GERMANY

Growth is projected to ease somewhat but still remain solid and employment is set to expand further. Stronger activity in the euro area is boosting exports and business investment, but euro appreciation and higher wages may dent competitiveness. Low unemployment and wage gains underpin private consumption, but are also raising consumer price inflation. Low interest rates and strong housing demand, partly due to immigration, sustain residential investment. The current account surplus will fall somewhat, but will still remain high.

Fiscal policy is mildly supportive of growth, but the budget balance will remain in surplus. The supply of childcare and full-day primary schools needs to expand and infrastructure needs to be modernised. There is scope to shift the tax burden from wage income to environment and real estate taxes. Taxes on second earners should be lowered. These steps would strengthen inclusive, green growth.

Private and public indebtedness are modest. However, house prices have risen, especially in major cities. So far the rise is mostly in line with higher household incomes, lower interest rates and immigration. The authorities need to be ready to apply macro-prudential tools which would specifically address risks in case house prices and mortgage lending accelerate. More demanding leverage requirements on banks would reduce risks, improve the efficiency of lending and strengthen inclusiveness.

Economic growth is strong

Economic activity has expanded on a broad basis. The recovery in euro area trading partners has boosted exports and machinery and equipment investment. Construction has also been buoyant as the housing needs of immigrants, higher incomes and low interest rates have increased housing demand and the government has stepped up spending to improve maintenance of transport infrastructure and schools. House prices have risen,
mostly in line with lower interest rates, higher rents and incomes. However, price increases have been particularly strong in major metropolitan areas. Mortgage lending has also been in line with income growth. On the back of stronger investment, business borrowing has picked up.

Strong labour market performance underpins the growth of household consumption. Vigorous employment growth has pushed the unemployment rate to record-low levels, while the number of vacant jobs is rising strongly. Female labour market participation is increasing and more women work longer hours, reflecting in part improved childcare provision. Still, most women work part-time, which limits their access to attractive careers. Skill shortages are increasing, yet women’s skills are used less than men’s, resulting in unexploited opportunities for productivity, income and well-being gains. Immigration, mostly from other EU countries, remains strong. The number of refugees entering the labour market after they have received initial training is increasing and many of them are unemployed.

**Fiscal policy should support inclusive growth**

The fiscal stance is projected to be mildly supportive in 2018 and 2019. Higher income tax allowances, child benefits and somewhat higher public spending to support municipal
investment and to improve childcare provision are mostly offset by revenue-raising measures. These include stricter rules in the taxation of households’ capital income and the extension of road user charges to a wider range of roads and freight transport vehicles. On current policies, tax revenue growth is likely to increase the government surplus above 1% of GDP.

The strong fiscal position provides room to fund priority spending and tax reforms. Despite substantial improvements in recent years, the demand for full-day care for young children is not yet met and the quality of childcare is uneven. Most school children attend school only half-day. Enrolling more young children from disadvantaged socio-economic backgrounds in high-quality childcare and providing more full-day schooling would boost education outcomes and increase social mobility, which is low in Germany. These steps would also make it easier, especially for women, to reconcile family life and full-time employment. Rollout of high-speed fibre broadband infrastructure is low, especially in rural regions. Accelerating rollout could improve economic development of rural regions which have fallen behind.

The incidence of low-pay employment in Germany is widespread, but the tax burden on low labour incomes is high. Steps to lower social security contributions especially for low-paid workers would make the tax system more inclusive. Lower taxation of second earners would give women access to better professional carriers and reduce the large gender earnings gap. To make room for such tax reductions, tax expenditures for environmentally damaging activities could be phased out, energy tax rates could be aligned with carbon intensity and taxation of nitrogen oxide emissions could be introduced. Updating real estate tax valuations and extending the taxation of capital gains to residential real estate would be particularly timely in view of house price developments and would also benefit inclusiveness. Taxes on household capital income could be better
aligned with taxation of other household income. Reduced VAT tax rates, for example on hotel services, should be raised to the standard rate.

Financial market conditions are supporting the economic expansion. Lower implicit government guarantees for banks and lower leverage have reduced risk. Nonetheless, leverage remains high among large banks, which continues to exacerbate risks, harm efficiency and increase inequality. The small cooperative and public savings banks are less leveraged but their profits are under pressure on account of low interest rates. They are more exposed to losses should short-term interest rates rise.

**Growth is projected to remain robust**

Economic growth is projected to ease somewhat but still remain robust and broad-based. The recovery in the euro area sustains exports and business investment. Nevertheless, business investment is still subdued by historic standards. Housing investment will remain strong, driven by higher house prices, although unmet housing needs of refugees will diminish. The tight labour market will boost private consumption and is expected to result in some pick-up of wage and price inflation. The current account surplus will remain large.

There are downside risks related to the impact of the exit of the United Kingdom from the European Union, as it may disrupt the sourcing of inputs by key German industries, including automotive production and chemicals. On the other hand, some businesses have announced they will transfer activity to Germany. Geopolitical risks could reduce world trade and German exports. Steps to implement reforms to complete the Single Market in the European Union and establish a more comprehensive banking union in the euro area could strengthen confidence in the euro and boost the attractiveness of Germany as a location to invest.