

## »» SMEs' resistance is weakening as mood turns sour

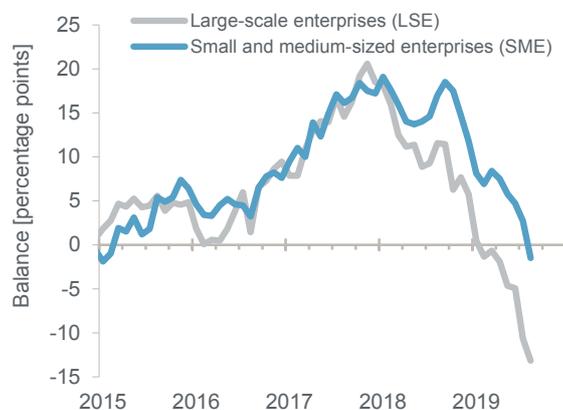
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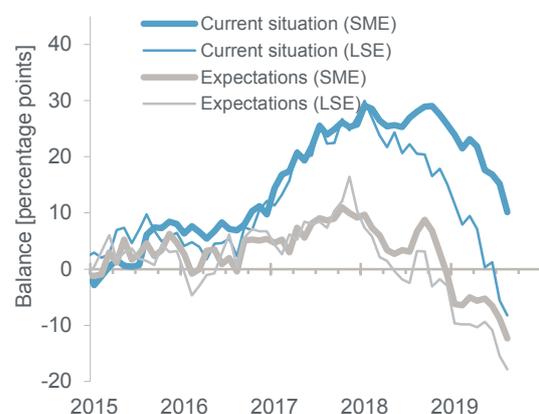
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- SME business confidence drops below the zero line for the first time in four and a half years
- Their expectations are now almost as pessimistic as those of large enterprises
- SMEs' situation assessments remain positive but are much lower than in the previous month
- Technical recession in Germany now appears inevitable

### KfW-ifo business climate



### KfW-ifo climate components



Source: KfW Research, ifo Institute

### Sentiment decline in SME sector is accelerating

With a time lag of around half a year, the negative mood that has prevailed among large enterprises for some time has now spilled over to SMEs. In August, SME business confidence fell by 4.2 points – twice the usual monthly variation – to -1.5 balance points, the first below-average result since February 2015. The downward trend has thus accelerated since the record high confidence level eleven months ago. Both sentiment components contributed to the recent decline:

- Assessments of the current business situation fell by a sizeable 5.1 points to now just 10.1 balance points. The sustained deterioration of situation assessments suggests a weak third quarter following a slight contraction in economic output in the second quarter.
- At the same time, SMEs' expectations fell by what was also a very significant 3.5 points on July. Now down to -12.3 balance points, they have slipped even further below the zero line and are nearing the levels of large enterprises, which have been extremely pessimistic since spring.

### Sentiment among large enterprises is even lower

Confidence is continuing to fall among large enterprises as well but this time less sharply than among SMEs. Specifically, sentiment in the large enterprise sector fell by 2.5 points in August to what is now a far below-average -13.1 balance points. Both situation assessments (-2.7 points to -8.3 balance points) and business expectations (-2.4 points to -17.9 balance points) are down.

### Expectations are on multi-year lows

As a result, the expectations of small, medium-sized and large enterprises are now only 5.6 points apart – a universal expression of a very pessimistic outlook on the coming six months. The last time expectation indicators were on a similarly low level was in 2012, when the survival of the euro area temporarily appeared to be in doubt as a result of the debt crisis. It was only during the Great Recession in the winter half of 2008/2009 that expectations were much lower than now. SMEs' situation assessments, however, still show a very wide gap of 18.4 points to large enterprises. The latter's significantly poorer situation assessments reflect what has long been a strong external headwind, including the trade policy uncertainties which are increasingly affecting large export-oriented enterprises, while SMEs with their broad domestic focus still benefit from relatively sound domestic de-

mand. However, the convergence of the expectations indicators of both size classes, which is driven by growing pessimism, is a sign that the external weakness has now spilled over to the domestic economy.

### Sentiment in the services sector turns negative

These contagion effects first hit the wholesale sector and now the services sector, too. Wholesalers operate at the junction between domestic and external markets, so they feel a significant portion of the direct dampening effects of an external trade slowdown. It is therefore easy to comprehend that sentiment in the wholesale sector has already been consistently negative in both company size classes since May. The business climate in the services sector, for its part, dipped into negative territory in August for the first time in around five years (SMEs: -4.8 points to -0.8 balance points; large enterprises: -8.2 points to -5.9 balance points). Industry-related services in particular are likely to suffer from the downturn.

### Manufacturers continue to struggle

Irrespective of the most recent minor stabilisation in large industrial firms, in no other economic sectors is the business climate currently as poor as among export-oriented manufacturers (SMEs: -2.1 points to -13.3 balance points; large enterprises: +1.2 points to -22.4 balance points). They are not only worried about the weak global economy, the escalation of trade conflicts and Brexit, as reflected in their nearly unchanged negative export expectations (SMEs: -0.3 points to -12.6 balance points; large enterprises: +1.5 points to -13.8 balance points). German manufacturers specialising in cyclical capital goods are also struggling because many companies are postponing investment decisions in Germany and around the world until the fog of political uncertainty lifts at least a little bit.

### Retailers are bucking the downward trend

The retail sector was the only one to buck the general downward trend in August. SME retailer confidence improved by 1.7 points to 13.8 balance points, while large retailer sentiment improved again by 7.1 points to 6.3 balance points after plummeting in the previous month.

Only among SME construction firms is business sentiment clearly better than in the retail sector (-0.3 points to 30.7 balance points), after large construction firms reported a surprisingly sharp drop in August.<sup>1</sup> Consumption is set to continue playing the role of cyclical stabiliser, although the dynamic is likely to weaken here, too. After all, the labour market is clearly losing strength as a long reliable tailwind. The KfW-ifo employment expectations in both enterprise size classes are now near the zero line, which represents the long-term average.

### Technical recession in the second half of 2019

The August result of the KfW-ifo SME Barometer indicates weakening cyclical resistance of the SME sector. Business confidence is now negative, not just in large companies but in small and medium-sized enterprises as well. Another important piece thus adds to the cyclical puzzle for the second half of 2019. The emerging picture shows an increasingly clearer technical recession, that is at least two successive negative quarterly growth rates. In the second quarter, Germany's gross domestic product already contracted by 0.1% and we expect a further slight quarter-on-quarter drop at least for the third quarter as well. Indicative of this is not just the increasingly negative business sentiment, including very pessimistic expectations. It is corroborated by hard monthly data such as new orders (-0.6% from May to July compared with the preceding three-month period) and industrial output (-1.6% in the same period). The cyclical weakness is concentrated in export-oriented manufacturing and the closely related sectors such as wholesale and business-related services. Thanks to the good start to the year, real growth should still be 0.4% for all of 2019. It could recover moderately to 0.6% next year. This is based on our assumption that damage from Brexit will ultimately be limited even if the United Kingdom should leave the EU without a deal, which is still possible, and that the trade conflicts will at least ease somewhat in the lead-up to the US elections of 3 November 2020 because the Trump administration will surely want to impress with a good economic and stock market performance in the election campaign. ■

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<sup>1</sup> The business climate in large construction firms fell by -10.7 points to 14.9 balance points. This sudden and sharp drop is not comprehensible based on the fundamentals; there is a high likelihood that this is a statistical outlier in this segment of the survey, where numbers are rather low, and which might be corrected again in the month ahead.

# KfW Research

## KfW-ifo SME Barometer: August 2019

### KfW-ifo SME Barometer in figures

Balance [Percentage points]*		Aug/18	Mar/19	Apr/19	May/19	Jun/19	Jul/19	Aug/19	m-o-m	y-o-y	3m-o-3m
<b>Business climate</b>											
Manufacturing	SME	13.4	-1.2	-4.4	-4.3	-5.9	-11.2	-13.3	-2.1	-26.7	-6.8
	LSE	12.0	-8.8	-11.8	-13.0	-16.0	-23.6	-22.4	1.2	-34.4	-9.5
Construction	SME	35.5	28.7	27.4	31.3	29.9	31.0	30.7	-0.3	-4.8	1.4
	LSE	36.5	21.8	28.1	31.2	28.8	25.6	14.9	-10.7	-21.6	-3.9
Retail trade	SME	11.3	14.2	10.4	11.1	14.2	12.1	13.8	1.7	2.5	1.5
	LSE	-3.8	0.1	2.0	4.3	12.5	-0.8	6.3	7.1	10.1	3.9
Wholesale trade	SME	12.3	0.9	0.8	-1.2	-1.1	-4.0	-8.4	-4.4	-20.7	-4.7
	LSE	13.8	3.5	-0.5	-0.4	-1.6	-17.2	-9.9	7.3	-23.7	-10.4
Services	SME	16.2	10.9	9.7	6.2	4.5	4.0	-0.8	-4.8	-17.0	-6.4
	LSE	16.6	10.6	8.7	0.6	3.9	2.3	-5.9	-8.2	-22.5	-6.5
<b>Germany</b>	<b>SME</b>	<b>17.0</b>	<b>8.4</b>	<b>7.5</b>	<b>5.8</b>	<b>4.7</b>	<b>2.7</b>	<b>-1.5</b>	<b>-4.2</b>	<b>-18.5</b>	<b>-5.3</b>
	<b>LSE</b>	<b>11.6</b>	<b>-0.6</b>	<b>-1.9</b>	<b>-4.6</b>	<b>-4.9</b>	<b>-10.6</b>	<b>-13.1</b>	<b>-2.5</b>	<b>-24.7</b>	<b>-7.2</b>
Current situation	SME	28.0	23.1	21.8	17.6	16.8	15.2	10.1	-5.1	-17.9	-6.8
	LSE	20.5	9.4	7.1	0.3	1.2	-5.6	-8.3	-2.7	-28.8	-9.8
Expectations	SME	6.7	-5.0	-5.6	-5.2	-6.5	-8.8	-12.3	-3.5	-19.0	-3.9
	LSE	3.2	-9.9	-10.4	-9.4	-10.9	-15.5	-17.9	-2.4	-21.1	-4.9
<b>Employment expectations</b>	SME	12.0	7.3	4.8	4.9	2.2	3.0	0.2	-2.8	-11.8	-3.9
	LSE	16.4	5.6	4.4	1.2	1.3	-3.9	-1.6	2.3	-18.0	-5.1
<b>Sales price expectations</b>	SME	14.2	8.3	6.5	4.3	3.6	2.4	3.3	0.9	-10.9	-3.3
	LSE	10.0	4.2	3.1	2.0	1.1	-1.0	-1.0	0.0	-11.0	-3.4
<b>Export expectations of manufacturing</b>	SME	2.3	-6.8	-8.1	-6.1	-10.3	-12.3	-12.6	-0.3	-14.9	-4.7
	LSE	5.3	-13.2	-12.3	-13.0	-13.0	-15.3	-13.8	1.5	-19.1	-1.2

Source: KfW Research, ifo Institute

Explanations and abbreviations:

\*Seasonally and mean adjusted (long-term mean since January 2005 = 0)

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

L(arge-)Scale E(nterprises).

Change in percentage points m(onth)-o(ver)-m(onth).

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. The KfW-ifo SME Barometer was fundamentally revised for the reporting month of April 2018 (new aggregation process, inclusion of services, start of time series now 2005 instead of 1991, consideration of export expectations, discontinuation of regional indicators for western and eastern Germany). Publications prior to and from April 2018 are therefore comparable to a limited extent only.

### 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 ifo economic surveys which are used to calculate, among other things, the well-known ifo Business Climate Index. Each month about 9,000 enterprises from trade and industry, construction, wholesale, retail and services (without the banking and insurance sectors or the state) are polled on their business situation, among them some 7,500 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 distinctions have to be drawn more narrowly for retail trade (maximum annual turnover of EUR 12.5 million), the building and the construction industry (up to 200 employees) and services (maximum annual turnover of EUR 25 million). 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 and – exclusively for manufacturing – export expectations are also captured as balance figures for the next three months. All time series are seasonally and mean adjusted. The zero line therefore marks the long-term 'cycle-neutral' average since January 2005. Indicators above (or below) zero point to an above average or favourable (below average or negative) business situation.