Germany's economy: not more than potential growth, with many downward risks

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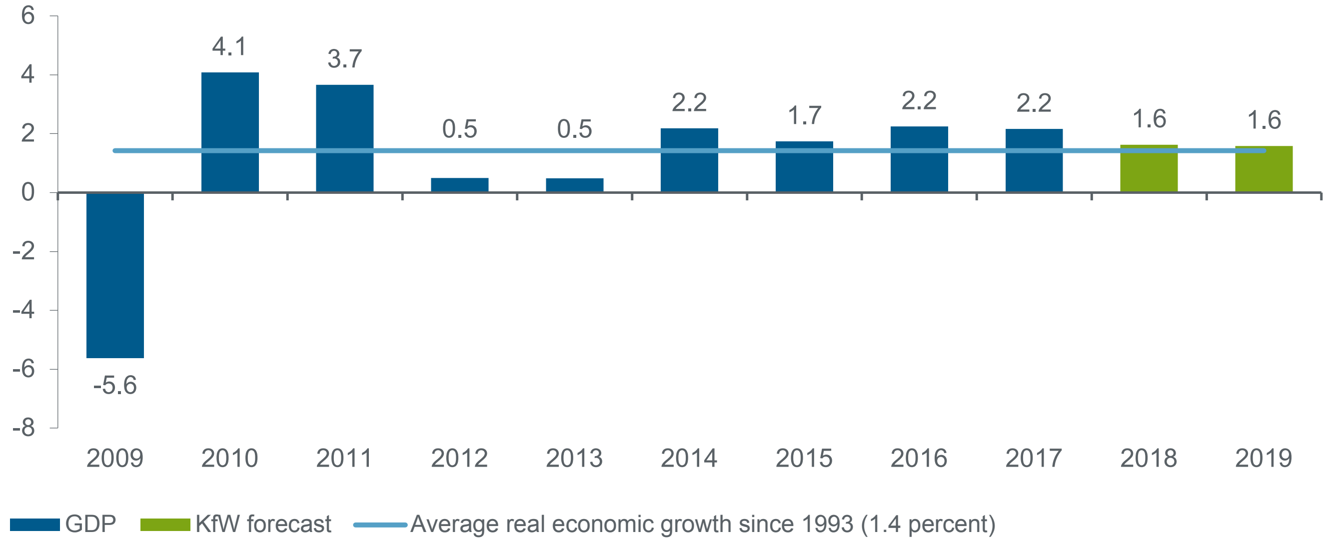
- Third-quarter growth was a bitter disappointment (-0.2 %); around half the unexpected loss of momentum on the strong second quarter (0.5 %) was due to production cuts in the automotive industry; but its problems with the new WLTP emissions testing standard appear to be subsiding already
- KfW Research expects quarterly growth to pick up noticeably towards the end of the year; nevertheless, the rate will now be just 1.6 % for 2018 as a whole (previous forecast: 1.8 %); we confirm our already cautious economic forecast of another 1.6 % for 2019
- As a result, Germany's growth this year and next is likely to continue only at roughly the rate of its output potential; utilisation of production potential will thus remain high but not grow further, which actually improves the likelihood of the already long-standing German upswing continuing
- Downward risks are numerous; in addition to US protectionism, Italy's confrontation course on fiscal policy and Brexit are causing great unease; owing to internal political turmoil within the United Kingdom, it is touch and go whether the country will make an orderly exit at the end of March 2019

Germany's gross domestic product
Variation on previous year in per cent, adjusted for prices



Source: KfW Research

Unexpected setback in summer

The German economy met with an unexpected setback in the third quarter. Gross domestic product (GDP) adjusted for price, seasonal and calendar effects shrank by 0.2 % on the previous quarter. Around half the loss of momentum on the strong second quarter (0.5 %) was due to production cuts in the automotive industry, where output from July to September was 7.4 % lower than in the preceding three months. The decline was probably caused mainly by problems in the certification of vehicles to the new emissions testing standard WLTP (Worldwide Harmonised Light Vehicle Test Procedure) which came into effect across the EU in September. These problems weighed not just on the actual production of motor vehicles but also on private consumption (which includes the purchase of cars by private households) and exports because as of September all new vehicles sold within the EU must be WLTP certified. This has probably even put a dampener on investments, as businesses' capital formation in machinery and equipment includes the acquisition of vehicles. The fact that investment in the third quarter increased not just in construction but also in machinery and equipment despite this burden indicates continuing basic confidence in the future. The contraction in the summer should therefore remain an outlier. The relatively vigorous growth of imports, which suggests a consistently strong underlying momentum of domestic demand, also points in this direction.

Short-term growth spurt expected towards the end of the year

Moreover, the clear 3.8 % increase in automobile production in September on the previous month indicates that the WLTP problems appear to be subsiding already. After incoming orders trended rather weak in the course of the year, they have recently shown signs of recovery and started lively into the fourth quarter (with a statistical overhang of around 1 %). We therefore expect a significant rebound in the fourth quarter, with GDP possibly growing by around 0.8 % towards the end of the year. But even with this strong growth, the cyclical momentum in the second half of 2018 (with average quarterly rates of 0.3 %) would remain slightly lower than in the first half (0.4 %). This is consistent with our assessment of a cooling of the very strong momentum which culminated in the year 2017, when quarterly growth rates averaged 0.7 %.

Potential growth in 2018 and 2019

For all of 2018, real growth will only reach 1.6 % and thus somewhat less than we expected in August (previous forecast: 1.8 %). For 2019, however, we confirm the cautious forecast we made almost exactly three months ago – that is, we expect economic output to grow by 1.6 % for the coming year as well. The GDP growth rates we expect for this year and next will therefore be more or less in line with the typical current estimates of Germany's growth potential. As Germany will presumably grow at the rate of its production possibilities, production capacity utilisation is not likely to increase further for the time being. But since Germany's upturn has already been running for nine years straight, this is actually positive for its chances of survival because capacities are already fairly tight, especially in the labour market.

Subdued investment momentum

Investments in productivity enhancements that could act as a counterforce are being stifled by a host of stubborn risks. Current increases in corporate investment therefore remain substantially behind the rates that were typical in previous upturns. In the strong upturn of the years 2006 and 2007, for example, their quarterly growth rates averaged around 2 %, whereas currently (early 2016 to mid-2018) they are at a modest 0.6 %. We expect a continuation of this comparatively subdued growth for the time being.

Conditions for domestic demand remain good

We expect public and private consumption as well as residential construction to sustain the business cycle across the forecast period as well. Growing real wages, falling unemployment, favourable borrowing conditions, a renewed drop in energy prices and expansionary fiscal impetus in the coming year, with the structural public surplus set to fall from currently 1.4 % of GDP to 1.0 % in 2019 according to most recent European Commission estimates, mean that the fundamentals for domestic demand will remain positive for the foreseeable future.

Moderately negative growth contributions from foreign trade

Global economic growth has already weakened slightly in 2018 and this is already reflected in a lower boost coming from exports. This is likely to change only little in 2019, even if the US continues to support the global economy despite its probably slightly lower real growth than in 2018. As imports will continue trending clearly upward at the same time on the back of steady, robust domestic demand, on balance foreign trade in purely arithmetic terms is likely to weigh slightly on Germany's economic growth this year and next.

Multiple downward risks

Our forecast is subject to multiple downward risks. These include US protectionism and its various facets, such as the escalation of the trade conflict with China and the ongoing general threat of punitive tariffs on European products, such as cars, as well as Italy's confrontation course on fiscal policy and continuing uncertainty about the outcome of Brexit, which are causing great concern. On 21 November the European Commission already classified Italy's very expansionary budget plans as a violation of EU budget rules. It can therefore be expected that the ECOFIN Council will officially open an excessive deficit procedure against Italy early next year. Until this conflict is settled, Italy's government budget is set to pose continuing uncertainty. Owing to internal political turmoil within the United Kingdom, it is touch and go whether the country will make an orderly exit from the EU at the end of March 2019. In particular, it is unclear whether the UK Parliament will approve the withdrawal agreement negotiated with the EU, even if it appears to be gradually recognising the consequences of a rejection. But if the outcome is a no-deal Brexit, the UK will likely slip into recession in 2019. In the euro area and Germany, the shockwaves would be much less severe but felt nevertheless. Should at least some of these risks materialise in the coming year, Germany's growth in 2019 would probably turn out significantly lower than we predict here. ■