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Article

Germany's economic boom is cooling off

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AT A GLANCE

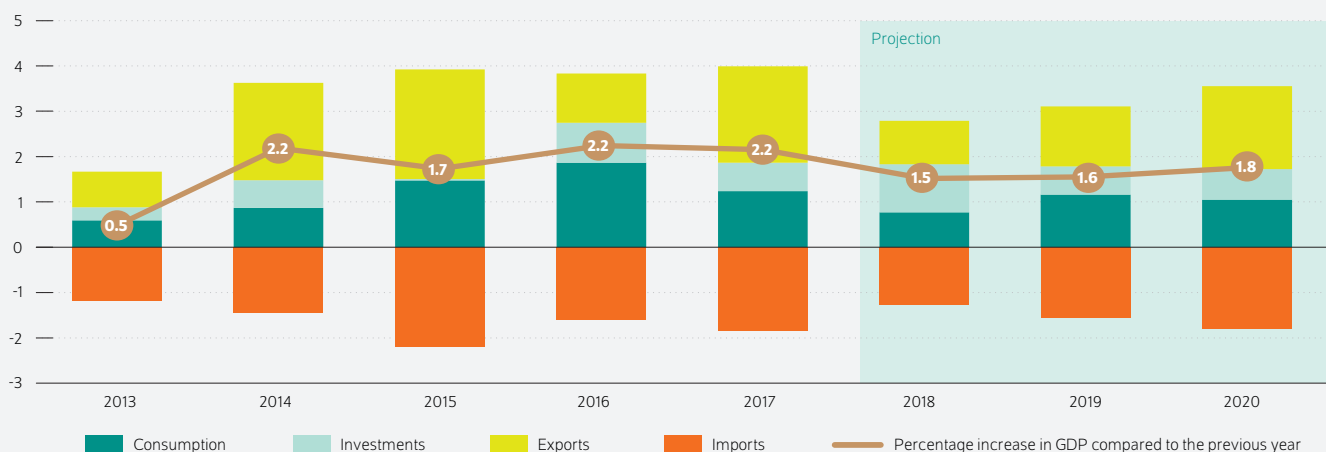
Growth rate of German economy normalizing after prolonged economic boom

By Claus Michelsen et al.

- DIW Berlin is adjusting the growth forecast for the German economy to 1.5 percent for 2018 and 1.6 percent for 2019
- Economic boom ending after years of above-average growth; German economy still performing well
- Temporary problems in the automotive industry have hampered development—but a good situation on the labor market and strong private consumption are supporting economic performance
- Foreign trade continues to perform well although the global economy has passed its peak
- A hard Brexit would hit the export-oriented German economy hard
- Public budgets still have significant (2018: 56 billion euros) but declining surpluses (2020: 38 billion euros)

Stable foreign demand and strong private consumption are supporting the German economy

Contributions to growth of the individual GDP components in percentage points



Source: DIW Economic Outlook Winter 2018

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FROM THE AUTHORS

“The danger of a recession is rather low, as the German economy is keeping a steady pace. Foreign trade is still doing relatively well. Above all, private consumption is being boosted by the measures agreed upon in the coalition agreement, which will take effect in the beginning of 2019—reduced social security contributions being a significant part.”

— Claus Michelsen, Head of Forecasting —

MEDIA



Audio Interview with Claus Michelsen (in German)
www.diw.de/mediathek

Germany's economic boom is cooling off

By Claus Michelsen, Guido Baldi, Christian Breuer, Martin Bruns, Geraldine Dany-Knedlik, Hella Engerer, Marcel Fratzscher, Stefan Gebauer, Max Hanisch, Simon Junker, Malte Rieth, and Thore Schlaak

According to DIW Berlin estimations, the German economy will continue to grow noticeably over the next two years. However, the economic boom is over as economic momentum is likely to cool off. DIW Berlin thus confirms its estimations from the late summer that the growth rate of the German economy is gradually returning to normal, overlaid by non-recurring effects. However, DIW Berlin is lowering its forecast for 2018 to 1.5 percent.

At present, the economic situation is unusually unclear, partly due to developments in the automotive industry. Motor vehicle manufacturers are having major problems certifying their vehicles in accordance with the new exhaust and consumption standards. Certification is a prerequisite for selling their vehicles in Europe. As a result, fewer cars were sold both domestically and abroad in late summer, which led manufacturers to cut back production. This also curbed exports, investments in the vehicle fleet, and private consumption.

The production losses are expected to be made up at least in part in the winter half-year. However, this forecast is subject to unusually high uncertainty: it is quite possible that there will be no further recovery and that the growth momentum this year and next will be weaker than forecast. At present, GDP is expected to grow by 1.6 percent in 2019. Frequently voiced concerns that the German economy will overheat are thus likely finally over. In 2020, the growth rate is likely to be 1.8 percent—but it will be a good 0.4 percentage points stronger due to a higher number of working days.

Apart from the situation in the automotive industry, there are still many aspects indicating the upward trend will continue—after all, the pace of the German economy will only normalize after years in which production capacities were very well utilized. Robust foreign demand, a booming

construction industry, and private consumption should continue to support the economy in the coming year. Employment continues to grow on the labor market and the unemployment rate continues to fall below the five percent mark. The favorable situation is increasingly benefitting workers: in the coming years, wages will probably rise by more than one percent per year after deducting inflation of a good two percent. In addition, the state has made generous decisions: at the turn of the year, citizens will experience relief in the amount of several billion euros. This is due to a reduction in their unemployment insurance contribution and the insurance period recognized for bringing up children (*Mütterrente*). Additionally, contributions to statutory health insurance will again be borne equally by employees and employers. Private households will thus have significantly more money left over.

The earnings situation of companies remains positive. They should continue to be able to finance their operations at extremely favorable rates, even though the European Central Bank has announced that it will tighten its monetary policy. Thus, while companies expanded their investment activity in the summer, the investment level is still comparatively low. Investment conditions in Germany continue to offer opportunities for improvement, which is also repeatedly documented in the World Bank's Ease of Doing Business Index. The trade conflicts between the United States and the rest of the world are causing many companies to be cautious and refrain from a major investment offensive. Developments within the European Union are also likely to cause companies to act cautiously.

Although foreign business is likely to develop much less briskly compared to a year ago, many important sales markets are still in good shape. The US economy will benefit

from lower corporate taxes until the middle of 2019, China's economy has so far been largely unaffected by the trade policy conflicts with the US, and growth in the euro area remains strong despite political turbulence, such as in Italy.

There is great uncertainty about how Brexit will progress. After the vote on the Brexit referendum in the British House of Commons was postponed, a "hard Brexit" has not yet been ruled out. The export-heavy German economy would be strongly affected. However, it is still in the mutual interest of both the UK and the EU to avoid such a scenario. If the forthcoming renegotiations of the Brexit treaty and a new vote in the British Parliament do not take place in time, postponing the treaty or holding a new referendum is more likely than a hard Brexit—especially if new elections are held in the UK during the current political turbulence.

A lot also depends on how the conflict with the US develops. Recently, there have been signs that tension with China is decreasing. In the dispute over car imports from the European Union, on the other hand, the tone has once again intensified since the summer. An escalating trade conflict would have serious consequences for the European—and in particular for the German—economy, which would materialize above all in key sectors of the German economy. Joint simulations by economic research institutes show that automobile tariffs can lead to a motor vehicle production slump of a good seven percent. By contrast, the situation in Turkey and other emerging markets, which were still suffering from considerable exchange rate turbulence in the summer, has eased somewhat.

Public budgets are expected to close the year with a record surplus of 56 billion euros. On the one hand, these are cyclically-induced surpluses while on the other, they are based on the currently favorable interest rates for government bonds. The discussion about the use of surpluses should therefore not be aimed at permanently weakening the revenue side of the state through comprehensive tax cuts—rather, it should be invested in the future of the country. Over the next few years, the consequences of the demographic change will be clearly felt. The labor force potential is shrinking, thus putting pressure on growth potential. At the same time, although the participation of women and older workers in the labor market has increased, they often work part-time. Under more favorable conditions, many would like to work even more. Investments in childcare and education are likely to further increase labor market participation. A change in the tax system, such as abolishing joint taxation of married couples with full income splitting, could also increase incentives for labor market participation. In addition, productivity has been developing rather weakly for years. On the one hand, this may have to do with the fact that a considerable part of job creation is occurring in sectors with low productivity, such as the nursing and health care sector. However, investment activity is also too weak, which contributes to low productivity growth. To compensate for the consequences of demographic change on growth, investments in the digital future are also necessary. Not only is the private sector in demand here. The state can also support investments in the digital future both directly (with advance payments) and indirectly (by financing research and development).

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