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German economy booming but not to the point of overheating

By Ferdinand Fichtner, Dawud Ansari, Guido Baldi, Karl Brenke, Martin Bruns, Marius Clemens, Kristina van Deuverden, Christian Dreger, Hella Engerer, Marcel Fratzscher, Stefan Gebauer, Simon Junker, Claus Michelsen, Malte Rieth, Thore Schlaak, and Aleksandar Zaklan

The German economy continues to boom and the upswing has recently gained breadth. In addition to continuing strong consumer demand on the domestic front, the flourishing global economy is making itself felt in a growing Germany economy. In view of strong exports and abating global risks companies in capital-intensive manufacturing and processing industries are currently investing more. This activity is adding momentum to the upswing.

The German Institute for Economic Research (DIW Berlin) is raising its forecast compared to the fall, partly because the first half of 2017 was more robust than currently documented in the official statistics. The German economy is expected to grow by 2.2 percent this year and next. The growth rate will likely be somewhat lower again in 2019: around 1.6 percent. In September, the growth forecast for this year and next was 1.9 percent; for 2019 the forecast remains unchanged.

The German economy is booming right now. Production is running at high capacity and wages and prices should gradually begin to rise more substantially than recently discernable. But there is no sign of overheating. This year the unemployment rate was 5.7 percent, and it should drop to 5.2 percent by 2019. Despite the exceptionally favorable situation in the labor market wage hikes are only moderate right now. Cost pressure on companies and the prices of manufactured goods and services have virtually remained the same. At 1.7 percent, this year’s inflation rate is significantly higher than it was last year. This is due almost entirely to the fact that energy prices are no longer falling and hence, cost relief from this side has ceased. But even in 2019, the inflation rate is not expected to top the two-percent mark. Thus, there is no wage-price spiral typical of an overheating economy on the horizon.

The persistently high unemployment rate in many European Union member states is partially responsible for this, as migration from other EU countries feeds the increase in employment in Germany. For this reason, the employee negotiating position in collective bargaining rounds has improved only gradually. And energy prices have held down the inflation rates of past years, which probably also contributed to the moderation in wage agreements. Most of them have terms that will not expire until next year and will therefore leave their marks on the wage trend for a longer period.

In the European Union and the euro area the economy is also on an upswing, and production is rising more sharply than potential output. As a result, the euro area is approaching normal capacity utilization as measured by conventional estimation methods. However, unemployment remains high in many countries. Both private and public debt levels are declining in relation to GDP in many places, but they are still at rather high levels. And many bank balance sheets—particularly those in Italy—still harbor risks because a significant volume of loans is at risk of default.

Under these circumstances, the European Central Bank (ECB) would be well advised to tighten monetary policy in a very gradual manner only. It would be premature to commit to a long-term phase out of unconventional monetary policy or future interest rate increases at this time because aside from fluctuations caused by energy prices, the inflation rate should remain lower than the ECB’s inflation tar-
billion euros could result in an increase in the growth rate of up to half a percentage point.

The fiscal margin for maneuver should not be overestimated. Germany’s financing surplus will be 47 billion euros this year and should rise to 54 billion euros by 2019. However, a major portion of the surplus in the public budget is a result of the favorable economic situation—it is not permanent and should not be used for long-term planning. And the public sector is currently benefiting from unusually low interest rates. As monetary policy is normalized, the savings associated with low interest rates will gradually decrease.

Measures targeted at supporting short-term economic growth are not appropriate in the current environment. In view of the current boom, financial policy measures should focus on positively influencing the German economy’s longer-term growth trend. The looming demographic shift is an unfavorable factor that challenges policy makers to make the general conditions for investment in Germany more attractive. As the working age population declines, the remaining labor pool must be able to work more productively. And when there are fewer and fewer working age people in Germany, relatively more people must want to enter the labor market and be as productive as possible. One way to achieve this is reducing the tax and transfer burden on labor. Another appropriate measure could be based on targeted public expenditure with the character of investment—in education-related or infrastructure projects. Companies also need more incentives to invest in Germany’s capital stock.

The external environment continues to pose uncertainty for economic development in Germany. In many respects, the course of economic policy in the USA is still ambiguous, and the plans its government announces are being implemented hesitantly. Should the U.S. terminate trade agreements, German exporters would also feel a negative impact from the resulting constriction in the international flow of goods—a scenario the present forecast does not consider.

The European environment harbors other major risks, although Brexit has not yet seriously weakened the
German economy. In this forecast, we assumed that the economic relationship between the EU and the UK would not change within the forecast horizon: Either the exit process would be canceled, or a follow-up treaty would be concluded that creates a climate for trade and investment similar to that of the EU treaty. If such an agreement proves impossible, Brexit could impair the European and German economies more than assumed here.

And further risks may also arise from the economic situation in the euro area. In the wake of reining in expansionary monetary policy, a faster rise in the interest rate than assumed here could weigh on bank stability in many countries, and thus—in the worst case—reigniting a financial crisis in the euro area. This would noticeably weaken the European and German economies.

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