

| The current economic situation in Germany

Overview

German economy displays upward underlying momentum

Global economy

The global economy progressively improved during 2013 after getting off to a slow start. In the final quarter of 2013, the world economy probably just about maintained the moderate pace of growth it had generated up to then. This was due mainly to the strong performance of major industrial countries. In the United States and the United Kingdom, for instance, real gross domestic product (GDP) in the fourth quarter grew as robustly as in the third quarter. The euro area's aggregate output expanded slightly more strongly in the fourth quarter than in the previous three months. The emerging markets as a whole apparently did not quite match the third-quarter growth rate in the final months of 2013. However, the financial market turbulence that some emerging markets encountered in the summer has so far had no serious impact on the real sector of the economies concerned.

Global growth momentum could strengthen somewhat during the current year. A key contributory factor is that fiscal policy in the industrial countries is likely to have less of a dampening effect than last year, while the overall monetary policy stance remains very expansionary, despite the US Federal Reserve's gradual tapering of its asset purchases. Mixed economic signals emanated from the emerging market economies at the beginning of 2014. While the expansion of the Chinese economy still appears to be on a relatively smooth path, tensions on the financial markets have deepened in several countries. Many central banks in the countries affected have responded to the, at times, considerable capital outflows and currency depreciation by pushing up interest rates, in some instances substantially. Although this may dampen overall economic growth in the countries concerned, their small global weight

means that this is unlikely to hamper the global economic recovery to a marked degree.

In the fourth quarter of 2013, the international financial markets were buoyed by the brightening economic outlook in the United States, which prompted a decision by the US Federal Reserve (Fed) in late December to gradually scale back its quantitative easing programme. The economic recovery in the euro area likewise picked up somewhat. In the wake of these developments, bond yields in the most important economies rose considerably towards the end of 2013 and stock markets recorded further share price gains. Bank shares outperformed the market, profiting notably in Europe *inter alia* from an easing of tensions in the government bond markets of the periphery states.

Financial markets

At the start of this year, the global financial markets encountered renewed uncertainty for a time. This was triggered by the aforementioned developments in several emerging market economies. A reassessment of the risk-return trade-off in the context of the Fed's tapering of its quantitative easing programme was a key factor in these developments, underpinned by domestic macroeconomic imbalances and, in some countries, rising political tensions. In the industrial nations, growing risk aversion eroded share prices and caused a flight into liquid government bonds. Nonetheless, equity valuations remain comparatively high on both sides of the Atlantic. On the foreign exchange markets, the yen, in particular, appreciated at the start of 2014. The euro has traded in a relatively narrow band since the beginning of the fourth quarter of 2013. It posted slight net gains on a weighted average against the currencies of 20 major trading partners.

After lowering the interest rate on its main refinancing operations by another 25 basis points to 0.25% at its meeting of 7 November 2013, the Governing Council of the ECB left the key

Monetary policy

interest rates unchanged at its subsequent meetings. Since then interest rates on the marginal lending facility and main refinancing operations have stood at 0.75% and 0.25%, respectively, while the rate of remuneration applying to the deposit facility has been 0.00% since mid-July 2012.

The Governing Council of the ECB also confirmed its forward guidance for interest rates, which it first communicated in July of last year. It expressly confirmed its intention of leaving the key interest rates at present or lower levels for an extended period of time and underscored its determination to maintain an accommodative monetary policy stance for as long as necessary.

These decisions were based on the view that the accommodative monetary policy stance will continue to assist the gradual economic recovery in the euro area and that the euro area will experience a prolonged period of low inflation given low price pressure and subdued monetary dynamics. With an economic recovery expected, inflation is likely, however, to rise to rates below, but close to, 2% again later on in the recovery process.

The downward trend in monetary growth since the beginning of 2013 continued in the reporting period. Balance sheet cleansing in the banking sector was a major determinant of monetary developments. Besides year-end effects, this was influenced mainly by the forthcoming comprehensive balance sheet assessment ahead of the launch of the Single Supervisory Mechanism (SSM). This was reflected particularly in an accelerated reduction in securitised lending. The decline in lending to the private sector also continued, although it slowed perceptibly in view of the better economic developments. Monetary growth was again underpinned by inflows of funds from outside the euro area, which were once more significantly larger than in the preceding quarters, fuelled by ongoing current account sur-

pluses and higher demand for euro-area securities.

According to the Federal Statistical Office's flash estimate, Germany's economic output grew by 0.4% in the final quarter of 2013 compared with the preceding three months after adjustment for seasonal and calendar factors. As before, the rise in aggregate output was bolstered by domestic demand. Private consumption is benefiting from a favourable consumer climate and continues to show a rising underlying dynamic. While the surge in housing investment abated, this can be seen as more of a normalisation than a trend deceleration given the weather-related and catch-up effects during the earlier part of 2013. Foreign demand provided a distinct boost for the first time in over a year, benefiting industry in particular. Consequently, investment in some machinery and equipment components and in new buildings also increased. At year-end, aggregate output showed slightly stronger growth than potential output, and capacity utilisation was high.

German economy

In contrast to the reduction in lending in the euro area as a whole, credit business in Germany remained on the positive path begun in the previous quarter. This was mainly due to marked growth in securitised lending to general government and a noticeable increase in loans to the private sector. The latter still consisted primarily of loans to households, which, for several quarters, have largely been fuelled by housing mortgages due, *inter alia*, to the fact that financing conditions remain favourable.

However, loans to domestic non-financial corporations also developed increasingly positively after contracting during the previous quarters, in some cases significantly. The distinct increase in lending in December marked the end of the downward tendency evident in this credit segment since late 2012. This is most likely due to the fact that German enterprises have slowly

upped their investment activities since the third quarter of 2013.

German firms' foreign business picked up again in the fourth quarter of 2013 in the wake of the economic revival in the industrial countries. Although exports to euro-area countries only increased slightly because the economic upturn there has, until now, been very subdued, exports to non-euro-area countries expanded considerably. During the reporting period, exports of intermediate goods, in particular, showed an increase. Following the recovery in foreign trade and the ongoing adjustment processes, imports from the euro area, above all, rose markedly. It is striking that Portugal and Spain, two of the euro-area countries strongly affected by the crisis, have significantly increased their exports to Germany.

The German labour market situation is still characterised by continuous employment growth and persistently high levels of immigration. Over the course of the fourth quarter, unemployment initially rose before falling a little, owing mainly to favourable weather conditions. Employment subject to social security contributions continued to follow the upward tendency of the previous quarters. However, the sectoral base of the increase in employment expanded to include areas which are particularly sensitive to the business cycle, such as manufacturing and temporary employment. The leading indicators for the labour market suggest that, over the next few months, the upward employment trend will strengthen and that unemployment could ease slightly. However, the DIHK survey from the beginning of 2014, while agreeing that the outlook for employment is generally positive, also points to the risks stemming from the shortage of skilled workers and the planned introduction of a minimum wage.

In 2013, collective wage bargaining was typified by extended employment contracts with a graduated increase in basic rates of pay. Negotiations proved difficult in some sectors, which

led to delays in the introduction of pay increases. According to Bundesbank calculations, collectively agreed wages therefore rose by only 2.4% on average during 2013. At 5½% on average, the trade unions' wage demands to date for the 2014 pay round are only slightly lower than in 2013, while demands for public sector employees are somewhat higher still. This implies similarly sizeable pay rises to those agreed for 2013. The first major pay agreement of the year in the chemical industry is in keeping with this picture. Therefore, with the drop-out of last year's one-off retarding effect, collectively agreed wages are expected to rise strongly on the whole. With regard to the planned introduction of a statutory minimum wage of €8.50 per hour from January 2015, special agreements for the lowest wage groups might be introduced in some industries in order to make use of the transitional arrangements up to 2017 announced in the coalition agreement.

The fall in prices at the upstream stages of the economy observed during the course of 2013 largely came to a halt in the final quarter. On a quarterly average, seasonally adjusted import prices fell only slightly on the previous quarter. External industrial producer prices remained unchanged, while domestic industrial producer prices pointed slightly upwards. As a result, the terms of trade improved again, reaching their highest level in three years. Despite the unusually high utilisation of equipment in the main construction sector, the increase in prices for construction work remained within fairly narrow bounds. According to calculations made by the Association of German Pfandbrief Banks (Verband deutscher Pfandbriefbanken), residential property prices grew by an annual rate of 2.4% in the final quarter of 2013. Consumer price inflation weakened significantly in the final quarter of 2013 on the back of the euro's appreciation. The flatter price trend was mainly due to energy prices. Furthermore, the extremely sharp rise in food prices in the third quarter, caused by inclement weather conditions, decelerated distinctly. Year-on-year infla-

tion fell slightly to 1.3% according to both the Consumer Price Index (CPI) and the Harmonised Index of Consumer Prices (HICP).

The underlying growth dynamics in the German economy are likely to have strengthened distinctly in the latter part of 2013 and early part of 2014. This is suggested by the virtually continuous improvement in firms' and households' assessments of the current situation and outlook. However, the improved situation is unlikely to be fully reflected in GDP growth rates until after the turn of the year, when the higher inflow of orders has an impact on output. Key factors behind the acceleration in economic growth are increased stimuli from external demand against the background of consistently robust domestic activity. Although the debt crisis continues to impose some strains within the euro area, there are nonetheless growing signs that the euro-area economy is gradually recovering, and other advanced economies should likewise pick up speed. The difficulties facing a number of emerging market countries are likely to be of lesser importance by comparison. With industrial capacity utilisation levels now largely at normal levels and financing conditions still favourable, the steady improvement in economic prospects means that the key prerequisites are now in place for firms to overcome their reluctance to invest and for domestic demand to surge further on the basis of increasing purchases of machinery and equipment and of industrial and commercial buildings. The DIHK survey carried out at the beginning of 2014 suggests, however, that growth could face impediments from economic policy factors relating to energy and the labour market alongside a growing shortage of skilled workers. According to surveys by the consumer research institution, Gesellschaft für Konsumforschung (GfK), the already exceptionally buoyant level of consumer confidence has improved still further since the fourth quarter, chiefly on the back of higher economic and income expectations. The clear upturn in the already very pronounced propensity to purchase is consistent with this view. Against this

backdrop, wage growth in the coming quarters can be expected to feed through via private consumption and bolster the domestic component of growth. This is likely to give a distinct impetus to imports and open up additional sales opportunities for enterprises from European partner countries, which in turn will ease the adjustment processes in the euro area.

General government ran a budget deficit of -0.1% of GDP last year, which means that the budget has been close to balance for two years in succession (2012: surplus of +0.1% of GDP). While cyclical factors had a marked positive impact on the budget balance in 2012, their effect was largely neutral last year. The structural fiscal balance improved somewhat thanks to lower refunding costs and buoyant labour market conditions, which meant that it, too, was close to balance. The various levels of government showed different developments. The high surplus run up previously by the social security funds contracted significantly, while central, state and local government saw their existing deficit diminish markedly, not least owing to a shifting of financial burdens from the central government budget to the social security funds. The drop in the debt ratio to 78.4% at the end of the third quarter of 2013 (end-2012: 81.0%) owed something to nominal GDP growth in the ratio's denominator but was chiefly attributable to portfolio sales at government-owned bad banks. These factors clearly outweighed the increases in debt brought about by further payments related to the euro-area assistance mechanisms.

Public finances

The fiscal balance is expected to barely change in 2014 from the current perspective. Cyclical factors and, among other things, an easing of the debt servicing burden could improve public finances slightly, but otherwise the structural position could well remain largely static. The additional expenditures planned by the coalition government might turn out to be relatively small, not least because the benefit increases by the statutory pension insurance scheme are not scheduled to become effective until mid-

year, and the announced increase in government infrastructure investment will probably only come about with a time lag. The debt ratio looks set to diminish further this year but, at 75%, it is still well in excess of the ceiling laid down in the Maastricht Treaty.

In order to implement the Fiscal Compact with its European partner countries, Germany once again explicitly enshrined its medium-term target of a general government structural deficit ratio of no more than 0.5% in national legislation. However, in light of the high debt ratio and the burdens associated with demographic change, there is much to be said for targeting budget surpluses in the financial plans, rather than exploiting this deficit ceiling to the full. It would be sensible, not least in view of the national budget rules, to make the most of the current exceptionally favourable conditions and swiftly reduce the structural deficits still remaining at the central, state and local government levels and to build up safety margins below the strict long-term national upper limits. In this setting, it would be appropriate for new fiscal policy measures, such as the planned additional expenditure in the areas of public infrastructure and education, to be neutral in budgetary terms. A key challenge for the social security funds is to maintain their sustainability in the face of demographic change. Close attention needs to be paid, too, to the substantial burden that is already weighing on younger generations. With demographic factors foreseeably diminishing the labour force, extending the working life will play an important role in this

regard. By contrast, any attempt to shorten the working life would only tend to aggravate the problem still further.

Central government narrowed its budget deficit slightly in 2013. Whereas the core budget's structural deficit distinctly overshoot the permanent upper limit of 0.35% of GDP that will apply from 2016, the structural deficit already complied with this ceiling when off-budget entities are included. This owed much to the outturn of the flood assistance fund, which ran a high surplus owing to the advance funding received from the central government budget last year and only very limited outflows. Generally speaking, it would be consistent to include the structural balances of off-budget entities in the assessment in line with the European fiscal framework procedure. That is to say, the deficits that the flood assistance fund is expected to accumulate should also be accounted for in 2014 and in the coming years. What this ultimately means is that the target mapped out in the coalition agreement of achieving a structurally balanced budget this year will only be within reach if the core budget runs a surplus to compensate for this. Central government's multi-year financial planning had originally projected increasing surpluses for the years thereafter. These funds ought to be used to pay down debt to make allowance for the rising demographic burdens. In light of all this, there appears to be very limited scope for unfunded expenditure compared to earlier budget and financial plans.