Real growth will remain strong in 2018 but be more moderate in 2019

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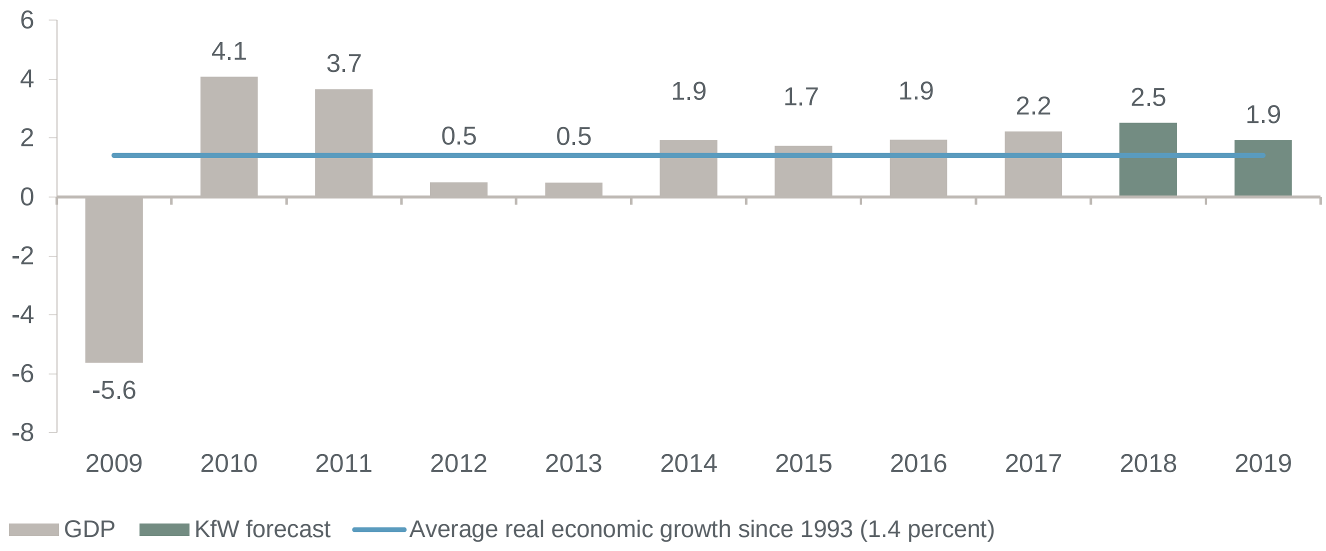
- At the end of 2017 Germany's economy grew by a strong 0.6 % on the previous quarter; we expect first-quarter growth in 2018 to be even slightly higher due to full order books and high business confidence
- KfW Research confirms its GDP growth forecast of 2.5 % for 2018 and issues a solid preliminary forecast of 1.9 % growth for 2019; serious risks of overheating are absent amid generally expected restrained wage and price growth
- Consumption, investment and exports are contributing to the continuing, long upswing; increasingly scarce production capacities and the interest rate reversal, however, will cause the currently very high growth dynamic to level off in future
- Uncertainty may result from the bumpy Brexit negotiations and unclear US policy, as well as the forthcoming election in Italy; increased volatility in the financial markets and unexpectedly strong euro appreciation also pose risks

Germany's gross domestic product

Variation on previous year in per cent, adjusted for prices



Source: KfW Research, Destatis

Final quarter of 2017: growth remains strong

The strong growth of the German economy continues. In the final quarter of 2017, gross domestic product (GDP) adjusted for price, seasonal and calendar variations grew 0.6 % on the previous quarter, completing what was a very dynamic year for the economy. Real GDP growth for 2017 as a whole was 2.2 %, the highest rate since the exceptional year 2011. The high pace of third-quarter growth (+0.7 %) was not fully reached at the end of last year. But that was mainly due to a 'technical' obstacle. As a result of the unusually high number of holidays and bridging days in October, the economy was very weak going into the fourth quarter (October industry output: -1.2 % on September). This drop in output was the result of a lower number of working days and had to be recovered first before overall quarterly growth could resume. The fact that fourth-quarter GDP grew despite this handicap by a rate of 0.6 % – around double the average rate since data were first surveyed for unified Germany in 1991 – underscores the current strength of the German economy.

The new year began with high momentum

The economy should start the new year with strong momentum. We expect GDP to grow at an accelerated rate of 0.7 % in the first quarter of 2018. This estimate is supported not just by the historically high level of business confidence but also by hard data, such as incoming orders in the manufacturing sector in the fourth quarter. These rose by 4.1 % on the previous quarter, more strongly than in the already outstanding third quarter (+3.7 %), creating very good conditions for another significant output increase. All the same, we expect the high calculatory growth contribution of the export surplus in the fourth quarter of 2017 (+0.5 percentage points) to remain an exception given the continuing very good fundamental conditions for domestic demand.

Business cycle will reach its peak in 2018

Continuing employment growth (+1.5 % in 2017 on the previous year) and rising real wages (+0.8 % in 2017 on the previous year) are benefiting consumption. Both trends are showing no signs of abating any time soon. Given the continuing high need for housing in attractive conurbations, the prospects for residential construction also remain positive. Corporate investment is also set to remain on an upward trend on the back of continuing favourable financing conditions, the multi-year high industrial capacity utilisation level (87.9 % at the start of the first quarter of 2018, according to the ifo Institute) and robust increases in demand also from international markets. The recovery of the global economy should provide impetus for German export growth irrespective of the recent euro appreciation. All in all, we therefore maintain our previous forecast of 2.5 % GDP growth for 2018. The cyclical momentum would thus continue on a similar level as last year, when GDP growth was 2.2 % with significantly fewer working days.[1]

GDP growth in 2019 will be solid but lower

In 2019, however, real growth is set to slow. Nonetheless, our initial forecast is a robust 1.9 %. The moderately lower growth rate next year will likely result primarily from capacity constraints in the wake of the long upswing phase, particularly on the labour market. In the most recent survey by the Association of German Chambers of Industry and Commerce (DIHK), its members now see skills shortages as the most serious business risk by far. However, the shortage will be significantly mitigated by the free movement of workers in the EU and by labour potential untapped within Germany. Apart from the roughly 1.6 million unemployed workers, the latest micro-census conducted by Destatis shows that on balance 1.4 million persons (difference between underemployed and overemployed workers) declared their willingness to work more if they received a commensurate pay rise. In addition to a growing skills shortage, the global interest rate reversal that has begun is likely to slow real growth slightly in the year ahead as many businesses will probably bring planned investments forward to 2018 in anticipation of rising borrowing costs. Considering the next German government's fiscal policy, a very significant slowdown in growth in 2019 is unlikely. The new grand coalition is planning additional expenditure and revenue shortfalls of just under EUR 46 billion for the years 2018 to 2021 which, spread out across individual years, represents an average 0.3 % of GDP. This fiscal impetus is likely to stimulate demand particularly from next year, as it takes some time to implement the planned investment measures in particular.

Hardly a sign of dangerous overheating trends

Despite the long upswing, which has seen GDP growth rates above the potential rate since 2014 – and according to our forecast, this year and next as well – we do not expect the economy to overheat dangerously anytime soon. For one thing, the economy had previously been slowed down sharply by the global financial crisis in 2009 and again by the euro crisis of 2012/13. The initial underutilisation of production capacities was correspondingly large. For another, prices and wages in particular would have to increase much more drastically than is generally expected. The increase in collectively agreed wages in the years 2018 and 2019 is currently estimated to average 2.8 % in each year. Given the most recent labour productivity increases of around 1 % per year, these increases are compatible with the ECB's inflation target of just under 2 %. This is also compatible with the fact that the vast majority of economic analysts expect consumer price increases to remain below the 2 % mark (consensus surveyed in February for 2018: +1.7 %; 2019: +1.8 %); even the maximum inflation forecast for 2019 is at just 2.3 %.

Old and new risks

The bumpy Brexit negotiations and their uncertain outcome, as well as the unclear direction of US policy, remain important risk factors for the business cycle across the forecast period. The US continues to regard its trading partners as the ones responsible for trade imbalances and therefore reserves the right to take protectionist 'countermeasures' – including vis-a-vis the EU and Germany. Besides, the result of what may turn out to be a difficult formation of government in Italy after the parliamentary election of 4 March has the potential to cause uncertainty. The return of heightened volatility to the financial markets also poses risks. Finally, an unexpectedly strong euro would be a burden. That is a conceivable scenario should the US be overestimated and its tax reform and additional expenditure expand the public deficit to such a level without growing the economy sufficiently that rattled international financial investors may find papers in US dollars significantly less attractive. ■

[1] As is generally customary in Germany, our forecast for annual price-adjusted GDP growth refers to the original rates, which are not adjusted for variations in the number of working days. In 2017, Germany had around three fewer working days than in 2016, which took away 0.3 percentage points from annual growth for 2017(calendar effect). This year and next, the calendar effect will be very small and noticeable in rounded figures at best. The result for 2017 and the GDP growth rates we have forecast for this year and next equate to calendar-adjusted real growth of 2.5 % (2017), 2.5 % (2018) and 2.0 % (2019). In other words, the purely cyclical rate which we expect for 2018 is just as high as in the previous year and will dip slightly in 2019.