Weak manufacturing drives Germany into technical recession

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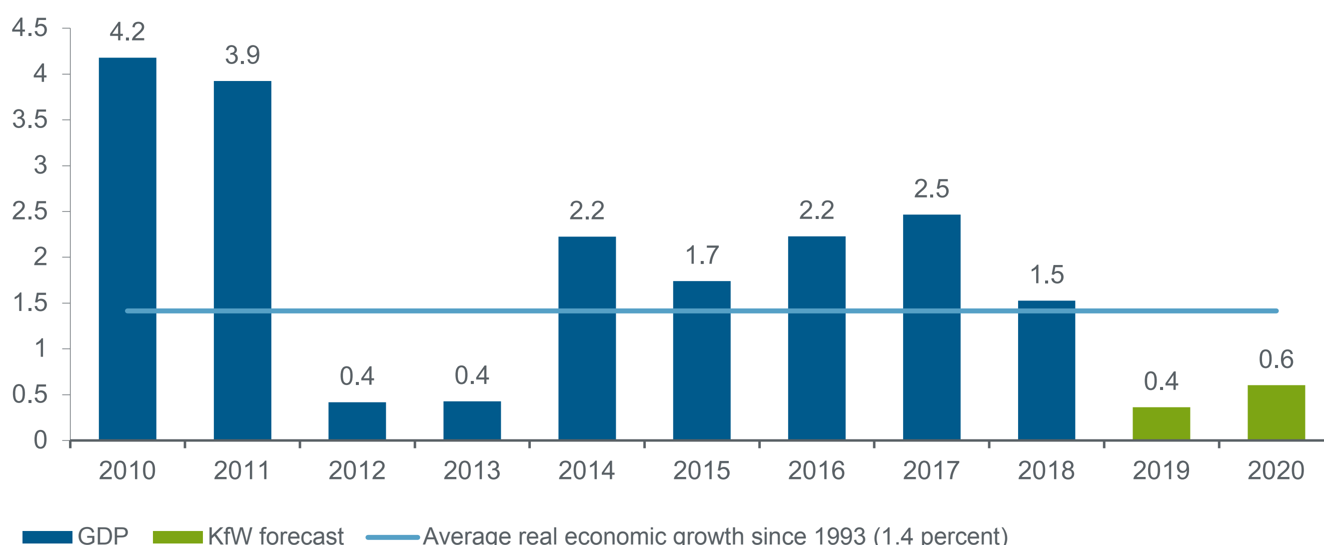
- The German economy shrank by 0.1% in the second quarter. Foreign trade weighed hard on economic output while domestic demand grew again, primarily bolstered by consumption.
- There is little hope for improvement in the short term. Manufacturers in particular are struggling because while industrial orders were clearly up in June, the trend is pointing downward and business and export expectations remain pessimistic.
- KfW Research now expects real growth of only 0.4% for 2019 and 0.6% for 2020 (previously 0.8% and 1.8%). With exacerbated trade conflicts and the increasing likelihood of a hard Brexit, the external headwinds will continue and hamper domestic investment activity.
- Major economic risks have materialised or have become the base scenario. Should it still be possible to agree on an orderly Brexit, or should the trade conflicts soon subside, growth might turn out higher. Escalations in the transpacific and transatlantic trade conflict, however, are the prevailing downward risks.

Germany's gross domestic product

Variation on previous year in per cent, adjusted for prices



Source: KfW Research, Destatis

German economy goes into reverse

Germany's economic output contracted slightly in the second quarter. Gross domestic product (GDP) adjusted for price, seasonal and calendar effects shrank by 0.1% on the previous quarter. Exports in particular dropped (-1.3%), which is also apparent in a significant 1.4% decrease in industrial value-added. Germany's very heavily export-oriented industry has been in recession for four consecutive quarters now. Domestic demand, however, underpinned growth again. Both private (0.1%) and public consumption expenditure (0.5%) grew quarter-on-quarter. Residential construction experienced an additional boost in the first quarter owing to favourable weather (2.4%), putting into perspective the -0.7% decline in the second quarter.

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

Enterprises' clear reluctance to invest in machinery and equipment (-2.4%), on the other hand, is the probably inevitable consequence of growing political risks, especially at global level.

Significant risks are materialising

The trade conflict between the US and China intensified significantly over the course of the year and reached a new peak with the new special tariffs announced by the US in August for practically all remaining imports from China and the spiral of retaliation they ignited. Even though Germany has so far not been burdened with any significant special tariffs, German manufacturers are heavily affected indirectly because of their close trade relations with both countries and the focus on particularly cyclical capital goods industries. The high level of global uncertainty over future trade policy conditions is detrimental to the engineering industry in particular. Technological and regulatory uncertainties in relation to future drive technologies also hamper sales in the automotive industry and related sectors. We expect persistently strong headwinds from the global trade conflicts for the remainder of the year. Next year's US election campaign is likely to provide at least a temporary respite, when the Trump administration will look to shine with a good economic and stock market performance.

Hard Brexit at Halloween as a working scenario

The new UK government under Boris Johnson, which is full of hardliners, is also spreading enormous uncertainty with the looming no-deal Brexit on 31 October. The EU-27 is set to fundamentally insist on the negotiated final withdrawal agreement including the backstop – the legal assurance to keep the intra-Irish border open – which is problematic for the UK but essential for Europe. At the same time, while the UK Parliament in its majority opposes a Brexit without an agreement but is otherwise divided, it has little scope to act and time is running out. We therefore expect a hard Brexit at Halloween as a working scenario.

Second half-year is not looking good

As a result, the rebound hoped for in the second half of 2019 will not happen. The leading indicators signal this as well. New industrial orders grew at a surprisingly high rate in June, but that was solely due to large orders, which are erratic and often have a delayed effect on production. But even the strong increase of 2.5% on the previous month could not prevent the renewed quarterly decline. Orders dropped by 1.0% from April to June, after an even sharper drop of 4.2% in the first quarter. Domestic capital goods orders were particularly soft lately, signalling a growing weakness in corporate investments. The most recent sentiment indicators such as the ifo Business Climate Index and the purchasing managers' indexes, which are already available up to August, do not point to a positive trend reversal either. Manufacturers' business and export expectations in particular remain exceptionally pessimistic. Consumption and residential construction, however, will likely continue to stabilise economic performance, especially thanks to what generally continues to be a reasonably robust labour market. On balance, we expect another minor GDP contraction of -0.1% for the third quarter. The formal criterion for a technical recession – two negative consecutive quarterly growth rates – would thus be fulfilled. In the final quarter the downturn is likely to accelerate again somewhat in the short term under our assumption of a hard Brexit, before the business cycle gradually improves again in the course of 2020. If damage from Brexit remains limited and the trade conflicts ease, after an initial stagnation we expect the economy to revert to trend growth.

Forecasts for 2019 and 2020 significantly downgraded

As we now expect a further contraction of GDP in the second half of the year, we have significantly downgraded our overall economic forecast for 2019 to just 0.4% (previous forecast: 0.8%). Without the general revision of national accounts for the past four years which regularly takes place in August, as a result of which the momentum carried over from the previous year ('statistical overhang') is now 0.2 percentage points higher than based on the previous figures, the new forecast for 2019 should have been even lower. For 2020 we have also significantly downgraded our forecast to 0.6% (previous forecast 1.8%). On the one hand, the high statistical underhang of 0.3 percentage points considerably reduces the annual rate for 2020 in computational terms, masking the economic recovery we expect in the course of the year. On the other hand, the calendar effect alone – the mere fact that 2020 has four working days more than 2019 – will contribute nearly 0.4 percentage points of growth next year.

Downward and upward risks to the forecast

We see forecast risks on both sides. The economy could perform better than predicted here should the UK yet exit the EU in an orderly fashion or if the US and China manage to strike a deal soon. But the downward risks are also considerable. The stock markets in particular are worried that the global economy could slip into recession. There is a possibility, for example, that the trade conflict develops into an unsolvable geopolitical rivalry between the US and China. Furthermore, the impact of the trade conflict might be underestimated, especially given the unreliable data situation in China. For Europe, Italy's high government debt represents an ongoing risk in addition to the Brexit uncertainties. Besides, Germany could be hit particularly hard by the introduction of the US special tariffs on European cars and car parts which have been threatened for some time now. A positive, however, is the wide fiscal space which Germany has without breaching national and European budget rules. The domestic economy at least could be stabilised if required by using instruments such as state-promoted short-time work or immediate depreciations for investments in fixed capital. ■