

## BDI Economic Report

Issue 04 | 30 October 2009

The nascent economic recovery needs economic policy support and must not be allowed to falter due to the insufficient availability of credit.

The global economy is slowly moving forward again as more and more indicators are turning positive, however gradually. Now the economic policy groundwork must be laid so as to foster a recovery that will lead to long-term growth. Banks are called upon now more than ever to prevent a potential credit crunch from materialising.

### Global economy entering gradual recovery

The global economy has bottomed out after its sharpest decline in post-war history. Broad and comprehensive monetary and fiscal policy measures have staved off an outright crash. Accordingly, in its October 2009 growth forecast the IWF revised this year's GDP upward by 0.3% to -1.1%, projecting a respectable 3.1% growth for 2010. The key emerging Asian markets are expected to resume their fast growth within a relatively short period of time. The **US** economy remains mired in weakness at present. Output fell in Q2 2009 for the fourth quarter in a row (-1%), albeit at a much slower pace. Government stimulus packages and increasing trade surpluses are having a positive impact on GDP growth, and the banking sector is continuing to recover, but declining consumer spending poses a problem. Fallen real estate prices, the necessity of paying off debt, increased commitment to saving and a tremendous rise in unemployment to 9.8% in September will likely rule out these primary components contributing to GDP growth in the near future. **Japan's** economy posted a slight recovery thanks to huge government spending and a rise in exports (+6.3% QoQ for Q2 2009). GDP increased by 0.9% in Q2 2009 versus the previous quarter. The new government's announcement of additional stimulus packages and the brightened outlook for exports have further improved economic prospects. The precarious situation with regard to the state's finances and fears of rising unemployment are the primary threats to the economy. The decline in **Eurozone** economic output slowed in the second quarter of 2009 to -0.1%. As with many other countries, the reasons include government stimulus packages and a slight pickup in global demand. Consumer spending is coming under increasing pressure from unemployment, which was at 9.6% in the Eurozone in August 2009. The highest rates were seen in Spain (18.9%) and Ireland (12.5%).

### German government's economic stimulus packages taking effect

Coming after three successive quarters of negative growth, German economic output was up slightly in Q2 2009, with GDP climbing by 0.3%. Increased consumer spending

## Economic overview

### Global economy entering gradual recovery

The global economy is finding a bottom after falling sharply. However, some parts of the world are worse off than others and global demand is still far from pre-crisis levels.

### German government's economic stimulus packages taking effect

Economic stimulus packages implemented by the German government are starting to take effect on GDP. Public and private spending continue to provide stability, though exports and capital expenditure are still weak.

### Industrial sector in slight uptrend

Incoming orders are rising for manufacturers month by month, but are not yet fully felt in production. The business situation and outlook continue to improve.

### No sustained recovery in sight

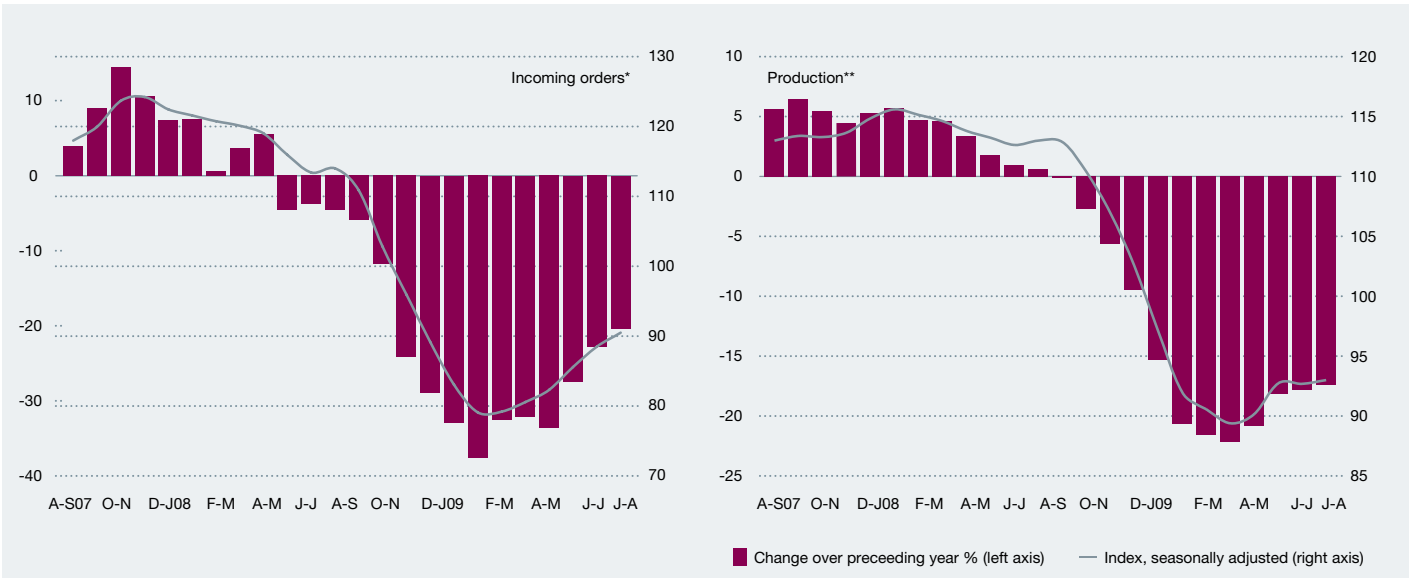
Although the crisis is bottoming out, there is still no tangible recovery. The sharp fall in capacity utilisation is hampering capital expenditure and putting pressure on employment.

### Rapid response to challenges

Germany must position itself for recovery, as the global growth outlook is generally favourable. Coalition negotiations must be guided by the objective of improving conditions for the industrial sector to ensure that a rebound in global demand leads to a rapid return to growth in Germany.

(+0.7% QoQ) and government spending (+0.4%) combined with a rise in construction spending (+1.4%), which in part had been deferred due to weather conditions, contributed to this growth. Inventories fell substantially (-1.9%), while the 0.5% decline in equipment spending was less severe than in the previous quarter (-18.5%). The trade balance contributed to growth, as imports declined more (-5.1%) than

## Incoming orders and production: bottoming out



\*Manufacturing, Volumenindex2000=100, \*\* Production, seasonally adjusted, volume index 2005=100, two-month average  
Source: Federal Statistical Office



exports (-1.2%) between April and June. It should not be forgotten, however, that while these figures look positive at first glance they are the result of a base effect and major government support, which in any case has been effective in halting the economy's fall.

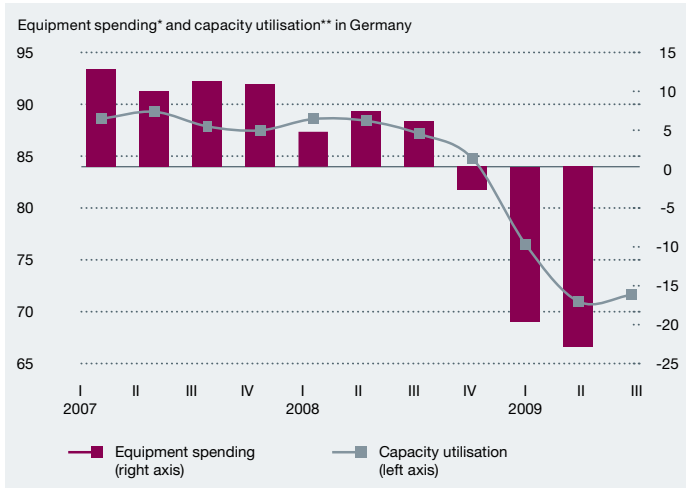
Private consumption has had a stabilising effect on the economy in recent months. This is due to two factors: Firstly, economic stimulus packages have increased disposable household income. The specially earmarked »car scrapping scheme« totalling €5 billion was a major element of this. Breaks on taxes and social security contributions have had a noticeable effect, as well as increased unemployment benefits and public assistance. Short-term working has also helped avoid a drastic fall in employment and softened the blow on consumer spending. Secondly, upward revisions in GDP forecasts have had a positive impact on consumers' expectations. The GfK consumer climate index rose again in September 2009, as future income expectations have improved in parallel with willingness to spend. It is, however, questionable whether consumer spending will have a lasting stabilising effect on GDP. A renewed rise in crude oil prices is limiting consumer spending, the »car scrapping scheme« programme has expired and a substantial rise in unemployment is becoming increasingly probable. In September 2009, 8.0% of individuals able to work were unemployed. This represented a month-on-month decline of 0.3%, or 125,000 (previous year: 266,000). On a seasonally adjusted basis the decline in this figure was 12,000; however, this primarily reflects the effect of a

change in statistical methodology whereby unemployed individuals using private referral agencies are no longer counted as unemployed. Without this effect, unemployment would have risen by 10,000 on a seasonally adjusted basis in September. Capital expenditure activity remains muted. On a seasonally and calendar-adjusted basis, capital goods manufacturers saw domestic sales decline by between 15 and 23% in the period January to August 2009 versus the same period one year ago. Major overcapacity and expectations for an only gradual return to former capacity utilisation levels have temporarily rendered investment in expansion superfluous. Investment in streamlining and replacement is hampered by a lack of demand and more difficult financing. Construction spending is more of a mixed picture. Investment in housing properties is down due to the crisis, so is investment in commercial properties. But public construction spending has increased, benefiting road construction in particular. Overall, spending from public budgets has had a stabilising effect on GDP in this crisis, even if it is still too early for a detailed assessment of the specific growth effects. However, any positive impact is limited in scope and duration. A pick-up in global demand is crucial for economic recovery.

### Industrial sector in slight uptrend

The trend remains up for incoming orders for industrial producers on a month-on-month basis. In August 2009, new orders rose (+1.4% month-on-month) for the sixth time in a row. Non-domestic (+4.6%) and non-Eurozone (+5.6%) demand rose the

### Weak capacity utilisation holding back equipment spending



Sources: Federal Statistical Office, Ifo Institute

\*In comparison to preceding year, in percent, \*\*In percent of full operating capacity, manufacturing excluding food, beverage and tobacco industry, seasonally adjusted



most (domestic: -1.9%). A two-month comparison, which provides a more reliable view, of July/August 2009 and May/June 2009 likewise looks favourable, with industrial orders up 5.8% on a price, seasonally and calendar-adjusted basis (domestic: +8.7%; non-domestic: +3.2%). However, the significant rise in July resulted from an above-average level of large orders. In May 2009 producers of intermediate goods saw the biggest increase (+2.8%) among the main manufacturing subsectors, reflecting the cyclical increase in inventories. In a two-month comparison of July/August 2009 and May/June 2009, demand for intermediate goods surged (+8.3%), especially among German buyers (+8.6%). Capital goods manufacturers recorded a 1.2% increase in incoming orders. In August there was a 5.1% drop in demand from domestic buyers for capital goods; this came after a major 15.6% boost in July from a number of large orders and equipment orders. This decline was erased by demand from the Eurozone (+6.5%) and from non-Eurozone countries (+1.8%). Domestic demand (+10.3%; non-domestic: +1.6%) rose significantly in a two-month comparison (+5.3%). Consumer goods manufacturers, however, saw new business decline by 3.8%. Domestic demand was unchanged, while incoming international orders fell by 11.1%. A two-month comparison yields a similar picture, with consumer goods manufacturers down (-2.5%) mainly on Eurozone (-5.7%) rather than domestic (-0.3%) orders. In a two-month comparison the year-to-date difference in incoming orders versus the previous year narrows from 30 to 20%. The stable trend seems to indicate that a floor has been reached.

The steady rise in orders has yet to fully impact on production, which gained only moderately in August 2009, up 1.1% versus a 1.1% decline in July. Industrial output increased by 2%, while

energy production declined by 2.6%. This increase was mainly due to construction, which in August rose by 4.2%, providing a preliminary indication of the increasing impact of the stimulus packages. Producers of intermediate goods saw the most significant increase in output among the main manufacturing subsectors (+3.4%; capital goods manufacturers: +1.5%; consumer goods manufacturers: +0.1%). A two-month comparison of July/August 2009 and May/June 2009 reveals a slight increase of 0.2%. Energy production increased the most (+2.8%); construction increased by 0.6%. In the industrial sector (+0.1%) production of intermediate goods increased by 4.1%, while production of capital goods decreased by 3.2% and consumer goods decreased by 0.8%. Therefore, production data alone does not definitively show an uptrend. However, if the delay between the rise in incoming orders and the effect on the production process is taken into account, a pickup in industrial production in particular should be just around the corner.

This picture is confirmed by the Ifo business climate index, which, since January 2009, has shown continually rising expectations among manufacturers for the coming six months. The business situation has also been improving for five months. In view of these two components, the Ifo sees a recovery on the horizon. Given the severity of the preceding fall, however, such a recovery will take place at a low level – and threatened by the possibility of a renewed downturn. GDP growth for 2009 clearly illustrates that recovery from the crisis will itself take substantial energy and endurance to reach pre-crisis levels. The 5% drop projected by the economic research institutes in their autumn report is the largest ever in the history of the Federal Republic of Germany. On a positive note however, this contraction is not as severe as was feared at the start of the year.

### Still no sustained recovery in sight

Economic indicators suggest that the global economy, and with it the German economy, has found a foothold after a serious fall. Yet a number of uncertainties continue to cloud the economic outlook. As an export-dependent nation, Germany needs global demand to recover. The US economy continues to play a critical role as the primary driver of the global economy. Economic data from the United States have improved, but both private and public debt consolidation could mean a structural shift in terms of growth – with consequences that will be felt worldwide. Hopes now centre on the key emerging markets of China, India and Brazil, whose financial sectors have largely escaped the impact of the crisis. But their economies are still weak compared with the US. Germany in particular, which sells 60% of its exports in the Eurozone, will only be able to benefit moderately from the strength of such countries. Like other countries, Germany is exposed to several risks that threaten a sustained recovery. Government stimulus packages, as we have seen,

can be effective in combating the worst effects of the crisis and in slowing declining output. However, they are no substitute for growth, which is ultimately driven by entrepreneurialism and private-sector demand. A self-sustaining recovery is what is needed. Progress has been made in redesigning the architecture of global financial markets, but implementation will take time. In the meantime the financing situation for the non-banking sector remains tense, and may in fact be worsening. Private consumption is holding steady thanks to government stimulus measures and a positive outlook (which may or may not hold). The considerable rebound in oil prices and threatened capacity adjustments by producers are having a counter balancing effect. The gap between production and production capacity remains large, which is likely to rule out capacity increases over the medium term.

### Rapid response to challenges

The nascent, tentative economic recovery underway in Germany as in other countries needs a firm basis in the form of growth-oriented economic policy. The CDU and FDP are thus called upon to lay the proper foundations in the new legislative session. What is certain is that a sustained recovery in Germany can only follow from rising global demand. Industrial products make up 90% of German exports. Keeping German industry strong is thus the only way out of the crisis. As in the last recovery, the industrial sector will then deliver robust growth and jobs. However, a recovery also requires economic policies that encourage growth in businesses and that promote Germany as a business location. There are five areas in which structural problems must be rapidly resolved and barriers to growth eliminated:

#### 1. Avoiding a credit and liquidity crunch

Growth requires stable financial markets and a sufficient supply of liquidity. The nascent recovery must not be allowed to fail due to a lack of bank lending. The resolutions adopted at the G20 summit in Pittsburgh must be rapidly implemented.

#### 2. Growth-oriented tax policy

The taxation system must be revised to provide relief to those who are the main drivers of the economy, and with a view to international competitiveness – in relation to business interest expense deductions and inheritance tax.

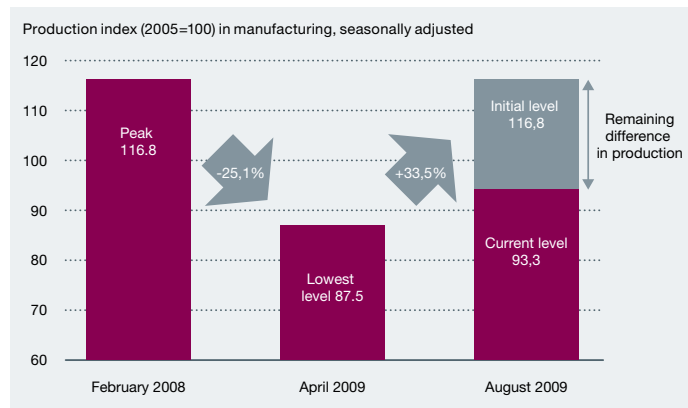
#### 3. Innovation and infrastructure

Industries and technologies with extremely high growth and innovation potential, such as IT/communications, healthcare and sustainable transportation should receive political support without imposing undue restraints.

#### 4. Energy and climate policy in alignment

The industrial sector needs to find a balance between secure

### Steep drop in production - the long road back



Sources: Federal Statistical Office, Deutsche Bundesbank



After the sharp drop in economic output last winter, positive economic data is now clearly coming as a surprise. Is the crisis behind us, and is Germany now poised for a robust recovery? A number of basic statistical and special factors must be considered in interpreting current economic data. In particular, statistical »base effects« currently play a crucial role, causing the now-past economic fall and the evident recovery underway to appear overstated. This is due to simple mathematics: When a 50% decline, for example, is measured in a statistic such as production or orders, it will take a 100% increase to reach the former level.

We are seeing this effect in play right now. After peaking in February 2008 (116.8) the manufacturing production index fell by roughly 25% to its low recorded in April 2009 (87.5). From this statistical level the production index will have to increase by roughly 34% to reach its previous high. The chart illustrates this. Based on the production index, it shows how much of the slump manufacturers have actually made up and how much is left to go.

energy supply at competitive prices on the one hand and modern energy technology offering global growth opportunities on the other.

#### 5. Streamline public finances, cut bureaucracy

The German government must continue working towards a strong federal budget. This means consolidating and refocusing to reduce costs, and eliminating expense by cutting bureaucracy.