Overview

In the shadow of the sovereign debt crisis

Global economy

Global economic growth picked up slightly in the third quarter compared with the previous three months, which can mainly be explained by the evaporation of temporary strains. However, the outlook for the world economy in the latter part of 2011 and early part of 2012 has worsened considerably, in part because of the renewed escalation in the European sovereign debt crisis. Hard business activity numbers have, to date, drawn a more favourable picture. However, leading economic indicators based on surveys among businesses and households have for several months been pointing clearly downwards and signalling appreciable downside risks.

The sovereign debt crisis in the euro area could weigh on the recovery in Europe and could also have negative consequences for trade partners in other economic areas. Against this backdrop, it is particularly important that the affected euro-area countries take rapid and decisive measures to prevent a further erosion of confidence in the soundness of their public finances and to regain lost competitiveness. This is a key precondition for reducing the uncertainty that prevails among consumers and enterprises. However, doubts about national fiscal and economic policymakers' ability to resolve the problems are in some cases obscuring more favourable economic fundamentals and settings. Abating inflation, a strongly expansionary monetary policy stance in the industrial countries and the still robustly growing demand in the emerging market economies will continue to

constitute important global driving forces in the months to come.

Financial markets

The heightened uncertainty about the evolution of the European sovereign debt crisis has been a key determinant of events on the financial markets since the middle of the year. At the European level, the resolutions of the heads of state or government at the summit meetings in July and October failed to bring about a long-term improvement in the situation on the financial markets. Investors have widened their critical gaze to include not only the peripheral states that had already been identified as endangered but also other countries, notably Italy. The problems have therefore, for the first time, reached large economies of the euro area.

Even after the resolutions made at the October summit, it remains unclear what a coherent institutional framework for monetary union should look like going forward. A fundamental decision must be taken on whether to strengthen the existing framework, with national fiscal sovereignty and the application of some Community rules with a no-bail-out rule, or whether to create a fiscal decision-making structure where a central level has ultimate powers to intervene in national budget sovereignty. The route currently being taken of partially expanding joint liability, and thus concurrently reducing the incentive for countries to achieve sound public finances on their own, without at the same time significantly strengthening the right to intervene in national budgets is yielding an increasingly incoherent framework for monetary union. This is increasing the risk of unsound public finances, and the potential for conflict with a stability-oriented monetary policy is likewise growing significantly. The recent escalation of the crisis demonstrates that the pivotal decision on the future framework for monetary union cannot be delayed if a further deterioration is to be avoided.

Monetary policy

The deterioration in the macroeconomic prospects and the implications this has for the inflation outlook prompted the ECB Governing Council to cut interest rates by 25 basis points at the beginning of November. The negative effects of the spreading sovereign debt crisis on banks' funding situation caused a massive increase in their demand for liquidity from the Eurosystem. The Governing Council responded in October by agreeing on the renewed provision of longer-term liquidity for a period of around 12 months through two additional longer-term refinancing operations, one in October and the other in December. It also decided to continue to conduct all monetary refinancing operations on the basis of full allotment for as long as necessary, and at least until the end of June 2012. Given the uncertainty on the money and financial markets, excess liquidity in the banking system reached a level last observed in the summer of 2010. In order to help ease the strained funding situation experienced by euro-area banks, the ECB Governing Council in October also decided to relaunch its covered bond purchase programme, which will this time have a volume of €40 billion – one-third smaller than the May 2009 programme.

The expansion in the M3 monetary aggregate since the spring of 2010 accelerated in

the third quarter of 2011. The quarter-on-quarter increase was the highest since the fourth quarter of 2008. However, the sharp rise in monthly year-on-year growth rates in M3 was largely due to heightened uncertainty on the financial markets. Unlike monetary growth, loans to the domestic private sector have been expanding at an almost constant pace since the beginning of the year, at around 2½% on the year. However, growth in loans to non-financial corporations slowed again in the reporting quarter, though data on these loans for the entire euro area mask very heterogeneous developments in the individual member states.

Germany

Such heterogeneity is also evident in economic developments. Several of the peripheral countries that had shown considerable overheating before the global financial and economic crisis continue to see economic activity decline sharply or stagnate. By contrast, growth in Germany, for instance, remained robust in the third quarter. According to the Federal Statistical Office's flash estimate, seasonally and calendar-adjusted real gross domestic product increased fairly sharply again in the third quarter by 0.5% on the preceding three months after extraordinary effects had slightly slowed the pace of growth to 0.3% in the second quarter. At the beginning of the second half of 2011, the underlying cyclical tendency was therefore not much weaker than in the first six months. During the reporting period, seasonally and calendar-adjusted economic output exceeded the peak it had marked before the onset of the financial and economic crisis. In the year to date, moreover, the utilisation of aggregate capacity, which had previously already reached the corridor of normal utilisation, is likely to have risen perceptibly.

However, a look at developments in monthly production indicators shows that economic momentum has waned of late. Furthermore, the substantial lowering of business expectations that has been observed for some time is being reflected in a considerable deterioration of industrial new orders. Disruptive externalities, as mirrored in the increasingly bearish sentiment, are now perceptibly weighing on real economic activity in Germany and are likely to leave their mark over the next few months. This increases the risk of the domestic economy weakening.

German enterprises' exports remained buoyant in the third quarter despite growing concerns about global economic momentum. Of late, German enterprises' foreign business has benefited from stimuli from the United States and Japan and the country's east European neighbouring countries. Exports to China and other south and east Asian emerging market economies, by contrast, stagnated, as did deliveries of goods to the euro area. Imports expanded again appreciably in the third quarter. However, the rate of increase is likely to have been lower than in the previous quarter.

The dynamic of business investment likewise remained intact in the third quarter. The current high level of capacity utilisation of tangible fixed assets in large parts of the economy, in conjunction with the now considerable backlog of orders, explains why enterprises

have, so far, barely revised their intention to expand production capacity. Provided it remains a temporary phenomenon, the fact that demand has eased off from its cyclical high does not therefore contradict plans to expand production plants. Taking a longer-term view, the business investment cycle has not yet achieved maturity. Housing construction again provided support to the domestic economy. Demand for residential property remained strong throughout the third quarter, not least because mortgage rates fell to new lows.

Private consumption recovered from its temporary lull – largely caused by the deteriorating price climate in the spring months – in the second half of the year. Retailers reported a seasonally adjusted quarter-on-quarter increase in sales for the reporting period. Moreover, households purchased significantly more motor vehicles again. Higher consumer spending was in part attributable to sharply improved earnings and a robust propensity to purchase.

An important factor underpinning private consumption was the ongoing positive – albeit less dynamic – labour market trend. Employment continued to rise in the third quarter of 2011 on the back of sharply higher economic output. Most new jobs that were created were again subject to social security contributions, while the number of persons working exclusively in low-paid part-time jobs remained virtually unchanged in seasonally adjusted terms, and government-sponsored working arrangements (one-euro workfare jobs) were reduced further. The falling trend in unemployment likewise continued in the third quarter of 2011. The pace at which joblessness decreased decelerated compared with the first half of the year, however. While there was only a moderate decline in the number of longer-term job seekers receiving welfare benefits, no further significant drop was recorded in the number of unemployed workers claiming insurance benefits, which was already at a very low level. According to the leading indicators available for the labour market, the positive development is likely to continue for the time being as the incentive to expand production capacities is still the dominant factor in staffing plans in trade and industry. This assessment is, however, presumably predicated on the assumption that the emerging economic slowdown is confined to the fourth quarter of 2011 and early part of 2012.

Meanwhile, employees are benefiting from the favourable labour market situation in the form of sharply higher earnings. In many industries, these are well above the collectively agreed wage increases. A moderate drop in prices, or at least a slowdown in the rate of increase, was evident across all stages of the economy in the third quarter. Consumer price inflation has also weakened. The rate of price increase for energy almost halted; by contrast excluding energy it continued virtually unchecked. Over the next few months, year-on-year inflation rates are likely to fall further, not least given the emerging economic slowdown.

The German economy is likely to encounter a more turbulent phase in the coming months.

External demand, in particular, has fallen markedly and financial markets are jittery. The industrial sector has now scaled back its export expectations to a level which is somewhat below the longer-term average. By contrast, the construction sector and consumption-related sectors are anticipating a much less severe deterioration in their business prospects. One positive factor is that enterprises have so far scarcely revised their basic expansionary focus in terms of investment intentions and recruitment plans. Moreover, there is no evidence of supply constraints on bank lending.

Growing concerns about the economy are also being clearly reflected in household sentiment. This has done little to dent income expectations, however, as employees still anticipate a perceptible rise in their earnings in view of the currently very favourable labour market environment. There were no signs in recent months of any reduction in consumers' pronounced tendency to make major purchases despite the heightened uncertainty. The underlying conditions for buoyant consumer demand are consequently still in place, at least in the short term.

Overall, economic growth is likely to slow next year, with the baseline scenario of GDP growth amounting to between ½% and 1% appearing realistic. This is likely to entail a shift from external to domestic growth dynamics. No major change for the labour market is expected to result from this. However, there are significant risk factors. For instance, a pronounced downturn cannot be ruled out if the sovereign debt crisis in Europe were to intensify appreciably.

Public finances

Despite the easing of cyclical strains, the deficit ratio in Germany deteriorated significantly again last year. This year, however, it is likely to fall substantially to around 1%. This is due in no small part to the economic recovery. Moreover, in 2011 there are likely to be very few of the extensive capital transfers to financial institutions that were seen in 2010.

In 2012, the deficit ratio is likely to remain virtually unchanged given the macroeconomic prospects outlined above. The cyclical deterioration could be small, not least because the economic slowdown is likely to have mainly external causes and thus has less of an impact on cyclically sensitive domestic factors that have greater weight for public finances. Only a slight structural improvement is on the cards, partly because the originally announced fiscal consolidation path has now been relaxed. Looking forward, the possibility of an escalation of the sovereign debt crisis and a stronger-than-expected economic slowdown entail considerable risks.

Overall, German budgetary policy should focus on reducing the deficit in a timely manner. However, the fact that several aspects of the original consolidation course have been weakened – as happened recently with the decisions taken by the coalition committee at the beginning of November – suggests that a different course has now been embarked upon. In particular, the series of upward revisions of forecast tax revenue in the wake of the economic upswing have encouraged pol-

icymakers to delay eliminating the structural budget imbalance. It would be better to use the windfall gains instead in order to reduce the deficit faster and to achieve the medium-term objective of a structurally (close-to-) balance budget earlier. The virtually unchecked growth in the debt ratio since the 1970s highlights the continuous erosion of fiscal policymakers' radius of action that has ensued from their habitual tendency to keep putting off budgetary consolidation indefinitely. The reforms of the national budgetary rules and of the European Stability and Growth Pact are intended precisely to avoid making this mistake in the future. However, this will succeed only if the requirements are implemented rigorously – which did not happen in the past.