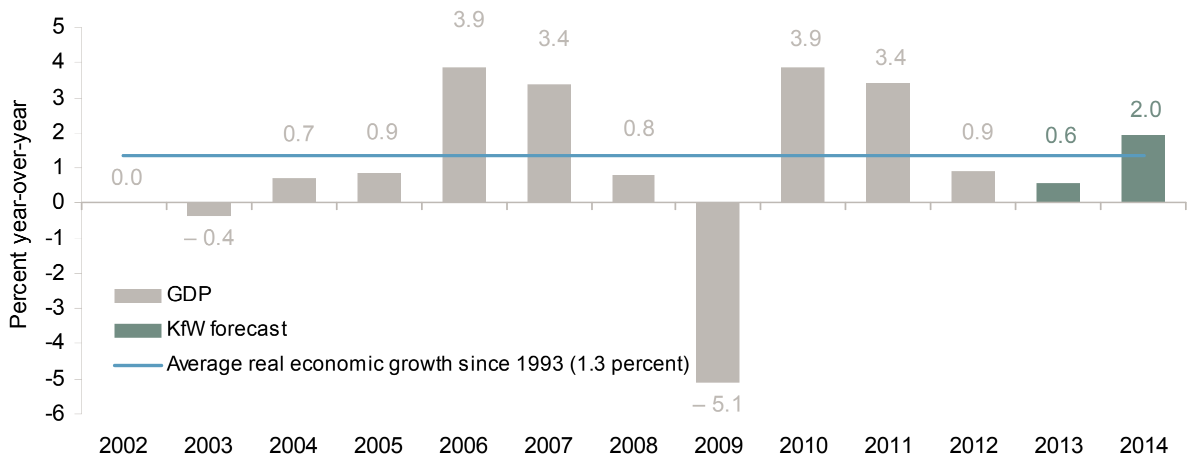
Frankfurt, 23rd August 2013

KfW Business Cycle Compass Germany

End of recession in Europe benefits Germany

- ***KfW has revised its economic forecast for 2013 upwards, from 0.3 % to 0.6 %. Real growth will accelerate to 2.0 % in 2014 (previous forecast: 1.7 %) and thus be above the long-term average following two weak years***
- ***The main reasons for the upwards revision for this year are, first of all, the strong second quarter (0.7 %) – also thanks to a weather-related rebound in construction activity – and, secondly, the fact that according to the latest data, the adverse statistical carry-over effect from the slump in the final quarter of 2012 is less pronounced. For the second half of 2013 we continue to forecast quarterly rates of around 0.4 %. Slightly higher average quarterly growth rates are possible in 2014, provided Europe expands slightly***
- ***Consumer spending and residential construction remain a pillar of the economy. They are benefiting from low unemployment, an increase in real wages and favourable financing terms. Public-sector capital formation will be boosted slightly by the repairs necessitated by flood damage. Capital formation by companies is expected to recover finally in the course of the forecast period in view of diminished uncertainty, increased capacity utilisation and improved prospects for exports. The contribution of foreign trade to growth will remain more or less neutral in the coming year, despite a perceptibly greater export momentum, as imports will also rise substantially***

German gross domestic product, adjusted for price and calendar effects



Source: KfW Economic Research, national accounts data from 23rd August 2013

Overview of our forecast

The German economy put on a convincing performance in the spring: It has quickly left the weak winter half-year behind it and returned to its expansion course. Gross domestic product (GDP) adjusted for price, seasonal and calendar effects recorded vigorous growth of 0.7 % quarter on quarter in the second quarter of 2013 following zero growth in the starting quarter.[1] The quarterly growth rate is thus slightly higher than we had expected three months ago (0.5 %).

The high growth seen in the second quarter cannot, however, be extrapolated into the future. Alongside fundamental factors such as the end of the recession in the euro area, this growth is partly due to the capricious weather. For the remaining two quarters of 2013 we still project slightly slower growth of around 0.4 % and thus reaffirm the picture we predicted in May of a modest recovery in the second half of the year.

Nevertheless, we are adjusting our forecast for annual growth in 2013 perceptibly upwards, from 0.3 to 0.6 %. Above all, this is due to past developments – specifically, the slightly higher growth rate in the second quarter, which came as a surprise, in tandem with the result of the most recent official data revision. Based on the current national accounts data from the Federal Statistical Office, the strain on this year's annual growth (statistical underhang) resulting from the slump in the final quarter of 2012 is less than previously calculated using the data officially published in May.

Real growth next year is likely to increase to 2.0 % (previous forecast: 1.7 %), provided that Europe expands slightly and the economies in the Americas and Asia are able to meet the current moderately optimistic expectations.

Broad-based growth in the second quarter

Growth in the second quarter is broadly based: It is buoyed not only by consumer spending and capital formation, but to a lesser extent also by net exports. Private households are expanding their consumption by 0.5 % thanks to secure jobs and rising real wages. Even gross fixed capital formation is showing a perceptible quarter-on-quarter increase overall (1.9 %) for the first time in six quarters. Construction, in particular, did all it could to quickly recoup the production disruption seen in the first quarter and occasioned by the unusually long and cold winter.

Finally, a slight increase in capital formation

On a positive note, the increase in capital formation has finally exceeded construction. In the investment statistics that we alone have computed, gains were recorded by private residential construction (3.2 %) and also by public-sector capital formation (12.7 %), which is heavily dominated by construction activity. What is more, the protracted downturn in capital formation by companies has also come to a virtual standstill (-0.3 %). A substantial rise was pre-

[1] Unless otherwise specified, data on GDP and its components refer to price, seasonal and calendar adjusted figures according to the Census X-12-ARIMA method.

vented only by commercial construction, which is declining against the general construction trend and fractionally offsets the solid growth of corporate spending on machinery and equipment (1.3 %), which in turn is important for production capacity. Corporate capital formation is benefitting from the fact that the recession in the euro area – Germany's most important trading partner – that had been ongoing for a year and a half has come to an end. France and Portugal are able to provide a pleasant surprise with strong quarterly growth rates while the decline in output in Italy, Spain and the Netherlands has almost come to a halt. Consequently, capacity utilisation in industry has risen perceptibly by 1.1 percentage points to 83.2 % in the second quarter, equivalent to the highest level in five quarters and roughly in line with the long-term average.

Fittingly, exports are growing again for the first time in three quarters (2.2 %). Since the export gain is even slightly higher than the rise in imports (2.0 %), net exports – the difference between exports and imports – provide a marginally positive contribution of 0.2 percentage points to quarterly growth.

More modest quarterly growth from the third quarter onwards

The vigorous and broad-based growth recorded in the spring is encouraging. The fact that the euro area has finally begun to work its way out of the recession supports justified economic hopes, as does the improvement in business sentiment, the growth in new orders and the pick-up in industrial output. However, for the near future a more modest pace is to be expected, as the dynamic growth seen in the second quarter is also partly attributable to a weather-related one-off effect. Just as the unusually protracted and cold winter weighed on construction activity after the start of the year and depressed growth in the first quarter, the pent-up construction activity has given it an additional boost in the spring. For the second half of 2013 we therefore continue to expect slightly lower quarterly growth rates of around 0.4 % and thus confirm our picture of a modest recovery in the second half of the year, as predicted in May.

Upwards revision in 2013 is mainly due to new data for the past

Despite this, we have to adjust our forecast of annual growth in 2013 perceptibly upwards, from 0.3 to 0.6 %. On a non-calendar adjusted basis this corresponds to an increase of 0.5 %. The adjustment is due to the slightly higher growth rate in the second quarter, which came as something of a surprise (0.7 % instead of the 0.5 % we originally predicted). It also reflects the result of the official data revision that is routinely published in August by the German Federal Statistical Office for the past four years. Based on recent calculations, the slump in the final quarter of 2012 (-0.5 %, up from -0.7 %) and the resultant strain on this year's annual growth due to the low starting level is slightly less pronounced (statistical underhang now 0.3 percentage points instead of 0.4 percentage points).

Real growth of two percent is possible in 2014 ...

We are upbeat about 2014 and now project real growth of 2.0 % (previous forecast: 1.7 %). From a non-calendar adjusted perspective this also works out to an increase of 2.0 %, as the calendar effect next year will be negligible. The most important precondition for our optimism is the expected slight expansion of economic output in Europe, still the most important market for German companies.

... provided Europe bears up

However, there will not be scope for much more than a moderate recovery in Europe, for the following reasons: (1.) The extension of the deadline for budget consolidation now agreed with a large number of reform countries is to be welcomed and will also have a positive effect on Germany through exports. However, this in itself does not amount to a growth stimulus. (2.) The countries in question have already made noticeable progress towards strengthening their competitiveness. However, the structural reforms must be continued within a realistic timeframe. For now, they create insecurity which makes planning difficult and thus weigh on economic growth. (3.) Real interest rates remain too high for many companies. (4.) The impaired ability of some countries to sustain debt stands in the way of higher capital formation by the government. (5.) Job insecurity remains high in many parts of Europe. Pay increases are not an option in most euro area countries as they would jeopardise even more jobs. Without fresh stimuli, we therefore anticipate no more than weak growth in the euro area in 2014.

Consumer spending is most likely to provide a positive surprise. Some private households in the reform countries have considerable assets. Once the economy improves and the uncertainty about important underlying conditions such as the tax burden, working life and pension entitlements recedes, they will be able to reduce their savings ratio in favour of consumer spending.

German exports would benefit further from this. A pick-up in exports and further rise in capacity utilisation looking forward might provide German capital formation with a boost – after almost two years of generally weak capital formation by companies, many projects now in the pipeline are likely to prove highly attractive if sales prospects brighten and financing interest rates are low. If this is the case, we expect to see a substantial acceleration of capital formation by companies. However, despite all optimism this is not enough to sustainably overcome Germany's structural weakness with respect to capital formation.

Domestic demand to remain a reliable pillar of the economy in 2014

As we have been stressing for some time now, the other domestic growth factors will remain a reliable pillar of the economy. German employment remains historically high, and the unemployment rate is moving sideways having reached a low level. At the same time, appropriate rises in nominal wages above the rate of inflation guarantee perceptible increases in real purchasing power. This means that job security in tandem with perceptible rises in real wages and persistently good financing conditions will ensure solid growth contributions from consumer spending and private residential construction. Moreover, the recent very weak level of public capital formation should receive a stimulus from the repairs necessitated by flood damage in southern and eastern Germany and from rising tax revenue. The solid growth in domestic demand is, at the same time, pushing imports up. Consequently, the growth contribution from foreign trade is likely to remain roughly neutral next year despite the perceptible increase in export momentum we are expecting.

Risks lurking mainly on the international stage

The risks to our economic forecast are balanced. In any case, they may emanate from the international markets, particularly in Europe. The continuing stabilisation of the situation in Europe is a key prerequisite for our optimism regarding the economy in 2014. This is because the expected increase in growth of the major European export destinations and the US weighs far more heavily than the probably rather muted growth in the major emerging markets of Asia and South America, which are currently battling with internal structural problems and are suffering from the fact that the US Federal Reserve has announced to taper its bond buying programme. Even if these countries were to fall substantially short of their forecasts in 2014, the German export markets will, on balance, pick up momentum – provided that Europe bears up.

The most important factors for the stability of the euro area are as follows: (1.) the ECB's ability to act, (2.) a strengthening of the balance sheets of euro area financial institutions to enable them to extend more corporate loans and (3.) financing commitments (against reforms) for those reform countries that are not yet able to refinance their sharply contracting budget deficits and outstanding liabilities – predominantly to other European and international public-sector creditors – on the capital market.

Although we expect this to happen, the recovery is naturally fragile at this very early stage, not least also because the credit market conditions in the reform countries are still quite restrictive. Moreover, setbacks in recovering the sustainability of public-sector finances in individual countries and political debates about the future of the EMU, which cause uncertainty on the financial markets, can still not be ruled out. On the other hand, the recovery in Europe might prove to be more vigorous than assumed. This is because after the deep recession, the potential for recovery is correspondingly large.

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