

Overview

German economy began the year strongly, but price climate remains troubled

The global economic upturn continued during the first quarter, but lost some of its momentum. From a current perspective there is a good chance that the US economy will be able to avoid the slump into recession feared by some and that the corresponding negative impact on global economic growth will thus be more muted. However, it remains to be seen how rapidly and durably the economic and financial difficulties in the United States will be overcome. The pressure to adjust created by the distortions in the US real estate market is still high, and the situation on the financial markets remains fragile despite some rays of hope. At the same time, the global price climate has deteriorated significantly. The sustained strong growth in world market prices for crude oil and food since the beginning of the year is affecting consumer price inflation both in industrial countries and, to an even greater extent, in emerging market economies and developing countries.

*International
setting*

The international financial markets again encountered strong turbulence in the first few months of the year, although this has since subsided somewhat. Concerns about the soundness of several financial institutions and increasing fears about global economic activity initially caused global stock market prices worldwide to plummet; at the same time, the spreads on risky bonds reached new highs in some cases. A marked rise in risk aversion among investors prompted sizeable portfolio shifts into safe-haven vehicles, as had also been the case in the previous quarter, thus

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considerably squeezing government bond yields, which fell below 4% in the euro area compared with 4½% at the end of 2007. However, after the Federal Reserve eased access to liquidity and lowered its key interest rate again in mid-March, the markets rebounded and interest rates on the European capital markets rose up to 4¼% by the end of the reporting period. Against this backdrop, the euro performed comparatively strongly in the foreign exchange markets. It temporarily marked new highs against major currencies before relinquishing part of its gains towards the end of the period under review. On a weighted average, the euro gained 3% against the currencies of the euro area's major trading partners between the beginning of 2008 and the end of the reporting period.

Monetary policy

The fall-out from the financial market turmoil continued to set the mood in the euro money market, especially in the longer maturity ranges. Following reports from European and US banks of further write-downs on their structured loan portfolios, the risk spreads on unsecured money market interest rates have increased – considerably in some cases – since March 2008 after falling perceptibly at the start of the year. As in the preceding months, the Eurosystem countered these developments with various liquidity policy measures. Thus, it again provided banks with generous additional liquidity at the beginning of the reserve maintenance periods and enabled institutions to meet their minimum reserve requirements early (frontloading). Furthermore, the Eurosystem supported banks' somewhat longer-term liquidity arrangements by focus-

ing central bank lending to a greater extent on three-month and recently also six-month maturities. The continuation of additional three-month tender operations and introduction of the new six-month transactions did not increase the total refinancing volume, however. This underlines the special role played by liquidity policy operations – which should not be equated with a more expansionary European monetary policy stance – in supporting the smooth functioning of the euro money market. In the face of continuing tensions in the money and credit markets and the marked deterioration in the price climate, the ECB Governing Council has maintained its steady monetary policy course over the past few months. The minimum bid rate in the main refinancing operations (MROs) has consequently been kept at 4% since summer 2007.

Monetary developments in the first quarter of 2008 were again characterised by strong growth in money holdings in the euro area. At a seasonally adjusted annualised growth rate of 8½%, the pace of monetary expansion was down somewhat on the two-digit growth rates of previous quarters, however. The main driving force behind monetary expansion continued to be lending by euro-area banks to the private sector. Loans to the private sector rose by a seasonally adjusted annualised rate of 10% in the reporting period, thus matching the growth rate seen in the closing quarter of 2007. This development was driven not least by the more dynamic credit growth in Germany. The banking statistics data do not indicate any major constraints on credit availability in the private sec-

tor, which some observers had feared might ensue from the tensions on the money and credit markets. This appraisal is also confirmed by the German results of the Bank Lending Survey.

Nevertheless, the sustained strong monetary growth, driven primarily by copious lending to non-financial corporations, continues to give cause for stability policy concern. Inflationary risks are associated in addition with the overall robust state of the euro-area economy, the tightening of the labour market and, above all, the persistent price pressures emanating from the international crude oil and food markets. At all events, the strong upward thrust of consumer prices continued in the first quarter of 2008. The Harmonised Index of Consumer Prices (HICP) for the euro area was up by an average of 3.4% on the year; in April, the HICP measure of inflation eased only marginally to 3.3%.

In the first quarter of 2008, the euro-area economies grew by a seasonally adjusted rate of 0.7% vis-à-vis the final quarter of 2007. This development is attributable not least to the sharp increase in aggregate output in Germany. According to initial figures from the Federal Statistical Office, German gross domestic product (GDP) in the first three months of 2008 expanded by 1.5% on the quarter in seasonally and calendar-adjusted terms. Following a moderate rise of 0.3% at the end of 2007, the pace of growth picked up again considerably, and a substantial increase in overall capacity utilisation was recorded as well. The expansion in economic output was broadly based across the individ-

ual sectors. Industrial output was very robust and, given the comparatively mild weather, the construction sector was able to press ahead with processing the surge in orders received in the final quarter of last year. Business-related service providers likewise benefited from these two factors. As far as it is possible to tell, growth on the expenditure side continued to be sustained mainly by brisk investment demand and buoyant exports. Moreover, following its dip in the fourth quarter of 2007, private consumption regained some ground, which also pushed up imports.

The strong growth momentum seen in the early part of the year shows what potential the German economy still essentially has following an upturn extending over more than four years. The pace of output growth should be interpreted cautiously, however, as it cannot be simply projected forward given the special factors that boosted the good first-quarter result and the dampening effect on the German economy that may be expected from the slackening of global economic growth. This is consistent with the fact that, according to the Ifo Institute, sentiment in the industrial sector deteriorated significantly in April 2008.

Looking at the empirically quite robust relationship between the Ifo business climate indicator and the year-on-year change in GDP, the latest survey results provide some tentative evidence that growth in the German economy may be more subdued in the coming months. This is also suggested by technical factors, such as the weather-induced

shifting of production in the construction sector and the fact that Easter fell early, which may have led to higher sales figures being recorded by retail trade outlets in March. The – in some cases substantial – negative factors in the international setting are likely to be mirrored by more muted export growth. As a result, investment in machinery and equipment, which remained robust throughout the reporting period, may also lose momentum. Given the persistently high energy prices, the mainstays of growth in the German economy will, nevertheless, continue to profit both from the continuing stimuli from oil revenue recycling via the foreign trade channel and from the above-average growth in global demand for energy-efficient and environmentally-friendly technology, a sector in which the German economy offers competitive products. Furthermore, there are prospects that the process of recovery in private consumption – which was interrupted in the fourth quarter of 2007 – can be resumed. Consumers are likely to abandon their reluctance to purchase, especially if inflation abates. According to figures from the Gesellschaft für Konsumforschung (GfK), the consumer climate is currently benefiting from more optimistic income expectations that are solidly underpinned by the sustained improvement in the labour market and higher employee remuneration.

Labour market

The clear improvement in the labour market has continued so far this year and the available leading indicators suggest that this will persist in the near future – albeit not at the robust pace recorded to date. There was a further perceptible decline in the official

unemployment figure in the first quarter. At a seasonally adjusted 3.36 million, there were 211,000 fewer persons registered as unemployed than in the final quarter of 2007. This is equivalent to an unemployment rate of 8.0%, which is thus down by 1.5 percentage points on the year. However, there was no month-on-month decline in joblessness in April.

In the context of the much brighter employment situation, new wage agreements with higher negotiated rates – which in some cases clearly exceeded the levels negotiated in previous years – were concluded in a number of sectors in the first few months of 2008. According to the Deutsche Bundesbank's pay rate statistics, the year-on-year increase in wages in the first quarter of the year, at 2.3%, was double that recorded in the final three months of 2007. In the production sector, which benefited from flourishing export and investment activity, the overall increase in negotiated rates of pay (3.4%) was noticeably greater than in the more domestically-oriented service sectors. The higher wage settlements per se virtually rule out the prospect of any further positive stimuli for employment, and the 2008 wage round is not without risks to stability policy either.

Wages

Consumer prices (as measured by the national CPI) rose again sharply in the first quarter of 2008. The annual growth rate fell only slightly, from 3.0% to 2.9%, despite the dampening baseline effect due to the VAT hike of 1 January 2007. Energy and food prices again rose faster than the other com-

Prices

ponents (by 9.3% and 8.0%, respectively). The HICP inflation measure stood at 3.1%, as in the fourth quarter of 2007. When recalculated using a methodologically comparable basis to the CPI, the figure is even somewhat higher. In April, there was no further month-on-month increase in seasonally adjusted consumer prices, partly because the higher crude oil prices were not passed on in their entirety. Food price inflation eased. The cost of industrial goods (excluding energy) and rents increased only marginally. The year-on-year rate of price inflation (CPI) fell from 3.1% to 2.4% owing in part to baseline effects resulting from the introduction of university tuition fees in a number of federal states in April 2007, delayed price effects of the increase in VAT as of 1 January 2007 and the fact that Easter fell early. The HICP figure was 2.6% compared with 3.3% in March. A further rise in inflation rates is to be expected in the coming months.

Public finances

In 2008, the state of public finances is likely to deteriorate somewhat. After the general government deficit was reduced markedly in the past few years and a balanced budget was achieved in 2007, a slight reversal is expected in the current year. The cyclical setting will continue to make a positive impact owing to the beneficial economic growth profile from the point of view of general government. The unfavourable budgetary development is due more to structural factors such as, notably, sizeable cuts in taxes and social security contributions and, in addition, to a probable weak trend in revenue from profit-related taxes. The rate of increase in expenditure which, although still moderate, is higher

than in previous years, will not provide an adequate counterweight. The overall development is fraught with much uncertainty, however, owing to the financial market turbulence and increased risks to the macroeconomic outlook. The debt ratio, which in 2007 recorded a clear decline for the first time in years, is likely to decrease further. Nevertheless, the 60% ceiling stipulated by the EC Treaty will continue to be overshot. The public finance situation is likely to remain more or less unchanged in the coming year. A small structural deficit is again likely provided there are no additional increases in expenditure or cuts in taxes and social security contributions.

On the one hand, the outlook indicates that the structural general government deficits in 2008 and 2009 are likely to be low and that the budgetary situation should therefore be much better than in recent years. The debt ratio is also falling closer towards the 60% ceiling. On the other hand, it is becoming clear that it will not be easy to achieve the structural improvements in 2009 announced by the Federal Government in the latest stability programme. After adjustment for asset realisations, central government will probably again record a sizeable deficit next year. Contrary to the impression sometimes created by current fiscal policy discussions, there is therefore no scope for additional deficit-increasing measures without corresponding counterfinancing. Instead, policymakers should bear in mind the fact that the recalculation of the socio-cultural minimum subsistence level means that the relevant tax allowances (and possibly child benefit payments, too) as well as basic allowances will need to be raised

starting in 2009, and that subsequently a less favourable budgetary situation is to be expected. A substantial drop in revenue levels is also likely to result from 2010 onwards from the implementation of a ruling by the Federal Constitutional Court referring to the offset-

ting of health and long-term care insurance contributions against tax. These strains on public budgets could be borne more easily if a more favourable situation were to be achieved in 2009.