

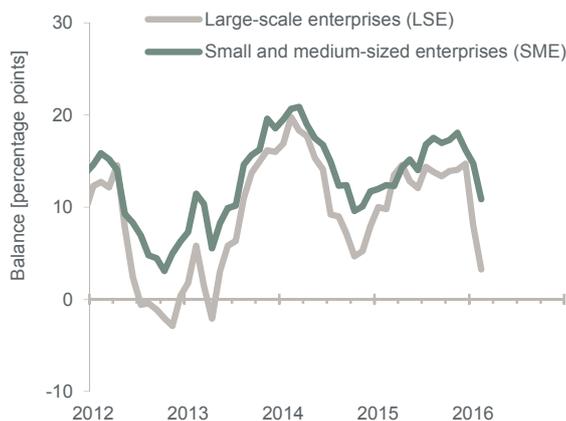
»» Although concerns are growing, it is too early to throw in the towel

3 March 2016

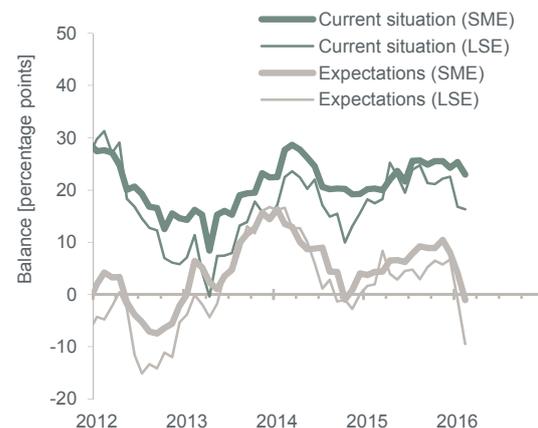
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- Pessimism is spreading to German SMEs and weighing on business sentiment
- Mood among large manufacturers plummets to three-year low
- Sales price expectations take another nosedive
- Risks are rising but an end to the upswing is not in sight

KfW-ifo business climate



KfW-ifo climate components



Source: KfW, ifo

Uneasiness spills over to SMEs

The fear of a global downturn, fuelled by the severe financial market turmoil and the many unsolved issues in Europe – including concern over an end to the Schengen area and a possible Brexit – are now affecting sentiment in the small and medium-sized enterprise sector as well. After the SME business climate was still comparatively stable in January, it fell by a very significant 3.8 points to 10.9 balance points in February. That is the third consecutive decline, which is often seen as indicative of a sustained downturn in sentiment. Fear is spreading that the outlook for 2016, which was optimistic until recently, could suddenly deteriorate.

- Expectations declined by 5.3 points, or nearly two and a half times the usual monthly variation, to -1.1 balance points. It is the first time since October 2014 that they have fallen below the zero line, which stands for the long-term average since 1991.
- SMEs, on the other hand, still rate their current business as exceptionally positive, at 23.0 balance points, despite

a dip of 2.3 points in February. This constellation shows that the mood is so far affected mainly by the many disturbing news reports and the concerns and fears they create and not by actual economic trends. Particularly thanks to the reliable performance of the domestic economy, the trend clearly points upward, as evidenced by the very stable real gross domestic product (GDP) growth rates of 0.3 to 0.4 % in the last four quarters.

Large enterprises: confidence continues to fall

Large enterprises, on the other hand, are much more deeply concerned. The nosedive in business sentiment that began in January continued almost unchecked in February. Sentiment among large enterprises deteriorated by 4.8 points on the previous month to 3.2 balance points. It is now hardly any better than the long-term average. While situation assessments remained nearly stable (-0.5 points to 16.3 balance points), the downturn in sentiment is also almost exclusively due to their business expectations (-8.7 points to -9.5 balance points). In the last half-century, similarly intense surges in pessimism within a two-month

period were seen only in 2008, in the lead-up to the great global economic slump.

Uncertainty is spreading beyond export industries

Business sentiment among large manufacturers has practically nosedived since the preceding two-year high in December. The second exceptionally intense decline of 8.1 points in February pushed it down to -1.7 balance points. That sees large manufacturers – so far the only segment – back in negative territory for the first time in roughly the last three years. The drop in the sentiment indicator is exceedingly clear even among manufacturing SMEs, at more than twice the usual monthly variation (-5.2 points to 5.3 balance points). In contrast with the previous month, the deterioration in sentiment in February, however, goes beyond export-oriented manufacturing. The sentiment indicators dropped on a high level across all SME industries. Small and medium-sized retail businesses in particular are considerably less confident (-7.5 points to 18.3 balance points). The financial market turmoil and concern over the state of the global economy are starting to chip away at the confidence of even the very optimistic domestic sectors. A more positive sentiment than in January, however, can be seen in large retailers and, above all, in large construction firms, which knocked SME retailers off the top of the sentiment leaderboard in February.

Price expectations hit new low

While the recruitment plans of enterprises of both size classes remained well above the zero line, despite declines in February, sales price expectations were again very low, particularly those of large enterprises (-2.8 points to -9.0 balance points; SMEs: -2.6 to -4.3 balance points). The excessively low inflation rate is exerting pressure on enterprises' nominal profit expectations and is an obstacle to investment – along with the acute uncertainty.

Downward risks are increasing but ...

Admittedly, it is difficult to remain calm given the many negative results of the KfW-ifo SME Barometer in February. In our view, however, precisely the great intensity of the slump in sentiment amid what are fundamentally unchanged real economic conditions is highly indicative that the widespread pessimism is due to the massive insecurity spread by the financial market turmoil and the many unsolved issues in Europe – and not to any significantly deteriorated factual circumstances. Nevertheless, in the months ahead we will have to monitor very closely whether the slump in sentiment will trigger a self-fulfilling downward spiral – particularly through the avenue of exaggerated investment restraint, given the current fundamentals.

... it is too early to throw in the towel

The key message for us is therefore: it is true that downward risks are currently increasing. Nevertheless, it is too early to throw in the towel and join the ranks of economic pessimists. The uncertainty could dissipate as quickly as it appeared. The last time that occurred was in autumn 2014, when company expectations also plummeted below the zero line suddenly and quite unexpectedly out of concern over the state of the European and global economy. At the time, many forecasters swiftly revised their GDP forecast for 2015 downward to 1 % – and were later pleasantly surprised with the 1.7 % actually achieved.

The fundamental conditions for Germany's upswing to continue are favourable today as well. A much higher number of homes are needed and the state wants to invest in infrastructure. In other words, construction is booming, which is evidenced not least by the sector's very positive sentiment. Recruitment plans also remain positive, real wages are on the increase and the integration of new migrants requires additional public expenditure. Therefore, neither private nor public consumption can be expected to slow down anytime soon. Moreover, thanks to the recovery of many smaller countries, the global economy will presumably grow slightly more strongly than in the past year. All of this makes us confident that we will again see GDP growth of 1.7 % in 2016. ■

KfW Research

KfW-ifo SME Barometer February 2016

Attachment: SME business climate in figures

KfW-ifo SME Barometer

Balance [Percentage points]*		Month/Year							m-o-m	y-o-y	3m-o-3m
		Feb/15	Sep/15	Oct/15	Nov/15	Dec/15	Jan/16	Feb/16			
Business climate											
Manufacturing	SME	10.5	12.6	13.0	13.6	12.3	10.5	5.3	-5.2	-5.2	-3.7
	LSE	10.3	9.9	10.7	12.8	15.8	6.4	-1.7	-8.1	-12.0	-4.3
Construction	SME	17.9	24.0	23.7	25.7	23.6	23.5	22.3	-1.2	4.4	-1.3
	LSE	10.2	18.7	20.2	24.3	18.1	18.9	27.1	8.2	16.9	0.3
Retail trade	SME	16.3	29.6	31.6	30.3	24.7	25.8	18.3	-7.5	2.0	-7.6
	LSE	3.9	15.4	14.1	9.6	7.5	4.6	8.0	3.4	4.1	-6.3
Wholesale trade	SME	10.5	18.9	20.8	19.8	19.6	17.9	14.0	-3.9	3.5	-2.7
	LSE	10.9	22.4	21.9	18.3	16.3	13.9	10.1	-3.8	-0.8	-7.4
All economic sectors	SME	12.4	17.0	17.3	18.1	16.2	14.7	10.9	-3.8	-1.5	-3.5
	LSE	9.8	13.4	13.9	14.0	14.7	8.0	3.2	-4.8	-6.6	-5.1
Current situation	SME	20.3	24.8	25.5	25.5	24.3	25.3	23.0	-2.3	2.7	-1.1
	LSE	17.5	21.3	21.1	22.2	22.5	16.8	16.3	-0.5	-1.2	-3.0
Expectations	SME	4.3	8.9	8.9	10.4	8.0	4.2	-1.1	-5.3	-5.4	-5.7
	LSE	1.9	5.2	6.4	5.7	6.7	-0.8	-9.5	-8.7	-11.4	-7.0
West Germany	SME	12.6	17.6	18.1	18.7	16.9	15.2	11.2	-4.0	-1.4	-3.7
	LSE	9.6	13.4	14.1	13.6	14.6	7.8	2.9	-4.9	-6.7	-5.3
East Germany	SME	11.5	13.4	12.3	14.4	12.1	12.5	9.7	-2.8	-1.8	-1.9
	LSE	14.5	12.5	9.7	25.3	16.6	14.5	12.2	-2.3	-2.3	-1.4
Employment expectations	SME	8.0	9.2	10.5	10.5	11.1	10.2	8.7	-1.5	0.7	-0.1
	LSE	10.9	8.5	6.4	9.6	11.3	6.8	5.9	-0.9	-5.0	-0.1
Sales price expectations	SME	-2.0	-2.6	-0.4	-0.8	-0.6	-1.7	-4.3	-2.6	-2.3	-0.9
	LSE	-5.2	-7.5	-6.3	-4.9	-5.3	-6.2	-9.0	-2.8	-3.8	-0.6

Source: KfW, ifo

Explanations and abbreviations:

*Seasonally and mean adjusted (long-term mean since January 1991 = 0)

S(mall and) M(edium-sized) E(nterprises)

L(arge-) Scale E(nterprises)

Change in percentage points m(onth)-o(ver)-y(ear)

Change in percentage points y(ear)-o(ver)-y(ear)

Change in percentage points 3 m(onths period)-o(ver)-3 m(onths period)

Revisions relative to previous publications may occur due to seasonal and mean adjustments as well as rounding.

Construction and interpretation of the KfW-ifo SME Barometer

The KfW-ifo SME Barometer indicator family is based on a scale-of-enterprise evaluation of the well-known ifo business climate index for which about 7,000 enterprises from trade and industry (manufacturing, construction, wholesale and retail trades) from western and eastern Germany are polled every month on current and future business, including around 5,600 SMEs. Enterprises are generally classed as small to medium-sized if they employ a workforce of not more than 500 and record an annual turnover not exceeding EUR 50 million. For a more accurate analysis, however, these quantitative limits have to be drawn more narrowly for retail trade (maximum annual turnover of EUR 12.5 million) and the construction industry (up to 200 employees). All enterprises that exceed at least one of these thresholds are classed as large-scale enterprises. The KfW-ifo SME Barometer reports the balance of current business assessments (percentage of positive answers less percentage of negative answers), the balance of business expectations for the next six months, ascertained in a similar way, and the inferred mean average value for the business climate. Moreover, the enterprises' employment and domestic sales price expectations are also expressed as balance figures. All time series are seasonally and mean adjusted. The zero line therefore marks the long-term 'cycle-neutral' average. Indicators above (or below) zero point to an above average or favourable (below average or negative) business situation.