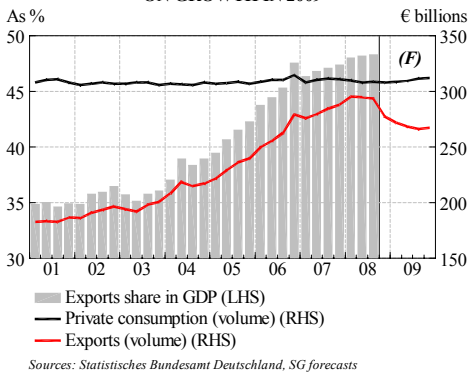


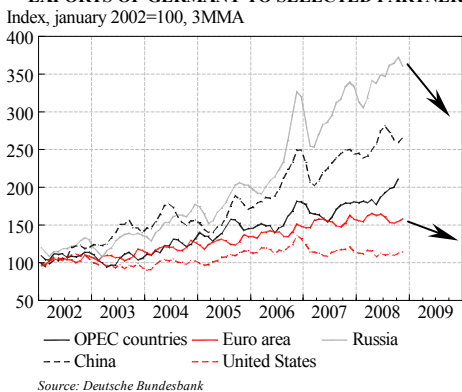
ENGINE FAILURE

By focusing on exports as its main growth driver, Germany has tied its economy to worldwide growth much more tightly than the other industrialised countries. Now that this strategy is showing its limitations against the collapse of external demand, the government is trying to revive private consumption in order to limit the recession via a massive second stimulus plan. This will not be enough, and we expect German GDP to shrink by 2.3% in 2009.

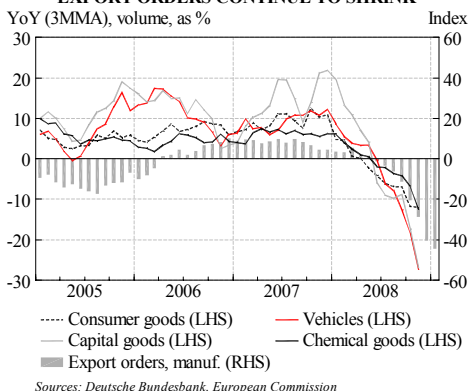
EXPORTS WILL DRAMATICALLY WEIGH ON GROWTH IN 2009



EXPORTS OF GERMANY TO SELECTED PARTNERS



EXPORT ORDERS CONTINUE TO SHRINK



The heavy focus on exports in the German model comes at a price

World export champion in 2007 and certainly again in 2008, ahead of China, Germany can boast that it has ridden the globalisation wave to its best advantage in the past years. The volume of its overseas sales of goods and services exploded by some 64% between 2000 and 2007 with, in addition, GDP growth of 3.2% and 2.6% in 2006 and 2007, well above potential growth, which is estimated at 1.6-1.7%.

While this export performance is partly explained by cultural factors and a major R&D effort (having led to specialisation in the high-end segment of growth industries during a period of strong global expansion: capital goods, chemicals, vehicles, etc), it is also due to political choices made by the Schröder and then Merkel governments aimed at improving the country's competitiveness at the expense of domestic demand (VAT hike, cut in social welfare contributions, sustained wage moderation, etc). As a result, the weight of exports in the German economy has risen rapidly: from 35% of GDP in 2001 to 48% of GDP in the third quarter of 2008, leading to a substantial increase in business investment along the way.

However, the increased significance of exports carries a risk that is materialising today: that of a more pronounced German economic cycle due to the greater volatility of exports. The current drop in external demand is massive and is attributable to both the developed and emerging countries.

Foreign trade will be the plague of Germany in 2009

The volume of export orders received by manufacturing industry recorded its third consecutive fall in November, plummeting by some 21% since August and returning to mid-2005 levels. This major contraction is explained by, in particular, the slump in foreign orders for capital goods (-28% since August). Furthermore, the latest industrial opinion surveys show that the trend worsened at the turn of the year; the European Commission ESI survey, for example, saw its "new export orders in manufacturing industry" component fall far below its long-term average to -45 points in January – a level not seen since the beginning of the 1990s, a period in which German exports contracted sharply.

After the sudden correction in November (-10.6% on the previous month – the biggest recorded drop since 1988), overseas sales will doubtless continue to decline sharply throughout the first half of 2009, while the prospects for recovery from summer onwards are highly uncertain, despite some bolstering of foreign demand by stimulus plans in the United States and Europe. The unremitting deterioration in activity in the emerging countries, notably of Eastern Europe, where there is also severe pressure on exchange rates, will help to intensify the historic fall in German exports in 2009, which is likely to reach a yearly average of 7.5%. Thus, the share of exports in GDP is expected to fall to 44% in the fourth quarter of 2009, the lowest since early 2006.

On the other hand, imports should undergo a more measured decline of 4.5% over the year, with domestic demand spurred on by the big increase in public spending and the smaller rise in private consumption, thanks in particular to disinflation and the implementation of the bulk of the stimulus plans in the second half of the year.

German foreign trade will therefore make a highly negative contribution to growth in 2009 (-1.7%), with the collapse of exports having a very large impact on GDP in absolute terms. Furthermore, the fall in the capacity utilisation rate in industry, combined with difficult financing conditions should lead to a sharp contraction in productive investments, equal to 9% in 2009 and 3.8% in 2010.

A massive second stimulus plan – but too late to cushion the fall in 2009

Faced with the sudden failure of the export engine and its major impact on growth, the ruling coalition has agreed on a second massive stimulus plan worth EUR 50 billion over

two years (1% of GDP per annum), in order to jump start the faltering engine of domestic demand. The new plan includes:

- Tax relief totalling EUR 9 billion (3 billion in 2009 and 6 billion in 2010) by way of a percentage point reduction in the minimum marginal income tax rate (from 15 to 14%) and an increase in the income tax threshold of 4% to EUR 8,000;
- A 0.6% cut in health insurance contributions, divided evenly between employer and employee contributions, amounting to EUR 9 billion;
- Investments by the Federal State totalling EUR 14 billion, 65% of which will be spent on educational structures and 35% on roads and canals as well as information technology;
- Direct aid to households, including a payment of EUR 100 per child, a EUR 2,500 "scrap bonus" and help for the unemployed with dependent children, etc;
- Subventions for companies that use temporarily short-time working in order to prevent lay-offs.

This massive programme puts Germany at the forefront of countries taking part in the recovery effort in the eurozone. It does in fact address several issues: shoring up an extremely large automotive industry that is dealing with enormous difficulties in selling its output; providing significant stimulus that will generate benefits for the post-recession period (in the case of the planned public investments), and limiting the impact of credit restrictions on SMEs (in the case of the EUR 100 billion in business loan guarantees), etc. But, the programme is ill-timed. The advantage of tax cuts – less effective because partially affected by households to savings – is that they are quick to implement. Yet, the cuts that have been decided will not take effect before July the 1st, after the toughest phase of the recession is over. The majority of the impact of this second plan will be concentrated in 2010; nevertheless, its announcement seems to have been sufficient to halt the fall in confidence, the IFO index having stopped its spectacular fall in January (83 points, +0.4 MoM). Overall, the plan's impact on growth is likely to border 0.6% in 2010 versus 0.4% in 2009, while the government deficit will plunge to 3.6% of GDP this year and 5% in 2010.

Slight support from private-sector consumption this year

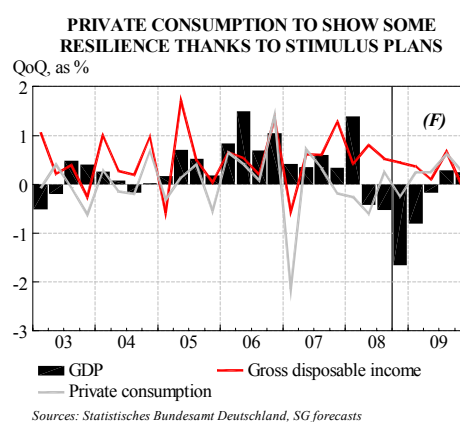
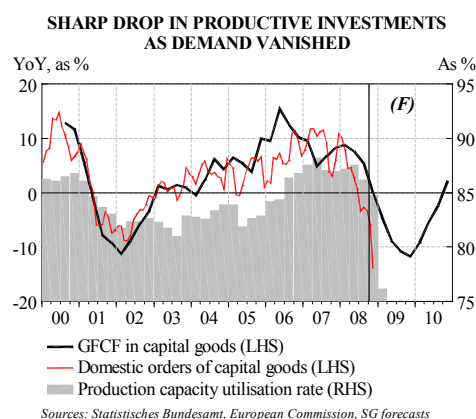
Private consumption is likely to recover somewhat this year, at least in recent German standards, after a year 2008 in which soaring inflation drastically curtailed purchasing power despite improved employment conditions. Three factors will help to increase purchasing power slightly in 2009 for the first time in three years, namely: i) rapid disinflation, which is likely to continue into the first quarter, impacting positively on household purchasing power, ii) the continuing strength of the labour market, with wages still rising in the first half of the year and iii) the implementation in summer of the parts of the second stimulus plan involving tax reliefs and payments to households.

The large savings accumulated by German households over the past few years (11.4% of disposable income in net terms in Q3 2008) should also help to sustain private-sector consumption and act as a buffer against rising unemployment, which will affect more than 9% of the active population from Q4 2009 onwards and 9.7% on average in 2010.

Therefore, household consumption should hold up in the first and second quarters and grow more rapidly in the latter part of the year following the actual implementation of the tax relief. Household consumption should therefore rise modestly, by 0.6% in 2009, half of which will be due to the direct effects of the second stimulus plan on household income.

The picture for 2009 is thus particularly gloomy for the German economy, while the end of 2008 will already have been a disaster, with GDP expected to have fallen 1.7% qoq in the fourth quarter and yearly growth of just 1%. Further declines in GDP in Q1 and Q2 2009 followed by soft rebounds in the second half when carry-over growth is already -1.6% will send GDP to an historic low of -2.3 %.

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As %	2005	2006	2007	2008(f)	2009(f)
Real GDP	0.9	3.2	2.6	1.0	-2.3
Consumer prices (CPI)	1.6	1.6	2.4	2.6	0.1
Unemployment rate	11.7	10.8	9.0	7.8	8.6
Current account (% GDP)	5.8	6.6	7.9	7.0	6.0
Budget balance (% GDP)	-3.3	-1.5	-0.2	-0.4	-3.6

WORTH WATCHING

Sovereign debt issuance is on the increase in Europe with the worsening public deficits. This strong competition could penalise Germany, which, unlike France, does not have recourse Primary Dealers to facilitate the issuance and management of the debt.

GERMANY

% Change at annual rate	2006	2007	2008(f)	2009(f)	2008 Q3	2008 Q4(f)	2009 Q1(f)	2009 Q2(f)
Private consumption	1.2	-0.3	-0.5	0.6	1.0	-1.0	1.0	1.0
Public consumption	0.6	2.2	2.7	3.9	3.3	4.0	3.5	3.5
Expenditure on capital goods	11.9	7.3	5.4	-9.0	-2.1	-6.0	-12.0	-15.0
Expenditure on construction	5.8	1.9	2.7	-1.8	1.2	-0.5	-1.9	-1.9
Intangible investment	8.0	8.0	6.8	3.6	10.6	8.0	-2.0	0.0
<i>Contrib. of inventories to GDP growth</i>	-0.2	0.0	0.3	-0.5	0.9	-0.7	-0.4	-0.1
Domestic demand (incl. inventories)	2.3	1.2	1.4	-0.5	5.3	-3.3	-1.9	-0.9
Exports of goods and services	13.1	7.7	2.9	-7.5	-1.5	-20.0	-8.0	-5.0
Imports of goods and services	12.2	5.2	3.8	-4.5	16.2	-16.0	-6.0	-6.0
External trade contribution	1.0	1.5	-0.2	-1.9	-7.2	-3.5	-1.4	0.2
Gross Domestic Product (GDP)	3.2	2.6	1.0	-2.3	-2.1	-6.5	-3.2	-0.7
<i>% change year-on-year</i>	4.1	1.7	-1.2	-0.5	0.8	-1.2	-3.4	-3.1
Consumer prices (CPI)	1.6	2.4	2.6	0.1				
<i>% change year-on-year, end of period</i>	1.4	3.1	1.0	1.5				
Labour productivité	2.5	1.3	-0.3	-1.4				
Unit wage costs	-1.2	0.4	1.7	2.6				
Employment	0.6	1.7	1.4	-0.9				
Unemployment rate	10.8	9.0	7.8	8.6				
Unemployment rate (ILO)	0.6	1.7	1.4	-0.9				
Real Disposable income	1.0	0.0	0.4	0.8				
Household saving rate	17.2	17.5	18.0	18.3				

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