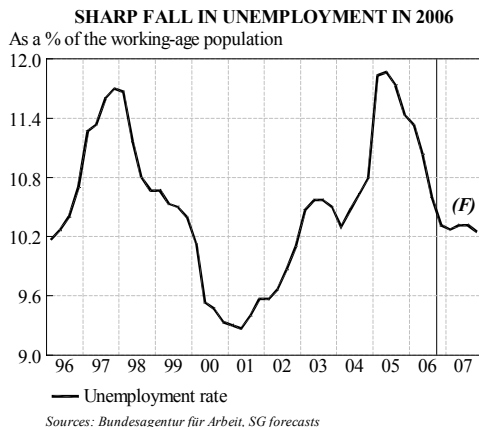


THE VAT HIKE: HOUSEHOLDS ON THE FRONT LINE

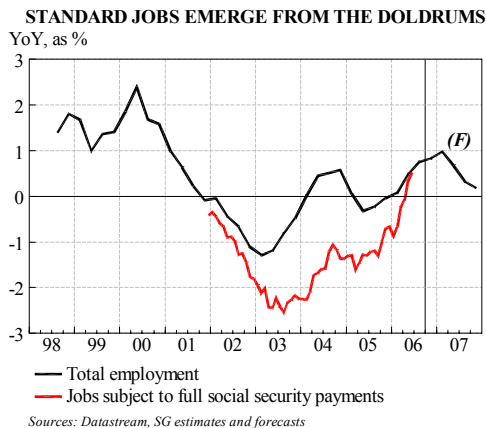
- 2006 is proving to be a good year for German households. Unemployment is falling and most of the jobs created are fixed-contract and remunerated at collective bargaining agreement wage rates. Further cause for cheer is that household confidence is perking up after being mired in the doldrums for four years. The only blot on the landscape is that wages remain under pressure.
- On a less optimistic note, households will be hard hit by the hike in the standard VAT rate at the beginning of next year. As economic activity will be less buoyant, growth in employment will be lacklustre. Despite the fact that wage negotiations ought to result in a slight increase in collective bargaining agreement wage rates, the impact on payroll figures will remain limited. Moreover, measures to boost the economy will fail to offset the sharp increase in inflation.
- On this basis, household purchasing power will be severely undermined. As German households' precautionary savings remain high, private-sector spending can be expected to stagnate in 2007, following a particularly difficult first quarter.

The current business climate is good news for households

Sharp improvement in the job market

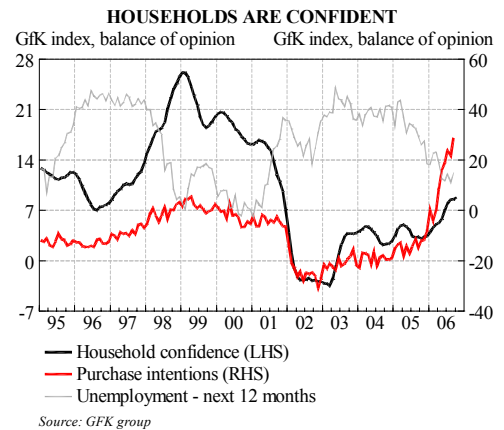


The job market has been improving gradually since March 2005: the unemployment rate (seasonally adjusted) fell from 12.1% to 10.6% of the working-age population in September 2006. This took the number of unemployed down by 408,670 persons to some 4.24 million (unadjusted data).



Unlike the situation witnessed in 2005, the fall in unemployment in 2006 came hand in hand with job creations. The trend in total employment on a yoy basis has been positive since February and has been steadily gaining momentum: +0.8% in August (+301,000 persons) versus +0.7% in July and June. The systematic contraction in standard jobs (i.e. subject to social security payments) underway since 2001 has finally come to an end. This category of jobs increased for the third month running in July: +0.7% yoy (+194,400 persons). At the same time, subsidised jobs continue to fuel the decline in unemployment. *Mini-jobs* – the main form of subsidised jobs, which account for 4.9m of private-sector jobs – rose by 133,000 units relative to July 2005. 1-Euro-Jobs (351,000 subsidised public-sector jobs) are estimated to have risen by approximately 50,000 units.

Household confidence perks up



The improvement in the job market has sparked a recovery in household confidence. The latter nonetheless remains well below the levels recorded over the period 1998-2001. This is in contrast to with the IFO and PMI survey findings. The GfK index received substantial support from two factors: i) greater optimism about the state of the job market over the next 12 months; ii) present purchase intentions with respect to durable goods. In contrast, the financial situation and savings components have held broadly static since January, even if the impending VAT hike is starting to cast a slight shadow over sentiment about prospects for 2007.

2007 will be a hard year for households

Little joy in terms of jobs and wages in 2007

2006 will be a good year, but followed by a slowdown in economic activity in 2007. Growth should nonetheless remain slightly above potential at 1.4%. Total employment ought to continue advancing (+0.5%). The unemployment rate is expected to inch back to 10.3% of the working-age population, versus 10.8% in 2006 and 11.7% in 2005. Subsidised jobs, notably *Mini-jobs*, will remain the key source of the downward momentum, as standard jobs are likely to remain lifeless over the year.

Inflation will, in all probability, impact on negotiated wages and salaries. Inflation will be high in the first half and then start stabilising at less than 2% from July onwards. The wage negotiation round, which is set to kick off at this stage of the year, will concern some 20m waged-employees. Bargaining in the metallurgical and electronic industries (3.2m workers), which generally set the tone, will take place at the end of March. Growth in negotiated wages and salaries monthly rates (calculated on a 12-month moving average basis) emerged at approximately 1.1% yoy in July, and is glued to this level since the beginning of 2005. Although the deterioration in the job market and in the economic situation at the beginning of 2007 will prevent wage increases from assuming a major proportion, it is probable that annual growth rates of negotiated wages and salaries will pick up to around 1.5 to 2%.



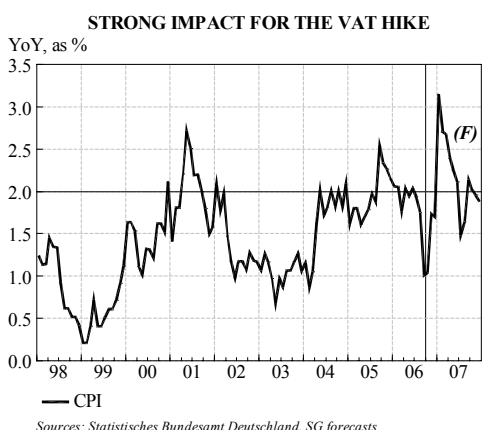
However, the gross payroll per job will increase by only 0.9%. The lag relative to growth in negotiated wages and salaries (a phenomenon observed between 2003 and 2005) is largely the result of the fact that *Mini-job* wages are lower than the conventional ones. On this basis, wage restraint can be expected to continue in Germany. An acceleration in the gross payroll between 2006 (+1.2% yoy) and 2007 (+1.4% yoy) can thus be ruled out. Payroll growth will remain well below levels seen over the period 1998-2001 (+2.6% on average) and is still negative in real terms.

The recovery programme will have a limited impact on households

Reductions in welfare contributions will not do much to help households. The 2-point decrease in unemployment insurance contributions to 4.5% of gross wages will be partially offset by the increase in state pension contributions (+0.4 points to 19.9%) and in healthcare insurance contributions (+0.5 points to 13.9% on average). Deductions on standard jobs will fall by 1.1 points. As these deductions are borne equally by employers and employees, the rate of deductions for employees will drop by only 0.5 points. The net payroll will consequently rise by 2.3% yoy, with the total reduction in contributions representing an extra EUR 5bn for German households.

According to 2007-2009 budget programme projections, the principal measures to boost the economy ought to result in a near EUR 3bn increase in welfare benefit payments (the "parental wage", subsidies for personal services, etc.).

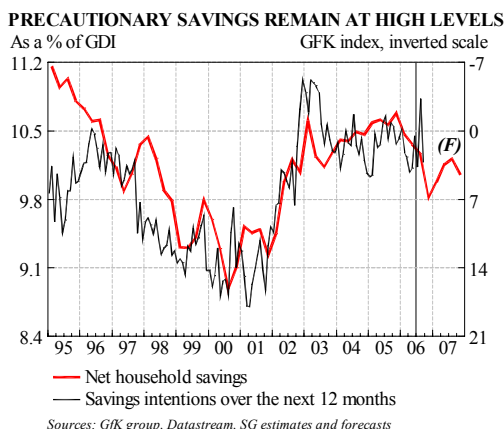
High inflation in the first half of 2007



The 3-point increase in VAT applies to approximately 70% of products included in Germany's CPI index. Assuming that (i) companies – which will be in a stronger position as a result of the profitability gains in 2005 and 2006 – reduce their margins and pass on only 75-85% of the hike to the consumer, and (ii) oil prices gradually retreat to around USD 52 a barrel next year, inflation should emerge at approximately 2.2 to 2.3% in 2007. Inflation is

likely to be particularly strong in the first and second quarters (2.8% and 2.3% respectively).

The savings rate should remain at a high level in 2007

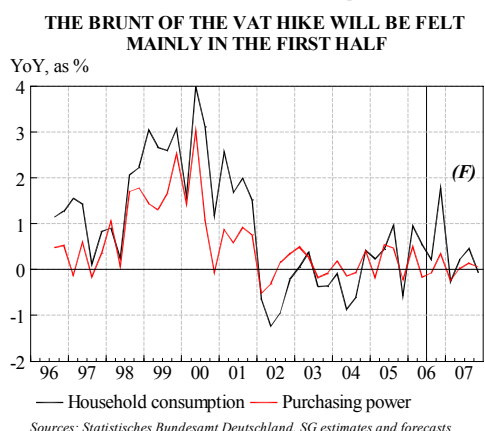


The household savings rate in Germany is high (gross savings represented 17% of disposable income in 2005, compared with 15% in France and around 14% in the eurozone). This can be explained by the fact that property market-related wealth effect (54% of household net wealth) did not come into play in Germany: housing prices rose by an annual average of 0.1% between 1998 and 2005 (versus +10.4% in France and +12.8% in Spain). The situation is unlikely to change in 2007. As indicated by the GfK survey, German households would appear unwilling to dip into their savings to finance their consumption. The propensity to save, both present and future, has remained virtually stable since 2003. In addition, the state of the job market, combined with wage restraint, can be expected to continue to underpin high levels of precautionary saving. We nonetheless believe that the savings rate will edge back slightly at the end of 2006 in order to finance advance buying to beat the VAT hike.

All things considered, the annual average net savings rate should hold stable in 2007 after slipping from 10.6% in 2005 to 10.2% in 2006.

In conclusion, household consumption will be undermined by low purchasing power in 2007

Household disposable income is made up of the net payroll (39.2% of disposable income in 2005), the revenue of private entrepreneurs (35.3%) and welfare benefit payments (25.5%). Whilst the payroll and welfare benefit payments will pick up slightly in 2007, revenues of private entrepreneurs and property-related revenues will slacken in line with economic growth rates.



And so, spending power will stagnate in 2007. This will have a direct impact on household consumption. Given the slight increase in the savings rate expected after the downward blip at the end of 2006, household consumption will emerge virtually static in volume terms in 2007 – the brunt of the impact will be felt in the first quarter of the year.

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