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Economic forecast 2009/2010

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1. THE GLOBAL ECONOMIC SITUATION AND OUTLOOK

At the moment, it would appear that anything is possible – at least as far as the bad news is concerned. The horror scenarios include economic collapse in eastern Europe, state bankruptcies in what were previously solid economies, such as Austria, the breakup of European Monetary Union and various different deflationary, inflationary and depression scenarios. As is typically the case when the economy is stuck in a painful rut, the situation appears to be practically hopeless. No one can really envisage how, exactly, it will be possible to stop the self-perpetuating downward spiral and get the economy heading north again. The only thought that offers any comfort is the fact that all of the crises experienced in the past have been conquered.

The considerable insecurity and uncertainty is affecting economic policy in particular. On the one hand, it is the focus of high hopes, while on the other, it is caught in the cross-fire of criticism. What approach is the right one, which measures promise to deliver the long-awaited turnaround? In the debate that is brewing at present, Europe is being accused of being too restrained, both with respect to economic stimulus packages and as regards ECB policy. By contrast, the US Fed has started printing money, and the US government has its wallet wide open. Nevertheless, some voices are asking whether it might not be the case that, while the very aggressive US economic policy may manage to get the better of this crisis, it will, in doing so, set the stage for the next, possibly even more severe crisis.

The current economic slump is characterized, in particular, by the fact that the abrupt slump in industrial production, investment and exports has been a more or less synchronized process across the globe. This certainly has something to do with the fact that we are dealing with a global dip in demand, and that the global production chains now in place have resulted in negative multiplier effects. At the same time, however, the slump in global trade also appears to have something to do with the fact that trade credit is harder to come by. It is also likely that less favorable financing conditions – naturally coupled with grim sales prospects and low capacity utilization – are putting a damper on investment activity. So it is no coincidence that central banks and governments alike are doing everything in their power to try to boost the economy's credit supply.

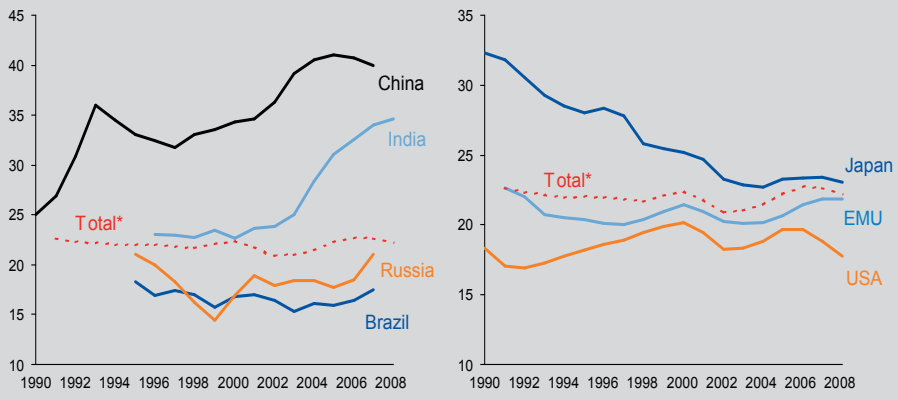
As far as demand development is concerned, one has to ask oneself: will the current crisis mean that so many fewer cars, PCs, refrigerators, stereos and machines will be bought in the long run? The idea is absurd. The abiding pent-up demand in the populous emerging markets is enough in itself to guarantee a demand revival. And even in the industrialized nations, demand is anything but saturated. At global level, demand is not the problem in the long term. As a result, the drastic economic policy measures aimed at stimulating demand will bear fruit, too. A recovery in global demand is likely to be achieved in the not-too-distant future.

But will this recovery be enough to utilize the available capacities in full? This is where we arrive at a crucial point. It may well be the case that the economic boom prompted the creation of capacities that far outstripped actual demand. In particular, China and a number of other Asian emerging markets are accused of having created substantial overcapacities as a result of the inflow of funds from abroad and the high level of domestic savings. The chart below shows the investment ratios of the major industrialized regions – the US, the EU and Japan

– and those of the four leading emerging markets, known as the BRIC countries – Brazil, Russia, India and China. While the investment ratios in China and India have been rising considerably since the early 1990s, Japan's investment ratio has been on a marked decline. The US and euro area ratios, on the other hand, have been astoundingly stable. If you add up the investment ratios of the industrialized regions and the four emerging markets, which together generate more than 70% of global value added, a surprising picture emerges: at global level, the investment ratio has crept up only ever so slightly, and was recently only negligibly higher than in the early 1990s. This means that there is plenty of evidence arguing against overcapacities at global level, even if the situation in individual sectors tells a different story. All in all, however, there is no reason for us to expect a long-lived global reduction in production capacities.

Investment ratio

Machinery & equipment investment as % of GDP, nominal



* USA, Japan, EMU and BRIC countries (1991 - 94 without India, Russia, and Brazil, 1995 without India, 2008 estimate).

While the conclusion reached above is generally encouraging, it sheds little light on specific economic development in the course of this year. How drastic will the drop in GDP in the major industrialized nations ultimately be for this year as a whole? Will the second quarter of the year see the economy stabilize? When will the real turnaround kick in, and who will be the trendsetters and the laggards? What impetus can be expected to come from the emerging markets as a whole? First of all, we will take a look at the key global regions so that we can ultimately piece together the complete global economic jigsaw.

US

The US economy has been locked in a recession since late 2007, with a considerable amount of fuel being added to the fire in the fall of last year. This recession is primarily attributable to the pronounced correction on the residential real estate market, which has, at the same time, made it more difficult for the private sector to access credit across the board.

Even now, at the beginning of 2009, the negative economic data continue to dominate. While there are some indications that consumption might be stabilizing, a number of factors are hinting at another drastic slump in investment spending. In the 2008/2009 winter half-year, aggregate output is likely to have dipped by around

3%. This makes the current economic slump not only one of the longest, but also one of the most intense in US post-war history.

One thing that will be decisive as far as the further development is concerned is how well the economic policy moves will complement one another. The government and the Fed have launched a whole number of initiatives over the past few months – to stabilize the financial system, the residential real estate market and to stimulate aggregate demand – so that the economy can get back on its feet. Such a broad package of measures is absolutely imperative in order to put an end to the negative feedback loop between the financial sector and the real economy.

Even if there is some degree of uncertainty surrounding the impact that these extraordinary economic policy endeavors will have, the substantial reduction in mortgage rates to a record low prompted by the Fed's aggressive policy can already be hailed as a success. This move can make a visible contribution to stabilizing the residential real estate market. The interest rates for conventional mortgages with a 30-year term are now more than 1 percentage point lower than the average level for 2008. The impact of this rate reduction can be equated to a cut in house prices of around 10 % in terms of how affordable it is to own a residential property. From the second quarter onwards, the implementation of the economic stimulus program is likely to boost economic activity. This year, fiscal policy measures will provide a boost worth an estimated USD 300bn (2% of GDP in 2008). All in all, the US economy is expected to crawl its way back to moderate growth in the second half of the year. For 2009 as a whole, however, aggregate output is expected to contract by 2.3%.

Euro area

In the euro area, the GDP sequential rate for the first quarter of this year is likely to be just as poor as it was in the closing quarter of 2008, at around -1 ½%. This would bring the year-on-year change down to around -3 ½%. There is, nonetheless, hope that this marks the low point. The most recent sentiment indicators, for example, showed signs of improvement, although they will have to be reinforced over the next few months. With gross domestic product expected to virtually stagnate in the second quarter of the year, we expect to see an appreciable economic revival from the middle of the year onwards, resulting in what we predict will be a decline in EMU GDP of 2.3% for 2009 on average.

Unlike investment, private consumption will probably turn out to be relatively resilient, which is why inventory liquidation is, in some cases, likely to prove to be exaggerated, which should help the industrial sector out of the deep recession. Private households are benefiting from the sustained decline in inflation: in June/July of this year, EMU inflation is expected to be slightly negative in a year-on-year comparison, with the average inflation rate for 2009 as a whole predicted to come in at around 0.5%, as against 3.3% in the previous year. On the other hand, the downturn on the labor market is becoming increasingly problematic. While the unemployment rate in the euro area was still at its all-time low of 7.3% in March 2008, it has already risen back up to 8.2%, and is likely to climb further towards the 10% mark by mid-2010. This could prove to be socially explosive, meaning that fiscal, but also monetary, policy will come under particular pressure to provide support. As far as fiscal policy is concerned, however, the economic stimulus packages introduced to date mean that there is only limited scope for additional measures

that will benefit private households. The EMU deficit ratio is already expected to rise to around 4% in 2009 and then to increase further in 2010.

The European Central Bank is likely to avoid drifting even further into the "uncharted territory" of very low key rates by cutting rates to below the 1% mark. With the rise in unit labor costs coming in at 4.3% y-o-y of late, as well as core inflation that is not expected to fall to any considerable degree below the current level of 1.7%, any real risk of deflation would appear to be limited on the whole. Nevertheless, the ECB will presumably remain under pressure, as far as the euro exchange rate is concerned, to take monetary policy measures that are similarly unconventional to those taken by the Fed, or by the Japanese, British and Swiss central banks. The nominal effective exchange rate of the euro – compared with the currencies of 21 key trading partners – was recently close to 115, i.e. well above the average level of 113 seen in 2008, which was high to begin with. While the ECB will likely attempt to start normalizing its monetary policy next year, the fact that economic growth is expected to be subdued at 1.6% in 2010, coupled with the prospect of yet another decline in economic momentum in the course of next year and inflation that looks certain to remain under 2%, means that only cautious increases in key rates can be expected.

Emerging markets

The emerging markets are now feeling the full blast of the financial and economic crisis. Nevertheless, the extent of the impact varies considerably from region to region and also from country to country. The crisis has hit hardest in Eastern Europe, a region in which some countries have built up marked imbalances over the past few years, for example in the form of high current account deficits, or substantial private sector foreign-currency debt. It is precisely these economies that have now been hit head-on by the crisis. Countries like Hungary, Latvia, Romania and Ukraine have already had to request international financial assistance in order to avert the large-scale exacerbation of the crisis, or even sovereign bankruptcy. The gross domestic product of the eastern European emerging markets is expected to shrink by more than 1% this year. We expect to see a particularly hefty slump in those countries that have been hit hard by the crisis. Ukraine's economic output, for example, is expected to drop by around 6% in 2009, while in Latvia, it is likely to plummet by a whopping 10%. By contrast, Poland, which is far more stable than some of its neighbors, is still expected to return slight growth.

There is no doubt that we are currently witnessing an exceptionally hard landing in eastern Europe. While this will not, in any way, change the fact that the catch-up process will continue after the current adjustment phase, the momentum behind this process is likely to be weaker than it was before the crisis, mainly as a result of what is expected to be far more moderate lending growth in the future. Before the crisis took root, eastern Europe was witnessing a real lending boom, which was one of the driving forces behind the buoyant economic growth. Lending growth rates of between 20% and 40% a year were the rule rather than the exception, thanks, in particular, to the strong local presence of western European banks. Many of these banks are currently still struggling with the consequences of the financial crisis as far as their balance sheets are concerned. Given that these banks are now being clobbered by the economic slump and the resulting deterioration in the credit quality of their eastern European investments, they are likely to remain more cautious when it comes to granting loans in eastern Europe for the time being. For the coming year, we expect to see GDP growth of around 2% in the region as a whole.

In the medium term, we believe that an increase of 4% is realistic, after a growth rate averaging around 6% over the past five years.

It goes without saying that Latin America has also been unable to escape the global turmoil unscathed. Nevertheless, the region is far less at the forefront of the crisis than it has been in the past. So why would this be? Many Latin American countries have generated current account surpluses, some of them substantial, over the past few years. This means that they were not forced to considerably increase their foreign debt in order to finance current account deficits. Rather, the countries that managed to generate surpluses were able to further increase their currency reserves to a considerable degree, making them far less susceptible to a crisis. Brazil, for example, is now actually a creditor in net terms, despite having had what was still a very high level of foreign debt only a few years ago. Furthermore, there is no credit bubble in Latin America, unlike in eastern Europe. Foreign currency loans to the private sector are virtually non-existent. Another factor that has made this region more crisis-resistant is the fact that the Latin American banking sector is in relatively good shape. Bank margins are high (in particular in Brazil), which is why investments in the subprime market, for example, were never made in the first place. And, last but not least, economic growth over the past few years has been driven more by strong domestic demand and less by exports. This means that now, in a time when foreign trade is gasping for breath across the globe, the economic slump, too, is less pronounced.

Of course, this is not intended to distract from the fact that the real economic consequences of the crisis are, in some cases, massive. Mexico, for example, has been hit very hard by the US recession. After all, around 85% of Mexican exports are destined for the US. Argentina is also increasingly finding the going tough again, as the financial situation of the Argentine state deteriorates. The country is being weighed down in particular by the worst drought catastrophe in decades, which has wiped out massive amounts of crops. All in all, the Latin American economy is expected to contract slightly this year. We expect to see an increase of 2.5% next year.

Asia, too, has not fallen into a structural crisis so far, despite the economic slump, thanks to a relatively robust banking system, currency reserves that are at a record high, a low level of foreign debt and substantial current account surpluses. But it goes without saying that the Asian emerging markets are also feeling the heat of the global recession. After all, exports were the driving force behind the strong growth witnessed in recent years in most of these countries. These exports have now collapsed everywhere in the region. Many countries are now trying to use economic stimulus packages and a loosening of the monetary policy reins to combat the recession. China, for example, has come up with a two-year fiscal package worth around 14% of the country's GDP. In actual fact, an increasing number of signs are currently pointing towards a stabilization on Asia's largest emerging market. Following economic growth of 9% last year, we expect to see China return economic growth of between 5% and 6% in 2009. We expect to see an increase of 3% for the region as a whole, the poorest result since the 1998 Asian crisis. While growth is expected to pick up to 5% next year, this would still put it well below the average seen over the past few years (1999-2008: 7.2%).

On the whole, negative economic performance in eastern Europe and Latin America and moderate growth in Asia means that the emerging markets will grow by only

1.5% this year – very modest growth given that these countries still have considerable catch-up work to do. We expect to see an increase of 3.7% next year.

The Japanese economy has been hit full-on by the drastic slump in global trade. The slump in the demand for advanced manufacturing products, which by international standards account for a large proportion of aggregate output, has dealt the Japanese economy a particularly hefty blow. The considerable appreciation of the yen has made matters worse. As a result, the extreme slump in exports was the main reason behind the decline in aggregate output in the final quarter of 2008, which was far more pronounced than in other major industrialized nations. In the first half of 2009, an inventory adjustment process is likely to continue to weigh on production. Although progress was made at the beginning of the year, if the experience gained during the last recession is anything to go by, industrial production will not bottom out until the end of the second quarter at the earliest.

GROWTH RATES IN MAIN ECONOMIC REGIONS

- GDP, real % change over previous year -

	2005	2006	2007	2008	2009[1)]	2010[1)]
Industrialized countries	2.3	2.8	2.4	0.7	-2.6	1.7
European Union	1.9	3.2	2.9	1.0	-2.3	1.4
Euro area	1.7	2.9	2.6	0.8	-2.3	1.6
Germany	0.8	3.0	2.5	1.3	-3.0	2.0
USA	2.9	2.8	2.0	1.1	-2.3	2.1
Japan	1.9	2.1	2.4	-0.7	-5.7	1.3
Emerging markets	6.5	7.3	7.4	5.3	1.5	3.7
Asia	7.9	8.8	9.0	6.5	3.0	5.0
Latin America	4.3	5.2	5.5	3.9	-0.2	2.5
Central an Eastern Europe	5.3	6.7	6.9	4.7	-1.2	1.9
World	3.3	3.9	3.7	1.9	-1.5	2.2

[1)] forecast.

All in all, the global economy is likely to contract by 1.5% in 2009 (country weighting on the basis of current exchange rates) after growing by just under 2% in 2008. The global economy has not witnessed a decline on this scale in at least two decades. Next year, the global economy is then expected to grow again by 2.2%.

International trade is expected to shrink to an even more considerable degree than global value creation this year. We expect to see global trade decline by 7 - 8% in 2009 in terms of volume. 2010 is likely to see a recovery of 4 - 5%.

We have assumed the following global conditions for our forecast:

- The financial market crisis will gradually die down in the course of this year, as the major "adjustments" have already taken place. This does not, however, mean that the easing on the markets will be an uninterrupted process. Temporary setbacks are expected to keep popping up time and again, and investors are also likely to remain far more risk-averse than usual.

- Most of the major central banks, such as the Fed, the Bank of England, the Bank of Japan and the Swiss National Bank will continue to pursue their quantitative easing policy in 2009, the aim being to directly increase money supply. At the same time, they will keep their key rates at zero, or close to zero. The ECB, which will cut its key rates to only 1 ¼% , will employ unconventional monetary policy methods to

only a very limited extent. Nevertheless, this will be enough to continue to supply banks with a high level of liquidity. In the course of this year, the central banks will manage to get the money markets – short-term money trading between banks – back on track. Towards the end of 2009, the central banks will start to withdraw some of the excess liquidity from the banks as the markets start to ease. The withdrawal of further liquidity and moderate key rate hikes are expected to come in the course of 2010.

- The economic stimulus programs will be implemented as planned across the globe. All in all, fiscal stimulus measures will account for a volume of between USD 1500bn and USD 2000bn at global level, no less than 3 - 4% of global value added.

- Commodity prices will remain at a low level for the time being, but will chart a moderate upward path as the economy recovers. The price of crude oil is expected to come in at an average of USD 60 a barrel in 2010.

- The US dollar will not be subject to spectacular swings in 2009 and 2010. The expected economic recovery in the US will shore up the currency, while the ongoing need for consolidation in the US economy will weaken it. We estimate that one euro will be worth around 1.35 US dollars at the end of 2009, and approximately 1.40 US dollars at the end of 2010.

A much higher uncertainty factor than usual attaches to all economic forecasts in times of global economic crisis such as these. We see a risk that developments could be more unfavorable than we are forecasting, and that the crisis could drag on for longer.

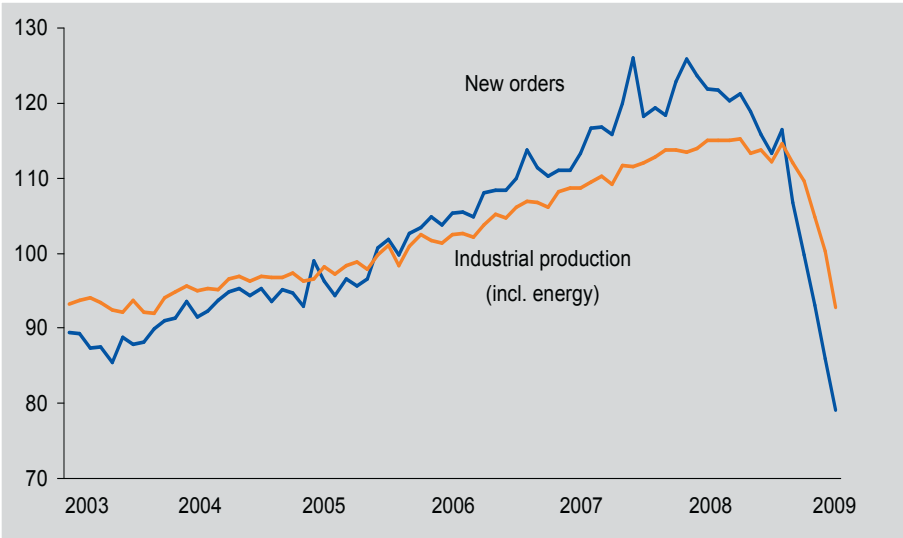
2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

2.1 Economy in free fall

Since last autumn the German economy has been in an out-and-out tailspin. In the space of five months, from August 2008 to January 2009, new orders in manufacturing plunged 32% (with the domestic intake down 26% and foreign orders 37% off). Industrial output during the same period was cut back by 20%.

Industry: Production and new orders

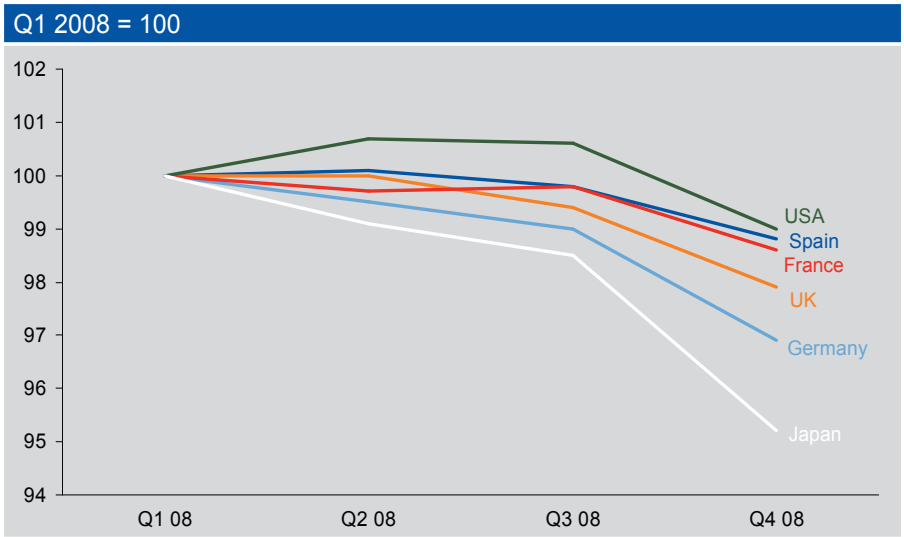
2005 = 100, volumes, seasonally adjusted



This collapse in industrial production alone would trigger a 4% drop in gross domestic product. But to make matters worse, the crisis is taking a growing hold on wholesalers, commercial construction and business services. All told, gross domestic product has presumably shrunk by more than 4% from the third quarter of 2008 to the first quarter of 2009. Never before in the history of the Federal Republic has economic performance been so bad.

By international standards, too, Germany has seen comparatively severe contraction in its gross domestic product. Of all the major industrial countries, only Japan's GDP turned in a steeper decline than Germany's in 2008.

Real gross domestic product



The main reason for Germany's exceptionally poor economic record in recent months lies in its heavy reliance on exports. Whereas shipments abroad accounted for 13% of US GDP in 2008, the equivalent share in Germany works out at around 48%. What essentially constitutes the German economy's strength – its international competitiveness – is currently working against it. Over the past months international trade has downright collapsed in various world regions. Germany has close trade ties with Eastern Europe, and many countries there are being hit disproportionately hard by the crisis. Another drawback for the German export industry is its concentration on capital goods. In 2007, mechanical engineering and motor vehicles (including automobile parts) generated a trade surplus of EUR 190bn. A mere halving of this surplus costs the German economy 4% of its value added. That highlights the potential downward danger to the German economy from the foreign trade side.

2.2 When will Germany turn the corner?

The dramatic economic downturn in Germany gives rise to various issues:

- What good is it to Germany that businesses and households have not racked up their debt as a proportion of GDP in recent years and exhibit a lower level of debt by international comparison?

- What good is it to Germany that there are no excesses on the property market?

- What good is it to Germany that wage restraint was exercised for many years, improving its international competitiveness?

In our opinion the answer is clear: Germany stands a better chance of a sustained economic recovery than other countries. No pressing need for consolidation stands in the way of domestic demand. But before the economy can begin to bounce back, two things are necessary. First, relief must continue to come from commodity prices, enabling households to preserve, or possibly slightly enhance, their purchasing power even as companies start to shed jobs. Second, foreign demand must abandon its steep downward trajectory. World trade needs to bottom out.

With regard to the first point, lower prices for raw materials are considerably boosting household purchasing power. Inflation has declined rapidly in recent months, sliding from 3.3% in July 2008 to 1.0% in February 2009. This trend will persist; indeed in the middle of the year inflation is even likely to dip below zero. With disposable incomes expected to grow by 1 to 1 ½% in 2009, real incomes look set to expand by between ½ and 1%. Even in the event of another slight hike in the savings rate, consumer demand should therefore have a stabilizing effect.

The second point is a greater cause of concern. At present demand from abroad shows no signs of stabilizing. Dire news continues to pour in from several parts of the world, with the chief focus currently on Eastern Europe. Smaller countries in particular are reporting spectacular economic nosedives. Individual Asian economies are also registering similarly high rates of contraction to the smaller European countries. On the other hand, China's massive economic stimulus package has got under way and production shows signs of a tentative recovery. Even in America the economic indicators are no longer uniformly negative.

GERMANY | Economic indicators and forecasts*

		2008				2009				2010						
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008f	2009f	2010f
GDP real		1.5	-0.5	-0.5	-2.1	*-2.0*	*0.5*	*0.8*	*0.8*	*0.4*	*0.2*	*0.2*	*0.1*	1.3	*-3.0*	*2.0*
Private consumption		-0.2	-0.6	0.3	-0.1	*0.1*	*0.3*	*0.3*	*0.7*	*0.3*	*0.3*	*0.1*	*0.2*	-0.1	*0.6*	*1.5*
Government spending		1.0	0.8	0.3	0.0	*1.0*	*0.5*	*1.5*	*0.3*	*1.0*	*0.5*	*0.3*	*0.3*	2.0	*2.6*	*2.7*
Investment in machinery/equipment		1.8	0.6	0.3	-4.9	*-5.0*	*-1.0*	*0.7*	*1.5*	*1.0*	*1.0*	*0.5*	*0.7*	5.9	*-8.3*	*3.8*
Construction		5.5	-3.5	-0.1	-1.3	*-3.0*	*4.5*	*2.0*	*1.5*	*-0.5*	*0.5*	*0.5*	*0.5*	3.0	*-0.3*	*3.8*
Domestic demand		1.6	-1.0	1.3	-0.1	*-0.3*	*0.5*	*0.6*	*0.7*	*0.4*	*0.3*	*0.2*	*0.2*	1.7	*0.8*	*1.8*
Exports		2.3	-0.3	-0.2	-7.3	*-6.0*	*0.0*	*1.2*	*1.0*	*0.9*	*0.7*	*0.5*	*0.3*	2.7	*-10.6*	*3.5*
Imports		2.5	-1.4	4.1	-3.6	*-2.8*	*-0.2*	*0.9*	*1.0*	*1.0*	*1.0*	*0.6*	*0.6*	4.0	*-3.3*	*3.7*
Industrial production (excl, construction)		1.2	-0.7	-1.1	-7.2	*-8.0*	*0.0*	*1.0*	*1.5*	*0.5*	*0.7*	*0.2*	*0.5*	0.3	*-12.9*	*3.1*
Unemployment rate (EU def.)	%	7.6	7.4	7.2	7.1	*7.5*	*7.9*	*8.3*	*8.5*	*8.5*	*8.6*	*8.6*	*8.5*	7.3	*8.1*	*8.6*
Unemployment rate (nat. def.)	%	8.0	7.9	7.7	7.6	*8.0*	*8.5*	*8.8*	*9.1*	*9.1*	*9.2*	*9.2*	*9.1*	7.8	*8.6*	*9.2*
Employed persons (nat. def.)	y-o-y	1.7	1.5	1.4	1.1	*0.1*	*-0.6*	*-1.2*	*-1.5*	*-1.2*	*-0.5*	*0.1*	*0.3*	1.5	*-0.8*	*-0.3*
Consumper prices	y-o-y	2.9	2.9	3.1	1.7	*0.8*	*0.2*	*-0.3*	*0.5*	*1.0*	*1.1*	*1.2*	*1.3*	2.6	*0.3*	*1.2*
Consumer prices (HICP)	y-o-y	3.1	3.0	3.3	1.7	*0.9*	*0.3*	*-0.2*	*0.6*	*1.1*	*1.2*	*1.3*	*1.4*	2.8	*0.4*	*1.3*
Producer prices	y-o-y	3.8	6.0	8.5	5.8	*2.5*	*0.0*	*-1.4*	*-0.5*	*1.0*	*1.4*	*1.7*	*2.0*	6.0	*0.2*	*1.5*
Current account balance	EUR bn	45.7	46.6	39.3	30.1	*22.0*	*25.0*	*28.0*	*30.0*	*30.0*	*28.0*	*27.0*	*25.0*	*162.5*	*105.0*	*110.0*
	% of GDP													6.5	*4.3*	*4.4*
Budget balance	EUR bn													-3.3	*-85.0*	*-95.0*
(Maastricht-definition)	% of GDP													-0.1	*-3.5*	*-3.8*
3-month money market rate*	%	4.7	4.9	5.3	2.9	*1.5*	*1.5*	*1.6*	*1.7*	*2.1*	*2.3*	*2.5*	*2.8*	4.6	*1.7*	*2.3*
10-year gov.bond yield**	%	3.9	4.6	4.0	2.9	*3.0*	*3.0*	*3.4*	*3.8*	*4.0*	*4.3*	*4.2*	*4.1*	4.0	*3.3*	*4.1*
Exchange rate**	USD per EUR	1.58	1.58	1.43	1.39	*1.35*	*1.35*	*1.35*	*1.35*	*1.37*	*1.40*	*1.40*	*1.42*	1.47	*1.35*	*1.40*

* 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.

Obviously, for the time being restrictive forces (economic agents' lack of confidence in one another, huge uncertainty over the economic outlook, difficult financing conditions for some businesses) and expansive stimuli (expansive fiscal and monetary policy, relief with production costs and purchasing power gains from lower raw material prices) will continue to battle for dominance. It will not become apparent until around mid-year whether the global economy and world trade are gradually recovering some of their poise. That is also when Germany should begin to show signs of turning the corner – the scenario we still consider most likely.

In the second half of 2009 Germany's economic recovery will gain in breadth. Construction will benefit from government spending on infrastructure. Consumers, faced with an ebbing financial market crisis and complete price stability, should gradually abandon their reticence and not ratchet up their currently high savings rate any further. International trade will pick up again, particularly in sectors – such as commercial vehicles and large machinery – in which it has at times dried up almost entirely. But despite recovering in the second half of 2009, German exports at the end of the year will still be more than 10% off their level at the beginning of 2008. On average for the year, too, the drop will easily top 10%. We expect German GDP to shrink 3% in 2009.

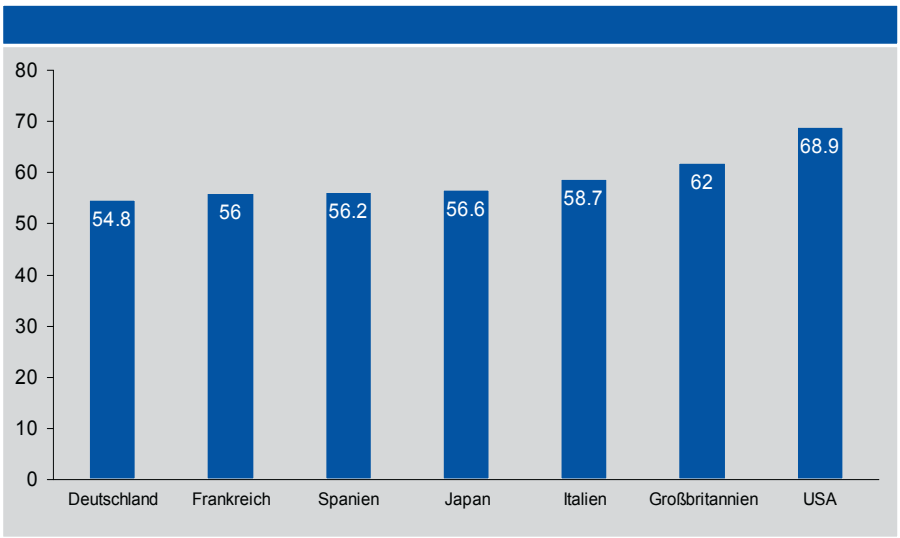
The economy will get off to a relatively good start in 2010, although the overall backdrop will probably soon prove to be a constraint. Globally, impetus from the stimulus packages will wane. Although crisis-ridden property markets are likely to bottom out or pick up a little, the situation there will not return to normal in 2010 either. In general, German exports will not power economic growth to the same extent as in earlier economic upswings. And in the course of 2010 the additional demand resulting from the German government's two economic packages will taper off. Given the high level of new public sector borrowing, moves will be made to increase taxes and contributions and cut back on spending. Private consumption will remain a mainstay of economic recovery as job cutting comes to an end and inflation remains narrowly contained. All in all, the economic rebound will lose some of its vigor again in 2010. Nonetheless, the economy will grow by 2% in 2010 as a whole – although that still puts overall economic production 1% lower than in 2008.

2.3 Private consumption more important than ever

In 2008, private consumption in Germany generated not quite 55% of gross domestic product – a low reading by international standards.

Whereas some countries can look back on years of exuberant consumer demand, the opposite is the case in Germany. For years, German consumers have lived "beneath their means". A certain correction is likely here. For 2010 we expect consumption to account for 56% of GDP, which is at least a good percentage point more than in 2008.

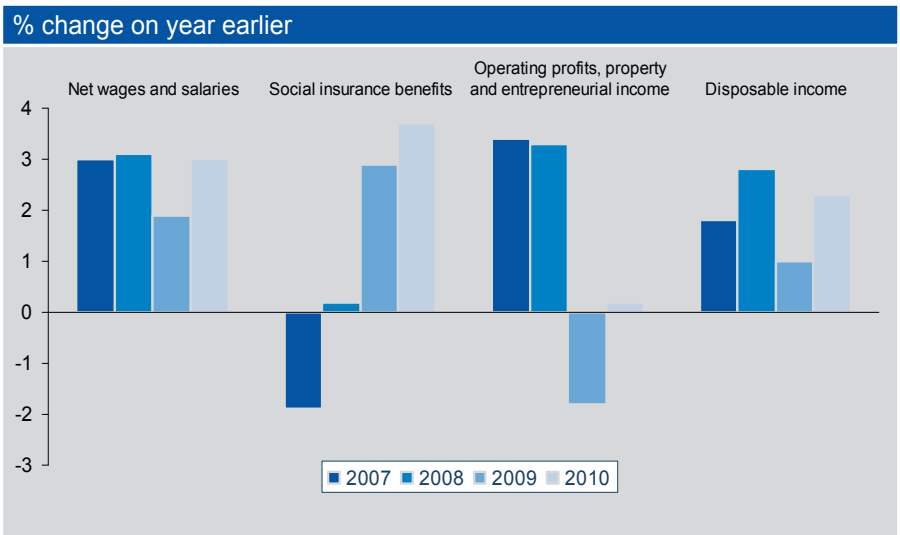
Private household consumer spending as % of GDP (2008)



This year and next opposing forces will impact the development in consumer demand:

- the jobs market (negative impact),
- the tax and contributions burden (positive impact),
- raw material prices (positive impact),
- profit income and interest income (negative impact),
- transfer incomes (positive impact).

Private household disposable income



The rise in labor incomes by roughly 4% in 2008 was the strongest for a long while. This increase consisted of a 2.3% jump in actual earnings per employee and employment growth of 1.6%. In view of the job cuts now starting to be made and the

likelihood of slower wage growth, we expect gross labor incomes to climb by only 1.6% in 2009 and 1.2% in the following year. As a result of the marginal drop in social insurance contributions and income tax relief, the increase in total net wages and salaries will work out slightly higher, at 1.9% in 2009 and 3.0 % in 2010. Social benefits other than social transfers in kind will be stepped up considerably faster in 2009 and 2010 than in the past years. For one, mid-2009 pensions will be hiked significantly for the first time in years (by 2.4% in west Germany and 3.4% in east Germany). Second, the worsening situation on the labor market will push up benefits to the unemployed and to workers on short time. After several years of declining or flat (monetary) payouts from the social security funds, we predict an increase of 2.9% in 2009 and 3.7% in 2010. The years-long trend of buoyant growth in withdrawals from entrepreneurial income and in mixed income is expected to be reversed in 2009 into a marked downturn. The same applies to property income, amid falling interest rates. We see net operating surplus, entrepreneurial and property income contracting by 2% in 2009 and remaining flat in 2010.

All in all, we expect disposable incomes (including the increase in occupational pension entitlements) to climb in 2009 by a meager 1.0% and by 2.3% in 2010. But with inflation dropping sharply, households will still be left with 0.6% higher real incomes in 2009 and a 1.2% increase in 2010. The household savings rate, which hit a high level of 11.5% in 2008, is likely to remain flat in 2009 and to ease very slightly next year. This is suggested by the drop in interest rates and the shift in the structure of incomes in favor of transfer and labor income and away from profit income and mixed income. Added to which, as the financial market crisis ebbs, panic saving will also become less of an issue. In the light of this we expect real consumer spending to tick up by 0.6% in 2009 and 1.5% in 2010. Consumer demand will be crucial to shoring up the economy.

2.4 Sharp clampdown on investment

Having already fallen by around 5% in the fourth quarter of 2008, machinery and equipment investment is likely to remain on a sharp downward trajectory in the first half of this year. According to the Ifo Business Survey, industrial capacity utilization plunged nine percentage points between July 2008 and January 2009 from 86% to 77%, its lowest level since German reunification. It is understandable that such scant use of existing capacities erodes the need for capital expenditure. Added to this is the severe slump in profits and the unfavorable external financing conditions for some businesses – mainly bigger companies. This puts a severe strain on both the inclination and the ability to invest.

Even so, the investment outlook is not negative. Small and medium-sized businesses are far better provided with equity at present than during economic crises in past decades. This gives rise to the hope that, once the economy regains its stride, investment demand will pick up again. German companies are alive to the fact that the export successes of the past could be achieved only through investments in new technologies and productivity gains. As soon as uncertainty over the economic prospects is allayed, German companies will start channeling more funds back into their businesses again. We are penciling in a slight recovery in investment demand for the second half of 2009. Nonetheless, on average for the year machinery and equipment investment will fall by more than 8%. But then in 2010 we expect to see growth of almost 4%.

The construction sector started 2009 on the wrong foot. Due mainly to the adverse weather conditions, construction spending in the first quarter of 2009 was an estimated 8% down on the first three months of 2008. However, the outlook is brighter for the rest of this year. With the exception of commercial construction, which will suffer considerably from companies' scant inclination and ability to invest, the rest of the construction industry should bounce back strongly in the course of 2009. As from mid-year public sector construction will receive a powerful boost from the government's stimulus programs, the effect of which will also be carried over into 2010. We are therefore looking for double-digit growth in public building works in the second half of 2009 and the first half of 2010.

For housing construction the picture is not quite so rosy. Extremely low interest rates, a gradual easing in households' concern over the general economic outlook and the additional (albeit limited) tax stimulus should trigger a revival, particularly for the finishing trade. All in all, we see construction spending in 2009 down very slightly on 2008 (-0.3%). The likelihood of a recovery in commercial construction next year sets the scene for a marked rise in construction spending in 2010, when we expect real growth to brush the 4% mark.

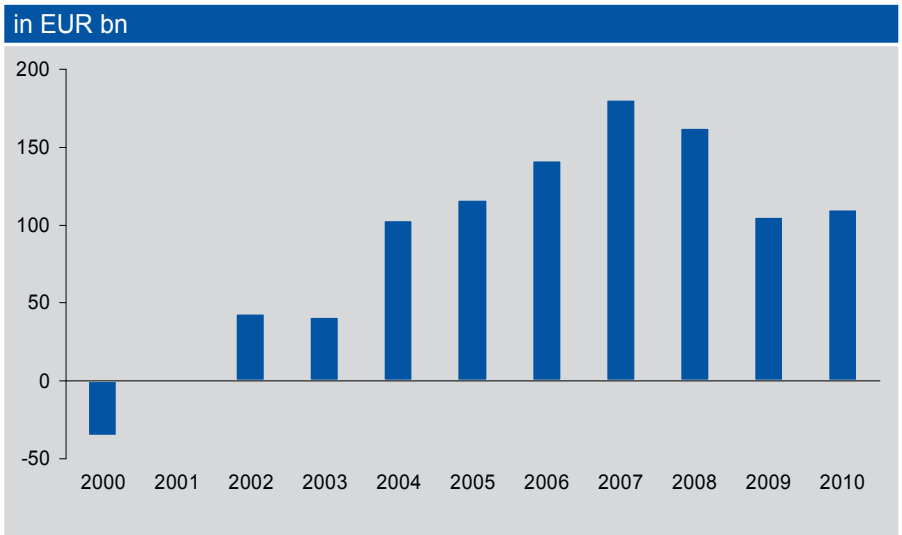
2.5 Exports in for a rocky ascent

In terms of volume, we estimate that German deliveries of goods and services abroad contracted by around 15% in the first quarter of this year, but trade in goods is thought to have stalled by as much as 18 – 20%. Similarly massive declines in imports are not to be reckoned with. Year-on-year, we expect real first-quarter imports of goods and services to have fallen by 4 – 5%, with purchases of goods alone dropping by 6 – 7%. This has halved Germany's current account surplus within the space of a year – from the first quarter of 2008 to the first quarter of 2009 – from EUR 45bn to an estimated EUR 22bn. The fifty-percent shrinkage is all the more surprising since imported raw materials have become considerably cheaper during the twelve-month period, resulting in a marked improvement in the terms of trade – the ratio of export to import prices – for German industry. The dramatic reduction in Germany's trade surplus is a clear indication that the global imbalances in foreign trade are leveling substantially.

In our estimation, exports can already be expected to bottom out in the second three months of 2009. In the second half of the year shipments abroad should then gradually start to pick up. For 2009 as a whole this would imply a slide in exports by around 13%. On the back of a further moderate bounceback in world trade in the course of 2010 German exports should also continue to recover. In 2010 we expect sales abroad to grow by 3 ½%. That is anything but a powerful upswing, still putting German shipments at the end of 2010 almost 10% below the level they held at the beginning of 2008. We do, however, see the chance of a considerably brisker export upturn in the event that the crisis on the financial markets dies down more quickly.

On the import side, we see foreign purchases growing by a good 3 ½% in 2010, having dropped in 2009 by not quite that percentage. In both 2009 and 2010 the surplus on current account will be much lower than in the past. At somewhere in the region of EUR 105 – 110bn, it will be equivalent to a good 4% of gross domestic product, compared with 6 ½% in 2008 and 7 ½% in 2007.

Current account surplus



2.6 Lagged reaction on the jobs market

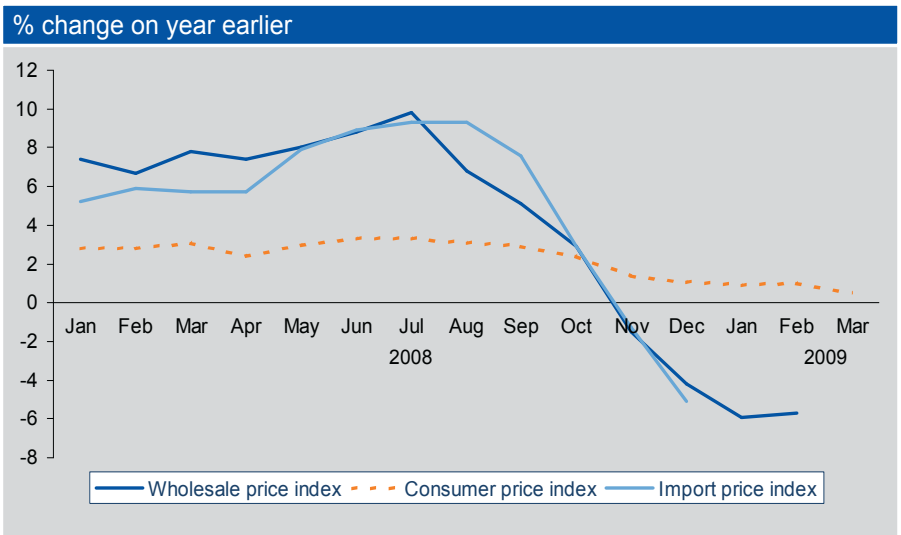
Having progressed briskly from 2005 to 2008, the improvement on the labor market came to an abrupt end late last year in the grip of the economic crisis. Employment has been falling since last October and the number of people out of work rising. From December 2008 to February 2009 the seasonally adjusted jobless tally climbed by around 100,000, even though putting employees on short time – an instrument that many companies are currently using – has significantly slowed the rise in unemployment. The longer the economic crisis persists, the less able companies will be to maintain their workforce levels. We expect the grimmest reports from the labor market around the middle of this year. Then as from autumn 2009 the downward employment spiral should slow as the economy starts to claw its way back. Even so, an estimated 600,000 more people will be out of work at the end of 2009 than a year earlier. In parallel, the number of people in work will probably decline by 1 ½% in the course of 2009. But 2010 certainly holds out the prospect of stabilization on the jobs market given a moderate upturn in business activity. At 3.8 million on average for 2010, the jobless count will probably still be about 200,000 higher than in 2009, although unemployment will not continue to rise in the course of next year. All in all, if the situation were to pan out in this way the German jobs market would escape fairly lightly. But with each month that the economic crisis lasts longer than we expect, this forecast would have to lower its sights significantly.

2.7 Close to price stability – neither inflation nor deflation likely

Scarcely any economic issue is the subject of such controversial debate at present as the question of whether the economic crisis is raising the specter of deflation or whether swamping the banks with liquidity and jacking up government debt is the road to inflation. In our assessment the likely scenario is that neither phenomenon will materialize. This is not to say, however, that the risk of deflation can be dismissed out of hand.

Since the summer of 2008 import and wholesale prices have been in free fall. But it would be wrong to interpret this as heralding deflation. The nosedive is the result of a collapse in prices for raw materials and food in the aftermath of an unprecedented

Inflation



price boom. Falling import prices are cutting costs for companies and boosting household purchasing power, with the effect of shoring up economic activity. Only a situation in which the prices of goods fall for a protracted period across practically all product categories could be described as deflationary. But that is not the case at present, nor is it to be expected this year – even if the consumer price index around mid-year probably will register slightly negative four-quarter rates. Another factor arguing against deflationary tendencies in the German economy is the recent acceleration in prices apparent in the gross domestic product. The GDP deflator in the fourth quarter of 2008 was 2.1% higher than in the fourth quarter of 2007. But for 2008 as a whole GDP inflation was just 1.5%.

Businesses are evidently not passing on the reductions in commodity prices in full, trying instead to at least maintain their profit margins per unit of production in an environment of slumping sales. What this also shows is that companies still possess sufficient market power and are not engaged in price wars that would erode their earnings base. In the probable event of an economic revitalization in the second half-year, profit margins can be expected to stabilize anyway. On average for 2009 we forecast a 0.3% uptick in consumer prices, followed by an increase of 1.2% in 2010. Any marked intensification of inflationary pressure this year and next is extremely unlikely given that companies' capacity utilization is low and the employment situation will not tolerate any high pay settlements. In our opinion this still leaves the central banks ample time to set about mopping up the huge amounts of liquidity they have made available to the banks and markets, thereby avoiding the risk of inflation gathering sustained pace.

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

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