

## Economic conditions in Germany

### Underlying trends

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Following a cyclical sideways movement in the second half of 2004, the German economy showed perceptible growth again in the first few months of the current year. According to the official statistics, which are based on revised data in line with the modified methodology described in the notes on page 36-37, real gross domestic product (GDP) in the first quarter of 2005 was 1.0% up on the final quarter of 2004 after seasonal and working-day adjustment. In year-on-year terms, this signifies an increase in overall output of 1.1%, compared with +0.5% in the final quarter of last year. The changes in the unadjusted figures, ie excluding the marked working-day effects, amount to 0.0%, compared with +1.3% in autumn 2004.

*Strong GDP  
growth in  
2005 Q1*

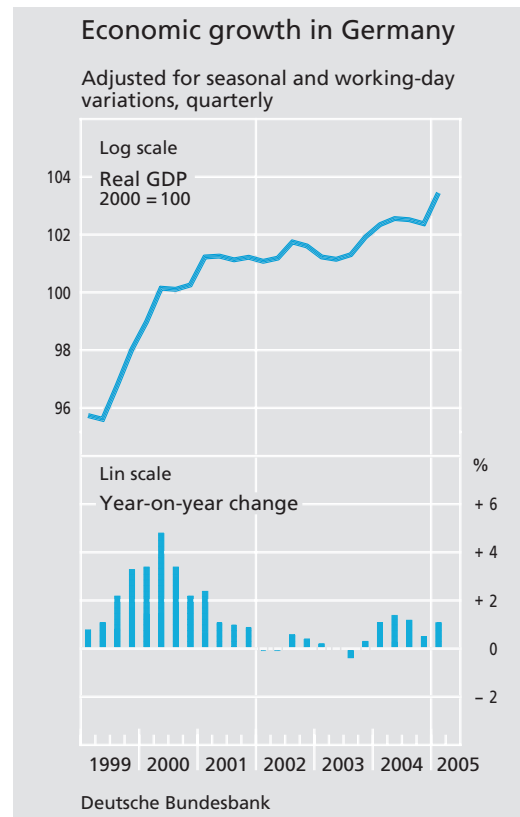
The major differences in the year-on-year rates reflect the fact that November and December 2004 clearly had more working days than the same months of 2003. On the other hand, the fact that Easter fell early this year had the opposite effect in March 2005. Working-day adjustment attempts to eliminate such differences in order to obtain a more reliable assessment of cyclical developments. Especially with regard to the current situation, it should be remembered in this context that a great deal of the data for March are still provisional or estimated. Moreover, adjustment calculations are fundamentally subject to uncertainty as the actual impact of a varying number of working days cannot be identified directly and adjustment has to rely on estimates on the basis of multi-year averages. It is in the nature of such estimation methods

*Working-day  
adjustment*

that the effects of changes in the flow and organisation of the production processes and in the current business and orders situation can be captured only approximately. The particular calendar features affecting the number of working days in the past two quarters along with greater flexibility in the deployment of labour and machinery as well as the widely varying orders situation in the different economic sectors suggest that the estimated effects are, if anything, exaggerating the working-day influences somewhat. As a result of this, the stagnation in growth in the final quarter of 2004 is possibly likewise overstated as is the subsequent recovery in the first quarter of this year. Under these circumstances, it may be assumed that the upward cyclical momentum is less than may seem to be the case at first glance when looking at the figures for the first quarter of 2005.

*Expanding  
foreign trade*

GDP growth in the first quarter of 2005 was sustained mainly by foreign trade. After a weak development in the last few months of 2004, exports of goods and services have clearly expanded again. As import activities declined during the same period, net exports have shown a sharp increase. By contrast, domestic demand was still generating hardly any stimuli. Despite picking up slightly in the last few months of 2004, construction investment has been on a downward trend for a long while and was hampered at the beginning of the year, not least, by the spells of cold winter weather. In contrast to the fourth quarter of 2004, purchases of tangible and intangible capital goods increased. It is doubtful, however, that this implies the start of a sustained improvement. According to Ifo In-



stitute data, for example, utilisation of available industrial capacity in March 2005 was no longer as high as it had been in December 2004.

The estimation of private consumption is currently made more difficult by the still-incomplete reorganisation of the retail trade statistics. Although the existing official data show a slight increase in sales, this outcome is very uncertain owing to the fact that the survey has only a low degree of representativeness. Despite an improvement during the first three months of the year, registrations of new cars are noticeably down on the level at the end of 2004, when a very large number of cars were purchased. Furthermore, the petroleum industry is reporting marked falls in the consumption of its products. Not only was there

*Restrained  
consumer  
demand*

## Revision of Germany's national accounts

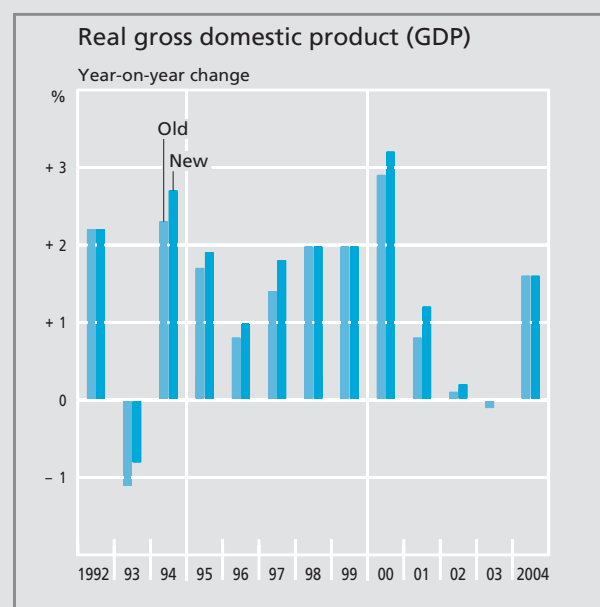
At the end of April 2005, the Federal Statistical Office published the results of a major revision of Germany's national accounts for the period from 1991 to 2004. Apart from the standard practice of including newly available basic statistical data, this revision involved, in particular, two conceptual changes by means of which legally binding directives issued by the European Commission were implemented in the official German statistics. This firstly concerned the changeover from a fixed-price basis to calculations based on the previous year's prices when determining real economic variables; in this connection, increasing use was also made of hedonic methods in measuring the prices that are adjusted for changes in the quality of goods. Secondly, the calculation and allocation methods for the imputed bank service charge were revised.

According to Federal Statistical Office data, the conceptual adjustment of the imputed bank service charge – now termed “financial intermediation services indirectly measured (FISIM)” – has, on balance, resulted in an increase in the level of nominal gross domestic product (GDP) of between 1.2% and 2.2% on an annual basis. The value of bank services is now no longer fully allocated to intermediate input, except in the case of producing economic entities. For all other economic entities, especially households, any financial services that are used are now counted as part of consumption expenditure and thus have an impact on the level of GDP. The same accounting practice applies to cross-border banking business. The banks' implicit service fee is thereby measured as the difference between actual and “pure” interest flows. The latter are ascertained using a hypothetical “pure” interest rate which is assumed to be identical for both deposits and loans.

As part of the revision, real variables are no longer calculated on the basis of fixed prices but on the previous year's prices with subsequent chaining. Under the previous fixed-price approach, the volume variables were evaluated using the average prices in a given base year. In Germany, this was most recently 1995. This approach does have the advantage that volume data can be calculated in the same way as value data. Under this concept, therefore, real GDP is determined as the sum of domestic expenditure plus exports and less imports. However, this advantage has a number of accompanying drawbacks. Firstly, the economic growth shown in the accounts is dependent on the chosen base year. Secondly, the volume movements determined in this

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way become less and less meaningful the further removed the period under review is from the base period. This is because the price structure in the base period tends to become less and less representative. Therefore, depending on the strength of price-induced substitution effects, this approach produces methodology-related distortions, which means that the published GDP growth rates tend to be too high.



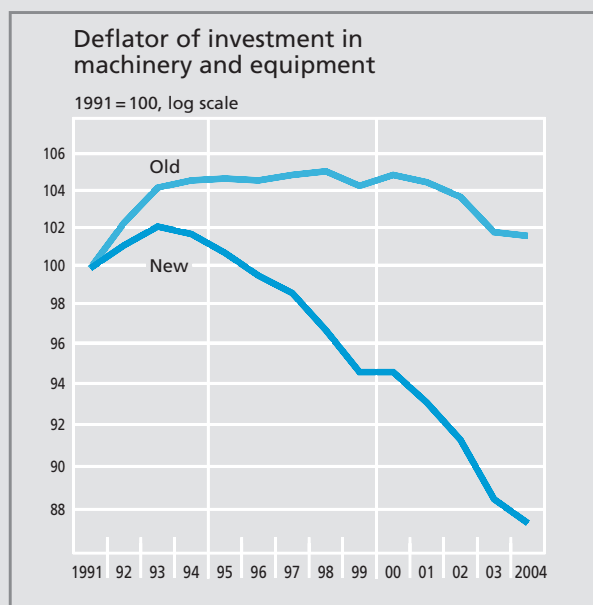
An obvious alternative approach is therefore to use the most up-to-date price basis possible in each case. This development was pioneered by the USA, which introduced an annually changing weighting as long ago as 1996. Following the revision of the national accounts, the volumes in Germany are now evaluated using the relevant average prices from the previous year. Although this no longer produces a continuous volume time series owing to the annually changing price basis and the associated breaks, the chaining of the relevant factors measuring the change – which describe the ratio of the volume evaluated at previous-year prices to the nominal values of the previous year – allows this jump to be eliminated. The outcome is a “chain index”, set at a standard 100 in the chosen reference year of 2000. A major feature of this chain index is that a subsequent changeover to a new reference year has no impact on the rates of change shown, for example, for GDP growth. Although the findings for the individual chain links are still additive, this is no longer the

case for the chain index – apart from the reference year and the following year. In other words, unlike before, real GDP cannot be derived from the summation of its components. The annually changing price ratios now also have to be taken into account in the aggregation.

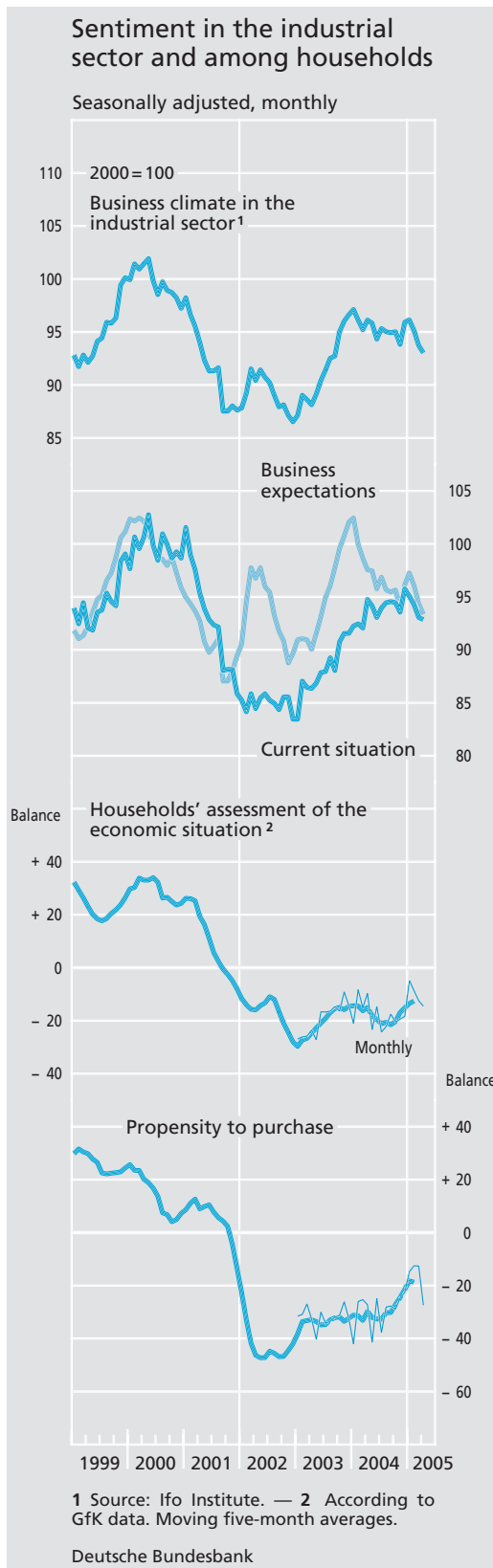
The chart on page 36 shows that the economic picture painted in Germany since 1991 remains largely unchanged even after the revision. Nevertheless, the new rates of change shown for real GDP differ from the previous data by up to 0.4 percentage point in some years. All in all, this now reveals annual average economic growth of 1.5% for the period from 1991 to 2004. Compared with the earlier calculation approach using 1995 prices, this represents an upward revision of 0.2 percentage point per year. This initially seems surprising as the changeover from a fixed-price basis to figures based on the previous year's prices should tend to lead to economic growth being shown at a lower level for the years following the earlier base year. The upward revision can be explained by the increased use of hedonic methods in measuring prices that are adjusted for changes in the quality of goods.

In the case of products with rapidly changing features, hedonic methods are particularly suitable for breaking down price differences between new and old variants into a "real" change in price and a (monetary) component for a change in quality. Following the introduction of price indices calculated in this way for PCs in the consumer price index in 2002, Germany's national accounts also applied such techniques to PC prices and not only in the area of private consumption expenditure, but also with regard to machinery/equipment, imports and exports so as to ensure consistency in the national accounts system. Moreover, since 2004, hedonic methods have been used for IT investment goods in the producer price indices, import price indices and export price indices. For reasons of temporal consistency, hedonically-determined price variables have now also been applied to past periods. The fact that greater account is being taken of these methods is likely to be a key reason why the price trend not only of GDP, but also of many expenditure components, now exhibits a flatter curve. Therefore, given a virtually unrevised average rate of nominal GDP growth throughout the revision period (+2.8% per year compared with +2.9% earlier), the calculation produces the somewhat higher growth trend for real GDP.

Sharp corrections have been recorded, in particular, in the prices of machinery and equipment, a large part of which consists of IT goods. Whereas the deflator of investment in machinery and equipment hitherto showed a slight rise in the period from 1991 to 2004 overall, the chart below now shows a distinct decline of 1% per year on average. Real expenditure on new machinery and equipment was sharply revised upwards accordingly. Whereas previous records suggested that 2004 was 5% down on the 1991 level, the new figures indicate that real expenditure on new machinery and equipment was recently 10% higher than in 1991.



The method involving annually changing calculations based on the previous year's prices is legally binding only for the annual national accounts. However, in order to ensure that there are no discrepancies between the annual national accounts and the quarterly national accounts, the Federal Statistical Office has adapted the calculation methods for the quarterly data accordingly. The economic picture hitherto painted for 2004 remains largely unchanged. Upward economic developments in the first half of the year – which are, however, shown to be somewhat weaker than before – were followed by a sideways movement in the second half of the year. Owing to the somewhat more favourable "statistical overhang", the annual result for 2004 still shows an increase of 1.6% in calendar-month terms or 1% after working-day adjustment.



comparatively little demand for petrol, owing to the high prices, purchases of heating oil were also cut back despite the continuing cold weather. Overall, this means that there was little change to the picture of subdued consumer spending in the first quarter of 2005 either.

After the fairly sharp expansion in overall output in the first quarter, growth in the following months is likely to have lost some momentum. One indication of this is that both industry and the construction sector failed to match their January level of business activity. According to the surveys conducted by the Ifo Institute, the business climate in trade and industry, too, deteriorated after the start of the year. An increasing number of firms were rating the current situation as well as the outlook for business less positively than before. Studies by the Centre for European Economic Research (ZEW) indicate that optimism among commercial service providers has likewise waned. This information points to a flattening of growth in the second quarter of 2005.

*Muted spring outlook*

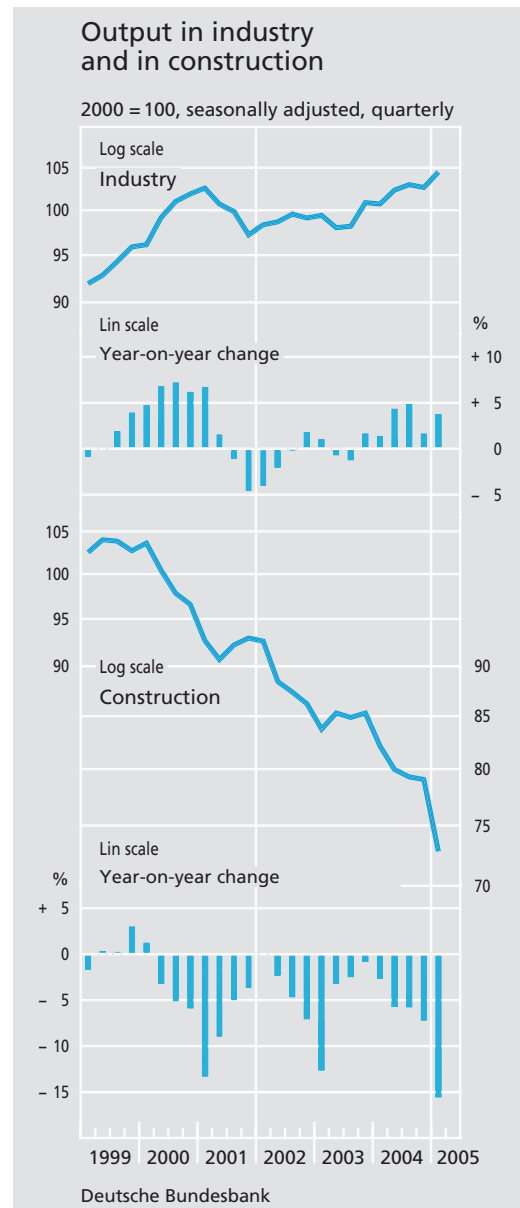
## Output and labour market

Industrial output in the first quarter was noticeably higher than in the fourth quarter of last year. In seasonally and working-day adjusted terms, the figure was around 1¾% up on the average level of the final quarter of 2004, in which the potential of the large number of working days was probably not fully utilised. The year-on-year increase went up to 3¾%. This was noticeably more than in

*Increase in industrial output*

the final quarter of 2004, when growth of no more than 1½% had been achieved.

The increase in production at the start of the year was higher than average in the case of consumer goods. In terms of durable goods, manufacturers of household electrical appliances and of television receivers and apparatus for telephony and telegraphy made a particular contribution to this. In the case of non-durable goods, along with pharmaceutical products and toilet articles, the clothing industry was to the fore, which was therefore able to compensate, at least to some extent, for the period of weakness in the second half of 2004. Production has clearly picked up in the food and drink industry, too. The year-on-year rise in output in the consumer goods sector, at 3¾%, was sharper than it had been for several years. There was also quite a strong expansion in the production of capital goods. There was a cutback in the manufacture of road vehicles, partly owing to technical problems with suppliers. However, this was more than offset by an improvement in the manufacture of machinery and equipment as well as in the case of computer equipment and office machinery. With a seasonally adjusted increase in output of just under 1% from the fourth to the first quarter, the performance of the basic goods sector clearly lagged behind the average growth in industry as a whole. The situation in the chemicals industry continued to improve, as it had been doing for some time. Given an extended period with a high degree of utilisation, steel production, however, appears to have reached the limits of its capacity.



In the construction sector, the mild weather at the end of 2004 and the beginning of 2005 meant that business activity was comparatively little affected by climatic conditions. Construction output in December and January was therefore quite high in seasonally adjusted terms. This changed with the onset of winter weather in February. As the weather in March was also cold, there was a marked decline in the number of hours

*Decline in construction output*

worked in these two months. In the first quarter of 2005 as a whole, seasonally adjusted output was almost 8% down on the final quarter of 2004 and was more than one-tenth down on the year. The decline in the finishing trades is likely to have been somewhat smaller since inside work is less dependent on the weather. Apart from these temporary negative effects, an end to the contractionary process of structural adjustment in the construction sector was still not apparent at the start of 2005 either.

*Positive development in sales in some sectors of the economy*

The situation in the wholesale and retail trade is likely to have improved somewhat in the first quarter of this year. This is suggested by the fact that year-on-year sales were more favourable than in the last few months of 2004. In the wholesale trade, it was not only business in machinery and equipment for the production sector that registered a positive development. Fairly sharp increases in turnover were also achieved in the case of durable and non-durable goods, which are largely destined for households. Whether the same applies to the retail trade must remain an open question at present since the available data – as mentioned at the beginning of this article – are subject to major uncertainty. At all events, business in the first few months of this year appears not to have been unfavourable. Statistical difficulties also make it harder to assess the situation with regard to hotels and restaurants. For this sector as a whole, the information that is available points to an improvement. At least, for the first time in some while, the year-on-year figure for turnover seems no longer to have been negative. According to the survey of the European

Centre for Economic Research, this is hardly the case for the commercial service providers. Their assessment of current business developments took a further slight turn for the worse. For the first time in a year, the firms reporting falls in turnover were in the majority. The negative balance was especially large in the case of architects, in IT services and in the communication and information technology (CIT) sector.

In the first few months of the year, the labour market was shaped to a major extent by the impact of administrative measures. Developments in employment continued to be marked by an increased use of government-assisted special forms of employment, such as one-person businesses, “mini-jobs” and one-euro job opportunities. As calculated by the Federal Statistical Office, the total seasonally adjusted number of persons in work had risen to 38.97 million by March. On an average of the first three months of 2005, there was a rise of almost 40,000 on the final quarter of 2004. This was some 200,000, or 0.5%, higher than in the same period of last year. The number of self-employed persons and persons assisting in family-run businesses, which amounts to around 4.4 million, rose within a year by over 140,000. According to provisional calculations, at the beginning of this year, 4.7 million employed persons were performing only low-paid part-time work, ie 135,000 more than one year previously. According to the Federal Employment Agency, around 120,000 recipients of basic social security (unemployment benefit II) were employed in one-euro job opportunities in April. By contrast, the beginning of 2005

*Employment marked by labour market policy measures*

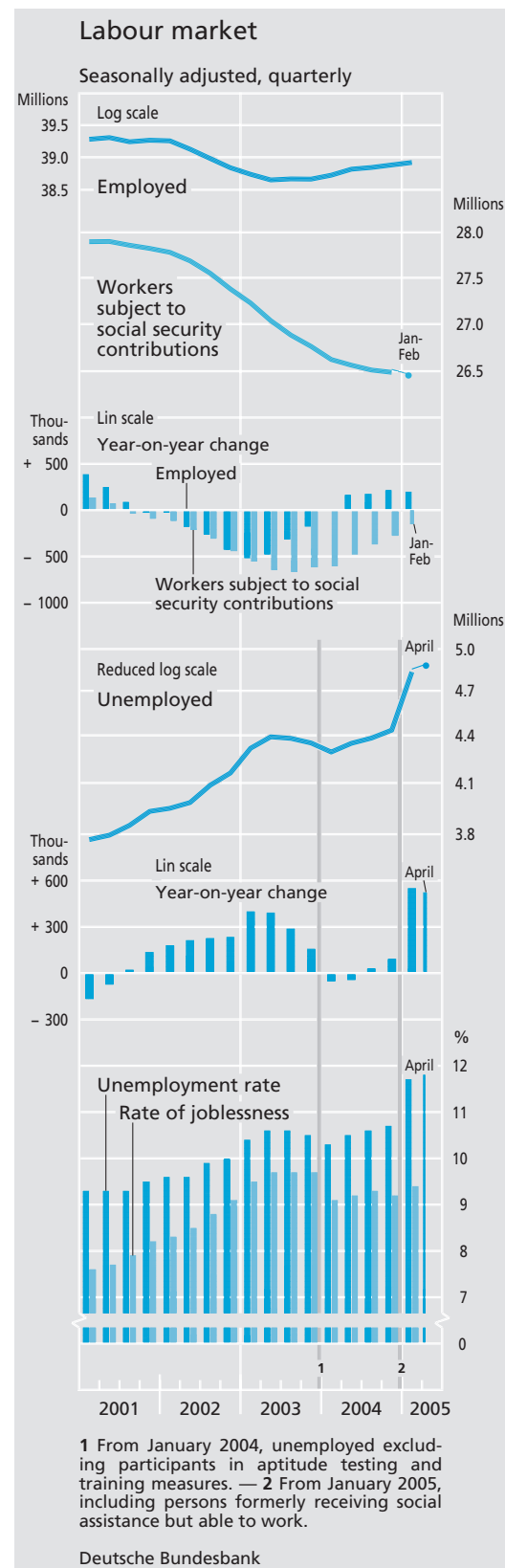
saw no end to the long-continuing negative trend in terms of employees fully subject to social security contributions. The figure in February was 150,000 lower than in the same month of 2004, which was probably due, in part, to a delay in the spring upturn on account of the persistent cold weather. In March, the number of persons employed under traditional work creation measures was around 50,000 lower than one year earlier.

*Persistent low labour demand in the economy*

The Federal Labour Agency's statistics on vacancies are also being increasingly affected by labour market policy measures. For example, the seasonally adjusted increase in registered vacancies since the beginning of this year is due mainly to the additional supply of one-euro job opportunities. If these are excluded, the number of job vacancies has probably shown hardly any increase. This is indicated by the fact that, according to the latest survey of firms undertaken by the *Institut für Arbeitsmarkt- und Berufsforschung (IAB)*, the Federal Employment Agency's labour market and employment research institution, the supply of jobs in the German economy as a whole has shown a further year-on-year fall. Although the survey refers to the fourth quarter of 2004, the demand for labour in the economy is unlikely to have picked up significantly in the first few months of the current year.

*Fall in unemployment owing to special factors*

Following a sharp January rise in the seasonally adjusted registered unemployment figure, the increase slowed down again in the two ensuing months. From March to April, there was even a slight fall to 4.89 million. This is not a sign of a cyclical improvement, how-





ever. Rather, one factor in the slight drop in registered unemployment is that the usual spring upturn was delayed until April owing to the persistently cold winter weather. According to the Federal Labour Agency, this may have affected roughly 50,000 persons in seasonally adjusted terms. Another factor is that no more former recipients of social assistance are likely to have registered as unemployed in April, which contrasts with the first three months of the year when there were some 380,000 registrations of this kind. A further alleviating factor was that around 20,000 former recipients of unemployment assistance, who are not granted basic social security because they have an adequate income, did not re-register.

The seasonally adjusted unemployment rate, as calculated by the Federal Employment Agency, was 11.8% in April, compared with 10.8% in December 2004. The seasonally adjusted rate of joblessness (which is calculated by the Federal Statistical Office in accordance with the ILO methodology on the basis of a telephone survey), at 9.5% in March, was only slightly higher than at the end of last year (9.2%). This is due to a seasonally adjusted increase of 135,000 in the number of persons out of work, which may probably be seen as being largely independent of administrative factors and therefore interpreted as a cyclical change.

## Orders

New industrial orders in the first few months of the year failed to match their peak of De-

cember last year, when some very large-scale orders had been received. In seasonally and working-day adjusted terms, the level in the first quarter as a whole was a good  $\frac{1}{4}\%$  down on the final quarter of last year. The year-on-year increase went down to  $3\frac{1}{2}\%$  from  $4\frac{1}{2}\%$  in the last few months of 2004. The main reason for the slowdown was the decline in domestic demand. On an average of the first quarter, domestic orders were around 3% down on the final quarter of 2004 in seasonally adjusted terms. The year-on-year figure was  $-3\frac{3}{4}\%$ , having been  $+2\frac{1}{2}\%$  in autumn last year. The performance of the capital goods sector was especially unfavourable. This was also due to the fact that demand for motor vehicles became more subdued again following a surge in demand in the last few months of 2004. Additionally, fewer orders were placed with mechanical engineering manufacturers and for steel and structural metal products. This contrasts with the consumer goods sector, where the orders situation has improved. Pharmaceutical goods and printed products were particularly in demand. In the case of intermediate goods, the positive performance of the chemicals industry contrasted with cutbacks in the manufacture of basic metals.

External demand remained buoyant up to the end of the period under review. The level of orders in the first three months of the year as a whole was  $2\frac{3}{4}\%$  up on the average of the fourth quarter. The year-on-year figure, at  $+7\frac{3}{4}\%$ , was, in fact, higher than at the end of last year ( $+6\frac{1}{2}\%$ ). The capital goods sector with its main representative – mechanical engineering – was clearly the best performer,

*Weakening  
of domestic  
demand*

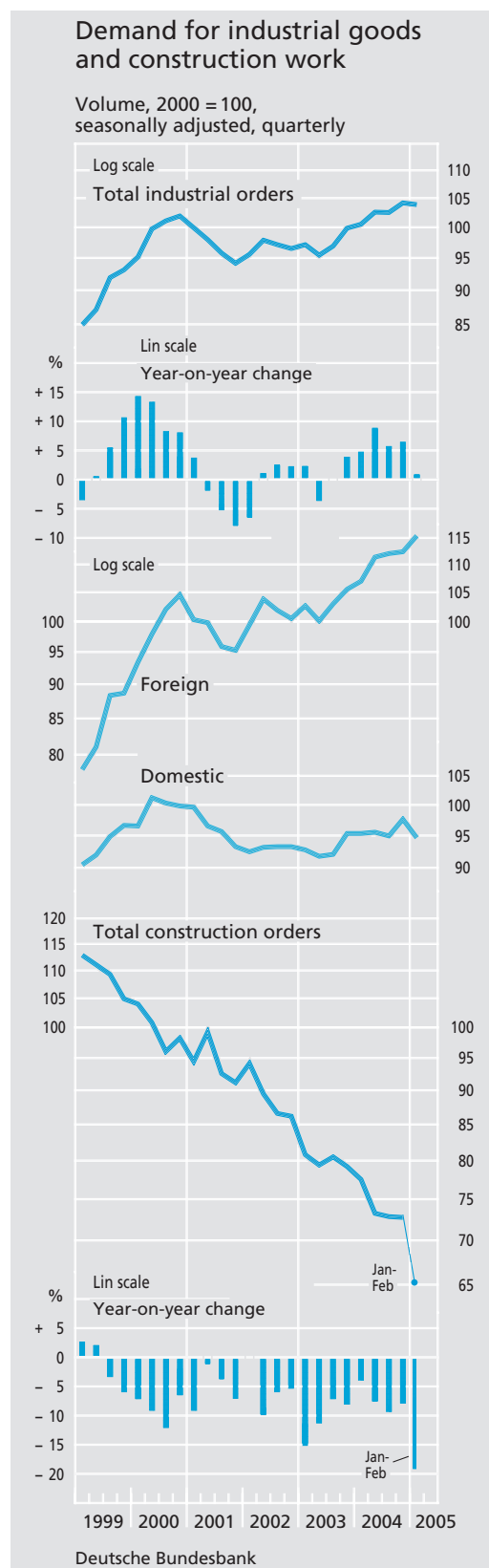
*Buoyant export  
business*

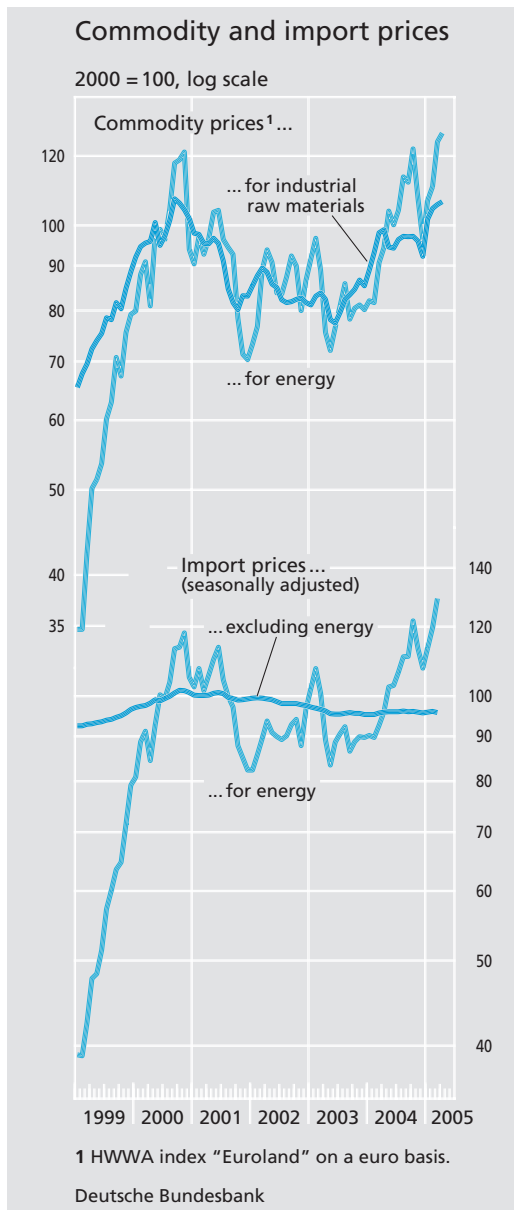
*Decline in  
construction  
orders*

along with structural metal products. By contrast, the improvement in the intermediate goods sector was on a distinctly smaller scale. There were, in fact, slightly fewer orders for consumer goods than at the end of 2004.

Demand for construction work, which appeared to be stabilising at a low level last year, showed a further marked decline in the first few months of the current year. In January/February, new construction orders were roughly one-tenth down on the final quarter of 2004 in seasonally adjusted terms and just over 15% down on the already low level in the same period of last year. This signals a further perceptible loss of level in ordering, even though this may be somewhat exaggerated by delayed orders owing to the persistent cold winter weather in February.

The decline in industrial construction was especially sharp. In the first two months of 2005, there was a seasonally adjusted fall of around 17% in this subsector, signifying a year-on-year decline of over one-quarter. The fall in demand for residential construction compared with the end of 2004 was not quite as marked (-8½%). Even so, the level of residential construction orders has halved in the past five years, while the other subsectors performed somewhat better. This applies particularly to public sector construction, where the longer-term drop in demand is “only” somewhat over one-fifth. Latterly, too, public sector customers’ restraint has been less marked. On an average of the first two months of this year, they reduced their orders by 5% in seasonally adjusted terms compared with the final quarter of 2004.





*Waning optimism of commercial service providers*

A clear majority of the firms among the commercial service providers surveyed by the Centre for European Economic Research in the first quarter of the year still rated the demand situation as positive. The assessments in the fourth quarter had been even more favourable, however. There was somewhat less optimism not only among firms of architects but also in the telecoms sector and among tax consultants and auditors. This was

not offset by the continuing improvement in the outlook for the advertising industry and research and development enterprises.

## Prices

Prices have continued to be strongly influenced by the energy sector recently. International oil prices seem to have eased somewhat from their peak at the end of March and in early April, when a barrel of Brent North Sea Oil was being quoted on some days at more than US\$55 on the spot markets. International oil prices had not gone down below US\$50 even at the beginning of May, however. From a European perspective, this corresponded to around €40 per barrel, which is also a very high level in historical terms. Along with the price of oil, gas prices, too, have risen sharply in Germany. Finally, electricity has become noticeably more expensive. At the end of the period under review, import prices were almost one-third up on the year. At the industrial producer level, the price of electricity in Germany was higher than at any time since mid-1999.

*Major impact of energy on the price climate*

The higher cost of energy has noticeably shaped import prices as a whole. The seasonally adjusted 2.3% rise between December 2004 and March 2005 and the 3.8% year-on-year price increase were attributable solely to energy. If energy is excluded, imported goods cost hardly any more in seasonally adjusted terms in March than they did at the end of 2004 and were only marginally up on the year. This was due to the fact that the persistent price reductions in the case of cap-

*Import prices ...*

ital and consumer goods largely offset the higher cost of intermediate products caused, in particular, by the higher prices for non-ferrous metals as well as iron and steel.

*... and industrial producer prices have gone up owing to energy*

There were similar, albeit not quite so marked, trends in German domestic industrial factory gate prices of raw materials and energy. Here, an overall year-on-year price increase of 4.2% contrasted with a price rise of 2.6% if energy is excluded. The increase in the prices of both capital goods and consumer products, at 1.2% and 1.4% respectively, was distinctly lower, while prices of basic goods and inputs went up 5.0% on the year. At all events, the sharp upward movement in the price of metals, which is the main factor behind the increase, seems to have eased somewhat compared with the peak at the start of the year, when the annual rate of price increase had reached 22.6%.

*Moderate consumer prices*

The overall year-on-year price increase at the consumer level in April was 1.6%. Excluding energy, the figure was 0.9%. The costs of energy, taken on its own, was 9% higher than 12 months previously. The sharpest price fluctuation was in light heating oil, which was 36.5% up on the year owing, not least, to the late spell of cold weather. Gas cost 8.0% more and the price of electricity was 4.0% higher than in the same period of 2004. Outside of the energy sector, services continued to show higher-than-average price increases. In April, services cost 1.5% more than at the same time last year. The cost of using motor vehicles have shown a particularly strong rise owing to a tax increase on cars that do not meet strict criteria for exhaust gases. By con-

## Consumer prices

### Annual percentage change

Item	2004		2005	
	Q3	Q4	Q1	April
Food	-0.6	-1.0	-0.3	0.1
Manufactured goods	1.6	1.8	1.2	0.4
<i>of which</i>				
Tobacco	12.2	16.2	19.4	10.7
Energy	6.1	7.1	6.8	9.0
<i>of which</i>				
Refined petroleum products	10.3	11.2	8.4	11.4
Gas	-0.2	2.1	7.3	8.0
Electricity	4.0	3.8	4.1	4.0
Central heating, district heating	1.4	3.1	6.1	10.7
Services	2.3	2.4	2.2	1.5
Rents	1.0	1.2	1.0	1.0
<b>Total</b>	<b>1.8</b>	<b>2.0</b>	<b>1.8</b>	<b>1.6</b>
Total excluding seasonal products, energy, tobacco	1.3	1.3	0.8	0.7
<i>Memo item</i>				
Harmonised Index	2.0	2.1	1.6	1.4

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trast, the prices of package holidays have been reduced perceptibly more sharply than is usual at this time of year. There has been a marked decline in the year-on-year figure for manufactured goods which was +0.4% at the end of the period under review. Although this is related to a base effect caused by last year's tobacco tax increase, upward pressure on prices in the case of many industrial goods, too, has been within narrow bounds. Clothing, household appliances and computers, in fact, cost less in year-on-year terms. In the case of food, seasonal products became much more expensive in February and March, mainly on account of the unfavourable weather conditions which affected harvests in many regions, including the Mediterranean. In April, prices returned to normal again, however. In the case of house



rents, the burden on households remained moderate up to the end of the period under review. In year-on-year terms, rent adjustments were no more than +1% on average.

The increase in construction prices has accelerated, however. In the first quarter, construction work cost 2.0% more than in the same period of last year. At the beginning of 2004, the rate of price increase was no more than 0.2%. This was due mainly to the dramatic

price increases for steel and steel products. In line with their differing use of steel, price developments vary among the individual construction subsectors. Road construction was least affected, with prices remaining nearly constant over the past 12 months. Commercial and industrial buildings, which have a relatively large percentage of steel constructions, were most affected with a 3.2% rate of inflation. Office buildings and residential construction were in mid-position.

*Construction  
work costs  
more*