Overview

German economy slowed in second quarter as expected, but underlying trend remains positive

Global economy

The global economy was characterised by muted growth in the second quarter. However, much of this was due to temporary factors that obscured the basically ongoing positive underlying trend. Moreover, the influence of these short-term negative factors waned considerably towards the end of the reporting period. The disruptions to Japanese production, and carmakers in particular, following the natural disaster of mid-March have now largely been eliminated. The considerable erosion of purchasing power as a result of rising energy and food prices in the latter part of 2010 and early part of 2011 also weighed considerably on the global economy. Both effects were also a key feature in the dulled economic momentum in the United States.

In addition to these temporary constraints on the global upturn, longer-term factors also played a role, however. These include appreciable interest rate hikes and other central bank measures to reduce the expansionary bias of monetary policy that the emerging market economies used to avert the danger of second-round inflation effects. In several advanced economies, the necessary consolidation efforts are having a dampening effect.

Overall, there is still much evidence suggesting that the global economic upswing remains intact and that worldwide growth will remain robust next year. Nonetheless, there are doubtless risks, not least in connection with a loss of

confidence in the long-term sustainability of public finances in several countries.

Financial markets

Financial market players have been monitoring not only the slowdown of the global economy but also, increasingly, the large sovereign debt burden facing some developed countries. In Europe, the markets were only temporarily calmed by the news that Greek solvency is to be assured by another rescue package agreed by the heads of state or government in mid-July. At the beginning of August, the situation on the financial markets deteriorated further. Against the backdrop of a fierce parliamentary debate on whether to raise the statutory debt ceiling, the United States suffered its – first ever – credit downgrade by a rating agency. In the euro area, meanwhile, Spanish bond yields rose perceptibly, as did yields on bonds issued by heavily indebted Italy. In this environment, share prices around the world tumbled, and yields on the government bonds of the major industrial nations weakened noticeably as a result of safe haven inflows.

Market participants' uncertainty regarding economic developments on both sides of the Atlantic caused the euro-dollar exchange rate to fluctuate sharply, and both currencies depreciated against the yen and, in particular, the Swiss franc.

Monetary policy

With the sovereign debt crisis worsening and uncertainty rife on the financial markets, the Eurosystem's monetary policymakers face the challenge, in keeping with their mandate, of meeting banks' increased demand for liquidity while simultaneously addressing the threats posed to price stability in an appropriate and timely manner. Once again, the clear segregation of liquidity-providing measures, on the one hand, and the monetary policy stance as expressed in interest rate decisions, on the other, has proved the right course of action.

During the second quarter, inflation as measured by the Harmonised Index of Consumer Prices (HICP) remained well above 2%, mainly on account of energy and commodity prices. In order to combat the resultant medium-term upside risks to price stability and anchor inflation expectations at a level consistent with price stability, the Governing Council of the ECB decided in July that, following the interest rate increase in April, its accommodative monetary policy required further tightening.

At the start of the second quarter of 2011, banks initially continued to reduce their surplus liquidity, a course they had been pursuing since the beginning of the year. However, the growing uncertainty on the financial markets halted this temporary normalisation of the money market in mid-June. Since then, banks' rapidly increasing borrowing from the Eurosystem has caused excess liquidity in the banking system to reach a level last observed in the fourth quarter of 2010. Moreover, banks resorted more and more to frontloading their minimum reserve requirement, which meant that money market rates increasingly tended to fall over the course of each maintenance period in a pattern that is typical of situations characterised by abundant excess liquidity.

Faced with renewed tensions in some euro-area financial markets, the Governing Council decided in early August to continue conduct-

ing all refinancing operations as fixed-rate tenders with full allotment for as long as needed, and at least until the end of 2011, and to conduct a one-off supplementary longer-term refinancing operation at the beginning of August to provide liquidity for approximately six months. With the sovereign debt crisis spreading to other euro-area member states, the Governing Council also reactivated its Securities Markets Programme (SMP). This would, it argued, help restore better monetary policy transmission.

The increase in the M3 money aggregate that has been apparent since the spring of 2010 continued in the second quarter of 2011, although the pace of growth remained moderate. As regards the counterparts of M3, loans to the domestic private sector expanded further, albeit slightly less rapidly than in the previous quarter. Broken down by sector, growth was due in equal measure to an increase in loans to non-financial corporations and to households.

Germany

The German economy continued its upswing in the second quarter of 2011 at a muted pace, as anticipated. According to an initial estimate by the Federal Statistical Office, real gross domestic product (GDP) in the second quarter, after seasonal and calendar adjustment, expanded by 0.1% on the first quarter, which had recorded very strong growth of 1.3%. This slower growth rate is in line with the Bundesbank's June forecast. The volatile pattern in the first half of the year can be attributed in part to the weather-related output losses at the end of last year. The resultant catching-up effects, which were fairly pronounced in some areas of the economy, had boosted output above all in the first few months of this year.

The weak growth in the second quarter is therefore not in itself proof that the German economy's dynamics have become less stable as a result of the foreseeable weakening of foreign demand and heightened uncertainty.

German enterprises further expanded foreign sales in the second quarter. In real terms, the second-quarter increase was only marginally smaller than that of the previous period; imports of goods even rose more strongly in the second quarter in real terms than in the first. Germany's euro-area partner countries were once again beneficiaries of the German economy's strong import demand. The country's function as a pacemaker for the entire euro area therefore remains intact at the current end.

Within Germany, corporate investment geared to expansion was a main driver of economic activity. Replacing and adding to machinery and other equipment were the main priorities. Although business expectations were not quite as optimistic towards the end of the reporting period, many industries continued to extend their production facilities in the light of the current high level of capacity utilisation of tangible fixed assets. This is likely to have been fuelled by the still positive investment environment, which is characterised, amongst other things, by favourable earnings developments as well as advantageous external funding conditions.

In recent months, consumer demand is likely to have been dented by the strained price climate despite the favourable economic and labour market situation in Germany. For instance, fuel prices – which are a sensitive and closely monitored barometer – were high at the beginning of the second quarter, which could have weighed on households' propensity to consume.

The labour market revival continued in the second quarter of 2011. A key feature of the positive employment trend was once again an increase in jobs subject to social security contributions. Unemployment fell noticeably again in the second quarter. The official jobless statistics probably understate the positive impact of cyclical factors, as active labour market measures have concurrently been reduced. Thus, overall underemployment fell twice as much year on year as the official measure of unemployment. Leading indicators suggest that the favourable labour market development will continue for the time being, albeit probably at a slightly more moderate pace.

The higher collective wage agreements in 2011 compared with 2010 on the back of the very buoyant labour market situation are gradually affecting the overall level of negotiated wages. Moreover, effective wages are likely to have outpaced negotiated wages as hours worked increased further, as was also the case in the preceding quarters.

Nevertheless, prices at the various stages of the economy either fell during the second quarter or their increase levelled off. This was mainly caused by falling crude oil prices. Lower prices for refined petroleum products also dampened consumer price inflation during the second quarter. On average, consumer prices nonetheless rose over the spring months. The rate of price increase for components determined by domestic costs is likely to pick up again slowly in the near future. However, the burden on the consumer should be limited, as long as crude oil prices do not rebound perceptibly.

Consumer sentiment remains strong. Provided uncertainty remains limited, there is a chance that the very positive labour market outlook and realised or foreseeable wage increases will continue to dominate the consumer climate in Germany.

As things currently stand, the German economy looks set to maintain its positive underlying economic trend in the second half of the year, albeit at a slightly slower pace. The previously extraordinarily optimistic business expectations have been lowered considerably, and incoming orders – excluding large orders – have also lost momentum. Moreover, there are a number of global risk factors such as uncertainty as to what lies ahead for the US economy and a potential cyclical slowing in the emerging markets. In addition, increasingly jittery global financial markets and the ongoing sovereign debt problems could erode confidence. Whereas the external setting has become less favourable, the domestic economy is still very robust, largely as a result of enterprises' marked willingness to invest, sharply higher demand in housing construction in recent months and the favourable labour market outlook. In addition, if actual growth largely

matches its potential path – as looks likely at the moment – this should help counteract the risk of increasing tensions and supply shortages within the domestic economy. Overall therefore, real GDP growth in the magnitude of 3% may still be expected for the full year.

Public finances

Following a sharp deterioration in German public finances over the past two years, a marked decline in the deficit ratio is expected in 2011, provided the financial crisis and the sovereign debt crisis do not cause any major new strains. The German government's most recent deficit forecast of 1½% appears realistic. The buoyant macroeconomic development is considerably facilitating the task of deficit reduction. All other things being equal, the lower deficit, coupled with relatively high nominal GDP growth, should bring the debt ratio down considerably from its record 2010 level.

From a current perspective the deficit is expected to contract further in 2012, albeit at a slower pace. Lower deficits than in previous years should not, however, be allowed to mask the fact that fiscal consolidation is far from complete. Even in the economic upturn the deficit will still be substantial. Moreover, the debt ratio is very high, and demographic trends will soon place an additional strain on public coffers. Therefore, the medium-term objective of a close-to-balance structural budget ought to be achieved rapidly and, given a favourable overall economic setting, a surplus should also be recorded. Conversely, cuts in tax and social contribution rates are not appropriate at this juncture unless they are fully funded by counterfinancing measures. They would delay the consolidation of central and state government budgets required under the national debt brake, and the opportunity for consolidation provided by the currently favourable conditions might be missed. In view of the European debate on the introduction of national debt brakes, it is particularly important that the German rules be strictly implemented at central and state government level. Lax interpretation should be avoided, and no attempt should be made to circumvent the rules.

The sovereign debt crisis in several euro-area states underscores the supreme importance of sound public finances for a stability-oriented monetary union. On 21 July 2011, the heads of state or government of the euro area and the institutions of the European Union took further steps towards containing the crisis. They resolved to appreciably extend the set of instruments available to the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). They are to be able to intervene on a precautionary basis, allowed to recapitalise financial institutions through loans, including to non-programme countries, and have the option of buying government bonds in secondary markets. Yet the aid is still to be activated only as a measure of last resort to avert an immediate risk to the stability of the euro area as a whole, and financial assistance must be subject to strict conditionality. Furthermore, assistance for Greece has been expanded significantly by announcing an additional €109 billion aid programme, which is to run until the end of 2014. Private creditors are to be involved in financing the measures, although their exposure will, at the same time, be partly underwritten by the countries pro-

viding the assistance. The maturity of future EFSF aid loans to Greece, Portugal and Ireland was extended to 15 to 30 years; and the EFSF will largely refrain from adding an interest rate premium to its cost of funding.

The recent resolutions transfer sizeable additional risks to the countries providing assistance and their taxpayers, and go a long way towards communitising risks caused by unsound public finances and misguided macroeconomic policies in individual euro-area countries. This weakens the foundations of monetary union, which is based on the principles of national fiscal responsibility and the disciplining effect of capital markets, without noticeably increasing the influence and control over individual national fiscal policies as a *quid pro quo.* Overall, there is a risk that the originally agreed institutional framework of monetary union will increasingly become eroded. While fiscal policy will continue to be determined by democratically elected parliaments at national level, the resultant risks and burdens will increasingly be borne by the Community in general and the financially sound countries in particular, without this being offset by any concrete powers to intervene in the sovereignty of national fiscal policies. No comprehensive change in the European treaties is currently envisaged that would democratically empower a central entity to exert some control over national budgetary policies. This means there is a danger that the euro-area countries' propensity to incur debt may increase even further, and the pressure on the euro area's single monetary policy to adopt an accommodating stance may grow. Unless and until a fundamental change of regime occurs involving an extensive surrender of national fiscal sovereignty, it is imperative that the no bail-out rule that is still enshrined in the treaties and the associated disciplining function of the capital markets be strengthened, and not fatally weakened.