

Overview

Still no upswing

The German economy has been stagnating since the third quarter of 2004. Until then, German economic activity had been fuelled mainly by strong global economic growth and the ensuing buoyant foreign demand. Since those external impulses lost some of their initial momentum, the dynamics of the German economy have once again been shaped by persistently weak domestic demand. This was compounded by burdens resulting from the sharp increase in oil prices and the appreciation of the euro. According to provisional figures from the Federal Statistical Office, in the final quarter of 2004 real GDP actually declined by 0.2% on the quarter after adjustment for the usual seasonal variations and extra working days. Thus, the current figures are less favourable than had been expected in the light of the Federal Statistical Office's flash estimate a few weeks ago.

*GDP in 2004
Q4*

It should, however, be borne in mind when interpreting the first release of the national accounts data for the fourth quarter of 2004 that the working-day adjustment for this period had a strong downward impact on the recorded rate of change. Owing to the quirks of the calendar, there were more working days in the final quarter of 2004 compared with the average in previous years. If this factor is discounted, the figures show an increase of 0.4% instead of a decrease of approximately 0.2%. In so far as the additional working hours were not exploited for production to the usual extent, the adjusted output figure, although absolutely correct in terms of the number of working days, would under-

*Marked effects
of working-day
variations*

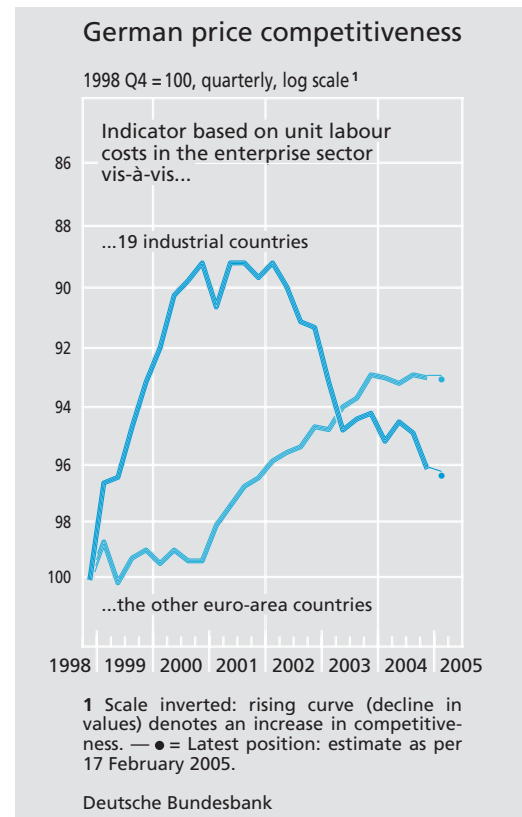
state the true cyclical position. The fact that the additional working days were concentrated in the last two weeks of the year, ie in the traditional holiday period around Christmas, supports this hypothesis. Quite apart from the uncertainties associated with this, however, there is no doubt that, after stagnating in the third quarter of 2004, the economic recovery again failed to make any progress in the final quarter of the year. Enterprises' investment demand appears to have weakened again following a sharp rise in the third quarter. Although there was a slight increase in private consumption, it is too early to conclude that this indicates a sustained increase in the propensity to consume.

Improved sentiment and expectations since the turn of the year

Nonetheless, there is no reason to be pessimistic about the outlook for the current year. Evidently, many consumers and investors subscribe to the view that the current flat movement will give way to renewed growth. Enterprises, in any case, began the new year with more favourable business expectations. This is particularly so in the case of the wholesale/retail trade sector. This may be due partly to the fact that, according to consumer surveys, there was a marked improvement in the mood among households in January. Individuals' expectations concerning their income and the economy turned positive and the propensity to purchase rose considerably. Although industry is somewhat more cautious about its export prospects than it has previously been, business expectations remain favourable.

External competitiveness

Despite the burdens resulting from the appreciation of the euro, the upward trend is clear-



ly expected to continue in this area, too. The German economy is benefiting from its presence in the most important growth regions in the world and from the restructuring and diversification of its production sites. The more intensive utilisation of the international division of labour through relocating certain production processes abroad is boosting Germany's competitive position, while simultaneously rendering it less susceptible to temporary exchange-rate fluctuations. In addition, the German economy has improved its competitiveness vis-à-vis the economies of the other euro-area countries by exercising cost discipline on the wage front. Measures to create greater flexibility in labour utilisation and more efficient production processes have also played a significant role. Measured by the development of relative unit labour costs in the

enterprise sector, since the start of monetary union German suppliers have improved their competitiveness by 7% compared with the other euro-area countries.

*Relaxed price
climate*

This is also reflected in the favourable price trend of recent years. The price climate has remained essentially relaxed in the past few months, too. In particular, external influences, especially the appreciation of the euro, have helped to ease inflationary pressures. The stabilising of oil price developments and the easing of prices on some commodity markets have been key factors in the decline, on average, of German import prices since October. At the consumer level, however, this decline was eclipsed up to the end of the year by the further increase in tobacco tax in December and the other tax measures which came into force beforehand as well as the effects of the health service reform. However, at 1.6% the rise in the consumer price index in January was down considerably on the year. Thus, price developments are bolstering the purchasing power of households' disposable income.

*New forms of
employment*

In view of the very subdued development towards the end of the year, there was little change in the labour market situation either. Rising unemployment was once again accompanied by an increase in employment, however the latter consisted mainly of "mini-jobs", subsidised start-ups ("Me-PLCs") or "one-euro jobs" that allow benefit recipients to earn a little extra income. By contrast, the number of full-time employees subject to full social security contributions continued to fall up to the end of the period under review. At

first glance, this might appear to indicate a trend towards the substitution of "normal" jobs with publicly subsidised forms of employment. However, a closer examination of the underlying changes shows that there is no basis for such a sweeping assumption. In general, jobs subject to social security contributions are not being eroded in the same areas in which government subsidised jobs or low-paid part-time work are simultaneously being created. These new forms of employment have provided a greater degree of flexibility on the labour market which has, in turn, created additional jobs (see p 37-40).

The sharp rise in the official unemployment figure at the start of the year to more than five million has led to a debate on the true scale of the unemployment problem in Germany. It certainly needs to be borne in mind that the (seasonally-adjusted) rise of 225,000 in the number of people unemployed between the end of last year and the end of January 2005 is due mainly to the first-time registration of persons previously receiving social assistance, even though they were without work beforehand, too. Thus, the rise in the official unemployment figure is purely of a statistical nature. On the other hand, it should not be overlooked that the shortage of competitive jobs in Germany is greater than the official unemployment figure immediately implies. The macroeconomic costs which this causes year after year are one of main reasons behind the current strained public finance situation.

*Rise in
unemployment
in January...*

*... of a statistical
nature*

Last year, the general government deficit remained virtually unchanged from its level in

*Large general
government
deficit in 2004*

2003 (3.8% of GDP). The lack of improvement was due primarily to a decline in revenue. Two key factors behind this were the extensive tax cuts made at the beginning of 2004 and the structure of macroeconomic growth, biased as it was towards exports, which yield less tax revenue than domestic economic activity. By contrast, expenditure was actually reduced, even in absolute terms.

*Need for
consolidation*

The general government deficit could go down significantly this year. The target of keeping within the 3% ceiling for the first time since 2001 seems feasible from today's perspective. However, major uncertainties, especially surrounding the macroeconomic development and the financial impact of the numerous fiscal policy measures, entail significant risks. The success of the consolidation efforts this year will hinge on expenditure growth remaining contained. This will require efforts from all levels of government. In the medium term, further consolidation measures are needed to reduce the government deficits, observe the national deficit ceilings and bring the debt ratio back down again. This is made more difficult by the fact that a large part of the planned deficit reduction for this year is intended to be achieved through one-off relief measures. The reduction of the deficit ratio to 1½% in 2008 envisaged in the

updated stability programme of December 2004 does not appear ambitious enough given the relatively optimistic assessment of macroeconomic development in that programme.

Monetary policy has maintained its expansionary stance in the last few months. In the fourth quarter of 2004, the money stock M3 grew at a (seasonally-adjusted) annual rate of just under 7½%, ie almost as strongly as it had done in the preceding three-month period. The main driving force behind this development is the strong growth in private credit which is, however, emanating less from the German economy than from the other euro-area countries. Given the ample provision of liquidity and the ensuing investment pressure, the tendency towards an easing of capital market conditions continued with little interruption. Thus, in the fourth quarter of 2004, long-term interest rates in the euro area clearly decoupled from the US dollar interest rate trend and fell to 3½%. They have almost gone down to their historical low reached in the third quarter of 2003. Thus, from a financing perspective, the conditions for private investors and consumers have become slightly more favourable still. The present monetary policy stance is thus not impeding an ongoing economic recovery.

*Expansionary
monetary policy*