

## Economic conditions in Germany

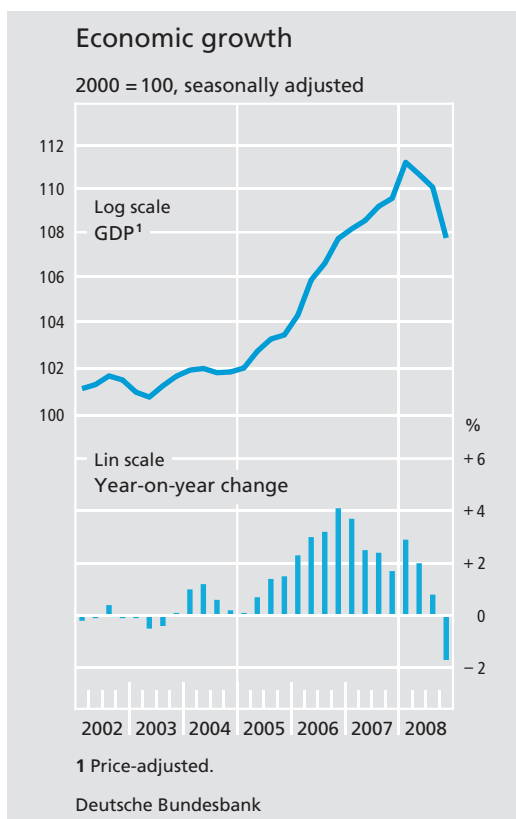
### Macroeconomic situation

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In the fourth quarter, the German economy was very clearly feeling the effects of the sharp global economic downturn following the renewed escalation of the international financial crisis. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real gross domestic product (GDP) in the final quarter of 2008 fell by 2.1% following a 0.5% decline in the previous quarter. The calendar-adjusted figure was 1.7% down on the year.

*Sharp fall in  
GDP in 2008  
Q4*

The sharp economic downturn was due mainly to substantial cutbacks in manufacturing output at the end of the year owing to a massive deterioration in the orders situation. Enterprises used the scope available in various ways to bring production into line with changing demand conditions. In addition to the usual fluctuations in staffing levels, the first measure employed was to run down working hours accounts. Recently, short-time working arrangements and making temporary workers redundant have been playing a greater role. Furthermore, factories were shut down temporarily by extending plant closures over the Christmas holiday period. The massive, primarily external strains spilled over exceptionally quickly into the upstream production sectors and then had an almost immediate knock-on impact on business-related services. Owing to the speed at which the negative demand shock was transmitted, overall capacity utilisation exceeded the corridor of normal utilisation within just a few months, which means that there is likely to have been a con-



considerable underutilisation of production capacity as early as the end of the year.

*Severe setback in exports*

The downward pressure on the economy through the foreign trade channel intensified, firstly, due to the trend economic downturn in the industrialised countries. Secondly, the central and east European economies as well as many emerging market economies were also no longer immune from the real economic effects of the international financial crisis; a number of them suddenly found themselves thrown into an economic crisis owing to their comparatively high susceptibility to redirections of international capital flows. As a result of the high degree of synchronicity of the downturns on all major sales markets, exports plummeted in the fourth quarter after no more than a moderate de-

cline in the second and third quarters. Exports to the EU suffered very heavily at the end of the period under review. Foreign trade activities with Russia and Latin American countries were showing clear signs that their currencies had depreciated – in some cases very sharply – against the euro and that, following the end of the commodity price boom and given growing credit constraints, these countries were finding it more difficult to finance investment. This meant that what was hitherto a major area of business for German exporters became less important. In contrast to this, the value of exports to OPEC countries increased strongly in October and November.

In actual fact, despite the fall in prices, oil-exporting countries' revenues are likely to have remained at quite a high level in the fourth quarter, not least, as a result of the strong build-up of oil inventories in the industrialised countries at the start of the heating season. The seasonally adjusted average volume of energy imported by the German economy in October and November was slightly above the high level of the third quarter, while other imports showed a sharp fall in line with declining output in Germany. There was a very pronounced decrease in imports of intermediate and capital goods.

*Imports influenced by strong demand for oil*

Given the production capacity that was freed up, enterprises were restrained in terms of new investment. An additional factor may have been a further marked deterioration in the external financing conditions from mid-2008 onwards, which mainly affected large enterprises which typically operate internationally and are more dependent on the

*Enterprises' propensity to invest subdued*

capital market. Overall, compared with the last downturn at the start of the millennium, the corporate sector is showing a notable financial resilience. This means that it has been possible to use own funds to finance process and product-related adjustment measures which become urgent especially in times of slack sales, or that, given the sound balance sheet structures in medium-sized enterprises, "house banks" are still prepared to provide the necessary loans. Although there has been a further perceptible tightening of credit standards in recent months, the German economy is yet to be affected by a credit crunch. A deterioration in the sales situation and a cautious wait-and-see attitude are the main reasons why investment in machinery and equipment is likely to have been significantly lower in the fourth quarter after already having slowed down in the preceding three-month period.

*Weak  
construction  
investment*

Construction investment in the October to December period is also likely to have declined in seasonally adjusted terms. Owing to enterprises' cyclically-induced reluctance to invest, no stimulus is to be expected from the industrial construction sector at present. Owing to the time lags that usually have to be allowed for planning and project preparation, the public infrastructure measures adopted in the first economic stimulus package of November last year had not yet had time to take effect during the reporting period. By contrast, there was probably a moderate upward movement in investment in residential construction in the fourth quarter. Government assistance measures for major modernisations and refurbishment are

### Foreign trade by region and category of goods

#### Percentage change

Item	Average of Oct-Nov 2008 compared with			
	2008 Q3 seasonally adjusted		Oct-Nov 2007 unadjusted figures	
	Ex-ports	Im-ports	Ex-ports	Im-ports
Total	- 5.5	- 6.7	- 5.3	2.1
Countries or group of countries				
Euro-area countries	- 7.6	- 10.2	- 6.5	- 0.9
Other EU countries	- 11.5	- 4.9	- 9.3	- 0.1
<i>of which</i>				
New member states <sup>1</sup>	- 10.1	- 4.6	- 4.2	0.1
United States of America	- 1.6	- 2.5	- 8.3	0.5
Russian Federation	- 7.6	- 13.2	0.0	12.7
Japan	- 6.2	0.7	- 11.2	- 2.9
South-East Asian emerging economies <sup>2</sup>	- 6.9	- 5.0	- 13.3	- 5.8
China	5.2	- 0.2	7.7	11.4
OPEC countries	22.9	- 13.7	33.0	16.2
Categories of goods				
Main categories				
Intermediate goods	- 9.6	- 8.5	- 9.1	- 6.1
Capital goods	- 5.6	- 6.7	- 9.4	- 8.4
Consumer goods	- 4.7	- 1.2	- 3.8	- 1.1
Energy		- 11.1	.	24.9
Selected categories				
Chemicals	- 7.7	- 7.2	- 4.3	- 2.5
Machinery	- 2.8	- 1.3	- 2.6	- 1.4
Motor vehicles and motor vehicle parts	- 9.2	- 12.3	- 17.4	- 20.5
IT products	- 3.0	1.3	- 14.1	- 1.7
Metals and metal products	- 13.7	- 10.2	- 11.8	- 6.7

<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 Darussalam, Indonesia, Malaysia, Philippines, Thailand.

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also likely to have played a part in this development.

*Private consumption slackened somewhat*

Following a slight increase in the third quarter, private consumption at the end of the year was marked by contrasting influences. The price climate improved considerably owing to a sharp fall in the prices of energy and food, which meant that the higher collective pay agreements in 2008 were reflected more clearly in real income. The sharp deterioration in the economic outlook and reports of increasing short-time working and, sometimes, redundancies impaired the propensity to consume *per se*, however. It is also likely to have been adversely affected by the sizeable losses and further bad news in the financial markets. In the fourth quarter, seasonally adjusted real retail sales (excluding the motor vehicle trade) fell by ¼% on the quarter, which was the same amount as the increase in the third quarter. A sharp rise in sales of light heating oil was an alleviating factor. Seasonally adjusted new car registrations by private owners were down by only 1¾% in the fourth quarter, mainly as a result of a strong performance in December which was aided by considerable discounts in some cases on purchases of cars.

### Sectoral trends

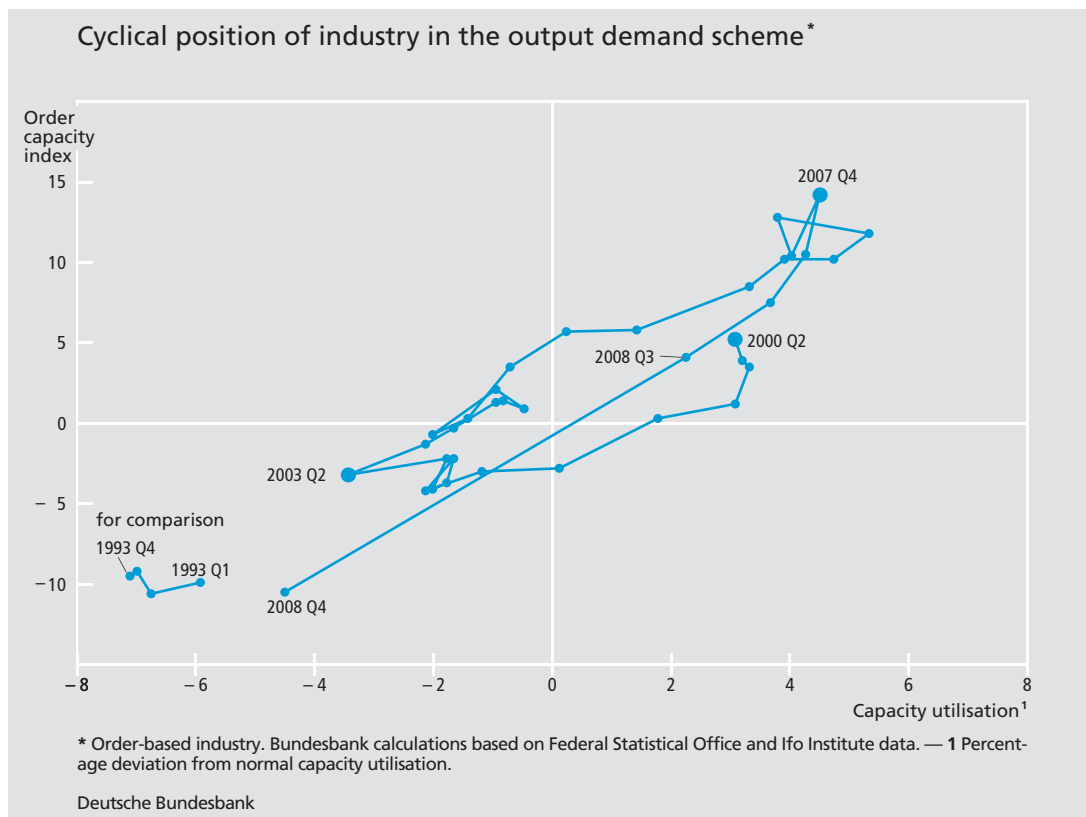
*Slump in industrial output in 2008 Q4*

There was a slump in industrial sector production in the final quarter of 2008. Seasonally adjusted industrial output in the reporting period fell by 7.5% on the third quarter and, in response to the sharp drop in enterprises' new orders, by 7.8% on the year (after calen-

dar adjustment). At the same time, the stock of orders on hand has probably been more or less completely processed. These orders had been built up during a prolonged period of extremely favourable sectoral conditions and had supported industrial output into the third quarter of 2008 despite what was already a waning flow of orders. This is indicated by the fact that the mechanical engineering sector, which was able to use up the reserves of orders for the longest period, and the chemicals industry are the last two large industrial sectors to be affected by the economic downturn. The need for adjustment is especially pronounced in the motor vehicle industry, another key pillar of the German economy. Owing to the integration of production at many different levels, significant effects spill over from the car industry into many other industries (see the explanatory notes on pages 46 to 47).

Within the space of one year, manufacturing – Germany's core economic sector – slid from a distinct boom phase into recession. This is evident from a joint analysis of activity and demand. According to Ifo Institute data, production capacity in order-based industry was considerably underutilised in the final quarter of 2008 while, one year earlier, capacity utilisation was only marginally below its record level since reunification. Furthermore, 12 months previously, demand for industrial goods as measured by the order capacity index, at more than 14% above available production capacity, reached a record peak for Germany as a whole. At the start of 2008, what was still a comfortable situation of a persistently high intake of orders and a very

*Industry's rapid descent into recession*



good degree of capacity utilisation degenerated extremely rapidly into a situation where industrial enterprises, given an already depressed level of capacity utilisation, suffered a further setback in orders. Capacity utilisation and the order capacity index recently fell far below the figures they recorded during the period of stubborn stagnation at the start of the millennium and are, if anything, now comparable to the figures in the wake of the reunification boom. However, in contrast to the situation then, the fact that this is coinciding with the cooling of the real economy in other regions of the global economy is now having a severer impact.

The situation in the construction sector remained more relaxed. After falling already in the summer quarter, the volume of construc-

tion output was not quite maintained in the fourth quarter (-0.2%). The construction sector was still providing no stimulus. Nevertheless, given almost no change in the level of utilisation of machinery and equipment, this sector stabilised the overall economic situation in relative terms. The same applies to the wholesale and retail trade. While retail activities, including the trade in motor vehicles and fuel, declined on the quarter in seasonally adjusted terms, wholesale enterprises' transactions still recorded a slight increase. By contrast, the business services sector was drawn relatively quickly into the downward spiral emanating from the industrial sector. According to the Ifo Institute, the business situation in key business-related branches of the tertiary sector showed a massive deterioration in the second half of 2008.

*Construction and trade less affected but service providers being dragged down by industry*

## The macroeconomic repercussions of a decline in demand for cars, taking into account the intersectoral integration of production

Media reports on the real economic impact of the financial crisis are taking a great deal of interest in the automotive industry. The fiscal stimulus packages of November 2008 and January 2009 both contained specific assistance measures for this sector. Car manufacturing is extremely important for the economy, not least owing to its close integration of production at many different levels with other sectors. Moreover, following strong growth over the past few years, the slump in demand in the automotive industry in recent months has been particularly marked. The volume of orders received in the second half of 2008 was down by more than one-fifth in seasonally adjusted terms on the previous six months.

As a result of the deterioration in sales conditions, the automotive industry cut back production in the second half of the year by just over one-eighth in seasonally adjusted terms compared with its overall output between January and June 2008. Taking account of the standard time frame for completing an order in this sector, industrial output was adjusted by around two-thirds to the markedly lower volume of orders at the end of the period under review.

According to the national accounts data, manufacturers of motor vehicles, trailers and semi-trailers make a directly contribution of just over 3% to the German economy's total value added (valued at basic prices).

### Structural ratios of selected economic sectors <sup>1</sup>

Sectors	Value added ratio <sup>2</sup>	Employment ratio <sup>2</sup>	Export ratio <sup>3</sup>
Automotive sector	3.3	2.2	57.3
Mechanical engineering	3.5	2.7	64.2
Chemicals industry	2.3	1.2	78.7
Construction	4.0	5.7	0.0
Retail trade (excluding the sale of motor vehicles and automotive fuel); Repair of personal and household goods	4.0	8.7	0.2

<sup>1</sup> Average for the years 2004 to 2006. — <sup>2</sup> Data taken from the national accounts. — <sup>3</sup> Exports by product category relative to the output figures

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Within the manufacturing sector, mechanical engineering, for example, has an even somewhat greater importance, while the construction sector and the retail trade (excluding the sale of motor vehicles and automotive fuel) both exceed the automotive industry's direct share of value added. The automotive industry employs around 850,000 persons, which is about one-fifth lower than the number of persons working in the mechanical engineering sector. The construction sector and, above all, the retail trade are also bigger providers of jobs. With an export ratio of 57% between 2004 and 2006, the automotive industry has an upper mid-table ranking among the sectors of the manufacturing industry.

In cyclical terms, however, due account also has to be taken of the automotive industry's intersectoral integration of production at many different levels. This is all the more important as the automotive industry is characterised by a very small depth of value added and many sectors are involved in car manufacturing in Germany. Furthermore, a sector-specific shock can spread very quickly through related bought-in goods and services and thus develop into a macroeconomic phenomenon. In this context, however, it is important not to overlook the fact that the spillover effects of a sectoral disruption to demand primarily only take the form of a diffusion effect which has a correspondingly smaller impact on the sector that is directly affected. Nevertheless, the sum of the sectoral losses in sales can quickly reach a level that is several times higher than the macroeconomic loss of value added, which is also likely to have a corresponding negative effect on the sentiment indicators for the sectors concerned. How large the "sales lever" of a negative final demand shock is to be assessed is shown in the input-output tables of the Federal Statistical Office.

The basic variables for the sectoral effects of production integration are the input coefficients. These may be interpreted as a measure of the direct output effect in a given sector arising in the manufacture of a unit of final demand in the same or another sector. From this,

of the relevant economic sector. — <sup>4</sup> However, this does not yet take account of negative income effects, owing, say, to reduced investment

it is possible to derive further coefficients which indicate how many units of intermediate output of one sector are needed in total – ie directly and indirectly – (Leontieff multipliers) in order to produce a final unit of demand in another sector. From these values, a domestic cumulative output multiplier of 2.2 is produced for the final demand unit “car”. This means that a decline in final demand by one unit of value added is accompanied by a fall in sales that is 2.2 times larger, because not only does the value added in the automotive industry itself have to be cut back, but purchases of inputs from many other sectors (eg casting of metals, electrical engineering, chemicals) also decline, which, in turn, impacts on the automotive industry.<sup>4</sup> Measured by the output multipliers of other goods, car manufacturing in Germany occupies a leading position.

From the statistical data it can be extrapolated that the slump in orders experienced by the German automotive industry in the second half of 2008 reduces the volume of sales in the goods cycle with domestic producers through direct and indirect deliveries by around €55 billion. If foreign inputs are included, the figure is as high as €81 billion. After deducting both the import share of goods and services totalling just over €26 billion and inputs of around €39 billion, which have been calculated using sector-specific input ratios, the value-added (at basic prices) of the domestic sectors declines by an amount of just under €16 billion. The automotive industry itself accounts for just under half of this amount. Business-related (mainly commercial) services which also include temporary work, and the trade and freight sector (excluding sales to final consumers), must each shoulder around one-tenth. The losses of earnings from sales of finished products and the tax shortfalls from sales of new cars to domestic private end users likewise have to be taken into account when determining the effect on GDP (at market prices). With respect to this, an estimated €6 billion are to be included. In nominal terms, this means that German GDP is dampened by some €22 billion, or by just under 1% of overall annual economic

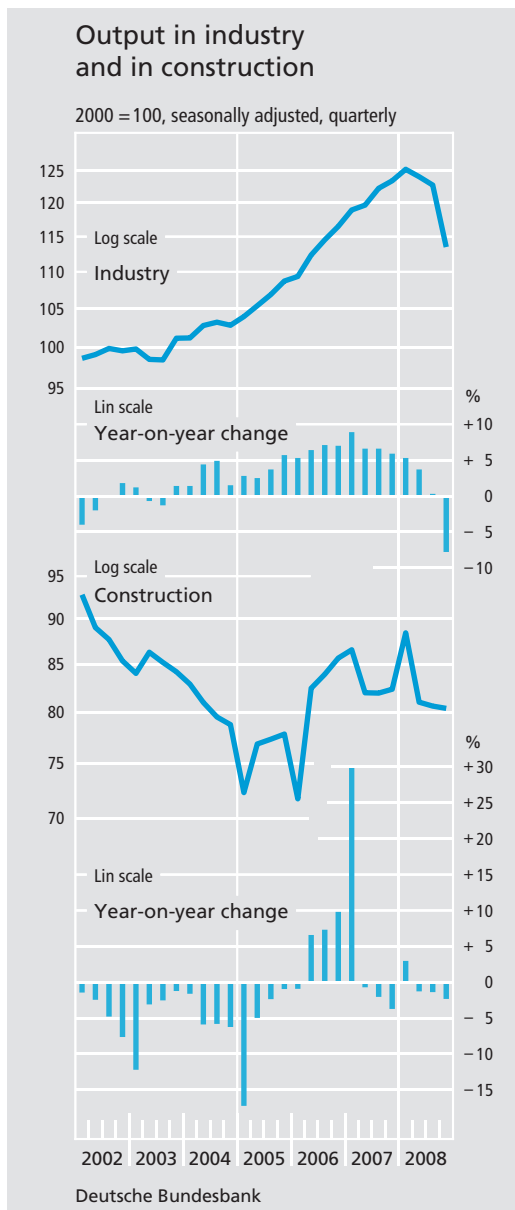
output. As the present model calculation concerns the negative demand shock from the second half of 2008, the overall impact in dynamic terms is likely to have been reflected only to some extent in the decline in output in the fourth quarter.<sup>5</sup> Given the currently short time of transmission to other sectors, it may be assumed that the continuing effects of this shock will still have a severe impact, above all, in the first quarter of 2009.

Cumulative output multipliers<sup>5</sup>  
of selected product categories



increase (or decrease) if final demand (at basic prices) in one economic sector increases (or decreases) by a single value unit.

in the upstream sectors of the economy. — <sup>5</sup> The cumulative output multiplier indicates how total sectoral sales in the economy as a whole



## Employment and unemployment

*Declining working hours as economic buffer*

So far, the sharp drop in output in the fourth quarter of 2008 has had only a very subdued impact on staffing levels. In the main, the total number of hours worked has been adjusted through hours worked. According to the industrial statistics, average hours worked in the core cyclical sector of manufacturing fell by 2.6% on the year in the reporting

period after calendar (and seasonal) adjustment. Although overtime was initially cut back and working hours accounts were run down, extended plant closures during the holidays and government-assisted short-time working arrangements are likely to have played a growing role at the end of the year. Precise information on the volume of short-time working for the final quarter of 2008 will not be available until the end of February 2009. Nevertheless, in the fourth quarter of 2008, firms registered short-term working arrangements for a total of 626,000 employees at the Federal Employment Agency.<sup>1</sup> In the same period of 2007, the figure was only 156,000, mainly in the construction industry for seasonal reasons. In the final quarter of 2008, however, such registrations came largely from the manufacturing sector. The use of short-time working arrangements was made easier by the fact that, from January 2009, the period of entitlement was extended to 18 months and that temporary employment agencies were also authorised to make use of this facility. Furthermore, as part of the second economic stimulus package, the government is to pay half of the employers' social security contributions for the loss of earnings associated with the reduced working hours. The prospect of orders from the public sector is also likely to have helped to ease pressure in the construction sector to lay off staff.

According to the provisional calculations of the Federal Statistical Office, there was a

*Growth in employment at a standstill*

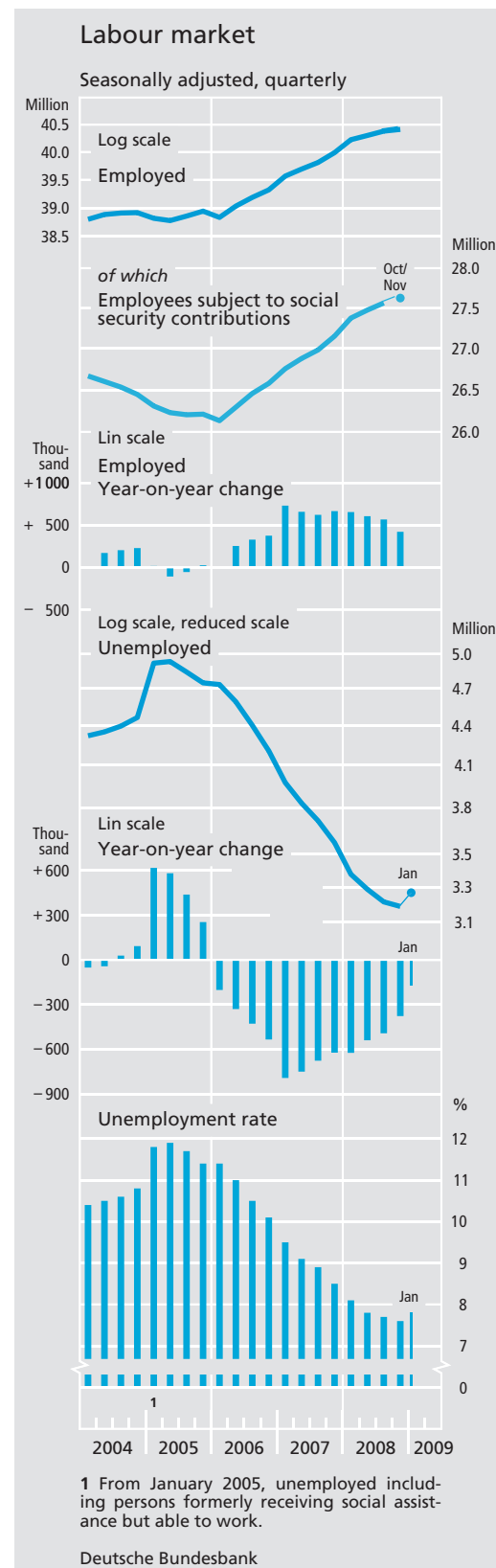
<sup>1</sup> A considerable number of these registrations – in particular, those for December – probably refers to the first few months of 2009. Nevertheless, the large rise in registrations is an indicator of the increasing use of short-time working in the final quarter of 2008.



steady and continuous decline in employment growth in seasonally adjusted terms over a period of several months, which came to a standstill in November. However, this was still an increase of 0.1% on the preceding three-month period on a quarterly average. The year-on-year increase was 1.0%. Jobs subject to social security contributions show a similar profile. The business-related services sector including labour leasing – which was a key source of employment growth during the last upswing – was already showing a clear decline. The outlook for employment has become even gloomier. The Ifo employment barometer fell considerably again in the final quarter of 2008 but matched the low level at the start of 2009. This means that, especially in manufacturing, a reduction in staffing levels is to be expected in the next few months. The number of vacancies also went down again in the fourth quarter; non-government-assisted jobs were affected disproportionately.

*Reversal of unemployment trend*

Unemployment bottomed out in the fourth quarter of 2008 following a protracted decline. Although unemployment fell slightly on a quarterly average by a seasonally adjusted 26,000 persons on the quarter and the unemployment rate went down from 7.7% to 7.6%, the total number of persons out of work increased over the quarter as a whole. This was due mainly to the fact that the decline in the number of unemployed persons receiving the basic welfare allowance was no longer pronounced enough to offset the growing number of job seekers receiving unemployment benefits under the statutory insurance scheme, which is more susceptible to



cyclical influences. At the start of 2009, unemployment was trending upward again. The number of jobless persons receiving basic welfare allowance also rose considerably for the first time. In seasonally adjusted terms, this represented a total increase of 56,000. The unemployment rate for such persons went up to 7.8%. The use of short-time working arrangements – for which an additional 291,000 registrations were received – is likely to have prevented this development from being even more unfavourable.

## Wages and prices

*Sharp rise in negotiated pay*

Negotiated rates of pay rose sharply in the fourth quarter of 2008 owing to the lump-sum payment agreed in the metal-working and electrical engineering industries in November. According to the Bundesbank's negotiated wage index,<sup>2</sup> negotiated rates of pay went up on a monthly basis by 3.6% on the year. Excluding one-off payments, the increase amounted to 2.8%. Despite a low volume of one-off payments, the rise in negotiated rates of pay in 2008, at 2.8%, was more than twice as high as in the previous year. According to the WSI wage archive, the average duration of the collective wage agreements went up slightly to 22.4 months. According to the provisional annual calculation of the Federal Statistical Office, the increase in actual earnings on a monthly basis, at 2.3%, was somewhat slower than that of the negotiated rates of pay. The negative wage drift was also due to the fact that, for cyclical reasons, the actual number of hours worked was below the number of working hours under

the collective pay agreements. Despite the cooling of the real economy, the increase in negotiated rates of pay is unlikely to level off significantly in 2009, as a number of agreements that have already been concluded provide for further, albeit – in some cases – smaller increases.<sup>3</sup> Nevertheless, a number of these pay agreements are subject to liberalisation clauses.

After rising substantially up to mid-2008, there was a sharp decline in import prices in the wake of the price adjustments in the international energy and commodity markets. On an average of the fourth quarter, import prices were down by a seasonally adjusted 7.3% on the quarter. The decline in the case

*Significant corrections in import prices ...*

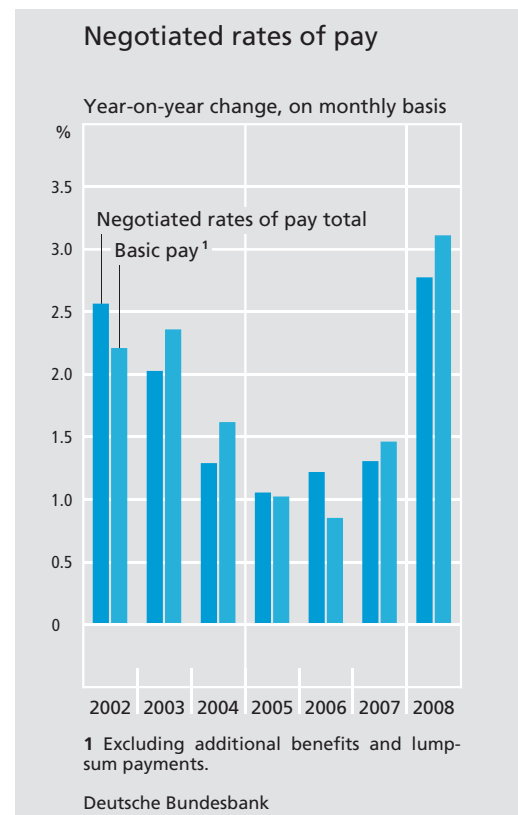
<sup>2</sup> The Bundesbank's negotiated wage index comprises all the major wage components laid down in the collective pay agreements, including regular special payments, such as holiday pay, Christmas bonuses and one-off lump-sum payments, which are often concluded as a supplement to the permanent percentage increases in regular pay. The negotiated wage index of the Federal Statistical Office (see M Bick, *Tarifverdienste in Deutschland – Was sagt die Tarifstatistik?* *Wirtschaft und Statistik*, 12/2008, pp 1101-1106) shows changes in the regular monthly rates of pay (basic rates of pay and capital formation benefits). It records only part of the wage agreements relevant to income and costs. According to this definition, employee remuneration went up by 3.1%, and hourly wages of employees by 3.0% on an annual average of 2008. In addition to its comprehensive index, the Bundesbank calculates sub-indices, excluding one-off payments and additional payments. According to these indices, contractually agreed basic rates of pay went up by 3.1% in 2008 and thus more or less as sharply as according to the index of the Federal Statistical Office. These sub-indices serve as supplementary information and primarily as an aid to interpretation for changes in the annual rates of the overall index, which can be affected by base effects owing, for example, to one-off payments. Admittedly, they cannot be a substitute for the comprehensive index as a macro-economic indicator of the wage dynamics laid down in the collective pay agreements.

<sup>3</sup> In addition, at the beginning of February 2009, Deutsche Bahn and the trade unions GDBA, GDL and Transnet reached a new pay agreement with a duration of 18 months. In line with this agreement, rates of pay will be increased by 2.5% in February 2009, followed by a one-off payment of €500 in December 2009 and a further increase of 2.0% in January 2010.

of energy prices, at 27.7%, was particularly pronounced. The cost of intermediate goods fell by 4.2%. By contrast, the prices of capital goods went up by 0.7%. This means that, for the time being, the almost continuous seven-year decline in prices for this category of goods came to an end. The depreciation of the euro against other currencies, especially the US dollar, is likely to have played a key role in this. The rate of price increase for consumer goods went up from 0.8% in the previous quarter to 1.2%. While there was a marked price rise in the case of clothing, there was decline in the cost of food. All in all, the cost of imported goods was 1.2% down on the fourth quarter of 2007. However, the cost of exports went up by an average of 1.0% on the year. As a result, the terms of trade improved by 2.2% on the year.

... and  
domestic  
producer prices

Triggered by lower import prices, German industry lowered its domestic prices, in total, by a seasonally adjusted 1.0% on the quarter. The sectoral pattern largely matches that of imported goods. Prices for energy were reduced by 2.6%, and for intermediate goods by 2.2%. The prices of capital goods rose by 0.6%, while the cost of consumer goods fell by 0.3%. The marked decline in the cost of agricultural commodities, which have a far larger weighting in domestic industrial consumer prices than in import prices, played a crucial role in this. Agricultural producer prices – ie unprocessed food products – were down by as much as 9.6% on the quarter in seasonally adjusted terms. Owing to the sharp price rises up until July 2008, industrial producer prices were still up 5.8% on the year overall in the fourth quarter of 2008. Ex-



cluding energy, the figure was 2.1%. There was no further quarter-on-quarter rise in construction prices for the first time since the second quarter of 2005. In the fourth quarter of 2008, however, construction prices went up by 3.4% on the year.

Seasonally adjusted consumer prices fell substantially by 0.7% during the final quarter of 2008. Owing to base effects – consumer prices went up by no less than 1.2% during the same period of 2007 – the year-on-year increase in the national consumer price index (CPI) went down from 2.9% in September to 1.1% in December. This positive development in purchasing power was due very largely to corrections in the international crude oil markets, where the price for a barrel of Brent crude oil was 57% lower in December than it

Consumer  
prices fall

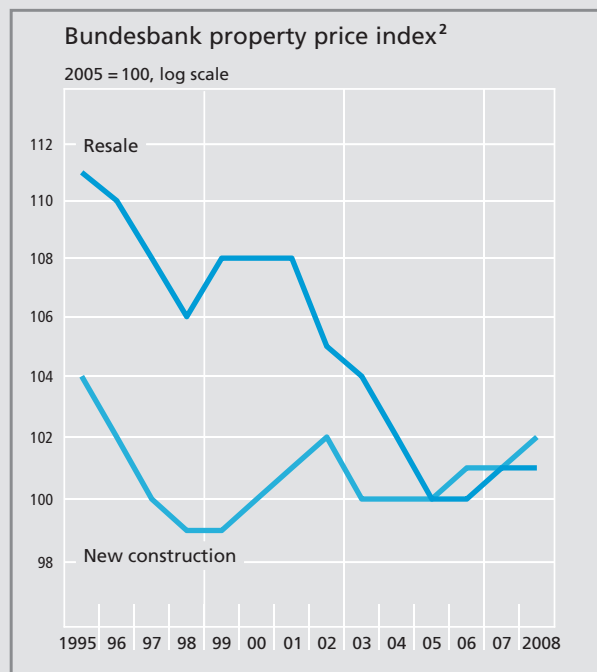
## Real estate prices in Germany in 2008

In 2008, the prices of newly constructed housing rose slightly. As can be seen from the real estate price indices calculated by the Bundesbank on the basis of BulwienGesa AG data,<sup>1</sup> this increase reflects the rise in prices for owner-occupied apartments, while there has been no discernible change in the price of new terraced housing. The prices for existing terraced housing and owner-occupied apartments likewise remained largely stable. In regional terms, only minor differences are apparent. In eastern Germany, older housing became cheaper while new property was available at prices roughly the same as in the previous year. In western

Germany, the prices for resale real estate remained unchanged with slight increases in the prices for newly constructed housing.

A similar picture is revealed by the hedonic housing price indices which have been published regularly by Hypoport AG since autumn 2008. While the cost of new residential housing rose by just under 2% on an annual average compared with 2007, there was a slight fall in the price of existing real estate. Averaged over the year, the separately recorded data for owner-occupied apartments show virtually no change in price. Over the four quarters of the year, fluctuations are discernible in all three categories. In particular, the prices for existing real estate and owner-occupied apartments fell for a time below their medium-term trend but then recovered again.

Overall, the subdued price trend in the German real estate markets continued. Neither the strong economic upturn of recent years nor the considerable price increases for construction services have had any significant impact on real estate prices. This could be due to the fact that, over the past few years, the real value of income growth has been diminished by rising energy and food prices and the increase in the standard rate of VAT by 3 percentage points at the beginning of January 2007. Demographic factors also had a dampening effect. Recently, the uncertainty emanating from the financial markets might at least have delayed purchasing decisions as well.



<sup>1</sup> See Deutsche Bundesbank, Price indicators for the housing market, Monthly Report, September 2003, pp 45-58. — <sup>2</sup> Bundesbank calculations based on BulwienGesa AG data. — <sup>3</sup> According to Hypoport AG, the platform is used to process an average of almost 8,000 mortgage contracts per month. This is equivalent to one-tenth of all real estate transactions in Germany. However, this also includes

new financing and refinancing. — <sup>4</sup> See H-J Dübel and S Iden, Hedonischer Immobilienpreisindex für Deutschland, Isolierung qualitativer Hauspreismerkmale durch hedonische Regressionsanalyse aus Daten der Europace-Plattform (Hypoport AG) und Machbarkeit eines hedonischen Hauspreisindex für Deutschland (available in German only), Berlin 2008. — <sup>5</sup> Further indices of the Association of German

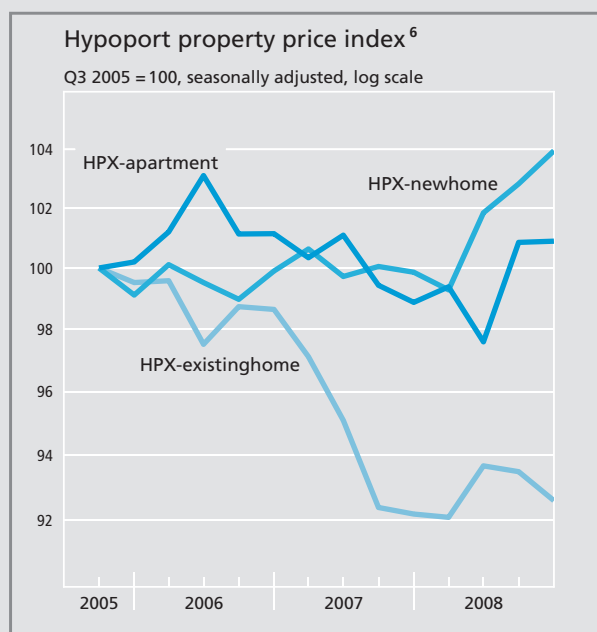
The stable development in Germany stands in stark contrast to developments in other euro-area countries where real estate has become considerably more expensive in some cases over the past few years. Sharp price adjustments are now emerging in some subsectors, which should bring about a normalisation of real estate prices in these countries.

When interpreting the data, it should be noted that the information supplied by BulwienGesa AG is essentially based on expert assessments. The aim is to standardise the assessment by using the method of typical properties in the categories of newly constructed housing and resale owner-occupied apartments as well as terraced housing offering a satisfactory living standard in average to good locations in 125 German towns. The individual town data are aggregated to calculate weighted averages for each category using the population figures of 2005. On the basis of these data, the Bundesbank computes an index of newly constructed housing and an index of properties for resale. In this context, owner-occupied apartments and terraced houses are weighted by the estimated costs of the finished building taken from the construction statistics (newly constructed housing) and by the percentage shares of terraced housing and owner-occupied apartments in total living space in Germany (resale real estate). The annual index values are published at the beginning of each following year.

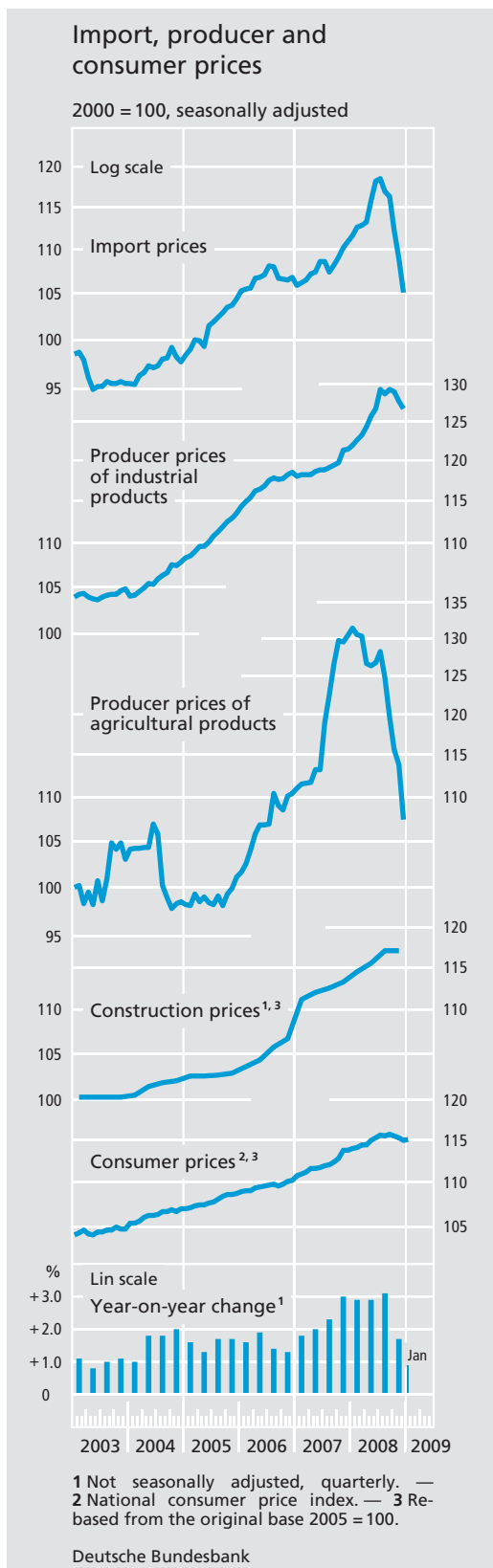
Hypoport AG collects data on real estate transactions via its internet platform for mortgage loan brokerage.<sup>3</sup>

Pfandbrief Banks (vdp) and the Federal Statistical Office are available only up to 2007. See J Dechent, Häuserpreise – Ergebnisse für 2008 und erste Resultate für Transferkosten, Wirtschaft und Statistik 10/2008 (available in German only) and F Eilers and T Hofer, Die statistische Erfassung der Immobilienpreisentwicklung in Deutschland. in Profes-

On the basis of this information, the company then computes real estate price indices which are published on a monthly basis. The data for new (HPX-newhome) and existing (HPX-existinghome) one-family and two-family houses as well as for existing owner-occupied apartments (HPX-apartment) were originally subject only to a rough quality adjustment (calculation of prices per square metre). Following a study commissioned by the German Federal Office for Building and Regional Planning (BBR) showing how it was possible to compute quality-adjusted indices from the basic data by means of hedonic regression,<sup>4</sup> Hypoport AG started to publish such information in August 2008.<sup>5</sup>



sionelles Immobilien-Banking – Fakten und Daten 2007/2008, Berlin 2007 (available in German only). — <sup>6</sup> Newly constructed housing: HPX-hedonic-newhome; resale housing: HPX-hedonic-existinghome; owner-occupied apartments: HPX-hedonic-apartment. Rebased from the original basis of August 2005 = 100.



had been in September. As a result, consumer energy prices fell by almost 7% in seasonally adjusted terms, although, owing to the sharp fall in demand, the decline in the price of heating oil was not yet being fully passed on. Finally, corrections in the prices of agricultural products were becoming increasingly apparent at the consumer level. The overall cost of food was somewhat more than ½% lower after seasonal adjustment. There were no further price increases for the other goods which had become quite clearly more expensive in the third quarter. The steady increase in the case of housing rents continued at a moderate pace. By contrast, there was a slight acceleration in the rise in the prices of services. On a quarterly average, consumer prices went down by a seasonally adjusted 0.3% overall, compared with an increase of 0.7% in the previous quarter. The year-on-year increase in the national consumer price index (CPI) went down from 3.1% in the third quarter to 1.7% in the fourth quarter. The corresponding figures for the Harmonised Index of Consumer Prices (HICP) were 1.6% and 3.3% respectively.

Consumer prices in January 2009 showed a moderate increase of 0.1% on the month in seasonally adjusted terms. This was due mainly to the fact that there were no further price reductions in the case of energy. The cost of petrol and heating oil, as well as of gas and electricity, went up rather sharply in some cases. Furthermore, there was a 5.2% increase in radio and television licence fees. This was offset to some extent by the broad-based price reductions in the retail food sector which began in mid-month and which

*Moderate price increase in January 2009*

were therefore recorded only to a certain extent in the price index for January. The price reductions at the beginning of the winter clearance sales were more or less as sharp as in the previous year and the prices of package holidays were quite favourable. The year-on-year increase in the national CPI and the HICP fell from 1.1% in December to 0.9% in January.

*Price trend to remain stable in coming months*

The latest round of price reductions in the retail food sector will also be reflected in the consumer price index in February. Further food price reductions are likely in the coming months. The price of heating oil can also be expected to show a further decline. For gas and also for electricity, a reversal of the previously upward trend is possible. The price reductions at the turn of 2008-09 will, to a certain extent, reverse the comparatively sharp rise in prices in 2008, especially in the first half of the year. This makes it more likely that the year-on-year rates of the consumer price index will be negative for a time in the coming months. In other words, this year-on-year decline in consumer prices does not indicate a general deflationary trend. Instead, it should be seen in connection with the correction to a number of previously sharp import-related price rises for certain groups of products.

### Orders received and outlook

*Characterised by an underlying recessionary trend ...*

The German economy entered a period of recession in the fourth quarter of 2008, which is also set to continue in the coming months. The strong external withdrawal effects have

dealt a severe blow to the German economy, the dynamism of which was due largely to its buoyant exports in recent years. The persistent turmoil in the international financial markets combined with structural weaknesses and imbalances in a number of countries are leaving a distinct mark on the real economy worldwide. There is a very strong cyclical interlinkage at present among the industrial countries and the economic catching-up process in the emerging market economies has slowed down or, in some cases, even ground to a halt.

Against this backdrop, sometimes extensive fiscal measures to stimulate the economy have been taken in a large number of countries. In addition, wide-scale use has been made of interest rate and liquidity policy instruments. Furthermore, the banking systems are currently being supported in an unprecedented manner and intensity. Given the problematic situation, it is scarcely possible to overemphasise the importance of the fact that the vast majority of enterprises and households in Germany are generally on a sound economic footing and that relationship banking, which plays a greater role in Germany than in many other industrialised countries, can now bring its traditional advantages to bear. This means that a major requirement is in place to enable the fiscal stimulus packages, which were approved by the Federal Cabinet in November 2008 and January 2009, to take effect. Nevertheless, these impulses will fall a long way short of compensating for the losses expected in export business in the short run, even given optimistic assumptions regarding their multiplier effects.

*... extensive government stabilisation*

Government measures to support demand can therefore only aim to prevent an intensification of the downward pressure emanating from external trade, thereby affecting domestic demand on a broad front and prolonging the underlying recessionary trend. The crucial factor for a successful discretionary fiscal policy is ultimately not just the volume of funding provided, but also its impact on the formation of enterprises' and consumers' expectations with the assessment of the long-term sustainability of government budgets playing a key role.

*Sluggish order book situation in industry more critical*

The first quarter of 2009 will be characterised by further sharp cut-backs in output, however. In industry, it is especially noticeable that a number of those enterprises particularly affected by the lull in orders not only extended their usual plant shutdowns over the Christmas holiday period well into January, but also announced additional production stoppages during the first quarter of 2009. This was due mainly to the fact that demand conditions worsened significantly during the period under review. First, the downward trend in new orders accelerated markedly in the fourth quarter, declining by more than 15% on the quarter (seasonally adjusted) during the reporting period, compared with an average of just under 3% in the preceding three quarters. Second, the manufacturing sector's current assessment of its order situation is worse than it has been at any time for 15 years. In addition, the surveyed firms reported that – measured in terms of production time – there has been a marked reduction in the volume of orders still to be pro-

cessed and that the lack of orders is the main reason for the hold-ups in production.

It was probably not only the persistently cold winter weather which adversely affected construction at the beginning of the year; the order situation is also to be regarded as unfavourable at present. Commercial and industrial construction is becoming an increasingly detrimental factor for the construction sector. In October and November – more recent data are unavailable at present – a seasonally adjusted 5½% fewer orders for, say, production facilities and office buildings were placed on average than in the third quarter. While housing construction recorded moderate growth in new orders in October and November, orders placed by public authorities, with a decline of more than 10%, were very weak in this period. The fact that state and local government postponed the implementation of certain infrastructure projects, with a view to a possible assumption of some of the costs by central government as part of the economic stimulus packages, may also have played a part in this.

*Construction orders also declined*

In line with the economic situation, enterprises' and households' sentiment was at a very depressed level at the beginning of the year. According to the survey results of the Ifo Institute, short-term output and export expectations were deteriorating further up to the end of the reporting period. The surveys conducted among households by the consumer research institution *Gesellschaft für Konsumforschung* (GfK) also indicated increasing pessimism about the economy and declining income expectations. The moderate

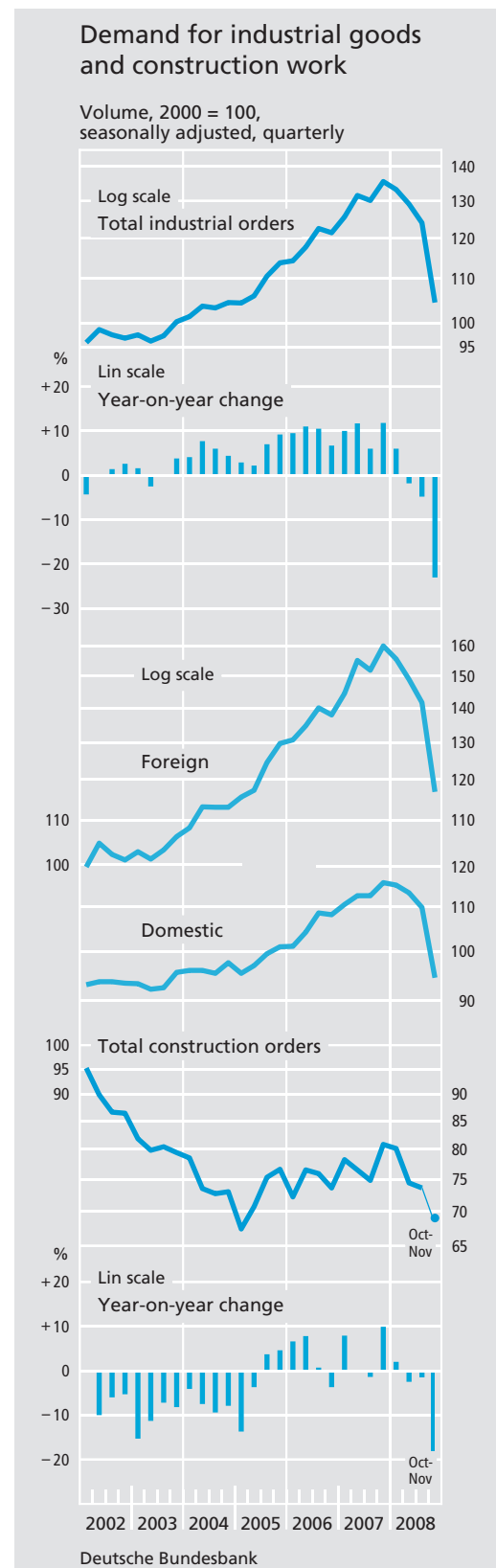
*Sentiment of enterprises and households still very subdued*



improvements apparent in the business expectations of trade and industry for the coming six months and in households' propensity to purchase, can be seen in connection with the various government measures to support the economy, but do not *per se* point to the emergence of an endogenously sustained recovery. This probably also reflects the fact, for example, that, owing to the environment premium granted to encourage motorists to scrap old passenger vehicles, private motor vehicle owners are increasingly considering the purchase of a new vehicle and that, seen in this light, the short-term outlook for the motor vehicle industry and suppliers is no longer quite as unfavourable as before.

*Private consumption a possible stabilising factor*

The funds earmarked for public sector investment in infrastructure within the federal government's two economic stimulus packages will provide the construction sector, in particular, with a perceptible boost. The depth of the recession will crucially depend on how well private consumption can perform a stabilising function. The higher level of employment and the rather substantial wage gains over the past few years have significantly improved the income situation of households. This, however, has had no dramatic impact on private consumption, as, initially, the sharp increase in VAT, followed by the sudden rise in energy and food prices, severely restricted the scope of real earnings. The price climate has improved substantially since the autumn of last year. In the fourth quarter of 2008, the reduction in the cost of fuel alone provided budget relief of some €2 billion on the quarter. The alleviating effect in the case of heating costs is not likely to take full effect until a



later date, as there is usually a time lag before gas prices are brought into line with the lower prices of crude oil and many persons in rented accommodation will probably have to make additional payments in the coming months for the billing period of 2008. Furthermore, owing to major fiscal measures and effects, households' disposable income will rise by an estimated total of €14 billion this year. The main factor in this will be the tax cuts agreed as part of the second economic stimulus package, the increase in child benefit allowance in 2009, the one-off child bonus and the reintroduction of the original tax treatment of the commuter allowance. The extension of the maximum period of entitlement to short-time working benefits, the

extension of this arrangement to cover temporary employment agencies, and the halving of the social security contributions to be paid by the employer in the event of short-time working will make it easier for enterprises to adjust labour volume in response to economic conditions without having to resort to large-scale redundancies. This *de facto* also extends the length of time benefits are paid, as unemployment benefits can be claimed in the event of redundancy following short-time working. What seems more important at present, however, is that this measure reduces the individual risk of job loss, thus mitigating one factor that usually has a negative impact on private consumption.