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Comeback of the year

Private consumption in Germany



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Executive summary

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- The weak growth in the German economy over the last few years has been largely due to a stagnation in wages and private consumption. This has had important consequences:
 - Tax receipts have lagged significantly behind budget and forecasts, with the result that Germany has repeatedly missed the targets set by the stability pact.
 - Social security receipts have also been poor, so contribution rates have had to be raised, undermining moves to make labour less expensive.
 - On the other hand, the weak macro-environment in Germany has caused interest rates and yields in the European currency union to fall to historic lows. This has supported corporate investment in particular.
 - Globalisation-induced wage restraint also allowed companies to clean up their balance sheets and earn record profits, which has been rewarded on the equity markets.
- In 2006 private consumption rose in Germany for the first time, mainly because the labour market stabilised. Politicians, central bankers and financial markets are today faced with the question of whether this is just a temporary intermezzo or the start of a lasting improvement. If the latter is the case we are likely to see a reversal in the reaction to the earlier weakness; in other words, there is a risk that interest rates and yields could return to their long-term trends. This would cast doubt on companies' ability to continue to generate strong profits growth without provoking a reaction from the unions.
- This study examines longer-term trends in German private consumption and the factors which influence it, and particularly looks at the origins of the weakness in the income and expenditure of private households between 2002 and 2005, drawing conclusions for the outlook over the next few years.
- The good news is that our results suggest the recent period of exceptional weakness is indeed over and that we can expect consumption trends in Germany to return to normal. Retailers in particular should benefit after a long period of difficulties. This does not, however, mean that we can now expect a multi-year reaction in consumption, with sustainable above-average growth.
- As long as the global economy supports German exporters and hence the labour market, the uptick in consumption will probably continue; but in the medium term it is important to remember that key structural problems remain unresolved – most notably how to finance the welfare system, which is based on transfer payments. The progressive ageing of the population and the loss of technological advantages over the emerging markets are likely to limit potential growth in the German economy and the labour market in particular – and hence in private consumption.

- For the ECB, this scenario means that a tighter monetary policy is initially called for, particularly if growth in 2007 accelerates despite the German VAT hike and the unions push through notably higher pay rises. This process should be seen as a normalisation of the interest rate level and is unlikely to extend beyond neutral territory. On a twelve-month horizon, we look for a key rate of 4% in the Eurozone, with risks currently tilted to the upside.
- In this environment domestic economic factors might lead us to expect rising yields, as a flat yield curve hardly looks compatible with a return to growth. In our view the external picture, characterised mainly by a rising euro and a gentle slowdown in global growth, will have the greater influence on the long end of the curve and keep yields near their current level.
- The effect of the scenario we describe on company profits and how these are valued on the equity market is likely to be interesting. It will probably be hard to achieve further big cuts in labour costs; at the very least, Germany will not stand out in this regard over the next few years in the same way it has done recently. Any restructuring premium that may have been priced into the German equity market is likely to unwind.

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Completed on: 3 April 2007

Editorial

Positive growth surprise due to consumption rebound

There is much talk these days of the German economy rising like a phoenix from the ashes, now that we have had several months of positive growth surprises. This is due not least to the unexpectedly sharp recovery in consumption, which emerged last year from a four-year period of stagnation.

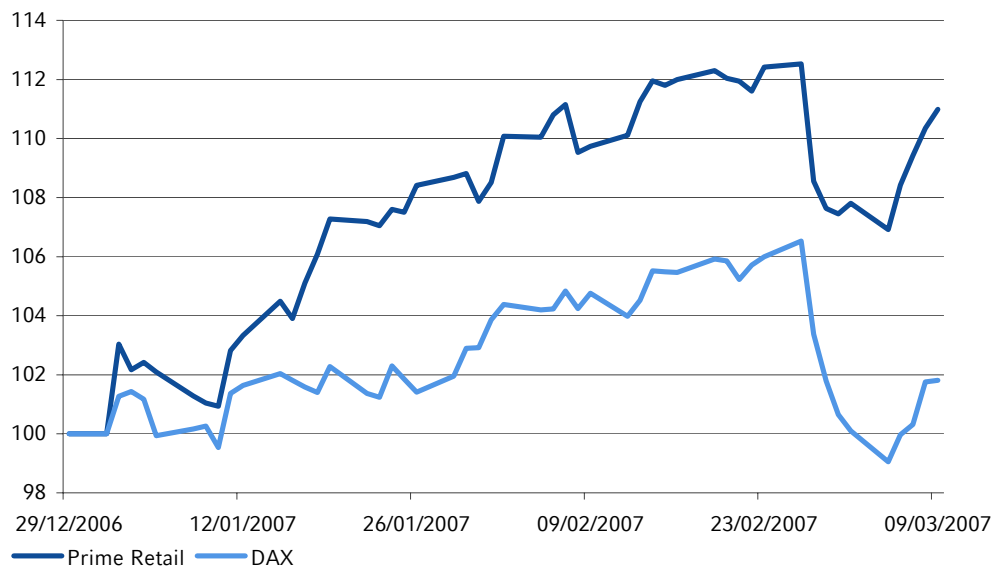
Ever since then forecasters have been falling over each other to move their growth projections up. Until just a few months ago the consensus amongst economists was that there would be a brief consumer recession due to this year's VAT hike, but now we are seeing GDP forecasts of up to 2.8% – these imply solid consumer growth this year despite the fiscal squeeze on households.

Retail share performance indicates sustained improvement

So are we seeing the end of a period where German consumers were written off? Or is this just a flash in the pan that will die out as soon as it started, unless it gets something to feed on? Certainly the performance of German retail shares suggests that plenty of people are counting on a sustainable improvement in private consumption.

DAX vs. Prime Retail

29/12/2006 = 100



Source EcoWin, WestLB Research

Normalisation of consumption trend

This study presents a detailed analysis of recent German consumption trends and sets out the prospects for the future. Our outlook is positive to the extent that we expect growth in income and consumption in Germany to return at least to trend, and even see the potential for short-term overshoot.

However, we also conclude that this happy macroeconomic scenario will bring serious challenges for investors. Firstly, what we are currently seeing is part of an economic cycle. Corporate profits do not tend to grow very rapidly at the stage of the cycle because the cost base increases. Secondly, it is hard to assess the impact of a 'special German cycle' on the financial markets because the global economic picture is likely to be slowing down. Finally we have to remember that a resurgence in the German domestic economy will also have far from welcome consequences for the ECB and the bond markets. Despite all these caveats our recommendation on how to deal with the present upturn is: **'make hay while the sun shines'**.

'Make hay while the sun shines'

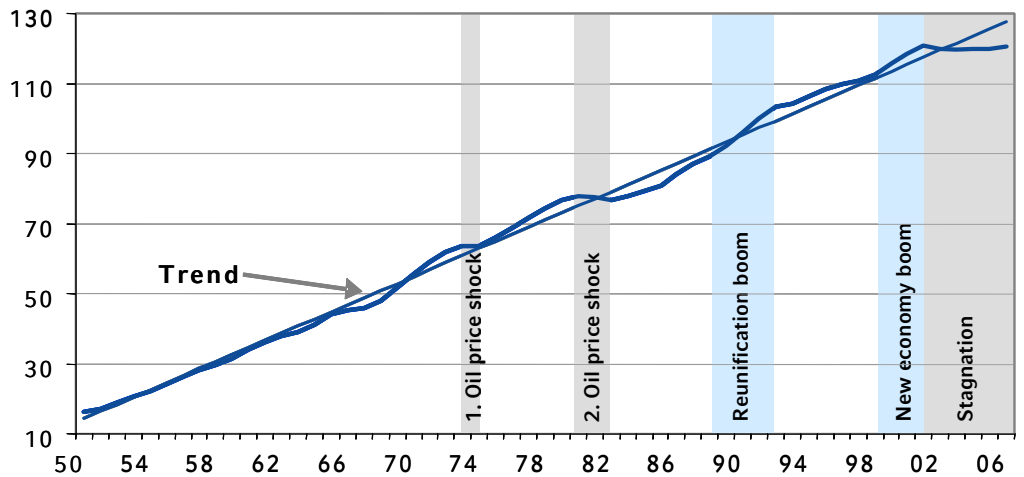
Look back in horror

Phases of weak consumption are not unusual

At first glance the trend in German consumption since the war looks linear. There were repeated periods of weakness but until the end of the 1990s these were compensated by episodes above the long-term trend.

Real consumption

1991=100



Source EcoWin, WestLB Research

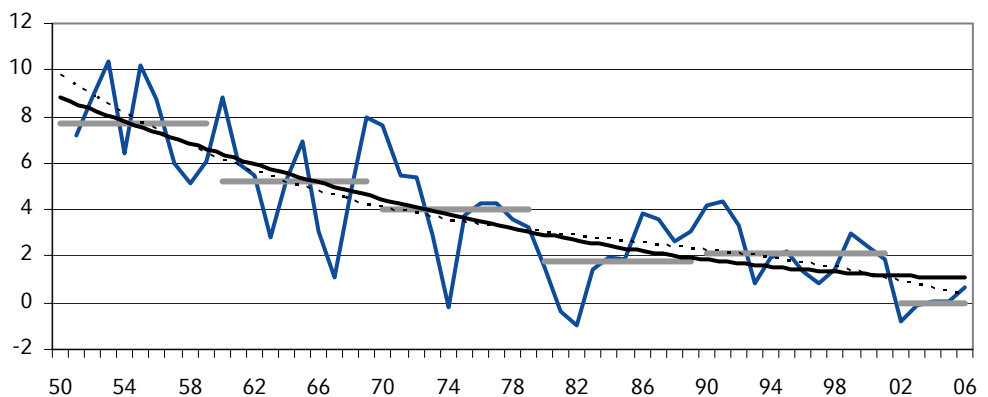
Cyclical trend dominated by shocks or special events

However, contrary to first impressions the trend is not always one of 'normal' cycles but is often marked by large economic shocks or structural changes. The weak periods in 1974 and 1981/82 for example were largely due to oil price shocks, which cut the real purchasing power of private households via rising consumer prices. In the other direction, reunification at the start of the 1990s and the New Economy boom at the turn of the century pushed consumption into overdrive.

Simple mathematics tells us that the almost linear long-term trend means the level of growth in consumption has steadily weakened. Various fundamental reasons might lie behind this, for instance rising satiation in the population as wealth increases (which can be observed in the USA and elsewhere – see chart on next page) or slower growth in the population, to name but two.

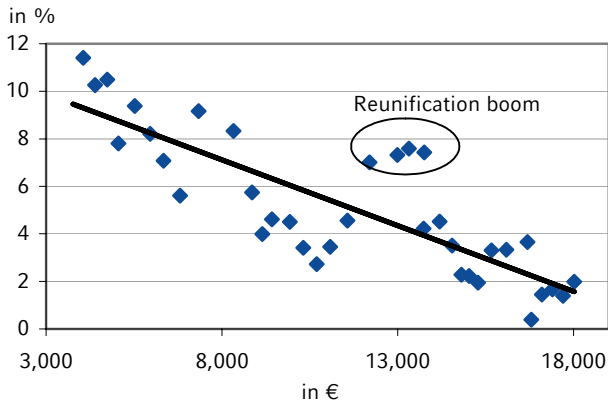
Trend growth in consumption slows

% y/y



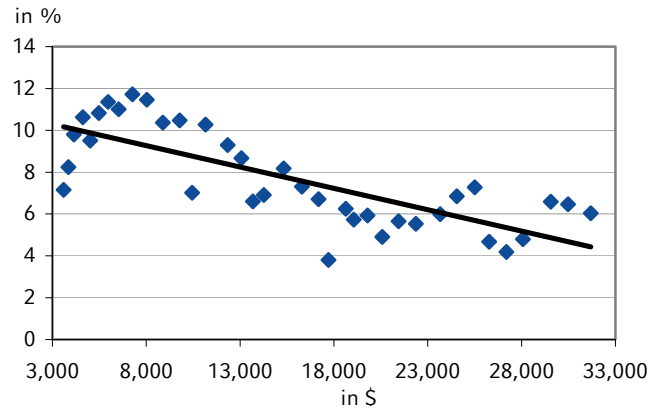
Source EcoWin, WestLB Research

Consumption as % y/y and disposable income per inhabitant in Germany in €



Source EcoWin, WestLB Research

Consumption as % y/y and disposable income per inhabitant in the USA in \$



Source EcoWin, WestLB Research

Does weak consumption in 2002 and 2005 exhibit a structural break?

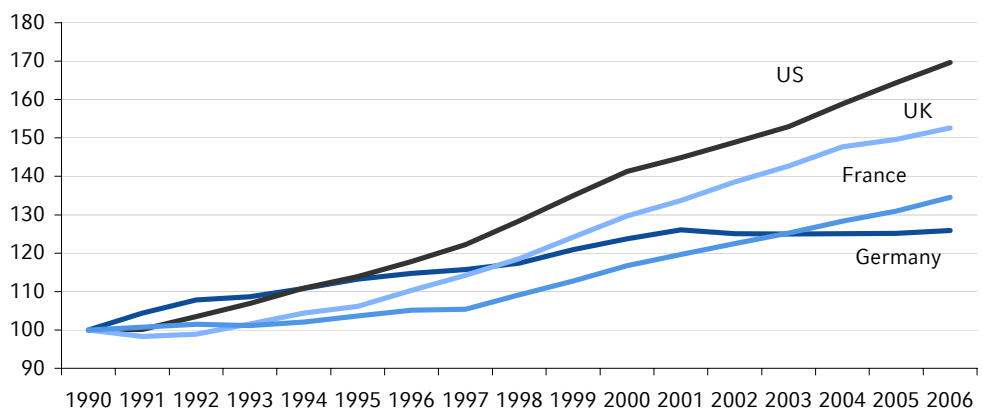
It is often said that the weakness in consumption from 2002 – 2005 was a structural turning point and resumption of the historical trend is unlikely. The purely statistical evidence is ambiguous. While it is true that consumption deviated further from its long-term trend than ever before (see upper chart on previous page), growth rates had in the past deviated from their long-term trend even more.

The answer is statistically unclear

Note that because of the weaker trend in consumption, even small movements downwards are sufficient to give negative rates of change (as in 2002 and 2003). In addition, depending on how the trend is modelled one can indeed speak of a break in the last five years (the broken line in the lower chart on the previous page is a third degree polynomic trend, which has weakened sharply since the end of the century). These two factors plus the length of this period of weakness could explain why the consumer weakness at the start of the decade was felt more sharply than in previous periods.

Private consumption

1991=100

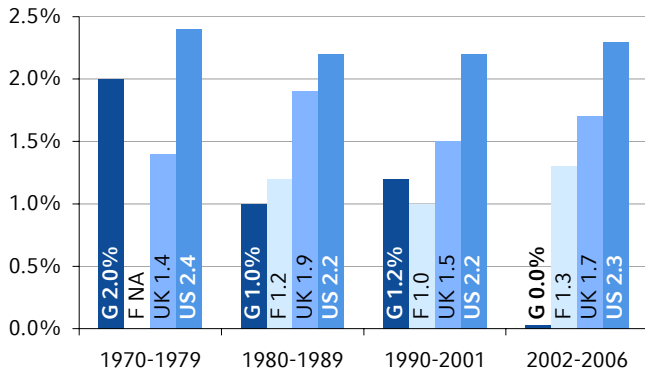


Source EcoWin, WestLB Research

Sluggish consumption in Germany marks an exception on an international scale

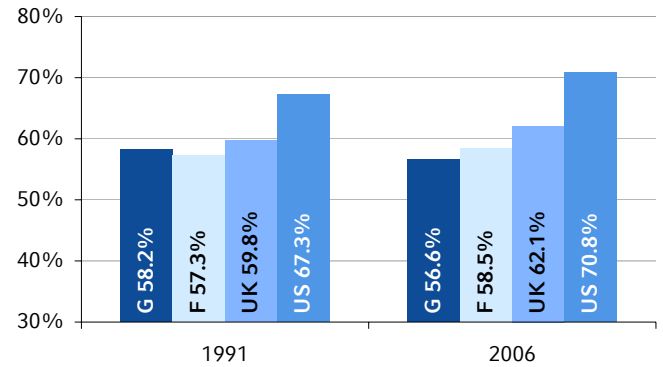
Another explanation could come from comparing international consumption trends. As the previous chart shows, Germany did indeed show its own particularly weak special trend, starting in 2002. In the other countries examined the prevailing trends remained largely stable; in the USA consumer growth even accelerated after 2003 (we shall discuss the reasons for this in more detail later).

Growth contribution from consumption
in percentage points



Source EcoWin, WestLB Research

Consumption share
as % of GDP



Source EcoWin, WestLB Research

As a consequence of this drifting apart, Germany is the only country among those compared here where the growth contribution from private consumption and its share as a percentage of GDP has declined since the 1990s.

Two fundamental conclusions can be derived from the past

This review of past consumption trends allows us to draw two key conclusions:

- Trend growth in private consumption in Germany has been slowing steadily since the 1950s.
- This long-term slowing trend alone is not sufficient to explain the pronounced weakness in consumption between 2002 and 2005.

In order to be able to form a view as to how sustainable the consumer recovery we have seen since last year is, and whether a return to the long-term trend or even an overshoot above trend is likely, we first have to look at the main drivers behind this past weakness.

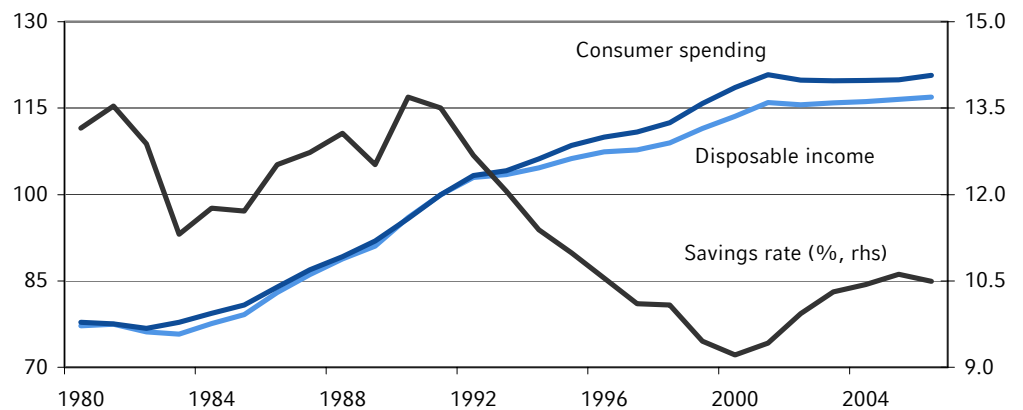
A look at the causes

Level of disposable income determines consumer behaviour

The following chart shows that German consumption follows the trend of disposable household income very closely. The relationship became a little looser for a while in the 1990s when a declining savings rate supported consumer expenditure, but this has now partly reversed again. Unlike in the USA, for example, in Germany there has been no permanent change in propensity to save that might have caused a lasting decoupling of consumption and current income.

Income and how it is used

1991 = 100 (lhs), % (rhs)



Source EcoWin, WestLB Research

No income growth – no growth in consumption

Significant deceleration in growth of incomes over the past decades

In the course of the past decades growth in disposable household income has slowed sharply. During the 1980s it averaged about 5% per year (2.5% in real terms). Even over the period from reunification to the end of the New Economy boom it fell to 3.2% (1.5% real). Since 2001 incomes have only been growing at a nominal average of 1.5%, which means in real terms they have stagnated.

Four factors are responsible for the weakness in incomes

Four main factors lie behind this:

- decline in employment
- low wage growth
- high tax burden
- change in the structure of incomes

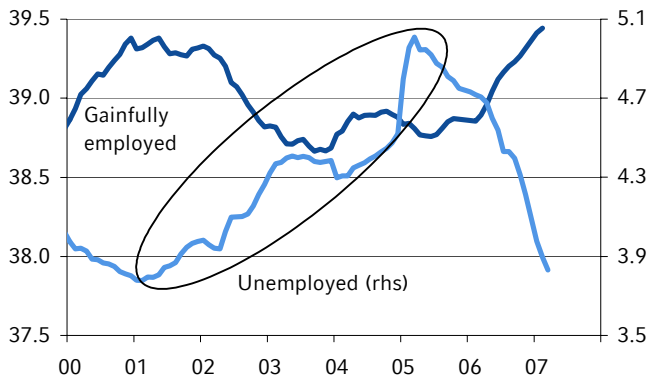
We will now look at these in more detail.

Income dampener No. 1: the decline in employment between 2001 and 2005

Marked rise in unemployment due to weak growth and restructuring

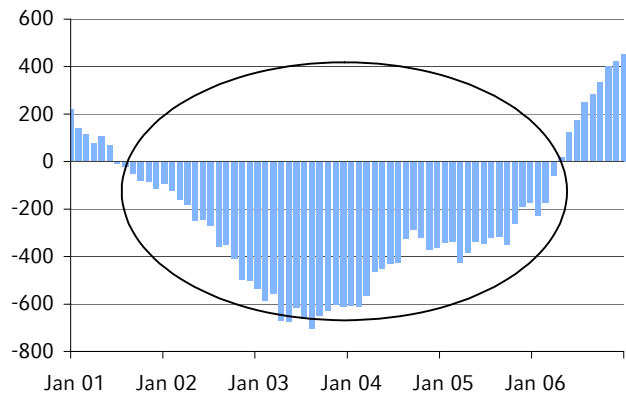
Following the general economic weakness and major corporate restructurings after the turn of the century, the number of registered unemployed rose by a total of 1.2 million between spring 2001 and spring 2005. This increase is even understated because of government intervention in the labour market such as early retirement programmes and encouraging innovative forms of employment like mini-jobs and one-man companies.

Unemployment and employment in millions



Source EcoWin, WestLB Research

Employees paying social security 000s, y/y



Source EcoWin, WestLB Research

Reduction in number of employed exceeds rise in unemployment

The rise in unemployment did not fully reflect the problem: the number of regular jobs (where employees pay social security) continued to fall until January 2006 and the number of jobs lost was 1.8m, a fall of 6.5%. This labour market erosion had both a quantitative and a qualitative element, as non-traditional jobs generally pay less well than regular ones.

Income dampener No. 2: low wage growth

The rate of wage growth has been slowing in Germany since the 1960s. This long-term trend was interrupted during the reunification boom, as East German wages rose disproportionately and the trade unions in the West had more power because of high capacity utilisation.

Slowdown in standard wage growth

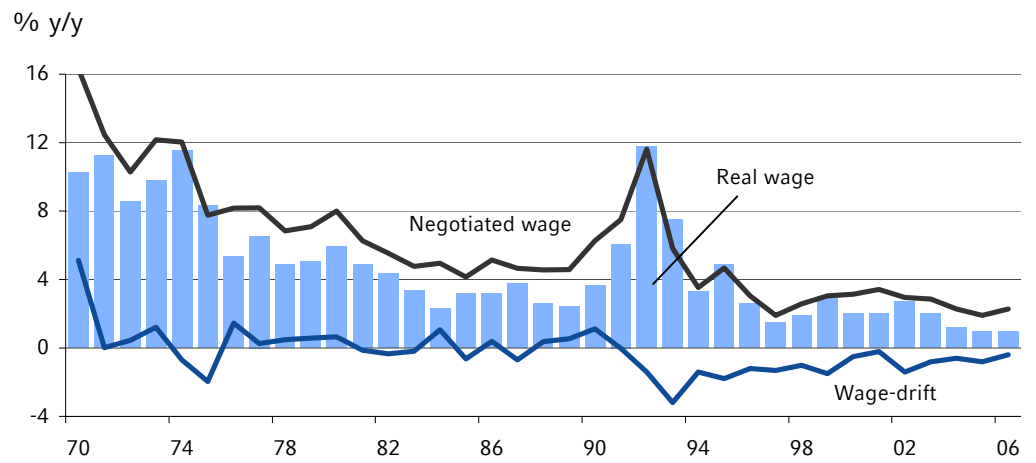
A further drag on corporate competitiveness at this time came from the reduction in working hours in various industries and tax hikes to finance the costs of reunification. This cocktail led to a rising number of insolvencies and, from the mid-1990s, serious efforts by companies to cut labour costs. The rise of globalisation provided another catalyst. The result was the rise in unemployment we have described (which limited the power of the trade unions) and a decline in the average level of collectively negotiated salary increases between 2000 and 2006 to less than 2% p.a.

The pressure from globalisation also meant that companies were able to unwind at least some of the unfortunate developments seen in the 1990s. For example, the working time cuts agreed were reversed in some industries at no extra cost by clauses in the collective wage agreements. Labour market reforms also meant that companies could make more use of cheap part-time or subsidised workers (one-man companies, mini-jobs etc.) rather than traditional employees.

Negative wage drift lessens growth of effective wages

The results can be seen in increasing negative wage drift in the 1990s and this decade – i.e. actual wages lagging behind the rates set in the collective agreements. Consequently, over the last 10 years effective wages have only risen 1%.

Wage growth



Source EcoWin, WestLB Research

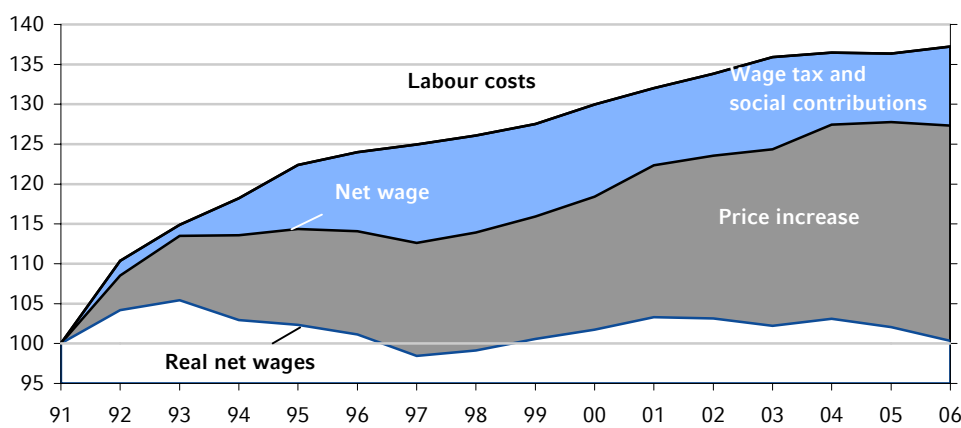
As far as employees were concerned the years after the New Economy boom brought lower income growth and greater insecurity over jobs and wages, reinforcing the negative impact from a reduced propensity to spend.

Income dampener No. 3: appropriation by the state and by inflation

A further brake on (net) incomes came from the high and rising tax burden required to finance reunification transfer payments and the welfare system. Some of the already modest wage increases since the mid-1990s have gone not into the pockets of employees but to the taxman. What little was left for employees was also reduced by (admittedly low) inflation. The bottom line was that net real wages in 2006 were scarcely higher than in 1991.

Higher contributions and inflation eroded nominal wage increases

Labour costs and net wages 1991=100



Changes 1991 – 2006

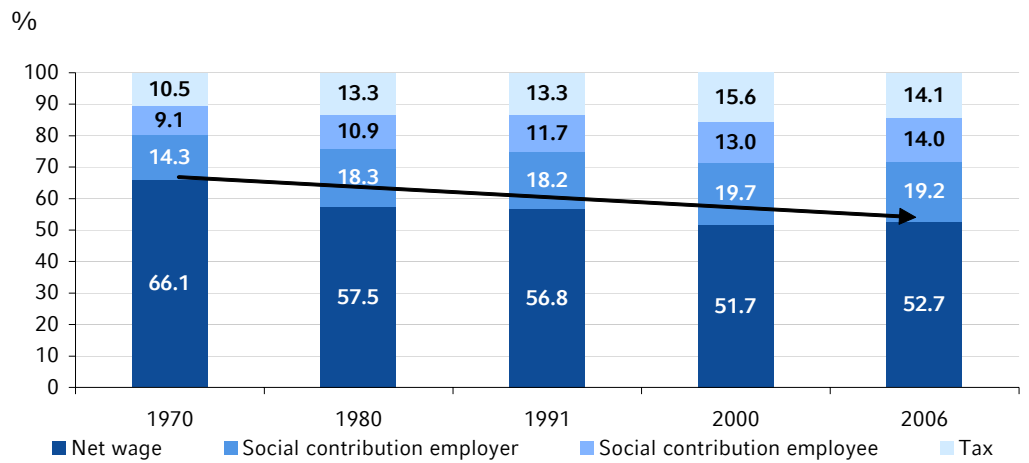
Labour costs	37.30%
Taxes	50.30%
Net wages	27.30%
Consumer prices	26.90%
Real net wages	0.30%

Source EcoWin, WestLB Research

Contributions still too high

The reforms of recent years have scarcely provided any relief to the net wages of employees, as tax cuts have been offset by increases in social security contributions. Overall the total burden on labour in Germany from taxes and other contributions is still well above the international average.

Share of labour costs



Source EcoWin, WestLB Research

For every €100 a company pays in labour costs the employee is only left with €53 after tax and other payments. The tax burden at least did not grow over the last six years – but that is only because the government preferred to use indirect taxes instead.

Income dampener No. 4: the reduced significance of labour income

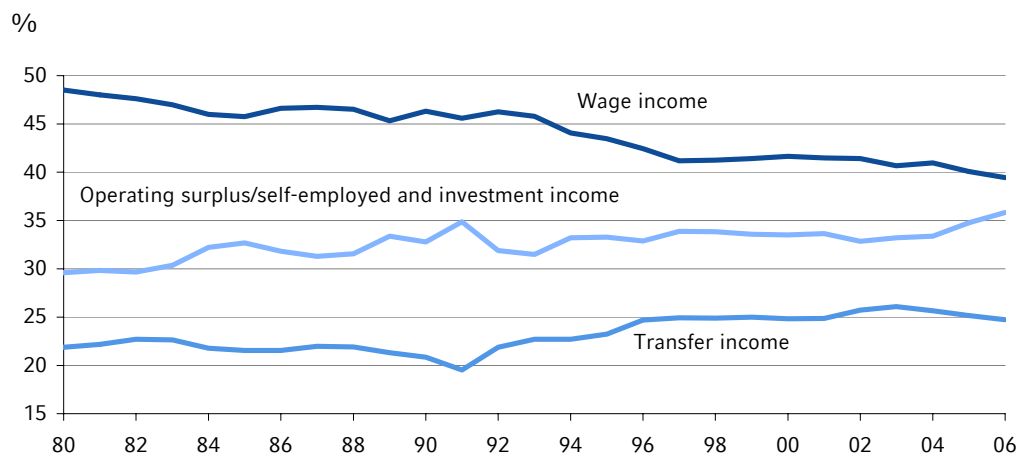
Marked decrease in earned income as a proportion of overall income

The net result of falling employment and low wage growth was that labour income became less significant. It accounted for nearly 50% of available income in 1980, and has fallen from around 45% at unification to below 40% at present.

Disproportionate increase in transfer income

By contrast, the importance of social transfers as a source of income since reunification has seen a step-change upwards. Although their share in disposable income has not been growing recently, since 1991 they have risen 75% – three times the growth in net wages. This reflects both the higher number of unemployed and also the growing number of pensioners – but their individual income in recent years has tended to fall rather than rise.

Share of disposable income



Source EcoWin, WestLB Research

Income components less reliable and stable than in the past

The economic expansion currently underway was further boosted by profit income, but not all private households benefit from this. Overall therefore, the composition of household income has become less 'reliable' and stable, which has probably further reduced the propensity to consume.

Moderate inflation eliminated as major cause of income weakness

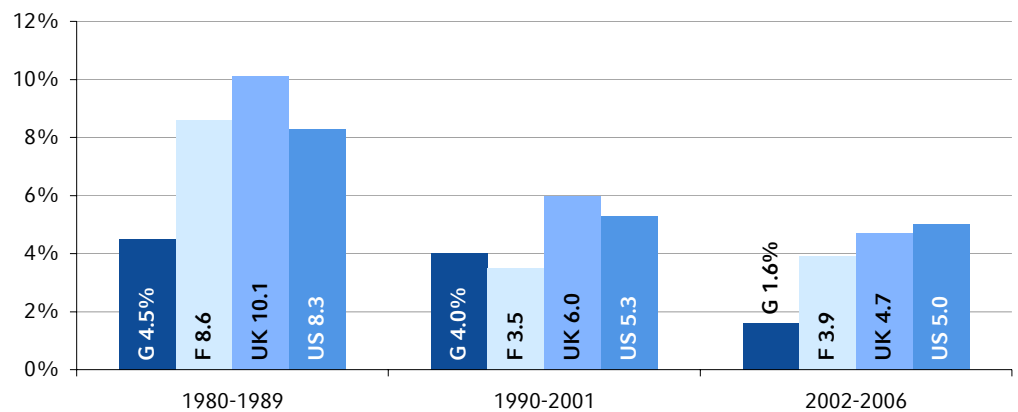
Inflation effect almost zero

There is also a fifth potential income dampener in addition to the factors we have already discussed – inflation. However since the recession at the start of the 1990s this has been very moderate. Consumer inflation has not risen above 2% since 1994 – despite the sharp rise in energy prices. It is fair to say that inflation has played a secondary role in the low growth in incomes over the last five years.

Of the factors we have considered here, the decline in employment and low wage growth are by far the most important. Their influence is probably due to the fact that income growth in Germany has been weak not only relative to its own history but also in an international comparison.

Disposable income

% y/y



Source EcoWin, WestLB Research

Subdued rise in savings rate in Germany...

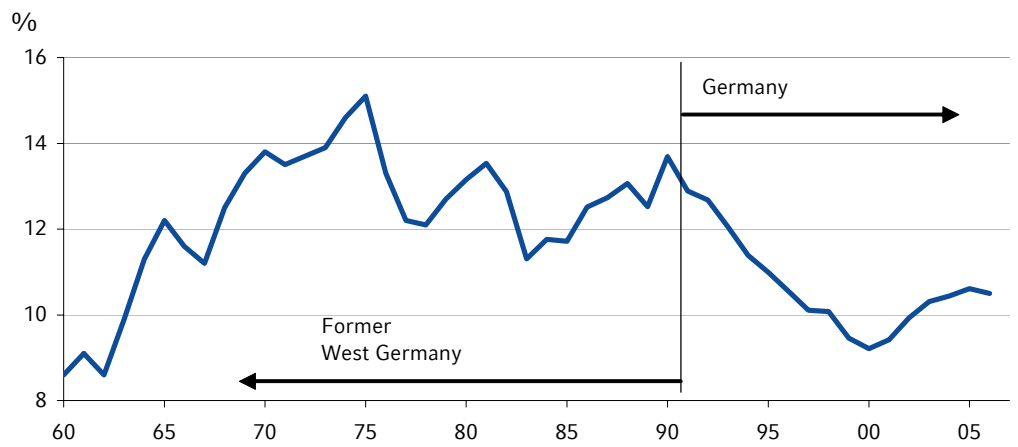
No growth in credit-driven consumer spending

As the US example shows, households can maintain their consumption habits during periods of weak income growth by saving less. In Germany's case this pattern has not yet been observed – rather the reverse. Consumer spending has actually dipped while the savings ratio has risen, albeit at a moderate rate. Commentators often attribute this phenomenon to anxiety-driven saving based on greater job insecurity or concerns about the welfare system.

...should also be viewed as part of normalisation process

We believe, however, there are other factors at play. Aside from the fact that the savings ratio has been low over a long period of time, we must not overlook the fact that the recent increase was a normalisation from the previous fall. That fall was partly fuelled by the bull market during the second half of the 1990s when private households' sense of wealth rose on the back of higher returns, making them feel that their long-term investment objectives could be attained even if they were saving less.

Savings ratio



Source EcoWin, WestLB Research

Increased tendency towards precautionary saving...

The bursting of the New Economy bubble and shrinking yields from fixed-income investments coupled with falling returns from insurance investments have severely dented savers' return expectations and partially account for why the savings ratio has risen. The growing realisation that the support provided by the contribution-based welfare system of the future will probably be no more than basic has been a significant factor in the growth of private provision.

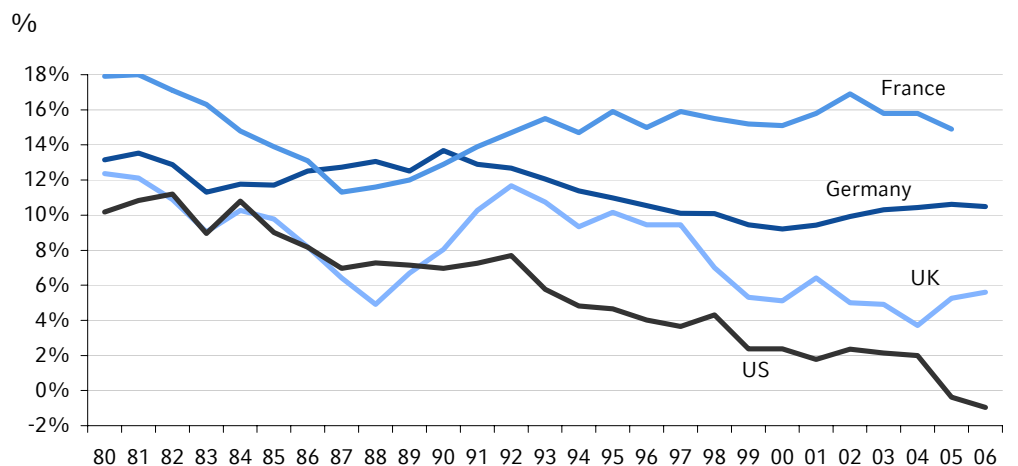
...and for good reason

To talk in terms of anxiety-driven saving would therefore appear to be somewhat of an overstatement; it would be more accurate to use a description such as rational or precautionary-driven saving. We can also say that the recent rise in the savings ratio should be viewed more as a normalisation than an exception, so it is unlikely that we shall see a sustained and marked fall in the savings ratio, even if the employment market begins to revive and people are less anxious about losing their jobs.

Savings rate comparisons on international scale pose problems

Is Germany's savings ratio unusually high at the moment compared with other countries? Before answering this, we should first point out that it is very difficult to compare savings ratios with one another as each one is determined by a number of factors unique to the country in question such as the structure of the welfare system and the distribution of income. Nevertheless, it is possible to predict some future trends.

Savings ratio



Source EcoWin, WestLB Research

Positive wealth and income increases explain savings rate decline in Anglo Saxon economies

Over the past few decades, savings ratios have diverged considerably in different countries. Since 1980, people in the UK and US have increasingly turned their backs on saving; in the latter case the savings ratio recently even became negative. In the economies of the English-speaking world, savings ratios have been eroded primarily by positive wealth effects (rising property prices) but also by strong income growth, causing a boom in spending.

Relatively high stability of household savings in Continental Europe

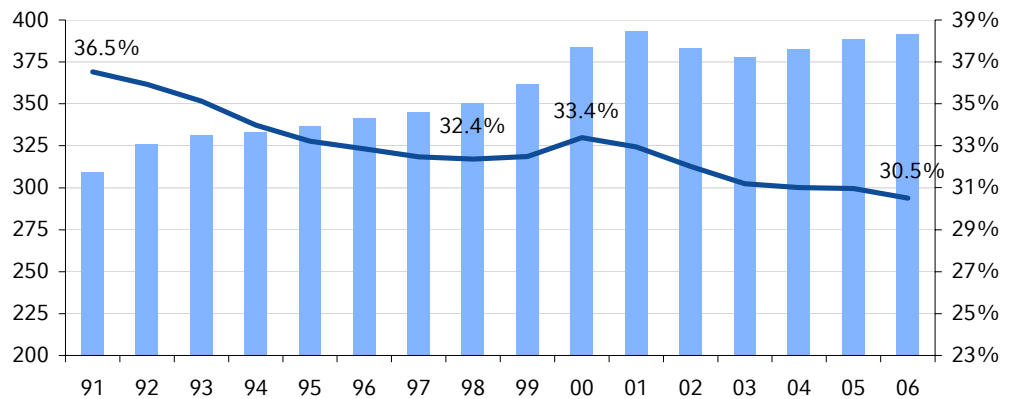
In Germany and France on the other hand, savings ratios have fallen only slightly. And although the savings ratio is much higher in France than it is in Germany, consumption rates there have risen significantly more over the past few years. But we can say that in continental Europe any room for manoeuvre for spending has been generally limited by the relative stability of the desire to save, which in itself is partly a reaction to a contribution-financed welfare system and the lack of positive wealth effects.

Shifts in consumer structure

Changes in consumption patterns can have an impact on people's perceptions of how the economy is performing, even if the economy itself is unaffected. Over the past few years, for example, higher energy expenditure has come at the expenses of other purchases.

Retail sales in absolute terms and as a % of consumption

in €bn and as a %



Source EcoWin, WestLB Research

Retailers have been particularly affected by this trend. Their share of overall consumption has fallen by almost 3 percentage points over the past six years, and by double this since German reunification in 1990. Almost all retail sectors have been hit, as the chart on the next page shows.

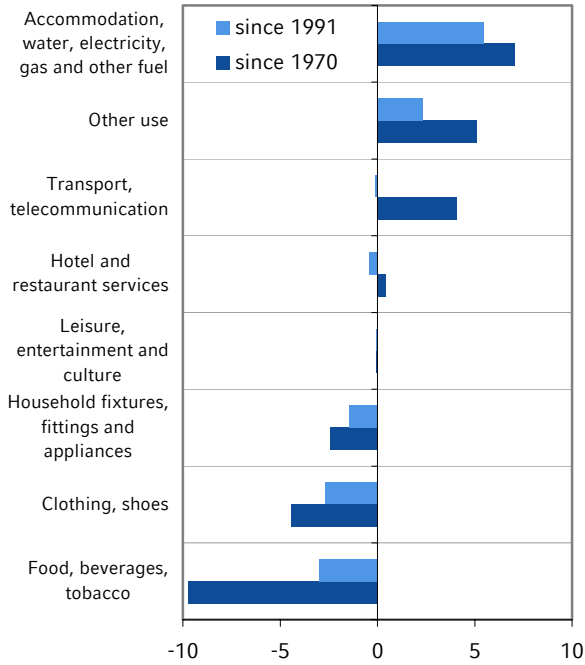
Shift in consumer behaviour favours services to the detriment of other purchases

Over a number of years spending has generally shifted from everyday goods (e.g. food) to services, mainly because of rising levels of wealth.

It is also apparent that discretionary spending on items such as fittings and furnishings and other durable goods has been cut during periods of weak income growth, as was the case last year.

Changes in share of consumption

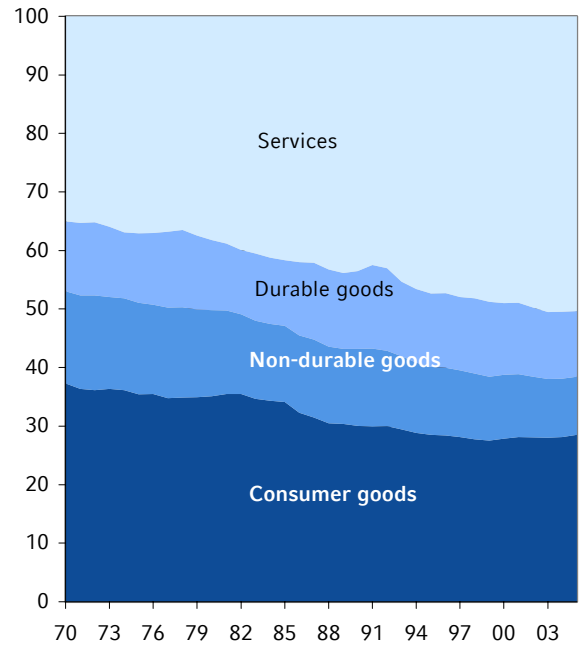
in percentage points



Source EcoWin, WestLB Research

Consumer spending by duration

as % of consumption



Source EcoWin, WestLB Research

Change in consumption structure not exclusively German phenomenon

If the relationships that we have described here have particularly hit the retail trade, they probably also markedly increased awareness of the recent weak period of consumer spending. Nevertheless, we should point out that this phenomenon is not wholly confined to Germany. In all developed economies of the world spending on services has risen at the expense of spending on goods.

Hope for the future

Fairly subdued consumer expectations for 2007 due to VAT increase

Consumer spending increased much more than expected last year. This was initially ascribed to one-offs such as the World Cup in Germany and a surge in buying before this year's VAT increase was introduced. Expectations for 2007 were therefore rather more modest. It was not too long ago that many commentators were forecasting a short-term dip in consumption at the start of the year as the 3-percentage-point VAT hike began to bite.

Labour market recovery triggers rebound in consumption

In fact, the outlook for private consumption has markedly brightened. Last year was the first time since 2001 that it made any positive contribution to growth, due mainly to a recovery in the employment market, which has since exceeded even the most optimistic expectations and raised the prospect of the first substantial growth in income over the same time-frame.

Income growth gathers pace

The situation on the employment market has improved continuously since the start of last year. Unlike in previous years, most new jobs now being created are full-time i.e. where employees work sufficient hours for social security contributions to be triggered; almost 500,000 have been created since January 2006.

Rapid decline in unemployment

Unemployment is falling at a virtually unheard-of rate. In March, the number of unemployed was 870,000 below the level it was at in the same period last year, the biggest drop since the Federal Republic was established in 1948. Unusually mild weather conditions and more intensive efforts by the government to boost employment may have favoured this trend, but other factors have helped, most notably the improved economic environment.

Unlike in earlier growth cycles, current cycle shows no increase in base unemployment

One other factor should not be overlooked in explaining the change in the employment situation. Ever since the first oil price shock and on a number of occasions, unemployment levels in Germany have jumped with each downturn and recession. On each occasion it subsequently fell but only slowly and never regained its original level. Structural unemployment therefore became entrenched. As each cycle passed, base unemployment crept up to ever higher levels. However, what should be noted from the current economic cycle is that unemployment is falling at an accelerated rate and is close to its 2001 level. We can therefore assume that it has been not only the improved economic picture that has caused the situation on the employment market to improve, but also that the reforms introduced by the previous federal government are now beginning to take effect. Structural unemployment should therefore also fall.

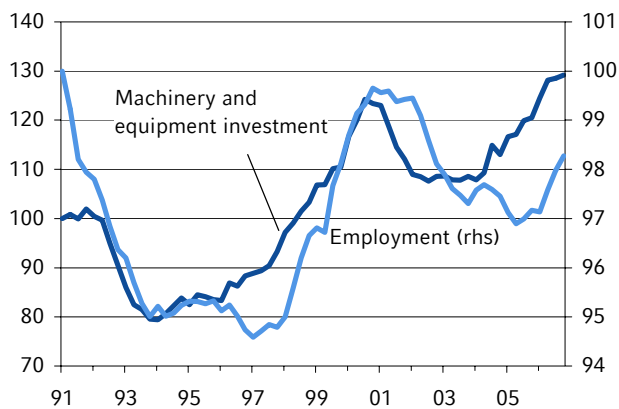
Recovery in the employment market set to continue

Job-creating expansionary investment can be expected based on favourable earnings prospects and high capacity utilisation

We believe that the recovery in the employment market will continue. Following years of restructuring and modernisation, German companies have almost never been so lean. As a result, the pick-up in economic momentum has caused capacity utilisation to soar. Despite brisk levels of investment, utilisation of industrial capacity has climbed to levels not seen since Germany was reunified. If the earnings outlook for companies remains favourable both this year and in 2008, companies will almost certainly be looking to expand capacity and create new jobs.

Investment and employment

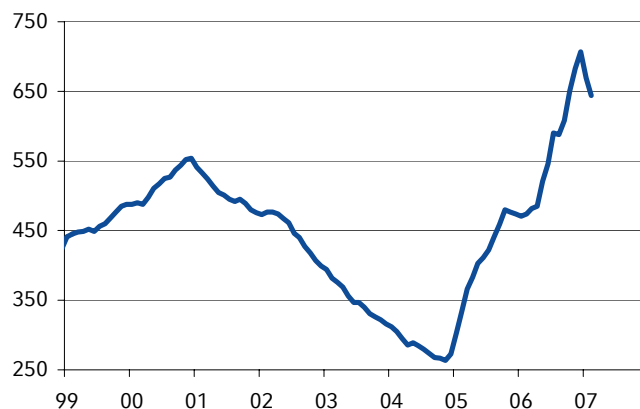
1991=100



Source EcoWin, WestLB Research

Vacancies

in 000s



Source EcoWin, WestLB Research

Creation of regular jobs should predominate

Since the reservoir of subsidised labour is virtually exhausted and often does not meet the needs of employers in any case, the overwhelming bulk of new jobs are likely to be full-time. These tend to be better paid on average compared with part-time work so the growth in employment should boost income levels and lead to a contraction in the wage drift that we have already referred to. We therefore believe that the employment situation will improve in both quantitative and qualitative terms.

Wage negotiation situation for employees is more favourable than in recent years

Wage rounds in the midst of an upturn

With a thriving economy, healthy corporate earnings, an employment market in the advanced stage of recovery and the VAT increase digested, employees are entering the forthcoming collective wage agreement negotiations with the strongest bargaining position they have held for a long time. Aware of their advantageous position, the unions have been putting in higher pay demands than in previous years. IG-Metall are asking for 6.5% in the negotiations for their 3.2 million members in the metal and electronics industries. In other major sectors too – such as chemicals, construction and retailing – pay demands are significantly higher than before.

Important announcement dates for wage rounds in 2007

Contract ends	Industry	No of employees
31.01.2007	Chemical industry (several federal states)	550,000
31.03.2007	Metalworking and electronics (western and eastern Germany)	3,199,200
	Construction (western and eastern Germany)	586,900
	Retail (several federal states)	414,000
	Wholesale and foreign trade (several federal states)	344,200
	30.04.2007	Retail (several federal states)
30.04.2007	Wholesale and foreign trade (several federal states)	723,700
	Retail (several federal states)	211,100
30.06.2007	Retail (several federal states)	211,100
	Public sector (central and local, various sectors)	1,582,100
31.12.2007	Cleaning services (western and eastern Germany)	316,400

Source WSI tariff archive

Wage settlement for chemical industry has been finalised

The chemical industry has been the first major sector this year to agree wage levels. Around 550,000 workers will receive a one-off payment of €70 and a 3.6% rise. In addition, they will receive a flexible one-off payment of 0.7%, although this can be lowered or not paid at all depending on how profitable the company has been. The wage tariff agreement remains in effect for 14 months. In the previous tariff negotiation in the chemical industry, workers were given a 2.7% rise and a special payment of 1.2% of one month's salary.

As this special payment ceases to apply this year, the average annual salary increase for the chemical industry is lower than the agreed rate.

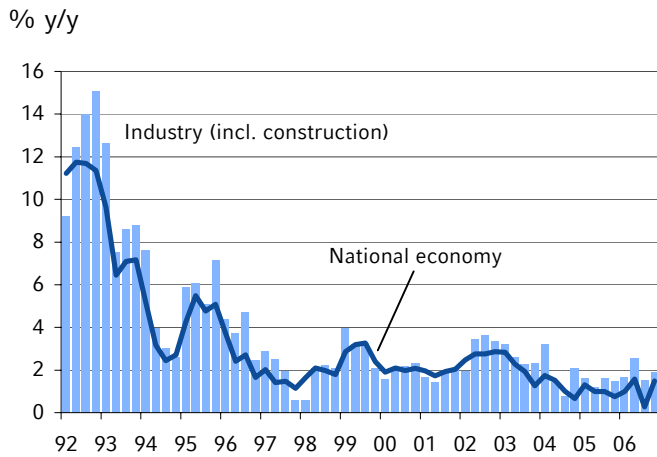
Wage settlements of roughly 3% this year are significantly higher than in recent years

We believe other sectors will also secure higher collective salaries than in previous years and will see roughly 3% on average. In the industrial sector they will be significantly higher, while in retailing they will be somewhat lower. Based on past evidence, we assume that negotiated salary levels will be around half the level of the original pay demands and may be boosted or discounted in line with the state of the economy and employment market. Significantly higher wage agreements in the retail sector could probably be reached if employers were able to win the appropriate concessions from the unions in terms of shop working hours (evenings, nights, weekends etc.).

2007 wage round results in significant increases in incomes

Overall, significant rises in income are likely following the wage rounds in 2007, even if real salary increases are likely be lower than those agreed in the new tariffs. This is also due to the fact that the vast proportion of employees are not due for an imminent salary review – new agreements are only due to be negotiated for around 9.6 million workers (about one third of the total). For the remainder, the agreements from last year and 2005 are still in force. As has been the case for some years, collective salary agreements are not binding on all companies either. We can therefore conclude that wage drift will remain negative, even if not on the same scale as previously. Our prediction is that effective salaries will go up by around 1.5% this year, the steepest rise since 2001.

Negotiated wages

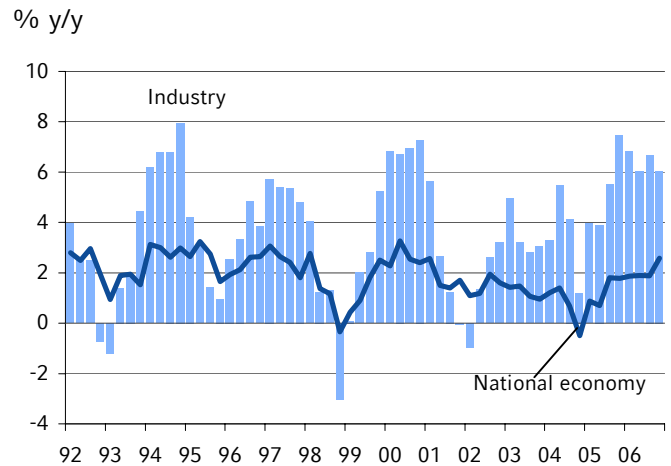


Source EcoWin, WestLB Research

Although risks of a wage-price spiral are low, ECB will monitor the wage round carefully

In view of the high wage demands by IG Metall in particular, there is the danger that a price/wage spiral might start, provoking the central bank to slam its foot down on the monetary brakes and adopt a restrictive policy.

Productivity per hour



Source EcoWin, WestLB Research

But it should be noted that industrial productivity growth is currently much higher than in the rest of the economy, so pressure on unit labour costs is likely to remain moderate. A moderate rise in unit labour costs would certainly not be untypical as we reach the threshold of a period of reduced unemployment and significantly higher capacity utilisation. Even if a wage/price spiral remains extremely improbable, the ECB board will be watching the progress of the wage rounds in Germany with intense interest.

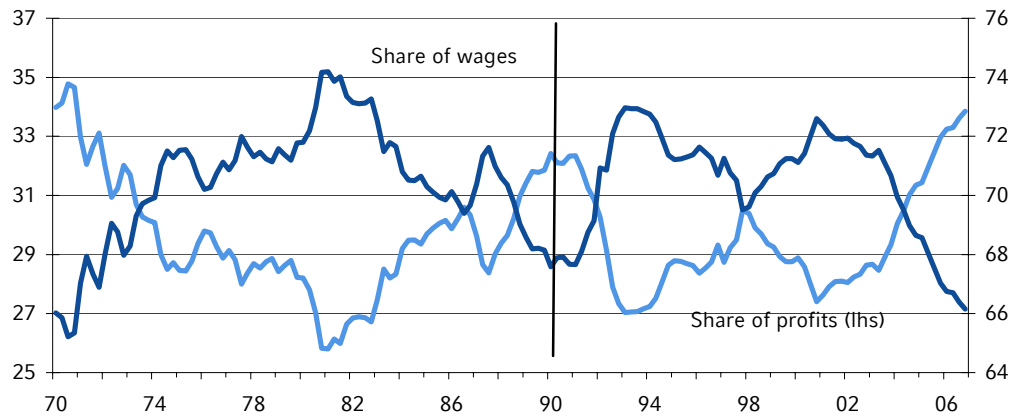
Slight increase in wage rate likely...

Further falls in income unlikely in the short term

Having driven margins to almost record levels through their efforts at restructuring, companies will probably be hard-pressed to make any more significant cuts to their cost base in 2007. We therefore expect a trend reversal in income distribution to take place, with a slight rise in the share from salaries and a slight fall in the share from corporate profits.

Profits and wages

as % of national income



Source EcoWin, WestLB Research

...but not to the same extent as in recent years

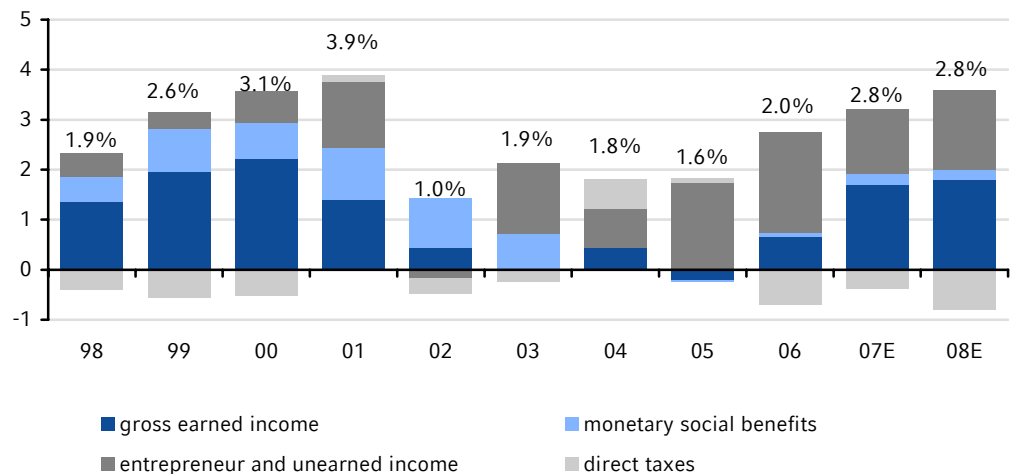
Even if a trend reversal were to favour salaries in 2007, we doubt that we would see the cyclical peaks and troughs on the scale of previous decades. What is far more likely is that the growth we are expecting this year, and probably the year after that, will be just a temporary reversal in the overall long-term trend, which is driven by the forces of globalisation and where capital is, on balance, better rewarded than labour.

Incomes in line for an increase

All in all, employment income is heading back to normality. Its contribution to overall income growth in 2007 is expected to rise significantly. We are predicting both a rise in

Contribution to growth in private household disposable income

in percentage points



Source EcoWin, WestLB Research

Strongest increase in disposable income in six years

welfare benefits and, after a long period of stagnation, a moderate increase in pensions this year. Entrepreneurial and investment income are robust and should continue to be supportive too. Profit growth is unlikely to be as marked as in previous years but reports suggest dividend payments will be far higher than last year's level.

Even allowing for the fact the private households will have to find money to pay for a whole raft of taxes, we are forecasting a rise of 2.8% in nominal disposable income, the steepest rise in six years.

VAT hike has had almost no effect

Pricing pressure is markedly lower than expected and this has also bolstered consumer spending. It is particularly clear that the 3-percentage-point increases in VAT and insurance tax have so far not affected prices to the extent predicted.

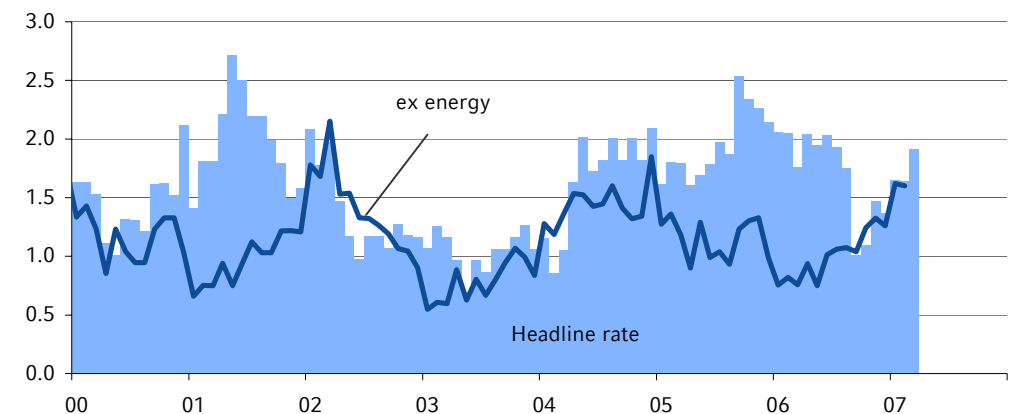
Inflation remains moderate this year as well, despite VAT hike

If the full impact had been felt, it would have pushed the consumer price index up by 1.3%. In the first two months of the year, the inflation rate, as measured year-on-year, was just 0.1% higher than at the end of 2006. Even though the VAT hikes were compensated by falling oil prices, large discounts and price cuts in the retail industry, the actual effects from value added tax have been much lower than they would have been in hypothetical terms.

While there might still be a knock-on effect which could be felt over the next month or two, all the signs suggest that rises in consumer prices will remain below 2% this year.

Consumer prices

% y/y



Source EcoWin, WestLB Research

Overall, we would therefore expect real incomes to rise by around 1% during the course of this year and believe that private households will spend the additional income at their disposal rather than boost their savings.

Significant fall in savings ratio unlikely

Concerns about state pensions and private household wealth structure argue against savings rate decline

With unemployment falling, many employees are likely to be less concerned about losing their jobs and therefore we should expect to see a drop in precautionary saving, although only to a limited extent as we have already argued. Other factors working against a marked and sustained fall in the savings ratio are the long-term concerns about the state pension system and private households' asset structure.

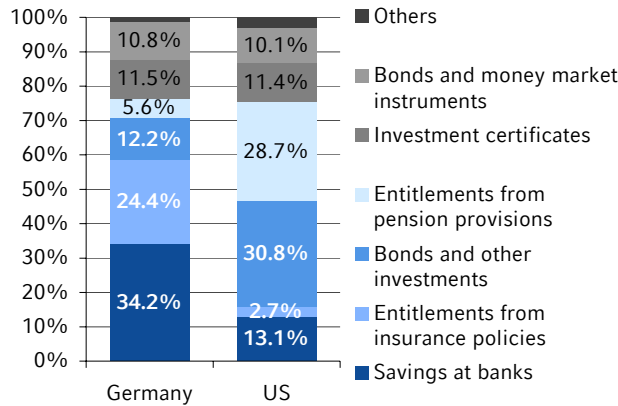
Low risk appetite of savers in Germany...

If we compare the structure of monetary assets (excluding ownership of property) held by German households with those of their US counterparts, we can see some noticeable differences. In Germany, the two most important forms of investments are bank accounts (34.2%) and insurance policies (24.4%). Bank investments include savings accounts, current accounts and call accounts. These are considered to be safe places to invest money, but returns are modest. They are therefore seen as a very good indicator for the risk tolerance of German private households that save.

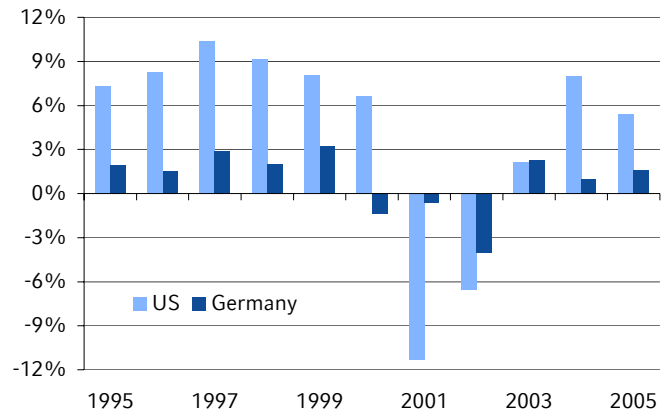
...leads to relatively low-return capital investments

Insurance investments (e.g. life insurance and private pension plans) are also seen as safe houses but potential returns are again limited. The vast proportion of contributions to state-subsidised pension schemes are also in assets that are low-risk but also low-return. German investors are rather defensive, and put safety at a premium when it comes to building assets, particularly when compared with the US.

Financial assets structure of German and US households (in Q3 2006)



"Implied returns" from assets in Germany and the US %



Source WestLB Research estimates

Source EcoWin, WestLB Research

US households increasingly opt for risky and therefore...

In the US too, people invest in two different forms of assets. More than 30% of overall assets is invested directly in equities. While equities are much riskier for investors, the returns they generate are much higher. The second most important form of investment is the company pension. The risk-return profile here is comparable with a company or private pension in Germany.

...higher return capital investments

The US system is more return-orientated compared with Germany, but the downside is that it is more subject to volatility. US households benefit more from stock market upturns but their assets can also come under heavy pressure during corrections, as, for example, in 2001 and 2002 after the New Economy bubble burst.

Implicit returns on US investments are significantly higher than those of German savers

Statistics show that implied returns from assets are much higher in the US than they are in Germany, although volatility is also considerably higher. Returns on assets in the US have been markedly higher on average than those in Germany over the past 10 years, despite the stock market corrections that we have referred to.

Investment behaviour is a key determinant of divergent savings patterns

US investors enjoyed 84% asset growth over this period while in Germany, the figure was "just" 61%, despite the fact that the proportion of income that US households save was considerably lower. The gap is a clear illustration of the importance of the asset structure and the resultant returns. By focusing on returns, US households do not have to save as much to boost their assets over the long term. Because the essential asset

structure in Germany is not going to change over the foreseeable future, it is rather unlikely that savings levels will fall by any appreciable extent.

Private consumption – comeback of the year

Consumption only temporarily weakened at start of year

Private consumption is expected to continue to recover this year on the back of the improved outlook for incomes. The recent downturn in the consumer climate, a consequence of consumers' reluctance to spend after the VAT increases, will probably only be short-lived. Nevertheless, it is probable that private consumption will fall in the first quarter of 2007.

Even if the VAT rises had less of an impact on prices than had previously been feared, they are likely to have unsettled consumers. Bearing in mind that consumers last year decided to spend before the VAT increases came into effect, we must also be prepared for a slump in demand.

But the effect of this has been much lower than had been expected, at least going by the GDP data from the Federal Bureau of Statistics. Any falls in demand should therefore be moderate during this quarter.

Income and private consumption

	2005	2005	2006	2007E	2008E
	bn €	% y/y			
Mass income	978.9	-0.2	0.3	2.1	1.8
Gross wages and salaries	911.4	-0.3	1.4	2.7	3
Less social security payments	152.6	1.2	4.3	-1	3
Less income tax	157.3	-2	2.7	4.5	5
Monetary welfare benefits ¹⁾	377.4	-0.1	0.3	0.6	0.7
Other primary income ²⁾	512.7	6.2	5	4	4.5
Other transfers ³⁾⁴⁾	-40.8	-4	-5.2	-2	0
Disposable income	1,459.80	1.7	1.7	2.8	2.8
Savings ratio (in %)		10.6	10.5	10.4	10.4
Private consumption deflator		1.3	1.4	1.8	1.3
Real private consumption		0.1	0.6	1	1.5

¹⁾ less taxes on welfare benefits and consumption taxes. –

²⁾ operating profits/income from assets and self-employment

³⁾ net balance of transfers made and received

⁴⁾ y/y change in €bn

Source WestLB Research estimates, Federal Bureau of Statistics

We forecast that consumption will slowly rise during the rest of the year. Real growth should be around 1% for 2007.

Increasing consumption momentum in the course of the year

If we compare this rate with last year's predictions, then we would be quite justified in saying that private consumption has been the star performer of the year. As the year progresses, growth in consumer spending is likely to be even stronger, giving Germany's economy a much broader base.

ECB to monitor trend in Germany carefully

As we have already mentioned, the ECB will probably be taking a very close look at the growth trend in Germany, as it still views even current interest rate levels as accommodative. But if the German economy as a whole, and particularly consumer spending, continues to grow, we would have to say that that the interest rate hike to 4% that we are expecting will not be the last. Were this the case, it would be equally unlikely that fixed-income yields would remain at or even below 4%.

Challenges for equity market investors

Investors in the German stock market should also brace themselves for bumpy times ahead. Although we have said that Germany is likely to enjoy growth, most of the country's largest companies are global players more than exclusively domestic operators and so we are more likely to see a slowdown in growth this year.

Improved structural growth outlook for Germany

	2003	2004	2005	2006	2007E	2008E
	% y/y					
Real GDP	-0.2	1.3	0.9	2.7	2.2	2.2
Domestic demand	0.6	0.0	0.5	1.6	1.2	1.7
Private consumption	-0.1	0.1	0.1	0.8	1.0	1.5
Public consumption	0.4	-1.3	0.6	1.8	0.2	0.3
Investment in PPE	-0.8	-0.4	0.8	5.6	3.7	3.0
Equipment	-0.1	4.2	6.1	7.3	5.0	4.8
Buildings	-1.6	-3.8	-3.6	4.2	2.7	1.5
Other PPE	2.5	1.2	4.7	5.9	5.7	5.3
Inventory ¹⁾	0.7	0.3	0.2	-0.2	0.1	0.0
Balance of trade ¹⁾	-0.8	1.2	0.4	1.1	1.0	0.5
Exports	2.4	9.6	6.9	12.5	6.3	5.5
Imports	5.4	6.9	6.5	11.1	5.0	5.3
Consumer prices	1.0	1.7	2.0	1.7	1.8	1.5
Financial balance public budget						
in bn €	-86.6	-81.2	-72.6	-39.2	-25	-20
as % of GDP (nom.)	-4.0	-3.7	-3.2	-1.7	-1.1	-0.8
Unemployed persons (m)	4.38	4.38	4.86	4.50	3.8	3.5

¹⁾ % contribution to GDP growth

Source WestLB Research, Federal Statistics Office

Further restructuring gains difficult to realise

And we should not forget that domestic manufacturers could face higher wage bills in 2007. Many companies will find it considerably harder or practically impossible to boost profit margins – as investors have become accustomed to seeing in recent years – simply by restructuring.

Structural problems remain unresolved despite cyclical recovery of consumption

And while Germany's positive growth outlook is undeniable, consumption is still being hindered by long-term structural problems. The idea that Germany might become a consumer-driven growth machine over the long term is only a hope, and likely to remain that way too.

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