

# **| The current economic situation in Germany**

## Overview

### Upturn in Germany is broadening

#### *Global economy*

Following a strengthening of global activity in 2013, worldwide economic output appears to have expanded at a somewhat more subdued pace in the first quarter of 2014, with advanced economies and emerging markets alike experiencing flattening growth rates. Significant factors dragging on emerging market growth include the Chinese economy's sputtering start to the year and Russia's economic woes, which were made distinctly worse by the Ukraine crisis. Developments in the group of industrial countries were driven by various opposite special factors. While an unusually harsh winter partly hampered production in the United States, substantial frontloading effects in Japan ahead of the VAT hike on 1 April 2014 gave a big boost to domestic demand, and thus real gross domestic product (GDP). Growth in the euro area remained sluggish. The global economy looks set to at least maintain its modest rate of expansion during the current quarter, with the special factors in the industrial countries likely to reverse to a certain degree. In the United States, monthly indicators at the current end already point to a sharp upturn in growth. In Japan, by contrast, household demand is likely to contract substantially in a natural counterswing to the frontloading surge and might even cause GDP to contract.

#### *Financial markets*

The financial markets were relatively robust in the first quarter of 2014 despite a raft of negative factors. Although the geopolitical tension surrounding the Ukraine crisis triggered volatile price movements in response to the daily news reports, there was nothing to suggest that the financial market as a whole had been gripped by heightened risk aversion, with the heavy price losses that this normally entails. Even the fresh bout of financial market turbulence which hit a number of emerging markets early in the year tailed off quite quickly. A batch of cyclical

indicators which mostly delivered a downside shock up to the end of March likewise had only a muted impact on the markets. The financial markets appeared to be partly shielded from these shocks by the perception of a relatively robust underlying pace of global economic growth and by the persisting expansionary monetary policy stance of the major industrial countries (notwithstanding the US Federal Reserve's gradual tapering of its asset purchases). Moreover, sentiment has brightened again of late. This tended to push down bond yields worldwide, while equity markets – with the exception of Japan – posted gains. Government bonds of European periphery countries, in particular, saw their yields narrow substantially. Funding conditions for European enterprises in the capital market likewise improved further, which is underpinning the cyclical recovery in the euro area. The strengthening euro exchange rate – which was particularly evident between autumn 2012 and the end of 2013 – should therefore also be seen against the backdrop of capital inflows in euro-area portfolio investment, which themselves contributed to the shrinking yields. All in all, the aggregate stimulus effect for the periphery countries is clearly positive. It would be short-sighted to focus solely on the euro's exchange rate level as such an approach disregards other key factors. The euro's position has otherwise even lost a little ground (-1/2%) on a weighted average since the beginning of the year.

In view of the modest economic recovery and expectations that the ongoing improvement will gradually nudge inflation rates higher, the ECB Governing Council has taken no further policy action so far this year. Hence, interest rates for the marginal lending facility and main refinancing operations have stood at 0.75% and 0.25% respectively since mid-November 2013, while the interest rate on the deposit facility has been 0.00% since mid-July 2012.

#### *Monetary policy*

Given capacity reserves, despite discernible signs of a recovery, and subdued monetary and credit dynamics, the ECB Governing Council underscored its intention to hold the key interest rates at their present or lower levels for an extended period of time. The ongoing decline in inflationary pressure also prompted the Council at the beginning of April to signal its readiness to use unconventional instruments within its mandate in order to effectively counter potential risks arising from a protracted period of low inflation.

*German  
economy*

Economic activity in Germany has remained on a clear upward path since the start of 2014. The positive trajectory which domestic activity has been showing for some time was boosted of late by the fact that investment in machinery and equipment is now also picking up again following a prolonged phase of stagnation. These broadly based demand-side dynamics have been complemented over the past year by moderate but steady external impulses. So far, disruptive factors stemming from the international setting have not noticeably affected the upbeat sentiment of enterprises and consumers in Germany; instead, the upward momentum in the euro area has probably helped to improve the climate for investment, which was dogged for a long time by uncertainty. However, the quarter-on-quarter real GDP growth rate reported for the first quarter of 2014, at 0.8% after seasonal and calendar adjustment, perceptibly exceeds the underlying cyclical thrust. The unusually warm and dry winter gave an extra boost, since it allowed outdoor economic activity to continue largely unabated.

Construction investment rose steeply overall, fuelled mainly by housing construction. Enterprises likewise increased their investment budgets. Investment in machinery and equipment typically picks up in the wake of an improving economic outlook. This is especially true if aggregate capacity utilisation has already reached a normal level, as at the current end. Private consumption remained a major pillar of

the cyclical upturn in the first three months of this year.

This is in keeping with the fact that banks' lending to households increased distinctly in the reporting quarter. In addition to accelerated growth in consumer credit, loans to households (and therefore also to the domestic private sector as a whole) were again mainly driven by lending for residential construction, which benefited from the mild winter weather and ongoing favourable financing conditions. The dip in lending business with domestic non-financial corporations in the quarter under review is likely to have been caused by several factors. First, there is much to suggest that, in light of firms' past investment restraint, they have increasingly been using their earnings to pay down outstanding liabilities. Second, the importance of bank borrowing as a source of corporate financing has been experiencing a trend decline for years, while other forms of financing (especially internal financing) have gained ground. Third, there is likely to be a short time-lag before the pick-up in investment is reflected in higher credit demand.

Foreign trade has been pointing upwards for a year again now. It is, above all, the import side that has gained in dynamism recently, whereas German firms' export activities – given moderate global economic growth – are expanding at a subdued pace at present. The volume of goods exports and imports implies a fundamentally dampening effect on the foreign trade surplus. To date, however, this has been countered by perceptible gains in the terms of trade due to clearly declining prices for internationally traded commodities and semi-finished products. Even so, in seasonally adjusted terms, both the trade balance and the current account balance decreased substantially in the first three months of 2014 compared with their heightened levels at the end of last year.

The economic upturn significantly boosted the labour market in the first part of 2014. Added to this were the positive effects of the mild

winter on sectors of the economy in which employment is usually subdued at this time of year. The rise in the number of people employed was chiefly attributable to additional regular jobs subject to social security contributions. Registered unemployment fell markedly on a seasonally adjusted basis during the first three months after showing a slight upward tendency in the previous two years. The fall in joblessness related both to short-term unemployment covered by the statutory insurance system and the longer-term recipients of social welfare payments. Given low unemployment, the growing demand for labour in Germany is encouraging people who were not previously available for work to join the labour market and is leading to continuing large-scale immigration, especially from EU countries. Recruitment in trade and industry and business-related services is initially likely to remain as expansionary as it was in the first few months of this year.

Negotiated rates of pay rose much more sharply in the first three months of 2014 than in the previous quarter. This was due mainly to the retroactive component of the negotiated pay rise in the retail sector being paid at the beginning of this year as a lump sum in many cases. Judging by the wage bargaining outcomes so far, the 2014 pay round is continuing last year's robust rising trend. Taking account of industry-specific differences, the annualised agreed increase in negotiated pay averaged roughly 3%. At the beginning of April 2014, the Federal Cabinet adopted the draft Act Reinforcing Collective Bargaining Autonomy (*Tarifautonomiestärkungsgesetz*) which provides, *inter alia*, for the introduction of a general statutory minimum wage of €8.50 an hour from January 2015. Very few groups of workers are exempt from this minimum wage.

Price trends in Germany are currently subject to opposing forces. While prices that are more sensitive to external influences are falling, prices that are determined to a greater extent by domestic factors are showing a marked in-

crease. At the upstream stages of the economy, seasonally adjusted prices decreased further on the previous period, but to varying degrees. In terms of domestic producer prices, the decline was focused on the energy component and, to a lesser extent, on intermediate goods, whereas prices for capital goods remained unchanged and consumer goods prices rose markedly. Although construction activity was extremely buoyant, prices for construction work continued to expand only moderately. Consumer prices picked up again noticeably in the first quarter of 2014. Energy prices declined perceptibly due to falling crude oil prices, the appreciation of the euro and the mild winter weather, albeit less sharply than in the final quarter of 2013. Over the course of the quarter, there was a countermovement to the prior-year sharp food price increases, which had likewise been caused by weather conditions. By contrast, prices for services, in particular, went up perceptibly even though Easter fell in the second quarter this year, and the increase in rent levels accelerated. The prices of industrial goods also rose slightly more sharply than in the previous quarter despite the euro's appreciation. The upswing in prices accelerated in April, with the falling of Easter in that month contributing to the year-on-year growth rate of 1.3% as measured by the consumer price index.

In the coming months, the economic upturn in Germany will be driven mainly by domestic growth. External impulses, by contrast, are likely to play a smaller role. In addition, the potential for external disruptions has recently increased significantly owing to the greater perception of economic risks in a number of emerging markets and the considerable geopolitical uncertainties in eastern Europe. Unless major unforeseen events unfold from this, the economic upturn is nonetheless expected to continue. However, because the positive effect of the mild winter in the first quarter will statistically dampen the seasonally adjusted growth rate in the second quarter, GDP growth is likely to be comparatively low in the second quarter after seasonal and calendar adjustment. Yet

this should not be interpreted as a slowdown in the underlying economic momentum.

*Public finances*

Looking at Germany's public finances, a roughly balanced general government budget and a perceptible drop in the debt ratio remain likely in the current year. In structural terms, too, the budget should be roughly balanced. On the one hand, the fiscal stance was slackened by various spending programmes agreed after the parliamentary elections. On the other hand, the positive economic setting, the ongoing favourable financing conditions and the higher Bundesbank profit are, besides other factors, noticeably easing the pressure on public finances. The receding debt ratio is largely attributable to higher nominal GDP growth in the ratio's denominator. In addition, government-owned bad banks are likely to continue to reduce their liabilities as financial assets are realised. Despite distinct risks in the international environment, developments in public finances could be similar next year, although the new spending programmes will raise outgoings.

According to Germany's updated stability programme, the budget should be balanced or even slightly in surplus by 2018. With the German government expecting cyclical factors to exert a negative impact until 2017, the structural surplus is put at ½% of GDP. The debt ratio is expected to drop to 65% by 2018. The deficit and debt targets look manageable, and it is to be welcomed that they are well within the European fiscal framework. The public finance situation in Germany is thus relatively good by international standards.

However, the fiscal policy stance is far from ambitious. The German government has noticeably relaxed its spending policy as compared to previous plans. Although some of the envisaged higher spending will go into investment, education, childcare as well as research and development, the bulk of the extra expenditure will be allocated to pensions. Thus the German government has promised to spend, on average, an additional sum of around

€3½ billion a year on investment, education, childcare and on research and development in the current legislative period – in part to ease the burden on other levels of government. Spending on pensions, by contrast, is to be raised by around €8 billion a year in net terms (from mid-2014). This contrasts with the course pursued in Germany in recent years, as well as in other countries, which aims, first, to limit the foreseeable pressure on spending and social contribution rates as a result of demographic trends and, second, to promote labour force participation over early retirement. The overall loosening of German fiscal policy as outlined in the stability programme is currently enjoying uplift from an improving economic situation, the still favourable financing conditions and the relief brought about by the decline in the high debt ratio. The additional revenue automatically generated by bracket creep in income taxation between 2014 and 2018 is to be used to massage the budgetary situation, largely without compensating cutbacks.

Given the buoyant and unclouded macroeconomic outlook, the persistently high level of government debt and the foreseeable demographic challenges, more ambitious targets for the fiscal balance would certainly be appropriate. The estimated structural surpluses of around ½% of GDP outlined in the stability programme may be questioned given that cyclical factors are actually unlikely to place undue strain on public finances in the current year. In fact, all the recent macroeconomic data in Germany suggest that the cyclical situation is actually not unfavourable for public finances. The unadjusted fiscal development for the coming years outlined in the stability programme, showing a balanced budget or slight surpluses, would thus partly reflect favourable cyclical factors, and the structural budget position would, in fact, be balanced or slightly negative.

With a view to the national budget rules, too, it would be advisable to use the expected positive developments in the economy as a whole to rapidly bring down the remaining deficits at

all levels of government and to establish sizeable safety margins below the long-term deficit ceilings. In good times, this requires sizeable surpluses, and it would be imprudent to focus solely on achieving an unadjusted balanced budget. Safety margins are particularly important in view of the strict deficit ceilings that were enshrined in the German constitution to help ensure sound public finances. Past experience has shown that estimates of the structural

budget position are subject to major uncertainty and that negative macroeconomic shocks often trigger a fundamental reassessment of the growth outlook and an upward revision of structural deficits. The need for procyclical consolidation in phases of economic weakness can be avoided by taking this uncertainty into account by factoring safety margins into the budget plans.