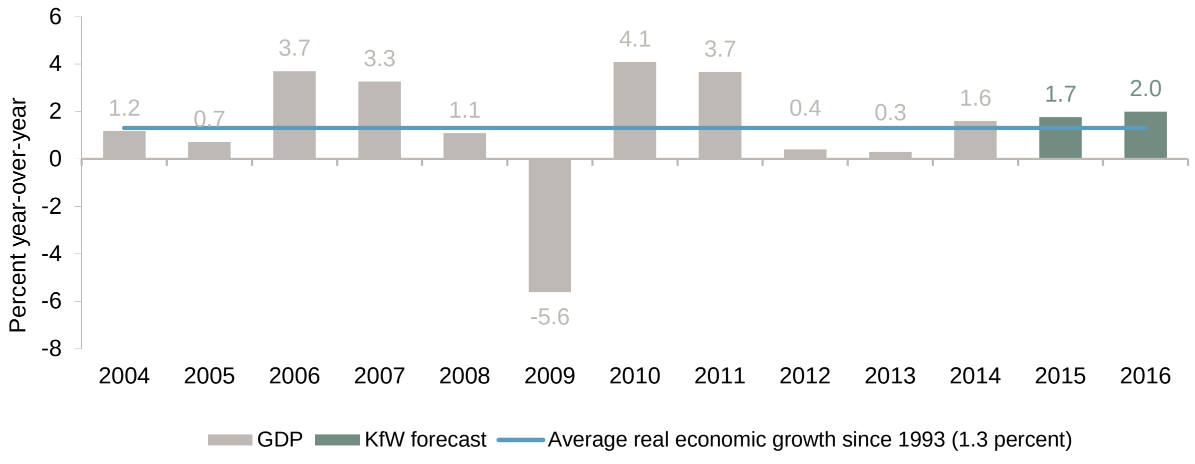
Frankfurt, 1 December 2015

KfW Business Cycle Compass Germany

Recovery will pick up pace in 2016

- ***KfW Research expects 2.0% real GDP growth for 2016, confirming the optimistic previous forecast from August***
- ***1.7% growth in 2015 (previous forecast: 1.8%); second half slightly weaker than previously forecast***
- ***While domestic economy stays on track, the foreign trade environment will improve in 2016, bolstering exports and corporate investments***
- ***Risks: political controversies in Europe (migration, reform countries), geopolitics and terrorism, excessive US monetary tightening, commodity price volatilities***

Germany's gross domestic product, price-adjusted



Sources: Destatis, KfW Research

KfW's forecast for 2016: a 'two' before the decimal point

Despite the rather more subdued growth in the third quarter of 2015, which roughly matched the long-term trend rate at 0.3% on the previous quarter, we continue to expect the German economy to clearly pick up steam in the coming quarters and price-adjusted gross domestic product (GDP) to grow by 2.0% in 2016 as a whole (1.9% adjusted for calendar effects). For the year 2015, which is drawing to a close, we now expect 1.7% real growth (1.5 % adjusted for calendar effects), 0.1 percentage points below our August forecast. The minimal downward revision is due to the somewhat weaker than previously expected third-quarter growth and to our expectation that this shortfall can no longer be fully made up for in the final quarter.

Strongest real growth in five years

Our forecast of a ‘two’ before the decimal point not only signals clearly above-average growth momentum for 2016; after all, the mean value of growth rates in unified Germany has been a mere 1.3 %. At the same time it would be the strongest increase since the high GDP rates of 2010 and 2011, which were sustained by strong catch-up effects in the aftermath of the Great Recession of 2009. The German economy would thus once again grow more strongly than the euro area and the EU as a whole, as it has done every year since the slump of 2009. Germany has weathered the financial crisis far better than most other European countries, also thanks to the ECB’s record low interest rates (and missing risk premium) and the weak euro.

Our economic optimism is based on the expectation that domestic demand will remain strong – particularly consumption – and that the foreign trade environment will improve tangibly in 2016. That will benefit exports and boost the recently weak corporate investments as capacity utilisation rises.

Private and public consumption continue to soar

Private consumption expenditure grew 0.6 % in the third quarter, which is not only the fifth consecutive rise but the strongest this year. This momentum will continue, mostly thanks to the labour market. The number of persons in employment increased by 0.7 % in the first three quarters of 2015 on the same period of last year. In the long term, the current influx of asylum seekers will make a positive contribution to the labour force potential, with the Institute for Employment Research (IAB) estimating an increase of nearly 600,000 in the medium term. Moreover, the parties to collective agreements have negotiated substantial wage and salary increases of 2 to 3.5 %. After adjusting for the very low inflation rate – mainly the result of decreasing energy price levels – that will leave a palpable, real purchasing power increase. Finally, the low interest rate environment provides little incentive to save.

General government consumption expenditure increased in the third quarter of 2015 at the highest rate since early 2009 (+1.3 % on the previous quarter) and will continue to rise significantly, not least as a result of the additional expenditure caused by the refugee influx. This includes, in particular, additional staff in the public service and social transfers in kind for refugees, for instance in the health sector.

Long overdue turnaround in public investment

Government investment has been disappointing so far this year, falling in all three quarters, recently by 0.3 %. The KfW Municipal Panel 2015 now estimates the municipal investment shortfall at EUR 132 billion. Nevertheless, we are confident that we are now at a turning point. Policymakers have recognised the problem and have taken measures. The municipal investment initiative launched by the German Federal Government this year, totalling EUR 15 billion, is designed to enable particularly the financially weaker municipalities to invest more. Investments in infrastructure projects will also be supported by the European Fund for Strategic Investments proposed as part of the Juncker Plan. Together with continuously rising tax revenues, these initiatives are likely to contribute to significant growth in government investments in 2016. It would be the first significant annual increase since 2011.

Residential construction benefits from net immigration

Although they virtually stagnated in the third quarter (-0.1 %), residential construction investments are on a strong upward trend driven by low interest rates, real purchasing power increases and high net immigration. They now exceed the real level of early 2010 by some 25 %. The strong refugee influx is likely to further stimulate rental housing construction in particular. The continued strong residential construction activity is reflected not least in the number of building approvals, which were almost five per cent higher in the first three quarters of this year than in the same period last year.

Corporate investments are picking up as capacity utilisation increases

Despite extremely favourable financing conditions, corporate investments again lost momentum over the summer, dipping by 0.4 % in the third quarter, which was hardly less than in the second quarter (-0.5 %). Nevertheless, thanks to very strong growth in the previous winter half of 2014/15, corporate investments will close the year 2015 with more than 2 % growth. We expect momentum to pick up in 2016, as the main reasons for the temporary weakness – recent weak export growth and a resulting stagnation in capacity utilisation – should be gradually overcome in the course of what we expect to be a brighter foreign trade environment. The slightly higher utilisation of industrial capacity at the beginning of the fourth quarter and the recently noticeable improvement in business sentiment (ifo Business Climate November) support our view.

Exports benefit from improved foreign trade environment

On the external side, for 2016 we expect slightly better performance in the recently disappointing emerging economies and a continuing recovery in Europe. Compared with the very high pace in the first decade after the turn of the millennium, global momentum will remain subdued. Nevertheless, the improved external environment should be strong enough to revive exports (third Quarter: +0.2 %) – especially since the price competitiveness of German products outside the euro area has improved noticeably as a result of the euro depreciation. As import growth can be expected to remain strong (third quarter: +1.1 %) as a result of strong domestic economic performance, the growth contribution of foreign trade on balance will still be almost zero – a healthy development given Germany's very high current account surplus of around eight and a half per cent of GDP.

Downward risks have global sources

The vast majority of risks is global. Possible political controversies in Europe arising from the refugee influx, insufficient successes in the reforming countries or the threat of a Brexit may undermine trust in the recovery just as much as unfavourable geopolitical developments, e.g. in the wake of new terrorist attacks. What cannot be ruled out either is that an excessively fast tightening of interest rates in the USA or commodity price volatilities could unexpectedly send the global economy into a new downturn. If these risks were to materialise, real growth would likely be lower next year than in 2015.

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