KfW Research
KfW Business Cycle Compass Germany

››› Germany's economy in 2017 and 2018: staying the course amid high risks

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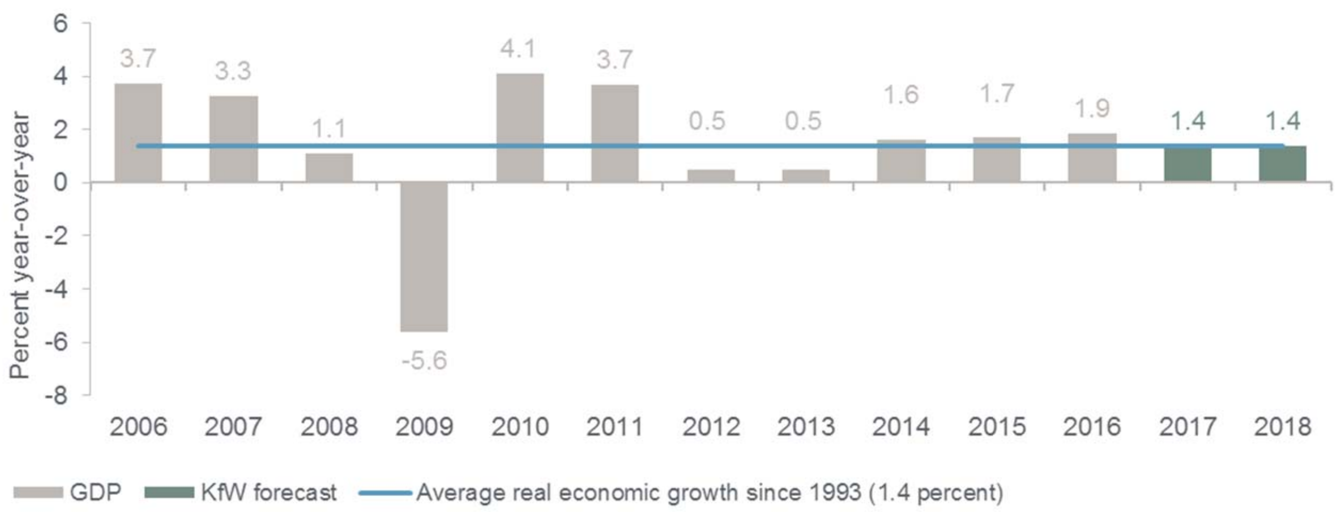
- The fourth quarter of 2016 brought the expected recovery; thanks to consumption and residential construction, the German economy grew by 0.4 % on the previous quarter; in the first quarter of 2017 the quarterly momentum should even rise to 0.6 % for the short term.
- KfW Research now forecasts real growth of 1.4 % for 2017 (previous forecast: 1.3 %) and 1.4 % for 2018 as well (initial forecast); that would make the most recent upswing one of Germany's longest since the 1970s.
- Irrespective of the more moderate increases, private consumption and residential construction continue to drive the economy; a variety of global imponderables are preventing a strong upturn in business investments for now; the growth contribution of external trade remains negligible while exports and imports are rising.
- Forecast uncertainty is high – the situation can deteriorate significantly if important trading partners adopt protectionist plans, or if Europe destabilises further; if these risks dissipate, growth may be significantly higher once the investment backlog is eliminated.

Germany's price-adjusted gross domestic product



Source: KfW Research, Destatis

Strong growth in the winter half-year 2016/2017

The German economy recovered noticeably in the final quarter of 2016. Adjusted for price, seasonal and calendar effects, fourth-quarter gross domestic product (GDP) increased by 0.4 % on the previous quarter after growth had nearly come to a standstill in the summer in the wake of the UK's unexpected vote to leave the EU (+0.1 %). Compared with the previous quarter, the strongest impetus was generated by consumption (+0.5 %) and private investment in residential construction (+1.6 %), while external trade weighed on growth (-0.4 percentage points). Business investment dropped for the third consecutive quarter (-0.3 %), signalling ongoing, substantial uncertainty among enterprises. Irrespective of this, the prospect for continued strong growth remains good in the short term. We expect GDP growth to accelerate to 0.6 % in the first quarter of 2017. This is corroborated not only by the extraordinary momentum of incoming orders in the fourth quarter of 2016 (+4.3 %, the highest quarterly increase since the second quarter of 2010), but also by the very good recent sentiment

Note: This paper contains the opinion of the author and does not necessarily represent the position of KfW.

indicators such as, in particular, the PMI indexes and the February situation assessments under the Ifo Business Climate Index.[1]

KfW's forecast for 2017 and 2018

As the outlook for the first quarter is now more optimistic, we have revised our real growth forecast for 2017 upward slightly to 1.4 % (previous forecast: +1.3 %), after last year's GDP grew by a noteworthy 1.9 % in a difficult international environment. The slowdown by 0.5 percentage points on 2016 considerably exaggerates the actual weakening of the cyclical momentum as around three quarters of it is due exclusively to substantial variations in the number of working days. Our forecast sees the underlying momentum as slowing only moderately this year – a trend that is likely to continue in 2018. Our initial GDP growth forecast for the coming year is 1.4 % as well.

Upswing is steady

The current upswing would thus come to at least nine years of uninterrupted growth, which would make it one of the longest periods of growth since the outbreak of the first oil crisis in the mid-1970s. Even in terms of strength – measured by an expected overall GDP growth of a good 18 % from the recession low of 2009 to 2018 – it could keep up well with the other upswing phases over nearly five decades past. Only the upswing from 1982 to 1992 was slightly longer – ten years – and significantly stronger (+35 %). However, in its late phase it benefited from what was probably a historically unique situation: the very strong demand surge triggered by the fall of the wall and Germany's unification.

Domestic demand remains the main driver

Domestic demand remains the main driver in our economic outlook for 2017 and 2018. Consumption expenditure and residential construction are likely to continue growing at particularly healthy rates in both years, even if the growth will presumably slow by comparison with 2016. Lower increases will result not only from slower employment growth but also from rising inflation, which will subdue real wage growth. The gradual rise in interest rates since the US election should also slightly dampen what has so far been very strong residential construction activity. Nevertheless, financing costs remain extremely low in a historic context, and the need for new housing remains high, not least as a result of immigration.

Risks are weighing on business investments

Businesses currently have to be mindful of adverse influences in their investment decisions. The now very high industrial capacity utilisation (86.0 % at the start of the first quarter of 2017, the highest level since late 2008), the solid global economic outlook and continuing favourable borrowing conditions would suggest a strong investment upturn. But the various global political uncertainties are making decisions difficult. We therefore expect business investments to rise only moderately at first in 2017 and potentially accelerate in 2018. For many businesses it may be prudent to hold off on new projects at least until the real consequences of Brexit and the new trade policy plans of the USA become clearer. The growth contribution of external trade should be negligible both this year and next. Exports should recover slightly, not least because important emerging economies such as Brazil and Russia will probably be able to shake off their recession. At the same time, however, Germany's imports will increase noticeably on the back of domestic demand, which is clearly set for continued growth.

Forecast is fraught with downward risks ...

Our key scenario for the economy in 2017 and 2018 is subject to significant forecast risks, both upward and downward. Downward risks would materialise if the USA and the UK, as important partners in trade and direct investment, were to strictly follow through with their isolationist plans regardless of the significant damage they would inflict upon themselves, while the centrifugal forces in continental Europe continue to increase. Given the time lag in the implementation of protectionist measures, a significant drop in real growth would have to be expected in this case, especially for 2018.

... as much as with upward risks

Conversely, the upswing could also gather greater momentum than anticipated under the main scenario already this year. For this to occur, the political risks would have to be reduced relatively fast. In specific terms, this would require: pro-European election outcomes in the Netherlands and France, fair negotiations with the UK on a viable separation from the EU, and credible steps on the part of the US to avert a collision course over trade policy. At the same time, the remaining 27 EU member states need to adopt a convincing strategy for the future of the EU as fast as possible. In this positive scenario, businesses would abandon their wait-and-see attitude and probably ramp up their investments significantly. ■

[1] The slump in industrial production in December (-3.0 % on the previous month) does not contradict this. Rather, the characteristics of the seasonal adjustment procedure applied to industrial production in combination with last year's holiday situation pushed the statistically reported output result downward artificially. Thus, December 2016 had a nominal 21 working days because Christmas and New Year's each fell on a weekend. That meant an above-average number of working days for a December which, accordingly, formed the basis for the seasonal adjustment. Actual production, however, was probably significantly lower than is usually the case on 21 working days because a large number of workers took leave between Christmas and New Year's, or businesses were closed during this period. Because the seasonal adjustment procedure is typically based on average values, it can only inadequately take account of this holiday effect, which is why the indicator underestimates actual production trends for a short term in this case. A significant countermovement can be expected already for the January production result (to be published on 8 March), which will positively impact real GDP growth in the first quarter of 2017.