The current economic situation in Germany

Overview

German economy emerging from sluggish phase faster than expected

Global economy

The global economy looks to have expanded in the fourth quarter of 2014 at roughly the same moderate pace as in the third quarter. Growth in the industrialised countries gained a broader footing. Real gross domestic product (GDP) in the United States did not increase at quite the same speed as in the third quarter, when one-off effects had played a role. By contrast, initial estimates suggest that output growth in the euro area gained some momentum, due in part to robust impulses from Germany. The underlying dynamics in the major emerging market economies continued to show a rather disparate pattern at the end of the year. Whereas China and India maintained the, by their standards, moderate rate of economic growth, economic momentum in Russia and Brazil appears to have remained weak.

According to an estimate made by the International Monetary Fund (IMF) in January 2015, global GDP expanded at a similar annual average rate in 2014 as in 2013. This means that the pace of growth of the world economy in the past three years was markedly below the average of the upturn years 2010 and 2011 and the period 2002 to 2007. Given that monetary policy has been exceptionally accommodative for quite some time and that fiscal policy, especially in the past year, has had a far smaller retarding effect on growth, there is much to suggest that this deceleration is due primarily to weaker expansion of potential output in both the advanced economies and the emerging and developing countries.

The world economy appears to be maintaining its moderate path of expansion in the first quarter of 2015. Global growth is likely to have been buoyed by the steep slide in oil prices which began in mid-2014. According to an IMF calculation, the part of the price slide attributable to supply-side factors could increase real global GDP by between ¼% and ¾% this year. This stimulus is likely to primarily benefit oil-importing countries, whereas particularly oil-producing countries that lack appreciable financial reserves will probably have to make perceptible cuts to their absorption.

Financial markets

Developments on the international financial markets in the fourth quarter of 2014 were increasingly marked by the expectation of large-scale asset purchases by the Eurosystem. This expectation was predicated on falling medium and long-term inflation expectations in the wake of tumbling oil prices. The prospect of an expanded asset purchase programme pushed down bond yields across the whole euro area apart from Greece, with new lows being temporarily recorded for several countries. As this report went to press, yields on ten-year Bunds stood at 0.33%. Bond yields outside of the euro area also fell amid the abundant liquidity supply and falling oil prices. This triggered a rally on most equity markets. For example, European stock exchanges benefited from a high demand for shares, with prices rising by approximately 9% on their levels at the end of September 2014. The Eurosystem's asset purchase programme evidently exceeded the expectations of some market participants in terms of both volume and breadth, causing an intensified search for alternative investment opportunities after its announcement. Furthermore, the euro's depreciation is likely to have boosted exporters' earnings expectations. Measured by its weighted average against the currencies of 19 major trading partners, the euro lost approximately 5% of its value on balance compared with the end of September 2014. The rise in implied stock market volatility and analysts' differing assessments are indicative of greater stock price uncertainty.

Monetary policy

The ECB Governing Council left the key interest rates in the euro area at the levels reached following the interest rate cut of 4 September 2014. On 22 January 2015, the Governing Council also decided to lower the interest rate for the six remaining targeted longer-term refinancing operations (TLTROs) to that applying to the main refinancing rate.

It simultaneously announced an Extended Asset Purchase Programme (EAPP). Under the EAPP, the Eurosystem will continue to purchase covered bonds (CBPP3) and asset-backed securities (ABSPP). From March 2015, it will additionally purchase bonds issued by euro-area central governments, agencies and European institutions. The monthly purchase volume under the EAPP is to total €60 billion, and this volume of purchases is to be maintained until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. The majority of the ECB Governing Council regarded the EAPP as being necessary to fulfil the Eurosystem's price stability mandate. The reasons given for this assessment were that the inflation dynamics and inflation expectations were weaker than expected and that the existing level of monetary accommodation was insufficient to address the increased risks of a prolonged period of low inflation.

Last year saw a marked recovery in the growth of the broad monetary aggregate M3 despite sluggish economic activity, weak inflation dynamics and, latterly, a significant depreciation of the euro. The continued rise in the annual M3 growth rate from 2.5% at the end of September to 3.6% at the end of the year was due mainly to the money-holding sector's sustained preference for highly liquid assets, which was encouraged by a further decline in interest rates. The quarter under review also saw a continuation of the gradual recovery in lending to the private sector that began in the third quarter of 2013. One particularly encouraging sign is that the upward movement was again strongly supported by loans to non-financial corporations. The pick-up in lending is likely to have been due not only to muted growth in real economic activity, but also to the extremely accommodative monetary policy stance.

On 4 February 2015, the ECB Governing Council decided to lift the waiver of minimum credit rating requirements for marketable instruments issued or guaranteed by Greece. This waiver had allowed such instruments to be used in Eurosystem monetary policy operations despite the fact that they did not fulfil minimum credit rating requirements. The Governing Council decision is based on the assessment that it is currently not possible to assume a successful conclusion of the programme review and is in line with existing Eurosystem rules. As a result, funding of the Greek banking system shifted away from monetary policy refinancing towards emergency liquidity assistance (ELA). This consists of short-term assistance provided by Eurosystem national central banks to solvent financial institutions facing temporary liquidity problems. The Greek banks receiving ELA should therefore take measures to improve their liquidity position. This requirement would be contravened by an expansion of liquidity needs as a result of purchasing short-term Greek government debt in the coming weeks.

German economy

Following extended periods of sluggish growth during 2014, economic activity in Germany regained considerable momentum even before the turn of the year. According to the Federal Statistical Office's flash estimate, real GDP in the final quarter of 2014 expanded strongly by a seasonally and calendar-adjusted 0.7% compared with the preceding three-month period, when only very modest growth had been recorded. Given that corporate sentiment did not begin to rebound until November, it is remarkable how quickly and, in particular, how strongly economic growth in Germany picked up towards the end of last year.

The depreciation of the euro and the slide in oil prices, which began in mid-2014 and acceler-

ated at the end of the year, have considerably altered some key indicators of the global setting. Despite moderate expectations for global economic growth, enterprises consequently stepped up their production in the hope of an improvement in business. The upward movement was not based solely on export markets, however. An especially strong stimulus was provided by domestic activity. The background to this was the considerable increase in purchasing power due to the decline in energy prices; this helped to strongly boost private consumption in an environment that had already been buoyed for some time by marked pay rises and low unemployment. Investment in machinery and equipment is unlikely to have provided any impetus in the final quarter of the year. By contrast, more was probably invested in buildings again.

The labour market in the fourth quarter of 2014 was characterised by both a stable upward tendency in employment and a marked decline in unemployment. One factor in this is that firms again recruited more persons from among the unemployed. For one thing, there was a greater need for labour in the services industries, which are booming at present. For another, replacements had to be found for workers taking up the option of early retirement on a full state pension at the age of 63. The rapid increase in the number of vacancies reveals that it was not possible to meet the growing demand for labour immediately. This, along with the other leading indicators for the labour market, suggests further increasing employment and decreasing unemployment during the next few months.

The 2014 pay round brought employees an average year-on-year rise of 3.0% in their negotiated rates of pay. This means that the increases in rates of remuneration negotiated by management and labour were the highest for almost 20 years.

The key factor shaping price developments at all stages of the economy at the current end is the fall in crude oil prices. The countervailing trend in domestic wage costs and the marked depreciation of the euro against other major currencies will probably not become more apparent in the headline rates until the direct effects of falling oil prices have run their course. The decline in energy import prices accelerated perceptibly in the final months of 2014. On an average of the fourth quarter, import prices were almost one-fifth down on the year. If energy is excluded, import prices were tending to go up slightly, however. Domestic sales prices for energy receded more slowly than import prices owing to the greater role played in the former by electricity and gas – the prices of which did not go down to the same extent as those of refined petroleum products. Consumer price inflation eased noticeably in the last three months of 2014 compared with the preceding quarter. It continued to do so at the start of 2015, and the year-on-year rate turned negative. Along with the continued sharp decline in energy prices, this was due to an exceptional moderation of prices for package holidays. The introduction of a general statutory minimum wage on 1 January 2015 has had only a marginal effect on consumer prices to date. Over the next few months, the annual rates for consumer prices – as for import and producer prices – are likely to be negative if crude oil prices do not increase further.

The German economy will continue to benefit from the economic upturn in the current year. In the short term, the pick-up will be driven mainly by private consumption. In addition, the distinct fall in the euro's external value will provide industry with greater sales opportunities outside the euro area despite the continued moderate global economic momentum. The stimulus from the euro's depreciation in the euro-area partner countries could also trigger secondary effects via the trade channel. This is supported by the broad-based increase in industrial orders in the fourth quarter. Over time, improving business prospects and rising capacity utilisation could reignite the currently stalled recovery in investment. Given the

brighter overall economic picture, it is understandable that current forecasts for economic growth in Germany this year are markedly higher than the projections made in the autumn of last year.

Public finances

The situation of public finances in Germany improved in the past year. Initial preliminary outturns indicate that the general government budget posted a distinct surplus, after having been virtually balanced in the two preceding years. With cyclical factors largely neutral, a similar structural surplus was generated. On balance, the year-on-year improvement was attributable to lower interest expenditure, while the primary balance (excluding interest expenditure) barely changed. The debt ratio fell further up to the end of the third quarter, primarily owing to nominal GDP growth. The fiscal balance is likely to deteriorate in the current year, but will probably remain in positive territory. Social spending will continue to grow significantly, and expenditure in other areas such as transport infrastructure, education and research is expected to accelerate. From the current perspective, the debt ratio is set to contract further.

Achieving a government budget position that is at least balanced on average over the business cycle would make an important contribution to reducing the still high debt ratio to 60% by the end of this decade. Not least in view of the fact that demographic strains will subsequently intensify, maintaining the moderate structural surplus as well would not be an overambitious objective. Given the still difficult macroeconomic environment at the European level, however, the fiscal plans so far for the general government budget seem appropriate. These plans envisage a marked structural deterioration this year, chiefly owing to the depletion of the social security funds' reserves. Unexpected cyclically induced budget developments should be tolerated, ie the automatic stabilisers should be allowed to take effect. Overall, German fiscal policy is making a decisive contribution to stabilising the situation in the euro area, although more resolute efforts could be made towards strengthening growth potential within the current fiscal framework. By contrast, little would be gained from launching a debt-financed demand stimulus in Germany, given a largely neutral domestic cyclical effect and only a limited impact on the rest of the euro area.

Central government closed fiscal year 2014 without posting any net borrowing for the first time since 1969 (ie with a balanced budget). It was notably aided in this by the extremely low interest rates. While the 2015 budget approved at the end of November does not foresee any further improvement in the balance compared with the actual 2014 figures, various positive budget deviations in 2014 are likely to extend into this year, and the German economy's improved growth prospects will additionally boost public finances. However, this more favourable outlook should not be misinterpreted as creating scope for discretionary spending. Ballooning demographic burdens and rising interest rates are likely in the longer term, and various budgetary risks exist at the current end. With respect to the many calls for and recent announcement of increased investment, it is important to first critically determine the real investment requirements, to realistically estimate expenditures, including their follow-up costs, and to make systematic use of cost-cutting opportunities in planning, construction and operation. In the case of public-private partnerships, due regard should also be given to fairly sharing the economic risk involved. A good infrastructure is important but requires neither new public borrowing nor circumventing the debt brake.