Domestic demand stabilises economy in difficult global environment

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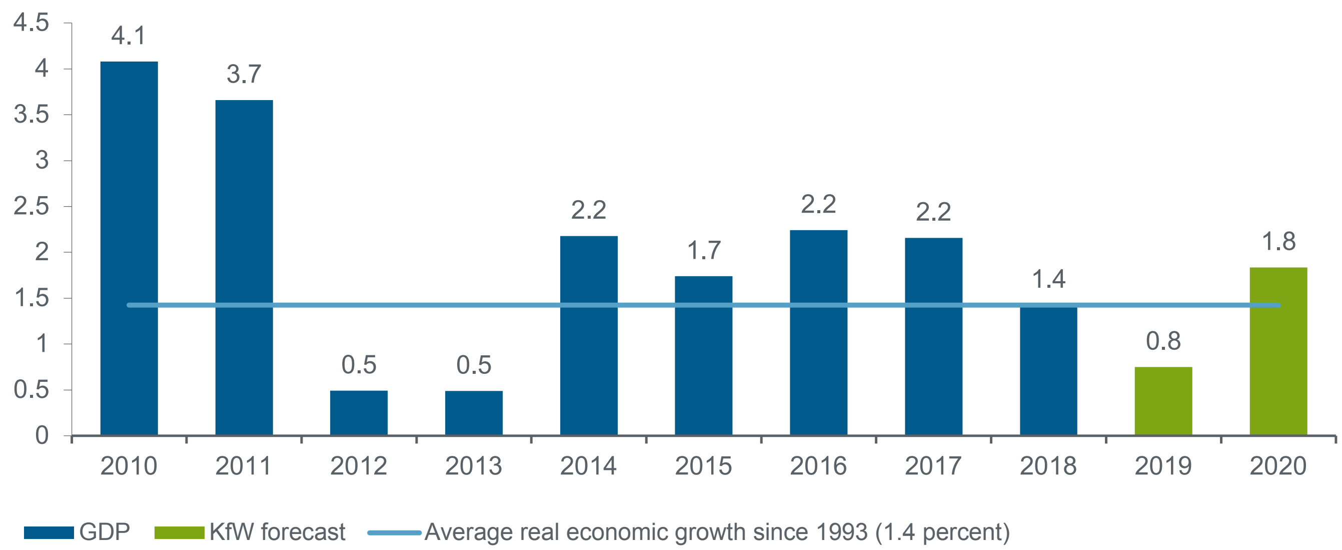
- The year 2019 was off to a good start with 0.4% first-quarter growth. Thanks to vigorous private consumption and a surge in investment boosted by favourable weather, the German economy emerged from six months of stagnation.
- The outlook, however, has dimmed. Significantly fewer orders, subdued business confidence and a negative rebound in construction investment signal only weak second-quarter growth before the rate picks up again.
- Overall, KfW Research confirms its economic outlook of 0.8% for 2019 and 1.8% for 2020; four extra working days overstate the expected recovery; adjusted for calendar effects, real growth in 2020 will only be in line with potential, at 1.5%.
- Negative risks predominate, primarily due to the renewed delay in resolving the Brexit issue and simmering US trade conflicts with China and the EU, which weigh on exporters in particular.

Germany's gross domestic product

Variation on previous year in per cent, adjusted for prices



Source: KfW Research, Destatis

Positive surprise at the start of the year

Measured against the initially low expectations, the German economy started the year 2019 with surprising strength. Adjusted for price, seasonal and calendar variations, first-quarter gross domestic product (GDP) increased by 0.4% on the previous quarter. The stagnation in the second half of 2018, which was also the result of special factors such as production distortions in the automotive industry and extremely low water levels in the Rhine River, are now a thing of the past. GDP is now growing again at the same rate seen in the first half of last year. The crucial impetus in the first quarter came from domestic demand, which once again proved to be a significant driver of the business cycle. Household consumption expenditure grew strongly and gross fixed capital formation in equipment and construction also increased noticeably. Investment in construction also benefited from unseasonably mild weather, however, which enabled projects to be brought forward. For internationally oriented manufacturers, on the other hand, the situation remained difficult – despite the somewhat higher exports again, which were probably also served from previously built up inventories.

Setback in the second quarter

As encouraging as the return to growth was at the start of the year, it still does not mark a convincing trend reversal. Rather, we expect a setback very soon and predict very meagre GDP growth of just 0.1% for the second quarter. Indications of this are not just the dip in construction investment that can be expected following the extra boost from mild weather in the first quarter, but also the continuing recession in the industrial sector, which was slightly masked by the fading special factors at the start of the year. Given the slump in incoming orders in the first quarter, there is no end in sight to the recession in industry. At -4.1%, the decline in orders was the highest in the past ten years, due primarily to strikingly weak demand from countries outside the currency union, among other factors. The very high volume of existing orders, which has so far stabilised industrial output, has also been decreasing since the start of the year. The growing pessimism that has also been documented by our KfW-ifo SME Barometer for the industrial sector does not show any light at the end of the tunnel either. The expected minimal GDP growth expected for the second quarter will be solely due to robust domestic demand.

Confirming our forecast for 2019 and 2020

The surprisingly good start to the year 2019 and the significantly dimmer outlook especially for the second quarter compared with our previous forecast roughly balance each other out in their effects on expected GDP growth. On balance, we therefore confirm our forecast of 0.8% for 2019 and 1.8% for 2020. This is based on the assumption that the global trade conflicts and Brexit will not lead to massive disruptions. Otherwise, the slightly higher quarterly momentum which we have factored in again from the second half of this year would be under immediate threat.

Effect of additional working days overstates recovery

The growth acceleration by one percentage point which we predict for next year may appear strong at first glance. However, annual growth in 2020 will receive impetus not just from a demand-driven (‘genuine’) economic recovery but, to a considerable degree, simply from a different calendar constellation. On average for all federal states, in 2020 the economy will have almost four more working days than in 2019, and that in itself will contribute growth of almost 0.4 percentage points (calendar effect). Adjusted for this calendar effect, the underlying cyclical momentum in 2020 will be just under 1.5%, which is roughly in line with the typical current estimates of Germany’s growth potential.[1] Our general view is therefore that the business cycle will recover only moderately next year.

Less incentive for expansion investment

As Germany will first be growing below and later within the range of its production potential in the two-year forecast period, overall economic production capacity utilisation will initially decrease from a high level and should subsequently trend sideways. At least so long as global risks remain under control, this may actually be positive for the continuation of the long expansion phase that began back in 2010. After all, capacity is already quite tight, particularly in the labour market. At the same time, however, incentive for investment is decreasing because businesses see capacity expansion as much less important. The resulting weaker demand for capital goods is further negative impetus for the already battered industrial sector, with mechanical engineering obviously taking the hardest hit.

Negative risks predominate

Moreover, Germany’s export-dependent industrial sector is the sector that is finding it most difficult to plan ahead given the persistently high uncertainties over future global trading conditions. The situation shows no signs of easing or at least clarification. On the contrary, the US administration has recently made the unexpected move of considerably escalating the trade conflict with China. It has delayed until late autumn possible punitive tariffs on automobile imports from the EU, which would hit Germany more than other exporters, but probably only with the aim of using them to exert further pressure in the ongoing trade talks with the EU. Also, the US is likely to regard avoiding a further front in its trade-policy conflict alongside China as a wise tactical move. The risks to the German and European automotive industry thus remain unchanged and high. Even if the EU were to remain ultimately unaffected by these special tariffs, the continuing high political uncertainty is dampening global investment activity and thereby hampering sales in the engineering sector in Germany and around the world. A definitive solution to the Brexit issue has not been found yet either because of the deep division within the House of Commons and the people of the UK. Instead, the exit date initially planned for 29 March 2019 has been postponed yet again, this time flexibly until not later than 31 October 2019. Even if our basic scenario assumes that an orderly exit of the United Kingdom from the EU will ultimately be achieved, the increasingly unstable situation of the UK government makes the likelihood of a chaotic Brexit alarmingly high. If the risks were to materialise, the economy could tip into a recession. ■

[1] The calendar effect this year is virtually negligible, and our forecast for real growth in 2019, after adjusting for calendar effects, is likewise 0.8%. The calendar effect was very small in 2018 as well. But rounding effects mean a slight divergence in real growth rates established for 2018 between a calendar-adjusted view and an unadjusted view (1.5 vs. 1.4%).