Overview

Robust economic growth, but less favourable price environment

International setting

The world economy continued to grow strongly in the third quarter. One reason for this was the ongoing dynamic expansion of the emerging market economies (EMEs). Another was that growth in the euro area and in Japan strengthened appreciably. In addition, the US economy continued to expand vigorously. However, given the correction and adjustment processes now under way in the financial markets and the renewed price surge in various commodity markets, the overall setting for the near term no longer looks as favourable.

Financial markets

The crisis in the US real estate market and the general reassessment of credit risks which it triggered initially led to a marked increase in the market players' risk aversion. This sharply impaired trade in complex financial products, in particular. Share prices, which had touched multi-year peaks at the start of the third quarter, also came under strong pressure. Following the Federal Reserve's easing of its monetary policy stance and in view of the overall robust state of the world economy, the stock markets were able to recoup some of the losses as the reporting period progressed. Longer-term interest rates in the euro area and, in particular, the USA were pushed down by a flight to safe-haven investments. By the time this report went to press, long-term government bond yields in the euro-area capital markets had fallen by ½ percentage point to just under 4%. In the foreign exchange markets the parities between the major currencies shifted perceptibly to the detriment of the US dollar while the euro continued to appreciate. At the beginning of November, the euro reached a new high against the US dollar of over US$1.47. However, on a trade-weighted average against the 24 most important currencies, the euro was only some 3½% higher than it was before the financial market turbulence broke out during the summer despite its relatively strong appreciation against the US dollar.

Monetary policy

The crisis in the subprime segment of the US mortgage market was reflected in tension in the euro money market, which ultimately expressed the particularly high degree of uncertainty about the banks' associated liquidity requirements. This was visible in the evolution of the interest rate at which banks trade overnight liquidity. Although this rate is usually quoted at slightly above the marginal allotment rate of the main refinancing operations, it initially rose significantly at the beginning of August after the banks were confronted with unexpected liquidity risks. In order to reduce the tensions and to counter the functional shortcomings in the longer-term maturity segments of the money market, the Eurosystem repeatedly carried out generous fine-tuning operations in addition to its regular main refinancing operations. The purpose of these measures was to prevent long-term and destabilising liquidity shortages for the financial system as a whole and thus to boost confidence in the markets during this particularly critical period. Moreover, the ECB Governing Council kept the central bank rates unchanged given the high degree of uncertainty with regard to assessing the implications of the financial market turmoil. This has not, however, altered the general orientation of monetary policy to maintaining price stability. Hence the calmer state of the money markets has put the spotlight back onto the growing inflationary risks after a sharp rise in energy prices and an increase in the prices of food and other consumer goods increasingly fuelled concern. Thus whereas in the third quarter consumer prices in the euro area rose by an average of 1.9% over 12 months, in October the year-on-year increase widened significantly to 2.6%.

German economy

The cyclical upturn in the German economy continued and intensified in the third quarter of 2007. According to initial figures from the Federal Statistical Office, aggregate output went up between July and September by 0.7%, after adjustment for seasonal and calendar effects, compared with 0.3% in the second quarter. The year-on-year rate of growth was 2.5% after calendar adjustment. This suggests that overall capacity utilisation has risen further so far this year.

After pre-emptive purchases ahead of the VAT hike at the beginning of the year and the ensuing dent in demand thereafter had substantially curbed the development of private consumption and housing construction in the first half of the year, the cyclical momentum began to reassert itself in the quarter under review. Although there are no detailed figures yet on the development of the individual demand components in the third quarter, the available indicators point to stronger domestic impulses. It is thus likely that private consumption, which had already recovered somewhat during the second quarter after reaching a low in the first three months of this year, contributed further to overall growth. Besides this, enterprises stepped up their investment activities.

Foreign trade, too, remained an important driver of German economic growth in the third quarter. Of late this has been the case not only for exporters of capital goods, who are traditionally heavily export-oriented, but also for manufacturers of consumer goods. The fact that most sectors were able to profit from this indicates both the broadly based nature of the cyclical upturn and German firms' favourable market position, especially in the euro area. Imports have likewise become more significant on the back of growing domestic demand and particularly in connection with increased stockbuilding, meaning that, on balance, foreign trade made only a neutral contribution to overall economic growth.

Labour market

Accelerated economic growth has also helped to improve the employment situation. The number of persons in employment rose by 98,000 in the third quarter after adjustment for seasonal variations. The year-on-year increase amounted to 638,000 persons or 1.6%. Therefore growth was almost as strong as the average for the first half of 2007. In particular, jobs subject to social security contributions grew at an above-average rate. Some 3.74 million people, or 8.9% of the dependent labour force, were registered as unemployed during the third quarter (after seasonal adjustment) compared with an unemployment rate of 9.2% in the second quarter and 10.6% one year earlier. The drop in unemployment equally benefited long-term unemployed persons receiving the basic welfare allowance "unemployment benefit II" and shorter-term jobless claimants of the insurance-related "unemployment benefit I". The decline in unemployment continued in October. The unemployment rate fell to 8.7%.

Older workers benefited to a greater extent from the higher rate of employment than other groups of persons. The reforms implemented some time ago regarding pension receipt and unemployment insurance played a crucial part in this. The extension and staggering of the maximum period of entitlement to unemployment benefit for older workers, which has now been agreed, will partly reverse those reforms. It not only contradicts the fundamental character of the statutory unemployment insurance scheme as an insurance policy against the risk of losing one's job, but also represents a setback in the efforts to create a more favourable institutional framework for greater employment. Thus the job risk of older workers, in particular, has tended to increase again.

Wages

Wage agreements this year have also been slightly higher owing to the improved labour market situation. This is gradually being reflected in the development of contractually agreed basic rates of pay, which were up 1.7% on the year in the third quarter. However, in the production sector, which has particularly benefited from the economic upturn, negotiated wages increased by 3.1% on the year in the third quarter, which is a much higher rate than the average for the economy as a whole. Despite higher negotiated rates, wage cost pressure has remained quite moderate overall so far this year. This is due, firstly, to the fact that in the services sector wage settlements from previous years are coming into effect which foresee no or only small wage increases for the current year. Secondly, some wage agreements have expired without a replacement agreement having been negotiated as yet. Thirdly, some new wage agreements do not envisage an increase until 2008.

Prices

Recent price developments were influenced more strongly by external influences. Alongside higher crude oil prices, increases in food prices have particularly contributed to this. On average, the increase in the Harmonised Index of Consumer Prices amounted to 2.2% in the third quarter and 2.7% in October. Consumer prices are expected to continue to rise sharply in the coming months. Energy in particular is likely to become even more expensive due to the fact that the latest increases in crude oil prices only began to be passed on to the consumer in November. Sharp rises in electricity and gas prices have already been announced for the beginning of 2008. Moreover, the effects of the boom on the international agricultural markets are only likely to fade slowly. Year-on-year rates are unlikely to start receding to more moderate levels before the second quarter of 2008, given an incipient return to normal on the international markets and as a consequence of baseline effects relating to the VAT hike in January 2007 and the introduction of tuition fees in April 2007.

Outlook

Parallel to the marked deterioration in the price environment, the risks to overall economic activity also increased in the third quarter. To a certain extent the two must be seen as being directly related. Thus the unfavourable rate of price development is placing a strain not only on households' current budgets but also on their future real income prospects. Moreover, the further steep rise in oil prices is engendering ongoing risks to global economic momentum. Furthermore, negative repercussions of the financial market turmoil are to be expected to a certain extent. From Germany's point of view, by contrast, the most recent exchange rate fluctuations are rather ambivalent. On the one hand, they are helping to alleviate the price environment and to form a certain counterweight to the oil-price related deterioration in the terms of trade. On the other hand, they are squeezing profit margins and hampering sales opportunities abroad. However, the positive underlying trend of economic development is not under threat.

This assessment is notably based on the robust condition of industry. Thus the forward reach of existing orders has stood at the unusually long margin of around three months since the turn of the year. Surveys of current business conditions and future expectations in trade and industry support this conclusion. They suggest that, although enterprises have continuously lowered their exceptionally favourable and optimistic assessments over the past few months in the wake of rising crude oil and commodity prices, the euro's appreciation and the temporary acute tensions on the financial markets, the current situation in the German economy continues to be characterised by a very confident underlying sentiment. This conclusion is strengthened by the fact that enterprises' export expectations have deteriorated only moderately in comparison with the other expectation indicators. This is particularly noteworthy in view of the generally anticipated slowdown in the US economy, which has been adversely affected by the real estate and mortgage crises. The persistently high growth expectations for the emerging market economies, the OPEC countries and the east European transition countries evidently represent a sufficient counterweight, especially as the German economy's product profile is tailor-made to suit the high demand for capital goods in these regions.

Given the fact that enterprises are currently utilising their existing capacities to the full, continued buoyant foreign business should cause them to invest more in the coming months. This is aided by the fact that expenditure on movables enjoys favourable tax treatment until the end of this year as a result of the improved depreciation facility. Not least against the backdrop of Germany's regained attractiveness as a production location, industrial construction, which usually lags behind investment in machinery and equipment, may be expected to increase. By contrast, the future outlook of the housing construction sector is less favourable.

With respect to private consumption, the dampening effects of the VAT increase are likely to have largely petered out by now. This is indicated, *inter alia*, by the sharp increase in new passenger car registrations by private owners in the third quarter, although the level is still clearly subdued. The higher rate of employment is likely to support private consumption over the coming period. The recent surges in energy and some food prices have, however, reduced consumers' purchasing power. Another factor which should not be underestimated in this context is an uncertainty component based, for the most part, on subjective perceptions which since the third quarter has considerably depressed the propensity to purchase in anticipation of rising prices. In this context it seems all the more important that European monetary policy remains a reliable anchor of stability.

Public finances

The public finance situation in Germany improved perceptibly in 2007. For the first time since German reunification, the general government budget should be balanced after a deficit of 1.6% of GDP was run up last year. Although the favourable course of economic development has also had its part to play in this decrease, it is attributable in large measure to structural improvements, in particular the increase in VAT and the continued moderate development of expenditure. This makes it possible to attain a balanced budget this year, also in structural terms. This means that a key objective of the Stability and Growth Pact, which the Federal Government had not planned to achieve until 2010, can already be attained in 2007. If this target is also met in the coming years or if a structural budgetary surplus is generated, then the debt ratio could be brought below the reference value of 60% within a reasonable period of time. The resulting relative easing of the debt service burden would provide a cushion for coping with the likely expansion of expenditure ensuing, in particular, from the ageing of the population. Structural surpluses would make an important contribution to this as well as additionally easing the burden on younger and future generations. The outlook for 2008 shows that expenditure growth has to continue to be tightly curbed to ensure that the budgetary consolidation achieved so far is not endangered and to create scope to possibly reduce taxes and social contributions. Given the danger that the surge in revenue from profit-related taxes that has been observed so far will not continue indefinitely and that the turbulence on the financial markets is generating additional risks for government budgets, any straying from the consolidation course would be problematic.