Economic conditions in Germany

Underlying trends

Slight increase in GDP

After declining somewhat in the first half of 2003, German economic output picked up slightly in the summer months. According to initial figures from the Federal Statistical Office, third-quarter real gross domestic product (GDP) was 0.2% up on the preceding three-month period after adjustment for seasonal and working-day variations, although it was still down on the year in both working-day and calendar-month terms. The current national accounts figures confirm the assessment that there has been a slight cyclical upturn, although there is unlikely to have been an increase in overall capacity utilisation so far.

At all events, recent surveys by, for example, the Ifo Institute reveal a somewhat more positive assessment of the current situation. Expectations about the future development of the economy have been quite optimistic for some time. This is probably due mainly to the improved global economic setting and enterprises' internal consolidation efforts in real economic and financial terms. Judging by the statistics on orders in industry and construction as well as on households' propensity to consume, it will probably only be during 2004 that these factors will start to have a greater impact. As the indicators look at present, it remains to be seen whether a sustained and broadly based cyclical improvement will set in as soon as early next year.

Net exports provide strong contribution to growth

The slight increase in GDP in the third quarter was due mainly to the external component. First, exports of goods and services picked up following a sharp decline in the second quarter and were up on their level during the first few months of the year. Second, imports – having already declined in the spring quarter in the wake of the continuing economic slowdown – showed a further fall.

Domestic demand still weak

There were hardly any identifiable domestic stimuli to growth. Investment in machinery and equipment, for example, remained weak. Given persistent marked underutilisation, there was very little need for expanding capacity. With regard to buildings, a large number of vacant properties, particularly in terms of office space and housing, may have had a dampening impact. Moreover, public infrastructure investment is still suffering as a result of the poor government budgetary position.

Households' consumption spending remained subdued. Even though surveys show growing confidence with regard to the economy in general and the outlook for incomes, there has been scarcely any improvement so far in the propensity to purchase durable consumer goods. This is also clear from retail trade turnover, which – at constant prices – was both down on the second quarter and down on the year in the third quarter. This was not adequately offset by a renewed increase in purchases of private cars. The propensity to consume was not encouraged by the continuing unfavourable situation on the labour market, which is characterised by a persistent shedding of labour, or by the ongoing debate on new public levies and cuts as part of a reorganisation of the social security systems. While disposable incomes remained largely unchanged, there is likely to have been an increase in the private saving ratio.

Economic growth in Germany

Adjusted for seasonal and working-day variations, quarterly

1 At 1995 prices. — **o** From 1999, in euro.

Deutsche Bundesbank

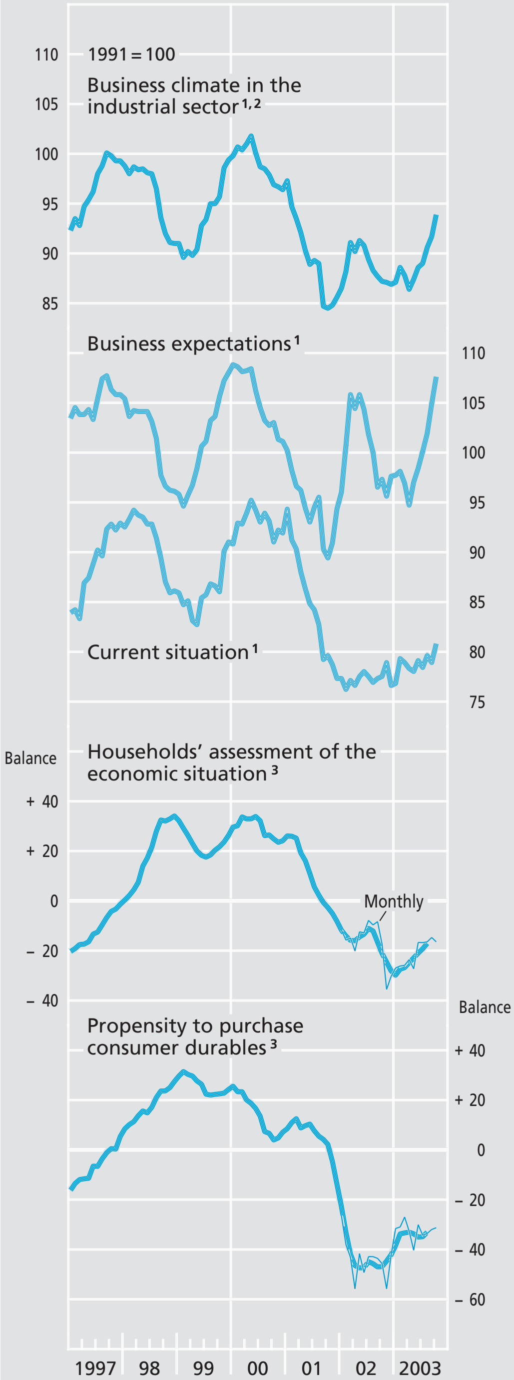
Output and labour market

Sharp fluctuations in output

Third-quarter industrial output was marked by sharp fluctuations, which make it difficult to determine the cyclical trend. This was due to the unusual timing of the summer school holidays this year. While July was much less affected than in the past, there was a concentration of holiday periods in August and (at a significantly lower level) September. Seasonal adjustment is based on an average holiday pattern over the medium term and cannot completely compensate for such exceptional circumstances.

Sentiment in the industrial sector and among households

Seasonally adjusted, monthly



1 Source: Ifo Institute. — **2** Western Germany. — **3** Based on data from the *Gesellschaft für Konsumforschung.* Moving five-month averages.

Deutsche Bundesbank

Slight fall in output

On an average of the period from July to September, seasonally adjusted industrial output was no higher than in the second quarter and was more than 1% down on the year. This shows that the cyclical slowdown in the industrial sector has not yet been overcome. The moderate increase in capacity utilisation in the past few months points in the same direction. According to Ifo Institute data, seasonally adjusted capacity utilisation in September was a good 1 percentage point higher than in June. However, it was no higher than the comparable figures for the end of last year and the start of 2003 and still down on the medium-term average.

Capital goods was the only sector in which there was an expansion of production in the third quarter with a seasonally adjusted increase in output of just under 1% on the preceding three-month period. Nevertheless, as the preceding cutbacks had been especially marked, the figure still failed to match the level at the turn of 2002-03. Producers of intermediate goods made further cutbacks in production over the past few months. The year-on-year figure, which had shown an increase in the second quarter, was 2½% down on the year. Producers of consumer goods were more or less able to hold their own. In the third quarter as a whole, their output was around 1% down on the comparable level in 2002.

Improvement in exports

Judging by the information on turnover, the sole improvement was in industrial export business. This, in turn, has to be seen in the context of a marked decline in the spring. The improvement was therefore mainly a case of drawing close to the earlier level. Domestic business activity remained without momentum up to the end of the period under review.

Slight increase in construction output

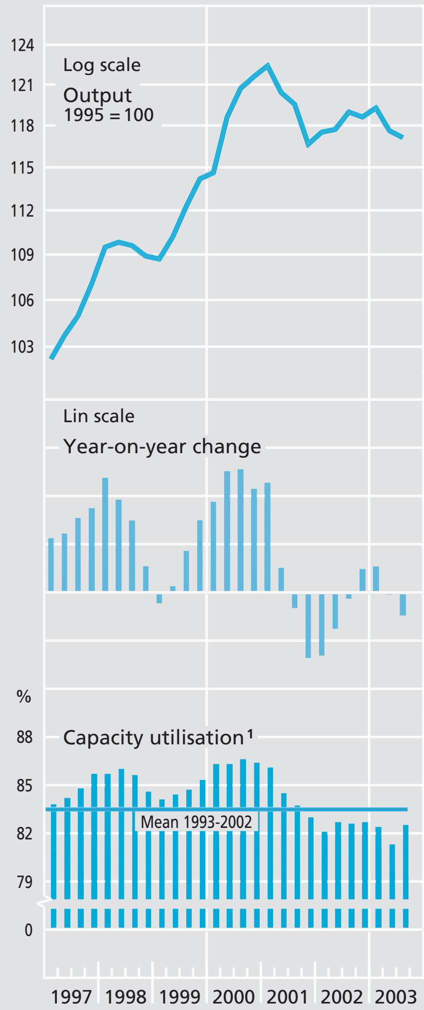
In seasonally adjusted terms, third-quarter construction output was slightly up on the preceding three-month period. Taking account of the upward revision to be expected with the overall survey, output in this sector in the second quarter was probably just as high as in the last few months of 2002. This means that the long prevailing downward trend at least appears to have come to a halt for the time being. However, the year-on-year fall of around 5% (including the annual revision of approximately -2¼%) shows that the level of output is still very low. This applies particularly to the building industry, which has been showing larger-than-average cutbacks for some while.

Declining trade turnover

The situation in trade worsened in the summer months. In spring, both wholesale and retail trade turnover was higher (at constant prices) than in the comparable period of 2002. However, at the end of the period under review, the figures were showing a decline on the year. In terms of the wholesale trade, there was a fall especially in the case of food and raw materials. In the retail trade, purchases of articles of clothing and of household furniture and appliances were particularly down. There were continuing falls in turnover in the hotel and catering trade. This affected hotels, hotel/restaurants, restaurants and cafés almost equally.

Output and utilisation in industry

Seasonally adjusted, quarterly

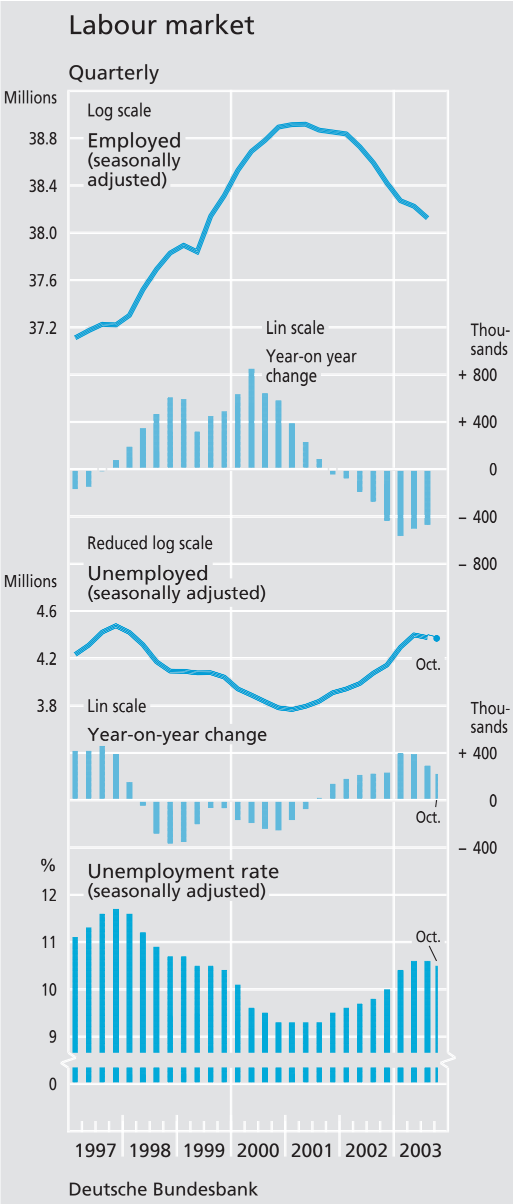


1 Results of the Ifo business survey.

Deutsche Bundesbank

Slight improvement in the case of services

According to surveys, in some branches of the services sector the situation has improved somewhat in recent months, however. There are increasing reports of growth in turnover in the third quarter, albeit starting from a comparatively low level. Not least the transport sector is likely to have benefited from the upturn in output in the economy as a whole. The banking industry as well, however, appears to have achieved a turn for the



better. By contrast, service providers in the IT sector were remaining relatively cautious up to the end of the period under review and were generally still a long way from matching earlier very high figures.

Despite continuing fall in employment ...

Even though firms have become distinctly more optimistic, there are no signs of an improvement yet in terms of employment. Rationalisation and cutbacks are still the order of the day, with employment being reduced up to the end of the period under review. Even though there has been a sharp increase in the one-person businesses promoted by the Federal Labour Office and in mini-jobs, the officially recorded seasonally adjusted total number of persons in work fell to 38.1 million in the third quarter. This was 100,000 down on the second-quarter average and around 470,000 fewer than 12 months earlier, which corresponds to a figure of -1.2%. The fall in employment in the construction sector continued to be much sharper, even though the negative trend appears to be flattening out. The producing sector as well as the trade, hotels and restaurants and transport sectors also registered job losses that were higher than the year-on-year average. However, the situation is more favourable for business service providers, as it is for public and private service providers. Nevertheless, fewer new job opportunities were now being created recently in that sector, too. Moreover, it should be borne in mind that these are likely to have been mostly part-time rather than full-time jobs.

... falling unemployment

Despite the continuing job cuts, unemployment has been declining recently. At the end of October, the official seasonally adjusted unemployment figure, at 4.38 million, was 60,000 lower than at its most recent peak in April. Although this was still 220,000 persons more than one year earlier, the maximum increase had been more than 470,000. In October, the seasonally adjusted unemployment rate, as calculated by the Federal Labour Office, was 10.5%. Using the internationally standardised method, the figure was 9.3%.

The crucial reason for the decline in reported unemployment was a stricter application of registration criteria by the labour exchanges. According to the Federal Labour Office, increased efforts to update applicant levels and to encourage unemployed persons to play an active role in job-seeking in connection with legislation on labour market reform led in many cases to what was at least a temporary outflow from the official statistics. According to the economic research institutions in their recent autumn report, the statistical adjustments could result in the number of unemployed persons going down by more than 100,000 this year.

Orders

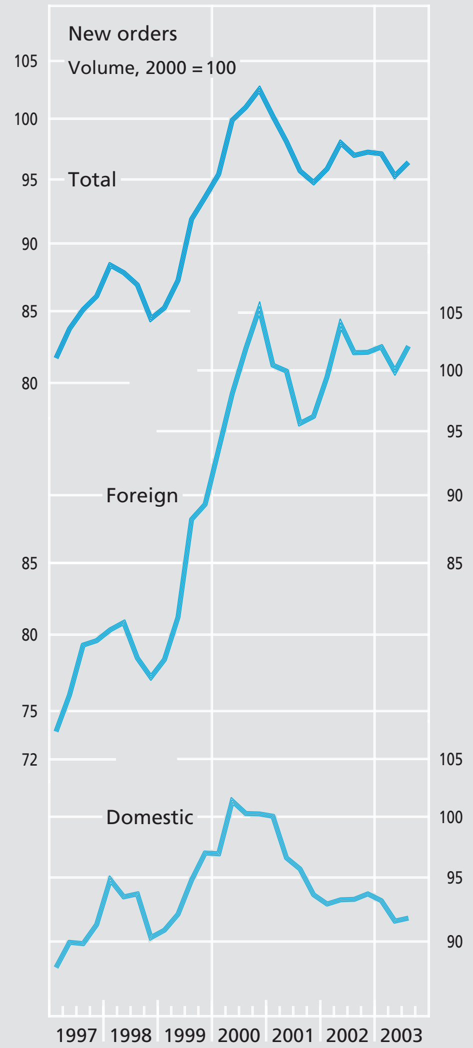
Subdued demand for industrial products

Demand for industrial products remained very subdued in the third quarter. It did recover slightly in seasonally adjusted terms compared with the second quarter, but new orders had fallen to a new low during that period. So far, there has been a failure to match the fourth-quarter level of 2002 and the level of the first few months of 2003. How low the intake of orders was up to the end of the period under review is also revealed by the fact that the figure was ½% down on the year. At present, there is no sign of a widespread upturn in business activity.

Domestic customers, in particular, remained restrained in their ordering. Even though orders in the third quarter were just as high as in the preceding three-month period in seasonally adjusted terms, they were clearly down on the year at -1½%. This was due, in particular, to sharp falls in business in the consumer goods sector. There was little demand not least for household furniture and for clothing in some cases. Producers of intermediate goods did not perform quite so unfavourably, although here, too, orders in the third quarter were around 2% down on the year. Capital goods held up at the previous year's level.

Demand for industrial goods

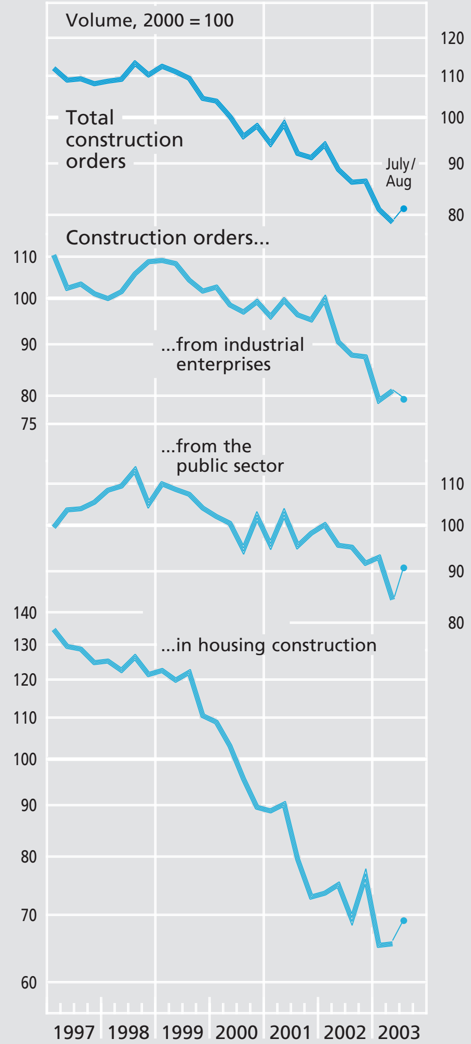
Seasonally adjusted, quarterly, log scale



Deutsche Bundesbank

Demand for construction work

Seasonally adjusted, quarterly, log scale



Deutsche Bundesbank

Following a slump in the second quarter, the flow of export orders has picked up again in the last few months, almost matching the figure for the first quarter in seasonally adjusted terms. A slight increase on the year was also achieved, following a notable failure to match the comparable period of 2002 in the preceding quarter. Nevertheless, the improvement has not been broadly based so far and is being sustained largely by the intermediate goods sector. Frequent orders were placed for electricity generation and distribution equipment as well as rubber and plastic products, for example. The improvement was noticeably more subdued in the other sectors of industry, however. While capital goods achieved at least a slight seasonally adjusted increase in the third quarter, the consumer goods sector suffered a further downturn.

Temporary improvement in construction orders

The situation in construction orders improved somewhat in the summer months. In seasonally adjusted terms, new orders in the two-month period of July and August were 2¾% up on the second quarter. Even so, it seems doubtful whether this has brought an end to the prevailing downward trend over the past few years, which has led to a further decline of around 5½% in the past 12 months. One of the reasons for the upturn in the third quarter was an accumulation of road construction and railway orders. This is unlikely to continue in the immediate future.

So far, it is hardly possible to assume a turn for the better in housing construction either. Seasonally adjusted construction orders in July and August did attain their highest level so far this year and the year-on-year fall narrowed to just over ½%, compared with a figure of -12% in the second quarter. Construction permits do not suggest an upturn over the past few months, however. Rather, following a marked rise at the end of 2002 and at the start of 2003, they are tending to go down again. That increase is likely to have been due mainly to the debate in late 2002/early 2003 on cuts in housing construction assistance, which many customers wanted to pre-empt. It may be that some of the permits have now been translated into actual construction work. After this special movement has run its course, it may be expected that the placing of new construction orders will level off.

Improvement in the case of service providers

Surveys suggest that demand has picked up in the last few months in the case of service providers, especially those providing services to businesses and those in the IT sector. The total number of firms submitting a positive assessment significantly extended their lead. Tax consultants, auditors and the advertising industry were especially optimistic. In the IT and telecommunications sectors, the preponderance of negative judgements has become noticeably smaller.

Consumer prices

Annual percentage change

Item	Percentage weighting	2003 Q1	Q2	Q3	Oct
Energy	8.1	7.7	2.0	3.2	2.2
of which					
Refined petroleum products	4.2	14.4	0.7	1.9	– 0.6
Food	9.0	– 2.2	– 0.6	0.7	1.5
of which					
Seasonal products	1.6	– 9.5	– 2.6	2.2	6.2
Industrial goods	31.3	0.0	0.2	0.3	0.5
Services	27.1	1.4	1.4	1.2	1.5
of which					
Package holidays	2.0	1.0	2.5	– 0.5	– 1.7
Rents	24.4	1.2	1.2	1.1	1.0
Total	100.0	1.2	0.9	1.1	1.2
Memo item					
Harmonised Index of Consumer Prices	100.0	1.1	0.9	1.0	1.1

Deutsche Bundesbank

Prices and wages

Moderate price developments

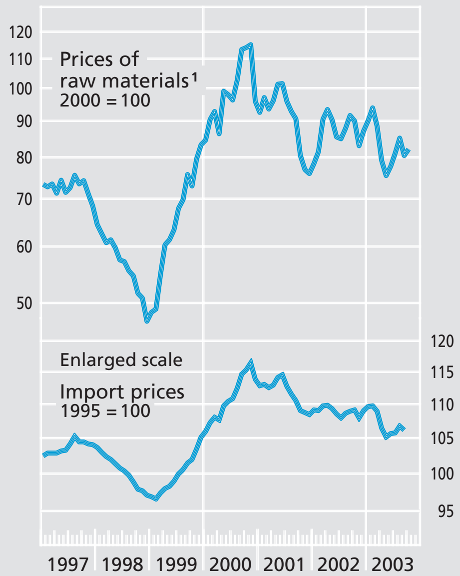
Price developments in Germany were very moderate up to the end of the period under review. The year-on-year rate of consumer price increase was no more than 1.2% in October. The fact that there has been a somewhat more rapid pace of increase since the summer, which followed a period of largely stable prices in the first half of the year, was mainly due to higher price for seasonal food items and energy including, in particular, refined petroleum products. Seasonal food products were affected by comparatively poor harvests in the wake of adverse weather conditions. Refined petroleum products followed movements on the world oil markets. After adjustment for these special factors, the year-on-year rate of consumer price increase, even recently, has not exceeded 1%. A significant factor in this was that the year-on-year increase in the prices of industrial goods, in particular, was no more than 0.5%. This partly offset the faster rate of inflation in the case of services, which was 1.5% in October. Housing rents were 1% higher than 12 months previously.

Rise in oil prices

International oil prices went up again in October. This largely offset their decline in September. At US$29, a barrel of North Sea Brent crude oil was not only around US$2 more expensive in month-on-month terms, the price almost matched the already high level in August. Given the start of the cold period of the year, the spot market prices for heating oil, in particular, reached new highs. In the case of petrol the rise remained within

Prices of raw materials and imports

Seasonally adjusted, log scale



1 HWWA Index of World Market Prices of Raw Materials "Euroland" on a euro basis; not seasonally adjusted.

Deutsche Bundesbank

narrow bounds. The appreciation of the euro against the US dollar calmed price movements somewhat but the upward pressure on prices remained in terms of the underlying trend.

Seasonal food products more expensive

The poor harvests were clearly reflected in the producer prices of plant products. The overall year-on-year increase in vegetable selling prices up to September was 8.5%. There were even double-digit rates for domestically produced vegetables and for potatoes. This was partly offset by animal products: at the end of the period under review, these were scarcely more expensive than in 2002. For agricultural products as a whole, there was a 3% year-on-year increase in prices.

Industrial and construction prices unchanged

Industrial factory gate prices remained largely constant over the past few months. Excluding energy, which is affected by international movements, producer prices in September were no more than 0.3% higher than in the same period of 2002. While the pace of price increase in capital and consumer goods was somewhat faster, intermediate goods were marginally cheaper in year-on-year terms. Construction prices remained unchanged overall in the third quarter of 2003. There was no year-on-year price change either. Slight price reductions in road construction contrasted with a slight rise in the case of commercial and industrial buildings.

2003 wage round

There was only a small "wage round" this year. This was due to the fact that, in addition to improved negotiated rates of pay for 2002, further pay round increases for 2003 had already been agreed last year in several sectors such as metal-working and electrical engineering, construction and private banking. On the whole, the new agreements in the 2003 pay round were lower than those last year. This means that the overall negotiated pay level is likely to go up by just under 2½% this year, compared with an increase of 2.7% in 2002. Last year's higher pay agreements had an impact especially in the first few months of 2003, however. Enterprises' effective cost burden was somewhat lower, as is revealed by the still clearly negative wage drift.

Pay settlement in the public sector, ...

The collective pay settlement for the public sector concluded in January is scheduled to run for a total of 27 months with two one-off payments in March 2003 and November

2004 and an increase in the contractually agreed basic rates of pay for salaried staff and wage earners of 2.4% on 1 January 2003 and of 1% in each case in January 2004 and May 2004. The pay adjustment agreed for eastern Germany provided for the earnings of public sector employees being raised from 90% to 91% of the corresponding west German negotiated pay rates as of 1 January 2003, rising to 92½% from the start of 2004. Complete parity is to be achieved by the end of 2007 or, for those in higher pay categories, by the end of 2009. As an alleviating factor for the employers, the abolition of one employee-selectable work-free day was agreed, as was a reduction (to be introduced up to the end of 2004) when employees move up into the next age category of basic remuneration. In many *Länder,* there have already been reductions in special payments for civil servants (*Beamte*) in the current year.

... in the chemicals industry, ...

With collective pay agreements starting to run at different times across the regions, the negotiated rates of pay in the chemicals industry were raised with a one-off payment of €40 for the first month in which the new pay agreement came into effect and a 2.6% increase for a further 12 months. As a further step towards parity with rates of remuneration in western Germany, east German employees additionally received a previously agreed 2.8% increase in their pay level from October 2003. Furthermore, from 2004 working hours can be "saved up" for an extended period to be used either as free time before retirement or for training measures with employers sharing the costs.

... in the printing industry, ...

The new pay agreement for the printing industry runs for a total of 24 months and provides for three months without an increase ("zero months") followed by an improvement in employees' negotiated rates of remuneration amounting to 1.5% as of 1 July 2003 and a further 1.7% as of 1 June 2004. Additionally, the collective agreement on pre-retirement part-time work, which was scheduled to run out in the middle of 2004, was extended by three years. In the retail trade, too, the new agreements generally run for two years. With slight differences from region to region, negotiated pay rates will be increased this year (after three "zero months" or one-off payments) by between 1.6% and 1.8% and again by roughly the same percentage next year, with a somewhat higher increase in pay in the lower wage and salary categories. In addition, given the extended shopping hours, pay bonuses were agreed for working on Saturday afternoons.

... the retail trade

... and for temporary or part-time work

In spring, the unions of the German Trade Union Federation (DGB) and the Federal association representing the temporary employment and personnel services industry (*Bundesverband Zeitarbeit Personal-Dienstleistungen e. V.*) concluded the very first pay agreement for temporary and part-time workers. The impetus for this was provided by the First Act Promoting Modern Labour Market Services of December 2002, under which subcontracted workers can demand to be remunerated like permanent staff if no appropriate collective pay agreement is in place. For western Germany, the new agreement establishes a grid consisting of nine pay categories with hourly rates ranging between €6.85 and

€15.50. In the event of an extended, uninterrupted period of employment with the same client, remuneration can be raised by up to 7.5%. Reduced rates apply in eastern Germany. The rates of pay will be increased by 2.5% at the start of 2005, 2006 and 2007 respectively.