Economic Update Germany

1 February 2011

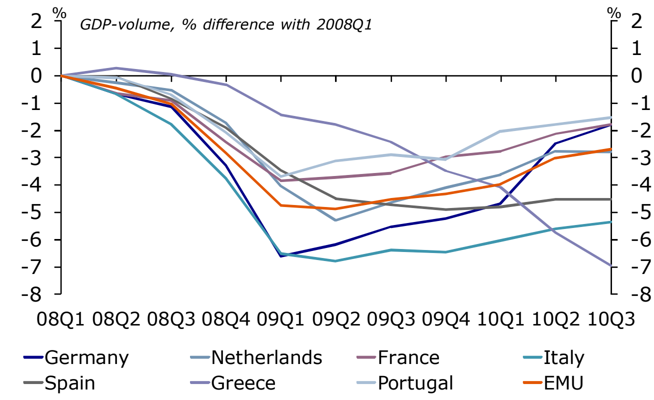
A robust economic performance expected for 2011

year-on-year change (%)	'09	'10	'11
Gross Domestic Product	-4.7	3½	2
Private consumption	-0.1	½	1½
Government consumption	2.9	2¾	½
Investment	-10.0	5¼	3
Exports	-14.3	14¾	6½
Imports	-9.4	13¼	6¼
Inflation	0.2	1	1¼
Unemployment (%)	8.2	7¼	7
Government balance (% GDP)	-3.3	-3.5	-2¾
Government debt (% GDP)	71.8	75¾	76

Source: EcoWin, Rabobank

- 2010 GDP growth was strongest since unification thanks to strong exports and investment.
- The export outlook has become far less certain as the benefits of US stimulus package can be outweighed by the troubles in the eurozone.
- Consumption shows no sign of revival as nominal wage growth remains subdued.
- Inflationary pressures are building amid sharp rebound in commodity prices and the country's strong economic conditions. The ultra loose monetary policy stance of the ECB may lead to higher inflation going forward.
- Rising inflation may also act as a drag on profit margins, hence slowing investment growth.
- Deficit is expected to fall below 3% in 2011.

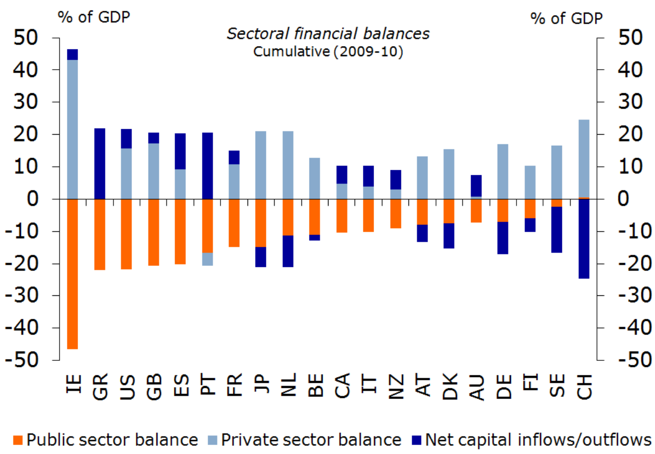
2010 GDP growth was strongest since unification



Source: Reuters EcoWin

Germany's economic recovery was very strong in 2010 (GDP grew 3.5%) – slightly above our expecation. Net exports contributed 1.1%-points to growth, domestic demand 1.7%-points, and inventory formation 0.8%-point. Fixed investment was the chief contributor among the domestic demand components (1.0%-point). Private consumption, on the other hand, added marginally to GDP (0.3%-point) even though the labour market (outlook) was improving over the entire period. It is important to note that the quick pace of recovery needs to be seen in light of the economic slump in 2009 (-4.7% y-o-y). In level terms, the economy is still performing below its potential and its pre-crisis level.

Will the world buy more German goods in 2011?



Source: Reuters EcoWin, Rabobank

The export outlook has become far less certain this year. On the one hand, a possible weakening of the euro owing to the sovereign debt turmoil in the eurozone and the recently enacted US fiscal stimulus package pose an upside risk. On the other hand, fiscal policies across the industrial world will turn contractionary (US being the exception). It remains to be seen whether the battered private sectors in Germany's most important trading partners will be able/willing to fill in the spending gap left open by the public sectors. Even the booming emerging markets, which Germany strongly benefited from in 2010, seem to be running into boundaries of potential production.

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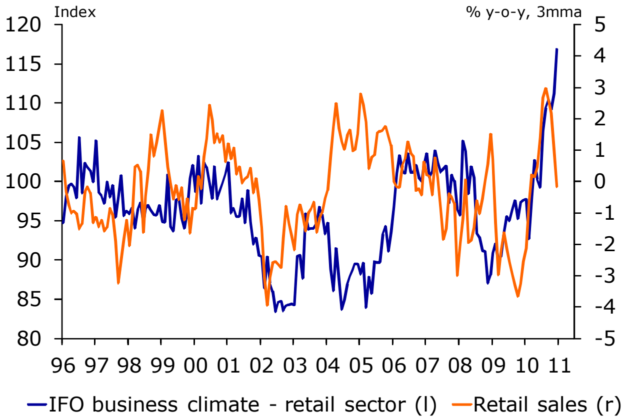
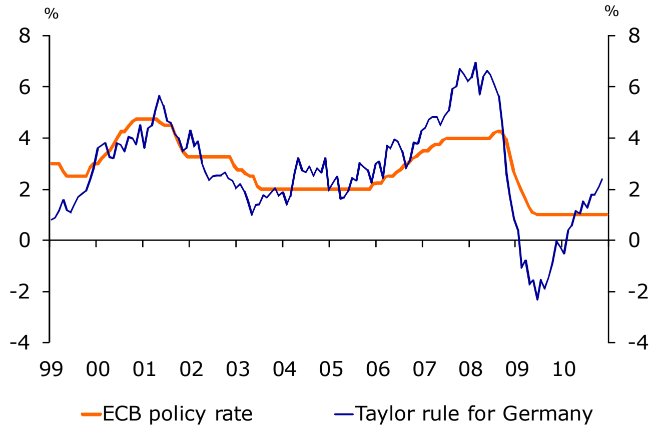
Consumers are likely to spend more if wages rise



Source: Reuters EcoWin

Retail sales volume, excluding cars, posted a disappointing decline of 0.3% m-o-m during December 2010, after contracting 1.9% in the previous month. Clearly these figures are very poor given the massive improvement in labour market conditions and the upbeat message sent by retailers in the IFO index. So far, wage growth has remained muted (hourly wages rose 1.2% y-o-y in 10Q4) as most wage deals were negotiated during the crisis (i.e. job security was the main priority for unions). It remains yet to be seen whether the recovering labour market will lend impetus to wage growth, thereby leading to higher consumption and thus a rebalancing of the economy.

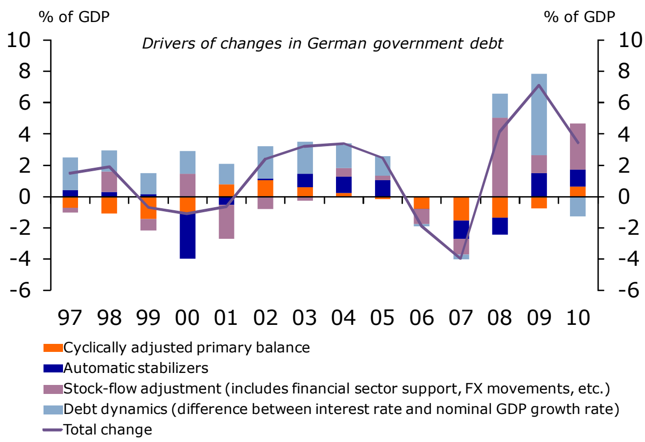
Inflationary pressures are rising



Source: Reuters EcoWin, Rabobank

The risk of rising wage growth is a further rise in inflation, which is already on an upward trend (1.9% in January) amid the sharp rebound in commodity prices. Luckily, core inflation is still low (0.7%). Rising price pressures may also slow down fixed investment growth. According to January PMI figures, the sub-index for input price inflation has jumped from 74.2 to an all-time high of 81.2 while the output price sub-index has slipped from 56.9 to 56.3, thus suggesting deteriorating profit margins. Germany's inflation will overshoot the European Central Bank's target (below 2%) if the policy rate is kept too low for an extended period to accommodate the poor economic conditions in the European periphery.

Improving fiscal metrics call for income tax cuts



Source: Reuters EcoWin, Rabobank

According to the Federal Statistical Office, the 2010 government deficit will be 3.5% of GDP. Hence the worsening of public finances due to the global crisis has turned out to be fairly limited, notably compared to other advanced economies. This is closely linked to the strong performance of the economy. Given our expectation for robust GDP growth (i.e. favourable debt dynamics) this year, we expect the deficit to drop below 3% in 2011. In other words, Germany will meet the European Commission's criteria much earlier than scheduled. This will give the government the necessary fiscal space to introduce the much-awaited income tax cuts that can further bolster consumer spending.

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