Overview

German economy robust in difficult European setting

Global economy

The global economy accelerated somewhat at the beginning of 2012 although the strong rise in oil prices acted as a brake. Overall, global industrial output picked up appreciably in the first two months of the year as compared with the last quarter of 2011, when it had risen only slightly. Global trade, which had stagnated in the final quarter of 2011, likewise grew at a brisk rate. Macroeconomic momentum was higher in the emerging market economies than in the advanced economies, so that the decoupling of trend growth between the emerging market economies and the industrial countries that has been in evidence since the mid-1990s continued. Whereas the US economy remained on a sound expansion path, the euro-area economy continued to stagnate. While the negative confidence effects emanating from the nervous financial markets on account of the sovereign debt crisis, which persisted at the end of 2011, have since diminished somewhat, renewed uncertainty has arisen in recent weeks.

The global economy could pick up speed as the year progresses. This is suggested by easing pressure from the oil markets. Moreover, monetary policy in the industrial countries still has an exceptionally expansionary stance, and several emerging market economies have now also loosened their policy stance perceptibly. Nonetheless, the global economic revival remains fragile and is exposed to non-negligible downside risks. For instance, an intensification of the Iran conflict could drive up oil prices dramatically and thereby undermine the as yet muted expansionary forces. In addition, uncertainty on the financial markets remains high, particularly with regard to developments in Greece. However, there are also opportunities. For example, the pace of economic activity in the emerging markets and in the United States could well exceed widely held expectations.

Financial markets

Given the resumption in global economic growth and the exceptionally expansionary monetary policy stance worldwide, the situation on the financial markets eased on balance in the first few months of this year. As the “flight” into safe-haven investments let up, stock market prices picked up appreciably and intra-euro-area yield differentials narrowed perceptibly. European credit institutions were among the main beneficiaries as their funding conditions improved sharply at times, probably in part thanks to the crisis resolution decisions at the European level and the Eurosystem’s three-year refinancing operations. However, from April the situation deteriorated noticeably again. Alongside less favourable economic indicators in some countries, this was prompted chiefly by concerns about the future of Greece and developments in Spain.

Monetary policy

Inflation forecasts for 2012 were revised sharply upwards as this report went to press, mainly to take account of the resurgence in crude oil prices. However, the Governing Council of the ECB believes that inflation will return to a level compatible with price stability over the policy-relevant horizon. Moreover, inflation expectations are firmly anchored. This view is also borne out by the still muted underlying pace of monetary expansion and the trend in credit growth. Against this backdrop, the Governing Council of the ECB left its policy rates unchanged.

The key requirement going forward is that the macroeconomic adjustment processes in the euro-area countries are compatible with price stability for the euro area as a whole and leave long-term inflation expectations broadly anchored. As in the preceding years, individual countries will report above-average or below-average rates of price increase. While countries requiring extensive structural reforms and those that have experienced excessive wage and price increases in the past will post below-average inflation owing to the necessary corrections, countries with low unemployment and favourable economic prospects – probably including Germany – will likely report marginally higher-than-average rates of price increase at times. After the impact of raising indirect taxes is factored out, inflation is already well below average in the programme countries Greece and Portugal.

In terms of monetary policy, the reporting period was characterised by the implementation of the non-standard measures that the ECB Governing Council agreed on in December 2011. In particular, the additional funding provided by the Eurosystem through its three-year longer-term refinancing operations and the implementation of the measures adopted by the ECB Governing Council in the fourth quarter of 2011 contributed to a more relaxed financing situation for banks in the euro area overall. However, the worsening state of the financial markets that has been in evidence since April again clearly demonstrates that the Eurosystem's measures could well turn out to be ineffective if confidence in sustainable developments in individual countries, which monetary policymakers are unable to guarantee, deteriorates. The non-standard monetary policy measures themselves are also associated with risks and problems, especially if they extend beyond bridging short-term liquidity problems. For instance, they potentially distort competition in the banking sector, and there is a danger that necessary structural reforms and adjustments both in fiscal policy and in the financial sector may be delayed or even prevented. The growing interconnectedness between the national banking system and public finances in several countries (not least in connection with banks' increasing purchases of government bonds) runs counter to the fundamental goal of reducing systemic risks. It will be crucial to contain risks arising from monetary policy operations and phase out the non-standard measures in the future. Monetary policy and fiscal policy must remain segregated.

Current developments in Greece

Current developments in Greece are extremely worrying. Greece is threatening not to implement the reform and consolidation measures that were agreed in return for the large-scale aid programmes. This jeopardises the continued provision of assistance. Greece would have to bear the consequences of such a scenario. The challenges this would create for the euro area and Germany would be considerable, but manageable given prudent crisis management. By contrast, a significant dilution of existing agreements would damage confidence in all euro-area agreements and treaties and strongly weaken incentives for national reform and consolidation measures. In such circumstances the institutional *status quo* comprising liability, control and individual responsibility of member states would be fundamentally called into question.

When the Eurosystem provided Greece with large amounts of liquidity, it trusted that the programmes would be implemented and thereby ultimately assumed considerable risks. In the light of the current situation, it should not significantly increase these risks. Instead, the parliaments and governments of the member states should decide on the manner in which any further financial assistance is provided and therefore whether the associated risks should be assumed.

Germany

The German economy managed to pull out of the lull in which it found itself at the end of last year and return to positive growth rates. Following a slight drop in economic output in the fourth quarter of 2011, seasonally and calendar-adjusted real gross domestic product (GDP) rose by 0.5% on the preceding three months in the first quarter of 2012, according to the flash estimate produced by the Federal Statistical Office. The fact that expansionary forces retained the upper hand, despite the difficult situation in several euro-area partner countries, attests to the robust state of the German economy. Although the temporary slowdown in the pace of economic growth noticeably dented enterprises' investment, construction demand remained essentially strong. Moreover, private consumption probably picked up again after the turn of the year. The expansionary monetary policy stance will likewise have an increasing effect. Nonetheless, the surprisingly strong GDP outturn probably overstates the prevailing underlying cyclical trend and cannot simply be projected forward over the coming quarters.

Exports rose over the reporting period in seasonally adjusted terms, after failing to record quarter-on-quarter growth at the end of 2011 for the first time since the current upturn began. The increase in goods exports in the first two months of 2012 was attributable in equal measure to euro-area and non-euro-area countries. However, demand from Germany's euro-area partner countries is currently relatively weak. Seasonally adjusted imports in the first three months of this year may have remained at their prior-quarter level in real terms, with the German economy's import demand vis-à-vis the euro-area partner countries holding up slightly better overall than vis-à-vis non-euro-area countries. The comparatively robust German economy is therefore having somewhat of a stabilising influence on the other euro-area countries. The share of the current account surplus that is attributable to the euro-area partner countries has tended to decline continuously since 2009.

Production can be expanded in the near future without a pressing need for investment in extra capacity. Unlike the less dynamic outlook for investment in machinery and equipment, the prospects for construction investment remain exceptionally buoyant. This is attributable not only to temporary weather-related catching-up effects, but also to overall robust domestic demand, which is increasingly supporting the German economy.

Private consumption appears to have risen slightly in the early part of this year after declining in the fourth quarter of 2011. Surveys show that retail business improved dramatically during the initial part of 2012. Moreover, economic optimism among consumers has picked up again following the pronounced uncertainty at the middle of last year. Income expectations, too, have remained largely stable.

The favourable setting for private consumption is also being buoyed not least by the ongoing robust labour market situation. The positive labour market development continued in Germany during the winter. In the first quarter of 2012, the number of persons in work in Germany again rose markedly on the quarter. The increase, in turn, probably relates largely to additional regular jobs subject to social security contributions. The reduction in unemployment has, for some time, lagged the increase in employment in terms of numbers. This suggests that the additional demand for labour is being decreasingly covered from the reserve pool of unemployed. First, vacancies are increasingly being filled by persons in the latent labour force, which pushes up labour force participation. Second, there is growing immigration from abroad. The outlook for the labour market remains positive, although the available leading indicators suggest that growth will slow in the immediate future.

Given this labour market situation, considerable wage increases look likely in this year's pay round. This is indicated not only by the trade unions' high wage demands but also by the wage agreements that have been reached to date.

Current price developments are being decisively influenced by external factors. For instance, the distinctly stronger inflationary pressure across all stages of the economy at the beginning of 2012 can largely be attributed to the sharp rise in crude oil prices and the noticeable revival in the global economy, while the marked weakening of the euro since last summer also played a role. Consumer prices even rose slightly more sharply in the first quarter of 2012 than in the fourth quarter of 2011. Sharply higher crude oil prices significantly drove up prices for petroleum products especially, while gas and electricity rates were also raised.

The economic upturn could essentially remain in place in Germany during the second quarter. Industry will, however, probably only make a comparatively small contribution to this, as the stimuli from non-euro-area countries have, to date, been insufficient to lift production levels above normal utilisation given the further waning demand from the euro area. This also limits the degree to which investment could act as a rapid catalyst of economic expansion. By contrast, construction is likely to make a significant contribution to growth, and consumption, too, could pick up further. The exceptionally strong dynamics in the construction sector are, moreover, having a knock-on effect on other areas of the economy.

Public finances

After falling significantly to 1% in 2011, the general government deficit ratio in Germany looks set to record just a limited decline this year. The cyclical situation is unlikely to have a perceptible impact, as the macroeconomic aggregates that are particularly relevant to government revenue and expenditure are proving relatively stable. There are likely to be structural improvements, in particular as a result of ongoing muted growth in pension payments and a continued drop in structural unemployment and in interest spending as a result of favourable funding conditions. The debt ratio, by contrast, could start to rise again, having fallen perceptibly to 81.2% by end-2011. Government debt is on the rise as a result of aid for euro-area states and the debt-financing of the capital transferred to the European Stability Mechanism (ESM). In addition, support for German financial institutions could be associated with a renewed transfer of liabilities and assets to the government sector.

In April, the German government presented its updated stability programme. The fact that it met the reference figure for the deficit ratio in 2011, ie two years before the deadline set in the excessive deficit procedure, is welcome, but also appropriate given the favourable economic conditions. The Stability and Growth Pact additionally obligates general government to achieve and maintain a structurally close-to-balance budget or a surplus. According to the German government's budget plans, it is likely to meet the medium-term budget target it has set itself of a structural deficit ratio of at most 0.5% of GDP, although this is largely due to the temporary high surpluses run up by the social security funds. However, the objective of 0.5% of GDP is not ambitious given the foreseeable demographic trends and the high government debt ratio.

The recently introduced national fiscal framework enshrined the goal of achieving a (structurally close-to) balanced budget in the constitution as the strict borrowing limit for both central government and the state governments. Deviations are normally allowed during the current year at most. The resulting debt is additionally limited and must, where necessary, be reduced in line with a rule-bound path. The familiar estimation uncertainties associated with budget forecasting mean that it is recommendable for central and state government to plan to achieve a budget surplus as a general rule so as to avoid having to make adjustments at short notice and with a procyclical impact. It is crucial, not least given the demographic challenges ahead and the considerable risks relating to the sovereign debt crisis, to rapidly reduce the debt ratio, which is very high and has grown almost incessantly. Against this backdrop, the German government's plans to meet the stipulations of the debt brake, which apply from 2016, from as early as 2014 are to be welcomed. It is problematic, however, that the original consolidation agreements were diluted, and the currently favourable environment will therefore not be fully used to reduce the central, state and local government deficits faster.

In the light of all this, calls on German fiscal policymakers to loosen their fiscal policy stance in order to stimulate the economy appear inappropriate. A cyclical recovery is being forecast for Germany in general, and the automatic stabilisers would be better suited to cushion an unexpected economic slowdown. Moreover, the impact of a German stimulus programme on demand in the European peripheral states would be very limited. Sound public finances and rigorous compliance with budgetary rules in Germany are, not least, a key stability anchor in the European sovereign debt crisis. Stability-oriented budgetary rules and confidence in their compliance are imperative, particularly for the extensive and extended consolidation processes needed in several euro-area states. Attempting to kick-start the economy in the short term and putting off consolidation efforts to the long term are not conducive to regaining lost confidence. The key need, rather, is to rigorously implement growth-oriented structural reforms in Germany and the other euro-area states without jeopardising budgetary objectives.