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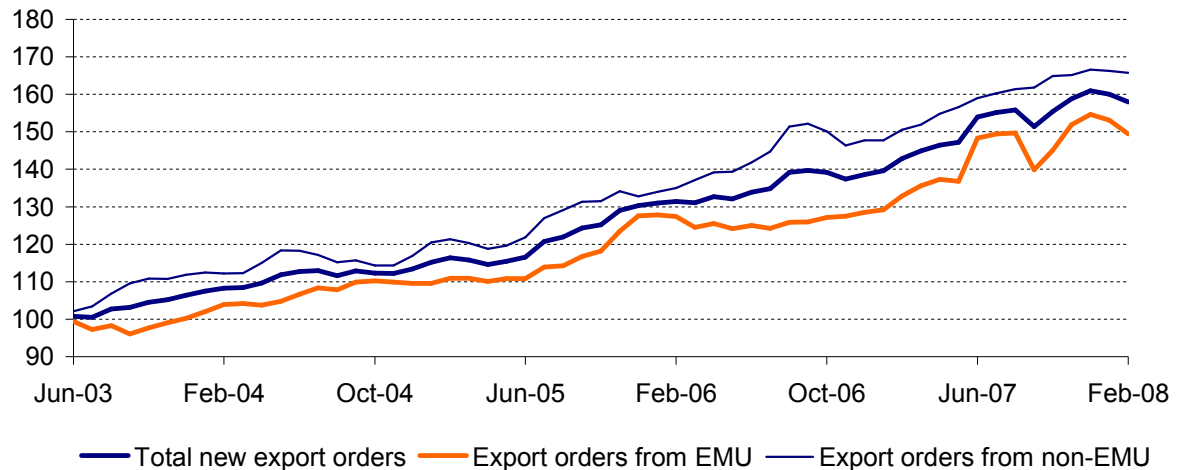
Germany's export engine sputters

WE SUGGEST: Growth below-trend in H1

SUMMARY: Super-competitive Germany has had exports as its main growth driver. But while the strong euro has not so far been much of a constraint, judging by today's manufacturing orders data weaker growth within Euroland has begun to take its toll. With no near-term support from consumption, German growth is set to falter.

Today's data on new orders to manufacturing rang alarm bells for the resilience of German growth. Total new orders were down by 0.6% in February (on a three-month moving average basis), following a 1% decline in January. Both domestic and export orders fell. Exports have been the main growth driver in Germany, with their share in real GDP rising to 51% in Q4 last year from 46% at the start of 2006. Aggressive business restructuring has led to a sharp improvement in competitiveness. Over the past two years net exports added 2 percentage points to the average quarterly annualised output growth rate of 2.8%. Hence, the deterioration in new export orders is particularly bad news.

New export orders to manufacturing, 3-month moving average



As the chart above shows, the strong euro has so far not been the culprit. Export orders from outside the EMU have held up, despite the 10% increase in the real euro effective exchange rate. Recent IMF research suggests that real exchange rate movements have limited negative effects in Germany during periods of robust global growth, but the negative impact increases significantly if real appreciation is combined with below-trend global growth. So it is too early to rejoice that the German export machine can overcome the strong euro obstacle. Moreover, exports to Euroland at 42% are by far the bulk of total

German exports and the new orders story there is worse. Yesterday saw the release of dire PMI surveys for Italy and Spain, suggesting already a sharp deterioration in their economic fortunes. With their respective share in total German exports at 6.5% and 5%, it is not a surprise that Germany is already feeling the pinch.

On the domestic side, the new orders data did not inspire optimism either. The German consumer has been spooked by inflation. Nominal wages have been on the rise, but higher inflation actually resulted in falling real income in Q4. No wonder that since inflation began to pick up, consumer confidence has plummeted and the savings rate has continued to rise. Earlier this week saw the release of retail sales data, showing a 1.5% fall in volumes in February. So far in Q1, real retail sales are down by 0.9% on Q4, compared with a 1.3% decline in Q4. On a three-month moving average basis, new domestic orders for consumer goods were flat in February, after recovering some ground in January.

All in all, Germany looks set to see output growth remain below potential at least in the first half of this year. Going forward, Germany's fundamentals – improved productivity and corporate profitability – suggest the economy can de-couple. It all depends on whether improved corporate profitability will translate into higher consumer incomes, with real wage growth picking up speed in coming quarters.

Diana Choyleva

diana.choyleva@lombardstreetresearch.com