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Cyclical upswing in Germany and in the world

At the turn of the year, the cyclical upswing in Germany continues. Gross domestic product is expected to increase by 2.2% in 2017, and because this year has seen significantly fewer working days than before, the rate of change amounts, adjusted for calendar effects, to even 2.5%. "The upswing is broad-based", says Oliver Holtemöller, head of the Department Macroeconomics and IWH vice president. "For quite a long time now, significant increases in employment have been driving private incomes, consumption and housing construction. The latter was, in addition, stimulated by low interest rates." Currently, German exports are benefiting from the vivid international economy. Not least since monetary policy in the euro area remains expansionary for the time being, we expect the upturn to continue in 2018 and production to increase again by 2.2%. Consumer price inflation is, with 1.7%, still moderate in both 2017 and 2018. Although domestic price pressures are on the rise, the effects of the energy price increase in 2017 expire in 2018, and the appreciation of the euro in the summer of 2017 will dampen price dynamics.

Forecast for Germany: Key Economic Indicators[a] for Germany, 2017–2019

	2016	2017	2018	2019
	percentage change over previous year (price adjusted)			
Germany	1,9	2,2	2,2	1,6
East Germany[a]	2,1	2,1	2,0	1,5
	percentage change over previous year in %			
hours worked	0,6	1,3	1,2	0,8
hourly union wages	2,1	2,3	2,4	2,4
hourly actual wages	3,2	2,8	2,8	3,0
unit labour costs[b]	1,6	1,8	1,8	2,2
consumer price index	0,5	1,7	1,7	1,7
	1 000 persons			
employment (domestic)	43 638	44 295	44 878	45 322
unemployment[c]	2 691	2 535	2 440	2 397
	in %			
unemployment rate[d]	6,1	5,7	5,4	5,3
East Germany[a]	8,5	7,6	7,1	6,9
	in % of nominal GDP			
general government overall balance	0,8	1,4	1,3	1,3
current account balance	8,4	8,1	8,1	8,1

[a] East Germany including Berlin. – [b] Per hour (IWH calculations). – [c] Federal Employment Agency (BA) concept.– [d] Unemployment in % of civilian labour force (Federal Employment Agency (BA) concept).
Source: Federal Statistical Office; 2017–2019: forecast (as of December 14, 2017).

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The international economy

In 2017, the previously modest global economy gained considerable momentum. The centers of the upswing are China, the USA and the euro area. The strong global economy is likely to be due to the combination of three factors. First, extremely expansionary monetary policies have been supporting real economic activity for many years. Second, since 2015 the oil price is on average only about half as high as in previous years. Finally, Chinese demand for imported goods has contributed significantly to the revival of world trade. In 2018, monetary policy is expected to remain expansionary, albeit to a lesser extent. Fiscal policy is slightly expansionary, especially since a tax reform is to be expected for the USA. The latest corporate surveys also point to a continuation of the strong global economy. With advanced economies likely on average to face over-utilisation of economic capacities for the first time since the financial crisis and the Great Recession, companies will have reason to increase their investment to expand capacities. We also expect that the price and wage dynamics in this group of countries will pick up, possibly triggered by the recent increase in energy prices.

The German economy

The German economy has been in a **cyclical upswing** for four years now, but its strong performance in 2017 was still surprising. The upturn is broad-based; while the driving force of the years before was mainly consumption, in 2017 the economy received a strong stimulus from abroad, in particular from the rest of the euro area and from Asia. The improved export prospects have caused investment in equipment to expand markedly. In contrast, construction activity hardly increased during summer, despite large order backlogs. Apparently, the construction industry is currently coming up against capacity limits: In this sector, labour costs and prices are now increasing by more than 3% per year, and rising.

Still, there are many indications that overall the **upswing will continue** in 2018. Financing conditions in Germany are likely to remain very favourable, as the European Central Bank (ECB) will only slowly be reducing its expansionary monetary policy stance. Due to the budgetary surplus that is not only cyclical, but to a considerable degree also structural, fiscal policy has considerable room for maneuver. However, because at present it is unclear when a new government will come to power and what it will do, only discretionary measures that have already been decided on are included in the present forecast. On this basis, fiscal policy in 2018 is slightly expansionary. The international economic conditions should remain favourable. All in all, according to this forecast, GDP in Germany will increase by 2.2% in both 2017 and 2018. The unemployment rate will continue to decline in 2018. The public budget balance, at 1.3% in relation to gross domestic product, will be almost as high as in 2017.

The **East German economy** is expected to expand at slightly slower rates of 2.1% in 2017 and 2.0% in 2018. Because the manufacturing sector in East Germany is not as export-oriented as that in the West, it also does not benefit as strongly from the currently strong international economy.

This very favourable forecast for the German economy is associated with three main **risks:** First, it is not known which direction economic policy will take in the coming years, as long as there is no new government. A much more expansionary fiscal policy than assumed here is well conceivable, but by no means certain. Another risk concerns the international economy: Financial markets may see a revision of the current very optimistic valuation of many asset classes. In that case, the international environment could deteriorate rapidly. Finally, the favourable economic situation in Germany carries its own risks: If aggregate demand increases as strongly in 2018 as recently, it is conceivable that production capacities in many sectors will no longer be sufficient, and price increases will increasingly replace expanding real production. Such a development seems to be emerging already in the construction sector.

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