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## **Fall 2016 joint economic forecast: German economy on track – economic policy needs to be realigned**

The German economy is experiencing a moderate recovery: the GDP is expected to grow by 1.9 percent this year, 1.4 percent next year, and 1.6 percent in 2018. Over the course of the forecast period, capacity utilization will be somewhat higher than the long-term average. Nevertheless, corporate investment's contribution to the current upswing is minimal: the global economy is generating only minor stimulating effects, which means that exports are only increasing moderately; as well, the extremely low interest rates on the capital market are likely to reflect not only the current monetary policy, but also the low growth expectations. All of these factors are inhibiting equipment investment, and thus consumption continues to be the main growth driver. Private consumption is benefiting from the sustained increase in employment; the high expenditure for housing and integrating the refugees is still having a strong impact on public spending. Residential construction is getting a boost from the low interest rates.

After a very subdued first half of the year, the **global economy** regained momentum this past summer. In the developed countries, production should now start picking up again, while the emerging economies are stabilizing. Overall, however, the global dynamic is still weaker than it was in the years preceding the financial crisis.

After a weak first half of the year, production in the US is starting to pick up again, while recovery in the euro area continued over the summer at a consistent pace. In Japan, new stimulus programs should help boost the economy, even if the yen's considerable appreciation is having a dampening effect. In China, production in the second quarter was considerably higher than it had been in the previous three months, in part due to the more expansive economic measures. In Russia and Brazil, both of which had been going through a recession, the economic situation is improving somewhat; this may be partly due to the rise in export revenues resulting from the increase in commodity prices that has been taking place since the beginning of the year. Monetary policy in the major currency regions has been markedly expansionary for some time. The current fiscal policies in many regions are expected to have a supportive effect on the economic cycle.

Later on in the forecast period, growth in the developed countries is expected to slow down somewhat. Private consumption should remain the primary driver of global economic expansion. Marked increases in employment are expected in the US, Japan, and the euro area – even though productivity growth is expected to remain low, with the result that wages will pick up at only a moderate pace. In addition, the purchasing power gains that resulted from the low oil prices are tapering off, which is likely to hinder the growth of private consumption.

Given the increased capacity utilization and the aging of the capital stock, there should be a gradual rise in the demand for capital goods. Financing conditions are likely to remain favorable over the course of the forecast period. However, exports to emerging countries will be weakened by these countries' more subdued growth prospects, and that in turn weakens investment. In the UK, the Brexit decision should have a negative impact on investment.

Although global production recovered in the second half of 2016, a weak start to the year means that production will only expand by 2.3 percent this year – significantly slower than in 2015. Growth should pick up again in 2017 and 2018, with an increase of 2.7 percent in each year.

There are still major risks for the global economy. For one, although China's recently implemented fiscal measures are stimulating domestic production, the risk of an economic downturn in the long run has increased. In the EU, the uncertainty resulting from the problems in the Italian and Portuguese banking sectors and the conflicts in the eastern Mediterranean countries could dampen consumption and investment. But above all, the consequences of the Brexit decision are presenting the biggest risk. Since the exit process is likely to be drawn-out and complicated when it comes to the extent to which the single market will remain open to the UK in the future, the UK – and to a lesser extent, the rest of the EU – could face a long period of investment restraint. A further disintegration of the global economy could slow economic growth, especially since the uncertainty about the future institutional and regulatory framework would noticeably dampen companies' propensity to invest.

The **German economy** continues in its moderate recovery. Overall economic capacity utilization is now slightly higher than the long-term average. Primary contributors to the recovery include the construction and service sectors, as well as the employment growth taking place in both areas. Stable wage growth and low inflation rates are enabling a brisk expansion of private consumption, but public expenditure is also increasing vigorously due to the influx of refugees. Unlike in previous upswings, industry's contribution to the recovery is below-average. The exceptionally favorable financing conditions are doing little to stimulate Germany's corporate investment activity. The corporate sector's persistently high financial surplus indicates that a large part of the savings is not being invested in Germany, but rather in other countries; this is contributing to Germany's high current account surplus.

The GDP grew significantly in the first half of 2016; primary drivers included consumption and exports, which benefited from the increasing demand in Asia and Eastern Europe, among others. However, the expansion dynamic of production decreased significantly in the second quarter, and even domestic consumption experienced a short-term decline. Corporate investment experienced a marked decrease during this time period. In construction, the weather-related priority given to construction projects in the first quarter had a negative impact in the second quarter. The fact that the real income gains related to last year's oil price decline are tapering off has also hindered growth.

In the third quarter, economic growth likely slowed down again: in July, for example, manufacturing output and exports declined significantly. However, this was likely also due to the fact that schools and factories were closed, which was insufficiently recorded in the seasonal adjustment. Although a countermovement likely took place in August, the dynamic of incoming orders was subdued, which means that industrial production probably dropped somewhat. Construction activity, however, probably experienced considerable growth; this is suggested by the high backlogs and the Ifo Business Climate Index for the construction sector. In the service sector as well – particularly in retail, transport, and hospitality as well as in IT and communications – the high Ifo Business Climate Index suggests continuous expansion.

In the fourth quarter, production will probably return to a higher growth rate, which is brightening up the prospects considerably for companies across the board. The labor market remains solid, which in turn is helping to boost private consumption, and the sharp rise in disposable income resulting from the increase in employment will continue.

All in all, GDP is expected to increase by 1.9 percent in 2016; the 68-percent projection interval ranges from 1.7 to 2.1 percent. The number of workers is likely to grow by 500,000 compared to 2015, though the number of individuals registered as unemployed will experience only a slight decrease, by roughly 100,000 people. This discrepancy is primarily due to the large influx of immigrants, which increased the pool of potential employees by 460,000 in 2016. This group will mostly be comprised of immigrants from within the EU, since there will be a considerable delay before the newest refugees become available to the labor market. As a result of the drop in oil prices, the inflation rate will remain very low this year, amounting to just 0.4 percent. Public budgets are expected to conclude 2016 with a surplus of 20 billion euros; cyclically adjusted, this amounts to 9 billion euros.

GDP is expected to increase by 1.4 in 2017 (with a prognosis interval of -0.1 percent to 2.9 percent). This lower growth rate is essentially due to the fact that there are fewer working days in 2017; were this adjusted for, next year's growth rate would also amount to 1.6 percent. In the somewhat more robust global economy, German exports will experience a gradual increase. Imports are likely to expand with even more intensity due to the relatively powerful dynamic in the domestic economy. With a slightly positive output gap, investment should receive somewhat of a boost. The inflation rate is expected to increase to 1.4 percent, mostly due to the fact that oil prices are no longer on the decline. Though employment is on the rise, unemployment is also expected to increase somewhat, since integrating refugees into the labor market is a drawn-out process; however, this will not be reflected in the unemployment rate, which is likely to remain at 6.1 percent. The public budget surplus will decrease to just under 14 billion euros.

For 2018, the forecast predicts that the GDP will expand at a similar rate to the production potential.

The risks for the forecast period will stem primarily from the monetary environment and foreign trade. The German economy could, for example, experience stronger growth than has been forecasted here, since monetary conditions are extraordinarily favorable from a domestic perspective – which could in turn have a stronger impact on construction, for instance. Given the emerging capacity constraints, however, it could also lead to higher price pressure in this sector.

Downside risks for the forecast period are primarily linked to critical social issues that might lead to a reduction of the degree of global economic integration. One example is the Brexit decision, which could also have an impact on the German economy. For this forecast, it is assumed that corporate investors will not be thrown off too much by the Brexit decision; this is suggested by already available indicators. If the EU and the UK take a hard confrontational approach when it comes to exit negotiations, or if a significant deterioration of the economic relations between both regions starts to emerge, the British economy will be impacted more heavily than

predicted in the joint report, with capital goods and imports experiencing the biggest losses. As a result, German exports – as well as domestic investment – will also be lower than projected.

The Brexit decision reflects the fact that the overall economic benefits of global integration are not catching on with certain sections of the population – or at the very least, are not being perceived at all. Should this phenomenon gain a greater influence over politics in other regions of the world, the global economy's growth potential could turn out to be lower than predicted in the joint forecast. This development will have a particularly strong impact on Germany, which draws its prosperity from the integration of the global economy more than any other comparable country. It is therefore of particular importance that German economic policy be designed to counter protectionism.

In the past few years, fiscal policy has been focused on consumption and distribution expenditures rather than on growth-oriented measures. Given the challenges presented by the recent influx of refugees, as well as other long-term challenges for the German economy – especially those related to changes in the demographic – policy urgently needs to be realigned. The authors of the joint forecast emphasize the importance of setting and focusing on long-term goals. Investment expenditure in human capital and infrastructure as well as employment-friendly tax breaks and lower mandatory social insurance contributions would increase production potential.