

Economic conditions in Germany

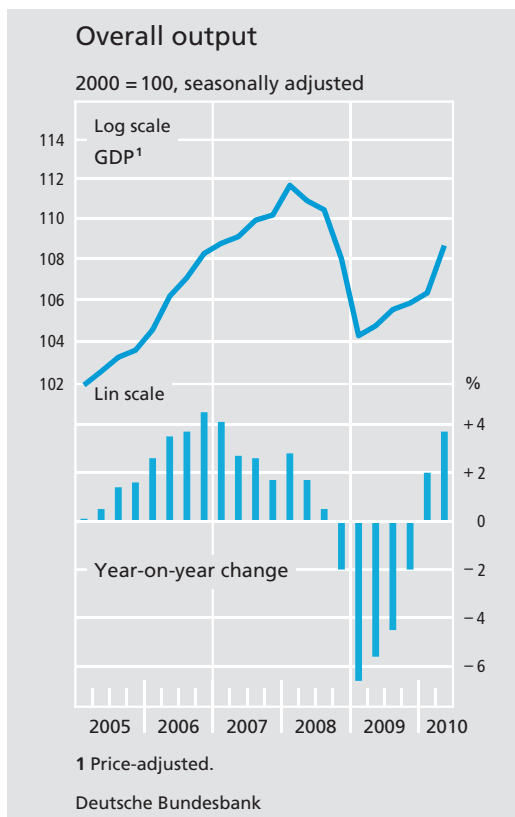
Macroeconomic situation

The recovery of the German economy took a major step forward in the second quarter. According to an initial estimate by the Federal Statistical Office, real gross domestic product (GDP) in the second quarter of 2010 rose by no less than 2.2% on the quarter in seasonally and calendar-adjusted terms. This means that more than half of the crisis-induced decline in output has now been regained. This exceptionally sharp increase in overall output was driven by strong impulses from the global economy. Added to this were stimuli on the domestic side. Temporary factors played a role in this. This largely offset the weather-related output losses in the construction and transport sectors during the winter months, which may have had a knock-on effect on other sectors, too. Furthermore, there are mounting signs that the cyclical recovery in Germany is becoming increasingly self-sustaining. Investment in new machinery and equipment picked up considerably. Private consumption spending is likely to have increased again for the first time in three quarters.

Exceptionally sharp rise in output

Just as it had suffered from the slump in global trade, above all in high-quality durable industrial goods in the final quarter of 2008 and the first quarter of 2009, the German economy is now participating in its strong revival (to which it is itself contributing through sharply rising imports). In the second quarter, German exporters benefited to a particularly large extent from the fact that the economic upturn has gathered pace worldwide and has become more broadly based regionally. Senti-

Strong impulses from the global economy



ment was temporarily dampened somewhat only by uncertainties in connection with the crisis in public finances in a number of euro-area countries. On a quarterly average, the value of exports of goods went up by a seasonally adjusted 9.4% on the preceding three-month period. Although the increase, at an estimated 7½%, was somewhat less pronounced in real terms, almost 75% of the crisis-induced export losses have now been recovered.

Exports to countries outside the euro area, which lost some momentum at the beginning of the year, returned to a steeper growth path in the second quarter. The emerging market economies thus once again proved to be the key engine of growth, even though exports to China, which grew by almost one-

third in the first quarter, also remained at a high level. Export business with customers in the United States also increased rapidly in the wake of the recovery in the US economy. Despite the structural problems in some countries, exports to euro-area partner countries, which are particularly important for German foreign trade, also expanded at an accelerated pace.

For the first time since the beginning of the global economic recovery process, demand for German capital goods increased much faster than demand for intermediate goods, albeit from a depressed level. The main beneficiaries of this were manufacturers of machinery, who recorded exceptionally sharp growth in exports. There was also a sharp pick-up in exports of motor vehicles, which had temporarily lost momentum after government funding made available in a large number of countries for the purchase of new cars had been used up. This suggests that the major trading partners are, for the most part, increasingly optimistic in their assessments about the future.

The increase in the value of goods imports, at a seasonally adjusted 10.5%, was, in fact, somewhat sharper than that in exports in the second quarter. Although a large part of this increase was due to higher prices, there was still a marked rise of around 7% in real terms. Most of this stronger import activity is linked directly to the considerable rise in exports. Marked growth in domestic output was accompanied by a substantial rise in demand for imported intermediate goods, especially metals and metal products. Imports of capital

Imports also rose considerably

goods grew even more rapidly in real terms. This applies to both machines and motor vehicles. A large part of the additional imports again came from South-East Asia and China, but also from the Russian Federation. With regard to foreign trade with euro-area countries, it is striking that German imports from these countries in the first two quarters of 2010 expanded more than twice as rapidly as German exports to these regions. The European trade partners are therefore benefiting to a considerable degree from the current rapid pace of growth in the Germany economy, which is largely determined by its success in exporting to third markets.

Strong growth in investment in machinery and equipment

Investment in machinery and equipment picked up noticeably in the second quarter. This is indicated by the rise in imports of capital goods and the increase in domestic sales of German manufacturers. Given the continued below-average degree of industrial capacity utilisation, purchases are likely to have been concentrated primarily on the necessary and previously deferred replacement of existing assets. Purchases of machinery and equipment by commercial customers were focused mainly on motor vehicles. Expenditure on new machinery also seems to have increased perceptibly for the first time, however.

Rapid catch-up in construction investment following downturn in Q1

Construction investment also received a sharp boost in the second quarter. This was partly due to the rapid recovery of the weather-related output losses in the construction sector at the beginning of the year. Added to this was a sharp rise in the first quarter in both industrial and public sector



orders, most of which were in connection with the government economic stimulus programmes to renew infrastructure and renovate public buildings. The volume of housing construction orders also increased sharply, providing a boost to output in the second quarter. Additional expansionary stimuli were probably generated by the finishing trades, which had already recorded sharp growth in the first quarter.

*Further rise
in private
consumption*

After adjustment for seasonal and calendar variations, private consumption is likely to have risen again in real terms during the reporting period for the first time in three quarters. Retail spending increased slightly. One contributory factor in this was that sales of information and communication technology (ICT) products were given a boost by the FIFA World Cup. Although the number of new cars registered to households was down on the quarter owing to a number of car purchases having been brought forward to the previous year, more higher-quality vehicles than usual are likely to have been procured.

Sectoral trends

*Broad-based
recovery in
industrial
output*

The upward trend in industry strengthened considerably in the second quarter of 2010. Output in the manufacturing sector expanded by a seasonally adjusted 5.2% after rising by 2.4% in the first quarter. With the exception of output in consumer goods, which was only slightly up on the level of the first quarter, the increase in output was broadly based in sectoral terms. Once again, it was producers of intermediate goods that recorded the sharpest increase (6.9%). The rise in the output of capital goods, at a seasonally adjusted 5.5%, was considerably stronger than in the previous three-month period. The production of machinery (+5.7%) and electrical goods (+7.5%) picked up significantly. Output in the automotive industry also went up by 10.6%. Manufacturers of metals and metal products also benefited from this; they increased their output by a seasonally adjusted 9.8% in the second quarter.

The faster pace of industrial activity – a trend which is likely to have continued in the second half of the year – is reflected in the sharp rise in manufacturing capacity utilisation. Following an increase of 4½ percentage points between January and April, it had gone up by a further 2½ percentage points by July. Further ground was made up primarily in those sectors which are particularly sensitive to the business cycle, intermediate (+2¾ percentage points) and capital goods – including cars (+3¾ percentage points). In the intermediate goods sector, the degree of utilisation is again already slightly above the longer-term average. By contrast, the capital goods industry has not yet progressed quite as far; according to corporate surveys, the gap compared with normal utilisation still amounts to 4¼ percentage points.

The divergent developments in the energy and construction sectors in the second quarter of 2010 are to be seen against the backdrop of changing weather conditions. Energy production, which reached a very high level in the first two months of the year owing to the exceptionally cold weather, fell again for a time afterwards before reaching an even higher level in June owing to the hot weather conditions. There was also a slight quarter-on-quarter increase (1.1%) owing to the economically induced rise in industrial demand for energy. By contrast, construction output, which suffered as a result of the very cold winter, rose by a seasonally adjusted 16.1% in the second quarter. The average level of output of the previous year, which can be used as a rough estimate of the normal level when not affected by special factors, was ex-

*Sharp rise in
industrial
capacity
utilisation*

*Increase in
energy
production and
strong growth
in construction
activity*

ceeded by 6.0%. Output in civil engineering, which had benefited mainly from public sector orders as a result of the government fiscal stimulus programmes, expanded somewhat more strongly on the quarter than it did in the building industry. Construction activity returned to a normal level to some extent during the second quarter, which indicates that a large part of the output losses from the first quarter were quickly offset.

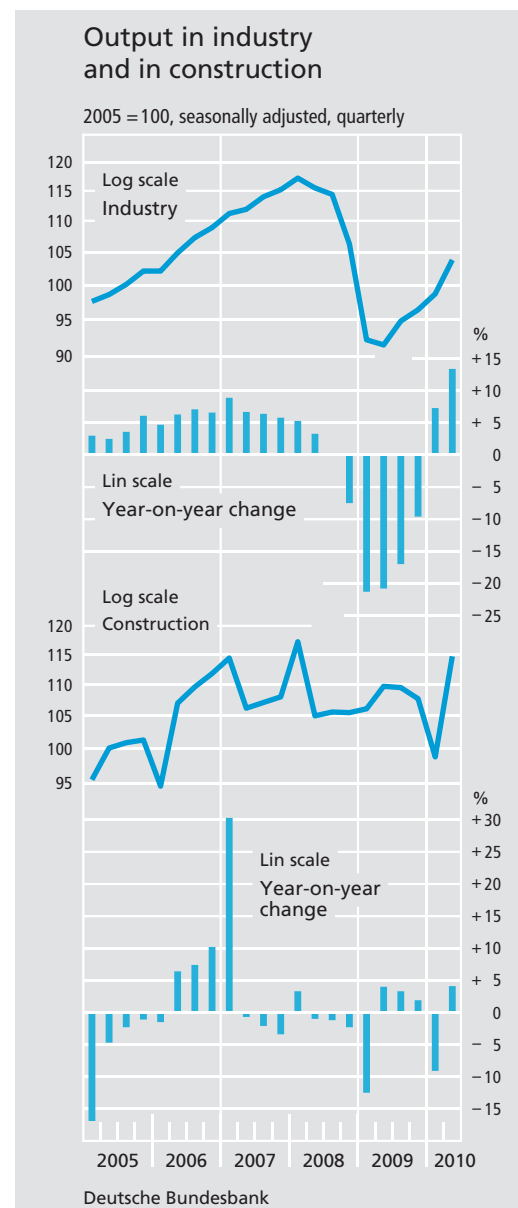
Upswing in industry-related services sectors

Within the services sector, it was primarily the industry-related areas that recorded an upswing. According to the statistics on motorway tolls, German transport and logistics enterprises are showing strong growth, which is consistent with the faster pace of domestic production and cross-border transactions in goods. Business-related services – judging by the available survey results for these sectors – were also performing significantly better during the period under review. There was strong growth in motor vehicle sales as the increase in commercial business far outweighed the decline in sales of new vehicles to households. A sizeable increase in turnover in price-adjusted terms was also recorded in the hotel and restaurant sector. Furthermore, there was a slight seasonally adjusted increase in sales in the wholesale and retail trades in real terms.

Employment and unemployment

Labour market likely to have bottomed out

Roughly one year after overall economic output, the German labour market has probably now also bottomed out in cyclical terms. By historical standards, the time lag is, *per se*, in line with the customary pattern. Neverthe-



less, it is notable that, despite sharp growth in the second quarter of 2010, output is still well down on its pre-crisis level and that the earlier decline in employment was extremely subdued in comparison with earlier economic downturns. Job shedding in the manufacturing sector came to an end and temporary employment agencies hired a considerable number of new staff. This, together with the steady decline in cyclically motivated short-

time work, is a clear sign that the recovery is gradually starting to be felt on the labour market.

Subdued, but broadly based growth in employment across sectors

According to estimates by the Federal Statistical Office, employment in the second quarter of 2010 rose by 81,000, or 0.2%, on the quarter after adjustment for seasonal variations. The number of employees subject to social security contributions in manufacturing, which has been particularly hard hit by the financial and economic crisis, and in the logistics sector, with which manufacturing has close economic ties, increased again slightly in April-May for the first time since the fourth quarter of 2008. There was a sharp expansion in hired labour, much of which is generally used by industrial enterprises. Since the low point one year earlier, the number of persons in temporary employment went up by around 150,000 following a decline of 170,000 in the previous 12-month period. The rise in April-May 2010 compared with the previous three-month period accounted for almost half of the total increase in employment subject to social security contributions (+132,000). In addition, there was a further considerable rise in the number of new jobs created in the health and social work sector. By contrast, there was a slight decline in the number of persons working in low-paid part-time employment as their main source of income.

Decline in short-time work

The fundamental improvement in the business situation in many parts of the economy led to a massive reduction in the use of cyclically induced short-time work. According to initial estimates by the Federal Employment

Agency, 481,000 persons were still affected by this in May 2010, compared with 809,000 in the first quarter. This development is likely to have continued, especially as the number of new registrations has been falling steadily in recent months and, with just 27,000 cases in July, was only slightly above the pre-crisis level.

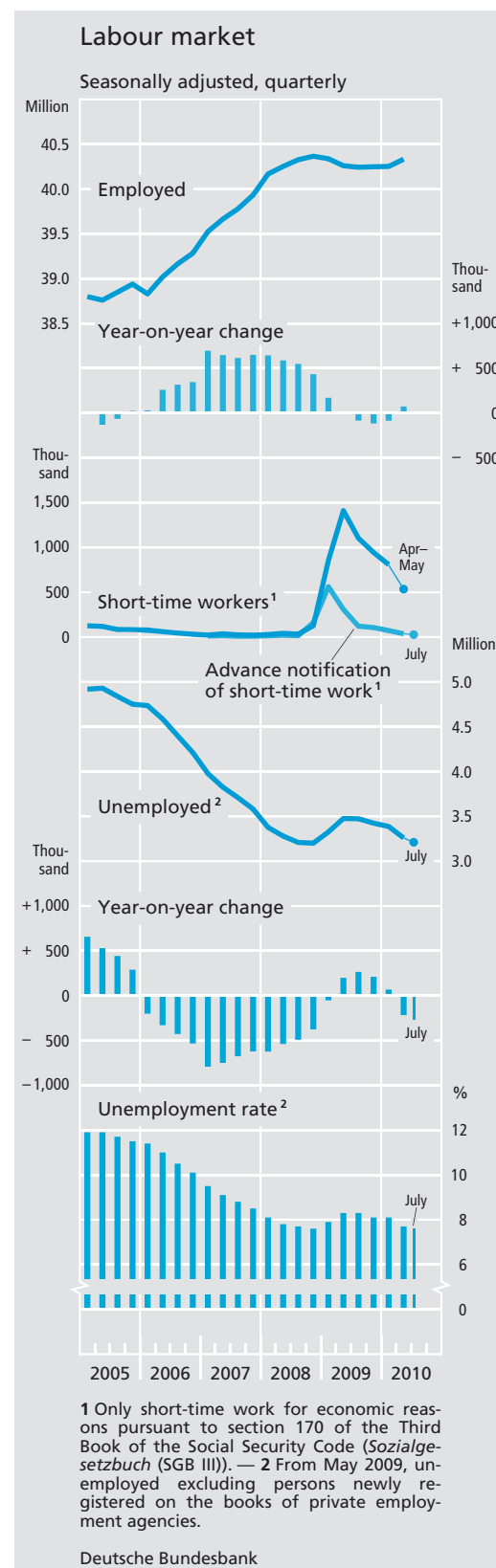
There was a perceptible decline in unemployment in the second quarter of 2010. At 3.26 million, there were 128,000 fewer persons registered as unemployed in the reporting period (seasonally adjusted) than in the first quarter of 2010; in year-on-year terms, the figure fell by as much as 217,000. A significant cyclical effect is indicated by the fact that the second-quarter decline of 83,000 in the number of persons receiving unemployment benefits under the statutory insurance scheme was almost twice as large as the decline in the number of persons receiving basic welfare allowance. The official unemployment rate in the second quarter of 2010 stood at a seasonally adjusted 7.7% and was therefore 0.4 percentage point down on its level in the previous quarter. Compared with the same period last year, which also marked the peak level of the cyclical downturn, the unemployment rate fell by 0.5 percentage point in the official statistics. Even according to the extended concept of the Federal Employment Agency, the unemployment rate would no longer have shown an increase on the year. There was a further perceptible decline in the official unemployment figure in July, although the fall was somewhat smaller than in the second quarter. The unemployment rate went down to 7.6%.

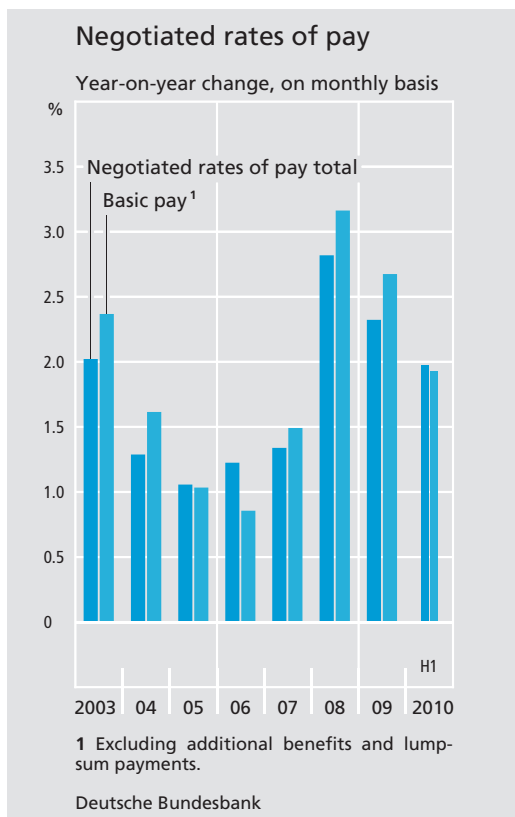
Sharp reduction in unemployment

Brighter labour
market outlook

The economic upturn is likely to continue making itself felt on the labour market over the coming months. Owing to the perceptible cyclical recovery, the profile of the workforce in the manufacturing and services sectors, both of which were affected by the economic crisis, is being shaped less and less by measures and instruments which served to safeguard existing jobs during the period of recession. The use of short-time work is therefore likely to be reduced further. Furthermore, regular weekly working hours are likely to increase again for a large number of employees, as are the number of overtime hours worked. According to the monthly survey results, the number of hours worked per employee in the manufacturing sector went up by a seasonally adjusted 2% in the second quarter.

The already rather high degree of utilisation in some areas of the production sector is likely to have benefited temporary employment first. The stabilisation of the recovery process has also increased planning certainty for a large number of enterprises, which is usually a precondition for increasing the number of core staff. This was probably a factor behind the sharp rise in the Ifo Employment Barometer for trade and industry, which is again already showing a comparatively high willingness to recruit new staff. Moreover, according to the survey conducted by the German Chamber of Industry and Commerce (DIHK) in the early summer, the number of enterprises wishing to increase their staffing levels is slightly higher than those planning to reduce their staffing levels. Furthermore, in the second quarter there was a discernible in-





crease in the supply of jobs subject to social security contributions in the more cyclically volatile economic sectors. By contrast, the stagnation of vacancies in the health and social work sector as well as in the education sector indicates that there might be a slowing expansion of vacancies in these sectors. These trends are confirmed by the IAB Job Vacancy Survey. On balance, the increase in aggregate employment is therefore likely to remain subdued.

Wages and prices

Moderate rise in negotiated rates of pay

As in the first few months of the year, a number of collective pay agreements were concluded in the second quarter as well. These do not provide for any or only very moderate

increases in regular rates of pay (at least for 2010). The efforts of the wage bargainers are still focused on enterprises not being placed under excessive strains during the phase of economic recovery. In the private banking industry, only a one-off payment was agreed for the current year. A permanent rise in wages will not take place until January 2011. Following a moderate increase in scheduled rates of pay this year, the outcome of the negotiations in the German motor vehicle industry do not provide for a significant rise until 2011 either. Following the low wage settlements of the past few years, however, somewhat larger graduated pay increases were agreed in the hotel and catering trade.

The Bundesbank's pay rate statistics show that the year-on-year increase in negotiated pay rates in the second quarter of 2010, at 2.1% on average, was sharper than in the first three months of the year (+1.8%). The year-on-year increase in the basic negotiated rates of pay rose by just 1.7%, compared with 2.2% in the first quarter. The increase was therefore more or less as sharp as it was according to the index of the Federal Statistical Office, which shows a year-on-year rate of change of 1.9% for April. Actual earnings (on a monthly basis) are likely to have risen somewhat more sharply than negotiated rates of pay in the second quarter owing to the gradual return to normal working hours.

In the second quarter of 2010, price trends continued to point upwards at all stages of the economy, although the strength of the price movement varied depending on the significance and composition of the energy

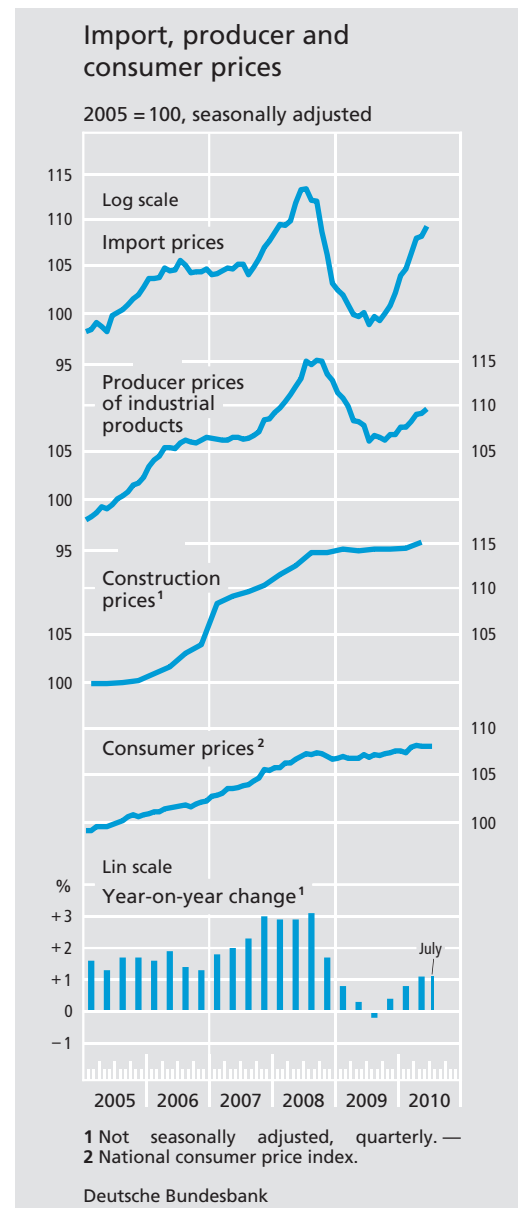
Some sharp price rises at the upstream stages of the economy

component. Import prices, which are particularly dependent on mineral oil prices, increased quite sharply on the quarter (+3.3%), while the increase in export prices, at 1.8%, was roughly only half as large. Accordingly, there was a further marked deterioration in the terms of trade. Domestic industrial producer prices rose by 1.3%.

Energy prices at the upstream stages of the economy rose quite sharply again in the second quarter of 2010, even though prices fell temporarily over the quarter as a result of declining crude oil prices. As regards the other components, the depreciation of the euro over the past few months was being increasingly reflected in higher prices. The increase in the cost of intermediate goods was especially pronounced. The prices of imported capital goods continued to accelerate. The cost of consumer goods went up quite markedly on the whole and at an increasing rate, although price rises in the case of dairy products played a major part in this. Given rising input prices and quite favourable construction activity, domestic construction prices rose by 0.6% on the previous period and were thus 0.9% up on the year. According to vdp, prices of owner-occupied housing also rose only moderately on the year (0.7%).

*Moderate rise
in consumer
prices*

As in the first quarter, the rise in consumer prices in the second quarter was characterised by price increases for energy and food. Unlike in the previous quarter, the prices of the other major components also went up somewhat, although the rise in import prices owing to the depreciation of the euro might have played a part in this. Consequently, con-



sumers had to pay somewhat more again for other durable and non-durable goods. Despite a reduction in the cost of package holidays, the prices of services went up marginally. Housing rents continued on a slight upward trend. On the whole, consumer prices were 0.4% up on the quarter in seasonally adjusted terms, which was much the same rate of increase as in the two preceding quarters. The year-on-year increase in both the

national Consumer Price Index (CPI) and the Harmonised Index of Consumer Prices (HICP) went up to 1.0%, compared with 0.7% and 0.8% respectively in the first quarter. The cost of living increased slightly in July in seasonally adjusted terms. Annual CPI inflation also rose by 0.3 percentage point to 1.2% owing to a base effect. (The HICP figure was 1.2% after 0.8%.) Despite the strains on the import side, a further moderate rise in consumer prices is still to be expected over the next few months.

Orders received and outlook

Economic recovery likely to continue in 2010 H2

The upturn in domestic economic output should continue in the second half of 2010, although the pace of expansion will return to normal. It is to be expected that the growth path of South and East Asian countries will level off. The cyclical outlook for the industrial countries is to be rated as moderate for the second half of 2010. The pace of German exports is therefore likely to be more subdued. Added to this is the fact that weather-related catching-up effects in the construction sector and stimuli from public sector projects are waning. By contrast, commercial investment is likely to develop greater intrinsic momentum as replacement purchases are becoming more pressing and product ranges need adjusting. Private consumption is likely to benefit from the recovery on the labour market.

Inflow of orders remains buoyant, especially from abroad

The inflow of new orders in the second quarter was up on the already rapid pace of the first quarter. After adjustment for seasonal variations, German industrial enterprises re-

corded a 7.7% increase in their volume of orders. The increase in export orders, at 9.0%, was therefore once again significantly higher than that in domestic orders (5.9%). Here, there was a continuation in the characteristic trend observed during the recovery process so far that demand from customers outside the euro area has been rising significantly faster than demand from euro-area partner countries. Producers of capital goods who, in price-adjusted terms, suffered the greatest slump in exports during the crisis, were the main beneficiaries of the rise in export orders from non-euro-area countries recently. In addition to computers and aircraft, motor vehicles were in particular demand. The large exports orders that were received by manufacturers of other transport equipment towards the end of the second quarter will not boost productivity in the immediate future, however, but over an extended period of time. Furthermore, the recovery in domestic investment activity had a positive impact. In the intermediate goods sector, which had been at the forefront of the cyclical recovery, stimuli from abroad eased off somewhat. Export demand for German consumer goods has also increased noticeably of late.

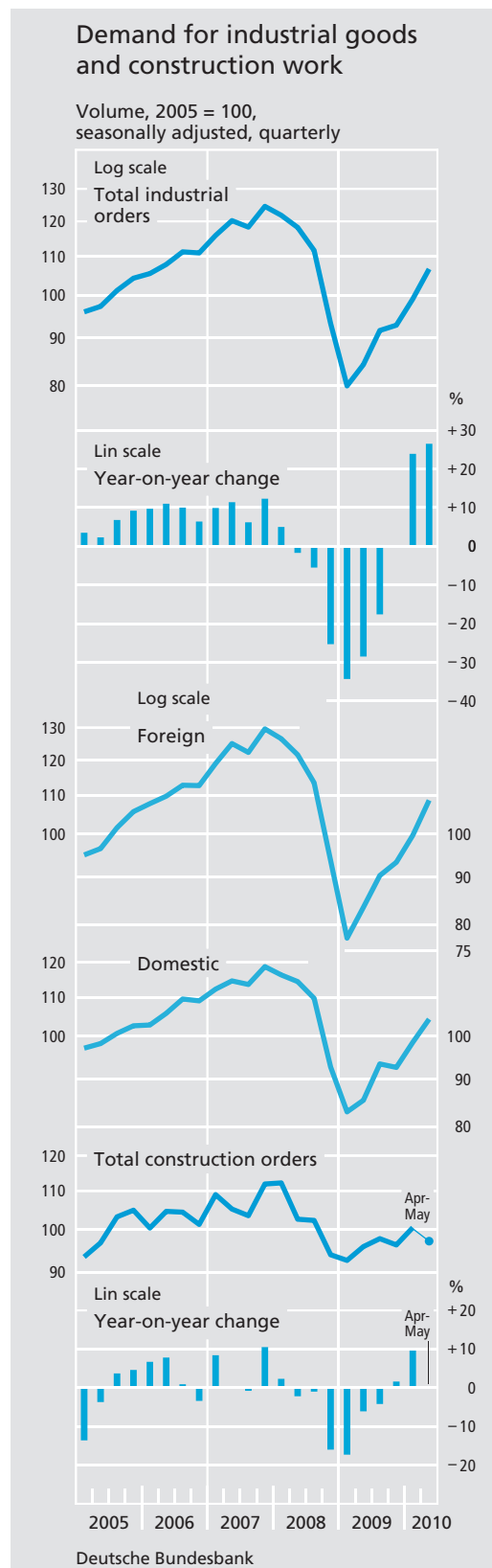
The greatly improved situation in orders has further uplifted business sentiment. According to the Ifo business survey, firms' assessments of their current and future business situation improved significantly in July following a two-month period of sideways movement. The more optimistic expectations are largely due to the fact that enterprises are still expecting further growth in their export business. The corporate surveys conducted by the

More optimistic sentiment and greater propensity to invest

German Chamber of Industry and Commerce (DIHK) present a similar picture. This improved outlook is likely to be the primary reason why – as reported by the Ifo Investment Survey – the majority of west German industrial enterprises are intending to increase their investment expenditure as early as this year. Here, the focus is increasingly on expanding and modernising the production programme, which is usually the case during periods of economic recovery. By contrast, rationalisation projects continue to play a subordinate role, which is in line with the favourable labour market development during the crisis. Given the persistent underutilisation in many areas, primarily in the case of manufacturers of capital goods, it will probably take a while before domestic investment activity reaches a normal level again. As things stand, however, funding constraints are unlikely to stand in the way of an expansion of fixed capital formation.

Construction demand supported by commercial and residential construction

The construction industry will benefit to a much lesser extent from the special factors which boosted output in the second quarter. The weather-related production shortfalls from the first quarter have probably already been recovered to a large extent, for example. Furthermore, the positive impetus generated by the government fiscal stimulus programmes to renovate public buildings is gradually waning. However, a greater number of housing construction orders were placed by persons wishing to benefit from the current exceptionally low mortgage lending rates.



*High level of
consumer
confidence*

The cyclical recovery and the optimistic business climate in trade and industry are being reflected in the increasing optimism of consumers. According to the surveys of the consumer research institution, Gesellschaft für Konsumforschung (GfK), consumer sentiment showed a further slight improvement. The decline in short-time work and the increase in employment have led to a considerable improvement in income expectations. As a result, households have expanded their spending plans. The general propensity to purchase has also remained at a high level. Furthermore, there are signs that new passenger car registrations by households are bottoming out. A good foundation is therefore in place to prevent private consumption from having a negative impact on economic growth in the second half of the year.

The economic prospects identified in the June forecast¹ have been realised with unexpected speed and force. Including the revision of the GDP calculation, mainly for the first quarter of 2010 (+0.5% instead of +0.2% owing to a sharp upward revision of industrial output and a perceptibly more favourable than expected development in the finishing trades) and assuming a further moderate expansion of total economic value added in the second half of the year, real GDP in Germany, as things stand, is expected to rise by around 3% on an annual average in 2010, after an estimate of just under 2% in the June forecast.

*Significantly
higher annual
GDP result to
be expected*

¹ See Deutsche Bundesbank, Outlook for the German economy – macroeconomic projections for 2010 and 2011, Monthly Report, June 2010, pp 15-27.