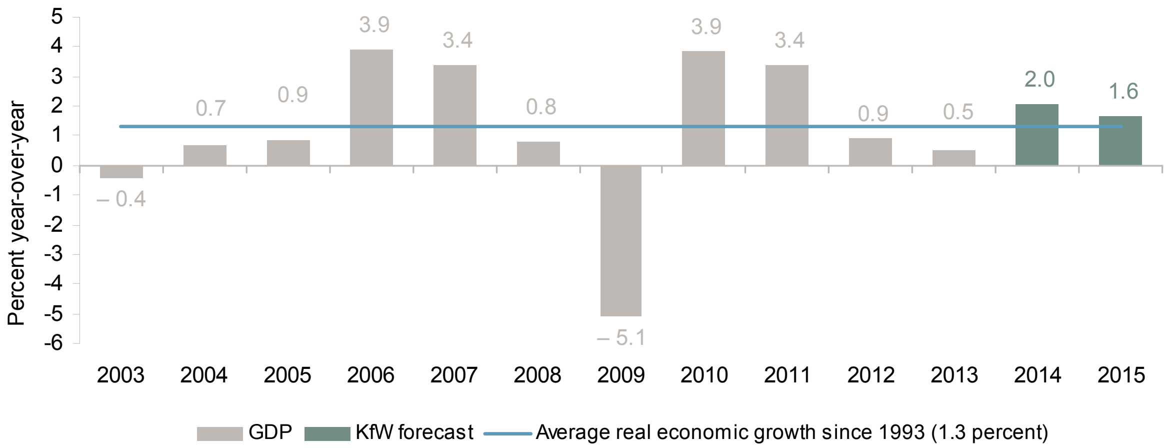
Frankfurt, 25th February 2014

KfW Business Cycle Compass Germany

Proper recovery – no more, but also no less

- ***KfW has confirmed its economic forecast for 2014 and presented its first estimate for 2015: After a quick jump in 2014 (2.0 %), real economic growth adjusted for calendar effects will slow to 1.6 % in 2015; the general conditions in Europe and the emerging countries will not allow for more***
- ***For the first half of 2014 we expect rather strong quarterly growth rates of 0.6 % on average, after which growth should then slow down somewhat and hover near the long-term trend rate***
- ***Alongside consumer spending and residential construction, business investment will pick up in 2014 and 2015 together with exports. The contribution of net exports to growth in those two years will be slightly negative nonetheless, as the domestic growth will also give imports a rigorous boost***
- ***A setback in Europe remains the greatest economic risk. However, a noticeable slow-down of the global economy is also possible if the financial market turbulence seen in major emerging countries gets out of control***

German gross domestic product, adjusted for price and calendar effects



Source: KfW Research, national accounts data as at 25th February 2014

Weak economic year of 2013 ends agreeably

The German economy appears to be on a path of moderate recovery. Gross domestic product (GDP)[1] in the fourth quarter of 2013 rose by 0.4 % over the quarter prior. This is a bit more than the average of the first three quarters. However, the agreeable end to the year

[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.

cannot hide the fact that Germany very much failed to live up to its growth potential for the second year in a row: At 0.5 % (not adjusted for calendar effects: 0.4 %), real economic growth in the past year was even lower than in 2012. The main reason for this is the prolonged recession in Europe, our most important trading partner by far, which was only overcome in mid-year. The unfavourable external economic conditions strained not only exports in the full year 2013, but company investments as well. The latter shrunk markedly again as a result of underutilised capacities and weak sales perspectives – a side effect of the tough consolidation programmes in Europe. Consumer spending and residential construction, on the other hand, provided reliable impulse for annual growth. These benefited from the continuous rise in employment and the low interest level.

Bold start to the new year

The outlook for the year now underway appears much friendlier. The moderate momentum from the final quarter of the past year is expected to intensify. Companies are confident, as the ifo business climate demonstrates: At the start of the year it was listed at its highest level since summer 2011; both the assessments of the current situation and, even more so, business expectations are picking up. Large, export-sensitive companies especially within the industrial sector are also optimistic once again. This is underscored by the hard data: Foreign trade made a positive contribution to growth in the final quarter of last year thanks to lively exports, and new orders in industry grew by a solid 1.2 % over the previous quarter at the same time, primarily as a result of the foreign orders (also from the eurozone). This is the fifth quarter of order intake growth in a row. Against this backdrop, we are assuming a strong first half of the year with quarterly growth rates of 0.6 % on average, mostly with a boost from exports and investments. After the weak consumption in the final quarter of 2013 put up a bit of a surprise, consumer spending is also expected to see a rapid recovery in light of the still favourable labour market prospects and the continuously good consumer sentiment. Consumers may have delayed purchases of new winter clothing due to the relatively warm weather and they now tend to wait until after the new year to go shopping with money received as Christmas gifts, when they can benefit more from discounts.

KfW forecasts for 2014 and 2015

The relatively high pace that we expect in the first half of 2014 is owed in part, however, to catch-up effects – especially in the case of business investment – and will be impossible to maintain in the longer term. The eurozone is growing again, but the recovery will prove difficult in the medium term given the fact that the general conditions are still tough and unemployment remains high, in addition to the problems of little fiscal leeway, a number of yet uncompleted reforms in the banking sector and at least latent deflation risk. Not even Germany will manage to fully break away from this trend, the more so as the economic dynamism in the emerging countries as another important export market will no longer come close to the peak levels from the past. We therefore assume that this dynamism will move more in the direction of the long-term trend rate again from summer until the end of 2015. Real economic growth will increase to 2.0 % under these conditions in the full year 2014 (also 2.0 % not adjusted for calendar effects). The economic pace should then slow to 1.6 % in 2015 (not adjusted for calendar effects, GDP growth will be much higher at 1.9 %, as 2015 will have

2.3 more working days on average throughout Germany than 2014). As a result, we are reaffirming the forecast we had already given for 2014 back in August of last year, while we are presenting a forecast for 2015 for the first time.

Healthy growth across a wide front – business investment finally on the rise

The real economic growth of 1.6 % can be seen as satisfactory, even if it means a slowing over 2014. On the one hand, it still exceeds the long-term average, but only slightly and thus minimising the risk of bottlenecks on the labour market. This is also a benefit for the sustainability of the recovery. The wide range of drivers is another positive factor. Consumer spending will continue to be a reliable pillar in both forecast years, and business investment is finally on the rise – supporting gross fixed capital formation beyond further increases in residential construction and a slight improvement in public-sector investments. The investments by businesses are getting a substantial boost from the improvement of the European and global economies and the recovery of German exports as a result. After two years of contraction, the eurozone should grow moderately by 1¼ % this year and next, while the global economy should improve by around 3¾ % in each of the two years. This falls well short of the boom years, but noticeably beats 2012 and 2013. The rising capacity utilisation as a result of the recovery of exports will boost business investment together with the favourable financing terms. Utilisation of industrial capacities at the start of 2014 has reached the level of the long-term average (83.4 %) for the first time in seven quarters. Experience has shown this to be a sign of a significant revival of investment. Business investment in 2014 will grow by around 6 % in real terms after two years of contraction, then by a good 4 % in 2015. In light of the widespread revival of domestic demand, imports this year and next will see stronger growth compared to 2013, which may contribute to reduce Germany's extremely high current account surplus (2013: 7.3 % of GDP) to a certain extent.

Setback in Europe and escalation in emerging countries the greatest risks

The greatest downside risk still lies in the possibility of a setback in Europe. Despite Ireland's return to the financial markets as well as the progress (institutional and otherwise) made in the establishment of a banking union for example, unsettling political debates over the currency union remain just as hard to rule out as recurring doubts over the sustainability of the consolidation, which could lead to further tension on the financial markets. On a global level, we could see an unexpected escalation of the financial market turbulence in the emerging economies, which the tapering announcement by the US Federal Reserve triggered in May of last year against the backdrop of some disappointing growth figures and internal structural problems in the emerging markets. This would stall the export recovery here at home, bring business investment back down and increase unemployment.

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