THOUGHTS

Economic scenario 2013

We had hoped for more:
The German economy experienced sluggish growth in 2012.
Many now think 2013 will be even worse. We disagree.
What scenarios are conceivable?
And what are the risks?
Our economic scenario for 2013

Roland Berger
School of Strategy and Economics

THOUGHTS

Economic scenario 2013

AUTHORS:
Burkhard Schwenker
Tobias Raffel

Our scenario for Germany in 2013

THE DAX-LISTED COMPANIES ARE POSTING RECORD SALES. EXPORTS CONTINUE TO RISE. UNEMPLOYMENT IS LOW. INFLATION IS STILL NOT AN ISSUE. NO MAJOR BANKS ARE EXPECTED TO GO BELLY-UP.

All the signs are that 2013 will be a good year. Yet growth forecasts remain decidedly downbeat. The IMF is predicting growth of only 0.9% in Germany. A figure of 0.8% is being touted by the EU Commission and the Cologne Institute for Economic Research (IDW). The OECD's projection for Germany is as low as 0.6%. The average of all growth forecasts has slipped to just 0.7% – even less than the 1% expansion we probably achieved in 2012. The expectation that a tough 2012 would be followed by a dynamic 2013 is being revised almost across the board.

But why? Are there any fundamental factors that argue against more forceful growth and new-found dynamism? Or are growth opportunities once again being systematically underestimated? For our part, in 2013 we are staying true to the optimistic view that has already been proven right three times.

Having said that, we got it wrong in 2012 – along with many others. This economic scenario is all about why, what conclusions can be drawn and, above all, how we rate the prospects for growth in 2013 in light of these developments.

THE MAINSTREAM VIEW: PESSIMISTIC AND FLAWED

THIS YEAR'S FORECASTS FOR GERMAN GROWTH ARE ONCE AGAIN SUBDUED. YET PAST EXPERIENCE CLEARLY SHOWS THAT GERMAN GROWTH IS REGULARLY UNDERESTIMATED

CURRENT GDP FORECASTS FOR 2013

German government	0.5%
HWWI	0.5%
OECD	0.6%
EU Commission	0.8%
Consensus	0.7%
IMF	0.9%

GERMANY'S GROWTH HAS BEEN SYSTEMATICALLY UNDERESTIMATED*

Forecasts for 2010		Shortfall (in points)
Kiel Institute (IfW)	0.3%	3.4%
EU Commission	1.2%	2.5%
Ifo	1.7%	2.0%
Actual growth:	3.7%	

Forecasts for 2011		Shortfall (in points)
German	1.8%	1.2%
Deutsche Bank	2.0%	1.0%
IMF	2.0%	1.0%
Actual growth:	3.0%	

Forecasts for 2012		Shortfall (in points)
Economist Intelligence Unit	-0.6%	1.6%
Ifo	-0.4%	1.4%
Deutsche Bank	0.0%	1.0%
Actual growth:	Est. 1.0%	

* Forecasts made in December of the previous year

Where we went wrong

IT IS EXACTLY FOUR YEARS SINCE THE GLOBAL ECONOMY PLUNGED INTO ITS DEEPEST CRISIS SINCE THE WAR. SCARCELY ANYONE HAD FORESEEN SUCH AN UNPRECEDENTED COLLAPSE.

At the start of 2009, few dared to predict when the economy would begin to grow again and how quickly. At the time, our clients bombarded us with requests for guidance: What indicators can we use to make sound business decisions? How do you see things developing from here?

So we launched our own series of economic scenarios. We were, and still are, of the opinion that the traditional scientific and econometric forecast models are no longer able to properly model the markets' uncertainty and volatility. Accordingly, we charted a different course. Instead of analyzing short-lived trends, we went looking for fundamental strengths and weaknesses. Instead of applying complex computational models, we drew on the entrepreneurial experience we have accumulated working with clients all over the world. Above all, we questioned the prevailing consensus – critically and systematically – to find a way to develop alternative scenarios (see page 7 for details of our methodology).

This approach proved very successful in 2009, 2010 and 2011. Unlike almost all other organizations that ventured to make predictions, our scenarios were spot on:

◆ For 2009, we correctly forecast that the near vertical nose-dive triggered by the crisis would be followed by a rapid upswing – what we called a V curve

◆ For 2010, we rightly predicted "growth of at least 3%" – it actually turned out to be a remarkable 3.7%

◆ For 2011, we stood by our optimistic view and a growth rate of 3%. Once again, we hit the mark

In 2012, our scenario did not materialize. Instead of the forecast growth of 2% to 3% ("only […] 2.5% or even 2% growth […] would still be an excellent result"), the final figure is likely to be more like 1%. This naturally caused some people to scoff at us. But it also raised the question of how come we were right three times in a row and then so wide of the mark at the fourth time of asking – and what we could learn from this for our latest scenario.

Let's look back at what actually happened. Our optimistic growth scenario for 2012 was rooted in the intrinsic strength of the German economy, global growth potential (especially in the US and China) and the chance of a more integrated Europe. With the benefit of hindsight, we would add the following:

◆ The intrinsic strength of the German economy has been confirmed: manufacturing skills matter. There is no other way to explain how Germany was able to buck the negative trend in Europe, how its exports continue to grow, and how robust its labor market remains. This argument plays a crucial role in our new scenario
◆ On the subject of global growth potential, one could argue that our forecasting errors for the USA (2.5%, compared to an actual estimated 2.2%) and China (8.0%, compared to a likely figure of 7.8%) were not all that serious. However, part of our reasoning when it came to our forecast for Germany was that these two economies have a very powerful influence on the global growth climate. And that is precisely why sluggish reindustrialization in the US and the constant slowdown in the pace of Chinese growth both had a lasting impact, eroding confidence. Both ultimately emitted the wrong signals, thereby accelerating the negative development
◆ Europe was where we made our real forecasting error, however. We overestimated the dynamism that would be fueled by a more integrated growth policy, and we underestimated the downforce above all in France, Italy, Spain and the UK. Instead of posting gently positive growth, Europe's economy actually contracted, probably by 0.3%

In our new scenario for 2013, we remain fundamentally optimistic about Europe and the euro. But we have taken a longer, harder look at whether there will indeed be a chance for vigorous growth initiatives.

There is a fourth argument that plays a part in our new scenario, too: an economy's potential for growth. We know that four times in the past six years (in 2006, 2007, 2010 and 2011) Germany grew by 3% or more and, in so doing, outperformed all other advanced economies. Last year, we reckoned that the German economy was strong enough to do the same again for a fifth time. Given the historical context, we were probably rather too ambitious. At the end of this publication, we will thus come back to the question of what growth rates are realistically sustainable in the long term.

OUR METHODOLOGY:
THINKING SCENARIOS THROUGH FROM AN ENTREPRENEURIAL PERSPECTIVE

We are not an economic think tank, so our methodology for preparing forecasts is slightly different. Rather than using econometric models, we craft scenarios that reflect our entrepreneurial experience on the world's markets, deliberately calling the mainstream view into question.

1 COLLATE FORECASTS

We begin by systematically collating the numbers and opinions published by others.

2 DEFINE THE MAINSTREAM

On this basis we define the mainstream, deriving mean figures from existing forecasts and citing typical expert views.

3 QUESTION THE MAINSTREAM

Our third step is to consciously look for arguments and numbers that go against the mainstream. We also take "symbolic" developments and impressions into account.

4 APPLY A BUSINESS PERSPECTIVE

We then present the overall picture painted by these numbers and impressions to our consultants in Germany and abroad – experts who know their clients, industries and markets first hand and can access the personal opinions of selected clients.

5 FORMULATE A SCENARIO

Based on the first four steps, we then form our own opinion, drawing up a scenario based on the facts and including selected figures that plot the development we consider most likely.


THE DOMESTIC ECONOMY IS HEALTHY
MANUFACTURING SKILLS MATTER
THE GLOBAL ECONOMY IS PICKING UP SPEED
EUROPE IS BECOMING MORE STABLE

In search of growth potential: Our optimistic view

WE BELIEVE THAT GERMAN GROWTH IN 2013 WILL BE DRIVEN BY MANUFACTURING SKILLS, A MORE VIGOROUS GLOBAL ECONOMY, A MORE STABLE EUROPE AND A HEALTHY DOMESTIC ECONOMY.

OUR OPTIMISTIC VIEW

As we noted earlier, everything seems to point to 2013 being a good year. At the start of the year, conditions are not bad at all – indeed, they are much better than expected:

- Christmas business was very brisk, showing that the Germans' confidence and their propensity to consume are stable
- German companies have had another record year: Some are reporting double-digit sales and earnings growth
- Of late, German exports have been developing far better than expected, climbing a remarkable 3.6% to EUR 275.4 billion in the third quarter of 2012
- It is also remarkable that exports to non-European countries increased by nearly 10% and now account for 44% of total exports
- Nor does the situation on the financial markets look at all bad. German banks and insurance companies have been able to further reduce their risk exposure. The banks have also improved their capital positions, and the lending market is back on its feet again. The DAX index, too, rose by a remarkable 29.1%
- Developments on the labor market are decidedly positive. Unemployment remains very low at 6.7%. Only 2.84 million people in Germany are currently jobless
- Lastly, the corporate sector is upbeat about the future. At year end, the ifo business climate index was up again and now stands at 102.4 points

The picture is rosy – yet official growth forecasts for 2013 are very modest. The expectation that a tough 2012 would be followed by a dynamic 2013 has been revised almost across the board:

- In spring 2012, the IMF was still saying that the German economy would expand by 1.5% in 2013 – significantly faster than in 2012. By fall, however, it had corrected its forecast to 0.9%
- The Consensus Research forecast was still assuming growth of 1.6% as late as last summer, but it too had fallen to just 0.7% by December 2012
- In fall 2012, the OECD rolled its forecast back to just 0.6% growth in 2013 – in spring it had been anticipating 1.9%

Is the skepticism justified? Or are people exaggerating the economic difficulties we witnessed in the second and third quarters of last year? For our economic scenario, we have remained true to our methodology and tried to find both arguments that contradict the mainstream view and potential that could enable stronger growth. In the process, we have identified four distinct factors: the manufacturing skills of German industry, a global economy that is finally picking up speed again, a more stable Europe and a healthy domestic economy.

1. MANUFACTURING SKILLS MATTER

GERMANY WILL BENEFIT FROM ITS MANUFACTURING STRENGTH

Manufacturing skills were the pivotal issue in our last economic scenario. We stand by this view in the new scenario too, because we are convinced that a superior manufacturing base translates into superior growth rates. To be on the safe side, we double-checked the relevant factors in detail:

◆ In Germany, manufacturing currently accounts for 22.6% of gross value added, far more than in the other major European economies. At the same time, our economy has recorded substantially stronger growth (an average of 2.6%) than all other major EU countries in the three years since the economic crisis: 2010, 2011 and 2012

◆ Outside Germany, the same positive correlation can be seen in Eastern European countries – especially Poland, where manufacturing accounts for 17.6% of GDP and where the value added by manufacturing has been increasing sharply. The same is true of the Czech Republic and Slovakia, in both of which manufacturing has a 21% share of value added. Indeed, Poland and Slovakia have enjoyed the best average growth rates in the post-war years of all of today's EU countries: 3.5% in Poland and 3.7% in Slovakia

◆ The UK and France show that the same is true from an opposite perspective: Manufacturing accounts for just 10.8% of the UK's GDP and 10.1% of French GDP (about half the German figure) and growth has averaged a mere 0.7% in the UK and 1.2% in France (not even half the German figure). Moreover, both countries have been de-industrializing on a massive scale since 2001 – by 4.6 percentage points in the UK and 4.0 points in France – and rapidly losing their manufacturing skills in the process

◆ The same negative correlation is found in Spain, Italy (with the exception of the north, with its predominance of small and medium-sized enterprises) and Portugal. Surprisingly, the same also increasingly goes for the Netherlands and Belgium

◆ Less surprisingly, Greece brings up the rear: It has both the lowest share of manufacturing (just 9.2%) and the worst growth performance (minus 5.5% on average over the past three years)

The figures on pages 12 and 13 show the positions of all European countries in our share of manufacturing/growth portfolio. In no uncertain terms, this confirms that there is a significant correlation between manufacturing's share of a national economy and the rate of growth: The larger the share of manufacturing, the stronger the growth. It goes without saying that the share of manufacturing in percentage terms is only one side of the coin: The other is the ability to put it to profitable economic use. Germany's manufacturing industry scores here, too. What makes Germany so strong is its unique mix of large corporations and SMEs, their solid global footprint and a successful blend of manufacturing and high-end technical services.

We believe that this strength and uniqueness of the German economy will once again lay the foundation for positive growth in 2013. Another development may deliver even more advantages: Manufacturing skills are a prerequisite for constant productivity gains, and productivity gains are the answer to the problem of scarce resources in terms of people, materials and the environment. The German economy may thus benefit to an exceptional degree from three specific megatrends: climate change, the scarcity of resources, and demographic change.

MANUFACTURING EQUALS FASTER GROWTH

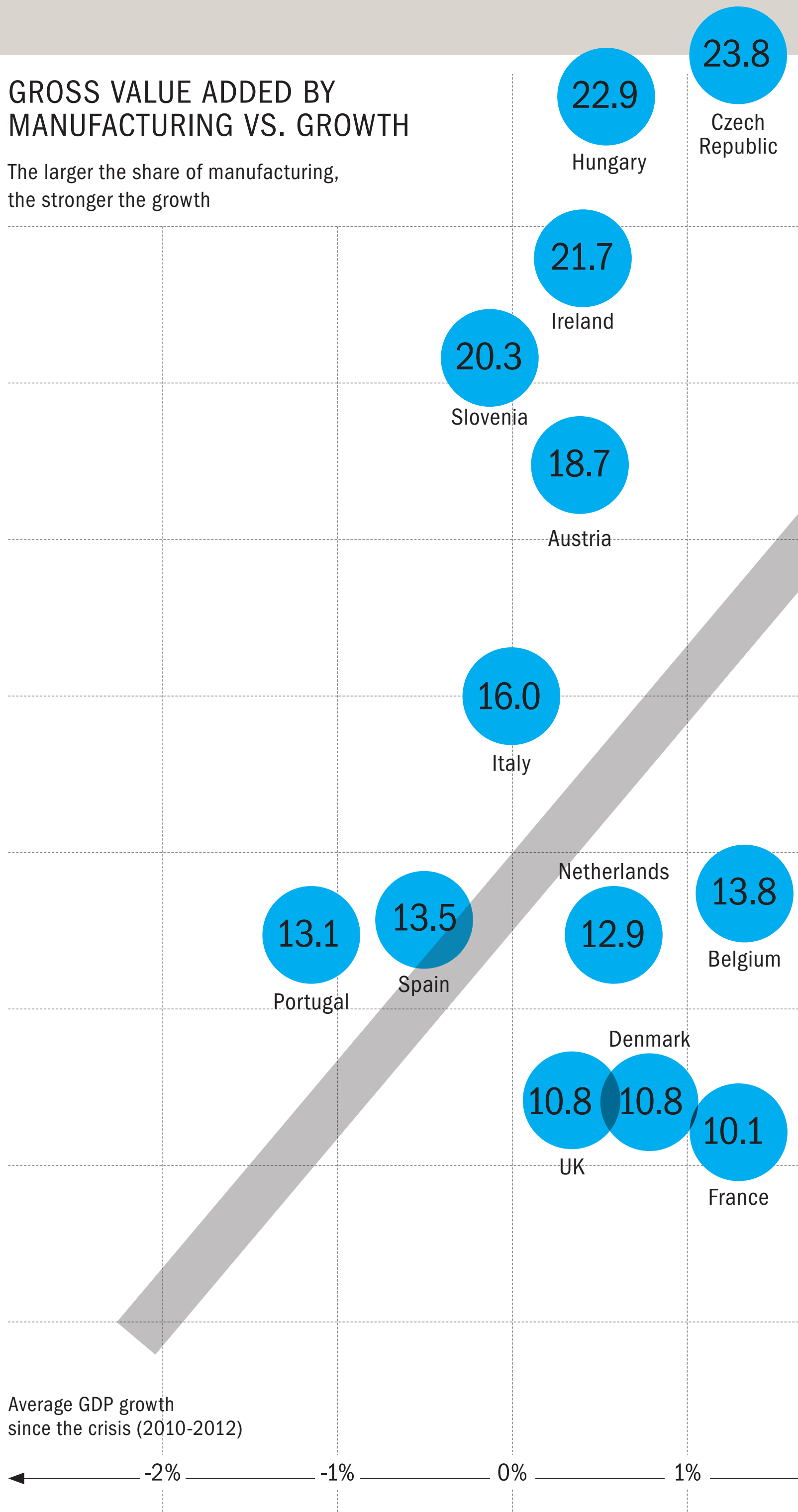
A SIGNIFICANT CORRELATION EXISTS BETWEEN MANUFACTURING'S SHARE OF A NATIONAL ECONOMY AND THE RATE OF GROWTH

GERMANY VS. THE REST

Manufacturing is responsible for nearly a quarter of all value added in Germany

GROSS VALUE ADDED BY MANUFACTURING VS. GROWTH

The larger the share of manufacturing, the stronger the growth



THREE GROUPS OF COUNTRIES

Manufacturing skills are at risk in many parts of Europe

GROWTH IN MANUFACTURING SKILLS

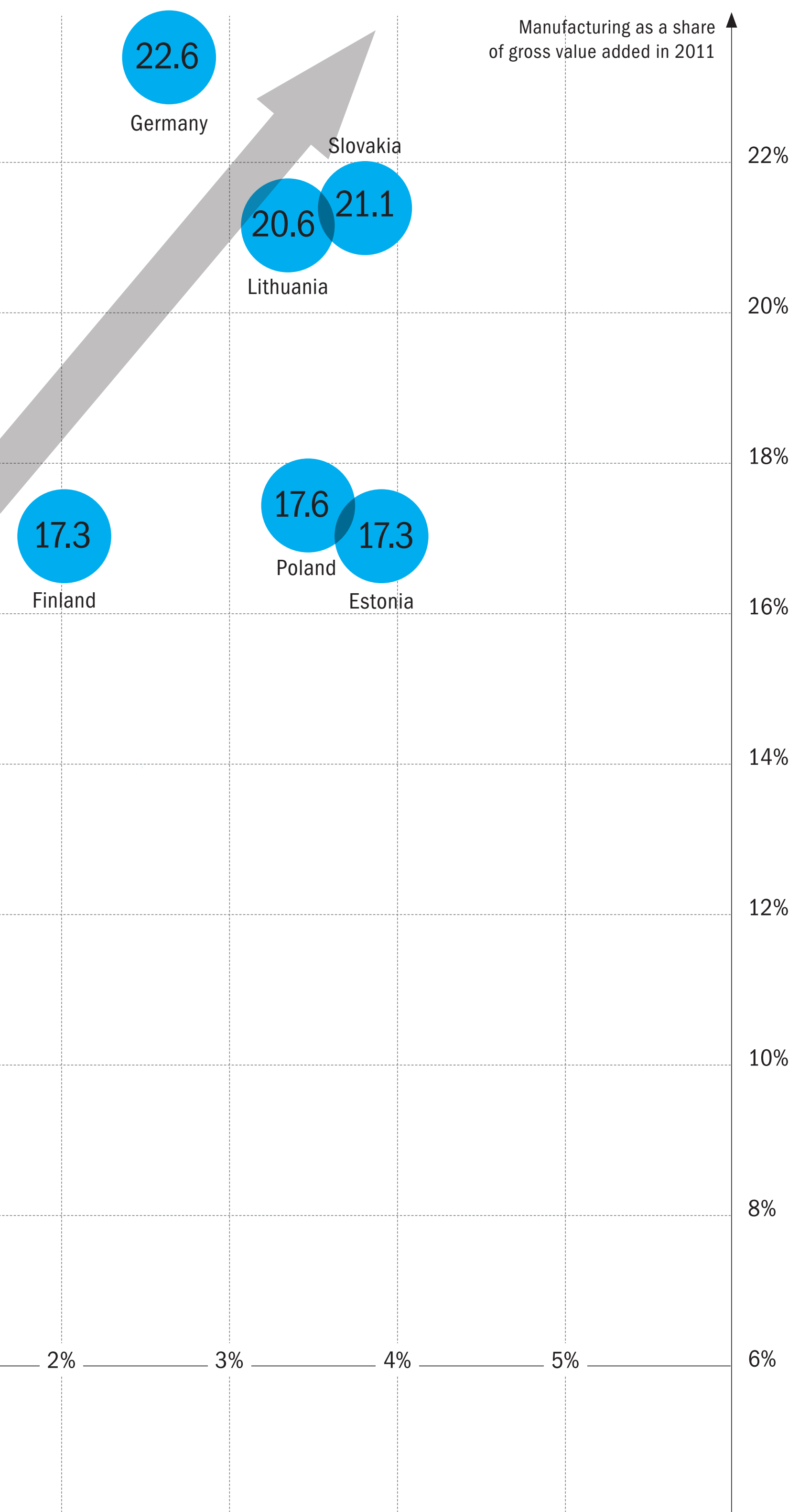
Germany, Poland, Hungary, Lithuania

SLIGHT DECLINE IN MANUFACTURING SKILLS

Netherlands, Austria, Italy, etc.

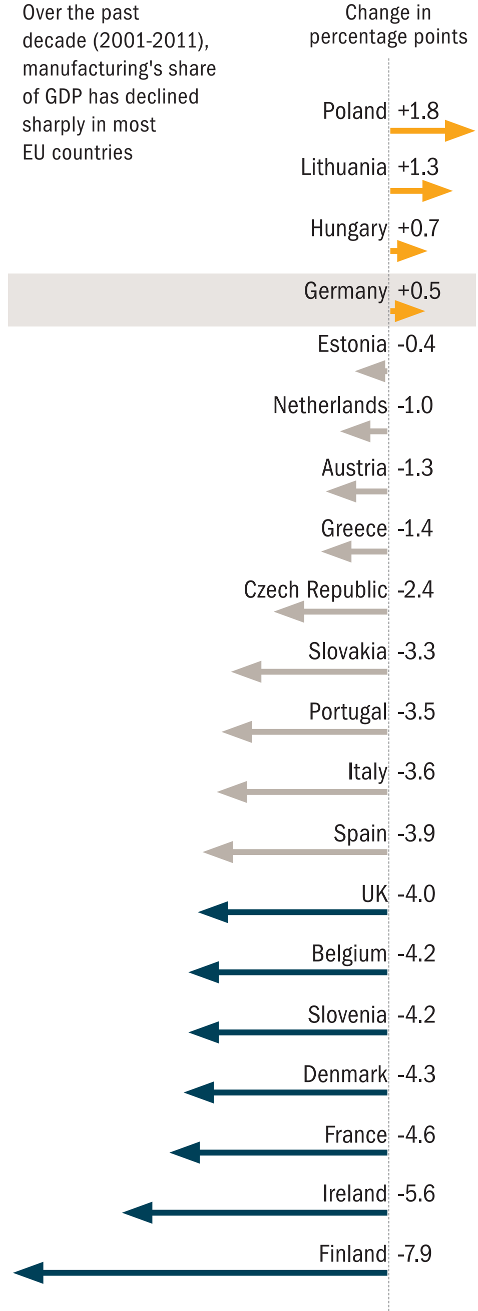
SHARP DECLINE IN MANUFACTURING SKILLS

UK, France, Belgium, etc.



INDUSTRIALIZATION VS. DE-INDUSTRIALIZATION

Over the past decade (2001-2011), manufacturing's share of GDP has declined sharply in most EU countries



Source: Eurostat

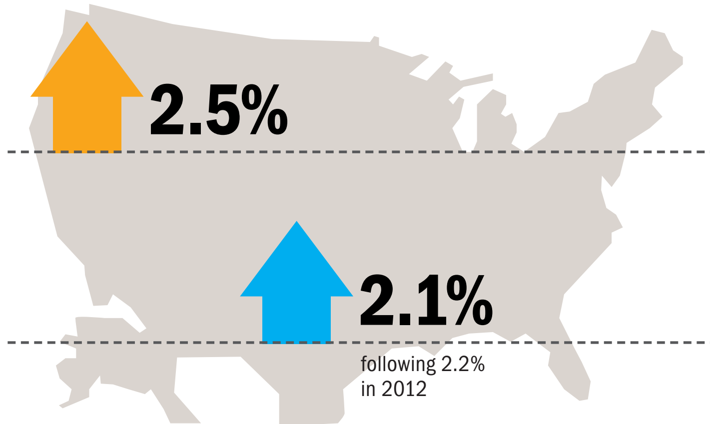
HOW FAST THE KEY MARKETS WILL GROW IN 2013

GDP growth forecasts for 2013

OUR FORECAST FOR 2013

CURRENT IMF FORECAST FOR 2013

Source: Destatis



2. THE GLOBAL ECONOMY IS PICKING UP SPEED AGAIN

AS EXPORT CHAMPION, GERMANY STANDS TO BENEFIT MORE THAN OTHERS

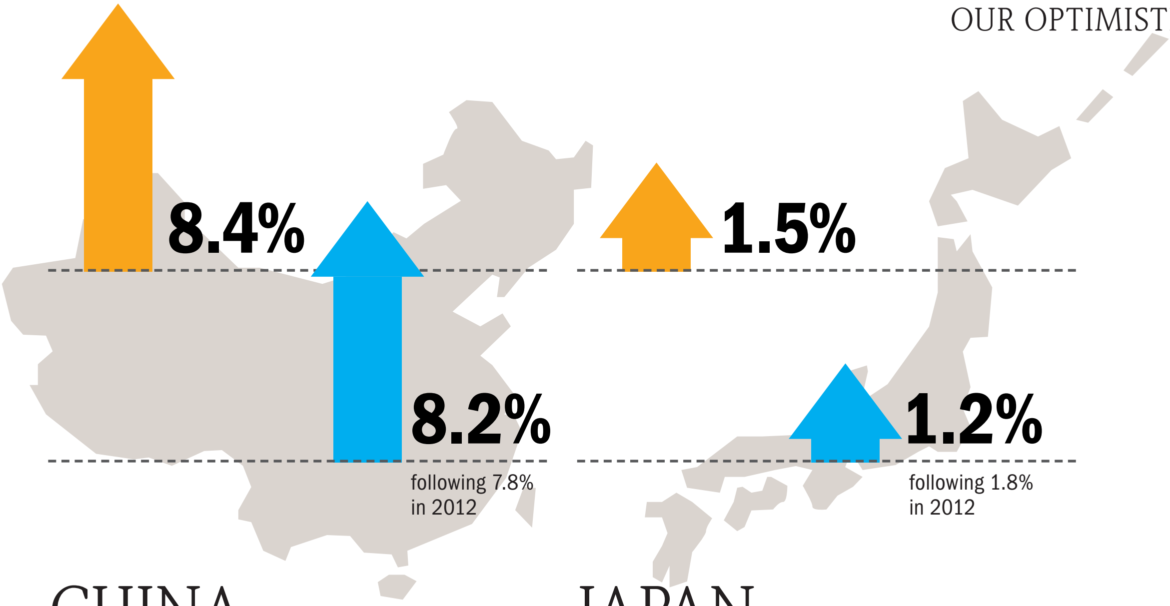
We remain convinced of the intrinsic strength of the German economy. Having said that, whether German business is able to put it to good use and translate it into faster growth as early as 2013 depends largely on positive stimulus in the country's most important foreign markets. The good news is that the Federation of German Wholesale, Foreign Trade and Services (BGA) expects 2013 to deliver record export sales and that business could grow by a very substantial 5%.

We agree with this optimistic view and, having searched for growth potential, anticipate the following developments in our most important non-European markets.

US

At the present time, the IMF is forecasting 2.1% growth in the US and Consensus is predicting 1.9%. Both figures are lower than that actual figure of 2.2% seen in 2012. We disagree. Our positive growth scenario assumes that the Democrats and Republicans will be able to reach pragmatic compromise solutions (e.g. about the fiscal cliff), that the US government will press ahead resolutely with the reindustrialization of its economy, and that the labor market will improve significantly as a result. Admittedly, this optimistic view takes into account the fact that, in his second term of office, Barack Obama will no longer have to worry about being re-elected and can therefore take bolder steps to boost growth in the US economy.

In our opinion, unexpectedly strong growth of 2.7% in the third quarter of 2012 and falling energy prices in the US (due to "fracking") both point to greater momentum in the American economy. This view is corroborated by the German American Business Outlook survey we recently conducted together with the German-American Chamber of Commerce. According to this survey, 95% of German companies with activities in the US expect to do better business in 2013. Some 76% are therefore planning to recruit new staff for their US subsidiaries, which already employ 570,000 people. Accordingly, we expect US growth in 2013 to be slightly higher than in 2012, probably ending the year at around 2.5%.



CHINA

China's is also likely to return to stronger growth in the year ahead. The IMF is predicting growth of 8.2% in 2013 (following 7.8% in 2012). Power has changed hands at the head of both the government and the party, and the two new leaders have got off to a good start. Xi Jinping (the party leader and president) and Li Keqiang (the head of government as of March 2013) are clear about their key goals for the coming years: to drive sustainable growth, modernize public finance, open up the country's capital markets and fight corruption.

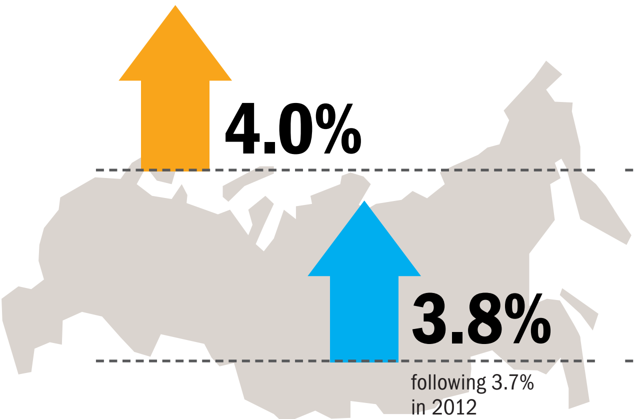
Our positive scenario assumes that 2013 will again see major credit-financed infrastructure projects in China. In all probability, the Chinese government will continue to stimulate growth by using the exchange rate and subsidies to boost exports. The result of this macroeconomic control will be that China's growth rate should be well over 8% at the end of 2013 – our prediction is 8.4%, though it could easily be a few tenths of a percentage point more.

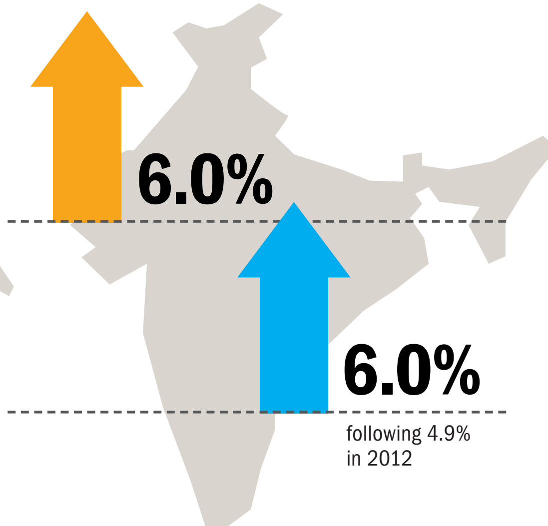
JAPAN

Japan has not been growing as fast as the US or China of late. After a robust first six months, in which Japan built on the momentum with which it had recovered from the Fukushima disaster in 2011, growth ground to a halt at the close of 2012. Factors such as border disputes with China and, more recently, the overvalued yen are partly to blame for this situation.

For 2013, however, growth is back on the agenda. The IMF expects expansion of 0.8%, while Consensus anticipates 0.8% (following 1.8% in 2012). In our optimistic scenario, we believe that Japan will see neither stagnation nor deflation in 2013. The newly elected government led by Shinzo Abe is planning a new economic stimulus program. Whether or not this will help resolve the country's structural problems in the medium term is hard to say. In the short term, however, it should stimulate Japan's advanced economy to grow by a very stable 1.5% this year.

OUR OPTIMISTIC VIEW





RUSSIA

The Russian economy should also see vigorous growth in 2013. The IMF is currently forecasting growth of 3.8% (following 3.7% in 2012) – in other words constant, positive development. Our optimistic scenario anticipates that, thanks to stable oil and gas prices, Russia will have the financial resources to continue modernizing and diversifying its economy. German expertise will continue to be much in demand. German exports to Russia hit a new record in 2012, easily surpassing the figure of EUR 34.4 billion recorded in the previous year, and we are likely to see new record levels this year. All in all, we are expecting a growth rate of 4% in Russia in 2013, putting Russia firmly back on its pre-crisis course.

INDIA

India was disappointing in 2012. Monsoons drove agricultural yields down by a good 20%. In addition, a backlog of political reforms, infrastructure bottlenecks that have still not been eliminated and widespread corruption meant that GDP grew more slowly (at 4.9%) than it had for a decade. More recently, the mood among India's companies has brightened. Fresh investment and rising industrial output can therefore be expected. Our optimistic scenario foresees a return to faster growth at a rate of 6.0%, in line with current IMF forecasts.

WHERE OUR EXPORTS GO

(2012 figures)

1. FRANCE **9.5%**

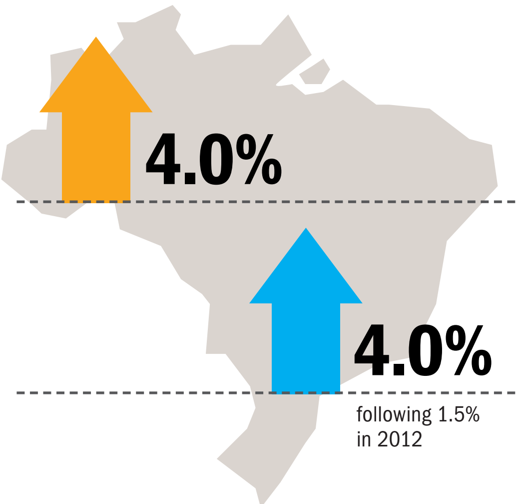
2. US **7.9%**

3. UK **6.6%**

4. NETHERLANDS **6.5%**

5. CHINA **6.2%**

6. AUSTRIA **5.3%**



BRAZIL

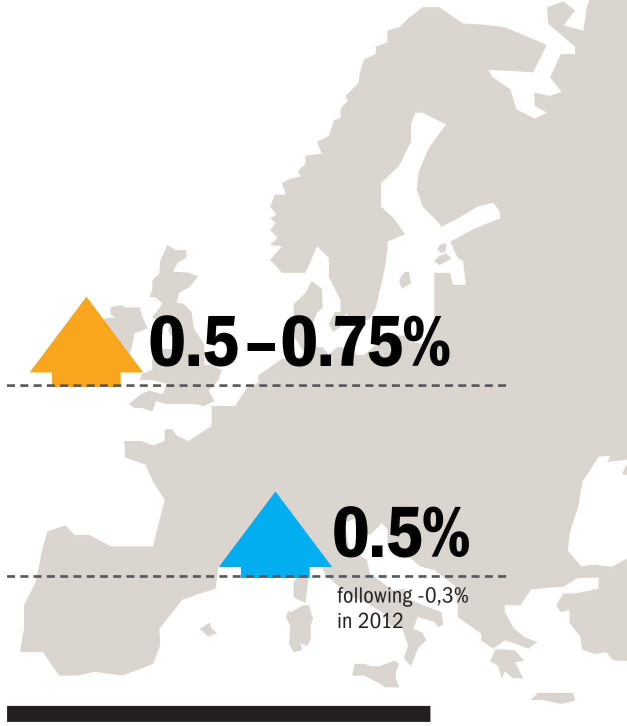
The largest economy in South America has big plans. The soccer World Cup in 2014 and the Olympic Games in 2016 will boost investment in the country in 2013, and have an important symbolic effect. In the short term, the drop in energy prices of around 15% on January 1, 2013 will also help; previously, energy had cost up to 50% more than in neighboring countries. The government is also supporting the upswing by encouraging people to buy energy-saving products, from household appliances to cars. After a disappointing 2012, with growth of only 1.5%, we expect growth to quickly pick up again in 2013. In line with the IMF's current forecasts, we predict a growth rate of 4.0%.

7. ITALY
5.1%

8. SWITZER-LAND
4.5%

9. BELGIUM
4.0%

10. POLAND
3.8%



3. EUROPE IS BECOMING MORE STABLE

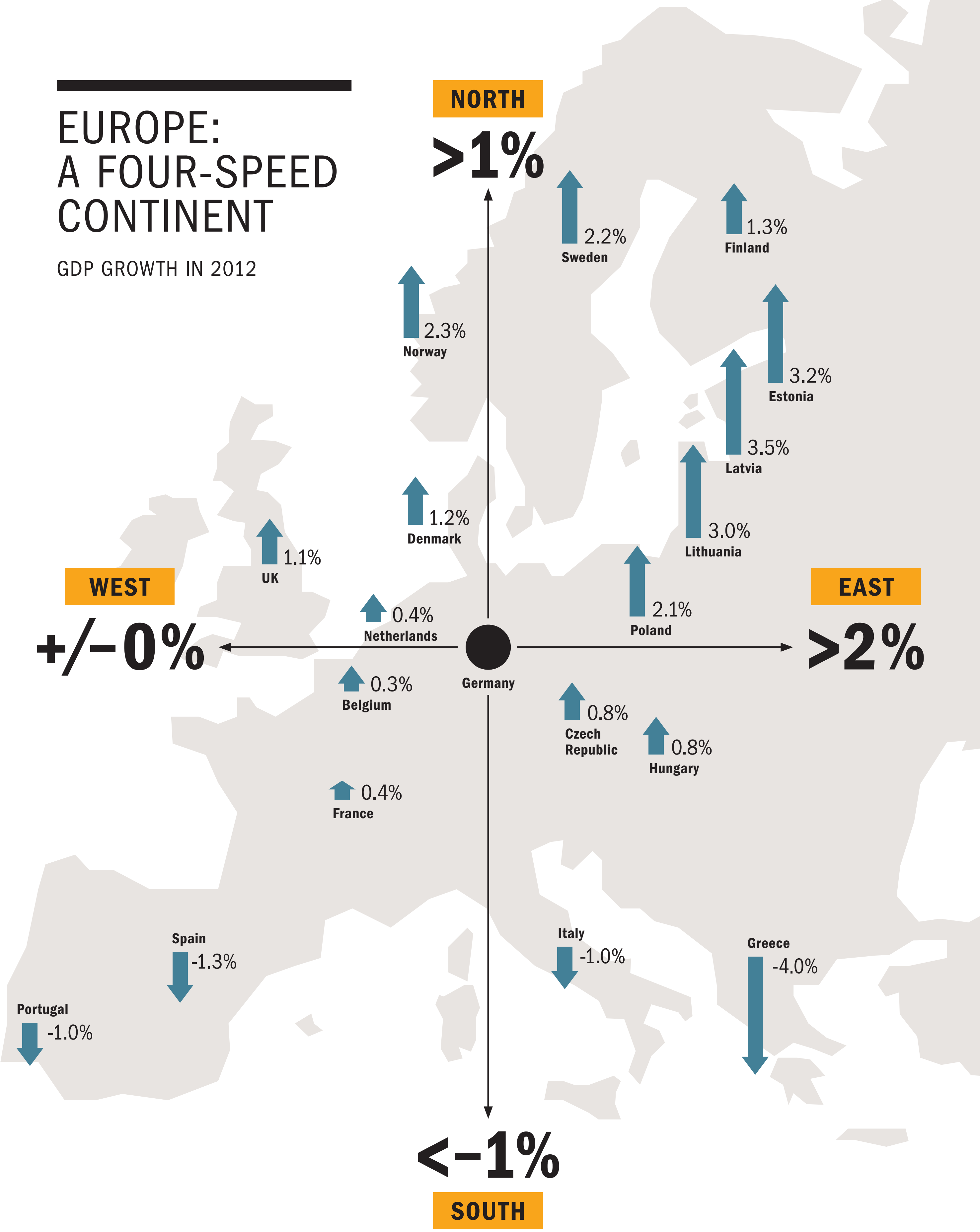
GERMANY WILL BENEFIT MORE THAN ANY OTHER COUNTRY FROM AN END TO THE EURO CRISIS

If the dynamic effects that our optimistic scenario foresees for key foreign markets materi-alize, the German economy will benefit more than most – thanks to its strength as a net exporter. Exports to countries outside Europe have grown at an above-average rate in recent years, from 38% in 2009 to 43% in 2012. At the same time, a majority of exports (57%) still go to Germany's neighbors. Europe still plays a critical role economically, politically, and in terms of the prevailing mood.

Most forecasts are predicting improvement in Europe in 2013. Following a decline of -0.3% in 2012, Consensus expects to see mild, positive growth of 0.2% in 2013, while the IMF's is currently forecasting 0.5% (the growth rate we had anticipated in 2012). Close analysis of these growth forecasts produces an astonishingly clear picture – Europe is a continent with four different speeds of growth:

EUROPE: A FOUR-SPEED CONTINENT

GDP GROWTH IN 2012



◆ Eastern Europe will post the strongest growth of all European regions (2% or more) in 2013. Individual forecasts currently stand at 2.1% for Poland, 3.0% for Lithuania and 3.5% for Latvia, for example
◆ Northern Europe will probably grow by well over 1% in 2013. Forecasts include 1.2% for Denmark, 1.3% for Finland and just over 2% for Sweden and Norway
◆ Western Europe will probably stagnate in 2013, and in the process will become another serious problem for the continent as a whole. Current forecasts are close to zero: 0.4% for France, 0.4% for the Netherlands and 0.3% for Belgium
◆ Southern Europe remains the real problem child, however, with negative growth rates of 1% and more. Forecasts include -1.0% for Italy, -1.3% for Spain and -4.0% for Greece

The different growth speeds in different regions reflect the correlation between growth and manufacturing skills. Wherever the manufacturing industry is important and manufacturing skills are valued and promoted, growth expectations are higher. A key factor in our optimistic scenario – and our search for growth potential – is whether the conditions for manufacturing-driven growth are in place, and whether the advance of deindustrialization across large swathes of Europe can be halted.

In our optimistic scenario:
◆ The EFSF (successfully launched in 2010) and the ESM (which followed in 2012) will continue to underpin stability in Europe in 2013
◆ The ECB will uphold its successful policy and ward off speculation
◆ The integration of economic policy in Europe will continue to advance, albeit more slowly than was hoped. One good example is the recent decision to press ahead with banking union
◆ Financing Greece will not lead to turbulence. The regular progress reports are positive, so the EU, ECB and IMF *troika* will be able to continue providing support
◆ Italy will not collapse after its elections at the end of February. On the contrary, the new government will quickly gain (or regain) the trust of the capital markets and the country will continue on its reform course
◆ France will stabilize. Its 2013 growth rate will be low, but positive. The country will find the courage to implement structural reforms on the labor market and in its social security systems. (We will come back to France's risks later.)

We are optimistic: The EU Commission has recognized the need to reindustrialize Europe. We believe that the right actions have been chosen to achieve this:
◆ More investment in factories and in research and development
◆ Further expansion of the single market and the "opening up of international markets"
◆ Support for small and medium-sized enterprises as they seek to penetrate international markets
◆ More employee development and training and closer alignment between supply and demand for labor

It looks like the single market will be revitalized – something that we have long been urging. This will create additional growth stimulus. Under these conditions, we believe that growth of at least 0.5% is possible for the EU 27, rising to 0.7% in the best-case scenario.

4. THE DOMESTIC ECONOMY IS HEALTHY

GERMANY WILL BENEFIT FROM ITS ROBUST DOMESTIC MARKET

Our optimistic scenario assumes that Germany's domestic economy will remain stable and healthy and will again be a mainstay of German growth in 2013. This view stands up to realistic analysis, we believe: the key data and positive climate lend credence to our hypothesis.

LABOR MARKET

Only 2.84 million people are currently jobless in Germany, an unemployment rate of 6.7%. Germany has never had so many people in gainful employment: currently 41.94 million. The number of employees who pay compulsory social insurance contributions – 29.45 million – is also substantially higher than it was a year ago. As we see it, not much will change over the next 12 months. Frank-Jürgen Weise, head of Germany's Federal Employment Agency (BA), expects to see a flat labor market over the year as a whole, with a difficult first six months followed by an easier second half of the year. We broadly agree with this view.

CONSUMPTION CLIMATE

German consumers have been optimistically spending money for more than two years, as recently confirmed by the upbeat Christmas business. The reasons are self-evident: High employment figures are driving purchasing power and allowing people to plan for the future. At the same time, moderate inflation is bolstering the propensity to consume, and very low interest rates are encouraging consumers to spend money rather than save it. Market research organization GfK's "propensity to buy" indicator is currently very high and rates are constant. We expect this to continue in 2013.

ENVIRONMENT

In recent years, we have repeatedly seen how economic and financial turbulence can negatively affect the domestic economy and consumer behavior by increasing uncertainty. We expect things to be different in 2013, with stable conditions prevailing as in the figure below.

LITTLE MOVEMENT ON THE COMMODITY AND FOREIGN EXCHANGE MARKETS

OIL PRICE (BRENT) in USD/barrel **6.2% decline**

Current price
112.5

Forecast for end 2013:
105.6
Consensus

STEEL PRICE in USD/t **7.1% increase**

Current price
700

Forecast for end 2013:
750
CRU Analysis

- Inflation: Even if inflation edges a few tenths of a percentage point above the 2% ceiling set by the European Central Bank, that would not be a problem. In 2013, we expect to see average inflation of 2.0% in Germany and 2.2% in the eurozone
- Exchange rates: Of late, the euro has been surprisingly stable against the US dollar and other major currencies. There is therefore little reason why it should depreciate. Over the next few months, we expect to see an exchange rate of between USD 1.25 and USD 1.30 to the euro
- Financial markets: Having ramped up their reserves of equity, cleaned up their balance sheets and improved their risk management systems, banks and insurance companies around the world are now much more solid than they were a year or two ago. We expect 2013 to be a quiet year on the financial markets, and that companies will continue to be able to source money cheaply and without difficulty
- Oil price: The oil price began 2012 at USD 110, then fluctuated between USD 128 and USD 88, before closing the year back at USD 110. After such gyrations last year, there are indications that oil will become a little cheaper in 2013. We expect the price to be around USD 105 per barrel at year end

POLITICAL FACTORS

The year 2013 will probably be more exciting in the political arena, not least due to the German general elections in the fall. Having said that, the impact of any change of government or policy will not be felt until 2014 at the earliest. One issue remains important for the next 12 months: the German government's new energy policy. Our optimistic scenario assumes that electricity prices will continue to rise, but that this will not damage Germany's industrial competitiveness or the positive consumer climate long term. (See the next section for a discussion of the related risks.)

COPPER PRICE in USD/mt **0.9% decline**

Current price
8,085

Forecast for end of 2013:
8,010
Bloomberg

EUR/USD EXCHANGE RATE **Depreciation of 4.0%**

Current rate
1.30

Forecast for end of 2013:
1.25
Consensus

The risks: Why things may turn out differently

FRANCE FAILS TO DELIVER THE GOODS

THE EURO CRISIS WORSENS


CHINA DOES NOT GET BACK INTO ITS STRIDE
POLITICAL CRISES BURDEN THE GLOBAL ECONOMY
US ECONOMIC DEVELOPMENT WEAKENS
GERMANY'S NEW ENERGY POLICY FAILS

The risks: Why things may turn out differently

WE SEE SIX MAIN RISKS FOR GERMAN GROWTH IN 2013: THE EURO CRISIS, FRANCE, THE US ECONOMY, CHINA, GERMANY'S NEW ENERGY POLICY AND POSSIBLE POLITICAL CRISES

Taking all the positive effects together – a more vigorous global economy, stability in Europe and a healthy domestic economy – Germany should be able to put its manufacturing skills to good use at home and abroad and achieve must faster growth than last year. Specifically, if our optimistic scenario materializes, we believe that Germany's economy could expand by as much as 2% in 2013.

Things may turn out differently, however. In our search for growth potential, we intentionally ignored a number of key risks. We must now look at these risks – six specific developments that could negatively affect German growth over the next 12 months.

1. THE EURO CRISIS

WORSENS

There are plenty of reasons to think that Europe has the worst behind it and will return to a modest growth trajectory in 2013. However, considerable risks remain. Two questions that need to be answered are whether the integration of European economic policy will indeed be stepped up, and whether the EU Commission will energetically pursue its reindustrialization and growth initiatives. Beyond these fundamental matters, we see two main problem areas:

- High unemployment: Joblessness has reached a historic peak of 11.7% in the eurozone overall and over 25% in Spain (with more than 50% of the country's young people out of work). Southern Europe is firmly in the grip of unemployment, which is both eroding purchasing power and fueling political instability
- A backlog of reforms is making key economies such as France and Italy less competitive. This will not be resolved in the short term

We cannot rule out the risk that parts of Europe might slip into an even deeper crisis instead of recovering. What will happen to Italy's structural reforms after Mario Monti has gone? Will Spain's policy of austerity stand up to popular pressure? How much backing does the British government have for its austerity policy? Will Greek haircuts, rescue packages and government crises continue to dominate EU summits in the coming months? In 2012 the EU economy probably shrank by 0.3% and the eurozone by 0.4%. It would be remiss of us to exclude the possibility that 2013 could be even worse – especially in light of our experience in 2012.

2. FRANCE

FAILS TO DELIVER THE GOODS

Apart from the general problems that could negatively impact Europe's ability to grow in 2013, we also see one specific source of risk: France. France has a population of 65 million, accounts for 16.2% of Europe's economic output and is an influential political player. Alongside Germany, it plays a key role in Europe. All the more alarming, then, that the *grande nation* has seen its competitiveness dwindle for years without undertaking rigorous structural reforms.

As we saw earlier, France is one of the countries whose manufacturing base has eroded most heavily in recent years. This decline has happened despite – or maybe because of – decades of focused industry policy. The jury is still out on whether the country will succeed in turning the corner and whether the French government will have the courage to agree a French version of "Agenda 2010", breathing fresh life into the labor market and pension system. If all goes well, France will at best enjoy minimal growth in 2013 according to current forecasts. More likely than not, it will stagnate. If all does not go well and France's economy contracts, this would have dramatic repercussions for Europe's return to economic health, not least because of the sheer weight of the French economy.

3. US ECONOMIC DEVELOPMENT

WEAKENS

The IMF is forecasting US economic growth in 2013 at 2.1%, Consensus at 1.9%. Our optimistic scenario assumes that the American economy will continue its recovery and can achieve growth of 2.5%. Our main arguments for this are a continued recovery on the US labor market, further progress with reindustrialization and a pragmatic policy backed by both Democrats and Republicans.

Each of these points harbors its own risks. At 8%, unemployment is still painfully high for the US. Nor is there yet any evidence that President Obama's economic initiatives will be implemented with the necessary vigor. Moreover, Congress clearly remains a house divided. Instead of facilitating a structural solution supported by both parties, this situation could once again lead the country into an impasse. Even if the US is ultimately able to step back from the brink of the fiscal cliff – which our risk analysis assumes – we cannot rule out the possibility that its economy continues to run out of steam and grows by less than 2%.

4. CHINA

DOES NOT GET BACK INTO ITS STRIDE

Our optimistic scenario assumes that the new Chinese government will energetically implement the growth initiatives that have been announced, enabling China to return to growth rates of 8% and more. For this to happen, one important requirement is that the party must rebuild trust by rigorously combating corruption and nepotism.

If it fails to do so, we cannot rule out the possibility that the current negative trend – shrinking growth for the past seven quarters – might continue in 2013. Low growth rates would then make it increasingly difficult to keep a lid on structural problems such as the prosperity gap between urban and rural areas. This will not as yet lead to more serious crises in 2013, but it could have a markedly negative influence on the growth rate – with all the consequences that would entail for the pace of global growth and German companies' sales in China. In our pessimistic scenario, China grows by just 7% or so.

SUMMARY

Potentially, each of the risk factors above could have a lasting negative impact on the German economy in 2013. If the euro crisis worsens, or if German export markets in the US and China weaken, German companies' export figures would naturally shift into reverse. It would also have a knock-on effect on the domestic economy: The mood in the corporate community and among consumers would become gloomier and the willingness to invest and consume would lessen. This would be compounded by the negative

5. GERMANY'S NEW ENERGY POLICY

FAILS

Alongside the foreign trade risks outlined above, Germany's new energy policy is a major source of risk on the home front – one that could inhibit growth in Germany. Our optimistic scenario assumes that energy prices will continue to rise, but it does not expect this to have a lasting influence either on manufacturing's ability to compete or on citizens' willingness to consume.

Things look different in the pessimistic scenario. The disparity between the development of renewable energy (which is making good progress) and the development of power grids (only 200 km of the 4,400 km of new lines needed by 2020 have so far been built) will cause energy costs to rise higher and higher. Consumers will be more reluctant to go shopping, and the corporate sector will begin to feel the heat, especially in international competition, as early as 2013. Why? Because in most countries – the US being just one example – energy costs are falling rather than rising. In terms of economic policy, the balancing act between exempting certain energy-intensive industrial companies from the renewable energy law levy and trying to meet defined cost and environmental targets at the same time may yet fail.

6. POLITICAL CRISES

BURDEN THE GLOBAL ECONOMY

Our growth scenario assumes that no geopolitical crises with a lasting impact on the global economy will occur in 2013. Given the current political situation around the world – the Middle East conflict, Syria, developments in the Arab world and in Afghanistan, Pakistan and North Korea – this may seem naïve. But this risk factor is particularly difficult to quantify.

Studies show that major political crises or wars can put the brake on global economic growth. This was the case in both oil crises (1973 and 1982), the crisis years in the Middle East (e.g. the Yom Kippur War in 1973), all three Gulf Wars (1979, 1990 and 2003) and the Asia crisis (1997/98). During the Cuba crisis (1962), the Argentina crisis (1998) and, more recently, the Arab uprisings (2011), the consequences could be measured more in terms of changes in trade flows and political priorities than in a reduction in global growth. Generalizations are impossible here.

consequences of the change in energy policy and the general uncertainty caused by foreign or defense policy crises. Clearly, things may turn out different to our positive growth scenario. Indeed, even in our negative scenario we assume that Germany's economy is still strong enough not to implode despite all the risks. But the negative scenario assumes that positive stimulus from the growth potential we have identified would, in the worst case, be more than offset by negative factors. If the worst comes to the worst, then, Germany will not even repeat its growth performance in 2012 and economic expansion will drop back to around 0.5%.

1.2%

Our growth forecast for Germany in 2013

Our growth forecast for Germany in 2013

OUR SEARCH FOR GROWTH POTENTIAL FOR THE GERMAN ECONOMY INITIALLY LED US TO AN OPTIMISTIC SCENARIO.

If all goes well and the potential we have identified actually materializes, Germany may grow by as much as 2% in 2013. As we have seen, however, events can also take a different turn. If the risks identified in our pessimistic scenario are realized, Germany's rate of growth will shrink to 0.5%. German manufacturing skills play a part in either scenario – exercised to the full in the positive scenario, and at least ensuring that growth does not collapse entirely in the negative scenario.

It is just as unlikely that everything will go smoothly as that everything will go wrong. We have therefore taken a closer look at the 1.5 percentage points of risk potential that separate our two scenarios. We discussed two questions in particular with many of our clients and colleagues:

◆ How likely is it that the opportunities and risks identified in our scenarios will materialize in reality?

◆ How strongly will each opportunity or risk impact Germany's growth potential?

These questions are underpinned by specific mathematical considerations. If the probability of a given growth opportunity being realized is high, we have little to worry about: our growth target of 2% will be met. But if the probability that a given risk will be realized is high, there is a specific threat to our growth target. To quantify the risks involved, we therefore assign a score to their potential impact – a negative one in this case – based on the probability of their realization, and then reduce our growth target accordingly.

We summarize the results of these discussions and calculations for key variables on page 31. Positive impacts are indicated by a plus sign and negative impacts by a minus sign. We draw the following conclusions for our growth forecast:

- Many of our growth opportunities have high probability scores and will therefore provide a positive fundamental impetus to the economy. They include the single market factors (labor market, consumption climate, inflation, financial markets) as well as the growth potential in Russia, Brazil and Japan. We also think it highly probable that the issues with Greece will not lead to any new euro crises
- We believe that the manufacturing skills and intrinsic strength of the German economy should deliver 0.5% growth. If these factors are combined with the positive fundamental impetus described above, it is highly probable that growth will exceed 1%. The 1.5 percentage points of risk potential that separate our two scenarios could thus be reduced to one percentage point
- However, our analysis also shows that key factors with a moderate to high impact only have a moderate probability score, and are therefore a source of risk. On the upside, this primarily involves the growth potential from positive developments in the US and China. On the downside, it also involves the possibility of negative developments in France and Italy, which could exacerbate the euro crisis

Many of the factors are interrelated and can amplify the positive or negative impact. We therefore use a robust scoring model:

- Factors with moderate probability are given a score of 0.5, meaning that positive and negative developments are equally probable
- Factors with a high-impact potential are given a score of 0.3 percentage points, and factors with moderate potential a score of 0.2 percentage points (this is in line with experience from our most recent economic scenarios)

The risk drivers in our analysis – all factors with moderate probability scores – lead us to identify a risk potential of around 0.8 percentage points. The remaining risk of one percentage point can therefore (sadly) be reduced by just 0.2 percentage points. In other words, our growth forecast for 2013 is 1.2%.

THE KEY VARIABLES IN OUR ECONOMIC SCENARIOS

THE PROBABILITY THAT THEY WILL OCCUR – AND THE IMPACT THAT THEY WILL HAVE ON GERMAN GROWTH IF THINGS TURN OUT DIFFERENTLY

PROBABILITY \ IMPACT	LOW	MODERATE	HIGH
HIGH	+ Japan grows >= 1.5% + Inflation remains subcritical	+ The euro remains stable + Consumption climate remains upbeat + Russia grows >= 4% + Brazil grows >= 4%	+ Labor market remains healthy + Greece is successfully rescued + Financial markets function properly
MODERATE	– Geopolitical crises flare up	– Italy's confidence erodes – France fails to achieve stability + India grows >= 6% + Oil price remains reasonable	+ US grows > 2% + China grows > 8% – Euro crisis worsens
LOW	+ New energy policy is successful		

+ Optimistic scenario – Pessimistic scenario

Beyond 2013: The problem with potential growth

IS GROWTH OF 1.2% DISAPPOINTINGLY LOW? SURE, COMPARED TO THE 3% AND MORE GERMANY MANAGED IN 2006, 2007, 2010 AND 2011. AT FIRST GLANCE, AT LEAST.

In fact, it is even more disappointing when you think of the high growth rates of the 1950s and 1960s. But is that a fair way to look at things? The crux of the matter is that growth rates are exponential. The base is getting bigger all the time, so any increase in absolute terms also has to increase constantly if high growth rates are to be maintained. In other words, even if the growth rate remains the same, more and more is expected. This can easily push up estimates – which was also a problem in our 2012 scenario. So what would be a fair benchmark? We analyzed the rate of economic growth over the past 30 years. In this period:

- The global economy expanded by an average of 2.9% per annum
- Emerging economies (the BRIC countries) grew almost twice as fast as this, at an average of 5.2%
- However, developed economies (the OECD countries) saw average annual growth of just 2.3% – significantly lower than the perceived rate of growth

Incidentally, the pace at which companies and the capital markets grow is often overestimated too. Our analysis shows that long-term sales growth in traditional industries is around just 4%. Similarly, total shareholder return – the sum of share price increases and dividends – does not grow by more than about 7% long term (see figure on page 35).

From this, we can conclude that a long-term growth rate of 3% (such as we assumed in our 2012 scenario) is overambitious and – at least when we look at the actual data – unrealistic. However, growth rates of around 1% mean that we are failing to live up to our potential, at least on paper. Something closer to 2% feels more like a fair growth rate – the figure in our optimistic scenario for 2013. Even this figure is ambitious, because the pace of growth has been declining continually since the 1950s (see figure on pages 34 and 35). Between 1950 and 1960, average annual growth was 8.2%. This figure then dropped to 4.4% in the 1960s, 2.9% in the '70s, 2.6% in the '80s, barely 1.6% in the '90s and just 1.0% on average in the first decade of the new millennium.

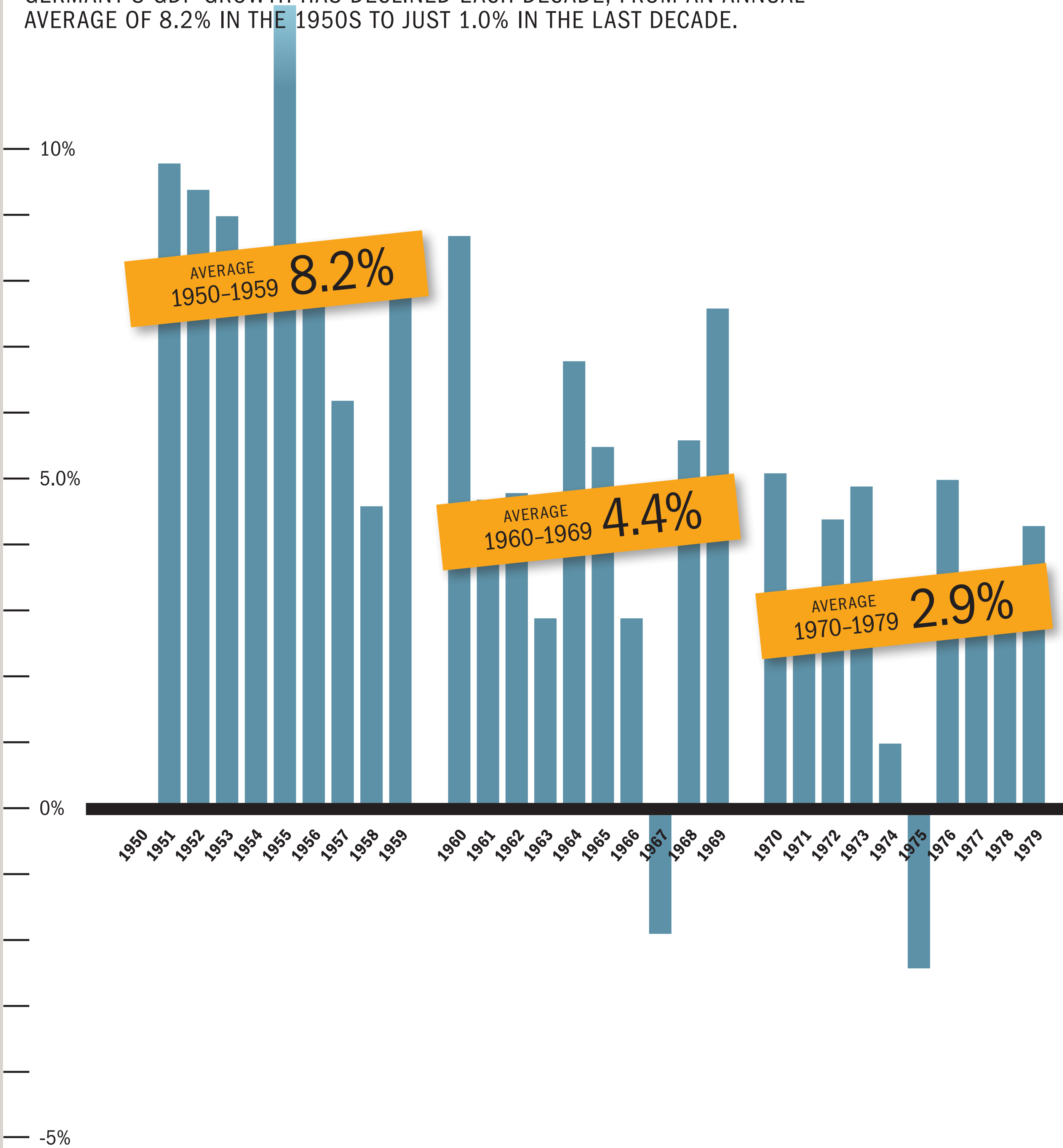
If all goes well, the gap between this 1% growth rate and a potential rate of 2% will be closed by strong German exports and the position of German manufacturing on the global markets. Proportionally, Germany benefits more than other countries when the global economy flourishes. Indeed, this is one of the fundamental reasons for our optimistic growth scenario for 2013. However, it will take more than that to break out of the long-term trend toward dwindling growth rates. Germany now has to lay the foundation for additional growth potential.

If our take on future megatrends is right (see the last THOUGHTS publication), Germany has every chance of being able to lay this foundation. Why? Because climate change, demographics and the scarcity of raw materials share a common denominator: They are all about translating the way we handle scarce resources – the environment, people, materials – into growth by constantly raising productivity. Germany's manufacturing skills – and this is where our argument comes full circle – offer innovative solutions for high-quality green technologies, energy and resource efficiency, mobility and intelligent production systems.

What we now need is intelligent government policies and the right conditions to support these skills. Under the heading "Agenda 2020", our last economic scenario spelled out exactly what is now needed. We believe that Germany can successfully buck the trend toward diminishing growth rates – and achieve growth of 2%.

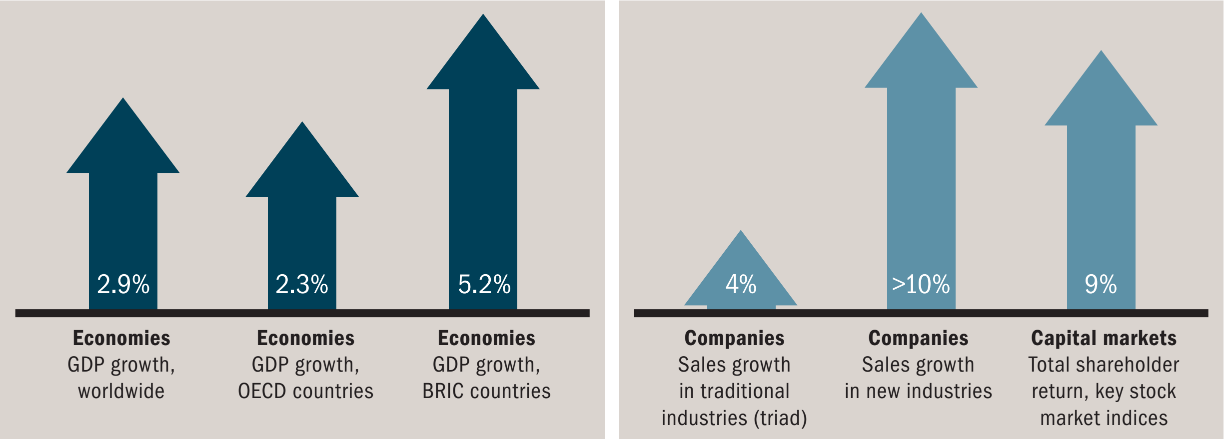
LONG-TERM GROWTH

GERMANY'S GDP GROWTH HAS DECLINED EACH DECADE, FROM AN ANNUAL AVERAGE OF 8.2% IN THE 1950S TO JUST 1.0% IN THE LAST DECADE.

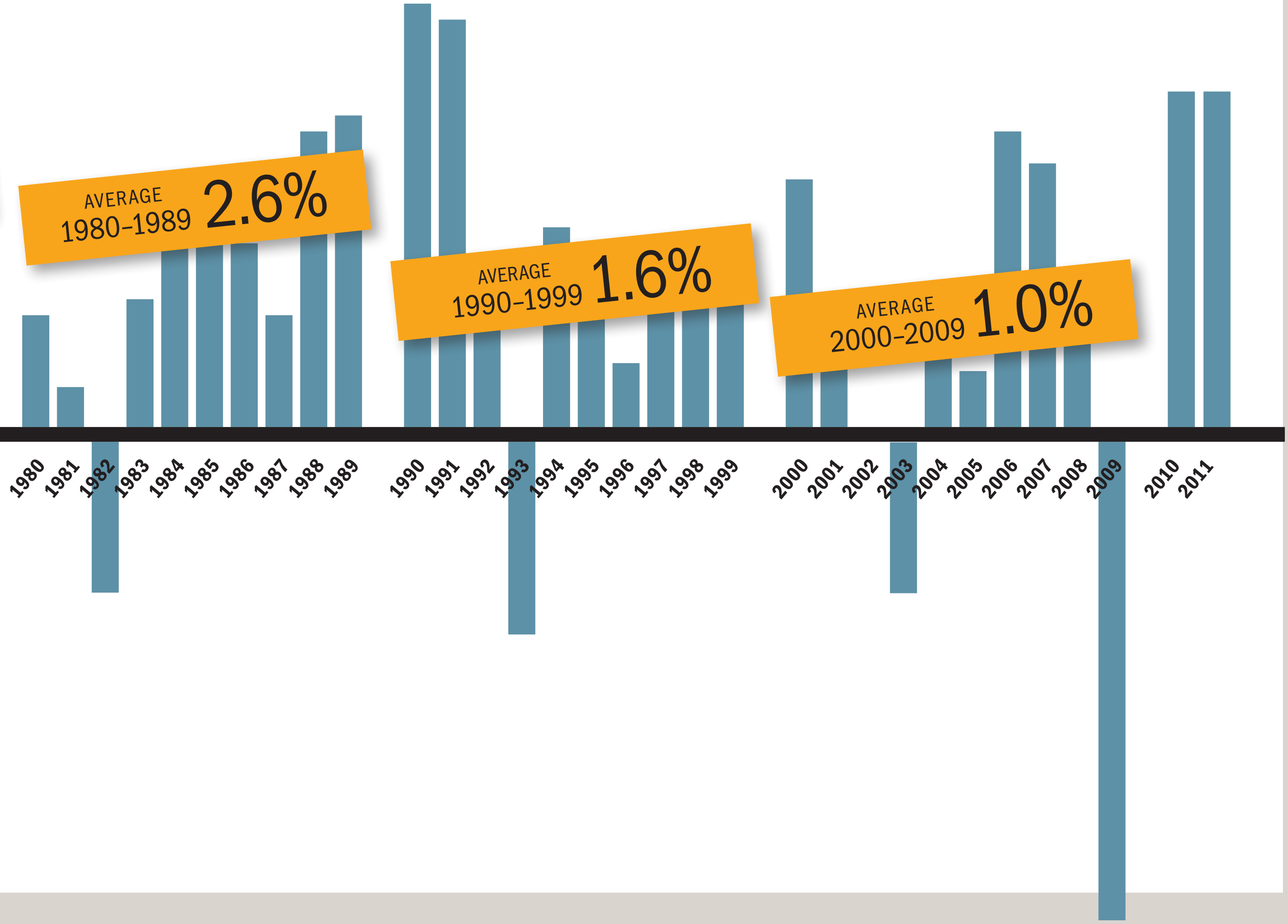


POTENTIAL LONG-TERM ANNUAL GROWTH RATES

Our calculations for the period from 1980 through 2010 indicate what growth rates are realistic in the long term

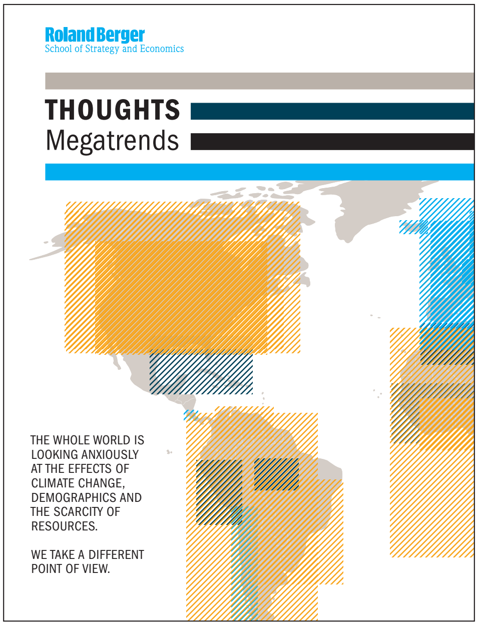


Source: RBSE



RECENT PUBLICATIONS

ROLAND BERGER SCHOOL OF STRATEGY AND ECONOMICS (RBSE) IS THE CORPORATE UNIVERSITY OF ROLAND BERGER STRATEGY CONSULTANTS. IT IS WHERE OUR CONSULTANTS POOL THEIR KNOWLEDGE, AND THE MEANS BY WHICH THEY SHARE IT BOTH WITHIN ROLAND BERGER AND WITH THE OUTSIDE WORLD. OUR THOUGHTS SERIES AND OTHER PUBLICATIONS REGULARLY GIVE OUR READERS ACCESS TO THE LATEST RESEARCH FINDINGS. THE FOLLOWING TOPICAL PUBLICATIONS MAY BE OF INTEREST TO YOU.



THOUGHTS #2 MEGATRENDS

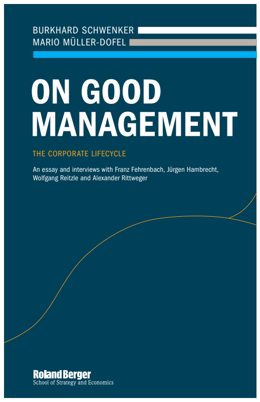
Burkhard Schwenker / Tobias Raffel
July 2012

The whole world is looking anxiously at the effects of climate change, demographics and the scarcity of resources. We take a different point of view. Our global map of opportunities shows the great opportunities that these megatrends are opening up for companies – and who can profit from them. An intentionally optimistic view of the major changes of our times.

ALSO AVAILABLE FROM THE RB KIOSK

Read our recent studies on your iPad. Download our free app "RB Kiosk" from iTunes.

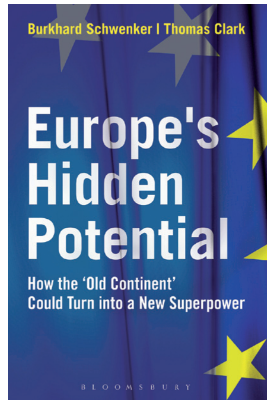
RECENTLY PUBLISHED



ON GOOD MANAGEMENT
THE CORPORATE LIFECYCLE

Burkhard Schwenker
Mario Müller-Dofel
November 2012

An essay and interviews with Franz Fehrenbach, Jürgen Hambrecht, Wolfgang Reitzle and Alexander Rittweger

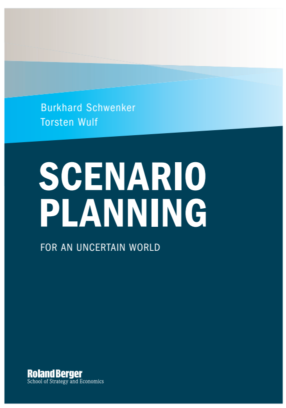


EUROPE'S HIDDEN POTENTIAL
HOW THE "OLD CONTINENT" COULD TURN INTO A NEW SUPERPOWER

Thomas Clark / Burkhard Schwenker
January 2013

In defense of Europe's culture of skilled crafts

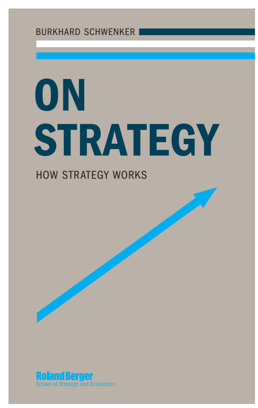
COMING SOON



SCENARIO PLANNING
FOR AN UNCERTAIN WORLD

Burkhard Schwenker / Torsten Wulf
Spring 2013

The new approach from Roland Berger and the Leipzig Graduate School of Management: How scenario planning works and why this tool is so useful



ON STRATEGY:
HOW STRATEGY WORKS

Burkhard Schwenker et al.,
Spring 2013

An essay on the challenges of strategic planning, plus recommendations for action in corporate practice

THOUGHTS

PUBLISHER

Roland Berger School of Strategy and Economics

Roland Berger Strategy Consultants Holding GmbH
Mies-van-der-Rohe-Str. 6
80807 München
Germany
+49 (0)89 9230-0
RBSE@rolandberger.com
www.rolandberger.com/RBSE

THE AUTHORS WELCOME YOUR QUESTIONS, COMMENTS AND SUGGESTIONS.

Prof. Dr. Burkhard Schwenker
Chairman of the Supervisory Board
+49 (0)40 37631-4100
burkhard_schwenker@de.rolandberger.com

Dr. Tobias Raffel
Senior Expert
+49 (30) 39927-3559
tobias_raffel@org.rolandberger.com

LAYOUT & DESIGN

Roland Berger Media Design

JANUARY 2013