BDI Economic Report

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Indications of economy bottoming out, potential for credit crunch

The synchronised downturn affecting economies around the world persists, though signs that the sharp fall has reached an end are increasing. Reaching the bottom is no return to growth though. Capacity-adjustments are unavoidable. In addition, the financing end of the equation is becoming increasingly problematic.

Economic overview

Global economy still languishing
The plunge in global demand continues to weigh heavy on the world's economies. The outlook for the US and key developing economies has improved slightly, but too many negatives make a rapid recovery unlikely.

Export slump dragging down GDP
The drop in exports is the biggest problem for the German economy. Capital expenditure is greatly restrained. Consumer and government spending continue to provide a stabilising effect. Higher unemployment is a definite risk.

Incoming orders up
Manufacturing orders rose in May for the third time in a row. Combined with improving mood indicators, this positive hard data points toward a bottom.

Financing situation acute
No universal credit crunch, but the financing situation is becoming acute. The gap between financing needs and available credit requires urgent action by banks and the government.

Strengthening Germany's industrial economy
Next to keeping the real economy liquid, the biggest challenge for the short to medium run is achieving a growth-oriented economic policy. In the interests of our economy, the German industrial sector must be at the heart of such a policy.

Global economy still languishing

Fundamental economic data still paint an unfavourable picture of the global economy. While some countries are heavily and directly impacted by the real estate and financial crisis, others dependent on exports remain wracked by the shock to global demand. There are increasing signs that a bottom will be found in the second half of the year. The IMF has now revised its 2009 estimate for global economic growth slightly to -1.4%, down by 0.1%. But for 2010 the IMF is still projecting growth of 2.5%, 0.6% higher than its April projections, primarily due to an improved outlook for the US and Japan. A sustained recovery is still in jeopardy however, as recovery from financial market induced crises has always taken a long time in the past, and talk of reforming the global financial architecture has all but died down.

US total economic output has declined steadily since autumn 2008. Unemployment has risen to its highest mark since 1983 as a result, reaching 9.5% in June 2009. Consumer spending is turning ever more negative with accelerated consolidation of private consumer debt driving it down further. Stimulus payments and tax breaks have recently boosted consumer confidence, and production data indicates a similar mild improvement: manufacturing orders and the manufacturing purchasing manager index show the rate of decline has slowed substantially.

The collapse of exports in **Japan**, particularly of capital goods, continues to cause a sharp contraction in gross domestic product. In Q1 2009 industrial output fell by over 21% quarter-on-quarter. Despite rising unemployment, consumer spending is having a stabilising effect, thanks in part to government stimulus measures. Many corporations are also seeing a brighter outlook, but exports are key to a sustained recovery.

Dramatically falling demand for international trade goods has pulled **eurozone** economies decidedly into the red. In Q1 2009 economic output declined 2.5% quarter-on-quarter, more than Q4 of last year (-1.5%). The woes of the manufacturing sector, particularly in Germany, Spain and Italy, were to blame (Q1 2009: -18% QoQ). With declines in production and incoming orders slowing, it seems that a bottom is being found.

Export slump dragging down GDP

German economic output declined again in the first quarter of 2009 as exports continued to fall, particularly of capital goods. The 3.8% quarter-on-quarter GDP contraction was higher than in Q4 2008 (-2.2%). Q1 2009 saw the third consecutive quarter of exports (-9.7%) falling faster than imports (-5.4%). The trade balance thus caused a -2.2% decrease in GDP. A further drop off in investment in plant and equipment (-7.9%) also reduced economic output. The largest decline was in equipment spending (-16.2%), as opposed to construction, which declined significantly less between January and March 2009 (-2.6%). Declining inventories (-0.5%) also had a negative impact on GDP in the first quarter of 2009. Domestic demand was supported only by a rise in private consumption (+0.5%) and public-sector spending (+0.3%).

Weak global demand in May 2009 caused a slide in exports (-24.5% YoY). Even after the first five months of this year, there is no definite evidence of a bottom due to the degree of volatility. Private consumption remains extremely stable. Disposable incomes have risen due to wage increases in collective bargaining agreements in combination with the tax and social security contribution cuts from the economic stimulus packages. The car-scrappage scheme boosted car buying, while lower prices enhanced private households' spending power. There are currently no indications of inflation risks in the absence of a pickup in global demand, and the extra liquidity created by central banks can rapidly be drained again. The biggest risk for consumption is rising unemployment, though short-time work has helped the labour market and the service sector has not been severely impacted by the recession as yet. The labour market rebound in the spring was significantly weaker than in previous years, and if the recession continues, higher unemployment and lower consumption will follow. Unemployment in May was 8.1%, 0.1% lower than the previous month (-48,000 unemployed). At 3.41 million, the number of unemployed was nonetheless 250,000 higher than in June 2008. Manufacturers have revised their capital investment plans in view of much lower capacity utilisation caused by declining demand. Capital goods manufacturers recorded a roughly 13% drop in domestic revenues quarter-on-quarter in Q1 2009. In April 2009, revenues fell again by 3.7%. The pace of decline has since slowed, but the Bundesbank is projecting a 15% decrease for 2009 versus 2008, and 2010 to come out 6% lower than 2009. The German government's infrastructure spending as part of the stimulus measures has softened the blow on construction spending resulting from declining demand for commercial and residential real estate. As the government is still taking its time in actually spend the money allocated in the package, a tangible impact will likely only be seen in the second half of the year and early 2010. Government spending is currently playing an important role in supporting the economy. The effects of the downturn are being buffered by automatic stabilising mechanisms, particularly transfer payments. In sum, Germany is currently seeing much lower demand for capital goods and exports, the impact of which is being partially offset by consumer and government spending. Yet consumer spending could run out of steam if there is a general worsening in the economy leading to higher unemployment.

Incoming orders up

In May incoming orders again seemed to be restabilising after the slump. Manufacturers recorded increasing new orders for the third month in a row. The rise seen in May 2009 (+4.4%) exceeded April and March 2009 together (+0.1%/+3.7%), ahead of expectations. Orders also rose in a two-month comparison, which is a more reliable yardstick. In April/May 4.2% more new orders were recorded than in March/April, which had been 2.0% higher in turn. In May 2009 capital goods manufacturers recorded the biggest increase in orders (+5.9%), especially from outside the eurozone (+9.2%). Producers of intermediate goods (+3.0%) likewise saw orders up from non-eurozone countries (+7.2%). Consumer goods makers fared similarly, with orders up 2.6% (non-eurozone: +3.6%). New domestic order volume also rose. In a season and price-adjusted two-months' comparison of April/May 2009 versus March/April, producers of intermediate goods benefited most (+8.4%). Domestic orders for intermediate manufactures increased 7.7% (non-domestic +9.2%, non-eurozone +11.2%). Consumer goods orders (+4.9%) were strongest from the eurozone (+13.6%). Capital goods producers saw orders up 1.3% (domestic +1.1%, eurozone -3.5%, non-eurozone +4.8%). The situation remains grim however, as compared to May and April/May 2008 orders having plunged 30% and 33% respectively.

It is not yet possible to make out a trend for the industrial sector. Output increased in May 2009 by 3.7% month-to-month. Manufacturing fared best (+5.1%) in all the main sectors (capital goods +8.3%, intermediate goods +4.3%, consumer goods +0.6%), while construction declined 3.2% and energy production 3.2%. A two-months' comparison of April/May versus March/April looks more modest however, with industrial processing, energy and construction up 0.7% and manufacturing up 0.3%. Comparing March/April versus February/March 2009, output declined -2.3% (industrial processing, energy and construction) and -2.6% respectively. There was considerable volatility in the main sectors, with consumer goods up 0.3% and down 2.6% in April/May and March/April respectively, and intermediate goods down 2.8% and up 0.2% in these respective periods (capital goods -1.3%/-2.3%). Construction fared particularly well at +1.3% and 7.3%, while energy production fell 5.8% and 6.1%.

Slight improvement in orders and production

Sources: Federal Statistical Office, Deutsche Bundesbank

Macroeconomic data has not yet afforded a reliable picture of the outlook going forward. While hard data on exports, sales and production for industrial processing is still too volatile and orders seem to be recovering only somewhat, a clear trend can only be observed in mood indicators like the ifo business climate index. The mood upswing is attributable to a steady outlook improvement since December 2008. But despite the more favourable expectations now held in June 2009, the situation is still considered as very bad. Estimates of the German economic output for 2009 are still being revised downward. Reputable economy watchers deem a 6% GDP contraction likely.

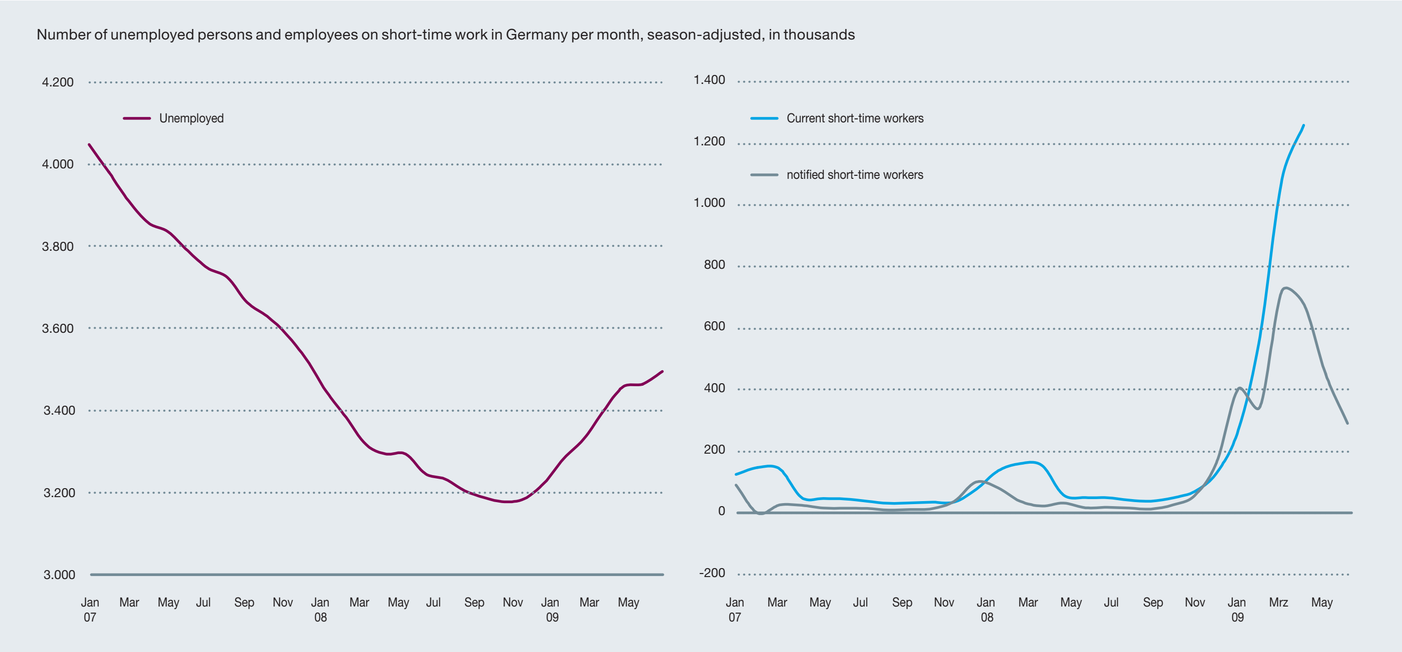
Financing situation acute

Though lending terms have definitely deteriorated, the situation is not yet at the stage of a universal credit crunch. Things may worsen severely however in the months ahead, leading to a widening gap between the financing requirements of the real economy and the supply of credit from banks. After huge write-downs on toxic assets and with write-downs on other loans increasing, bank balance sheets are shrinking, having implications under the Basel capitalisation requirements. The crashing economy has impacted real-economy businesses in the same way over the last several months, undermining their financial position and credit standing. This divergence is all the more cause for concern as it comes just as the first rays of hope of a bottom and eventual rebound are being seen.

Credit terms have deteriorated rapidly for many manufacturers in the wake of the crisis. Basically healthy manufacturers are increasingly being affected, alongside those hit hardest by the crisis. The financial crisis has, by way of foreign trade, evolved into a global crisis especially for the industrial sector characterised by heightened risk of insolvency, lower incoming orders and production volume, and less favourable financing terms for the real economy. The industrial sector has played a key role, in Germany at any rate, in the economic rise seen over the last few years. This growth potential may be lost for good if part of the value added chain goes under, and is not there when the recession ends.

Financing the real economy is currently the biggest problem, especially as negative consequences for the financial economy, which is still just regaining its bearings, must be avoided. Continuing efforts to stabilise the financial markets have not yet ended the crisis of confidence in the economy. After the Lehman debacle, other financial firms were not allowed to go bankrupt stopping a potential domino effect. The 'bad bank' plan being implemented represents another step to strengthen lenders. Nonetheless, credit is still not yet flowing freely from the financial to the real economy. The German government's credit and guarantee programme is helping to unfreeze credit, but is taking time to get rolling. Urgent action must be taken to remove barriers to accessing credit. Additionally, the 'top-up' strategy decided on to solve the credit insurance problem must be implemented fast. Furthermore, a solution must

Unemployment rising, short-time work helping



Source: Deutsche Bundesbank, Federal Labour Office

be found for companies that are basically healthy, but can no longer obtain any insurance at all. Since the G8 reached agreement on correcting the procyclicality of Basel II, action must be taken now: the ECOFIN Council must not be allowed to block a solution any longer. The securitisation market, which is of key importance to SME financing, should be revived, but with more effective regulation and liability rules. Lastly, export financing and guarantees must be redesigned to adjust to the current situation. Though the industrial sector is now suffering, it should not be forgotten that the recession originated from the financial markets, which is also where the healing process must begin. The G20 summit in Pittsburgh cannot afford to stop at basic decisions but must lead to the implementation of decisions that have already been made.

Strengthening Germany's industrial economy

The measures specified above would substantially improve liquidity for manufacturers. This is merely the starting point however for more growth-oriented policy. The new German government's economic policy objective must be to focus more on growth, concentrating principally on the industrial sector and industrial service providers. While industry has declined in importance for the world's leading economic powers, in Germany it has seen a renaissance. Germany will always be an industrial economy. A policy of growth built around the industrial economy must be based on the following points:

- Trust must be regained in the social market economy as the framework for economic activity
- Free world trade rather than protectionism must be promoted as the mode of globalisation
- Cutting taxes is part of an active growth policy
- The European Union has brought prosperity –private individuals and corporations will benefit if the EU economy can be made more streamlined and competitive
- Investing in the infrastructure enhances the long-term growth potential of the German economy
- Innovation and education drive growth and the government must foster these so that their long-term effect can unfold
- German industry manufactures and uses innovative technologies that help protect the environment and fuel growth
- Dependable and efficient energy supply concepts allow dependable planning and lower costs for businesses.

The present crisis notwithstanding, the outlook is still good for German industry. Demand for German industrial products in future will remain high due to the global pursuit of economic prosperity, global demographics and the technological challenges posed by climate change and scarcer resources.

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Editors: Dr. Hans-Joachim Haß • Dr Juri Schudrowitz, Phone: +4930 2028 1592, Fax: +4930 2028 2592, j.schudrowitz@bdi.eu
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