The economic scene in Germany in summer 2009

Overview

Cyclical downswing comes to a halt

Global economy

The world economy appears to have bottomed out in the second quarter of 2009. One sign is that a number of emerging market economies, in particular China, grew at a markedly accelerated pace or returned to growth. Another is that the contractionary influences in the industrialised countries weakened substantially. This was mainly because manufacturing output, which has been especially hard hit by the recession, picked up somewhat in the course of the second quarter, after dragging down gross domestic product (GDP) in the latter part of 2008 and first part of 2009.

The tendency towards a worldwide economic recovery may be even more pronounced in the second half of 2009. This view is supported by the distinct global improvement, in particular, of expectation components in surveys among firms and households alike. Among other things, the brighter sentiment is a reflection of the burgeoning effects of the fiscal stimulus programmes, the highly expansionary monetary policy stance and the extensive financial market stabilisation measures. However, the fact that the worldwide shock to confidence has eased somewhat, but has by no means been overcome, argues against a strong recovery in the second half of 2009. What is more, banks in the industrial countries, whose capital base has already been eroded – in some cases substantially – by the financial crisis, could encounter further strains in the event of a cyclically induced deterioration of credit quality.

Financial market setting

The international financial markets began to regain confidence during the reporting period. Increasingly up-beat economic indicators, government aid for the financial sector and supportive measures by central banks ignited a recovery. Against the backdrop of a somewhat stronger risk appetite, market participants apparently reversed their previous portfolio shifts into safe assets and became more active in the stock markets, thus significantly boosting share prices worldwide.

At the same time, financing conditions for European enterprises improved appreciably in tandem with the resurgent financial markets and diminishing uncertainty. Corporate bonds with the lowest investment grade rating, BBB, saw their spreads narrow substantially after reaching record values towards the end of the first quarter, and there was a marked decline in absolute yields, too. This easing of financing conditions reflects receding credit risk spreads, while lower liquidity premiums are likely to have been a further contributory factor. Compared with their long-term average, corporate bond spreads nevertheless remain at a relatively high level.

In the foreign exchange markets the euro lost a little value against 21 major currencies on balance vis-à-vis the end of the first quarter. Gains against the US dollar, the Chinese renminbi and the Japanese yen were more than offset by losses against the pound sterling and some commodity currencies as well as central and east European currencies.

Monetary policy

In the second quarter of 2009, a favourable price climate combined with firmly anchored inflation expectations gave the Governing Council of the ECB scope to lower its key interest rate in April and May by a further 0.25 percentage point in each case to currently 1%.

The cut in the main refinancing rate was accompanied by the Governing Council's decision to launch a programme to purchase euro-denominated covered bank bonds for an amount of €60 billion in order to stabilise liquidity conditions in the European banking system over the long term as well. Moreover, the Governing Council decided to offer three additional refinancing transactions with a maturity of 12 months and at a fixed interest rate up to December 2009. With the first long-term refinancing transaction of this kind, the Eurosystem on 25 June 2009 provided 1,121 credit institutions with a total of €442.2 billion at a rate of 1%.

The European credit institutions' very comfortable liquidity situation following the allotment of this twelve-month tender led to a renewed distinct decline in money market rates. Longer-term money market rates, too, again fell noticeably on the back of the twelve-month tender. The measure was therefore exceptionally successful.

Monetary expansion in the euro area continued to weaken in the second quarter of 2009, albeit at a slower pace. As in the previous two quarters, the weak underlying monetary momentum must be seen in connection, above all, with continued muted credit growth. In particular, lending to non-financial corporations again experienced an accelerated decrease. This was due to the steep decline in unsecuritised loans with a maturity of up to one year, whereas medium to long-term loans still rose slightly. According to the Bank Lending Survey, the decline in loan dynamics reflects both the fall in demand from corporate borrowers and the tightening of banks' supply standards.

German economy

In line with the improved global economic setting, the cyclical downward movement of German economic activity came to a halt in the second quarter of 2009. According to a flash estimate by the Federal Statistical Office, real GDP in the second three months of 2009 rose slightly by 0.3% quarter on quarter in seasonally and calendar-adjusted terms. Calendar-adjusted output was down 5.9% year-on-year in the reporting period. Plant capacity utilisation at firms remained exceptionally low and was accompanied by high underutilisation of the workforce. According to leading indicators, a further marked pick-up in overall economic output is possible in the third quarter from a low level.

However, a high degree of uncertainty continues to prevail. Both in Germany and internationally, expansionary monetary and fiscal policies in particular are currently having a bearing. Yet given the German economy's specialisation profile, an endogenously sustained recovery process depends primarily on continued and broadly based stimuli from exports. This is reinforced by the fact that enterprises' propensity to invest is likely to remain weak and consumption could turn out to be less resilient during the remainder of 2009. As foreign demand has perked up, however, one of the key conditions is in place for further boosting corporate confidence. If this picture is confirmed and enterprises gear their investment and staff management planning to this brighter outlook, the monetary and fiscal policy stimuli might have had a stabilising effect at just the right time, and the extension of short-time working would have fulfilled a bridging function towards sustaining a high employment level.

In the second quarter, Germany's exporting enterprises initially saw their external business shrink further following the weak result posted in the first quarter of 2009. However, the drop in exports was much more muted than in the previous two quarters. Moreover, first demand stimuli came from east Asia in recent months.

With capacity utilisation at exceptionally low levels, enterprises again invested less in machinery and equipment in seasonally adjusted terms in the second quarter than in the first. However, the downward movement slowed down noticeably after the sharpest decline since German reunification had been recorded in the preceding three months. Construction investment is likely to have posted a marked increase in the second quarter. On the one hand, this was fuelled by a natural counterswing to weather-related losses in January and February. On the other hand, construction activity also received impetus from a spate of public-sector orders, even though the financial resources earmarked for infrastructure projects in the fiscal stimulus packages have had only a minor impact on demand so far.

The cyclical restraint in investing in machinery and equipment is largely due to the significant capacity underutilisation at present. This, in turn, lowers demand for external financing. Consequently, bank lending to non-financial enterprises fell sharply again in the second quarter. The Bank Lending Survey indicates that credit standards, too, were tightened further in Germany in the reporting period, albeit to a lesser extent than in the two previous quarters. The most important determinant of the, on the whole, slackening lending dynamics is probably still the weak cyclical momentum, which is leading in particular to a drop in demand for short-term credit financing for current operational expenditure. The available data still show no sign of a broad-based credit crunch in Germany.

What is more, since the late 1990s, German firms have significantly bolstered their financial robustness and built up considerable reserves. Between 1998 and 2007, for example, they raised their equity capital and return on sales ratios perceptibly and lightened their interest burden. Another key factor in building up resilience to crisis situations has been that, in the past years of buoyant economic activity, undercapitalised firms not only positioned themselves more strongly in absolute terms, but also narrowed the gap between themselves and enterprises with a sounder equity base. In the present context it is important, moreover, that construction and the retail trade – sectors in which a large number of firms typically face a high risk of insolvency during a recession – are benefiting most from the fiscal policy stimuli.

As in the first quarter, household spending in the second quarter of 2009 is likely to have posted an increase in seasonally adjusted terms. Thus, consumption in Germany is remarkable in continuing to defy the negative effects of the global economic and financial crisis. The raft of stabilisation measures successfully averted the undermining of confidence in the functional viability of the financial sector. Moreover, the fiscal programmes focused, *inter alia*, on strengthening households' disposable income. Numerous tax relief measures and additional transfer payments were adopted which appreciably boosted the disposable income of households in the first half of 2009. Finally, arrangements extending short-time working offered firms strong incentives to resort less to laying off employees. As a result, the risk of unemployment has so far not been uppermost in households' minds when assessing their economic prospects.

While firms responded to the sharp, crisis-induced fall in output levels with further staffing cut-backs in the second quarter of 2009, job losses have largely been concentrated in three sectors so far. In manufacturing, which has been especially hard hit by the global demand shock, the number of employees subject to social security contributions fell sharply measured over twelve months. The decline was even more pronounced in the sector "other business services", which also covers all subcontracted workers irrespective of the sector in which they work. In the logistics sector, too, which also has very close links with manufacturing, employment was cut back perceptibly.

However, much of the impact that the massive economic slump was expected to have on the labour market has so far largely been cushioned by reducing the number of hours worked per employee. Whereas in the first quarter of 2009, firms focused on trimming overtime, running down working time accounts and reducing the working week, short-time working has again gained in importance in the meantime. Conversely, registered unemployment has grown relatively moderately to date, rising quarter-on-quarter by a seasonally adjusted 130,000 to 3.47 million persons in the second quarter of 2009 after an increase by 139,000 in the first three months.

Turning to price developments in Germany, the decline in factory gate prices continued at a slower pace in the second quarter of 2009. By contrast, consumer prices rose slightly in seasonally adjusted terms, after falling in the previous two quarters. The year-on-year rate eased further in the second quarter. Consumer prices were down again in July, also in seasonally adjusted terms, and the year-on-year rate was negative for the first time in 22 years. This was due mainly to the fact that the sharp energy and food price hikes in the second half of 2007 and the first half of 2008, which drove the annual rise in the consumer price index to 3.3% towards the middle of 2008, have been partly reversed since then. In the months ahead, against the backdrop of favourable overall price developments, the negative year-on-year rate may be first be expected to decline, followed by a return to slightly positive annual rates later in the year.

Public finances

The state of public finances is deteriorating dramatically in the current year. Whereas a virtually balanced general government budget was recorded for 2008, this year's deficit is likely to rise above 3% of GDP and thus exceed the ceiling stipulated by the EC Treaty. This is due, first, to the direct impact of the cyclical downturn on public finances. It should be borne in mind, however, that actual earnings and private consumption, both of which are particularly important to public finances, are currently experiencing a far more favourable development than GDP itself, and that growth in unemployment is likely to remain limited on an annual average. Nevertheless, there are indications of an exceptionally sharp decline in revenue from profit-related taxes that is far more severe than the regular macroeconomic reference variable would suggest and should be regarded as a counterswing to the unusually high growth seen in the past few years. Second, extensive deficit-increasing measures, especially the fiscal stimulus packages, which will represent a total of around 1¼% of GDP in 2009, are having an impact. General government debt will shoot up to €1¾ trillion and could reach almost 75% of GDP. In addition to the substantial budget deficit itself, the drop in nominal GDP and the measures supporting financial institutions – which are not reflected in the deficit – are driving factors in this context.

The public finance situation will take a further sharp turn for the worse in the year ahead. Thus the debt ratio could rise to a new high of around 80%, while the deficit ratio could reach approximately 6%. This primarily reflects the extensive automatic stabilisers and the discretionary fiscal stabilisation measures which – given the exceptional dimensions of the economic downturn – are of a justifiable magnitude. At the same time, however, a strong need for consolidation is building up. The deficit forecast for 2010 is due only to a lesser extent to temporary measures and effects or to cyclical factors. Instead, the structural deficits which already existed in 2008, when the overall economic situation was still favourable for public finances, will be driven up by permanent cuts in taxes and social contributions and an appreciable increase in the structural expenditure ratio. Without fiscal consolidation, the general government debt ratio would continue to expand rapidly, leading to a swift rise in the interest burden and further limiting scope for fiscal policy action. Moreover, both the European fiscal rules and the new national budgetary rules now enshrined in the constitution stringently require that the deficits be resolutely scaled back. Thus, fiscal policymakers will find themselves confronted with a major consolidation task in the coming legislative period.