Economic activity

In the wake of the global financial and economic crisis, the German economy suffered its sharpest decline in overall economic activity since the founding of the Federal Republic of Germany. Even though the crisis did not originate there, the German industry's pattern of specialisation meant that the global demand shock in the fourth quarter of 2008 and the first quarter of 2009 hit domestic activity particularly hard. This led to a significant decline in exports. Domestic final demand proved to be comparatively robust, however. This is especially true of private consumption, which was given a significant boost by the stable labour market. This discrepancy between external and domestic economic developments distinguishes Germany from other countries, which were characterised by major structural distortions. The earlier cyclically induced excessive surplus on Germany's current account declined perceptibly. Germany therefore built up a buffer for global demand during this period.

Conversely, the German economy is benefiting to a large extent from the strong recovery in the global economy which began in the second quarter of 2009. From a cyclical perspective, the pace of recovery is therefore faster than in most other industrial countries. This, together with the fact that domestic demand was hardly affected during the crisis, supports the assessment that a considerable part of the decline in output in Germany was due to cyclical factors. Nevertheless, it is unlikely that the German economy will return in the foreseeable future to its growth path immediately prior to the crisis.

The resilience of the German economy during the crisis was due, not least, to the restructuring measures in the corporate sector and to structural reforms over the past decade. This is why Germany is now also in a better starting position than it was in earlier periods of economic recovery. Even so, there is still scope for strengthening the resilience and the flexibility of the German economy even further. The broadening of the basis for growth, which is now under way, is taking place through market-based processes. These processes need to be backed up by further economic policy reforms, but not at the cost of restricting the competitiveness of German industry. Doing so would squander potentials for growth and wealth, not just in Germany.

Macroeconomic developments during the crisis

Sharp economic downturn in 2008 Q4 and 2009 Q1 ...

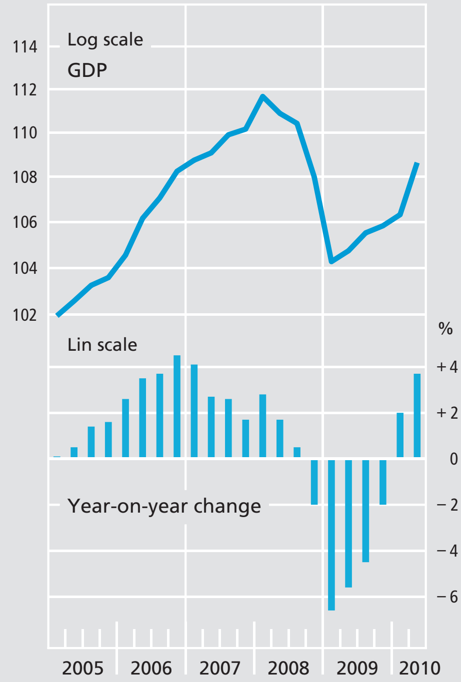
In the wake of the global financial and economic crisis, the German economy suffered its sharpest decline in overall economic activity since the founding of the Federal Republic of Germany. Nevertheless, the first phase of the tensions in the financial and real estate markets of a number of countries did not have any noticeable impact on economic activity in Germany. Output was in full swing up to the first quarter of 2008, and the cooling tendencies as the year went on also initially remained within the bounds of normal cyclical fluctuations. It was not until the second half of 2008 that a dramatic deterioration in sentiment took hold. This, together with the further escalation of the financial crisis following the Lehman insolvency and the subsequent sharp slump in world trade, especially in durable consumer and capital goods, led to a marked decline in economic activity in Germany in the final quarter of 2008 and the first quarter of 2009. This deterioration was much more pronounced than in many other industrial countries.

... followed by a cyclical recovery

Nevertheless, owing to the extensive worldwide support measures for the financial system as well as significant economic stimuli from monetary and fiscal policy measures, world trade and global output stabilised from the second quarter of 2009 onwards, albeit at a clearly depressed level. This was also true of the German economy. The gradual restoration of confidence was initially accompanied by a subdued cyclical recovery, which then strengthened significantly on the back of the extremely buoyant pick-up in global trade. There are signs that economic output in Germany will rise by over 3% in 2010, after declining by 4.7% last year.

Overall output

2000 = 100, price and seasonally adjusted



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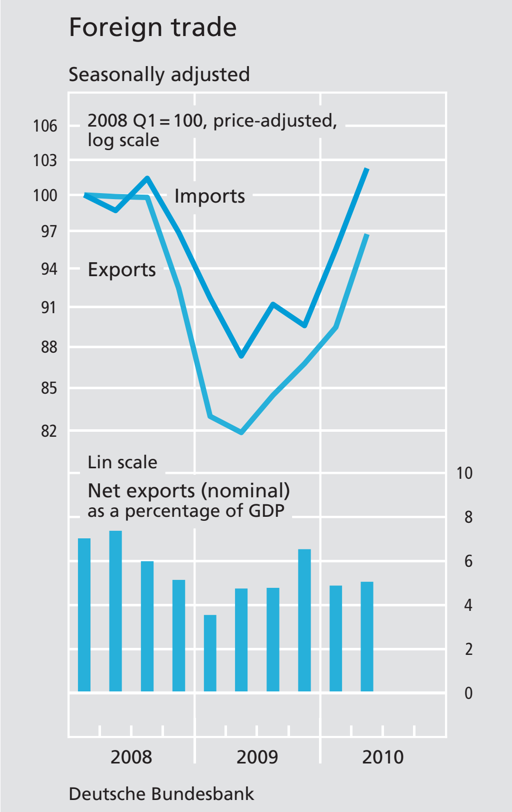
Only minor impact on the economy at first

Favourable starting position before the crisis

The financial and economic crisis hit the German economy during a period of exceptional growth. Manufacturing enterprises, in particular, were working at near to full capacity in 2007 to meet strong export demand and, increasingly, demand on the domestic side. The difficult structural adjustment processes of earlier years had restored the German economy's profitability. Corporate profits then reached new record highs in the wake of the global economic upswing. Given the existing capacity constraints, sizeable investments were made against the backdrop of still quite optimistic expectations. The improved situation in the German economy was also revealed by the marked recovery of the labour market. Some sectors experienced increasing difficulties in filling vacancies.

First signs of weakening after strong start to year in 2008

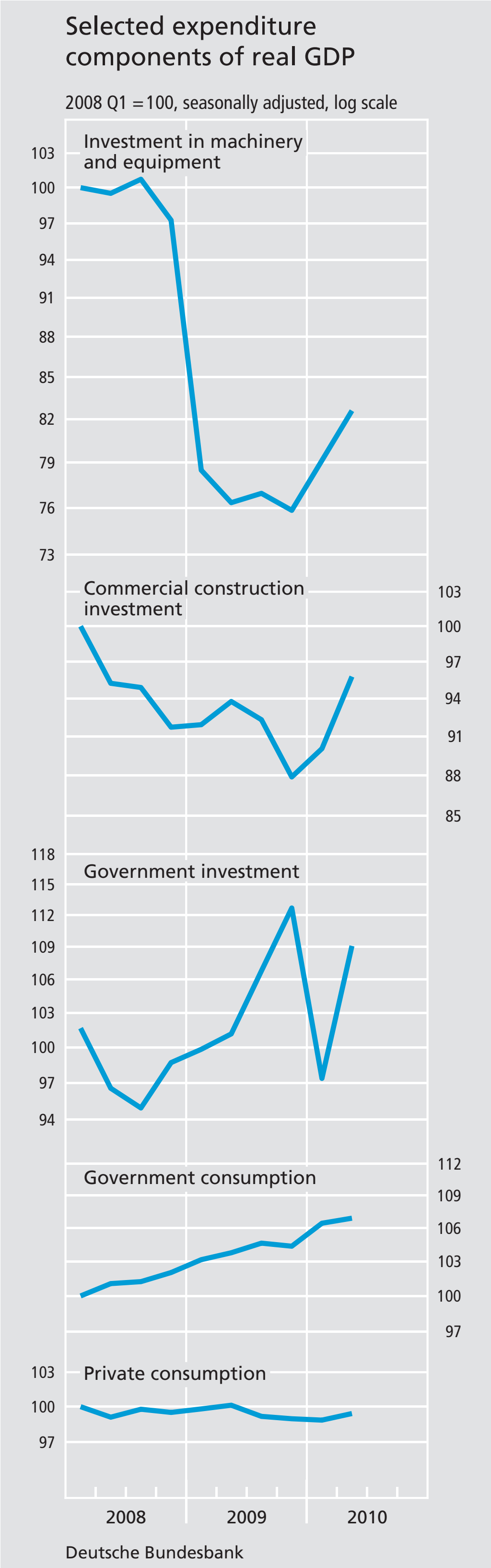
Although it was evident in 2008 that the rapid pace of growth of earlier years could not be maintained, there were initially no signs of a massive downturn. Enterprises' investment and staffing decisions were also based on the expectation that economic activity would not be impaired by major dislocations. Business expectations in industry gradually deteriorated from a very high level and the volume of new orders failed to match the buoyant growth of 2006 and 2007. With regard to the current business situation, positive assessments still predominated during this period, however. This was true, above all, of manufacturing, where the considerable volume of orders on hand appeared to ensure a high degree of capacity utilisation for a certain amount of time. Despite this, overall economic activity began to decline as early as the second quarter of 2008. One contributory factor in this was the exceptionally strong growth in the construction sector in the previous quarter, which was due, in part, to weather-related special factors. The decline in the third quarter remained within the bounds of normal cyclical weakness.



Sharp recession in the final quarter of 2008 and the first quarter of 2009

Sharp decline in global demand for industrial products

Sentiment and then the business situation, too, deteriorated dramatically in the last few months of 2008. Even before the Lehman Brothers insolvency, firms had revised their expectations sharply downwards, and demand for German industrial products declined considerably. This downward tendency became stronger in the following months as a result of the escalating financial crisis and rapidly growing uncertainty. Many enterprises worldwide stepped up their efforts to increase their available resources by reducing their inventories as far as possible, halting their investment projects, abstaining from placing new orders and even cancelling orders in some cases. Households restricted



their demand for high-quality durable consumer goods. This all had the direct effect of exacerbating the crisis, and there was the risk of a downward spiral.

Germany was hit particularly hard by this global demand shock, even though the crisis did not originate there. The sharp decline in economic activity in the German economy was due, above all, to the very major importance of foreign trade for the size of the economy and its specialisation in the manufacture of high-quality intermediate and capital goods, which are particularly sensitive to cyclical influences.[1] While data from the Dutch Centraal Planbureau indicate that the volume of global trade in goods fell by 18½% between the second quarter of 2008 and the first quarter of 2009, Germany's exports of goods declined by 22½% owing to the specific range of its products. Germany's real gross domestic product (GDP) decreased by 6% during this period, compared with 4¾% in the OECD area as a whole.

Sharp decline in output in 2008 Q4 and 2009 Q1 ...

The impact of the sharp contraction in world trade went far beyond the immediate effects on output. It is noteworthy, however, that the indirect effects were much less intense than might have been expected given the severity of the downturn. Enterprises abruptly cut back their investment budgets, which was due not only to the increasing underutilisation of production capacities, but also to growing uncertainty about future economic growth. In the first quarter of 2009, pur-

1 See Deutsche Bundesbank, Financial market shock and downturn in industrial output in advanced economies, Monthly Report, May 2009, pp 14-15.

chases of new machinery and equipment were down by one-fifth on the quarter in seasonally adjusted terms. By contrast, there was initially hardly any reduction in expenditure on commercial buildings, which have a longer planning horizon than investment in machinery and equipment. Much the same applies to staff planning (for more details, see pages 55 to 69). As a result, private consumption proved to be comparatively robust with the result that domestic final demand fell much less sharply than value added.

... primarily in export-oriented sectors

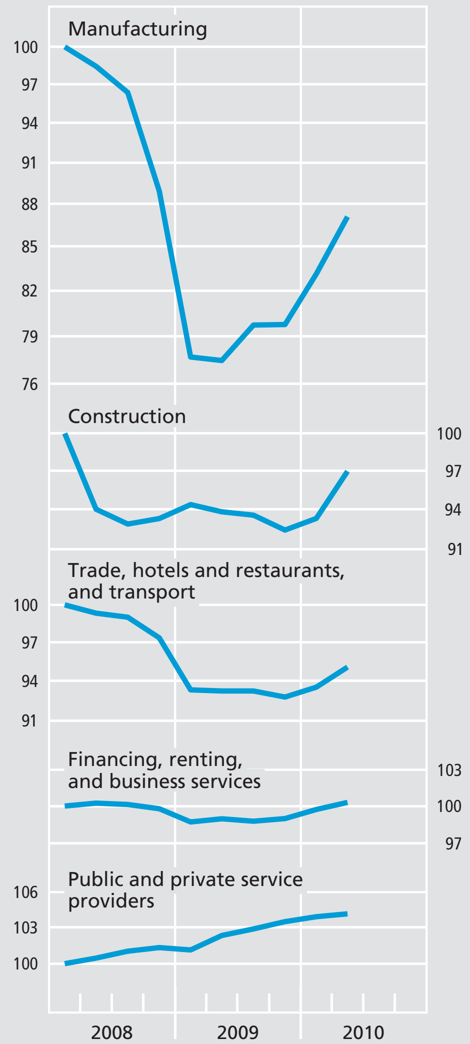
In sectoral terms, manufacturing was directly affected. Value added in this sector contracted by almost one-fifth in the final quarter of 2008 and the first quarter of 2009. Knock-on effects stemming from the closely integrated nature of economic activity led to the shock spreading to other sectors of the economy, such as wholesale and foreign trade, the transport sector and numerous business-related service providers. The construction sector, retail trade and public and household services remained largely unaffected, however. This discrepancy between external and domestic developments distinguishes Germany from those countries where the crisis originated, which are characterised by major structural distortions.

Lower current account surplus

Owing to the comparatively moderate reaction of domestic demand, imports declined much less sharply than exports in the fourth quarter of 2008 and the first quarter of 2009. The surplus on Germany's current account decreased from 7½% of nominal GDP in 2007 to 5% in 2009. Germany therefore built up a buffer for global demand during this period.

Real gross value added in selected economic sectors

2008 Q1 = 100, seasonally adjusted, log scale



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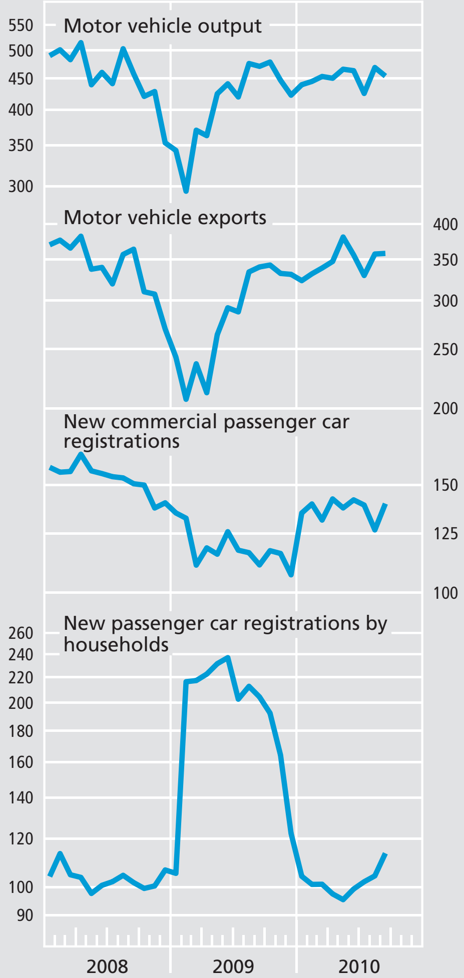
Stabilisation of the activity in the second quarter of 2009

Extensive economic policy measures to aid recovery from paralysis

The worldwide large-scale use of monetary and fiscal policy measures and the rescue packages for the financial system contributed to the paralysis in global activity easing gradually in the second quarter of 2009. Above and beyond the already considerable impact of the automatic stabilisers, expansionary

Indicators of the motor vehicle industry*

Number in thousands, seasonally adjusted, log scale



* Only passenger cars.

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fiscal policy measures were implemented in a large number of countries. In Germany, following an initial, smaller package of measures in November 2008, a second economic stimulus package was approved in January 2009. This essentially made provision for a funding volume of around €50 billion, or 2% of GDP, to be spread over a period of two years (for further details, see pages 71 to 85). In addition to extensive public investment, the package also contained cuts in income tax, reductions in social security contributions, increased social security benefits, business guarantee programmes and an environmental premium for replacing old privately used cars with new vehicles, the volume of which was increased shortly afterwards from €1.5 billion to €5 billion.

Environmental premium with strong stimuli for the economy ...

Unlike the scheduled public-sector investment under the economic stimulus programme, the implementation of which occurred with a considerable time lag in some cases owing to lengthy planning and approval procedures, the environmental premium had a rapid impact. Household demand shot up – especially in the small and medium car segment – and largely offset the shortfall in commercial orders that affected other market segments. As a result, output in the motor vehicle industry, which had previously declined by almost two-fifths, began to recover. Foreign motor vehicle manufacturers and foreign subsidiaries of German automotive groups also benefited to a large extent from these stimuli. For example, imports of motor vehicles between the second and fourth quarters of 2009 were up by an average of 5¼% on the start of the year. In 2009, the total number of new car registrations by households showed a year-on-year increase of 1.1 million to 2.4 million.

... but a split balance sheet

As an instrument to stabilise the economy, the impact of the environmental premium was undoubtedly target-oriented, timely and of limited duration. Seen in that light, it met three major requirements of an effective public spending programme. For the automotive industry as a whole, it effectively bridged the period between the broad-based slump in demand and the revival of, initially, foreign demand and then of demand from domestic businesses, which had previously largely deferred replacement purchases. It was not only motor vehicle manufacturers themselves that benefited from this, but also the suppliers of this sector.[2] Even so, the large-scale scrapping of old, but still roadworthy vehicles meant the destruction of valuable tangible assets.

Initially subdued, then sharp economic recovery

Economic recovery subdued at first

In the second quarter of 2009, the initial impetus for the economic recovery came primarily from the government economic stimulus packages, which were reflected in growing private and public consumer demand. There was also an expansion in demand from China and South-East Asia again. Exports started to pick up again on a broad front as early as the third quarter. In addition, public construction investment was stepped up substantially. The cyclical pace of recovery weakened temporarily in the fourth quarter of 2009 owing, in part, to a reversal of the positive stimuli generated by the environmental premium, which had previously benefited private consumption. Added to this was the fact that enterprises were still cautious with regard to investment in machinery and equipment in view of the continuing severe capacity underutilisation at the time. At the beginning of 2010, the underlying pace of recovery picked up significantly; this was still not fully reflected in GDP as the exceptionally cold and snowy winter weather had an adverse effect on construction output in particular and to a lesser, yet still perceptible, extent in other economic sectors.

Sharp growth in 2010 Q2 ...

There was an extremely sharp 2.2% quarter-on-quarter rise in economic output in 2010 Q2, not least as a result of the associated catching-up effects. The pick-up in world trade was reflected, above all, in a sharp rise in German exports, however. This was already indicated by the substantial increase in the volume of export orders for the German economy in the first quarter of 2010. The associated massive improvement in sentiment is likely to have been a key reason for the pick-up in investment. With increasing optimism that the global economic crisis could be overcome more quickly than previously thought, there was a decline in the reluctance to make consumption decisions. On the financing side, supply constraints continued only in sub-segments, and so the fear of a broad-based credit crunch did not materialise (see pages 36 to 43).

... but output losses not yet recovered

Despite the clear economic upturn, overall economic activity has not yet matched the level of the most recent cyclical peak. To date, around three-fifths of the crisis-induced decline in output has been recovered. In the manufacturing sector, which was hit particularly strongly by the fall in demand, the figure is only two-fifths. Economic output in the retail and transport sectors – in contrast to business-related services, including financing

2 See Deutsche Bundesbank, The macroeconomic repercussions of a decline in demand for cars, taking into account the intersectoral integration of production, Monthly Report, February 2009, pp 46-47.

and leasing – was likewise still down on its pre-crisis level.

Outlook and challenges for the German economy

In real economic terms, crisis in Germany primarily a cyclical phenomenon

While the German economy was particularly hard hit by the massive decline in global demand in the wake of the financial and economic crisis – owing to its pattern of specialisation which is accompanied by a high degree of international economic integration – it benefited to a very large extent from the quite strong recovery of the global economy beginning in the second quarter of 2009. From a cyclical perspective, the pace of recovery is therefore faster than in most other industrial countries. Together with the fact that domestic final demand was remarkably robust during the crisis, this supports the assessment that the decline in output in Germany was, to a considerable extent, a cyclical phenomenon. As things stand, however, it is unlikely that the German economy will return in the foreseeable future to its growth path immediately prior to the crisis.

Slower pace of global expansion ...

One reason for this is that the last global upswing, at least in its final phase, was characterised by a non-sustainable pace of growth. This was due primarily to international misallocations of resources as well as the build-up of macroeconomic imbalances and exaggerations.[3] In many countries, the necessary restructuring process will require some time. Thus, there is much to suggest that growth in the world economy will become more subdued after the rapid recovery especially in the first half of 2010. This has direct implications for the German economy, which is closely integrated with the global market.

Flattening of the potential growth path in Germany

On balance, economic crises also generally trigger self-contained effects that minimise potential. The fact that corporate insolvencies have so far increased no more than is usual in times of recession, and the recent sharp rise in demand for German products indicate that the market adjustments initiated in Germany during the financial and economic crisis will not be exceptionally large. Therefore, the direct losses of capital stock, which are connected with firms' exit from the market or the economic obsolescence of existing fixed assets, are likely to be limited. Nevertheless, industrial investment is still being dampened by the continuing underutilisation of plant capacity in many parts of the economy. By contrast, given the anticipated slower pace of growth in global demand, product range adjustments and process innovations with the aim of retaining and/or increasing market shares are likely to gain in importance. Overall, potential growth may have decreased by around ½ percentage point since the beginning of the crisis. Given the marked cyclical fluctuations, such estimates are fraught with considerable uncertainty, however.[4]

Rising capacity utilisation ...

Given the anticipated sharp rise in aggregate economic activity this year by over 3%, the overall output gap will decrease significantly.

3 See also Deutsche Bundesbank, On the problems of macroeconomic imbalances in the euro area, Monthly Report, July 2010, pp 17-38.
4 See also Deutsche Bundesbank, To what extent has the potential output of the German economy been impaired by the economic and financial crisis? An interim assessment, Monthly Report, December 2009, pp 24-25.

There is still likely to be spare capacity, above all, in industry and the closely related trade and the transport sectors as well as in business-related services. According to the Ifo institute surveys, for example, manufacturing capacity utilisation in July was just under 2 percentage points down on its longer-term average, although there is still a considerable backlog, particularly in the capital goods sector. This is especially true considering that the cyclical fluctuations in output are reflected only to a limited extent in the Ifo indicators of capacity utilisation. Working hours in industry have not yet returned to normal, either.

... despite dampening fiscal policy measures in 2011

As things stand, the corridor of normal utilisation could be reached in 2011, despite the expected slower pace of economic activity. Given the still intact, yet moderate momentum of the global economy, the external impulses for the Germany economy are less pronounced. Furthermore, growth-dampening effects could be generated in the short term by the consolidation of public finances. The restructuring measures initiated in a large number of countries should, however, help to restore confidence in the sustainability of public finances and thus even trigger positive effects for economic growth.

Improved structural starting position, but ...

As a result of the efforts made over the past decade, Germany is, despite the exceptionally sharp economic downturn, in a better structural starting position than in earlier periods of recovery. The relative competitive position of German enterprises did not change significantly during the crisis and their financial situation did not suffer excessively either. Unlike in a number of other developed economies, which are struggling with the after-effects of a property market bubble, the financial situation of households is not giving any cause for concern either. Furthermore, there are no indications of an increase in structural unemployment during the crisis. Therefore, the need for structural adjustments in the private sector is likely to be limited. In contrast to the situation after the previous cyclical downturn, no severe strains for the economy are to be expected on this front.

... unused growth potential in services

Nevertheless, there is potential for broadening the German economy's basis for growth and for strengthening its resilience to crises as well as its flexibility. Even so, this cannot be a matter of restricting German industry's competitiveness. Not only in Germany, this would squander potentials for growth and wealth and fail to make adequate use of (and thus devalue) competitive production structures and highly specialised human capital. Need for reform in Germany exists, above all, in the services sector where lower barriers to market entry and less bureaucracy could help to make greater use of existing opportunities and to create new ones.

Ongoing high level of export dependency

An improvement in the underlying economic conditions would enhance the attractiveness of Germany as a production location and could also enhance potential growth and reduce structural unemployment. Even if stronger stimuli are likely to be generated by domestic activity in the future, there is much to suggest that the strong export orientation of German industry will continue. This will help to further increase wealth and prosperity in Germany. At the same time, its dependency on global economic developments will continue. Against this backdrop, it remains important for enterprises to build up reserves during periods of economic upturn so that economically bad periods can be overcome without major harm to potential output due to losses of fixed or human capital. This has succeeded extremely well in the current crisis so far.