German economy continues steady upswing with no sign of overheating

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

The German economy's upswing is holding steady. The fine state of the world economy and robust domestic economic development are driving Germany's GDP growth. After an unexpectedly strong first half of 2017, the German Institute for Economic Research (DIW Berlin) forecasts 1.9 percent growth for Germany's GDP this year and next. In June, DIW Berlin anticipated 1.5 percent growth for 2017 and 1.7 percent for 2018. In 2019, the German economy is likely to lose a bit of steam and only grow by 1.6 percent.

The country's production capacity will still be well utilized at that growth rate. The past five years have seen the output gap more or less closed, that is, actual output has been approximately equal to potential output. In the course of the stable upswing, the economy will be producing in the upper range of normal capacity utilization during the forecast horizon.

An overheating of the German economy is not to be expected for the forecast horizon, however. Other than fluctuations due to energy prices, the inflation rate should rise only gradually and will not permanently climb past the two-percent mark until 2019. That is: strong economic growth will not endanger price stability in Germany. An overheating economy, i.e. an overutilization of capacities in combination with strongly increasing prices, is out of sight.

However, there are signs of bottlenecks—primarily in the job market. Employment will surge, by roughly 640,000 persons in 2017 and 370,000 persons in 2018; 2019 will see another increase by 250,000 persons. Therefore, unemployment will decrease further, despite the unemployment rate (ILO standard) only falling slightly below its current value, to 3.6 percent in 2019. Instead, migration is fueling the rising number of persons in employment; the domestic population is decreasing. Though the number of women and older people participating in the labor market is rising, they are too few to cover the increasing demand for labor.

In this environment, wages should also gain momentum during the forecast horizon. However, when measured against the booming job market, wage increases will be moderate. This is partly due to the fact that some unions have priorities above and beyond tariff hikes—such as early retirement and flexible working hours. Owing primarily to rising energy prices, the inflation rate will probably be significantly higher than it has been in the recent past. In turn, employees' purchasing power should also experience only mild growth. Instead, companies are likely to continue to make substantial profits—the bottom line is that, during the forecast horizon, the wage ratio will decline.

In individual sectors of the economy only, such as the construction industry, high capacity utilization is likely to lead to sharply rising prices. Because of a lack of serious competition from abroad construction companies will have more room to drive prices upward than those in other sectors. However, this should not hamper the strong growth forecast for investment in construction. The environment for financing real estate should remain favorable due to low interest rates.

The European Central Bank is expected to be steering its policy in a somewhat less expansionary direction during the next few quarters, which will cause interest rates to gradually rise as well. The recently robust euro area economy appears to be poised for broad-based growth. In all member states of the currency union, economic growth is on an upswing, and even countries of concern such as Italy and Portugal are following an upward trend.

Many member states continue to have very high unemployment rates, so a sharp rise in wages and inflation is hardly to be expected. However, prices will gradually rise in the currency union anyway. For this reason, the European Central Bank should start preparing the markets for a normalization of its monetary policy, and it should do it now. It would be well advised to kick off such an effort by reducing bond purchase programs as of the beginning of 2018; this forecast also assumes an initial interest rate increase at the beginning of 2019. Other central banks are also expected to tighten their monetary policy during the forecast horizon.

This will, to some extent, slow down the world economy's currently strong pace of growth and cause German exports, which have recently risen, to lose some momentum during the forecast horizon. And in the short term, the economy will reflect the appreciation of the euro perceptible since the first half of 2017, leading to a rise in the price of German products in markets outside of Europe. This will not make much of a dent in the excessively high current account surplus forecast for the period until 2019, however. The surplus should remain at a level of around eight percent in relation to GDP, considerably higher than the threshold value of six percent the European Union set as part of its Macroeconomic Imbalance Procedure.

The capital drain that comes with high current account surplus indicates that German firms still find it more appealing to invest abroad than in Germany. This is supported by the fact that, although the German economy is experiencing an upswing, firms are only cautiously investing in new machinery and equipment. That is, however, also due to the upswing being mostly based on sectors of the economy, which tend to produce less capital-intensive. In the short run, the weakness of investment contributes to the expectation that the economy does not, as in earlier upswings, gain additional momentum and runs into an overheating. In the medium run, the investment weakness will adversely affect the growth of the country's capital stock and with it, the German economy's potential output.

The impending demographic shift is an unfavorable factor that will put an additional damper on potential output. Policy makers must therefore make the general conditions for investment in Germany more attractive. This can happen via targeted public investment spending (e.g., on education or infrastructure). The fiscal room for maneuver to do so exists to a limited extent. However, it is not large enough to accommodate the drastic tax cuts invoked in the heat of the current Bundestag election campaign. A large portion of the surplus in the public budget is due to the economic upswing, making it ephemeral and a poor basis for long-term planning. We can only hope that after the Bundestag election policy makers set the right priorities.

In that sense, the present forecast's accuracy depends on the results of the election. For example, the direction fiscal policy takes with regard to setting priorities for short-term and long-term measures depends to a great extent on which parties have the majority in the new Bundestag. The outcome of the election is thus indispensable when determining Germany's economic outlook. The present forecast is based on the status quo of fiscal policy. It only considers fiscal policy measures that are already part of the legislative process. Given this situation, this forecast must be read with due caution.

The external trading environment also poses uncertainty for economic development in Germany. The course that economic policy will take in the US is virtually impossible to forecast; the government seems to have lost its assertiveness, and central elements of the government's projects are proving impossible to implement. The extent to which the economic policy measures announced—such

as tax cuts, investment programs, and reneging on trade agreements—will be implemented in reality remains to be seen. For the present forecast, the authors assume that there will be no measures with a significant effect on the economy in the coming years.

Finally, the economic situation in the euro area continues to pose risks for the German economy. There has recently been an upswing, but the banks in many countries, in particular Italy, are still encumbered by non-performing loans. A faster rise in the interest rate as a consequence of tightening monetary policy could push those banks to the breaking point and rekindle the financial crisis in the euro area—with possibly substantial consequences for the economy.

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