

Economic conditions in Germany

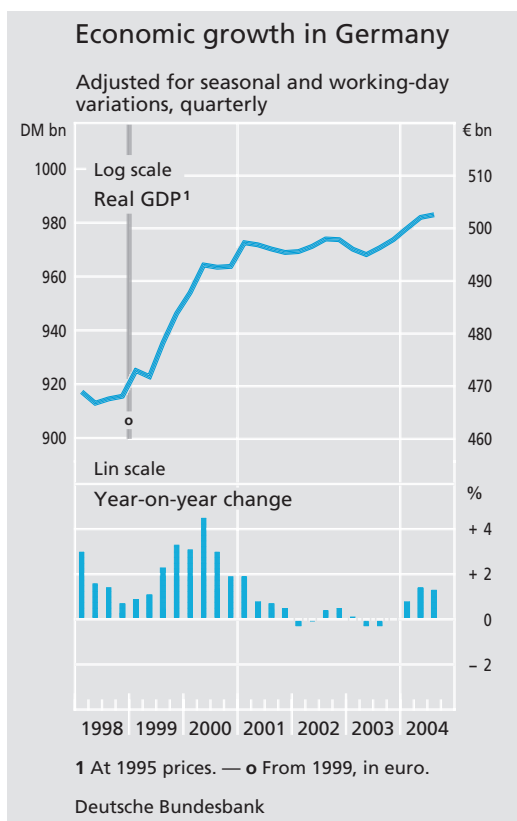
Underlying trends

The German economy achieved a notable pace of growth in the first half of the year but made hardly any further progress in the third quarter. According to initial calculations by the Federal Statistical Office, the increase in real gross domestic product (GDP) in the third quarter of 2004 amounted to 0.1% after seasonal and working-day adjustment. The year-on-year rate after adjustment for working-day variations as well as according to the non-adjusted figures was 1.3%. On an average of the first nine months of the current year, the increase in overall output amounts to 1.2% after working-day adjustment, and to 1.6% on the basis of the original figures.

*Cyclically weak
quarterly result
but ...*

The current phase in the recovery process indicates yet again that a self-sustaining, broadly based upswing has not yet occurred. Indeed, up to now the upturn has been based almost entirely on external demand. This makes the economy especially sensitive to external changes and disruptions. As the cyclical movement is also taking place along quite a flat growth trend, periods when overall output is stagnating or temporary setbacks are by no means unusual. Resilience to exogenous shocks and risk factors will increase only if the endogenous forces of the domestic economy are revitalised. In the present situation, however, the Germany economy did not have much to counter the slackening of export activity, especially as higher oil prices were likewise placing a strain on domestic real incomes and the demand for domestic goods. At all events, despite the unfavourable

*... recovery
scenario
remains intact*



setting, private consumption held up at the level of the second quarter and there was a distinct increase in investment in machinery and equipment, although this was accompanied by rising imports. Much the same applies to inventories, which also made a contribution to growth. The strains due to construction investment were no longer as severe at the end of the period under review, although the situation here is unlikely to have bottomed out yet.

Slower pace of growth possible

Judging by the latest Ifo and German Industrial and Trade Association (DIHK) surveys, the recovery scenario is not being fundamentally called into question. At present, however, it is scarcely possible to tell whether there might be slower cyclical progress for a time. The transition from the initial phase of cyclical re-

covery to an upturn additionally sustained by domestic demand is taking more time than expected. While demand for heating oil was still declining in the third quarter, rising purchases in the fourth quarter are likely to have tied up a lot of purchasing power. Furthermore, households' current scope for expenditure is being restricted by cutbacks in special annual bonuses and wage components outside the agreed pay scales, which have been announced or adopted by many firms and in the public sector.

Given very dynamic export activity in the first half of the year, the lull in exports in the third quarter is not unusual. The good shape of the global economy, enterprises' export expectations and the latest data on new export orders suggest that external impulses will increase again in the final quarter of 2004, even though the recent depreciation of the US dollar might have a slightly dampening impact on export growth.

Chances of external improvement

What is also to be seen in a positive light is that employers and workers have demonstrated a great deal of flexibility in the past few months and that agreement has been achieved on moderate pay agreements as well as on measures to safeguard jobs and production sites in Germany. Together with the reforms that have been initiated, this means that important conditions are in place for a turnaround on the labour market. Furthermore, developments so far in machinery and equipment do not suggest that there has been a structural change in corporate investment behaviour (see explanatory notes on page 36-37). Rising investment in machinery

More favourable underlying conditions

and equipment in the third quarter is pointing in the same direction.

Output and labour market

Slowing of industrial output

The slowing of export activity has been reflected very obviously in the performance of industry. The increase in output, which became perceptibly stronger in the second quarter in the wake of buoyant demand, tailed off after the middle of the year. The summer holiday period played a part in this. In August, particularly, production was cut back owing to an accumulation of holidays. Taking the third quarter as a whole, which is advisable to offset special factors, seasonally adjusted output held up largely at the second-quarter level, which had brought an increase of around 1¾%. The year-on-year increase amounted to some 4%, compared with 4½% in the second quarter. This indicates, as before, a sharp improvement in industrial activity.

Taking sales as a yardstick, production for export, in particular, declined in the summer months, whereas domestic activities were much less affected. Besides consumer goods producers, manufacturers of capital goods were hit especially. Seasonally adjusted capital goods output in the third quarter was no higher than it had been before and the year-on-year increase fell from 6¼% to 5½%. Not least, the motor and mechanical engineering industries lost momentum compared with the high level of production in spring. By contrast, producers of intermediate goods expanded their output again slightly. In particu-



Corporate investment behaviour in the current cycle – hints of a structural break?

Since the second half of 2003, macroeconomic activity in Germany has tended to show an upward trend. Preceded by inventory cycle effects, the recovery was initiated by strong stimuli exerted by foreign trade. However, one year after the start of the recovery, there has not yet been any broadening of growth. The “typical growth scenario” in macroeconomic forecasts envisages that, on the basis of external stimuli, the domestic economy will strengthen, mainly as a result of a rise in corporate investment while private consumption will support growth with a time lag (for example, as a consequence of an improvement in the labour market situation). However, the sustained downturn in private investment has given rise to doubts that the current weakness in investment is of a purely cyclical nature. Although industrial investment has evidently increased significantly in the third quarter of 2004, there could have been a structural change in investment behaviour.

The table below shows the statistical shares of expenditure aggregates in the cumulative change in the year-on-year seasonally and working-day adjusted real gross domestic product (GDP) since the respective cyclical

trough. In contrast to the previous recovery periods, no element of final domestic demand has made a positive contribution to economic growth since the second half of 2003. The latest upward movement is, for the most part, attributable to net exports. Not only is the increase in exports exceptional by historical standards, it should also be taken into account that there was a comparatively small increase in imports this time owing to subdued domestic demand.

In terms of the national accounts figures, the current recovery process is so far to be regarded as atypical, mainly because after one year, it is still almost completely based on buoyant foreign trade. However, the low level of corporate investment cannot alone be “blamed” for the fact that the basis for growth has not yet broadened. Indeed, it should be pointed out that there has been little sign of an improvement in either private consumption or housing construction. In particular, investment by enterprises in the expansion of productive capital remained low, especially as capacity is underutilised in many cases.

Recovery phases since 1970 in a chart of national accounts

Recovery phases ¹	GDP ²	Share of use aggregates in the cumulative change in GDP (in %) ^{2, 3}					
	Cumulative change (in € billion)	Public demand ⁴	Private consumption	Private investment		Foreign balance	
				Non-housing construction	Housing construction	Total	Of which exports
1975 Q3 to 1976 Q2	13.6	6	36	20	8	2	33
1983 Q1 to 1983 Q4	9.5	7	36	29	11	-29	17
1993 Q3 to 1994 Q2	10.2	15	28	-1	43	30	95
2003 Q3 to 2004 Q2	7.4	-7	-30	-19	-7	142	298

¹ For reasons of comparability, uniformly defined as a one-year period after the cyclical trough. — ² Seasonally and working day-adjusted quarterly data at 1995 prices; as of August 2004. — ³ Quotient of differences, whereby the year-on-year cumulative change is calculated from the cyclical low. — ⁴ Government consumption expenditure and

public investment. — ⁵ The standard error of the estimated coefficient is given in parentheses. — ⁶ Commercial investment comprises private investment in machinery and equipment and other capital as well as in commercially used non-residential buildings. — ⁷ OLS residual-based CUSUM tests were conducted; see W Ploberger and W Krämer (1992),

An econometric study of enterprises' investment behaviour complements the circular flow analysis finding, which asks whether a structural break can be statistically proven at the current end. Using the accelerator model, a close relationship to the long-term trend of aggregate economic activity can be established for industrial investment. As part of a vector error correction model on the basis of seasonally and calendar-adjusted quarterly data in the sample, the estimate of this connection produces for the period since 1970 the cointegration relationship⁵

$$i_t - 1,18 y_t$$

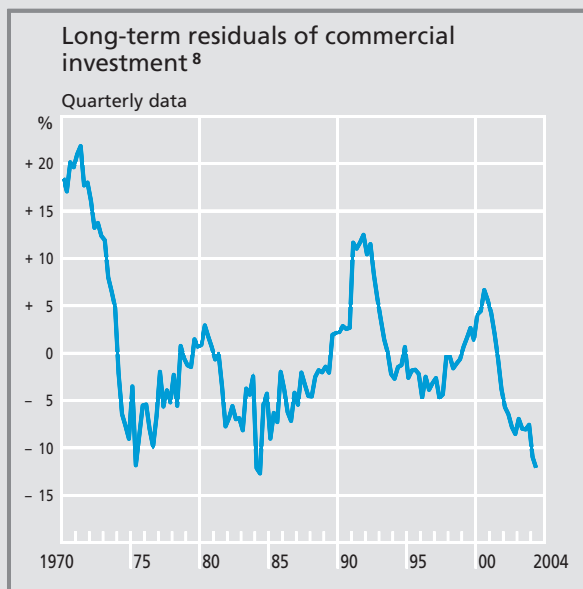
(0,17)

where i_t denotes commercial investment⁶ and y_t GDP – both variables are in logarithmic form and real terms.

As the adjacent chart shows, the cyclical fluctuations in industrial investment around their long-term equilibrium value show considerable volatility. These would be fully consistent with the fall in the volume of investment, which has already been ongoing for four years, provided that the level achieved in summer 2004 was roughly in line with the lower turning point. An econometric modelling of investment behaviour taking into account the above long-term relationship as well as suitable regressors for short-term dynamics provides a residual structure which does not provide any statistically significant evidence for a structural change at present.⁷

If the structure is presumed to remain unchanged (ie if such a model equation were to valid in the future), industrial investment would pick up in the not-too-distant future as part of a continued upward economic trend and, in that way, increasingly broaden the basis

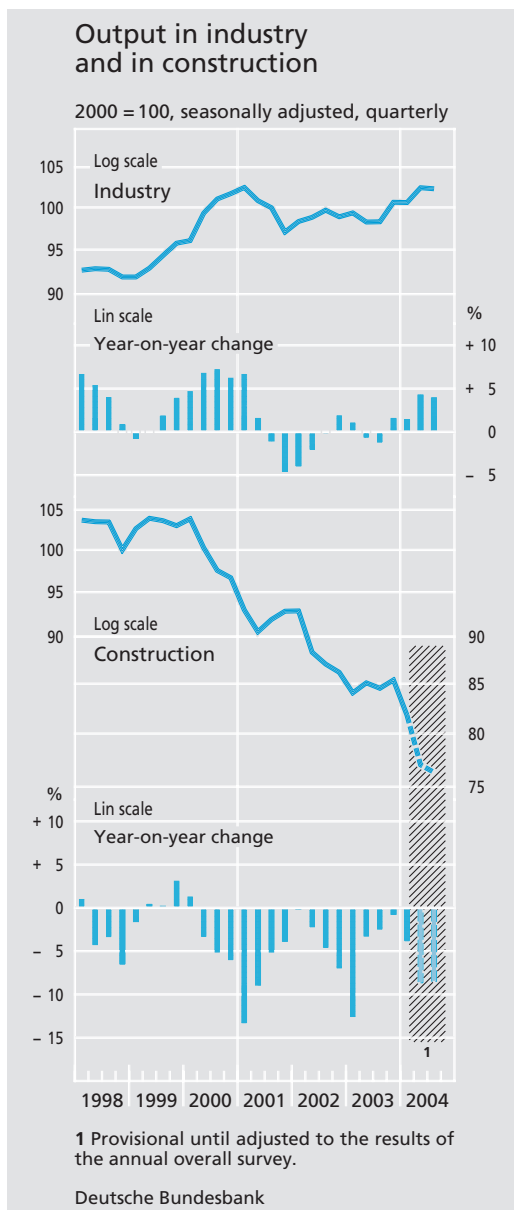
The CUSUM Test with OLS Residuals, *Econometrica* 60, 2: 271-285. Alternative critical values were used for this in order to improve the quality of the test at the current end; see A Zeileis (2004), *Alternative Boundaries for CUSUM Tests*, *Statistical Papers* 45: 123-131. Furthermore, a new test was applied which was developed by DWK Andrews (2004),



for growth. Economically, the very favourable financial conditions as well as the considerable need for replacement investment support this view. In commercial and industrial construction, on the other hand, the fact that enterprises evidently have little incentive to expand their production capacity at present has a negative influence.

All in all, according to the current data, it would be premature to talk of a structural change in the investment behaviour of enterprises. Nevertheless, the growth profile of the current recovery phase has special features by historical standards. Once again, the structural problems of the German economy are manifesting themselves in the weakness of investment. This includes the widespread uncertainty among households, the future demographic burdens as well as the fact that functional disruptions in the labour market are only gradually being reduced.

End-of-Sample Instability Tests, *Econometrica* 71, 6: 1661-1694. — ⁸ The long-term residuals measure the percentage deviation from the long-term equilibrium value and, in this case, result from regression of the cointegration relationship on a constant and a dummy variable modelling the statistical break resulting from German reunification.



lar, output was stepped up significantly in the chemicals and chemical products industry after having remained unchanged over a prolonged period.

Sluggish construction activity

There was no improvement in business in the construction sector in the summer either, although, in seasonally adjusted terms, the decline in construction output clearly slowed down in the third quarter. A gradual trend

stabilisation at a low level is becoming apparent. How low output has now become is also revealed by the fact that the figure for the period from July to September was again 8½% down on the year. Even an upward adjustment of between 3 or 4 percentage points in the overall survey, as has been the case over the past few years, would probably be a long way from offsetting this shortfall. The situation was especially unfavourable in the building industry, with all the major sub-sectors – residential, industrial and public sector construction – being equally affected. Civil engineering performed somewhat better, however. With a 6½% fall in output on the year (according to the present data), the situation was not fundamentally different here either, however. This also applies to the finishing trades. In the second quarter of 2004 (more recent statistics are unavailable), hours worked were 7½% down on the same period of 2003. The corresponding figure for sales was -5%.

The indicators available for the services sector point to a generally more subdued performance recently. A large number of consumption-linked producers were still being affected by the fact that households are cutting back on purchases. At least, there was no further fall in retail sales in the third quarter. Nevertheless, they were still down on the year, as was wholesale turnover in some branches. Business in motor vehicles was especially affected, whereas pharmaceutical products, in particular, enjoyed buoyant demand in both wholesale and retail terms. The business-related branches of the wholesale trade likewise performed relatively well. The

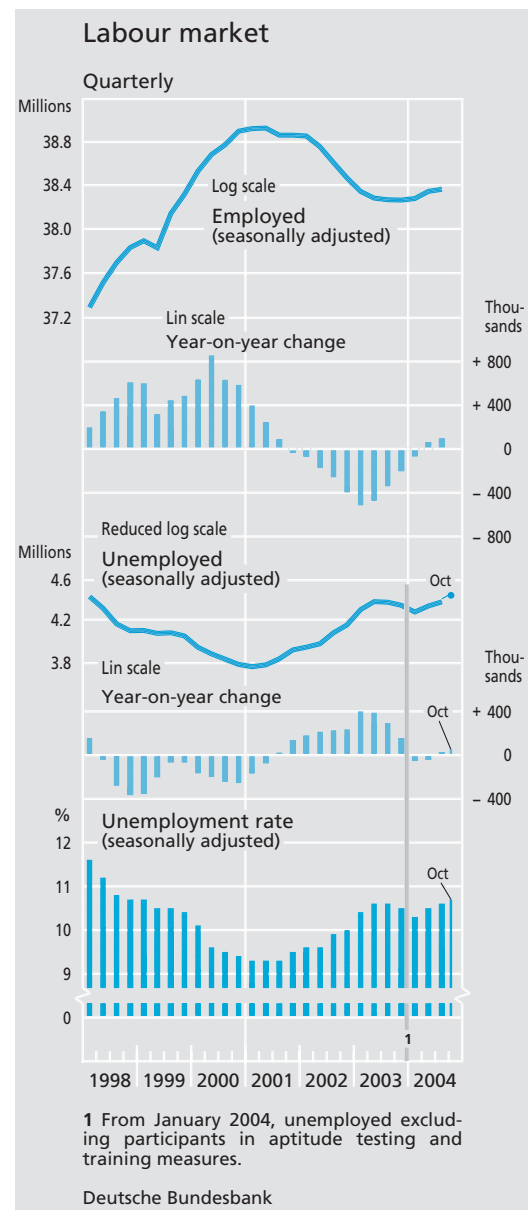
Moderate performance in services

pace of growth slackened somewhat along with the slowing of industrial activity.

In the hotel and restaurant industry, there had been a gradual consolidation in the situation with regard to accommodation services, resulting in a steady reduction of the decline in year-on-year turnover. This did not continue in the third quarter. In the case of some commercial service providers, too, the improvement in the business situation, which was apparent in the second quarter, has faltered during the past few months. According to the surveys of the Centre for European Economic Research (ZEW), this applies, not least, to suppliers of IT services and the ICT trade. Furthermore, among both management consultants and architects, optimism about positive developments was more subdued again. Technical consultancy as well as research and development continued to be in demand, however. In the telecoms sector and in the case of tax consultants and auditing firms, too, there were increasing reports of a positive development in turnover. A massive rise in costs due to the international price surge on the oil markets caused problems for the transport sector, in particular.

Unfavourable development on the labour market

From a cyclical point of view, there has been hardly any improvement in the labour market situation of late. Following a further revision of the data by the Federal Statistical Office, there has been an increase in the number of persons in work since the start of 2004, with the seasonally adjusted figure reaching 38.39 million in August. This was roughly 110,000 persons more than in December 2003 or 105,000 more than 12 months earlier. To a



large extent, however, the upward adjustment was due to the recording in the statistics of additional part-time low-income workers, who are active, not least, in households. There is a possibility that this was partly due to the campaign against illicit working conducted by the Federal Government and that a greater number of household helps were reported. The number of self-employed persons has also been adjusted upwards, which is

partly related to the promotion of one-person businesses under current labour market policy. Industrial employment was continuing to fall well into the third quarter, however, albeit at decreasing rates. The figure in August was more than 1½% down on the year. There was also a further decline in employment in the construction sector and the finishing trades, with reductions that were close to being in double figures. Furthermore, a year-on-year fall in employment was again reported by many branches of the services sector, including the wholesale and retail trade as well as the commercial service providers surveyed by the ZEW.

Rise in unemployment

Any sign of an identifiable cyclical improvement on the labour market is also belied by the increase in unemployment going into the fourth quarter. According to the Federal Employment Agency, the seasonally adjusted number of persons officially registered as unemployed had risen to 4.46 million by October. This was almost 190,000 higher than the level in January of this year. The year-on-year increase was 55,000. Taking into account the methodological adjustment at the start of the year, as a result of which persons taking part in aptitude testing and training schemes are no longer counted as being unemployed, the increase over 12 months amounted to 185,000. The seasonally adjusted unemployment rate, as calculated by the Federal Employment Agency, was 10.7% in October. Using the standardised international method, the figure was 10.0%. In both cases, this was around ½ percentage point higher than at the beginning of 2004.

Numerous labour market policy measures have continued to have an alleviating impact. Direct assistance for employment was granted to 375,000 persons in October. This mainly took the form of one-person businesses and, to a minor extent, personnel service agencies (PSAs). Just under 120,000 participants in job creation schemes were reported. The labour exchanges supported pre-retirement part-time work for roughly 80,000 persons. Arrangements similar to pre-retirement were being taken up by 395,000 older workers, for which they are no longer registered as unemployed. 110,000 persons were taking part in aptitude testing and training measures. Vocational training schemes were being attended by 165,000 persons. The expected impact of the Fourth Act Promoting Modern Labour Market Services (Hartz IV) on unemployment in 2005 are roughly quantified in the explanatory notes on page 41.

Extensive labour market policy measures

Orders

The slowing of export activity has been clearly reflected in the volume of new industrial orders. Furthermore, the summer months of July and August were marked by various holiday influences. Whereas there tended to be fewer (school) holidays in July than has been usual during the past few years, which meant that there were relatively few hold-ups of business activity, August – as the main holiday month – was especially affected. In the period from July to September as a whole, the seasonally adjusted level of new orders was just as high as in the second quarter. This meant that, for the time being, there was no con-

Weaker demand for industrial goods

The effects of "Hartz IV" on the labour market

The Fourth Act Promoting Modern Labour Market Services ("Hartz IV") merges unemployment assistance with social assistance for persons able to work into a basic national social security system for job seekers ("unemployment benefit II"). The new act comes into force on 1 January 2005. It is expected to have a noticeable impact on employment and unemployment. However, only a conditional quantitative assessment, which is subject to great uncertainty, is possible at present.

It can be taken as read that, at the start of January, many previous recipients of social assistance will register as unemployed in order to claim unemployment benefit II. Based on the statistics on social assistance recipients for 2003, the *Institut für Arbeitsmarkt- und Berufsforschung* (IAB), the Federal Employment Agency's labour market and employment research institution, predicts that around 300,000 will do so in the coming year. As the increase in unemployed persons will take place at the beginning of the year, the cited figures also apply to the annual average.

However, there will be relief as a result of the jobs planned as part of the integration measures. These will be non-profit-making and additional activities, for which an expense allowance work-related benefit bonus will be paid amounting to €1 to €2 per hour worked in addition to unemployment benefit II. On the basis of the financial resources provided for this purpose, the Federal Ministry of Economics and Labour has estimated a potential for 600,000 jobs, 200,000 to 250,000 of which are estimated to be already available for recipients of social assistance. According to the Federal Employment Agency, a further 45,000 job opportunities had been created throughout Germany by the end of October, with the result that an additional 300,000 jobs can be expected for 2005. As these will only be created gradually, this will result in an average of 150,000 jobs per year provided that growth is relatively steady. The number of people out of work will fall and the number of people in work will rise accordingly.

A further reduction in registered unemployment is expected among persons who are currently claiming unemployment assistance but are not entitled to claim unemployment benefit II under the new rules because they have offsettable assets or sufficient family income. This is estimated to affect around half a million people. The level has been calculated by both the IAB and the trade unions from basic information supplied by the Federal Government. Experience from 2003 can be cited in order to exclude from this group those who are likely to take themselves off the unemployment register after a while. Following the reorganisation of job placement to encour-

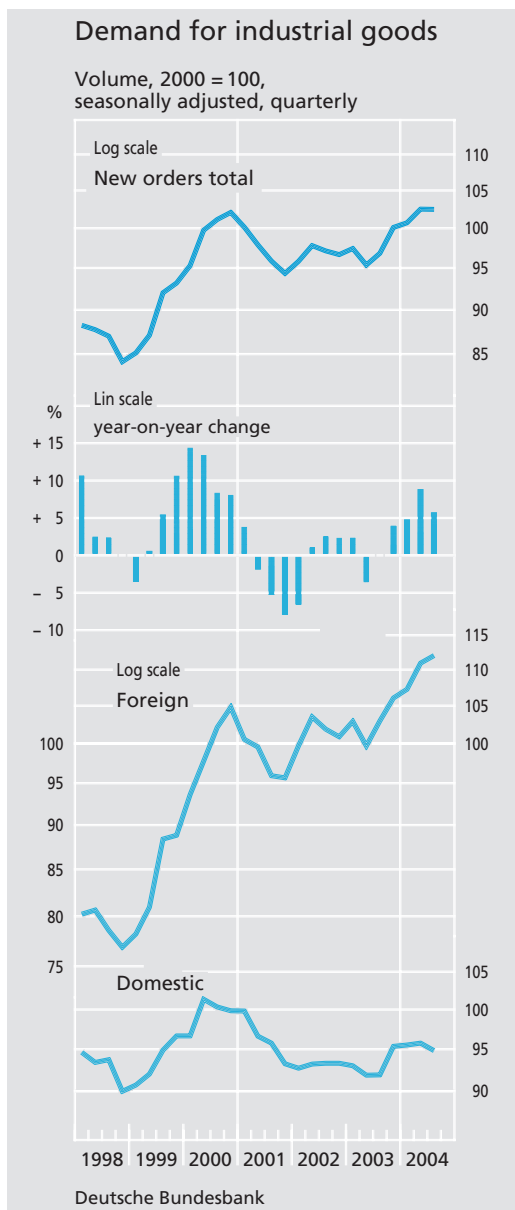
Effects of "Hartz IV" on average unemployment in 2005

Item	Change
Persons receiving social assistance but able to work who were not previously registered as unemployed	+ 300,000
Unemployment benefit II recipients with a "one euro job"	- 150,000
Previous recipients of unemployment assistance who are not entitled to unemployment benefit II and are no longer registered unemployed	- 100,000
Intensified job intermediation	- 25,000
Estimated overall effect	+ 25,000

age active job-seeking and involving a tightening of the criteria for registering as unemployed, around one-fifth of those unemployed who were registered but did not receive benefits were taken off the register at that time. This number of benefit recipients deregistering from assistance results in around 100,000 deregistrations on an annual average.

Finally, it is not unrealistic to assume that more intense job placement activity which the Federal Government is aiming for will, together with stricter rules on accepting jobs that become available, will lead to a reduction in registered unemployment. However, the stated number of 100,000 persons deregistering in connection with this appears, if anything, to form the upper limit. Assuming that 50,000 will deregister over the course of the year, there will be a fall of 25,000 per year on average. Employment is unlikely to increase not quite as sharply, as experience shows that there will be some withdrawals into the hidden reserve.

Combining these partial effects, it becomes apparent that Hartz IV will arguably not have a significant impact on registered unemployment on average in 2005. On the other hand, the number of persons in work will rise. At the start of the year, though, there is likely to be a sharp rise in registered unemployment. This will not only gradually go back down again but is also even likely to turn into an increasing decline over time. Employment will continuously rise after a slow start. If one adds the gradual improvement in the labour market, which is supported by the cyclical component, there could be a turnaround in 2005. Admittedly, this will be less significant when looking at full-time workers subject to social security contributions or the hours worked than in purely person-related terms.



tinuation of the steadily rising demand for German industrial products, which had begun in spring 2003, producing an increase in orders of around 7½%.

Export orders, which had been the main driving force for about a year, were especially affected by this. Quarterly growth, which had averaged 2¾% in the phase of expansion, fell to not quite 1%. Capital goods producers

performed better. Producers of machinery and equipment, especially manufacturers of other transport equipment, which includes aircraft, ships and boats, railways and rolling stock, achieved significant growth in orders, while manufacturer of road vehicles was noticeably down on the quarter. In the case of intermediate goods, it was, above all, the chemicals industry that helped to stabilise orders in the sector as a whole. Orders received by producers of consumer goods were a long way from matching their outstanding level in the second quarter. In seasonally adjusted terms, they fell by 2¾%.

In the summer months, domestic demand, which had previously increased not even half as much as export orders, lagged behind the second-quarter level. At 3%, it continued to show a year-on-year increase. However, the rise has become distinctly smaller lately. In particular, as in the second quarter, there was a decline in new orders received by producers of capital goods. Not only manufacturers of machinery and equipment but also the IT and telecoms sectors took in fewer orders. In both the consumer and intermediate goods sectors, the volume of new orders in the third quarter was likewise lower than before. A clear rise in incoming orders in the chemicals and steel industry contrasted with sharp losses for suppliers of important products of the textile sector and the plastic goods industry.

Among the commercial service providers included in the ZEW survey, advertising firms, in particular, reported a positive situation with regard to orders. Technical consultancy as

Positive orders situation in the case of service providers

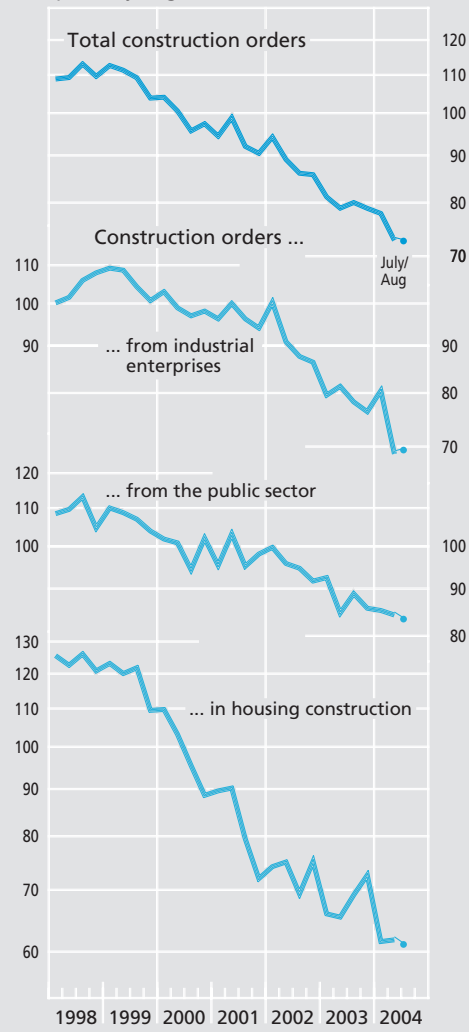
well as research and development activities were in considerable demand. In the IT sector, it is likely that specialised firms often had to be employed to set up programs. However, in contrast to the first half of the year, telecoms services met with only limited interest. Many firms of architects also reported a substantial lack of orders.

Weak construction demand

Demand for construction work remained weak in the summer months. In seasonally adjusted terms, incoming construction orders in July and August were down again on the preceding three-month period from April to June. Even though the decline became markedly slower, the year-on-year decline – at just under one-tenth – was, in fact, sharper than before. Only in public construction was the situation marginally more favourable with the fall amounting to around 6½% on the year. In commercial construction as well as in the case of dwellings, however, the deterioration over 12 months was in double figures. Taking construction permits as a yardstick, no improvement in construction activity appears likely in the immediate future either. With no more than 15,800 dwellings on an average of the period from July to September, there was a further decline of around 11½% in the number of new dwellings approved compared with the second quarter. In particular, there has been a massive decline in construction projects for owner-occupied houses. In the summer months, they were no less than roughly 13% down on the spring quarter and 17½% down on the year. There was also a reduction in construction applications for rented and owner-occupied apartments, although the fall was distinctly smaller at little

Demand for construction work

Volume, 2000 = 100, seasonally adjusted, quarterly, log scale



more than 8%. It should be borne in mind, however, that the willingness to build has been falling dramatically for several years now.

Prices and wages

Wage developments in the economy as a whole remained quite moderate in 2004.

Moderate wage developments

Consumer prices

Annual percentage change

Item	2004			
	Q1	Q2	Q3	Oct
Food	0.7	-0.3	-0.6	-1.4
Industrial goods	0.9	1.8	1.6	1.5
<i>of which</i>				
Tobacco	4.4	12.2	12.2	12.2
Pharmaceuticals and therapeutic appliances	17.2	23.2	23.2	23.3
Energy	-1.6	4.9	6.1	9.5
<i>of which</i>				
Refined petroleum products	-6.3	7.7	10.3	16.3
Services	2.2	2.4	2.3	2.3
<i>of which</i>				
Outpatient and inpatient medical services	17.0	17.0	18.7	18.5
Rents	1.1	1.0	1.0	1.2
Total	1.0	1.7	1.8	2.0
Total excluding seasonal products, energy, tobacco, healthcare	0.6	0.5	0.5	0.4
<i>Memo item</i>				
Harmonised Index	1.0	1.8	2.0	2.2

Deutsche Bundesbank

Agreed rates of pay, including all ancillary agreements, went up 1.1% on a monthly basis in the third quarter, compared with increases of 1.9% in the first quarter and 1.6% in the second quarter. The smaller increase in negotiated rates of pay in the summer months was due, first, to the abolition of holiday bonuses for civil servants and, second, to a base effect in the metal-working and electrical engineering industry, since workers in that sector had been granted a one-off payment last year as part of the "ERA structural component". For 2004 as a whole, a 1½% increase in agreed rates of pay appears likely.

At present, data on actual earnings in the third quarter are available only for industry and the construction sector. These show that wages and salaries per employee in industry

during this period were 1.1% up on the year. In July and August, earnings in the construction sector were also up 1.1%. It is very likely that the increase in average actual earnings among the individual services subsectors was significantly lower, particularly in view of the sharp expansion of part-time employment in the form of "mini-jobs". On an overall average, the rise in actual earnings is therefore likely to have markedly lagged behind the increase in negotiated rates of pay in the third quarter as well.

As an outcome, the corporate cost account in the third quarter was perceptibly alleviated from the wages side. Given a 1% increase in productivity per person employed, unit labour costs were quite clearly down on the year in this three-month period, too. They thus formed a major counterweight to the sharp rise in energy and commodity prices, especially as the scope for raising prices is currently very limited in the case of many enterprises.

In the past few months, external factors have had a sharp impact on domestic prices. Brent crude oil, to which prices in Europe are geared, cost almost US\$50 a barrel in October. This was US\$15 more than in mid-2004, a rise of more than two-thirds on the year. The depreciation of the dollar against the euro has dampened the price rise to some extent for European customers, but the increase was still very large at just under 60%. When measured against that, the rate of price increase for internationally traded industrial raw materials was moderate. The year-on-year rate was, nevertheless, quite sharp at more than one-fifth in US dollar terms and

*Sharp increase
in the cost of
energy and raw
materials*

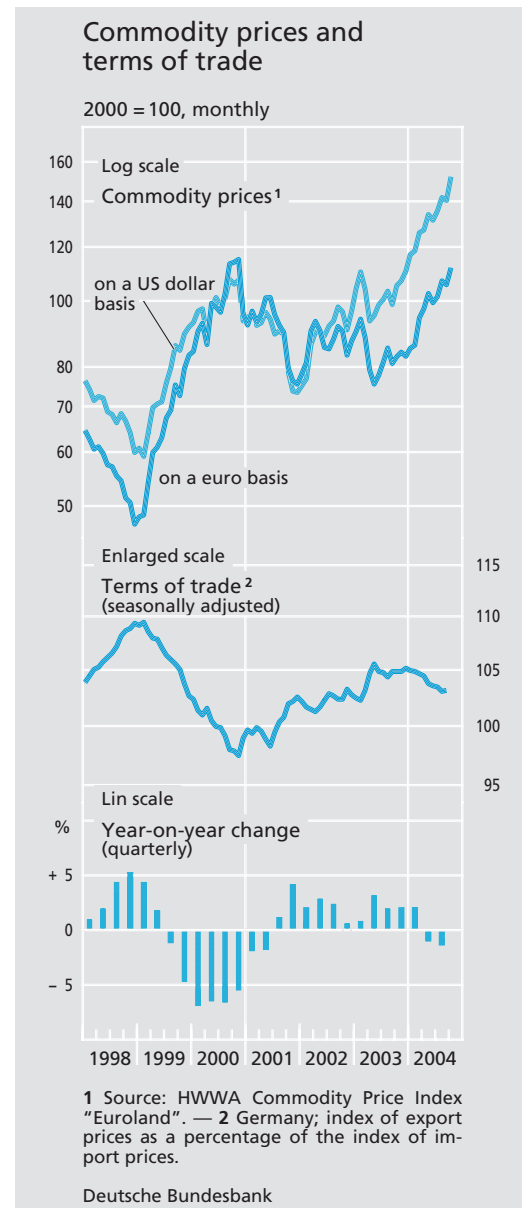
around 15% in euro terms in October according to the HWWA index. The prices of non-ferrous metals and iron ore and scrap went up by more than 35% or about two-fifths.

Rising import prices

The international surge in prices has been recognisably reflected in German import prices. Imports of crude oil in September were nearly 40% up on the year and refined petroleum products were, in fact, over twice as expensive. Iron ore and non-ferrous ores were around one-quarter up on the year, with iron and steel products costing over one-third more. Although overall import prices were no more than 2.7% higher than their level in September 2003, this was due to persistently low prices for capital and consumer goods. At the end of the period under review, capital goods prices were 2.6% down on the earlier level. The corresponding figure for consumer goods was -1.5%. This suggests that the increase in the cost of energy and commodities has so far not led to major price adjustments in the case of finished goods. No more than subdued demand together with fierce competition has probably made it considerably more difficult to adjust prices.

Deterioration in the terms of trade

As German exports are heavily concentrated on finished products, price increases for exported goods were comparatively small on the whole. Even though domestic suppliers were able to charge their customers fairly high prices in comparison with the relevant competing imports – for example, exporters of capital goods made price concessions in year-on-year terms amounting to no more than 0.3%, while importers reduced their quoted prices by 2.6% over the same period



– overall export prices were only 1.0% up on the year in September, while imports became 2.7% more expensive. At the end of the period under review, there was therefore a noticeable deterioration in the terms of trade on the basis of external trade prices. For the year as a whole, however, the losses are still likely to be limited.

*Rise in industrial
factory gate
prices*

In terms of domestic industrial factory gate prices, there were likewise major differences in price developments at the individual stages of production. Capital goods showed a 0.5% increase on the year in October, while non-durable consumer goods (leaving aside tobacco on account of the tax increase in March) cost 0.1% less than in the same month in 2003. Intermediate goods, by contrast, were 5.2% higher over 12 months. For energy, the overall figure was +6.4%. Taken together, the year-on-year rate of increase for industrial factory gate prices was 3.3% in October, compared with +0.2% in the first quarter.

*High overall
rate, low core
rate for
consumer
prices*

Price changes in the case of industrial products were quite small at the consumer level as well. After excluding tobacco and healthcare products, there was, in fact, a year-on-year fall of 0.7% in October. Food was also 1.4% cheaper than in 2003. This contrasted with a relatively sharp price rise in the case of services. Excluding healthcare, the year-on-year rate of increase for services was 1.1%. Increases in housing rents were on a similar scale. For all these components together, the rate of price increase was only 0.3% on the year. However, adding the price rises for energy (+9.5%), the (to a large extent) tax-induced higher cost of tobacco (+12.2%), and the price effects of the health system re-

form (+20.4%) means that there was a 2.0% increase on the year in the cost of living. This was twice as much as in the first few months of the year, when the year-on-year rate had been +1%.

The dramatic increases in the price of commodities have also been pushing up the costs of construction work noticeably since the spring. This means an end to the ongoing period of largely constant construction prices since autumn 2001. In August 2004, construction work cost 1.5% more than in the same month of 2003.

*Construction
work costs
more*

International oil prices have been going down since the last few days of October. By mid-November, the prices quoted for Brent North Sea Oil had fallen to below US\$45, which was, at all events, a reduction of more than 10%. In euro terms, in fact, this was a fall of over 15%, as the US dollar was depreciating against the single currency. Even so, oil prices are still noticeably higher than at the start of the year, when they had scarcely gone higher than US\$30½. In year-on-year terms, the rates of increase are still around 45%. Even though this means that direct oil-price-related inflation is no longer being stoked up, the price adjustments sparked off by the oil price surge will persist in the case of other energy sources and in the enterprises' cost structure.

*Slight fall in
international
oil prices*