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Germany Being Dragged Along by Global Recovery

Economic recovery in Germany is struggling to gain momentum. While exports are the main driving force, domestic demand remains weak. How good are the prospects for the year ahead? Is there a chance of a lasting upturn?

Germany's economy is hesitant in breaking free of the stagnation experienced in recent years. While demand and output have been increasing again since the summer of 2003, the rate of expansion is still relatively slow, so that the average utilisation of total capacity has continued to fall until most recently.

Exports the Mainstay of the Economy

Recovery continues to rest on a slender foundation. It is borne by exports alone, which have picked up strongly since the middle of last year in the wake of the global economic upturn. This distinct rise in exports has been largely responsible for the renewed increase in industrial production since the autumn of last year. The dampening effects of last year's appreciation of the euro – in January this year its effective exchange rate was around 10% higher than a year previously, both in nominal and real terms – have easily been offset by the stimulus provided by the expansion of the global economy.

Contrary to previous periods of recovery, momentum has not yet spread to domestic demand which remains weak. This is true of private consumption in particular. The tax cuts that came into force at the start of the year were largely neutralised by burdens arising from measures introduced to reform the health system and to dismantle tax privileges; in addition, uncertainty regarding employment and future income developments dampened consumers' inclination to spend. With sales prospects outside Germany brightening – orders placed with domestic producers of investment goods have been increasing again modestly since the summer of 2003 – the propensity of the corporate sector to invest has improved in general, although there has so far been little growth in investments in plant and equipment. Modest sales prospects at home and the ongoing uncertainty among investors caused by economic policy have continued to discourage capital expenditure; soaring oil prices in recent months have doubtless added to this uncertainty.

As far as the labour market is concerned there are still no signs of improvement. The decline in employment – which had slowed perceptibly last year following the introduction of new mini job regulations and measures to support business start-ups[1] – has accelerated again slightly during the first months of this year; as the positive effects of labour market policies begin to fade, it appears that the underlying economic trend is coming increasingly to the fore. The number of unemployed, which on a seasonally adjusted basis had declined in the second half of last year due to statistical modifications accompanying the reorganisation of the government's labour market policy, fell by a further 80 000 or so at the start of this year owing to changes in registration rules which mean that, since January, those participating in aptitude assessment programmes and training courses are no longer counted as unemployed. However, it increased strongly thereafter, and by June was considerably higher than in December 2003. This is an indication that unemployment continues to follow a fundamentally upward trajectory.

World Economic Environment Remains Favourable

It is to be expected that the world economy will continue to be a source of significant stimulus for the German economy in future. However, the pace of expansion in the USA and China, which have so far been the centres of economic growth, will probably slacken somewhat. In the USA, fiscal stimuli will peter out during the course of this year; moreover, the American central bank has now begun to tighten the monetary reins. In China there are already signs that the economy is overheating, so that economic policy is striving to stifle the boom by curbing loans. Somewhat slower growth can thus be expected in both countries in 2005 in particular. In contrast, economic developments in the EU – which remains by far Germany's most important foreign market and, following enlargement, now absorbs almost 70% of German exports – can be

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[1] Cf. G. Weinert, E. Wohlers et. al.: Aufschwung mit Risiken – Konjunktur 2004, HWWA-Report No. 240, February 2004, p. 77 f.; J. Hinze: Keine Entwarnung vom Arbeitsmarkt, in: Wirtschaftsdienst, No. 6/2004, pp. 395 ff.

expected to gain a certain amount of momentum. This is partly due to the fact that the dampening effects caused by last year's appreciation of the euro are now on the wane.

Monetary Policy Remains Expansive

Monetary policy continues to chart a markedly expansive course, bolstering the economy both in the euro area and in Germany. Short term interest rates are comparatively low both in nominal and real terms, and the three-month interest rate is well below the Taylor rate.[2] At present there is little justification for tightening monetary policy. Prices in the euro area are increasing at a modest rate close to the stability mark of just under 2% laid down by the ECB. Inflation has accelerated slightly in recent months owing to the sharp rise in the price of oil and other commodities, but it should fall again appreciably – due also to base effects[3] – in the autumn. There are currently neither demand side nor cost-related signs of any real inflationary danger which could necessitate a change of monetary policy in the near future. In addition, the rate of expansion of the money supply aggregate M3 has slowed substantially in spite of the fact that the economy is beginning to pick up; the M3 growth rate recently stood at 4.7% compared to a year previously, only marginally higher than the reference value. For the forecast it is thus assumed that the ECB will leave its key interest rates unchanged at today's levels well into the year 2005. Not until the middle of next year is it likely to raise its rates slightly as the economic upturn becomes established and capacity utilisation within the euro area increases. Even then, monetary policy would still be expansive.

Long-term interest rates will pick up slightly as demand for capital increases in the wake of economic recovery and a growing normalisation of capital investors' portfolio structures. In comparative terms, however, they will still remain low in 2005. One risk factor involved in all these considerations is the price of oil. Should it continue to rise, there would also be an increase in the rate of inflation. The danger of inflation would be all the greater if rising energy prices were used to justify demands for higher wages. If there were any threat of such second round effects, the ECB would certainly raise interest rates sooner and more sharply than is assumed here.

In contrast to the ECB, the American central bank has already tightened the monetary reins. The most recent interest rate rises will be followed by further moves, so that the interest rate spread between the USA and the euro area will narrow considerably. Upward pressure on the value of the euro will thus decline in this respect. Moreover, the differences in growth rates between the two economic regions are also likely to diminish in the coming year. This supports the assumption made in the forecast that there will be no further appreciation of the euro and that the exchange rate will stand at around 1.25 US dollars up to the end of 2005.

Dampening Influence of Fiscal Policy

Given the favourable global economic environment and the relatively good monetary conditions, economic recovery can also be expected to continue in Germany. However, a strong, self-reinforcing upturn is somewhat improbable. This is due in decisive part to fiscal policy, which continues to be a source of restrictive effects. While tax cuts for private households and companies amounting to around 15 billion euros came into force at the beginning of this year, these are offset by additional burdens of similar volume created by an increase in tobacco tax, the dismantling of tax privileges and depreciation opportunities, higher welfare contributions to be made by pensioners as well as by measures aimed at containing the cost of the health system. All in all, a slightly restrictive fiscal policy course can be expected next year as well. While the conclusion of the "Tax Reform 2000" will bring further tax cuts amounting to around € 6 billion, the tobacco tax increase will take full effect and further tax privileges will be removed. Within the health system, moreover, there will be a further shift of the cost burden towards the insured, and a "sustainability factor" is to be introduced in the pension insurance system. Finally, the amalgamation of unemployment aid and social security payments to create the so-called "Arbeitslosengeld II" will in some cases lead to cuts in unemployment benefit payments.

More weighty than the direct effect on demand is the uncertainty that fiscal policy is generating among companies and private households. The increase in confidence that the government hoped to gain from its Agenda 2010 and the restructuring of its labour market policy has so far failed to materialise, and the current back and forth is hardly cut out for strengthening people's faith in politics and politicians.[4] Uncertainty is apparent not least in what remains a high savings rate among private households and also in the very tentative improvement in corporate investments in spite of favourable sales and earnings expectations abroad. The level of uncertainty will remain high for

[2] The Taylor rate is often used as a standard for assessing the course of monetary policy. If the three-month interest rate or the ECB's key rate are below the Taylor rate, then monetary policy is considered expansive, if the reverse is true, it is deemed to be restrictive.

[3] There was a strong rise in oil prices last autumn that resulted in an appreciable increase in the rate of inflation.

some time to come. This is partly because it is difficult for private households to assess the burdens arising from the new "Arbeitslosengeld II" and from changes in the pension insurance system. Under these circumstances, it is unlikely that the savings rate will decline for the time being.

Recovery Continues to Make Slow Progress

Under these conditions, economic recovery in Germany will be slow to make real progress. It continues to be driven primarily by exports, which are buoyed up by considerable impulses from the upturn in the global economy. Furthermore, the dampening influences caused by last year's appreciation of the euro are on the wane. Gradually at least, domestic demand will probably also begin to gain a certain amount of momentum. Favourable sales and earnings prospects in the export sector together with auspicious financing conditions will gradually prompt somewhat more spirited investment activities, and private consumption can be expected to increase slightly once again as employment prospects become generally brighter. However, the rate of expansion remains restrained, and a further acceleration during the coming year is not to be expected if only because the global economy will have shifted down a gear by then.

All in all, real gross domestic product is likely to increase by 1.5% this year and by 1.4% next year, whereby the difference in the number of working days should be taken into account. Around one third of the growth in 2004 is due to an unusually high number of working days. Adjusted to allow for this effect, real growth of gross domestic product is only a little less than 1% this year, and around 1 ¾% in 2005. The aggregate utilisation of capacity can be expected to increase slightly next year and the output gap will probably narrow somewhat. This development is also helped by the relatively flat growth path of potential output.[5] At 3.4% next year (2004: 3.7%), the government budget deficit will once again exceed the 3% ceiling laid down in the Maastricht Treaty. Germany will thus be in breach of the Stability and Growth Pact for the fourth year in succession.

In view of the restrained pace of expansion, a rapid and sweeping improvement of the labour market situation is improbable for the time being. Not before the final quarter of 2004 or the first quarter of 2005 is a slight upward trend likely to become gradually apparent. In 2004, the number of employed will fall again on average for the year, in 2005 it will increase marginally. The number of registered unemployed in 2004 will be roughly the same as in 2003 despite the further decline in employment. However, this is entirely due to the fact that, since the beginning of the year, those taking part in aptitude assessment programmes and training courses are excluded from the unemployment statistics. According to previous definitions, the number of unemployed this year would rise to 4.5 million.

Labour market policy continues to eclipse economic developments, although its effects will be less pronounced than last year. Thus for example, the number of mini jobs cannot be expected to further expand at the rate witnessed so far. In addition, many one-person enterprises, the so-called "Ich AGs" encouraged under the government's self-employment scheme, will fold again as subsidies decline, returning their founders to the ranks of the unemployed.[6] With regard to the unemployment statistics, the available "adjustment potential" was probably exhausted to a large extent last year, so that this approach is unlikely to bring much further "relief" in future. The effects of combining unemployment aid and social security to create the so-called "Arbeitslosengeld II" are still difficult to assess at the present time. Since any recipients of social security who are capable of gainful employment and who were previously not registered as seeking work must now register as unemployed in order to maintain their benefit claims, the number of unemployed ought to increase initially, by as many as 300 000 according to an estimate published by the Federal Labour Office. The government's ambition of being able to offset this increase quickly through more efficient job placement procedures is hardly likely to materialise. In the forecast, the effect of combining unemployment aid and social security benefits on the number of unemployed has not been considered.

Oil Price Risk

German fortunes continue to hinge on developments in the global economy. The strong expansion of domestic demand that would be necessary to give the country's economic recovery a broad foundation is currently not in sight. This makes the German economy highly susceptible to external shocks, and today's soaring commodity prices, particularly in the case of oil, represent a considerable risk. In the fore-

[4] Cf. E. Wohlers: Zwischen Skylla und Charybdis, in: Wirtschaftsdienst, No. 5/2004, p. 270 f.

[5] The German Council of Economic Experts currently puts the growth of potential output at 1 ½% p.a., according to OECD estimates it stands at a little over 1 ½%. Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 2003/04, Ziff. 186; OECD: Economic Outlook, No. 75, May 2004.

[6] In contrast to cases where interim aid is paid, claimants of unemployment benefit who make use of the business start-up subsidy do not have to present a viable business concept. Further evidence is the fact that social welfare contributions, which may amount to around € 430 a month, have to be paid out of the subsidies of € 600 in the first year, € 360 in the second, and € 240 in the third.

cast presented here it is assumed that there will be no renewed increase in the price of oil and that it will prevail at or around $ 32 per barrel next year. However, the HWWA macroeconomic model[7] was also used to examine possible effects of higher oil prices. The following scenarios were examined:

1. The price of oil remains at the level of $ 35 per barrel that was reached in the spring of this year until the end of 2005.
2. The price of oil climbs to a level of $ 45 per barrel and remains there until the end of 2005.
3. The price of oil climbs to $ 45 per barrel, remains there until the end of this year and then falls again to $ 35 per barrel by the end of 2005.

[7] On the HWWA's macroeconomic model cf. R.-F. Danckwerts, M. Danckwerts: Das ökonometrische Modell des HWWA zur Prognose der kurzfristigen Wirtschaftsentwicklung in Deutschland, HWWA-Report No. 197, Hamburg 1999.

In order to consider the repercussions of oil price shocks on the global economy it was further assumed that an increase of $ 10 per barrel in the price of oil reduces the growth of world trade by one percentage point in 2004 and 2005 respectively. No monetary policy reactions on the part of the central bank – such as an increase in interest rates in the wake of stronger inflation – were assumed. The results of the model calculations demonstrate that a further increase in the price of oil would have significant consequences for economic development in Germany. Even a level of $ 35 per barrel up to the end of 2005 would lead to an appreciable loss of growth next year. An increase to $ 45 per barrel would restrict economic recovery considerably and would lead to a further deterioration of the labour market situation; a slide into recession could not be ruled out.