

# Economic Environment

Global economic growth slowed in 2011.

## Macroeconomic development

The following information on inflation and growth rates in 2011 reflects the status of estimates at the time this Annual Report went to press.

### Global economy

According to the latest information from the International Monetary Fund (IMF), global economic growth in 2011 amounted to 3.8% after 5.1% in the previous year. Thus, after three years of severe financial and economic crisis, the global economy not only grew more slowly, it was also dominated by high volatility on the financial markets. At the start of the year under review, the IMF had anticipated a rise in global economic activity of 4.4%.

Growth slowed over the course of the year, particularly in what the IMF calls the “advanced economies”. These countries were impacted in particular by the financial and economic crisis. In 2011 the economic activity of these countries rose only 1.6% as against 2010, thus falling far short of the 2.5% growth rate that was expected at the beginning of the year. With a growth rate of 1.8%, the U.S.A. missed forecasts by 1.2 percentage points, the largest deviation amongst these countries. Here, the U.S. government’s extensive stimulus measures showed little effect, especially in the first half of the year. Furthermore, the natural disaster in Japan led to interruptions in industrial production there and in the U.S.A. The eurozone was less affected by the events in Japan, though its growth also slowed over the course of the year. This was essentially due to high public deficits, a downturn in global demand and a substantial waning of the business climate and consumer confidence. This slowdown was intensified by the tension on the capital markets and deteriorating financing conditions for a rising number of euro nations.

Among what the IMF calls the major advanced economies, Germany again acted as the growth driver in 2011 with an increase in real gross domestic product of 3% as against 2010, followed by Canada (up 2.3%

as against the previous year) and the U.S.A. (up 1.8% as against the previous year). Due to the effects of the natural disaster, economic activity in Japan declined by 0.9% as against 2010.

The significance of what the IMF defines as “emerging and developing markets” to global economic growth is continuing to rise. In 2011, the economy in the emerging and developing markets again expanded substantially by 6.2%, though the pace here has also slowed. Economic activity in these countries had still increased by 7.3% in 2010. Restrictive monetary and fiscal policies to combat inflation contributed to the slowdown in growth. Economic performance in Central and Eastern European countries rose 5.1% in 2011. The biggest contribution to growth in the emerging and developing markets came from China, with an increase in economic activity of 9.2% as compared to 2010. Thus, the Chinese government landed in its target corridor for economic growth in the high single digits after real economic growth in 2010 of 10.4%. India’s economy expanded much more moderately in 2011 by 7.4% after 9.9% in the previous year. In 2011, Brazil’s economic growth was only 2.9%, less than half of the rate reached in the previous year. This is also substantially less than had been forecast at the start of 2011 (+4.5% as against 2010).

According to provisional calculations by the IMF, 2011 also saw a sharp rise in consumer prices, mainly on account of the greater cost of energy and food. After strong increases in the price of crude oil, with Brent oil reaching a high for 2011 in early April of \$128.04 per barrel, the situation on the commodities markets eased in spite of the highly unstable political situation in many countries of the Middle East and Northern Africa. This led to a decline in inflation at the end of 2011. A similar trend was observed in food prices. In the advanced economies, consumer prices increased 2.7% in 2011 (up 1.6% in the previous year). In the emerging and developing economies, prices climbed 7.2% (up 6.1% in the previous year).

### The eurozone

The economy in the eurozone grew by 1.9% in real terms in 2010. Germany posted the highest growth of the core Western European countries of the currency union. The recovery in economic activity also continued in the period under review. The opening quarter of 2011 saw vigorous development on account of production restrictions due to poor weather conditions during the closing quarter of 2010, though this exaggerated the momentum somewhat. Gross domestic product in the eurozone climbed by 0.75% in this period as against the fourth quarter of 2010. In the second quarter, economic activity expanded by only 0.25% as against the previous quarter. France even reported a slight decline in growth of 0.1% while Germany's economy rose by 0.3% in the second quarter as compared to the previous quarter. However, both countries posted stronger economic growth of 0.5% in the third quarter after seasonal adjustment, thereby simultaneously making the most significant contributions to growth within the eurozone. Real economic growth in the eurozone was again 0.25% in the third quarter as compared to the previous quarter. A key factor behind the modest growth was probably the increasing uneasiness among consumers and investors as a result of the escalation of the debt crisis in the eurozone during the summer months as events on the capital market since the middle of the year were largely stamped by uncertainty regarding the repercussions of the crisis for the real economy. This was why the increase in economic performance in the third quarter was mainly driven by investments and exports while private consumer spending again stifled overall economic growth.

There were a total of three EU summits to tackle the debt crisis in the second half of 2011. The governments passed various measures at the end of July, essentially resolving a second bailout package of €109 billion for Greece. The participants in this package are to include the euro nations, the IMF and private lenders. Furthermore, the scope of the euro bailout fund (European Financial Stability Facility (EFSF)/European Stability Mechanism (ESM)) was extended so that it will be able to act on the secondary market in future and support the recapitalization of financial institutes. However, this failed to ease the capital market's doubts as to the viability of the public finances of some periphery European nations. Among other things, the summit resolutions from the end of October 2011

specified the voluntary participation of private lenders of 50% in the Greece package yet to be negotiated, and agreed more stringent equity requirements for banks as well as an extended scope for the EFSF. The Member States of the eurozone were also called on to establish the requirements of a structurally balanced budget (debt limit) in their constitutions by the end of 2012 and to prepare budget planning on the basis of independent growth forecasts. Further steps were taken to ensure budget discipline with the resolutions of the European Council and the EU summit at the start of December 2011. An understanding was reached that members would strive more strongly for economic union. A significant aspect in terms of financial policy is the fact that the rule agreed at European level for a structurally balanced budget will not just be implemented in national law but also provides for an automatic correction mechanism in the event of deviations. For example, sanctions have been stipulated for the event of nations exceeding the deficit ceiling of 3% of gross domestic product. It was also decided in January 2012 to launch the standing European Stability Mechanism (ESM) in July 2012. In addition, the heads of state and government leaders of the EU agreed for the national central banks and other organizations to issue further bilateral lines of credit to the IMF of up to €200 billion.

The political situation in some EU countries is also still fragile. This applies particularly to Greece, where a referendum was even recently discussed, and which has since formed a new government, as is also the case in Italy and Spain. However, the resolved implementation of the necessary reforms to strengthen economic growth and reorganize national budgets is especially significant. As the year progressed, Greece came under fire for its slow rate of reform in particular. However, Italy also found itself under pressure and was ordered to impose further austerity measures on account of its weak growth forecasts and high debt. This is the first time that the financial markets have focused on a major EU Member State. Parallel to this, the considerably dimmer economic prospects hampered developments on the capital market.

Economic activity in the eurozone increased by 1.6% in 2011, thus falling within the forecast issued by the IMF at the beginning of the year. According to the IMF, the downward risks for economic development had however intensified substantially by the end of the

year. That is why the European Central Bank (ECB) cut interest rates for the second time within the fourth quarter by 25 basis points to currently 1%. Moreover, special monetary measures have been resolved by the ECB Council. Among other things, the ECB will expand its range of refinancing transactions to limit the effects of the difficult situation on the refinancing markets for banks and to support lending in the eurozone.

The recovery on the labor market faltered over the course of the year. After seasonal adjustments, the unemployment rate was 10.3% in November 2011 and has risen steadily since its low point in March 2011.

According to provisional calculations by the European Union's Statistical Office (EuroStat), consumer prices in the eurozone were up on average by 2.7% for the whole of 2011 against the previous year. For the full-year 2010, consumer prices increased by 1.6%. The future risks of inflation within the eurozone are however considered moderate.

### **Germany**

In 2010, the German economy expanded by 3.6%, not just marking its strongest growth since reunification but also becoming the economic engine for the entire eurozone as Europe's biggest economy. This upswing continued in 2011, albeit at a lower level. After strong growth in the first quarter at 1.3% as against the previous quarter, expansion slowed in Germany as well in the second quarter to 0.3%, before gaining a little momentum again in the third quarter at 0.5% as compared to the previous quarter. After the German real economy remained relatively unaffected by the effects of the debt crisis in the eurozone in the first nine months of 2011, the downgrades in business forecasts observed for some time now and several macroeconomic leading indicators as well as the level of incoming orders pointed to a slowdown in economic performance. Accordingly, growth of the gross domestic product fell by 0.25% in the fourth quarter of 2011 as against the previous quarter. Nonetheless, economic activity rose by 3.0% in 2011 as a whole, based upon preliminary calculations. This is 0.8 percentage points more than the IMF had forecast at the start of the period under review. Domestic contributions to growth increased as compared to exports, which were positively influenced mainly by the strong rise in private consumer spending. This sets Germany apart from most eurozone countries, where the recovery in private

consumption has been only halting. According to provisional calculations by the German Federal Office of Statistics, retail sales are believed to have risen by around 1.2% in 2011 after adjustment for inflation.

The labor market has so far benefited from this positive economic performance. According to provisional calculations by the German Federal Office of Statistics, the number of people in employment in Germany rose by 521,000 in November 2011 to 41.61 million. The unemployment rate as calculated by the German Federal Office of Statistics based on the European method (ILO employment concept) was 5.5% in November 2011.

There was a moderate budget deficit of 1% of real gross domestic product in 2011. In 2010, this value was still 4.3%. Consumer prices were up in 2011 as a whole by 2.5% as against the previous year.

### **Russia**

Economic growth in Russia in 2010 amounted to 4%, still significantly less than the pre-crisis growth rate of 8.5% in 2007. In 2011, gross domestic product rose moderately by 4.1% as against the same period of the previous year. Growth of 4.5% had been forecast by the IMF at the start of the period under review. Above all, this was due to the higher commodities prices, a very good harvest season, increased industrial production and rising employment. According to preliminary calculations, the Russian budget has a surplus for the period from January to October 2011. According to the IMF, the downward risks in relation to global economic activity have continued to intensify. As a result, there is a greater risk of price declines on the commodities exported from Russia as well as a greater risk regarding growth forecasts for the entire Russian economy.

The unemployment rate in Russia declined to 6.3% in November 2011 according to the Finnish central bank. As a result of the faltering price increases for food thanks to the excellent grain crop, the rise in consumer prices in the second half of the year slowed, amounting to 6.1% for 2011 as a whole. Effective December 26, 2011, the Russian central bank surprisingly cut interest rates by a further 25 basis points to 8%, after they had been raised to 8.25% in May 2011. The effects on the Russian economy of the debt crisis in

Europe have so far been limited. However, the country experienced increasing outflows of capital.

### **U.S.A.**

Economic development in the United States was divided in 2011. After an increase of 3% in 2010, economic growth amounted to only 1.0% in the first half of 2011 according to the IMF. This is above all due to the negative, exceptional factors such as the rise in the price of commodities and the repercussions of the natural disaster in Japan for the U.S. economy. The extensive stimulus measures by the government and the Federal Reserve Bank (Fed) to boost the economy have had only a minor impact. Catch-up effects, a rise in consumer spending and corporate investments also helped the country to more stable growth in the second half of the year. According to the IMF, there was 1.8% growth in 2011.

Economic growth in the U.S.A. is still being curbed by the high level of unemployment. The labor market is showing only slow signs of recovery. The unemployment rate was at 9.6% in 2010, recovering slightly until April 2011. However, the number of new jobs had fallen substantially by the start of the third quarter. There were then signs of recovery again in the fourth quarter, with the result that the unemployment rate dropped to 8.5% in December 2011. This was not yet able, however, to provide any substantial impulse to the American economy, around 70% of which depends on private consumption. The slight upward trend on the construction and real estate markets until mid-2010 was due to pull-forward effects as a result of government aid. Residential construction in 2011 suffered setbacks again after these measures expired.

After 1.6% in 2010, the U.S. inflation rate climbed to 3.9% by September 2011 as a result of the rise in the price of commodities and oil until the spring. However, this seems to be the highest point for inflation. It dropped again at the start of the fourth quarter, reaching 3.0% in December – essentially as a result of the drop in commodity and food prices.

The Fed has been focusing a great deal on stimulating the economy for some time now. It is still maintaining a zero interest rate policy with a range of 0.00% to 0.25% and has reiterated that the key lending rate should remain at a low level until 2014. No new stimulus programs were announced in its December meet-

ing, though it did announce that further liquidity measures (for instance quantitative easing 3) will be initiated if necessary.

The billion-dollar spending and tax cut programs during the financial market crisis have further elevated the U.S. debt levels. The IMF currently estimates the budget deficit for 2011 at 9.5% of gross domestic product after 10.5% in 2010. Discussions in the summer of 2011 over raising the U.S. debt ceiling and the failure of the “Super Committee”, which was supposed to draft proposals for budget reorganization, have harmed the environment for the U.S. economy. This prompted the rating agency Standard & Poor’s to downgrade the United States from AAA to AA+ with negative outlook. This move triggered greater uncertainty on global financial markets.

### **Brazil**

The slowdown of the global economy, combined with the delayed effects of Brazil’s restrictive domestic monetary policy, impaired the country’s economic growth in the second half of 2011. This is being widely shown by declining production, demand and labor market indicators. After economic growth of 7.5% in the “exceptional year” 2010, the gross domestic product rose 2.9% in 2011 according to the IMF. At 7% in October, inflation fell far from the target of 4.5% and even exceeded the tolerance limit of 6.5% as defined by the central bank. The IMF has forecast an inflation rate of 6.6% for 2011 as a whole. However, given the significant deterioration in prospects for the global economy and the effects of the debt crisis in Europe on retail and investments in South America’s biggest economy, the Brazilian central bank is assuming that the country’s inflation will decline. Between April 2010 and July 2011, it raised the key interest rate in seven steps from 8.75% to 12.5% and in August switched from its cycle of interest rate hikes to a moderate monetary policy to support the domestic economy. By the end of the year, interest rates were lowered in three phases from 12.5% to currently 11%. At 6.7%, the unemployment rate is consistent with that of 2010.

The strong appreciation of the Brazilian real as against the U.S. dollar and the euro in recent years has proved problematic, leading to a strong capital inflow and increase in imports. In a move to curb the capital influx from abroad and the high inflation rate, in October 2010 the government raised the tax rate on foreign

capital inflow in Brazilian fixed-rate bonds in two phases from 2% to 6%.

### Japan

On March 11, 2011, Japan was rocked by an underwater earthquake 72 kilometers off its east coast. It registered over 9.0 on the Richter scale and caused an immense tsunami. Although the areas affected were a relatively unimportant region economically, certain value chains were substantially disrupted worldwide. As a result, the Japanese economy shrank by 1.7% in the second quarter of 2011 as against the previous quarter. The heavy drop in exports also weakened the third quarter, with a decrease of 0.8% in comparison to the previous quarter. The economy did not begin to recover significantly from the consequences of the natural disaster until the fourth quarter, when it grew by 1.4% as against the previous quarter. The recovery was driven by a rise in domestic demand and strong expansion in exports as a result of foreign customers replenishing stock levels after delivery bottlenecks following the earthquake. In the third quarter, the export sector compensated for the slump in the second quarter with an increase of 6.2% as against the previous quarter.

Residential construction investments also picked up sharply as a result of redevelopment measures and the expiry of an incentive program for environmentally friendly renovations. An additionally stabilizing factor was the labor market. The unemployment rate dropped to 4.5% in October after 5.1% at the end of 2010. In the fourth quarter, the Japanese economy waned as a result of the strong appreciation of the yen and the drop in global demand. According to the IMF, economic activity in 2011 fell 0.9%.

The annual inflation rate dropped further to -0.5% in November. The IMF is anticipating an inflation rate of -0.4% for the whole of 2011. Thus, the deflation phase is believed to have continued. At its monetary policy meeting at the end of November, the Bank of Japan resolved to leave interest rates at between 0.0% and 0.1% for unsecured deposits. Additional government spending to revive the economy further increased Japan's public deficit. According to IMF information, this is now thought to be 233.4% of GDP for 2011 and therefore by far the highest debt ratio of all of what the IMF calls advanced economies. As Japan is mostly refinanced by investors from within the country and

has little need for capital inflows from abroad, its high debt level is considered to be less critical.

### China

After 2010, the Chinese economy was again one of the world's growth guarantees in 2011. Although the tempo did slow down finally, growth nevertheless amounted to 9.2% in 2011 according to the IMF. In 2010, growth was still at 10.3%. Retail sales rose slightly more slowly in 2011 than in the previous year. Among other things, this was due to lost purchase power among consumers as a result of the consistently high inflation rate in the first half of the year. This reached its provisional high in July at 6.5%. The main drivers behind inflation were the high costs of certain foodstuffs. The inflation rate declined again by the end of the year as a result of slowing inflation of food prices and lower economic growth, coming closer to the government's 4% target at 4.2% in November.

In response to the rapidly rising inflation, a turnaround in monetary policy was implemented at the end of 2010. On October 19, 2010, China's central bank raised key interest rates for the first time since December 2007. Further hikes brought rates to currently 6.6%. As of the end of 2011, however, the first signs of an easing of monetary policy were seen. For example, the minimum reserve rate, a standard instrument for controlling the amount of money in China, was cut by 0.5%.

According to the IMF, the unemployment rate is expected to have dropped to a lower level of 4% by the end of 2011. A major issue in 2011 was lending to local governments. The instruction to the largely state-owned banking sector resulting from the 2008/2009 economic package to massively increase lending resulted in more relaxed financing conditions. Local governments, which are unable to issue bonds, utilized this to finance infrastructure projects. At the end of 2011, the central government's debt amounted to 26.6% of gross domestic product. If it were to assume all local government debt, this figure would rise to 50% of gross domestic product – still well below the debt level of other major nations.

### India

Economic activity in India increased by 7.4% in 2011 (PY: 9.9%). This represents a downturn compared to 2010, but still exceeds the global average. Following

the rapid rise in food prices in 2010, the government increased the social spending detailed in its budget for the 2011/2012 fiscal year presented in February 2011 by 17% to cushion the cost explosion for the population at large. This centered on direct food aid and the subsidization of everyday goods to help the poorer members of society in particular. The inflation rate is still at a relatively high level. It rose to double digits in September 2011 at 10.1% and amounted to 9.4% in October. The IMF is assuming 10.6% for 2011. India's central bank raised lending rates to 8.5% in November 2011. This was its seventh interest hike in 2011. By increasing public spending by 13%, the government has distanced itself from the policy of budget consolidation it had announced in 2010. Public debt climbed to 65.8% of gross domestic product in 2011.

### Industry development

As an international automotive supplier, global business with the manufacturers of passenger and commercial vehicles is our most important market segment. This is where we generate around 72% of our revenue. The second-biggest market segment is global replacement tire business for passenger and commercial vehicles. Geographically, the most important sales markets are Europe and NAFTA. The share of revenues generated by the corporation in Asia has increased significantly in recent years.

### According to preliminary figures, new registrations of light vehicles around the world rose to roughly 75 million units

A key factor for our revenues in original equipment is the globally produced volume of passenger cars, station wagons, and light commercial vehicles weighing less than 6 tons. The regions of Europe and NAFTA, where Continental generates around 78% of its revenues, are particularly significant.

Among the major vehicle markets within the triad (Europe, NAFTA, and Japan), the U.S. vehicle market posted the highest growth rates in 2011. In total, around 1.2 million more new vehicles were registered

in 2011 than 2010. Thus, the U.S. market is still falling well short of the peak figure from 2005, when more than 17 million vehicles were sold.

The situation in Europe was highly mixed in 2011: While new registrations in Germany increased by almost 9% to 3.17 million units according to the VDA (German Association of the Automotive Industry), sales figures from national associations in Italy (down 11% to 1.74 million vehicles), Spain (down 18% to 0.8 million vehicles) and the U.K. (down 4% to 1.95 million vehicles) slipped significantly on prior-year figures. Of the big five markets within Europe, only France showed a stable performance. New registrations in France were down just 2% to 2.20 million vehicles.

The drop in new registrations in Japan of nearly 700,000 units is due solely to the natural disaster in Fukushima (March 2011). However, there were already signs of a significant recovery in the third quarter, and especially in the fourth quarter.

Following a significant recovery (30%) in 2010, the scrapping bonus available since March 2010 for old vehicles in Russia brought the market a further considerable rise in new registrations of almost 39% in 2011 to around 2.7 million vehicles. Thus, the Russian market has almost returned to its old high levels of 2007. As anticipated, the high growth of recent years waned in the rest of the BRIC markets. This was particularly clear, for instance, on the Brazilian market where, in the fourth quarter of 2011 alone, new registrations dropped by 7% as against the fourth quarter of 2010. This equates to an increase of just 3% over the year as a whole. Growth also slowed in India, particularly in the fourth quarter, shrinking the year's expansion to only 6%. Despite the expiry of several purchase incentive programs and the restriction of the number of licenses for new registrations in some cities (e.g. Beijing), the swell in new registrations in China amounted to 8%. Thus, the absolute increase in newly registered vehicles was for the first time significantly less than the growth on the U.S. market.