

Overview

Continued strong upswing

The global economy continued to grow sharply in the final quarter of last year. It is now in one of its most dynamic periods since the 1950s. A major part in this was played by the ongoing rapid pace of expansion in the emerging market economies. The cyclical momentum of the industrial countries also picked up, however, following a perceptible downturn in the third quarter, especially in the US economy. The fall in oil prices, which gave a noticeable boost to consumers' purchasing power as well as providing relief for enterprises on the cost side, had an expansionary effect on global growth. Furthermore, the exceptionally mild winter weather had a positive impact on developments in the United States and Europe, especially benefiting construction output. The decline in oil prices in the fourth quarter triggered a simultaneous marked fall in consumer price inflation in the industrial countries. In the fourth quarter, the year-on-year rate of change, at 1.8%, was $\frac{3}{4}\%$ down on the preceding three-month period. However, domestic price pressure built up somewhat in the last few months of 2006. The core rate (excluding energy and food) stood at 1.9%, compared with 1.8% in the third quarter.

International setting

The financial markets were lifted by the brighter economic climate. The stock markets, in particular, were very buoyant with share prices in Europe climbing more strongly than in the USA. In autumn, the bond markets were characterised for a time by declining longer-term interest rates in the wake of a perceptibly more pessimistic assessment of

Financial markets

the outlook for the US economy following the slowdown in economic activity in the third quarter. Once the US indicators largely turned positive again towards the end of the year, however, long-term interest rates, too, started to move upwards. This rebound was especially apparent in the European bond markets. Starting in early October, the yields of European government bonds went up in total by just under ½ percentage point to more than 4%. This was accompanied by a marked appreciation of the euro, above all, in November and early December. Measured by its effective exchange rate, the single currency had gained around 1½% since the start of the fourth quarter.

*Monetary
policy*

The appreciation of the euro ultimately reinforced the dampening effects on prices in the euro area that were being generated on the external side. The year-on-year rate of increase in the Harmonised Index of Consumer Prices (HICP) for the euro area undershot the 2% mark for the first time since the first quarter of 2004, dropping to 1.8%. As mentioned above, this was due mainly to the sharp fall in energy prices. Prices of unprocessed food also went up less sharply than they had done in the third quarter. Excluding these two volatile components, however, prices rose somewhat faster in the final quarter than before. Although the short-term price outlook eased somewhat following the fall in oil prices and the firming of the euro in the foreign exchange markets, domestic price risks were tending to become greater owing to the pick-up in aggregate demand in the euro area. The risks to stability policy have increased, especially on the wage front follow-

ing the rapid growth in employment over the past few years. This is being reinforced by excessively strong monetary expansion, which is being driven by ongoing strong growth in lending, and which, in the longer term, points to inflation risks. For this reason, the Eurosystem's expansionary monetary policy stance was scaled back in October and December with an interest rate rise of ¼ percentage point in both months. Since then, the main refinancing rate has been at 3½%.

In the course of the the past year, Germany increasingly began to act as the euro area's economic engine. The German economy continued to grow sharply in the final quarter. According to the initial figures of the Federal Statistical Office, German output went up by 0.9% in the fourth quarter after adjustment for seasonal and working-day variations. This was 3.7% up on the year in working-day-adjusted terms. After factoring in the upward revision of the two preceding quarters, this now gives working day-adjusted growth of 2.9% for 2006 as a whole, compared with 1.1% for 2005. On a longer-term view, the German economy performed more successfully than at any time since 2000. Based on present knowledge, foreign trade again seems to have made a major contribution to the expansion of economic output. Real growth in exports of goods and services, which was already quite buoyant in the third quarter of 2006, quickened further in the final three months of the year. Overall, the external sector provided a considerable expansionary stimulus to the growth of the economy as a whole in the fourth quarter, reflecting both the persistently favourable inter-

*German
economy*

national setting and the fact that the German economy continued to be in a good competitive position.

Domestically, investment was on the up again. Given the continued growth in capacity utilisation, the desire to expand capacity is likely to have played a greater role in spending on machinery and equipment. This is borne out by the most recent Ifo Investment Test as well as the latest German Chamber of Industry and Commerce (DIHK) survey on investment. These reveal that, while replacement purchases are still the prime motive for investment, more and more firms are stating the wish to expand their capacity, particularly in industry and in the construction sector. The upbeat business sentiment in trade and industry offers further evidence of the positive trend in investment. Construction investment was additionally boosted by the exceptionally mild winter and was presumably given an extra fillip by the advanced processing of orders ahead of the increase in value added tax (VAT) at the start of 2007.

Private consumption still presents no clear-cut picture. As in the third quarter, retail trade sales (excluding cars) via traditional outlets remained quite subdued at the end of the year. Whereas anticipatory purchases in advance of the rise in VAT were evident for certain categories of goods during the period under review, this contrasted with lower spending elsewhere. In November and December, there was an extremely sharp rise in new passenger car registrations, however. But as the higher unit car sales were accommodated partly by depleting existing stocks, increased consumer

demand did not have an impact on production in the reporting period.

In the last few months of 2006, the underlying upward cyclical momentum was reflected in a sharp increase in employment and a sharp decrease in unemployment. Much of the growth in employment was recorded in business-related services, which includes temporary employment. According to Federal Employment Agency figures, there was a year-on-year increase in employment of nearly 265,000 in this sector in November 2006 – more recent data are unavailable at present – compared with a gain of 430,000 jobs subject to social security contributions in the economy as a whole. This in itself reveals that reforms to improve the flexibility of labour hold out the promise of considerable gains in employment. The positive trend continued at the start of 2007. The seasonally adjusted unemployment rate fell from 9.8% in December 2006 to 9.5% in January 2007. The figure one year earlier had been as high as 11.4%.

Labour market

The gratifying improvement in the labour market situation is, not least, the result of the moderate wage developments during the past few years, owing to which jobs in Germany have been safeguarded and new employment opportunities have been created in the ongoing cyclical upturn. In 2006, as before, negotiated rates of pay increased only slightly. On an hourly basis, their rise amounted to 1.1%, compared with 1.0% in 2005. There will be one large wage round in the first six months of 2007. Many pay agreements, mainly in major industrial sectors, are eligible for termination. Given the positive

Wages

economic situation, especially in the export-oriented sectors, wage bargainers will have to ensure that, as well as allowing employees to participate appropriately in firms' commercial performance, they take due account of the requirements of the economy as a whole when determining wage adjustments.

Prices...

Consumer prices in Germany showed hardly any further rise during the final quarter, although this was due mainly to crude oil becoming cheaper, which was reflected in falling fuel and heating oil prices. If energy is excluded, however, pressure on prices continued to mount. In seasonally adjusted terms, goods and services (including food and rents) were 0.6% more expensive in the fourth quarter, compared with 0.3% in the second quarter and 0.5% in the third quarter. This owed something to accelerated price adjustments ahead of the VAT increase on 1 January 2007. For example, the prices of tobacco products were raised by almost 5% as of 1 October 2006. The prices of some items of clothing, too, gave indications of accelerated price adjustments. Overall, prices of industrial goods (excluding food and energy but including tobacco products) were 1.0% up on the quarter, compared with 0.2% in the two preceding quarters. By contrast, the increase in prices for services and housing rents remained quite moderate (0.4% and 0.3% respectively). According to both the national index and the HICP, the year-on-year rate of inflation in the fourth quarter was 1.3% overall.

*... and VAT
increase*

There was quite a sharp rise of 0.5% in seasonally adjusted consumer prices in Germany

at the start of 2007. According to the national consumer price index, the year-on-year figure went up from 1.4% to 1.6% and according to the HICP from 1.4% to 1.8%. The fact that the rate of price increase was not greater, given the increase in the standard rate of VAT from 16% to 19% as from 1 January 2007, was due partly to the falling prices of heating oil. Furthermore, as was expected, the price effect of the VAT increase was not concentrated solely on the beginning of 2007. In addition to the accelerated price adjustments during 2006, lagged effects are likely to become operative over the course of 2007. Nevertheless, the prices of goods in January 2007 did not go down, as is usual for this time of the year, but went up instead, and the usual seasonal fall in the prices of services was smaller than on average in the past few years. According to the Bundesbank's estimates, the VAT increase may have contributed just under 1 percentage point to the annual HICP rate in January 2007, two-thirds of which may have been accounted for by January itself and one-third by anticipatory effects in the latter part of 2006.

The impact that the VAT increase will have on economic developments in the current year is still uncertain. This is suggested, at all events, by some sentiment indicators, such as the slight deterioration in the Ifo business climate in January and consumers' lower propensity to purchase. On the other hand, sentiment in the retail trade has not slumped and expectations have latterly even shown a further improvement. The relief afforded to consumers by lower oil prices suggests that this trend will continue. Along with markedly lower so-

cial security contributions, this forms a counterweight to the VAT increase. The continuing improvement in the labour market is even more important as a basis for a gradual and sustained strengthening of consumer demand.

Overall, the central government fiscal measures are likely to dampen economic growth at the start of this year. The German economy is on a sound footing, however. Following a temporary, slight interruption, economic activity could pick up momentum again in the near future. If fiscal and economic policymakers continue to pursue the path of reform and wage policy remains geared to employment, this, together with the strong underlying economic trend, will indeed give the upswing a longer-term perspective.

Public finances

These are favourable conditions for pressing ahead with the consolidation of public finances. In the past year, the situation of public finances improved and is now clearly more positive than was expected at the beginning of 2006. According to the initial provisional data of the Federal Statistical Office, the general government deficit ratio went down by 1.2 percentage points to 2.0%. This meant that it undershot the 3% ceiling stipulated in the EU Treaty for the first time since 2001. The sharp fall in the deficit was due mainly to

the favourable development of the economy and the exceptionally large rise in revenue from profit-related taxes, which is erratic and very volatile. By contrast, the debt ratio is likely to have remained largely unchanged. In the current year, the deficit ratio will probably show a further fall and the debt ratio is likely to record a marked decrease. The main reasons for this are measures on the revenue side and a moderate rise in expenditure.

Not least in order to bring the debt ratio swiftly down below the 60% reference value, it will be necessary to continue reducing the deficits at a rapid pace and to quickly achieve the medium-term objective of a structurally balanced budget. Under the German stability programme of December 2006, a deficit ratio of 1½% is planned for 2007. Given the more favourable outcome for 2006 and what is now assessed to be a decidedly more positive macroeconomic momentum, it should be possible to achieve a considerably lower figure. If the favourable economic trend assumed by Federal Government for the ensuing years were to be used appropriately in accordance with the requirements of the reformed Stability and Growth Pact and if an annual structural consolidation of at least 0.5% of GDP were to be ensured, a structurally balanced budget could be achieved in 2009.