services sector. Throughout the reporting period, the trade dispute between the United States and China has been detrimental to global economic activity. Should the two countries reach an initial agreement soon, this could boost businesses' confidence again.

Political risks and accommodative monetary policy influencing financial markets

The international financial markets have been characterised in the third and fourth quarters by shifting assessments of the political risks and the accommodative monetary policy decisions made by central banks on both sides of the Atlantic. Yields on government bonds – amid fluctuations – largely fell overall as a result. This decline was quite considerable in the United States, where the Federal Reserve lowered the interest rate corridor by a total of 0.75 percentage point in three stages during the reporting period. Yields on ten-year Federal bonds (Bunds) also dropped sharply for a time, reaching temporary historically low levels before recovering again. The interest rate spreads between ten-year bonds of other euro area countries and same-maturity Bunds narrowed in some cases, especially where Italian and Greek government bonds were concerned. The high demand for fixed-income securities also benefited European corporate bonds, net yields on which had fallen sharply. In the international equity markets, lower yields and investors' increased appetite for risk – coupled with diminishing volatility – pushed prices up considerably. After analysts had scaled back the profit expectations for the reporting period, most US corporations, in particular, surprisingly generated better-than-expected profits for the third quarter. In the foreign exchange markets, the euro has slipped slightly since the end of June on a weighted average against the currencies of 19 major trading partners. Above-average depreciation against the US dollar, the yen and the pound sterling were counteracted by gains against some European currencies.

Monetary policy: reduction in deposit facility rate and adjustment to forward guidance, …

The Governing Council of the ECB adopted a comprehensive package of easing measures at the monetary policy meeting in September. It lowered the deposit facility rate by 10 basis points to -0.5% and adjusted its forward guidance on key interest rates. The Governing Council of the ECB now expects the key interest rates to remain at their present or lower levels until it has seen the inflation outlook clearly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in core inflation dynamics.

… resumption of net purchases under APP, …

Moreover, the Governing Council decided to restart net purchases under its expanded asset purchase programme (APP) at a monthly pace of €20 billion as from 1 November. It expects these net purchases to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates.

… measures to support bank-based transmission

To provide further support for its accommodative monetary policy stance, the Governing Council of the ECB adjusted the modalities of the third series of targeted longer-term refinancing operations (TLTRO III). It extended the maturity of the individual operations and shelved the previously planned interest rate premium of 10 basis points. In order to provide additional support for the bank-based transmission of monetary policy, the Governing Council decided to introduce a two-tier system for reserve remuneration. This means that, as of 30 October 2019, part of banks' holdings of excess liquidity on current accounts with the Eurosystem will be exempt from the negative deposit facility rate and remunerated at 0%.

Robust underlying monetary dynamics

The broad monetary aggregate M3 registered strong inflows in the third quarter, continuing its robust growth. Lending to the domestic private sector and inflows of funds from abroad remained the main drivers of growth. While the expansion of loans to households continued on its upward trajectory, growth in lending to non-financial corporations was dampened somewhat by the persistent economic slowdown in the euro area. According to the latest bank lending survey, banks' lending policies remained largely unchanged on balance in both corporate and retail banking during the reporting quarter.

Economic activity in Germany rose slightly in Q3 2019

German economic output was up slightly in the third quarter of 2019. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) increased by 0.1% on the previous quarter after seasonal and calendar adjustment. The underlying cyclical trend remained muted. This was again mainly attributable to the persistent weakness in the export-oriented industrial sector. Meanwhile, domestically oriented sectors continued to provide some impetus, having been bolstered by the ongoing favourable income outlook for employees. Although the cyclical slowdown gradually became noticeable in the labour market, it remained fairly robust.

Economic activity still split

In terms of the individual economic sectors, the bifurcation of German economic activity continued in the third quarter. Declining manufacturing activity was the main reason for a lack of GDP growth. Construction output is likely to have risen, however. Value added in business-related services sectors (excluding trade) also probably exceeded the level of the previous quarter somewhat. Trade provided a clear positive stimulus. This was not just down to flourishing retail trade; turnover in wholesale trade also saw a distinct rise despite the sluggishness of industry. On the demand side, higher private and government consumption expenditure, in particular, boosted overall economic output. Exports likewise rose markedly again compared with the weak preceding quarter. This is noteworthy because export activity and industrial output usually track each other fairly closely. By contrast, private investment in machinery and equipment is unlikely to have changed much. The degree of overall capacity utilisation decreased further and drew closer to the normal capacity utilisation range.

German banks' lending to domestic private sector lively again

This bifurcation of economic activity can also be seen in credit developments. While banks in Germany expanded their lending to the domestic private sector distinctly again in the reporting quarter – albeit to a lesser extent than in the first half of the year – growth was primarily driven by loans to households, especially in loans for house purchase. Loans to non-financial corporations increased only slightly in the reporting quarter, however. First, a countermovement to the strong growth was apparent in the third quarter; second, subdued investment activity set in. Demand for loans to enterprises and housing loans was propped up by the prolonged downward trend in lending rates, notably for longer lock-in periods. Lending policies remained virtually unchanged on balance across all segments. Nevertheless, margins, especially on riskier loans, were expanded significantly in some cases.

Impact of downturn on labour market limited so far

The considerable economic downturn is gradually affecting the labour market. Nonetheless, the labour market still appeared fairly robust in the third quarter. Employment continued to rise, albeit at a considerably slower pace in comparison with last year. Unemployment did not fall any further, but stagnated at a level that was exceptionally low by historical standards. There was a slight increase in short-time work for economic reasons. However, the labour market outlook for the next few months has deteriorated further.

Sharp rise in negotiated pay rates on account of one-off effects

The third quarter saw an exceptionally strong increase in negotiated pay rates. Including additional benefits, these rates rose year-on year by 4.2% in the third quarter of 2019, compared with 2.1% in 2018. This temporary, considerably higher growth rate was mainly due to new special payments in the metal-working and electrical engineering industries, which had been agreed last year and were first due in July 2019. The increase in negotiated rates of basic pay – into which these special payments do not flow – was less significant. As in the previous quarter, the main drivers here were the services sectors. The weaker growth in the negotiated rates of basic pay in the production sector including construction was primarily due to a several-month freeze at the old pay rates from the previous year's collective wage agreements. One factor at play here was that regular increases in the negotiated rates of basic pay had been substituted by special payments in some cases. By contrast, the economic downturn in industry was not yet particularly evident. The wage demands for the outstanding negotiations in this year's wage round are mostly higher than those of the last wage round for the same sectors.

Statistical effect temporarily dampened consumer price inflation in third quarter

Consumer prices picked up moderately in the third quarter of the year. The Harmonised Index of Consumer Prices (HICP) rose by 0.3% in seasonally adjusted terms. In particular, this had a dampening effect on prices for energy, owing to distinctly lower crude oil prices. By contrast, food prices increased substantially and thus continued their upward movement, which has been persisting for some time now. Services also continued to become more expensive, albeit only slightly. The travel market was a source of dampening impulses here – a market in which prices often fluctuate heavily. The cost of air travel increased by roughly the same amount as the price for package holidays decreased. Given that package holidays account for a larger share in the basket of goods, their decline had a greater effect. The prices of industrial goods excluding energy saw a slight increase, in line with the development of the corresponding producer and import prices. Despite this, overall, annual headline HICP inflation declined significantly from 1.7% to 1.1%. This was also the case for the rate excluding energy and food, which fell from 1.5% to 0.9%. Above all, this was driven by a statistical effect in prices for package holidays, which is likely to have reduced the headline rate in the third quarter of 2019 by 0.4 percentage point and core inflation by as much as 0.6 percentage point. Seasonally adjusted consumer prices were unchanged in October on the month. Overall, inflation remained at 0.9% in year-on-year terms. Leaving aside not only energy and food but also the equally volatile price components, travel services and clothing, the rate of inflation, at 1.5%, still stood at a higher level.

German economy could stagnate by the end of the year

The slowdown of the German economy will probably continue in the fourth quarter of 2019. However, it is not likely to intensify markedly. As things currently stand, overall economic output could more or less stagnate. Thus, the economy would largely tread water in the second half of this year as a whole. However, from today's vantage point, there is no reason to fear that Germany will slide into recession. On the contrary, leading economic indicators for industry are showing the first tentative signs that the downward trend in this economic sector could decelerate. According to the ifo Institute, business expectations in the manufacturing sector recently brightened somewhat. Industrial enterprises' order situation deteriorated only slightly in the third quarter. The underlying trend of incoming orders has remained the same for some months, albeit at a low level. The export-oriented industry could therefore stabilise before the more domestically-oriented sectors are affected more strongly. The domestic economy will probably continue to provide momentum. Capacity utilisation in the booming construction sector remains high, and no substantial growth in output is to be expected here. However, because the labour market is likely to remain fairly robust and wages are expected to grow considerably, households' income prospects should remain favourable. It is therefore assumed that private consumer demand will support economic activity in the current quarter, too. This also applies in general to the expansionary fiscal policy stance.

Government budget surplus still significant this year, but shrinking

Public finances remain in very good shape. The general government surplus stood at 1.9% of GDP in 2018. It is likely to decline this year, yet still remain significant. Above all, the spending policy is being relaxed and pensions and investment, for instance, are seeing dynamic growth. The economic slowdown is causing the rise in tax revenue, in particular, to decelerate slightly compared with the previous years. Overall, however, the cyclical component is moderate given the robust domestic economy.

Surplus to continue shrinking over next two years

It is foreseeable that the surplus will continue to shrink considerably in the coming two years. For example, fiscal policy is set to be loosened further. More funds are to be made available for infrastructure and education, and there are indications of continued high growth in social spending. Furthermore, the solidarity surcharge is being partially abolished in 2021. The new climate protection programme will put a slight burden on the government budget on balance.

Federal budget once again records significantly better result than planned

The Federal budget is expected to record a surplus again this year. In contrast to the original plans, it will not be necessary to tap the refugee reserve to avoid net borrowing. In fact, the reserve could see a further marked increase. The budget plans for 2020 also appear to have been drawn up with caution.

Measures conducive to growth and employment could be accelerated

The structural surpluses of central and general government are likely to decline significantly. However, the national and European fiscal rules still make for financial leeway, which could be used to improve the conditions for growth and employment. As a result, the solidarity surcharge could be reduced as early as in the coming year. It still appears appropriate to completely abolish this surcharge in the foreseeable future and, if necessary, to combine this step with a fundamental tax reform. State and local governments could reinforce their efforts to improve education and infrastructure.

Public finances are supporting economic activity, currently no need for economic stimulus packages

By contrast, a special package of measures to stimulate the economy does not seem necessary at present. Most recent forecasts show the current and future economic situation more or less within the normal range. In this context, public finances are already stabilising economic growth appreciably. The considerable risks to the economic outlook, primarily resulting from the external environment, are nonetheless to be borne in mind. Should economic activity slump and aggregate capacity become substantially underutilised, fiscal policymakers would also be called upon to take steps to spur the economy. The fact that German public finances are sound would then facilitate a sizeable contribution to stability.