European Economics

Economic Brief

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Holger Schmieding
(44) 20 7174 4924
holger.schmieding@bankofamerica.com

German Outlook: The Best Is Yet to Come

Austerity Pays Off – Consumer-led Boom Ahead – Fiscal Surplus?

- **Germany has emerged from its five-year adjustment crisis. Leaner and fitter than before, the economy has weathered the VAT hike remarkably well. We look for economic growth to stay well above trend, underpinning a fall in unemployment to 3.2 million late next year and a small budget surplus by 2008 at the latest.**
- **Unlike the Anglo-Saxon countries, Germany can still look forward to the best part of its business cycle. After years of misery, German consumers will soon enjoy a significant rise in disposable income, supported by strong gains in employment and less subdued wage increases. We expect consumption to take off soon.**
- **Unfortunately, the cyclical upswing has aborted the zeal for reform. Beyond a corporate tax cut, we expect no major nitiative before the 2009 elections. The worst threat to the outlook is not the euro but the risk that the government may impose costly burdens on the economy such as a job-killing minimum wage.**

Phoenix Rising

Strong momentum

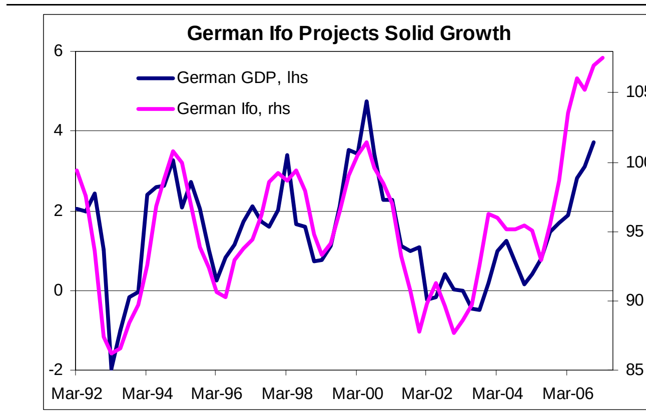
In our last German Outlook six months ago, we had predicted that growth would take a short breather after the VAT hike in January 2007 but re-accelerate nicely afterwards. Once again, the actual results have surpassed our optimistic expectations. Although the VAT increase led to a stunning 8.3% slump in retail sales in the first two months of 2007 relative to the 4Q 2006 average, firms took the hit in their stride, using weaker final sales as an opportunity to replenish inventories rather than as a reason to curtail output growth or to stop hiring new workers. GDP growth apparently slowed down only slightly in early 2007. Germany has successfully emerged from a wrenching five-year adjustment crisis. Short of a major external shock, the country looks set to enjoy above-trend growth for years to come, led ever more by firmer private consumption. Germany has turned from the sick man into the phoenix of Europe.

Figure 1. Economic and Financial Forecasts

	2005	2006	2007	2008
GDP	1.1%	2.9%	2.6%	2.5%
Household Consumption	0.3%	0.9%	0.3%	2.5%
Government Consumption	0.6%	1.8%	0.6%	1.1%
Gross Fixed Capital Form.	1.2%	6.5%	5.0%	3.7%
Final Domestic Demand*	0.5%	2.2%	1.3%	2.5%
Net Exports*	0.4%	1.2%	1.6%	0.0%
Inflation (HICP)	2.0%	1.7%	1.7%	1.3%
Unemployment Rate (ILO)	9.3%	8.3%	6.8%	6.2%
Budget Balance (% GDP)	-3.3%	-1.7%	-0.4%	0.2%
ECB Refi Rate**	2.25%	3.5%	4.0%	4.5%

*Contribution to GDP growth; ** end of period. Source: BoA estimates.

Figure 2. German Ifo Projects Solid Growth



German Ifo business confidence on right-hand scale. Source: Destatis; Ifo

Forecast Changes

Strong and long upswing

The strong and long upswing which we had predicted for the last two years has by and large materialised (see for instance our January 2006 report: "Phoenix Rising?"). Still, the strength of the bounce in growth in late 2006 and the resilience of German corporates after the VAT hike has surprised even us. Since the end of last year, we have made a number of forecast changes which all reflect the remarkable pace and quality of the upswing: We have

More growth, less inflation – Goldilocks could not have asked for more

- raised our forecast for GDP growth in 2007 from 1.9% to 2.6%,
- reduced our call for the unemployment rate in late 2007 from 7.5% to 6.5% (ILO),
- cut our estimate for the fiscal deficit in 2007 from 1.2% to 0.4% of GDP, and
- shaved our 2007 inflation forecast from 2.2% to 1.7%.

Cyclical Drivers

Five major factors are likely to shape the growth profile in the next two years:

Monetary policy turning neutral

1. Although the ECB has progressively reduced its monetary stimulus since December 2005, the lagged impact of low ECB rates will support activity well into 2007. Credit growth to the private sector picked up in Germany from -0.5% yoy in November 2004 to 4.6% in September 2006, although the VAT hike seems to have contributed to a deceleration to 2.1% in February 2007.

From a fiscal hit worth 1% of GDP to a small stimulus

2. Fiscal tightening worth 1% of GDP in 2007, mostly in the form of a hike in the standard VAT rate from 16% to 19%, will probably give way to a small fiscal stimulus of 0.3% of GDP in 2008, mostly through a cut in corporate taxes and slightly lower payroll taxes.

No more oil shock

3. Although oil prices have rebounded since mid-January, the price for Brent crude in April of €49.5 per barrel is still slightly below the 2006 average of €52. We expect 2007 to be the first year since 2003 without a major new oil shock. This removes a key factor that has so far restrained real consumer purchasing power.

The end of the construction crisis

4. Germany's construction sector has emerged from its 11-year downturn. Although the 5.3% rebound in construction investment in 2006 was exaggerated by a rush of households to receive construction bills ahead of the VAT hike, the broad-based advance in construction orders and leading indicators suggests that the sector as a whole has finally found a bottom. This makes a major difference. If construction had expanded in line with overall GDP instead of shrinking, average German GDP growth would have been 1.9% instead of the actual 1.4% in the 11 years to 2005.

Export outlook

5. The protracted slowdown in US demand growth and the 4% appreciation of the trade-weighted euro versus its 2004-2006 average so far this year will likely dampen export growth. Still, resilient demand from emerging Europe and Asia, an increase in the propensity of cash-rich oil producers to import and subdued unit labor costs in Germany's tradable goods sector should support at least a 10% rise of exports in 2007 after 12.9% in 2006, ahead of the projected 7.4% advance in imports.

Domestic Demand: Consumption Follows Investment

Phoenix in full flight

Like a Phoenix rising from the ashes, Germany has emerged from its 2001-2005 structural adjustment crisis. The post-unification spike in wages and taxes had turned Germany into a costly place to do business, forcing corporates to shift ever more jobs abroad. However, when the recession of 2001 drove home the need for change, corporates, workers and politics reacted. With severe wage restraint, serious cuts in benefits and taxes and some structural reforms, Germany gradually turned itself into a better place for business again. Since 2000, German manufacturers, which are mostly export-oriented, have slashed their unit labour costs by 11.1%. Such austerity, much derided by outside commentators at the time, has paid off remarkably. Following a strong surge in exports, investment activity has firmed since mid-2005. Last year, investment expanded by 6.5%, the best result since the unification boom in 1989-91. Healthy corporate profits and business confidence close to record highs despite headwinds from the stronger euro, the VAT hike and a less stimulative ECB policy signal further gains in investment ahead.

A stunning turnaround in the labour market

The growing propensity to invest has supported an astonishing turnaround in the labour market. The seasonally adjusted number of registered unemployed has already fallen by 1.178 million since its peak of 5.010 million in March 2005, equivalent to an average monthly decline of 49k. We expect unemployment to drop to 3.2 million by the end of 2008. The unemployment data are distorted by a reclassification of some unemployed as being sick as well as demographic effects, namely a lower number of school leavers and a trickle of immigration by German residents to countries like Switzerland and the UK with lower unemployment rates. Still, Germany's underlying employment performance is remarkable, with a net gain of almost 700k jobs between June 2005 and February 2007, equivalent to a monthly average of 34k. Most importantly, the number of standard jobs subject to social security taxes started to rise again in February 2006, reaching a six-month annualized growth rate of 2.4% in January 2007 (latest available data, see Figure 5). We suspect that a combination of modest structural reforms and wage moderation as well as the stagnant working-age population has lowered the "threshold" of GDP growth that generates a meaningful rise in German employment to 1.4%.

Robust growth, with a modest dip in mid-2007

All in all, we expect growth to stay close to 2.5% in 2007 and 2008, probably with a temporary modest loss in momentum in mid 2007 in response to the stronger euro and less buoyant US demand, followed by a re-acceleration in late 2007 once the end of the US residential construction crisis has lifted both the US economy and the US dollar again out of their current malaise.

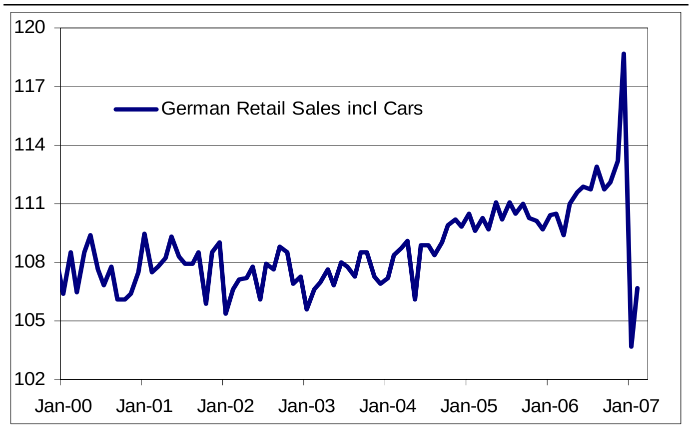
Heading for a consumer boom…

Unlike the Anglo-Saxon world and some countries on the Euro-periphery such as Spain and Ireland, Germany has not had even the slightest trace of the consumption boom which is typically the last and most pleasant phase of an economic upswing. Instead, German consumption has virtually stagnated from mid-2001 to mid-2006 as consumers had to tighten their belts amid cuts in real wages and government benefits. Germany as a whole had to go on a diet to restore its economic health. By now, however, corporates are lean and fit again and its citizens can return to more normal spending patterns, just as a patient who goes off a diet can eat more than while he was trying to shed the fat.

…once the VAT shock has faded

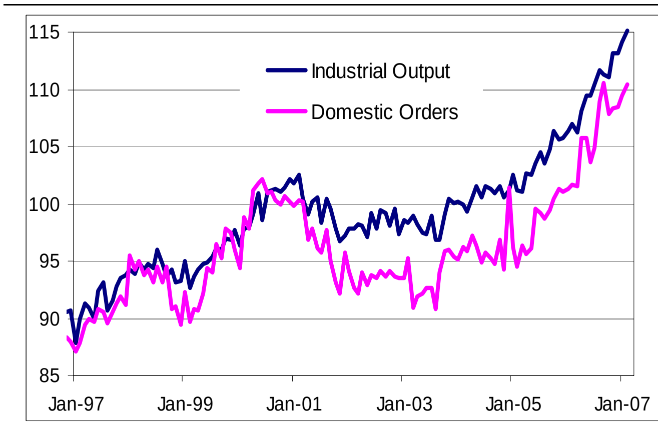
Although we always criticised the January VAT hike as the wrong way to cut the budget deficit, we had maintained that firmer employment growth, less subdued wage gains and a modest decline in the savings rate would largely offset the fiscal hit of 1% of GDP. Of course, the VAT hike does matter. Germans brought purchases of durable goods forward from early 2007 into late 2006, as Figure 3 for retail sales including cars show. Beyond this short-term volatility, which will mechanically depress the annual average rate of consumption growth for 2007, we expect a significant strengthening of consumer spending over the course of the next few years. The rise in GfK consumer confidence to a record 5.5 in May supports this view.

Figure 3. The VAT Shock: Now You See It…



Index levels in 2000 prices; source: Bundesbank

Figure 4. …Now You Don't



Index levels; 2000=100; source: Bundesbank

Disposable Income Dynamics: Heading for a Small Boom

After 5 years of stagnation...

Abstracting from temporary fluctuations, the real disposable income of German households did not rise at all between early 2001 and the autumn of 2006. Adjusted for inflation, the major single component of disposable income, net labour income (40% of the total), even fell by a cumulative 6% from 1Q 2001 to 4Q 2006 due to a decline in employment, lower real wages per worker and a higher burden from income taxes and mandatory social security contributions. This looks set to change significantly. We expect

...real disposable incomes should soon rise again noticeably...

- a 1.5% gain in employment for 2007 and 2008 after 0.75% last year and a decline in 2005,
- an acceleration in wage inflation from a mere 0.8% in 2006 to 1.9% in 2007 and 2.8% in 2008, measured as wage per hour in the economy as a whole, and
- a small cut in social security contributions in 2008, reflecting the rising surplus in the unemployment insurance scheme.

...supported by rising labour incomes and buoyant profits

In addition, income from profits and assets (38% of the total) will likely stay robust (up at least 5% after 6.1% in 2006) while transfer incomes (25% of the total) will be supported by the first modest increase in basic pensions (0.54% in mid-2007) after 3 years of stagnation. All in all, German households will likely enjoy a rise in their nominal disposable incomes of 3.6% in 2007 and 2008 after 2.0% last year and 1.6% in 2005.

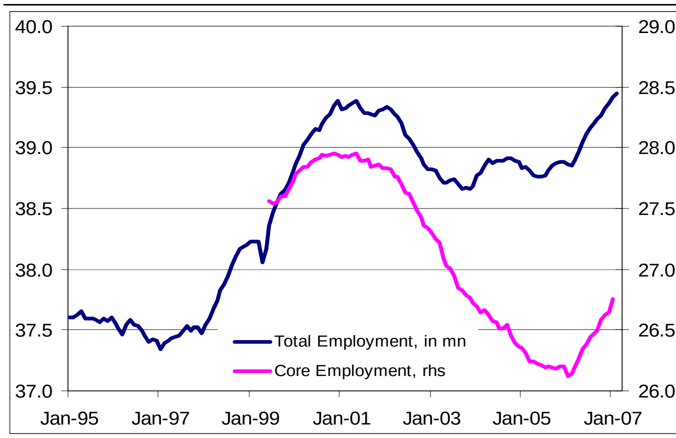
Inflation remains subdued as the end of the oil shock offsets higher wage settlements

Whether this advance will translate into the real purchasing power of consumers depends on inflation. The increase in the standard rate of VAT from 16% to 19% in January 2007 has already lifted the price level by roughly 1%. A further 0.3%-0.4% rise may still be in the pipeline for the remainder of this year according to our calculations. Despite this VAT shock, however, overall inflation in the first three months of 2007 has averaged merely 1.7% yoy, well below the 2.0% recorded in early 2006. In other words, the absence of a new oil shock comparable to the one consumers had to endure last year has more than offset the fiscal hit from the increase in indirect taxes. We expect inflation to average 1.7% this year, in line with the 1.7% recorded in 2006. When the base effect from the 2007 VAT hike drops out of the annual rate next year, inflation will probably recede to 1.3% despite some underlying wage-driven increase in service price inflation and a small increase in global inflation for manufactured goods as the disinflationary impact from China lessens over time.

Less need to save

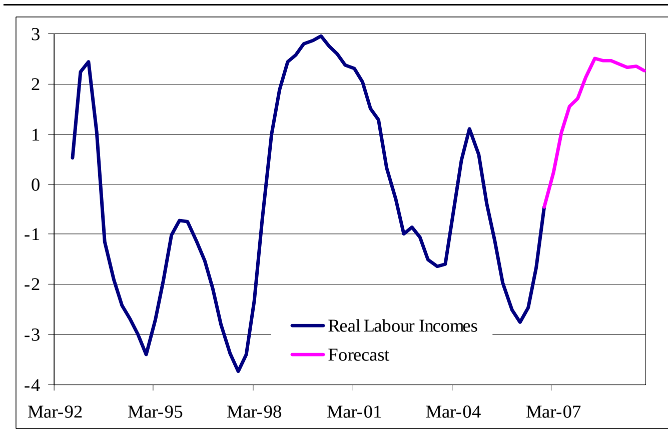
The outlook for real disposable incomes is thus even more favourable than for nominal incomes. In addition, Germans may feel less inclined to save. Between 2H 2000 and 1H 2006, Germans had reacted to a wave of benefit cuts and worries about job losses by raising their savings rate from 9.0% to 10.65% of their disposable incomes. Beyond a likely spike in the savings rate right after

Figure 5. Sharp Rebound in German Core Employment...



In millions; core employment subject to payroll taxes on right-hand scale
Source: Bundesbank

Figure 6. ...Heralds a Surge in Real Labour Incomes



Net take-home wage and salary incomes deflated by CPI, yoy in %.
Source: Bundesbank; BoA forecasts

the VAT hike in early 2007, we expect the savings rate to decline gradually to no more than 10% by late 2008. As a result, we look for private consumption to expand 2.5% in 2008 after a VAT-depressed 0.3% in 2007. The risks to our consumption forecasts are probably still on the upside.

Policy Challenges: Trying to Avoid the Backlash

Reaping the benefits of previous reforms…

German's economic reforms since 2001, usually agreed jointly between the centre-right CDU/CSU and the centre-left SPD which now form the "grand coalition" under Chancellor Merkel, are paying off. To give one telling example: roughly half of the net increase in employment since the labour market hit bottom can be attributed to the boom in temporary work agencies. With the first of the so-called "Hartz" labour market reforms in 2003, temp agencies were given the right to de facto send workers to corporates on a permanent basis instead of for a maximum of two years. Some corporates now use temp workers for half or more of their entire shop floor staff. With this reform, German corporates can circumvent the still-unchanged anti-dismissal regulations. The costly dismissal risk is now borne by the temp agency, not the corporate which utilises the worker. This lowers the threshold for a corporate to employ extra labour. It also enhances overall economic efficiency. As the temp agency can redirect a worker from one corporate to another, it can – unlike the end-user of the labour input – sometimes avoid a costly dismissal.

…which have eased some of the worst rigidities

We expect the modest structural reforms of the previous years to gradually ease some of the rigidities that have held back the economy over the last decade. While the patchwork reforms may not suffice to raise German trend growth, currently around 1.7%, they provide more resilience to shocks and will likely offset the negative economic impact of the aging population for the next few years.

Will Berlin hold the line – or return to its bad old ways?

Looking forward, however, German politicians are more likely to passively reap the benefits of previous reforms and vigorous corporate restructuring than to maintain the pace of change. Instead, the improved cyclical performance has eased the pressure to pursue reforms. Fortunately, the envisaged corporate tax reform, if implemented as scheduled in 2008, will likely make Germany more attractive for domestic and foreign investors. Beyond this reform, the major task for the dwindling band of reformers is to hold the line, that is to prevent serious slippage or even an outright return to extra regulations. The imposition of a minimum wage, for which major elements in the government are pushing hard, could do severe damage over time, reducing the employment chances of the less skilled who make up the bulk of the long-term unemployed. And while the recent cabinet decision to prohibit supermarkets from selling foodstuffs below costs may not have much economic impact, it shows that Berlin is not beyond endorsing some genuine economic nonsense. Unfortunately but unsurprisingly, the genuine reform process, which is far from complete, may only advance again once the cyclical upswing has run its course and a new downturn exposes the remaining structural weaknesses.

Major Risks

The risks to our growth forecasts are broadly balanced:

The usual external risks

- Externally, a further major appreciation of the euro, a slide of the US economy into a genuine recession, a renewed surge in the oil price or a dramatic correction in global financial markets with knock-on effects on business investment and consumer spending could slow down and potentially derail the upswing, especially if some of these risks were to materialise jointly. Conversely, however, lower oil prices and a possible correction of the euro to less elevated levels could boost the advance in exports and domestic demand beyond our forecasts.

Excessive wage hikes could hurt

- Internally, the dynamic looks very strong, with a chance that the gathering momentum may boost the growth in domestic demand beyond our forecasts. However, if wage inflation accelerates more than we project, corporates could slash their investment plans, leading to a severe slowdown in employment and overall demand growth shortly afterwards.

Figure 7. German Economic and Financial Forecasts

		2006	2007	2008	Q106	Q206	Q306	Q406	Q107	Q207	Q307	Q407	Q108	Q208	Q308	Q408
GDP	% y/y	**2.9**	**2.6**	**2.5**	1.9	2.8	3.1	3.7	3.4	2.7	2.3	2.0	2.2	2.4	2.6	2.7
	%q/q ann.				3.4	4.8	3.2	3.5	1.9	2.0	2.0	2.3	2.5	2.8	2.8	2.8
	% q/q				0.8	1.2	0.8	0.9	0.5	0.5	0.5	0.6	0.6	0.7	0.7	0.7
Private Consumption	% y/y	**0.9**	**0.3**	**2.5**	0.7	0.5	0.7	1.8	0.0	0.5	0.2	0.5	2.1	2.5	2.7	2.8
	% q/q				0.8	-0.1	0.7	0.3	-1.0	0.4	0.5	0.6	0.6	0.7	0.7	0.7
Government Consumption	% y/y	**1.8**	**0.6**	**1.1**	2.9	0.7	1.5	2.0	-0.2	1.0	0.5	0.9	1.0	1.1	1.2	1.2
	% q/q				2.4	-1.0	0.7	-0.1	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Investment	% y/y	**6.5**	**5.0**	**3.7**	3.7	8.2	7.2	6.8	7.6	4.3	4.1	4.0	3.8	3.6	3.6	3.6
	% q/q				0.3	4.3	1.1	1.0	1.1	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Final Dom Dd[1]	% y/y	**2.2**	**1.3**	**2.5**	1.6	2.0	2.0	2.7	1.4	1.3	1.0	1.2	2.1	2.3	2.4	2.5
	% q/q				1.0	0.6	0.8	0.4	-0.3	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Net exports[1]	% y/y	**1.2**	**1.6**	**0.0**	0.0	0.7	0.7	3.1	2.5	2.4	2.0	-0.3	0.0	-0.1	-0.1	0.0
	% q/q				0.3	0.2	0.5	2.2	-0.3	0.1	0.0	-0.1	0.0	0.0	0.0	0.0
Stockbuilding[1]	% y/y	**-0.3**	**-0.3**	**0.2**	0.2	0.2	0.4	-1.8	-0.5	-1.1	-0.7	1.0	0.1	0.2	0.2	0.2
	% q/q				-0.3	0.5	-0.4	-1.6	1.0	-0.1	0.0	0.1	0.1	0.1	0.1	0.1
Current Account Balance	EUR bn	**108.4**	**119.4**	**113.4**	25.3	25.7	22.9	34.6	28.3	28.7	25.9	36.6	29.3	28.7	25.9	36.6
	% of GDP	**4.6**	**4.9**	**4.5**												
Industrial production [2]	% y/y	**5.8**	**3.9**	**2.5**	5.0	5.9	6.5	5.9	5.8	4.4	2.9	2.4	2.2	2.5	2.6	2.7
	% q/q				0.9	1.7	2.0	1.1	0.9	0.3	0.6	0.6	0.6	0.7	0.7	0.7
Unemployment rate [3]	% y/y	**8.3**	**6.8**	**6.2**	8.5	8.0	8.1	7.7	7.1	7.0	6.7	6.5	6.4	6.3	6.2	6.1
CPI [4]	% y/y	**1.7**	**1.7**	**1.3**	2.0	2.0	1.6	1.3	1.7	1.7	1.6	1.8	1.2	1.1	1.3	1.4
	% m/m				0.0	0.2	0.0	0.3	0.2	0.1	0.1	0.2	0.0	0.2	-0.1	0.2
General govt balance	% of GDP	**-1.7**	**-0.4**	**0.2**												
General govt debt	% of GDP	**67.9**	**65.9**	**63.2**												
Refinancing rate [5]	%	**3.27**	**4.00**	**4.50**	2.32	2.55	2.90	3.27	3.55	3.80	4.00	4.00	4.10	4.30	4.50	4.50

Notes: [1] Contribution to GDP growth [2] Ex construction, s.a., quarterly averages [3] ILO measure, period averages, s.a. [4] Period averages, m/m changes are quarterly averages; 2007 includes 1.3% point impact from VAT hike [5] Quarterly averages. GDP excludes calendar effects.

Sources: Eurostat; Bloomberg; Bank of America forecasts for 2007 and 2008.

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