Overview

German economy in the throes of the global economic downturn

Global economy

The downward slide of the global economy accelerated markedly in the fourth quarter of 2008. The underlying recessionary tendencies in the industrialised countries hardened in the wake of the escalating crisis in the international financial markets in the final months of the year and its negative knock-on effects on confidence and wealth. As the emerging market economies and developing countries could not avoid these negative influences either, the global economy as a whole cooled appreciably in the fourth quarter. A feature of the current downturn, which has few historical parallels, is its pronounced synchronicity across regions. The worldwide fall in demand also caused commodity prices to fall steeply in the fourth quarter. The resulting increase in real purchasing power in the consumer countries failed to compensate for the negative external effects, particularly as it was accompanied by muted economic growth in the commodities-exporting countries. However, the brighter inflation outlook on the back of declining energy prices allowed numerous countries to relax monetary policy significantly. At the same time, a number of states launched sizeable fiscal stimulus programmes.

Financial market setting

The negative developments in the financial markets and the real economy intensified as the international financial market crisis came to a head with the insolvency of the US investment bank Lehman Brothers in September 2008. Share prices on the international stock markets suffered hefty

losses. By contrast, demand was high for safe, liquid securities, especially government bonds. This also caused a reassessment of credit risk for government bonds which differed among the various euro-area countries and was evident, *inter alia*, in the debtor-specific increases in premiums on credit default swaps. Not only has the yield spread between German government bonds and all other euro-area government bonds widened since the end of September, the yield dispersion between the government bonds of all member states excluding Germany has also increased perceptibly. In the fourth quarter of the year, the duller economic outlook led to a further deterioration in financing conditions in the international capital markets for private investors. The interest rate premiums on European corporate bonds temporarily marked new highs. In the international foreign exchange markets, the euro appreciated significantly in December, though it ceded a large part of these gains in the first few weeks of the new year.

Monetary policy

The easing of the monetary policy stance in the euro area, which was initiated in the fourth quarter, was continued. The Governing Council of the ECB has now cut the main refinancing rate for the Eurosystem by a total of 2¼ percentage points to 2% since October 2008, thereby exploiting the scope for discretionary action created by significantly reduced inflation risks. In cutting the rate, the Governing Council was also responding to the much gloomier outlook for the real economy in the euro area in the wake of the financial market crisis.

The looser monetary stance adopted since October 2008 has resulted in a significant decline in interest rates on the euro money market. The overnight rate (EONIA) fell sharply; it is now clearly below the main refinancing rate – as a consequence of the switch to full allotment in all Eurosystem refinancing operations and the widening of the gap between the main refinancing rate and the deposit facility rate at the end of January. By historical standards, however, the trading volume in interbank lending, on which EONIA is based, remained low; while this can probably be attributed partly to the generous provision of liquidity by the Eurosystem, it also points to ongoing distortions in the interbank market. Longer-term euro money market rates have also dropped appreciably in recent months. This was, moreover, accompanied by a significant narrowing in the relevant risk premiums. For instance, the yield spread between unsecured three-month money (three-month Euribor) and its secured counterpart (Eurepo) has narrowed distinctly, by around 1 percentage point, since October, despite more bad news from the European and US banking sectors. As this report went to press, it stood at just over 0.9 percentage point.

M3 growth slowed perceptibly in the fourth quarter. In seasonally adjusted, annualised terms, the broad monetary aggregate expanded by 6% from October to December 2008, having risen at a rate of more than 8% in the preceding quarter. Monetary momentum continued to weaken on a slightly longer-term view, too. The moving three-month average of the annual growth

rates for the months October to December was 7.9%, 1 percentage point lower than in the preceding quarter and 4 percentage points down on the year.

Lending to the euro-area private sector waned considerably in the period under review. It actually declined slightly from October to December 2008. This slowdown can be explained in part by substantial securitisation transactions, as a result of which the relevant credits are no longer reported as loans to the private sector. In particular, both loans to households and loans to monetary financial institutions (MFIs) declined in non-seasonally adjusted terms, while lending to non-financial corporations rose marginally in October and November. The Bank Lending Survey indicates a further marked tightening in credit standards in the euro area in the last quarter of 2008.

German economy

The German economy slipped into a severe recession in the fourth quarter of 2008, which will continue in the next few months. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real gross domestic product (GDP) fell by 2.1% in the fourth quarter of 2008, following a decline of 0.5% in the previous quarter. The main reason for the sharp economic downturn was that the manufacturing sector, the cyclically sensitive hub of Germany's economy, responded to the marked fall-off in orders by sharply cutting output towards the end of the year. The heavy, primarily external, strains spilled over extraordinarily fast into the upstream production sectors and had an almost immediate knock-on effect on business-related services, too. In view of the speed at which the negative demand shock spread, overall capacity utilisation also dropped below the corridor of normal utilisation within just a few months. Production capacity was therefore probably already considerably underutilised at the end of the year.

Given the temporarily very high co-movement of the downturns in all major sales markets, exports fell very sharply in the fourth quarter, after declining only moderately in the second and third quarters. Exports to EU partner countries have been particularly hard hit of late.

Given spare production capacity, enterprises have recently refrained from making new investments. This may have been compounded by the fact that, from mid-2008 onwards, the external financing conditions for large enterprises especially, which are typically more dependent on the capital market, worsened significantly. Overall, however, the corporate sector has shown remarkable financial resilience compared to the last downturn in the early part of the current decade, as is also evident in the latest credit data. For example, loans to non-financial corporations proved robust overall, despite declining annual growth rates. The comparatively resilient credit environment can also be seen in the current data from the Bank Lending Survey for Germany. While the gloomier outlook for the real economy is likely to have a dampening impact on lending in Germany over the next

few months, there are still no signs of broad-based supply-side restrictions on borrowing.

Following a slight increase in the third quarter, the development of private consumption at the end of the year was marked by contradictory influences. The price climate improved considerably as energy and food prices moved sharply lower, which meant that the higher collective wage agreements of 2008 had a perceptible uplifting impact on real income. However, the sharp deterioration in the overall economic outlook and reports of increasing use of short-time working arrangements and some redundancies dented the propensity to consume and are likely to remain a drag over the next few months.

The labour market proved remarkably resilient up until the fourth quarter of 2008. To date, the sharp drop in output in the fourth quarter of 2008 has had only a very moderate impact on staffing levels. In the main, the total number of hours worked in the economy as a whole has been adjusted by reducing the working time per employee. According to preliminary calculations, employment growth has weakened steadily over the past few months and, in November, ground to a halt. Similarly, unemployment reached its cyclical bottom in the fourth quarter of 2008, following a long decline.

Germany is therefore currently experiencing an exceptionally pronounced and abrupt economic downturn, which is, moreover, being accompanied by a crisis on the financial markets. In this exceptional situation and in view of a largely balanced general government budget, the decision not to rely exclusively on the automatic stabilisers, as in a normal cyclical downturn, but also actively to take fiscal policy measures aimed at reviving the economy is justifiable. With this aim in mind, the German government adopted two sizeable economic stimulus packages in November 2008 and January 2009, which will probably provide a noticeable boost to the economy as a whole in 2009 and 2010. Nevertheless, this will fall a long way short of offsetting the slowdown in growth expected in export business in the short run. In the current environment, government aid measures to support demand can only attempt to prevent the downward pressure emanating from foreign trade from spreading across the board to domestic demand and thus to mitigate the impact of recessionary influences.

The financial resources within the Federal Government's two economic stimulus packages that are earmarked for public-sector investment in infrastructure will give an impetus to the construction sector, in particular. In addition, the measures will underpin the stabilising function of private consumption. Besides the positive impact of the more favourable price environment and noticeable increases in wages, households' disposable income will rise by an estimated total of €14 billion this year as the tax cuts contained in the second economic stimulus package, the increase in child benefits, the one-off child bonus and the income tax refunds as a result of the reintroduction of the tax break for commuters take effect. The

changes to short-time working benefits that have also been agreed on will make it easier for enterprises to adjust labour volume in response to economic conditions without having to resort to large-scale redundancies. This *de facto* extends the length of time over which wage substitutes are paid, as unemployment benefits are, if necessary, granted for the full entitlement period if employees are laid off following a spell of short-time working. This could hamper necessary structural adjustments. However, in view of the exceptionally high uncertainty, it currently appears more important that this measure reduces the individual risk of job losses in the short term and thus mitigates a factor that generally has a negative impact on consumption behaviour.

Overall, however, the problems associated with the selected fiscal measures must likewise be borne in mind. The attempt to steer economic processes by means of a flurry of government interventions – whether through direct spending, tax benefits or guarantees – is always problematic. The planned rapid and sharp increase in government investment will also necessitate major efforts to ensure the efficient use of government funds. Care should be taken that these investments – which amount to no less than around 50% of the annual government investment budget – do not merely to inflate prices. In terms of the timing of their impact, it would have been macroeconomically more effective to focus the measures more strongly on the immediately coming quarters. As it stands, some will not develop their full impact until the second half of 2009, while others do not become fully effective until next year or even later. Some of the measures will prove a lasting, rather than merely temporary, strain on public finances.

Public finances

Maintaining confidence in the long-term sustainability of public budgets is a vital requirement for a successful discretionary fiscal policy. When the measures were agreed on, the fiscal situation was comparatively favourable, and the general government budget was largely balanced last year. This year, however, the general government deficit will grow considerably, though it should remain below 3% of GDP as things stand. The debt ratio will rise dramatically and is likely to reach a new high. One driving factor is the very dull cyclical setting. Another factor is that the extensive fiscal stimulus measures will significantly swell the deficit. If they are implemented as planned, the stimulus packages of November 2008 and January 2009 are likely to increase the deficit for 2009 by more than 1% of GDP. At the end of January, the German government presented an update of the stability programme of December 2008. According to this, the deficit ratio will rise further to around 4% in 2010. This indicates that Germany could exhaust its original fiscal leeway. Past experience suggests that it is simpler to achieve consensus on increasing debt financing than on subsequently consolidating public finances. In the current situation, it is therefore indispensable that there be a realistic prospect of bringing the expected high deficits back down.

This is also a requirement under European budgetary rules. They are flexible enough temporarily to allow deficits exceeding, but close to the 3% threshold in exceptional circumstances. In some member states, the scope for an expansionary fiscal policy was significantly smaller than in Germany, or even non-existent. It is now important to apply the Stability and Growth Pact as it was intended, not least in order to credibly safeguard the sustainability of public finances in the EU member states. To this end, binding undertakings should be made to reduce the deficits rapidly once the economic situation improves until budgets are virtually balanced in structural terms. Germany has an important role to play in the European context. The reform of national budgetary rules agreed in the Federal Reform Commission II can make an important contribution to this, as it anchors the European fiscal commitments more firmly and more consistently at the national level. However, very long transitional periods are planned before the new debt rules become effective. Ultimately, the litmus test will be the extent to which the words proclaimed in the consolidation promises are followed by deeds.