



Highlights and Key Issues

- Germany appears to be slipping deeper into recession. The latest industrial figures are alarming: production fell 2.1% in October and orders were down 17.3%. If output remained at current levels to year-end, then Q4 would be down 3.2% on Q3, but the situation is deteriorating. The manufacturing PMI is below 40 and the expectations component of the Ifo is at its lowest level since the first oil crisis in the early 1970s.
- Key to the rapid decline has been an abrupt halt to investment, both in Germany and globally. Investment in machinery and equipment had stalled in Q3 and domestic orders of capital goods then dropped 6% in both October and November. Business investment will fall by over 4% in 2009.
- But exports have also seen a rapid decline, having fallen in both Q2 and Q3, while export expectations are near all-time lows. Export volumes are expected to drop next year, despite the depreciation of the euro.
- We have slashed our growth forecasts, with GDP now likely to fall by at least 1% in Q4. And we now do not expect the economy to emerge from recession until 2009H2 and for the economy to shrink by over 2% in 2009 overall – the biggest drop in over 60 years.
- Rapidly declining oil prices and an extended recession mean inflation could fall close to zero by next summer. Inflation has already slowed to 1.4% in November from a peak of 3.1% in July.

Forecast for Germany

(Annual percentage changes unless specified)

	2007	2008	2009	2010	2011	2012
Domestic Demand	1.2	1.1	-2.0	0.7	1.9	2.3
Private Consumption	-0.3	-0.5	-1.4	0.6	1.8	2.4
Fixed Investment	4.5	3.5	-6.3	-0.4	2.7	3.7
Stockbuilding (% of GDP)	-1.1	-1.0	-1.1	-0.9	-0.8	-0.9
Government Consumption	2.2	2.5	1.6	1.0	1.0	1.0
Exports of Goods and Services	7.7	4.0	-3.1	2.8	5.5	7.0
Imports of Goods and Services	5.2	4.2	-3.0	2.6	6.3	7.7
GDP	2.6	1.2	-2.1	1.0	1.8	2.3
Industrial Production	5.9	0.9	-5.2	1.1	2.8	3.4
Consumer Prices	2.3	2.6	0.7	1.3	1.9	1.9
Current Balance (% of GDP)	7.5	7.4	7.7	7.5	7.2	6.9
Government Budget (% of GDP)	0.0	-0.3	-2.3	-3.0	-2.7	-2.0
Short-Term Interest Rates (%)	4.28	4.53	1.53	1.17	2.05	3.80
Long-Term Interest Rates (%)	4.28	4.11	3.55	4.12	4.57	4.75
Exchange Rate (US\$ per Euro)	1.37	1.46	1.32	1.37	1.29	1.25
Exchange Rate (£ per Euro)	0.68	0.79	0.85	0.79	0.72	0.71

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Overview

Slide into recession gathers pace...

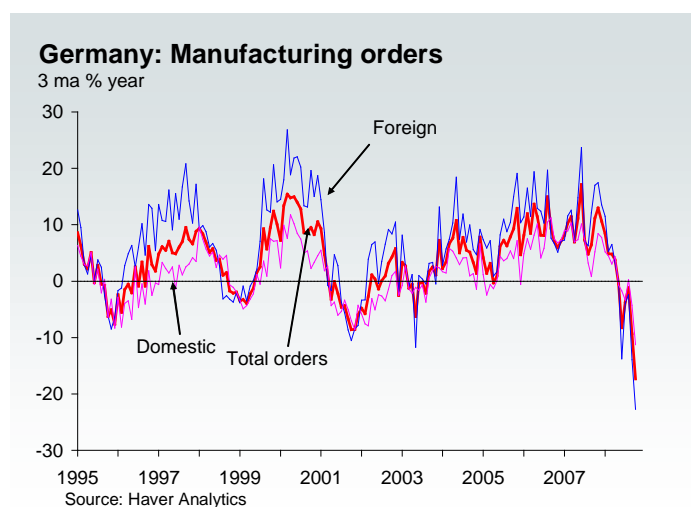
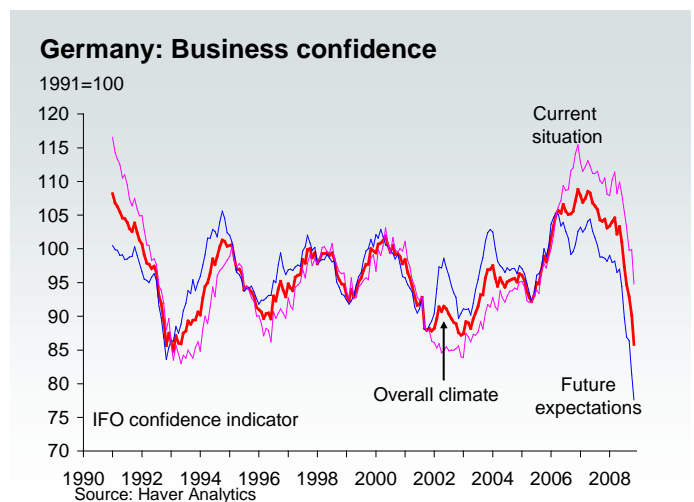
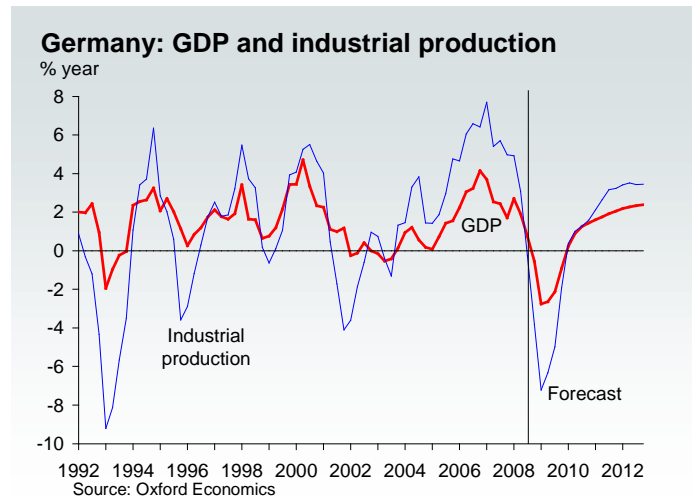
- GDP contracted by 0.5% in Q3 and, after the 0.4% fall in Q2, Germany is now officially in recession. And the downturn appears to be worsening. The latest industrial figures are alarming: production dropped 2.1% in October and orders were down 17.3%. If output remained at current levels to year-end, then Q4 would be down 3.2% on Q3, but the situation is deteriorating fast. The PMI for manufacturing is below 40 and the expectations component of the Ifo is at its lowest since the first oil crisis in the early 1970s. It seems likely that there will be a 1%+ contraction in GDP in Q4 and that growth will average 1.2% in 2008 as a whole.

...as investment tumbles...

- Key to the rapid decline since the summer has been an abrupt halt to investment – both in Germany and globally. Investment in machinery and equipment had already stalled in Q3 and domestic orders of capital goods dropped 6% in both October and November. And with business confidence plunging, investment plans are being dramatically scaled back. The DIHK survey of investment intentions shows business plans to reduce capital outlays and, with capacity utilisation set to fall further as the global economy falls into recession, investment is likely to weaken sharply. Business capital spending is forecast to drop by over 4% in 2009 and to stage only a modest recovery in 2010.

...and global recession hits exports

- Germany also exports a lot of investment goods – capital goods accounted for 45% of total exports in 2007 – and exports of capital goods to Eastern Europe and Emerging Asia have been strong areas of growth in recent years. But these markets have been caught up in the financial crisis and exports to traditional markets such as other Eurozone countries have tumbled. The volume of exports had already fallen in Q2 and Q3 and, with foreign manufacturing orders falling 18% in October and November and export expectations close to all-time lows, the outlook is bleak. Export volumes are expected to drop next year, despite the depreciation of the euro, and to recover only slowly as the global investment cycle picks up in 2010.



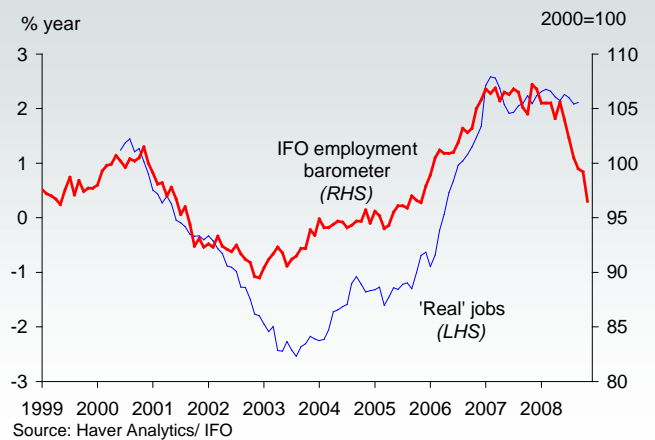
Economy to contract 2% in 2009

- The decline in the business environment will also see firms shed jobs. Although unemployment continues to edge down and currently stands at 7.5%, survey evidence from the DIHK survey and Ifo employment barometer shows employment is set to fall. As the economic slowdown bites harder, we expect the jobless rate to rise to over 9½% by end-2009. This will weigh on consumer demand – as will households' uncertainties about the economic outlook, which will encourage precautionary saving. We expect consumption growth to remain in negative territory and the savings ratio to climb further, despite the relatively low indebtedness of households.
- As a result of the rapid deterioration in economic conditions in Germany and globally, we have slashed our forecasts for GDP. We now expect Germany to remain in recession until at least 2009H2 and for the economy to shrink by just over 2% in 2009 as a whole – the biggest drop in over 60 years. The emergence from recession is also likely to be slow and we forecast growth of 1% in 2010.
- One piece of positive economic news can be found on the inflation front. Rapidly declining oil prices and an extended recession mean inflation could fall close to zero by the summer. Inflation has already dropped to 1.4% in November from a peak of 3.1% in July and is now forecast to average 0.7% in 2009 as a whole. The accompanying boost to household incomes is unlikely to be sufficient to offset the impact of higher unemployment, but it does release the shackles from monetary policy and allows the ECB to make further significant cuts to interest rates.

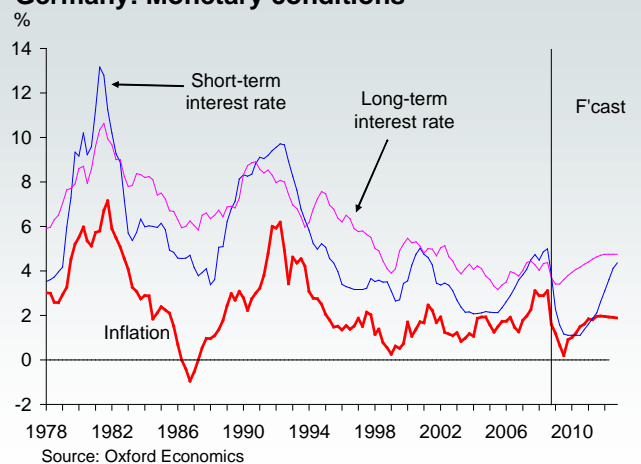
Government offering modest help

- The deteriorating economic backdrop has resulted in a fiscal stimulus package appearing on the political agenda. The main measure consists of tax breaks on investment for the next couple of years and providing credit to the Mittelstand to encourage firms to bring forward investment. The estimated cost for the stimulus is €12 billion over the next couple of years. In addition, there is a €20 billion boost for households through lower social security contributions and higher child benefits. The government is also discussing a second package amounting to around €25 billion, the details of which will be announced in January.

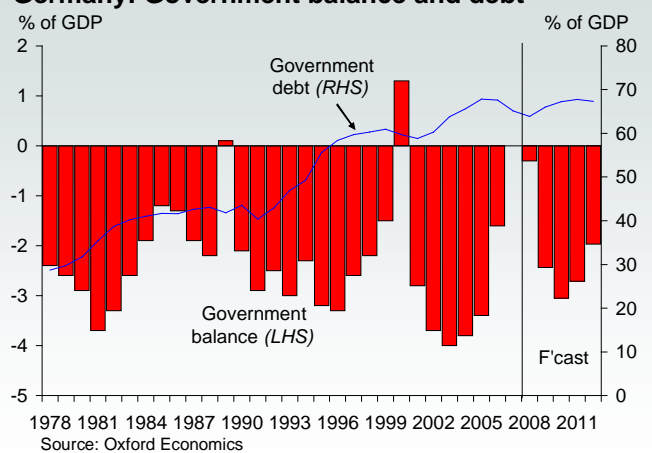
Germany: IFO Employment Barometer



Germany: Monetary conditions



Germany: Government balance and debt



Key Indicators: Germany

Percentage changes on a year earlier unless otherwise stated

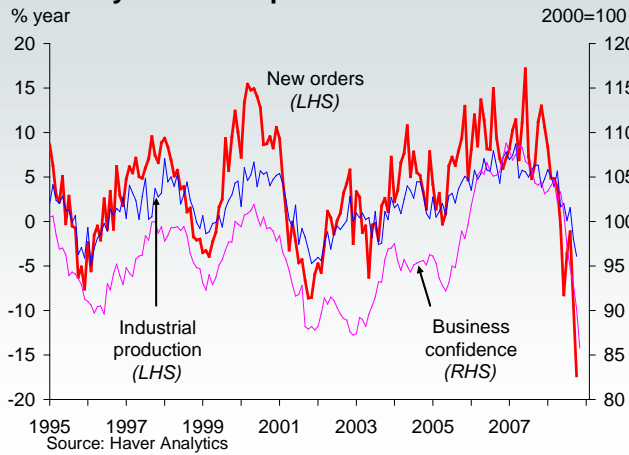
	Industrial production	Unemploy- ment	CPI	IFO Index 2000=100	Consumer confidence % balance	Exports	Imports	Trade balance (€ bn)
Nov	3.9	8.5	3.2	104.4	3.2	2.6	1.7	19.3
Dec	4.8	8.3	3.1	103.1	2.1	4.2	3.0	16.2
2008								
Jan	5.8	8.2	2.8	103.4	-1.1	9.2	10.0	16.0
Feb	5.1	8.1	2.8	104.0	-2.6	6.8	4.8	16.4
Mar	3.9	8.0	3.1	104.6	-1.6	7.1	7.6	15.8
Apr	5.6	7.9	2.4	102.2	-0.2	7.0	6.6	16.5
May	1.6	7.9	3.0	103.3	-4.2	4.6	9.0	14.9
Jun	2.0	7.8	3.3	101.0	-4.0	6.6	4.1	17.8
Jul	0.1	7.8	3.3	97.3	-7.2	5.1	13.8	12.0
Aug	1.5	7.7	3.1	94.7	-9.1	2.2	5.9	13.7
Sep	-1.9	7.6	2.9	92.9	-8.6	2.5	10.6	13.7
Oct	-3.9	7.5	2.4	90.2	-11.5	1.2	5.4	15.8
Nov	-	7.5	1.4	85.8	-14.7	-	-	-

Financial Indicators: Germany

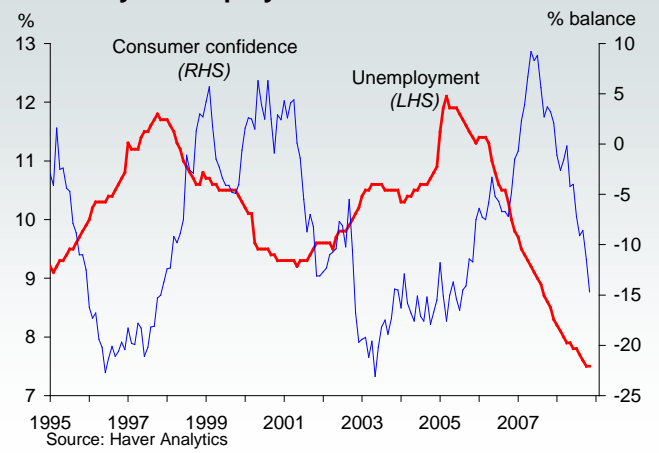
Percentage changes on a year earlier unless otherwise stated

	Short rate %	Long rate %	Money Supply (M3)	Nominal effective 2000=100	Real effective 1999Q1=100	Share price XETRDAX	Reserves US\$ bn
Nov	4.6	4.1	10.5	114.3	100.3	7715	89.2
Dec	4.8	4.3	10.6	114.5	99.9	7942	92.5
2008							
Jan	4.4	4.0	11.2	114.7	99.9	7324	99.0
Feb	4.3	4.0	12.1	114.7	99.7	6887	100.9
Mar	4.6	3.8	11.1	116.0	101.2	6500	95.1
Apr	4.8	4.1	12.1	117.0	101.3	6763	92.6
May	4.8	4.2	11.9	116.7	100.9	7056	92.4
Jun	4.9	4.6	10.6	117.0	100.6	6717	95.2
Jul	4.9	4.5	10.7	117.4	100.7	6341	93.7
Aug	4.9	4.2	10.2	116.2	99.3	6421	93.0
Sep	5.0	4.1	10.0	114.9	98.5	6136	99.9
Oct	5.1	3.9	12.8	112.2	96.8	4947	97.4
Nov	4.3	3.6	-	-	96.4	4692	104.6

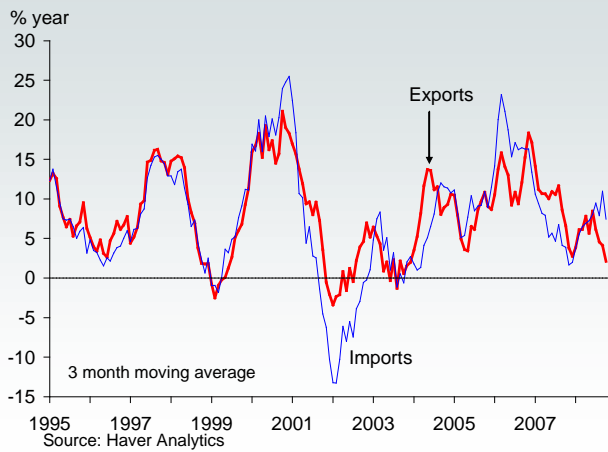
Germany: Industrial performance



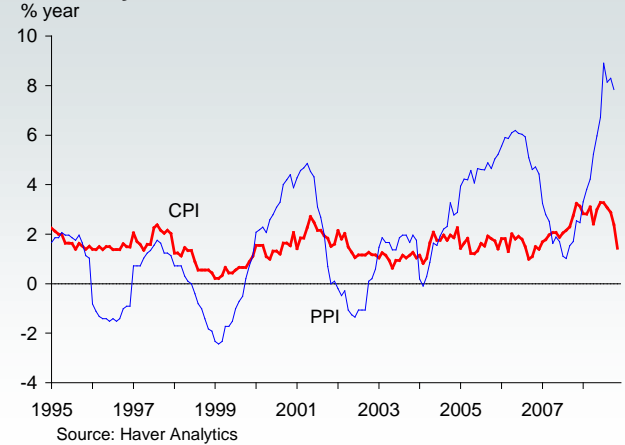
Germany: Unemployment



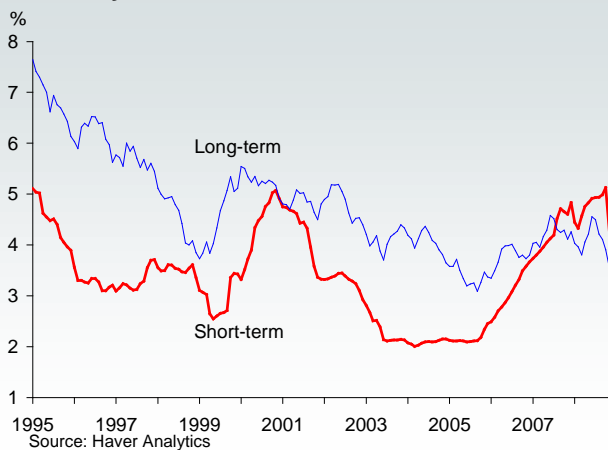
Germany: Exports and imports



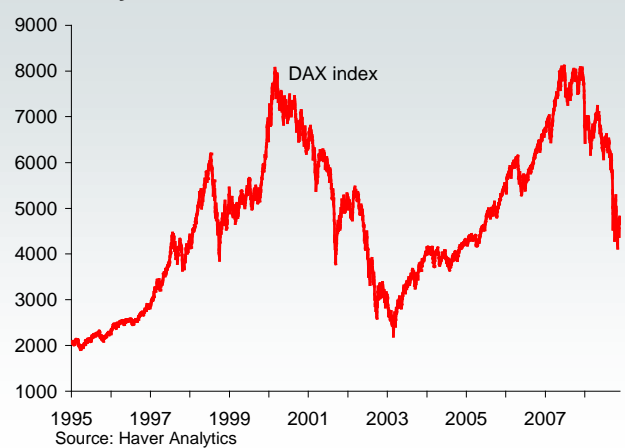
Germany: Inflation



Germany: Interest rates



Germany: Stockmarket



GERMANY

TABLE 1 SUMMARY ITEMS

Annual Percentage Changes, Unless Otherwise Specified

	CONSUMERS EXPENDITURE (C)	REAL PERS. DISPOSABLE INCOME (PEDY)	SAVING RATIO (%) (PESR)	REAL GDP (GDP)	INDUSTRIAL PRODUCTION (IP)	UNEMPLOY- MENT RATE (%) (UP)	AVERAGE EARNINGS (ER)	WHOLE ECONOMY PRODUCT- IVITY (GDP/ET)	COMPETIT- IVENESS (2000=100) (WCR)	PRODUCER PRICES (PPI)	CONSUMER PRICES (CPI)
YEARS BEGINNING Q1											
2007	-0.3	0.0	10.8	2.6	5.9	9.0	1.6	0.9	94.8	2.0	2.3
2008	-0.5	0.3	11.5	1.2	0.9	7.8	2.1	-0.2	93.5	6.3	2.6
2009	-1.4	-0.4	12.4	-2.1	-5.2	8.8	2.3	-0.9	89.6	2.1	0.7
2010	0.6	0.6	12.4	1.0	1.1	9.7	2.7	2.1	87.5	1.0	1.3
2011	1.8	1.2	11.9	1.8	2.8	9.8	3.0	1.8	83.4	1.4	1.9
2012	2.4	1.8	11.4	2.3	3.4	9.5	3.1	1.8	81.3	1.6	1.9
2007											
I	-0.3	0.2	11.2	3.7	7.7	9.5	1.4	1.8	95.6	2.9	1.8
II	0.0	0.0	10.6	2.5	5.4	9.2	1.7	0.8	94.9	1.8	2.0
III	0.3	0.2	10.4	2.4	5.7	8.9	1.4	0.8	94.2	1.2	2.3
IV	-1.3	-0.3	11.0	1.7	5.0	8.5	1.8	0.0	94.6	2.2	3.1
2008											
I	0.6	0.6	11.2	2.7	4.9	8.1	2.1	1.0	94.8	3.8	2.9
II	-0.7	0.7	11.8	1.9	3.1	7.9	1.9	0.4	95.3	5.9	2.9
III	-0.8	0.5	11.5	0.8	-0.2	7.7	2.3	-0.7	93.1	8.5	3.1
IV	-1.1	-0.7	11.3	-0.5	-3.8	7.6	2.3	-1.5	90.8	6.9	1.6
2009											
I	-1.5	-0.5	12.1	-2.7	-7.2	7.9	2.0	-2.8	90.4	5.4	1.2
II	-1.3	-0.7	12.4	-2.6	-6.3	8.5	2.1	-1.8	89.4	2.8	0.7
III	-1.7	-0.5	12.5	-2.1	-5.0	9.1	2.4	-0.3	89.4	-0.1	0.2
IV	-1.1	0.2	12.5	-0.9	-1.9	9.5	2.6	1.3	89.3	0.3	0.9
2010											
I	-0.2	0.2	12.5	0.2	0.4	9.6	2.6	2.3	88.9	0.5	1.0
II	0.4	0.5	12.5	0.9	1.0	9.6	2.7	2.4	88.1	1.0	1.2
III	0.9	0.7	12.3	1.3	1.3	9.7	2.8	2.1	87.2	1.3	1.5
IV	1.2	0.9	12.3	1.4	1.6	9.7	2.8	1.8	85.9	1.3	1.6
2011											
I	1.4	1.0	12.1	1.6	2.1	9.8	2.9	1.7	85.0	1.4	1.8
II	1.7	1.2	12.1	1.8	2.6	9.9	2.9	1.8	83.7	1.3	1.8
III	1.9	1.3	11.8	1.9	3.2	9.8	3.0	1.8	82.8	1.4	2.0
IV	2.1	1.4	11.7	2.1	3.2	9.8	3.0	1.9	82.0	1.5	2.0
2012											
I	2.2	1.6	11.6	2.2	3.4	9.7	3.1	1.9	81.9	1.6	2.0
II	2.4	1.7	11.5	2.3	3.5	9.6	3.1	1.8	81.3	1.6	1.9
III	2.4	1.8	11.3	2.3	3.4	9.4	3.1	1.7	81.1	1.6	1.9
IV	2.4	1.9	11.2	2.4	3.4	9.2	3.1	1.6	80.8	1.6	1.9

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GERMANY

TABLE 2 SUMMARY ITEMS

	TRADE BALANCE (EURO BN) (BVI)	CURRENT ACCOUNT (EURO BN) (BCU)	CURRENT ACCOUNT (% OF GDP) (BCU*100 /GDP!)	GOV. FIN. BALANCE (MAAS.DEF) (EURO BN) (GBM)	GOV. FIN. BALANCE (MAAS.DEF) (% OF GDP) (GBM*100 /GDP!)	SHORT-TERM INTEREST RATE (RSH)	LONG-TERM INTEREST RATE (RLG)	REAL SHORT-TERM INTEREST RATE (Note 1)	REAL LONG-TERM INTEREST RATE (Note 1)	DM PER US DOLLAR (RXD)	EFFECTIVE EXCHANGE RATE (1990=100) (RX)
YEARS BEGINNING Q1											
2007	195.3	180.8	7.5	0.0	0.0	4.28	4.28	2.00	1.99	1.43	112.49
2008	195.8	183.2	7.4	-6.8	-0.3	4.54	4.11	1.92	1.49	1.34	115.26
2009	203.6	189.9	7.7	-57.5	-2.3	1.53	3.55	0.79	2.82	1.49	113.69
2010	201.0	190.6	7.5	-76.9	-3.0	1.17	4.12	-0.16	2.79	1.43	113.97
2011	197.9	187.9	7.2	-71.0	-2.7	2.05	4.57	0.15	2.67	1.52	111.48
2012	198.9	188.7	6.9	-54.1	-2.0	3.80	4.75	1.88	2.83	1.57	110.63
2007											
I	48.2	45.3	7.6	0.0	0.0	3.82	4.03	2.04	2.25	1.49	111.21
II	48.2	40.6	6.7	0.0	0.0	4.07	4.37	2.10	2.40	1.45	112.19
III	50.2	41.8	6.9	0.0	0.0	4.50	4.43	2.24	2.17	1.42	112.47
IV	48.7	53.1	8.7	0.0	0.0	4.73	4.27	1.62	1.16	1.35	114.08
2008											
I	50.6	48.3	7.8	11.1	1.8	4.48	4.03	1.60	1.15	1.31	115.13
II	53.0	42.0	6.7	4.1	0.7	4.86	4.33	1.96	1.44	1.25	116.87
III	39.3	34.5	5.5	-10.5	-1.7	4.98	4.37	1.88	1.26	1.30	116.16
IV	52.9	58.4	9.4	-11.5	-1.9	3.82	3.70	2.23	2.11	1.52	112.90
2009											
I	53.5	50.4	8.2	3.9	0.6	2.28	3.40	1.10	2.22	1.54	112.84
II	52.3	42.1	6.9	-7.5	-1.2	1.56	3.40	0.90	2.74	1.52	113.20
III	52.3	45.1	7.3	-23.7	-3.9	1.16	3.60	0.96	3.40	1.47	114.03
IV	45.5	52.2	8.4	-30.1	-4.9	1.11	3.80	0.21	2.90	1.42	114.68
2010											
I	51.8	49.9	8.0	-4.7	-0.8	1.11	3.93	0.11	2.93	1.42	114.63
II	51.6	42.2	6.7	-13.3	-2.1	1.11	4.06	-0.10	2.86	1.42	114.39
III	52.5	46.0	7.3	-26.8	-4.2	1.11	4.18	-0.38	2.68	1.43	113.79
IV	45.2	52.4	8.2	-32.1	-5.0	1.36	4.29	-0.25	2.68	1.46	113.07
2011											
I	51.4	49.8	7.7	-5.8	-0.9	1.61	4.41	-0.23	2.57	1.49	112.27
II	50.7	41.5	6.4	-11.8	-1.8	1.86	4.52	0.05	2.71	1.51	111.63
III	51.8	45.4	6.9	-25.6	-3.9	2.11	4.64	0.15	2.68	1.54	111.12
IV	44.0	51.2	7.7	-27.8	-4.2	2.61	4.71	0.64	2.74	1.55	110.89
2012											
I	51.0	49.3	7.3	-3.8	-0.6	3.11	4.75	1.15	2.79	1.56	110.74
II	50.9	41.7	6.1	-7.4	-1.1	3.61	4.75	1.69	2.83	1.57	110.59
III	52.4	46.0	6.7	-22.0	-3.2	4.11	4.75	2.20	2.84	1.57	110.59
IV	44.6	51.7	7.5	-20.8	-3.0	4.36	4.75	2.48	2.87	1.57	110.60

Note 1 : REAL INTEREST RATES = Nominal interest rate (RSH or RLG) - % change in CPI

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Background

- Europe's largest economy and the world's third largest in US\$ terms (fifth largest in PPP terms) has struggled economically over recent years and, until recently, was labelled "the sick man of Europe". Since re-unification, the economy has expanded at an average annual rate of just 1.4% as the West had to absorb huge reunification costs and stagnation in the construction sector following the end of the reunification boom.
- In the so-called solidarity pact II, the east German *länder* are to receive a total of EUR156bn in transfers from the central government during the period 2005-19. In light of the continuing stagnation in eastern Germany, there have been calls for this money to be assigned to projects that generate increased employment. Since 1997, there has hardly been any catching up by the *neuen Länder*, where GDP per capita is just 62% of the level in former West Germany despite the transfer of EUR980bn since reunification.
- Recent economic performance has been categorised by surging exports that have left Germany as the world's leading exporter and that boosted investment but only slowly filtered into the labour market – consumer demand is still being held back by the effects of higher VAT. Exports are more important to the German economy than in other major European economies, accounting for some 40% of GDP. Main export products are engineering products, both mechanical and electrical, and main markets include other EU countries and Russia. The importance of exports in GDP has been the main factor behind Germany's emergence from several years of stagnation, but it is also a key factor in explaining the weakness of household demand. Many argue that Germany entered European Monetary Union at an overvalued exchange rate, leaving German exports uncompetitive. In the ensuing years, corporate Germany rationalised production, scaling back on capacity – limiting investment and shedding employees – as well as forcing through wage restraint. These measures have been successful, as witnessed by Germany's export success, but unemployment rose steadily between 2001 and 2005 and real incomes barely grew.
- The corporate agenda highlighted the significant structural problems in the domestic economy, most notably in the labour market, but also in product markets and financial services. The problems are particularly severe in Eastern Germany where unemployment is around 15% and led the previous government under the leadership of Gerhard Schröder to introduce wide-ranging reforms (in a German context, at least) that were collectively known as 'Agenda 2010'. These reforms were aimed at tightening up on claims for unemployment benefit, while offering increased incentives to work, including the possibility of working alongside claiming benefit. These reforms, however, did not significantly improve the attractiveness of being an employer in Germany, leaving the collective bargaining system largely untouched and not significantly relaxing hiring and firing rules.
- The current government – a grand coalition of the two main political parties (the CDU/CSU and SPD) – with Angela Merkel as Germany's first female chancellor promised to accelerate the reform agenda. However, the government has so far disappointed with little significant progress being made in the labour market and reducing non-labour costs – and reform of the health insurance system seems to be a chance missed. Significant success has only been achieved in reshaping the allocation of responsibilities between the central government and the *länder*, which should smooth the passage of legislation through the Bundesrat. Reform of business taxation is due to be implemented in 2008. More controversially, the government increased the rate of VAT from 16% to 19% on 1 January 2007 to ensure that Germany met the requirement of the Growth and Stability Pact, after the budget deficit exceeded 3% between 2002 and 2005.
- The reform agenda over the past couple of years has been ambitious by German standards, but the pace has been held back by the need for political and social consensus, meaning a Thatcherite shake-up is unlikely. Most politicians and voters have accepted the need for structural reforms but even the more ambitious reformers want to implement these reforms in a social manner. Most Germans are happy with the idea of having a 'social market economy' that offers significant safety nets to society but this is not conducive to an aggressive reform agenda. And the impact of the current recession is likely to further delay any early progress on reforms.

Key Facts

Politics

Head of state: President Horst KOEHLER
 Head of government: Chancellor Angela MERKEL
 Political system: Federal Republic
 Date of next presidential election: May 2009
 Date of next legislative election: September 2009
 Currency: Euro

Long-term economic & social development

	1975	1985	1995	2006*
GDP per capita (US\$)	6035	9124	30901	35388
Inflation (%)	5.9	2.1	1.7	1.6
Population (mn)	78.7	77.7	81.5	82.4
Urban population (% of total)	73.0	73.0	73.0	74.0
Life expectancy (years)	-	74.0	76.0	79.0

Source : Oxford Economics & World Bank

Structure of GDP by output

	2006
Agriculture	1.0%
Industry	30.0%
Services	69.0%

Source : World Bank

* 2006 or latest available year

Structural economic indicators

	1990	1995	2000	2006*
Current account (US\$ billion)	17	-29	-32	178
Trade balance (US\$ billion)	18	57	55	200
FDI (US\$ billion)	-21	-27	150	-39
Govt budget (% of GDP)	-2.1	-3.2	1.3	-1.6
Govt debt (% of GDP)	43.5	55.6	59.7	67.6
Long-term interest rate	8.7	6.9	5.3	3.8
Oil production (000 bpd)	0.0	58.5	63.8	67.6
Oil consumption (000 bpd)	2682	2882	2772	2663

Source : Oxford Economics / World Bank / EIA

Destination of goods' exports (2006)

European Union (27)	63.2%
United States	8.7%
Switzerland	4.0%
China	3.1%
Russian Federation	2.6%

Source : WTO



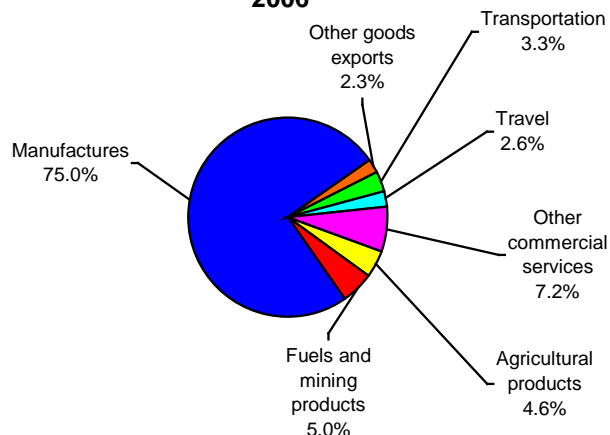
Source : CIA Factbook
 Central Europe, bordering the Baltic Sea and the North Sea, between Netherlands & Poland, south of Denmark (CIA Factbook)

Corruption perceptions index 2008

	Score
Developed economies (average)	7.73
Emerging economies (average)	3.44
Germany	7.90

Source: Transparency International
 Scoring system 10 = highly clean, 0 = highly corrupt

Composition of goods & services exports, 2006



Source : WTO