

## Germany-Economy Recovery at crossroads: fragile consumption suggests ECB easing needed in late 2004

- Sectoral breakdown confirms investment remains the main economic driver
- Unusual sequencing of recovery likely reflects impact of structural reform in subduing consumer spending
- Recovery at a cross-roads – either consumption gradually picks up (our central case) or investment recovery peters out
- However, extended and gradual nature of German reform process suggests consumer spending growth may remain subdued for some years to come
- ECB's sensitivity to weak consumer confidence & final demand means a further easing -as recovery insurance- cannot be ruled out, later in 2004
- Contractionary re-structuring pressures in retailing and banking sectors outweigh benefits of lower interest rates – though some stabilisation in Q1
- Impact of euro recovery uneven across sectors, reflecting capacity utilisation rates and different profit margins

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**Asset conclusions:** persisting low rates because of, not despite high petrol prices, stocks: bar-bell strategy (high beta and low beta) recommended

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### Current economic activity different from previous recovery sequences

The current pattern of economic activity in Germany differs from previous recovery sequences, when export rebounds were followed by private consumption, while investment activity was the last to recover. This time investment activity shows more and more signs of firming, while consumption activity has declined by 1% since 2Q03.

The March ifo business sentiment indicator fits this picture, since manufacturing sentiment fell only slightly (by 1 pp), while retail sentiment slumped by a further 4 pp. Also, other consumer-related industries such as automotive and banking sectors have disappointed since last year, while investment-related sectors such as mechanical engineering are performing distinctly better.

The unusual sequencing of the German cyclical recovery could reflect the uneven impact of structural reforms, which appear to be weighing most heavily on consumer spending, due to high unemployment rates and depressed consumer confidence. The gradual and extended nature of the German reform process also suggests that this period of subdued consumption growth could well extend for some time to come.

Given shares in GDP, German private consumption growth of less than 1% makes it extremely difficult to generate overall growth of above 2%, without extraordinary strength in investment and exports.

### German economy at cross-roads, could go in either direction

All in all, the German economy is at a crossroads: either the recovery of investment activity may signal the end of a short economic recovery or the current weakness in consumption is transient, given the cumulative burdens from a rise in health care fees, petrol prices and unemployment, which might subside in the months to come.

We tend to favour the second scenario – as reduced health care costs finally reach consumers and exports help secure jobs.

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ECB may make further easing move this year as insurance against a premature end to the recovery

Consumer confidence recovering slowly as tax cuts, medicare cost savings filter through

But there are clear risks to the German economic recovery, which are recognised by ECB President Jean-Claude Trichet, Chief Economist Otmar Issing and other board members who have all expressed their concern about the sustainability of consumption growth in both Germany and the euro-zone.

As a result, the ECB may yet make a further interest rate easing move later in the year, as insurance against a premature end to the recovery.

## German consumer and consumer related industries – still the achilles heel of recovery

After its previous sharp decline, consumer activity showed the first signs that a floor may have been reached. Retail sales recovered by 3% (mm) in Jan04, car registrations in Feb04 fell by 3% y/y and consumer sentiment jumped in February back to the levels seen in Jul03.

While underlying factors remain weak – unemployment edged up in the first two months and wage growth will decelerate sharply given the IG Metall agreement – consumer confidence seems to be recovering slowly as tax cuts and medicare cost savings filter through.

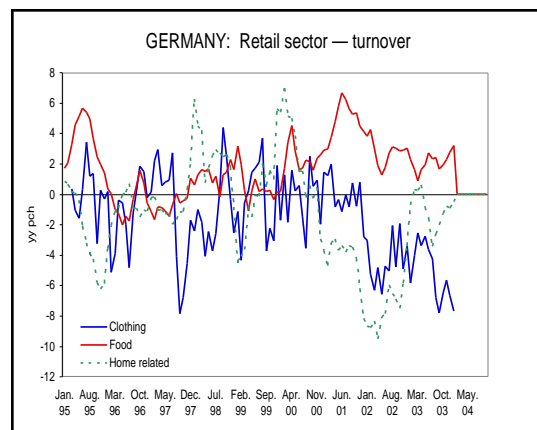
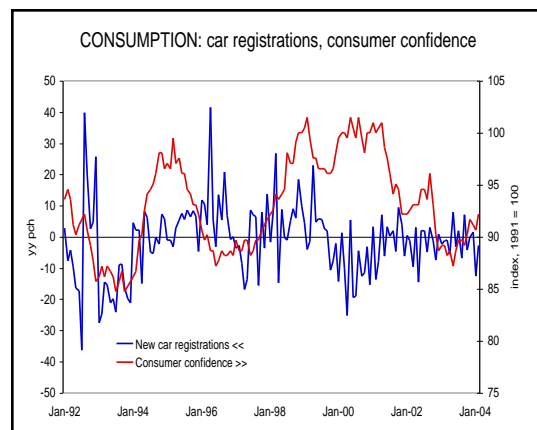
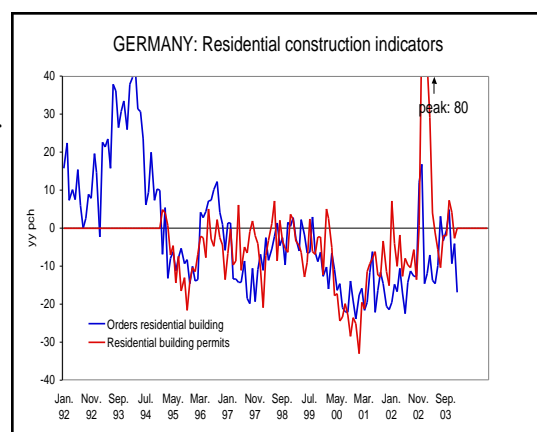
The increase in oil prices, however, has a significant impact on spending power. In particular, the car industry seems vulnerable.

## Retailing – cyclical recovery faces structural headwinds

Despite a rebound of 3% in Jan03, sentiment among retailers remains depressed; the retailers association HDE just reduced its turnover forecast for 2004 to stable from 1% growth expected previously. Consumer demand seems to be focused on consumer electronics – benefitting in particular big discount stores – while textiles and car sales (the latter are not included in the traditional retailing definition) remain weak (see chart).

The expiry of discount regulations has led to increased competition in particular in the field of consumer electronics and home fittings, benefiting large discount chains. Cosmetic stores and food stores, which had undergone a first wave of concentration some years ago, were the only sector showing sustained growth for the last four years (turnover in Jan04 was up 3% yy).

All in all: after two years of decline, retailing could at last bottom out this year. However, forecasts for the sector remain affected by the uncertainty caused by structural adjustment and with increased competition, small business bankruptcy



ratios are likely to remain at long term highs, while large stores – like Metro, Karstadt-Quelle – step up their repositioning efforts.

## Automotive sector – impact of stronger euro and global capacity pressures

For the automotive industry, 2004 started on a disappointing note: although new car registrations stabilised in Feb04 following a 12% yy slump in Jan04, during the first two months car registrations trailed last year's level by 7.5% - compared to an expected increase in domestic turnover by 2%.

In particular, mass car producers such as Volkswagen, Opel and Ford Germany were hard-hit by consumers' newly found price sensitivity – having spilled over from other retail sectors. The expansion of “catalogue” car sales since last year helped increase price elasticity and boost the market share of non-German brands. Exports, which saved the German car industry last year now appear to be suffering from the stronger euro.

The recent rise in petrol prices could be seen as an additional dampener for the industry outlook. Overall, the automotive sector seems at risk not only of missing its 2004 turnover target of 2% growth (in real terms) but also of underperforming the rest of the economy.

## Investment related industries – benefitting from automation and exports

Capital goods industries are currently outperforming on most economic measures – new orders, business sentiment, employment. Although investment activity shows some underlying strength – given an increasing profit share in national income, reduction in corporate deficits (which however might be debatable) and a bottoming of the stock market – the momentum of investment activity is not yet as strong as previous recoveries and flattered by comparison with the weakness in private and government consumption.

## Mechanical engineering – major beneficiary of investment recovery

Mechanical engineering had been the only industry, where business sentiment did not decline in Mar04. The upward trend in business sentiment – the diffusion index had risen by 25 points during the last 12 months – confirms the general momentum in this sector.

All sub-indices in the ifo-sentiment indicator in this sector re-mained positive, demand, export expectations and inventories.

Incoming orders were up 8% yy in Jan04 – on a three-months-average, stripping out the usual year-end spike in Dec. In particular the strength of key export markets – eastern Europe and China – provide an extra-fillip to these industries, while domestically this sector benefits from automation and restructuring.

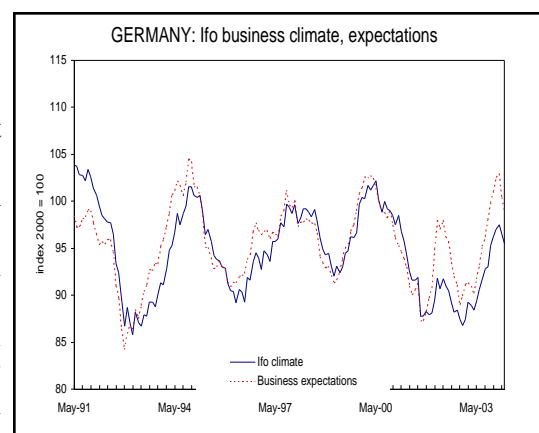
This is in contrast to the weaker export performance of the automobile industry (which may indicate structural over-capacity in the automobile industry, globally).

The bulk of the firms are “second tier” stocks and non-listed small and medium size companies, which have realised cost savings through outsourcing to eastern Europe on an increasing scale.

De-unionisation of employees and a decline in the ratio of affiliation should increase flexibility and competitiveness of companies in this sector. The growth target of 2% seems easily achievable.

The automotive sector is at risk of missing its 2004 turnover target and also underperforming the rest of the economy

All sub-indices of the Ifo sentiment indicator have remained positive



Interest rate-sensitive industries – contractionary pressures from re-structuring offset expansionary impact of low interest rates

Bank lending to business has shown elements of a credit crunch

## Electrical engineering

In contrast to the highly diversified mechanical engineering industries, electrical engineering consists of four key areas – power generation, optical and electrical equipment, computer hardware and software, and consumer electronics.

While all sectors benefited last year from exports and a drive towards automation, which had boosted order inflow to 8% yy in 4Q03, sentiment declined in the course of this year, following the intake of large scale orders in Jan04. Sharp competition in consumer electronics seems to have taken its toll in particular on small listed firms. The ZVEI industry association expects this year's growth to come in at 2%.

## Chemicals

Ifo industry business sentiment declined 5 points (diffusion index) in Mar04. Although the index is still at a relatively high level – compared to other manufacturing industries – business confidence failed to show any momentum during the last six months.

In particular, export business is negatively affected by euro strength according to the ifo survey. Still, the chemical industry association VCI this week declined to reduce its 2004 growth target of 1.5% this week. Dependence on currency movements may be one factor behind the decision of chemical giant Bayer to spin-off (and sell) its former key chemical business. This would leave BASF the last big player in this industry, which then consists mainly on foreign and second tier listed companies.

## Financial industries, real estate

The financial industries and real estate are clearly the sectors most sensitive to ECB policy and financial conditions. Although in these sectors structural forces are clearly prevailing over cyclical ones, the latter have a strong impact on recent trends.

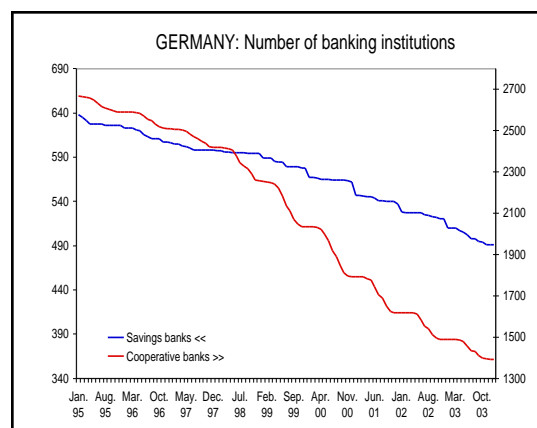
## Banking – structural consolidation pressures and weak personal lending re-main key issues

Since Sep03, bank lending to the private sector weakened (again) – in Jan04 this figure dropped for the first time within Bundesbank records below the year-ago level (-0.1% yy).

According to the latest bank lending survey, recent trends show a marked difference in bank lending behaviour by sector – corporate loans, mortgage lending and consumer credit – both as regards the strength and the determinants of lending.

Persistent weakness in corporate loans (-2% yy in Dec02) and a sharp decline in consumer credit was offset by a surge in mortgage lending – owing to the expectation of a cutback in home owners' tax allowances. While mortgage lending (up 11.5% yy in 4Q03) was generally demand-driven, bank lending to business has shown elements of a credit crunch as bank lending officers tightened lending criteria.

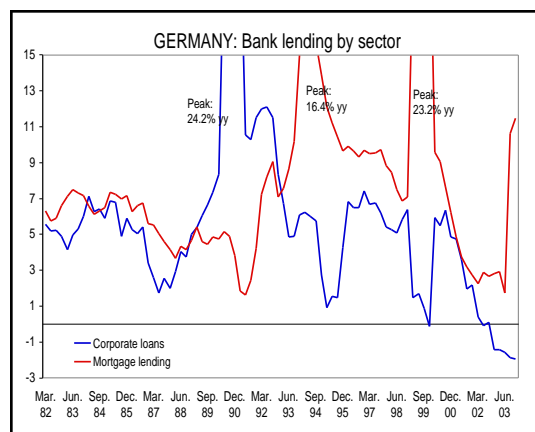
This applies in particular to small and medium sized companies, where savings banks and cooperative banks – due to Basle II rating pressure – seem to have been more selective than in the past. As there is little chance of a trend



reversal in the near term, banks have become increasingly diversified and specialised in the fields of private banking and asset management.

Investment banking activity on the other hand has suffered setbacks, as two IPOs have been abandoned this year due to the fragile stock market. Hopes seem to be geared towards fixed income markets such as the true sales initiative, launched Jul03.

The squeeze in lending business and the drive towards higher margin, investment-related business with clear economies of scale tended to boost M&A activity both among commercial banks and among savings banks, whose numbers declined by 6% last year.



The downturn was amplified by a glut of new homes which is depressing the residential market

## Housing – little sign yet of a strong recovery, despite low interest rates

The expectation of a general recovery and an ensuing rise in interest rates plus the above-mentioned debate on home-owners tax allowances – initially boosted housing activity. But when it became clear that these allowances will be maintained, in Nov/Dec03, the trend in residential orders (and building permits) reversed sharply.

The downturn was amplified by a glut of new homes, which is depressing the residential market and reflects much higher supply elasticity in the German housing market than the UK. According to the DIHK survey, estate agents sentiment was less negative at the end of 2003, but this should have turned again, given the decline in orders and building permits since Nov03.

Given similar weakness in other construction areas (business structures and civil engineering), the Ifo forecast of a 1% increase in construction output this year (after a 3.5% decline in 2003) seems rather ambitious. Weakness in residential construction has knock-on effects on home fittings and furniture, dampening the outlook for a noteworthy recovery in these retailing areas. **EZA**

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