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The road to recovery will be a thorny one

Germany in 2009



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Executive summary

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Exports and investments, the previous guarantors of growth, are facing a setback

Exports are slowing, investments are declining in absolute terms

Modest growth in private consumption is preventing a severe economic collapse

Averaged out over 2009, gross domestic product will contract

- As 2008 draws to a close the German economy has entered a recession that is turning out to be more severe than generally feared. There are many reasons for the economic downturn. They range from the slower pace of global growth and the euro's long-standing firmness, through rocketing crude oil and commodity prices up to and including an increasingly restrictive monetary policy. These downside forces have been magnified by the financial market crisis, which is more than a year old and is now gradually affecting all parts of the real economy.
- The previous guarantors of success, namely exports and investments, are facing a bitter setback at the very moment that the global economic upswing, the global investment boom and the oil price's bull-run have all come to an end. The impact of this is all the greater as these two demand aggregates were virtually the sole growth drivers in the preceding upswing.
- We believe exports will slacken off notably next year. However, we do not believe they will decline in absolute terms. This is, however, likely to be the case for capital expenditure on plant and equipment. Besides the gloomy earnings outlook and narrower profit margins, investing activity will also be greatly impaired by the tighter lending standards resulting from the crisis in the financial markets. We do not, however, expect a credit crunch.
- The employment-market success story threatens to come to an end at the turn of the year. After falling by around 1.9 million over the past three years, the number of unemployed is set to increase in 2009. Per se this will curb disposable incomes growth. Nevertheless, in the light of the significantly reduced price buoyancy, real incomes will probably increase more than in 2008. Even if part of this increase in income goes into savings, sufficient leeway will be left for a moderate increase in private consumption. Although this will not be enough to put an early end to the economic downturn, it is likely to be sufficient to prevent an even more severe slump.
- We estimate that the economic downturn will continue well into next year. After growth of 1.6% this year, gross domestic product will probably contract by around 1% in 2009. We expect it to stage a gradual recovery towards the end of 2009. This creates a chance of a stronger economic recovery in 2010. Compared to earlier recessions, the current downturn will be exceptional as regards its extent and duration. This is due to the crisis in the financial markets.

German economy – key figures

	2005	2006	2007	2008	2009	2010
Gross domestic product (% y/y)	0.8	3.0	2.5	1.6	-1.0	1.3
Consumer prices (% y/y)	1.5	1.6	2.3	2.7	0.9	1.3
Unemployment rate (%)	11.7	10.8	9.0	7.8	7.9	8.1
Budget Balance (% of GDP)	-3.2	-1.6	-0.2	0.2	-1.0	-1.2

Source Federal Statistical Office, WestLB Research

Contents

Executive summary	1
Global economic environment: Painful recession	3
USA: economic policy moves to the fore	3
Eurozone: worst downturn since the introduction of the single currency	4
Emerging Markets: a serious test	6
Forecast risks	7
German economy's bull run comes to an abrupt halt	8
Economy suffers a surprisingly steep downturn	8
Notable decline in gross domestic product	8
Exports and capex: from guarantees of success to a risk	9
Exports will not be a growth engine in 2009	11
Significant decline in investment	11
... has a negative impact on the labour market.....	12
Private consumption as a lifeline?	13
Scope for increased consumer spending.....	13
Moderate increase in consumer spending.....	14
Economic downturn will continue into well into next year	15
Economy will stage a gradual recovery towards the end of 2009	15
Positive surprise possible due to falling oil price	16
Excursus: Economic policy in a recession and ahead of a general election	18
Federal government passes a bundle of measures to bolster a weak economy.....	18
The success of the bundle of measures is doubtful	19
'Social justice' as a leading general election issue	22
Scenarios for after the general election.....	23

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General crisis of the financial system

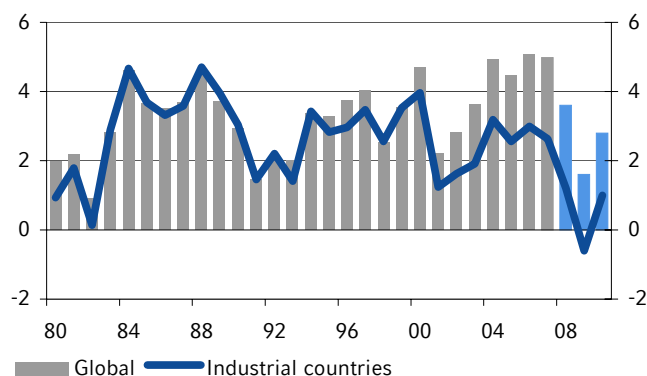
Global economic environment: Painful recession

This year the subprime and credit market crisis turned into a general crisis of the banking and financial system that is having a serious adverse effect on growth in all regions of the global economy. The financial market crisis has triggered deep-seated uncertainty among consumers and companies, which is being reflected in various sentiment indicators and, increasingly, in hard economic data, both in industrialised nations and emerging markets.

We expect global growth in 2009 to be lower than at any time since 1991

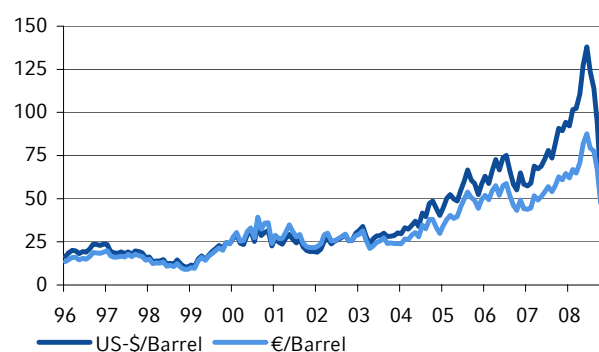
2009 will be a difficult year. There will inevitably be a sharp slowdown in global growth and a contraction in economic output across many industrialised countries. We expect the rate of global growth in 2009 to be 1.6%, the lowest since 1991. Economic output in industrialised countries is likely to shrink by around 0.6% next year (2008: +1.2%). That is unprecedented in post-war history. We put growth in the emerging and developing markets at around 4% (2008: 6.3%), although we think that the risk of that forecast being undershot is greater than the chance of it being exceeded. Only a slight growth of global trade is likely next year.

Global economic growth (in % yoy)



Source EcoWin, WestLB Research forecastt

Oil price (Brent)



Source EcoWin, WestLB Research

Much lower oil prices than in 2008

In the economic downturn, and with commodity prices much lower, the inflation problem should continue to recede. We base this on the expectation of the oil price averaging US\$50 over the 12 months of 2009, and US\$60 in 2010. This would mean a 50% fall in the annual average price in 2009 compared with 2008 – delivering a hefty boost to the current account balances of oil-importing countries. The last time there was a decline in the annual average oil price was 2001.

USA on the brink of a recession

USA: economic policy moves to the fore

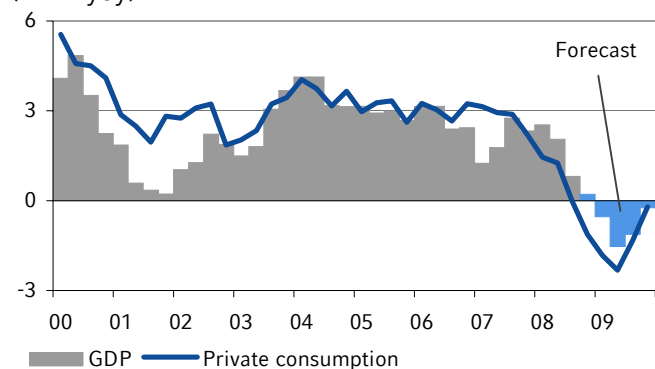
Intervention and support measures on a massive scale by the US Federal Reserve and government have prevented the financial system there from collapsing. The money market situation has now stabilised to some extent, although it is still a long way from being business as usual on the market. However, the intervention has not been able to stave off a likely US economic recession. There is great concern that, given the financial market crisis and the impact it is still expected to have on the real economy, the recession will be deeper and longer-lasting than previous economic downturns. At least, this is what past experience tells us.

In our forecasts we are assuming that things will not be so bad, as the economic policy-makers have acted relatively quickly and the US government is to put together a further

WestLB

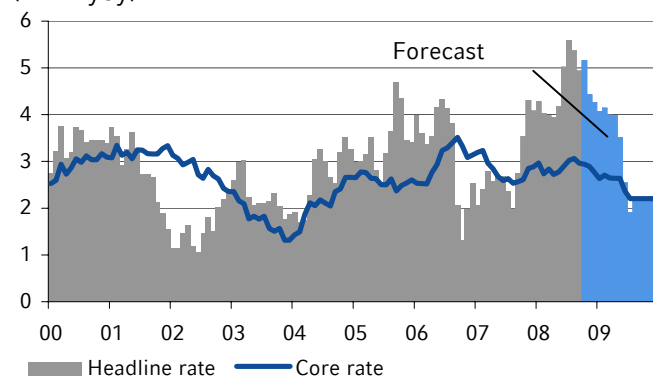
economic package. This, together with the considerable relief provided by lower energy prices, the very expansive monetary policy being pursued and the diminishing negative impact of the financial crisis and residential construction sector, ought to ensure that the economic slump is not too severe. Nevertheless, the current spell of weak growth is likely to drag on until well into next year. We think it is highly likely that there will be a contraction in aggregate economic output spanning three to four quarters. We expect the average contraction in GDP for 2009 as a whole to be 1.0%, which will include a sluggish recovery in the latter part of the year.

US: GDP and private consumption (in % yoy)



Source EcoWin, WestLB Research forecast

US: consumer prices (in % yoy)



Source EcoWin, WestLB Research forecast

Strong boost from fiscal and monetary policy

Now that a programme of measures to help the financial sector has been put in place, the political authorities and the Federal Reserve are switching their focus to the real economy. Given the lack of economic drivers, US economic policy will need to remain very expansive so as to lay the foundations for the next upturn. The US administration is likely to put together a further package of measures, probably no later than the beginning of next year, to help the ailing economy, homeowners and the middle class. As inflation risks are receding faster than originally expected, the Federal Reserve is set to cut interest rates again in December, bringing the fed funds rate down to 0.50%.

Dollar firmer in the short term, but softer again in the medium term

Since mid-July, the US dollar has recovered strongly, not only against the euro but also against other major currencies. We expect the dollar to continue appreciating in the near term, driven by the expectation that the US government will soon put together another economic package and that the US economy will emerge from the doldrums more quickly than other regions. In addition, if the market takes the view from the middle of next year that the economic recovery will probably be sluggish and that US economic growth will remain well below potential, so that the gap is therefore much greater than in the eurozone, the twin deficits in the US – i.e. public budget and current account – will become more of an issue again. On a 12-month view, we therefore expect much lower spot rates around 1.40 USD/EUR.

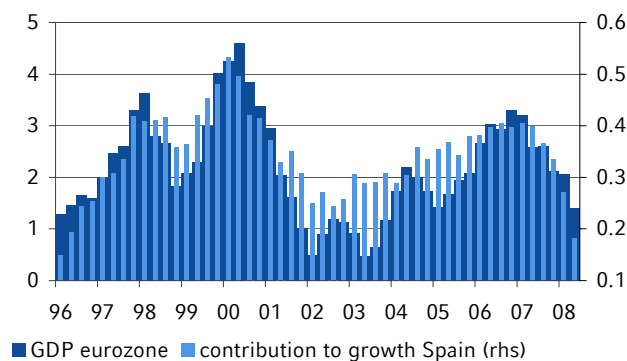
Eurozone affected by the global nature of the financial market crisis and a lack of growth drivers

Eurozone: worst downturn since the introduction of the single currency

For the coming year, we expect only a very modest recovery in the eurozone. The single currency area slid into its first recession this year, and output is still likely to be falling as we go into 2009. There are two reasons for this severe recession. The first is that the financial market crisis is a global shock that has led to a remarkable synchronisation of industrialised countries' economies. The correlation between the GDP growth rates of

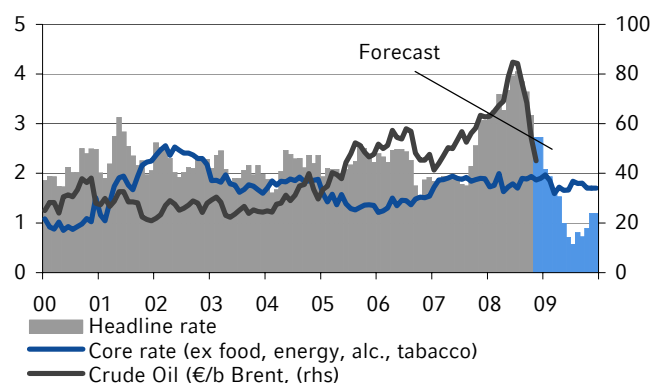
the G3 is likely to be even greater than at the time of the first oil price shock in the 1970s. Home-made crises are the second reason. Spain, one of the eurozone's growth drivers in past years, is experiencing its own property crisis. Already, the country's contribution to eurozone growth is the lowest since 1996. We expect Spain, too, to slide into a recession and to continue dragging on eurozone growth for the foreseeable future.

Eurozone: GDP and Spain's contribution to growth
(in % yoy and in percentage points)



Source EcoWin, WestLB Research

Eurozone: consumer prices and the oil price
(in % yoy and in € per barrel)



Source EcoWin, WestLB Research

Inflation rate significantly below 2% in 2009

Inflation in the eurozone reached unprecedented levels this summer, driven by the continued rise in the price of oil and steep rises in food prices as a result of crop failures. The ECB responded in June with a hike in the refi rate, citing the risk of second-round effects. However, the inflation picture has since changed considerably. The ECB will meet its own target – 2% inflation or less – clearly next year on the basis of the headline rate. That would be the first time it had done so since 1999. We expect inflation over the year to average 1.2%. This gives the ECB greater scope for cutting interest rates.

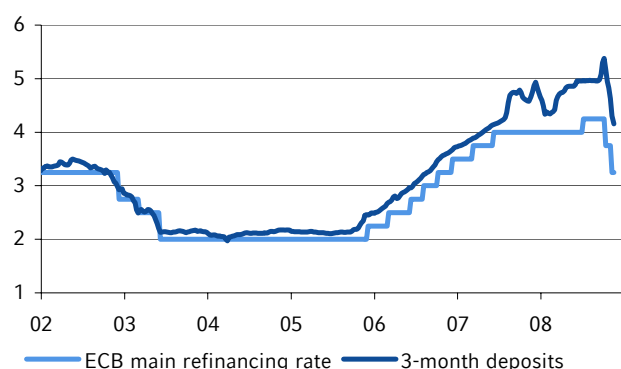
ECB monetary policy rapidly becoming expansive

After the failure of the interest rate hike at the start of July from a business cycle point of view, the ECB switched to an expansionary strategy in the autumn. We believe that the two cuts of half a percent in October and November will be followed quickly by another, probably at the start of December. With a nominal key rate then of 2.75% and an actual rate – after deducting the core inflation rate – of below 1%, a rate would be reached within a few weeks that at least aims to be expansionary. During the downturn at the start of the decade, the ECB lowered the key rate from 4.75% to 2% within two years. The current cycle of rate cuts has begun more rapidly. The far-reaching problems in the banking sector and the sharp downturn indicate that the current cycle of rate cuts will occur more quickly with a lower end result. We anticipate that the ECB key rate will reach a low of 1.5% in summer next year.

Bunds still have upside price potential

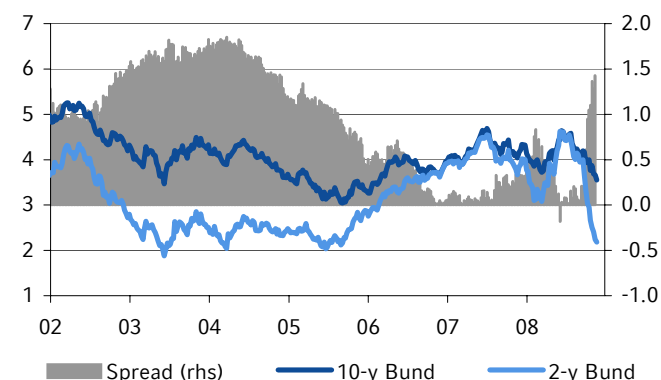
Government bonds have benefited in recent months from the recessionary environment, with German government bonds (Bunds) in particular gaining from the flight of investors to safe havens. In our view, yields on 10-year Bunds have yet to reach their cyclical low. If the next few months see significantly lower inflation and the economy remains weak, as we expect, yields on 10-year Bunds are likely to sink towards 3%. In the course of the resulting intensifying debate on deflation, the existing historic low of 3.0% from 2005 could be in sight. However, we do not think that such a low yield is sustainable. In the past, real interest rates of below 2% have usually only lasted for a short period.

Euro money market rates
(in %)



Source EcoWin, WestLB Research

Yields on Bunds
(in %)



Source EcoWin, WestLB Research

Significantly steeper yield curve

In the past few weeks, a downward movement at the short end has made the yield curve considerably steeper. If our view that the ECB will cut interest rates to 1.5% is correct, yields on two-year Bunds will fall significantly below 2% as a result of which the yield gap between ten- and two-year Bunds will widen further over a six-month horizon.

Emerging Markets: a serious test

The rate at which the emerging markets are catching up has slowed

The rapid pace at which many emerging markets have been catching up on the industrialised nations has been slowed this year by rising inflation and more restrictive monetary policy. Initially this was merely a reflection of a normal cyclical downturn. In autumn, key rates were cut in many countries – including China, India, Korea and the Czech Republic – in order to mitigate the growing risks to growth. In most emerging markets key rates are, however, higher than at the beginning of the year.

Growth rates more or less cut in half

We expect economic growth to be roughly halved in all emerging markets next year compared to 2008 due to weaker global economic growth, reduced inflows and private capital, and less favourable terms of trade for commodity exporters. We do not anticipate a slump in economic performance in any of the BRIC countries.

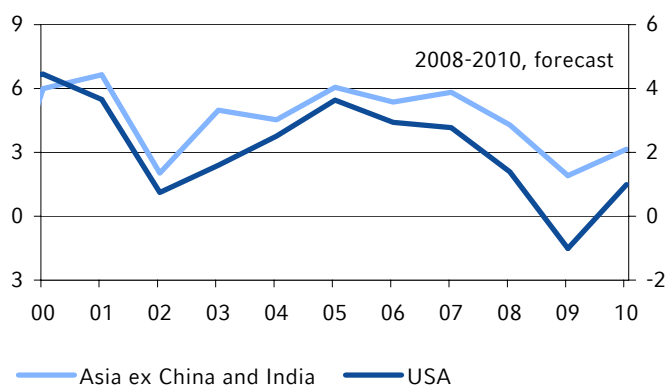
Central and eastern Europe: downwards alongside the eurozone

The international financial market crisis has also left its mark in central and eastern Europe. The countries most affected are those whose economic performance was characterised by significant imbalances such as for example high current account deficits. Among these countries are Hungary and Romania who also suffer from high levels of foreign debt. What makes the situation more difficult is that Hungary and Romania have flexible exchange rate systems, and a depreciation of the local currency during the financial crisis has increased the debt levels of private households and companies.

Synchronous downturn in Asia

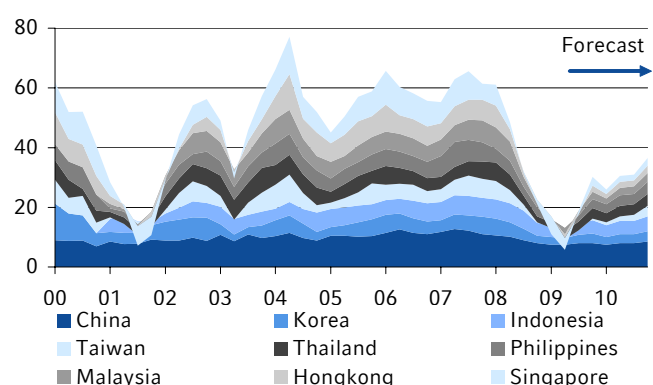
Rapidly falling demand in the G3 (US, EU, Japan) states is not only affecting the countries in Asia simultaneously, but is also clearly reflected across the board in the consumer and capital goods markets and in commodities. In addition, the integrated value chain in Asia is now more dependent than ever on external demand from the West. Following 6% growth in Asia (excluding China and India) in 2007, we expect growth of 4% this year and 2% in 2009. Growth in China and India is likely to slow from 11.9% and 9.3% respectively to around 8% and 6.5% in 2009 and 2010.

Asia and the US: GDP growth (in % yoy)



Source EcoWin, WestLB Research forecast

Asia: economic growth (cumulative growth rates, in percentage points)



Source EcoWin, WestLB Research

Latin America: adjustment to lower commodity prices

Latin America has benefited more than any other region from the rise in oil, gas, metal and agricultural commodity prices in recent years. Since 2003, the region has recorded current account surpluses, but a deficit is likely this year, and is expected to increase in 2009. In addition to lower commodity prices, growth is being impacted by the significantly weaker global environment and tough financing conditions. We expect economic growth in the region to slow to 2.2% (from 4.6% in 2008.).

Forecast risks

The main scenario outlined here of a painful global recession, limited to a few years with a subsequent gradual recovery, describes what we believe to be the most likely development. The uncertainties of the forecast at this time are unusually high. We believe that the risk of weaker growth is greater than the prospect of improved growth.

Alternative scenarios:

downward spiral versus...

Negative scenario: downward spiral (likelihood: 20%). If the financial crisis should worsen, the counter measures taken by the central banks and governments to date could prove to be insufficient. The banks' liquidity and solvency problems would increase, lending would dry up, capital expenditure and consumption would slow more sharply, a deflationary gap would develop, and a lack of 'ammunition' would mean that monetary policy could barely be tackled at all and financial policy only with huge efforts. In this event, it is conceivable that the global economy could even contract in terms of GDP adjusted for purchasing power parity, due to declining economic activity (instead of noticeably less expansion in the main scenario) even in the larger emerging markets. The process of repairing balance sheets could then take several years. Yields on government bonds would drop even more sharply and for a longer period in this scenario.

... v-shaped recovery

Positive scenario: v-shaped recovery (likelihood: 10%). Studies show that on average, economists not only underestimate the severity of downturns but – contaminated by general pessimism – also the rate of the subsequent recovery. A possible exaggeration of the actual situation by the latest slump in numerous sentiment indicators should not be ruled out, nor that the recent weak economic data in many countries may already be showing almost the lowest point in the downturn. Surprisingly positive reports from the economy and the financial sector could lead to an upturn in sentiment among consumers and companies. Driven by lower interest rates, drastically falling commodity prices and a more expansive fiscal policy, the economy could be pulled out of the downturn. In this scenario, instead of deflation, inflation would re-emerge as a risk, alongside significantly higher yields on government bonds.

German economy's bull run comes to an abrupt halt

Robust economic trend well into spring

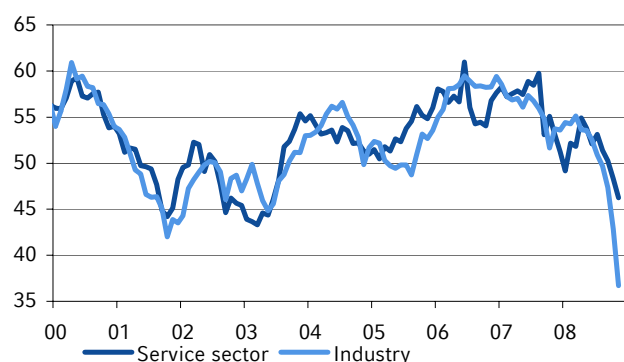
Well into spring it looked as though the German economy was coping relatively well with the many external and internal pressures to which it was exposed, and that growth would therefore slow only moderately. This optimistic view was founded on the extensive modernisation and restructuring measures which had been taken in earlier years and which have made the German economy more resilient to crises. It was reflected in the unusually strong growth in Q1, although this was positively distorted by non-recurrent effects.

Economy suffers a surprisingly steep downturn

Economic outlook has deteriorated significantly since spring

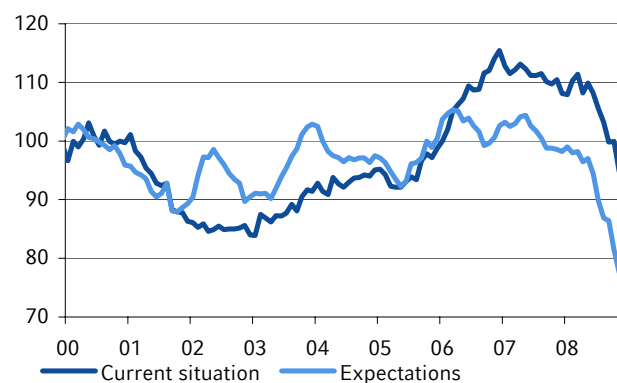
But just a short time later cracks started to show in this rosy picture and the economic outlook has now deteriorated worryingly. Virtually all sentiment indicators and hard economic data have fallen across a broad front. The purchasing managers' indices for manufacturing industry and the service sector have both slipped below the contraction-expansion threshold of 50 points. The Ifo business climate index has been deteriorating since May. Despite the fact that crude oil prices have fallen back significantly and that the euro has depreciated noticeably, companies' business expectations have suffered a veritable collapse recently. In November they fell to the lowest point since the Ifo-Index has been polled for the Federal Republic of Germany as a whole. Besides the gloomy global growth outlook, this was due to the concern about a pending credit crunch.

PMI



Source EcoWin, WestLB Research

Ifo business climate



Source EcoWin, WestLB Research

Industrial demand slacker

In industry demand has been contracting since as early as the end of last year. Recently it has suffered a downright collapse. Since November 2007 the volume of orders has contracted by 13%, with domestic orders down 8% and international orders by as much as 18%. The downtrend left no major sector of industry unscathed. Orders have also fallen recently in the construction industry.

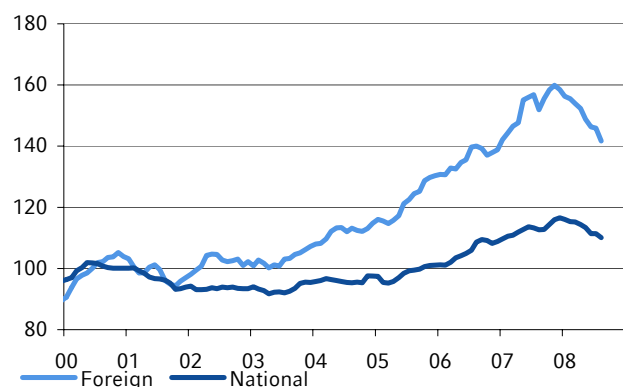
Notable decline in gross domestic product

Germany is in recession

The facts are sobering: after three good years, the German economy is in a recession as 2008 draws to an end. Gross domestic product contracted in Q2 (-0.4% qoq), and did so even more severely in Q3 (-0.5% qoq). We estimate that the decline will be similarly steep in the final quarter, as production in many plants – particularly in the automobile industry – has been throttled back significantly since the autumn break. In addition, companies were forced to increase their inventories in Q3 as they were not able to tune their pro-

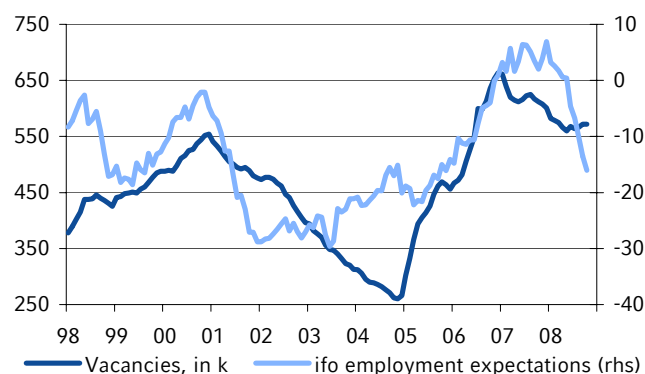
duction to the slump in demand fast enough. Experience teaches that this will have a negative impact on the coming quarter.

Manufacturing Orders (2000 = 100)



Source EcoWin, WestLB Research

Demand for labour thousands, balance



Source EcoWin, WestLB Research

The employment market is still posting a positive trend, but not for much longer

Upbeat economic news is scarce at the moment. So far, the trend in the jobs market has been very robust, posting an unusually positive net balance. Since the beginning of 2005 the number of unemployed has fallen by around 1.9 million and in October the number of registered unemployed fell back below the three-million mark for the first time since autumn 1992. However, as the employment market usually lags the economy, an early turnaround and a return to rising unemployment rates are to be expected. Companies' shrinking demand for labour bears out this expectation.

Many and varied reasons for the economic downturn

The reasons for the economic downturn are myriad. They range from the slowing momentum of global growth and the euro's long-standing firmness, sky-rocketing crude oil and commodity prices up to and including an ever more restrictive monetary policy. These downside forces have been magnified by the crisis in the financial markets, which is more than a year old and is now increasingly spilling over into all parts of the real economy. Nevertheless, one should not forget that after an upturn lasting almost three years a cyclical downturn would have been normal anyway.

Two guarantees of success seem to be turning into risks

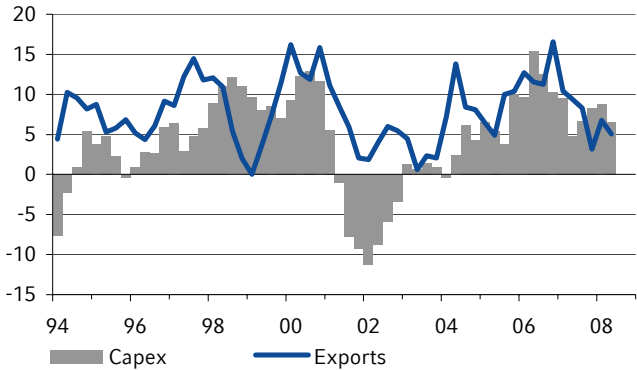
Exports and capex: from guarantees of success to a risk

Two former guarantees of success for the preceding upturn now seem to be turning into downside factors, and thus to harbour a substantial risk for the future economic trend:

- **Germany's close integration in international trade:** an export ratio (exports relative to gross domestic product) of over 50% is unusually high for such a large economy as Germany's. The corresponding ratio in the USA is only 13%; it is also far lower in Japan (17%) and France (20%) than in Germany. The export ratio here in Germany has increased by almost 20 percentage points since the beginning of the decade.
- **The high proportion of capital goods:** Almost 40% of goods produced by German industry are capital goods; these also account for a large part of exports. Slightly more than half of all foreign sales by industry come from the capital goods sector (including automobiles). Manufacturers of capital goods have even benefited from the high oil price, as many oil-producing countries have used their revenues for additional purchases of capital goods from Germany.

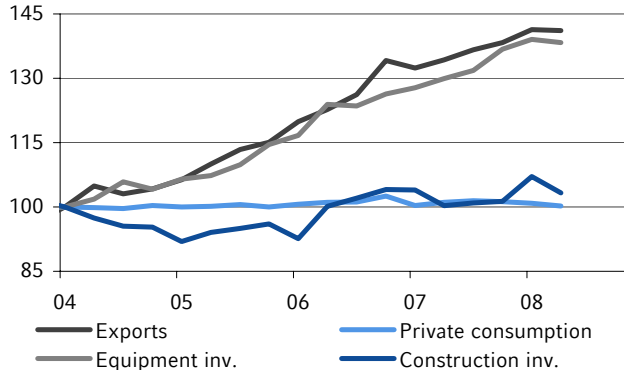
■ **Considerable inter-dependency between exports and investments:** It can be shown empirically that domestic investing activities depend heavily on export demand. Companies step up their investments when foreign sales opportunities are increasing and the outlook for earnings abroad is improving. In the process, new jobs are created, the incomes of private households increase at a faster rate and – under normal conditions – private consumption benefits. This classic economic pattern also applies in the converse sense, i.e. a downturn usually stems from slowing foreign demand followed by investment cutbacks. Barring one exception – at the beginning of the eighties – German companies have never stepped up their investing activities unless foreign demand was growing.

Exports and capex
(in % yoy)



Source EcoWin, WestLB Research

Components to GDP
Q 1 2004 = 100



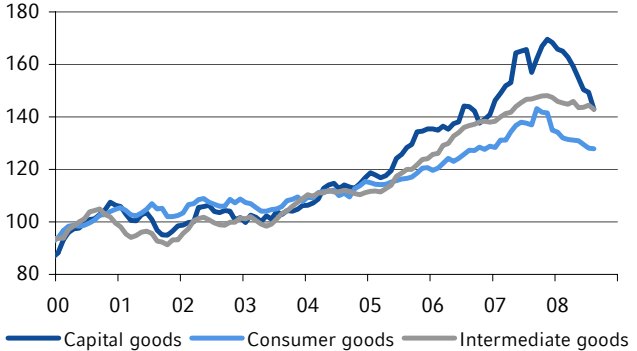
Source EcoWin, WestLB Research

Are exports and capital expenditure facing a collapse?

But exports and investments have been suffering a severe setback since the end of the global economic upswing, the global investment boom and the oil price's bull run. Since exports and investments were almost the sole growth drivers in the previous upturn, there is clearly a risk that Germany could be heading for a hard landing.

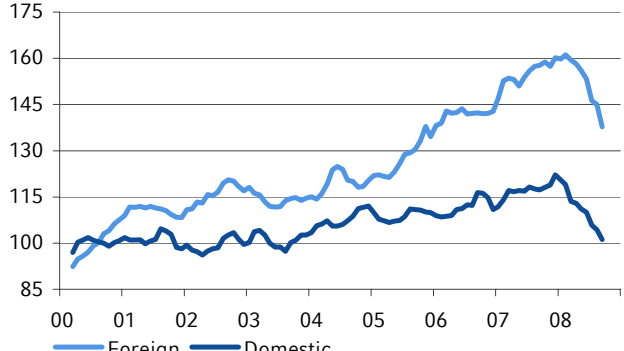
This set of problems is now clearly reflected in the manufacturing orders figures. The producers of capital goods have so far seen the steepest decline in demand. The corresponding foreign demand has contracted by almost one quarter since November 2007. Order volumes have recently fallen back to a level last seen at the end of 2006. While the

Foreign manufacturing orders
(2000 = 100)



Source EcoWin, WestLB Research

Motor vehicles orders
(2000 = 100)



Source EcoWin, WestLB Research

declines have been dramatic in the automobile and metal-working industries, the mechanical engineering and electrical appliances industries have done relatively well. With regard to the decline in domestic demand for capital goods, things do not yet look quite so dramatic. Since November 2007, it has fallen by 'only' 10%. What is alarming here is the situation at the car makers, where demand recently fell back to the level of 2003.

Exports will not be a growth engine in 2009

Momentum of exports is slackening appreciably ...

The volume of German exports is likely to decline appreciably, given the global growth rates we forecast for 2009. Another problem is likely to be the economic downturn in other EMU states, which are among Germany's most important trading partners.

... but exports have not declined in absolute terms

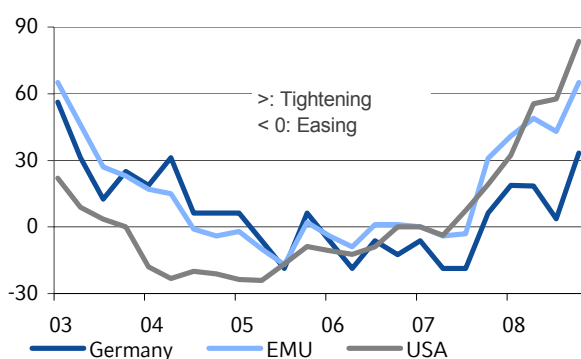
There are, however, some aspects that argue against an absolute decline in exports: Germany's international competitiveness remains very high. Among the major industrialised countries, only Germany has been able to defend its competitive position in the global markets during the past few years. Extensive rationalisation measures are likely in many countries, and the plant and machinery needed for this in many cases come from Germany. The German export sector is also likely to benefit from the fact that a large number of countries have launched economic stimulus programmes; many of these are aimed at improving public infrastructure and increasing energy efficiency. Germany's mechanical engineering and plant construction sectors are likely to benefit particularly from this.

Significant decline in investment ...

Investment activity likely to be curtailed

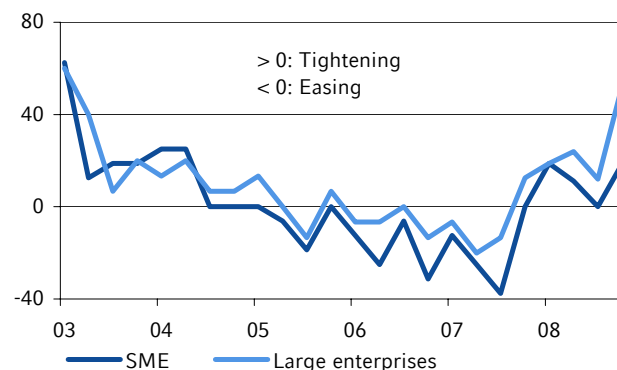
A gloomy earnings outlook in the export business, continuing doldrums in domestic business, rising costs, pressure on margins and gradually falling capacity utilisation will squeeze capital expenditure, which will probably be reduced in the next few quarters.

An international comparison of credit standards (balance)



Source EcoWin, WestLB Research

Credit standards in Germany (balance)



Source EcoWin, WestLB Research

Tightening of credit standards is a drag on investment

Investment activity is likely to slacken off because it has become harder to raise funds as a result of the crisis in the financial markets. Corporate spreads in the bond market have widened significantly, and banks have recently tightened their credit standards significantly. Lending standards have become tighter, especially for large companies. This may be partly due to the fact that lending standards had already been tightened significantly for smaller and medium sized enterprises in connection with Basle II, so that the further tightening that is now occurring looks more moderate than at large enterprises. The second reason – and this is also underpinned by the fact that lending standards have been tightened less here in Germany than in other eurozone countries – probably lies in the three-tier

structure of the German financial system: cooperative banks and savings banks cover a good deal of the business with SMEs. Since these two groups of banks have been less affected by the crisis in the financial markets than other banks they have less need to tighten their credit standards.

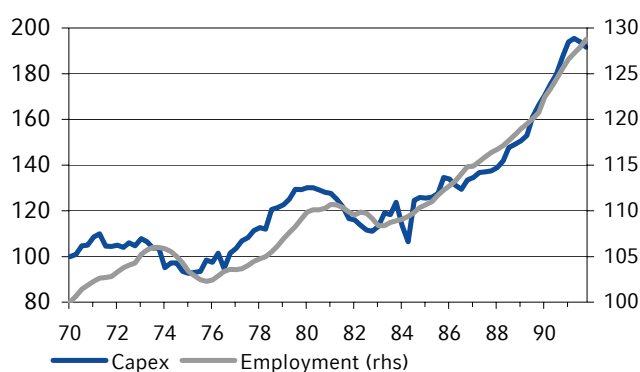
A credit crunch is not likely in Germany

We do not therefore expect a credit crunch, as the support measures for the financial sector are likely to have the desired impact. The fact that companies are able to finance a bulk of their capex out of equity due to significant increases in their profits during the past few years also eases the pressure on them.

Accumulated decline in capital expenditure of around 15%

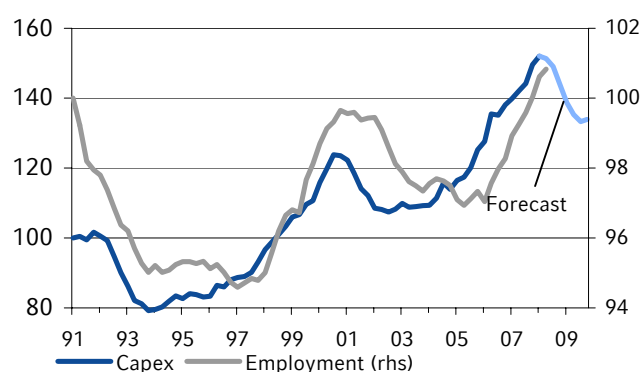
Experience of previous economic cycles shows that investment contracts during a downswing by 10-25% in cumulative terms over a period of five to eight quarters. The extent of the decline depends essentially on how much capacity was increased previously, but also on how quickly the economy is expected to recover.

Capital expenditure and employment (1970 = 100)



Source EcoWin, WestLB Research

Capital expenditure and employment (1991 = 100)



Source EcoWin, WestLB Research

In the last upturn, capital expenditure on plant and equipment was increased by around 40% overall, which is not an excessive amount compared with previous cycles. We assume that the cumulative decline will be around 15%, which is towards the lower end of the above-mentioned range, and will continue until roughly the middle of next year. The worst of the adjustment is, however, still ahead of us.

... has a negative impact on the labour market

Increase in unemployment is already inevitable

As a result, employment will probably decline and unemployment will rise, at the latest at the beginning of next year. Experience has taught us that the decline in employment is initially limited as companies first make use of productivity and labour reserves before laying off employees.

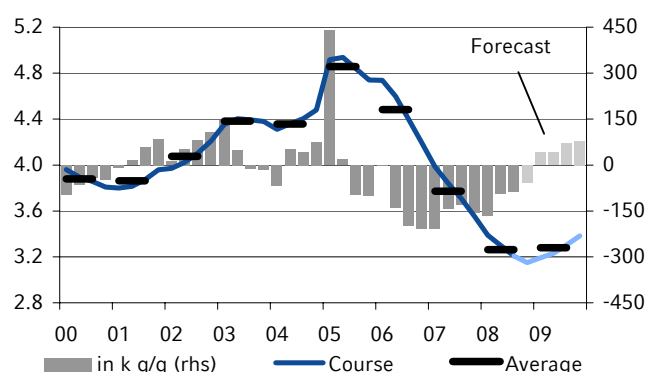
We do not expect to see a wave of redundancies similar to that seen at the beginning of this decade, but companies are nevertheless likely to react to falling capacity utilisation and the initially continuing wage pressure by cutting jobs. Unlike in 2007 and at some times during 2008, companies may no longer be able to offset large increases in collectively negotiated pay, most of which will still be having an impact next year, with corresponding gains in productivity.

Unit labour costs and productivity in industry
(2000 = 100)



Source EcoWin, WestLB Research

Numbers of unemployed
(millions and '000s)



Source EcoWin, WestLB Research

+250,000 unemployed persons
in the course of 2009

We assume that the number of unemployed will increase in 2009 by around 250,000. We forecast that the average level of unemployment in 2009 will not be significantly higher than this year because of the low level at the beginning of the year 2009.

Private consumption as a lifeline?

Consumer spending remains
weak so far

How deep the downturn turns out to be will probably depend largely on the behaviour of consumers. So far, consumption has remained weak. As in the previous year, it has failed to live up to expectations. This time, however, the basis for a revival was better than it had been for a long time. As a result of increased employment and what mainly turned out to be steep increases in collectively negotiated pay, wage growth and thus the expansion of disposable incomes accelerated appreciably. But with inflation accelerating until the summer these nominal increases in incomes were eroded again, leaving little scope for increased consumer spending.

Scope for increased consumer spending

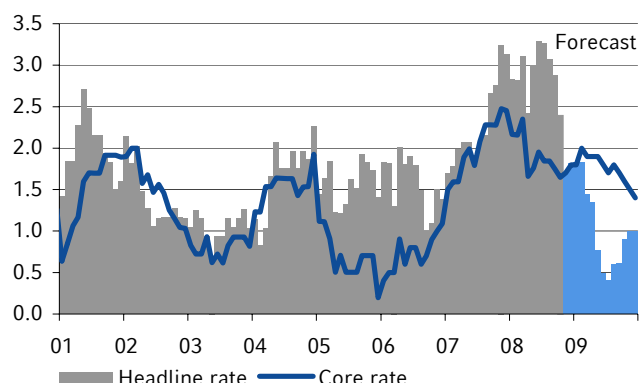
Waning inflationary pressure
strengthens ...

In the meantime, inflation has slowed significantly in the wake of the dramatic decline in oil prices. In November, the inflation rate will probably have slipped back below the 2% mark for the first time since the beginning of 2007. Inflationary pressure will most probably continue to ease off in the coming months. This is because gas prices will also come down with the usual six-month time lag, and the rate at which food prices are rising has slowed again. Nor have there been any wide-spread second-round effects. We forecast that the inflation rate will move back towards 0.5% in the summer months of 2009. All in all, inflationary pressures have ebbed far faster and far more significantly than had been feared in many quarters during this year's summer months.

... consumers' purchasing power

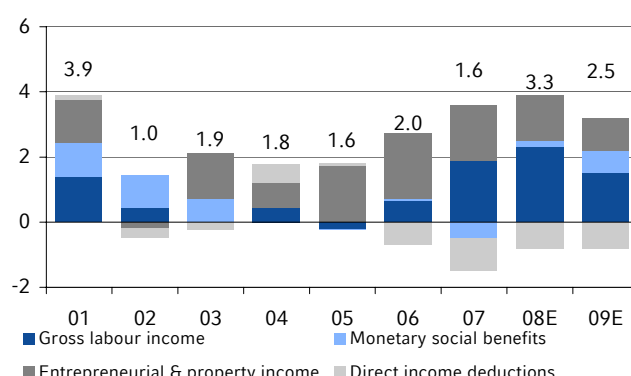
Growth in disposable incomes is likely to slow next year. This year's increases in collectively negotiated pay will continue to be felt in 2009, and transfer income will increase by significantly more next year than in previous years. However, rising unemployment and the likelihood that profits and investment income will grow less strongly all suggest that growth in incomes will slow. We calculate that real incomes will increase by roughly 1.25%, assuming that inflationary pressures continue to abate. This would be a steeper increase than in 2008 (+0.75%).

Consumer prices (in % yoy)



Source EcoWin, WestLB Research

Contribution to income growth (in percentage points)



Source EcoWin, WestLB Research

Moderate increase in consumer spending

To what extent this could boost consumption depends on the pattern of household savings. For consumers to increase their spending on consumption significantly just when the economic setting is deteriorating and they fear that unemployment is set to rise would not be in line with past experience.

To this extent part of the increases in incomes is likely to go into savings. The continuing trend towards private pension provision and the asset losses associated with the crisis in the financial markets also suggest that private households will save more.

Moderate increase in private consumption, and a rising savings rate

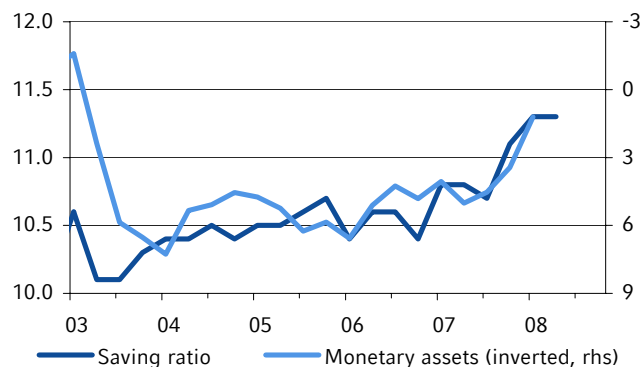
Assuming that private households were to save all of the increase in incomes, the saving rate would rise in the coming year from around 11½ to 12½%. There has been nowhere near such a steep increase in recent times. Only in the sixties was there a similar increase in savings. Although we are going through unusual times at the moment because of the crisis in the financial markets, we do not expect the saving rate will rise so abruptly. We therefore see headroom for an increase – albeit moderate – in consumer spending in 2009, which we estimate at one half of a percentage point.

Unemployment expectations of private households and unemployment



Source EcoWin, WestLB Research

Saving rate and monetary assets of private households (in % and % yoy)



Source EcoWin, WestLB Research

Economic downturn will continue into well into next year

Economic downturn may extend well into the coming year

But this would not prevent the forces of recession from retaining the upper hand for the time being; nor would it prevent the downturn from going on until well into the coming year. We believe the slight increase in private consumption will prevent an even steeper economic downturn. Gross domestic product is likely to contract by around 1% in 2009, after growth of 1.6% this year. Average annual economic output last fell in Germany in 2003.

Key macroeconomic data

	2005	2006	2007E	2008E	2009E	2010E
	% y/y					
Real GDP	0.8	3.0	2.5	1.6	-1.0	1.3
Domestic demand	0.0	2.1	1.1	1.1	-0.3	0.8
Private consumption	0.1	1.0	-0.4	-0.4	0.5	0.5
Public consumption	0.4	0.6	2.2	1.8	2.3	0.6
Capital expenditure	1.1	7.7	4.3	3.5	-4.0	3.0
Equipment	6.0	11.1	8.2	3.5	-9.0	5.0
Buildings	-3.0	5.0	1.8	3.0	0.0	1.0
Other PPE	4.9	8.0	8.0	5.3	3.5	4.3
Inventory ¹⁾	-0.4	0.0	0.1	0.2	-0.1	-0.1
Balance of trade ¹⁾	0.7	1.0	1.4	0.5	-0.7	0.5
Exports	7.7	12.7	7.5	4.5	1.0	6.0
Imports	6.5	11.9	5.0	4.2	3.0	6.0
Consumer prices	1.5	1.6	2.3	2.7	0.9	1.3
Financial balance public budget						
in bn€	-72.6	-39.2	-4.0	4	-25	-30
as % of GDP (nom.)	-3.2	-1.6	-0.2	0.2	-1.0	-1.2
Unemployed persons (m)	4.86	4.49	3.78	3.3	3.3	3.5

¹⁾ Contribution to GDP growth in %

Source Federal Statistical Office, WestLB Research forecasts

Economy will stage a gradual recovery towards the end of 2009

The German government's 'economic stimulus package' will not have any impact

Nor will the measures taken by the German government to support the economy (see our Excurses on economic policy for details), do anything to stop the trend we forecast. The package would have had to be far larger and less thinly spread to have any effect. In addition, such measures only work through into the economy after a certain time lag.

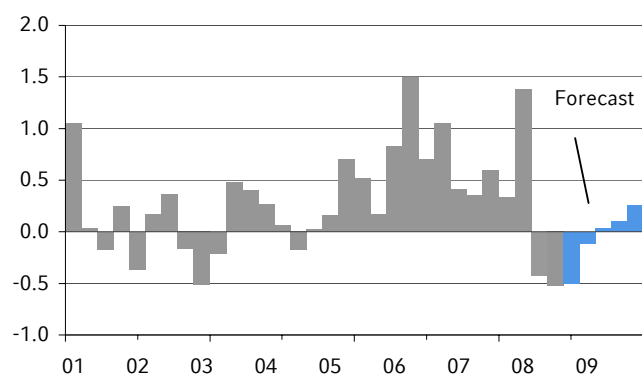
Reasons for economic stabilisation at the end of 2009

The economic outlook may gradually brighten towards the end of 2009, though fiscal policy may make only a modest contribution to this. Stabilisation can be expected due to the easing of the reins of monetary policy, normalisation in the financial markets, and falling crude oil and commodity prices. There is, therefore, a prospect of an economic recovery in 2010; we assume annual average growth of 1.3% in that year.

Economic downturn in Germany is more pronounced than in the eurozone as a whole

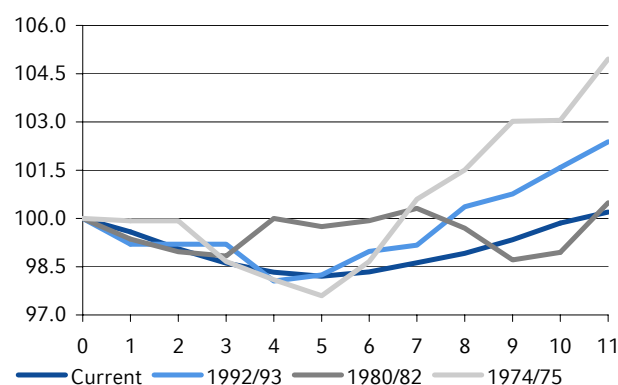
We believe next year's downturn will be more pronounced in Germany than in the eurozone as a whole, even though its property market remains sound. This is primarily due to Germany's heavy reliance on global growth and the highly cyclical nature of demand for capital goods. However, this does not cast doubt on German companies' success in restructuring, or on the previous government's reforms. On the contrary: we expect that growth in Germany will again be somewhat stronger than the average for the eurozone when the economy recovers in 2010.

Gross domestic product (in % yoy)



Source EcoWin, WestLB Research

Comparison of recessions (GDP before recession = 100)



Source EcoWin, WestLB Research

Parallels between the current downturn and the recessions in 1974/75 and 1992/93

If one compares the current recession and our forecasts with earlier recessions, there are parallels between the current downturn – as far as its depth is concerned – and the first oil price shock (1974/74) as well as the slump that followed the reunification-driven boom (1992/93). On both occasions, gross domestic product contracted to a similar extent as that which we now forecast. However, again on both occasions, the economy recovered significantly faster than we expect this time.

Compared to the recession at the beginning of the eighties, the decline in gross domestic product will be far greater – at least according to our forecast – in the current economic cycle. However, following the second oil price shock it took a comparatively long time for the economy to recover and regain its starting level. If our forecast is correct as regards the extent and duration of the downturn, the current phase of weakness would be exceptional – compared to earlier recessions. The reason for this is the financial markets crisis.

Economists tend to underestimate upturns

Nor, naturally, can one rule out that we are underestimating the subsequent economic recovery. Indeed, given the drastic fall in crude oil prices this is quite possible. Studies show that on average economists' economic forecasts not only underestimate the severity of downturns, but – undoubtedly infected by general pessimism – also the dynamism of the subsequent recovery.

Positive surprise possible due to falling oil price

Falling crude oil and commodity prices harbour considerable potential for positive surprises

We see the greatest potential for a positive surprise for the German economy in falling crude oil and commodity prices, which would most probably lead to an easing of inflationary pressure. The inflation rate is likely to move back towards 0.5% in the spring, when gas prices should come down steeply with the usual six-month delay on the falling oil price. Provided that unemployment has not increased too much by then, or at least does not rise by more than consumers fear at the moment, there would then be a prospect of a stronger recovery in consumption, as the increase in the savings rate that we forecast would then be more moderate. In addition, one should not forget that the significant fall in crude oil and commodity prices will take a huge amount of pressure off companies' costs, which would in turn greatly mitigate the pressure on their profit margins.

Lower oil price is a more effective economic stimulus than the package of German government measures

The relief provided by falling crude oil and gas prices per se – not counting those of other raw materials – would be around €25bn, or 1% of nominal gross domestic product. Demand from oil producing countries for products from Germany could be curtailed due to their falling oil revenues, but lower oil and gas prices would still provide a substantial economic stimulus, provided households do not put all their additional incomes into increased savings. The decline in the oil price is undoubtedly a far more effective economic stimulus than the package recently put together by the German government.

An even greater downturn in global growth would hit Germany hard

The biggest risk that the German economy will grow less than in our basic scenario is undoubtedly to be found in a steeper global slowdown in growth, if – contrary to our expectation – the situation in the financial markets fails to improve in the foreseeable future. In this case, exports would be likely to decline in absolute terms and capital expenditure would probably slump even more steeply. Since unemployment would then inevitably increase at a faster rate, consumption too would be likely to remain weak.

Excursus: Economic policy in a recession and ahead of a general election

It is the parties in government that bear the brunt of voter discontent during a downturn. Hence it was little surprise to us that the German federal government passed a bundle of measures at the beginning of November aimed at shoring up the economy. Alas, these will probably not suffice to kick-start an ailing economy. We do not expect the course of a new economic policy to be set before the general election in September 2009. Germany's political parties are more likely to stake out, by next spring at the very latest, their positions in an election campaign in which the topic of 'social justice' is likely to play a key role. Moreover, this topic will, in all likelihood, dominate the agenda of the new federal government in the areas of tax, contributions, social security and the labour market, which are of paramount importance to the economy.

Federal government passes a bundle of measures to bolster a weak economy

In passing rescue measures for Germany's financial system the federal government has shown a degree of determination of which few observers had thought a grand coalition to be capable. The 'Financial Market Stabilisation Act' sailed through parliament in a mere five days. To date there are only a handful of instances in the history of the Federal Republic of a piece of legislation becoming law faster.

The stabilisation programme for the financial sector should be followed by one for the economy ...

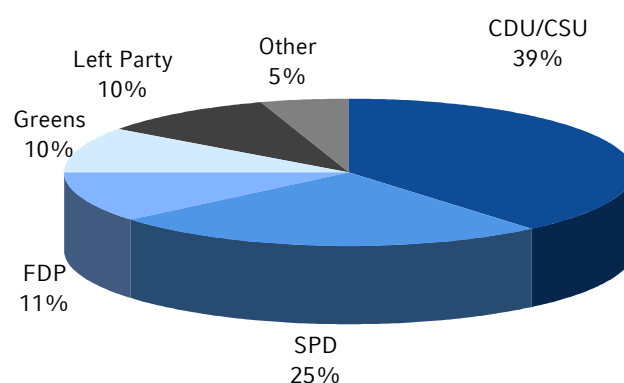
Following the passing of a rescue package for the financial sector, debate is heating up about whether the government should also pass measures to shore up the economy. For a long time these have been thought unnecessary, or have been rejected on principle – on the one hand because of reservations in terms of regulatory policy, and on the other owing to doubts about their effectiveness.

Election dates 2009

State	Type	Date
Hesse	FSP	18. Jan
Baden-Württemberg	local	07. Jun
Mecklenburg-Western Pommerania	local	07. Jun
North Rhine-Westphalia	local	07. Jun
Rhineland Palatinate	local	07. Jun
Saarland	local	07. Jun
Thuringia	local	07. Jun
European parliament		07. Jun
Saarland	FSP	30. Aug
Saxony	FSP	30. Aug
Thuringia	FSP	30. Aug
Bundestag elections		27. Sep
Brandenburg	FSP	autumn

FSP = Federal state parliament Source German Bundesrat, WestLB Research

If the general election were held next Sunday As at 21 November 2008



Source ZDF Political Barometer, WestLB Research

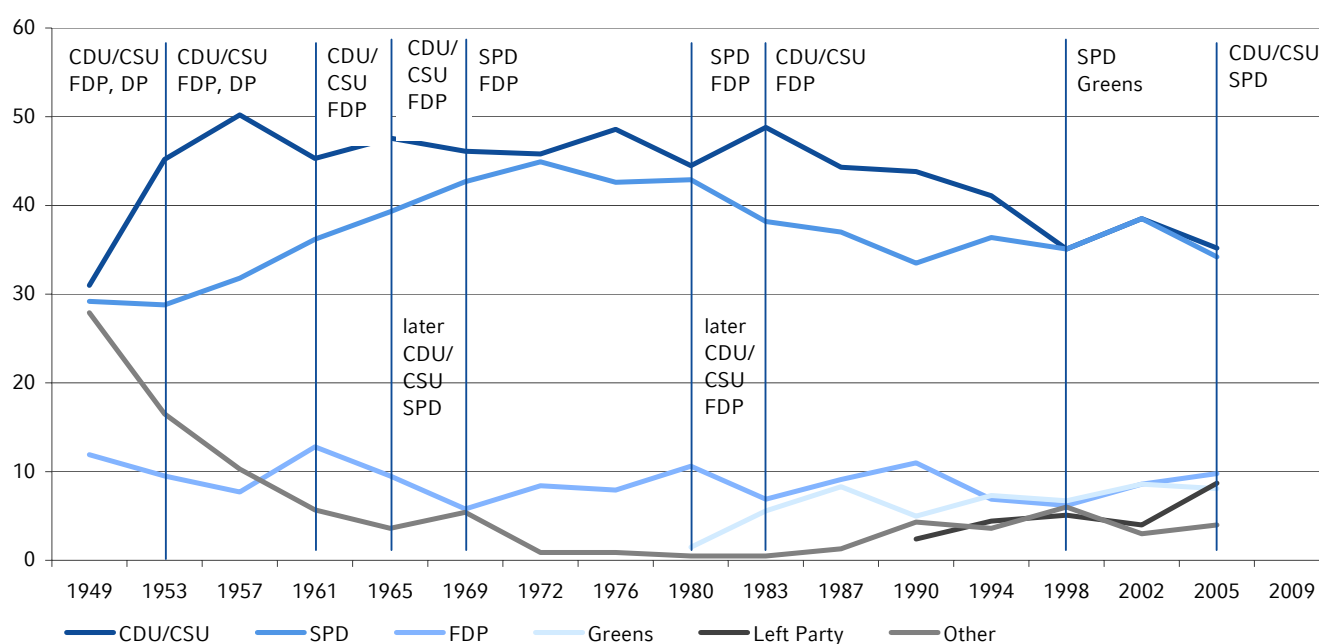
The government enacted a concrete programme at the beginning of November. Even before the financial markets crisis intensified, we had at the beginning of this year predicted such a move in the event of the economy slowing down – in the run-up to the general election and a string of other elections scheduled for next year – and threatening to drive up the number of unemployed. As the Left Party would be likely to profit from such

developments at the expense of the Social Democratic Party (SPD) during an election campaign, we assumed at the time that a stimulus package would be passed.

... because governments during a recession are prone to losing votes

Historically speaking it has often been the case that parties in government have borne the brunt of voters' discontent during a recession or a period of weak economic growth, and on occasions have seen their shares of the vote plummet in subsequent elections. However, the government has not changed hands immediately when this has been the case. After the recession of 1967, and again after that at the beginning of the 1980s, the original ruling coalition stayed in power for a time, and it was only in the course of the parliamentary term in question that power changed hands.

Long-term comparison of general election results



Source German Bundestag, WestLB Research.

A large section of the population is in favour of a package of economic stimuli

Current surveys (such as the Political Barometer of the public broadcaster ZDF) indicating that some two-thirds of households – fearing a rise in the number of unemployed next year – are in favour of measures designed to bolster the economy, are likely to have played a role in the context of the upcoming general election. The government will thus be keen to avoid being accused, when campaigning kicks off in earnest, of having made substantial funds available to stabilise the financial sector while neglecting to do something similar for the rest of the economy. Moreover, the fact that the financial markets crisis and the weak economy have rendered the goal of achieving a balanced budget by 2011 a distant prospect should have made it easier for politicians to vote for the stimulus package.

The success of the bundle of measures is doubtful

An extensive bundle of measures to shore up the economy

The package of measures passed by the government to shore up the economy, which goes by the name of 'Securing Jobs by Strengthening Growth', comprises 15 measures (for details see the table below). The package is designed to trigger investment worth €50bn over the next two years. These in turn are meant to secure 1 million jobs that would presumably otherwise fall victim to the weak economy. The bundle of measures, whose impact on the budgets for 2009 and 2010 is put at about €12bn, will not be accompanied by funding measures designed to offset the costs. Instead, the government

intends to put up with the loss of revenue and the extra expenditure that the current economic situation will likely bring about.

... that is necessary in principle ...

We believe that, given the current situation, a programme to bolster the economy is indeed called for in principle, as the financial markets crisis has made the downward risk to the economy a lot greater than it would have been during a 'normal' downturn. We also consider it acceptable for the government to be prepared to temporarily countenance a larger deficit, and hence higher levels of debt.

... but whose success is doubtful

However, we doubt whether this particular bundle of measures will in fact have the desired effect – though it must be said that, in our view, some of the measures approach the problems from the right direction. It would surely have been more appropriate to markedly expand public infrastructure spending, as this directly enhances demand in general, for the need to modernise and expand public infrastructure remains acute.

Overview of economic policy measures for 2009 – effects on public budgets

Measures	€bn
Economic stimulus package	-4.2
Additional financing instrument from KfW	
Reintroduction of degressive depreciation and one-off write-downs for SMEs	
Enlargement of KfW building renovation scheme for reducing CO2 emissions	
Enlargement of KfW infrastructure scheme	
Acceleration of investment in transportation systems	
Increase in tax incentives for employing tradesmen	
Tax amnesty for purchase of new vehicles	
Extension of entitlement period for short-time working benefit	
Other measures	
Miscellaneous	
German Family Support Act (e.g. increase in child benefit)	-2.3
Changes to welfare benefits (e.g. housing benefits, student grants, entitlement period)	-1.8
Suspension of Riester factors (pensions, unemploy. benefit - ALG II, basic old-age l)	-0.5
Labour market measures	-1.3
Decrease in unemployment insurance contribution	-4.3
Increase in health insurance contribution	6.1
Other measures	-1.5
Overall effect	-9.8

(-) Relief, (+) Burden

Source Ministry of Finance, WestLB Research

A special amortisation regime would have been more effective

The temporary reintroduction of degressive amortisation would have improved the tax write-down environment for companies. However, a temporary special amortisation regime would have been even more effective had the government opted for it. Such a regime is the most tried and tested means to stimulate investment activity, as the investment boom in the eastern states that joined the Federal Republic after reunification has shown.

Temporary reduction of VAT rate

Regarding the tax burden on households, the question arises as to whether the measures were implemented early enough. It is doubtful whether exempting consumers from vehicle tax will induce those on small or medium-sized incomes – who in the current environment are increasingly afraid of losing their jobs – to buy a new car. An alternative would have been a temporary reduction of the VAT rate; cutting the rate by 1 percentage point would have reduced the burden on consumers by about €8bn.

Fiscal policy will be only slightly expansive in 2009

Fiscal policy – including measures that have already been passed for 2009 (see table above) – will probably generate slightly expansive impulses, though they are unlikely to have an effect before the second half of 2009, and hence will have no impact on current weakness. Banking on companies and households having faith in policies in a situation that is characterised by an extremely high degree of insecurity is too optimistic an approach, in our view.

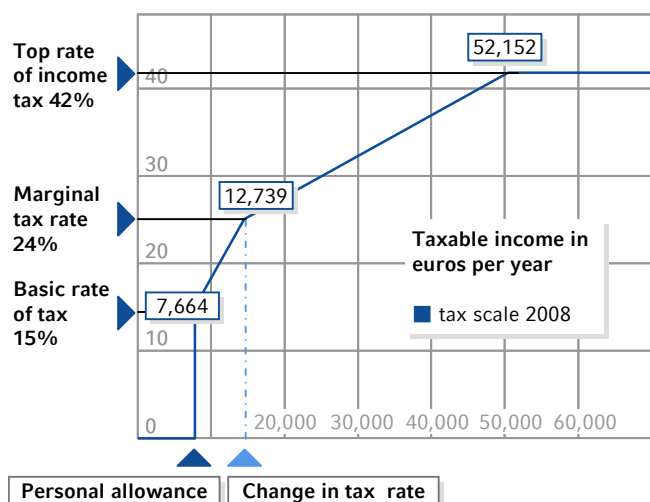
More extensive economic stimulus package

The package of stimuli would have had to be of a significantly greater order of magnitude to stimulate the economy effectively, and hence bring about the results the government hopes to achieve. According to our assessment it should have amounted to at least 1% – ideally 2% – of nominal gross domestic product, i.e. between €25bn and €50bn.

No income tax reform for the time being

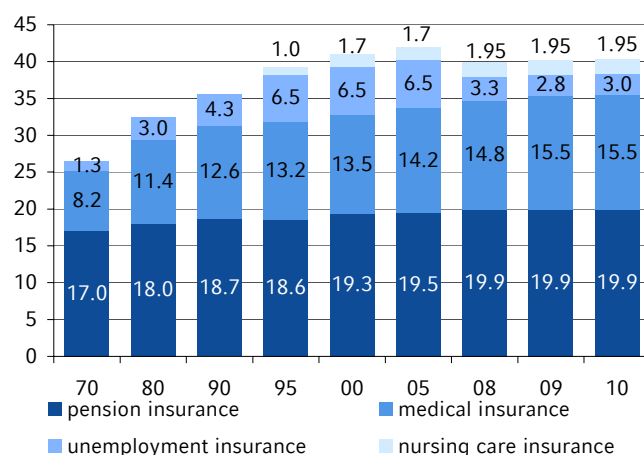
Income tax reforms, or other measures designed to lighten the load of taxation and other contributions, are not part of the package. Basically, an income tax reform would have made sense simply because the tax load on many income earners has become heavier this year because of the ‘cold progression’.

Income Taxation (in %)



Source IW, WestLB Research

Social security contributions (in %)



Source EcoWin, WestLB Research

Cold progression increases the tax burden

Because of the higher increases in nominal incomes an increasing number of tax payers are entering pay brackets with higher marginal rates of taxation. As a result, their tax bill is growing, although their purchasing power has hardly increased because inflationary pressures have also increased in the meantime. Since this affects the recipients of smaller and medium incomes particularly greatly, a tax reform could reduce their effective tax bill. Ultimately, this would also have a positive impact on private consumption as these households usually have a disproportionately high consumption-income ratio. Significant relief could also be achieved if the higher tax allowances for contributions to health and nursing care insurance were to come into effect next year and not as planned only in 2010. This would put a total €9bn back in the tax payer’s pocket.

In the short term tax cuts do little for the economy

Although tax cuts are a suitable means of stimulating the forces of economic growth, they do little to pump-prime the economy in the short term. Disregarding for a moment the fact that it will presumably be some time before the tax reform is passed, it is doubtful whether private households would really step up their consumption immediately in the current situation. They are far more likely to use their additional income headroom to increase their

savings. Larger tax allowances for health insurance contributions would not benefit a large number of tax payers until 2010 anyway, namely when they fill out their income tax return for 2009. Nevertheless, the 'cold progression' issue will be a major item on the political agenda at the latest after the German parliamentary elections in September 2009.

Contributions set to rise somewhat

Lowering social security contributions would have a positive impact on incomes and employment, and would benefit employees and employers alike. On the contrary, the ruling parties have agreed to actually increase social security contributions slightly in 2009. Admittedly, the rate of unemployment insurance contributions is to be lowered by 0.5 percentage point to 2.8%. But it is to rise again to 3.0% in 2010, and in any event it is more than offset by the 0.7 point increase – to 15.5% – in the average rate of contribution to health insurance entailed by the kicking-off of the Federal Health Insurance Fund and the introduction of a uniform rate of contribution. Early signs are that this latter increase will not be the last.

'Social justice' as a leading general election issue

No movement is likely until after the general election

There is little likelihood of any additional fundamental changes to the course of economic-policy now being set ahead of the general election scheduled for the autumn of next year. And what likelihood there is will diminish even further once campaigning begins in earnest in the spring. Such a course of events would confirm the scepticism that we voiced when the coalition agreement was signed, regarding the ability of a grand coalition to engage in reform. We predicted at the time that today's government would not be disposed to tackle the business of unfinished reforms, and hence would not continue down the trail blazed by its predecessor.

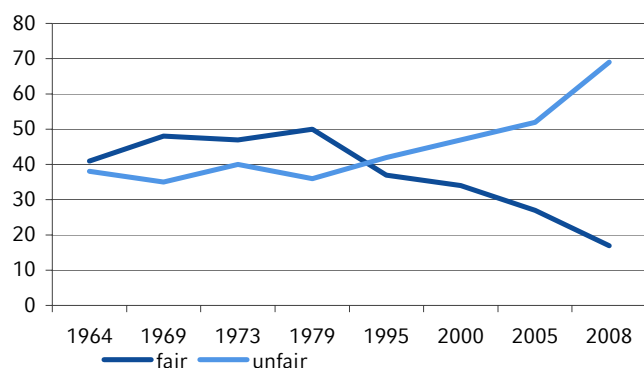
The grand coalition's record of reform is disappointing

In fact the ruling grand coalition's record of reform is even worse than this – a circumstance that the predominantly positive trend of the economy and of the labour market failed to reflect directly during the last parliamentary term. It has rolled back a number of reforms, including the extension of the period of entitlement to type I unemployment benefit, the introduction of a minimum wage in sectors other than construction, tampering with the pensions formula, the planned extension of early retirement measures, and the introduction of the Federal Health Insurance Fund and other bureaucratic burdens.

Topics likely to dominate the upcoming general election campaign

Political parties have yet to publish their election manifestoes. That said, the financial markets crisis, the weak economy and an unemployment rate that will probably be much higher next year will, in all likelihood, dominate the campaign – along with education and healthcare issues. The issue of 'social justice' is likely to play a major role in relation to all these issues. According to a survey by the Allensbach Research Institute, the share of Germans who view the economic situation that prevails in the Federal Republic as unjust has leapt to a record high of 70%. The subjective assessment of more than two-thirds of the population that the implementation of social justice in Germany leaves much to be desired is a serious obstacle to reform. It thus stands to reason that the issue of redistribution will be of considerable importance during the campaign. The scope for far-reaching reforms in the Agenda 2010 mode may remain limited for some time to come.

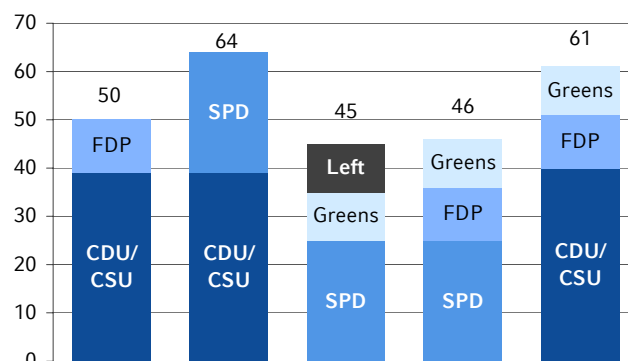
Allensbach survey on social justice* (%)



*)'The economic situation in German is ...?'

Source EcoWin, WestLB Research

Coalition options at federal level As at 21 November 2008



Source ZDF Political Barometer, WestLB Research

Economic policy following the general election

Scenarios for after the general election

It is impossible to predict the results of the general election from today's perspective. This circumstance, in addition to the missing election manifestoes, makes it difficult for us to answer the question of what politicians might have in mind for the economy after the election. Even so, we shall attempt to provide a general outline of what impact possible election outcomes might have on taxation, social security and labour-market policy. To do so we shall look in detail at three conceivable coalitions:

- CDU/CSU/FDP:** The likelihood of income tax reform would be high. The conservative Christian Social Union (CSU) and the liberal Free Democratic Party (FDP) both presented concrete proposals in this field in the spring this year. Both parties' plans call for a significant reduction of the burden on taxpayers, with the degree of relief provided for persons with small and medium-sized incomes being the greater in the CSU's model. We consider it more or less certain that a substantial part of the grand coalition's healthcare reform package – the Federal Health Insurance Fund that came into force on 1 January being a prime example – would be shelved and replaced by, for example, a 'healthcare bonus model'. This was the conservatives' preferred approach during the last general election campaign. Whether such a coalition would continue to pursue a reform of the labour market is difficult to tell. We do not expect the coalition to call previous measures into question in any fundamental way, but we are nonetheless doubtful whether the FDP would be able to push through further reforms in the face of opposition from the conservative Christian Democratic Union (CDU), especially without having unambiguously called for such steps during the general election campaign.
- SPD/Green Party/Left Party:** A significant increase in the tax burden on more affluent citizens and/or those with higher incomes appears to be something of a foregone conclusion, given these parties' current ideas on tax policy. The probability of a reintroduction of a wealth tax and of heavier taxation of large inheritances – not excluding the transfer of enterprises to direct descendants – would increase dramatically. An extension of the so-called wealth tax – a surcharge of 3% on the top rate of income tax that applies to annual incomes of €200,000 and €500,000 for unmarried persons and married couples respectively – to larger sections of the income-tax-paying population also would be very likely. The additional tax revenues would make it possible to finance cuts in contribu-

tions, a step that would probably mainly benefit those on low incomes. This is likely to be accompanied by a raising, or perhaps even the abolition, of ceilings on contribution assessment, a move that would impose additional financial burdens on those on higher incomes. Few observers doubt that a 'citizen insurance' scheme would be introduced in the field of healthcare – given that the Social Democratic Party (SPD) came out in favour of such a scheme during the last general election campaign. What is more, a rescinding of part of the package of labour market reforms – especially the merging of long-term unemployment and social security benefits that goes by the name of Hartz IV – and a comprehensive introduction of minimum wages and severe restrictions on temporary employment cannot be excluded. Such a set of measures would to all intents and purposes amount to a renunciation of large sections of the Agenda 2010 package of reforms.

- **CDU/CSU/SPD:** Tax reforms worthy of the name are unlikely. The conflict between tax cuts (conservative Christian Democratic Union (CDU)) and cuts in contributions (Social Democratic Party (SPD)) would at most result in a moderate increase in tax-free allowances and a slight lowering of tax rates for those on low or medium-sized incomes. Changes to the 'healthcare reform' package that was part of the coalition agreement of November 2005 are unlikely. According to our assessment, this package of measures is ill suited to solving the problems that beset Germany's health insurance system. So it appears that, further contribution increases would be inevitable in this event. Furthermore, the introduction of a minimum wage in additional sectors would be on the cards, as would the regulation of temporary employment agencies. A resumption of the reform process that came to a halt with the grand coalition would be a distant prospect.

Continuation of the grand coalition, or an alliance of conservatives and FDP, look the most likely outcomes

It remains to be seen what type of government will in fact emerge. Of course, other governing coalitions too are possible, such as a 'traffic light coalition' (SPD/FDP/Green Party – named after the three parties' colours: red, yellow and green) or a 'Jamaica coalition' (Conservatives/FDP/Green Party – named after their black, yellow and green party colours, which also appear on the flag of Jamaica). What is certain, however, is that a coalition comprising the SPD, the Left Party and the Green Party would not be much welcomed by the business community. Such an outcome to the general election – assuming the polls failed to point to it in the run-up to the election – would probably lead to a marked deterioration of sentiment, which in turn would carry the risk of prolonging the phase of economic weakness well into 2010. However, the likelihood of such an outcome has declined markedly following the recent failed attempts to form a government along these lines in the state of Hesse. From today's perspective a continuation of the grand coalition or the emergence of a coalition made up of the conservatives and the FDP are the most likely outcomes.

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