Overview

Germany in the financial and economic crisis

At the onset of the financial crisis in summer 2007, no-one could have foreseen that, little more than a year later, it would become the biggest global economic crisis in the post-war period, placing the euro area under severe pressure. Conversely, at the height of the turmoil in the latter part of 2008 and first part of 2009, no-one would have expected not only the global economy but also, and above all, the German economy, which was particularly hard hit by the worldwide downturn, to recover as quickly as they have since the second quarter of 2009. Against this backdrop, this edition of the *Monthly Report* takes a closer look at economic developments in Germany during the financial and economic crisis, focusing on the financial system, the macroeconomic setting – in particular, the remarkable developments on the labour market – and, in light of the extensive economic policy measures implemented to combat the crisis, public finances.

Three-phase crisis

One of the salient features of a financial crisis is the dramatic loss of confidence in the functioning of central markets and in the solvency of the market players. This is illustrated in the current crisis by the premium that banks demand of each other on the interbank market for uncollateralised over collateralised debt (see chart on page 19). The financial crisis was preceded by a phase of extremely favourable financing conditions and a high propensity to take risks. In some countries this fostered an unsustainable asset price increase that led to high private sector debt and excess domestic demand. The financial crisis may be divided accordingly into three crisis phases. These phases begin in August 2007, September 2008 and May 2010 respectively, and mark three key events, namely the outbreak of the subprime crisis in the USA, the collapse of US investment bank Lehman Brothers and the escalation of the government debt crisis in the euro area.

Upturn continued initially, despite financial crisis

Banking system quickly at the epicentre of the crisis

Although the financial crisis was triggered by the turmoil on the US subprime market, the banking system, as the direct or indirect holder of structured bond products backed by subprime mortgages, quickly found itself at the epicentre of the crisis, worldwide. Considerable gaps and weaknesses in the regulatory framework were thereby exposed. Risk aversion among financial market participants surged, fuelled by growing uncertainty about the true extent of liquidity and solvency risks in the banking sector; as a result, in August 2007, the interbank markets witnessed at times substantial tensions and a rise in risk premiums on a broad front. The spillover of the crisis to Germany can mainly be explained by the fact that, when the crisis broke out, isolated German credit institutions affected had reached the brink of collapse. In the euro area, the Eurosystem responded with a generous provision of liquidity and a stronger focus on longer-term refinancing operations and so prevented liquidity shortages from having a destabilising effect on the financial system as a whole.

Problems intensified in the course of 2008

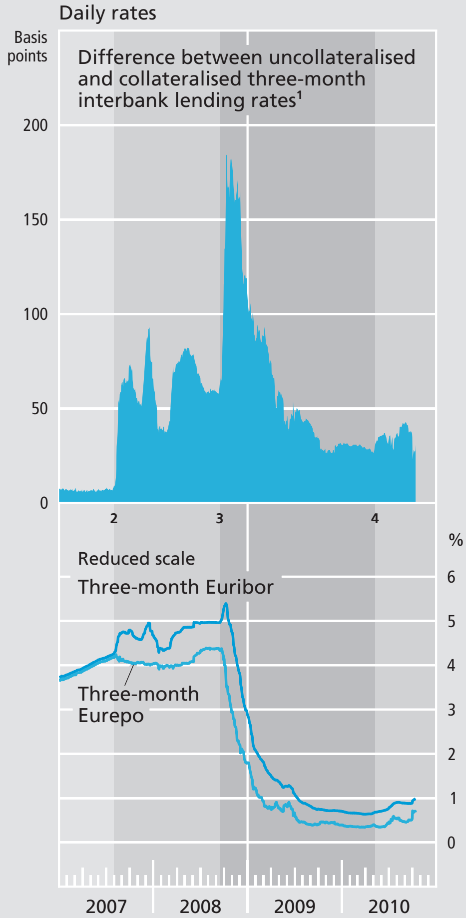
As the financial market turmoil spread and the loss of confidence accelerated in the global financial markets, the problems facing the international banking system were further aggravated during the course of 2008. Financial market prices fell more and more rapidly, write-downs on structured products rose and heavy losses were posted in the derivatives business, so that attention became progressively more focused on insolvency risks, particularly as the hitherto robust global economy grew increasingly weak. In many countries, including Germany, the situation of more banks became so critical that they had to be rescued through government support measures or be taken over by institutions with sounder balance sheets than their own.

In the euro area, this generous provision of liquidity went hand-in-hand, in this phase, with a tightening of the monetary policy stance. With that, the Eurosystem responded to growing price risks as a consequence of the, at first, still robust economy and a pronounced rise in commodity prices, which pushed the price of oil above US$140 at its peak. At this time, the German economy was in a favourable situation. Following successful changes to the production structure in previous years, the German economy benefited from the strong demand for capital goods and durable consumer goods, notably from the rapidly growing emerging market economies. Corporate profits reached record levels, capacities were expanded and the labour market picked up again noticeably, driven by a combination of strong economic stimuli and previously implemented structural reforms. Employment reached a new all-time

German upturn continued initially, ...

Euro-area money market rates during the financial crisis

Daily rates



1 Three-month Euribor less three-month Eurepo. — **2** Beginning of the financial market turbulence. — **3** Lehman insolvency. — **4** Intensification of the government debt crisis in the euro area.

Deutsche Bundesbank

high as a result and, for the first time in decades, unemployment fell below its low point in the previous upswing. Since domestic economic growth remained subdued, high current account surpluses were recorded. In the second and third quarters of 2008, there were growing signs that the upswing in Germany would be terminated by the slowdown in global economic activity and rising inflationary pressures. However, the decline in

... but petered out in 2008 Q2/Q3

economic output in the second and third quarters of 2008 stayed in line with normal cyclical fluctuations.

Public finances: slight surplus in 2007 and 2008

The public finance situation in Germany received a pronounced boost from the steep increase in output, and from a fiscal policy that remained geared to consolidation until 2007. Whereas in 2005, the general government deficit in relation to GDP was still above the 3% ceiling, a slight surplus was recorded in both 2007 and 2008.

Into the most severe post-war downturn – and out again

Lehman insolvency triggered dramatic escalation of the crisis

The Lehman Brothers insolvency and the near-collapse of the US insurer AIG in September 2008 dramatically heightened the global financial crisis which, by that point at the latest, turned into a systemic crisis. Important markets ground to a halt, stock prices plummeted, investors fled to the safe haven of government bonds, and for a while the entire banking system was on the verge of collapse. Around the world, monetary and fiscal policymakers took extensive and far-reaching countermeasures to prevent the breakdown of the international financial system and contain negative feedback effects between the stricken financial system and the accelerating global economic downturn.

Eurosystem adopts extensive counter-measures

The Eurosystem responded by significantly easing the monetary policy stance and introducing a number of unconventional liquidity policy measures. The price outlook and the noticeably declining inflation expectations justified repeated key interest rate cuts, refinancing operations were conducted as fixed-rate tenders with full allotment of all bids, the average maturity of refinancing operations was extended by additional longer-term operations, and the range of eligible collateral was broadened. Moreover, in the second quarter of 2009, the Eurosystem launched a covered bond purchase programme which was limited to one year and to a volume of €60 billion. This programme was for the purchase of covered bonds, which include German Pfandbriefe, and sought to revive the market for such bonds given their importance for bank funding.

Extensive support measures for the German financial system ...

In Germany, the Federal Government and a banking syndicate provided extensive liquidity support to Hypo Real Estate, a German mortgage bank that was threatened by insolvency, before the bank was ultimately taken into public ownership in mid-2009. Additionally, to prevent a general bank run, the government in early October 2008 issued a guarantee in respect of all private savings deposits. The German Financial Market Stabilisation Fund (SoFFin), created in mid-October 2008, played a central role in ensuring that the financial system continued to function. This fund was endowed with a total of €480 billion for granting guarantees for bank debt securities, recapitalisation measures and the removal of impaired assets from banks' balance sheets.

... and the economy

Furthermore, in late 2008 and early 2009, the German government put together two extensive fiscal stimulus packages that were designed to boost domestic economic activity by way of tax and social contribution cuts, higher transfers, additional public investment and incentives such as the car scrappage premium. To ward off fears of a credit crunch, the government also launched a credit guarantee scheme or "Germany Fund".

Fiscal policy made important contribution to stabilisation

Such a decisive fiscal policy response was justified by the severity of the crisis and played an important part in stabilising the economy and the financial system. However, the precise form and implementation of the fiscal stimulus packages, which, in part, must be viewed critically, also highlighted the problems associated with attempts to macromanage the economy. The general government deficit rose to 3.0% of GDP in 2009, while the debt-to-GDP ratio climbed from roughly 66% in 2008 to 73½%. In addition, significant risks were assumed under government guarantees.

2008 Q4/2009 Q1: massive economic downturn ...

Large-scale monetary and fiscal policy initiatives were launched in other countries, too, to stabilise the financial markets and the real economy. Moreover, intensive debate was conducted at the international level, notably among the main industrial countries and emerging markets (G20), about the need for economic policy harmonisation and the form it should take. Despite the swift countermeasures taken by monetary and fiscal policymakers, global economic activity collapsed in the last quarter of 2008 and the first quarter of 2009. The manufacturing sector and world trade bore the brunt of the impact. Given German industry's extensive international links, it was hardly surprising that of the major, advanced economies, Germany was hit particularly hard. In the two abovementioned quarters, output fell by a total of 5½%. As a result, real GDP in the first three months of 2009 was a calendar-adjusted 6½% below the previous year's figure.

... while domestic economic activity stayed robust overall ...

The decline in economic output was concentrated, above all, on exports and on investment in machinery and equipment. Private consumption, on the other hand, proved to be a stabilising factor. Thus, an abrupt counterswing followed on the heels of the preceding upturn during which exports had benefited to a particular extent from the strength of global economic growth.

... and labour market proved highly resilient

The exceptional resilience of the German labour market played a decisive role in stabilising private consumption. The export-oriented sectors, which were especially hard hit by the global slump in demand, experienced an appreciable reduction in employment. Yet the decline proved to be considerably less steep than the severity of the economic slump might have suggested. This relatively benign adjustment was made possible by the extensive use, by companies, of in-house agreements on flexible working hours and short-time work, collective pay deals geared primarily to safeguarding jobs and the acceptance of sharp rises in unit labour costs. What is more, the decline in employment in the export-dependent sectors was counterbalanced by a sustained rise in employment in domestically-oriented sectors. Overall, employment declined little and unemployment hardly rose at all.

Recovery from 2009 Q2 onwards

Once German economic output stabilised at a low level in the second of quarter of 2009, economic activity gradually regained its footing. Besides the robust labour market situation and the fact that global economic recovery had got underway, a further important factor was that, despite the massive drop in earnings in the banking system, transitory fears of a broad-based credit crunch did not materialise. Enterprises were able for the most part to continue covering their substantially reduced funding needs through the banking system or alternative financing channels. At the beginning of 2010, the pace of economic growth then picked up and, together with weather-related special factors, led to an exceptionally strong rise in output in the second quarter, when new financial market turbulences loomed on the horizon.

Government debt crisis in the euro area

Spotlight on sovereign default risk, ...

Towards the end of 2009, investors and rating agencies were increasingly turning their attention to the financial risks that the government sector worldwide, but particularly in some euro-area countries, had already incurred or was likely to incur. The default risk of these countries' government debt securities, which until then had been considered safe, was valued anew on a more differentiated basis. As a result, intra-euro-area yield spreads widened significantly to the detriment, above all, of several countries on the euro-area periphery. In Greece, which had previously pursued an irresponsible budgetary policy and had tried to conceal this, in part, by statistical window-dressing, the situation escalated dramatically and the country's ability to tap the capital markets was very much endangered. In April 2010, a financial assistance package subject to stringent conditionality was subsequently assembled for Greece with the participation of the International Monetary Fund (IMF), but it did not dispel investors' concerns. The erosion of confidence came to a head on the second May weekend in 2010, when the markets for government bonds of countries on the periphery of the euro area threatened in some cases to dry up. To stop the situation from escalating further, extensive stabilisation efforts were embarked upon. Again with the participation of the IMF, fiscal policymakers put together a preventive rescue shield with a volume of up to €750 billion, which has not yet been availed of. The Governing Council of the ECB decided to reintroduce selected non-standard monetary policy measures and launch a programme for the purchase of public and private sector debt instruments. These measures had the effect of preventing a crisis situation; nevertheless, tensions in the bond markets of the euro-area peripheral countries persisted.

... but economic effects limited to date

In contrast with the previous phase of the financial crisis, the renewed turmoil had a relatively small impact on the financial markets and, above all, on the global economy. Although financial market uncertainty remained high, it was nothing like the situation in the autumn of 2008. And although growth dynamics are expected to be more muted during the remainder of the current year, the economic recovery both worldwide and in Germany has remained intact so far and is likely to continue. The necessary fundamental economic adjustments have only just begun in many countries, and the resulting dampening effects have been obscured by the expansionary stance of fiscal policy. However, since endogenous forces of growth are gaining in momentum, there is no reason to fear a renewed downturn. It should be emphasised all the more strongly that credible fiscal consolidation is now indispensable; a loss in confidence in the sustainability of public finances would have a much more serious impact than the potentially short-term dampening effect of a deficit reduction.

Real GDP up by more than 3% in 2010

Real GDP in Germany is likely to rise by more than 3% in 2010 year on year. Even the very low, crisis-induced trough in employment has bottomed out in the meantime, and unemployment is about to drop below pre-crisis levels. What is more, the importance of domestic demand for economic development is steadily increasing.

Deficit in 2010 expected to be well below 4%

The general government deficit will probably not rise as strongly as initially feared, and should stay well below the 4% mark for 2010 as a whole, whereas the debt ratio is expected to rise substantially owing, above all, to the support measures for the financial system. In this context, Germany is benefiting from a very low interest rate level, which is based on the high level of confidence in the sustainability of the country's public finances and probably also in the overall economic outlook.

Lessons learned from the crisis

Crisis successfully dealt with to date

Despite, in some cases, substantial turmoil in the German banking system, Germany has so far coped well with the financial and economic crisis compared with other countries. There are two main reasons for this. First, thanks not least to far-reaching reforms implemented in the preceding years, the German economy was in good shape when the crisis broke out, and was not troubled by serious imbalances in domestic economic activities, as other countries were. Second, the German government was able to play a major part in stabilising the real economy and the financial system – not only with regard to Germany itself but also to the euro area as a whole, for which Germany proved to be a stabilising factor; this was possible because belief in the long-term robustness of Germany's public finances remained strong even though the fiscal balance had worsened radically.

Need for adjustment to the financial system

Against this backdrop, what are the tasks now facing economic policy? One central challenge lies in strengthening the resilience of the financial system to future crises. Although many details still need to be clarified with regard to this reform agenda, which for good reason is being internationally coordinated, it is already clear that the German banking system will have to strengthen its capital base, and that a fundamental restructuring is called for in some market segments. Both these tasks should be tackled resolutely.

Labour market reforms must be upheld

During the crisis, previously implemented labour market reforms, in particular, paid off handsomely. It would therefore be a mistake to reverse the reforms, which has already happened in isolated cases. Instead, the success achieved so far should act as a spur to continue along the present path and tackle the problems that remain, for example in the area of long-term unemployment. Along with measures designed, for instance, to promote further liberalisation in various service sectors, this would give an important boost to domestic economic growth forces. This is all the more necessary as the more sustainable global economic growth aimed for is likely to be less dynamic than before the crisis, and will drive German output less strongly in future.

German economy well positioned for the future

Although the German economy is, on the whole, well positioned to tackle the challenges associated with its extensive integration in world trade, and Germany will for the time being continue to post current account surpluses, not least given the demographic burdens it faces, domestic sources of growth are therefore likely to rise in importance in future.

Fiscal room for manoeuvre needs to be restored ...

In the field of public finances, finally, the fiscal room for manoeuvre to deal with new challenges needs to be restored. To this end, it will be necessary to rapidly reduce the high structural deficit and quickly rein in the soaring debt ratio and the risks from guarantees in order to strengthen confidence in public finances on a lasting basis. Fiscal rules have a key role to play in this context. At the national level, an ambitious fiscal rule has been created in the shape of the debt brake, the binding nature of which will need to be demonstrated in the coming years.

... and European fiscal framework to be strengthened

At the European level – in the light of the debt crisis – one central objective for Germany especially is to tighten and supplement the existing fiscal framework in order to place European monetary union on a sounder fiscal footing going forward.

As long as euro-area countries continue to be responsible for their own national fiscal policy, rigorous compliance with the agreed budgetary rules has to be ensured so as to obviate the future need for support measures to ward off the danger of serious repercussions. As a last resort, the restructuring of a country’s sovereign debt should also be an option on the basis of a suitable framework in conjunction with financial market regulation that supports financial market stability. In addition, wider macroeconomic surveillance might help to identify severe distortions and imbalances earlier. Notwithstanding a possible role for carefully targeted government intervention in exceptional economic circumstances, ongoing macro-management of the economy is neither promising nor advisable – both at national and international level.