

Economic conditions in Germany

Macroeconomic situation

The German economy grew very sharply in the first quarter of 2008. According to the flash estimate of the Federal Statistical Office, overall economic output increased by 1.5% in seasonally and calendar-adjusted terms during the reporting period. Although the extent of expansion in GDP has to be seen in connection with subdued growth towards the end of 2007, when the trend in construction was weak and there was a temporary interruption in the upturn in consumption, this figure also reflects the sound underlying dynamics of the economy. Overall capacity utilisation showed a further substantial increase in the final quarter of 2007 and the first quarter of 2008, for example. After adjustment for the different number of working days, GDP in the first three months of 2008 was 2.6% up on the year, compared with 1.8% in the final quarter of last year.

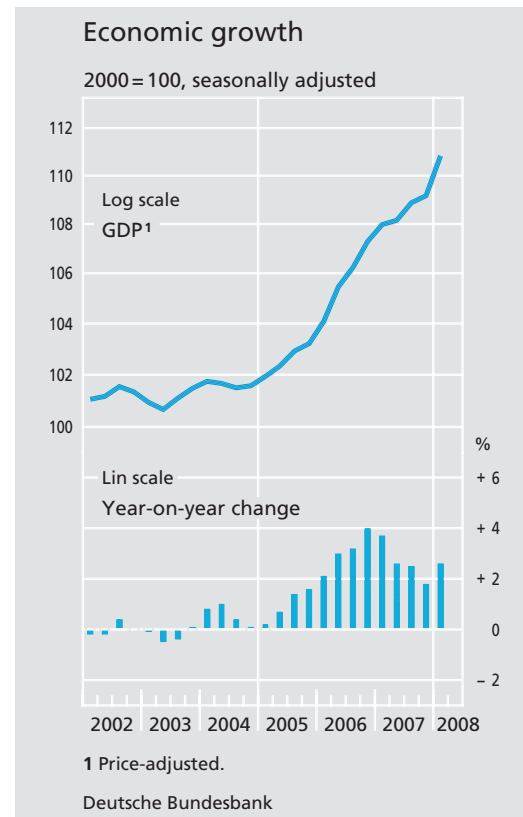
*Very sharp
GDP growth
in 2008 Q1 ...*

The expansion in economic output was also broadly based in sectoral terms. Industrial output was very buoyant and, given the comparatively mild weather, the construction sector was able to press ahead with processing the surge in orders received in the final quarter of last year. Business-related services also benefited from the growth in the production sector, especially the wholesale trade and the transport sector. On the expenditure side, growth continued to be sustained mainly by buoyant investment demand as well as positive exports. Moreover, despite persistent strains with regard to prices, private consumption made up ground again, which also gave an added boost to imports.

*... broadly
based*

*Buoyant
domestic
demand*

Although there is currently no detailed information on the demand components in the first quarter of 2008, the available indicators suggest that overall economic growth was sustained primarily by domestic demand. Above all, there was a sharp increase in corporate investment, which was mainly in machinery and equipment. This is striking insofar as the bringing-forward of such purchases to 2007, which was advantageous on tax grounds, evidently had no impact, at least in macroeconomic terms. One factor in this may have been that the cyclically induced long delivery times had led enterprises to order capital goods well in advance of the cut-off date in order still to benefit from the favourable depreciation facility. Furthermore, the earnings outlook, financing conditions and locational factors – fundamental economic determinants which are crucial to the profitability of investment projects – were rated positively on the whole throughout the period under review. In addition, there was a jump in construction investment. Not only were a large number of industrial construction projects and infrastructure measures realised in the first quarter with scarcely any weather-related losses of output, housing construction, too, is likely to have picked up following what was a weak 2007 overall. Finally, households spent perceptibly more in real terms for consumption purposes in the first quarter of this year. Against the backdrop of an unexpectedly strong price shock and increased financial turbulence, their sudden reluctance to purchase had put a brake on consumption in the final quarter of last year and was reflected to a certain extent in a marked rise in the saving ratio. This reluctance is likely to have lessened



somewhat in the first three months of this year.

According to the available data, exports showed a marked growth in the first quarter of 2008. In real terms, seasonally adjusted exports of goods were 1¼% up on the final quarter of 2007. German exporters were thus hardly affected by the declining pace of growth in the world economy. Added to this was that the predominantly exchange-rate-related deterioration in the German economy's price competitiveness compared with major trading partners – an ongoing trend for more than two years now – was also continuing to have no more than a moderate impact. Moreover, the regional structure remained essentially unchanged during the reporting period. There was very sharp expansion again

Robust exports

Foreign trade by region and category of goods
Percentage change

Item	Average of Jan-Feb 2008 compared with			
	2007 Q4 seasonally adjusted		Jan-Feb 2007 unadjusted figures	
	Ex-ports	Im-ports	Ex-ports	Im-ports
Total	2.6	6.3	8.8	8.4
Countries or group of countries				
Euro-area countries	2.8	7.8	5.8	8.8
Other EU countries of which	0.5	3.6	9.5	10.2
New member states ²	4.0	2.1	17.0	14.9
United States of America	5.2	-3.8	4.9	-6.3
Russian Federation	15.8	-4.3	31.0	31.4
Japan	8.3	-3.4	7.4	-4.6
South-East Asian emerging economies ¹	5.0	6.6	11.3	-5.5
China	9.0	3.5	23.4	5.2
OPEC countries	4.4	36.1	12.0	35.9
Categories of goods				
Main categories				
Intermediate goods	6.9	5.4	9.2	2.6
Capital goods	1.6	5.3	6.4	4.8
Consumer goods	5.0	3.5	16.1	7.1
Energy	.	11.2	.	36.9
Selected categories				
Chemicals	8.3	4.7	16.7	8.2
Machinery	5.5	6.4	10.9	12.6
Motor vehicles and motor vehicle parts	2.0	4.1	7.1	7.7
IT products	-1.1	-1.0	1.1	-3.1
Metals and metal products	6.9	5.5	6.8	-0.3

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

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in exports to the new EU member states, to China and to the South-East Asian emerging economies, for example. Exports to Russia and the OPEC countries continued to benefit from these countries' increasing oil and gas revenues. Exports to other euro-area countries have also shown a marked increase. The fact that the German economy has been able to maintain its competitiveness under difficult underlying conditions is demonstrated by the sharp growth in exports to the United States, for example. In this context, not only the generally high volatility of foreign trade flows should be remembered, however, but also the fact that German enterprises' US business was increasingly showing signs of slowing down in the course of last year.

At 4¼% in real terms, imports of goods in the first quarter of 2008 grew even more sharply than exports in seasonally adjusted terms. Energy imports recorded the highest rate of growth in terms of value, but two-thirds of the rise was price-related. Owing to buoyant domestic investment, it was mainly imports of capital goods that increased in real terms. However, the improvement in the propensity to consume in Germany is also likely to have prompted firms to import more consumer products, especially as foreign products were becoming relatively cheaper owing to the appreciation of the euro. Added to this was a marked expansion in imports of intermediate goods – not only in connection with the marked increase in German industrial output but also due in part no doubt to inventories being stocked up. Price expectations may also have played a role, however.

Marked recovery in imports

Sectoral profile

Sharp rise in industrial output

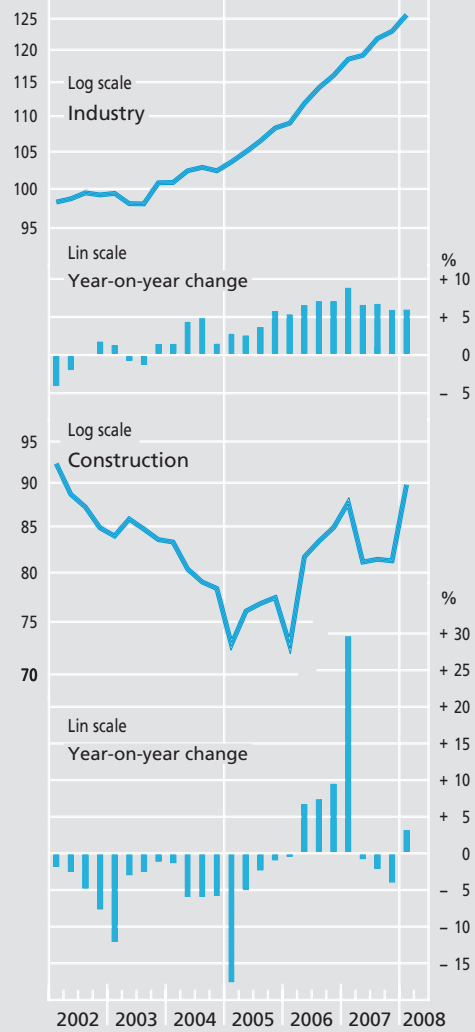
Industrial output was very buoyant again in the first quarter after having tailed off for a time in the final quarter of 2007. The positive underlying trend is also revealed by the fact that the high level of output at the start of the year was almost maintained in March as well in seasonally adjusted terms, even though there were more public holidays than usual in this month owing to the early date of Easter this year. Seasonally adjusted industrial output in the first three months of 2008 was 2.2% up on the quarter. The renewed surge in output was broadly based, with capital goods producers achieving the largest growth. Industrial output was 6.0% up on the year in calendar-adjusted terms.

Capacity extensions to the fore

With an average growth of 1½% per quarter, industry has set a quite notable pace of growth in the past three years. Cyclical factors predominated at the start of the upswing – something that can be recognised, say, by the sharp increase in industrial utilisation at that time. For one and a half years, however, the growth in output has not been accompanied by any further increase in capacity utilisation. According to the Ifo Institute, industrial capacity utilisation in 2007 remained at the record high of more than 87% of normal full capacity, while real value added in this sector increased by more than 6½% in calendar-adjusted terms. These trends reflect the fact that industrial enterprises are very willing to invest in capacity extensions at their domestic locations. This noticeable supply effect has been made possible, not least, by the fact that both sides of industry have exer-

Output in industry and in construction

2000 = 100, seasonally adjusted, quarterly



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cised wage restraint for a lengthy period and that economic policy has tackled overdue reforms in the labour market and in the social security systems. Germany's regained attractiveness as a location of modern industrial technology can be secured in the long term only if wage moderation is preserved and scope for flexibility at firm level is maintained.

Industry as provider of stimulus for construction sector and craft trades

The positive business conditions in industry also spread to other sectors of the economy. Additional factory workshops and storerooms have to be constructed for new production facilities, for example, which has been providing stimulus especially to construction sector activity for some time. Numerous corporate sector orders as well as a larger volume of public sector infrastructure projects from the final quarter of 2007 are the main reason for an increase in construction sector output in the first quarter of no less than 10.4% in seasonally adjusted terms. This rise was, admittedly, positively influenced by the fact that, owing to the mild weather at the beginning of the year, there were comparatively few of the usual winter hold-ups in production. In March, the Easter holidays and a late spell of winter weather considerably reduced the heightened level of activity, however. The continuing positive outlook in industry and the upturn in the construction sector also benefited the craft trades, which recorded employment growth in 2007 for the first time in one and a half decades.

Employment and unemployment

Sharply expanding employment

The marked rise in employment has been continuing in 2008 so far. According to estimates by the Federal Statistical Office, there was a seasonally adjusted quarter-on-quarter increase – aided by the extremely mild winter weather – of 220,000, or 0.5%, in the first three months of this year. Including the upward revision of the data from the third quarter of 2007 onwards, the year-on-year rise is now 684,000, or 1.7%. This growth in em-

ployment consists very largely of jobs which are subject to social security contributions; according to Federal Employment Agency data, these showed an increase of 2.5% on the year in February. Among these jobs, there was a disproportionately large growth of 6.6% in business-related services, under which temporary work is also recorded for statistical purposes. According to preliminary estimates by the Federal Employment Agency, the number of persons solely in marginal employment showed a rise of 1.7% on the year, while the corresponding figure for persons with mini-jobs was as much as +9.8%. The scale of assisted forms of employment in connection with job creations measures, employment opportunities (one-euro jobs) as well as assisted self-employment showed a decline in both quarter-on-quarter and year-on-year terms.

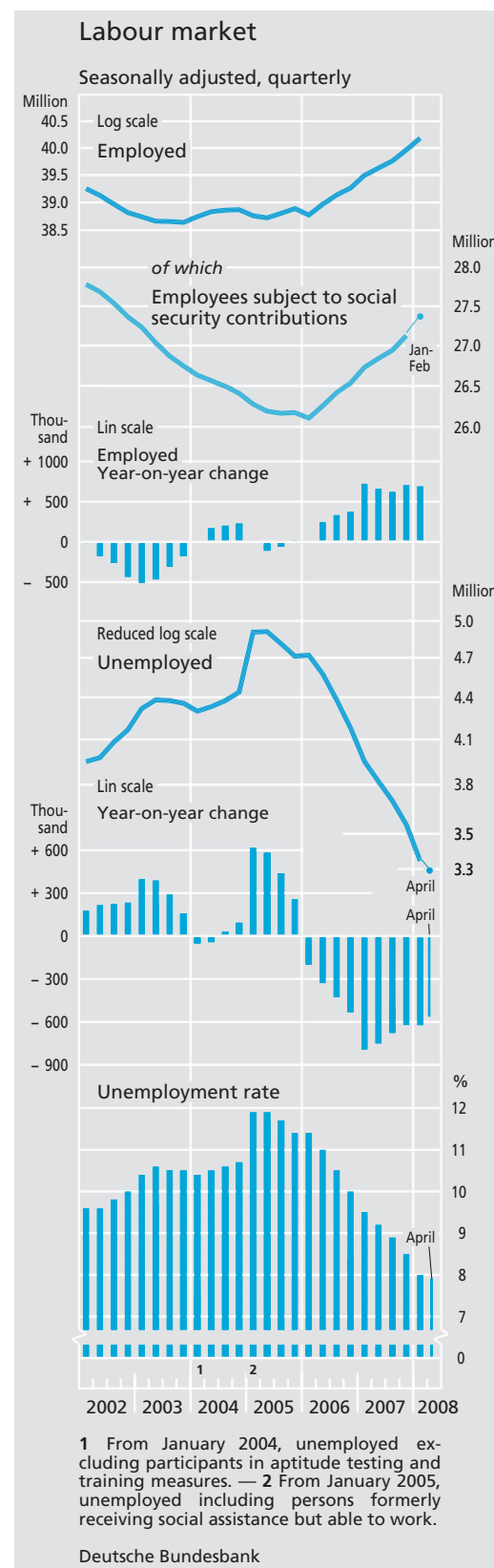
The available indicators point to a continuation of the expansion in employment. Nevertheless, there are growing signs of some slowing-down. The Ifo employment barometer shows further need for recruitment but has been declining slightly since the first quarter of 2007. The number of vacancies reported to the Federal Employment Agency declined somewhat in seasonally adjusted terms in the first few months of 2008. In particular, the inflow of new vacancies, which was very strong before, has become slower since the beginning of the year. There was no further rise in April in the Federal Employment Agency's BA-X index for non-government-assisted jobs, which includes jobs in the primary labour market advertised on the internet. The IAB survey on jobs on

Further need for recruitment

offer in the economy as a whole already shows a decline for the fourth quarter of 2007 in both quarter-on-quarter and year-on-year terms.

Marked fall in unemployment

There was a further perceptible decline in the official unemployment figure in the first quarter. At a seasonally adjusted 3.36 million, there were 211,000 fewer persons registered as unemployed than in the final quarter of 2007. The mild weather and seasonal short-time working benefits are likely to have strengthened the cyclical improvement, however. The year-on-year decline amounted to 624,000. Of these, somewhat over 60% were job seekers receiving unemployment benefits under the Third Book of the Social Security Code (SGB III) (statutory insurance scheme) and just under 40% were job seekers subject to the Second Book of the Social Security Code (SGB II) (basic allowance system).¹ At 8.0%, the seasonally adjusted unemployment rate was 0.5 percentage points lower than in the preceding quarter and 1.5 percentage points down on the year. The internationally comparable, standardised unemployment rate (calculated according to International Labour Organization (ILO) criteria) stood at 7.4% in the first quarter, compared with 8.7% one year earlier. In seasonally adjusted terms, there was no further decline in unemployment in April compared



¹ For the structure of the decline in unemployment since April 2005, see the explanatory notes on page 56-57.

Who stands to gain from the fall in unemployment?

Within the space of three years, the number of persons officially registered as unemployed has gone down by 1.64 million to 3.41 million (April 2008). Several factors are likely to have contributed to this marked decline. First, at the beginning of 2005, all persons receiving social assistance and able to work, but not entitled to claim unemployment benefit or unemployment assistance, were included in the labour market statistics for the first time. This initially had the effect of pushing up the number of registered unemployed by around 470,000. At the same time, assistance was geared more strongly to the principle of encouraging and helping people to take up work, while unemployment assistance – which was calculated on the basis of past earnings – was replaced by a standard basic allowance known as unemployment benefit II. In the course of 2005, this already led to a significant drop in registered unemployment in spite of what was initially only a mild pick-up in employment.¹ In 2006 and 2007, the – cyclically – rapidly rising demand for labour brought about a speedy reduction in unemployment. A major contributory factor in this was that jobs subject to social

security contributions had become more attractive to employers again, owing to the changed underlying conditions (reduced promotion of “mini-jobs” and the deregulation of temporary employment) together with a wage moderation process. Furthermore, the restructuring of benefit payments strengthened the willingness of job-seekers to compromise. It may also have been helpful that demographic factors were tending to depress the labour supply.

The past few years have seen a broadly-based decline in unemployment – for instance, in contrast to the boom period of 1998-2000, the reduction in unemployment in eastern Germany was only slightly behind that in western Germany. Nevertheless, measurement by various criteria reveals clear regional and group-specific differences in scale and speed. For example, the improved labour market situation benefited men to a markedly greater extent than it did women. The export and industry-oriented nature of the current period of economic upswing may well have played a major role in this connection. By contrast, during the New Economy boom at the end of the 1990s, the percentage decline in unemployment among women was somewhat greater than among men. Likewise, men appear to be benefiting to a particular extent from the broad deregulation of temporary employment. At all events, according to Federal Employment Agency statistics, three-quarters of persons hired for temporary employment are men.

There are also marked differences according to age group. The number of young unemployed persons (ie up to 25 years of age) almost halved during the period under review. This contrasts with the drop in the number of older unemployed persons (ie above 55 years of age) which was at first less pronounced than the fall in the number of unemployed persons up to 25 years of age or “middle-aged” persons. However, in the course of 2007 the decline accelerated discernibly. This may well also be due to the fact that the amalgamation of unemployment assistance and social assistance to form unemployment benefit II and the tightening of work availability requirements applying to former recipients of social assistance had already entered into force in 2005, while the shortening of the previously relatively long period of entitlement to unemployment benefit, which was of significance particularly for older claimants, did not take effect until the beginning of 2007.

Changes in unemployment according to various criteria

Cumulative change compared with April 2005 in thousands
(in brackets: percentage change since April 2005)

Item	April 2006	April 2007	April 2008
West	- 138 (- 4.1%)	- 728 (- 21.8%)	- 1,123 (- 33.6%)
East	- 124 (- 7.2%)	- 348 (- 20.3%)	- 515 (- 30.1%)
Women	- 88 (- 3.8%)	- 353 (- 15.3%)	- 649 (- 28.1%)
Men	- 175 (- 6.4%)	- 723 (- 26.3%)	- 990 (- 36.1%)
Below 25 years of age	- 81 (- 12.7%)	- 233 (- 36.6%)	- 297 (- 46.7%)
Between 25 and 55 years of age	- 178 (- 4.6%)	- 761 (- 19.9%)	- 1,177 (- 30.8%)
Above 55 years of age	- 3 (- 0.6%)	- 82 (- 13.7%)	- 164 (- 27.5%)
Unemployed persons receiving unemployment benefits (SGB III)	- 395 (- 17.9%)	- 849 (- 38.5%)	- 1,159 (- 52.5%)
Unemployed persons receiving social benefits (SGB II)	+ 133 (+ 4.7%)	- 227 (- 8.0%)	- 479 (- 16.9%)
Total	- 262 (- 5.2%)	- 1,076 (- 21.3%)	- 1,639 (- 32.4%)

¹ This would indicate that persons who lost their entitlement to unemployment assistance as a result of the new regulations did

not re-register. In addition, the employment agencies reviewed the employability of earlier registered recipients of social assistance.

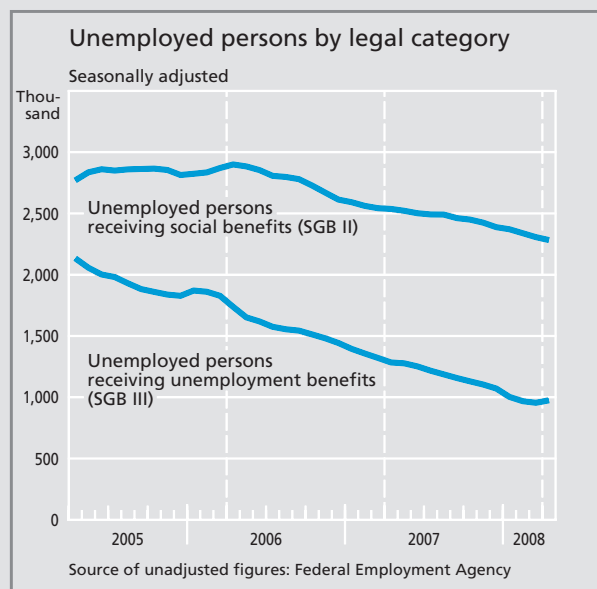
Since the amalgamation of unemployment assistance and social assistance and the reduction of the maximum period of entitlement to unemployment benefit it has been possible to approximate roughly the level of cyclical and frictional unemployment, based on the number of persons in legal category SGB III (unemployed persons receiving benefits from the statutory insurance scheme under the Third Book of the Social Security Code: standard unemployment benefits) and the level of structural unemployment, based on the number of unemployed persons contained in legal category SGB II (unemployed persons receiving a basic allowance subject to the Second Book of the Social Security Code: unemployment benefit II). There are fewer long-term unemployed persons among the unemployed in category SGB III than there are in category SGB II (April 2008: 18.3% compared with 47.4%) and, on average, they also have better school qualifications. According to Federal Employment Agency statistics, 18.4% of these individuals possess a certificate of aptitude for higher education, compared with 9.0% of recipients of unemployment benefit II. The percentage of unemployed persons without any school-leaving qualifications or having only a certificate of secondary education, at 44.6%, is well below the figure for unemployed persons in legal category SGB II (64.0% in April 2008 in each case).

While the number of unemployed persons in category SGB III decreased at quite a rapid pace, shrinking to half by April 2008, the decline in category SGB II was sluggish at first. However, as the labour market continued to revive, the decline accelerated markedly, while the fall in category SGB III slowed down. In absolute figures and in seasonally adjusted terms, the reduction in legal category SGB II during the first four months of 2008 was as sharp as in legal category SGB III. All in all, the number of unemployed persons in category SGB II has decreased by almost half a million over the past three years. As a percentage of the labour force, this corresponds to a fall in the unemployment rate of around 1%. Even though the usual distinction between cyclical and structural developments cannot be made in a clear-cut manner, clear progress in the reduction of entrenched labour market problems is nonetheless identifiable in the current economic cycle. Hence, since April 2005, roughly one-quarter of the total decline in unemployment of roughly 4 percentage points may have been attributable to a fall in the hard core of unemployment, which is to be seen in the context of the structural reforms of the past few years. The overall impact of

Finally, by the end of 2005, the number of persons employed in newly created job opportunities had risen to more than 300,000.

these reform measures in the labour market may be rated as even greater, however, inasmuch as the reorganisation of the labour exchanges and intensified job placement have made it possible to reduce frictional unemployment as well. In addition, the reduction in cyclical unemployment has benefited from the deregulation of temporary employment.

However, at below one million, the number of unemployed persons covered by the statutory insurance scheme has now moved to a fairly low level, which mainly includes the frictionally characterised segment. A further marked reduction in unemployment will probably primarily be achieved only by eroding its structural core. However, the underlying reform and pay policy conditions do not harbour any further potential relief. In view of this, measures such as the introduction of comparatively high sector-specific minimum wages or the extension of older claimants' period of entitlement to unemployment benefit are, in fact, counterproductive. Hence, any further substantial and sustainable reduction in the continuing high level of unemployed persons receiving a basic welfare allowance, numbering 2.3 million at present, can be achieved only by persisting with reform policy. Otherwise, there would be the risk of the trend growth rate of the German economy decelerating again following the period of moderate recovery in the past few years.



with the level in March.² The unemployment rate, as defined nationally, stood at 7.9%.

Wages and prices

2008 pay round with higher negotiated rates in the public sector...

New pay settlements were concluded in many sectors in the first few months of 2008. In some cases, the negotiated rates were well above those agreed in earlier years. Following a virtual three-year pay freeze (apart from one-off payments amounting to €300 per year), the parties engaged in public sector pay bargaining for central and local government agreed on a permanent increase in remuneration by a base amount of €50 and 3.1% backdated to 1 January 2008.³ At the beginning of 2009, salaries will be raised by a further 2.8%, in addition to which there will be a one-off payment of €225.⁴ In local government in western Germany, standard weekly working hours are being extended by half an hour to 39 hours. The new pay settlement runs till the end of 2009. There were similar improvements for doctors at local hospitals, who had gone on strike in 2006 to achieve a separate pay agreement and a marked increase in salary.

... and in the private sector

A pay increase of 4.4% was agreed in the chemicals industry. From the 14th month of the agreement, which runs for a total of 25 months, there will be a further rise of 3.3%. Added to this will be a one-off payment of 0.5% of the remuneration for the first 13 months. Marked gains in income were also negotiated in the steel industry (+5.2% with an agreement running 13 months plus a one-off payment of €200 for a month

with no increase in standard pay). By contrast, the improvements in the textiles and fashion industry were more modest, at 3.6% (plus one-off payments), than they were in the paper, paperboard and plastics processing industry (+3.9% from May 2008, +2.9% from May 2009) as well as in parts of the motor vehicle maintenance sector (in Baden-Württemberg, for example, +2.5% in April 2008, followed by +2.0% in both December 2008 and 2009). Negotiations in the hotel and catering industry also ended in a comparatively moderate pay rise (+3.0% initially, followed by an increase of 2.5% at a later date with an agreement running for 27 months). Deutsche Post AG and the public sector trade union ver.di agreed on a linear 4.0% increase in pay to take effect after six months plus a one-off payment of €200; a further increase of 3.0% will follow 12 months later. In the retail trade, there is still no settlement at the regional level in the pay dispute that has been under way for one year. Company-specific solutions have been found instead in some cases.

On the whole, the higher pay settlements reflect the generally improved labour market situation as well as, in terms of their differentiation, the positive performance of industry. With regard to the public sector, the particular situation of the past few years has to be borne in mind. The salary improvements tend to have been made less through one-off pay-

Stabilisation policy risks

² Problems in the data processing of the Federal Employment Agency may have resulted in the situation having been depicted too unfavourably, however.

³ An increase in pay from April 2008 was agreed for local government in eastern Germany.

⁴ Different arrangements apply in some cases to hospital employees and those working in municipal utilities.

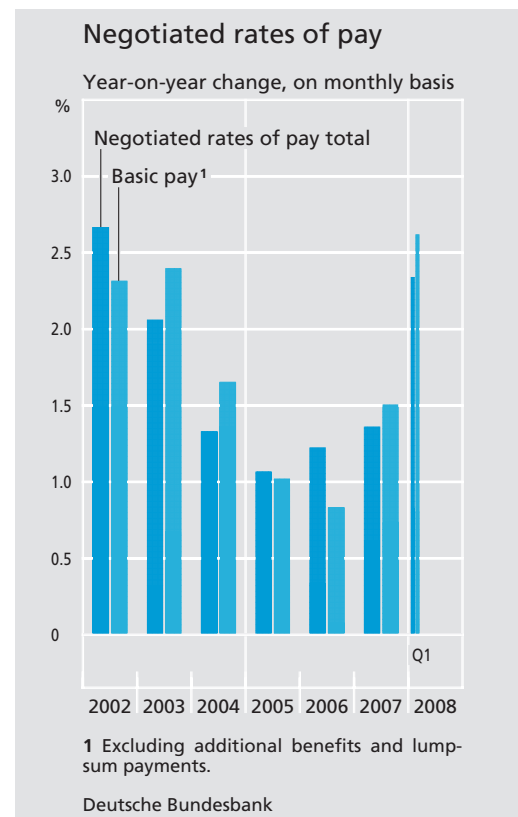
ments than was the case in 2007. On the other hand, the agreements are characterised by the fact that they run for relatively long periods of time. This increases enterprises' planning certainty but might reduce flexibility with regard to pay policy. All things considered, additional positive stimuli for employment are not to be expected, however. From a stabilisation policy perspective, the 2008 pay round is not free of risks.

Markedly higher rise in negotiated rates of pay in 2008 Q1

According to the Deutsche Bundesbank's pay rate statistics, the year-on-year increase in rates of pay in the first quarter of 2008, at 2.3%, was double that of the final quarter of 2007. The contractually agreed basic rates of pay, in which baseline effects of non-repeated one-off payments are omitted, went up by 2.6%. In the production sector, which benefited from buoyant exports and investment, the rise in negotiated rates of pay, at 3.4%, was noticeably sharper than in the more domestically-oriented services sectors.

Continuing energy-related price increase for imports ...

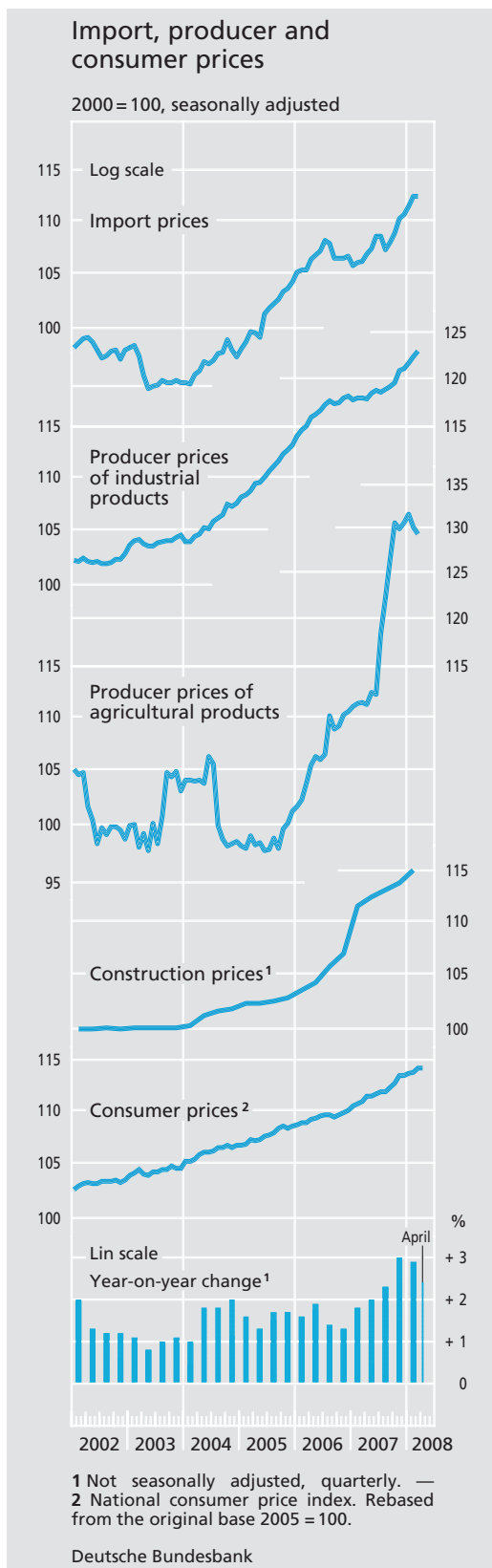
As was the case in the last few months of 2007, marked increases in crude oil prices crucially shaped price developments at the beginning of 2008. While import prices excluding energy went down in the final quarter of last year, they have been rising quite sharply since December 2007 despite the strong appreciation of the euro. In addition to continuing price increases for food and animal feed, there were further rises in the cost of inputs. Durable goods likewise cost considerably more. Imports were 2% more expensive overall in seasonally adjusted terms. Excluding energy, the figure was +0.7%.



A baseline effect due to the marked price reductions for crude oil in the first quarter of 2007 also played a part in the year-on-year figure for import prices going up from +3.2% in the final quarter of 2007 to +5.7%. Owing to the impact of the euro's appreciation, the increase in the price of exports was clearly weaker in seasonally adjusted terms than the increase in the price of imports. As a result, there was a marked deterioration in the terms of trade, where the year-on-year decline – not least owing to the baseline effect in import prices – widened from 1.7% to 3.4%.

At the domestic industrial producer level, the quarter-on-quarter rate of price increase went up from 1.3% to 1.6% in seasonally adjusted terms. Although this acceleration is

... and continuing high rate of price increase at the domestic producer levels



due in large part to the sharp increase in the case of energy, the cost of other industrial products, too, went up sharply at a seasonally adjusted 0.9%, with price impulses from imports being passed on rapidly. The rise in producer prices for products of the food and beverages industry has not perceptibly weakened so far, although a certain moderation is apparent in the case of agricultural producer prices. The year-on-year increase in industrial factory gate prices went up further from 2.2% to 3.8%, a factor in this being the marked fall in the corresponding rate in the first quarter of 2007. If energy is excluded, the increase was slightly smaller, ie from 2.3% to 2.6%. Prices for construction accelerated somewhat again in the first quarter. The year-on-year rate fell by half to 3.2%, however, since the price effects in connection with the increase in the standard rate of value added tax (VAT) as of January 2007 dropped out of the figures.

At a seasonally adjusted 0.6%, consumer prices in the first quarter of 2008 showed a further sharp rise on the quarter. Owing to higher crude oil prices and marked price increases for electricity and gas at the beginning of the year, energy was 2.6% more expensive in seasonally adjusted terms than in the fourth quarter of 2007. The unfavourable price trend for food continued, even though there was a marked flattening of the increase to 1%, compared with the previous very sharp seasonally adjusted rise of 4.2%. Sharp increases in the prices of dairy products, cereals and confectionary contrasted with downward adjustments in the case of vegetables and edible fats and oils, however. The

Unfavourable trend in consumer prices at the start of 2008 as well ...

rate of price increase eased somewhat in the case of industrial goods (excluding energy). The somewhat stronger rate of increase in services was also due to the early date of Easter. Housing rents (excluding ancillary costs) accelerated slightly. The marked quarter-on-quarter rise in consumer prices meant that the annual CPI rate only went down from 3.0% to 2.9% despite the baseline effect due to the VAT increase on 1 January 2007.⁵ Among its components, the increases in energy and food prices, at 9.3% and 8.0% respectively, were sharper than the average.⁶ HICP inflation was 3.1%, as in the fourth quarter of 2007. When calculated on a basis that is comparable to the national consumer price index (CPI) in terms of methodology but using the restricted basket of goods of the HICP, the figure is even somewhat higher.

... but
interrupted
in April

There was no further seasonally adjusted increase in consumer prices in April, however. The higher crude oil prices were not yet being reflected in energy prices. The rate of food price inflation weakened. There was no more than a small increase in the cost of industrial goods (excluding energy) and rents. The year-on-year increase in the CPI went down from 3.1% to 2.4%. Contributory factors behind this were the early date of Easter in March 2008, favourable baseline effects resulting from the introduction of university tuition fees in a number of federal states in April 2007, and the delayed price effects of the increase in VAT on 1 January 2007. The HICP figure was 2.6% compared with 3.3% before. Despite various price reductions in the case of food, there is likely to be a marked

rise in the annual rate of inflation again in the coming months, not least on account of high crude oil prices and given that temporarily lower prices for services owing to Easter falling in March will no longer be an alleviating factor. A marked fall cannot be expected until late autumn provided new adverse factors do not emerge.

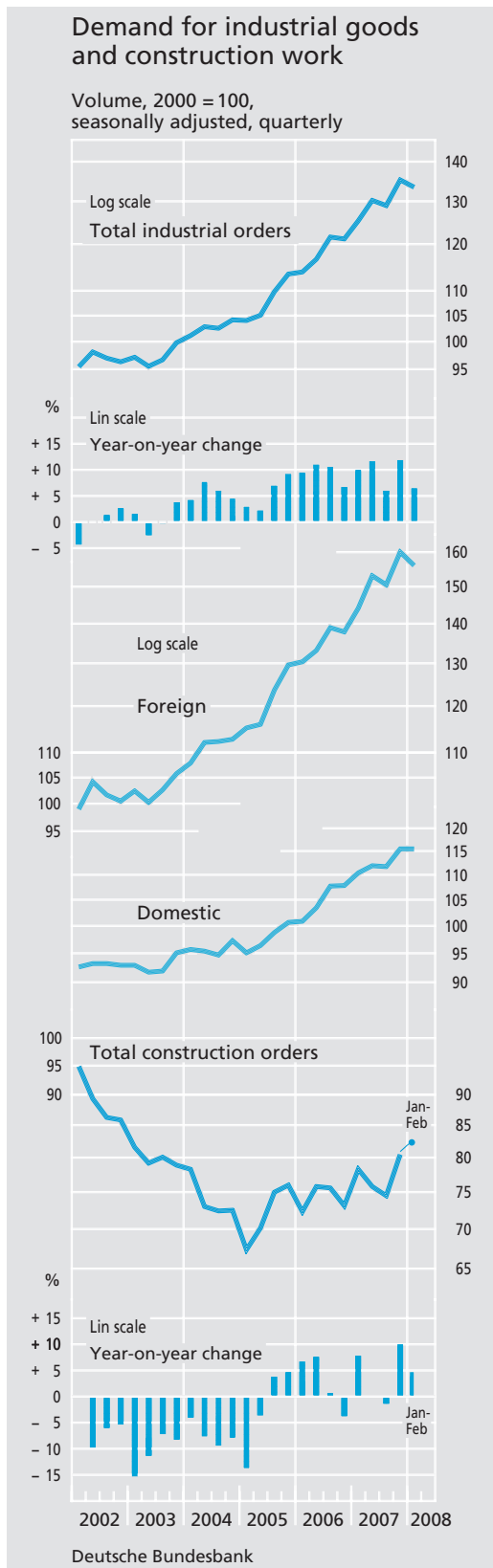
Orders received and outlook

The decidedly strong growth at the beginning of the year has revealed the inherent potential that the German economy, in principle, still has even after more than four years of cyclical upturn – although the current level of growth should not be overstated. The considerable risk factors in the international setting are obviously put into perspective in terms of their real economic significance by the fact that the German economy now displays a greater degree of resilience owing to the strengthening of its supply-side growth fundamentals. The demand profile which the available indicators suggest for the reporting

Sound business activity owing to robust exports and domestic stimuli

⁵ In rebasing to 2005=100 at the beginning of 2008, the national consumer price index was back-calculated to the base year 2005. Before this, the annual rate in the fourth quarter of 2007 had been 2.8%. For details of the changes made in connection with the rebasing, see the explanatory notes, Impact of the 2008 index recalculation on the national price index and the Harmonised Index of Consumer Prices, Deutsche Bundesbank, Monthly Report, April 2008, pp 32-33.

⁶ Following the back-calculation, markedly higher rates are shown for food from the second half of 2007. This is probably due to the weighting by type of outlet that was newly introduced with the rebasing. This results in greater importance being attached to food discounters. Their prices showed a very sharp percentage rise in the second half of the year. On this point, see also Impact of the 2008 index recalculation on the national price index and the Harmonised Index of Consumer Prices, Deutsche Bundesbank, Monthly Report, April 2008, pp 32-33.



quarter confirms the assessment that the economy can essentially go on developing favourably, especially owing to a shift of emphasis to domestic expansionary forces. Furthermore, despite substantial shifts in the exchange rate structure, it seems that German exporters have enjoyed a good deal of success so far in sharing in global growth due to appropriate adaptation strategies, even in the context of weaker underlying dynamics and marked differences from region to region.

The demand for German products is highly satisfactory at present. The intake of industrial orders in the first three months of this year was 1¼% down on the quarter after seasonal adjustment. It should be remembered, however, that there was an extremely large number of large orders in November and December 2007, which led to a very sharp seasonally adjusted increase of 5% in the volume of industrial orders. Adjusting for this special effect gives a growth of roughly 3% for the fourth quarter of 2007. The flow of orders in the first quarter of 2008, which was not marked by a concentration of large orders, would therefore be ¾% up on the adjusted prior-quarter level. In addition to the ongoing positive underlying trend in current orders up to the end of the period under review, if such an adjustment is taken into account, industry is also benefiting from what is still an extremely large stock of orders on hand. Although Ifo Institute surveys show something of a year-on-year deterioration in the assessment of orders which have not yet been processed, the surveyed firms estimated what was still quite a long time span of three full production months.

Orders situation in industry remains favourable

*Continuation of
the upturn in
construction*

Since last autumn, there has been a perceptible improvement in the demand situation in the construction sector, albeit with marked monthly fluctuations. Following the very notable seasonally adjusted 8% increase in orders in the final quarter of 2007, there was also growth of 2% for the first two months of this year (more recent data are unavailable at present). While industrial orders were still expanding strongly during this period, public sector construction projects showed a clear decline again at the end of the period under review following their significant sharp rise in the previous quarter. The fact that demand for housing construction rose perceptibly at the start of the year is a positive factor. It gives cause to believe that the dip in orders that followed the interim peak, which was due primarily to the abolition of the grant to homebuyers and the VAT hike, may have bottomed out. Even so, housing construction is still at a very low level overall.

*Sentiment still
optimistic*

According to the Ifo Institute, the business climate showed a marked deterioration in April 2008, following temporarily improved ratings during the first three months. When assessing this development, however, due account should be taken of the fact that the business climate indicator is currently still well above the level of the most recent cyclical peak in the second quarter of 2000 and roughly matches enterprises' sentiment at the beginning of 2006, which was a boom year. In comparison with the cyclical upswings of the 1990s, the high in sentiment is remarkable not only with regard to its scale but also in terms of its duration. Taking as a basis the correlation between the Ifo business climate



and year-on-year GDP, which is empirically quite robust,⁷ the recent surveys do not *per se* point to an interruption in the economic cycle.

The level of overall output achieved in the first quarter of 2008 sets a high standard in seasonally and calendar-adjusted terms, however, which will scarcely be possible to surpass in the coming months. This is suggested by a number of technical factors. First, the weather-related shifts in output means that a certain countermovement may be expected in the construction sector. At the beginning of the year, an extremely large amount of

*Half-year
analysis
indicated*

⁷ See How robust is the empirical relationship between the Ifo business climate indicator and overall economic activity?, Deutsche Bundesbank, Monthly Report, November 2006, pp 40-41.

machinery and equipment was delivered and enterprises stocked up heavily on materials and supplies. This means that there could well be a lull in investment in machinery and equipment as well as in inventories in the short term. Nevertheless, with regard to the first half of 2008 – a period which is appropriate in this case from an analytical point of view – a clearly upward underlying cyclical trend is apparent.

*Retarding
effects
economically
manageable*

Enterprises' marked propensity to invest and their inventory planning are consistent with the overall picture of a continuing positive economic outlook. The – in some cases, substantial – negative factors in the international setting are likely to be mirrored mainly by more muted export growth. As a result, investment in machinery and equipment, which remained robust throughout the reporting period, may also lose momentum. Given persistently high energy prices, the

existing mainstays of growth will, nevertheless, still be able to benefit not only from the continuing stimuli due to the recycling of petrodollars through the foreign trade channel, but also from the above-trend growth in global demand for energy-efficient and environmentally friendly technologies – a sector in which the German economy can offer competitive products. Furthermore, there is the prospect of a resumption of the recovery process in private consumption, which was interrupted in the final quarter of 2007. In particular, given falling inflation, consumers should become less reluctant to purchase. According to figures from the market research institution, Gesellschaft für Konsumforschung (GfK), the consumer climate is currently benefiting from more optimistic income expectations, which, together with the ongoing advances in the labour market and higher employee remuneration, form a sound basis for this.