New government prolongs German economic upswing

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

According to DIW Berlin estimates, the German economy should grow by 2.4 percent this year and 1.9 percent the following year. The GDP growth forecast has thus increased by 0.2 percentage points for this year compared to December and by 0.3 percentage points for the coming year. This primarily reflects the new fiscal policy framework resulting from the coalition agreement between the three parties forming the new German government (CDU, CSU, and SPD). The measures featured in the coalition agreement alone should lift growth by a good 0.3 percentage points next year, if—as it is assumed here—said measures will come into effect in 2019.

Significant relief for private households is expected for the legislative period up to 2021, and, to a substantial degree, already in 2019. For example, the plan to finance statutory health insurance by splitting the costs equally between employers and employees should result in relief for employees in the amount of 5.8 billion euros in 2019 alone. Conversely, higher costs for companies will translate into slightly lower profits; however, on balance, the move will result in a significant increase in the net disposable income of private households. In addition, a reduction in the unemployment insurance contribution rate, assumed to be implemented in the beginning of 2019, will also entail 3.6 billion euros in relief for private households next year. Finally, the announced increase in children benefits and tax allowances, as well as the increase in the insurance periods recognized for bringing up children (*Mütterrente*) and the introduction of a basic pension, are providing billions of euros in stimuli, boosting both disposable income and household consumption.

Furthermore, the coalition agreement includes additional federal government investment expenditures for things such as broadband expansion, research and development, and public housing. These expenditures amount to a total of 1.5 billion euros during the forecast period and are likely to somewhat stimulate the economy.

The German economy would not need any of these stimuli, however. It is experiencing an economic boom: the global economy is growing strongly and ensuring German exports are expanding dynamically. This benefits German industry in particular, which heavily invests in machinery and equipment. Service providers are also faring well, seeing as private households are spending more and more due to the prolonged favorable labor market situation and overall strong wage agreements. Growth is slowing only in the building and construction industry, as the branch is reaching its full capacity and prices are now rising significantly, leading to a gradual reduction in demand. Prices will rise somewhat more strongly in other branches in the coming quarters as well, which should dampen demand.

Furthermore, given that global economic growth is likely to lose some momentum in the context of a less expansive monetary policy, the German economy would gradually slip into a moderate slowdown in 2019 without the additional financial stimulus. However, that would cause no harm due to the current favorable labor market situation. No fiscal countermeasures would be required.

Instead, policies should focus more on positively influencing the German economy's long-term growth. In light of the foreseeable unfavorable demographic development, policies especially need to focus on making investment conditions more appealing. If there are increasingly fewer people of working age, then they must be able to be even more productive. The Grand Coalition has rightly agreed on additional education and infrastructure expenditures. To have a real impact on growth, spending in these areas needs to be targeted and not distributed indiscriminately regardless of the recipients' needs.

The financial flexibility for these and further measures is there. The total public (federal government, regional states, municipalities, and social security bodies) budget surplus is expected to increase to 48 billion euros this year (1.4 percent in relation to GDP) and will only decrease slightly next year (1.2 percent), despite the billions of extra spending agreed on by the new government. However, the flexibility should not be overestimated: a large part of the surpluses is due to the sound economic situation, is thus not permanent, and should therefore not be prematurely earmarked for future spending. Moreover, the government is currently profiting from unusually low interest rates; as monetary policy normalizes, the associated savings will decline in the long term. This argues against the demand for a broad-based reduction in income tax that has repeatedly been brought up in public debate.

From an economic point of view, the less expansive monetary policy is likely to somewhat dampen the pace of expansion in the euro area. The U.S. Federal Reserve is also likely to tighten its monetary stance, resulting in the U.S. economy losing some momentum, despite the fact that the fiscal policy there will be much more expansive in terms of tax relief. All in all, it is to be expected that the currently strong global economic momentum will slightly fade.

As a result, the pace of German exports will decline in the later forecast period and investment activity will also pivot to a slightly lower rate. Throughout the course of the forecast, employment growth will be somewhat less buoyant. However, the slower pace of employment growth will not be detrimental to the strong labor market; at the end of the forecast period, the unemployment rate is likely to be 4.8 percent.

Nevertheless, risks loom over the generally very favorable economic prospects. For example, the recent fierce conflict over the introduction of tariffs on U.S. imports and other protectionist tendencies, such as Brexit and the outcome of the Italian general election, is worrying from a German perspective. If such measures significantly impact international trade, it would affect the German export economy. Additional risks arise from the monetary policy environment, especially in the euro area. An increase in interest rates faster than assumed here could exacerbate banks' difficult financial situations in some countries and lead to a resurgence of the financial crisis in the euro area—which could impact the German economy.

Ferdinand Fichtner is head of the Forecasting and Economic Policy department at DIW Berlin | ffichtner@diw.de

Guido Baldi is a visiting researcher in the Forecasting and Economic Policy department at DIW Berlin | gbaldi@diw.de

Karl Brenke is an advisor in the Executive Board at DIW Berlin | kbrenke@diw.de

Christian Breuer is a junior professor at the University of Chemnitz | christian.breuer@wirtschaft.tu-chemnitz.de

Marius Clemens is a research associate in the Forecasting and Economic Policy department at DIW Berlin | mclemens@diw.de

Geraldine Dany-Knedlik is a research associate in the Forecasting and Economic Policy department at DIW Berlin | gdanyknedlik@diw.de

Hella Engerer is a research associate in the Forecasting and Economic Policy department, and the Energy, Transportation, Environment department at DIW Berlin | hengerer@diw.de

Marcel Fratzscher is president at DIW Berlin | mfratzscher@diw.de

Stefan Gebauer is a research associate in the Forecasting and Economic Policy department at DIW Berlin | sgebauer@diw.de

Simon Junker is deputy head of the Forecasting and Economic Policy department at DIW Berlin | sjunker@diw.de

Claus Michelsen is a research associate in the Forecasting and Economic Policy department at DIW Berlin | cmichelsen@diw.de

Malte Rieth is a research associate in the Macroeconomics department at DIW Berlin | mrieth@diw.de

Thore Schlaak is a research associate in the Forecasting and Economic Policy department at DIW Berlin | tschlaak@diw.de

LEGAL AND EDITORIAL DETAILS

DIW BERLIN

DIW Berlin — Deutsches Institut für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
www.diw.de
Phone: +49 30 897 89–0 Fax: –200
Volume 8

Sale and distribution
DIW Berlin Leserservice, Postfach 74, 77649 Offenburg
leserservice@diw.de
Phone: +49 1806 14 00 50 25

Layout
Roman Wilhelm, DIW Berlin

Cover design
© imageBROKER / Steffen Diemer

Composition
Satz-Rechen-Zentrum Hartmann + Heenemann GmbH & Co. KG, Berlin

ISSN 2568-7697