DIW Weekly Report 37 2019

AT A GLANCE

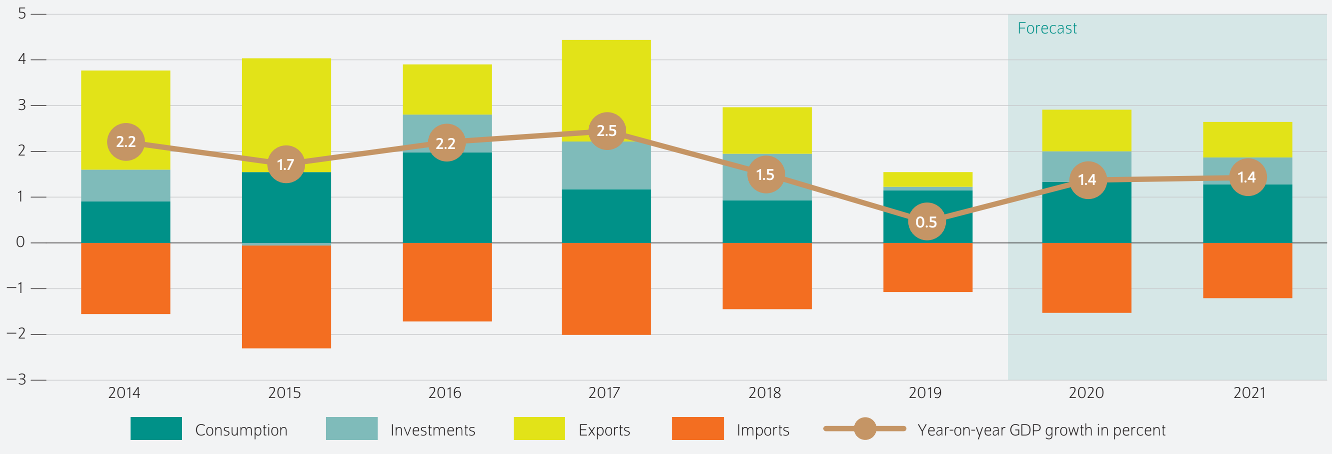
Growth program needed as the foundation of the German economy crumbles

By Claus Michelsen et al.

- Weak foreign trade is weighing on the export-oriented German economy: DIW Berlin is forecasting GDP growth of 0.5 percent this year and 1.4 percent per year in 2020 and 2021
- Brexit, the US-China trade disputes, and the Iran conflict are negatively affecting the global economy; global growth only 3.7 percent this year
- In Germany, marked fiscal stimuli and positive labor market developments are preventing the economy from sliding into a more serious crisis
- High government surpluses are dwindling: public surplus is expected to grow by 48 billion euros this year and 33 billion euros next year
- In the long term, an investment agenda is necessary to keep Germany competitive as a business location and to encourage companies to invest

Fiscal policy stimuli and positive employment development are supporting private consumption and thus the German economy

Growth contributions of the individual components of GDP in percentage points



Source: Authors' own surveys and calculations.

FROM THE AUTHORS

*"Germany is in a technical recession. However, thanks to strong private consumption and the continuing good situation on the labor market, this will not turn into a crisis in the short term. In order to successfully stabilize the German economy over the long term, a policy geared to strengthening potential growth is necessary. This will encourage companies to invest and increase Germany's competitiveness." — **Claus Michelsen** —*

MEDIA

Audio Interview with Claus Michelsen (in German)
www.diw.de/mediathek

Growth program needed as the foundation of the German economy crumbles

By Claus Michelsen, Guido Baldi, Marius Clemens, Geraldine Dany-Knedlik, Hella Engerer, Marcel Fratzscher, Stefan Gebauer, Max Hanisch, Simon Junker, Konstantin Kholodilin, Malte Rieth, and Thore Schlaak

Germany's economic foundation is crumbling. Industrial production, especially in the exporting sector, has been experiencing a significant decline in output for a year now. Demand from within Europe is lacking in particular, especially from the United Kingdom and Italy. In contrast, exports to East Asia have remained stable despite the escalating trade conflicts between Washington and Beijing. This development, coupled with strong domestic demand, saved Germany from slipping into a recession at the end of 2018 and beginning of 2019. Private households markedly increased consumption due to fiscal measures introduced in the beginning of the year that increased income (such as splitting health insurance costs between employers and employees equally and an increase in children benefits). Companies also invested heavily in expanding their production capacity in the first quarter and the construction industry again reported record order backlogs. For this reason alone, DIW Berlin is still expecting economic growth of 0.5 percent this year. Provided the significant political risks do not materialize, the projected growth rates of 1.4 percent for 2020 and for 2021, respectively, are around the long-term average.

However, the foundations of growth in Germany have cracked considerably, primarily due to serious economic risks. In addition to the continuously escalating trade conflict between the US and China, there are problems in Europe weighing on the economy. Trade with the United Kingdom is already substantially weaker and exports to Ireland have decreased significantly over the past six months. If a no-deal Brexit occurs, this would drag down growth rates by 1.1 percentage points in the UK, 0.2 percentage points in the euro area, and 0.4 percentage points in Germany over the coming year. In Italy, the economic crisis and issues with the previous government in the months ahead also left their mark on overall growth.

These uncertainties and conflicts are weighing on demand for capital goods and thus are negatively affecting Germany in particular. Entrepreneurs in Germany seem to be losing confidence as well: In the second quarter, private investment in new machinery, equipment, and vehicles plummeted. Unemployment figures were falling until the spring and employment was growing, but both have now almost reached a standstill. The domestic economy does not seem to be able to permanently decouple itself from weakness in the industrial and export sectors. It is therefore likely that the German economy slipped into a recession over the summer months.

However, the Grand Coalition's expansive fiscal policy has kept the crisis from becoming worse. Financial measures from the coalition pact will provide substantial economic stimuli this summer and will take effect at the turn of the year in both 2019 and 2020. These measures include, for example, pension increases, an increase in children benefits, and partially abolishing the solidarity tax. Overall, these additional stimuli from measures agreed upon in the coalition pact will amount to a good 15 billion euros in 2019, ten billion euros in 2020, and almost 17 billion euros in 2021. Compared to the previous year, there will be an additional 2.6 billion euros, 2.1 billion euros, and 2.5 billion euros in 2019, 2020, and 2021, respectively, available for investments, such as in the expansion of the broadband network, the Digital Pact for Schools, or the expansion of the Deutsche Bahn network. The Federal Government is boosting growth in Germany by 0.3 percentage points per year.

However, the government has almost used up all available fiscal measures. Its declared objective is a structurally balanced budget over the long term. Initially, measures to support consumption were prioritized and a policy aimed at

DOI: https://doi.org/10.18723/diw_dwr:2019-37-1

strengthening production potential was neglected for a long time. It is only more recently that public investment has been increased significantly and laws have been passed which, for example, favor investment in research and development. However, an economic policy focusing on long-term growth is needed urgently in several respects. From an economic point of view, the measures already adopted will help support demand in the short term. However, companies lack confidence due to the many uncertainties; this is reflected in lower levels of investment. On the one hand, a plan to invest in long-term modernization would strengthen companies' future prospects and directly increase their propensity to invest. On the other hand, this is also urgently necessary with regard to Germany's competitiveness. In key areas such as digitization, infrastructure, and education, Germany has lost ground to other locations significantly. At the same time, such investments strengthen social cohesion. In addition to improved competitiveness, the German business model should be modified towards a growth model that is more inclusive. This requires, for example, investments in housing or better access to digital services in rural areas.

At present, there is a good opportunity to make up for these disadvantages. The Federal Government can borrow in the long-term at negative interest rates. However, the dogma of preserving a balanced budget stands in the way of more comprehensive debt financing. The "black zero" is not a meaningful economic policy in its own right. However, moving away from it would only be a first step. In view of the scale of the challenges and the historically low financing costs, it would also be advisable to review the rules of the debt brake to strengthen the foundations of the German economy in the long term.

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Phone: +49 30 897 89–0 Fax: –200
Volume 9 September 11, 2019

Sale and distribution
DIW Berlin Leserservice, Postfach 74, 77649 Offenburg
leserservice@diw.de
Phone: +49 1806 14 00 50 25 (20 cents per phone call)

Layout
Roman Wilhelm, DIW Berlin

Cover design
© imageBROKER / Steffen Diemer

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

ISSN 2568-7697