Outlook for 2017: German economy is on course but sailing into very foggy waters

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- Brexit shock leaves Germany with a black eye as third-quarter growth is up 0.2% on the previous quarter; growth is set to pick up again to just under 0.5% in the final quarter of 2016.

- KfW Research confirms its economic forecast of +1.8% for 2016 and +1.3% for 2017; around two thirds of the slowdown is due exclusively to variations in the number of working days; in 2017 as well, the fundamental economic momentum will at least match the potential rate; Germany thus remains on a good path.

- Although consumption and residential construction will grow at a slightly slower pace, they remain the main growth drivers of the economy; very high political uncertainties will allow only a modest increase in corporate investment in 2017 despite growing capacity utilisation; foreign trade will provide negligible growth impetus.

- After the Brexit and the US elections, in 2017 core Europe will hold important elections that may also reveal a growing preference for isolationism and protectionism with very uncertain outcomes; the outlook for 2017 resembles a voyage into an area of dense fog where the ship can easily drift off course.

Germany's price-adjusted gross domestic product

Bruised in the third quarter
After the Brexit shock, Germany came out of the summer months with a black eye. Adjusted for price, seasonal and calendar effects, third-quarter gross domestic product (GDP) increased by 0.2% on the previous quarter. It was the weakest quarterly increase in a year. While consumption again proved itself to be a reliable pillar (+0.6%), the external trade balance, the difference between exports and imports, reduced growth by 0.3 percentage points. Exports remained below the level of the previous quarter (-0.4%) while imports grew slightly (+0.2%). Gross fixed capital formation (+/-0.0%) showed a mixed picture: private residential construction was still climbing (+0.4%) and so were public investments (+0.5%). By contrast, the renewed decline in corporate investment (-0.2%) underscores that the structural weakness of investment activity is anything but overcome.

Note: This paper contains the opinion of the author and does not necessarily represent the position of KfW.
In the current final quarter, however, real growth is set to pick up again noticeably. Our main source of optimism is the significantly improved sentiment in the industrial sector since September, as illustrated by the ifo business climate indicator, for example – despite the dip in November. The industrial sector continues to provide important impetus for the German economy, and manufacturers are satisfied with the strong increases in foreign orders in the third quarter (+2.4 % on the previous quarter). Employment growth, real wage increases and the highest pension increase in 23 years that came into effect in the middle of the year also provide retailers with good reasons to look forward to a successful Christmas season. Against this background, we assume that Germany will close the year with quarterly growth of just under 0.5%. The year 2016 as a whole is set for real GDP growth of 1.8%. That would be the strongest real growth since the exceptional year 2011, when GDP grew 3.7% as the economy emerged from the deep trough into which it had fallen as a result of the global financial and economic crisis.

**Outlook for consumption and residential construction remains good**
The robust state of the German economy indicates that the healthy domestic climate will continue in the coming year. Consumption is set to remain on a sound growth path. The main reasons for this are the continuing significant growth in employment – despite slowing momentum – (+0.9% year-on-year in the third quarter) and an unemployment rate that will likely remain near the record low for all of Germany for some time to come, although a rising number of refugees will seek to enter the job market. However, as real wages will be rising at a lower rate due to the gradually increasing consumer prices, consumption growth in 2017 will probably be slightly lower than in 2016. We expect the same trend for residential construction – continuing sound but slowing growth rates compared with the previous year. Interest rate increases on the back of the US elections are also likely to have a slightly dampening effect on construction activity. Nonetheless, financing costs are still extremely low in a historic context and the need for new housing remains high, also as a result of immigration. This was very clearly demonstrated by the number of new residential construction permits, which soared by an impressive 24% in January to September on the same period last year.

**Corporate investments are on the backburner**
At the start of the final quarter, industrial capacity utilisation rose to 85.7% – the highest level since 2008. Corporate investment is usually expected to expand strongly under these circumstances, particularly when financing is obtainable at favourable conditions, as it is now. However, we expect only a muted increase as the spectre of a more protectionist global economy has been hanging over the export nation Germany like a sword of Damocles since the US presidential election. This, combined with the still completely unclear future relationship with the United Kingdom, creates unusually high levels of uncertainty for the German export industry. The US is the number one and the UK the third most important export market for Germany. Both countries together account for some 40% of all German direct investment. The unclear situation in these important partners makes long-term investment planning significantly more difficult. Therefore, many businesses will probably put their investment plans on the backburner for the time being.

**External trade with no impetus**
Trade will likely make neither a positive nor a negative contribution to real growth in 2017. Exports should recover slightly, not least because important emerging economies such as Brazil and Russia will probably be able to come out of recession and, from our perspective, a growth slump in China is unlikely. At the same time, however, Germany's imports will increase noticeably as a result of domestic demand, which is clearly set for continued growth.

**Fewer working days are the main reason for lower GDP growth in 2017**
Under these conditions, we expect Germany's real growth to slow overall to 1.3% in 2017. We thus confirm our preliminary forecast for the coming year, as we have already done for 2016. But only around one third of the expected growth slowdown of half a percentage point is due to weakening economic momentum. Roughly two thirds is due to significant variations in the number of working days (2016 has one more working day than the previous year, while 2017 has three fewer working days) and hence only a technical effect. According to our forecast, the underlying economic momentum will at least match the potential rate in 2017 as well, so Germany will stay on the good path it has been on since 2014.

**Sailing into a sea of uncertainty**
Within a matter of just a few months, however, the US presidential election and the UK referendum catapulted protectionist aspirations to the top of the chart of global risks. On the western side of the Atlantic, important and probably highly controversial economic policy decisions will be taken in early 2017. On the eastern side of the Atlantic, an important referendum in Italy and the rerun of the presidential election in Austria are set to take place in early December. Parliamentary elections in France and the Netherlands, which may reflect a growing preference for isolationism and protectionism in core Europe as well, will follow in 2017. Smouldering in the background are the tensions with Turkey and possible controversies over the handling of (mainly Italian) banks in distress. The outcome of all these political uncertainties is still completely uncertain. The outlook for 2017 thus resembles a voyage into an area of dense fog where the ship can easily drift off course.