

Economic conditions in Germany

Underlying trends

In the second quarter of 2005, the German economy maintained the level of activity achieved in the first few months of the year. According to initial calculations by the Federal Statistical Office, overall economic output in the second quarter matched that of the first quarter after adjustment for seasonal fluctuations and variations in the number of working days. However, the somewhat longer-term trend is more apparent if the first two quarters of 2005 are taken together; gross domestic product (GDP) rose by $\frac{3}{4}\%$ compared with the second half of 2004. The year-on-year increase was on the same scale.

GDP on flat path in the second quarter of 2005

In the second quarter, overall economic output was bolstered by a slight improvement in domestic demand. The positive development in investment in machinery and equipment continued in the second quarter, albeit at a slower pace than in the first few months of the year. The restraint in construction activity due to the cold winter weather, which had been discernable earlier, eased somewhat, although real expenditure on new buildings remained subdued. Higher imports are likely to have sharply increased stocks, especially of intermediate and consumer goods, resulting in inventory investment making a positive contribution to growth. Export activity also generated expansionary stimuli in the second quarter, although these were no longer as strong as in the first few months of the year, leading to a decline in net exports.

Increase in investment and exports

Seasonally adjusted private consumption fell again slightly in spring. This was due mainly



Private consumption in decline again

to weak sales in the traditional retail trade. After showing signs of a slight upturn in the first few months of the year, sales levelled off again in the second quarter. The year-on-year increase, which amounted to around 2% in the first quarter, went down to 1½%. On average, sales of petrol and heating oil between April and June were down on the same period of 2004. Persistently high prices are likely to have curbed demand. By contrast, seasonally adjusted new vehicle registrations recovered strongly in the second quarter from the very low level in the first few months of the year. At the end of the period under review, they were also somewhat up on the year again.

Output

After a very strong start to 2005, business in industry was more subdued in the second quarter. On an average of the period from April to June, seasonal and working-day adjusted output rose ½% compared with the first few months of the year. However, the year-on-year increase fell from 3¾% in the first quarter to 2¾% in the second quarter. While the basic and capital goods sectors were still able to step up their production somewhat in the past few months, consumer goods recorded a decline in output. Non-durable consumer goods were particularly affected, with both pharmaceuticals manufacturers and the clothing industry no longer performing so well.

Stable industrial output

Activity in major areas of the construction sector picked up again as winter receded, which had hindered production until well into March of this year. Adjusted for seasonal and working-day variations, construction output in the second quarter was around 2¼% up on the first three months of the year. The year-on-year fall, which had grown to just over 16% in the period from January to March, went back down to 6¾%. However, this was scarcely lower than at the end of last year. This clearly illustrates the fact that the structural adjustment process, which affects construction more than civil engineering, has not yet been completed. The development in the finishing trades is also likely to have improved in the second quarter as winter-related restrictions came to an end.

Improvement in the construction industry



Wholesale more positive than retail

In the wholesale and retail trade sector, wholesale business was very favourable in the second quarter. First-quarter sales were already somewhat better than in the same period of 2004 and showed a further sharp increase in April and May. As has been the case for a while, this was particularly true of branches linked to the production sector. The performance of suppliers of machinery and equipment was better than average in this

context. Firms trading in consumer goods clearly performed less well. Sales of food, beverages and tobacco, in particular, were only modest. Much the same applies to the corresponding branch in the retail sector. Although sales increased year on year, in seasonally adjusted terms the second quarter did not quite match the figures for the previous months. This was only partially offset by substantially higher consumer purchases of textiles and clothing and buoyant demand for items from pharmacies and for medicinal and orthopaedic goods. According to the official statistics, which are based on a new index, second-quarter retail sales overall were slightly down on the first quarter.¹ At constant prices and after working-day adjustment, there was a year-on-year rise of 1½%. In the hotel and restaurant industry, the gradual improvement in the situation previously indicated by a reduction in the falls in year-on-year turnover does not appear to have continued in the second quarter. On the contrary, business has recently been further down on the comparable figures for 2004. This applies especially to accommodation services and, to

¹ Sometimes, the retail sales figures at the current end exhibit a relatively large margin of uncertainty. This is due to the procedure by which substitute data for figures unavailable on the relevant cut-off date are calculated for individual enterprises and incorporated into the index. In such cases, for the current month a value is used that is derived from the annual change over the last three available periods. This can produce unsatisfactory results if the pattern of working days and public holidays differs from that of the previous year. One recent example of this is that, unlike in 2004, Easter fell in March this year. Owing to the smaller number of shopping days in the reference period, the hypothetical annual rate is therefore understated for April. In addition, the makeshift calculation is based on a low sales figure last year because of the Easter holidays. An inaccurate assessment also occurs if there is a reversal of trend. Over time, as the missing reports come in, the accuracy of the statistics will increase.

a somewhat lesser extent, the restaurant and catering trade.

Largely positive developments in the services sector

In the transport sector, aviation firms, in particular, were able to expand their output. Although data on sales is currently available only for the first quarter, it may be assumed that this positive trend continued in the second quarter. For road-based transport firms, the negative results recorded last year were increasingly superseded by a more favourable development. The situation in communications remains positive. Although turnover growth was no longer quite as strong as it had been since the second quarter of 2004, when double-digit growth rates had been achieved, large increases continued this year. Among commercial service providers, the situation for providers of IT services and databases took a turn for the better in the second quarter after a difficult phase which persisted into early 2005. According to data from the surveys of the Centre for European Economic Research, the majority of reports on sales were positive again for the first time in more than six months. Tax consultants and auditors also recorded brisk business. Furthermore, services from consultancy firms as well as research and development companies were also in strong demand.

Labour market

Marked impact of labour market policy on the employed ...

Throughout the period under review, the labour market was strongly influenced by the effects of labour market policy measures, relegating cyclical changes to the background. The sustained increase in the number of per-

sons in work to date has been due mainly to the expansion of job opportunities. Previously, the increase in both mini-jobs and one-person businesses had made substantial contributions. According to the Federal Statistical Office, the total seasonally adjusted figure for the number of people in work went up to 38.92 million.² This was just over 70,000 more than at the end of the first quarter and 45,000, or 0.1%, more than 12 months earlier. Continued job cuts in industry and construction were offset by additional jobs created in the services sector, particularly by commercial service providers and in the health and social work sector. In quite a few cases, such employment is likely to be part-time, whereas it is probably mainly full-time jobs that have been lost in the manufacturing sector. The total number of hours worked (ie the total number of hours worked by all employed persons) is therefore likely to be only slightly higher than in the previous year after adjustment for working-day variations.

Labour market policy also had a marked impact on registered unemployment. Over the past few months, it has promoted a reduction in unemployment, with a large number of persons receiving social assistance having registered as unemployed at the beginning of the year as a result of the introduction of "unemployment benefit II". According to an estimate by the Federal Employment Agency, new registrations due to labour market policy at around 380,000 have now been followed

... and the registered unemployed

² The Federal Statistical Office has made a substantial downward revision to the existing employment figures, particularly those since the start of 2005. In January, the figure was revised downwards by 158,000 and by 111,000 in May.

by some 60,000 departures from the statistics. The total seasonally adjusted number of unemployed persons had fallen to 4.81 million by mid-July. This was roughly 410,000 more than in the same period last year. The seasonally adjusted unemployment rate was 11.6%, compared with 10.6% in July 2004.

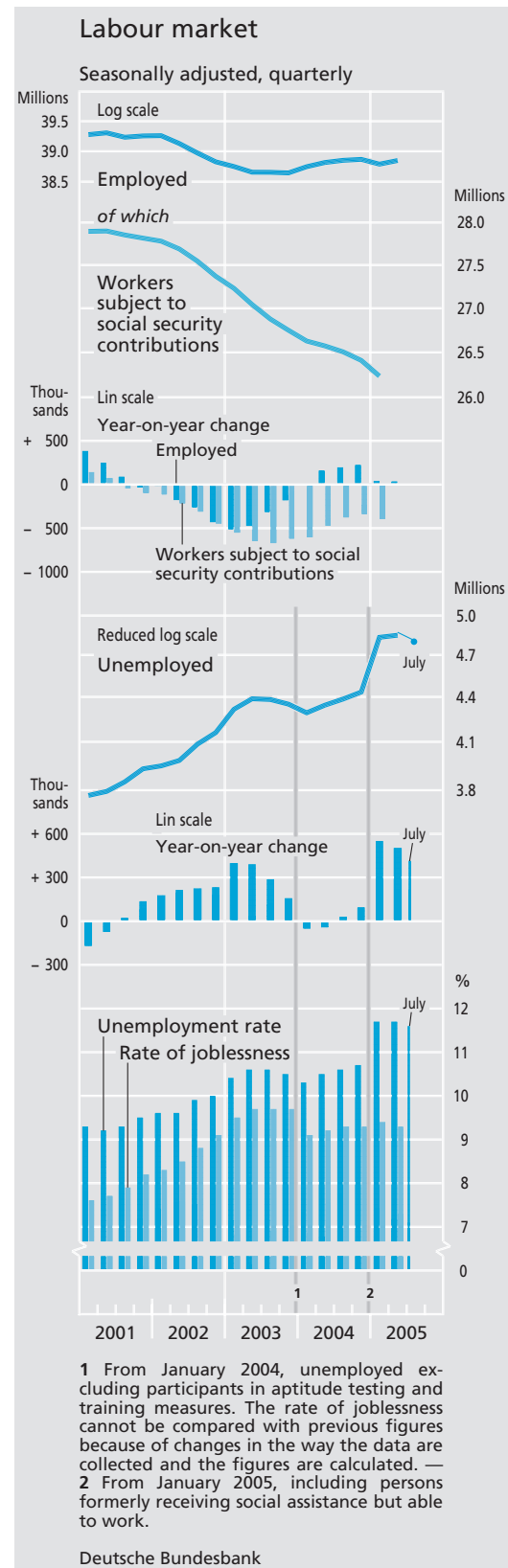
According to a telephone survey by the Federal Statistical Office, the seasonally adjusted number of persons out of work, calculated according to ILO³ criteria, stood at 3.92 million in June. This was somewhat down on the two preceding months. Since administrative effects do not have a great impact here, this is an indication that cyclical unemployment remained broadly constant in the second quarter. The seasonally adjusted unemployment rate in June was 9.2%.

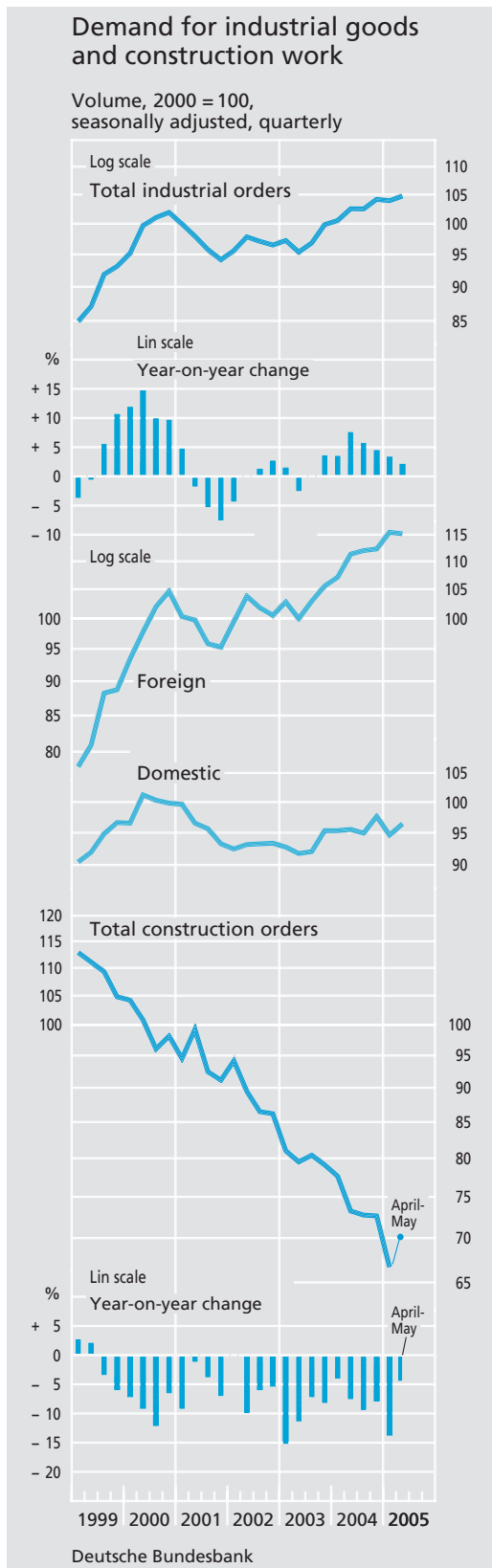
Demand

Slight increase in demand for industrial goods

Following a weak performance in April, demand for German industrial goods picked up considerably in the course of the second quarter. As a result, orders received on average over the three-month period were ¾% up on the quarter after adjustment for seasonal and working-day variations. However, the year-on-year increase slipped from almost 3½% in the first quarter to somewhat more than 2% owing to a fall in April.

³ According to the ILO labour force concept, an unemployed person is defined as someone between the ages of 15 and 65 who has not been in work during the reporting week (not even for one hour), is available to start work within two weeks and who has actively sought a job in the past four weeks.





Positive demand stimuli came especially from the domestic market in the second quarter. Orders within the consumer goods sector had already been increasing for some time and were boosted further by a rise in orders placed with capital goods producers. As well as a major order for other transport equipment, including aircraft, there was a rise in the number of orders for machinery and equipment, in particular, in June. Road vehicle manufacturers also added a large number of new orders to their books.

By contrast, export demand did not quite match its high level at the start of the year, when a series of major orders were received. Year-on-year growth fell from 7¾% in the first quarter to around 3½% in the following three-month period. Demand was no longer as strong, especially for capital goods. This was due mainly to a fall in orders for machinery and equipment. However, manufacturers of office machinery and computers were also affected. By contrast, manufacturers of intermediate goods reported a somewhat higher level of orders and, in the consumer goods sector, demand even picked up substantially on the weak first quarter.

Demand for construction work – which was affected by the winter weather in the first few months of the year – picked up again in early spring. On an average of April and May, new construction orders were around 5% up on the first quarter in seasonal and working-day adjusted terms. Nevertheless, they were still 3¾% down on the fourth quarter and 4½% down on the same period last year. This means that the recent more favourable devel-

Slightly higher demand for construction work

opment in orders should be seen as a return to normal after the winter break. This view is also supported by the fact that the number of housing construction permits was falling again at the end of the period under review. As a result, the discernible stabilisation of orders in housing in April and May is unlikely to be sustained. It was only in May that public sector customers placed a larger number of orders and, for the first time in some while, their volume was no longer down on the year. Although the increase in orders in commercial and industrial construction also resulted in a year-on-year rise, they were still considerably lower than in the final quarter of 2004.

Good demand for some service providers

Among commercial service providers, tax and business consultants as well as corporate consultants reported sustained strong demand according to surveys by the Centre for European Economic Research. Research and development services also met with keen interest. The outlook for architects and technical consultancy firms as well as in trade in information and communications technology products was, however, far less positive.

Wages

Only small "pay round"

As several multi-year wage agreements were concluded in many sectors of the economy in 2004, there will only be a small "pay round" this year. There have been no major surprises so far. The newly negotiated contracts largely follow the pattern of last year's agreements. The trend towards lower wage increases, the phasing-out of special payments under col-

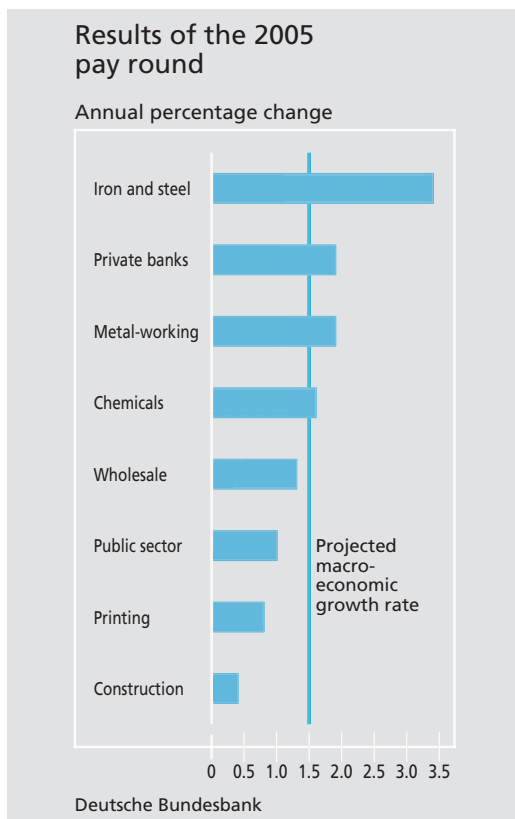
lective wage agreements, and longer working hours has continued. In addition, liberalisation clauses have increasingly been conceded in industry-wide collective agreements.

Negotiated pay rate rises in the first six months of 2005 varied between 0.4% in the construction sector and 3.4% in the iron and steel industry. As an overall average, there has been an increase of around 1½% for the year to date. In real terms, this corresponds to an increase in wage costs of roughly 1% given an expected rise of ½% in the gross value added deflator.

Sectoral spread of negotiated wage rates

This year's wage round was initiated by the public sector. The focus was on a fundamental restructuring of the 50 year-old legislation on collective pay bargaining in this sector. A key part of the agreement is a standardised pay table for wage earners and salaried staff, which unifies the existing wage and pay groups. In addition, the current age and seniority increments are being replaced by six "experience levels". During the transition to the new remuneration structure, which is likely to enter into force on 1 October 2005, compensation payments will ensure that earnings are not reduced (safeguarding of acquired rights). Moreover, a performance-related pay element will be introduced from 2007, which will initially amount to 1% of total pay and is scheduled to rise to 8% in subsequent years. Additionally, from October 2005, working hours can be increased to 40 hours at local government level in western

Public sector



Germany and to 39 hours at central government level.⁴

The new rates of pay will remain unchanged for all central government employees until the end of 2007. However, a one-off payment of €300 per employee is planned for each year. There will be no such one-off payments for local government employees in eastern Germany. Instead, gradual convergence towards west German rates of pay has been agreed. In eastern Germany, 92.5% of the level in the west has been achieved. An increase to 94% is scheduled as of 1 July 2005, which will rise to 97% by July 2007. Taking a representative pay scale for public sector salaried staff, the pay agreement results in an average increase in earnings in 2005 of just under 1%.

Higher wage increases were achieved especially in the steel industry. The new wage agreement recognises the high speed of development in the sector, caused primarily by the boom in global demand, with monthly one-off payments of €100 between April and August 2005 and a permanent 3.5% wage increase as of 1 September 2005. The average annual rise in negotiated pay comes to 3.4% in 2005 and 2.3% in 2006.⁵

Steel industry

A 2.7% pay increase is scheduled as of 1 June 2005. There is also to be a one-off payment of 1.2% of an employee's monthly salary each month for the duration of the wage agreement, to be paid on 28 February 2006. However, there is a liberalisation clause for this one-off payment stating that it may be postponed, reduced or withheld altogether in struggling companies by means of in-house agreements. This clause is intended to reflect the split development in the chemicals industry. Although large, export-oriented companies are performing strongly, in many cases smaller companies are suffering from weak domestic demand. Negotiated rates of pay will increase by 1.6% on average in 2005 and, including the one-off payments, by 3% in 2006. Without the special payment, the increase will amount to 1.1%. The west German agreement was adopted in eastern Germany and additional wage adjustments from 1 October 2006 (+1.5%) and 2007 (+1.6%) were agreed. The latter are designed to further the convergence of wages between the

Chemicals industry

⁴ This wage agreement applies only at the central and local government levels. An agreement for the federal states has not yet been reached.

⁵ These figures and those below are on a monthly basis and include ancillary agreements.

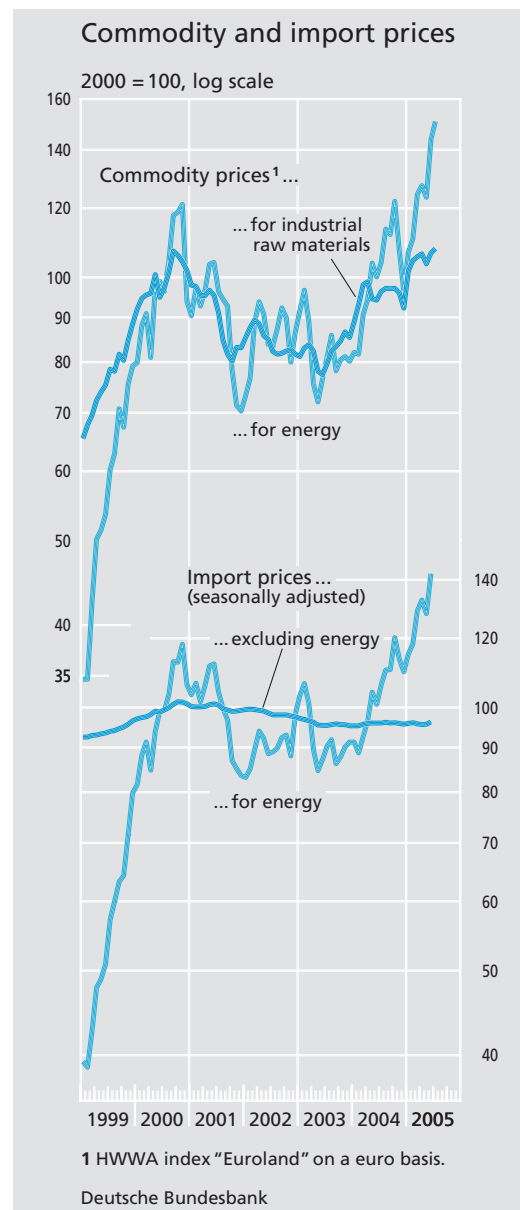
western and eastern parts of Germany. They mean that, on an annual average, the east German negotiated pay level in 2006 will rise by 5.7% including the one-off payment or by 3.8% excluding it – substantially more than in western Germany.

Printing industry

In mid-June, both sides of the printing industry agreed on one-off payments of €340 for the period from 1 April 2005 to 31 March 2006 and a permanent 1% pay increase from 1 April 2006. For the union, it was especially important to safeguard a working week of 35 hours in western Germany and 38 hours in eastern Germany in the national collective pay agreement. For that reason, significant wage concessions and a cut in various bonuses (eg for working on Saturdays) were accepted. On an annual average, negotiated rates of pay will go up by 0.8% in 2005 and 0.5% in 2006.

Construction sector

The wage increases agreed in the construction sector in western Germany were comparatively small. One-off monthly payments of €30 will be paid between September 2005 and March 2006. The negotiated pay rate will increase by 1% from 1 April 2006. At the same time, the working week will increase to 40 hours with no extra pay. Holiday pay and the minimum wage will both be lowered. On an annual average, negotiated monthly rates of pay will rise by 0.4% in 2005 and 1% in 2006. The construction industry is therefore at the lower end of this year's round of collective wage agreements, which is appropriate given the ongoing need for structural reforms.



Prices

Price movements in recent months have been largely driven by the increase in oil prices. With interruptions, quotations have been rising since the autumn of 2003. The last time there was a temporary stabilisation was in May this year, which was also reflected in German prices at various levels, ranging from imports to private consumption. The average

Sharp fluctuations in oil prices

Consumer Prices

Annual percentage change

Item	2005			
	Q4	Q1	Q2	July
Food	-1.0	-0.3	0.3	-0.1
Manufactured goods of which	1.8	1.2	0.4	0.4
Tobacco	16.2	19.4	10.7	10.7
Energy of which	7.1	6.8	8.3	11.7
Refined petroleum products	11.2	8.4	9.3	14.6
Gas	2.1	7.3	8.4	9.7
Electricity	3.8	4.1	4.3	4.4
Central heating, district heating	3.1	6.1	12.4	15.8
Services	2.4	2.2	1.9	2.0
Rents	1.2	1.0	1.1	1.1
Total	2.0	1.8	1.7	2.0
Total excluding seasonal products, energy, tobacco	1.3	0.8	0.8	0.8
<i>Memo item</i>				
Harmonised Index	2.1	1.7	1.6	1.9

Deutsche Bundesbank

spot market price for a barrel of Brent North Sea Oil in July was US\$58.08. The price occasionally rose higher, when reports about supply shortfalls in the Gulf of Mexico, Nigeria or Iraq created uncertainty. In mid-August, international oil prices hit a new record high of US\$65, or €52.50.

*Marked impact
of energy on
import prices ...*

After dipping slightly for a time, seasonally adjusted import prices in Germany went up more sharply again in June. The year-on-year increase, which had fallen to 2.2% in May, went up to 4.4%. Energy prices played a major part in this renewed upward pressure on prices. It was not only the prices of crude oil and refined oil products that went up – gas prices also continued to rise. Excluding energy, price movements would have been significantly smaller. The year-on-year figure

was no more than +0.3%. In both of the previous months, prices were still 0.3% below the corresponding figures for the same period in 2004. The recent slight price increase is likely to have been, in particular, a reflection of the euro's depreciation on the international currency markets.

After a temporary lull, seasonally adjusted domestic industrial factory gate prices rose again in June under the impact of rising oil prices. The year-on-year increase, which was 4.1% in May, grew to 4.6%. Excluding the energy component, prices did not rise by more than 1.9% on the year, which represents a slight decrease compared with the previous months. Price movements in the cause of capital goods were noticeably smaller, with prices in June no more than 0.9% higher than in the same month of 2004. At 1.3%, price increases for consumer goods were lower than average throughout the period under review. Price inflation in the intermediate goods sector continued to be comparatively steep, however. This is essentially due to the fact that crude steel and foundry products were about 13% more expensive than 12 months previously, despite a recent noticeable easing of price pressure.

*... at the
industrial
producer
level ...*

In July, seasonally adjusted consumer prices again rose somewhat more sharply than before. Year-on-year price inflation went up to 2% from 1.7% in the second quarter. In July, the Harmonised Index annual rate rose from 1.6% to 1.9%. Energy sources also played a major role in consumer prices, as seasonally adjusted prices of other goods and services and of housing rents remained stable. Exclud-

*... and on
consumer
prices*

ing energy, the annual rate of price increase dropped to 0.9%. Manufactured goods played a particular part in this. Seasonally adjusted food prices were also lower in July than in previous months. For some time now, the annual increase in housing rents has been barely more than about 1%. It was only in the services sector that there were some price increases.

The increase in prices for construction work, which began last year not least because of the sharp rise in the purchase price for steel, petered out in the second quarter. The year-on-year increase, which had totalled 2% in the first few months of 2005, fell to 1.1% in the second quarter. In road construction, where steel is not widely used and which had therefore seen only small price movements earlier, the price increase was 0.3%.

*Increase in
construction
prices has run
its course*