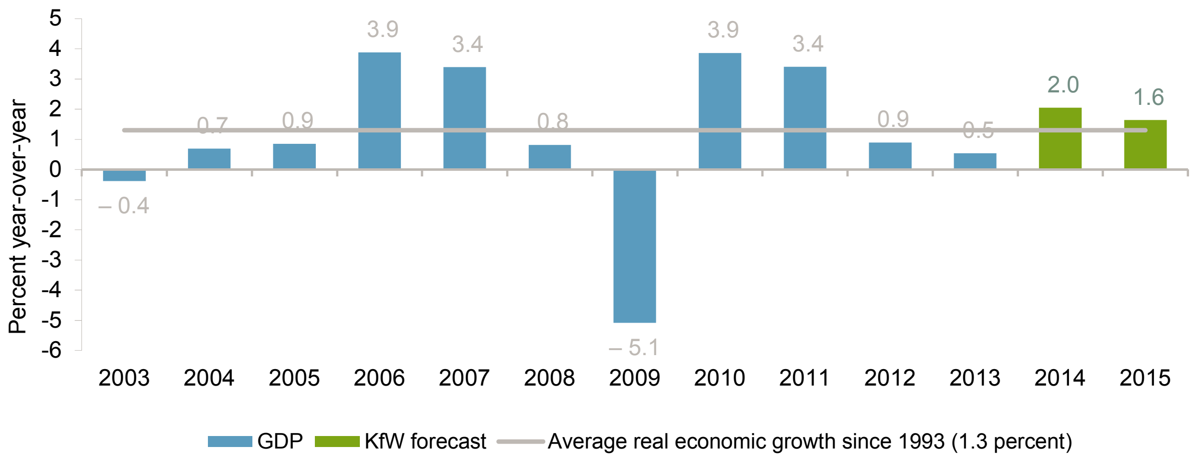
Frankfurt, 27th May 2014

KfW Business Cycle Compass Germany

German growth: return to cruising speed

- ***KfW reconfirms its economic forecast from last summer: In 2014 the German economy will grow by 2.0 %. In 2015 the growth adjusted for calendar effects will slow down to 1.6 %. European and international framework conditions prevent higher growth rates***
- ***Following the dream start due to the mild weather (+0.8 % in the first quarter 2014), growth in Q2 and beyond will be close to the trend rate (0.3 to 0.5 %)***
- ***Consumption and residential construction are benefiting from the good labor market and appropriate real wage increases, business investments are benefiting from the continued good sentiment, favourable sales prospects, increasing capacity utilisation and continually low interest rates. Despite the recovery in exports, a slightly negative growth contributionof net exports is expected as vivied domestic damand is increasing imports***
- ***The greatest economic risks are a strong euro, setbacks in Europe and an escalation of the crisis in Ukraine***

German gross domestic product, adjusted for price and calendar effects



Source: KfW Economic Research; data status national accounts: May 2014

Catapult launch into 2014

The German economy got off to a particularly strong start this year. Gross domestic product (GDP) [1] grew by 0.8 % in Q1 2014 compared with the previous quarter, growing at the fastest rate in three years. Positive impulses came exclusively from domestic demand, and thus

[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.

from public consumption (+0.4 %) and private consumption (+0.7 %), private residential construction (+3.8 %), business investment (+1.6 %) and public investment (+11.6 %). In contrast, net exports considerably reduced quarterly growth by 0.9 percentage points. The negative growth contribution of net exports, that is from the balance of exports (+0.2 %) and imports (+2.2 %), is not critical. Structurally it is due to vivied domestic demand. It allows imports to increase, creating demand for products from other euro area countries and thus supporting their recovery. In 2013, nominal imports of goods from these countries grew by 1.4 %, contrary to the trend (overall imports of goods: -1.1 %). Consequently, 38.4 % of Germany's imports over the last year came from the euro area, which is one percentage point more than in 2012. On the other hand, world trade was more or less stagnant at the start of the year, limiting export growth.

New strength domestic demand

Germany's new strength is its domestic economy. It protects us to a certain extent against the slowdown, above all in the emerging economies, as well as the economic risks in the international environment. It also contributes towards investing a larger share of national savings domestically and thus reducing the unhealthily high current account surplus of more than 7 % of GDP. Germany has by far the highest export share among the large industrialised countries. At 51 % of GDP (2013) it is twice as high as that of the G7 countries excluding Germany on average. As a result, the German economic cycle is very dependent on foreign countries without strong domestic demand.

Germany stronger through business investment

Companies can contribute significantly towards reducing the current account surplus. This would be very positive for Germany. While companies have built up net financial assets domestically over the last ten years (not including 2008) and as such have financed direct and portfolio investments overseas, we are perhaps facing a turning point. Private investments in machinery and equipment in particular have clearly returned to a positive economic trend, from stagnation in Q2 2013 to 2.9 % quarterly growth in Q1 2014. In future the companies will ideally become net borrowers again in order to finance real economic investments domestically, as was generally the norm until 2003.

Exports stagnate only temporarely

We are not concerned by the stagnating exports at the start of the year, since they also followed a leap in Q4 2013 (+2.5 %, a three-year high). This stagnation is easily comprehensible in light of the lack of quarterly growth in important export destinations (GDP in France and the US: 0.0 %, Italy: -0.1 %, Netherlands: -1.4 %). Meanwhile such temporary weak phases in important industrialised countries have a greater impact compared to the past as the global demand has become structurally less dynamic due to the necessary reform efforts in key emerging countries (above all in China). However, exports are expected to recover again soon. Zero growth in the US in Q1 was primarily due to the extremely cold winter. The economic outlook remains positive. Europe is also on route to recovery, albeit very slowly. Not least the companies themselves are confident: the ifo export expectations index has been moving in a positive direction for many months. Therefore we are expecting that exports will rise again in future, so that net exports will be less of a strain on growth than at the start of the year.

Onwards at normal cruising speed: KfW forecast for 2014 and 2015

However, irrespective of our cautious optimism for exports, the strongest quarterly growth rate for now is already behind us. According to our estimations, the German economy will return to normal "cruising speed" in the spring. In other words: the economic dynamic is expected to move close to the trend rate in Q2 and probably beyond, thus at quarterly rates between 0.3 and 0.5 %. Under the given circumstances this is satisfactory. Real growth will increase to 2.0 % in 2014 overall (also 2.0 % when not adjusted for calendar effects), as we have predicted since August last year. This would be the first notable increase in GDP for three years. In 2015 the economic pace is set to slow down to 1.6 %. Not adjusted for calendar effects, growth will however be considerably higher at 1.9 %, as there will be 2.3 more working days in 2015 than in 2014 (average of all federal states). Hence, we are not only confirming our forecast for 2014 but also for 2015.

Trend growth broad based

In line with the plateau that has been reached in the ifo business climate, we are not expecting an increase in economic growth despite a good domestic economy and the anticipated recovery of exports. There are various reasons for this:

- The euro area is continuing to grow, although the speed of the recovery is set to be slow in the medium term in light of the continued difficult framework conditions with high unemployment, small fiscal space, reluctand lending to companies in the reform countries and the latent risk of deflation. The euro area will probably not be able to grow by much more than 1 % this year and next year. Germany cannot completely detach itself from this, especially as the dynamic in the emerging markets as another key export destination is no longer reaching past peak levels. All the same, this is sufficient in order to better utilise German industrial capacities through a moderate recovery in exports – at the start of Q2 capacity utilisation was 84.3 %, the highest level in two years – and to provide an impetus for business investments. After falling for two years in succession, we expect business investments to grow at a rate of around 5 % this year and next year.

- Domestically – in addition to the revival in business investments – consumption and residential construction will continue to reliably support the economy. Key drivers such as increasing employment (+0.8 % year-on-year in Q1), noticeably higher agreed wages (negotiated increases 2013/14: +3 % and higher) agiast the backdrop of an ongoing very moderate rate of inflation (+1.3 % in April) and negative real interest rates continue to provide an economic tailwind. However, in Q1 there were also two special factors at work that are unlikely to be repeated. On the one hand construction activity was massively frontloaded due to the unusually mild weather. Furthermore, the strong increase in private consumption overstated the underlying fundamental trend due to a catch-up effect. In Q4 2013 consumption unexpectedly shrank. Below the line there is still a solid revival of domestic demand that is also increasing imports. Hence, net exports may contribute slightly negatively to economic growth this year and next year.

Setbacks in Europe and escalation of the Ukraine crisis are the greatest risks

The greatest downside risk still relates to setbacks in Europe. Even minor shocks could disrupt the fragile recovery in the euro area and disappoint expectations. A continually increasing euro exchange rate would be particularly difficult for the European export economy to absorb. The European Central Bank would therefore do well to boldly combat the deflation risks. The shift to the right in some EU member states during the European elections as well as the upcoming referendum on Scotland's independence in autumn are also factors contributing towards potential uncertainty for the whole of the EU. Despite the successful withdrawal of Ireland and Portugal from the financial support programmes, there is potential for further tension in the financial markets. At an international level, there are risks as a result of the persistent unclear situation in eastern Ukraine. It remains to be seen whether the newly elected president will be able to overcome the deep divides between the conflicting parties. A noticeable strain on the global economy might be expected in the event of an escalating sanctions spiral between the West and Russia. A significant deterioration of the international environment would damage the export recovery here in Germany, business investments would decline once more and unemployment would rise.

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