Overview

German economic recovery resumes

Global economy

Having fallen sharply in the latter part of 2008 and early months of 2009, the world economy subsequently rebounded swiftly and strongly. The slowdown in global growth dynamics that emerged in the spring of 2010 led to fears that this upturn could come to an abrupt halt. This did not happen, however. Instead, the global economy picked up speed again in the fourth quarter of 2010. Industrial output increased perceptibly in October-November compared to the third quarter. According to the global purchasing managers indices, services have recently also been a relatively strong catalyst for growth. Stronger momentum in several emerging market economies was the main factor driving the resurgence in global activity. Among the advanced economies, however, the pace of growth slackened further in the final quarter of 2010, according to estimates. While momentum picked up appreciably in the United States, which has thereby recently started to spearhead economic expansion among the industrial countries again and was the second G7 country after Canada to surpass its pre-crisis level of output, the seasonally adjusted rate of growth in the euro area was unchanged, while aggregate output declined in the United Kingdom and Japan.

Following the turn of 2010-11, global economic momentum seems to have remained elevated or even to have accelerated somewhat. For instance, the global purchasing managers indices rose perceptibly again in January. The Bundesbank's leading indicator for the world economy has also displayed a

clear upward trend again after dipping noticeably in the second and third quarters of 2010. The favourable global economic setting is, however, currently being accompanied by higher energy and food inflation.

Financial markets

Developments on the international financial markets were likewise influenced by the brighter global economic outlook in the latter part of 2010 and early part of 2011. Capital market rates worldwide picked up amid growing confidence among market participants in the United States, Japan and Germany, too. This was reflected *inter alia* in higher yields on corporate bond markets. On the international stock markets, the reversal of previous safe-haven flows along with positive earnings figures and improved earnings expectations strongly boosted share prices on both sides of the Atlantic; at the same time, investors' uncertainty eased appreciably.

In addition, the sovereign debt crisis in several peripheral euro-area countries continued to cast a shadow. Market participants had their sights trained on Ireland which, given the large strain which the restructuring of its financial sector placed on its budget, accepted assistance under the European rescue shield at the end of November. The country's risk premiums on the capital market temporarily climbed to new highs, and burgeoning uncertainty also drove up the spreads of other peripheral countries. Caught between countervailing forces, the euro displayed no clear trend.

Monetary policy

Against this backdrop of robust overall economic growth, albeit still characterised by capacity underutilisation, and given muted monetary and credit growth, the Governing Council of the ECB concluded that inflation in the euro area would remain in line with price stability over the policy-relevant medium-term horizon. However, it stressed the need to monitor developments very closely, as several factors, in particular a continued upsurge of commodity prices, might cause the risks to price stability, which are currently still balanced, to move to the upside in the medium term. As a result, the Governing Council left key interest rates at their historically low levels.

The improvement in conditions on the euro money market that began in the summer continued over the winter months. After a noticeable increase at the beginning of October, money market rates initially eased slightly until year-end. Following the first monetary policy meeting of the ECB's Governing Council in 2011, rates picked up sharply again, however. On balance, from October to January money market rates therefore remained on the upward path on which they had embarked in the second quarter. This was largely because banks significantly reduced excess liquidity as the last outstanding six and twelve-month tenders expired.

Monetary growth in the euro area weakened perceptibly in the last quarter of 2010, after accelerating appreciably in the two preceding quarters. Among the counterparts of M3, lending by banks resident in the euro area to domestic non-banks was again a key driver of monetary expansion in the final quarter of

2010. Loans to non-financial corporations fell distinctly, by contrast, after having recorded the first clear growth in six quarters in the preceding period.

Germany

The German economy continued its cyclical recovery in the fourth quarter of 2010. According to the flash estimate released by the Federal Statistical Office, seasonally and calendar-adjusted real gross domestic product rose by 0.4% quarter on quarter in the final three months of the year, thus displaying slightly weaker growth than in the summer. However, the result probably understates the underlying economic momentum, as the extremely cold and snowy winter weather caused severe disruptions in the construction and transport sectors in December. The rapid upturn of the last one-and-a-half years means the German economy is almost back at normal capacity utilisation levels, and in some areas of the economy capacity utilisation already exceeds the longer-term average.

One reason for the favourable overall economic situation in Germany is the distinctly optimistic sentiment among businesses and consumers, which has helped strengthen domestic growth stimuli. Businesses are investing in new plant and equipment, raising working hours and hiring additional staff. As a result, employees' income is rising and the labour market is improving, in turn boosting households' propensity to purchase and thereby providing noticeable impetus to consumption as well as housing construction. The pronounced and broad-based cyclical expansion of the German economy is also having a knock-on effect on its trading partners – especially in the European Union – in the form of rising expenditure on imports. However, the upturn continues to be fuelled chiefly by buoyant demand for German industrial products, particularly from non-EU countries – as is to be expected in an economy as open as that of Germany. The present confidence in the German economy is largely based on the expectation that this trend will continue.

Against this background, German economic momentum was barely dented by the fact that in the fourth quarter exports probably grew less strongly than before. The reduced external dynamics were largely the result of stagnant sales to euro-area partner countries. By contrast, deliveries to non-euro-area countries continued to expand.

Renewed strong growth in investment helped offset the mixed figures for foreign demand. With many enterprises having reached or, in some cases, even exceeded their plants' normal capacity utilisation, they are increasingly looking to capacity extensions. Construction investment, too, would probably have supported growth in the fourth quarter of 2010 had the early onset of winter not considerably curtailed output in December.

Nonetheless, the sharp cyclical upturn has not yet led to accelerated lending to the corporate sector. A key reason for this is probably that the upswing has provided non-financial corporations with better access to alternative sources of funding, notably including internally generated financial resources.

Supply-side restrictions are unlikely to have presented an obstacle to corporate funding.

Private consumption has emerged as another driver of domestic demand. The moderate increase in the fourth quarter of 2010 is consistent with a slow but steady recovery of consumption. In the reporting period, retailers benefited in particular from households' willingness to spend during the Christmas business.

The labour market recovery also continued in the fourth quarter of 2010. Almost all sectors of the economy are meanwhile experiencing employment growth. Moreover, effective working hours are now back at normal levels, or higher, for large swathes of industry. In manufacturing, the average number of hours an employee worked in the fourth quarter of 2010 was no longer significantly less than during the last cyclical high in the first quarter of 2008. According to leading indicators, the outlook for the labour market remains very positive. Up to January 2011, the number of vacancies had increased further in seasonally adjusted terms.

However, the price climate in Germany has deteriorated considerably. A major factor behind this was the surge in world market prices for energy, industrial commodities and food in the wake of the global economic recovery, which was reflected in increased inflation, in particular, at the upstream sales and production stages. This is largely the result of prices returning to pre-crisis levels, which – like the recovery in the real sector – is temporarily being accompanied by higher rates of price increases.

The outlook for the German economy is positive. It should be able to carry over much of the economic momentum from the second half of 2010 into the current year, as incoming orders from non-EU countries are very strong. Exporters are benefiting from their presence on the strongly expanding non-European markets, particularly as the economic recovery in the United States has recently accelerated perceptibly. Impetus from the euro area is likely to stay fairly muted, however, and if orders from this region remain weak, the pace of economic growth might conceivably ease somewhat.

Private consumption, by contrast, is likely to continue to support economic activity over the next few months as consumers' propensity to purchase is high, based notably on very optimistic income expectations. Their confidence is grounded in the expectation of an ongoing labour market revival and the prospect of a perceptible increase in pay.

Public finances

Against this backdrop, public finances in Germany developed more favourably last year than had been anticipated at the height of the crisis. The situation is also better than in many other countries. However, this should not mask the existence of substantial fiscal problems and the need for large-scale adjustment. Public finances still had an expansionary bias in 2010. This, as well as the assistance provided to financial institutions, drove the general government deficit ratio up to 3.5%, although the buoyant economy and

positive one-off effects significantly eased the burden on public coffers. The debt ratio reached a new high, estimated at well over 80%. The very sharp increase can mainly be attributed to measures to stabilise the financial markets, which involved the government sector assuming liabilities – and risky assets – on a large scale.

The deficit ratio could drop perceptibly towards 2% this year, provided all levels of government start to initiate the deficit reduction necessary, not least to comply with budgetary rules, and there is no let-up in the planned consolidation measures. Despite the expected reduction in the deficit, policymakers still face a huge restructuring task over the next few years, as is abundantly clear from central, state and local government budgets. The medium-term objective of a structurally close-to-balance budget is still a long way off. The debt ratio has exceeded the 60% reference value ever since 2002 and rose very sharply again during the crisis. The better performance in terms of national and European budgetary rules should therefore not be used to ease consolidation efforts. On the contrary, the current good economic conditions represent an excellent opportunity for rapid and comprehensive budget consolidation.

Against this backdrop, the concrete implementation of the constitutional rules on the debt brake in Germany to date continues to merit a critical appraisal. For instance, the starting level for the graduated reduction in the maximum borrowing limit that must be achieved by 2016 has not been adjusted to take account of the more favourable macroeconomic and fiscal outcome last year; instead the much higher estimate of the summer of 2010 has been used as the basis. This provides additional scope for government borrowing, which is initially even higher than under the old constitutional rules, which were regarded as insufficient. To ensure compliance with the legislative intent of the new debt brake and avoid violating it upon its first-time application, thereby undermining confidence in the effectiveness of the reform, the reduction path should be adjusted to the 2010 outturn, which is now available. This is particularly pertinent in the light of attempts to establish the new German budgetary rules as a model for ensuring sustainable public finances in other euro-area countries.

Confidence in the soundness of public finances remains extremely strained in several euro-area countries, with Ireland, following Greece, also forced to apply for financial assistance from the EU, other member states and the IMF. Action will be required primarily from the stricken countries themselves to improve this situation on a sustainable basis by eliminating the root causes of the problem. But financial assistance can at most buy time to allow the necessary adjustment processes to be spread over a longer period. As things currently stand, the euro rescue shield agreed in May 2010 would appear to provide a sufficient range of instruments.

Nonetheless, the possibility of adding new instruments to the rescue package, which runs to 2013, is currently being floated. One demand is that the European Financial Stability Facility (EFSF) should buy up the government

bonds of the affected countries on the secondary market. That would, however, absolve private creditors and national policymakers of even more of their responsibility and possibly result in the taxpayers in the countries providing the finance having to shoulder more and potentially large-scale risks. Bond buybacks by the country itself using low-cost loans extended by the EFSF are being proposed, as is the idea that bonds acquired by the EFSF cheaply should be passed on to the debtor country below par. In economic terms, this would, like the reduction of the agreed interest rate conditions, involve an additional intergovernmental transfer.

This is also an issue with the future European Stability Mechanism (ESM). It is planned as a last resort to safeguard the stability of the euro area if the preventive measure of strengthening the Stability and Growth Pact, the targeted expansion of an early warning system for serious macroeconomic imbalances which could jeopardise other member states and improved financial market regulation prove insufficient. At the end of November 2010, the euro-area finance ministers established important cornerstones for the ESM, which the European Council confirmed in December. The ESM will accordingly be based on the EFSF in its current form. To protect the taxpayer, ESM loans are, moreover, to be given preferred creditor status, amongst other things. At present, negotiations are ongoing with the objective of finalising the mechanism by March. Some of the proposals being discussed – for example involving secondary market purchases, extending joint liability (Eurobonds) or perceptibly lowering the interest rate charged on ESM loans – reduce incentives for sound fiscal policy and contravene important basic principles of the currency union such as subsidiarity, national fiscal responsibility and the no bail-out principle.