

| The current economic situation in Germany

Overview

Strong second-quarter growth in German economy

Global economy

Global economic output is likely to have increased moderately in the second quarter of 2013. This growth was dampened by a relatively weak expansion in the emerging economies, largely because of still-sluggish external demand and structural problems in these countries – including infrastructure constraints and China’s very export and investment-driven growth model, which is reaching its limits. Growth in the industrial countries as a whole accelerated distinctly. Among this group, Japan’s previously strong growth lost steam, while the US economy picked up slightly and the UK economy markedly. In addition, aggregate output in the euro area improved distinctly on its subdued first-quarter level, which could mark an end to the recession which began in autumn 2011. The strong expansion in the German economy, the return to significant growth in French real gross domestic product (GDP) and a slower fall in output in Italy and Spain were all important factors in this development.

The global economy could remain on this upward path in the third quarter of 2013. Certain factors will probably bar the way to a stronger recovery, including growth constraints caused by a slight rise in the previously very low capital market yields, and the gradual nature of improvements in the euro area. In addition, the large emerging economies still face structural growth problems. Furthermore, the central banks of several emerging economies which require large capital inflows to fund their current account deficits have been forced to tighten their monetary policy stance in response to depreciation pressures on their currencies, which could also hold back growth. The main reason for this situation was that comments by the US Federal Reserve led the markets to expect that it might phase out its very expansionary monet-

ary policy measures earlier than had generally been thought.

Changes in economic indicators and in expectations regarding the future US monetary policy stance – the latter shifts being closely related to the former – had a major impact on the international financial markets from late March 2013 onwards. In addition, some major central banks continued to loosen their already expansionary monetary policy stance. The Bank of Japan outlined its new monetary easing policy framework, and the ECB lowered its key interest rates. The expansionary measures initially drove down yields on long-dated bonds around the world. In May, however, yields began to climb again worldwide in view of positively received economic data. Subsequently, expectations that US monetary policy might be tightened more rapidly than previously thought also took a firmer hold. Towards the end of the period under review, however, the Federal Reserve stressed that it would maintain an accommodative stance for the foreseeable future, which curtailed and partly reversed the rise in interest rates. The situation in Germany was affected not only by the interest rate linkage between Germany and the United States but also by a slight improvement in leading economic indicators. The higher yields on government bonds put pressure on the stock markets for a time. Yet the low price uncertainty, largely positive quarterly financial results from US enterprises and budding hopes of an end to the euro-area recession gave the stock markets enough of a boost for distinct price rises overall. On the foreign exchange markets, the euro appreciated against the other major currencies, making particularly strong gains against the yen.

Since lowering the main refinancing rate to 0.50% and the marginal lending rate to 1.00% in May 2013, the ECB Governing Council has left the key interest rates un-

Financial markets

Monetary policy

changed. This decision is based on the Governing Council's expectation that underlying price pressures in the euro area will remain subdued over the medium term. The ongoing accommodative monetary policy stance is intended to support the gradual recovery in economic activity expected for the remainder of this year and for 2014.

Yet short-term money market rates have, on average, been marginally above first-quarter levels since April despite the ECB lowering its key interest rates on 2 May 2013. In view of this situation, the ECB Governing Council announced after its meeting on 4 July 2013 that it expected the key ECB interest rates to remain at present or lower levels for an extended period of time, and repeated this phrase following its meeting on 1 August. The ECB Governing Council has thus issued "forward guidance" on its macroeconomic expectations and future monetary policy stance. However, this is not an unconditional commitment and does not mark a change in the ECB's monetary policy strategy: the actual key ECB interest rates will continue to depend on the medium-term outlook for inflation, which is based on expectations regarding future developments in the real economy and on credit and monetary aggregates.

As in the preceding quarters, the main factors influencing euro-area monetary dynamics in the second quarter were the economic situation, inflows from abroad, low interest rates and a flat yield curve. As a result, growth in the monetary aggregate M3 continued to lose pace in the second quarter, as growing cut-backs in loans to the private sector increasingly outweighed expansionary factors.

The German economy grew strongly in the second quarter of 2013. According to the flash estimate by the Federal Statistical Office, second-quarter real GDP was up 0.7% on the quarter after seasonal and calendar adjustment. However, this high quarter-on-quarter growth must be viewed in the context of the

stagnant economic output seen in the first quarter of 2013, when an incipient pick-up in the economy was held back by particularly bad weather. The strong expansion in activity in the second quarter is likely to have brought the German economy back to a normal level of capacity utilisation, which had fallen temporarily in the second half of 2012 as a result of the escalating euro-area debt crisis and the dip in global economic growth.

German enterprises' foreign business picked up again somewhat after the slump recorded in the final quarter of 2012 and the first quarter of 2013, although without yet making good all of last autumn's losses. Growth in external demand remained fairly subdued, mainly because of a substantial decline in exports of aircraft, ships and railway vehicles. Meanwhile, Germany imported a much larger volume of goods than in the previous two quarters, with imports from other euro-area countries increasing much more sharply than those from elsewhere.

Enterprises' investment in machinery and equipment, which had stabilised at a low level at the beginning of 2013 following a significant fall in 2012, gathered little momentum in the spring despite the sharp increase in economic output. Capital formation in the domestic corporate sector remained largely subdued despite enterprises having ample own funds and access to cheap sources of funding. This was probably mainly due to the long-standing gloomy sales outlook, above all in the euro area, and the ongoing uncertainty about the economic policy situation in view of the debt crisis. By contrast, construction investment increased considerably in the second quarter following a weather-related fall in the winter. Catch-up effects played a role in this development, yet additional demand also created momentum, as a very large number of permits for residential construction have been issued since the beginning of the year. Private consumption also boosted demand, although with a different emphasis to the first quarter of the year. While retail sales did not rise any further on the

quarter according to provisional statistical data, new private passenger car registrations increased distinctly.

Developments in lending were in line with the profile for domestic demand. Loans to non-financial corporations in Germany declined sharply in the second quarter of 2013, reflecting the German economy's weakness towards the end of 2012 and the increased use of alternative sources of finance. By contrast, loans to households rose perceptibly, mainly as a result of continued high demand for housing loans, but also because of a slight increase in consumer loans, which can be explained by brighter income prospects.

The labour market moved sideways in the second quarter of the year. The number of persons in work in Germany grew slightly. However, new jobs subject to social security contributions – which caused this increase – were now created in just a few services sectors. Germany's labour supply is still being boosted by immigration, with workers increasingly coming from southern Europe. The after-effects of the economic weakness are evident in the slight rise in underemployment. However, unemployment started to drop in June. In July the seasonally adjusted unemployment rate remained unchanged at 6.8%. Leading indicators suggest that the labour market could remain calm in the coming months.

The pace of wage increases weakened temporarily in the second quarter. Negotiated rates of pay overall climbed by just 2.2% year on year, compared to 2.9% in the first quarter. This was because several of the new wage agreements did not include any pay increases at the beginning of their validity period and no agreement has yet been reached in retail despite months of negotiations. The latest settlements in the insurance industry, in wholesale and foreign trade and at Volkswagen continued the trend in this year's pay round towards fairly balanced wage increases.

With the global economy muted and especially given the gloomier economic outlook for the emerging markets, seasonally adjusted prices in upstream branches of the economy fell noticeably in the second quarter. The decline was particularly pronounced for energy prices, which are directly linked to oil prices. However, prices for intermediate goods, too, dropped considerably. By contrast, prices for capital goods, which had previously fallen, stabilised, and consumer goods prices even edged up slightly. On the real estate market, prices continued to rise unabated in the second quarter of 2013, while the prices charged for construction services remained fairly subdued despite extremely lively demand. Consumer prices picked up somewhat in the second quarter of the year. This is noteworthy in that energy prices eased slightly after rising sharply at the beginning of the year. A key reason for the slightly higher rate of price increase was the ongoing perceptible food price inflation. Moreover, the state lottery operator raised ticket prices dramatically. The rate of price increase for industrial goods (excluding energy), by contrast, was within the normal range, as was the rise in housing rents. The national Consumer Price Index (CPI) was 1.5% year on year, unchanged from the first quarter. By contrast, the year-on-year rate of the Harmonised Index of Consumer Prices (HICP), whose basket of goods does not contain gambling, fell from 1.9% to 1.5%. Over the course of the quarter, inflation increased to 1.8% (CPI) and 1.9% (HICP) respectively. In July, the annual CPI rate climbed slightly to 1.9%, and was thus on a par with the HICP. Over the next few months, the rate of consumer price inflation is likely to ease somewhat. Food prices, which have reached a very high level, in part due to the weather, will no longer exhibit the same pace of growth and the favourable price trends on the import side are likely to have a moderating impact on industrial goods.

In the second half of 2013, economic growth in Germany is likely to return to normal and steady rates. The expected increase, more or

less equalling that of potential growth, will ensure that capacity utilisation remains good; it is doubtful, however, whether this will be enough to noticeably revive investment activity. Additional demand for German industrial enterprises' products largely comes from third countries, where firms tend to expand their production capacities. This curtails fixed capital formation at domestic production sites and the growth of exports to third countries. Domestic investment is unlikely to pick up discernibly until there is a long-term improvement in the economic prospects for Germany's neighbours and the uncertainty surrounding economic policy is further checked through suitable measures to combat the debt crisis in the euro area.

Public finances

Germany's government budget looks set to be virtually unchanged this year and thus to be close to balance again, as in 2012. Given the stable development of important macroeconomic aggregates for government finances (gross wages, unemployment, private consumption), this only partially reflects this year's economic slowdown, and the cyclically adjusted fiscal balance, too, is unlikely to change much. The fiscal policy stance is therefore more or less neutral. The debt ratio (2012: around 82%) is likely to decline perceptibly given a further portfolio reduction among the government-owned "bad banks" and the growth of the GDP in the denominator.

The situation could remain largely unchanged next year, though there is considerable uncertainty as to how the debt crisis will develop, and new financial policy decisions could be taken after the general elections. As things stand at present, the currently advantageous conditions for public finances, characterised by relatively low unemployment and interest rates as well as a revenue-rich GDP structure, could continue. Based on the fiscal stance currently mapped out in budget plans, which on balance includes only limited new budgetary burdens, the fiscal balance would improve slightly, not least because of a further decline in interest ex-

penditure, and the debt ratio would continue to drop.

In the supplementary budget for the current year, central government's net new borrowing was raised to €25 billion. Half of the deficit is being used to finance the aid fund set up to repair the damage caused by the floods of this spring and to cover the net burden from temporary financial transactions (in particular, further capital transfers to the European Stability Mechanism (ESM)). Net borrowing in the draft budget for 2014 is to drop significantly as compared to the supplementary budget for 2013, to €6 billion, in part because the above-described temporary burdens will disappear or decrease significantly. Other specific key factors include (alongside a stable rise in tax revenue) declining interest expenditure and a slightly greater reduction in transfers to the health insurance fund. In structural terms, a small surplus will therefore be reported for 2014. This picture appears too positive, however, as a significant cyclical deficit is factored into these calculations, which is difficult to reconcile with the fairly favourable situation for the macroeconomic variables of particular relevance to the budget. The fiscal plan to 2017 outlines a further steady improvement culminating in a (structural) surplus of just over €9 billion. However, the draft budget for 2014 will be revised following the elections in September, and the current budgetary and financial planning does not include measures that might be promised in election manifestos.

As regards general government, the German government's medium-term projection currently anticipates continued structural surpluses of ½% of GDP. The planned fiscal policy stance is thus largely neutral and complies with European rules, although it forecasts that the debt ratio should still be 69% in 2017. It would be recommendable to achieve perceptible structural surpluses in a timely manner, not least given the imminent budgetary burdens caused by an ageing population and the currently favourable conditions. In addition, planning

should generally include clear safety margins vis-à-vis the deficit limits under the debt brake. What will ultimately be decisive is that surpluses are not merely outlined in plans but that

they are in fact achieved. Sound public finances and policymakers' plans for the future are not contradictory aims; they must complement one another.