Overview

Strong external impulse, weak domestic demand

Buoyant start to the year

Following a flat cyclical evolution in the second half of 2004, the German economy picked up speed in the first few months of the current year. According to the calculations of the Federal Statistical Office, real gross domestic product (GDP) increased by the surprisingly strong rate of 1% compared with the previous quarter after adjustment for seasonal and working-day variations. The year-on-year growth rate likewise improved appreciably from 0.5% in the final three months of 2004 to 1.1% in the first quarter of 2005. That holds at least for the working day-adjusted figures. It should be noted in this context that the outcome for the fourth quarter of 2004 was significantly depressed vis-à-vis the unadjusted figures by the exceptionally high number of working days in that period, whereas the adjusted result for the first quarter of 2005 has been increased sharply compared with the unadjusted figure owing to the relatively low number of working days as this year the Easter holidays fell in March. Hence it appears likely that both the decline in the fourth quarter and the recovery during the period under review are somewhat overstated. But even after these possible statistical disparities are taken into account, there was a marked increase in macroeconomic momentum during the first quarter. This is borne out by the fact that aggregate GDP during the past two quarters (ie the fourth quarter of 2004 and the first quarter of 2005), over which these exceptional calendar effects largely cancel out, shows an increase on the previous two-quarter period of 0.4%.

External demand acting as dynamo

The main factor fuelling the economic recovery in the first quarter of 2005 was external demand. Although the pace of global economic expansion slowed somewhat in the early part of this year in the wake of the new record highs reached by crude oil prices and the expectation that the situation on the oil markets will remain tense, the negative cyclical consequences of the booming commodity markets have remained within bounds so far. Besides the reduced energy dependency of production in the industrial countries, this is doubtless due also in part to the fact that the additional revenues accruing to the oil-exporting countries are today apparently being recycled into a rising import demand on the part of the oil-producing countries faster than was the case in the past – from which the German economy and other oil-consuming countries are benefiting (see box on page 12).

Domestic demand still weak

The downside of this exclusively export-driven growth is the heavy dependence of current economic activity in Germany on the external sector. The pronounced global imbalances harbour risks which could adversely affect Germany, in particular, as its weak domestic demand offers an insufficient counterweight. In the early part of this year domestic demand remained fundamentally sluggish. According to initial data, private consumption provided no noticeable impetus in the first quarter despite higher retail trade turnover. Construction investment remained muted, partly on account of the inclement weather, and a sustained revival in investment in machinery and equipment is likewise not yet in sight.

Poorer sentiment and expectations

Judging by the surveys carried out by the Ifo Institute, business sentiment deteriorated in the course of the first months of this year. The announced intention to lower corporation tax rates constitutes an effort to improve the underlying conditions for entrepreneurial activity and more employment. The efficacy of such an initiative would be enhanced especially if it were perceived not as a one-off measure but rather as a step towards a comprehensive reform of the overall income tax and corporation tax regime. New problems of credibility would arise, by contrast, if the announced move were to fail to materialise. However, given the tense situation of public finances and the result of the most recent estimate for the tax revenue outturn, it is also crucial to prevent any further haemorrhaging of tax receipts.

Moreover, critical utterances concerning the competition-oriented behaviour of enterprises and investors have engendered fresh uncertainty. Together with the Federal Cabinet's decision to broaden the scope of the German Employee Posting Act *(Arbeitnehmer-Entsendegesetz)* with a view to extending the reach of collective labour agreements in response to fears of downward pressure on wages in the wake of the phased EU enlargement, this has clearly aroused doubts about the economic policymakers' readiness to continue the reform course. This debate needs to be informed by the realisation that jobs which are costlier than the employees' contribution to the company's earnings are just not viable in an open economy.

Labour market still in the doldrums

To date there has been no marked improvement of the situation on the labour market. Although registered unemployment fell a little during the reporting period and in April totalled 4.89 million on a seasonally adjusted basis, this is not so much a sign of a cyclical upturn as an expression of a delayed seasonal revival and of a technical lowering of the jobless total in connection with the registration of former recipients of unemployment benefit. By contrast, the declining trend in the number of employees subject to full social security contributions persisted up to the end of the reporting period. The increase in the number of employed persons in the first quarter is chiefly attributable to the trend in government-subsidised special forms of employment. Marked headway in the creation of new jobs is not just the key to strengthening the confidence of consumers and their income prospects; it would also make an important contribution to consolidating public finances and the social security systems.

Monetary policy framework

The current monetary policy stance of the Eurosystem certainly constitutes no obstacle to making such headway. With a policy credibly oriented to price level stability and favourable financing conditions, the monetary policymakers have put in place a framework conducive to more growth and employment. Despite the renewed rise in oil prices, the increase in consumer prices of 1½% in April remains consistent with price stability. Hence price developments are continuing to bolster purchasing power. In addition, low interest rates across the maturity range are strengthening the propensity to spend on the financing side. Banks' lending rates in Germany have likewise declined further, and the institutions active in the German market have eased their credit standards slightly. Even so, the demand for credit is stagnating in Germany; it is thus well below the average trend in the rest of the euro area, where some countries are recording a brisk demand for credit from households to finance the purchase of real estate and entrepreneurial activities.

If the weak domestic demand is to be lastingly overcome and the potential output of the German economy strengthened through new investment and a higher labour force participation rate, there is no alternative to further resolute reform measures in Germany. That applies to the labour market and to wage formation as well as to the social security and taxation systems.