

Economic conditions in Germany

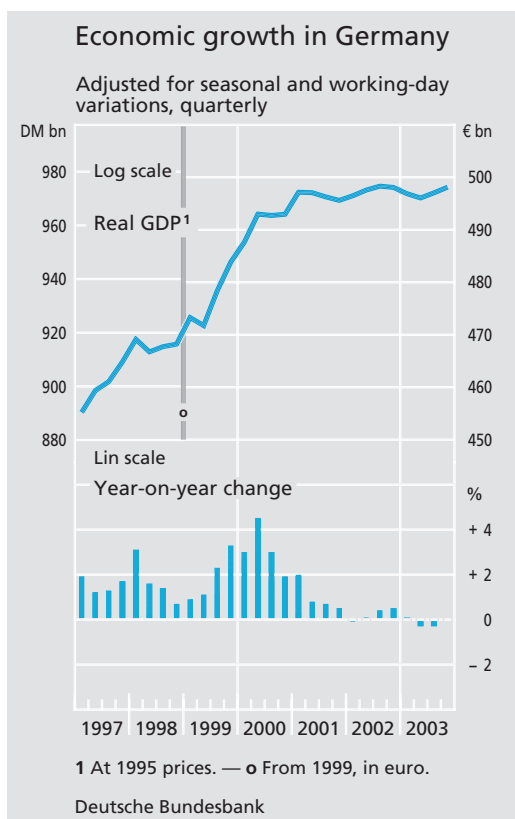
Underlying trends

The cyclical improvement in the German economy continued in the fourth quarter of 2003. However, much as in the summer months, which had brought an initial upturn, the recovery progressed at only a moderate pace. According to the flash estimate of the Federal Statistical Office, the increase in real gross domestic product (GDP) in the final quarter amounted to 0.2% after seasonal and working-day adjustment. At all events, this offset the dip in output which had arisen in the first half of the year and, after adjustment for variations in the number of working days, was slightly up on the comparable end-2002 level. In calendar-month terms, there was a rise of 0.2%. This confirmed the -0.1% annual result for 2003 announced in early January.

*Slight increase
in GDP
in Q4 2003*

The slight growth in GDP in the fourth quarter was sustained by an improvement in domestic demand, where there was a slight revival in investment. Furthermore, inventories were no longer being reduced. By contrast, households' consumption was still proving to be an area of weakness. Seasonally adjusted expenditure – at constant prices – showed a further decline and, as before, was down on the year. Despite numerous special offers and discount campaigns, it was principally retail purchases that showed a sharp fall. Furthermore, there were fewer registrations of new cars. According to the surveys of the consumer research institution, Gesellschaft für Konsumforschung (GfK), which are conducted for households on behalf of the European Commission, consumer sentiment,

*Recovery in
domestic
demand*



after having become more upbeat for a time, has undergone a marked deterioration again recently. It is not only the propensity to purchase which appears to have faltered, after previously revealing signs of an improvement. Despite the relief afforded in the case of income tax, income developments were again being assessed more sceptically. This is likely to be due, not least, to the reduced framework for incomes as a result of a discontinuation of special payments. However, strains due to the health reform as well as general uncertainty about future measures to restore the viability of the social systems are likely to have had a dampening impact, too. Convincing reforms are needed to strengthen consumer confidence and to give rise to renewed optimism about the sustainability of public fi-

nances. An improvement in the labour market situation is also indispensable.

Exports, which had supplied crucial stimuli to growth in the third quarter, continued to generate a positive impetus. According to the national accounts data, which are based on the results of the balance of payments statistics, seasonally adjusted fourth-quarter exports were again up on the extremely good outcome for the summer months. At the same time, imports – in contrast to the preceding quarter – also showed a marked rise, however. This meant a considerable fall in real net exports, which thus had a dampening impact on overall growth.

Recent fall in net exports

The generally optimistic expectations of the business sector (as reflected, say, in the surveys of the Centre for European Economic Research and the Ifo Institute) as well the overall improved underlying conditions nevertheless suggest that the course of recovery will continue.

It is still impossible to tell at present how smoothly this process will progress and when it will lead into a self-sustaining upswing. Much depends on economic and reform policy, both sides of industry and the global setting. At the moment, the exchange rate is being pinpointed as the main external risk to economic activity. The euro's appreciation, especially against the US dollar, has undoubtedly been surprising, at least in terms of its pace. What also has to be recognised, however, is the fact that the weighted effective exchange rate of the single European currency in mid-February was no more than 3%

How large is the exchange rate risk?

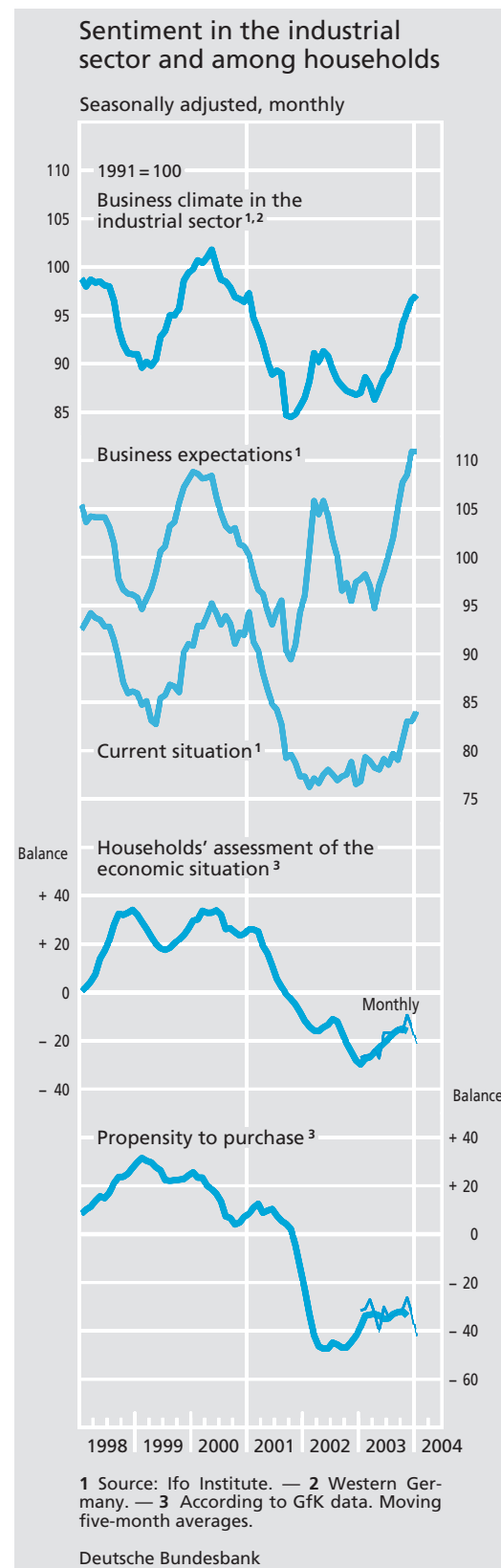
higher than in autumn 2003, when most of the forecasts for 2004 were made. This means that, under *status quo* conditions, the need for adjustment in terms of forecasting is likely to have been generally limited so far.

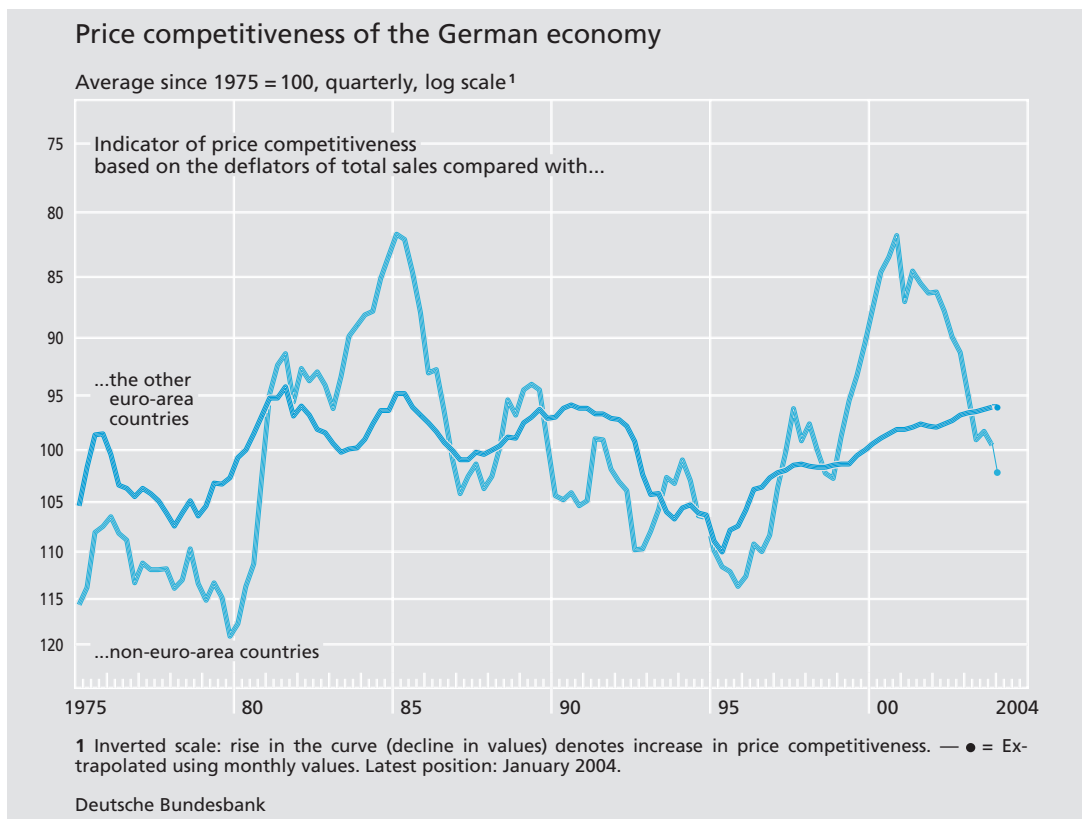
*Stronger
expansionary
stimuli from
world trade*

That is also true because the stimuli to economic activity in Germany generated by world trade have become identifiably stronger and global economic growth this year may indeed be somewhat higher than originally expected. The German economy is likely to benefit quite well from this, too, especially as the global pick-up in investment demand – which is also comparatively price-inelastic – operates very much to its advantage and Germany is present on a regionally broad front. Moreover, despite the considerable exchange-rate-related losses compared with earlier high levels, the price competitiveness of the German economy may still be rated as being as good as on a multi-year average. An additional favourable factor in this context is that German enterprises' market position vis-à-vis suppliers from the rest of the euro area has been further expanded on the price and cost side. This "real depreciation", as it were, is mitigating the real appreciation on third markets, especially in the dollar area. That is not the least reason why the economic risk emanating from the appreciation of the euro so far has been reasonably predictable. Nevertheless, a close watch will have to be kept on future exchange rate developments.

*Model
simulations*

As revealed by various simulation results using econometric models, the effects of an exchange rate shock are spread over several years and are, moreover, weakened by the





real income gains of domestic enterprises and households owing to the improvement in the terms of trade. An additional factor is that the effects of changes in exchange rates are dependent on the underlying causes and on market players' expectations, above all, with regard to the persistence of the appreciation or depreciation. Simulation results describe the average effect based on estimated structural parameters of fairly long sample periods. They therefore invariably have to be placed in the current context and interpreted against that background.

Price and growth effects

For the hypothetical case of a general and sustained (as well as unanticipated) 10% appreciation of the euro, calculations using the Bundesbank model produce the following

short and long-term price and quantity reactions of the German economy.

- Consumer prices in the third year are ½% lower overall than in the baseline scenario; the short-term dampening impact on the inflation rate in the first year amounts to between 0.1 and 0.2 percentage point.
- Real GDP in the third year is between 1% and 1½% lower overall than in the baseline scenario; roughly half of the effect (between ½ and ¾ percentage point) occurs as a loss of growth in the first year.

Following these quantitative "rule of thumb" formulae and taking due account of the current exchange rate relationships and how they differ from the typical exchange rate

Recovery scenario continues intact

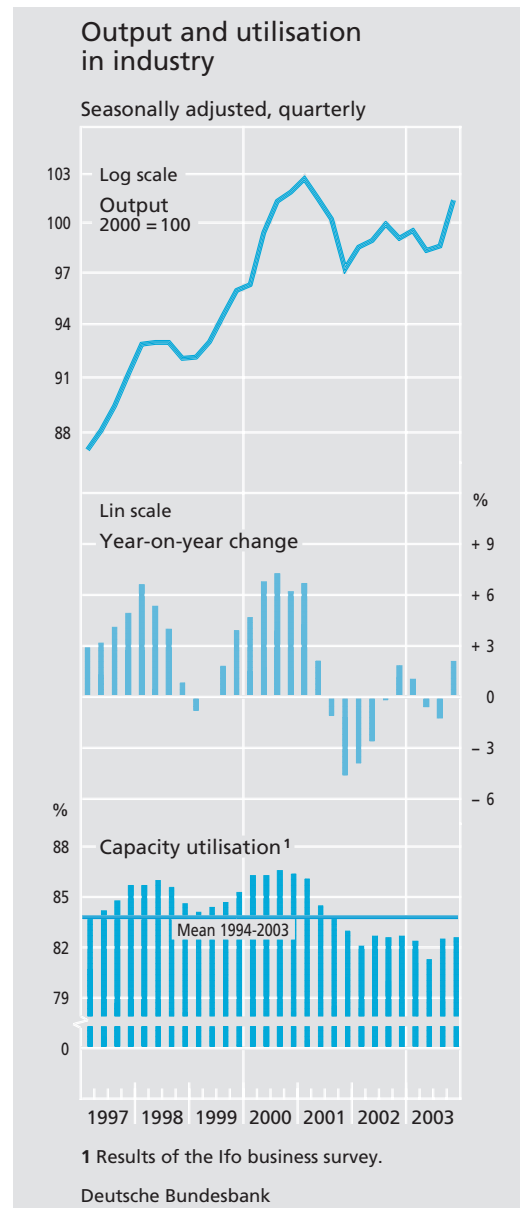
assumptions in the autumn 2003 forecasts, the recovery scenario – notwithstanding some minor qualifications – still has the fundamentally highest probability. That is all the more the case as the chances of global economic recovery simultaneously appear to be on the favourable side. The available data on export expectations and foreign orders support such an assessment.

Output and labour market

Rising industrial output

Business developments in industry showed a perceptible improvement in the fourth quarter; in December, the highest level of output in 2003 was achieved after seasonal adjustment. In the fourth quarter as a whole, output was around 2¾% up on the average of the preceding three-month period. The figure was 2¼% higher than in the corresponding period of 2002, having been as much as 1¼% down on the year in the third quarter.

Developments were especially positive in the capital goods sector, where the quarter-on-quarter increase was 4% in seasonally adjusted terms. In particular, manufacturers of road vehicles and producers of communications equipment as well as of measurement and control instruments expanded their production sharply. A factor in the case of transport equipment was that one major group shut down its main production plant between Christmas and the end of January for renovation, which meant that advance work was performed. Output in the intermediate goods sector was also expanded – by not quite as much but still quite sharply at 3%. The steel



industry, in particular, stepped up production in this sector.

This acceleration in output was accompanied by an increase in capacity utilisation. According to the Ifo surveys, the degree of utilisation on an average of the fourth quarter went up to 82½% of normal full utilisation in seasonally adjusted terms. This matched the level in the comparable period of 2002, after the

Increased capacity utilisation

lowest level since the mid-1990s had been reported in the first half of 2003.

*Weak
construction
output*

The situation in the construction industry remained subdued. According to the data available so far, construction output in the last few months of 2003 was slightly up on the third-quarter level in seasonally adjusted terms. The level of output was still very low, however, and was still somewhat down on the year in the fourth quarter as a whole. At least, there are signs that things are stabilising. Developments in the finishing trades were more unfavourable. Turnover in the third quarter (more recent information is unavailable at present) was 7% below that of the comparable period in 2002. Hours worked were nearly 8% down, in fact. Earlier, the minus figures had been even larger, however.

*Cautious
service
providers*

In the fourth quarter, the commercial service providers, who provide quarterly information on their economic situation and expectations in a Centre for European Economic Research survey, were somewhat more cautious again in assessing their situation. In terms of current trends in both demand and turnover, the reports were no longer as positive as they had been in the preceding quarter. Sentiment has deteriorated again of late, particularly among telecommunications services providers, management consultancies as well as technical consultancy and planning firms. IT service providers and the IT equipment trade performed better, however.

Turnover in the wholesale and retail trade – at constant prices – was down on the year at the end of the period under review. This applied

particularly to the retail trade, where the fourth quarter figure was around 2% down on 2002. The development in the wholesale trade was distinctly less unfavourable due, in particular, to increased turnover in solid fuels and refined petroleum. Durable and non-durable consumer goods also performed comparatively well, however. By contrast, the hotel and restaurant trade was faced with declining turnover up to the end of the period under review. Even though the declining year-on-year figures are gradually becoming less severe, there was still a fall of just over 3¾% on an average of the last three months of 2003. Restaurant businesses continued to be affected to an above-average extent. This shows that people are evidently slow to overcome their reluctance to eat out – a development that began against the background of sharp price increases in connection with the introduction of euro banknotes and coins. Furthermore, the persistently unfavourable developments on the labour market and in incomes are likely to have had a dampening impact.

The labour market continued to be characterised by persistent job losses during the last few months of 2003. According to the calculations of the Federal Statistical Office, the seasonally adjusted number of persons in work fell to 38.21 million in the fourth quarter of 2003. This was around 30,000 fewer than in the summer quarter and 235,000, or ½%, down on the year. Construction and industry remained particularly affected by the shedding of labour. Only a small number of new employment opportunities were being created on balance in the services sector as well, however. While there was a decline in

*Decline in
turnover in
wholesale and
retail as well as
in the hotel
and restaurant
trade*

*Continuing
reduction in
employment*

the number of persons in paid employment, more people took up self-employment, encouraged not least by increased labour market policy assistance, say, in the form of a one-person business.

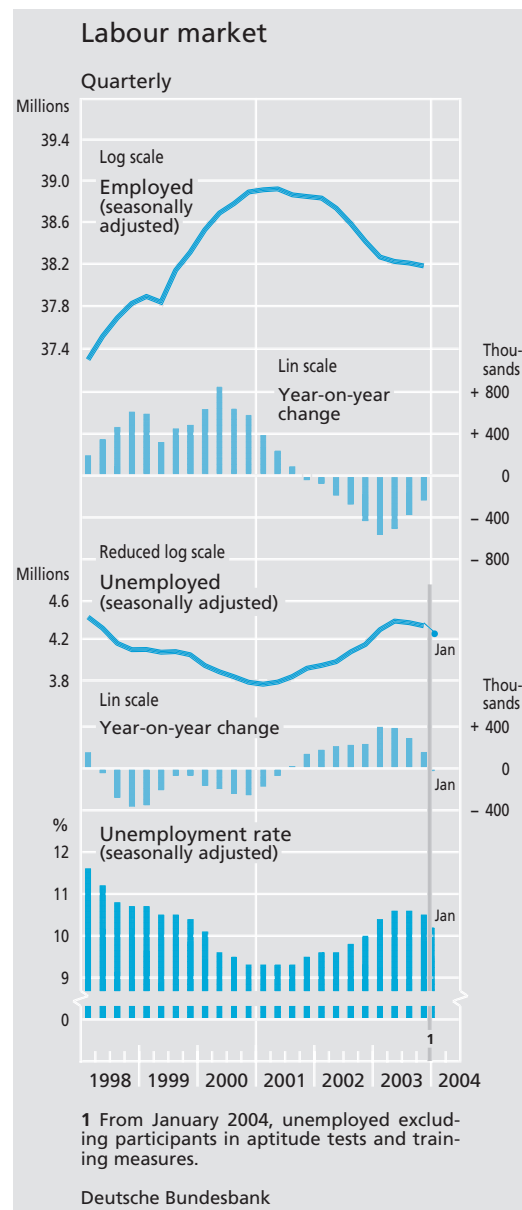
Falling unemployment

The seasonally adjusted number of persons registered as unemployed with the Federal Employment Agency has fallen since spring 2003. At the end of January 2004, the number was 4.27 million. This takes account of the change to the methodology, which means that persons taking part in aptitude tests and training measures (roughly 85,000 persons in December) are no longer included among the unemployed. The figure was 160,000 down from the most recent peak in May. The year-on-year increase, which had been as much as 400,000 in the second quarter of 2003, was followed by a 26,400 decline. The seasonally adjusted unemployment rate, as calculated by the Federal Employment Agency, was 10.2% in January 2004. Using the standardised European method, the relevant figure was 9.2%. The labour exchanges' efforts to filter out persons with insufficient commitment to finding a job from among the registered unemployed continued to be a crucial factor in the declining official unemployment figure. During the last three months of 2003, no less than around one-quarter of all de-registrations from unemployment were connected with this.

Orders

Upturn in demand...

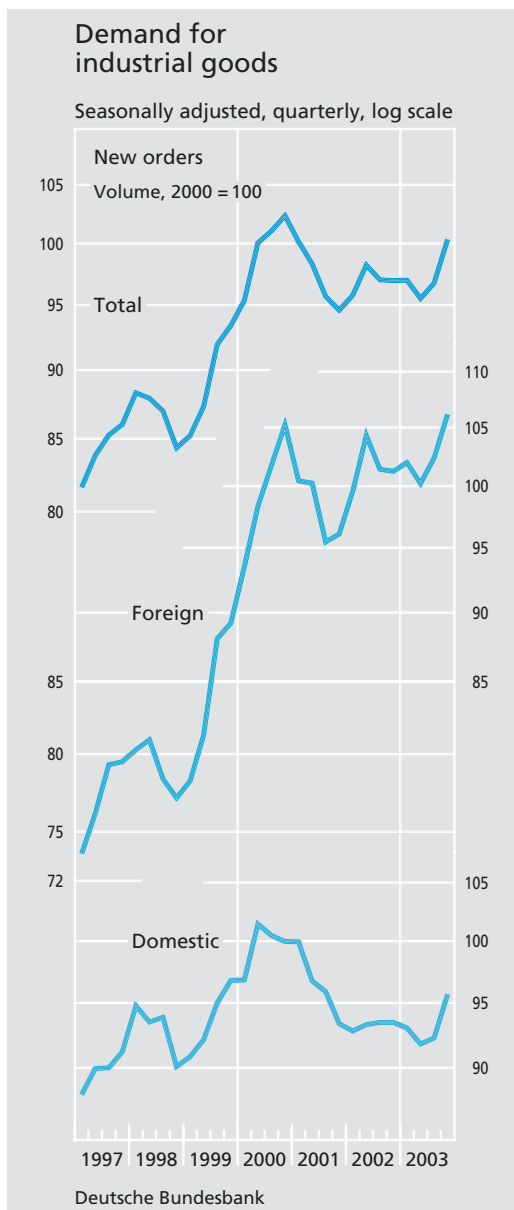
New industrial orders showed a marked increase after the end of last year's summer



holidays. In the fourth quarter of 2003, they were a good 3¾% higher, after seasonal adjustment, than the average level of the period from July to September. Orders were some 3½% up on the year, having been somewhat down over 12 months in the third quarter.

Domestic demand, which had been largely stagnant in summer, showed a sharp rise at the end of the period under review. In sea-

... both in Germany...



sonally adjusted terms, growth in the last three months of the year amounted to 3¾%. The year-on-year rate jumped from -1¼% in the third quarter to +2¼% in the fourth quarter. The fact that new orders were concentrated particularly on the October and November period points, firstly, to the effects of catching up on the summer holiday period and, secondly, to orders being placed early in view of the upcoming Christmas period. The

intermediate goods sector recorded the strongest surge in orders at a seasonally adjusted 4¾%, showing, for the first time in some while, growth in year-on-year terms at 2¼%. The lead was taken by the iron and steel industry, where orders went up by one-tenth. Manufacturers of electricity distribution and control apparatus achieved an increase of 4¼%. There was a 3½% seasonally adjusted rise in demand for consumer goods. This largely offset the downturn in orders in the first three quarters of 2003. Orders for capital goods also picked up in the last few months of the year, albeit only to a below-average extent. Quarter-on-quarter growth was 2¾% after seasonal adjustment. The increase on the year was almost 3½%. Although the flow of orders for machinery and equipment slowed down perceptibly again towards the end of the year, growth for the quarter as a whole was still around 7%.

Foreign demand for German industrial goods reached a peak in December last year when a whole series of major orders was put on the books. The fourth quarter as a whole produced a 3½% rise on the average of the July to September period, which had already brought an increase on the low in spring. The flow of orders was 5% up on the year, compared with no more than +1% in the third quarter. The increase in the case of consumer goods producers was particularly sharp. There was buoyant demand especially for consumer goods, including textiles and textile products. Growth in the capital goods sector was also quite strong. Manufacturers of machinery and equipment, in particular, were faced with a whole series of major

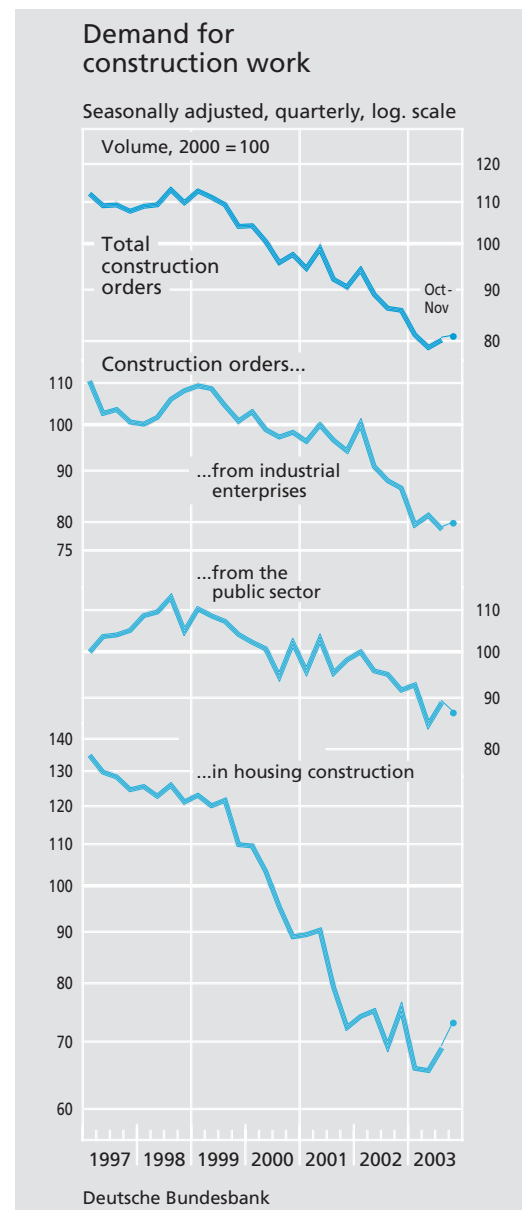
... and from abroad

orders, resulting in a seasonally adjusted surge of more than 10% in the fourth quarter as a whole. Furthermore, demand for motor vehicles picked up somewhat after being nearly stagnant for quite some time. Among intermediate goods, the manufacture of basic metals and fabricated metal products featured prominently, with orders being around 16% up on the quarter in seasonally adjusted terms in the final three months of 2003.

Construction demand largely constant

Demand for construction work remained largely constant in October and November. Although this meant that demand had recovered somewhat from the low in the second quarter of 2003, there has been no sign so far of a sustained improvement. This is due to the fact that, while housing construction orders have shown an increase, industrial customers remain cautious. No stimuli have been generated by the public sector either. Not least, a year-on-year decline of 6% reveals just how low the total intake of construction orders is. This was not much better than in the third quarter when the figure was 7½% down on the year.

Demand for housing construction in October and November was 5½% up on the third quarter in seasonally adjusted terms and roughly one-tenth up on the low level in the first half of 2003. This is likely to have been due mainly to the debate on cutbacks in assistance for housing construction. In order to pre-empt such a cutback, quite a number of building projects were embarked on more speedily. Taking construction permits as a yardstick, this principally concerned single-family houses. By contrast, there was little



demand for owner-occupied dwellings and properties with three or more apartments. It is likely that demand for owner-occupied houses will level off again in the current year.

Prices

Consumer prices went up quite sharply at the beginning of 2004. Having remained largely

Healthcare more expensive

The health reform and consumer prices

According to initial, provisional calculations, the sub-index for healthcare, which reflects the changes due to the health reform, went up in January 2004 by no less than some 17% on the month. This means that the overall year-on-year rate of consumer price increase rose to 1.2%. Excluding healthcare, the figure is estimated to have been no more than 0.6%.

A crucial element of the current reform is the partial changeover from contribution-funded goods and services to goods and services paid for by the consumers themselves. This leads to an increase in private consumption expenditure. For example, non-prescription drugs may generally no longer be prescribed at the expense of the statutory health insurance institutions (*Krankenkassen*). As a rule, they are to be paid for in full by the patient. Furthermore, many additional charges have been increased and a surgery charge has been introduced for the first time. Moreover, payments for certain items (such as spectacles and travelling expenses) will no longer be assumed by the health insurance institutions.

The health system reform has such a large impact on measured inflation because the consumer price index is based on households' consumption expenditure as defined in the national accounts. This includes solely that expenditure on which, in principle, consumers are able to decide freely. However, direct taxes and social security contributions – in this instance, compulsory health insurance contributions – directly reduce households' disposable income. The lowering of the health insurance contributions, which the reform is designed to achieve, therefore has a positive effect on incomes. Benefits provided by the health insurance institutions, which are funded from contributions, are classified as public consumption in the national accounts.

Under this classification, the consumer price index, following the net price concept, includes only the households' share of mixed-financed goods and services. In other words, the price of a medicine, for example, is the amount that has to be paid directly by the consumer. If there is a reduction in the payment made by the statutory health insurance institutions or restrictions are imposed on the eligibility for prescription of certain medical products and services, consumers' spending will increase. Given a change in the method of funding, the consumer price index will therefore show a price increase even if the market price of the medicine has remained unchanged. Much the same situation obtains in the case of medical services for which charges have been introduced for the first time.

In the national accounts, purely redistributing the funding of health services to households leads to a rise in private consumption expenditure, accompanied by a decline in government consumption spending. In much the same way, a decline in the deflator of government consumption offsets consumer price inflation so that the price developments of GDP, in principle, remain unchanged. As long as the producer prices of medical services do not change, a shift in spending has no impact on the general level of prices in the economy as a whole. In monetary policy terms, such a situation is to be assessed differently from, say, a cost-driven increase in consumer prices.

The same applies to wage policy if consumer prices are taken into consideration when pay demands are made. A price increase due to redistribution has no impact on the corporate sector's profitability nor on its ability to pay wages. The situation is different if – as is hoped – there is a reduction in health insurance contributions. Taken in isolation, this would mean an increase in the scope for income distribution. However, it is the explicit aim of the health reform to provide relief to employers in terms of their contributions to health insurance as non-wage labour costs and, by extension, total wage costs are seen as being at a high level that obstructs employment. For that reason, it would be inappropriate to fully exploit the expanded scope for income distribution in wage bargaining.

There are good reasons to hope that the health reform will lead to greater efficiency within the health system. Since the price of medical products and services to be paid directly by the consumers will go up considerably in many cases, it may be expected that there will be a more sparing take-up. For example, visits to the doctor that are not absolutely necessary will be reduced and demand for more cost-effective generic drugs will increase. If such saving and substitution effects do occur, the consumer price index will tend to overstate inflation from the point of view of a cost-of-living index since it is calculated as a Laspeyres index and, therefore, for a given quantity structure. With a (partial) non-take-up of those products which have become more expensive for the consumer, a Laspeyres index will give a non-representative inflation rate (because it is too high). Besides such quantity effects, there may also be some direct price effects if the suppliers of medical products and services respond to a fall in demand by lowering their prices. As part of the health reform, price controls for non-prescription drugs have been lifted and pharmaceutical products may now be obtained by mail order. Such direct price effects are therefore to be expected in the course of time.

stable in seasonally adjusted terms in the last few months of 2003, the index calculated on a provisional basis by the Federal Statistical Office showed a rise of 0.4% in January. This was due mainly to the increased additional charges as part of the health reform. (See the explanatory notes on page 48.) The charges are also the main reason for the year-on-year rate of increase of 1.1% in December going up to 1.2% in January. Leaving aside the "healthcare" category of goods, the year-on-year rate of price increase in January is reduced to 0.6%. A particular factor here is the baseline effect of the higher tax on energy and tobacco, which became effective on 1 January 2003. Furthermore, the customary price reductions for package holidays and hotel services following the Christmas holiday period turned out to be comparatively sharp, linked to the fact that households are showing less enthusiasm for travel.

Energy prices dampened by appreciation

The appreciation of the euro has more than offset the persistent rise in prices on the international markets for oil and refined petroleum products. This has had a dampening impact on energy prices. While spot market

prices for Brent North Sea Oil went up to well over US\$30 at the end of 2003/in early 2004, German import prices in December (more recent data are unavailable at present) showed a fall for crude oil as well as for petrol and heating oil. At the consumer level, this contributed to petrol prices remaining nearly constant in January 2004 and heating oil prices going up less than last year despite some spells of cold winter weather.

There was only a small increase in industrial factory gate prices on the domestic markets in the last few months of 2003. In December, they were 1.8% up on the year. A large part of this increase was due to energy. At the end of 2003, it had risen in cost by over 8% on the year, with the tax increases at the beginning of 2003 also playing a part in this. Excluding energy, industrial goods cost very little more on average in December 2003 than they had one year earlier (+0.2%). Construction work, too, was only marginally more expensive in the fourth quarter of last year than it had been 12 months previously (+0.1%).

Moderate price pressure at the producer level