

Attack on Ukraine has sent business expectations into a tailspin

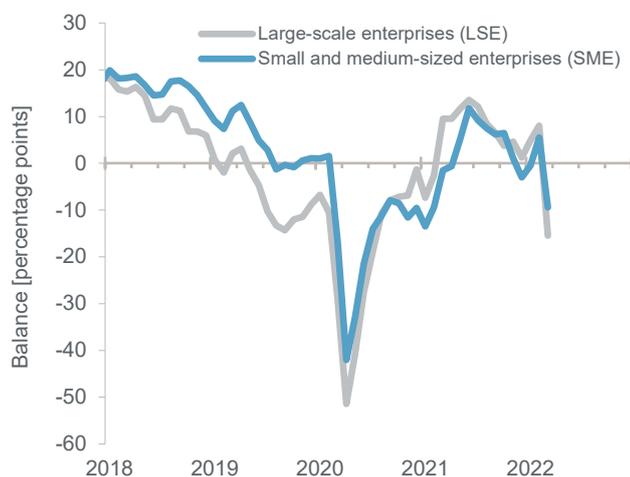
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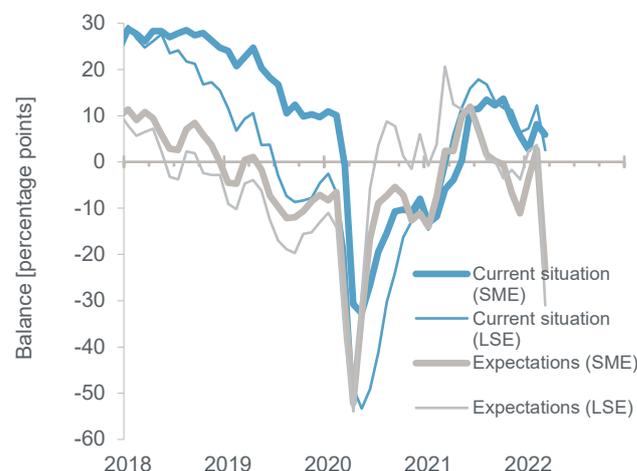
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- War in Ukraine has sent SME business confidence tumbling
- Record slump in expectations but only marginally lower situation assessments
- Large enterprises' confidence has fallen even more sharply
- Business outlook has dimmed but threat of recession not imminent unless Russia interrupts gas supplies

KfW ifo Business Climate Index



KfW ifo climate components



Source: KfW Research, ifo Institute

Expectations have taken a nosedive

SME business sentiment in Germany fell abruptly by 14.9 points as a reaction to Russia's invasion of Ukraine. At -9.4 points it is now on a similar level as during the second COVID-19 wave in the winter of 2020/2021.

- The drop in sentiment was driven primarily by business expectations, which plunged dramatically by 25.9 points to now -23.2 balance points, the sharpest decline recorded since the beginning of the time series in 2005. However, expectations are still well above the low during the first wave of the pandemic in April 2020.
- Assessments of the current business situation, however, worsened only by a moderate 2.3 points. Even after this drop, at 5.9 balance points they are still well above the zero line, which stands for the long-term average. Unlike business expectations, there have still been improvements in situation assessments, at least in the sectors previously hit particularly hard by the pandemic.

Expectations plunged across all sectors

The surge in pessimism was particularly strong among small and medium-sized manufacturing enterprises, whose business confidence fell from +9.9 to -10.1 balance points within only a month. The prospects of a strong rise in energy prices over the longer term, the risk of natural gas supply shortfalls and new bottlenecks in important commodities from Russia and Ukraine have massively clouded the business outlook in the manufacturing sector. This is compounded by more and more lockdowns in China which are likely to disrupt global supply chains again. But SMEs also downgraded their situation assessments slightly as the war has already caused problems in the supply of specific inputs, such as wiring harnesses for the automotive industry, and some businesses are losing turnover in Russia and Ukraine.

Nonetheless, the deterioration in SME business sentiment in March 2022 pervades all sectors. In construction, wholesale and retail, confidence dropped by a pronounced 16 to 17 points and even the services sector recorded what is still a considerable drop of nearly 10 points. With the outlook for the

coming months plummeting across all sectors, retail and services were the only sectors with improved situation assessments. Both are currently benefiting from the relaxation of most pandemic restrictions. A record-high increase of 11.8 points in sales price expectations to an unprecedented 47.9 balance points illustrates that many SMEs currently expect to be able to pass at least part of the massive increases in energy and commodity costs on to consumers. The resulting loss in purchasing power, however, is also likely to dampen private consumption.

Large enterprises are even more pessimistic

As is usually the case with international shocks, large enterprises are again more heavily affected than small and medium-sized firms. After all, most are export-oriented and more closely integrated into international value chains. Furthermore, the manufacturing sector has more weight in the survey among large enterprises. Their business sentiment thus fell by a notable 23.5 points to -15.5 balance points in March. As with SMEs, their expectations dropped most sharply (-34.7 points to -31.0 balance points) but their situation assessments also fell by a notable 9.7 points to now just 2.6 balance points. The deterioration in business sentiment was particularly pronounced in industrial and construction firms, but sentiment moved into the red very abruptly in the wholesale sector as well.

The war has clouded the outlook for the economy

The immediate effect of the war on Germany is first and foremost an additional surge in inflation from what is likely to be a longer-term increase in energy and commodity prices which will weigh on both household purchasing power and business activity in particularly energy and commodity-intensive sectors. But since Russia plays a secondary

role as an export destination, the loss of Russian demand will have less of an impact, while bottlenecks in critical commodities from Russia are potentially more severe but nearly impossible to predict. However, Putin's invasion of Ukraine is definitely a taboo violation with dramatic humanitarian and geopolitical consequences as well as considerable risks, including for Germany. So it was foreseeable that the KfW-ifo SME Barometer would show a very pronounced deterioration of the business climate in March. In particular, the collapse of business expectations signals broad agreement that the outlook is worsening. But because of the way the indicator is designed, it does not specify the degree of deterioration. It can be assumed that small and medium-sized enterprises are not directly affected as much. A supplementary survey conducted as part of the KfW SME Panel in the second week of March showed, for example, that only one third of small and medium-sized enterprises see the war in Ukraine as a high or medium risk to their business prospects in the coming twelve months, while the vast majority of SMEs is not that worried about their outlook. The economic impact will ultimately depend on the duration of the war and the spiral of escalation in military action and sanctions. In any case, the war and China's new problems in containing the pandemic have stalled the momentum from the previously expected vigorous recovery. But since services still have considerable recovery potential after most coronavirus restrictions were lifted in Germany and a number of households have financial buffers from the lockdowns, growth this year may still be around the 2% mark. Still, a much more negative development to the point of stagflation or recession is also possible, especially if Russia decides to interrupt natural gas supplies abruptly and on a sustained basis.

KfW-ifo SME Barometer in figures

Balance [Percentage points]*		Month/Year						m-o-m	y-o-y	3m-o-3m	
		Mar 2021	Oct 2021	Nov 2021	Dec 2021	Jan 2022	Feb 2022				Mar 2022
Business climate											
Manufacturing	SME	8.0	8.2	2.9	3.4	5.7	9.9	-10.1	-20.0	-18.1	-3.0
	LSE	24.0	8.2	9.2	7.7	10.8	16.0	-11.1	-27.1	-35.1	-3.1
Construction	SME	9.4	18.6	17.2	13.4	11.4	11.9	-4.5	-16.4	-13.9	-10.1
	LSE	5.9	11.9	14.9	10.0	13.9	13.2	-18.2	-31.4	-24.1	-9.3
Retail trade	SME	-4.4	3.2	-1.2	-10.1	-1.0	10.4	-6.7	-17.1	-2.3	3.6
	LSE	-1.6	-13.2	-7.1	-16.4	-0.6	-2.7	-15.0	-12.3	-13.4	6.1
Wholesale trade	SME	2.2	1.6	-1.7	-4.2	-0.6	6.6	-9.7	-16.3	-11.9	0.2
	LSE	5.1	1.2	1.3	0.3	3.3	12.4	-10.5	-22.9	-15.6	0.8
Services	SME	-11.6	3.5	-4.8	-11.7	-8.2	-0.7	-10.5	-9.8	1.1	-2.1
	LSE	-2.8	4.0	-1.2	-10.2	-3.0	-0.1	-17.0	-16.9	-14.2	-4.2
Germany	SME	-1.5	6.5	1.1	-3.0	-0.5	5.5	-9.4	-14.9	-7.9	-3.0
	LSE	9.5	3.7	4.6	1.2	4.9	8.0	-15.5	-23.5	-25.0	-4.0
Current situation	SME	-5.9	13.7	9.2	5.7	2.7	8.2	5.9	-2.3	11.8	-3.9
	LSE	-2.2	11.7	11.3	6.5	7.3	12.3	2.6	-9.7	4.8	-2.4
Expectations	SME	2.4	-0.5	-6.6	-11.1	-3.7	2.7	-23.2	-25.9	-25.6	-2.0
	LSE	20.6	-3.6	-1.7	-3.8	2.4	3.7	-31.0	-34.7	-51.6	-5.3
Employment expectations	SME	1.1	12.2	10.9	8.2	8.7	13.4	9.1	-4.3	8.0	0.0
	LSE	-0.9	12.6	12.7	15.6	16.1	18.7	12.2	-6.5	13.1	2.0
Sales price expectations	SME	8.9	33.3	36.9	35.2	36.6	36.1	47.9	11.8	39.0	5.1
	LSE	8.5	32.4	36.4	35.0	35.0	40.6	47.5	6.9	39.0	6.4
Export expectations of manufacturing	SME	5.5	0.3	1.8	-1.2	0.6	4.3	-13.2	-17.5	-18.7	-3.1
	LSE	24.3	7.2	9.5	6.9	10.1	7.6	-8.0	-15.6	-32.3	-4.6

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 9,500 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 8,000 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.