

Economic conditions in Germany

Underlying trends

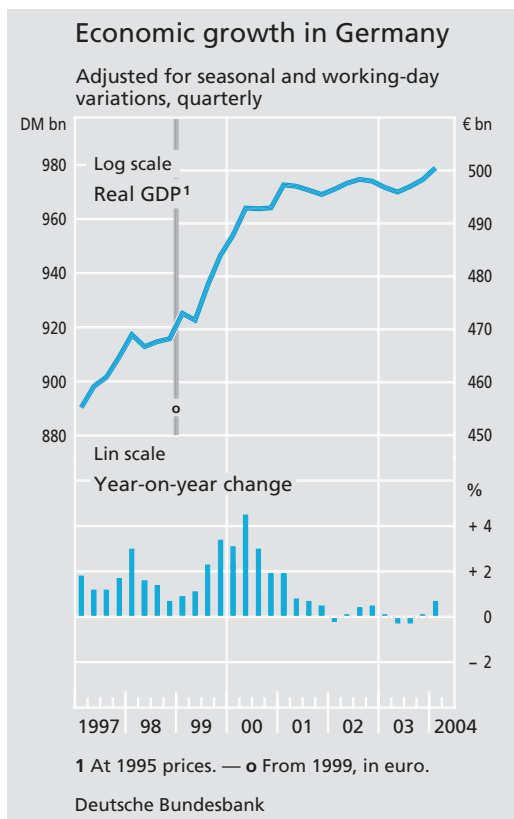
The cyclical recovery of the German economy gained strength somewhat in the first quarter of 2004. According to the flash estimate of the Federal Statistical Office, real gross domestic product (GDP) increased by 0.4% after seasonal and working-day adjustment. Growth had been 0.2% and 0.3%, respectively, in the previous two quarters. At an annualised rate, the current pace of expansion corresponds to a 1¾% rise in overall output. This means that there is likely to have been no further decline in average capacity utilisation for the first time in some while. Real GDP in the first quarter was 0.7% up on the year after working-day adjustment. The corresponding unadjusted figure shows a 1.5% year-on-year increase. The fact that there were more working days than in the same period of 2003 played a part in this.

*Faster increase
in GDP...*

However, it would be rash simply to extrapolate from the growth rate of the first quarter. Various leading indicators and the surveys of the Ifo Institute and the Centre for European Economic Research (ZEW) continue to signal a rather subdued upturn in the next few months. The fact that international crude oil and commodity prices are very high might also have a temporary retarding impact, especially as the euro area – which is important for the economy – is only slowly gaining momentum.

The cyclical upturn also remains narrowly based. While domestic demand was very subdued at the start of the year, external trade was generating strongly positive stimuli. Fol-

*... on a narrow
base*



Following a temporary lull in the last three months of 2003, exports picked up noticeably in the first quarter. At the same time, imports were only slightly up on the quarter, when they had shown a rise not least as a result of sizeable imports of intermediate and IT goods. This led to a sharp increase in net exports. However, there was still quite little willingness to invest more in the domestic capital stock. At least, there is unlikely to have been a seasonally adjusted increase in investment in machinery and equipment in the first quarter of 2004. Activity in the construction sector is also likely to have weakened again somewhat following the anticipatory effects that occurred in connection with the cutback in assistance for housing construction.

The restraint in households' consumption, which had been noticeable for some while, continued after the start of 2004. This is revealed, first, by the surveys of the consumer research institution *Gesellschaft für Konsumforschung* (GfK). In terms of their underlying trend, neither expectations regarding economic activity nor the outlook for incomes indicate an improved assessment. The propensity to purchase is persisting at a very low level. Second, as is consistent with the survey, retail turnover in the first few months of the year was down on the fourth quarter of 2003 as well as down on the year. Although the income situation improved somewhat at the beginning of the year after an additional stage of the tax reform had come into effect, this was offset by additional burdens due to the health reform and higher tobacco taxes. Furthermore, the continuing difficult situation on the labour market and the resulting job insecurity are likely to have dampened the propensity to spend. A further factor to be considered is that the incomes in many new forms of employment, such as one-person businesses or mini and midi-jobs, tend to be low in line with their low level of labour productivity and small number of working hours.

Precisely because the interest rate level and price developments are very consumer-friendly at present and since there are currently no major negative wealth effects stemming from the financial and real estate markets that might depress consumption, looking at the subdued income trend alone does not provide an adequate explanation of the persistent weakness of consumption in Germany. On the contrary, there are indications that the

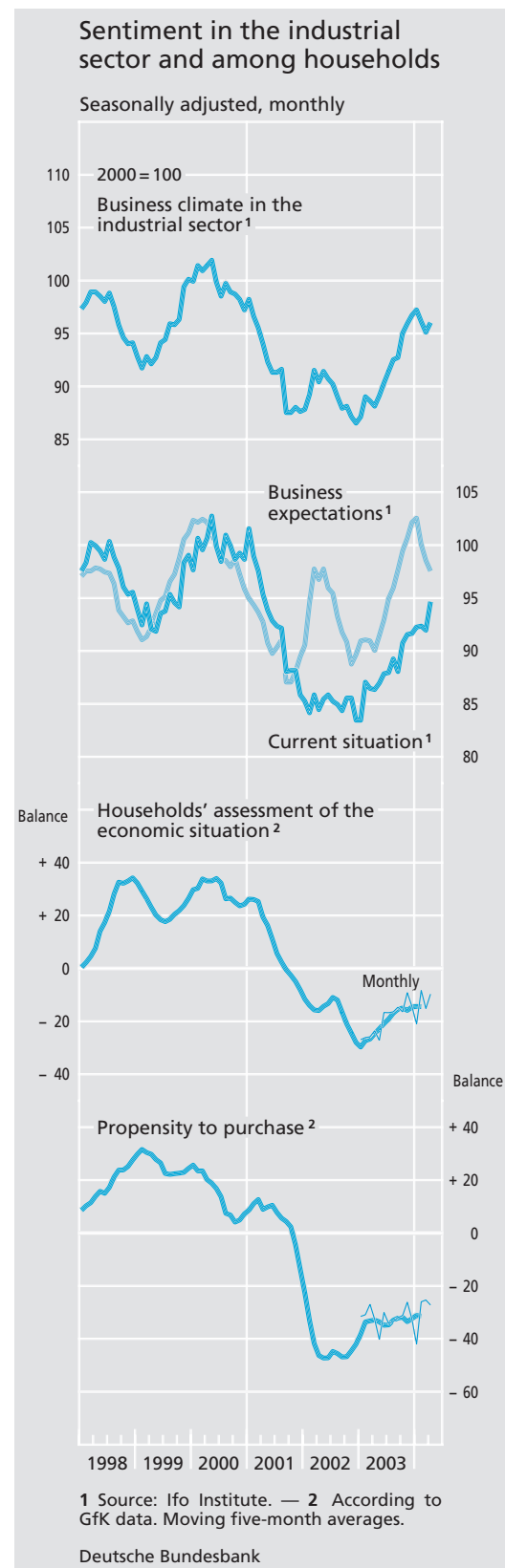
Weak private consumption

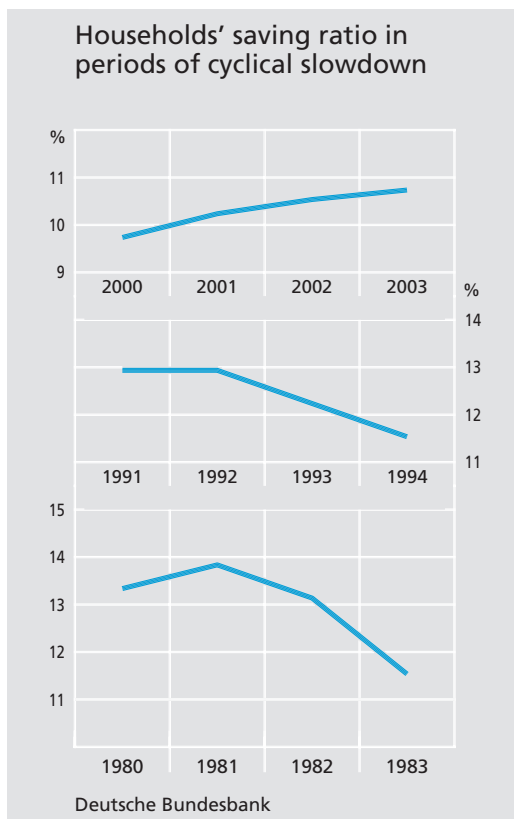
Change in savings behaviour

consumption and/or savings behaviour of households has changed.

A comparison of the saving ratios in periods of cyclical weakness since the early 1980s shows that, in such comparable periods, there was no continuous increase like the one observed since 2000. At the same time, econometric estimates of the consumption function show persistently high negative residues.

The current increase in the saving ratio might be due partly to the debate on the problems of the health and pension systems. This may have raised awareness of the necessity to make personal provision. In general, the accumulation of private assets for maintaining the standard of living in old age is to be seen positively as a major contribution to coping with the demographic strains. Actually, the marked uncertainty about the specific features of the reform in the social and labour market sectors has made it much more difficult for households to assess the future outlook for incomes. The sooner and more convincingly the appropriate political decisions ensure greater planning certainty and reliability in terms of the underlying conditions, the sooner households' caution in terms of their consumption decisions – which is rooted in this situation – can be overcome. In saying all that, it should be pointed out that both the private and the national saving ratios in Germany are to be rated as low on a longer-term comparison. Higher domestic saving is by no means a disadvantage for longer-term growth as long as the financial resources find a productive use there. Enhancing the attract-





iveness of Germany as a location for investment in this way is always a key task of economic policy.

Output and labour market

Industrial output stabilised...

The situation in industry improved somewhat in the first few months of the year. Seasonally adjusted output in the first quarter was up slightly on the comparatively high figure for the final quarter of 2003. After eliminating working-day effects, the figure was 1½% up on the year.

Intermediate goods performed better than average with a clear seasonally adjusted increase in output. The year-on-year rise went up from 2% in the final quarter of 2003 to

more than 2½% in the first three months of the current year. This was due mainly to a sharp seasonally adjusted increase in output in the chemical industry. Producers of consumer goods also performed comparatively well. Producers of non-durable goods, in particular, expanded their production somewhat, although, in the case of tobacco goods, this is likely to have been due in part to anticipatory effects owing to the further increase in the tax on cigarettes and other tobacco products as of 1 March. By contrast, cutbacks in production were reported by the capital goods sector. Not least, completions of motor vehicles were cut back again somewhat after having been stepped up considerably towards the end of last year.

Construction output in the first few months of 2004 was affected by marked fluctuations in the weather. Following cutbacks in January, it was possible to step up work again in February. However, construction output in the first quarter as a whole was clearly down on the final quarter of 2003. The figure was 3% down on the year compared with -¾% in the October to December period of last year. This shows that there was no continuation of the stabilisation that was becoming apparent in 2003. Business conditions remained difficult in installation and building completion work, too. In the fourth quarter of 2003 (more recent statistics are unavailable at present), hours worked and turnover were both still noticeably down on the year, although the minus figure has become smaller recently.

... but further decline in construction

The first few months of this year brought no improvement for the wholesale and retail

Weak business activity in the wholesale and retail trade as well as in the catering industry

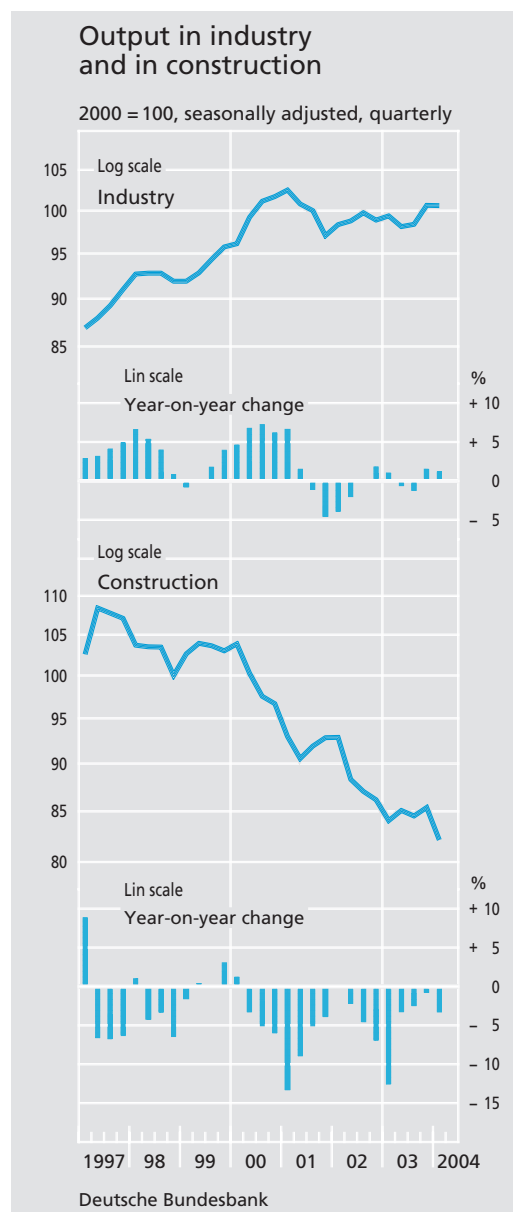
trade, with turnover – at constant prices – being down on the end of last year. Households' reluctance to buy was even quite obvious in the wholesale trade. This was not offset by the more favourable development in deliveries of commodities and primary materials as well as of machinery and equipment to industry. In the hotel and catering trade, there was a lessening of the ongoing decline in turnover that had been triggered by sharp price increases in connection with the introduction of euro cash. While hotel and accommodation services even achieved initial increases in turnover, business in the restaurant sector continued to be on a downward trend.

Upturn in the services sector

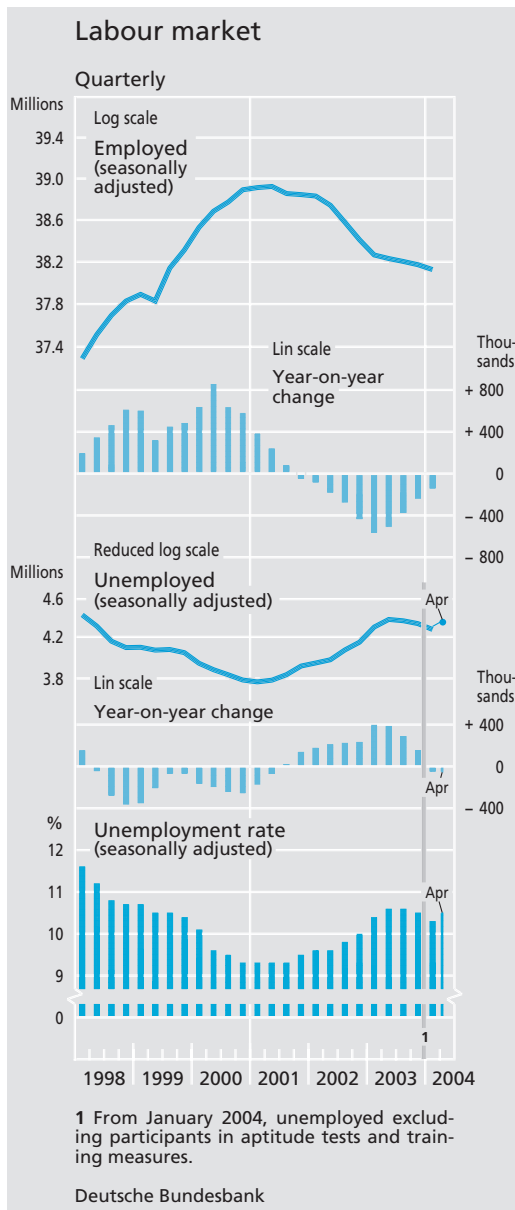
The available indicators suggest an upturn for other services sectors. According to the surveys of the German Industrial and Trade Association (DIHK), this applies, not least, to the banks and insurance companies. Many branches of the commercial services provider sector likewise report a positive development in turnover. According to the spring survey of the Centre for European Economic Research (ZEW), business developed positively especially for the advertising industry, tax consultants and auditors as well as for firms of management consultants. By contrast, in the field of information and communications technologies (ICT) expectations have probably not been entirely fulfilled. Nevertheless, in the first few months of this year the wholesale trade continued to report double-digit year-on-year increases in sales of office machinery and equipment.

Unfavourable development in employment

The upward cyclical movement has not yet been reflected on the labour market. Instead, unemployment has been going up again since



the start of 2004 and there has been a further decline in employment. According to Federal Statistical Office data, the seasonally adjusted number of persons in work had fallen to 38.16 million by February. This was around 35,000 fewer than at the end of 2003. This means that the shedding of labour, which had nearly come to a standstill in the last few months of 2003, has accelerated again. The fact that the year-on-year decline of around



employees. A perceptible decline is to be assumed in this context, with construction and industry being especially heavily affected.

There was a marked rise in seasonally adjusted unemployment in the past few months. At the end of April, the number of persons officially registered as unemployed was 4.37 million. This was 95,000 more than in January. The seasonally adjusted unemployment rate, as calculated by the Federal Employment Agency, was 10.5% in April compared with 10.3% in January. At the end of the period under review, the standardised EU rate was 9.8%. This clearly reveals the progressively waning effects of redefining the unemployment criteria, which accompanied the reform of the labour market and which led to a decline in registered unemployment in the second half of last year, and shows that the cyclical trend is regaining the upper hand. A change to the statistics as of 1 January 2004, which removed participants in aptitude testing and training measures from the unemployment numbers, is the reason for the April unemployment figure being around 55,000 lower than in the same month last year. Without this adjustment, there would have been an increase.

Rise in unemployment

240,000, or 0.6%, in the fourth quarter of 2003 had nevertheless narrowed to 130,000, or 0.3%, by February was partly due to the increase in the number of self-employed persons – to a certain extent, a result of one-person businesses promoted by labour market policy. Moreover, there was an increase in the number of low-paid part-time jobs, which include mini and midi-jobs. The fall in employment therefore mainly affected full-time

There have been further cutbacks in the traditional measures of labour market promotion. Fewer participants in vocational training courses and in job creation schemes were reported than 12 months previously, for example. By contrast, more persons received bridging allowances and business start-up grants. Many unemployed persons have also been integrated into personnel service agen-

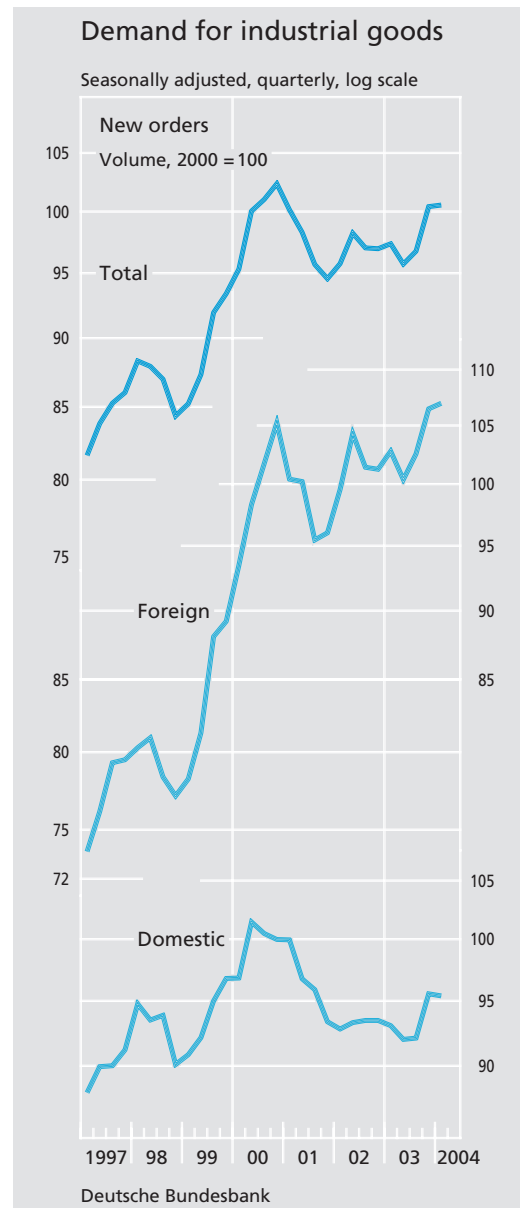
cies (PSAs), although employment in this area fell recently owing to the insolvency of one large agency.

Orders

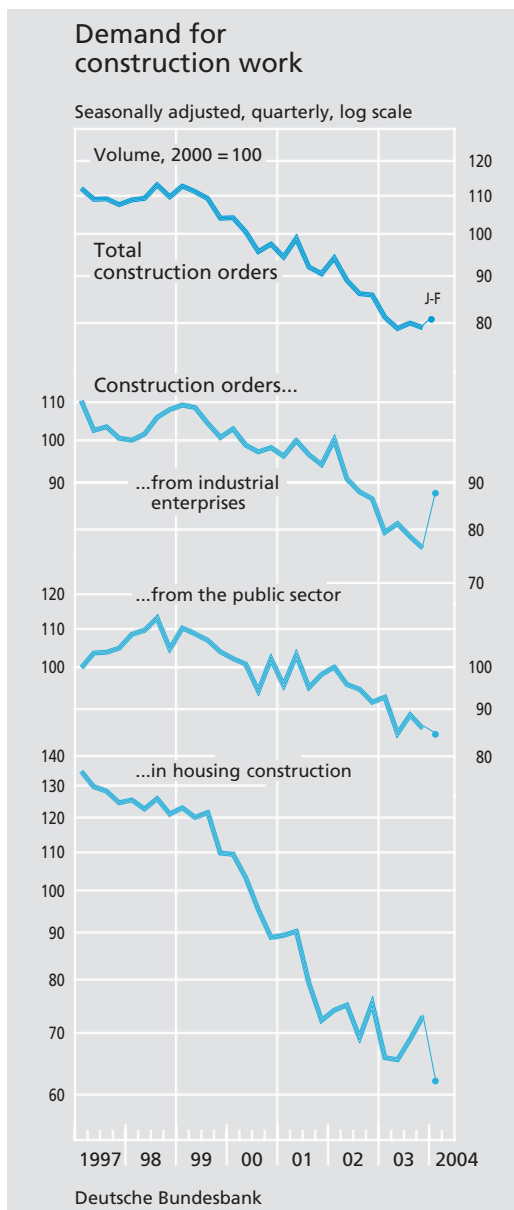
Virtual stagnation in demand for industrial goods

Seasonally adjusted demand for industrial products in the first three months of the year somewhat exceeded the relatively high level achieved in the fourth quarter of 2003. Year-on-year growth was only slightly down on the good 3½% of the preceding three-month period. The development in foreign orders was even more positive. Compared with autumn 2003, they went up ½% in seasonally adjusted terms and were 4% up on the year. Demand for capital goods took the lead but producers of intermediate goods also recorded increasing export orders. It was only consumer goods for which fewer orders were placed than before. The overall persistent high level of interest abroad in German industrial products indicates that the appreciation of the euro has so far had a limited impact on German competitiveness. According to the official export price statistics, there were no major changes in contract prices either.

Domestic demand generated no stimuli in the first three months of this year. In seasonally adjusted terms, incoming orders were slightly down on the final quarter of 2003, which had marked the high point of last year. The year-on-year increase, at 2½%, was roughly just as high as in the fourth quarter of 2003. Consumer goods producers, in particular, suffered a significant decline in orders. The figure was therefore further down on the year,



ie -4% compared with no more than just under -2% at the end of 2003. There was scarcely any increase in orders for capital goods due, not least, to weak demand for mechanical engineering products and for apparatus for telephony and telegraphy. This contrasted with intermediate goods, which made up further ground. In seasonally adjusted terms, the first quarter showed an increase of roughly 1% in new orders on the preced-



ing period, which had already been quite good. This was sustained by the metal-working industry, with the identifiable upturn at the end of 2003 continuing at a substantial pace.

Slight rise in construction demand

Construction demand has been virtually stagnant since spring last year and this underlying trend persisted in the first few months of 2004. Taking January and February together

(more recent data are unavailable), seasonally adjusted incoming orders were, in fact, around 1¾% up on the fourth quarter of 2003. However, this was due to a number of major industrial construction orders. In this construction subsector, the volume of orders in the first two months of 2004 was more than 14% higher than in the final quarter of 2003. This formed a counterweight to the declines in public sector construction and, above all, in housing construction, where orders contracted by around 15% compared with the end of 2003. Owing to the cutbacks in public assistance as of 1 January 2004, many customers had started their construction projects at an earlier date, which meant that there was a “gap” in orders at the beginning of the year. Even though business activity returned to normal in February, there are no signs of a sustained upturn. According to reports from brokers, supply is outstripping demand in many parts of Germany and the number of vacant properties is increasing in some areas.

Prices

Prices have been rising at a somewhat faster pace recently. This has been due, in part, to a surge in prices on the international energy and commodity markets. World market prices for oil have been steadily pointing upwards for some weeks. Measured by the spot market prices for Brent North Sea Oil, a barrel of oil cost around US\$36½ in the first half of May. This was nearly one-quarter more than at the end of 2003 and around 50% more than 12 months previously. One main cause

Somewhat faster pace of price increase...

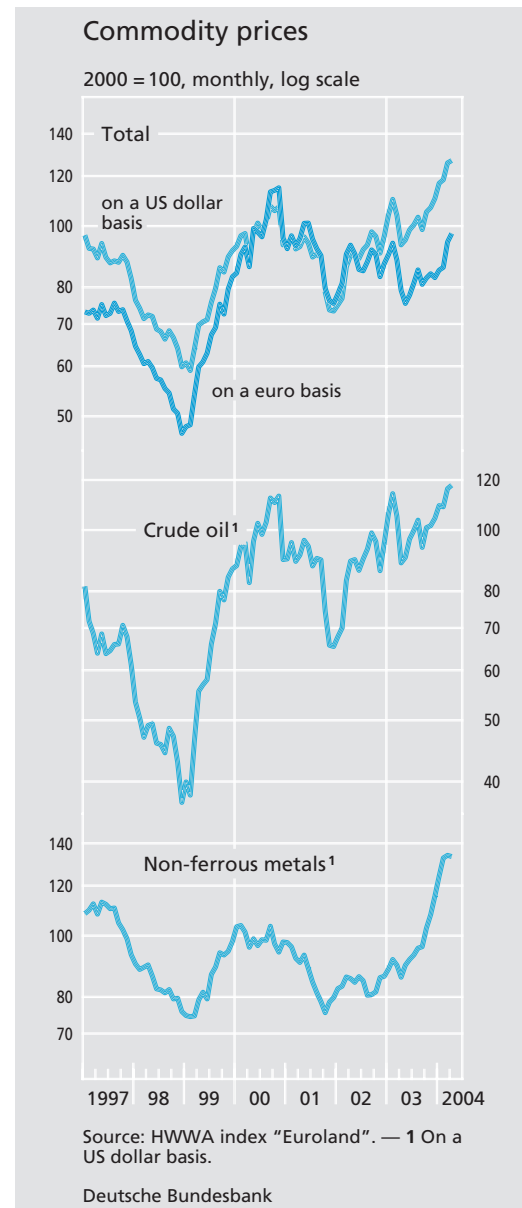
of this price surge – apart from geopolitical risks – is the sharp rise in demand, especially in China and the USA, which is accompanying the cyclical upturn. Moreover, the OPEC producing countries have a declared interest in a high dollar price level, which also cushions depreciations of the settlement currency. Additionally, the global economic upswing has led to a marked price surge in industrial commodities. According to HWWA data, world market prices for non-ferrous metals and for iron ore plus scrap have gone up by about two-fifths and around one-third, respectively, year on year. It should be noted in this context, however, that the prices in the years before had been quite low. Domestically, price developments were affected by costs being shifted to households in connection with the health reform and by higher tobacco taxes.

... at the
consumer
level...

After adjustment for seasonal variations, consumer prices in the first four months of the year went up by 1.1%, compared with no more than 0.2% in the preceding reference period. The year-on-year rate reached 1.6% in April, compared with 1.1% in December 2003. After excluding energy, health care and tobacco, the increase was 0.6% in April, compared with 0.7% at the end of last year. This clearly reveals that there were only quite minor price movements in the case of other goods and services as well as house rents.

... and in
industry

In the case of industrial factory gate prices, international and national influences were also easily identifiable. Specifically, there were well above-average increases in the prices of basic metals and semi-finished products as



well as of products of the food and drink industry (including tobacco products). For commercial goods as a whole, the annual rate in March was +0.3%. For industrial goods alone, the figure was +0.7%.

Quoted prices for construction work remained largely constant at the start of 2004. The construction price index, which covers developments ranging from housing con-

*Minor price
movements in
construction
and real estate
prices*

Working-day adjustments to consumer prices since April 2004

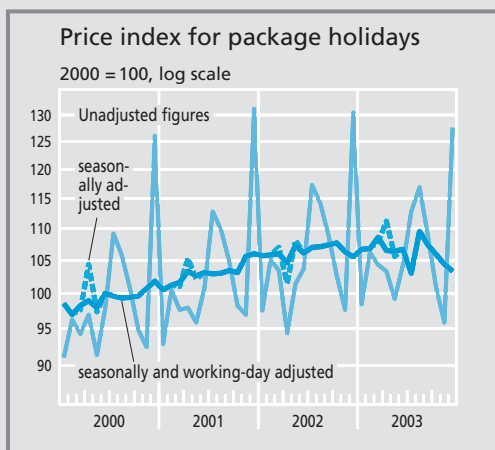
The adjustment of time series to take account of calendar effects such as the average impact of monthly variations in the number of working days, is an indispensable tool of short-term economic analysis. Seasonal adjustment which does not take account of calendar influences eliminates only those effects which occur regularly and with similar intensity. However, there are also events which occur at varying times from one year to another. For example, the number of working days varies in a month depending on the number of Saturdays, Sundays and – in some cases, movable – public holidays. The aim of working-day adjustment is to assess and eliminate such working-day effects using regression analysis models.

Adjustments for working-day variations are particularly important with regard to real economic indicators. The Bundesbank publishes seasonally and working-day adjusted series for construction and industrial output as well as for the individual components of GDP in its Monthly Reports and Statistical Supplement 4. Working-day effects also arise with regard to a number of demand components.¹ By contrast, price indices have, up to now, not usually been adjusted for working-day variations. However, consumer prices for travel and holiday services are noticeably dependent on fluctuations in seasonal demand in connection with the school holidays. In some cases, these occur in the same month every year, like the price peak at Christmas. In others, however, they vary according to the pattern of working days and public holidays. For example, although the price effect of the Easter holidays mostly becomes apparent in April, it is sometimes felt as early as March.

The Federal Statistical Office bases its calculation of the consumer price indices for package holidays and air travel on the offers which start on the latest date before the 16th day of the month.² Working-day effects may, therefore, occur in months with a varying number of days off work in the second half of the month. As the timing of holidays varies across the German *Länder*, the number of days taken off work after the middle of the month in the individual *Länder* is first determined for working-day adjustment. These figures are then condensed – together with the consumption weightings of the *Länder* – into mean values for Germany as a whole. Finally, the pan-German holiday variable is analysed in terms of its capacity to explain the time structure of prices. This establishes the existence of a statistically significant calendar effect on the prices of package holidays and air travel in March and April owing to

the varying dates of the Easter holidays.³ Much the same applies with regard to the timing of the Whitsun holidays in May. June is not affected as the Whitsun holidays can fall, at the latest, in the first half of June. No statistically significant calendar effects have been identified for the other months, in particular from July to September (summer holidays), in October (autumn holidays) and in December (Christmas).

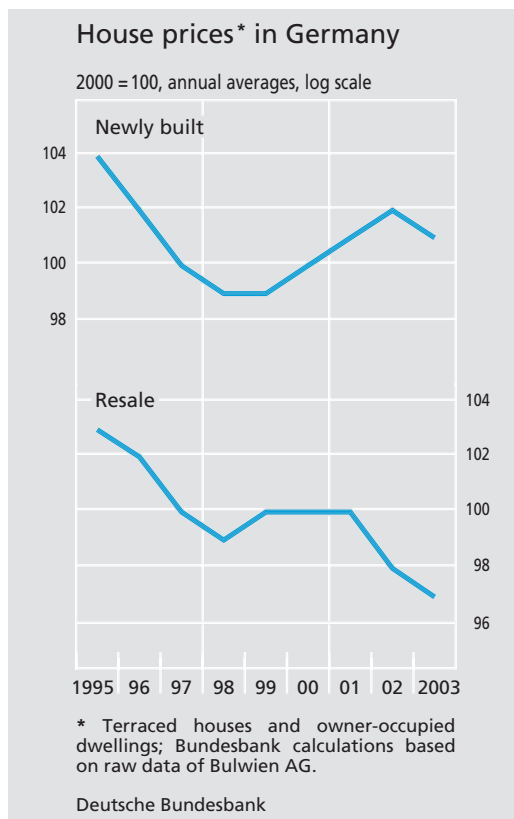
The adjustment of consumer prices of package holidays and air travel starts in 1991 and is confined to March, April and May. The chart below shows the extremely volatile unadjusted series for package holidays – the price differentials within one year are greater than 30% – and a seasonally adjusted series which, although much smoother, is usually very unsettled around the Easter period in particular. Working-day adjustment smooths out the peaks in the spring months.



Adjustment for working-day variations has only a minor effect on the overall index of consumer prices owing to the low weight of package holidays and air travel in the basket of goods (only 2.2% of underlying expenditure in 2000). In most years, the difference between the seasonally adjusted series and the seasonally and working-day adjusted series is no more than one-tenth, in rare cases two-tenths. The influence on the partial index for service prices is more important, however. This time series is considerably smoother when adjusted for working-day variations, thus making the underlying trend easier to identify.

day off work over the Easter period is smaller in March than in April. In addition, price determination practice, namely taking the middle of the month, means that, in some years, the Easter effect is not visible in the unadjusted series in either March or April. In this case, the annual average price level is pushed downwards. Working-day adjustment compensates for this.

¹ For the Bundesbank's seasonal adjustment practices, see Deutsche Bundesbank, The changeover from the seasonal adjustment method Census X-11 to Census X-12-ARIMA, *Monthly Report*, September 1999, pp 39-50. — ² Two-week travel for two persons and city breaks from Friday to Monday are captured. In December, the prices of travel over the Christmas period are used. — ³ However, these effects are not strictly symmetrical. The price effect of an additional



struction to industrial commercial and office buildings and road construction, was only 0.2% up on the year in the first quarter.

Prices fell slightly in the real estate sector.¹ For the first time in some while, the prices of newly constructed owner-occupied apartments and houses were on a slight decline in 2003 (data during the course of the year are currently unavailable). Used owner-occupied dwellings have been becoming somewhat cheaper for quite some time. In regional terms, the price decreases were somewhat sharper in eastern Germany than in western Germany and also tended to be somewhat smaller in small towns than in large towns and cities.

¹ The information refers to data provided by Bulwien AG for an expanded group of 125 towns and cities which are pooled by the Bundesbank to form a broad index.