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Upswing of German Economy Prevails

By Ferdinand Fichtner, Guido Baldi, Franziska Bremus, Karl Brenke, Christian Dreger, Hella Engerer, Christoph Große Steffen, Simon Junker, Claus Michelsen, Katharina Pijnenburg, Maximilian Podstawski, Malte Rieth and Kristina van Deuverden

The German economy is continuing on an upward trend. Due to surprisingly weak production at the start of this year, GDP is likely to increase by 1.8 percent and is therefore growing somewhat slower this year than previously predicted. Growth of 1.9 percent is still expected for the coming year.

After an unexpectedly weak first quarter, the global economy is expected to regain momentum as the year progresses. While growth in the emerging economies increased only slowly, both cyclically and structurally, recovery will primarily be driven by positive consumer spending in industrialized countries. With low inflation and an improving labor market situation in those countries, household income and purchasing power are likely to increase. The global economy's average annual growth rate is predicted to reach 3.5 percent in 2015 and 4.0 percent in 2016. Inflation is expected to remain at two percent this year and increase to three percent next year.

Germany's strong domestic economy is driving growth. Most recently, additional social benefits and, above all, low inflation temporarily boosted real incomes; nevertheless, consumer spending will increase substantially going forward due to favorable developments in the labor market. Companies are moderately expanding their investment in equipment; however, uncertainties related to the crisis in the euro area, geopolitical tensions, and concerns about economic development in important emerging countries have a dampening effect. Exports are benefiting from the global economic recovery and temporarily also from the depreciation of the euro; overall, the stimulus from net foreign trade is likely to be modest.

Europe and the Global Economy

After an unexpectedly weak first quarter in 2015, global economic activity is expected to regain momentum as the year progresses. Among advanced economies, increases in production in the euro area and Japan were only partly able to offset shrinking economic output in the US (see Figure 1). A number of specific factors occurring at the beginning of the year led to a decline in US gross domestic product (GDP). Emerging markets also had a weak start to 2015. Growth has been decelerating in these markets for several years now and, more recently, there has also been a cyclical slowdown. Nevertheless, the rate of expansion of the global economy is expected to accelerate slightly going forward (see Table 1): The US economy is likely to pick up again, and growth in the euro area and in Japan remains strong.

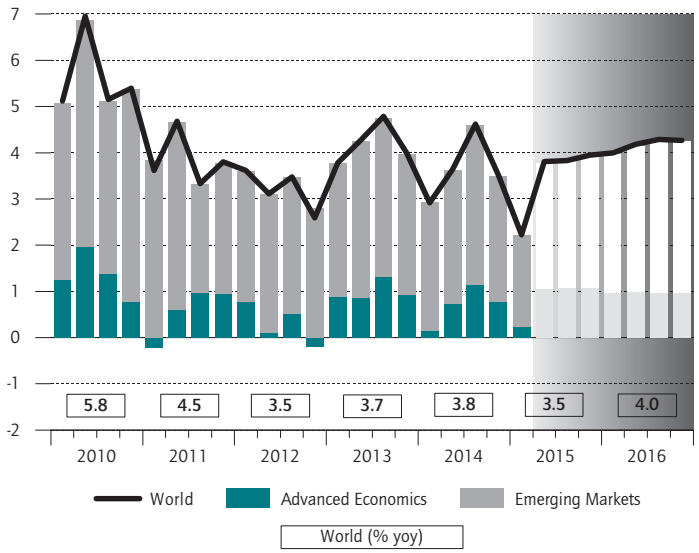
However, there are still a number of risks facing the global economy. If negotiations between the international creditors and Greece were to fail, this would lead to greater uncertainty in financial markets. This would burden already weak business investment and have a dampening effect on growth in the euro area. A resurgence of the conflict in Ukraine could lead to renewed uncertainty. A further risk could come from increased volatility in the global monetary environment—i.e., interest rates, inflation, or exchange rates—resulting from stronger-than-expected interest rate hikes in the US.

Growth in advanced economies is mainly driven by consumer spending. With continued low inflation and the labor market situation gradually improving, household income and purchasing power are likely to rise. Moving forward, this ought to stimulate investment although these increases will be moderate.

The euro area economy is expected to grow robustly all in all. Within this context, gradual improvements in the labor market, less restrictive fiscal policies, and overall consumer confidence should kick-start private consum-

Figure 1

World Real GDP
In Percent



Source: National statistical offices; DIW Spring projections 2015.

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The world economy will expand gradually in the years 2015 and 2016.

er spending. The low exchange rate of the euro will also support exports.

In emerging markets, growth will only pick up slightly. Only India can expect strong gains. In contrast, the economy will remain extremely weak in Russia and subdued in Brazil. Growth in China is likely to be lower than in previous years due to structural adjustments.

On the whole, the global economy's average annual growth rate is expected to reach 3.5 percent in 2015 and 4.0 percent in 2016. Inflation will remain low this year at two percent but is expected to increase to three percent next year, mainly due to energy prices no longer declining.

The monetary policy environment is likely to be less expansive globally. While monetary policy in the euro area will remain accommodative throughout the whole forecast period, Japan is likely to pursue additional expansionary measures. China is also expected to introduce further interest rate cuts. Nevertheless, the central banks of both the US and the UK are likely to raise interest rates. Fiscal policy, however, is likely to be less restrictive overall than in recent years, while there is considerable cross-country heterogeneity.

United States

GDP in the US fell by an annualized 0.7 percent in the first quarter of 2015. This can be explained by several—mostly temporary—factors. The exceptionally cold winter in many parts of the US and a strike by dock workers on the West Coast have slowed the economy. In addition, the US trade deficit expanded, in contrast to the downward trend of recent years—probably due to the strong appreciation of the dollar. Although the decline in oil prices has had a stimulating impact on consumer spending, at the same time, it also led to a slump in investment in the oil sector. The US economy is expected to grow considerably again over the forecast period as a result of catch-up effects and strong domestic demand. Consumer spending is boosted by lower oil prices and the continued recovery in the labor market. The unemployment rate has fallen by almost one percentage point over the past year and was at 5.5 percent in May. However, the number of those who have at least temporarily withdrawn from the labor market remains high. Underemployment—i.e., those working part-time who would like to increase their working hours—remains at a high level. In the course of further gradual improvements in labor market conditions, the trend toward slightly higher disposable incomes will continue during the forecast period and underpin consumer spending and housing construction. Against the background of rising consumer demand, companies will increasingly take advantage of historically low interest rates to expand investment. Given the upward economic momentum, the Federal Reserve is likely to start raising interest rates in the second half of this year. Overall, the US economy is expected to grow by 2.3 percent in 2015 and by 3.1 percent in 2016.

Japan

Production in Japan expanded by 0.6 percent in the first quarter, following a similar increase in the previous quarter. Nevertheless, final demand lagged behind production; without the resulting expanded stock levels, growth would have been just 0.2 percent. Despite the depreciation of the yen, exports rose only minimally, probably due to a weak first quarter in key partner countries such as the US and China. Consumer spending rose by 0.4 percent. Corporate capital investment improved again for the first time in four quarters but continued to lack dynamic growth. Going forward, companies are likely to first reduce their stock levels before ramping up production. There is, however, scope for wage increases due to higher profits from the depreciation of the yen. The greater consumer confidence should also drive consumer spending. The Bank of Japan will continue to buy up bonds and expand its program still further to bolster the economy. Overall, developments

Table 1

Real Gross Domestic Product, Consumer Price Inflation, and Unemployment Rate in the World Economy
In Percent

	Gross Domestic Product				Consumer Prices				Change over previous year, in percent			
	Change over previous year, in percent											
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016
Euro area	−0.4	0.9	1.3	1.5	1.3	0.4	0.2	1.0	12.0	11.6	11.1	10.5
without Germany	−0.6	0.4	1.3	1.3	1.3	0.3	0.0	1.0	14.0	13.8	13.3	12.7
France	0.7	0.2	1.0	0.9	0.8	0.5	0.1	1.0	10.3	10.3	10.6	10.5
Italy	−1.2	1.4	3.0	2.7	1.4	−0.2	−0.5	1.1	26.1	24.5	21.9	19.8
Spain	−1.7	−0.4	0.3	0.6	1.3	0.2	0.2	0.6	12.2	12.7	12.8	12.3
Netherlands	−0.7	0.9	2.0	1.7	2.6	0.3	0.5	1.4	7.3	7.4	6.8	6.5
United Kingdom	1.7	2.8	2.4	2.2	2.6	1.4	0.1	1.6	7.5	6.1	5.7	5.6
USA	2.2	2.4	2.3	3.1	1.5	1.6	0.0	1.9	7.4	6.2	5.3	4.8
Japan	1.6	−0.1	0.8	1.5	0.3	2.7	0.5	0.3	4.0	3.6	3.7	3.8
South Korea	2.9	3.3	3.0	3.6	1.3	1.3	0.6	1.7	3.1	3.6	3.2	3.0
Middle Eastern Europe	1.6	3.0	3.4	3.1	1.4	0.3	−0.5	1.2	9.5	8.4	7.6	7.1
Turkey	4.2	2.9	3.5	3.7	7.6	8.8	8.8	8.2	8.9	10.2	10.2	10.3
Russia	1.4	0.6	−3.4	−0.1	6.7	7.9	14.6	7.1	5.5	5.2	5.5	5.4
China	7.7	7.6	6.7	7.0	0.0	−0.6	0.1	2.4	3.9	3.8	3.8	3.8
India	6.4	7.3	6.4	6.2	6.8	4.1	4.3	6.1	–	–	–	–
Brazil	2.7	0.2	−0.1	1.2	6.2	6.3	7.0	5.0	5.4	4.9	5.3	5.1
Mexico	1.7	2.1	3.2	3.6	3.8	4.0	2.8	3.2	4.9	4.8	4.7	4.8
Advanced Economies	1.5	1.8	1.9	2.4	1.3	1.4	0.1	1.4	7.9	7.0	6.5	6.1
Emerging Markets	5.5	5.4	4.6	5.2	2.9	2.4	3.4	4.1	4.9	4.8	4.8	4.8
World	3.7	3.8	3.5	4.0	2.2	2.0	2.0	3.0	6.2	5.8	5.5	5.3

Source: National statistical offices; DIW Spring projections 2015.

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during the forecast period are expected to follow a moderate upward trend. An increase in real GDP of 0.8 percent is predicted for this year, while next year growth will be around 1.5 percent.

China

China's economic output increased to 1.3 percent in the first quarter, compared to 1.5 and 1.9 percent in the previous two quarters. This lower growth reflects both the transformation from an investment-driven export economy to a consumer and service economy and an economic slowdown. Corporate capital investment will no longer increase at previous growth rates. At the same time, recent growth in consumer spending remained cautious despite high wage increases. Exports have slowed due to the weak demand in industrialized countries and the appreciation of the renminbi, particularly against the euro and yen. Going forward, growth is expected to remain subdued; HSBC's Purchasing Managers' Index (PMI) points to another slight decrease in economic activity in the manufacturing sector. However, expansionary measures, in particular further rate cuts by the People's Bank of China, are likely to prevent flattening growth. Since public debt is already quite high, further fiscal stimulus programs are unlikely. Overall, growth in real GDP is expected to be 6.7 percent this year, probably reaching only seven percent next year.

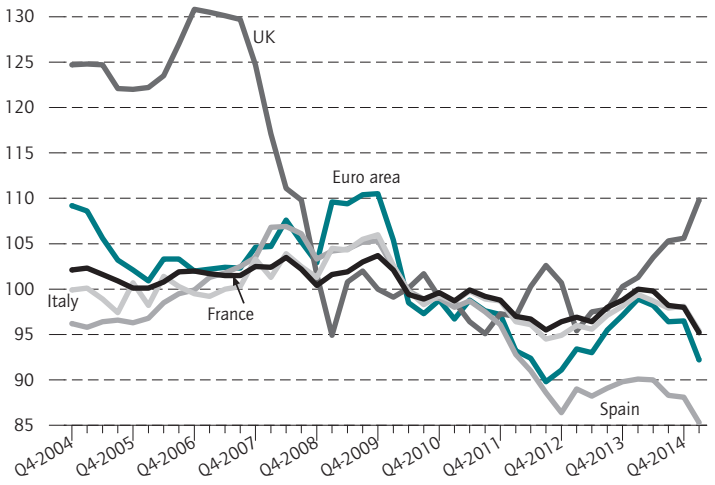
Euro Area

GDP in the euro area grew by 0.4 percent in the first quarter. Consumer spending rose strongly as in previous quarters. There was also surprising investment growth at the beginning of the year. In contrast, export performance was weak despite a markedly devalued exchange rate.

Going forward, consumer spending will support growth. Real disposable income continued to improve due to the sharp decline in energy prices and the continuing recovery in the labor market, resulting in high consumer confidence. The recent dynamic increase in new car registrations and new orders for consumer durables suggests that this additional disposable income is largely being consumed by households. Continued increases in employment can be expected thanks to the recovering economy in Spain and with a certain time lag and

Figure 2

Real Effective Exchange Rate Based on Relative Unit Labour Costs
Index



Source: OECD.

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The decrease in relative unit labour costs implies an improvement in price competitiveness.

at a slower pace, also in Italy; labor market reforms are likely to contribute to this growth.[1]

Price competitiveness, as measured by the real effective exchange rate based on unit labor costs, which has improved considerably since December 2014, is expected to result in stronger exports, albeit with a certain time lag (see Figure 2). This is indicated by export forecasts which have recently improved in the euro area as a whole and particularly in Italy and Spain. Stronger development of foreign markets is expected to provide an additional impetus for exports next year.

The favorable development of domestic and foreign consumer demand is likely to have a positive impact on investment. This is also indicated by the increase in new orders for capital goods. However, this increase will probably be restrained, especially in the short term. Continuing uncertainty from geopolitical tensions and the prospect of a disorderly Greek exit from the euro area are having a negative impact. Furthermore, confidence indicators suggest that the manufacturing industry is not yet convinced that demand will continue to develop more sustainably.

In April, the rate of inflation in the euro area was zero percent, having been consistently negative for several months previously. Inflation is expected to rise slightly during the forecast period. This is mainly because oil prices have stopped falling and import prices are rising due to the depreciating euro. The European Central Bank's monetary policy is still likely to be extremely expansionary during the forecast period. The bond-buying program worth 60 billion euros per month will continue until September 2016. The main refinancing rate ought to remain at 0.05 percent. Fiscal policy will be relatively neutral in both 2015 and 2016.

The euro area's economy is expected to grow by 1.3 percent in the current year and by 1.5 in the coming year.

United Kingdom

Economic growth in the UK is expected to remain robust. Private incomes will develop favorably in real terms, partly due to very low inflation. In addition, the positive situation in the labor market will ensure a high degree of confidence among consumers. In the first quarter, 202,000 more jobs were created than in the previous quarter, unemployment fell to 5.7 percent. Exports, which had a weak start to the year, are likely to recover going forward, partly because demand from the euro area is increasing. Inflation was –0.1 percent in the first quarter. Inflation is likely to climb continuously in the course of the coming year. The Bank of England is not expected to raise its base rate before the first half of 2016, particularly since current production is still well below its potential. Despite favorable conditions, the outlook for investment by domestic and foreign investors remains clouded by the referendum on EU membership. Overall, the UK economy is expected to grow by 2.4 percent this year. Next year, growth is expected to slow somewhat to 2.2 percent.

Central and Eastern Europe

In the first quarter of 2015, the GDPs of most of the Central and Eastern European EU member countries were again stronger than in Western Europe. Domestic demand is robust and exports in many countries were hardly affected by the sanctions against Russia and the Russian import ban on certain agricultural products and foodstuffs. Growth in the populous countries of the region was particularly strong. In Poland, GDP rose by one percent and in Romania by as much as 1.6 percent. Inflation in Central and Eastern European Countries (CEECs) is also low due to low energy and food prices; in Poland and Bulgaria, inflation was actually in negative

1 See OECD, *The 2012 Labour Market Reform in Spain: A Preliminary Assessment* (2013) and K. Orsini and S. V. Núñez, "The impact of the Spanish labor market reform on the on-the-job search rate," *ECFIN Country Focus* (2014).

territory at the end of April. Low inflation should continue to contribute to rising real incomes and, together with the improved situation on the labor market, stimulate consumer spending in most countries.

Monetary policy is expansionary. At the beginning of May 2015, the National Bank of Romania lowered its base rate by one-quarter of a percentage point to 1.75 percent while Hungary lowered its base rate from 1.8 to 1.65 percent at the end of May. The low interest rates are likely to stimulate investment. In terms of foreign trade, the structure of trading partners is likely to shift further. Central and Eastern European currencies have rallied considerably against the ruble which has put a strain on exports to Russia. Since the start of the year, only the Polish złoty and the Hungarian forint have appreciated against the euro. Overall, there will be greater growth in Central and Eastern Europe than in the euro area both this year and next.

Russia

In the first four months of 2015, Russian GDP shrank by 2.4 percent compared to the same period in the previous year. Russian export volume, which are predominantly made up of energy supplies, fell by 25 percent in the face of declining oil prices. Due to the Russian ban on imports of certain agricultural and food products, imports contracted even more sharply by 37 percent in value terms. Investment declined again. Consumer spending is also likely to have been restricted, as indicated by the drop in retail sales. The number of employed persons has fallen only marginally since the beginning of the year and the number of unemployed persons has increased only slightly. In the first four months, however, real wages per employee declined markedly compared to the same period in the previous year. Although inflation has slowed recently, it still reached 16.4 percent in April. Nevertheless, the central bank cut its base interest rate to 12.5 percent in early May. Financing conditions are difficult because of the sanctions. The decline in investment is therefore likely to continue. Consumer spending is also expected to be restricted further, given declining real wages. Imports will remain subdued—assuming sanctions and the Russian import ban remain in place. The Russian economy will shrink considerably this year and is not likely to recover next year either.

German Economy: Strong Domestic Activity

The German economy has continued its recovery. Consumer spending provided the main impetus in the first quarter, but investment also continued to expand (see Figure 3). While this has noticeably boosted imports, exports have developed weakly—despite the much improved price competitiveness of the economy—because the global economy had an unexpectedly weak start to the year. This has placed a burden on industrial production. By contrast, growth was seen in consumer-related service sectors.

In the current and upcoming quarters, exports are expected to step up a gear (see Table 2): In particular, the euro area recovers somewhat even though economic output remains far behind pre-crisis levels in many countries. Investment will benefit from this and will probably expand moderately—supported by continued low interest rates (see Table 3). Yet, uncertainty about the composition of the euro area, sluggish negotiations with the Greek government, the skeptical attitude of the UK to the EU, ongoing tensions with Russia, and the unexpectedly sharp slowdown of the Chinese economy are likely to damp investment growth. In relation to GDP, investment is expected to remain below pre-crisis levels.

Consumer spending is expected to continue to contribute significantly to growth, since jobs are still being created—albeit at a somewhat slower pace. Unemployment is forecast to continue to decline—to 6.4 percent this year and to 6.2 percent in the coming year (see Table 4). Wages are expected to rise a little more in this environment than they have recently. However, as inflation picked up again in the spring, real income is developing weaker than in the winter months, when the fall in oil prices strengthened consumer purchasing power. Inflation is expected to reach 0.6 percent this year and 1.2 percent in the coming year.

The dynamic domestic economy will boost imports, so net foreign trade will only provide modest stimuli. However the nominal surpluses are likely to be considerable due to low import prices attributable to the fall in oil prices; the current account surplus is predicted to remain at just under eight and a half percent in relation to nominal GDP this year and next.

Fiscal policy is relatively expansive in 2015 but is anticipated to be more or less neutral in 2016. Public budgets will continue to develop favorably.[2] The surplus is forecast to be lower than in the previous year, mainly due to higher spending. In relation to nominal GDP, it is expected to reach 0.5 percent in both 2015 and 2016.

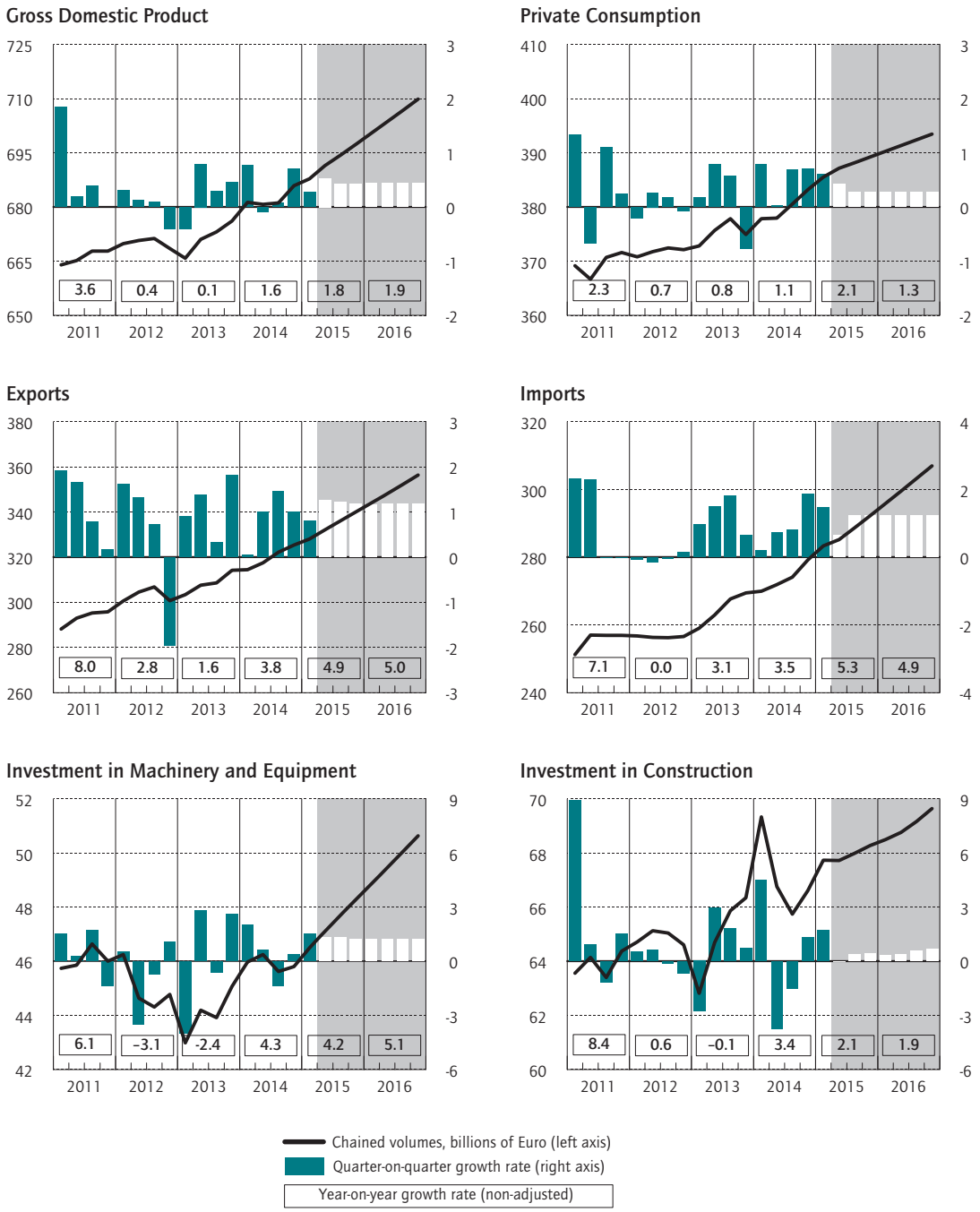
On average, GDP in 2015 is predicted to be 1.8 percent higher than in 2014. Therefore, the forecast for average annual growth is lower than previously expected; in its spring forecast, DIW Berlin had predicted growth of 2.2 percent.[3] The reason for the downward revision

2 See the report on fiscal policy in this week's issue of *DIW Economic Bulletin*.

3 See "DIW Economic Outlook," *DIW Economic Bulletin*, no. 11 (2015).

Figure 3

Gross Domestic Product and Use of GDP
Seasonally and Working Day Adjusted



Sources: Federal Statistical Office; Computations by DIW Berlin, forecasts as of 2015 Q2

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was unexpectedly weak production in the first quarter; development going forward is expected to be about the same as that forecasted in spring. In 2016, economic output is anticipated to rise by 1.9 percent. The output gap is at –0.4 percent on average for the current year and is expected to close at the beginning of next year. On average for the coming year, capacity utilization is likely to be normal.

Table 2

Use of Gross Domestic Product, Quarter-on-quarter Growth Rates
Price, Seasonally and Working-Day Adjusted, in Percent

	2014				2015				2016			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Private consumption	0.8	0.0	0.7	0.7	0.6	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Public consumption	0.0	0.7	0.6	0.3	0.7	0.0	0.2	0.4	0.3	0.3	0.2	0.5
Gross fixed capital formation	3.0	−1.7	−1.2	0.8	1.5	0.5	0.7	0.7	0.6	0.7	0.8	0.8
Investment in machinery and equipment	2.0	0.6	−1.4	0.4	1.5	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Construction investment	4.5	−3.7	−1.5	1.3	1.7	0.0	0.4	0.4	0.3	0.4	0.6	0.7
Other investment	0.8	0.1	0.2	0.2	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Change in inventories[1]	−0.2	−0.1	−0.5	0.4	−0.3	−0.1	0.0	0.0	0.0	0.0	0.0	0.0
Domestic uses	0.9	−0.3	−0.3	1.1	0.5	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Net Exports[1]	−0.1	0.2	0.4	−0.3	−0.2	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Exports	0.1	1.0	1.5	1.0	0.8	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Imports	0.2	0.7	0.8	1.9	1.5	0.6	1.2	1.2	1.2	1.2	1.2	1.2
Gross Domestic Product	**0.8**	**−0.1**	**0.1**	**0.7**	**0.3**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**

1 contribution to gdp growth in percentage points.
Source: Federal Statistical Office; DIW Berlin, Forecast from 2015q2 onward.

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Inflation Expected to Increase Slightly

Consumer prices fell during the winter months. This was primarily due to the drastic slump in crude oil prices which initially affected energy costs such as fuel prices. However, this direct and quantitatively significant dampening effect on inflation has ceased: since the spring, energy prices and consequently consumer prices have resurged again (see Figure 4). Nevertheless, energy prices have remained low. So far, companies are likely to have passed only a small fraction of the associated cost savings on to downstream stages of production and the consumer. However, they will gradually catch up, albeit only partially, such that inflation will be mitigated going forward (see Figure 5).

On the other hand, in the face of strong consumer demand, many providers are trying to pass higher costs on to consumers. The considerable depreciation of the euro will make goods and services with a high import share more expensive this year. In addition, wage increases will be strong. The introduction of a general minimum wage makes its mark on prices in some sectors and regions; overall, the effect will probably not be considerable. Consequently, inflation without energy is likely to reach 1.3 percent this year and 1.1 percent in the coming year.

Overall, inflation is low this year at 0.6 percent because energy prices declined sharply compared to the previous year. Next year, the direct effect of lower energy prices is expected to abate: crude oil futures indicate oil price increases going forward. The inflation rate is then likely to be higher, at 1.2 percent.

Table 3

Assumptions underlying this forecast

		2014	2015	2016
ECB policy rate	Percent	0.16	0.05	0.05
Money market rate	three month EURIBOR in percent	0.2	0.0	0.0
Long-term interest rate	10 year government bond yields, euro area	1.8	1.0	1.3
Long-term interest rate	10 year government bond yields, Germany	1.2	0.6	0.9
Exchange rate	US-Dollar/Euro	1.32	1.11	1.11
Negotiated wages	Percent changes over previous year			
Oil price	US-Dollar/Barrel	99.4	63.4	68.6
Oil price	Euro/Barrel	75.0	57.0	61.7

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Employment Growth Continues

Favorable developments in the labor market are continuing. Employment is rising and the unemployment rate is falling. Labor force potential, which only expanded at a slower pace in the second half of last year, has declined recently. It was noticeable that the domestic labor force

Table 4

Key Economic Indicators for the German Economy

	2011	2012	2013	2014	2015	2016
Real GDP[1] (percent change over previous year)	3.6	0.4	0.1	1.6	1.8	1.9
Domestic employment (1000 persons)	41,570	42,033	42,281	42,638	42,839	43,022
Unemployed (ILO concept)	2,398	2,223	2,182	2,092	1,974	1,914
Unemployed (BA concept)	2,976	2,897	2,950	2,898	2,783	2,719
Unemployment rate[2] (ILO concept)	5.8	5.4	5.2	5.0	4.7	4.5
Unemployment rate[2] (BA concept)	7.1	6.8	6.9	6.7	6.4	6.2
Consumer prices	2.1	2.0	1.5	0.9	0.6	1.2
Unit labor costs[3]	0.4	3.1	2.2	1.6	1.6	1.7
Government budget balance[4]						
in billion EUR	−23.3	2.6	4.2	18.5	14.1	15.8
in percent of GDP	−0.9	0.1	0.1	0.6	0.5	0.5
Current account balance, in percent of GDP	6.1	6.8	6.5	7.6	8.4	8.4

1 Price-adjusted, chain-linked
2 as a share of domestic labor force (ILO), resp. Civilian labor force (BA)
3 compensation of employees (national concept) per hour worked over real GDP
4 according to ESA 2010

Sources: National and international institutions; computations by DIW Berlin 2015 and 2016: DIW forecast

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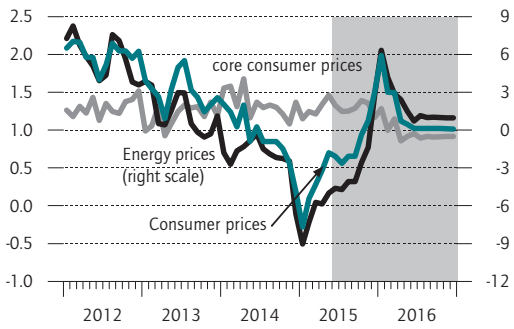
Figure 4

Consumer Price Inflation

Percentage Change over Previous Year



Source: Federal Statistical Office, own calculations.

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Consumer price inflation picks up slowly after energy driven CPI contraction at the onset of 2015

declined, not least because of the program allowing individuals to retire at 63 under certain conditions *(Rente mit 63)*. The inflow of workers from the EU, however, has continued to increase, albeit to a lesser degree.[4] The swelling influx of asylum seekers since mid-2013 means that—after completing the recognition procedure which lasts several months—there is now a growing number of refugees gradually entering the labor market.

A structural shift has continued in the labor force. While the number of employees continued to rise, the number of self-employed has fallen (see Table 5). Given the favorable situation in the labor market, dependent employment is apparently preferred to self-employment which, for the corresponding persons, is often associated with a low and unreliable income. For employees in particular, there is an increasing number of jobs subject to social insurance, while the number of what are known as "mini-jobs" (salary up to 450 euros per month) has declined considerably since last fall. This is probably a consequence of the introduction of the general minimum wage, which has reduced the attractiveness of mini-jobs. It is likely that some mini-jobs have been replaced by jobs subject to social insurance. To what extent the establishment of a wage floor has led to a downturn in employment cannot be estimated based on the data currently available; there has not, however, been a substantial slump in employment.

This year, employment growth is likely to continue (see Figure 6), albeit at a somewhat slower pace. This will be enough to reduce unemployment further, although the potential labor force is likely to increase again slightly, mainly due to migration. The development of the labor market is expected to follow a similar course in 2016,

4 See Federal Employment Agency, Statistics, "Hintergrundinformation. Auswirkungen der Arbeitnehmerfreizügigkeit und der EU-Schuldenkrise auf den deutschen Arbeitsmarkt," reporting month: March 2015 (Nuremberg: May 2015).

with employment growth expected to gain momentum slightly. The number of hours worked per employee is likely to increase somewhat—also because mini-jobs continue to become less important; involuntary part-time work is also likely to decline further due to the favorable employment situation.

Despite the introduction of the general minimum wage, the overall wage increase has only been moderate recently. This is because the rise in negotiated wages has recently slowed. However, given the continuing gains in employment and recent wage tariff settlements, wage increases are likely to pick up again in the current year. Wage growth will continue at a somewhat accelerated pace next year.

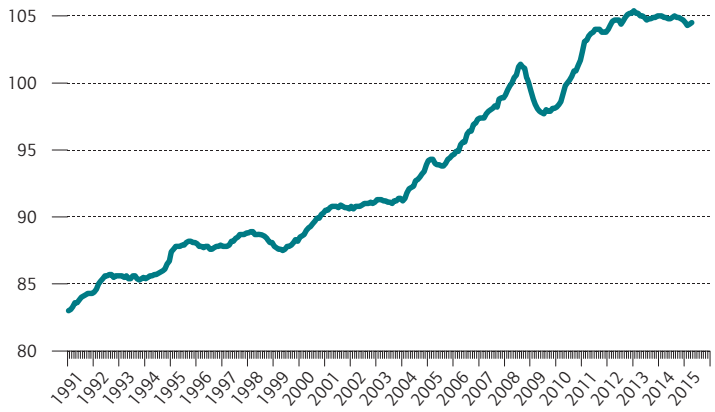
Consumer Spending Supports Growth

Household spending has grown sharply in recent quarters. Consumer spending will steadily increase, albeit at lower rates. Most recently, some special effects became noticeable. The higher payments associated with pension expansion from the middle of last year were predominantly not settled until the winter months and resulted in subsequent payments. More significantly, lower energy prices in the winter months led to increased purchasing power.

Even without these effects, consumer spending will continue to grow considerably—this is also indicated by a positive mood among consumers and encouraging assessments of the situation by retailers. Inflation will only increase slightly and is not likely to markedly dampen strong gains in nominal income. In particular, the wage bill is expected to climb steeply: employment is set to continue to expand and wages to increase noticeably, partly because of the minimum wage. Due to the greater increase in wage taxes, related to tax progression, net growth is lower but still strong. Monetary social benefits have also risen noticeably, although there are fewer payments to the unemployed due to the favorable employment situation. Child benefit and in particular pensions are forecast to increase considerably in both years. The increase this year is because of the increase in the insurance payments for raising children *(Mütterrente)* and the "Retirement at 63" *(Rente mit 63)* program for the first time coming into force for the full year; in the coming year, it is because the regular pension adjustment will be substantial. In addition, households' corporate earnings and unearned income are expected to rise. Overall, nominal disposable incomes are forecast to increase by 2.6 and 2.4 percent, considerably more than inflation. In the course of a slight decline in the savings rate—households are likely to spend a share of their energy-price-related savings in the current quarter—consumer spending is predicted to grow vigorous-

Figure 5

Producer Prices, Seasonally Adjusted
Index (2010 = 100)



Source: Federal Statistical Office, own calculations.

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Producer prices are stagnating and have been even downward trending recently

Table 5

Labour Market Performance
Millions

	2012	2013	2014	2015	2016
Persons in employment (domestic concept)	**42.03**	**42.28**	**42.64**	**42.84**	**43.02**
Self employed	4.54	4.46	4.40	4.33	4.32
Employees subject to social security contributions	29.36	29.73	30.22	30.74	31.09
Public officers, judges, military personel	1.89	1.89	1.90	1.91	1.91
Mini jobbers (without persons with a second job)	4.98	5.02	5.03	4.84	4.69
Others	1.26	1.19	1.09	1.02	1.01
+/− Commuters, employed persons in foreign state institutions in Germany or in foreign states	−0.05	−0.06	−0.05	−0.06	−0.06
Persons in employment (national concept)	**41.98**	**42.23**	**42.58**	**42.78**	**42.96**
Unemployed (ILO concept)	**2.22**	**2.18**	**2.11**	**1.97**	**1.91**
Active population	**44.20**	**44.41**	**44.70**	**44.75**	**44.88**
Unemployed (Federal Labour Office (BA) concept)	2.90	2.95	2.90	2.78	2.72
Unemployment rate (BA concept[1]) – in %	6.8	6.9	6.7	6.4	6.2
Unemployment rate (SGB concept[2]) – in %	9.0	9.0	8.8	8.7	8.4
Unemployment (NSA concept[3]) – in %	5.0	4.9	4.7	4.4	4.3
Unemployment rate (ILO concept) – in %	5.4	5.2	5.0	4.7	4.5
Employed persons (domestic concept – ILO)	39.02	39.41	39.74	40.02	40.19

1 Unemployed persons, registered at the federal labour office, in relation to civil active population.
2 Unemployed persons in relation to unemployed plus employed persons subject to social insurance contribution.
3 Unemployed persons, ILO concept, in relation to unemployed (ILO) plus persons in employment (national concept).

Sources: Federal Statistical Office; Federal Labour Office; DIW calculations and estimations.

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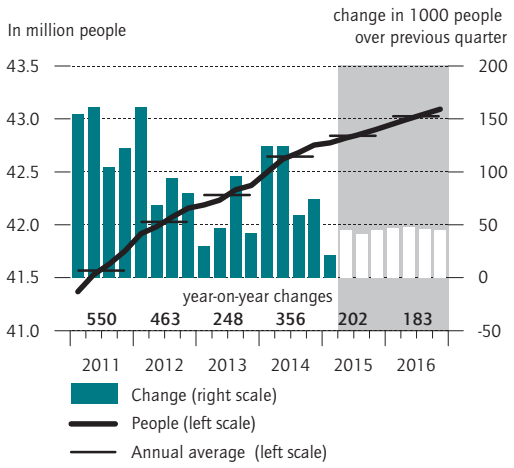
Figure 6

Work Force



Source: Federal Statistical Office, own calculations.

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work force growth recovers after setback at the onset of 2015.

ly. In 2015, the annual average increase will be high because the temporary energy price declines strengthen purchasing power. Overall, consumer spending will remain the driver of the German economy.

Investment Expanding Moderately

Companies have considerably expanded their investment in machinery equipment recently. This was supported by the positive outlook for German exporters due to the euro area, the most important foreign market, currently recovering strongly. In addition to the already favorable external financing conditions, internal financing options for German companies are outstanding overall, also boosted more recently by low costs due to oil prices.

However, this does not necessarily indicate strong growth: sales and new orders of domestic capital goods are following a weak upward trend, albeit with considerable fluctuations, and capacity utilization in the manufacturing sector is only slightly above the long-term average. Despite recently declining, uncertainty remains high: Tough negotiations with the Greek government and EU skepticism in the UK are stoking fears of unfavorable developments in the Economic and Monetary Union (EMU), the political relationship with Russia remains tense, and the economic impact of economic reforms in China is unpredictable.

Construction investment overall remains on an upward trend (see Table 6). With weather conditions prompting a strong start to the year, the traditional spring revival is likely to be weaker; construction investment will probably stagnate in the second quarter. However, conditions remain favorable, particularly for housing construction. Positive income developments for households and the labor market situation would indicate that currently favorable conditions for construction loans will continue to be used to expand investment in housing construction. However, this upward trend will probably tail off. Interest rates on housing construction loans have risen slightly since April, and returns on mortgage debentures suggest the rise in interest rates will accelerate further in the coming months.[5] In addition, the upward trend of building permits has levelled off since mid-2013. Commercial prospects for housing construction have also deteriorated. In commercial construction, the momentum is likely to be reserved after a strong start to the year. Government investment in construction, however, is benefiting from the favorable financial situation of public finances, also at municipal level. Nevertheless, it will not gain momentum until the end of 2015 when additional investment is implemented—initially in nursery construction and then increasingly as part of the planned increase in infrastructure investment.

Table 6

Investment in Construction
Constant Prices, Percentage Changes

	2014	2012	2013	2014	2015	2016
	shares	year-on-year changes				
residential construction	59.3	3.3	0.6	3.8	1.9	1.8
non-residential construction	40.7	−2.9	−1.0	2.7	2.4	2.2
commercial construction	28.7	−0.9	−2.1	2.2	3.4	1.5
public construction	12.0	−7.7	1.6	3.9	0.0	4.1
total construction	100.0	0.6	−0.1	3.4	2.1	1.9

Source: Federal Statistical Office, own calculations.

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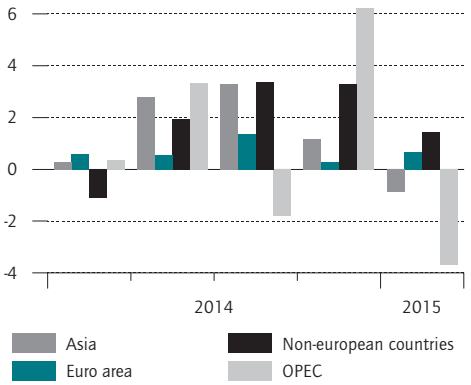
Euro Area Recovery and Depreciation Bolster Exports

German exports have only risen slightly in the wake of weak developments in the global economy at the beginning of the year. Exports to Asia, particularly to China, and those to OPEC countries suffering from revenue

5 Mortgage debentures are used to refinance construction loans and are therefore a reliable indicator of the development of interest rates on housing loans. They have a lead time of around two months. The current changes in returns on mortgage debentures indicate stronger increases in interest rates on home loans will follow in the summer months.

Figure 7

German Exports by Region
Quarter-on-quarter Changes in Percent



Source: Bundesbank, own calculations.

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Exports to euro area countries increased, but exports to the non-European countries rose more.

losses from crude oil business have actually declined (see Figure 7). Important early indicators, such as export expectations or recent sluggish imports of intermediate goods, suggest that developments in the emerging markets will also be somewhat subdued in the current quarter. Overall, exports should grow more rapidly than in the first quarter since the global economy is gaining some momentum and the euro area, the most important German sales market, is currently developing well; this is also suggested by goods exports, which expanded substantially in April. There has also been considerable improvement in price competitiveness, which should result in additional demand with some delay.

Imports grew sharply in the first quarter. In addition to increased imports of investment goods, which are likely to have benefited from the recovery in equipment investment, there was also an increase in goods imports that have seen rising consumer demand in the wake of substantial consumer spending growth. The rise in consumer spending is not expected to be quite as dynamic going forward, but imports are likely to continue to benefit from the strong domestic economy, even if imports in April suggest weak import activity for the second quarter after the strong start to the year.

On balance, foreign trade is likely to provide the economy with a tangible stimulus for growth in the current quarter. The considerable improvement in price competitiveness is expected to give exports a temporary boost. Going forward, export growth is likely to be offset by more dynamic imports and, as a result, net exports will only be slightly positive.

Oil prices slumped massively in the first quarter, but part of this decline was offset in the second quarter. Accordingly, import prices have developed positively. Oil prices are expected to continue to rise over the forecast period, leading to import prices increasing toward the end of the period. The higher cost of imports will, in part, be passed on so export prices will probably climb slightly. Due to the sharp decline in import prices in the first quarter, the terms of trade will improve markedly this year, by around two percent. They will then deteriorate again somewhat in the coming year. The current account is expected to swell to almost eight and a half percent in relation to nominal GDP this year; low import prices in particular will contribute to this increase. Next year, the current account balance will remain at this level. Although the oil price effect will be gone, foreign trade will contribute more to growth than it did in the current year.

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