Germany's 3D export strategy to bring an additional EUR36bn in 2015

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Executive summary

- In 2015 German goods exports are expected to rise by EUR36bn over 2015. Europe, China and the UK are the top 3 destinations: 20.3bn, 4.2bn and 3.7bn respectively. Stronger demand for high value added goods and a lower euro (only explaining EUR5bn) will boost machinery (+9.3bn), chemicals (+7.8bn) and vehicles (+7.4bn).
- The German success story is one in 3D, based on: (i) Diversification of export destinations; (ii) Dependability on exports in the premium segment based upon strong R&D investment; and (iii) Dissemination with an increasingly internationalized supply chain and greater FDIs.
- Key risks stem from exposure to economic and political turmoil in export destinations, particularly the Russian balance of payment crisis costs EUR7-8bn in German exports. Competitiveness risk arises from 5pps faster manufacturing wage growth than the US and Japan, but the EUR depreciation should offset on third of the 2015 wage growth (3.3%)

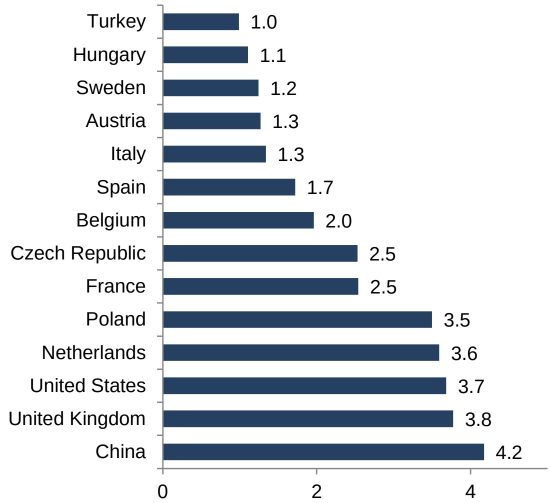
2015: German exports to increase by EUR36bn

German export growth is likely to accelerate moderately to +4.5% in volume during 2015, after expanding +3.8% in 2014. In value terms, 2015 exports are expected to increase by 2.7% (i.e. EUR36bn), but less than in 2014 (y/y growth of 3.6%, export gains of EUR45bn). Behind this deceleration of nominal exports stands an expected decrease of export prices caused by (i) lower energy prices and (ii) higher price competition in deflationary key outlets.

In 2015, Europe remains the most important market for German goods with EUR20.3bn additional exports, while the greatest additional demand should come from the UK (EUR3.8bn), the Netherlands (EUR3.6bn) and Poland (EUR3.5bn, see figure 1). China remains the top market for German export growth with expected gains of EUR4.2bn. The US recovery should lift German exports by EUR3.7bn in 2015.

2015 export gains are mainly concentrated on high value added sectors. The highest export gains should come from machinery, estimated at EUR9.3bn, followed by chemicals and

Figure 1: 2015 potential export gains by destination (in bn EUR)



Sources: IHS Global Insight, IMF, Chelem, Euler Hermes vehicles with additional gains of 7.8bn and 7.4bn respectively (figure 2). Together, these three sectors should contribute about 68% of additional exports in 2015. Also the Electronic and Electric sectors should see exports increase significantly with EUR3.9bn and EUR2.9bn respectively.

The recent drop in the Euro (25% since March 2014) should support exports this year. However, the magnitude of the effect should be limited to additional export gains of EUR5bn even though Germany's largest share of exports (61%) goes outside the Eurozone as (i) the real effective exchange rate (the weighted average of a countries currency) depreciated only by -3% for the same period since emerging market currencies have also depreciated; (ii) German exports have a comparatively low price elasticity (0.6) due to the high share of high value goods; and (iii) with corporate margins at a 10 year low, companies may seek to increase these instead of decreasing sales prices in foreign currencies.

A success story in 3D: Diversification, Dependability and Dissemination

Diversification – aiming at new markets

The diversification process of export destinations has accelerated since the financial and economic crisis of 2008/09. With a share of almost 40%, the Eurozone remains Germany's main export destination. However, the economic crisis and continued lack of economic momentum in the Eurozone has seen exports to the region stagnate, increasing the importance of other, faster growing, regions for German exports. Since 2011, exports to the Americas have increased by +23% (driven by the US), followed by exports to Asia (+14%). Overall exports to non-Eurozone countries increased by 8% whereas exports to the Eurozone decreased by -2%. Today, among the leading economies Germany has the highest diversification of export destinations.

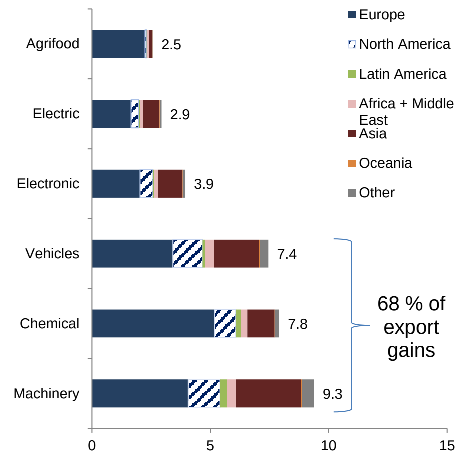
There remain potential gains in market share: promising export markets are those that offer high GDP growth in the coming years and have seen German export growth lagging behind the country's imports (see figure 4). An example being India: the country should see GDP grow by 7.7% in 2015, while capital expenditure is expected to rebound to 20.1%. However, 2015 German export gains in India are still limited at EUR0.75bn.

Other Asian candidates where GDP growth is favorable and German export penetration lags behind are Malaysia, Singapore, South Korea and the United Arab Emirates. For Africa, particular sub-Saharan countries such as Nigeria, Ghana or Kenya show export potential. The only American country that is well positioned in the ranking is Colombia (see figure 4).

Dependability – rising global desire

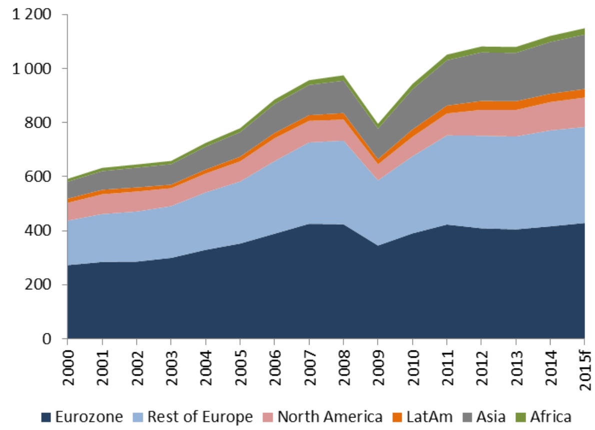
Quality and reputation for both final and equipment goods is critical to success for the German export strength. The product placement supports exports to countries with

Figure 2: 2015 potential export gains by sector and region (in bn EUR) for top 6 sectors



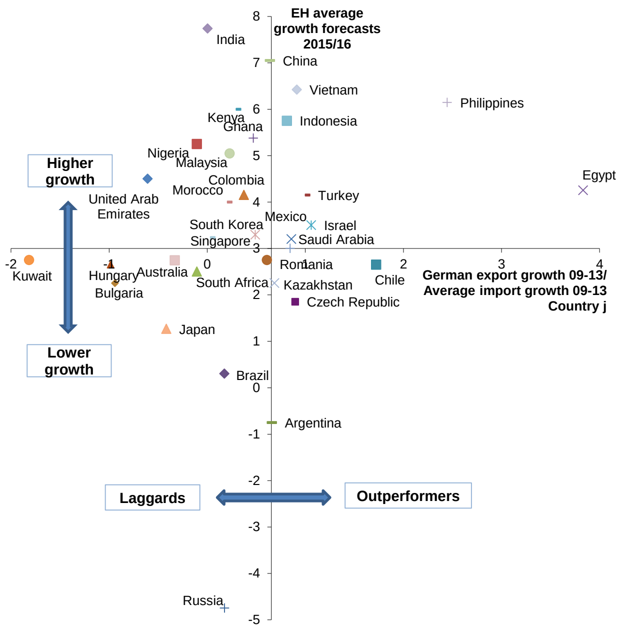
Sources: IHS Global Insight, IMF, Chelem, Euler Hermes

Figure 3: Nominal exports to regions in EUR bn



Sources: DeStatis, Euler Hermes

Figure 4: German export markets: laggards and outperformers



Sources: IHS Global Insight, IMF, Euler Hermes increasing consumer demand. For instance, despite the structural slowdown in economic activity (EH expects GDP to increase by 7.1% in 2015 after 7.4% in 2014), exports to China accelerated in 2014 to 11.3%. The portion of consumption goods in Chinese imports from Germany increased from 5% in 2000 to 21% in 2014 while the share of equipment goods decreased from 48% to 36% (see figure 5). With per capita income rising by 9% y/y in 2014 in urban areas and by 11.2% in rural areas the shift in Chinese demand from capital to consumption goods should continue in the medium term and should see overall 2015 exports to China increase by 4.2 bn.

A driving factor behind the placement in the upper segment of medium-high tech industries of German manufacturing is the focus on innovation, based on high R&D investment. Gross domestic expenditures on R&D as a percentage of GDP is 2.9%, the highest in the Eurozone; R&D expenditure is only higher in Japan (3.4%) and Korea (4.0%) (see figure 6). Moreover, Germany compares favorably internationally with 8 researchers per 1000 employees.

Dissemination – internationalizing the value chain

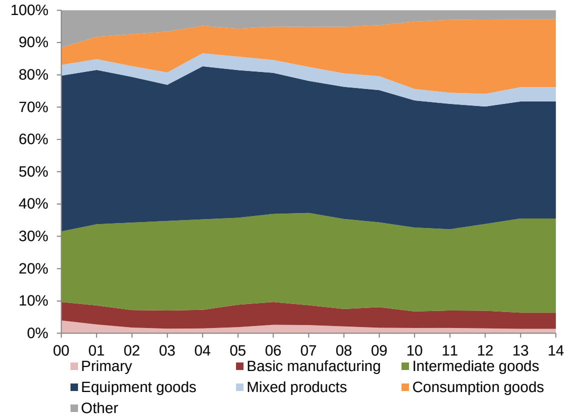
The German strategy is however not an exclusive export story. FDIs play an important part in accelerating German exports. FDIs to China (+123% between 2009 and 2013) and Eastern Europe (+19%) show the rapid internationalization for intermediary goods. Beyond transactions, the focus on quality has allowed *Made in Germany* to evolve into an increasingly global value chain. While focusing production on its comparative advantages, foreign value added in exports increased in Germany from 19% in 1995 to 27% in 2009 (Euro area 25% in 2009). For instance, the German economy outsourced parts of its value chain to lower cost countries in Emerging Europe and Asia. Between 2000 and 2012, employment in foreign subsidiaries of German companies increased by almost 45%, with the highest increase in Asia (141%) and non-EU Europe (91%, figure 7). 2015 should see higher investment abroad for German companies with a profitability boost coming from lower energy prices (increasing margins on average by 0.9pps).

Selected country risks and competitiveness issues

Risks for foreign demand

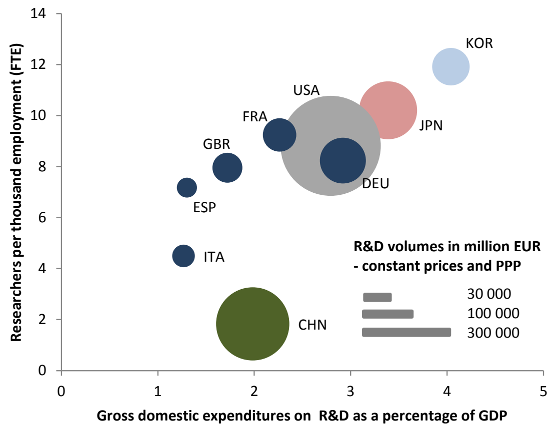
In Germany exports represent 46% of GDP. In spite of the diversification in destinations, any turmoil in a destination country can cost billions before Germany reroutes elsewhere. The recession in Brazil, or the revision in investment plans for oil rich countries (such as Saudi Arabia) may reduce German exports by as much as EUR360mn and EUR4bn respectively. In addition to sudden shocks, two regions do matter more. The false start of the Eurozone recovery last year (GDP growth below 1% against initial expectations of a 1.5% GDP growth) cost EUR10bn to Germany. Similarly,

Figure 5: Chinese imports from Germany, weight of product classes



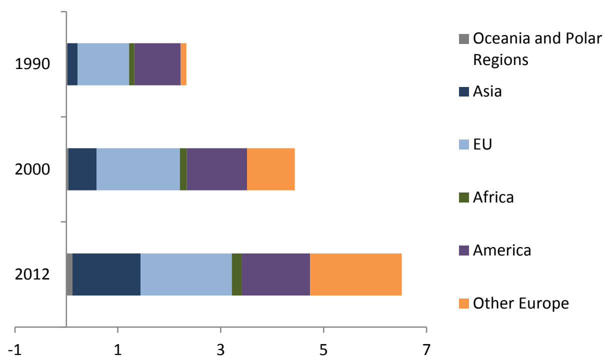
Sources: Chelem, Euler Hermes

Figure 6: Human and financial resources devoted to R&D



Sources: OECD, Euler Hermes

Figure 7: Employment in German enterprises abroad (in million)



Sources: IHS Global Insight, Deutsche Bundesbank, Euler Hermes risks exist in a slower China recovery: A drop of Chinese GPD growth below 6.5% would induce a reduction of German exports by EUR5bn.

Political risk and recession in Russia
A major downside risk for 2015 is Russia, which accounts for about 3% of German exports: In EH's core scenario the country will enter in 2015 a balance of payment crisis with a severe recession (GDP declining by -5.5%). German exports to Russia decreased already by 18% in 2014. Given the extensive depreciation of the Ruble (-43% against the EUR since June 2014) and the lower Russian foreign demand, German exports should decrease in 2015 by at least 25% or EUR8.1bn.

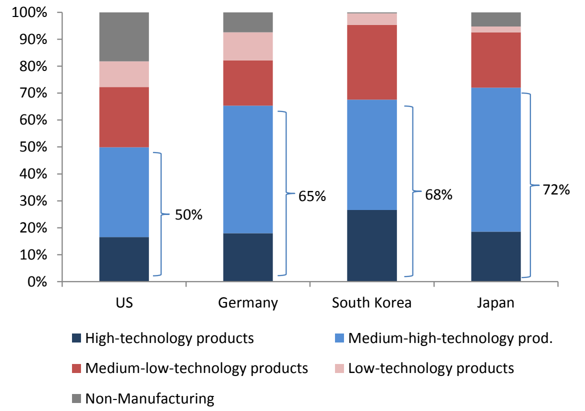
Some sectors are more affected by the Russian crisis than others. 10% of German companies export to Russia. For about 3% of companies at least a quarter of exports go to Russia. The market matters particularly for some exporters: machinery (22%), vehicles (21%) and chemicals (9%) account for more than half of German exports to Russia. Russia is the 4th most important export market for machinery (with a share of 4.9% of all exports in the sector, worth EUR8.1bn) and the 5th most important for vehicles (with a share of 4%, worth EUR7.5bn, figure 8). The ore industry and the apparel sector are exposed with a share of 10.6% and 5.4% respectively of exports going to Russia (worth EUR14mn and EUR747mn in 2014).

Competitiveness risk
Finally, the competitiveness risk for German exporters is increasing. South Korea, Japan and the US produce at a similar quality. High and medium technology products have a share of 65% of German exports, compared to 68% in South Korea and 72% in Japan (see figure 9). When quality is on a more even playing level field, price is at risk of becoming a method of competition. Manufacturing hourly earnings already increased between 2010 and 2014 in Germany on average by 5pp faster than in Japan and the US. A further drift apart in 2015 is likely, as wages are expected to increase significantly again in 2015 at +3.3%. However, the cheaper euro is safeguarding, in part, Germany's competitiveness, offsetting 33% of the rise in compensation.

Figure 8: Exposure of German sectors to Russia

Sources: DeStatis, Euler Hermes

Figure 9: Share of product class in total exports, by country



Source: Chelem, Euler Hermes

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