Appendix A.
Germany: the chickens come home to roost

From 2009Q3, the German economy rebounded quickly and strongly from the global economic crisis. It benefited from strong emerging market demand for investment goods and from the competitive advantage built up within the euro area during the pre-crisis period. The use of short-time working schemes and annualised working time accounts encouraged labour hoarding during the crisis and maintained domestic demand. Last but not least, as the euro crisis deepened the country benefited from its safe haven status, driving down interest rates and easing the burden on public budgets. In 2011 the German economy grew at an annual average rate of 3.0%. This above-trend growth sufficed to-again on annual averages-raise employment by 1.4% and cut unemployment by more than a quarter of a million.

These seemingly positive developments came in spite of a restrictive fiscal stance in Germany-a discretionary fiscal impulse of around -0.5% of GDP, largely because of the termination of previous stimulus measures-and the increasing turn to fiscal austerity across the whole of Europe. They quickly proved illusionary, however. The positive annual averages largely reflected the very strong first quarter (1.2% q-o-q) and the carry-over from 2010. Growth rates came down in subsequent quarters and actually went negative in the fourth quarter of 2011. Particularly striking was the decline in investment towards the end of the year: in the face of declining confidence about the outcome of the euro crisis and as the prospect of widespread and lasting austerity led to downward revisions of sales expectations, firms increasingly shelved planned investment projects.

In 2012 real GDP growth during the first three quarters totaled a meagre 0.8%. Even this was due to a positive contribution from net exports that compensated for weak domestic demand (especially declining investment). A range of indicators clearly suggest that the slowdown will initially accelerate: a decline in GDP is expected for the fourth quarter. Capacity utilisation in German industry declined in the third quarter of 2012 for the fourth consecutive quarter. Industrial output and sales as well as incoming orders are declining. The positive labour market development has come to a halt. The IMK's recession indicator has been rising steadily this year: in November it put the chances of Germany entering a recession-defined as a substantial fall in industrial output-in the coming months at close to 60%.

In short, the period during which the German economy has managed to stay aloof from the crisis in much of the remainder of the euro area has come to an end. An annual average growth rate of 0.8% is expected for the current year and with a declining quarterly trend. A slow and uncertain recovery is expected for 2013. GDP is expected to increase by 0.6% on annual averages, slightly more strongly (1%) over the course of the year. Even this forecast is conditional on an easing of the euro area crisis, and specifically on the ECB following up on its recent decision to purchase unlimited amounts of government bonds to the extent required to ensure that the monetary transmission mechanism in crisis-hit countries is restored. Even if this is achieved, euro area developments will continue to be weighed down with excessive fiscal austerity, not least as a condition for the provision of ECB support.

Factors conducive to the forecast slow recovery in the course of next year include an improvement in monetary conditions: the lagged effect of the depreciation of the euro in the current year and an expected further slight decline expected in 2013, together with slightly lower short and long-term interest rates. Even if capacity utilisation will remain low, after an extended period of negative investment in machinery and equipment, some recovery of fixed capital formation, at least for replacement purposes, is expected in the course of the year. German fiscal policy is expected to be neutral in 2013 following this year's restrictive stance: consolidation measures will continue but will be offset by some stimulatory measures recently decided by the German government, in part with a view to federal elections late next year. The most important measure is a reduction of the pension contribution rate from 19.6% to 19%.

Real private consumption growth is expected to continue to expand at a moderate pace (2012: 1%, 2013: 0.9%). Support next year comes from the fall in the inflation rate and the reduction in pension contributions. On the other hand nominal gross wage and salary growth is expected to be considerably lower next year (2.1%) than in the current year (3.6%). Lower inflation and nominal wage growth is undesirable from the point of view of redressing current account imbalances. Despite talk of a housing boom in Germany in the light of low interest rates and a desire by investors for higher returns in supposedly safe "German concrete", overall construction activity declined marginally (0.4%) in the course of the current year and will do no more than make good this loss in 2013: while private-household construction activity is indeed robust it is offset by the decline in public and commercial construction in 2012, with only a stabilisation expected next year.

This year the German labour market has been characterised by a seemingly paradoxical increase in both employment and unemployment. Apart from a declining intensity of labour market policy measures, the explanation lies in increased inward migration, notably from eastern Europe and increasingly also from the crisis-hit euro area countries. Already the deteriorating economic situation is making its effect felt on the labour market. Employment is set to decline once more, although only marginally (-20 000 persons). The unemployment rate (ILO definition) will rise slightly from 5.3% to 5.4%. Labour market developments will depend importantly on the extent to which German companies resort to external flexibility or, as in the wake of the 2008 crisis, internal flexibility measures. Already there is evidence of declining overtime and accumulated working hours in time banks. The stocks of the latter are considerably lower than they were prior to the Great Recession, however, so that the scope for internal flexibility appears limited.

Regarding economic policy, from a European perspective the cut in the pension contribution rate is a double-edged sword. The positive effect on other countries via German domestic demand will be partly offset by the further increase in German competitiveness implied by the lower labour costs. This runs counter to the need to correct current account imbalances within the euro area. Clearly, given the country's trade surpluses and the need to stimulate the European economy, expansionary fiscal measures would be in order. There are tough legal-political constraints, however, given the debt brake recently enshrined in the German constitution—and seen as a model for the whole of Europe. Given these constraints an approach based on the concept of the balanced budget multiplier should be adopted: growth-promoting public investment in areas such as education, infrastructure and childcare should be expanded, funded by higher taxes on items and individuals where the negative impact on demand is lowest (*i.e.* taxes on high incomes and capital).

A key policy need is to bolster German companies' ability to react to the downturn with internal rather than external flexibility measures. Specifically the conditions under the short-time working scheme (*Kurzarbeit*) should once again be made as attractive to companies and workers as they were in the recent recession.

Table A. OFCE, ECLM, IMK macroeconomic forecasts

Germany

%	2010	2011	2012	2013
GDP	4.2	3.0	0.8	0.6
Private consumption	0.9	1.7	1.0	0.9
Investment	5.9	6.2	-2.0	0.9
Public consumption	1.7	1.0	1.1	0.9
Exports	13.7	7.8	3.6	3.1
Imports	11.1	7.4	2.5	4.5
Contribution to growth				
Internal demand	2.5	2.4	-0.1	0.9
External trade	1.7	0.6	0.7	-0.4
Inventories	0.6	0.2	-0.3	0.2
Unemployment rate	6.8	5.7	5.3	5.4
Inflation	1.1	2.3	1.9	1.5
Public deficit	-4.1	-0.8	-0.2	-0.3
Fiscal impulse	1.5	-0.9	-0.5	0.0
Public debt % GDP	82.5	80.5	82.7	81.6
Current account % GDP	6.1	5.7	6.0	5.2
Unit labour costs	-1.5	1.2	2.7	1.4

Source: National accounts, OFCE, ECLM, IMK.