

## Economic conditions in Germany

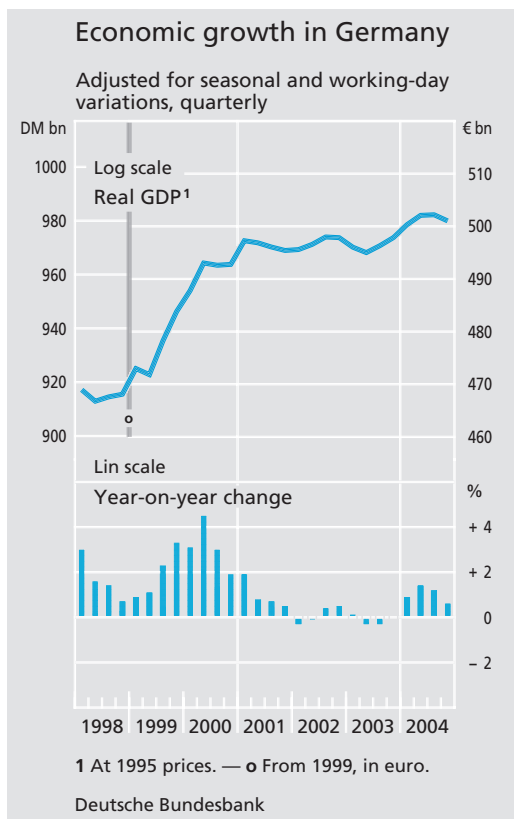
### Underlying trends

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In cyclical terms, the German economy failed to make ground in the last few months of 2004. This means that it has been on a virtually flat path of growth since the summer of last year. According to the latest calculations of the Federal Statistical Office, real gross domestic product (GDP) in the fourth quarter was 0.2% down on the preceding three-month period after adjustment for seasonal variations and the comparatively large number of working days in the year. This takes account of the impact of additional working days on output, which is calculated on a multi-year average. It is conceivable, however, that the actual working-day effect (which is not directly measurable) was smaller in the fourth quarter of 2004 than might have been expected on the basis of the multi-year mean value. This could be due to the additional working days falling in the Christmas holiday period.

*Flat cyclical  
movement*

The year-on-year increase was 0.6%, compared with +1.2% in the third quarter. Taking into account the fact that there were two and a half more working days in the reporting period than in the same period of 2003 and a corresponding increase in the number of hours worked, the figure was +1.5%. The national accounts figures for 2004 that are now available are therefore somewhat less positive than those initially reported by the Federal Statistical Office in mid-January of this year. Average annual GDP growth is now put at 1.0% in working-day-adjusted terms and 1.6% according to the unadjusted figures.



External disruptive factors

The faltering of the cyclical recovery process is undoubtedly due, first and foremost, to the growth path of the world economy having become flatter since mid-2004 and the dampening effect of the deterioration in price competitiveness caused by the appreciation of the euro. Exports, which had been the main driving force behind the increase in overall economic output, were now turning out to be a vulnerable flank in terms of business activity. Moreover, energy price inflation stemming from the international crude oil markets placed a strain on domestic demand, especially on private consumption. In addition, the combination of oil price and appreciation effects has left a clear mark on the overall economic production process since, up to now, there has been no breakthrough in domestic business activity. Seen in that

light, even after one and a half years, the German economy is still in the initial phase of an economic upturn. Despite external disruptive influences, however, sentiment in trade and industry as well as the consumer climate among households have improved somewhat recently. Evidently, many investors and consumers subscribe to the view that the current flat movement of the economy will lead into an economic upturn again as the year progresses.

Nevertheless, developments in the fourth quarter also reveal that the economy entered the new year without momentum. That holds true for all the major demand aggregates and economic sectors. As industrial activity was inclining to weakness in the last few months of 2004, a large part of the somewhat higher level of exports is likely to have come from existing stocks. Expenditure on machinery and other equipment, following the sharp increase in the third quarter, may have been somewhat lower again recently. With regard to construction, a large amount of unoccupied real estate (with an increasing number of vacant premises in some regions) had a persistently dampening impact. Weather-related cutbacks in production, which are usual in the fourth quarter, are likely to have been comparatively minor in 2004, however. Households' retail purchases continued to be restrained in the last few months of 2004. A good start in October was nullified by a marked decline in November, and even the Christmas trading period failed to produce a turnaround. Nevertheless, in autumn there was no continuation of the reluctance to buy motor vehicles that had been clearly felt in

Weak demand profile

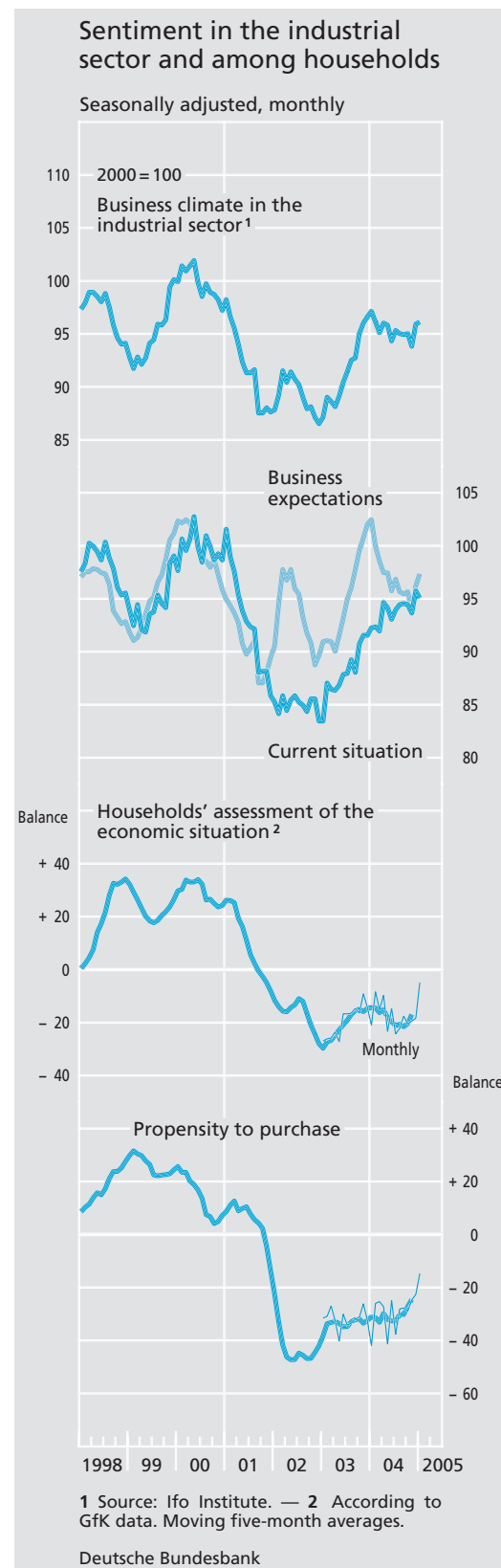
the third quarter. On an average of the fourth quarter, in fact, registrations of new motor vehicles went up by no less than 21½% in seasonally adjusted terms hitting a multi-year peak. In addition, purchases of refined petroleum products – especially heating oil – increased, having previously been deferred in many cases owing to rising prices. Overall, there was a slight increase in private consumption in the last few months of 2004, although it is not possible to conclude from this that there was a sustained growth in the propensity to consume.

### Output and labour market

*Deterioration  
in industry*

In cyclical terms, the business situation in industry deteriorated somewhat in the last few months of 2004. After adjustment for seasonal variations and the quite large number of working days, average output in the fourth quarter was ½% down on the summer months. The year-on-year increase in output, which had been 5% in the third quarter, went down to 1½%. Taking sales as a yardstick, domestic deliveries and exports were almost equally affected.

The slow pace of economic growth affected both the capital goods sector and the consumer goods sector. In the case of capital goods, the cutbacks in the production of machinery, equipment and motor vehicles as well as in telecommunications systems had an impact. In the case of durable consumer goods, developments in the major branches of consumer electronics and furniture manufacturing were rather unfavour-





able. By contrast, production of intermediate goods held up well. Comparatively slow growth, say, in the glass and ceramics sector as well in the manufacture of electrical machinery and apparatus was more than offset by the continuing expansion in output in the chemicals industry and in steel production.

In the construction sector, there was no further deterioration in business activity in the last few months of 2004. In seasonally adjusted terms, construction output in the fourth quarter was largely at the same level as in the previous months. Given the persistent decline in demand, however, this is not yet a sign a consolidation. It is rather the case that the comparatively mild weather in early December, in particular, allowed work to continue on quite a large scale. The even larger year-on-year fall of 7¼% in the fourth quarter of 2004 shows how unfavourable the situation in the construction sector still is. The applies particularly to the building industry, where seasonally adjusted output in the last three months of 2004 continued to decline. To a large extent, this is likely to be due to a further reduction in housing construction activity, although the increasing amount of unoccupied real estate, including vacant office premises, has doubtless also contributed to a reduction in the volume of construction. Civil engineering work, which is sustained predominantly by public sector contracts, benefited more from the quite mild temperatures. In this subsector, output increased somewhat in the fourth quarter, in fact. Owing to its close link with the building industry, business activity in the finishing trades is more likely to have been negative. In the third quarter, the number of hours worked, at -8%, was already further down on the year than before. However, much the same is to be expected for the fourth quarter, for which no statistics are available yet.

*Construction output still weak*

The situation in trade remained unfavourable towards the end of 2004. The price-adjusted

*Unfavourable  
development  
in trade*

level of sales was again clearly down on the year. At least, there was no further acceleration of the decline in the wholesale trade. The main reasons for this were that trade in agricultural products has improved recently and that sales of fuels and refined petroleum products showed an increase. This largely offset the weak development in food, drink and tobacco and the deterioration in the machinery and equipment sector, which is probably connected to the faltering growth in industry. In the retail trade (excluding motor vehicles and sales of automotive fuel), the year-on-year decline in sales was tending to increase at the end of the period under review. In particular, sales of consumer electronics and of books and magazines remained weak. According to the latest consumer surveys, there has been some increase in the propensity to make major purchases, but, overall, households tended to remain cautious as before. The situation in the hotel and restaurant trade, where the earlier identifiable gradual recovery had been interrupted in the autumn of 2004, was brightening up again somewhat towards the end of the year. This applies particularly to the accommodation businesses, where the volume of turnover was again up on the year at the end of the period under review. Restaurant businesses were still showing a minus figure, however.

*Slowdown  
in the case  
of commercial  
service  
providers*

In the case of the commercial service providers, the cyclical flattening in the production sector meant that many expectations for the last few months of 2004 were not fulfilled. Indeed, according to the surveys of the Centre for European Economic Research, the marked preponderance of firms that had still

been reporting a positive development in sales in summer disappeared almost entirely. Pessimistic reports were in a clear majority, not least in the IT and telecoms sectors. In the case of firms of architects, hope of the situation improving has largely faded. This was not offset by more positive developments in the case of management consultancy and advertising firms.

Towards the end of 2004, the labour market was still marked by a rising level of employment as well as by unemployment. According to Federal Statistical Office data, the seasonally adjusted number of persons in work had gone up to almost 38.6 million by December 2004. This signifies an increase of roughly 80,000 on the third quarter and around 290,000, or 0.8%, on the year. While employment in industry and construction was declining up to the end of the period under review – albeit at what tended to be a slower pace – employment in the services sector was showing an accelerated rise. This was focused on commercial service providers and workers employed in households, ie persons who are likely, for the most part, to be low-paid part-time workers. The numbers of these have probably increased again in the past few months. At the end of 2004, a total of around 8½ million jobs of this kind were registered with the Miners' Federal Statutory Health Insurance Scheme. The rise in employment was also supported by formerly unemployed persons who have become self-employed – for example, as one-person businesses – with financial assistance from the labour exchanges. Business start-up grants were paid to nearly 225,000 persons, with

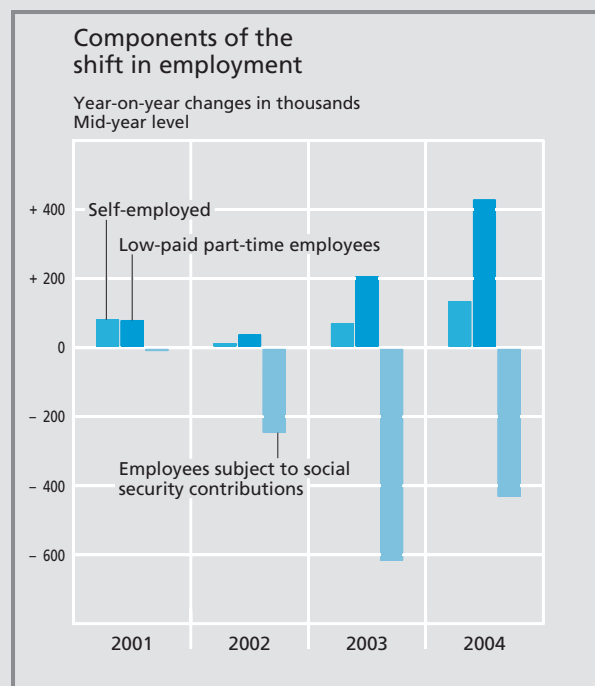
*Continuous rise  
employment*

## Sharp increase in low-paid part-time jobs

With effect from 1 April 2003, new regulations for low-paid part-time (and short-term) jobs were introduced as part of the Hartz II Act. The ceiling for monthly earnings was raised from €325 to €400, for example. At the same time, the restriction to 15 hours worked per week was abolished. The compensation of employees is exempted from taxes and social security contributions. The employers pay a flat rate of 25% of the earnings for the social security contributions and income tax. Every employed person subject to social security contributions can work in a second job exempt from social security contributions. For persons employed in households, there is a reduced contribution rate of 12%; the employers receive an additional tax allowance amounting to 10% of the costs incurred up to a maximum tax savings of €510. A simple reporting procedure to the Miners' Federal Statutory Health Insurance Scheme (*Bundesknappschaft*) facilitates the establishment of jobs of this kind.

The new arrangements for "mini-jobs" has considerably enhanced the attractiveness of low-paid part-time jobs. In particular, demand has been stimulated by the large degree of flexibility with regard to working hours as well as the scope available with regard to pay and straightforward administrative reporting processes. Added to this is a broad regional availability. In the nine months up to the end of 2003, the number of low-paid part-time workers had increased by around 700,000 to about six million. Approximately a further 900,000 persons were added to this figure during 2004. This means that the total number has risen to nearly seven million. Roughly one-quarter of these persons already had a main job fully subject to social security contributions. In other words, their low-paid employment was a second job. Roughly 1½% were employed in a household.

As the sharp increase in low-paid part-time employment coincided with a marked reduction in employment fully subject to social security contributions, it is often



assumed that, in many cases, full-time jobs have been split up and reclassified. At all events, the number of persons subject to regular social security contributions fell by 450,000 between March and the end of 2003. In 2004, the decline amounted to roughly 300,000. Looking at these developments in terms of the sectors of the economy, the changes in employment in hotels and restaurants as well as in the retail trade, in particular, support this substitution theory. In both economic sectors, the sharp expansion of low-paid part-time employment was accompanied by marked reductions in "normal" employment. On the other hand, the level of both categories of employment was increased noticeably not least in the case of commercial service providers and in the healthcare sector. A similar parallel situation is identifiable in a Federal Labour Agency study<sup>1</sup> based on business data. In around 180,000 firms, a decline of just over half a million in the number of persons subject to social security contributions in the

<sup>1</sup> See *Mini- und Midijobs in Deutschland*, special report 2004. —

period from March 2003 to March 2004 was accompanied by an increase of almost 400,000 in the case of mini-jobs. There are not a few cases, however, where both types of employment increased or where the rise in the number of employees fully subject to social security contributions was accompanied by a fall in the number of low-paid part-time employees. Based on the group of employees, at just under 450,000, almost exactly the same number of persons switched from a low-paid part-time job to "normal" employment as vice versa. The cited study concludes that there have been some exchange processes between the two types of employment. Nevertheless, there is likely to have been a greater number of cases in which new job opportunities have been created.

A study by the *Rheinisch-Westfälisches Institut (RWI)*<sup>2</sup> investigated the question of unemployed persons being integrated into a low-paid part-time job. According to this study, around 15% of persons employed in mini-jobs had been unemployed before taking up a low-paid part-time job. Nevertheless, as the number of 15 hours worked per week, which is needed for no longer being counted in the unemployment statistics, is not achieved in most cases, these persons generally remain registered as unemployed. No more than 3% of all persons in low-paid part-time employment exceed the statistical threshold. While there are major differences in specific cases, weekly working hours average somewhat less than ten hours. The quite small percentage of persons in mini-jobs who used to be unemployed is explained by the fact that two-fifths of the persons surveyed by RWI had previously been housewives or "house-husbands" and roughly another quarter was drawing a pension or in training. The vast majority of low-paid part-time workers therefore come from what is known as the "hidden reserve" or an expanded labour force potential.

The reorganisation of low-paid part-time employment has probably contributed to a reduction in illicit working.

<sup>2</sup> See *Aspekte der Entwicklung der Minijobs*, Gutachten im Auftrag der Minijob-Zentrale der Bundesknappschaft 2004. — <sup>3</sup> Also contains

## Shifts in employment subject to social security contributions and low-paid part-time employment

March 2003 to March 2004, in thousands

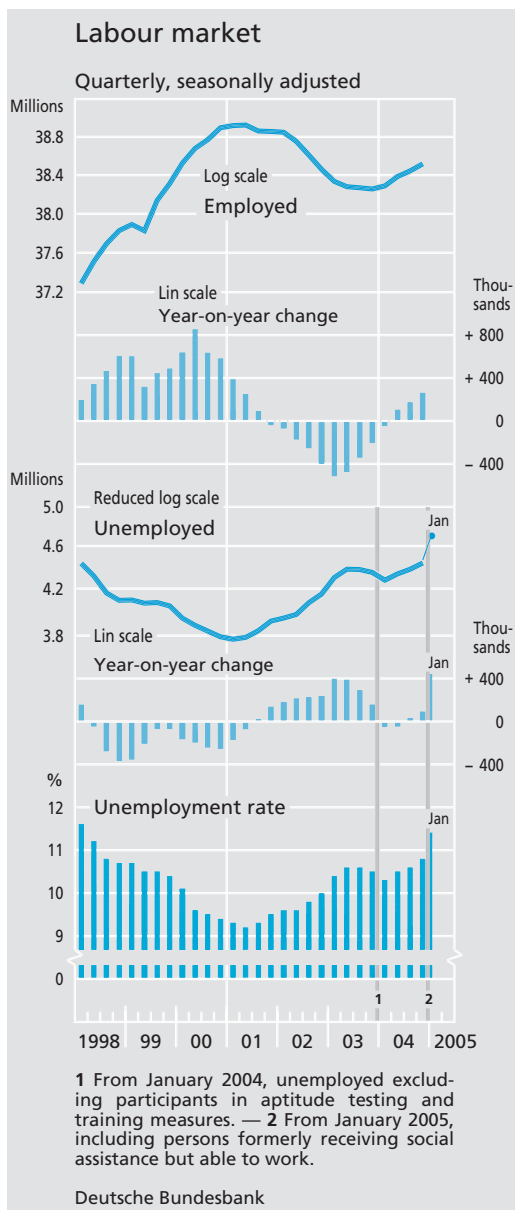
Category	Change	Number of firms	Persons subject to social security contributions A	Low-paid part-time employees B
A	–	182	– 558	+ 379
B	+			
A	+ 3	278	+ 532	+ 538
B	+			
A	+ 3	1,283	+ 937	– 320
B	– 3			
A	–	404	– 1,829	– 281
B	– 3			
Cannot be allocated <sup>4</sup>		646	+ 354	+ 207
Total		2,793	– 564	+ 523

This is suggested, at least, by the reports from households. At the end of the third quarter of 2004, just under 90,000 "mini-jobbers" were involved in the household cheque procedure, ie around 60,000 more than in June 2003 when the statistical recording began.

The figures available so far allow no more than an initial assessment of part of the overall reform package. Generally speaking, the findings are quite varied and can by no means be interpreted as a failure of the approach to reform. Rather, the boom in mini-jobs can be understood as a call to make the core areas of the labour market more flexible as well. Moreover, it is important that mini-jobs play a greater part in the integration of the unemployed. A less restrictive practice in offsetting earnings against benefits, which would increase the incentive for recipients of "unemployment benefit II" to take up a mini-job – especially when compared with "one euro jobs" – would therefore seem appropriate.

the cases where there has been no change. — <sup>4</sup> Firms which had no employees either in March 2003 or in March 2004.





(more recent statistics are unavailable at present) was still more than 1% down on the year, which was more than 300,000 persons. In mid-2004, the decrease had been 1.6%, or 430,000 persons.

The cyclically unfavourable labour market situation, which is evident from the development of employment subject to social security contributions, may have contributed to unemployment rising in the autumn of last year, too. According to the Federal Employment Agency, at the end of December the seasonally adjusted number of persons affected was a good 40,000 higher than in September. The sharp seasonally adjusted rise of 225,000 in January 2005 was due mainly to persons able to work who had previously been receiving social assistance now registering as unemployed. For these persons, registration was necessary in order to draw unemployment benefit II. By the end of January, the number of persons officially registered as unemployed had risen to a 5.04 million (unadjusted figure). In cyclical terms, unemployment has remained largely unchanged. The seasonally adjusted unemployment rate, as calculated by the Federal Employment Agency, was 11.4%.

*Steady rise in unemployment*

90,000 persons received bridging payments in December. Furthermore, more job opportunities with a work-related benefit bonus (known as one-euro jobs) have been created. The number of full-time workers subject to full social security contributions – which is affected more by cyclical developments – was falling up to the end of the period under review, however. This decline has, nevertheless, become slower. The figure for November

The sharp increase in registered unemployment at the start of the year has led to a debate on how the headline unemployment rate is to be interpreted correctly. According to the method currently employed by the Federal Employment Agency, persons are counted as unemployed who do not work, or who work fewer than 15 hours a week, who are seeking work with a greater number of

*Informative value of the unemployment rate*

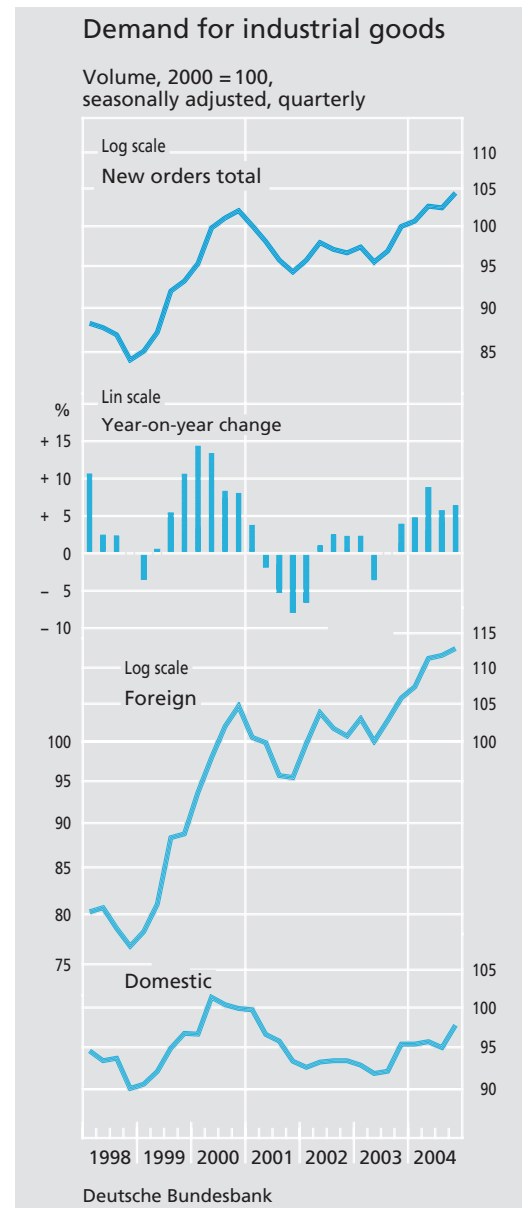


working hours, who are available for job placement, and who are personally registered at a labour exchange. However, statistical effects were already playing a considerable role in 2003. Since January 2004, participants in training and aptitude-testing schemes have no longer been registered as unemployed. On balance, the informative value of the unemployment statistics has been improved by the administrative measures and the revisions of the methodology undertaken in the past few years, even though they disrupt time comparisons for a while. Nevertheless, for quite a number of reasons, the unemployment rate is still an imperfect measure of the scale and severity of the chronic under-employment in Germany. Moreover, the problems on the German labour market are too complex to be captured by a single indicator. The lack of competitive jobs is likely to be a more important factor.

## Demand

*Orders received  
by industry...*

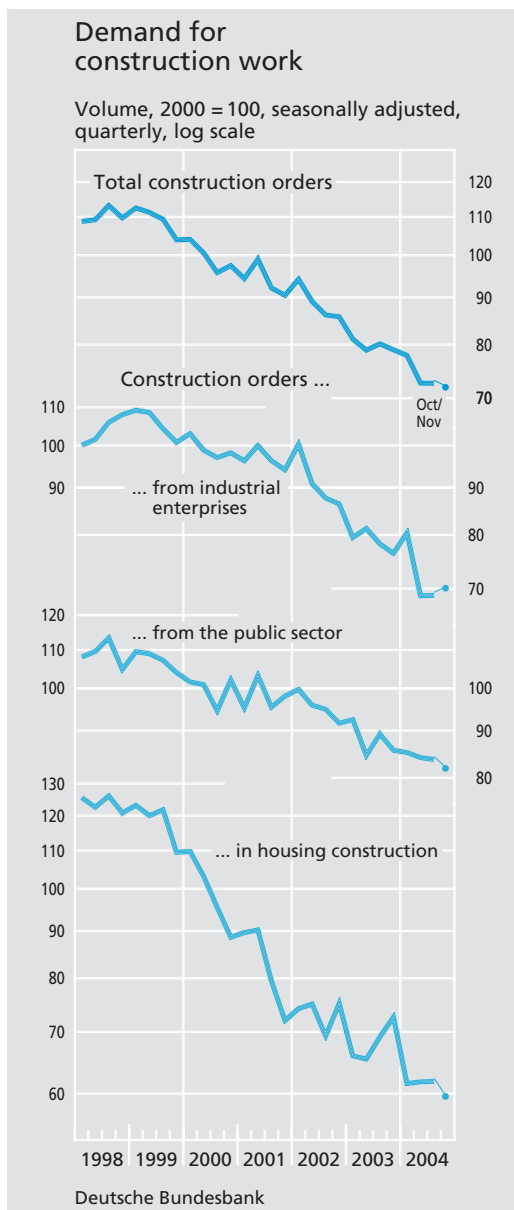
Demand for German industrial goods became perceptibly more buoyant again in December. In the fourth quarter as a whole, it was not quite 2% up on the preceding three months. Even so, the fact that the year-on-year increase went down to 4¼% from 5¾% in the third quarter shows that the pace of growth was still restrained. This is all the more the case given that there was an exceptional accumulation of major orders in December. This applied, in particular, to parts of the mechanical engineering and other transport equipment sectors, the latter including building



and repairing of ships and boats as well as construction of air transport equipment.

The major domestic orders were concentrated on these sectors. Overall, the seasonally adjusted average intake of domestic orders in the last three months of the year was 3% up on the quarter. The stronger flow of orders was largely sustained by capital goods. Not only producers of other transport equipment,

*... from  
domestic  
firms ...*



but also manufacturers of road vehicles recorded a marked increase in orders. In the consumer goods sector, the lull in orders during the summer was offset, with the figures nearly matching those of the second quarter. By contrast, orders placed with producers of intermediate goods were no higher in the fourth quarter than they had been in the summer.

In seasonally adjusted terms, foreign demand for German industrial products was likewise higher in the fourth quarter than it had been in the July to September period, which was also due to a large number of major orders in December. In the capital goods sector, in particular, this resulted in an overall quarter-on-quarter increase in orders in the final three months of the year. There was also a marked improvement in the order situation in the consumer goods sector, where a seasonally adjusted 5½% increase in the last three months of 2004 brought the best quarterly result of the entire year. This helped to compensate for the declining orders in the case of intermediate goods. In this sector, steel producers, in particular, suffered a decline from the high level of orders in the summer, while there was a further increase in demand in the chemicals industry.

*Restrained export business*

The situation in the construction sector remained unfavourable throughout the reporting period. Whereas demand for construction work during the summer had been pointing to a gradual stabilisation of the situation, there was a further setback in November. In seasonally adjusted terms, the average figure taking October and November together was around 1½% down on the third quarter, when the level had already been low. The year-on-year figure was down by more than one-tenth. The decline was far sharper in residential construction, where orders fell by roughly 18% on the year. In seasonally adjusted terms, in October and November period they were 4% lower than in the third quarter. With a seasonally adjusted figure of no more than 11,800 units, construction per-

*Persistently weak construction demand*

mits for single-family housing were nearly halved compared with the most recent peak in 1999. In apartment house construction, compared with 1994 – the first year for which statistics are available for Germany as a whole – orders have now fallen to less than one-fifth. In seasonally adjusted terms, public sector construction orders in the two months of October and November were 2¾% down on the third quarter. It was only industrial construction that held up. After adjustment for seasonal and working-day variations, there was a slight increase in incoming orders. Even though this means that the level of orders had remained largely unchanged since spring 2004, the year-on-year fall of 10% shows that there have been sharp cut-backs in this sector, too.

*Positive demand outlook in the case of some service providers*

In the case of commercial service providers, the outlook for demand is brighter. According to the European Centre for Economic Research survey in the fourth quarter of 2004, the enterprises in this sector take quite a positive view of the orders situation. Even so, there are greater differences between the individual sectors than in the past. The most positive assessment comes from the telecoms, closely followed by tax consultants and auditors. This contrasts with the strongly negative expectations of firms of architects as well those of firms working in technical consultancy and planning. This is likely to be connected with the restrained investment activity in industry, especially with regard to construction projects.

## Consumer prices

### Annual percentage change

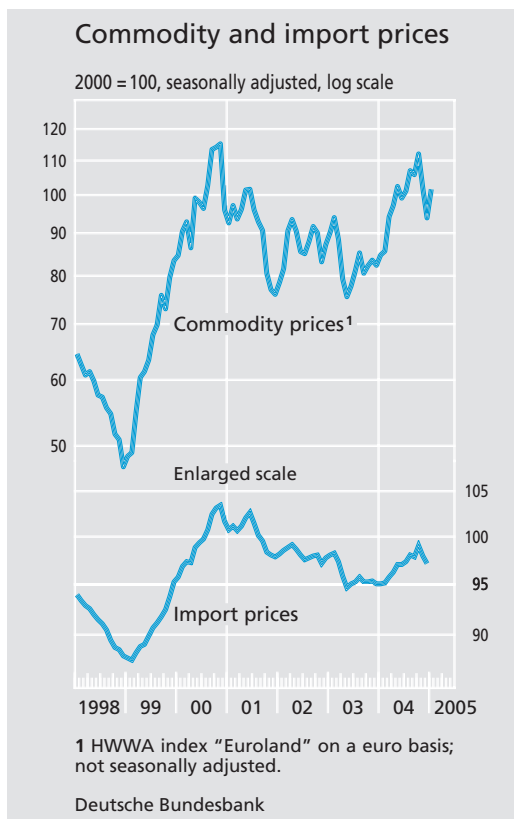
Item	2004			
	Q2	Q3	Q4	Jan
Food	-0.3	-0.6	-1.0	-1.1
Industrial goods	1.8	1.6	1.8	1.4
<i>of which</i>				
Tobacco	12.2	12.2	16.2	24.3
Pharmaceuticals and therapeutic appliances	23.2	23.2	23.1	5.4
Energy	4.9	6.1	7.1	5.3
<i>of which</i>				
Refined petroleum products	7.7	10.3	11.2	5.9
Services	2.4	2.3	2.4	2.4
<i>of which</i>				
Outpatient and inpatient medical services	17.0	18.7	18.5	2.6
Rents	1.0	1.0	1.2	1.0
<b>Total</b>	<b>1.7</b>	<b>1.8</b>	<b>2.0</b>	<b>1.6</b>
Total excluding seasonal products, energy, tobacco, healthcare	0.5	0.5	0.4	0.7
<i>Memo item</i>				
Harmonised Index	1.8	2.0	2.1	1.6

Deutsche Bundesbank

## Prices

The overall rate of price increase remained within limits in the last few months of 2004. While tax factors again had a marked impact domestically, there tended to be more dampening effects from the external side. In seasonally adjusted terms, German import prices were declining slightly from their most recent peak in October. In December, they were scarcely higher than they had been in the second quarter of 2004. The year-on-year rate of increase went down from 4.1% to 2.2%. Cheaper imports of crude oil and refined petroleum products, which had risen by one-half on the year in early autumn, were the crucial factor behind this. At all events, the decline in prices was so sharp that it more than offset the contrasting movement in gas,

*Import prices declining slightly*



which traditionally follows oil prices with a time-lag of roughly half a year. Added to this was an initial easing of upward price pressure on steel products. This meant that raw materials and semi-finished became somewhat cheaper on the whole. Probably not least owing to the depreciation of the euro, the price level of finished products, which has been down on the year for quite some while, fell back again slightly.

*Tobacco tax driving industrial producer prices*

In the case of German domestic industrial producer prices, cheaper energy coincided with the second increase in tobacco tax. The outcome of this was that there was no continuation of the decline in factory gate prices in December. In seasonally adjusted terms, in fact, there was a slight increase. The year-on-year rate of increase, which had fallen to

2.8% in November, went up to 2.9%. Excluding tobacco, the figure went down from 2.6% to 2.4%. One factor in this was the easing of steel prices, which meant that there was no further rise in the prices of intermediate goods. Price changes in the case of other industrial goods were moderate up to the end of the period under review. In December, capital goods and consumer goods (excluding tobacco) were no more than 0.6% and 0.5% more expensive respectively than in the same month of 2003.

Construction prices, after a lengthy standstill, had started moving upwards in the spring of 2004, and showed a further slight rise again in the fourth quarter. The year-on-year figure for construction prices went up to +1.7%. The building industry was especially affected. Commercial and industrial buildings were 2.6% more expensive. Office buildings and housebuilding cost 2.0% and 1.7% more respectively. The perceptibly higher steel prices were a main cost factor. As steel is much less important in road construction, there were hardly any price changes in this subsector.

*Higher construction prices*

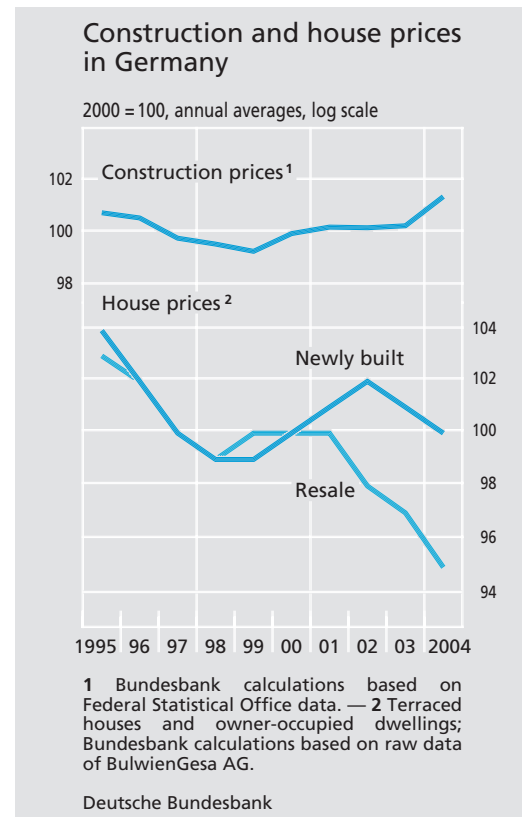
According to the regional data supplied by BulwienGesa AG, which has been aggregated by the Bundesbank, in 2004 there was a further decline in prices for residential buildings (terraced houses and owner-occupied apartment housing). In the case of newly built housing, price reductions (as in 2003) were around 1%. In the case of resale, the figure was as much as just over 2%. This meant that used property was no more expensive last year than it had been in 1993. Purchase

*Falling house prices in 2004*

prices for newly constructed houses and apartments, including land, were similar to those at the end of the 1990s.

*Lower rate  
of consumer  
inflation*

According to both the national price index and the (EMU) euro area Harmonised Index of Consumer Prices (HICP), the prices of goods and services purchased by households were 1.6% up on the year in January. The decline on December 2004, when the rate of change had been 2.1% and 2.2% respectively, was due, to a large extent, to a base effect of the health system reform, which had started to affect prices at the beginning of last year. Added to this were comparatively minor price increases for food as well as quite sharp falls in the prices of clothing and shoes in connection with special sales. By contrast, services became more expensive. The increases in motor vehicle tax for older vehicles with a higher pollutant emission and in motor vehicle insurance had a particular impact in this sector. Moreover, the price reductions for



package holidays and in accommodation services were smaller than had been the case in earlier years.