German economy continues to grow moderately but risks remain

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According to DIW Berlin estimations, the German economy will continue on its current growth path over the next three years. This confirms the forecast from early summer that economic output will grow at a more moderate pace than previously. DIW Berlin's forecast indicates growth of 1.8 percent for 2018, 1.7 percent for 2019, and 1.8 percent for 2020.

In contrast to the strong export performance of the previous year, the domestic economy is now primarily driving growth, with both consumption and the construction boom as contributing factors. Thus, the labor market situation remains favorable and the unemployment rate is likely to fall below the five percent mark as early as next year. Wage increases are also stronger than in previous years and enabling households to earn somewhat more money—even after deducting inflation, which is now higher.

By contrast, companies are continuing to hold back on their investments, partly because their sales expectations are clouded in light of the trade policy conflicts. Frequently voiced concerns that the German economy will overheat are therefore likely to be dispelled. Production capacity utilization is gradually declining and inflation is also not expected to rise any further, as it is currently mainly due to higher oil prices.

Public budgets are expected to close the year with a record surplus of 60 billion euros. However, some of the surpluses can be attributed to cyclical effects as well the currently favorable interest rates easing the strain on the budget. Therefore, the scope of lasting benefits for households and companies should not be overestimated.

DIW Berlin forecasts that the pace of growth will remain moderate for the rest of the year, as considerable risks continue to weigh on global economic development. Concerns regarding a further trade conflict escalation between the European Union and the United States were initially dispelled at a meeting between US President Trump and EU Commission President Juncker. Among other things, it was agreed to not impose higher customs duties on automobiles for the time being. However, the United States' confrontation with major economies such as China or Canada should continue to negatively affect companies' willingness to invest, both domestically and abroad. Concerns are also growing about a "hard" Brexit, as statements made by British Prime Minister May suggest. If the EU and the United Kingdom do not come to an agreement by the end of March 2019—negotiations are currently progressing slowly at best—the trade rules of the World Trade Organization would then apply, which should make the exchange of goods and services considerably more difficult. That is reason enough for many companies to be cautious in their planning. The German manufacturing industry's order books are full once again, but new orders have noticeably declined in the past months.

However, consistently positive news is coming from the labor market. Job creation is continuing and unemployment continues to fall significantly: the unemployment rate is expected to be 5.2 percent this year, 4.9 percent next year, and 4.6 percent in 2020. This represents an increase of around half a million in the number of employees compared with the previous year. The labor market situation is increasingly reflected in higher wage agreements. Collective wages indicate a wage increase of almost three percent for the current and coming years. Despite higher inflation, households should therefore have noticeably more disposable income, which will further boost consumption.

Domestic demand is also likely to be supported by the German government's plan to increase expenditure in the coming year and reduce tax burdens. Although it is planned to reduce the unemployment insurance contribution rate by 0.5 percentage points, that will be offset by a burden from an increased contribution to nursing care insurance. However,

the plan to finance statutory health insurance by splitting the costs equally between employers and employees will lead to an increase in disposable income. In addition, numerous other measures are planned, such as *Baukindergeld* (a subsidy granted per child to help families buy or purchase homes), an adjustment of child allowance (*Kinderfreibetrag*), and an increase in the insurance period recognized for bringing up children (*Mütterrente*).

The state's financial situation will remain favorable over the coming years. Both social security contributions as well as tax revenue—especially from wage and income taxes—should continue to increase substantially. In addition, the interest burden on public budgets will remain low for the foreseeable future. At the same time, the unemployment insurance surplus is increasing due to the positive labor market development. The general government surplus will reach a record 1.8 percent of GDP this year. Even when the cyclical surpluses of around 10 billion euros per year are taken into account, spare funds of almost 50 billion euros are likely to be available to the state as a whole.

The financial leeway should first be used to strengthen the growth potential of the German economy. This can be done by improving the financing of the educational and research sectors as well as increasing the speed of digitalization, which would increase productivity and thus also counter the consequences of demographic change that will soon be noticeable. However, it is also necessary to increase investments in public infrastructure, which also has a decisive influence on private sector actors' willingness to invest. Currently, the quality of local infrastructure has suffered severely over the past few years. In addition, the capacity and efficiency of the municipal building and planning authorities have fallen considerably as a result of continuous personnel reduction. Increasingly, there is a lack of experts who can supervise public construction measures on the administrative side. However, capacity and efficiency are necessary in order to maintain and develop strong infrastructure.

In addition to numerous smaller projects, there are discussions about securing the pension level in the long term. However, stabilizing the pension level by 2040 and beyond by using the pension funds themselves would entail considerable increases in contribution rates. The current budget surpluses are ample, but since they are in part due to favorable interest conditions, financing from them is not secured in the long term. It would make more sense to combine such a reform with decisions that strengthen growth potential. Improving the basic conditions for women's participation in the labor market would help increase the revenue side of pension insurance and, at the same time, help increase the number of people in employment and thus the potential. It would be necessary to expand full daycare for children, have better coordination in the tax transfer system, or abolish *Ehegattensplitting* (joint taxation of married couples with full income splitting).

As always, forecasts are subject to uncertainties. Risks to the described economic development include, for example, an escalation in the trade conflict between the European Union and the United States or a further tightening of trade restrictions between the United States and other major economies. Additionally, the danger of an unregulated Brexit has significantly increased. These developments are already affecting the willingness to invest worldwide and could possibly reduce it even more. The discussions in Italy about only partially repaying public debt have abated in recent months, but could again lead to tensions in the financial markets. In contrast, the developments in Turkey pose little risk, as the Turkish demand for goods and services from Germany and the European Union is rather low. There is also currently no particularly high risk of renewed turmoil on the financial markets and, as a result, of contagion effects.

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