Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

GERMAN UPSWING TAKES ONLY A SMALL BREATHER

Berenberg Macro Flash

After a bounce in early 2016, the German upswing took less of a breather than expected in Q2. Despite a drag from a weather-related drop in construction, gains in private and public consumption and a further rise in exports raised German GDP by 0.4% qoq, well ahead of the 0.2% qoq consensus. The downside risk to our own 0.3% qoq call did not materialise.

The outlook remains positive. Of course, the descent of the UK into self-inflicted stagnation and other Brexit-related uncertainties will weigh somewhat on German – and Eurozone - sentiment and growth in the second half of the year. Outside the Eurozone, the UK is Germany's biggest export market after the US, accounting for 7.5% of German goods exports. However, solid domestic fundamentals, a buoyant labour market, rising real incomes, a modest fiscal stimulus and excellent financing conditions should underpin a return to trend growth around annualised rates of 1.6% for 2017 after a marginal softening in the next two quarters.

Much of the volatility in the German GDP data, from a 0.7% qoq rise in Q1 to a 0.4% gain in Q2, was caused by weather-related construction. After a 2.7% quarterly gain in construction output in Q1, helped by an unusually mild winter, output in this sector fell 4.6% in Q2. However, that unusual plunge looks more like an aberration in the volatile data rather than a new trend. According to the Ifo survey, business expectations in the construction sector advanced further to 111.4 in July, up steadily from 108.9 in Q1 and 109.7 in Q2. Also, construction orders surged to an all-time record in May (latest available data), up 18.7% year-on-year. Construction looks set to grow solidly again in coming quarters.

Hampered by the British problem, the near-term outlook for export-oriented industry is slightly more muted. Manufacturing orders fell 0.5% in Q2 after a 0.9% rise early this year. The setback in Q2 was driven by a 3.7% drop in export orders from outside the Eurozone. As a result, we expect little growth in German industry for the next two quarters. Fortunately, German industry is good at overcoming short-term setbacks such as those caused by exchange rates or problems in major trading partners. We look for industry to return to normal growth of close to 2% annualised in early 2017, propelling the overall economy back to trend growth. For the economy as a whole, we project quarterly gains of 0.25% qoq for Q3 and Q4, followed by 0.4% qoq increases throughout 2017. The risks to our calls are skewed slightly to the upside for the next two quarters if Theresa May and Angela Merkel manage to contain the Brexit-related uncertainties.

The outlook for domestic demand remains encouraging. Solid advances in core employment of 2.3% yoy (that is in the number of people earning enough to be subject to payroll taxes) and rising real wages (wages were up 2.8% yoy in Q1 at 0% inflation) underpin further gains in private consumption.

Abstracting from the short-term volatility of the data, distorted by weather effects, Germany's economic position continues to look strong: full employment, stable prices, a small fiscal surplus and a rapidly declining ratio of public debt to GDP. This provides an excellent basis for the extra public spending needed to integrate the late 2015 inflow of refugees, which has now slowed down to manageable proportions, and to gradually support domestic demand through some extra spending on infrastructure and – probably – modest tax cuts after the September 2017 elections. Germany continues to reap the rewards of its 2004 "Agenda 2010" reforms and of the ECB's successful policies to stabilise the Eurozone since 2012. While Germans continue to grumble about low interest rates and the like, the economic data show that Germans never had it so good than they do today. For the time being, Germany continues to enjoy the "golden decade" we proclaimed some six years ago. It won't last forever – but it's not over yet.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
holger.schmieding@berenberg.com