



Economic outlook 2010

January 26, 2010

Positive signals for the German economy

The German economy emerged from its deepest post-war recession in the middle of 2009.

We are optimistic that during 2010 the recovery will continue and that the upturn which is currently still being largely driven by monetary and fiscal policy will become increasingly self-sustaining. This is indicated by the expansionary monetary and fiscal policies, the stabilisation of the financial markets, the synchronised global economic upturn, low inflation and the improved sentiment among both companies and households.

This year we expect real GDP to grow more than 2% after having contracted by 5% in 2009.

Private consumption looks set to rise again this year by around ¾%, as households benefit from further tax relief, inflation remaining low and only marginal employment declines thanks to the continued widespread deployment of short-time working arrangements.

With exports recovering and profits rising, investment is also likely to resume despite the gross underutilisation of production capacities. We forecast that investment in plant and equipment will rise almost 6% after tumbling 20% in 2009. We believe that construction investment could grow nearly 1%, in particular on account of brisk public-sector construction activity triggered by the stimulus packages.

The leading central banks will start to slowly crank up their key rates from mid-2010 onwards and exercise extreme caution in phasing out their unorthodox measures. In 2011 the monetary policy reins will probably be tightened further. Since we assume that fiscal policy will also be tightened in 2011 we expect the growth momentum to slow in the course of 2011. Nevertheless, the German economy should still post slightly higher growth than potential, almost reaching 1 ½%.

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This report is based on the "World Outlook" published by Global Markets Research in December 2009 and provides a more in-depth analysis of Germany.



German economy growing again

Both the global economy and German GDP recovered significantly since the dramatic slump in the winter of 2008/09 when the world was paralysed by the collapse of Lehman Brothers and the German economy contracted by 6%. In Q2 2009, after four quarters of declining economic activity, Germany resumed positive growth (of 0.4% compared with the previous quarter) and in Q3 posted growth of no less than 0.7%. Nevertheless, average annual real GDP fell by 5% in 2009 and the recovery made to date is largely attributable to the extremely loose monetary policy and the government stimulus packages.

Five reasons why things will be better in 2010

This year we expect the recovery to continue and Germany to post robust economic growth of over 2%. The reasons are:

1. The resolute response from policymakers
2. The stabilisation of financial markets
3. The synchronised global economic upturn
4. Low inflation and
5. Improved sentiment, especially in the business sector.

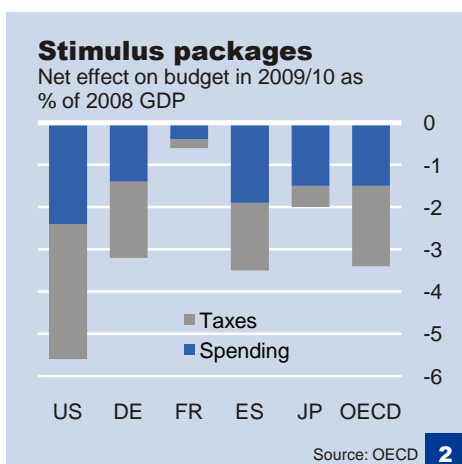
Reason 1: Economic policy still expansionary in 2010

One reason for our optimism is the rapid and correct reaction of policymakers to the dramatic escalation of the financial crisis and the global downturn. At an early stage extensive global action was taken to bail out banks, stabilise financial markets and launch comprehensive stimulus packages. The volume of these stimulus packages is estimated at around 2 ½% of global GDP. The US went to especially great lengths to avert an economic meltdown with a particularly comprehensive package equalling 5.5% of US GDP. The important aspect is that the support measures were not only aimed at 2009 but also at 2010. This means that fiscal policy remains expansionary this year almost everywhere in the world – also due to time lags.

Germany's stimulus packages amount to more than 3% of GDP

This applies particularly to Germany where two stimulus packages totalling 3% of GDP were implemented. A third one was passed recently, the so-called "Growth Acceleration Act", amounting to EUR 8 ½ bn or a good ¼% of GDP. The stimulus packages I and II comprise among other things tax cuts and tax reliefs both on income and corporation taxes, increases in child benefits, the reduction in contribution rates for unemployment and statutory health insurance, the car scrappage bonus, the extension of short-time working arrangements and higher public spending especially on infrastructure. The latter measures will take effect primarily in 2010. With the Growth Acceleration Act families will gain additional relief in 2010 via a higher child allowance. There are also concessions on inheritance and corporation taxes as well as a reduction in VAT on hotel stays from 19% to the lower rate of 7%.

The growth momentum generated by the stimulus packages is, however, smaller than the impact on the budget as the tax and expenditure multipliers are likely to be lower than usual on this occasion given the extraordinary speed and depth of the collapse. The German Council of Economic Experts estimates the economic growth impact of the two stimulus packages at about 1.6% of GDP



in 2009 and nearly ½% of GDP in 2010. Such estimates must, however, be treated with caution since they are highly reliant on the model on which they are based. The effect could be greater in 2010 as there has been slippage particularly of spending on infrastructure budgeted for 2009 into expenditure in 2010.

Huge widening of the deficit

The other side of the coin is the widening of the budget deficit. The stimulus packages together with the impact of the automatic stabilisers (including lower tax receipts and higher expenditure on unemployment due to the recession) will probably inflate the general government deficit to more than 6% of GDP in 2010 from 3.2% in 2009. This would be more than double the Maastricht criterion of 3% of GDP. This is, however, permitted temporarily within the framework of the revised Stability and Growth Pact. According to our calculations, general government debt will rise from about 66% of GDP at the end of 2008 towards 80% in the years ahead. Complying with the Maastricht Treaty's 60% debt limit will thus be firmly ruled out.

Fiscal policy will be tight in 2011

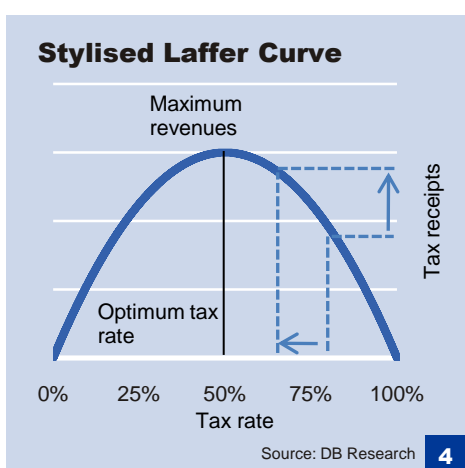
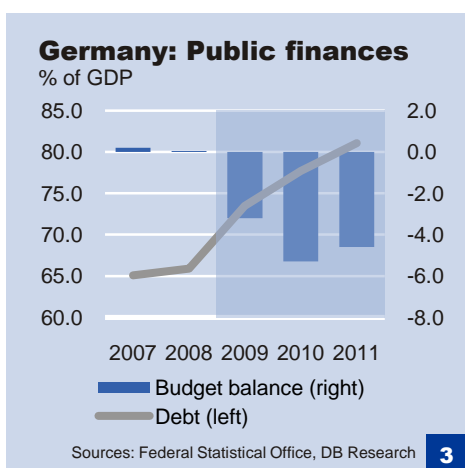
Public-sector debt will expand even further in 2011 as well and will probably also shoot around 80% of GDP mark, although we assume that initial austerity measures will be introduced in 2011 and the general government deficit will fall towards 5% of GDP. This assumes that there will be at best an initial setting of the course for commencing the income tax relief hammered out in the coalition agreement. This, like all the other measures in the coalition agreement, is explicitly subject to the "availability of funding". Austerity imperatives will also dominate with an eye on the European Commission's excessive deficit procedure in 2011. Providing the announced tax relief of up to EUR 24 bn or around 1% of GDP thus appears to be barely feasible, especially as a self-financing ratio of 50% is the best that can be hoped for.

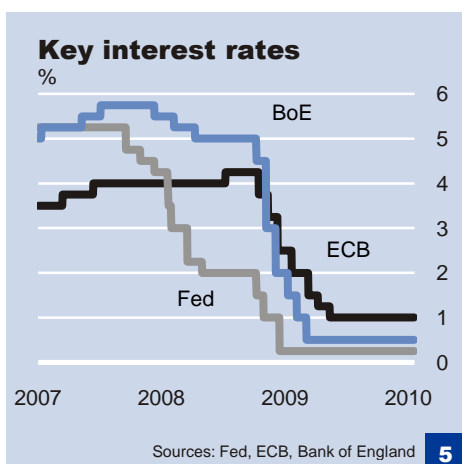
Planned income tax cut not self-financing

Theoretically a tax cut can be self-financing if the incentives it provides prompt economic agents to work harder, boosting wages and thus increasing tax receipts. The famous "Laffer Curve" describes the correlation between the tax rate and tax revenues in an economy. A very low tax rate generates low tax revenues as the state only creams off a small proportion of national income. A very high tax rate, however, reduces economic dynamism by lowering incentives and thus also leads to low tax receipts. According to the Laffer Curve, it is possible to determine the optimum tax rate that maximises tax receipts. If the current tax rate is above the optimum level, a reduction in the tax rate boosts tax receipts. A tax cut could thus theoretically be definitely self-financing. However, a current empirical study finds that the self-financing ratio in Germany is only about 50%, and according to many other analyses the self-financing ratio is in fact a great deal lower. This means that a tax cut of one euro would indeed stimulate the economy, but the additional tax revenue would be at best a mere 50 cents.

Debt cap makes cuts necessary

Cuts are also required by Germany's constitutionally anchored debt cap, which specifies a consolidation of public sector budgets over the coming years. Federal and Länder government budgets are then to be balanced without borrowing. For the federal government this





means that the new structural debt, i.e. cyclically adjusted borrowing, must not exceed 0.35% of GDP from 2016. Germany's individual states will be subject to even stricter rules that ban new structural debt completely from 2020.

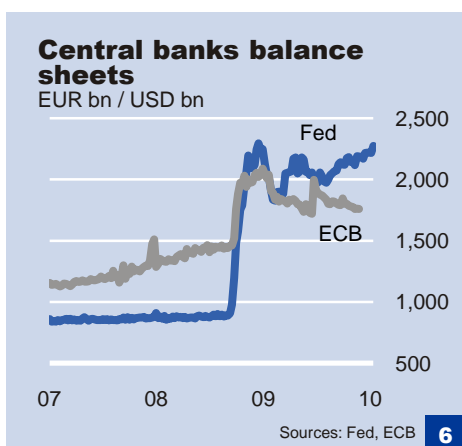
Monetary policy: Entering the exit phase

Monetary policymakers reacted faster than fiscal policymakers to the unfolding financial crisis and the global economic downturn. In the space of just a few months the leading central banks slashed their key rates to historically low levels. For example, the Fed Funds target rate is currently a range between just 0% and 0.25%, the Bank of England's base rate is 0.50% and the refinancing rate of the European Central Bank is 1%. Furthermore, the ECB has extended the maturity of its refinancing operations to 12 months, all tenders have been fully allotted and unorthodox measures have also been adopted – at least to a limited extent. To date it has completed EUR 31.5 bn slightly more than half of the announced covered bond (Pfandbrief) purchases of EUR 60 bn. Even if they are fully executed, however, they will amount to only about 3% of the market volume. The ECB balance sheet expanded by 40% between September and December 2008 to EUR 2,000 bn or a good one-fifth of eurozone GDP; since then, however, it has fallen by nearly 15%.

ECB carefully preparing markets

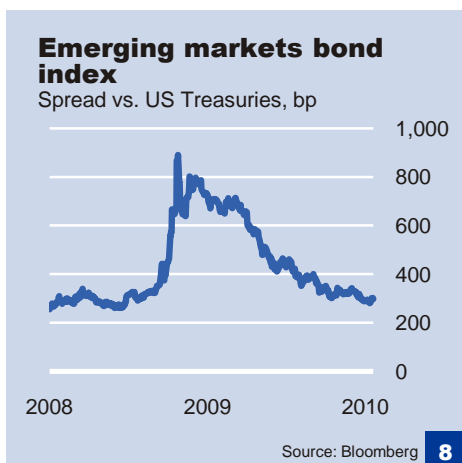
The ECB is currently preparing the markets for the exit from its extremely loose monetary policy. It conducted the third and last refinancing operation with a maturity of 12 months in the middle of December 2009, has set the end of March as the date for its final 6-month tender and committed itself to full allotment at the fixed refinancing rate only until the middle of April. Compared with the Fed the ECB can implement its exit strategy relatively easily since its expansionary measures are primarily focused on rate cuts and repo maturities and volumes, that is measures to provide temporary liquidity which runs off automatically when the operation expires.

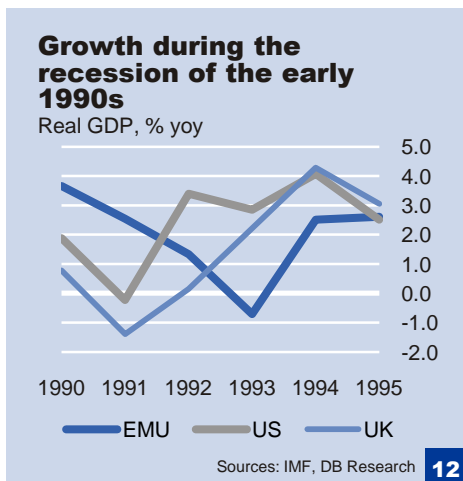
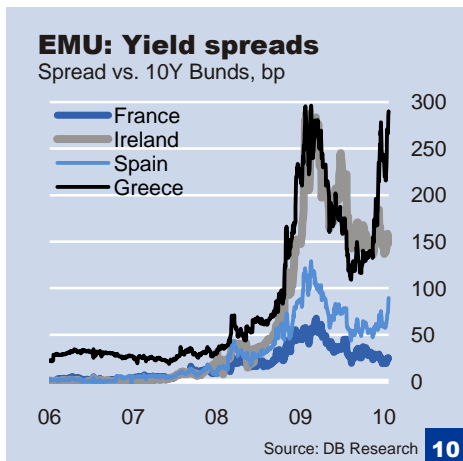
We do not expect rate hikes until autumn of this year, so the refinancing rate could stand at 2% at the end of the year. It is, however, still too early to talk of tight monetary policy. Figuratively speaking, the ECB thus still has its foot on the accelerator, but not quite as much as in the crisis year 2009. Monetary policy will thus also provide growth stimuli in 2010, which will probably only slowly recede in 2011, if the ECB makes further progress along its course towards neutral monetary policy.



Reason 2: Stabilisation of the financial markets

Another reason for our optimism about growth in 2010 is the ongoing stabilisation of the financial markets, which is bringing down corporate funding costs and thereby improving the investment environment. The positive equity market performance and lower spreads of emerging market and corporate bonds over government bonds show that the flight to safety in H1 2009 triggered by the international financial crisis has been superseded by a moderate degree of risk tolerance. The spread between the bonds of euro-area financial institutions over German Bunds has narrowed sharply since its high of 800 basis points at the start of 2009 and has settled at about 250 basis points since September 2009. The yield on these bonds has thus fallen to 5 ¾% at last reckoning, compared with its peak of 11%. Although this is still much higher than before the financial crisis broke (in 2007 it averaged 5%), funding conditions for financial institutions have nevertheless improved markedly





compared with the peak of the crisis. The same applies to industrial companies whose bond yields have again reached 2007 levels.

Bond yields rising only slightly

In view of the robust economic growth and assuming that the financial crisis eases further and thus risk appetite continues to rise, we expect government bond yields to increase to 4% by the end of 2010 (from 3 ¼% at present). The rise in corporate bond yields is thus also likely to remain within tight bounds. Capital-market-based funding will thus remain appealing. Nonetheless it may – under certain circumstances and in certain segments – become more difficult to be granted bank loans, as shown by the central banks' lending surveys. There is still no hard evidence of a general credit squeeze, i.e. a greater shortage of loan resources than can be expected given the deep slump in investment.

Reassessment of risk in the euro area

The ballooning of budget deficits resulting from the financial crisis has led to extensive debate in the euro area about their funding as well as the sustainability of public finances. As part of a general reassessment of risk the yield spreads over Bunds widened dramatically in some cases. The yield spread of Irish bonds over Bunds for example peaked at nearly 300 basis points, after remaining roughly stable until the end of 2007, but the spread between German and French government bonds also widened to more than 60 basis points.

In H1 2009 cases of overshooting then corrected appreciably, though the spread levels prior to the outbreak of the crisis were not regained. Recently Greece caused renewed uncertainty by announcing that its budget deficit could turn out to be more than twice as high as planned at over 12% of GDP. Accordingly, the yield spread over Bunds widened sharply from around 125 basis points to nearly 250 basis points. Although we assume that the situation in the euro area capital markets will ease somewhat, we expect a general reassessment of risk and therefore no longer expect a decline to old spread levels, especially not among the Southern European countries.

Reason 3: Synchronised recovery stimulating German exports

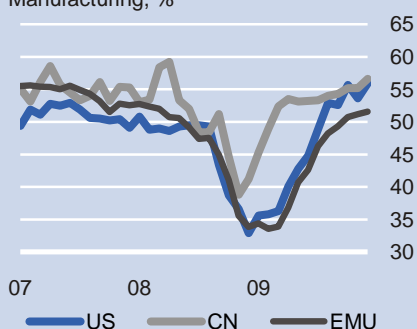
The state of shock induced by the collapse of Lehman Brothers spread quickly to international trade. Orders were postponed or cancelled to a large degree; exports – the driving force in many countries – collapsed worldwide. In the space of just three months German exports slumped more than 20% compared with the previous year, while in Japan they fell nearly 50% and even Chinese exports declined by 25%. A simultaneous slide into recession was the consequence, unlike the situation in previous crises and global recessions. During the Asian crisis of 1997/98 and during the recession in the early 1990s there were countries and/or regions that performed better and thus dragged others out of the recession. In the winter of 2008/09 there was no major country for the global economy that managed to avoid sliding into recession.

The synchronised worldwide decline in demand hit the German economy particularly hard because of its strong dependence on exports compared with other countries. Subtracting foreign inputs, goods exports contributed nearly 22% to GDP in 2007, and about one in four jobs in Germany depends on exports. There were



Purchasing managers' index

Manufacturing, %

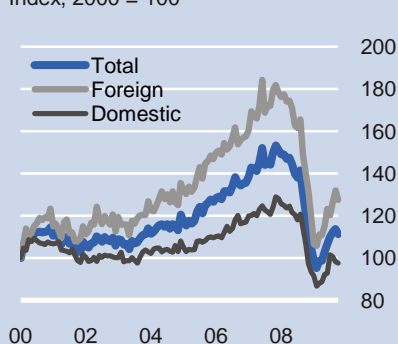


Sources: Reuters, ISM, China Federation of Logistics and Purchasing (CFLP)

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Germany: Order intake

Index, 2000 = 100



Source: Federal Statistical Office

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Global economic growth

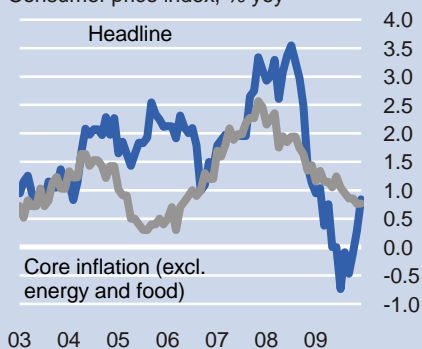
Real GDP, % yoy	2008	2009	2010
US	0.4	-2.5	3.7
Japan	-1.2	-5.5	0.7
Euro area	0.6	-3.9	1.5
Germany	1.3	-5.0	2.0
Asia	6.5	4.8	6.7
Latin America	4.2	-2.2	3.3
Eastern Europe	4.3	-5.5	2.0
Middle East	5.2	1.2	3.1
World	3.0	-1.2	3.9

Sources: IMF, DB Research

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Germany: Inflation

Consumer price index, % yoy



Source: Federal Statistical Office

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correspondingly sharp drops in order intake (-40%) and industrial output (-20%). But in exactly the same way that the synchronised global downturn hit the German economy particularly hard, the discernible synchronised recovery is now stimulating the German upswing significantly. Since the start of 2009, for example, there has been a global turnaround in sentiment among purchasing managers. The indices have recently regained roughly their levels before the slump and nearly everywhere are above the threshold of 50 points that signals further growth. And the improved sentiment has also already been reflected in order intake from outside Germany. Since its low in February 2009 order intake has again risen more than 20%, which has stabilised German exports.

New global leader in exports: China

The turmoil in the global economy was one of the factors that helped China become the world's leading exporter in 2009. Prior to this, Germany had held the title for six years in a row. Such a title should not be overrated, though. Its value is only symbolic. Besides, only goods exports are taken into consideration. If services – with their increasing significance for trade – were included, neither Germany nor China would be the leading exporter, but rather the United States. Moreover, as the national export figures are converted into a common currency for the sake of comparison, exchange rate developments play a major – and sometimes decisive – role.

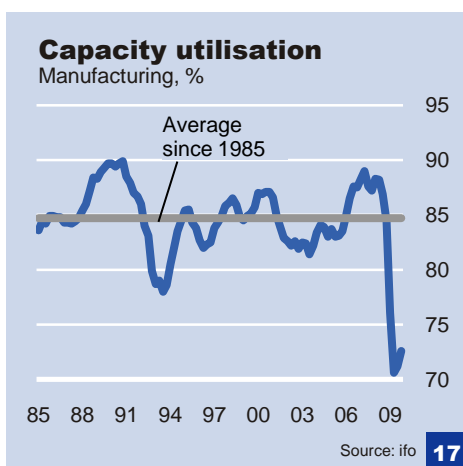
World trade to resume strong growth in 2010, with German exports trailing the average

We expect world trade to continue recovering and the global volume to increase by 8 ½% on average in 2010 after having slumped by over 12% in 2009. While this seems like a big increase at first glance, it corresponds to the usual reading on global export elasticity of just over 2 when global GDP expansion approaches 4% (adjusted for purchasing power parities). Since the appreciation of the euro (around 10% against the US dollar since mid-2009, and over 4% on a trade-weighted basis) will only start to weigh on German exporters with a time lag, expect exports to increase at a slightly below-average pace of about 7 ½% in real terms in 2010, after having fallen by nearly 15% in 2009.

Reason 4: Inflation environment conducive to growth

Another reason why we expect a healthy recovery is the persistently low level of inflation. Over the next 2-3 years at least, the forces of inflation are likely to remain very moderate and thus provide a conducive environment for growth. As capacity utilisation has fallen dramatically the return of the inflation rate to positive territory towards the end of 2009 can only be attributed to the increase in the price of oil. At year-end, capacity utilisation was down nearly 16 ½ percentage points (pp) from the last peak in the second quarter of 2007 and 11 pp on the long-term average. This suggests little likelihood of price pressure in the current year from this area at any rate. All in all, we forecast an average inflation rate of 0.8% for Germany in 2010, up from 0.3% in 2009. In 2011, it is likely to accelerate slightly to 1%.

As monetary and fiscal policies remain extremely loose at present, though, inflation risks do loom on a longer-term horizon. It is no small task for the policymakers to size up the current situation and assess how the economy and markets are reacting to their stimulus measures. This means they might be too slow or too late in launching their exit strategies. As a result, there could be a bout of



Earnings reports and trends

Unfortunately, company earnings are reported in only rudimentary fashion in the national accounts. This is partly because profits earned by joint-stock corporations (including those in the legal form of an open partnership or a limited partnership) are reported as a residual amount in the income account. The other reason is that earnings for the current year are not available on a quarterly basis – like other key data in the national accounts. As a proxy, one can use income from entrepreneurship and assets (also a residual), which is published quarterly as a component of national income. However, this variable also contains net asset income from the rest of the world. On an annualised basis this time series correlates very closely with corporate earnings, their growth being driven primarily by changes in unit labour costs.

asset price inflation in the short run and an acceleration of consumer price inflation in the long run. Nevertheless, the structural changes over the past few decades suggest that the central banks will be unwilling to tolerate higher inflation. All the major central banks have gained their independence and have managed to anchor inflation expectations at a low level. This achievement would not be lost only temporarily. In addition, capital market investors are probably no longer subject to money illusion. This means that the benefits for government coffers inherent in a higher inflation rate – which are limited anyway by the large shares, in some cases, of index-linked bonds in circulation – would be further reduced by higher interest rates.

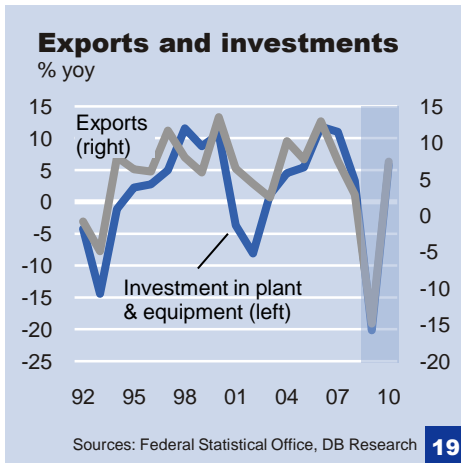
Reason 5: Increased confidence

The fifth factor that supports robust growth in Germany is the increased confidence of both industry and households. The recovery of the global economy has been accompanied by an improvement in business sentiment in Germany. First of all, the expectations component of the ifo Business Climate Index started showing a steady improvement from December 2008; in fact, expectations have already surpassed the long-term mean. Since roughly mid-2009, assessments of the current situation – at the same time as foreign order intake has increased – have also turned positive. While the ifo Business Climate Index as a whole is still slightly below its long-term average, the current level suggests industrial growth will continue to flourish, especially since company earnings probably reached their nadir in Q3 2009.

Earnings: The worst is probably over

The serious collapse in demand during the winter of 2008/09 triggered a severe decline in industrial capacity utilisation. The downturn in revenues and the deterioration in cost structures resulted in a substantial slump in company earnings. While unit labour costs in the overall economy were up by over 8% yoy in H1 2009, the increase in industry came to no less than 23%. The key reason for the higher costs was the virtual absence of attempts to counter the fall in demand by reducing headcount. In this context, Germany's short-time working scheme (Kurzarbeit) also played a role. Nonetheless, arithmetically speaking there was still an excess of 2 ¼ million workers on company payrolls in Q3. But labour costs are probably not the only factor that drove companies far away from their optimum cost structures. Company earnings have plunged accordingly. In the second quarter of 2009, income from entrepreneurship and assets was down 18.4% on the year-earlier reading. In the third quarter, unit labour costs in industry fell noticeably (-5.3%) because of the upswing in production, while entrepreneurship and asset income increased by 11.3% qoq accordingly. This reading was still down 7.5% on the year though, notwithstanding.

The fact that the earnings trend may have reversed in Q3 is also indicated by the Dax companies' quarterly reports and analysts' earnings estimates. Profit forecasts for the Dax-30 were boosted significantly in December, even though the stronger euro is a negative factor for export-oriented companies. Following a 47.6% decline in profits in 2008, a modest increase of just over 7% is expected for 2009 as a whole. Analysts say companies look set to grow their earnings by 27% in 2010, and 21% in 2011. These figures are somewhat exaggerated though by the heavy weighting of



financials in the Dax, and will probably prove to be much more moderate for the corporate sector as a whole.

Investment: Slight recovery in 2010

The global upswing, the increase in business confidence and the reversal of the earnings trend suggest that the recovery of investment activity observed since mid-2009 is likely to continue in 2010 despite the still low degree of capacity utilisation. Moreover, the expiry of declining-balance depreciation options suggests that some investments will be brought forward towards year-end 2010. We therefore expect investment in plant and equipment to increase by 5 ¾% on average in 2010 after having collapsed by 20% in 2009.

Consumer confidence is surprisingly robust

While the improvement in business confidence was to be expected considering the budding recovery in the global economy, it did come as a surprise that household confidence has been trending upward since late 2008, even though it has eased again slightly of late. The reasons for the bolstered confidence are likely not only the low inflation rate but also the government stimulus packages which, on the one hand, have afforded households tangible fiscal relief and, on the other, boosted demand for new cars by implementing the scrappage bonus. The EUR 5 bn earmarked for the car scheme was fully exhausted by the end of Q3 2009. Including the 2 million cars subsidised by the scrappage bonus there were nearly 4 million new car registrations in 2009, corresponding to an increase of over 26% on 2008.

Short shifts keeping unemployment in check

A further reason for the upbeat consumer confidence is that the labour market has remained fairly stable. Despite the huge declines in production the jobless figures have risen by less than 250,000 since the low in October 2008, to 3.4 million. Accordingly, the unemployment rate has increased by merely 0.5 pp to 8.1%. This was mainly attributable to the short-time working scheme (*Kurzarbeit*), where the term of funding was extended from 6 months to 24 months if applied for by end-2009. The funding for short-time work serves the purpose of bridging a phase of joblessness, preventing job redundancies and avoiding the costs of having to rehire staff. Short-time workers receive 60% of their net wage differential (normal working hours minus actual working hours) from the Federal Employment Agency, or 67% if there is a child living at home. Since autumn 2008 the number of short-time workers has skyrocketed, peaking at 1.5 million in mid-2009. But since then it has declined to roughly 1.1 million. On average, the participating employees have worked roughly two-thirds of their normal hours, so the short-time model has, on paper, saved up to 400,000 jobs to date.

Recently, the government decided to set the funding period for short-time work at 18 months if a company applies to join the scheme in 2010. This means that companies can benefit from it until mid-2012. From 2011, however, related social-security contributions will no longer be shouldered by the federal government. Expenditures on short-time work totalled around EUR 5 bn in 2009; more than EUR 3 bn has been budgeted for 2010.

Unemployment likely to stay low

Given the robust upswing and the continuation of the short-time work scheme we expect only a very moderate increase in unemployment in the coming months. This view is supported by the ifo Employment Barometer, which has tended to show an improvement since April. The number of jobless is likely to average just over 3.6 million for 2010 as a whole, with the unemployment rate rising towards roughly 8.5%, compared with 8.2% in 2009.

Private consumption: Slight increase again in 2010

Considering the relatively favourable development of the labour market, private consumption looks set to increase again slightly in 2010, especially since households will also gain a tangible amount of fiscal relief. The fact that social-security contributions will become tax deductible from 2010 will put an additional EUR 7 bn or so into their pockets, and the planned increase of the child benefit and child allowance could boost this amount by a further EUR 4 ½ bn. This could more than compensate the damping effects of a slight decline in employment and a further slide in wages per employee, so real private consumption should expand by about ½% to ¾% in 2010. Even though collective hourly wages increased by around 2 ½% in 2009, gross wages and salaries per employee already edged down by about ½%, the reason being the significant decrease in the volume of work. This trend is hardly likely to continue in 2010. Equally, our consumption forecast assumes that the savings ratio, which declined slightly during the spate of incentivised car purchases, will not return to the former level.

Germany:

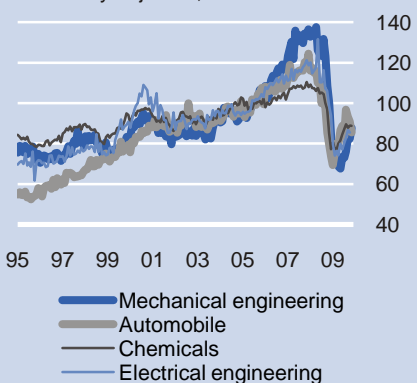
Forecasts at a glance

% yoy	2008	2009	2010	2011
Real GDP	1.3	-5.0	2.0	1.6
Private consumption	0.4	0.4	0.8	1.1
Gov't expenditure	2.0	2.7	0.7	0.8
Fixed investment	3.1	-8.6	2.4	1.8
M&E	3.3	-20.0	5.8	3.4
Construction	2.6	-0.7	0.8	0.3
Exports	2.9	-14.7	7.4	4.8
Imports	4.3	-8.9	6.5	4.0
Consumer prices	2.7	0.3	0.8	1.0
Budget balance, % GDP	0.0	-3.2	-5.3	-4.6
Unemployment rate, %	7.8	8.2	8.5	9.5

Sources: Federal Statistical Office, DB Research **22**

Incoming orders

Seasonally adjusted, 2005=100



Source: Federal Statistical Office **23**

Germany: GDP set to grow by over 2% in 2010

All in all, we expect German GDP to grow by a relatively robust 2% or more in the current year, driven not only by net exports but increasingly also by domestic demand. However, we assume that the growth momentum will subside in 2011 as monetary and fiscal policies become more restrictive. GDP growth could slow to just under 1 ½% in 2011, but this would again put it slightly over its potential.

Industry: Recovery from a low level

From 2002 through to 2008, production rose by 22% in the manufacturing sector. However, the peak was reached back in spring 2008. The downturn accelerated in Q4 2008, with output falling by over 10%. Consequently, the beginning of 2009 was heavily overshadowed by a substantial statistical growth underhang in excess of 6%. The two stimulus packages, including the scrappage bonus for old cars in particular, were only able to stabilise the economy by around mid-year. Moreover, the simultaneous impact of stimulus packages launched globally also created strong demand from abroad. The auto industry in particular registered a production boom from May 2009, and by October 2009 output had increased by over 40% from the low in February 2009. This growth also benefited the auto parts suppliers and upstream industries, especially chemicals and metal engineering. All in all, the production level in October 2009 had already topped the lowest reading of the year by over 9%. Nonetheless, despite the recovery of the annual average in 2009, output persisted at nearly 20% below the pre-year reading. Capital goods sectors such as mechanical engineering and metal engineering had been hit particularly hard, with output plunging 27% in 2009. Electrical engineering and the auto industry recorded a drop of over 20%. The situation is strikingly good in the



Recovery by sector

(Current index minus low)

	Business expectations	Situation
Food	14.7*	8*
Textiles	24.6*	13
Clothing	29.7	-0.4
Chemicals	36.5*	20.6
Plastics	29.2*	19.7
Metal engineering	30.6	11
Mechanical engineering	32.7	4
Electrical engineering	36.5*	14.1
Automobile	45.2*	8.1
Manufacturing	25.8	7.6

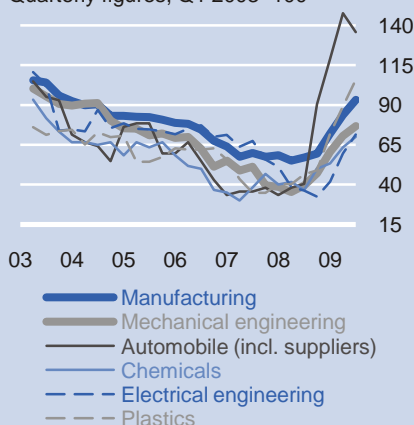
*=outstripped index 2000=100

Sources: ifo, DB Research

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Insolvencies

Quarterly figures, Q1 2003=100



Source: Federal Statistical Office

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Germany: Industrial production

% yoy

	2008	2009	2010
Food	0.2	0	1
Textiles	-4.5	-20	-3
Clothing	-15	-14	-10
Chemicals	-3.8	-14	10
Plastics	-1.9	-10	6
Metal engineering	-1.1	-27	13
Mechanical engineering	5	-26	4
Electrical engineering	5.2	-21	6
Automobile	-3.8	-23	9
Manufacturing	1	-19	6

Sources: Federal Statistical Office, DB Research

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less cyclical industries such as food, pharmaceuticals and, barring some significant exceptions, power generation.

Increases in foreign and domestic orders

The outlook for most industrial sectors is relatively favourable: incoming orders from Germany and abroad have picked up considerably since spring 2009. Order intake in all the capital goods sectors is now up by double-digit percentages on the respective lows. In fact, the auto industry is up by over 30%. While the auto industry and mechanical engineering are seeing greater growth stimuli from abroad than from inside Germany, precisely the opposite is true for chemicals and electrical engineering. This is also reflected in company managers' expectations: the expectations component of the ifo Business Climate Index has risen by 15-45 pp in all sectors since spring 2009. In many sectors, in fact, the optimists are now in the majority again. The fact that this increase was not merely based on vague hopes is documented by the second component of the ifo Index: the assessment of the business situation. This subindex has also risen significantly in nearly all sectors since the spring of 2009. The sole exception is the clothing industry: the assessment of the business situation there is currently even worse than in spring 2009. However, the clothing industry index did not decline as sharply as those for the capital goods sectors in the wake of the financial and economic crisis. For this reason, there is also only little room for improvement.

Capital goods picking up faster than consumer goods

Higher demand at home and abroad, the ongoing effects of the stimulus packages and the overall increase in confidence in the financial markets suggest that there will be a palpable increase in industrial production of around 6% in 2010 as a whole. Capital goods industries are likely to perform better than consumer goods in 2010 thanks partly to a strong basis effect. However, one should note that this increase will not suffice to rapidly regain the high degrees of capacity utilisation seen before the outbreak of the crisis. It will probably take another three years to attain approximately the same level, as capacity utilisation remains more than 5 pp below the lowest reading of recession year 1993.

This means that the risk of insolvency – typically a trailing indicator – remains high in spite of the recovery. The number of insolvencies has continued to climb in all sectors; so far there has not even been any sign of the slowdown. The sole exception is the auto industry, which has benefited the most directly and extensively from the stimulus packages. However, the risk of insolvency is still very high there, too. Furthermore, the expiry of the car scrappage bonus means that the number of new car registrations is set to plummet in 2010, so it would be premature to claim that the auto industry is out of the woods. In addition, the effects of other stimulus programmes are gradually starting to dwindle.

Mixed outlook for the building industry

Stimuli will be mixed also in the building industry in 2010: residential construction stands to benefit from the incentivisation of energy-efficient building. Moreover, more and more investors are hoping that buying residential property will help stabilise the growth of their assets. The still very low number – by historical standards – of permits issued for residential construction puts the significance of the two effects into perspective, though. At any rate, investment in residential construction should remain largely stable in 2010. Public-

sector building activity, civil engineering in particular, could even trigger growth thanks to the economic stimulus packages, while commercial building activity – especially office and retail complexes – is likely to shrink in 2010 on account of rising vacancy rates. All in all, we expect the volume of investment in construction to increase slightly in 2010.

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