Overview

Expected countermovement in output alongside continued high inflation pressure

International setting

The ongoing deterioration in the global price climate, which was triggered by the renewed upsurge in oil prices and strong food price inflation and is now increasingly leading to indirect knock-on effects, placed perceptible strains on the global economy in the second quarter of 2008. In addition, conditions in the real estate markets in the United States and several European countries continued to have a dampening effect. Economic momentum in south and east Asia likewise weakened owing to losses in purchasing power, although it still remained relatively strong. Nonetheless, as the major economic areas have different underlying conditions and are affected to varying degrees, there is no fear of a slump in global economic growth.

Financial markets

The international financial markets also had a dampening effect on global economic activity in the second quarter. Despite noticeable progress in the consolidation process, the markets are still in a fragile condition. The stock markets, which at the beginning of the second quarter were still underpinned by the relatively positive earnings results posted by companies, subsequently recorded net losses following renewed concern about the ramifications of the US mortgage crisis and increasing fears of an economic slowdown during the remainder of 2008. European capital market rates increased between the beginning of April and the beginning of July by around ¾ percentage point to almost 5% amidst rising inflation expectations and initially still rather robust economic indicators. However, they subsequently fell back to just under 4½% in the wake of a series of unfavourable economic data for the euro area and Germany. After holding very firm for a time, the euro concurrently lost considerable ground against other major world currencies from mid-July onwards. On a trade-weighted average, the euro depreciated by around 2½% between the beginning of April and mid-August.

Monetary policy

As a result of the sharp increase in the prices of crude oil and agricultural products on the world markets, consumer prices in the euro area at the end of the second quarter – as in July – were up 4.0% on the year. The inflation rate was thus well above the price stability benchmark defined by the Eurosystem. The primary duty of monetary policy is to ensure that the general price level in the economy as a whole remains stable in the medium term. The medium-term risks to price stability in the euro area increased further in connection with the ongoing external price surges. This is borne out by the macroeconomic projections made by Eurosystem experts in June. The fact that a somewhat slower pace of economic growth is expected in the near future does not of itself constitute an adequate stability policy counterweight which will automatically offset the inflationary pressure. For one thing, macroeconomic activity is unlikely to weaken so much that it could trigger an equal and opposite counterswing in the price level. For another, the more moderate pace of growth is not due exclusively to reduced demand and therefore cannot simply be equated with a corresponding closing of the output gap, which is a major factor in stoking domestic inflation pressure. Besides the primary cyclical factors, dampening effects are currently also coming from the supply side; these likewise ultimately stem from the sustained rise in the prices of energy and raw materials as they depress the profitability of production capacities and processes and lower the demand for energy-intensive products. Hence, despite the generally muted assessment of the euro area's growth outlook, market players' inflation expectations – as ascertained from surveys or financial market data – remained above a level compatible with long-term price stability throughout the period under review.

This impression is confirmed by longer-term inflation forecasts based on monetary aggregates. In the second quarter of 2008, money holdings in the euro area grew again strongly from what was already a high level. The broad monetary aggregate M3 expanded at a seasonally adjusted annualised rate of just under 8%, compared with 7% in the first quarter. As in the preceding quarters, it was primarily those components remunerated at close-to-market rates which increased. The robust monetary growth was again caused by a marked rise in loans to the private sector.

Against this backdrop, the Governing Council of the ECB decided in early July to tighten the reins of monetary policy somewhat and therefore raised each of the Eurosystem's central bank rates by ¼ percentage point. The minimum bid rate for the Eurosystem's main refinancing operations conducted as variable-rate tenders has since stood at 4.25%. The short-term money market rates increased correspondingly in July. Apart from transient and short-lived fluctuations towards the end of the month, the EONIA overnight rate stood at around 4.3% compared with around 4% in the preceding months. The longer-term money market rates rose as early as June in anticipation of the ECB Governing Council's interest rate adjustment. On average, the three-month rates in June, at just under 5%, were up around 0.1 percentage point on the month.

German economy

After growing very dynamically in the early part of the year, the German economy slowed perceptibly in the second quarter of 2008. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real GDP declined by 0.5% on the first quarter between April and June. Nevertheless, economic output was still up 1.7% on the year after calendar adjustment, compared with 2.6% in the previous quarter. The decline in overall economic output in the reporting quarter is to be seen primarily in the context of the very high output volume recorded in the first quarter when, owing in part to special factors in the production sector, the German economy grew by 1.3% on the fourth quarter of 2007. As expected, economic developments in the second quarter were also significantly dampened by corresponding counterswings.

However, this does not indicate a fundamental deterioration in the overall economic situation, nor does it point to a loss of the cyclical resilience that has been regained over the past few years. Nonetheless, further difficulties arose in the first half of 2008 in addition to the ongoing uncertainties and the global challenges which have yet to be surmounted. Consequently, the cumulative overall "risk mix" now implies a noticeable impact on Germany's economic development, meaning that a slower pace of activity is to be expected for the remainder of the year.

This emanates particularly from the current price pressures both in Germany and abroad. The massive energy price rises have led to considerable real income losses in the mature economies over the past few years and the propensity to consume has been hampered. This is weakening domestic demand and activity in major German export markets.

Labour market

Despite the weaker economic activity, employment in Germany increased further in the second quarter of 2008, albeit more modestly. There was a corresponding reduction in unemployment. At a seasonally adjusted 69,000 persons, the decline in unemployment was, however, significantly smaller than in the first quarter (209,000 persons). The unemployment rate, as defined nationally, fell from 8.0% in the first quarter of 2008 to 7.9% in the second quarter. There was a further slight decline in registered unemployment in July. As in June, the corresponding rate stood at 7.8%. The considerable improvement in the labour market situation of the past few years was reflected in higher wage agreements in many sectors. Measured in terms of growth in negotiated basic pay rates, wage agreements were up 3.4% on the year, compared with 3.1% in the first quarter. The accelerated trend in negotiated wages is also likely to have been reflected in a more rapid increase in national unit labour costs in the second quarter.

Prices

Price developments in the second quarter of 2008 were marked all along the production and sales chain by the sharp rises in crude oil prices in the world markets. External price pressures on the German economy increased again discernibly as a result. German consumer prices rose on average by a seasonally adjusted 0.8% on the quarter. Just over half of this was attributable to the energy component, which increased by 4.4%. The prices for heating oil and fuel climbed by almost 20% and just over 7%, respectively, on the first quarter. By contrast, the upward pressure on food prices eased. The prices of industrial products (excluding energy) and services rose somewhat. In July, the inflation rate in Germany, measured in terms of the increase in the consumer price index, was up 3.3% on the year.

Public finances

Following a marginal surplus in 2007, general government finances are likely to record a slight deficit again this year. This is primarily due to structural factors. In particular, the reform of business taxation and a further lowering of the contribution rate of the Federal Employment Agency from 4.2% to 3.3% will result in significant revenue shortfalls. The sizeable tax and social security rate cuts have not been matched by the evolution of expenditure which, while still fairly moderate, is rising faster than in previous years. In addition, the exceptionally robust growth trend in revenue from profit-related taxes, which has been evident for several years now, could reverse during the remainder of the year, especially given the turbulence on the financial markets.

Overall, the public finance situation in Germany has improved noticeably in the past few years. The European requirements for the medium-term budgetary objective arising from the Stability and Growth Pact and the reference value for government indebtedness stipulated in the EC Treaty could well be met in the not-too-distant future. However, this prospect is subject to considerable uncertainty. This concerns, firstly, the possibility of further budget-burdening measures. Thus the upcoming recalculation of the official socio-cultural minimum subsistence level can be expected to lead to an increase in the relevant tax allowances (and, in all likelihood, child benefit, too). Secondly, further cuts in tax and social security rates and extra spending are currently under discussion. Thirdly, a substantial drop in revenue levels is likely to result from 2010 onwards owing to a ruling by the Federal Constitutional Court referring to the offsetting of health and long-term care insurance contributions against tax. If the balanced general government budgetary position that has been painstakingly achieved is not to be frittered away, any additional budget-burdening measures will require solid counterfinancing. Fourthly, the current macroeconomic outlook is fraught with considerable uncertainty. Both past experience and the latest developments in some other countries have shown just how quickly the public finance situation can deteriorate given an unfavourable economic setting. Not least the extremely sharp growth trend in profit-related taxes over the past few years harbours the risk of a considerable setback potential.

A credit-financed economic stimulus package would promptly plunge government budgets back into difficulties – even if the above-mentioned risks do not materialise. In addition, problematic past experiences of active fine-tuning should be borne in mind. A stimulus package appears inappropriate, too, in the light of the macroeconomic outlook described above.