››› Germany's economy is in good shape: solid growth despite Brexit vote

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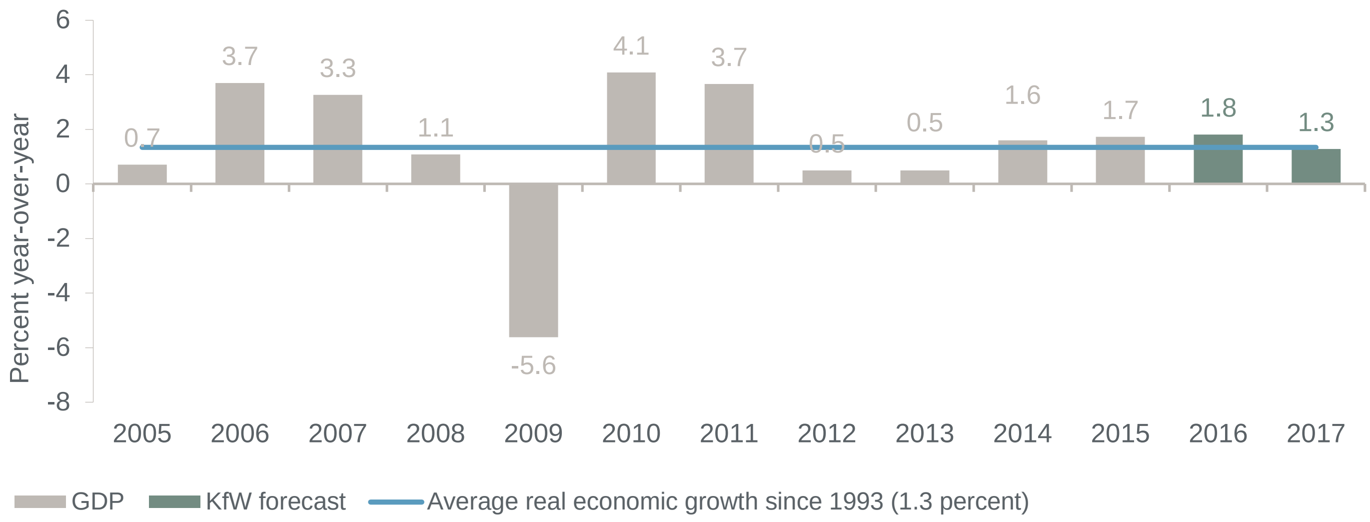
- The growth slowdown in the second quarter was weaker than expected. After the renewed +0.4 % rise on the previous quarter, we now see a strong first half.
- The good figures allow KfW Research to lift its forecast. The German economy will grow by 1.8 % in 2016 – in spite of the Brexit, which will dampen growth in the second half.
- Next year fewer working days will mean more free time for workers, but also lower growth. That will limit GDP growth in 2017 to only 1.3 %, but the underlying economic momentum will hardly diminish.
- Domestic demand will remain solid. Buoyed by the good employment situation, consumption and residential construction will expand reliably. Although the global economic environment is brightening, the Brexit will likely dampen export dynamics. As a result, the recovery of corporate investment will be weaker than was hoped for before the referendum.

Germany's price-adjusted gross domestic product



Source: Destatis, KfW Research

Second-quarter growth was better than expected

Following the very strong start to the year, a slower rate of growth was to be anticipated. Growth did slow down, but not as much as would have been expected after the exceptional winter construction boom brought about by unseasonably good weather. Rather, second-quarter growth still turned out slightly higher than the long-term average trend despite a clear drop in industrial production. Adjusted for price, seasonal and calendar effects, second-quarter gross domestic product (GDP) increased by 0.4 % on the previous quarter.

Again, consumption (up 0.3 %) proved to be what is now a familiar and reliable mainstay of growth. Gross fixed capital formation (down 1.5 %) fell as expected, following the positive leads of the first quarter. The strong decline in investment in machinery and equipment (down 2.4 %), however, is a negative which shows that the structural weakness of investment activity is not yet overcome. This time, the biggest contribution to growth came from foreign trade. Exports gained significantly (up 1.2 %), but imports fell slightly (down 0.1 %). That is a rare combination which last occurred in 2012 – one that will hardly repeat itself given the solid domestic demand within Germany, for which the outlook remains stable, and the engagement of German businesses with world markets.

German enterprises remain upbeat

From an economic perspective, the first half-year of 2016 was generally a very good one for Germany. However, the UK vote to leave the European Union has created a significant downside risk. We still do not know much more about the consequences of the Brexit vote on the German economy than in late June. Initial hard economic data for July will be published together with retail turnover and labour market statistics on 31 August, and figures on industrial production and new orders will be released in early September. What is pleasing is that the feared panic reaction on the financial markets did not occur – just as we had hoped. Sentiment among domestic companies has also remained positive. As expected, the ifo business climate fell only slightly in July and the preliminary purchasing managers' index of August (composite) reflects the average for the year so far.

Outlook for the domestic economy remains good

The robust state of the German economy is indicative of an enduring healthy domestic climate. Employment is growing further, expanding by 1.2 % in the second quarter on the previous year, interest rates are extremely low, and on 1 July pensioners received the highest pension increase in the last 23 years. That is bolstering private consumption as well as residential construction, which is receiving additional impetus from immigration. After the temporary drop in the second quarter, construction activity can be expected to regain momentum in the months ahead. Anything else would be a disappointment in view of the exceptionally high increase in construction permits of over 30 % in the first half of the year. The state will also expand its consumption expenditure in response to the refugee influx, as public budgets have adequate scope for spending.

Brexit dampens growth through the export channel

Nevertheless, we continue to expect the pace of growth to slow down as a result of the Brexit vote, especially up to the end of the year. The impact on the UK economy will be noticeable. The purchasing managers' index for the service industries, for example, has seen the sharpest drop since 2009 and is now well below the 50 mark delineating expansion from contraction. In simple terms, this will bear on the 2017 growth rate. We expect UK growth to remain below half a percent. The growth weakness in the second half of 2016 will influence growth in the coming year owing to the statistical carry-over effect.

That will not leave German export growth unaffected. After all, the UK is a very important market for German enterprises. In 2015, exports worth a total of EUR 89.3 billion went to the UK, which represents 7.5 % of all German goods exports and nearly 3 % of German GDP. Export growth should therefore cool off despite the gradual improvement of the situation in the developing and emerging market economies, especially since the upswing in the remaining euro area countries is also slowing down and a further important trading partner, Turkey, is undergoing a phase of increased political uncertainty following the coup attempt. The weaker export trend will also limit the upward potential of what is already structurally (too) weak corporate investment.

Strong first half – KfW Research lifts forecast for 2016; more holidays will slow growth rate in 2017

In short, our assessment of the consequences of the Brexit vote has not changed since we published our unscheduled forecast update in July[1]. On the basis of unexpectedly strong figures in the first six months, however, we still lift our forecast for the year 2016 as a whole to 1.8 %. Economic momentum will pick up again in 2017 after the immediate impacts of the Brexit vote have subsided. Nevertheless, KfW Research expects a significantly lower annual growth rate for Germany of 1.3 %. Roughly four fifths of the growth decline, however, can be attributed to the higher number of holidays. Next year there will be three fewer working days. In addition to the Christmas holidays falling on weekdays, employees will also have one additional holiday on 1 May and a one-time special national holiday on 31 October in observance of 500 years of Reformation.

Downward risks remain, but so do opportunities for unexpected positive development

Our economic forecast is subject to symmetrical upward and downward risks. Increased political controversies in Europe over refugee migration or the proper treatment of banks in distress can impair growth. The same applies to adverse geopolitical developments, such as in Ukraine. Additional growth impetus is conceivable should the residential construction sector receive a stronger than expected boost or if global economic momentum accelerates more quickly. ■

[1] KfW Business Cycle Compass – Brexit Update, https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-KfW-Konjunkturkompass/PDF-Dokumente-KfW-Konjunkturkompass-EN/KfW-Konjunktukompass_Brexit-Update_2016-07_EN.pdf, 11 July 2016