Economic conditions in Germany

Underlying trends

Higher GDP growth in Q2

The cyclical upturn in the German economy gathered further slight momentum in spring 2004, having already been somewhat stronger in the first few months of this year. According to an initial estimate by the Federal Statistical Office, real gross domestic product (GDP) in the second quarter was 0.5% up on the preceding three-month period after adjustment for seasonal and working-day variations. There was a 1.5% year-on-year increase in overall output in working-day adjusted terms. The unadjusted figure was 2.0%.

At the end of the first half of the year, seasonally adjusted overall output was 0.9% up on the final quarter of 2003. This corresponds to an annualised growth rate of just over 1¾%. This means that, for the first time in some while, there is likely to have been an increase in capacity utilisation. Not only have developments so far confirmed the general cyclical expectations in spring 2004, the slight upswing has also opened up the opportunity for somewhat stronger growth.

Strong external stimuli

Nevertheless, it is still not certain whether the current pace of expansion can be maintained in the coming months. Surveys such as those by the Ifo institute, for example, indicate that, even though the business climate showed some improvement in July, there is still a certain amount of caution in industry with regard to how both current and future developments are being assessed. Moreover, up to the end of the period under review, economic growth was not broadly based but was, in-

stead, sustained almost exclusively by the external economy. Sizeable export orders led to a sharp upturn in industrial output. By contrast, even recently no significant stimuli have been coming from domestic demand. For example, business investment remained weak despite the cyclical improvement. This was mainly due to the continuing low degree of willingness to undertake construction work, which affected business demand for commercial buildings, warehouses and offices as well as private housing construction. The decline in this sector was so large that it more than offset the stabilisation in expenditure on machinery and equipment.

Sluggish consumption continues

In addition, households remained rather cautious in terms of consumer spending. Although private consumption probably increased somewhat in the second quarter in seasonally adjusted terms, it did not give a significant boost to economic growth. This is also indicated by the weak take-up of consumer loans, which is often connected with the buying of higher-quality consumer durable goods. Furthermore, the rate of price increase – accelerated by government influences and the higher cost of energy – has narrowed the real scope for expenditure. There is still a widespread lack of optimism about the economy. As shown by the surveys of the consumer research institution, *Gesellschaft für Konsumforschung* (GfK), households' sentiment has not improved in the last few months either.

The retail trade, in particular, reported that there is a continuing reluctance to purchase. According to the official data on this that are currently available (which are, admittedly, often subject to considerable revision), sales in the April-June period did not exceed the low level of the first few months of the year in seasonally adjusted terms. In real terms, they were 3% down on the year. In contrast to this, after a lull at the start of the year, private registrations of new motor vehicles picked up again somewhat in seasonally adjusted terms at the start of spring. Even so, so far this year, the domestic car market has remained quite weak overall, while demand in the euro area has shown a noticeable increase.

Output and labour market

Sharp increase in industrial output

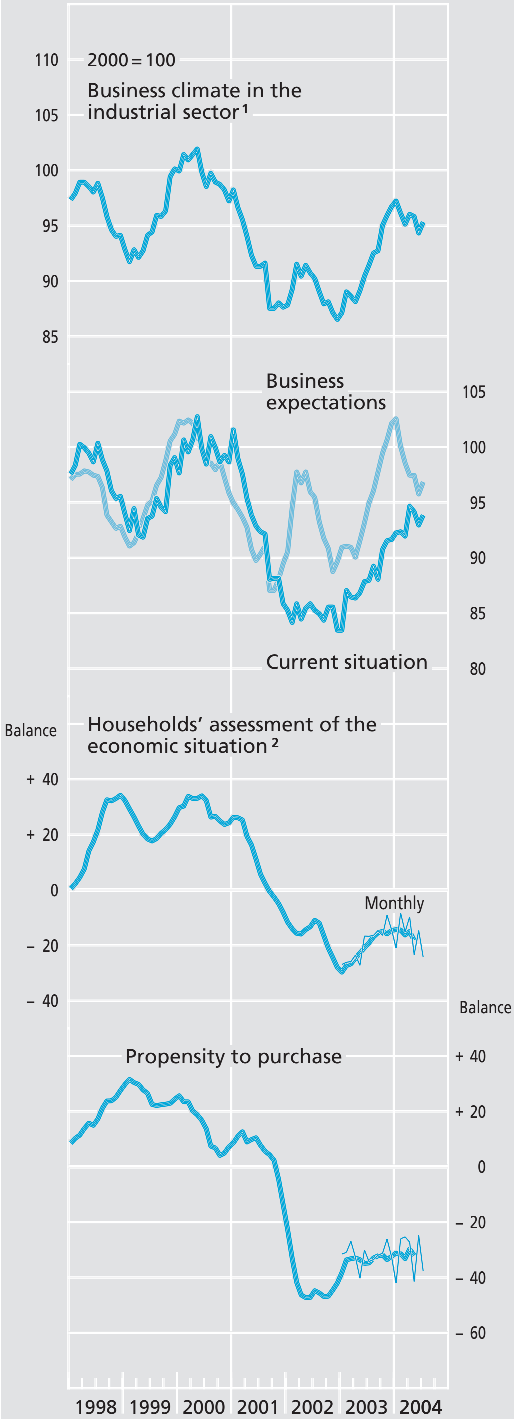
Industry has given strong stimuli to growth recently. After eliminating seasonal and working-day variations, second-quarter output rose by around 1¼% compared with the first three months of the year. The year-on-year increase, which was 1½% in the first quarter, grew to just under 4%. The sharpest increase was achieved in the capital goods sector, where the seasonally adjusted expansion of output amounted to over 2¾%. In year-on-year terms, there was a 5¾% increase. Taking turnover as a yardstick, exports showed the sharpest increase. This was especially true of the motor vehicle sector. Production of IT equipment and mechanical engineering goods was stepped up, too. The fact that sales of capital goods to domestic customers also showed an above-average increase was due, to a considerable extent, to a high level of sales of commercially used motor vehicles. By contrast, increases in the case of other capital goods were at a noticeably lower level. The expansion of output was also comparatively weak in the intermediate and consumer goods sectors. In seasonally adjusted terms, production in those sectors in the second quarter was ¼% and ½% up on the quarter respectively. Once again, the emphasis was on exports.

Growing importance of imported inputs

It is not only exports that are of crucial significance for developments in German industry. Imported inputs have also become increasingly important over the past few years. According to the calculations of the Federal Statistical Office, in 2000 the percentage of imported intermediate goods in output in the produc-

Sentiment in the industrial sector and among households

Seasonally adjusted, monthly



1 Source: Ifo Institute. — 2 According to Gfk data. Moving five-month averages.

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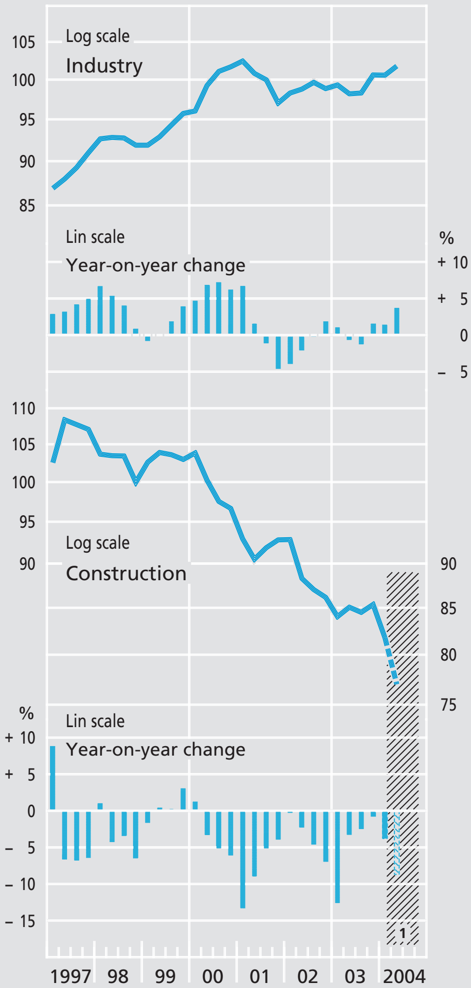
Output in industry and in construction

2000 = 100, seasonally adjusted, quarterly



1 Provisional until adjusted to the results of the annual overall survey.

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tion of machinery amounted to some 16%. In the manufacture of road vehicles, the corresponding figure was around 18%. An even larger role is played by material imports in the field of radio, television and communication equipment, at nearly 30%, as well as in the production of office equipment and computers, at no less than just under 45%. This gives an average ratio for these sectors of 19½%. In the mid-1990s, the figure had been as low as 13¾%. Behind this is a growth in imported inputs of more than 45% within five years. The rise is likely to have continued up to the end of the period under review.

Increase in capacity utilisation

Capacity utilisation in manufacturing has increased noticeably due to the sharp rise in output. According to the Ifo surveys, in seasonally adjusted terms, the level of capacity utilisation in June was 0.6 percentage point higher than in March. This gives a year-on-year increase of 2 percentage points. This means that longer-term average capacity utilisation was exceeded slightly for the first time since summer 2001. However, utilisation was still 3 percentage points away from the earlier peaks in 2000. This is also likely to be a major reason for industrial enterprises still showing a low propensity to invest.

Further decline in construction output

The long-prevailing downward trend in the construction sector continued during the past few months. According to the data available at present, seasonally adjusted construction sector output in the second quarter was about 6% down on the already poor figure for the first three months of the year. There was a further decline of nearly one-tenth compared with 2003, which had already brought significant performance shortfalls of more than 4%. The overall survey in the construction industry, which is scheduled for the middle of the year, is likely to bring about some positive adjustments. Nevertheless, as experience over the past few years has shown, these will do no more than mitigate the decline somewhat.

If the number of hours worked is taken as a yardstick, all the major construction sectors were affected by this negative development. At distinctly more than 10%, the cutback in construction activity compared with last year was somewhat larger in industrial and public construction than it was in housing construction. Output in the finishing trades was also perceptibly down on the year. Relevant statistical data beyond the first quarter are unavailable so far but construction activity during this period was already noticeably lower than in the same period of 2003. There is unlikely to have been any change in this development in the second quarter. This, too, suggests that there was a further reduction in construction investment in spring 2004. Compared with the most recent peak in 1994, this now corresponds to a fall of almost one-quarter. A decline in level on such a scale had not been recorded since the early 1950s.

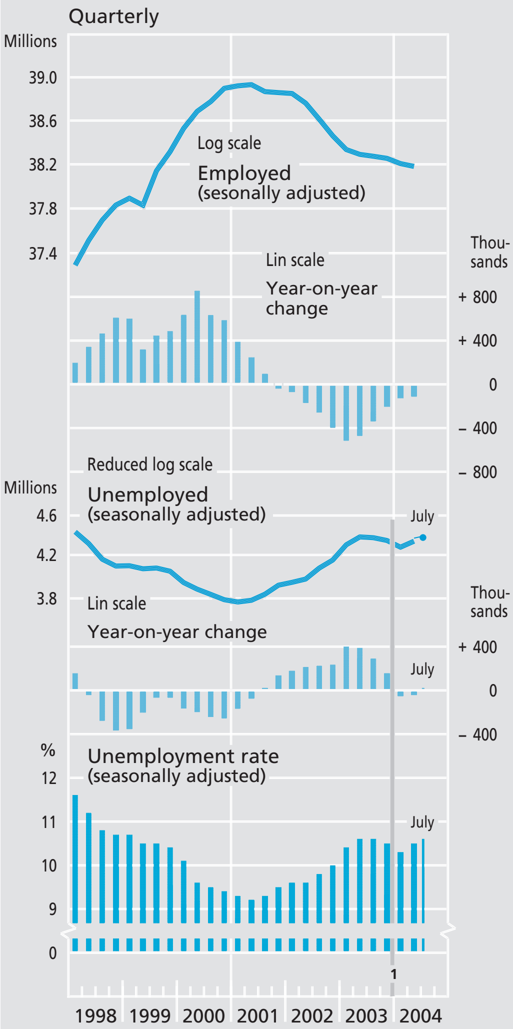
Differing developments in trade and in the case of service providers

The situation in trade was marked in the spring months by persistently weak domestic demand. The consumer-related sectors at both the retail and wholesale levels were especially affected, with sales, at constant prices, remaining clearly down on the year. While, in the retail trade, suppliers of radio, television and sound reproduction equipment suffered fairly heavy losses, wholesalers of fuels and refined petroleum products in particular, felt the reluctance of the consumers, who reduced their purchases at least temporarily, not least owing to the high prices. The situation in productivity-oriented trade in machinery and equipment was better, however, with undoubtedly mainly export business that was flourishing. The situation in the hotel and restaurant trade has continued to stabilise over the past few months. At least, real turnover – which had fallen noticeably after the introduction of euro banknotes and coins – was no longer showing such a large year-on-year fall in April and May as it had in the first quarter, when the figure had been -2%. The business performance of hotels, motels and guest houses, in particular, has taken a positive turn. This contrasted with turnover in restaurants, which was still down on the year. The continuing improvement in industry has also had an impact on the commercial service providers. According to the survey by the Centre for European Economic Research (ZEW), the assessment of sales and earnings was noticeably brighter in the second quarter. This applies mainly to the information and communication sector, which had complained of disappointed expectations in the first few months of the year. In the case of management and tax consultants, too, positive views were clearly in the majority. By contrast, the advertising industry expects no more than a gradual recovery in its business conditions.

Continuing fall in employment ...

There were no signs of any improvement on the labour market up to the end of the period under review. Unemployment remained high and employment was still falling. The number of persons in work – which was recently adjusted upwards by more than 100,000 – had declined by the second quarter to 38.21 million. This was a good 25,000 fewer than in the first quarter and 110,000, or 0.3%, down on the year. This means that the reduction in employment has accelerated somewhat again following an identifiable slowdown for

Labour market



1 From January 2004, unemployed excluding participants in aptitude tests and training measures.

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a time towards the end of 2003. Many jobs have continued to be lost particularly in industry and construction. In construction, the figure on an average of the April-June period may have been more than 80,000 down on the year. This is equivalent to a fall of 3½%. In industry, the decrease may have been just over 2%, affecting nearly 180,000 persons. In the case of services, the trend in employment was more favourable, but even there few new employment opportunities have arisen compared with earlier years. In many cases, these are likely to have been part-time jobs, the number of which continued to increase noticeably, while fewer and fewer persons were in full-time work. The ratio of employees in part-time jobs is now moving towards 30%. That means almost a doubling compared with the early 1990s.

... and high unemployment

At the end of July, 4.36 million persons were officially registered as unemployed. The seasonally adjusted figure was 4.39 million. The seasonally adjusted unemployment rate, as defined by the Federal Employment Agency, went up to 10.6%. The internationally standardised rate was 9.9%. The fact that this was scarcely higher than before was partly due to a greater use of labour market policy measures, especially business start-up grants and bridging allowances. There was also an expansion of job creation schemes following some temporary cutbacks.

In July, there was a slight year-on-year rise of 7,000 in the number of persons out of work. However, it should be borne in mind that, since the beginning of the year, persons taking part in aptitude tests and training measures have no longer been counted as being unemployed. If such persons are excluded from the July 2003 figure, the increase amounts to 83,000. Last year, too, administrative measures contributed to a reduction in registered unemployment, when labour market policy was reoriented towards active job-seeking and tighter registration requirements for the unemployed. As a result, on an annual average, between 120,000 and 150,000 registered unemployed persons may have been eliminated from the official unemployment statistics in 2003. If both of these factors were to be taken into account, the number of persons without employment would currently be roughly 250,000 to 300,000 higher.

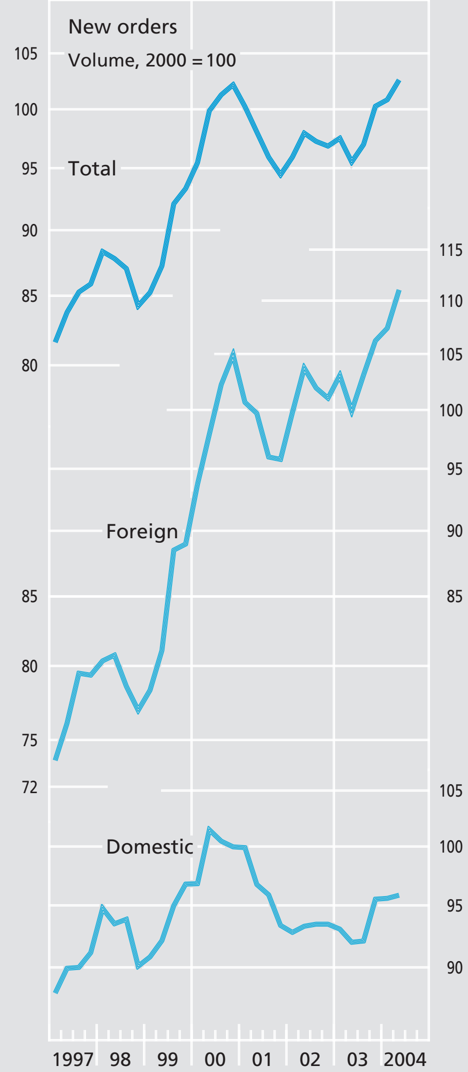
Orders

Further rise in foreign demand in industry ...

The demand for German industrial products showed a further increase in spring. Seasonally adjusted orders received in the second quarter were almost 2% up on the average of the first three months of the year. In year-on-year terms, there was a 7½% increase. This was noticeably more than in the first quarter, in which growth of 3½% had been achieved. A crucial part in the accelerated increase was played by export orders placed with German firms. After adjustment for seasonal and working-day variations, 3½% more orders were placed in the April-June period than in the first quarter. The figure was more than one-tenth up on the year. A similarly strong pace of growth was last recorded at the start of the current decade. The sharpest increase was recorded by consumer goods producers, especially manufacturers of non-durable goods. Among these, a greater volume of orders was placed, in particular, for pharmaceutical products following a slight lull in orders during the first few months of the year. In the case of durable consumer goods, a surge in orders for electrical household appliances and for optical and photographic products had a positive impact. Capital goods producers also recorded a clear growth in orders in the second quarter with a seasonally adjusted increase of 3¼%. The best performer in this area was the car industry, which continues to be very successful with its cars internationally. In addition, manufacturers of machinery and equipment were able to conclude contracts for sizeable orders with export customers. Even though the producers of intermediate goods failed to equal the expansion of business in the other

Demand for industrial goods

Seasonally adjusted, quarterly, log scale



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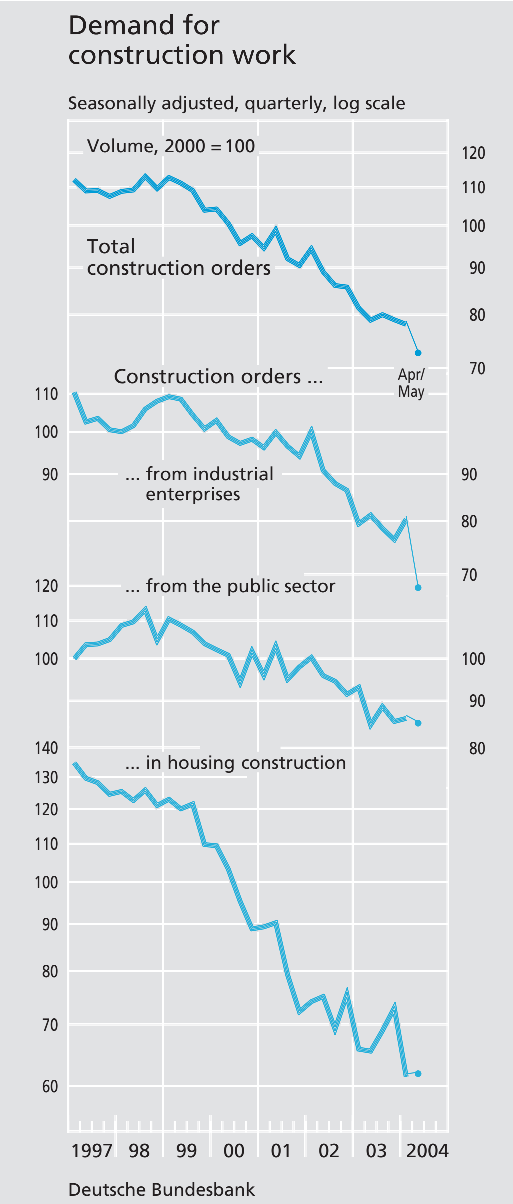


sectors, they also recorded a significant increase in demand at a seasonally adjusted 3½%. This was true especially of the chemicals industry. Demand for steel production held up at the high level at which it had been for some time.

... but domestic orders languishing

In contrast to external demand, which was broadly based and very strong overall, domestic orders provided no significant stimuli over the past few months. In seasonally adjusted terms, the intake of orders in the second quarter was no more than ½% higher than in the first few months of the year, in which new orders had stagnated at the higher level achieved in the final quarter of 2003. Owing to the temporary pick-up in demand at that time, which followed on from earlier weak growth, orders in the second quarter were, at all events, around 4½% up on the year. The best performance was put in by the producers of intermediate goods, which was mainly due to the iron and steel industry. The capital goods sector was only slightly behind. The car industry and producers of machinery and equipment performed best in this sector, followed by manufacturers of structural metal products. Latterly, orders in the consumer goods sector almost matched last year's levels as the sharp decline in ordering in the first quarter was partially made up again.

Poor orders situation in the construction sector

Demand for construction work remained weak in spring, however. In April and May, the seasonally adjusted intake of construction orders declined on average by 7¼% compared with the first quarter and by 8% on the year. This means that the falling trend in demand, which has been under way since the most recent peak in 1994, was continuing up to the end of the period under review. Overall, the volume of orders since then has almost halved. The most recent deterioration in business is due mainly to commercial customers. Following more buoyant ordering activity for an interim period in the first few months of the year, they cut back their new orders again perceptibly. In May, orders were down on the year by almost one-quarter. A fairly large number of vacant and unlet properties are being reported on the office markets, for example, with many properties being completed only now owing to long planning and construction times. Public clients were also reluctant to tackle new construction projects, however. At least, new orders were roughly just as high as they were last year. In housing construction, seasonally adjusted demand in April and May remained at the low level of the first quarter. The orders situation deteriorated perceptibly at the start of the year because many new orders had been brought forward to the last few months of 2003 owing to the cutback in government assistance.

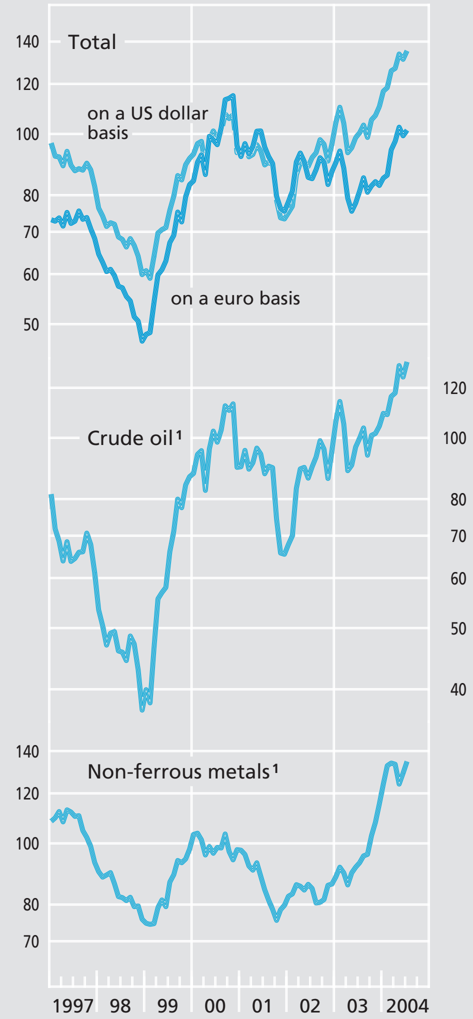
Prices

High oil and commodity prices ...

Prices in Germany continued to be affected by the international energy and commodity markets as well as by administrative measures. Oil prices on the world markets have been rising sharply for some time with heavy upward and downward fluctuations in the short term. Brent North Sea Oil, which has a lead function for the European markets, repeatedly went over the US$40 per barrel mark during the past few weeks. In July, the cost was around US$37½ on a monthly average. Compared with the average of the years 2000 to 2003, this signifies an increase of no less than US$11, or more than 40%. In contrast to similar periods of high oil prices, the main underlying cause is a rapidly increasing global "appetite" for energy rather than an acute or abrupt supply shortage. A positive economic performance and a brisk pace of expansion mean that the USA and China, in particular, have a rapidly growing demand for oil and oil products. Furthermore, high risk premiums are being created by repeatedly emerging fears of supply shortfalls in the case of major oil suppliers, notably in the Middle East and (recently also) Russia. Added to this are concerns about capacity reserves that are effectively still usable and how long stocks will last.

Commodity prices

2000 = 100, monthly, log scale



Source: HWWA Commodity Price Index "Euroland". — 1 On a US dollar basis.

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Consumer prices

Annual percentage change

Item	2003 Q4	2004 Q1	2004 Q2	2004 July
Food	1.6	0.7	– 0.3	– 0.3
Industrial goods	0.5	0.9	1.8	1.7
of which				
Tobacco	8.5	4.4	12.2	12.2
Pharmaceuticals and therapeutic appliances	0.1	17.2	23.2	23.1
Energy	3.3	– 1.6	4.9	5.8
of which				
Refined petroleum products	1.4	– 6.3	7.7	9.7
Services	1.3	2.2	2.4	2.3
of which				
Out-patient and in-patient healthcare services	1.2	17.0	17.0	19.0
Rents	1.0	1.1	1.0	1.0
Total	1.2	1.0	1.7	1.8
Total excluding seasonal goods, energy, tobacco, healthcare	0.7	0.6	0.6	0.4
Memo item				
HICP	1.2	1.0	1.8	2.0

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The extremely dynamic growth of the Chinese economy has also driven up the prices of commodities. According to the HWWA index, the slight calming in the case of industrial commodities that was apparent in April and May again gave way to a rise which approached the peak prices of March. This meant that the dollar prices in July exceeded the previous year's level by 30%. In the case of non-ferrous metals, the figure was as much as 45%. From a European point of view, the associated increase in the cost of imported inputs was roughly one-tenth lower owing to the euro's appreciation against the US dollar but was still quite large.

... affect import prices ...

The international price movements can also be clearly identified in German import prices. Import prices for commodities and semi-finished products in the middle of this year were around 15% higher than in the same period of 2003, after having been 5% cheaper in year-on-year terms in the first quarter. This price increase has been reflected, at most, only partly in the case of finished goods. In July 2004, import prices for finished goods were still more than ½% down on the year. At the start of 2004, however, the year-on-year decline had been significantly larger at almost -2½%.

... and industrial producer prices

German industrial factory gate prices reflected not only the oil price rise but also the increased cost of other important raw materials and inputs. Intermediate goods, for example, were 2.2% up on the year in July 2004, compared with -0.2% at the start of the year. The manufacture of basic metals led the way with an annual rate of growth that was now in double figures. Capital goods, however, were scarcely more expensive at the end of the period under review than they had been one year earlier. In the case of consumer goods, the price rise was mainly determined by the increase in tobacco tax. By contrast, other products, such as clothing and consumer electronic equipment, became cheaper. Marked increases in the cost of primary products due to high energy and steel prices were also one main reason for the first fairly sharp increase in construction prices in four years. As a result, in the second quarter the level of prices for residential and commercially used buildings showed an increase of around 1% on both the quarter and the year.

The differing price trends are also reflected in consumer prices. Despite prices falling at

Consumer prices affected by energy and health reform

times, energy, for example, cost households 5.8% more in July than it had done in the same month last year. Heating oil and fuel alone cost 9.7% more. Added to this was the sharp price rise in healthcare, an area in which physiotherapy services have latterly become more expensive. Overall, the price effects of the health reform for households therefore add up to just over one-fifth. The fact that, in July, the year-on-year rate of consumer price increase did not exceed 1.8% in total was due, in particular, to no more than minor price movements in the case of food and industrial goods (excluding tobacco and pharmaceuticals as well as therapeutic appliances). In July, both food and industrial goods were somewhat cheaper to buy than 12 months earlier. Price developments in the case of services (excluding in-patient and out-patient healthcare) and housing rents, albeit moderate, were not so positive at year-on-year rates of 1.1% and 1.0% respectively. Despite some price surges in certain segments, the general price trend in Germany has not shown a persistent deterioration so far.