EURO THEMES

German outlook: Another soft patch ahead

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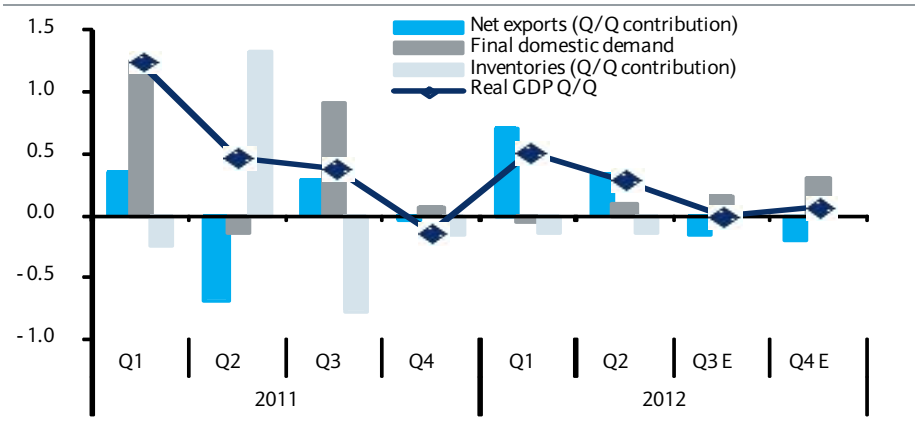
- **Despite the recession in parts of Europe, the German economy recovered from its brief slump in Q4 2011, growing at an annualized rate of c.1% in H1 2012.**
- **Weaker global investment demand is set to weigh on the German economy. We cut our GDP growth forecast for 2012 by 0.2pp to 0.9% and for 2013 by 0.4pp to 1.4%.**
- **Our medium-term outlook remains cautiously optimistic, but it could be derailed if the euro area crisis intensifies or other global risks materialize.**

In the first half of this year, the German economy recovered from its brief slump in Q4 2011 (GDP growth -0.1% q/q) and grew at an annualized pace of about 1 percent, (H1 2012/ H2 2011, annualized). A strong export performance, despite the ongoing recession in many parts of Europe, and robust consumer demand more than compensated for weak investment activity and leaner inventories.

Survey indicators (from the PMI and IFO) point to the risk of economic contraction ahead. Weaker global investment demand will soon be felt in Germany where domestic investment, which has been suffering from uncertainties created by the euro area crisis, has stalled since late last year. Household consumption, residential investment and steady public demand should support the economy throughout this soft patch, but will likely not in themselves be sufficient to outweigh the negative factors at play.

However, the dent in economic activity should be mild and short-lived if emerging market growth accelerates again in H2, on the back of additional fiscal and monetary stimulus, the U.S. economy expands, as we expect at an annualized pace of about 2%, and the euro area crisis does not worsen again (see *Global Economics Weekly: Outlook softens a bit more*, 10 August 2012).

Figure 1: Quarterly GDP and its main components (q/q growth rates in %, unless otherwise noted)

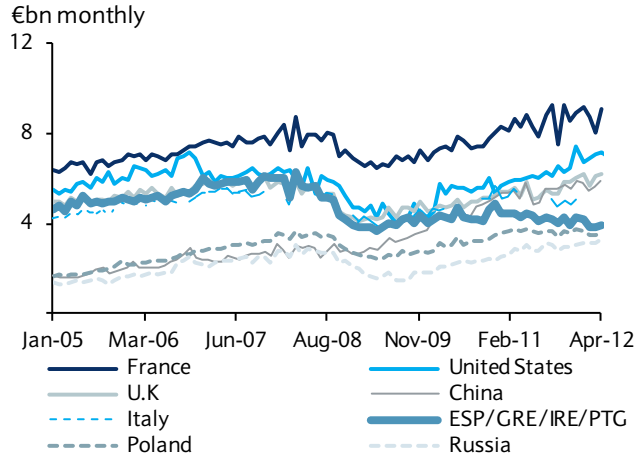


Source: Federal Statistical Office, Haver analytics

Softer global activity set to weigh on German economy

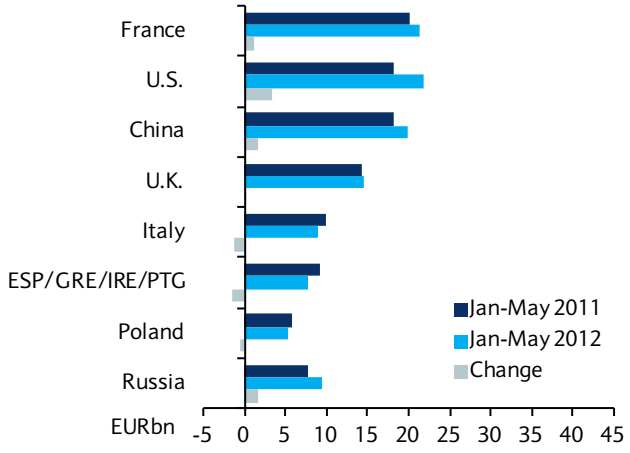
Export volumes again grew in the second quarter by 2.5 % (q/q), more than in Q1 (1.2%, q/q). Strong demand in Asia, Eastern Europe and the U.S. more than compensated for weak demand in other euro area member states, with the latter still accounting for about 40 percent of total exports, down from 44 percent in 2007. This decline mainly reflects less trade with Greece, Italy, Ireland, Portugal and Spain. The relative share of German exports to these destinations combined has fallen to about 10 percent, from 14 percent in 2007. In contrast, the emerging economies of China, Poland and Russia have all become significantly more important export destinations with their relative shares rising to about 6%, 4%, and 3%, respectively. Surging demand for German goods from these countries, and especially from China, contributed broadly as much as other euro area member states to export growth in Germany in recent years.

Figure 2: Major exports by destination



Source: Haver analytics

Figure 3: Capital goods exports



Source: Haver analytics

Future export performance appears likely to weaken on the back of weaker global growth visible in Asia (including China) and the U.S., which usually affects the German economy with a 1-2 quarter lag. PMI and IFO surveys indicate economic contraction ahead and revealed lower export expectations of German firms (see, Figure 2). In their Q2 earnings reports, many global German firms scaled down their expectations for H2 2012; but revenues were mostly projected flat rather than declining, while a weaker euro is boosting profits.

Core factory orders have been relatively resilient so far this year. However, June orders were pulled down by weaker overseas demand. At the same time, core orders from other euro area member states have shown tentative signs of stabilization over the past two months.

Figure 4: Composition of German order flows

(In percent of total orders)	Total	Intermediate	Investment	Consumption
Domestic	46.5	19.4	22.9	4.2
Foreign	53.5	17.0	32.5	3.9
Of which:				
Euro area	24.0	8.5	13.6	1.9
Non-euro area	29.5	8.5	18.9	2.0

Source: Bundesbank.

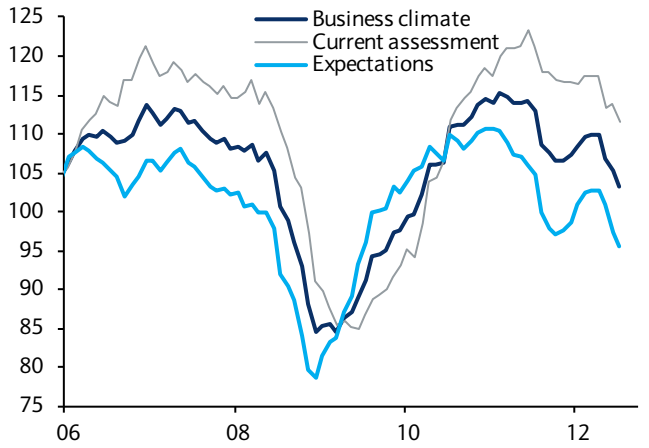
We expect overseas orders to weaken in the next few months but to bounce back thereafter assuming that, emerging market growth in H2 accelerates in line with our forecasts on the back of additional fiscal and monetary stimulus, and the U.S. economy returns to an expansion rate of about 2 percent (annualized). However, there is a risk that global investment activity may turn out weaker than currently expected as the euro area crisis drags on and other large economies rebalance. This would be particularly felt in Germany where investment goods make up the largest share of exports and orders.

Sound domestic fundamentals provide support

In contrast to many other large economies and euro area member states, Germany's domestic fundamentals appear relatively healthy. The country's fiscal accounts are broadly balanced, yet euro area crisis management and rescue operations of various domestic banks are still adding to Germany's debt and implicit liabilities. The recent and significant improvement in the fiscal balance has been driven by lower interest payments and surging tax revenues (again almost 10 percent higher y/y in January-July 2012) on the back of a strong labour market. Other expenditure items are growing modestly in nominal terms and generally, the fiscal policy is neutral and is not having much extra impact on GDP growth.

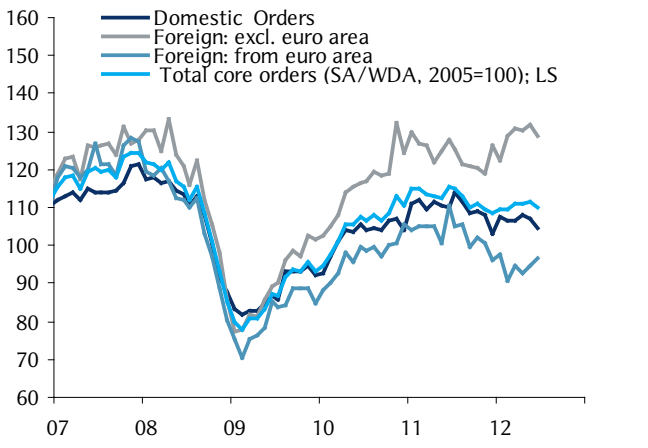
The unemployment rate has fallen to record lows and many regions, especially in Southern Germany, are virtually at full employment. Job growth has repeatedly surprised on the upside and immigration has been quite buoyant recently. This, together with robust wage growth, has lifted incomes and household consumption has increasingly supported growth in recent years, in contrast to 2002-07 where it was virtually flat due to wage moderation following labour market liberalization. Recent wage agreements should ensure a continuation of income growth over the next year, and we do not expect any decline in overall employment although job creation may be slow. Household savings (2011 savings rate: 11%) and household debt (60%) remain at relatively prudent levels (see, Figure 7). Some minor tax relief could come in the form of lower contribution rates to the public pension system next year. At the same time, however, higher energy costs may again be weighing on households' purchasing power. Here, it is likely that households will have to pay most of the additional costs stemming from Germany's energy reform, where the plan is for nuclear energy to be replaced by other environmentally friendly sources.

Figure 5: IFO Survey (2005=100)



Source: IFO Institute, Barclays Research

Figure 6: German 'core' new orders



Note: "Core" excludes large transport orders. Source: Haver analytics, Barclays Research

Figure 7: Government balances and key debt figures

In percent 2012 GDP (unless otherwise stated)	US	Japan	UK	Euro Area	France	Germany	Italy	Spain
Government gross debt[2]	107	236	88	90	89	79	123	79
Government net debt[2]	84	135	84	70	83	54	102	67
General government balance[2]	-8.1	-10.0	-8.0	-3.2	-4.6	-0.8	-2.4	-5.9
Primary balance	-6.1	-8.9	-5.3	-0.5	-2.2	1.0	3.0	-3.6
Households' gross debt[4]	88	74	99	70	63	60	51	89
Nonfinancial corporates' gross debt[4]	87	143	118	138	152	112	112	196

1) Cells shaded in dark blue indicate a value in the top 25 percent of a pooled sample of all countries (incl. Belgium, Greece, Ireland, Netherlands, Portugal all not shown here) shown in the table from 1990 through 2009 (or longest sample available). Mid-blue shading indicates values in the bottom 50 percent, and light blue in the 50th to 75th percentile.
2) IMF World Economic Outlook (Apr. 2012) projections for 2012.
3) Net general government debt is calculated as gross debt minus financial assets corresponding to debt instruments.
4) Most recent data divided by annual GDP (projected for 2012). Nonfinancial corporates' gross debt includes intercompany loans and trade credit, and these can differ significantly across countries.
Sources: Bank for International Settlements (BIS); Bloomberg, L.P.; EU Consolidated Banking Data; U.S. Federal Deposit Insurance Corporation; IMF; BIS-IMF-OECD-World Bank Joint External Debt Hub (JEDH).

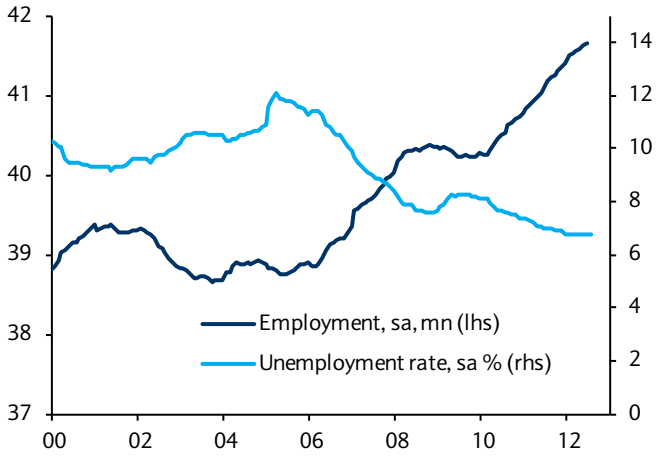
No investment rebound in sight

Amid uncertainty firms are holding back on planned investments. Spending on new equipment and machinery has been far below regular levels, although capacity utilization has been at or above average. We expect future investment activity to remain subdued but the downside to be limited: inventories are much leaner than before the global crisis, and there has been little build-up of excessive capacity. Construction investment has been a bright spot and should continue to support the economy in the near term, but new construction orders have also been receding lately. Yet, with record low interest rates and few credit constraints, rising house prices and a strong labour market, the fundamentals, especially for residential construction, remain in good shape.

Stagnating economy likely in H2 2012 and growth at around its potential in 2013

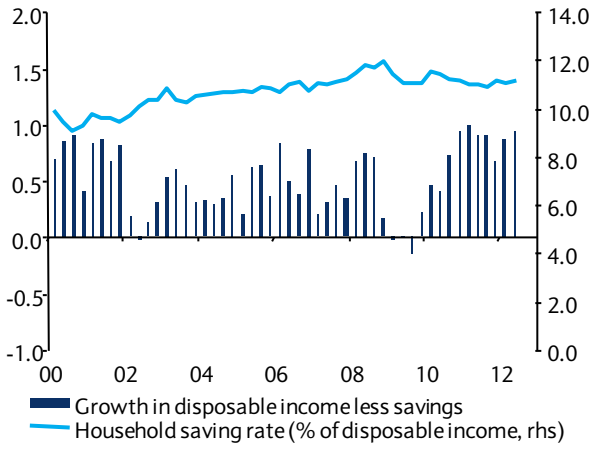
All in all, we mark down our 2012 GDP growth forecast slightly by 0.2 ppts to 0.9%, which carries over into 2013 where we now expect growth at around its potential. Although we expect domestic demand to become the key growth driver in Germany next year, it will still be too modest in our view to rebalance the German economy and bring down the current account surplus—likely above 6% of GDP in 2012—in a meaningful way. However, our still cautiously optimistic medium-term outlook could be derailed, if the euro area crisis intensifies or other global risks materialize. In that case, the German economy with its strong export bias could, as in 2008/09, be the worst affected among the world's large industrialized economies.

Figure 8: Total employment and unemployment rate



Source: Bundesbank

Figure 9: H'hold income growth and saving rate (% 2012 GDP)



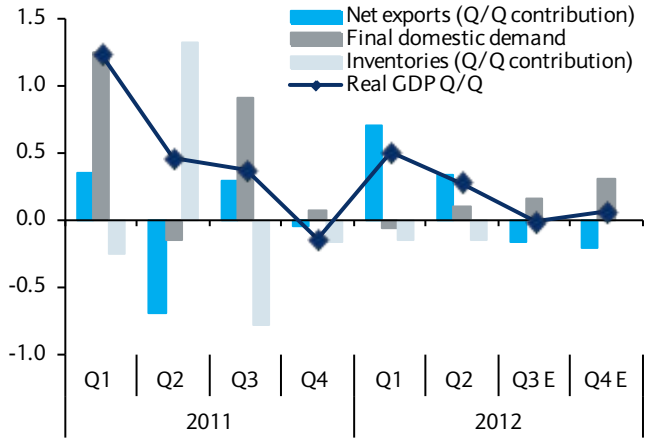
Source: Bundesbank

Figure 10: Annual growth forecast, 2012-13, (%)

	2012	2013
Average annual GDP rate, Barclays (seasonal and working-day adjusted quarterly data)	0.9	1.4
Calendar effect	-0.2	-0.1
Annual GDP growth		
Barclays	0.7	1.3
Bundesbank	1.0	1.6
Federal government	0.7	1.6
IMF	1.0	1.4

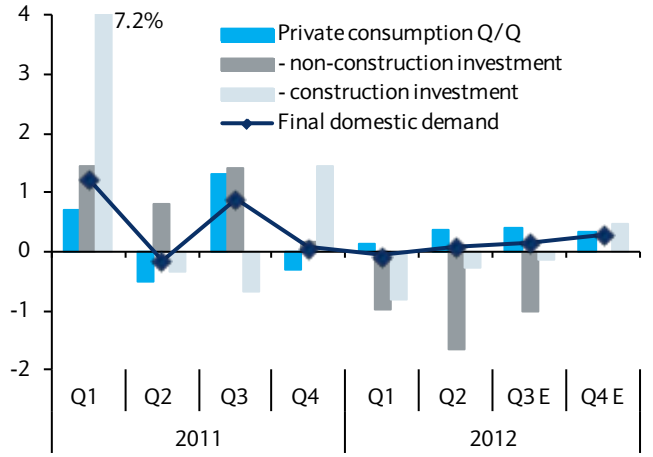
Source: Bundesbank, BMWi, IMF, Barclays Research

Figure 11: Quarterly GDP and its main components (q/q growth rates in %, unless otherwise noted)



Source: Federal Statistical Office, Haver analytics

Figure 12: Quarterly final demand and its main components (q/q growth rates in %, unless otherwise noted)



Source: Federal Statistical Office, Haver analytics

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