The current economic situation in Germany

Overview

Economic slowdown due to persistent weakness in industry

Global economic growth somewhat slower

In the second quarter of 2019, the global economy probably expanded at a slightly slower pace than in the preceding quarter. The upturn decelerated distinctly in the advanced economies, in particular. A key reason was that one-off factors that had supported growth in the first quarter were no longer present. After a strong start to the year, the euro area economy returned to the weak growth path it had been charting previously. Economic growth also slowed in the United States, although final domestic demand gained significant momentum. In the United Kingdom, real gross domestic product (GDP) even contracted. The rate of growth in the Chinese economy, which is high by international standards, fell slightly.

World trade and global industrial activity still anaemic

The pronounced weakness in world trade persisted over the past few months. One reason that is frequently cited for this is the trade dispute between the United States and China. Bilateral trade flows did in fact shrink considerably. Perhaps more significant, however, were flagging industrial activity and investment even in countries not directly affected by the conflict. Despite the persistent slowdown in industry, survey results show that business activity in the services sector remained relatively robust. This is supporting employment growth and hence private consumption, as a key pillar of the economy. For the pace of global growth to pick up sustainably, however, industrial activity will need to recover.

Loosening of monetary policy and intensification of trade disputes shaping developments on the financial markets

Events on the international financial markets in the second and third quarters of 2019 were heavily shaped by the monetary policy of major central banks and more recently by the resurgence of the trade dispute between the United States and China. Above all, the Eurosystem's communication of monetary policy, which is perceived to be accommodative, and the Federal Reserve System's policy rate cut at the end of July played a part in falling capital market rates around the world. Added to this were concerns about a cooldown in world trade and global economic activity, which recently led to increased demand for government bonds, with yields on Federal bonds (Bunds) falling to historic lows. No broad-based "flight to safety" was observed, however, as both the interest rate spread of euro area government bonds and the yield spreads of European corporate bonds over Bunds narrowed. On the stock markets, the intensified trade dispute led to significant price falls at the beginning of August. These undid, in many places in full, the price gains previously recorded since the end of March. At the same time, uncertainty about future stock market developments rose sharply. The indicators derived from the Bundesbank's dividend discount model are not currently signalling an unusually low or high valuation level for either the S&P 500 or the EURO STOXX. On the foreign exchange markets, the pound sterling depreciated distinctly against the backdrop of the government reshuffle in the United Kingdom and the attendant growing concerns about Brexit. The renminbi also became a focus for market monitors after temporarily dropping to a multi-year low against the US dollar. On a weighted average against the currencies of 19 major trading partners, the euro gained around 2%, however.

Monetary policy: forward guidance on key interest rates adjusted

After its monetary policy meetings in June and July, the Governing Council of the ECB adjusted its forward guidance on key interest rates. The Governing Council now expects the key ECB interest rates to remain at their present or lower levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels below, but close to, 2% over the medium term.

Interest rate for TLTRO III decided

In addition, the Governing Council decided at its June meeting on the interest rate and other modalities of the new series of targeted longer-term refinancing operations (TLTRO III) announced in March. The interest rate for each operation will initially be set at a level of 10 basis points above the average rate applied to the Eurosystem's main refinancing operations over the life of the respective TLTRO, and where benchmark net lending is exceeded the rate can be as low as the average interest rate on the deposit facility plus 10 basis points.

Robust underlying monetary dynamics

The broad monetary aggregate M3 experienced considerable inflows in the second quarter as well, continuing its robust growth. Key drivers of growth remained loans to the domestic private sector and inflows of funds from abroad as the attractiveness of investing in Germany continues to grow for non-residents. As yet, the slowdown in the euro area has not dampened credit growth in most countries, but according to the current Bank Lending Survey (BLS) credit standards and conditions in the euro area have been tightened overall in the reporting quarter.

German economy contracted slightly in Q2 2019

Economic output in Germany contracted slightly in the second quarter of 2019. According to the Federal Statistical Office's flash estimate, real GDP was 0.1% down on the quarter after seasonal and calendar adjustment. The prior-year level was exceeded by 0.4% in calendar-adjusted terms. Thus, the underlying trend in economic output was still slightly positive overall in the past four quarters, but significantly lower than the increase in potential output. Several factors played a role in the second-quarter decline in GDP. First, the downturn in industry even intensified slightly on the back of decreased foreign demand. A contributing factor was that the date of Brexit in the United Kingdom, initially scheduled for the end of March, led to substantial stockpiling in the first quarter. Exports to the United Kingdom were therefore especially weak in the second quarter. Second, one-off effects that had supported economic activity in the first quarter acted as a distinct brake on the still intact domestic expansionary forces in the second quarter. For instance, construction output dropped off steeply after expanding strongly in the first quarter due to weather conditions. Meanwhile, demand for cars, pent up by delivery bottlenecks last year, was largely met in the first quarter and did not increase further in the reporting month. This curbed private consumption.

Economic activity weak across the board

The slight decline in economic output in the second quarter was fairly broadly spread across sectors. Only the retail trade and a number of other service industries are likely to have provided positive momentum. By contrast, sales in the construction sector and in the restaurants and hotels industry decreased. Wholesale trade slid into the downturn afflicting industry. On the demand side, too, economic activity saw a broad-based weakening. Private consumption is not likely to have exceeded the level of the strong preceding quarter by much. Exports were down substantially. Against this backdrop, and in light of declining capacity utilisation and the subdued outlook for manufacturing, businesses probably held back on investing in new machinery and equipment. Construction investment also went into reverse. Government consumption may have provided the only meaningful boost to economic activity. Aggregate capacity utilisation is still above average, despite the decline in the past few quarters.

German banks' lending to domestic private sector lively again

Although the German economy cooled, bank lending to the domestic non-bank sector was extremely dynamic in the reporting quarter. Among loans to the private sector, lending to domestic non-financial corporations recorded the largest net inflows. However, lending to households, particularly loans for house purchase, also made a significant contribution to the growth in German banks' lending business. According to the bank managers surveyed for the BLS, demand rose primarily because financing needs for fixed capital formation increased in the corporate lending segment and borrowers took advantage of the low general interest rate level in the loans to households for house purchase segment. At the same time, the results of the BLS indicated that lending policy in the former segment was made slightly restrictive overall, while it was loosened somewhat in the latter segment.

Weak economy affecting labour market in Q2

The cyclical weakness present for a year at this point also left its mark on the German labour market in the second quarter. This was reflected by the fact that the rise in employment was considerably slower in the reporting period than in previous quarters. In particular, this applies to the number of employees subject to social security contributions, which had previously seen strong growth. In addition, unemployment did not recede any further. However, this does not mean that labour market conditions are deteriorating, at least for now. On the contrary, the situation remains exceptionally favourable. The only difference is that it did not improve as before and that the outlook for the next few months has deteriorated further.

Negotiated wage growth perceptibly weaker in Q2

In the second quarter, the increase in negotiated wages was noticeably smaller than a quarter earlier. Including additional benefits, negotiated wages rose by 2.1% on the year in the second quarter of 2019, compared with 2.9% in the first. At an annual growth rate of 2.4%, the increase in negotiated rates of basic pay was likewise down compared with the first quarter (3.0%). However, this is unlikely to be a reflection of an economic slowdown. In fact, the slower pace of growth in negotiated pay rates can primarily be attributed to the second round of increases under old, long-running collective wage agreements being lower (or even non-existent). At the time these agreements were concluded, the persistent economic downturn had not yet been foreseeable. Moreover, the second quarter included a number of months with no pay rise under newly reached pay agreements. As in previous quarters, actual earnings are likely to have slightly outpaced negotiated wages in the second quarter.

Broad-based and strong rise in consumer prices in Q2

Consumer prices recorded a strong and broad-based rise in the second quarter. One-third of the seasonally adjusted increase in the Harmonised Index of Consumer Prices (HICP) of 0.9% on the quarter was attributable to energy, which became considerably more expensive due to temporarily higher crude oil prices. In addition, prices for food, beverages and tobacco went up substantially. This was mainly on account of tobacco. However, even excluding energy and food, the upward pressure on prices was substantial, especially for services. First, the prices for package holidays rose even more strongly than the late date of Easter might have suggested. Second, prices rose considerably in some parts of the services sector, e.g. maintenance and repair of dwellings or hairdressing. This is probably attributable, in part, to marked wage increases in these areas. The prices of non-energy industrial goods grew at a moderate pace, tracking the trajectory of earlier stages. Annual consumer price inflation rose only moderately on the whole from 1.6% to 1.7% as inflation had also been fairly strong in the second quarter of 2018. Excluding energy and food, the figure was 1.5%, up from 1.4%. In July, prices rose by a further 0.1% in seasonally adjusted terms. However, year-on-year HICP inflation dropped considerably from 1.5% to 1.1%. The main reason behind this drop was that the recent deceleration of prices for package holidays disproportionately dampened core inflation and headline HICP. This is down to the way in which weighting adjustments to Germany's HICP were handled.

German economy lacklustre in Q3 as well

The German economy is probably set to remain lacklustre in the third quarter of 2019. GDP could continue to fall slightly, due mainly to the continued downturn in industry. According to the data currently available, industrial production is expected to further contract perceptibly in the ongoing quarter. Enterprises, for example, received significantly fewer orders in the second quarter than in the already weak first quarter. Moreover, ifo institute data indicate that short-term output and export expectations in the manufacturing sector further deteriorated of late. The more domestically-oriented sectors have thus far largely been able to evade this downward trend and are supporting the economy. The boom in the German construction sector is likely to persist. Enterprises in some service industries, however, were less confident about the future of late. Although households' income prospects remain favourable, the economic downturn has now also started to affect the labour market. Future developments will hinge on how long the present economic dichotomy lasts and which direction it takes once it dissolves. As things currently stand, it is unclear whether exports and, by extension, industry will regain their footing before the domestic economy becomes more severely affected.

Public finances situation remains favourable this year

The public finances situation in Germany has remained favourable. Although the general government surplus is likely to fall in the current year (2018: 1.7% of GDP), it will probably remain significant owing to the favourable underlying conditions. The debt ratio is likely to decline further and, as the year progresses, comply with the ceiling of 60% for the first time since 2002.

Looser fiscal policy reducing surplus

The reduction of the surplus is mainly attributable to a loosened fiscal policy. The spending stance, in particular, is expansionary, which is boosting the economy as a whole. The consequences of weaker economic activity on the budget have been limited thus far. The labour market and private consumption – two components which are particularly important for public finances – are likely to show robust development for the year as a whole.

More fiscal loosening in coming years but still leeway for now

Over the next few years, fiscal policy is set to be loosened further. However, barring fundamental changes, and based on the current macroeconomic projections, the government budget is likely to keep running a surplus in the medium term. This means that there is still a gap to the deficit ceiling and that the debt ratio remains on its downward path. In the longer term, public finances will increasingly come under demographic pressure. This pressure should be taken into account when decisions are taken in the future, especially regarding strongly affected areas such as pension and long-term care insurance.

Federal budget has buffer initially but will increasingly tighten in the medium term

From today's perspective, the Federal budget developments for this year and next will be more favourable than planned, making continued surpluses possible. As a result, the refugee reserve would not be reduced as planned; instead, it would further expand. The Federal Government's medium-term financial plan for 2021 to 2023 seems ambitious by contrast. It envisages a highly moderate spending stance, in spite of several additional requirements.

Abolish solidarity surcharge faster and revise income tax if necessary

Added to this is the substantial default risk attached to the funds stemming from the solidarity surcharge, the continuation of which, in whole or in part, is legally contentious. This risk concerns not only the income planned for the medium term but might also lead to repayment obligations. There are calls – not least because of such legal risks – for the surcharge to be abolished completely. Given fiscal leeway in the year ahead, it may be worth considering phasing out the surcharge earlier than planned thus far. Yet the medium-term leeway is not sufficient for it to be done away with entirely. If plans are not intended to be otherwise adjusted, what could be done is to revise the standard income tax by, for instance, eliminating exceptions and adjusting rates. In the process, the desired tax burden for the various income groups could be made transparent.

Address problematic developments at local government level and reliably avoid them in future

The state and local governments, too, are posting high overall surpluses and the outlook is currently favourable. However, some local governments' finances are still in distress. Given that the state governments are responsible for organising local governments' revenue-sharing schemes and providing local government budgetary oversight, they are partially responsible for any accumulated legacy debt accruing to individual local governments from cash advances. Together with their local governments, state governments ought to address these issues promptly, reliably preventing new unsound developments. Multi-year cash advances should be avoided in the future. If local governments with budgetary shortfalls were only allowed to obtain such advances from their respective state government, the responsibility would lie directly with the state government. If these advances were also to be counted towards that state government's debt brake, this would create an added incentive to take effective countermeasures in a timely manner.