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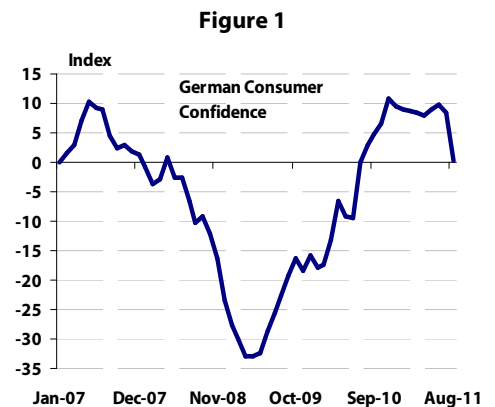
## Germany: personal consumption is expected to bounce back in Q3

- German households' consumption disappointed in Q2, shaving off 0.4% q-o-q from GDP growth, most likely due to highly unfavorable commodity price developments.
- We expect private consumption to rebound in Q3 on the backdrop of healthy fundamentals and abating commodity price pressures.
- Lingering uncertainties stemming from the sovereign debt crisis are expected to confine growth and thus personal consumption at a modest pace.

Output in the second quarter disappointed as it printed a meager 0.1% increase, in contrast to expectations of 0.5% growth on a quarterly basis. The shortfall was mainly due to a sharp contraction of private consumption, resulting in the latter contributing to GDP growth a negative 0.4%. The lingering uncertainty over the debt crisis in the euro zone combined with worsening global growth prospects are unfavorable for a strong rebound in German households' consumption. The PMI manufacturing indicator has fallen to a level slightly above the 50 threshold (50.9 in August), while factory orders fell on a monthly basis in July, mainly due to a sharp decline in foreign orders for capital goods. The services component of the PMI is following a similar declining path, standing at 51.1 in August. The recent deterioration in consumer sentiment is in line with gloomy business indicators. The European Commission's German consumer confidence survey declined sharply in August (Figure 1) as households' expectations about future economic and employment conditions have deteriorated substantially.

Against this negative backdrop, we believe there are several reasons for which the German consumer may prove resilient. Climbing energy prices may have played an important role in denting private spending in the second quarter. In the period ahead, we see little chance for sharp increases in oil prices as those seen in the first half of the year. In our view, oil prices will likely stabilize at a lower level, supporting

household's propensity to consume.



Source: European Commission

Recent data on consumer prices imply that inflationary pressures may have reached peak (Figure 2), suggesting that inflation will be a smaller burden on consumers' purchasing power.

Recent retail sales data leave room for expectations of higher consumption in Q3. Calendar and seasonally adjusted real retail turnover jumped by 4.5% on a monthly basis in June, followed by a flat reading in July. This implies that there is decent momentum in sales that could boost private demand in the third quarter. Assuming flat changes in August and September, real retail sales would increase by about 2.4% in Q3, relative to the previous quarter. In a similar tone, sales of motor vehicles surged by 2.6% s.a. on a monthly basis in July, after five

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consecutive declines.

Figure 2



Source: Bundesbank

The strong export-driven rebound of the German economy has led to a stellar improvement in labor market conditions. The unemployment rate seems to have stabilized at around 7%, standing at the lowest level since reunification, which should be supportive for consumption. On the positive side, the Manpower Employment outlook reveals that more firms plan to increase hiring in the second half of the year. On the backdrop of improving labor market conditions, German consumers' disposable income (Figure 3) has been rising at an even higher rate than that observed during the booming years before the recent financial crisis, corroborating our call for firm private consumption ahead. In line with disposable income, net wages keep printing substantial growth (Figure 4). In addition, German households possess a fairly large amount of net financial wealth (Figure 5) that could back their consumption expenditures.

Figure 3



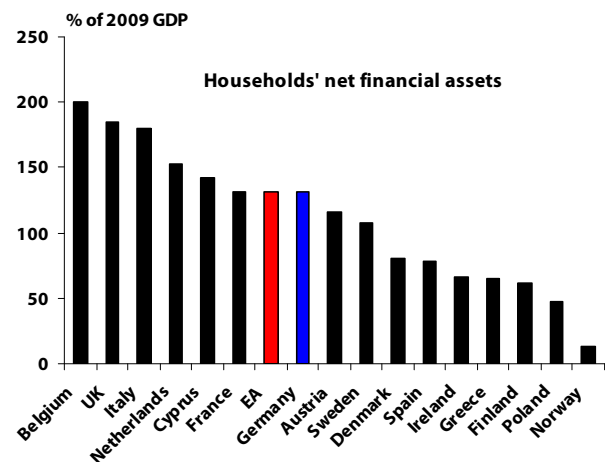
Source: Bundesbank

Figure 4



Source: Bloomberg

Figure 5

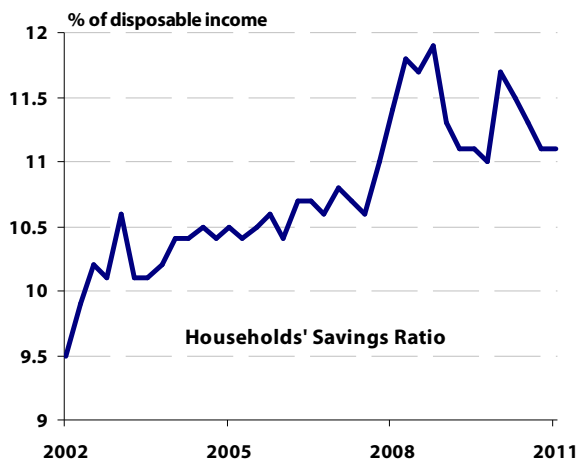


Source: Eurostat

Productivity, as measured by GDP per total hours worked, inched lower in the second quarter of 2011, relative to the previous quarter by 0.1%. However, it has recovered from its deep decline during the crisis and it now stands at 99% of its record peak in the first quarter of 2008. High productivity gains provide a favorable backdrop for further increase in employees' income.

The household's savings ratio (Figure 6) increased sharply during the financial crisis, receding to lower levels since the onset of the rebound. Its downward trend seems to have been interrupted when the debt crisis erupted but it has declined again. In the period ahead, the savings rate is in our view, unlikely to rise substantially, while risks are tilted towards further declines. The meaningful improvement in employment conditions reduces

consumers' fears of job security, thus diminishing the need for precautionary saving. Moreover, German public finances remain relatively healthy, suggesting that there is no need for severe budget cuts or structural reforms in the pension system and the labor market, both of which would force workers to ramp up their savings. Not least, household's rising financial wealth bodes well with our call for lower savings, as it acts as a cushion. The decline in households' financial assets during the crisis may have contributed to the sharp increase in the savings ratio. High growth rates of financial assets seen thereafter may make workers feel there is a safety net to fall back in case they lose their jobs, which also argues against an increase in precautionary savings.

**Figure 6**

Source: Bundesbank

Overall, we expect German consumer demand to bounce back in the third quarter and contribute positively to domestic demand. However, personal consumption growth will likely remain moderate, as concerns over the debt crisis and its repercussions are expected to keep weighing negatively on the euro area economic outlook. On the other hand, we expect an improvement in consumers' confidence, as the global economy proves resilient and the scenario of a renewed recession becomes even more remote.

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