

5. GERMANY

Export-led rebound eventually turning into broad-based recovery

Sizeable fiscal stimulus in response to slump in exports and investment

Due to its large export-oriented manufacturing sector and its specialisation in investment goods, Germany was more exposed to the global trade shock triggered by the financial crisis than most other economies. As a result, the contraction of real GDP in the second half of 2008 and the first quarter of 2009 was among the sharpest of all industrialised countries, fuelled by an unprecedented slump in exports and investment activity. However, thanks to a rebound in exports and a remarkably resilient labour market – helped by short-time work measures – the German economy bounced back earlier than expected, with positive quarterly real GDP growth returning already in the second quarter of 2009.

In response to the crisis, the German government adopted a set of measures to stabilise the banking sector, including the provision of guarantees of up to EUR 400 bn (around 16% of GDP) via a Financial Market Stabilisation Fund. An additional EUR 80 bn (around 3% of GDP) was earmarked for capital injections and purchasing of troubled assets. A "bad bank" scheme was introduced to remove impaired assets from bank balance sheets. Moreover, apart from letting the automatic stabilisers fully operate, Germany also introduced a welcomed sizeable fiscal stimulus of around 1¾% of GDP on average in 2009 and 2010. Stimulus measures were aimed at providing relief to households and enterprises, increasing public infrastructure investment and stabilising the labour market.

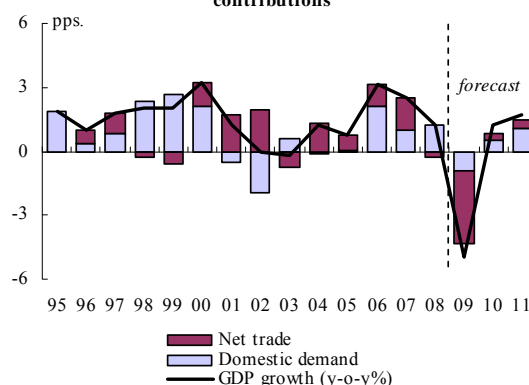
Early rebound followed by gradual recovery, gathering pace in 2011

The surprisingly swift rebound of the German economy is set to accelerate further in the third quarter on the back of a pronounced turnaround in exports, the reversal of the inventory cycle and the start of public infrastructure projects. Rising unemployment and the expiry of the car scrappage scheme are, however, likely to entail some setback as from the end of this year, with activity remaining subdued especially in the first half of 2010 and gathering pace mainly during 2011. Real GDP is thus projected to grow by around 1¼% in 2010 and 1¾% in 2011.

Private consumption has remained remarkably resilient during the economic downturn thanks to low inflation, relatively stable employment, the lagged effect of higher wage growth prior to the crisis, and policy-induced relief measures. The stabilising role of private consumption will, however, come to an end in the second half of 2009 when unemployment and inflation are expected to pick up. The temporary decline of the household saving rate will also most likely be reversed with the phasing out of the car scrappage premium. Private consumption is therefore expected to hold back growth for most of 2010 despite the implementation of additional tax relief measures.

In view of extremely low capacity utilisation rates and tightened financing conditions, private investment is likely to remain weak throughout 2010. However, with the recovery gathering pace, the need in a number of sectors to adjust to structural shifts in global demand should lead to a marked increase in capital formation from 2011. Higher public investment, mainly in the construction sector, will at least partly compensate for the shortfall in private investment demand, especially in 2010. In contrast, the withdrawal of the stimulus is set to have a dampening effect during 2011, when private investment is expected to accelerate.

Graph II.5.1: Germany - GDP growth and contributions



Given the production structure of the German economy, an impulse from external demand will be crucial to kick-start the economic recovery. The rebound in exports already started in spring 2009, boosted by global stimulus measures and mainly

from emerging market economies. The sustainability of this recovery still needs to be confirmed. The expiry of stimulus measures and the continued deleveraging of the private sector in a number of countries are likely to weigh on export growth, especially in 2010. Nevertheless, with its cost competitiveness largely intact and its comparative advantage in supplying investment goods, Germany should be well placed to benefit from the recovery especially in emerging market economies and should be able to reverse the loss of market shares encountered during the crisis. Therefore, a moderate but steady recovery in exports is projected for 2010, gathering momentum in 2011 and sustaining a relatively broad-based post-crisis recovery in the economy. With domestic demand projected to respond more vigorously to the increase in economic activity than in the past, import growth should also pick up markedly, especially in 2011. The contribution of net exports to growth is projected to remain moderate compared with the pre-crisis situation, reflecting a more balanced growth composition.

Given the sharp contraction in economic activity, inflationary pressures are projected to remain subdued throughout the forecast period. Thanks to lower energy prices and associated favourable base effects, annual HICP inflation has decelerated sharply during 2009 and has turned temporarily negative. With the base effects gradually petering out by the end of the year and energy prices rising again, HICP inflation is expected to edge up from 0.3% on average in 2009 to 0.8% in 2010. With the recovery gaining ground and the negative output gap gradually starting to close, a slight pick-up in inflation is projected for 2011.

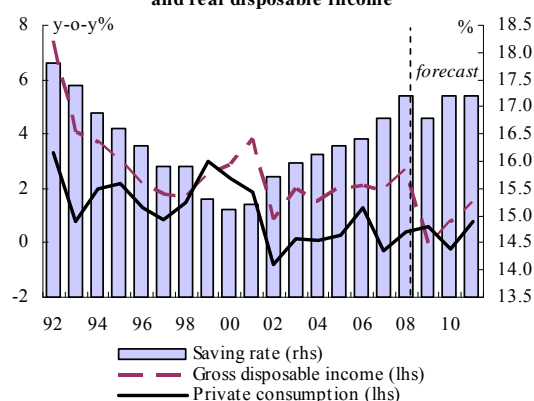
This forecast is subject to a number of risk factors. Firstly, a sharper-than-expected increase in unemployment could lead to a stronger contraction of private consumption in 2010 and a more moderate recovery in 2011. Secondly, bank balance sheets have been considerably weakened because of the high exposure to toxic assets, concentrated in some commercial banks and *Landesbanken*. This could impair the capacity of the banking sector to provide finance to the corporate sector, thereby hampering a recovery in investment demand. On the other hand, following the sharp and sudden contraction of economic activity in 2008/09, a normalisation of the situation could entail a more buoyant rebound than currently envisaged. In line with strong improvements in business and consumer confidence indicators, the

internal dynamics of the recovery could turn out stronger than currently expected and together with a stronger labour market counterbalance the dampening factors identified above.

Internal adjustments in the 2000s laid the basis for more balanced growth

The medium-term outlook is influenced by the fact that Germany went through a decade of profound internal adjustments prior to the crisis. Following the post-unification boom with above-average wage and price inflation, a prolonged period of wage moderation helped to restore price competitiveness. The household saving rate, which had dropped after unification, returned to its longer-term average. Companies used increasing profit margins to strengthen their balance sheets. This came primarily at the expense of domestic investment, as the establishment of the euro area, enlargement of the EU, globalisation and closer financial integration triggered higher capital exports from Germany. In the public sector, fiscal consolidation brought the general government budget back into balance by 2007, from a deficit of 3.8% of GDP in 2004. A series of labour market reforms – in combination with wage restraint – helped tackle the high level of structural unemployment.

Graph II.5.2: Germany - Private consumption and real disposable income



As a consequence, domestic demand remained sluggish for almost a decade with weak private investment growth, fiscal tightening and lacklustre private consumption due to stagnant real disposable incomes and a rising saving rate. The mirror image of these internal adjustments was a growth pattern that was tilted towards exports, fuelled by improved competitiveness and ebullient demand from countries experiencing asset bubbles and strong capital inflows.

At the onset of the crisis, the process of internal adjustment had effectively come to an end. Economic growth picked up strongly as from 2006, with private investment increasing sharply. Thanks to past wage moderation and labour market reforms, unemployment decreased markedly and employment growth accelerated, spilling over into higher wage growth. These wage gains did not immediately lead to stronger private consumption growth, as the 2007 increase in VAT and higher energy prices in 2008 reduced real disposable incomes. However, the resilience of private consumption during the downturn is clearly linked to the improved labour market situation and past income gains. As a result, Germany's growth composition has become considerably more balanced already during the crisis, with the current account surplus almost halving from close to 8% of GDP in 2007 to 4% of GDP in 2009. Moreover, after the protracted adjustment period in the 2000s, Germany's medium-term growth outlook is no longer hampered by major domestic imbalances.

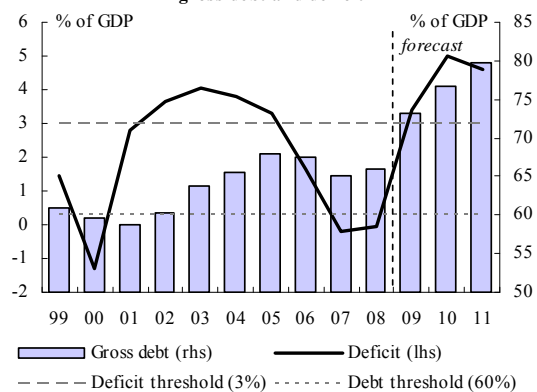
Labour market adjustments ahead

Contrary to most other countries, the economic crisis so far had only a very limited impact on the German labour market. The unemployment rate has increased by less than 1 pp. since October 2008 and employment initially kept growing even during the downturn. A number of factors have been responsible for this. First, companies took advantage of the increased use of flexible working time arrangements, cushioning the impact of the crisis by reducing overtime work and depleting working time accounts. Second, they resorted on a large scale to short-time work, especially since the German stimulus package increased the maximum duration of short-time work to 24 months and offered additional financial incentives to companies to use the scheme. Third, given the difficulties in hiring qualified workers during the 2007/08 upswing, many companies proved reluctant to lay off workers prematurely. Fourth, past labour market reforms and wage moderation have arguably reduced structural unemployment in Germany. The adjustment to this lower level of unemployment was not yet fully completed at the beginning of the crisis.

Nevertheless, the sharp contraction in economic activity combined with relatively stable employment levels has led to a sharp drop in productivity and an accompanying hike in nominal unit labour costs. This is hardly sustainable and

companies will inevitably start to adjust their employment levels. Therefore, unemployment is set to increase noticeably well into 2011, albeit to a much lesser degree than envisaged in the spring forecast. In this context, the challenge is to prevent the cyclical increase in unemployment from turning once again into higher structural unemployment. Thus, strengthening the capacity of the labour market to generate jobs during the upswing will be critical for sustaining the recovery of private consumption.

Graph II.5.3: Germany - General government gross debt and deficit



Overcoming the crisis requires sustained rise in productivity...

For Germany, the unwinding of global imbalances after the crisis implies a number of challenges. With the process of deleveraging in full swing in countries with high current account deficits, the recovery of the German economy relies to a larger extent on domestic factors than in the past. This entails a number of structural changes, including a certain re-allocation of resources between sectors, which depends crucially on flexible product and factor markets. Particularly important for boosting potential output and sustaining high income growth would be a reversal of the observed trend of declining productivity growth. At the same time, the growth and employment opportunities in the services sector still appear to be largely untapped in Germany.

...and a stable banking sector

The German banking sector has come under severe strain from the financial and economic crisis. The capital base of financial institutions has been significantly weakened by losses and write-downs from investments in structured assets. Moreover, bank balance sheets could be burdened in the

future by further rating downgrades of borrowers and by a surge in insolvencies and credit defaults. This may impair the ability of banks to provide financing to the corporate and household sector. A successful economic recovery will therefore crucially depend on the stabilisation of the banking sector and securing access to finance by the corporate sector.

Sound fiscal positions allowed budgetary expansion

Benefiting from the balanced budgetary position in 2008, the German authorities adopted a wide range of measures to counter the economic downturn, including measures to stabilise financial markets and a sizeable fiscal stimulus. At the same time, automatic stabilisers were allowed to operate fully (around 3% of GDP in 2009), including a massive increase in short-time work benefits.

Consequently, the general government balance fell to a deficit of 3½% of GDP in 2009. The deficit is projected to increase further in 2010 (5% of GDP) mainly on the back of substantial tax losses and measures in support of the economy. It is set to diminish in 2011 to 4½% of GDP as a result of the withdrawal of certain stimulus measures and with additional investment leveling off. Debt is projected to increase from almost 66% of GDP in

2008 to close to 80% of GDP in 2011, fuelled by increasing deficits and financial market stabilisation measures.

The budgetary situation after the recession will be complicated by the implicit shortfall in tax revenues and significantly higher expenditure. Uncertainties related to the strength of the recovery also pose a risk to public finances. At the same time, the new fiscal rule anchored in the German constitution, which prescribes a structural deficit ceiling of 0.35% of GDP for the Federal government as of 2016 – and a structurally balanced budget for the *Länder* as of 2020 – requires retrenchment from 2011 onwards with an additional structural effort estimated by the German authorities in the draft medium-term financial plan (2009-2013) of 0.2% of GDP annually.

The main challenge will be to reconcile the necessary fiscal consolidation with the strengthening of the economy's long-term growth potential. A careful review of government expenditure, including the fiscal stimulus administered, the removal of subsidies potentially hindering structural adjustment, and safeguarding growth-enhancing spending should be conducive to higher potential growth.

Table II.5.1:

Main features of country forecast - GERMANY

	2008			Annual percentage change						
	bn Euro	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	2495.8	100.0		1.4	3.2	2.5	1.3	-5.0	1.2	1.7
Private consumption	1409.7	56.5		1.3	1.3	-0.3	0.4	0.6	-0.2	0.8
Public consumption	451.8	18.1		1.3	1.0	1.7	2.1	2.3	1.5	0.8
Gross fixed capital formation	474.7	19.0		0.5	7.8	5.0	3.1	-8.9	2.1	3.9
of which : equipment	201.8	8.1		1.4	11.1	6.9	5.3	-20.8	1.0	7.0
Exports (goods and services)	1179.4	47.3		6.0	13.0	7.5	2.9	-15.4	2.6	4.7
Imports (goods and services)	1023.7	41.0		5.0	11.9	4.8	4.3	-9.5	2.0	4.3
GNI (GDP deflator)	2537.0	101.7		1.4	4.1	2.4	0.9	-5.0	0.8	1.6
Contribution to GDP growth :										
Domestic demand				1.2	2.3	1.0	1.2	-0.9	0.6	1.4
Stockbuilding				-0.2	-0.2	-0.1	0.5	-0.7	0.3	0.0
Foreign balance				0.4	1.1	1.5	-0.3	-3.4	0.3	0.3
Employment				-0.8	0.2	1.5	1.4	-0.5	-1.9	-0.3
Unemployment rate (a)				8.5	9.8	8.4	7.3	7.7	9.2	9.3
Compensation of employees/f.t.e.				3.2	1.5	1.1	2.0	-0.2	1.3	1.6
Unit labour costs whole economy				1.0	-1.4	0.2	2.2	4.6	-1.8	-0.4
Real unit labour costs				-0.3	-1.9	-1.7	0.7	3.6	-2.4	-0.9
Savings rate of households (b)				-	-	16.8	17.2	16.9	17.2	17.2
GDP deflator				1.4	0.5	1.9	1.5	0.9	0.6	0.5
Harmonised index of consumer prices				-	1.8	2.3	2.8	0.3	0.8	1.0
Terms of trade of goods				0.5	-1.8	0.6	-1.1	3.4	-0.4	-0.7
Trade balance (c)				4.0	7.0	8.2	7.3	4.7	4.7	4.7
Current account balance (c)				0.3	6.6	7.9	6.6	4.0	3.8	3.7
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				0.3	6.6	7.9	6.6	4.0	3.8	3.7
General government balance (c)				-2.7	-1.6	0.2	0.0	-3.4	-5.0	-4.6
Cyclically-adjusted budget balance (c)				-2.6	-2.2	-1.2	-1.5	-1.9	-3.6	-3.5
Structural budget balance (c)				-	-2.2	-1.2	-1.1	-1.9	-3.6	-3.5
General government gross debt (c)				57.6	67.6	65.0	65.9	73.1	76.7	79.7

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.