

Overview

Weaker growth but upturn intact

Global economic growth suffered a noticeable loss of momentum in the fourth quarter of 2007. This was due mainly to the distinctly slower rate of expansion in the industrial countries, whereas the emerging market economies and the commodity-exporting countries continued to grow at a rapid pace. The weakening of the cyclical momentum in the industrial countries was attributable partly to the effects on the real economy of the continued turmoil in the financial markets, which was triggered by the subprime crisis in the USA in the third quarter of last year. This was compounded in the fourth quarter by the steep increase in oil prices and the rise in food prices.

International setting

The financial markets continued to grapple with the ongoing problems emanating from the US real estate market. Supported by interest rate cuts in the United States, stock markets around the world proved relatively robust until the year-end. However, a sharp slump in share prices has been recorded since January 2008 amid mounting fears of a US recession. Significantly greater risk aversion on the part of investors resulted in a "flight to safety" and declining yields on government bonds. At under 4%, the yield on ten-year Federal bonds (Bunds) in the fourth quarter was more than ½ percentage point down on the third quarter. At the same time, the spreads on risky bonds widened significantly, so that financing conditions for corporate issuers in the bond market became slightly less favourable in spite of the fall in the "base rates".

Financial markets

In the fourth quarter of 2007, the euro maintained a strong position overall. At the beginning of January 2008, it reached a new historical high against the US dollar of US\$1.49. Disappointing figures for the US economy and problems experienced by US banks and other financial institutions as a result of the turbulence on the US credit markets weighed on the US currency. By contrast, the sharp interest rate cuts made by the US Federal Reserve in January have had little impact on the euro-dollar exchange rate. Instead, it was intermittent increasing concerns that weak growth and financial market problems in the USA will spill over to the euro-area economy that caused the euro-dollar exchange rate to slip below its record high from the start of January.

Following a phase of stabilisation and consolidation in the euro money market, which lasted until November 2007, new reports of high losses of US banks triggered a fresh wave of uncertainty on the financial markets. However, generous refinancing operations and a flexible use of liquidity policy instruments largely eased the tense liquidity situation on the German money market.

*Monetary
policy*

Given the difficult situation and the uncertainty about the effects of the US real estate crisis, the ECB Governing Council maintained its steady monetary policy course over the past few months. The minimum bid rate in the main refinancing operations (MROs) has consequently been kept at 4% since the last interest rate increase in June 2007. However, the Governing Council continues to harbour concerns regarding longer-term inflation

risks, which had previously led it to gradually reduce the expansionary thrust of monetary policy. The ongoing dynamic monetary and credit expansion is not the only indication of such risks. Risks to stability are also latent in the generally robust macroeconomic setting, tightening labour markets and, above all, strong price pressure. Measured by the Harmonised Index of Consumer Prices (HICP), year-on-year euro-area consumer prices rose to 2.9% in the fourth quarter of 2007. In January, prices increased further, with the result that the HICP was 3.2% up on the year at the end of the reporting period.

As expected, the German economy recorded fairly muted growth in the final quarter of 2007. According to initial figures from the Federal Statistical Office, aggregate output increased by 0.3% in the fourth quarter after adjustment for seasonal and calendar effects, compared with 0.7% in the third quarter.

*German
economy*

While there is no detailed information on the demand structure in the reporting quarter at present, the available indicators suggest that private consumption and construction investment failed to match their level of the third quarter – ie the same demand components which have so far realised little of their growth potential.

Subdued final domestic demand is likely to be one reason why imports likewise declined in the fourth quarter. Possible causes are that enterprises pursued a more cautious course of inventory management in the reporting quarter and that exports were no longer increasing as sharply as before. However, in

statistical terms, foreign trade probably nonetheless generated a clearly positive contribution to overall economic growth.

Labour market

In spite of the slowdown in economic growth, the rise in employment strengthened again somewhat in the final quarter of 2007. Industry, in particular, further increased its number of employees. In addition, there was an expansion of headcount in the “renting and business services” sector, in which the hiring-out of labour is also recorded. At the same time, unemployment continued to fall at an accelerated rate in the fourth quarter. One reason for this might be that, up to the day of the official count in December, there had not yet been any weather-induced restrictions in the outdoor occupations. Furthermore, the granting of seasonal short-time working benefits, which were introduced in 2006, may have dampened the seasonal fluctuations somewhat. The number of persons out of work, at 3.57 million, was 623,000 lower than in the same period of 2006. The quarter-on-quarter seasonally adjusted unemployment rate went down from 8.9% to 8.5% and showed a further fall to 8.1% in January 2008. Although this was noticeably lower than one year before, unemployment remains at an unacceptably high level. A moderate wage policy therefore remains imperative so as to underpin further labour market improvements. Furthermore, it is crucial that the rewards of the labour market reforms undertaken in the past years, which are now becoming evident, are not jeopardised by backward-looking modifications. In particular, extending minimum wages to additional sectors would endanger the chances of further

progress being made in the problematic segments of the labour market.

Alongside labour market reforms and economic growth, moderate wage developments have made a major contribution to reducing unemployment over the past few years. On an annual average in 2007, the rise in labour costs in the economy as a whole was again fairly moderate – despite some large claims submitted at the beginning of the 2007 pay round and some relatively large settlements in industry. The same can be said of growth in negotiated pay rates in the fourth quarter (+1.1% year on year). This muted increase was due in part to a baseline effect after one-off payments raised the reference figure for the final quarter of 2006. Cuts in end-of-year bonus payments in the public sector and at public sector banks were an additional factor. If one-off payments and additional benefits are excluded, the year-on-year rate of wage increases in the fourth quarter of 2007 was 1.7%.

Wages

Negotiated wage rates will rise distinctly more sharply in the first half of 2008 since many of the increases in standard pay agreed in 2007 will come into effect. Furthermore, pay agreements will be expiring in a number of major sectors – above all, for employees of central and local government, as well as in the iron and steel industry, the chemicals industry, textiles and textile products manufacturers and hotels and restaurants. Negotiations in the metal-working industry are scheduled for the second half of the year. As far as is known at present, the scale of some of the claims will exceed the level seen initial-

ly in the last round of negotiations, with the loss of purchasing power in 2007 being cited as one of the reasons for this. It should be noted, however, that the price increases of 2007, owing to their strong fiscal and external components, have scarcely increased the (nominal) scope for income distribution.

Prices

Price developments in Germany continued to be strongly influenced by external influences in the fourth quarter of 2007. As well as energy prices, the global rise in prices of food stoked consumer price inflation. Somewhat sharper price increases were also recorded in the field of industrial goods. The price trend for services and housing rents was still comparatively moderate, however. Overall, the year-on-year rate of consumer price increase jumped from 2.1% in the third quarter to 2.8% in the fourth quarter. This was the highest rate of inflation since early 1994. Based on the old 2000 basket of goods, the Federal Statistical Office has estimated a year-on-year increase in consumer prices of 2.7% in January 2008. The annual rate as measured by the HICP was 3.0%. The final January figures will be published at the end of February and will then refer to a new basket of goods from 2005. In addition, various methodological changes, especially concerning the seasonal pattern of price developments, will become effective.

Outlook

Despite the slowdown in growth towards the end of 2007, which came as no great surprise, the future outlook for the economy in Germany has not deteriorated noticeably compared to the forecasts of last December. Nevertheless, the risk factors that have been

making the economic outlook appear subject to a greater measure of uncertainty than usual since the middle of last year continue to exist. They have, in fact, become more significant in some respects, such as the scenario of a marked cyclical slowdown in the United States. So far, however, the probable impact on the German economy remains very limited. On the whole, the German banking system has coped well with the turbulence of the past few months and has maintained its stability and functional viability. Overall there is still the prospect that domestic demand – which was dulled by general uncertainty and the strong upward pressure on prices in the fourth quarter, which is probably only temporary – will be lifted by the upside potential justified in terms of the fundamentals.

This applies most of all to private consumption, which has been curbed not only by the sharp increases in prices since the final quarter of 2007 but also by the suddenly gloomier expectations in respect of prices and incomes. Household sentiment has meanwhile recovered slightly and the propensity to purchase large consumer items has increased again. Precautionary saving, which was initially their prevailing motive, is therefore likely to have become somewhat less important. Private consumption might thus benefit more in future from the ongoing strong revival in the labour market and the more favourable income prospects.

One component that will be missing at the start of the year is the portion of investment in machinery and equipment that was shifted forward to last year owing to the expiry of

the declining-balance depreciation facility for movable assets. Looking at the high level of capacity utilisation in many sectors of industry, however, there are a large number of enterprises which still need to procure new machinery and equipment. And, indeed, industrial enterprises have recorded a big rise in new orders of late. The seasonally adjusted volume of orders in the fourth quarter was 5% up on the preceding three-month period.

The sharp (6½%) increase in new export orders indicates that German industry has been able to extend its market position even under difficult underlying conditions. This is due, above all, to the strong position of capital goods producers thanks, not least, to their attractive range of goods on offer. Despite the somewhat more subdued global growth and unfavourable price competitiveness in the dollar area, export-oriented industry is looking optimistically to the future.

Public finances

The public finance situation again improved significantly last year. After the general government deficit fell to 1.6% of gross domestic product (GDP) in 2006, a balanced government budget was achieved in 2007 for the first time since German reunification according to provisional data from the Federal Statistical Office.

Germany's budget is also balanced in structural terms (ie after adjustment for cyclical and temporary effects), meaning that the medium-term fiscal objective set by the Federal Government was therefore already reached in 2007. Following the dropping of

the excessive deficit procedure in June 2007, an additional important provision of the EU fiscal framework has thus been met. If this course of sound public finances is maintained, then the debt ratio could also quickly be brought below the reference value of 60% defined in the EC Treaty.

The renewed incurrence of a deficit in 2008 envisaged by the Federal Government in the latest update to the stability programme is not fully compatible with the European fiscal framework, particularly as the programme is based on rather favourable macroeconomic assumptions. The deficit is mainly attributable to lightening the load on tax and contribution payers from lowering the contribution rate to the statutory unemployment insurance scheme and reforming business taxation.

A further loosening of fiscal policy, as has recently been adopted in the United States, for example, to avert the threat of recession, currently does not seem appropriate in Germany. Although the macroeconomic risks have risen slightly in Germany, overall the domestic economy remains in robust shape and within the corridor of normal capacity utilisation. Therefore, there is no justification for jeopardising the consolidation that has been painstakingly achieved over the past few years. Furthermore, it may generally be doubted – not least given past experience – that attempts to actively steer the German economy by fiscal means will be crowned with success. As a rule, it appears to be more appropriate, given a structurally sound financial situation, to let the automatic stabilisers take effect – as is also envisaged in the European fiscal frame-

work. In the light of Germany's particular situation at the present time, embarking upon an

expansionary fiscal policy could prove to be an unnecessary and costly venture.