Germany

Slowing growth but peaking confidence

- **GDP grew by 2.3% on average in H1 2016, which is well above Germany's potential growth rate.**
- **Soft data in early Q3 is contradicted by more reliable strong business survey data.**
- **Next year's Brexit negotiations are likely to weigh on German investment and activity.**

The German economy performed very well in H1 2016. GDP increased on average by 2.3% y/y (adjusted for calendar effects, 1.8%). This is well above the economy's potential growth rate, estimated at 1.4% by the OECD. However, the pace of growth slowed somewhat from 0.7% q/q in Q1 to 0.4% in Q2.

Growth is mainly driven by domestic demand

Domestic demand was the main engine behind this good performance. Lower energy prices and generous pay settlements boosted household purchasing power. In addition, the good employment situation - the unemployment rate declined to 4.2% in July - underpinned household spending. Private consumption rose by 2.0% y/y in H1. Government consumption was boosted by expenditures related to the reception of refugees. It rose by more than 4% y/y.

Investment also contributed substantially to year-on-year GDP growth in H1 2016, mainly due to a 1.7% q/q increase in both Q4 2015 and Q1 2016. In Q1, investment was boosted by substantial purchases of commercial motor vehicles and increased building activity thanks to mild winter weather. However, in Q2 2016, capital spending became much less dynamic and actually declined by 1.5%, as both construction activity and vehicle purchases returned to normal levels. These were the main reasons for the slowing GDP growth pace in Q2.

By contrast, exports strengthened significantly in Q2, after having stagnated since the middle of 2015. This was mainly due to increased purchases by other Eurozone countries. As import growth remained robust on the back of strong domestic demand, the contribution of net exports to GDP growth was close to zero in H1.

High confidence points to robust growth

The first hard data for Q3 suggest a substantial slowdown. Manufacturing production declined sharply in July (-2.3% m/m), reaching its lowest level since August 2014. This could chime with the sharp fall in exports in the same month (-2.6% m/m). However, because of their high volatility, monthly data should be interpreted with care. This is even more so the case for the summer months, when activity is normally dull. Thus, the strong seasonal correction applied in these months might magnify a modest weakness out of proportions.

IFO survey points to industrial recovery

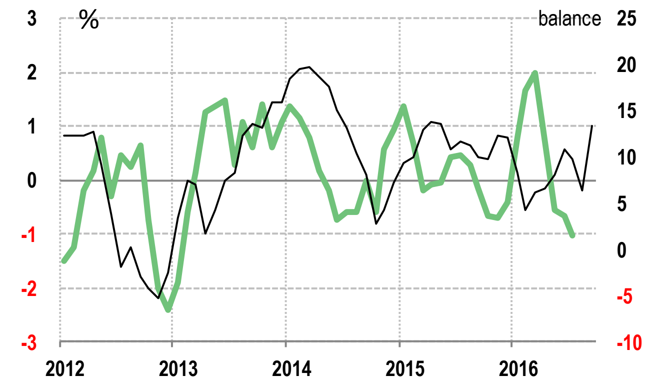

Chart Sources: IFO, Destatis

We have good reason to expect that economic activity has not significantly slowed in recent months. Business sentiment has remained at relatively high levels. In September, the IFO climate index even gained 3.2 points, reaching its highest level since May 2014. In particular, the improvement in the expectation component was remarkable after the weakness in H1 2016. It gained 4.4 points. In particular, German manufacturers anticipate strong demand from abroad. Export expectations, which had been dented by the Brexit vote, bounced back in almost all key sectors. Only the chemical industry expected foreign business to stagnate. As survey data remain well oriented, we expect GDP growth to remain close to its potential.

Uncertainty as Brexit talks get underway

Thanks to the strong first half of 2016, we expect growth to reach 1.8% in 2016 (adjusted for calendar effects). This would be the best growth performance since 2011. In 2017, the pace is likely to slow again to 1.3%, as energy prices are rising again. Moreover, as the Brexit negotiations get underway, the uncertainty concerning the outcome might weigh on investment spending, not only in Germany, but also in other European countries. This will negatively affect activity in the large German capital goods industry.