Upswing in a subdued global economy

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The German economy continues to recover, and will grow by 2.2 percent in 2015 and by 1.9 percent in 2016. The unemployment rate will further decline, to 6.4 percent this year and 6.1 percent in 2016. Inflation, which averages 0.5 percent this year, will be substantially dampened by the slump in oil prices; in 2016 as well, inflation will remain low, at 1.2 percent.

The global economy continues in its recovery. In industrialized countries, a gradually improving situation in labor markets, as well as the slump in oil prices, is propelling the purchasing power of private consumers. Corporate investment activity should also pick up, benefitting from easy monetary policy. In many economies in the euro area, unemployment remains high and the public and private debt is dampening demand. For the time being, growth in the emerging markets is expected to lag behind. Overall, the average annual growth rate of the global economy is expected to be 3.8 percent in 2015, and 4.0 percent in the following year.

The German economy is currently recovering, driven by strong domestic demand, and should be back on its potential path later on. Inflation is bound to remain weak. There is no sign of the German economy overheating; important markets have lost momentum when compared to the pre-crisis years—foreign trade is therefore likely to provide only minor stimulus, and in this environment, investments in equipment and machinery will only experience a moderate expansion. Government revenues are surging: despite a rather loose spending behavior, the public budget surpluses will reach approximately 0.5 percent in both years of the forecast period.

Europe and the global economy: recovery continues

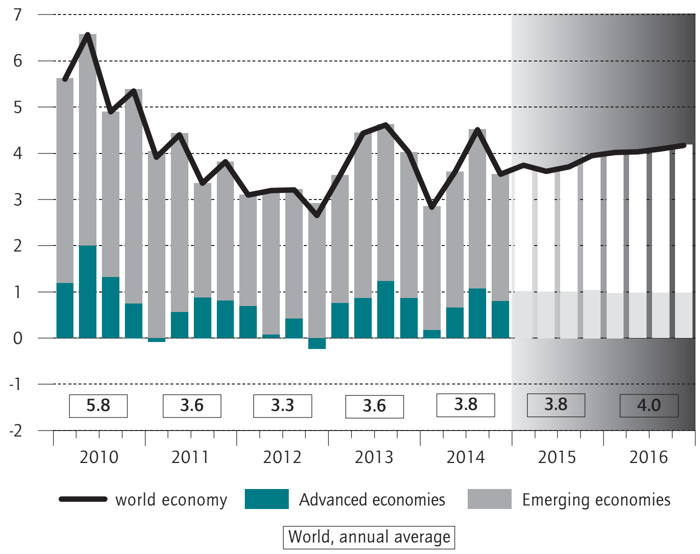
The global economy continues in its recovery. In both the industrialized and emerging markets, growth in the final quarter was comparable to the average of the previous quarters (Figure 1). Initially, this rate of expansion should remain stable, with a slight acceleration expected over the coming year (Table 1). The moderate recovery is mainly driven by the growth of consumption in industrialized countries. The sharp decline in energy prices, particularly oil prices—which is also reflected in low inflation rates—is propelling the purchasing power of households. The development in industrialized countries is also supported by the gradually improving situation in the labor market, which has a positive effect on income growth. Together with expansionary monetary policy these developments are expected to stimulate corporate investment activity over the course of the year. For the time being, the deleveraging process in the private sector appears to be coming to an end, especially in the U.S. and the U.K.

Despite a gradual upturn in economic activity in the euro zone, a number of structural drags continue to hinder a strong recovery. Nevertheless, private consumption currently supports growth; at the same time, the gradual improvements in the labor market, as well as the increased purchasing power following the drop in energy prices, are becoming apparent. As well, the corporate financing conditions are improving bit by bit, enabling moderate growth of investments in equipment. Exports are supported by the depreciation of the euro. However, since imports are likewise expected to increase due to the slight upturn in the domestic economy, foreign trade as a whole will probably contribute little to growth.

Several structural factors still prevent a stronger recovery. In particular in crisis countries there is a considerable degree of uncertainty about the financial situation of non-financial companies and banks. In case of the latter, the potentially large number of non-performing loans seems to hold back liquidity demand by banks and their provision of credit to the private sector.

Figure 1

Real GDP growth
in percentage points



Sources: National statistical offices; Computations and forecasts by DIW Berlin.

The world economy is bound to continue its recovery in 2015 and 2016.

Against this backdrop, low inflation rates and the risk of outright deflation in several countries of the currency union aggravate the reduction in debt levels across the economy, that is, for the public sector, for household, and for private companies. In addition, still high unemployment rates together with structural weaknesses in educational systems dampen output growth dynamics. Finally, the tense negotiations between international official lenders and the Greek government about the implementation of the second program depress confidence in European intergovernmental governance structures.

For the time being, growth in the emerging markets is expected to lag behind that of recent years. Such is the case with China, which is expecting a further decrease in the rate of expansion. The politically intended transformation to a consumer- and service-based economy is likely to be accompanied by lower growth rates. Additionally, the drop in oil prices is also having a negative impact in the emerging markets that export oil.

Overall, the average annual growth rate of the global economy is expected to be 3.8 percent in 2015, with an increase to 4.0 percent in the following year. Inflation remains at just two percent this year, and will increase to just under three percent in 2016.

For now, the monetary policy environment is expected to be globally expansionary. In both the euro zone and in Japan, additional expansionary measures have been adopted. Also, in a number of emerging markets—including China—interest rates have been lowered, and previous rate increases have again been re-

Table 1

Real gross domestic product, consumer price inflation, and unemployment rate in the world economy
In percent

	Gross domestic product				Consumer prices				Unemployment rate			
	year-on-year change in percent											
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016
Euro area	−0.4	0.9	1.3	1.4	1.3	0.4	0.2	1.0	12.0	11.6	11.1	10.7
France	0.4	0.4	0.7	1.2	0.8	0.5	−0.2	1.0	10.3	10.2	10.3	10.1
Italy	−1.7	−0.4	0.0	0.5	1.3	0.2	0.5	1.0	12.2	12.8	13.2	12.6
Spain	−1.2	1.4	2.3	2.1	1.4	−0.2	−0.3	1.0	26.1	24.5	22.4	20.8
The Netherlands	−0.7	0.8	1.8	1.8	2.6	0.3	0.2	0.7	7.3	7.4	6.8	6.5
United Kingdom	1.7	2.6	2.7	2.4	2.6	1.4	0.3	0.9	7.5	6.2	5.6	5.2
USA	2.2	2.4	3.1	3.2	1.5	1.6	−0.3	1.5	7.4	6.2	5.5	5.0
Japan	1.6	0.0	0.9	1.5	0.3	2.7	0.6	0.3	4.0	3.6	3.8	3.8
South Korea	3.0	3.4	3.5	3.6	1.3	1.3	1.0	1.7	3.1	3.6	3.0	3.0
Middle and East Europe	2.5	3.0	3.2	3.7	4.3	4.4	4.0	4.4	9.5	9.1	8.9	8.7
Russia	1.4	0.6	−3.4	0.0	6.7	8.0	11.7	7.7	5.5	5.2	5.5	5.4
China	7.7	7.5	7.0	6.6	0.0	−0.6	1.0	2.4	3.9	3.8	3.8	3.8
India	6.4	7.3	6.4	6.2	6.8	4.1	4.3	6.1	–	–	–	–
Brasil	2.5	0.1	1.4	1.7	6.2	6.3	5.1	5.0	5.4	5.1	5.1	5.1
Mexico	1.7	2.1	3.4	3.5	3.8	4.0	3.5	3.2	4.9	4.8	4.8	4.8
Advanced economies	1.3	1.7	2.3	2.4	1.3	1.4	0.0	1.2	8.2	7.4	6.9	6.5
Emerging economies	5.5	5.4	4.9	5.1	3.2	2.7	3.7	4.3	5.0	4.9	4.9	4.8
World	3.6	3.8	3.8	4.0	2.4	2.1	2.1	3.0	6.4	6.0	5.8	5.6

Source: National statistical offices; DIW Spring projections 2015.

versed; further steps toward monetary expansion are likely to follow during the forecast period in particular in Asia. Over the course of the year, only for the U.S. and the U.K first rate hikes are expected. However, because of the low inflationary pressures and to prevent unintentionally strong currency appreciation, rate increases are likely to be moderate in both countries. The stance of fiscal policy will be less of a drag on growth over the forecast period than in recent years. In some of the emerging markets as well as in the euro zone, the consolidation of public finances will not occur as rapidly.

One risk for the forecast period is the resurgence of the crisis in the euro zone due to political disagreements about the continuation of the reform process. In particular, a failure of the negotiations between the international public lenders and Greece could lead to increased uncertainty in financial markets, and have a dampening effect on the economic activity of the euro zone. Another risk could arise from a prolonged period of low inflation rates – in particular in the euro zone. This would exacerbate the reduction of the often still-high levels of public and private debt, and thus have a dampening effect on demand. Additionally, an intensification of the crisis around Russia and Ukraine could lead to uncertainty in financial markets, with negative consequences for the global economy. Another risk is an unexpectedly sudden or stronger-than-expected increase in the U.S. federal funds rate. Apart from bringing about abrupt capital outflows from some emerging markets, the higher interest rates could also bring about a massive correction of asset prices in industrialized countries.

German economy: Strong growth, but no signs of overheating

Driven by strong domestic demand, the German economy is currently undergoing a strong recovery (Figure 2); over the course of the later part of 2015, capacity utilization will return to nearly normal levels. Subsequently, the German economy should pick up at rates that are roughly consistent with potential growth. At the same time, the average growth is slightly higher than it was before the crisis, primarily due to improvements in the labor market; it is also driven more heavily by consumption than it was before the crisis.

There is no evidence, however, that the German economy is in danger of overheating. When compared with the pre-crisis years, the sales prospects of German companies in international markets have weakened: with the euro area , the most prominent market will be developing poorly for the foreseeable future, and also, demand in key emerging economies countries markets in which German companies are increasingly operating has also noticeably lost momentum. In this environment, investments in equipment and machinery are also expected to increase less dynamically than before the crisis, with their share of GDP remaining well below pre-crisis levels. Following the strong development for construction investments in previous years, a flattening has likewise begun to emerge, with profit opportunities in residential construction having recently abated. All in all, the risk of the German economy overheating is low.

At the same time, the underlying conditions at the moment are markedly conducive to expansion. Since the middle of last year, crude oil prices — when calculated in euros — have temporarily fallen by almost 50 percent, and currently amount to 40 percent of the original amount; this is already reflected in a significant drop in prices. Furthermore, the value of the euro has fallen considerably since mid-2014 — and since the beginning of 2015, this devaluation has actually accelerated, resulting in substantial improvements in price competitiveness outside the euro area. With the announcement of the ECB's new bond purchase program, lending rates have continued to fall as well. Furthermore, the fiscal policy is having a stimulating effect. However, there are risks arising from possible disruptions in the financial markets, which could be triggered by doubts about the continuation of the reform agenda in the euro area. Market participants might interpret this as an increasing likelihood that countries will break away from the monetary union. Additionally, the crisis surrounding Russia and Ukraine could lead to developments that endanger the stability of the financial market, among other things.

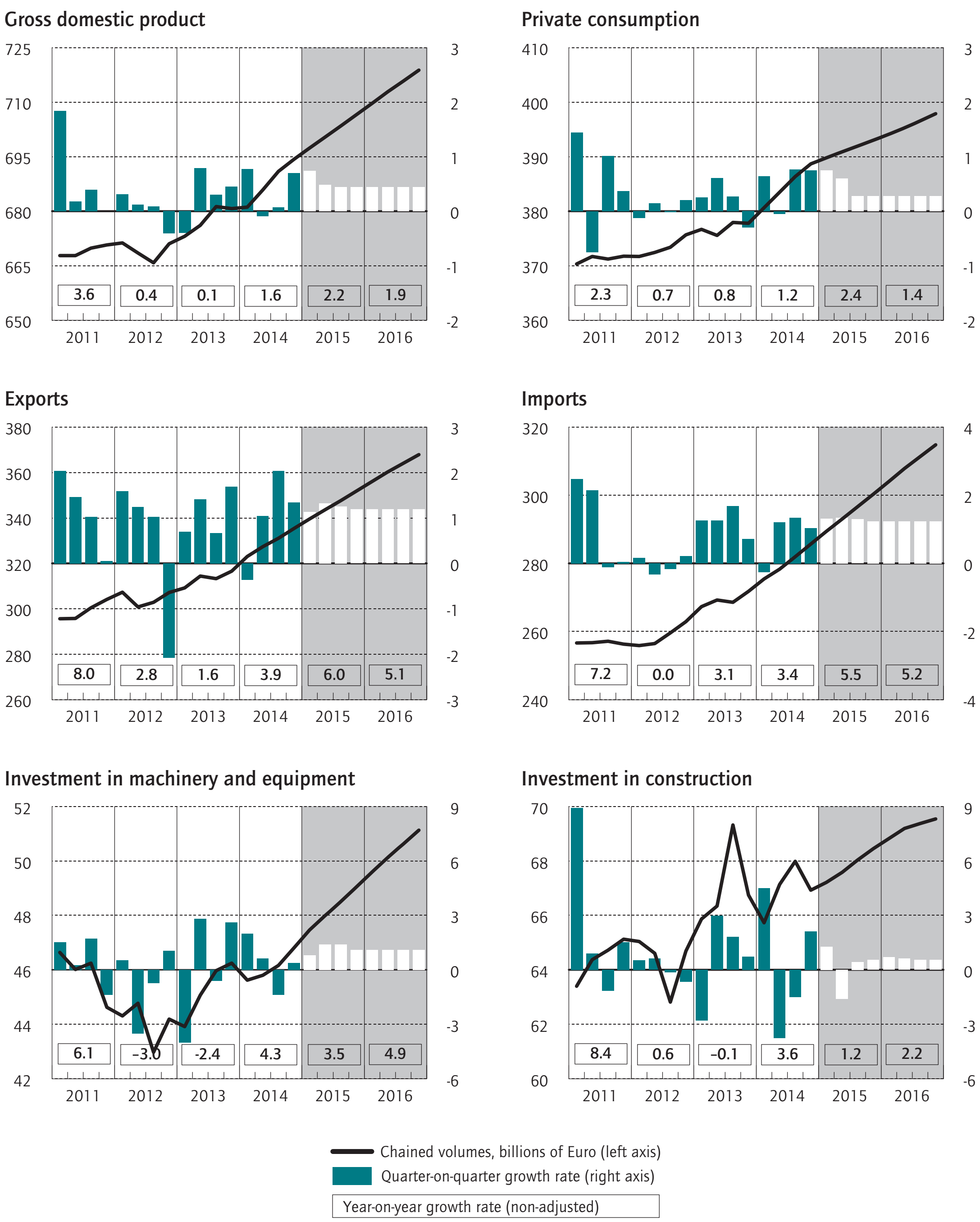
At the turn of the year, the German economy picked up significantly and will likely maintain this pace for the first half of 2015 (Table 2). This boost has, to some extent, been due to specific, temporary factors. The positive effect of low oil prices on consumer purchasing power, as well as on corporate profits, will decline from mid-year, in accordance with the assumed slight increase in oil prices. The depreciation of the euro will, with a partial delay, have a positive impact on exports; for this projection, it is assumed that the exchange rate will remain constant in the long run. From the second half of the year onward, the overall economic expansion rates will roughly correspond to the long-term average. Due to a strong start and a high level of growth during the first half of the year, the German economy is expected to grow by 2.2 percent this year, and by 1.9 percent next year (Table 3).

Despite the fact that the economy is operating at full capacity, the inflation rate remains low. This year, the slump in oil prices is dampening the inflation rate sub-

Figure 2

Gross domestic product and use of GDP

Seasonally and working day adjusted



Sources: Federal Statistical Office; Computations and forecasts by DIW Berlin; Forecasts as of 2015 Q1.

Table 2

Use of gross domestic product, quarter-on-quarter growth rates

price, seasonally and working-day adjusted, in percent

	2014				2015				2016			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Private consumption	0.6	0.0	0.8	0.8	0.8	0.6	0.3	0.3	0.3	0.3	0.3	0.3
Public consumption	0.1	0.6	0.6	0.2	0.5	0.5	0.2	0.2	0.3	0.3	0.4	0.2
Investment in equipment and machinery	2.0	0.6	−1.4	0.4	0.8	1.4	1.4	1.1	1.1	1.1	1.1	1.1
Construction investment	4.5	−3.7	−1.5	2.1	1.3	−1.6	0.4	0.6	0.7	0.6	0.5	0.5
Other investment	0.8	0.1	0.2	0.2	0.3	0.3	0.4	0.5	0.5	0.5	0.5	0.5
Change in inventories[1]	−0.2	0.2	−0.6	−0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic uses	0.9	−0.1	−0.4	0.5	0.8	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net Exports[1]	−0.1	0.0	0.4	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Exports	−0.4	1.0	2.0	1.3	1.1	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Imports	−0.3	1.2	1.3	1.0	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Gross Domestic Product	**0.8**	**−0.1**	**0.1**	**0.7**	**0.7**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**

1 Total domestic uses

Source: Federal Statistical Office; DIW Berlin, Forecast from 2015q1 onward.

Table 3

Key economic indicators for the German economy

	2011	2012	2013	2014	2015	2016
Real GDP[1] (percent change over previous year)	3.6	0.4	0.1	1.6	2.2	1.9
Domestic employment (1000 persons)	41 570	42 033	42 281	42 652	42 962	43 163
Unemployed (ILO concept)	2 398	2 237	2 190	2 090	1 913	1 806
Unemployed (BA concept)	2 976	2 897	2 950	2 898	2 768	2 673
Unemployment rate[2] (ILO concept)	5.8	5.4	5.3	5.0	4.5	4.3
Unemployment rate[2] (BA concept)	7.1	6.8	6.9	6.7	6.4	6.1
Consumer prices	2.1	2.0	1.5	0.9	0.5	1.2
Unit labor costs[3]	0.4	3.1	2.2	1.6	1.7	1.5
Government budget balance[4]						
in billion EUR	−23.3	2.6	4.2	18.1	14.9	13.5
in percent of GDP	−0.9	0.1	0.1	0.6	0.5	0.4
Current account balance, in percent of GDP	6.1	7.1	6.7	7.4	8.4	8.6

1 Price-adjusted, chain-linked
2 as a share of domestic labor force (ILO), resp. civilian labor force (BA)
3 compensation of employees (national concept) per hour worked over real GDP
4 according to ESA 2010

Sources: National and international institutions; computations by DIW Berlin 2015 and 2016: DIW forecast.

stantially, amounting to an annual average of 0.5 percent. Companies affected by the minimum wage law will potentially make greater use of the current low-inflation environment in order to pass on the higher labor costs to consumers. Until now, however, there has only been occasional examples of minimum wage-related price increases; in this projection, it is assumed that the overall price effects related to the minimum wage will remain low. From the second half of the year onward, the dampening effect of energy prices will come to an end; as a result, prices will be significantly higher when compared with last year. This will be somewhat offset by the low production costs related to the low oil prices being passed on, more and more, to consumers. In the coming year, inflation is expected to amount to 1.2 percent.

Employment growth continues; concerns that it could be disrupted by the introduction of the general statutory minimum wage appear to be, as of yet, unfounded. In the current projection, it is assumed that the minimum wage regulation leads only to gradual job losses, and to a much lesser extent than previously anticipated. The rise in employment is likely to lose momentum over the course of this year and the next, just as economic growth eases; however, there will still be strong increases, with an annual average increase of 300,000 employees in 2015 and 200,000 employees in the coming year.

Table 4

Labor market performance

Millions

	2012	2013	2014	2015	2016
Persons in employment (domestic concept)	**42.03**	**42.28**	**42.65**	**42.96**	**43.16**
Self employed	4.54	4.46	4.41	4.41	4.42
Employees subject to social security contributions	29.36	29.73	30.23	30.54	30.76
Public officers, judges, military personel	1.89	1.89	1.90	1.91	1.91
Mini jobbers (without persons with a second job)	4.98	5.02	5.03	5.01	4.98
Others	1.26	1.19	1.08	1.09	1.09
+/− Commuters, employed persons in foreign state institutions in Germany or in foreign states	−0.05	−0.06	−0.06	−0.06	−0.06
Persons in employment (national concept)	**41.98**	**42.23**	**42.60**	**42.90**	**43.10**
Unemployed (ILO concept)	**2.24**	**2.19**	**2.09**	**1.91**	**1.81**
Active population	**44.21**	**44.42**	**44.69**	**44.81**	**44.91**
Unemployed (Federal Labour Office (BA) concept)	2.90	2.95	2.90	2.77	2.67
Unemployment rate (BA concept1) – %	6.8	6.9	6.7	6.4	6.1
Unemployment rate (ILO concept) %	5.4	5.3	5.0	4.5	4.3
Employed persons (domestic concept – ILO)	39.02	39.41	39.78	40.30	40.49

1 At the federal labour office registered unemloyed in relation to civil active population.

Sources: Federal Statistical Office; Federal Labour Office; DIW calculations and estimations.

The unemployment rate is likely to fall to 6.4 percent in 2015, and to 6.1 percent in 2016 (Table 4). In this environment, the wage increases, as well, will remain noticeable. This year, the implementation of the minimum wage will provide an additional boost, accounting for roughly one-third of the increase in hourly wages. The collective negotiations that have already been completed do not, however, indicate a strong wage boost.

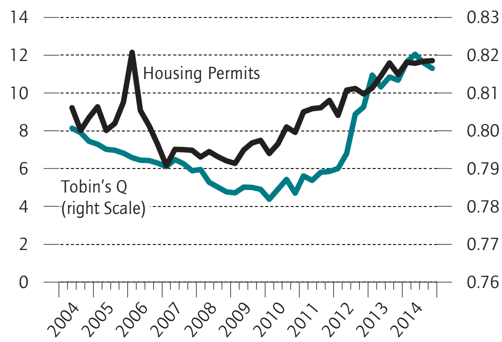
The favorable situation in the labor market is having a positive effect on private consumption, which should continue to increase at a strong rate. Within the past two quarters, households have already strongly increased their consumption. The expansions to pension benefits will likely have made a noticeable contribution; in the first half of the year, the consumption expenditure thereof will be buoyed. The low price further increases consumers' purchasing power considerably, even if only temporarily.

Investments in equipment and machinery are only gradually gaining momentum; after a sharp increase in the winter of 2013–2014, private investments in this domain stagnated on the whole, and recently, they have even decreased. The improving sales prospects, as well as the favorable profit situations—which are also due to the sharp decrease in import costs—and the further decline in interest rates should stimulate these investments, albeit gradually. Recent business surveys, as well as the development of orders and sales, indicate an uptick in investment. The share of investment in equipment and machinery to GDP however, will remain well below its pre-crisis levels. Moreover,

Figure 3

Housing permits and Tobin's Q for residential property

Housing permits in billion Euro



Source Bundesbank, Empirica AG, calculations by DIW Berlin.

The development of incentives to invest and housing permits have slowed down.

construction investments are losing momentum, with profit opportunities in housing construction worsening (Figure 3), apart from a strong start in the beginning of the year due to favorable weather conditions.

Exports have boosted growth considerably in recent quarters, and are expected to experience a marked increase in the long run as part of the improving global

Table 5

Selected fiscal key figures[1]
as percent of nominal GDP

	Revenue			Expenditue			Net Lending/ Net Borrowing	*Debt (Maastricht)*	Interest as percent of tax revenue
	total	*of which* Tax Revenue	*of which* Social Contribution	total	*of which* Interest	*of which* Investment Expenditure			
2000[2]	45.7	23.2	18.1	47.1	3.1	2.3	−1.4	13.5	58.7
2001	43.8	21.5	17.8	46.9	3.0	2.3	−3.1	14.0	57.5
2002	43.4	21.0	17.9	47.3	3.0	2.2	−3.9	14.1	59.2
2003	43.7	21.1	18.1	47.8	2.9	2.1	−4.1	13.8	62.9
2004	42.6	20.6	17.7	46.3	2.8	2.0	−3.7	13.6	64.6
2005	42.8	20.8	17.4	46.1	2.8	1.9	−3.3	13.3	66.8
2006	43.0	21.6	16.9	44.6	2.7	1.9	−1.5	12.6	66.3
2007	43.1	22.4	16.1	42.7	2.7	1.9	0.3	11.9	63.5
2008	43.5	22.7	16.1	43.5	2.7	2.0	0.0	11.8	64.9
2009	44.4	22.4	16.9	47.4	2.6	2.3	−3.0	11.8	72.4
2010[3]	43.1	21.4	16.5	47.3	2.5	2.3	−4.2	11.5	80.3
2011	43.7	22.0	16.4	44.6	2.5	2.3	−0.9	11.3	77.6
2012	44.3	22.5	16.5	44.2	2.3	2.3	0.1	10.2	79.0
2013	44.5	22.7	16.6	44.3	2.0	2.2	0.1	8.8	76.9
2014	44.6	22.7	16.6	43.9	1.7	2.2	0.6	7.7	72.9
2015	44.2	22.6	16.5	43.7	1.6	2.1	0.5	7.1	68.7
2016	44.2	22.7	16.6	43.8	1.5	2.2	0.4	6.7	65.4

1 ESA

2 Net of Sales of UMTS licences (50,8 billion Euro).

3 Net of Sales of licneces for moblile communication (4,4 billion Euro).

Sources: Statistisches Bundesamt; Calculations of the DIW Berlin; 2015 and 2016: Forecast of the DIW Berlin.

economy—especially since the sharp depreciation of the euro should also stimulate demand from abroad. Weak demand from oil-producing countries, however, will exert a slightly dampening effect. Given a stronger domestic economy, imports are also likely to be on the rise. The growth contribution from net exports will remain moderate during this period; however, the nominal trade balance will swell significantly due to the strong decline in import prices. The current account surplus will likely be at around 8 ½ percent in both years of the forecast period.

In spite of a rather loose spending behavior, the government will realize substantial surpluses in both years of the forecast period as revenues rise sharply due to the favorable economic development. This year, the surplus should amount to € 15 billion, equivalent to 0.5 percent of nominal GDP (Table 5). It is expected to be somewhat lower in the coming year, at 0.4 percent. The structural surplus—that is, the surplus that has been adjusted for cyclical factors—is only slightly higher this year, at 0.6 percent. In the coming year, working at full capacity, the structural balance will be 0.4 percent of nominal GDP.

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