

# German Industry's Record-Breaking Upswing

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A number of German indicators have delivered record-breaking performances in recent days. Almost all of this is due to exports. However, there are signs that capital spending could soon join the party. Prospects for consumption are also improving, but we remain cautious on this sector of the economy.

While markets continue to fret over the outlook for growth in the euro-area periphery, data released over the past week show that economic conditions in Europe's largest economy, Germany, are rapidly improving. The recovery is currently concentrated in the export and manufacturing sectors, but there are tentative signs that this could soon spillover to domestic demand.

One of the peculiarities of the German recovery has been its stuttering nature. Having surprised on the upside with an increase of 0.7% in the third quarter of last year, economic growth immediately slipped back to just 0.2% in the final quarter of 2009 and first quarter of the current year. Part of the softness around the turn of the year can be explained by the unusually severe winter. But even allowing for this, recent GDP data have been disappointing.

Data for April and May suggest that the economy is now making up for lost time. In the three months to May, industrial

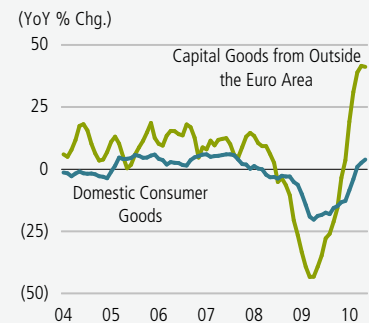
production was 5.6% (non-annualized) higher than in the previous three-month period, factory orders rose by 9.0% and exports increased by 10.5%. Each of these numbers represents the strongest growth rates for these series since reunification in the early 1990s. In late 2008 and early 2009, Germany suffered an unprecedented economic downturn. It is now enjoying a record-breaking rebound.

The one problem with the recovery is that it is still heavily concentrated in the export sector. The factory orders data put this in stark perspective. In the three months to May, capital goods orders from outside the euro area were 41.1% higher than they were a year earlier. Over the same time period, domestic consumer goods orders rose by just 3.9% (**Display 1**).

If the recovery is to be sustainable and, crucially, if it is to benefit Germany's euro-area neighbors, there has to be a response from domestic demand and imports. At a superficial level, this is already happening, with imports now

Display 1  
**Foreign Capital Goods Lead the Cycle**

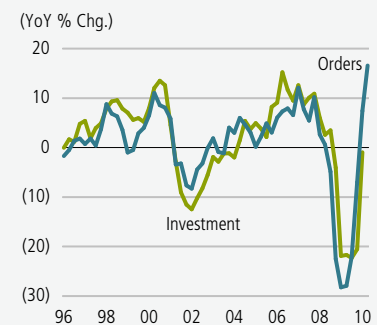
Domestic Consumer Goods Orders and Capital Goods Orders from Outside the Euro Area



Source: Haver Analytics and AllianceBernstein

Display 2  
**Brighter Outlook for Capital Spending**

Domestic Capital Goods Orders and Equipment Investment



Source: Haver Analytics and AllianceBernstein

rising even more quickly than exports. However, this strength is concentrated in intermediate goods, which might not give that much support to the rest of the euro area. German imports from other euro-area countries are currently growing at just 7.0% per annum compared with 15.4% for imports from non-European countries (and 26.1% for imports from Asia).

So what are the chances of a meaningful pickup in domestic demand? While there is not much concrete evidence at present, there are a number of indications that the outlook is starting to improve.

In the past, German recoveries have often been driven by exports, with investment following and consumption only recovering once the cycle has matured. Recent data suggest that the current recovery is following this pattern. Historically, domestic capital goods orders have been a very good leading indicator for investment spending (**Display 2, first page**). In the three months to May, domestic capital goods orders were 7.4% higher than in the previous three-month period and 14.8% higher than a year ago. This points to a substantial pickup in capital spending from very depressed levels—especially in relation to exports (**Display 3**).

In our view, the outlook for consumption is more muted. However, there are grounds for cautious optimism, particularly with respect to recent labor-market developments. Employment has grown for three consecutive months and is now slightly above year-earlier levels. Moreover, surveys of hiring intentions point to strong gains in coming months. This, in turn, should feed through into a further improvement in labor-income growth (**Display 4**).

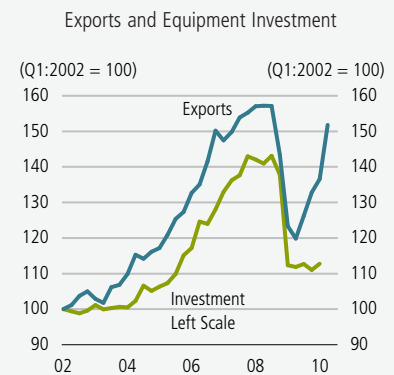
When considering the outlook for German consumption, it is important to note that household balance sheets are not subject to the strains evident in a number of other developed economies. In addition, a low budget deficit means there is no need for

aggressive tax increases in coming years.

Both of these factors suggest that future increases in employment income should feed through quickly to consumption. However, the sovereign debt crisis requires a note of caution. Should Germans lose confidence in the stability of the euro or begin to think that taxes will eventually have to rise to support the periphery, this could lead to a further increase in the savings rate (**Display 5**). For this reason, we are more confident in the investment leg of the recovery and retain a cautious stance on consumption.

The German outlook is not without risks. Credit markets remain fragile and the sovereign debt crisis could escalate further, engulfing countries beyond the embattled periphery. But the German economy is now following a fairly normal recovery path and momentum is strong. In light of this, and with the euro trading at more appropriate levels, we believe it would take a substantial negative shock to knock the recovery off course. This is important for the periphery. The sovereign debt crisis would be far more difficult to manage against the backdrop of a weak German economy. ■

Display 3  
Level of Investment Still Very Low



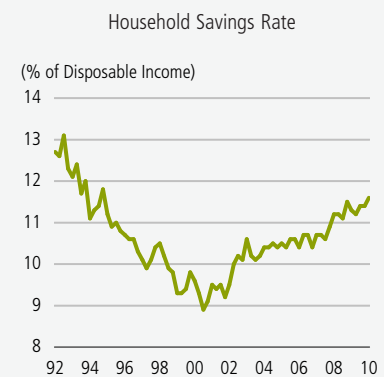
Source: Haver Analytics and AllianceBernstein

Display 4  
Income Growth Starts to Recover



Source: Haver Analytics and AllianceBernstein

Display 5  
Savings Rate at a 15-Year High



Source: Haver Analytics and AllianceBernstein

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