

Overview

German economy suffers temporary sluggishness

Global economy

The world economy performed robustly last year despite having to contend with numerous shocks. In the fourth quarter, however, the global upturn started to falter. The main reason was a widespread weakening of economic momentum, not least in the emerging market economies where monetary policy was tightened perceptibly during 2011 in response to clear signs of economic overheating. In the euro area, the worsening sovereign debt crisis has had a severe knock-on effect on overall economic developments in the countries concerned. The dampening influences have meanwhile also spilled over to other euro-area countries via the trade and confidence channels. The extent of the negative impact on other countries differs, however. Thus the US economy, in particular, is likely to have remained relatively unscathed.

The short-term economic outlook for the global economy has brightened of late. This more positive environment should remain in place provided that the sovereign debt crisis in Europe and the situation on the oil markets do not deteriorate noticeably in the near future. Business and household surveys have recently mostly barely fallen or have actually risen. Moreover, the marked rebound in share prices suggests increasing economic optimism. This is underpinned by the ongoing strongly expansionary monetary policy bias in several industrial countries and the actual or prospective easing of the monetary stance in the emerging market economies. Overall, some of the current forecasts by international organisations look overly pessimistic.

Financial markets

Diverging and volatile economic expectations are also determining events on the financial markets. Of late, however, market participants' risk aversion has waned somewhat as the eco-

nomical prospects have improved. This was attributable *inter alia* to the resolutions agreed at the summit meetings of the EU heads of state or government and the consolidation and reform measures announced by the new Italian and Spanish governments. Investors were undeterred by the fact that the rating agencies, for the first time, downgraded previously top-notch sovereigns such as Austria and France. Confidence on the financial markets was additionally buoyed by the monetary policy decisions taken by the ECB Governing Council and the US Federal Reserve's announcement that it would keep its benchmark federal funds rate low until 2014. On balance there have been considerable stock market gains, particularly since the turn of the year, while yields on Bunds and US Treasuries have been squeezed by safe haven flows on the one hand and changing assessments of the economic outlook on the other into a fairly narrow band.

The gloomier macroeconomic outlook and its consequences for inflation prospects prompted the ECB Governing Council to reverse the interest rate hikes agreed in April and July by cutting rates twice in the fourth quarter of 2011. Moreover, the reserve ratio was reduced from 2% to 1% with effect from 18 January 2012.

Monetary policy

In addition, growing tensions on the financial markets and the difficulties encountered by banks in some member states in wholesale market funding led the ECB Governing Council to introduce further non-standard monetary policy measures. Ultimately, these are intended to shield the banking sector's lending to households and non-financial corporations from a potentially excessive fall-out from the financial market tensions. At the beginning of October, the Governing Council therefore decided to launch a second covered bond purchase programme (CBPP2) to help resolve banks' longer-term funding problems. The Governing Council also decided to offer two additional longer-

term refinancing operations (LTROs) with maturities of 12 and 13 months respectively. In December, central bank liquidity was, for the first time ever, provided in two LTROs with a three-year maturity. These operations will be conducted as fixed-rate tenders with full allotment. The interest rate will be indexed to the main refinancing rate, and these operations will – like regular main refinancing operations – require sufficient collateral from the counterparties. The first three-year operation was carried out on 21 December 2011. The record sum of €489.2 billion was allotted.

In addition, a number of measures to extend the collateral framework were agreed at the beginning of December. These can, on application, be applied by individual central banks and are not subject to risk-sharing. The Bundesbank sees no need for such measures to provide liquidity in Germany. The German banking system is currently very generously supplied with liquidity as a result of the inflow of funds from other euro-area countries. This is evident, not least, in the strong use of the deposit facility by German credit institutions. The considerable inflows of funds in recent months are a sign of the ongoing disruptions on the interbank market. This lack of confidence and the inflows to Germany are reflected in the sharp increase in the Bundesbank's claims under the TARGET2 payment system.

The strong uptake of the first three-year operation sent excess liquidity in the banking system to a new record high averaged over the maintenance period from mid-December 2011 to mid-January 2012. By contrast, M3 growth decelerated sharply in the last quarter of 2011. The perceptible outflows from many subcomponents of M3 were, in many instances, counter-movements to the large uncertainty-related inflows seen over the summer months. However, monetary developments were also muted by a weak trend in lending to the domestic private sector. At the end of December, the associated annualised and seasonally adjusted three-month rate reached its lowest figure

since the third quarter of 2009, with loans to non-financial corporations in particular reduced.

Germany's economic upturn started to falter in the fourth quarter of 2011. According to the flash estimate released by the Federal Statistical Office, real gross domestic product (GDP) in the fourth quarter was 0.2% down on the quarter after seasonal and calendar adjustment. The economic dip, which had been on the horizon for some months, was triggered by the slowdown in global economic growth combined with strains on the euro area's real economy.

Numerous enterprises have in recent months registered a drop in demand, especially from abroad, and have adapted their short-term plans accordingly. For example, they have scaled back purchases of intermediate goods and probably also postponed non-urgent investments in various instances. However, enterprises are unlikely to have reappraised their medium to long-term strategic plans on the whole, as the problems are widely regarded as being temporary in nature.

The slowdown in the global economy clearly dented German enterprises' exports in the fourth quarter of 2011. Over the reporting period, deliveries of goods to foreign business partners declined in seasonally adjusted terms for the first time since the onset of the recovery in mid-2009. Dampening effects emanated from the euro area, in particular. Import momentum dissipated completely in the fourth quarter of 2011 as production and demand growth slowed.

In line with the weakened import dynamics, private consumption in the fourth quarter of 2011 is also unlikely to have matched the quicker pace seen in the third quarter. However, retailers probably benefited from households' increased propensity to consume in the run-up to Christmas. According to the ifo business survey, they rated their business situation in December as being much better than either

*German
economy*

in the preceding months or in the following January.

The positive sentiment among households is proving a key catalyst for housing construction. Wage growth and the perceived low risk of redundancy, in combination with the still very favourable financing conditions, are making buying property more attractive. The improved income prospects are also buoying the buy-to-let market, which buyers currently appear primarily to see as a form of investment that is likely to maintain its value.

The cyclical upswing in investment in machinery and equipment, by contrast, seems to have been interrupted around year-end 2011. One reason for this is that industrial enterprises are waiting until they have greater clarity on their business prospects again before expanding their plant.

Germany's labour market remains on course for growth despite the temporary economic slowdown. Employment continued to accelerate appreciably in the last quarter of 2011. Jobs subject to social security contributions again slightly outpaced overall employment. Employment growth was accompanied by increased immigration from the eight central and east European EU member states, to which complete free movement of workers has applied since May 2011. The effects of lifting the restrictions on workers from these countries does not, however, alone explain the higher immigration. Greece, Italy, Spain and Portugal accounted for roughly 10% of net immigration. A year earlier, migration to and from these countries was more or less balanced.

The overall propitious economic situation last year was clearly reflected in earnings. In 2011, gross wages and salaries per employee rose at a pace last seen in 1993. One reason for this was the negotiation of collective wage agreements with higher scheduled increases in pay rates. Another was that employers made, in some cases considerable, special and bonus

payments on a voluntary basis. For the current year, a shift towards higher negotiated wage increases coupled with smaller wage drift looks likely.

Consumer price inflation was marked by the sharp rise in energy prices in the final quarter of 2011, although the inflation rate excluding energy also showed a slight acceleration. However, assuming slower energy-price inflation, year-on-year inflation should tend to moderate from its present level over the next few months.

The outlook for the German economy improved perceptibly towards the end of the reporting period, though risks relating to the sovereign debt crisis remain. In the first quarter of 2012, external factors will continue to weigh on production. From the second quarter onwards, cyclical stimuli could gain the upper hand, however. The assumption underlying the Bundesbank's economic forecast in December of a fairly rapid resumption of growth looks more likely to materialise at the present juncture. Vigorous construction demand will provide the economy with a strong stimulus for the foreseeable future. This also applies to the winter months – unless weather conditions mean that production has to be interrupted for prolonged periods. But in this case there would probably be considerable catching-up effects in the spring. Private consumption is likely to continue to bolster economic activity. This is being driven by the persistent positive sentiment among consumers. They appear to see only limited income risks at present. As a result, saving is not a primary motive at the moment. Monetary policy will continue to exert a very expansionary influence, and ample liquidity will ensure very low interest rates.

Germany's public finances improved last year. The deficit ratio fell from 4.3% to 1.0%. This was mainly due to the phasing-out of financial market support measures, favourable cyclical effects and additional budget relief from higher tax revenues and reduced labour market-related spending.

Public finances

In the current year, by contrast, the deficit ratio looks set to remain virtually unchanged as things currently stand. Assuming a limited economic slowdown and barring any major additional impact from the financial and sovereign debt crisis, there should be a slight structural improvement. Germany's fiscal consolidation aims therefore appear very unambitious, and the calls – which have also been made at an international level – for Germany to relax its consolidation course have no basis in substance.

Both central government and numerous state governments are still falling well short of the medium-term objective of a structurally close-to-balance budget. At the general government level this is, however, masked by high surpluses run up by the social security funds. It is also becoming apparent that the debt ratio will remain well above the reference value of 60% for many years to come, even assuming that the sovereign debt crisis does not escalate further. Against this backdrop, further consolidation should not be delayed, and a structurally balanced budget, which is now enshrined in the German constitution through the debt brake for central and state governments, should be brought about rapidly. Nor does the economic outlook justify any relaxation of consolidation efforts, besides which the automatic stabilisers would take effect should the economy weaken significantly (which does not currently appear probable). Strict implementation of the national budgetary rules is also important in order to avoid undermining the credibility of the planned European fiscal compact.

At the European level, the heads of state or government of the euro-area countries agreed at the beginning of December 2011 to “move towards a stronger economic union”, and announced the above-mentioned fiscal compact. A key component of the compact is that general government budgets shall be at least close to balance in structural terms. Although the Stability and Growth Pact includes very similar requirements, the fiscal compact is to hardcode

them into national legislation (preferably into the constitution). Moreover, it envisages an automatic correction mechanism that is triggered if targets are missed by a wide margin, for which the Commission will subsequently propose uniform principles. The Commission will also verify the transposition of the budgetary rules into national legislation. Another important element is a stronger automatic sanction mechanism, in which Council members with voting rights undertake to follow the Commission's recommendation if they fail to meet the deficit criterion unless a qualified majority opposes (what is known as a reverse qualified majority).

The objectives of the fiscal compact are welcome. If placing them on a firmer legislative footing means that it is possible to make compliance with a structurally at least close-to-balance budget the norm, this would be an important contribution to ensuring the sustainability of public finances, and could create confidence. The compact's success hinges crucially, however, on both its details, which have still to be spelled out, and its stringent implementation going forward. Yet aside from its potential to reinforce fiscal rules across the euro area, the fiscal compact in no way introduces a fiscal union. Outside the Stability and Growth Pact, the European authorities are to be given no supranational right to intervene in national fiscal policy. This would not be the case even if the agreed national rules were not properly applied in practice. The fiscal compact does not, consequently, justify any extensive joint liability (eg Eurobonds). Otherwise, there would be an even greater mismatch between liability and control than is currently already the case, and the framework of monetary union would become increasingly inconsistent.

In order to overcome the crisis, agreement was reached to set up a permanent mechanism, the European Stability Mechanism, or ESM, which is scheduled to come into force in mid-2012 and is to replace the European Financial Stability Facility (EFSF) in the medium term. It might

help to limit risks to financial stability in the euro area. However, it will weaken the basic no-bail-out principle that applies within the euro area and lessen incentives for sound public finances. Hence it is imperative that any as-

sistance is tied to strict conditionality and granted only at appreciable interest rate premiums. Under the ESM Treaty, it appears, however, that no interest rate premiums are to be charged as a general rule.