››› Germany's real growth in 2017 and 2018: heading for two per cent

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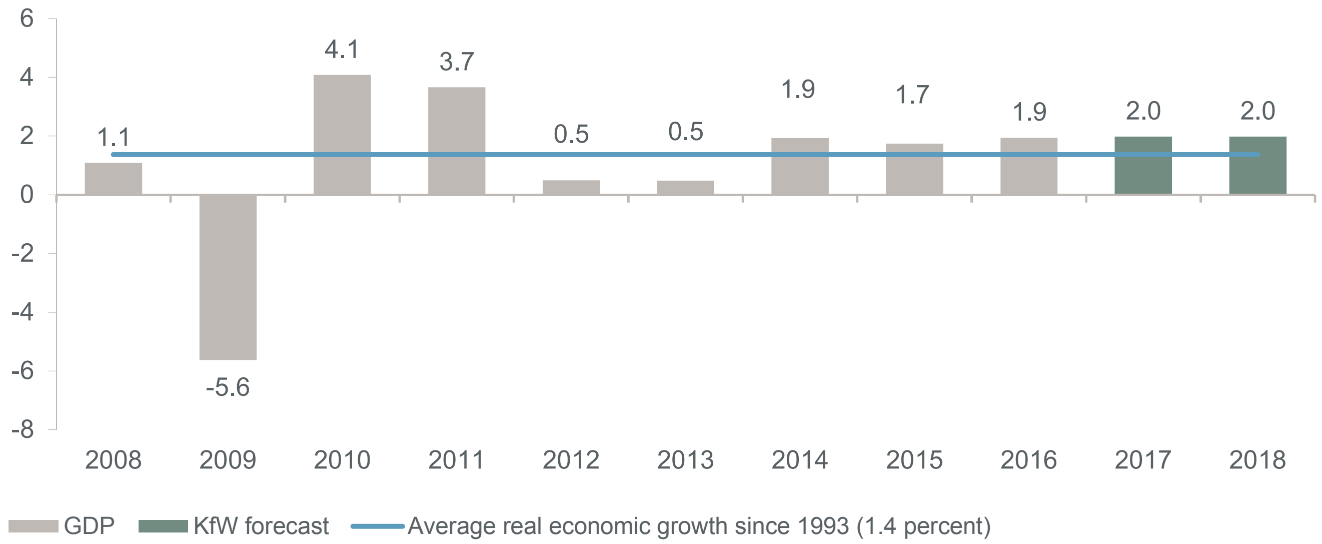
- The first half of 2017 saw a strong upturn; growth in the first quarter had been revised upwards to 0.7 %, second-quarter growth was insignificantly lower at 0.6 %; real growth momentum is set to pick up slightly again in the third quarter
- KfW Research now expects real growth of 2.0 % for both 2017 and 2018 (previous forecast: 1.6 % for each year); that would make 2018 the fifth consecutive year in which the rate of Germany's growth exceeds the long-term trend
- Exports benefit from the broad recovery in Europe and around the world, but domestic demand remains the main driver; high, growing capacity utilisation is spurring a noticeable revival in corporate investment
- The unclear direction of US economic and foreign policy might dampen the cyclical upturn unexpectedly, especially if geopolitical tensions intensify noticeably; Brexit negotiations are another risk factor; upturn might also turn out stronger if euro area makes progress in structural reforms

Germany's gross domestic product

Variation on previous year in per cent, adjusted for price effects



Source: KfW Research, Destatis

A convincing first half of 2017

The German economy looks back on a cyclically strong first half of 2017. Adjusted for price, seasonal and calendar variations, second-quarter gross domestic product (GDP) increased by 0.6 % on the previous quarter. According to new figures released by the German Federal Statistical Office, first-quarter GDP growth was now 0.7 %, 0.1 percentage points higher than the first estimate reported in May. Just as pleasing as the persistently high growth rate is the growth structure, as the economy now firmly rests on two pillars – domestic and foreign demand. In spring the domestic economy again provided the strongest impetus, with both gross fixed capital formation (+1.0 %) and private consumption (+0.8 %) picking up noticeably. But exports continued on a growth path as well, benefiting from the broad recovery in Europe and around the world (+0.7 %). External trade, however, nevertheless dampened quarterly growth by 0.3 percentage points because the dynamic domestic economy pushed imports even more strongly upwards (+1.7 %). Given Germany's already very high current account surplus, we see the import-driven decline in the external trade balance as a welcome development.

An autumn boom

There is a good chance that real growth will pick up again in the third quarter and roughly match the rate recorded at the start of the year. It is not just the excellent business confidence at the beginning of the second half that points to an autumn boom. For the third time this year, the KfW-ifo business climate indicator for SMEs reached a new all-time high in July. Confidence levels among large enterprises and export expectations are not far behind any more either, having improved significantly in recent months. The rise in incoming orders in the second quarter to 0.8 % quarter-on-quarter (first quarter: -1.0 %) also points in this direction, with demand from the euro area rising at a particularly strong rate of 2.6 % in spring. The confidence crisis in the automotive industry does constitute a risk. But we do not rule out the chance that the trade-in premiums – promised on the occasion of what has been referred to as the 'diesel summit' – on the purchase of a low-emission new car will generate short-term pull-forward effects in private consumption.

Significant upward revision – half due to revised data

Overall, the broad improvement of the external environment, soaring confidence levels across the business sector, and the annual benchmark revision performed by the German Federal Statistical Office have prompted us to revise our economic forecast for 2017 and 2018 significantly upward to 2.0 % for each year (previous forecast: 1.6 % for each year). As every year in August, the German Federal Statistical Office has revised all the time series for the past four years on the basis of underlying statistical data material now available for the first time. Half of our upward revision for 2017 is due to this new official dataset alone and thus based on historical data.[1] That leaves a 'genuine' 0.2 percentage points more optimism compared with our previous forecast of May.

Exceeding trend growth for at least five years

If we include 2018, our forecast sees at least nine years of uninterrupted real growth for Germany (since 2010), the last five of which (since 2014) with very stable annual GDP growth rates of 2 % or slightly less. At these quite strong increases well above the long-term trend rate of around one and a half per cent, aggregate production capacity utilisation will rise to increasingly higher levels. According to a survey by the ifo Institute, industrial capacity utilisation was already at 86.7 % at the beginning of the third quarter, the highest level since spring of 2008.

Corporate investment is picking up

We therefore expect a steady revival in corporate investment this year and next, especially since financing conditions will remain at historically low levels despite the fact that borrowing costs are likely to rise somewhat in the future. If Germany's upswing is to remain robust beyond 2018, its capital stock will have to be expanded significantly, otherwise the economy would be at risk of gradually overheating. Overall, domestic demand will remain the main driver, as spending on consumption and residential construction should continue to point steadily upward – not least because wage levels are set to rise more strongly because of increasing labour shortages. The upswing generally rests on a very broad foundation. Exports should continue to recover on the back of an improving European and global economy. At the same time, strong domestic demand is generating high import momentum, however, leaving the growth contributions of external trade hovering around the zero line.

Risks on both sides

As always, our economic forecast is subject to symmetrical upward and downward risks. At global level, geopolitical factors prevail, including the possibility of renewed escalation of the North Korea conflict. In addition, introverted policy initiatives and protectionism – originating primarily from the USA – might gain ground as well. That would not just have negative effects on trade but would likely lead to less political cooperation as well. Within the euro area, economic growth could unexpectedly suffer from the situation in Italy in particular. An anti-European election outcome coupled with the European Central Bank's exit from its asset purchase programme would likely send Italy's funding costs soaring quickly. A less favourable development in Europe is also possible should the Brexit negotiations get out of hand and again create uncertainty. A renewed increase in the influx of refugees, with the accompanying political controversies, might also cloud the economic outlook. But growth in Germany – and in Europe overall – might even turn out higher, especially in 2018, should the euro area make further progress in structural reforms. ■

[1] Even if future expectations had remained unchanged we would have had to revise our economic forecast for 2017 upward by 0.2 percentage points because the cyclical momentum of the recent past now presents itself as more vigorous than before the revision. The updated data show stronger momentum carrying over from 2016 (statistical overhang now 0.6 instead of 0.5 percentage points), while the second one tenth comes from the previously mentioned upward revision for the first quarter of 2017.