

Powerful upswing following historic recession



The German economy is working its way out of the crisis with remarkable speed and vigour. Manufacturing exports are the driver, which continue to benefit from favourable global economic conditions. Domestic demand has been boosted in turn, in many cases more than making up for the effect of expiring economic stimu-

lus programmes. Capital expenditure has picked up, and consumer spending is contributing to growth too thanks to unexpectedly low post-crisis unemployment. This macroeconomic environment has allowed the German economy to grow significantly faster than the rest of Europe. Even in the unlikely event of a stagnation setting in the second half of 2010, GDP growth would still end up 2.8% higher year-on-year. On the basis of current economic data the BDI believes growth will come in at around 3.5%.

Though the global economy is showing signs of slowing, this type of scenario would have been scarcely imaginable

just one year ago. This same applies regarding the risks jeopardising the recovery. Overheating tendencies in certain emerging markets, low growth in the US, financing problems and exploding budgets are definitely a hindrance to economic expansion, but these are known factors now seen as manageable. The most likely scenario is thus for a slower recovery as opposed to a renewed drifting into recession.

World Economy



Expansion continues at a slower pace

Emerging markets still strong, US and eurozone having problems

>> page 2

German Economy



Consumption surprisingly strong, exports still rising

Booming exports benefiting the domestic economy

>> page 3

Incoming Orders/Industrial Production



Order books full, production picking up

Availability of credit and commodity prices dampening optimism

>> page 4

Outlook



Situation and outlook still positive despite risks

Growth set to slow after a solid 2010

>> page 5

Policy Agenda



Making Germany an attractive country for investment

More private and public-sector capital investment needed to stabilise the recovery

>> page 6

Foreign Economic Report



Exports set to increase significantly in 2010

»The export sector is pulling Germany out of the crisis.«

>> more

World Economy

Expansion continues at a slower pace



Photo: BDI/fotolia (Tanja Bagusat)

In early autumn of 2010 the trend remained in place that the global economy had gradually entered in mid-year. The worldwide economic recovery continues, though the pace of expansion has slackened somewhat. This partly reflects the expiring of economic stimulus programmes that had been implemented around the world. Crisis-related setbacks have not yet been erased, but the state of and outlook for the global economy are more favourable now than expected just one year ago. The emerging markets of Asia and Latin America continue to drive the global economic recovery. Germany is playing a role in boosting global demand as well by way of higher imports.

The outlook for the **US** is still unclear. The world's largest economy continues to recover, but it is having trouble sustaining the growth rates recorded at the start of the year. Fiscal stimuli are being discontinued, inventory cycles are mostly at their end and consumer spending is restrained by high unemployment and low real estate values. Imports have recently been rising faster than exports. The outlook appears to be for a slow economic recovery that at least will not likely revert to recession. And the innovative spirit and flexibility of the world's largest economy should not be underestimated.

Even **Japan** has been unable to keep up the output level seen in the first half of 2010. GDP stagnated in Q2 2010 at 0.1% quarter-on-quarter growth. This was due to stimulus programmes running out and greater pressure to save, as well as stagnating private consumption, a situation not likely to change given continuing price declines (July 2010: down 0.9% month-on-month). The soaring yen is making Japanese products more expensive on foreign markets and imports cheaper. The trade balance thus failed to provide any stimulus, and there is little leeway left for monetary policy measures after the recent interest rate cut.

In the **eurozone**, the strong German economy stands alone. The IMF has just hiked its growth forecast for Germany this year by 1.9% to 3.3%. France and Italy on the other hand may very well stagnate in the last two quarters, coming down from a moderate recovery in the first half. While Greece remains deeply mired in recession (EU forecast for 2010: -3%), Ireland's banking sector remains dependent on the country's government to prop it up. The budgetary situation in some member states could put a major burden on growth. The eurozone economies are drifting further and further apart, a situation that will likely heighten political tensions. Germany's accelerating domestic economy is having a large stabilising effect though. Private consumption and capital investment have emerged as drivers of the economy alongside exports, while consumer and capital goods are in demand abroad as well. Imports from EU countries increased 17% between January and August 2010 versus the same period last year. During the same period exports increased only 14.3%.

Growth continues in large developing countries

Real gross domestic product, change over previous year in percent



Source: IMF, World Economic Outlook October 2010



German Economy

Consumption surprisingly strong, exports still rising

After an impressive Q2 2010, economic output will likely turn out significantly better than expected for the full year. Between April and June 2010 GDP grew 2.2% quarter-on-quarter (+4.1 for the quarter year-on-year). GDP-driving expenditures were up across the board quarter-on-quarter. Gross capital expenditure increased the most (+4.7% quarter-on-quarter). Slowing government spending (+0.4%, Q1 2010: +2.0%) reflected the expiration of economic stimulus programmes in Germany. The trade balance helped accelerate growth, with exports (+8.2%) rising faster than imports (+7.0%). Private consumption rose for the first time in three quarters (+0.6%).

2010: Signs of a strong recovery

Real gross domestic product, change in percent



Source: Federal Statistical Office

Chain index (2000 = 100)



Manufacturing exports, the heart of the German economy, continued benefiting from an improving global economy. The global diversification of German exports proved a competitive advantage, as Germany profited particularly from trade with emerging market countries in the first half of 2010. Exports to Brazil (+61.3%), China (+55.5%) and Turkey (+38.8%) increased the most. The relatively low percentage of business from these countries is steadily growing. The eurozone remains the biggest sales market, accounting for 43% of exports. As a result, the considerable 10.9% rise in exports to the eurozone noticeably impacted the trade balance.

Consumer spending is now also reflecting the overall strength of the German economy. In September 2010 the GfK consumer climate index registered a three-year high. The index tracks private households' spending willingness and expectations regarding the economy and income. Consumption is being fuelled by a favourable economic outlook through the end of the year and a drumbeat of good employment news. With employment largely intact after the crisis thanks to the practice of furloughing, foresighted business planning and reasonable collective bargaining, now jobs are actually being created on a sustained basis. Temporary employment is also increasing. In September 2010

nearly three million people were without work, 157,000 less than in the previous month, and 315,000 fewer than in September 2009. The unemployment rate fell to 7.2%. The Federal Employment Agency's employment index, which tracks the season-adjusted change in labour demand, has now returned to pre-crisis levels. Thus the labour market problem at hand is not rising unemployment, but rather a shortage of skilled workers.

Positive expectations confirmed by robust business situation ifo Economic Gauge, manufacturing*



Source: Ifo Institute



Increasing capital investment by businesses is also contributing to higher domestic spending. In Q2 2010 gross capital expenditure rose 4.7%, which includes a 5.2% gain in construction spending, slightly outstripping capital equipment spending (+4.4%). The rise in capital equipment spending in large part reflected necessary replacement investments. Postponed investments are now increasingly being pursued, allowing businesses to expand capacity. A lot more is being invested in motor vehicles and machinery in particular. Construction spending continues to be driven by weather-related production backlog. During the hard winter months construction activity effectively came to a standstill. Building construction accounts for the majority of investment, especially housing. Commercial construction, which has been surprisingly vigorous, has had much to do with replacement and maintenance activity. Below-ground construction has declined however. Public construction projects have been cut back in particular in view of local government budgets.

Public-sector consumption is slowing as a result of the progressive expiration of economic stimulus programmes. No one knows for sure when unspent funds will yet be expended, thus there may be a pro-cyclical effect when an upturn is underway. Currently there are many indications that the other spending elements of GDP are providing stimulus and stability.

Photo: BDI/fotolia (Andrey Armyagov)

Incoming Orders/Industrial Production

Incoming orders: Up sharply in the eurozone

Industry has nearly regained its pace



Source: Federal Statistical Office



Incoming orders kept rising throughout the summer. Despite some fluctuation, the upward trend remains in place, with new orders increasing 3.4% for manufacturers in August after a slight decline in July 2010 (-1.6%). Spikes principally reflect large orders. The sharp rise in orders in August stemmed from strong demand for aircraft, ships and rail vehicles. Even in a two-months comparison, this metric was up a considerable +2.0% for July/August 2010 versus the previous period. In a two-months comparison foreign orders were up most (+3.5%), driven by the eurozone (+7.4%, non-eurozone: +0.7%). Domestic demand on the other hand stag-nated.

Orders for intermediate goods slowed somewhat in August 2010. While still up by 0.3%, orders were no longer strong like in July (+3%). In a two-months comparison, however, the increase was still considerable (+3.2%). The eurozone (+7.2%) was the chief impetus behind rising foreign orders (+6.4%). In a two-months comparison, orders from non-eurozone countries rose (+5.8%), but have recently lost momentum (August 2010: +0.6%). Domestic demand was only up 0.4% on a two-months basis following a weak August (-2.3%).

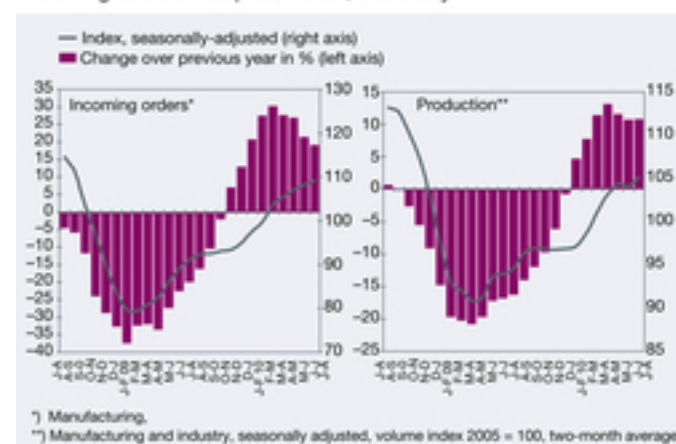
The cyclical nature of demand has now affected capital goods manufacturers as well. The decline versus July 2010 (-4.8%) was followed by a surge in demand in August (+6.7%), which is clearly reflected in a two-months comparison (+1.5%). Eurozone orders jumped, up 22.6% in August alone, for a 9.0% gain in a two-months comparison. Foreign demand increased 2.6% overall for the period (non-eurozone: -1.2%). In August orders for German capital goods manufacturers rose across all markets relative to July 2010. The increase in domestic demand (+2.0%) completely made up for the previous month's decline, but left a slight decline on a two-months basis (July/August 2010: -0.2%).

On a season-adjusted basis consumer goods manufacturers saw orders decline, due in part to prices (August 2010: -3.9% in July/August 2010: -2.0%). In a two-months comparison non-eurozone demand fell (-4.7%), while domestic demand remained relatively stable (-0.8%).

Production: Manufacturing sector working its way out of the crisis

Incoming orders and production growing at same pace

Incoming orders and production, Germany



Source: Federal Statistical Office



Manufacturing production is increasingly following the nearly straight-line rise in incoming orders, a trend that continued in August 2010 (+1.7%). A two-months view of July/August 2010 shows a steady increase (+0.7%). Industrial production was behind this development, which increased 1.8% in August on a working day and season-adjusted basis, and 0.8% over the two-months period. In the month under review capital goods manufacturers led the way in terms of output (+2.6%; two-months comparison: +0.3%). Producers of intermediate goods also increased production (+1.6 %/+1.1%), and to a lesser extent consumer goods manufacturers as well (+0.6 %/+1.0%). Full pipelines mean production will likely remain stable, thus capacity will probably keep expanding.

The construction industry is emerging more slowly from the crisis. Production fell 0.4% in August 2010, but was still up on a two-months basis (+0.4%). Energy producers' output increased 1.2% during the month under review, but was 0.1% lower over a two-month period versus May/June 2010.

Rising orders and production indicate that German manufacturing has already come a long way on the road out of crisis. Pre-crisis levels thus no longer appear as far away as they were at the start of the year. However, momentum is likely to slow given the anticipated softening of the economy, a view supported by recently lowered business expectations on the part of manufacturers surveyed by the ifo Institute. The business climate was considered favourable in the survey, however, pointing to a continuation of the recovery.

Photo: BDI/fotolia (Andre Bonn)

Outlook

Situation and outlook still positive despite risks



Further easing of the credit situation. Photo: BDI/fotolia (imageteam)

In January 2010 the BDI optimistically estimated growth could reach 2% for the year, but things have turned out much better than expected. Coming after an unexpected surge during the second quarter of 2010 and an upward revision of last year's GDP (-4.7%), economic output will likely be up substantially for the full year. Even in the very improbable event of stagnation in the third and fourth quarters of 2010, the statistical overhang would still ensure 2.8% GDP growth in 2010. In light of the continuing rise between July and September, 2010 growth is projected to come in at 3.5%.

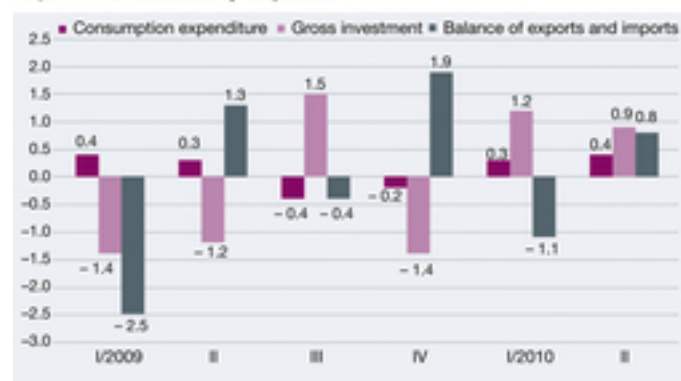
The current situation is thus far better than seemed possible given the circumstances one year ago. The macroeconomic environment has improved so much as to allow for an improved economic outlook. The crisis and its consequences have not yet been fully overcome, however. Incoming orders, production and capacity utilisation are not yet back at pre-crisis levels. Intermediate goods manufacturers are faring much better than late-cyclical producers, which will take longer to put the crisis behind them. The most likely scenario appears to be a continuation of the recovery at a slower pace, in view of economic opportunities and risks seen at this time.

There remains a portfolio of risks to be considered. It would be trouble if high-deficit countries fail to reduce expenditures, and countries mired in debt fail to return to sustainable growth. Overheating emerging market economies and continuing economic weakness in the United States could also deprive the global economy of momentum.

Still, the risks do appear to have become more manageable. Thus far there have been no setbacks to the stabilisation of the financial sector, and progress is being made on measures for tightening financial market regulation. Governments and markets are aware of the potential for negative developments, making a "double dip" fairly unlikely for that reason alone. Germany's pickup in capital expenditure and private consumption can be seen as an expression of greater confidence. The availability of financing is still an issue, but a credit crunch has been averted. Indicators are now pointing to a further easing of the credit situation. Additionally, the change in M3 money supply in the eurozone shows that inflation risk is still low. The austerity measures implemented in many countries demonstrate how a different course is now being taken after the (quite successful) intervention to stabilise aggregate demand.

Broad-based growth drivers

Growth contributing to change in GDP over previous quarter; in percent, seasonally adjusted



Source: Federal Statistical Office

Policy Agenda

Making Germany an attractive country for investment



Photo: BDI/fotolia (momanuma)

In early autumn of 2010 we find the German economy in extremely robust condition. Instead of surging unemployment, there is a shortage of skilled labour. Capital investment and consumption have picked up, and exports are again showing their traditional strength. The ongoing process of recovery comes as the result of several good decisions. A preliminary qualitative assessment indicates that the economic stimulus packages implemented by the German government have worked. It proved wise for companies to retain their core workforce, and workers demonstrated an exemplary willingness to make concessions.

The economic outlook for the year ahead is furthermore quite favourable. The global economy will soften somewhat, but the domestic economy factors of private consumption and capital investment will likely improve. But this is not something to be taken for granted – we have to work for it. Further job creation is necessary for consumer spending to thrive, which means that unions must display a prudent restraint. Capital expenditure can only be kept going by eliminating structural problems so as to create the right conditions.

Demand for capital goods is stimulating the economy, but this may only be for now. In a long-term comparison with other EU-27 nations, Germany is in fact at the bottom of the list for gross capital investment relative to GDP, factoring in both public and private capital investment.

If the government wants to keep the present recovery going and create more favourable conditions, it must make Germany the land of not just industry, but also capital investment. This can be achieved if more government spending is allocated to public-sector investment. Despite pressures to consolidate, the capital assets and infrastructure on which the German economy runs may not be allowed to further degrade. Intergenerational equality is called for in this area as well, which government could foster by improving cooperation between public procurers and the private sector. The right approach is to revive public/private partnerships; re-municipalisation is the wrong approach. Capital investment can after all be promoted by making Germany more attractive for foreign investors. This could be done by eliminating investment barriers and more effectively communicating the attractiveness of Germany as a business location. Taken together these measures could effectively strengthen domestic demand and ensure sustainable growth.