Overview

Economic recovery encountering temporary strains

Global economy

The global economy remained on a recovery path as 2009 drew to a close. Although the pace of global industrial output growth moderated slightly compared with the third quarter, the volume of world trade continued to expand briskly. The south and east Asian emerging market economies, in particular, continued to generate considerable momentum. The region's resultant rising demand for oil and other commodities was one of the factors that sharply drove up prices in the international markets last year. The OPEC countries and several Latin American states were the principal beneficiaries of this. Among the industrialised countries, the United States was the frontrunner in the fourth quarter, recording a perceptible acceleration in economic growth. By contrast, the euro area's recovery was muted, mainly because of waning stimuli from fiscal programmes and stockbuilding.

Despite temporary strains, the available leading indicators show that the dynamic upward thrust of the global economy continued into the new year. The scenario of a broad-based global upturn therefore remains intact.

Financial market setting

In view of this benign overall environment and given continuing abundant liquidity and low interest rates, the situation on the international capital markets eased further on the whole as the new year began. Phases of uncertainty were comparatively short-lived. This initially pushed up stock market prices and pushed down corporate bond yields. In the

euro area, too, wholesale funding conditions for enterprises improved perceptibly. The spreads of BBB-rated, euro-denominated corporate bonds over government bonds narrowed to levels last seen at the beginning of 2008. Declining interest rate spreads since early 2009 were accompanied by lively issuance activity on Europe's corporate bond markets.

Since mid-January, however, the positive economic signals have increasingly been clouded by political developments in the perception of market participants. Thus plans to tighten banking regulation and potentially force financial institutions to shoulder a greater part of the cost of the financial crisis triggered stock market losses worldwide, particularly among financial stocks. Moreover, the public discourse on the sustainability of Greece's sovereign debt has seen spreads on Greek debt securities widen considerably vis-à-vis German Bunds. This has also affected the euro, which has fallen widely in the foreign exchange markets, particularly since the beginning of 2010.

Monetary policy

Monetary growth slowed again in the reporting quarter as lending to the private sector was virtually stagnant; monetary developments consequently present no medium-term inflation risks at present. Not least owing to the likelihood that economic recovery will be gradual, consumer prices are currently expected to remain compatible with price stability over the horizon relevant for monetary policy, and market participants' medium to long-term inflation expectations likewise remain well anchored in the euro area.

In consideration of this constellation, the Governing Council of the ECB left its key interest rates unchanged between October 2009 and January 2010. Throughout the fourth quarter of 2009, the main refinancing operations were again conducted as fixed-rate tenders with full allotment at an interest rate of 1%.

The liquidity situation within the European banking sector can still be described as exceptionally good. This is borne out by the fact that demand for the third 12-month tender in December was significantly lower than for the first transaction of this type in June 2009. Moreover, the number of banks taking part in this operation was smaller than in the two previous ones.

As developments on the money and capital market continued to normalise, the Governing Council of the ECB was able to initiate a gradual phasing-out of the extraordinary liquidity measures at the turn of the year. The last supplementary three-month longer-term refinancing operation and the last twelve-month longer-term refinancing operation, which will be fixed at the average minimum bid rate of the MROs over the life of this operation, were conducted in December 2009. In January 2010, the Eurosystem's counterparties were offered liquidity-providing operations in US dollars and Swiss francs for the last time. In addition, the Governing Council of the ECB decided to conduct its last six-month longer-term refinancing operation at the end of March 2010. Euro-area money market rates barely reacted to the announcement that the non-standard monetary policy

measures would gradually be phased out. The Governing Council will take decisions on the continued implementation of the gradual exit measures at the beginning of March.

For the first time since the fourth quarter of 2008, bank lending in the euro area recorded an increase, albeit a small one, in the volume of loans to domestic private non-banks. However, this was the outcome of fairly heterogeneous developments in the individual sectors. Lending to households expanded most, with the positive developments seen in the last two quarters firming further. This was again attributable to loans for house purchase, which make up the lion's share of household borrowing. Growth in loans to households in the final quarter of 2009 contrasted with a strong cyclical decline in lending to non-financial corporations. However, the fact that short-term lending contracted sharply whereas long-term loans continued to expand appreciably indicates that cyclical factors were paramount in determining credit dynamics.

German economy

The economic recovery in Germany faltered in the autumn months of 2009, partly as a result of temporary factors. The phasing-out of the car scrappage environmental premium, in particular, considerably dented macroeconomic momentum. According to a flash estimate by the Federal Statistical Office, real gross domestic product stagnated quarter on quarter. This compares with a gain of 0.7% in aggregate output in the third quarter of 2009. While domestic activity was sluggish, export business again expanded robustly during the reporting period. The fact that the slowdown in growth can to some extent be explained by temporary factors, whereas export business, which is traditionally a mainstay of the German economy, continues to expand at a rapid pace indicates that the economic recovery basically remains intact.

Nominal exports of goods rose by 5.1% in seasonally adjusted terms in the fourth quarter compared with the previous three months, in which growth of 5.4% had already been recorded. Having picked up spectacularly between May and September, deliveries to the European Union moderated towards the end of the period under review. Interestingly, the volatile growth pattern not only affected deliveries to euro-area partner countries but was also fairly similar for deliveries to both old and new EU member states that are not members of the euro area. In numerous countries, the strongly expansionary effects emanating from the stockbuilding cycle appear to have combined with the impact of the fiscal stabilisation measures to create an appreciable economic stimulus in the third quarter, which spread across the entire European Union via production interlinkages and thus temporarily gave a major boost to German exports to the countries in this region. Seasonally adjusted imports of goods and services fell significantly in the period under review, after having outpaced exports in the third quarter of 2009. Given the ongoing revival in exports and recently weaker import activity, external trade made a considerable positive contribution to GDP growth on balance in the fourth quarter of 2009.

Enterprises' willingness to invest in machinery and equipment and in industrial and com-

mercial property appears to have remained muted at the end of the year. According to the available indicators, investment volumes did not match the third-quarter levels. Given continuing considerable underutilisation of production capacity, it is, however, notable that the fall-off in investment following the marked correction at the beginning of 2009 has remained within narrow bounds. This applies both to investment in industrial and commercial construction and to investment in new machinery and equipment and can, moreover, be read as an indication that the internal funds available to enterprises have, to date, covered planned real investment. This suggests that the slow growth in loans to non-financial corporations in Germany does not reflect a credit crunch.

Private consumption was again extremely sluggish in the fourth quarter of 2009, having already fallen by 0.9% in the third quarter in seasonally and calendar-adjusted terms. As in the third quarter, this weakening of demand was mainly due to passenger car sales, deliveries of which remained elevated but dipped appreciably compared with the preceding three months as the boosting effect of the environmental premium wore off. By contrast, retail sales were unchanged on the quarter.

The resilience of the German labour market is one of the most remarkable features of the current recession. The adjustment to the slump in production in the final quarter of 2008 and first quarter of 2009 differs from that seen in past economic downturns in important respects. Job losses in the generally volatile manufacturing industry have, to date, been very moderate. By contrast, the number of hours worked has responded much more sharply than in previous recessions. Another unusual feature of the current overall economic situation is the rise in labour market participation (disregarding trend factors). Although jobs will probably continue to be cut in manufacturing in the coming period, there is no indication of a sharp increase in lay-offs. In fact, leading indicators for the labour market point upward and are, in some cases, even approaching neutral territory.

In the upstream stages of the production and distribution chain, the drop in prices that had, a year earlier, first affected commodities and intermediate goods and later spread to finished products abated, at least temporarily, in the fourth quarter of 2009 as the global economy picked up steam. While the disinflationary process that has been in evidence since mid-2008, and which ran through the various stages of the production chain, initially continued with respect to final products, there have been signs of a trend reversal in import prices at the current end. This is also likely to have a lagged effect on domestic producer and consumer prices. To date, the slightly accelerated but still moderate pace of consumer price inflation has, however, mainly been the result of higher energy prices. All other product categories experienced little or no inflation.

The German economy is on a recovery path, the underlying momentum of which does not, according to the available indicators, appear at risk but which is currently still subject

to negative influences. In the short term, the comparatively cold and snowy winter weather has considerably dampened construction activity, in particular, since the turn of the year and is also likely to have adversely affected the transport sector and other outdoor industries. Yet despite the fairly volatile quarterly pattern, neither the underlying dynamics of economic growth nor the demand profile indicates that the expansionary cyclical forces in Germany have abated, especially given the, to date, very robust recovery of the global economy.

Public finances

The economic slump and the expansionary fiscal policy response have had a profound impact on public budgets. Following two years of a virtually balanced government budget, a high deficit was recorded in 2009. According to provisional data released by the Federal Statistical Office, the deficit ratio amounted to 3.2% and thus exceeded the EU reference value. Cyclical factors accounted for not quite half of the dramatic deterioration vis-à-vis the previous year. In this context the negative cyclical impact was significantly mitigated by the fact that the macroeconomic profile was favourable for public finances. The deficit ratio is likely to continue to rise substantially in 2010 and could reach as much as 5%. Based on current analysis, the cyclical component of the deficit is likely to increase slightly again even though GDP is expected to expand perceptibly, as the overall growth profile will – unlike in 2009 – probably be fairly unfavourable for public finances. The increase in the deficit will nonetheless be primarily structural in nature, as further spending measures and tax cuts take their toll.

The German government presented a revised draft budget for 2010 in mid-December 2009. Although expectations regarding the macroeconomic environment have improved significantly compared with the first draft budget of June 2009, forecast net new borrowing was revised down by barely €½ billion to just short of €86 billion. However, the structural deficit, ie the deficit adjusted for cyclical effects and financial transactions which constitutes the starting point for the gradual reduction of the constitutional borrowing limit to 0.35% of GDP by 2016 envisaged under the new "debt brake" rules, was racheted up substantially compared with the June 2009 draft budget. This can be explained in part by the reclassification of loans to the social security funds as grants. It should be recalled that the new budget rules are intended to reverse the persistent trend towards ballooning debt ratios and prevent further delays in the structural consolidation of public finances, which is widely acknowledged to be necessary. The transitional arrangements seek to ensure a relatively constant structural improvement starting in 2011. This would be jeopardised, however, if the necessary consolidation were postponed until the next legislative period or if the budgetary situation were even to deteriorate further as a result of additional fiscal measures, potentially endangering the success of the new rules. Against this backdrop, when setting the central government budget for 2011 and the medium-term financial plan, the reference deficit in 2010 should not only be based on a realistic

assessment of current budgetary developments. By the same token, temporary charges (such as the one-off conversion of the loan to the Federal Employment Agency into a grant) should not be misused in order to artificially increase the scope for borrowing during the transitional period, thus postponing the necessary consolidation.

In December 2009 the Ecofin Council adjudged Germany to have an excessive deficit and called on the German government to bring the deficit ratio back below the 3% ceiling by 2013 at the latest. It demanded no consolidation for 2010, instead recommending that the fiscal measures be implemented as planned. Germany is to reduce its structural deficit by an average of 0.5% of GDP a year starting from 2011, with consolidation to be accelerated should economic and budgetary developments be better than expected. Not least in the light of the macroeconomic outlook, these recommendations are not very challenging and ultimately constitute minimalist requirements as measured by the intention of the Stability and Growth Pact.[1] The updated stability programme that the German government presented on 9 February just complies with these requirements, although the necessary measures were not specified and greater efforts would have been desirable in view of the high deficits and the fact that the debt ratio will continue to rise in 2013.

Germany has prominent responsibility for ensuring that the fiscal rules in the euro area are rigorously complied with. These fiscal rules in particular and the EU's fiscal policy in general are currently being put to their severest test since monetary union was launched. Compliance with the national consolidation requirements agreed on by the EU bodies is therefore imperative. It was thus heartening to see that on 11 February the European Council demanded that Greece take additional measures and on 16 February the Ecofin Council imposed extensive conditions under the excessive deficit procedure. The European Council has highlighted all countries' responsibility for ensuring euro-area stability. It is now up to national policymakers to meet their obligations in order to safeguard the institutional foundations of monetary union.

1 See also Deutsche Bundesbank, Monthly Report, November 2009, pp 63 to 66.