Overview

Buoyant start to the year

International setting

The global economy has remained on a growth path since the turn of the year. The International Monetary Fund (IMF) expects global output growth in 2007 to more or less match that of the three preceding years, which had seen growth rates of around 5% and more. The regional parallelogram of forces driving the global economic expansion process has changed slightly, however. Thus, whereas the emerging market economies have continued to develop dynamically, the considerable growth gap that long persisted between the USA, on the one hand, and the euro area and Japan, on the other, has narrowed significantly.

In the first few months of 2007, price movements in the industrial countries were again influenced by energy price volatility. After having abated temporarily towards the end of 2006 and at the beginning of the current year, upward pressure on prices has picked up perceptibly again in the past few months. This caused the rate of inflation in industrial countries to rise from 1.8% in January to 2.3% in March.

Financial markets

The changed growth outlook for Europe and the United States was duly mirrored in the international financial markets in the first few months of the year. Whereas in the euro area good business data reinforced market participants' positive assessments, in the USA fears of a real estate market crisis and intermittent inflation concerns temporarily dulled the market momentum. In conjunction with a sudden slump on the Chinese stock market at the end of February, the looming bankruptcy of a large US real estate financing agency and the subsequent crisis in the US subprime mortgage market led to considerable corrections in international financial markets up to mid-March; these corrections were quickly overcome on both sides of the Atlantic, however. European stock markets ended up reaching new highs, and the temporary decline in bond market yields was more than offset by an increase in interest rates in tandem with favourable business indicators. As this report went to press, euro-area government bonds were delivering yields of just over 4¼%, or around ⅓ percentage point higher than at the beginning of the year. This is largely a reflection of the markets' more favourable assessment of euro-area growth and the concurrent interest rate tightening by the Governing Council of the ECB. By contrast, some market players even expected the Federal Reserve to cut US interest rates. Against that background, the euro appreciated distinctly, especially against the US dollar and the Japanese yen. On a trade-weighted average, the euro has appreciated by 2% since the beginning of the year against the currencies of the euro area's 24 most important trading partners.

Monetary policy

The strength of the single European currency in the foreign exchange markets did form a certain counterweight to the upward pressure on euro-area consumer prices exerted particularly by the renewed surge in crude oil prices. Year-on-year inflation as measured by the Harmonised Index of Consumer Prices (HICP) therefore only grew slightly, from 1.8% on average for the fourth quarter of 2006 to 1.9% in the first quarter of this year. However, at the same time the risks to stability have increased. Wages, in particular, could cause inflationary pressures following the rapid growth of employment and the improvement in enterprises' profitability. This could be reinforced by the capacity bottlenecks now becoming evident in individual sectors. According to most macroeconomic projections, the present underutilisation of production capacity is likely to be eliminated over the course of the year not only in individual sectors but also across the euro-area economy as a whole.

This is also consistent with the results of the monetary analysis, which is used to cross-check the signals emitted by real indicators, especially with regard to longer-run inflation risks. The extremely strong double-digit monetary growth is being driven by equally strong credit growth, despite the interest rate rises adopted thus far by the Governing Council of the ECB. At any rate, monetary inflation projections point to increased inflation risks over a time horizon of two years or more. For this reason, the Eurosystem's expansionary monetary policy stance was scaled back further in March by an interest rate increase of ¼ percentage point to 3.75%. The current data, too, give cause for particular monetary policy vigilance. This is reflected in the prevailing interest rate expectations in the money market. These suggest that market players are anticipating further upward interest rate adjustments in the course of this year.

German economy

The German economy has become one of the engines of growth in the euro area. Its cyclical upswing continued at the start of 2007. According to initial calculations by the Federal Statistical Office, overall economic output went up by 0.5% in seasonally and calendar-adjusted terms in the first quarter. It rose by 3.6% on the year. While economic growth in Germany failed to match the fast pace seen in the second half of 2006, that had been boosted by advance demand ahead of the VAT increase. Although exact figures regarding the structure of aggregate demand are not yet available, those indicators that are available indicate that corporate investment is likely to have played an even more prominent role than before as the main driver of domestic economic growth after the turn of the year. The sentiment indicators, in particular, suggest a large degree of confidence in the enterprise sector. Given the renewed increase in capacity utilisation, recent investment was probably prompted more by capacity expansion motives. This is also suggested by the buoyant demand for industrial construction. In addition, public construction investment is likely to have expanded in the wake of increasing tax revenue. A further sustaining investment is that companies sharply restocked their inventories in the first quarter of 2007 after their stocks had been severely depleted during the last few months of 2006 owing to surging demand. This is also consistent with a sharp rise in imports in the first quarter of this year. By contrast, export growth slowed down, although this was partly influenced by various special statistical factors. Nevertheless, taking the last quarter of 2006 and the first quarter of 2007 together, foreign trade, along with investment, remained a mainstay of economic growth in Germany.

By contrast, private consumption demand sagged considerably as expected after the turn of the year. This was particularly evident in traditional retail outlets. Although a revision in the relevant primary statistics has made it more difficult to analyse sales patterns, the quarter-on-quarter decline in real sales in the first three months of this year exceeds the enlarged margin of uncertainty. In the first few months of 2007, car sales were also depressed strongly by the VAT effect. Total registrations of new cars fell by a seasonally adjusted 25% on the quarter; this was attributable largely to the decline in registrations by households following an extremely sharp rise towards the end of last year. However, in the meantime, according to recent consumer sentiment indicators published by the *Gesellschaft für Konsumforschung* (GfK), the continued outlook for private consumption in Germany has brightened considerably. There are many signs that the decline in private consumption in the first few months of this year is not due to a general and lasting fall in household demand but is simply the expected countermovement to the advance purchases of goods at the end of last year and will be limited largely to the first quarter of 2007. The more favourable employment situation and the consequent reduction in income risk are the main reasons for the improved consumer climate.

Labour market

The situation in the labour market continued to improve quite rapidly in the first few months of 2007 in the wake of the cyclical upturn. Employment rose once again, and unemployment fell significantly. Employment was up by around 570,000 or 1.5% on the year, primarily in the form of conventional jobs subject to full social security contributions. At the same time, official unemployment once again fell sharply in the first quarter. At a seasonally adjusted 3.91 million, there were 287,000 fewer persons registered as unemployed than in the final quarter of 2006. The year-on-year decline widened to 820,000 persons. At 9.4%, the seasonally adjusted unemployment rate was 0.6 percentage point down on the quarter. Within the space of a year, the unemployment rate has gone down by as much as 2.1 percentage points.

However, the decline in unemployment in the first quarter of 2007 is likely to have overstated the cyclical influences and the medium-term trend somewhat. Both the mild weather and the introduction of seasonal short-time working benefits are likely to have had a mitigating effect. It is also important to remember that, for demographic reasons, the labour supply is currently on the decrease, causing the decline in unemployment to appear to be greater than the increase in employment.

Wages

The improved labour market situation, and especially the welcome developments in employment, are signs that the reform efforts encouraging greater flexibility in the deployment of labour and moderate wage agreements are beginning to bear fruit. These were prerequisites for enabling the cyclical revival to translate into the creation of new domestic employment opportunities. The first-quarter trend of negotiated wages – up by 0.8% on the year – still accords with those premises. Following the launch of the 2007 wage round in March, however, the agreements that have since been reached in the major industrial sectors are increasingly reflecting the cyclically-induced improvement in employees' bargaining power as a result of above-average capacity utilisation and healthily stocked order books. The main macroeconomic objective now is, while understandably allowing employees to participate appropriately in their enterprises' commercial success, not to lose sight of the need for moderate wage agreements so that even those sectors that are more oriented to the domestic market still have some leeway to create new jobs.

Prices

In the first three months of this year, consumer prices rose by a seasonally adjusted 0.6%, which was distinctly higher than in the preceding months. The year-on-year figure (1.7% in the first quarter of 2007 following 1.3% in the fourth quarter of 2006) does not show this as clearly. The HICP inflation measure, calculated for European purposes, was 1.9% following 1.3% at the end of 2006. This is attributable chiefly to the increase in the standard VAT rate from 16% to 19% which took effect on 1 January 2007. According to the Bundesbank's own estimations, the higher VAT rate contributed around 0.6 percentage point to the quarter-on-quarter increase in the national consumer price index (CPI) and just under 0.8 percentage point to the HICP increase. This increase came on top of advance price adjustments in the course of the preceding year, such as the nearly 5% increase in tobacco prices in October. If these anticipatory effects are added to the price effects in the first quarter of 2007, the result is that the rise in VAT will have added currently around 1 percentage point to the year-on-year CPI increase. The contribution to HICP is likely to be somewhat higher. The price effect of the rise in VAT has thus been considerable, but not as high as the calculatory effect of a full pass-through of 1.4 percentage points to CPI and 1.6 percentage points to HICP. Two factors need to be taken into consideration in this context. One is that a reduction in social security contributions in January 2007 provided relief to enterprises. The other is that it may be assumed that further VAT-induced price adjustments will occur in the course of 2007.

Public finances

The VAT increase, along with the favourable cyclical environment and moderate expenditure policies, will contribute to a continuation of the positive trend in German public finances over the current year. Following an unexpectedly sharp drop in 2006 to 1.7%, the general government deficit ratio is expected to fall well to below 1%, and the debt ratio is expected to decline perceptibly. In the coming year, too, the deficit ratio could continue to decrease slightly provided no additional tax and social security cuts or expenditure hikes are adopted. However, this is due mainly to the cyclical outlook, which from today's vantage point is positive, whereas barely any structural improvement is in sight. The favourable developments in government budgets at the current time should not, however, be used as a motive for relaxing efforts to achieve a radical consolidation of public finances. The experience since the turn of the century has shown clearly how quickly a structurally unbalanced budget position can, through a combination of economic slowdown, insufficiently financed tax cuts and sharply falling revenues from the highly volatile profit-related taxes, be turned into high deficits that take years of hard work to reverse. To attain and maintain a structurally balanced budget, it is necessary to achieve clear surpluses during economic boom periods. Cyclically-induced additional revenue and lower spending must accordingly not be used to finance tax cuts or expenditure increases. Otherwise, this would result in a procyclical fiscal policy which would then have to rigorously counter the automatic budgetary deterioration occurring during downturns, thus amplifying cyclical volatility.

Even if the excessive deficit procedure initiated against Germany is soon dropped, the country will still not have fulfilled all the requirements of the Stability and Growth Pact. Rather, there is still a long way to go before the medium-term objective of a structurally balanced budget is achieved. Although the expected reduction in the structural deficit over the current year may be regarded as sufficient, the assumed continuation of the favourable macroeconomic environment means that a further significant improvement really ought to be achieved in 2008 so that the structural deficit would then be largely eliminated. The goal of a structurally balanced general government budget will be within reach as early as 2008 and should be achieved by 2009 at the latest.