››› Germany's upswing is losing some pace, cyclical risks are rising

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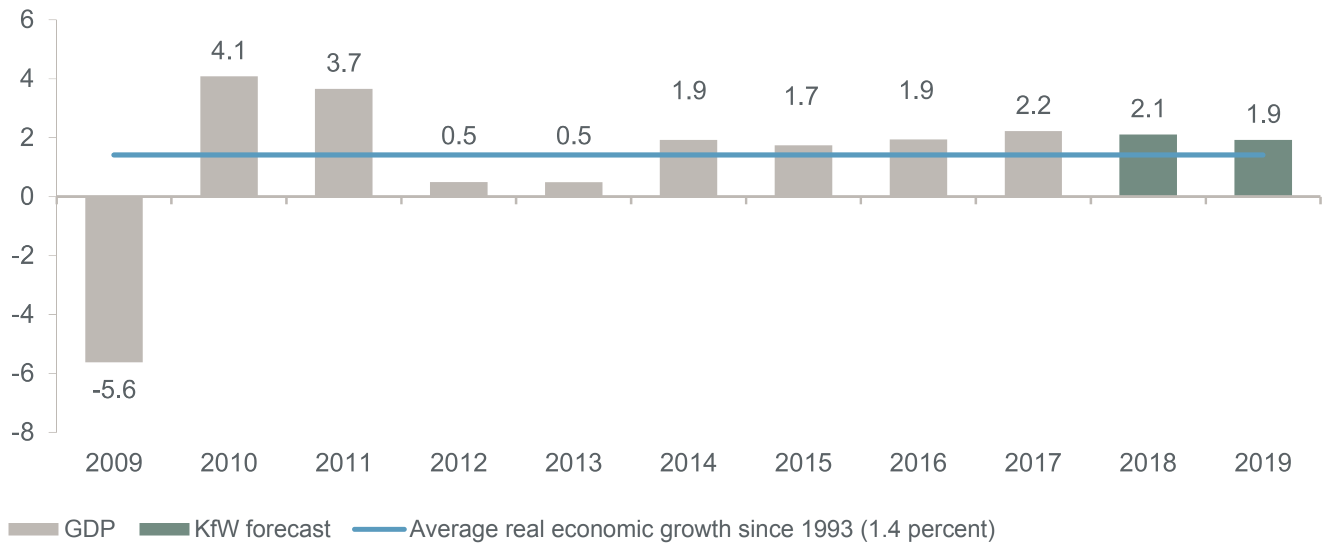
- Germany's economy grew by a disappointing 0.3 % in the first quarter of 2018; quarterly growth is set to pick up again to 0.6 % in spring once special adverse factors such as strikes, an influenza wave and unusually cold weather have ended
- Given the weak start to the year, KfW Research revises its growth forecast for 2018 downward to 2.1 % (previous forecast: 2.5 %); we still expect the economy to grow by 1.9 % in 2019
- The most recent phase of weakness in public consumption and exports should soon be over; corporate investment is set to continue rising but many international uncertainties, some of which are new, are slowing the pace of growth
- Brexit, ongoing tensions in global trade relations, the unilateral US withdrawal from the Iran nuclear deal and the political situation in Italy pose rising cyclical risks

Germany's gross domestic product
Change on previous year in per cent, adjusted for price effects



Source: KfW Research, Destatis

Special factors ruined the start to the year 2018

Measured against the initially high expectations, the German economy had a weak start to the year 2018. In the first quarter, the expansion of gross domestic product (GDP) adjusted for price, seasonal and calendar effects slowed to 0.3 % on the previous quarter, dropping to the average growth rate since German unification. In all four quarters of the previous year, GDP had grown at least twice or even three times as fast. The renewed surge in incoming orders at the end of 2017 – at 3.5 % the strongest quarterly rise since early 2011 and the sixth in a row – coupled with outstanding business sentiment initially provided hope that this strong momentum could be maintained into the start of 2018 as well. The weak start to the year is basically the result of an accumulation of special factors. What put a handbrake on economic activity was not just the unusually high number of holidays and the warning strikes in the metal industry but also a strong outbreak of influenza that has left its imprint on both production and consumption, along with an unseasonably intense cold spell in February and March.

No end in sight to the upswing

All these one-time effects are now over. We therefore expect the most recent growth slowdown to remain a temporary episode. Enterprises, not least, are banking on continued growth, as illustrated by the renewed increase in corporate investment in the first quarter (+1.0 %) – the fifth consecutive rise already. Private consumption (+0.4 %) was slightly more lively at the start of the year than in the second half of 2017 – a trend that should continue this year amid steady growth rates in employment and real wages and a further substantial rise in pension payouts. Assuming the global business cycle remains generally positive, exports should overcome the weak start to the year (-1.0 %) just as quickly as public consumption (-0.5 %), which will probably pick up again now that the government was successfully formed in mid-March. Private residential construction investment, which also expanded by a strong 1.9 % despite adverse weather conditions at the start of the year, is a reliable mainstay anyway.

Downward revision for 2018 despite positive outlook

Irrespective of this continued positive cyclical outlook, we have lowered our growth forecast for 2018 to 2.1 % (previous forecast: 2.5 %). That would mean a slightly more moderate cyclical momentum compared to 2017, when Germany's economic output grew by 2.2 % with significantly fewer working days.[1] The downward revision is the immediate consequence of the weak start to the year, with otherwise identical assumptions regarding the momentum in the further course of the forecast period. For the second quarter we specifically expect real growth to rise noticeably to 0.6 %. A number of virtually insurmountable obstacles, in our view, prevent an even faster pace of growth that would completely offset the unexpected weakness in the first quarter. These include the further growing insecurity in the global environment, which has been triggered primarily – but not only – by the trade and foreign policy of the United States and has weighed on business sentiment for quite some time now. Another factor is the decrease in new orders for manufactured goods (-2.1 %) in the first quarter. This decline is of course very relative given that the order backlog and its range[2] are currently on multi-year highs after the very large volumes of new orders previously recorded.

We confirm our forecast for 2019

For 2019, however, we confirm our forecast of 1.9 % real growth. The primary reason for the expected moderate drop in momentum next year is the rising level of capacity utilisation in the course of the long upswing, particularly on the labour market.

Downward risks are clearly rising

So even if, on the face of it, our view of the economy has changed very little in the past three months, we would like to emphasise one aspect in particular. Compared with the previous forecast from February we currently see significantly increasing downward risks. In addition to Brexit, which remains unresolved, a coalition government has emerged in Italy that was previously regarded as rather unlikely and whose main parties campaigned on very expansionary fiscal projects and strong criticism of the EU and the euro. Much of this has been laid down in the coalition agreement. Unless these plans are scaled back substantially in practice, new conflicts within Europe and noticeable interest rate responses in the Italian capital market will be scarcely preventable. Moreover, there is still no solution in sight to the trade conflicts of the US with the EU and China. Quite the opposite: The US administration is escalating the conflict with its recently announced order to consider levying tariffs of up to 25 % on imports of cars and car parts.

The unilateral US withdrawal from the Iran nuclear deal not only has the potential to lead to a further increase in the price of oil but could further widen the transatlantic rift over trade issues. While Europe (as well as China) wants to keep the nuclear deal and, with it, continue trading with Iran, the US is clearly urging its partners to quickly suspend these very trade relations. Germany's strong integration into international value chains, the high importance of the automobile sector and its high current account surplus make it particularly vulnerable should this situation lead to serious distortions in global trade relations.

Enterprises' willingness to invest is crucial

Our forecast assumes that corporate investment will remain on a noticeable upward trend, backed by vigorous demand, very high industrial capacity utilisation (87.7 % at the start of the second quarter according to ifo Institute – a noteworthy 4.5 percentage points more than the ten-year moving average) and favourable borrowing conditions, with international uncertainties merely dampening growth slightly. But should enterprises soon clearly hit the brakes on investment as a result of these uncertain conditions, a significantly more negative economic development than what we are forecasting may have to be expected – including an end to the upswing. ■

[1] As is customary in Germany, our forecast for annual price-adjusted GDP growth refers to the original rates, which are not adjusted for variations in the number of working days. In 2017, all the federal states had around three fewer working days on average than in 2016, which took away 0.3 percentage points from annual growth for 2017 (calendar effect). This year and next, the calendar effect will be virtually negligible and noticeable in rounded figures at best. The result for 2017 and the GDP growth rates we have forecast for this year and next equate to calendar-adjusted real growth of 2.5 % (2017), 2.1 % (2018) and 2.0 % (2019).

[2] The range of the manufacturing order backlog is defined as the orders backlog divided by monthly turnover, each adjusted for price variations. It thus shows how many months enterprises are busy processing the orders on their books to meet existing demand under the assumption that their turnover remains constant. Currently (February 2018) the range is 5.6 months.