

Joint Economic Forecast Spring 2016

Press release

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Joint Economic Forecast Spring 2016: Upturn Remains Moderate – Economic Policy Lacks Growth Orientation

The German economy is experiencing a moderate upturn. Gross domestic product is expected to increase by 1.6 percent this year and by 1.5 percent in 2017. The upturn will be driven by private consumption, which will benefit from continued employment growth, sizeable increases in wage and transfer income and purchasing power gains thanks to lower energy prices. Fiscal policy will also be expansively oriented, partly due to rising costs related to refugee immigration. While investment in construction is also expected to expand markedly, corporate investment activity will remain subdued. Against a background of only gradual world economic recovery and strong domestic demand, no positive economic stimulus is expected from foreign trade. Public budgets will post significant surpluses in the forecasting period. Failing to use this room for manoeuvre to promote growth, as seen in recent years, is not a sustainable path.

At the beginning of 2016 it became clear that the world economy had cooled down markedly in the preceding months. This bad news led to significant valuation losses on stock markets worldwide in January and February, as well as to a significant upturn in the perception of risk. This was largely due to rapid structural change in China. For several years now the Chinese economy has been moving away from growth mainly driven by investments in industry and exports to growth that is more based on consumption and services. This shrinking process entails significant economic risks and is accompanied by a decline in foreign trade's importance to China, as well as weaker demand for commodities.

Combined with strong growth in the oil supply, this led to sharp falls in oil prices last winter. The drop in commodity prices partly reflected weaker demand worldwide. At the same time, it boosted economic activity in most advanced economies by increasing real income and lowering production costs. The overall effect on global demand for goods is expected to be positive, despite revenue losses in the major commodity-exporting, emerging economies, since a large share of lost revenues was not spent on consumer or capital goods prior to the price slump, but was set aside as savings.

The gloomier economic outlook and decline in oil prices led to a further slowdown in the global price dynamic. This prompted recourse to additional, unconventional fiscal policy measures in the euro area and Japan, which will further stimulate economic activity. In Britain and the USA central banks are more cautious about their announced policy turnaround. While the Bank of England is expected to leave its base rate unchanged during the forecasting period, two further interest rate increases are expected in the USA this year, despite a clear increase in the US core inflation rate over the winter. China's central bank significantly lowered its minimum reserve ratio for commercial banks at the end of February.

Since government debt ratios are high in almost all advanced economies and policies are often restricted by budgetary rules, fiscal policy stimulus for economic activity will be limited. The fiscal policy orientation in the USA is more or less neutral and only slightly expansive in the euro area. In Britain and Japan fiscal policy is expected to remain restrictive. China's government is currently providing the greatest fiscal policy stimulus worldwide. Many commodity-exporting emerging economies, by contrast, will be forced to take tough consolidation measures.

In the meantime there are growing signs that international economic activity will not weaken any further in the first half of 2016. In advanced economies in particular the dynamic has already gained momentum slightly. Production growth, by contrast, will remain moderate on the whole. US monetary policy will gradually become less expansive, with the strong US dollar curbing international demand. In the euro area last year's stimulus provided by the strong depreciation of the euro will disappear. The Chinese economy will continue to struggle with structural change, as well as the high indebtedness of several state-owned manufacturers. In Japan production will increase again, as the drop seen at the end of last year was mainly due to temporary factors. It has become clear, however, that its economic policy ("Abenomics") implemented with high expectations has failed to trigger any self-sustaining upturn.

All in all, world production will expand this year at around the same moderate pace as last year, according to this forecast. This will mean growth of 2.4 percent in 2016 and of 2.8 percent in 2017. Growth in world trade is also expected to be weak during the forecasting period. The institutes forecast growth rates of 2.9 percent this year and of 3.4 percent in 2017.

Although the financial markets have calmed down since mid-February, the risks underlying their unrest have not dissipated. On the one hand, it is still possible that structural change in China will affect the whole country's economy to a greater extent than previously. Inflation, on the other hand, which has already risen clearly in the USA, could increase more rapidly than predicted in this forecast, obliging central banks to make swift interest rate increases. This may cause turbulence in financial markets, and especially in emerging economies. Finally, Europe's economy faces significant political risks. Forces in favour of reversing the political and economic integration achieved in the European Union have been gathering power for several years. There is a possibility that Britain may vote to exit the European Union in June. Moreover, it is difficult to estimate the implications that this may have for trade and financial flows within the EU.

The German economy is experiencing a moderate upturn. Against a background of sustained employment growth, sizeable wage increases and purchasing power gains thanks to lower energy prices, private consumption is driving the upturn. Expenditure on caring for and accommodating the large number of refugees is also providing an additional stimulus. Low interest rates are boosting demand too. The world economy, by contrast, is hardly providing any stimulus.

After losing impetus in the second half of 2015, the increase in aggregate economic production accelerated significantly at the beginning of 2016. This is suggested in particular by rising production levels in manufacturing and growth in the working population in January and February. The pace of growth is expected to slow slightly over the rest of the year. This forecast is backed up by the Ifo Business Climate, which clouded over somewhat in the first quarter, although it remains historically favourable.

The positive development in the labour market is expected to continue over the rest of the forecasting period. The labour force will grow by 500,000 persons on average this year and by around 390,000 persons in 2017. As in previous years, migration will more than compensate for the decline in the working population due to demographics. Moreover, the availability of refugees in the German labour market will also make itself increasingly felt over the forecasting period. Unemployment will edge upwards as a result, despite employment growth. However, the average unemployment rate of 6.2 percent this year and 6.4 percent in 2017 will remain almost unchanged.

Sizeable income growth combined with a weak price dynamic mean that private households will enjoy a sharp increase in purchasing power. Wages will rise markedly and transfer income will rally, mainly due to sharp pension increases. All of these factors will lead to significant growth in private consumption. Public consumption is also expected to increase. The migration of refugees will play a central role here, initially leading to rising material costs for refugee care, and subsequently to higher monetary welfare benefits.

Overall, growth in investment activity will be subdued over the forecasting period. Indeed, its development will be two-tier: investment in residential construction will continue to grow thanks to low interest rates, strong developments in the labour market and income levels, as well as far higher demand for residential accommodation due to the influx of immigrants. Investment in both commercial construction and corporate investment in equipment, by contrast, is only expected to grow sluggishly at first, despite low interest rates, partly due to a significant deterioration in business expectations.

Scepticism on the part of companies was primarily due to multiple reports of a worldwide economic cooldown at the beginning of the year. There are now a growing number of signs that the global economy will not continue to weaken in the first half of 2016. It is expected to pick up again somewhat over the rest of the forecasting period, albeit only moderately. After a modest upturn in the spring, German exports are expected to see slightly higher growth in the second half of the year. Indeed, imports will rise so significantly that foreign trade will, on balance, strongly curb the production increase this year. In 2017, by contrast, the production increase is expected to make a slightly positive contribution.

All in all, gross domestic product is expected to rise by 1.6 percent this year and by 1.5 percent in 2017 - rates that are slightly higher than growth in production potential. The output gap is expected to narrow further in 2016 and to almost close in 2017. The 68 percent projection interval for this year will range from 0.9 percent to 2.3 percent and from -0.5 percent to 3.5 percent in 2017.

Pressure due to inflation is limited thanks to the sharp drop in energy prices. Consumer prices are expected to rise by 0.5 percent versus last year. Inflation excluding energy prices (core rate) is at 1.2 percent. In view of the sharp upturn in domestic demand and the accelerated increase in unit wage costs, the core rate is expected to rise to 1.5 percent in 2017. Since oil prices are not expected to have any curbing effect, the inflation rate will also reach 1.5 percent.

Government budget surpluses are also expected to decrease. Expenditure related to the inflow of refugees will rise and fiscal policy will be slightly expansive. Thanks to a marked increase in income tax revenues, taxes from revenues and social contributions and lower spending on interest, the German federal government will nevertheless post a budget surplus of 11 billion euros this year and 10 billion euros in 2017.

From a structural point of view – adjusted for economic influences – the overall public budget will also post surpluses that create budgetary room for manoeuvre. The State will admittedly benefit from temporary factors, including the significant drop in spending on interest due to the low-interest environment, as well as more favourable, short-lived demographic developments (“demographic interim high”). Against this background, surpluses should only be used to cover temporary additional expenditure or to finance measures that increase production potential on a lasting basis. In their past Joint Economic Forecasts the institutes have repeatedly outlined the contours of such a growth-friendly policy. In addition to reducing the burden of taxes and charges on employers, spending on investment in real capital, and especially in human capital, could boost production potential. The latter is also particularly important to facilitate the integration of refugees into the labour market. Economic policy priorities to date, however, have focused on consumption and distribution policy spending, rather than on growth-oriented measures. The continued pursuit of the economic policy of recent years, which has done little to promote growth, is not a sustainable path.

Key Forecast Figures for Germany

	2012	2013	2014	2015	2016	2017
Price adjusted GDP (percentage change over previous year)	0.4	0.3	1.6	1.7	1.6	1.5
Persons in employment ¹ (1 000 persons)	42 060	42 328	42 703	43 032	43 535	43 921
Unemployment (1 000 persons)	2 897	2 950	2 898	2 795	2 737	2 822
Unemployment rate ² (in percent)	6.8	6.9	6.7	6.4	6.2	6.4
Consumer prices ³ (percentage change over previous year)	2.0	1.5	0.9	0.3	0.5	1.5
Unit labour costs ⁴ (percentage change over previous year)	3.1	2.0	1.7	1.7	2.5	2.0
General government financial balance ⁵						
EUR billion	-2.7	-3.8	8.4	21.2	11.0	9.8
in percent of GDP	-0.1	-0.1	0.3	0.7	0.4	0.3
Balance on current account						
EUR billion	193.6	190.4	212.9	257.5	254.2	263.3
in percent of GDP	7.0	6.8	7.3	8.5	8.1	8.1

1 Domestic employment.

2 Federal Employment Agency concept, unemployed persons as percent of civilian labor force.

3 Consumer price index (2010 = 100).

4 Compensation of employees per hour worked by employees in relation to labour productivity (per hour worked by persons in employment).

5 On national accounts definition (ESA 2010).

Source: Federal Statistical Office, Federal Employment Agency, Deutsche Bundesbank, 2016 and 2017: forecast by the Institutes.

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