

Research

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Germany: Recession looming

- Germany is the last man standing in the Euroland economy, but it is suffering from a deteriorating international environment and sluggish domestic demand. If Germany falls it will have a profound effect on Euroland growth – and downside risks have risen markedly in just a few months.
- Although the German economy is in relatively good shape, it cannot shield itself from deteriorating export markets that are giving in to the massive headwinds that have hit most of Germany's trading partners. Domestic consumption is very unlikely to make up for the fading demand from export markets, as consumers are suffering high inflation rates that are eroding purchasing power, and the rather strong employment growth of recent years is coming to an end. Furthermore, investments cannot fill the gap, as they are very sensitive to exports.
- Thus the German economy is facing a tough time. Negative growth will probably be seen in Q2 due to the underlying weakening of the economy, but because of the unwinding of special effects (i.a. a reversal of the warm weather effect on production, and the build-up of unintended inventories). We expect the economy to stagnate in Q3, but there is a risk of contraction. For 2008 as a whole, we expect GDP to grow by 1.6%. Growth is forecast at 1.1% in 2009, but this may prove too optimistic.
- What does this mean for ECB interest rates? One thing is sure – it will be harder for the ECB to hike rates further. Furthermore, the “north-south” tensions in Euroland will evaporate as the conflicting interests of the “hardliners” in the north (with relatively moderate inflation and high activity) and the doves in the south (with relatively high inflation and fading economic growth) diminish. Whether this means that rate cuts are just around the corner is another question, however. It remains to be seen, for example, how the ECB will interpret the expected rise in core inflation later this year and Euroland wage growth, which we forecast to stay rather elevated well into 2009 despite slow economic growth.

Germany setting the pace for Euro-land's economy

Last man standing in Euroland

The “Big 4” in Euroland have responded rather differently to the headwinds that have hit the Euroland economy.

Overall, Euroland is on the brink of recession. The French economy is cooling very fast at the moment,

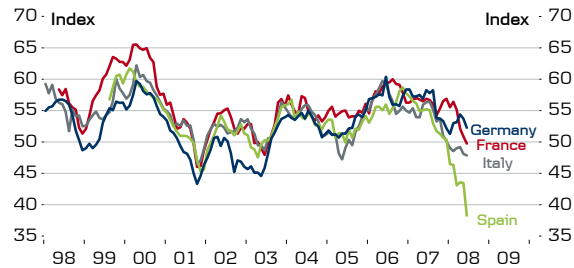
as indicated by the composite PMI falling from above 55 to below 50 in just 3 months, meaning French PMI has entered contraction territory. In addition, French consumer confidence is in freefall, hitting a record-low for the sixth straight month in June.

In Italy, growth has been slow for years, and Italy has been well into PMI contraction territory for some time. Spain is in deep trouble, and is set to

slide into recession this year on the back of the collapsed housing market, which had been the main driving force for growth in recent years.

Germany, in contrast, has performed relatively well during these turbulent times, and is now more or less the last man standing in Euroland. Therefore, Euroland growth heavily depends on how Germany copes with the blows it has been dealt.

Germany - Euroland's strongman - Big 4 composite PMI



If Germany weakens [further] in the coming months, this will have a profoundly negative effect on the Euroland economy, as Germany accounts for more than a quarter of total Euroland GDP.

Furthermore, as the Euroland economies are rather intertwined, a weakening in Germany will most likely have a substantial knock-on effect on the other Euroland economies - and the risk of a significant economic slowdown in German has risen in recent months, as the other major economies in Euroland have weakened considerably.

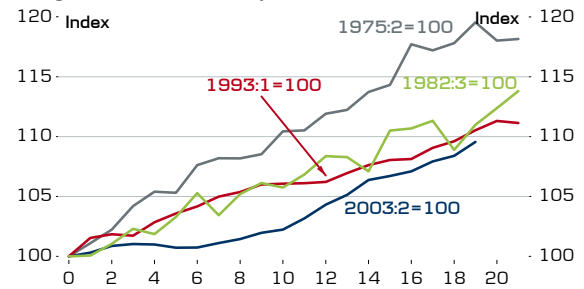
GDP correlation of year over year growth rates

	Germany	France	Italy	Spain
Germany	1,00	0,69	0,72	0,66
France		1,00	0,34	0,57
Italy			1,00	0,61
Spain				1,00

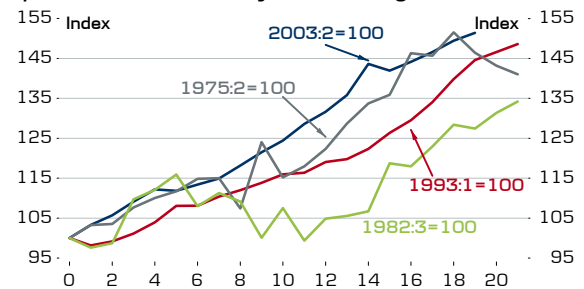
The recent upswing - so far so good...

As is the norm, the recent upswing in the German economy began in the export sector. Exports have grown strongly since 2004, underpinned by strong growth in export markets and Germany's specialisation in capital and intermediate goods. Investment expenditures turned around next, but in contrast to previous recoveries the private consumption cylinder has failed to fire in this business cycle. Private consumption has been weak mainly because household income growth has been low. In turn this is primarily due to rather slow wage growth. In addition, household saving rates have increased, partly due to the introduction of a tax-favoured retirement savings scheme.

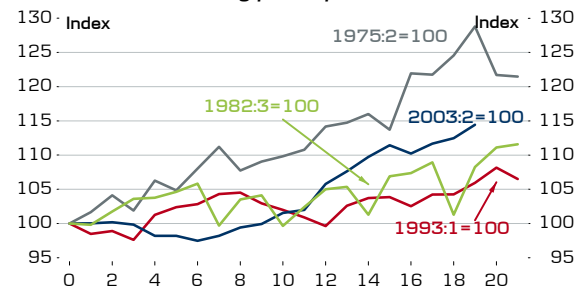
GDP growth not that impressive this time around



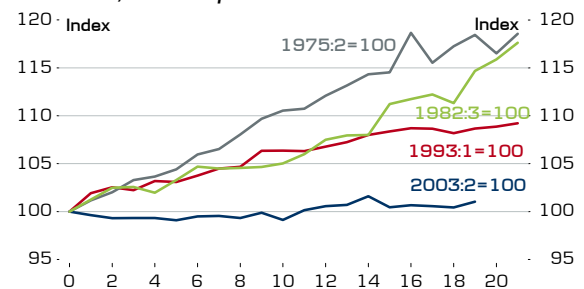
Exports have been a major driver of growth ...



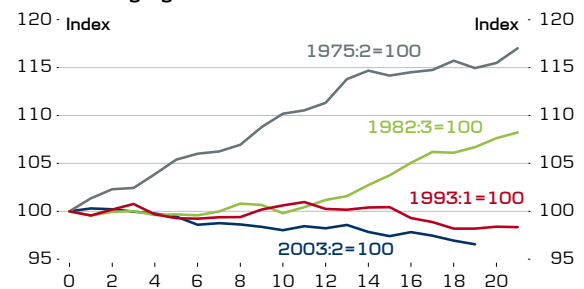
... that induced a strong pick-up in investments



In contrast, consumption has been subdued ...

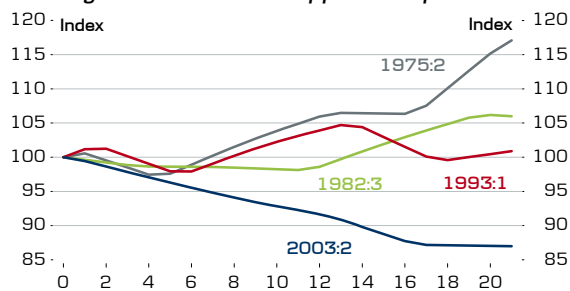


... as real wage growth has been rather low ...



... and the saving rate has increased

The flipside of the wage-moderation coin has been a marked decrease in unit labour costs following the significant increase in the years immediately after reunification.

Declining unit labour cost support competitiveness

This has supported both employment (and in turn household consumption) and competitiveness. Combined with a favourable product mix and a supportive geographical position, declining unit labour costs have led to the above-mentioned relatively dynamic development in exports.

To sum up: rapid growth in export demand has been at the heart of Germany's most recent expansion, and export demand has been supported by wage moderation. In contrast, higher household saving rates have risen, leading to just modest growth in private consumption.

The German economy is fairly well balanced at the macroeconomic level at present: public finances have improved due to both cyclical shifts and structural improvements, labour market performance has been impressive during the recent upswing - in part due to past labour market reforms that increased incentives to take up work - and the housing market has not been overheated.

Thus, the German economy is in relatively good shape, and this is - in combination with continued strong support for exports from emerging markets - the reason why Germany has performed relatively well so far despite the strong headwinds (financial turmoil, steep increases in oil and food prices, a

strengthening euro and a slowdown in some of Germany's main trading partners, in particular the UK and the US) that have caused most Euroland countries to tumble.

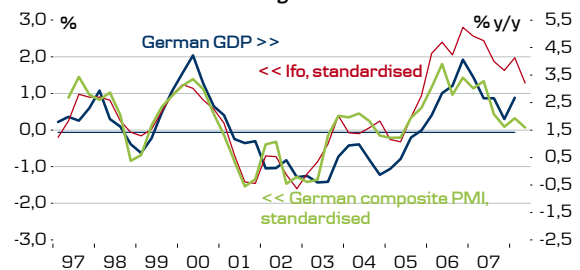
...But tide is turning

Although in good shape, the German economy has begun to wobble, and the good days are apparently over. The main reasons are:

- Payback for temporary factors that spurred Q1 growth.
- Weakening export market demand that has consequences for investments.
- High inflation is eroding consumer purchasing power.

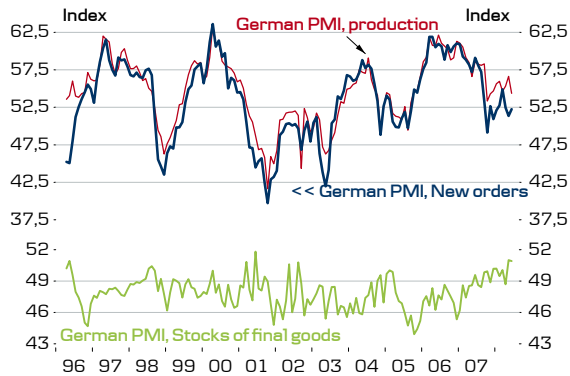
Payback time

To state that the good times are over may seem at odds with the very impressive start to the year. GDP was up by a whopping 1.5% in Q1 08 compared to Q4 07. This could indicate significant momentum in the economy, but the numbers are deceiving. We believe underlying developments have been in line with the gradually fading growth rates seen since they peaked at the end of 2006.

Growth has been declining since the end of 2006

The Q1 numbers are "artificially" high for two reasons. First, favourable weather conditions boosted construction sector output (to 4.5% q/q), and secondly - and even more importantly - stock-building contributed to almost half (0.7 percentage points) of the 1.5% growth in GDP. Both these factors are likely to reverse later this year. Indeed, activity indicators for the construction sector have already fallen back close to H2 07 levels. Regarding stocks, the detailed PMI figures indicate that production continues to outstrip orders, so stocks of final goods have most likely grown in Q2 as well. We expect some destocking to take place in Q3.

Stocks of final goods have increased



Perhaps one indicator says it all, namely industrial production. As can be seen from the seasonally adjusted output in the chart below, industrial output has been deteriorating for some time – and there is worse to come. Orders are coming in at a much slower pace than just a few months ago – manufacturing orders in June were down for the sixth straight month.

Industrial production already in sharp decline – and worse is to come ...



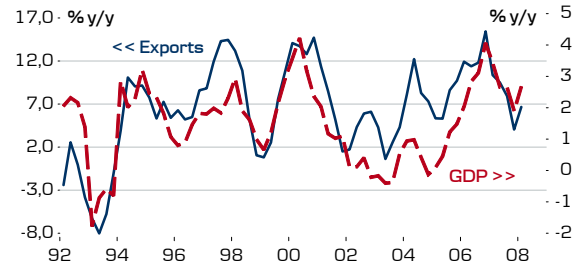
This means production has to slow – and new orders indicate that it will soon be at the same level as a year ago.

It may well be that recent production data overstate the slowdown, as the PMIs, which are usually quite reliable, still point to some growth. However, a marked slowdown is surely underway.

Export market demand weakens

To get an impression of how the German economy waxes and wanes you almost only have to track exports. The chart below makes this co-movement reasonably clear.

Exports at the heart of the German economy



This is, of course, a rather simplified way to view things, but it highlights that German household consumption has remained weak and that Germany has a large manufacturing sector which is both sensitive to the global economic and industry cycle and also much more volatile than the service sector.

Exports are important for (at least) two reasons:

- They are an important part of total demand
- They play a major role for investments.

German economic growth therefore depends heavily on exports – as can be seen in the most recent expansion, where rapid growth in export demand fuelled industrial production. Germany is therefore likely to react rather dramatically to a downturn in export markets, as the economy falters if exports are sluggish.

During the past 1½ years exports and GDP growth rates have been declining in tandem, and recently there has not been much cheer for German manufacturing exporters.

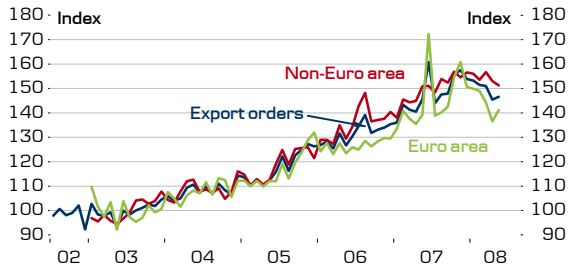
Around three-quarters of German exports head for European countries. Approximately two thirds is bound for EU countries, and more than 40% goes to Euroland. So it may be worthwhile to take a brief look at the data we have on these countries.

Good economic news from fellow Euroland countries is a rarity:

- French PMI is in freefall (with manufacturing PMI going from almost 54 to just above 49 in 4 months) and consumer confidence has hit a record-low for the sixth straight month at -46.
- Spanish PMI and consumer confidence also hit historic lows in June.
- Italian consumer confidence has tumbled and Italian manufacturing PMI is at its lowest level since 2001.

As a result, export orders from the Euro area have already lost momentum and are now markedly below the level in H2 07. Further, we have no reason to believe in a pick-up anytime soon.

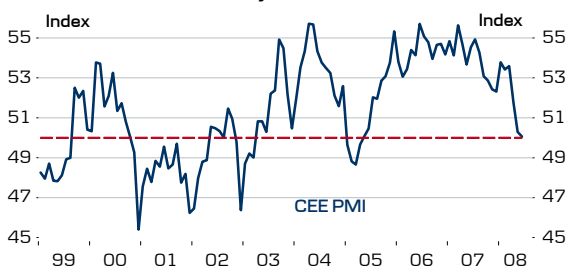
Export orders falling - inside and outside Euroland



Non-Euro-area export orders have held up relatively well. Emerging markets (including i.a. Russia and other parts of Eastern Europe) have contributed to this. It is worth noting that German exports to many non-Euro-area European countries is not that sensitive to fluctuations in exchange rates, as many of these currencies have largely risen in tandem with the euro. This is one of the reasons why German exports have been so resilient to the rising value of the euro.

We expect emerging markets to outperform Euro-land, but growth in many Eastern European countries is set to slow markedly and some of these countries are even facing a deep recession.

CEE set to slow markedly



The UK economy is cooling fast at the moment following the collapse of the housing market and the strains in the financial sector.

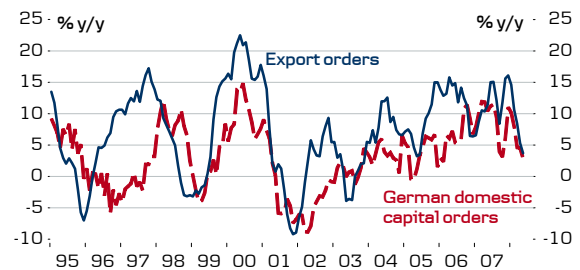
Outside Europe, both the US and Japan are suffering. US economic activity has almost stalled over recent quarters, and the picture looks rather uneven going forward. While the fiscal stimulus package will provide a significant, albeit temporary, boost to consumer spending, the underlying economy will remain weak. In Japan, we expect GDP growth to be negative in Q2 and close to zero in Q3, as both exports and private consumption have

slowed sharply. Downside risk to the Japanese economy is obviously increasing, as higher inflation has weakened demand.

Investments fading in tandem with exports

The large German manufacturing sector is sensitive to the global economic situation. This is reflected in the close connection between export orders and domestic capital orders. When exports boom, the need for production capacity spurs companies to invest in new machinery, etc. Now, however, export markets are beginning to shrink, and this is going to drag down German capital investments. The expected just moderate growth in consumer demand will also hold back investments.

Investments suffering from slowing exports ...



Furthermore, investments are suffering from falling stock markets, as this makes new capital relatively expensive compared to existing capital. Thus adding new capital will reduce the market value of firms.

... and the drop in equity prices



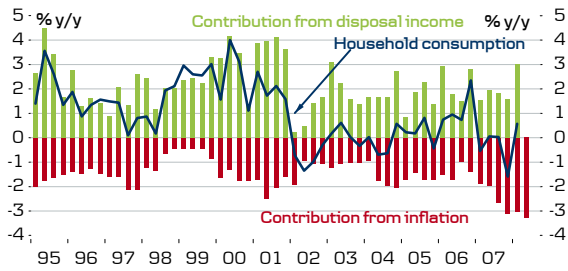
Although German companies are well bolstered, as profits have been healthy in recent years, it is hardly realistic to expect that they will keep up their high level of investment.

This prompts an obvious question: How realistic is it to expect a very export-dependent German economy to avoid a substantial slowdown or even recession when so many of its most important customers - France, Italy, Spain, the UK, the US, etc - are either slow-moving or entering recession? Consumption gives us some indication.

Private consumption hit by inflation

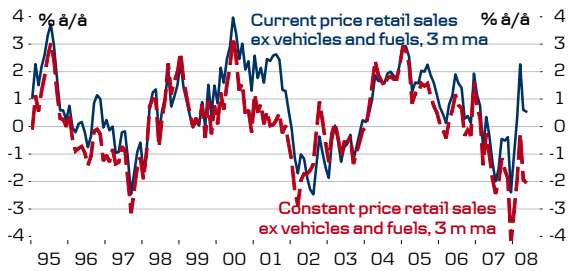
The current high inflation rates mean that consumer purchasing power is being eroded. Consequently, already subdued private consumption growth is being brought to a halt. Thus consumption is very unlikely to make up for the fading demand in export markets.

Private consumption growth restrained by inflation



The effect of high inflation is perhaps most evident in retail sales. Retail sales in current and constant prices usually moved in tandem because inflation has been quite stable. Now, however, the series are drifting apart, pretty much like they did in 2000 and 2001, when oil and food prices soared. Consumers have managed to keep current price retail sales more or less constant. In constant prices, however, retail sales have been shrinking.

Inflation drives a wedge between constant and current price retail sales growth

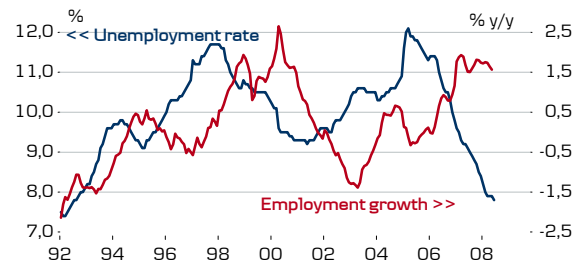


Looking at retail sales over a longer period, it is remarkable that growth has been low since the sharp spike in December 2006 ahead of the 3 percentage point hike in VAT. The spike was followed by a huge trough in January 2007, and retail sales have never really fully recovered.

Until now consumption has been supported by employment growth. Indeed, the German job-creation

machine is still functioning, but at a slightly slower pace than in previous months.

Employment growth still supporting consumption...



Looking forward, employment is likely decline as a result of both the export-market-driven slowdown in industrial production and a reduction in consumer demand due to high inflation. Thus the employment stimulation to consumption is likely to vanish or even become a drag in the coming months, albeit with a lag due to the usual labour hoarding effects. It is also important to bear in mind that the German labour force is currently close to its historical peak and will steadily decline going forward.

... but the effect is likely to reverse



Consumers are well aware of the rising risk of unemployment and this usually makes consumers more reluctant to open their wallets (because precautionary savings increase when uncertainty with regard to the household economic situation increases).

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First date of publication

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