

## Economic conditions in Germany

### Macroeconomic situation

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The recovery in the German economy made marked progress in the third quarter of 2009. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real GDP rose by 0.7% in the third quarter following an expansion of 0.4% in the preceding three-month period. Owing to the massive slump in production in the final quarter of 2008 and first quarter of 2009, output remained at a cyclically low level, however. This is also revealed by the fact that output was as much as 4.8% down on the year in calendar-adjusted terms. Even so, overall capacity utilisation is likely to have increased perceptibly in the third quarter for the first time in one-and-a-half years. Although risks still exist with regard to the sustainability of the current rebound, more and more enterprises are now looking to the future with growing confidence – not least against the backdrop of marked signs of an easing of tensions in the financial markets. This is one reason why there has been no increase over the past few months in the existing moderate pressure on the labour market in terms of redundancies.

*Cyclical  
recovery  
strengthened  
in Q3*

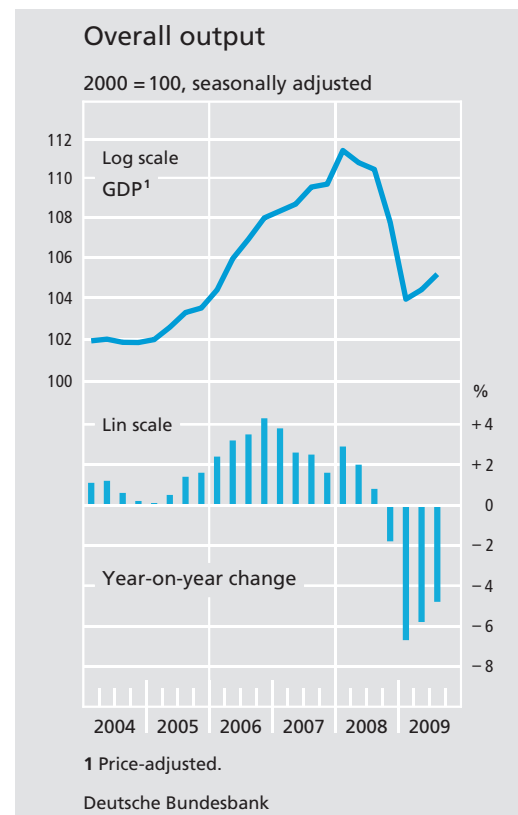
The brighter international environment has played a key role in the improved overall economic situation in Germany. In the wake of the global shock to confidence triggered by the insolvency of Lehman Brothers, the German economy was hit particularly hard by the sharp downturn in global economic activity. The reason for this is the country's dependence on exports and its specialised manufacturing profile. Within the space of

*Export as the  
primary  
stimulus*

nine months, its export volume fell by more than one-fifth. In the third quarter, however, German exports picked up noticeably. In seasonally adjusted terms, the value of exported goods in the third quarter was 5.4% up on the preceding three months. There is likely to have been a similarly sharp increase in real terms. From a regional perspective, the key factor was not only that demand from Asia was continuing on an upward trend; exports to other EU countries, which account for by far the largest part of Germany's foreign trade, also recovered perceptibly. German firms, in particular, were able to boost their export sales of intermediate goods. This suggests that – in global terms – the inventory cycle has advanced further. In major industrial countries, the recovery has recently also been sustained by endogenous market factors, even though large-scale measures to stabilise the economy have continued to play a major role, as is also evident from the sharp rise in motor vehicle exports.

*Imports, too, growing again*

Imports to Germany also increased sharply during the reporting period. In seasonally adjusted terms, the rise in the value of imported goods was just as large as that in exports. In real terms, growth is likely to have been even somewhat greater. German enterprises gearing their plans to renewed growth in output gave a clear boost mainly to imports of intermediate goods. Taken in isolation, imports were dampened by the fact that motor vehicle traders imported fewer new cars in the first two months of the third quarter than in the second quarter. This was done in the expectation that available funds for the



government environmental premium would soon be exhausted.

Fixed investment showed a slight overall rise in the third quarter. This was probably due chiefly to stimuli from the public sector. By contrast, private investment remained fairly subdued. Firms have been buying more machinery and equipment again recently, with the growth in imports more than offsetting the continuing decline in domestic sales of capital goods (excluding motor vehicles). Industrial and commercial construction may have slackened in the third quarter, however. Housing construction has not yet picked up appreciably from the low level of the preceding quarters, even though there has been a perceptible increase in applica-

*Fixed capital formation in the corporate sector lacks stimulus, but increase in the public sector*

## Foreign trade by region and category of goods

Percentage change

Item	2009 Q2		Average of Jul-Aug 2009	
	compared with			
	2009 Q1		2009 Q2	
	seasonally adjusted			
	Ex-ports	Im-ports	Ex-ports	Im-ports
<b>Total</b>	- 2.9	- 7.2	4.6	3.3
<b>Countries or group of countries</b>				
Euro-area countries	- 4.4	- 4.9	5.5	1.8
Other EU-countries of which	- 1.2	- 1.0	6.6	3.3
New member states <sup>1</sup>	- 1.7	2.2	5.7	0.8
United States of America	- 0.9	- 19.7	- 10.9	- 4.1
Russian Federation	- 17.4	- 7.5	3.4	5.5
Japan	0.0	- 14.6	6.2	2.3
South-East Asian countries <sup>2</sup>	4.3	- 6.1	12.6	10.4
China	5.3	- 4.4	7.9	4.8
OPEC countries	- 3.4	- 8.2	- 9.0	9.7
<b>Categories of goods</b>				
<b>Main categories</b>				
Intermediate goods	- 3.2	- 8.7	6.6	4.4
Capital goods	- 0.6	- 2.8	3.8	- 1.1
Consumer goods	- 4.9	- 4.2	2.7	4.6
Energy	.	- 13.5	.	6.8
<b>Selected categories</b>				
Pharmaceutical and chemical products	- 1.1	- 4.1	2.9	5.5
Machinery and equipment	- 7.4	- 16.1	0.6	3.6
Motor vehicles, trailers and semi-trailers	5.9	5.2	11.1	- 1.1
Computer, electronic and optical products as well as electrical equipment	- 3.0	1.8	6.4	4.7
Basic metals and fabricated metal products	- 7.8	- 16.0	5.6	2.8

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

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tions for building permits and in orders since the beginning of 2009.

Private consumption in the third quarter is likely to have been well down on the preceding three-month period in seasonally and price-adjusted terms. This is suggested, first, by the decline in retail sales and the marked restraint households have shown recently in buying heating oil. Moreover, the government's environmental premium for scrapping old cars did not stimulate motor vehicle sales as strongly in the third quarter as it did in the second quarter. Despite this, private consumption has held up comparatively well so far. Had consumers downgraded their income expectations in response to the sharply fallen production levels, they may well have aggravated the crisis. The unexpectedly moderate level of redundancies to date has undoubtedly played a key role in this not occurring. After adjustment for the effects of the car scrapping scheme, consumer spending is likely to have been largely in line with households' disposable income. This also means, however, that private consumption – except for additional car purchases – did not generate any positive stimuli.

*Dampening impact of private consumption*

## Sectoral trends

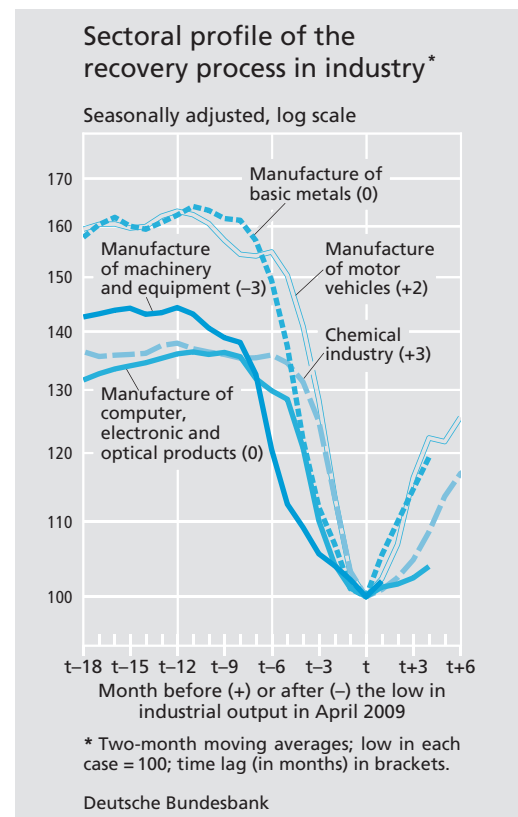
Following a large loss of output since the final quarter of 2008, industrial production showed a seasonally adjusted increase for the first time again in the third quarter of this year. With a 3.6% rise in output on the quarter, the recovery was, in itself, quite sharp, although it lagged behind the pace of growth

*Sharp increase in industrial output from a low level*

in orders and the very well advanced upturn in business expectations. The fact that production of goods was 17¾% down on the year in calendar-adjusted terms highlights a clear indication that output is still at a decidedly low level despite the considerable growth.

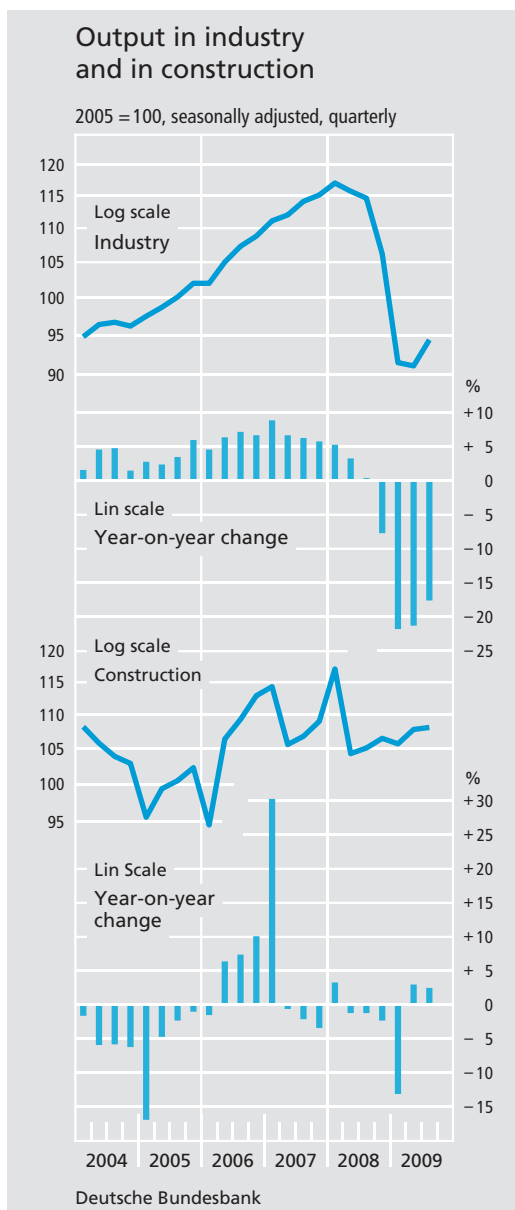
*Disparate  
sectoral profile  
in industry*

The biggest advances in the process of stabilisation and recovery have been made by manufacturers of intermediate goods. The chemicals industry achieved a cyclical turnaround at an early stage, for example, and, since the low at the very beginning of 2009, has already made up one-half of the fall in output due to the crisis. Basic metals manufacturing has been trending upwards since the second quarter, with the boosting impact of the scrappage premium also being a factor in this sector, which is a major supplier to the car manufacturing industry, where these effects, naturally enough, were strongest. The boom this created quickly raised car production by roughly one-quarter compared with the low in the first quarter of 2009. Looking to the future, this implies a considerable potential for a setback, however, as private car demand will then be suffering the counter-effects of purchases brought forward at home and abroad, and commercial orders for motor vehicles are likely to remain weak. In major sub-areas of traditional capital goods production, such as the manufacture of machinery and equipment or in electrical engineering (including IT), no more than the beginnings of a cyclical improvement can be identified in the pattern of growth at present.



According to the Ifo Institute surveys, manufacturing capacity utilisation rose to 73¾% of normal full capacity in October with a small increase already having been reported in July. This meant that industrial capacity utilisation was still at a very low level. This is shown by the fact that it was not only roughly 10 percentage points below its multi-year average, but also undershot the lowest point of all the preceding cyclical downturns since 1970. At the end of the period under review, it was the producers of intermediate goods that were able to increase their obviously crisis-hit capacity utilisation the most. By contrast, following an even sharper slump, capital goods producers (including motor vehicle manufacturers) made up hardly any ground. Nevertheless, capacity utilisation in consumer goods had shown no more than a relatively

*Somewhat  
higher  
industrial  
capacity  
utilisation*



moderate decline owing to the fact that it is less cyclically vulnerable and was already picking up again a little.

*Sharp rise in energy production and robust construction activity*

Production sector output in the third quarter of 2009 also benefited from a sharp seasonally adjusted increase in energy production compared with the weak second quarter. Furthermore, construction output in August and September picked up noticeably from its

rather moderate figures at the beginning of the third quarter. The robust situation in construction is shown by capacity utilisation surveyed by the Ifo Institute. In the core sector of the construction industry, the increase in public sector orders at least partly offset the declining demand from industrial investors, and stimulus from the public sector is also likely to have helped building completion activities and the finishing trades.

The activities of the wholesale and retail trade are likely to have declined in the third quarter on balance. The overall picture was dominated, first, by the negative effects stemming from traditional retail trade whose sales showed a fairly sharp seasonally adjusted decline at the end of the period under review. Second, there was a marked fall in motor vehicle sales in the reporting period following the massive boost to car sales from the government environmental premium in the first half of the year. Wholesale trade, on the other hand, benefited in the third quarter from the upturn in the production sector. Growth in real sales of 1¼% on the quarter was quite modest, however, compared with the quite considerable losses in the two preceding quarters. Business-related services – judging by the available results of surveys in this subsector – were also no longer performing as unfavourably as before.

*Trade and services showing growth in business-related sector, losses in consumer-related sector*

## Employment and unemployment

The labour market again proved to be extremely robust in cyclical terms in the third quarter of 2009. According to current data,

*Hardly any decline in employment overall, ...*

employment showed a fall of 30,000, or not quite 0.1%, on the quarter in seasonally adjusted terms and, in fact, remained unchanged over the quarter. After an upward revision of earlier statistics, there was only a decline of 84,000, or 0.2%, on the year. This stands in striking contrast to the sharp contraction of aggregate output of almost 5%.

*... but reduced working hours*

Labour input was adjusted to the lower level of output partly through government-subsidised short-time working. In the second quarter, firms were claiming short-time working benefits from the Federal Employment Agency for 1.49 million employees. Average working hours lost for each employee on short-time work were just under one-third of regular working hours. In nominal terms, this was the employment equivalent of 474,000 employees, or 1.1% of the labour force. In the third quarter, relief afforded by this measure – taking expenditure on short-time working benefits as a yardstick – may have been one-fifth less. Seasonal effects are likely to have played a part in this, too. A year-on-year comparison of the employment figures adjusted for this short-time working effect would show a noticeably sharper fall in employment that is more than 1% higher, but this would still be much smaller than the fall in aggregate output. Probably more significant in quantitative terms were other mechanisms for adjusting working hours to operational requirements; these were introduced over the past few years by both sides of industry and are now very much proving their worth in the crisis. They include working time accounts as well as the possibility of (temporarily) reducing regular working hours

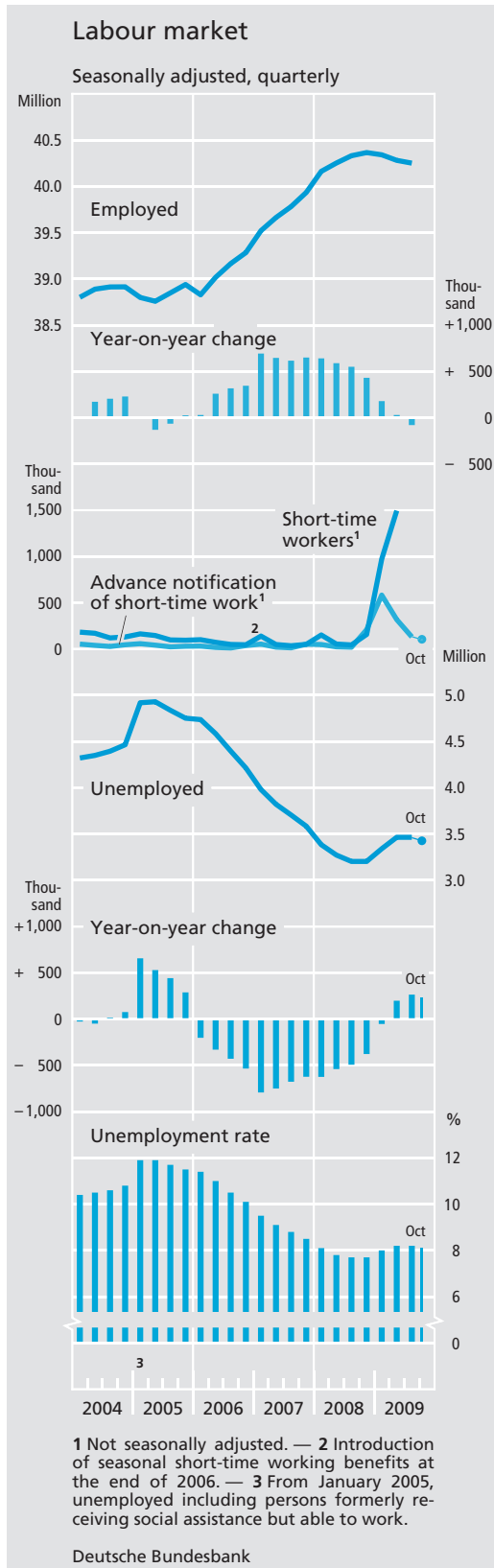
with a corresponding cut in pay. Moreover, firms have tolerated a clear decrease in hourly productivity, which is reflected *inter alia* in much higher unit labour costs and correspondingly lower profit margins.

In sectoral terms, manufacturing, business-related services (including temporary employment) as well as transportation and storage, and information and communication have shown a marked decline in employment subject to social security contributions. Compared with August 2008, a total of 386,000 jobs have been lost in the sectors that were severely hit by the crisis. This corresponds to a decline of 3.1%. This contrasts with fairly large employment gains in sectors which are wholly or largely publicly financed – health and social work, and public administration – and hotels and restaurants, and private services (a total of 250,000, or 3.2%). Furthermore, there has been a marked increase of 95,000, or 2.0%, in low-paid part-time employment.

*Job losses in industry, gains in services*

There was also very little change in the official unemployment figure in the third quarter of 2009. On a quarterly average, 3.47 million persons were registered as unemployed in seasonally adjusted terms, which was 265,000 more than one year previously. As in the second quarter of 2009, the seasonally adjusted unemployment rate was 8.2%. By a broader definition, which also neutralises intervening changeovers in the labour market statistics, the year-on-year rise in unemployment would have been roughly 50% higher, at 424,000. During the same period, the decline in the number of employed residents

*Hardly any change in unemployment*



was much smaller (-138,000) and there was a further decrease in the working-age population. One explanation for such discrepancies could be that job losses in industry and in other sectors especially affected by the crisis often lead directly to unemployment, while persons who were previously not in the active labour take some of the new jobs in the services sector. Added to this is the fact that persons registered as unemployed can be in marginal employment.

As things stand at present, a sharp rise in unemployment in the near future looks unlikely. Nevertheless, employment will probably be adjusted more and more to the now rising, but still cyclically depressed volume of output. Despite short-time working and the extensive use of flexible working time models, this is likely to lead to job losses in manufacturing and in the transport and logistics sectors, although these could be partly offset by new recruitment in other sectors of the economy. This is suggested at least by various surveys. According to a special survey by the Institute for Employment Research (IAB) in the summer of 2009, only 16% of enterprises and public authorities (with currently about six millions employees subject to social security contributions) have plans to reduce staff, while 13% of firms (likewise with six million employees at present) intend to increase staffing levels.<sup>1</sup> The remaining 71% of enterprises (with 15 million employees) are considering maintaining their staffing levels over the next 12 months. According to the autumn 2009 business survey conducted by

*Labour market outlook*

<sup>1</sup> See "Wie Betriebe in der Krise Beschäftigung stützen", IAB-Kurzbericht 18/2009 (German only).

the German Chambers of Industry and Commerce (DIHK), one-quarter of enterprises are planning to cut back the volume of employment, 10% would like to expand it, and two-thirds want to leave it unchanged. This means that there has been a marked improvement in the outlook for employment since the early summer – which is also consistent with the movement in the Ifo Employment Barometer. The fact that DIHK paints the overall picture somewhat less positively than IAB is probably due to the fact that the DIHK survey is restricted to trade and industry. Even so, the health and social services sector – which is, if anything, underrepresented in this survey – signals an increasing number of jobs, as does in the Federal Employment Agency’s statistics on vacancies. The latter show that there has been no further reduction in the number of non-government-assisted jobs over the past three months as a whole. Nevertheless, a year-on-year decline of more than one-quarter is reported. According to the quarterly IAB Job Vacancy Survey, there was a fall in the number of vacancies between the second and third quarters of 2009, but the decline was down to 16.6% in year-on-year terms.

## Wages and prices

*Price pressure continuing to ease*

Low capacity utilisation and depressed profitability are increasingly making themselves felt in negotiated wages and actual earnings. The Bundesbank’s pay rate statistics show that the year-on-year increase in negotiated rates of pay in the third quarter of 2009, at an average of 2.1%, was somewhat lower than

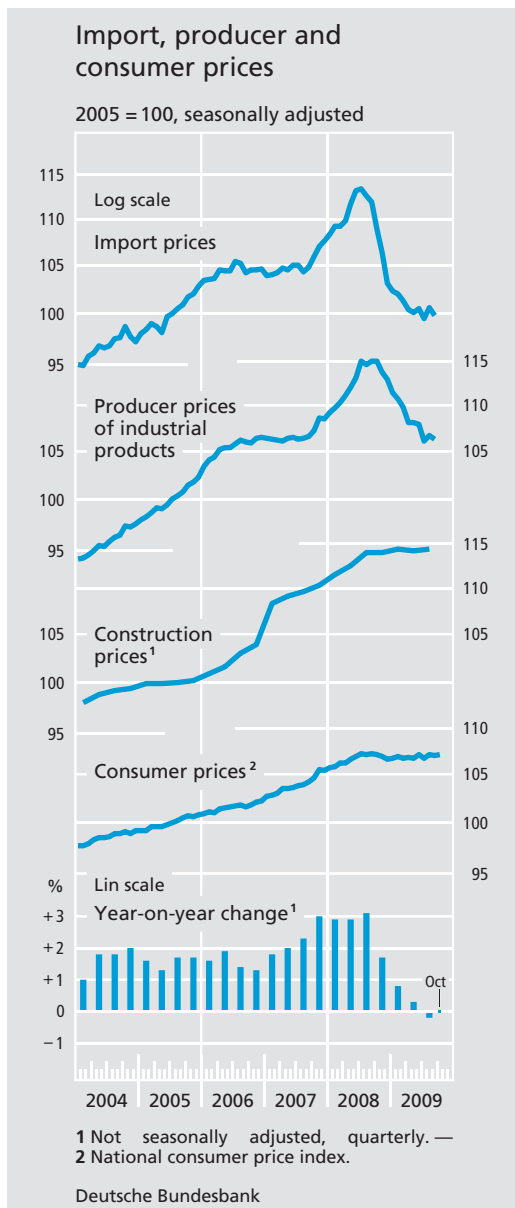


in the second quarter (2.8%). If collectively agreed one-off and special payments are excluded, negotiated pay rates increased by 2.5%, compared with 2.8% in the second quarter of this year. According to the negotiated wage index of the Federal Statistical Office, which refers only to basic rates of pay and does not include civil servants, the year-on-year increase in July was somewhat higher at 3.0%.

New collective pay agreements in the past nine months reflect not only general developments in the economy but also, in particular, sectoral and firm-specific features. The new negotiated payment agreement for Volkswagen AG at the end of September does have large similarities with the agreement in the metal-working and electrical engineering

*Collective wage agreements with sector-specific features*





industries in autumn 2008, but is markedly more generous in some respects. In this case, it is likely that the earnings from the boom as result of the car scrappage scheme have quickly been split up between the enterprise and its employees. These new firm-level pay agreements do not make any provision for the possibility of worse times. Following a pay freeze in the industrial cleaning trade in 2009, remuneration will increase by a total of

roughly 5% in both of the following years. In the case of Deutsche Post AG, which is being affected by a structural decline in letter delivery, there will be no linear wage increase in the next two years, only a one-off payment.

On balance, by no means all employees benefited fully from the collectively agreed pay increases. This was due mainly to short-time working and the reduction in statutory or regular weekly working hours, with lower bonus payments and a temporary suspension of pay rises as additional factors. Actual earnings fell, in fact, by 0.7% year on year in the second quarter. On a monthly basis, this corresponds to a negative wage drift of 3.4 percentage points. This trend is likely to have continued in the third quarter.

*Strong negative wage drift continues*

The fall in prices at the upstream stages of the economy slowed further in the third quarter of 2009. Seasonally adjusted import and (domestic) factory prices were down by no more than 0.3% and 1.5% on the quarter respectively. Export prices remained unchanged. Owing to base effects, the year-on-year decline accelerated to -11.5% for imports, -7.4% for domestic sales, and -3.3% in the case of exports. The terms of trade improved for the fourth quarter in succession. Seasonally adjusted consumer prices remained unchanged on the quarter. The annual CPI inflation rate fell from +0.3% to -0.3% (HICP: -0.5%), as the sharp seasonally adjusted price increase of 0.6% in the third quarter of 2008 dropped out of the year-on-year figure and no longer offset the sharp fall of 0.3% in the fourth quarter of 2008. A moderate increase in the year-on-

*Price climate still favourable*

year rate may be expected again for the fourth quarter of 2009.

*Varying price trends depending on production stage*

The disinflationary process that began in the second half of 2008 now appears to have run its course in some areas, while it is only just starting to gain momentum in other product categories. The decline in producer prices for energy and intermediate goods has now come to a virtual halt and has, in some cases, even been superseded by an upturn, reflecting the global economic recovery. In the case of finished products, however, the decline in producer prices has been tending to accelerate – with the exception of food, where prices peaked as early as the beginning of the year. This is probably due mainly to capacity overhangs and the earlier sharp fall in the prices of primary products, which is now being followed with a time lag by the end products. Construction prices were back up to the level before their decline in the second quarter and were 0.4% up on the year.

*Moderate rise in consumer prices*

Stable consumer prices in the third quarter of 2009 mask diverging underlying patterns. Quite a sharp increase in the prices of industrial goods contrasted with lower prices for energy and food. There was a continuation of the previous quarters' moderate upward price trend for services and rents. The fall in energy prices was due mainly to gas, which followed crude oil prices with a time lag. By contrast, the prices of fuel and heating oil accelerated in line with the current movements in crude oil prices. The fall in food prices was somewhat weaker than in the second quarter of 2009. There was a marked seasonally adjusted fall in the cost of fruit and

vegetables (including potatoes). In addition, prices of dairy products continued to fall. The marked quarterly rise in the cost of durable and non-durable goods (excluding energy) was due, to a considerable extent, to tobacco products, the prices of which were increased by the manufacturers in June. Apart from this, however, there was a further rise in the retail prices of durables and non-durable goods despite the more favourable trends at the upstream stages of the economy.

In October, owing to higher heating oil prices, the cost of living went up 0.1% in seasonally adjusted terms; the annual rate of change in the CPI rose from -0.3% to 0.0% (HICP: -0.5% to -0.1%). This quite marked increase in the annual rate is also due to a base effect caused by the decline in prices in October 2008. The slight trend increase in consumer prices means that moderately positive annual rates are likely in the following months.

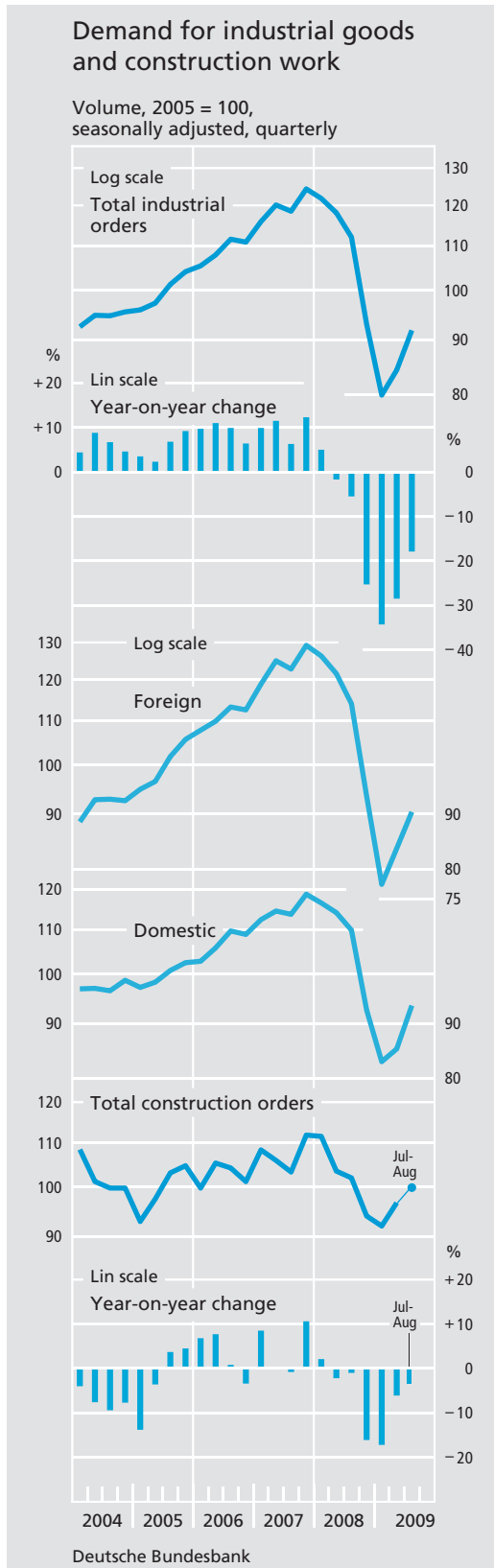
*Year-on-year rate no longer negative in October*

## Orders received and outlook

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The Germany economy has made good use so far of the potential for recovery offered by the improvement in global economic conditions. Even so, the unfavourable starting position, the still underdeveloped basis, as well as a number of remaining vulnerabilities mean that the cyclical upturn is not without risks. The inventory cycle is currently generating major stimuli which are unlikely to have a growing impact in the coming months. Nevertheless, the measures taken in Germany and elsewhere to stabilise economic activity have probably not yet fully taken effect, even though the

*Recovery still narrowly based*



pace of recovery is being retarded *per se* by the expiry of some measures, such as the temporary financial incentives to buy a new car granted in many industrial countries. Added to this is the possible future loss of momentum in the countermovement to the shock-like drop in demand following the insolvency of Lehman Brothers. This is especially the case as the necessary correction of structural macroeconomic imbalances in the global economy might not only dampen activity in the German economy's major export markets abroad but also lead to changes in the international monetary framework. Finally, the risk of a still vulnerable financial system placing a strain on the process of recovery in the real economy owing to lagged cyclical effects has not been entirely eliminated.

The key asset for economic growth in the coming months will be demand for industrial goods. Starting from a very low level, this has achieved a notable momentum in the second and third quarters of 2009. At a seasonally adjusted +8.9%, orders grew very sharply in the third quarter. This followed an increase of 5.5% in the volume of orders in the second quarter. One exceptional, large armaments order in the reporting period means that the underlying pace of the pick-up in demand was somewhat slower. Nevertheless, the overall picture includes the fact that orders of capital goods were on the up, even excluding this major order and the special demand for non-commercial private motor vehicles. Together with a very sharp, 10.8% increase in intermediate goods, the stimuli were thus broadly based in sectoral terms. Given the

*Marked improvement in the order situation in industry...*

growth in both domestic and export orders, this is also been true regionally up to now.

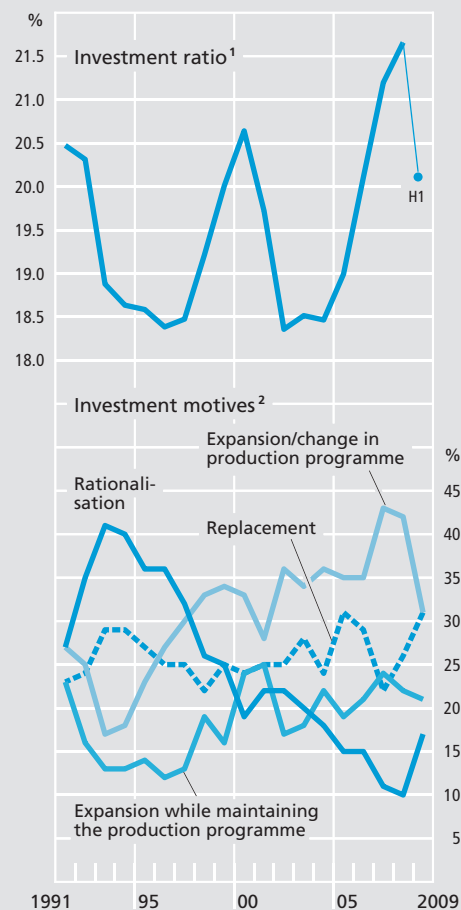
*... gives further boost to business sentiment*

With a more positive order situation again, it comes as no surprise that business sentiment has shown a further improvement. According to the latest Ifo and DIHK surveys, business expectations have now moved into neutral territory. Nevertheless, a sectoral breakdown reveals considerable discrepancies. Although such variations can generally be explained by the differing amount of progress made in the recovery process, a certain degree of overstatement cannot be ruled out given the fact that the Ifo expectations component is already indicating comparatively high values in the case of intermediate goods producers. One reason for this is that survey indicators generally show the balance of trend estimates: in the context of cyclical turnarounds accompanied by marked synchronicity, this construction can lead to sharp fluctuations and short transition periods. The movement of the indicator is being additionally accentuated at present by the fact that firms' expectations were very depressed at the height of the crisis. By contrast, the current business situation in industry is still clearly being assessed more cautiously, even though it has shown a marked improvement on the low levels of the second quarter.

*Expectations of general economic activity based mainly on exports*

Enterprises are basing their optimistic expectations about the economy predominantly on a further pick-up in export demand. This is clear from export expectations as reported by Ifo and DIHK. In the case of future final domestic demand, greater caution is probably being "priced in", even though the leading

### Indicators of corporate sector investment



1 Ratio of gross fixed capital formation to corporate gross value added (data for 1991 at current prices, extrapolated using the relevant change factors based on the previous year's prices). — 2 Source: Ifo Investment Survey (Spring).

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indicators are pointing to certain stimulatory effects in the short term. For example, industrial investment demand showed a perceptible improvement in the third quarter. Domestic firms not only placed orders for more machinery and equipment again but also commissioned a number of new construction projects, including investment in the rail infrastructure which is being funded by the stimulus packages.

*Cyclical  
retarding  
factors still  
overshadowing  
propensity to  
invest*

The low level of capacity utilisation plays a major role for future investment planning, however. As there will still be a considerable degree of underutilisation even if the economic upturn continues, the traditional close cyclical link between export demand and industrial investment could be loosened somewhat in this phase of the cycle. According to the spring 2009 Ifo survey, investment was, to quite a large extent, still characterised in structural terms by the motive of expanding and changing the product programme, even though replacement and rationalisation were becoming more important. Germany also retained its attractiveness as a production location throughout the crisis: this is demonstrated, not least, by the fact that, up to now, far fewer firms have considered investment focusing on rationalisation than was the case, say, during the recession of the early 1990s.

*Outlook for  
consumption*

Private consumption from the middle of the year onwards is unlikely to have gone on buttressing economic activity to the same

extent as did in the first half of 2009. According to the survey data of the consumer research company GfK, consumer sentiment remained intact overall up to the end of the period under review, although a number of sub-indicators, such as income expectations and the general propensity to purchase, showed no further improvement in October on the upturn of the preceding months. Moreover, the price climate is likely to remain favourable overall, and the scope for expenditure will, in itself, also be increased quite considerably in 2010, above all, by a number of fiscal policy measures. Under these circumstances, the labour market will assume a key role. In this context, it is mainly those who bear responsibility within the enterprises who will be facing the challenge of fully utilising and developing the potential for flexibility that has been created over the past few years. The success achieved so far, which has also gained much attention internationally, should act as an encouragement.