KfW Research
KfW Business Cycle Compass

Pre-crisis level coming into sight but supply bottlenecks are slowing the recovery

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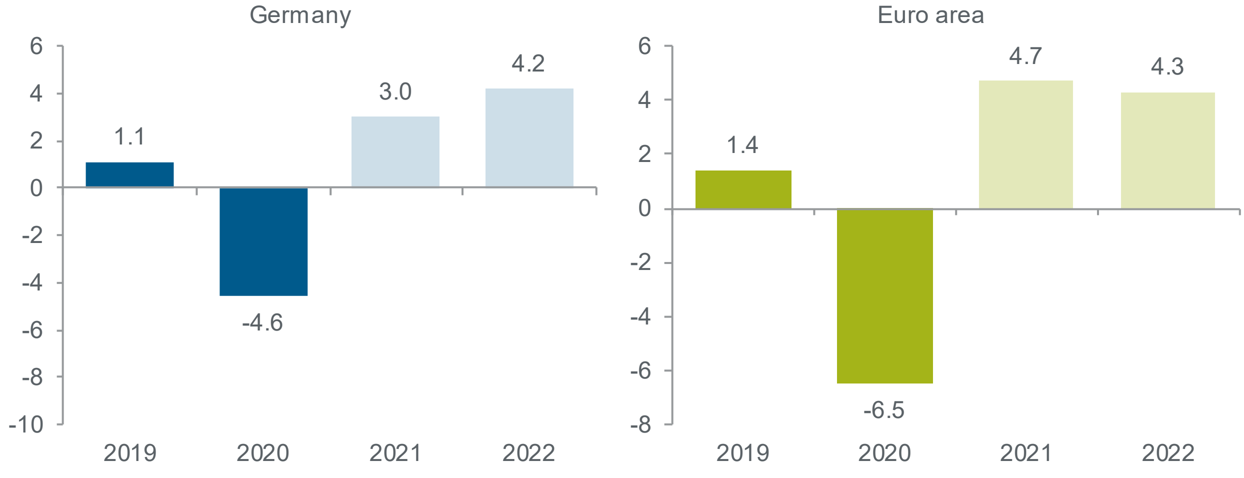
– Growth is back. Thanks to the at times marked fall in the number of infections, the economy recovered in the second quarter, with German GDP growing by 1.6% and euro area output even by 2.0%.
– The current quarter is set for strong growth. But the Delta variant and, in particular, persistent supply shortages serve to limit upside potential. Still, German GDP is set to slightly exceed the pre-crisis level at the end of the year.
– KfW Research now expects price-adjusted growth of 3.0% in Germany for 2021 (previous forecast from May +3.5%). The statistical overhang and a large backlog of industrial orders are set to generate a plus of 4.2% in 2022 (previously +4.0%).
– Driven by vigorous catch-up growth, euro area GDP will likely grow by 4.7% in 2021 (previous forecast +4.5%), followed by 4.3% in 2022 (previously also +4.3%).
– Downside risks are posed by, among other factors, the course of the pandemic and the currently sluggish vaccination pace in Germany.

Figure 1: Growth of gross domestic product in Germany and the Euro Area
Variation on previous year in per cent, adjusted for prices



Source: KfW Research, Destatis

German GDP is growing again

The German economy returned to growth in the second quarter of 2021, with GDP expanding by 1.6% (adjusted for price, seasonal and calendar effects), after contracting by 2.0% in the first quarter. While the 'federal emergency brake' *(Bundesnotbremse)* was still applied in many places in April, infection rates fell dramatically from May onwards thanks to an accelerated vaccination rollout. Towards the middle of the quarter, major reopenings became possible and were emphatically welcomed by consumers. On the demand side, private (+3.2%) and public consumption expenditure (+1.8%) were the main drivers of growth. Retail, transport and hospitality, the sector previously hit hard by restrictions, experienced strong growth in gross value added (+1.1%). Manufacturing and construction, on the other hand, were again hit by shortages of supplies of materials and inputs. Gross value added in manufacturing fell by 1.3%. Construction managed to pick up by 0.1% on a quarterly average but the only contributing factor was a statistical overhang resulting from strong growth in March, which made up for the slump caused by adverse weather conditions at the start of the year. Construction output fell during the quarter, however, also likely due to shortages of materials.

Supply shortages will put the brakes on manufacturing for some time to come

The supply of materials and inputs will remain the limiting factor for construction and, in particular, industrial output for the remainder of the year as well. In a survey conducted by the ifo Institute in July, almost two thirds of industrial firms complained about production disruptions from a shortage of inputs. In construction, the situation did improve slightly in July on the preceding month but the share of companies affected by material shortages remains many times higher than in all previous years since unification, at around 49% in building construction and 34% in civil-engineering. The current bottlenecks affect a wide range of products. The shortage of semiconductors is particularly serious, however, which is why the manufacturers of electrical equipment are hardest hit (84.4%). But 83% of manufacturers of motor vehicles and automotive parts are also primarily blaming the semiconductor shortage for their production disruptions. A drastic decline in automobile production has also been the primary driver of the almost continuous decline in manufacturing output since the start of the year, which according to the latest data of June has been just under 93% of the pre-crisis level of February 2020. Still, there are positive signs from manufacturing, especially with respect to demand for German products. New orders received in June were already 11% above the pre-crisis level. And the ifo business climate in the manufacturing sector is also outstanding despite a dampener in July and August, with enterprises reporting an extraordinarily good business situation with predominantly positive expectations. And survey-based indicators that map production activity specifically are actually pointing to an expansion as well. Thus, the production expectations surveyed by the ifo Institute for the next three months are on an unusually high level. Given that ‘hard’ early indicators such as the truck toll index actually point to a renewed drop in industrial output at the beginning of the quarter and the semiconductor shortage in the automotive industry persists, industrial value added can be expected to be just slightly positive at best in the current quarter. Material shortages will subsequently continue to limit growth as well, since new production capacity and the recovery of transport capacities can ease the situation only gradually. But without any new supply-side shocks, the manufacturing industry is expected to make a significant contribution to growth again from the fourth quarter onwards.

Service providers as drivers of growth in Q3

Yet, the services sector is set to provide major growth impetus again in the current quarter. While many businesses had to remain closed at the beginning of the second quarter, foot traffic in inner cities and visits to retailers, hospitality venues and recreational facilities registered by Google have been near or above pre-crisis levels since July. Thanks to additional savings built up during lockdown periods, some consumers will be somewhat more eager to open their wallets. Domestic tourism is booming as travel warnings and quarantine rules are making international travel more difficult. Accordingly, sentiment indicators from the services sector point to a vigorous start to the summer quarter. However, declining vaccination rates and the spread of the Delta variant are leading to a rapid and continuous rise in new infections, which is a cause for concern. Infection risks are also likely to increase after the end of the school holidays and due to seasonal factors in autumn. But since infection risks can be contained with face coverings, tests and, in particular, vaccination, broad closures of retail outlets or hospitality venues are now rather less likely. The fact that some countries, for example the Netherlands and Spain, have broken the first Delta wave with only minor restrictions is also cause for hope. Germany is likely to postpone further relaxations, however, and moderate voluntary consumption restraint is likely to limit the upside potential in critical services segments until next spring. But what will be crucial for a milder pandemic progression in the course of the winter half year is continuing vaccination progress, which presupposes that low-threshold offers, political pressure and the increased likelihood of infection can still increase the vaccination rate significantly.

Forecast for Germany: +3.0% in 2021; +4.2% in 2022

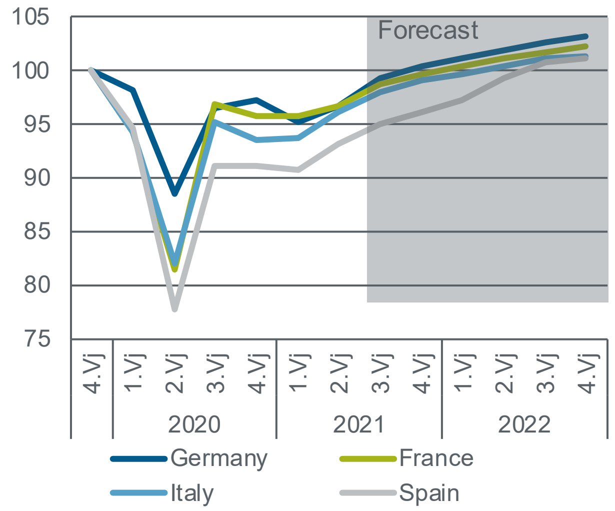
The catch-up effect in the services sector and strong private consumption is set to generate very strong economic growth in the current quarter that will continue with more moderate rates in autumn. On average for the year, we expect price-adjusted GDP to grow at a rate of 3.0%. As the calendar effect is negligible this year, this forecast means the same rate of growth adjusted for price as well as calendar effects. We therefore predict slightly lower growth than in our previous forecast of May (+3.5%), especially because the supply shortages appear to be more persistent. The downward correction is also partly due to the routine data revisions undertaken by the Federal Statistical Office, which has now calculated a slightly larger drop of -2.0% for the first quarter of 2021 in contrast to the originally published figure of -1.8%. It has also revised several quarters in the previous year. We have become slightly more optimistic for 2022, however, as the manufacturing sector will be gradually reducing its order backlog. That, in particular, will ensure that next year’s quarterly growth rates will be well above the long-term average. There is also a considerable statistical overhang from the current year, so that a growth rate of 4.2% can be expected in 2022 (previous forecast +4.0%). This represents a price and calendar-adjusted growth rate of 4.3%. According to our forecast, the pre-crisis level – measured by fourth-quarter 2019 GDP – will be moderately surpassed already in autumn of this year.

Strong second quarter in southern Europe

At 2.0%, GDP grew slightly faster in the euro area than in Germany. The main engines of growth were the southern European countries, where the containment measures were relaxed a little earlier and supply bottlenecks in industry play a lesser role. Of the four large euro countries, Spain grew the fastest at +2.8%, followed by Italy, which exceeded all expectations significantly with a quarterly growth rate of +2.7%. France, on the other hand, expanded more slowly than Germany, at +0.9%. What is also remarkable, however, are noticeable revisions to previous quarters. Euro area growth in the first quarter was upgraded from -0.6 to -0.3% and Italy now even records a moderate plus rather than a contraction. In France, on the other hand, moderate growth was revised to a stagnation at the start of the year but the statistical overhang from the previous year has increased noticeably. In the winding recovery rally, France and Germany were neck and neck in the second quarter of 2021, achieving nearly 97% of pre-crisis GDP (of the final quarter of 2019). But Italy, too, is now almost on a par with a good 96%, and Spain has slightly closed the gap, now sitting at around 93% (see Figure 2).

Figure 2: GDP development in the four large euro countries

Adjusted for price, seasonal and calendar variations; Q4 2019=100.



Euro area: + 4.7% in 2021 and +4.3% in 2022

We expect the quarterly profiles of most euro countries to be similar to Germany's in the remainder of the year, as the joint procurement of vaccines and the European Central Bank's very expansionary monetary policy have created similar conditions for beating the coronavirus crisis. Particularly in Italy, however, a surprisingly strong first half-year has created the need for significant upward revision. Instead of 4.5%, a growth rate of 6.0% can now be expected for the current year (see Table 1). The growth rate in the following year, however, will likely be lower than initially expected as a result of the faster recovery already achieved previously. We had largely anticipated strong quarterly growth for Spain already.Yet, we believe the upside potential this year will be rather limited because of high infection rates and severely reduced international tourism still due to travel warnings and quarantine regulations, so that we have slightly reduced our forecast for 2021. For France, however, we have made a slight upward revision which is primarily due to the slightly stronger data from the past. Overall, the downward revision to the forecast for Germany and the upward revisions for the other three large euro states largely balance each other out, so that the economic forecast of 4.7% in 2021 and 4.3% in 2022 for the euro area is similar to what we forecast in May.

Table 1: Price-adjusted GDP growth

Per cent year-over-year change

	DE	FR	IT	ES
2020	-4.6	-8.0	-8.9	-10.8
2021	3.0	6.1	6.0	5.8
2022	4.2	3.7	3.7	6.2

Source: KfW Research, Eurostat

Downside risks predominate

On the one hand, forecast uncertainties result from familiar problems such as supply shortages in the manufacturing sector. It is therefore possible that industrial output will continue to stagnate for several quarters despite good sentiment indicators, which would lead to slightly lower average annual growth in 2021. A similar effect could result from new shutdowns in Europe, which would probably be limited to fewer sectors than in the past winter. However, new shocks could also occur in supply chains, for example if the Chinese zero-Covid strategy leads to new lockdown measures due to the higher transmissibility of Delta. Any emergence of a completely vaccine-resistant mutation of the coronavirus would obviously be a particularly serious downside risk. In any case, unlike the years following the economic and financial crisis, there is currently no sign of a premature rollback of monetary and fiscal policy support in the euro area. This could change in the medium term, however, should inflation remain high for an unexpectedly long period. Sufficient availability of effective vaccines now puts Europe in the privileged position of being able to bring the end to the pandemic within reach. But in order to prevent the healthcare system from becoming overwhelmed and new damage being done to the economy, more adults need to be vaccinated with urgency, particularly in Germany.