The economic scene in Germany in spring 2004

Overview

Recovery continuing

Global economic upturn is firming

In the first few months of this year the global economic upturn grew both stronger and more widely based. The terrorist attacks in Madrid and the escalation of the situation in the Middle East had only a temporary unsettling effect on economic agents. Judging from the present perspective, there is a good prospect that, despite the high geopolitical risks, no serious disruption of the world economy will occur. According to the IMF's latest forecast, global output will expand strongly in 2004 by just over 4½%.

Major positives and risks

Business activity continued to be buoyed by favourable financing conditions, the bolstering of purchasing power thanks to moderate price movements and growing corporate profitability. Although the widely feared distortions on the foreign exchange markets did not materialise, risks will persist in this area unless and until the correction of the external imbalances also includes the pursuit of sustainable economic policies and the adoption of structural reforms. In addition, the continuing high level of crude oil and commodity prices is now jeopardising the global upturn. Economic expansion could be slowed down in the dollar zone, in particular, if the upward price pressures on the crude oil and commodity markets continue or even increase; but the latest oil price hikes have made themselves felt in the euro area, too.

Cyclical upswing in euro area slightly stronger

In the euro area the muted recovery which began last year strengthened slightly in the first quarter of 2004. According to initial estimates, real GDP grew by just over ½%. The upswing was driven by the buoyant foreign demand, although the revival of private consumption demand also played a part.

Stable price outlook

During the period under review the inflation rate in the euro area was affected by changes in healthcare and by tax increases. The increases in copayments from patients in Germany and the Netherlands and the raising of tobacco tax in some euro-area countries accounted for three-quarters of the overall rise of 0.4% in the Harmonised Index of Consumer Prices in the first quarter of 2004 compared with the previous quarter. The annualised rate of price increases during the quarter under review came to 1.7%. The price evolution of oil products and the aforementioned increases in taxes and administered prices were partly masked in the first quarter by baseline effects. According to Eurostat estimates, the inflation rate rose to 2.0% in April. In the longer run the inflation risks appear limited as long as there is no perceived danger of a sharp upthrust of external price impulses.

Slower monetary expansion

The previously robust pace of expansion of the money stock M3 has slowed further in the past few months; its annualised seasonally adjusted three-month growth rate amounted to 4½% during the reporting period and was thus in line with the Eurosystem's reference value. Although the accumulated excess liquidity harbours an inflationary potential, it is unlikely to become virulent in the foreseeable future given the low level of capacity utilisation and the favourable domestic cost trend. Against this background the Governing Council of the ECB decided to keep its key interest rates unchanged during the period under review. Consequently, monetary conditions in the euro area remained expansionary in the first quarter of this year and supported the recovery in the real economy.

Cyclical improvement continuing

The German economy, too, is slowly picking up speed. At any rate, the pace of economic expansion accelerated in the first three months of this year compared with the two preceding quarters. There is still no sign of a self-sustaining upturn, however. It is noticeable that macroeconomic growth in the first quarter was fuelled exclusively by external business, whereas domestic demand stagnated.

Internal momentum low

The salient feature of the current cyclical situation in Germany is households' entrenched consumption restraint, which looks set to persist for the time being. This is indicated by both the pattern of retail turnover and consumer surveys. Besides the further deterioration of the situation on the labour market and a subdued income trend, the continuous rise in the saving ratio – which was not evident during similar cyclical phases in the past – indicates that consumption is being dampened at present by both households' pronounced uncertainty and the greater need for making private provision for old age. If the high level of savings is be channelled into domestic investment, further structural reforms will be required that engender confidence in the policy makers' ability to master the demographic and fiscal challenges and create new earnings prospects. Up to now, however, the propensity to invest in Germany has been low. Investment in machinery and equipment, at any rate, is unlikely to have increased further during the period under review after seasonal adjustment. The earlier commencement of planned residential construction projects prompted by the reduction of subsidies to home buyers has now come to an end; consequently, construction investment, too, presumably fell somewhat, and this was reflected in a decline in the output of the building trade. A ray of hope, by contrast, is offered by the slight revival of the services sector, where banks and insurance corporations as well as commercial service providers are reporting a positive trend in turnover.

Further deterioration in labour market situation

The cyclical recovery was insufficient to have a positive impact on the labour market. The employment trend continued its downward slide in the first quarter, with the seasonally adjusted number of employed persons falling by 35,000 below the level at the end of 2003. The sharp drop in full-time employees was only partly offset by the increases in low-paid part-time working and in the number of self-employed. Registered unemployment also rose again in seasonally adjusted terms as the effect of tougher checks by the authorities on the willingness and availability of jobless persons to take up work petered out. The year-on-year fall is due solely to the changed statistical method of recording participants in aptitude tests and training measures, who have no longer been counted as unemployed since the start of this year. Without this methodological change unemployment in April would have increased by just under 20,000 over the past 12 months.

Inflation rate pushed up by exceptional effects

The rate of price increases in Germany, which remains moderate, accelerated a little in the first quarter of the year. The rise in the annual rates of consumer price inflation from 1.1% in December 2003 to 1.6% in April was caused – as was largely the case in the euro area as a whole – not only by the ongoing price growth of refined petroleum products but also, and more especially, by the increased payments in the context of the healthcare reform as well as the raising of taxes on tobacco products. If the product categories energy, healthcare and tobacco are disregarded, the year-on-year rate of inflation is reduced to 0.6%, compared with 0.7% in December 2003.

Parlous state of public finances...

The state of public finances deteriorated further. The combined deficit of central and state government (ie excluding local government) in the first quarter exceeded the already high prior-year figure. Nor does the outlook for the rest of the year indicate any fundamental improvement. At the moment it appears that the general government deficit ratio will more or less match last year's figure.

... marked by declining tax revenue

The main reason for the unsatisfactory development of public finances in the first quarter was the decline in tax revenue. This in turn owed something to the introduction of the penultimate stage of the income tax reform at the beginning of this year. Furthermore, it is now becoming apparent that the expectations associated with the subsidy cuts and revenue-boosting measures planned in order to counterfinance the earlier introduction of the next stage of the tax reform were overly optimistic.

European commitments need to be honoured in 2005

The deterioration of the underlying situation this year will also make it difficult to comply with the 3% deficit ceiling in 2005. Above all, revenue levels will remain low, in particular owing to the introduction of the final stage of the income tax reform at the start of next year. Given the importance of fiscal policy support to ensure the stability of the euro, further savings are needed on the expenditure side over and above those planned to date if the deficit limit laid down by the Stability and Growth Pact is to be met in 2005. Reallocations of financial assets, such as the disposal of participating interests, have no impact on the deficit as defined by the Maastricht criteria and, what is more, make no contribution to sustainable budgetary consolidation.