JOINT ECONOMIC FORECAST – SUMMARY 2/17

Berlin, 28th September 2017

JOINT ECONOMIC FORECAST—AUTUMN 2017:

Upturn Remains Robust—Amid Mounting Tensions

The German economic upturn has gained both in terms of strength and breadth. In addition to consumer spending, external trade and investments are now also contributing to economic expansion. Whereas the very high economic momentum in the first half of the current year will slow slightly, expansion of economic output this year and next will exceed production capacity growth. As a result, overall capacity utilisation will increase, with economic output exceeding potential output. Gross Domestic Product is likely to grow by 1.9 percent this year and by 2 percent in 2018 (calendar-adjusted: 2.2 and 2.1 percent, respectively). Unemployment will see a further decline, to 5.7 percent in 2017, and to 5.5 percent in 2018 (previous year: 6.1 percent). On the other hand, the pace of new job creation is expected to slow down. Consumer price inflation will see a substantial rise as oil prices are not declining any longer; upward pressure on domestic prices is also becoming discernible. Accordingly, the inflation rate, at 1.7 percent this year and next, will turn out appreciably higher than last year, when consumer prices were only up by 0.5 percent. Public-sector budgets are generating appreciable surpluses that are not due to cyclical factors alone. If the next federal government makes use of the scope provided by structural government budget surpluses in order to lower taxes and levies or increase its spending, financial policy would have an expansionary orientation, not only in this but also in the extended forecast period; otherwise, it would have a more or less neutral effect as of the coming year.

PRESS EMBARGO
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Table

Forecast for Germany: Key Economic Indicators

	2014	2015	2016	2017	2018	2019
Real gross domestic product						
(percentage change over previous year)	1,9	1,7	1,9	1,9	2,0	1,8
Domestic employment (1 000 persons)	42 672	43 069	43 638	44 285	44 768	45 155
Unemployment[1] (1 000 persons)	2 898	2 795	2 691	2 541	2 460	2 380
Unemployment rate[1] (in % of labor force)	6,7	6,4	6,1	5,7	5,5	5,2
Consumer price index[2]						
(percentage change over previous year)	0,9	0,2	0,5	1,7	1,7	1,8
Unit labor costs[3]						
(percentage change over previous year)	1,4	1,8	1,6	1,9	1,8	2,0
General government balance[4]						
in billions of euros	9,5	19,4	25,7	28,3	37,3	43,7
in % of nominal GDP	0,3	0,6	0,8	0,9	1,1	1,2
Current account balance						
in billions of euros	218,0	260,0	262,4	254,5	267,4	278,6
in % of nominal GDP	7,4	8,5	8,3	7,8	7,9	7,9

[1] Federal Employment Agency (BA) concept. [2] 2010 = 100. [3] Hourly compensation of employees relative to real GDP per hour worked. [4] According to national accounts definition (ESA 2010).

Sources: Federal Statistical Office; Federal Employment Agency, Deutsche Bundesbank; 2017, 2018 and 2019: forecast.

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The **global economy** is meanwhile in an upswing phase. In the USA, in Japan and in the euro area, production growth is outpacing trend growth by far, and normal utilisation of production capacities is close to being reached or has even been exceeded. Owing to economic policy stimuli imposed, the Chinese economy has returned to a phase of robust expansion, which is meanwhile likely to have peaked, however. The upturn in these large economies, in combination with a surge in commodity prices, has also supported economic momentum in the emerging market countries as a whole.

Nevertheless, **consumer price inflation** still remains at a low level. After inflation rates had accelerated significantly from autumn 2016 to the spring of 2017 especially due to rising energy prices, they declined again in recent months. Adjusted for the short-term effects of energy price fluctuations, however, inflation in the euro area, in tandem with robust economic momentum, increased from 0.9% at the end of last year to 1.3% in the summer, and the current economic upturn is also likely to have a gradual impact on consumer prices in the US and Japan.

Monetary policy is likely to be tightened more slowly than had been expected in the spring. In the US, the next interest rate hike will probably be imposed only in December, and for the coming two years the institutes expect only few additional policy rate increases. The ECB is likely to allow its bond purchasing programme to gradually expire in the year 2018—this forecast is based on an assumed period of nine months. The institutes assume that the key interest rate will be raised only in the course of the year 2019 because the euro has appreciated markedly in recent months, and this counteracts the ECB's efforts to bring the inflation rate close to its target, at least in the short term.

In the current year, **financial policy** on the whole has become slightly more expansionary. What is behind this is the greater degree of scope for fiscal policy on account of lower interest rates and positive economic trends. In the euro area, financial policy orientation will probably remain slightly expansionary next year. In the US, public-sector budgets will be impacted by extraordinary burdens in the wake of the recent hurricane disasters. In China, financial policy will probably become more restrictive: the fiscal programmes launched for the industrial sector last year will probably be gradually reduced in the course of the forecast period.

The global upturn is likely to continue during the forecast period, even though growth in **global output** is likely to gradually slow down. For this year and next year, the institutes have forecast an expansion rate of 3.1 percent for the group of countries taken into account in this expert opinion; for 2019, a growth rate of 2.9 percent is expected. In relation to the spring expert opinion, the institutes have thus raised their forecast by 0.1 percentage point (2017) and 0.2 percentage points (2018).

Production in the **euro area** is forecast to rise more sharply than potential output throughout the forecast period. In view of the cyclical tailwinds and

structural improvements, it is not assumed that any major cyclical strains will emerge in the wake of the slower exit from unconventional monetary policy assumed in this forecast. Nevertheless, in some areas—such as risk on banks' balance sheets—increased alertness will remain necessary at some locations.

The latest acceleration of **global trade** is most probably the primary factor responsible for the gain in momentum of the global economy. In contrast, key factors causing the dynamic trends in international goods trade to slow down in structural terms in recent years continue to exist. The institutes expect global trade to expand by slightly lower growth rates again in the coming years, roughly 3½ percent—following 4.2 percent growth in the current year.

On the one hand, many of the geopolitical **risks** addressed in the course of past Joint Economic Forecast discussions remain in place, with the escalation of the North Korea conflict constituting a further such risk. On the other, the economic policy risks have decreased considerably in the past several months. It has meanwhile emerged that policymakers in the US will most probably introduce far less drastic changes than had been thought possible as recently as the spring of this year. In Europe, election defeats of parties critical of the European idea in some EU countries have led to a decline in the probability of political destabilisation in the European Union. It has also become more probable that Great Britain's exit from the EU will proceed without any abrupt difficulties.

The buoyant forces within the **German economy** have grown stronger. In the first half of the year the expansion rate accelerated substantially – the annual rate amounted to 2.5 percent. The level of capacity utilisation therefore continued to grow, and overall economic output exceeds the potential output. Impetus was generated by exports, which gained increased momentum in the first half of the year. Domestic demand, however, likewise remained a driving force behind expansion. Private and public-sector investment expenditure grew significantly. Construction activity continued to be boosted by low interest rates and growing demand for residential housing. Equipment investments also saw robust expansion; most recently these are likely not to have predominantly been stimulated by the good domestic economy but also by strengthening external trade.

As the economy has already been headed in a robust upward direction for some time, initial signs of **tension** are discernible in a number of segments of the economy. The number of vacancies reported on the labor market has increased considerably, and it is taking increasingly longer to fill a vacant job reported. In the construction sector in particular, more and more enterprises are indicating that a lack of available labor is impairing their output. Meanwhile prices are rising fairly sharply in this sector. Producer prices (excluding energy utilities) have also seen a marked rise in the course of this year, while consumer price inflation has increased moderately, if at all.

For the second half of this year, the institutes expect further substantial economic expansion, albeit at a slightly lower rate in comparison with the first half-year. Whereas the production indices suggest slightly less dynamic growth in the current quarter, the assessment of the business situation according to the ifo economic activity test still remains close to its all-time high in spite of a slight decline in August. Factors in favour of a continued upturn include the large order books in the construction industry and increasing employment—a trend continuing until most recently. Finally, exports are likely to post further fairly high growth rates. All in all, the institutes expect **Gross Domestic Product** to rise by 1.9 percent in 2017; the 68 per-cent forecast interval in this context ranges from 1.7 to 2.1 percent. Adjusted for the number of working days, Gross Domestic Product will expand by as much as 2.2 percent, the highest value since the year 2010. Accordingly, the institutes have raised their spring forecast for Gross Domestic Product growth for the current year by 0.4 percentage points.

The **upturn** is likely to continue throughout the remaining forecast period. Meanwhile it rests on a considerably broader base than only a year ago. Investments are likewise making a sizeable contribution to economic expansion, and further robust impetus is discernible from abroad. For next year and the year after next, the institutes expect Gross Domestic Product to rise by 2 percent and 1.8 percent, respectively. Accordingly, overall economic capacity utilisation will not ease at all. The output gap will rise from currently 0.5 percent of the potential output to 0.8 percent in the year 2019.

Investment activity is picking up noticeably, even if the expansion rates remain below those recorded in earlier boom cycles. As the level of capacity utilisation has become high, companies are likely to invest to a greater extent in expansion projects. Ongoing favourable financing terms and conditions, which will see hardly any changes during the forecast period, will continue to support economic momentum. Only in the course of the year 2019 is a gradual surge in interest rates expected on the capital market. Investments in residential housing construction are also likely to benefit from the ongoing low level of interest rates. Moreover, a substantial order backlog has accumulated that can only be processed gradually. In the public sector, draw-downs of the funding made available for investment purposes are likely to increase following a number of previous delays. Mounting construction costs are likely to have a dampening impact on construction activity, however.

The dynamic pace of **private consumer demand** is likely to decline slightly, even though it will still remain high in a long-term comparison. Dampening factors in this regard—unless policymakers take corrective action—include an increasing tax burden; another is the higher inflation rate. In contrast, gross wages are likely to grow at practically unchanged rates. While the pace of employment growth is slowing down slightly, the rate of wage increases is accelerating due to the scarcities on the labor market that are partly already identifiable and likely to grow in the forecast period. Transfer income is likely to witness less robust growth in future than this year, in which the exceptionally large pension increase continued to make itself felt until mid-

2016. All in all, the level of disposable incomes will grow at a slightly lower pace.

Exports are being stimulated by robust global economic growth, in particular by the ongoing upturn in the euro area; this will only partly be offset by the recent fairly strong appreciation of the euro, which reduces price competitiveness and therefore exerts a dampening effect. On the whole, exports are likely to grow at a slightly higher rate. This, in combination with robust domestic absorption, will culminate in an appreciable expansion in imports.

The situation on the **labor market** will continue to improve. Employment continues to grow, albeit at a lower rate in the wake of slightly reduced production growth. In addition, owing to scarcities and bottlenecks in some segments of the labor market, capacity utilisation of existing personnel is likely to increase, which is reflected by the fact that the working time per employed person is no longer declining, for instance. The number of employed persons is likely to grow by 1.1 percent in 2018 and by 0.9 percent in 2019, following an increase of 1.5 percent this year.

However, measured **unemployment** will continue to decline to a lesser extent than the rate at which employment is rising. Causes of this include the increasing labor participation particularly by women and older persons and the continuing immigration. An additional factor is that the refugees who came to Germany in recent years are increasingly available on the labor market following the completion of their asylum procedures and qualification measures. The unemployment rate is forecast to decline from 5.7 percent this year to 5.5 percent in 2018 and to 5.2 percent in the year 2019.

Inflation is likely to only slightly accelerate slightly in the forecast period. Initially, the latest appreciation of the euro and the decline in energy prices until July will have some enduring effects. In the course of time, however, sharper wage cost increases will probably be passed on gradually to consumers. The institutes anticipate an increase in consumer prices by 1.7 percent in each of the current and the coming year, and by 1.8 percent in 2019.

The **general government's financial situatio**n will continue to improve in the forecast period. Government revenues will remain highly copious since expansion supported by domestic consumption yields substantial tax income, assuming that no extensive tax cuts will be enacted. Government expenditure—based on current budget figures—is likely to grow but at slightly declining rates over time. Indications are that this year's general government budget surplus will rise from 26 billion euros to 28 billion euros. This surplus is likely to grow to 37 billion euros in 2018 and to 44 billion euros in 2019. In these conditions, the general government debt balance will continually decrease to 59 percent in relation to Gross Domestic Product in the year 2019. In addition to rising economic output, local and regional

government budget surpluses and reduced liabilities of government resolution agencies will contribute towards this.

On the whole, the **risks** inherent in the forecast have turned out to be more moderate than in the spring. The decisive factor here is the global economic environment, which appears to be more stable at present. As always, the effects of monetary policy with an expansionary stance for a very long time now are difficult to assess. For instance, monetary policy stimulus could lead to an accumulation of systemic risks. However, even in the event of a speedy increase in short-term interest rates, banks that granted long-term loans at lower interest rates might come under pressure to adjust. This might slow down the expansion in Germany to a considerable degree. The German economy might experience even more robust expansion than forecast here if the new federal government passes legislation to reduce tax burdens beyond the subsistence level subject to constitutional law, which is not assumed in this forecast in view of the current status quo. This would already stimulate demand in the short term. On the other hand, in view of the good capacity utilisation prevailing in any case, this might perceptibly reinforce consumer price inflation.

Economic policy was hardly growth-oriented in nature during the last legislative period. It is worthy of emphasis, however, that the fiscal consolidation policy adopted in recent years actually succeeded in lowering public-sector debt in relation to economic output, which means that Germany today has a a public sector that is able to take action based on a strong economy.

The general government budget surpluses likely to be unfolding for the forecast period, equivalent to ¾ percent of economic output, should be utilised in order to improve the **economic conditions**; in view of the high capacity utilisation in any case, there currently is no need for policy with short-term cyclical objectives in mind.

From the institutes' perspective, more attention should be paid to the general government's revenue side of the equation. In view of the high burdens imposed on labor incomes in the form of levies and a particularly sharp increase in direct tax revenues, the focus should be on the income tax rate curve. However, there is also scope for action in terms of social security contributions, which are also of particular significance to low-income workers, especially as regards unemployment insurance.

Corrections in the field of social security contributions are also necessary in view of the forthcoming **demographic challenges**. In particular, the situation regarding statutory pension insurance is likely to deteriorate to a marked degree in the medium to long term. So far, demographic change has not made itself felt all that clearly, but the process of ageing is already in full swing. The German economy is currently undergoing an interim high in terms of potential

growth rates, which will turn out considerably lower in the coming decade for demographic reasons.

The foreseeable slowdown in potential growth can be partly offset by rising **labor participation**—particularly by women and older persons. For this reason, measures like the introduction of "Flexi-pension" are endorsed since this would enable pensioners to earn additional money and might increase their labor participation, or it would improve the harmonisation of family and working life.

Successful integration policy as well as an **immigration policy** that relies for guidance on requirements of the labor market can also mitigate the effects of demographic change. And reforms are needed particularly with regard to immigration from non-EU countries.

Annex

Long version (German):

Projektgruppe Gemeinschaftsdiagnose: Upturn Remains Robust—Amid Mounting Tensions. Autumn 2017. Kiel 2017.

The report can be downloaded from the following website as of 11:00 a.m., 28th September 2017:
www.gemeinschaftsdiagnose.de/category/gutachten/.

About the Joint Economic Forecast

The Joint Economic Forecast is published twice a year in spring and in autumn on behalf of the Federal Ministry for Economic Affairs and Energy. The Joint Economic Forecast in autumn 2017 was prepared by:

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