

Economic conditions in Germany

Underlying trends

Germany's cyclical upturn continued at a brisk pace after the middle of the year. According to initial calculations by the Federal Statistical Office, overall output, which had already been at a high level in the second quarter after data revisions, grew by 0.6% in the third quarter in seasonal and calendar-adjusted terms. Output was 2.8% up on the corresponding figure last year after adjustment for the varying number of working days.

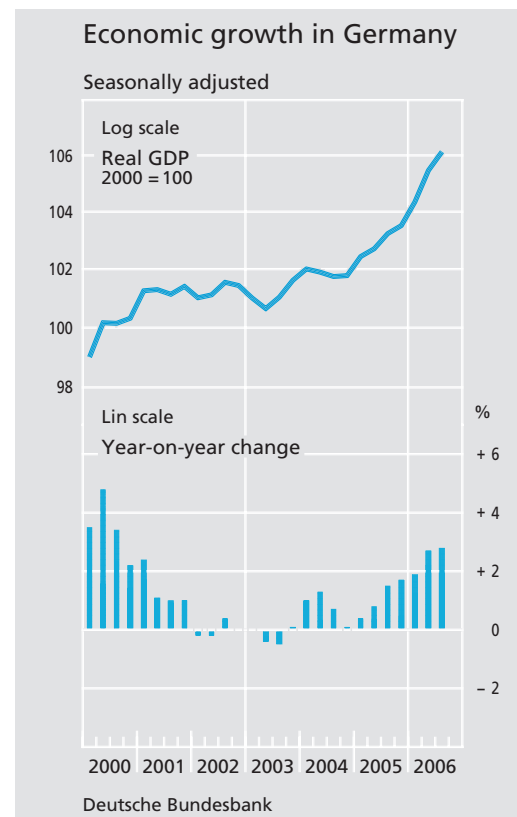
*Brisk growth
again in Q3*

Economic growth thus slowed somewhat compared with the second quarter, when GDP had increased by just over 1% according to the latest revised figures – in part owing to favourable exceptional factors. Adjusted for the catch-up effects in construction activity, which had been greatly hampered by adverse weather conditions at the beginning of the year, and for the temporary surge in demand in connection with the FIFA World Cup, however, the underlying cyclical momentum remained fairly steady during the first three quarters of the current year. Anticipatory effects in connection with the rise in VAT at the beginning of next year have probably played only a minor role up to now. Calculated from the fourth quarter of 2005, the annualised rate of overall economic growth amounts to approximately 3½%. This means that Germany is also providing considerable impulses to the euro area as a whole, especially as the German economy's demand profile is now looking far more balanced. Furthermore, the labour market, too, is now benefiting increasingly from the strengthening of business ac-

tivity. Both the hard indicators and the results of the Ifo business survey (see box on pages 40 and 41) suggest a continuation of the positive underlying trend in the coming months. It should also be noted that in many areas of the handicraft sector – which contains many small and relatively labour-intensive companies – a clear turnaround in sentiment has emerged and the enterprises operating in this sector are increasingly reporting that they are hiring more staff.

Rise in domestic demand

Even though – as is often the case – important disaggregated information is still missing for the third quarter, there is still much to suggest that the growth in domestic output was attributable to domestic as well as foreign demand. For example, investment during the period under review was up on the second-quarter level. Given the growing level of capacity utilisation, plant expansion measures are likely to have assumed a more prominent role in the rising expenditure trend for machinery and equipment. This is borne out primarily by the high level of both confidence and capacity utilisation in industry. Construction investment also rose significantly in the third quarter, albeit to a somewhat lesser extent than in the second quarter, when weather-induced catch-up effects were exerting a significant impact. The quite high level of investment seen so far this year indicates that it has now become a second mainstay of economic activity alongside foreign trade. By contrast, private consumption still showed no clear-cut picture. Modest sales figures recorded by conventional retail trade outlets in the period from July to September contrasted with growth in the sales of motor vehicles and



motorcycles. If the favourable trend in the purchases of services are included, real household consumption is likely to have increased during the reporting period.

Exports imparted renewed positive stimuli in the third quarter of 2006 after they had slowed to a somewhat more subdued pace in the second quarter. Although cross-border service income was down sharply on the previous quarter, which had benefited substantially from the higher revenue from tourism during the FIFA World Cup (see box on page 43), exports of goods expanded strongly again. In terms of value, seasonally adjusted goods exports were 5% up on the previous period. There was a particularly sharp rise in exports of intermediate goods in July and August, up to when disaggregated sectoral fig-

Buoyant foreign trade

How robust is the empirical relationship between the Ifo business climate indicator and overall economic activity?

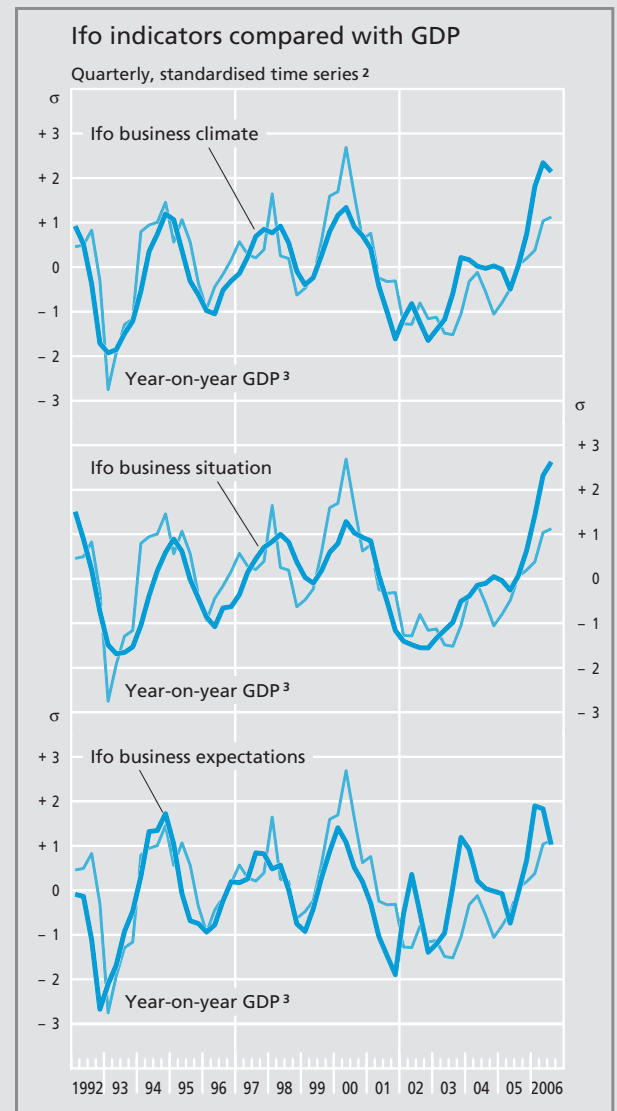
Since the second quarter of this year, the Ifo Institute's closely observed business climate index has maintained a level that was last reached during the reunification boom in the early 1990s. Whether or not this finding suggests a continued strong upturn of the German economy depends on whether the empirical relationship between the Ifo business climate and overall economic activity can be regarded as sufficiently robust. This has recently been called into question on occasion. Sustained by its expectations component, the Ifo business climate, for example, showed a sharp upswing during the winter term 2001/2002 and in the year 2003. However, since the economy's recovery at that time was moderate at most, these were later interpreted as "expectation bubbles". Recently, the indicator again appeared to have overshoot the economic reality at first, until the summer and autumn revisions of the national accounts showed a clearly more favourable picture of past cyclical developments.

The year-on-year growth rate of calendar-adjusted real gross domestic product (GDP) is used as the reference variable for the survey balances from industry and trade considered here. Besides the overall index, which is referred to as the "business climate", its two components "business situation" and "business expectations" are also included in the study. The seasonally adjusted data that are available on a monthly basis are aggregated to quarterly series. The period under review covers the time from the first quarter of 1992 to the third quarter of 2006.

The adjacent chart shows the time series of the Ifo survey indicators along with the year-on-year change in GDP in a standardised format. In particular up to 2001, the business climate index as well as the individual indicators show a very high degree of cyclical co-movement with the annual percentage change of real GDP. This synchronicity is by no means inevitable since statements made by enterprises concerning their business climate presumably do not relate only to production activity but are generally more broadly based. It should also be noted that industry and trade generate only about one-third of total value added.

A study of the cross-correlations points to the conclusion that the overall index fluctuates coincidentally with the year-on-year change in GDP.¹ The same applies to the

1 The capacity of the Ifo business climate index to be a leading indicator is therefore based not so much on a statistical lead property, but rather on its early availability. — 2 Mean-adjusted and normalised to a standard deviation (σ). — 3 Real, calendar-adjusted. — 4 This causality



assessments of the business situation, whereas the business expectations component – in accordance with its design – runs somewhat ahead of the reference variable. In the period as a whole, the maximum correlation between the year-on-year change in GDP and each indicator is about $\frac{3}{4}$, considering a lead of one quarter in the case of business expectations.

concept based on predictive properties was first presented in C W J Granger (1969), Investigating Causal Relations by Econometric Models and Cross-Spectral Methods, *Econometrica* 37, 3, pp 424-438. — 5 The statistics of the test for empirical Granger non-causality are asymp-

In order to answer the question whether the empirical relationship between the survey indicators and overall economic activity is robust, it is also necessary to analyse the time pattern of correlation. As can be seen in the adjacent chart, the contemporaneous correlation between business climate and the year-on-year change in GDP – based on rolling samples of a constant length of 40 quarters – has fallen by about one-tenth since 2002. In the light of the statistical margins of uncertainty which accompany the correlation estimation, this decline, by itself, is not unusual, but it is interesting when compared with the correlation time patterns of the components. While the corresponding results for the business situation are largely constant and always remain within the margin of uncertainty of the correlation estimations for the overall business climate, there is a marked decline in the case of business expectations. Starting from a level of over 0.7 in 2002, the rolling correlation estimator has shown a value of only just over 0.5 since 2005. This means that the co-movement between business expectations and the year-on-year change in GDP has been significantly reduced over the past few years owing to the phenomenon of temporary expectation outliers as discussed above. However, for the overall index, this also means that the slight decline in synchronicity with the reference series which can be observed for the business climate can be solely attributed to the decreasing correlation of the expectation component.

The evidence of a significant correlation does not necessarily imply that the indicator has predictive ability for the reference variable. Provided that this property is econometrically specified as Granger causality, it can be tested empirically.⁴ The tests for Granger non-causality are carried out individually for each indicator in three bivariate vector autoregressions, which contain the year-on-year change in GDP as an additional variable. As can be seen from the table, the null hypothesis can be clearly rejected both for the business climate and for the individual indicators over the entire period. It follows that each one of these survey balances provides information that is meaningful for short-term projections of overall economic activity.

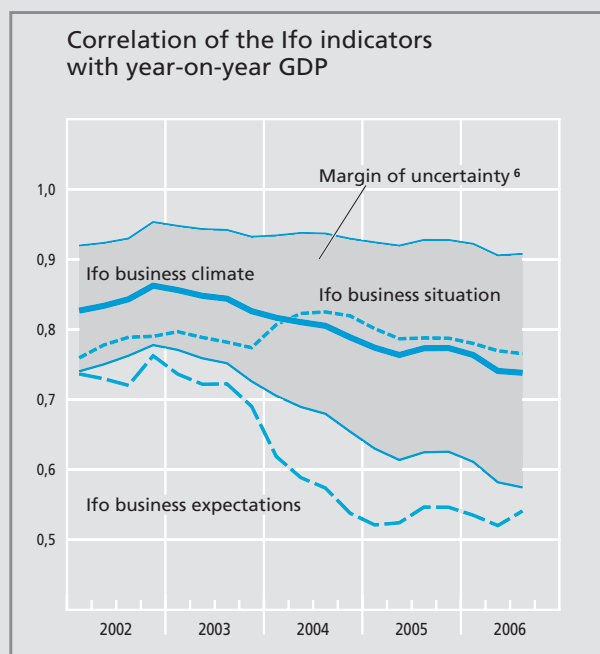
The Ifo Institute's business climate index thus still shows a statistically verifiable close relationship with the general cyclical development, which can be used for making pre-

totically χ^2 -distributed; see, for example, H Lütkepohl (2005), *New Introduction to Multiple Time Series Analysis*, chapter 3.6.1. In the cases at hand, the number of the degrees of freedom is equal to the specified lag order of the underlying vector autoregression, which is determined

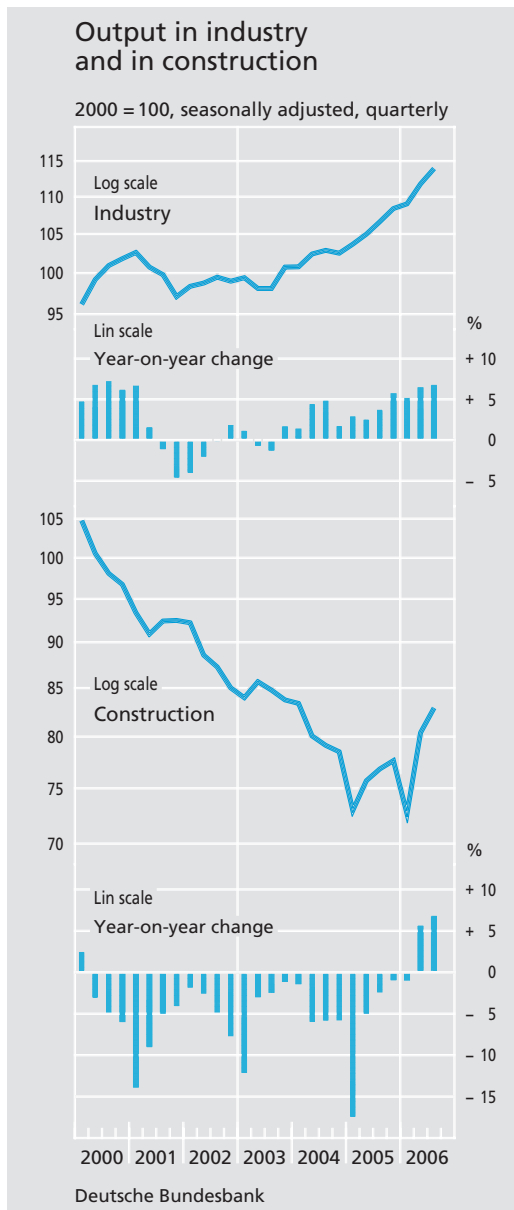
Granger causality analysis ⁵

Indicator	Lag order	Test statistic
Business climate	5	17.7**
Business situation	5	18.4**
Business expectations	6	20.0**

dictive statements. In order to obtain robust assessments it is advisable to take a comprehensive view, which also includes "hard" indicators, encompassing not only the overall index but also its two components. The sharp increase in the business climate at the current end is supported not merely by optimistic expectations but especially by extremely positive ratings of firms' current business situation. In view of the continued quite high correlation with overall economic activity, which is documented for the indicator of the business situation, the survey results of the Ifo Institute thus provide further evidence of the favourable macroeconomic situation of the German economy.



on the basis of Akaike's information criterion. — ** Indicates the rejection of the null hypothesis at the 1% level. — ± 1 standard error of the rolling correlation estimator for the Ifo business climate index.



ures are available. Exporters of chemical products, in particular, as well as exporters of metals and metal products recorded high sales figures abroad. Exports of consumer goods likewise expanded sharply. Capital goods producers were also able to step up their exports. This was accompanied by a significant rise in imports. At 4¾%, however, the rise in imports did not quite match that of exports. Imports of intermediate and capital

goods grew particularly strongly. On balance, however, foreign trade made a significant contribution to overall economic growth in the third quarter.

Output and sales

At the sectoral level, industry continued to be the main driver of macroeconomic growth in the third quarter, just as it had been in the second quarter. Output went up by 2% in seasonally and calendar-adjusted terms compared with the second quarter, the figures for which were revised significantly upwards by the Federal Statistical Office. The degree of capacity utilisation also increased. According to the Ifo Institute, utilisation in September was 3¾ percentage points up on the year and 2¾ percentage points greater than the medium-term average. Investment in capacity extensions is therefore likely to become even more significant.

Continued major stimuli from industry

Manufacturers of intermediate goods recorded further sizeable increases in production. For example, manufacturers of machines used to generate and distribute electricity recorded perceptible increases. The chemicals industry also recorded a growth in output following a lull in the first half of the year. Output in the manufacture of basic metals did not grow as strongly in the third quarter as in the previous quarter. Suppliers of capital goods recorded sizeable growth in output in the third quarter. This was particularly the case for orders of machinery and equipment. There was also significant growth in the production of computers and other information

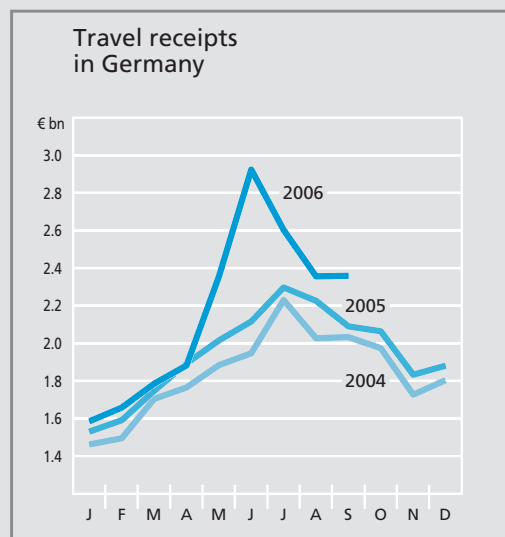
The World Cup effect on travel receipts in Germany

Germany's expenditure on cross-border travel usually considerably exceeds the corresponding receipts. While there is a huge demand from German consumers for holidays abroad, there is noticeably less demand from foreign tourists for holidays in Germany. In 2005, German residents spent €58½ billion on private and business travel, whereas only €23½ billion worth of revenue was generated from cross-border travel. In previous years, too, the balance on German travel was in deep deficit.

In the second and third quarters of 2006, however, the FIFA World Cup in Germany had a positive effect on travel receipts. They were boosted, in particular, by spending on overnight stays and consumption by visitors to the World Cup in Germany from abroad, including purchases of tickets for the individual football matches and expenditure on journeys within Germany.¹ According to provisional data, the overall effect of the 2006 World Cup on Germany's revenue from travel, which was essentially spread between May and July, totalled just under €1½ billion.² Two-thirds of this amount came from EU countries and one-third from the rest of the world, with the percentage of revenue from some non-European countries (such as Ghana, Trinidad and Tobago, and Togo) – which do not generally play a part in tourism in Germany – rising exceptionally sharply.

As early as May (the World Cup itself began on 9 June and ended on 9 July) there was a year-on-year increase in revenue, albeit a small one.

¹ The additional revenue raised by domestic airlines from flying World Cup visitors into and out of Germany, which was considerable, has to be added to the World Cup effect on travel receipts described here. However, this must be offset against the fact that FIFA headquarters in Switzerland is entitled to part of the revenue from ticket sales and that German television companies, as well as German firms which advertised at or with the World Cup, had to pay licence fees to FIFA. These payments are booked not under the travel account, but under other sub-balances of the services



Among other things, this can be attributed to the fact that some teams of the participating football associations, including staff and relatives as well as the players themselves, travelled to Germany relatively early on. Around half of the additional revenue was raised in June, the month in which most of the matches were played. In total, the World Cup effect contributed just under ¼ percentage point to GDP growth in the second quarter.

In July, travel receipts rose only slightly on the year. They had no significant effect on GDP in the third quarter. The relatively small increases in July can be attributed mainly to the fact that only a few games were played that month. In addition, day trips, which are generally less costly, were a major factor, since the teams involved in the semi-finals and the final were all European.

account. — ² For more information on how the Bundesbank processes data on the collection of revenue from travel, see Deutsche Bundesbank, "Capturing foreign travel in the balance of payments statistics from January 2001", Monthly Report, March 2003, pp 60-61. When assessing the World Cup effect, information on the distribution of tickets to the participating football associations was also taken into account. The final data on travel receipts in 2006 will be published in March 2007.

Foreign trade by category of goods

Percentage change

Item	Average of July–Aug 2006 compared with			
	Q2 2006; seasonally adjusted		July–Aug 2005; unadjusted figures	
	Exports	Imports	Exports	Imports
Total	+ 2.7	+ 3.5	+ 11.4	+ 15.9
Selected main categories				
Intermediate goods	+ 4.5	+ 5.9	+ 16.1	+ 22.0
Capital goods	+ 0.9	+ 5.3	+ 7.6	+ 14.8
Consumer goods	+ 3.0	- 0.1	+ 12.8	+ 5.8
Energy	.	- 1.5	.	+ 28.0
Selected categories				
Chemicals	+ 5.9	+ 1.3	+ 15.6	+ 9.6
Machinery	+ 6.3	+ 4.1	+ 11.7	+ 15.9
Motor vehicles and motor vehicle parts	+ 1.4	+ 2.5	+ 7.1	+ 10.5
Information tech- nology	+ 1.6	+ 4.3	+ 2.9	+ 5.1
Metals and metal products	+ 7.7	+ 9.2	+ 27.6	+ 40.0

Deutsche Bundesbank

processing equipment compared with the prior period. Manufacturers of consumer durables, in particular, recorded a marked expansion of output after having already registered strong growth rates in the second quarter. By contrast, the output of non-durable goods remained virtually unchanged.

The recovery in the construction sector continued in the third quarter following the strong weather-induced catch-up effects in the previous quarter, with net output growth in this sector amounting to 3% on the quarter. The corresponding year-on-year figure was a marked increase of 6¾%. Substantial increases were achieved in the construction of buildings, in particular.

*Recovery in
construction
sector
continues*

Commercial service providers are likely to have made a further contribution to the buoyant dynamics of industrial activity. Although the enterprises questioned as part of the Ifo business survey assessed their commercial situation in the third quarter somewhat less favourably than in the second quarter, on balance, the positive assessments considerably outweighed the negative assessments. Furthermore, the indicator in October showed a further boost in sentiment compared with September. In line with the favourable momentum in industry, the transport sector is also likely to have performed strongly. In the third quarter, the hotel and catering industry recorded a slight increase on the already high result of the second quarter when it had substantially benefited from the FIFA World Cup.

*Largely positive
situation for
service
providers*

Real turnover in the retail trade sector remained unchanged in the third quarter after adjustment for seasonal fluctuations and variations in the number of working days after increasing by ½% in the period from April to June. While there was a slight increase in the sales of furniture and furnishings, home improvement materials and other consumer durables, there was a sharp decline in the turnover of textiles. Retail sales of motor vehicles were up perceptibly on the second quarter in terms of volume, which is likely to be partly related to forestalling the pending rise in VAT. The course of development in the wholesale trade was also somewhat more favourable in the third quarter.

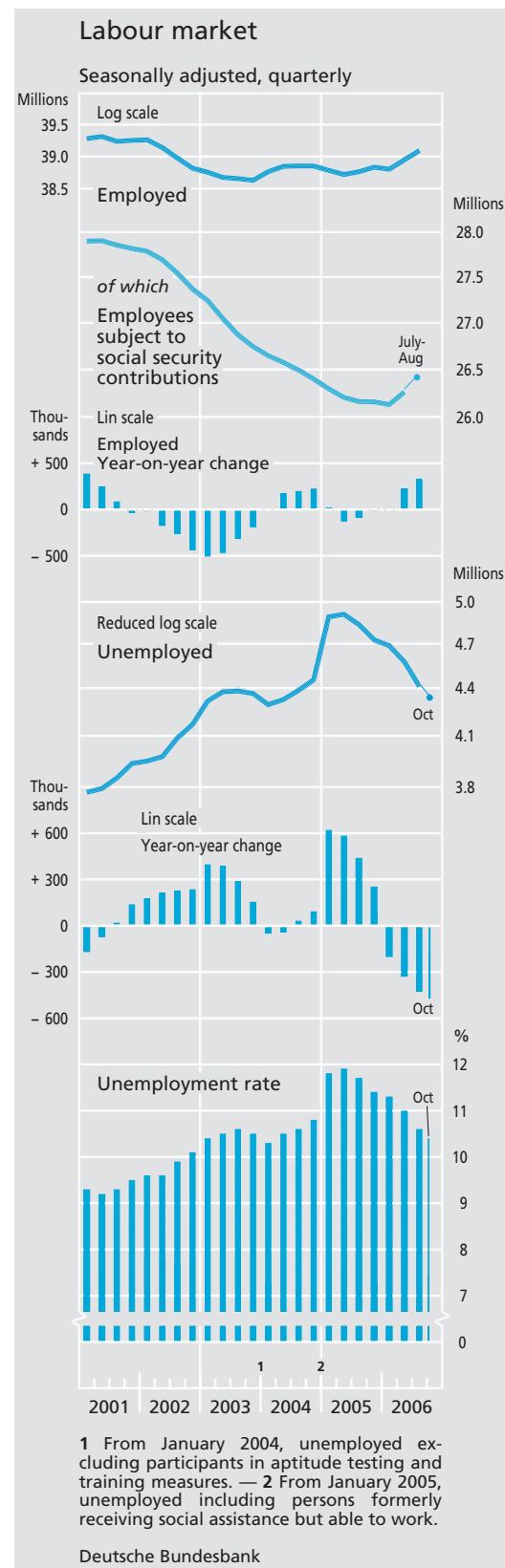
*Mixed picture
in trade*

Employment and unemployment

*Labour market
buoyed by
economic
upturn*

The cyclical revival of the labour market continued in the third quarter of 2006. The number of persons in employment rose by 150,000 or 0.4% to a seasonally adjusted 39.14 million. The year-on-year increase is now at 0.9% or 340,000 persons. A similarly sharp rise was last recorded at the beginning of 2001 as the "new economy" boom was tailing off. This latest increase concerned employees subject to social security contributions. According to estimates made by the Federal Employment Agency, their number in the July-August period was a seasonally adjusted 0.5% higher than the second-quarter average. Reports from the social security schemes suggest that this positive trend has continued.

Developments in the number of job vacancies reported also suggests an improved labour market situation. The year-on-year increase in the number of job vacancies has now gone up by a third to a seasonally adjusted 600,000. By contrast, the stagnation in the number of self-employed persons was due not least to the amendment of the government promotion policy in this segment which came into effect in August. At the same time, the promotion of paid employment picked up significantly following the end of the summer holidays. Some 315,000 persons were employed in workfare placements (one-euro jobs) at the end of the reporting period. One particularly striking feature is the growing importance of reintegration grants, which have doubled in number compared with the low level recorded at the beginning of the year.



*Further
decline in
unemployment*

The seasonally adjusted number of persons officially registered as unemployed fell by 165,000 in the third quarter to 4.43 million. This is approximately 430,000 fewer than during the same period of last year. The seasonally adjusted unemployment rate (as defined by the Federal Employment Agency) went down from 11.0% in the second quarter to 10.6% and by 1.1 percentage points over twelve months. Whereas the decline was previously due, first and foremost, to the labour market structural reforms, it is now primarily attributable to an increase in demand for labour. The decline in unemployment continued in October. The seasonally adjusted month-on-month decrease amounted to 67,000 persons, while the unemployment rate went down to 10.4%.

Wages and prices

Wage policy

Only a few new collective wage agreements were concluded in the third quarter. In the steel industry in the north-west of Germany, management and trade unions agreed to increase wages by 3.8% as of 1 January 2007. Furthermore, the new collective agreement provides for substantial one-off payments, which are to be disbursed before the end of this year. In addition, agreements were reached with regard to the employment of older workers. The previous labour agreement expired in August 2006, which means that the new agreement will run for 17 months before expiring in January 2008. The relatively high overall volume of the wage agreement reflects the particular situation of the industry, which is benefiting from the strong inter-

national demand for steel products. By contrast, the negotiations regarding the company-wide labour agreement for Volkswagen were focused on reducing labour costs with the aim of ensuring the future viability of production sites. The most significant aspect of the new labour agreement is the new working time corridor. Instead of the previous 28.8-hour fixed working week, the new agreement allows the employer to deploy employees between 25 and 33 hours per week, depending on company requirements, for the same fixed monthly salary. As compensation for the increased number of working hours, and instead of awarding general wage increases for 2006 and 2007, it was agreed that a one-off payment of €1,000 shall be paid out in November 2006. In addition, employees have been given the option of either taking a further one-off payment of €5,000 in cash or having €6,300 credited to their company pension plan. Other conditions of the new company labour agreement include the coupling of future monthly wage adjustments to those in the metalworking industry in Lower Saxony, a virtual promise of no compulsory redundancies and an extension of the validity of the new agreement to the end of 2011.

On an average of all sectors, the monthly negotiated rates of pay in the third quarter of 2006 were 0.5% up on the year. This increase was smaller than in the previous quarter, a fact which is primarily attributable to exceptional factors. For example, it was agreed that employees of public sector banks would not receive any holiday pay in July 2006. Flat-rate overtime payments were also abolished. In July 2006, employees working for central and

*Aggregate level
of negotiated
wages*

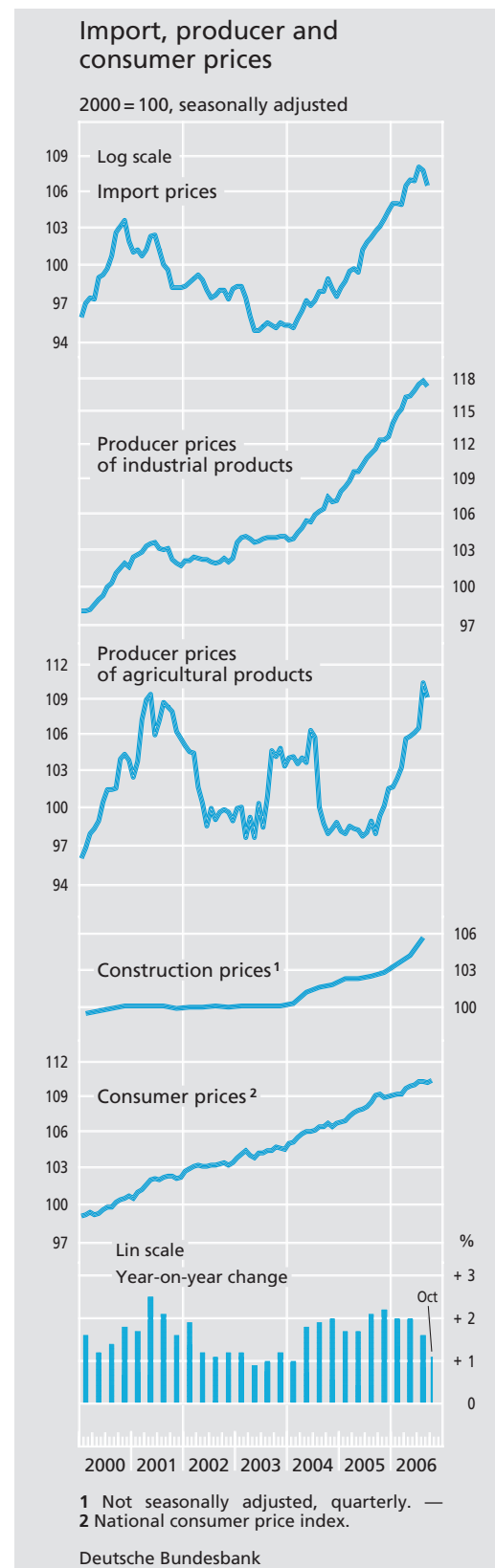
local government likewise received no holiday pay for the first time. On the whole, the moderate growth in wage costs in the German economy thus continued, although the general trend towards shortening the duration of wage agreements should be seen as a warning signal from an anti-inflation perspective.

Decelerating price increases for imports ...

The external upward pressure on prices weakened somewhat in the third quarter. Seasonally adjusted import prices rose by 0.7% in the third quarter of 2006, compared with 1.7% in the previous quarter, and the year-on-year increase went down from 6.7% to 5.2%. This was due primarily to the decline in energy prices, whereas the rising price trend for other raw materials continued. Excluding energy, seasonally adjusted import prices were up almost 1% on the quarter; the year-on-year increase widened from 2.5% to 3.3%. This was due to further sharp price increases for agricultural and forestry products as well as for industrial intermediate goods. By contrast, the prices of consumer goods rose less sharply, and the decline in prices for capital goods even accelerated.

... and at domestic producer level

At the domestic producer level, too, price pressures on industrial products weakened considerably in the third quarter. The seasonally adjusted price level of goods intended for domestic sale went up by 0.9% in the third quarter, compared with 1.7% in the second quarter. The year-on-year increase fell from 6.1% to 5.7%. This was also due primarily to the sharp decline in energy prices. Excluding energy, the seasonally adjusted price increase of +0.8% was almost as high as in the previous quarter, while the year-on-year increase



widened from 2.2% to 3.0%. As in the case of imports, the rise in the price of intermediate goods, at almost 6%, was particularly sharp. However, the upward price thrust on domestically produced capital and consumer goods has likewise intensified of late.

Weather-induced increase of agricultural producer prices

Owing to the unusual weather conditions during the course of 2006 so far, agricultural producer prices have been rising sharply ever since the beginning of the year. The farm-gate price of potatoes doubled in the space of twelve months; the price of cereals went up by more than 15% and the price of both fruit and vegetables rose by just under 30%. The price of animal products at the producer level was 5% up on the year.

Cost and demand-induced price rises in construction

The increase in construction prices intensified again in the third quarter. The year-on-year increase widened from 1.9% in the second quarter to 3.1%. Such a sharp rise in prices has not been recorded since 1993. This upward trend is apparent in all areas of construction and in almost all individual construction services. This was particularly marked in the case of road construction where the year-on-year rate of increase stood at 5%. The increase in the cost of intermediate goods owing to the rise in oil prices as well as the general upturn in construction activity are likely to have contributed to this. Construction prices of residential buildings were 2.7% up on the year in the third quarter of 2006. Here, too, there was a sharp rise in prices for virtually all individual construction services, which, given the moderate wage developments in the construction sector, cannot be attributed solely to rising costs.

The recent lower oil prices also shaped consumer price developments in the third quarter. Thus, fuel became cheaper, while there was a sharp slowing of the rise in the price of heating oil. But excluding energy, the consumer price index in the third quarter, at 0.5%, increased more sharply than in the second quarter (+0.3%). Food products, in particular, recorded further price increases as a result of the sharp rise in agricultural producer prices. Consumers had to pay an average of almost 13% more for vegetables (including potatoes) than during the same period last year. The corresponding figure for fruit was over 4%. The price of meat and fish rose by 2%. The cost of services also went up somewhat faster of late. Price developments for goods (excluding energy), on the other hand, were somewhat more favourable. Increases in housing rents, at just over 1%, remained moderate on average. On the whole, consumer prices were 1.6% up on the year in the third quarter. The corresponding figure in the second quarter was 2.0%.

Slower rise in consumer prices

Seasonally adjusted price pressure intensified again somewhat in October, even though fuel and heating oil prices declined and food products became somewhat cheaper again. This was due to two main reasons. First, there was a price increase for tobacco products ahead of the forthcoming rise in VAT, which contributed around 0.1 percentage point to the overall rate. Second, package holidays were unusually expensive in October and the prices of industrial products (excluding energy and tobacco) rose sharply. Anticipatory effects of the rise in VAT may also have played a role in this. The year-on-year increase in

both the national consumer price index and the Harmonised Index of Consumer Prices (HICP) widened from 1.0% to 1.1%.

Orders received and outlook

Dynamic demand for industrial goods

The level of industrial orders received maintained a markedly positive trend in the third quarter. For the period from July to September, orders received were 3¾% up on the second quarter after adjustment for seasonal and calendar effects. This was considerably more than in the second quarter when orders rose by 2¾%. The year-on-year increase remained virtually unchanged at 10½%. This was primarily attributable to a number of large orders in the shipbuilding industry. Even excluding the manufacture of other transport equipment, orders received still showed a sharp rise in demand of 2¼%.

The growth stimuli came in equal measures from both domestic and foreign demand, with foreign demand being generated exclusively by non-euro-area countries. By contrast, there was a decline in orders received from euro-area countries. Producers of capital goods, who had booked few new orders in the second quarter, made a very notable contribution to the increase in demand in the third quarter. The computers and electrical equipment sectors were the principal beneficiaries of this. Demand for machinery also remained very buoyant. Growth in intermediate goods, on the other hand, was more subdued. Manufacturers of consumer goods recorded marked growth in export business only, whereas domestic demand was weak.



*Further pick-up
in demand for
construction
work*

Construction orders in the two-month period of July and August – official data beyond this period are not available – were 1% up on the second quarter. Growth was therefore distinctly weaker than in the second quarter, when demand had been heavily influenced by catch-up effects following the winter months. In this respect, the recent developments in the construction industry are fully consistent with the picture of an ongoing gradual upswing in this sector. This is borne out, firstly, by the favourable level of investment, which is being increasingly influenced by capacity extensions and the associated commercial construction orders. Secondly, exceptional factors, such as the abolition of the grant to homebuyers at the end of last year, which led to an increase in housing construction orders, are also likely to have played a role. Much the same applies, to a certain extent, to the increase in VAT, which may have triggered private individuals, in particular, to bring their construction orders forward. This appears to have had an even greater impact on the order situation in the finishing trades.

*Service
providers and
retail trade
more subdued*

Business prospects in the services sector were assessed less favourably in the third quarter than in the second quarter. According to the Ifo Institute's survey, commercial service providers, in particular, did not rate their outlook in the third quarter quite as optimistically as before. Business prospects in the trade sector in the coming months are likely to be influenced by the effects of the rise in VAT. This could especially be the case for motor vehicles and other consumer durables. So far, however, advanced purchases have been rather limited in this area. Nevertheless, con-

sumers' general propensity to purchase has increased again and income prospects have also improved. The extent to which all of these factors actually stimulate demand is likely to depend to some extent on the durability of the recent oil price cuts, which have boosted the scope for expenditure in other areas. This would also act as a counterbalance to the hampering effect of the increase in VAT. In particular, the improved situation in the labour market can provide a solid basis for a gradual revival of consumer demand.

In view of the fact that industrial activity is still buoyant and many commercial service providers are enjoying a more stable outlook, the underlying cyclical trend in Germany is likely to remain on an upward course. Owing to its improved competitiveness, the German economy will continue to benefit substantially from global economic growth. Furthermore, as a result of the increased investment in capacity extensions in the machinery and equipment sector and in construction, domestic demand has now become a second mainstay of overall economic activity. This is particularly true now that the decline in the construction sector that has persisted over a decade appears to have come to an end and a discernible improvement has emerged in the employment situation. However, there is still no sign of a broadly based upswing in consumption. Given the favourable employment trend, there is cause to hope that – despite the increase in VAT that will come into effect in January 2007 – the conditions are now largely in place for a widespread recovery process.

*Economic
outlook positive
overall*