Overview

Economy regains momentum

GDP growth in third quarter...

After slowing in the second quarter, the German economy grew remarkably strongly in the third quarter of 2005. According to initial calculations by the Federal Statistical Office, real third-quarter GDP after seasonal and working-day adjustment was up 0.6% on the previous quarter, which showed a slight upward revision of the initial estimate. In seasonally adjusted terms, this constitutes a year-on-year increase in overall economic output of 0.9% for the first three quarters of this year. According to the available data, growth for 2005 as a whole can be expected to reach approximately 1%.

... somewhat more broadly based

Once again, the favourable external economic developments were a significant contributor to the positive overall result. Closely in line with the sustained flow of orders, exports of German products increased considerably between July and September. In addition, there were stronger domestic growth stimuli in Germany. First, there was another significant rise in purchases of machinery and equipment after a temporary lull in the second quarter. Second, seasonally adjusted construction investment also increased somewhat for the first time in a while. By contrast, consumer spending by households remained very restrained. This is reflected in the declining retail sales figures, for example. The general increase in expenditure on energy, which includes, say, shared charges for heating in rented accommodation as well as the cost of electricity and gas, will most certainly have restricted spending power in other areas.

Persistent difficulties in the labour market

Above all, however, consumer demand is being curbed by the difficult situation in the labour market. While the number of persons in work has been increasing since the second quarter, this development is less the expression of an increased demand for labour in the economy and more a sign of the effects of labour market policy such as measures to create low-paid jobs ("one-euro jobs"). The unemployment rate fell only slightly from the second quarter to 11.6 %. In the light of the increased economic burden resulting from higher oil and commodity prices, the moderate wage developments helped bolster employment. In the corporate sector, at least, year-on-year unit labour costs in the first six months were down by 1%.

Accelerated rise in consumer prices

The rise in factory gate prices affected mainly energy and refined petroleum products. It is likely that these price impulses will also have a knock-on effect on consumer prices. The inflation rate has already accelerated somewhat in the past few months. While still 2 % in July, year-on-year inflation had increased to 2.3 % by October.

Capital market rates increase

The financial markets also point towards an increase in inflationary risks while scepticism about the economic development has increasingly given way to more benign expectations. Against this backdrop, capital market rates in Germany, as in other euro-area countries, have risen by around ½ percentage point from their low in September to 3½%. At the same time, however, US dollar rates have risen markedly, as a result of which the yield differential for German bonds vis-à-vis corresponding US dollar paper currently stands at around 1.1 percentage points.

Effective euro exchange rate

The euro has only recently depreciated significantly against the US dollar. Valued for a time at less than US$1.17, the exchange rate was at its lowest level for two years and lower than at the start of monetary union. Measured against the currencies of the euro area's major trading partners, the euro also weakened slightly on average over the reporting period. In mid-November, the euro's effective exchange rate was around 7 % lower than at the start of this year.

Monetary policy strategy

The low level of interest rates maintained over a long period in the euro area continued to stimulate monetary expansion in the past few months. At its most recent meeting following its regular economic and monetary analysis of the monetary policy situation in the euro area, the ECB Governing Council considered the steady interest rate course to be still appropriate. However, the Council took the view that the recent increase in inflationary risks over the somewhat longer term would require a high degree of monetary policy vigilance.

Monetary expansion accelerates further

In this connection, it is particularly worth noting the increasingly rapid monetary and credit growth in the euro area. During the third quarter, M3 grew at a seasonally adjusted annual rate of 11½ %, up from just under 10 % between April and June. As was previously the case, monetary growth was primarily sustained by a continuing increase in loans to enterprises and households in the euro area. Housing loans accounted for more than half the rise although bank loans to the corporate sector also increased strongly. In addition, the demand for credit from German banks in the third quarter revived somewhat after a long period of stagnation. Nevertheless, loans to financial institutions outside the banking sector were also a factor, the majority of which concerned transactions by German banks in securities lending.

Critical public finance situation

The economic prospects for consumers and investors in Germany are darkened not least by the very critical state of public finances and, despite undeniable progress in recent years, a continued lack of flexibility in the German labour market. Against this backdrop, the coalition negotiations' particular focus on the fundamental objective of budgetary consolidation is to be welcomed. Consolidation of government budgets is necessary to regain the trust of consumers and investors. A move towards reforming the federal structure, raising the retirement age and the planned reduction in subsidies are also important steps in the right direction. The same applies to the cut in the contribution rate to the Federal Employment Agency, which is to be financed, at least in part, by reductions in expenditure already approved.

Consolidation in 2007

On the whole, however, the fiscal policy strategy outlined in the coalition treaty should be viewed with significant reservations. For example, the consolidation planned for 2006 does not go far enough. Through the implementation of these measures, the general government deficit ratio is likely to fall below the threshold defined in the EC Treaty again in 2007 and a significant reduction in the deficit is likely to be achieved. However, national and European budgetary rules will be breached in 2006, something which will further weaken their credibility. Given the fundamental necessity of reducing the structural deficit, cyclical conditions, as things stand at present, would not have hindered consolidation being spread more evenly over a period of time or, therefore, significant progress as early as next year. In addition, the bulk of the consolidation is being accomplished through higher tax rates, with only limited spending cuts. This will not help create the conditions for growth and employment in the longer term.

Implementing further cuts in government spending in the medium term is therefore vital. The government should further aim to reduce the government expenditure ratio in order to achieve its target of a balanced budget and a further reduction in the tax burden.

Fundamental reforms envisaged

The coalition treaty envisages fundamental reforms in key areas for the coming parliamentary term. These include, particularly, income and corporation taxation, the statutory health insurance scheme, the financial constitution and an increase in incentives to take on low-paid employment. In this respect, there is scope for improving the macroeconomic framework. The crucial elements here will be to strengthen individual responsibility and competition, improve incentive structures and enhance the transparency of the systems.