German economy takes a breather in 2019; growth should pick up again in 2020

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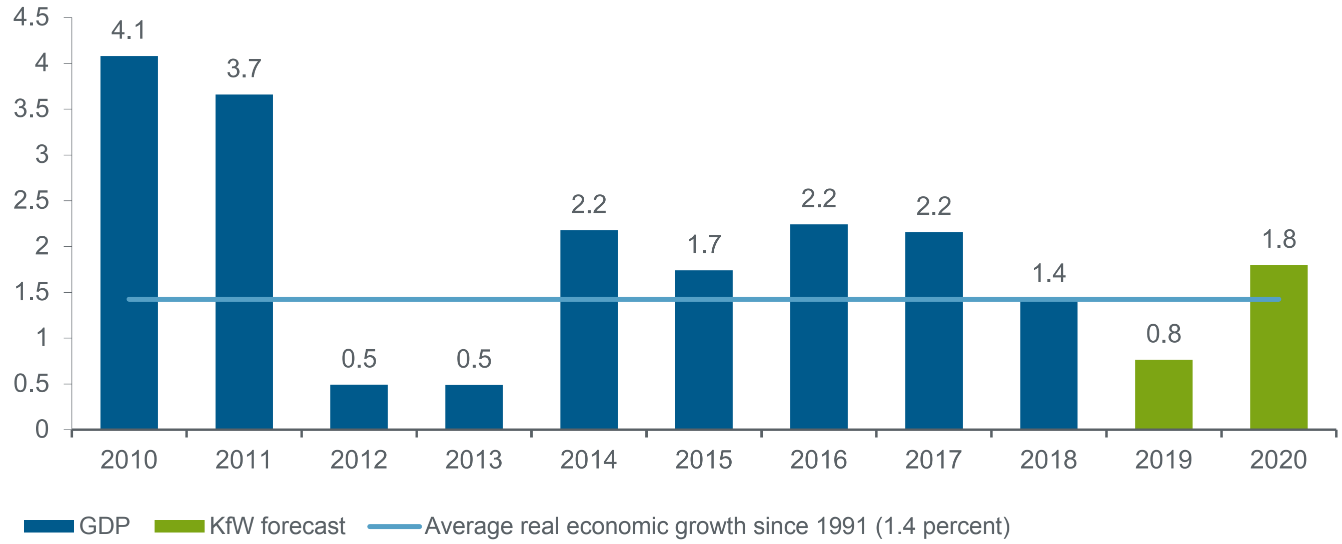
- Cyclical weakness continues; after stagnation in the final quarter of 2018, the slump in sentiment at the start of the new year suggests economic output will rise slightly at best in the first quarter of 2019
- Given the lack of momentum at the start of the year and the less favourable outlook for the global economy, KfW Research has significantly downgraded its economic forecast for the year 2019 to only 0.8% (previous forecast: 1.6%).
- Growth should pick up again to 1.8% in 2020 (initial forecast); four additional working days will exaggerate the recovery considerably, however; adjusted for the effect of these additional working days, real growth will be just barely below growth potential, at 1.4%
- Negative risks predominate, mainly due to the unresolved Brexit issue, trade tensions, political controversies in Europe (Italy's national budget, France's yellow vests) and the unclear direction of the Chinese economy

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



Source: KfW Research, Destatis

Standstill in the second half of 2018

The hoped-for vigorous rebound of economic output in the final quarter 2018 failed to materialise. Gross domestic product (GDP) adjusted for price, seasonal and calendar effects stagnated in comparison with the previous quarter. Along with the previous minor contraction of -0.2%, Germany's economy more or less flatlined in the second half of 2018, with an abrupt and significant loss of momentum from the good first half. The cause of this cyclical headwind was a combination of temporary special factors and weaker international demand. Most prominent among the special factors were the persistent difficulties of the automotive industry in implementing the new WLTP (Worldwide Harmonised Light Vehicles Test Procedure), which began in the third quarter. Then, in the fourth quarter, the record-low water levels of important inland waterways such as the Rhine River added to the complications and created considerable logistical problems, particularly for the chemical and pharmaceutical industry. Irrespective of that, domestic demand remained robust and continued to bolster the economy.

Slump in sentiment after the turn of the year ...

Hopes of a return to clearly positive quarterly growth rates as early as at the start of the new year would nevertheless be premature – even if water levels have now normalised and the WLTP problems are subsiding, highlighted by the very strong month-on-month increase by a good 7% in both new orders and production of automobiles in December. What we are particularly concerned about is that economic confidence has slumped after the turn of the year. Our KfW-ifo SME Barometer for January 2019 shows that the business climate recently fell most significantly in those segments of the economy that are particularly susceptible to international developments. Sentiment in large manufacturing firms and wholesale enterprises has even dropped below average for the first time in years. This is primarily due to the much more pessimistic business expectations, not least as a result of the surprisingly clear rejection by the UK Parliament of the withdrawal agreement negotiated between the UK government and the EU in the middle of the month, which has probably had a significant impact. The United Kingdom is, after all, the destination of slightly more than six per cent of Germany's exports and thus its fifth most important foreign market, not very far behind China. Even if neither Europe nor the United Kingdom has an interest in a no-deal Brexit and the return of hard borders along the English Channel, this would automatically occur unless an alternative solution is found by the end of March. The outlook for the Chinese economy is also increasingly uncertain and the trade tensions created by the US administration – including the threat of punitive tariffs on European automobile imports – remain an issue.

... points to a weak first quarter

Against this background, we expect first-quarter growth at the start of 2019 to pick up slightly at best. In particular, businesses are likely to exercise more investment restraint than before, at least until the Brexit fog begins to hopefully lift with the onset of spring. In spite of everything, we still hold out hope that a hard exit of the United Kingdom from the EU at the end of March can be avoided. Otherwise, the noticeable growth acceleration which we predict in the course of the year would be in jeopardy.

Strong downward revision for 2019

Even though we expect an upward trend to set in as the year progresses, real growth for 2019 as a whole will not exceed 0.8%. That would be not just significantly less than we predicted last November (previous forecast: 1.6%) but the lowest GDP growth rate since 2013. A significant portion of the downward revision is due to the unexpectedly low starting level from which growth began this year after the stagnation in the second half of 2018. As a result, there is no momentum from the previous year whatsoever (no statistical overhang). This 'retrospective' factor accounts for some three quarters of the forecast correction.

Effect of additional working days exaggerates recovery in 2020

In the coming year, for which we are presenting a forecast for the first time, economic growth is expected to accelerate to 1.8%. However, the growth rate will be driven not just by a 'genuine' economic recovery but to a considerable degree by calendar constellations. On average for all federal states, in 2020 the economy will have almost four more working days than in 2019 and that in itself will contribute just under 0.4 percentage points to economic growth (calendar effect). Adjusted for this calendar effect, the underlying cyclical momentum next year is therefore likely to be 1.4%, which only narrowly corresponds to the typical current estimates of Germany's growth potential and the calendar-adjusted GDP growth of 2018 (+1.5%).[1] All in all, our take is that the business cycle will recover only moderately next year, after taking a breather this year.

Global uncertainties continue to linger

In our view, slower growth on a global scale, e.g. in China and the US among other regions, is preventing stronger momentum while domestic demand, bolstered by the robust labour market and clearly expansionary fiscal policy this year, remains a reliable pillar of the economy. We also expect the global uncertainties surrounding trade tensions and Brexit to continue to simmer even if progress is made, thus creating some pressure that will weigh on investment decisions. In the past years, the US administration has often only made preliminary agreements, which it has then linked to further demands. It is hardly likely that it will fundamentally change this strategy. With respect to the Brexit process, after an orderly withdrawal the uncertainties could shift to controversies in the negotiations about long-term relations.

High capacity utilisation will consolidate

As Germany will presumably grow below its production potential during the forecast period, the utilisation of its production capacities will decrease on a high level. At least so long as global risks remain under control, this may actually be favourable for the further chances of survival of Germany's already old upswing. After all, nine years of uninterrupted growth means capacities are now quite tight, especially in the labour market.

Negative risks predominate

However, there is great uncertainty and negative risks, such as a no-deal Brexit, automobile import tariffs, economic worries in China and the possible re-emergence of political controversies in Europe – yellow vest protests, Italy's national budget, for example – predominate. If these risks were to materialise, the economy could stall or even tip into recession. ■

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[1] The calendar effect this year is virtually negligible and our forecast for real growth in 2019, after adjusting for calendar effects, is likewise 0.8%. The calendar effect was very small in 2018 as well. But rounding effects mean a slight divergence between the calendar-adjusted (1.5%) and the unadjusted real growth rate (1.4%) for 2018.