Macro
European Economics

Hope springs eternal

Is the German consumer finally on the mend?

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- **Higher confidence no guarantee of strong German consumption in 2005**
- **Real income growth to remain weak & personal savings high this year**
- **But labour reforms and weak real wages sowing the seeds for a better future**

Feeling confident?

The last couple of months have seen some better news on the German consumer, with confidence rising to 3-year highs and retail sales jumping in January. So is consumption finally on the path to a sustained recovery?

We doubt it. The rise in confidence to date could be consistent with the improvement in consumption growth we have already seen, while the fundamentals for 2005 don't look great. Income tax cuts at the beginning of this year may provide a temporary lift, but downward pressure on employment, as the export cycle continues to weaken, and falling real wages will keep a firm lid on personal income growth.

Low interest rates could drive the saving ratio lower but the experience of the last few years suggests this is far from guaranteed as heightened job insecurity and pension concerns are leading to a structural rise in savings. Admittedly, French savings have been falling recently but this reflects a number of one-off government measures.

Meanwhile, although it is certainly true to say that German consumption is along way below its long term trend, and in this sense there is plenty of 'pent up demand', the experience of Japan suggests that this kind of analysis is not always useful.

Overall we believe that Germany will do well to see anything more than a modest rise in consumption in 2005 as a whole, with the first quarter probably stronger than the other three. Indeed it wouldn't be a huge surprise if consumer spending was contracting again by year-end.

It is not all doom and gloom, however. The government's labour market reforms and falling real wages in the country should eventually encourage greater job search and help price labour back into work.

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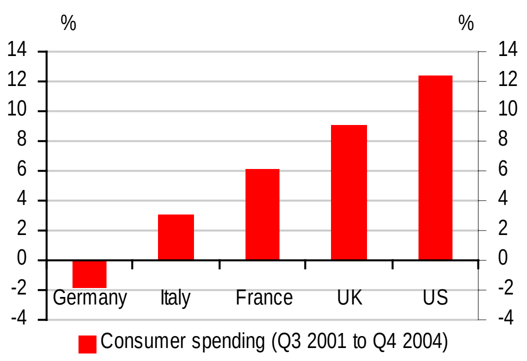
German consumer recovery?

- Consumer confidence has picked up but this is no guarantee of a strong consumption recovery ahead
- Real income growth will remain lacklustre and savings high, keeping a lid on consumer spending which could be falling again by year-end
- Labour market reforms and weak real wages, however, bode well for stronger employment and spending in the long term

Hope springs eternal

Is the German consumer finally awakening from his multi-year slumber? Chart 1 would certainly suggest that some sort of improvement is long overdue. Since 2001Q3, real consumer spending has fallen by nearly 2% in Germany, which compares with rises of 6.2% in France, 9.1% in the UK and 12.4% in the US. Even Italy has done better, showing a 3.1% increase over the period.

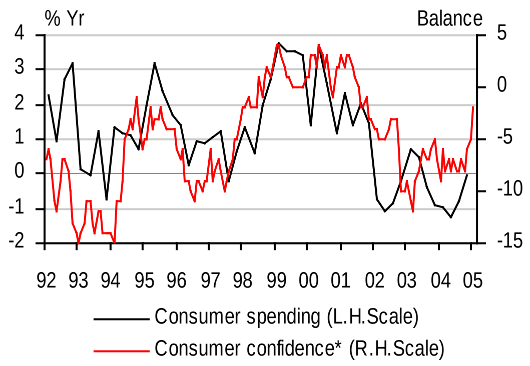
1. German consumption has massively underperformed



Source: HSBC, Thomson Financial Datastream

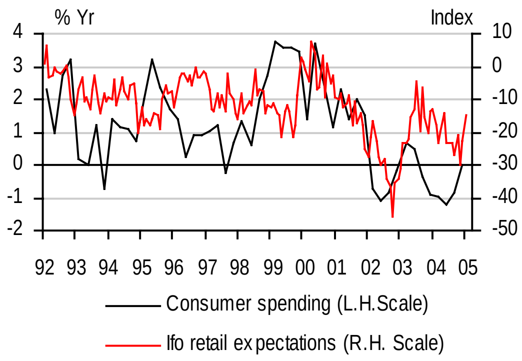
Recent weeks have seen a renewed bout of optimism from some, sparked by a couple of developments. First, a number of anecdotal stories suggesting that retailers had seen a relatively strong Christmas/new year period. And second, survey data, in the form of consumer confidence and the Ifo retail business climate indicator, which both picked up strongly around the turn of the year (charts 2 & 3). We have used income expectations as the measure of consumer confidence here, given that it has statistically the best relationship with consumer spending.

2. Consumer confidence at highest level since 2001...



Note:*GFK income expectations series
Source: HSBC, Thomson Financial Datastream

3. ...while Ifo retail sentiment has also strengthened



Source: HSBC, Thomson Financial Datastream

So far, so good?

So how much faith should we have in these indicators? The latest hard data have been mixed. German consumption rose just 0.2% in Q4 from the previous quarter (although, admittedly, this was the strongest quarterly rise for more than two years!). Meanwhile, the Bundesbank's measure of retail sales, including autos, fell in both November and December but bounced strongly in January.

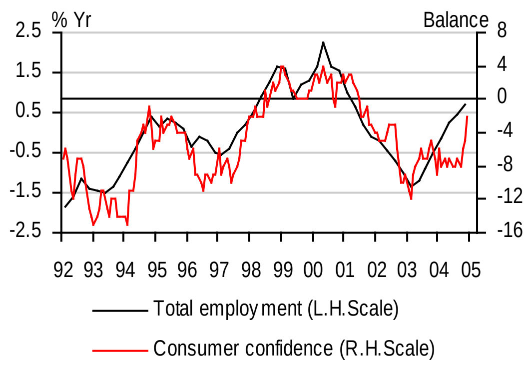
Crucially, there is no evidence that the surveys lead consumer spending. Moreover, the relationship between confidence and consumption looks to have changed over the last couple of years. Looking at chart 2, a given level of confidence has generally been associated with weaker consumption over the last couple of years than was the case in the past. It is worth noting at this point, that the link between the Ifo retail survey and consumer spending has never been particularly good which in turn casts doubt on the 'quality' of the improvement in overall Ifo expectations in December and January (which was partially reversed in February).

With these points in mind it is tempting to suggest that the rise in consumer confidence to date is largely consistent with the modest improvement in spending that we have already seen.

Feeling confident?

So why might the relationship between confidence and consumption have changed and will it re-establish itself? It seems to us that the main trigger for the improvement in sentiment has been stronger employment – chart 4 showing a close link between the two series.

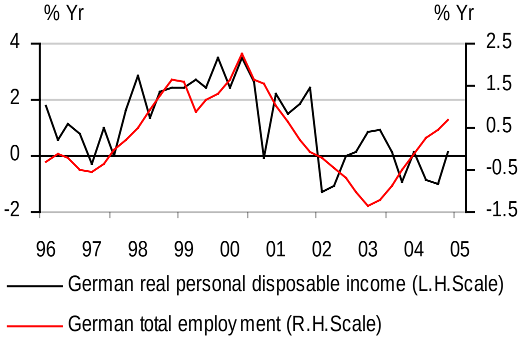
4. Improving labour market explains rise in confidence



Source: HSBC, Thomson Financial Datastream

The trouble is, however, the rise in employment has not translated into the sort of improvement in real income growth that one might have expected (chart 5). This is largely because real wage growth has been so weak (chart 6) and, according to the Bundesbank, much of the job creation has been in temporary and part-time jobs. Indeed, some of the pick-up in jobs has probably come as a direct consequence of the recent weakness of real wages.

5. Better employment not reflected in income growth...



Source: HSBC, Thomson Financial Datastream

6. ...as real wage growth has collapsed

Source: HSBC, Thomson Financial Datastream

It is not clear why confidence should apparently have responded more to employment developments than real incomes recently, but we would have thought that this would change in time. The question is will the gap between confidence and income growth narrow through a fall in confidence or via stronger real income growth which, in turn, boosts consumer spending.

Real income prospects

The good news here comes from the income tax cuts that were delivered in January this year. These were equivalent to ½% of disposable income and involved the top rate of tax falling to 42% from 45% and the lowest rate to 15% from 16%. The bad news, however, is that much of the benefit will be clawed back later in 2005 by a rise in health contributions (from July), while the reduction in unemployment benefits (in January as well) will also cut incomes for the long-term unemployed. The overall net effect of all these changes on the consumer will be roughly zero, although it is positive in the first half of the year and negative in the second.

Real wage growth should strengthen a little from current levels as inflation falls back but will remain subdued given the structural downward pressure on nominal wage growth. The latter stems from the growing power of the corporate sector in Germany, which we wrote about in detail in *"Germany: adapting or dying?"* (World Economic Watch, 23rd July 2004).

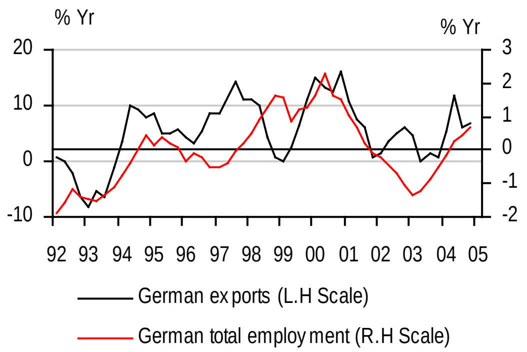
As far as employment is concerned, the on-going weakness of real wage growth will help, but the fact that the economy didn't grow at all in the second half of 2004 obviously won't. In the fourth quarter of last year, German whole economy productivity growth slowed to zero (chart 7) - not the kind of environment where one would expect to see surging job growth.

7. German productivity growth has fallen to zero

Source: HSBC, Thomson Financial Datastream

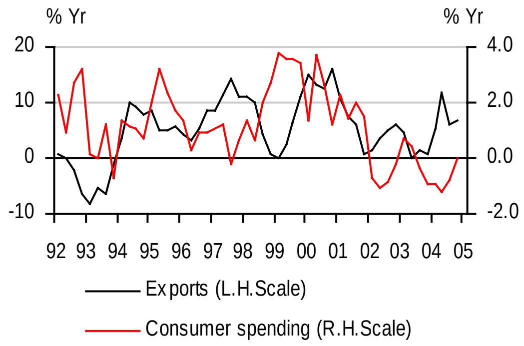
The key issue is whether there will be a big enough demand driver from here to keep the recovery in the labour market going, bearing in mind that the benefits of the government's labour market reforms could take several years to come through.

8. Export slowdown would bode badly for jobs...



Source: HSBC, Thomson Financial Datastream

9. ...and consumption



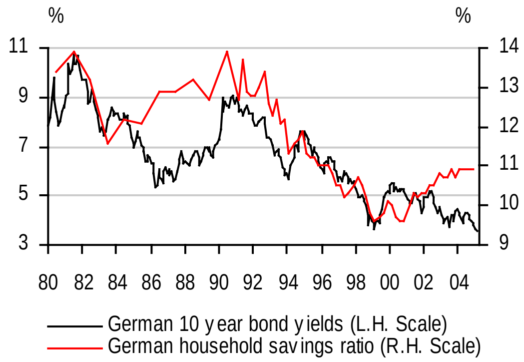
Source: HSBC, Thomson Financial Datastream

We have our doubts. The one and only driver behind the German economic recovery has been exports, but even this is now slowing. During the second half of 2004, German exports actually fell ½% (although, admittedly, this did follow a very strong first six months of the year) and we expect further weakness ahead. As charts 8 & 9 make clear it would be very unusual for weakening export growth not to be associated with softer jobs growth and a downturn in consumer spending.

Carry on saving?

One other potential driver would be a fall in the saving ratio either through a decline in gross savings or a rise in borrowing, perhaps reflecting the renewed decline in bond yields. But as chart 10 shows the link between long-term interest rates and the German household saving ratio is far from perfect. In particular, the last five years has actually seen a negative relationship between the two series – as interest rates (both short and long) have fallen, savings have risen. Indeed the rise in savings knocked about ½% point a year off spending growth between 2000 and 2003.

10. Saving ratio has risen recently while interest rates have fallen



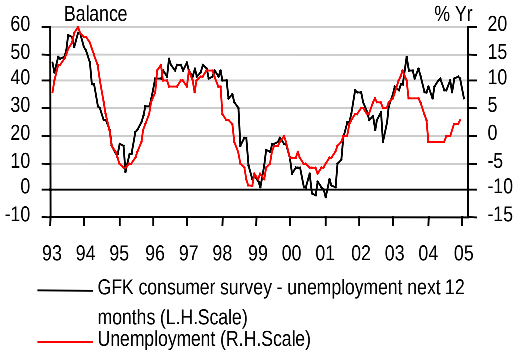
Source: HSBC, Thomson Financial Datastream

Clearly, there have been other factors at play here. It may be, for example, that the causality between interest rates and savings is starting to run the other way around, such that higher savings, by depressing consumption, is putting downward pressure on long term interest rates.

It is also interesting to note that people's job insecurity, as measured by their expectations of unemployment, have remained higher than one would have anticipated given what has actually happened to unemployment over the last couple of years. (In chart 11 we haven't included the January or February jobless figures as they were massively distorted by a change in the definition of unemployment). This could reflect the perception amongst workers that they are now at greater risk of losing their job to lower paid workers abroad. Companies certainly seem to be increasingly prepared to at least threaten to move operations overseas if they don't get what they want from their domestic workforce.

The most powerful explanation, however, probably relates to a growing awareness that the State won't be able to maintain current levels of pension provision. The government's budgetary situation and the demographic outlook for the country means that people will have to put aside more for their own pension and this is perhaps starting to be reflected in a structural rise in savings. It may also imply that a lot of the January tax cuts will be saved rather than spent.

11. Feeling increasingly insecure



Source: HSBC, Thomson Financial Datastream

What about the French experience?

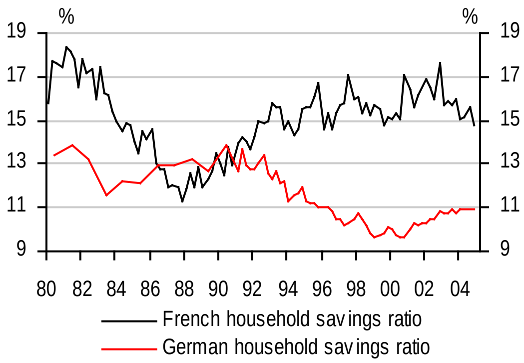
One counter-argument to this is the experience of France, where the saving ratio has recently fallen sharply (chart 12), helping fuel a pick-up in consumption. There are, however, several differences between the two countries worth pointing out:-

- Although the French saving ratio is down from a peak of 17.6% in 2002Q4 to an estimated level of just under 15% at present, the gap between the two is not unusually narrow at present relative to the experience of the last twenty-five years.

- The French government has introduced a number of measures over the last year designed explicitly to reduce savings and boost consumption. These have included incentives to use consumer credit and pass money on to their children. The authorities are also thinking about encouraging mortgage equity withdrawal so that people can borrow against the value of their rising property price. Germany does not look as though it is following the same route.

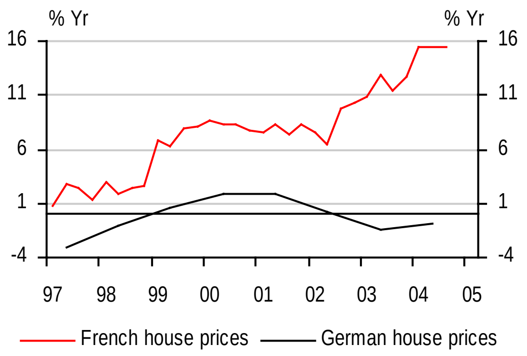
- To the extent that there are any wealth effects from property prices in Germany and France (which admittedly are hard to identify statistically) they will be working in different directions. While, French house price inflation is running at around 16% year-on-year, it is negative in Germany (chart 13). Germany's problem relates mainly to the structural over-supply of property, particularly in the east, which is unlikely to disappear quickly.

12. French saving ratio down from it's peak



Source: HSBC, Thomson Financial Datastream

13. Different house price experiences

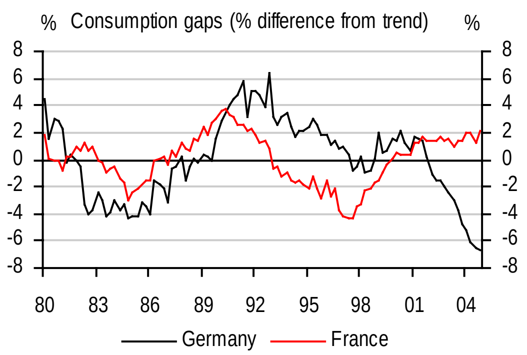


Source: HSBC, Thomson Financial Datastream

Plenty of pent-up demand?

Another frequently used argument is that after such a protracted period of weak consumption, there is plenty of pent-up demand in Germany that must come through eventually. As evidence of this, people point to the likes of chart 14, where we have shown the percentage difference between the actual level of German (and French) consumption and estimated trend consumption since 1980. This suggests that German consumer spending is roughly 7% below a linear trend at present, while that in France is 2% above. Surely, it is only a matter of time, therefore, before the huge German gap is closed?

14. German consumer spending apparently massively below trend

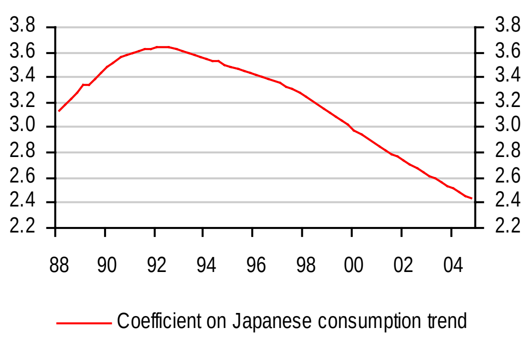


Source: HSBC, Thomson Financial Datastream

While accepting that this argument is roughly right, it is important to bear in mind that the gap could close in one of two ways – either by a strong rise in German consumption or a fall in the estimated trend rate of consumer spending. In the case of the latter, if German consumption is weak enough for long enough then the trend will inevitably come down. Indeed one only needs to look at the experience of Japan to see this in practice. Chart 15 shows how the coefficient on Japanese trend consumption has developed over time in a simple equation 'explaining' consumer spending on the basis of a linear time trend. It has dropped by 1% point over the last ten years and is still falling.

Of course, just because this has happened in Japan doesn't necessarily mean that the same thing will happen in Germany. But clearly it is also not enough just to say that because consumer spending is weak it is bound to bounce back. If, for example, there is a structural rise in savings going on, as we suspect, then underlying consumer spending growth may soften. Moreover, even if one accepts that consumption growth must improve as the replacement cycle kicks-in, for example, predicting the precise timing of this is extremely hazardous. One could easily be out by several years.

15. Japanese 'trend' consumption has weakened



Source: HSBC, Thomson Financial Datastream

Conclusions & implications

- Recent signs of life amongst German consumers should not be over-interpreted. In particular, the relationship between confidence and consumption seems to have changed such that the rise in confidence to date could be consistent with the improvement in year-on-year consumption growth that we have seen. There is also no evidence of a lead from confidence to spending.
- The improvement in consumer confidence seems to reflect stronger employment, rather than higher personal income growth which is being held back by falling real wages. January's tax cuts added around ½% to real incomes, but benefit cuts and higher health contributions will eventually offset this effect.
- Looking ahead, the key issue is whether there will be a big enough demand driver to keep the labour market recovery going. We have serious doubts, particularly when bearing in mind the slowdown in German export growth.
- One other potential driver is the renewed fall (until recent days) in long-term interest rates, which could drive savings down. The experience of the last few years, however, suggests that this is far from guaranteed as it looks as though heightened job insecurity and pension concerns are leading to a structural increase in savings. The recent decline in the French saving ratio has been driven largely by a number of one-off government measures.
- German consumption is very low relative to its long time linear time trend, suggesting that there may be plenty of pent-up demand. But the experience of Japan suggests that this kind of analysis is not always useful.
- Overall, we believe Germany will do well to see anything more than modestly positive consumption growth in 2005 as a whole, with any improvement concentrated in the first half of the year. Indeed it wouldn't be the biggest surprise in the world if consumer spending was contracting again by year end.
- Does this matter? Yes, in the sense that it is hard to envisage eurozone GDP growth picking up when the German consumer isn't and global growth is slowing. German consumer spending directly accounts for 17% of eurozone GDP (roughly the size of Italy) as well as having indirect effects via the exports of other countries.
- As such, the ECB will be watching developments closely and is another reason for believing that rates are more likely to be cut than raised in the eurozone this year.
- But all is not doom and gloom. Germany is sowing the seeds for better times ahead as the government's labour market reforms and the weakness of real wages should eventually feed through into stronger employment. We just have to hope that these will kick-in before the demographic situation becomes too bad.

Notes

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