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## Economic Forecast 2010/2011

# Working Paper

# No. 137

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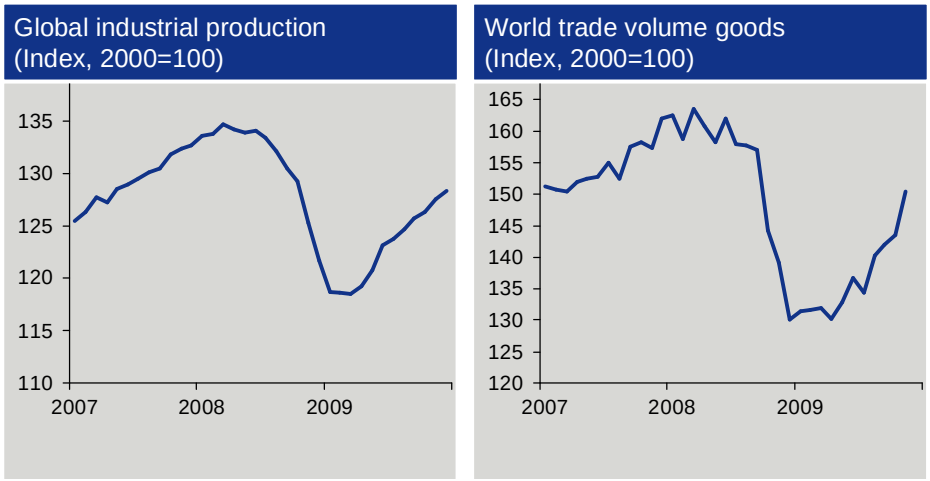
## 1. GLOBAL ECONOMIC SITUATION AND OUTLOOK

Thanks to the unprecedented expansionary economic policy worldwide, the global economy emerged from recession in spring 2009 and increasingly recovered over the remainder of the year. In some ways, the global economy is in a better position now than we dared to imagine a year ago. For example, according to preliminary figures, global industrial production at the end of 2009 had already made up much of the losses sustained since the summer of 2008. Furthermore, global trade did not suffer the lasting damage feared as a result of the financial crisis. Problems in trade financing were resolved and it did not come to protectionism. In fact, the production ties between national economies – some of which are very close – meant that the international exchange of goods expanded more strongly than industrial production. Global trade exhibited double-digit year-on-year growth again at the beginning of 2010.

Chart 1

### Appreciable turnaround in world trade




Source: CPB Netherlands Bureau for Economic Policy Analysis.

This view of the global economy must not distract from the fact that the economic recovery process has progressed with varying momentum in different regions and countries. The emerging markets in Asia powered the recovery to a large extent, with China as the driving force. Indeed, by the end of 2009, industrial production in these countries was already well up on the mid-2008 level. In contrast, the industrialized nations are far from making up the losses incurred as a result of the crisis.

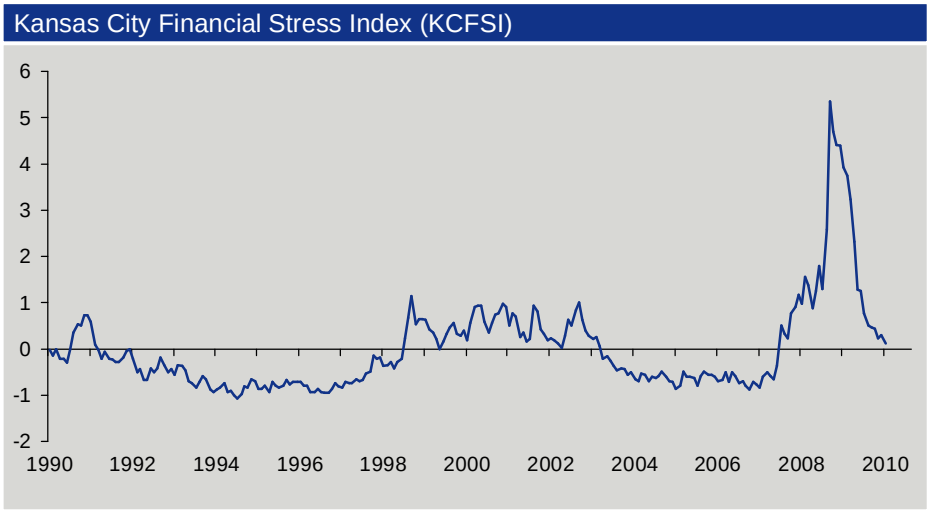
At the beginning of this year, the unusually severe winter in many countries made it difficult to judge underlying economic trends. However, leading indicators and company surveys, which to some extent are also forward-looking, point to a continuation of the upward trend and good chances of sustained growth. It is also encouraging that the labor market situation has now also eased somewhat thanks to the increase in overall output.. There has at least been no increase in unemployment in the large industrialized nations over the past few months. But a significant buildup in employment has so far not been evident either.

The upturn in global economic activity was accompanied by increasing stability on the financial markets. Comprehensive indicators for the degree of stress in the financial system, such as the Federal Reserve Bank of Kansas City's Financial Stress Index for the USA, are now back down close to their long-term average, confirming that financial markets are now functioning more normally again. The combination of reduced

uncertainty and more favorable financing costs that this indicates is likely to have a positive effect on real economic activity.

Chart 2

## Financial market stress continues to ease




Source: Federal Reserve Bank of Kansas City.

With things returning to normal on the money and capital markets, individual central banks have already been able to start phasing out their quantitative easing programs. In the US, given the banks' improved refinancing opportunities via the market, the Fed also took the first step towards the normalization of its interest rate structure by nudging up the discount rate, where the traditional gap over the key rate proper had been trimmed substantially during the crisis.

However, the situation on the public finance front is now becoming a major headache. Public budgets are under enormous pressure following the measures to overcome the crisis. This was apparent before Greece's difficulties in refinancing its government debt – but has been more in the spotlight since then. Fiscal policy is basically caught between an early withdrawal of the measures supporting demand and the risk of rising premiums for government debt instruments. To counter the loss of confidence, it would appear essential to provide market participants with sufficiently reliable expectations regarding the longer-term development of public budgets. This calls for credible strategies defining a path towards sustainable budgets, with clear targets. There is thus little room for additional expansionary measures. The fiscal policy impetus provided by the previous measures will gradually taper off, and next year at the latest, fiscal policy will have a dampening effect on economic activity.

So, even some time after the economy picked itself up off the floor, a fairly large question mark still hangs over the sustainability of the recovery. Here are our estimates of the economic prospects in the key regions and countries:

## USA

The US economy has been in recovery mode since the middle of last year. It gained significant momentum in the final quarter of 2009, with annualized growth of almost 6%. Aggregate output benefitted the most from the fact that the sharp rundown in

inventories seen in the previous quarters came to a virtual standstill. Indicators point to a slower rate of expansion at the beginning of 2010, partly as a result of extremely bad weather conditions in the northeast of the country. Despite such hurdles, output in the manufacturing sector in particular is likely to continue recording significant growth. After individual measures within the stimulus package had kick-started the dynamic recovery in industry, the external backdrop is now also increasingly fueling an expansion in output. Alongside the pickup in world trade, the low valuation of the US dollar is now also playing a role here.

Following a sharp adjustment phase, positive impetus is to be expected from the business sector over and above the inventory cycle. There is some indication that, at the end of 2009, earnings of non-financials (according to the national accounts definition) had returned to the pre-recession level. The earnings ratio was thus probably back above its longer-term average. Against this backdrop, the chances are good that equipment investment will see a sustainable rebound. With demand pointing up, production capacities down and the rise in the average age of the capital stock over the past few years, the portents for increased investment, particularly in industry, are positive. The improved situation in the business sector should also have a positive effect on the household sector via an increase in employment. Hourly labor productivity rose by an average of more than 7% (annualized) from Q2 to Q4 2009. Growth in productivity on this scale is scarcely possible in the long term; companies are expected to react to the increase in production by expanding their workforce. An encouraging pointer in this respect is that the existing workforce is being used more intensively with extended working hours. The recovery in labor income creates the basis for stable consumer demand. However, with consolidation still a priority in the household sector given the loss of wealth, the rise in consumer spending is likely to be only moderate initially.

The conditions required for a significant trend reversal in residential construction are not yet in place either. The level of new construction activity is far below the long-term need, and continues to be constrained by the vacancy rate in residential properties, which remains above average. An improved sales situation on the back of low mortgage rates and tax incentives for house purchases, along with a turnaround on the labor market should gradually provide relief.

All in all, we expect to see a continued but relatively moderate recovery. After a drop of 2.4% last year, aggregate output in the US is likely to increase by 2.9% in 2010.

## Euro area

The economic picture in the euro area has brightened up. Coordinated and sweeping fiscal measures helped turn around the steep slump seen in the winter months of 2008/2009. The combination of stimulus packages, automatic stabilizers and the massive liquidity injections by the ECB prevented a sustained downturn in consumption.

In the course of 2009 leading economic indicators pointed to a swift and vigorous recovery. However, at the end of 2009 this was not fully confirmed. Gross domestic product expanded only marginally in the fourth quarter.

From the spring of 2009 Germany helped pull the euro area out of recession. France, which experienced a relatively weak slump in economic activity, saw steady GDP growth in the last three quarters of 2009. The economic picture in Italy was more mixed.

With regard to the economic outlook up to the end of 2011, we take a closer look at government consumption, exports, investment and private consumption:

- The stimulus measures pushed up government consumption in 2009. Although we saw a decline of 0.1% in Q4 2009, the stimulus packages will continue to have an impact in 2010. However, in the shadow of the current debt crisis debate raging in many European capitals, the issue of consolidation has moved back up to the top of the agenda.

- From their peak in April 2008, merchandise exports tumbled by 25%, down from EUR 136bn to EUR 102bn in May 2009. However, from May to December exports recorded growth of around 12%, climbing back to their August 2006 level.

  The marked rebound in the world economy, coupled with upbeat growth expectations in the emerging markets Brazil, China and India, will help underpin the economic upswing in the euro area. For most euro area countries external trade is a pivotal engine of growth. Once foreign demand starts to push up industrial resource utilization, the propensity to invest is likely to pick up again.

- Machinery and equipment investment closely reflects business reaction to the crisis. The steepest drops were recorded in Q4 2008 and Q1 2009, at -4.1% and -5.4% respectively. Thereafter the downward trend slowed markedly to -0.8% in Q4 2009. Although consumer and business confidence indicators started to pick up in the second half of 2009, surveys show that capacity utilization at 72% in Q1 2010 is still well below the average 82% recorded between 2000 and 2008.

- Private consumption stagnated in Q4 2009, after rising by 0.1% in the second quarter and falling by 0.2% in the third. The increase seen in the second quarter was attributable not least to the cash for clunkers scheme which was implemented successfully in a number of euro area countries. Given the high levels of household debt in a number of member states, households are unlikely to see any great opportunity to step up consumption. Up to 2011 we do not expect any pronounced boost to growth from private consumption.

All told, we expect to see overall growth in the euro area of 1.7% in 2010 and 1.5% in 2011.

## Japan

The Japanese economy has been on the road to recovery since the second quarter of 2009. Until recently, the incentives for environmentally friendly durable goods offered by the stimulus packages had a positive effect on consumption and resulted in a temporary expansion in public-sector investment. Nonetheless, it was not until the final quarter of 2009, when business investment stabilized, that overall domestic demand picked up slightly. The significant turnaround in foreign trade played a key role in helping the economy turn the corner. This is largely due to higher demand from its East Asian trading partners, which absorb more than half of Japanese goods exports. The export-driven boost to the economy will likely continue this year, albeit with lesser momentum. However, the improved sales situation should gradually reinforce business investment activity and the labor market. Household incomes, moreover, are improving also due to the government's permanent new child benefit initiative, so even after expiry of the incentives to purchase durable goods at the end of the year, a steep setback in private consumption is not necessarily on the cards. However public investment will be throttled

back sharply as early as 2010. Overall, we see aggregate output rising moderately by 1.8% in 2010 and 1.7% in 2011.

## Emerging markets

At present, signals in the emerging market regions eastern Europe, Latin America and Asia clearly indicate economic recovery. As regards the extent of this recovery, however, there are considerable differences - not only between regions but also between the individual countries in these regions. All in all, we expect the emerging markets to grow by 5.2% this year. Next year, we expect growth of 5.5%. The emerging markets are thus set remain one of the driving forces behind global economic development for the foreseeable future.

Years of heavy reliance on foreign capital proved to be eastern Europe's undoing in the latest financial and economic crisis. The consequence: Eastern Europe not only had to contend with the worst growth slump of all regions in the world in 2009, it appears that 2010 will also see only relatively modest economic growth, with momentum varying greatly from country to country. Thanks to its robust domestic demand and low dependency on foreign capital, Poland, for example, will be the only country in the region not only to have completely avoided recession in 2009 but to even record substantial growth; moreover, it is poised for sound expansion this year as well. Hungary, by contrast, which was forced to call on financial aid from the EU and the IMF in fall 2008 in order to avoid financial collapse, will at best stagnate in 2010 after the steep drop in GDP in 2009. The Russian economy is likely to fare better; with 4% real GDP growth expected, it will recoup at least around half of the economic output lost last year. Overall, we expect eastern Europe to grow in real terms by 2.7% this year. Thus, in terms of economic momentum, the region would bring up the rear among all major emerging markets for the second year in a row. The reason for this is obvious: It simply takes time to work off the immense economic disruption some countries experienced. We expect economic activity to pick up appreciably next year, with real GDP rising by 3.9%.

Following the steep slide seen in 2009, Latin America will record a marked economic recovery this year, driven by robust private consumption and rising investment activity. However, a closer look at the individual countries reveals considerable growth differentials, as in eastern Europe. Brazil, for example, is expected to grow by 5% in 2010, more than probably any other country in the region. And for Mexico we are penciling in a 3% increase. Venezuela, by contrast, can be expected to remain mired in recession this year as well, with the economy contracting by 1% on average. There are a variety of reasons behind the sizeable growth gaps. Brazil, for example, is reaping the fruits of its many years of stability-focused economic policy. This has made the country far less vulnerable to external shocks. Brazilian domestic demand was far quicker to find its feet again during the crisis than many other countries, and was thus rapidly able to more than offset weak export demand. In Venezuela, on the other hand, governmental mismanagement continues to escalate, which in turn impairs long-term growth prospects as well. Lastly, Mexico was simultaneously dealt several blows last year: by the economic slump in the USA, Mexico's most important trading partner; by the sharp swings in the oil price and not least by the outbreak of swine flu. GDP plummeted by more than 6%. The rise in output expected for 2010 will not even offset half the losses suffered in 2009. We expect real GDP growth of 3.5% for the whole of Latin America in 2010. For 2011, when the "laggards" have also more or less got back on their feet, we expect to see a 3.8% increase.

Asia is likely to be the region with the strongest growth again this year. Economic data for Q4 2009 is clear proof that Asian emerging markets closed the crisis year 2009 with considerable economic momentum. The ongoing pickup in world trade, the appreciable drawdown in industrial inventories, and the government stimulus packages in place in a host of countries until the end of 2010 aimed specifically at boosting domestic demand all point to a positive economic outlook for the current year. While consolidation pressure in Asia is on the low side compared to other regions in the world thanks to relatively sound public finances, allowing government stimuli to remain in place until the end of the year, there is already clear evidence of a gradual tightening of the monetary policy reins: For example, the central banks of India and Malaysia each jacked up their key rates by 25 basis points in March. Furthermore, China increased its minimum reserve ratio in the past few weeks. Additional measures such as raising the main policy rate can be expected in the months to come. Other Asian countries are also expected to begin normalizing monetary policy during the course of this year; although we expect no aggressive tightening overall. Concern about the stability of the upswing is still likely to be too widespread. We believe Asian emerging markets will grow by 7.3% in real terms in 2010. Next year the increase in GDP is likely to be somewhat weaker at 7%, largely due to the expiry of government stimulus packages.

**Growth rates in main economic regions**
**- GDP, real % change over previous year -**

| | 2006 | 2007 | 2008 | 2009 | 2010[1)] | 2011[1)] |
|---|---|---|---|---|---|---|
| **Industrialized countries** | **2.7** | **2.5** | **0.3** | **-3.4** | **2.1** | **1.9** |
| European Union | 3.2 | 2.9 | 0.8 | -4.1 | 1.5 | 1.6 |
| Euro area | 3.0 | 2.8 | 0.6 | -4.0 | 1.7 | 1.5 |
| Germany | 3.2 | 2.5 | 1.3 | -5.0 | 2.3 | 1.8 |
| USA | 2.7 | 2.1 | 0.4 | -2.4 | 2.9 | 2.3 |
| Japan | 2.0 | 2.4 | -1.2 | -5.2 | 1.8 | 1.7 |
| **Emerging markets** | **7.5** | **7.7** | **5.3** | **0.7** | **5.2** | **5.5** |
| Asia | 9.1 | 9.8 | 6.5 | 5.5 | 7.3 | 7.0 |
| Latin America | 5.4 | 5.6 | 4.0 | -2.4 | 3.5 | 3.8 |
| Central and Eastern Europe | 7.3 | 7.3 | 4.8 | -6.1 | 2.7 | 3.9 |
| **World** | **4.1** | **4.0** | **1.8** | **-2.1** | **3.1** | **3.1** |

1) forecast.

All in all, the global economy looks set to grow by 3.1% in both 2010 and 2011 (country weighting in each case based on current exchange rates), following a contraction of a good 2% in 2009. Accelerated growth in emerging markets in 2011 is likely to offset the expected slowdown in growth in industrialized nations.

We have made the following assumptions for our forecast:

- Real world trade is set to increase by 10% this year following the dramatic slump estimated at around 12% in 2009. Growth may decline to 6 - 7% in 2011.

- The annual average cost of Brent crude is predicted to be around USD 80 per barrel in 2010. In 2011, it is likely to be between USD 85 and USD 90 per barrel. The price of crude oil has meanwhile doubled since its lows at the end of 2008. The upward movement had already occurred before the actual rise in global oil demand. The latest prices already also likely reflect some of the expected rise in demand.

- Timing and scale of monetary policy normalization will vary, not least because the economies of the different countries have been affected to differing degrees by the financial crisis. Overall, aggressive tightening appears unlikely. Even with the first interest rate signals from the ECB and the US Federal Reserve in the latter part of this

year, the real interest rate level will remain extremely low in the euro area and the USA.

- The US dollar will not be subject to spectacular fluctuations in 2010 and 2011. The expected economic recovery in the US will bolster the dollar, but it will be undermined by the ongoing need for consolidation in the US economy. We see the euro at USD 1.36 at the end of 2010, and around USD 1.40 at the end of 2011.

# 2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

## 2.1 Upward forces retain upper hand

The German economy has been on a cyclical rebound since the second quarter of 2009, even if the recovery did appear to be stalling at the end of last year. Output and new orders declined in individual months, and the figures from the Federal Statistics Office flagged up flat gross domestic product in the fourth quarter of 2009. The severe winter weather even fueled fears that the German economy would fail to grow for two quarters in a row.

But the latest economic data point to a fairly positive start to 2010. There has been a strong surge in new orders, and manufacturing output in January was up slightly on the fourth quarter of 2009 despite the collapse in construction due to the weather. Business expectations in industry have brightened almost continuously from month to month.

Chart 3



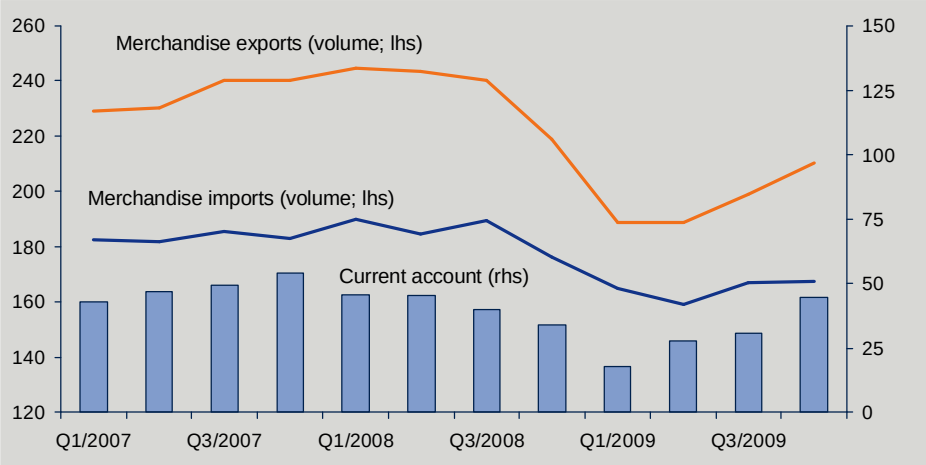
Exports are delivering a particularly powerful impetus, having already picked up during the second half of 2009 by 6½% in real terms. Since imports have not yet revved up on a comparable scale, the current account surplus widened dramatically in the course of 2009, from EUR 17bn in the first quarter to EUR 44bn in the closing three months, lifting it to a level very close to its highs at the end of 2007/beginning of 2008.

Given the drop in the external value of the euro and the intact global economic revival, German exports look very likely to stage a further increase in the course of this year. However, there is less probability of Germany's trade surplus also continuing to expand. So far German companies have hardly stepped up their imports at all, suggesting that they have not yet stocked up their intermediate inventories very much. Traditionally, these are built up in an upswing, generating additional demand. The corporate sector's restraint despite the rather upbeat business expectations is presumably due to the fact that in the aftermath of the financial crisis companies are still trying to tie up as little capital as possible in inventories. But as the economy increasingly finds its feet, so businesses will be obliged to purchase more intermediates to ensure that their output expands smoothly.

Chart 4

## Exports, imports and current account

EUR bn, seasonally adjusted




Consumer demand shored up the German economy in 2009, although high street spending did slacken during the second half of the year, especially after the "cash for clunkers" car scrappage incentive scheme was phased out. A key factor was the German labor market's very stout performance by international standards. There is hardening evidence to suggest that the robust trend will persist in 2010 and that the "rude awakening" on the jobs front forecast from time to time will not in fact materialize. Early indicators, such as the Federal Labor Agency's job index and the number of non-subsidized vacancies, already signal a slight recovery in employment. And although the number of short-time workers has since fallen by more than half a million, this has not been accompanied by a sustained slump in employment. All in all, we see the bias in 2010 towards a slight pick-up in consumer demand rather than towards stagnation, with demand for motor vehicles gradually steadying.

**Germany: Economic indicators and forecast***

| | | 2009 | | | | 2010 | | | | 2011 | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | 2009 | 2010f | 2011f |
| GDP real | | -3.5 | 0.4 | 0.7 | 0.0 | *0.5* | *0.9* | *0.6* | *0.6* | *0.3* | *0.3* | *0.3* | *0.6* | -5.0 | *2.3* | *1.8* |
| Private consumption | | 0.8 | 0.9 | -1.0 | -1.0 | *0.4* | *0.5* | *0.3* | *0.2* | *0.2* | *0.1* | *0.2* | *0.3* | 0.2 | *0.1* | *0.9* |
| Government spending | | 1.4 | 0.5 | 1.2 | -0.6 | *0.5* | *0.5* | *0.3* | *0.3* | *0.1* | *0.0* | *0.0* | *0.0* | 3.0 | *1.4* | *0.6* |
| Investment in machinery/equipment | | -18.4 | -0.5 | 0.8 | -1.5 | *3.0* | *2.0* | *2.0* | *2.0* | *1.0* | *0.5* | *0.5* | *1.0* | -20.5 | *5.6* | *4.8* |
| Construction | | 0.2 | 1.4 | 0.7 | -0.5 | *-3.0* | *3.5* | *1.0* | *0.5* | *-0.5* | *-0.5* | *-0.5* | *0.0* | -0.8 | *0.8* | *0.5* |
| Domestic demand | | -1.1 | -1.3 | 1.3 | -2.1 | *1.0* | *0.4* | *0.6* | *0.6* | *0.0* | *0.0* | *0.1* | *0.2* | -2.1 | *0.6* | *0.9* |
| Exports | | -10.4 | -0.7 | 3.4 | 3.0 | *1.0* | *2.5* | *1.5* | *1.5* | *1.5* | *1.3* | *1.5* | *2.0* | -14.2 | *8.3* | *6.3* |
| Imports | | -5.4 | -5.1 | 5.2 | -1.8 | *2.5* | *1.5* | *1.5* | *1.5* | *0.8* | *0.8* | *1.2* | *1.3* | -8.9 | *5.0* | *4.6* |
| Industrial production (excl. construction) | | -12.9 | -0.6 | 3.7 | 0.6 | *1.5* | *1.5* | *1.2* | *0.8* | *0.4* | *0.6* | *0.7* | *1.0* | -16.9 | *5.9* | *3.1* |
| Unemployment rate (EU def.) | % | 7.3 | 7.6 | 7.6 | 7.5 | *7.6* | *7.7* | *7.7* | *7.7* | *7.7* | *7.7* | *7.6* | *7.6* | 7.5 | *7.7* | *7.7* |
| Unemployment rate (nat. def.) | % | 8.0 | 8.2 | 8.2 | 8.1 | *8.2* | *8.3* | *8.4* | *8.3* | *8.3* | *8.3* | *8.2* | *8.2* | 8.1 | *8.3* | *8.3* |
| Employed persons (national def.) | y-o-y | 0.4 | 0.1 | -0.2 | -0.4 | *-0.4* | *-0.4* | *-0.3* | *-0.3* | *-0.2* | *0.0* | *0.1* | *0.2* | 0.0 | *-0.3* | *0.0* |
| Consumer prices | y-o-y | 0.8 | 0.3 | -0.2 | 0.4 | *0.7* | *0.9* | *0.9* | *1.0* | *1.0* | *1.4* | *1.6* | *1.7* | 0.3 | *0.9* | *1.5* |
| Consumer prices (HICP) | y-o-y | 0.8 | 0.2 | -0.4 | 0.3 | *0.7* | *0.8* | *0.9* | *1.1* | *1.3* | *1.4* | *1.6* | *1.7* | 0.2 | *0.9* | *1.5* |
| Producer prices | y-o-y | 0.9 | -3.6 | -7.4 | -6.3 | *-2.6* | *0.3* | *2.5* | *3.0* | *2.4* | *2.3* | *2.2* | *2.2* | -4.1 | *0.8* | *2.3* |
| Current account balance | EUR bn | 17.7 | 27.6 | 30.6 | 44.6 | *35.0* | *38.0* | *39.0* | *40.0* | *40.0* | *41.0* | *41.0* | *42.0* | 120.6 | *152.2* | *164.2* |
| | % of GDP | | | | | | | | | | | | | 5.0 | *6.1* | *6.4* |
| Budget balance | EUR bn | | | | | | | | | | | | | -79.3 | *-120.0* | *-106.0* |
| (Maastricht-definition) | % of GDP | | | | | | | | | | | | | -3.3 | *-4.8* | *-4.1* |
| 3-month money market rate **) | % | 1.5 | 1.1 | 0.8 | 0.7 | *0.6* | *0.7* | *1.0* | *1.3* | *1.5* | *1.8* | *2.0* | *2.3* | 1.3 | *0.9* | *1.9* |
| 10-year gov.bond yield **) | % | 3.0 | 3.4 | 3.2 | 3.4 | *3.2* | *3.4* | *3.7* | *4.0* | *4.2* | *4.2* | *4.0* | *4.0* | 3.3 | *3.6* | *4.1* |
| Exchange rate **) | USD per EUR | 1.33 | 1.41 | 1.46 | 1.44 | *1.35* | *1.30* | *1.33* | *1.36* | *1.37* | *1.38* | *1.39* | *1.40* | 1.39 | *1.35* | *1.38* |

*) 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.

The positive outlook for exports, the probable slight revival in private consumption and powerful stimuli from public sector demand, combined with catch-up effects as the weather improves, argue in favor of strong GDP growth as from the second quarter of 2010. We expect that at the end of 2010 gross domestic product will outperform its year-earlier level by a good 2½%. On average for the year this should result in economic growth of 2.3%.

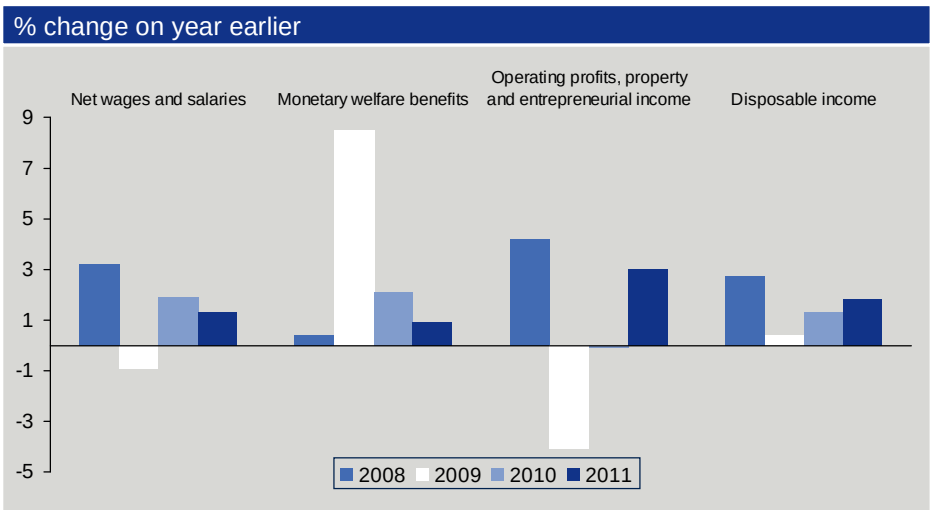
More difficult to assess is the impact that phasing out the economic stimulus packages at the end of 2010 will have on 2011. This year, the programs will create stimuli worth around EUR 55bn (through contribution cuts, increases in transfer payments and higher public spending) in comparison to 2008. But since most of the reductions in contributions and increases in transfers are of a permanent nature, some 2/3 of the stimuli will continue to feed into the economy. The restrictive effect stems chiefly from the phasing out of government spending, although some of the public infrastructure investment subsidized by the stimulus packages will not be complete in 2010. We estimate the negative fiscal stimulus in 2011 at around EUR 10bn. It will not choke off an intact, broadly-based economic recovery. What is more, tax cuts are planned for 2011, which we have not factored into the framework conditions for our economic forecast given their as yet nebulous shape and the uncertainty over their funding. We are penciling in a sharp slowdown in overall economic expansion in the first half of 2011 but expect the economy gradually to start gathering steam again towards the end of the year. For 2011 as a whole this will result in economic growth of 1.8%.

## 2.2 Limited potential for private consumption

2010 is not likely to bring either a collapse or a sustained revival in consumer spending. Although households will benefit from tax relief and additional government transfer payments worth almost EUR 20bn, the fallout from the economic crisis will still put a serious damper on the general development in incomes.

Chart 5

### Private household disposable income




Unlike 2009, actual earnings per employee this year are set to edge up a little, by 1.3%; however, the drop in employment means the increase in gross labor incomes will be marginal, at around 1%. But the lighter contributions load will at least allow net labor incomes to climb by about 2%. For 2011 we expect both gross and net labor incomes to grow by approximately 1½%. At 3% and 1% respectively, monetary social benefits in 2010 and 2011 will rise considerably less than last year's 5.2% due to the reduction in short-

time work and the likelihood of substantially lower pension adjustments. All in all, we expect to see mass incomes increase less in 2010 and 2011 (by 2% and a mere 1% respectively) than in the crisis year 2009, when they jumped 2.6%. However, profit income should develop better in 2010 and 2011 than in 2009. Having fallen by 4% last year, we expect mixed income and entrepreneurial and property income to be flat this year and then to grow again by 3% in 2011.

All told, disposable incomes will probably rise by 1.3% in 2010 and 1.8% in 2011, barely more than the erosion of purchasing power by inflation, which we are penciling in at 0.9% in 2010 and 1.5% in 2011. The development in real incomes thus leaves very little leeway for higher consumption. Some impetus could potentially come from a diminishing savings rate, which in 2009 hit its highest level since 1995 at 11.3%. But given the uncertainties surrounding the labor market, we see the savings rate holding its high tide mark for 2010, before possibly dipping slightly below 11% in 2011. Consequently, private consumption looks set to remain virtually flat this year in real terms, ticking up by a meager 0.1% and then expanding in 2011 by 0.9%.

## 2.3 Investment demand slow to bounce back

Machinery and equipment investment, which in 2009 collapsed by more than 20%, should rebound in the course of 2010.We see the development in capacity utilization and corporate earnings as the key determinants of investment demand. At present capacity utilization in industry is still very low, although it has already hauled itself up from its trough by several percentage points, climbing from 71.3% in April 2009 to 75.0% in January 2010. Company earnings also staged a surprisingly rapid recovery in the second half of 2009. In the fourth quarter of 2009 entrepreneurial and property income was already around 15% higher than in the second quarter of 2009. This naturally improves the financial scope for investment, even though we do expect companies to try and hold relatively high liquidity reserves. More substantial investment projects will presumably be embarked on only if they do not cause any notable deterioration in the company's liquidity situation. We expect corporate credit demand to remain extremely muted, making only a moderate recovery in investment activity likely from this quarter. On average for 2010, our forecast is for machinery and equipment investment growth in the region of 5½%. In 2011 the increase should be around 5%. However, in terms of renewal and expansion of the capital stock, which has the effect of unlocking further growth potential in the medium term, the level of investment remains wholly unsatisfactory.

A slight 0.8% increase in construction spending is on the cards for 2010. Public sector construction will undoubtedly provide the most powerful boost, expanding by an estimated 15%. However, since the volume of commercial construction is roughly three times and the volume of housing construction roughly five times that of public building works, strong growth in public sector construction does not imply a similar performance by the construction sector as a whole. We expect commercial construction spending to register a downturn of an estimated 5% in 2010, since it generally lags machinery and equipment investment in the economic cycle (due partly to longer planning times). The picture is looks somewhat brighter for housing construction, where extremely low mortgage rates are sure to encourage maintenance and modernization work. So despite a decline in residential new builds, housing construction overall should notch up marginal growth.

In 2011, with the economic stimulus packages coming to an end and very straitened general government budgets, public sector construction spending seems set to shrink, although the trend will not yet be all that marked for the year as a whole since not all

state-subsidized construction projects will have been completed by the end of 2010. On the other hand, commercial construction should develop more satisfactorily in 2011. With machinery and equipment spending starting to pick up already in 2010 and capacity utilization enjoying steady improvement, at least a slight increase in commercial construction investment is probable for next year. Similarly in 2011, cautious optimism is justified for housing construction. But all in all, we expect no more than a scant expansion of 0.5% in construction expenditure next year.

## 2.4 Rebound in exports

Having contracted by around 14% last year in volume, German exports are benefiting in 2010 from the recovery in world trade. We estimate that international trade will expand by around 10% in 2010 and German shipments by a good 8%. The slightly below-average growth in German exports on an international comparison is due to the preponderance of capital goods in Germany's export range. Low capacity utilization in many economies is initially making global capital investment demand less responsive to the business revival than other sectors, and in some cases also with a time lag. But in 2011 demand for capital goods should have caught up with the economic trend. Viewed in this light, German exports in 2011 stand a good chance of rising by upwards of 6%, falling into step again with the 6-7% rate of increase in world trade.

German imports will presumably expand by roughly 5% in 2010 and about 4½% in 2011, a little less than exports. On the assumption that there will be no notable shift in the terms of trade – the ratio of export to import prices – in 2010 and 2011, this will set Germany's trade surplus on a distinctly upward path. We see the current account surplus, which at EUR 120bn in 2009 was equivalent to just 5% of GDP, escalating to around EUR 150bn in 2010 (roughly 6% of GDP) and to between EUR 160 and 170bn in 2011 (roughly 6½% of GDP).

## 2.5 Deflation no longer an issue

Negative inflation rates at times last year fueled concerns that deflationary tendencies could take a firm hold. But these fears have since dissipated. Commodity prices are clearly heading north. Having fallen more than 10% below their year-earlier levels from time to time in 2009, import prices have turned positive again year-on-year, gaining around 5% within the past six months alone. Producer prices are also picking up once more, albeit only moderately. Still, this January's index was roughly 1% higher than in the fourth quarter of 2009. And wholesale prices in February 2010 jumped by fully 2.1% on the same month of the previous year, registering their strongest rise for a year and a half.

We expect the increase in consumer prices in the early part of 2010 to hit 1% and then hover around this level in the further course of the year. For 2011 we are reckoning on an average inflation rate of 1.5%. In our assessment, the uptick in high street prices this year and next will thus remain very muted. Although commodity prices are likely to remain on an upward path, relief can be expected from wage costs. Given the critical situation on the labor market and almost complete wage restraint on the part of the metalworkers, the increases in pay rates for 2010 and 2011 will come in even lower than the 2.3% hike negotiated in 2009. With labor productivity on track to deliver a marked improvement on the back of economic revitalization, unit labor costs should drop sharply during 2010. Companies will probably succeed in slightly widening their profit margins without having to raise their prices substantially.

## 2.6 Very little further increase in unemployment

The German job market has weathered the gravest economic crisis in many decades far better than was to be expected. From autumn 2009 to spring 2010 unemployment has climbed by roughly a quarter of a million. Considering that an increase of up to two million had been expected at times during the crisis, the labor market has proved extremely resilient. The main reasons for this are that the German government's short-time working scheme took a lot of pressure off the job market, that companies were better equipped with equity than in previous economic crises and part of the economy (services sectors) escaped the clutches of recession and continued building up employment.

Chart 6

### Germany: Number of people in work and unemployed

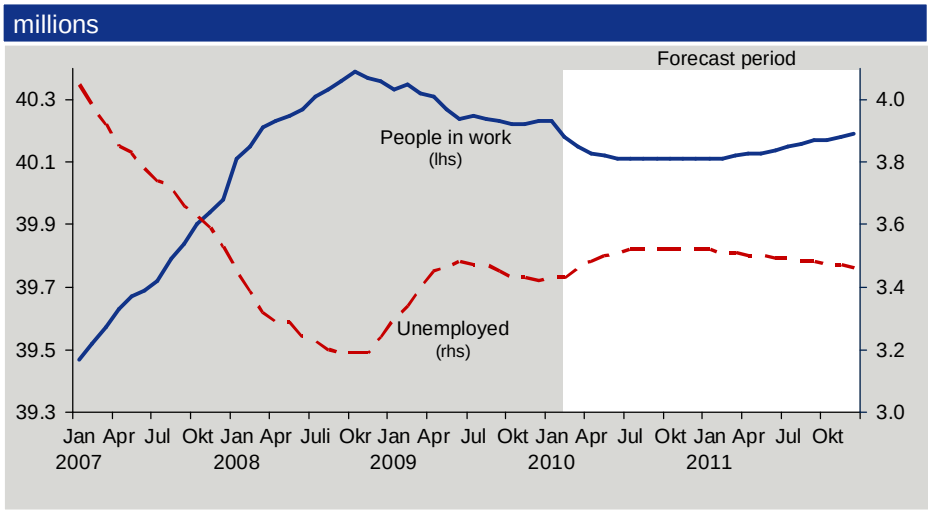
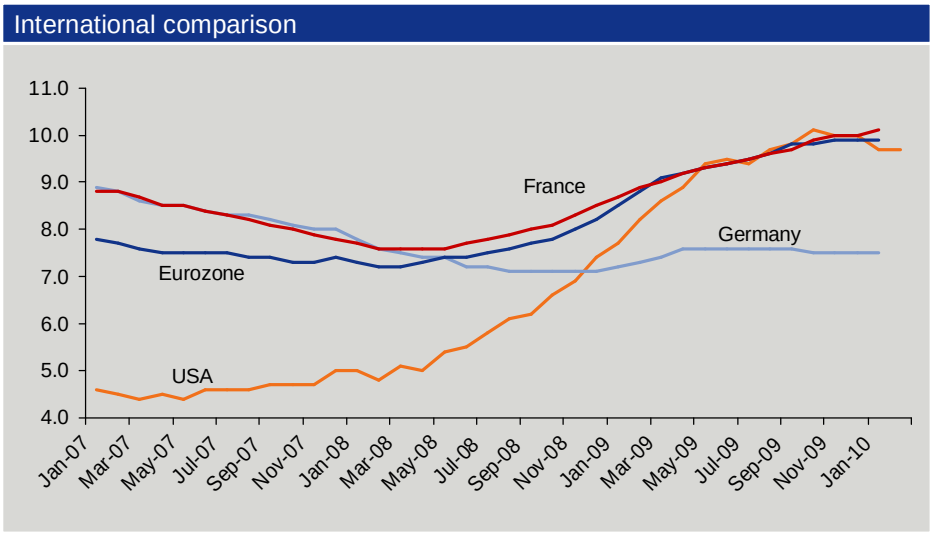


Chart 7

## Harmonized unemployment rate in %




Nor do we expect the situation on the labor market to deteriorate much further in the course of this year. For one thing the number of short-time workers is now sinking fast. At the end of last year 600,000 fewer people were already registered on short time than in the spring of 2009. As the number of short-time jobs decreases so, too, does the risk of short-time work ultimately culminating in job losses for a large number of employed persons. Another positive is that forward indicators on the job market, such as the Federal Labor Agency's job index and the number of non-subsidized vacancies, have already been edging up for some months.

We expect to see seasonally adjusted unemployment figures continuing to climb until mid-2010 and then to remain broadly steady at the level reached. A slight decline in joblessness is possible in the course of 2011, given a marginal increase in employment and a demographically induced drop in the labor force. On average for the years 2010 and 2011 not quite 3.5 million people will therefore be out of work, only about 70,000 more than in 2009.

## 2.7 Government debt manageable

Although new public-sector borrowing did soar in 2009 to 3.3% of GDP, the debt ratio is still comparatively low by international standards. However, Germany will step up its new borrowing appreciably again in 2010, chiefly because the measures contained in the government's economic stimulus programs are concentrated around 2010. This year the stimuli from the discretionary fiscal measures provoked by the economic crisis will represent an estimated 2.1% of GDP, compared with 1.4% in 2009. We estimate the German public deficit this year at 4.8% of GDP – a slightly more upbeat assessment than the official government projection, which envisages a public deficit equivalent to 5½% of GDP, based on a more skeptical economic forecast. In line with ECOFIN recommendations, the German government is aiming to restore new borrowing to not quite 3% of GDP by 2013, a target that we do not consider overly ambitious. Assuming that the annual step-up in public spending remains two percentage points behind the growth in gross domestic product and the contribution rate is held steady relative to GDP, the German deficit can realistically be trimmed by almost one percentage point a year. A moderate development in spending will be encouraged in 2011 by expiry of the infrastructure investment contained in the economic stimulus packages. Given

disciplined spending behavior by all layers of government, scaling down new borrowing to 2% of GDP by 2013 would therefore be quite feasible. An almost balanced budget could conceivably be presented as early as 2015. Indeed, this would be crucial to a gradual reduction in the debt-to-GDP ratio, which in 2012/2013 is set to break through the 80% barrier, if only marginally.

## 3. "THE GERMAN BUSINESS MODEL" – OBSOLESCENT?

The financial and economic crisis has once again made it abundantly clear just how reliant Germany's economic performance is on the development of the international environment. The economic crisis shaved 5% off the real gross domestic product (GDP) of the several times "export world champion" in 2009, whereas economies who owe more of their GDP to domestically-geared sectors suffered less of a setback. So should Germany stick with its industry-driven focus on exports – known as the "German business model" – in its current form? And what would an alternative strategy look like?

### 3.1 The situation as it stands

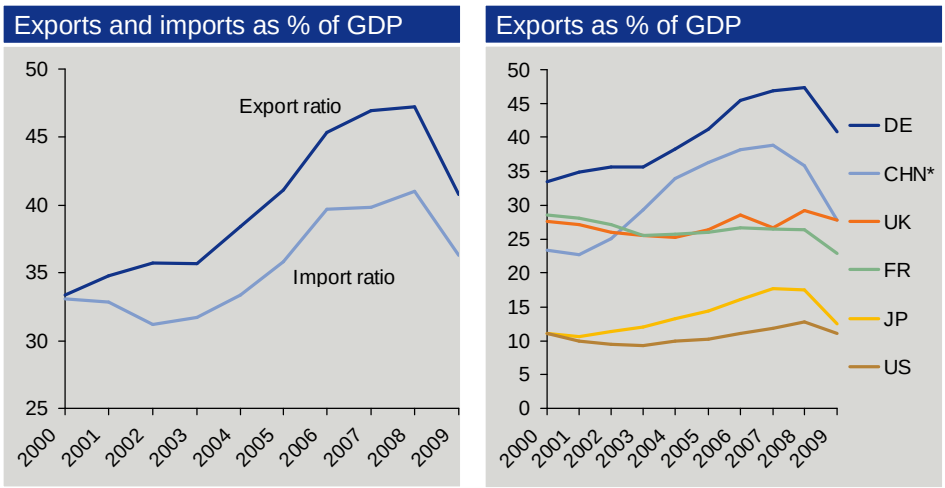
The term "business model" refers neither to a strategy coined by a macroeconomic planning expert, nor to the sort of business model that we know from the world of commerce. Rather, the term is used to describe Germany's industry-driven focus on exports.

An economy's export ratio – i.e. the ratio of the value of its exports to its GDP – is one way of measuring how export-focused it is. This ratio shows what proportion of the goods and services manufactured domestically are destined for abroad. As Figure 8 shows, the period stretching from 2000 to the crisis was characterized by a steady increase in the export ratio. Whereas in 2000, goods and services worth 33.4% of GDP were exported, this figure had risen to 47.3% by 2008. This means that, from 2000 onwards, exports became significantly more important to the German economy. The crisis, however, brought the 2009 export ratio down by 6.5 percentage points to 40.8%. The comparison of the export ratios of various industrialized nations, and that of China, illustrated in Chart 8 shows just how exceptional the role that exports play on the German economy is at international level.

A glance at Chart 8 also illustrates that Germany enjoys not only a high export ratio, but also a substantial import ratio, earning it the status of an open economy. The degree of openness – total exports and imports expressed as a proportion of GDP – has doubled since the 1990s, and came in at as much as 88.3% in 2008 (77% in 2009).

Chart 8

## German foreign trade



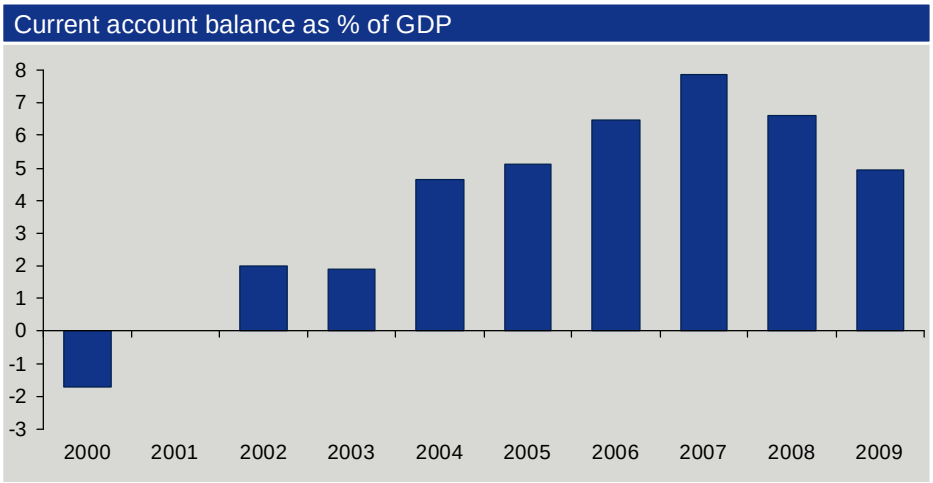

Sources: Eurostat, Ecowin.
* Exports according to current account statistics; 2009: Estimate.

Nevertheless, Germany's exports clearly outstrip its imports, resulting in a substantial current account surplus. A positive current account balance implies a negative capital account balance, which corresponds to the difference in value between capital imports and capital exports. This means that a current account surplus goes hand-in-hand with an outflow of capital abroad in the form of direct investment, securities investments or loans granted to foreign borrowers, and equates to an increase in the international investment position.

As Chart 9 shows, the ratio of Germany's current account balance to its GDP rose from around minus 2% in 2000 to somewhere in the region of 8% in 2007. The decline in German exports triggered by the crisis brought the ratio of the current account balance to GDP down to 6.6% in 2008 and to around 5% in 2009.

Chart 9

## German current account balance



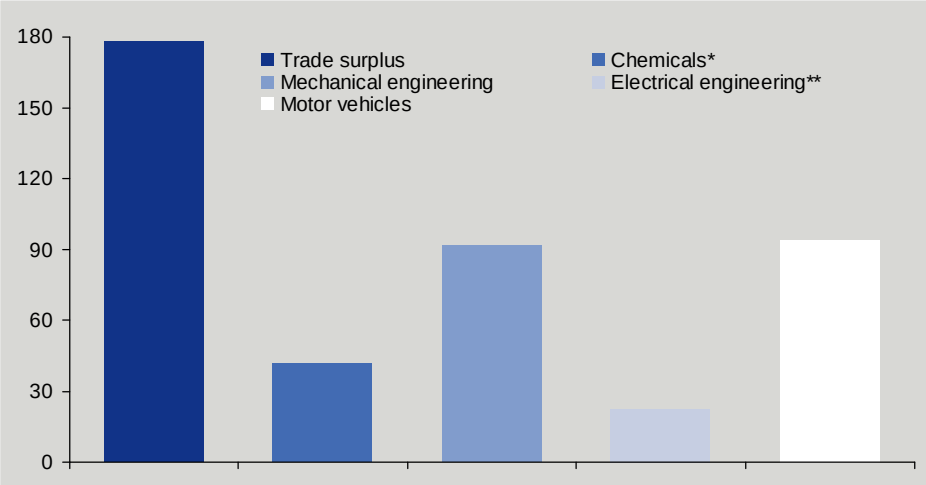

Source: Statistisches Bundesamt.

Although Germany's exports exceed its imports on the whole, Germany imports more services than it exports. Consequently, the positive current account balance is achieved on the basis of goods exports, which is why Germany's export focus is said to be industry-driven. Germany's trade surplus totaled around EUR 178bn in 2008 – the second-largest trade surplus in the world. This surplus was generated primarily by the vehicle manufacturing, engineering, electrical engineering and chemicals industries. Figure 10, which shows the surpluses generated by these sectors compared with the trade surplus as a whole, provides a good illustration of this. These industries accounted for 62% of Germany's exports in 2008.

Chart 10

## Surpluses of individual goods categories

Surplus 2008 in EUR bn



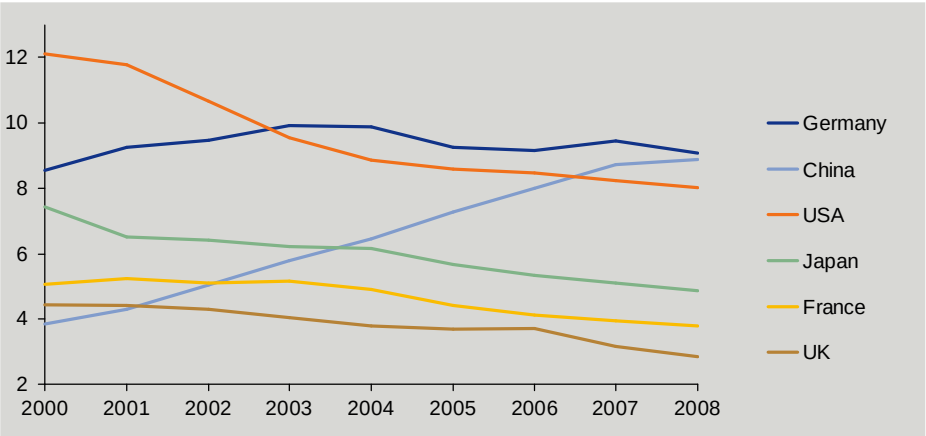

Source: Deutsche Bundesbank.
* Chemical and pharmaceutical products. ** IT equipment, electronic and optical products and electrical equipment.

The global trade volume has been following a steady upward trend over the past decade. Germany's share of global goods trade has remained more or less constant since 2000, as Chart 11 shows. While China's share of the cake has increased dramatically, other industrialized nations have seen their share of global goods trade dwindle. This means that Germany is the only larger industrialized nation that has managed to more or less

Chart 11

## Development of international foreign trade

% share of global merchandise trade in %




Sources: World Trade Organization, Statistisches Bundesamt, Ecowin.

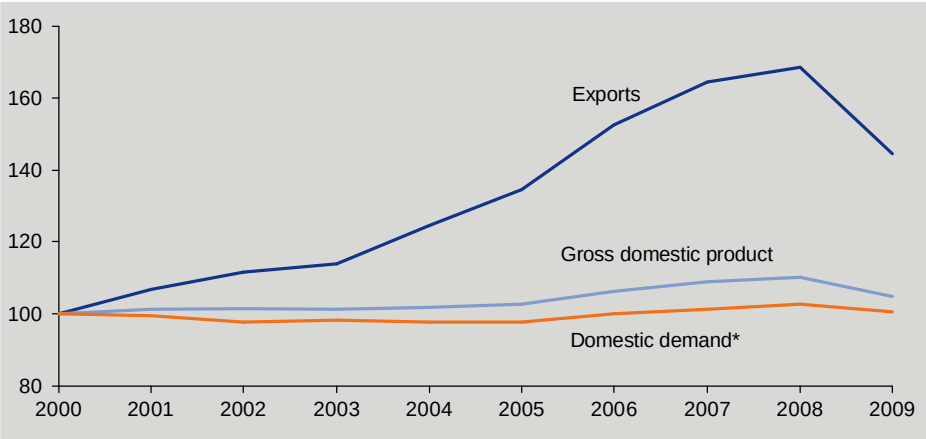
defend its share of the global market. In nominal terms, German goods exports climbed from EUR 596bn in 2000 to EUR 981bn in 2007. Even in 2008, exports rose further to EUR 1.1 trillion, before slumping to EUR 826bn in the wake of the crisis.

The development of German exports in the period leading up to the crisis appears all the more extraordinary if we compare it with the GDP and domestic demand trends. Chart 12 shows that, unlike GDP and domestic demand, there was a huge increase in exports from 2000 onwards. In 2008, real exports were almost 1.7 times as high as in 2000. By contrast, Germany's GDP in 2008 was up by only 10% on 2000, while domestic demand was a meager 2.8% higher. Nevertheless, the crisis has hit exports the hardest in relative terms.

Charts 12

## Exports and domestic demand

Price adjusted, chain index (2000=100)




Source: own calculations.
* domestic use: consumption + gross investment.

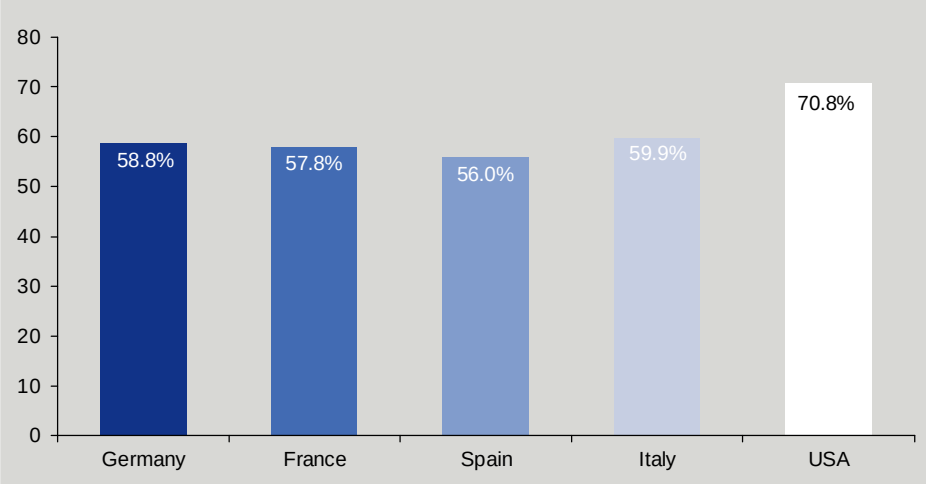
What is more, since part of domestic demand is aimed at foreign goods and services and is satisfied by imports, the weak domestic demand trend witnessed over the past few years has meant that imports have been lagging increasingly behind exports. This is one of the reasons behind in the increase in the current account surplus.

The question is which domestic demand components – investment or consumer demand – are at the root of the weakness. Debate tends to focus on insufficient consumer demand, the argument being that increasing the ratio of consumption to GDP would boost domestic demand and, as a result, strengthen imports. But the average propensity to consume in Germany, i.e. consumer spending expressed as a proportion of GDP, is not as low as it once was. At 58.8%, it is in the middle ranks in a comparison with other industrialized nations, as Figure 13 shows. This casts some doubt over whether low average propensity to consume is really the main problem.

Chart 13

## Consumption ratios

Private household consumption as % of GDP (2009)



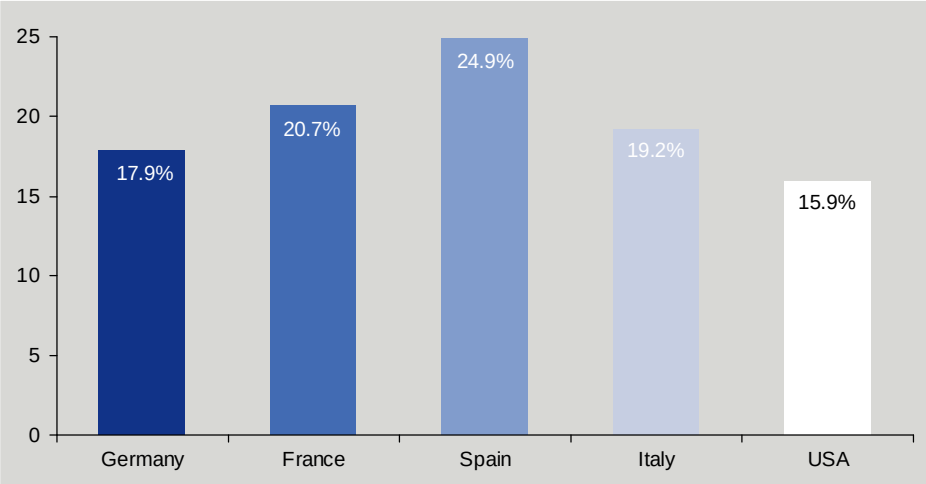

Source: Eurostat.

A glance at the investment ratios, i.e. the proportion of investment spending to GDP in each case, set out in Chart 14, however, shows that investment levels in Germany are relatively low at 17.9%. Spain, France and even Italy have higher investment ratios, suggesting that this is an area that offers potential as far as boosting domestic demand is concerned.

Chart 14

## Investment ratios

Investment expenditure as % of GDP (2009)




Source: Ecowin.

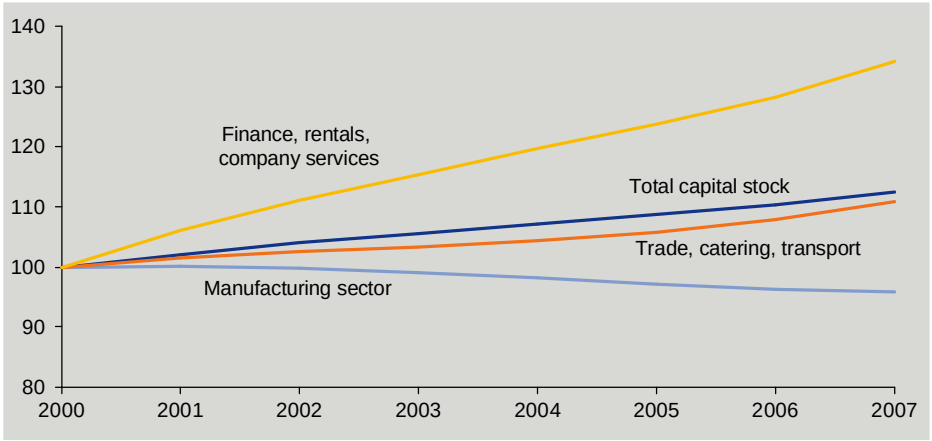
A low investment ratio means lower growth in capital stock. Chart 15 shows the development of the capital stock of the economy as a whole and in individual areas of the economy from 2000 onwards. After adjustments for price differences, the total capital stock had, nevertheless, risen by 12% by 2007. By contrast, the capital stock in the manufacturing industry fell by around 4% during the same period. The significance of the manufacturing industry in terms of implementing technological innovations and

ensuring Germany's competitiveness means that this trend is cause for concern. All the same, the capital stock in the financing, leasing and corporate services sectors rose by 34% between 2000 and 2007, a trend that is in line with the contribution that the service sector has made to cutting unemployment over the past few years.

Chart 15

## Capital stock in Germany

Gross non-financial investment at year 2000 prices




Source: Statistisches Bundesamt.

## Where the debate stands now

The views that have been voiced on Germany's export-driven economy over the past few months often diverge considerably. This is due to conflicting perspectives as far as the economic mechanisms are concerned, but primarily to differing ideas about what the ultimate objectives should be.

Three camps appear to dominate the debate. The *growth perspective* that is often addressed in public debate in Germany, asks whether the direction in which the German economy is currently headed will be able to deliver strong economic growth. The *stability perspective*, on the other hand, is concerned with current account imbalances as a source of international and, in particular, inner-European instability. Those arguing based on the *distribution perspective* take a different approach and criticize the growing chasm in income distribution in Germany, which they see as the result of the emphasis Germany places on exports.

### The growth perspective

Up until the Greek debt crisis thrust Germany's current account surplus into the limelight, public debate in Germany was primarily concerned with whether or not the country's export focus would allow it to achieve its objectives of high economic growth and – as a complementary goal – low unemployment in the future. There is a broad spectrum of opinions in this respect.

Some voices continue to see the export-driven economic model as a guarantor of high growth, arguing that the country's focus on exports has spurred growth to date, and that export demand is now working its way back to full strength following the downturn

triggered by the crisis. Member of the German Council of Economic Experts, Christoph Schmidt, for example, refers to the current situation as an out-of-the-ordinary one that should not entice us to draw any wrong conclusions. He believes that the wage restraint exercised in recent years has been a factor in Germany's success, and, given that the number of people out of work remains high, calls for it to be maintained in the years to come. Bert Rürup also expects to see high growth in global trade in the future, and believes that Germany should hedge its bets with exports in this respect, also in light of the weak potential offered by the domestic demand side due to the ageing population. He recommends that the country pursue a "high productivity strategy" and aim to improve education standards among the population at large.

Others, however, view the role that exports play in securing growth with a somewhat more skeptical eye, and are calling for stimulus to boost domestic demand. Wolfgang Franz, for example, who is also a member of the German Council of Economic Experts, is of the opinion that Germany is advised not to rely on a foreign demand revival alone, and calls for better education and more investment incentives in Germany to "create jobs, boost incomes and, in doing so, stimulate private consumption". Franz also recommends that wage restraint remain on the agenda. The consultancy firm Prognos takes a similar view, and also expects to see the demand for German export goods dip in the medium term. Prognos recommends that domestic demand be strengthened by increasing net wages, a move that it believes will require continued wage restraint, more of an incentive to work, lower tax burdens and public-sector investments.

Presumably the most strident criticism of the German economy's reliance on exports from a growth perspective comes from the President of the Ifo Institute for Economic Research, Hans-Werner Sinn. He describes the status quo of the Germany economy as a pathological recipe for low economic growth. Sinn's theory is that the focus on exports was adopted when, faced with increasing low-wage competition from abroad, German wage policy and the social security system made low-skilled labor in Germany too expensive in relative terms. This, he feels, meant that labor-intensive sectors of the manufacturing and service industries were destroyed before their time. Part of the capital that was freed up as a result then made its way into the export industries, inflating them artificially. Low-skilled workers, however, were pushed into unemployment. Sinn believes that the value added that was lost as a result is to blame for low economic growth. Unlike many, he does not agree that the strong focus on exports came as a result of a successful role played by Germany in international competition thanks to low wage agreements. Rather, he believes that it is rooted in Germany's refusal, expressed in the form of the country's high wages and social security benefits, to enter this very competition as far as low-skilled work is concerned. Sinn's solution would be based on measures to get low-skilled workers back on to the job market, including the continuation of the Hartz IV reforms and better education.

### The stability perspective

As the Greek debt situation started to escalate, the international community, in particular, started to pipe up with criticism of Germany's current account surplus and the associated increase in international debt owed to Germany. Since the current account surplus is the result of the extent to which exports overshadow imports, this can be viewed as a critique of Germany's focus on exports at the same time. There are particular concerns that Germany's EMU partners might become overindebted, putting the stability of monetary union at risk and potentially leading to a situation in which "the idea of European unity blows up in our faces", to use the words of UNCTAD economist Heiner Flassbeck and Friederike Spiecker. Pisa-based professor and economist Stefan

Collignon is one example of the criticism being leveled against Germany, accusing the country of growing at the expense of its indebted partners.

The solution to the problem is usually cited as being to stimulate German domestic demand – a view championed only recently by the Managing Director of the International Monetary Fund, Dominique Strauss-Kahn, and the French finance minister Christine Lagarde. The idea behind this proposal is that stronger domestic demand is associated with higher imports, which in turn serves to reduce the current account deficit.

Wage rises are often proposed as a tool to strengthen consumer demand directly. In terms of specific suggestions, Luxembourg's Prime Minister Jean-Claude Juncker, for example, proposes that public-sector wages be increased to lift wage levels as a whole. This, he argues, would set a macroeconomic trend, meaning that the impact would also extend to wages outside of the public sector. Apart from the fact that the first step would have to involve assessing how effective a wage hike would be in terms of boosting consumption in the medium term, such a move would certainly make Germany less competitive. Exports and the current account deficit would fall as a result. The question that springs to mind here is whether reducing Germany's exports isn't the actual objective of these views.

An editorial article published in The Economist, on the other hand[1] calls for investment and consumption to be stimulated by way of deregulation, making the job market more flexible and implementing reforms to the health, social security and education systems. Unlike wage increases, these are measures that can be expected to *boost* Germany's competitiveness. The underlying theory is apparently that Germany has created too many hurdles to employment due to its inflexible structures and high tax burden, and that, by removing these hurdles, investment levels would rise, shortly followed by consumer spending.

### The distribution perspective

Increasing income disparity, which has been more marked in Germany than in any other OECD country since 2000, has already been a subject of public debate in Germany for some time now. Gustav Horn, Simon Sturn and Till van Treeck link[2] this trend to Germany's focus on exports coupled with sustained weak demand. They believe that the rising disparity is the result of wage restraint and the reforms implemented on the labor market and in the country's social security systems over the past few years. In their view, however, these measures – which were designed to make Germany more competitive – have gone further than necessary, and are fused with an ideology of distributing wealth from the poor to the rich.

Consequently, they support the argument put forward by Jean-Paul Fitoussi and Joseph Stiglitz, who point out that the propensity to consume falls proportionally to income levels. Fitoussi and Stiglitz argue that increasing income disparity driven by rising incomes for high wage-earners is the reason behind the low propensity to consume at macroeconomic level, giving rise to sustained weak demand in Germany. In their opinion, more even income distribution would boost the propensity to consume and stimulate domestic demand, bringing unemployment and the current account surplus down. This means that taking measures to distribute incomes more evenly would not

[1] The Economist, 13 March 2010.
[2] Horn, G. / Sturn, S. / Van Treeck, T.: Die Debatte um die deutsche Exportorientierung. In: Wirtschaftsdienst, Volume 90, 2010, no. 1.

only have a distribution effect, but could also help solve problems like unemployment and international imbalances.

## 3.2 Outlook and recommendations

When attempting to answer the question as to how the structure of the German economy will develop, a distinction has to be made between the shorter and the longer term. In the shorter term, the focus is on economic development – the time frame being one to two years. In the longer term, the main issue is an economy's growth potential, the time frame here being one spanning at least three to five, if not ten years.

### The economic aspect

The German economy has been operating well below capacity in the aftermath of the severe financial crisis that hit in 2008/09, particularly as far as the industrial sector is concerned. An Ifo test put utilization in the industrial sector at only 75% at the start of the year, compared to as much as 85% in 2008. In Germany's key sectors, engineering and vehicle manufacturing, capacity was recently as low as 72%. The longer capacity utilization remains as low as it is at the moment, the higher the risk, despite the regulations on reduced working hours, of massive job cuts that could cause domestic demand to plummet. This means that Germany is in dire need of a rapid economic recovery to ensure that it can climb its way back to normal capacity utilization levels sooner rather than later. In our view, there is no doubt that the export engine will have an important role to play in making this possible. In order to save jobs in Germany's major industries, a recovery in export demand is an absolute must. It is simply impossible to imagine that the production capacity available in Germany's engineering and vehicle manufacturing industries can be utilized by additional domestic demand in the short term. An estimated 9 million people in Germany currently work for the export industry (compared with 8.4 million in 2005 according to the German Federal Statistics Office). The fact that exports slumped by more than 18% between Q2 2008 and Q2 2009 means that around 1½ million people would have to fear for their jobs if the export volume remained stuck at the level seen in the first three months of 2009 in the long term. Fortunately, export demand was already on the mend in the last two quarters of 2009, a trend that is likely to continue in 2010 and 2011. We expect the volume of German exports to have climbed back to the level seen in early 2008, when the crisis struck, by the end of 2011. This would also ensure that any job cuts affecting individuals working in the export industry would remain within bounds.

Unlike in other industrialized nations, Germany has not seen any slowdown in consumer demand as a result of the economic crisis. In actual fact, private consumption in Germany increased slightly in real terms in 2008 and 2009. Real private consumption was hit hard in Spain (-5.6%), Italy (-2.5%) and the UK (-2.2%) in 2008 and 2009, and was dealt a minor blow in Japan (-1.6%) and the US (-0.8%). France was the only country in which private consumption growth outperformed the increase witnessed in Germany. Given the high savings ratio in Germany and a labor market that is stable in an international comparison, Germany has a fairly good chance of achieving growth in real consumer demand in 2010 and 2011, too. If this materializes, private consumption – the largest component of domestic demand – will have fared relatively well during the economic crisis, and will have made a key contribution to stabilizing the German economy.

## The growth aspect

Over the last few decades, globalization has significantly increased trade ties between economies. Global trade has shown very dynamic growth as a result – growth that by far outstrips the growth in global production. Exports have delivered substantial economic impetus in those countries that have proven their competitive edge. Focusing on exports is a strategy that has paid off. Whether or not this will continue to apply in the future depends on where globalization goes from here. We are quietly optimistic in this respect and expect that, although globalization will not progress in the leaps and bounds seen in the past, the trend towards increased protectionism and regulation will only hinder the expansion of international trade to a limited extent. Consequently, it would be downright absurd for any economy to make a conscious decision to forgo the growth contributions made by exports. Not to mention the fact that countries low on raw materials, like Germany, rely on having an export base.

If we consider the factors set out above, Germany looks set to remain an export-focused country in the future. The emphasis is likely to remain on exports of machinery, cars and chemical products – all of which are capital-intensive goods.

It is not, however, necessarily the case that export-driven economies have to have a foreign trade surplus. It is a common misinterpretation to measure export strength on the basis of the current account balance. A high export surplus can also be attributable to low domestic demand and to factors that make a country less attractive as a business location.

There is no doubt that strong domestic economic growth helps to reduce any foreign trade surplus by boosting imports. Strong domestic demand is not, however, something that can be pushed through by policymakers. Ultimately, the lion's share of domestic demand is determined by private households and the corporate sector. The only thing the state can do is to make sure that the overall environment is favorable.

We believe that Germany harbors domestic demand potential that has yet to be exploited. Our diagnosis, however, suggests that this does not relate first and foremost to insufficient consumer demand – as is often claimed - but primarily to a lack of investment demand. When the acquisition of non-financial assets by German companies (non-financial corporations) in 2009 accounted for only 3.1% of GDP, and that this was actually the highest value since 2000, when the foreign direct investment made by Germany outstrips foreign investment in Germany by just shy of EUR 200bn (2007), when German industry has not increased its capital stock in Germany since 2000, then we can no longer speak of isolated indicators of Germany's weakness as a business location. Germany is not attractive enough for investment. And it comes as little solace that other major economies like the US and the UK appear to be faced with similar problems given their low investment rates.

Boosting investment activity in Germany would bring a whole range of positive effects along with it: it would call for technological innovations to be implemented, would increase productivity, boost the medium-term growth potential, create jobs and, by fostering an improved situation on the labor market, would stimulate consumer demand.

## Focal points of economic policy

A favorable backdrop for investment can only be achieved by implementing a growth policy geared to the long term. There are a whole number of factors that can affect how attractive an investment location is. In our view, the main factors that policymakers are in a position to influence are:

- good public infrastructure,
- high education levels and a highly-skilled workforce,
- low labor costs in relation to productivity,
- a flexible labor market,
- a tax system that is friendly to the corporate sector and ensures that there is an incentive to work,
- efficient and streamlined bureaucratic structures.

Germany has made significant progress over the past few years on a number of these fronts, for example as regards a flexible labor market and a tax system that is more business-friendly. It is, however, important to bear in mind that many countries are trying to make themselves more attractive for investment. Despite the progress made in specific areas, it is not certain whether Germany has made itself more attractive as an investment location in an international comparison. More and more emerging markets have established themselves as interesting investment locations. They lead the field thanks to their low labor costs, rising productivity, low taxes, infrastructure improvements and increasing legal stability. Industrialized countries with high labor costs – a group that doubtless includes Germany – will therefore have to put a great deal of effort into remaining attractive for investment. In the coming years, every effort should be devoted to promoting the propensity to investment at home.

Nevertheless, our proposals are justified for reasons other than those relating to growth. There is no doubt that strong domestic economic growth helps to reduce the foreign trade surplus by increasing imports, and this would also be of benefit to Germany's European partners without undermining Germany export prowess. Boosting the domestic economy also creates jobs. This would allow many people who are currently condemned to unemployment to earn their living themselves, giving them a better quality of life. Low unemployment would also help to counteract income disparity.

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