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Economic Forecast 2010

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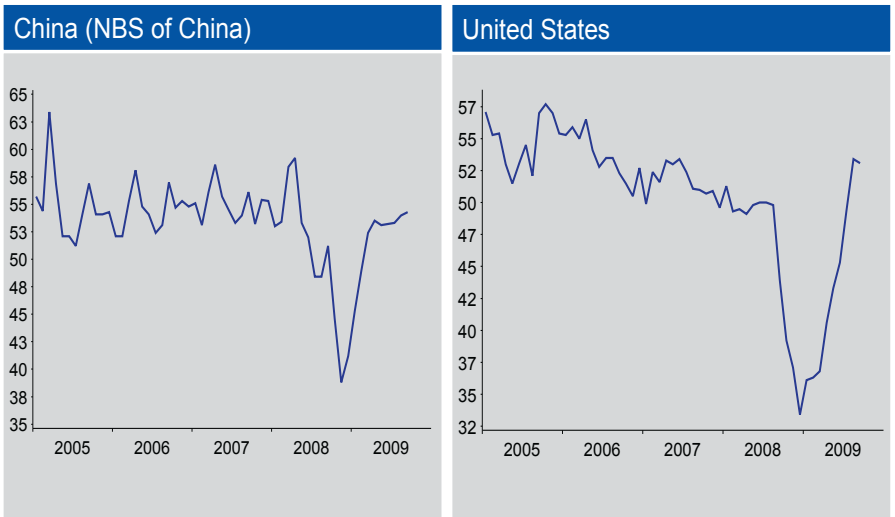
1. The global economic situation and prospects

The global economy suffered an economic slump in the winter half-year of 2008/2009 which was unique in post-war history for more than just its intensity. A particular feature of this slump was the more or less synchronized drop worldwide in industrial production, investment and exports. While certainly not the only cause of this development, yet nonetheless the trigger, the insolvency of the Lehman Brothers investment bank on 15 September 2008 literally sent the global economy into a state of shock. Suddenly anything seemed possible; from the disintegration of the European Monetary Union, through a protracted depression, to the collapse of the global financial system. Despite the decisive action on the part of monetary and fiscal policy around the globe, no one could quite imagine how the downward spiral could be stopped and the global economy set to chart growth once again.

This situation lasted until the spring of 2009 when the first signs of economic stabilization were visible, particularly in Asia. Second-quarter figures on economic growth then provided the proof that the dramatic slide in production had indeed been halted. Some countries, including Germany and France, surprisingly posted slight quarter-on-quarter increases in GDP. The Japanese economy also returned to growth, while the slump in other industrialized nations was at least no longer as pronounced as in previous quarters. A number of emerging markets, primarily in Asia, actually reported a dramatic increase in economic output.

And how are things set to continue? Economic indicators, such as those on economic sentiment and the order situation in industry, signal dynamic development at least in the short term. Various letters of the alphabet are currently being used to help describe the likely course of economic development, with V, W and L the most frequently cited. At present it is actually the case that the graphic representation of many indicators increasingly yields a “V” shape. The question, however, is whether the “V” form will be finished off, or whether the right arm will suddenly turn downward again, leaving us with an economic development pattern in the shape of a “W”.

Purchasing managers’ indices (PMI) show clear improvement



Even if the more short-term economic development seems relatively clear, there are a number of potential negative factors hanging over the medium and long-term horizon, which could cloud the economic outlook as soon as next year and thus noticeably curb global growth momentum. Only a few of these aspects are briefly highlighted here:

- The economic stimulus packages in many countries will continue to have an effect into next year. However, the growth impetus they have generated is likely to increasingly peter out over the course of 2010.

- One issue is certain to gain in importance during the course of the economic recovery, namely that of the exit strategies of central banks. Will monetary policy succeed in reabsorbing the liquidity made available to the banks during the crisis and in gradually normalizing key rates without this directly stifling economic growth?

- Although global imbalances have lessened in the past few months, this certainly does not solve the problem of high current account surpluses and deficits for the long term. Charting pre-emptive economic policy courses at global level would seem necessary. This is especially true for the USA and China.

- The need for private household and public-sector budget consolidation in many countries may slow the momentum of global demand and thus also of global trade.

- Some arguments indicate that potential growth post-crisis will be lower than before the crisis. For instance, it must be assumed that the capital stock in many countries has declined in the course of the crisis. And, what is likely to be stricter regulation of the financial system, as much sense as it may make, will also probably tend to slow potential growth.

We will continue by first taking a look at the key world regions so that we can then piece together the complete global economic jigsaw for 2010.

USA

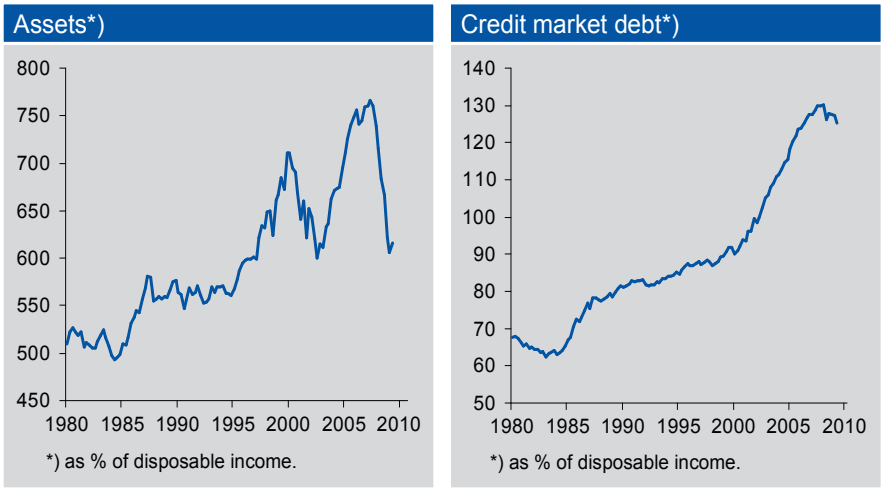
After four quarters of continuous decline by a total of almost 4 %, the signs point to recovery in the third quarter of 2009. Available indicators signal a broad-based upward trend. Viewed in the light of a pickup in housing sales, residential construction investment is also likely to increase again quarter-on-quarter for the first time since mid-2005.

The extraordinary and comprehensive economic stabilization measures, such as the US "cash for clunkers" scheme, as well as mortgage interest rates at a record low and tax incentives for first-time home purchases have undoubtedly fueled a large part of this development. Moreover, public-sector investments in infrastructure can still be expected to provide an economic boost into 2010, as the total funds allocated have only been tapped to a limited extent thus far.

Furthermore, the adjustments typically made during the course of an economic cycle increasingly favor the economy developing a positive momentum of its own. For example, after slashing costs and equally drastically reducing investment

spending, the (non-financial) corporate sector now displays a clear financial surplus and is thus less dependent on external financing. The drastic curtailment of credit in the wake of the lending market turmoil in the winter months of 2008/2009 doubtlessly accelerated this process. Corporations' internal financing resources exceed investment volume to an extent that has seldom been seen at the end of a recession. Given the rebound in earnings, this ratio may initially continue to increase. This improved financial position gives companies more leeway for investment activity, which should initially be visible primarily in inventory investments. It should also enable them to increasingly take their foot off the hiring brake. In our opinion, the high financial pressure thus far could explain why there have been far more job cuts than would have been expected on the basis of traditional factors that determine demand for labor, such as production level and real wages. On this basis, we see a chance that employment figures will pick up again by the beginning of 2010 at the latest. The associated recovery in labor income will be essential to steady consumption in the long term. However, the high net worth losses that will have been, at best, partially recovered in the course of 2009, allow for only moderate expansion.

US: Financial position of the household sector
(incl. non-profit organizations)



All in all, we expect continued but moderate recovery. After a decline in aggregate economic output of 2.5% this year, we forecast GDP growth of 2.2% for 2010.

Euro area

The economic picture in the euro area brightened up considerably in spring. Despite a substantial drag once again from declining inventory investment, real GDP fell only slightly in the second quarter. The stabilizing trend was largely due to a firming up of consumption and an increase in real net exports. Foreign trade thus made its first positive contribution to growth since Q2 2008.

The economy can be expected to clearly pick up speed in the second half of 2009. This is evident from company surveys indicating continued improved results, which are also now noticeably reflected in new orders. Exports look set to play a major role given the recovery of global trade, with foreign-trade financing problems estimated to have been behind at least one third of the collapse witnessed in the winter

months of 2008/2009. For now, implementation of economic stimulus packages will continue to set the direction for the domestic economy. At the same time, the reduction in debt servicing generated by the expansive monetary policy will have positive effects on the disposable income of private households. And finally, an increase in overall sales volumes will also cause the inventory cycle to turn around and boost production expansion. Consequently, we expect economic growth to continue in 2010. However, in comparison with the second half of 2009, the economy will lose momentum over the course of the year as the various stimulus packages come to an end. Overall, we expect 2% annual average growth in aggregate economic output in the coming year.

Japan

The Japanese economy resumed growth in the second quarter. The incentives offered by the stimulus packages had a positive effect on consumption and resulted in a significant expansion in public-sector investment. However, a key factor was the significant rebound in exports that had previously taken a dramatic tumble. The export-driven boost to the economy will likely continue for the rest of the year. However, the high valuation of the yen can be expected to curb export momentum in the next few quarters. Private consumption is also under pressure from increased unemployment and declining wages. Thus the economy is likely to slow once again in 2010, with only moderate real GDP growth of 1.7% on the cards.

Emerging markets

The current crisis has once again demonstrated impressively that the emerging markets are not a homogenous group. The extent to which they have been affected not only varies greatly between Asia, Latin America and eastern Europe, but also between the individual countries within these regions. For example, while numerous emerging markets in Asia showed signs of economic recovery in the second quarter of 2009, other emerging markets in eastern Europe continue to languish in a pronounced recession.

Those countries that have allowed marked imbalances to develop over the past few years, for example in the form of high current account deficits, or substantial private sector foreign-currency debt, have been hit the hardest by the crisis. The majority of the countries fitting this description are located in eastern Europe. With economic output set to decline by 6.2%, this region will register the steepest slump of all emerging market regions in 2009. Countries like Hungary, Latvia, Romania and Ukraine have even had to request international financial assistance in order to avert a massive worsening of the crisis, or even state bankruptcy. One of the few positive exceptions in the region is Poland, which looks to have avoided a recession entirely and is even expected to grow by around 1% this year. The economic situation in eastern Europe will increasingly stabilize over the course of the second half of 2009 and throughout 2010; however, economic growth may be subdued in 2010, at 1.8%, with the effects of the macroeconomic turmoil still lingering in some countries. Nevertheless, the recovery process in eastern Europe is likely to continue after this adjustment phase, although given the rather moderate increase in lending, momentum will be weaker than before the crisis. We consider economic growth of around 4% a realistic medium-term estimate. By way of comparison, growth averaged more than 6 % over the past five years.

In Latin America there is currently growing evidence that the economy is picking up. For example, Brazil reported surprisingly buoyant economic growth for the second quarter of 2009, thus ending a brief but sharp recession in the largest economy in the region. It is striking that Latin America has fared significantly better in the current crisis than in previous crises. This is primarily due to a marked improvement in the macroeconomic framework, which has rendered the region as a whole less vulnerable to external shocks. Consider, for example, currency reserves. Thanks to the substantial current account surpluses of the past few years, Latin America's currency reserves increased sharply from just under USD 142bn in 2004 to a good USD 323bn in 2008. Real economic output is expected to fall by 3% overall in 2009. We expect to see an increase of 2.2% next year. The appreciably weaker growth compared to the years before the crisis is due not least to the renewed need for public-sector budget consolidation in the wake of the economic stimulus packages.

The Asian emerging markets which are heavily reliant on exports have battled the crisis with in some cases hefty stimulus packages. Countries such as China and South Korea already saw a noticeable improvement in the economic situation in the second quarter of 2009. We are optimistic that thanks to the pickup in global trade, the upswing will spread to the entire region in the second half of the year. Overall, the Asian emerging markets are set to grow by 4.2% this year, led by the heavyweights China and India. We expect to see an increase in GDP of 6.3% next year. We consider medium-term growth in the 7 to 8% range feasible. In view of the more moderate growth trends in global trade, we believe that growth of over 9%, as achieved before the crisis in some years, is unrealistic. Nonetheless, the Asian emerging markets may return to a higher growth path in the long term. For this to happen though, there would have to be much more growth impetus from domestic demand. This is especially true for China.

GROWTH RATES IN MAIN ECONOMIC REGIONS

- GDP, real % change over previous year -

	2005	2006	2007	2008	2009[1)]	2010[1)]
Industrialized countries	2.4	2.7	2.5	0.4	-3.2	2.0
European Union	2.0	3.2	2.9	0.9	-3.6	1.7
Euro area	1.7	3.0	2.7	0.7	-3.5	2.0
Germany	0.8	3.2	2.5	1.3	-4.2	2.7
USA	3.1	2.7	2.1	0.4	-2.5	2.2
Japan	1.9	2.0	2.3	-0.7	-5.7	1.7
Emerging markets	6.6	7.5	7.7	5.2	-0.1	4.2
Asia	8.2	9.1	9.8	6.5	4.2	6.3
Latin America	4.5	5.4	5.6	4.0	-3.0	2.2
Central and Eastern Europe	5.6	7.3	7.3	4.7	-6.2	1.8
World	3.5	4.1	4.0	1.9	-2.3	2.7

[1)] forecast.

So what does this mean for the global economy as a whole? The global economy is expected to grow tangibly by 2.7% in 2010, after the 2.3% slide in global output this year (country weighting based on current exchange rates). For industrial nations, the increase is expected to be 2% and for emerging markets 4.2%. Taking the emerging markets' share in the global economy into account, which we put at a good 32% for 2010, this means that emerging markets will contribute exactly half of the forecast global growth of 2.7% in 2010.

The financial and economic crisis has eased appreciably in recent months. However, this is not to say that it is over yet. In such an environment, forecasts are tainted by a considerably higher degree of uncertainty than is the case in "normal" times anyway. We have assumed the following global conditions for our forecast:

- Most of the major central banks such as the US Federal Reserve and the European Central Bank will start to gradually withdraw the excess liquidity made available to banks during the financial crisis, in the course of 2010. We also assume that we will see the first increases in key interest rates next year. This could be the first time in history that the ECB initiates the cycle of interest rate hikes before the US Federal Reserve.

- Following the significant depreciation of the US dollar against the euro in recent weeks, exchange rate developments should resume a calmer course for now. The latest exchange rate development is less ominous than it may initially appear. It actually corrects the crisis-related appreciation of the US dollar in the latter part of 2008, which was due to liquidity bottlenecks in the interbank markets for the US dollar, among other reasons. We estimate that one euro will be worth around 1.50 US dollars at the end of 2009, and approximately 1.55 US dollars at the end of 2010.

- In view of the rather muted economic development expected in industrialized nations, we assume that commodity prices will rise only slightly in 2010. The annual average cost of Brent crude is predicted to be between USD 70 and 75 per barrel. The lower end of the forecast range corresponds more or less to the price we forecast for the end of 2009.

- Global trade in 2009 is expected to have experienced its heaviest slump in around 50 years. We expect a year-on-year decrease of around 9%. We have assumed a 6 % rise in world trade volume for our 2010 forecasts.

2. Economic situation and outlook in Germany

2.1 Recovery is underway

The German economy, which experienced a dramatic slump in the winter half-year 2008/2009, is meanwhile climbing out of the trough. New orders in the industrial sector rose by 16% within a five-month period – from February to July 2009. In order to achieve the pre-recession level, however, a further increase of 34% is necessary. Even if the path to the pre-crisis level is long, it is nonetheless encouraging to see steps in that direction.

The stabilization of industrial demand was a key factor behind the modest growth in the German economy in the second quarter of 2009 (+0.3%), the first growth since the beginning of 2008. However, economic growth was squeezed considerably by the reduction in inventory levels (contribution to growth -1.9%). Companies evidently slashed their finished goods inventories once again; this is evidenced by information from various sectors. This offers hope that companies will quickly ratchet up production upon further recovery of demand.

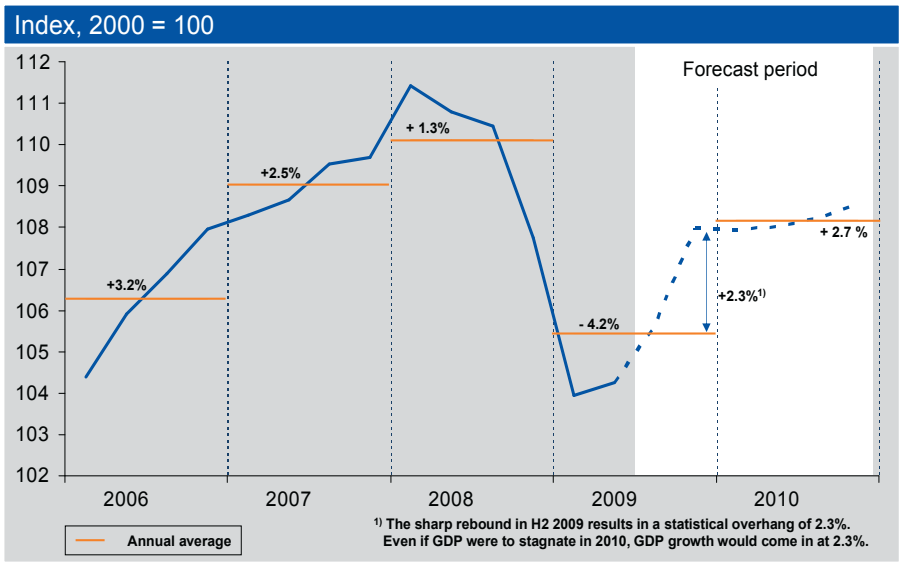
Industry: Production and new orders

2005 = 100, volumes, seasonally adjusted

Economic surveys such as the purchasing managers' index and the Ifo business survey show a sustained recovery in business sentiment. While assessment of the business situation has improved only slightly according to the Ifo survey, business expectations have risen sharply in recent months. Visually, the trend in business expectations over the last twelve months resembles a "V". The improvement in the general business expectations goes hand in hand with a similarly significant recovery in export expectations. Global trade is evidently coming out of its state of shock. Despite the euro's high external value, a strong rebound in exports is likely for the second half of the year. We expect German exports to increase around 5% quarter-on-quarter in both the third and fourth quarters. This represents a very strong economic boost. Even taking a renewed rise in imports into account, net exports will probably contribute a good one percentage point to growth in both the third and fourth quarters. Since domestic demand is also likely to increase in the second half of 2009 due in part to impetus from the stimulus packages, GDP growth of a good 1 to 2% is expected in each quarter. Despite the strong economic recovery in the second half of the year, gross domestic product (GDP) for Germany will post an estimated average 4.2% decline for 2009.

The economy will get off to a bullish start in 2010. Compared to the previous year, first quarter GDP is expected to rise by around 4%. It will soon become clear, however, that the overall conditions will not allow for any fireworks. Globally, the impetus generated by the stimulus packages will wane. Although recovery is expected for the housing markets affected by the crisis, there will be no return to pre-crisis levels in 2010 either. In countries with high household debt ratios, the expansion in consumer demand will be moderate at best. Global demand for capital goods will remain subdued given that capacity utilization still remains below average. German exports will therefore not be the strong economic driver they were in previous upturns. Domestic investment activity is likely to pick up, but 2010 will see rather less impetus from consumer demand than 2009 – in part because labor market developments will remain a drag for some time and purchasing power gains made on the back of lower energy prices will come to an end. All in all, the economic recovery will lose momentum, at least temporarily. The economy is expected to grow by an annual average of 2.7% in 2010, with the production level at the beginning of 2010 already likely to be more than 2% above the average level for 2009.

German GDP at previous-year prices



GERMANY | Economic indicators and forecasts*

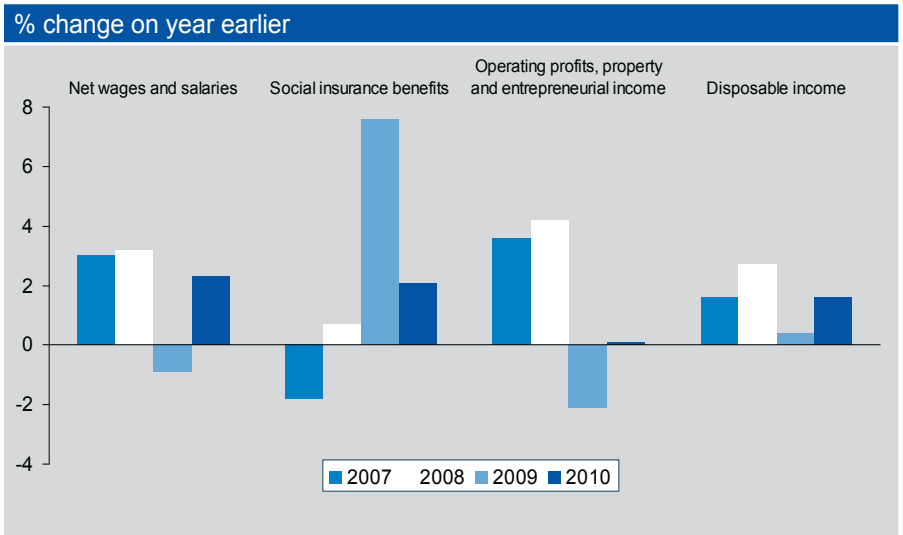
		2008				2009				2010						
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009p	2010p
GDP real		1.6	-0.6	-0.3	-2.4	-3.5	0.3	*1.3*	*2.2*	*0.0*	*0.1*	*0.2*	*0.3*	1.3	*-4.2*	*2.7*
Private consumption		0.4	-0.6	0.3	-0.4	0.6	0.7	*0.2*	*0.1*	*-0.4*	*0.3*	*0.1*	*0.2*	0.2	*1.0*	*0.3*
Government spending		1.0	0.7	0.1	0.6	1.1	0.4	*0.4*	*0.4*	*0.8*	*0.5*	*0.3*	*0.3*	2.0	*2.4*	*2.0*
Investment in machinery/equipment		-0.6	-0.8	1.5	-3.7	-18.5	-0.5	*0.0*	*2.0*	*3.0*	*2.0*	*2.0*	*1.0*	2.6	*-20.2*	*7.3*
Construction		5.9	-4.3	-0.4	-1.0	0.2	1.4	*1.0*	*1.0*	*-0.5*	*0.5*	*0.5*	*0.5*	1.8	*0.0*	*1.9*
Domestic demand		2.3	-1.3	1.2	-0.4	-1.0	-1.3	*0.2*	*1.1*	*-0.1*	*0.3*	*0.2*	*0.3*	1.5	*-1.7*	*0.9*
Exports		1.7	0.2	-0.1	-7.9	-10.5	-1.2	*5.0*	*5.0*	*0.7*	*0.5*	*0.8*	*1.2*	2.4	*-13.5*	*7.8*
Imports		3.3	-1.5	3.4	-4.2	-5.3	-5.1	*3.0*	*3.0*	*0.6*	*1.2*	*1.0*	*1.3*	3.9	*-8.7*	*4.8*
Industrial production (excl. construction)		1.1	-0.8	-1.1	-7.1	-12.6	-1.1	*3.0*	*4.3*	*0.8*	*0.5*	*0.6*	*0.6*	0.3	*-16.5*	*6.3*
Unemployment rate (EU def.)	%	7.6	7.4	7.2	7.1	7.3	7.6	7.7	*7.8*	*8.1*	*8.5*	*8.6*	*8.6*	7.3	*7.6*	*8.5*
Unemploment rate (nat. def.)	%	8.1	7.8	7.6	7.6	8.0	8.2	8.3	*8.4*	*8.8*	*9.1*	*9.3*	*9.3*	7.8	*8.2*	*9.1*
Employed persons (nat. def.)	J/J	1.6	1.5	1.4	1.1	0.4	-0.1	-0.4	*-0.8*	*-1.0*	*-0.8*	*-0.7*	*-0.2*	1.4	*-0.2*	*-0.7*
Consumer prices	J/J	2.9	2.9	3.1	1.7	0.8	0.3	-0.2	*0.4*	*0.9*	*1.0*	*1.1*	*1.2*	2.6	*0.3*	*1.0*
Consumer prices (HICP)	J/J	3.1	3.0	3.3	1.7	0.8	0.3	-0.4	*0.4*	*0.9*	*1.0*	*1.1*	*1.2*	2.8	*0.3*	*1.0*
Producer prices	J/J	3.2	5.4	7.9	5.3	0.8	-3.6	*-5.2*	*-2.9*	*0.6*	*3.2*	*2.6*	*2.0*	5.5	*-2.7*	*2.1*
Current account balance	EUR bn	46.7	44.8	40.4	33.7	17.5	25.5	*28.0*	*30.0*	*30.0*	*28.0*	*27.0*	*25.0*	164.9	*101.0*	*110.0*
	% GDP													6.6	*4.2*	*4.4*
Budget balance	EUR bn													1.0	*-70.0*	*-105.0*
(Maastricht-definition)	% of GDP													0.0	*-2.9*	*-4.2*
3-month money market rate**	%	4.7	4.9	5.3	2.9	1.5	1.1	0.8	*1.0*	*1.3*	*1.6*	*1.8*	*1.9*	4.6	*1.3*	*1.5*
10-year gov.bond yield**	%	3.9	4.6	4.0	2.9	3.0	3.4	3.2	*3.6*	*4.0*	*4.3*	*4.2*	*4.1*	4.0	*3.3*	*4.1*
Exchange rate**	USD per EUR	1.58	1.58	1.43	1.39	1.33	1.41	1.46	*1.50*	*1.52*	*1.54*	*1.55*	*1.55*	1.47	*1.39*	*1.53*

* quarterly figures: percentage change over previous period, seasonally and working day adjusted, except where noted. Yearly figures: percentage change, not working day adjusted.
** end of quarter, yearly average. f = forecast.

2.2 Private consumption – a real support

Private consumption in Germany in the first half of 2009 picked up, unlike consumption in the majority of other industrial countries. It was most certainly positively affected by the car scrappage program, which drove demand for automobiles up considerably. However, more important was the fact that the German labor market proved to be surprisingly stable given the extent of the crisis, allowing the purchasing power gains generated by falling energy and foodstuff prices to have a positive impact.

Private household disposable income



The prospects for consumer demand for the second half of 2009 are not unfavorable either. Although the impetus from the car scrappage program is gradually ebbing, consumer sentiment has recently continued to perk up. The business climate appears more positive again on the retail side (excluding car sales).

Labor income is expected to fall by 1% on average in 2009, based on a 0.2% drop in employment as well as a decline in actual earnings per employee of 0.8%. The reduction in actual earnings per employee is the result of an estimated 4½% fewer working hours per employee (reduced working hours, extended vacation time, etc.), with earnings per employee hour rising by 3½ - 4%. Working hours per employee are not expected to fall any further in 2010. Thus, we expect a slight increase in the annual average actual earnings per employee (+1.7%). In view of a reduction in employment figures of 0.7%, 2010 will see only meager growth of 1% in the total gross wages and salaries. The net figure looks somewhat better. A series of tax reliefs will result in the sum of net wages and salaries increasing by an estimated 2.3% in 2010 after a decrease of just under 1% for 2009. Weak development in labor income is largely being offset by welfare benefits. Monetary welfare benefits this year will increase dramatically (+7.6%), with a further slight increase expected next year (+2.1%). This is largely due to rising benefits for employees working reduced hours and the unemployed. Moreover, pensions were raised significantly in 2009 for the first time in a number of years. In view of the slump in corporate earnings, it is not surprising that a decline in distributed profits and property and entrepreneurial income of at least 2% is expected for 2009; for 2010, we expect this item to stagnate.

All in all, disposable income (including the increase in occupational pensions) appears set to rise by 0.5% in 2009 and by 1.7% in 2010. These are very modest increases, but against the backdrop of the economic crisis it is in fact positive that private household income has not shrunk overall. In view of the largely stable consumer prices this year and only a minimal increase estimated for next year (private consumption deflator 2009: -0.1%, 2010: +1.2%), slight increases in real disposable income are even likely for both years (2009: +0.7%, 2010: +0.5%). The savings rate, which reached the highest level for several years in 2008 (11.4%), may be somewhat lower in 2009 and 2010, at 11.1% and 11.3% respectively, based on the shift in income structure towards transfer income at the expense of profit and self-employment income.

Moreover, panic saving will become less of a factor once the financial crisis has died down. Real private consumption is forecast to expand by 1% in 2009 and by 0.3% in 2010. Thus, Germany is the only major industrial country other than France where private consumption has not taken a hit.

2.3 Gradual stabilization of investment activity

Machinery and equipment investment was down by 18.5% on the preceding quarter in the first three months of 2009 in seasonally adjusted terms – a record slump. This rapid decline reached a virtual standstill in the second quarter (-0.5%). Nonetheless, the level of machinery and equipment investment remained extremely low, down by 23.4% on a year earlier.

One of the main reasons behind the slump was without a doubt the underutilization of production capacities resulting from the continuous slide in incoming orders in the period from late 2007 to early 2009. According to the European Commission economic survey, capacity utilization in the manufacturing industry fell by almost 16 percentage points from 87.6% to 71.8% from Q2 2008 to Q2 2009, the lowest reading since records began in 1980 and well below the average for the past ten years of 84%. Another factor that cannot be discounted was the massive blow to confidence dealt by the insolvency of the investment bank Lehman Brothers in the fall of last year, which prompted many companies to make abrupt adjustments to their investment plans.

Machinery and equipment investment is expected to stabilize at a low level in the second half of this year. We expect to see quarter-on-quarter stagnation in the third quarter, and a slight increase of 2% in the fourth quarter. Signs of a turnaround in capacity utilization in the second half of the year are starting to emerge too. We expect to see a considerable increase in the second half of this year and in 2010, from its very low level, thanks to an improvement in the overall backdrop. First of all, various leading indicators such as the Ifo business climate index have been improving steadily over the past six months; the index climbed from 82.2 points in March to 91.3 in September. The expectation component of the business sentiment index is showing particularly positive development, rising by more than 5 points to 95.7 points over the past two months, compared with a drop to 77 points in December of last year. Investment is benefitting from this recovery in confidence, as well as from more favorable earnings expectations. The returning confidence will buoy investment activity next year as well. Second, the Ifo business survey showed the business expectations of domestic capital goods producers also to be largely balanced in August and September, after being negative overall every month of last

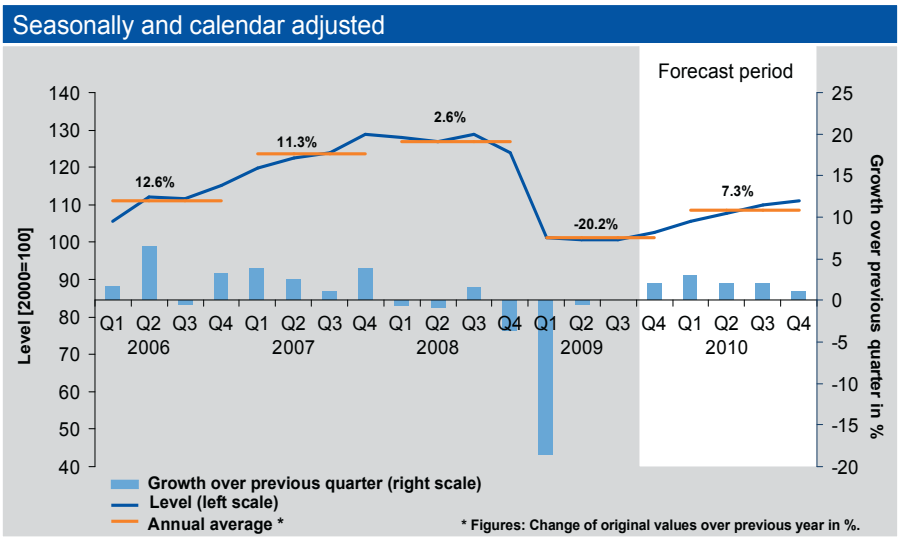
year, when the survey returned readings as low as minus 66 points (December 2008). This is another sign of an imminent recovery in investment. The current low level of interest rates is also a supporting factor.

Furthermore, we assume that the credit crunch that many feared was on the horizon is a fairly unlikely scenario, even though lending to non-financial companies has been on the decline since the beginning of the year. Any downturn in lending business is always caused by both supply and demand-related factors, and does not allow any conclusions to be drawn as to a credit crunch on the supply side per se. An in-depth look at individual influences shows that the decline in lending activity is not strikingly pronounced in historical terms; furthermore, weak real economic performance and the associated slump in credit demand had a major impact on lending development. An assessment based on loan maturities also highlights the dominant role played by demand-related factors, as banks are likely to be more interested in granting short-term loans at present, meaning that the more pronounced drop in short-term loans points towards a decline in the need for short-term financing in the corporate sector triggered by the economic climate.

This is corroborated by the fact that, due to the considerable underutilization of capacities in the nascent economic upswing, companies are more likely to step up the utilization of free capacity before making new investments. According to a special survey conducted in July this year by the Bundesbank on German banks' lending business with domestic companies, it is true that the major banks, in particular, expect to see only subdued development in their new lending business; all in all, however, not even the banks themselves believe that there are signs of an across-the-board credit crunch in their business with domestic non-financial companies. As a result, we do not expect to see a restriction of lending supply to an extent that could have any pronounced effect on corporate investment plans.

For 2009 as a whole, we expect machinery and equipment investment to slide by 20.2%, which is attributable primarily to the poor start made in Q1 2009. The vast majority of investments are likely to relate to replacement and rationalization investments.

Equipment investment



In 2010, we expect to see a recovery in machinery and equipment investment to the tune of 7.3% over the previous year; growth momentum will, however, remain subdued next year, and the average level for 2010 as a whole will be down by almost 15% on 2008 – too low for Germany to remain internationally competitive in the medium term.

The construction industry did not get off to too good a start in 2009. Construction investment, for example, was down by 5.6% year-on-year in the first quarter, and by 2.9% in the second three months of the year. Incoming orders, which had plummeted in the first quarter with a year-on-year drop of 16.3%, were still down by 8% in the second quarter. Looking at the changes witnessed in the first half of 2009 as against the previous six months, a slightly positive trend becomes apparent: Construction investment was up by 0.4% in seasonally adjusted terms, although momentum varies between the individual construction sectors.

Commercial construction, which had shown positive development in recent years, has been hit hard by the crisis, with incoming orders on a continual slide over the past four quarters. As yet, there are no signs of a recovery, and we expect to see a clear decline in commercial construction this year and next.

Economic stimulus packages of the federal government

Measures with regard to construction	Financial resources 2009/ 2010 (EUR bn)
Additional investment in transportation	4
Infrastructure programs for laggard regions	3
CO_2 building restoration program and energetic restoration	3
Program for additional investment of municipalities and states (with focus on energetic restoration in the education sector and modernization of the infrastructure)	13.3 (Government: 10 bn, States: 3.3 bn)
Additional investment in building, equipment and departmental research of the government	2
Total	25.3

Source: German Federal Ministry of Economics & Technology.

In residential construction, investment remained largely stable in the first half of this year, with growth of 0.9% over the previous half-year. In the first six months of this year, incoming orders in the residential construction sector fell by 4.1% as against H2 2008, and have not provided any positive impetus to date. Although the low mortgage rates at present can be seen as a positive factor, the low interest rates are only boosting residential construction to a limited extent due to the moderate development in disposable income. Measures relating to existing properties will continue to dominate the residential construction sector, which is set to benefit, in particular, from energy-efficiency work on existing buildings over the next few years. All in all, we expect to see a slight decline in residential construction in 2009 and 2010.

The outlook for the public-sector construction segment is much better. While investment in this sector in H1 2009 was still 1.3% down on the previous half-year,

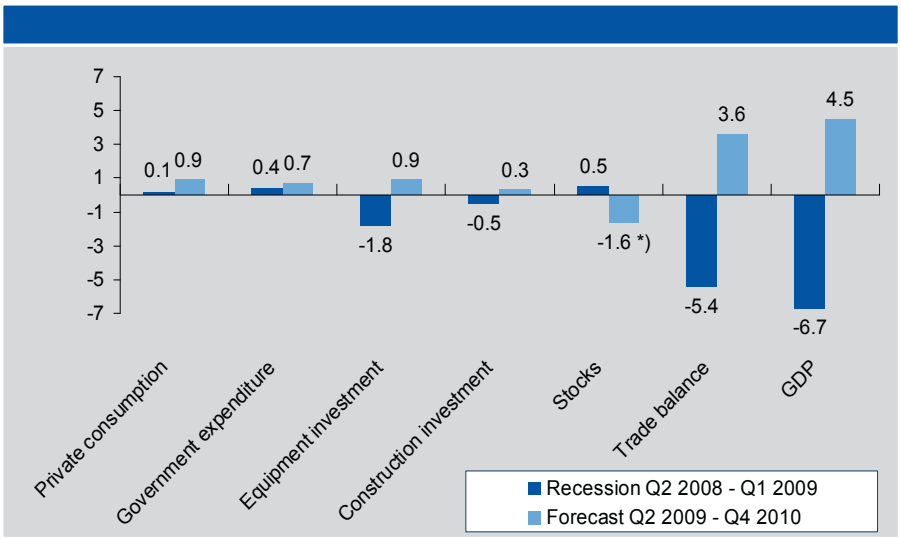
the public-sector construction segment is expected to make considerable gains in the course of this and next year, largely as a result of considerable impetus from the economic stimulus packages. Of the funds totaling EUR 70bn made available as part of the two economic stimulus packages, around EUR 25bn is earmarked for construction-related measures. The funds will be made available by the federal government, the federal states or the municipalities, depending on the measures in question. The measures resolved are likely to be implemented mainly in the second half of this year and in 2010, so we expect to see double-digit growth in the public-sector construction sector next year.

All in all, the funds available as part of the economic stimulus packages that will boost public-sector construction investment are likely to largely compensate for the decline in the commercial and residential construction sectors. For 2009 as a whole, we expect construction investment to stagnate as against the previous year, and predict growth of just short of 2% for 2010.

2.4 Exports – still alive and kicking

In the first half of the year, German exports of goods and services, which accounted for around 47% of GDP in 2008, saw the steepest slide in the history of the Federal Republic of Germany, down by 18.9%, in terms of volume, on the first six months of 2008. Business surveys, however, have shown a considerable improvement in export expectations over the past few months. Incoming orders from abroad, for example, have recovered by around 14% from the low seen at the beginning of the year. Nevertheless, developments vary considerably from sector to sector. While producers of intermediate goods and automobiles have already seen a marked recovery, the mechanical engineering sector is still very close to the trough.

German GDP: Demand components' contributions to growth



*) Q2 2009: -1.9; Q3 2009 until Q4 2010: +0.3

We estimate that, by the end of this year, exports will be back to a level at least 10% higher than in the spring of this year – a step back towards normality. Nevertheless, the question as to whether this positive development will continue at the same pace in 2010 remains open. In many countries, there is a dire need for debt reduction in both the private and public sector, meaning that the propensity to invest is likely

to remain fairly moderate at global level. As a result, we expect German exports to increase by only around 5% in the course of 2010, giving average annual growth of 7.8% for 2010.

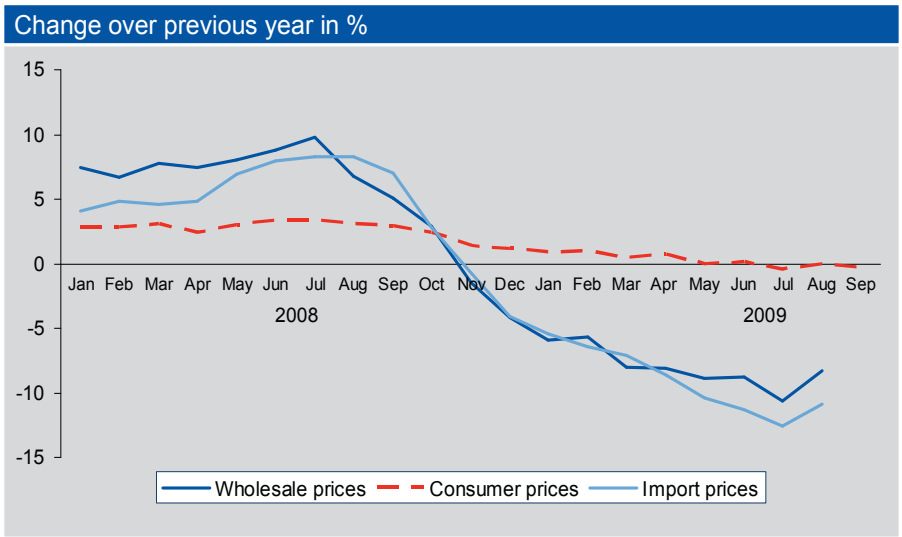
As regards imports, which are likely to fall by 8.7% in volume terms this year, we expect to see growth of 4.8% in 2010. As far as net exports are concerned, this means that they will once again make a key contribution to growth. During the recession – from Q2 2008 to Q1 2009 – net exports were responsible for 5.4 percentage points of the 6.7% decline in GDP in purely arithmetical terms. During the economic recovery – taking Q2 2009 to Q4 2010 – net exports will contribute 3.6 percentage points to the GDP growth of 4.5%.

The current account surplus, which amounted to 6.6% of GDP in 2008, is expected to decline to between 4% and 4½% of GDP in 2009 and 2010. Although this is a substantial correction, it is less pronounced than looked likely at the beginning of this year, when the surplus was almost halved in the space of a quarter. This takes account of the fact that the terms of trade, i.e. the ratio of export to import prices, which showed a huge improvement in 2009, are set to deteriorate slightly again next year.

2.5 Fall in prices tapering off

The inflation rate, measured in terms of the change in the consumer price index, has been negative at times over the past few months, as expected. Prices for energy and foodstuffs, in particular, were down sharply on a year earlier. The price indices for wholesale prices and producer prices, where energy and foodstuffs are weighted more heavily than in the consumer price index, have been showing more substantial negative values to date (producer prices -6.9%, wholesale prices –8.3% y-o-y). This does not, however, point towards a deflationary trend. Looking at all of the product groups, there is still no downward trend in prices. Price increases remain slight to moderate in the hotel and catering, leisure and entertainment, healthcare, furnishing and household appliance segments, as well with regard to rents excluding utilities. The fact that aggregate output prices are still headed north is also an argument against deflationary pressure. The GDP deflator was up by 1.6% year-on-year in Q1 2009, and by 1.3% in Q2 2009.

Price development



The rate of inflation for the cost of living is likely to come back to around ½% by the end of this year, with inflation expected to accelerate again slightly in the course of 2010, climbing to between 1 and 1½% by the end of the year. This assumes a modest rise in commodity prices by the end of 2010. Although 2010 will see a marked improvement in capacity utilization in the corporate sector as against 2009, it will remain below average. This means that there will be no inflationary pressure, and companies' scope for passing any price increases on will remain limited. The tight situation on the labor market means that 2010 is likely to see fairly low wage settlements. It is, however, important to bear in mind that unit labor costs have increased considerably in the course of the recession, because production cutbacks far outstrip reductions in the workforce. Even if unit labor costs fall slightly again as a result of the economic recovery, cost pressure in the corporate sector will remain considerable. For this reason alone, the corporate sector is unlikely to be very willing to make price concessions as far as its sales goods are concerned – unless forced to do so to remain competitive. Weighing up these considerations, neither deflationary nor inflationary trends are expected in 2010.

2.6 Labor market surprisingly resilient

Given the severity of the recession, the labor market has so far proven to be more robust than expected. In August 2009, the number of people in work was down by only 0.4% y-o-y. The number of people out of work has risen, in seasonally adjusted terms, by almost 300,000 from the low seen in October/November of last year. Statistical changes (unlike in earlier periods, more of the strain has been taken off the unemployment figures since May of this year due to changes in the way that participation in labor market policy measures is recorded), however, mean that since May, the official unemployment figure has been understating the increase to the tune of more than 100,000 people. However, this is offset by the fact that provisions governing those close to retirement age were phased out in 2008 – increasing the number of people registered unemployed. Even taking these factors into account, the increase in unemployment is well below average in international terms. At last count, the German unemployment rate, which was above the international average for quite some time, was in the lower midfield. While July's rate stood at 9.5% in the euro area, and at 9.4% in the US, it was only 7.7% in Germany.

There are certainly a number of reasons explaining the moderate increase in unemployment in Germany. The increased use of working time accounts and reduced working hour schemes have played a key role in this respect. In mid-2009, reduced hour schemes had saved the equivalent of almost half a million full-time jobs. Furthermore, however, the fact that companies entered this recession better placed in terms of earnings and capital than in previous recessions is also significant. This means that companies have better resources to help them ride out the recession. In this respect, the policy of wage restraint applied over the past few years is now also paying off. Collective bargaining parties and works councils have demonstrated far more flexibility as regards wage costs and working hours, lowering the "employment threshold". This basically means that the economic growth required at present to prompt companies to create jobs, or to prevent job cuts, is lower than in the past.

Nevertheless, the question inevitably arises as to whether the worst is still to come on the labor market. There would appear to be no doubt that the employment trend will most likely be headed south, and unemployment rates north, in the immediate

future. However, we do not expect to see quite as dramatic a deterioration on the labor market as many have feared to date. The number of people out of work will definitely not hit the 5-million mark in 2010. If the economic recovery continues as we forecast, around 3.5 million people will be out of work at the end of 2009, rising to just under the four-million mark in the winter months from January to March. We predict an annual average for 2010 of 3.8 to 3.9 million, with job cuts expected to taper off in the course of the year. We do not, however, expect to see anything more than stabilization on the labor market in 2010.

Short-time working schemes – a useful tool

In the course of the economic crisis, the government has considerably expanded the provisions governing short-time working, among other things by extending the period of time for which individuals can be paid partial unemployment benefit as a supplement to their salary to up to two years. The considerable use that has been made of these provisions, coupled with the relatively low increase in unemployment, suggest that the measures have been successful. Nevertheless, there is still widespread skepticism regarding further developments on the labor market. This skepticism is fueled by the theory that the legislation governing reduced hour schemes will stabilize the labor market only temporarily. Companies have been surprised by the extent of the slump in demand, and have been unable to adjust their workforce to reflect the production situation. Dismissal protection legislation prevents any swift adjustments being made anyway. So could it really be the case that companies are only using the legislation governing reduced working hours to bridge the gap required to prepare for dismissals? It doesn't seem entirely impossible. Contrary to widespread opinion, employees who have been informed by their employer that their working hours are to be reduced are not completely protected from dismissal for the duration of this reduced-hour period. Even compulsory redundancies are an option. However, compulsory redundancies on the same grounds that led to the reduced working hours in the first place are not permissible.

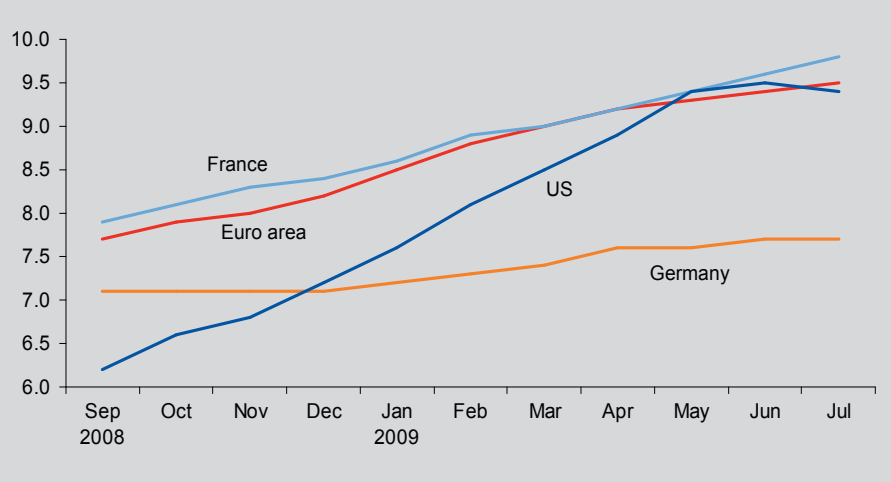
If, however, companies are able to cut jobs despite having introduced a reduced hours scheme, the argument to the effect that they are only using these models so that they can dismiss the affected employees at a later date hardly appears feasible. After all, more than a year has passed now since the severe recession set in. Extensive job cuts could have been made some time ago, despite the dismissal protection provisions in place. Furthermore – assuming that the figures are not deceptive – the use of reduced hour schemes has now passed its peak (unfortunately, precise figures are available only with a time lag of several months). Although the number of employees involved in reduced hour schemes for economic reasons increased again in the period from March to June from 1.12 million to an estimated 1.43 million, the fact that the number of new notifications of reduced working hours dropped from 720,000 in February to an estimated 110,000-120,000 in August means that the number of employees in reduced hour schemes should start to decline as early as in fall of this year. More and more companies (particularly in the chemicals industry) are now suspending the short-time working schemes implemented in the spring. But suspension does not necessarily bring the schemes to an end. Up until the end of 2010, employers can continue to receive the supplementary

payments from the government even after a break of more than three months, without having to make a new notification of reduced working hours.

One key factor in determining to what extent short-time working schemes will be used in the future and the jobs expected to be cut will be how quickly the economy recovers. If rapid economic improvement materializes as we forecast, we can expect reduced hour schemes to decline considerably by the end of 2009, and the rate of job cuts to slow down considerably from early 2010 onwards. We do not expect to see a wave of dismissals over the next few months; reduced hour schemes have played a key role in propping up the labor market in 2009.

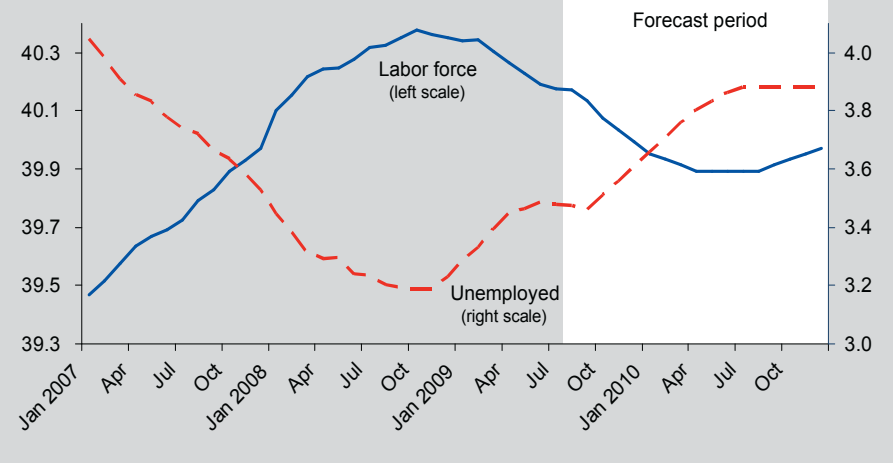
Harmonized unemployment rate in %

International comparison



Germany: Labor force and unemployed

In million



2.7 High budget deficit, but medium-term consolidation possible

The fiscal policy impetus provided by the stimulus packages and the tax relief resulting from the decisions of the Federal Constitutional Court (reversal of the cuts affecting commuter tax relief, increase in the extent to which retirement provision and similar expenses can be offset against tax) will account for a total of almost EUR 90bn in 2009 and 2010. In actual fact, at around 2% of GDP, the impetus for 2010 is expected to be somewhat larger than in 2009 (around 1½% of GDP). The very expansive fiscal policy, together with revenue losses and increased spending as a result of the crisis, have sent new borrowing soaring. Following the slight surplus in the federal budget (including social security) in 2008, we forecast a deficit of EUR 70bn this year (2.9% of GDP), and of EUR 105bn for 2010 (4.2% of GDP). This would mean that Germany will breach the Maastricht deficit criterion of a maximum of 3% of GDP in 2010; however, it is a distinct possibility that borrowing will be reduced to well below the 3%-mark within the new legislative period until 2013. If, as envisaged in the medium-term financial plan, government spending growth remains 2 percentage points below the growth rates of nominal GDP from 2011 (e.g. GDP plus 3 percent per annum, government spending plus 1 percent per annum), the deficit ratio could be reduced by almost one percentage point a year. It would then only be around 1.5 % in 2013, assuming no change in tax legislation. Given discipline on the spending front, there is certainly scope for fiscal policy to lower the overall tax burden.

Tax cuts self-financing to a considerable extent

The severity of the economic crisis has revived the debate about the effectiveness of fiscal policy. Across the globe, the stimulus packages launched to combat the crisis consist of almost the same proportion of spending increases and tax/contribution cuts. Nevertheless, it remains the predominant view that state spending measures have a more direct impact and a higher multiplier effect on aggregate output than tax cuts do. While studies conducted by the OECD (OECD Economic Outlook, March 2009) also take this view, they also point out that fiscal multipliers will fall again as a result of the crisis, particularly relating to tax cuts.

But is this really the case? What we have seen from the German economic stimulus packages is that the additional spending on infrastructure involves a great deal of time before it is implemented. In contrast, increased purchasing power thanks to falling commodity prices has provided a swift, substantial boost to private consumption. Tax cuts also serve to directly increase purchasing power.

The OECD is certainly right when it says that the ways in which households react to an economic crisis can vary from previous patterns of behavior. This, however, is precisely why it makes little sense at the moment to assess fiscal multipliers based on economic estimates from phases of normal economic activity. This also applies with respect to the effectiveness of the tax cuts planned by the new government.

In order to nevertheless be able to gauge how effective and financeable tax cuts would be, we have attempted to estimate the multiplier and self-financing ratio of a tax cut based on what we believe to be plausible assumptions of behavioral patterns. We have assumed an income tax cut for those on low and moderate incomes to the tune of EUR 10bn , without counter-financing measures, which would initially increase the budget deficit in full. Households on low and moderate incomes have a high consumption ratio. Since sentiment among consumers has surprised on the upside, we therefore believe that it is likely that a tax cut affecting these income groups would be fully translated into additional consumer demand. Additional consumer spending generates income which, in turn, increases demand. It is, however, worth bearing in mind that some of the additional demand will not remain in Germany, but will be met by imports. Furthermore, the government siphons off some of the additional income and revenue from private persons in the form of taxes, although this benefits the state in the sense that it makes a contribution to self-financing. Based on realistic assumptions for the German economy – an import ratio/foreign intermediate input ratio for consumer goods of 25%, a ratio of direct taxes of around 10% of GDP and a ratio of indirect taxes that also comes in at around 10% – the original tax cut impetus of EUR 10bn would likely increase aggregate demand by up to EUR 25bn. This additional aggregate demand would be associated with additional tax revenue in the region EUR 5-6bn , meaning that 50-60% of the tax cut could be self-financed.

Some may argue that this calculation fails to take account of crowding-out effects – i.e. the suppression of private economic activity by new government debt. There is no doubt that the additional government debt could fuel a rise in interest rates. Nevertheless, we would not expect a tax cut on the scale of EUR 10bn to have any emphatic impact on German government bond yields at present. Yields are determined to a large degree by international factors. At present, investors on the bond market are likely to be particularly interested in whether the central banks manage to pick the right time for an exit.

Another factor that is worth bearing in mind as far as tax cuts for lower and moderate income groups are concerned is that these result not only in demand effects, but, in the medium term, also in supply effects. There is no doubt that when taxes and contributions are lower there is more of an incentive to increase the labor supply. In the longer term, this would promote economic growth. This means that when looking at the 50-60% self-financing ratio of a tax cut, it is not only true that the negative impact of crowding-out has to be factored in. The positive impact resulting from longer-term growth effects should also be taken into account. All in all, the fact that they are likely to be self-financing to a considerable degree means that tax cuts will not herald any horror scenarios for government finances.

These assessments are, as always, subject to the disclaimer provided below

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