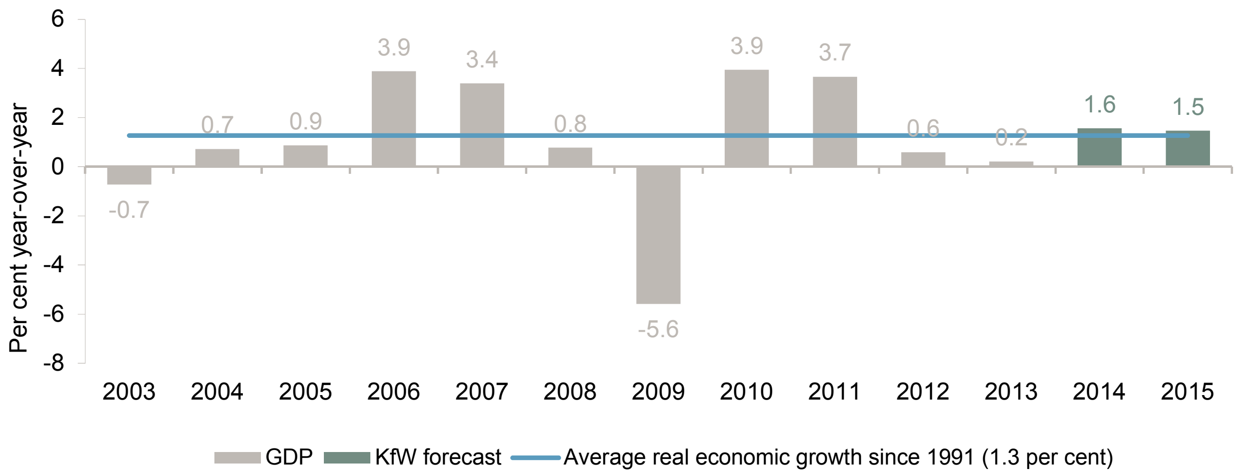
Frankfurt, 26th August 2014

KfW Business Cycle Compass Germany

German economy: stifled for now

- ***KfW revises its economic forecast for 2014 downwards – from 2.0 % to 1.6 %***
- ***The domestic economy (primarily consumption) is preventing an even heftier downwards correction for the time being. The eurozone is too weak, business sentiment is too low and the decline in gross domestic product for Q2 is too significant to hope for anything more***
- ***The risks are on the downside. Europe urgently needs a growth strategy for France and Italy, the German economy has grown considerably more slowly in the last two years than previously stated following the revision of the figures, and geopolitical tensions could continue to weigh down significantly on the budding investment appetite of companies***

German gross domestic product, adjusted for price and calendar effects



Source: KfW Economic Research, data status national accounts: August 2014

Decline in second quarter fundamentally overstated

The German economy shrank slightly in the spring. Gross domestic product (GDP)[1] dropped by 0.2 % in the second quarter of 2014 compared to the previous quarter – the first decline since early 2013. Only public and private consumption produced any positive stimulus, while investments and foreign trade were a drag on growth. Export growth was weak, which is understandable given the more sluggish global trade, but particularly in light of the fragile stability in the key domestic market of Europe. While some small and medium-sized

[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.

eurozone countries like Spain and the Netherlands have recovered, the heavyweights of France and Italy fell short of expectations. All told, the eurozone stagnated in the second quarter.

By contrast, the relatively strong growth in imports underlines the rude health of German domestic demand, especially consumption. That the decline in investment – especially in construction – is fundamentally overstated offers another ray of hope. Many construction projects were realized already in the first quarter thanks to the very mild winter, which means a “technical” slide was to be expected. Unfortunately this effect was greater than anticipated, pushing the overall quarterly GDP rate into the red after a robust start to the year.

The lack of momentum is a cause for more concern. The average quarterly growth in the first half of the year came in around ¼ % – this falls short of the long-term trend and shows that Germany too has recently lagged well behind its economic expectations.

Recent past weaker than thought

What is more, following the general revision of national accounts data[2], the first quarter of 2014 was adjusted downwards slightly (from 0.8 to 0.7 % compared to the previous quarter) while the previous two years were adjusted downwards significantly (from 0.9 to 0.6 % in 2012; and from 0.5 to 0.2 % year-on-year in 2013). This means the period after the end of the recovery growth stint that started in 2012 was considerably weaker than it seemed under the previous figures. Germany essentially stagnated in 2013. With exports accounting for roughly 50 % of GDP, the very open German economy remains vulnerable to the crisis in Europe, with efforts to decouple from the trend failing. It is therefore rather unlikely there will be any major recovery in Germany unless there is a noticeable improvement in the eurozone's position too – especially since there has been a structural slowdown in the emerging markets, which are therefore less able to compensate.

What brings the summer?

Germany is likely to grow again in the third quarter. If this growth falls short of roughly ½ %, the forecast figure of 1.6 % will probably be too ambitious. However, the overall effects on exports caused by sharp setbacks in business with Russia are probably manageable as long as the USA continues to grow. That said, the increasing scepticism is jeopardising the investment activity of companies in the second half of the year. The declines in the ifo business climate index send a clear warning, while capacity utilisation also fell again slightly at the start of the third quarter. On a positive note, however, the pace of consumption and housing construction in Germany is reliable thanks to the labour market (building permits rose by 9.6 % year-on-year in the first half of 2014). Foreign trade is being boosted by impulses from the USA, the UK, and possibly China too.

[2] Introduction of the European System of Accounts in the Version of 2010 (ESA 2010) and regular integration of base data available for the first time.

Recovery ahead – but will be sluggish for now: KfW forecast for 2014 and 2015

Under these circumstances we assume that growth will undergo a recovery again after the setback in Q2, which means average quarterly rates of 0.4–0.5 % are achievable over the forecasting period until the end of 2015. Thus the projected rate of annual growth for 2014 is 1.6 %, and 1.5 % for 2015 (in calendar-adjusted terms). Consequently, Germany could potentially record its most notable GDP growth performance for three years in 2014, despite the ongoing difficulties. Serious geopolitical risks have now come into play alongside the problematic economic obstacles in Europe.

Domestic economy still a reliable pillar

In our forecast we assume domestic demand will be stable. Increasing employment (0.9 % year-on-year in June), higher wages (collective agreements in 2013/14 of 3 % and more) a still very low inflation rate (0.8 % in July) and favourable interest rates are fuelling consumption and housing construction. A further devaluation of the euro could generate some tailwind. This is a likely scenario because the Fed will continue to scale back its expansionary course, while ECB policymakers will presumably maintain their very loose stance for some time to come given the latent deflationary trends in Europe. Even if this means we can expect a gradual revival of German exports over the forecasting period, net exports will likely curtail growth slightly in 2014 and 2015 because imports should grow somewhat more quickly than exports given the stable domestic economy.

Setbacks in Europe and escalation of geopolitical tensions the main downside risks

Most of the risks point downwards. Positive impetus from Europe is becoming increasingly unlikely without some help from economic policy, which is restraining any recovery in corporate investment. Geopolitical tensions may escalate further at the same time. Corporate investment could ultimately drop even more and the jobless rate could rise if the international conditions deteriorate significantly.

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