The economic scene in Germany in summer 2004

Overview

Economic recovery still intact, but largely dependent on export business

Growth in second quarter ...

In the second quarter, the German economy again received a considerable boost from exports. The economic recovery, which had already become somewhat stronger in the first three months of this year, gained a little more momentum in the second quarter of 2004. According to initial estimates by the Federal Statistical Office, real GDP in Germany (adjusted for working-day and seasonal fluctuations) grew by 0.5% compared with the previous quarter. Including the growth attained in the first quarter (+0.4%), this gives an annualised growth rate for the current year of 1¾%. Consequently, overall average capacity utilisation is likely to have increased somewhat for the first time in nearly three years; hence the pattern of economic development seen in the first half of 2004 may well be described as a slight upturn.

... once again export-led

The upswing was again fuelled by exports in the wake of the expansion of world economic activity, which continued at a strong pace this spring. The world economy was still driven primarily by the two global centres of growth, the United States and China, although the economic growth rates in these two countries fell somewhat compared with the peak levels recorded at the beginning of the year. The Federal Reserve Bank as well as international organisations recently forecast US growth rates for next year of between 3½% and 4%. In addition, the global upturn has increasingly taken hold in other parts of the world, including the euro area, and as a result is now more broadly based.

Domestic demand sluggish

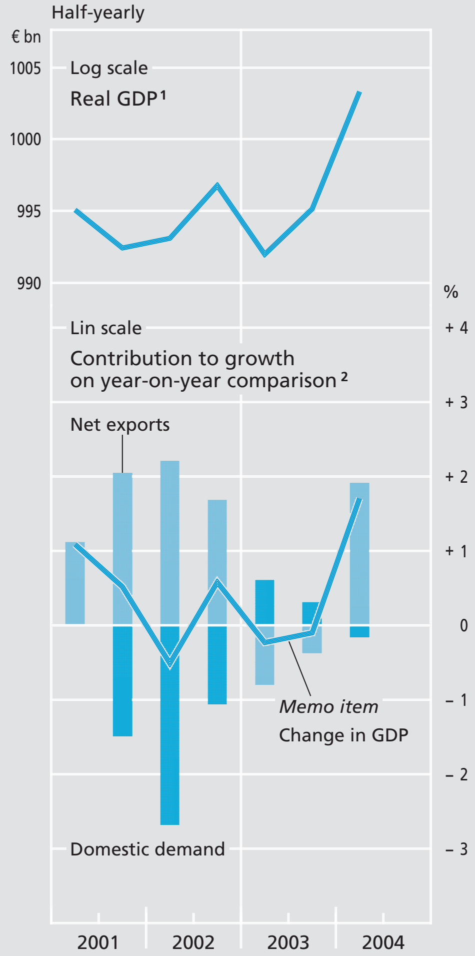
At the same time, however, the German economy's high dependence on external economic stimuli remains the "Achilles' heel" of the economic recovery. As previously, domestic demand provided little impetus in the second quarter, with the result that investment remained weak on the whole despite the cyclical improvement and favourable financing conditions. This was mainly due to the further drop in demand for construction work. Other fixed investment and investment in machinery and equipment remained stagnant. The situation was compounded by the fact that households remained very restrained in their consumer spending. Hence, the economy received no stimulus from this area either. Retail trade, in particular, is suffering from the persistently muted level of consumer spending, whereas some service industries have experienced a slight improvement in the past few months. This holds true for consumer-oriented sectors such as the hotel and catering trade but even more so for commercial service providers, which ultimately also benefited from the buoyant demand for German exports.

Uncertainty on the part of households

One of the main reasons for households' ongoing spending restraint is the widespread lack of economic confidence. The tense situation on the labour market and the poor condition of public finances, with the implications for future burdens on households in the form of taxes and social security contributions, are unsettling households' confidence in their income outlook. Evidently, the authorities have not yet managed to convincingly convey the necessity for and the future benefits of the large legislative reform package and hence to give households, in particular, greater planning certainty. Controversy particularly surrounds "Hartz IV", one of the key measures taken to improve the situation on the labour market.

Macroeconomic trends and demand profile

Half-yearly



1 At 1995 prices; adjusted for seasonal and working-day variations. — **2** Partly based on Bundesbank estimations using the unadjusted figures of the national accounts data from 12 August 2004.

Deutsche Bundesbank

Large public deficits

Measures to bolster confidence are also needed not least in the area of fiscal policy in the narrower sense of the term. After having risen in the past few years due to an unfavourable economic climate and extensive cuts in taxes and social security contributions, the general government deficit reached 3.9% of GDP in 2003, thereby exceeding the 3% limit stipulated in the Stability and Growth Pact for the second time in succession. From the present perspective, no significant improvements can be expected for the current year either. Given the burgeoning economic recovery, it is now essential to define the budget figures, at least for the coming year, in a way that convincingly conveys the willingness and resolve to consolidate public finances. This includes staying below the ceiling of 3% prescribed for the general government deficit. This requirement ensues not least from the commitments which were entered into within the framework of European monetary union and which were recognised by the representatives of all levels of government (for details, see box on page 64).

Scope for real spending squeezed by government measures and surging oil prices

In the past few months, the real scope for household spending has been additionally squeezed by higher consumer prices. The year-on-year rate of price increases in the second quarter averaged 1.7%. This largely resulted from the entry into force of the healthcare reform and the increase in tobacco tax at the beginning of the year. In addition, the cost of energy rose in the wake of the surging oil prices. In the past few weeks, the quotations for North Sea Brent crude exceeded US$40 per barrel. The primary cause of this price hike is the unusually rapid rise in the worldwide demand for energy. Oil prices are being additionally inflated by a "fear premium" in anticipation of possible production losses in the case of major suppliers in the Middle East, Latin America and Russia. In macroeconomic terms, the oil price hike represents a steep loss of real income for oil consumers and a gain for oil producers, a fact which per se will dampen growth.

Recovery scenario ...

The desired recovery in domestic demand in Germany could be additionally hampered by further oil price rises. The current level of oil prices is not jeopardising the general recovery, however, especially as most of the economic forecasts made before the recent price surge had already factored in relatively high oil prices for this year and next. Even so, a continuation of the rise in oil prices or a strong negative impact on market participants' expectations would pose a serious threat to the current economic scenario.

... and price outlook not basically undermined

On the price front, too, sustained oil price increases would also bear serious risks. However, the current level of oil prices does not warrant a fundamental correction of the price outlook for Germany. The average annual rise in consumer prices in Germany is likely to remain below 2% in 2004 and 2005, although this is based on the assumption that no second-round effects occur and that the primary impact on income stemming from the rise in energy costs is absorbed. This requires even greater wage restraint than if the situation in the oil markets were less acute.

Favourable monetary conditions

Stability-oriented behaviour on the part of all participants makes it easier for monetary policymakers to ensure price stability in the euro area in an environment of favourable monetary conditions. At the same time, the somewhat higher upside risks to prices in the euro area require further close monitoring in order to maintain confidence in stable prices both in the euro area as a whole and in Germany in particular.