Overview

Economic recovery broadens

Global economy

The incipient global economic recovery that began in the spring months of 2009 firmed in the third quarter. The impetus came from the extensive fiscal stimulus programmes, the expansionary monetary policy stance and the inventory cycle. The increased risk appetite in the financial markets further supported economic growth worldwide. Global industrial output has accelerated markedly in the second half of the year, and this recovery in industrial activity has been accompanied by a considerable expansion in world trade.

Broken down by region, the world economy again received considerable expansionary stimuli from the emerging market economies, especially China. Moreover, the industrialised countries made their first positive contribution to global growth since the beginning of 2008. The main factor here was that real gross domestic product (GDP) in the United States, Japan and the euro area grew perceptibly in the third quarter.

According to the available leading indicators, the cyclical upturn in the world economy will continue in the current quarter and in subsequent months. All in all, a global recovery with a more solid foundation therefore appears to be taking shape, with the indicators for the major emerging market economies remaining more buoyant than those for industrial countries as this report went to press.

Financial market setting

Developments in the international financial markets were likewise characterised by rising confidence during the reporting period.

Growing risk appetite, partly as a result of the brighter economic outlook, helped lift stock market prices and drive corporate bond yields lower. A lot of shares marked year highs in mid-October, while the spreads between high quality corporate bonds and government bonds dropped to the level of early 2008. On the foreign exchange markets, the euro appreciated on a trade-weighted average, with gains against the US dollar and the pound sterling and losses only against the currencies of several smaller economies.

However, there is still some doubt as to the sustainability of the upturn in financial markets, particularly as it is not clear whether the upbeat mood is also backed by endogenous factors or whether it is primarily being driven by the generous fiscal stimulus programmes and the abundant supply of liquidity worldwide. One reason for caution is that market volatility on both sides of the Atlantic picked up somewhat during the summer months and currently remains above its long-term average.

Monetary policy

The monetary policy environment in the euro area in the third quarter was characterised by the return to a moderate growth path and low inflation rates. Given significant capacity underutilisation and the only gradual economic recovery, the outlook for prices also remains benign.

In view of this constellation, the Governing Council of the ECB maintained its expansionary monetary policy stance and left its key policy rates unchanged from June to September. The Eurosystem therefore continues to provide its counterparties with as much liquidity as they want at a fixed interest rate of 1% through its main refinancing operations and longer-term refinancing operations. It currently charges interest of 1.75% on its marginal lending facility while continuing to pay 0.25% on credit balances under its deposit facility.

Euro-area banks' liquidity situation can currently be described as extremely good thanks to the Eurosystem's generous refinancing measures and the launch of the covered bond purchase programme. One indication of this is that the allotment volume in the second supplementary 12-month refinancing operation, which was decided at the end of September, was significantly lower than in the first transaction of this type at the end of June. The number of banks participating in the September operation was also considerably smaller. Another sign of the currently very strong liquidity supply is that interest rates in the euro money market are at historically low levels across all maturities. Rates moved only slightly lower even after the second 12-month tender had been allotted. Given a more favourable financial market setting and improved refinancing conditions for credit institutions, attention is now increasingly focusing on the question of when the Eurosystem should initiate a gradual exit from its non-standard measures.

However, in the euro area bank lending to the domestic private sector declined on balance during the reporting quarter. This was a key reason why M3 growth remained low from July to September, causing the under-

lying monetary dynamics – in other words, the expansion of those monetary aggregates which are ultimately relevant to inflation – to slow considerably further. On balance, inflation projections based on monetary data therefore point to no pronounced risks to price stability in the medium term.

German economy

The German economy advanced with a marked momentum in the third quarter of 2009. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real GDP rose by 0.7% in the third quarter, after having already expanded by 0.4% in the previous three months. However, output levels remained very low in the wake of the massive slump in production in the latter part of 2008 and early part of 2009. Thus, output was still 4.8% down on the year in calendar-adjusted terms. Nevertheless, overall capacity utilisation appears to have picked up perceptibly in the summer months for the first time in one-and-a-half years. Although the sustainability of the current rebound is not yet assured, an increasing number of enterprises are now looking to the future with growing confidence – which is partly attributable to the partial easing of tension on the financial markets. This is one reason why the hitherto very moderate pressure on the labour market in terms of lay-off levels has not increased in recent months.

The brighter international environment has played a key role in the improvement of the overall economic situation in Germany. In the wake of the global shock to confidence triggered by the Lehman insolvency, the German economy had been hit particularly hard by the sharp drop in global economic activity and world trade given the country's extensive integration into the world economy and its specialised manufacturing profile, causing its export volume to plummet by more than a fifth in just nine months. In the third quarter, by contrast, deliveries of German goods to other countries picked up noticeably. In terms of the regional breakdown of exports, not only did demand from Asia continue to point upwards but exports to European Union countries, which account for the lion's share of German foreign trade, also recovered perceptibly. Moreover, German enterprises were able to lift their sales of intermediate goods abroad substantially. This is another indication that – in global terms – the inventory cycle is well advanced. In major industrialised countries, the recovery has recently also been supported by endogenous market factors, although the massive, stabilisation measures have continued to play an important role, as is evident from the sharp rise in automobile exports.

Fixed investment rose slightly overall in the third quarter. This can probably be attributed in the main to stimuli from the public sector. By contrast, private investment remained fairly sluggish. Of late, enterprises have bought more machinery and equipment, although manufacturing capacity utilisation remained exceptionally low despite recording a slight increase in October. Not only was it around 10 percentage points below its long-term average, it also remained beneath the lows marked in all previous cyclical downturns since 1970. Industrial and commercial con-

struction may have slackened in the third quarter. Housing construction has not yet managed to rise appreciably above the low level of the preceding quarters, although applications for building permits have increased perceptibly and orders have grown since the beginning of 2009.

Domestic credit institutions reduced their overall net lending in the third quarter, mainly in response to the muted economic environment and low capacity utilisation and less to a broad supply-side tightening of banks' credit standards. Another contributory factor were distinct net loan repayments by domestic non-financial corporations.

Seasonally adjusted private consumption in the third quarter was probably well down on the preceding three months. This is attested by the decline in retail sales and the marked restraint households have recently shown in their purchases of heating oil. In addition, the government's environmental premium for scrapping old cars did not stimulate automobile sales as strongly in the third quarter as in the preceding months. Nevertheless, consumer spending has held up remarkably well so far. Had consumers downgraded their income expectations in response to the sharply fallen production levels, this might well have aggravated the crisis. The fact that this has not happened is doubtless due chiefly to the surprisingly moderate level of redundancies to date.

The labour market remained extremely robust in the third quarter of 2009. According to current data, employment declined only slightly on the quarter in seasonally adjusted terms and was actually unchanged over the quarter. In a year-on-year comparison, the number of employed persons was down by only 84,000, or 0.2%, following a statistical upward revision of earlier data. This contrasts starkly with the sharp contraction of aggregate output by almost 5%.

Part of the strain of adjusting labour input to the lower output was borne by resorting to government-subsidised short-time working. While a year-on-year comparison of the number of employed persons adjusted for this short-time working effect would therefore show a significantly larger drop in employment, the percentage decline would still be much smaller than the fall in aggregate output. Contrary to popular notions that short-time working has been a key factor in the moderate fall in employment, other mechanisms for adjusting working hours to operational requirements must therefore have made a bigger contribution. These mechanisms were introduced by employer and labour representatives in recent years and are now proving very effective during the crisis. They include working time accounts as well as the possibility of (temporarily) reducing regular working hours with a corresponding cut in pay. Moreover, firms have tolerated a clear decrease in hourly productivity, which is reflected *inter alia* in sharply higher unit labour costs and correspondingly lower profit margins.

While unemployment currently looks unlikely to rise substantially in the near future, headcounts will probably be increasingly adjusted

to the still cyclically depressed (albeit rising) output volume. Despite short-time working and the intensive use of flexible working time models, this is likely to lead to job losses in manufacturing and in the transport and logistics sectors, although these could be partly offset by hiring in other sectors of industry.

In the third quarter of 2009, the drop in producer prices slowed further. The disinflationary process that began in the second half of 2008 now appears to have run its course in some areas, while in other product categories it is only just starting to gain momentum. The decline in producer prices for energy and intermediate goods has now come to a virtual halt and has, in some cases, even been replaced by an upturn, reflecting the global economic recovery. In the case of finished products, by contrast, the downward tendency has accelerated, with the exception of food, where prices stopped falling at the beginning of the year. Seasonally adjusted consumer prices remained unchanged on the quarter.

Public finances

Public finances are deteriorating dramatically in the current year. While a balanced budget was achieved in 2008, supported by favourable economic conditions on an annual average, the deficit is forecast to increase this year to just over 3% of nominal GDP and thus exceed the ceiling laid down in the EC Treaty. This unfavourable development will continue next year. The debt ratio (forecast to exceed 75%) will mark a new historic high, while the deficit ratio will rise to around 5%. In view of the crisis in the financial and real sectors and the associated high macroeconomic risks, it was justifiable for policymakers to launch extensive fiscal measures to stimulate the economy in addition to allowing the automatic stabilisers to take effect and granting direct support to the financial markets. However, as only a relatively small part of the deficit forecast for 2010 currently appears to be cyclical in nature, while a large part of the stimulus measures will probably prove permanent, large deficits and a rapidly rising debt ratio are likely to persist over the medium term unless the measures are properly counterfunded.

In almost all other EU countries, too, the European Commission's autumn forecast points to the prospect of very high deficit ratios and, in some cases, a veritable explosion in debt ratios. Such a development would not only entail fiscal and macroeconomic problems but would also present monetary policymakers with a serious challenge. Markets might, for instance, form high inflation expectations on the perception that the budget situation is unsustainable in the long term. Meanwhile, an excessive deficit procedure has been initiated against Germany and 12 other euro-area countries, and the European Commission has put forward recommendations for correcting the excessive deficits. In these, the Commission has stretched the rules laid down in the Stability and Growth Pact to breaking point. A particular concern are the long deadlines for correcting the deficits granted to countries that continue to flout the fiscal rules even after an excessive deficit procedure has been launched against them. As economic prospects stabilise, it will be vital to adopt a cred-

ible strategy to rapidly and rigorously correct the currently dramatic outlook for public finances in many countries, as envisaged in the Pact.

Germany has a special responsibility for implementing the European fiscal rules. Additional deficit-raising measures in a country against which an excessive deficit procedure has already been launched are incompatible with the Pact. Moreover, the overall economic outlook has now brightened significantly, and a large part of the expansionary measures initiated to date will not take effect until 2010. If the necessary fiscal consolidation is not tackled rapidly and rigorously, the next downturn could set in before a sound budgetary position has been re-established. Overall, further unfunded spending increases and tax cuts are a problematic signal in this situation and in view of the large deficit and debt levels. It is vital that policymakers do more than just pay lip service to the European fiscal rules. As the prospects for public finances have improved of late, it would certainly be possible to bring the deficit back below the 3% ceiling as early as 2012.

From 2011, strict fiscal consolidation is essential, not least in view of the new national debt rules. Central government, in particular, but also most state governments as well have veered a very long way off their basic budgetary course. Yet not only the European but also the national fiscal rules stipulate, in the light of past experience, that any unexpected budgetary improvements that might result from a more favourable economic development should be used not to reduce revenues or increase spending but instead to curb new borrowing. It would be particularly worrying if policymakers, in connection with the newly adopted debt rule for central government, were to attempt to resort to one-off measures in order to inflate the structural deficit in the base year 2010 with a view to gaining greater scope for new borrowing to fund additional spending in subsequent years by exploiting the fact that the prescribed debt reduction progression is benchmarked to the base-year level. This would, from the very outset, undermine the fundamental legislative intention of the new provisions, which is to effectively curb and curtail the ballooning growth in government debt.