»› The German economy is moving ahead at full steam into the year 2018

30 November 2017

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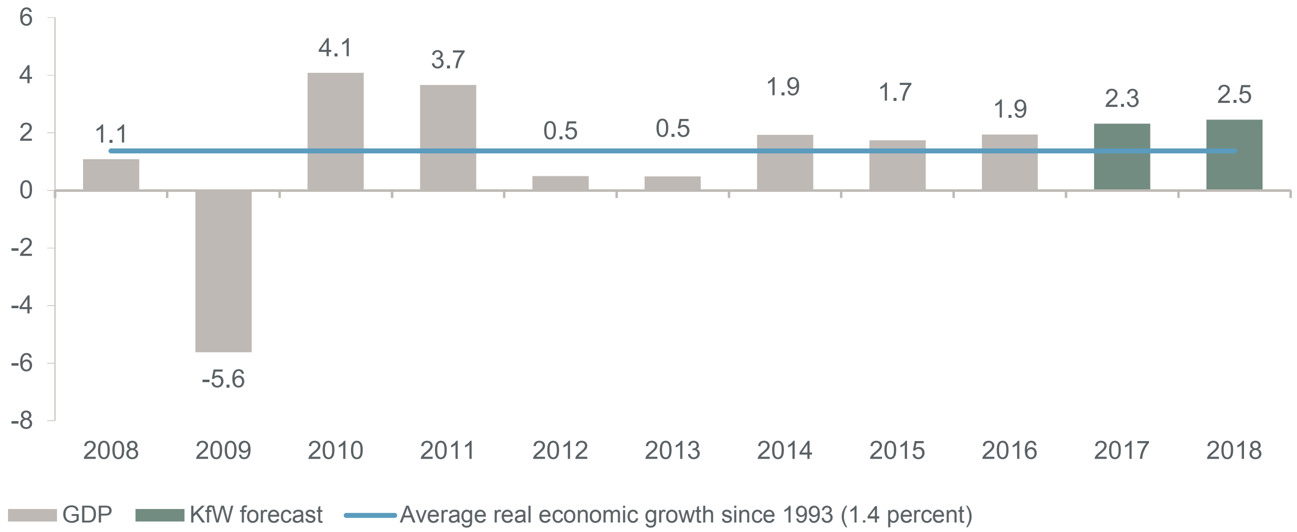
- 2017 has been a year of steady, robust growth: After 0.9 % in the first and 0.6 % in the second quarter, real growth accelerated to 0.8 % in the third quarter and is likely to maintain this momentum in the final quarter as well.
- KfW Research now expects real growth of 2.5 % for 2018 and 2.3 % for 2017 (previous forecast: 2.0 % for each year); despite the strong upturn, wages and prices show no signs that the economy might run hot any time soon
- Export growth driven by a strengthening recovery in Europe and around the world has combined with stable domestic demand to ensure steadily rising levels of capacity utilisation, generating outstanding business confidence and driving corporate investment
- The Brexit negotiations and unclear direction of US policy remain the primary risk factors with the issue of protectionist measures still on the table; the challenging task of forming a new German government, however, is hardly likely to affect the business cycle in the short term

Germany's gross domestic product

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



Source: KfW Research, Destatis

A summer of strong growth

The German economy moved up a gear during summer. Adjusted for price, seasonal and calendar variations, third-quarter gross domestic product (GDP) grew by 0.8 % on the previous quarter. The current pace of growth exceeded that of the robust second quarter (+0.6 %), resuming the unusually strong momentum at the start of the year. With the newly released GDP figures, the German Federal Statistical Office revised real first-quarter growth upwards again for the second time since May, this time by 0.2 percentage points to now 0.9 %.

In the third quarter, corporate investment provided particularly positive growth impetus (+1.3 %). Private residential construction investment rose as well, but not as much as in the preceding quarters (+0.5 %). In contrast, consumption took what will probably be just a short breather (-0.1 %). Exports continued on a path of accelerated growth (+1.7 %), benefiting from the stabilising recovery in Europe and around the world. In purely arithmetic terms, external trade contributed 0.4 percentage points to quarterly growth because imports grew much more moderately by comparison (+0.9 %).

2017 will end with continuing high quarterly momentum

The economy is set to continue growing at a fast pace in the final quarter of 2017; we expect GDP to rise by another 0.8 %. It is not just the outstanding business confidence that is pointing to strong economic performance in autumn and at the start of winter. Hard data such as incoming orders in the manufacturing industry were also on much higher levels in the third quarter, rising 3.6 % on the previous quarter (second quarter: +0.8 %), creating very good conditions for further significant expansion of production. The fact that incoming orders signal strong increases in both domestic (+3.1 %) and international demand (+3.9 %) is particularly pleasing. That shows the economy is on very firm footing. With continuing strong employment growth (third quarter: +1.5 % on the same quarter in the previous year) and rising wages per worker (third quarter: +2.8 % on the same quarter in the previous year), consumption is also expected to pick up again and remain clearly on an upward trend during the forecast period. The outlook for residential construction is also very good – not just for the present quarter but well beyond – given the very high number of 600,000 building permits issued and waiting for implementation.

Forecast for 2017/2018: real growth of more than 2%

With respect to annual GDP growth we have revised our forecast for 2018 to 2.5 % (previous forecast: +2.0 %). The German economy is likely to have grown at a similarly strong rate of 2.3 % in the year now ending[1] (previous forecast: +2.0 %). Part of this significant upward revision is owed to the newly released official dataset and thus merely of technical nature.[2] Nevertheless, that leaves noticeably more ‘genuine’ optimism for 2018 compared with our previous forecast of August. Our prediction reflects the continuing European and global recovery and the steady upward trend of domestic demand in Germany.

Low-risk of imminent overheating

Including the year 2018, we forecast at least nine years of uninterrupted real growth in Germany (since 2010), the last five of which (since 2014) with quite strong GDP growth rates around the two per cent mark. As these rates of growth are well above the potential rate of a good one and a half per cent, aggregate production capacity utilisation is reaching increasingly higher levels. Nevertheless, we do not see any risk of the economy overheating any time soon, even if an important industry indicator such as manufacturing capacity utilisation reached 87.1 % at the beginning of the final quarter, the highest level since 2008. The main indication the German economy is not at risk of overheating is the absence of price and wage pressure. So far, no economic observer expects inflation of more than 2 % for 2018 (the current consensus is 1.6 % in a forecast range of 1.3 to 2.0 %). In the coming year, growth of collectively agreed wages is expected to average 2.6 %, and, taking into account the growth trend in labour productivity of recently around 1% per year, that will not have a destabilising inflation impetus either based on the ECB’s inflation target of close to 2 %.

Capacity set to be expanded further

Furthermore, aggregate economic production capacity, which is limited by the availability of labour and capital as production factors, is not a constant but likely to be expanded further during the forecast period. Corporate investment has already picked up noticeably. In the face of rising export and domestic demand, this development will probably continue at a somewhat faster pace in 2018, particularly since borrowing conditions remain favourable in a historic comparison. It is true that labour shortages are already becoming apparent in some occupational groups. Migration from other EU states into the German labour market is counteracting the occurrence of severe shortages across the economy as a whole, however, and with rising labour participation of older and female persons it is ensuring that the factor labour can also continue to grow in Germany.

Difficulty in forming government is not affecting upturn

The challenging work of forming a new government after the failure of the ‘Jamaica’ talks is hardly likely to affect the cyclical upturn in the short term, especially since Germany still has an experienced, functioning government. This can be concluded not least from developments in other European countries. Unexpected political events (such as the Brexit vote) and lengthy processes of forming government after parliamentary elections, such as in the Netherlands with 209 days, Spain with 315 and Belgium with an even longer 541 days, did not leave any immediate skid marks on the business cycle there either. In the longer term, however, the risks are higher because important structural challenges in Germany and Europe cannot be tackled effectively without a fully functioning government. The Brexit negotiations and the unclear direction of US foreign and economic policy thus remain the most important risk factors for the business cycle in the coming year. The US continues to regard trade imbalances as being caused by its trading partners, so the issue of protectionist ‘countermeasures’ which could also affect Germany is anything but settled. ■

[1] In the year 2017, Germany has around three fewer working days on average than in 2016, which takes away 0.3 percentage points from annual growth for 2017 (calendar effect). Next year, however, the calendar effect will be almost negligible. The GDP growth rates we have forecast thus equate to calendar-adjusted real growth of 2.6 % in 2017 and 2.5 % in 2018. In other words, the purely cyclical growth rate is nearly the same in both years.

[2] Even if our 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 even more vigorous than on the occasion of our previous forecast in August, after the renewed strong upward revision for the first quarter of 2017 and our moderate underestimate of real growth momentum in the third quarter of 2017 (which we had expected to be 0.7 %). The now significantly higher statistical overhang effect of 1.2 instead of 0.9 percentage points accounts for around half of the upward revision to our forecast for average annual growth in 2018.