

EUROPEAN ECONOMICS UPDATE

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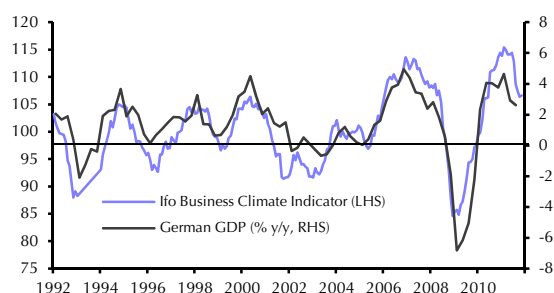


Have we underestimated Germany?

- **The recent rise in some of the German business surveys has prompted optimistic media reports about Germany saving the euro-zone, acting as Santa, being a twinkling Christmas star in the euro-zone gloom etc. We are sorry to say that, whichever way we look at it, such optimism seems overdone.**
- Admittedly, December's rise in the headline Ifo index was the second in a row and came as a pleasant surprise compared to our own forecast and the consensus expectation of a slight fall. While the index has not had a reliable relationship with actual activity, it currently seems to point to annual GDP growth of almost 3%. (See Chart 1.) Indeed, growth was closer to 4% the last time that it was at this level. This seems very encouraging and is certainly at odds with surveys elsewhere in the euro-zone.
- **Note, too, that the Ifo is not the only German indicator to have improved lately – both the ZEW investor expectations index and the composite PMI business indicator rose in December. However, these surveys do not match the Ifo's optimism in terms of their implications for growth.** Table 1 shows that the last time they were at the current level, GDP was either stagnant or contracting sharply.
- **This gloomier picture mirrors the tone of the latest hard data much more closely.** German export values fell sharply in October, causing the annual growth rate to drop to 6.7%, miles below May's peak of 26%. While industrial production rose in October, the annual growth rate has fallen from 15% to 4% in the past 9 months. Meanwhile, retail sales fell on both a monthly and annual basis in October.
- And it is difficult to find any evidence that the situation is about to improve. For a start, demand from outside Germany is set to weaken further. **And the forward-looking components of the German business surveys paint a consistently dismal picture.** The expectations index of the Ifo survey, for example, points to annual GDP growth of about zero, below 2012's consensus forecast of +0.8%.
- We don't want to sound perennially pessimistic and perhaps the economy will pick up despite subdued global demand and businesses' low expectations. **But while robust German GDP growth would bring up the euro-zone average from a purely mathematical perspective, it would do little to improve the prospects for the region's periphery.** Exports to Germany account for 2%-4% of Italian, Spanish, Portuguese and Irish GDP, suggesting that the direct benefit of continued growth there will be limited.
- **And solid economic performance alone is unlikely to convince the German Government to step up its support for the southern and peripheral economies.** Note that it has been strongly opposed to large fiscal transfers throughout the crisis, despite the fact that the economy was growing at rates of 4% or more throughout most of last year. With public opposition to bail-outs mounting, Angela Merkel has continued to stress that Germany's contribution will *not* be increased.
- **The upshot is that we doubt very much that the recent uptick in the German business surveys is a sign of a recovery to come and see GDP there falling by about 0.5% next year. What's more, even if Germany surprises us, there is little hope that this will end the crisis in the euro-zone's periphery.**

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Chart 1: German GDP & Ifo Business Climate Indicator



Source – Thomson Datastream

Table 1: German Headline Survey Indicators

	Level	Date last at this level	Annual GDP growth at that time
Ifo Business Climate	107.2	Q2 2010	4.1%
EC Economic Sentiment	104.0	Q1 2010	2.4%
ZEW Economic Sentiment	-53.8	Q3 2008	0.5%
Composite PMI	51.3	Q3 2009	-5.0%

Source – Thomson Datastream, Markit