

MITTELSTANDSMONITOR 2005

MASTERING THE UPSWING - STRENGTHENING THE DOMESTIC
BUSINESS CYCLE AND COMPETITIVENESS

Annual report on cyclical and structural issues relating to
small and medium-sized enterprises – Abridged version.

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Preface

In Germany, as in almost all industrialised countries, more than 99% of all enterprises are small or medium-sized (SMEs). They produce nearly half the enterprise sector's gross value added. Their main qualitative feature is that owners and responsible management are identical. Small and micro enterprises - which factually include all start-ups and most young enterprises - belong to this sector as do larger enterprises with several hundred employees and a leading position in the world market. With their diversity they ensure economic stability and form an integral part of a balanced enterprise size structure that facilitates structural change, promotes innovation and thus ultimately contributes to more growth and prosperity of a national economy. Despite the enormous importance rightly attributed to small and medium-sized enterprises time and again in the debate about economic and social policy, the economic situation of SMEs is not apparent in the official statistics.

Only a few institutions possess sufficient statistical information bases of their own that would put them in a position to make regular observations on issues concerning SMEs. However, reliable data and an unbiased - empirical - formation of opinions are necessary if the debate about central issues of economic life is to be conducted in an objective manner. For this reason the Verband der Vereine Creditreform (Creditreform), the Institut für Mittelstandsforschung (IfM Bonn), the Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI) and the Zentrum für Europäische Wirtschaftsforschung (ZEW) have joined an initiative of KfW to publish the MittelstandsMonitor, which is a joint annual report on cyclical and structural aspects relating to small and medium-sized enterprises. The key idea is to collect and compare new expert findings in order to subsequently present them to the public in a concise form. The prime objective is to conduct an analysis based strictly on objective facts. The exclusive databases of the partners complement each other and provide a comprehensive empirical basis for the MittelstandsMonitor.

The assessment of the cyclical economic situation of small and medium-sized enterprises and the development of company start-ups and liquidations represent a firm element of the report. Different focal topics concerning the small and medium-sized enterprise sector that are of current economic interest are added each year. This 2005 edition is dedicated to the subjects of "Innovation – Challenges for SMEs" and "SMEs and the EU Eastern Enlargement".

The project partners have decided to give the MittelstandsMonitor 2005 the title

“Mastering the Upswing - Strengthening the Domestic Business Cycle and Competitiveness”

With this title they want to underline that small and medium-sized enterprises did participate in the almost exclusively export-driven cyclical recovery, however, to a much lesser extent than large companies. Only if the domestic upswing is further strengthened will the investment activities of small and medium-sized enterprises pick up and give a positive impulse to the labour market. The protagonists in economic policy expect that more start-up activities will also alleviate the problems in the labour market, as was the case in the years 2003 and 2004. A special segment of business fluctuations is start-ups out of unemployment, which substantially gained importance in the period 2003/2004. (Chapter 2). In order to ensure the competitiveness of the economy and to strengthen the motors of growth, it is absolutely vital to continue to improve the framework conditions for both young companies and established companies and above all for innovative SMEs and start-ups. Such companies made a significant contribution to the German innovation system, accounting for around one third of innovation expenditure. Still, the innovation expenditure of the SME sector has been stagnating for some years. Obviously, the SME sector is much less able to exploit its innovative potential (Chapter 3). Should the innovation activities decline further this might increasingly result in a loss of competitiveness on the part of small and medium-sized enterprises. Tapping the idle innovation potential of small and medium-sized enterprises and, in this way, improving their innovative activity may also contribute to overcoming the growth weakness of the German economy. Additional growth potential will result from the EU eastern enlargement because it offers small and medium-sized companies much better export and investment opportunities. Still, large sections of the SME sector are rather sceptical about EU enlargement (Chapter 4). Even if enlargement is associated with risks for individual companies there is no denying that in a careful comparison of the opportunities and risks of the eastward enlargement the opportunities also clearly prevail also for the SME sector.

The participating institutions

Chapter 1: The economic situation of small and medium-sized enterprises

Moderate recovery continues with some boost from domestic demand

The recovery, which in part began already in 2003, continued in 2004: The SME business cycle recovered noticeably from its low in 2002. The business climate and the order books, however, have still not reached the long-term average. The very optimistic expectations that existed a year earlier were corrected while the actual business situation improved only hesitantly in the course of 2004. Thus, small and medium-sized enterprises did participate in the almost exclusively export-driven cyclical recovery, however, to a much lesser extent than large companies, which are more strongly integrated into the global division of labour.

Already since the year 2000 and in the wake of the pronounced weakness in domestic demand, the SME business climate has been lagging behind that of large companies, with the gap widening rapidly in the last two years. SMEs in the manufacturing and wholesale trade sectors, which have a relatively strong international orientation, benefited above average from the export push. In contrast, the retail trade sector and the construction industry, but also the service sector, are lagging behind. When comparing the cyclical development in the western and eastern parts of Germany west German SMEs were clearly doing better.

Driven by the sales and earnings development the investment propensity somewhat improved: Recently almost 35% of SMEs intended to invest in new projects in the next six months. Measured by the long-term average (47%), however, this figure is far too low to ensure a strong upswing. As in the three preceding years, small and medium-sized enterprises on balance did not have any positive impact on the labour market in 2004 either. Though the downswing has slowed noticeably a reversal of the trend is not to be expected in the short term. Only one in ten SMEs plan to hire additional staff in the first half of 2005, however, only one in five SMEs plan staff reductions.

In accordance with the expectations of SMEs themselves the research institutes involved expect the moderate recovery to continue. The cyclical gap between SMEs and large companies, which has widened heavily in the last few years, is expected to narrow due to stronger domestic demand. Higher investments and positive employment effects cannot be expected unless SMEs are convinced that the strength of the domestic recovery will be sustainable. This is not the case for the time being.

Chapter 2: Business fluctuation: Newest trends in start-up activity

Start-up rates 2003/04 on the rise

The downwards trend these past few years in the number of business start-ups and existence founders has reversed: for the first time, the number of start-ups rose in the year 2003. The increase was particularly strong in eastern Germany. Not least, this was due to a steep rise in the number of people setting up their own business to escape from unemployment: as of early 2003 a special grant has given self-employed people added support on top of the bridge money provided by the Federal Employment Agency. According to preliminary estimates, a similar rise in the number of start-ups is expected for 2004.

The upward trend in the year 2003 again regarded technology-intensive sectors but the start-up activity mainly involved businesses founded in the areas of high-quality technology and technology-intensive services. On the other hand, the start-up rates in the field of advanced technology – which is particularly important in macro-economic terms – dropped again in 2003. The negative development especially in this area is a sign of continuing deficits.

The start-up activity has a downside: liquidations. In Germany as a whole and in western Germany, all sectors of the economy experienced a rise in liquidations in 2003 over 2004. In eastern Germany, on the other hand, there was a decline in agriculture and forestry, manufacturing and building. 2003 was a record year for insolvencies, which account for only a small percentage of the liquidations. A further increase in business insolvencies is expected for 2004, although a drop is anticipated in the eastern states. On balance, once again the start-ups outnumber the liquidations by a wide margin, even in 2003. For 2004, the number of start-ups can again be expected to be far higher than the number of liquidations.

Business start-ups by jobless people have increased rapidly in the last two years and now account for much more than half of all founders of full-time enterprises. Most of them are micro enterprises, which do not require much capital. Since they operate in similar market segments, they compete with the small companies and one-person businesses that had previously dominated the start-up scene and self-employed structure. In order to ensure the competitiveness of the German economy and to strengthen the motors of growth, it is absolutely vital to continue to improve the overall conditions for existing companies - above all for innovative companies - and for innovative start-ups.

Chapter 3: Innovation – A Challenge for SMEs

Far less innovative activity at SMEs than at large companies; financing still a major obstacle to innovation

Various innovation indicators show that the gap is widening to the disadvantage of small and medium-sized enterprises. Innovation expenditure by large companies has noticeably increased in the past few years, yet it has stagnated at SMEs. What is more, the share of companies bringing innovations onto the market, conducting R&D and cooperating with science is much smaller for SMEs than for large enterprises. Yet, SMEs still make a substantial contribution to German innovations, accounting for approximately one-third of the EUR 94 billion in innovation expenditure by businesses in 2002.

Apart from the high economic risk and the costs incurred by innovation, small and medium-sized enterprises list the lack of financing as a key obstacle to innovation. Compared to their large counterparts, SMEs have less internal financial strength and fewer opportunities to diversify their risks across several innovation projects, which makes it difficult to access external capital. The growing risk/return orientation within the financial sector aggravates this problem. In addition, SMEs frequently lack sufficient capacity to gather knowledge about innovation through own R&D activities or cooperation with research institutes. As a result of these obstacles – some of which are due to functional deficiencies in market mechanism – it is much harder for them to realise their innovation potential than it is for large corporations.

Our analyses confirm that international competitiveness, sustainable growth and permanent jobs mainly result from innovations that succeed in the market. Against the backdrop of an unfavourable demographic development in Germany and rising globalisation, the development of innovative ideas and their rapid transformation into marketable products and processes will become increasingly important in the future.

We need to undertake greater efforts to develop innovations, as stated by the German federal government during the Lisbon process – and strive to increase the share of R&D expenditure in GDP to 3% by the year 2010. However, simply attaining this mark is no guarantee for an increase in innovative power: efficient use of financial resources is also essential. Tapping the idle innovation potential of SMEs and, in this way, improving their innovative activity plays a significant role in overcoming the growth deficit of the German economy.

Chapter 4: SMEs and the EU's eastern enlargement: Opportunities and risks

The European Union's enlargement towards the east poses a tremendous challenge to the European integration process. Never before have so many countries joined the EU at the same time, and the economic divide between old and new member countries has never been so wide.

In public discussion the eastern expansion is frequently associated with risks for the German economy overall, for German companies or for individual sectors. Our analysis paints a different picture: production is not yet being relocated to Central and Eastern Europe on a large scale. The SME sector – i.e. the majority of small and medium-sized enterprises – will not leave Germany. Direct investments and exports to the accession countries do, however, offer many companies – above all larger SMEs – attractive business opportunities. The protection of jobs in Germany will depend not least on whether these opportunities are seized.

For the time being, broad sections of the SME sector are slightly skeptical about the eastward expansion. This is a result of the company survey conducted by Creditreform for the SME Monitor 2005. According to the survey, over 40% of the responding companies believe that the eastward enlargement will bring them more risks than opportunities. Only 20% believe that the opportunities outweigh the risks. The survey thus documents deep concerns of many German SMEs about the EU's eastward expansion.

Surely this expansion towards the east is associated with risks for individual businesses, yet the opportunities that are opening up are far more important. Eastern Europe is an attractive place to invest and a lucrative sales market. Especially the geographical proximity and the economic relations that already exist play into the hands of German companies. Nevertheless, our survey shows that currently, only a small percentage of the companies are at all active in the accession countries. Solely 13% of the responding companies conduct business in the accession countries in one form or another (export, import, direct investments). However, in view of the fact that the greater majority of SMEs operate on the local and regional level and will therefore hardly consider conducting business across international borders, this share is quite sizeable.

Naturally the eastward enlargement offers opportunities not only for German companies but also for companies in the accession countries. In the future, businesses in Central and Eastern Europe will be more active in western European and especially in German markets, thus competing with German companies in their home market. There will also be a few German SMEs among the losers of the foreseeable changes. From our point of view, the

situation in the building industry and in transport could become critical – particularly once full freedom of services has been established.

Yet, in conclusion a careful comparison of the opportunities and risks tied to the eastward expansion shows that the opportunities are much greater. The worries that some SMEs still have are, however, an indication that there is still a considerable need for clarification about the conditions and impacts of the eastward enlargement.