

Economic conditions in Germany

Underlying trends

The German economy picked up again in the third quarter and achieved a noticeable pace of growth after the temporary economic slowdown in the second quarter of this year. According to the initial calculations of the Federal Statistical Office and after adjustment for seasonal and working-day variations, real GDP in the third quarter was up 0.6% on the preceding three-month period, which was revised upwards slightly from the initial estimate. Working day adjusted real GDP was up 1.4% on the year. The corresponding figure for the second quarter was 0.7%. Thus, the year-on-year increase in overall economic output for the first three quarters of the current year as a whole was 0.9%. Current data support the expectation of a working-day-adjusted rise in GDP of approximately 1% in 2005.

*Stronger GDP
growth in 2005
Q3*

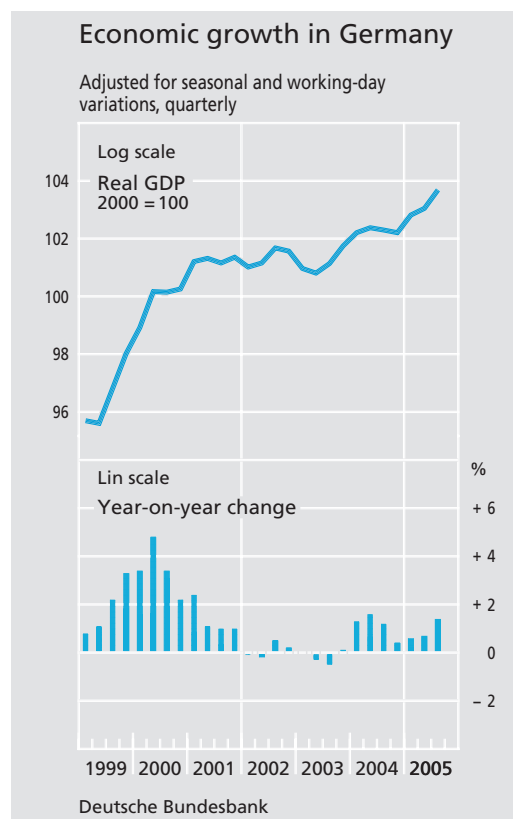
Once again, favourable external economic developments made a significant contribution to the positive overall outcome. Closely in line with the sustained positive situation in orders, exports of German products increased considerably between the period from July to September. There was a sharp rise particularly in exports of goods to countries outside the euro area, whereas exports to euro-area partner countries were, on the whole, only slightly higher than in the second quarter. At the same time, imports, especially from non-EU countries, also recorded a marked increase. As well as imports of consumer goods, imports of intermediate and capital goods were stepped up, which was a result of the buoyant output and production-related trade links

*Favourable
external
economic
developments*

which have become ever more intensive over the past few years. In real terms, overall foreign trade and payments recorded a clearly positive balance. Furthermore, there were fairly strong growth impulses in Germany as well. First, there was a significant increase in purchases of machinery and equipment, which had been weak for a time in the second quarter. Second, construction investment also increased somewhat for the first time in a long while. Although it was still noticeably down on last year's level, the shortfall had become much smaller.

Weak private consumption

By contrast, households continued to show a great deal of restraint in consumer spending. This is evident in declining retail sales, for instance. In the third quarter, new car registrations also failed to match the level recorded during the second quarter. High petrol prices may well have deterred potential buyers. The high fuel prices also played a part in petrol sales being clearly down on the year, even during the peak holiday months of July and August. However, even with the sharp rise in prices, many households felt compelled to increase their supplies of heating oil somewhat in view of the reduced stocks. The general increase in expenditure on fuel supplies, which includes both contributions for central heating and hot water, as well as electricity and gas consumption, have undoubtedly restricted the scope for spending in other areas. The propensity to save is unlikely to have changed much.



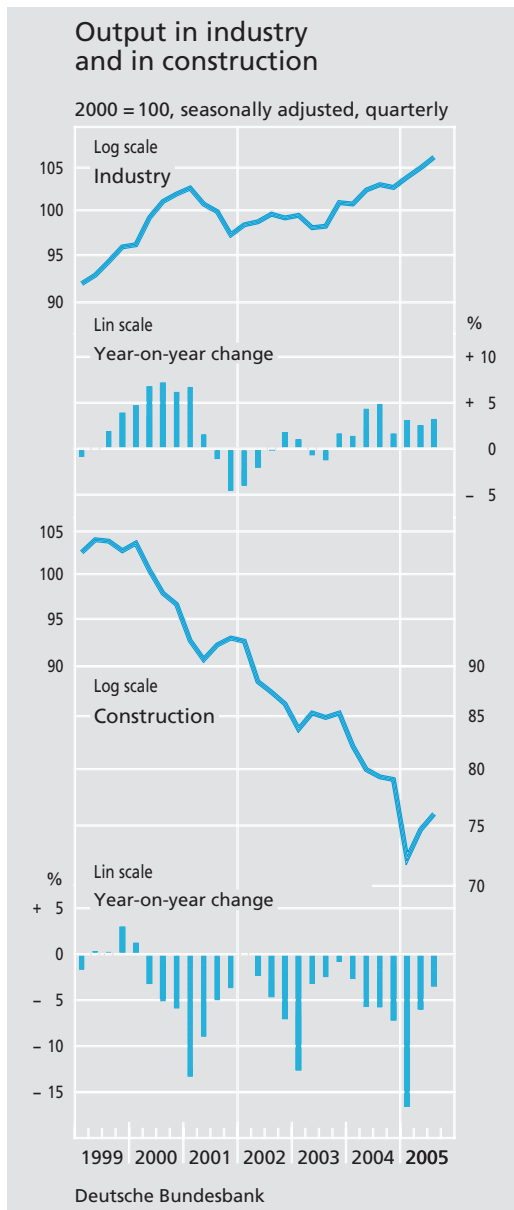
Output and sales

Broken down by sector, persistently buoyant industrial business activity significantly contributed to the positive performance during the third quarter. After adjustment for seasonal and working-day variations, output in the third quarter was up 1¼% on the second quarter, during which a similarly high increase had been recorded. The year-on-year increase rose to 3¼%, compared with 2½% in the previous quarter.

Sharp increase in industrial output

According to the Ifo Institute, the increase in production also resulted in a higher capacity utilisation. On an average of the companies surveyed, capacity utilisation is now likely to have returned to a normal level. As a result, investment in expanding capacity is becoming

Slight increase in capacity utilisation



ing more of an immediate concern, although production capacities in many companies have been enhanced by optimising machine running times on the basis of extended or more flexible working hours.

Intermediate and non-durable consumer goods, in particular, were significant contributors to the growth in industrial production. In the basic goods sector, by far the largest in-

crease was in the manufacture of basic metals. While there had been a slight slow-down in this sector during the first six months of the year, the figure was now, in fact, somewhat higher than the peak figures achieved in the middle of last year. As a result, the iron and steel industry probably came close to its production limits again. Furthermore, output in the chemicals industry also showed a marked increase and largely offset the slow-down recorded in the second quarter. Among the producers of non-durable consumer goods, some parts of the food industry, in particular, showed a good performance. The capital goods sector, on the other hand, remained well below the industry average, although it was able to maintain the increased level of production achieved in the second quarter.

Once again, a significant part of production was intended for export. After seasonal adjustment, German exports were 4½% up overall on the second quarter in terms of value. There was a very sharp increase in exports of capital goods. In July and August – figures with a sectoral breakdown are available up to then – they were 4½% up on the second-quarter level as well in seasonally adjusted terms. This is also probably linked to the current high level of capacity utilisation in large sections of the world economy, which is making investment increasingly necessary. Manufacturers of information and communications technology products, in particular, were able to increase their exports. In addition, there was an increase in exports of German-manufactured machinery and vehicles to customers abroad. Furthermore, there was

Large volume of exports

Growth in intermediate and non-durable consumer goods

a moderate increase in exports of intermediate goods.

Rise in construction output

The situation in the construction industry continued to improve during the third quarter. After adjustment for seasonal and working-day variations, construction output increased again between July and September, although not quite as steeply as in the second quarter when a good amount of construction work made up for winter losses. The figure was still below that for the same period last year, although the shortfall, at 3½%, was distinctly lower than before when it was as much as over 6%. Based on the number of hours worked, all of the major subsectors of this industry, from residential and commercial construction to public sector construction, more or less contributed equally to the increase in overall construction activity. In the finishing trades, too, the year-on-year fall in turnover decreased perceptibly in the second quarter – the most recent period for which statistics are currently available.

Mixed picture for trade and transport

By contrast, the situation in trade remained quite unfavourable in the third quarter. The retail trade sector, in particular, failed to match its level of sales 12 months previously. Purchases of food products, beverages and tobacco decreased in particular. At the wholesale level, however, sharp increases in turnover were achieved in those areas geared towards trade and industry, such as machinery, equipment and accessories. Buoyant business activity was also recorded in the case of motor vehicles. This was consistent with the fact that the transport sector was continuing to experience an upturn. Not only

Trend in foreign trade by category of goods

Item	Percentage change			
	Average of July and August 2005 compared with			
	Q2 2005; seasonally adjusted		July and August 2004; unadjusted figures	
	Exports	Imports	Exports	Imports
Total	+ 3.5	+ 4.8	+ 8.2	+ 8.7
Selected main categories				
Intermediate goods	+ 2.2	+ 4.1	+ 2.5	- 0.8
Capital goods	+ 4.7	+ 3.7	+ 6.8	+ 1.2
Consumer goods	- 0.5	+ 5.8	+ 3.4	+ 3.6
Energy	.	+ 7.9	+ 13.2	+ 30.6
Selected categories				
Chemicals	+ 3.2	+ 3.7	+ 7.0	+ 9.8
Machinery	+ 4.4	+ 2.9	+ 6.6	+ 1.3
Motor vehicles and motor vehicle parts	+ 4.4	+ 0.6	+ 10.1	- 5.8
Information technology	+ 8.7	+ 14.1	+ 3.6	+ 7.9
Metals and metal products	+ 1.4	+ 0.3	+ 6.1	+ 0.3

water transport, but also the land transport sector, achieved an improved year-on-year result. In the hotels and restaurants sector, accommodation services in July and September managed to surpass the turnover figures for the comparable period last year, after having undergone a negative development well into the second quarter. Restaurants, by contrast, were suffering losses up until the end of the period under review, although the minus rates had become noticeably smaller.

In line with the positive trends in the production sector, the business situation for commercial service providers showed a marked improvement in the third quarter. According to surveys of both Ifo and the Centre for European Economic Research (ZEW), enterprises' assessment of the current situation

Positive development in the business services sector

Service transactions with non-residents in the first three quarters of 2005

With a share of 13% of the total value of exports and 20% of that of imports in the first three quarters of 2005, Germany's service transactions with non-residents played an important role in foreign trade. From January to September 2005, both cross-border service receipts and cross-border service expenditure were 3½% up on the same period last year. Owing to the relatively large difference between the two amounts involved, the deficit on services rose by €1 billion to €25½ billion.

The rise in the deficit on services can be attributed mainly to insurance-related services. German receipts from cross-border insurance services fell by €1 billion. One reason for this was that for German reinsurers, the relation of receipts from premiums to their payments of claims to non-residents deteriorated. The opposite was true in the case of foreign reinsurers. The premiums which they received from German residents improved in relation to their payments of claims, with the result that German expenditure on insurance increased by €1 billion.

Developments in travel, the most important services segment, also contributed to the increase in the deficit on services in the first three quarters. Although, at 4½%, receipts from travel rose somewhat more sharply than expenditure on it (2½%), the deficit on travel went up by €½ billion as the level of receipts was perceptibly lower than that of expenditure. An above-average number of short trips were made to the Czech Republic and the Netherlands. There was also a sharp increase in expenditure on journeys to the traditional holiday destination of Italy as well as to the United Kingdom. By contrast, fewer journeys were made to Spain, in particular, than in the previous year. There was likewise a decrease in expenditure on journeys to the United States.

If the services account is taken as a whole, the increase in net expenditure on insurance services and travel was slightly moderated by larger surpluses in transport services, the second most

important services sector. This is largely linked to Germany's buoyant export trade, which is handled to a greater extent by German transportation enterprises than imports. In the first three quarters of the year taken together, the year-on-year financial services balance remained practically unchanged at €1 billion.

Service transactions with non-residents

€ billion				
Item	2004	Year-on-year change in 2004	Jan to Sep 2005	Change from Jan to Sep 2005 compared with Jan to Sep 2004
Services				
Total				
Receipts	116.4	+ 5.3	88.9	+ 3.2
Expenditure	147.3	+ 2.2	114.2	+ 4.0
Balance	- 31.0	+ 3.0	- 25.4	- 1.0
Travel				
Receipts	22.2	+ 1.8	17.4	+ 0.7
Expenditure	57.1	- 0.1	46.6	+ 1.1
Balance	- 34.8	+ 2.0	- 29.2	- 0.4
Transport				
Receipts	29.0	+ 3.1	22.9	+ 1.4
Expenditure	24.6	+ 0.5	18.6	+ 0.3
Balance	+ 4.3	+ 2.6	+ 4.3	+ 1.2
Merchanting				
Balance	+ 5.3	+ 3.0	+ 5.2	+ 0.7
Insurance services				
Receipts	2.9	- 3.1	1.0	- 1.0
Expenditure	4.1	+ 1.2	2.5	+ 1.0
Balance	- 1.2	- 4.3	- 1.5	- 2.0
Financial services				
Receipts	4.4	+ 0.6	3.4	+ 0.3
Expenditure	2.8	+ 0.7	2.2	+ 0.3
Balance	+ 1.6	0	+ 1.2	0
Other services				
Receipts	52.6	- 0.1	39.0	+ 1.0
Expenditure	58.8	+ 0.1	44.3	+ 1.3
Balance	- 6.2	- 0.2	- 5.4	- 0.4

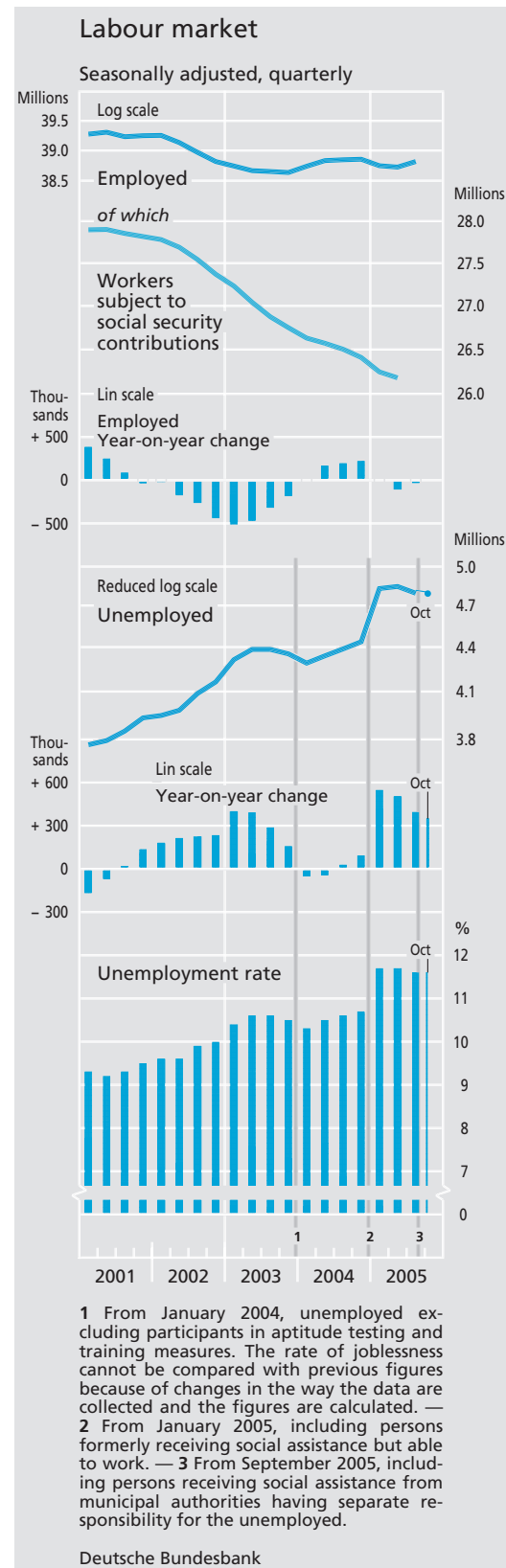
was positive. This is particularly the case for IT and telecommunications companies, many of which had still been complaining about sluggish business activity in the second quarter. Even tax consultants, auditors and business consultants were noticeably more optimistic. Firms' turnover, which, in the first few months of the year, was down on the year in many cases, now showed a marked increase over 12 months.

Employment and unemployment

Increase in employment due to labour market policy

In the third quarter, the labour market was heavily influenced by the effects of labour market policy. The rise in employment since April, which offset the decline during the first quarter, is, therefore, hardly likely to have been due to an increasing economic need for labour. According to the Federal Statistical Office, the seasonally adjusted number of persons in work in Germany had gone up to 38.9 million by the end of September. This signifies an increase of some 150,000 persons in comparison with the most recent low. Two-fifths of these persons were cross-border commuters into Germany, who were often employed as seasonal workers.

Furthermore, there was a sharp increase in small employment opportunities promoted by labour market policies, which are also known as "one-euro jobs". In September and October, 270,000 persons were registered at the Federal Employment Agency as having jobs of this kind. This was roughly just under 100,000 more than at the start of the second quarter. It should be noted, however, that the



Impact of the amalgamation of social assistance and unemployment assistance: initial findings

The start of 2005 saw the „Fourth Act Promoting Modern Labour Market Services“ (Hartz IV) enter into force. The central component of this reform was the introduction of the Second Book of the Social Security Code (*Sozialgesetzbuch II*) “job seekers basic allowance”. This provides a standard legal framework for persons who are fit to work but who cannot secure a livelihood on their own, ie those people whose income is too low or who are not (or no longer) entitled to benefits under the statutory unemployment insurance scheme. The new benefit, unemployment benefit II (*ALG II*), replaces the previous system in which unemployment assistance and social assistance existed side by side, effectively standing in the way of efficient support and promotion owing to differences in responsibilities, benefit entitlements, weighting provisions, rules covering jobs which the unemployed can reasonably be expected to accept and career advancement tools.

It is still too early for a comprehensive assessment of this reform, which many consider to be radical. Both the institutions and the people affected are still in the learning and transitional phase. Government also intends to make amendments to unemployment benefit II. Furthermore, labour market reforms generally need time to unfold. Finally, the data required to make a scientific evaluation is not yet available.¹ Only once the success of the reforms have been examined will it be possible to make a balanced assessment of the impact of Hartz IV.

The focus of public interest is currently on the number of people who (rightly or wrongly) receive unemployment benefit II and whether the system changeover has resulted in significant changes to social transfers. According to preliminary figures from the Federal Employment Agency, in October 2005 around 6.7 million people in 3.7 million income support households received social benefits from the basic allowance system under the Second Book of the Social Security Code. That is almost 10% of the population under the age of 65. Of this figure, 1.8 million are people who are unable to work, ie mostly children under the age of 15 whose parents are entitled to unemployment benefit II. The remaining 4.9 million recipients who are, in principle, fit to work can be divided into those who are

registered as unemployed (2.8 million, mostly long-term unemployed) and those who not unemployed and receive unemployment benefit II (2.1 million). Of the latter group, around half are working – including jobs created as part of integration measures – and receive unemployment benefit II in addition to their wages. This also includes self-employed persons with low incomes, who often have only a small claim to unemployment benefit II but receive a grant for the statutory health insurance scheme. The other half are recipients who are fit to work and are not employed but are, nevertheless, not classified as unemployed. A person is defined as “fit to work” by law if they are aged between 15 and 65 and are capable of working at least three hours per day. These persons are then only deemed unemployed if they are actually available for work. This is usually not the case for persons over the age of 15 in education or vocational training, nor for single parents with small children in view of the frequent lack of childcare. The criteria for entitlement to unemployment benefit II are the individual’s financial need and ability to work, rather than unemployment.

Before the introduction of unemployment benefit II, there was much concern that it would lead to big cuts in social benefits. On the other hand, it was hoped that the transition from a benefit entitlement based on previous earnings to an entitlement that is means-tested, together with a cut in the maximum period of entitlement to unemployment benefit (however, not until after 2007), would reduce the duration of non-employment. However, unemployment benefit II has also relaxed the criteria for eligibility to social benefits. The principle of mutual responsibility for maintenance within the family has been greatly eased. This is one of the reasons for the unexpectedly strong increase in the number of income support households. In addition to this, social benefits are now issued from one source. In the past, recipients of unemployment assistance had to submit an additional application for social assistance if they wished to claim supplementary benefits. Furthermore, paying out benefits via the labour exchanges presumably reduces the social stigma, which, in turn, is likely to have increased claims. Moreover, previous one-off payments under social assistance have been incorporated into unem-

¹ It is to be welcomed that the legislator has provided for an impact analysis on the instruments used in the Hartz IV reform to promote

integration into the labour market and on the incentives of unemployment benefit II using scientific methods and has indicated that the rel-

employment benefit II as flat-rate payments and no longer require a separate application. Although this reduces the level of administrative spending and increases the recipient's level of personal responsibility, the regular monthly payments are higher. Finally, former recipients of unemployment benefit are paid a limited add-on, financed from tax resources, for a further two years. This is equivalent to two-thirds of the difference between unemployment benefit (including any housing allowance entitlement) and unemployment benefit II in the first year and one-third in the second year. Only in the fourth year of unemployment is the actual social welfare level reached.

All these facts make it clear that the amalgamation of unemployment assistance and social assistance has not resulted in a general reduction in benefits. This was also confirmed in a study conducted by the Institute for Employment Research (*Institut für Arbeitsmarkt- und Berufsforschung, IAB*) which examined how the benefit entitlements had been changed by the Hartz IV reform.² According to this study, around 83% of all former recipients of unemployment assistance are also in need of income support within the meaning of the Second Book of the Social Security Code. According to simulations carried out by the IAB, almost half of these recipients actually receive higher benefit payments. Cuts were made on benefits to older people receiving a relatively high level of unemployment assistance and (married) couples where one partner is employed. By contrast, benefits to younger people were increased.

The IAB study assumes unchanged behaviour on the part of the benefit recipients. However, it is evident that potential benefit recipients adjust their behaviour in order to increase their benefit claim. An example would be the division of an income support household.

The unexpectedly large number of recipients of unemployment benefit II is putting greater strain on public finances than was expected. By the end of the third quarter, central government's expenditure on unemployment benefit II amounted to €19 billion, thus exceeding the original target figure for the whole of 2005 by over €4 bil-

evant authorities are to provide the necessary data. — 2 See K Bloß and H Rudolph, "Verlierer, aber auch Gewinner, Simulationsrechnungen

Breakdown of unemployment benefit II recipients

6.7 million unemployment benefit II recipients in total		
2.8 million recipients of unemployment benefit II who are fit to work and unemployed (usually long-term unemployed)	2.1 million recipients of unemployment benefit II who are fit to work and not unemployed	
	1.0 million recipients of unemployment benefit II who are working (mainly "one-euro jobs", self-employed and other people in work with very low employment income)	1.1 million recipients of unemployment benefit II who are not working (mainly students and vocational trainees over the age of 15, single parents with small children)
		1.8 million recipients of social benefit who are not fit to work (usually children under the age of 15 in income support households)

Source: Preliminary figures from the Federal Employment Agency as at October 2005.

lion. However, local government, in particular, is likely to record significant relief on balance owing to the cessation of expenditure for recipients of social assistance who are fit to work and the simultaneous assumption of accommodation costs for income support households since central government is making a substantial contribution to these benefits and state government has also agreed to pass on any savings of its own to local government. Nevertheless, given the unexpectedly high number of recipients, there is likely to be far more additional expenditure for the government as a whole than there would have been had the old system continued to exist. Once the teething problems have been overcome, the necessary corrections have been made and the anticipated positive employment effects have occurred, financial relief for public finances can be expected.

One crucial factor will certainly be whether steps are taken against parties filing fraudulent benefit claims once the complex reform of the social benefit systems has been completed. In addition, a review of the range of benefits is also necessary. However, the most important task now is to concentrate on efforts to (re)integrate benefit recipients into the labour market.

zum Arbeitslosengeld II", *IAB-Kurzbericht Nr 17/2005*.

relevant current figures only reflect the lower limit of the employment level, as experience has shown that such data are reported only with significant time lags. Moreover, according to initial provisional data, the number of persons occupying low-paid part-time jobs, for which there is an earnings ceiling of €400, increased by approximately 50,000 between April and August.

By contrast, other employment-promoting measures failed to generate much stimulus. In line with this, the take-up of business start-up grants, which led to the creation of numerous one-person businesses in 2004, has lessened perceptibly during the current year. This was mainly due to the fact that, since the beginning of this year, only recipients of "unemployment benefit I" are entitled to such start-up grants and a business plan has to be submitted. At the end of the period under review, there were just under 3,000 fewer small business start-ups than in the second quarter. Bridging payments were granted to just over 70,000 persons, around 20,000 fewer than six months previously. There was also a reduction in traditional job creation measures, albeit on a small scale.

Given the overall changes in employment resulting from all of the cited components, it is clear that the cyclical component of employment continued to be weak. This is also indicated by the number of persons subject to regular social security contributions, which was falling up to the end of the period under review.

The fall in unemployment since May was interrupted by a rise in September. In seasonally adjusted terms, the number of persons registered as unemployed at the Federal Labour Office went up to 4.84 million. This increase was due solely to the fact that, for the first time, data from the municipalities having separate responsibility for recipients of unemployment benefit II were included in the unemployment statistics. According to the Federal Labour Office, this effect roughly sums up to 68,000 persons. As calculated by the labour exchanges, the seasonally adjusted number of persons registered as unemployed would be 22,000 lower if they were not included. Taking this into consideration, the registered unemployment has generally been declining since the second quarter, something which is to be seen primarily in connection with the measures to ease the situation in the labour market. Unemployment declined again in October. The seasonally adjusted number of persons registered as unemployed was 4.80 million. The unemployment rate declined slightly to 11.6%.¹

Clear administrative effects on unemployment

Prices and wages

The burden of wage costs in the production sector, for which current data are available, fell again slightly in July and August. Although there was a slight increase in the seasonally adjusted wages and salaries per employee in industry, there was no rise in terms

Continued relief in wage costs

¹ The rate of unemployment derived from the telephone survey conducted by the Federal Statistics Office is not discussed here, as the September figure is based on a monthly decline of approximately 650,000 in the number of persons out of work, which is hardly plausible.

of unit labour costs. In the construction sector, the decline already recorded in the second quarter also continued in July and August. The corporate sector as a whole probably experienced a similar trend. Here, seasonally adjusted unit labour costs in the first half of 2005 were, at all events, ¼% lower than in the second half of 2004. The figure was 1% down on the year.

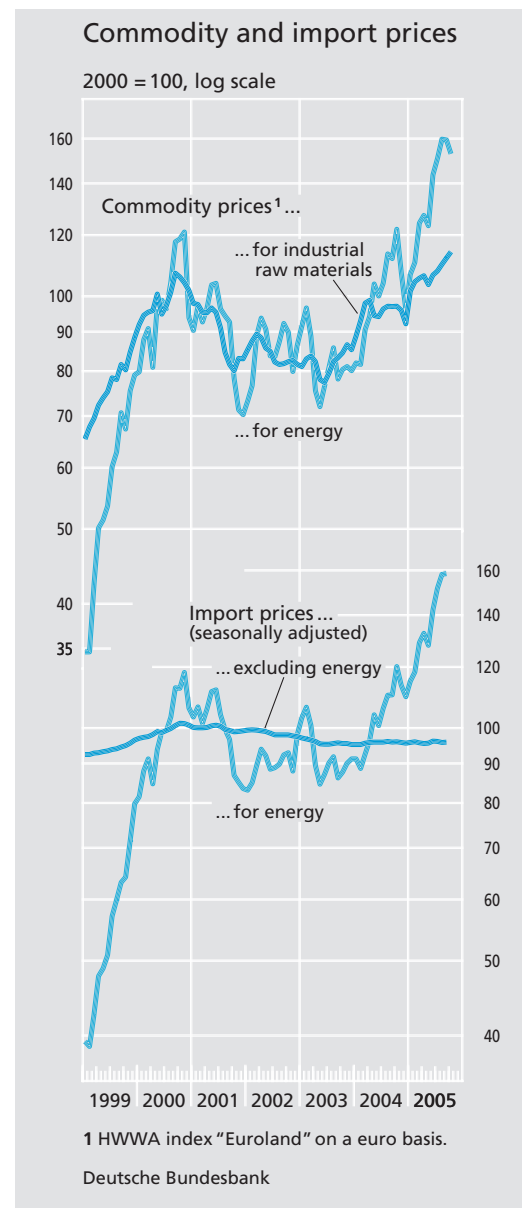
In the third quarter, the increase in actual earnings was still lagging behind the increase in negotiated pay rates. Based on an hourly rate of pay, the latter were 1.1% up on the year in the third quarter, compared with 1.3% and 1.0% in the first two quarters. Among other factors, this further rise was due mainly to one-off payments in the textiles and textile products industry as well as in the iron and steel industry, where there was also an increase of 3.5% in earnings from September onwards.

Easing in the oil markets

The price situation in the international oil markets has eased in recent weeks. At the time this report went to press, the price for a barrel of Brent crude oil was just under US\$56. By historical standards, this price was still very high. However, compared with the most recent peak in August of just under US\$68 and the interim peak of around US\$65 in mid-September, stemming from fears of a shortage owing to the hurricanes in the Gulf of Mexico, the situation has obviously eased off. This relief was also felt in the German markets.

More expensive energy imports

Crude oil imports became somewhat cheaper in September. However, this was more than



offset by further price increases for refined petroleum products and gas. Imported electricity also cost more. As a result, import prices for energy in total showed a further rise in September. The price increase was a good two-fifths on the year. Outside the energy sector, price movements remained very moderate throughout the period under review. In seasonally adjusted terms, imported goods were no more expensive in September than

Consumer Prices

Annual percentage change

Item	2005			
	Q1	Q2	Q3	Oct
Food	-0.3	0.3	0.1	0.2
Manufactured goods of which	1.2	0.4	0.7	1.4
Tobacco	19.4	10.7	13.0	17.5
Energy of which	6.8	8.3	13.0	12.6
Refined petroleum products	8.4	9.3	16.5	13.8
Gas	7.3	8.4	10.9	15.3
Electricity	4.1	4.3	4.4	4.2
Central heating, district heating	6.1	12.4	17.8	20.9
Services	2.2	1.9	2.0	2.1
Rents	1.0	1.1	1.0	1.0
Total	1.8	1.7	2.2	2.3
Total excluding seasonal products, energy, tobacco	0.8	0.8	0.8	1.0
<i>Memo item</i>				
Harmonised Index	1.7	1.6	2.2	2.4

Deutsche Bundesbank

at the start of 2005. The previous year's level was not exceeded either. At the time this report went to press, industrial goods alone were 0.2% cheaper than in the same period last year.

German industrial producer prices for energy went up again in October. Nevertheless, the year-on-year rate of increase slowed down somewhat at the end of the reporting period. The year-on-year increase narrowed slightly to 16.7%. The price of refined petroleum products went up by 13.2% in October, and there was a 26.8% price rise for natural gas. Electricity prices had risen by 11.1% year on year by the end of the period under review. Producer price increases in the case of deliveries to distributors, such as municipal utilities, were even sharper. Here, in September, elec-

*Sharp rise in
gas and
electricity prices*

tricity cost 17.9% more than in the same period of 2004. The corresponding figure for gas was +35.5%. It may be expected that these price increases will have knock-on effects on consumer prices.

In September and October, seasonally adjusted producer prices for other industrial goods were raised somewhat more sharply than before. The third stage of the increase in tobacco tax was one cause of this. Even so, even at the end of the period under review, producer prices were scarcely higher than during the first few months of the year. The year-on-year rate of increase was 1.4% in October, compared with 2.1% in the second quarter. For intermediate goods, in particular, there was a decline in the rate of increase owing to the fact that the price movements in the case of steel and steel products continued to decelerate. The rate of inflation for capital goods remained below 1%.

*Inflationary
effects of
tobacco taxes*

The rise in consumer prices has accelerated somewhat in the last few months.² In seasonally adjusted terms, the price increases of 1% between August and October were almost twice as high as in the previous quarter. The year-on-year rate of increase, which was 2.0% in July, went up to 2.3% in October. According to the Harmonised Index of Con-

*Price surge in
industrial goods*

² A new index of Perceived Inflation (IWI) was published recently, which indicates much higher price increases. For methodological reasons, the rates of inflation shown by this index are not comparable with usual year-on-year price index changes. Moreover, a number of convincing arguments suggest doubts as to whether inflation as perceived by the general public is adequately captured by this new index. For further details, see J Hoffmann, H A Leifer and A Lorenz, Index der wahrgenommenen Inflation oder EU-Verbraucherumfragen? – Zu einem Ansatz von Professor H W Brachinger, in: Wirtschaftsdienst, November 2005, pp 706 ff.

sumer Prices (HICP), the figure was 2.4%. Alongside energy, where the pace of price increase lost some momentum only towards the end of the period under review, industrial goods were a particular contributor to this rise. Here, the further increase in tobacco tax as of 1 September played a major part in the surge in the annual rate of inflation from 0.3% in August to 1.3%. Added to this were fairly large price adjustments in the case of clothing and motor vehicles. In October, the annual overall rate of inflation for industrial goods was 1.4%. The price rise for services was 2.1%. This was, not least, a result of surcharges for package holidays and air travel. The year-on-year rate of price increase was significantly lower for housing rents at 1.0% and no more than 0.2% for food products.

Orders received and outlook

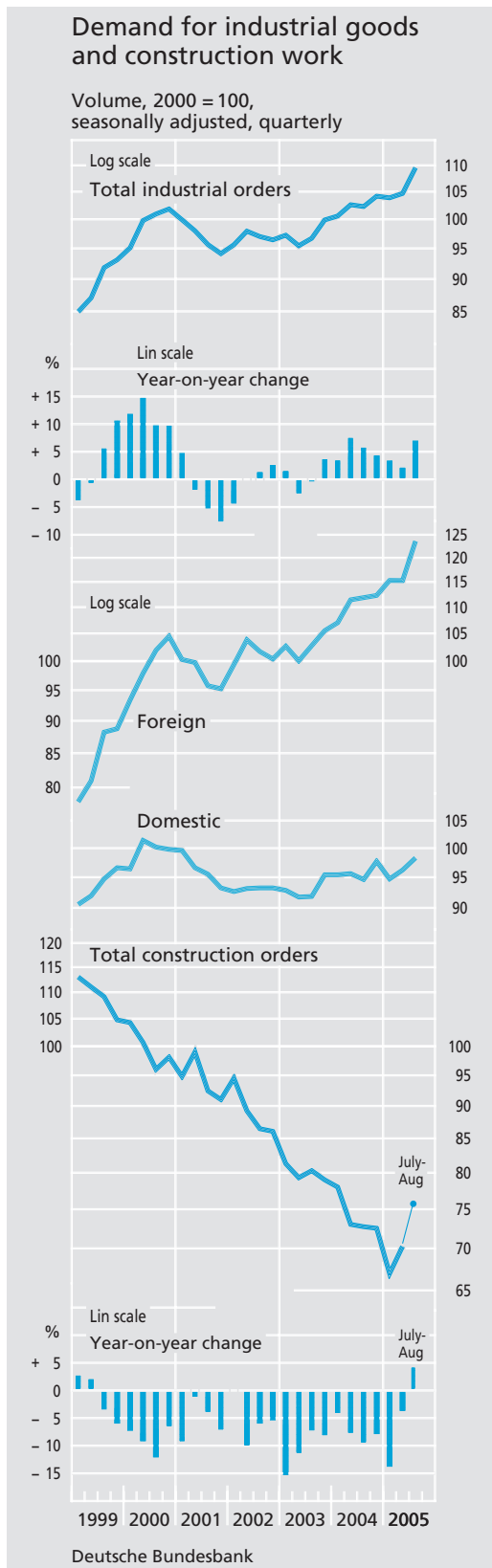
*Industrial
business activity
still positive*

The outlook is good for the buoyant industrial activity continuing in the last few months of the current year. The main factor in this is the perceptible pick-up in demand for German industrial goods, which remained at a high level throughout the summer. After adjustment for seasonal and working-day variations, new orders in the third quarter were up 4³/₄% on the previous quarter. The year-on-year increase in the volume of orders, which barely exceeded 2% in the second quarter, rose to 7%.

Export orders, in particular, increased substantially again following a temporary lull in the second quarter. On an average of the third quarter, export orders were no less than

7¹/₄% up on their level in the second quarter. The year-on-year increase, which narrowed to 3¹/₂% in the second quarter, went up again to 10¹/₂%. Buoyant demand for capital goods was one of the main factors contributing to this improvement. This included, not least, office machinery and telecommunications equipment. Moreover, a further series of major orders came in for manufacturers of other transport equipment, which primarily includes railways as well as the shipbuilding and aircraft manufacturing industries. Finally, the mechanical engineering industry managed to recover again following a slight lull in orders in the second quarter. In the intermediate goods sector, a noticeable rise in orders was recorded by the steel industry, in particular, which had been experiencing a slowdown since the fourth quarter of last year. The order situation has also improved in the chemicals industry.

Domestic orders also increased in the third quarter. With a seasonally adjusted increase of 2%, the growth in the volume of orders was even stronger than in the second quarter. This was also reflected in year-on-year terms, where the rate of increase went up from 3³/₄% in the second quarter to almost 4% in the third quarter. The performance of the intermediate goods sector was better than average. Manufacturers of basic metals as well as manufacturers of machines used to generate and distribute electricity recorded an increase in orders compared with the previous quarter. Suppliers of capital goods and consumer goods were not quite so successful, although their order situation also showed an improvement compared with the previous year. This



was, not least, the case for manufacturers of industrial process controls and of optical and photographic devices.

Positive sentiment in industry also suggests that this favourable business development will continue. According to surveys conducted by the Ifo Institute, expectations for the next six months show a marked improvement since the middle of the year. There has been an improvement not just in the prospects for output, which had been judged unfavourably by a majority of firms as recently as the second quarter. Export opportunities are also rated highly. The autumn survey conducted by the Association of German Chambers of Industry and Commerce (DIHK) also revealed a more positive picture than in the early summer.

The structural adjustment process in the construction industry, which has been ongoing for a number of years, seems to have been interrupted, at least in the second half of 2005. In the third quarter, construction orders were clearly on the up. After the level of output in the second quarter had already overcome its first-quarter low, demand for construction work in July and August showed a further increase of 7½% on the spring months after adjustment for seasonal and working-day variations. This means that, for the first time in a long while, there was a clear year-on-year rise again.

Situation in construction stabilised

It is still too early to tell, however, whether this favourable development in business activity signals an end to the downward trend in the construction sector. The improvement

was due in part to a number of major orders and it is uncertain whether this will be repeated. This is especially true of industrial construction, where enterprises from the railway and post office subsectors began work on a major construction project in August. Public sector clients also started work on an exceptionally large number of road construction projects in July and August. The volume of orders had clearly been down on the year up to that point while growth rates of over 20% were being recorded at the end of the period under review. By contrast, developments in housing construction remained subdued. Although there was a slight seasonally adjusted increase in new orders during the third quarter, the figure was still clearly down on the year. Taking construction permits as a yardstick, this was mainly due to rented housing construction. The trend in single-family houses and owner-occupied apartments, on the other hand, was somewhat more promising.

Service providers optimistic

The outlook for many commercial service providers remained quite optimistic in the third quarter. According to the latest Ifo Business Climate in the German Services Sector, the outlook has recovered again following its slight deterioration in the second quarter. According to data from the surveys of the European Centre for Economic Research, there was a considerable increase in the positive expectations of telecommunications and IT service providers as well as enterprises in the ICT sector, in particular. In addition, positive sentiment among tax consultants, auditors and business consultants stayed broadly constant. By contrast, the outlook for architects and

firms working in technical consultancy and planning remained unfavourable.

It appears uncertain whether improved consumer sentiment in the trade sector, which is indicated in the surveys of both the Association of German Chambers of Industry and Commerce (DIHK) and the Ifo Institute, will lead to an increase in consumption in the last few months of the year. Consumer retail purchases declined considerably in the third quarter and, in September, they fell to their lowest level in a long while. High expenditure on energy, which is probably going to increase even further, is taking up an increasingly large share of the budget for consumption. Moreover, in terms of wages, there are no signs of any major increase in households' scope for income. Furthermore, the employment situation will only improve gradually. Many of the employment opportunities promoted by labour market policy have been created in the low-wage sector.

Ongoing weakness of private consumption

Owing to the positive developments in industry and for the majority of commercial service providers as well as the emerging stabilisation in the construction sector, a further increase in overall output can be expected for the autumn of this year. As before, the stimuli will come, in particular, from export business. This is a reflection not only of German enterprises' attractive range of products, but also of their high degree of price competitiveness, which is based not least on a moderation of operating costs. The financing conditions remain a good essential starting point for stronger domestic demand.

Continuation of GDP growth