

Overview

Cyclical upswing still intact

The robust momentum of the global economy persisted in the second quarter of 2007. Emerging market economies, in particular, expanded dynamically. The upswing in the industrial countries also continued at a considerable pace. Despite the spillover of tensions originating in the US mortgage loan market into the global financial markets over the past few weeks, the further global economic growth prospects may still be rated as favourable. Even so, risks for the world economy have increased with the ongoing adjustment process on the US real estate market. Furthermore, the oil markets' highly vulnerable state poses certain risks to the global economy and to the overall price environment. Continuing energy and food price increases were passed through to a large extent to the consumer price level in the second quarter. Prices in the industrial countries in the second quarter were consequently up 0.9% on the first quarter after seasonal adjustment. This amounts to an annualised inflation rate of more than 3½%.

International setting

Underpinned by the robust state of the global economy and market players' high level of confidence, stock prices and bond yields rose strongly at first in the second quarter. While predominantly positive company news and buoyant merger and acquisition activity pushed up stock price indices to multi-year highs, interest rates in the ten-year segment of the capital market rose by around ½ percentage point to 5½% in the USA and 4½% in the euro bond market by mid-July, partly in anticipation of higher central bank rates in

Financial markets

several large economies. However, after problems in the US mortgage loan market and the consequences for institutions investing both directly and indirectly in this market became increasingly apparent, investors' risk perceptions fundamentally changed. Stock prices consequently dropped considerably and interest rate spreads on riskier investments widened noticeably. Conversely, the "flight to quality" lowered the bond yields of top-rated borrowers. The continuing positive expectations for corporate earnings and robust growth tended to have a stabilising effect on the stock market. This is especially true of German equities, which have performed comparatively well to date, not least owing to the currently buoyant cyclical momentum. The euro remained very strong into July against the backdrop of the ongoing favourable growth prospects for the euro area. It was only recently that the euro started to weaken a little amid increasing uncertainty in the financial markets. Since the beginning of the year, the euro has gained slightly on average against a basket of 24 major currencies.

*Monetary
policy*

Although the euro's strength in the foreign exchange markets in the first half of this year supported European monetary policy to a certain degree, upward price pressure in the euro area resulting, in particular, from higher prices for crude oil and other commodities as well as for food nonetheless intensified. Overall prices rose by 0.8% from the first to the second quarter compared with 0.5% in the previous three months. In terms of monetary policy, future prospects are more important than current and past price developments. In spite of the interest rate adjustments that

have been made to date, the further outlook again appears less favourable. Strong monetary expansion, driven by the buoyant demand for credit, causes concern that the average increase in consumer prices in the euro area will clearly exceed the 2% mark over the next few years. The persistently high oil prices, upward pressure on prices for industrial raw materials and in the agricultural sector as well as increasing overall production capacity utilisation, together with the growing pressure on costs from wages, likewise indicate risks to macroeconomic stability that need to be taken seriously. The ECB Governing Council therefore further tightened the interest rate policy stance at the beginning of June, raising the main refinancing rate by $\frac{1}{4}$ percentage point to 4%. At the same time, the ECB Governing Council indicated that it intends to monitor ongoing developments with great vigilance so that it can take further measures if necessary. Correspondingly, interest rate expectations in the money market remained on the upside until this report went to press. During the past few weeks developments in the money market have been additionally overlaid by tensions connected with the problems in the US subprime mortgage market, particularly in the somewhat longer maturity segments. The Eurosystem successfully countered what was at times substantial pressure on bank liquidity by offering the banks generous refinancing.

The cyclical upturn in the German economy continued into the second quarter of 2007. According to initial figures from the Federal Statistical Office, aggregate output went up in the second quarter by 0.3%, after adjust-

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economy*

ment for seasonal and calendar effects, compared with 0.5% in the first quarter. However, the statistically recorded slowdown of the pace of growth may in fact understate the underlying economic dynamics, particularly bearing in mind the impact of the fiscal withdrawal of purchasing power due to the VAT increase since the beginning of the year as well as the advanced purchases in 2006 not just of consumer durables but also of residential construction. The fact that growth has not come to a standstill in these circumstances may therefore be seen as a clear indication of the stronger endogenous base of the current upswing. This is supported by the further upward revision of GDP growth in 2006 by another $\frac{1}{10}$ percentage point to 3.1% (in calendar-adjusted terms), which was announced with the publication of the latest GDP figures.

The slower momentum of economic growth in the second quarter is also to be seen in the context of the dynamic construction activity in the early part of this year due to the mild winter. A “technical rebound” was therefore expected in this sector. By contrast, expenditure on machinery and equipment increased further in the second quarter. It was a mainstay of growth throughout the first half of the current year. Furthermore, private consumption is likely to have made a positive contribution to growth in the second quarter. Retail turnover through traditional sales outlets and purchases of cars, at any rate, developed more favourably following the dent in demand accompanying the rise in VAT. Lastly, foreign trade made another marked

positive contribution to macroeconomic growth in the second quarter.

Labour market trends continued to be promising in the second quarter. Although employment did not increase by as much as in the first quarter, comparisons with past economic upswings show that labour input is playing a greater role in the current upturn, measured by the increase in the total number of hours worked in the overall economy and the fact that employment intensity is higher. These are the first visible rewards of the wage restraint and labour market reforms of the past years. The number of unemployed fell in the second quarter by 97,000 to 3.84 million. This was 754,000 persons fewer than a year before. In July seasonally adjusted unemployment decreased by a further 45,000 persons. The unemployment rate decreased to 9.0%, compared with 10.6% a year earlier.

Labour market

The improved labour market situation has altered the existing wage bargaining conditions. Thus the labour agreements concluded so far this year vary distinctly according to industry, reflecting the different economic situation of individual sectors and the relative strength of sectoral bargaining positions. For example, the large pay rise agreed in the metal-working industry mirrors the exceptionally buoyant state of that industry, while the agreement in the printing industry is to be seen in the context of the more moderate economic growth that has been recorded in that sector. The protracted negotiations in the construction industry as well as at the principal railways operator, Deutsche Bahn, illustrate difficulties experienced in reaching a

Wages

consensus on both the employer and employee side. However, the settlement concluded at the major telecoms company, Deutsche Telekom, shows that even during an upswing employees are willing to make concessions with regard to the pay level and standard working hours if their jobs are threatened. As a whole, negotiated rates of pay in the second quarter of 2007 were up by 1.8% year-on-year.

Prices

Price movements in Germany were again significantly shaped by developments on the markets for energy and other commodities. However, the resultant pressure on prices was slightly eased by the appreciation of the euro. Owing to higher crude oil prices, German imports were nevertheless considerably more expensive in the second quarter. Import prices increased by 1.6% compared with the first quarter.

Consumer prices rose slightly faster in the second quarter of 2007 than in the first quarter. This was due not only to the continuing rise of energy prices but also to the impact of a jump in prices for a number of agricultural commodities and dairy products on international markets. Food prices were 2.0% more expensive year-on-year. Prices of industrial goods (excluding energy) increased by 1.7%. Services were 2.8% dearer over 12 months, mainly owing to the VAT increase and the introduction of student tuition fees. Taking the average increase of 1.8% in energy prices and 1.1% higher housing rents into account, the year-on-year rate of price rises for the second quarter of 2007 as a whole amounts to 1.9% as measured by the

national consumer price index (CPI). The corresponding measure of the Harmonised Index of Consumer Prices (HICP) is 2.0%. In July, too, the inflation rate amounted to 1.9% and 2.0%, respectively. In the coming months, significantly higher year-on-year rates of consumer price inflation are expected, not least owing to the baseline effects due to the comparatively low energy prices in the second half of 2006.

The outlook for a continuation of economic growth remains favourable. This is suggested, at all events, by the orders on hand and the relevant sentiment indicators. New orders increased further in the second quarter from a high level and the stock of orders on hand for many firms grew again. The relationship between the order volume in the order-based manufacturing industries and production capacity available indicates a further increase.

Outlook

Overall the available indicators point to a continuation of the positive underlying trend. Fixed investment is likely to benefit more during the course of the year from the high capacity utilisation in the industrial sector and the positive order situation, after the normalisation in the construction industry had temporarily dampened demand in the second quarter. The prospects of continuing strong export growth are also good given an increase in incoming orders from abroad and in view of German firms' high level of competitiveness and attractive range of goods. To date, the euro's higher external value has done little to curb exports. This is also due to the fact that today the German economy has a product range whose sales profile responds

far less sensitively and fairly slowly to shifts in exchange rate patterns. Moreover, world trade is continuing to grow most favourably.

Judging from the present perspective, the recent developments in the international financial markets give no cause to essentially revise this assessment of favourable fundamentals. The fluctuations associated with the problems in the US subprime mortgage market derive from the repricing of risks in market segments which were previously characterised by above-average growth. In principle, this adjustment to a changed risk landscape is a welcome return to the norm, although it did occur very abruptly. Moreover, some market segments experienced extreme nervousness and overreactions. It is therefore necessary to monitor the corresponding developments carefully, not least so as to help ensure an orderly risk repricing in liquid markets.

The dampening effects of the VAT increase could have a lingering impact on private consumption. The higher oil prices are likewise squeezing the purchasing power of disposable income. However, households' spending behaviour, which was temporarily constricted by their response to the VAT rise, should be bolstered more and more in the next few months by the improved situation on the labour market. The GfK index of consumer confidence has been developing positively since March, and income expectations in the second quarter were significantly higher than in the first quarter. Households' economic expectations show that the upswing is increasingly present in the perception of consumers.

The development in public finances is currently very positive. After the general government deficit ratio had already halved to 1.6% last year, a further marked decline is expected for 2007. Significant progress has thus been made in the consolidation of public finances and a balanced government budget is already possible this year.

Public finances

The fiscal balance could be somewhat more favourable in the coming year if the positive macroeconomic dynamics persist. According to the budgetary plans, however, no further improvement in the structural balance is likely. The reform of business taxation, which will come into force next year, will lead to extensive revenue losses. In addition, a certain acceleration of the rise in expenditure, which has been subdued over the past few years, is on the horizon. There is a danger that, as during previous cyclical upswings, the favourable course of budgetary development may be seized as a chance to make additional expenditure hikes or cuts in taxes and social security contributions without taking due account of the partially temporary nature of the improvement.

The positive overall fiscal picture should not obscure the fact that extensive consolidation measures are required not only for central government but also for some state and local governments. If the surpluses generated by some government entities (eg the Federal Employment Agency or individual federal states) were used for significant cuts in contribution rates or increases in expenditure, the partially unresolved budgetary problems

would resurface, also at the general government level.

The current favourable circumstances provide the opportunity to rapidly eliminate the continuing budgetary imbalances and to attain and lastingly maintain a balanced budget position in the medium term, in line with the goals of the European fiscal framework. After the excessive deficit procedure that had been imposed on Germany in January 2003 was

dropped in June owing to the country's favourable budgetary development, the non-binding preventative agreements of the European fiscal framework must now be rigorously implemented. In this way, Germany can set an example within the European Union and simultaneously strengthen the credibility of the Stability and Growth Pact, which was reformed not least owing to pressure from Germany.