Germany: The economic stalemate continues for the time being

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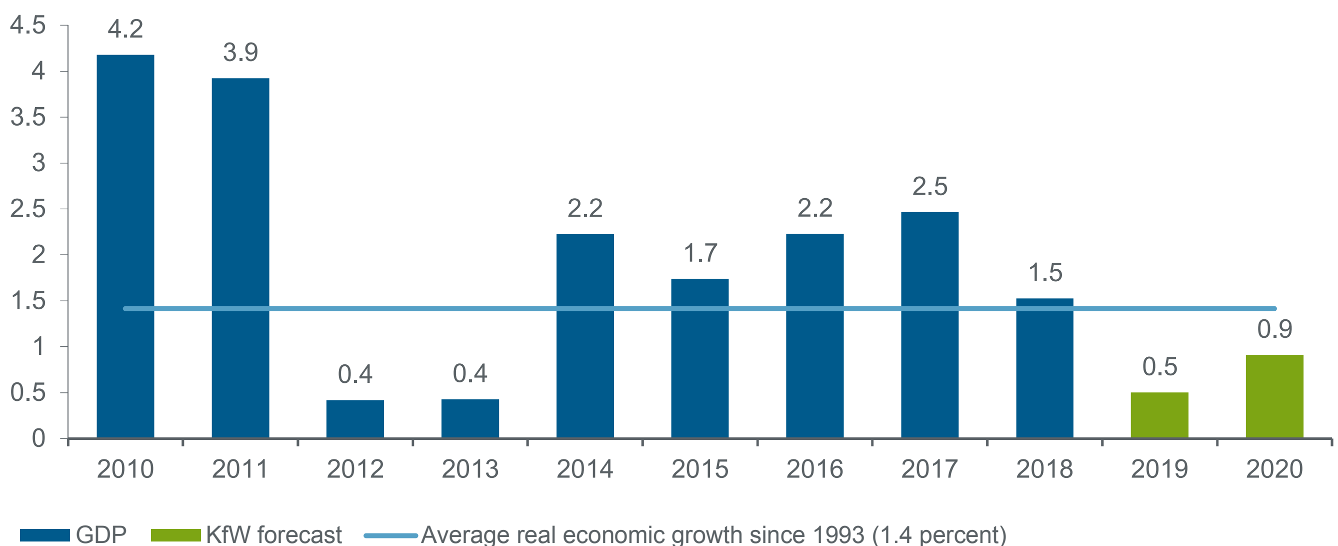
- The German economy has narrowly escaped a technical recession, growing at a rate of 0.1% in the third quarter. In particular, consumption and residential construction underpinned economic performance.
- Economic growth should be equally weak in the final quarter. Manufacturing continues to struggle to return to a path of growth. That will allow only below-average GDP growth for the time being.
- KfW Research now expects real growth of 0.5% for 2019 and 0.9% for 2020 (previous forecast: 0.4 and 0.6%). The upgraded forecast is based on the moderate easing of the US's trade conflicts and the avoidance of a hard Brexit at Halloween.
- The growth pickup of 0.4 percentage points expected for 2020 is exclusively due to the additional output generated on four additional working days (calendar effect). Adjusted for calendar effects, real growth in 2020 will be a mere 0.5%, just as in 2019.

Germany's gross domestic product

Variation on previous year in per cent, adjusted for prices



Source: KfW Research, Destatis

Technical recession avoided

In the third quarter of 2019, Germany narrowly escaped a technical recession. Gross domestic product (GDP) adjusted for price, seasonal and calendar effects rose by 0.1% on the previous quarter after falling by 0.2% in the preceding quarter. Domestic demand was the backbone of economic performance. Consumption expenditure (+0.5%) and private residential construction investment (+1.5%) grew noticeably. Even corporate investment picked up again slightly (+0.6%) after contracting sharply in the preceding quarter (-1.5%). Exports grew again (+1.0%), although pull-forward effects in the face of a looming Brexit at the end of October likely played a role, as they already did before the original Brexit deadline in March. However, a large portion of this export demand was probably met by destocking (growth contribution: -0.7 percentage points), so the impetus for industrial production was accordingly low. Value added in manufacturing contracted for the fifth consecutive quarter (-1.1%)

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

Cyclical momentum remains listless for the time being

Economic momentum will languish for the time being because the split in the economy is set to continue into winter. While domestic demand remains solid thanks to construction and consumption, the recession in the manufacturing sector is set to continue and, with six consecutive quarters, will then become the longest in the history of post-unification Germany. The most recent sentiment indicators such as the ifo Business Climate Index, however, point to a bottoming out and the expectations for the next six months are not quite as pessimistic anymore. The export expectations of large manufacturing firms, which are most closely integrated with the world economy, experienced a veritable surge, although from a multi-year low. This gives rise to hope that exports will pull out of the trough. On balance, however, we expect GDP to grow by no more than 0.1% again in the fourth quarter. The cyclical momentum will probably be just as muted again in the first quarter of 2020, before improving again as the year progresses. But this will require the manufacturing sector to recover at least moderately in the coming year, which we anticipate with cautious optimism given the recent positive signals from the US-Chinese trade conflict and the UK exit process.

US-Chinese trade tensions have eased slightly

The recently envisaged partial agreement defused the trade conflict between the US and China to a certain extent. An agreement would also benefit Germany. Although German manufacturing has so far not been burdened with any major special tariffs, this conflict heavily affects it indirectly because of its close trade relations with both countries and its focus on particularly cyclical capital goods industries. To what extent the most recent easing of tensions will continue remains to be seen, however, given the unpredictability of the current US administration.

A hard Brexit is now unlikely

At the same time, a hard Brexit has become significantly more unlikely since our last forecast in August. The EU has agreed on a revised withdrawal agreement with the UK government that essentially includes modified provisions on keeping the intra-Irish border open. But the UK House of Commons has not yet ratified the agreement. Instead, it has scheduled new elections for 12 December after the EU granted the UK's application for a flexible delay on its departure to the end of January 2020. Given that the election outcome is still anything but certain, we believe there are two likely scenarios. Should the Conservative Party under Prime Minister Johnson win, the United Kingdom would ratify the revised agreement and make an orderly departure from the EU, possibly as early as 1 January. That would mark the start of the transition phase to negotiate the long-term relations. Should the opposition emerge victorious, however, the new UK government will likely be intent on reaching a softer agreement with the EU and submitting it to a popular vote in a further referendum. That would require a renewed extension of the exit date, which is unlikely to be opposed by the EU. Either way, there would be no material changes in the trade relations of the EU-27 with the United Kingdom until the end of 2020, which is now our working scenario for our economic forecast.

Forecast for 2019 and 2020 upgraded

As tensions in the US-Chinese trade conflict have gradually eased and the hard Brexit at Halloween has been avoided, we now have a significantly better outlook on the final quarter of 2019 than in our previous forecast. As a result, and also because the third quarter was slightly better than previously expected, there is no statistical underhang anymore, which means economic growth next year will start from a higher level than previously assumed. Although we generally want to maintain our quarterly prediction for the year 2020 – with a moderate economic revival not before the next spring –, this results in an upward revision of our economic forecast to 0.5% for 2019 and 0.9% for 2020 (previous forecast: 0.4 and 0.6%).

Strong calendar effect overdraws growth in 2020

For the cyclical interpretation of the average annual GDP growth rates we are expecting, it is crucial to bear in mind that the growth pickup in the coming year is due exclusively to the unusually strong calendar effect. As significantly more holidays will fall on a weekend in 2020, the year has almost four more working days than 2019. The additional value added will contribute just under 0.4 percentage points to growth next year. Adjusted for calendar effects, that is, from a purely cyclical perspective, GDP in all of 2020 will therefore grow by just 0.5% and, thus, at the same weak pace as this year, for which the calendar effect is negligible.

Much too early for the all-clear

It is therefore much too early to give the all-clear as the economy is and remains vulnerable to negative surprises given the continuing significant uncertainties. There is a possibility, for example, that the trade conflict evolves into an unsolvable geopolitical rivalry between the US and China. Besides the residual risk of a disorderly Brexit, risk factors for Europe that need to be monitored are possible new lines of conflict in the negotiations that will have to be conducted at some stage about the long-term relations between the EU and the United Kingdom, as well as Italy's high government debt. Besides, Germany could be hit particularly hard by the introduction of special US tariffs on European cars and parts which have been threatened for some time now. However, Germany's fiscal policy would have enough scope to contain any damage from recession if necessary.