Overview

German economy gets off to exceptionally good start to the year

Global economy

The world economy got off to a dynamic start to 2011, already having recovered from the dip of the second and third quarters of last year by the end of 2010. The emerging market economies remained the primary drivers of growth. At the same time, the cyclical upturn in the euro area regained a lot of momentum after weakening in the final quarter of 2010, mainly owing to the severe winter weather.

The rapid pace of global growth at the beginning of 2011 is all the more remarkable given that, even before the natural disaster in Japan, several factors *per se* were weighing on worldwide growth. These notably include the political unrest in North Africa and the Middle East, which significantly aggravated already high demand-driven inflation in crude oil prices.

Global purchasing managers indices suggest, however, that the world economy has shifted down a gear of late. Besides recent events in Japan, this can probably be attributed mainly to the perceptible loss of consumer purchasing power as a result of considerably higher energy and food prices. On the other hand, inflation on the commodities markets has eased appreciably. Against this backdrop, the outlook for the global economy remains favourable.

Financial markets

In the first few months of 2011, developments on the international financial markets were largely driven by the positive economic

setting and growing concerns about inflation. Both factors pushed up capital market rates in some instances. The political unrest in several North African countries and the devastating earthquake in Japan unnerved the markets only temporarily.

By contrast, the worsening sovereign debt crisis drove bond yields in some euro-area peripheral countries up to new record highs. At the beginning of April 2011, Portugal applied for international financial assistance, which the euro-area finance ministers approved on May 16. Moreover, investors harboured renewed doubts about Greek's consolidation path. The international equity markets were largely unaffected by these negative factors; with the exception of the Japanese market, they have all rallied in the year to date, mainly because corporate results, buoyed by cyclical factors, have exceeded expectations. On the foreign exchange markets, diverging interest rate expectations, in particular, led to shifting parities. While the US dollar weakened, the euro strengthened on balance.

Monetary policy

The ongoing dynamism of the global economy and the still extremely expansionary monetary policy setting helped to maintain the positive economic momentum in the euro area over the winter months. The recovery, which has to date largely been export-driven, has boosted business confidence, suggesting that domestic demand, too, will take off shortly and increasingly underpin economic activity. Bearing this in mind along with the continued rise in commodity prices, the Governing Council of the ECB concluded in the course of the first quarter that the upside risks to price stability in the euro area warranted an adjustment of the very accommodative monetary policy stance. At the beginning of April, therefore, the Governing Council decided to raise key interest rates by 25 bp.

During the first quarter of 2011, banks reduced their excess liquidity appreciably. On the one hand, this drove average overnight rates higher still, bringing them closer to the main refinancing rate. On the other hand, the policy of full allotment pursued in refinancing operations meant that demand-driven fluctuations in excess liquidity were reflected in the overnight rate. From a monetary policy perspective, this heightened volatility was not problematic, however, as market players understood the demand-driven reasons for the greater volatility in ultra-short money market rates.

M3 growth accelerated perceptibly in the first quarter of 2011. The upward trend in underlying monetary growth – the measure that is ultimately relevant for inflation – that has been evident over several quarters therefore continued. Among the counterparts of M3, loans to the private sector in the euro area again rose sharply in the first quarter of 2011. As before, this was largely driven by strong growth in lending for house purchase. In addition, loans to non-financial corporations also expanded significantly, after recording clear falls in the previous quarter.

Germany

The German economy expanded very sharply after the start of 2011. According to a flash

estimate released by the Federal Statistical Office, seasonally and calendar-adjusted real gross domestic product (GDP) rose by 1.5% in the first three months of 2011 compared with the previous quarter, in which aggregate output had increased by a mere 0.4% amid cold and snowy winter weather in December. Output growth was clearly lifted during the reporting period by backloading and catching-up effects. The quarterly GDP growth rate therefore considerably overstates the underlying economic momentum. Nonetheless, the economic advance is unmistakable. The massive drop in economic activity caused by the financial and economic crisis has been completely recouped over the past two years. The economic upswing in Germany, which was triggered by the global economic recovery, has now spread from those sectors that were immediate beneficiaries to the overall economy.

In many industries, investment and hiring plans are geared to expansion as production capacity utilisation is at normal levels. The decidedly good state of the labour market, combined with the prospect of perceptible earnings growth, is making households more willing to undertake major purchases. This is benefiting private consumption and residential housing construction, especially as financing conditions are favourable.

Following the turn of the year 2010-11, exports initially maintained their somewhat subdued trend of the preceding months before surging in March. The basis for the upward trend remains in place as economic momentum in the emerging markets is still strong, despite having eased somewhat in the meantime, and current economic dynamics in other important traditional sales markets remain buoyant.

Investment is likely to have been the main driver of growth in Germany in the first three months of 2011. One factor was construction, which given milder weather conditions in the first quarter of 2011 rapidly regained the considerable weather-related output losses sustained in December 2010 and also benefited from sharply higher demand. Purchases of machinery and equipment are also likely to have risen further.

Expanding investment is likewise reflected in lending data. During the winter months, loans to non-financial corporations rose at a rate last seen in the fourth quarter of 2008, with borrowing up across all maturity segments. Loans to households also developed positively. Overall, loans to households have thus recorded gains for the eighth quarter in succession.

The moderate increase in private consumption appears to have continued after the turn of the year. Although rising consumer inflation depressed purchasing power, households' income situation improved perceptibly on the back of higher employment, a further normalisation in hours worked and large bonus payments.

The labour market revival continued in the first few months of 2011. As in 2010, an above-average number of jobs subject to social security contributions were created.

Virtually all industries reported that they had filled additional such jobs. In manufacturing, in particular, headcount has accelerated sharply of late. Employment growth in industry is likely to have gained momentum because working hours, which were sharply reduced during the crisis, have now almost returned to pre-crisis levels. At the same time, the decline in unemployment accelerated in the first quarter of 2011. Leading labour market indicators suggest that employment growth will continue. The number of job vacancies reported to the Federal Employment Agency continues to rise sharply. As the Federal Employment Agency sees only part of the jobs on offer throughout the economy, the actual number of vacancies is likely to be significantly higher.

In the first few months of 2011, the price climate was still dominated by inflationary effects stemming mainly from the international commodity markets. This is particularly evident in the case of import prices. Sharply higher crude oil prices fed through directly to consumer prices for petrol, diesel and heating oil. Other than that, price developments were subdued overall. Nonetheless, those components more influenced by domestic supply and demand conditions are clearly showing a slow albeit discontinuous rise in price inflation.

As it gains a broader base, the upturn could support economic activity in Germany for some time to come. This is also indicated by the favourable external and internal conditions. Growth opportunities resulting from increasing immigration into Germany could also play a role. Nonetheless, the pace of growth is likely to ease somewhat in the foreseeable future following the explosive start to 2011.

The stabilising effects emanating from domestic demand can only take full effect in a tension-free environment. Potential risks in this respect accompany the current scenario in that the economy is traversing the corridor of normal utilisation at what appears to be a virtually undiminished pace of expansion compared to the previous recovery phase, and that both enterprises' business expectations and consumers' economic and income outlook have reached highs exceptionally early on in this cycle. In addition, the price climate has deteriorated significantly.

Public finances

Both the crisis-ridden year 2009 and the high-growth year 2010 witnessed an expansionary fiscal policy, large general government deficits and the debt ratio soaring to new historical record levels. A marked improvement is now on the cards, however, as long as budgetary consolidation is implemented as planned and new burdens arising from the financial and sovereign debt crisis remain within narrow bounds. The deficit ratio could consequently fall below 2% in 2011, after it rose to 3.3% in 2010. This notably mirrors a clear structural improvement, although the ongoing cyclical recovery is also making an important contribution. All other things being equal, a lower deficit coupled with relatively high nominal GDP growth should bring the debt ratio down from its record 2010 level. However, the European support programmes for other euro-area coun-

tries will create additional debt, and uncertainty in connection with support measures for German financial institutions remains high.

The German government presented its updated stability programme in April, outlining the adjustment path towards achieving a structurally balanced general government budget in 2015. In a welcome development, the unexpectedly favourable macroeconomic setting is, as stipulated in the excessive deficit procedure initiated against Germany, to be used to achieve a lower deficit path rather than to dilute the fiscal policy course. The deadline set by the Ecofin Council in December 2009 – which was, even then, excessively long – to bring the deficit below the 3% ceiling in 2013 will be reached ahead of schedule. By contrast, progress along the adjustment path towards the medium-term objective is likely to be slower than specified in the preventive arm of the European Stability and Growth Pact. This is regrettable, not least given efforts at EU level to give this part of the Pact, in particular, greater binding force.

Overall, it is now crucial that the more favourable conjuncture is not seen as an opportunity to relax the consolidation course before the medium-term objective is achieved. Remaining on track is essential given the worryingly high levels of government debt. This is warranted even more by the present benign macroeconomic situation. Moreover, the time window for making adequate fiscal allowance for the imminent demographic burdens ensuing from an ageing population is rapidly narrowing. In addition, the new constitutional budgetary rules for central and state governments stipulate much stricter deficit ceilings. Given such stricter limits, it appears indispensable to leave a larger margin of safety between the deficit targets and the deficit ceilings to prevent having to take procyclical consolidation measures should the GDP outturn be worse than expected or in the event of other negative shocks. This is another reason why it is highly advisable to use the "good times" to reduce deficits more quickly.

However, safety margins should not be created artificially by using dubious interpretation to extend the upper bounds. Yet precisely this appears to be the intention in the Federal Government's current plans as well as in the agreements that were recently signed with the states receiving consolidation aid. Outdated and inflated estimates of the structural deficit in 2010 are being used as the basis for determining the ceilings for the structural deficit reduction path from 2011 to 2016 for the Federal Government and to 2020 for the states receiving consolidation aid. This violates the intention of the debt brake. For central government alone, this increases the scope for new borrowing by a total of approximately €50 billion. This additional leeway can potentially lead to higher debt even if it is not fully utilised at the current end, as it can later be used by crediting the difference to the fiscal control account.

Overall, therefore, the implementation of the new national budgetary rules to date continues to merit a critical assessment. It would,

for instance, be appropriate to base the ceilings for the deficit reduction path on the actual 2010 deficit outturn. The Federal Government's deficits as specified in its March 2011 benchmark outline are similar to the figures calculated in this way. Finally, the favourable macroeconomic conditions should then be used to more speedily comply with the rules on the debt brake, which come into effect from 2016, establishing a safety margin below the constitutional borrowing limits as early as possible.

The public finance situation in numerous euro-area member states is much more critical than in Germany, and deficit ratios in particular are significantly higher. All member states except Estonia and Luxembourg are currently subject to an excessive deficit procedure. The European Commission's most recent economic forecast underscores the danger that many countries might fail to meet the European fiscal consolidation requirements. In order both to comply with the minimum requirements for structural deficit reduction and to meet the deficit correction deadline, additional consolidation efforts over and above the measures specified to date are required in many cases.

Greece faces particular challenges. Although the deficit ratio of 10.5% for 2010 represents a considerable improvement on the previous year, it is well above the target of 8.1% that was agreed when the aid programme was put together in May of last year. In its spring economic forecast, the European Commission expects the target to be missed again in the current year unless additional measures are taken (deficit ratio of 9.5% rather than 7.5%). By granting loans and reducing the interest rate payable on them – which is itself problematic, not least given the moral hazard this entails – Greece's European partners have provided enormous *ex ante* assistance. The aid commitments are therefore rightly subject to strict conditionality. The Greek government is thus obligated to return to the deficit reduction path outlined in the adjustment programme this year, resorting – as agreed – to additional readjustment measures if need be. Any softening of the targets would call into doubt both the sustainability of Greece's debt and the credibility of future European agreements. The comprehensive and rapid consolidation steps plus the economic reforms needed to comply with the adjustment programme undoubtedly involve considerable difficulties and hardship. They are, however, ultimately unavoidable in order to restore sustainable public finances, and they are also the precondition for aid payments, without which the adjustment path would be even more daunting. In order to strengthen confidence in sound public finances in the individual euro-area member states going forward, it is vital to strengthen incentives for nations to solve their fiscal problems on their own and to ensure that shifting the burden onto third parties is not seen as a viable option.

Portugal, too, recently had to apply for international financial assistance, with the euro-area finance ministers approving a comprehensive aid package on May 16. Under this programme, Portugal will receive €78 billion worth of financial aid for three years, funded

in equal parts by the IMF, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The fiscal adjustment programme is largely based on the consolidation plan presented in March 2011. It does not, however, envisage a return to the deficit reduction path announced in May 2010. The fiscal objectives that have now been agreed are less ambitious than the previous deficit reduction path, even taking into consideration statistical revisions for 2010 and the more muted macroeconomic outlook. Strict compliance with the rules is vital given the precarious budgetary situation, the failure to tackle structural issues in the past and the particular conditions of the aid programme.

In Ireland, the new government is sticking to the agreed objective of bringing the deficit ratio back below the 3% limit by 2015. The necessary measures have, however, been fully approved only for the current year. Other areas still need to be detailed in the budget plans for the next few years. Weaker economic growth could jeopardise the fiscal plans. But potential further costs in connection with restructuring the Irish banking sector pose an even greater risk.