

Economic conditions in Germany

Underlying trends

The German economy experienced a lull in growth in the last few months of 2005. According to Federal Statistical Office figures, which are still lacking in detail, real gross domestic product (GDP) in the final quarter of 2005 after adjustment for seasonal and working-day variations was more or less as high as it had been in the preceding quarter. Owing to the high degree of volatility from quarter to quarter, monitoring developments over a six-month period seems more appropriate. In this view, the underlying pace of economic growth in the second six months of the year showed an annualised increase in GDP of 1½% after adjustment for seasonal and working-day variations, which was almost the same rate of increase as in the first half of the year. After elimination of working-day variations the outcome was still 1½% up on the year. Owing not least to the weak start to the year, the rate of growth in overall output for 2005 as a whole was no more than 1.1% after adjustment for working-day variations, which was the same as in 2004. As the number of working days is different, however, the unadjusted figures produce a clear decline from 1.6% in 2004 to 0.9% in 2005.

*GDP
unchanged in
2005 Q4*

According to the available data, the external growth stimuli, which had been very strong in the third quarter of 2005, did not prevail into the fourth quarter. Although exports, which had gained momentum during the year, continued to increase slightly, this was due to the fact that a slight increase in goods exported to countries outside the euro area

*Export surplus
declines*

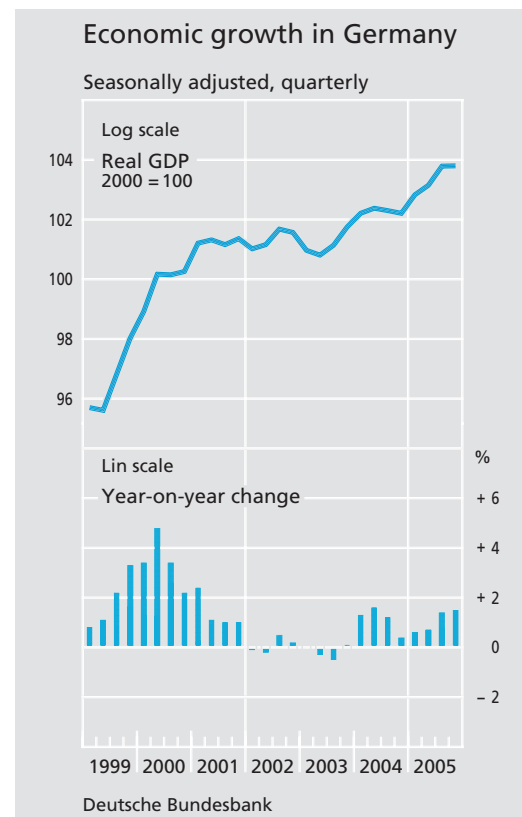
offset the decline in exports to euro-area partner countries. By the end of the period under review, however, imports were expanding faster than exports. The greatest increase was in goods imported from the euro area whereas imports from non-euro-area countries stagnated. However, the sharp increase was probably due, at least in part, to an increased accumulation of inventories. Furthermore, the price competitiveness of German exporters improved again in the second half of 2005.

Subdued domestic demand

Final domestic demand exerted little economic stimulus in the fourth quarter. Although the generally positive course recorded for purchases of machinery and equipment was sustained, these purchases were increasing more moderately towards the end of the period under review. Construction investment, which in the third quarter of 2005 had expanded sharply for the first time in a while, recovered further in the final quarter of the year. Even so, the level of investment was still down on the year.

Private consumption remains weak

The increase in investment was offset by continuing restraint in households' consumption. After seasonal and working-day adjustment, there was a further fall in private consumption in the fourth quarter. The sharp decline in retail sales is characteristic of this. Sales of petrol and diesel oil also declined between October and December. The high fuel prices, in particular, probably had reduced car travel. Purchases of heating oil were likewise reduced because many households had already replenished their depleted stocks to some extent during the summer. Nevertheless, ex-



penditure on energy rose sharply and had a detrimental effect on the demand for other goods. The Christmas trade did not live up to expectations either. Only new vehicle registrations exceeded their moderate summer level.

According to the consumer research institution, *Gesellschaft für Konsumforschung* (GfK), however, consumers' assessment of the economic situation improved discernibly during the last few months of the year. Evidently in line with the frequently cited improvement in business sentiment, households were also assessing the cyclical outlook and their income prospects much more favourably. At the same time, the propensity to buy increased sharply right into January 2006. This might also reflect the intention to bring forward sizeable purchases owing to the an-



nounced increase in value added tax at the beginning of 2007. However, it is not yet clear whether the volume of purchases will actually be increased to any great extent. In the past there have often been discrepancies between the propensity to purchase claimed in surveys and the actual level of expenditure measured.

Output and sales

Industrial output also expanded rapidly in the final quarter of 2005. At a seasonally adjusted 1¼%, however, the quarterly average rise was not quite so fast as in the period between July and September. Furthermore, the momentum declined in the course of the fourth quarter. Even so, year-on-year growth increased from 3¾% in the third quarter to approximately 5½% between October and December. According to the Ifo surveys, capacity utilisation was much greater in December than in September. The average medium-term capacity utilisation was again exceeded. This means that investment to expand capacity is also more likely to benefit now from a further increase in output than before.

Further increase in industrial output

Intermediate goods and capital goods showed the greatest growth in output. By contrast, manufacturers of consumer goods did not quite repeat their good third-quarter performance. Output in the chemical industry, in mechanical engineering and in computers rose particularly fast. However, the rate of output in the motor industry and in the manufacture of basic metals, which had increased discernibly in the third quarter and almost reached capacity limits, declined significantly.

Exports of German industrial products were more subdued towards the end of the year. Exports of goods in the fourth quarter were only slightly up on the level of the previous period which had seen a rapid expansion. While deliveries of inputs and consumer goods increased marginally, those of capital

Moderate exports

goods barely maintained their third-quarter level. Exports of mechanical engineering products actually fell. Imports, on the other hand, were fairly buoyant. Their value in the fourth quarter exceeded that of the period between July and September by 2¾% in seasonally adjusted terms. Growth was considerable in real terms, too.

Slight improvement in construction industry

The situation in the construction industry continued to improve slowly during the fourth quarter. The level of output was again slightly up on the previous quarter, but this was due largely to the fairly mild weather, which lasted well into December. Although no general turning point was reached in the fourth quarter, a certain degree of stabilisation seems to have set in. In terms of the hours worked, the decline in housebuilding was somewhat less pronounced than it had been a year earlier but was slightly greater in the case of public sector construction. In the case of commercial construction the decline continued to be largely constant. Turnover in the finishing trade in the third quarter – the latest quarter for which statistics are available – did not decline year on year for the first time for a while.

Service providers optimistic

Commercial service providers continued to benefit from the favourable developments in industry. According to surveys conducted by the Ifo Institute and the Centre for European Economic Research (ZEW), corporate assessments of the situation generally continued to improve somewhat during the last few months of 2005. The providers of IT services, in particular, became more optimistic. Management consultants, tax consultants and au-

Foreign trade by category of goods

Item	Percentage change			
	Average of October and November 2005 compared with			
	Q3 2005; seasonally adjusted		October and November 2004; unadjusted figures	
	Exports	Imports	Exports	Imports
Total	+ 0.8	+ 1.6	+ 7.3	+ 7.7
Selected main categories				
Intermediate goods	+ 1.0	+ 1.5	+ 2.4	- 1.0
Capital goods	- 0.1	+ 2.4	+ 5.9	+ 0.5
Consumer goods	+ 0.9	+ 0.7	- 0.3	+ 0.7
Energy	.	+ 1.9	+ 27.0	+ 31.8
Selected categories				
Chemicals	+ 3.0	+ 6.2	+ 5.1	+ 1.3
Machinery	- 4.4	- 1.7	+ 1.8	- 1.9
Motor vehicles and motor vehicle parts	+ 0.4	- 2.2	+ 13.8	+ 3.5
Information technology	- 1.1	- 4.3	- 0.6	- 0.4
Metals and metal products	+ 1.4	+ 3.0	+ 6.8	+ 0.8

ditors were also fairly confident about the economic situation. In the advertising sector the firms surveyed were again more optimistic towards the end of the period under review than they had been in the third quarter.

The cyclical improvement in trade and in the hotel and restaurant sector did not continue during the last few months of the year, however. If measured at constant prices, turnover in the retail trade, in particular, was down. After elimination of the usual seasonal variations, business in the fourth quarter was down on the third quarter, and the turnover achieved a year earlier was not regained. This is particularly true of shops specialising in furniture and fittings and household appliances. Developments in the wholesale trade were much more favourable, but here, too, the

Trade and the hotel and restaurant sector weak

momentum declined. Towards the end of 2005 the hotel and restaurant sector actually deteriorated again. While accommodation services were largely able to hold their own, the decline in turnover in the catering trade again increased.

Employment and unemployment

*Employment
stabilises*

Employment in Germany stabilised during the final quarter of 2005. The decline in jobs fully subject to social security contributions seems to have ceased for the most part. There was only a slight increase in the number of self-employed persons, whose significance had previously risen sharply owing to the promotion of one-person businesses ("Me plcs"). The number of persons in low-paid part-time employment (mini jobs) has fallen slightly since the middle of 2005. Although there was a great deal of movement in the area of subsidised employment, little changed in the end. For example, the number of casual work opportunities for recipients of unemployment benefit (one-euro jobs) increased sharply well into the third quarter of 2005 but fell again to some extent after that. The number of persons benefiting from the traditional job creation schemes and structural adjustment measures as well as the reintegration grants remained largely constant. According to preliminary estimates by the Federal Statistical Office, a seasonally adjusted total of 38.78 million people were in employment in the fourth quarter of 2005. That was approximately the same number as in the third quarter but 0.3% fewer than a year earlier. It must be remembered when interpreting

these figures, however, that the underlying data on developments in the number of jobs fully subject to social security contributions and of persons in low-paid part-time employment are largely to be regarded as provisional and have frequently been revised significantly in the past.

The number of registered unemployed persons declined further in the final quarter of 2005. There was a seasonally adjusted quarter-on-quarter fall of 130,000 persons to 4.73 million.¹ The unemployment rate fell from 11.7% in the third quarter to 11.4% in the fourth quarter. Even so, there is still a rise of 330,000 in the number of registered unemployed persons year on year. However, this increase is due solely to the merging of social assistance and unemployment assistance to create the new "unemployment benefit II" and the associated improvement in the statistical capturing of social assistance for recipients able to work. Without this effect, the number of registered unemployed persons would be below the figure a year earlier. The more rigorous criteria to be fulfilled before drawing benefits and the partial cuts in benefits subsequently led to certain groups of individuals ceasing to report to the employment exchanges.

*Unemployment
declines*

In January 2006 there was a seasonally adjusted month-on-month increase of just

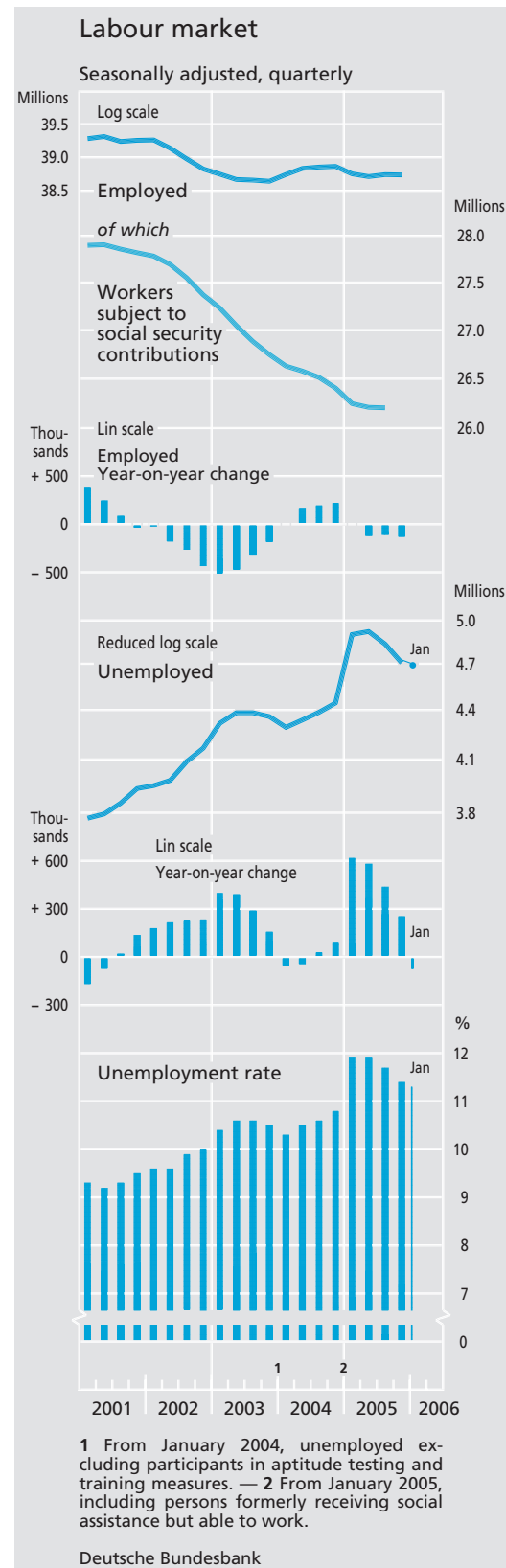
¹ The official unemployment figures for January to August 2005 were revised in January 2006. The effect of including persons receiving social assistance although able to work in the case of the municipalities with separate responsibility for the unemployed in September 2005 was brought forward to the beginning of 2005. This means that the rise in the number of unemployed persons previously shown does not recur in September.

under 70,000 in the number of persons reported as unemployed. However, this increase is probably largely the result of the very cold winter weather since the end of December. Another factor was the relatively early reporting date in December, which meant that part of the seasonal increase in unemployment was not recorded until January. Finally, anticipatory effects probably also played a role; for example, from February the disproportionately long entitlement to unemployment benefit I has been significantly reduced for persons over 45 years of age. The unemployment rate rose from 11.2% in December to 11.3% in January. A year-on-year comparison based on the data for January 2005 and including the previous recipients of social assistance then recorded for the first time results, on the grounds of this baseline effect, in a fall of 75,000 persons compared with a rise of 140,000 in December.

Wages and prices

Unit labour costs fall further

The sectoral information so far available indicates that unit labour costs in the economy as a whole continued to develop favourably in the final quarter of 2005. In the production sector they averaged ½% less after adjustment for seasonal and working-day variations between October and December than they had done in the third quarter. Not only the gross wages and salaries per employee but also the level of output increased sharply. Owing to the generally moderate economic growth in the final quarter of the year, this trend was probably less pronounced in other sectors.



In 2005 as a whole unit labour costs throughout the economy declined by just over $\frac{3}{4}\%$. This result was partly determined by the moderate growth in negotiated pay rates, which increased by no more than about 1% (calculated on a monthly basis). A negative wage drift reduced the increase in the compensation actually paid per employee to $\frac{1}{2}\%$. The marginal expansion in labour costs per employee is primarily the result of the increasing number of one-euro jobs, which in purely arithmetical terms lowers average earnings. Another factor was that the employer's contributions to the statutory health insurance scheme had been reduced by 0.45 percentage point in mid-2005.

Large wage round in 2006

In 2006 there will be a large wage round in the private sector as numerous pay agreements may be terminated. In addition, in some sectors the wage negotiators did not reach agreement in 2005. While individual agreements, which provide for no more than marginal wage increases, have since been concluded in the retail trade, the IG Metall trades union is demanding pay increases of 5% for the metal-working and electrical engineering industry under an agreement running for 12 months. In the public sector there has so far been no agreement at local and state government level on longer working hours like the one that has already come into effect for civil servants. In view of the fairly diverse situation in the various sectors and labour market segments, the key need is for settlements which allow sufficient leeway for differentiation and flexibility.

As a result of the increased prices for crude oil and ores in the international markets, German import prices again increased considerably in the final quarter of 2005. In seasonally adjusted terms the increase amounted to 1.2% quarter on quarter and 5.6% on the year. These price increases were also reflected in German producer prices, which rose by 1.3% on the quarter and 4.9% on the year. In the case of imports, the price of energy increased by no less than 41% year on year and at the domestic producer level – despite a smaller share of petroleum products – by as much as almost 18%. Ores were about 55% more expensive than a year before. If these categories of goods are disregarded, price developments remained moderate. In the case of capital goods, import prices actually declined by 1.7%; in the case of consumer goods, they increased by no more than 1.0%. At the producer level the increase in the price of German capital goods was 0.7% while that of German consumer goods (with the exception of tobacco products which had been affected by tax increases) was 0.5%.

Import and producer prices rise sharply

At the consumer level, too, sharp price increases for energy (+12.9% year on year) and tobacco products (+13.4%) were accompanied by only moderate movements in the case of other components. Food was only 0.3% more expensive on an average of the last three months of 2005 than it had been a year earlier. The prices of industrial goods (excluding tobacco) did not change on average. The prices of services rose by 1.5%, and those of housing rents by 1.0%. In seasonally adjusted terms the basket of goods on which the consumer price index is based increased in price

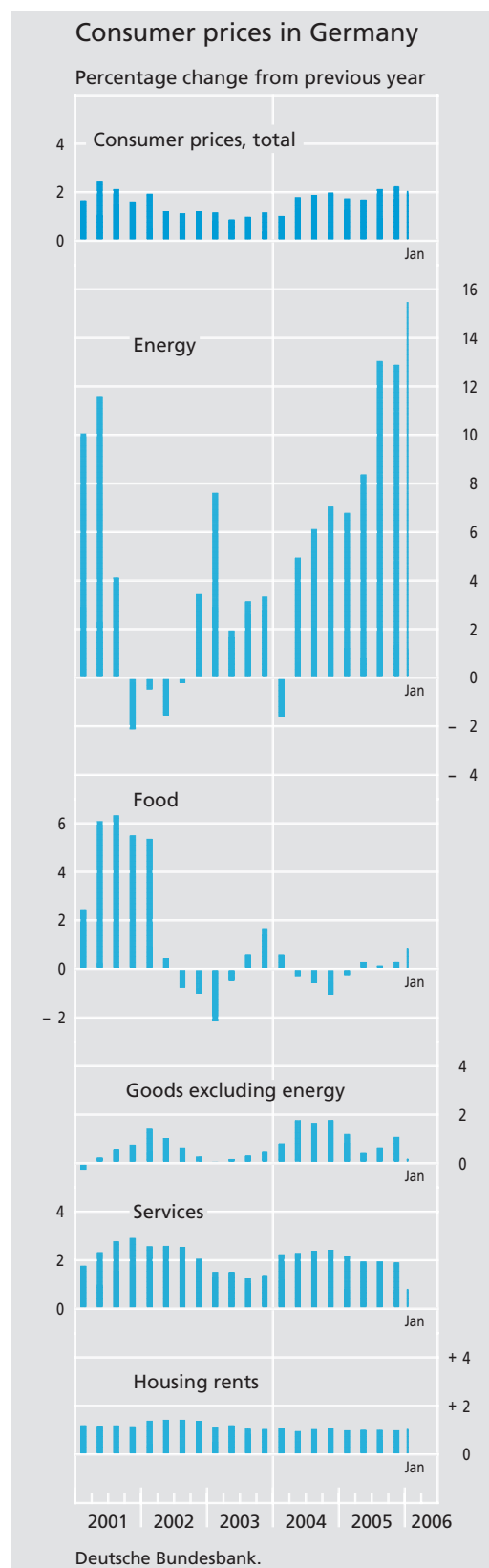
Consumer price increase slows down

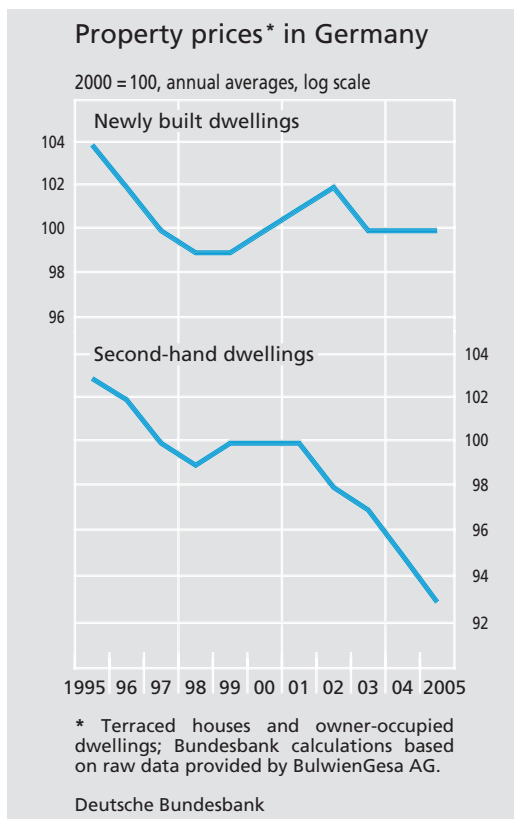
by ½% on the quarter. This corresponds to an annualised rate of about 2.0%. Owing to the fairly sharp price increases in the second and third quarters of the year, the actual year-on-year difference was somewhat greater, at 2.2%. According to the Harmonised Index of Consumer Prices (HICP), prices rose by 2.3%.

The rise in prices weakened considerably at the turn of the year. After a decline in November, prices remained unchanged in seasonally adjusted terms in December and January. While there were particularly sharp price reductions for industrial products in the winter sales at the beginning of 2006, there was a substantial increase in the prices of electricity and gas. At more than 3%, the price increase for electricity was hardly any less than it had been in those years in which the electricity tax had been increased. The consumer price index increased by 2.1% from January 2005, as did the Harmonised Index of Consumer Prices.

Construction prices and house prices move in opposite directions

Construction prices increased by 0.3% in the final quarter of 2005. This gives an annualised growth rate of +1.3%, the fastest rate of increase for ten years. It was due primarily to the sharp rise in the price of construction steel. The price rise in the case of housebuilding was somewhat less steep, at 0.9%. Renovation work on existing buildings actually came down in price. According to the Bundesbank's price index for residential property, which is based on data provided by Bulwien-Gesa AG, the prices of newly built dwellings tended to stagnate. By contrast, the prices of





second-hand dwellings again showed a slight decline.

Orders received and outlook

Growth in industrial orders continues

The positive trend in industrial orders continued in the last few months of 2005. After adjustment for seasonal and working-day variations, the inflow of orders in the fourth quarter was just over 3% faster than the average rate in the previous three months. That is equivalent to a year-on-year increase of 8¾% compared with one of approximately 7% in the third quarter. There was also a number of large orders again. A whole series of orders were placed, especially for the manufacture of other transport equipment, which includes aircraft manufacture, in par-

ticular, as well as shipbuilding. These orders deserve special attention in that their production takes place over a lengthy period. If orders for the manufacture of other transport equipment were eliminated from the total orders received, however, a slight downturn in the flow of orders emerges during the fourth quarter. There is likewise a slight deceleration in growth on the quarter if the last three months are considered as a whole. This applies not least to foreign demand. If all sectors are taken into consideration, however, foreign demand in the final quarter of 2005 rose by almost 4½% in seasonally adjusted terms over the earlier three-month period. It was up by approximately 15% on the year compared with 10½% in the third quarter. Domestic orders were again unable to keep pace with this development although they, too, were as much as 1¾% higher than three months earlier. This represents a year-on-year increase of 2¾%.

Orders received in the construction industry in November, which is the latest month for which figures are available, picked up again after a decline in October. Although the total orders received in October and November were about 2¼% down on the third quarter, the improvement in November augurs well for a stabilisation in demand. After all, the year-on-year comparison also showed a slight improvement for the first time in quite a while. The main reason for this was the prolonged upturn in industrial construction. The steady revival in construction which had been observed since the second quarter of 2005 continued in both October and November. Housebuilding orders will probably benefit in

Construction demand shows signs of improvement

the short term from the abolition of the grant to home buyers. At all events, the rate at which building permits were granted in November rose substantially in seasonally adjusted terms. Work began on the construction of single-family houses in particular.

Expectations of service providers optimistic

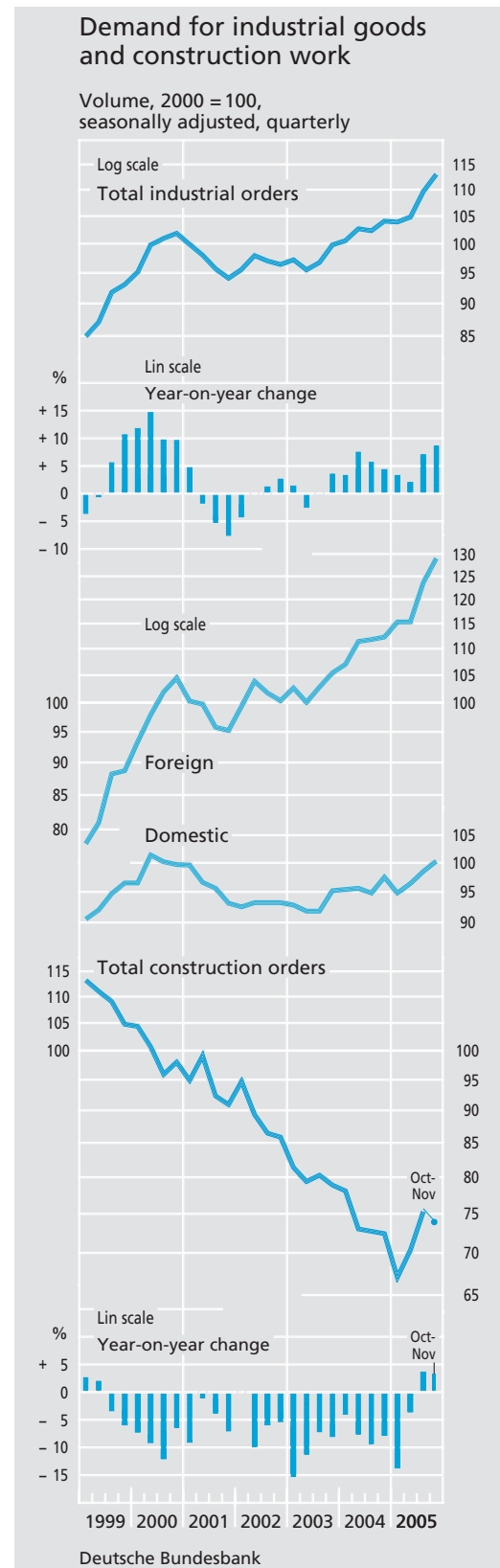
Towards the end of the period under review commercial service providers were fairly optimistic about the future. According to surveys conducted by the Ifo Institute and studies undertaken by Reuters, business expectations brightened considerably at the end of 2005 and the beginning of 2006. The Centre for European Economic Research (ZEW) reported that telecommunications was the sector with a particularly large majority of firms that were optimistic about future demand. However, management consultants and tax and external auditors were not far behind.

Trade outlook gloomy

By contrast, the prospects for retailers will probably continue to be subdued for the time being. The reason is that the burdens which household are having to bear, not least because of the high and in some cases still rising energy prices, will limit their scope for purchasing other goods and services. Even so, surveys by the GfK show that there is a greater willingness on the part of consumers to buy. More than anything else, this is probably a reflection of some consumers' intention to bring forward major purchases owing to the increase in value added tax announced for 2007.

Economic outlook remains positive

Given a continuation of the favourable industrial climate and positive prospects for most commercial service providers, the sideways



movement in overall output in the fourth quarter of 2005 is not a sign of a lasting cyclical downturn. Instead, the continuing robustness of the global economy and the German economy's vigorous participation in the rapidly progressing international division of labour suggest a continuation of the rising cyclical trend. Owing to the substantial increase in the utilisation of industrial production capacity, this will probably also bring an increasing boost to investment in machinery

and equipment. Given the emerging bottoming-out in construction investment, it is hardly likely to pose a further threat to overall economic growth. The confidence of households could be strengthened by the stabilising of employment subject to regular social security contributions and a reduction in unemployment. Only gradual success can be expected here, however, especially as the substantial burdens posed by energy prices are likely to persist.