The current economic situation in Germany

Overview

German economy sees growth dip in fourth quarter of 2012

Global economy

Global economic growth remained subdued in the fourth quarter of 2012. In regional terms, the group of emerging market economies appear to have stepped up the pace of their economic activity to a marked degree, while the already weak growth in the industrial countries gave way to a significant decline in output. The worsening contraction in the euro area played a part in this. At the same time, real gross domestic product (GDP) in the United Kingdom in the last three months of 2012 fell short of the noticeably higher level posted in the prior quarter. Overall economic output in Japan shrank again, though only slightly. In the United States, temporary negative influences on certain expenditure components caused fourth-quarter real GDP to hover at the level seen in the previous quarter, in which it had expanded at quite a strong pace. However, private domestic final demand grew at a faster rate, thereby underpinning expectations that overall economic growth in the United States will return to positive territory in the first quarter of 2013.

All in all, there have been increasing signs in recent months that the global economy is gradually picking up momentum. The signs of an upswing are particularly clear in the manufacturing sector of the Asian emerging market economies, but leading indicators in the industrial countries indicate that things are gradually improving there as well. The global Purchasing Managers' Index (PMI) for manufacturing climbed back above the expansion threshold in December for the first time since May 2012 and continued to gain ground in January, while the index for the services sector indicates that growth in this segment is still sound. Moreover, the upbeat trend on the equity markets suggests that confidence is on the increase.

Financial markets

Market participants in the international financial markets had a perceptibly stronger appetite for risk in the autumn and winter months of 2012-13, their sentiment being buoyed chiefly by the slightly brighter economic outlook for the current year and by the crisis management measures taken by the central banks in the major currency areas. In the euro area, the potentially unlimited bond purchase programme referred to as Outright Monetary Transactions (OMT), which has not yet been activated, boosted financial market prices. The Ecofin agreement to establish the Single Supervisory Mechanism (SSM) for banks at the European Central Bank, and the conclusion of a debt buy-back operation which cleared the way for further financial assistance for Greece also bolstered the markets. Investors likewise breathed a sigh of relief when policymakers in the United States reached a partial agreement in their budget dispute. Meanwhile, negative factors such as the political difficulties that some euro-area countries are experiencing in implementing the necessary reform and consolidation measures receded somewhat in importance. The increased optimism among financial market participants primarily benefited risky assets, with sovereign bonds of peripheral countries and equities alike posting notable gains. On the forex markets, the euro appreciated sharply during the period under review, particularly so against the yen. However, the current relaxation in the financial markets should not conceal the fact that substantial structural adjustments are still needed in many countries.

Monetary policy

In the quarter under review, the ECB Governing Council left its key interest rates unchanged at the historically low level reached in July 2012. The downward revisions to the growth forecasts for the euro area in autumn had virtually no impact on the medium-term inflation outlook. The ECB Governing Council continues to believe that inflation will fall below the 2% mark in the next few months and will stay at a

level compatible with price stability over the policy-relevant horizon. This view is also supported by the fact that underlying monetary growth remains subdued and that lending to the domestic private sector in the euro area is still weak, both due in particular to the ongoing reduction in lending to non-financial corporations in the countries especially affected by the sovereign debt crisis, which played out against a backdrop of a weak economic environment and the major structural adjustment processes associated with these countries' efforts to tackle their persistently very high debt levels.

Following the slight decline in the monetary policy funding volume provided by the Eurosystem in the fourth quarter of 2012, banks were given the first opportunity at the end of January 2013 to prematurely repay liquidity which the Eurosystem had provided in the first three-year refinancing operation settled in December 2011. A volume of around €137 billion was returned on the first repayment date. Since banks did not switch instead to shorter-term refinancing operations, the early repayment distinctly reduced both the monetary policy funding volume and the excess liquidity. The broadly based increase particularly shown by longer-term money market rates in January should be seen in conjunction with expectations among market participants that excess liquidity will continue to recede on account of further early repayments of liquidity provided in the three-year refinancing operations.

At its latest meeting, the ECB Governing Council took note of the remarks by the Governor of the Central Bank of Ireland regarding the treatment of the state-owned Irish Bank Resolution Corporation (IBRC), which the Irish government had liquidated shortly beforehand. The Irish central bank had granted emergency liquidity assistance to IBRC and, following its liquidation, assumed full ownership of the relevant collateral. Among other things, the Irish government and central bank subsequently agreed that the Irish government's promissory notes which formed part of the collateral would be exchanged for longer-term Irish government bonds with lower coupons. The Irish central bank ultimately pays interest on the new bonds to the rest of the Eurosystem at the main refinancing rate, while the Irish government's interest payments are collected as net income by the Irish central bank and can be used for distributions to the government at a later date. This approach underlines the increasingly close and problematic ties between monetary and fiscal policy in the European monetary union. Responsibility for providing any assistance to individual member states in servicing their sovereign debts should lie with the European Stability Mechanism (ESM), which was established for this purpose.

German economy

The growth in overall German economic output was interrupted at the end of 2012. According to the Federal Statistical Office's flash estimate, real GDP growth in the fourth quarter of 2012 diminished by 0.6% quarter on quarter following adjustment for seasonal and calendar factors. The slowdown in demand that had begun to unfold over a year ago on the back of flattening global growth, recessionary tendencies in the euro area, and considerable uncertainties associated with the resolution of the debt crises together ended up putting a noticeable damper on German economic activity. Nonetheless, aggregate capacity utilisation in Germany remained just about within the range of normal.

Foreign business among enterprises saw a broadly based decline in autumn 2012. Exports of cars to countries outside Europe, the key component driving momentum, and one that had been highly effective until well into the summer, dropped into negative territory. Exports of goods to the euro area did not diminish quite as strongly as goods shipments to non-euro-area countries in the quarter under review. Here, though, the cyclical setback did not interrupt what had previously been a clearly positive underlying trend; rather, it shunted an already listless movement downwards. Imports

performed better than exports in autumn 2012. The foreign trade surplus, which had widened sharply in the second and third quarters of 2012, diminished again noticeably.

Purchases of moveable fixed assets receded further in the fourth quarter of 2012. Investment in machinery and equipment has thus been plotting a downward trend for more than a year now. In light of the moderate utilisation of fixed assets, it was only natural that capacity extensions were not on the agenda. Reticence appears to have affected enterprises' investments in upgrading their machinery and equipment and vehicle fleets as well. Given the frail investment activity, the commercial construction industry is likewise lacking impetus. The environment for housing investment remained exceptionally favourable in autumn, but as in the previous quarters, the rate of growth is likely to have fallen short of the strong pace seen in 2010 and 2011. This is due, to a considerable extent, to the bias of new construction activity shifting away from owner-occupied houses towards apartment blocks, but it can also be attributed to the elevated level that has already been reached.

Lending by German banks to domestic non-banks was unable to maintain the growth trend it had begun at the start of the year and diminished perceptibly in the quarter under review. This decline was caused primarily by a distinct drop in loans to general government, in which one-off effects associated with restructuring measures in the banking sector played a role. Lending to the domestic private sector, on the other hand, posted a further increase, though this was driven solely by a rise in loans to financial corporations and households. Lending to non-financial corporations, meanwhile, fell appreciably after having expanded distinctly in the first three quarters of 2012. Besides the persistently subdued investment in machinery and equipment, net redemptions in this credit segment are also likely to be attributable, in part, to non-financial corporations cleansing their balance sheets at year-end.

Consumer demand continued to provide only muted stimulus, to be sure. However, the surveys of the consumer research institution *Gesellschaft für Konsumforschung (GfK)* indicate that the consumer climate is highly optimistic, chiefly because the weak economy has so far left barely any dent on the labour market. In fact, the seasonally adjusted number of persons in work rose again slightly in the fourth quarter of 2012. Although more people were registered as unemployed between October and December than in the summer, increasing the unemployment rate to 6.9%, this figure fell back to 6.8% in January 2013 because the seasonally adjusted number of persons registered as unemployed declined again noticeably for the first time since the beginning of 2012.

Despite the sideways movement of crude oil prices and the recovery in the euro exchange rate, the fourth quarter of 2012 saw prices at all stages of the economy rising distinctly in seasonally adjusted terms compared with the previous quarter. However, the year-on-year rate of increase in import prices narrowed further to 1.0% while that of domestic producer prices widened again slightly to 1.5% after hitting a low in the third quarter. In seasonally adjusted terms, the increase in consumer prices matched that of the prior quarter. Prices for oil products diminished while those for food rose again sharply. Prices for other goods and for services (excluding rents) likewise showed a greater upward tendency. Year on year, consumer prices in autumn rose by 2.0% overall according to both the national Consumer Price Index (CPI) and the Harmonised Index of Consumer Prices (HICP).

Economic expectations in Germany have recovered at quite a rapid pace and to a remarkable degree over the past three months. The reduced uncertainty in the euro area played a part in this marked turnaround in sentiment. There is thus a greater chance that the discernible "wait and see" attitude to investment, which was difficult to reconcile with the medium-term growth outlook, might gradually

be easing. From today's perspective, an increase in overall economic output can be expected in the first quarter of 2013. This view is supported by the prospect of the industrial sector, in particular, exhibiting a countermovement in response to the considerable adjustments made to output at the end of 2012. There are signs that economic activity will gradually pick up pace in the remainder of the year, although the external environment should not be expected to kick-start a very strong surge in demand.

Public finances

The conditions for public finances in Germany remained favourable in the past year. The general government budget recorded a narrow surplus of +0.1% of GDP (2011: -0.8%), the still-perceptible deficit posted by central, state and local government being more than offset by the surplus run by the social security funds. According to Bundesbank calculations, the cyclical influence on the general government budget remained positive year on year, which meant that a (limited) deficit remained in structural terms. Compared with the previous year, there was a structural improvement of around 1% of GDP particularly on account of the ongoing rapid growth of profit-related tax revenue, the curtailed rise in social payments, the expiry of the 2009 investment programme and the exceptionally favourable financing conditions. The debt ratio rose to 81.7% at the end of the third quarter and is expected to be at a similar level at year-end (2011: 80.5%). The increase is attributable to the support measures in the euro area as well as the transfer of further liabilities (and claims) to the government sector as part of the liquidation of the public regional bank WestLB.

As things stand at the moment, the general government fiscal balance will drop back into negative territory in the current year and might reach a level somewhere around -½% of GDP. The slowdown in economic activity can be expected to reduce the cyclical influence, which had been positive in 2012, thereby revealing the existing structural deficit. The structural deficit remains largely unchanged year on year. The debt ratio, on the other hand, should decline if – as expected – the redemption of liabilities at the government-owned "bad banks" outweigh new burdens associated with stabilising the euro area and supporting German financial institutions.

In 2012, central government's structural deficit – when calculated in accordance with the debt brake provisions – already formally undershot the permanent constitutional ceiling for structural borrowing of 0.35% of GDP that will apply from 2016. This is to be welcomed even if it is based on the simplified cyclical adjustment procedure for the budget outturn. By contrast, if a fully updated cyclical adjustment is carried out, the structural deficit in 2012 is still clearly above the ceiling. In the current year, it can be expected – not least owing to cuts in the transfers to the social security funds – that the structural deficit will fall below 0.35% of GDP in *de facto* terms, and the structurally balanced budget targeted for 2014 likewise appears to be within reach. Budgetary developments at central government level have been better than planned since 2010. For this, higher tax revenue and favourable financing conditions were crucial, while fiscal policy has been gradually eased compared with the consolidation package from June 2010. Although interest expenditure looks set to provide further relief in the short term, a renewed increase in interest rates from their exceptionally low level might place a perceptible additional burden on public finances. Additionally, the considerable uncertainties involved in measuring the structural deficit would suggest that maintaining a clear safety margin from the borrowing limit would be highly advisable. Overall, therefore, general government still needs to make progress in consolidation. With regard to the financing of the social security funds, it would be desirable to transparently define the non-insurance-related benefits and to then ensure that they are reliably financed via the central government budget. It regularly appears as though transfers here are made on a rather

arbitrary basis depending on the cash resources available at a given time, which runs counter to a rules-based funding model that is geared to the principle of equivalence and which also impairs planning certainty.

Germany's budget situation is favourable by international standards. In light of the high debt ratio and demographic trends, however, it is nonetheless essential for Germany to swiftly plug the remaining structural gaps in central, state and local government budgets – especially considering the temporary nature of social security fund surpluses. Against this backdrop, the fiscal expansion that some parties are asking of Germany does not appear to be appropriate. The automatic stabilisers cushion the cyclical fluctuations in the German economy to a sufficient degree; moreover, the impact of any additional stimulus for domestic demand on the European countries affected by the adjustment recessions would be limited at most. All levels of government should therefore rigorously focus their efforts on achieving sound public finances. Furthermore, clear safety margins with respect to the permanent constitutional borrowing limits should be established for central government and the 16 Federal states so that negative surprises do not require a pro-cyclical budgetary policy at a later date. The Federal states should make full use of the long transitional periods for the reformed national budget rules only in those cases where it is virtually impossible to rectify extraordinary budgetary imbalances in the short term, and in these instances ambitious minimum steps for deficit reduction should be stipulated.

The reformed national and European budget rules provide a more robust foundation for achieving sound public finances. Under the favourable current conditions, Germany complied with these rules, and the underlying objective of achieving a structurally balanced general government budget is increasingly being used in the public debate as a benchmark for evaluating budgetary policy. However, the touchstone for fiscal policy will ultimately be whether the upward trend shown by the debt ratio is reversed on a lasting basis and the rules are rigorously implemented even when general conditions are less favourable.