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**Article**

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# German economy on track

By Ferdinand Fichtner, Guido Baldi, Karl Brenke, Christian Dreger, Hella Engerer, Marcel Fratzscher, Stefan Gebauer, Simon Junker, Claus Michelsen, Malte Rieth and Thore Schlaak, and Kristina van Deuverden

Germany's economic output is now experiencing significant and steady increases for the fourth year in a row—a trend that will also continue throughout the forecast period. DIW Berlin predicts an increase of 1.5 percent for the current year, a figure that is nearly identical to that of the Institute's spring forecast. This year's growth rate will be lower than last year's, a difference that is solely due to 2017 having fewer working days. The German economy is expected to more or less maintain its pace in the coming year as well, with a growth rate of 1.7 percent.

After the economic phase of weakness in the winter 2012/2013, when the European debt crisis caused a decline in the economic output of many countries, the German economy—which suffered indirectly as a result of these recessions—returned to a path of growth. Since then, there has been a gradual increase in overall capacity utilization and a significant drop in unemployment. But the rate of expansion in the initial years of the upswing was noticeably below that of previous phases of economic recovery, and in the time since the production potential was reached in 2015, GDP has been growing with marked stability along the long-term growth path. In a nutshell, the German economy has been growing over the past few years, but not excessively. There are currently no signs of any significant capacity shortages, nor is there any talk of the German economy overheating.

That prices are still only experiencing moderate increases also reflects these conditions. Although inflation will rise significantly this year—to 1.7 percent from last year's 0.5 percent—this is mainly due to the fact that crude oil prices experienced a sharp increase in the final months of 2016, when the OPEC countries were able to agree on sup-

ply cuts. Core inflation, which is influenced to a greater extent by the cyclical utilization of capacities—and thus by the leeway that businesses have to impose price increases—will remain low in this and the coming year, at roughly one-and-a-half percent.

In the context of the growing scarcity in the German labor market—employment numbers will increase by about one million over the course of the forecast period, and the unemployment rate will continue to drop, hitting 5.3 percent in 2018—the wage increases that appear powerful on paper are actually rather low considering the overall positive development. This is connected to comparatively weak collective wage agreements, with some unions prioritizing other issues (such as early retirement schemes) over collective wage increases. Moreover, the large-scale immigration into Germany—both from within Europe and beyond—is probably making it easier for companies to attract employees without having to offer significantly higher wages. In this sense, the persistently high unemployment levels that plague many other European countries are also having an impact on Germany, since it is this lack of employment opportunities elsewhere that is triggering the influx into Germany.

In many parts of Europe, unemployment rates still clearly exceed pre-crisis levels. This also applies to the euro area specifically, where even though a considerable economic recovery has taken place over the past few years—and on a broader scale, as well—unemployment in many countries still exceeds the 2009 rates. This is dampening wage development and—apart from the temporary influences of energy prices fluctuations—will likely also cause the inflation rate in the euro area to remain below the price stability

level defined by the European Central Bank of just under two percent for a longer period of time. From this perspective, demands for the ECB to significantly reduce or even end its expansive monetary policy are premature. However, given the strong economic development in the euro area, it would be appropriate to gradually prepare markets for a normalization of monetary policy, which—as long as the upswing proves to be robust—should be initiated through the reduction of the bond-purchasing programs starting between the end of 2017 and the beginning of 2018.

The threats to economic development in both Germany and Europe as a whole are still significant. Although the elections in France and the Netherlands yielded positive outcomes with regard to the cohesion of the EU—and thus helped avoid a considerable increase in uncertainty that less positive outcomes could have triggered—the ongoing political tensions in Italy, among other issues, still present risks. In addition, drafts of protectionist and isolationist policies are gaining acceptance in the UK and the U.S.; if such measures were to be implemented, the German economy would suffer noticeable losses in growth.

This is a major issue for Germany in particular because its economy is still highly dependent on foreign trade. Although domestic demand has become more important for growth in recent years, the excessively high current ac-

count surplus—which will remain so throughout the forecast period—reflects a weakness in imports, which in turn can be attributed to the fact that private consumption and investment has been only moderate.

It is primarily the weak investment situation that poses a threat to the German economy's longer-term growth, since it inhibits productivity development. Policy is needed here to prepare the German economy for future challenges, such as those resulting from foreseeably unfavorable demographic trends. There is, however, a certain amount of fiscal leeway for this, even if it is not as high as the current surpluses suggest.

A portion of this leeway is only temporary in nature, and this portion can and should be used for public investment, especially in education and infrastructure. Another portion is sustainable in nature, but it is not sufficient for accommodating the strong tax reductions that are being demanded in the current political discussion. Nevertheless, the burden on the production factor labor should decline in order to achieve a higher growth potential in the long term. This can be achieved through an adequate increase in federal subsidies for social security funds—and thus lead to higher net income.



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