

Economic conditions in Germany

Underlying trends

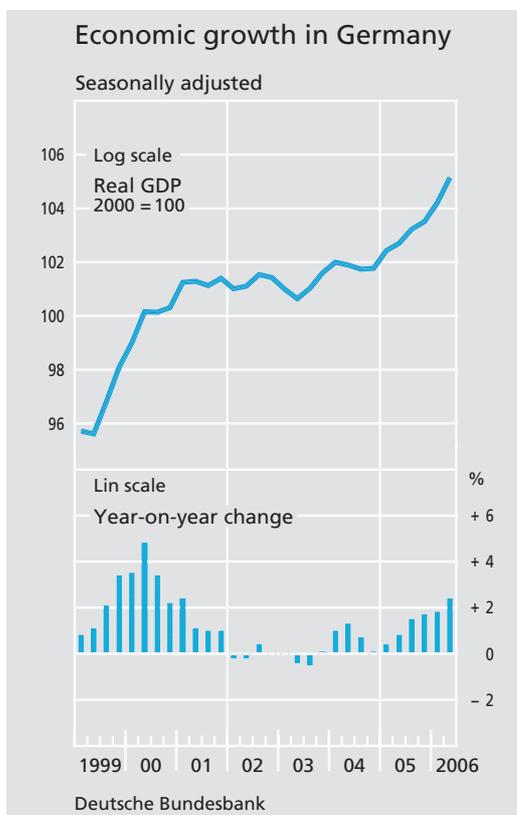
The economic upswing of the German economy has become significantly stronger during the course of this year. According to initial calculations by the Federal Statistical Office, overall output, which had already increased more rapidly (¾%) at the start of the year according to the most recently revised data of the national accounts, was almost 1% higher in the second quarter than in the previous three-month period.

*Growth surge
in second
quarter*

Even though this positive result benefited from one-off effects such as the normalisation of construction activity and certain special factors in connection with the FIFA World Cup, the underlying tendency shows a similar finding. For instance, the annualised real gross domestic product increased by just over 2½% in the first half of 2006, compared with a corresponding growth rate of 1½% in the second half of 2005. The now substantial gap of 2% in working-day-adjusted terms compared with the overall production level of the first half of 2005 and the higher degree of capacity utilisation in the main industries are evidence of the progress that has now been achieved in the current business cycle. The fact that the labour market is now increasingly benefiting from this and that the aggregate demand in the first half of the year showed a more balanced profile warrants the conclusion that the expansion process has now clearly improved.

Although, as usual, important details of the national accounts for the second quarter are not yet available, there is strong evidence

*Marked
increase in
investment*



that there has been a sharp rise in investment in the period under review. This particularly applies to construction, which was characterised by a strong backlog effect after the weather-induced losses. In addition, investment was boosted by expenditure on machinery and equipment. In view of the sustained rise in production, which, according to Ifo Institute data, has now led to a further marked increase in capacity utilisation, capacity extension now also plays a more significant role in the investment decisions of enterprises. Another reason why this is probably the case is that despite the downturn of the Ifo business climate in July, there is still a high level of confidence in the German economy.

The external sector is also likely to have made another positive, albeit small contribution to

growth. In real terms, exports may have marginally exceeded the level of the first quarter. In this context, spending by foreign visitors in connection with the FIFA World Cup had a temporary stimulating effect. Thus, German exports of foreign travel services expanded considerably.¹ Real imports may also have increased somewhat. By contrast, consumption by households is not likely to have increased any further after the sharp rise in the first three months. Nevertheless, the fact that classical retail purchases experienced a positive trend, especially in June, is also likely to be linked to the World Cup because a large number of foreign visitors generated domestic turnover. According to the available data and indicators, private consumption also showed a moderate upward trend during the first six months of the year.

Output and sales

Industry was also an important cyclical pace-maker in the second quarter. Output was 1½% up on the first quarter after adjustment for seasonal and calendar effects. Industry was therefore able to maintain the pace of growth experienced in the second half of 2005, after momentum temporarily weakened to ½% in the first quarter. At the same time, there was also a further sharp rise in capacity utilisation. According to Ifo surveys, it exceeded the average level of medium-

Industrial activity remains positive

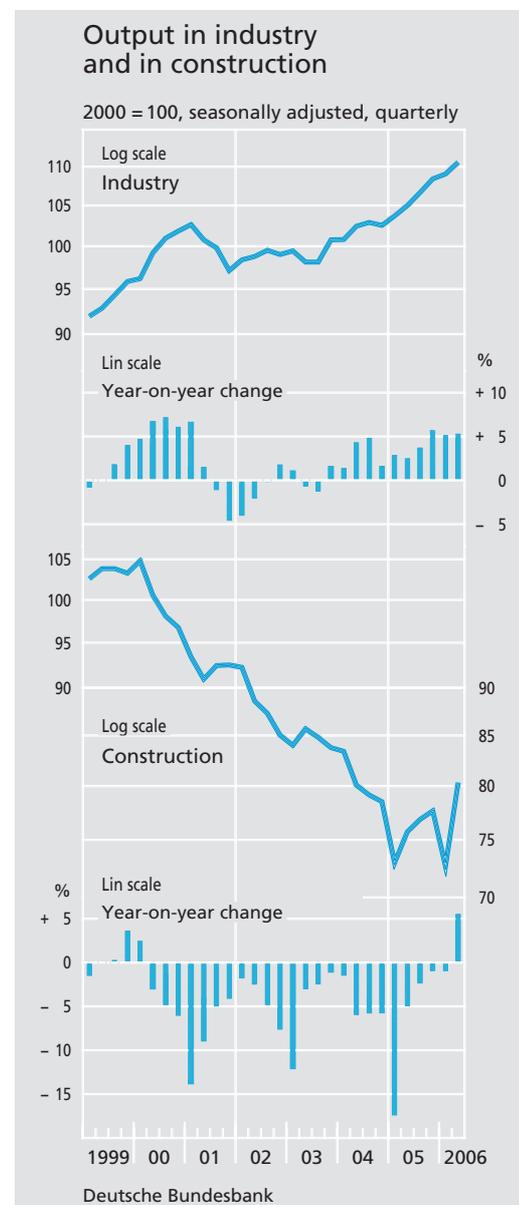
¹ In accordance with the residence concept, overnight accommodation expenses, the purchase of admission tickets by non-residents and the consumption by World Cup visitors in Germany, for example, are recorded as income from cross-border services both in the balance of payments statistics and in the national accounts system.

term capacity utilisation by roughly 3¼ percentage points in June 2006. This signifies a further rise in the propensity and necessity for investment in capacity extensions.

The intermediate goods industry recorded the largest growth in output. Manufacturers of basic metals, in particular, recorded significant gains. Manufacturers of electrical machinery and apparatus were also able to grow more strongly than in the first quarter. By contrast, chemicals suppliers had to curtail their production level somewhat after a stagnation in the first three months. Output in the consumer goods and durables industry clearly surpassed the level recorded between January and March. After sustaining losses in the first quarter, the non-durable consumer goods industry was also able to increase its output in the second quarter. The capital goods sector experienced only moderate growth in output after recording a sharp rise in the first quarter. This was mainly due to the subdued trend in the motor vehicle manufacturing sector. Output in the manufacture of machinery and equipment became somewhat weaker. By comparison, there was a marked decline in the manufacture of computers and other information processing equipment.

*Foreign trade
more subdued*

In the second quarter, seasonally adjusted German exports of goods were 1% up in nominal terms on the previous period where there had been a sharp rise in exports. However, this growth can primarily be traced back to the price component. Although exports to countries outside of the euro area increased further, particularly to the ten new EU mem-



ber states and the Russian Federation, sales of German products to the euro area partner countries did, however, decline recently. While exports of capital and consumer goods declined in April and May (figures with a sectoral breakdown are available until then), the intermediate goods industry was able to expand its foreign business somewhat. The motor vehicle industry also showed good sales figures abroad.

Foreign trade by category of goods

Percentage change

Item	Average of April and May 2006 compared with			
	Q1 2006; seasonally adjusted		April and May 2005; unadjusted figures	
	Exports	Imports	Exports	Imports
Total	+ 0.8	+ 0.2	+ 11.2	+ 14.5
Selected main categories				
Intermediate goods	+ 2.4	+ 3.1	+ 12.4	+ 15.6
Capital goods	- 0.2	- 2.1	+ 10.2	+ 10.5
Consumer goods	- 1.3	+ 0.2	+ 6.6	+ 9.3
Energy	.	- 0.4	.	+ 44.6
Selected categories				
Chemicals	- 1.6	- 4.2	+ 9.4	+ 9.6
Machinery	+ 0.5	+ 1.3	+ 8.7	+ 11.9
Motor vehicles and motor vehicle parts	+ 1.2	- 0.5	+ 9.4	+ 4.1
Information tech- nology	+ 0.7	- 4.2	+ 11.8	+ 14.5
Metals and metal products	+ 4.2	+ 7.7	+ 17.7	+ 23.2

Deutsche Bundesbank

The value of imports rose by just under 1% in the second quarter after adjustment for seasonal variations and thus much the same as export sales. In real terms, however, there was a decline in imports of goods. This mainly affected imports of capital goods and energy sources. However, imports of intermediate goods, in particular from the ten new EU member states, rose slightly in real terms.

After the construction industry had particularly suffered from adverse weather conditions in the first quarter, the second quarter saw the emergence of a rapid period of normalisation in construction activity. During this time period, output exceeded the weak first quarter by 10½% after adjustment for seasonal and calendar effects. Compared with the fourth quarter of 2005, which was not af-

Construction industry in period of normalisation

ected by adverse weather conditions, the increase was 3½%. There was a particularly strong growth in output in the civil engineering sector, which is possibly connected with catch-up effects after the production losses in the winter months and an increase in road construction assignments in the run-up to the FIFA World Cup.

Commercial service providers continue to benefit from the favourable economic activity in industry. According to the Ifo business survey, the current business conditions are still rated positively. According to the survey by the Centre for European Economic Research, the rating has even improved vis-à-vis the first quarter. Computer and telecommunication service providers, in particular, assessed their situation more confidently, as did computer retailers. Architects, external auditors and tax consultants were also among those who cited more optimistic turnover ratings. By contrast, the advertising enterprises questioned as part of the survey were more restrained in their assessments.

Service providers continue to assess current situation as positive

Real turnover in the retail trade sector grew by just over ½% in the second quarter in seasonal and working-day adjusted terms after it had already increased by 1¼% in the period from January to March. The slowdown may also have been related to the back payment of expenses for the last heating period, which limited spending in other areas. The retail trade sector is likely to have benefited from special effects in connection with the FIFA World Cup in June. This is at least indicated by the sharp rise in turnover among grocers, beverage retailers and tobacconists in this

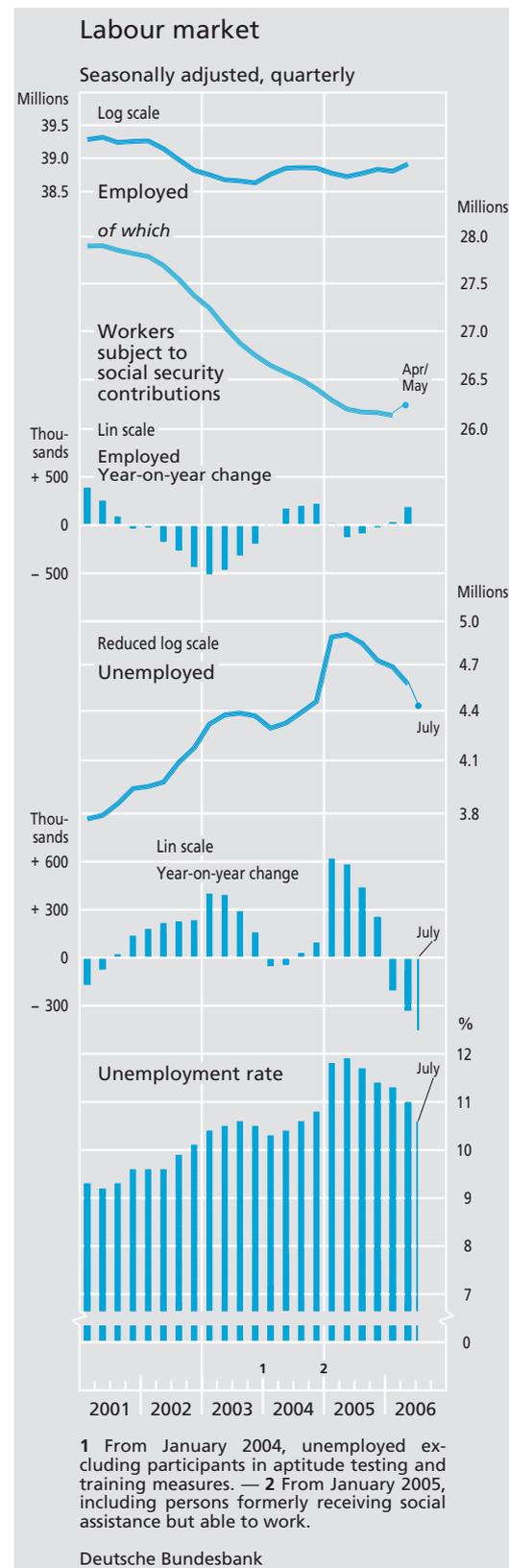
Trade subdued, hotel and restaurant services more favourable

month. In wholesale trade, the development in the second quarter, which saw a year-on-year rise of 1¾%, was also not as favourable as in the previous three-month period when wholesale turnover was 3¾% up on the year. By contrast, developments in hotel and restaurant services were more favourable. Growth was recorded in the area of accommodation services, in particular, and for the first time in quite a while, the turnover in the catering trade was virtually no longer below the corresponding prior-year figures.

Employment and unemployment

Employment on the increase

The more favourable overall economic development has now reached the labour market as well. The number of persons in work, which has been revised considerably upwards since the third quarter of 2005, increased by over 100,000 to almost 39 million persons in the second quarter of this year after adjustment for seasonal variations. In a year-on-year comparison, this increase, which was just as strong for employed persons as for self-employed persons, was also quite significant at 0.5%. Estimates by the Federal Employment Agency, which, however, only go as far as May, suggest that seasonally adjusted employment subject to social security contributions has not decreased for the first time in over five years. According to these calculations, there was an increase of 85,000 jobs in April and May, compared with the first quarter. If these figures are confirmed, it would mean that this would also be the first time in a long while that there has not been a year-on-year decrease. There was a particularly



strong increase in commercial services, which also include labour leasing. The declining number of short-time workers and the rising number of job vacancies also point to an emerging cyclical revival of the labour market. Surveys carried out among enterprises regarding their hiring plans also seem to confirm this. Part-time low-paid employment in the form of "mini jobs" also expanded further. However, the number of persons employed in government-assisted employment opportunities (one-euro jobs) declined somewhat in the second quarter.

*Declining
unemployment*

The reduction in unemployment continued in the second quarter of 2006 owing to the improved situation in employment. The number of persons registered as unemployed decreased by 115,000 to now 4.59 million persons in the second quarter; the unemployment rate went down from 11.3% in the first quarter to 11.0%. This decline, however, is overstated by about 0.1 percentage point owing to the annual adjustment of the reference variable (size of labour force) in May.² In a year-on-year comparison, the number of persons registered as unemployed at the Federal Employment Agency decreased by 330,000. The unemployment rate was down by 0.9 percentage point on the year. Apart from the increase in demand for labour, another significant reason for this trend was the more stringent requirements set by employment services for job seekers and the reduction of wage substitution benefits with the result that some job seekers did not reregister themselves as unemployed. In addition, more people took advantage of the early retirement rule pursuant to Social Security Code III,

section 428, the "58-year-old regulation" (*58er-Regelung*). In line with this regulation, the beneficiaries receive unemployment benefit but are generally no longer counted as being unemployed.

The decline in the number of persons registered as unemployed also continued in July. After adjustment for seasonal variations, this figure was down 85,000 persons on the month. However, owing to the fact that the reporting date was brought forward to the middle of the month, the economic upturn may be somewhat overstated as the usual seasonal rise in unemployment in July will not be fully recorded until August this year.

Wages and prices

The pay settlements on the labour market were, on average, somewhat higher than in 2005 although there was considerable variation from sector to sector. In the public sector, the agreement reached in May by local governments to extend the negotiated number of working hours per week after a 14-week strike was followed by a new collective pay settlement (TV-L) by state governments for fee structures, weekly working times and annual special payments. More-

*Pay settlements
somewhat
higher than in
previous year*

² In the unemployment statistics for the first quarter of 2005, persons receiving social assistance but who are able to work were included only in the numerator of the ratio (unemployed persons), but not in the denominator (total of all civil members of the workforce). The denominator is adjusted only once a year when the results of the microcensus of the previous year become available. Owing to this adjustment of the numerator, the national unemployment rate has been overstated by about 0.1 percentage point since the beginning of 2005. The recalculation of the reference variable in May 2006 corrected this statistical effect.

over, management and the trade unions agreed on one-off payments graded according to income for this year and next year, but not on a general increase of remuneration. Following the doctors at university hospitals and hospitals run by the Federal state, doctors at local authority hospitals achieved significant pay increases and improved working conditions.

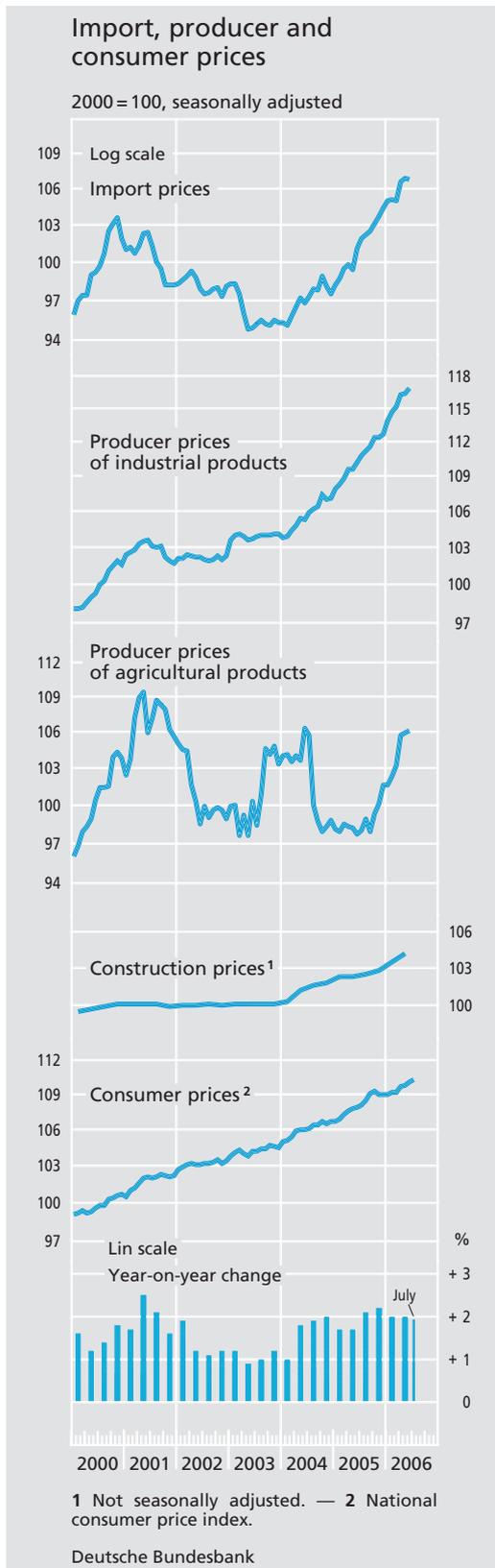
In the private banking sector, the negotiating partners agreed that a one-off payment and linear increases of 3% as of 1 September 2006 and 1.5% as of 1 December 2007 would be paid by the end of June 2008. In the case of Deutsche Telekom AG, the wage agreement which is to remain valid until the end of July 2007, envisages the pay-out of one-off payments and a 3% pay increase for employees as of 1 November 2006. Furthermore, the negotiating partners agreed on measures to cut costs and boost productivity. In the wood and plastics processing industry, there were settlements comprising one-off payments and a linear pay increase of 2.5% for a period of 12 months. Depending on the economic situation of the enterprise, the amount of the one-off payment can be adjusted upon agreement with the workers' council. For the temporary employment sector, a minimum wage agreement of €7.00 per hour in West Germany and €6.10 per hour in East Germany was reached during the period under review, which is to be achieved by broadening the scope of the German Employee Posting Act (*Arbeitnehmer-Entsendegesetz*) to this sector.

On an average of all sectors, the monthly negotiated rates of pay were 1.6% up on the year in the second quarter of 2006. The greater increase compared with the first quarter is mainly due to an increased number of one-off payments not applying to scheduled rates of pay, which had already been determined in previous pay agreements for the corresponding months. When assessing the most recent pay agreements in terms of their effects on costs and employment, it should be borne in mind that the final rates are not only higher on average, but they also do not become fully effective until later in the year. Moreover, shorter durations were agreed on the whole, which means that a new round of negotiations will be required in the second and third quarters of next year when the price effects resulting from the increase in VAT as of 1 January 2007 will start to have a real effect.

The external upward pressure on prices intensified again in the past few months. After adjustment for seasonal variations, import prices rose by 1.7% in the second quarter after rising by 1.3% in the first quarter. The year-on-year increase went up from 6.2% to 6.7% despite the appreciation of the euro against the currencies of the most important trading partners. In this context, the appreciation of the euro only marginally alleviated the domestic price effects resulting from the surge in commodity prices on the international markets. Prices for imported energy were up by almost 35% on the year and by more than 20% for metal ores. Apart from that, however, the external upward pressure on prices remained within narrow bounds, even

*Aggregate level
of negotiated
wages*

*Sharp increase
in import prices*



though the general price development was rather more unfavourable than in the previous year. Although prices of imported capital goods were down 1.2% on the year and prices of consumer goods rose by a mere 1.3%, price decreases for capital goods, however, were still at 3.7% in the second quarter of 2005 and prices of consumer goods fell by 0.6%. Owing to moderately increasing export prices, the terms of trade were down by 3.8% on the year.

Industrial producer prices for domestic sales rose by a seasonally adjusted 1.7% in the period from April to June, almost as sharply as at the beginning of the year. Although pressure on prices for energy from domestic production eased somewhat, it intensified in the case of intermediate goods, which also include metals and semi-finished products. Capital goods experienced a relatively moderate price increase with a year-on-year rise of +0.6%. The accelerated price increase for consumer goods (+1.6%, after being +1.2% in the first quarter) was primarily due to higher prices for pork, the supply of which suffered from a decline in sales owing to the hot and dry summer weather. All in all, the year-on-year rate of increase of industrial producer prices rose to 6.1% in the second quarter, compared with 5.7% in the first three months.

Price of domestic industrial products rises

There was a further sharp rise in construction prices in the second quarter; an increase of 1.9% on the year. The increase in the cost of road construction was particularly strong with an annual growth rate of 3.4%. This is attributable to the sharp rise in the price of

Rising prices in construction

bitumen (+54% on the year) in connection with the rising oil prices. Construction prices of residential buildings also increased by 1.5% compared with the second quarter of 2005.

Accelerated increase in consumer prices

After the seasonally adjusted pressure on consumer prices had initially come to a halt at the beginning of the year, it intensified again in the following months under the influence of rising oil prices. There was a particularly sharp rise in the price of fuel and heating oil. The particularly warm and dry summer weather from June onwards also played a role in this, especially as it followed a long and particularly cold winter. This led to a price increase particularly for vegetables and potatoes, but edged up the prices of other food products, too. After adjustment for seasonal variations, the consumer price index rose by 0.7% in the second quarter of 2006. Compared with the previous year, the increase was +2.0%. Excluding energy and food, price inflation declined to 0.2% on the quarter and to 0.8% on the year. This shows that, apart from the components which are especially sensitive to the weather and the conditions on the world market, the domestic price trend remained subdued. The price for industrial goods (excluding energy) increased by 0.7% on the year, services by 0.9% and housing rents by 1%.

Consumer prices were 1.9% up on the year at the beginning of the third quarter compared with the previous year; the Harmonised Index of Consumer Prices increased by 2.1% on the year. Apart from the increase in oil prices, this was also due to the fact that the

decrease in food prices in July was more restrained than usual and that package holidays became much more expensive. By contrast, the strong price reductions for clothing during the summer clearance sales had a dampening effect on the growth rate of consumer prices.

Orders received and outlook

The situation in industrial orders also showed a positive trend in the second quarter. After adjustment for seasonal and working-day variations, the inflow of orders in the second quarter was 1% up on the average level recorded in the previous three months when demand increased by 1½%. That is equivalent to a year-on-year increase of 10%, compared with 10½% in the first quarter. Taking the first six months of the year as a whole, the growth in demand in the second half of 2005 at 6½%, which was, however, influenced by large orders, has now fallen to 3¾%.

Favourable economic activity in industry at somewhat slower pace

Against this backdrop, there was a slight downturn in the flow of orders during the course of the second quarter. After a sharp rise in April, slight deductions were recorded in May and June. In June, these mainly affected domestic demand, which had previously recorded an increase, whereas demand from abroad remained at a high level in this month. In the period from April to June, domestic orders rose by 3% in total, after they had remained unchanged in the first quarter. The rise in domestic demand was thus at its highest level in a long time. By contrast, for-



Foreign orders slowed down a little in the second quarter.

The capital goods manufacturing sector played a key role in this. The decline in this sector was almost exclusively due to a lull in orders for manufacturers of motor vehicles and motor vehicle parts, which did, however, experience strong growth in the first quarter. Excluding this sector, overall foreign demand was up on the already high level recorded in the first quarter. By contrast, there was an increase in the number of incoming orders in the mechanical engineering sector, which was due to more buoyant domestic business activity. The producers of office machines and telecommunication equipment concluded as many orders as in the first quarter. In the case of intermediate goods, however, incoming orders grew considerably in the second quarter after they had stagnated at first. Manufacturers of basic metals, in particular, closed a number of new deals. The key stimuli in this area came from domestic customers, but there were also more orders from foreign customers. Manufacturers of electrical machinery and apparatus also significantly increased their inflow of orders. Foreign business picked up in particular. In the chemicals industry, foreign business was also a key factor for the overall increase in incoming orders, whereas the improved situation in orders for manufacturers of consumer goods resulted in equal measure from domestic and foreign business.

The fact that the stocks of orders are quite high and that the positive sentiment in industry has remained strong also suggests that this favourable business development will

continue. The picture for small and medium-sized enterprises is also now looking more favourable. Although the Ifo business climate was revised downwards somewhat in July owing to the fact that business expectations were not as optimistic as before and that export expectations were rated somewhat more cautiously in June and July, there is still, however, an overall strong feeling of confidence in the German economy. The decline in business expectations in July may also be linked to the fact that the negative effects of the increase in VAT that are expected to affect wholesale and retail trade in particular have been entered as part of the survey's expectations horizon for the first time.

*Revived
demand for
construction
work*

However, the fact that the situation in orders in the construction industry has improved further is particularly likely to ease the burden. On average and after adjustment for seasonal and working-day variations, the number of incoming orders was 7% up in April and May on the weak first quarter, which was influenced by poor weather conditions. This is equivalent to a year-on-year increase of 10%. The sharpest increase in construction demand in May was among industrial customers. With a seasonally adjusted growth of just under 15% in the period from April to May, following the interruption sustained as a result of the subdued first quarter, industrial demand for construction work again benefited from the positive underlying trend which had been underway since the second quarter of last year. In housing construction, losses were made in May after an exceptionally strong rise in April. All in all, incoming orders in April and May were about 7% up on the subdued

level of the first quarter and 2¾% up on the average level of the final quarter of 2005. Following the previously apparent effects in connection with the discontinuation of the grant to homebuyers, considerably fewer building permits were issued in the past few months.

According to the Ifo Institute survey, commercial service providers are not rating their prospects quite as optimistically as before. Thus, business expectations in the second quarter barely held their ground against the high level recorded in the first quarter. The assessments were more cautious in July. According to reports of the Centre for European Economic Research, it is mainly telecommunication service providers, computer retailers and technical consultants who are rating their demand situation more favourably. By contrast, the advertising industry and computer service providers made more cautious assessments.

*Service
providers
somewhat
more sceptical
about future
developments*

In the coming months, the outlook for trade will probably be increasingly influenced by the special effect of the rise in VAT. Therefore, certain anticipatory effects are likely to be expected later on in the year, which could then be accompanied by corresponding losses. According to the most recent survey for the month of July by the consumer research institution, *Gesellschaft für Konsumforschung* (GfK), households are more pessimistic about their income outlook as well as their expectations regarding economic activity. Although the propensity to purchase has clearly risen, as was seen in the past few months already, it remains to be seen to what extent the increased propensity to spend will actually be reflected in a sustained stronger consumer

*Outlook
in trade
influenced by
special effects*

demand. In the past, there have always been longer periods in which these factors developed in opposite directions. Another factor to be taken into consideration is that energy prices went up strongly again recently, thereby limiting the amount of disposable income available for other consumption.

*Economic
outlook
remains
positive*

Against the background of the sustained positive outlook in industry among commercial service providers, albeit recently on a somewhat weaker scale, there is much to suggest that the economic upswing will continue. The German economy is likely to continue to benefit from the strong growth of the global economy. Owing to the substantial rise in industrial capacity utilisation, investment in capacity extensions is becoming ever more important. The recent increase in demand for private non-residential construction

from industrial customers is also encouraging. However, since no further stimuli are being generated as a result of the normalisation in construction activity, the contribution to growth from construction investment in the coming months is likely to be less substantial than in the second quarter. One-off effects in connection with the FIFA World Cup are now also disappearing. However, anticipatory effects are to be expected in the construction industry in the second half of 2006 owing to the increase in VAT. Private consumption could therefore also assume a more prominent role. More important, however, is that consumption gains a sound footing in light of the sustained improvement in the labour market, while the persistently high energy prices continue to place a great deal of strain on consumption.