The current economic situation in Germany

Overview

The German economy against the backdrop of the dip in global growth

Global economy

After picking up at the start of 2012, global economic activity weakened distinctly in the second quarter. Although the current economic policy debate has highlighted the euro-area debt crisis, it is only partly to blame for the weaker global momentum. Other industrial countries, too, still have considerable macroeconomic imbalances to overcome. Another likely contributory factor was the lingering impact of the first-quarter surge in crude oil prices on purchasing power in oil-consuming countries. Moreover, domestic problems have become increasingly prominent in some emerging market economies. All in all, the second-quarter dip in global growth affected most of the major industrial countries and emerging market economies. Aggregate output contracted slightly in the euro area and considerably in the United Kingdom, while the rate of expansion slowed elsewhere (including in the United States, Japan and China). Global industrial output in April-May stagnated at its first-quarter level. However, global gross domestic product (GDP), which tends to follow a flatter path than industrial output, is likely to have risen slightly.

Global economic activity is likely to pick up gradually in the second half of the year, although developments on the financial and oil markets pose downside risks. Overall, the stimuli from the still very expansionary monetary policy stance in the industrial countries and the recent loosening in the emerging market economies could regain the upper hand.

International financial markets

Weaker activity in the world economy and a renewed flare-up of the euro-area debt crisis shaped events on the international financial markets from spring 2012 onwards. With regard to Europe, the mood was dominated by concerns about Spain's banking system and public finances and doubts over the implementation of reform programmes in some euro-area countries. Financing conditions for banks and governments on the southern European capital markets initially continued to worsen, whilst a flight to safety drove down yields in Germany, the United States and Japan. Equity markets were depressed for a time by the gloomier economic picture, a further percentage rise in non-performing real estate loans in some countries, and financial institutions' increased exposure to sovereign bonds. It was subsequently announced that Spain would be receiving financial support to recapitalise its banking sector and that the Eurosystem might consider taking further non-standard monetary policy measures. These declarations led, in particular, to a recovery in equity prices. They also delivered a limited boost to the euro, which, however, had predominantly depreciated in the preceding months.

Monetary policy

At its monetary policy meeting at the beginning of July, the Governing Council of the ECB lowered the three key interest rates by ¼ percentage point. Its rationale for this decision was that the ongoing deterioration in the euro area's economic outlook had further dampened inflationary pressure over the policy-relevant horizon and that the underlying pace of monetary expansion remained subdued.

The evolution of the broad monetary aggregate M3 has been unusually volatile since the financial crisis worsened in summer 2011. Overall, however, the underlying pace of monetary expansion remained subdued in the second quarter of 2012. Although portfolio shifts towards highly liquid assets and the continued rise in bank lending to euro-area governments bolstered M3 growth, bank lending to the euro-area private sector continued to weaken. Lending patterns varied greatly within the euro area, with credit growth recorded in member states which had retained their high credit rating and credit outflows from the countries hit hardest by the crisis, which are undergoing a substantial structural adjustment process.

To support bank lending to the non-financial private sector, the ECB Governing Council decided in the second quarter to further relax the collateral requirements to be met by banks in return for Eurosystem refinancing. By contrast, when the buy-back scheme for marketable debt instruments issued or guaranteed by Greece expired on 25 July 2012, these instruments became ineligible for use as collateral in monetary policy operations for the time being as they do not comply with the Eurosystem's rating threshold for marketable assets. However, the Greek central bank is still supplying its domestic financial sector with ample liquidity assistance.

Towards the end of the reporting period, safe-haven flows to countries with a high credit rating decelerated somewhat overall compared with spring. Nonetheless, Spain in particular continued to suffer net outflows of capital, which were offset by a greater supply of liquidity from the Eurosystem. Net inflows of liquidity to Germany, reflected in its TARGET2 balance, largely ground to a halt. At the end of July, Germany's TARGET2 claims stood at €730 billion.

Although the ECB Governing Council did not adopt any further non-standard measures at its latest meeting on 2 August 2012, it did announce that it might consider expanding such measures substantially. In particular, the Governing Council indicated that it would, under certain conditions, support a new, possibly extensive government bond purchase programme in order to correct what it deemed to be severe disruptions in the price formation process on these markets. The Governing Council stated that the activation of an EFSF/ESM programme for the country in question would be a necessary condition for any interventions by the Eurosystem. The Eurosystem's securities purchase programme would focus on the shorter end of the yield curve. Its volume could be unlimited and would in any event be sufficient to achieve the programme's objectives. The Eurosystem's committees are to prepare the details of the programme and the Governing Council's decision. The Bundesbank remains of the opinion that, in particular, government bond purchases by the Eurosystem should be viewed critically and entail, not least, substantial stability policy risks. It is the responsibility of fiscal policymakers – the governments and parliaments of the euro-area countries – to decide whether to possibly considerably enlarge the communitisation of solvency risks; such steps should not be taken via central bank balance sheets.

German economy

Despite the difficult economic situation in some euro-area countries and the dip in global economic activity, the German economy continued to expand in the second quarter of 2012, albeit at a slower pace. The Federal Statistical Office's flash estimate recorded quarter-on-quarter GDP growth of 0.3% in the second quarter of 2012 (after seasonal and calendar adjustment), compared with 0.5% in the first quarter. Enterprises' average capacity utilisation remained around normal. Although the external demand stimuli were less pronounced in the first half of 2012, they were strong enough in tandem with expanding domestic activity to enable output to grow in line with potential growth.

Germany's exports may have risen almost as sharply in the second quarter of 2012 as during the first three months. While export growth to non-euro-area countries continued virtually unabated, exports to euro-area countries stagnated as expected. As the sizeable demand losses of autumn 2011 were barely recouped in the first quarter of 2012, this sideways motion means that, on balance, Germany's euro-area business was dominated by contractionary dynamics as a result of the adjustment-induced recessions in some member countries.

The uncertainty triggered by the euro-area debt crisis evidently continued to dampen investment in machinery and equipment. Purchases of moveable fixed assets have now been faltering for the past three quarters. This is because few companies are looking to expand production capacity at the moment. Capacity utilisation in manufacturing has fallen since autumn 2011, although it remains just within the longer-term average range. By contrast, construction investment increased in the second quarter. This owed something to the rebound following the sharp weather-related reduction in activity in February but also to building firms' very buoyant order situation. Towards the end of last year, a very large number of building permits were granted for new residential and commercial properties. In addition, public sector demand surged after the turn of the year.

Although the uncertainty triggered by the debt crisis is also weighing on households' purchasing decisions, the underlying domestic setting for private consumption remains positive. Thanks to the favourable labour market situation and strong wage growth, consumer spending rose further in the second quarter of 2012 in seasonally adjusted terms. The weakening of inflation pressure probably bolstered consumer confidence, while households' real spending capacity was definitely boosted by falling petrol and heating oil prices.

Having stagnated in the first quarter of 2012, imports recorded a marked quarter-on-quarter increase in the spring (after seasonal adjustment). However, growth in imports has lagged behind that in exports since the beginning of 2012. This is partly because of an underlying trend in which construction activity, with its relatively low import content, has increasingly become the main driver of domestic economic expansion. Imports from euro-area countries and EU member states in central and eastern Europe were higher in the second quarter of 2012 than in the first three months of the year. The total value of imports from other parts of the world (apart from China) largely decreased, although this fall should be viewed in the light of the marked decline in energy prices.

The growing concerns about the economic situation are reflected in more cautious recruitment plans. Although the continued rise in employment in the second quarter confirmed the positive underlying labour market trend, employed persons were working fewer hours towards the end of the period and, after seasonal adjustment, the number of unemployed persons rose somewhat quarter on quarter for the first time since the cyclical upturn began. The available leading indicators suggest that the labour market may continue to lose momentum in the coming months.

The social partners negotiated appreciable wage rises in this year's pay round. Whereas in the service sector negotiators mostly concluded progressive wage increments staggered over a longer period, the latest pay deals in industry tended to feature large wage rises and run for a shorter term. On top of the collective agreements for core staff, wage bargainers in the metal-working and electrical engineering sector and the chemical industry agreed on phased wage add-ons for agency-hired temporary workers.

The price climate initially improved somewhat in the second quarter of 2012 as a result of the gloomier global economic outlook. Cheapening commodities eased price pressure across all stages of the economy, although the weakening euro exerted a countervailing influence on the price level. The rising seasonally adjusted trend in consumer prices ground to a halt in the course of the second quarter. Annual consumer price inflation stood at 1.9% in the period under review, compared with 2.1% in the first quarter. Going forward, inflation is likely to edge up, however, in view of the renewed price upturn in the international commodities markets and the euro's ongoing depreciation.

The prevailing uncertainty in the euro area could have a greater negative impact on economic activity in Germany in the second half of the year. This is borne out by the Ifo surveys, which point to a considerable deterioration in the business outlook for trade and industry in the second quarter. This is chiefly attributable to the impact of firms' worsening sentiment on investment and, above all, to direct effects via foreign trade.

However, as long as demand for German products from non-euro-area countries remains essentially intact despite the deteriorating expectations, a reversal of the cyclical trend in Germany is highly unlikely. Under this constellation, key components of domestic demand should remain buoyant; construction demand remains strong and the outlook for private consumption continues to be favourable. This is due, not least, to the fact that job and income opportunities are considered to be comparatively good in Germany regardless of the cyclical turbulence.

Public finances

Germany's public finances are likely to record a patchy performance this year. After falling to 1% last year, the deficit ratio could decline further in 2012 and would thus be low by international standards. The main factors encouraging such a decrease are the favourable growth structure for government revenue, moderate developments in pension and labour market expenditure and exceptionally good financing conditions. By contrast, the debt ratio is likely to rise from the very high level recorded last year (81.2%). The debt-increasing impact of of the regional bank WestLB's liquidation and of the European assistance mechanisms outweighs the downward trend that had begun to emerge. Germany's general government deficit may change only slightly next year. Various opposing influences – such as the continued loosening of the fiscal policy stance on the one hand and the ongoing subdued trend in social and interest expenditure on the other – could roughly cancel each other out. However, the debt ratio could fall – driven down by GDP growth in the denominator. But this scenario is subject to certain risks, not least in connection with the euro-area debt crisis.

The supplementary budget for 2012 will lead to a clear year-on-year rise in central government's structural deficit, although some of the estimates on which this is based are rather cautious. Central government's multi-year fiscal plan envisages that it will already comply with the borrowing ceiling of 0.35% of GDP (which will be compulsory from 2016 onwards) in 2013 and achieve a slight structural surplus by 2016, thus continuing the favourable budget developments seen since 2010. However, this projection largely depends on additional tax revenue stemming from robust growth in the German economy (and low financing costs), which is assumed to continue up to the end of the fiscal plan. As the debt brake imposes strict limits on structural borrowing, it would seem imprudent, not least in view of past experience, to delay the consolidation originally planned – as is to some extent envisaged – and to significantly erode the safety margin below the borrowing limit.

As Germany's general government deficit ratio was significantly below the 3% threshold in 2011, the EU excessive deficit procedure initiated against Germany at the end of 2009 was dropped. This and the now historically low general government deficit are welcome developments. Yet despite the currently very propitious macroeconomic setting for Germany's public finances, many state and local governments are still running deficits, some of them sizeable. This is partly masked by high but temporary surpluses in the social security funds. The very high debt ratio, which has risen almost without interruption since the 1970s, reflects past failures to consolidate public finances. In view of the foreseeable future budget burdens stemming from demographic developments, and the substantial risks to public finances, policymakers should make use of the current favourable conditions in order to resolutely consolidate and start making the deficit cuts that are still required without delay. The automatic stabilisers will cushion the impact of any risks that might materialise. The aim should be to swiftly comply with the permanent consolidation requirements enshrined in the national debt brakes for central and state government. Furthermore, appreciable and binding safety margins below the national borrowing limits should be introduced as a general principle. Given the high estimation uncertainty regarding the state and development of structural budgets, such buffers that can absorb the impact of negative shocks are a key condition for being able to pursue a stable, target-oriented fiscal policy. This would allow the debt ratio to be rapidly lowered, which would yield an extra benefit in view of its current very high level. Confidence in German public finances is a key anchor of stability in the current crisis, but it cannot be taken for granted.

At the European Council meetings at the end of June, the heads of state or government of the euro-area countries considered the possibility of closer fiscal and economic policy cooperation. However, they have yet to clarify what form that this cooperation would take, and intend to discuss the details at a later date. Among other issues, the question of whether and to what extent national sovereignty should be transferred to the European level and whether there should be a greater communitisation of government debt appear open to dispute. In the near future, the European Commission intends to present proposals for a single supervisory mechanism for financial institutions. It is emphasised that this would be a necessary condition for permitting the planned European Stability Mechanism (ESM) to provide financial assistance not just to governments but also directly to banks. To maintain an adequate balance between liability and control, however, this would necessitate the introduction of powers of intervention, including in fiscal and economic policy, as well as their rigorous deployment. It would therefore make sense for the EMU countries to assume joint liability (via the ESM) only for those risks which arise after the single supervisory mechanism has been set up. Changes would be needed in the framework for banking supervision and regulation to ensure that interconnections between banks and governments do not increase excessively, thereby transferring substantial sovereign solvency risks to other member states by the back door of granting financial support to the banking sector. A single supervisory mechanism for financial institutions could constitute an important step towards a more stable institutional framework for the single market. However, it is not an appropriate solution – at least in the short and medium term – to the current European sovereign debt and banking crisis.