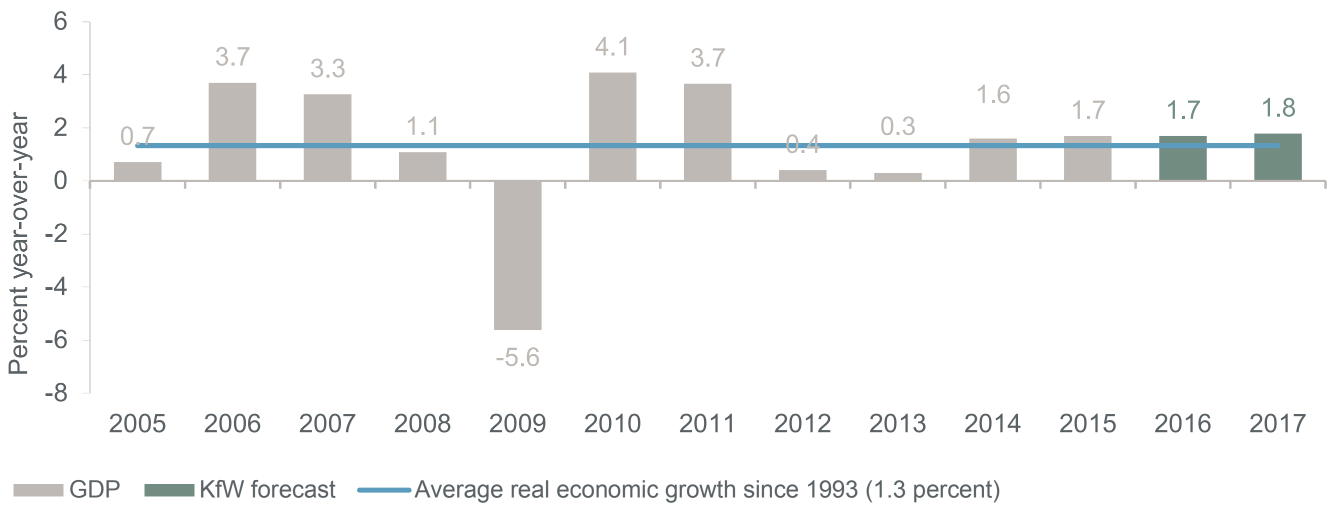
››› German economy to strengthen noticeably after weak spring

24 May 2016

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

- KfW Research forecasts 1.7 % growth for Germany in 2016 and 1.8 % in 2017; working day effects mask significant increase in growth momentum
- After a strong start to the year (+0.7 % on the previous quarter), the economy is taking a breather in the second quarter, but momentum will pick up again noticeably
- Domestic demand remains brisk, the external environment is gradually improving, and exports and corporate investments are on the rise
- Germany's real growth would turn out lower if the United Kingdom should decide to leave the EU or the global economy were to hit an unexpected roadblock

Germany's price-adjusted gross domestic product



Source: Destatis, KfW Research

Strong start to the year thanks to domestic demand

The German economy started the year 2016 off with a bang. In the first quarter, gross domestic product (GDP) adjusted for price, seasonal and calendar effects grew by 0.7 % on the previous quarter. This is not just the strongest quarterly rise in two years, but also roughly double the average increase of the four preceding quarters. Growth at the start of the year was bolstered exclusively by very brisk domestic demand. Private consumption (+0.4 %) and, in particular, gross fixed capital formation (+1.8 %) rose strongly. In contrast, foreign trade put a slight damper on overall growth. Exports did expand noticeably (+1.0 %) – which attests to Germany's enduring competitive success in what remains a rather difficult international environment – but less than imports (+1.4 %).

Economy takes a breather in the second quarter

As encouraging as this strong start to the year may be, it must be kept in mind that favourable weather conditions in the strong first quarter made the fundamental economic trend look better than it is. Once again, the winter was much too warm. That allowed construction projects to be completed without any major disruptions, as shown by the strong increase in construction investment (+2.3 %). As they were brought forward, these construction projects are missing in the second quarter and their absence will create a corres-ponding countermovement. In addition, industrial production and retail turnover moved into spring from a comparatively low basis after significant monthly declines in March. This shows the economy is taking a breather and we expect GDP growth of only around ¼ % in the second quarter.

Momentum will pick up again in summer

Quarterly momentum will probably pick up noticeably in the second half of the year already and linger at around a good half a percent on average in the further course of the forecast period up to the end of 2017. After all, the ingredients of a continuing solid German recovery are all still in the mix, especially on home turf:

- Both private consumption and private residential construction are benefiting from a growing workforce (+1.3 % on the previous year in the first quarter), rising real incomes (with collective wage increases estimated at around 2¾ % in 2016 and inflation at ¾ %), and persistently very low interest levels.

- Immigration is creating an additional need for affordable rental housing and order books in the construction sector are overflowing, with incoming orders up 10.5 % between December 2015 and February 2016 on the preceding three-month period.

- At the same time, fiscal policy is having an expansionary effect through a number of channels. Taxpayers felt tangible relief at the turn of the year (child allowance and tax-free threshold were raised, income tax rate thresholds were adjusted to offset the additional revenues from bracket creep in the years 2014 and 2015), on 1 July pensioners are set to receive the highest pension increase in 23 years (+4.25 % in the west; +5.95 % in the east of Germany), the government is correctly aiming to invest more, and public consumption expenditure is inevitably rising appreciably in response to the refugee influx. As Germany achieved the highest public surplus in the last four decades in 2015 – 0.6 % of GDP, an outstanding starting position –, the national budget will nevertheless remain roughly balanced despite the fiscal relief and additional expenditure.

A brightening external environment

Not only is the domestic economy set to remain vibrant, but the external environment is likely to continue brightening as well – irrespective of the fact that the recently rather more dampened ifo business expectations indicate continuing uncertainty among enterprises over the global economic outlook. The price of crude oil has now increased significantly from its lows in January (Brent Blend: USD 47.40 at the end of April; up 36 % since the end of January), slightly easing the burden on producing countries.

The picture of the developing and emerging market economies is currently characterised by a weak Chinese economy and recession in Russia and Brazil. This obscures the fact that many smaller countries are already recovering again this year. We expect the heavyweights to at least stabilise in 2017 and global economic growth to pick up pace then as well. Despite weakening impulses from the past euro depreciation, that will benefit German exporters and boost corporate investments as capacity utilisation increases.

KfW Research reaffirms forecast for 2016 and 2017

Under these conditions, the German economy can be expected to grow 1.7 % in 2016 and 1.8 % in 2017. KfW Research thus reaffirms its forecast of February, which is optimistic particularly with a view to 2017. At this predicted rate, Germany's real growth in both years will be reliably above the long-term trend growth of +1.3 % in post-unification Germany. The great variation in the number of working days from 2015 to 2017 also masks the fact that the upswing will gain considerable momentum in the forecast period. Adjusted for this calendar effect, Germany's real growth will rise from 1.4 % in 2015 to a forecast 1.6 % in 2016 and 2.0 % in 2017.

The necessary prerequisite: Bremain

Our economic optimism is contingent on the citizens of the UK voting for a "Bremain" in the June 23 referendum, that is, for the UK to remain in the European Union. In the light of the many recent political disputes, that would be more than just a positive signal for Europe as a whole. The fear of a long phase of uncertainty over the future relationship between Germany and its third most important export market, which is putting a damper on investment, would dissipate instantly. Exports to the UK in 2015 amounted to EUR 89.3 billion, representing 7.5 % of all German goods exports and just under 3 % of Germany's GDP.

Brexit and other significant downward risks

Although our main scenario assumes the UK will vote against a Brexit, this outcome is anything but certain. Opponents and supporters are still neck and neck. The risk of a Brexit is therefore substantial. If it materialises, Germany's real growth in 2016 and particularly in 2017 will likely be much lower than in 2015, especially because these conditions can be expected to cause renewed distortions on the global financial markets. Businesses would remain very anxious and probably more reluctant to invest and recruit staff. But this is not the only risk. Germany's upswing could be compromised by unexpected setbacks in the global restructuring and recovery process of emerging market economies and by resurging controversy in Europe over issues such as the refugee influx and unfavourable developments in the reforming countries, and by negative geopolitical developments, for example in case of new terrorist attacks. ■