



Economic Update Germany

2 August 2011

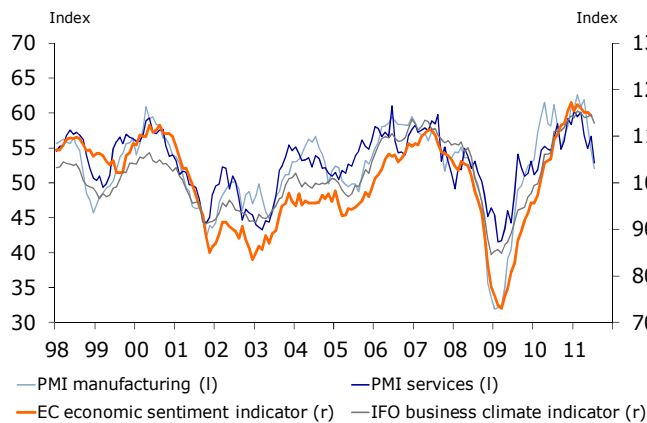
The pace of growth is moderating

year-on-year change (%)	'10	'11	'12
Gross Domestic Product	3.5	3¼	2
Private consumption	0.4	1¾	1½
Government consumption	1.9	2	1
Investment	5.7	6½	3¾
Exports	14.4	8½	6¼
Imports	12.8	7	6¾
Inflation	1.2	2½	2
Unemployment (%)	7.7	6½	6
Government balance (% GDP)	-3.3	-2	-1¼
Government debt (% GDP)	83.2	82½	81

- Various leading indicators suggest that Germany's growth has hit a soft patch, much like the rest of the world. This is primarily due to weaker global demand.
- Rising inflation and lack of a comprehensive solution to the debt crisis in the periphery is pushing consumer sentiment downwards.
- But our expectation of falling inflation going forward means that consumers' purchasing power is likely to improve in 11H2 and beyond.
- Consumer spending may also be buoyed by the ongoing labour market recovery. We expect unemployment to fall further (due to rising employment and stagnant labour force), albeit at a slower pace.

Source: Reuters EcoWin, Rabobank

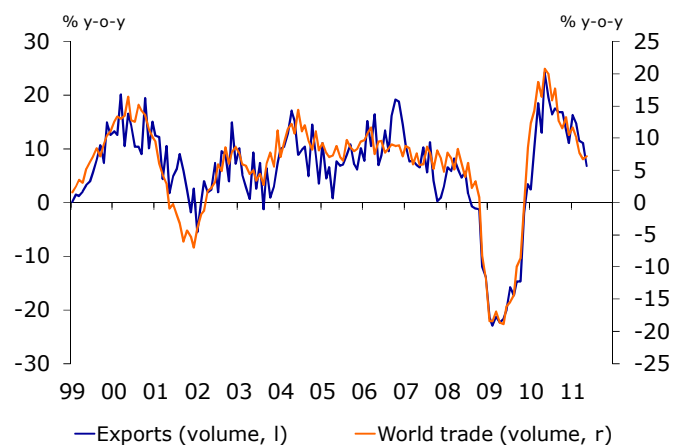
Leading indicators point to more subdued growth...



All major economic indicators are heading South. In July, the German headline Economic Sentiment Indicator (survey from the European Commission) fell to its lowest level since last September. Meanwhile, the IFO index experienced the sharpest drop since December 2008. The ZEW economic expectations indicator fell for a fifth successive month to its lowest level since January 2009. Most noteworthy though was the spectacular drop in the composite PMI from 56.3 in June to 52.2 in July, the lowest level since mid-2009. Taken together, the current levels of business sentiment are signaling a moderation in growth going forward, but, at least for the time being, also nothing more than a moderation.

Source: Reuters EcoWin

...partly due to the waning global demand



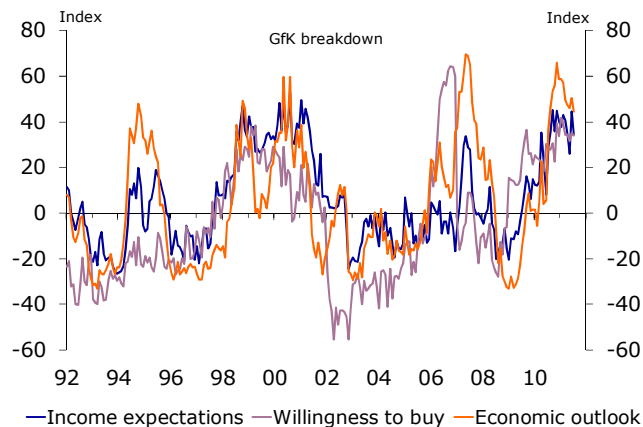
As we mentioned in our last update, the slow-down in Germany's growth was to be expected. Part of the pick-up in activity in 11Q1 was due to a weather-related surge in construction investment and a sharp rise in government consumption. Neither was likely to be sustained. What's more, the soft patch in global growth owing to monetary and fiscal tightening around the world was bound to weigh on activity. The near-halving of the annual world trade growth volume over recent months could not have gone unnoticed. We have reiterated time and again that as long as Germany's economy remains geared towards the export sector it will be highly susceptible to swings in global demand. Well, there you have it.

Source: Reuters EcoWin, CPB

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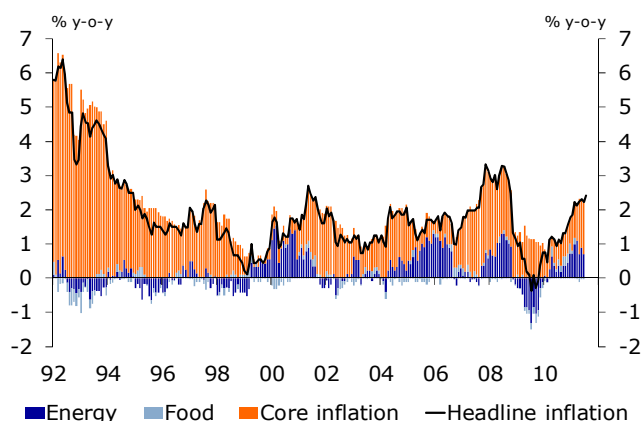
Consumers are feeling gloomy...



Source: Reuters EcoWin

On the domestic front, Germany's economy is sending mixed signals. The GfK's forward-looking consumer confidence indicator suggests that households are getting less optimistic about the outlook. The index has fallen from a 3½ year cyclical peak of 6.0 in March to 5.4 in August. The figure shows that the drop was broad-based with all sub-categories registering a decline. According to the GfK press release, rising inflationary pressures (CPI inflation rose to 2.4% in July) and concerns about the debt crisis in the eurozone periphery are taking their toll on German consumer sentiment. Even the retailers are becoming less upbeat as evidenced by the fall in IFO index for the retail sector in July.

...thanks in part to rising inflation



Source: Reuters EcoWin

On the face of it, the evidence suggests that the long-awaited German consumer revival might not materialise. But there is still hope. The recent increase in inflation primarily reflects rising energy prices and should be short-lived. Assuming an unchanged oil price, falling energy inflation should knock about 0.8%-points off the headline figure by the end of this year. Admittedly, core inflation (ex. food and energy) might rise in response to the recovering labour market (i.e. workers' greater negotiation power might lend impetus to higher nominal wage growth). But we believe the risks to inflation still lie to the downside. Note that July's PMI surveys are pointing to receding price pressures going forward.

Labour market improving, but at a slower pace



Source: Reuters EcoWin

The labour market recovery will also be an ongoing support for consumer spending in the coming months. Unemployment fell by another 11,000 in July, similar to the pace seen in May-June but significantly slower than during January-April (when there was an average monthly decline of 37,000). Labour market conditions are expected to improve in the months ahead as employment intentions of businesses based on different surveys and vacancy data point to high demand for labour. Of course, we need to mention that the pace at which unemployment will decline during the remainder of 2011 will be slower than the average monthly pace seen during the initial economic upswing.

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