



Daily Note: 26 March 2008

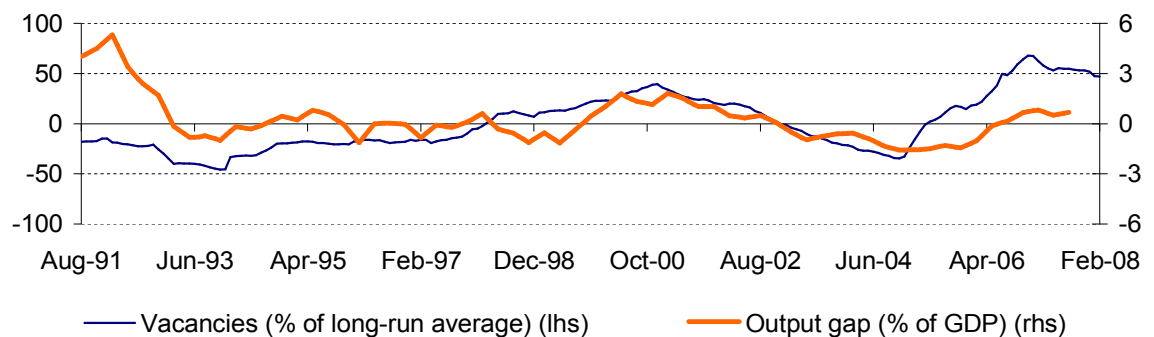
## Why faster wage inflation is good for Germany

**WE SUGGEST:** Germany can de-couple

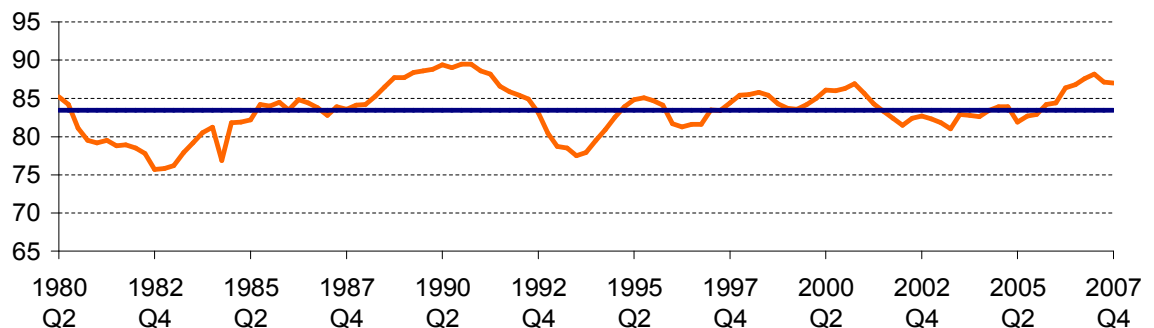
**SUMMARY:** Rising consumer price inflation and falling real incomes have spooked the consumer. But Germany's export-led expansion has exceeded the economy's capacity limit, so slower growth is needed. Waning external demand should result in a healthy re-balancing if firms accelerate the transfer of increased profitability into higher consumer incomes. Productivity improvements allow for faster wage increases without the loss of competitiveness.

Germany has overheated. Output growth has run ahead of the economy's potential growth rate, resulting in the opening of a positive output gap to the tune of ½% of GDP in Q4.

Germany's output gap and the deviation of vacancies around the mean



Industrial capacity utilisation versus its long term average



With the economy now operating above its capacity limit, it is no surprise that core inflation has accelerated, on top of the external cost-push increase in headline inflation.

The positive output gap is small relative to previous episodes of overheating, but survey evidence suggests that our estimate of the output gap may be underestimating the extent of the overheating. The charts above show that both industrial capacity utilisation and the level of vacancies in the economy are significantly above their long-term averages. Firms' pricing power has also risen.

The increase in consumer price inflation, especially since the middle of last year, has spooked the German consumer. Consumer confidence plummeted, pushing the household savings rate up. And with good reason as by the end of 2007 real household incomes actually fell on an annual basis. No wonder consumer spending also contracted in the fourth quarter of last year. Overall output growth was below trend, causing the positive output gap to shrink. But the output gap will need to turn negative for domestic inflationary pressures to abate. Hence, below-trend output growth is desirable in coming quarters.

With external demand set to weaken Germany is not only set to get the needed growth slowdown, but it is also offered the chance to re-balance its economy towards consumer spending. A relatively short period of below-trend growth will be needed to eliminate domestic inflationary pressures, while the global slowdown should ease the cost-push energy and food price increases. Hence, while consumer price inflation is likely to accelerate in the near term, by the start of 2009 it should start to fall.

But for consumers to turn into a growth engine firms will have to accelerate the transfer of their improved profitability into higher consumer incomes. Today saw the release of the Ifo survey for March. The business climate index arrested its fall in recent months and overall it remains above its long-run average. The predictive power of the Ifo index vis-à-vis GDP growth has diminished in recent years, but the index remains a good gauge for corporate performance. German firms have restructured aggressively and improved profitability tremendously. The share of profits in output has risen relentlessly over the past few years. Higher productivity growth would allow firms to increase wages at a faster pace without the loss of competitiveness. A sustained increase in wage growth above consumer price inflation is needed for the Germany to return to trend growth in 2009.

Diana Choyleva

[diana.choyleva@lombardstreetresearch.com](mailto:diana.choyleva@lombardstreetresearch.com)