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Economic forecast 2011

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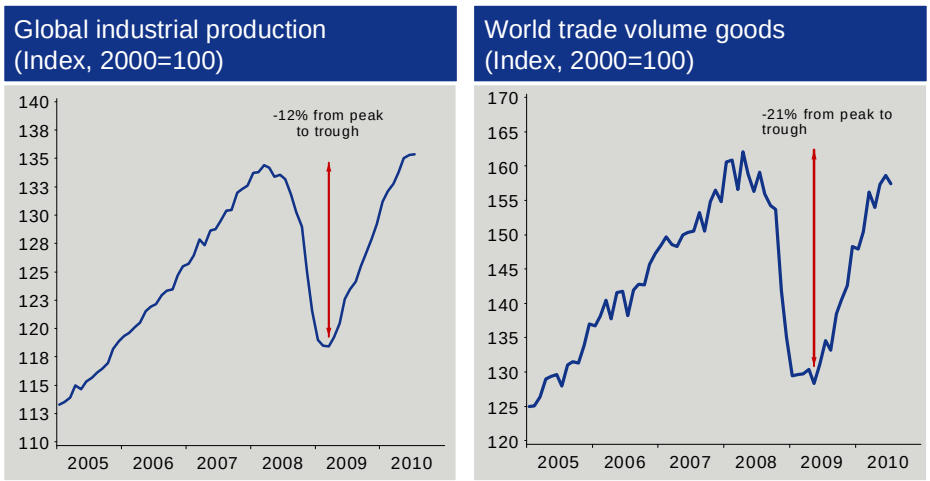
1. GLOBAL ECONOMIC SITUATION AND OUTLOOK

If we look at the economic development witnessed since the global financial crisis reached its dramatic climax in the autumn of 2008, there have been three fairly distinct phases of global economic development since then. The first lasted until early 2009 and was characterized by the trend that sent industrial production, investment and exports plummeting in virtual unison across the globe. This was followed by a period of economic stabilization in which, particularly in Asia, signs of the economy bottoming out started to emerge. Thanks in particular to expansive economic policy at global level on a scale never seen before, the global economy then entered phase 3 as 2009 progressed. More and more countries started to shake off the recession and there was a marked upsurge in economic activity again across the globe. The expansion phase continued in the first six months of 2010, with growth momentum actually continuing to build in some economies, particularly in those that rely heavily on exports and those not hobbled by major macroeconomic imbalances. Some of the countries that fit this description witnessed astounding GDP growth in the first two quarters of this year. The Singapore economy, for example, grew at an annualized rate of 24% quarter-on-quarter in Q2 2010, after already returning growth of a good 45% in the first three months of the year. Germany's economy also reaped substantial benefits from the recovery in global trade, reporting what was, by German standards, very generous annualized quarter-on-quarter growth of 9% in Q2. All in all, the global economy has clocked up some astonishing achievements over the past one-and-a-half years or so: global trade and industrial production are now sitting at roughly the same level as they were before the financial and economic crisis took hold. This means that industrial production has managed to shrug off a slump of 12%, while global trade has clambered back from a 21% nosedive.

Chart 1

Global production already back at pre-crisis level



Source: CPB Netherlands Bureau for Economic Policy Analysis (EcoWin).

So what lies ahead of us now? Data on industrial activity and business sentiment, for example, have been hinting at ebbing growth momentum worldwide for some time now. We believe that the global economy is currently on the brink of phase 4 of economic development in the post-Lehman era. This phase, which is likely to last longer than its predecessors, is characterized not only by more moderate growth, but also by only modest inflationary pressure.

There are a whole number of reasons suggesting that, especially in the industrial

countries, underlying economic momentum will, for the foreseeable future, be more moderate than it has been in the course of the economic recovery seen to date and, more to the point, than it was before the crisis as well. At this point, we would like to sketch out just a few of these reasons:

- The very strong growth momentum witnessed in many countries over the last few quarters has to be viewed in the context of the abrupt economic slump that preceded it. Obviously, this sort of growth momentum is impossible to maintain once the economy has made up for the production losses triggered by the confidence shock.

- The growth seen in recent quarters has by no means been a self-sustaining upswing. Rather, it was fanned by economic stimulus packages that are now gradually being unwound. So the global economy will have to do without this source of stimulus in the future. And that's not all: the sovereign debt crisis in the euro area has exposed drastically the profound challenges facing many industrial economies, in particular, as far as their state finances are concerned. The consolidation measures that need to be, and in some cases have already been, implemented are likely to put a damper on economic growth for years to come.

- Many countries are in dire need of consolidation, not only in the public sector but also among private households. This is another factor that will curtail global demand and, as a result, global trade.

- Monetary policy remains another pivotal issue. At the moment, major central banks like the Fed and the ECB seem to be continually postponing any real break with their very expansive monetary policies and we do not expect to see any interest rate signals until next year at the earliest. Nevertheless, there is still a question mark hanging over whether the central bankers can ultimately manage to siphon the liquidity made available during the crisis off the banks again and to gradually coax key rates back to normal without any major negative impact on the economy.

- The problem of global imbalances is still awaiting a solution, particularly in view of the high deficit or surplus positions lurking in the current accounts of some countries. Preventative economic policy measures seem to be called for, not only in countries like China, but also in the US. China's domestic demand, for example, is still not robust enough to compensate for a long-term dip in export growth. Strengthening private consumption, for example by expanding the country's welfare systems, is a job that will take time. Not least with this in mind, it would appear unlikely that we will see any marked appreciation of the renminbi against the US dollar in the foreseeable future.

Nevertheless, we believe that it would be wrong to conclude that all of these negative factors translate into a bleak outlook for the global economy, or even into a renewed recession. Our view is supported not least by the considerable economic catch-up work still left to do on the emerging markets. All in all, however, we look set to enter a prolonged period in which global economic growth is likely to be lower than before the crisis, but which by all means can be labeled moderate and satisfactory.

In the following we will take a look at the world's major economic regions before piecing together the "big picture" for the global economy in 2011.

USA

After a buoyant recovery in the winter months driven mainly by the inventory cycle, growth momentum in the US economy slowed appreciably in Q2 2010. Although domestic demand was still clearly headed north thanks, first and foremost, to substantial growth in business investment, an unusually large portion of demand was met by imported products, meaning that, despite solid export performance, net exports shaved 3½ percentage points off GDP growth (annualized rate) on balance.

The marked slowdown in growth, along with weaker data on the housing market following the expiry of tax incentives for home buyers, have raised grave doubts as to the sustainability of the recovery. The current economic indicators for the third quarter, however, suggest that growth momentum will at least be moderate. All in all, the economy has so far not proven strong enough to fuel any job creation to speak of. However, a further improvement on the labor market is a critical factor if there is to be any lasting stabilization on the housing market.

Against this background, we expect most of the tax cuts enacted in 2001 and 2003, which on current legislation are set to expire at the end of this year, to be extended beyond 2010. Taking into account the waning impact of the economic stimulus package, fiscal policy is likely on balance to put a moderate damper on the economy over the next few quarters.

By contrast, foreign trade is likely to have a slightly positive effect on growth again to begin with, especially now that import momentum is likely to be corrected after the surge in Q2. With investment activity on the emerging markets still intact and higher agricultural exports as a result of the global grain production bottlenecks, exports look set to continue to expand solidly.

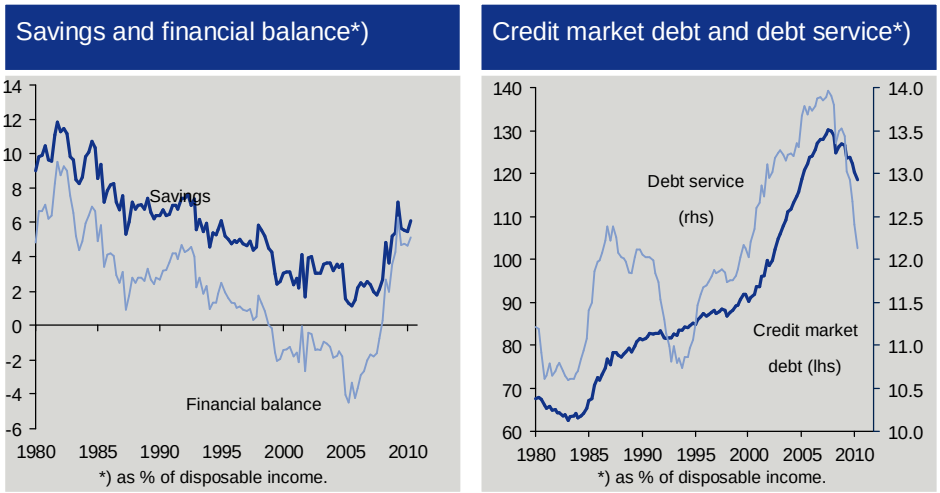
Equipment investment in the corporate sector also continues to offer upside potential. After all, despite the marked recovery in investment demand evident since late 2009, net equipment investment, expressed as a proportion of GDP, is still below the low point reached in the previous cycle.

The conditions for a sustained recovery in consumer spending have improved. US households have made significant progress in adjusting their spending to the net wealth losses recorded since mid-2007. This is reflected in the savings rate, which has climbed by around 4 percentage points to a level that recently stood at approximately 6%. Given the low level of net investment in this sector, this produces an ample financial surplus corresponding to around 5% of disposable income, which is being used to build up financial assets and/or to clear debt. Even if the savings rate does not increase any further, the financial position of private households is likely to continue to improve, as long as assets are not hit by any new shocks. The decline in the debt ratio and in lending rates seen to date means that the debt service ratio is already heading back towards the historical average. One positive aspect in this regard is the fact that the willingness among banks to grant consumer instalment loans has picked up a bit again.

Chart 2

USA: Financial position of private households

(incl. nonprofit organizations)



Sources: Federal Reserve, own calculations, EcoWin.

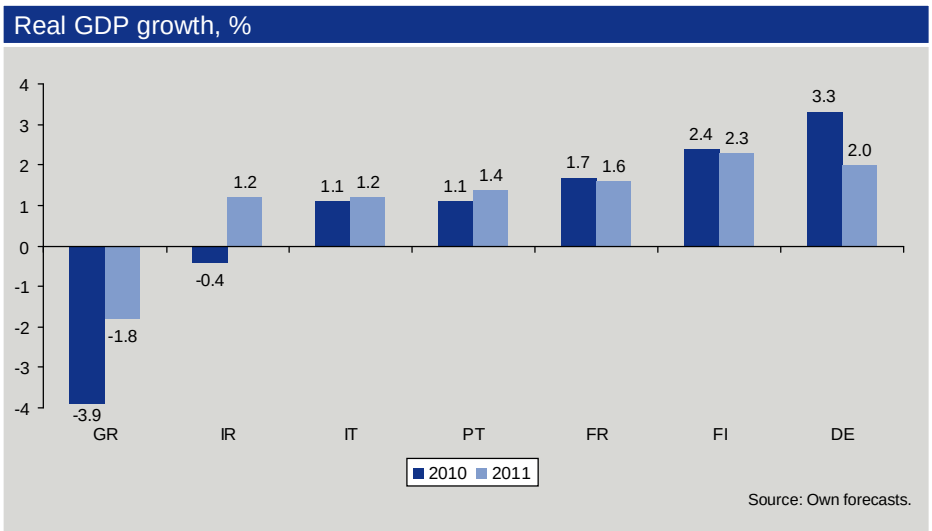
All in all, the US economy is likely to witness moderate growth. After growth of 2.7% this year, economic output is likely to increase by 2.3 % in 2011.

Euro area

Upward forces dominated the economic situation in the euro area in the first six months of this year. Buoyed by low interest rates and economic stimulus measures, GDP showed strong expansion, particularly in Q2, growing at an annualized rate of 3.9%. This economic momentum was owed partly to a catch-up effect following the negative impact of the long winter in the first quarter. But for Q3, too, the euro area looks set to remain on an upward path.

Chart 3

Growth prospects in Europe vary widely



Nevertheless, this aggregate view cannot belie the fact that economic developments vary widely from member state to member state (see Chart 3). Much of the recovery is being driven by the economic engine of the German economy, whereas growth in countries like France and Italy is far more restrained. Spanish GDP has shown only weak growth. In the meantime, Greece has been hit by a marked slump in aggregate output, particularly as a result of the country's rigorous budget consolidation efforts. The (structural) differences within the EMU area have really come to the fore, not least in the euro area debt crisis that came to a head in the spring.

In the forecast period, the global economic slowdown, the negative impact of fiscal policy measures and the end of the inventory cycle are likely to weigh on economic development throughout the single currency area. Turning to the economic outlook up to the end of 2011, we have looked at private consumption, government consumption, exports and investmentsin more detail:

- Private consumption in the euro area expanded by 0.5% in Q2, compared with an increase of 0.2% in each of the two previous quarters. During the forecast period, we expect private consumption to provide only limited economic impetus given only modest improvement on the labor market, sluggish wage development, government austerity measures and the fact that private household debt in some EMU countries remains high.

- In the first few months of this year, concerns surrounding the sustainability of public finances in some EMU countries triggered severe turbulence on the financial markets which only settled after a rescue fund was made available by the member states, the EU and the IMF in May. In response to the debt crisis, moves to consolidate state finances were passed in numerous member states. In spite of its stringent austerity drive, Ireland is facing a steep rise in its deficit this year due to the hefty one-off payments needed to keep its banks afloat. All told, we expect government consumption to have a negative impact on the euro-area economy in the forecast period, not only due to the step-up in budgetary consolidation, but also because economic stimulus packages are now coming to an end.

- Exports in the euro area are likely to benefit from the marked recovery of the global economy and in world trade, as well as from the temporary weakness of the euro. In the first three months of the year, exports were up by 2.4%, growing by a further 4.4% in Q2. Looking at the forecast for the period up to late 2011, however, more subdued global economic development is likely to curb the rapid increase in export demand.

- After a drastic slump in investment demand to the tune of 11.3% in 2009, fixed capital investment made a considerable contribution to GDP growth in Q2 of this year, up by 1.8% on a quarter-on-quarter basis. In 2010, however, we expect investment demand to remain within bounds as a result of underutilized capacities, fairly tight lending conditions and the cloud of uncertainty that is hanging over the corporate sector as regards the sustainability of the recovery. Next year, we expect low interest rates, a steady recovery and the gradual easing of lending conditions, as well as an increasing need in the corporate sector for capacities to be expanded or replaced, to spur stronger growth in investment demand in the euro area to the tune of at least 2½%.

All in all, we believe that continued, but relatively moderate economic recovery is on the cards for the euro area. We predict that overall output will grow by 1.8% this year and 1.7% next year.

Japan

The Japanese economy remained firmly on the path to recovery in the first half of 2010, with average quarterly growth of 0.8%. Foreign trade remained the main driver. On the domestic front, the recovery in business investment that emerged in the closing quarter of 2009 continued at a measured pace. Real consumer spending, on the other hand, stagnated in the second quarter of the year. All in all, however, private consumption has played a key role in economic stabilization since early 2009, a development that reflects, in particular, the state subsidies for the purchase of durable environmentally-friendly goods. From the second half of 2010 onwards, economic momentum is expected to flatten out on balance. Export growth is likely to lose momentum as world trade drops down a gear. Consumer spending, in particular, could cause considerable fluctuations in aggregate demand, because the various subsidy programs for purchases of environmentally-friendly cars and household goods are set to be gradually phased out in the period leading up to Q1 2011. Nevertheless, the underlying trend in consumption is likely to remain on an upward trajectory, thanks to the recovery in labor income. In this environment, there is still some degree of upside potential as far as investment demand in the corporate sector is concerned; momentum is not, however, expected to pick up for the time being, especially since the strong yen seen of late will curb the propensity to invest in the export sector. All in all, we expect aggregate output to increase by 1.4% in 2011, after 2.9% this year.

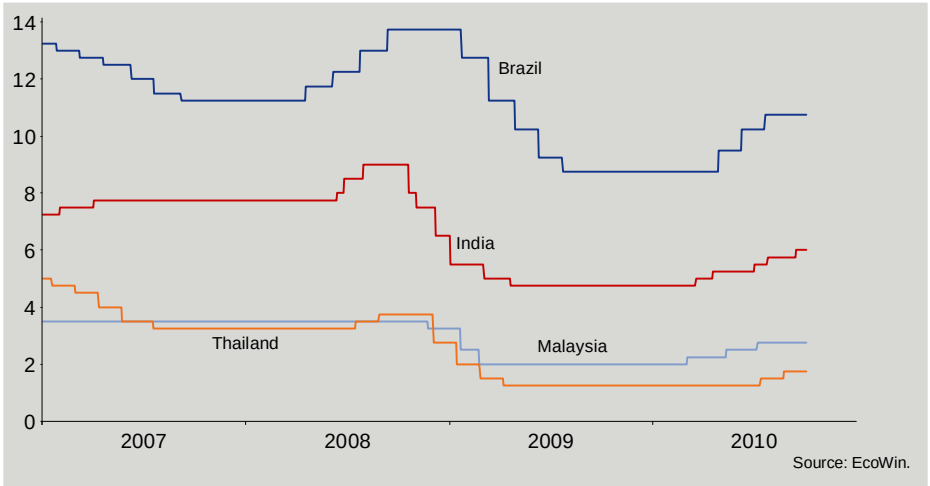
Emerging markets

The last winter half-year was characterized by vigorous economic activity in most of the emerging markets. Many of these countries, especially in Asia and Latin America, went on to report very strong growth in Q2 2010 as well. However, the current economic indicators suggest that economic momentum in most of the emerging markets has passed its peak. Although the upswing is expected to continue, the pace of growth will be somewhat more moderate given a more subdued outlook for exports to industrialized nations, the end of economic stimulus packages and the tightening of monetary policy in many emerging markets. All in all, we expect the emerging markets to grow by 6.6% in 2010 (2009: +0.9%). Next year, growth is likely to come in at 5.9%.

Chart 4

Emerging market monetary policy returning to normal

Key interest rates, %



After being the only region in the world to achieve positive economic growth in 2009, Asia is expected to emerge clearly top of the list of the fastest-growing economic regions this year, too. Asia's emerging markets are expected to grow by an average of almost 9%, compared with what was, after all, growth of 5.6% in 2009, thanks primarily to China and India. But after a sizzling performance in some countries in the first half of 2010, clear signs of a slowdown are now evident. In the case of China, where economic momentum had already started to taper off in Q2, the slowdown is also intentional. It is largely the result of the Chinese government's exit from the stimulus programs it launched to combat the crisis, together with the measures taken by the government to curb the brisk activity in the real estate sector and to curb bank lending. It is not just in China, however, but rather in a whole host of other countries in the region that the last few months have heralded a turnaround in economic policy. Numerous central banks have started to nudge their key rates up. In mid-September, the Indian central bank pushed its key rate up to 6% in what is already the fifth rate hike this year. Especially in view of the more moderate development in world trade, economic growth in Asia's emerging markets in 2011 is likely to be lower than this year. We expect growth to come in at 7.5% in 2011.

For basically the same reasons that apply to the Asian emerging markets, Latin America is also facing a slowdown in growth. The only marked difference lies in the level of the growth rates. This year, Brazil is set to report GDP growth of 7.4%, making it the economy with the strongest growth in the region. The country is currently witnessing very robust domestic demand, with growth being propelled in particular by investment thanks to the sustained favorable outlook for the economy and high industrial capacity utilization levels. Venezuela will be the only major economy in the region to see its economic output decline again this year. However, this has less to do with the recent global financial and economic crisis and more with the fact that the Venezuelan government's mismanagement on the economic policy front is casting an ever darker shadow on the country's economic prospects. We expect to see economic growth of 5.4% for the entire Latin American region this year. Next year, growth is forecast to come in at 4.4%.

Out of the three major emerging market regions, there is no doubt that economic development in eastern Europe is currently the most erratic. The spectrum ranges from Hungary, Romania and the Baltic states to the Czech Republic and countries like Poland and the Slovak Republic. Due to their considerable macroeconomic imbalances, the first group of countries was dealt a massive blow by the financial and economic crisis. Since the consequences of the crisis are still being felt, these countries will, at best, report very modest economic growth this year, despite what was, in some cases, a very savage economic slump in 2009. The situation in Poland, on the other hand, is quite different. Thanks to its relatively low reliance on foreign capital and its stable domestic demand, Poland was the only country in the region to report growth in 2009. This year, the Polish economy will benefit, in particular, from the economic recovery in the EU and is expected to report strong growth again thanks to very dynamic export performance. Looking at eastern Europe as a whole, we expect to see economic growth of 3.1% after a slide of more than 6% last year. Despite what we expect to be a weaker global economic environment, we predict that next year will bring stronger economic growth for eastern Europe than this year did. We expect growth in 2011 to come in at 3.8%. This is due largely to the fact that the catch-up work done by eastern Europe's crisis-stricken economic “stragglers” will more than offset the slowdown in growth expected in the region's other economies.

So what does this mean for the global economy as a whole? After a 3.7% rise in global output this year, the increase is expected to be slightly weaker next year at 3.3% (country weighting based on current exchange rates). Growth rates are set to fall both in the industrialized countries and in the emerging markets, although the slowdown in the industrial economies will be more pronounced than in their emerging counterparts.

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

	2006	2007	2008	2009	2010[1)]	2011[1)]
Industrialized countries	**2.7**	**2.4**	**0.1**	**-3.5**	**2.3**	**2.0**
European Union	3.2	3.0	0.6	-4.2	1.8	1.9
Euro area	3.0	2.8	0.6	-4.1	1.8	1.7
Germany	3.2	2.5	1.3	-4.7	3.3	2.0
USA	2.7	1.9	0.0	-2.6	2.7	2.3
Japan	2.0	2.4	-1.2	-5.2	2.9	1.4
Emerging markets	**7.8**	**8.1**	**5.4**	**0.9**	**6.6**	**5.9**
Asia	9.6	10.6	6.8	5.6	8.9	7.5
Latin America	5.4	5.7	4.1	-2.1	5.4	4.4
Central and Eastern Europe	7.3	7.3	4.7	-6.1	3.1	3.8
World	**4.2**	**4.1**	**1.7**	**-2.1**	**3.7**	**3.3**

1) forecast.

Sources: EcoWin, own forecasts.

We have applied the following assumptions for the overall global environment to our forecast:

- Following the drastic slump in global goods trade in 2009, which came in at just shy of 13% on average, goods trade is expected to gain more than 17% this year. Looking ahead to next year, we expect to see an increase that will be more in line with the expansion of global output, and predict growth of between 7% and 8%.

- Against the backdrop of more temperate global economic development, we expect to see commodity prices edge up only slightly in the course of next year. The average price of Brent crude oil is likely to come in at between USD 85 and USD 90 a barrel in 2011, compared with around USD 78 this year.

- The economic situation in the US, particularly on the labor market, is making it practically impossible for the Fed to start getting its monetary policy back to normal. The ECB is faced with a similar dilemma. In the euro area, plans for normalization are still being hindered by the current debt crisis in some member states, and in particular by the problems facing banks in the affected countries. As a result, both the Fed and the ECB are highly unlikely to start any aggressive tightening of the monetary reins at any time in the near future. Even if next year were to bring the first interest rate signals from the Fed and the ECB, real interest rates in these economic regions would still remain exceptionally low.

- In the course of the debt crisis in the euro area, the euro slid sharply against the US dollar. The exchange rate temporarily dipped below the 1.20 USD/EUR mark, having stood at 1.45 at the beginning of this year. However, in the second half of the year, the euro has made a marked recovery from its annual lows. At the end of 2010, we expect to see an exchange rate in the region of 1.30 USD/EUR, with the US dollar

likely to weaken against the euro in 2011. The dollar is likely to be hit not only by the ongoing need for consolidation in the US economy, but also by the progress we expect the euro area to make in repairing its public-sector finances. By the end of next year, one euro is likely to cost 1.45 US dollars.

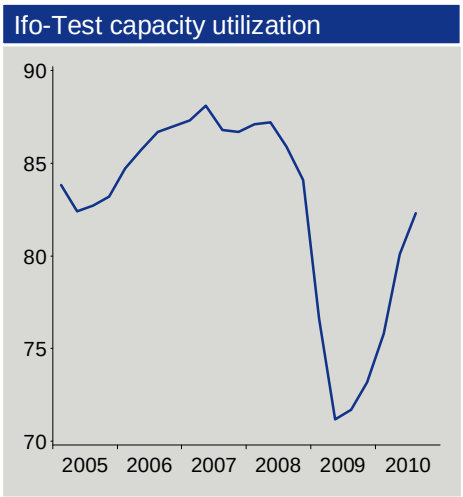
2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

2.1 Recovery continues at a more subdued pace

The German economy experienced an extraordinary surge in growth in the first six months of 2010, expanding by more than 5% at an annualized rate and making Germany one of the most dynamic industrial economies.

The strongest impetus came from the industrial sector. The sector of the economy that was hit hardest by the economic crisis is now making the most rapid recovery. Since the industrial sector is now receiving around one third more orders than at the nadir of the crisis, there is now only around 10% separating current incoming orders from the level that prevailed before the crisis in the summer of 2008. The sector has also stepped up its production considerably to reflect the upward trend in demand. Value added in the manufacturing industry was up by around 14% on the corresponding period a year earlier in Q2 2010. This has also prompted a sharp rise in capacity utilization, which is now back at the long-term average.

Chart 5



Source: EcoWin.

The fact that all major areas of the economy, with the exception of the agricultural sector, are showing an increase in output is testimony to the broad-based nature of the recovery. This has already had a very positive impact on the labor market. For a good year now, the number of people out of work has been on the decline, and the number of people in work has also been on the rise again since the start of the year. Employment growth has been relatively strong in many service areas (healthcare and social services, financial services, education and training).

The positive interplay between rising employment, increasing incomes and higher demand suggest that the German recovery has now developed a momentum of its own and is no longer dependent on the impetus provided by the government's economic policy. This recovery cannot be quashed by a mere slowdown in the global economy. On the other hand, however, it goes without saying that less dynamic global trade will not leave the pace of the German upswing completely untouched.

Germany: Economic indicators and forecast*

		2009				2010				2011							
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009	2010f	2011f
GDP real		-3.4	0.5	0.7	0.3	0.5	*2.2*	*0.5*	*0.4*	*0.3*	*0.4*	*0.4*	*0.5*	1.0	-4.7	*3.3*	*2.0*
Private consumption		0.3	0.3	-1.0	-0.2	-0.1	*0.6*	*0.5*	*0.3*	*0.3*	*0.3*	*0.2*	*0.3*	0.7	-0.2	*0.2*	*1.3*
Government spending		1.1	0.6	0.8	-0.3	2.0	*0.4*	*0.3*	*0.3*	*0.1*	*0.0*	*0.0*	*0.0*	2.3	2.9	*2.9*	*0.6*
Investment in machinery/equipment		-19.3	-2.7	0.8	-1.4	4.4	*4.4*	*2.0*	*3.0*	*0.5*	*1.0*	*1.0*	*1.5*	3.5	-22.6	*8.6*	*6.5*
Construction		0.9	-0.2	0.5	-0.7	-0.7	*5.2*	*1.0*	*0.5*	*-0.5*	*-0.5*	*-0.5*	*0.0*	1.2	-1.5	*3.9*	*0.9*
Domestic demand		-1.0	-0.9	1.1	-1.6	1.7	*1.4*	*0.4*	*0.3*	*-0.1*	*0.1*	*0.2*	*0.2*	1.2	-1.9	*2.3*	*0.8*
Exports		-10.2	-1.4	3.2	2.7	3.1	*8.2*	*1.5*	*1.7*	*1.8*	*1.7*	*1.7*	*2.0*	2.5	-14.3	*14.7*	*8.6*
Imports		-5.4	-4.8	4.4	-1.8	6.7	*7.0*	*1.5*	*1.5*	*1.0*	*1.0*	*1.2*	*1.3*	3.3	-9.4	*13.4*	*6.3*
Industrial production (excl. construction)**		-12.5	-0.9	3.8	1.5	2.4	*4.9*	*1.9*	*0.8*	*0.4*	*0.6*	*0.7*	*1.0*	0.1	-16.2	*10.6*	*4.4*
Unemployment rate (EU def.)	%	7.3	7.6	7.6	7.5	7.3	*7.0*	*6.8*	*6.6*	*6.5*	*6.3*	*6.2*	*6.2*	7.3	7.5	*6.9*	*6.3*
Unemployment rate (nat. def.)	%	7.9	8.3	8.3	8.2	8.1	*7.7*	*7.6*	*7.4*	*7.2*	*7.1*	*7.0*	*6.9*	7.8	8.2	*7.7*	*7.0*
Employed persons (national def.)	y-o-y	0.4	0.0	-0.2	-0.3	-0.2	*0.2*	*0.5*	*0.6*	*0.8*	*0.7*	*0.5*	*0.4*	1.4	0.0	*0.3*	*0.6*
Consumer prices	y-o-y	0.8	0.3	-0.2	0.4	0.8	*1.1*	*1.2*	*1.3*	*1.3*	*1.3*	*1.6*	*1.6*	2.6	0.4	*1.1*	*1.5*
Consumer prices (HICP)	y-o-y	0.8	0.2	-0.4	0.3	0.8	*1.0*	*1.2*	*1.3*	*1.4*	*1.3*	*1.5*	*1.6*	2.8	0.2	*1.1*	*1.4*
Producer prices	y-o-y	0.9	-3.6	-7.4	-6.3	-2.6	*1.0*	*3.5*	*3.6*	*3.0*	*2.2*	*1.9*	*2.2*	5.5	-4.1	*1.4*	*2.3*
Current account balance	EUR bn	20.8	28.4	31.1	39.7	29.4	*29.4*	*33.0*	*35.0*	*35.0*	*36.0*	*36.0*	*37.0*	167.1	120.0	*126.7*	*143.9*
	% of GDP													6.7	5.0	*5.1*	*5.6*
Budget balance	EUR bn													2.8	-72.7	*-98.0*	*-73.0*
(Maastricht-definition)	% of GDP													0.1	-3.0	*-3.9*	*-2.8*

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

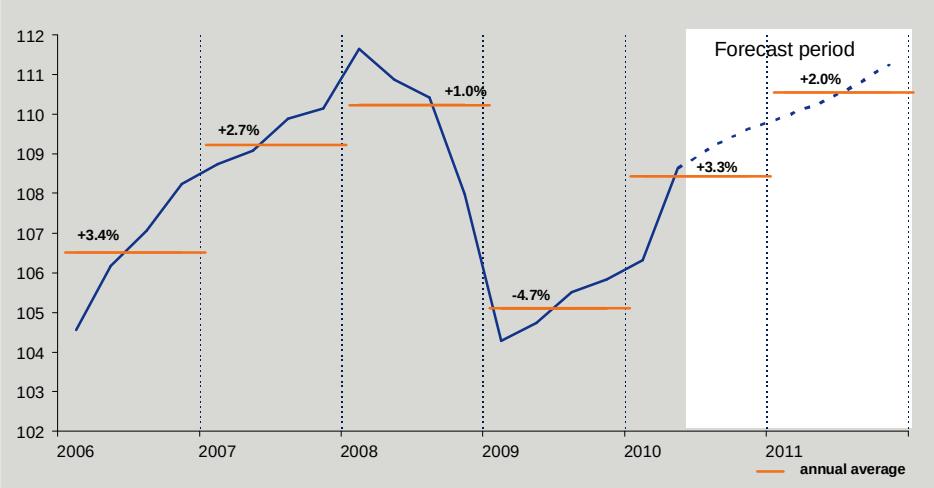
There are many factors suggesting that the expansion of global trade will slow in the second half of 2010. Consequently, German exports, which grew at a rate in excess of 20% in the first six months of this year, will only be able to achieve moderate growth in the second half of the year. Even assuming that a further boost to consumer demand is on the cards thanks to improved income development, we expect to see real GDP growth of only around ½% on a quarter-on-quarter basis in Q3 and Q4 of this year. Consequently, we predict that the German economy will grow by an average of 3.3% in 2010.

The economic outlook for the German economy in 2011 is cautiously positive from today's perspective. The recovery will lose steam. On the government side, the economy will be hit by the unwinding of the economic stimulus packages and the planned consolidation measures. Since, however, the need for consolidation is less acute than many assumed it to be a while back, the measures that will put a damper on the economy are likely to be limited and will not exceed the level planned to date (around ½% of GDP). On the external side, we expect to see further impetus in 2011 as global economic development remains on an upward path. Growth in German exports, however, is unlikely to surpass the single digits. Relatively positive income development will bolster consumer demand and is expected to boost real consumption by more than 1%. All in all, GDP is expected to grow by 2.0% in 2011.

Chart 6

Germany: Strong recovery 2010, momentum eases 2011

Germany: Real GDP, Index, 2000=100



Sources: Statistisches Bundesamt, EcoWin, own forecasts.

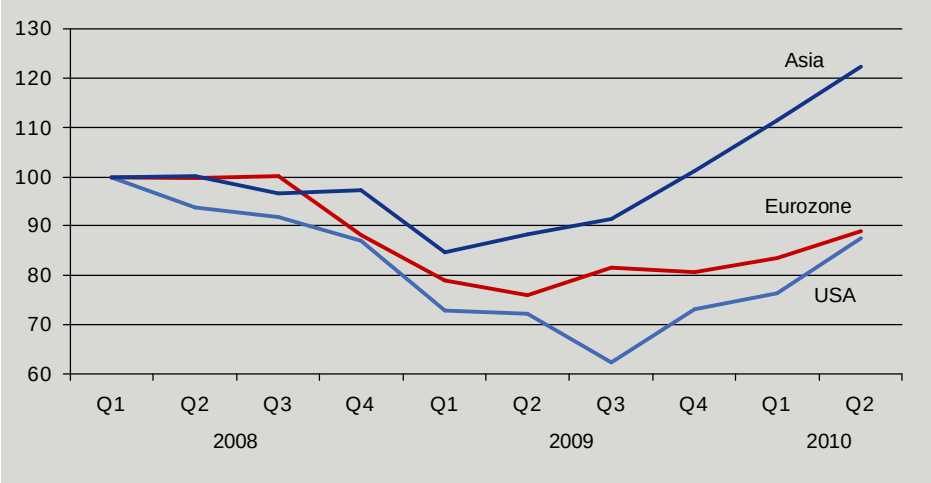
2.2 Exports lose momentum

The German economy experienced a real export boom in the first six months of this year, with goods and services exports in Q2 2010 up by around 19% on the same quarter of 2009 in volume terms. This means that the export volume is only around 3% lower than it was in the summer of 2008 before the economic crisis struck. Development does, however, vary from region to region. In value terms, goods exports to Asia are more than 25% higher than they were before the crisis, while exports to other EU countries have not even reached 90% of the pre-crisis figure. Nevertheless, exports to the rest of the EU also picked up considerable speed in the first half of 2010, rising by around 10% in the space of two quarters. The export boom has now touched almost all goods categories. Even engineering, a sector which tends to lag behind economic developments, recently saw its exports rise by around 16%, in terms of value, within a one-year period.

Chart 7

German exports by region

Index, Q1 2008 = 100



Source: Deutsche Bundesbank.

There is no doubt that this sort of export momentum cannot be regarded as a permanent fixture. Lower growth rates are on the cards, but not the end of the export boom. The Ifo business survey still suggests a positive export outlook in the corporate sector. This leaves us confident that the global economy will not trip up and stumble, as some predict it will. Looking ahead to the second half of 2010 and 2011, we expect to see moderate, but still relatively brisk export growth. On average, 2010 is likely to see exports gain just under 15% in volume terms, while 2011 is expected to herald in export growth to the tune of around 8½%.

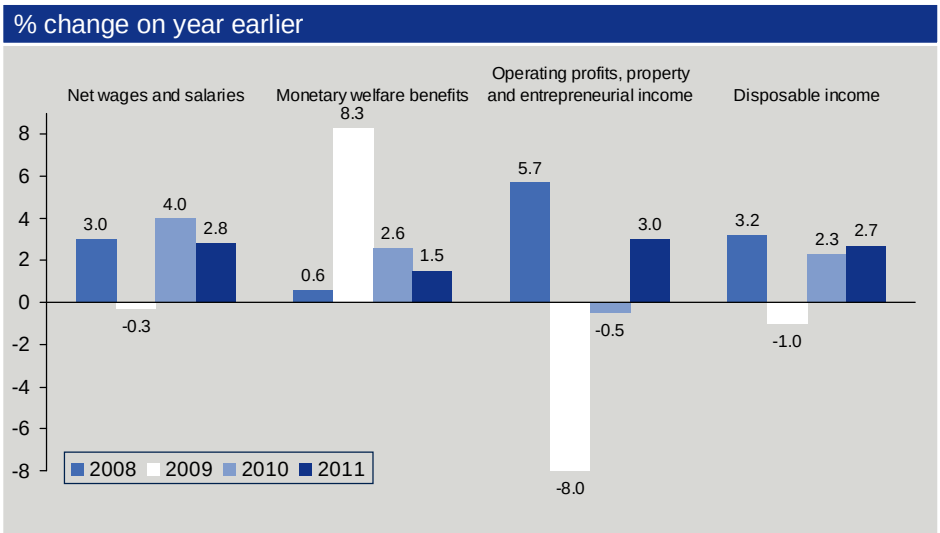
But it wasn't just exports: imports also experienced something of a boom in the first six months of 2010. In the second quarter imports were up by around 18% on a year earlier in volume terms. Most recently, Germany was already importing more than it was before the onset of the economic crisis. Import growth for intermediate goods was considerably higher than for capital and consumer goods, suggesting that the corporate sector has been building up its intermediate goods inventory to fuel planned increases in production. These moves are already likely to be well under way, meaning that import growth over the next few quarters will probably be less dramatic. We predict real import growth of around 13½% this year and just under 6½% next year. With import growth of around one fifth within a two-year period, this makes Germany a far from insignificant force behind the global trade recovery.

2.3 Higher real income levels boost consumer demand

Consumer demand has stabilized considerably in the course of this year. There has been a clear improvement in consumer confidence and business sentiment in the retail sector has not been this positive since the 1990s. The marked improvement on the labor market, which also translates into a return to a rosier income outlook, is likely to have played a key role in this respect.

Chart 8

Private household disposable income



Source: Statistisches Bundesamt.

Growth in income from employment is expected to average 2.7% in 2010, compared with an increase of a meager 0.2% last year. This improved development is attributable to a slight increase in employment (+0.3%), as well as to an increase in actual earnings per employee by just short of 2½%. The fact that the less extensive use of shortened working hours models combined with more overtime is pushing the average working hours per

employee up is having a positive impact on actual earnings. By and large, longer working hours spurred by economic trends will have a positive impact on actual earnings development in 2011, too. Since pay settlements are also likely to increase slightly and given that, at 0.6%, employment growth in 2011 will outdo the figure for 2010, we predict that labor income will climb by 3½% in 2011.

In terms of net income, employees will benefit from considerable tax relief in 2010, whereas they will be hit again by the higher unemployment and health insurance contributions that are already on the calendar for 2011. This means that total net wages and salaries will grow by 4% this year, outstripping the projected growth of just under 3% in 2011. The sizeable increase in transfer payments will not be repeated in 2010 and 2011. Transfer payment growth will slow considerably in 2010 and 2011, due first and foremost to stagnating pensions, the decline in shorter working hours models and a drop in unemployment. Following the 5.2% increase in monetary social benefits paid out by the social insurance authorities in 2009, we expect the same increase to come in at 2.8% in 2010 and 1.5% in 2011. The recovery in corporate earnings means that the decline in withdrawn earnings, the income of self-employed persons and income on investments, which was very significant in 2009 at 8%, will gradually run its course. This year, we expect this income component to drop by 0.5% before rising by 3% next year.

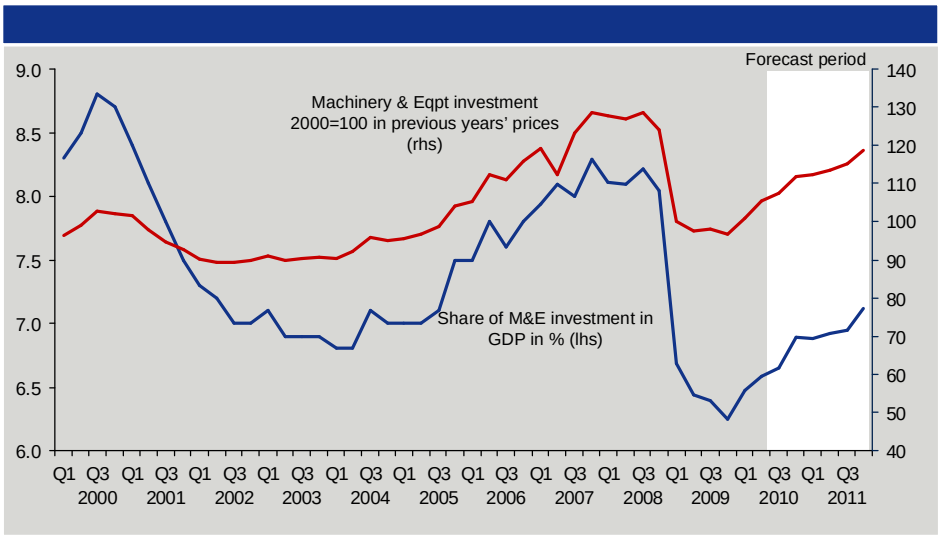
All in all, the disposable income of private households is likely to increase by 2.3% in 2010 and by 2.7% in 2011, compared with a 1% decline in 2009. With inflation at a low level, this will push real incomes up by around 1% in 2010 and by at least 1% in 2011. Low interest rates and increasing consumer confidence suggest that the propensity to consume will tend to increase, whereas the savings rate will decline from the high level seen at the beginning of this year. In 2010, private consumption is likely to increase ever so slightly, by 0.2%. In 2011, we expect to see growth of 1.3%, which would be the best development since 2006.

2.4 Rising utilization spurs investment

Equipment investments, which plummeted by more than 22% in 2009, are now making an admirable recovery, due primarily to the developments outlined below. Capacity utilization on the German economy has been making a surprisingly swift ascent over the last few quarters and is now likely to have returned to a normal level. The same applies to corporate earnings performance. By way of example, corporate and investment income in the first six months of 2010 was up by almost 20% on the prior-year level, meaning that it has already almost returned to the level seen before the outbreak of the crisis. This means that the corporate sector has significantly improved its ability to finance its own investments. Since many investment projects were put on hold, or project timescales elongated, during the crisis, a considerable investment backlog is likely to have formed. This suggests that equipment investments will continue to increase in the course of this year. This is compounded by the fact that the maximum 25% reducing balance depreciation rate introduced along with the first economic stimulus package will expire at the end of the year. It is difficult to judge the extent to which this will result in anticipatory investment effects. We believe that the impact of this change in tax legislation will be limited, meaning that the upward trend in equipment investments is likely to continue in 2011, albeit at a slower pace. For 2010 on average, we expect to see real equipment investments increase by at least 8%, and predict that they will rise by at least 6% in 2011.

Chart 9

Investment volume and investment ratio



Sources: Statistisches Bundesamt, EcoWin, own forecasts.

As encouraging as the recovery in investment demand is, it is important to remember the fact that the level of investment activity is extremely low. Equipment investment recently accounted for a good 6½% of GDP, lower than in any other quarter of the last decade prior to the economic crisis. After deductions for depreciation and amortization, the increase in capital stock is most likely a negligible one. The rosy medium-term growth outlook for the German economy means that investment activity has to pick up considerably. Construction investment was up by around 2½% year-on-year in the first six months of 2010 despite adverse weather conditions at the start of the year, a positive trend that is likely to continue in the second half of the year, too. For 2010 as a whole, we now expect construction investment to grow by almost 4%.

Developments in the residential construction sector were particularly favorable in the first half of 2010 (+3.5% over H1 2009). Very low interest rates and the marked improvement in income development mean that this positive trend is expected to continue. The residential construction volume is expected to increase by more than 4% in 2010. While the commercial construction sector was still down on the prior-year level in the first six months of this year, the second half of 2010 is expected to more than make up for the decline. Rising capacity utilization levels will gradually boost companies' propensity to invest in expansion measures. In 2010 as a whole, however, commercial construction investment is likely to report only modest average growth of an estimated 1- 2%. The economic stimulus packages mean that the public construction sector is expected to return growth in the range of 5 - 6% in 2010, with year-on-year growth already coming close to the 5% mark in the first half of the year.

Looking ahead to 2011, the outlook for the construction sector is not quite as promising as in 2010. We expect real construction investment to report growth of only around 1% in 2011. Public-sector construction demand, in particular, is likely to have a negative impact as the economic stimulus pacakges expire and the local authorities remain in a tight financial situation. We predict that public-sector construction investment will contract by 1-2% in 2011. We expect the residential construction segment, on the other hand, to report slight growth next year. This segment will continue to benefit from favorable financing conditions and improved income development, although the demand for building renovation work aimed at improved energy efficiency is likely to tail

off. Demand in the commercial construction segment is expected to continue to grow as capacity utilization increases. Commercial construction investment could increase by 3 - 4% in 2011.

2.5 Neither deflation nor inflation

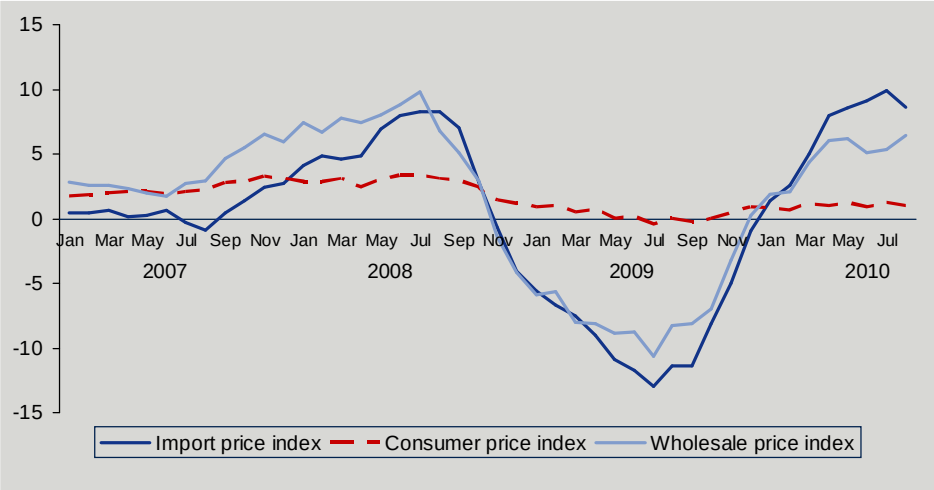
While the ongoing fear of deflation is providing fodder for debate on the financial markets, consumer inflation is starting to pick up as the economy recovers. We believe that inflation will average 1.1% in 2010 as a whole, compared with 0.4% last year.

In August 2010, the wholesale and import price indices were up by 6.4% and 8.6% respectively on the same month of 2009. After taking a tumble in 2009 in the midst of the global economic crisis, both have now virtually climbed their way back to their pre-crisis levels. The rise in import prices is driven by a 20% increase in the price of energy and other commodities. According to the HWWI commodities price index, prices have already outstripped the 2008 high. Commodity inflation is expected to be a lasting trend due for one to rising demand for commodities in line with the ongoing global economic recovery and for another to their appeal as an asset class. At the moment, the import prices for foodstuffs such as milk or wheat are also rising strongly, a trend that is being reinforced by shortages caused by environmental catastrophes. As sub-components, the increase in the price of minerals and foodstuffs is also pushing the wholesale price index up.

Chart 10

Price trends

% change on previous year



Source: Statistisches Bundesamt.

There has been an above-average increase in consumer prices for energy and foodstuffs, too. In August, energy inflation stood at 2.5% year-on-year, driven by rising prices for oil products and electricity. Food prices were up by 2.8%. The most marked price increase in a year-on-year comparison affected cooking fats and oils (16.5%), although consumers had to cough up more for fruit and vegetables as well. Core inflation, which leaves energy and foodstuffs out of the equation, stood at 0.7% in August 2010.

The following long-term price trends are still intact: the sustained decline in the price of some consumer durables, e.g. electronics goods, and the increase in the price of services, for example in the education sector.

Consumer prices were recently up by 1.3% year-on-year. The small-scale nature of this increase despite the burgeoning economy is due to what is still low capacity utilization, which narrows the scope for price increases. Wage increases are also expected to remain low well into next year due to the pay agreements that are already in place. So far, private households' marked propensity to save has put a damper on any potential for price pressure. However, the positive impetus from the labor market, coupled with the economic recovery, have improved consumer sentiment, suggesting that consumer demand will start to creep up. Consequently, we expect to see a slight increase in the inflation rate in 2011 to an average of 1.5%.

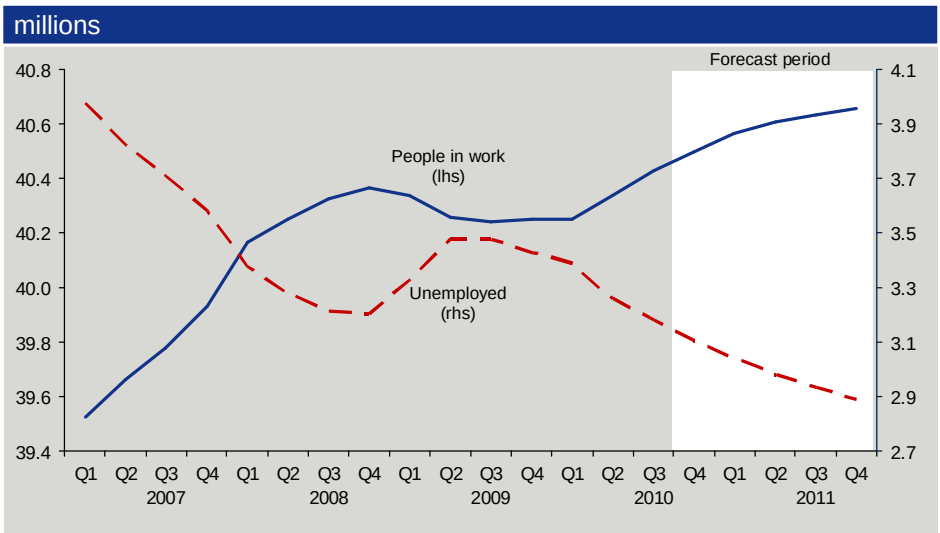
2.6 Remarkable labor market improvement continues

The German labor market is on the rebound in 2010. The number of people in work (up until August) has risen by at least 150,000 since the start of the year, while the number of people out of work has fallen by around 270,000 (up until September). At the same time, there has been a considerable drop in the extent to which shorter working hour models are being applied. In July of this year, only around 290,000 people were still receiving short-time working allowance, more than 900,000 fewer than in the same month of last year. The low level of new announcements on the use of shorter working hour models suggests that the number of people whose working hours have been shortened has continued to decline of late. The sustained increase in the number of vacancies since mid-2009 rounds off an encouraging labor market story.

In all likelihood, the positive trend on the labor market will continue. Even if the GDP growth rate slips to around 2% in 2011 - which is what we expect - employment growth is likely to continue. Growth in Germany has been very labor-intensive for some years now, suggesting that the labor market has become more flexible and more efficient.

Chart 11

Germany: Number of people in work and unemployed



Sources: EcoWin, own forecasts.

The number of people out of work is expected to fall below the three million mark as early as October or November of this year. The winter months will see this figure edge back up to 3.3 million at the very most. If our expectations of a sustained moderate upswing materialize, the number of people out of work is likely to move below the three million mark, and stay there, from the spring of 2011 onwards. Based on our estimates, this means that an average of around 3.24 million people are likely to be out of work in

2010, with an average of approximately 2.96 million people expected to be unemployed in 2011.

This drop in the unemployment figures by around 280,000 in 2011 is likely to go hand-in-hand with an increase in the number of people in work by around 240,000. This would see the workforce (people in work plus the unemployed) shrink by around 40,000. According to the German Institute for Employment Research (Institut für Arbeitsmarkt- und Berufsforschung), the potential workforce would have to shrink by around 200,000 in 2011 for demographic reasons alone. Nevertheless, the workforce participation rate is expected to continue to increase among older members of the workforce, in particular, meaning that the labor supply will not decline proportionately to the demographic effect.

2.7 Budget deficit below the 3% mark in 2011

New government borrowing, which came in at a revised 3.0% of GDP in 2009, is expected to be far lower, at an estimated 3.9% of GDP, than official projections assumed at the beginning of this year (5.5% of GDP). This is due primarily to the overly skeptical economic forecast upon which the projections were based.

The German federal government has set itself the objective, in line with the recommendations issued by the ECOFIN Council, of getting its new borrowing back down to less than 3% of GDP by 2013. With state finances in better shape than expected this year, this target is likely to be achieved as early as 2011. On the basis of our economic forecast, we expect to see a state deficit corresponding to 2.8% of GDP in 2011.

State income is forecasted to increase slightly again in 2010 (+0.3%), after dwindling by 2.2% in 2009. Extensive relief measures are likely to push tax revenue down ever so slightly again by 1%, whereas income from social security contributions should gain almost 3% in 2010. In 2011, income from both taxes and social security contributions is expected to swell considerably, by between 3½% and 4%. All in all, we expect government revenue to increase by 3.6% in 2011.

Government spending, which increased by a considerable 4.9% in 2009 due to the economic stimulus packages, is expected to increase by only 2.5% in 2010. Unchanged pensions and the decline in both shortened working hour models and unemployment have meant that the increase in monetary social security benefits has flattened out considerably. In other spending categories, too, such as employee compensation and inputs, slowing growth is also evident. We expect government spending growth to decline further in 2011. With the economic stimulus packages ready to expire and the planned spending cuts, we estimate that government spending will increase by only 1.2% in 2011.

At the moment, the development of state finances from 2012 onwards can only be analyzed as a possible scenario, as any speculations as to long-term fiscal policy are no more than mere assumptions. In one scenario for the period leading up to 2016, we have assumed that the government will keep a tight rein on spending up until 2016 and that no new regulations will be passed on tax and social security contributions over and above the agreements that have already been reached. In this respect, we have assumed nominal GDP growth of 3% in the period between 2012 and 2016, whereas the main components of government spending (with the exception of interest expenditure) will increase by only 1% a year. Low spending growth on this sort of scale, however, cannot be achieved solely by implementing the savings measures set out in the German government's "Future Package" (Zukunftspaket), which sets out consolidation efforts

worth EUR 82 billion for the period up to 2014, to the letter. There is no getting around the need for additional efforts.

In the scenario we have described, the German budget will be in the black from 2015 onwards. The government spending ratio, which leapt up by 3.7 percentage points to 47.5% in 2009, would have fallen to around the 42% mark by 2016, even lower than the relatively modest level seen in 2007 and 2008. The scenario shows that the commitment to balancing the state books made as part of the drive to slash debt can be met even earlier than the law requires if the government maintains its disciplined stance on spending.

General government budget: Forecast 2010 and 2011, Scenario ongoing spending restraint 2012 to 2016

in EUR bn	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenue	1088.5	1066.0	1069.1	1108.0	1141.4	1176.0	1211.6	1248.5	1286.5
of which:									
Taxes	590.1	564.5	558.8	581.2	601.5	622.4	644.4	666.9	690.3
Social contributions	407.8	409.9	421.4	436.1	449.2	462.7	476.6	490.9	505.6
Expenditure	1085.6	1138.7	1167.2	1181.0	1195.2	1209.7	1224.4	1239.4	1254.8
of which:									
Inputs	104.8	111.3	115.2	117.0	118.1	119.3	120.5	121.7	122.9
Employee compensation	170.7	177.6	183.0	186.6	188.5	190.4	192.3	194.2	196.1
Property income payable (interest)	66.7	62.2	64.1	66.0	69.3	72.8	76.4	80.2	84.2
Subsidies	27.8	31.5	32.4	32.8	33.1	33.4	33.8	34.1	34.4
Monetary welfare benefits	421.1	443.5	452.4	456.9	461.5	466.1	470.7	475.4	480.2
Welfare benefits-in-kind	185.7	196.6	204.5	207.5	209.6	211.7	213.8	216.0	218.1
Other current transfers	40.3	45.2	47.0	47.5	48.0	48.4	48.9	49.4	49.9
Gross investment	36.8	39.3	41.3	40.1	40.5	40.9	41.3	41.7	42.1
Financial balance	2.8	-72.7	-98.0	-73.0	-53.8	-33.7	-12.8	9.0	31.8
memorandum (in %):									
State spending ratio[1)]	43.8	47.5	46.8	46.0	45.2	44.4	43.6	42.9	42.2
Financial balance[1)]	0.1	-3.0	-3.9	-2.8	-2.0	-1.2	-0.5	0.3	1.1

% change on previous year	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenue	2.1	-2.1	0.3	3.6	3.0	3.0	3.0	3.0	3.0
of which:									
Taxes	2.4	-4.3	-1.0	4.0	3.5	3.5	3.5	3.5	3.5
Social contributions	1.9	0.5	2.8	3.5	3.0	3.0	3.0	3.0	3.0
Expenditure	2.5	4.9	2.5	1.2	1.2	1.2	1.2	1.2	1.2
of which:									
Inputs	4.8	6.2	3.5	1.5	1.0	1.0	1.0	1.0	1.0
Employee compensation	1.4	4.1	3.0	2.0	1.0	1.0	1.0	1.0	1.0
Property income payable (interest)	-0.9	-6.7	3.0	3.0	5.0	5.0	5.0	5.0	5.0
Subsidies	0.6	13.3	3.0	1.0	1.0	1.0	1.0	1.0	1.0
Monetary welfare benefits	0.5	5.3	2.0	1.0	1.0	1.0	1.0	1.0	1.0
Welfare benefits-in-kind	4.2	5.9	4.0	1.5	1.0	1.0	1.0	1.0	1.0
Other current transfers	10.4	12.3	4.0	1.0	1.0	1.0	1.0	1.0	1.0
Gross investment	7.1	7.0	5.0	-3.0	1.0	1.0	1.0	1.0	1.0

[1)] in relation to gross domestic product in current prices.

Sources: Statistisches Bundesamt, own forecasts.

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

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