Outlook for Germany

Household spending to drive the German economy

Published in collaboration with

OXFORD ECONOMICS
The German economic recovery appears to be regaining momentum. We expect strong fundamentals to lift GDP growth to a four-year high of 2.2% this year.

Although the 1.6% rise in GDP in 2014 was respectable by German standards, growth would probably have been rather stronger had it not been for the situation in Ukraine and the associated sanctions imposed on Russia. Firms responded to the uncertainty by deferring investment and slashing inventories.

A renewed flare-up of the conflict in Ukraine could delay any rebound, particularly of investment. Nonetheless, the gradual improvement in sentiment, easing credit standards, the low interest rate environment and weak euro suggest that conditions are in place for a sustained investment recovery.

More importantly, the outlook for household spending appears brighter. Employment continues to rise, despite the unemployment rate falling to a record low, and the tightening labor market and introduction of a minimum wage should push up wages this year.

Meanwhile, in the shorter term, the acceleration in wage growth will be even sharper in real terms thanks to energy-related falls in inflation. With households’ balance sheets in a healthy state, strong income growth should translate into robust household spending, particularly this year.

Although export growth may pick up this year, the strength of domestic demand will prompt a faster acceleration in imports, implying that the boost to the economy from net trade will fade.

We expect this year’s economic strength to extend into 2016, when GDP is forecast to grow 2%. Further ahead, a lack of spare capacity may start to constrain activity and we see growth slowing gradually to 1.2% by 2019, broadly in line with the economy’s sustainable rate.
Household spending to drive the German economy

Recuperation regaining momentum

After some weakness in mid-2014, the German economy ended last year on a better note, growing 0.7% on the quarter in Q4. While the industrial sector only increased production marginally in Q4, the more domestically focused service sector continued to post healthy growth, and household spending expanded at a robust pace for the second quarter running.

In 2014 as a whole, GDP increased by 1.6%, a very respectable pace considering the negative effects associated with the conflict in Ukraine and the imposition of sanctions on Russia.

The signs are that economic conditions may have continued to improve in early 2015. Both the Ifo measure of business sentiment and the composite Purchasing Managers Index (PMI) have been rising, suggesting that GDP in Q1 this year could grow at a similar pace to that seen in Q4 2014.

Households to take center stage

One important reason why we see the economic recovery gathering pace over the rest of this year is that the outlook for household spending appears particularly favorable. In 2015, we think that real household income growth is on track to rise at its strongest pace since 1992. Given this, and the fact that there has typically been a close relationship between incomes and spending growth in the past, 2015 looks set to be a good year for household spending in Germany.

Our view is that real income growth will strengthen sharply from 1.4% to 3.5% this year, due to three key factors. First, despite the record low unemployment rate of 4.9% (on the International Labour Organization measure), there are no clear signs that capacity constraints in the labor market are yet prompting employment growth to slow. In December 2014, annual employment growth was 1%, up from 0.5% a year earlier. While our view is that this will slow, we may have underestimated the sustainable rate of unemployment, implying that employment growth may stay stronger for longer. Another possibility is that the strength of the labor market will result in stronger inward immigration than we have assumed, boosting the labor supply and hence potential further growth in jobs.

Table 1

Germany (annual percentage changes unless specified)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1.6</td>
<td>2.2</td>
<td>2.0</td>
<td>1.6</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Private consumption</td>
<td>1.2</td>
<td>2.5</td>
<td>1.7</td>
<td>1.3</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Fixed investment</td>
<td>2.9</td>
<td>0.2</td>
<td>3.7</td>
<td>3.2</td>
<td>2.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Stockbuilding (% of GDP)</td>
<td>-1.1</td>
<td>-0.4</td>
<td>-0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Government consumption</td>
<td>1.1</td>
<td>0.7</td>
<td>0.8</td>
<td>0.9</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>3.9</td>
<td>5.3</td>
<td>5.0</td>
<td>4.0</td>
<td>3.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>3.6</td>
<td>6.3</td>
<td>6.1</td>
<td>4.9</td>
<td>4.6</td>
<td>4.1</td>
</tr>
<tr>
<td>Consumer prices</td>
<td>0.8</td>
<td>-0.1</td>
<td>1.5</td>
<td>1.9</td>
<td>1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>Unemployment rate (level)</td>
<td>5.0</td>
<td>4.9</td>
<td>4.9</td>
<td>4.7</td>
<td>4.6</td>
<td>4.5</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>7.6</td>
<td>8.2</td>
<td>7.8</td>
<td>7.4</td>
<td>7.1</td>
<td>6.9</td>
</tr>
<tr>
<td>Government budget (% of GDP)</td>
<td>-0.1</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Government debt (% of GDP)</td>
<td>76.6</td>
<td>76.5</td>
<td>76.2</td>
<td>76.1</td>
<td>76.0</td>
<td>75.1</td>
</tr>
<tr>
<td>ECB main refinancing rate (%)</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
</tr>
<tr>
<td>Euro effective exchange rate (1995 = 100)</td>
<td>123.6</td>
<td>108.6</td>
<td>104.7</td>
<td>105.4</td>
<td>106.6</td>
<td>108.0</td>
</tr>
<tr>
<td>Exchange rate (US$ per €)</td>
<td>1.33</td>
<td>1.07</td>
<td>1.01</td>
<td>1.01</td>
<td>1.02</td>
<td>1.04</td>
</tr>
</tbody>
</table>

Source: Oxford Economics.
Second, job vacancies, which rose 13.6% from a year earlier in February 2015, are at a record high, suggesting that firms may be forced to push up wages in order to fill unoccupied positions. Upward pressure on wages will be exacerbated by the introduction of a minimum wage at the beginning of this year. Estimates suggest that up to a quarter of east German workers may benefit, while the figure for western Germany is still large, at just under 15%. The effect on wages could be larger still if it prompts workers earning just above the minimum wage to seek pay rises. Admittedly, the impact of this on workers’ incomes may be lessened if firms lay off some low-paid workers or cut their hours. But for now at least, the headline employment figures and survey-based measures of employment are not consistent with widespread layoffs in early 2015. The upshot is that we see a period of fairly strong nominal wage growth this year.

Finally, in real terms, households will experience even stronger wage growth as a result of the expected slowdown in inflation, which is expected to be -0.1% this year, down from 0.8% in 2014 and 1.6% in 2013 (on the European Union-harmonized measure). Strong income growth is not the only reason for optimism about household spending. German households have little need to undertake deleveraging, since debt as a share of disposable income has been falling for over a decade. We see household spending rising by 2.5% this year. Thereafter, spending growth will weaken as real wage and employment growth ease. We expect a rise of 1.7% in 2016 and a further slowdown in 2017-19.

Recent investment weakness to end

Investment stuttered in the middle of 2014 in response to the uncertainty created by developments in Russia and was an important factor behind the German economy’s loss of momentum. Since then, it appears that this uncertainty has dissipated somewhat. In Q4, investment increased moderately. This gradual improvement is likely to continue. In the short term, at least, there are signs that firms’ demand for bank lending is increasing. According to the Bundesbank’s bank lending survey, the net percentage of banks reporting increased demand for loans rose sharply at the end of Q4 to a three-and-a-half year high, with a notable factor behind this being increased demand for loans to finance fixed investment. This supports our view that the reversal in the recovery of equipment investment in the middle of last year was in response to a temporary Russia-related uncertainty shock that is now unwinding.

Table 2
Forecast for Germany by sector (annual percentage changes in gross added value)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1.6</td>
<td>2.2</td>
<td>2.0</td>
<td>1.6</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>1.7</td>
<td>1.0</td>
<td>2.1</td>
<td>1.8</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Agriculture</td>
<td>5.8</td>
<td>1.5</td>
<td>2.0</td>
<td>1.5</td>
<td>0.8</td>
<td>0.6</td>
</tr>
<tr>
<td>Construction</td>
<td>3.6</td>
<td>-0.3</td>
<td>0.5</td>
<td>0.8</td>
<td>0.7</td>
<td>1.0</td>
</tr>
<tr>
<td>Utilities</td>
<td>-4.3</td>
<td>1.7</td>
<td>2.2</td>
<td>1.4</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Trade</td>
<td>2.4</td>
<td>2.2</td>
<td>2.2</td>
<td>1.7</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Financial and business services</td>
<td>1.6</td>
<td>2.2</td>
<td>2.1</td>
<td>1.7</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Communications</td>
<td>2.2</td>
<td>5.7</td>
<td>5.0</td>
<td>4.2</td>
<td>3.3</td>
<td>3.1</td>
</tr>
<tr>
<td>Non-market services</td>
<td>1.0</td>
<td>1.5</td>
<td>1.3</td>
<td>1.1</td>
<td>0.7</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: Oxford Economics.
In addition, rising capacity utilization also bodes well for investment spending. And due to the tight labor market, many firms that are under pressure to raise capacity to meet expected future increases in demand may increasingly focus on raising investment rather than expanding their workforce to boost potential output. The fact that the rate of interest of five-year bank loans has fallen to around 2% should provide further impetus to the recovery.

Of course, investment will only take place if firms have access to finance. Encouragingly, though, there are signs that the publication of the European Central Bank (ECB) bank stress tests and asset quality review late last year may have prompted a sea change in banks’ behavior. The size of banks’ balance sheets troughed in April 2014, but since then has increased by about 4% in a sign that the bank deleveraging process may have come to an end. The ECB’s ongoing attempts to ease supply constraints could further boost credit supply over the coming quarters.

Furthermore, there may be scope for greater internal financing of investment. After all, cost reductions associated with the oil price fall could provide firms with a windfall, freeing up money for investment.

On balance, there appears to be plenty of scope for a rebound in private sector investment, which beyond this year will be supported by a planned increase in public sector infrastructure investment. Our forecast shows overall investment rising by just 0.2% in 2015 as a result of base effects, but we forecast that it will rise in each quarter of the year. As a result, much stronger investment growth of 3.7% is expected in 2016, before a gradual slowdown thereafter.

Boost from net trade set to diminish

Although demand in Germany’s main export markets is not expected to strengthen significantly this year, this may be offset by the boost to competitiveness from the euro’s fall. We expect a 5.3% rise in exports this year and a gradual weakening thereafter. But if we have underestimated the potential global growth stimulus from sharply lower oil prices, export growth could be stronger still.

The big picture, however, is that export growth will not match the bumper rates recorded prior to the global financial crisis. So with a bout of reasonably robust domestic demand growth, at least by German standards, net trade is unlikely to provide GDP with much of a boost over the next few years.

Germany to remain the engine of Eurozone growth

Overall, we believe that the German economy is in the early stages of a rebound that will yield GDP growth of 2.2% this year and 2% in 2016. Thereafter, our central view is that growth will slow toward the economy’s medium-term potential growth rate, which we estimate at 1.2% a year.

In the near term, there are downside risks to our forecast, which mainly stem from outside influences, such as global macroeconomic weakness or a renewed bout of Russian-induced uncertainty. But further ahead, the risks to our forecast lie to the upside. Given the expected strength of households’ real income growth, a sharper pickup in consumer spending should not be ruled out. Meanwhile, the projected slowdown in 2017 is predicated on capacity constraints restricting growth. If we have underestimated the amount of spare capacity or the degree to which immigration and labor participation respond to the tight labor market, a longer period of above-trend growth is possible.
Learn more about the *EY Eurozone Forecast* at ey.com/eurozone:

- Download the latest *EY Eurozone Forecast* and individual forecasts for the 19 member states.
- Use our dynamic Eurochart to compare country data for the next five years.
- Use the trend analysis tool to compare forecasts for specific economic indicators across the 19 Eurozone nations.

---

**EY Eurozone Forecast: outlook for financial services – Winter 2014**

- The *EY Eurozone Forecast: outlook for financial services* explores the implications of the latest Eurozone economic forecasts for banks, asset managers and insurers.
- Our latest forecast sees improving GDP, growth in consumer spending and falling unemployment across the Eurozone.
- Learn more and download the report at ey.com/fseurozone.

---

**EY Rapid-Growth Markets Forecast: July 2014**

- Our latest report explores the role of urbanization in the rapid-growth markets.
- Learn more and download the report at ey.com/rapidgrowth.

---

**EY’s attractiveness survey: Europe 2014**

- *EY’s attractiveness surveys* are annual reports that examine the attractiveness of selected nations and regions to foreign investors.
- *EY’s attractiveness survey: Europe 2014* finds that Europe remains the world’s top destination for foreign direct investment.
- Learn more and download the report at ey.com/attractiveness.
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2015 EYGM Limited.
All Rights Reserved.
EYG no. AU2993

BMC Agency
GA 0342_01365

ED None

In line with EY’s commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com

About Oxford Economics
Oxford Economics was founded in 1981 to provide independent forecasting and analysis tailored to the needs of economists and planners in government and business. It is now one of the world’s leading providers of economic analysis, advice and models, with over 850 clients including international organizations, government departments and central banks around the world, and a large number of multinational blue-chip companies across the whole industrial spectrum.

Oxford Economics commands a high degree of professional and technical expertise, both in its own staff of over 150, including 90 economists, based in Oxford, London, Belfast, Paris, the UAE, Singapore, New York and Philadelphia, and through its close links with Oxford University and a range of partner institutions in Europe and the US. Oxford Economics’ services include forecasting for 200 countries, 100 sectors, and 3,000 cities and sub-regions in Europe and Asia; economic impact assessments; policy analysis; and work on the economics of energy and sustainability.

The forecasts presented in this report are based on information obtained from public sources that we consider to be reliable but we assume no liability for their completeness or accuracy. The analysis presented in this report is for information purposes only and Oxford Economics does not warrant that its forecasts, projections, advice and/or recommendations will be accurate or achievable. Oxford Economics will not be liable for the contents of any of the foregoing or for the reliance by readers on any of the foregoing.