

Economic conditions in Germany

Macroeconomic situation

Following decidedly strong growth at the beginning of the year, overall economic activity in Germany slowed down perceptibly in the second quarter of 2008. According to the flash estimate of the Federal Statistical Office, real GDP between April and June was 0.5% down on the first quarter after adjustment for seasonal and calendar effects. This figure already takes into account the fact that GDP growth in the first quarter, at 1.3%, was somewhat weaker than initially reported. According to the figures now available, economic output was 1.7% up on the year after calendar adjustment, compared with 2.6% in the previous quarter.

*GDP decline
in Q2 ...*

The decline in overall economic output in the reporting quarter should be seen primarily in the context of the very high level of output in the first quarter when, owing to a number of special factors in the production sector, the German economy grew very sharply.¹ As expected, economic growth in the second quarter was significantly dampened by matching counter-reactions. In the first half of 2008 – a reference period which is more meaningful from an analytical perspective – seasonally and calendar-adjusted GDP, at an annualised rate of 1½%, nevertheless almost reached the level of potential growth, which meant that overall capacity utilisation was quite largely maintained during this period. Negative cyclical factors are likely to have intensified towards the middle of the year, however.

*... influenced
by technical
counter-
reactions ...*

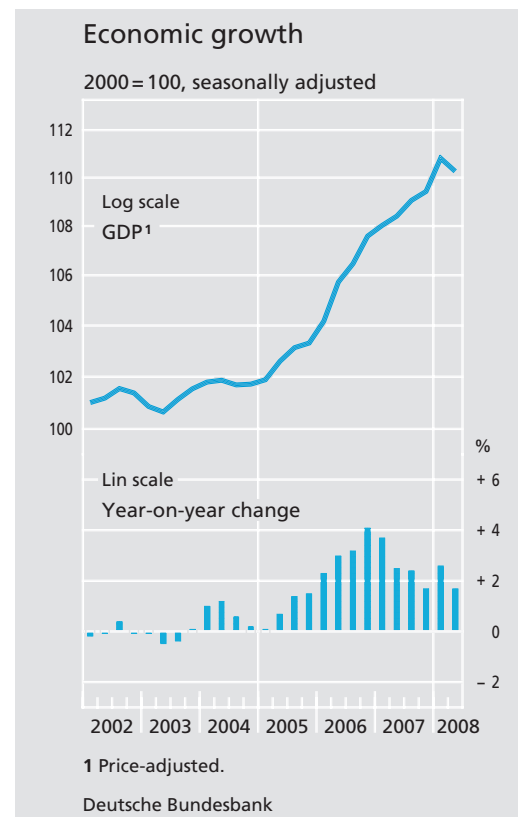
¹ See also Deutsche Bundesbank, Economic conditions in Germany, Monthly Report, May 2008, pp 50-64.

... and a
gloomier price
climate

Although there is currently no detailed information available on the use of GDP in the second quarter, the indicators do suggest, however, that domestic demand declined in the reporting period on the whole. The weak growth in retail sales, for example, indicates that private consumption was again dampened discernibly. According to the consumer research institution, *Gesellschaft für Konsumforschung* (GfK), consumer sentiment deteriorated perceptibly once more in the second quarter. This was due mainly to the renewed surges in the cost of energy and persistently high food prices. Households' real scope for expenditure is being substantially restricted by the current pace of inflation. The gloomier price climate is also likely to have been a key reason for the income outlook being assessed as clearly less favourable of late – despite a positive trend in the labour market and higher negotiated wages in this year's pay round. Further news of ongoing problems in the international financial markets is also likely to have increasingly fuelled concerns about the economy. As a result, consumers' propensity to purchase has again fallen almost to the level measured in the second quarter of 2005 before the current upswing gained momentum.

Disrupted
consumer
behaviour

On the income side, the expectation that private consumption could take off and gradually push the economic cycle into a new phase had been perfectly justified since the beginning of the recovery in the labour market just over two years ago. The fact that private consumption was virtually stagnating during this period, however, was not due solely to the inflation-induced loss of purchas-



ing power, but also, in part, to a high level of saving. The emergence of external price shocks from the summer of 2007 onwards, for example, is likely to have given rise to growing concern, as time went on, that the loss of purchasing power might persist over the longer term. Furthermore, the announcement of further energy price rises may have caused some households to be more cautious with regard to the purchase of consumer durables. This particularly affected the buying of passenger cars, especially in view of the sharp rise in the price of petrol. In addition, the debate on the reform of motor vehicle tax in Germany as well as the planned EU climate protection provisions for passenger cars may have prompted a number of households to put off purchasing a new vehicle. Measured in terms of new car registrations, sales of pas-

sender cars to private individuals showed a perceptible fall in the first half of 2008. According to the national accounts data, between the beginning of 2006 and the first quarter of 2008 moderate growth was recorded in other consumer durables and services, whereas households deliberately reduced their purchases of goods which showed higher-than-average price rises. Prices of non-durable goods, for example, went up roughly twice as sharply during this period as the prices of all other areas of expenditure combined. This was due, not least, to sharp price rises in the case of food and fuel. In the same period, real expenditure on non-durable goods, which accounted for as much as 28% of all domestic consumption expenditure, declined by just over 6%.

*Rebound effect
in construction
investment,
moderate
underlying
trend overall*

Demand for new housing was adversely affected by a lack of follow-up orders in the wake of the special developments in 2006 when, owing to the abolition of the grant to homebuyers and the announced increase in VAT, a comparatively large number of construction projects were realised. Although there has been a decline in job risk, bringing at least some improvement in income prospects and a consequent easing of banks' lending conditions, private housing construction has become hardly more affordable. Construction services, for instance, have become considerably more expensive since 2006 following years in which the price trend had been virtually stagnant. Financing costs have also gone up. By contrast, housing rents have been raised at a very subdued pace in many places, and prices of older housing have remained unchanged. Up to the end of

the period under review, the volume of permits and orders for housing remained at a very depressed level. By contrast, in line with the current cyclical pattern, the underlying trend in industrial and public sector construction stayed on an upward course, even though a significant decline may be expected for the second quarter in seasonally and calendar-adjusted terms. In purely nominal terms, this was due mainly to a countermovement of a more technical nature since construction activity in the winter months had benefited to a great extent from weather conditions. Nevertheless, the rebound effect is also likely to have been due, in part, to orders since the beginning of the year failing to match the surge in demand in the final quarter of 2007.

Demand for machinery and equipment slackened in the second quarter following a period with some strong increases. Given the exchange-rate-induced losses in earnings, surges in the cost of intermediate goods, and a renewed acceleration in wage costs, enterprises are likely to have become more cautious in making new acquisitions. Following the sharp build-up in capacity over the past two and a half years, a certain amount of caution was probably appropriate anyway, especially as the noticeable slowdown in the flow of orders since the beginning of the year temporarily eased the pressure for a rapid expansion of production capacity. This is all the more the case given that export-oriented firms, of which there are a large number, are currently faced with less favourable export expectations.

*Investment in
machinery and
equipment
quite robust*

Exports lacking momentum, imports clearly down

According to the data available so far, exports of goods and services are likely to have declined somewhat in real terms in the second quarter. The total value of exports of goods was down ½% on the first quarter after seasonal adjustment, although there were noticeable regional differences. While the decline in exports to the euro area and Asia was still comparatively moderate on the whole, exports to the United States, in particular, as well as to the UK, showed a perceptible fall. This development reflects not only the economic downturn in these economies, but also the fact that German exporters were increasingly feeling the effect of the euro's ongoing appreciation against both the US dollar and the pound sterling up to July. On the whole, foreign trade still made a positive contribution to growth in the second quarter since imports declined more sharply than exports. Nominal imports of goods in the second quarter were a seasonally adjusted 1¾% down on the quarter. German enterprises' investment, which has been more subdued of late, as well as households' recent consumption restraint, are also likely to have played a role in this development. Added to this was the moderation in inventories, which is to be seen more as a technical reaction following a very sharp build-up of stocks in the first quarter.

Sectoral trends

Subdued industrial activity

Industrial activity was perceptibly more subdued overall in the second quarter following the marked increase at the beginning of the year. On a quarterly average, output was

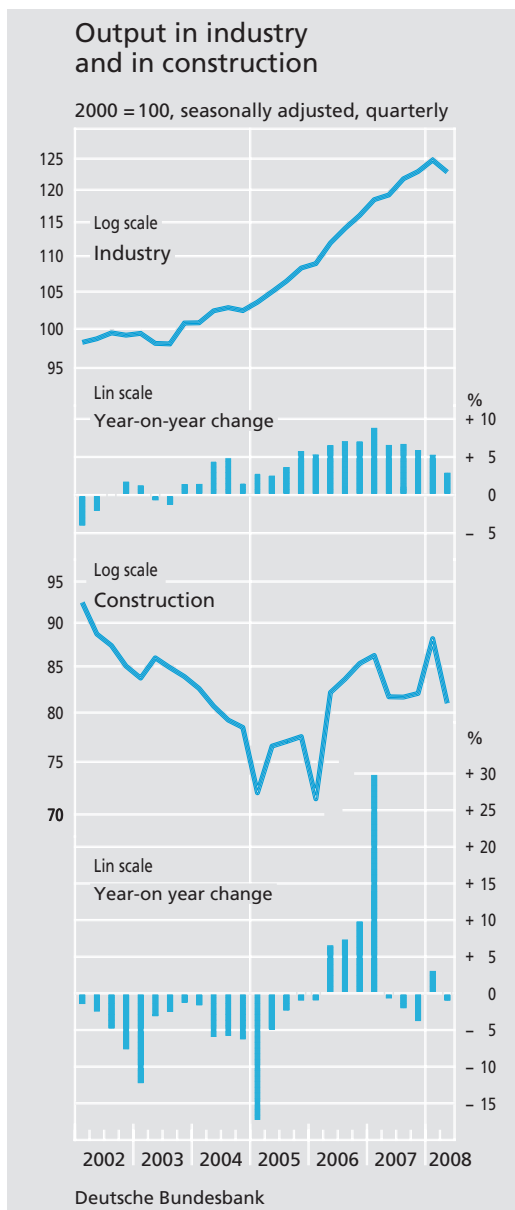
Foreign trade by region and category of goods

Percentage change

Item	Average of Apr-May 2008 compared with			
	2008 Q1 seasonally adjusted		Apr-May 2007 unadjusted figures	
	Ex-ports	Im-ports	Ex-ports	Im-ports
Total	- 1.1	- 1.8	8.0	9.8
Countries or group of countries				
Euro-area countries	- 0.9	- 1.2	5.5	7.1
Other EU countries	0.8	1.7	8.1	9.2
of which				
New member states ¹	- 1.0	- 2.3	14.7	10.9
United States of America	- 10.5	- 2.6	- 0.7	- 2.1
Russian Federation	- 1.9	5.8	20.5	29.9
Japan	- 0.3	- 11.0	2.1	- 2.7
South-East Asian emerging economies ²	- 7.6	- 5.2	4.9	- 0.3
China	0.9	- 0.1	20.8	12.6
OPEC countries	0.2	10.9	16.0	53.2
Categories of goods				
Main categories				
Intermediate goods	0.3	- 0.2	9.3	4.5
Capital goods	- 1.5	- 3.7	6.6	5.5
Consumer goods	- 3.6	- 0.6	7.4	7.5
Energy	.	6.8	.	42.7
Selected categories				
Chemicals	- 7.4	- 1.9	9.7	6.4
Machinery	- 1.5	0.2	10.0	13.9
Motor vehicles and motor vehicle parts	- 2.6	- 2.5	8.0	8.5
IT products	- 3.1	- 3.7	- 3.7	- 2.4
Metals and metal products	2.3	3.7	7.9	5.0

¹ Excluding Slovenia, Cyprus and Malta, which now belong to the euro area. — ² Hong Kong, Singapore, South Korea, Taiwan, Brunei Daressalam, Indonesia, Malaysia, Philippines, Thailand.

Deutsche Bundesbank



1½% down on the first quarter in seasonally adjusted terms. Although hardly any industrial sector remained unaffected by the slowdown, it is still striking that manufacturers of consumer goods significantly cut back their output, while, in the capital goods sector, the decline was comparatively moderate. Evidently, given the considerable orders still on the books, manufacturers of machinery and equipment, were still able to maintain

their production volume at a high level, even though it was precisely this sector which had recorded the sharpest decline in new orders since the beginning of the year.

In capacity utilisation, this same picture is apparent in terms of the overall trend as well as at the sectoral level. According to Ifo Institute data, overall industrial capacity utilisation declined significantly at the mid-year point following two years of record highs. Nevertheless, utilisation was not only well above its long-term average, but also above the peak level achieved during the last business cycle in the second quarter of 2000. While manufacturers of capital and intermediate goods were still reporting quite a high level of capacity utilisation, increasing spare capacity was becoming apparent in the consumer goods sector.

Capacity utilisation no longer as high

Output in the construction sector between April and June was a seasonally adjusted 8% down on the level of the first quarter. This very sharp decline is, however, to be seen in the context of an even sharper increase in the previous quarter. The marked peak in output at the beginning of the year was linked to the mild early-winter weather, which was conducive to the speedy processing of the surge in orders received in the fourth quarter of 2007. With regard to the overall weak situation in orders since the turn of the year, it should be noted, however, that the underlying trend in construction output has not picked up from its low prior-year level.

Large technical revisions in construction output

The subdued growth in the production sector and consumer restraint made themselves felt

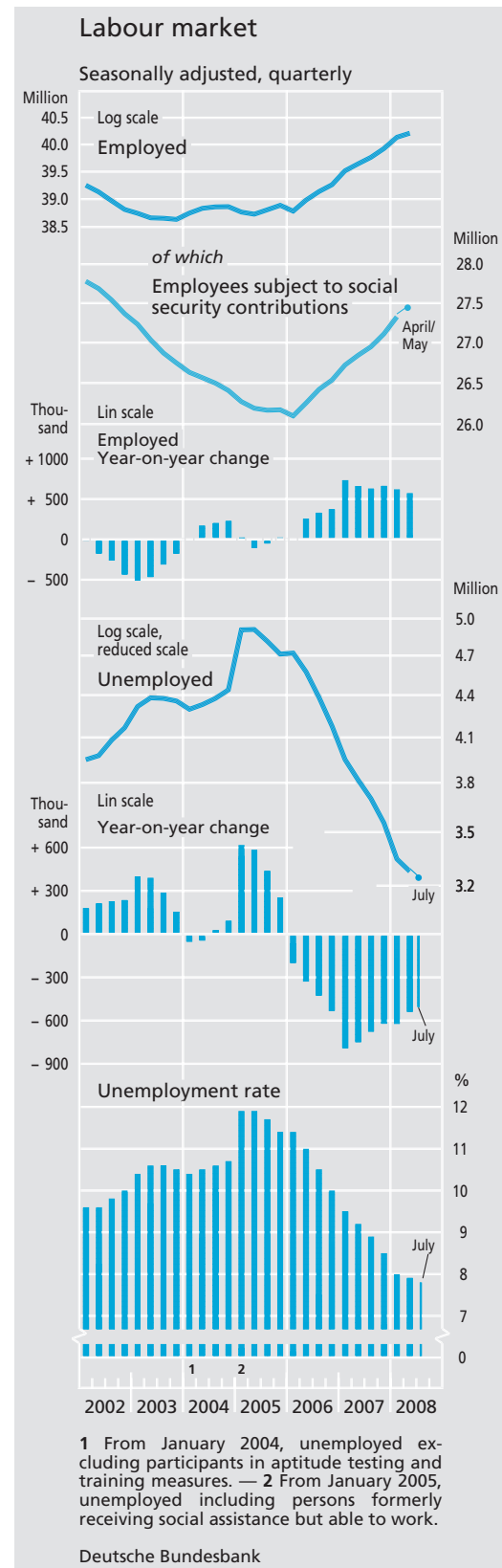
Trade and commercial service providers less positive

in the services sector in the second quarter. Following the moderate upturn in the first quarter, sales activity in the retail trade was again weak at the end of the period under review with the extremely high prices for fuels not only leading to a decline in sales at petrol stations, but also affecting sales by motor vehicle traders. Wholesale turnover shot up in the first quarter not least owing to buoyant foreign trade activity and strong procurement activity by industrial enterprises, but fell back down below the level of the second half of 2007 in the period under review. Similar factors are also likely to have had a dampening effect in the transport and logistics sector recently. According to the Ifo Institute surveys, the business climate trend for providers of business-related services between April and June largely paralleled the gloomier ratings in the manufacturing sector. By contrast, the credit reform/ZEW survey among ICT service providers, tax advisors, auditors, architects and advertising firms presented a picture of consistently positive sentiment in the first half of the year.

Employment and unemployment

Further increase in employment ...

Despite weaker economic activity, there was a further increase in employment in the second quarter of 2008, albeit on a noticeably reduced scale. The seasonally adjusted number of persons in work went up by 76,000, or 0.2%, on the quarter, compared with an increase of 0.5% in the first three months of the year. In contrast to the first quarter, employment subject to social security contributions did not benefit especially from



the improved labour market situation. The level achieved in May – more recent data are not yet available – was also 0.2% up on February. Business services, which also includes the hiring out of labour, accounted for over half of this growth. The number of persons working exclusively on a part-time low-income basis remained virtually unchanged at 4.83 million. There was a slight seasonally adjusted increase in the case of government-assisted employment opportunities (one-euro jobs). Employment was therefore up by 567,000 persons, or 1.4%, on the year.

... and declining unemployment

The fall in unemployment largely matched the rise in employment. At a seasonally adjusted -69,000, the decline in unemployment was, however, significantly weaker than in the first quarter when it had stood at 209,000. It is noteworthy that, for the first time in a long while, there was a slight increase in the number of unemployed persons in category SGB III (statutory insurance scheme), although changes to benefits legislation also played a part in this.² By contrast, the decline in unemployment in the category SGB II (basic allowance system) continued at an unreduced pace when compared with the first quarter of 2008. The unemployment

² The seasonal short-time working benefits in the construction sector, which led to a reduction in the number of unemployed persons in the first quarter and the effects of which cannot yet be fully excluded from the seasonally adjusted figures, are likely to have contributed to the quarter-on-quarter seasonally adjusted slowdown in employment growth and the decline in unemployment, especially in category SGB III. Furthermore, in nominal terms, there was an increase in the number of unemployed persons owing to the discontinuation of the regulation allowing unemployed persons over the age of 58 to draw employment substitution benefits without being available for work and who were therefore not registered as seeking employment.

rate, as defined nationally, went down from 8.0% in the first quarter of 2008 to 7.9% in the second quarter; the standardised rate fell from 7.5% to 7.4%. In July, there was a further slight decline in registered unemployment. As in June, the relevant rate stood at 7.8%.

The available leading indicators suggest that the improvement in the labour market will continue at a more moderate pace. The number of vacancies reported to the labour exchanges showed a further fall in the second quarter. The number of positions to be filled immediately with their associated vacancy periods was nevertheless still quite high, however. According to surveys by the Institute for Employment Research (IAB), the number of vacancies in the primary labour market declined by one-tenth on the year overall. The Ifo employment barometer for trade and industry also shows that the propensity of enterprises to recruit new staff is less favourable than before. Following a long period of increase, the BA-X index, which covers all non-government-assisted jobs reported to the Federal Employment Agency, showed a slight fall at the end of the period under review. On average, however, enterprises' staffing policies are still likely to be expansionary. This is also evident from the results of the DIHK survey carried out in the early summer of 2008.

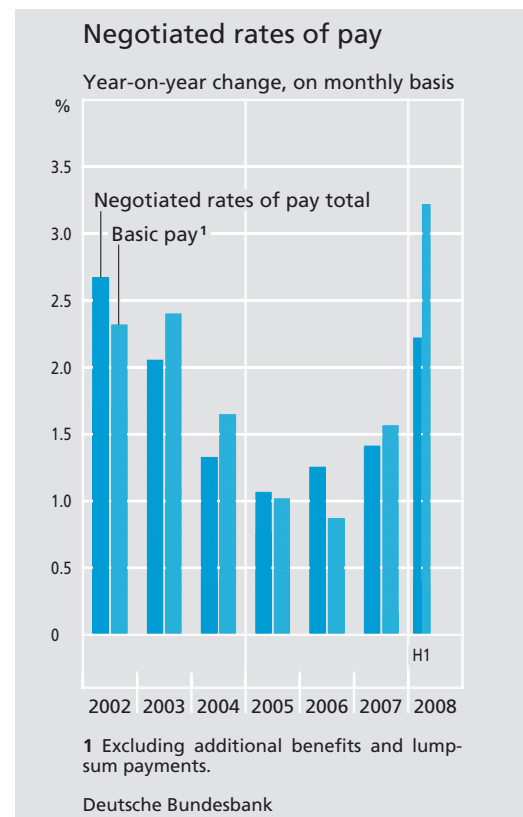
Fewer number of employment schemes

Wages and prices

Following the conclusion of a fairly large number of wage agreements in several major sec-

Acceleration in wage inflation

tors in the first four months of 2008, only a few new pay settlements were completed towards the end of the second quarter or at the beginning of the third quarter. The pay agreement for employees working for central and local government was largely implemented for civil servants, too, and was also adopted by a number of state governments. In the utilities sector (electricity, gas and district heating), various agreements were concluded, typically consisting of two-stage settlements running for longer periods. In the case of salaried employees at cooperative banks, the trade unions DBV and DHV concluded a wage agreement for the first time without the usual involvement of Ver.di. This agreement is effective retrospectively for the past two years and will remain valid for a further two years. It comprises a 3.0% salary increase, which will come into effect in the fourth quarter of 2008, followed by a further increase of 2.0% in the fourth quarter of 2009. After retail sector wage negotiations, which went on over the period of one year, the wage-bargaining area of Baden-Württemberg reached an agreement lasting 12 months. This envisages a retrospective pay increase of 3.0% with effect from April 2008 and a retrospective flat-rate payment of €400 for the 12 months prior to that. This agreement has since been adopted by other wage-bargaining areas. The year-on-year rise in negotiated rates of pay went down from a total of 2.7% in the first quarter of 2008 to 1.7% in the second quarter.³ This was due primarily to base effects of non-repeated one-off payments from the year 2007. The trend in negotiated wages is better reflected in the negotiated basic rates of pay. These went up 3.4% on the year, compared

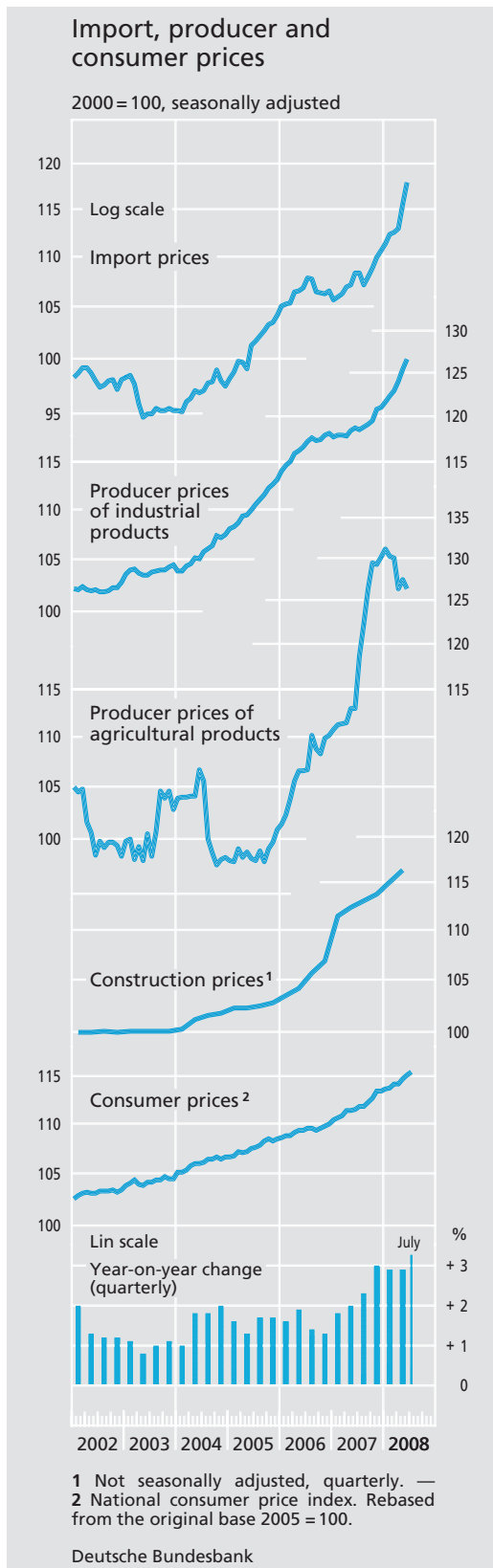


with 3.1% in the first quarter. In the second quarter, the acceleration in negotiated wages is also likely to have been reflected in more rapidly rising national unit labour costs.

On the price side, events were marked by the sharp rises in crude oil prices in the world markets across all trade levels in the second quarter of 2008. As a result, external pressure on prices increased discernibly in this period. Seasonally adjusted import prices were up by a total of 3.0% on the quarter, compared with 2.0% in the first three months of the year. The vast majority of this increase is attributable to the energy component, the cost of which rose by just under 13% on the quar-

Clearly accelerating rise in import prices ...

³ The increase in negotiated rates of pay has been revised upwards from 2.3% to 2.7% for the first quarter owing to new agreements with retrospective effect.



ter in seasonally adjusted terms. In the case of other goods, price inflation, at a seasonally adjusted 0.6%, was almost as strong as in the first quarter, despite the continuing appreciation of the euro. Food prices, however, have shown signs of a certain easing following very sharp price increases in this area. Owing to the greater share of crude oil products, the overall year-on-year rise in import prices, at 7.5%, was far greater than that in exports (2.4%). As a result, there was a further deterioration in the terms of trade.

Owing to the sharp rise in energy prices, the (quarter-on-quarter) increase in the industrial producer prices of goods intended for domestic sale went up from a seasonally adjusted 1.6% in the first quarter of 2008 to 2.4% in the second quarter. If energy is excluded, the increase, at 0.9%, was just as high as in the previous period. As a result of slight downward revisions in the case of domestic agricultural producer prices and declining price trends in the world markets, price increases in the food and drinks industry showed a marked fall. Factory gate price inflation also eased in the case of other consumer goods. By contrast, it increased in the case of intermediate goods. The overall year-on-year increase in industrial factory gate prices went up from 3.8% in the first quarter to 6.0% in the second quarter of 2008. Prices for construction work were up 3.6% on the year.

Consumer price inflation accelerated again somewhat in the second quarter of 2008 after slowing down at the beginning of the year. On average, prices increased by a seasonally adjusted 0.8% on the quarter. Just

... and producer prices

Consumer prices still unfavourable in Q2, ...

over half of this was attributable to the energy component, which increased by 4.4%. The price of heating oil went up by almost 20% on the quarter and fuel by more than 7%. By contrast, there was an easing of upward pressure on food prices, which was also due to the fact that the expected downward corrections occurred in the case of dairy products. The price of milk went down by approximately 5%,⁴ for example, with farm cheese (*Speisequark*) and cream becoming some 6% cheaper. The price of butter went down substantially, as in the previous quarter. The rate of price increase for bread and cereals also weakened. The prices of industrial products, services and housing rents went up by 0.3% overall and therefore just as rapidly as in the previous quarter. Despite the sharp rise in prices on a quarterly comparison, the year-on-year increase in the consumer price index (CPI) remained unchanged at 2.9%.⁵ Energy prices were 12.4% up on the year. Consumers even had to pay just over half as much again for heating oil. The rate of food price inflation went up to 7.6%, despite a few partial downward corrections. By contrast, the annual rate of inflation for goods (excluding energy), at 0.8%, for services, at 1.3%, and for housing rents, at 1.4%, were rather subdued. Year-on-year HICP inflation went down from 3.1% to 3.0%.⁶

⁴ Owing to the increased supply of milk, price reductions for fresh milk were considerably greater in May than in the previous quarter. However, owing to the milk delivery strike at the beginning of June, some of the corrections were reversed again.

⁵ The introduction of tuition fees in a number of federal states in the second quarter of 2007 contributed 0.2 percentage point to this price increase.

⁶ Using a basis methodologically comparable to the CPI, but calculated using the HICP basket of goods, the inflation rate would have been 3.1%.

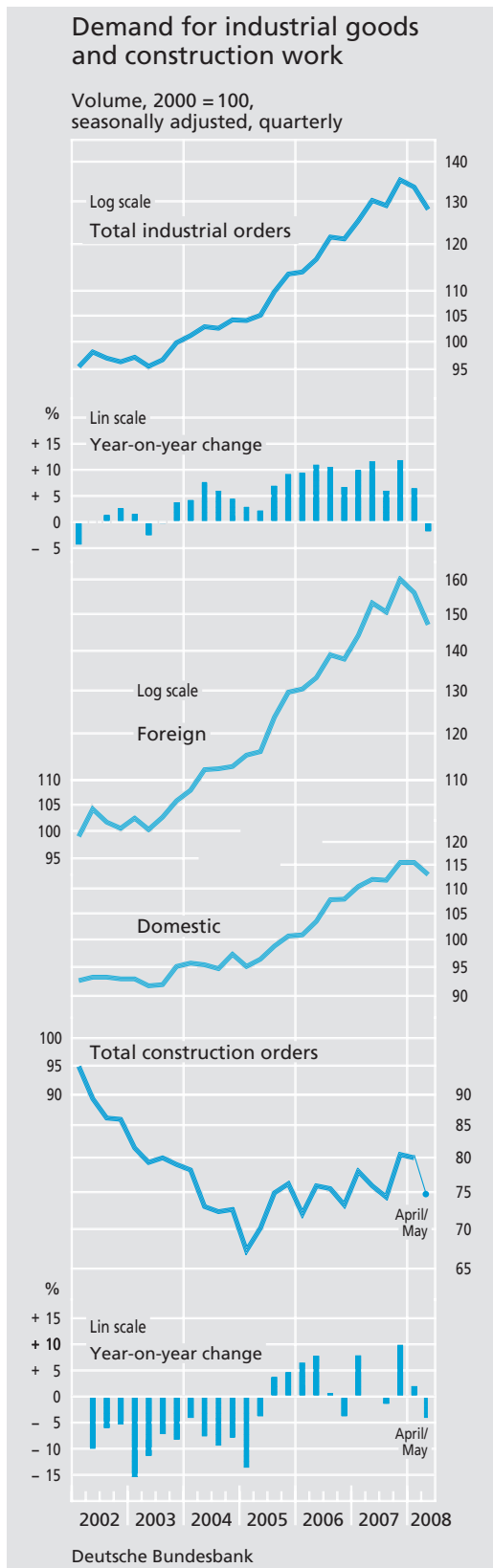
The seasonally adjusted rise in consumer prices in July was somewhat more subdued than in the two preceding months. The annual CPI rate remained at the prior-month level of 3.3%, whereas the annual HICP rate rose to 3.5%. Upward pressure on energy prices weakened despite a further increase in the cost of refined petroleum products, gas and electricity. The increase in the cost of services was somewhat sharper and the usual seasonal decline in the price of food products failed to materialise. Given the increasingly abundant supply of agricultural products, it is likely that there will be a certain easing of pressure in the coming months. Fuel and heating oil will probably also become cheaper again owing to corrections to the price of crude oil. In the case of gas, further sharp price rises have been announced, however. There could be a slight overall moderation in the year-on-year rate of consumer price inflation, although it is likely to remain well above 2%.

... price inflation somewhat weaker in July

Orders received and outlook

The scale of the decline in overall economic output in the second quarter was due, to a considerable extent, to negative special effects. Nevertheless, this GDP result indicates a more mixed macroeconomic constellation, which, after a fairly long period of rapid economic growth, has come more to the fore recently. This does not, however, point to a fundamental deterioration in the overall economic situation nor does it imply a loss of the cyclical resilience that has been regained over the past few years. Nevertheless, in addition

Greater impact of negative factors



to the ongoing uncertainties and the global challenges which have yet to be resolved, further negative factors emerged in the first half of 2008. Consequently, the aggregate “risk mix” that has been built up is now no longer without a perceptible impact on Germany’s economic development.

This is particularly true of the energy-price and inflation-related strains which not only have an adverse effect on domestic consumption, but also on economic activity in major German export markets. For one thing, the massive increase in the cost of energy has meant that the developed economies have experienced considerable losses in real income in the past few years. (Data for the German economy may be found in the explanatory notes on “Energy bill for the German economy under increasing price pressure” on pages 54-55.) Secondly, adverse effects on potential overall economic output may be expected in connection with this. For example, owing to a lack of scope for passing through higher prices, enterprises may, on cost grounds, be forced to cut back their energy use. For technical reasons, this can initially be accomplished only by reducing output. This, in turn, affects demand for other production factors. Furthermore, the value of production capacity that is, in fact, still available is reduced by the high energy prices, since the lack of energy efficiency means that it is no longer economical. Not least, an additional capital devaluation effect may occur as there will be less market demand for energy-intensive capital and durable goods. The aggregate output gap will therefore probably tend to react less strongly to the energy price shock

Negative supply and demand effects

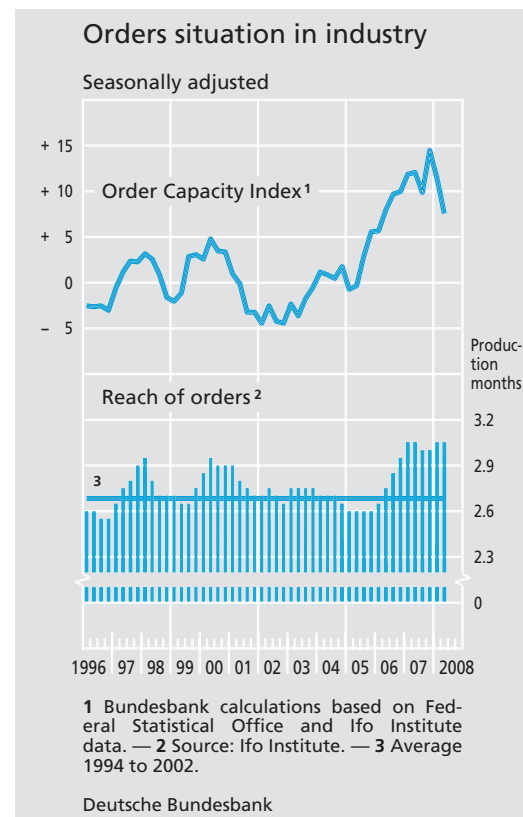
than might be expected for cyclical reasons alone. The cyclical price-dampening effects are therefore also likely to be correspondingly moderate.

*Deterioration
in household
sentiment ...*

Moreover, the current accumulation of shocks has led to fairly large revisions of shorter-term expectations recently. Thus, the considerable deterioration in enterprises' and households' sentiment in the second quarter also has to be seen in connection with the fact that the price surge in the energy and commodity markets in the first half of the year attained unprecedented levels in terms of both scale and pace. In the case of extrapolatory expectations, this can lead to an excessive deterioration in real income prospects. Given all due caution in assessing its sustainability, the fairly substantial revision to the oil price in mid-July is one illustration of the fact that simple extrapolations of the current trend may turn out to be inaccurate. Seen in this light, the picture presented by current sentiment, which is undoubtedly being shaped by such effects as well, should not be overestimated.

*... and in trade
and industry*

Nevertheless, it should be noted that the Ifo business climate indicator has been declining steadily since its all-time high in the second quarter of 2007, with an accentuation recently of the hitherto more moderate corrective movement. In particular, business expectations for the next six months were rated significantly less favourably in July than, say, one year ago. By contrast, assessments of the business situation have been declining at a more subdued pace; given the high starting level as well, this means that they are currently still in the positive range.



With regard to industry, unfavourable earnings expectations are likely to be one of the causes of the deterioration in sentiment. A reduction in profit margins and increased cost pressure, together with weaker sales expectations, have prompted a more cautious assessment. Nevertheless, despite the declining volume of new orders, the current order situation is still satisfactory on the whole. Measured by the order capacity index, demand exceeded the production capacity of order-based industry by 7.9% in the second quarter, compared with 11.8% in the previous quarter. According to the Ifo institute, the reach of the order books in July, at just over three production months, remained at a high level. Furthermore, there are no indications at present of any major overcapacity or employment overhang. Exchange rates have not

*Order situation
in industry
satisfactory
at present ...*

Energy bill for the German economy under increasing price pressure

In mid-July 2008, the world market price of (Brent) crude oil reached an all-time high of US\$146½ per barrel. Prices subsequently showed a marked decline to US\$113½ (mid-August), but were still one-sixth higher than at the start of the year and almost three-fifths above the previous year's average. The rise in crude oil prices measured in euro – of one-sixth or just under one half – was somewhat more subdued owing to the euro's appreciation against the US dollar. Even so, in June (more recent data are unavailable) German import prices for energy – comprising not only crude oil and refined petroleum products, but also gas, coal, electricity and other energy sources – were more than one-quarter up on their December 2007 level and half as much again above the previous year's average (see also the chart on page 55).¹ Even taking into account the forward quotations in the oil markets for the coming months there is much to indicate that Germany's bill for imported energy will rise sharply this year. For the most part, this is likely to put pressure on the purchasing power of households' disposable income.

Based on a crude oil price of around US\$120.00 per barrel of Brent crude oil and a euro-US dollar exchange rate of somewhat over US\$1.50, the price increase for imported energy amounts to roughly 40% for 2008 as a whole. Since the volumes of imported energy display a low price elasticity in the short term, only a minor volume effect of demand is to be expected. Overall therefore, Germany's net energy costs (ie the difference between nominal energy imports and exports) could rise in value in 2008 by €23 billion on the year to €82¼ billion. In statistical terms, this energy-related loss of purchasing power would almost match the scale of the purchasing power loss due to the increases in VAT and insurance tax as of 1 January 2007.² In relation to nominal gross domestic product (GDP) as the comprehensive domestic income variable, this would signify an increase in energy-related costs of roughly 1 percentage point to 3¼%. This ratio is one-quarter higher than the corresponding figure in the first oil price crisis of the mid-1970s but it is still around one-third below the peak burden in the second crisis of the early 1980s.

This means that, since the recent round of crude oil price increases began in 2002, the German economy's

¹ Empirical studies show that it does not take long for changes in the price of crude oil to be passed through almost entirely to the import prices of petroleum products. Natural gas prices follow oil prices with a greater time lag. — ² See Deutsche Bundesbank, Price and volume effects of VAT increase on 1 January 2007, Monthly Report, April 2008,

bill for imported energy has risen by 140%. As a ratio of nominal gross domestic product (Y), the value of net energy imports (E) has more than doubled to 3¼%. In order to separate the structural effects this contains from the pure price and exchange rate effects, it is possible – in simplified form – to make a distinction between four sub-components: a price component, an exchange rate component, the import-dependence of German energy consumption, and aggregate energy intensity.

$$\frac{E}{Y} = \frac{P_e}{P_y} \cdot \frac{1}{W} \cdot \frac{e}{v} \cdot \frac{v}{y}$$

In the above equation, P_e denotes world market prices for energy sources in US dollar (energy commodities in the international markets are predominantly quoted in US dollar), P_y denotes the GDP deflator, and W denotes the euro-US dollar exchange rate. The quantity variables represent the volume of German net energy imports (e), domestic energy consumption (v) and real GDP (y).

The first expression, (P_e/P_y) is a measure of the relative energy price effect. In the period from 2003 to 2008, world market prices for energy in US dollar terms relative to the GDP deflator increased by an average of 28% per year. From a German perspective, this was due mainly to a deterioration in the terms of trade for crude oil. The exchange rate component $(1/W)$, which corresponds to the reciprocal euro-US dollar exchange rate, had a dampening effect. Between 2003 and 2008, the euro appreciated against the US dollar by 8¼% on an annual average, which thus lessened the increase in world market prices for energy commodities. The third term (e/v) reflects the dependence of domestic energy consumption on energy imports, which may be approximated by the ratio of net imports of primary energy to aggregate primary energy use.³ In the period from 2003 to 2007 (up to which data are available) this variable declined in Germany by an annual average of ½ percentage point.⁴ Assuming a matching development for the entire period up to 2008, the German energy bill, as a ratio of GDP, has fallen *per se* by 3 percentage points. Furthermore, the decline in aggregate energy intensity in Germany (v/y), measured by the use of primary energy in relation to real GDP,

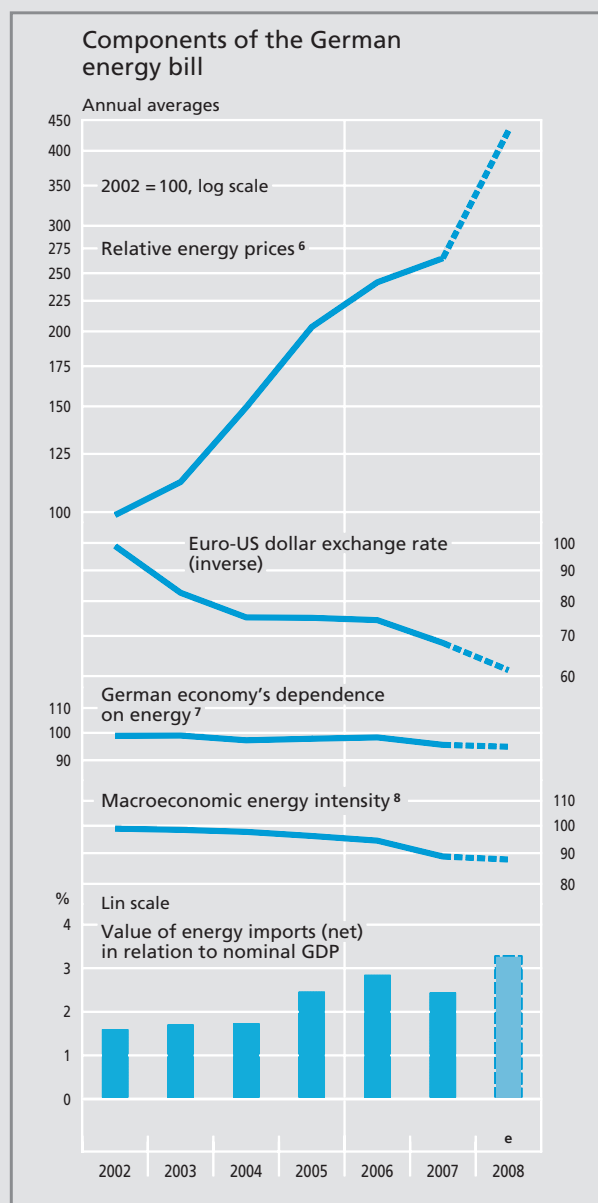
p 30. — ³ The calculations on import-dependence and energy intensity are based on data from the AG Energiebilanzen. See Auswertungstabellen zur Energiebilanz für die Bundesrepublik Deutschland 1990 bis 2006, October 2007 and Energieverbrauch in Deutschland im Jahr 2007 (available in German only) — ⁴ Weather conditions may also have

had an alleviating effect. Between 2003 und 2008, this decreased by an annual average of 2%; this also holds if primary energy consumption is temperature-adjusted for the individual years.⁵ Energy-saving technology and production methods and structural change in the German economy, which is characterised by a declining importance of the energy-intensive manufacturing industry and the growth of the services sector, have played a part in this. For the entire period between 2003 and 2008 under consideration here, the cost-dampening effect of the increased energy efficiency of production amounted to 11% for the German economy. Together with the alleviating effect of the euro's appreciation against the US dollar and declining dependence on energy imports, this clearly mitigated the aggregate loss of income due to the development of international oil and energy prices.

Overall, however, this still means that, during the period from 2003 to 2007, some 8¾% of the nominal increase in the domestically generated incomes of all sectors was transferred abroad. Matching calculations show that, in 2008 alone, the marginal loss of income in favour of other countries is likely to amount to as much as 27%. Taking only the energy price component and leaving other determinants unchanged produces figures as high as 12% and 33¾% respectively.

The increase in the prices of energy sources has therefore considerably restricted the real scope for income distribution in Germany. Even taking into account the fact that finished industrial goods, especially capital goods, can be bought more cheaply abroad this year, the terms of trade have become considerably less favourable with regard to the economy as a whole, especially as there has been a sharp rise in the prices of imported commodities and primary materials. Ultimately, from a macroeconomic perspective, such cuts in real income are unavoidable in the short term. Any attempts, as in the 1970s and early 1980s, to offset this "internally" through higher pay settlements, merely trigger second-round effects which threaten stability policy or put jobs at risk domestically. Apart from a change in the energy mix, the only approach with a prospect of success is to adopt strategies geared to a further reduction in energy intensity. In terms of growth policy, the good sense of continuing down this

path is borne out by the fact that the German economy is already a highly successful exporter of energy and environmental technology products.



a perceptible impact on primary energy consumption from year to year. — ⁵ On temperature-adjusted primary energy consumption, see Federal Ministry of Economics and Technology, Kennziffern des Energieverbrauchs (www.bmwi.de/BMWi/Navigation/Energie/energiestatistik, did=176662.html), (available in German only). — ⁶ World mar-

ket prices for energy in US dollar (Source: HWWI, Hamburg Institute of International Economics) in relation to the GDP deflator. — ⁷ Net imports of primary energy as a percentage of total primary energy use. — ⁸ Use of primary energy (temperature-adjusted) in relation to real GDP.

exerted any additional pressure over the past few months; added to this, in mid-July, the euro started to depreciate against the US dollar. The latest results of the bank lending survey do not indicate any restrictive lending behaviour by German banks either.

... but increasingly characterised by a decline in new orders

Even so, in terms of the future outlook, one factor that should not be underestimated is that it has since not been possible to maintain the large flow of orders received at the turn of 2007-08, which was characterised, not least, by an exceptional number of major new contracts. Demand for German industrial goods showed a marked decline, especially in the export markets. Losses of new orders were particularly pronounced in the case of enterprises

domiciled in euro-area partner countries. By contrast, domestic orders were trending only moderately downwards.

Given that the order situation in the construction sector has been without stimuli over the past few months, the available hard economic indicators are currently pointing to more subdued economic growth in the third quarter. This will be due in part to the lingering effects of those negative factors which, apart from technical counter-reactions, hampered output in the second quarter. This does not, however, imply any growing downward pressure, although as things currently stand, a cyclical "lean period" appears to be in the offing for the second half of 2008.

Cyclical "lean period" in second half of 2008