KfW Research
KfW Business Cycle Compass Germany

››› Solid growth but many risks

24 August 2018

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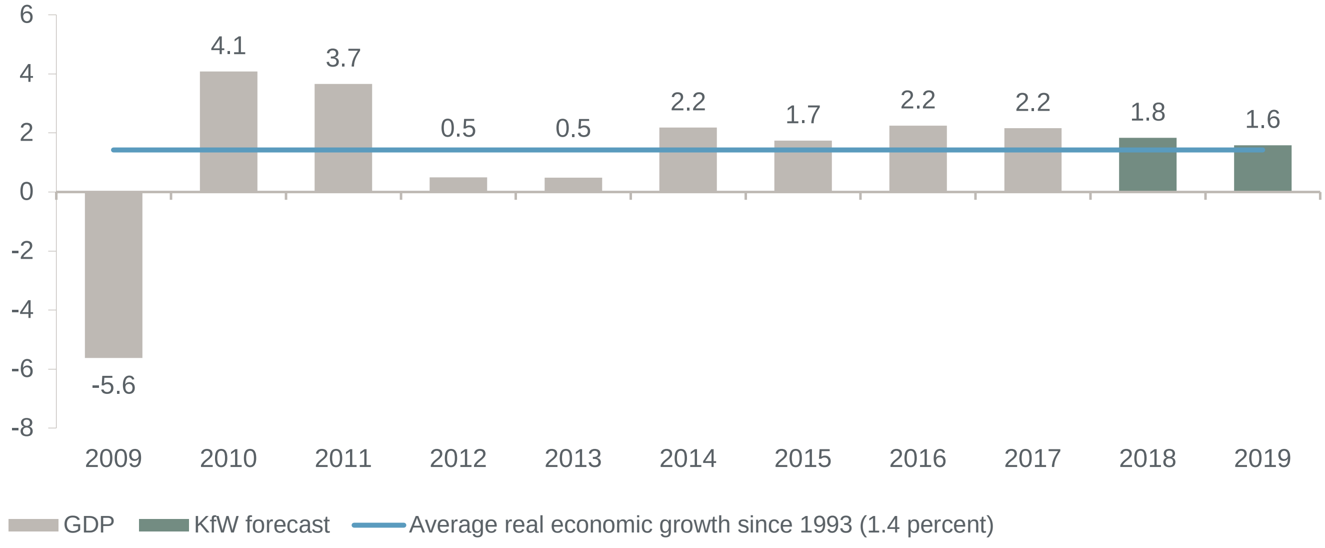
- Growth accelerated somewhat in the second quarter of 2018; after 0.4 % – revised upward – in the first quarter, Germany grew by just under 0.5 % from April to June; we expect a similar pace for the rest of 2018 as in the first half-year
- The revision of the 2017 quarterly growth rates means current annual growth carried over less momentum from last year; KfW Research now expects real growth of 1.8 % for 2018 (previously 2.1 %); for 2019 we now expect 1.6 % (previously 1.9 %)
- Consumption and construction investment remain solid pillars of the upturn; in light of a multitude of risks, corporate investment is likely to grow at a rather subdued rate; we have also slightly reduced our expectations for exports
- The tensions in transatlantic trade relations have diminished since mid-July but are still on the table; other cyclical risks emanate from an escalating trade conflict between China and the US, crises in emerging economies such as Turkey, Brexit and a possible conflict between the EU and Italy

Germany's gross domestic product



Variation on previous year in per cent, adjusted for prices

Source: KfW Research, Destatis

First half of 2018 fell short of expectations

After a first quarter burdened by special factors, between April and June 2018 Germany's economy failed to achieve the vigorous rebound initially hoped for. Adjusted for price, seasonal and calendar effects, second-quarter gross domestic product grew by just under 0.5 % on the previous quarter. The Federal Statistical Office revised previous quarter growth upward by 0.1 percentage points from the initial estimate to just under 0.4 %. New risks accumulated in early summer, eliminating the euphoria about a synchronous global economic recovery that prevailed until the turn of the year. With the decline in incoming orders and falling sentiment indicators, we do not expect the growth rate to pick up further in the second half-year. And since the periodic revision of national accounts by the German Federal Statistical Office reduces Germany's growth in purely arithmetic terms this year, we have lowered our forecast for real growth in 2018 to 1.8 % (previous forecast: 2.1 %).

Domestic economy is the driver of growth

In the second quarter the domestic economy proved itself once again to be a reliable mainstay of the upturn. Private consumption picked up noticeably (0.3 %) and should continue to grow steadily in the future as well given the positive

Note: This paper contains the opinion of the author and does not necessarily represent the position of KfW.

trend in employment and real wages, as well as strong pension increases. The same is true of private residential construction (0.8 %), which continues to be driven by low interest rates. Public consumption, which was hampered at the start of the year by the tedious formation of government, climbed by 0.6 % in the second quarter and should expand even further given the impetus measures agreed by the new government in the coalition agreement. The growth of corporate investment which has now run for six consecutive quarters has also continued unabated (0.5 %), although growth has slowed since the start of the year. Unusually high capacity utilisation levels, however, point towards continued growth in corporate investment. Nevertheless, despite an – at least temporary – easing in the trade conflict with the US, corporate investment activity is likely to be hampered by the current abundance of uncertainties. Exports appear to be practically unaffected by the US tariffs on EU steel and aluminium that came into effect only in June, not least because of their low volume. After a decline at the start of the year, exports grew by 0.7 % in the second quarter. Because imports grew at an even higher rate (1.7 %), however, the arithmetic growth contribution of trade is negative (-0.4 percentage points).

Downward revision for 2018 primarily due to the past

We are marginally more sceptical about growth in the second half of the year than in our May economic forecast. The sharp decline in incoming orders from abroad and within Germany, as well as the downturn in sentiment indicators since the turn of the year, have given us reason to doubt a return to the sometimes extraordinarily high rates of the previous year. At the same time, still very positive business situation assessments, a high volume of existing orders and the rise of the purchasing managers' indexes in July are not pointing to a significant slowdown. We expect similar momentum for the rest of the year as in the first half, that is, average quarterly growth of 0.4 %. We have lowered the forecast for the year as a whole mostly because of a revision of historical data. In August the German Federal Statistical Office completed the periodic revision of the last four years' growth rates.[1] The shift in the quarterly profile last year is of arithmetic importance for the forecast of the 2018 annual growth rate. According to current calculations, the German economy expanded by 1.1 % in the first quarter of 2017, which is a significantly higher rate than initially expected, while growth in each of the subsequent quarters was one tenth lower. As the statistical overhang has shrunk as a result, our forecast for 2018 has fallen by 0.2 percentage points for technical reasons alone. Accordingly, only 0.1 percentage points of the downward revision are due to our slightly more sceptical outlook on the future.

Growth rate will normalise further in 2019

We expect real growth to drop further to 1.6 % in 2019, a rate that is still above the long-term average since German unification (1.4 %). The moderately slower growth rate next year will likely be due in part to increasing capacity constraints in the wake of the long upswing phase, including in the labour market. Productivity enhancing investments that could act as a counterforce are being stifled by a host of stubborn risks. In addition, we expect exports to provide less impetus as the dynamic of the global economy and growth in the other large euro countries are also likely to weaken slightly.

Downward risks remain high

Even if we have already reduced our forecast to reflect the sheer multitude of uncertainties, if some of these risks should fully materialise, the growth rate may drop even more strongly. Since the meeting between European Commission President Juncker and US President Trump at the end of July, an armistice has been in effect in the trade conflict with the US. But given the erratic behaviour of the US administration, it is too early to lower the guard. Meanwhile, the US and China are escalating their trade conflict. Particularly for China, which is regarded as a candidate for a major cyclical correction because of its very high corporate debt levels and partly problematic accumulated risks in the banking sector, the trade war may turn dangerous. As both economies are among Germany's largest export markets (USA: 9 %; China 7 % of German exports), resulting growth losses would also be felt at home. The currency crisis in Turkey, which was recently exacerbated by US punitive tariffs, might put pressure on Germany, particularly through a general reassessment of emerging economy risks by international investors. For emerging economies, the situation is also becoming more difficult because of rising US interest rates and, consequently, tightening international lending conditions. In Europe, the Italian government's announcement of an expansionary fiscal policy harbours significant risk. Unless the election promises are scaled back, longer-term interest rates in Italy will likely rise further and worsen conditions for private investment. In the Brexit negotiations there has been a rapprochement in the last few months but the risk of a messy exit from the EU remains, particularly due to the parliamentary scrutiny reservation. ■

[1] The periodic review undertaken in August is based on newly available basic statistical information, notably tax data. As real growth for each of the years 2014 and 2016 was revised upward by 0.3 percentage points to now 2.2 %, the growth rate of 2.2 % confirmed by the revision for 2017 is now no longer quite as unusual. However, 2017 had significantly fewer working days, so with calendar-adjusted growth of 2.5 % (0.3 percentage points more than in the years 2014 and 2016), that year still marks the peak of the current cycle.