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**Article**

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# Despite weaker job market, Germany's economic upswing continues

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

In spite of persisting unfavorable external economic conditions, the German economy's upward trend continues, with a growth of 1.2 percent expected for the coming year – slightly less than the 1.8 percent growth rate of 2016, a difference primarily due to the fact that 2017 has fewer workdays. A growth rate of 1.6 percent is expected for 2018. Although employment growth has slowed down somewhat since this past summer, private consumption remains the German economy's primary growth driver – but given the higher inflation, this dynamic will lose momentum in the course of the coming quarters. Exports are picking up in the moderately recovering global economy, and this will be even more noticeable later on in the forecast period. Though investment activity will be somewhat stimulated by the improvement in foreign demand, it will remain rather modest.

The German economy's upward trend persists, with current economic activity slightly exceeding the efficient production capacities. Recently, however, the economic momentum has slowed down (table 1) and is expected to increase only slightly through the end of the year. Growth is expected to amount to 1.8 percent in 2016 and 1.2 percent in 2017 – a discrepancy that is primarily due to the fact that there will be fewer working days next year (table 2). The 2017 growth rate will thus be slightly higher than predicted in the fall forecast, in part because the dampening effects of the Brexit vote appear to be less noticeable, according to current indicators. A growth rate of 1.6 percent is expected for 2018.

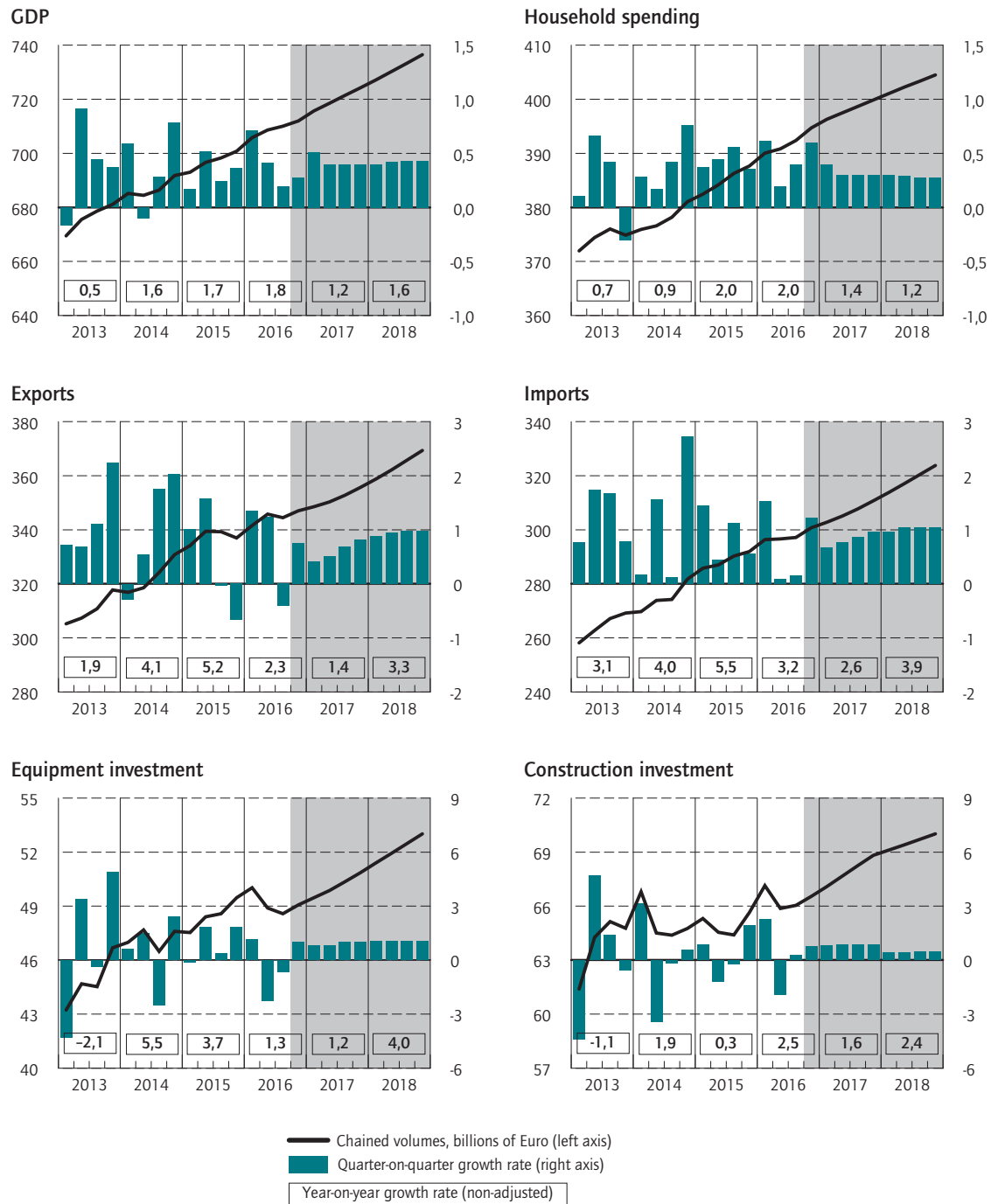
Private consumption will remain the primary growth driver during the forecast period, though it is likely to lose some momentum in the long run (figure 1). Employment growth continues, though it has plateaued somewhat since the summer, and its development over the forecast period is expected to be slower than in previous years. Because the labor force growth is declining as a result of shifting demographics, wages are experiencing sharper increases. The unemployment rate is expected to fall from 6.1 percent this year to 5.9 percent in 2017 and 5.8 percent in 2018. Real income development will be dampened by higher inflation; in fact, inflation is expected to be one percentage point higher – amounting to roughly 1.5 percent – in the next two years than in this year.

Imports should continue to rise, picking up again in the second half of 2017 as a result of rising exports. Imports are consistently developing more dynamically than exports, mainly due to the marked growth in consumption. These are likely to rise only slightly at first, as the weaker foreign demand resulting from the Brexit vote is having a temporary dampening effect. From the middle of 2017 onward, however, exports should benefit from the recovery in the global economy. The current account is likely to conclude 2016 with a surplus of nine percent in relation to the GDP; however, this is also partly due to the substantial drop in this year's oil prices compared

Figure 1

**GDP and use of GDP**

Adjusted for seasonal factors and working days



Sources: Federal Statistical Office; computations by DIW Berlin, forecasts as of Q4 2016.

Table 1

**Constituents of GDP, 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	0.6	0.2	0.4	0.6	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Public consumption	1.1	1.2	1.0	-0.5	1.2	0.9	0.5	0.5	0.4	0.4	0.4	0.4
Gross fixed capital formation	1.6	-1.6	0.0	0.8	0.8	0.8	0.9	0.8	0.7	0.7	0.7	0.7
Investment in machinery and equipment	1.1	-2.3	-0.6	1.0	0.8	0.8	1.0	1.0	1.1	1.1	1.1	1.1
Construction investment	2.3	-1.9	0.3	0.7	0.8	0.9	0.9	0.8	0.4	0.4	0.4	0.4
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 <sup>1</sup>	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic uses	0.7	-0.1	0.5	0.4	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Net Exports <sup>1</sup>	0.0	0.5	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Exports	1.4	1.2	-0.4	0.8	0.4	0.5	0.7	0.8	0.9	0.9	1.0	1.0
Imports	1.5	0.1	0.2	1.2	0.7	0.8	0.9	1.0	1.0	1.0	1.1	1.1
<b>Gross Domestic Product</b>	<b>0.7</b>	<b>0.4</b>	<b>0.2</b>	<b>0.3</b>	<b>0.5</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>

<sup>1</sup> Use of GDP growth in percentage points.

Source: Federal Statistical Office; DIW Berlin, Forecast from 2016 Q4 onward.

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Table 2

**Key economic indicators for the German economy**

	2013	2014	2015	2016	2017	2018
Real GDP <sup>1</sup> (percent change over previous year)	0.5	1.6	1.7	1.8	1.2	1.6
Domestic employment (1,000 persons)	42,328	42,662	43,057	43,497	43,740	44,016
Unemployed (ILO concept)	2,182	2,092	1,949	1,797	1,728	1,655
Unemployed (BA concept)	2,950	2,898	2,795	2,691	2,618	2,566
Unemployment rate <sup>2</sup> (ILO concept)	5.2	5.0	4.6	4.2	4.0	3.8
Unemployment rate <sup>2</sup> (BA concept)	6.9	6.7	6.4	6.1	5.9	5.8
Consumer prices	1.5	0.9	0.2	0.5	1.4	1.5
Unit labor costs <sup>3</sup>	1.8	1.7	1.5	1.4	1.7	1.7
Government budget balance <sup>4</sup>						
in billion EUR	-5.4	8.6	20.9	26.0	4.1	-1.2
in percent of GDP	-0.2	0.3	0.7	0.8	0.1	0.0
Current account balance, in percent of GDP	6.7	7.3	8.3	9.0	8.5	8.4

<sup>1</sup> Price-adjusted, chain-linked.<sup>2</sup> As a share of domestic labor force (ILO), resp. Civilian labor force (BA).<sup>3</sup> Compensation of employees (national concept) per hour worked over real GDP.<sup>4</sup> According to ESA 2010.

Sources: National and international institutions; computations by DIW Berlin; 2016–2018: DIW forecast.

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to last year's average (table 3). Over the next two years, the current account surplus is likely to be roughly half a percentage point lower.

Although business investment has been down throughout the second half of 2016, an upward trend is expected to materialize as a result of the rising exports and increasing capacity utilization in the manufacturing sector. Since the international environment will initially remain characterized by high uncertainty, business investment should experience only modest growth at first

and will only pick up somewhat later on in the forecast period, as the global economy recovers. Unlike business investment, the housing sector continues to show significant growth.

Overall, the German economy continues to develop more or less on its potential path. According to the methods used here, the potential will experience an annual average growth of 1.5 percent per year until 2025, despite the fact that the labor force is likely to shrink in the medium term due to Germany's aging population.

Public budgets will conclude 2016 with a surplus of 26 billion euros, but in 2017, the surplus will decrease significantly. This drop will be due to – among other special factors – the somewhat more subdued employment development that has been taking place since this past summer. In 2018, the public budget is actually expected to show a slight deficit as a result of financial developments in social security systems.<sup>1</sup>

There are a number of risks for the forecast period. Political uncertainty remains high in Europe, partly as a result of the Brexit decision, upcoming parliamentary elections in major EU countries, structural challenges in the banking sector – especially in Italy – and a general tendency toward political disintegration. Furthermore, the new U.S. government may pose a risk to world trade through possible protectionist measures, which can have a particularly negative impact on Germany's open economy.

### Consumer prices on the rise once again

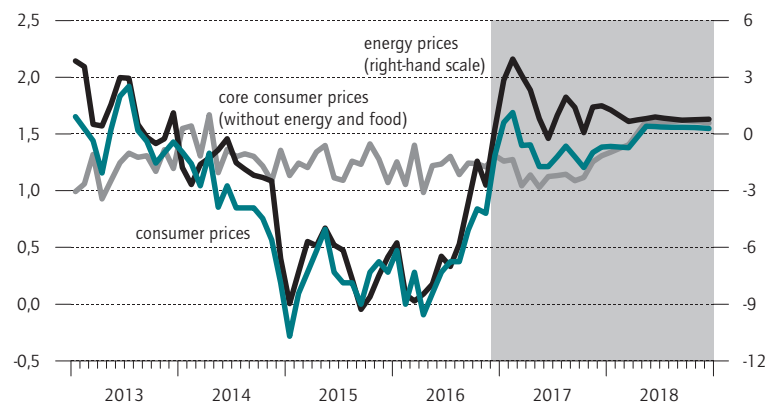
Consumer prices will increase only slightly more than before. Up to now, energy prices have been the primary determinant of the inflation rate: in the current and coming quarters, the high inflation rate is mostly a result of the fact that prices in the winter of 2015–2016 were very low. Added to this is the increase in the Renewable Ener-

<sup>1</sup> Kristina van Deuverden, "Öffentliche Finanzen bis 2025: Nur auf den ersten Blick günstig," DIW Wochenbericht 50 (2016).

Figure 2

### Consumer price inflation

Percentage change over previous year



Sources: Destatis; DIW Berlin.

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Consumer prices are rising again.

Table 3

### Assumptions underlying this forecast

		2016	2017	2018
ECB policy rate	Percent	0.0	0.0	0.0
Money market rate	three month EURIBOR in percent	-0.3	-0.2	-0.1
Long-term interest rate	10 year government bond yields, euro area	0.7	1.0	1.1
Long-term interest rate	10 year government bond yields, Germany	0.1	0.4	0.7
Exchange rate	US-Dollar/Euro	1.11	1.10	1.10
Negotiated wages	Percent changes over previous year	2.1	2.4	2.8
Oil price	US-Dollar/Barrel	44.4	47.6	49.5
Oil price	Euro/Barrel	39.9	43.4	45.2

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gy Sources Act (Erneuerbare-Energien-Gesetz, EEG) re-location charge that will be implemented at the beginning of 2017. In the subsequent quarters, energy price increases will be somewhat lower. On the annual average, energy prices will rise by 1.7 percent in the coming year and by 0.8 percent in the following year, after dropping by an expected 5.6 percent this year.

Despite the favorable economic environment, core inflation in the coming year is expected to amount to 1.2 percent – and thus slightly below the long-term average, since businesses are belatedly passing on to households the energy cost savings resulting from the long period of low energy prices that ended in spring 2016. In 2018, core inflation is expected to increase to 1.5 percent in the context of strong wage growth.

After a rate of 0.5 percent this year, inflation is expected to reach 1.4 percent in the coming year and 1.5 percent in the following year (figure 2).

### Employment growth is losing momentum ...

Since this past summer, employment growth has slowed down somewhat. The potential labor force is also growing at a slower pace, not least due to the fact that Germany's migration gains are weakening in the population exchange with other EU countries. At the same time, more and more migrants related to last year's substantial asylum-seeker influx – which began to subside by the beginning of this year – are being granted asylum and thus obtaining residence and work permits and becoming increasingly active on the labor market. The number of registered unemployed has barely decreased – and without the expansion of labor market policy measures, it would have actually grown.

The moderate employment growth will continue in 2017. It is also becoming clear that as fewer refugees arrive, certain types of work in the social and education sectors will no longer be necessary. From fall 2017 onward, the number of employed persons is expected to increase somewhat more strongly as a result of heightened external demand. Employment growth is being accompanied by a more dynamic development of productivity, since industry is once again picking up some momentum.

Employment subject to social security contributions will continue to grow, while the number of self-employed workers will decline – albeit to a lesser extent. Mini-jobs have lost their attractiveness due to the introduction of the statutory minimum wage. Workers who would have otherwise taken on mini-jobs instead seek out other forms of work – which benefits social security-obligated employment overall.

Immigration has led to an expansion of the working-age population and thus a widening of the potential labor force. An increasing number of newcomers of working age will probably take part in labor market programs,<sup>2</sup> however, which is why the number of officially registered unemployed persons will decline somewhat in both 2017 and 2018.

Wages have recently regained powerful momentum – a consequence of already agreed-on wage increases, particularly in large sections of the industrial sector. This one-time effect is now becoming less significant. Furthermore, the impending increase in the statutory minimum wage will not lead to an overall increase in wages. Currently, the existing tariff agreements do not indicate an acceleration in wage increases – but given the favorable employment development, dependent employees' bargaining positions are likely to improve even more, with the result that the rate of wage increases will pick up from next spring onward. In addition, non-tariff wages are experiencing a powerful increase. Since working hours per employee are decreasing – due to calendar effects, as well – hourly wages will increase faster in 2017 and 2018 than the wages of each employee.

### ... and so is private consumption

Private consumption grew noticeably in recent quarters, primarily due to the intermittent increases in purchasing power resulting from the drop in energy prices. In mid-2016, the strong pension increases boosted household income; this is expected to fuel consumption in the current quarter as well. In the final quarter of 2016,

public consumption will decline as expenses related to the refugee influx subside, with monetary transfers now going straight to the migrants themselves, as many of them have since been granted asylum; this should stimulate private consumption throughout the winter half of the year. Such a scenario is also reflected in the persistent positive outlook among service providers, October's high retail turnover, and positive consumer sentiment. In the long run, however, private household consumption is likely to weaken: not only has employment growth lost momentum, but the rise in prices has and will continue to put a strain on households' purchasing power.

Wages will continue to develop dynamically between 2016 and 2018, although the weaker employment development will dampen their growth in the next two years. From 2018 onward, this will be counteracted by the somewhat higher wages resulting from increased scarcity in the labor market. Net wages are also increasing substantially overall, though slightly less dynamically than gross wages: wage taxes and social contributions are rising noticeably, above all with the increase in the cumulative social insurance contribution rate having a negative impact. Monetary social benefits will continue to expand noticeably; this is also due to the increase in additional transfers being given to recognized refugees. The increase in social benefits will be considerable in 2017, with another significant pension raise planned for the middle of the year – but the main contributor will be this year's pension increase, which will affect the comparison in the first half of 2017. All in all, private households' nominal disposable income will increase steadily over the three years of the forecast period, by roughly 2.5 percent annually. However, due to a higher inflation rate in the next two years – which is likely to grow from half a percent this year to one and a half percent each year – private consumption will experience a lower level of growth.

### Investment in equipment remains subdued

After a strong start to 2016, investment in equipment and machinery was down in the summer half of the year, with both the public and private sectors buying fewer new machines, equipment, and vehicles. Corporate investment is also expected to have been temporarily impaired by the uncertainty surrounding the Brexit referendum and the temporarily gloomy global development prospects.

In the current and coming quarters, the continued moderate underlying dynamic will cause investment activity to pick up momentum, a situation that is indicated by the high level of domestic sales and orders received by producers of capital goods. In the final quarter of 2016, this will be due primarily to increased motor vehicle sales. Currently, there is little evidence of expansion investment

<sup>2</sup> Individuals taking part in labor market education and training, for example, are temporarily unavailable to the labor market and thus not counted as part of the potential labor force.

Table 4

**Investment in construction**

Constant prices, percentage changes

	2015	2014	2015	2016	2017	2018
	Shares	Year-on-year changes				
Residential construction	60.4	2.9	1.5	3.6	2.2	3.1
Non-residential construction	39.6	0.4	-1.4	0.6	0.6	1.2
Commercial construction	28.0	-0.4	-1.8	-0.8	-0.9	2.2
Public construction	11.61	2.4	-0.4	4.0	4.1	-1.1
Total construction	100.0	1.9	0.3	2.5	1.6	2.4

Sources: Federal Statistical Office; DIW Berlin; 2016–2018: DIW forecast.

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**Residential construction drives the building sector.**

in machinery and equipment: according to the order-capacity-index, there is still only a slight order backlog. According to the Ifo Business Survey, manufacturing capacities are being utilized only slightly more heavily than the long-term average. The more favorable export prospects, however, indicate a slight increase in investment; rising exports will expand capacity utilization and spur additional investment. In addition, corporate financing conditions are still quite favorable despite the slight increase in interest rates that recently took place; political uncertainty continues to have a negative impact, however.

**Housing construction remains driving force in construction sector**

After the major weather-related increase in building construction in the winter of 2015–2016, the construction industry lost significant momentum over the summer, with only residential construction retaining the dynamic. Housing construction companies' expectations and assessments are extremely positive, given the well-filled order books and increase in the order dynamic. Basic conditions also remain favorable. Residential property demand remains high – especially in large cities – as a result of the robust labor market and income prospects as well as the influx of immigrants. The slight increase in mortgage rates is actually expected to serve as a stimulus in the short term, leading to a faster implementation of the high number of recently approved construction projects. As a result, housing construction activity will experience powerful expansion in the coming year. In 2018, a lower availability of capacities – among other factors – will contribute to a slight slowdown.

On the other hand, the growth in commercial building construction is likely to remain subdued, increasing only gradually – this is suggested by the fact that the construction project approval process is stalling and there has been a decline in new orders. In construction compa-

nies as well, the business outlook is somewhat less positive than it was just a few months ago. At the same time, business expectations reflect an upward trend and suggest that construction activity will become more dynamic later on in the forecast period. This will also be supported by additional funding from the broadband network expansion program.

In contrast, impulses in public construction have gotten stronger in recent months – and in the current quarter as well, the full order books suggest that a sharp and renewed increase in construction spending is underway. Furthermore, considerably more fiscal resources will be available for new construction projects in the coming year, with expansion in construction activity likely to continue. This is due to both the improving cash flow situation as well as the provision of additional funds for promoting municipal investments. In 2018, however, it will probably no longer be possible to maintain this level (table 4).

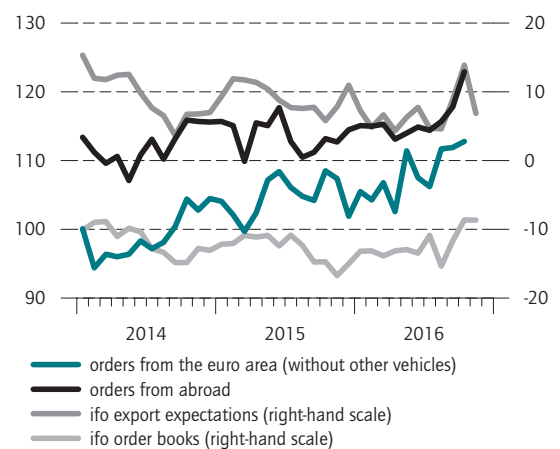
**Weaker foreign trade, initially**

After a sharp increase in the first half of the year, exports declined slightly in the third quarter of 2016. This was primarily due to a lower demand for capital goods, which account for roughly half of all German goods exports. At the same time, exports to countries in the euro

Figure 3

**Short-term foreign trade indicators**

Orders from abroad/from the euro area: Index 2010=100  
Ifo export expectations/order books: net total



Source: Datastream; calculations of DIW Berlin.

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Orders from abroad have shown a clear upwards trend lately, while the Ifo export expectations fell in the past month.



area and Europe's non-EU countries increased, while deliveries to the remaining foreign markets – including, once again, the U.S. – declined. The export figures from October, along with the recent and significant upward trend in incoming orders from abroad (figure 3), suggest a rise in exports for the final quarter. Overall, however, the upward trend will initially be subdued, precisely because demand from Europe is likely to remain modest until mid-2017 due to the Brexit decision as well as political uncertainty in other EU countries. This is also suggested by the recent drop in the Ifo export expectations. Exports are then expected to pick up slowly again in accordance with foreign demand (figure 4) and grow at roughly the same pace in 2018.

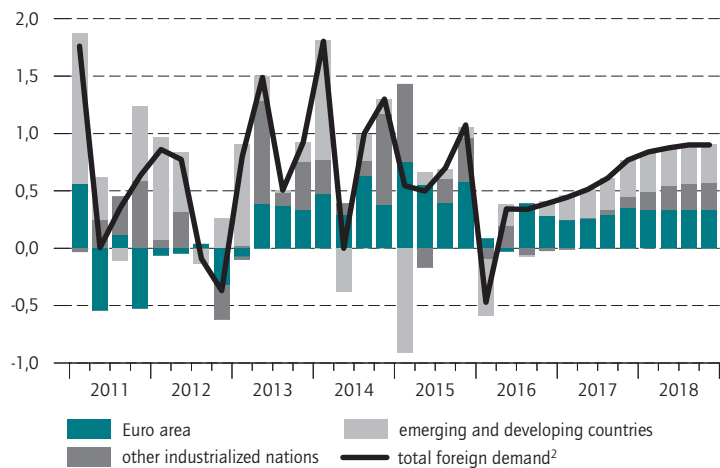
Imports stagnated in the third quarter of 2016: services imports, especially those related to transport and insurance benefits, declined significantly. However, this was easily balanced out by the increase in imported goods: the demand for motor vehicles and parts as well as energy products were robust, while the weak export development stifled the growth of intermediate goods imports. In the fourth quarter, import growth is expected to pick up significant momentum, since the considerable expansion of private consumption is persisting and equipment investment is likely to increase again. In 2017 and 2018, imports are expected to develop more similarly to exports, albeit with a slightly higher expansion rate, partly because of the revitalization of equipment investment. All in all, foreign trade will dampen economic growth by almost two-tenths of a percentage point in 2016 and three-tenths of a percentage point in 2017. In 2018, it will make no contribution to economic growth.

Foreign trade prices rose in the third quarter for the first time in over a year, with increases in commodity prices – especially those of oil and gas, but also steel, among others – the primary contributor to this development. The increase in the price of intermediate goods was accompanied by a rise in export prices, and this development

Figure 4

**Foreign demand<sup>1</sup>**

Contribution of various region of the world to growth



1 Imports of the trade partners, weighted for exports.

2 Change on previous quarter, in percent.

Source: Datastream; calculations of DIW Berlin.

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The Brexit decision is weighing on foreign demand until end-2017.

is expected to continue in the short term. Since both export and import prices have similar dynamics, the terms of trade should change only slightly. Although they are likely to rise substantially in 2016 – by 1.6 percent – this is mostly due to the strong gains at the beginning of the year; in 2017 and 2018, they should remain virtually unchanged. This year's noticeable terms-of-trade profit is contributing to the fact that the current account balance should increase to nine percent in relation to the GDP. In both of the coming years it will be only slightly lower – by just half a percentage point.

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