Economic Insight

German growth outlook remains favorable

June 8, 2018

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Executive Summary

- The German economy got off to a weak start in 2018, with growth halving to 0.3% in the first quarter of this year compared with the end of 2017 (+0.6%). Within the euro area, the German economy is now growing at below-average rates. Germany's real gross domestic product in the first quarter of 2018 was only 2.3% higher than the corresponding prior-year level, but that of the euro area by 2.5%.

- However, the domestic economic conditions for a continuation of the upswing remain very good. The earnings situation in the corporate sector is positive, financing conditions are exceptionally favourable, the debt of companies and households is relatively low, high capacity utilisation promotes investment demand, job creation generates additional income and real purchasing power of disposable incomes is growing despite higher oil prices. We therefore expect domestic demand to pick up again already in the second quarter of this year.

- All in all, despite the increased risks, we expect overall economic utilization in Germany to continue to increase in 2018 and 2019. However, with a not-working-day adjusted real GDP growth of 2.1% this year and 1.9% next year, 2017´s growth rate of 2.2% will not quite be reached.

- There are more downside risks to the growth outlook for Germany than there is upside potential. While we see upside potential primarily in the case of a better-than-expected performance of the US economy, downside risks exist far and foremost in the context of the ongoing trade conflict with the US, the inflation outlook and political imponderabilities in Europe.

Economy temporarily shifts down a gear in the first quarter

The German economy got off to a weak start in 2018, with growth halving to 0.3% in the first quarter of this year compared with the final quarter of 2017, when real GDP expanded by 0.6% quarter-on-quarter. While domestic demand – and here in particular investment – registered fairly solid growth rates, the external sector simply disappointed. Both real exports and real imports shrank over the preceding quarter. Moreover economic sentiment measured by the ifo business climate index and the purchasing manager´s indices retreated significantly from their highs reached in late-2017. Within the euro area, the German economy is now growing at below-average rates: Germany's real GDP in the first quarter of 2018 was only 2.3% higher than the corresponding prior-year level, but that of the euro area by 2.5%.

Has Germany stopped being a European growth engine? Is it perhaps even slowing down the upswing in Europe? From our point of view this would be a misinterpretation. Several factors contributed to Germany´s subdued start to the year 2018. Higher sick leave, an

above-average number of strike days and early Easter holidays are likely to have dampened overall economic production. However, in view of the length of the upswing, the German economy is close to its capacity limits in some areas. The overall economic growth rates can therefore only deviate upwards from the medium-term growth potential to a limited extent. At present, we see Germany´s growth potential at about 1.5% per annum. By contrast, a number of other European countries still have considerable economic catch-up potential.

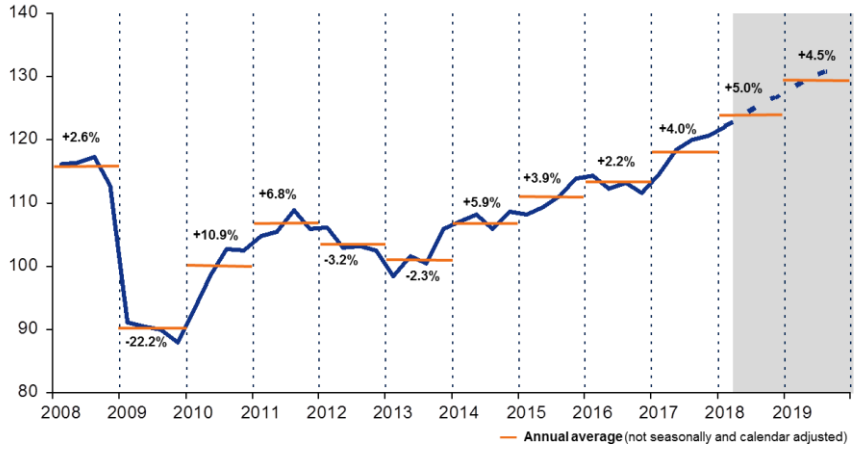
Expansion in Germany proves to be robust

The domestic conditions for a continuation of the expansion in Germany remain excellent. The earnings situation in the corporate sector is positive, financing conditions are exceptionally favourable, the debt of companies and households is relatively low, high capacity utilisation promotes investment demand, job creation generates additional income and real purchasing power of disposable incomes is growing despite higher oil prices. We therefore expect domestic demand to pick up again already in the second quarter of this year.

Investment demand, which had already gained momentum in 2017, is likely to continue its upward trend in 2018. In view of above-average capacity utilization and the good earnings and liquidity situation of companies, we estimate that real investment in machinery and equipment will increase by around 5% in 2018 and 4.5% in 2019. Construction remains in an expansion mode anyway, even if capacity bottlenecks are dampening growth rates here. The noticeable increase in investment activity is positive in view of the medium-term growth potential of the German economy.

Investment clearly heading upwards

Seasonally and calendar adjusted investment in machinery and equipment, index (2010 = 100), in previous year's prices



Sources: Thomson Reuters Datastream, own forecasts.

Looking at the drivers of private consumption, the disposable income of private households will continue to grow quite strongly in nominal terms. Last year's increase of 3.8% was the highest since 2001. For this year we have penciled in growth of 3.4% and 3.8% for 2019. The acceleration in the increase in 2019 is mainly due to the expected tax relief and additional monetary social benefits. Despite slightly higher inflation rates due to the oil price, purchasing power gains are sufficient for a continuous expansion of real private consumption, which is expected to rise by 1.4% on average in 2018 and 1.7% in 2019.

In contrast to the outlook for domestic demand, much more uncertainty prevails with regard to foreign trade prospects. Experience shows that trade flows react sensitively to increased uncertainty – and, without doubt, there currently is an increased level of untertainty (see next section). In our base case scenario, however, we expect no major risk (such as a substantial escalation in the trade conflict with the US) to materialize. Although the external value of the euro has declined noticeably in recent months, which improves the price competitiveness of German exporters, this will probably not fully offset the dampening factors in conjunction with the increased level of uncertainty. Exports are unlikely to show such a significant upward trend in the further course of 2018 as we had previously penciled in. We now expect real exports to grow by only 3.4% in 2018 (previously +5.6%) and by 3.3% in 2019.

All in all, overall economic utilization will thus continue to increase in 2018 and 2019. However, with a not-working-day adjusted real GDP growth of 2.1% this year and 1.9% next year, 2017´s growth rate of 2.2% will not quite be reached. The labour market will prove to be robust if the economy as a whole continues to expand. However, employment growth is expected to slow gradually. The number of employed persons, which increased by around 630,000 last year, is expected to increase by 590,000 this year and by 420,000 next year. In particular, the declining increase in the working age population speaks in favour of this slowdown. The number of unemployed should continue to fall relatively steadily. We estimate that the number of unemployed will decrease by around 180,000 in 2018 and by around 140,000 in 2019.

Germany: Economic indicators and forecast*

		2016				2017				2018				2019							
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2016	2017	2018e	2019f
GDP real (not calendar-adjusted)		0.6	0.5	0.3	0.4	0.9	0.6	0.7	0.6	0.3	*0.6*	*0.5*	*0.5*	*0.5*	*0.4*	*0.4*	*0.4*	1.9	2.2	2.1	1.9
Private consumption		0.5	0.1	0.5	0.7	0.5	0.8	0.0	0.1	0.4	*0.6*	*0.4*	*0.4*	*0.5*	*0.4*	*0.4*	*0.3*	2.1	1.8	1.4	1.7
Government spending		1.5	0.7	0.2	0.5	0.1	0.5	0.5	0.4	-0.5	*0.5*	*0.5*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	3.7	1.5	0.9	1.7
Investment in machinery/equipment		0.4	-1.8	0.7	-1.3	2.6	3.3	1.3	0.7	1.2	*1.3*	*1.3*	*1.0*	*1.2*	*1.2*	*0.8*	*0.8*	2.2	4.0	5.0	4.5
Construction		2.0	-1.8	0.2	1.0	2.9	0.5	-0.2	0.1	2.1	*1.2*	*1.0*	*0.8*	*0.8*	*0.8*	*0.7*	*0.7*	2.7	2.8	3.7	3.4
Domestic demand		0.9	-0.2	0.8	0.8	0.4	1.1	0.4	0.1	0.4	*0.8*	*0.6*	*0.5*	*0.5*	*0.4*	*0.4*	*0.4*	2.4	2.2	1.9	2.0
Exports		1.0	1.3	-0.2	1.3	1.6	1.1	1.7	2.6	-1.0	*1.0*	*0.9*	*0.9*	*0.8*	*0.8*	*0.7*	*0.7*	2.6	4.6	3.4	3.3
Imports		1.7	-0.2	0.7	2.5	0.5	2.4	1.0	1.8	-1.1	*1.5*	*1.5*	*1.0*	*0.9*	*0.9*	*0.7*	*0.7*	3.9	5.2	3.4	4.0
Industrial production (excl. construction)**		1.6	-0.6	0.2	0.1	1.1	1.6	1.4	0.9	0.0	*1.0*	*0.6*	*0.8*	*0.5*	*0.5*	*0.5*	*0.5*	1.3	3.3	3.0	2.4
Unemployment rate (EU def.)	%	4.4	4.2	4.1	4.0	3.9	3.8	3.7	3.6	3.5	*3.4*	*3.4*	*3.3*	*3.3*	*3.2*	*3.2*	*3.1*	4.2	3.8	3.4	3.2
Unemployment rate (nat. def.)	%	6.2	6.1	6.0	6.0	5.9	5.7	5.7	5.5	5.4	*5.3*	*5.3*	*5.2*	*5.1*	*5.0*	*4.9*	*4.8*	6.1	5.7	5.3	5.0
Employed persons (national def.)	y-o-y	1.3	1.3	1.3	1.4	1.5	1.5	1.5	1.4	1.4	*1.4*	*1.3*	*1.3*	*1.1*	*1.0*	*0.9*	*0.8*	1.3	1.4	1.3	0.9
Consumer prices	y-o-y	0.3	0.1	0.5	1.1	1.9	1.7	1.7	1.7	1.5	*1.8*	*1.9*	*1.8*	*1.9*	*1.8*	*1.9*	*1.9*	0.5	1.7	1.8	1.9
Consumer prices (HICP)	y-o-y	0.1	0.0	0.4	1.0	1.9	1.6	1.7	1.6	1.3	*1.6*	*1.6*	*1.7*	*1.9*	*1.8*	*1.9*	*1.9*	0.4	1.7	1.6	1.9
Producer prices	y-o-y	-2.8	-2.7	-1.7	0.2	2.8	2.9	2.7	2.6	2.0	*2.5*	*2.8*	*2.5*	*2.6*	*2.4*	*2.2*	*2.0*	-1.7	2.7	2.5	2.3
Current account balance	EUR bn	69.3	69.4	63.2	64.7	65.4	59.6	68.2	70.7	70.9	*65.0*	*65.0*	*63.0*	*62.0*	*61.0*	*60.0*	*59.0*	268.8	263.9	263.9	242.0
	% of GDP																	8.5	8.1	7.8	7.0
Budget balance	EUR bn																	25.7	36.6	40.6	28.2
(Maastricht-definition)	% of GDP																	0.8	1.1	1.2	0.8

*) quarterly figures: percentage change over previous period, seasonally and working day adjusted, except where noted, yearly figures: percentage change, not working day adjusted; **) yearly average working day adjusted;

e = estimate; f = forecast.

Government budget remains in surplus

Since 2014, the German government has recorded a positive budget balance – and it is increasing year after year. This will not change in 2018. We expect a budget surplus of just under EUR 41bn. Thanks to the buoyant economy, both social contributions and tax revenues will grow strongly. Total government revenues are expected to increase by 3.8%. As in 2017, expenditures are expected to increase by 3.6%. All in all, we expect a budget surplus of 1.2% of GDP in 2018, after an increase of 1.1% in 2017.

While the economic policy agenda of the new government will have no major impact on the public budget in the current year, the planned tax cuts and additional expenditures will be clearly visible on the revenue and expenditure side of the budget in 2019. We expect growth in both tax revenues and social contributions to slow down. The planned

further increase in tax allowance and the shift in the tax rate should slightly dampen the increase in tax revenues. The 0.3 percentage point reduction in unemployment insurance contributions, which will come into force at the beginning of 2019 at the latest, will dampen dynamics in social insurance contributions. Overall, we expect total revenues to increase by 3.6% in 2019 compared to the previous year and thus somewhat weaker than in 2018. At the same time, government spending will grow faster than revenues for the first time since 2013, rising by 4.5% next year. The main reason for this is the expected strong increase of 5% in monetary social benefits. It is assumed that the basic pension (*Grundrente*) will be implemented at the beginning of 2019 and the expansion of the so-called "maternity pension" (*Mütterrente*) in the middle of 2019. The planned increase in child benefit should also have an impact from the middle of the year. Overall, the budget surplus is set to decline to EUR 28bn or 0.8% of GDP.

What is worth highlighting is that public spending in 2019 will grow faster than nominal GDP. As a result, government expenditures as percent of GDP should rise quite perceptible from 44.0% to 44.4%. Against the backdrop of the fact that the German economy will again grow above potential in the coming year and in view of the long-term demographic challenges for the government budget, we take a critical view of the increase in the state spending ratio at this point in time.

Risks to the outlook are clearly tilted to the downside

There are more downside risks to the growth outlook for Germany than there is upside potential. We see the latter primarily in the case of a better-than-expected performance of the US economy. Stronger growth in the US, if e.g. the pass-through effect of the sizeable pro-cyclical fiscal stimulus is higher than expected, would have positive repercussions globally – given the weight of the US economy in global output of more than 25%.

There is no doubt that increasing protectionism poses a considerable risk for global trade and thus also for the global economic outlook. Given the openness of the German economy, this holds true for the biggest EU economy in particular. The EU Commission has just recently announced that, in accordance with WTO rules, it intends to introduce countermeasures to the additional US import tariffs on steel and aluminum at the beginning of July. Is this the beginning of a spiral of protectionism, that actually nobody wants to have? Just keep in mind that in May the US Commerce Department has started to look into whether import tariffs on cars and automobile parts could be raised for US national security reasons. The automobile industry is Germany´s #1 export sector. As of today, we do not expect a noticeable expansion of protectionist measures on a global level. It still seems most likely to us that economic reason will prevail and that a noticeable escalation of the conflict can be avoided through negotiations. But even if an escalation can be avoided, prolonged uncertainty about further progress in the trade conflict can also cause considerable economic damage.

Negative inflation surprises, meaning that inflation surprises on the upside, also pose a downside risk to our growth outlook. Firstly, it would put a dent on the purchasing power of private households. Secondly, central banks might be tempted to tighten their monetary policy stance faster and/or stronger than financial markets have previously anticipated. This could finally lead to sharp market reactions and increased volatility. We experienced a possible foretaste of this in February, when US wages and inflation data

turned out to be higher than expected and the financial markets corrected sharply out of concern about a more pronounced Fed tightening path.

Political imponderabilities in Europe remain at an elevated level. Top risk in this respect is Italy, where uncertainty around the course of the newly installed populist government is high. There are many open questions e.g. with regard to the new government´s EU stance and the possible negative impact of expansive fiscal policy measures on public debt fundamentals. However, we expect that the new coalition will implement less than half of the announced policy measures. Policies are likely to be delayed, watered down or not implemented at all for a number of reasons such as M5S / Lega infighting, institutional curbs and market constraints on borrowing.

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