

## BDI Economic Report

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Downturn continues at slower pace, stabilising financial markets crucial

The global economy remains in the depths of an economic crisis. The slump in orders and production continues and has begun to affect the labour market. Of critical importance now are the government's plans to manage the crisis. A key factor will be the stability of the financial markets; without it, the global economy will not be able to recover.

### Global economy shows no signs of easing

The global economic crash has been severe, as was expected. There is currently no end to the recession in sight, nor does anyone know when it will bottom out. The International Monetary Fund predicts that 2009 will be the first time in 60 years that world trade declines.

The continued gloomy outlook is due primarily to the state of the **US economy**. In 2008, GDP decreased by 1.1%, mainly as a result of the weak second half of the year. Trends in consumer spending and now gross capital expenditure are contributing to significant negative growth. Negative signals are also coming from exports, which had developed into a driver of growth in past quarters. Major capital losses and a pessimistic view of the future have slowed spending and investment just as much as the fact that the country now faces a prolonged and painful adjustment process to reconcile its public and private debt.

Of all the industrialised nations, it was **Japan** whose exports dropped the most in Q4 2008 (-13.9%). GDP fell 3% versus the previous quarter and 0.7% for 2008 as a whole. Consumer spending and gross capital expenditure have also fallen into the red. Deflationary tendencies have led households and businesses to put off major purchases. Macroeconomic forecasts are also bleak.

The situation remains tense in the **Eurozone** as well. The slump in global demand for goods has resulted in a steep decline in European exports (Q3 2008 down 7.3% versus Q3 2007) and triggered a prompt reaction in investment activity. High inflation kept a lid on consumer spending up until the middle of 2008; net asset losses and anxiety about the future have meant that spending has not picked up since then – even though consumer prices have begun to drop.

### Germany's GDP continues to contract

In February, the Federal Statistics Office published detailed results on Germany's GDP in Q4 2008. After posting negative growth in the second and third quarters (-0.5%

## Economic overview

### Global economy shows no signs of easing

The global economic crisis is not letting up. The downswing has hit every area of the world, and no regions have begun to recover yet.

### Germany's GDP continues to contract

The beginning of the year saw another decline in Germany's net exports. Capital goods are expected to fare particularly poorly. Increased government spending and stable consumer spending have kept demand steady, but the rising rate of unemployment could soon slow consumption.

### No signs of improvement in orders and production

The sharp decline in new orders and production in the manufacturing sector continues. The business climate has grown even colder and assessments of the business situation are at their lowest levels ever.

### Severity of crisis depends on its duration

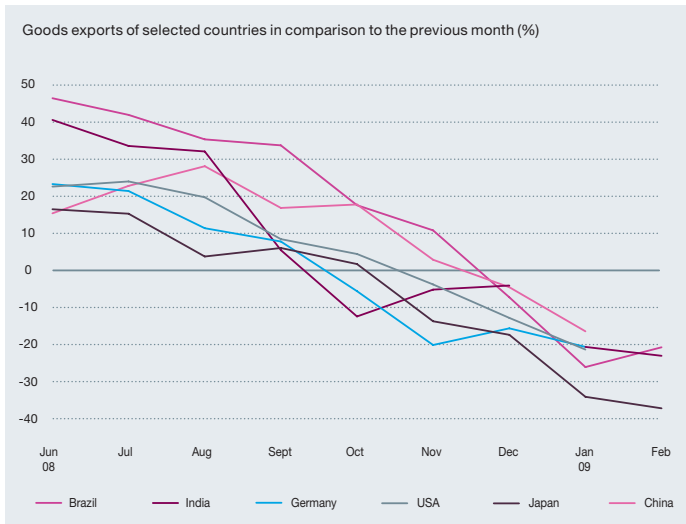
The severity of the crisis will not be measured by how deep the recession is but by how long it lasts. German companies are well-positioned and remain largely unaffected by the crisis. If the downward trend continues, though, more businesses may become insolvent and unemployment may rise.

### Quick action needed to encourage a turnaround

The top priority must be to ensure financing for businesses. Without it, no sustainable growth can be achieved. Further economic stimulus is not advisable. Approaches that do not require additional spending are better, as are moratoriums on restrictive legislation.

in both), GDP fell once again, this time a miserable -2.1% versus the previous quarter. The trade deficit contributed

## Decline in world trade, exports nosedive



Sources: OECD, US Bureau of Economic Analysis, Ministry of Finance Japan, German Federal Statistical Office



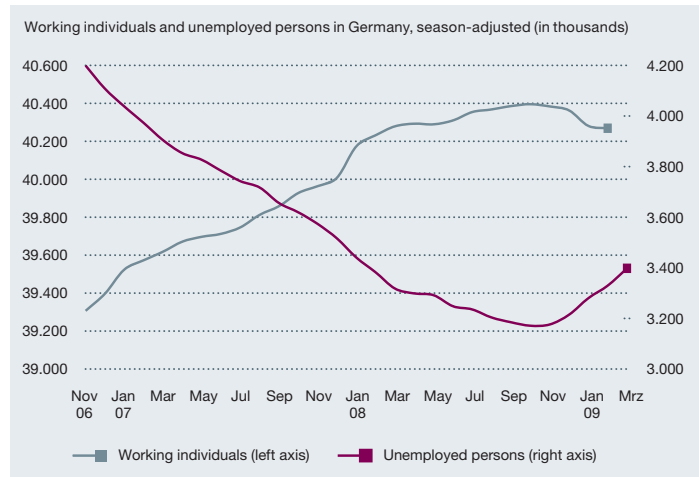
to this decline with exports (-7.3%) falling much more sharply than imports (-3.6%). Domestic demand for capital goods was negative for the first time (-4.9%). At the same time, inventories are increasing, which contributes to growth in GDP (+0.5%) according to the national account systems, but is also an alarming early indicator. Consumer spending fell just 0.1%. The service sector has not had to wait to feel the effects of the crisis either.

The expenditure-related components of GDP reflect the tense macroeconomic environment in 2009 as well. Exports in January and February were off -4.4% and -0.7% respectively. Although imports also fell (-0.8% and -4.2% respectively), the fact that year-on-year exports (-23.2% in January and -23.1% in February) dropped even more than imports (-13.7% and -16.4% respectively) erases the trade balance's positive impact on GDP.

Private consumption, by comparison, is still stable. The GfK German Consumer Climate index currently shows no change in consumer confidence among private households. Although economic forecasts were poorer in March 2009 and there was less hope for an increase in wages, the overall forecast for April is at 2.4 points, just 0.1 points below the March forecast. Consumer confidence fell slightly. The improvement comes as a result of lower end consumer prices for food and, to some extent, energy, as well as positive expectations regarding the country's second economic stimulus plan.

One factor hampering spending, however, is anxiety regarding the future employment situation. The negative trend on the job

## Reversal in job market trends



Source: Deutsche Bundesbank, Federal Labour Office



market continues. In the typical scenario, working-time accounts are depleted first, then temp workers get laid off. After that, companies turn to part-time work as a solution and ultimately to laying off permanent employees. March 2009 was the first time in three years that unemployment rose. Now at 3.58 million, the number corresponds to a rate of 8.6% and an increase of 0.2% versus the year before. The usual spring upswing is nowhere in sight. Seasonally adjusted, the number of unemployed was 3.4 million. The number rose more in former West Germany (57,000) than in former East Germany (12,000).

The slump in new orders and production among capital goods manufacturers has been accompanied in early 2009 by a significant drop in gross fixed capital formation. Many companies are reluctant to invest because they already expanded capacity in recent years. In addition, capital goods manufacturers saw sales drop 22% below the previous year's figures. With high added-value industries such as automobiles, machinery and electronics in the doldrums, the manufacturers that supply these industries are also facing tougher times. The only glimmer on the horizon is that construction investment will pick up again with the second economic stimulus plan.

Government spending will increase more in 2009 than it did in 2008, due in part to relatively sluggish public consumption expenditures, but also as a result of the effects of automatic stabilisers and new investment triggered by the second economic stimulus plan.

Taken as a whole, demand components remain under a great deal of stress. Even though private consumption is stagnating, it is still currently the variable providing the most stability for

## Incoming orders and production in freefall



Source: Federal Statistical Office, \*) Manufacturing, \*\*) Industrial sector, season-adjusted, volume index 2005=100



GDP. Gross capital expenditure and net exports, in contrast, are headed down a steep slope. Government consumption and investment is likely to shore up aggregate demand in 2009.

### No signs of improvement in orders and production

Incoming orders, an important early indicator, have not yet bottomed out. Incoming orders and production continue their freefall.

Industrial enterprises felt the pinch in January and February 2009, with orders dropping 6.7% and 3.5% versus the previous month. Customers outside the Eurozone cut demand dramatically in January (-17.2%) but provided an, albeit slight, increase in February (+0.5%). In the key industrial sectors, manufacturers of intermediate goods (-6.5%) and consumer goods (-8.7%) were the hardest hit in February. Demand for capital goods inched back by just 0.5%. However, the strong basis effect from the month before (-9.4%) must be kept in mind. Eurozone demand for consumer goods (-14.4%) and intermediate consumables (-11.0%) was most affected by the high buying resistance. The more informative two-month comparison shows that in January 2009/February 2009 orders were down 11.8% from the previous period, and non-Eurozone orders for industrial goods were down 20%. The largest drop was in capital goods (-13.1%), though manufacturers of consumer goods (-11.9%) and intermediates (-9.7%) also suffered from a significant drop in orders. Industrial production reflects the decline in orders. In February 2009, manufactur-

ing was down 2.9% from the month before. Manufacturers of capital goods (-4.5%) and consumer goods (-3.6%) cut output the most. While industrial production was down 3.3%, power generation fell 2.9%. Production for the construction industry moved ahead 1.9%. In January/February, average daily production and seasonally adjusted production in manufacturing was down 9.4% from the previous period. The negative trend in industrial production (-10.7%) is primarily due to losses in capital goods (-17.3%) and intermediate goods (-7.7%). Production of consumer goods fell by 1.7%. Construction fell 3.9% and energy rose 4.5%.

Those who take a serious look at the numbers will not find it hard to believe that 2009 could bring a two-digit drop in production versus the year before. Also pointing in this direction is the business climate, which declined yet again in ifo's March 2009 report. The assessment of the current business situation shows it to be at its poorest since German reunification. Forecasts, on the other hand, have improved once again. Before anyone sounds an all-clear signal, though, they should recall that forecasts are usually based on past experience. And since no one has ever experienced a crisis like this one, the index is probably not a reliable indicator of things to come.

### Severity of crisis depends on its duration

It is hard to compare current developments in the global economy with anything seen before. Hence any prognosis of

growth in GDP would draw on data that are open to a great deal of interpretation.

Yet the severity of the crisis will not be measured by how deep the recession is but by how long it lasts. Mainstream economic forecasts are predicting that the economic downtrend will shrink the 2009 GDP by 4-5%. The greater danger, however, would be for the economy to remain at those low levels in 2010. If that happens, entire parts of the value-added chain could break away forever. The inevitable consequence would be a prolonged period of high structural unemployment.

A crucial factor has been and will continue to be the stability of the financial markets. More and more manufacturing companies are facing a liquidity crunch. It is becoming increasingly difficult and expensive to obtain financing. All corporate financing instruments are affected, not just traditional lending. Plummeting figures for incoming orders and production could make the situation worse. Thus the crisis in the financial markets is in effect giving industry a one-two punch – first through the global drop in demand, and then through more difficult financing terms as a result of the increased risk of default.

#### Quick action needed to encourage a turnaround

The G20 summit in London has set the course for realignment in the global financial system. Immediate multilateral action is now needed to reform regulation and supervision. The psychological strain will begin to wane when there are slight signs of improvement in the real economy – even if they are only a result of the combined effect of various national stimulus plans. But that will not spell sustained economic growth as long as the underlying financial system continues to suffer. Such a scenario could easily lead to a double-dip recession.

The federal government can contribute to renewed stability in the financial markets right now by providing liquidity to industries outside the banking sector to ease the liquidity crunch. The BDI has compiled several suggestions to guide the political sector along this path:

- **Special KfW program**  
Assume up to 90% of liability from banks that provide capital loans, as in the case of investment loans; businesses suitable for the capital markets should also be incorporated into the scheme.
- **Risk absorption for credit insurance**  
Private credit insurers have raised premiums and added

more self retention but reduced coverage. Holes in coverage threaten to break entire supply chains. A reliable risk absorption scheme would introduce conditions that would encourage insurers to begin covering more risks again.

- **Export financing**  
Improve the refinancing of banks that provide export financing. Create ceiling, for example, for export loan provider AKA, with the option of refinancing with the Bundesbank and/or the ECB.
- **Adjust limitation of interest deduction**  
Limitation of interest deduction in corporate taxation are exacerbating the crisis by forcing companies to draw on their own capital. The barrier for interest deductions must be raised to 50%.

The above analysis of current economic data and the tense financial markets are no reason to throw in the towel. The economic upswing that preceded this recession is a strong indication that German industry can again play a leading role when the global economy begins to recover. Of critical importance now is to set the course for this recovery. The federal government's Financial Market Stabilisation Act and its two economic stimulus packages are steps in the right direction. These measures are sufficient for current needs. Some pundits have raised the subject of a third economic stimulus package, but such a step would be a very bad idea for two reasons. For one, some of the new measures have not been implemented yet. Funds from local investment programs, for instance, have to be put into the economy before they can have an impact on it. For another, the federal government has already spent all it can. More government debt would be an unbearable burden on the budget for years to come.

The federal government can take action in two key areas to further contribute to managing the crisis. Firstly, it could pursue approaches that would require no additional spending and would relieve individuals and businesses in the crisis, rather than burdening them further. This would include acting quickly to eliminate red tape costs and reforming tenancy law to encourage investment in renovations to make buildings more energy-efficient. Secondly, it could provide provisional relief by avoiding the additional burdens for businesses that new laws for emissions trading or ecologically efficient production would entail.