Macro Comment 10/09

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# Germany: Will growth also disappoint in H1 2010?

Rabobank

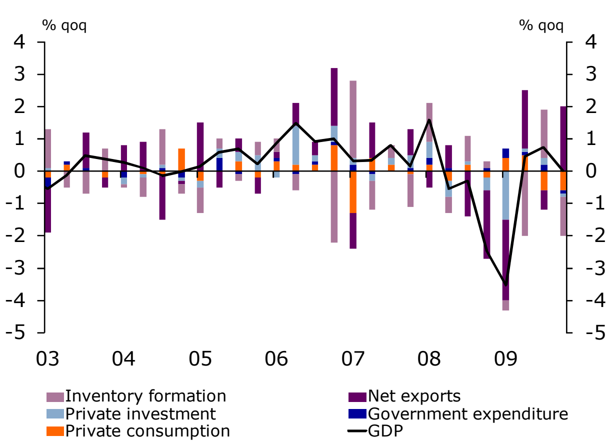
*We expect Germany's economy to be supported by the inventory correction as well as external demand in H1 2010. There are, however, significant downside risks to this forecast. The severe weather conditions in 09Q1 can slow industrial production and world trade more than we currently envisage. Moreover, domestic demand can weaken significantly as consumers face a higher rate of inflation and unemployment while wage growth falls.*

The second German GDP release confirmed that growth indeed stagnated in 09Q4 after rising 0.4% q-o-q and 0.7% q-o-q in Q2 and Q3, respectively (see figure 1). Looking at the breakdown, there is nothing really surprising in the report. The Federal Statistical Office had already stated that consumption was down again in 09Q4 (-1.0% q-o-q) erasing the gains seen in H1 2009. Gross fixed investment decreased by 0.7% q-o-q after +0.9%. Fortunately, GDP was buoyed by export growth, which rose +3.0% q-o-q after +3.4% in the previous quarter, while imports were down 1.8% q-o-q after +5.2%. Therefore, net trade contributed 2%-points to growth.

The main culprit for the stagnation of growth was the rapid pace of destocking by the German companies – subtracting 1.2%-point from growth. If the contribution of inventory formation would have equaled that of 09Q3 (+1.5%-point), the German economy would have grown by 2.7% q-o-q in 09Q4. Regrettably, accurate forecasting of this very important component of GDP is notoriously difficult given that it includes all statistical discrepancies in the GDP figure and is, therefore, very volatile. The result is that the swings in the quarterly GDP growth become amplified. In any case, there are reasons to be hopeful that the drag from inventories will *not* be sustained in H1 2010. The first reason is that businesses are already holding very low stock levels thanks to the rapid pace of destocking until now. The other reason is that business surveys suggest that actual stocks are getting closer to businesses' desired levels (see figure 2). It is important to note, however, that restocking is not a necessary condition for inventory formation to contribute positively to growth. To clarify this concept, we should go back to the introductory macroeconomics books. The GDP of a country, production (Y), is the sum of spending by households (C), businesses (I), government (G), and net spending by foreigners on German produced goods and services (NX). More formally, $Y = C + I + G + NX$ . Since aggregate spending does not necessarily equal production at a given time, the excess is added to inventories. The opposite relationship also holds, whereby inventories are drawn down if production cannot meet demand. As such, the *change* in inventories (ΔINV) has to be added to total spending (i.e. $Y = C + I + G + NX + \Delta INV$ ). We can rewrite this equation as $\Delta Y = \Delta C + \Delta I + \Delta G + \Delta NX + \Delta(\Delta INV)$ to measure the growth of GDP. In other words, it is *the change in inventories accumulation that matters for growth*. Therefore, if the pace of destocking merely slows in 10Q1, which we do expect, inventories will be a positive impulse for growth. This makes sense since production will be moving closer to the actual level of demand.

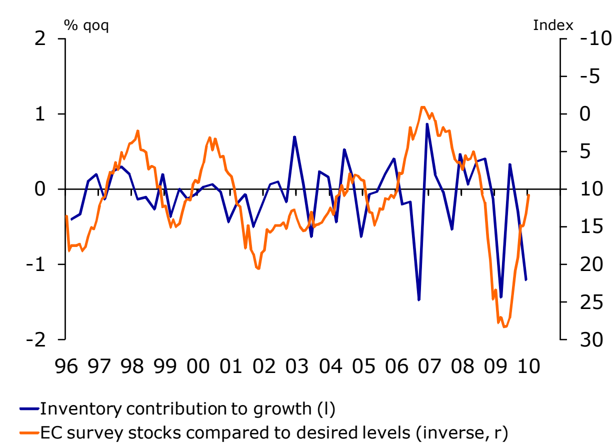
There are other reasons to be relatively optimistic about growth in H1 2010. The strength of external

**Figure 1: Quarterly GDP growth**




Source: Reuters EcoWin

**Figure 2: Destocking cannot go on forever**




Source: Reuters EcoWin

demand can support Germany's economy. In addition, the recent depreciation of the euro will also increase German exporters' external competitiveness. What's more, the exporters should benefit from the recent slowdown of unit labour costs (+1.2% y-o-y in 09Q4 after +5% in 09Q3). The recent deals with the trade unions point to a slight moderation of wage growth going forward. Most notably, the wage agreement with IG Metall, largest and most influential union, will set a precedent for other sectors. These developments are very positive given that the competitive position of the German firms was seriously being undermined. The boost to profit margins, as a consequence of waning wage growth, also poses an upside risk to investment growth in H1 2010 (see figure 3). Although we do not expect firms to go on an investment spree this year while capacity utilization rates remain ultra low.

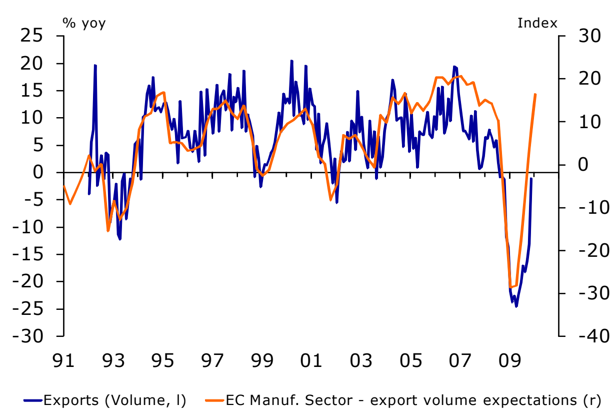
| Union | Industry | % total workforce | Agreed pay rise | From | To |
|---|---|---|---|---|---|
| IG Metall | Engineering | 1.6 | €320 lump sum | May-10 | Mar-11 |
| | | | 2.7% | Apr-11 | Mar-12 |
| IG Bau | Building | 0.9 | 3.8% - 6.2% | Jan-10 | Dec-11 |
| IG Metall | Metal | 0.9 | 0.0% | Jan-10 | Dec-10 |
| Ver.di | Public services | 2.9 | 5.0% | Jan-10 | Dec-10 |

But not everything looks fine and dandy for the German economy. The flip side of moderate wage growth is weaker consumption this year and next. Not only will Otto Normalverbraucher get a lower pay, but he will also be facing a higher rate of inflation and unemployment. These headwinds have, naturally, made consumers and retailers more somber about the future. Both the Gfk consumer confidence and the IFO business climate index for the retail sector dropped in February for the fifth and second month in a row, respectively. Against this backdrop, the much-needed consumption recovery remains a distant prospect.

So it all boils down to how robust external demand will be in the coming months, which is, in turn, dependent on a plethora of government measures. This implies that Germany's economy will be particularly vulnerable to any slowdown in global demand. Recovery can be particularly hurt if the main trading partners of Germany begin tightening their fiscal and monetary policies – which can start as soon as H2 2010. Moreover, the ongoing difficulties in the European periphery (Portugal, Ireland, Italy, Greece and Spain), that together account for almost 12% of Germany's exports, can prove costly for the country.

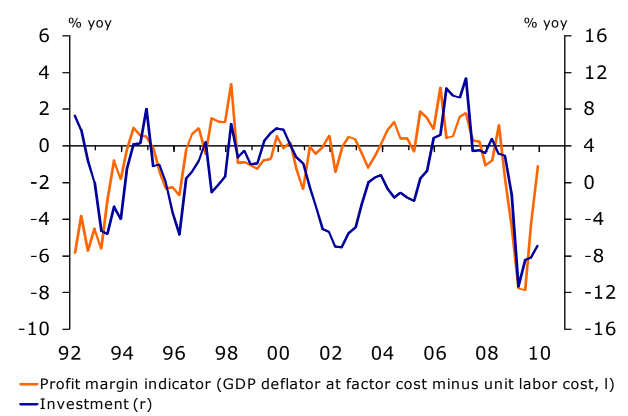
To sum up, we are convinced that Germany's economy will grow at a healthy clip in H1 2010 on the back of strong exports and the inventory correction. However, the downside risks to growth are non-negligible owing to the weakness of domestic demand as well as the severe weather conditions in 10Q1. As we have stressed time and again, therefore, there is all the reason for the Germans to kick their export addiction and encourage more demand at home. Otherwise, the economy will be in for a bumpy ride.

**Figure 3: Massive optimism amongst exporters**




Source: Reuters EcoWin

**Figure 4: Producers have more breathing space**




Source: Rabobank, Reuters EcoWin

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