Economic conditions in Germany

Macroeconomic situation

Further increase in recessionary pressure in 2009 Q1

In the first quarter of the year, there was a further marked increase in recessionary pressure in the German economy. According to the flash estimate of the Federal Statistical Office, gross domestic product (GDP) fell 3.8% on the quarter in seasonally and calendar-adjusted terms, following a decline of 2.2% in the final quarter of 2008. In calendar-adjusted terms, economic output in the first three months of 2009 was 6.9% down on the year. The large cutback in output was due to the sharp and broad-based decline in German enterprises' demand for goods and services in the winter half-year of 2008-09 after the escalation of the international financial and economic crisis. However, in the first quarter of this year, Germany not only suffered a further severe setback in export business, but also experienced significant strains on the domestic side. There was a marked increase in the degree of underutilisation in the economy as a whole.

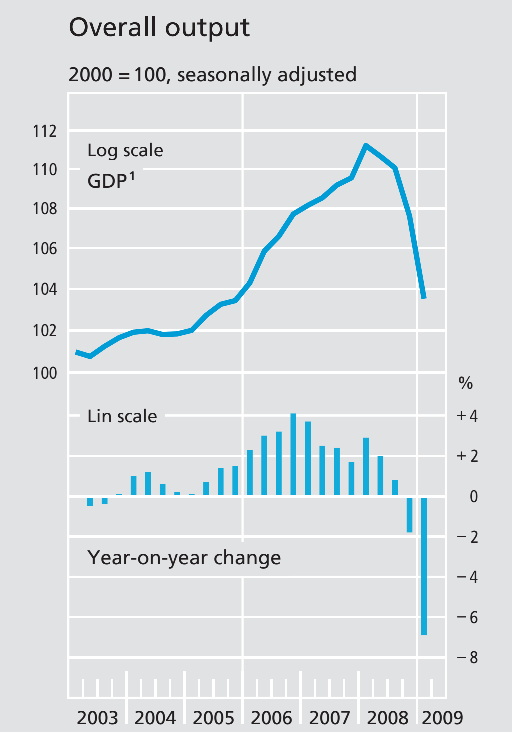
Continued export shock

The decidedly sharp downturn in the German economy was triggered by an unusually severe export shock in the wake of the global crisis that affected financial markets and confidence following the collapse of the investment bank Lehman Brothers in September last year. Through various transmission channels, this crisis spilled over very quickly to the real economy in many regions of the world economy. Up to that point, there had been a decline mainly in orders from trading partners in countries facing domestic problems of adjustment in the real estate and banking sectors. Now, German enterprises had to contend with major losses of orders in all of its key export markets. Simultaneously with a further slowdown in the economies of the industrial countries, the redirection of international capital flows had perceptible effects on the real economy in some central and east European countries as well as in most other emerging markets. The reason why this had such a major impact on large sections of export-oriented industry was that it affected a number of customer countries where the broad range of capital and intermediate goods "made in Germany" has enjoyed a good reputation and a high level of demand. The available indicators show that there was a further acceleration of the downward slide in exports on an average of the first quarter of 2009. This followed what was already a seasonally and calendar-adjusted 7½% decline in the export volume of goods and services in the final quarter of last year.

Imports affected by slower domestic output

With regard to imports, during the period under review the impact of sharply declining domestic output outweighed the special factor of higher imports of energy and raw materials, which had been at a relatively high level up to and including the final quarter of 2008 on account of their favourable purchase prices. In view of the perceptible increasing pressure on inventories, enterprises cut back their imports of inputs and intermediary products. By contrast, given the temporary boost to demand owing to the "wreckage premium" for scrapping old cars, car imports picked up markedly.

Since the beginning of the year, the slump in exports has had a perceptible impact on the



1 Price-adjusted.
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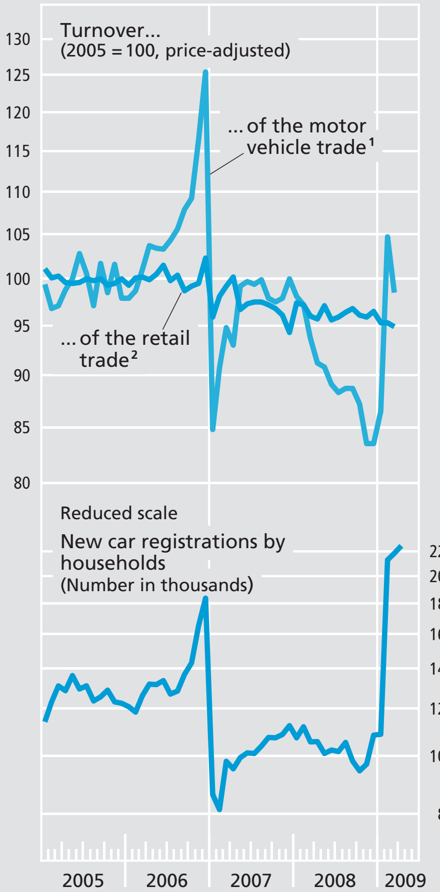
domestic economy. Inventories of unsold finished goods are likely to have prompted enterprises to make further cutbacks in production. There are two main reasons for this. First, an involuntary growth in inventories has taken place as a result of the unexpectedly sharp fall in demand. Second, it can be assumed that firms' usual inventory management has been adjusted in line with the less positive outlook for sales. Given considerable capacity underutilisation, enterprises have also revised their investment plans. Large sections of the economy probably see no need to expand the existing stock of machinery and plant in the foreseeable future. In seasonally and calendar-adjusted terms, there is likely to have been a very sharp fall in private investment in machinery during the reporting period. This came on top of a decline of just

Investment accelerator and inventory adjustment in full swing

Selected indicators of households' consumption behaviour

Seasonally adjusted, log scale



Sources of unadjusted figures: Federal Statistical Office and Federal Motor Transport Authority. — 1 Excluding heavy goods vehicles. — 2 Excluding the motor vehicle trade.

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over 5% on the quarter in the last three months of 2008.

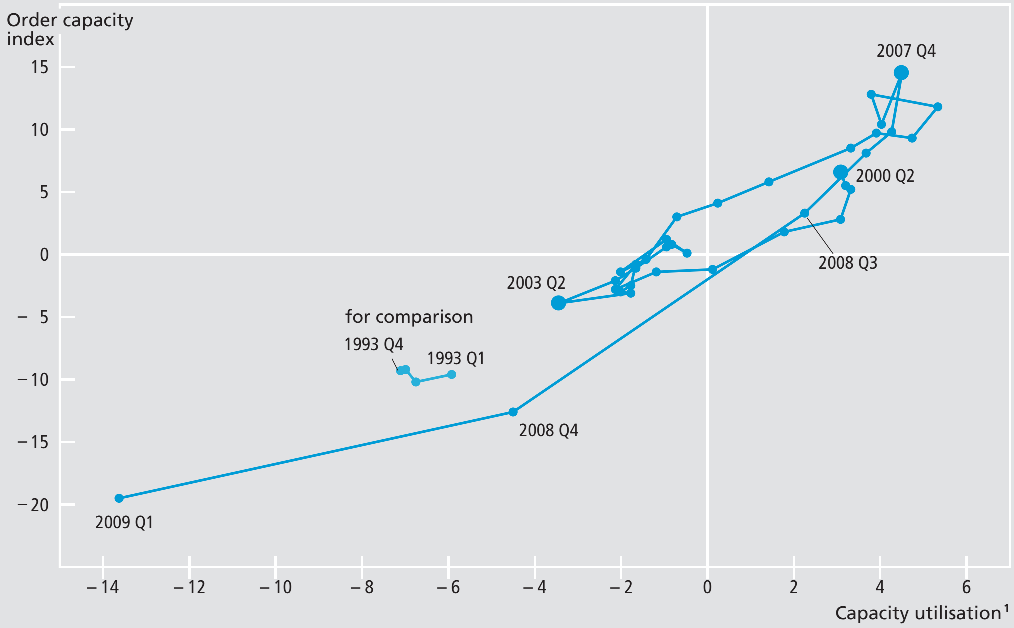
Construction investment quite robust

The poor economic environment did not generally make itself felt in terms of construction investment in the first quarter of 2009, although there were hold-ups in January and February owing to the weather. With regard to the individual subsectors, the first quarter was characterised by industrial construction already feeling the impact of investors' loss of confidence, while public sector infrastructure measures, which were to be implemented as a result of the economic stimulus packages, were not yet making any major contribution to stabilising the situation. Despite low interest rates on mortgage loans, a strain is likely to have been placed on housing construction, not least, by the fact that households willing to engage in construction had suffered in the wake of the dramatic fall in prices on the international capital markets last year. Added to this was the increased job risk.

Selective incentives to buy give temporary boost to private consumption

By contrast, private consumption buoyed up demand to some extent in the first quarter of 2009. In this context, a particular role was played by the environmental bonus granted for the scrapping of old cars since the adoption of the Federal government's second economic stimulus package. The number of new registrations for private owners nearly doubled between January and February in seasonally adjusted terms and showed a further increase in March and April. On an average of the first three months of this year, the number of newly registered passenger cars was 80% up on the quarter. However, mainly since the number of small and mid-range cars that were bought was far higher than usual and firms have not benefited from the premium, this sharp increase has not boosted sales to the same extent; in the first quarter of 2009, turnover was 14% up on the final quarter of 2008 after seasonal adjustment. Although savings were used, resulting in more free funds becoming available in the short term, new cars were probably purchased to the detriment of other consumer

Cyclical position of industry in the output demand scheme*



* Order-based industry. Bundesbank calculations based on Federal Statistical Office and Ifo Institute data. — **1** Percentage deviation from normal capacity utilisation.

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goods. In line with the overall economic situation, households' propensity to consume did not improve fundamentally in the early part of the year. Rather, it picked up temporarily in response to selective incentives to buy and shifted in structure.

Sectoral trends

Rapid slide in industrial output

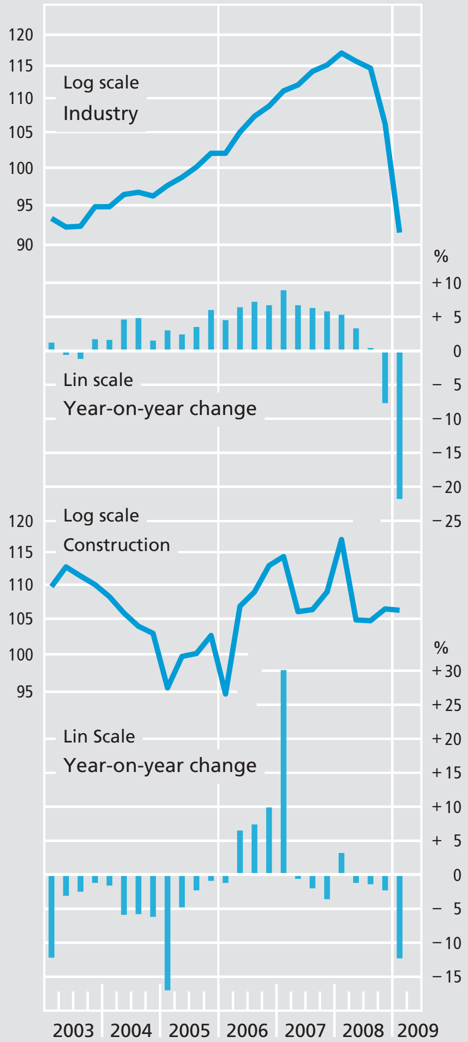
In the first quarter of 2009, there was a further discernible acceleration in the downturn in industrial output, which had already assumed a very rapid pace towards the end of last year. Industrial enterprises cut back their production by a seasonally adjusted 14% on the quarter. The decline in February was not as sharp following the very large-scale adjustments in production around the turn of the year, where exceptional measures – such as temporary plant closures – were a major factor. In March, too, the low level of activity was largely maintained. In view of the continuing marked weakness of orders in the reporting period, industrial activity is unlikely to have bottomed out yet, however. In March 2009, industrial output was around one-fifth down on the year in calendar-adjusted terms.

Extremely low industrial capacity utilisation

According to the Ifo Institute surveys, industrial capacity utilisation in April fell to its lowest level since 1992 when the survey for Germany as a whole began. At only 71% of normal full capacity, industrial enterprises reported an average degree of utilisation of machinery and equipment that was even lower than in western Germany during the cyclical downturns of the mid-1970s and early

Output in industry and in construction

2005 = 100, seasonally adjusted, quarterly



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1980s. It is already becoming apparent that the current cycle in industrial output has been characterised by a very pronounced fluctuation. That is true not only of the current downturn, but also of the preceding upswing. Large sections of industry, despite expanding their production potential, had been working at full capacity virtually without interruption for more than two years up to mid-2008.

Construction output affected by cold winter weather

Construction output in the first three months of 2009 fell by 0.2% on the quarter in seasonally adjusted terms. While construction work was adversely affected mainly by relatively unfavourable weather conditions in January and February, there was a catching-up effect in March. All things considered, construction activity was still quite robust during the reporting period. Apart from the effects of the weather, capacity utilisation in the construction sector showed scarcely any decline up to the end of the period under review according to Ifo Institute data. Furthermore, in the less cyclically sensitive finishing trades, there was a further trend increase in the total number of hours worked up to the fourth quarter of 2008, the current end of the surveys.

Mixed picture in the services sector

The economic situation in services has shown a further overall deterioration in the wake of the downturn in the production sector. The most severely affected in relative terms were those subsectors active in export business or providing services primarily for export-oriented firms and the banking industry. By contrast, those service providers whose activities are geared either directly or indirectly to the domestic markets performed better, not least in view of the government measures to support domestic demand. In line with this pattern, opposing trends are discernible in trade. Whereas sales of passenger cars to households has picked up noticeably since February owing to the “wreckage premium”, and traditional retail sales have suffered rather moderate losses, the wholesale trade and exports have shrunk severely in the wake of the global economic slowdown. The slump in world trade has also left a deep mark in the transport and logistics sector. Hotels and restaurants also performed poorly. Furthermore, the spare capacity and staffing surpluses that exist in the production sector at present have probably had an adverse impact on the business of leasing firms and temporary employment agencies.

Employment and unemployment

Adjustment initially largely by means of shorter working hours

In marked contrast to the sharp decline in aggregate value added, the fall in the number of persons in work and the rise in unemployment have been relatively limited so far. In the period from the cyclical low in October 2008 up to April 2009, roughly 48,000 additional persons were registered as unemployed on a monthly average in seasonally adjusted terms. The year-on-year increase was relatively small at 171,000. Given unchanged hourly productivity and weekly working hours and all other things being equal, the year-on-year decline in real GDP of almost 7% would have had a negative employment effect of 2¾ million. However, there has been a considerable adjustment of working hours by reducing overtime and lowering working hours accounts as well as the use of flexible working arrangements and special leave of absence. Furthermore, increasing use has been made of government-assisted short-time work. Although there is no precise information available on the extent of short-time work and the average number of hours worked since the beginning of 2009, the number of registrations has shot up and amounted to a total of 2.20 million in the first four months of the year. According to estimates by the Federal Employment Agency, the scale of short-time work implemented for economic reasons may have increased from 201,000 persons in December 2008 to 1.4 million in April 2009. Despite the cutback in working hours, the decline in the total number of hours worked fell well short of the fall in output. This led to a considerable drop in labour productivity per hour worked and a sharp increase in unit labour costs, as hourly wages also continued to rise. Given the cyclically limited opportunities for passing on costs, this is placing a considerable strain on enterprises' profitability.

Aspects of short-time work

For hours not worked – in December 2008, more than 36% of normal working hours – short-time workers receive payments equivalent to the rates of unemployment benefit (67% of standardised net earnings or 60% if there are no children). There is provision for a further extension of the maximum period of entitlement from 18 to 24 months and for social security contributions being paid in full by the Federal Employment Agency from the seventh month. Moreover, the payments are often topped up on the basis of collective wage settlements or by in-house agreement so that employees' purchasing power is largely maintained. In addition, part-time unemployment in the form of short-time work maintains hope in the possibility of a return to full-time employment in the same job. From a fiscal policy perspective, however, this is offset by the fact that short-time working benefits followed by unemployment *de facto* extends the right to insurance benefits because short-time working benefits do not

1 Not seasonally adjusted. — **2** Introduction of seasonal short-time working benefits at the end of 2006. — **3** From January 2005, unemployed including persons formerly receiving social assistance but able to work.

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shorten the period of entitlement to unemployment benefit (maximum of 24 months). Added to this is the fact that short-time benefits being granted for a very long period of time may have macroeconomically undesirable effects on structural adjustments which are needed as quickly as possible.

Faster rise in unemployment recently...

Should the contraction of aggregate output continue and hope of a rapid and strong recovery in the global economy recede, enterprises will, however, increasingly resort to laying off staff. At least, however, new (replacement) staff are unlikely to be recruited. This process is already under way. There has been a marked trend rise in unemployment recently. During the past three months, the seasonally adjusted number of persons out of work increased by 181,000 following a rise of 108,000 in the period from October 2008 to January 2009. The seasonally adjusted unemployment rate was 8.3% in April, compared with 8.0% on an average of the first quarter and 7.6% in the final quarter of 2008.

As those made redundant are, as a rule, initially entitled to claim unemployment benefit above the level of the basic allowance, three-quarters of the increase was concentrated on the statutory insurance scheme. However, following an almost continuous three-year decline, the number of unemployed persons drawing the basic allowance also went up again during the period under review. One reason for this is the increased difficulty in moving from unemployment into paid employment in the current economic setting. Second, this group includes jobseekers whose claim to benefits does not reach the level of the basic allowance or who have not been insured for a sufficiently long period of time and are needy.

... and growing decline in employment

According to estimates by the Federal Statistical Office, the number of persons in work (which is likely to be revised downwards), fell by 133,000, or 0.3%, during the first quarter, compared with a decline of no more than 27,000, or 0.1%, in the final quarter of last year. Initial provisional data allow the conclusion that the fall was especially marked in the case of temporary employment, with the figure, according to the available data, being more than 15% down on the year in February.

Further deterioration in the outlook for employment

According to the Ifo Institute, the outlook for employment has continued to deteriorate since the beginning of the year. Especially in industry, there has been a further downward adjustment in personnel planning. The seasonally adjusted number of job vacancies reported to the Federal Employment Agency went down by more than 10% in the period from December 2008 to April 2009. The decline in non-assisted job vacancies subject to regular social security contributions amounted to more than 15%. According to surveys by the Institute for Employment Research (IAB), the number of vacancies in the economy as a whole in the first quarter of 2009 was one-quarter down on the year.

Wages and prices

2009 wage round with lower negotiated rates so far

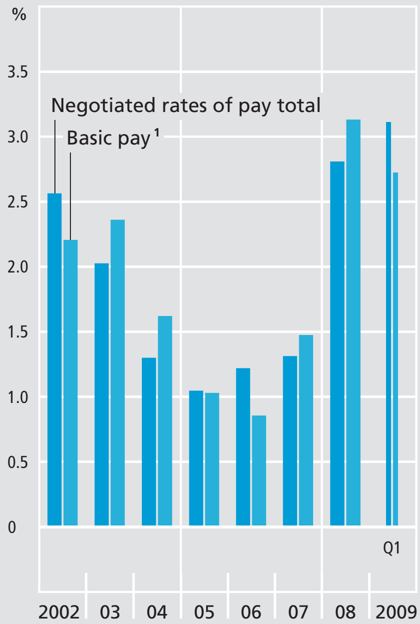
The first few months of 2009 saw the conclusion of a number of new collective pay agreements with lower growth rates of pay in some cases than in the previous year but with lump-sum and one-off payments playing a greater role. At the same time, longer durations and liberalisation clauses were agreed in many cases. Especially in manufacturing, the pay negotiations were influenced by the massive deterioration in the economic situation. The new pay settlements in the textile industry and in the iron and steel industry also contain arrangements for safeguarding jobs. The agreements in the services sectors were shaped more by firm and sector-specific special factors, however, and were scarcely weaker than in 2008. The quite generous pay settlement of Deutsche Bahn has to be seen against the backdrop of last year's disputes. Much the same applies to Deutsche Telekom; a marked increase in pay was agreed following a general freeze as well as pay cuts and longer working hours in 2007-08. A comparatively moderate rise in wages and salaries was agreed for the employees of the crisis-stricken private and public banking industry. The gap with the negotiated rates of pay for central and local government was closed in the public sector of the federal states.

Slower rise in negotiated rates of pay

According to the Bundesbank's pay rate statistics, negotiated rates of employee compensation in the first quarter of 2009, at +3.1%, rose less sharply on the year than in the final three months of 2008 (+3.7%), in which the one-off payment in the metal-working and electrical engineering industries had been

Negotiated rates of pay

Year-on-year change, on monthly basis



1 Excluding additional benefits and lump-sum payments.

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booked. The year-on-year increase in the basic negotiated rates of pay, which do not include the one-off payments, went up by 2.7%, compared with +3.1% in the fourth quarter of 2008.

Continuing decline in import prices ...

The favourable overall trend in prices was maintained at all levels of the economy. The decline in import prices continued at the beginning of the year at a somewhat slower pace. The costs of imports was 3.9% down on the quarter in seasonally adjusted terms, compared with -6.0% in the final quarter of last year.[1] While the downward correction in the case of energy, at roughly 15%, was weaker than in the last three months of 2008, it was stronger in the case of intermediate goods at 5.3%. The prices of capital goods remained broadly unchanged. Despite persistent falls in food prices, the cost of consumer goods went up almost as sharply as in the preceding quarter. The year-on-year decline in import prices widened from 0.7% in the final quarter of 2008 to 6.3% in the first quarter of 2009. However, this was also due to a baseline effect as prices rose sharply at the beginning of 2008. Excluding the price-lowering impact of energy, intermediate goods and food, however, the year-on-year rate went up from 0.6% to 1.5%. As the year-on-year decline in the prices of exports was noticeably smaller, at 1.2%, the terms of trade improved by 5.4%.

... and price reductions continuing at the domestic producer level, too

In contrast to the import side, the seasonally adjusted quarter-on-quarter decline in industrial producer prices at the beginning of the year accelerated from 0.8% to 3.2%. One factor in this was that, in some cases, there had been a time lag in passing on price adjustments for crude oil and other imports. Once again, lower price demands from the food industry led to consumer goods continuing to become cheaper. Agricultural producer prices also eased in the first quarter of 2009 by a seasonally adjusted 5.2%. The year-on-year increase in producer prices went down from 5.3% to 0.8%, with a base effect due to the sharp rise in early 2008 likewise being a factor. Excluding the impact of energy, intermediate goods and food, domestic producer prices remained unchanged compared with the final quarter of 2008, however, and

1 With the reporting month of January 2009, both the foreign trade and industrial producer price indices were rebased on 2005. The weights were updated in the new base year in line with the foreign trade and industrial domestic sales structures and the index results were back-calculated up to then.

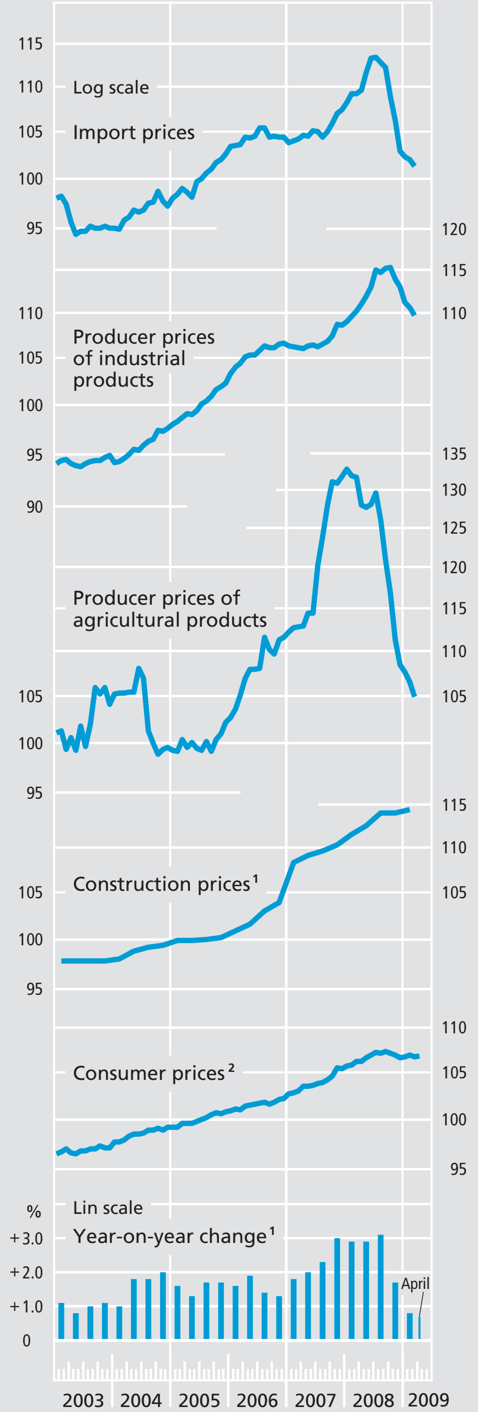
the year-on-year rate fell only marginally on the quarter to 1.4%. Construction prices went up by 0.4% on the quarter. Owing to a base effect, the year-on-year increase went down from 3.4% to 2.6%, however.

Further easing of consumer prices at the beginning of the year...

Following the fairly sharp seasonally adjusted fall in consumer prices of 0.3% in the final quarter of 2008, the decline in the first quarter of 2009 was modest at 0.1%. Energy prices were obviously lower again overall, with further reductions in the case of fuels and heating oil being counteracted by higher electricity prices. Food prices also continued to be adjusted to the lower commodity prices. While this had previously been the case for dairy products and for edible oils and fats, it now applied increasingly to cereal products as well. By contrast, industrial goods and services were both 0.3% more expensive. Housing rents continued their steady moderate rise as well. The year-on-year increase in the national Consumer Price Index (CPI) – partly as a result of a base effect for services owing to the early date of Easter in 2008 – declined from 1.1% in December 2008 to 0.5% in March 2009 and on a quarterly average from 1.7% to 0.9%.[2] Consumer prices for fuel were 15% down on the year. The figure for heating oil was nearly -30%, in fact. The increase in the price of food fell from 2.8% in the preceding quarter to 0.8%. Excluding energy and food, the year-on-year rise in consumer prices was nevertheless unchanged at 1.3% because industrial goods had become markedly more

Import, producer and consumer prices

2005 = 100, seasonally adjusted



1 Not seasonally adjusted, quarterly. — **2** National consumer price index.

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2 The corresponding figure for the Harmonised Index of Consumer Prices (HICP) was 0.8% in the first quarter of 2009, compared with 1.6%.

expensive, thus offsetting the base effect in the case of services.

... but went up slightly in April

In April, consumer prices accelerated again somewhat in seasonally adjusted terms at 0.1%. Energy prices were declining since sharp price reductions for gas more than offset the higher cost of fuel and heating oil. Lower prices of fruit and vegetables meant that consumers also paid less for food. There was a sharp seasonally adjusted increase in the prices of industrial goods, however. Services likewise became more expensive in seasonally adjusted terms owing to marked price increases for package holidays. The year-on-year CPI rate went up from 0.5% to 0.7% and the HICP rate from 0.4% to 0.8%. The fact that Easter in 2008 fell early in March played a part here, too. The round of price cuts in the retail trade that started in the second half of April is likely to impact fully on the consumer price index in May. Additionally, further gas suppliers have announced price reductions. There will be some markedly negative year-on-year rates in the coming months, mainly as a result of the sharp increase in energy and food prices up to the middle of 2008 and the subsequent price corrections. However, these reflect the ups and downs in the international commodity markets rather than any general deflationary tendencies.

Orders received and outlook

The strains placed on the German economy by the continuing massive export shock and the increasing occurrence of secondary effects on the domestic side are likely to have peaked in the first quarter of 2009. Along with the gradual easing of tensions in the international financial markets and the expected stabilising impact of large-scale monetary and fiscal policy measures, there have recently been growing signs of an easing of the downward pressure in the global economy. It seems that the confidence which had been lost is gradually returning.

Gradual easing of cyclical strains from the second quarter onwards

Despite some identifiable signs of an easing, consideration still has to be given to the factors that are acting as a brake on the real economy, which result from the reorientation in the international financial and banking system directly or through tighter credit standards, higher interest rate spreads in the money and capital markets, and the redirection of financial flows. In the coming months, the external retarding effects for the German economy are unlikely to be as severe as they were in the winter half-year of 2008-09, however. At the same time, the downturn in investment activity will continue and the depletion of inventories could go on a while further. From the second quarter onwards, however, the domestic economy will probably benefit perceptibly from a sharp rise in public sector construction investment. Moreover, a further contribution to stabilisation will probably be made by the ongoing favourable price climate, fiscal policy relief in taxes and social security contributions, increased social benefit payments as well as, with some qualification, the hitherto moderate reaction of the labour market.

Still continuing heavy downward pressure in industry...

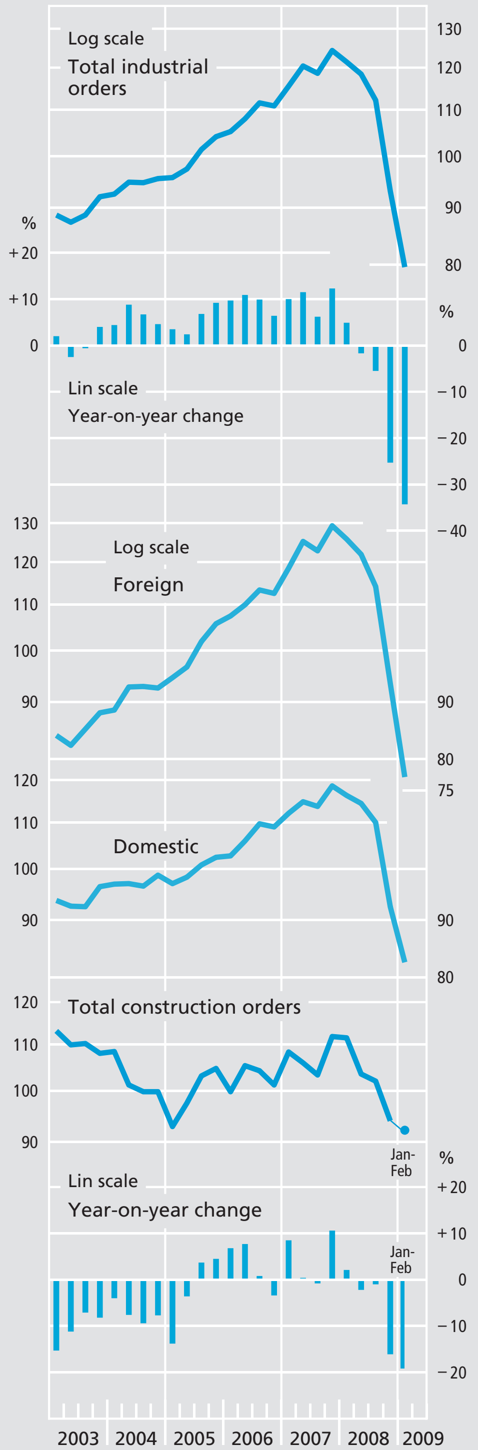
In the second quarter, contractionary effects will probably continue to have the upper hand on balance. This is suggested, in particular, by the extremely poor orders situation in industry. Seasonally adjusted orders in the first quarter of this year were 14½% lower than in the final quarter of 2008, when the decline was already 17%. In the reporting period, orders received for intermediate, capital and consumer goods fell at a similarly rapid pace, while it was mainly demand for capital and intermediate goods that had slumped in the second half of 2008. The regional shift in the contraction in demand after the turn of 2008-09 is explained by the fact that German industry's major export markets in central and eastern Europe as well as the east Asian emerging market countries were affected by the global economic and financial crisis later than the euro-area partner countries. Another contributory factor is that, in the euro area, the member states' economic stimulus programmes, which are fairly extensive overall, are likely to have had an initial positive impact during the period under review.

... but unmistakable first signs of improvement

The very poor quarterly figure for incoming industrial orders nevertheless partially conceals the fact that, following an uninterrupted sharp six-month slump, there was *per se* a sizeable increase in orders in March after seasonally adjustment. Given the continuing very low volume of orders, the importance of this initial rise should not be exaggerated in cyclical terms. Even so, there is now also an initial ray of hope from a "hard" economic indicator. According to the Ifo Institute, the business climate in manufacturing recovered

Demand for industrial goods and construction work

Volume, 2005 = 100, seasonally adjusted, quarterly



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somewhat in April from its earlier extremely pessimistic ratings in the first quarter. While the assessment of the business situation was not much brighter, business expectations for the next six months improved for the fourth time in succession. What is also striking about the survey results is that, following their abrupt slump in the second half of 2008, export expectations were likewise trending upward slightly. This is consistent with the fact that the growth in orders in March was due predominantly to an increase in export contracts. The increase remained quite modest on the domestic side and was confined essentially to car manufacturing and its ancillary industries.

Expected stabilising effect of public construction investment…

Demand for construction work at the beginning of 2009 was characterised not only by marked reluctance on the part of private sector customers but also by a considerable increase in new public sector orders. In the first two months of the year – more recent information is unavailable at present – demand for industrial construction, following the slump in February, was down by an average of 11½% on the final quarter of 2008 in seasonally adjusted terms. There was also a very sharp deterioration in the orders situation in housing construction during this period. By contrast, the volume of public sector orders in construction output in January and February combined was 12% larger than in the fourth quarter of 2008.

… and private consumption

Besides public construction investment, private consumption will remain a factor stabilising the economy in the immediate future. Given the decidedly unfavourable economic situation, consumer sentiment has been remarkably robust. Although expectations regarding general economic activity are still only at a very low level following the marked setbacks last year, the favourable price climate, above all, has led to a steady improvement since January in the outlook for real incomes. The propensity to purchase is also obviously greater at present than might be expected in view of the sharp economic downturn. The measures to boost purchasing power and the temporary incentives to buy contained in the economic stimulus packages are undoubtedly playing a part in this. An additional likely factor is that the perception of the risk of becoming unemployed has been reduced so far by the extended possibilities of introducing short-time working.