

Economic conditions in Germany

Macroeconomic situation

The growth of the German economy was no more than moderate in the final quarter of 2007. According to initial figures from the Federal Statistical Office, overall output increased by 0.3% after adjustment for seasonal and calendar effects, compared with 0.7% in the third quarter. This means that, over the year as a whole, real gross domestic product (GDP) went up by 1.8% after calendar adjustment. In its recent flash estimate, the Federal Statistical Office also confirmed the annual figure for 2007 of 2.5%, or 2.6% after calendar adjustment, which had been published in early January. The rather moderate growth in the fourth quarter is mainly a reflection of a slower pace in the production sector. Strong demand stimuli indicate that the expansionary cyclical forces have remained fundamentally intact, however, and that the current quarterly figure somewhat understates the underlying cyclical trend. This interpretation is also supported by the high level of capacity utilisation, the robust business climate and the fact that there is still a great willingness to recruit new staff.

*Moderate GDP
growth in 2007
Q4*

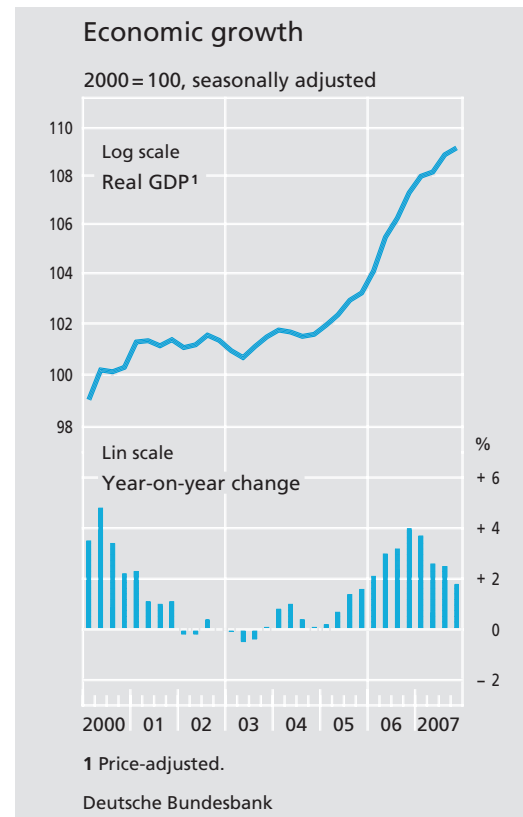
There is no more detailed information on the expenditure structure in the reporting quarter at present. Nevertheless, the available indicators suggest that the demand components which failed to match their figure for the third quarter – private consumption and construction investment – are those which have so far exhausted little of their growth potential. The marked decline in retail sales in the final quarter may be explained principally by the fact that the sharp price increases for

*Declining
domestic
demand*

some food items in the third quarter and sharply rising energy prices did not imply solely a considerable loss of purchasing power. Given the increasing risks facing other economies and the reported problems in the international banking system, these price surges have, moreover, evidently resulted in more cautious consumer spending behaviour. This is also suggested by the survey conducted by the consumer research institution, *Gesellschaft für Konsumforschung (GfK)*, which shows a sharp deterioration in price expectations between August and November and, with falling expectations for the economy and incomes, also a perceptible decline in the propensity to purchase. The fact that enterprises and the public sector had previously been quite subdued in placing new orders and that the trend in housing construction was still decidedly weak had a dampening effect on construction investment in the final quarter. Not least, the expiry of the declining-balance depreciation facility for movables at the end of the year is likely to have meant that there was a contrasting further expansion of investment in machinery and equipment in the fourth quarter.

Positive contribution to growth from foreign trade

Subdued final domestic demand is also likely to be one reason for the decline in imports in the fourth quarter. Another factor in this connection is likely to have been that enterprises reduced their inventories in the reporting quarter and exports were no longer increasing so sharply. Nonetheless, export performance remained a major pillar of growth, even though there were fewer new orders from the United States owing to the cooling of the US economy and the exchange rate making



exports more costly. Major sales markets for German products – the euro area, central and eastern Europe, the emerging economies in East Asia, and the OPEC countries – remained in robust economic condition, however. From an accounting perspective, foreign trade is likely to have generated a noticeably positive contribution to overall economic growth.

Sectoral profile

During the final quarter, industry only slightly increased the high output level achieved in the summer. On a quarterly average, there was still a seasonally adjusted rise of 0.8%, however, compared with an earlier increase in industrial output of more than 2.0%. While the output of enterprises in the inter-

Lull in industrial output



mediate and capital goods sectors continued to increase markedly at the end of the year, output growth in the consumer goods sectors was somewhat more limited. This reflected the fact that, given the strained consumer climate, fewer consumer durables were being sold domestically at the end of the period under review.

According to the Ifo Institute, the manufacturing sector continued to record a very high level of capacity utilisation overall. On an annual average of 2007, the degree of utilisation was not only up on the year but also well above its most recent cyclical peak in 2000. Taking into account the fact, too, that it is precisely during the past two years that enterprises have considerably expanded their capacities, industrial activity may be said to be decidedly positive at present. Capacity shortages are evident mainly in the capital goods sector. By contrast, producers of intermediate and durable consumption goods had to scale back the utilisation of their production facilities in 2007 following the peak levels (owing to special effects) reached in both sectors in 2006.

Continuing high level of industrial utilisation

Construction output fell by a seasonally adjusted 0.6% in the fourth quarter and was therefore back at the depressed level of the second quarter. In sectoral terms, the fact that construction investment made no progress in its core area in the second half of 2007 was due equally to the building industry and civil engineering. Output in the finishing trades is unlikely to have been much more favourable with virtually no change in the seasonally adjusted number of hours worked in the third quarter, for example, (more recent data are unavailable at present), while construction output went up by 0.5% during the same period but went back down again in the following quarter.

No improvement in construction output

A number of dampening factors are likely to have affected value added in the services sectors in the fourth quarter. Christmas trading

Dampening factors in the services sector

failed to meet the retail trade's expectations and the services of the transport and logistics enterprises may have been temporarily affected somewhat by the train drivers' strikes at Deutsche Bahn. Another factor was that the financial market turbulence and the associated discussions on economic risks since August placed a strain on the business activity of at least a part of the financial and business-related services sector.

Employment and unemployment

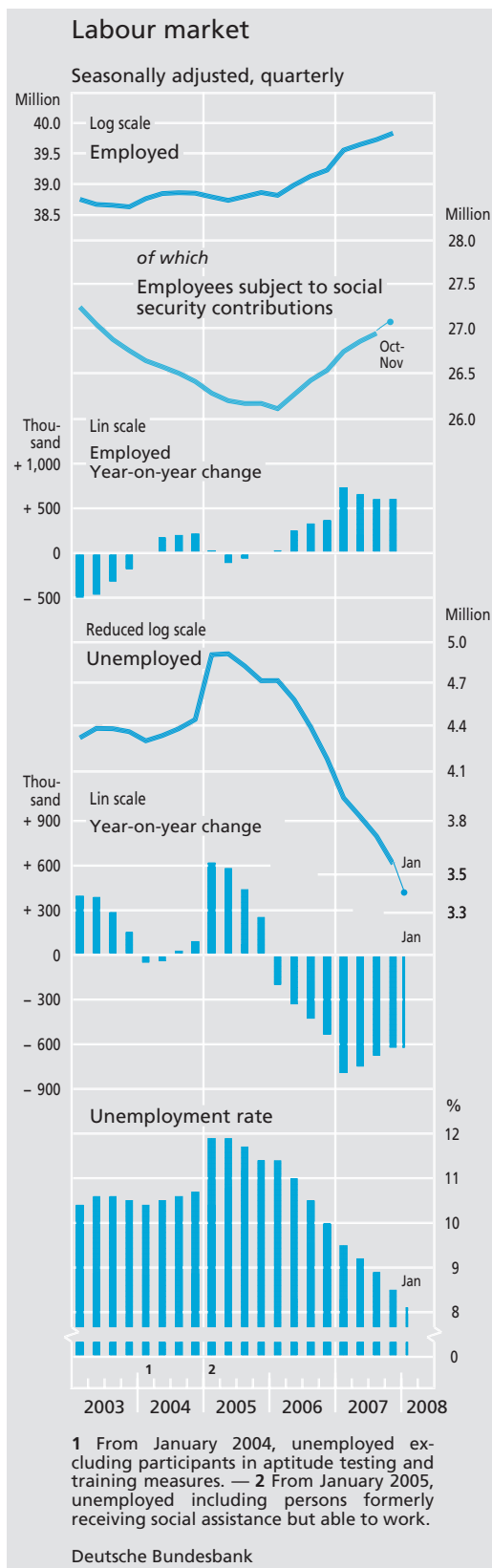
*Further increase
in employ-
ment ...*

The rise in employment strengthened again somewhat in the final quarter of 2007. The number of persons in work went up by a seasonally adjusted 106,000, or 0.3%, to 39.88 million. The year-on-year increase amounted to 617,000, or 1.6%. By November, employment subject to social security contributions had gone up by as much as 2.0%. Industry, in particular, further increased its number of employees. In addition, there was an expansion of the "finance, renting and business services" sector, in which the hiring out of labour is also recorded statistically. According to the available leading indicators, the positive development in the labour market could continue in the more immediate future. There was only a slight seasonally adjusted decline in the number of job vacancies reported to the Federal Labour Agency. The more broadly based BA-X index of non-government-assisted jobs, which captures all the vacancies in the primary labour market known to the Federal Employment Agency, showed a further increase, however. Not least, the Ifo employment barometer also indicates that industrial

enterprises are planning to recruit additional personnel.

Unemployment continued to fall at an accelerated rate in the fourth quarter. In seasonally adjusted terms, there was a decline of 156,000 compared with the third quarter, following a decrease of roughly 110,000 in each of the two preceding quarters. One reason for this might be that, up to the day of the official count in December, there had not yet been any weather-induced restrictions in the outdoor occupations. Furthermore, seasonal short-time working benefits, which had been introduced the year before, may have dampened the seasonal fluctuations somewhat. The number of persons out of work, at 3.57 million, was 623,000 lower than in the same period of 2006. Three-fifths of the decline was accounted for by job seekers receiving social benefits under the Third Book of the Social Security Code (SGB III)), primarily the short-term unemployed, and two-fifths by unemployed job seekers subject to the Second Book of the Social Security Code (SGB II), who are mostly long-term unemployed. Owing to the relatively sharp decline in the case of the short-term unemployed, there has been a marked increase in the percentage of long-term unemployed among those out of work; the figure was roughly 70% in the fourth quarter. However, this was due in part to the shortening of the period of entitlement to unemployment benefit, which came into effect at the beginning of 2007, and the fact that job seekers were therefore placed on the basic allowance (maybe plus a temporary add-on benefit) sooner than before.

*... and
further fall in
unemployment*



The quarter-on-quarter seasonally adjusted unemployment rate went down from 8.9% to 8.5% and showed a further fall to 8.1% in January 2008. In the final quarter of 2007, the internationally comparable standardised unemployment rate stood at 7.9%. Although this was noticeably lower than one year before – the figure for the fourth quarter of 2006 was 9.2% – it was still 0.7 percentage point higher than the average of the other euro-area countries and was, in fact, 4.1 percentage points higher than the average of the three euro-area countries with the lowest unemployment rate. This indicates that the German labour market is in much better shape than it was even one year ago, although the unemployment rate for certain segments of the workforce is still at an unacceptably high level. Given the existing heightened macroeconomic uncertainty, a moderate wage policy accompanied by flexible rates of pay will still be crucial to ensure that firms actually carry out their plans to expand employment.

Labour situation still unsatisfactory despite improvement

Wages and prices

On an annual average, the rise in labour costs in the economy as a whole was no more than comparatively slight in 2007 – despite the large claims at the beginning of the 2007 pay round and some relatively large settlements in industry. At 1.3%, the increase in negotiated rates of pay, when calculated on a monthly basis, was no higher than in 2006. Calculations on an hourly basis produce a similar picture. While negotiated pay rates in the production sector went up by 2.3%, the

Wage inflation moderate overall in 2007 with major differences between sectors

figure was only +0.8% in services. In the services sector, pay settlements providing for no – or only small – wage increases in 2007 were still in effect. In other cases, negotiations lasting several months led to no agreement, as in the retail trade. The last significant agreement concluded in 2007 was in the insurance industry, where the parties engaged in pay bargaining agreed that remuneration be increased by 3.0% in January 2008 following four months with no increase and a one-off payment in December 2007. With the agreement running for a total of 25 months, a second staged increase of 1.6% is scheduled for January 2009. Furthermore, there will be a further one-off payment in July 2008.¹

In the fourth quarter of 2007, the year-on-year rise in negotiated rates of pay, at 1.1%, was *per se* smaller than in the third quarter (+1.7%). The lower rate of increase was, however, due in part to a baseline effect owing to one-off payments having raised the reference figure for the final quarter of 2006. Cuts in special payments in the public sector and at public sector banks were an additional factor. If one-off payments and additional agreements are excluded, the year-on-year rate in the fourth quarter of 2007 remained unchanged at 1.7%.

2008 wage
round

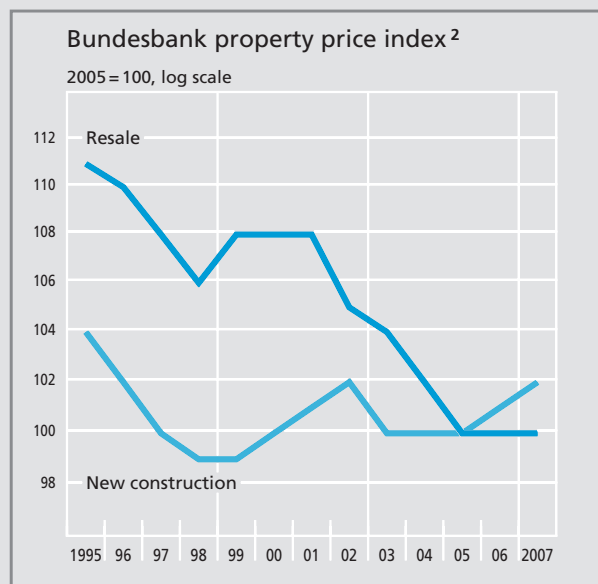
The rise in negotiated wages will be distinctly sharper in the first half of 2008 since many of the increases in standard wages agreed in

¹ The pay dispute at Deutsche Bahn AG was settled in early 2008 by a compromise under which the train drivers' union received an autonomous collective pay agreement with marked improvements in remuneration. This separate pay agreement is to be supplemented by similar agreements for other groups of professions.



Real estate prices in 2007

According to the real estate price indices calculated by the Bundesbank on the basis of BulwienGesa AG data,¹ the price of newly constructed housing rose slightly in 2007 – as in the previous year. The average price of existing property, in contrast, remained the same. There were only minor differences between both eastern and western Germany and between terraced and owner-occupied housing. Prior to 2006, house prices in Germany had been falling slightly. The reversal in the price trend may be cyclical in origin; added to this were rapidly rising costs for the construction of new buildings. The price of housing construction rose by 2.3% in 2006, mainly owing to the increased cost of building materials; it rose again in 2007 by 7.2%, not least owing to the increase in the standard rate of VAT from 16% to 19%.



¹ See Deutsche Bundesbank, Price indicators for the housing market, Monthly Report, September 2003, pp 45–58, and H-A Leifer, Preisindikatoren für Wohnimmobilien in Deutschland, Allgemeines Statistisches Archiv, Vol 88, 2004, pp 435–450. The price indicators have been recalculated and rebased on 2005=100. — ² Bundesbank calculations based on BulwienGesa AG data. — ³ For trends in this area, see J Hoffmann and A Lorenz, Real estate price indices for Germany: past, present and future, OECD IMF Workshop on Real Estate Price Indexes,

The Bundesbank's real estate price indices are based on the prices of typical properties (for example, selling prices of high-quality terraced housing in average to good locations with approximate living space of 100 square metres) in 125 towns and cities (100 in western Germany and 25 in eastern Germany). The local data by type of building are weighted together with population breakdowns from 2005. The estimated costs of newly completed buildings from the construction statistics for 2004 to 2006 are used for weighing together the data on the group "new owner-occupied housing and terraced houses". For existing properties, the percentages of terraced housing and owner-occupied apartments in relation to the total living space in Germany pursuant to the 2002 microcensus survey and the construction statistics for 2001 to 2005 are used.

The decision to publish these real estate price indices in 2002 was essentially motivated by the increasing discrepancy between the growing interest in such indicators and/or their availability and quality.³ The Bundesbank's indicators can be calculated only on an annual basis, however. Internationally, quarterly data are standard. For some time, Hypoport AG, which operates an internet platform for mortgage loan brokerage, has been providing monthly real estate price indices for Germany which are derived from loan application data.⁴ The indices are based on new (HPX-newhome) and existing (HPX-existinghome) one-family and two-family houses as well as existing owner-occupied apartments (HPX-apartment).⁵ For 2007, these indicators show a different picture from that of the 2007 indices calculated on the

<http://www.oecd.org/dataoecd/31/20/37625451.pdf>. — ⁴ Based on Hypoport AG data, 10% of real estate financing for private customers in Germany is conducted via this platform, ie 6,000 to 8,000 reports per month. For details, see <http://www.hypoport.de/indizes.html>. — ⁵ The housing stock indices only take into account real estate built after 1950. — ⁶ To limit the resulting volatility of the indices, Hypoport AG publishes the three-month moving average only. — ⁷ The hedonic method is used for turnkey buildings and existing real

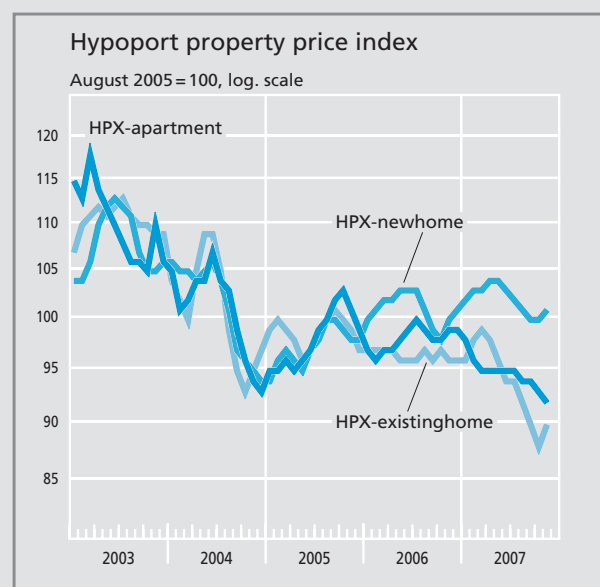
basis of BulwienGesa AG data. According to Hypoport AG, housing prices fell last year. Hypoport data shows that, compared with 2006, the value of existing, free-standing one-family and two-family houses fell by 2.5% on the average of the first 11 months of 2007 compared with 2006; the price of existing owner-occupied apartments dropped by 3.3%. The Hypoport index shows a price trend similar to that shown by the Bundesbank's indicators (+1%) only in the case of newly constructed housing.

While BulwienGesa AG reports purchase prices for standardised properties chiefly on the basis of expert opinions, but also based on association data and information from surveyor committees, Hypoport AG records the average values of actual transactions. Such average values are of no more than limited usefulness for constructing a price index since like is not being compared with like. Housing is typically extremely heterogeneous – variables such as location and size as well as age and features are key price determinants. Although Hypoport AG makes adjustments for size differences and discloses the average age of properties, changes in the composition of the housing stock over time in terms of location and features are fully reflected in the published price differential rates.⁶ This makes these rates considerably more difficult to interpret.

The Association of German Pfandbrief Banks (vdp) and the Federal Statistical Office are currently working on indices which use hedonic methods in an attempt to compensate for changes in the composition of trans-

estate only. — ⁸ See J Dechent, Häuserpreisindex – Entwicklungsstand und aktualisierte Ergebnisse, *Wirtschaft und Statistik* 12/2006, pp 1285–1295 and J Dechent, Häuserpreisindex – Projektfortschritt und erste Ergebnisse für bestehende Wohngebäude, *Wirtschaft und Statistik* 1/2008, pp 69–81. — ⁹ See F Eilers and T Hofer (2007), Die statistische Erfassung der Immobilienpreisentwicklung in Deutschland, in *Professionelles Immobilien-Banking, Fakten und Daten 2007/2008*, Berlin, pp 50–57. — ¹⁰ Furthermore, in the case of surveyor commit-

tees,⁷ regression analysis is used to explain house prices in terms of the characteristics of the housing. While the Federal Statistics Office uses data from surveyor committees, which collect data on property transactions in all the federal states, the vdp has created a transaction database into which the member institutions enter prices and housing characteristics in a standardised form. Initial results of calculations by the Federal Statistical Office⁸ and the vdp⁹ are very promising. Both indices are still in need of improvement with regard to a consistent coverage of all regions in Germany, however.¹⁰ From a monetary policy perspective, too, it would be desirable if Germany, like France, were to publish comparable and highly representative quarterly, transaction-based real estate price indices on a timely basis in future.¹¹



tees, data can be accessed for statistical purposes only at a comparatively late stage of real estate transaction settlement. — ¹¹ For French real estate price indices, see Insee (2005), *Les indices Notaires Insee de prix des logements anciens*, Insee Méthodes n° 111, and C Gouriéroux and A Laferrère (2006), *Managing hedonic housing price indexes: the French experience*, OECD-IMF Workshop on Real Estate Price Indexes, <http://www.oecd.org/dataoecd/2/24/37583497.pdf>.

2007 will come into effect. Furthermore, pay agreements will be expiring in a number major sectors – above all, central and local government, the iron and steel industry, the chemicals industry, textiles and textile products, and restaurants and hotels. Negotiations in the metal-working industry are scheduled for the second half of the year. The scale of the claims, as far as is known at present, will go beyond that made initially in the last round of negotiations in some cases, with the loss of purchasing power in 2007 being one of the reasons cited for this. It should be noted, however, that the price increases of 2007, owing to their strong fiscal and external components, have scarcely increased the (nominal) scope for income distribution.

Sharp energy-induced price increase in imports ...

On the external side, price impulses, in particular, strengthened again perceptibly in the fourth quarter owing to the rise in the cost of crude oil. Seasonally adjusted import prices were not quite 2% higher than in the third quarter, in which import prices had gone up by 0.4%. The increase in the case of energy was as much as 14.3%. However, the appreciation of the euro against the currencies of major trading partners made other exports 0.5% cheaper in seasonally adjusted terms. As was the case in the third quarter, lower prices for intermediate goods as well as for durables and capital goods more than offset the higher cost of food and animal feed. Imports were just over 3% more expensive year on year overall; excluding energy, prices were 0.2% lower. As export prices increased no more than moderately in seasonally adjusted terms, there was a marked deterioration in the terms of trade. The year-on-year figure was a clear -1.7%

There was stronger upward pressure on prices at the industrial producer level. The seasonally adjusted prices of goods intended for domestic sale went up by 1%. This was due not only to sharp rises in the cost of energy, but also to quite marked increases in the price of other goods. The strong pressure on prices continued especially for products of the food and beverages industry. Upward pressure also persisted in the case of agricultural producer prices. The ongoing unfavourable price trend for agricultural products was also the main reason for the annual rate of wholesale price inflation, at 6.6% in January 2008, being the highest since June 1982. The year-on-year increase in factory gate prices went up from 1.2% to 2.2%. Excluding energy, the increase is reduced slightly from 2.5% to 2.3%. Prices for construction continued to rise in the final quarter of 2007; they were 6.4% higher in year-on-year terms. The sharp rise in construction prices, which began in 2006, has been reflected in house prices only to a very limited extent so far. (For house price developments in 2007, see the explanatory notes on page 46-47.)

... and a marked price increase at the domestic producer level

In the final quarter of 2007, seasonally adjusted consumer prices, at 0.8%, rose even somewhat more sharply than in the third quarter. The increase in food prices was exceptionally large at 3.7%. The price trend was particularly marked in the case of dairy and cereal products. For example, compared with the previous quarter, consumers had to pay over 20% more for white farm cheese (*Speisequark*) and over 10% more for wheat flour. In December, there were initial downward adjustments to the price of butter, how-

Unfavourable trend in consumer prices

ever. Nevertheless, the unabated sharp rise in wholesale food prices in January 2008 indicates that the generally unfavourable price trend in this area will continue for the time being. Furthermore, the cost of energy went up by 2% owing to higher crude oil prices. Upward pressure on prices also intensified somewhat in the case of industrial goods. The price trend in services and housing rents was still comparatively moderate, however.

Owing to the exceptionally sharp quarter-on-quarter increase in consumer prices, the year-on-year rate of price increase went up from 2.1% in the third quarter to 2.8% in the fourth quarter. This was the highest rate of inflation since early 1994. At that time, however, the sharp rise in prices affected all the components of the consumer price index and may be interpreted as an after-effect of the excessive rise in wages during the unification boom. In the present case, the sharp price increases have hitherto been concentrated on energy and food, which have gone up 8.6% and 5.6% respectively in year-on-year terms. Furthermore, the increase in the standard rate of VAT from 16% to 19% at the start of 2007 is still having an effect on some categories of goods.

*Prices rises
continue at the
beginning of
the year*

Based on the old 2000 basket of goods, the Federal Statistical Office has estimated a year-on-year increase in consumer prices of 2.7% in January 2008. In seasonally adjusted terms, this corresponds to a 0.4% rise in comparison with December 2007. This would give an annual Harmonised Index of Consumer Prices (HICP) rate of 3.0%. The final January figures will be published at the end of February and

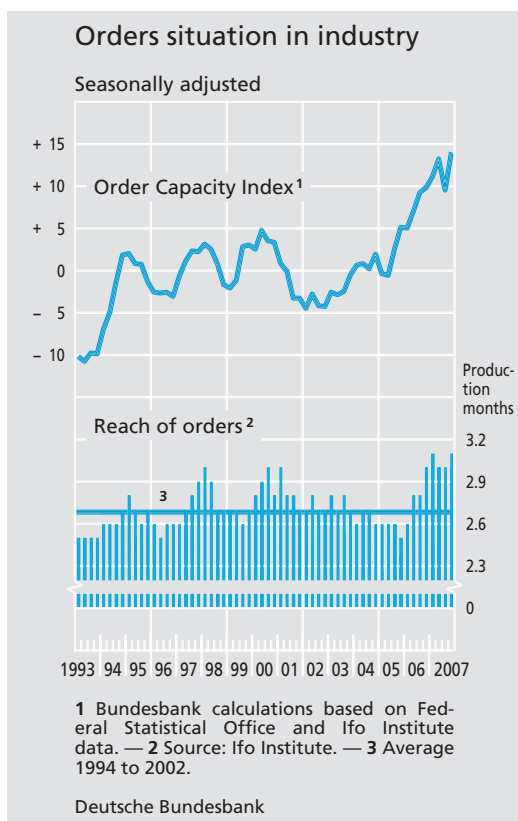
will then refer to the 2005 basket of goods. In addition, various changes to the methodology, especially concerning the way in which price developments are shown in seasonal terms, will become effective.

Orders received and outlook

Despite the slowdown in growth towards the end of 2007, which was by no means surprising, the future outlook for the economy has not significantly deteriorated. Nevertheless, the risk factors that have been making the economic outlook less certain than usual since the middle of last year continue to exist. They have, in fact, become more significant in some respects, such as the scenario of a marked cyclical slowdown in the United States. So far, however, the probable impact on the German economy has remained very limited. Neither extensive revisions to non-financial corporations' budgets nor major disruptions to households' confidence have been identifiable so far, for example. On the whole, the German banking system has coped well with the turbulence of the past few months and has maintained its stability and functional viability. This means that there is still the prospect that domestic demand – which was adversely affected in the fourth quarter by general uncertainty and the strong upward pressure on prices – will again be shaped more by the potential for recovery justified in terms of the fundamentals.

*Existing risks to
the economy*

This applies most of all to private consumption, which was curbed not only by the sharp increases in prices at the end of the year but



Private consumption with the potential for recovery

also by the suddenly gloomier expectations for prices and incomes. In the meantime, households' sentiment has recovered slightly and the propensity to purchase large consumption items has increased again. Precautionary saving, which was the prevailing motive in the fourth quarter, is therefore likely to have become somewhat less important. Private consumption might therefore benefit more in future, too, from the ongoing strong revival in the labour market and the more favourable income prospects.

Investment continues to be shaped by incentive to expand

At the start of the year, what will be "missing" is the volume of investment in machinery and equipment that was brought forward to last year owing to the expiry of the declining-balance depreciation facility for movables. Looking at the high level of cap-

acity utilisation in many sectors of industry, there are a large number of enterprises which still need to procure new machinery and equipment, however. Given the reserves of orders, the reach of which remained at a constantly high level on balance in 2007 despite the buoyancy of investment, industry can only meet the increasing customer needs on time by means of a further expansion of production capacity. Generally speaking, the propensity to invest will be boosted by the fact that the business tax reform that entered into force at the beginning of the year will help to improve the conditions for investment in Germany.

In actual fact, industrial enterprises have recorded a sharp growth in new orders of late. The seasonally adjusted volume of orders in the fourth quarter was 5% up on the preceding three-month period. The exceptional peak in orders in November was due principally to numerous large orders in the air transport equipment and the railway and tramway locomotives construction sectors as well as in the steel industry. Even after this effect is eliminated, however, there was still a quite considerable increase of approximately 3% in the volume of orders that will have an impact on output over the shorter term. The persistently favourable demand situation in order-based industry is revealed, moreover, by the fact that the Order Capacity Index – after a dip in the third quarter – was latterly even up on its previous record high of the second quarter. The sharp (6½%) increase in new export orders indicates that German industry has been able to well maintain its market position even under difficult underlying

Sharp pick-up in industrial demand

conditions. This is due, above all, to the fact that capital goods producers are in a strong position, which is due, not least, to the attractive range of goods on offer. Despite somewhat more subdued global growth and less favourable price competitiveness in the dollar area, export-oriented industry is looking optimistically to the future – which is evident, moreover, in the persistently favourable export expectations.

Perceptible improvement in the order situation in the construction sector

Demand for construction also picked up sharply in the fourth quarter. The average volume of orders in October and November was 12½% up on the third quarter. This was due mainly to a number of large orders placed by industrial customers and the public sector in October. The increase in demand for industrial construction should be seen in connection with domestic producers' capacity extensions, however, and, therefore also reflects an underlying trend. By contrast, orders for housing construction remained at a low level.

Economy in robust shape overall

The German economy remains in robust shape overall. The weakness of domestic demand in the fourth quarter was more temporary in nature. Furthermore, the leading indicators suggest that, although the changes in the exchange rate pattern and the slow-down in the US economy are *per se* curbing the momentum of exports, they will not severely impede it. This means that the main elements underpinning the upturn in Germany remain intact. Despite the obvious risk potential, the shift of emphasis to domestic expansionary forces, which is expected from a cyclical perspective, remains the most probable scenario.

