Europe’s tired engine

As the euro zone goes into another recession, Germany is slowing down

After a promising May and June, Steffen Knoop has seen his sales dip by 30%. His small Hamburg-based company, Wascut, sells cooling and cleaning oils for big machines, including those that make cars. “I have a pretty good window on the economy,” he says. Mr Knoop wonders whether the dip is caused by people taking extra long summer holidays or something more serious. Others with a broader and more long-term view of the economic landscape are asking the same question.

Hopes are pinned on Germany as the locomotive that will keep chugging even as large parts of the euro zone go into recession (see chart). As long as Europe’s biggest economy keeps growing, the argument goes, it can gradually pull others out of the mire. Figures released on August 14th duly showed that German GDP grew in the second quarter on the previous one, but only by 0.3%. That was better than in France (no growth at all), Spain (minus 0.4%) and Italy (minus 0.7%). Given its current weakness, can Germany continue to pull its neighbours along?

Until the end of last year, German growth seemed to be gathering speed. Then some warning signs started to appear. The business-climate index of Ifo (Institute for Economic Research), which started falling in August 2011, has edged more or less persistently down. In July business expectations hit a low not seen since mid-2009. The Markit/BME purchasing managers’ index, which measures the state of manufacturing, also started to fall last year; in July it too hit its lowest level since June 2009. This fall was reflected in a drop of 1.7% in new contracts won by German companies in June, compared with May—including a drop of 2.1% in domestic orders and of 4.9% in orders from the euro zone. “And we don’t see the orders that were cancelled,” points out Thomas Hüne, an economist at the Federation of German Industries.

At least German exports continue to be buoyant. Most companies with an export bias are reporting good half-year figures (as are many consumer businesses that would normally suffer in a downturn). German companies have found growing export markets in Asia, central Europe and America that more than make up for a fall in demand from euro-zone countries. A weaker euro has helped. The German trade surplus is so huge—nearly €100 billion ($123 billion) in the first half of the year— that it has drawn flak from the OECD club of rich countries, and from the European Commission. “A balance-of-payments surplus is no reason for Europe to intervene," says a government spokesman. Plenty of economists disagree, as does the German Confederation of Trade Unions, which is calling for more investment to stimulate domestic demand.

Steady consumers

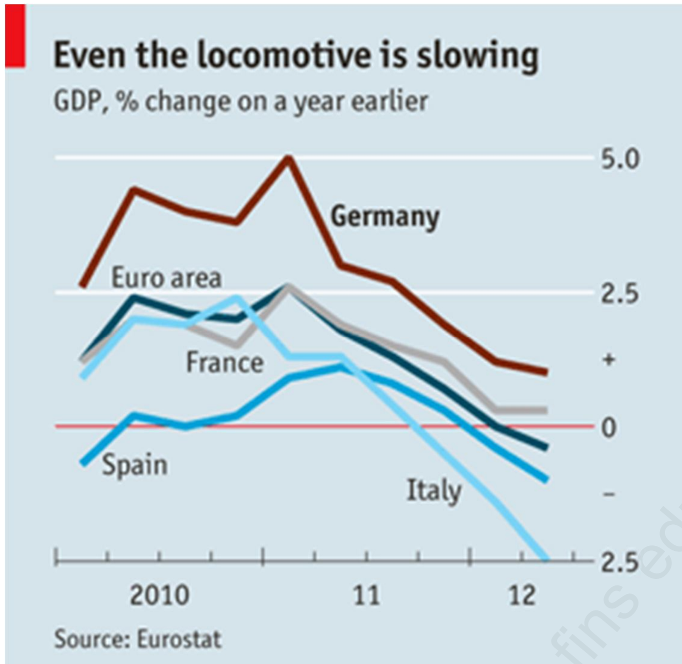
Consumption is actually quite steady. Retail sales showed a 2.9% increase in June compared with June 2011. The job market is robust, despite big lay-offs in retail chains, banks and power companies. Some recent union agreements have raised wages by as much as 4.5%. The property market is buoyant, especially in the big cities. Consumer sentiment as measured by GfK, a research company, shows that citizens feel well off and have a willingness to buy, but at the same time are fearful that the German economy will be sucked into the euro-zone crisis. HDE, the German retailers association, is forecasting retail-sales growth of only 1.5% for the year, despite a first-half number almost twice that, "because of the risks", which it sees as price rises in electricity and petrol and a possible fallout from the euro crisis.

The flashing light that worries economists most of all is the fall in capital investment. If companies are not willing to invest in new capacity, hopes for a domestically driven recovery will be dashed. The fall in investment, particularly capital spending, reported in the GDP announcement is an alarm signal, says Mario Ohoven, president of the Association for Small and Medium-Size Businesses. Germany's big car companies, however, show no sign of pulling in their horns. BMW is expanding capacity in China, North America and Britain. Daimler opened a truck plant in India in June and Volkswagen (VW) plans to invest over €60 billion worldwide by 2016.

Yet, despite continued record sales globally, these companies are not immune to what is happening to demand for cars in Europe—a fall of 6% in the first half of the year. BMW sold 0.5% fewer cars in Europe (and 1.5% fewer in Germany) in the second quarter than in the same period of 2011. Daimler sold 11% fewer Mercedes cars in western Europe in July than in July 2011. And those are the thriving carmakers. Opel/Vauxhall, GM's loss-making European subsidiary, saw a 14% drop in car sales over the first half. Over the long term weak demand for cars in Europe threatens seriously to affect the German car industry and its network of suppliers. However attractive the rest of the world may be, the EU still buys 40% of all German exports.

Hopes that the German consumer will somehow come to the rescue and reduce Germany's export dependence are misplaced. German retail and service industries are not good at tapping the consumer. The sorry state this year of four retail companies that have failed to adapt to the internet era—Schlecker (a drugstore chain), Neckermann (a mail-order firm), Görtz (a shoe retailer) and Karstadt (a chain of department stores)—is revealing.

It is hard for Germany to grow under negative conditions, says Stefan Schneider, an economist at Deutsche Bank. The last time it managed it was with German unification in the 1990s when tax incentives promoted investment in eastern Germany. Similar incentives to encourage investment and outsourcing to peripheral euro-zone countries might do the trick. Otherwise the locomotive is likely to stall.



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