Overview

German growth more broadly based

Global economy

Global economic development remained on an expansionary path moving into the second half of the year. As anticipated, the slowdown from the previously very dynamic pace of global growth, which was already a feature in the second quarter, continued. However, various indicators at the current end suggest that the rate of expansion is likely to speed up again somewhat towards year-end.

The lower momentum in the summer months was mainly due to more moderate growth in the industrial countries. In the third quarter, in particular, the cyclical dynamics in the euro area slackened compared to the very buoyant second quarter. Growth was again generated chiefly by the German economy, which is currently driving economic expansion in the euro area and is having a stabilising effect there. On balance, the peripheral countries again made a negative contribution to the overall outcome. Moreover, the strained public finances in several of these euro-area countries has recently again been intensely spotlighted by market players. Without urgently needed measures to regain investor confidence, the economic outlook in the countries concerned will remain clouded for the foreseeable future. In the second half of the year to date, the economic recovery in the United States remained on the moderate path upon which it had embarked in the second quarter. In the emerging market economies of south and east Asia as well as Latin America, exports often provided weaker impetus, while domestic demand continued to expand apace. Quarter-on-quarter aggregate growth in this

group of countries is likely to have been fairly strong again, so that economic policymakers continued to focus on preventing their economies from overheating.

Financial markets

The different pace of economic growth in the industrial and emerging market economies also left its mark on financial market trends during the summer months. Given the bright overall global outlook, confidence on the financial markets rebounded. This was reflected particularly in price movements on the international stock markets. Favourable quarterly results and improved earnings prospects for enterprises pushed up stock prices in the main. Funding conditions for European firms on the bond markets also improved perceptibly over the reporting period. However, the emerging regional disparities in cyclical recovery also caused tensions on the foreign exchange markets. In this environment, the euro continued to trend upwards against other major currencies. Moreover, in recent weeks, financial market fears regarding the sustainability of public finances in the peripheral countries of the currency union have escalated massively.

Despite Germany's very buoyant economic development, domestic capital market yields remained virtually unchanged on balance after mid-year, amid fairly high volatility and, at one point, an all-time low for Bunds. There are probably two main reasons why the positive economic stimuli were not reflected more in reported yields. First, Germany was unable to escape the dampening effects of increased scepticism regarding growth in other major industrial economies. Second, investors continued to differentiate very strongly between issuers given stark differences in the fiscal positions in the euro-area countries. While safe-haven effects temporarily drove Bund interest rates down to a record low close to 2%, bond prices in some euro-area partner countries came under a lot of pressure.

Monetary policy

Given the ongoing economic recovery expected in the euro area, firmly anchored longer-term inflation expectations and still weak underlying monetary dynamics, the Governing Council of the ECB identified no increased risks to price stability over the time horizon relevant to monetary policy. It therefore again left the Eurosystem's key policy rates unchanged in the third quarter of 2010.

Conditions on the euro-area money market also improved perceptibly over the summer months. The maturing of several large longer-term transactions since mid-year reduced the market's refinancing volume by more than €535 billion. As banks only partly offset this withdrawal of liquidity, excess liquidity in the banking system contracted significantly. This tended to lift money market interest rates. In view of the additional funding needs at year-end and the worsening of the sovereign debt problems in several euro-area member states, the Governing Council of the ECB again decided that the now index-linked full allotment procedure would be retained also for the three-month longer-term refinancing operations that do not expire until after the year-end.

The underlying monetary dynamics – in other words, those components of monetary

growth that are relevant to inflation – remained muted in the reporting quarter. The monetary aggregate M3 grew perceptibly between July and September for the second quarter in a row, with bank lending to the private sector the principal factor in this for the first time since the end of 2008. However, growth in loans and securitised lending in the euro area remained moderate overall in the third quarter of 2010. In line with this, aggregate inflation projections based on monetary data continue to indicate that there is no pronounced risk to price stability in the euro area over the time horizon relevant to monetary policy.

German economy

The German economy continued its upturn over the summer months. According to the flash estimate produced by the Federal Statistical Office, real gross domestic product (GDP) rose by 0.7% in the third quarter of 2010 after adjustment for seasonal and calendar effects. This reflects the anticipated normalisation after the second quarter, which was inflated by backlog and catch-up effects. The recovery of the German economy was again buoyed by the robust global economy. Nonetheless, there is no overlooking the fact that domestic economic growth forces are now gaining in strength. The sharp expansion in investment in machinery and equipment and the further appreciable increase in private consumption are clear evidence of this. The renewed rise in production has also lifted capacity utilisation in manufacturing.

In the third quarter of 2010, German exporters benefited from the continued global economic recovery. The fact that exports of intermediate, capital and consumer goods experienced similar levels of growth suggests that German manufacturers across the board participated in the recovery of the global economy.

The investment environment remained buoyant over the summer months. Purchases of machinery and equipment by enterprises are likely to have risen sharply again over the summer. The volume of investment in capacity extensions was probably larger than was to be expected given that capacity is, in part, still underutilised. Construction investment in the third quarter could have largely maintained the level of the second quarter, which was boosted by catch-up effects. Historically low mortgage rates appear to be prompting numerous households to hurry to realise their dream of home ownership.

Against this backdrop, the as yet muted growth of credit to non-financial corporations in Germany is probably mainly due to their improved internal funding sources in the wake of the economic recovery. The latest results of the Bank Lending Survey likewise indicate that banks are not hampering the upturn in Germany. They show that credit standards for enterprises were eased somewhat in the third quarter of 2010 for the first time since the onset of the financial crisis.

The recovery of the German labour market continued into the second half of 2010. Employment picked up further in the third quarter, and unemployment clearly declined again. In a welcome development, numerous additional jobs subject to social security con-

tributions were created, while the number of workers with a main occupation in low-paid part-time jobs not subject to social contributions fell further. Moreover, the total headcount engaged in short-time work continued to come down rapidly with the sharp recovery in industrial activity. However, the number of newly registered short-time workers is still higher than in the years immediately preceding the financial and economic crisis, which shows that not all industrial enterprises felt the effects of the economic upturn. Leading indicators suggest that the positive labour market trend will continue. Thus seasonally adjusted vacancies rose further up until October 2010, and the number of firms intending to hire new staff in the next 12 months has risen sharply according to a survey conducted by the German Chamber of Industry and Commerce (DIHK) in autumn 2010.

The robust upswing has appreciably lifted corporate profitability. The trade unions are consequently stepping up their calls for employees to be given a fair share in the growing economic rewards, a view which is increasingly finding support among the general public as elsewhere. More and more employers, too, are now willing to retrospectively compensate staff for their frequently significant income shortfalls during the crisis. The rise in negotiated wages in the third quarter of 2010 was still pegged to wage agreements concluded during the crisis when no or only very moderate increases in scheduled rates of pay had been agreed. The actual rise in wages is likely to have been much higher, however, given the normalisation in working hours.

During the summer of 2010, factory-gate prices rose much more moderately thanks to the euro's appreciation and lower crude oil prices. These factors also dampened consumer price inflation in the third quarter of 2010.

The buoyant momentum of the German economy appears to be firmly based at present and is unlikely to be dented much by the gradual phasing-out of the fiscal stimuli. The economy should benefit from further external stimuli over the next few months. This is indicated, not least, by enterprises' very optimistic export expectations. Moreover, growth is likely to become even more broadly based going forward; overall economic expansion will also be buoyed by rising domestic demand on the back of the positive state of the labour market and the very favourable financing conditions. Furthermore, capacity utilisation is back at its normal level at ever more enterprises, which makes investment in additional plant and equipment more pressing. Historically low mortgage rates are also boosting private housing construction. Nonetheless, the overall pace of economic growth will fall well short of the dynamic surge seen in the spring, which was partly driven by extraordinary factors.

However, the continued recovery remains conditional on expectations of global economic development in general and exports in particular being fulfilled, as they are underpinning the positive labour market developments. This expectation is additionally subject to the proviso that the sovereign debt crisis in the euro area causes no other marked down-

side risks to the real economy via the financial markets and banks.

Public finances

The positive macroeconomic performance so far this year has also prevented Germany's public finances from deteriorating to the extent that was initially expected. As things currently stand, the deficit ratio is likely to increase to roughly 3½%, after 3% last year. Given that fiscal policy remains clearly expansionary, the structural deficit will rise more sharply. And the debt ratio, too, will climb way above its already high 2009 level, driven mainly by the risk assets that were assumed when bad banks were set up for WestLB and HRE.

Next year, the general government deficit is likely to drop below the 3% threshold as the economic recovery is expected to continue, stimulus measures will be phased out and cost-cutting measures will have been implemented. Better-than-expected economic and budgetary developments mean that there is now a chance, in a favourable macroeconomic setting, of achieving the intended balanced budget more quickly. That would also limit the considerable increase in government indebtedness that is already in the pipeline. To this end, a strict austerity course should be pursued at all levels – in line with the underlying intent of the national and EU budgetary rules – and no concessions should be made in terms of the planned consolidation path. It remains to be seen whether policymakers avoid repeating the error they made in the past of postponing the necessary consolidation when times are good.

With regard to the German government's new debt brake, the fact that it will apparently not be rigorously implemented even in the first year is a bad sign. When it was adopted in the spring of 2009, it was agreed, given considerable uncertainty about the likely course of macroeconomic development, that there should be a transitional period up until 2016 during which the structural deficit recorded in the base-year 2010 would be reduced in equal steps. As the crisis-related strains are now obviously having a much smaller impact on the central government budget than was initially feared, the base value – and thus the scope for new borrowing up until 2015 – should be reduced accordingly. In the summer the German government rightly updated its adjustment path, but now evidently intends not to lower the base value further in line with the latest data. This gives policymakers greater scope for new borrowing over the next few years which, if fully used, would – as so often in the past – in good times put off the necessary consolidation until later years. The clearly documented legislative intent of the new debt brake, which is currently being regarded as a model for ensuring sustainable public finances in other euro-area countries, too, would thus be undermined on the occasion of its very first application, thereby hurting confidence in the long-term effectiveness of the reform.

The key importance of sustainable public finances is graphically illustrated by the present situation in several euro-area countries. During the crisis, the European fiscal framework and its implementation ultimately did not suffice to ensure sound public fi-

nances in all member states. In the light of this experience, the European institutional arrangements for crisis prevention and crisis management must therefore likewise be improved.

The changes to the Stability and Growth Pact that the European Council initiated at the end of October may result in progress vis-à-vis the *status quo*. However, it is already becoming evident that the adjustments will fall short of the more ambitious ideas proposed *inter alia* by the European Commission. Thus implementation of the rules by the Ecofin Council will remain decisive. In addition to the changes to the fiscal framework, greater macroeconomic oversight is to ensure that serious problems are identified and combated at an early stage. However, any temptation to indulge in macroeconomic fine-tuning should be resisted, and the rules should mainly seek to limit serious distortions and imbalances – for instance regarding unsustainable current account deficits or severe losses of competitiveness.

The European Council has also laid the foundations for setting up a crisis resolution mechanism. In particular, the reaffirmation of a central principle of the existing union, namely that neither the Union nor the member states are liable for the debt of another member state, is to be welcomed. A transparent and predictable procedure which also notably guarantees a comprehensive and credible consolidation and reform programme could, in conjunction with improved financial market regulation, largely limit the risk of a systemic crisis. In this context private creditors, too, have an essential responsibility for restoring sustainable public finances in over-indebted countries.