The current economic situation in Germany

Overview

German economy very buoyant

Global economy

Doubts about the stability of public finances in some euro-area countries featured prominently in the second quarter. While the escalating Greek debt crisis and its knock-on effects on other euro-area countries triggered tensions in the financial markets and considerably dented confidence and dampened economic activity in the countries concerned, real economic development in the single-currency area as a whole and in the rest of the world proved robust.

The upturn in global economic activity continued apace in the second quarter of 2010, with differences between developed and emerging economies narrowing. Several large emerging market economies, some of which were already displaying signs of overheating after a phase of very dynamic expansion, moved onto a flatter growth path. This is true, in particular, of China, where credit standards for loans to enterprises and households were tightened significantly. In the United States and Japan, too, growth slowed distinctly after a strong performance in the latter part of 2009 and early part of 2010. The euro area, however, generated a markedly stronger economic momentum, which was largely driven by Germany.

The outlook for the second half of the year remains favourable, although there are signs that the dynamics of global output and international trade will slacken somewhat.

Financial market setting

The international financial markets remained under the influence of the debt crisis that has continued to affect a number of euro-area countries even following the extensive stabilisation measures taken by the member states in early May. Although government bond spreads in the euro area stayed high despite narrowing temporarily on the back of the initiatives taken, overall the situation on the European government bond markets has eased somewhat. This was helped by the fiscal consolidation measures adopted by several euro-area countries, by steadier real economic developments and by the bank stress test, which showed the European and the German banking system to be quite robust even if confronted with challenging scenarios. Buoyed by benign economic indicators and upbeat company reports, the European stock markets have rallied since the end of May. The euro, too, rebounded after having fallen to its lowest level in several years in the wake of the Greek debt crisis.

Monetary policy

The Governing Council of the ECB left its key policy rates unchanged. Although the overall economic setting in the euro area has improved further, there is still considerable capacity underutilisation, uncertainties remain on financial markets, and monetary and credit growth is muted overall. The situation on the European money market has tended to stabilise further during the past few months. Longer-term unsecured money market rates have been edging upwards since the end of April. This dynamic accelerated when the first one-year long-term refinancing operation matured on 1 July 2010, as a result of which a total of €442 billion was withdrawn from the banking system. The overnight money market rate EONIA, too, has risen on balance, amid some volatility, since the expiry of the first one-year refinancing operation. Higher money market rates should not be interpreted as a monetary policy signal, however, but rather as a reflection of the improved situation on the European money market.

As planned, the covered bonds purchase programme (CBPP) was concluded on 30 June once the pre-announced €60 billion purchase volume was reached. In addition, the volumes of European government bond purchases, which were agreed in May, were sharply curtailed in recent weeks.

M3 growth in the euro area accelerated distinctly during the second quarter, although the underlying expansionary momentum remained weak. The current development is largely the result of banks' transactions with other financial intermediaries, which have proved very volatile in the wake of the financial market tensions of the last two years. The main counterpart of monetary expansion was again bank lending to the public sector. But lending to the private sector, too, gathered pace, turning positive again following three quarters of negative growth. Loans to non-financial corporations contracted moderately, however, after increasing slightly between January and March following three quarters of negative growth. Overall, current monetary and credit developments do not signal any pronounced risks to price stability in the euro area.

German economy

In the second quarter of 2010, the German economy staged a clear, and, at least in this magnitude, unexpectedly strong recovery.

Just as it had previously stalled in the wake of the slump in global trade, especially in high-quality industrial durables, the German economy is now benefiting from the strong revival in global trade – to which it is itself contributing through sharply rising imports. According to an initial estimate of the Federal Statistical Office, real gross domestic product (GDP) rose by a very strong 2.2% on the quarter in seasonally and calendar-adjusted terms between April and June. More than half of the fall in output attributable to the crisis has therefore now been recouped. Besides the favourable external environment, domestic factors also played a part. For example, weather-related output losses suffered during the winter months, which primarily affected the construction and transport sectors, were quickly made good. Moreover, investment in machinery and equipment rose perceptibly.

The fact that the economic upturn has gathered pace worldwide and has acquired a broader regional base has particularly benefited German exporters. Only uncertainty in connection with the debt crisis in the euro area temporarily dampened the mood somewhat. Overall, almost three-quarters of the downturn in exports due to the crisis have meanwhile been recovered. One indication of increasing optimism among Germany's trade partners is that, for the first time since the onset of the global economic recovery, demand for German capital goods has substantially outpaced that for intermediate goods. Measured by value, imports of goods actually rose a little more strongly than exports in the second quarter. Germany's European trade partners are benefiting from the currently fast pace of economic growth in Germany, which can, in turn, largely be attributed to its success in exporting to markets outside Europe. Thus, imports from other euro-area countries expanded more than twice as rapidly as German enterprises' exports to these countries in the first two quarters of 2010.

Investment in machinery and equipment picked up noticeably in the second quarter. Construction investment, too, rose sharply. This was fuelled by a backlog effect following the long cold winter as well as by the government's economic stimulus programmes to renew infrastructure and renovate public buildings.

Private consumption spending should have risen again in real terms during the reporting period for the first time in three quarters. Retail spending was somewhat higher. Moreover, it is likely that private car purchases, which declined much less sharply than in the preceding quarters in terms of unit sales, were concentrated on more up-market models.

The consumer climate in Germany continues to be bolstered by the very robust labour market, which has now probably bottomed out about a year after overall economic output reached its trough. According to estimates by the Federal Statistical Office, employment rose in seasonally adjusted terms in the second quarter of 2010 compared with the preceding quarter. In April and May, the number of employees subject to social security contributions in manufacturing – which has been particularly hard hit by the financial and economic crisis – and the logistics sector, with which it has close economic ties, increased for the first time since the fourth quarter of 2008. Moreover, temporary employment agencies hired a considerable number of additional staff. This, together with the steady decline in cyclically motivated short-time working, is another visible sign that the recovery is gradually starting to be felt on the labour market, too.

Prices continued to nudge upwards at all stages of the production chain in the second quarter of 2010, although the magnitude of the respective inflationary impulse was closely associated with the significance and composition of the energy component. Upstream energy prices rose sharply again in the second quarter of 2010, although prices temporarily fell in the course of the quarter as crude oil prices declined. Import prices, which are particularly sensitive to petroleum prices, rose again sharply on the quarter in seasonally adjusted terms, whereas the increase in export prices was only roughly half as high. Quarter-on-quarter consumer price inflation was roughly unchanged from the two previous periods, at 0.4% on a seasonally adjusted basis. The year-on-year rate rose to 1.0% on a quarterly average and 1.2% in July. The moderate upward development is likely to continue over the next few months.

Overall, the underlying cyclical momentum in Germany appears favourable at present, and the economic upturn is likely to continue in the second half of the year, although risks arising from developments on the international financial markets remain a potential threat. The pace of expansion will normalise following the exceptionally brisk growth of the second quarter. This is implied by the probably more moderate growth path of the global economy in the second half of the year. This would cause the current surge in export growth to decelerate. By contrast, commercial investment is likely to pick up steam as replacement purchases are becoming more pressing and product ranges need adjusting. Another factor driving the increasing propensity to invest is firms' buoyant optimism about their future prospects. Private consumption should profit from the ongoing improvement of the labour market. As things currently stand, funding constraints will pose no barrier to a continued economic recovery. Neither bank nor business surveys indicate any current or imminent credit crunch in Germany. Overall, gross domestic product is forecast to increase by around 3% in real terms this year.

Public finances

Despite the significantly brighter overall macroeconomic setting, Germany's public finances will deteriorate considerably again this year owing to the expansionary fiscal policy stance. The cyclical upswing will have little impact on the deficit as the growth structure, unlike last year, is not favourable to public sector revenues. The deficit ratio will therefore continue to rise appreciably. It is, however, likely to be lower than initially feared, remaining well below 5%. The debt ratio, which rose sharply last year, will increase perceptibly again.

Next year, the general government deficit could decline to around 4% of GDP provided that spending policy is basically restrained, the underlying cyclical dynamics remain positive and the economic stimulus measures are phased out. Additional consolidation measures that were announced in June could further reduce the deficit. However, the debt ratio is likely to rise further, largely as a result of the still high deficit.

Although the general government deficit could, therefore, be brought back down below the 3% ceiling by as early as 2012, public finances will have deteriorated dramatically compared with the pre-crisis situation. The debt ratio will have risen sharply, and central and state government budgets will still fall well short of the objective of achieving structurally more or less balanced budgets, which the reform of the national budgetary rules made a constitutional requirement. The Federal government's clear commitment to strengthening public finances and the recently adopted consolidation measures are therefore welcome. It is now crucial to avoid the cardinal error committed in past years of using a better-than-expected economic performance to dilute the fiscal policy stance. Should the macroeconomic outlook turn out to be more positive, this should be used to reach the deficit targets ahead of schedule.

In its draft budget plan for 2011 and medium-term financial plan up to 2014, the German government at the beginning of July mapped out a route to reducing the deficit in line with the new debt rule. This is based on a more favourable forecast for the central government budget this year and outlines the required structural deficit reduction stages over the next few years, which should ensure that the budget is more or less balanced by 2016. However, some of the planned consolidation measures have not yet been finalised, and a sizeable global spending cut must be achieved towards the end of the planning period; moreover, there is virtually no safety margin with respect to the borrowing limit. Hence fiscal policy measures will be required; moreover, it must be borne in mind that a potentially even more favourable macroeconomic development in the current year will not give fiscal policymakers a wider radius of action but will merely lower the starting point for the structural deficit reduction over the next few years. The further updated assessment of the course of economic development will have to be factored into the central government budget for 2011 when it is adopted in the autumn. State governments likewise face the task of continuously reducing the high structural deficits in their budgets in the coming years in line with the new constitutional debt rules.

Recent developments have made it abundantly clear that sound government finances are a key prerequisite for enabling fiscal policymakers to influence events in a crisis. Although the EU budget rules do, in principle, provide a suitable framework, they were poorly implemented in the past. This points to the need to strengthen the rules and sharpen the instruments used to enforce them. There seems to be a general consensus about the desirability of giving greater weight to the debt level and, in particular, to the preventive component of the Stability and

Growth Pact. It is also intended to improve the coordination of budgetary surveillance and recommendations at EU level with national budgetary plans. Any further-going crisis prevention strategies should reinforce the incentives for sustainable national fiscal policy. Joint liability for other member states' debt or institutionalised automatic support mechanisms at the European level are not compatible with the principle of sovereign responsibility for fiscal policy. Without the political will to comply with the jointly agreed framework, however, all efforts at reform will ultimately fail.