Germany will narrowly avoid stagnation in 2013

- **KfW** has revised its economic forecast for 2013 significantly downwards from 0.9 % to 0.3 %; the main reasons were the unexpected stagnation at the start of the year (0.1 %) and the even greater contraction in the fourth quarter of 2012 (-0.7 %), according to recent data; even under the most optimistic assumptions, these setbacks cannot be overcome anymore.

- The rest of the year, however, remains set for growth. After the stagnation up to the end of March in the wake of unusually frosty weather, the second quarter will see catching-up effects, particularly in the construction industry; we expect 0.5 % growth; thereafter quarterly growth will level off at around 0.4 % at best; only then will stronger growth of around 1.7 % return in 2014.

- Consumption is being driven by the stable job market combined with real wage increases, which bolsters economic activity; the same is true for housing construction, which also benefits from very low borrowing costs; in contrast, the ongoing recession in large parts of the euro area is weighing on exports and causing enterprises and government to hold back on investment in the capital stock; only when the European environment improves will the investment backlog be dissolved and give the German economy a boost.

**German gross domestic product, adjusted for price and calendar effects**

Germany's economy was stable at the beginning of 2013 thanks to private consumption. Because of an unfavourable mix of harsh weather, the continuing difficult situation in Europe and the associated weakness in capital formation, however, gross domestic product (GDP) in real terms remained just above stagnation level. At the same time, the contraction in the fourth quarter of 2012 was even deeper than previously assumed, according to new figures released by the Federal Statistics Office. Even with the construction industry likely providing...
additional impetus in the second quarter as it makes up for lost production due to unusually frosty weather, and although we continue to expect a recovery later in the year, growth for 2013 overall will remain only minimal given the very low level of GDP at the start of the year. We have therefore revised our forecast of real growth significantly downwards from 0.9 % to 0.3 % for the current year (not calendar-adjusted: 0.2 %). Growth in real terms is likely to increase to 1.7 % next year (not calendar-adjusted: 1.7 %), provided Europe makes progress and the rest of the world keeps up its current economic momentum as well.

Consumers prevent renewed contraction in first quarter of the year

Germany's GDP¹ was stable in the first quarter of 2013. The strong GDP contraction in the final quarter of last year, revised downwards to -0.7 % quarter-on-quarter by the Federal Statistical Office, remained an outlier, as was expected. This is almost exclusively due to private households which, backed by secure jobs and rising real wages, stepped up consumption by 0.8 % in the first quarter. This is the good news. However, at only 0.1 %, GDP growth was significantly behind expectations. A considerable portion of this is due to the extremely cold weather up to the end of March, which caused construction activity to decline noticeably (-2.1 %). Furthermore, enterprises and government remained reluctant to invest; for the sixth consecutive quarter, gross fixed capital formation in machinery and equipment was lower than in the previous quarter (-0.6 %). There are fundamentally understandable reasons for this. Manufacturing capacity utilisation dropped slightly in the first quarter and sales prospects with respect to the important European trading partners remain weak. With the exception of Germany, all major eurozone economies – France, Italy, Spain and the Netherlands, along with many smaller countries – were in recession at the beginning of the year. This impacted on exports, as illustrated by the renewed decline in the first quarter (-1.8 %). Net exports still provided minimal support to real growth only because imports also fell (-2.1 %). Imports of semi-manufactured and manufactured goods in stock, in particular, are likely to have been weak, as suggested by the slightly negative growth contribution of inventory investments.

Unfavourable initial conditions obscure the recovery in the course of 2013

The stagnation at the beginning of the year and the again higher statistical underhang after the downward revised contraction in the final quarter of 2012 are weighing heavily on growth in the year 2013. The level of GDP in the first quarter of 2013 was still 0.3 % lower than the 2012 annual average. This underhang will first have to be cancelled out in the remaining three quarters of 2013 before the German economy returns to annual average growth as well. We expect this to occur – if by only a small margin. After the weather-related stagnation that lasted until the end of March, the second quarter will benefit from catching-up effects in construction activity. This is also indicated by the excellent business climate in that sector. We therefore expect strong 0.5 % growth for the spring quarter. In the summer quarter, growth is likely to slow again moderately before it levels off at an average 0.4 % until the end of 2014, which is our current forecast horizon. Despite this positive infra-annual economic

¹ Unless otherwise specified, data on GDP and its components refer to price, seasonal and calendar adjusted figures according to the Census-X-12-ARIMA method.
momentum, which we had already assumed in a similar way in our previous economic compass of February, we are now forced to lower our GDP forecast significantly for 2013. Because of the bleak start to the year, we expect real growth to reach just 0.3 % for the year as a whole (previous forecast: 0.9 %). Not calendar-adjusted, this represents a growth rate of 0.2 %. For 2014 we remain optimistic for now and still expect real growth of 1.7 % (not calendar-adjusted: 1.7 %). This will require positive momentum from the euro area, mainly as a result of a slower consolidation of public budgets and higher corporate capital formation on the basis of improved credit market conditions and greater clarity on the pending structural reforms.

**Domestic economy firm, euro devaluation aids competitiveness on global market**

Our economic forecast assumes that employment in Germany will remain on historically high levels and unemployment will move sideways on the low level it has reached. At the same time, reasonably strong nominal wage increases coupled with low inflation will ensure noticeable increases in real purchasing power. Furthermore, monetary policy will stay on the course of expansion for quite some time because of the fragile economic situation in the euro area and lack of inflationary pressure. The low-interest environment will thus remain in place for some time to come. As a result, job security combined with tangible real wage increases and persistently favourable borrowing conditions will provide solid contributions to growth from consumption and housing construction. The resulting stability of the domestic economy will prevent the eurozone recession from spilling over to Germany as well. But this alone will not generate a vigorous recovery. Exports will have to increase and give corporate capital formation new impetus as well through expanding capacity utilisation.

At the level of the global economy, we see generally favourable conditions for a recovery of German exports, as corroborated by the recent significant increases in new foreign orders in particular. Large economies such as the USA and Japan achieved surprisingly positive growth rates at the beginning of the year. We expect the interest rate lead of the USA over Europe to widen, so that the euro will likely devalue significantly against the US dollar in the further course of the year until 2014. This will help the already very competitive German as well as the other European exporters in global competition. The devaluation of the yen, on the other hand, which is good news for Japan, has put pressure on German exports to Asia in particular.

**Strength of recovery mostly depends on Europe**

The strength of the recovery, however, mainly depends on Europe, which continues to be the most important market for German enterprises. The euro area is far from being out of the woods. Concern over European jobs and household incomes remains legitimate, as demand has been correspondingly weak for quite some time. Nevertheless, we are cautiously optimistic that the dampening effects from Europe will ease somewhat in the forecast period and the euro area will be able to find its way back to moderate positive growth rates until 2014. The main reasons: Uncertainty over the continuation of the euro area, which along with weak demand provides an additional disincentive for investors, should subside given policymakers' will to cooperate. Moreover, although the European reforming countries have
not yet reached their crisis management goals in fiscal consolidation and strengthening competitiveness, they have made visible progress nonetheless. The most important parties in Italy have formed a grand coalition, and the rescue package for Cyprus has also been adopted after some turbulence. We therefore anticipate that private households in the reforming countries, some of which possess substantial assets, will soon become more confident and somewhat reduce their savings ratios again in favour of consumption. The reasonable prospect of recovery in Europe should already provide a boost to German capital formation, because after one and a half years of declining gross fixed capital formation in machinery and equipment, many projects surely are now in the pipeline that will be very attractive in the light of improving sales prospects and low borrowing rates.

**Risk scenario: Europe's recession may end up spilling over to Germany**

However, Europe remains a focal area of major risks, even though negative surprises in demand from the USA and Asia cannot be ruled out entirely either. Should the crisis in Europe escalate anew and exacerbate the recession, the result for Germany will likely be much worse than we have forecast here. As previously argued, the margin between real growth this year and the zero line is already thin even if a recovery sets in as the year progresses, which we anticipate to be the main scenario. Should the dampening effects emanating from large parts of the euro area not ease but actually intensify, a spillover of the European recession to Germany would hardly be preventable. The willingness indicated by the European Commission in early May to extend the deadline for France, for example, to meet its deficit targets is therefore also in Germany's interest. The affected countries should be committed to carry out the necessary reforms within a realistic timeframe without sacrificing economic growth even more in the short term. This will make the reforms more acceptable to the affected populations and create more confidence in Europe again – an important precondition for the economy to expand again.

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