Germany is quickly recovering from the contraction in the final quarter of 2012

- In its quarterly revision, KfW confirms its economic forecast, maintaining its prediction of calendar-adjusted real growth of 0.9% for 2013, a rate it expects to almost double to 1.7% in 2014.

- At the start of this year, the economy is already making up for most of the ultimately expected sharp GDP contraction in the fourth quarter of 2012 (-0.6% against the preceding quarter); we now expect solid 0.4% growth for the first quarter of 2013.

- The main reasons for our optimism are the stable job market combined with real wage increases, the global recovery, changes in economic policy and institutions in the euro area, and the significantly improved business expectations and better filled order books in the economically crucial manufacturing sector. However, capital formation will only pick up gradually, mostly because the cautious export expectations, dampened by the weak performance of its European trading partners, will remain a considerable burden for the time being.

Germany’s gross domestic product, price and calendar-adjusted

After the significant decline in GDP in the fourth quarter of 2012, Germany entered the year 2013 with a considerable statistical underhang. However, given the very strong recent improvements in business and export expectations, we are confident that it will soon be overcome. GDP will be back to solid growth already in the first quarter of 2013, almost offsetting the decline. The recovery will then continue as global tailwind becomes stronger, uncertainty subsides and companies gradually abandon their reluctance to invest. We therefore affirm our forecast of November and continue to expect GDP growth of 0.9% for 2013 (not calendar-adjusted: 0.8%). This annual
growth rate, which is again relatively low and below potential, is very largely due to the unfavourable starting level. It masks dynamic development over the year that will have a positive effect on the economic performance in 2014. Real growth next year is expected to almost double to 1.7 % (not calendar-adjusted: 1.7 %).

**Significant underhang after sharp contraction at the end of 2012**

Upon price, seasonal and calendar adjustment, GDP contracted by 0.6 % at the end of last year. It was only supported by consumption. The last time Germany had to endure a sharper quarterly decline was in early 2009, the low point of the Great Recession. This year's growth will therefore begin from an exceptionally low level. Because the drop was so sharp, GDP in the last quarter was 0.3 % below the 2012 annual average. This so-called statistical underhang will first have to be cancelled out in the course of 2013 before the German economy can grow again in the year 2013 as a whole.

**Weak exports were the main reason – but not the only one**

This should be achievable. The contraction in the final quarter 2012 was severe because of a cumulative mix of technical and fundamental causes but not sustained, and is likely to be almost fully overcome already in the first quarter. In technical terms, the contraction is exaggerated by a preceding pull-forward effect in the automobile industry. In the third quarter (+7.5 % against the preceding quarter) automakers had cut order backlogs through additional shifts. This was production brought forward in an important industry which was then missing in the fourth quarter (-8.0 %). This alone contributed almost 0.3 percentage points to real growth in the third quarter but reduced growth accordingly in the fourth quarter. Now this distorting one-off factor is gone. The decisive, fundamental driver of downward momentum, however, was the sharp decline in exports. Given the consistently poor fourth quarter growth results in the world's most important advanced economies, which are also Germany's trading partners, this is quite plausible. Economic output contracted in the euro area at the same rate as in Germany while it stagnated unexpectedly in the USA and Japan. Only China recently stood out positively.

**The first quarter of 2013 will already see tangible growth**

These combined burdens will not last; a global turnaround is already discernible. Signs include an 11 point increase in the ifo export expectations from October to January and even a 14 point increase in general business expectations. This includes the economically important manufacturing industry, whose production variations are crucial to the German economic cycle and where business expectations have actually increased by 16 points. Improvements of comparable magnitudes in these central expectation indicators occurred for the last time in spring and summer of 2009, when Germany began to grow out of the Great Recession. However, the hard data also give reason to be optimistic about the first quarter. Manufacturers' order books developed much more positively in the last quarter (+1.0 %) than production (-3.0 %). An order backlog of this magnitude very typically provides a significant production impetus in the next quarter. For the first quarter of 2013 we therefore expect GDP growth of 0.4 % – which is strong in comparison with previous expectations. Spring and summer quarterly growth is likely to continue to accelerate moderately and then level off at just under 0.4 % on average until the forecast horizon at the end of 2014. Under these conditions the German economy will grow 0.9 % in real terms this year. Next year
real growth will presumably double to almost 1.7 %, exceeding trend growth again for the first time since 2011. We thus corroborate our forecast of last November for 2013. For 2014 we present an initial forecast.

**Consumption is firm, exports are picking up, capital formation will follow**

The robust job market combined with real wage increases and low interest rates will ensure continuing solid contributions to growth by private consumption and housing construction. Exports will return to positive growth rates despite the current appreciation of the euro because Germany's export momentum so far has been hampered primarily by weak economic performance in the buyer countries. If the world economy recovers, which we anticipate, a limited upward valuation would be quite manageable for export performance. It would even have benefits for consumers and resource-intensive industries because it lowers the price of imported inputs and consumer goods; however, deflation risks would increase for the economically severely underperforming euro area overall. At the same time the crisis potential in Europe will probably continue to dissipate in the foreseeable future given the existing political will to keep the euro area together. The European reforming countries have made visible progress in managing the crisis so that downward pressure from this side is weakening as well. This would form the basis for companies to abandon their reluctance to invest later this year, particularly since capacity utilisation in the first quarter of 2013 improved again slightly for the first time in one and a half years. For the time being, the cautious export expectations due to the weak performance of European trading partners will considerably weigh on capital formation.

Thus, the main risks are identified as well: if the global recovery were to collapse unexpectedly or the crisis in Europe were to re-escalate, an economic development would have to be expected that would be worse or, under unfavourable circumstances, much worse than forecast here. For this reason Germany should continue working on reducing its external vulnerability by bolstering domestic demand. If domestic savings were to finance more domestic capital formation again, Germany could not only make a contribution to reducing external imbalances. Besides, with the energy turnaround, the adaptation of housing to the needs of an aging population, and public infrastructure, which has been largely neglected for at least a decade, there are plenty of reasons for capital formation. They have to be addressed urgently in any event to secure Germany's growth potential in the long term.

Author: Dr Klaus Borger, +49 (0) 69 7431-2455, klaus.borger@kfw.de
Press contact: Christine Volk, +49 (0) 69 7431-3867, christine.volk@kfw.de