Tysk-Svenska Handelskammaren | Visby/Gotland, 3rd July 2017
Almedalen Seminar

German Economy after the Election

What actions does the next German Chancellor have to take?

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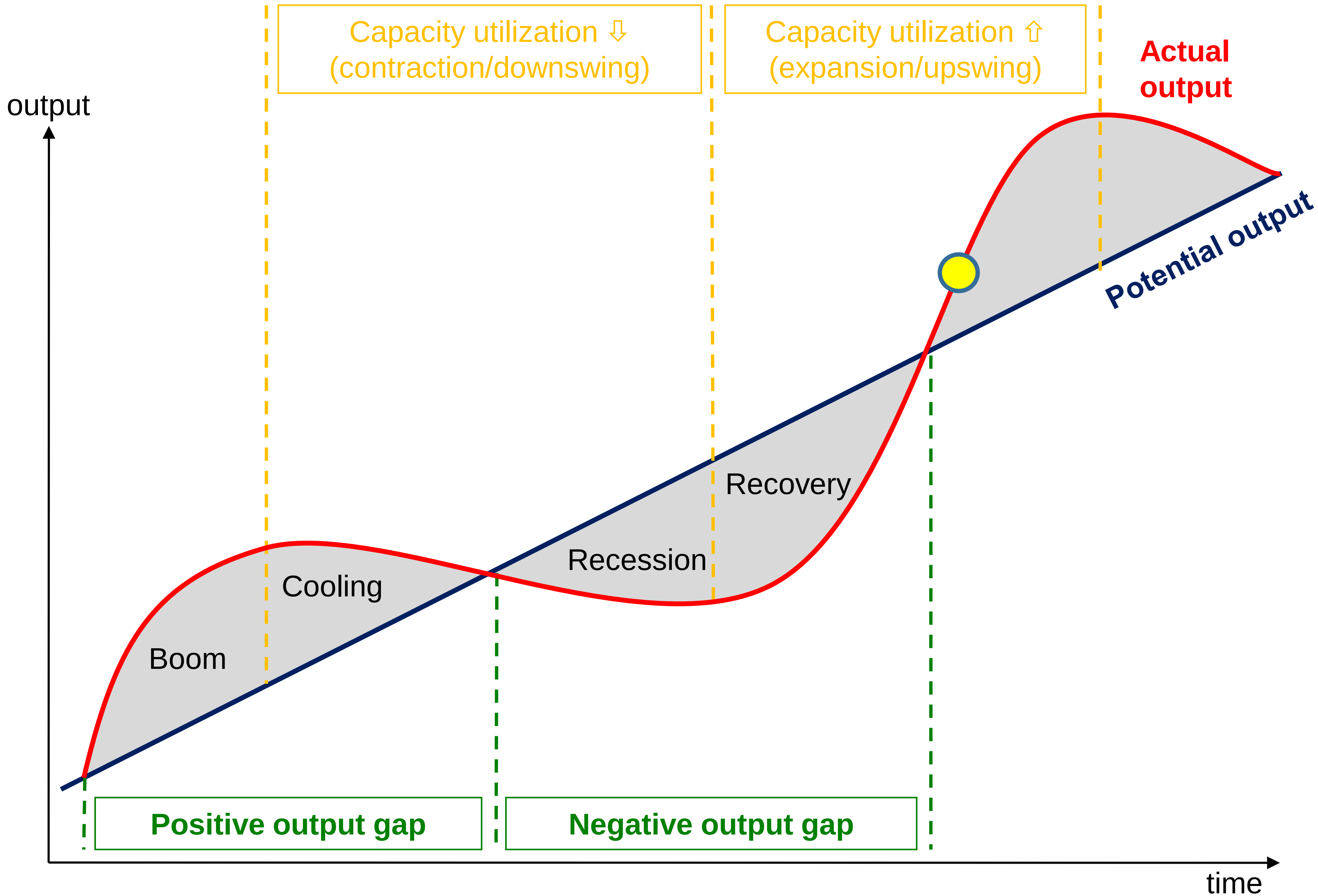
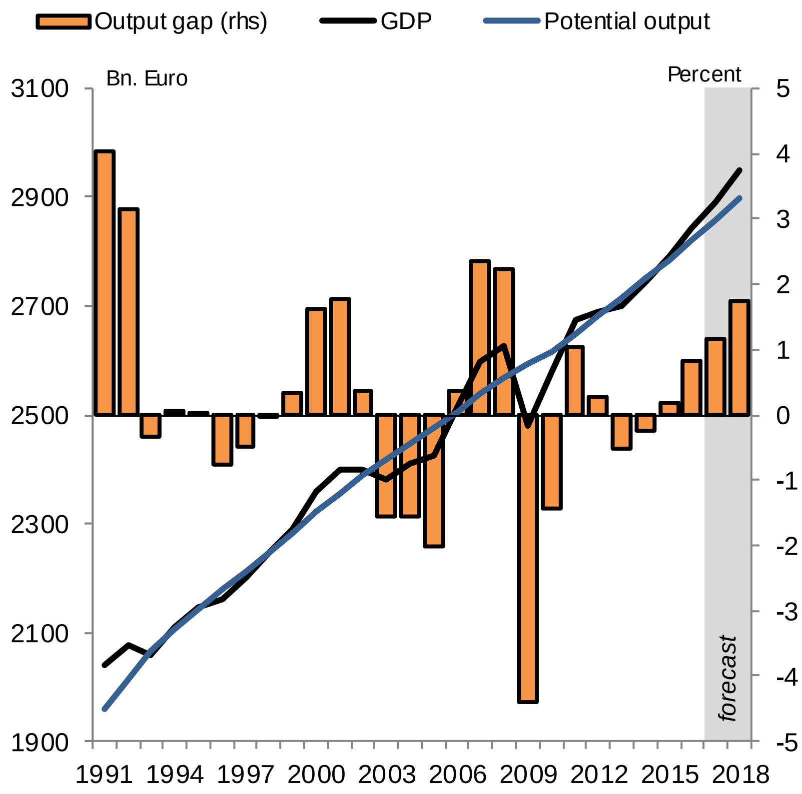
Forecasting Center

The stylized picture



Chewing gum cycle

Production and potential output

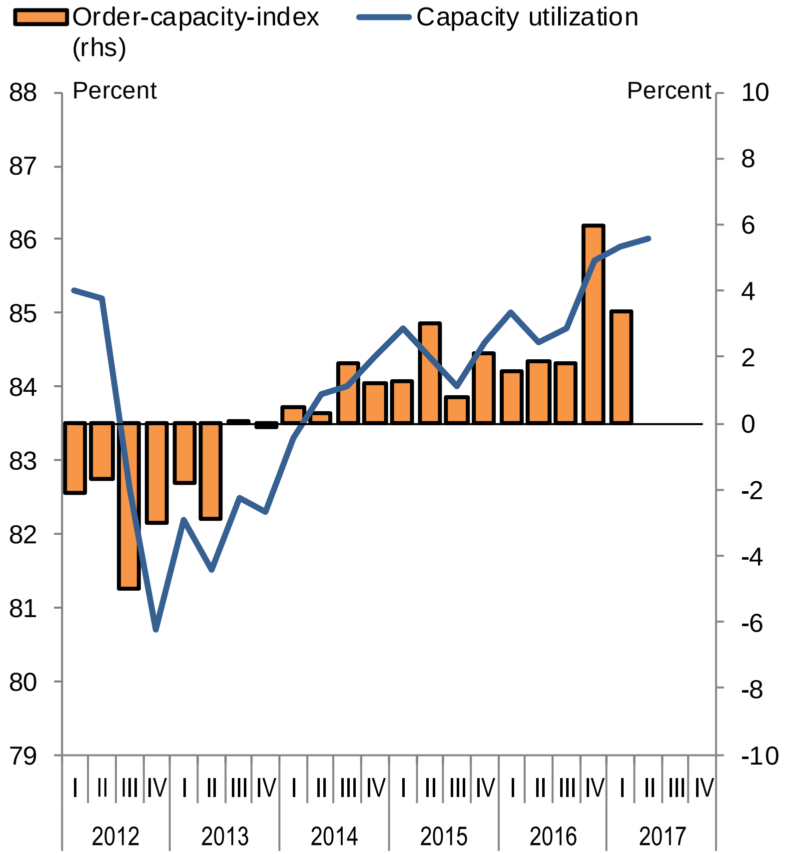


Annual data;
GDP, Potential output: price adjusted (chained volumes, reference year 2010).

- Stretched upswing, weak cyclical pattern
- Immigration supports labor force and potential growth (refugees: large time lag)
  - 2015: + 331.000
  - 2016: + 511.000
  - 2017: + 313.000
  - 2018: + 213.000
- Capacity utilization already above normal levels

Upward capacity utilization trend

Capacity utilization in manufacturing

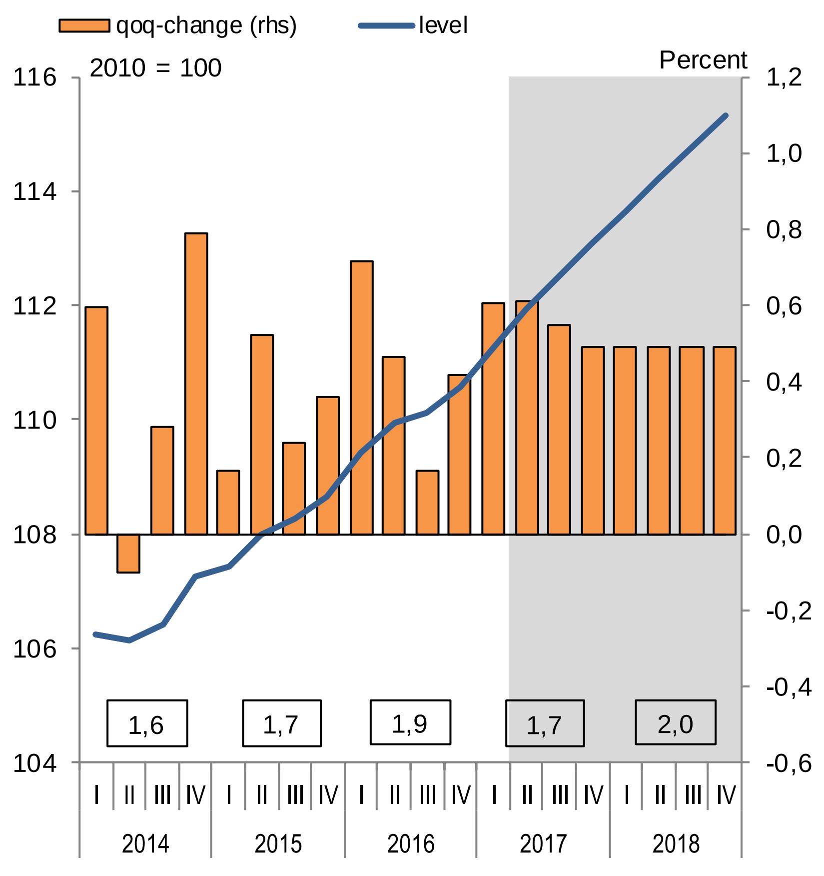


Quarterly data, seasonally adjusted;
Capacity utilization: axes cross at normal capacity utilization level.

- Manufacturing
  - » 5-years upward trend, above normal since three years …
  - » … order inflow exceeds capacities
- Construction
  - » Historically high levels
- Services
  - » Lack of demand (ifo) at lowest level since 2005
- Elastic labor market

2017 starts with strong momentum

Gross domestic product

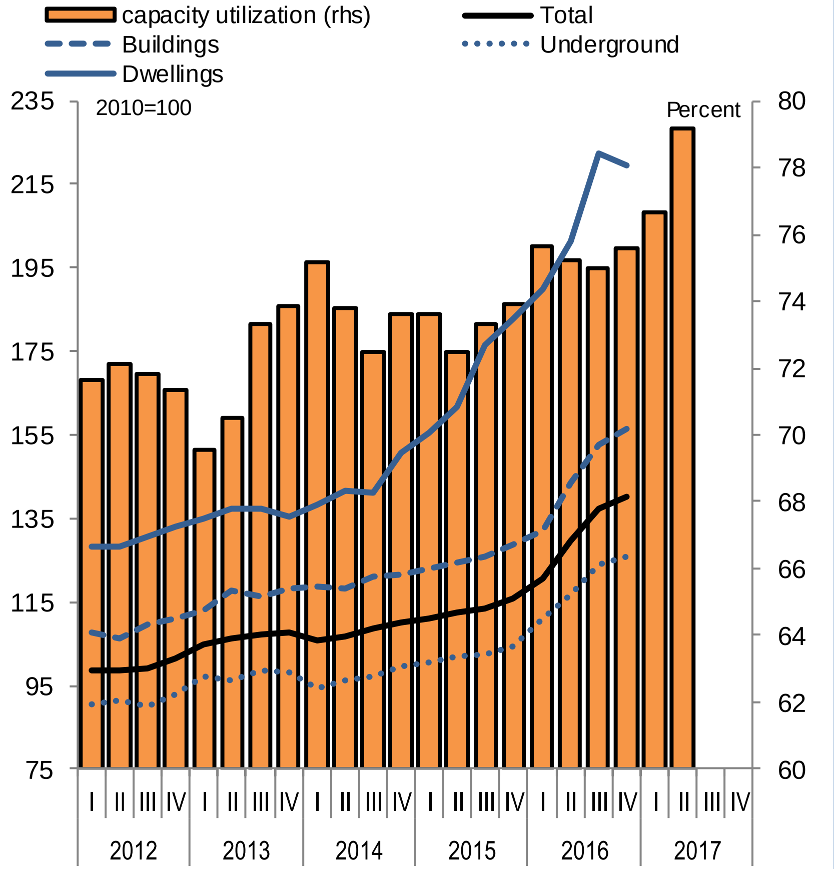


Quarterly data, price, seasonally and calendar adjusted, qoq-change.

- Shiny business climate (ifo)
  - » Composite/situation hits new record high (June 2017)
  - » Expectations above average and improving since 12 months
- Order inflow
  - » Upward trending (more than 4 years)
  - » Approaching pre-crisis peak
- Industrial production
  - » Upward trending
  - » Above pre-crisis peak
- 2017: Dampening working-day effect (0.3 ppt)

Construction activity is booming

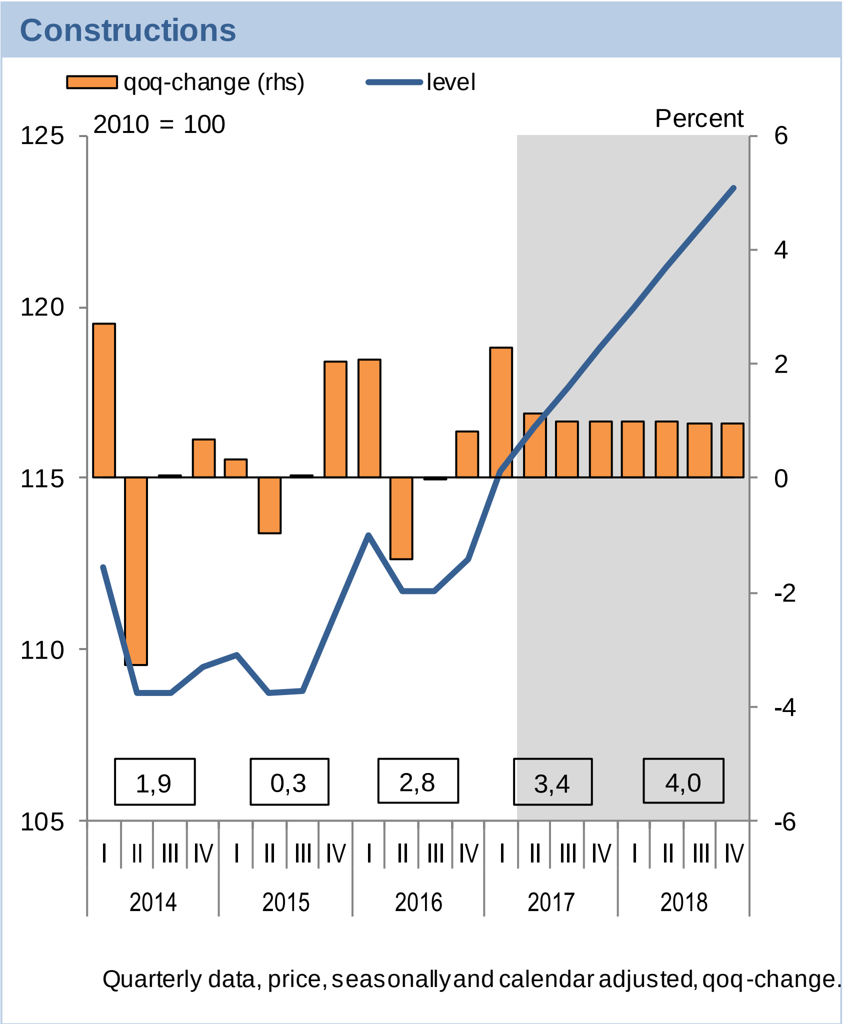
Order stocks and capacity utilization in construction industry



Quarterly data.
Capacity utilization: seasonally adjusted;
Order stocks: price, seasonally and working-day adjusted.

- Capacity utilization
  - Record high level
  - Long-term average: 66 percent
- Order books piling up
  - Total: + 21 % (Q4, y-o-y)
  - Dwellings: Two-digit growth rates since 2 years
- Price pressure
  - Value added: Upward pressure since two years
  - Stock transactions (vdp)
    - 2014: + 3.2 %
    - 2015: + 4.5 %
    - 2016: + 6.0 %

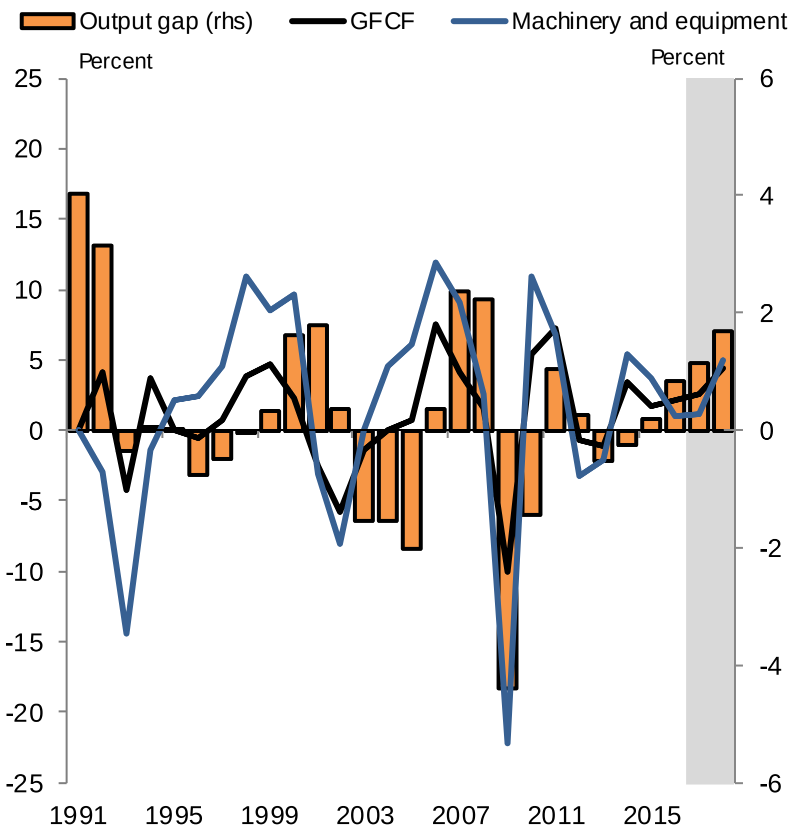
Strong further increase in constructions



- Dwellings as key driver
  - Extremely low financing cost
  - Dynamic labor market
- Pro-cyclical public investment spending
- Growth contributions
  - 2016: 0.2 ppt
  - 2017: 0.4 ppt
  - 2018: 0.4 ppt

Stretched upswing, dampened accelerator effects

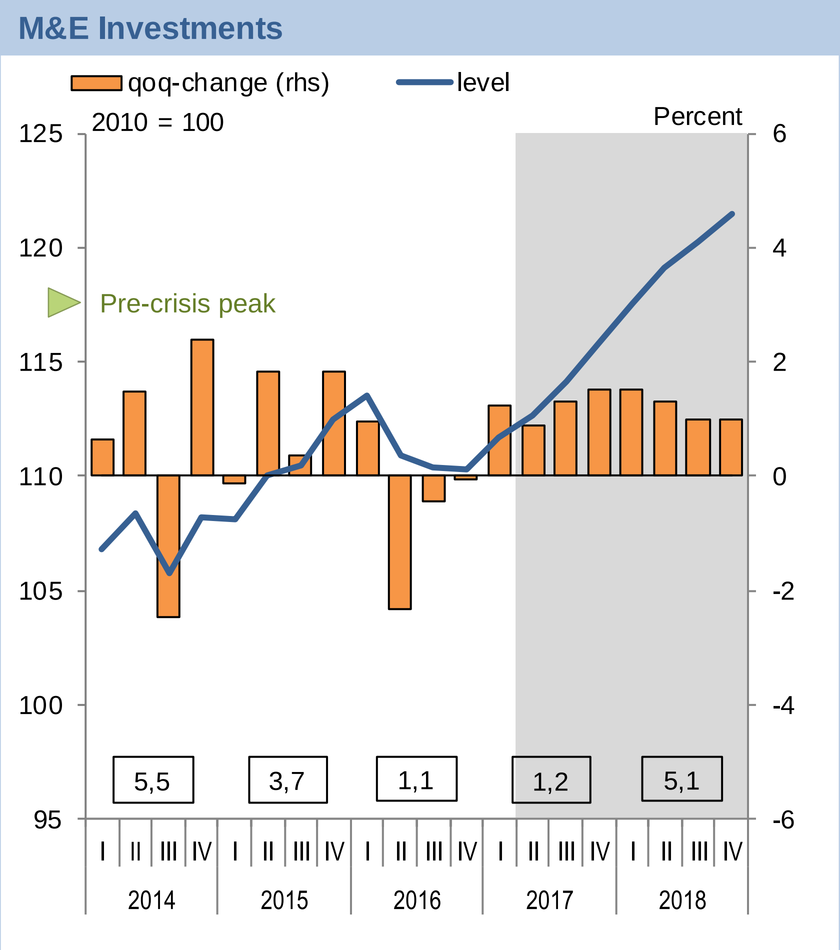
Investment cycles



Annual data.
GFCF, machinery and equipment: volumes, change on previous year;
Output gap: in percent of potential output.

- Overall unpronounced cyclical pattern
- Fixed capital formation responds less dynamic than usual

Spending on M&E gains momentum

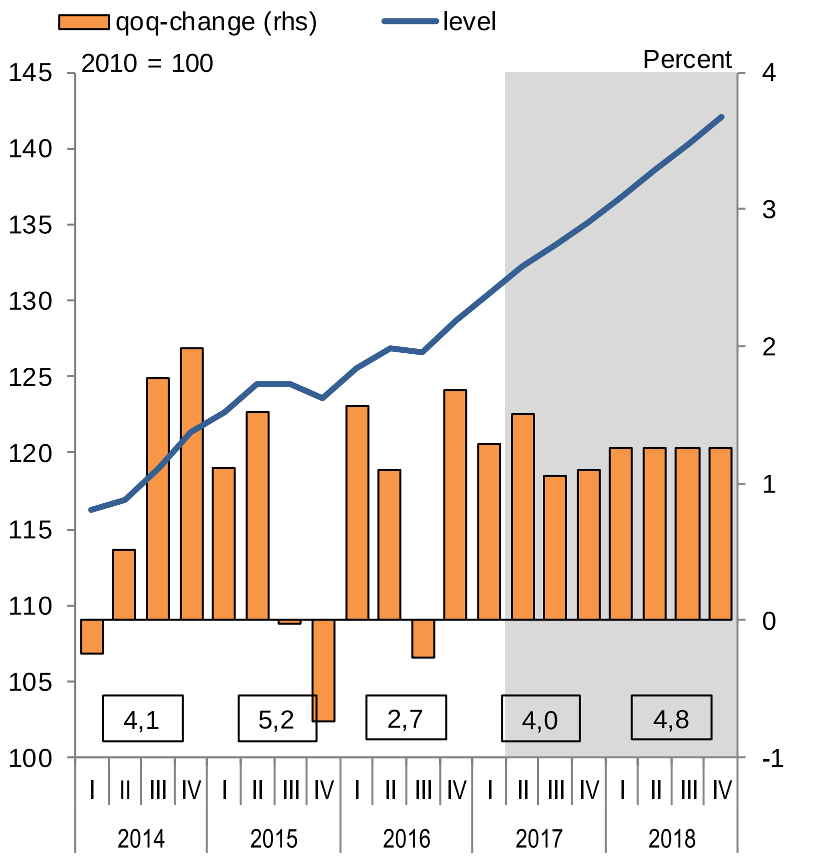


Quarterly data, price, seasonally and calendar adjusted, qoq-change.

- 2017
  - » Carry-over effect: - 0,9 ppt
  - » Calendar effect: - 0,9 ppt
- 2018: Exceeding pre-crisis level
- Weak cyclical pattern
- Financing
  - » Record low cost
  - » Very little restrictions
- Low market uncertainty, but increased policy uncertainty
- Harbinger of demographic change (lack of skilled labor)?

Exports back on track

Exports

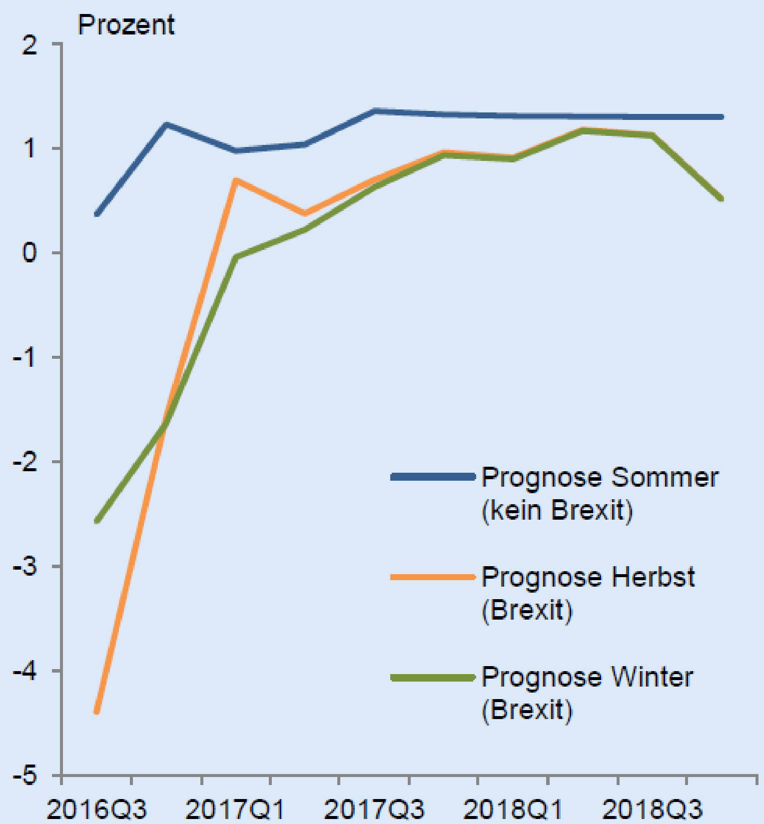


Quarterly data, price, seasonally and calendar adjusted, qoq-change.

- Stronger order inflow
- Foreign markets
  - » Less uncertainty
  - » Brighter business climate
- Export markets
  - » 2016: + 2.2 %
  - » 2017: + 2.6 %
  - » 2018: + 2.4 %
- Risks
  - » Brexit
  - » Neo-protectionism

Brexit: No game changer for German business cycle

Ausfuhren in das Vereinigte Königreich 2016–2018

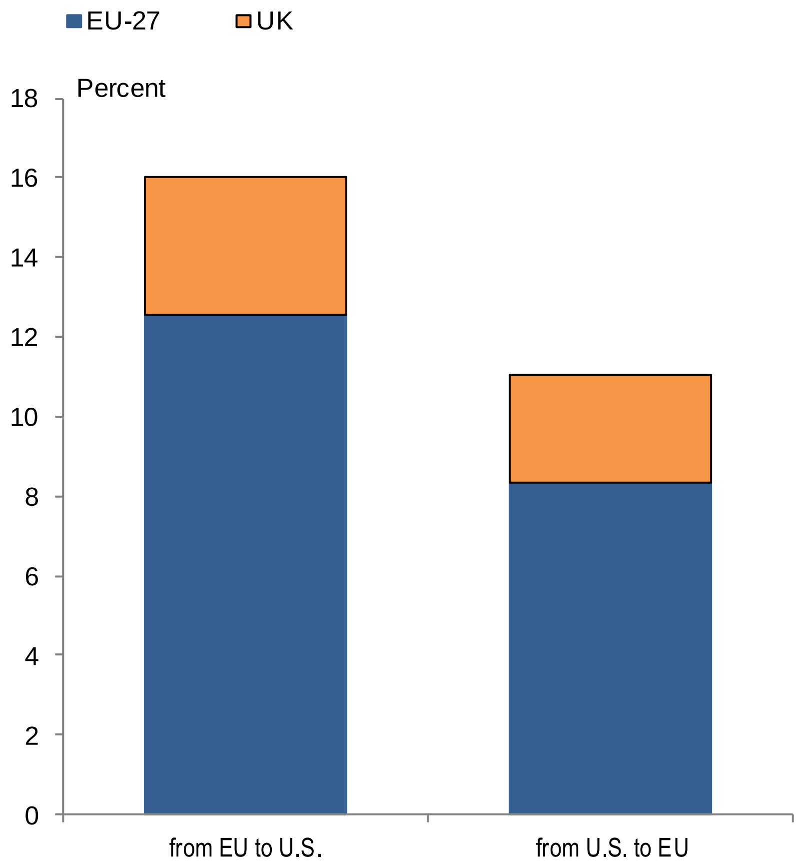


Veränderung gegenüber dem Vorquartal in Prozent. Prognose Sommer: Juni 2016, vor Brexit-Votum, Prognose Herbst: September 2016, nach Brexit-Votum. Prognose Winter: Dezember 2016, inklusive Daten für 2016Q3.

- Country-specific export function
  - UK-GDP
  - Exchange rate GBP/EUR
- UK-GDP [Autumn forecast]
  - 2016: + 2,0 % [+ 1,6 %]
  - 2017: + 1,2 % [+ 0,6 %]
  - 2018: + 1,6 % [+ 1,6 %]
- Strong currency revaluation:
  8 + 3.5 percent
- German UK exports (cumulated)
  - 2016: – 2.2 %
  - 2017: – 8.2 %
  - 2018: – 10.0 %
- GDP-impact (cumulated) < 0.5 %

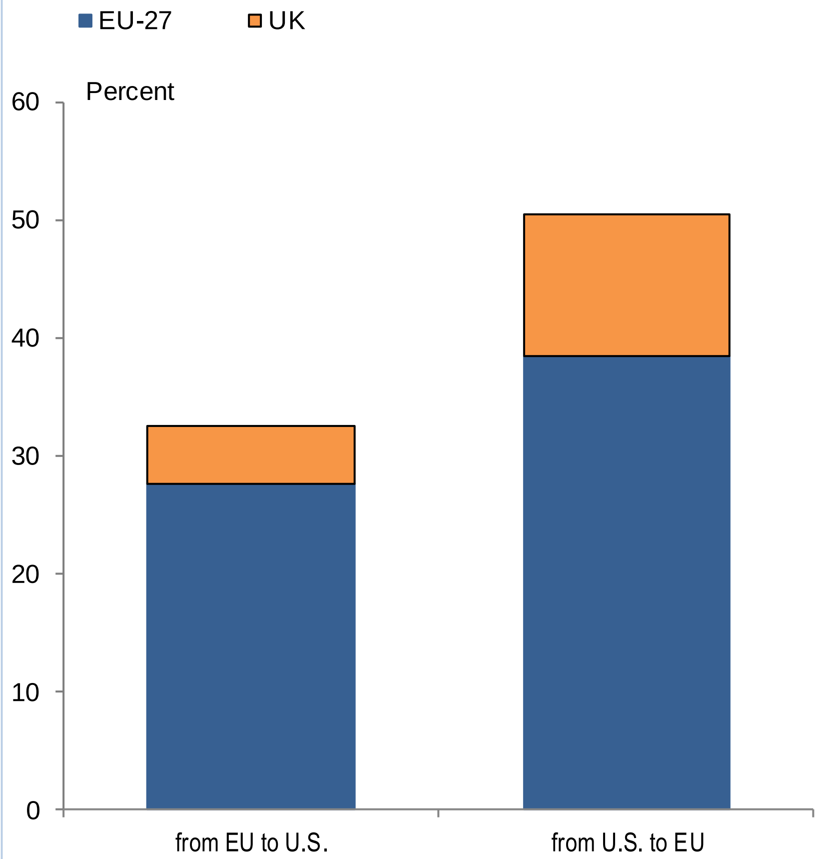
Transatlantic economic ties: Beyond the trade-centered debate

Fig. 1: Transatlantic trade links



Data for 2015; Exports: goods and services; Share of total exports; EU-27: EU excl. UK, in percent.

Fig. 2: Transatlantic direct investment positions

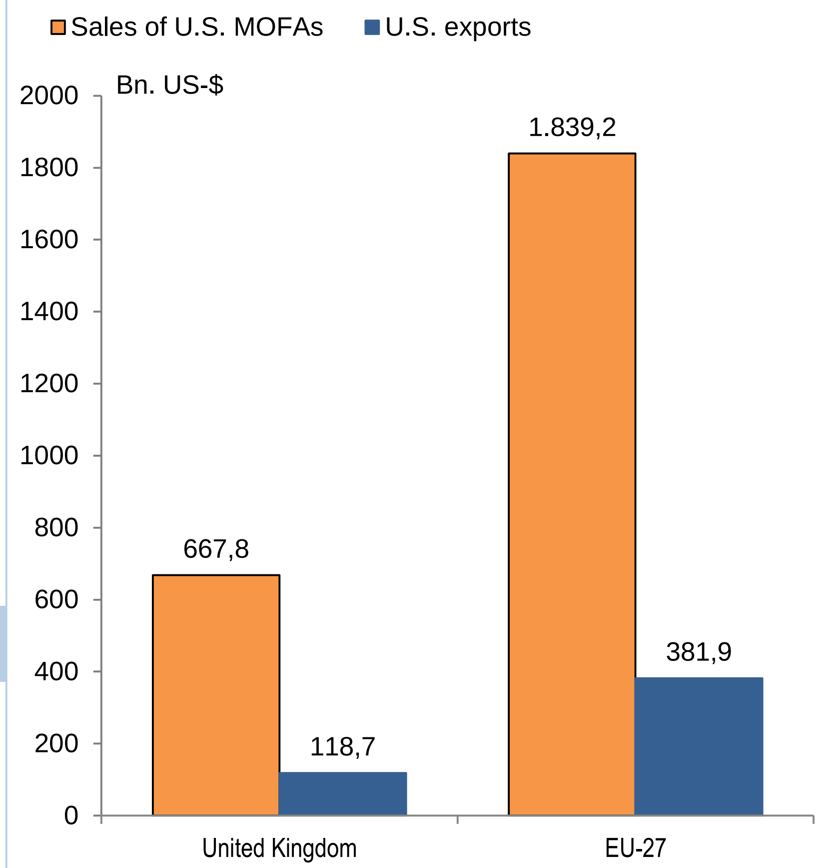


Data for 2011; Share of total outward foreign direct investment positions; EU-27: EU excl. UK, in percent.

Transatlantic economic ties: FDI as (some) protection against protectionism

- Bilateral trade balance
  - » EU-surplus: 115 bn. Euro
  - » Germany: 49 bn. Euro
- Export shares
  - » From EU to U.S.: 16 percent
  - » From U.S. to EU: 11 percent
- **FDI positions**
  - » From EU to U.S.: 32 percent
  - » **From U.S. to EU: 50 percent**

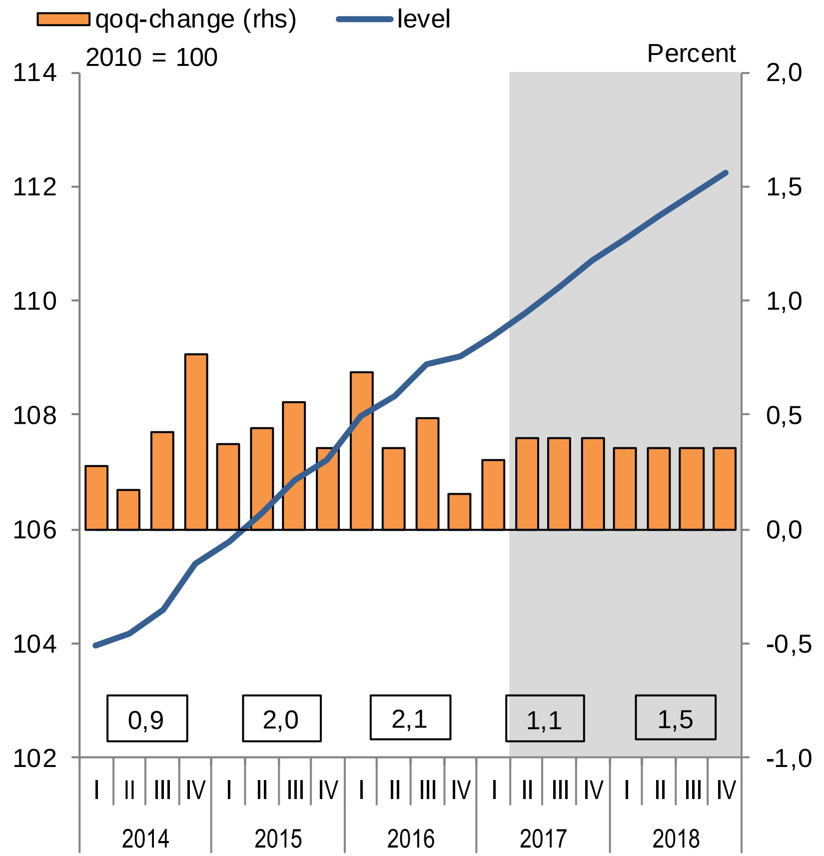
Fig. 3: Importance of the EU Market for the U.S.



Data for 2014; EU-27: EU excl. UK.

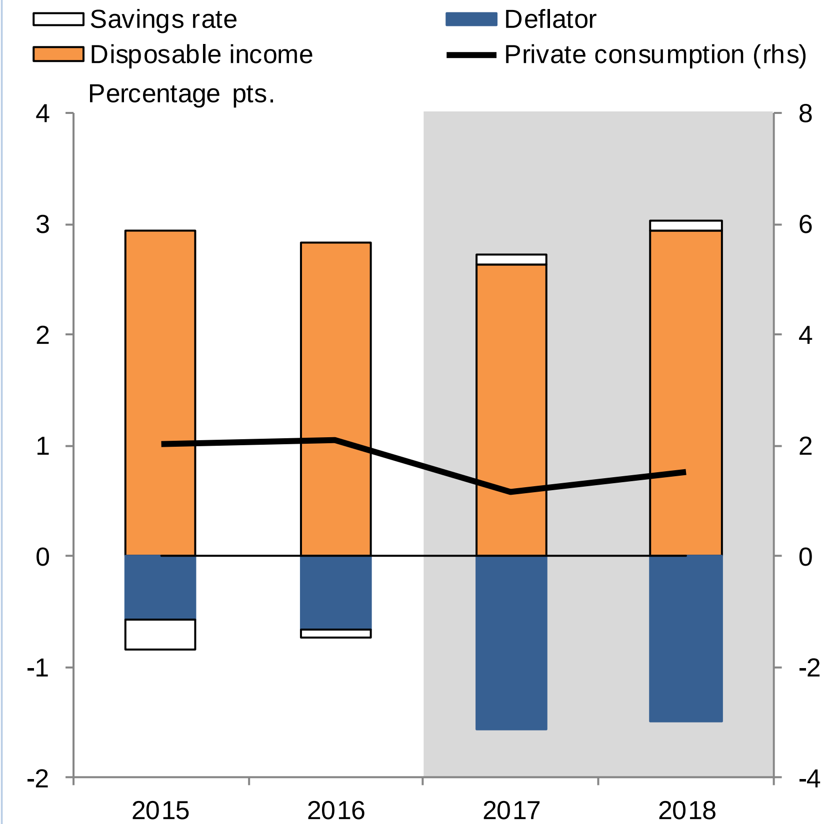
Oil price weighs on consumption dynamics

Private consumption



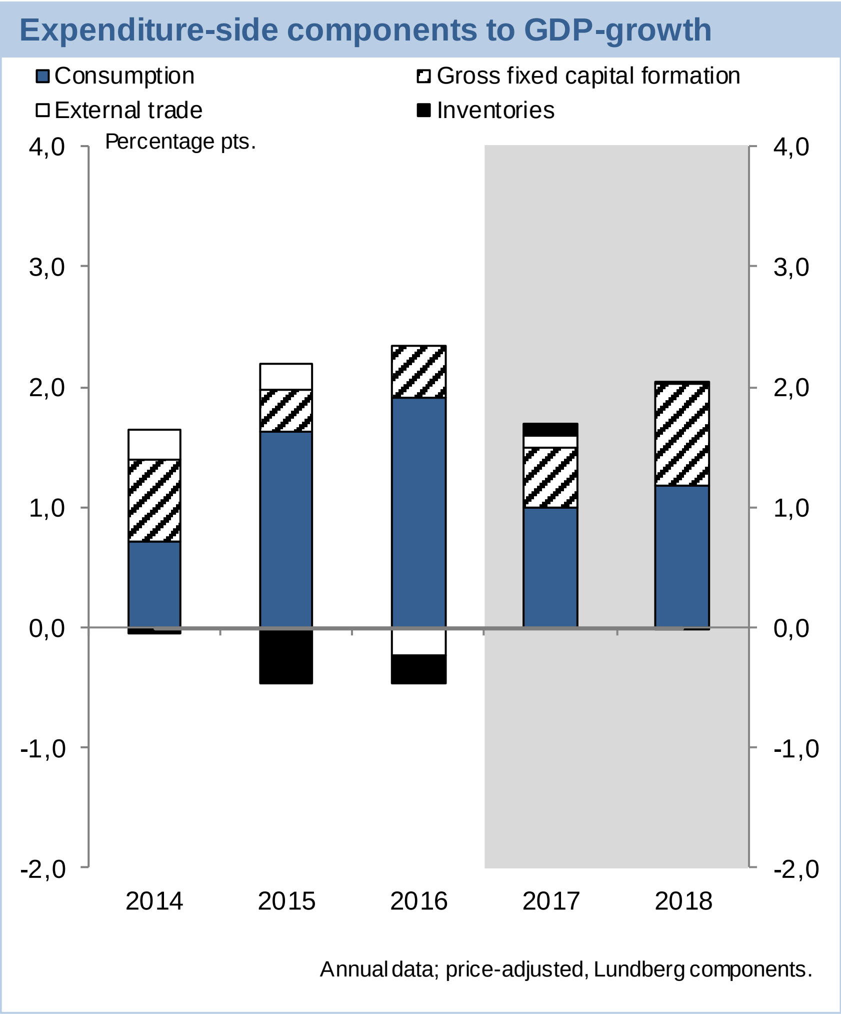
Quarterly data, price, seasonally and calendar adjusted, qoq-change.

Contributions to change in private consumption



Annual data; disposable income including adjustment for the change in pension entitlements.

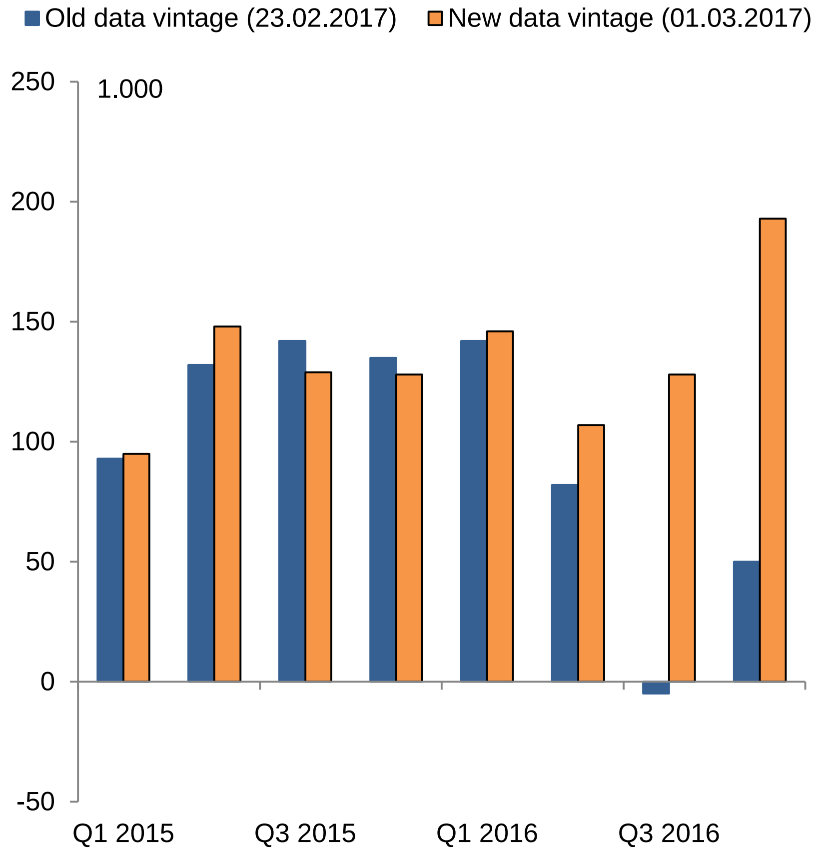
Broader picture on expenditure side of GDP



- 2015/2016 strongest consumption increase since 15 years
- Investment spending gains momentum
- Exports leave slack period behind

Robust labor market

Revision of employment numbers, 2015-2016



Quarterly data, seasonally adjusted.

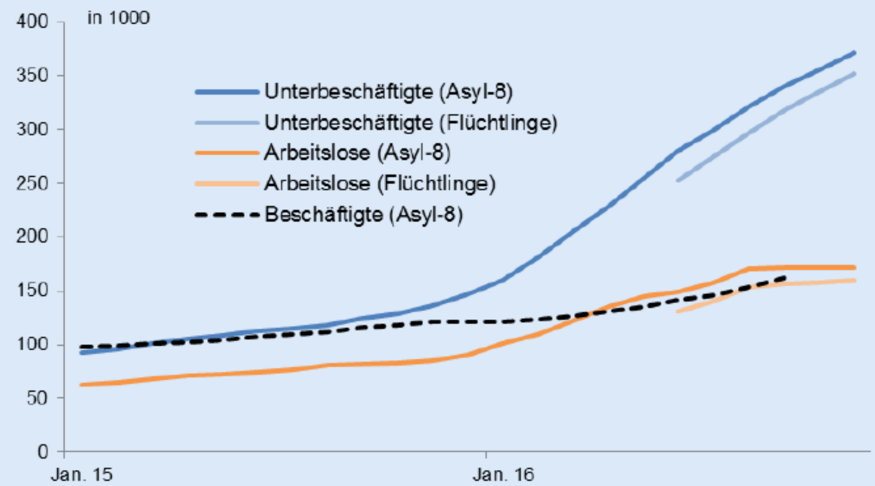
- Employment
  - » 2016: + 436,000
  - » 2017: + 638,000
  - » 2018: + 533,000
- Effective wages (hourly)
  - » 2016: + 2.8 %
  - » 2017: + 3.6 %
  - » 2018: + 3.1 %
- Unemployment rate

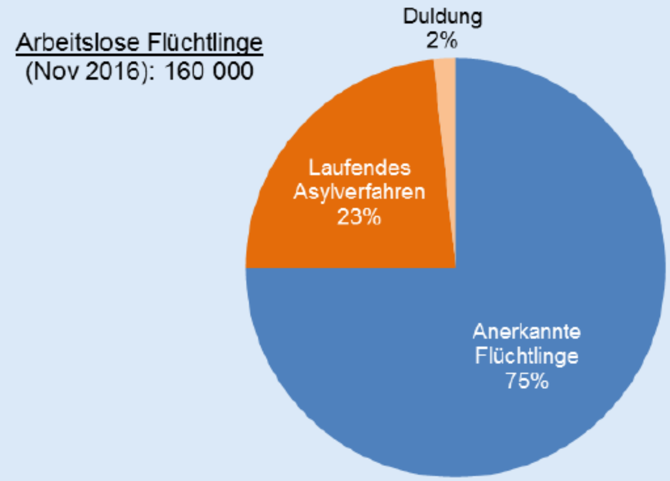
	BA	ILO
» 2016:	6.1 %	[3.9 %]
» 2017:	5.7 %	[3.6 %]
» 2018:	5.4 %	[3.3 %]

Refugees only gradually enter the labor force

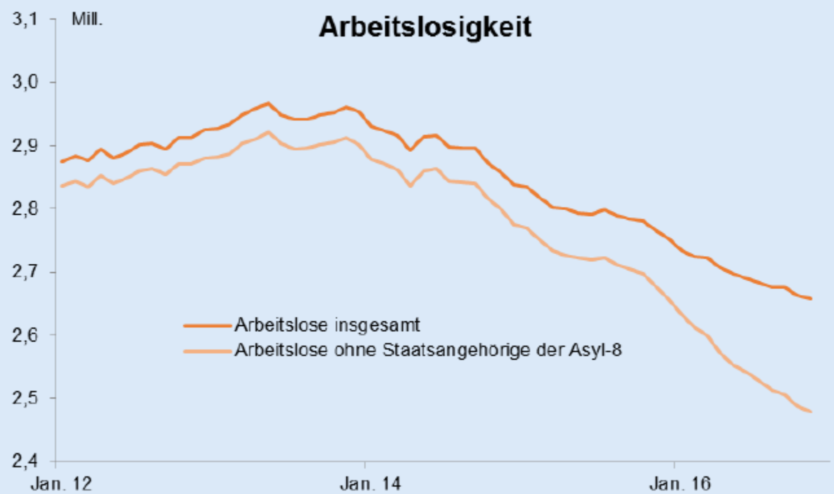
KIEL INSTITUTE FOR THE WORLD ECONOMY

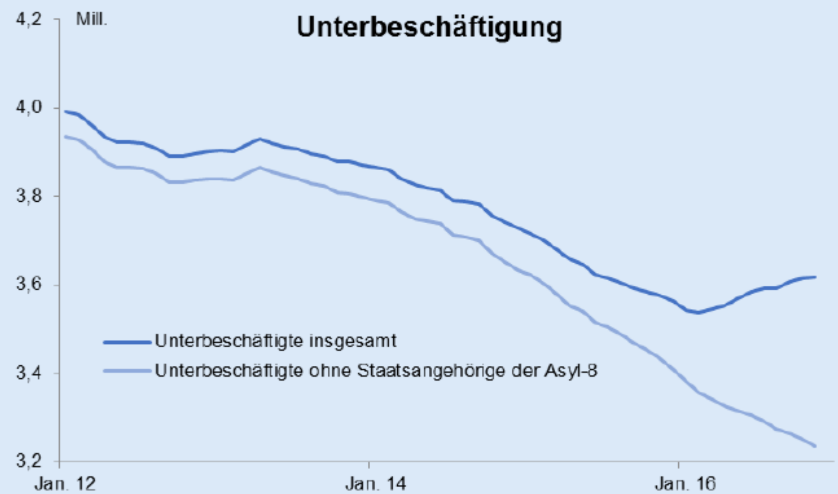
Unterbeschäftigte, arbeitslose und beschäftigte Flüchtlinge 2015-2016





Einfluss der Flüchtlinge auf Arbeitslosigkeit und Unterbeschäftigung 2012-2016



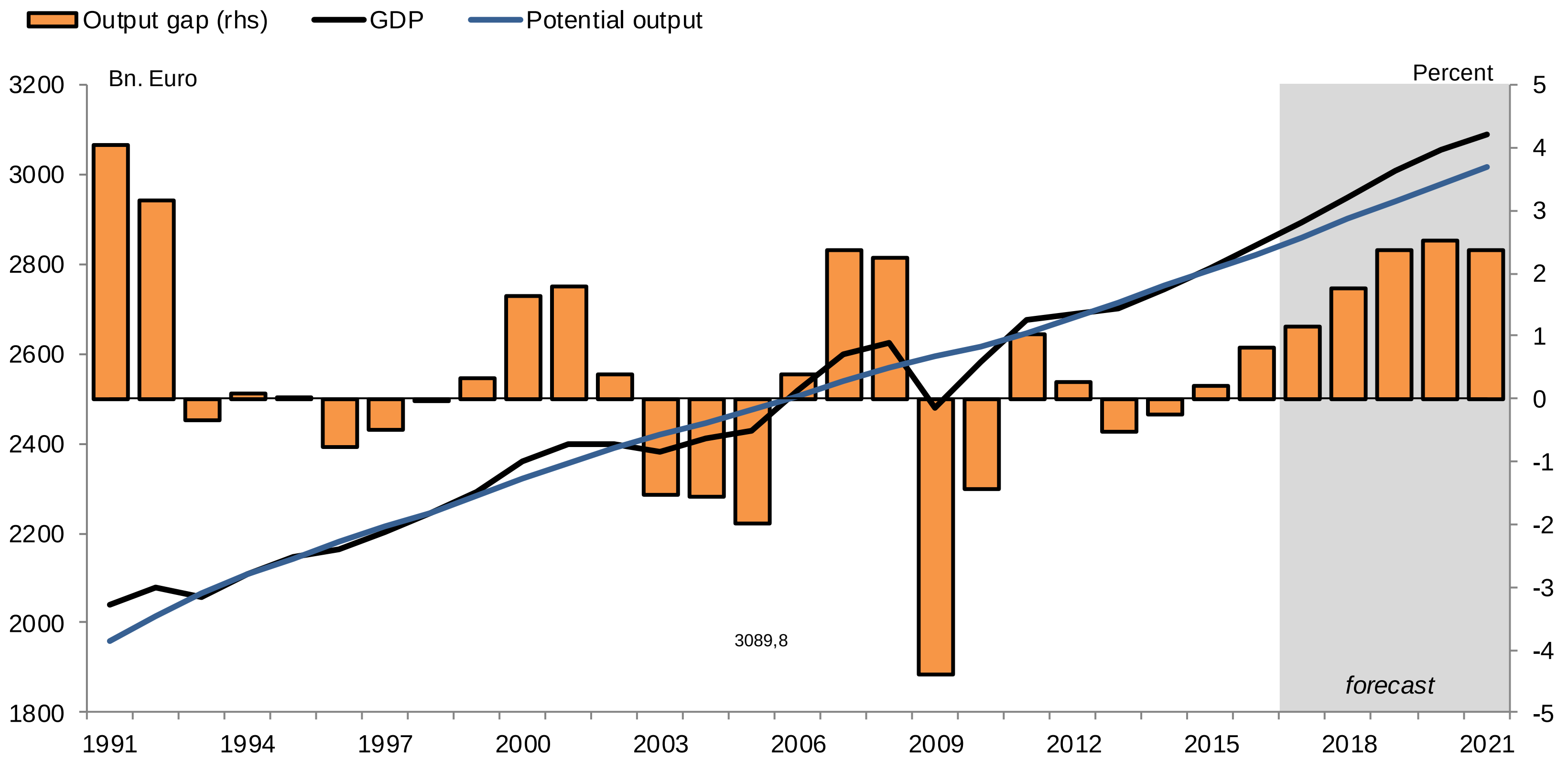


Key figures

	2016	2017	2018
GDP (%)	+ 1.9	+ 1.7	+ 2.0
GDP deflator (%)	+ 1.4	+ 1.1	+ 1.8
Consumer prices (%)	+ 0.5	+ 1.7	+ 1.7
Unit labor cost, hourly (%)	+ 1.7	+ 2.3	+ 1.7
Employment (1000 persons)	43.594	44.215	44.665
Unemployment (1000 persons)	2.689	2.529	2.424
Public budget balance (% of GDP)	0.8	1.0	1.1
Current account balance (% of BIP)	8.5	7.9	7.8

Medium-term: Drifting into overheating

Production and potential output



Yearly data; GDP, Potential output: price adjusted (chain indexvolumes, 2010=100).

Stability risks

- Ultra-expansionary monetary policy
  - Distortion of relative prices ⇨ production structures
    - Capital stock
    - Exchange rate
  - Financial stability
    - Inadequate risk premia (“insolvency slack”, hampered structural change)
    - Overstretched maturity transformation
- Overestimating potential output
  - Data edge problem
  - Demographic interim high, future of refugees
- No real spirit for supply-side reforms
- Macro-management bias in EMU context
- Neo-protectionism

Post election coalition scenarios

- AfD
- CDU/CSU
- FDP
- B'90/Die Grünen
- SPD
- Die Linke

Most likely

Second likely

Third likely

Un-likely

SPD proposals

- Social pension system: Higher expenditure
- Social health insurance: Extension to all citizens
- Income taxation
  - “Solidarity surtax”: Stepwise removal (starting with lower incomes)
  - Flattening tariff for middle-incomes, higher top-income tax rates
  - Property income tax: Integrated into general tariff
  - Family splitting
- Child benefits: Graded according to household income
- Death tax: High allowance range, all asset classes covered
- Financial transaction tax

⇨ **Balanced intra-tax system modifications, but social spending hardly in line with debt break requirements**

B’90/Die Grünen proposals

- Relief for communities
  - Shifting social spending to federal level
  - Mutualizing local legacy debt via settlement fund
- Social health insurance: Extension to all citizens
- Income taxation
  - Higher top income tax rates
  - Higher allowance range
  - Property income tax: Integrated into general tariff
  - Transformation of spouse splitting into family budget
- Financial transaction tax
- Reform of death tax
- Property tax for the “super rich”
- Higher depreciation allowances for minor economic goods

⇨ **Property tax reform faces legal headwinds (plus high administration cost), relief for communities may stimulate public investment**

FDP proposals

- Income taxation
  - » Shifting full tariff to the right (tax reduction: minimum 30 bn. Euro)
  - » Inflation indexing (“tariff on wheels”)
  - » Removal of “solidarity surtax”
- Reform of death tax (lower net tax burden?)
- Tax allowance for land transfer tax
- Reintroduction of digressive depreciation
- Discharge of public debt (low interest rates, inter-generational aspects)

⇨ **Most aggressive tax reduction ambitions of all parties, but tax plans and budgetary targets hardly achievable simultaneously**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