JOINT ECONOMIC FORECAST – SUMMARY 2/18

Berlin, 27th September 2018

Upturn Loses Momentum – World Economic Climate Grows Harsher

The economic upturn in Germany is entering its sixth year, but is losing momentum. This is due to both demand and supply side factors. On the one hand, Germany's key sales markets have weakened in line with the slowdown in world trade. On the other hand, a growing number of companies are apparently facing production-side bottlenecks, especially in terms of labour and sourcing intermediate goods. This overlaps with problems in the automotive industry related to the introduction of the new World Harmonised Light Vehicle Test Procedure (WLTP), which has clearly impacted gross domestic product (GDP) growth due to the branch's economic weight. Adjustment problems, however, should be overcome in the course of the winter half year. Stimuli from fiscal policy measures will also take effect as of the beginning of 2019. After 1.7% growth this year, economic output will increase at rates of 1.9% in 2019 and 1.8% in 2020. Employment will continue to expand clearly, although at a slower pace. The number of registered unemployed persons will approach the 2 million-mark by the end of the forecasting horizon. Inflation will pick up from an average rate of 1.8% this year to 2.0% in 2019 and 1.9% in 2020. Despite its expansionary fiscal stance, the German government will continue to post a budget surplus, although this can be expected to fall from 54 billion euros to around 40 billion euros.

Key Forecast Figures for Germany

	2015	2016	2017	2018	2019	2020
Real gross domestic product[1]	1.7	2.2	2.2	1.7	1.9	1.8
Employment[2] (1000 persons)	43 071	43 642	44 269	44 860	45 280	45 590
Unemployment (1000 persons)	2 795	2 691	2 533	2 340	2 200	2 085
Unemployment rate BA[3] (in %)	6.4	6.1	5.7	5.2	4.8	4.5
Consumer prices[1,4]	0.3	0.5	1.8	1.8	2.0	1.9
Unit labour costs[1,5]	1.7	1.2	1.5	2.3	2.2	1.8
General government financial balance[6]						
EUR billion	23.9	28.7	34.0	54	42	41
in % of GDP	0.8	0.9	1.0	1.6	1.2	1.1
Balance on current account						
EUR billion	271.4	268.8	257.7	251	245	261
in % of GDP	8.9	8.5	7.9	7.4	7.0	7.1

[1] Percent change over previous year.
[2] Domestic concept.
[3] Unemployed persons in percent of civilian labour force (Federal Employment Agency concept).
[4] Consumer price index (2010=100).
[5] Compensation of employees per hour worked by employees in relation to labour productivity.
[6] On national accounts definition (ESA 2010).

Source: Federal Statistical Office; Federal Employment Agency; Deutsche Bundesbank; 2018 to 2020: forecast by the Institutes.

GEMEINSCHAFTS-DIAGNOSE

PRESS EMBARGO
27th September 2018, 10:00 a.m. CEST

PRESS CONTACT
Sabine Weiler
RWI – Leibniz Institute for Economic Research
Tel +49 201-8149-213
sabine.weiler@rwi-essen.de

SCIENTIFIC CONTACT
Prof. Dr. Roland Döhrn
RWI
Tel +49 201 8149-213
roland.doehrn@rwi-essen.de

www.gemeinschaftsdiagnose.de

A great deal of uncertainty weighs on future developments in the **world economy** in autumn 2018. Although global production continued to expand sharply up until summer 2018, the outlook has clouded over in recent months. On the one hand, the financial conditions for emerging economies are now less favourable due the withdrawal of international investors, with events even taking a crisis-like turn in Turkey and Argentina. On the other hand, trade conflicts are also casting a cloud over the outlook. Differences in the economic dynamics between countries have grown again since the beginning of the year. In the US the upturn regained impetus thanks to strong fiscal stimuli, while production was ramped up again considerably in China. In the euro area, by contrast, the economy lost impetus, especially in France and Italy.

World trade, which rose sharply at the end of 2017, has hardly expanded since the beginning of this year. However, this is only partly due to the deterioration in trade policy conditions. World trade had already been stagnating since the turn of the year, while US trade policy measures and the retaliatory tariffs imposed by other countries did not take effect until the summer. The measures taken to date also only affect a small group of goods. Lastly, the currencies of those countries affected by US tariffs since the onset of the trade conflict have mostly depreciated strongly against the US dollar, offsetting the loss in price competitiveness related to higher tariffs. However, the trade conflict will dampen the world economy due to its direct impact on trade, since it reduces confidence levels in the corporate sector.

The crude oil price rose sharply over the course of the year and was around 45% higher in August 2018 than during the same period a year previously. This triggered a sharp increase in consumer prices in the larger advanced economies. In the summer the **inflation rate** in the US reached almost 3%, slightly exceeding the Fed's mid-term target inflation rate of around 2%. In Japan, however, inflation remained at 0.9%. The core inflation rate (adjusted for energy price components) has only risen in the US to date. In both Japan (0.3% in July) and in the euro area (1.3% in August) it remained almost unchanged.

The US stepped up the pace of tightening **monetary policy** due to the rising inflation rate. The Fed has already raised its target range for the Federal Funds Rate twice this year to its current level of 1.75 to 2.0%. It is also communicating that further increases are to be expected. As long as strong economic growth continues, the base rate will be 2.5-2.75% by the end of 2019, taking it to a level that is cyclically neutral. In the euro area and Japan, by contrast, base rates remain unchanged at 0%. The central banks are also scaling back their bond buying volumes. The ECB plans to completely phase out net buying by the end of 2018, but is not expected to raise its base rate until the second half of 2019. There are no signs of any interest rate increases for Japan yet.

In view of the expected monetary policy stance and the robust economy, capital market interest rates have risen in the US. For 10-year government bonds there is a 2.6 percent and 1.6 percentage point yield gap between US bonds and their respective German and British counterparts. At the same time, financial investments in the **emerging economies** have become less attractive. This has been accompanied by a significant drop in net capital inflows, which is weakening the economic dynamics in emerging economies. The fact that capital outflows can have self-amplifying effects is problematic, especially in cases where country-specific risks are perceived. This is currently the case in Argentina and Turkey. At the same time, the currencies in nearly all emerging economies have depreciated clearly in recent months, which may indicate that investors generally assess investments in this set of countries as riskier. Against this background, the economic risks for emerging economies have grown significantly, but a crisis-like escalation as seen during the Asian crisis of 1997/1998 is not expected. Most of the emerging economies are now less exposed than they were back then as they have scaled back their foreign currency debt considerably and their capital requirements for financing current account deficits are mostly small.

In advanced economies, **fiscal policy** is pronouncedly expansionary, especially in the US. It is also slightly expansionary in several euro area countries. Although the British government has loosened its austerity plans, it continues to pursue a slightly restrictive policy. In Japan there are plans to increase the value added tax rate from 8% to 10% in autumn, but the Japanese government wishes to use part of the additional revenues to finance additional public expenditure.

All in all, the institutes expect the **world economy** to continue on an upwards trend. Overall economic production in the countries covered by this report is expected to expand by 3.3% in 2018, followed by 3.0% in 2019 and 2.9% in 2020. The domestic economy remains the main driver in view of the monetary and fiscal policy pursued in most countries, while uncertainty concerning the world trade system will continue to have a negative impact. Globally, growth is expected to slow down over the forecasting horizon. The upturn in world trade will decline significantly to 3.4% in 2018, and is expected to reach 3% at best in the following two years.

After last year's strong growth, the **euro area's economy** weakened in the first half of 2018. This was due to a loss of impetus in exports after strong growth last year. Private consumption and fixed capital formation, by contrast, continued to grow at almost the same pace as in 2017 during the first half of 2018. At the beginning of the third quarter, problems with the switch to the new emissions testing standard WLTP negatively impacted production in the automotive industry, which had a knock-on effect on the entire economy. Fiscal policy will provide stimuli for the economy over the forecasting horizon. Favourable financing conditions and high capacity utilisation levels will trigger more investment. Continued improvements in the labour market and rising wages will boost consumer spending. The increase in gross domestic product will total 2.0% this year, followed by 1.8% in 2019 and 1.6% in 2020. The upturn is expected to continue in the euro area, although it will lose impetus. Expansion will mainly be driven by the domestic economy.

The upturn in **Germany** is entering its sixth year. One of its central pillars is the domestic economy, which is being stimulated by strong growth in employment and low interest rates. At the beginning of the year capacity utilisation levels were still very high, but have not increased further since for both demand-side and production-side reasons. On the one hand, the number of incoming orders has been in decline since the beginning of the year, partly because the economy in the largest German sales markets slowed down during the first six months of the year. On the other hand, companies are apparently facing growing supply-side bottlenecks, especially in terms of labour and intermediate goods. This is reflected in the production slowdown this year, despite full order books.

During the summer, economic activity was overshadowed by high **production and delivery fluctuations in the automotive sector**. Bottlenecks in certifying the new WLTP procedure that is required for all newly registered vehicles as of 1 September 2018 resulted in large build-ups in inventories, as well as intermittent production and delivery halts. Given the size of the automotive industry, this will impact the macro economy. In the second quarter of 2018 gross domestic product is only expected to have increased by 0.1% versus the previous quarter. The institutes expect the automotive sector to largely overcome its weakness in the last quarter of the year. As a result, economic growth will pick up strongly in the fourth quarter.

Fiscal policy will stimulate the economy at the beginning of 2019. Transfers and expenditure programmes will be expanded and the tax burden on employees will be lightened. Sustained favourable monetary conditions will also continue to bolster the economy. Stimuli from foreign trade, however, will be weaker as the world economy gradually slows down. On top of this, the domestic labour force potential is increasingly being exhausted and immigration is slowing down. Overall, the upturn is expected to gradually lose impetus over the forecasting horizon.

Gross domestic product is expected to increase by 1.7% this year on average. This represents a downward revision by 0.5% percentage points versus the institutes' spring forecast. Stimulated by fiscal policy, the German economy is expected to grow slightly more strongly in 2019 than this year at 1.9%. The 1.8% increase in gross domestic product forecast for 2020 overstates the economic dynamism due to the high number of working days in this year. All in all, the over-utilisation of economic capacities in the forecasting horizon will continue.

In the **labour market** the longer periods of time that job vacancies remain unfilled and higher wage pressure suggest that the supply of workers is increasingly unable to satisfy firms' high demand. Accordingly, growth in employment will gradually weaken over the forecasting horizon. On average the number of employed persons will rise by 590,000 this year. This figure will fall to 420,000 in 2019 and to 310,000 in 2020. On the one hand, it will be increasingly difficult to fill vacant positions with jobseekers, and the decline in unemployment will drop from 190,000 this year to

140,000 in 2019 and 120,000 in 2020. This corresponds to an unemployment rate of 5.2% this year and 4.8% and/or 4.5% in the next two years to follow. On the other hand, the potential labour force will increase to a lesser degree than to date. Positive trends in participation and immigration will increasingly fail to compensate for the age-related decline in the labour force.

Due to the growing labour shortage, **wages** will continue to rise sharply. After this year's 2.6% increase, agreed monthly wages can be expected to increase by an average of 2.7% in 2019 and 2020 respectively. Effective wage payments will increase more than collectively-agreed wages, since above tariff wage components will play an increasingly important role in attracting new employees and retaining existing staff.

Private consumption will continue to make a significant contribution to economic growth. The disposable income of private households will rise clearly in the two years ahead, boosted by fiscal policy, including reductions of the effective income tax rate and the return to equal contributions in statutory medical insurance. Disposable income will also be stimulated in the year ahead by the sharp increase in social benefits, mainly due to the higher pensions for mothers and another significant increase in old-age pensions. The **inflation rate** will rise from 1.8% this year to 2.0% next year and 1.9% in 2020. While the currently dominant influence over inflation, namely energy prices, will fade, core inflation will rise more sharply.

Thanks to very high capacity utilisation and favourable financing conditions, **investment activity** will also remain very strong over the forecasting horizon. The gradual loss of momentum in the upturn and severe bottlenecks in the labour market will nevertheless act as constraints. In the construction sector, in particular, capacity bottlenecks will continue to hamper economic activity reflected in a steep increase in construction prices. German exports will not regain momentum until the end of the year. Catch-up effects in automotive exports on completion of the certification of new cars will play a key role. Exports will only increase at gradually declining rates in line with world economic developments over the remainder of the forecasting horizon.

The institutes expect significant **fiscal surpluses** over the entire forecasting horizon. This year the surplus will total 54 billion euros or 1.6% of gross domestic product, thus hitting a new record high. In the subsequent years the German federal government's expansionary measures will make themselves felt and the fiscal balance will melt down to 41 billion euros (1.1% of gross domestic product). The structural fiscal balance will total 43 billion euros this year (1.3% of potential production). In the next two years it will be around half of this sum. The government's gross debt level in relation to gross domestic product will drop to around 60% in 2018. In 2019 it will fall below the Maastricht benchmark reaching 55% by 2020.

The **risks for the German and international economy** have grown since the spring. In particular, the rise of protectionism threatens the economy, as does any further escalation of the trade conflict between the US and China. Relations between the US and the EU have now eased in comparative terms. Thanks to the closely interconnected nature of added value chains, however, higher trade barriers between the US and China would push up production costs across the globe and would also impact German companies. This year has also shown that the US protectionist foreign trade policy does not merely consist of empty words. Another source of danger are the crises in Argentina and Turkey, especially if they trigger a loss of confidence in other emerging economies, leading to a significant deterioration in financing conditions.

Special risks for the European economy stem from the possibility of Britain's disorderly exit from the EU and the greater risk of a debt crisis in Italy. In the case of Britain, this forecast assumes that it an orderly exit from the EU in March 2019 will be agreed upon including a transition period that prevents barriers to trade with the EU-27 until the end of the forecasting horizon. Little progress, however, can currently be seen in negotiations, meaning that a disorderly, "No-deal" Brexit without a transition period remains a possibility. With the United Kingdom being Germany's third biggest export market, this scenario would hit the German economy particularly hard. In the case of Italy conflicts with the European Union's fiscal rules are to be feared if the Italian government implements its expansionary fiscal policy plans on a large scale. This could strengthen doubts over Italy's fiscal stability and potentially reignite the euro crisis.

In their assessment of economic policy the institutes have focused on **housing market policies**. Although rents are rising in Germany, these increases are hardly any faster than those in the cost of living on average. There are, however, significant regional differences, and especially large differences between existing and new rental agreements. The latter are rising sharply in many regions of Germany, making it hard for some income groups to find affordable accommodation. Politics has responded to this problem with a wide range of measures.

One of the former German government's responses to sharp regional increases in rents was the cap on rents. Experience to date shows that this did effectively dampen price increases in the regulated branch somewhat, and that the negative impact feared on new construction was small. This only applies, however, because new builds and extensive modernisation projects were initially completely excluded from the rental cap. The design of this rent cap should also ensure that the share of the housing market regulated by it should shrink over time compared to the unregulated share, since the rent cap creates incentives to pull down cheap housing prematurely and replace it with new buildings.

Some of the German federal government's initiatives to promote housing are designed in such a way that they run the risk of exacerbating price increases and reducing its impact on construction activity. The family home-owner allowance, for example, can only be applied for within a short period of three years. This short duration is prone to lead to large subsidies being requested for projects that are already at an advanced planning, creating a considerable windfall effect. On the other hand, higher demand is concentrated over a short period of time, increasing the likelihood of cost-driving effects.

In the current economic situation a housing policy is called for that is geared towards continuity and improves the outlook for raising long-term capacity utilisation in the construction industry. This could also favour capacity expansion in the industry. Government policy should also be more targeted towards supply conditions. One starting point would be providing more building plots, another would be to take measures to reduce construction and real estate transaction costs.

(**German):**

Projektgruppe Gemeinschaftsdiagnose: Aufschwung verliert an Fahrt – Weltwirtschaftliches Klima wird rauer, Autumn 2018. Essen 2018.

The report can be downloaded from the following website as of 10:00 a.m., 27th September 2018:
www.gemeinschaftsdiagnose.de/category/gutachten/.

About the Joint Economic Forecast

The Joint Economic Forecast is published twice a year in spring and in autumn on behalf of the Federal Ministry for Economic Affairs and Energy. The Joint Economic Forecast in autumn 2018 was prepared by:

- German Institute for Economic Research (DIW Berlin)
- ifo Institute - Leibniz Institute for Economic Research at the University of Munich in cooperation with the KOF Swiss Economic Institute – ETH Zurich
- Kiel Institute for the World Economy (IfW Kiel)
- Halle Institute for Economic Research (IWH) – Member of the Leibniz Association
- RWI – Leibniz Institute for Economic Research in cooperation with the Institute for Advanced Studies in Vienna

---

Scientific contacts

Dr Claus Michelsen
German Institute for Economic Research (DIW Berlin)
Tel +49 30 89789 458
CMichelsen@diw.de

Professor Dr Timo Wollmershäuser
ifo Institute - Leibniz Institute for Economic Research at the University of Munich
Tel +49 89 9224 1406
Wollmershaeuser@ifo.de

Professor Dr Stefan Kooths
Kiel Institute for the World Economy (IfW Kiel)
Tel +49 341 8814 579 or +49 30 2067 9664
Stefan.Kooths@ifw-kiel.de

Professor Dr Oliver Holtemöller
Halle Institute for Economic Research (IWH) – Member of the Leibniz Association
Tel +49 345 7753 800
Oliver.Holtemoeller@iwh-halle.de

Professor Dr Roland Döhrn
RWI – Leibniz Institute for Economic Research
Tel +49 201 8149 262
Roland.Doehrn@rwi-essen.de