

Economic conditions in Germany

Underlying trends

The cyclical upturn in the German economy continued at the start of 2007. According to initial calculations by the Federal Statistical Office, overall economic output went up by 0.5% in seasonally and calendar-adjusted terms in the first quarter. There was a 3.6% rise on the year.

*Favourable start
to the year*

Economic growth was therefore somewhat slower than the rapid pace of growth in the second half of 2006. Given the anticipatory effects in connection with the VAT increase alone, this was, however, to be expected. In terms of the overall outcome, the shortfalls in consumption demand which occurred after the turn of 2006-07 were, however, offset by the fact that the exceptionally mild weather had a positive impact on construction activity. Owing to a number of special factors, it will not be possible to make a more accurate assessment of the current underlying pace of growth until additional output and expenditure data become available. The current underlying trend can, however, already be identified to a certain extent by combining the final quarter of 2006 and the first quarter of the current year. Calculated in this way, German GDP in these six months of 2006-07 was up by an annualised 3.3% on the second and third quarters of 2006.

Investment expenditure is likely to have continued to be the main driving force behind Germany's economic growth after the turn of the year, too. Although data on the structure of aggregate demand are not yet available, the available indicators do point to this. The

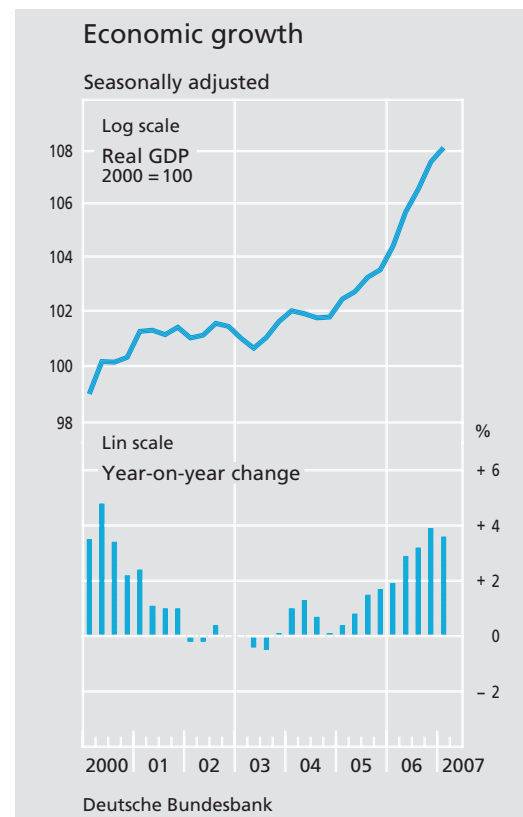
*Buoyant invest-
ment activity*

sentiment indicators, in particular, suggest a large degree of optimism in the corporate sector. Given the further increase in utilisation, motives for investment are likely to have shifted more in favour of expanding capacity. This is also suggested by survey data as well as the buoyant demand for industrial construction. Furthermore, public construction investment is likely to have been stepped up given the backdrop of sharply rising tax revenues. A further supporting factor is that enterprises may have built up their inventories considerably again in the winter months of 2007 following a sharp reduction during the last few months of 2006 due to the surge in demand. This is also consistent with the fairly sharp rise in imports in the first quarter of this year. By contrast, export growth slowed down, although various special statistical factors played a major part in this. Nevertheless, in the final quarter of 2006 and in the first quarter of 2007 as a whole, foreign trade along with investment remained the mainstays of economic growth in Germany.

Output and sales

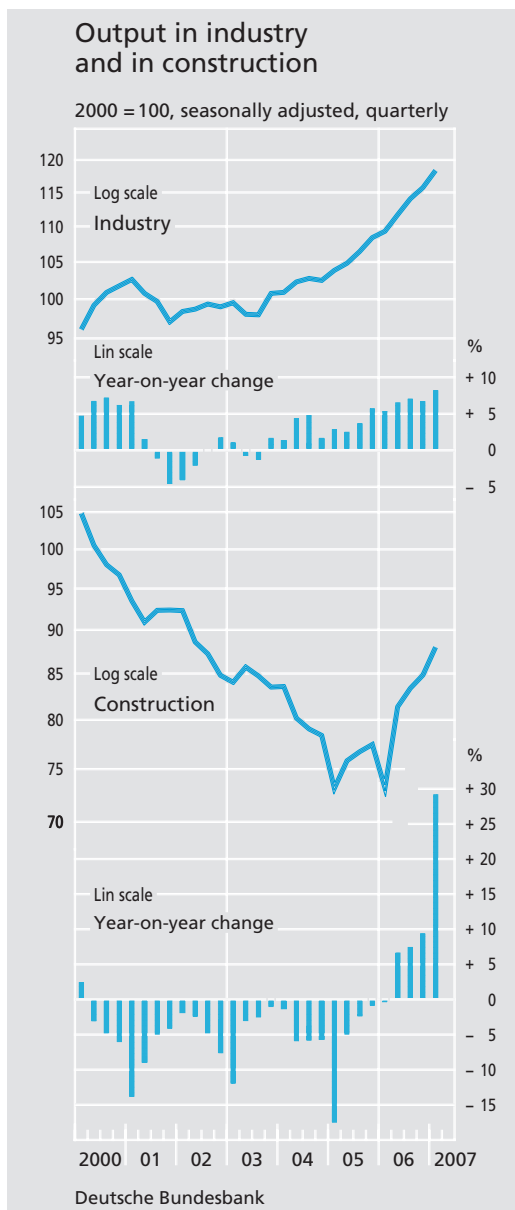
Buoyant industrial output

Industry got off to a good start in 2007. Output in the first quarter of 2007 was 2¼% up on the final quarter of 2006 after adjustment for seasonal and working-day variations. It therefore matched the brisk pace of growth in the second and third quarters of 2006 after the growth rate had slowed down to 1½% in the fourth quarter. At the same time, according to the Ifo surveys, there was a further rise in capacity utilisation. In March 2007, capacity utilisation was 3 percentage points up



on the year, with a particularly marked increase in utilisation in the capital goods sector. This is a reflection of the current favourable situation in this sector, although signs of capacity shortages are also emerging in certain areas.

The current robustness of industrial activity is reflected, in particular, by higher-than-average growth, at 3¾%, in the production of capital goods, which was essentially sustained by the mechanical engineering sector. Manufacturers of motor vehicles, trailers and semi-trailers also increased their output sharply after recording a decline in the previous quarter. Producers of intermediate goods also achieved a sharp rise (2¾%) with the manufacture of basic metals making a major contribution. Manufacturers of rubber and plastics



likewise recorded a sharp rise in output, whereas production in the chemical industry remained at a high level.

The bulk of German industrial output is still intended for export. The seasonally adjusted value of German exports of goods in the first quarter of 2007 was only slightly (½%) below the level of the previous quarter when there had been a very sharp increase.¹ German ex-

ports of mechanical engineering products and, in particular, motor industry exports, which had recorded no more than a comparatively slight increase in the final quarter of 2006, were still developing at an above-average level, however – possibly due to the fact that preference was being given to supplying the domestic market owing to the forthcoming VAT increase.

According to the data on the regional structure of German exports in the first two months of this year, there was a marked increase in exports to euro-area partner countries. German exports to Poland, the Czech Republic and Hungary also rose sharply. By contrast, there was a marked decline in exports to countries outside the European Union, the level of which had been positively influenced by late reports in the fourth quarter of 2006.

In the first three months of the year, nominal imports rose more sharply than the value of exports. Seasonally adjusted growth was 1¼% up on the fourth quarter. Foreign manufacturers of intermediate goods were the main beneficiaries of the perceptible rise in domestic industrial output. Imports of consumer goods also increased considerably. Given the decline in retail turnover, the replenishment of the reduced inventory levels

¹ In addition to late reports in the final quarter of 2006, this was also partly attributable to a methodological change in the compilation of data (movements of goods and services with regard to repair and maintenance work are no longer included in special trade), which means that, since January 2007, somewhat lower exports and imports have been recorded than in 2006. However, this effect is of no significance for the more broadly defined trade in goods in the system of national accounts.

Foreign trade characterised by high level of exports and stronger imports

may have played a part in this. Fewer capital goods were imported, however. This was due primarily to the fact that purchases of foreign motor vehicles and motor vehicle parts, which had increased as a result of anticipatory effects in connection with the VAT increase, went down perceptibly after the turn of the year. By contrast, foreign manufacturers of mechanical engineering products maintained the value of their exports to Germany. Although there was a decline in sales of imported information and communications technology (ICT) products, they were up in price-adjusted terms. Furthermore, there was a significant drop in the value of energy imports. This decline was, however, largely due to the temporary lower cost of imported energy sources.

All in all, manufacturers outside the euro area benefited more substantially from buoyant German imports than manufacturers in the euro-area partner countries. Goods from China were particularly in demand. Enterprises in Japan and the emerging market economies of South-East Asia also recorded substantial growth in sales in Germany. By contrast, imports of goods from the USA declined. There was also a decrease in the value of imports from the Russian Federation, which was due to the fall in energy prices.

Positive situation for service providers

The situation for commercial service providers has also improved as a result of the favourable developments in industry. According to the Ifo business survey, the situation of these enterprises was assessed somewhat more cautiously during the winter months, although this was due solely to the temporary

Foreign trade by category of goods

Item	Percentage change			
	Average of Jan–Feb 2007 1 compared with			
	2006 Q4 2; seasonally adjusted		Jan–Feb 2006; unadjusted figures	
	Exports	Imports	Exports	Imports
Total	–0.2	2.2	12.1	10.2
Main categories				
Intermediate goods	–1.1	7.5	16.2	24.1
Capital goods	–0.8	–3.0	10.2	7.6
Consumer goods	–0.3	5.5	11.3	11.1
Energy	.	–4.9	.	–17.1
Selected categories				
Chemicals	–1.1	4.3	13.8	13.3
Machinery	0.4	0.0	14.2	15.2
Motor vehicles and motor vehicle parts	5.9	–2.1	12.1	11.2
Information technology	–4.0	–0.5	3.1	0.4
Metals and metal products	–0.4	5.3	28.2	45.4

1 From January 2007, excluding supplies of goods for/after repair/maintenance. — 2 Exports positively influenced by late reports.

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deterioration in sentiment in January and February, which is to be seen in connection with the increase in VAT. In March and April, the trend was clearly on an upward course again. There was a decline in the Purchasing Managers' Index in this area only in February, but it was revised upwards again in March and April. The quarterly average was well up on the value of the final quarter of 2006.

The analysis of traditional retail sales (excluding cars) is currently being made more difficult by the fact that revisions have been made owing to newly opened retail enterprises being added to the statistical reporting population, which retroactively affects the figures going back to January 2006, at which point there is now a statistical break in the time series. According to current data, real

Trade sector influenced by special effects; uncertain database

sales in the first quarter of 2007 were perceptibly down on the final quarter of 2006. This is undoubtedly closely connected with the VAT increase at the beginning of last year, given the anticipatory effects that had occurred especially towards the end of last year. This is also supported by the fact that enterprises specialising primarily in furniture, kitchen equipment and construction materials recorded a drop in sales. The decline in sales in the first quarter of the year more than offset the increase in the final quarter of 2006, which, despite the anticipatory effects, was rather subdued. On an average of the first quarter of 2007, seasonally adjusted sales were at their lowest level since the statistical break in January 2006. Sales of motor vehicles in the first few months of the current year were also heavily influenced by the dampening effects of the VAT increase. In total, registrations of new passenger cars were 25% down on the quarter in seasonally adjusted terms. This was primarily attributable to a decline in the number of new registrations by households, which had shown a sharp rise towards the end of last year.

Employment and unemployment

Labour market benefits from cyclical upturn

The situation in the labour market continued to improve at a rapid pace during the first few months of 2007 in the wake of the cyclical upturn. Employment rose once again, and unemployment showed a marked fall. The mild weather conditions also played a part in this favourable development. The number of persons in employment in the first quarter of 2007 rose by a total of 175,000, or

0.4%, to a seasonally adjusted 39.45 million. The year-on-year increase went up to around 570,000, or 1.5%, primarily in the form of employment subject to social security contributions. In particular, enterprises in the labour leasing sector, which accounted for just under half of the growth, stepped up their recruitment of new employees. Preliminary estimates by the Federal Employment Agency indicate that other forms of employment, such as low-paid part-time employment (mini jobs), activities in connection with job creation measures and employment opportunities (one-euro jobs) as well as assisted self-employment have become less significant. Data on short-time working are not yet available for the first quarter. This form of employment is, however, likely to have increased again somewhat temporarily owing to the introduction of seasonal short-time working benefits in the construction sector. This is suggested in any event by the data for December 2006, according to which almost 30,000 more persons were receiving benefits than in November.

There was a further perceptible decline in the official unemployment figure in the first quarter. At a seasonally adjusted 3.91 million, there were 287,000 fewer persons registered as unemployed than in the final quarter of 2006. The year-on-year decline widened to 820,000 persons. At 9.4%, the seasonally adjusted unemployment rate was 0.6 percentage point down on the quarter. Within the space of a year, the unemployment rate had gone down by a substantial 2.1 percentage points.

Further decline in unemployment, ...

... cyclical
impulses
probably
overstated

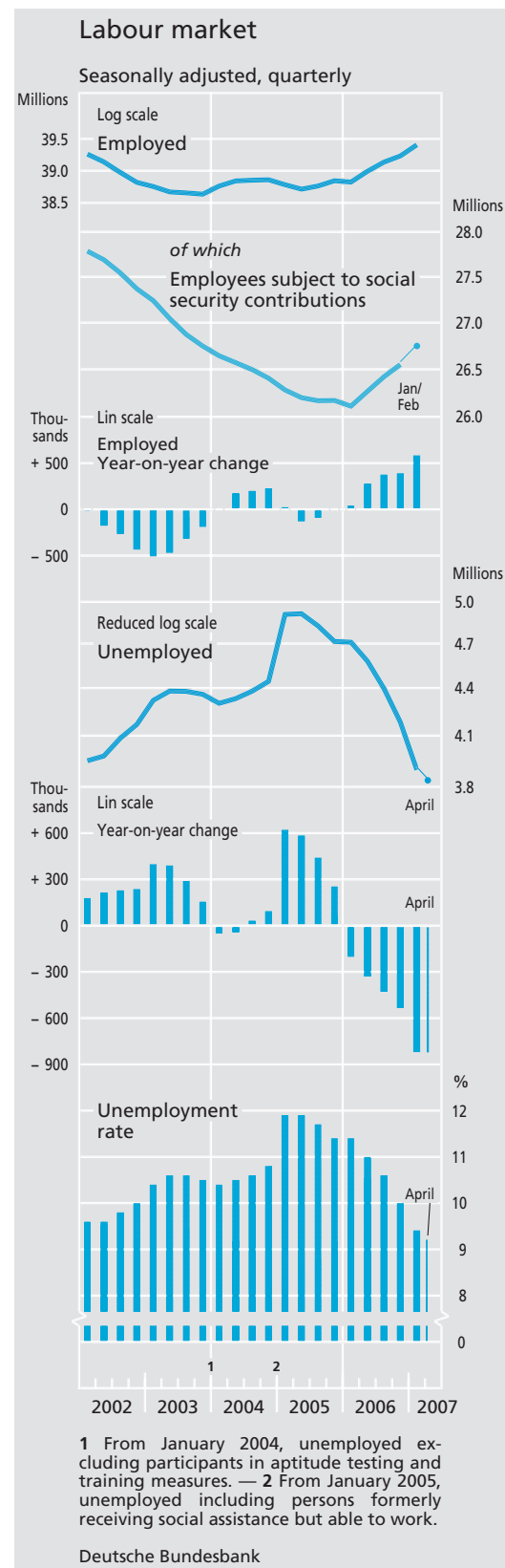
However, the decline in unemployment in the first quarter of 2007 is likely to have overstated the cyclical influence and the medium-term trend somewhat. Both the favourable weather conditions and the introduction of seasonal short-time working benefits are likely to have had a certain mitigating effect. The pick-up in the labour market in the second quarter could therefore be somewhat weaker than usual. At all events, there was barely any further decline in seasonally adjusted unemployment in April and the unemployment rate remained virtually unchanged on the month at 9.2%. It is also important to remember that, for demographic reasons, the labour supply is currently decreasing, which means that the fall in unemployment appears to be greater than the increase in employment. This is also due in part to the fact that the Federal Employment Agency is continuing to adjust the unemployment statistics.

Wages and prices

Wage agree-
ments in major
economic
sectors

The 2007 pay round began in March with wage agreements in the chemical and construction industries. The metal-working and electrical engineering industries followed in May.

Firstly, the negotiating partners in the chemical industry agreed on an increase in basic salaries of 3.6% starting from the second month of the term of the agreement, which runs for a period of 14 months. A flat-rate payment of €70 will be made in the first month, and a supplementary 0.7% of a month's salary for each of the remaining



months of the contract. In the construction industry, the negotiating partners agreed on a 12-month pay settlement with no increase in the first month followed by a 3.1% increase in the standard monthly remuneration. Additionally, monthly one-off payments of 0.4% of a single month's salary are to be made. Owing to the objections of some regional employers' federations to the outcome of the negotiations, however, a conciliation process has now been initiated. Moreover, the pay agreement in the construction sector, which has not yet been accepted, does not affect the existing minimum wage agreement, which is still valid until the end of August 2008 and which provides for an increase in wages and salaries of 1% as of 1 July 2007. The special payments negotiated in the chemical and construction industries can be modified or completely cancelled at individual firm level by alternative agreements.

Pay in the metal-working and electrical engineering industries is to be increased by 4.1% as of June 2007. This is to be followed by a further increase of 1.7% in June 2008. A one-off payment of €400 has been agreed for the first two months of the wage agreement, and one-off payments of 0.7% of a month's salary for the final five months. The scheduled increases and special payments from June 2008 may be deferred by up to four months at the individual firm level.

The wage agreements in the major industrial sectors are a reflection of the cyclical improvement in the trade union's bargaining position resulting from above-average capacity utilisation and ample reserves of orders.

It is also a question of giving employees a fair share of the reward for the enterprises' economic success, which has become possible not least owing to the wage restraint of the past few years. Pay agreements in the craft trades were much more moderate than in industry. A negotiated wage increase of 2.5% was agreed in the motor vehicle trade of the Federal State of North-Rhine Westphalia as well as a one-off payment of €50 for the first month of the 12-month wage agreement. In the electrician's trade, agreement on a 2.4% wage increase was also reached in North-Rhine Westphalia (effective as of 1 February 2007) after 34 months without a pay rise. Wages are to be increased by a further 2.2% one year later. Similar agreements were also reached in other wage-bargaining areas.

According to the Deutsche Bundesbank's pay rate statistics, negotiated rates of pay in the first quarter of 2007 were 0.8% up on the year, compared with +1.8% in the final quarter of 2006. The latter figure was primarily attributable to the one-off flat-rate payment for Volkswagen employees to compensate for the increase in weekly working hours. Furthermore, there were one-off payments in the chemical industry and in the metal working industry in the first quarter of 2006, which were not repeated on this scale. Excluding one-off payments, negotiated rates of pay went up by 1.2% in the first quarter of the 2007, compared with 1.6% in the final quarter of 2006, when public sector banks paid a Christmas bonus which compensated for the lack of holiday pay.

Negotiated wages and salaries in the economy as a whole

Reduced pressure on import prices due to the cost of oil, ...

Seasonally adjusted import prices went down by 0.6% in the first quarter owing to a further sharp downward revision of crude oil prices at the beginning of this year. The year-on-year rate of inflation showed a further fall to 0.8%. Even excluding energy, inflation slowed down significantly and the year-on-year increase went down to 2.1%. The marked price reductions for capital goods were accompanied by price increases for intermediate goods. Prices of consumer goods also accelerated.

... but greater industrial producer price inflation

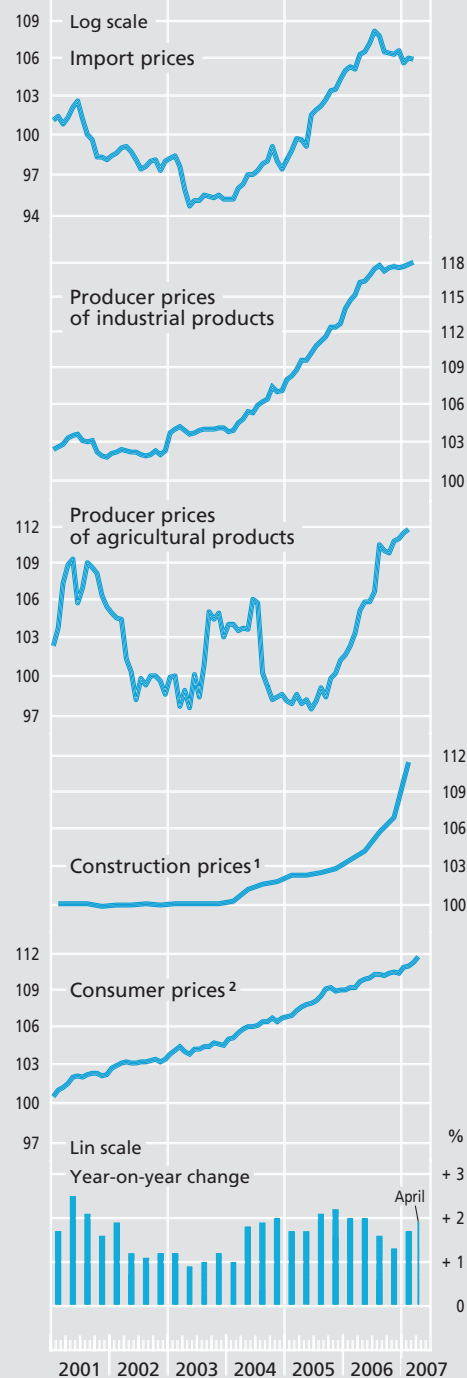
By contrast, prices of German goods intended for domestic use, at a seasonally adjusted +0.3%, went up somewhat more sharply than in the previous quarter. The year-on-year figure did, however, go down to 2.9%. Excluding energy, producer price rises, at 0.5%, were somewhat weaker than in the final quarter of 2006; the year-on-year rate remained unchanged at 3.0%. This was due primarily to the fact that price rises for imports of intermediate goods were passed on. By comparison, price rises for capital goods and consumer goods were quite moderate. Nevertheless, the corresponding year-on-year figures widened to 1.1% and 1.7% respectively. At +2.3%, industrial export prices rose somewhat less sharply than domestic sales prices. The improvement in the terms of trade continued as a result of the reduced pressure on import prices. Price inflation in the case of domestic industrial products weakened in April owing to lower energy prices.

Agricultural producer prices still high

There was no easing of agricultural producer prices despite the mild winter weather. On an average of January and February, prices

Import, producer and consumer prices

2000 = 100, seasonally adjusted



1 Not seasonally adjusted, quarterly. —
2 National consumer price index.

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showed a further rise and the year-on-year rate of increase persisted at nearly 10%. This was due to a 25% price increase for vegetable products. At the producer level, the price of grain was 43% up on the year, and potatoes were up by as much as 121%.

Sharp rise in construction prices

Following the continuous rise in the cost of construction services over the past few years, prices went up by no less than 4.3% in the first quarter of 2007, and the year-on-year rate of increase widened to 7.7%. There were price rises on this scale in virtually all subsectors of construction. This surge in construction prices is attributable to the VAT increase on 1 January 2007 and the sharply increased prices of intermediate goods. Added to this was an exceptionally high level of utilisation of machinery and equipment. Construction industry capacity has been run down in recent years, which means that the increasing recovery in demand for construction work is now encountering a scarcer supply. Furthermore, labour cost pressure, which has been moderate up to now, is likely to intensify somewhat against the backdrop of the recent wage agreement. A rise in construction prices, especially in residential construction, is usually also reflected – with a certain time lag – in the prices of older buildings and housing rents. Nevertheless, the fact that land prices are virtually unchanged is continuing to have a dampening effect.

Sharp rise in consumer prices

In the first three months of this year, the rise in consumer prices, at a seasonally adjusted 0.6%, was distinctly sharper than in the preceding months. The year-on-year increase in the national consumer price index (CPI) went

up from 1.3% in the fourth quarter of 2006 to 1.7% in the first quarter of 2007. This corresponding figure for the Harmonised Index of Consumer Prices (HICP) was 1.9%, compared with 1.3% at the end of 2006.

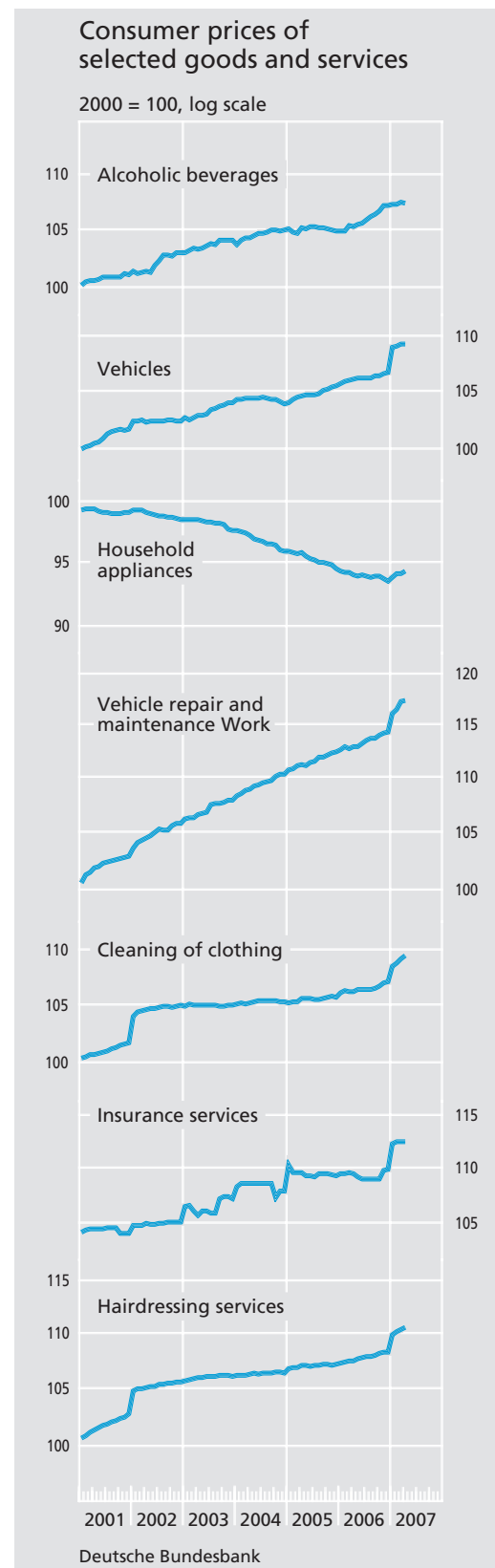
One reason for the sharp rise in prices, despite the fact that crude oil cost less on average, was that consumer energy prices rose by 2.3% on the quarter and 2.4% on the year. This was due chiefly to the increase in the standard rate of VAT from 16% to 19%, which took effect on 1 January 2007. The higher level of VAT also had a clear impact on the other components (for more information, see the initial results of a macro data analysis on pages 52-53). The cost of industrial goods (excluding energy and tobacco products) increased by a seasonally adjusted 0.5% in the first quarter of 2007, and the year-on-year figure went up from 0.6% to 1.4%. The effect of VAT on prices in the first quarter of 2007 was particularly marked in the case of motor vehicles; the year-on-year rate of price increase widened from 1.1% to 3.0%. There was an interruption in the downward price trend for household appliances. The cost of services (excluding housing rents) increased by a seasonally adjusted 0.8% on the quarter. The corresponding year-on-year rate doubled to 2%, a part in this also being played by the increase in insurance tax from 16% to 19%. As a consequence, insurance premiums were up by an average of 2.6% on the year. Significant VAT effects were apparent in the prices of hairdressing and motor vehicle repairs, for example.

Perceptible VAT effect

In assessing the overall impact of the VAT increase, there arises the problem that price adjustments are made for other reasons as well at the same time. Therefore, the “normal” price rise excluding VAT has to be deducted from the overall price increase. In the case of the two subcomponents of goods (excluding energy and tobacco) and services (excluding housing rents), it may largely be assumed that the price trend excluding VAT would have been much the same as in the previous two years. In the absence of more detailed information, it would appear reasonable to assume that, in the case of energy, the VAT increase was passed on in full. According to this calculation, the higher rate of VAT contributed around 0.6 percentage point to the quarter-on-quarter rate of increase in the national consumer price index (CPI) and just under 0.8 percentage point to the HICP increase.² This increase came on top of advance price adjustments last year, such as the increase in tobacco prices of just under 5% in October. There were also indications of accelerated price adjustments in the case of other goods, such as cosmetics and clothing. If these anticipatory effects are added to the price effects in the first quarter of 2007, the overall contribution of the higher rate of VAT to the year-on-year CPI increase is roughly 1 percentage point.³ The figure is likely to be somewhat higher for the HICP. The price effect of the VAT increase was thus considerable, but smaller than the mathematical ef-

² Given that owner-occupied housing is not included in the HICP, housing rents, which are not subject to VAT, are given a lower weighting.

³ This confirms the initial preliminary assessment made in February. See Deutsche Bundesbank, Economic conditions in Germany, Monthly Report, February 2007, pp 39-55.



Price effects of the recent increase in VAT – initial results of an individual price analysis

With effect from 1 January 2007, the standard rates of VAT and insurance tax were increased by 3 percentage points. Initial studies based on the regularly published aggregated price indices have shown that the tax increases have obvious price effects.¹ In the past, the analysis of individual data from the price statistics has permitted major additional insights into price developments. The Bundesbank, which began the analysis of individual prices in cooperation with the Federal Statistical Office along with the euro cash changeover², and subsequently extended this in the Eurosystem Inflation Persistence Network³, is now continuing this process for the analysis of the effects of the recent VAT increase. The Bundesbank is being assisted in this by the Federal Statistical Office and the statistical offices of the federal states. For this special study, 50 products – including 25 goods and 15 services which are subject to the standard rate of VAT – were selected from the total of 750 items which make up the German consumer price index basket. The dataset, which begins in March 2000 and is to be continued until March 2008, incorporates just over 14,000 of the total of roughly 350,000 price observations which are collected for the consumer price index every month.

One major result of the individual price studies hitherto is that, apart from exceptions such as fruit and vegetables as well as fuels and heating oils, prices tend to change rarely. A previous, more or less representative product selection showed that the average frequency of price adjustments was around 11% per month. If fruit and vegetables as well as fuel and heating oil are excluded, the average frequency was just half of this figure. Some of this was also due to special offers, ie temporary price reductions.

The current study focuses on products which are rarely subject to price adjustments. This should make any price effect of the VAT increase easier to identify. Unlike the previous study, the present study cannot, therefore, be seen as representative of the entire consumer price index. The results are, however, likely to be typical for the relevant subgroups, ie “goods excluding energy and unprocessed foods” as well as “services excluding rents and travel and holiday services”.

¹ See also Deutsche Bundesbank, Economic conditions in Germany, Monthly Report, February 2007, pp 40-56 as well as comments on pp 52 ff of this Monthly Report. — ² See Deutsche Bundesbank, The euro and prices two years on, Monthly Report, January 2004, pp 15-27.

One reason for less frequent price revisions, besides the extremely moderate rate of inflation in Germany in recent years, is that price changes entail costs. This results in prices being adjusted quite rarely but sharply when an adjustment is made. The average extent of price adjustments, at roughly 9%, was notably higher than the average annual inflation rate and significantly higher than the average monthly increase in prices.

It was to be expected that the increase in the standard rate of VAT from 16% to 19% on 1 January would lead to a concentration of price changes, as had been the case for the VAT increase in April 1998, although this was much smaller at 1 percentage point, and for the introduction of euro banknotes and coins in January 2002. While the conversion of prices from D-Mark to euro was prescribed by law and the costs of price changes were, therefore, unavoidable, this was not the case with the increase in VAT. Hence, the costs of price changes prevented a complete and precise adjustment of all the individual prices. Nevertheless, the VAT increase could have had a very significant effect on the price index as the usual scale of the individual price increases up to that point was much larger than the pure VAT effect of 2.6% for products taxed at the full rate (less possible relief through reduced social security contributions). In the case of the euro cash changeover, the virtually inevitable costs of price changes temporarily reduced the average scale of the price adjustments. Furthermore, not only were there increased upward price adjustments but also downward adjustments, which meant that the effect on the price index overall was limited.

It might initially be assumed that the VAT increase would have been a reason for enterprises to highlight the need for price increases in January 2007. If that had been the case, however, a large number of price adjustments in the range of 2½% to 3% would have been observed. Larger price adjustments would not be justifiable using this argument. Such considerations would, above all, play a role in the services sector, where personal customer relations are important. By contrast, in the wholesale and retail trade, price-strategic considerations could have temporarily obscured the VAT effect. These took the form, say, of announcements by discount chains that they would

On the studies by the Federal Statistical Office, see I Beuerlein, Fünf Jahre nach der Euro-Bargeldeinführung – War der Euro wirklich ein Teuro?, Wirtschaft und Statistik, February 2007, pp 208-211 — ³ See Deutsche Bundesbank, Price-setting behaviour in Germany, Monthly Report,

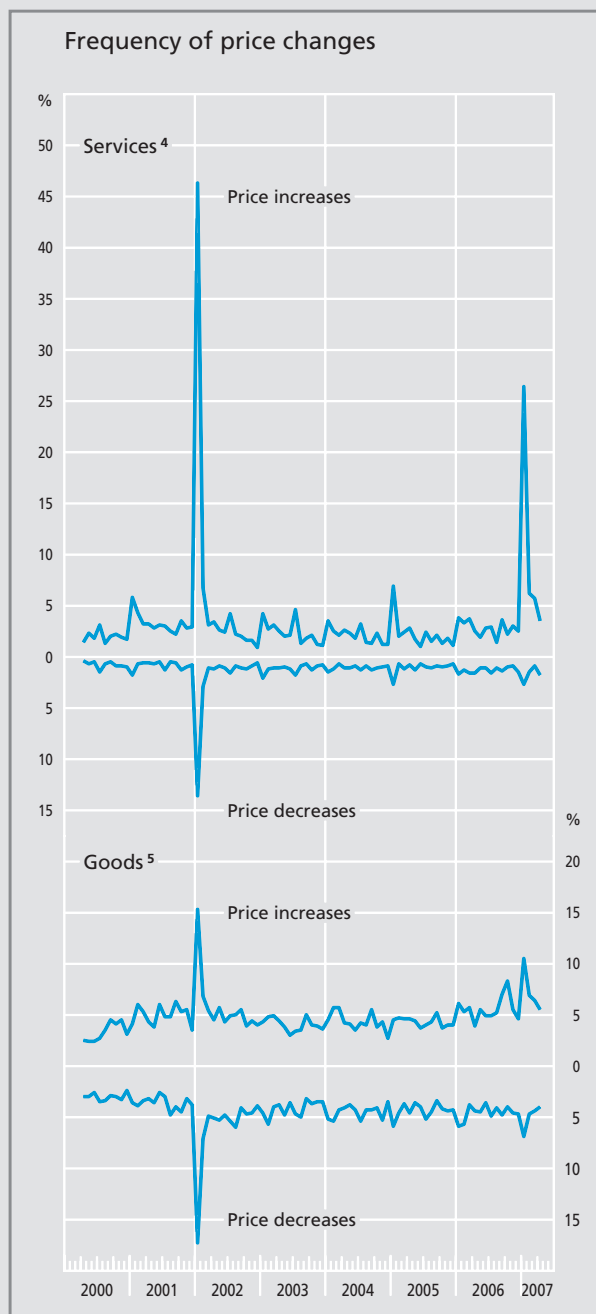
not be increasing prices for an unspecified period of time before and after the VAT increase. Accordingly, a separate analysis for services and for commercial goods would seem appropriate.

In the case of services which are subject to the standard rate of VAT, there were significantly more price adjustments in the first four months of the year than is normally the case. Of these, the overwhelming majority were upward adjustments. The VAT effect was strongest in January 2007, when more than 25% of prices were increased. However, the number of price increases in the three subsequent months was also higher than average. Price corrections in January, at around 6½% on average, were somewhat below the average of the observation period. These included quite a large number of price adjustments of 2% to 3%. Other price adjustments, however, were much larger. Surprisingly, a considerable number of price cuts acted as a certain counterweight to the large number of price increases. The quite obvious overall effect of the VAT increase on the subindex for services was, therefore, the result of more frequent price increases which were significantly larger on average than the price impulse directly attributable to the increase in VAT.

In the case of goods which are on sale in retail outlets and department stores, the picture is more complex. In this case, too, more prices were adjusted upwards in January 2007 than is typical for the time of year. However, the effect was less marked than it was for services. Price reductions were more frequent than in previous years but the extent of the adjustments barely deviated from the medium-term average. There were also clear indications of an increase in the frequency of upward price adjustments during 2006. This points to anticipatory price corrections. In the case of goods too, the palpable overall VAT effect was the result of more frequent and scarcely weaker price increases.

Overall, the individual data analysis shows that the increase in VAT which came into effect on 1 January 2007 had a significant influence on price formation in Germany. One particularly striking feature is the differing timings of the price responses of goods and of services.

December 2005, pp 15-28 as well as J Hoffman and J-R Kurz-Kim, Consumer price adjustment under the microscope: Germany in a period of low inflation, Deutsche Bundesbank Research Centre, Discussion paper,



Series 1, Economic studies, No 16/2006. — 4 Individual prices from the consumer price statistics. Average over 15 services. — 5 Individual prices from the consumer price statistics. Average over 25 goods.

fect of a direct full pass-through of 1.4 percentage points to the CPI and 1.6 percentage points to the HICP. Two factors need to be taken into consideration in this context. One is that a reduction in social security contributions in January 2007 provided relief to enterprises. The other is that it may be assumed that there will be further lagged VAT-induced price adjustments in the course of 2007.

New tuition fees

In April 2007, seasonally adjusted consumer prices rose quite sharply at 0.4%. In addition to higher prices for fuel (+3.4%) and heating oil (+4.8%) stemming from the markets for crude oil and refined petroleum products, this was essentially due to the introduction of tuition fees in a number of federal states. Consequently, the education sub-index, which has a weighting of 6.66% in the consumer price index, rose by 25.1% on the month. Excluding the new tuition fees, the overall price increase would have been just under 0.2 percentage point smaller. There was a 0.2% increase for other services. Food prices also rose significantly, which was due to weather-related factors. The cost of goods went up slightly. This was offset to a certain extent by substantial downward price adjustments for gas (-3.4%). The national consumer price index and the HICP rose by 1.9% and 2.0% on the year respectively. Assuming that no unexpected factors come into play in the case of crude oil prices and the euro exchange rate, similarly high rates may be anticipated in the coming months. Owing to the sharp rises in the price of energy last year, there could be a decline in inflation rates in the third quarter before an opposite base effect comes into effect in the fourth quarter.

Orders received and outlook

From a demand-side perspective, the outlook for continued economic growth is looking promising. This is suggested at all events by the indicators for orders. Strong new impulses were generated by industrial orders. New orders in the first quarter of the year were a seasonally adjusted 2½% up on the end of 2006. The year-on-year increase went up to 13¾%, which was due mainly to a number of large orders in March. Demand, after easing slightly in the fourth quarter, therefore matched the high level of the second and third quarters of 2006.

Very positive development in industrial orders

Export orders again grew very sharply in the first quarter, and were 5% up on the average of the period from October to December. There was a perceptibly higher intake of new orders in the capital goods sector, in particular. It was notably manufacturers of machinery and equipment that continued to benefit from the strong world economy and foreign business in large-scale plant engineering.

Furthermore, there was an exceptionally sharp rise in the number of new orders placed with manufacturers of machines used to generate and distribute electricity. Both this sector and the mechanical engineering sector benefited from large export orders in March. Stimuli were also generated by domestic investment. There was quite a sharp rise in new orders placed with manufacturers of motor vehicles and motor vehicle parts. The growth stimuli came in equal measure from both domestic and foreign demand. It would appear that the greater economic momentum has al-

ready more than offset the decline in demand brought about by the increase in VAT. Owing to buoyant new business, the overall order situation in German industry has held up at a remarkably high level. This is consistent with the expectations in trade and industry which, according to the Ifo Institute, have picked up sharply again in the first four months of this year following the dip in sentiment in the second half of 2006.

Buoyant demand for construction work

Demand for construction work also picked up distinctly after the turn of the year. In the two-month period of January and February – more recent official data are unavailable – construction orders were 8½% up on the average of the fourth quarter of 2006. It should be noted, however, that the cyclical trend was overstated as a result of the exceptionally mild weather conditions during the winter months, since experience has shown that this has an impact not only on output but also on orders. Both public authorities and trade and industry placed considerably more constructions orders. By contrast, demand for housing construction was 2¼% down on the fourth-quarter level. This is to be seen against the backdrop of the dampening effects of the VAT increase.

More favourable expectations for service providers

Service providers, too, are now rating their business prospects more favourably than before. According to the Ifo business survey, the subindicator for business expectations in the services sector in any event showed a marked rise in the first quarter. As thought at the time, the deterioration in the final quarter of 2006 was only temporary and was the result of a certain amount of uncertainty in connec-



tion with the announced VAT increase. The ZEW indicator for business expectations in the services sector rose significantly in the first quarter. The Purchasing Managers' Index for the services sector also went up perceptibly and is now once again well above the expansion threshold of 50. Measured by these indicators, a continuation of the upward cyclical trend in the services sector is to be expected.

Slowdown in trade sector likely to be just temporary

Business in the trade sector in the coming months is likely to depend on how well the dampening special effects of the VAT increase have already been "absorbed". Measured in terms of the estimated anticipatory effects, this is, in large part, likely to be the case. This is also suggested by the favourable developments in the labour market and the positive sentiment of households. According to data of the consumer research institution GfK, for example, consumer confidence picked up again in April, with income prospects, in particular, showing a marked improvement. The economic expectations of households are now at a record level.

Given the continuing positive outlook in industry, the fact that the structural crisis in the construction sector has now been overcome and the favourable position of commercial service providers, the underlying cyclical trend in Germany is likely to remain on an upward course. Investment in machinery and equipment, as well as industrial buildings are also likely to play a part in the ongoing relatively strong growth performance of the economy. Nevertheless, owing to the fact that the weather conditions were already exceptionally favourable during the winter months, the spring pick-up usually observed in the construction industry in the second quarter is likely to be less pronounced than usual. Although the dampening effects of the VAT increase are likely to have some continuing effect on consumption and private housing construction, their impact will probably give way more and more to a buoyant upswing. This will especially be the case if the favourable development in the labour market continues.

Economic outlook positive overall