Overview

The German economy under the impact of the escalating crisis on the financial markets and a worsening outlook for the real economy

Global economy

The prospects for the global economy have deteriorated considerably, particularly as the crisis on the financial markets has intensified significantly since the third quarter; as 2008 draws to a close, the outlook is worse than it has been in a long time. Though some relief has been afforded by the notable easing of price pressure on the commodities markets and of consumer price inflation in recent months, this will not be sufficient to noticeably brighten the dull real economic outlook for the next few quarters. The full negative impact on the goods and income cycle is not expected to show up until next year. Up until recently, the signs of trouble were mainly confined to the industrialised countries, some of which are now on the brink of a recession. In recent months, however, emerging market economies, too, have increasingly been feeling the effects of the events unfolding on the financial markets. In addition, they are facing growing strains from an initial marked slowdown in their exports to industrialised countries and from capital outflows.

Financial market setting

The escalating crisis in the financial sector since the summer was fuelled by the ongoing weakness of the US real estate market, the poor economic outlook and, notably, by spiralling risk aversion following the insolvency of a large US investment bank. Despite declining yields on government bonds, financing conditions for enterprises on the capital markets have worsened dramatically since

the middle of 2008. Plummeting share prices in industrialised countries and emerging market economies, a further decline in the prices of risky assets and pronounced tensions on the money markets have increased pressure on financial institutions. The foreign exchange markets, in turn, were sucked into the maelstrom and experienced considerable volatility in the third quarter. As a consequence, the single European currency depreciated against the other major global currencies into November and, as this report went to press, the trade-weighted value of the euro was 8½% below the high it marked in the second quarter. The difficulties in the financial system prompted numerous countries to launch government rescue packages for individual institutions as well as broad-based aid measures for the financial sector as a whole. These measures, combined with cuts in short-term key interest rates in numerous countries, brought a degree of stability to the markets. However, the international financial system is now having to contend more with the repercussions of the weakened macroeconomic environment.

Monetary policy

Against this backdrop and given waning price pressure, euro-area monetary policy was eased considerably in the fourth quarter. In a concerted action with six other central banks, the Governing Council of the ECB lowered its main refinancing rate by ½ percentage point to 3.75% on 8 October 2008. On 6 November, it cut key interest rates further to 3.25%. In addition, temporary changes to the monetary policy framework were agreed. These changes reflect the fact that the Eurosystem has responded to the ongoing serious disruption to the interbank market by *de facto* taking the distribution of liquidity, which normally takes place among credit institutions without the involvement of the central bank, into its own hands. This does not *per se* represent a change in the Eurosytem's basic monetary policy stance, but rather reflects the operational reaction to the evident dysfunctionality of the unsecured money market.

In view of the current market turmoil, euro-area banks have further tightened their credit standards, according to the Bank Lending Survey. However, there is no evidence yet of broad-based supply-side credit restrictions in the euro area.

Tough cyclical phase ahead for German economy

The rapid cooling of the global economy and the fact that the underlying sentiment in Germany is increasingly characterised by caution and restraint have progressively been weighing on the German economy, too, since the middle of 2008. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real GDP in the third quarter was 0.5% down on the preceding three months. While aggregate economic output grew almost at the same pace as potential output in the first half of 2008 on balance – excluding weather-related special factors – overall capacity utilisation subsequently declined significantly. Manufacturing, which had previously benefited strongly from the positive overall economic development, was particularly hard hit by the dwindling momentum. This caused enterprises to begin revising their investment and staffing plans downwards. Averaged over all sectors, however, the level of activity is likely to have

remained within normal bounds. Nevertheless, another marked slackening of the dynamics appears likely in the fourth quarter.

There are no signs to date, however, of the financial market crisis having a major dampening effect on the German economy in the form of restrictive lending by domestic banks, even if the fairly strong credit growth seen in the last few quarters has eased somewhat. This was chiefly caused by slower growth in loans to non-financial corporations and further reduced lending to households. However, in Germany, as in the euro area as a whole, the more moderate expansion of loans to the private sector compared to previous quarters can probably be attributed mainly to lower credit demand. While the German banks participating in the Bank Lending Survey did report tighter lending conditions, the tightening was less pronounced in Germany than in the euro area overall. All in all, the more muted credit growth in Germany can be attributed almost entirely to traditional factors. To date the financial market crisis is impacting Germany's real economy less as a result of restrained bank lending than as a consequence of the weaker external environment and a considerable deterioration in confidence.

The contribution of foreign trade noticeably dampened GDP in the third quarter, as marginally declining export volumes coincided with an above-average increase in imports. One reason why the external sector has ceased to be a driver of output since the second quarter is the temporarily high international co-movement of the cyclical conjuncture.

The profound and persistent dislocations on the international financial markets have, in the meantime, cast a dark shadow over the real economy in many countries. The German economy, with its broad regional export spread, will inevitably be clearly affected by the resulting drop in demand in major sales markets in the coming months, particularly as domestic demand is not expected to yield any noticeable positive impulses in the short term.

Given the more muted sales prospects in the international environment, exporting enterprises saw no immediate necessity to step up their fixed capital formation. Besides this, industrial investment is likely to have reached an advanced stage of the business cycle anyway. This is evident *inter alia* from the fact that the contribution which new machinery and equipment as well as new factories and office buildings made to value added in the corporate sector in the first half of 2008 reached a level not exceeded at the peak of the two previous investment cycles, ie shortly after German reunification and in the year 2000.

Private consumption probably held up well in the third quarter thanks to the abrupt turnaround in the price of crude oil, the ongoing positive evolution of the labour market and higher wage growth. However, the poor underlying trend in terms of real consumption expenditure and the muted propensity to pur-

chase would appear to indicate that the consumer climate in Germany is still fragile.

Over time, however, the fact that in a number of the countries worst affected by the financial market crisis government support measures for financial institutions have been launched to prevent the turmoil from spreading and to rebuild confidence could have a positive effect. In addition, energy and commodity prices have fallen steeply recently. For example, the seasonally adjusted price of energy imports dropped by more than 8% from June to September. The year-on-year rise in inflation as measured by the consumer price index declined from 3.3% in June to 2.4% in October. Partly as a result of the ongoing corrections on the international commodities markets and positive baseline effects, the rate of price increases is expected to decline significantly further over the next few months, notwithstanding the euro's marked depreciation against other major currencies. The lower exchange rate of the euro is likely to have boosted German goods' sales prospects.

Looking ahead to next year, the still very robust labour market situation gives reason to hope that the current slowdown of the German economy will not result in a self-reinforcing and entrenched downturn. Unemployment declined fairly steadily up until the end of October, and employment is expected to have increased further up to September. The fact that a lot of enterprises have demonstrated their readiness to keep core staffing levels unchanged in view of well-stocked working time accounts and the persistently acute shortage of skilled labour not only supports households' income situation, it also reduces the risk of job losses. It should be remembered, however, that although firms have a vested interest in maintaining a stable core labour force, they can currently make any necessary adjustments fairly rapidly given increased levels of temporary hiring from employment agencies and fixed-term contracts. Nonetheless, firms' strategy of initially not making – generally expensive – adjustments to core staffing levels is particularly likely to undergo a long-term change if the cost of safeguarding jobs increases. Continued wage policy moderation will consequently not only protect the substantial achievements made on the labour market in recent years, it will also limit the risk of primarily domestic downward pressure on the economy.

Public finance situation

The public finance situation could undergo a further slight improvement this year, despite the overall economic downturn since the second quarter, and the general government budget could post a surplus for the first time since German reunification. One reason for this is the positive cyclical momentum on an annual average following the economy's strong performance in the first quarter. However, the public finance situation will probably deteriorate noticeably in the coming year. In a baseline scenario, which includes recently agreed fiscal measures and a marked decline in profit-related taxes but excludes additional spending in connection with government support measures for financial institutions, the deficit could reach sizeable proportions.

Fiscal policymakers are currently making a major contribution to steadying the level of economic activity through the measures aimed at stabilising the financial markets, thus helping to avert the danger of a systemic financial crisis in Germany, although this intervention has not yet showed up in the usual indicators measuring the expansiveness of fiscal policy. In addition, the German government has responded to the economic slowdown using a number of different instruments assembled in a fiscal stabilisation programme. While the planned measures could provide a certain additional impetus, their overall influence should not be overestimated. The crucial importance of the past achievements in the field of fiscal consolidation for coping with hard times is currently being vividly demonstrated. The fundamental objective of achieving a structurally balanced general government budget in the medium term should therefore certainly not be abandoned despite the recent developments. A solid foundation will allow the automatic fiscal stabilisers to take full effect in the coming period. If the economic situation proves very unfavourable, further unexpected tax shortfalls could initially also be absorbed. Such an orientation of fiscal policy would exploit the considerable potential for automatic stabilisation. The fiscal consolidation achieved in recent years means that Germany has a certain radius of action without risking a breach of the 3% deficit limit. Substantial additional fiscal stabilisation programmes might be warranted if an extraordinary recession were thought likely. In any case, any further unfunded measures to boost the economy should be of very limited duration and should avoid causing unnecessary distortions of economic activity. In particular, substantial growth losses could ensue in the longer term in the event of a stampede to grant (sector-) specific subsidies at national and international levels, thereby distorting competition.

Given the tense current situation on the financial markets and the dented underlying sentiment in respect of the real economy, it is particularly important that economic and fiscal policymakers do not jeopardise the foundations for sustainable growth and employment gains as well as sound public finances by providing wrong incentives with longer-term implications in implementing the measures aimed at overcoming the crisis in the short term.