



# Germany

## Favourable business climate despite uncertainties

- The IFO climate index has been on a rising trend, supported by strong activity.
- The main drivers are the pick-up in global trade, euro weakness, and low interest rates.
- The lack of skilled workers is increasingly weighing on business investment.
- Entrepreneurs may also be reluctant to invest given the political uncertainty.

The German economy has been very dynamic in recent months. Sentiment indicators have picked up strongly and the earliest hard data confirm this picture. The IFO climate index has been on a rising trend since February. It reached 122.7, its highest value since 2011. Business leaders were in particular very satisfied with current business conditions. This component of the index has been improving since September 2016. However, the IFO panel remains rather cautious concerning the outlook. The expectations component has only marginally risen in recent months. That is not surprising given the uncertainties that the economy faces such as the unpredictable course of the new US administration, the triggering of article 50 by the UK government, and the elections in France and Germany.

In particular, the manufacturing sector recovered from the stagnation in the fourth quarter of 2016. In January-February, industrial output was on average 1.8% higher than in the preceding three months. Activity is especially driven by the strong pick-up in global demand. In January-February, the three-month rate of change of global trade surged to 2.7% compared with 1.4% in the fourth quarter of 2016 (CPB World Trade Monitor). Another factor is euro weakness, related to the ECB's very accommodative policy stance.

The ECB policy is also a major driver behind the surge in activity in the construction industry, as low interest rates and a favourable employment outlook have boosted the demand for housing. Although consumer prices have been sluggish, house prices have been rapidly rising. In 2016, in the seven major cities, real estate prices were more than 10% higher from the preceding year. The IFO business climate in the construction sector improved, thanks to a further rise in the assessment of current conditions, which reached a new record high.

The favourable situation is also reflected in labour market developments. The unemployment has been on a downward trend, falling to only 3.9% in February. But the situation is not the same in all the Länder. The labour market is especially tight in Bavaria and Baden-Württemberg, where unemployment was close to 3% in 2016. The highest unemployment was measured in the eastern part of the country, the so-called New Länder. In Sachsen-Anhalt, it even reached 7.4%.

### Germany's business climate is improving

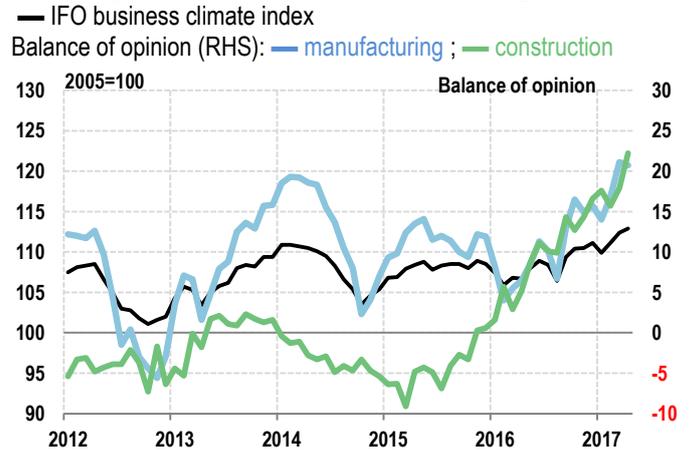


Chart 1

Source: IFO

Much of the unemployment is linked to skill-mismatches. Entrepreneurs find it increasingly difficult to recruit skilled workers. That is also the case in the New Länder, as young skilled workers are moving to the western part of the country, attracted by better salaries and career prospects. This movement is weighing on the growth prospects of the region.

Another concern for employers is the rise in labour costs, partly due to the shortage of skilled workers. In the fourth quarter, labour costs were 1.5% higher from the preceding three months and 3.1% from a year earlier. However, trade unions might be willing to moderate their demands in order to remain competitive in European markets and avoid the delocalisation of plants. Many employers also consider the rise in energy and commodity prices as a risk for their business.

In the coming months, entrepreneurs may hold off investment decisions until the uncertainty concerning the outcome of the elections in several European countries is lifted. In Germany, the general election will be held on 24 September. Chancellor Angela Merkel and the SPD leader Martin Schulz are neck-to-neck in the polls. In case of an SPD victory, some of the reforms that were implemented in recent years may be reversed.