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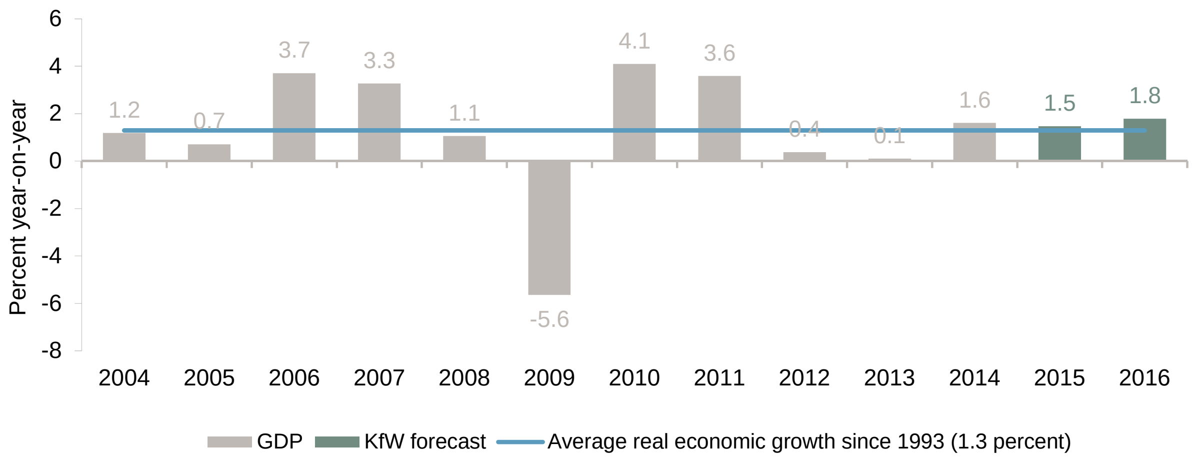
KfW Business Cycle Compass Germany March 2015

Weighed down, German growth is hardly accelerating despite strong tailwind

- ***KfW Research expects 1.5 % growth for 2015 (previous forecast 1.0 %); GDP growth will likely accelerate to 1.8 % in 2016 (initial forecast).***
- ***Growth in real terms will mainly be driven by domestic demand; steady contributions will continue to come predominantly from consumption but also from residential construction.***
- ***The main drivers are continued employment gains in combination with tangible wage increases and low interest rates; cheap oil and a cheap euro currently provide further stimulus which, together with the unexpectedly strong final quarter of 2014, account for the upward revision.***
- ***The fragile situation in Europe, tension with Russia and widespread scepticism among many entrepreneurs over the reliability of the economic policy measures are preventing a more vigorous recovery. In addition, pressure on margins exerted by falling prices and price expectations is dampening companies' willingness to invest.***

Gross domestic product, price-adjusted



Source: Destatis, calculations KfW Research

The year 2014 ended with a surprise bang

The German economy ended the year 2014 with a bang. In the final quarter, gross domestic product (GDP) jumped by 0.7 % on the previous quarter after price, seasonal and calendar adjustments. This is much more than expected after the economy was stuck in a rut over the preceding six months. Thanks to strong increases in the first and final quarters, total GDP growth for 2014 reached 1.6 %, the first significant expansion in real terms since 2011. The year-end boost was fuelled by almost every component of GDP, including foreign trade. Net exports contributed 0.2 percentage points to the quarterly gain, offsetting an identical negative effect from the ongoing destocking process. As has been the case for quite some time now, however, the most significant impetus came from the domestic economy. Private households stepped up consumption by 0.8 %, again at the same rate as in the previous quarter and far above the long-term average, while private residential construction posted a vigorous increase of 1.8 % after two consecutive negative quarters.

Public investment has picked up but not enough to offset the slump

The public sector also bolstered demand at year-end, not only through consumption expenditure, which rose by 0.2 %, but for the first time also through investment expenditure. Nevertheless, given the previous decreases, even the impressive quarterly growth of 8.2 % was not enough to ultimately lift public investment for the year above the previous year's level; instead, it remained negative for the third consecutive year at -0.5 %. A trend reversal is urgently needed to preserve and modernise public capital stock. Sufficient funds are available for this, as the public surplus of 0.6 % of GDP achieved in 2014 is not only the third consecutive annual surplus in a row but also the highest since unification – with the exception of the one achieved in 2000 (1.0 % of GDP), which was heavily distorted upward by the auctioning of the UMTS licenses.

Downturn in corporate investment not over yet

The private pillar of Germany's capital stock – corporate investment – has disappointed yet again. As the only final demand component of GDP, it fell in the final quarter of 2014, posting exactly the same contraction of -0.3 % as in the previous quarter. After a very promising start to the previous year, this is already the third consecutive decline in corporate investment.

The renewed decline is not unexpected. Numerous geopolitical unknowns and the repeatedly frustrated hopes for recovery in Europe have unsettled businesses and encouraged a wait-and-see attitude towards long-term investment decisions. European economic policy is perceived as unclear and uncertain and the backlog of reforms in Italy and France must be dissolved urgently. In Germany there is widespread uncertainty particularly over energy policy from 2020 onwards. Falling or at least stagnating sales prices are currently dampening nominal sales growth as well. In an environment of rising real wages, this is a disincentive for investment which also threatens Germany's record employment in the longer term.

Recently, the situation has improved gradually but not fundamentally. Neither has the tension with Russia eased significantly, nor has the security situation beyond Europe's borders improved. At the same time, the euro area is not back on a stable and strong path of growth either. As long as the admittedly difficult efforts to reorientate the Greek economy and restore its debt sustainability are made a test case time and again for the cohesion of the euro area, this situation will not change. Companies also know this and while their business expectations are again more optimistic, they are anything but euphoric.

Because these stress factors can hardly be eliminated in the short term, we expect corporate investment to overcome its current weakness only very gradually, despite currently very good consumer demand and a recovery in exports. Given the further expansion in industrial capacity utilisation early in the first quarter of 2015, the outlook for a speedy return of corporate investment to positive quarterly rates has improved but is likely to create little impetus for the time being. Because of the low initial level as well, we expect growth in real terms of less than one per cent for the year 2015 as a whole. Corporate investment in 2015 will continue to remain below the pre-crisis high of the year 2008.

Forecast for 2015 and 2016: moderate recovery despite many stimuli

The surprisingly strong final quarter 2014 will remain an exception for the time being. The impressive rebound that followed half a year of stagnation significantly exaggerates the strength of the current economic recovery and must not be extrapolated with this momentum. We expect clearly more moderate quarterly growth rates within the 0.2-0.5 per cent corridor for the forecast period. Overall, the German economy will probably grow by 1.5 % in 2015 – significantly more strongly than we had predicted three months ago (previous forecast: 1.0 %). Our initial forecast for 2016: under the assumption of reliable impetus, particularly from private consumption but also from residential construction, as well as more tangible medium-term progress in stabilisation in Europe, we expect growth in real terms to accelerate to 1.8 % next year.

Our upward revision for 2015 is partly due to technical reasons. Because of the unexpectedly strong growth surge at year-end 2014, the momentum carried over from last year now turns out to be significantly higher than initially estimated (statistical overhang: 0.5 percentage points). In addition, the oil price collapse and the decline of the euro justify a more optimistic outlook. These two new factors intensify the momentum generated by employment gains, decent wage increases, capital gains of real estate owners and lower interest rates, which have already provided impetus for some time now. Cheap oil leaves more money for other expenditures and encourages even more consumption, while the weak euro makes German exporters even more competitive.

Positive surprises are possible

Given these strong economic stimuli, the significant upward revision of our forecast for 2015 may even seem modest, especially taking into account that the 2.3 additional working days this year alone, that is the calendar effect, will contribute nearly one quarter of a percentage point to overall growth. Accordingly, the purely cyclical rate for the year will turn out lower. This caution is due not only to the continuing tension with Russia and scepticism over the duration of the low oil price but particularly to our persistent suspicion about how much economic stability is achievable in the euro area in the short term. If these uncertainties dissipate faster than assumed, stronger growth in real terms and a more tangible recovery in corporate investment can be expected.

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