Florian Hense, Economist | florian.hense@berenberg.com | +44 20 3207 7859

GERMAN GDP: MODEST REBOUND AFTER WEAK Q1

Berenberg Macro Flash

German GDP, Q2 2018 (in %)

	qoq	yoy
Actual:	**0.5**	**2.0**
Previous:	0.4	2.1
Consensus:	0.4	2.1
Berenberg:	0.5	2.1

On track despite serious risks: Withstanding the headwinds from trade tensions and higher oil prices, the German economy fared a little bit better in the second quarter after a weaker performance at the start of the year. GDP growth accelerated to 0.5% (0.45%) qoq in Q2 after an upward revised 0.4% in Q1 (see chart 1). In annualised terms, growth in H1 was above the underlying trend rate of 1.5%, but below the annual growth of 2.5% in 2017. During Q2 the German economy partly benefited from the bounce-back of temporary factors (almost flat industrial production, drop in retail sales and government consumption) that had weighed on growth in Q1, and from continued healthy gains in domestic demand.

Press release snippets: The first estimate of German GDP by Destatis does not come with a quantitative breakdown by expenditure or income components of GDP, but it provides qualitative comments.

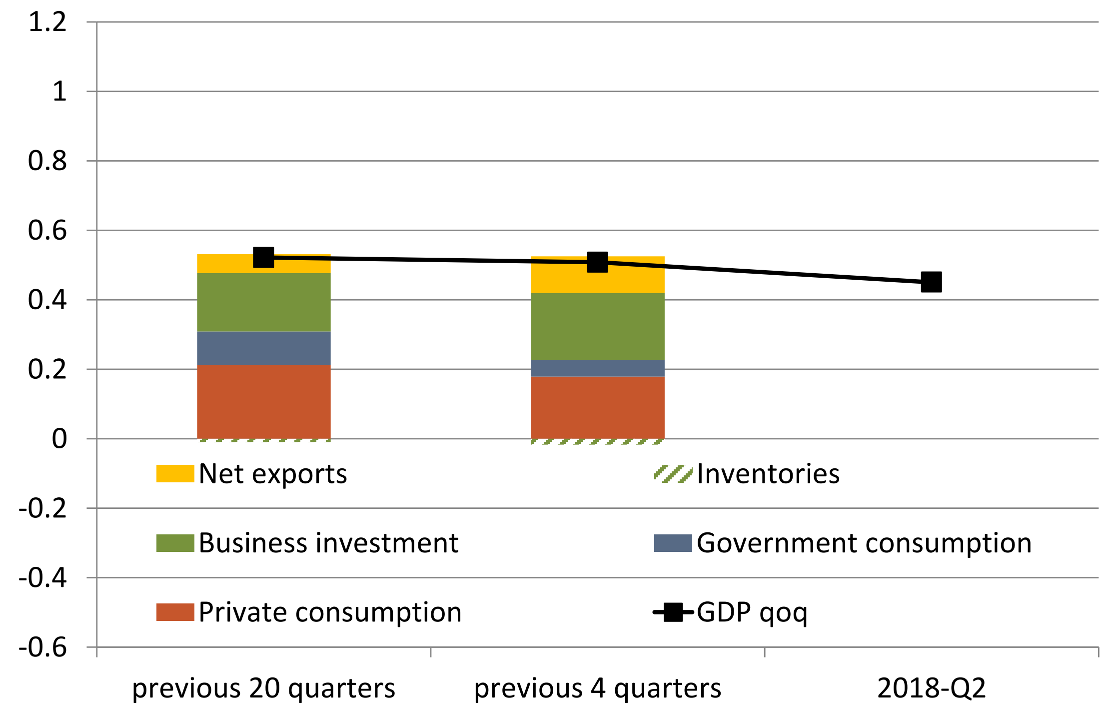
- According to the press release, a positive contribution came from **private consumption**, which makes up 54% of total GDP. Retail sales rose by 0.9% qoq, suggesting that the virtuous circle of employment, income and consumption is in full action and withstands periods during which higher energy costs limit consumers' purchasing power somewhat. While employment growth may slow down over the next quarters amid labour shortage, wage gains are accelerating and continue to push overall disposable income higher.
- The second-biggest pillar of demand (20%), **business investment** in machinery and equipment, construction and other fixed assets also somewhat increased in Q2 after the strong gains in Q1, according to the press release. In reaction to Trump's trade war threats, order growth has slowed and German businesses may have thought twice in Q2 about investing in big-ticket items. Some may have even started to turn down orders instead of accommodating their production capacity to increased demand. Still, industrial production held up firm during Q2 (+0.2%), suggesting that the high level of capacity utilisation is here to stay and will keep the pressure on businesses to invest (see chart 2 for limiting factors of production). This bodes well for the outlook for late 2018.
- **Government consumption** (19% of total GDP) recovered from the first drop in almost five years in Q1, after Angela Merkel finally renewed her "grand" coalition with the CSU and SPD in mid March.
- **Net trade** subtracted from growth. According to the press release, increasing exports were offset by an "even stronger rise in imports". Germany's current account balance dropped to the lowest level since Q2 2017.

Solid composition of growth: While the quantity of growth is this year below that of last year, the quality of growth remains good. Interestingly, domestic demand has probably contributed to growth in 2018 as much as last year (0.5ppt to the qoq rate). Meanwhile, net trade, which was a major contributor to growth last year (0.25ppt contribution), has so far been a drag this year. 90% of GDP growth since 2013 has come from domestic demand. The German economy has clearly passed the times when foreign demand contributed 30% to the gains in activity, such as in the pre-crisis era (2005-2008). Even though the German economy is still somewhat the indicator for the state of global trade, it is becoming less susceptible to these swings by the day. Take as testimony that Q2 2018 witnessed the 16th consecutive qoq growth, which contributed to the longest upswing phase since 1991.

Withstanding the trade tensions: Few major advanced economies rely on international trade as much as the German one. Naturally, the trade tensions stoked by US President Donald Trump were going to hit the German economy quicker and by more than its neighbours. Business sentiment suffered and the alleged "German angst" surfaced. But so far, reality has fortunately not lived up to the worst fears, and the Q2 print shows the German economy has withstood the trade tensions fairly well. Some surveys over the recent months suggest that the drop in sentiment may have started to peter out. In late July, Trump agreed to engage in serious trade negotiations with the EU. As German exporters get used to the noise, realise that business keeps coming in at a healthy pace, and the US and the EU get their trade deal, the fear factor should fade and the business environment could turn calmer again.

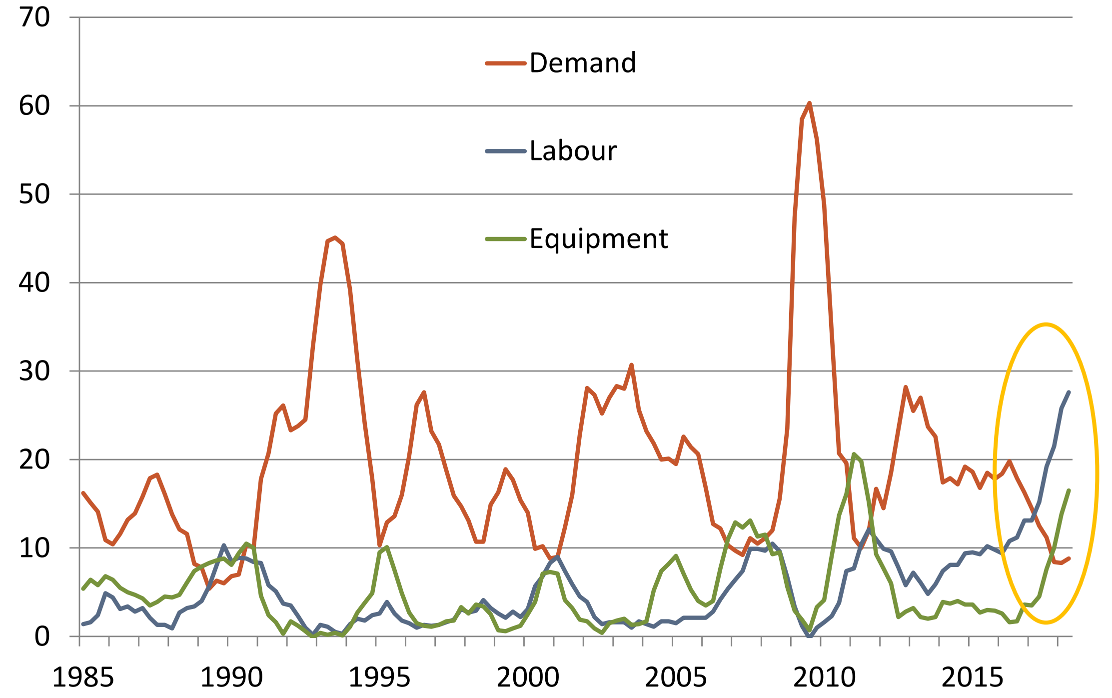
Short- to medium-term outlook: The Turkey crisis creates a moderate risk to the outlook for Eurozone sentiment, investment and exports in Q3 and Q4. Q3 could come in at 0.4-0.5% qoq. As the trade tensions ease and inflation declines, from Q4 and throughout 2019, however, the German economy should return to an above-trend pace of 0.5% qoq (2% annualised). This would add up to annual growth in real GDP of 2% in 2018 and 2019, before the economy decelerates to a pace of 1.8% in 2020. From the second half of 2019 and throughout 2020, we expect capacity constraints to become ever more binding and growth to revert towards its trend rate. To avoid this, the current German government would have to more forcefully take up measures to increase public and private investment, labour supply and productivity growth.

Chart 1: Contributions to Eurozone GDP growth (qoq, in percentage points)



Contributions to GDP growth in percentage points. No breakdown for Q2 2018. Source: Eurostat.

Chart 2: Limiting factors to production



The answers "demand", "labour" and "equipment" refer to the European Commission's economic sentiment survey's question of what limits the production of German manufacturing companies. Source: European Commission

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com