The current economic situation in Germany

Overview

Continued weakness in German industry

Global economic activity remains weak

Global economic activity appears to have remained weak at the end of 2019. In the advanced economies, economic growth even declined slightly. One-off effects played a role here, however. This is particularly true of Japan, where economic output is likely to have fallen substantially in the fourth quarter. In the United Kingdom, concerns about a disorderly exit from the European Union seem to have contributed to a sideways movement. In addition, growth in the euro area slowed. Only in the United States did economic expansion continue at the same moderate pace as before. The situation was slightly more favourable in the emerging market economies (EMEs). For instance, economic growth in China stabilised at the end of the year after continuously losing steam in the preceding quarters. Economic activity in the other large EMEs appears to have regained some momentum, too.

Improved outlook, but new risks

Nevertheless, economic growth in 2019 as a whole looks set to have been at its lowest level since the global financial and economic crisis, both in the EMEs and worldwide. This was chiefly due to weakness in the industrial sector and in global trade. That said, there have been increasing signs of a certain degree of improvement in the past few months. The global Purchasing Managers' Index for manufacturing, in particular, appears to have bottomed out and is now above the expansion threshold once more. The Bundesbank's leading indicator for the world economy has risen even more steeply of late. This is clearly due, in part, to the fact that the threat of a further escalation of trade disputes is no longer considered to be as high. However, at the start of 2020, a new risk entered the scene in the form of a novel coronavirus in China. On account of the extensive measures taken to contain the epidemic, amongst other factors, considerable losses for the Chinese economy – which may spill over to other economies – are to be expected, at least in the short term.

Financial markets shaped by receding political risks and concerns about potential implications of coronavirus

The international financial markets in the final quarter of 2019 and at the start of this year were initially characterised by an easing of political uncertainty. Market participants took a positive view of the UK general election in December producing a clear majority in the House of Commons and of the United States and China reaching an initial trade agreement. Furthermore, signs of recovery bolstered the global economy. Against this backdrop, investors switched from safe assets to riskier investments. In line with this, there was a rise in yields on high-quality government bonds, in particular, and share prices picked up significantly. By contrast, the yield spreads of ten-year sovereign bonds issued by other euro area countries as well as European corporate bonds narrowed against those of ten-year Bunds. In January, however, the positive overall picture was increasingly overshadowed not only by the Iran conflict flaring up briefly but also by concerns about the potential economic consequences of the coronavirus outbreak. Investors worldwide displayed a preference for safe investments, resulting in the yields on high-quality government bonds falling to levels close to their all-time lows in some countries (safe haven effect). However, the deterioration in stock market sentiment was only temporary, with positive business and economic data quickly triggering a countermovement. Shifts in exchange rates on the foreign exchange markets in the final quarter of 2019 and the first quarter of 2020 largely stayed within narrow bounds. On balance, measured as a weighted average against the currencies of 19 major trading partners, the euro has depreciated since the end of the third quarter of 2019.

The ECB Governing Council kept its policy rates unchanged over the reporting period. It ex-

ECB Governing Council's monetary policy stance unchanged

pects the key interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics. Furthermore, net purchases under the asset purchase programme (APP) were resumed at a monthly pace of €20 billion, as approved by the Governing Council in September 2019. It expects these purchases to run for as long as necessary to reinforce the accommodative impact of the policy rates, and to end shortly before the key ECB interest rates start to be raised.

ECB Governing Council decides to review monetary policy strategy

The ECB Governing Council also decided to launch a review of the Eurosystem's monetary policy strategy. This review will particularly focus on the quantitative formulation of price stability, the monetary policy toolkit, economic and monetary analyses and communication practices. In this context, the Governing Council will also review the effectiveness and the potential side effects of the monetary policy toolkit developed over the past decade. As things currently stand, the process is expected to be concluded by the end of this year.

Monetary growth remains robust

Growth in the broad monetary aggregate M3 remained robust in the fourth quarter of 2019. However, net inflows were less dynamic than in the preceding quarters, which was primarily attributable to reduced inflows of funds from abroad. Once again, monetary growth was largely supported by lending to the domestic private sector. However, developments in this area were mixed. While the expansion of loans to households continued on its upward trajectory, subdued euro area economic growth dampened non-financial corporations' demand somewhat. Aside from this, financing conditions on the capital markets improved in 2019, meaning that an attractive alternative to bank loans was available to enterprises. According to the latest bank lending survey, euro area banks' lending policies remained largely unchanged on balance in both corporate and retail banking during the reporting quarter.

Economic output in Germany stagnated at end-2019

The cyclical slowdown in Germany continued through the final quarter of 2019. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) remained at the level recorded in the previous quarter after adjustment for seasonal and calendar effects. For 2019 as a whole, real GDP increased by 0.6%. Last year, therefore, economic growth lagged significantly behind the expansion of potential output. Capacity utilisation is likely to have shifted into normal range at the end of 2019. The sustained weak underlying cyclical trend was chiefly the result of the downturn in industry, which could still be observed at the end of the year. By contrast, the more domestically oriented services sectors continued to bolster economic activity. The still fairly positive income and labour market prospects for consumers had a substantial part to play in this regard.

Renewed vigour in German banks' lending to domestic private sector

The various sectoral trends also left their mark on lending growth. Overall, German banks substantially expanded their lending to the domestic private sector in the final quarter of 2019. The largest contribution was again made by loans to households for house purchase, as growth in these loans gained further momentum. While loans to non-financial corporations likewise grew markedly in the quarter under review, the ongoing sluggishness in export-oriented industry dampened investment in machinery and equipment, and consequently also the demand for credit, among German enterprises. However, given the robustness of domestic activity, the financing needs of enterprises in the loan-intensive construction and real estate sector, in particular, remained high. Demand for corporate loans and loans for house purchase was supported by exceptionally low lending rates, especially for longer interest rate fixation periods. On balance, lending policies remained essentially unchanged across all segments. Nevertheless, loan margins were raised slightly on the whole.

Two-speed nature of economy impacts labour market

The persistent two-speed nature of economic activity was also reflected in the labour market. In this context, employment gains continued to outweigh losses in most sectors other than temporary work and manufacturing. Unemployment remained broadly unchanged at a low level. The number of employees in economically induced short-time work rose considerably, but not dramatically. The leading labour market indicators suggest that, over the coming months, growth in employment will continue and unemployment will remain largely stable.

Consumer prices see moderate rise in Q4 2019

In the final quarter of 2019, consumer prices (HICP) continued to rise at a moderate pace, increasing by 0.3% in seasonally adjusted terms compared with the preceding three-month period. There was a significant rise in prices for services, in particular, at the end of the period under review, with marked price increases being recorded most notably for travel services. Prices for industrial goods excluding energy likewise proceeded on their upward trajectory. By contrast, food prices were virtually stagnant. Energy prices, which fell further as a result of lower crude oil prices, had a dampening effect. Annual headline HICP inflation rose slightly from 1.0% in the third quarter to 1.2% in the final quarter. Excluding energy and food, the rate of inflation went up more steeply from 0.9% to 1.6%. The one-off effect of package holidays, which had put an especially heavy dampener on the annual rate of inflation in the third quarter, no longer had any net impact on average over the quarter.

No fundamental cyclical change expected for start of 2020

There are still no signs of any fundamental cyclical change in Germany for the first quarter of 2020. The domestic economy will probably continue to provide momentum, whereas industry will likely weigh on growth. In light of the ongoing robustness of the labour market and rising wages, domestic economic activity will be supported by private consumption. In addition, there is still no end in sight to the boom in the construction sector. With regard to industry, the downward trend in new orders persisted until the end of 2019 with diminishing momentum. However, according to the ifo Institute, sentiment in this sector recently experienced a noticeable improvement. Enterprises were once again taking a less pessimistic view of the future and ongoing business was also being assessed more favourably. Alongside this, short-term production expectations brightened considerably after the start of the new year and are now in positive territory. The survey results could indicate that the downward pressure on industrial production is gradually subsiding. This is consistent with the fact that industrial production capacity utilisation recently rose again somewhat.

Coronavirus epidemic also poses downside risk to German economy

Nevertheless, economic risks have emerged with regard to the outbreak of the coronavirus in the People's Republic of China. It is likely that a temporary decline in aggregate demand in China would subdue export activity in Germany. In addition, some global supply chains could be negatively impacted by the safety precautions that have been implemented. This would result in supply bottlenecks in certain individual sectors in Germany.

Marked decline in surplus in 2019 due to looser spending stance

Last year, economic growth was bolstered by Germany's public finances. The general government surplus fell markedly to 1½% of GDP, after totalling almost 2% of GDP in 2018. The main reason for this was central government's looser spending stance. Alongside social spending as well as staff and other operating expenditure, there was also a substantial rise in government investment. Furthermore, due to the slowdown in economic activity, tax revenue grew at a significantly slower pace than previously. The additional reduction in interest expenditure helped to relieve the strain on the budget. By the end of the third quarter of 2019, the debt ratio had fallen to just over 61%.

Fiscal policy stance to remain loose in current and coming year; surplus will continue to decline

The surplus is likely to continue to decline, and the government budget could then be more or less balanced in 2021. A persistently looser fiscal policy stance is the key factor here. It is probable that spending will continue to rise significantly. In addition, there will be moderate tax relief measures, primarily in the form of the partial abolition of the solidarity surcharge planned for 2021. Despite considerable increases in spending, social security contribution rates are still likely to remain fairly stable overall. It will be possible to bridge deficits, particularly in the statutory pension and health insurance schemes, by drawing on reserves. The climate package will probably have a largely neutral effect on the balance.

Federal budget result initially much better than planned

The Federal budget again posted a much better result than planned at the end of 2019 and continued to adhere to the debt brake by a wide margin. The large surplus of €13½ billion was channelled almost entirely into the refugee reserve, which grew to €48 billion. It again appears possible to achieve a balanced budget without the planned withdrawal from the reserve. Ultimately, however, the loose fiscal policy stance that has been adopted will lead to deficits. Moreover, demographic trends will place an increasing strain on the Federal budget from around the middle of this decade.

Fiscal leeway could be used for measures to foster growth and employment

Although central government's spending stance has been loose for several years now, there is still considerable leeway within the scope of the budgetary rules at present. This is due to the fact that revenue has risen substantially whilst interest expenditure has fallen. This leeway could potentially be used to improve the conditions for growth and employment. It is plausible that central government will at least begin to abolish the solidarity surcharge in the current year. State and local governments are likewise posting high surpluses overall and, as things stand today, their financial outlooks are favourable. These levels of government are responsible not least for education and a large share of infrastructure, which means that they play a major role in economic development. Although government investment has already been expanded to a considerable degree despite the high levels of construction capacity utilisation, swift progress is often hindered by planning bottlenecks at authorities, drawn-out authorisation procedures, and reviews of legal objections. Efforts to press ahead with the demand-driven expansion of infrastructure would merit looking at these areas first.