

6 May 2008

Spotlight

CONSUMER PRICE TRENDS IN GERMANY AND THE EUROZONE

Return of inflation – tough times for the ECB

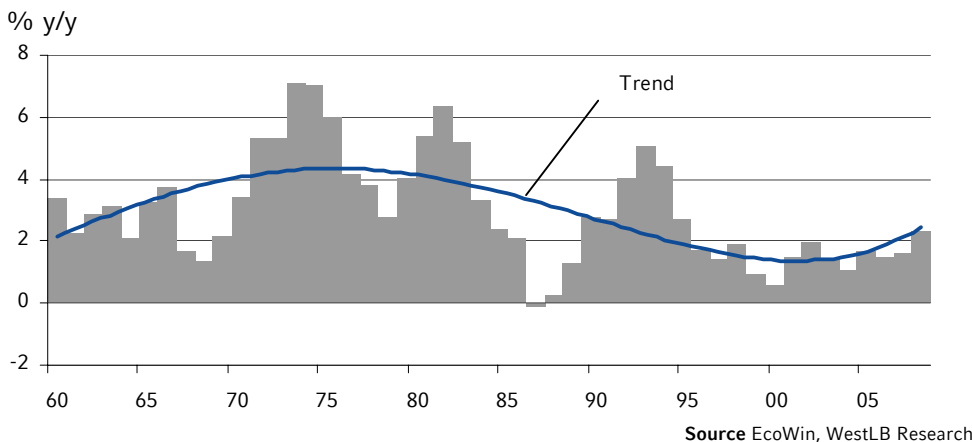
- The more than decade-long period of comparatively low inflation rates in Germany and the Eurozone has come to an end. Inflationary pressures have intensified since the beginning of last year.
- The unwinding of the price-dampening effects of globalisation, rising wage pressure, mounting price pressure on upstream markets and continued increases in energy and food prices look set to keep inflation pressure at a high level.
- A decline in the inflation rate below the ECB's 2% target ceiling is currently not in sight. Of potentially much greater concern is that the stronger pass-through of wage costs to consumer prices, and the ebbing of the disinflationary impact of globalisation, will increase general inflationary pressure (core inflation).

Inflation forecast

| | 2007 | 2008E | 2009E |
|----------|------|-------|-------|
| Germany | 2,3 | 2,7 | 2,2 |
| Eurozone | 2,1 | 3,1 | 2,1 |

Source WestLB Research

Germany: Consumer prices



- In order to contain inflation expectations under more challenging circumstances, we expect the ECB to pursue a more restrictive monetary policy, with higher key rates than in recent years.
- The yield on 10Y Bunds has averaged 3.9% since 2003. Owing to a slightly increasing inflation risk premium, we consider 4.5% to be a good middle-of-the-road estimate for the 10Y Bund yield in the coming years.

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Period of high stability of prices in Germany . . .

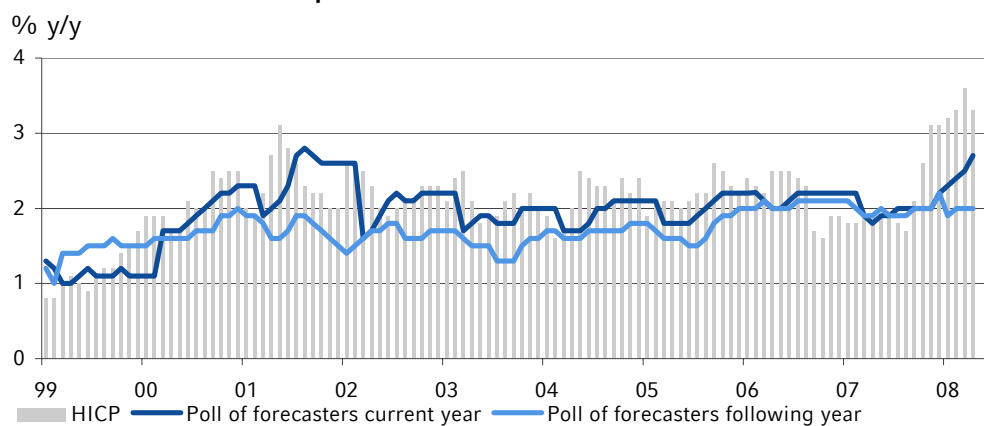
More than a decade-long period of moderate inflation in Germany

The annual increase in German consumer prices has averaged below 2% for more than a decade. Such an extended period of low inflation had not been seen in Germany since the beginning of the 1960s. This is all the more remarkable, given that energy prices climbed steadily from 2000 onward, with the euro – at least during the start-up phase of currency union – declining significantly in value, which made imported goods more expensive. A number of factors were responsible for the favourable inflation trend. In our view, the most important of these are:

Anchoring of inflation expectations by central banks

- Monetary policy:** With the maintenance of price stability as their prime objective, the German Bundesbank, and subsequently the European Central Bank, succeeded in damping inflation expectations. This is evidenced, for example, by the fact that – with very few exceptions – since 2000 the monthly consensus estimate for Eurozone inflation for the following year was consistently below the estimate for the current year. Furthermore, the majority of forecasters expected the inflation rate for the following year to be less than 2%. Their inflation forecasts exceeded that level only once, namely just prior to the VAT increase in Germany. Nevertheless, since mid-2005 their inflation forecasts for the following year were from 0.25 to 0.5 percentage point above those of the current year. Certainly, central banks were also helped not just by their enshrined independence, but also by the fact that monetary policy – thanks to more modern analytical and empirical instruments – is on a more stable footing than it was in the 1970s and 1980s.

Eurozone: Actual and expected inflation



Source EcoWin, WestLB Research

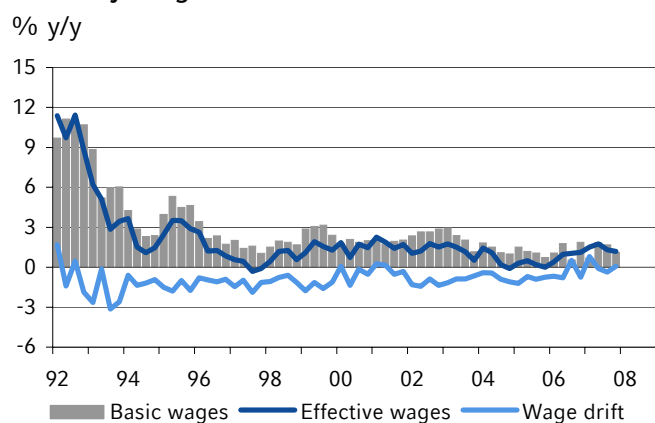
Price-dampening effect of globalisation

- Globalisation:** In the wake of globalisation, there has been a sharp increase in the international division of labour. As a result, prices for traded industrial goods have come under considerable pressure (for more complete details, refer to pp. 5-7). Germany has likewise seen a significant rise in the share of goods imported from “low-wage countries”, spurred by the increasing liberalisation of global trade. Today, the share of traditional goods imported from these countries, such as clothing, textiles and foodstuffs, is much lower than that of other goods such as motor vehicles, electronics and machines. Lower import prices have had a favourable impact on domestic price levels (the import price effect). At the same time, the level of global competition has intensified, limiting not only the scope of German companies to raise prices but also the wage-boosting power of trade unions (the competition effect). From a global point of view, additional aspects attest to the inflation-dampening effect of globalisation, namely fiscal policy discipline, greater attention paid by the central banks to stability, and expansion of production in countries such as China and India.

Very moderate wage increases for over a decade

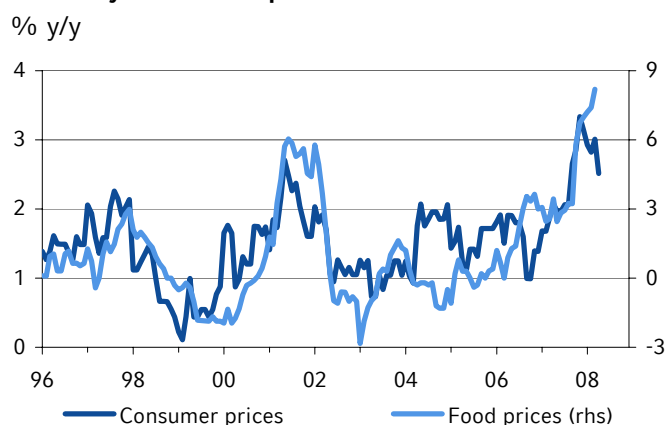
■ **Restructuring:** As a result of excessive wage increases during the reunification boom – particularly in East Germany – and the increases in tax and fiscal charges to help cover the costs of reunification, the competitiveness of the German economy was under considerable pressure. Consequently, companies have undertaken intense efforts since the mid-1990s to reduce their labour costs and improve the efficiency of their production processes. Rapidly advancing globalisation too acted as a catalyst, drastically raising unemployment and restraining the average collective wage increases to only 1.75% over the past 10 years. In addition, due to the curtailment of fringe benefits and the cost-neutral extension of working hours in various industries via wage contract escape clauses, and with increasingly fewer companies subject to collective wage agreements, a more pronounced negative wage drift ensued, i.e. collective wage growth outpaced effective wage growth. On balance, real wages have risen by a mere 1% annually. In the course of restructuring and modernisation measures, production has expanded at an accelerated rate while unit labour costs have declined. This in turn has had a dampening effect on prices.

Germany: wage trend



Source EcoWin, WestLB Research

Germany: consumer prices



Source EcoWin, WestLB Research

Stronger inflation since the start of 2007

... has come to end for the time being

Like many other countries, Germany saw inflation accelerate considerably last year. In November, the inflation rate climbed to a peak of 3.3%, its highest level since December 1993. The value-added tax increase from 16% to 19% was primarily responsible for driving the inflation rate in the first half of 2007. Based on our calculations, the VAT hike contributed 1 percentage point to inflation. Another inflation driver was the introduction of student tuition fees in several German states. In the second half-year, energy prices rose noticeably on the back of the oil price boom. Food prices eventually rallied strongly as well, having increased only moderately over the previous few years – with the exception of the price hikes of 2001-02 relating to outbreaks of animal disease (BSE/foot and mouth).

But recent decline in German inflation is probably not sustainable

Based on preliminary estimates, the inflation rate declined significantly from 3.1% to 2.4% in April this year; however, while a base effect from tuition fees played a role, the decline was primarily attributable to a seasonal shift in package holidays. We expect inflation to inch back up again as early as May. Another cause for concern is that inflation has become increasingly broad-based. There are currently few, if any, components whose prices are declining. For example, even clothing prices are rising, having declined over a number of years.

Firm euro noticeably held inflation in check

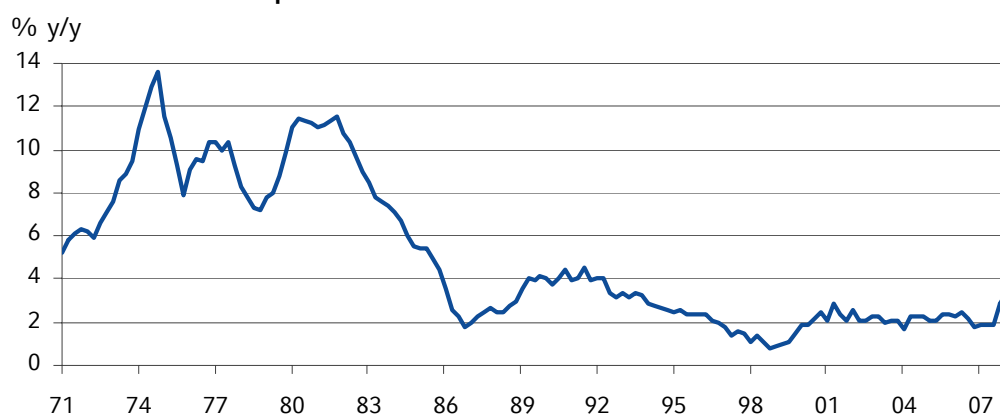
Inflation over the past 12 months would undoubtedly have been even higher had it not been restrained by the firmer euro. Based on the European Commission's calculations, an oil price increase of €1 results in an energy price hike of 0.5 percentage points. If the USD/EUR exchange rate had remained unchanged at 1.35 since the spring of 2007, the oil price in euros would be roughly €10 higher than it actually is, all else remaining equal. This would correspond to an impact of nearly 0.5 percentage points in terms of overall consumer price inflation.

Eurozone inflation rate at 15-year high

Eurozone has likewise experienced an extended period of moderate inflation

Inflation rates in the Eurozone too have remained moderate over the past 10 years. Although inflation, as measured by the Harmonised Consumer Price Index (HCPI), has exceeded the European Central Bank's target level of 2% every year since 2000, it has declined significantly compared to the early 1990s, when inflation rates surpassed 4%.

Eurozone: consumer prices



Source Area-wide model, EcoWin, WestLB Research

Disciplining effect of the single currency

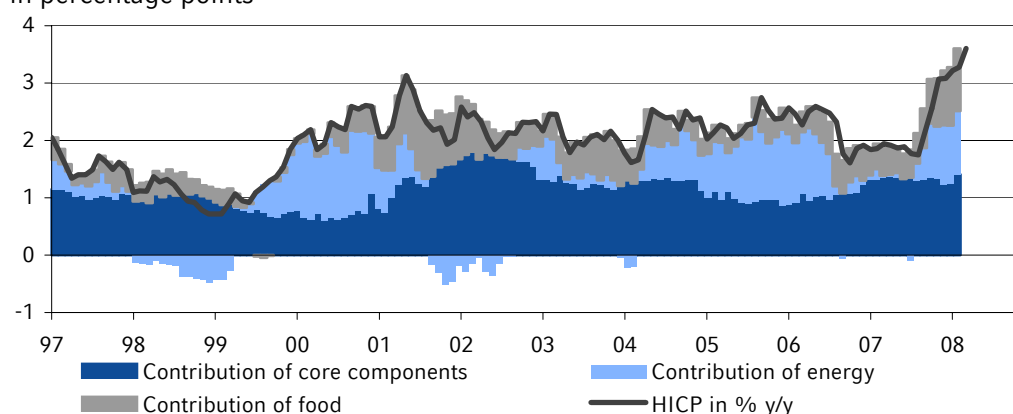
The Eurozone's inflation trend was basically attributable to the same factors as those we have identified for Germany, with wages having increased only 2.3% on average from 1998 to 2007 versus nearly 7% in the early 1990s. This was attributable to the disciplining effect of a single European currency. With depreciation of the domestic currency no longer an option following the introduction of the euro, excessive wage increases translated directly into a loss of competitiveness, contributing in turn to more moderate wage demands by trade unions.

Eurozone inflation recently hit highest level since 1992

However, inflation has accelerated significantly in the Eurozone since in the middle of last year, soaring to 3.6% in March this year, its highest level since 1992. Inflation in March was primarily driven by higher energy and processed food prices. Energy alone contributed 0.8 percentage point to the inflation rate. The impact of the energy component varies considerably among the Eurozone countries, however, depending on its weighting in the respective consumer price indices. In Germany (where the energy component has roughly a 10% weighting in the HCPI), the rise in energy prices has had a stronger impact on consumer prices than in France (with around a 9% energy component weighting) or in Finland (energy component weighting slightly over 7%).

Eurozone: contribution of energy and food prices to inflation

in percentage points



Source EcoWin, WestLB Research

More pronounced inflation divergences in the Eurozone

This factor has contributed to a pronounced divergence of inflation rates within the Eurozone, where inflation dispersion has been stable for years. External developments were responsible for this, however; this should not prove to be a concern to the European Central Bank, particularly as its primary mandate is the maintenance of price stability in the Eurozone as a whole. A more likely cause of concern for the ECB, however, is that inflation in the Eurozone has become much broader based – as it has in Germany. No component has posted price declines. Accordingly, core inflation has moved higher.

Are the ECB's concerns about inflation justified?

Going forward, the overall inflation trend in Germany and the Eurozone will largely depend on energy and food prices. What may be more relevant for monetary policy, however, is whether the latest increase in prices results in second-round effects, in particular whether there will be a stronger pass-through of wages to consumer prices in future. Past experience shows that it is extremely difficult to effectively combat a price-wage spiral once it has begun. An important determinant of inflationary pressure in the medium term is likely to be whether disinflationary effects of globalisation will continue or gradually weaken. Their impact on inflation is by no means a one-way street.

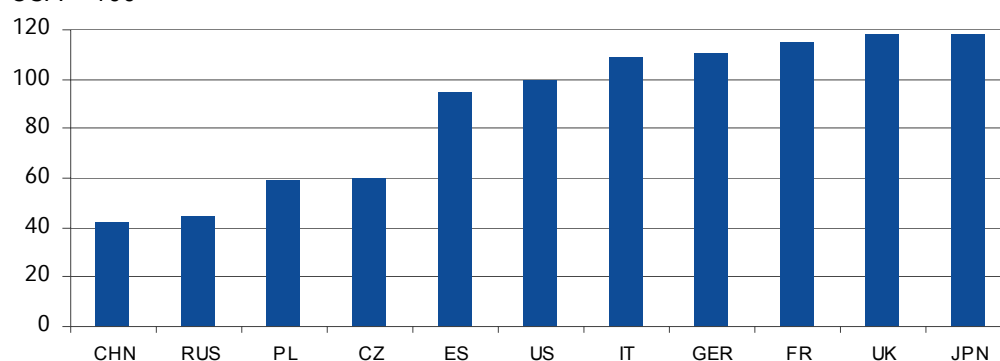
Disinflationary effect of globalisation is ebbing

Rising imports from low-wage countries have curbed inflation

Pronounced globalisation has exerted downward pressure on prices over the past few years. Based on an empirical study of the OECD between 2000 and 2005, for example, globalisation brought worldwide inflation down slightly. This is explained by an increase in imports from low-cost countries, notably China.

Comparative price level of GDP in 2005

USA = 100



Source World Bank, WestLB Research

Impact of trade with China on import price inflation is empirical

In a macroeconomic accounting sense, the impact of trade with low-cost countries on import price inflation in the Eurozone consists of the change in the share of low-cost countries in Eurozone imports, the differential in price levels between low-cost countries and other supplier countries, and the differences in the inflation rates of these groups of countries. However, this calculation would not take into account that increased trade with China has indirect effects, in that stiffer competition from Chinese imports keeps prices in other export countries in the Eurozone from rising. Thus, the overall impact can only be determined empirically through a regression of non-Eurozone import prices on the change in the share of Chinese goods in non-Eurozone imports.

Dampening effect on prices in 2001-05; slightly increasing effect on prices in 2006-07

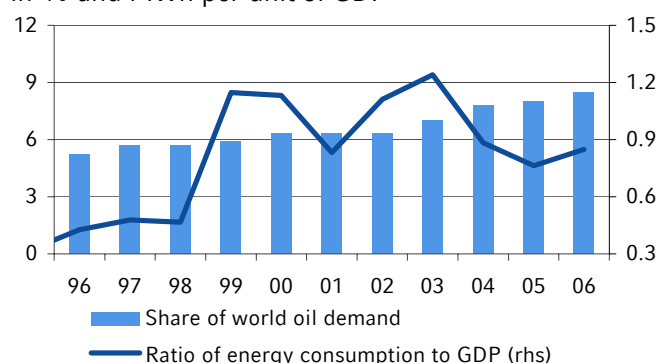
Broken down by individual goods sector, for the period 2001-05 there was a statistically significant negative correlation between changes in the share of Chinese goods in non-Eurozone imports and Eurozone import prices (based on average values). Accordingly, an increase of 1 percentage point in the share of Chinese goods within a single goods sector was linked to a decline in import price inflation of 0.23 percentage point. A look at the same correlation for the period 2005-07, however, shows that an expansion of foreign trade with China no longer triggered a price-dampening effect. Rather, there was actually a statistically significant, slightly positive effect, so that an expansion of 1 percentage point in trade with China within a single goods sector was linked to an increase of 0.06 percentage point in import price inflation. This is attributable to relatively high increases in prices of Chinese imports, with a resulting overcompensation of the pure volume effect that exists due to the still considerable price differentials between China and other supplier countries.

Conclusion: price-dampening effect has clearly weakened

However, it should be noted that the import prices used in our analysis are average value indices, which are calculated by applying the price of a good to the volume, usually in terms of weight. If – which is the more likely scenario – the quality of the imported good improves and there is no impact on the weighting, then the price increase of that import is overstated. It can be claimed with relative certainty, however, that the price-dampening effect of an expansion of trade with China has been diminishing for some time.

China: energy consumption

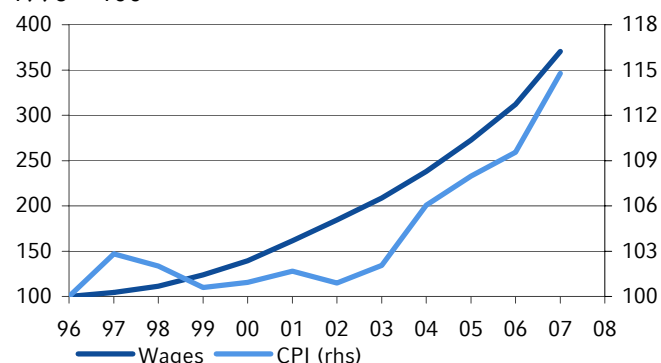
in % and MWh per unit of GDP



Source EcoWin, WestLB Research

China: wage and price trends

1996 = 100



Source EcoWin, WestLB Research

China's energy efficiency in decline

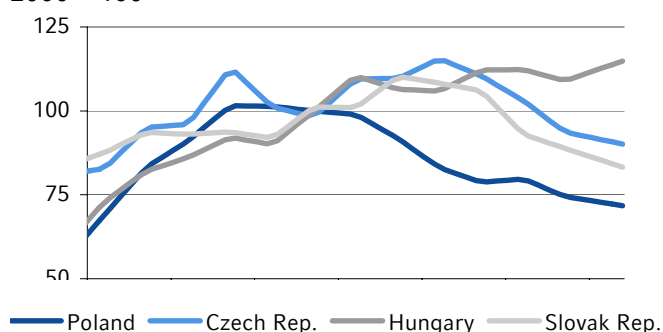
One explanation for the unwinding of the price-dampening effect of globalisation is the high demand for commodities and energy on the part of developing countries, which has resulted in sharp price increases in those markets. In the case of China, for example, energy efficiency has actually declined over time, i.e. in contrast to the usual pattern of development in emerging markets, China requires more energy today in order to achieve the same level of output that it produced 10 years ago. This can be explained in terms of the importance of heavy industry in China.

The Balassa-Samuelson effect

Another explanation of the unwinding of the price-dampening effect is that developing countries are now exhibiting high inflation rates relative to industrialised countries. This is because emerging markets are experiencing extraordinarily high productivity growth in the traded goods sector, whereas wage demands in the non-traded goods sector are based on wages in the traded goods sector, as otherwise workers would migrate from the former sector to the latter. Relatively high wage increases are passed through by companies in the form of higher prices (the Balassa-Samuelson effect).

CEE: unit labour costs in industry

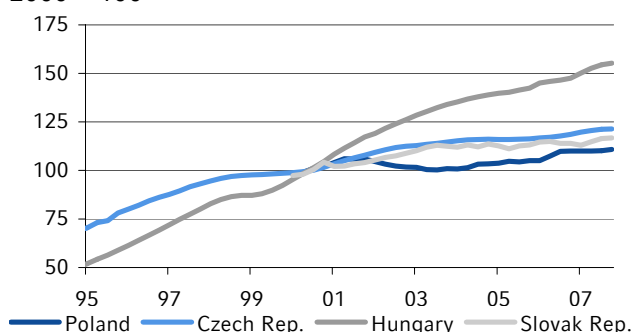
2000 = 100



Source EcoWin, WestLB Research

CEE: unit labour costs in the overall economy

2000 = 100



Source EcoWin, WestLB Research

Oil price at previously unimagined highs**Energy to remain expensive**

Since early 2007, the price of crude oil (for benchmark Brent grade) has not only doubled but has almost effortlessly passed the US\$100/barrel level, a development that was unthinkable but a few years ago. Owing to the continued upward trajectory of the European single currency, the price increase in euros amounts to what is almost a 'modest' 70%.

Oil price significantly higher than 'justified by fundamentals'

The latest oil price surge is closely related to the enormous demand of developing countries for energy, which has contributed to the price of crude oil 'as justified by fundamentals' being significantly higher today than in previous years. Speculation, geopolitical risk premiums and the prevailing financial market crisis have also played important roles. Investors on the lookout for safe investment opportunities are not only investing in gold but are increasingly turning their attention to commodities as well, with oil, the most liquid commodity market, benefiting the most.

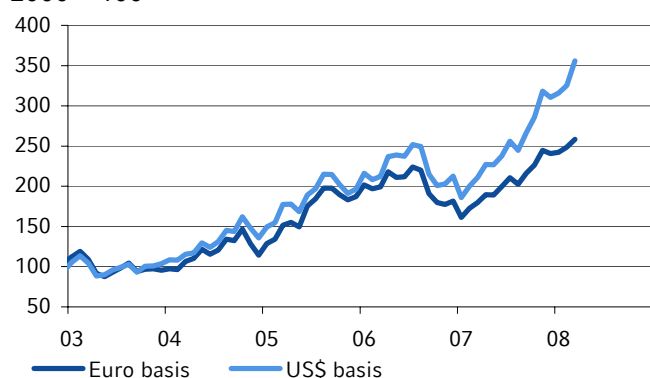
Decline in oil prices still likely

...

While a number of factors suggest that oil prices will remain high, we still believe it is more likely that prices will fall later in the year. This would have a positive impact on the trend in fuel and heating oil prices, although the year-on-year inflation rates in this sector may initially continue to climb.

Prices of Brent crude per barrel

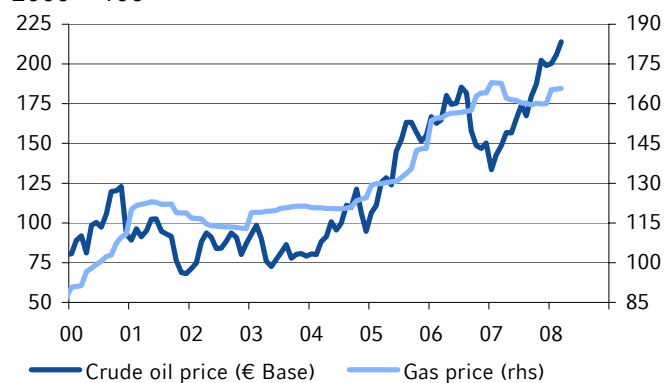
2000 = 100



Source EcoWin, WestLB Research

Crude oil and German gas prices

2000 = 100



Source EcoWin, WestLB Research

... but energy prices will continue to rise

However, prices of electricity, gas and other fuels may still have some way to go before they peak. Based on past experience, the price increases already announced for April and May will probably be followed by further hikes in autumn. This would lead to a sharp rise in energy prices this year, even if crude oil prices decline in line with our forecasts. Energy price inflation in Germany could reach 8% this year followed by 3.5% in 2009. For the Eurozone as a whole, we project growth in energy prices of almost 7% in 2008 and 2.5% in 2009. The rates vary between Germany and the Eurozone due to the different weightings of energy in the basket of goods, and because of the different levels of competitive intensity on between the two energy markets. If, contrary to our forecasts, crude oil prices do not fall, or even continue to rise, energy inflation rates could be considerably higher.

The new phenomenon of 'agflation'

Soaring food prices

Food prices around the world have been rising since last autumn. This has created unrest in some developing countries and emerging markets, where food is now barely affordable for many people. Food prices in Germany were 8.6% higher in March than in the same period a year earlier; this increase roughly equates to the total rise in prices between 1997 and 2007. Food prices in the Eurozone have increased by over 6% within the year.

Surge in food prices mainly driven by demand

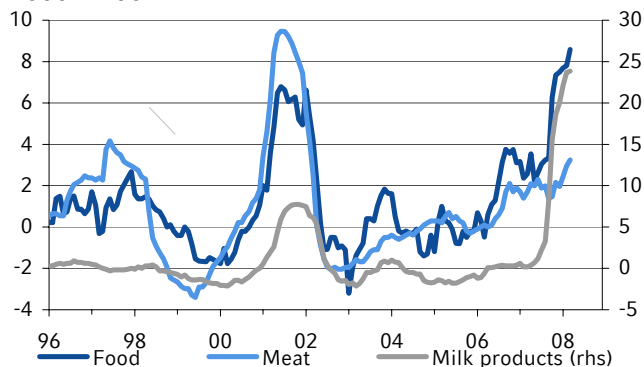
In contrast to the spring of 2001, when food prices soared due to the BSE and foot and mouth epidemics, the current surge in prices is not attributable to a classic supply shock, but seems to stem from pressure on the demand side. This is mainly due to the factors listed below.

Growing population

- Population:** The global population is constantly growing. At the same time, crop areas for food production are receding and arable land is being used increasingly for meat production. Cattle breeding in turn is driving up demand for crops to a substantial degree, as it is more crop-intensive than poultry farming, for example.

Germany: prices for selected foods

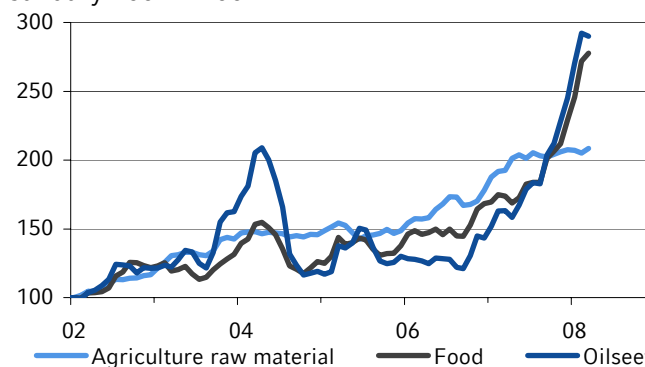
2000 = 100



Source EcoWin, WestLB Research

Prices for food and agricultural commodities

January 2002 = 100



Source EcoWin, WestLB Research

Greater demand from developing countries, in both quantitative and qualitative terms

- Catch-up process in developing countries:** Rapid growth in many emerging markets has been reflected by growth in incomes. As levels of wealth increase, there is not only greater demand for food, but also changes in eating habits. Demand for meat, for example, is soaring in many countries, and this requires increasing quantities of crops and other types of animal feed. Demand for foods that are widely available in industrialised countries, such as dairy products, is also rising.

Agricultural commodities increasingly used for biofuels

- Production of biofuels:** Agricultural commodities have been used increasingly in the production of biofuels in recent years to reduce dependence on crude oil and to contribute to climate protection at the same time. Cultivation of these commodities (e.g. soya, maize and sugar cane) as substitutes for oil is squeezing traditional farming. This trend has been encouraged by subsidies that are being widely offered for biofuels. The EU has set out binding targets for the use of biofuels, which are to constitute 10% of overall petrol and diesel consumption by 2020. According to calculations from the Federal Environmental Agency, half of Germany's entire agricultural land would have to be used for rape cultivation in order to increase the share of biofuel usage to just 5%. The International Grains Council estimates that global use of crops for energy purposes will rise by almost 25% this year.

Upward spiral in food prices has begun

The effects of advancing climate change are exerting additional pressure on prices. Increasingly warm, dry summers are pushing up the costs of growing crops. Droughts and weather-related catastrophes are leading to crop shortfalls and loss of land. Moreover, commodities have become an increasing focus for investors as their high price growth offers attractive returns. The surge in prices of many upstream products (e.g. seed, fertilisers and pesticides) in response to these developments has triggered an upward spiral that could stoke inflation pressure even further.

Increase in supply unlikely before the medium term

Many of the countries that are particularly affected by higher food prices have reacted by placing restrictions on exports in a bid to halt the upward price spiral. However, this is not a reliable solution. Rather, it could exacerbate food shortages, because incentives to farmers to increase their crop production will recede. In addition, in contrast to a classic supply shock, the situation of high food prices may not change significantly in the short term as it is not possible to expand currently scarce supplies before the medium term at the

earliest, because production can only be boosted by increasing yields, due to the short-term scarcity of farmland in the majority of export countries. However, the prospects of this happening are very limited without appropriate spending on research and development, which in any case will only have a medium-term effect. Consequently, inflation from the agricultural sector, known as 'agflation', is unlikely to diminish significantly in the years ahead.

High pressure on upstream prices

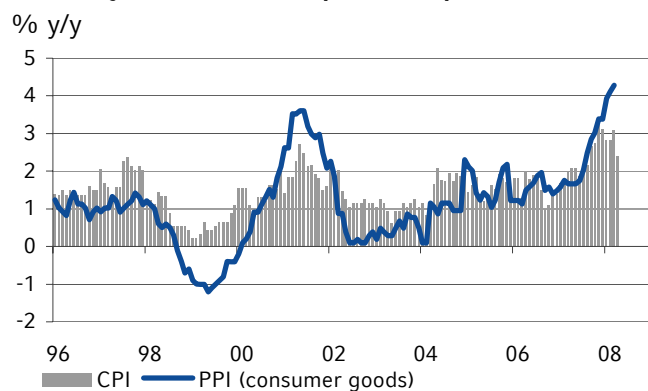
Climbing prices for crude oil, other commodities and food have noticeably increased pressure on upstream prices of late. Both import and producer prices have risen palpably as a result of higher commodity and energy prices, though – as is the case for crude oil – the firm euro has prevented a far stronger surge in prices in Germany and the rest of the Eurozone. In the first quarter of this year, for example, global market prices for commodities were up by almost 60% in dollar terms compared with the same period a year earlier, but the rise on a euro basis was 'merely' 37%. At present, however, there is little evidence that this situation will ease on the global commodity markets.

Strong rise in import and producer prices

Pass-through to consumer prices likely

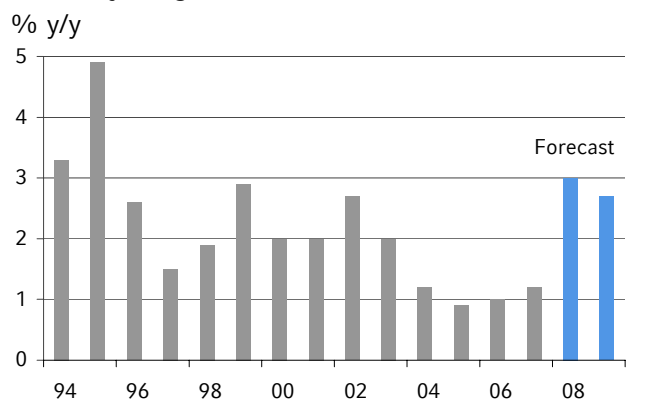
The fact that consumer goods as well as energy have become more expensive raises concerns for the future trend in consumer prices. Given the increasing pressure on profit margins, it can be assumed that companies will at least partly pass on higher production costs to consumers.

Germany: consumer and producer prices



Source EcoWin, WestLB Research

Germany: wage increases



Source EcoWin, WestLB Research estimates

Wage pressure increasing again after lengthy period of restraint

The end of wage restraint in Germany

As we have pointed out above, one of the main reasons for the limited rise in prices in recent years has been moderate wage growth; this is something that may not prevail indefinitely. Indeed, it is becoming increasingly clear that wage pressure on companies is rising again. After a very unfavourable situation in recent years, conditions for employees and trade unions in negotiating pay increases have improved, since unemployment has started to fall and has given way to a growing shortage of skilled staff. In addition, the political climate in Germany has changed, as commitment to reforms has waned and calls for higher wages are being met with widespread public acceptance.

Unions have the power to achieve higher collective pay deals

As the prevention of strikes has been the main priority for companies in many sectors because of their full order books, unions have succeeded in concluding unexpectedly high pay deals that far exceed those of previous years in this year's pay round. Usually, pay settlements equate to half of the demands made, with upward or downward variations depending on economic performance and company profitability.

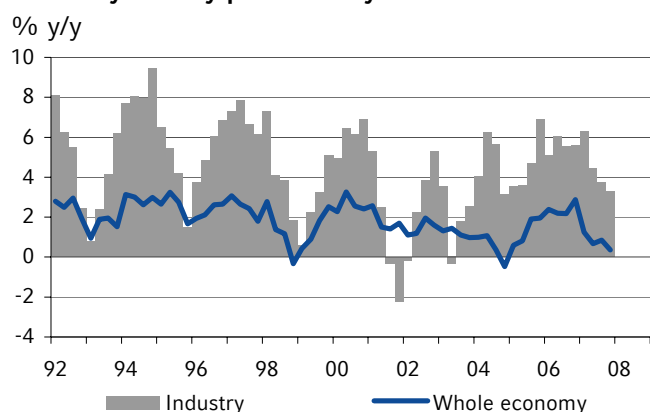
Current wage round is not untypical of the latter phase of an upswing

The trend towards significant pay rises for the majority of employees that began in the 2007 wage round has therefore intensified. As a result, new pay deals are likely to reach 4% compared with around 3% last year. The current wage round largely reflects the healthy economy and the profitability of companies; it is therefore not untypical for the current phase of the economic cycle. However, it should also reflect the need to make up for the sacrifices of the restructuring period.

Highest wage growth since the mid-1990s

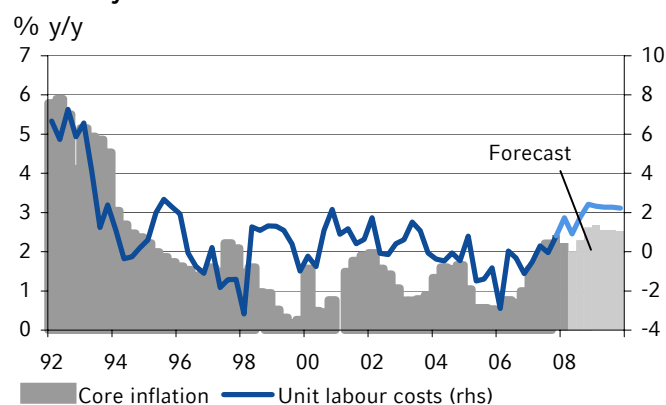
In addition, wage drift – i.e. the gap between trends in real and collective wages – has recently turned positive from the perspective of employees. With a shortage of skilled staff in many sectors, which is increasingly perceived as a hindrance to production, many companies will inevitably have to pay premiums to collectively agreed wages for suitable candidates when filling vacancies. Taking account of the generally lower pay settlements in the past, wages may increase by some 3% this year. This would be the highest rate of growth since the mid-1990s.

Germany: hourly productivity



Source EcoWin, WestLB Research

Germany: unit labour costs and core rate



Source EcoWin, WestLB Research estimates

Unit labour costs are the crucial variable

When assessing the value of pay agreements from a cost perspective, it is important to consider not only the percentage rise in wages, but also whether the cost increases can be offset by corresponding productivity gains. Unit labour costs are therefore the crucial variable. The drop in unit labour costs enjoyed during recent years is unlikely to be repeated this year or in 2009.

Rise in unit labour costs is probably inevitable

Productivity growth tends to soften in the latter phase of an economic upswing, such as that currently underway in Germany, which means that acceleration in unit labour costs is virtually inevitable when wage pressure is high. In a few sectors, particularly the highly capital-intensive areas of the industrial sector, productivity growth should remain strong enough to prevent an increase in unit labour costs. However, this does not apply to the economy as a whole: the pay deal in the public sector was substantial, and productivity gains will be very moderate at best.

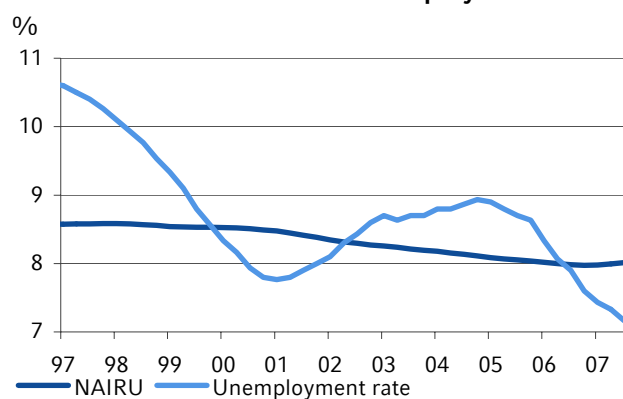
Core inflation driven by pass-through of wage costs to prices

We very much doubt that companies will allow their profit margins to bear the full burden of rising unit labour costs, particularly as pressure on margins is already high due to the rising commodity costs and the firm euro. This is exacerbated by the fact that production at many companies has been straining at the limits of capacity for some time. In this setting, we expect that they will at least partly pass the upward pressure on wages on to customers. The higher prices triggered by the uptrend in energy and food prices are likely to become established and to filter through to higher core inflation.

Risk of second-round effects in the Eurozone

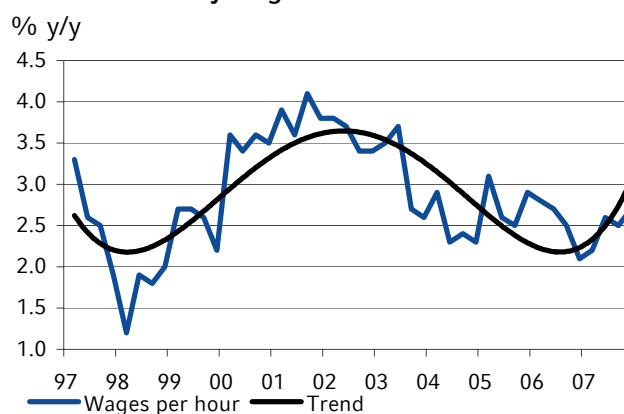
The current economic upswing has led to an impressive uptrend on the labour market throughout the Eurozone. The unemployment rate has dropped by almost 2 percentage points to 7.1% of the working population over the last two-and-a-half years, which is the lowest level in the history of the HCPI.

Eurozone: inflation-neutral unemployment rate



Source EcoWin, WestLB Research estimates

Eurozone: hourly wages



Source EcoWin, WestLB Research

Unemployment already below the inflation-neutral level

As unemployment is extremely low in the Eurozone, there is a risk of wage increases exceeding the distributionally neutral level. To estimate the potential inflationary pressure stemming from the labour market, however, unemployment has to be broken down into its economic and structural components, the latter known as the Non-Accelerating Inflation Rate of Unemployment (NAIRU).

NAIRU fell in the Eurozone between 1995 and 2007

The interrelation between the unemployment rate and the NAIRU generally restricts phases of fiscal policy leeway from those in which supply-side measures are the only means of lowering employment. Our estimate of the NAIRU in the Eurozone, having taken account of supply-side inflation factors such as the trend in the oil price and the exchange rate, indicates that it dropped by some 0.5 percentage point between 1995 and 2007 due to labour market reforms in member countries, and that it currently stands at some 8% of the working population. However, it also shows that unemployment has been lower than its inflation-neutral level since early 2007, a factor that is crucial for assessing inflation risks. Accordingly, there are signs of overheating in the Eurozone in the form of high wage increases.

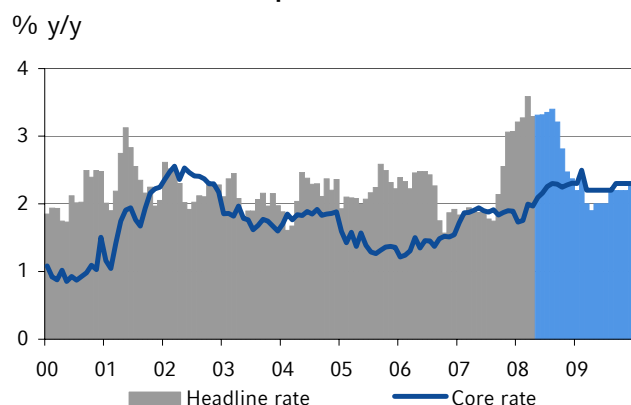
Accelerated rise in wages

This trend is already evident from the wage data in the Eurozone. Hourly wages have been subject to acceleration since early 2007, climbing by 2.7% y/y in Q4 2007. Although this is still far beyond the wage trend in the boom year of 2000, further increase in wage pressure is likely this year in some member countries, particularly Germany, due to the pay settlements agreed so far. Productivity growth may slow, as is typical during the latter phase of an upswing, and this would drive up unit labour costs even further. Signs of inflationary pressure in the economy because of the tight labour market will present a new challenge for the ECB.

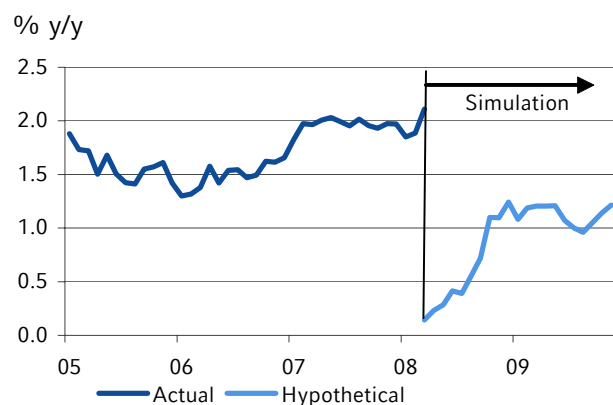
No prospect of inflation falling below 2% at present

Drop in inflation to below 2% is currently not in sight

We currently see little prospect of inflation sliding below 2% this year; this applies to both Germany and the Eurozone as a whole. Based on our energy price forecasts (see p. 8) and on expectations that food prices will climb by some 5.75% this year and around 4% next year, we have estimated the maximum permissible rise in the other components (i.e. core inflation) for the Eurozone inflation rate at slightly below 2%.

Eurozone: consumer prices

Source EcoWin, WestLB Research

Eurozone: simulation for the core rate*

*) Core rate trend required for the overall rate to reach 2% based on the forecast for energy and food prices.

Source EcoWin, WestLB Research

ECB's price target unlikely to be reached this year or in 2009

We believe this would be moderately feasible for end-2008 at the earliest. However, core inflation would have to be no more than 1.25%, which is lower than its current level. This seems ambitious to us, given rising wage pressure and the waning of the price-curbing effect of globalisation. Realistically, therefore, we believe an inflation rate of less than 2% is unlikely to be attained until around mid-2009. The annual inflation rate for 2008 may average 2.7% in Germany, compared with our forecast of 3.1% for the Eurozone. The average inflation rate will almost certainly breach the ECB's target next year as well.

However, what may weigh even more heavily is that the stronger pass-through of wage costs to consumer prices, and the receding disinflationary impact of globalisation, will increase general inflationary pressure (core inflation).

The consequences for monetary policy and bond yields

It is becoming harder to keep inflation expectations in check; central banks must increase their efforts to stabilise prices

Central banks are powerless in the short term to counter supply shocks such as a drastic rise in energy and food prices. However, they must ensure that inflation expectations do not rise, a task that we believe will become increasingly difficult. Central banks will have to step up their efforts to maintain price stability in future, based on the premise that the disinflationary effects of globalisation are gradually waning. While a feasible alternative would be to allow slightly higher inflation, we see virtually no prospect of the ECB raising its inflation target. A debate over whether 2.5% or 3.0% is the correct level for inflation would open a Pandora's box that would be impossible to close. The result would be increasing inflation expectations, which in turn would fuel inflation. This would mark a return to the unstable conditions of the 1970s. The alarming experience of inflation in this period has made a lasting impression on most of today's central bank officials, making a repeat of this trend unattractive and unlikely.

Independent central banks undoubtedly have the capacity to ensure price stability, even in an environment of advancing globalisation. Ultimately, they must raise key rates 'only' far enough to keep overall economic demand, the labour market, inflation expectations, wage increases and inflation in check. This is usually at the cost of an economic slowdown, if not a recession ('stabilisation crisis').

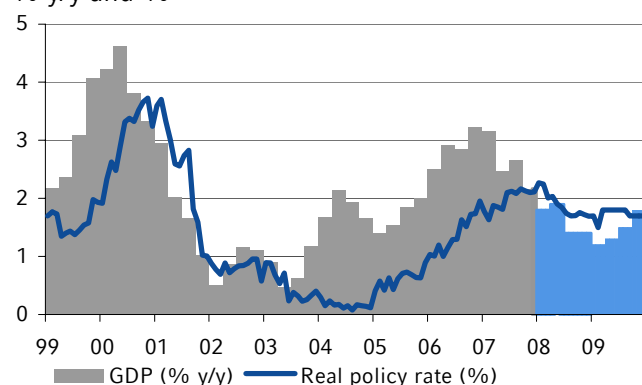
The correlation between volatility in the domestic economy and the general price trend has probably weakened slightly in the Eurozone because of globalisation. This means that, to combat excessive inflation, a greater economic slowdown and tougher intervention from the ECB are required. A forward-looking monetary policy geared towards stabilising inflation expectations is therefore all the more important. The ECB's repeated warning of 'second-round effects' with regard to wage and fiscal policy may seem like a mantra at times, but is ultimately aimed at avoiding a fatal conflict with monetary policy.

Are central banks having a less significant impact on the long end?

The interest rate channel, which is probably the most important conduit of monetary policy, extends from key rates across the entire interest rate spectrum to long-term bond yields. Whether the central banks' impact on long-term bond yields is receding due to the growing interdependence of the world's national economies via capital flows is open to debate. Such a development is suggested by, for example, the period between mid-2004 and mid-2006, when the yield on 10Y US Treasuries failed to rise despite substantial rate hikes by the Fed (Alan Greenspan's 'conundrum'). If a central bank's influence over the long end of the maturity spectrum diminishes, the bank has to raise key rates more significantly to achieve the desired effect on the average level of interest rates.

Eurozone: growth and real key rate*

% y/y and %

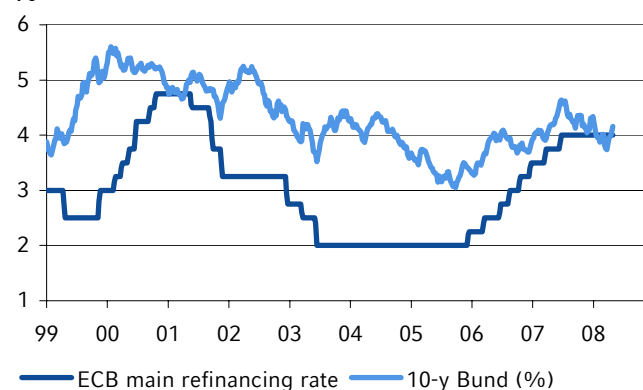


* main refinancing rate
– HCPI core rate

Source EcoWin, WestLB Research estimates

ECB key rate and 10Y Bund yield

%



Source EcoWin, WestLB Research

ECB: slightly more restrictive policy overall in future ...

Having considered the factors affecting inflation, we believe that the ECB will pursue a more cautious policy of higher key rates in the next few years and will move only very gradually towards a highly expansionary policy. In terms of the current situation, this means that the economy will have to weaken substantially (i.e. to a greater degree than we currently expect) in the coming months for the ECB to cut rates. The degree of expansion in monetary policy can be roughly measured according to the difference between real economic growth and the real key rate. We project that the real key rate will exceed the real economic growth rate in 2008-09 – in contrast to what happened in the 2004-07 period.

... to rein in inflation expectations

Will the ECB succeed in curbing inflation expectations even if conditions become more difficult? It will not be easy, particularly as the rise in energy and food prices is not a temporary shock, but a trend. Assuming that food and energy prices climb by 3% annually, prices of other components of the HCPI would have to increase by no more than 1.6% p.a. in order to keep overall inflation below 2%. If energy and food prices rise by 5% annually, the core rate would have to be only 1% to ensure the inflation target is met.

10Y Bund yields trending at 4.5%

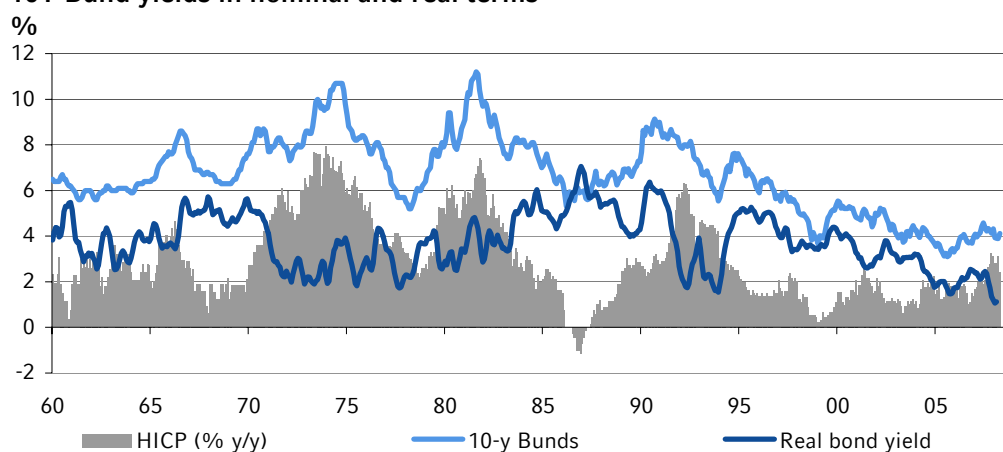
We are confident that the ECB will continue to keep inflation expectations in check. Consequently, we do not expect long-term bond yields to rise massively. The yield on 10Y Bunds has averaged 3.9% since 2003. Assuming that the inflation risk premium within the long-term yield increases slightly, we consider 4.5% to be a good middle-of-the-road estimate for 10Y Bund yields. This forecast is based on our assumption of economic growth in the Eurozone trending at 2%, and expected average inflation of 2%, in line with the ECB's target. The fluctuation range for the yield may be 3.5-5.5% in a normal economic cycle.

2007: 10Y Bund yield heading towards 5% - until the subprime crisis arrived

Short-term yield outlook – determined by the financial markets crisis

Bond yields barely reflect the high inflation rate and the various inflationary risks at present. Prior to the financial markets crisis, 10Y Bund yields traded at almost 4.7%, and were in our view heading towards the 5% mark. The flight to safe havens by many investors and the bleak economic outlook then pushed yields lower in both real and nominal terms.

10Y Bund yields in nominal and real terms



Source WestLB Research, Ecowin

Long-term bond yields likely to rise when the financial market crisis is over

Real bond yields at the current level of less than 1.5% have not been a lasting phenomenon in the past. They tend to rise due to rising nominal yields or falling inflation rates; we expect a combination of the two. The (headline) inflation rate in the Eurozone may retreat towards 2.25% at the end of the year, in our view. The short-term trend in nominal yields will greatly depend on how the financial markets crisis unfolds. As we saw in mid-April, bond prices have been weighed down by signs of relief in financial markets. Bond yields are likely to rise as soon as an end to the crisis is in sight. However, we do not expect this in the coming weeks or months. Moreover, the foreseeable economic slowdown and speculation over possible ECB rate cuts may curtail any uptrend in yields. We expect 10Y Bund yields to reach 4.3% at the end of this year. However, once the economy has regained its footing next year at the latest, the ECB will probably make up for lost time with the rate hikes it would have implemented last autumn if the sub-prime crisis had not arrived. Accordingly, we certainly see scope for 10Y Bund yields to head back towards 5% next year.

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