

## Forces of economic growth increasing, but downward risks remain virulent



After the adoption of broad-based fiscal and monetary stimulus packages, the German economy is gaining self-sustaining momentum. A GDP growth of between 1.5 % and 2 % is within reach, if exports get back on track. It is even likely that the growth rate will exceed 2 %, provided that the government releases all brakes on growth so that lasting self-su-

staining growth is possible. The forces of economic growth have to be safeguarded by a strategy to achieve higher growth.

However, statistical base effects make the upswing appear to be greater than it actually is. Even if there is a two before the decimal point, 2010 will be a difficult year as Germany has to move from growth generated by economic stimulus packages to self-sustaining growth. Growth will not be automatic. Future growth has to be earned the hard way, through wise and forward-looking policies. This comprises the implementation of an R&D tax credit scheme, as innovation secures jobs for the future. Germany

should be careful not to become overzealous in its engagement for climate protection, thus creating a situation where it ends up exporting jobs instead of exports technologies – with negative consequences for climate protection. To ensure that the upswing is not put at risk, the banks should safeguard company funding of the real economy. The danger of a credit crunch has not been banished. In principle, the banks – not the state – have the solution. The state has already made its contribution by launching stimulus packages worth billions. The upswing may not be allowed to fail as a result of under-financing the real economy.

### World Economy



## Global growth promotes World Trade

At the beginning of 2010 the global economy is on the brink of a recovery.

>> page 2

### German Economy



## Consumption stabilizes, capital expenditure still under pressure

However, stimulus-packages show increasing impact.

>> page 3

### Incoming Orders/Industrial Production



## Trend in orders and production slowly upwards

Incoming orders and industrial production pointing north but still erratic.

>> page 4

### Outlook



## Export-dynamics fuel growth

Foreign trade is the most likely force to enhance economic developments in 2010.

>> page 5

### Policy Agenda



## Company funding crucial to economic recovery

Business financing and public budgets to provide biggest challenges in 2010.

>> page 6

### Foreign Economic Report



## Pre-crisis levels will not be reached before 2014

» The export sector suffered a severe setback in 2009.«

>> more

## World Economy

### Global growth promotes World Trade

The global economy is showing clear signs of recovery at the start of 2010. Strong base effects are partially responsible for this, due to the preceding crash. The expansive monetary and fiscal policy measures implemented around the world also continue to have a stabilising effect. But the expected rise in world trade of up to three percent is improving the outlook for the global economy. The leading emerging markets in Asia continue to play an important role, and Russia and Brazil are also picking up momentum.

The situation and outlook have also improved in the **US**, which accounts for 25 percent of global GDP. In Q3 2009 GDP increased at an annualised rate of 2.8 percent, the first expansion in four quarters. This is a result of exports, consumer spending and the hesitant recovery of the property market. While expansive fiscal policy is buoying consumer spending and thereby compensating for huge job losses, positive signals are also coming from the industrial sector. The US manufacturing purchasing managers index ISM is tracking an improvement across all components, especially incoming orders, and in December 2009 it reached its highest mark since April 2006.

#### Global economic outlook brightening

Gross domestic product, in real terms, change over previous year in percent



Source: OECD Economic Outlook, November 2009



Port facilities: Global trade fuels growth. Photo: BDI/photocase (Warneke)

In **Japan** the crisis caused the sharpest fall in exports of any leading industrialised nation. At the same time Japan has implemented one of the biggest economic stimulus packages, which is now gradually taking effect. Private-sector capital spending (+1.6 percent) contributed to GDP growth of 1.2 percent in Q3 2009, in addition to consumer spending (+0.7 percent). Exports are also on the rise. An improving trade balance and greater public spending will be the growth drivers in 2010.

Among the key regions in the global economy, the **Eurozone** will exhibit the least economic dynamism this year. Even as Germany's economy is benefitting from the global recovery, Spain and Ireland (construction), and Greece (public budgets) are experiencing a renewed contraction of their GDP. While dramatically rising unemployment in those countries is putting the brakes on consumer spending, momentum is being provided by foreign trade and economic stimulus programmes, the greatest effect of which will be felt in 2010.

## German Economy

### Consumption stabilizes, capital expenditure still under pressure

German gross domestic product shrank by five percent in 2009. This was due mainly to plummeting exports (-14.7 percent) and a major drop in gross capital expenditure (-8.6 percent). Capital equipment spending declined the most (-20 percent), although construction was also down slightly in 2009 (-0.7 percent). The only boost came from government spending (+2.7 percent) and stable consumer spending (+0.5 percent), which was declining significantly going into the end of 2009. The data presented by the Federal Statistical Office for 2009 indicate that the German economy was virtually stagnant in Q4 2009 versus the previous quarter.

In Q3 2009 German gross domestic product increased by 0.7 percent quarter-on-quarter. This output figure had already been upwardly revised in Q2 2009 by 0.4 percent. In Q3 2009 growth was fuelled by capital spending (+1.3 percent) and construction spending (+1.5 percent) in particular. The balance of trade reduced GDP, as imports (+5.0 percent) rose substantially, exceeding exports (+3.4 percent). Government consumption expenditure slowed (+0.1 percent), yet contributed to growth. Instead of supporting the economy as in previous quarters, private spending had a surprisingly negative effect on GDP, declining 0.9 percent quarter-on-quarter.

Economic data indicate that foreign trade is quickly reviving. The persistent decline in exports from one quarter to the next came to a halt in Q3 2009, turning positive for the first time since Q2 2008. Although imports recently rose faster than exports and had a negative impact on growth, the overall increase in exports is certainly a good sign for the economy. The trade balance may be expected to again turn positive if exports maintain their momentum.

### Outlook continues to brighten, expectations stagnate Ifo Economic Gauge, manufacturing industries\*



Source: Ifo Institute



The expiration of the “cash for clunkers” environmental incentive scheme in September 2009 is having a noticeable impact on consumer spending. The employment situation remains quite favourable, thus consumer spending has not declined as dramatically as could be expected in view of the overall economic situation and experience of previous recessions. Nonetheless, the outlook for consumer spending has deteriorated in recent months. In January 2010 the GfK consumer climate index displayed a downward trend for the third time in a row. Consumer mood is being dampened by the spectre of rising unemployment and higher prices for energy and fuel. Consumer spending is therefore unlikely to drive growth in 2010. Yet a major slump is also unlikely to occur, as relief measures with regard to taxes and contributions, combined with higher social benefits will boost disposable income.

In December the number of unemployed increased only slightly, by 60,000 to just under 3.3 million. The average figure for the year 2009 thus came to around 3.4 million (8.2 percent). Despite the severe recession, this only amounted to a 0.4 percent increase, or 155,000 individuals. The expanded use of furloughs only partially explains this development. The other part of the equation is the moderation shown by unions in collective bargaining and the labour law reforms of recent years. Businesses are holding on to permanent staff to be able to participate fully in the anticipated upturn.

Capital spending is surging, primarily on construction, revealing the increasing impact of the German government’s economic stimulus programmes. Inventories, undergoing a cyclical increase (+1.5 percent in Q3 2009), are also boosting growth. Capital equipment spending recently rose by a surprising 0.8 percent. Capital investment in expansions was insignificant, as capacity utilisation remained at a low level. Although replacement spending was significant, demand for capital goods is unlikely to contribute to growth over the medium term. This view is supported by weak sales for capital goods manufacturers, down 18.1 percent year-on-year for the period January to October 2009.

The flood of public spending has had a continued stabilising effect. Although the impact of government economic stimuli cannot yet be quantified, most of the fiscal policy measures should take hold in 2010. The construction industry expects 60 percent of funds earmarked for public construction to be spent in the course of this year.

While capital spending and, increasingly, consumer spending are restraining gross domestic product on the demand side, expansive fiscal policy continues to exert a stabilising effect. Exports are accelerating.

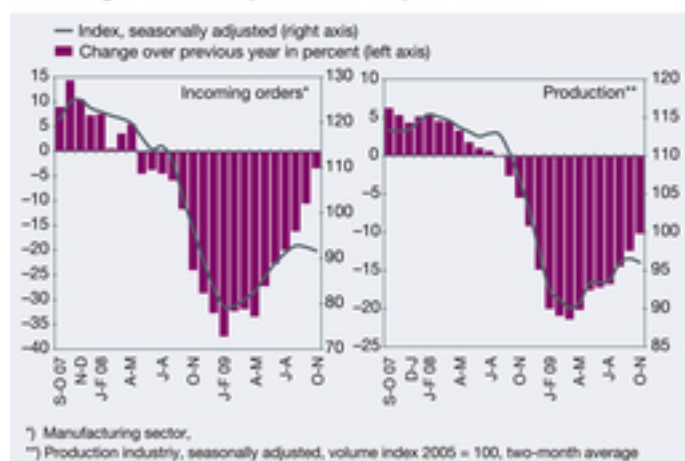
Photo: BDI/fotolia (3d-Master)

## Incoming Orders/Industrial Production

### Incoming orders: a short break, but the trend remains up

In late autumn 2009 incoming orders in the industrial sector lost the momentum they had gained in previous months. This leading indicator is not yet pointing to any clear trend. After declining by 1.9 percent in October 2009, new orders were up only 0.2 percent in November. The slight rise in November 2009 resulted from increased orders from the Eurozone (+2.0 percent) and the domestic market (+1.4 percent). Non-Eurozone demand continued to fall (-3.2 percent). A two-month comparison (versus the previous two months), which is more statistically significant, showed another decline since February/March 2008 (-1.2 percent). Fewer orders from the Eurozone (-2.4 percent) were primarily responsible, while domestic orders were only moderately down (-0.4 percent; non-Eurozone: -1.3 percent).

#### Incoming orders and production: Upward trend



Source: Federal Statistical Office



Among the main manufacturing groups, makers of consumer goods benefited the most in November 2009 (+3.7 percent) from higher demand, particularly from outside Europe (+19.1 percent). In a two-month comparison, which showed demand was up 5.4 percent, orders climbed most sharply among Eurozone buyers (+14.6 percent).

For manufacturers of intermediate goods, November 2009 brought only a minor decline (-0.4 percent), due less to the domestic (-0.1 percent) than to the international market (-0.6 percent). In a two-month comparison international orders held off (-1.3 percent), particularly in the Eurozone (-3.7 percent), while domestic (+2.7 percent) and non-Eurozone (+1.1 percent) demand actually increased.

Lower demand for capital goods is the main reason for the decline experienced by industrial producers in a two-month comparison (-3.6 percent; November 2009: -0.1 percent). While the domestic and Eurozone markets boosted orders in November 2009 (+3.0 percent and +5.5 percent), in a two-month comparison they contributed substantially to the decline (-3.1 percent and -4.4 percent). Non-Eurozone orders fell by 6.7 percent in a one-month comparison, and by 3.9 percent in a two-month comparison.

Expiration of the car-buying incentive programme is principally responsible for the current slowdown, but indications point to a prolonged downward trend. The underlying trend should remain positive.

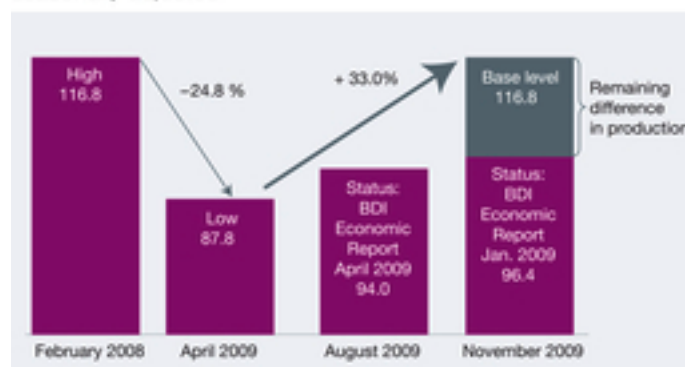
### Production: industrial production on the rise

New production orders have been delayed and inventories reduced, but now rising orders are increasingly lifting production. After an upwardly revised drop of 1.7 percent in October 2009, manufacturing production increased by 0.7 percent in November 2009. This reflects higher industrial (+0.9 percent) and construction output (+0.7 percent), while energy production declined by 2.0 percent. Among the main industrial groups, manufacturers of intermediate goods again increased production (+1.1 percent), as did consumer goods manufacturers (+1.7 percent; capital goods manufacturers: +0.3 percent). Manufacturing production was also up in a two-month comparison (+0.1 percent), due solely to industrial producers (+0.4 percent). Construction was down somewhat (-1.9 percent), as was energy production (-1.8 percent). In a work-day and seasonally adjusted two-month comparison, manufacturers of intermediate goods also recorded the largest increase (+1.9 percent), and makers of consumer goods were also up (+0.2 percent); capital goods manufacturers saw a decline (-1.0 percent).

In November 2009 incoming orders and production remained volatile, although both indicators are clearly showing an upwards trend. The same is true of the Ifo Business Climate index for manufacturers. While business expectations have improved month by month since January 2009, this streak was broken by a slight decline in December 2009. However, the number of optimists exceeded the number of pessimists. Business conditions continue to recover from their historical lows, as they have steadily done since April 2009.

#### Production: Still far below previous levels

Production index (2005 = 100) in the manufacturing sector, seasonally adjusted



Source: Federal Statistical Office



## Outlook

### Export-dynamics fuel growth

Foreign trade is expected to be the main driver of economic development in 2010. A BDI survey of member associations conducted in late 2009 yielded a projected average increase of 4 percent for exports in 2010. There are good reasons for this relatively modest forecast. After last year's severe recession, the outlook remains highly uncertain, calling for commercial prudence in not projecting business to be better than it is. However, exports could very well surge, as forecast by the council of economic experts (2010: +6.3 percent) and by wholesalers and exporters (up to 10 percent). Like overall economic development in Germany, foreign trade will depend on a number of risks of certain increases and decreases. The prices of crude oil and other resources have recovered after plunging in the crisis, and may have a restraining effect on the global economy. The euro has now fallen somewhat following an impressive rise, which was mostly a reflection of the weak US dollar. Should the euro remain this strong however, German and European products will be less price-competitive in foreign markets.

The troubled financial markets pose a primary risk for a downturn. The German government's credit and guarantee programme is relieving the situation, but it is mainly up to banks to avert an acute, widespread credit crunch by providing additional liquidity and access to financing to actively strengthen the businesses propelling the economy.

Job market data are positive on the whole, with unemployment up less than expected at the start of 2009. Both employers and employees have taken advantage of the options created in the last round of labour reforms and are preserving jobs. Nonetheless, companies are forced to close an enormous output gap. One way to do so is through reductions in permanent staff, but despite higher unit labour costs this option is deliberately being avoided for now. Another possibility is that the gap might close itself if the recovery happens faster than expected and lifts capacity utilisation. However, because it will take a long time to get back to former levels it is likely that unemployment will continue to rise, despite the willingness and measures taken to preserve jobs.



Photo: BDI/fotolia (Bertold Werkmann)

Consequently, consumer spending is likely to stagnate in 2010, despite tax cuts and higher social benefits. The high level of new borrowing also clouds the economic outlook overall. Capital spending should increase slightly, but this from extremely low levels. Expectations are mainly based on rapid developments in foreign trade. Just as the crisis hit Germany by way of foreign trade, German will now benefit from the upturn in the global economy. Even factoring in a statistical margin of error of up to one percent for 2009, GDP growth in 2010 should realistically range between 1.5 and 2 percent, or more in the best-case scenario.

Further information can be found on [http://www.bdi.eu/BDI\\_english/BDI-Foreign-Economic-Report.htm](http://www.bdi.eu/BDI_english/BDI-Foreign-Economic-Report.htm)

## Policy Agenda

### Company funding crucial to economic recovery

**Business financing: Downward trend in private-sector lending increasing – KfW credit market forecast, December 2009: Development in extension of new loans**



Source: KfW Bankengroup



The widening gap between credit supply and the demand for financing in the initial stages of recovery poses the biggest economic policy challenge for the year 2010. There are three top-priority issues:

#### Revive the securitisation markets

The securitisation market almost disappeared entirely in the financial crisis. Securitisation is a key source of financing for small and medium-sized enterprises (SMEs). Providers need to be sending the right signals now. Effective, high quality standards could form the foundation for a premium segment for German SME securitisations. A higher retained portion would also promote greater sensitivity to risk on the part of the securitising institutions.

#### Bolster equity

Companies lost a lot of equity in the financial crisis, and the situation is worsening. Equity-building measures such as internal financing through retaining profits and supply of liable equity could be utilised in combination to strengthen businesses. This would improve creditworthiness and facilitate access to debt financing.

#### Regulate financial markets in moderation

Initial proposals have been drafted and measures taken for re-regulating the financial markets. Further steps are required, such as creating incentives structured properly with regard to risk. At the same time, the G20 summit resolutions must be rapidly implemented. Undesirable side-effects for the real economy must be avoided at all costs.

Another challenge in 2010 will be public budgets, which are on the brink of a massive test of endurance. In 2010 alone Germany is projected to borrow an additional €86 billion – roughly as much as for the years 2005 to 2008 combined. The government must therefore develop strategies for progressively reigning in its expansive fiscal policy to pre-crisis levels without jeopardising the recovery. Germany must systematically act to restrain borrowing for technical reasons alone, in view of the budget provisions anchored in its Basic Law. The federal and state governments thus need to strike a clear course regarding tax and budgetary policy. Consolidation concerning expenditures should be a priority, favouring investment-related spending and identifying opportunities for savings. This would create space for debt consolidation and tax relief as part of a structural tax reform.



*Economic recovery requires sufficient funding. Photo: BDI/fotolia (Weim)*