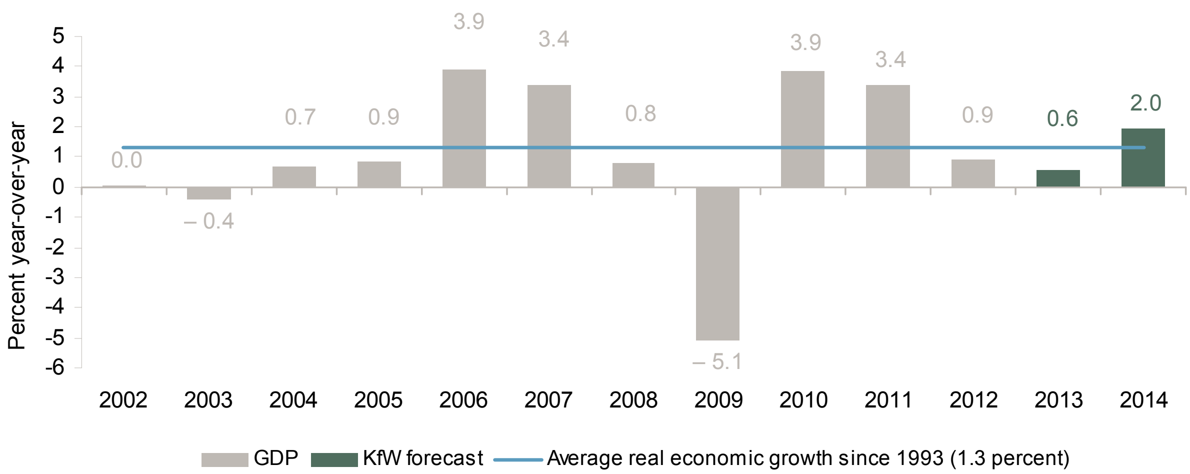
Frankfurt, 27th November 2013

KfW Business Cycle Compass Germany

Germany in recovery mode – some risks remain

- ***KfW has confirmed the economic growth forecasts for 2013 (0.6 %) and 2014 (2.0 %). After two years of weak growth, real growth in Germany will return to above the long-term average for the first time next year.***
- ***We anticipate growth at around 0.5 % for the fourth quarter of 2013. We expect similar average quarterly growth rates in 2014, provided that the European economy continues to stabilise.***
- ***Consumption and residential construction continue to be reliable economic drivers, while the foreign trade outlook is improving. Exports and corporate investment are set to gain ground. At the same time, domestic demand will boost imports, reducing Germany's import deficit.***
- ***The greatest economic risks are a downturn in Europe and further procrastination or an escalation of the dispute over the US budget and social policy.***

German gross domestic product, adjusted for price and calendar effects



Source: KfW Research, national accounts data from 22nd November 2013

The German economy continued its modest recovery in the summer: gross domestic product (GDP)[1] advanced 0.3 % quarter-on-quarter in the third quarter of 2013. This is consistent with the average growth rate in the first half of the year. However, one has to bear in mind that the observed economic growth initially understated and then exaggerated the “true” underlying cyclical trend, due to the unusually long and cold winter, and the construction sector's subsequent race to get back on track. We are therefore not concerned by growth being

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

lower than in the second quarter when the rebound effect in construction temporarily boosted growth (0.7 %). We had already expected such a development as stated in our forecast three months ago.

KfW forecasts for 2013 and 2014

Monthly sentiment indicators like the ifo business climate index and hard data such as new orders suggest that the economic recovery continues. Despite a few setbacks, the short-term economic indicators generally reflect a positive trend. Following a pronounced spike in November, the business climate index is now at its highest level for 18 months. We therefore expect growth in the last quarter to rise to around 0.5 %. We anticipate similar average quarterly growth in 2014, provided that the European economy continues to stabilise. This figure is only slightly higher than the potential rate, which means a rather modest recovery in Germany. Taking otherwise looming labour shortages into account, this development is actually favourable for the sustainability of the recovery. Under these assumptions, real growth is set to advance to 2.0 % in 2014 (not adjusted for calendar effects: 2.0 %), compared with just 0.6 % (not adjusted for calendar effects: 0.5 %) in 2013. We thus confirm the forecasts for 2013 and 2014 that we issued in August.

Solid third-quarter growth, corporate investment finally improves

Growth was mainly driven by domestic demand in the third quarter. Consumption of private households (0.1 %) and government (0.5 %) were a factor, but the main component was gross fixed capital formation (1.6 %). It is good to see corporate investment on the rise again – up 0.9 %, supplementing residential construction (2.6 %) and capital formation of general government (2.7 %). In contrast, net exports pushed quarterly growth down 0.4 percentage points, with imports outstripping exports (0.8 to 0.1 %). Overall quarterly growth was 0.3 %, roughly in line with current potential growth.

Domestic conditions have been good for some time now

Consistent with the “normal” cyclical speed in the third quarter, industrial capacity utilisation (83.2 %) has been on a par with the long-term average since the summer – and is up nearly two percentage points year-on-year. Unemployment moves sideways and remains low. Employment is record high, with more than 42 million people in work. Not least migrant workers from the rest of Europe are helping to increase that figure still further. Interest rates and inflation are, and will remain, low. Real wage growth is set to pick up slightly. However, the increase in unit labour costs will stay slightly below 2 % and thus in line with the inflation target of monetary policy, and will not harm competitiveness. All of these factors have boosted the domestic contributions to growth, particularly of consumption expenditure and construction for some time now. There will be no material change in 2014.

International markets also healthier

The global economy is also beginning to pick up. Growth in emerging economies will remain high, although due to internal structural problems and the quest for new growth models – particularly in China – growth will not match past performances. At the same time advanced economies are visibly improving, including key German export markets such as the US and UK.

Crucially, the euro area – still by far the most important market for German exporters – emerged from a lengthy recession this summer and since than has been on a modest growth path, with ever more countries following the trend. The economy should continue to stabilise in 2014, buoying up German exports. The resultant increase in capacity utilisation combined with less uncertainty and continued favourable borrowing conditions will revive corporate investment. This outlook is confirmed by the sharp rise in domestic orders for plant and equipment – up 4 % in the third quarter, the largest gain in over two years. Corporate investment will advance 5 % in 2014, after two years of decline. Even then, investment will remain more than 5 % below the pre-crisis level of 2008. There is still a lot to do to overcome the structural weakness in investment. As domestic demand is picking up across the board, imports are also set to rise significantly in 2014, which should reduce the German import deficit and therefore the extremely high current account surplus (7 % of GDP in 2013). However, the current account balance is unlikely to return to the EU target range (-4 to 6 %) in 2014.

Risks are international and – predominantly – European

The greatest threat to economic performance is an unexpected downturn in Europe, which could still happen. The recovery might be slowed by funding shortfalls in stressed economies. Political discussions about the single currency could cause unease, as could renewed concerns about whether fiscal consolidation is sustainable, which would revive tensions in the financial markets. If that were to happen, exports and corporate investment in Germany would not recover and unemployment would rise. However, Europe also offers opportunities: given the scale of the decline, the scope for regaining ground is also considerable. Consumption could offer some positive surprises, as southern European private households partly own considerable wealth. If the southern Europeans feel more confident about the future, they might reduce their savings ratio.

The United States could also jeopardise global growth, if the Democrats and Republicans are unable to resolve their profound differences over the budget and social policy in 2014 or indeed if the animosity worsens.

Author: Dr Klaus Borger, +49 (0) 69 7431-2455, klaus.borger@kfw.de
Press: Christine Volk, +49 (0) 69 7431-3867, christine.volk@kfw.de