Germany's economy in 2017/2018: like a long-distance runner

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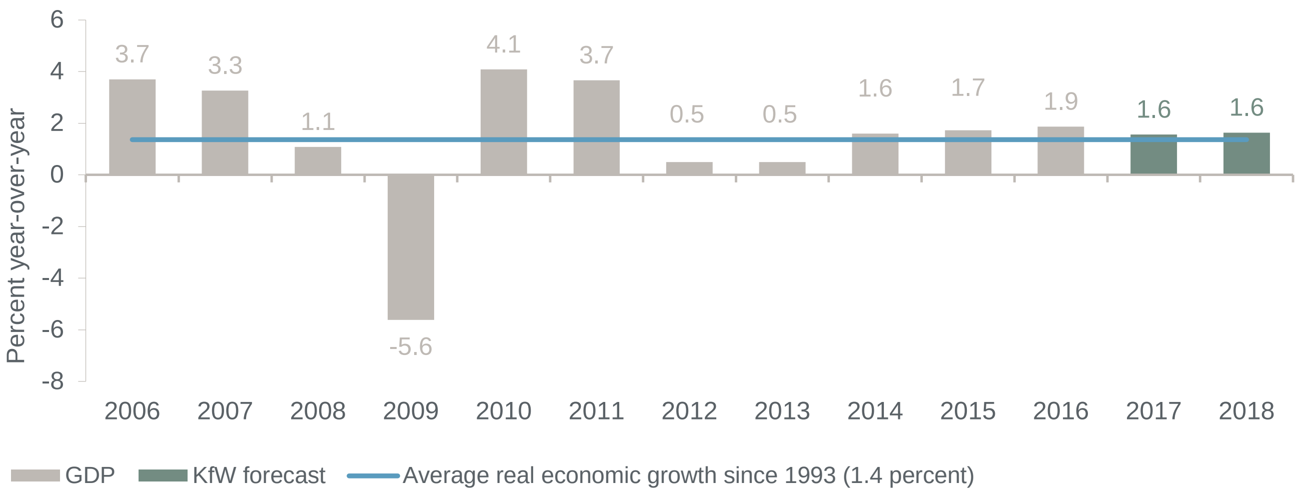
- The German economy started the year 2017 with convincing 0.6 % first-quarter growth; positive business sentiment points to real growth momentum of similar magnitude for the second quarter
- KfW Research now expects real growth of 1.6 % for both 2017 and 2018 (previous forecast: 1.4 % for each year), which would mean at least nine consecutive years of growth in Germany; only one upswing phase since the 1970s was longer
- The primary reason for the upward revision to the forecast is that the political risks in Europe have faded since the elections in the Netherlands and France; as a result, business investment should pick up more strongly than assumed in the previous forecast
- A more negative trend is possible should the USA implement protectionist plans or the Brexit negotiations get out of hand; however, growth could turn out significantly higher, particularly in 2018, if the euro area succeeds in making father-reaching structural progress

Germany's price-adjusted gross domestic product



Source: KfW Research, Destatis

A successful start to the year 2017

The German economy started the year 2017 with vigour. Adjusted for price, seasonal and calendar variations, first-quarter gross domestic product (GDP) increased by 0.6 % on the previous quarter. The structure of growth at the start of the year was just as pleasing as the growth rate itself, as all expenditure components of GDP made a positive contribution to the dynamic quarterly growth. The strongest impetus again came from domestic demand, with gross fixed capital formation – favoured in part by relatively warm weather – (+1.7 %) growing much more strongly in this quarter than consumption (+0.3 %). However, external demand also had a positive effect on growth, at +0.4 percentage points, as exports grew more strongly (+1.3 %) than imports (+0.4 %). The prospects for similarly strong real growth in the second quarter are good. Indicative of this is not just the excellent sentiment in the business sector at the start of spring, as shown by the all-time high of the SME KfW-ifo business climate index in April, for example. The most recent increase in incoming orders from abroad (+4.8 % in March on the previous month) also points in this direction.

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

Growth on a broad basis

The broad growth structure of the first quarter should tend to continue in the forecast period. Thus, domestic demand will remain the primary driver in our economic outlook for 2017 and 2018. Private consumption and residential construction expenditure are set to continue growing steadily – although with slightly less momentum than in 2016. Their reduced growth rates are primarily a consequence of higher inflation and the associated lower real wage growth, while ongoing employment growth will continue to be a dependable source. At the same time, the gradual increase in long-term interest rates since the US election will likely dampen residential construction activity slightly, but on a high level. Nevertheless, financing costs remain low in a historic context, and the need for new dwellings remains high, not least as a result of immigration. Exports should continue recovering on the back of an improving global economy and an upturn in international trade. At the same time, however, bolstered by domestic demand that is clearly set for continued growth, Germany's imports will grow significantly as well. The growth contributions of external trade should therefore be slightly positive at best.

Business investment is recovering

The revival of external demand, very high industrial capacity utilisation (stable at 86.0 % since the beginning of the first quarter 2017; the highest level since the end of 2008) and borrowing terms that continue at attractive levels are many good reasons for businesses to substantially expand their investment activities. At the same time, since the elections in the Netherlands and, especially, in France, the risk of further direct destabilisation of the EU has vanished. In our previous forecast that was still a key factor for businesses to exhibit extreme reluctance to invest despite generally good economic conditions. With this major uncertainty factor gone, as the year progresses we now expect business investment to be able to increase much more strongly than we had assumed in our previous forecast. Owing to the unfavourable starting level (negative statistical underhang of nearly one percentage point from 2016), the annual average increase in business investment will nevertheless remain rather modest in 2017 and will not strengthen visibly until 2018.

KfW revises its forecast for 2017 and 2018 upward

All in all, the fading away of major uncertainty factors and the brighter outlook for investment has led us to revise our real growth forecasts for 2017 and 2018 upwards to 1.6 % (previous forecast: 1.4 % for each year). The underlying cyclical momentum will stay virtually unchanged compared with 2016 because the slowdown of 0.3 percentage points on 2016 GDP growth (1.9 %) is exclusively due to unusually strong variations in the number of working days.

An enduring upswing

The underlying cyclical momentum will not drop until 2018, and only moderately, and will remain just above the long-term trend rate of around one and a half per cent. The reason for this forecast is that Germany's recovery has been under way for a very long time, so that production factors – such as skilled workers – are becoming increasingly scarce. Including the year 2018, the ongoing upswing would thus come to at least nine years of uninterrupted growth, making it one of the longest periods of growth since the outbreak of the first oil crisis in the mid-1970s. Also in terms of strength – measured by an expected overall GDP growth of a good 19 % up to 2018 since the recession low of 2009 – it would keep up well with the other upswing phases of nearly five decades past. Only the upswing from 1982 to 1992 was slightly longer – ten years – and significantly stronger
(+35 %). In its later stage, however, it also benefited from a historically unique situation: the very strong demand surge triggered by the fall of the wall and Germany's unification.

Good prospects for even more growth, ...

Such a historic situation is in principle conceivable again – provided Europe quickly develops a convincing strategy for the future of the EU and the EMU, and provided the remaining 27 states all pull together as one in the exit negotiations with the United Kingdom. Germany and France, as large countries and historic precursors of European unity, have a special responsibility in this environment. So there is definitely a chance for even more growth.

... but major cyclical risks also remain

Nevertheless, the downward side of risks should not be ignored either. They would come to fruition especially if the USA and the UK, as important partners in trade and direct investment, were to rigorously implement their isolationist plans regardless of the considerable damage they would inflict upon themselves. Given the time lag in the implementation of protectionist measures, a drop in real growth would then have to be expected especially for 2018. In addition, many open questions still remain in the euro area, for instance in Greece and the Italian banking sector. Cyclical momentum might be dampened by a lack of answers as much as by the early parliamentary elections in Austria that have been moved ahead to October this year – if Euro-sceptical forces there end up receiving a boost. That underscores yet again how important it is for consolidating Germany's and Europe's upturn to take bold steps towards achieving a sustainable solution for the future of Europe. ■