



Macroeconomics



Industry & Commodity



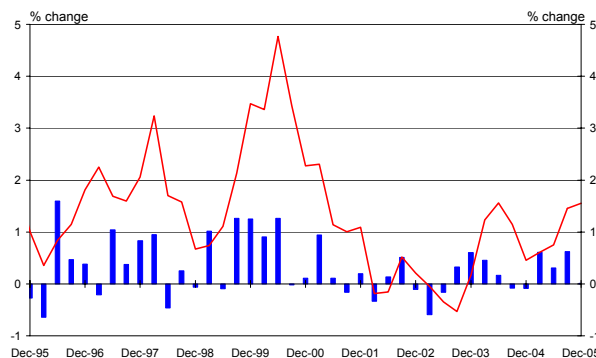
Markets

Germany economic comment – March 2006

German GDP was flat in the December quarter, but was 1.6% higher over the year with reasonable growth in the three prior quarters.

Within the December quarter, consumption and government spending fell by 0.6 and 1.6% respectively, but investment rose by 0.7%. Exports also rose by 0.5%, but this was more than offset by a 1.1% rise in imports – resulting in a 0.2 of a percentage point net exports subtraction.

Chart 1: GDP



Despite this poor quarterly result, the initial phases of a recovery are still on track. Exports rose by 8.8% over the past year and this has already fed into investment with a 1.7% rise – the strongest period since 2000, and there's more to come. This sets the scene for the latter phases of the recovery: more jobs, household income, and then consumer spending.

Employment growth has started to improve with a 0.7% yearly rise and further growth is expected. But this is yet to feed through to household income and consumption, down by 0.9 and 0.7% respectively. Unfortunately, a significant upturn in income and spending is unlikely as real wages are declining.

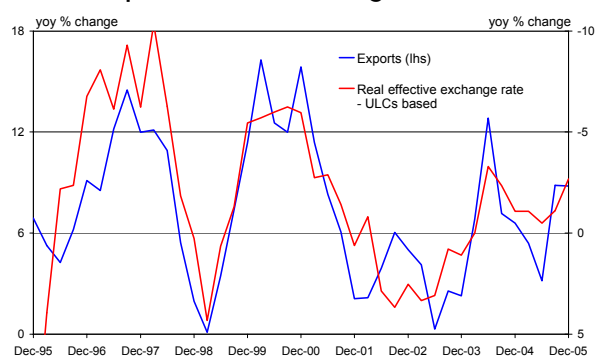
Added to this, there is very little room for increases to government spending (up 0.8% annually) within the Stability and Growth Pact as the deficit is already above 3% of GDP, and rising interest rates will likely rein in demand. Therefore, significant and self-sustaining domestic demand growth unlikely in the next year.

GDP growth will lift to around 1¼ in 2006, but decelerate in the following year as the boost from exports and investment wanes. This outlook is also driven by the additional 3% VAT in 2007, which will bring forward some demand into 2006.

Exports rose by 8.8% over the year to the December quarter, partly driven by a decline in the real effective Euro over the past year, which enhanced the competitiveness of German exporters.

Looking forward, world growth is expected to remain solid and we expect the Euro to depreciate further, albeit at a slower pace. Therefore, exports will continue to grow strongly.

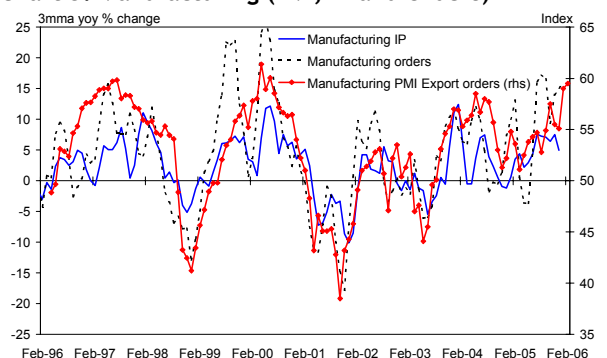
Chart 2: Exports and real exchange rate



The Manufacturing PMI supports this outlook (at least in the short term). Indeed, it suggests that the March quarter will be very strong, with export orders at 59.6 in February – the highest reading since mid-2000, and in line with the Bundesbank's Manufacturing Orders. The gap between positive survey results and hard data on output and orders has narrowed.

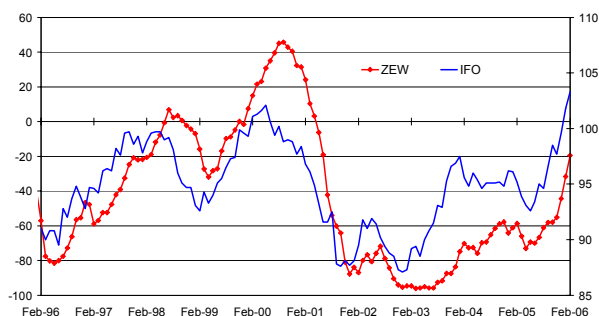
We should look through some of this strength for the short term, as a significant portion of these orders is larger items, such as Airbus aircraft for China, which will take a long time to produce.

Chart 3: Manufacturing (PMI, IP and Orders)



The positive conditions and outlook for exports has contributed to a substantial improvement in industrial confidence. The ZEW indicator is currently at the highest levels recorded since mid-2001. The Ifo survey is at levels not seen since the start of the 1990s.

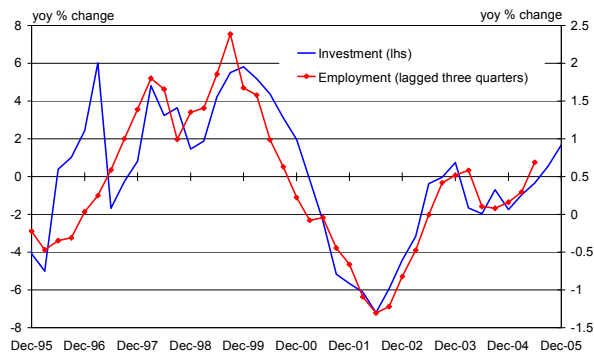
Chart 4: Industrial confidence measures



German businesses have been generating strong profits for some time now. Such high levels of industrial confidence have finally seen businesses respond to these profits with investment.

Investment increased by 1.7% over the year to December, which is the strongest period of growth since 2000. The present level of business confidence suggests that further investment growth can be expected in the coming quarters.

Chart 5: Investment and employment

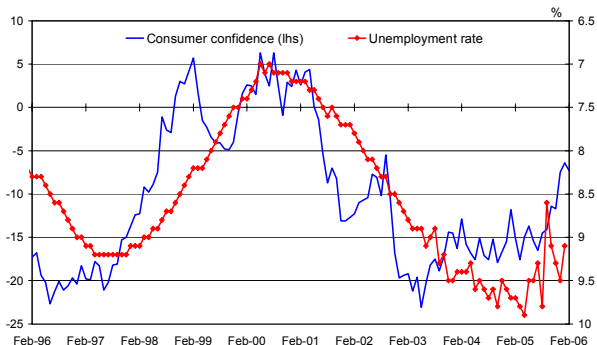


Hand in hand with investment in physical capital is investment in human capital – employment. However, it tends to follow investment with a lag of two to three quarters, and is up by 0.7% over the year to date.

The positive outlook for investment growth suggests that further employment gains can be expected over the coming quarters. The employment components of the Services and Manufacturing PMIs both support this outlook (at least in the short term), with readings of 51.6 and 51.4 respectively. These readings are only mildly positive, but they are the highest levels reached since 2002.

In turn, this has lifted consumer confidence to its highest levels since late 2002 and helped push the unemployment rate down to 9.1% in January, (which reached a recent peak of 9.9 in April 2005).

Chart 6: Consumer confidence and the UnN rate

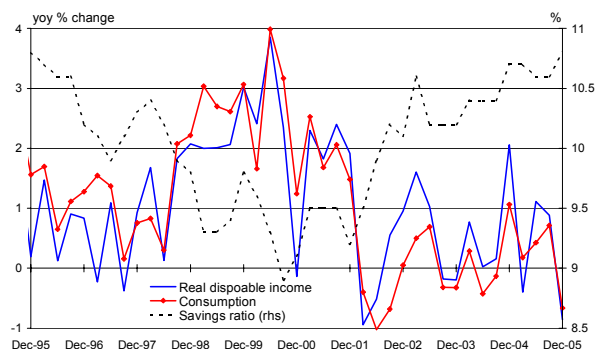


The household savings ratio has increased from 8.9% in mid-2000 to a high of 10.8 in December (see Chart 7), and been a consistent drag on consumption growth and thus overall economic activity over this period. The more secure jobs outlook and consumer confidence suggests that consumers may now start to spend more of their income, which will boost consumption and thus overall demand.

The more fundamental issue is real disposable income (RDI), which declined by 0.9% over the past year and dragged consumption growth down by 0.7%. RDI and thus consumption growth is likely to rise modestly over the next year, largely reliant on employment growth as real wages are flat or down by around ½% annually.

Wages are currently rising by around 1½ to 1¾% annually and unlikely to accelerate anytime soon (the labour market is still very weak), which is more than offset with the CPI and the consumption deflator running at around 1¾ to 2% respectively.

Chart 7: Income, savings and consumption



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