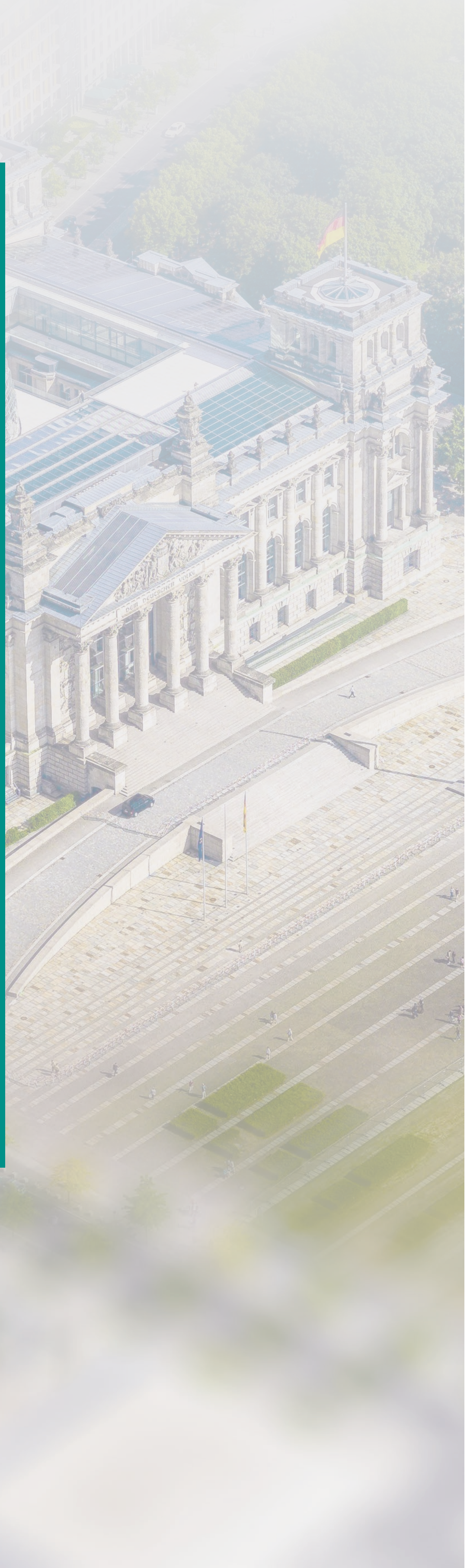
DIW Weekly Report 22+23+24 2019

A policy bulletin from the German Institute for Economic Research

Economy. Politics. Science.

DIW BERLIN



DIW Economic Outlook

LEGAL AND EDITORIAL DETAILS

DIW BERLIN

DIW Berlin — Deutsches Institut für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
www.diw.de
Phone: +49 30 897 89–0 Fax: –200
Volume 9 June 13, 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

DIW Weekly Report 22+23+24 2019

AT A GLANCE

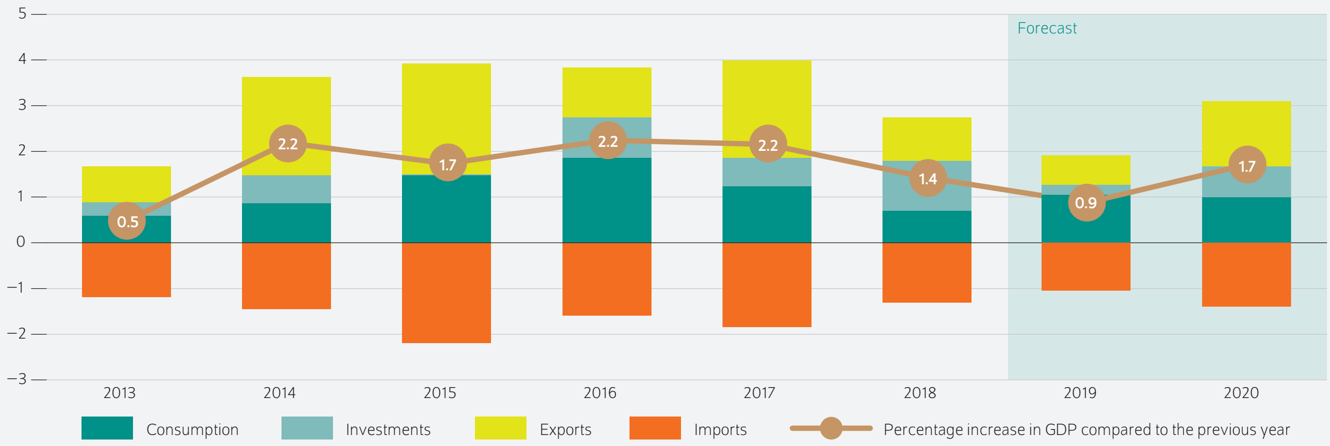
Protectionism weighing on global trade and investments – German economy is defying uncertainties

By Claus Michelsen et al.

- German economy is faring well in uncertain times: DIW Berlin forecast pegs GDP growth at 0.9 percent this year and 1.7 percent next year
- Tariff competition between USA and China weighs on global trade but domestic economy provides stimulus in many countries
- In Germany the domestic economy is supporting growth thanks to strong private consumption; services sector is taking advantage, industry is experiencing rough spell
- Growth pace will slow down slightly over the coming months in Germany
- Public finance surpluses of 40 billion euros this year and 32 billion euros next year expected in Germany

In 2019, private consumption is the driving force behind economic growth while foreign trade's contribution is negative

Individual GDP components' contribution to growth in percentage points



Source: Authors' own surveys and calculations.

FROM THE AUTHORS

"The German economy is performing much better than many think. However, these are uncertain times. It is therefore all the more important to take a clear stance on economic and financial policy. The municipalities, which are responsible for many important investments, should be strengthened financially."

*— **Claus Michelsen**, DIW Chief Economic Forecaster —*

MEDIA

Audio Interview with Claus Michelsen (in German)

www.diw.de/mediathek

German economy performing well despite odds; time to rethink debt rules

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

Thanks to private consumption and a strong labor market, the German economy is still performing well as of early summer 2019, better than many think. State coffers are well filled and will remain so for the time being. However, this does not necessarily indicate that everything is fine. The economic situation has become gloomier against the backdrop of unresolved trade conflicts and a fragile economic situation worldwide. Fiscal policy action must be taken. The time has long since come to reorganize municipal finances and duties in Germany so that the municipalities can once again properly fulfill their public service mission—even if that means loosening debt constraints and questioning the debt ceiling dogma.

DIW Berlin stands by its spring assessment that the economy will continue to develop quite well. We expect GDP growth of 0.9 percent in Germany for 2019 and of 1.7 percent for 2020. Growth will be driven primarily by the domestic economy while foreign business will remain comparatively subdued. Uncertainty over trade conflicts and developments within the European Union continue to weigh on companies' willingness to invest. This particularly affects the German economy, which mostly exports capital goods.

The German economy has regained its footing in the first quarter of 2019 after the lull in the second half of 2018 thanks to the flourishing construction industry and considerable fiscal stimuli. These include the reintroduction of equal financing for statutory health insurance, where employers and employees split the cost equally. This change has provided consumers with additional purchasing power. At the beginning of the year, companies also invested heavily in additional machinery and equipment. The fiscal stimuli are likely to continue to unfold throughout the year. Developments on the labor market are continuing to generate income growth: employment is increasing further and unemployment is expected to fall to an average of 4.6 percent in 2020, the lowest level since reunification. These developments are reflected in noticeable wage increases. In real terms, employees can look forward to an increase of around 1.3 percent this year. As domestic demand remains robust, the production of goods and services in Germany is likely to gradually pick up again and ensure that the now often empty inventories are filled up again.

The external economic environment continues to cause concern due to the ongoing trade conflicts. Increased protectionism is likely to weigh heavily on economic activity: prices for consumers will rise while conflicts are creating uncertainty for companies, slowing their willingness to invest.

The global economic situation remains fragile. Although German companies have a considerable order backlog—which makes the current drop in new orders appear less dramatic— there is a risk of a stronger economic downturn if global trade conflicts continue to escalate and problems within the European Union remain unresolved.

Public finances remain unperturbed by these developments. A revenue surplus of around 19 billion euros had already been achieved in the first quarter of 2019, mainly due to wage tax proceeds. DIW Berlin expects a total surplus in the order of 40 billion euros in the current year and around 32 billion euros in 2020. The federal budget alone will have a surplus of about 18 billion euros this year. However, only a small part of these surpluses actually reaches the municipalities, even though they are the most important public investors and are responsible for providing and maintaining much of the infrastructure that has been neglected for years. A change is now required. According to German state-owned

 DOI: https://doi.org/10.18723/diw_dwr:2019-22-1

development bank KfW, the financing requirements of the municipalities currently amount to over 150 billion euros.

In order for municipalities to be able to adequately provide public services again, it is important to restructure municipal finances and duties. To this end, the federal government could gradually use the funds it has accumulated to reduce the municipalities' debts. In addition, it could assume the tasks and expenditures of the municipalities depending on the business cycle, thus making their budgets much more stable. The current institutional framework does not offer much room for such a transformation, but additional public investment in education, research, and infrastructure is highly profitable given the low interest rates. It would therefore make sense to relax the debt constraints and, at least for projects financed by the federal government, to open up additional scope for net borrowing.

Claus Michelsen is Head of the Forecasting and Economic Policy department at DIW Berlin | cmichelsen@diw.de

Guido Baldi is a Visiting Researcher at the Forecasting and Economic Policy department at DIW Berlin | gbaldi@diw.de

Martin Bruns is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | mbruns@diw.de

Marius Clemens is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | mclemens@diw.de

Geraldine Dany-Knedlik is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | gdanyknedlik@diw.de

Hella Engerer is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | hengerer@diw.de

Marcel Fratzscher is President of DIW Berlin | mfratzscher@diw.de

Stefan Gebauer is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | sgebauer@diw.de

Max Hanisch is a Research Associate at the International Economics department at DIW Berlin | mhanisch@diw.de

Simon Junker is Deputy Head of the Forecasting and Economic Policy department at DIW Berlin | sjunker@diw.de

Konstantin Kholodilin is a Research Associate at the Macroeconomic department at DIW Berlin | kkholodilin@diw.de

Malte Rieth is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | mrieth@diw.de

Thore Schlaak is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | tschlaak@diw.de

Global economy and the euro area: protectionism weighing on trade and investment

By Claus Michelsen, Guido Baldi, Geraldine Dany-Knedlik, Hella Engerer, Stefan Gebauer, and Malte Rieth

ABSTRACT

The global economy is holding steady amidst uncertainty, although subdued export and investment growth in some places is already proving the extent to which protectionism and the unresolved trade conflicts are negatively affecting the economy. Contributing to the uncertainty is the continued unclear outcome of Brexit. In many countries, the domestic economy is fighting against a downturn. However, the situation on the labor market remains good overall and employment and wages are rising, leading many private households to spend some of the extra money. Although DIW Berlin expects the global economy to slow in 2019 and 2020, with growth of 3.7 percent for each year, its forecast remains largely stable compared to the spring of this year.

The global economy expanded somewhat more strongly in the first quarter of 2019 compared to the end of 2018. The expansion accelerated mildly in both developed and emerging market economies (Figure). The economy gained momentum in the US and the euro area in particular, mostly due to domestic demand. The labor markets are continuing to develop strongly and consumers remain mostly confident about the future. In contrast, foreign trade and corporate investment activity have been largely sluggish recently, mainly due to the uncertainties caused by the ongoing trade conflicts.

These conflicts will likely continue. In May, the US once again increased tariffs on imports from China. In addition, they threatened action against European and Japanese car and car part imports. Protectionism is likely to weigh on economic activity in both the US and the countries affected by the tariffs. Consumer prices are likely to continue to rise, but companies' uncertainty is increasing. Some investment decisions are likely to be postponed, and the slowdown in foreign trade momentum will likely weigh on the economy, particularly in Asian countries.

In most countries, robust consumer demand is counteracting these strains so that growth rates are declining only gradually overall. The labor market situation is even improving further in many places, although the pace of employment growth is slowing down. Wages are increasing more strongly than in the previous years, but core inflation rates remain mostly low. However, headline inflation is expected to pick up somewhat over the forecast period, as energy prices have risen due to political tensions in and around the Middle East.

There is hardly any need for action on the part of the central banks. Therefore, monetary policy will remain expansionary globally. In the US, previous interest rate hikes are currently having a slightly dampening effect. Towards the end of the forecast horizon, however, key US interest rates are likely to be lower, especially if the trade conflicts cause the economic situation to become gloomier than expected. In the euro area, longer-term refinancing operations will likely support the economy, especially in the southern countries. Here, too, key interest rate hikes are not to be expected until the end of 2020.

DOI: https://doi.org/10.18723/diw_dwr:2019-22-2

Fiscal policy is likely to become more expansionary globally than it has been recently. In the US, the stimulating effects of tax cuts and expenditure increases are slowly ending. In contrast, governments in China and large euro area countries are likely to launch fiscal stimuli in the near future.

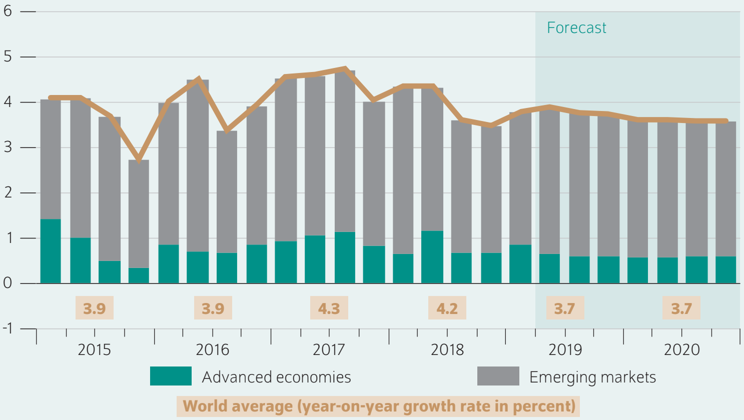
As a result, the global expansion is likely to slow to 3.7 percent in 2019 and in 2020 (Table). Thus, DIW Berlin's prognosis remains largely stable.

The largest risk for the economy are the trade conflicts originating from the US. Should the dispute with China escalate and Europe and Japan become even more involved in the tariff dispute, this will have a greater negative impact on corporate sentiment, foreign trade, and investment in Europe than in the past. Unclear plans for Brexit post a further risk: If a no-deal Brexit occurs, this is likely to affect not only the economy in Great Britain, but also those of its closest trade partners, primarily Germany, negatively. Moreover, due to the renewed budget dispute between the EU Commission and the Italian government, overall economic development in the euro area could be weaker than expected.

Figure

World real GDP growth

In percent



Source: National statistical offices; DIW summer projections 2019.

The global economy is holding steady amidst uncertainty.

Table

Real GDP, consumer price inflation, and unemployment rate in the world economy

In percent

	GDP				Consumer prices				Unemployment rate in percent			
	Change over previous year in percent											
	2017	2018	2019	2020	2017	2018	2019	2020	2017	2018	2019	2020
Euro area	2.5	1.7	1.2	1.4	1.4	1.8	1.4	1.7	9.0	8.2	7.7	7.6
without Germany	2.5	1.8	1.3	1.4	1.4	1.8	1.3	1.5	11.4	10.4	9.9	9.8
France	2.3	1.6	1.3	1.4	1.1	1.8	1.3	1.6	9.4	9.1	8.6	8.3
Italy	1.8	0.7	0.3	0.7	1.3	1.2	0.9	1.1	11.3	10.6	10.4	10.5
Spain	3.0	2.6	2.4	1.8	2.0	1.7	1.2	1.7	17.2	15.3	14.2	14.1
Netherlands	3.0	2.6	1.8	1.7	1.3	1.6	2.4	1.8	4.8	3.9	3.5	3.6
United Kingdom	1.8	1.4	1.3	1.3	2.7	2.4	2.0	2.0	4.5	4.2	4.1	4.2
USA	2.2	2.9	2.5	1.8	2.1	2.4	1.8	2.0	4.4	3.9	3.7	3.5
Japan	1.9	0.8	1.0	0.8	0.6	0.8	1.0	1.2	2.8	2.5	2.4	2.4
South Korea	3.1	2.7	1.7	2.4	1.9	1.5	1.1	2.7	3.7	3.8	3.3	3.0
East-central Europe	5.1	4.5	3.8	3.4	1.7	2.2	2.4	2.8	4.6	3.7	3.4	3.3
Turkey	7.4	2.7	−2.5	2.8	11.1	16.4	17.1	16.2	10.9	11.0	14.0	13.5
Russia	1.8	2.0	1.5	1.9	3.5	3.1	4.7	4.1	5.1	4.7	4.4	4.3
China	6.8	6.5	6.2	6.0	1.4	1.7	2.2	2.2	4.0	3.9	3.7	3.7
India	6.9	7.4	6.6	6.3	4.0	3.9	5.5	6.1				
Brazil	1.1	1.1	0.8	1.0	3.4	3.7	4.7	6.5	12.8	12.3	10.2	9.2
Mexico	2.3	2.0	1.6	1.4	6.0	4.9	4.2	3.2	3.4	3.3	4.8	4.8
Developed economies	2.3	2.2	1.9	1.5	1.8	2.0	1.6	1.9	5.3	4.8	4.6	4.4
Emerging markets	5.7	5.6	4.9	5.0	2.9	3.3	4.1	4.4	5.2	5.0	4.8	4.5
World	4.3	4.2	3.7	3.7	2.5	2.8	3.1	3.4	5.3	4.9	4.7	4.5

Source: National statistical offices; DIW summer projections 2019.

Claus Michelsen is Head of the Forecasting and Economic Policy department at DIW Berlin | cmichelsen@diw.de

Guido Baldi is a Visiting Researcher at the Forecasting and Economic Policy department at DIW Berlin | gbaldi@diw.de

Geraldine Dany-Knedlik is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | gdanyknedlik@diw.de

Hella Engerer is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | hengerer@diw.de

Stefan Gebauer is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | sgebauer@diw.de

Malte Rieth is a Research Associate at the Macroeconomic department at DIW Berlin | mrieth@diw.de

JEL: E32, E66, F01

Keywords: Business cycle forecast, economic outlook

German economy defying a turbulent and uncertain environment

By Claus Michelsen, Martin Bruns, Marius Clemens, Max Hanisch, Simon Junker, Konstantin Kholodilin, and Thore Schlaak

ABSTRACT

After a turbulent summer, marked by a weak second and a likely stronger third quarter, the German economy should return to an average pace of growth and end up with a growth rate of 0.9 percent in 2019. Despite the more subdued pace, capacity utilization remains high; employment growth is continuing, albeit more slowly; and the trend of foreign demand is weakening but remains buoyant overall. In this economic setting, companies are expanding their investments, yet are likely to act cautiously due to imminent upheavals in global trade.

After stagnating in the second half of 2018, the growth rate of the German economy picked up at the beginning of 2019 (Figure). The late Easter holidays weighed on economic activity in the second quarter, but this will likely be compensated for in the third. Over the further course of the year, the economy should increase at rates close to the long-term average (Table 1), and capacity utilization will remain high. In this respect, DIW Berlin confirms its cautiously optimistic assessment of the situation.[1] GDP is expected to grow by 0.9 percent[2] on average this year. However, two contrasting sub-trends underlie the overall economic development: the service sector is performing strongly while there is a pronounced industrial slump.

Service providers are benefiting from strong domestic consumption, which is being driven by the sustained rise in employment and noticeable wage increases. The average number of employed persons will rise by 435,000 in 2019, with nominal wages per capita rising by 2.8 percent. However, the increase in the number of employed is likely to lose momentum: Next year, it is expected to be only a quarter million people. Inflation is likely to remain low at 1.5 percent this year and 1.7 percent next year. Thus, as in recent years, it will not have an overly dampening effect on purchasing power. Fiscal policy measures will also give an extra boost to private households' consumption in 2019.[3] For example, implementing equal split costs for statutory health insurance between employers and employees at the beginning of 2019 boosted income and thus private household spending. Further transfers—pension and child benefit increases—are due in the middle of the year, which should also have an impact. The additional measures coming into force in 2020 will have a significantly lower impact. Overall, consumption is losing momentum, and the production of consumer-related service providers will expand less buoyantly going forward.

1 Cf. Claus Michelsen et al., "German economy remaining strong amidst uncertainties," *DIW Weekly Report*, no. 11/12 (2019) (available online; accessed June 5, 2019. This applies to all other online sources in this report unless stated otherwise).

2 The 68-percent confidence interval resulting from the forecast errors of the previous five years is between 0.4 and 1.3 percent for this year and between 1.3 and 2.1 percent for next year.

3 For calculating the economic stimulus, see Ferdinand Fichtner et al., "Deutsche Wirtschaft: Aufschwung hat an Breite gewonnen, wird aber an Fahrt verlieren – Grundlinien der Wirtschaftsentwicklung im Winter 2017," *DIW Wochenbericht*, no. 50 (2017), Box 2, pg. 1169f (in German) (available online).

DOI: https://doi.org/10.18723/diw_dwr:2019-22-3

Figure

GDP and use of GDP

Seasonally and working-day adjusted

Source: German Statistical Office; DIW summer projections 2019.

Table 1

Use of GDP, quarter-on-quarter growth rates

Price, seasonally and working-day adjusted, in percent

	2018				2019				2020			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Private consumption	0.2	0.3	−0.1	0.3	1.2	−0.3	0.4	0.3	0.3	0.3	0.3	0.3
Public consumption	−0.3	0.7	−0.3	1.3	−0.3	0.4	0.4	0.5	0.5	0.4	0.3	0.3
Gross fixed capital formation	1.1	0.6	0.5	0.8	1.1	0.8	0.7	0.6	0.5	0.5	0.5	0.5
Investment in machinery and equipment	2.2	0.3	0.0	0.7	1.2	1.0	0.9	0.7	0.6	0.6	0.6	0.6
Construction investment	0.9	0.8	0.9	1.0	1.9	0.6	0.6	0.6	0.5	0.5	0.5	0.5
Other investments	−0.5	0.3	0.2	0.5	−1.1	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Change in inventories[1]	0.1	0.3	0.8	−0.6	−0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Domestic uses	0.4	0.7	0.8	0.0	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net Exports[1]	0.0	−0.2	−0.9	0.0	0.2	−0.2	0.2	0.0	0.0	0.0	0.0	0.0
Exports	−0.2	0.8	−0.9	0.6	1.0	−0.9	1.4	0.6	0.5	0.5	0.5	0.5
Imports	−0.3	1.5	1.3	0.7	0.7	−0.6	1.2	0.8	0.7	0.7	0.7	0.7
GDP	0.4	0.5	−0.2	0.0	0.4	0.1	0.5	0.3	0.3	0.3	0.3	0.3

1 Contribution to GDP growth in percentage points.

Source: Federal Statistical Office; DIW summer projections 2019; forecast from 2019 Q2 onward.

Table 2

Key economic indicators for the German economy

	2015	2016	2017	2018	2019	2020
Real GDP[1] (percent change over previous year)	1.7	2.2	2.2	1.4	0.9	1.7
Domestic employment (1000 persons)	43,071	43,642	44,269	44,841	45,276	45,520
Unemployed (ILO concept)	1,949	1,775	1,621	1,469	1,336	1,193
Unemployed (BA concept)	2,795	2,691	2,533	2,340	2,233	2,116
Unemployment rate[2] (ILO concept)	4.6	4.1	3.8	3.4	3.1	2.7
Unemployment rate[2] (BA concept)	6.4	6.1	5.7	5.2	4.9	4.6
Consumer prices	0.5	0.5	1.5	1.8	1.5	1.7
Unit labor costs[3]	1.8	1.2	1.5	2.6	3.3	1.3
Government budget balance[4]						
in billion EUR	23.9	28.7	34.0	57.3	40.3	31.8
in percent of GDP	0.8	0.9	1.0	1.7	1.2	0.9
Current account balance, in percent of GDP	8.5	8.4	8.0	7.3	7.0	6.9

1 Price-adjusted, chain-linked
2 As a share of domestic labor force (ILO), resp. Civilian labor force (BA)
3 Compensation of employees (national concept) per hour worked over real GDP
4 According to ESA 2010

Sources: National and international institutions; DIW summer projections 2019; forecast from 2019 onward.

One reason for the industrial slump is car manufacturers' sluggish production since fall 2018. While production is usually in line with sales, which have risen sharply, of late it has remained extremely subdued. It seems that previously accumulated inventories accounted for most of the vehicles sold.[4] As overstocking is corrected gradually, it is likely to be accompanied by somewhat more marked production expansions.

Incoming orders have also been declining across the board for quite some time; in the mechanical engineering sector especially, orders have dropped over the last six months. This is probably due to lower demand from China, which has been weakening since the beginning of 2019. However, Chinese demand will probably stabilize over the further course of the year due to the Chinese government's economic policy stimuli.[5] Once demand has stabilized, orders should begin to improve again, with the current slack in order inflow resulting in lower production only temporarily. The industry

4 Cf. Box 1 of Claus Michelsen et al., "Deutsche Wirtschaft derzeit besser als ihr Ruf – Grundlinien der Wirtschaftsentwicklung im Frühjahr 2019," *DIW Wochenbericht*, no. 11 (in German) (available online) for more information.

5 See Claus Michelsen et al., "Global economy and the euro area: protectionism weighing on trade and investment" *DIW Weekly Report*, no. 22/23/24.

is likely to continue working off the exceptionally high stock of orders for some time to come.

In addition, despite contradictory signals and high political risks, demand from abroad has proved remarkably robust to date, and will most likely remain such in the forecast period. This also applies to corporate investments, which have increased strongly recently, as overall capacity utilization remains high and the current financing conditions are having a stimulating effect.

Industrial activity is expected to pick up over the course of the forecast period while service sector stimuli are likely to weaken somewhat. Overall, economic growth remains stable just below the long-term average. Average annual growth in 2020 will again be higher at 1.7 percent (Table 2). However, 0.4 percentage points are attributable to a higher number of workdays next year.

The risks remain elevated. The further course of Brexit is unclear, and a potential no-deal Brexit would severely impact the German economy. Trade disputes originating in the USA are the biggest threat. Should the USA's dispute with China intensify or the European Union become involved, this will likely place a greater burden on trade flows and investments than in the past—affecting Germany notably.

Claus Michelsen is Head of the Forecasting and Economic Policy department at DIW Berlin | cmichelsen@diw.de

Martin Bruns is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | mbruns@diw.de

Marius Clemens is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | mclemens@diw.de

Max Hanisch is a Research Associate at the International Economics department at DIW Berlin | mhanisch@diw.de

Simon Junker is Deputy Head of the Forecasting and Economic Policy department at DIW Berlin | sjunker@diw.de

Konstantin Kholodilin is a Research Associate at the Macroeconomic department at DIW Berlin | kkholodilin@diw.de

Thore Schlaak is a Research Associate at the Forecasting and Economic Policy department at DIW Berlin | tschlaak@diw.de

JEL: E32, E66, F01

Keywords: Business cycle forecast, economic outlook