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Article

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German economy: upward trend continues despite Brexit vote's dampening effect

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

The German economy has been growing significantly recently, also due to strong foreign trade, and will experience a powerful increase of 1.9 percent in 2016. In the coming quarters, the drag of the Brexit decision should become noticeable. This will dampen the year-on-year growth rate in 2017 to 1.0 percent, alongside somewhat weaker private consumption dynamics. From the second half of 2017 onward, industry will start benefitting once again from a more dynamic development in key foreign markets, and in 2018, the German economy is expected to grow by 1.6 percent. Throughout the forecast period, the increase in employment should continue, and private consumption will contribute to growth—albeit at a somewhat slower pace. The unemployment rate should continue to drop: from 6.1 and 5.9 percent in 2016 and 2017 respectively to 5.8 percent by 2018. At 0.5 percent, inflation is low again this year, but at one-and-a-half percent, it will be higher in both 2017 and 2018. Corporate investment remains weak and won't start picking up momentum until the end of next year, in view of accelerating global growth dynamics. The government surplus is expected to increase to 27 billion euros this year; however, the surplus will be smaller in the coming years, at 14 billion euros in 2017 and 16 billion euros in 2018.

Though the German economy is still following an upward trend, growth will slow down in the coming quarters due to the effects of the Brexit vote. UK-bound exports in particular are expected to be lower as a result (Figure 1). At the turn of 2017–2018, exports are likely to pick up momentum once again due to the gradually improving global and euro-area economies.

Business investment will initially remain weak (Table 1), since the current uncertainty—partially the result of the Brexit vote—is dampening investment. Due to the continuing recovery in the euro area, the robust domestic economy in Germany, the full capacity utilization in industry, and continued favorable financing conditions, investment is likely to grow somewhat, if only moderately. Later on in the forecast period, when the global economy starts to pick up speed, investment should increase with somewhat more momentum.

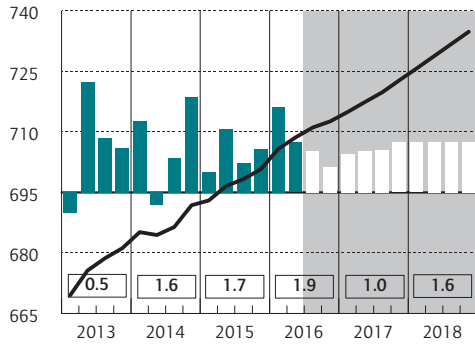
Private consumption will contribute to an increase over the course of the forecast period. The rise in employment will continue, albeit at a slower pace. In the past few quarters, real household incomes benefitted significantly from the drop in energy prices; at the present, however, energy prices are on the rise, which is dampening purchasing power. After only minor price increases this year, inflation is expected to increase over the course of the forecast period and will be somewhat higher in the coming years (Table 2). This is the primary reason why private consumption should lose some momentum.

The government's financial situation remains favorable, and the surplus is expected to rise again this year: to 0.9 percent in relation to nominal GDP. In the next two years, it will amount to 0.5 percent.

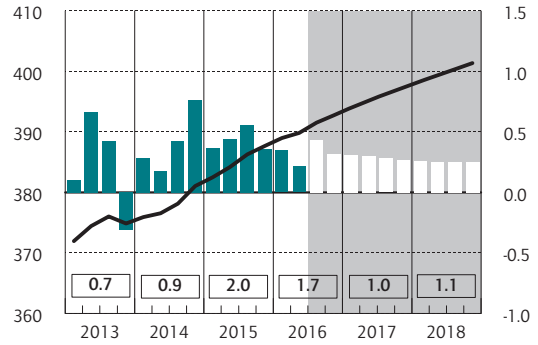
Figure 1

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

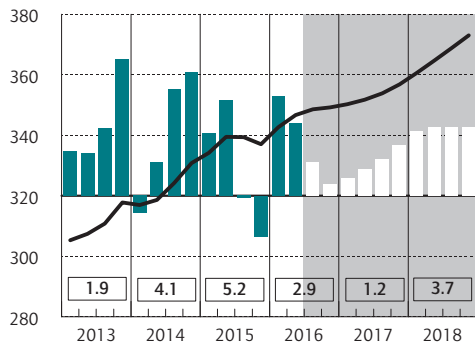
Gross domestic product



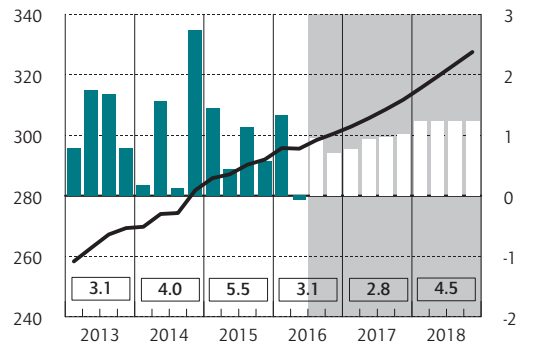
Private consumption



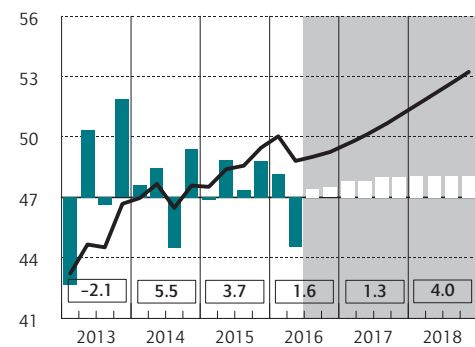
Exports



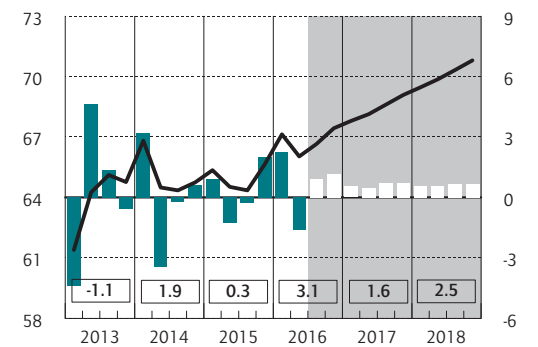
Imports



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 Q3.

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The German economy is expected to grow by 1.9 per cent by the end of 2016, roughly two-tenths higher than what was predicted in the summer forecast. After a revision of the official statistics, production turned out to be higher at the beginning of the year than was previously

reported; moreover, development in the second quarter was slightly stronger than expected.

In 2017, the German economy will probably grow by only 1.0 per cent. However, the fact that 2017 has few-

Table 1

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

price, seasonally and working-day adjusted, in percent

	2016				2017				2018			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Private consumption	0.3	0.2	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Public consumption	1.3	0.6	0.7	0.3	1.2	1.3	0.5	0.5	0.6	0.5	0.5	0.5
Gross fixed capital formation	1.7	-1.5	0.7	0.8	0.6	0.6	0.8	0.8	0.7	0.7	0.8	0.8
Investment in machinery and equipment	1.2	-2.4	0.4	0.5	0.8	0.8	1.0	1.0	1.1	1.1	1.1	1.1
Construction investment	2.3	-1.6	0.9	1.2	0.5	0.5	0.7	0.7	0.6	0.6	0.7	0.7
Other investment	0.9	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Change in inventories ¹	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic uses	0.5	-0.2	0.5	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Net Exports ¹	0.3	0.6	-0.1	-0.2	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0
Exports	1.6	1.2	0.6	0.2	0.3	0.4	0.6	0.8	1.1	1.1	1.1	1.1
Imports	1.3	-0.1	1.0	0.7	0.8	0.9	1.0	1.0	1.2	1.2	1.2	1.2
Gross Domestic Product	0.7	0.4	0.3	0.2	0.3	0.3	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 2016q3 onward.

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Table 2

Key economic indicators for the German economy

	2013	2014	2015	2016	2017	2018
Real GDP ¹ (percent change over previous year)	0.5	1.6	1.7	1.9	1.0	1.6
Domestic employment (1000 persons)	42,328	42,662	43,057	43,576	43,941	44,283
Unemployed (ILO concept)	2,182	2,092	1,949	1,818	1,768	1,708
Unemployed (BA concept)	2,950	2,898	2,795	2,685	2,635	2,586
Unemployment rate ² (ILO concept)	5.2	5.0	4.6	4.3	4.1	4.0
Unemployment rate ² (BA concept)	6.9	6.7	6.4	6.1	5.9	5.8
Consumer prices	1.5	0.9	0.2	0.5	1.6	1.5
Unit labor costs ³	1.8	1.7	1.5	1.4	2.0	1.5
Government budget balance ⁴						
in billion EUR	-5.7	8.1	22.6	27.1	14.6	15.8
in percent of GDP	-0.2	0.3	0.7	0.9	0.5	0.5
Current account balance, in percent of GDP	6.7	7.3	8.4	8.9	8.2	8.1

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.

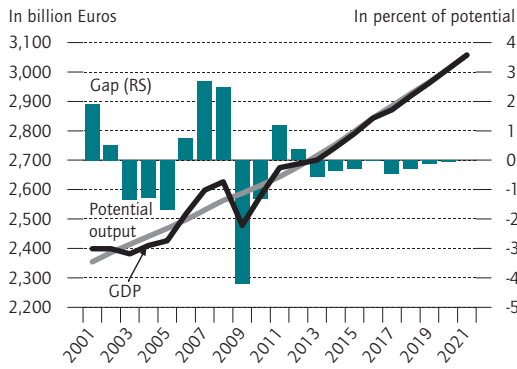
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er working days exerts a drag on the year-on-year comparison of four-tenths of a percentage points. In addition, the Brexit decision will have a strong impact in the coming year, reducing the growth rate by roughly three-tenths of a percentage point. Over the course of

2017, economic development is likely to start picking up the pace again to some degree; this momentum will be maintained in 2018, when economic growth is expected to grow by 1.6 percent. Throughout the forecast period, the economy is expected to be roughly utilizing all

Figure 2

Potential output and GDP



Sources: Federal Statistical Office, Projection by DIW Berlin.

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Normal capacity utilisation during projection period.

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capacities, with no significant negative gap or signs of overheating (Figure 2).

Upside and downside risks for the forecast period originate from assumptions related to the refugee migration. Secondly, the forecast assumes that no post-Brexit trade relations agreement will have been reached with the UK by the end of 2018. However, favorable agreements could reduce Brexit vote-related investment restraint, whereas more decisive moves towards a deterioration of trade relations would mean that companies would adapt to gloomier prospects by dampening investment even more.

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