

## Economic conditions in Germany

### Macroeconomic situation

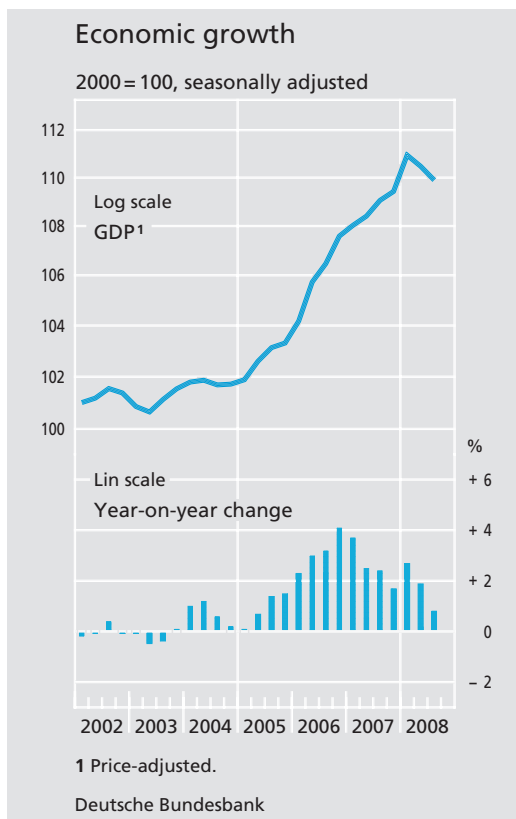
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The rapid cooling of the world economy and the fact that underlying sentiment domestically is increasingly being characterised by caution and restraint have been placing a growing strain on the German economy since the middle of this year. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real gross domestic product (GDP) in the third quarter was 0.5% down on the quarter. Year-on-year growth was 0.8% in calendar-adjusted terms, compared with 1.9% in the preceding three-month period. This already takes into account the fact that the figure for the first half of the year was revised upwards slightly. While overall economic output in the first half of 2008 – with the exception of some weather-related special factors – had almost kept pace with production potential, overall capacity utilisation has now shown a marked decline. Across all sectors, however, activity is likely to have remained in the area of normal capacity utilisation. Nevertheless, a further perceptible slowdown appears likely in the fourth quarter.

*Marked cooling  
of economic  
activity*

The German economy has been subject to considerable external pressure since the third quarter. Manufacturing was especially hard hit by this; the quite sharp cyclical downturn in some major sales markets meant that this sector failed to gain any new stimuli. With this in mind, enterprises made initial revisions to their investment plans and employment arrangements, which had been reasonably clear-cut hitherto. During the reporting period, there were no major signs of the

*Considerable  
external  
pressure,  
continuing  
disruptive  
factors on the  
domestic side*



financial market crisis having a major dampening effect on the German economy in the shape of more restrictive lending by domestic banks. Consumer confidence was still considerably impaired, not least because there was little sign of any price-related easing of pressure on purchasing power since July despite the massive price adjustment in the international oil markets. Nevertheless, consumers are likely to have used the comparatively favourable purchase prices to restock their oil inventories before the start of the winter heating period. Enterprises, too, probably took advantage of the easing in the energy and commodity markets to stock up with inputs and intermediary products.

Since most industrial raw materials as well as energy come from abroad, there was a very

sharp increase in imports in the third quarter. In real terms, there is likely to have been a seasonally adjusted 3½% growth in imports of goods compared with the second quarter. In purely nominal terms, foreign trade is also likely to have clearly dampened the GDP result for the third quarter owing to a seasonally adjusted fall of approximately ¾% in the total volume of German exports of goods during the same period following a moderate decline in the second quarter. The fact that export activity has been providing no stimulus since the second quarter is also due to the high degree of co-movement in the globalised economy. This meant that it was increasingly difficult to offset the trend decline in business activity with US and UK customers that had prevailed for some time.

*Strong import growth, declining exports*

Export-oriented industry, having expanded very strongly in the past few years as a result of the global upswing, has recently been behaving somewhat more cautiously owing to the marked decline in demand for exports. Given the first noticeable cuts in capacity utilisation, there was no longer any immediate necessity to step up fixed capital formation, especially as there will – as usual – have been a time lag before many newly acquired machines and equipment achieved their full capacity effect in the current production process. From a cyclical point of view, industrial investment is, in any case, likely to have entered a mature stage. This is also revealed by the fact that the corporate sector investment ratio (ie the share of new machinery and equipment as well as of newly constructed production facilities and office buildings in value added) in the first half of 2008 reached a level

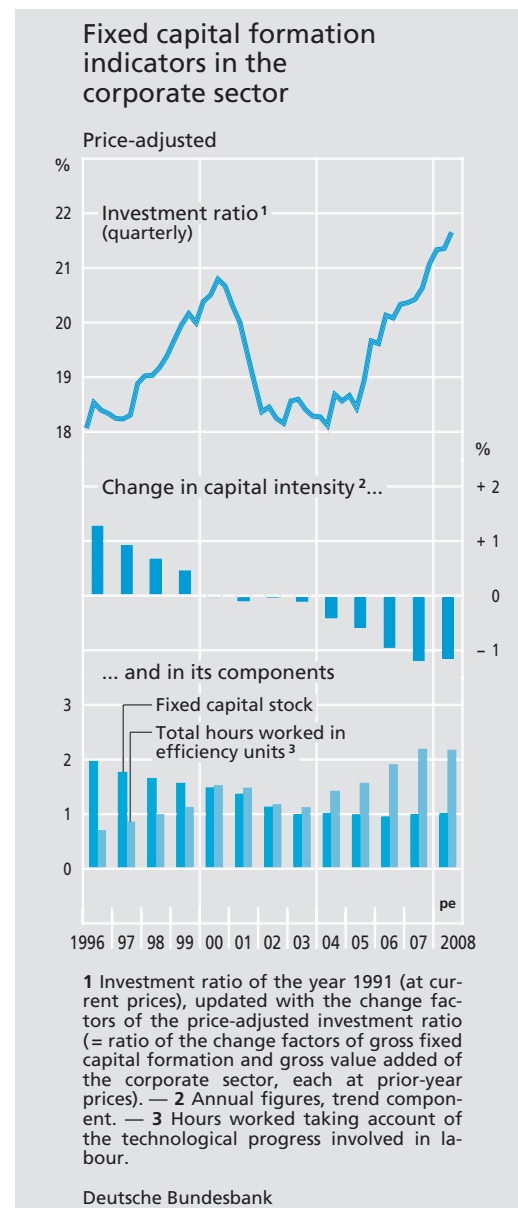
*Corporate investment at a cyclically mature stage*

matched only by the peaks of the last two investment cycles shortly after German reunification and in the year 2000. From a structural point of view, there is nevertheless indeed a continuing need to expand the capital stock in the corporate sector. This is because there has been a gradual decline in capital intensity in the past few years, not least as a result of the expansionary practice in recruitment. This, in itself, has dampened the trend in labour productivity, which means there is a need to focus more on projects that boost productivity.

This scenario is largely consistent with the autumn survey of the German Chamber of Industry and Commerce (DIHK). The results of this show that the surveyed enterprises have made a comparatively moderate adjustment to their plans for investment and employment despite a quite strong downturn in business and export expectations. In the third quarter, deliveries of machinery and equipment were still at quite a high level, not least owing to investment decisions taken earlier. By contrast, industrial construction investment in the reporting period is likely to have roughly matched the average volume achieved in the first half of 2008.

*Households' activity characterised by restraint*

Households were faced with diverging factors after mid-year. Above all, the abrupt reversal in crude oil prices is likely to have relieved consumers of the concern that their disposable income would be increasingly limited by disproportionately large rises in heating costs and spending on fuel. Against this backdrop, private consumption was probably able to stabilise in the summer months following



severe price-related setbacks in the first half of the year. Given the continuing positive trend in the labour market and higher wage growth, the weak underlying trend in real consumer spending together with the depressed propensity to purchase is nevertheless an indication of the fact that consumer confidence in Germany is still fragile. This uncertainty, which became more widespread as a result of the escalation of the crisis in the

**Foreign trade by region and category of goods**
**Percentage change**

Item	Average of July-Aug 2008 compared with			
	2008 Q2 seasonally adjusted		July-Aug 2007 unadjusted figures	
	Ex-ports	Im-ports	Ex-ports	Im-ports
<b>Total</b>	-0.2	5.0	2.6	9.3
<b>Countries or group of countries</b>				
Euro-area countries	0.1	5.4	2.1	9.9
Other EU countries	1.1	-2.2	3.6	6.2
<i>of which</i>				
New member states <sup>1</sup>	2.3	2.1	9.2	7.6
United States of America	-3.4	5.5	-9.8	3.9
Russian Federation	0.0	24.2	12.4	42.4
Japan	-6.5	3.2	-5.4	-6.2
South-East Asian emerging economies <sup>2</sup>	1.0	3.5	5.3	-11.3
China	-7.1	13.3	9.5	5.1
OPEC countries	-2.4	3.4	9.6	32.4
<b>Categories of goods</b>				
<b>Main categories</b>				
Intermediate goods	-1.4	2.0	-0.1	-0.5
Capital goods	-2.2	4.9	-4.4	-3.3
Consumer goods	5.0	3.9	4.9	-1.6
Energy	.	18.4	.	59.6
<b>Selected categories</b>				
Chemicals	7.6	5.7	9.1	1.5
Machinery	-1.9	0.8	0.3	-1.1
Motor vehicles and motor vehicle parts	-5.2	-3.7	-10.6	-9.3
IT products	-0.8	8.6	-10.4	-6.3
Metals and metal products	-1.9	0.9	0.5	0.0

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

Deutsche Bundesbank

international financial markets, is evidently reducing the willingness to purchase goods which considerably restrict consumers' financial scope or which entail payment obligations in the future. This mainly affects sales of motor vehicles, with the reluctance to purchase being reinforced by the political debate on a reform of motor vehicle tax in Germany and by European Commission plans to tighten climate protection provisions. Moreover, uncertain income prospects and rising construction costs are weighing down demand for new housing. In line with this, owing to the weak underlying trend in new housing construction, residential investment in the third quarter is hardly likely to have been any higher in seasonally adjusted terms than in the preceding quarter.

### Sectoral trends

Despite a marked fall in demand since the beginning of the year, industry reduced its volume of production comparatively moderately in the third quarter – as it had done in the second quarter. Output in the third quarter was 1¼% down on the quarter in seasonally adjusted terms, with output in the second quarter being 1% down on its peak in the first quarter. This means that the cyclical decline has been rather moderate in industry so far. This is also shown by the fact that output between April and September 2008 as a whole was slightly higher than in the second half of 2007. The calendar-adjusted figure was ¼% up on the year in the third quarter. The main reason why industry has been able to keep its output at quite a high level up to

*Sluggish industrial activity*

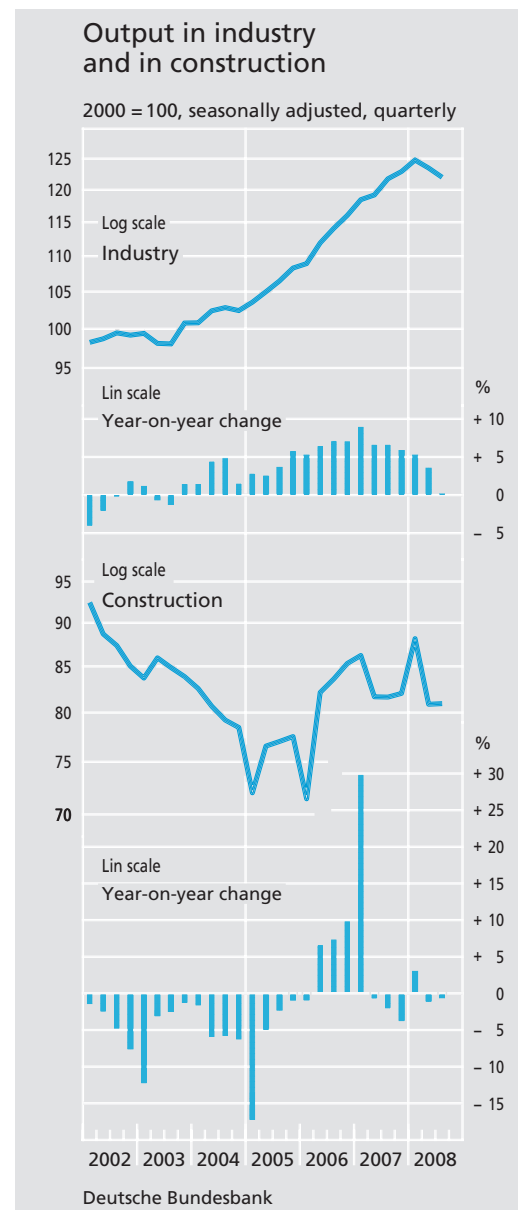
now is that the expansion of production capacity between 2005 and 2007 failed to keep pace with the very sharp growth in orders. This led to the formation of a stock of orders which is now being completed. Furthermore, a large number of major projects were commissioned at the turn of 2007-08 and, naturally enough, the time taken to process them stretches over a number of months.

*Declining capacity utilisation*

Accordingly, industrial capacity utilisation up to the end of the period under review was higher than average, even though utilisation, according to the Ifo Institute, showed a noticeable decline in October for the first time in two years. This decline was due mainly to a cutback in production by manufacturers of capital goods. Nevertheless, utilisation in this sector is still far above the longer-term average. Despite moderate losses, the intermediate goods industry was reporting above-average capacity utilisation up to the end of the period under review, while free capacity was becoming apparent in the consumer goods sector in some cases.

*Sideways movement in construction activity at a low level*

Construction output stabilised at a low level in the third quarter in seasonally adjusted terms. This followed a sharp decline in the second quarter, which was a technical reaction to the weather-related buoyant construction activity in the winter months. In 2008, construction's performance was better with regard to existing stock than in new construction activity – a trend that has been observable for a number of years now. Seasonally adjusted hours worked in the finishing trades in the first half of 2008 showed an increase of almost 6% on the second half of 2007. By



contrast, total hours worked in construction, which includes structural work on housing, virtually stagnated in the same period.

In the third quarter, commercial enterprises' activity is likely to have picked up noticeably from the setback in the preceding three-month period. Seasonally adjusted retail sales between June and September were largely unchanged in real terms, but the wholesale

*Services affected by production sector*

trade was able to expand its business perceptibly during the reporting period. The trend slowdown in the production sector is likely to have affected at least some areas of business-related services. According to the Ifo data, the business confidence of the surveyed services firms showed a further deterioration in the third quarter. Temporary work agencies, which have benefited considerably from the upturn in the labour market over the past few years, were not the only subsector to revise their expectations downwards. According to the survey conducted by Creditreform and the Centre for European Economic Research (ZEW), providers of IT and communications services also reported lower turnover in the third quarter.

### Employment and unemployment

*Further fall in unemployment*

The labour market has held up quite well overall against the backdrop of the economic downturn. By the end of October, unemployment had declined fairly steadily to a seasonally adjusted figure of 3.15 million. The unemployment rate fell from 7.8% in mid-2008 to 7.5%. This figure reflects the fact that alleviating demographic factors and statistical revisions more or less offset each other. (According to the estimates of the Institute for Employment Research (IAB) in Nuremberg, the labour force is declining slightly in 2008, while, since the beginning of the year, unemployed persons aged 58 and over have been included in the official figure again and are no longer counted as part of the "hidden reserve".) Roughly 70% of the decline in unemployment was accounted for by job seek-

ers receiving the basic welfare allowance. This means that the (net) exit rate from unemployment among this group of persons – who more often lack certain training and skills, have been unemployed for a lengthy period of time, and typically have major gaps in their work history – was just as high as for those persons receiving unemployment benefits under the statutory insurance scheme.

According to initial estimates by the Federal Statistical Office, employment, too, showed a further increase up to September, being 0.3% up on the June level. There was a similarly sharp growth on a quarterly average, and the figure for the second quarter was 1.5% up on the year. Although employment growth in industry came to a halt, and the decline continued in the construction sector, there was a further increase in staffing levels in the services sector. Employment creation measures accounted for a growing part of the increase. One factor in the still positive overall trend in employment is that the economic outlook did not start to become significantly gloomier until October. However, the continuing high level of vacancies (a seasonally adjusted 572,000 vacancies were registered with the labour exchanges in mid-October) and the long vacancy periods (in October, positions reported as having been filled had been vacant for an average of 64 days) indicate a considerable unsatisfied demand for labour as well as difficulties in recruitment. (See the explanatory notes on pages 54-55 concerning the labour market

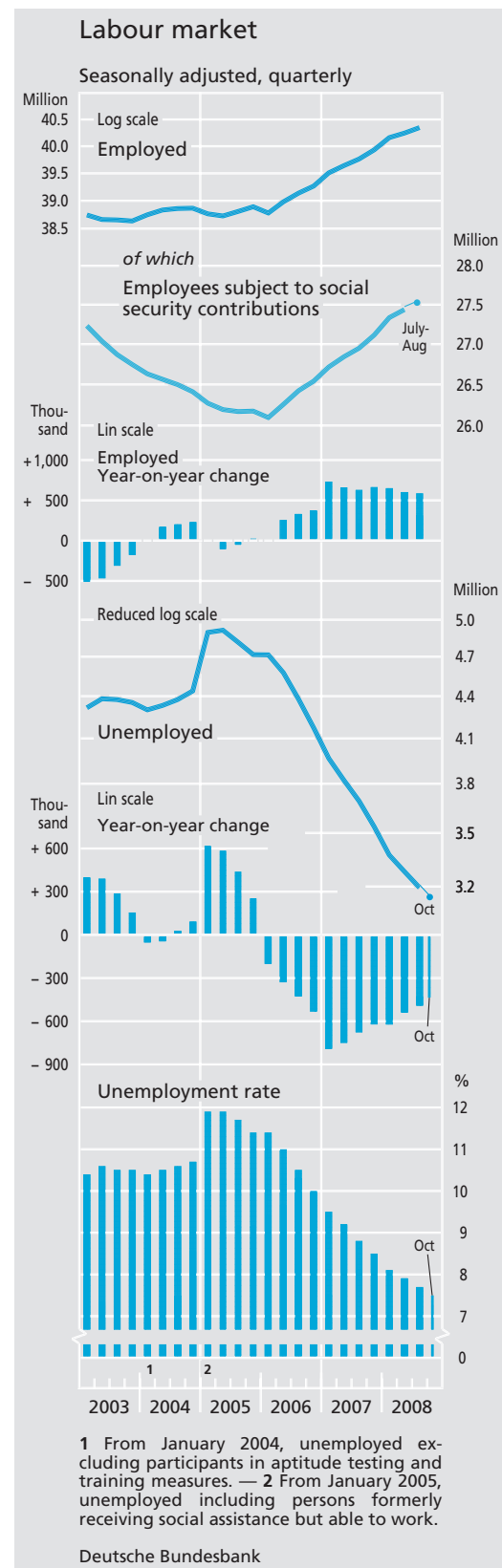
*Employment, too, still positive*

matching process.)<sup>1</sup> A cyclically induced moderate increase in the number of jobseekers is therefore not necessarily reflected fully in higher unemployment figures provided the jobseekers match the vacancies' job profile and are sufficiently mobile.

*Adjustment to  
the changed  
economic  
situation*

Between the start of the year and August (more recent data are unavailable at present), the increase in employment in the cases of business services (which includes labour leasing) slowed down and finally came to a standstill. Furthermore, reports that firms want to reduce the scale of temporary employment are becoming more frequent. This means that setbacks might be experienced in this sector, which has contributed around two-fifths to the expansion in employment subject to social security contributions since the beginning of 2006. On the other hand, given the problems in filling vacancies, firms will attempt to keep their core staff even in a difficult economic setting. Such behaviour is likely to be made easier by the working hours accounts that were filled up in the period of cyclical capacity overutilisation and the fact that short-time working benefits have recently been extended from 12 to 18 months. This is also suggested by the survey of the German Chamber of Industry and Commerce (DIHK). Its findings were that the number of firms planning additional recruitment was lower than in the second quarter and that more firms were intending to adjust staffing levels.

<sup>1</sup> For the third quarter, the more comprehensive survey-based estimate of vacancies in the economy as a whole by the IAB shows a total number of 998,000 jobs, which is 255,000 fewer, or one-fifth less, than one year earlier. At over 50%, the decline in the number of vacancies to be filled at a later date was especially marked.



## Improved matching on the labour market? – Evidence from the Beveridge curve

Despite the sharp decline in unemployment over the past few years, almost 3 million people were still looking for paid work in Germany in the third quarter of 2008. According to a survey by the Institute for Employment Research (IAB), there were approximately 800,000 immediate job vacancies during the same period. If enterprises have to spend considerable time looking for suitably qualified workers despite the high level of unemployment and if unemployed persons are having difficulty finding a job despite a large number of vacancies, it is a sign that there are serious matching problems on the labour market.

The Beveridge curve, which shows the relationship between the job vacancy rate and the unemployment rate, provides an indication of the quality of the placement function of the labour market.<sup>1</sup> As a rule, a reduction in unemployment is accompanied by an increase in job vacancies because, as the employment rate rises, the balance between supply and demand becomes more difficult. In a cyclical recovery phase, moreover, new jobs are created faster than they can be filled. At the same time, the number of unemployed can actually continue to rise for a time while the number of vacancies is already increasing. At a later phase of the upturn precisely the opposite is true: vacancies are filled much more quickly than new jobs can be created, with the result that there is a tendency for the number of vacancies to start showing a decline while unemployment is still falling. Ideally, these loops in the Beveridge curve return to their starting point at the end of the cycle. However, this did not happen in the first cycle illustrated in the accompanying chart.<sup>2</sup> Instead, there was an untypically sharp increase in the number of vacancies towards the end of the upswing in the year 2000 but no significant further reduction in unemployment, with the result that there was no return towards the starting point either. Instead, the loops of the Beveridge curve shifted further away from the origin, as it had done in the 1970s and 1980s. This is a sign that structural unemployment is increasing.

The present cycle is more in line with the ideal type. Both the number of vacancies and the level of unemployment have been falling since the end of 2006. Furthermore, this move-

<sup>1</sup> Measured in terms of the labour force in each case. Since 1992 the IAB has been collecting data on job vacancies in the German economy as a whole in the fourth quarter of each year. Since 2006 this has been extended to include additional quarterly surveys using reduced sample sizes. The surveys distinguish between vacancies that are to be filled immediately or at a later date. The figures on vacancies to be filled immediately are well above the vacancies reported to the Federal Employment Agency (see, for example, A Kettner and E Spitznagel (2007), *Stellenangebot geht zurück, bleibt aber auf hohem Niveau*,

ment is so pronounced that the last shift in the Beveridge curve to the right seems to have been largely reversed. The reasons for this can be seen both in the structure of the present cycle and in the change in the underlying labour market policy framework.

The last two expansionary phases differ substantially with respect to their sectoral configurations. The New Economy boom was heavily service-oriented. In the nine quarters up to the third quarter of 2000 employment in the tertiary sector increased by 6.6% while it declined by 2.2% in the production sector. The upswing in the past few years, by contrast, was driven to a greater extent by industry. Despite the fact that the rapidly rising number of temporary workers are fully captured statistically in the services sector, many of them are placed in industry. Employment in the production sector increased by 2.5% between the first quarter of 2006 and the second quarter of 2008. In the services sector the increase amounted to 4.1%. This means that the speed of structural change towards the tertiary sector was much slower than in the recovery period earlier. This might have been important with respect to the balance between supply and demand on the labour market in that differences in qualifications and other impediments to the mobility of labour, especially in the event of an accelerated sectoral structural change, could have played a less significant role in the present upturn. The rapid change in the sectoral structure and the stronger move towards new services at the end of the 1990s, however, could have had a greater limitation on the application of specific knowledge and skills. Developments on the supply side, which remained largely unchanged in their extent, likewise had an alleviating effect whereas in the preceding period there had still been discernible growth.

The balance between supply and demand on the labour market has also been assisted by the labour market policy reforms of the past few years. This is particularly true of the large-scale deregulation of temporary employment. Hiring temporary workers enables enterprises to meet their staffing needs in a flexible manner and to reduce the recruitment risks associated with employment protection legislation. In the last upswing the business services sector, which includes

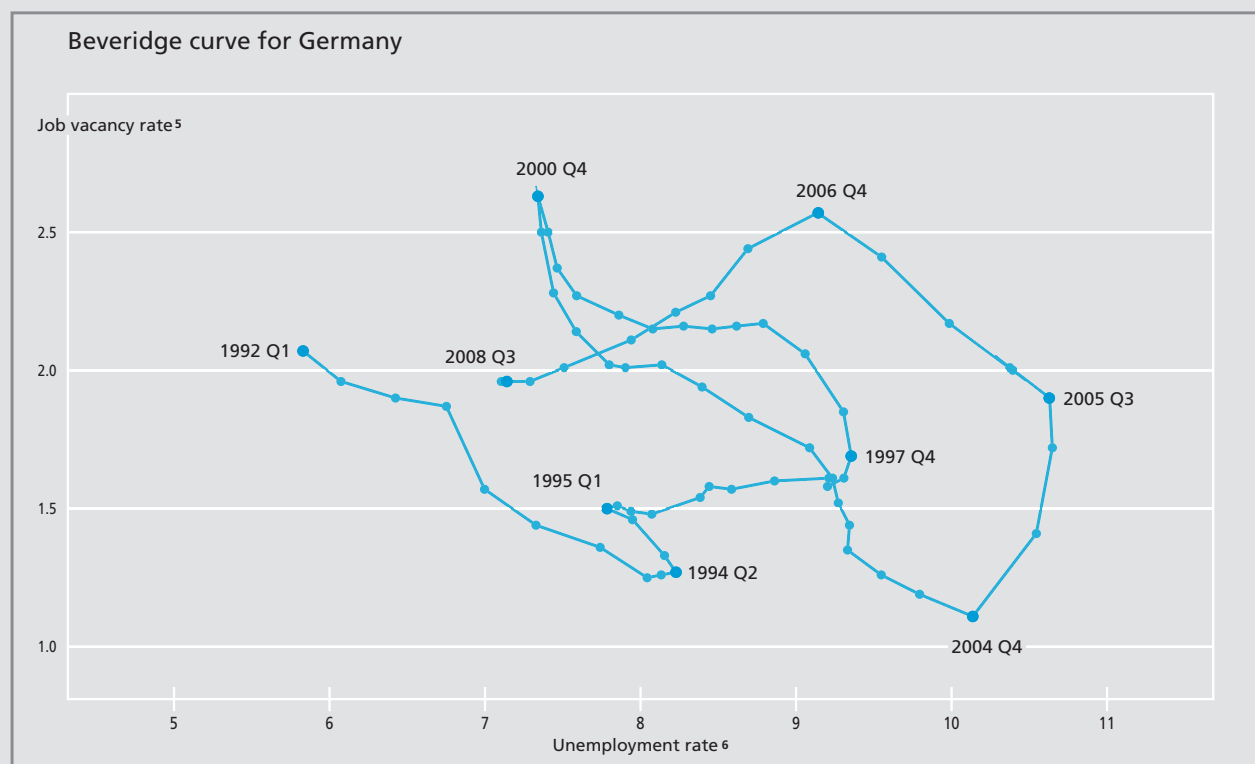
IAB-Kurzbericht No 7). Here the figures for the first, second and third quarters are interpolated consistently on the basis of (seasonally adjusted) reported vacancies. The standardised unemployment rate as defined by the International Labour Organization and likewise survey-based is used to quantify the rate of unemployment. The standardised rate is influenced to a lesser extent by changes in active labour market policy measures or registration regulations, such as the recent inclusion of persons receiving social assistance and able to work under the Hartz IV reform, than the registered unemployment data. — <sup>2</sup> Two cycles



agencies hiring out temporary labour, accounted for more than two-fifths of the growth in employment subject to social security contributions. Restricting unemployment benefit by reducing the period of entitlement and replacing unemployment assistance with the basic allowance will probably also have increased the willingness to accept job offers.<sup>3</sup> By contrast, other measures such as supplementing the state employment agency with private personnel service agencies and issuing job placement vouchers seem to have done little to improve the matching process.<sup>4</sup>

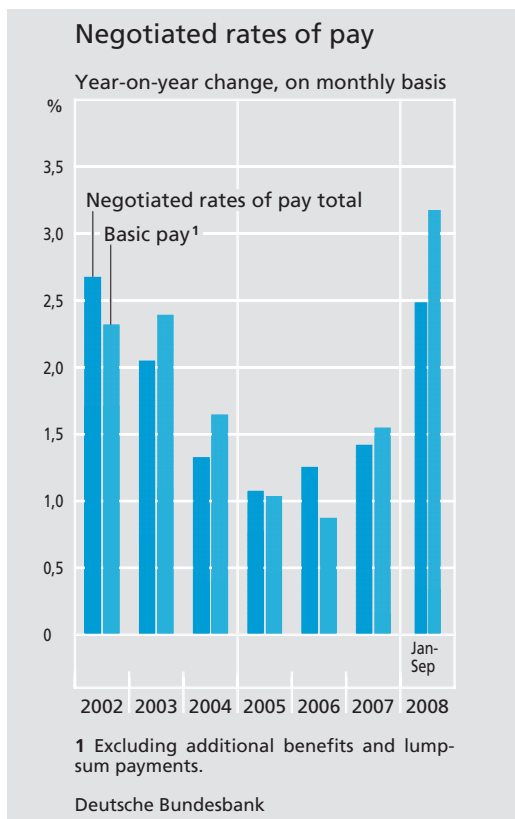
The shifts in the Beveridge curve indicate that the structural problems on the labour market have eased during the past few years. This is also illustrated by the appreciable decline in the number of unemployed persons receiving the basic

welfare allowance. However, this eliminates only part of the basic problem of high hard-core unemployment. Even if, in the coming quarters, the cyclical forces again become more prominent, the structural problems might rapidly become more pressing again if financial and real economic conditions return to normal. The need for qualified labour, which is already in discernibly short supply, will remain considerable. In view of the remaining high level of unemployment, this shows that further efforts to generate skills that are really needed and remuneration schemes that reflect scarcities are essential if the rewards of investment in education are to be appreciated by the individual citizen.



– delineated by cyclical peaks – are differentiated below: the earlier one ran from the first quarter of 1992 to the fourth quarter of 2000 and the present one from the beginning of 2001 to the current end. — <sup>3</sup> See A Kettner and M Rebien (2007): Hartz-IV-Reform: Impulse für den Arbeitsmarkt, IAB-Kurzbericht No 19. — <sup>4</sup> See Wissenschaftszentrum Berlin, ifas (2006): Evaluation der Maßnahmen zur Umsetzung der Vorschläge der Hartz-Kommission, Modul 1a: Neuausrichtung der Vermittlungsprozesse, a report for the Federal Ministry of Labour and

Social Affairs, Berlin, Bonn. — <sup>5</sup> As a percentage of the labour force on the basis of IAB surveys on jobs on offer in the economy as a whole (vacancies to be filled immediately) between the fourth quarter of 1992 and 2007, missing data: interpolation and seasonal adjustment on the basis of vacancies reported to the Federal Labour Agency. — <sup>6</sup> As a percentage of the labour force, standardised unemployed, seasonally adjusted.



Nevertheless, neutral plans for employment predominated on the whole. Furthermore, the Ifo employment barometer, which showed a clear fall in recent months, is still just within the neutral range.

## Wages and prices

*Faster rise in negotiated pay*

In the third quarter, no new pay agreements of significance for the economy as a whole were concluded; negotiated wages rose 3.0% on the year owing to pay increases that had been agreed earlier. Despite obviously higher rates of increase in regular monthly pay, the figure was only 1.7% in the second quarter, which was due to a smaller number of collectively agreed one-off payments being scheduled than in the same period of 2007.

Owing to new one-off payments in the metal-working industry, this effect was no longer operative in the third quarter. At 3.2%, negotiated basic rates of pay were, in fact, somewhat lower than one year earlier. This was due to the fact that older agreements which ran for more than one year and were still in force often provided for smaller increases at the end of the agreement's duration than at the beginning.

In November, wage bargainers in the metal-working and electrical engineering industries of Baden-Württemberg concluded a new pay agreement with a duration of 18 months. In addition to one-off payments (initially €510 followed by a further €122 later), permanent pay increases amounting each time to 2.1% are scheduled for both February and May 2009. The second stage of the pay increase as well as the second one-off payment can be deferred or shortened by up to seven months by in-house agreement. With the high one-off payment, the negotiating parties, first, took due account of the fact that business conditions were still positive in this sector. Second, the long duration of the agreement increased firms' planning certainty, and the scope for adjustment at firm level made advance provision for more difficult times. This agreement has since been adopted by other wage-bargaining areas.

*Pay deal in the metal-working and electrical engineering industries*

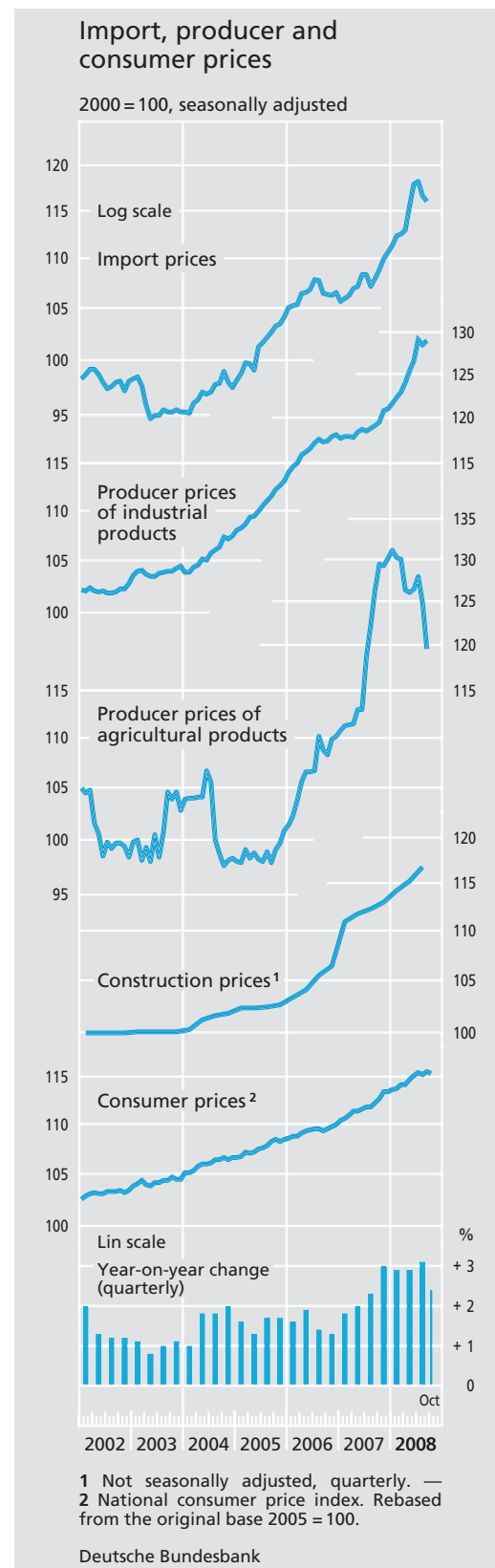
The third quarter saw a turnaround in the price trend on the import side. Although the cost of imports was still 1.3% up on the preceding period on a quarterly average, prices went down by 1.6% over the course of the quarter. This was due mainly to the sharp

*Import prices falling owing to crude oil...*

price adjustment in the international oil markets. As a result, the cost of energy imports fell by 8.6% in the period from June to September. The price trend for other imported goods was noticeably less favourable, the depreciation of the euro being a contributory factor. There was a quarter-on-quarter increase in the upward pressure on prices of intermediate goods and consumer goods. The decline in the cost of capital goods came to a standstill. The year-on-year increase in import prices, excluding energy, went up from 0.6% to 1.7%. If energy is included, the year-on-year figure went up from +7.5% to +8.7%. As the overall rise in import prices was somewhat larger than the increase in export prices, there was a seasonally adjusted deterioration in the terms of trade of 0.4% on the quarter. In year-on-year terms, the figure was -5.2%.

*... but even bigger increase in domestic producer prices*

At the domestic industrial producer level, however, there was a further, albeit comparatively moderate price increase over the quarter. On an average of the three months, the rise in seasonally adjusted domestic selling prices, at 2.9%, was even somewhat larger than in the preceding quarter, and the annual rate of increase went up from 6.0% to 8.5%. The difference between the trend in domestic factory gate prices and the price trend for imports are due partly to the reduced weight of crude oil and of refined petroleum products (50.3% compared with 73.2%). If energy is excluded, domestic selling prices went up by a seasonally adjusted 1.3% on the quarter, which was the sharpest increase for a long time. The year-on-year rate of price increase was 3.5%, compared with 2.9% in the



second quarter. Upward pressure increased especially on the prices of intermediate goods and capital goods. Consumer goods inflation flattened out somewhat, mainly because of falling food prices. Farm gate prices showed a further fall in the third quarter in seasonally adjusted terms after easing markedly in the second quarter. Baseline effects also meant that the year-on-year increase went down from just over 12% to 1.5%. Rising input prices were one reason for construction prices being raised by 1.3% on the quarter; the year-on-year increase was thus 4.0%.

*Only marginal slowdown in consumer price inflation in the third quarter...*

There was initially still no major relief at the consumer level. Although the seasonally adjusted rise in prices was no more than relatively subdued during the third quarter, at 0.4%, there was still a sharp increase of 0.7% on average, which was hardly any less sharp than in the second quarter. That price developments were not more favourable was also due to the alleviating effects of adjustments to crude oil prices coinciding with lagged effects of earlier increases in the cost of crude oil. Although the prices of refined petroleum products fell by 6.0% over the quarter, gas prices were simultaneously raised by 7.3%. Moreover, there were sharper seasonal price increases for clothing than in previous years, not least on account of the euro's depreciation in the international foreign exchange markets. Finally, the expected corrections to food prices in view of the downward price trend in the world markets largely failed to materialise. Nevertheless, the year-on-year increase in the national consumer price index (CPI) went down from 3.3% in mid-2008 to 2.9% in September. On a quarterly average,

prices went up by 3.1% on the year, compared with an increase of 2.9% in the second quarter. The annual rate of the Harmonised Index of Consumer Prices (HICP), which is calculated in accordance with European standards, went up from 3.0% to 3.3%.<sup>2</sup>

In seasonally adjusted terms, the purchasing power of the euro increased somewhat in October, mainly as a result of lower prices for fuel and heating oil. By contrast, further providers raised gas prices sharply. Moreover, there were increases in the prices of food again. As in previous months, the depreciation of the euro had a noticeably adverse impact in the case of industrial goods. The moderate price trend in services and housing rents continued, supported by the abolition/lowering of tuition fees in two federal states. Overall, the year-on-year rise in consumer prices according to the CPI was 2.4%. The HICP figure was +2.5%. Not least owing to the ongoing corrections in the international commodity markets and to positive baseline effects, a further marked decline in the rate of inflation is to be expected in November.

*... but with a marked fall in October*

## Orders received and outlook

The profound and persistent dislocations in the international financial markets have now cast a dark shadow over the real economy worldwide. Among the industrial countries, this applies, in particular, to the United States and the United Kingdom, but other countries,

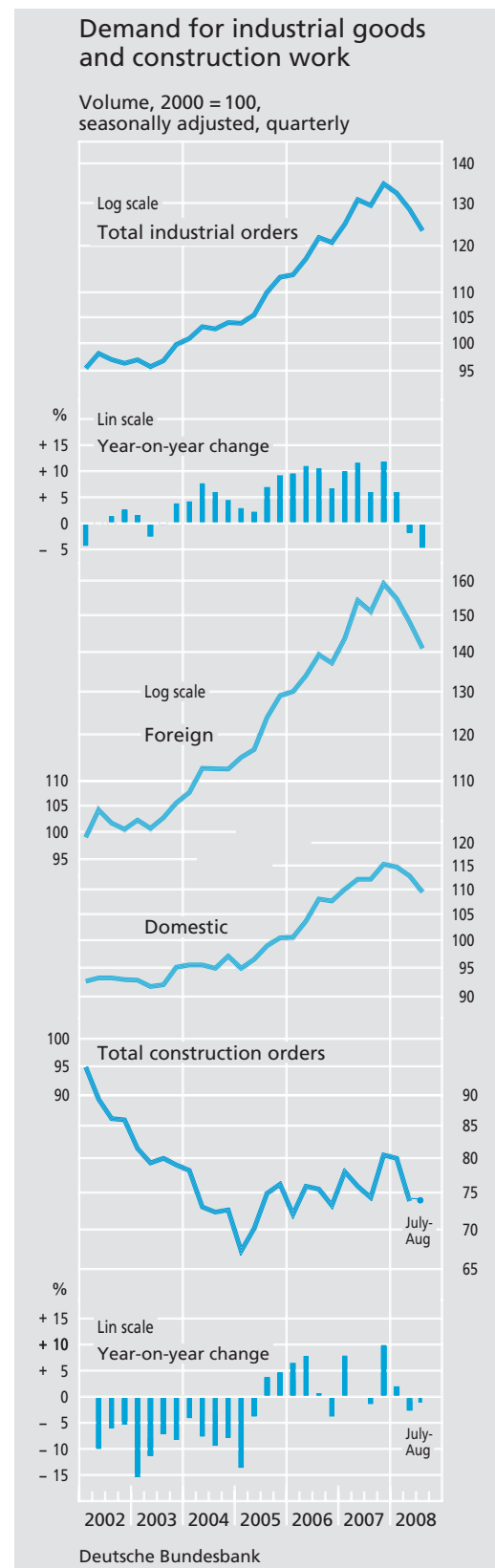
*Hard cyclical setback in the coming winter half-year*

<sup>2</sup> Using a basis methodologically comparable to the CPI, but calculated using the HICP basket of goods, the inflation rate in the third quarter would have been 3.4%.

too, which are major sales markets for the regionally broadly based German economy, have now been affected. The repercussions are now also overshadowing the economic catching-up process in the emerging market economies and in the transition countries of central and eastern Europe, from which German exporters have been benefiting strongly up to now. The resulting weakness in demand will discernibly dampen economic activity in Germany, especially as significant domestic impulses are not to be expected in the short term. As time goes on, the fact that there has recently been a massive reduction in the cost of energy and raw materials might have a noticeably positive effect, however. In addition, the sales outlook for German goods in overseas markets has, in itself, improved somewhat owing to the fact that the euro has depreciated very sharply since mid-July against both the US dollar and the Japanese yen. Finally, the governments of a number of countries most affected by the economic setbacks have also taken measures with the aim of preventing a slide into severe recession.

*Business expectations adversely affected in the short term by unfavourable export business and major uncertainty*

Export business must be expected to be quite unfavourable in the winter months. According to the surveys of the Ifo Institute, export expectations for the next three months in manufacturing have been deteriorating sharply since the middle of the year and were clearly contractionary in October. Given the major role which export customers play for most of German industry, it is understandable that such a massive worsening of the short-term outlook for exports has also had an impact on business expectations overall. What should not be overlooked when interpreting



the survey results, however, is the notable discrepancy between assessments of the business situation and expectations – a discrepancy which became even wider after the escalation of the international financial market crisis in September. This might also reflect the much higher uncertainty with regard to the real economic implications of this unpredictable risk factor. The Federal government's package of measures to stabilise the German financial system, which has the objective of restoring orderly business activity in the financial markets, has a key role in preventing home-grown financial problems from aggravating the current external strains on the German economy.

*Decline in industrial orders*

The substantial deterioration in short-term sales expectations, as revealed by the sentiment indicators, is consistent with the trend decline in the volume of industrial orders since the beginning of 2008. Seasonally adjusted orders, at 3¾%, were quite clearly down on the quarter in the summer months. This followed considerable falls in the first two quarters of the year. While the fall was comparatively moderate in the case of intermediate goods and consumer goods, the second and third quarters saw a sharp overall drop in demand for capital goods. It should be remembered, however, that the flow of orders in the final quarter of 2007 and the first quarter of 2008 was characterised to an exceptional extent by large-volume investment projects, especially from export customers. In purely nominal terms, one-half of the decline in orders of capital goods between April and September 2008 – a fall of almost 8½% on the preceding six-month period in

seasonally adjusted terms – was due to the volume of large orders returning to a normal pattern.

The weak flow of orders placed with order-based industry over the past few months has led to a marked decline in the reserves of orders. In terms of production, however, there is still the option of compensating for the lack of new orders by processing orders that are already on the books. This is also shown by the fact that the reach of the order books has declined only slightly so far according to the Ifo business survey, while the assessment of order backlogs – which is perhaps characterised more by the current flow of orders – has become noticeably less positive. Sectors of industry in which there is usually a short lead time before production are likely to cut back their output quite clearly in the near future, however. Given the marked slowdown in sales, much the same applies to the motor vehicle industry and suppliers of motor vehicle parts.

*Shrinking number of orders on hand*

On 5 November, against the backdrop of the increasing deterioration of the overall economic situation, the Federal government adopted a package of measures designed to counter the economic slowdown and safeguard jobs. These measures comprise fiscal policy instruments and increased funding for lending programmes for the years 2009 and 2010. Their main aim is to strengthen and/or stimulate private and public investment. Sales of new cars are also being promoted by a temporary lifting of motor vehicle tax. A widely differing assessment of the direct stimuli to domestic demand and of the indirect ef-

*Economic stimulus package by the Federal government*

fects on the macroeconomic process is called for depending on the type and scale of the particular measure taken. Experience of earlier stimulus packages and simulations using econometric models would lead to the expectation, if anything, of a limited effect in terms of the economy as a whole. There is the potential for a stabilising effect on the construction sector, however.

*Robust labour market as a cyclical stabilising factor*

The fairly robust labour market situation up to the end of the period under review gives hope that the current slowdown in the German economy will not lead into a self-reinforcing and persistent downswing. The fact that many enterprises are prepared to maintain their core staffing levels, given well-stocked working hours accounts and the continuing acute shortage of skilled labour, not only, in itself, supports households' income situation, it also reduces the risk of job losses that usually dampens the propensity to consume.

This stabilising element will be countered by the fact that the necessary adjustment in the firms' workforce can be implemented quite rapidly at present owing to the higher level of labour leasing and temporary employment. Firms' strategy of initially not making – generally expensive – adjustments to their core staffing levels is likely to change if the cost of maintaining jobs increases. Continued wage policy moderation will therefore not only safeguard the substantial success of recent years on the labour market, it will also lower the risk of downward cyclical pressure that is primarily domestic in origin. The markedly brighter price climate also offers the prospect of households' real incomes no longer being as strongly affected by inflation-related losses for the foreseeable future. For enterprises, too, cost pressure is likely to have eased perceptibly recently, the rise in the cost of materials having severely reduced enterprises' earnings earlier in 2008.