

Economic conditions in Germany

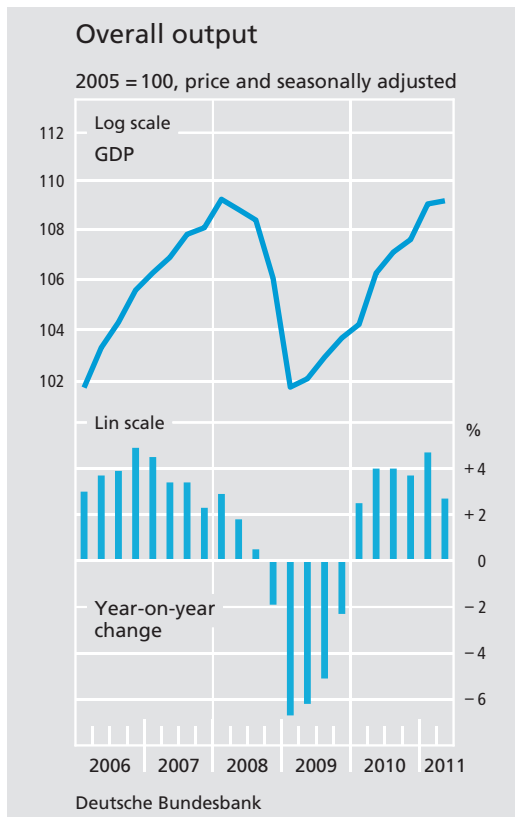
Macroeconomic situation

The German economy continued its upswing in the second quarter of 2011 at a muted pace, as anticipated. According to an initial estimate by the Federal Statistical Office, real gross domestic product (GDP) in the second quarter, after seasonal and calendar adjustment, expanded by 0.1% on the first quarter, which had recorded very strong growth of 1.3%. The volatile pattern over the first half of the year can be attributed in part to the weather-related output losses at the end of last year. The resultant catch-up effects, which were fairly pronounced in some areas of the economy, had boosted output above all in the first few months of this year. The return to a normal cyclical growth path during the course of the second quarter was accompanied by a low quarter-on-quarter rate of expansion in the reporting period which understates the underlying growth momentum.

GDP growth in Q2 understates underlying pace of economic growth

Furthermore, special factors have recently held domestic growth dynamics below the underlying trend. For example, fixed capital formation picked up noticeably only in the case of moveable goods, whereas construction investment fell back to a more normal level. Moreover, the fact that energy prices reached new record highs at the beginning of the second quarter may have prompted consumers to curb their spending somewhat. The muted growth in the second quarter is therefore not in itself proof that the German economy's dynamics have perceptibly slackened as a result of the foreseeable weakening of foreign demand and the sharply rising uncertainty of late as a result of heightened tension on the financial markets

Domestic dynamics dampened by special factors



in connection with the sovereign debt problem in the euro area and the USA. There are, however, significant risks in this respect going forward.

Continuing export growth

German enterprises further boosted their foreign sales in the second quarter. The seasonally adjusted value of exported goods went up by 2¼% during the reporting period, following a 4% increase in the first quarter. In real terms, the second-quarter increase was only marginally smaller than that of the previous period. According to the data available for April and May, sales to euro-area customers increased only marginally, whereas goods exports to non-euro-area buyers rose significantly. There was strong growth in exports to South and East Asian countries and to Russia. By contrast, turnover with central and east European coun-

tries, the other EU member states and the USA registered a noticeable loss of momentum. Deliveries to China fell sharply after recording very strong growth on the whole since the beginning of 2009. Exports to Japan also declined, although this is to be seen in connection with the output losses related to the recent natural disaster there. Exports of intermediate goods failed to pick up further in the second quarter owing to the global growth dip. By contrast, German-produced capital goods were still very much in demand across the globe. Exports of machinery, in particular, expanded strongly. Motor vehicle exports likewise climbed appreciably.

Corporate investment geared to expansion was a major driver of economic activity in Germany. Firms' spending on moveable fixed assets is likely to have risen substantially again in the second quarter. Replacing and adding to machinery and other equipment were the main priorities, whereas purchases of vehicle fleets played a subordinate role. Although business expectations were not quite as optimistic towards the end of the reporting period, many industries continued to extend their production facilities in the light of the current high level of capacity utilisation of tangible fixed assets. This is likely to have been fuelled by the still positive investment environment, which is characterised, amongst other things, by the favourable earnings situation as well as advantageous external funding conditions.

Higher investment in machinery and equipment

Seasonally adjusted construction investment in the second quarter was unable to match the high level recorded at the beginning of the year, which was characterised by weather-

Slight decline in construction investment

related catch-up effects. But given the marked underlying upward trend in construction activity, the decline is not likely to have been substantial. This was due not only to the very favourable situation in housing construction but also to the fact that construction firms additionally benefited from the large number of building projects of commercial customers and the public sector.

Private consumption dented by strained price climate

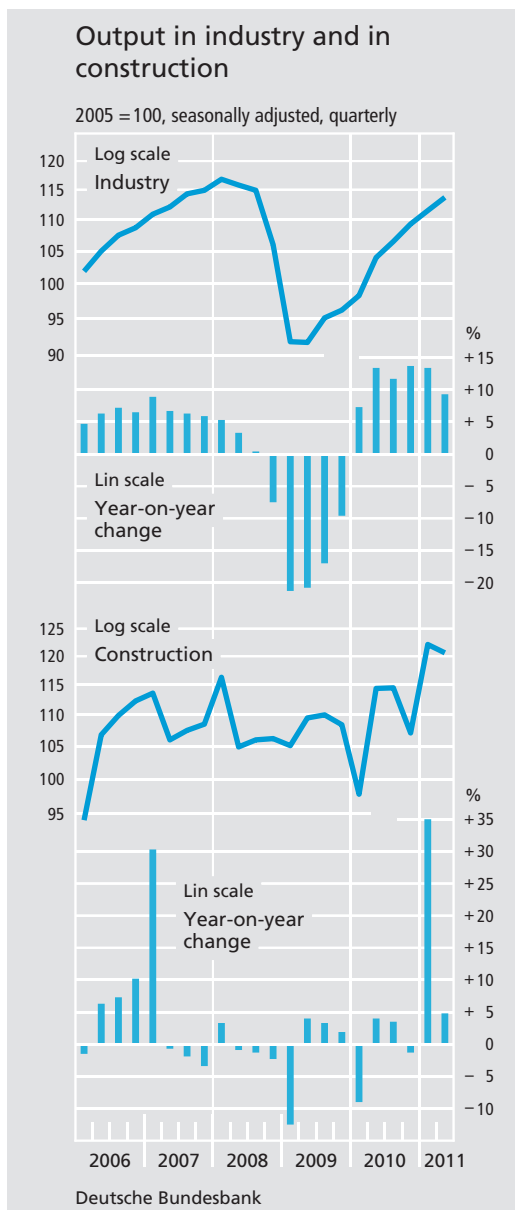
In recent months, consumer demand is likely to have been dented by the strained price climate despite the favourable economic and labour market situation in Germany. For instance, fuel prices – which are usually a sensitive and closely monitored barometer – were high at the beginning of the second quarter, which could have weighed on households' propensity to consume. The decline in the number of new cars registered by households, for example, points to more modest expenditure on automobile purchases in the second quarter. Seasonally adjusted expenditure on heating oil was also much lower than in the first quarter. By contrast, retail purchases – bearing in mind the current uncertainties in terms of statistical data recording – largely remained at the level of the first quarter.

Marked import growth

At 3½%, the seasonally adjusted value of goods imports expanded much more sharply in the second quarter than that of goods exports. In real terms, the rise in imports almost matched the nominal increase. Apart from the sharp increase in expenditure on foreign fuel, which was partly due to price-related factors, a greater number of computers, electronic and optical products as well as electrical equipment, which were largely attributable to the



capital goods sector, were imported as a result of the higher investment undertaken by German enterprises. Furthermore, starting from an already significantly elevated level in the first quarter, noticeably more machines were purchased from foreign manufacturers. There was also a rise in imports of consumer goods. Germany's euro-area partner countries, in particular, were once again beneficiaries of the German economy's strong import demand.



The country's function as a pacemaker for the entire euro area therefore remains intact at the current end.

Sectoral trends

Further rise in industrial output

Industrial output in the second quarter rose by a seasonally adjusted 2% on the quarter and therefore expanded equally as strongly as in

the early part of the year. Output of capital goods expanded at a slightly higher rate. This was driven by a significant increase in the production not only of motor vehicles but also of other transport equipment, demand for which was boosted perceptibly by large-volume orders in recent months. The production of intermediate goods also picked up further (+2%) after already recording strong growth in the first quarter. The largest growth rate among the intermediate goods sectors was recorded in the manufacture of machinery and equipment, whereas the chemicals industry increased its output only slightly. The manufacture of consumer goods recorded only modest growth (+1¼%), as in the first quarter.

The further rise in output was accompanied by continuing expansion of overall capacity utilisation in industry. According to the Ifo surveys, capacity utilisation went up slightly in July compared with April and is now 2 percentage points above its long-term average. This masked divergent developments in the individual sectors, however. Capacity utilisation in the capital goods sector increased further. The report by intermediate goods producers in July of a slight fall in their capacity utilisation might indicate weaker output in this industrial sector at the beginning of the third quarter. This is also suggested, for example, by the fact that the manufacture of crude steel was around one-tenth lower in July than the corresponding peak figure in May.

Further expansion in manufacturing capacity utilisation

Construction output in the second quarter was down 1¼% on the perceptibly higher level of the first quarter, which had been boosted by catch-up effects, but was still clearly up on the

Moderate fall in construction

level of the preceding quarters. Output in civil engineering declined a little more sharply than building construction in the reporting period. The fact that the utilisation of construction machinery is still at an exceptionally high level is a strong indication that construction activity is still buoyant. Economic activity in the second quarter is also likely to have been supported by the finishing trades, which had already recorded sharp growth in the first quarter.

Smaller energy output

According to initial official statistics, seasonally adjusted energy output fell sharply in the reporting period (-7¾%). It is likely that this was connected with the shutdown of a number of German nuclear power plants following the nuclear disaster in Japan.

Little impetus from service providers

Developments in the services sector appear to have been rather lacklustre on the whole. On the one hand, surveys by Ifo and ZEW (Centre for European Economic Research) suggest that the expansionary impulses from industry are continuing to have a knock-on effect on a number of business-related service sectors. On the other hand, the monthly statistics on motorway tolls indicate that the mileage of German hauliers and logistics enterprises increased only marginally. In the trade sector most firms sustained drops in real revenue. This applies in particular to wholesale and motor vehicle traders. By contrast, the business situation in the consumption-related service sectors appeared to be somewhat more stable. This can also be seen in the hotel and restaurant sector, where sales held up well in the second quarter.

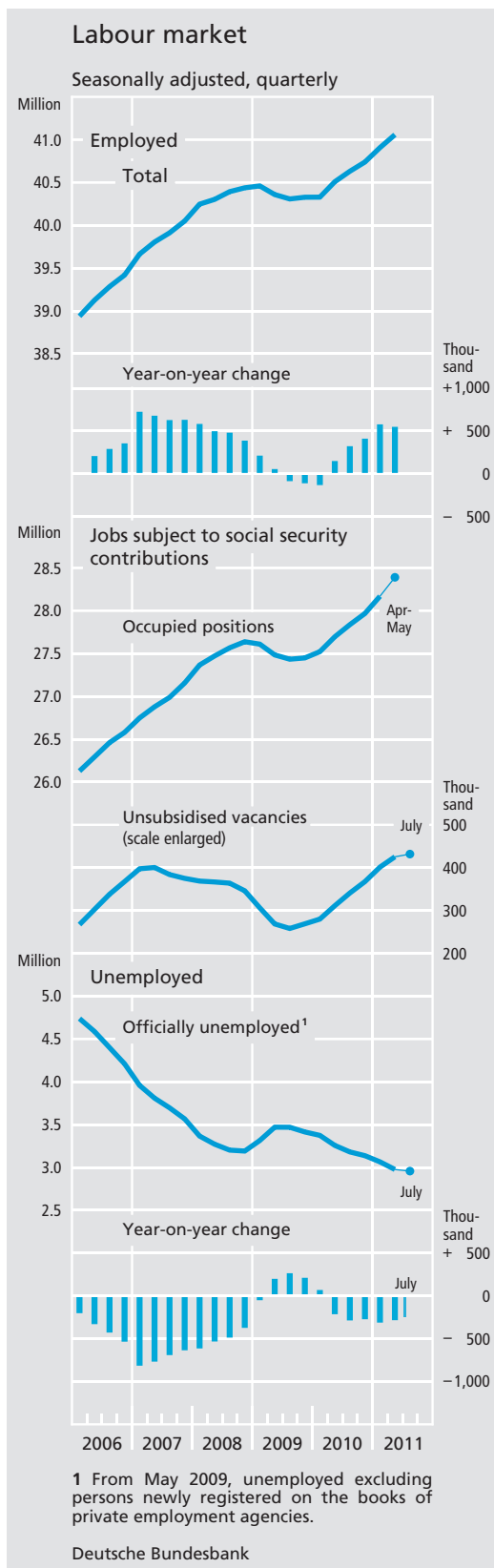
Employment and labour market

The labour market recovery continued in the second quarter of 2011. According to Federal Statistical Office estimates, the seasonally adjusted number of persons in work in Germany between April and June rose by 150,000 on the quarter, which is equivalent to an increase of 0.4%. The mainstay of the positive development in employment was again an increase in jobs subject to social security contributions. In April and May, 186,000 or 0.7% more such jobs were recorded than on an average of the first quarter after adjustment for seasonal variations. According to initial estimates, there was a slight increase in the number of persons working exclusively in low-paid part-time jobs. The number of self-employed persons remained largely unchanged.

Continued growth in employment ...

The growth in employment subject to social security contributions is proceeding at a relatively similar pace in the individual sectors. Thus there was a ¾% rise in April and May on the previous quarter in the seasonally adjusted number of positions filled in the manufacturing sector as well as in the health and social work sector, the construction sector and the transport sector. The increase in the trade sector, at just over ½%, fell slightly short of this figure, whereas the increase in the case of business-related services (excluding third-party hiring) was slightly above average at 1%. According to initial estimates by the Federal Employment Agency, the strong growth in third-party hiring observed over the past two years, which accounted for a large share of the overall growth in employment up until the first

... broadly based across sectors



quarter of 2011, was much more moderate in April and May.

According to calculations by the Federal Employment Agency, the number of payroll employees who are nationals of a central or eastern European EU member state which have now been granted full labour mobility (EU-8) rose sharply in May.¹ However, the net immigration of citizens from this region recorded by the German authorities for this same period was much lower,² which suggests that it was initially those nationals of the EU-8 countries already living in Germany who made use of the new employment opportunities. This snapshot from the first month of the new regulation becoming effective gives no grounds for implying that the German labour market could be flooded by a massive influx of workers from these countries in the near future. Nor, however, does it negate the proposition that the granting of full labour mobility to the east European EU states could well result in noticeable migration effects.³

Marked impact of full labour mobility on employment, but little change in immigration so far

There was a further perceptible decline in unemployment in the second quarter. The regis-

Lower unemployment

¹ According to a press release issued by the Federal Employment Agency on 27 July 2011, the number of persons from the EU-8 countries subject to full social security contributions and those working exclusively in low-paid part-time jobs went up by 33,000 or 15% between April and May 2011, which is much higher than usual for the time of year.

² According to an evaluation of the central register for foreigners, the migration surplus resulting from the EU-8 amounted to 8,000 persons in May 2011. In the past decade, the corresponding monthly average of net additions from these countries was calculated at around 2,500.

³ See also Deutsche Bundesbank, Outlook for the German economy – macroeconomic projections for 2011 and 2012, Monthly Report, June 2011, pp 13-26, and Deutsche Bundesbank, The possible growth effects of increased immigration from the new EU member states, Monthly Report, May 2011, pp 58-59.

tered unemployment figure for the second quarter of 2011, at a seasonally adjusted 2.98 million, was around 89,000 lower than in the first quarter. The unemployment rate fell by 0.2 percentage point to 7.1%. Only around three-fifths of the decline in the second quarter was attributable to job-seekers claiming insurance benefits as opposed to social benefits. The national statistics probably understate the positive cyclical impact, as active labour market measures have concurrently been reduced. Thus, overall underemployment, at 572,000 persons, fell twice as strongly as registered unemployment year on year (-284,000). The decline in government sponsored work experience programmes (one-euro workfare jobs) continued at a rapid pace in the second quarter. There were consequently just under 180,000 such jobs, which corresponds to a decline of around one-third on the year. Registered unemployment declined further to 2.96 million in July 2011. The unemployment rate decreased further to 7.0%.

*Hard to further
reduce insured
unemployment*

There was no change between April and July in the seasonally adjusted number of unemployed workers claiming insurance benefits, who tend to have been unemployed for a shorter period. In the current economic environment, there is unlikely to be much potential in the foreseeable future for a further reduction in worker unemployment, which stood at around 880,000 persons in the second quarter of 2011 in seasonally adjusted terms (see also the box "Sustainable contribution rate for the Federal Employment Agency" on pages 76-77). At the same time, a seasonally adjusted total of 2.1 million longer-term job seekers were receiving the basic welfare allowance. The on-

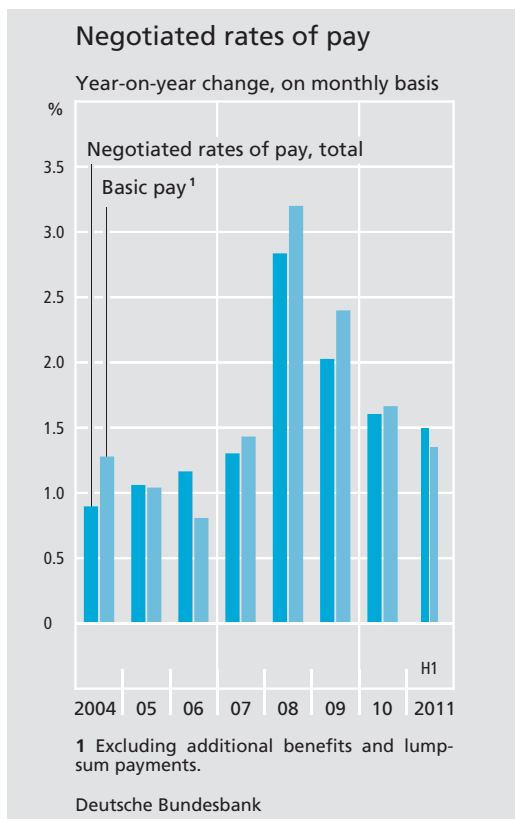
going upswing had an impact in this category of unemployment in the form of an improved net outflow to employment and a decline in the number of unemployed workers receiving the basic welfare allowance after their entitlement to insurance benefits had expired; its impact was dampened by the curtailing of labour market policy measures, however.

The available leading indicators suggest that the favourable labour market development will continue for the time being, although probably at a slightly more moderate pace. The Ifo employment barometer, which provides information about planned staffing levels in trade and industry over the next three months, declined slightly from its peak in March 2011 but still largely remained in expansionary territory. According to the survey conducted by the German Chamber of Commerce DIHK at the beginning of the summer, those enterprises intending to expand their staffing levels within the next 12 months by far outnumbered those with plans to reduce headcount.

At 457,000, the number of vacancies registered with the Federal Employment Agency was up by around 26,000 on the first quarter in seasonally adjusted terms. As in the past few quarters, the increase was accounted for solely by positions subject to social security contributions. Half of this increase was attributable to the sector for other business-related services, which also includes job vacancies posted by temporary work agencies. At the same time, the number of vacancies in manufacturing, construction, retail trade, transport as well as in technical and scientific activities increased considerably, just like in the early part of the

*Labour market
outlook
remains bright*

*Greater
number of
vacancies*



year. The number of vacancies in the health and social sector also remained at a high level. The Federal Employment Agency's BA-X job index reached a new record level in the second quarter, although it declined again somewhat in July owing to a reduction in the influx of new job offers. According to the IAB Job Vacancy Survey, there were around 975,000 vacancies available in the second quarter of 2011, which corresponds to an increase of 24% on the year.

Wages and prices

In the second quarter of 2011, collective wage agreements were reached primarily in the services sectors – notably with the trade sector and the insurance industry – as well as with two

smaller industrial sectors. The negotiated pay rises were lower than the negotiated wage increases in the larger and more cyclical manufacturing industries which were concluded in the first quarter of this year. The rather wide diversification of agreed wage increases in this year's pay round is a clear indication that sector-specific factors are still of primary importance in the wage bargaining process. Workers in the economically less favoured sectors have generally also been granted a clear increase in scheduled rates of pay. By staggering the pay increases and agreeing a longer term, however, the cost burden on firms remains within reasonable bounds.

The fact that the collective wage agreements reached so far in 2011 are higher than those concluded last year is gradually affecting the overall level of negotiated wages. According to Bundesbank statistics, the year-on-year rise in the level of negotiated basic pay rates in the second quarter of 2011, at 1.6%, was noticeably larger than in the first quarter (+1.1%).⁴ However, given that the volume of one-off payments in the second quarter of 2010 was particularly high, the overall increase, including these payments and all other fringe benefits, in the reporting period amounted to just 1.3% year on year, compared with an overall increase of 1.7% in the first quarter. As in the preceding quarters, actual earnings are likely to have risen more sharply than negotiated wages in the second quarter as well, as actual working hours are higher.

Growth in negotiated rates of pay still moderate

⁴ The Federal Statistical Office, whose index excludes civil servants, reports an increase of 1.5% for the negotiated rates of basic pay, compared with 0.9% at the beginning of the year.

Lower import prices owing to crude oil and appreciation ...

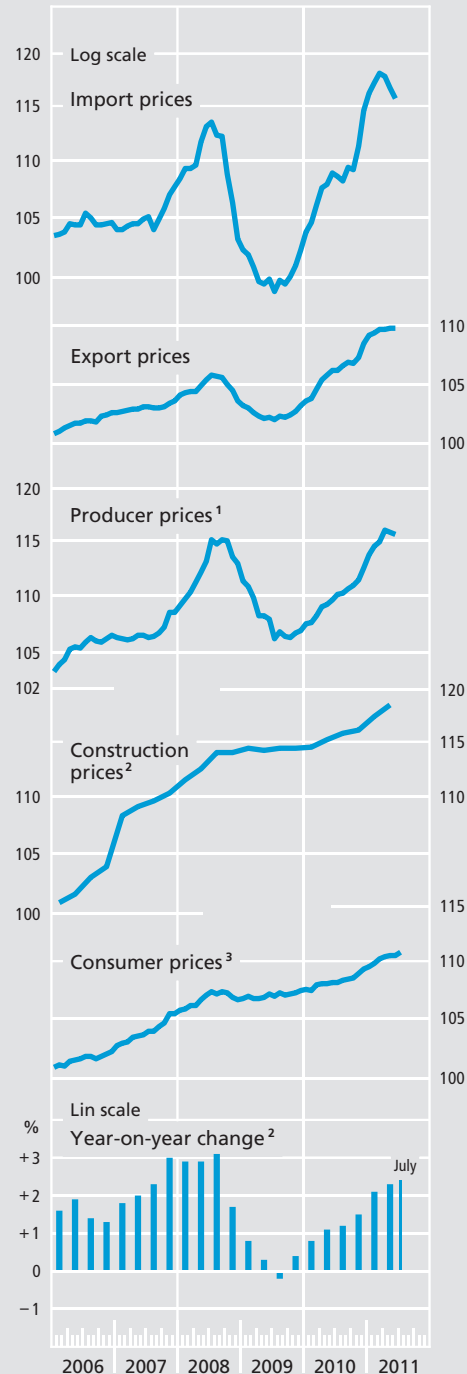
Prices at the various stages of the economy either fell during the second quarter or their increase levelled off. This is mainly a reflection of falling crude oil prices. Added to this were the effects of the euro's appreciation, especially in the case of imports. In June, for example, seasonally adjusted import prices for energy were around 7% lower than in March. On a quarterly average, however, they were practically just as high as in the first quarter. Excluding energy, importers had to pay 0.5% less than in the previous quarter, owing primarily to the appreciation of the euro. The price reductions in the case of intermediate goods also stemmed partly from lower prices for a number of industrial commodities. The increase in the cost of motor vehicles, trailers and semi-trailers was more than offset by price reductions in the case of other capital goods. Food prices were once again responsible for a rise in the prices of consumer goods, although these rises were considerably weaker than in the first quarter. Overall, imports were 0.4% cheaper than in the first quarter, but were still 8.0% dearer on the year.

... but further rise in industrial sales prices, ...

In the context of domestic industrial sales, energy prices fell only moderately during the course of the quarter owing to their smaller share of oil and on average were higher than at the beginning of the year. Unlike in the case of imports, prices excluding energy rose further by a seasonally adjusted 0.7%. This is also likely to have been due in part to the buoyant industrial activity, which expanded the scope for raising prices across all categories of goods. Price rises in the case of consumer goods were particularly pronounced as the food and drink industry was again able to impose considerable

Import, export, producer and consumer prices

2005 = 100, seasonally adjusted



¹ Producer price index for industrial products in domestic sales. — ² Not seasonally adjusted, quarterly. — ³ National consumer price index.

Deutsche Bundesbank

price increases. On the whole, prices went up by 1.2% on the quarter, and by 6.0% on the year. Price developments for foreign sales show a similar pattern. The previous-quarter level was exceeded by 0.4% and the prior-year level by 3.8%. This, together with declining import prices, improved the terms of trade again somewhat.

... construction and real estate prices ...

Construction prices, too, rose noticeably on the quarter (0.9%) on the back of buoyant construction activity. The year-on-year rise amounted to 2.9%. Real estate prices likewise continued their ascent. According to calculations by the Association of German Pfandbrief Banks (*Verband deutscher Pfandbriefbanken*), the prices of owner-occupied housing rose by 0.4% on the first quarter of 2011 and by 2.3% on the year.

... as well as consumer prices

Lower prices for refined petroleum products dampened consumer price inflation during the second quarter. On a quarterly average, however, consumers paid somewhat more for energy on the whole than in the first quarter after adjustment for seasonal variations. The increase in prices paid out to the food industry was swiftly passed on to consumers and therefore more than offset the decline in fruit and vegetable prices, which is likely to have been connected in part with the EHEC epidemic. Furthermore, other goods and services, including rents, continued to become gradually dearer in line with the ongoing economic upturn. Seasonally adjusted consumer prices went up by 0.6% on the whole on an average of the second quarter. The year-on-year rise expanded from 2.1% to 2.3%. Excluding en-

ergy, the corresponding growth rate rose from 1.1% to 1.5%.

Consumer prices accelerated somewhat in July owing to the temporary rise in crude oil prices. The year-on-year increase in the national consumer price index (CPI) went up from 2.3% to 2.4%, and the Harmonised Index of Consumer Prices (HICP) from 2.4% to 2.6%. The rate of price increases for components determined by domestic costs is likely to pick up again slowly in the near future. Price increases for gas have also been announced. However, the burden on the consumer is likely to be limited provided that crude oil prices do not increase sharply again.

Inflation accelerated in July

Orders received and outlook

As things currently stand, the German economy looks set to maintain a positive, albeit slightly slower underlying trend in the second half of the year. This is also suggested by the fact that the previously extremely optimistic business expectations have been lowered considerably and incoming orders, too, have lost momentum (excluding large orders). Added to this are a number of global risk factors such as uncertainty regarding further developments in the US economy and potential cyclical weakening in the emerging markets. Moreover, increasingly jittery global financial markets and the ongoing government debt problems could have a negative impact on confidence. Whereas the external environment has become less favourable, the domestic economy is still very robust, largely as a result of enterprises' marked willingness to invest, sharply higher

Economic growth continues at a moderate pace

demand in housing construction in recent months and the favourable labour market outlook. In addition, if growth remains on its potential output path, as looks likely at the moment, this should help counteract the risk of increasing tensions and supply shortages within the domestic economy.

Strong inflow of orders characterised by large orders

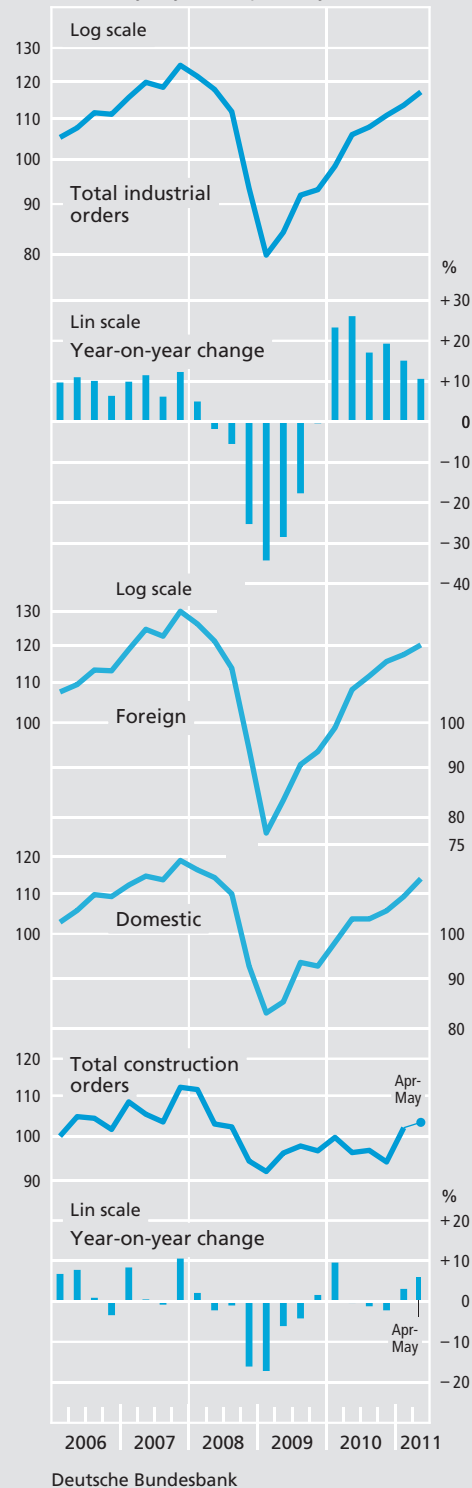
The overall order situation in the second quarter saw a continuation of the steep upward path. Growth in orders, at a seasonally adjusted 3¼%, appears to have even exceeded the already sharp increase recorded in the first quarter (+2¼%). The main reason for the sharp increase, however, was the exceptional number of large orders received from both Germany and abroad. Excluding the manufacture of other transport equipment, which accounts for the majority of these large-scale orders, the volume of new orders would have merely held up at around the first-quarter level. An increase of just under ¾% in domestic orders was offset by a decline of a similar amount in foreign orders. Producers of capital goods – excluding manufacturers of other transport equipment – recorded their first slight decline in orders since the beginning of the economic recovery. Only a modest ¼% increase was recorded in the intermediate goods sector following strong growth at the beginning of the year. By contrast, consumer goods producers recorded a comparatively marked increase in orders (+1¾%).

Further expansion in orders on hand

Nonetheless, the flat trend in new contracts in the second quarter should not be overstated. Large orders have an impact on production over a prolonged period of time and can – especially if they occur in multiple batches as was

Demand for industrial goods and construction work

Volume, 2005 = 100, seasonally adjusted, quarterly



recently the case – lead to a steady rise in economic output. The assessments made by the manufacturing sector in terms of the stock of orders are still exceptionally optimistic. The backlog of incomplete orders in July expanded further to over three production months.

Optimistic expectations in industry downscaled

According to the Ifo business surveys, the business expectations of manufacturing enterprises have been lowered significantly in recent months. This downscaling of expectations was accompanied by waning optimism with regard to the outlook for exports. In terms of level, however, the sentiment indicators are still clearly in expansionary territory. This is consistent with the fact that enterprises are stepping up their plans for investment in capacity extensions and for some time now have been reporting a perceptible shortage of skilled workers, raw materials and intermediate inputs.

Further stimuli for the construction sector

The construction sector is likely to prove a stimulus for economic activity in the second half of the year. This is suggested not only by the further improvement of the assessment of the current economic situation and the outlook in this sector, but also by the large inflow of new orders. The volume of new orders in housing construction, in particular, expanded further in April and May – more recent data are not yet available – after already recording

strong growth in the first quarter. The favourable financing conditions, the positive labour market outlook and, in some cases, doubts about the soundness of alternative forms of investment are still making themselves felt in this sector. Although demand from commercial customers in April and May did not reach the high level of the first quarter, it markedly exceeded the volume of the preceding quarters. The public sector also placed more construction orders of late after it had previously scaled back its demand significantly, probably due partly to the exhaustion of the financial resources available under the economic stimulus packages.

Consumer sentiment is still at a high level. However, economic and income expectations have been scaled back slightly, which was also reflected in a somewhat lower general propensity to purchase. The current relatively high inflation rate and the possible negative confidence effects in connection with the considerable increase in risks recently may also have had a negative impact on consumer sentiment. Provided uncertainty remains limited, there is still a chance that the very positive labour market outlook and realised or imminent wage increases will continue to prop up consumer confidence in Germany.

Private consumption setting less sure