

## Economic conditions in Germany

### Underlying trends

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Economic growth in Germany came to a halt in spring. The weakening of demand which began to emerge in the first quarter of 2001, but which did not affect output at that time because of sizeable order backlogs, had a strong impact in spring. Aggregate production mirrored the declining level of new business, especially as firms showed little inclination to stockpile. According to the Bundesbank's initial calculations, real GDP in the second quarter of this year (adjusted for seasonal and working-day variations) remained at the first-quarter level. This implies a year-on-year increase of around 1% (adjusted for working-day variations and subject to an imminent revision of the national accounts data), compared with a year-on-year rise of roughly 2% in the preceding three-month period. On a calendar-month basis the year-on-year increase was likewise 1%, after 1½% in the first quarter.

*Weakening of  
overall  
economic  
output*

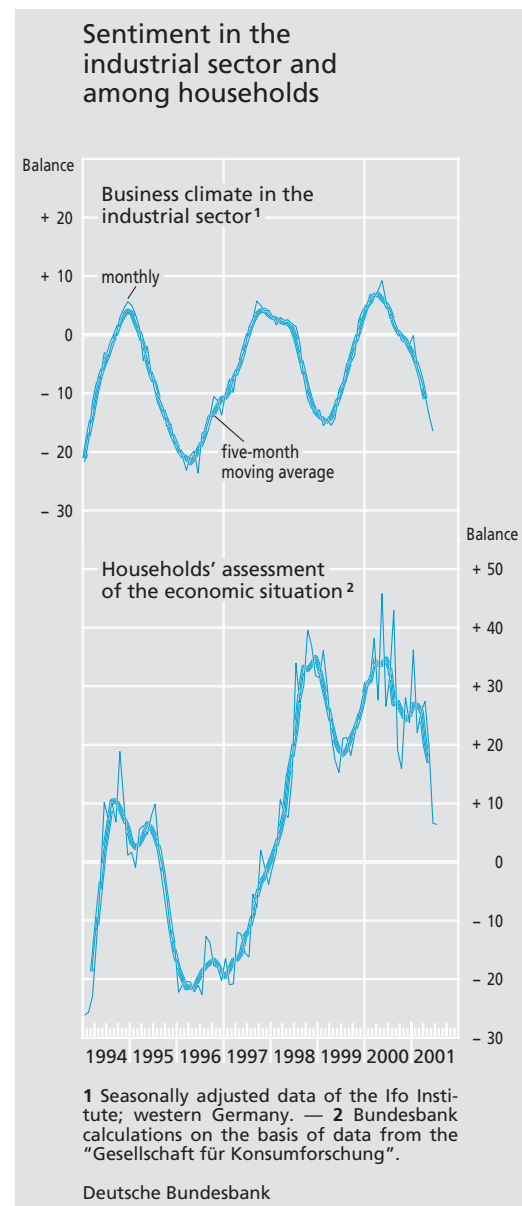
As a result, aggregate capacity utilisation decreased further and the slight worsening of the situation on the labour market, where employment has been stagnant for some months now and the number of unemployed has been growing in small steps, persisted. However, it would be unwarranted to infer that the German economy is already headed for a recession. Short pauses in growth or falls in output during a cyclical slowdown by no means inevitably lead to a protracted downswing. For example, the considerable strains placed on the global economy in 1997/98 by the problems in the east Asian emerging-market countries appear in retro-

*Headed for  
recession?*

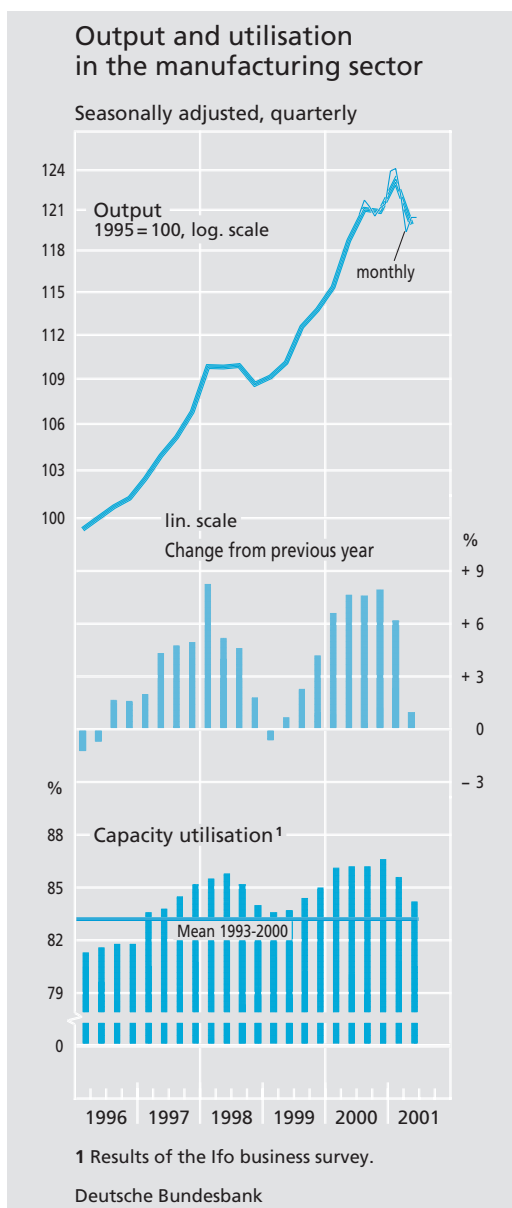
spect to have stunted the growth process in Germany only temporarily and to a limited extent. The word "recession" should only be used to denote a prolonged and broadly based contraction of macroeconomic activity affecting many sectors and regions. A view which focuses solely on growth rates and which ignores the level of production and the degree of capacity utilisation is too narrow, as is an approach which disregards the time dimension. It is true, however, that the German economy has been in a difficult phase since the second half of last year. This is due not least to the fact that, given only a rather moderate potential growth, the interaction of several distorting factors can easily lead to flat growth or stagnation of GDP. However, no self-reinforcing downward stimuli are apparent at the moment. Despite undeniable risks, there is a good chance of a "resumption" of the upward momentum. Growth impulses exist in the form of the tax reductions which came into effect on 1 January 2001 and the declining inflation rate.

*Drop in  
domestic  
demand*

Clear retarding effects are being exerted at the moment by the weakening of domestic demand for industrial products. Although Germany's product profile is far less concentrated than that of some other countries on the new economy sectors telecommunications and data processing, the overall slackening of investment has also affected the manufacturers of "traditional" capital goods. This has doubtless contributed to the fact that – as the Ifo Institute reports – the assessment of both the current situation and of the near-term outlook have deteriorated. According to surveys conducted by the Centre for Euro-



pean Economic Research (ZEW), the gloomier mood in the manufacturing sector has spread to commercial service providers. Along with the construction-related trades, which include architectural and technical planning offices, such segments as advertisers and plant hire firms have now also become noticeably more guarded. The same applies to IT service providers, which until recently were participating in the new economy boom. On bal-



ance, the enterprises surveyed by the Centre for European Economic Research downgraded their turnover expectations appreciably and were also less optimistic about their staffing requirements in the period ahead.

*Signs of a slight stabilisation*

However, demand for industrial products appears not to have decreased further during May/June. It is also possible that the structural

adjustment process in the construction industry, which has been going on for a number of years now, may be approaching its lower limits. At any rate, the orders received by the sector of late were distinctly higher than at the beginning of this year, and the year-on-year decline in volume was likewise not as pronounced as before. Hence one of the brakes on domestic growth may be slowly letting up. The increase in retail purchases during the spring months indicates a slight improvement in private consumption. Another factor that is having an increasingly positive effect is that the extra cost burden caused by higher energy prices has now eased and that inflationary pressures in general appear to have passed their peak.

Households' incomes, which have benefited since the start of this year from the lowering of income tax rates, continued to develop positively *per se* in the second quarter. According to the incomplete figures available so far, wages and salaries per employee, which in seasonally adjusted terms had already grown by 2% in the first quarter compared with the preceding three months, appear to have expanded further. In the producing sector (excluding construction and energy supply) actual earnings in April and May exceeded the average level of the first quarter by  $\frac{3}{4}$ % (after eliminating seasonal fluctuations). In many services industries, too, employees gained pay rises in spring that had been agreed last year or, in the case of banks, insurance enterprises and the retail trade, in this year's pay round.

*Positive income trend*

*Key conditions  
still in place*

On the cost side, personnel expenditure remained moderate, even though the improvement in labour productivity is likely to have lessened for cyclical reasons. The financing terms for industrial and housing investment as well as the good competitive position of German businesses likewise support the view that, despite the present economic lull, key conditions for an upturn remain in place.

### Output and labour market

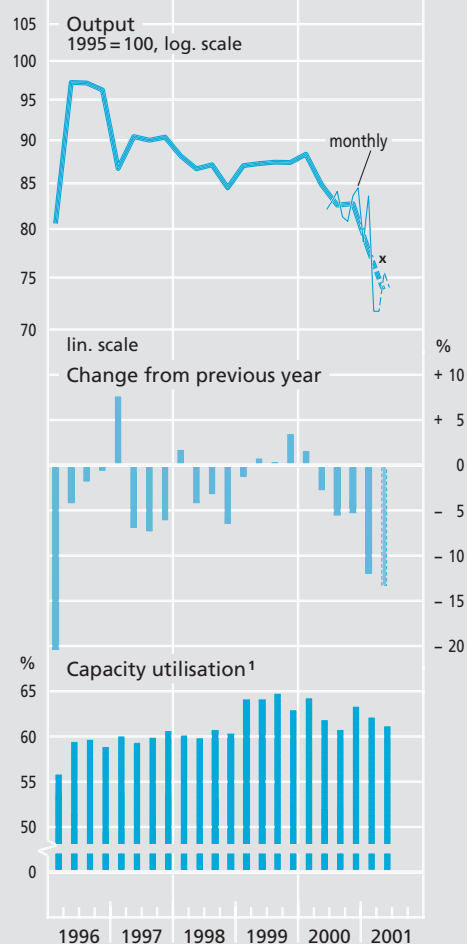
*Fall in industrial  
output*

In the second quarter of 2001 manufacturing output failed to match the level achieved in the first three months. On an average of the period from April to June, it was 2¾% down in seasonally adjusted terms on the first quarter (which, however, had marked a high point of production activity). Although a year-on-year increase of 1% was recorded in the second quarter of 2001, this contrasts with over 6% for the first quarter. According to Ifo survey data, order levels fell sharply; in seasonally adjusted terms they amounted to 2.8 production-months in June, compared with 3.0 months previously.

Production was cut back most strongly by manufacturers of capital goods. This applies in particular to the producers of office machinery and computers and of communication equipment and apparatus, which last year achieved record results. But output also contracted in the intermediate goods sector and in the field of consumer durables. By contrast, the production of non-durable consumer goods held up comparatively well.

### Output and utilisation in the construction sector

Seasonally adjusted, quarterly

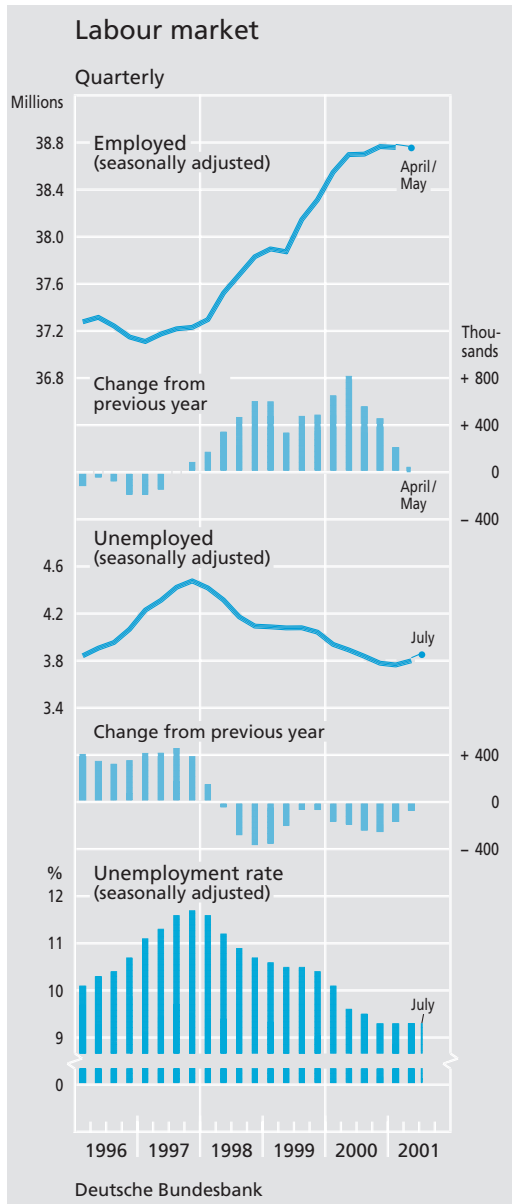


<sup>1</sup> Results of the Ifo business survey; western Germany. — x Provisional pending adjustment to the annual overall survey.

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The reduction in the level of business activity lowered the utilisation of production capacity perceptibly. According to the calculations of the Ifo Institute, utilisation in June fell further by around 1½ percentage points compared with March; it was 2 percentage points below the level of June 2000. Measured by its longer-term "normal level", however, the degree of utilisation of fixed assets was satisfactory.

*Lower capacity  
utilisation*



*Construction output showing hopeful signs*

In the construction sector a slight improvement has been evident during recent months. Construction output in May/June distinctly outstripped the unfavourable outturn in March/April. However, seasonally adjusted output for the second quarter as a whole was 5½% down on the first quarter, when it had benefited not least from the mild winter weather. Just how low the level of business activity in the construction sector is can be seen

clearly from the year-on-year decline of around 12¾% in the second quarter.

The labour market clearly mirrored the cyclical slowdown during the second quarter. According to the (revised) calculations of the Federal Statistical Office, employment in May was somewhat lower than at the end of 2000, when the last peak was reached. The seasonally adjusted number of persons in work (38.76 million) was barely 20,000 more than a year previously. In December the year-on-year increase had amounted to 385,000 persons, or 1%. Whereas the number of people employed in industry showed little change, the level of employment in the construction sector fell further. In the service sector, too, the recruitment pattern was restrained.

*Employment unchanged*

According to the Federal Labour Office, unemployment (after taking account of seasonal fluctuations) has risen slightly from month to month in the course of this year. From December 2000 to July 2001 the seasonally adjusted number of registered jobless increased by around 90,000 to 3.86 million. It was thus no longer lower than the comparable previous year's level. The seasonally adjusted unemployment rate at the end of July, according to calculations of the Federal Labour Office, was 9.3%; measured by the standard ILO yardstick, it was 7.9%.

*Unemployment somewhat higher*

At 17.6%, the seasonally adjusted share of unemployed (according to the definition used by the Federal Labour Office) in the total (civilian) labour force in eastern Germany at the end of the second quarter was almost two

and a half times as high as in western Germany. However, the slight cyclical rise in unemployment has so far been largely confined to the western part of the country, which accounted for around three-quarters of the increase since the low point reached in December. As is customary during a cyclically induced weakening of economic momentum, it was mostly men who lost their jobs as it is they who are mainly employed in goods-producing professions. The increase in unemployment among women was far smaller.

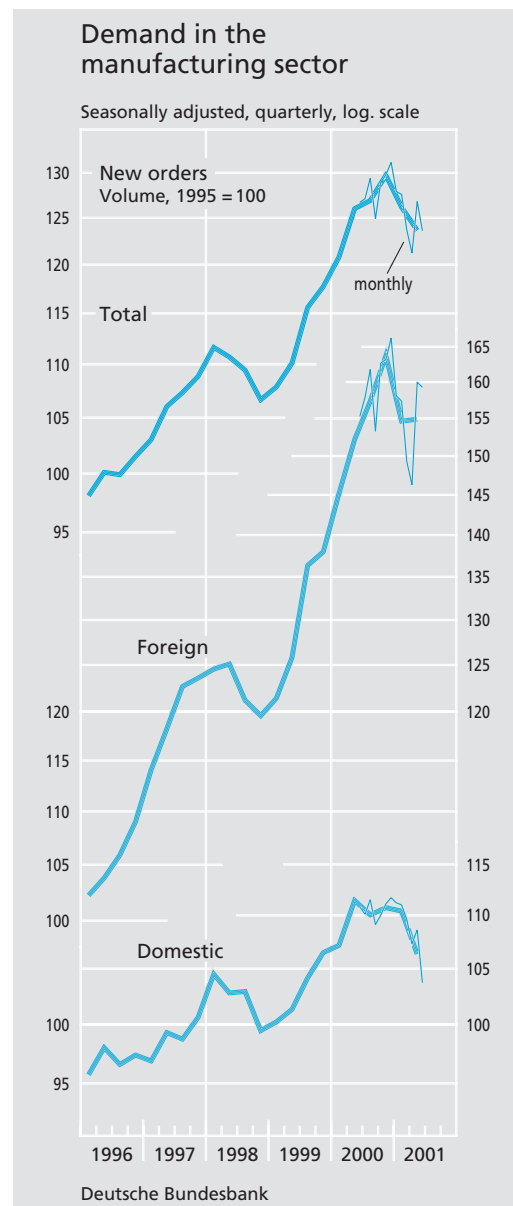
*Limited use of labour market policy instruments*

The deployment of labour market policy instruments was reduced further on balance. Job creation schemes, in particular, were pruned back considerably. Some 240,000 persons were taking part in such schemes in July 2001, which was 80,000 fewer than twelve months earlier. By contrast, reintegration grants and discretionary assistance by the Federal Labour Office were both expanded. Around 170,000 people benefited from these two measures, a year-on-year increase of almost 25,000. At 325,000, the number of individuals attending vocational training courses was roughly the same as a year earlier.

## Orders

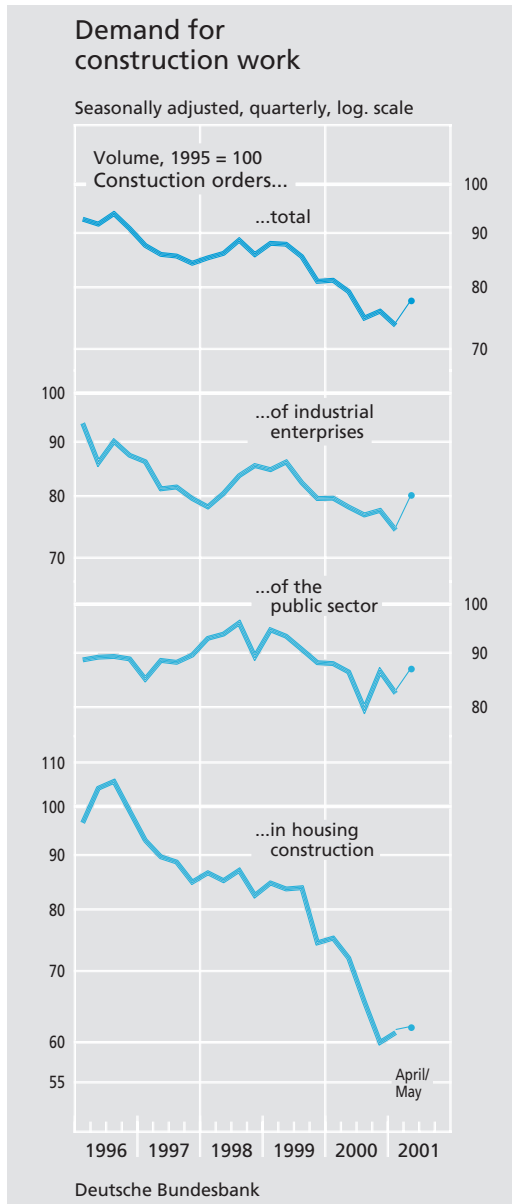
*Fewer orders received by industry*

Manufacturing orders, which had reached a very large volume at the end of 2000, receded significantly during the spring months, although this decline did not persist in May and June. However, this was insufficient to prevent a net decrease for the second quarter as a whole compared with the first three



months of 2001. Seasonally adjusted orders were 2% below the level during the first quarter of this year and 1¾% down on last year's corresponding level, after having grown by 4¼% in the first quarter.

The trend in domestic orders was particularly unfavourable. In seasonally adjusted terms, new contracts signed in the second quarter were 3¾% below the level in the first three



months. The year-on-year decrease was 4½%, following an increase of 3% on average between January and March. While the declines in orders for intermediate goods and especially for durable and non-durable consumer goods was moderate, manufacturers of capital goods sustained a considerable drop. A sharply negative change in trend was registered for communication equipment and apparatus – which notably include portable

telephones. Whereas in the first quarter orders in this segment had exceeded the previous year's level by around one-fifth, they showed a year-on-year fall of almost one-tenth in the second quarter. A similar, albeit less drastic trend, was apparent in the case of office machinery and computers – especially the latter.

By contrast, foreign orders did not decline in the second quarter vis-à-vis the first three months on a seasonally adjusted basis. One reason for this was a number of large-scale orders received by producers of intermediate goods and capital goods. Another reason was a persistently buoyant demand from foreign customers for German motor vehicles. The combination of the two factors was largely responsible for the fact that export orders in the three-month period April to June were 1¾% higher than a year before.

The demand for construction work picked up noticeably at the beginning of spring. The seasonally adjusted level of incoming construction orders on an average of the months April and May was about 5% above the first-quarter figure. However, given the very low level in the first quarter – partly due, perhaps, to delays in contract awards – the statistical rise probably overstates the underlying cyclical movement to some extent. Nevertheless, the number of new orders at the end of the period under review was slightly higher than the equivalent position in the second half of 2000. This indicates a stabilisation of the order situation, albeit at a very low level. The year-on-year decrease narrowed from 9½%

*Construction demand firmer*

in the first quarter to less than 4% in the two-month period April/May.

The improvement in the order situation was most marked in the commercial construction sector, where the gap vis-à-vis the prior-year level was quite small. In western Germany, to which the positive development was confined, there was a greater demand (measured by building permits granted) for the construction of both offices and factories. In addition, public sector contractors, whose demand for construction work had been very subdued at the beginning of 2001, awarded a larger number of orders during the spring months.

By contrast, demand for residential construction remained at a very low ebb. It was around 15% below the corresponding figure in the previous year, which in turn was nearly a third lower than the level in the mid-1990s. In eastern Germany, where there is a large stock of vacant dwellings, the decrease compared with 2000 was twice as large. No major change in the situation is on the horizon at the moment.

### Prices and wages

*Inflation past its peak*

The rate of increase in consumer prices, which in May reached a year-on-year peak of 3.5%, declined to 2.6% in July. In seasonally adjusted terms, too, inflation subsided following quite sharp surges in April and May. In July the movement of prices was actually smaller than is usual at that time of the year. This was principally due to the easing of price pressures on the oil markets. The prices of

### Consumer price index

Changes from previous year in %

Item	2000	2001		
	4th qtr	1st qtr	2nd qtr	July
Energy sources	15.8	11.2	12.3	6.6
of which				
Mineral oil products	19.3	5.2	9.3	-0.6
Food	1.1	2.7	6.2	6.8
of which				
Seasonal products	2.5	2.9	9.6	8.9
Meat and fish products	1.5	4.6	8.4	8.9
Manufactured goods	0.4	0.5	0.9	0.9
Services	1.5	3.0	2.9	3.0
Rents	1.3	1.2	1.2	1.2
<b>Total</b>	<b>2.4</b>	<b>2.5</b>	<b>3.2</b>	<b>2.6</b>

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services, seasonally adjusted, showed no increase in July; the year-on-year rate of price growth slowed marginally to 3.0% after 3.1% in the previous month. By contrast, consumer prices for foodstuffs rose further. At the end of the period under review they cost 6.8% more than twelve months previously, as against 2% at the start of 2001. On the one hand, prices increased in the wake of the BSE and foot-and-mouth epidemics and temporary adverse weather conditions. On the other hand, there are growing signs of a general upward movement of prices, presumably intended to offset the strong downward pressure on selling margins that prevailed in 1999 and 2000.

The growth of manufactured goods prices was fairly moderate. Factoring out the usual



### Indicators of consumer price movements

Change from previous year in %

Item	2000		2001	
	4th qtr	1st qtr	2nd qtr	June/July
Headline rate of inflation				
Consumer prices	2.4	2.5	3.2	2.8
Statistical core rates <sup>1</sup>				
Consumer prices excluding seasonal food and energy	1.0	1.6	2.0	2.1
Consumer prices with modified weights <sup>2</sup>	1.1	1.4	1.8	1.9
5 % trimmed mean <sup>3</sup>	1.3	1.8	2.6	2.4
Weighted median <sup>4</sup>	1.1	1.2	1.4	1.5
Mean of core rates	1.1	1.5	2.0	2.0

<sup>1</sup> Bundesbank calculations. — <sup>2</sup> Reduction of the weights of volatile components. — <sup>3</sup> 5% exclusion of components showing a high/low degree of price volatility. — <sup>4</sup> Price change for the component at which the cumulative individual weights reach 50%.

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seasonal fluctuations, these goods have become only slightly dearer during the past few months. The year-on-year rate of price increase amounted to about 1%. At 1.2%, house rents went up only a little more.

*Core inflation rate higher*

The core rate of inflation, which captures the underlying trend stripped of short-term fluctuations or exceptional movements, recently hovered around 2% – using different methods of calculation. Compared with the end of 2000, the core rate increased in the first half of the current year. In the case of some products this reflects the “pass-through effect” of the rise in energy prices and of the depreciation of the euro. To that extent the core rate – measured against the primary price disturbance – also contains an “after-math component”.

The international price quotations for Brent crude oil have settled at around US\$ 25 in recent weeks. That is a substantial easing compared with last year, when prices had been close to US\$ 30. The rate of increase of import prices, which had accelerated sharply in the first spring months, weakened markedly later in the second quarter. The year-on-year price growth slowed from 5.1% in April to 3.6% in June. Excluding energy, it amounted to 2.4% of late.

*Oil prices stabilised, import prices more moderate*

The year-on-year increase in the level of producer prices for industrial goods reached a high of 5.0% in April. By June it had receded to 4.3%. Excluding energy, it was only 2.1%. Whereas the prices of intermediate goods and capital goods both grew at a distinctly below-average pace of 1%, the price expansion in the case of consumer goods (+3.3%) was well above the mean figure. This was caused not least by a sharp rise in prices in the food, drink and tobacco industry.

*Deceleration of price growth in industry*

Producer prices of agricultural products in May – the latest month for which statistical data are currently available – were 8.2% ahead over twelve months. At the start of 2001 the comparable rate had been only 5.4%. While the annual rate of price growth of animal products eased from 13.4% in March to 8.9% latterly as the effects of the epidemics waned, it expanded to 6.8% in the case of vegetable products. The principal reason for this was poor weather conditions in early spring which caused the prices of seasonal produce to shoot up. In the meantime, however, the upward thrust of prices has probably abated.

*Sharp rise in producer prices for farm products*

*Construction  
prices  
unchanged*

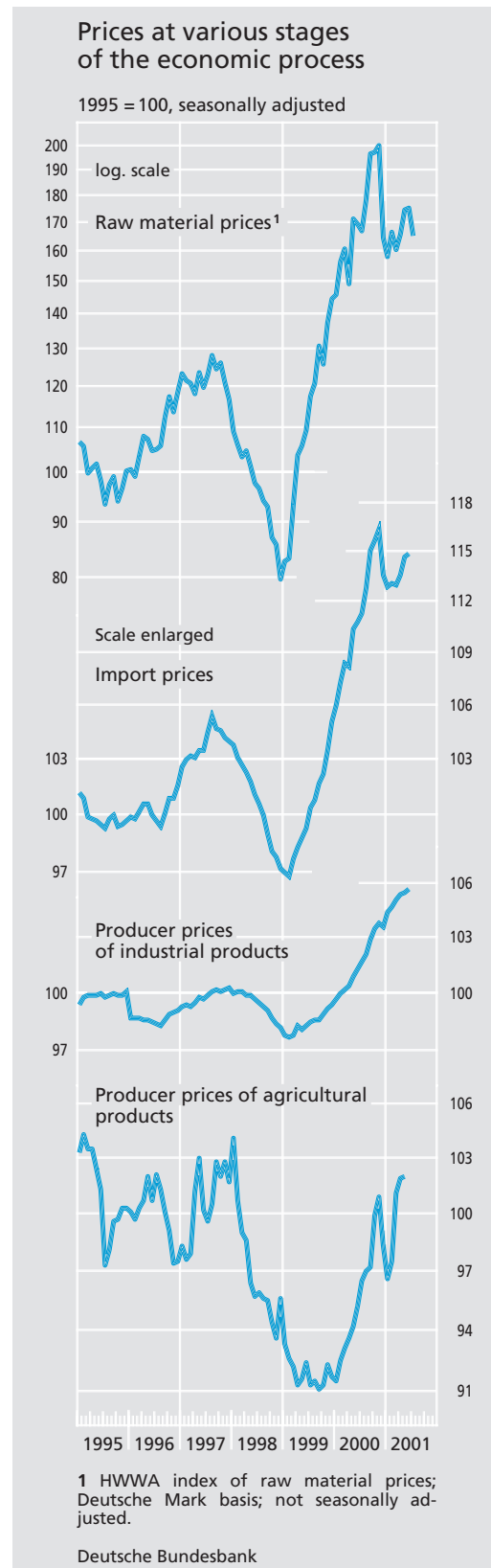
Construction prices showed hardly any change in the spring months. In the face of the persistently adverse construction climate, prices actually decreased slightly in some segments, such as the building of factories or roads. In the housing construction segment, price reductions in the basic building trades contrasted with price increases in the finishing trades and peripheral construction work; the net effect of these developments was an unchanged overall price level.

*2001 pay round*

New pay negotiations are due this year in only a few industries. Last year wage negotiators in many sectors agreed pay settlements lasting for more than one year – in most cases until spring 2002 – providing for pay increases this year averaging just over 2%. Although those pay agreements which were signed this spring were somewhat higher, the national average rise in wages and salaries for 2001 as a whole should be limited (as last year) to around 2% – in part because of baseline effects.

*Pay settlement  
in the banking  
sector, ...*

The first major settlement in the 2001 pay round occurred in the private banking sector. The new agreement runs for 13 months; besides a flat-rate payment of DM 280 for April, it provides for a linear increase of 2.8% in basic salary from 1 May 2001. In addition, the arrangements (which had been concluded earlier) for part-time working among older staff and for early retirement as well as the agreement that framework rules can be relaxed for the purpose of safeguarding jobs have been extended by a further two years until the end of 2003. The basic pay of employees in the insurance industry was likewise



*... the insurance  
industry and in  
the retail trade*

raised by 2.8%. The agreement also runs for 13 months, with a lump sum of DM 200 being paid for the first month. In the retail trade, in which pay negotiations are traditionally conducted on a regional basis, new agreements have been signed in virtually all parts of western Germany. They envisage a uniform increase of 2.7% with a term of 12 months.

*Greater role of  
company  
pension  
arrangements*

Many employees are receiving additional benefits this year stemming from agreements signed last year in several sectors regarding pre-retirement part-time working and company-based pension schemes. Extending company pension schemes was an important component of this year's pay negotiations, too. For example, employers' representatives and trade unions in the insurance industry

agreed a further initial financing by employers in 2002 of employees' supplementary private pension plans up to 1% of the employee's salary. Employees in the retail trade, likewise from 2002, are to receive an annual lump-sum payment of € 300, which will embrace the employer's traditional contribution to employee savings; the payment must be channelled to the company pension scheme. For enterprises these grants are an additional cost burden which will increase with the number of employees who opt to join the company pension scheme. This partly nullifies the impact of the reduction of pension-related costs to the employer brought about by the lowering of the contribution rate to the statutory retirement pension scheme from 19.3% to 19.1% at the start of this year.