

| The current economic situation in Germany

Overview

Economic outlook for Germany: cloudier, but underlying tendency remains positive

Global growth accelerated markedly in second quarter after weak start to year

Global economic growth failed to meet expectations in the first half of 2014, primarily owing to the bumpy start to the year. In the second quarter, however, the pace of growth picked up again markedly. Accelerated growth in China and the strong growth of aggregate output in the United States, which had been dragged down by a variety of special factors in the first quarter of the year, contributed to the faster growth. By contrast, real gross domestic product (GDP) in Japan contracted sharply as a result of the sales tax increase which took effect on 1 April 2014; this followed very strong GDP growth in the winter as purchases were brought forward. The UK economy continued to expand at the rather rapid pace of the preceding quarters, whereas euro-area real GDP unexpectedly failed to gain any further ground but instead stagnated at the previous period's level.

Signs of a continuation of upward trend in economic activity in the current quarter

The global economy appears to have got off to a good start in the second half of the year. As regards the industrial countries, Japan's economy is expected to rebound in the third quarter. The US economy is likely to remain on a growth path, although it will probably be impossible to maintain the rapid pace of growth attained in the second quarter of the year. Following second-quarter stagnation, the euro area is looking at a resumption of positive economic growth, albeit not at the pace predicted by many analysts in the spring. The underlying cyclical trend in some euro-area countries is turning out to be weaker than expected. At the same time, the geopolitical tensions in Eastern Europe owing to the Ukraine conflict as well as in other parts of the world are now appearing to weigh more heavily on corporate sentiment. Although they will only affect a small percent-

age of EU exports directly, the recently enacted EU sanctions and the Russian response are likely to dampen sentiment.

In the spring months, events in the international financial markets were dictated largely by the very expansionary monetary policy in the major currency areas. The Governing Council of the ECB adopted further monetary policy stimulus measures in June, for instance, which led to a considerable reduction in bond market yields, especially in the euro area; in many countries they hit new all-time lows. At the same time, market participants' risk appetite remained high, which meant that risky assets were trading at extremely low yield spreads up to and into June. The high prices of equities and corporate bonds were initially supported by market participants' positive underlying assessment of economic activity. However, the market valuations of European corporates in particular were dragged down by heightened geopolitical tensions as well as – in a probably related development – recent, and in some cases unexpectedly weaker business indicators, notably for the euro area. As a case in point, European equity markets have sustained net equity price losses of around 5% since the end of March, while the US equity market has fared more favourably. Market participants particularly saw the Ukraine conflict as a cause of concerns that the resulting economic sanctions imposed on Russia could weigh on corporates. The distressed state of a Portuguese bank and the partial default of Argentina, on the other hand, were regarded by the financial markets largely as locally contained events. Foreign exchange market price developments were characterised largely by current monetary policy decisions and expectations regarding the future monetary policy path on either side of the Atlantic. On balance, the euro has lost about 2½% of its trade-weighted value since the end of March.

Financial markets

Monetary policy Against the background of the persistently flat price trend, on 5 June 2014 the Governing Council of the ECB adopted a package of monetary policy measures designed to help the HICP return to levels closer to 2%. As part of this package of decisions, the Governing Council reduced the interest rate on main refinancing operations and the rate on the deposit facility by 10 basis points each. The main refinancing rate is now only 0.15% and the deposit facility rate -0.10%. At the same time, the marginal lending rate was lowered by 35 basis points to 0.40%.

Along with the interest rate reduction, the Governing Council of the ECB adopted a series of additional measures in June, including extending full allotment in its monetary policy refinancing operations until at least the end of 2016 and eight targeted longer-term refinancing operations maturing in up to four years. These new operations, to be offered for the first time in September of this year, are partly attached to banks' past and future lending to the private sector and will run until September 2018. Since, in particular, the medium-run inflation outlook is currently appreciably below the inflation rate sought by the Eurosystem, the adopted package of measures is justifiable, on the whole. Nonetheless, the expansionary monetary policy also involves the risk that exaggerations could occur on the markets and that the euro-area member states' resolve to persist in their consolidation and reform efforts could flag.

Monetary developments in the euro area

The modest macroeconomic recovery in the euro area, which took hold in the middle of last year, seems to be gradually having an effect on lending, even if heterogeneity in the euro area remains high. One indication of this is that euro-area lending to the private sector in the spring quarter was slightly positive, on balance, for the first time in two years. Securitised lending to the private sector was also up somewhat, following some strong outflows in the previous quarters. Against this backdrop, the modest upward trend in monetary and credit

growth that could already be seen in the previous three-month period continued in the reporting quarter. However, this does not yet represent a broad-based recovery in lending activity.

By contrast, the lending business of banks in Germany experienced a clear expansion in the second quarter of 2014 compared to the previous quarters. Banks in Germany upped their stocks of securities from private domestic issuers and increased their private-sector lending, particularly to the non-financial private sector. As regards lending to households, the positive development seen in the previous quarter continued. Loans for house purchase were once again the driver of growth, with their rate of increase continuing to accelerate somewhat. According to bank managers questioned by the Bank Lending Survey (BLS), demand for housing loans was fuelled by both optimism on the part of borrowers about housing market prospects as well as consumer confidence, which again rose slightly. There was also an upturn in lending to domestic non-financial corporations, with marked growth in short-term and medium-term loans being recorded in the reporting quarter for the first time since the summer of 2012. However, according to BLS data, demand in this credit segment was dampened, as in previous quarters, by companies tapping alternative sources of funding, particularly internal financing.

Lending in Germany

According to the Federal Statistical Office's flash estimate, aggregate output in Germany in the second quarter of 2014 was down 0.2% on the level of the previous quarter after seasonal and calendar adjustment. This was due in part to a significantly stronger rise in output in a number of weather-dependent economic sectors than is usual for the time of year, as a result of the exceptionally mild temperatures at the beginning of the year; in statistical terms, this exerted downward pressure on the quarter-on-quarter rate in the reporting period. This is compounded by the fact that cyclical developments fell short of expectations. If the eco-

German economy

conomic developments over the entire first half of this year are considered so as to eliminate the effects of the weather, the average pace of GDP growth amounted to ¼% per quarter. Growth therefore slowed compared with the second half of 2013 and growth potential, too, was not quite achieved. Overall production capacity utilisation therefore declined somewhat from its level at the turn of 2013-14, but remained within the range of normal capacity utilisation.

German enterprises' foreign business picked up again only very slightly in the second quarter of 2014. In the reporting quarter, exports to euro-area partner countries fared better than average, while overall exports to countries outside the euro area barely rose at all. It is striking that the downward trend in exports to Russia already started at the beginning of 2013, with the value of these exports falling by nearly one-fifth by May 2014. Quite clearly, the conditions necessary for prosperous trade with Russia began worsening some time before the Ukraine crisis. In terms of aggregate imported goods, the upward movement that had been visible since the start of 2013 did not continue in the second quarter of 2014. The weaker demand for foreign products hit suppliers from the euro area to a greater extent than suppliers from third countries in the reporting quarter.

Seasonally adjusted investment expenditure by enterprises for new machinery and equipment probably did not quite reach the same volume in the spring as it did in the winter months. This was therefore a blow to the recovery in investment expenditure that had started to take hold one year ago. Seasonally adjusted construction investment in the reporting period fell well below that of the previous quarter. This sharp fall, however, is primarily due to a technical reversal caused by highly elevated production levels in the first quarter resulting from weather-induced factors. Private consumption is likely to have picked up once again in the second quarter.

Labour market developments have remained positive on the whole. Job growth continued on its upward path in the second quarter of 2014. Owing, in particular, to the weaker than usual spring pick-up due to the mild winter, the increase in the seasonally adjusted number of persons in work in Germany on the previous quarter was less sharp than in the first quarter. The rise in the number of people employed was once again chiefly attributable to additional jobs subject to social security contributions. At the same time, there was a further fall in the number of self-employed persons. One possible reason for this is that some of the immigrant workers from Romania and Bulgaria might have taken up dependent employment after full labour mobility within the EU was introduced for this group of immigrants at the beginning of this year. Registered unemployment did not develop as favourably in the spring months as it did in winter, even when weather effects are eliminated. On balance, enterprises are likely to take a more cautious approach to recruitment in the coming months.

The year-on-year increase in negotiated rates of pay in the second quarter of this year was, at +3.4%, virtually just as pronounced as in the first quarter (+3.3%). In the first quarter, the increase was mainly attributable to the considerable back payments in the retail sector, whereas growth in basic rates of pay (+2.8%) was lower. By contrast, in the reporting period it was the substantial increases in the scheduled rates of pay under the first agreements in this year's pay round that made themselves felt. The year-on-year increase in collective wages, at +3.5%, excluding one-off payments and fringe benefits, is likely to have peaked in the reporting period. One reason for this is that the second round of increases that such agreements often contain has been lower than the first in the agreements to date. What is more, the increases contained in the most recent agreements fell short of the increases negotiated in the agreements concluded at the beginning of the year.

In the second quarter, prices at the upstream stages of the economy declined further in seasonally adjusted terms in Germany. The main reason was a downwards trend in the price of energy, and here especially the sharply reduced prices for gas and electricity, while the cost of petroleum products even rose slightly, in line with prices on the international markets. Other industrial goods prices, too, moderated both at the import level and at the domestic producer level. Consumer price inflation slowed somewhat again in the second quarter. The slightly weaker uptrend was due, in particular, to a clear drop in prices for fruit and vegetables, which had risen considerably in 2013 as a result of weather-related factors. Almost none of the sharp corrections in the prices of gas and electricity at the producer and import level have, to date, been passed on to consumers. In July, consumer prices – as measured using the national and the harmonised European concepts – were up 0.8% on the year.

A flurry of unfavourable news reports relating to the international environment have dampened Germany's economic outlook in the second half of the year. Current indicators cast doubt on the assumption on which the spring forecasts were based, namely that the underlying cyclical trend would strengthen further in the second half of 2014. The Ifo Institute's business climate index has dropped three times in a row of late, with the expectations component, in particular, falling. The fact that the order flow declined perceptibly over the course of the second quarter and export expectations have dropped suggests that the industrial economy will be especially hard hit by the disruptive external factors. This can probably be explained in part by the fact that sanctions against Russia have been tightened and the Russian government has taken countermeasures, which will impact foreign trade. Nonetheless, sentiment has deteriorated from a high level, which, together with the fact that the trend for domestic demand remains basically upwards, suggests that the economy will not change direction. In any case, the prospects for the construction in-

dustry remain favourable, and consumer sentiment has, so far, been undented by the increased economic risks.

Germany's public finances remain in comparatively good shape, and the very high debt ratio is starting to come down. Supported by generally favourable underlying conditions such as very advantageous funding conditions, small surpluses were recorded in both 2012 and 2013 and a roughly balanced government budget is expected for 2014 and 2015. Interest spending could drop further due not only to favourable cyclical factors, but also to lower average interest rates and reduced debt. By contrast, various fiscal measures are weighing on public finances. For instance, additional funds are earmarked for transport infrastructure, childcare, education and research as well as, notably, pensions. Nevertheless, the legal provisions limiting the amount of reserves that the statutory pension insurance scheme is allowed to hold could lead to the pension contribution rate being cut, which would accelerate the foreseeable reduction of the scheme's financial reserves.

Public finances

The Federal Finance Ministry's latest medium-term projection forecasts general government surpluses in a magnitude of ½% of GDP from 2016 onwards. The debt ratio is to be reduced rapidly, albeit not enough to bring it below the 60% limit by the end of 2018 (65%). It is basically a welcome development that a structural surplus of up to ½% of GDP is forecast, providing a clear safety margin vis-à-vis the medium-term European budget objective. However, the cyclical adjustment method used appears to paint too rosy a picture of the structural budgetary position and consequently the safety margin. Moreover, the structurally comparatively stable balance can be attributed in part to lower interest expenditure, which masks a slight easing of the fiscal stance. It is sometimes recommended that Germany pursue a significantly more expansionary fiscal policy, particularly by increasing government investment on an unfunded basis, and that it should

exploit deficit ceilings more fully. The reasoning is that this would, *inter alia*, strengthen growth potential. While basically laudable, this objective could, however, readily be achieved by initiating structural shifts or changing policy priorities without further easing the budgetary stance.

With regard to its pattern of expenditure, Germany's Federal government has, to date, clearly focused additional spending on pension benefits, while devoting considerably fewer additional funds to government investment, for instance. This appears counterproductive in terms of strengthening growth potential. Given the extremely favourable conditions for public finances and the ongoing budgetary risks, it would, in fact, be advisable to pursue a more ambitious budgetary policy rather than loosening fiscal policy. This would allow the debt ratio to be brought below the 60% threshold more quickly, helping to lessen the impact, in particu-

lar, of the demographic challenges that lie ahead. Furthermore, it would appear advisable to make the most of the currently favourable auspices and push ahead more energetically with the budget consolidation required at various levels of government. The Federal government has, however, noticeably lowered last year's medium-term fiscal targets and forecasts a deterioration in the structural budget situation for next year despite a balanced budget. Given that conditions are very favourable for the Federal budget, there is much to be said for planning on maintaining clear safety margins vis-à-vis the strict national deficit ceilings, not least as procyclical corrections may otherwise be necessary if the situation takes a turn for the worse. Experience shows the importance of prudent budgetary policy in good times in order to have scope for manoeuvre if the environment deteriorates. This is equally true of Germany as the euro area's stability anchor.