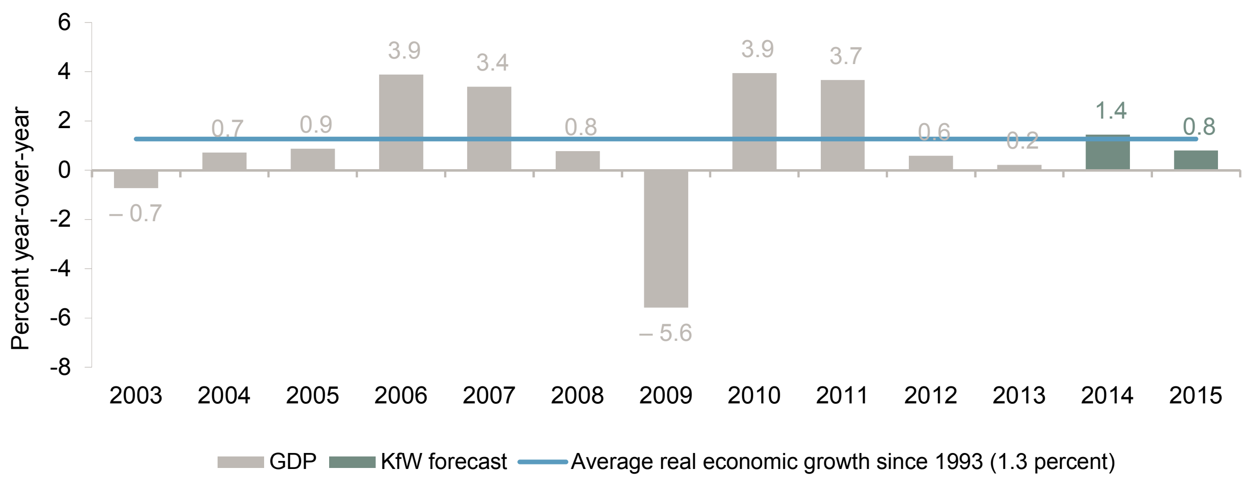
Frankfurt, 3rd December 2014

KfW Business Cycle Compass Germany

GDP in Germany: half steam ahead

- ***KfW is halving its economic forecast for 2015 to 0.8 %, adjusted for calendar effects (previous forecast 1.5 %). 2014 should see real growth of 1.4 %, lower than was expected last time round (previous forecast: 1.6 %)***
- ***Economic growth has come to a standstill since the brakes were applied in spring; also little more than stagnation is scarcely realistic until well into the coming year. Companies' expectations have deteriorated tangibly because of the numerous geopolitical uncertainties, but mainly due to hopes of an upturn in Europe being dashed anew. The situation will only ease gradually***
- ***The difficult international conditions are not only holding back growth in German exports but are also prompting firms to postpone investments on a considerable scale; while the positive impetus from the labour market, private consumption and residential construction is set to ease somewhat, it continues to be the mainstay of the economy***
- ***Public-sector investment is likely to decline in 2014 according to the most recent official downward revision; for 2015 we are expecting a noticeable increase***

German gross domestic product, adjusted for price and calendar effects



Sources: Destatis, calculations KfW Economic Research

Persistent stagnation

German economic growth was only minimal over the summer: following the slight fall this spring, third quarter gross domestic product (GDP) rose by 0.1 % over the previous quarter, just enough to restore economic output almost to the level of the first quarter. The bottom line is that the German economy has been stalling since the start of the year, which however benefited from favourable weather conditions. The stable level of activity at least is owed in particular to private households, which palpably increased their consumer spending in the summer (+0.7 %).[1] Private consumption, by far the largest component of GDP, is profiting from the – in view of the weak economy – impressively robust labour market and relatively substantial increases in nominal wages, in conjunction with persistently low inflation and interest rates. Similarly, government spending on consumption was also in decidedly positive territory (+0.6 %).

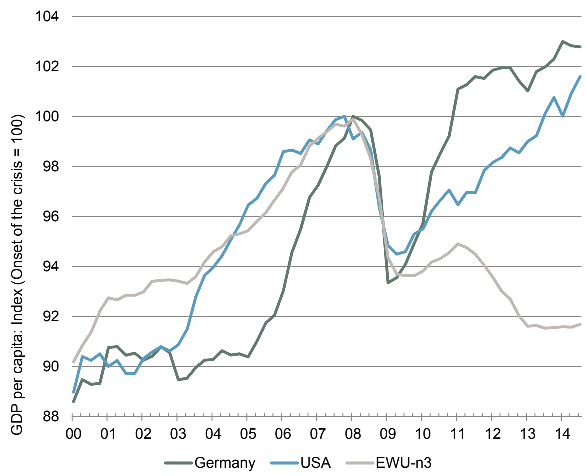
Recovery in corporate investment comes to a halt

Foreign trade, i. e. the balance between exports and imports, likewise made a positive contribution of 0.2 percentage points to quarterly growth, since exports (+1.9 %) grew at a rather higher rate than imports (+1.7 %). But this has to be seen in the light of a significant negative growth contribution from changes in inventories (-0.5 % percentage points), meaning that a considerable proportion of foreign demand were probably met not from current production, but by reducing stock levels. Residential construction only just managed to stabilise after the weather-related ups and downs of the first half of the year (-0.1 %). However, public investment (-3.2 %) and investments by companies were the greatest sources of disappointment. The promising recovery in corporate investment that began in spring 2013 has ended for now, following the second significant decline in a row (-0.9 % after -0.7 % in the second quarter).

Without a comprehensive turnaround in Europe, no real upturn in Germany

The investment freeze on the part of companies and government is regrettable, and the opposite of what would be needed in the long term. From an economic perspective, the reluctance is only understandable when it comes to companies: their sales prospects and business expectations have worsened markedly since the spring. This was due to numerous geopolitical uncertainties, but most of all to repeatedly dashed hopes of an upswing in Europe.

Real GDP per capita since onset of the crisis



Source: Feri, KfW Economic Research calculations

The adjacent chart underscores how greatly Germany, despite increasing diversification, continues to rely on the eurozone as the country's most important export destination. The diagram shows per-capita GDP – relevant for material wealth – in order to filter out the effects of the different population dynamics in the economic areas examined here.[2] In the wake of the Great Recession of

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

[2] The rest of the eurozone is pragmatically approximated using the mean of the three largest member states after Germany in economic terms (EMU-n3: France, Italy and Spain); these three economies together generate two thirds of the economic output of the rest of the EMU.

2008/09, the rest of the eurozone experienced an already sluggish recovery that was followed by a second downturn since the start of 2011. Since then German per-capita GDP growth has averaged at only 0.5 % per year. That is not only a fraction of the pace at which Germany emerged from the crisis-driven collapse from spring 2009 onwards (+4.0 % p. a.), or that it had previously achieved in the strong upswing of spring 2005 through to the pre-crisis high seen in early 2008 (+3.4 %). It is virtually just as weak as in the five years after the turn of the new millennium (+0.4 % p. a.), when Germany was regarded as "the sick man of Europe", even though the supply conditions and the competitiveness of German companies are far better now than then, and despite the fact that the USA – the most important trade partner globally and still a good indicator of the state of the world economy – has been displaying very stable growth since the low point of the crisis in spring 2009, albeit somewhat slower as compared to the period preceding the recession. It is chiefly the abysmal situation in Europe that is making the difference in the external conditions. For this reason, we believe Germany can only hope for a real upturn, provided its European partners experience a broad-based revival in demand as well.

Little more than stagnation in the winter half-year

We are sceptical about the short term: a weak GDP growth rate similar to that observed in the third quarter is likely for the final quarter of 2014, and only a slightly better outcome is expected for the first quarter of 2015. This is borne out by the strong decline in the ifo business expectations of companies over the year (-9.1 points compared to the annual high in January, despite the first improvement in November), the stagnation trend in new orders since the start of the year, and slightly decreasing industrial capacity utilisation for the second time in succession at the beginning of Q4 (-0.6 percentage points on Q2). All of which provides no incentives for additional investment, despite very favourable terms of financing. Nevertheless, the situation may gradually improve over time, meaning that quarterly growth rates averaging just below half a percent could again be achieved in the second half of 2015. In this forecast, it is largely assumed that the relationship to Russia will stabilise at a low level.

KfW forecast 2014 and 2015: scarcely more than stability

In these circumstances, Germany will grow by a modest 0.8 % in 2015, adjusted for calendar effects[3], which is only just over half as much as we had predicted three months ago (prior forecast: 1.5 %). The low starting level in particular, a consequence of the weak winter half-year we anticipate, will weigh on the annual result. In contrast, 2014, which is drawing to its close, will likely end with overall growth of 1.4 % (prior forecast 1.6 %), although practically all of this is attributable to the very strong start to the year and momentum still felt from 2013 (statistical overhang: 0.7 percentage points).

The domestic economy as the anchor of stability

Private consumption and residential construction will continue to support the economy in 2015. However, the growth dynamics will weaken somewhat relative to 2014. After five years

[3] 2015 has 2.3 more working days than the national average in 2014, meaning that the almost ¼ percentage point contribution to growth due to the changing holiday situation alone (calendar effect) is considerable in the coming year. Accordingly, real growth not adjusted for calendar effects is 1.0 % in 2015. On the other hand, the calendar effect is negligible in the current year (2014).

of sometimes very powerful growth, residential construction has reached a high level, so that the pace is expected to ease, even in the context of persistently low interest rates. Consumption is benefiting from a significant drop in the oil price in US dollars. This effect will, however, be partially offset by an anticipated further devaluation of the euro due to the progressive normalisation of monetary policy in the USA at the same time as what will likely be a very long, very expansionary course in Europe. What is more, this leads us to expect slightly higher inflation relative to its present very low rate. This will constrain further growth in real purchasing power, as will potentially somewhat weaker negotiated wage dynamics than in 2014 and the anticipated levelling off of employment growth at a high level. All in all, 2015 will nonetheless experience respectable growth in real disposable income in a longer-term context. Public-sector investment will probably see tangibly stronger growth than GDP in 2015, after having faced the third successive contraction in 2014. This appears inevitable after Destatis's sharp downward revision of the figures for the last few quarters.[4] Corporate investment, on the other hand, will average only slightly higher in 2015 owing to the still very low economic momentum in the winter half-year. We expect a rate of +0.5 %, adjusted for price and calendar effects, after growth of 3.5 % this year.

Trade balance slightly positive

Positive impulses for foreign trade are coming from the USA and UK; the falling external value of the euro and the declining price of crude oil are contributing to the stabilisation of the eurozone economy. We also assume that the structural reforms in southern Europe and the persistently expansionary monetary policy in 2015 will also ensure stability in Europe. However, unemployment is decreasing at a painfully slow rate and lagging behind the pace necessary to achieve far-reaching recovery. Nonetheless, the initial rays of hope are evident, such as solid growth in Spain and bottoming out in Greece – this is psychologically important. Even if this indicates a gradual revival in German exports during the forecasting period, the 2015 trade balance will not contribute much to growth, as imports and exports will probably rise at a similar pace.

Balanced risks

We perceive the risks as being roughly balanced. The positive external impulses may make an impact more rapidly and effectively than assumed. This would then probably lead to a recovery in corporate investment. Conversely, minor shocks could once again upset the fragile situation in the eurozone or geopolitical tensions could further escalate. Another clear deterioration in the international climate would further depress corporate investment and drive up unemployment.

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[4] As at the calculation date 25th November, public investment on average for the first three quarters of 2014 is 1.0 % below the average for 2013. By contrast, the official statistics in the preceding publication on 1st September showed a 5.3 % rise (average of the first two quarters of 2014 in comparison to 2013). In all four quarters since the third quarter of 2013, quarterly growth is now at times considerably weaker than had previously been thought, and in two quarters goes from plus to minus (3rd quarter 2013: -0.7 instead of +0.2 %; 4th quarter 2013: +1.3 rather than +1.5 %; 1st quarter 2014: -1.2 instead of +2.2 %; 2nd quarter 2014: -2.7 rather than -0.5 %).