

Economic conditions in Germany

Macroeconomic situation

The upturn in the German economy continued over the summer months. According to a flash estimate by the Federal Statistical Office, real gross domestic product (GDP) in the third quarter of 2010 rose by a seasonally and calendar-adjusted 0.7% on the quarter. A normalisation has therefore set in following the second quarter, which was characterised by catch-up and backlog effects. Owing to a revision of retail sales figures and including new information that has since become available for the finishing trades, growth of 0.6% and 2.3% respectively (previously 0.5% and 2.2%) is now shown for the first two quarters of the year. During the reporting period, overall economic activity was still down 1.8% on the cyclical peak of the first quarter of 2008; at its highest level, the shortfall had stood at 6.6%. The recovery of the German economy continued to be buoyed by robust global economic activity. Nonetheless, there is no overlooking the fact that domestic forces are now gaining in strength. The sharp expansion of investment in machinery and equipment and the further appreciable increase in private consumption are clear evidence of this.

*Normalisation
of the pace of
economic
recovery*

In the third quarter of 2010, German exporters benefited from the ongoing global economic recovery, even though its momentum slackened somewhat during the summer months. In real terms, exports of goods went up by a seasonally adjusted 3½% on the quarter, and export profits consequently reached similar levels in both euro-area and non-euro-area countries. However, this was also due to a slower pace of sales growth in

*Impulses from
the global
economy less
pronounced*



the emerging market economies, in particular, which has so far proven to be a major driving force behind the external catching-up process. In the first two months of the third quarter – more recent data are not yet available – exports to China, which had been growing very quickly in the first quarter, did not fully maintain the high level of the previous three-month period. Growth in exports to the USA were also markedly lower than in the first half of 2010. By contrast, the cyclical upturn in a number of euro-area partner countries seems to have steadied, which, in turn, has supported exports of goods to the region. The fact that exports of intermediate, capital and consumer goods experienced similar growth rates suggests that German manufacturers were participating in the global economic recovery on a broad basis.

Real imports of goods grew by a seasonally adjusted 2¼% in the third quarter. German customers' demand was again focused on motor vehicles and (other) capital goods. Imports of consumer goods also continued to rise sharply, however, owing to the pick-up in private consumption. Given the anticipated normalisation of the pace of economic recovery, imports of immediate goods did not go up quite as sharply in the period under review as on an average of the previous four quarters. In terms of their regional profile, it is striking that, in the first two months of the third quarter, the seasonally adjusted value of imports from the USA rose considerably on the quarter, while there was a slackening of the buoyant momentum of imports from Asia compared with the first half of 2010. The same is also true (albeit to a lesser degree) of imports from euro-area countries.

Imports also less buoyant

Purchases of machinery and equipment by enterprises are likely to have risen sharply again in the third quarter. Given the favourable outlook for growth, investment in machinery and plant would appear appropriate. Non-deferrable replacement purchases were not the only factor in this context. The volume of investment in capacity extensions was probably also larger than would be expected in view of the fact that capacity is, in part, still underutilised. One reason for this could be the discontinuation at the end of the year of the more generous tax depreciation rules for moveable fixed assets, which were introduced as part of the fiscal stimulus package in November 2008. Furthermore, the available funds of enterprises increased sharply in the wake of the buoyant economic recovery.

Perceptible increase in purchases of machinery and equipment

Added to this is the fact that external financing conditions are favourable at present.

Construction activity at high Q2 level

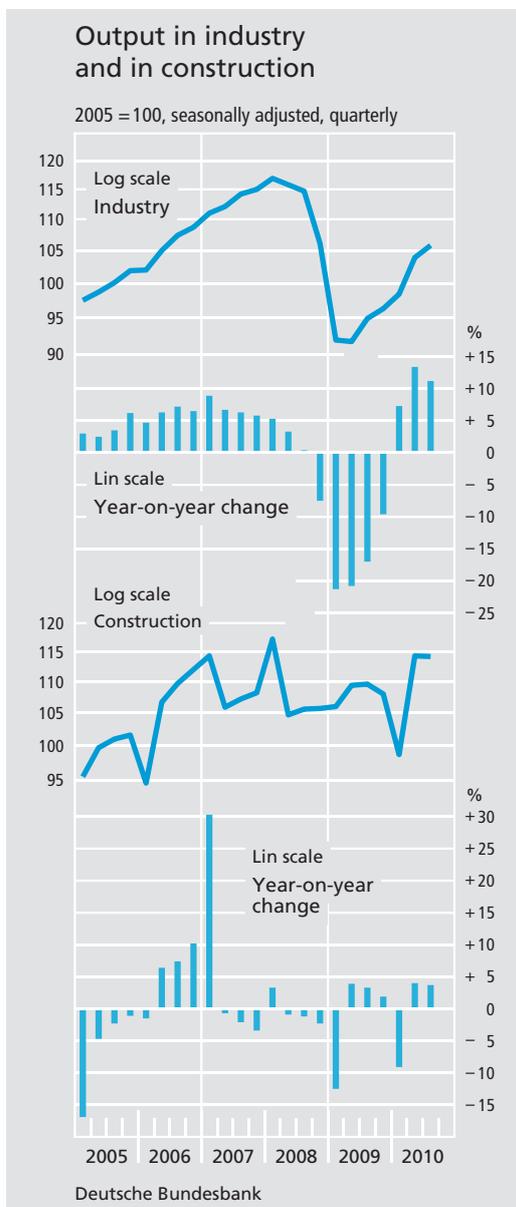
Construction investment in the third quarter could have largely maintained the level of the second quarter, which was boosted by catch-up effects. Further progress was made in working off the backlog of commercial and public sector construction orders that had been built up in the winter, most of which were in connection with the modernisation of public infrastructure under the government economic stimulus programmes. Furthermore, there has been a marked rise in demand for new housing since the second quarter. Historically low mortgage rates are evidently prompting numerous households to achieve their desire for home ownership quickly. Nevertheless, the planning and approval stage takes a certain amount of time. As a result, construction activity probably was not yet benefiting substantially in the third quarter from the new stimuli to housing construction.

Further pick-up in private consumption

In the third quarter of 2010, households further increased their consumption expenditure in real terms after adjustment for seasonal and calendar variations. The fact that more new cars were being purchased again was of particular importance in this context. The slump in demand following the period of a sharp rise in car sales owing to the environmental premium now seems to have been largely overcome. This was helped by the fact that the income situation of households improved perceptibly following the scaling-back of the crisis measures in enterprises, which had been associated with significant losses of



income in some cases. The retail trade sector also benefited from this. Furthermore, households began stocking up heavily on heating oil as early as the third quarter; they were obviously anticipating further price rises before the start of the heating period.



Sectoral trends

Further rise in industrial output

The pace of growth in industrial output moved on to a somewhat flatter path in the fourth quarter. Industrial output grew by a seasonally adjusted 1.8% after expanding by as much as 5.6% in the second quarter. This was due to quite diverse developments in the individual sectors. There was very strong growth in the output of capital goods

(+2.5% excluding vehicles), a sector in which the economic recovery set in comparatively late. This was attributable primarily to manufacturers of machinery and electrical equipment, who again managed to increase their output significantly by 4.9% and 4.1% respectively. The automotive industry, which benefited especially from the sharp rise in foreign demand and, most recently, from replacement orders for car fleets, increased its output by 1.5% on the second quarter. The large orders received by manufacturers of other transport equipment in the previous quarter had exerted only a marginal impact on output at this point in time. Manufacturers of intermediate goods, who have made the greatest headway in the catching-up process so far, increased their output again (+1.6%). The rise in output in the consumer goods industry, at 1.6%, was twice as strong as in the previous quarter.

The further rise in production has also lifted capacity utilisation in manufacturing again. On the whole, it was up 1 percentage point on the second quarter level. According to the survey results of the Ifo Institute, there was a higher than average rise in the capacity utilisation of capital goods manufacturers (+2 percentage points); capacity utilisation was therefore just 2¼ percentage points below the longer-term average. There was also a further increase in capacity utilisation in the intermediate and consumer goods sectors, where it has already been above the respective longer-term sectoral average, either entirely or in part, since the third quarter (+½ percentage point and +¾ percentage point respectively).

Rise in industrial capacity utilisation

Slight decline in energy output, construction activity at a high level

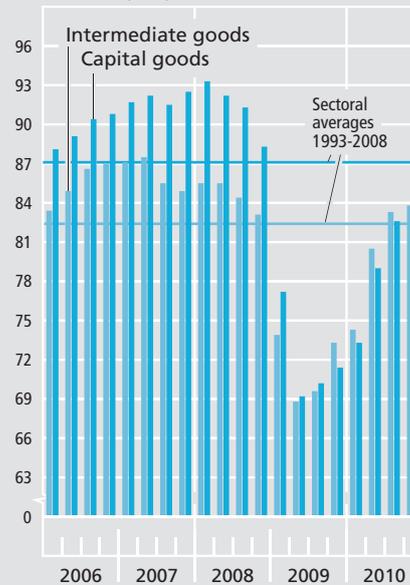
Energy producers reduced their output slightly on the quarter. The construction sector benefited from the fact that further headway was made in working off the construction orders placed in connection with the government economic stimulus packages. Seasonally adjusted construction output was therefore able to maintain its high level of the second quarter, which was still characterised by catch-up effects following the harsh winter. Output in civil engineering did not quite match its second-quarter level, however, since significantly fewer public sector orders were being received as early as the spring. This effect also had an impact on the building industry, although this was offset by an increase in the flow of housing construction orders. No current data are available at present for the finishing trades, which recorded extremely sharp growth in the first two quarters of the year.

Stronger pick-up in consumption than in industry-related services

There was a further pick-up in business activity in the tertiary sector. However, the slowdown in the pace of exports and in industrial activity made itself felt in the case of business-related service providers; according to the available corporate surveys, their business did not expand as sharply as in the previous quarter. There was even a slight decline in sales in the wholesale sector, which had been growing rapidly up to that point in the wake of the economic recovery. By contrast, the consumption-related service sectors were tending to expand their activities. Retail sales in the third quarter were slightly up on the preceding three-month period. There was even a marked rise in motor vehicle sales as the decline in sales to commercial customers

Manufacturing capacity utilisation

As a percentage of normal full capacity, seasonally adjusted



Source: Ifo Institute.

Deutsche Bundesbank

was more than offset by the increase in sales to households. Furthermore, turnover of hotels and restaurants rose perceptibly in the first two months of the third quarter in seasonally and price-adjusted terms.

Employment and unemployment

The recovery of the labour market continued into the second half of 2010. Employment showed a further rise in the third quarter, and unemployment showed a distinct decline again. Moreover, enterprises are reporting an increasing number of vacancies, which means that a continued upward movement in employment subject to social security contributions is to be expected in the coming months. Furthermore, recent survey data suggest that

Further improvement in labour market situation



the need to recruit new staff will remain high even longer.

According to estimates by the Federal Statistical Office, employment in Germany in the third quarter of 2010 rose by 110,000, or 0.3%, on the quarter after adjustment for seasonal variations. This increase was therefore only slightly down on the sharp 0.4% growth recorded in the second quarter. As in 2009, the commuter flows increased significantly with the start of the main harvest period. Domestic employment grew somewhat less strongly during the third quarter, which is generally characterised by holiday effects.

Pick-up in employment...

In a welcome development, numerous additional jobs subject to social security contributions were created, while the number of persons working in low-paid part-time employment as their main source of income showed a further fall. Taking the average of the first two months of the third quarter, the seasonally adjusted number of persons in employment subject to social security contributions rose by 121,000, or 0.4%, on the quarter. Although the expansion was again broadly based, there are, however, signs of a shift in focus. In the manufacturing sector, the subdued growth in employment continued unabated. The same applies to the transport and logistics sectors, although at a somewhat faster underlying pace. Around mid-2010, there were signs of a flattening of the perceptible upswing seen in the construction sector and in business-related services (including temporary employment) in the second quarter. Added to this was the fact that the em-

... owing to an increase in employment subject to social security contributions

ployment trend in the services sectors, where considerable numbers of new staff had been recruited during the crisis, was no longer looking quite so positive. Whereas further jobs subject to social security contributions were being created in the health and social work sector, there have been no further seasonally adjusted increases in the education sector or in public administration for a number of months.

Short-time working still declining

The total headcount engaged in short-time work continued to fall rapidly along with the sharp recovery in industrial activity. According to estimates by the Federal Employment Agency, the number of persons engaged in short-time work for economic reasons stood at just 173,000 in August 2010. This was down 12% on the peak recorded in May 2009. The decline was, however, slowed down by the fact that new registrations for short-time work have been stagnating at just under 30,000 per month since the second quarter. The number of newly registered short-time workers was therefore more than twice as high as the average for 2007, for example, and went back up to 40,000 in October 2010. This shows that not yet all industrial enterprises were feeling the effects of the economic upturn.

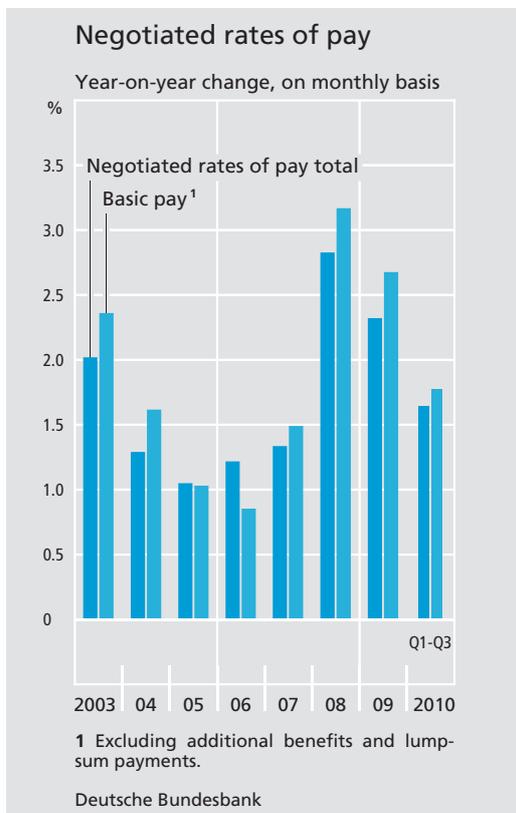
Decline in unemployment in Q3 no longer quite as steep

There was a further perceptible decline in unemployment in the third quarter of 2010. In line with trends in domestic employment, the decline in the reporting period, at a seasonally adjusted 69,000, was only half as large as in the previous quarter (-127,000), however. This was due primarily to the fact that fewer unemployed persons receiving

unemployment benefits under the statutory insurance scheme are likely to have found employment again between July and September, whereas the decline in the number of non-working recipients of unemployment benefit II was hardly smaller than the average of the previous quarter. The weakening of the cyclical effect during the summer months may also have been due to the holiday period. The obvious thing to do at this time was to moderate the pace of recruitment following the sizeable increases in staffing levels in the second quarter as well as in view of the anticipated normalisation of the economic recovery process. There were 290,000 fewer persons registered as unemployed in the third quarter of 2010 than in the previous year. The official unemployment rate declined by 0.7 percentage point on the year to a seasonally adjusted 7.6%. In October, the seasonally adjusted number of unemployed persons remained practically unchanged on the month; the corresponding unemployment rate remained steady at the September level (7.5%).

Leading indicators suggest that the positive developments in the labour market are continuing. The number of seasonally adjusted vacancies showed a further increase up to October 2010, with additional unfilled positions subject to social security contributions being reported, in particular, in the manufacturing, trade, transport, business-related services and the healthcare sectors. The fact that personnel planning in the industrial sector is currently geared towards expansion is also revealed by the Ifo employment barometer having reached an all-time high recently and the fact that the number of firms intending

Leading indicators extremely positive



to hire new staff in the next 12 months has risen sharply according to the autumn 2010 survey by the German Chamber of Industry and Commerce (DIHK).

Wages and prices

Cyclical strengthening of wage growth foreseeable

Corporate profitability has recovered appreciably in the wake of the robust upswing. The trade unions are therefore stepping up their calls for the workforce to be given an appropriate share of the upswing and are finding widespread support for this view not just among the general public. Employers, too, are now becoming more willing to provide employees with some degree of compensation for the, in some cases, significant earlier losses of income during the crisis. For ex-

ample, a number of enterprises in the metal-working and electrical engineering industries have announced that they will bring forward by two months the 2.7% increase in scheduled rates of pay that was agreed for April 2011; this was envisaged in the current wage agreement from February 2010 in the event of a positive development in the economy. In the steel industry, wage bargainers concluded a new agreement consisting of a one-off payment of €150 for September 2010 and a 3.6% rise in scheduled rates of pay from October 2010. Furthermore, temporary workers employed in the steel industry are to receive the same wages as the regular workforce.

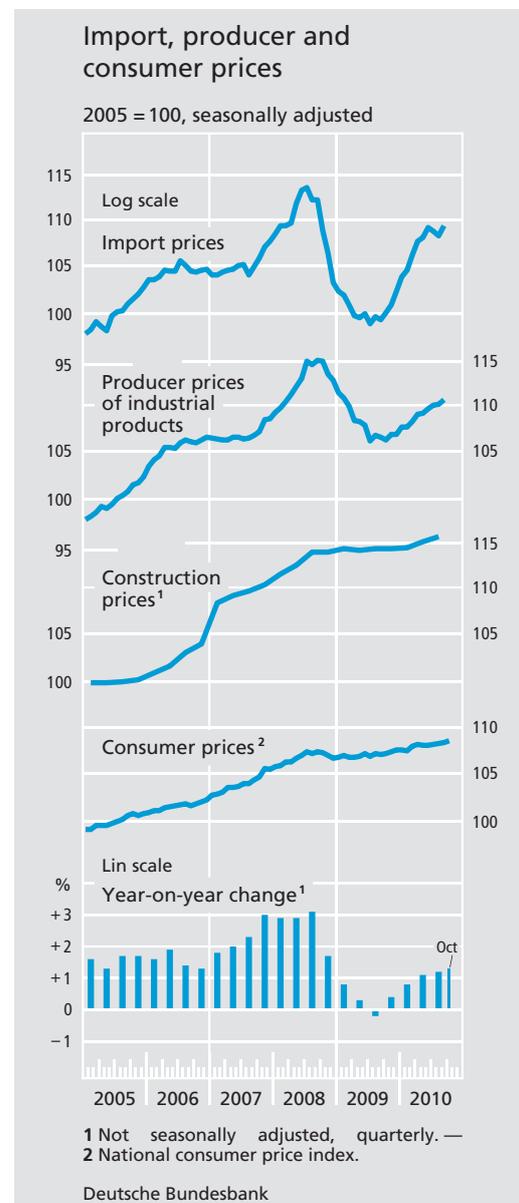
By contrast, the rise in negotiated wages in the third quarter of 2010 was still shaped by wage agreements concluded during the crisis when no or only very moderate increases in scheduled rates of pay were agreed. The Bundesbank's pay rate statistics show that the year-on-year increase in negotiated pay rates, at 1.0%, was even weaker than in the previous quarter (2.1%). The year-on-year increase in the basic negotiated rates of pay, which do not include one-off payments or fringe benefits, went up by 1.4% on the year. The comparable negotiated wage index of the Federal Statistical Office shows a similar increase with a year-on-year change of 1.3% in July. The effective increase in wages is likely to have been much higher given the normalisation in working hours.

Rise in negotiated wages in Q3 but still very moderate

During the summer of 2010, the rise in prices at the upstream stages of the economy lessened noticeably thanks to the euro's appreciation and lower crude oil prices. This is par-

Price rises more moderate at upstream stages of the economy

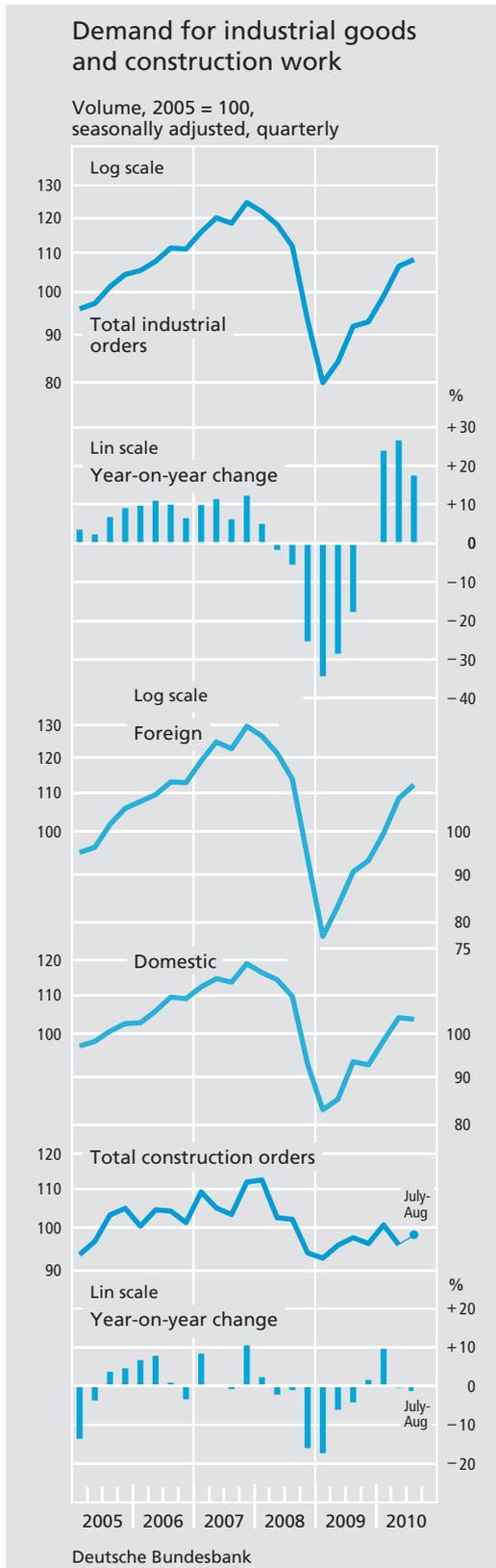
ticularly evident in the case of imports, the prices of which rose by just 0.5% on the quarter in seasonally adjusted terms after increasing by 3.2% in the second quarter. In the case of exports, this moderation was less pronounced (1.8% to 0.7%) owing to the lesser significance of crude oil products. Consequently, there was no further deterioration in the terms of trade. Domestic industrial producer prices rose by 0.9%, compared with +1.3% in the previous period. If the especially volatile component of energy is excluded, the seasonally adjusted rise in the price of imports goes down to 1.0%, and 0.8% in the case of domestic sales. Despite the appreciation of the euro, the prices of intermediate goods went up again significantly in terms of both imports and domestic sales; this is likely to have been due mainly to buoyant global industrial activity, which is also reflected in higher commodity prices. Owing to rising demand in the third quarter, German manufacturers of capital goods were able to increase their domestic prices, too, on a considerable scale again for the first time since the beginning of 2009; they were able to raise their export sale prices as early as the beginning of this year. The food industry increased its sales prices significantly in some cases owing to a rise in input prices and improved sales opportunities. The prices of imported consumer goods continued to rise, albeit at a declining rate. Construction prices rose by a further 0.5% on the quarter owing to the favourable economic situation in this sector, and were up 1.2% on their prior-year level. According to vdp, prices of owner-occupied housing rose 1.4% on the year, compared with +0.7% in the second quarter. This was due to a pick-up



in demand owing to favourable financing conditions. On the whole, there is an emerging picture of a moderate upward trend in prices in the economy as a whole, which is clearly being influenced by the cyclical recovery.

At the consumer level, too, the appreciation of the euro along with lower crude oil prices dampened the rise in prices in the third quar-

*Moderate rise
in consumer
prices*



ter of 2010. Consumer prices went up by just 0.2% on the quarter after adjustment for seasonal variations. This was due to opposing movements in the principal components. Owing to lower prices for petrol and heating oil, energy was somewhat cheaper than in the second quarter. By contrast, food products became more expensive again since agricultural production was hampered by adverse weather conditions in the summer months, too. There was little change in the prices of other goods. However, the prices of services were rising more sharply again for the first time since the end of 2009, which was in line with the economic recovery, but also the result of special factors. Housing rents continued their moderate rise. The year-on-year figure for consumer prices in both the national consumer price index (CPI) and the Harmonised Index of Consumer Prices (HICP) went up by 0.2 percentage point to 1.2%. The rise in the cost of living in October was somewhat more pronounced than in the previous months. The fact that the further appreciation of the euro did not quite keep pace with the sharp rise in crude oil prices probably played a part in this. The annual CPI and HICP rates both stood at 1.3%.

Orders received and outlook

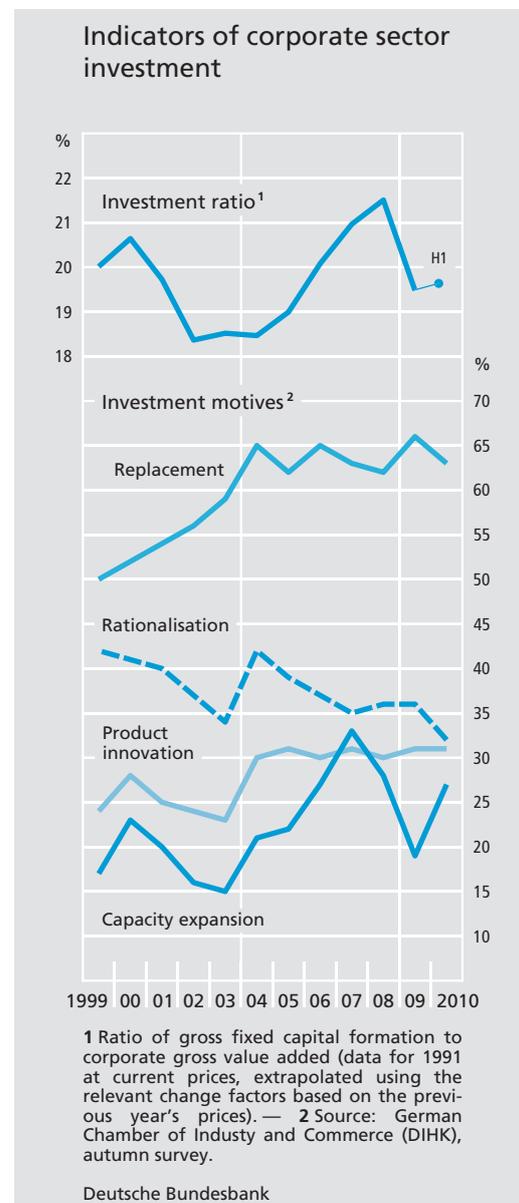
The upturn in the German economy appears to be quite firm at present. This is indicated, not least, by enterprises' very optimistic export expectations. Economic activity is likely not just to be supported by further external stimuli over the next few months, but will also benefit from rising domestic demand.

Firm economic activity on a broad footing

Nonetheless, the pace of overall economic growth will fall well short of the dynamic surge in the spring, which was driven by special factors. On the other hand, the basis for growth is likely to broaden. The positive developments in the labour market, as well as the outlook for growth in earnings, is giving rise to favourable income prospects for households, which will benefit private consumption in particular. The currently very positive financing conditions are giving a considerable push to housing construction. Capacity utilisation is back at its normal level at ever more enterprises, which is making investment in additional equipment more urgent. The German economy should therefore cope with the gradual phasing out of the fiscal stimuli without experiencing any major loss in the underlying pace of economic growth. This is, however, conditional on expectations of global economic developments, in general, and exports, in particular, being fulfilled as these form the basis of the positive labour market situation, favourable income prospects and expansionary investment plans.

Orders received dominated by foreign demand again, but somewhat calmer

The inflow of orders slowed down in most major industrial sectors in the third quarter of 2010 compared with the strong growth recorded in the first half of the year. In seasonally adjusted terms, the quarter-on-quarter increase in new orders went up by no more than 1.7% in total. Demand stimuli came solely from abroad (+3.4%), whereas domestic orders declined slightly (-0.4%). Orders from the euro area were very positive, which was also due to exceptionally strong growth in the manufacture of other transport equipment. Leaving this sector aside, orders from



non-euro-area countries, which have so far proven to be an engine of growth, were still increasing more strongly than orders from the euro area. On the whole, demand from foreign customers during the reporting period continued to be focused on both intermediate goods and capital goods. By contrast, there was a perceptible decline in domestic customers' demand for inputs and intermediary products. Instead, they stepped up their

orders of equipment, mainly machinery, but also electrical equipment and motor vehicles.

Rise in enterprises' propensity to invest

Investment activity is likely to pick up towards the end of the year, not least owing to anticipatory effects in connection with the discontinuation of the improved tax depreciation rules for moveable fixed assets. However, enterprises' fixed asset formation will not be influenced solely by this temporary special factor. According to the Ifo surveys, industrial enterprises' business expectations for the next six months are at an unchanging high level. Furthermore, the latest survey by the German Chamber of Industry and Commerce (DIHK), which covers a broader range of enterprises, is reporting a further marked improvement in business expectations. It is, first and foremost, those enterprises whose production capacities are already operating at normal capacity again that are increasingly thinking of stocking up on input factors. This is also suggested by the fact that the DIHK indicators of investment intentions and employment plans moved virtually in parallel into expansionary territory.

Pick-up in housing construction

Public sector construction orders are likely to have passed their peak now that the financial resources made available in the economic stimulus packages are being disbursed. The construction sector will, however, benefit from a pick-up in housing construction in the

coming months. Taking the average of July and August, around one-fifth more new housing projects were approved in seasonally adjusted terms than on an average of the previous one and a half years. This was not just the case for single-family and two-family houses; the number of projected new apartments soared at the end of the period under review following extremely subdued demand in this segment over a number of years. Given the exceptionally low interest rates and the lack of lucrative investment opportunities elsewhere, it would appear that investors, too, are once again taking a greater interest in the German housing market.

In view of the marked economic recovery, consumers are thoroughly optimistic at present. According to the surveys of the consumer research institution, *Gesellschaft für Konsumforschung* (GfK), consumer sentiment and the propensity to purchase are holding up at a high level. Given increasing employment as well as the reversal of the cuts in working hours and of the short-time working arrangements that were undertaken during the crisis, households' income is rising perceptibly. The prospect of larger wage increases is additionally improving income prospects. The foundation is therefore in place for a further marked rise in private consumption.

Optimistic consumers