German economy performing well despite odds; time to rethink debt rules

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Thanks to private consumption and a strong labor market, the German economy is still performing well as of early summer 2019, better than many think. State coffers are well filled and will remain so for the time being. However, this does not necessarily indicate that everything is fine. The economic situation has become gloomier against the backdrop of unresolved trade conflicts and a fragile economic situation worldwide. Fiscal policy action must be taken. The time has long since come to reorganize municipal finances and duties in Germany so that the municipalities can once again properly fulfill their public service mission—even if that means loosening debt constraints and questioning the debt ceiling dogma.

DIW Berlin stands by its spring assessment that the economy will continue to develop quite well. We expect GDP growth of 0.9 percent in Germany for 2019 and of 1.7 percent for 2020. Growth will be driven primarily by the domestic economy while foreign business will remain comparatively subdued. Uncertainty over trade conflicts and developments within the European Union continue to weigh on companies' willingness to invest. This particularly affects the German economy, which mostly exports capital goods.

The German economy has regained its footing in the first quarter of 2019 after the lull in the second half of 2018 thanks to the flourishing construction industry and considerable fiscal stimuli. These include the reintroduction of equal financing for statutory health insurance, where employers and employees split the cost equally. This change has provided consumers with additional purchasing power. At the beginning of the year, companies also invested heavily in additional machinery and equipment. The fiscal stimuli are likely to continue to unfold throughout the year. Developments on the labor market are continuing to generate income growth: employment is increasing further and unemployment is expected to fall to an average of 4.6 percent in 2020, the lowest level since reunification. These developments are reflected in noticeable wage increases. In real terms, employees can look forward to an increase of around 1.3 percent this year. As domestic demand remains robust, the production of goods and services in Germany is likely to gradually pick up again and ensure that the now often empty inventories are filled up again.

The external economic environment continues to cause concern due to the ongoing trade conflicts. Increased protectionism is likely to weigh heavily on economic activity: prices for consumers will rise while conflicts are creating uncertainty for companies, slowing their willingness to invest.

The global economic situation remains fragile. Although German companies have a considerable order backlog—which makes the current drop in new orders appear less dramatic— there is a risk of a stronger economic downturn if global trade conflicts continue to escalate and problems within the European Union remain unresolved.

Public finances remain unperturbed by these developments. A revenue surplus of around 19 billion euros had already been achieved in the first quarter of 2019, mainly due to wage tax proceeds. DIW Berlin expects a total surplus in the order of 40 billion euros in the current year and around 32 billion euros in 2020. The federal budget alone will have a surplus of about 18 billion euros this year. However, only a small part of these surpluses actually reaches the municipalities, even though they are the most important public investors and are responsible for providing and maintaining much of the infrastructure that has been neglected for years. A change is now required. According to German state-owned

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development bank KfW, the financing requirements of the municipalities currently amount to over 150 billion euros.

In order for municipalities to be able to adequately provide public services again, it is important to restructure municipal finances and duties. To this end, the federal government could gradually use the funds it has accumulated to reduce the municipalities' debts. In addition, it could assume the tasks and expenditures of the municipalities depending on the business cycle, thus making their budgets much more stable. The current institutional framework does not offer much room for such a transformation, but additional public investment in education, research, and infrastructure is highly profitable given the low interest rates. It would therefore make sense to relax the debt constraints and, at least for projects financed by the federal government, to open up additional scope for net borrowing.

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