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German economy on a stable growth path

By Ferdinand Fichtner, Karl Brenke, Marius Clemens, Simon Junker, Claus Michelsen, Maximilian Podstawski, Thore Schlaak and Kristina van Deuverden

Supported by dynamic domestic demand, the German economy is expected to grow by 1.7 percent this year. As consumption and investment in construction are likely to weaken in the coming year, is hardly contributing to growth 2017 should amount to roughly 1.4 percent. Foreign trade is contributing relatively little to growth. In both years of the forecast period, capacities will be at more or less normal levels of utilization; there are no signs of overheating. In the medium term, however, stronger investment in the capital stock is necessary to increase the growth potential of the German economy.

Supported by strong domestic demand, the German economy's moderate growth trend continues. Exports are also recovering (Table 1), but since imports are growing at somewhat higher rates, foreign trade contributes hardly to growth.

Consumption is expanding favorably due to developments in the labor market (Figure 1), though the pace is slowing due to the slightly lower employment growth and the fact that the once-again increasing energy prices are dampening real income. Unlike previously assumed, 2016 has seen far fewer refugees migrating to Germany. Additional demand stimulus—which will initially come from government expenditure on accommodation, care, and integration, and later, increasingly, from refugees' consumption—is likely to be lower next year than in the current year.

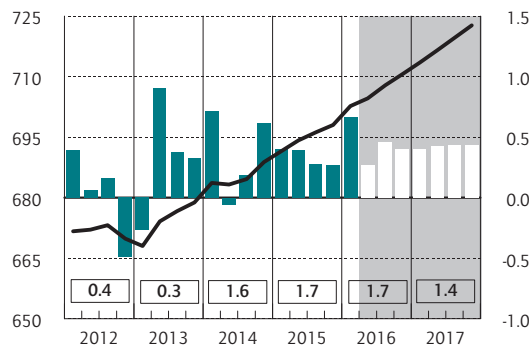
Exports have been recovering recently, and are expected to create noticeable and positive impulses over the forecast period. However, these will be significantly smaller compared to previous years; here, the structural growth slowdown in some key markets is taking its toll. This is expected to dampen investment spending, especially in industry. By contrast, service providers will probably be investing more dynamically in new equipment. On balance, equipment investment growth remains subdued, partly due to the uncertainty facing the economic development of key sales markets and concerns about the future cohesion of the EU. Construction investment continues to pick up momentum—especially in residential properties, which are still serving as forms of investment. In the coming year, however, public construction will stagnate.

Given the dynamic domestic demand, imports are experiencing stronger growth than are exports: on balance and compared with the annual average of the previous year, foreign trade will actually have a slight dampening effect on economic growth in 2016. In the upcoming quarters, foreign trade will hardly contribute to growth.

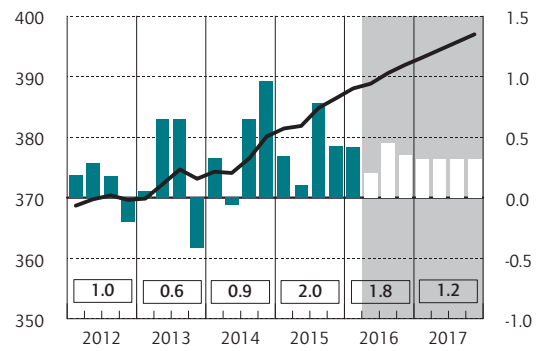
Figure 1

Gross domestic product and use of GDP
Seasonally and working day adjusted

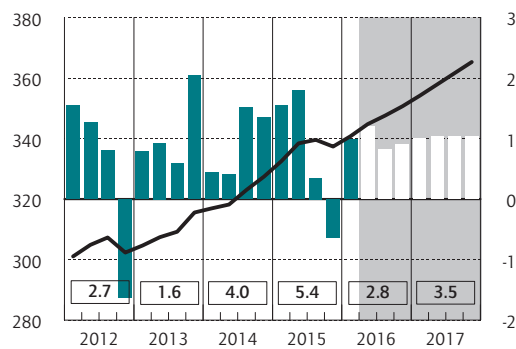
Gross domestic product



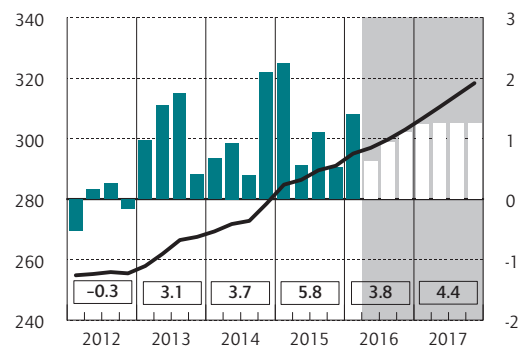
Private consumption



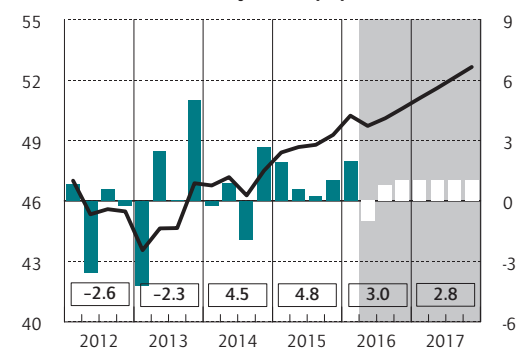
Exports



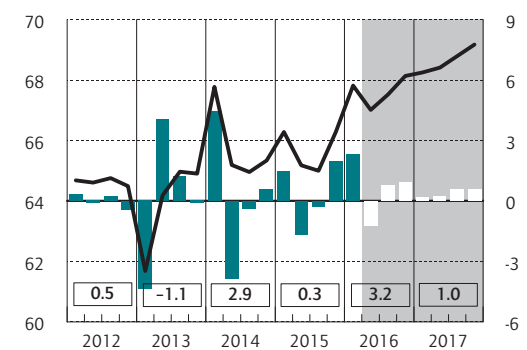
Imports



Investment in machinery and equipment



Investment in construction



— Chained volumes, billions of Euro (left axis)
 ■ Quarter-on-quarter growth rate (right axis)
 □ Year-on-year growth rate (non-adjusted)

Sources: Federal Statistical Office; computations by DIW Berlin, forecasts as of 2016 Q2.

Table 1

Use of gross domestic product, quarter-on-quarter growth rates

Price, seasonally and working-day adjusted, in percent

	2015				2016				2017			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Private consumption	0.3	0.1	0.8	0.4	0.4	0.2	0.5	0.4	0.3	0.3	0.3	0.3
Public consumption	0.7	0.7	0.7	0.9	0.5	0.8	0.3	0.3	0.7	0.7	0.5	0.6
Gross fixed capital formation	1.4	-0.5	0.1	1.4	1.8	-0.8	0.7	0.9	0.5	0.5	0.7	0.7
Investment in machinery and equipment	1.9	0.6	0.2	1.0	1.9	-1.0	0.8	1.0	1.0	1.0	1.0	1.0
Construction investment	1.4	-1.7	-0.3	2.0	2.3	-1.2	0.8	0.9	0.2	0.2	0.6	0.6
Other investment	0.7	0.6	0.7	0.7	0.2	0.7	0.7	0.6	0.6	0.6	0.6	0.6
Change in inventories ¹	-0.1	-0.3	0.0	0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Domestic uses	0.6	-0.2	0.6	0.9	0.8	0.0	0.5	0.4	0.4	0.5	0.5	0.5
Net Exports ¹	-0.2	0.6	-0.3	-0.5	-0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Exports	1.5	1.8	0.3	-0.6	1.0	1.2	0.8	0.9	1.0	1.0	1.0	1.0
Imports	2.2	0.6	1.1	0.5	1.4	0.6	0.9	1.1	1.2	1.3	1.3	1.3
Gross Domestic Product	0.4	0.4	0.3	0.3	0.7	0.3	0.5	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 2016 Q2 onward.

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Table 2

Key economic indicators for the German economy

	2012	2013	2014	2015	2016	2017
Real GDP ¹ (percent change over previous year)	0.4	0.3	1.6	1.7	1.7	1.4
Domestic employment (1,000 persons)	42,060	42,328	42,703	43,056	43,582	43,958
Unemployed (ILO concept)	2,223	2,182	2,092	1,949	1,762	1,730
Unemployed (BA concept)	2,897	2,950	2,898	2,795	2,692	2,657
Unemployment rate ² (ILO concept)	5.4	5.2	5.0	4.6	4.1	4.0
Unemployment rate ² (BA concept)	6.8	6.9	6.7	6.4	6.1	6.0
Consumer prices	2.0	1.5	0.9	0.2	0.6	1.5
Unit labor costs ³	3.1	2.0	1.6	1.7	1.9	2.4
Government budget balance ⁴						
in billion EUR	-2.4	-3.1	8.9	19.6	20.0	16.6
in percent of GDP	-0.1	-0.1	0.3	0.6	0.6	0.5
Current account balance, in percent of GDP	7.0	6.8	7.3	8.5	8.9	8.9

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; 2016 and 2017: DIW forecast.

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The surplus in the current account, at just under 9 percent (Table 2), will be substantial in both years of the forecast period. This is also due to the fact that imports are significantly cheaper this year than they were last year as a result of the massive oil price slump in winter 2015–2016.

All in all, the German economy is expected to grow by 1.7 this year, which is actually one-tenth of a percentage point higher than what DIW Berlin predicted in its spring forecast and is due to the surprisingly strong start of the

year.¹ Next year, growth should amount to 1.4 percent. Compared to the current year, there are fewer workdays in 2017; without this calendar effect, growth would be at 1.7 percent for both years. German capacities will be utilized almost normally in both years. There are no signs of overheating: private consumption is weakening somewhat and the uptrend in equipment investment is only

¹ See Fichtner et al. (2016): German Economy Back on Track, Despite Weak Global Economy, DIW Wochenbericht, no. 11.

moderate. Stronger investment in the capital stock—both private and public—as well as incentives to increase labor market participation would lead to a more dynamic economic development in the medium term.

Despite still-significant financial burdens on the public sector due to the refugee migration—11.8 billion euros this year and 12.8 billion euros next year—the public budget will end both years with surpluses.² In relation to nominal GDP, this amounts to 0.6 percent this year and 0.5 percent next year.

The current forecast is complicated by uncertainties related to refugee migration: for example, the number of asylum-seekers who come to Germany could deviate significantly from the assumptions put forth in the forecast.³ Secondly, a stronger-than-expected slowdown in the Chinese economy would put a considerable burden on German exporters, as well as dampening domestic investment. It is also unclear how a Brexit would affect the German economy.⁴

Moderate increases in inflation

The development of consumer prices is influenced by the dynamics of oil prices, and this year's average annual inflation rate was thus dampened by the drop in energy prices at the end of 2015/beginning of 2016. Since the spring, oil prices and thus the energy prices have been rising and recently, this increase has even been accelerating; in the current quarter, this is likely to noticeably increase inflation, resulting in a rate of 0.6 for 2016. Next year, oil prices are assumed to increase (Table 3). Primarily due to this, inflation is expected to be higher next year, at just over 1.5 percent. This year's core rate stands at 1.3 percent; this corresponds roughly to the annual growth of the past five years. In the coming year it is expected to be slightly higher—at 1.4 percent—in view of a dynamic domestic economy (Figure 2).

Employment growth continues at a somewhat slower pace

The number of employees is still increasing markedly at the same time, the influx of migrants to Germany has increased the potential labor force. The most notable group taking up work in Germany is made up of immigrants from other EU countries—refugees are accounting for

² See van Deuverden, K. (2016): *Finanzpolitik: Haushaltsspielräume gehen zurück, sind aber größer als zuletzt erwartet*, DIW Wochenbericht, no. 24/25.

³ For the forecast, it was assumed that the number of asylum-seekers counted in the initial registration process would be 310,000 this year and 230,000 next year.

⁴ For more on the potential effects of a Brexit, see Fichtner, F. et al. (2016): *Global growth still subdued*, DIW Economic Bulletin, no. 24/25.

Table 3

Assumptions underlying this forecast

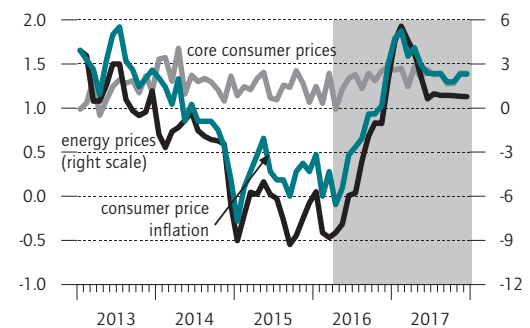
		2015	2016	2017
ECB policy rate	Percent	0.1	0.0	0.0
Money market rate	three month EURIBOR in percent	0.0	-0.2	-0.2
Long-term interest rate	10 year government bond yields, euro area	1.0	0.8	1.0
Long-term interest rate	10 year government bond yields, Germany	0.5	0.3	0.5
Exchange rate	US-Dollar/Euro	1.11	1.13	1.14
Negotiated wages	Percent changes over previous year	2.4	2.3	2.1
Oil price	US-Dollar/Barrel	53.1	45.4	50.7
Oil price	Euro/Barrel	47.8	40.2	44.6

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Figure 2

Consumer price inflation

Percentage change over previous year



Sources: Destatis; DIW Berlin.

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Inflation is dominated by swings in energy prices.

very little of the increase in employees, since they normally will only receive a work permit following a lengthy approval procedure. The number of registered unemployed individuals, however, has barely decreased—were it not for the expansion of labor market policies, particularly those for refugees, this number would have actually increased slightly.

Employment figures will continue their uptrend albeit at a somewhat slower pace (Figure 3). Productivity is gaining momentum; moreover, the actual working hours are increasing slightly. Both trends will continue in the coming year. As well the number of employees subject

to social security contributions will increase substantially, while mini-jobs, which have become less attractive as a result of the statutory minimum wage, will continue to decrease. Self-employment will decrease over the forecast period as well, but only slightly (Table 4). This year, the number of employees will exceed that of the previous year by 530,000; in 2017, this figure will amount to 380,000. The number of registered unemployed individuals will be less by 100,000 this year, and by roughly 30,000 next year. Given the solid development of employment and contrary to earlier forecasts, the influx of refugees does not result in an increase in unemployment. Firstly, the number of refugees migrating to Germany has dropped sharply since the beginning of spring, and secondly, it is expected that many recognized refugees will be accommodated by labor market policies, particular when it comes to qualification.⁵

Wage increases accelerated at the beginning of the year, even though the opposite was expected following the collective agreements. As it is usually the case in the first quarter, paid performance bonuses from the past year likely factored into this to a considerable extent. The wage drift is therefore likely to decrease over the summer, and the strong wage growth should lose some momentum. At the beginning of next year, wage increases will accelerate once again due to the impending rise of the statutory minimum wage.⁶ After this, they will slow down again somewhat as a result of the impending and overall rather moderate negotiated wage increases, which will take effect in 2017. But due to the favorable employment developments, the effective wages are likely to grow faster than those collectively agreed upon.

Consumption is driving growth, but losing momentum

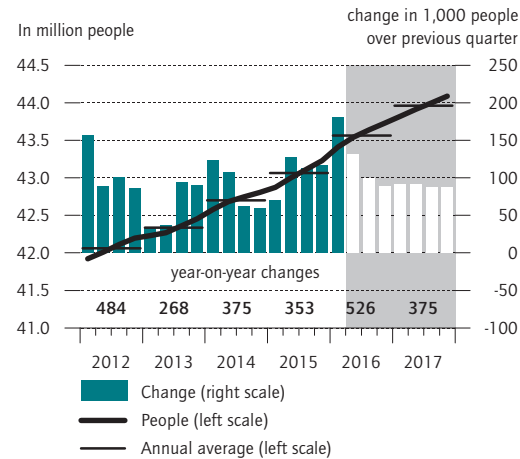
Because it is still benefitting from favorable development in income, particularly with regard to wages, private consumption should continue to grow significantly. It is likely to lose momentum, however, because the low oil prices' effect on purchasing power will start to move in the opposite direction due to the increase in crude oil prices. In the second quarter in particular, this will negatively affect real income, and thus the increase in private consumption will be more moderate in this quarter. A major pension adjustment in the third quarter of 2016 is expected to boost consumption, even though a larger proportion of this additional income is likely to be put into savings.

⁵ The number of completed asylum procedures is expected to amount to 590,000 in 2016, and 600,000 in 2017; protected status will be granted in 63 percent or 67 percent of cases for each year, respectively. However, not all of these people are of employable age, and not all those of employable age will seek employment: the number of employable asylum-seekers will increase by roughly 160,000 this year, and by 200,000 next year.

⁶ Here, a five-percent increase of the minimum wage—to 8.93 euros—is assumed.

Figure 3

Work force



Sources: Federal Statistical Office; DIW Berlin.

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Employment growth continues, albeit at lower rates.

Table 4

Labour market performance

In millions

	2013	2014	2015	2016	2017
Persons in employment (domestic concept)	42.33	42.70	43.06	43.58	43.96
Self employed	4.46	4.40	4.33	4.30	4.28
Employees subject to social security contributions	29.73	30.22	30.86	31.40	31.85
Public officers, judges, military personnel	1.89	1.90	1.91	1.93	1.95
Mini jobbers (without persons with a second job)	5.02	5.03	4.85	4.77	4.67
Others	1.23	1.15	1.11	1.19	1.21
+/- Commuters, employed persons in foreign state	-0.06	-0.06	-0.07	-0.06	-0.06
Persons in employment (national concept)	42.27	42.64	42.99	43.52	43.89
Unemployed (ILO concept)	2.18	2.09	1.95	1.76	1.73
Active population	44.45	44.73	44.94	45.28	45.62
<i>Memorandum item:</i>					
Unemployed (Federal Labour Office (BA) concept)	2.95	2.90	2.79	2.69	2.66
Unemployment rate (BA concept ¹) in percent	6.9	6.7	6.4	6.1	6.0
Unemployment rate (SGB concept ²) in percent	9.0	8.8	8.3	7.9	7.7
Unemployment (NSA concept ³)	4.9	4.7	4.3	3.9	3.8
Unemployment rate (ILO concept) in percent	5.2	5.0	4.6	4.1	4.0
Employed persons (domestic concept - ILO)	39.02	39.41	39.69	39.79	40.01

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; calculations and estimations by DIW Berlin.

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Throughout the entire forecast period, wage income will increase powerfully, by roughly four percent. Next year, however, net growth will be lower, at three percent; this is partly due to the fact that the cumulative social security contribution rate is being raised and the effect of this year's increase in basic allowances, which boosted income in net terms, is fading. Monetary social benefits will increase noticeably—by roughly four percent—in both years; this can be primarily attributed to pension increases in the middle of both years, respectively, as well as transfers to refugees. As in previous years, income from entrepreneurial activities and assets is expected to grow rather modestly, by roughly one percent. Income from self-employment should continue to rise noticeably, but asset income is expected to decline on the balance: while private households are benefiting from favorable credit conditions, the low interest rates mean that their savings will cast off relatively minor yields.

All in all, the disposable income of private households will continue to grow noticeably in 2016 and 2017, at a rate of 2.7 percent. Due to this year's low inflation rate, a strong real growth is materializing, resulting in a 1.8-percent rise in private consumption in the context of an almost unchanged savings rate. Next year, prices will experience a somewhat sharper increase, and private consumption is expected to grow by 1.2 percent.

The positive economic effects on private and public consumption as a result of refugee migration are likely to be lower next year than in the current year. The recording and processing of asylum-seekers in Germany initially involve considerable delays. As a result, the costs of housing and caring for refugees will initially rise—but given the currently much lower influx, these costs should become less and less significant over the course of the forecast period. When the refugees leave the reception centers, they receive more transfers, which stimulates private consumption. After they receive recog-

nition, a number of these refugees will be available to the labor market. Recognition entitles refugees to higher benefits, which further boosts consumption. For the forecast period, it is assumed that the number of refugees in this year and the next will be significantly lower than last year, and also considerably lower than previously assumed. Growth in demand will therefore be somewhat lower next year than this year.

Investment in equipment remains modest

After private companies were clearly holding back with investment activity in the second half of 2015, equipment investment expanded powerfully in the first quarter of 2016: businesses increased their investment at the beginning of the year by nearly three percent. A major impulse came from sales of new vehicles. Government investment, on the other hand, which had sharply increased in the second half of 2015 as a result of major bulk orders, has since experienced a considerable setback. Given the recent decline in domestic sales and orders for capital goods manufacturers, only minor additional investment is expected for the second quarter. In the subsequent quarters, investment in machinery, equipment, and vehicles is expected to increase, but only moderately. This is partly due to weak global economic growth; on the other hand, the ongoing recovery—in contrast to prior recovery periods—is being strengthened by domestic forces, particularly private consumption, which implies lower investment activity in the manufacturing sector. In addition, the production capacities remain at normal levels of utilization, with the result that expansion investment is unlikely to occur to a large extent. Other investment, including R&D, continues to experience growth. Nevertheless, the investment ratio will also be well below its long-term average.

A short pause for construction

After a strong start to the year due to favorable weather conditions, construction activity is not experiencing the usual spring revival in the second quarter, as evidenced by the current development in construction output and new orders. Overall, however, the construction industry is continuing on a path of strong growth. In the second half of the year, all construction sectors are expected to contribute to growth in Germany. Residential construction in particular is still experiencing dynamic development (Table 5), and will continue to increase—especially in metropolitan areas—given the favorable interest rates and high housing demand. This will be driven primarily by new construction, which is evidenced by a sharp and recent increase in the issuance of building permits. The development of investment in existing buildings, however, remains subdued, and in commercial construction, the dynamic will at first be somewhat slow; however,

Table 5

Investment in construction

Constant prices, percentage changes

	2015	2013	2014	2015	2016	2017
	Shares	Year-on-year changes				
Residential construction	59.9	-0.7	3.3	1.6	3.0	1.4
Non-residential construction	40.1	-1.5	2.4	-1.5	3.6	0.3
Commercial construction	28.2	-2.2	2.3	-1.8	2.1	0.3
Public construction	11.9	0.2	2.7	-0.6	6.9	0.1
Total construction	100.0	-1.1	2.9	0.3	3.2	1.0

Sources: Federal Statistical Office; DIW Berlin.

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In particular residential construction is increasing strongly.

there are also signs of a recovery during the forecast period. For example, the number of new constructions of factory and workshop buildings, but also of operational and administrative buildings, has been recently experiencing a considerable increase. Broadband expansion and the rising expenditure on the preservation and maintenance of railway lines will also create impulses. In public construction, which has likely been benefiting from the recent expenditure on refugee accommodation, strong impulses are expected for the second half of 2016. For this, investment resources—such as those from programs for the expansion of childcare services in day cares—are available. It is assumed that such resources will still be used this year. Next year, public construction is likely to plateau in real terms.

Moderate growth trend in exports

German exports have been expanding moderately since the beginning of the year. The stagnating demand from the US and Asia was compensated for by increased deliveries to European countries—especially non-EU countries (Figure 4). Exports have recently started regaining momentum, but even in the current second quarter, the subdued expectations for exports in industry and the volume of new orders are indicating only moderate growth. Exports will likely continue to grow during the forecast period. However, the robust demand from the developed economies—particularly those in Europe—is being offset by a weak performance in the emerging markets. With nearly three percent this year and three and a half percent in the coming year, the growth rates of exports are well below pre-crisis growth rates. These numbers primarily reflect the growth slowdown in key markets, particularly the Chinese economy.

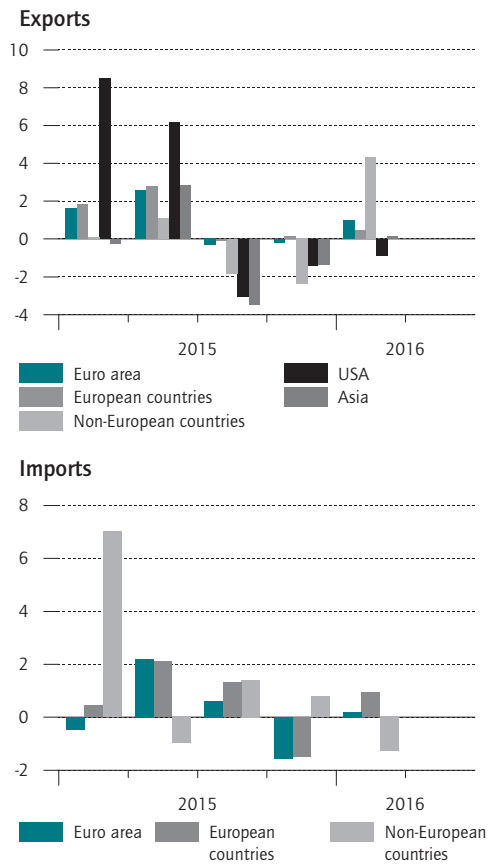
Imports have experienced significantly stronger growth than have exports since the beginning of the year. In the second quarter of 2016, however, somewhat weaker private consumption and decreasing investment are likely to dampen imports. From the middle of this year, the growth of imports, driven by the dynamic domestic economy, is expected to be only slightly above that of exports overall.

After a significant commodity price-related decline in foreign trade prices in the first quarter of this year, both the import and export prices will decline again in the second quarter, but only slightly. Since the decline in import prices is more pronounced than is that of export prices, the terms of trade will improve again somewhat in

Figure 4

Trade by region

Quarter-on-quarter changes in percent



Source: Bundesbank, calculations by DIW Berlin.

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The recent decrease in exports was broad based.

the second quarter of 2016. In subsequent quarters, the sharp increase in oil prices that already began in spring will lead to a rise in import prices. Export prices are increasing too, partly because unit labor costs are rising in the manufacturing sector, and German exporters can pass these price increases on to their customers. Overall, the terms of trade will show considerable improvement in 2016, and slight improvement in 2017. This favorable price development is influencing the fact that the current account balance is expected to rise to nearly nine percent this year, and remain there.

GERMANY

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