

Monthly update Germany

2 March 2010

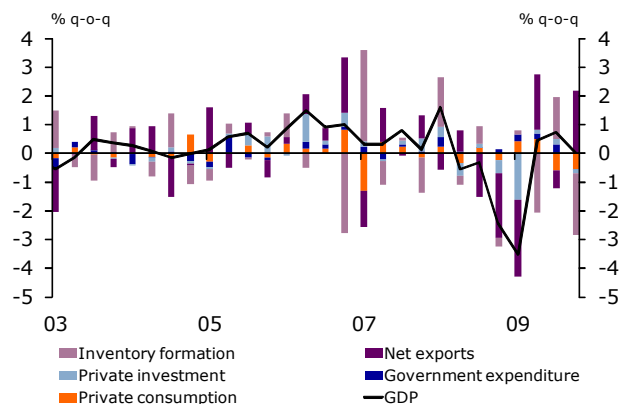
Economic recovery is not robust yet!

year-on-year change (%)	'09	'10	'11
Gross Domestic Product	-5.0	2	1¾
Private consumption	0.3	-¾	1¾
Government consumption	3.0	1½	1¼
Private investment	-8.8	¾	1¾
Exports	-14.2	10¼	5
Imports	-8.9	6½	6¼
Inflation	0.2	0.3	½
Unemployment (%)	8.1	8.5	9
Government balance (% GDP)	-3.3	-5	-3½
Government debt (% GDP)	77.3	82	85

- Growth in 09Q4 stagnated amid weak domestic demand and rapid destocking by firms.
- But the expected swing in the inventory cycle together with robust external demand can result in solid growth figures in H1 2010.
- There are a number of downside risks, however. Consumers might significantly tighten their belts given the severe headwinds they will face while the harsh winter might take its toll on industrial production.
- Investment can surprise on the upside due to the fall in unit labour costs. But the risk is that profit margins might come under pressure yet again if firms lose a lot of pricing power against a weak economic backdrop.

Source: Rabobank, Reuters EcoWin

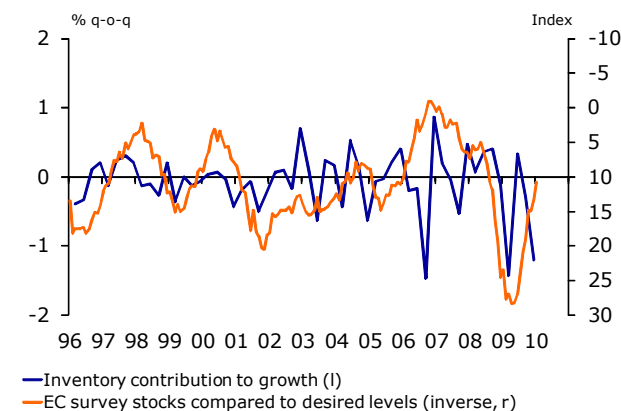
GDP growth in 09Q4 disappointed as expected...



The 09Q4 GDP release confirmed our view that growth would seriously disappoint. Consumption declined markedly (-1.0% q-o-q) while gross fixed investment decreased once more (0.7% q-o-q) after posting a solid growth (+0.9%) in 09Q3. However, the main culprit for the stagnant growth was the rapid pace of destocking by the German companies – subtracting 1.2%-point from the headline figure. If the contribution of inventory formation, the most volatile component of GDP, would have equalled that of 09Q3 (+1.5%-point), the economy would have grown by 2.7% q-o-q in 09Q4. In any case, the significant contribution of net trade (2%-points) prevented the economy from contracting in 09Q4.

Source: Reuters EcoWin

...but growth can surprise on the upside in 2010H1...



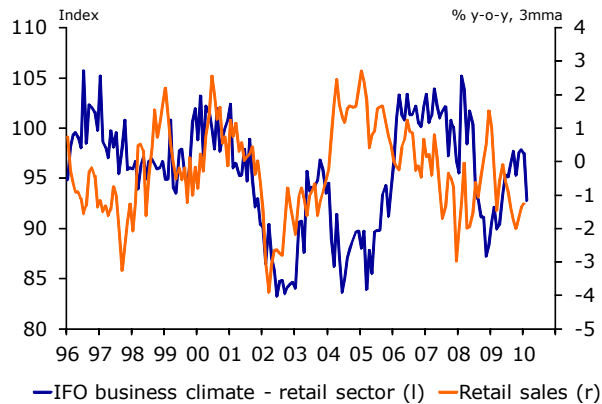
In our view, Germany's economy can grow at a healthy clip in H1 2010 on the back of strong exports – which is, in turn, supported by the robust growth in global demand and the depreciation of the euro. Moreover, we are quite convinced that the drag from inventories will not be sustained in H1 2010 since businesses are already holding very low stock levels thanks to the rapid pace of destocking until now. This is reflected in the recent EC survey, which suggests that actual stocks are getting closer to businesses' desired levels. It is important to note, however, that even if the pace of destocking merely slows in 2010H1, inventory formation will still add to growth (see our Macro Comment 10/09).

Source: Reuters EcoWin

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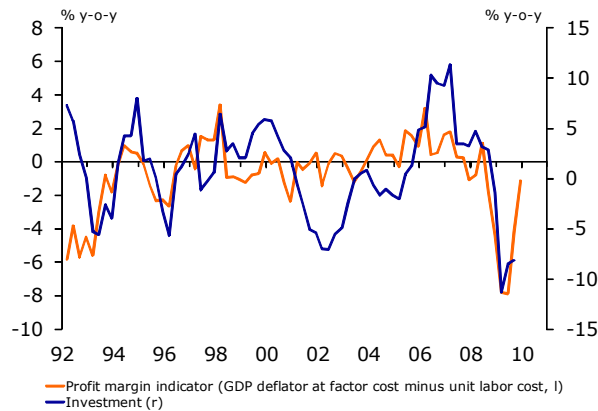
...unless waning domestic demand spoils the party



Source: Reuters EcoWin

The Achilles heel of the German economy is domestic demand. Not only will wage growth fall this year, but consumers will also be facing a higher rate of unemployment and tighter credit conditions. These headwinds have resulted in the drop of the GfK consumer confidence and the IFO business climate index for the retail sector for the fifth and second month in a row, respectively, in February. The harsh winter will not only make matters worse for retailers, producers are also likely to suffer. This means that the German economy's prospects will remain, by and large, in the hands of foreigners. And it is extremely difficult to predict whether external demand can outweigh domestic demand's weakness or not.

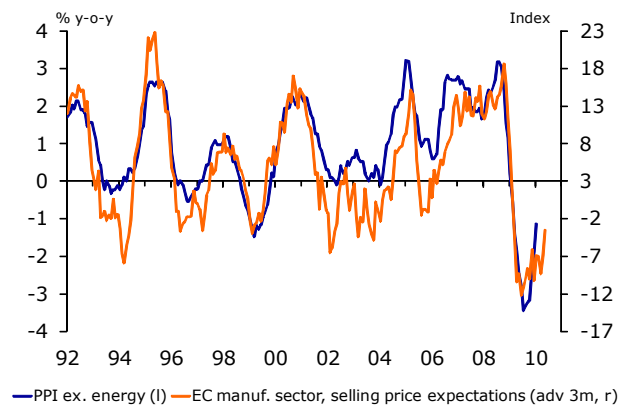
There are some upside risks to investment...



Source: Rabobank, Reuters EcoWin

Market participants tend to argue that German companies are unlikely to go on an investment spree amid a large spare capacity. However, one thing they fail to notice is that optimism amongst German producers concerning the global economic outlook, as is evident in various business surveys, can entice them to invest more in the hope of better days. In this regard, the "ability to invest" – measured by the firms' profit margins and the domestic credit conditions – might be as important as the "willingness to invest" in determining investments. As such, the recent drop in unit labour costs (-1.3% q-o-q in 09Q4), can pose an upside risk to our investment growth forecast.

...but not by as much as we would hope for



Source: Reuters EcoWin

Although costs have dropped recently, the German firms' profit margins might still come under renewed pressure on the back of a weaker pricing power. This is reflected in the selling price expectations of firms, which is still close to its all-time lows. Naturally, there is heavy price competition amongst firms to lure in the tight-fisted consumers. What is particularly worrying though is the large drop of CPI inflation in February (0.4% y-o-y from 0.8% in January) owing to the weakness of domestic demand. This means that firms might lose their pricing power even more in the coming quarters if (core) inflation resumes its downward tendency. So firms can be more hesitant in making a lot of investment decisions in the short-term.

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