

Economic conditions in Germany

Underlying trends

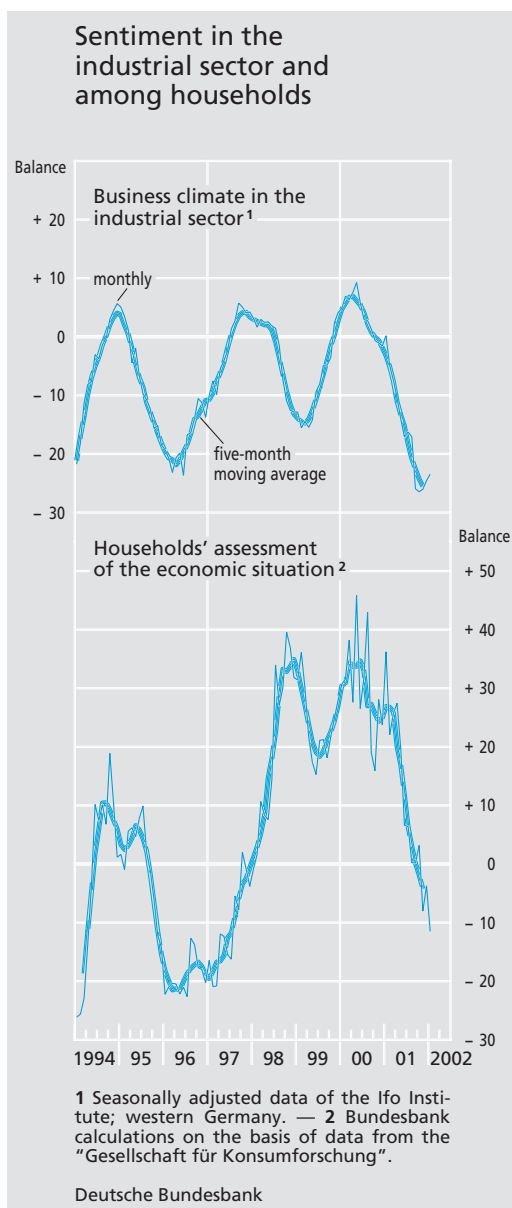
The cyclical weakness of the German economy that had become apparent in the second half of 2000 persisted during the last few months of last year. In total, there was a noticeable decline in output. According to initial Bundesbank calculations, real gross domestic product (GDP) – after eliminating seasonal and working-day variations – was around ¼% below its level in the third quarter of 2001. This means that it was more or less just as high as in the same period of 2000, compared with a year-on-year increase of just under ½% in the preceding quarter. The overall situation in autumn 2001 also deteriorated in terms of standard utilisation (which describes the average degree of capacity utilisation achieved over the medium term). On an annual average, real GDP increased by no more than ½%, compared with 3% in 2000.

*Decline in GDP
in Q4 2001*

Nevertheless, the probability of a further deterioration in the economic situation is, if anything, slight at present. In fact, a number of indicators point to the economy as a whole having stabilised at the turn of 2001-02. Also, major conditions for an economic revival during the course of this year are still in place.

The weakness in output in autumn was centred on manufacturing: production was being cut back further in response to slacker demand, thus leading to a continuing slide in the year-on-year figures. Foreign orders, which had reached record levels as recently as in 2000, were not the only ones to show a tendency to decline in connection with the perceptible slowdown in international growth

*Weakness
centred on
manufacturing*



and global trade. There was also a marked fall-off in new orders from domestic customers. The deterioration in manufacturing also had an impact on commercial services providers. As the ZEW (Centre for European Economic Research) reports from its surveys, most branches of this sector – which includes tax and business consultancy firms as well as firms which rent out and lease motor vehicles and those renting out and leasing machinery

and equipment – rated business conditions in the fourth quarter as showing a further deterioration. Even IT firms, whose performance had invariably been better than the average previously, were viewing the position much more cautiously than earlier. The fact that architects and planning offices also described the situation as unsatisfactory reflects the continuing process of adjustment in the construction sector. The orders position in construction remained very weak up to the end of the period under review, with output persisting at a low level towards the end of the year.

Households' consumption demand remained quite subdued in the fourth quarter of 2001. As shown by the surveys of the consumer research institution GfK, there has been no improvement in consumer sentiment so far – in fact, it remains unfavourable on the whole. With regard to the economic outlook, in particular, those surveyed were still cautious and even their expectations about their own incomes remained very pessimistic. This – together with a gradual deterioration in the situation on the labour market – is likely to have been a factor in the willingness to buy being weak. There were various reports of increased purchases owing to hoarded money being released in connection with the introduction of euro banknotes and coins. According to the official statistics on retail trade turnover, however, this did not generate any major stimuli.

Recently, however, there have also been recognisable signs that the economic situation is gradually becoming more stable. Firstly, there

*Restrained
consumption
demand*

*Signs of an
economic
stabilisation*

Official price statistics versus anecdotal evidence

What does the official price statistics do?

The basic data for the official statistics are collected on a widely dispersed regional basis throughout the Federal Republic of Germany. Every month, price surveyors go into selected retail outlets in 190 reporting communities in order to determine selling prices. The price analysis covers 750 goods and services. The individual goods are described as precisely as possible so that the prices relate to identical products in all cases. Each price surveyor fills in the report sheet in accordance with fixed guidelines. The combination of price reporting units and the selection of goods produces a current monthly basic pool of around 350,000 individual price series.

The goods and services included in the price analysis are selected on the basis of regularly recurring sample surveys of income and expenditure. These capture households' records of all their purchases within one year. From this is derived a representative basket of goods and a sum of expenditure for the average of all households. The importance of the individual purchases is measured by their percentage share of total expenditure. In accordance with the weighting scheme of the consumer price index (CPI) with the base year 1995, roughly 10% each is spent on food and energy, just over one-third is accounted for by purchases of manufactured goods (which include cars, electrical appliances, clothing and books), and one-quarter is spent on acquiring services. Rental payments account for the rest.

The "price question" in January 2002

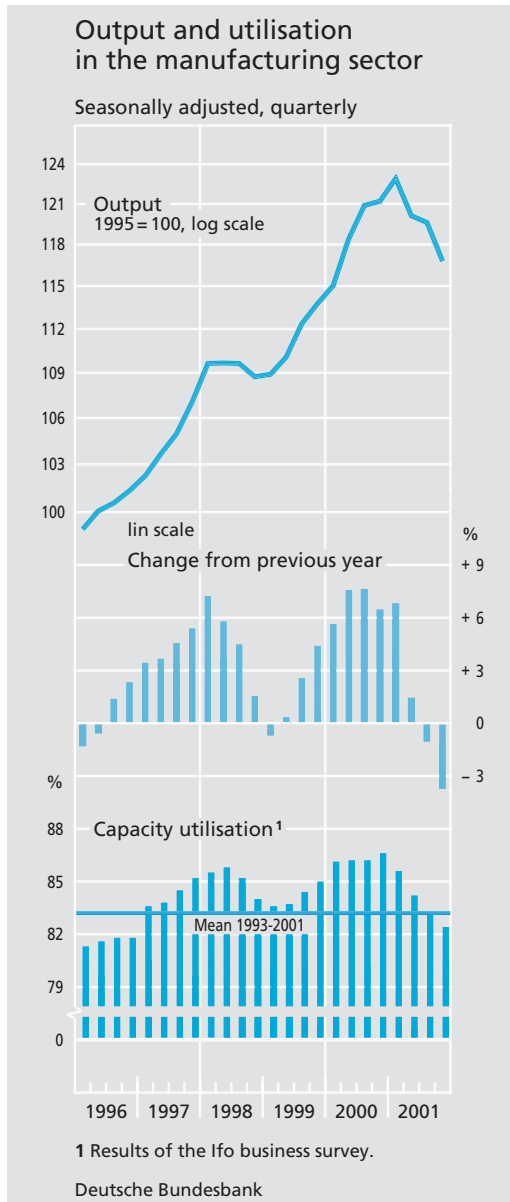
In January of this year, there were numerous reports that many goods had become appreciably more expensive. The "anecdotal evidence" was focused, in particular, on seasonal food products and the restaurant and catering trade. Fresh lettuce and peppers were said to have reached quite "astronomical prices". When the official statistics then reported that consumer prices had

risen by less than 1% month-on-month, and that the year-on-year rate of increase had gone up "only" from 1.7% to 2.1%, this finding did not seem to tally at all with consumers' personal experience.

It should be pointed out that the official statistics has indeed also captured these personally identified price movements. According to the official records, prices of seasonal food products, for instance, were 12% higher in January than they had been at the end of 2001. Vegetables alone, in fact, cost as much as 23% more, with price increases of up to 75% being recorded for a head of lettuce. In restaurants, month-on-month price rises of 2% were ascertained, which led to a year-on-year rate of price increase of almost 4%.

What additionally has to be taken into consideration, however, is that the price index also contains many other goods which have scarcely risen in price or have, in fact, become less expensive. For example, consumer electronics and photographic appliances were somewhat cheaper in January than they had been in December, and cars cost no more than before. Much less attention was directed at these prices, however. The general impression of prices is evidently influenced more strongly by daily shopping than by major 'one-off' purchases. Furthermore, the individual consumer tends to focus more on local price developments, while the price index with its widely dispersed reporting communities makes it possible to give a picture of prices nationally.

For all of these reasons, it can be justifiably assumed that the official price statistics has correctly recorded price developments in January as well. The large number of prices captured, the qualified personnel, and the plausibility checks carried out at the Statistical Offices indicate that the overall outcome is representative and accurate.



has been a visible improvement in manufacturing sentiment. Firstly according to the ifo surveys, enterprises' expectations about future developments, in particular, are less pessimistic than before, which means that there has been no further deterioration in the business climate overall. Looking to the future, the financial services providers surveyed by the ZEW were quite optimistic, although their assessment is probably some way ahead of

real developments. Secondly, the intake of orders in the manufacturing sector was somewhat better at the end of the period under review. Although the level of new orders remains unsatisfactory, the leading indicators suggest that the cyclical risks, which had been strongly accentuated earlier, have become less pressing.

Nevertheless, the enterprises' earnings position still leaves much to be desired. Cutbacks in output have led to a deterioration in productivity and an increase in unit labour costs. A rise in pay that overestimates the real scope for income distribution would considerably reduce the prospects of an economic revival.

The price climate had eased markedly at the end of 2001. The year-on-year consumer price rise, which is generally regarded as a yardstick of inflation, went down to 1.7% in November and December. In January, however, there was a sharp increase in the general level of prices. The consumer price index for Germany showed a month-on-month rise of almost 1%. The year-on-year rate of increase went up to 2.1%. It would be wrong, however, to see this development solely or primarily as having a causal connection with the introduction of euro cash. In fact, the price rise was overwhelmingly due, firstly, to weather-induced crop failures in the case of fruit and vegetables, and, secondly, to a number of tax increases. Although instances of the euro having a price-raising impact can also be ascertained, they are, on the whole, quite limited.

Jump-rise in prices at the start of 2002

Output and labour market

Decline in manufacturing output

As mentioned above, there was a further sharp cutback in manufacturing output in the last few months of 2001. In the fourth quarter, it was a seasonally adjusted 2¼% down on the preceding three-month period. Compared with the most recent peak in the first quarter of 2001, this represented a reduction in output of around 5%. The year-on-year decline widened from 1% in summer to 3¾% at the end of the period under review.

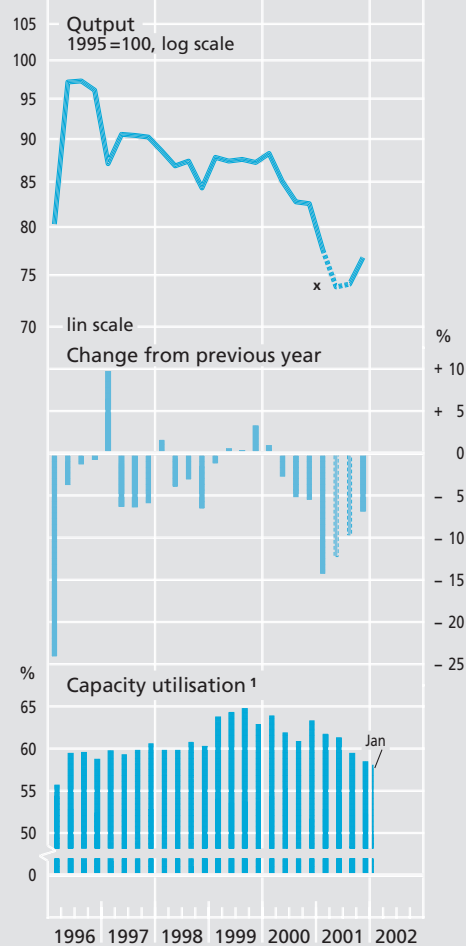
Firms in western Germany were more severely affected by this than the average. By contrast, eastern German industry was able to hold its own well into the late summer and it was only towards the end of the period under review that slight shortfalls in production were sustained. Accordingly, the figure for the fourth quarter of 2001 in eastern Germany was somewhat better than in the comparable period of 2000, whereas production in western Germany was 4% down on the year. Among the major branches of industry, the durable goods sector in both western and eastern Germany felt the deterioration in business activity most keenly, although capital goods producers sustained sharp reductions, too. While the motor vehicle sector held up quite well, there were dramatic cutbacks in the ITC sector, which includes both computer manufacturers and producers of telecommunications equipment.

Declining capacity utilisation

According to the ifo surveys, the utilisation of operating capacities declined in seasonally adjusted terms to around 82½% in December 2001. This meant that, for the first

Output and utilisation in the construction sector

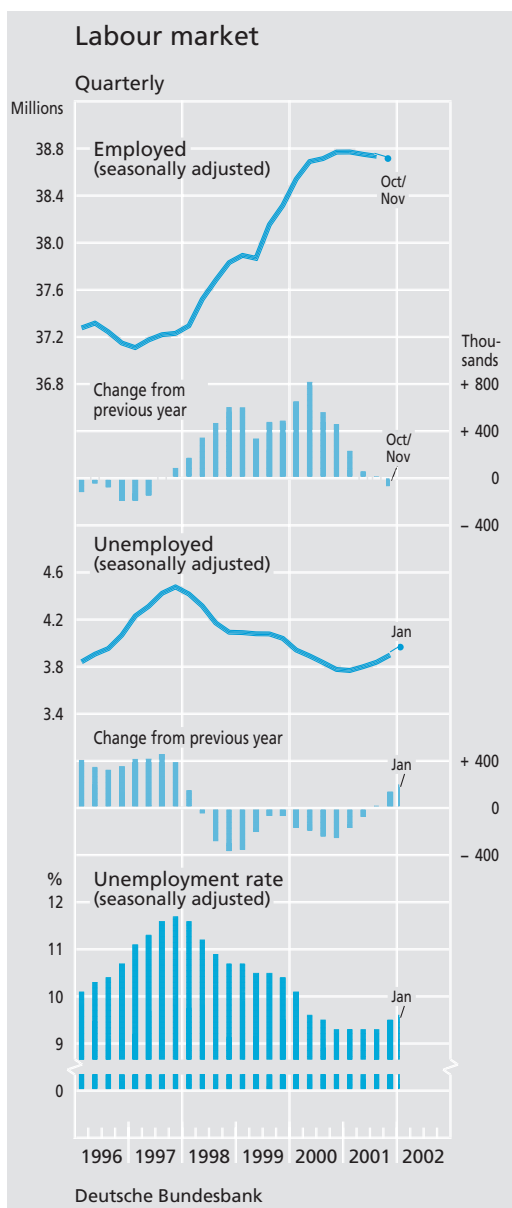
Seasonally adjusted, quarterly



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

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time since the end of 1996, it was again somewhat below the long-term average. At the same time, the cyclical situation led to a decline in the productivity of industrial labour – measured per employee, in particular, but also per hour worked – and a clear increase in unit labour costs. This suggests that the conditions for earnings in the enterprises have become more difficult.



Construction still in a trough

The construction industry was still unable to pull itself out of its trough in the last few months of 2001.¹ Construction output in the fourth quarter persisted at a level that was around 7% down on the same period in 2000. The situation in surface engineering, which is marked not least by persistently weak housing construction activity, remained particularly unfavourable. In underground construction engineering, the situation was

somewhat better. Local government construction activity, which accounts for a major part of this sector, is suffering from a very tight budgetary position, but the cutbacks are not as dramatic as those in the building industry. The degree of capacity utilisation recorded by the ifo institute, which had already fallen to a very low level in summer, deteriorated further at the end of 2001.

The cyclical weakness of the German economy has latterly been having a greater impact on the labour market. Employment, in particular, which had shown comparatively little response for an extended period, was cut back more sharply in autumn than before. According to the calculations of the Federal Statistical Office, the number of persons in work fell in November to a seasonally adjusted 38.72 million. Year-on-year, this was a decline of 85,000 persons, or 0.2%. It was not only the construction sector that made a further cutback in the number of persons it employed. There was a major reduction in manufacturing as well. Furthermore, the unfavourable development in business is likely to have led to redundancies even in several sectors of the services industry. Evidently, the scope that was available as a result of working time accounts and more flexible working arrangements, has now been largely exhausted. This is also indicated by the greater use being made of short-time working. In mid-January 2002, no fewer than 210,000 persons were registered in work with shorter

Accelerated decline in employment

¹ A cyclical assessment of developments in the construction sector is made more difficult at present by the fact that the results of this year's overall survey have not yet been incorporated into the output figures for the months from March to September 2001.

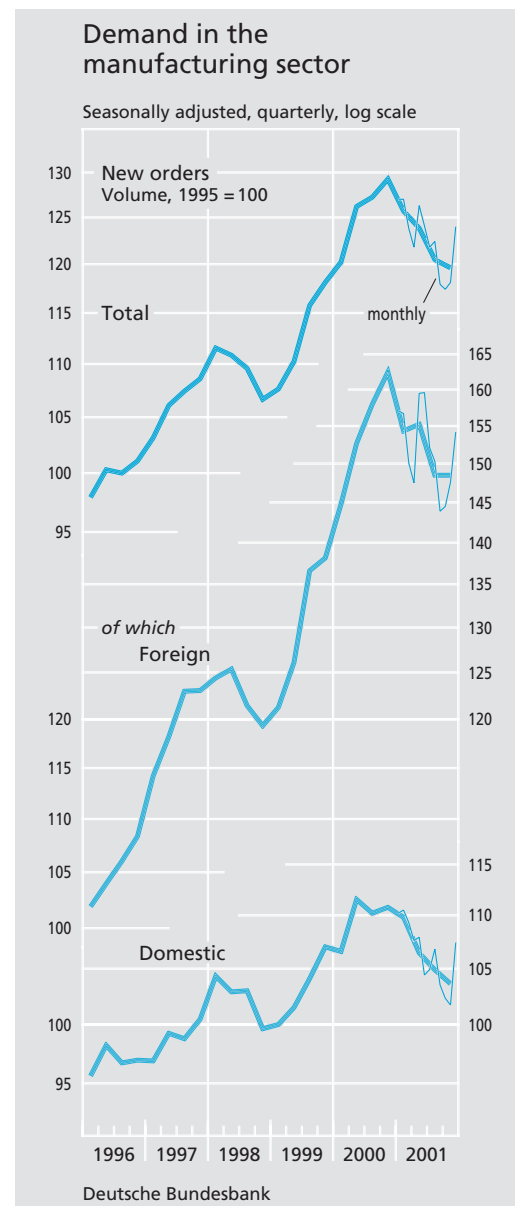
working hours – almost 120,000 more than 12 months previously.

Movements on the labour market have also been affected by changes in active measures designed to support jobs and employment. In January, for example, just under 200,000 persons were taking part in work-creation schemes, which was around 60,000 fewer than 12 months previously. Vocational training courses were still being attended by 315,000 participants, which was a year-on-year decline of not quite 40,000. These falls were partly offset by an increased take-up of part-time work by older workers and by a rise in the number of benefit recipients over the age of 58 who have decided not to register as unemployed.

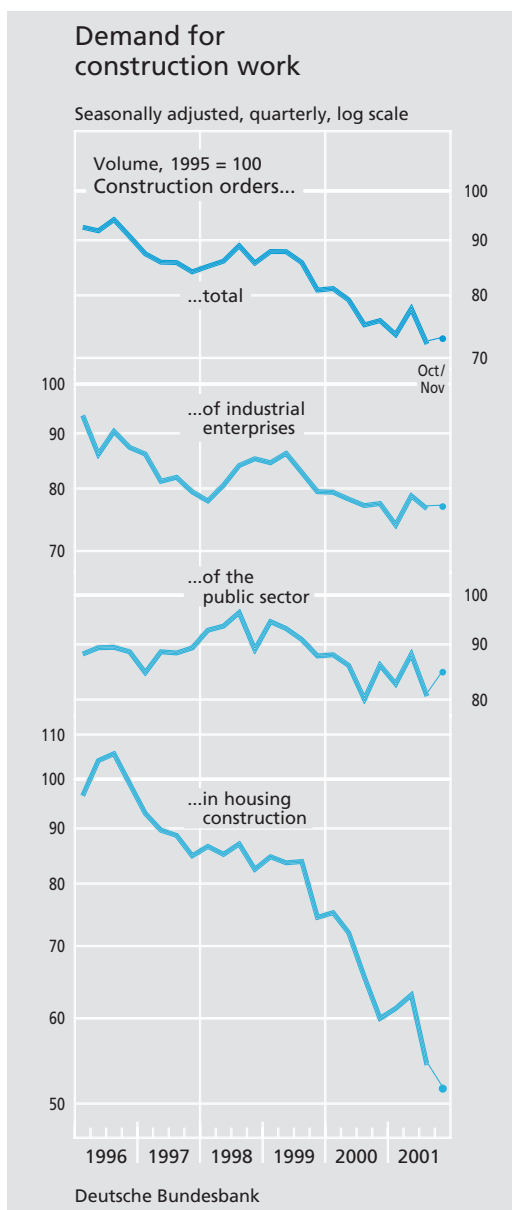
Sharp rise in unemployment

Unemployment, which had already been going up steadily during 2001, showed an especially sharp rise in January 2002. The number of persons registered as unemployed at the Federal Labour Office went up to 4.29 million, ie around 325,000 more than at the end of December. The increase was thus higher than usual at this time of year. Compared with January 2001, an additional 195,000 persons were out of work. The unemployment rate as calculated by the Federal Labour Office rose slightly to 9.6%, compared with 9.3% in 2000. According to the standard international method, the figure was 8.1% at the end of the period under review.

In addition to the slowdown in the economy, an additional factor in the above-average rise in unemployment at the turn of 2001-02 was



the exceptionally sharp onset of winter in the second half of December. As a result, many workers in the weather-dependent outdoor occupations are likely – at least temporarily – to have lost their jobs. The question of whether, and to what extent, they are taken on again when the winter weather recedes depends, not least, on the cyclical outlook in the construction sector.



Orders

Orders situation has stabilised in manufacturing and ...

New orders received by manufacturers visibly stabilised towards the end of 2001. After eliminating seasonal variations, incoming orders showed a marked increase from October onwards and, in the fourth quarter as a whole, were only slightly down on the third quarter. At the end of 2001, they were 5% down over 12 months, compared with a fig-

ure of -7½% in the fourth quarter overall. Above all, it was foreign demand which firmed up. In some branches of the capital goods sector, even a slight improvement was apparent. By contrast, domestic business declined again somewhat in the entire period from October to December 2001.

Demand for construction work likewise appears to have stabilised in October and November. At all events, incoming construction orders were showing a tendency to pick up. The year-on-year fall did not become any greater during this period either, although it remained considerable at around 4%.

... in construction

The improvement on the order books was particularly apparent in public construction. The level of new orders in this sector had been very low in summer, however, which means that the present increase signifies hardly more than a corrective movement. Industrial construction was able to make up ground somewhat compared with its low at the start of 2001, although there is still no identifiable sweeping change in trend. In residential construction, the downward slide continued up to the end of the period under review. There was a further decline in new orders in the autumn of last year in both eastern and western Germany. Year-on-year, the decline amounted to around one-fifth. The level of new orders is now no more than half as high as in 1995. Measured by the number of permits, construction of apartment houses and owner-occupied dwellings fell to a new low in western Germany, with the situation in the construction of owner-occupied houses additionally deteriorating in eastern Germany.

Prices

*Relaxed price
climate at the
end of 2001*

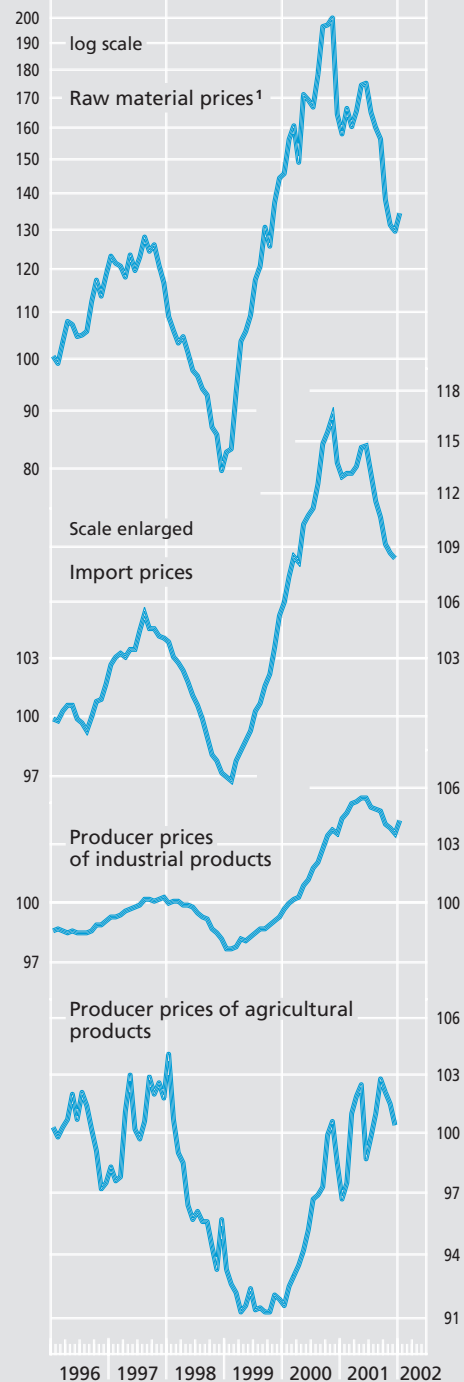
In terms of the underlying trend, the price climate remained obviously relaxed up to the end of the period under review. The decline in international oil prices means that, especially from the external side, major price-dampening stimuli have been generated. On the spot markets, Brent North Sea Oil came down in price to around US\$19½ at the turn of 2001-02, which was roughly US\$9, or one-third, less than when the price peaked most recently in May 2001; it was almost one-quarter lower than the previous year's level. This factor was clearly reflected in German import prices. Seasonally adjusted, they were declining well into December, being 4.7% down on the year at the end of 2001. Industrial producer prices also benefited from the falling oil prices. In December, they were nearly 2%, seasonally adjusted, below the preceding peak of May to June. This meant that they were scarcely any higher than one year before. In the wake of the persistently weak demand in autumn, construction work became slightly cheaper in year-on-year terms.

*Significant
increase in
prices in
January 2002*

At the start of 2002, however, a jump-rise in the general price level occurred. According to the data of the Federal Statistical Office, the year-on-year rate of increase in the consumer price index (CPI) went up to 2.1%, compared with 1.7% in November and December. This is not a case of an inflationary process, however. Rather, particularly seasonal foodstuffs (which include, specifically, fruit and vegetables), became appreciably more expensive. This was mainly due to the harsh onset of

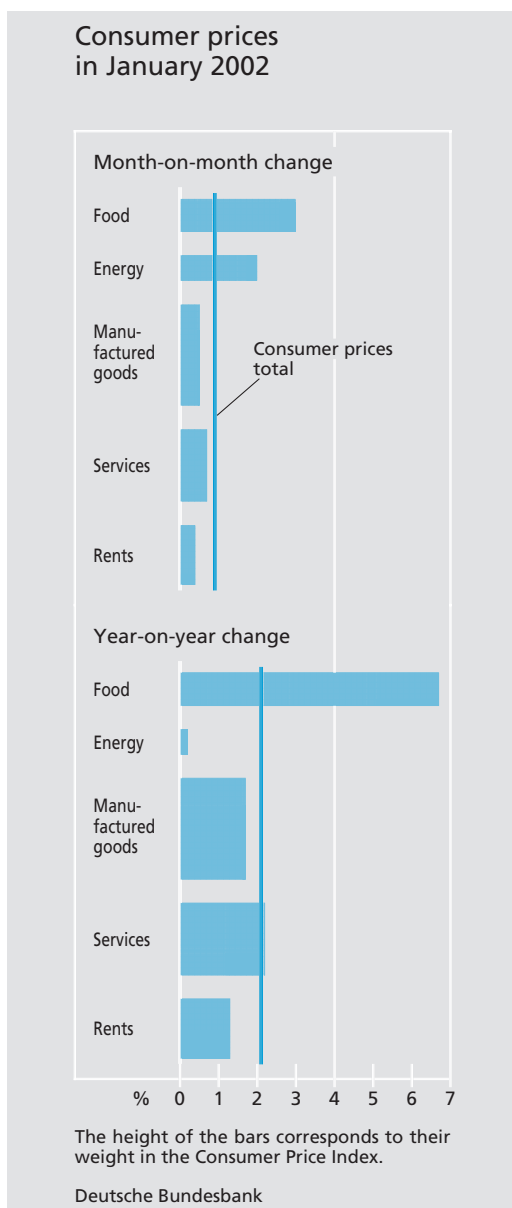
Prices at various stages of the economic process

1995 = 100, seasonally adjusted



¹ HWWA index of raw material prices; Deutsche Mark basis; not seasonally adjusted.

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winter weather conditions, which brought snow and ice to the south European countries where they are grown. This led to large-scale crop failure with dramatically increased prices. The seasonal food products were therefore more than 10% dearer in January than in 2001. The prices for these goods will return to normal, however, when the range of products from new crops comes on to the market.

Further tax rises were a second source of price increases. For one thing, there was a further stage of the ecological tax on petrol and electricity, added to which were increases in the tax on tobacco and in insurance tax. In purely mathematical terms, the tax measures contributed 0.4 percentage point to the month-on-month rise in the price index. The fact that the year-on-year price effect amounted, mathematically, to no more than +0.1 percentage point is due to administered price increases at the start of 2001 (motor vehicle tax on cars with high pollutant emissions, television and radio licence fees), which, in turn, had had a price effect of 0.3 percentage point.

Additionally, the price rise in January should be seen in connection with the introduction of euro banknotes and coins. One significant factor is that changing the price of goods and services to the new currency causes costs. It was therefore the obvious thing to combine general price increases, serving the purpose of passing on risen costs or of improving profit margins, with the changeover to the euro. The changeover to prices in euro is thus also likely to have been used as an occasion to implement price changes that had been scheduled for some time or planned for the immediate future anyway. The available statistical data indicate that there were sharp price increases especially in the hotel, restaurant and catering sector at the start of the year. The extent to which similar behaviour occurred in other sectors must remain an open question until specific detailed information provided as part of the official price statistics has been analysed. Whether the current

prices persist will also depend on the behaviour of consumers. In an intense competitive environment, the introduction of euro cash is

unlikely to have an enduring impact on the general price trend.