

Economic conditions in Germany

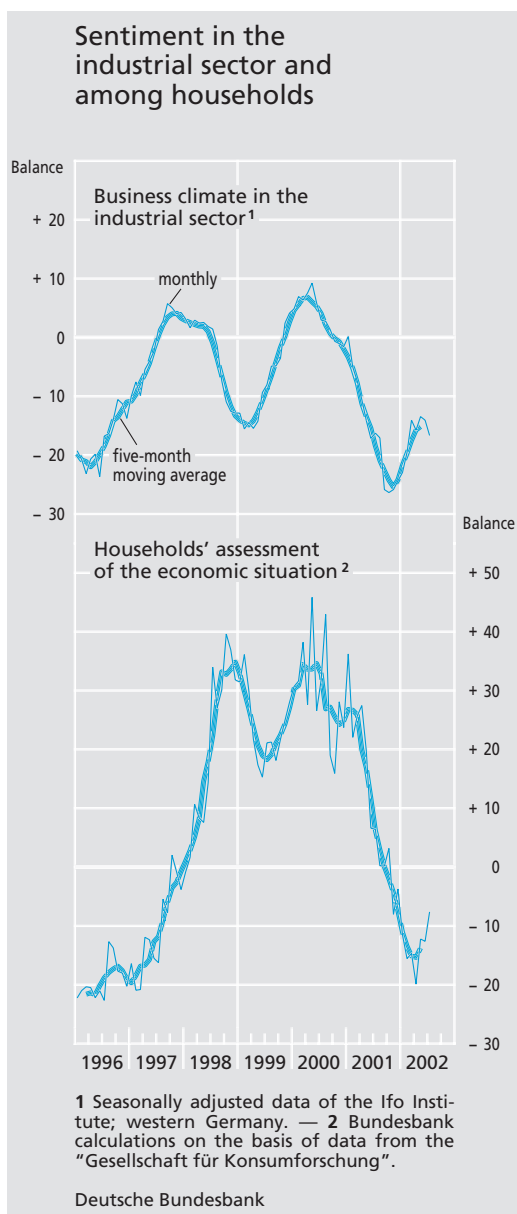
Underlying trends

The upturn in the German economy continued in the spring months, but remained quite subdued, not least on account of losses in production owing to strikes in the metal-working and electrical engineering industry and in the construction sector. After adjustment for seasonal and working-day variations, overall output went up by approximately ¼% in the second quarter. Real gross domestic product (GDP), adjusted for variations in the number of working days, is likely to have been at about the same level as it had been 12 months earlier, whereas the first three months of the year had shown a slight year-on-year decline of ¼%. In calendar-month terms, this signifies an increase of ½%, compared with -1¼% in the first quarter. In the first six months of the year as a whole, GDP was thus somewhat higher, seasonally adjusted, than it had been in the second half of last year, although the figure was marginally down on the first half of 2001.

*Continuation
of moderate
growth*

Taking account of the temporary price shocks and the strike-induced special factors in the first half of the year and given the fact that monetary conditions remain favourable with quite stable prices and an ongoing adjustment of inventories, the growth of the economy as a whole in summer may well be somewhat higher than before. Nevertheless, at present, the German economy has not yet gone beyond the initial phase of a cyclical recovery. Capacity utilisation remains at quite a low level and the after-effects of the earlier economic slowdown are still shaping the situation on the labour market. The fact that enterprises' are still cautious and restrained in

*Clouded cyclical
outlook*



their investment is another reason why it is not possible to speak of a firm upswing. Until business activity becomes stronger and gathers pace, the economy will remain vulnerable when faced with new strains – whether they be external or home-made.

As the surveys of the Ifo Institute and the Centre for European Economic Research (ZEW) show, the assessment of the current

situation is persisting at a depressed level, and the outlook for the immediate future has been rated as somewhat less encouraging again recently. There has been no further improvement in the outlook for sales and profits: in addition to the higher-than-expected wage settlements in this year's pay round and large-scale corporate insolvencies that have also weighed down sentiment, this is due to an international environment which is fraught with increased uncertainty. Furthermore, there is the possibility that the persistent domestic slump in share prices will have negative effects on confidence and that there will be certain losses in exports.

The euro's rapid appreciation against the US dollar since April of this year has also given cause for concern that the external stimuli which had initiated the cyclical turnaround might wane again and severely dampen the recovery. From the point of view of the German economy, however, little has changed so far with regard to its favourable overall international competitive position. In terms of the economy as a whole, the impact of the euro's appreciation against the US dollar is also put into perspective by the fact that the appreciation directly affects only around one-tenth of German exports, while it makes roughly one-quarter of imports cheaper. The import of stability, which provides relief to the enterprises' cost accounting and strengthens consumers' purchasing power, will provide no small boost to weak domestic demand. Together with the generally friendly price climate, the import of stability could play a part in creating a more balanced demand profile, especially as the gain in real income will have

Exchange rate effects

a comparatively rapid impact on the economy as a whole, whereas exports will be affected by the appreciation only gradually. Sight should also not be lost of the fact that the exchange rate adjustments have been accompanied by falling capital market rates in the euro area and Germany, which thus form a certain counterweight to the currently higher risk premia on the markets for corporate credit.

*Revival in
private
consumption*

Households' consumption, which had been quite weak during the winter months of the current year, picked up again somewhat recently. For the first time in nine months, spending on private consumption – adjusted for price movements and seasonal variations – is likely to have recorded an increase in the second quarter. It was not only the retail trade that reported slightly improved figures for turnover (after having complained of sales difficulties in many cases after the turn of the year). There also seems to have been less reluctance to purchase new motor vehicles. At all events, there has been an improvement – according to the consumer research institution, *Gesellschaft für Konsumforschung* – in households' sentiment, and the propensity to make major purchases has increased slightly for the first time in some while. Given the current rate of price increase of around 1% year on year, the impression of a general wave of price rises triggered by the introduction of euro banknotes and coins – which had been gained by many consumers – is perhaps becoming less important. Nevertheless, despite a slight improvement, the assessment of the outlook for incomes remained very cautious up to the end of the period under re-

view. This could indicate that uncertainty about jobs has remained high.

Output and labour market

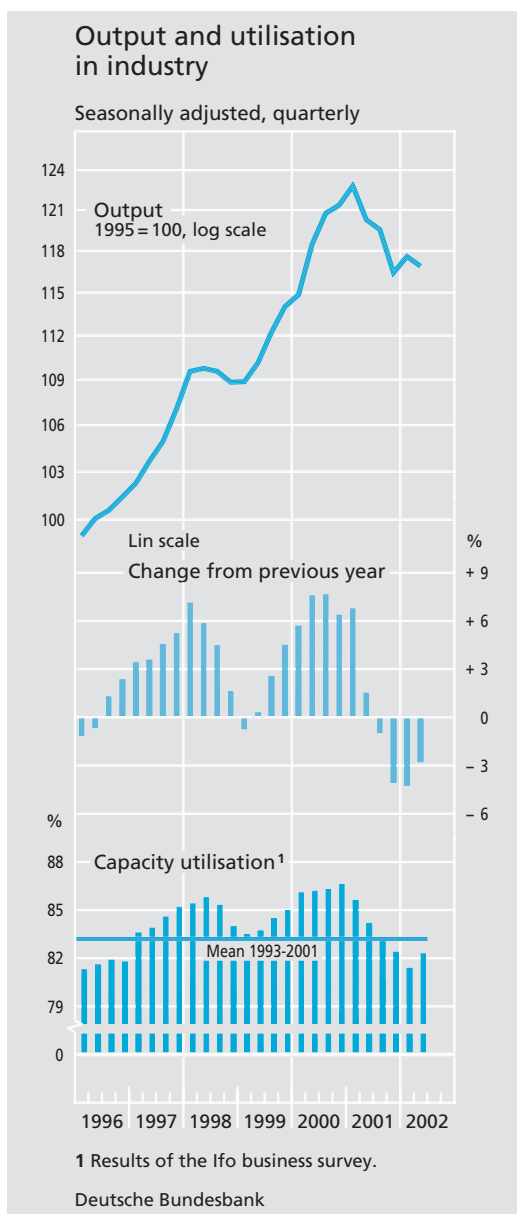
In contrast to the services sector and the retail trade, industrial production is likely to have been scarcely higher in the second quarter than in the preceding winter months. The figures available at present, seasonally adjusted, indicate a ½% fall, in fact. It has to be borne in mind, however, that the final figure for June and the quarterly survey will bring significant upward adjustments. The year-on-year decline, which had been as much as 4¼% in the first quarter, might go down to 2½%.

*Industrial
output
stagnating*

One crucial factor in the weak development of output was the strike in the metal-working and electrical engineering industry. This did not have a blanket impact, but its targeted work stoppages still had a perceptible effect in terms of holding up normal production. The production month May was especially affected. Output was stepped up in June, but this was not quite enough to offset the unfavourable figure for the previous month. This means that the underlying cyclical trend in industry is likely to have been understated in the second quarter.

*Negative
impact of
strikes*

The effects of the strike were felt most keenly in the capital goods sector. Although output in this sector in the second quarter was only slightly down on the first few months of the year, ie a seasonally adjusted ½% as the figures stand at present, production would have probably been significantly higher without the



strike. In the case of intermediate goods producers, output in spring was down on the winter months. The year-on-year decline, which had amounted to as much as 3¼% on an average of the first three months of the year, decreased to 1½%. The consumer goods sector was unable to make up lost ground. At -3%, on an average of the quarter, the downturn in relation to the comparable period of

2001 was, in fact, larger than it had been in the first few months of this year.

According to the results of the Ifo surveys, capacity utilisation in industry at the end of spring was somewhat higher than in February. Seasonally adjusted, utilisation was at 82¼% of normal full capacity in June. This was still 2 percentage points down on the year, however, and around 1 point below the longer-term average.

Increased capacity utilisation

There was a further fall in construction output in spring. Seasonally adjusted, construction output in the second quarter was around 7% lower than in the preceding winter months and almost 6% down on the already unfavourable figure of one year earlier. The present data are likely to be adjusted upward in line with the results of the overall survey, which will only become available later. Even so, it is very probable that this will be insufficient to revise the current impression of a deterioration. The situation was further exacerbated by strikes in June, which were the first to take place in this sector for some time.

Decline in construction output

The situation is also likely to have worsened in the spring months in the finishing trades, to which mainly craft firms belong. Although the official statistics are available only for the first quarter at present, there was a perceptible deterioration in both output – measured by hours worked – and turnover during that period. This situation is unlikely to have changed much in the months from April to June.

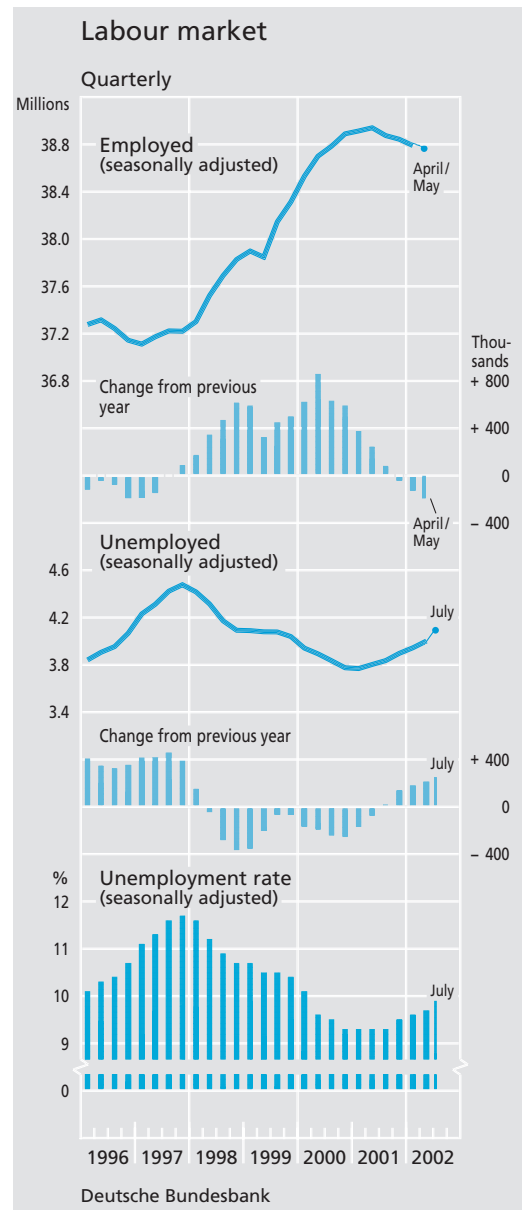
The unfavourable development affected all major subsectors of the construction industry. Residential construction as well as industrial and public sector construction were suffering losses up to the end of the period under review. There were also no major differences between eastern and western Germany in year-on-year terms.

*Continuing
reduction in
employment*

There was no easing of the labour market situation in the spring months. Instead, the tendency in employment continued to point downwards and unemployment was still on the increase. According to Federal Statistical Office data, by May the seasonally adjusted number of persons in work had fallen to 38.76 million, which was around 55,000 lower than on an average of the winter months of this year and 205,000, or ½%, lower than in spring 2001, when employment last peaked. Besides construction, where the number of employees has been declining now for years, industry has been significantly reducing its workforce lately. The figure in spring 2002 was no less than 2% down over 12 months. The labour-intensive services sector failed to offset this reduction, especially as staffing levels in this sector are increasing only hesitantly.

*Labour market
policy measures*

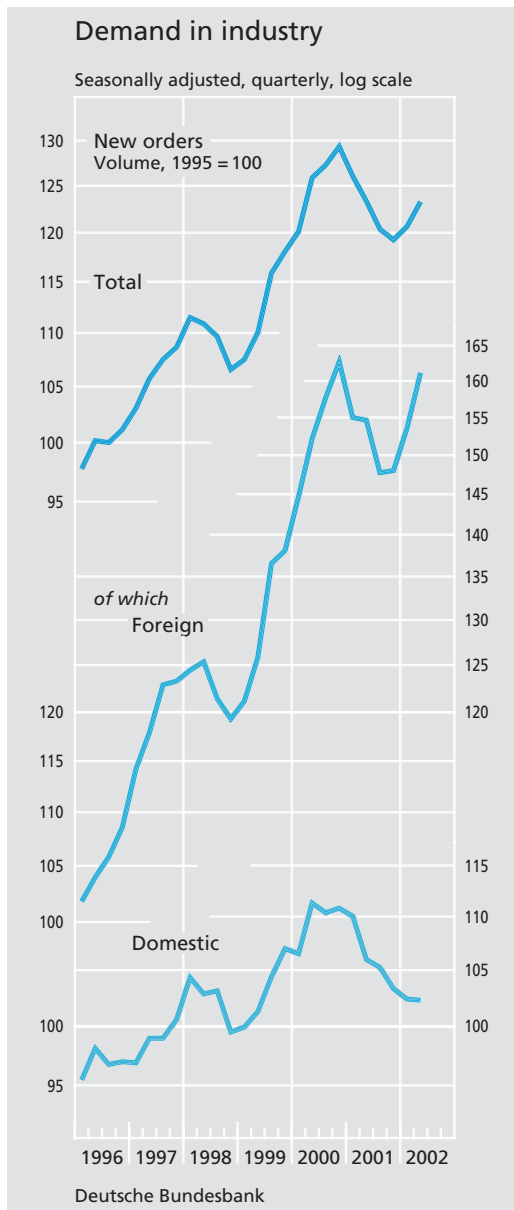
Reductions in normal working hours were reported for around 175,000 employed persons in July. On average, regular working hours were cut by one-third. In the same period of 2001, the number of persons on short-time work had been as much as 70,000 lower. Somewhat more than 185,000 members of the labour force were taking part in job creation measures, ie 55,000 fewer than one



year before. Vocational training courses were being attended by 315,000 persons, which represented a slight decline of 10,000 compared with the same period in 2001.

Unemployment has been increasing at a faster pace recently. This means that the slower rise during the first few months of the year, resulting from an intensified application of the *Job-AQTIV-Gesetz* (act), was only tempor-

*Rise in
unemployment*



ary. The act provides for greater efforts in terms of individual job placement. For a time, this led to a number of registered unemployed persons being taken out of the records. At the end of July, a seasonally adjusted 4.11 million persons were registered as unemployed with the labour exchanges. This signifies a year-on-year increase of 250,000, compared with 155,000 in March and April. The seasonally adjusted unemployment rate,

as calculated by the Federal Labour Office, rose to 9.9% at the end of July. By internationally comparable standards, the figure was 8.3%.

At a seasonally adjusted 18.3% in July, the unemployment rate (as defined by the Federal Labour Office) was far higher for eastern Germany. The rise compared with 17.6% in July 2001 is also very marked. One reason for this is that the propensity to participate in the labour force continues to be greater than in western Germany. Added to this is the fact that the supply of jobs remains tight. Ongoing structural adjustment in the construction sector and overstaffing in some areas in the public sector are leading to employment cutbacks. Moreover, there are only comparatively few new job opportunities in expanding industry.

*Eastern
Germany
particularly
unfavourable*

Orders

There was a further improvement in the order books of industry in the spring months. This followed an identifiable improvement that had already taken place during the first few months of the year. In seasonally adjusted terms, orders received in the second quarter were around 2% up on the preceding three months. This meant that the intake of orders was no longer down on the year, whereas the winter quarter had produced a figure of -4½%. A number of large orders played a major part in this. Since these will only gradually start to have an impact on output, however, the current underlying cyclical trend in ordering is somewhat overstated.

*Rise in order
intake, ...*

*... especially
from abroad*

Foreign demand, especially, accounted for several orders of above-average size. These concerned, in particular, “manufacture of other transport equipment”, in which the statistics for aircraft, ships and boats, railway and rolling stock are combined. This was one reason for export orders overall, on an average of the second quarter, being 5% higher than in the winter months in seasonally adjusted terms. They were around 4% higher than in the corresponding period of 2001, after being (in some cases, significantly) down on the year in the preceding three quarters.

*Subdued
domestic
demand*

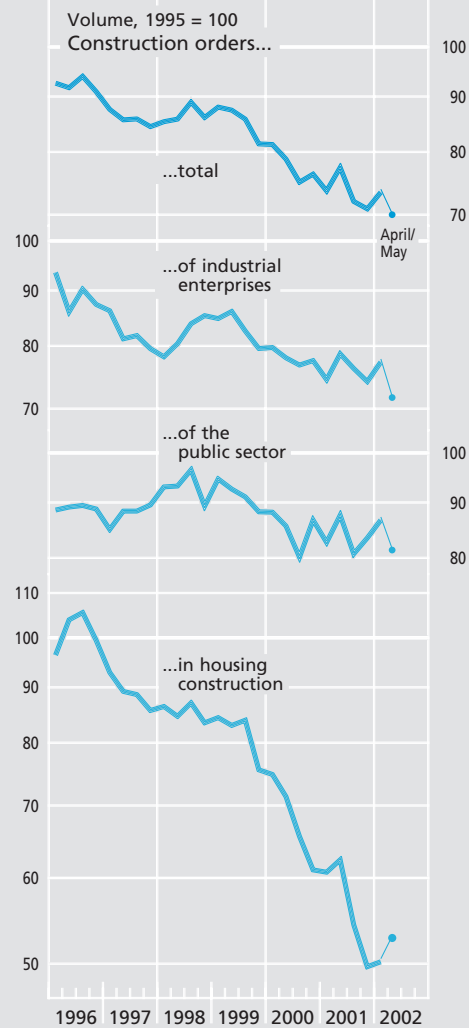
Domestic business activity remained very subdued in spring. Seasonally adjusted orders scarcely matched their level in the winter months of 2002. They continued to be significantly down on the year, even though the shortfall, at 3½%, was no longer as great as it had been in the first quarter (-7%). Capital goods producers, in particular, suffered a decline in orders. In seasonally adjusted terms, however, there was an identifiable slight increase in demand for both intermediate and consumer goods, although these, too, failed to match their levels of one year earlier.

*Negative
development in
construction
orders ...*

The development of construction orders showed a marked deterioration again in April and May (more recent statistics are unavailable at present). Seasonally adjusted, the two months, taken together, were around 5% down on the average level of the winter months, when construction demand had shown signs of stabilising. The year-on-year shortfall, having narrowed to around ½% in the first quarter, increased again to 9% – a figure last reached at the start of 2001.

Demand for construction work

Seasonally adjusted, quarterly, log scale



Deutsche Bundesbank

Industrial customers, in particular, have been noticeably cautious over the past few months. In seasonally adjusted terms, the placing of new orders, on an average of April and May, was at its lowest level for several years. An increase on the year in the first few months of 2002 – after a fairly long interval of negative year-on-year figures – was followed by a double-digit decline again at the end of the period under review. Public sector customers,

*... especially in
industrial and
public sector
construction*

too, effected a marked cutback in their ordering after initiating an exceptionally large number of projects in the first quarter.

Residential constructions showing signs of stabilising

Residential construction, by contrast, has shown signs of bottoming out recently, with – after seasonal adjustment – somewhat more orders being placed in the two spring months of April and May than before. The level did, however, remain very low. This is revealed not least by the fact that the level was still 13¾% down on the year. Since the mid-1990s, which marked the last peak in housing demand, the number of construction permits for dwellings has halved in western Germany, while, in eastern Germany, it is only one-quarter of the earlier level. There has been a particularly dramatic decline in construction projects for larger units with more than three apartments, with the number of relevant permits in May 2002 being only one-fifth of the mid-1990s figure in western Germany and, in eastern Germany, no more than one-tenth.

Prices and wages

Calm price climate again

The rate of price increase, which, for a variety of reasons, accelerated significantly in early 2002, has slowed down again over the past few months. In seasonally adjusted terms, consumer prices around the middle of the year were, in fact, slightly below the level reached in March. The year-on-year rate (which is often used as an indicator of inflation) did go up to 1.0% in July, from 0.8% in June, but this was due to base effects, notably in the case of refined petroleum products: there had been marked price reductions

in 2001, which contrasted with a slight price increase at the end of the period under review. The year-on-year fall in price for this group of products thus decreased from 5.5% in June to no more than 0.6% in July.

The recent moderate price developments are due, not least, to a steadying of prices for industrial goods. Seasonally adjusted, they have been going down since March, when they last peaked. Further sharp price reductions for information-processing equipment have played a part in this. (For changes in the relevant methods of statistical measurement, see the explanatory notes on page 38). The overall year-on-year rate of increase for industrial goods fell from 1.7% at the start of the year to 0.9% in July. The situation has returned to normal in the case of food as well, now that the special movements caused by unfavourable weather conditions are gradually petering out. By contrast, services (the prices of which had been raised perceptibly in connection with the introduction of euro banknotes and coins) were also distinctly more expensive at the end of the period under review than they had been early in the year. In July, they were 2.2% higher than in the comparable period of mid-2001. The cost of using a dwelling continued to be 1.4% higher than 12 months previously.

There have been external price-dampening influences over the past few months. Seasonally adjusted import prices, for example, have been falling markedly since early spring. By June, the fall on the year had increased to 5.2%. A key factor in this was a decline in energy prices: it was only after mid-year that

Price-dampening external influences

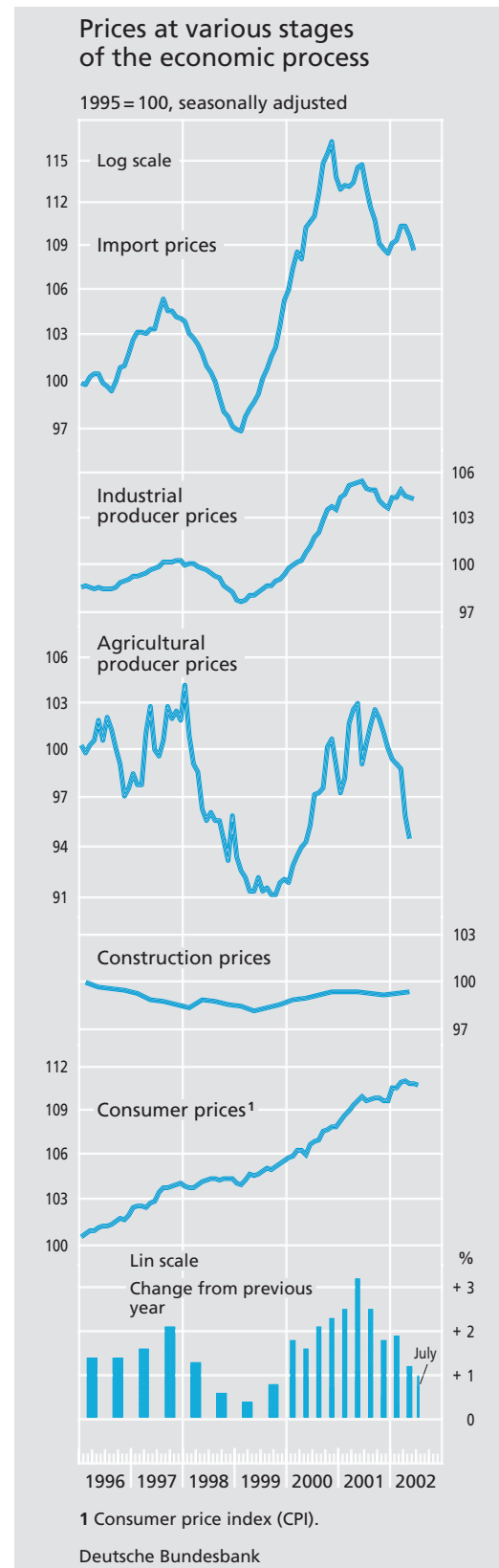
this movement came to a halt as a result of international oil prices having stabilised. Another factor was that some other goods became less expensive. Besides lower prices quoted by suppliers abroad, the appreciation of the euro had a further positive impact.

Calm price developments in Germany

The steadying of prices could also be noted on other domestic markets. Seasonally adjusted industrial producer prices, for example, have gone down slightly since March. The year-on-year rate fell to -1.1% in June, compared with +0.1% in December 2001. Up to the end of the period under review, construction prices persisted at the level reached in autumn 2000. Agricultural products have become perceptibly cheaper in the past few months. In seasonally adjusted terms, prices in May 2002 were more than 8% down on their peak of spring 2001, when weather-induced poor harvests of vegetable products had coincided with shortages in the supply of animal products owing to BSE and foot-and-mouth disease. This means that agricultural producer prices were back to their spring 2000 level and also lower than on an average of the years since 1993.

2002 pay round

In this year's pay round – unlike last year – wage negotiations were scheduled to take place in nearly all areas of the private sector. The pay settlement for the public sector concluded in 2000, on the other hand, runs until 31 October of this year, which means that talks on a new pay deal are not to be expected before the autumn. In contrast to preceding years, this year's pay round was a source of some conflict. Signs of this had become apparent at an early stage. The trade unions'

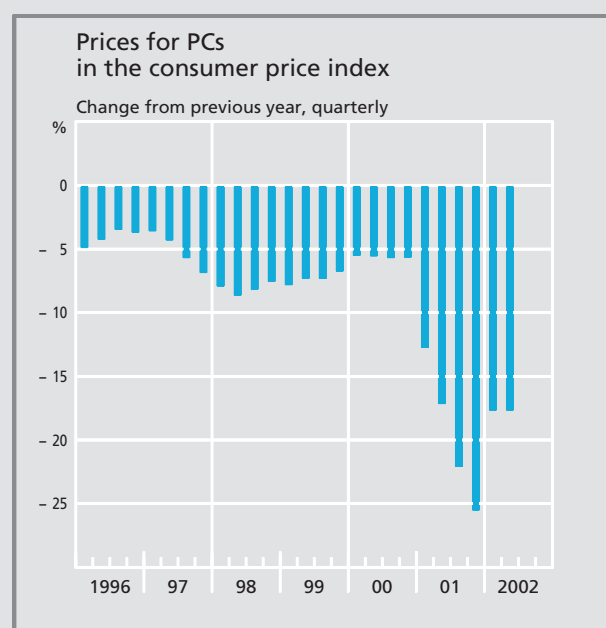


Changes in the official consumer price statistics and their implications for the "measurement bias" in the inflation rate

For a number of years now, the problems involved in the statistical recording of the "true" inflation rate have again been a subject of more intense debate. For example, a study published by the Economic Research Centre of the Deutsche Bundesbank in 1998¹ concluded that the bias in measuring the (west) German inflation rate from the perspective of a cost-of-living index was in the order of $\frac{3}{4}$ percentage point per year. The main reason for the estimated scale of statistical bias ascertained in the study was an under-recording of changes in quality – due, in part, to the methods employed in the official statistics – for which empirical evidence was found in case studies. A belated inclusion of new products and changes in retail structures as well as changes in consumption behaviour due to shifts in relative prices were identified as additional "sources of bias".²

As long ago as 1998, the Federal Statistical Office issued revised guidelines for the treatment of quality changes to price collectors in the field.³ As a further step, last year the price measurement of personal computers (PCs) was centralised at the Federal Statistical Office and adjustment for "option made standard", in place of traditional methods, was introduced for the quality adjustment. If, for example, a PC used in price analysis is given a larger main memory, the price found on the market for such a memory enhancement will be factored in and lower the index. The changeover in recording and processing prices for PCs resulted in the measured fall in price becoming considerably sharper. Whereas the subindex for PCs showed a decline of 5.6% on an annual average

in 2000, the index declined by no less than 19.3% in 2001. In the case of printers, too, the change in the method of recording prices led to a sharper fall in price being shown in the official statistics.



led to price changes being shown, on average, as another 1.1 percentage points lower than in the "option made standard" adjustment. At an annualised rate, the fall in price shown in the price statistics amounted to 16%. With a hedonic adjustment, the figure was more than 25%. This decline is on the same scale as that also reported in US studies for PCs. This means that the statistical bias due to quality changes is likely to have been eliminated in the subindex for PCs. Owing to their low weight in the basket of goods, however, this has no perceptible influence on the overall rate of increase in the consumer price index.⁴

The Federal Statistical Office intends to introduce hedonic methods gradually for other product groups as well. Since the price statistics are incorporated into the volume calculations for the national accounts, this will probably be of benefit in terms of the international comparability of economic statistics.⁵ Further progress in this direction is to be expected if, also following the recommendations of ESA 95, real GDP is calculated as a chain index.

The official statistics have, furthermore, made a move towards including new products more speedily in the basket of goods of the consumer price index (and also of the German Harmonised Index of Consumer Prices). This means that there will no longer be a wait in all cases until the next time a new base year is adopted (generally every five years). Internet use, for example, has been included in the calculation of the index since January 2001. A comprehensive adjustment of the basket of

ence, Cardiff 1999, p 380-406. — 4 PCs' relative weight of expenditure in the basket of goods for the base year 1995 amounts to 5.14%. Extrapolated with the relative price development, the weight had fallen to 2.8% by 2001. In 1996, a bias of 20 percentage points in the case of PCs would have signified a distortion of 0.1 percentage point in the overall inflation rate. In 2001, a bias of 10 percentage points would have led to a distortion of 0.03 percentage points. If the shares in expenditure of PCs were to remain constant despite falling prices, the bias would be greater. — 5 See also Deutsche Bundesbank, Problems of international comparisons of growth caused by dissimilar methods of deflation - with IT equipment in Germany and the United

goods to changed consumption habits, however, will not take place until 2000 is adopted as the base year, starting with the reporting month of January 2003.

A quantitative assessment of the "biases" resulting from a belated inclusion of new products and, above all, from quality adjustment is therefore to be set at significantly lower level now than it was in the earlier Bundesbank study of 1998. This is also indicated by recent research findings. It has been possible to show, for example, that the "option made standard" adjustment which the Federal Statistical Office has been applying for some time now to cars has resulted in the rate of price increase no longer being overstated over the past few years.⁶ Furthermore, a study by the Economic Research Centre of the Deutsche Bundesbank⁷ found evidence of the subindex for rents stating the development of rents in the second half of the 1990s without bias, whereas the "true" rate of inflation in this sector in the first half of the 1990s had been underestimated.

Overall, the rate of price increase as shown in the statistics is likely to be less than ½ percentage point higher than the "true" inflation rate from the point of view of a cost-of-living index. The "measurement bias" has thus been significantly reduced. A part in this has been played by advances in the area of quality adjustment, which are also important from the perspective of a pure price index.

States as a case in point, *Monthly Report*, August 2000, p 8, and Deutsche Bundesbank, Appendix: Problems of international comparisons of growth – a supplementary analysis, *Monthly Report*, May 2001, p 39-43. — 6 D Harhoff, Quality-Adjusted Price Indices for Cars in Germany, paper given at the conference on Price Indices and the Measurement of Quality Changes at the Centre for European Economic Research (ZEW), Mannheim 2002. — 7 J Hoffmann, C Kurz, Rent indices for housing in West Germany, 1985 to 1998, Discussion paper 01/02, Economic Research Centre of the Deutsche Bundesbank.

income demands for mostly 6.5% more pay and wages were distinctly higher than in preceding years, while employers pointed to the continuing weakness of the overall economic situation and to depressed profits. During the collective bargaining process, this led to strikes in a number of sectors, such as the metal-working and electrical engineering industry, the construction sector, the banking sector and the retail trade.

The pay settlements agreed so far in the 2002 pay round are noticeably higher than in the preceding years. Averaged across all economic sectors and on an annual basis, the level of negotiated wages and salaries is likely to increase by almost 3% in 2002, compared with a rise of no more than 2% in the previous two years. This implies that the basic position of moderate negotiated pay rises is not continuing. The wage increases exceed the available scope for income distribution. Additionally, it has to be borne in mind that higher indirect taxes this year and the raising of contribution rates to the statutory health insurance scheme at the turn of 2001-02 have considerably reduced the part which is relevant to distribution. This means that labour cost pressure on enterprises will increase again, which will be a negative factor in terms of employment and job security.

The first major settlement in the 2002 pay round was concluded in the west German chemicals industry. This new collective pay settlement is scheduled to run for a total of 13 months and encompasses a lump-sum payment of €85 for the first month and a linear 3.3% increase for the following

12 months. At the same time, the "earnings guarantee" introduced in the late 1980s for certain pay groups, which served to smooth out differences in remuneration between wage and salary earners performing comparable jobs, was integrated into the normal negotiated rates of pay. In future, this change will mainly affect how bonuses for shift work are calculated. According to the trade unions, it will have a volume of 0.3%. Furthermore, management and labour in the chemicals industry, having already shown themselves to be quite open to innovation in the past, introduced a major new element with regard to collective agreements, ie the option of making the annual special payment ("Christmas bonus") performance-related. Depending on the economic situation in which an enterprise or firm finds itself, this annual payment – normally 95% of monthly remuneration – can be increased up to 125% or lowered to 80% of monthly pay by means of a voluntary in-house agreement running for a minimum period of four years.

In contrast to the chemicals industry, where a settlement was reached by management and labour relatively quickly and easily, the new collective agreement in the metal-working and electrical engineering industry was concluded only after fairly long negotiations and strikes. This settlement is scheduled to run for 22 months and includes two "zero months" as well as a one-off payment of €120 for May 2002, which is to be followed by an increase in negotiated rates of pay in two stages: by 3.1% from 1 June 2002 and a further 2.6% from 1 June 2003. In addition, every employee will receive a lump-sum pay-

*Metal-working
and electrical
engineering
industry*

*Pay agreement
in the chemicals
industry*

ment amounting to 0.9% of the negotiated rate of pay for the period of the first stage and a further lump-sum payment amounting to 0.5% of the negotiated rate of pay for the period of the second stage. After the conclusion of each stage, the enterprises will allocate financial resources of the same amount to in-house adjustment funds. These funds are then to be used for paying the costs of integrating the (at present, still) separate pay rate systems for wage and salary earners in a single master collective pay agreement for all employees, which is scheduled for implementation between 2005 and 2007. The new settlement will result, by the end of 2003, in a 7% overall increase in the pay-related costs of the factor labour in the metal-working and electrical engineering industry. On an average of the two years 2002 and 2003, the new agreement will lead to a rise of some 3¼% in labour costs, compared with 1¾% in 2000-01.

In the construction industry, too, it was only after a strike – the first in this sector in the history of the Federal Republic – that an agreement was reached, with a two-year pay agreement being concluded for the employees in western and eastern Germany. The terms of the settlement in this sector, which is under severe pressure to adjust, provide for five “zero months” in eastern Germany and two “zero months” in western Germany as well as a lump-sum payment of €75 a month for a further three months. Following this, negotiated rates of pay will be increased by 3.2% from 1 September 2002 and by another 2.4% from 1 April 2003. Minimum wages will also be raised in both years at the start of September. Additionally, a minimum wage for skilled construction workers will be introduced as of 1 September 2003. An application is to be made to the Federal Ministry of Labour and Social Affairs to declare both sets of minimum wages generally binding.

Construction