

Robust recovery, yet still no sustained growth

The global economic climate remained quite favourable at the close of the first half of 2010. Economic expansion continues in the leading growth centres of recent years. The German economy is benefiting from rising demand for goods, with incoming orders and other metrics reflecting the acceleration in exports. Rising demand is translating more and more into increased production and domestic orders for capital goods. The employment picture remains extremely favourable as part of a generally good outlook for the year 2010. The rebound in spring created jobs, and employers are

increasingly moving away from short-time working. Six months ago the BDI considered 2% growth a possibility; this figure still seems to be a reasonable estimate given the way things have been developing.

There is cause for economic optimism, but not for euphoria. Historically, recovery phases following economic crises stemming from the financial markets tend to require great patience. The V-shaped recovery seen is the product of huge economic stimulus packages implemented around the world as well as of the correc-

tion of market overreaction. In addition to high commodity prices, other risks proceeding from the financial markets are emerging, including the bank levy, the financial transaction tax and heightened capital requirements for the banking system, which will create pressures that affect the availability of corporate funding. Distressed public finances in many countries are also contributing to macroeconomic concerns. Thus consolidation to control costs and bundle growth potential is a top priority, in Germany and elsewhere.

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Incoming Orders/Industrial Production

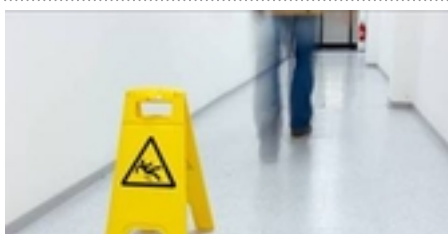


Rise in incoming orders boosts production

Production is seeing an increase in orders from Germany and abroad

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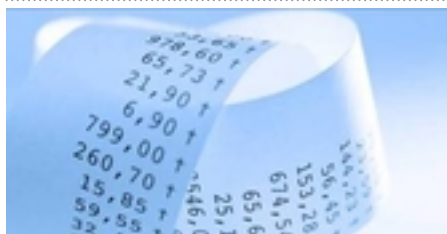


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Foreign Economic Report



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World Economy

Global economy on track to expand

The global economy remains in a phase of broad-based expansion. The OECD forecasts worldwide production to increase by 4.75% both this and next year. The newly industrialising nations in Asia and Latin America are driving growth to a significant extent.

The US too is sending positive signals for the global economy, exhibiting a moderate economic pickup. Rising inventories, consumer spending and capital expenditure contributed to GDP growth in Q1 2010 (+3.0% annualised), counterbalanced in part by lower government spending at state and local levels, declining construction and a negative trade balance. The economy may well cool down in the course of the year on declining consumer confidence and stagnating job growth.

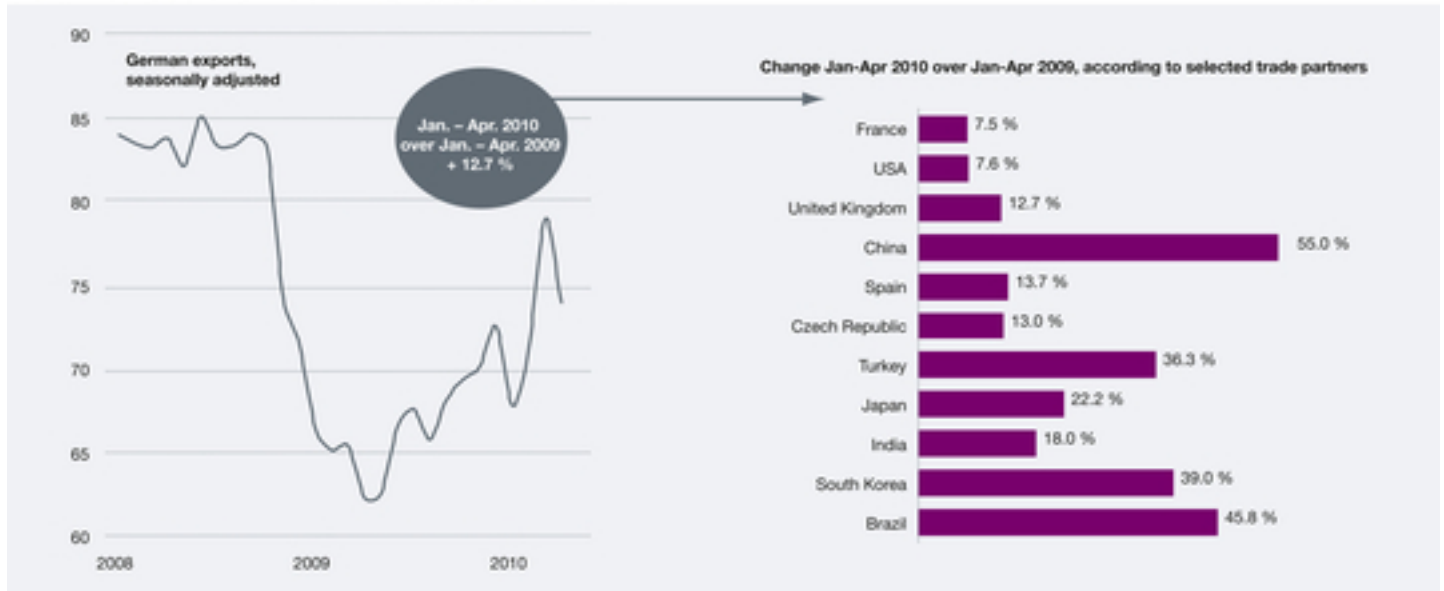
Japan's economy is benefiting the most from accelerating momentum in East Asia. In June the growth forecast for 2010 was revised upward to 2.6% on an improving outlook for exports. The Japanese economy expanded 1.2% in the first quarter of 2010, reflecting rises in international sales of goods and services, consumer spending, private-sector capital expenditure and residential construction.

China and India will record vigorous growth in 2010, and their outlook is good for 2011 as well. Economic stimulus programmes continue to play a large role in China, but rising consumer and capital spending are increasingly taking over as the engine. Inflation is still only moderate relative to the significant level of growth (April 2010: +2.8% year-on-year). The managed revaluation of the yuan should also help keep the economy from overheating.

The Eurozone economy is recovering, though more slowly than the rest of the world. GDP growth of 0.2% in Q1 2010 was driven exclusively by a cyclical rise in inventories. Unfavourable weather conditions across Europe slowed economic growth, which was burdened by consumption and the balance of trade. There is great heterogeneity within the Eurozone in terms of situation and outlook. Some countries are still mired in recession (Greece, Spain, Ireland), while others have resumed vigorous growth, especially Germany. Take, for example, the major growth disparity between Greece (IMF forecast for 2010: -2.0%) and Slovakia (IMF: +4.1%).

Photo: BDI/fotolia (Alexei Fateev)

Exports: Asia and Latin America increasingly important



Sources: Federal Statistical Office, Deutsche Bundesbank

German Economy

Economy-driving exports humming, capital spending up

Despite the hard winter of 2009/2010, the German economy expanded slightly in the first quarter of 2010. GDP rose 0.2% quarter-on-quarter. In Q1 2010 imports rose faster than exports, thus the balance of trade (-1.1%) weighed on price, season and calendar-adjusted GDP growth. Domestic demand, on the other hand, was positive (+1.4%). Declines in construction (-3.8%) and private consumption (-0.8%) were outbalanced by higher capital expenditure (+1.6%), government spending (+1.1%) and inventory investment (+1.9%).

2010: 2 percent economic growth increasingly likely



Source: Federal Statistical Office, own calculations;
 *Source: German Federal Government; **Source: Commerzbank

The negative balance of trade in Q1 2010 is not a bad sign though, as higher imports have to do with rising inventories. Germany is particularly dependent on imported intermediate manufactures, semi-manufactures and raw materials. These imported goods create the basis for adding value further down the chain in the form of German exports. Thus exports, which have risen three quarters in a row, are likely to grow faster than imports over the rest of the year. The BDI estimates export growth of around 8.0% for 2010. Year-on-year, exports were up 12.2% in Q1 2010, and 28.8% for May 2010; the month-on-month increase for May was 9.2%. German exports suffered badly as a result of the drop in demand during the financial and economic slide, but now Germany is participating more in the global recovery than other countries due to its diversified customer base. This applies to intermediate manufacturers, which are typically early-cycle businesses, and increasingly to capital goods manufacturers.

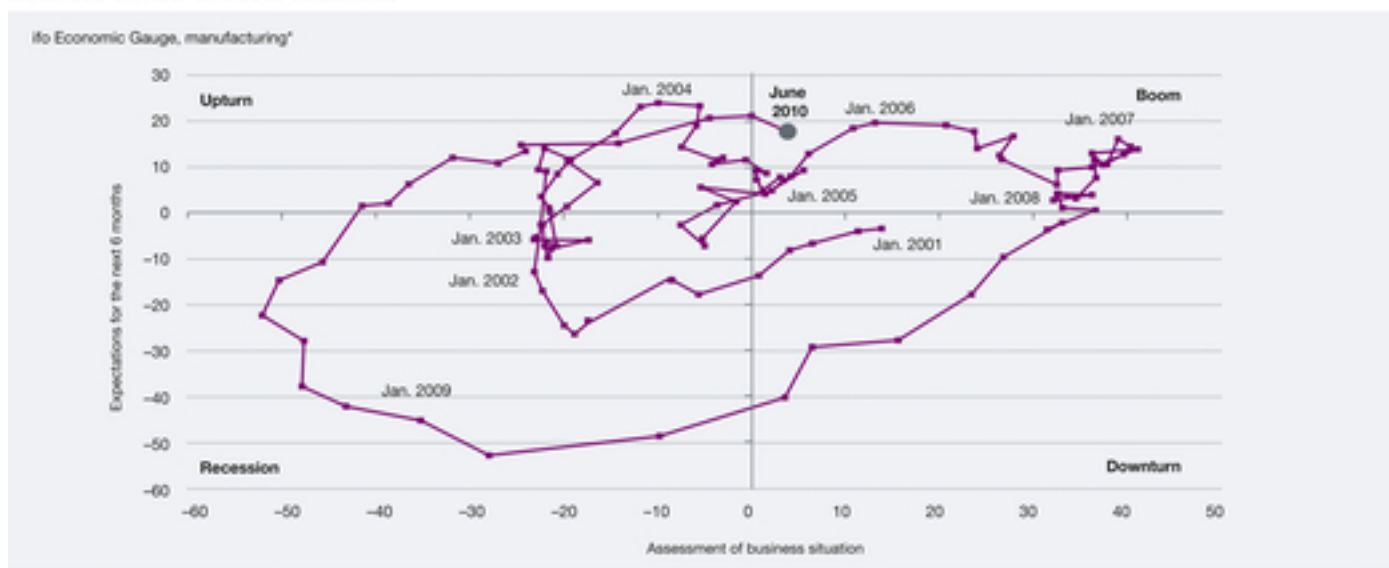
Private consumption has been declining in Germany for three quarters, yet only moderately in view of the severity of the recession. Consumer sentiment has not suffered despite the austerity measures announced by the German government and questions about the financial stability of certain Euro nations. The GfK consumption climate index recorded no change for July 2010 versus the previous month. Steady consumer confidence is primarily the result of the very good unemployment situation. In June 2010 unemployment declined 0.2% month-on-month to 7.5% (-21,000 individuals). Year-on-year the number of unemployed has decreased 257,000. And as unemployment continues to decline, the number of self-employed is also increasing. Another reason for the firmness of consumer sentiment is the diversity of economic stimulus initiatives implemented by the German government, which included the now-expired 'cash for clunkers' scheme as well as lasting tax breaks boosting disposable income. Less short-time working and slight inflation (May 2010: +1.2% year-on-year) are enhancing consumer spending potential. In consequence, disposable incomes of private households were up +1.0% y-o-y in Q1 2010, the biggest increase since the fourth quarter of 2008.

In March 2010 capital goods manufacturers recorded a 5.3% increase in domestic sales versus the previous month, terminating the downward trend with respect to the previous year. Replacement capital expenditure is playing the most significant role. Capital spending for expansion and rationalisation is growing in significance as well. The trend has been sideways, but the likelihood is that capital expenditure will increase rather than decline, as improving economic prospects and rising exports are increasingly fuelling private-sector demand for capital goods. The construction sector offers a varied picture with certain surprising aspects. Public-sector construction has not been very dynamic despite the German government's economic stimulus measures. This is primarily because municipal governments are postponing investment plans in view of their finances. Also, the "supplementarity criterion" was eliminated for construction spending under the economic stimulus programme. Private-sector construction is up surprisingly, although the statistical base effect is considerable after the big decline. And the worst is over for housing construction.

Public spending is contributing to growth, but the German government's austerity plans will likely have a contractive effect. In and of itself, the expiration of stimulus programmes does not jeopardise the economy, as any effects will be more than made up for by the resumption of a positive trade balance as a structural GDP element, reviving capital expenditure as a result.

Photo: BDI/fotolia (Roger Asbury)

Business climate in boom quadrants



* Balances, seasonally adjusted, as of 22 June 2010
Source: ifo Institute



Incoming Orders /Industrial Production

Incoming orders: big jump in the spring

Demand for industrial manufacturers continued to rise in the spring months of 2010, more stably in fact than in previous months. In May 2010 incoming orders were slightly lower month-on-month by 0.5%, but this mainly reflected a lower-than-average number of large orders. In addition, the two months preceding May were strong (March 2010: +5.1%; April 2010: +3.2%). In a two-months' comparison for April/May 2010, which is more statistically significant, the uptrend is more distinct, with orders up 5.6%. Domestic demand is having an increasing impact (April/May 2010: +5.4%) as it approaches the level of foreign demand (+5.8%).

Intermediate manufactures, which pick up early in the economic cycle, have lost some momentum. New orders were down 2.3% in May 2010 versus the strong month of April (+4.2%). A two-months' comparison (+5.1%) plainly reveals that the foreign demand effect is spilling over to the domestic economy. While foreign orders increased 3.4%, domestic orders rose 6.4%.

Capital goods manufacturers recorded a 0.4% increase in new orders in May 2010. This comes after a 2.9% increase in April 2010. Surging domestic orders (+1.9% vs. previous month; +0.9% in April 2010) tell the story of an increasing appetite for capital expenditure in Germany. Foreign orders declined 0.6% on the heels of a 4.1% increase in April 2010 that repre-

sented the culmination of a tremendous 35% recovery from the low recorded in February 2009 due to the crisis. In a two-months' comparison capital goods orders rose 6.1%, placed mainly by non-Eurozone customers (+10.7%).

Consumer goods manufacturing orders are exhibiting unusual volatility. They had been declining steadily until May 2010, when they rose sharply (+3.6%). A two-months' comparison comes out positive (+4.0%). Domestic orders were up in April 2010 (+3.9%), and foreign orders increased 3.1%.

Production gap closing further



Source: Federal Statistical Office



Production: incoming orders fuelling activity

Rising incoming orders are increasingly translating into higher manufacturing output. In April 2010 manufacturing output rose 2.6% on a price and season-adjusted basis. In a two-months' comparison of April/May 2010 versus February/March 2010, production increased by a hefty 4.3%. Industrial production rose again, up 3.4% (two-months' comparison: +4.5%). A look at the primary industrial groups shows a recovery is underway that has definite traction. In May 2010 production increased significantly for intermediate manufacturers (+3.2%, two-months' comparison: +6.2%), and even more so for capital goods manufacturers (+4.6%), who posted a 4.4% increase in a two-months' comparison. Consumer goods production was more moderate, increasing by only 1.7% in May (April/May 2010: +0.8%).

Construction output declined 2.3% in May 2010, but was up a dramatic 12.4% in a two-months' comparison. This reflects the severe weather earlier in the year, which statistical seasonal adjustments do not adequately take into account.

Incoming orders and production indicate the recovery has gained substantial momentum. Until now, rising incoming orders had not affected production. Orders are no longer being postponed the way there were in recent months. The relation of large to average-sized manufacturing orders is also back in balance. For the most part it is no longer possible to fill new orders from inventories. Domestic and foreign orders are nearing equal proportion. Demand has recently risen sharply from the Eurozone, which is the key market for German exports. The ifo business climate index is also showing positive, indicating economic expansion began in June 2010. The situation regarding incoming orders and production provides further cause for cautious optimism.



Metal industry: Rise in incoming orders boosts production.
Photo: BDI/fotolia (Oleg-F)

Budding upturn reflects on production



*) Manufacturing. **) Manufacturing and industry, seasonally adjusted, volume index 2005=100, two-month average
Source: Federal Statistical Office

Outlook

Conditions deteriorating for real economy recovery

Macroeconomic data paint a varied picture of the economic outlook. Worldwide sales of German products are accelerating, and domestic capital spending is reviving. Incoming orders and now production figures too are increasing steadily from month to month. The labour market reforms implemented in the early 2000s in combination with perspicacious collective bargaining agreements concluded in key industries in the manufacturing sector are having a positive effect. More so in fact than short-time working, which has lost a lot of influence in stabilising the economy. Even factoring out one-time events in the labour market statistics, unemployment is actually down from one year ago. This being the case, joblessness is unlikely to rise over the remainder of the year. Even if the inventory cycle slows and growth slips in the emerging economies, the outlook is still good for manufacturing production and sales. Six months ago the BDI estimated growth could reach 2%. Events thus far have corroborated this view.

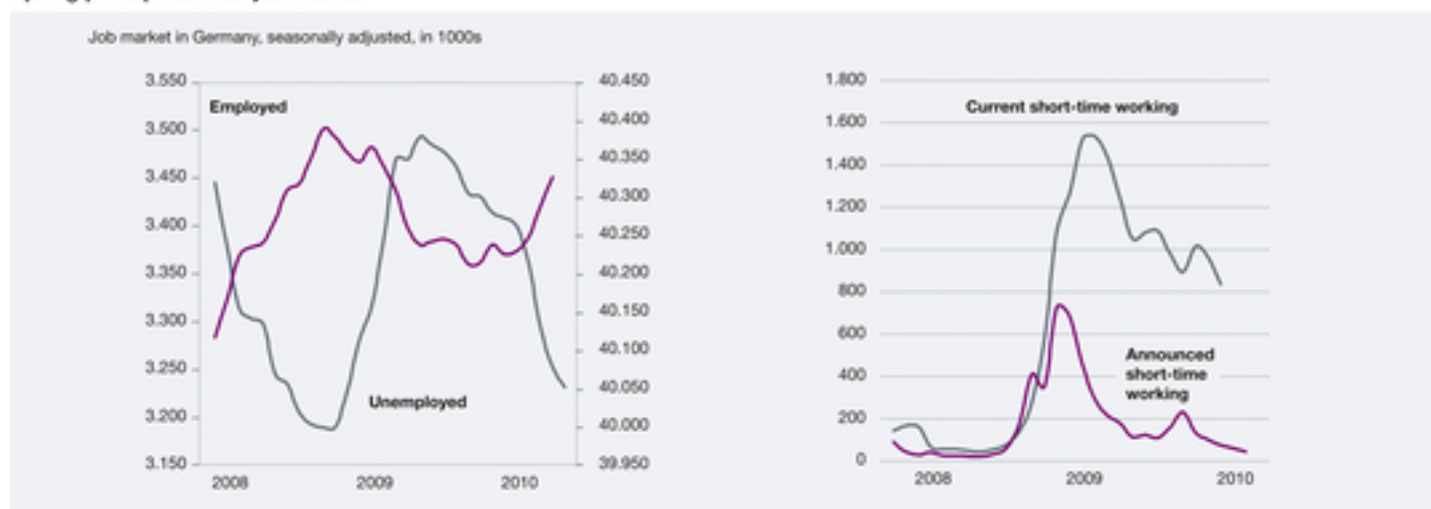
On the other hand, risks are accumulating, jeopardising the sustainability of the recovery. This is typical of real-economy crises precipitated by a financial markets crisis, as historical economic data show it can take a long time to work out the effects of a financial bubble. One should thus avoid putting excessive stock in the V-shaped recovery observable. Especially because this crisis, in contrast to previous ones, features huge and broad-based economic stimulus packages, and because the excessive pessimism that followed the crisis is now due for a correction.



Risks demand caution. Photo: BDI/fotolia (Alterfalter)

We still haven't made it back to pre-crisis levels, but a double-dip recession appears unlikely at this time. The flatter numbers are also due to statistical base effects, which may have exaggerated the positive developments seen this year. All the more reason to keep a closer eye on risks going forward. Commodity prices are high, and combined with the weak euro they are even more expensive. The corporate financing situation, which had improved somewhat, is now becoming acute again. The wave of manufacturing bankruptcies feared when the crisis broke out has not materialised thanks to the strength of the German industrial sector, but bank balance sheets remain troubled. Plans for a bank levy and a financial transaction tax along with more stringent capital requirements under »Basel III« will have a negative effect on lending. European capital markets may see crowding out as a result of the comprehensive government guarantees for the Eurozone.

Spring pickup reaches job market



Sources: Federal Employment Agency, Deutsche Bundesbank

Policy Agenda

Spending cuts have top priority

Rising and in some cases soaring borrowing and debt levels in many countries present a grave economic problem with vast structural implications.



*Soaring borrowing present a grave economic problem.
Photo: BDI/fotolia (Adam Gryko)*

The decision by G20 nations at their summit in Toronto to curtail new borrowing is thus very much appreciated. Their ambitious targets (cut deficits in half by 2011, no new borrowing until 2016) are not binding, nor is it clear by what means they are to be reached. Before the summit, however, the US and Canada were calling for Europe to implement further economic stabilisation measures, so the G20 declaration very much represents a success.

Returning to a culture of stability is urgently needed on a European level as well. The BDI and BDA have thus prepared a joint catalogue of recommendations for reforming the Stability and Growth Pact. The objective must be to enhance preventive measures under the Stability and Growth Pact, more effectively implement sanctions and coordinate member nations' economic policy for greater competitiveness.

A strict course of spending control is not only necessary from a fiscal standpoint, it also brightens the long-term growth prospects of national economies. Reducing the role of government creates room where private businesses can step in. Numerous empirical studies have observed a positive relationship between reigning in excessive government spending and economic growth. Concepts like public-private partnerships should thus be pursued to a greater extent.

In June 2010 the German government enacted austerity measures designed to bring the country's finances back in order. In principle the government's package is a move in the right direction. The first step is to cut spending. Even social welfare and benefits, the biggest expense item, are not being spared, and public administration is also coming under the knife. However, some of the cutbacks are not viable upon closer examination. For example, no one has explained how specific cuts will help achieve the »global spending reduction« by the year 2014. Other elements of the austerity package are clearly anti-growth. These include introduction of a nuclear fuel element tax, an air traffic environment charge and greater levies on energy-intensive industries in particular. The proposed bank levy also reduces growth prospects for the German economy. The common element we see in these initiatives is the questionable practice of selectively favouring some industries while subjecting others to specific levies.

Thus the German government still needs to come up with ways of effectively ordering state finances while promoting growth so that German businesses can stage the recovery on their own. Industry contributes to a balanced budget by making investments that create jobs and growth, which in turn generate more tax revenue. But this can only happen if conditions are in place to allow growth. Turning to additional taxes when the recovery is just getting underway is too short-sighted.