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DIW Economic Outlook

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Growth program needed as the foundation of the German economy crumbles



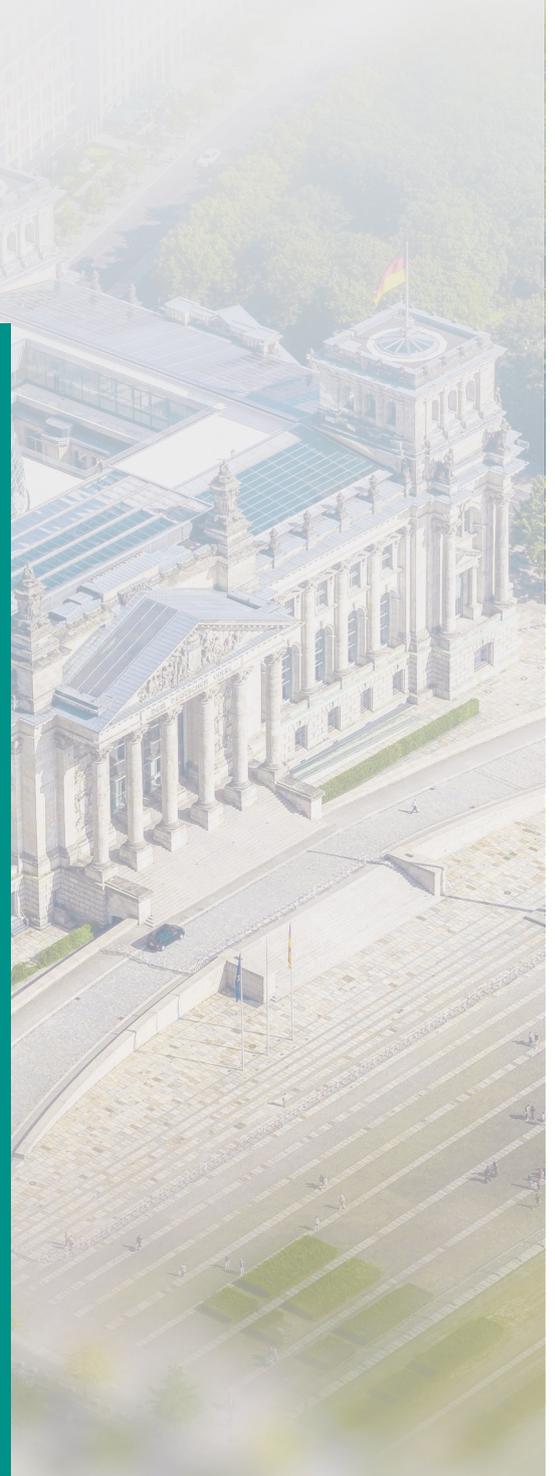
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AT A GLANCE

Growth program needed as the foundation of the German economy crumbles

By Claus Michelsen et al.

- Weak foreign trade is weighing on the export-oriented German economy: DIW Berlin is forecasting GDP growth of 0.5 percent this year and 1.4 percent per year in 2020 and 2021
- Brexit, the US-China trade disputes, and the Iran conflict are negatively affecting the global economy; global growth only 3.7 percent this year
- In Germany, marked fiscal stimuli and positive labor market developments are preventing the economy from sliding into a more serious crisis
- High government surpluses are dwindling: public surplus is expected to grow by 48 billion euros this year and 33 billion euros next year
- In the long term, an investment agenda is necessary to keep Germany competitive as a business location and to encourage companies to invest

Fiscal policy stimuli and positive employment development are supporting private consumption and thus the German economy

Growth contributions of the individual components of GDP in percentage points



Source: Authors' own surveys and calculations.

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FROM THE AUTHORS

“Germany is in a technical recession. However, thanks to strong private consumption and the continuing good situation on the labor market, this will not turn into a crisis in the short term. In order to successfully stabilize the German economy over the long term, a policy geared to strengthening potential growth is necessary. This will encourage companies to invest and increase Germany’s competitiveness.” — Claus Michelsen —

MEDIA



Audio Interview with Claus Michelsen (in German)
www.diw.de/mediathek

Growth program needed as the foundation of the German economy crumbles

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

Germany's economic foundation is crumbling. Industrial production, especially in the exporting sector, has been experiencing a significant decline in output for a year now. Demand from within Europe is lacking in particular, especially from the United Kingdom and Italy. In contrast, exports to East Asia have remained stable despite the escalating trade conflicts between Washington and Beijing. This development, coupled with strong domestic demand, saved Germany from slipping into a recession at the end of 2018 and beginning of 2019. Private households markedly increased consumption due to fiscal measures introduced in the beginning of the year that increased income (such as splitting health insurance costs between employers and employees equally and an increase in children benefits). Companies also invested heavily in expanding their production capacity in the first quarter and the construction industry again reported record order backlogs. For this reason alone, DIW Berlin is still expecting economic growth of 0.5 percent this year. Provided the significant political risks do not materialize, the projected growth rates of 1.4 percent for 2020 and for 2021, respectively, are around the long-term average.

However, the foundations of growth in Germany have cracked considerably, primarily due to serious economic risks. In addition to the continuously escalating trade conflict between the US and China, there are problems in Europe weighing on the economy. Trade with the United Kingdom is already substantially weaker and exports to Ireland have decreased significantly over the past six months. If a no-deal Brexit occurs, this would drag down growth rates by 1.1 percentage points in the UK, 0.2 percentage points in the euro area, and 0.4 percentage points in Germany over the coming year. In Italy, the economic crisis and issues with the previous government in the months ahead also left their mark on overall growth.

These uncertainties and conflicts are weighing on demand for capital goods and thus are negatively affecting Germany in particular. Entrepreneurs in Germany seem to be losing confidence as well: In the second quarter, private investment in new machinery, equipment, and vehicles plummeted. Unemployment figures were falling until the spring and employment was growing, but both have now almost reached a standstill. The domestic economy does not seem to be able to permanently decouple itself from weakness in the industrial and export sectors. It is therefore likely that the German economy slipped into a recession over the summer months.

However, the Grand Coalition's expansive fiscal policy has kept the crisis from becoming worse. Financial measures from the coalition pact will provide substantial economic stimuli this summer and will take effect at the turn of the year in both 2019 and 2020. These measures include, for example, pension increases, an increase in children benefits, and partially abolishing the solidarity tax. Overall, these additional stimuli from measures agreed upon in the coalition pact will amount to a good 15 billion euros in 2019, ten billion euros in 2020, and almost 17 billion euros in 2021. Compared to the previous year, there will be an additional 2.6 billion euros, 2.1 billion euros, and 2.5 billion euros in 2019, 2020, and 2021, respectively, available for investments, such as in the expansion of the broadband network, the Digital Pact for Schools, or the expansion of the Deutsche Bahn network. The Federal Government is boosting growth in Germany by 0.3 percentage points per year.

However, the government has almost used up all available fiscal measures. Its declared objective is a structurally balanced budget over the long term. Initially, measures to support consumption were prioritized and a policy aimed at

strengthening production potential was neglected for a long time. It is only more recently that public investment has been increased significantly and laws have been passed which, for example, favor investment in research and development. However, an economic policy focusing on long-term growth is needed urgently in several respects. From an economic point of view, the measures already adopted will help support demand in the short term. However, companies lack confidence due to the many uncertainties; this is reflected in lower levels of investment. On the one hand, a plan to invest in long-term modernization would strengthen companies' future prospects and directly increase their propensity to invest. On the other hand, this is also urgently necessary with regard to Germany's competitiveness. In key areas such as digitization, infrastructure, and education, Germany has lost ground to other locations significantly. At the same time,

such investments strengthen social cohesion. In addition to improved competitiveness, the German business model should be modified towards a growth model that is more inclusive. This requires, for example, investments in housing or better access to digital services in rural areas.

At present, there is a good opportunity to make up for these disadvantages. The Federal Government can borrow in the long-term at negative interest rates. However, the dogma of preserving a balanced budget stands in the way of more comprehensive debt financing. The "black zero" is not a meaningful economic policy in its own right. However, moving away from it would only be a first step. In view of the scale of the challenges and the historically low financing costs, it would also be advisable to review the rules of the debt brake to strengthen the foundations of the German economy in the long term.

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The global economy and the euro area: uncertainty weighing on world trade and industry

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

ABSTRACT

The ongoing trade conflicts initiated by the US and the uncertainty surrounding Brexit are negatively affecting the global economy. Global trade and investment activity, and thus in many places industrial output, are the areas most impacted. Consumption, however, is continuing to support the economy in many countries. DIW Berlin is expecting global GDP to grow to 3.7 percent this year and to slightly less in the following two years. Serious risks are weighing on the outlook, as the trade conflicts could continue to escalate and spread to the EU and the likelihood of a no-deal Brexit has increased.

The global economy maintained its rate of expansion in the second quarter of 2019 (Figure). Production expanded significantly in many Asian countries while the economy in western countries is losing momentum; economic output even decreased in the United Kingdom and Germany. In contrast, consumption expanded dynamically in the US and in the euro area, but investment activity was weak.

The overall outlook has dampened. The global trade conflicts, mainly initiated by the US but also between some Asian countries, and the political uncertainties in Europe are negatively affecting foreign trade and investment. Industrial output is sluggish in many places or has already declined. In addition, leading indicators suggest a further lull during the second half of the year. In the services sector, sentiment is dampened but remains good. Labor demand is mostly high and wage developments reflect this. Together with the recent drop in energy prices and generally stable financial conditions, consumers will likely remain in a buying mood.

In addition, various stimulating policy measures are coming into play: the federal funds rate was lowered in the US by a quarter of a percentage point in July and will likely be lowered again this year. In response to the continuing low inflation, the European Central Bank has signaled its willingness to support the economy. No interest rate hike is expected in the euro area before the end of 2021. Fiscal policy remains expansionary globally. Additional public expenditure is imminent in China as well as in several European countries such as France and Spain.

Therefore, the slowdown in the global economy is likely to be only gradual. Demand for capital goods in particular is sluggish while consumption continues to support the economy. The global economy is in a very advanced phase of the economic cycle. World production is expected to grow by 3.7 percent this year after increasing by 4.2 percent in 2018. Growth will be somewhat lower in 2020 and 2021 (Table). Compared to the Economic Outlook published in summer 2019, DIW Berlin is lowering its forecast slightly.

Risks are higher than usually, primarily due to the current high likelihood of a no-deal Brexit. In this forecast, it

is assumed a no-deal Brexit will not occur. However, if it does, growth is likely to be significantly lower than forecast, especially in Europe. In the euro area, a hard Brexit would trim 0.2 percentage point off GDP growth in 2020 and 2021, according to estimates from an econometric model by DIW Berlin. The global trade conflicts are not expected to ease, and the risk that Europe will be directly subject to US tariffs remains. Escalating trade conflicts and a no-deal Brexit would weigh on already weak global trade and subdued corporate investment activity. The political uncertainties in Italy have diminished for now, but the conflict between the US and Iran could lead to a blockade of important transport routes and make energy prices noticeably more expensive. This would weaken households' purchasing power and shake one of the last remaining pillars of the global economy.

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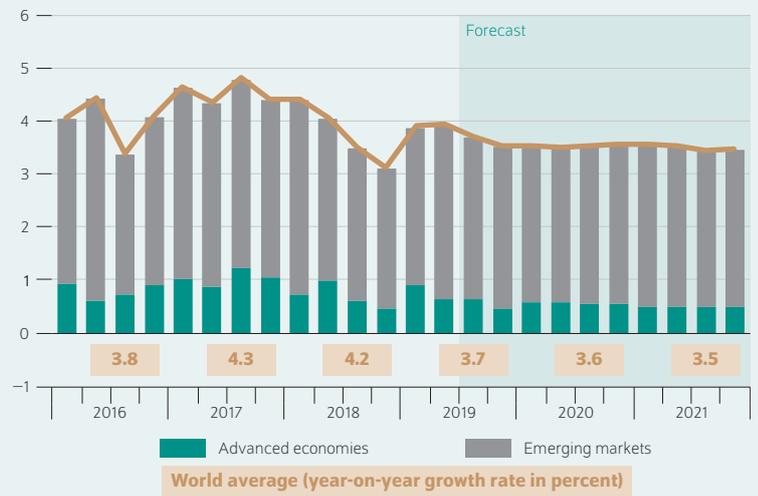
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Figure

World real GDP growth
Quarter-on-quarter, in percent



Sources: National statistical offices; DIW autumn projections 2019.

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Global growth is slowing down.

JEL: E32, E66, F01

Keywords: Business cycle forecast, economic outlook

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											
	2018	2019	2020	2021	2018	2019	2020	2021	2018	2019	2020	2021
Euro area	1.7	1.0	1.2	1.4	1.8	1.3	1.5	1.5	8.2	7.7	7.5	7.5
without Germany	1.7	1.2	1.3	1.4	1.8	1.3	1.4	1.4	10.4	9.8	9.7	9.7
France	1.7	1.3	1.4	1.4	1.8	1.3	1.5	1.4	9.1	8.5	8.2	8.1
Italy	0.7	0.1	0.5	0.9	1.2	0.9	1.1	1.3	10.6	10.5	10.5	10.6
Spain	2.6	2.2	1.8	1.8	1.7	1.1	1.5	1.6	15.3	14.1	13.9	13.8
Netherlands	2.5	1.8	1.6	1.7	1.6	2.4	1.5	1.6	3.9	3.4	3.6	3.7
United Kingdom	1.4	1.2	1.2	1.7	2.4	1.9	2.0	2.1	4.2	4.0	4.1	4.2
USA	2.9	2.3	1.8	1.5	2.4	1.8	2.1	1.9	3.9	3.7	3.5	3.5
Japan	0.8	1.1	0.5	0.8	0.8	0.8	1.1	0.9	2.5	2.4	2.3	2.3
South Korea	2.7	2.0	2.4	2.0	1.5	0.9	2.6	2.7	3.8	3.5	3.0	3.0
East-central Europe	4.5	4.0	3.4	3.5	2.2	2.9	3.0	3.0	3.7	3.5	3.5	3.5
Turkey	2.7	0.0	2.5	2.6	16.4	17.8	17.3	15.6	11.0	13.7	13.5	13.5
Russia	2.0	1.4	1.9	1.8	2.7	4.7	4.0	4.1	4.8	4.5	4.3	4.3
China	6.5	6.2	5.8	5.7	1.6	2.2	2.1	2.2	3.9	3.7	3.8	3.8
India	7.4	6.6	6.4	6.1	3.9	5.5	6.1	6.1				
Brazil	1.1	0.4	0.9	1.3	3.7	4.7	6.5	7.0	12.3	9.2	6.2	4.0
Mexico	2.0	0.8	1.4	1.1	4.9	4.2	3.2	3.2	3.3	4.5	4.8	4.8
Developed economies	2.2	1.7	1.5	1.4	2.0	1.6	1.9	1.7	4.8	4.5	4.4	4.4
Emerging markets	5.5	4.9	4.9	4.8	3.2	4.1	4.4	4.5	5.0	4.8	4.6	4.4
World	4.2	3.7	3.6	3.5	2.7	3.1	3.4	3.4	4.9	4.7	4.5	4.4

Sources: National statistical offices; DIW autumn projections 2019.

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German economy: a recession is not automatically a crisis

By Claus Michelsen, Marius Clemens, Max Hanisch, Simon Junker, Konstantin Kholodilin und Thore Schlaak

ABSTRACT

The slowdown in the global economy and the uncertainties caused by Brexit have affected the export-oriented German economy, which is expected to grow by only 0.5 percent this year. However, the German economy has not slid into a crisis due to marked fiscal policy stimuli and favorable developments on the labor market. Private consumption remains a mainstay of the economy; in addition, there is moderate inflation, which will barely dampen purchasing power over the next two years. Together with slightly stronger foreign demand, these factors will ensure that the German economy recovers somewhat over next year and the year thereafter. The economy is likely to grow by 1.4 percent in 2020 and 2021 as long as the serious political risks do not materialize. A no-deal Brexit, for example, would reduce growth in Germany by 0.4 percent in 2020.

The German economy is currently experiencing a period of weakness. After the export-driven booms in 2016 and 2017, a noticeable slowdown began in 2018, which initially seemed to be triggered by temporary factors in the automotive sector. However, it is now clear that the industry is facing bigger problems. Global demand for capital goods is weak, negatively affecting the export-oriented German economy in particular (see Figure). Industrial production has been declining for a year now, causing Germany to slide into a recession in the second half of the year.

Despite a strong start to the year, GDP will only grow by 0.5 percent¹ in 2019 and be roughly equal to its production potential. The phase of high capacity utilization will end. Over the next two years, the economy should be operating at roughly normal capacity. Companies are less confident across the board. The industrial downturn is now also affecting the service sector, as it is reducing demand for business-related services and, through weaker employment growth, is putting pressure on consumer-related sectors.

The global economic slowdown and uncertainties relating to Brexit and trade conflicts are the primary reasons the German economy has weakened. Demand for German exports is likely to remain below average over the forecast period (Table 1). Employment growth will also continue, albeit at a slower pace. Following last year's increase in employment of over 600,000 persons, this year's increase will slow to just under 400,000; over the next two years it will be around 200,000 each year. Weaker economic development as well as shortages in the labor market are leading to lower employment growth and preventing stronger growth. The unemployment rate this year is expected to be five percent and will sink to 4.9 percent and 4.7 percent, respectively, over the next two years while wages will continue to rise strongly.

¹ The 68-percent confidence interval resulting from the forecast errors of the previous five years is between 0.0 and 0.9 percent for this year and between 0.9 and 1.8 percent for next year.

Table 1

Use of GDP, quarter-on-quarter growth rates
Price, seasonally and working-day adjusted, in percent

	2019				2020				2021			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Private consumption	0.8	0.1	0.3	0.2	0.7	0.4	0.3	0.3	0.7	0.5	0.3	0.3
Public consumption	0.8	0.5	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4
Gross fixed capital formation	1.6	-0.1	0.2	0.5	0.9	0.8	0.6	0.6	0.9	0.7	0.5	0.5
Investment in machinery and equipment	2.5	-1.0	0.6	0.8	0.8	0.8	0.5	0.5	0.8	0.8	0.3	0.4
Construction investment	1.4	0.6	-0.9	0.0	0.8	0.6	0.6	0.6	0.9	0.6	0.6	0.6
Other investment	-0.6	1.0	0.9	0.8	1.1	0.9	0.8	0.8	1.1	0.8	0.8	0.8
Change in inventories ¹	-1.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic uses	-0.1	0.5	0.3	0.3	0.7	0.5	0.4	0.4	0.7	0.5	0.4	0.3
Net Exports ¹	0.5	-0.5	-0.4	-0.1	-0.2	-0.1	-0.1	0.0	-0.2	-0.2	-0.1	0.0
Exports	1.8	-1.3	-0.4	0.6	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Imports	0.9	-0.3	0.5	0.8	1.2	0.9	0.6	0.5	1.0	0.8	0.6	0.5
Gross domestic product	0.4	-0.1	-0.2	0.2	0.4	0.3	0.3	0.3	0.5	0.4	0.3	0.3
Gross value added	0.4	-0.3	-0.1	0.2	0.4	0.3	0.3	0.3	0.5	0.3	0.3	0.3
Manufacturing	-1.0	-1.4	-1.0	0.2	0.5	0.5	0.5	0.5	0.6	0.5	0.5	0.5
Construction	1.1	-0.5	0.5	0.8	0.8	0.8	0.5	0.5	0.7	0.7	0.4	0.4
Trade, accommodation, transport	2.3	-0.6	0.5	0.2	0.7	0.5	0.4	0.4	1.0	0.6	0.4	0.4
Business and production services	0.7	0.0	-0.2	0.0	0.7	0.4	0.4	0.4	0.5	0.4	0.4	0.4
Public admin., community and social serv.	-0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1

1 Contribution to GDP growth in percentage points.

Source: Federal Statistical Office; DIW Berlin, forecast from 2019 Q3 onward.

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Table 2

Key economic indicators for the German economy

	2016	2017	2018	2019	2020	2021
Real GDP ¹ (percent change over previous year)	2.2	2.5	1.5	0.5	1.4	1.4
Domestic employment (1 000 persons)	43,655	44,248	44,854	45,244	45,428	45,635
Unemployed (ILO concept)	1,775	1,621	1,469	1,359	1,313	1,206
Unemployed (BA concept)	2,691	2,533	2,340	2,271	2,269	2,165
Unemployment rate ² (ILO concept)	4.1	3.8	3.4	3.1	3.0	2.7
Unemployment rate ² (BA concept)	6.1	5.7	5.2	5.0	4.9	4.7
Consumer prices	0.5	1.5	1.8	1.4	1.6	1.6
Unit labor costs ³	1.2	1.2	2.5	3.5	1.7	1.7
Government budget balance ⁴						
in billion EUR	37.1	40.3	62.4	47.9	33.3	9.6
in percent of GDP	1.2	1.2	1.9	1.4	0.9	0.3
Current account balance, in percent of GDP	8.5	8.1	7.3	7.0	6.3	5.7

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.

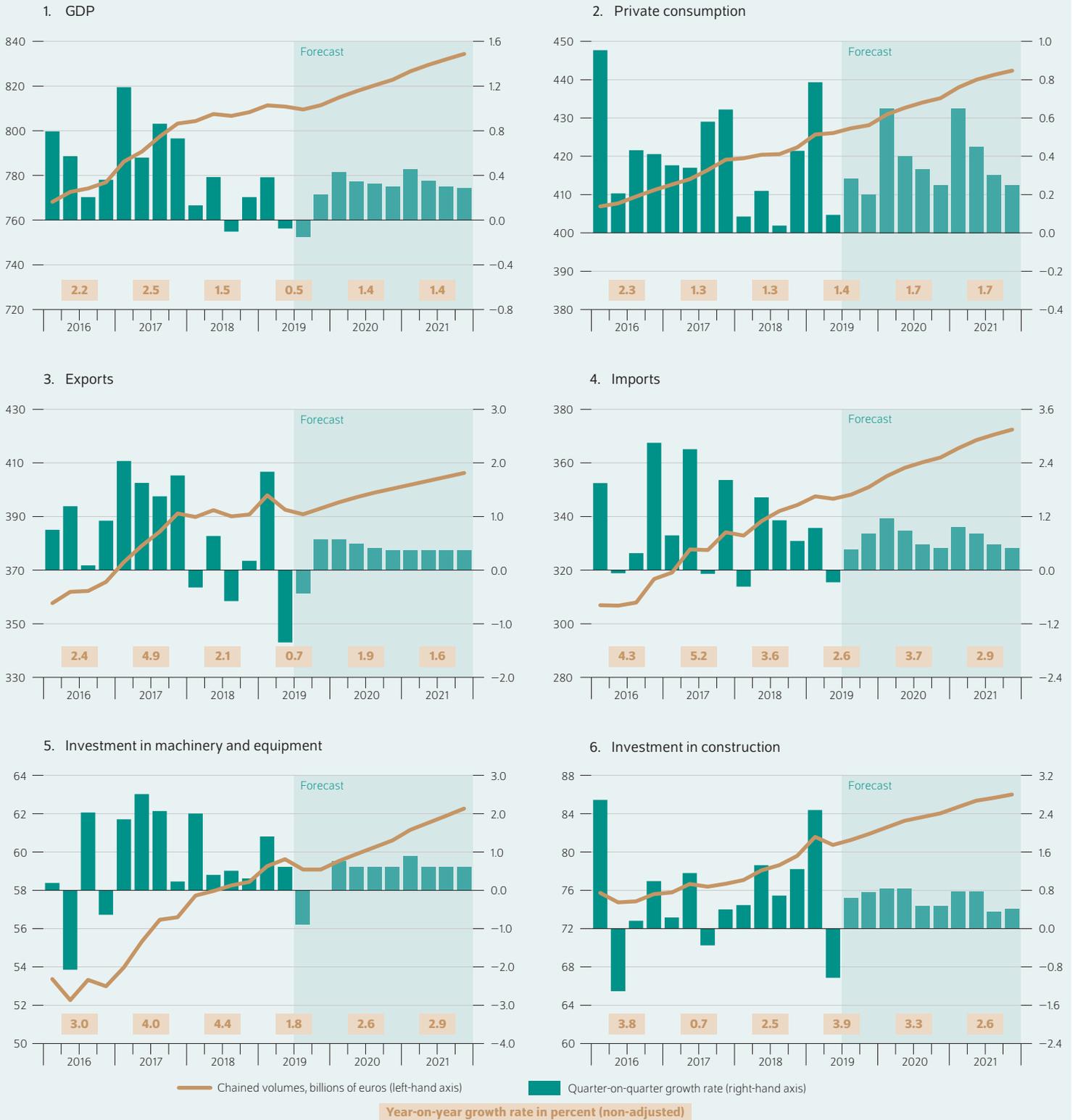
4 According to ESA 2010.

Sources: National and international institutions; computations by DIW Berlin; 2018 to 2020: DIW forecast.

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Figure

GDP and use of GDP
Seasonally and working-day adjusted



Sources: Federal Statistical Office; Computations by DIW Berlin 2019, forecasts as of 2019 Q3.

Overall, disposable income is growing solidly and supports private consumption, which is in turn supported largely by numerous fiscal policy measures implemented over the forecast period. At the beginning of 2019, reducing the bracket creep and reintroducing equally shared financing of statutory health insurance contributions had raised the net salaries of employees and contributed to a strong increase in private consumption. Further measures with tangible effects will be taken in the forecast period; in particular, the partial reduction of the solidarity tax in 2021 will increase income. The expected increase in consumption will make a noticeable contribution to domestic economic output as well, although a good portion will probably also be covered by imports. This increase is another reason why GDP growth in the coming two years will be higher than in 2019; at 1.4 percent each, it is likely to be slightly lower than potential growth. Due

to the additional imports, net exports are declining significantly and the still high current account surplus is declining accordingly: from 7.0 percent this year to 6.3 percent in 2020 and 5.7 percent in 2021 (see Table 2).

Private investment in equipment and machinery continues to suffer from the high economic uncertainty and remains restrained initially due to lower capacity utilization. However, with foreign demand rising slightly and probably decreasing uncertainty, investment will likely begin to recover; government measures will also contribute to this.²

² Marius Clemens, Marius Goerge, and Claus Michelsen, "Öffentliche Investitionen sind wichtige Voraussetzung für privatwirtschaftliche Aktivität," *DIW Wochenbericht* no. 31 (2019): 537–543 (in German; available online; accessed on September 6, 2019. This applies to all other online sources in this report unless stated otherwise.).

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