

Germany takes the lead

Global economic update: September 2010

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Moderate growth during second half of 2010

Global economic indicators suggest only moderate growth during the second half of 2010. The current slow-down in economic activity is partly a reaction to the European sovereign credit crisis in the second quarter of the year. The crisis led to tighter financial conditions in many economies and a sharp weakening of the Euro, and increased uncertainty about the sustainability of global economic growth.

Germany leads growth in Europe

Ironically, while the US and Japan were under pressure, Europe actually grew faster than expected in the second quarter, led by Germany and helped by the weaker Euro. German GDP grew by an amazing 2.2% quarter-on-quarter (q/q) (non-annualised) - a massive 9.0%, annualised. The market was expecting growth of 1.3% q/q (+5.5% q/q, annualised). This is the fastest growth the country has experienced in at least two decades (certainly since reunification in 1991), and actually outpaced growth in China during the same period (a very acceptable 7.2%, annualized).

Euro-area GDP grew by 1.0% q/q (non-annualised) in Q2 2010, which was ahead of market expectations for growth of 0.7% q/q. Germany comprises around 25% of the Euro-area, but contributed around 65% of the growth in the region during Q2 2010.

This better-than-expected economic performance was mostly due to an improvement in net trade (exports), inventories and (to a lesser extent) capital expenditure.

The rapid growth in Germany highlighted the growth differential across the Euro-area, with Greece still in a severe recession at -1.5% q/q and Spain barely growing at 0.2% q/q. Growth was good in Austria and the Netherlands, solid in France, and weak in Italy and Portugal. This growth differential is likely to raise concerns about on-going intra-regional tensions.

But...is German growth sustainable?

Another important issue is how sustainable the German 2010 boom will be in the second quarter, and whether it can provide a lift to the rest of the region. Part of the strong growth relates to German exports and the benefit of a weaker Euro. However, the Euro has since strengthened relative to the Dollar, diluting this

advantage. Additionally, German domestic activity is under some pressure due to government cutting back on spending, although recent employment and consumption figures have been quite encouraging.

Overall, the latest GDP growth estimates for Europe imply that the Euro-area, and German GDP growth estimates in particular for 2010, are likely to be revised higher over the coming few weeks. Despite the likely upward revisions, we still expect a softer second half of the year in Europe relative to the first half, especially if there is no upward momentum in employment.

Unemployment is a global challenge

Combating unemployment has become a global challenge. High levels of unemployment have persisted in many advanced economies and there is a major concern that temporary joblessness will turn into long-term unemployment.

A question that is being debated is whether unemployment is purely a result of cyclical unemployment because of economic changes, in which case government intervention could assist to some extent, or whether the problem is caused by a structural change in the economies which would lead to long-term unemployment issues. This is known as structural unemployment and there is not much governments can do about fixing the problem in the short-term. Restoring banking sector health and credit supply to employment-intensive sectors could help.

Global demand must be rebalanced to sustain growth

Looking further ahead, the world's ability to sustain growth over the medium term depends on rebalancing global demand. This means that economies that had excessive external deficits before the crisis need to continue consolidating their public finances in ways that limit damage to growth and demand.

Economies that ran excessive current account surpluses will need to increase domestic demand as much as possible to sustain growth, as excessive deficit economies scale back their demand. Rebalancing needs to be supported by financial sector reform and growth-enhancing policies in both surplus and deficit economies.

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