

## Overview

### Marked loss in Germany's economic momentum

*World economy so far treading water; only slight improvement expected in the last quarter of 2012 and first quarter of 2013*

The global economy remained weak in the third quarter of 2012. Although the focal point of this weakness is the crisis in the euro area, macroeconomic growth also continued at its subdued rate over the summer months in the major emerging economies, including China. The sluggish growth in this group of countries compared with earlier expansion rates can be attributed only in part to the crisis in the euro area, and relates to a considerable extent to internal factors. The Japanese economy even contracted sharply in the third quarter. In this highly unfavourable environment, the United States once again proved a bulwark to the world economy, with continuing moderate growth in gross domestic product (GDP). The UK economy has come out of recession, even though its latest increase in growth is largely the result of one-off effects. For the last quarter of 2012 and the first quarter of 2013 only slight improvement in the global economy is expected. Growth is likely to be bolstered mainly by significantly looser monetary policy, which the emerging economies have now also adopted. However, a cyclical upturn in the world economy is dependent on the swift achievement of clarity in the United States with regard to the country's future path of consolidation.

*Financial markets*

Since the middle of the year, the international financial markets have been torn between concerns about the economy and the sovereign debt crisis, on the one hand, and the announcement of further monetary policy measures, on the other. On the bond markets yields on government bonds largely fell overall. This is likely to be attributable mainly to the expectation of continuing low central bank interest rates and to the willingness of several central banks to purchase bonds. The Federal Reserve, with its quantitative easing programme (QE3),

and the Bank of Japan, with a further expansion of its bond purchase programme, seek to provide expansionary monetary policy impetus – in the USA through portfolio adjustment effects via purchases of mortgage-backed securities, and in Japan through the acquisition of government and corporate bonds. The Eurosystem bond purchase programme (OMTs) has not yet been activated, but has already elicited expectation effects from the markets. Market participants became less concerned about the sustainability of government finances in some countries and about the nexus between sovereign and bank risks, although urgent problems, such as the “fiscal cliff” in the United States and Greece's acute financial distress, are still to be resolved. Trading on the international equity markets was mixed from the middle of the year, under the influence of unfavourable corporate reports and gloomy prospects for economic growth – despite monetary policy impetus. While share prices in Japan and the United States declined somewhat, there were rising prices on European equity markets. Despite some fluctuation, the euro's effective exchange rate hardly changed in the period under review from its level at the end of June. In this financial market environment, the balances within the European large-value payment system TARGET2 stabilised in recent months, after expanding significantly in the first half of 2012. The Bundesbank's TARGET2 balance hovered around a value of about €740 billion from mid-year; at the end of October 2012 it totalled €719 billion. However, the overall stabilisation observed was accompanied by, at times, considerable fluctuations.

Following the interest rate cut at the beginning of July, the ECB Governing Council left key interest rates at the historically low level reached in July. Although, at the current end, HICP inflation remains significantly above 2%, the ECB Governing Council expects inflation to return to a level compatible with stability over

*Monetary policy*

the policy-relevant horizon. This was also indicated by underlying monetary growth, which remains subdued, and by continued weak lending to the domestic private sector in the euro area. The latter has resulted in particular from the ongoing reduction in lending to non-financial corporations in the countries especially affected by the sovereign debt crisis, caused both by the weakness of their economies and by the major structural adjustment processes taking place. Before the crisis, these countries had seen particularly strong credit growth.

After ECB President Mario Draghi announced a new bond purchase programme following the ECB Governing Council meeting on 2 August 2012, the ECB Governing Council decided in principle at its meeting on 6 September on the implementation of such a programme (outright monetary transactions, or OMTs). According to the Governing Council's decision, the new programme will serve to ensure an orderly transmission of monetary policy to the real economy as well as the singleness of monetary policy in the Eurosystem. The Bundesbank still remains critical of Eurosystem government bond purchases and the stability risks these may entail, in particular if they are used to resolve government financial difficulties through monetary policy. Against this backdrop, it is essential to maintain a strict separation of fiscal and monetary policy and to avoid the impression of monetary policy being co-opted by fiscal policy interests. It is clearly the responsibility of fiscal policymakers to decide on further help for Greece, as well as to provide the financing and assume the risks involved. This is not the responsibility of monetary policy.

Economic growth in Germany weakened further in the summer. The Federal Statistical Office's flash estimate recorded quarter-on-quarter real gross domestic product (GDP) growth of 0.2% in the third quarter of 2012 (after seasonal and calendar adjustment), compared with 0.3% in the second quarter and 0.5% in the first quarter. In the period under

review, the German economy made only isolated show of the strength which characterised the robust recovery phase of 2010 and 2011. These bright spots of expansion have so far enabled overall economic output to remain within the range of normal capacity utilisation.

All in all, foreign trade in the second half has continued to follow the pattern prevailing in the first half of 2012, with export growth largely driven by non-euro-area countries, whilst in the case of imports, which are expanding somewhat moderately overall, those from euro-area countries grew comparatively sharply. However, the growth in exports in the quarter under review was generated not by broad-based expansion across categories of goods, but by the extraordinary export success enjoyed by German car manufacturers in the summer months. In this context, there has been a further considerable increase in the overall German trade surplus. The reduction in the trade surplus with euro-area partner countries came to a halt, despite higher imports, because German firms sold significantly more goods in the euro area in July and August after a lean period of nine months.

Capital investment by enterprises is likely to have remained weak over the summer. Among broad segments of the business sector, there is a lack of confidence about new macroeconomic stimulus appearing in the short term. Thus, after a recovery phase in which capital investment began in impressive fashion in 2010 and continued at a slower pace in 2011, it has now not only become stuck half way, but has actually suffered a considerable setback of late. The current hesitancy amongst enterprises makes clear that there is no reason to expect an expansionary impetus from favourable financing terms if the investment climate is impaired by confidence effects resulting from a dimming in fragile expectations and from a continued high level of uncertainty. By contrast, highly favourable interest rate conditions and an uncertain financial market climate are giving a clear boost to residential construction.

The continued robust demand for residential property for both owner occupation and investment purposes is not only driving up residential property prices but also lending further momentum to the construction sector. Public-sector construction, on the other hand, is experiencing weak growth, now that the effects of the stimulus programmes launched following the crisis have dissipated.

Private consumption rose in the summer of 2012 in seasonally-adjusted terms. Supporting factors continued to include a healthy labour market situation and substantial wage growth. Even though somewhat sharper price increases curtailed households' real spending power *per se*, consumer purchasing remained high. Consumers' propensity to save declined, not least because of very low interest on deposits.

#### *Lending in Germany*

Lending by German banks to domestic non-banks maintained the trend it has been following since the beginning of the year, and gained noticeable further momentum in the quarter under review. Support for this positive trend came mainly from ongoing expansion in (unsecuritised) lending to households and non-financial corporations. Given the weakness in capital investment, the explanation for increased borrowing is likely to lie in a further improvement in financing terms, which may have prompted enterprises to substitute bank loans for other sources of financing or to increase their acquisition of financial assets.

It remains to be seen to what extent consumer sentiment will be affected by possible changes to the labour market outlook, where the gloomy economic picture is now having a visible impact. Over the course of the summer, the expansion in employment came to a standstill, and seasonally adjusted unemployment recorded a marked increase. This is being driven by cyclical effects. These developments currently outweigh the fact that spare capacity on the domestic labour market remains markedly high. It may also be noted that the substantial percentage increases in wages in this year's

wage-bargaining round are now being reflected noticeably in the overall level of wages in the economy.

In the third quarter, price increases in upstream branches of economic activity tended to be modest. However, short-term volatility was considerable, driven by oil prices and exchange rates. Global economic weakness has so far made itself felt in the reduction in intermediate input prices from foreign and domestic production. End-product prices, on the other hand, continued to rise, with those for consumer goods outstripping those for capital goods, whether produced domestically or imported. The acceleration of consumer price inflation was attributable to the energy component. Both the depreciating euro and climbing crude oil prices played their part in this.

Ever more areas of business are losing hope that the economy will brighten in the near future. Uncertainty as to the extent to which foreign demand will decline in view of slowing global growth and severe adjustment crises in parts of the euro area has so far primarily hampered the export-based industries. However, it is now obvious that the economy at large may also suffer. According to an economic survey produced by the Association of German Chambers of Industry and Commerce (DIHK), the business and export expectations of enterprises have dropped steeply. This provides confirmation of trends which have been discernible for some time from Ifo Institute surveys. Currently, only residential construction and consumer spending have been able to counteract the marked dampening effect.

Public finances in Germany have presented a mixed picture in the current year. On the one hand, the deficit ratio will fall further, and it may be possible to balance the general government budget. On the other hand, a further appreciable increase in the debt ratio can be expected owing to the assistance provided to stem the debt crisis in the euro area and in connection with the liquidation of WestLB. The

#### *Public finances*

slowdown in the economy will not yet affect public finances in the current year. In fact, the favourable average annual labour market figures and the stable rise in incomes will contribute to a large surplus in social security funds. The improvement in the budget will be based above all on strong growth in profit-related taxes, reduced charges because of low interest rates and a moderate general expenditure trend.

In 2013, however, the general government deficit is likely to rise as a result of the economic slowdown currently expected. In addition, various opposing trends are likely to more or less balance each other out. On the one hand, the pension contribution rate will be lowered significantly. In addition, a degree of fiscal policy loosening will continue to be provided by budgetary burdens which are not counterfinanced. On the other hand, the continuation of subdued growth in social welfare and interest expenditure is likely to relieve the budget. The debt ratio could fall. Overall, however, there are considerable risks with regard to the macroeconomic trend and the European debt crisis.

The government deficit in Germany has recently been very much a positive surprise, and is low by international standards. However, despite favourable underlying conditions, the structural general government budget deficit is unlikely to have been closed fully. Furthermore, the high temporary surpluses in social security funds, amongst other things, conceal the, at times, considerable deficits being run by central government as well as many state and local governments. In its budget and financial planning, central government is again making *ad hoc* use of the social security budgets, and budgetary burdens are being approved, the scope of which will not be fully visible until some time in the future.

Particularly in view of the high debt ratio and foreseeable adjustment burdens resulting from demographic trends, government finances should be consolidated swiftly and comprehensively. There is a danger that the favourable underlying conditions which have prevailed hitherto have not been, and will not be, utilised sufficiently to this end. The positive surprises in terms of tax receipts and interest expenditure have been used in part to water down the moderate consolidation course originally announced, which has prevented swifter reduction of central and state government deficits.

Because of the troubled economic situation in the euro area, there are demands in some quarters for Germany to pursue a more expansionary fiscal policy. However, in the context of current forecasts, this does not appear justified, particularly as macroeconomic fluctuations are quickly cushioned by the automatic stabilisers. Nor can it be assumed that a more expansionary German fiscal policy would provide a distinct direct economic boost to the European countries particularly affected by the debt crisis. Consolidation of budgets should have priority for all levels of government, so that Germany can continue to be an anchor of stability in the European debt crisis.

The permanent deficit limits set by the national debt brakes for central and state government should be complied with swiftly. Within the context of the new, stricter constitutional rules, it would also be advisable as a general principle to stipulate clear and binding safety margins below the borrowing limits, thereby taking account of the high degree of uncertainty in estimating the structural deficit situation. Given the experience gained during the present debt crisis, it would be very advantageous if, through more ambitious policies, the debt ratio could be successfully brought down more rapidly from its currently very high level.