Overview

Heightened recessionary pressure at start of year

Global economy

The steep slump that had gripped the world economy in the fourth quarter of 2008 continued in the first quarter of 2009. The decline in global production is already significantly worse than in any of the cyclical downturns since the middle of the last century. An additional feature of this recession is the pronounced synchronicity of slackening tendencies worldwide. Manufacturing remained hardest hit by the economic weakness in the first quarter, with output in most developed economies and many emerging market economies shrinking at double-digit rates on the year.

However, the pace at which the economy is contracting has recently begun to slow, and several expectation indicators – in particular in some surveys conducted among enterprises and consumers – have improved visibly. This is consistent with the recovery in commodity prices since the beginning of the year. However, one reason a quick cyclical recovery is unlikely is that the global shock to confidence triggered by the financial crisis has not yet been overcome; another is that banks' balance sheets, which had hitherto been impacted mainly by the need for write-downs on securitised instruments, are now being increasingly strained because the recession is taking its toll on credit quality. Moreover, it will be some time before the fiscal stimulus programmes that have been put in place as well as the very expansionary stance of monetary policy and the extensive financial market stabilisation measures take full effect.

Financial market setting

During most of the first quarter of 2009, the international financial markets were buffeted by ongoing turmoil, an increasing downward pressure on economic activity and large losses suffered by financial institutions in the final quarter of 2008. This prompted investors' risk appetite to drop sharply again at the start of the year. This, in turn, further pushed up credit risk premiums for financial borrowers into the first half of March; at the same time, share prices tumbled across a broad front.

Faced with tensions in the financial sector, governments reinforced their efforts to relieve banks' balance sheets of problematic assets. Moreover, central banks increasingly intervened directly in the financial markets in order to ease tight financing conditions.

Signs of a slight easing of tensions were evident from mid-March. For example, pressure on the stock and bond market valuations of financial institutions lessened. As a result, funds that had previously been moved to safe and liquid bonds were re-invested. This also reduced the perceived credit risks of borrowers in other sectors, although they were still at high levels as this report went to press. Improved sentiment indicators likewise helped create a more benign climate in the stock markets. In the foreign exchange markets, the euro depreciated slightly since the beginning of the year.

Monetary policy

Given the pronounced downward pressure on the economy and the more favourable medium-term outlook for price stability this entailed, the Governing Council of the ECB continued to ease its monetary policy stance. The interest rate for weekly main refinancing operations in the Eurosystem was lowered to 1% by May. Furthermore, a decision was taken to conduct both main and longer-term refinancing operations as fixed-rate tenders with full allotment until beyond the end of 2009 and to offer additional long-term refinancing transactions with a maturity of 12 months as of June.

The Governing Council also agreed in principle to purchase covered bonds in future. This measure is intended to further improve financing conditions in the banking sector and therefore represents a continuation of the monetary policy measures taken to date, which take due account of the key role which the banking system plays in monetary transmission in the euro area.

Money market rates have clearly tracked the Governing Council's reduction in key policy rates since October 2008. The EONIA overnight index, in particular, has traded below the main refinancing rate virtually constantly since the Eurosystem's refinancing operations were switched to the full allotment regime in October 2008. Longer-term money market rates also responded to monetary policymakers' guidance. Against the backdrop of the extensive monetary policy and fiscal measures of recent months and buoyed by positive news from the US and European banking sectors, the main risk premiums also narrowed.

The slowing in monetary dynamics in the euro area continued sharply in the first quarter of 2009. For the first time since the launch of EMU, the M3 measure of money supply shrank over a reporting quarter. This correspondingly reduced the year-on-year rate of change based on the moving three-month average, which recorded its lowest figure in some five years. The weak underlying monetary momentum during the reporting period must be seen in connection with continued muted loan growth, in particular. As in the previous quarter, new lending to the domestic private sector in the euro area was lower than redemptions.

German economy

The stark cooling of the global economy substantially increased the recessionary pressure on the German economy during the winter months. According to a flash estimate by the Federal Statistical Office, real gross domestic product dropped by 3.8% on the quarter in seasonally and calendar-adjusted terms in the first quarter of 2009, having already shrunk by 2.2% in the fourth quarter of 2008. In a year-on-year comparison, calendar-adjusted economic output was down 6.9% in the first quarter of 2009.

The German economy's sharp cyclical downturn was triggered by a particularly hefty export shock after the escalation of the global financial and confidence crisis very rapidly spilled over to the real economy in many regions of the world in September 2008. Whereas German exporters had previously mainly witnessed a decline in new orders from trading partners based in countries struggling with adjustments in their domestic real estate and banking sectors, they have more recently seen orders plummet in all major external markets.

However, in the first three months of the year, Germany had to contend not only with another severe setback to export business in the manufacturing sector; other sectors also faced severe deteriorations. As a consequence, the slump in exports has left a clear mark on other areas of Germany's corporate sector. A clear knock-on effect was apparent on business-related services, in particular in the transport and logistics industries. Growing inventories of unsold finished goods are also likely to have prompted enterprises to cut production further. Taken together, these negative factors further increased the degree of macroeconomic underutilisation significantly in the first quarter. Against this background, enterprises have revised their investment plans. Large swathes of the economy will presumably not need to expand or modernise their existing stock of machines and equipment in the foreseeable future. In the first quarter of 2009, the muted investment activity was also reflected in a decline in demand for loans from trade and industry.

In contrast to the constrained developments in exports and investment, private consumption bolstered aggregate demand somewhat in the first quarter of the year. The environmental premium for scrapping old cars introduced with the German government's second economic stimulus package has been instrumental in this. Under this scheme, drivers receive a cash premium if they scrap their old cars and buy new ones. As a result, the number of new registrations by private owners virtually doubled from January to February 2009 in seasonally adjusted terms and rose again in March and April. The principal beneficiaries of this have been foreign car manufacturers. Moreover, these figures are not indicative of an improvement in households' overall propensity to consume. Rather, they point to a temporary reaction to targeted incentives to purchase that, moreover, may to some extent have crowded out purchasing demand in other retail sectors. Further, there is likely to have been significant frontloading of demand, which will have a countervailing negative impact on automobile sales in the future.

In clear contrast to the marked drop in macroeconomic value added, the decrease in employment and increase in unemployment have been relatively limited so far. On the other hand, working hours have been adjusted considerably by reducing overtime and running down working time accounts as well as through the use of flexible working time corridors and special leave. Above all, use of government-subsidised short-time working has been stepped up. Given a continuing contraction of aggregate output and possibly dwindling hopes of a rapid recovery of the global economy, enterprises will, however, increasingly resort to layoffs. This process has already started.

On the positive side, the adjustment process on the labour market is not being hampered by any additional burdens on the wage policy front. Although overall negotiated rates of pay again rose markedly in the first quarter, the quarter-on-quarter rate of increase was smaller, and the new collective wage increases agreed in the first months of this year were, in some cases, distinctly lower than last year.

On the price front, the overall favourable trend was maintained at all levels of the economy. Import prices continued to drop at the beginning of the year, albeit somewhat more slowly; at the industrial producer level, however, the quarter-on-quarter decline in prices accelerated at the start of the year. One factor here was that there were, in some cases, delays in passing through adjustments in the prices of crude oil and other imported goods.

After consumer prices had experienced a fairly sharp drop of 0.3% in the final quarter of 2008 in seasonally adjusted terms, they fell by the much smaller margin of 0.1% in the first quarter of 2009. Energy prices were considerably lower again overall, with decreases in fuel and heating oil prices partly offset by higher electricity prices. By contrast, commercial goods and services and residential rents became more expensive. On a quarterly average, the year-on-year increase in the national Consumer Price Index declined from 1.7% to 0.9% – partly as a result of a base effect for services given the early Easter in 2008. In April, consumer prices picked up again somewhat after seasonal adjustment. There will probably be some markedly negative year-on-year rates over the next few months, however, mainly owing to the sharp increase in prices for energy and food up until the middle of 2008 and the subsequent price corrections. These primarily reflect the fluctuations in the international commodity markets rather than general deflationary tendencies.

Public finances

Last year, the incipient economic downturn had not yet led to a deterioration in public finances, and at the general government level, the budget was virtually balanced, as it had been a year earlier. Given the escalating economic crisis and the extremely unfavourable outlook, the German government adopted large-scale measures to stimulate the economy in November 2008 and January 2009. This, in conjunction with the effect of the automatic stabilisers, meant it was evident as early as the beginning of the year that the deficit and debt ratios would rise perceptibly in 2009 and 2010. In its updated stability programme of January, for example, the German government envisaged a temporary breach of the 3% threshold in 2010.

Since then, the macroeconomic outlook has worsened sharply, however. The deficit ratio is therefore likely to distinctly exceed 3% as early as this year and could even climb to around 6% in 2010. In 2009, government spending is likely to grow at a pace not seen since the mid-1990s. The debt ratio will rise rapidly and could reach a magnitude of 80% in 2010. In view of this dramatic deterioration and the fact that most of the economic stimulus measures will take time to take effect and that an excessive deficit procedure will probably be initiated against Germany under the Stability and Growth Pact, further debt-financed tax cuts or higher spending cannot be justified. In the medium term, considerable efforts will be necessary to correct the dislocations being created in public finances.

Macroeconomic outlook

As measured by the speed of output contraction, the German economic slowdown appears to have peaked in the first quarter of 2009. Of late, there have increasingly been economic signals which, read in conjunction with the gradual easing of tensions on the international financial markets and the anticipated stabilising influence of the large-scale monetary and fiscal policy measures, point to a lessening of the downward pressure in the global economy. Part of the lost confidence appears to be gradually returning. Despite discernible signs of an easing of tension, it would nevertheless be premature to discount the direct and indirect negative consequences of the financial crisis for the real economy.