

15 October 2009

Joint Economic Forecast Project Group

Hesitant Recovery, Growing Government Indebtedness

Joint Economic Forecast Autumn 2009

Summary

Members of the Joint Economic Forecast project group:

- **Ifo Institute for Economic Research at the University of Munich** [www.ifo.de]
in co-operation with:
Swiss Institute of Business Cycle Research (KOF), ETH Zurich
[www.kof.ethz.ch]
- **Kiel Institute for the World Economy** [www.ifw-kiel.de]
- **Halle Institute for Economic Research (IWH)** [www.iwh-halle.de]
in co-operation with:
Macroeconomic Policy Institute (IMK), Hans Böckler Foundation [www.imk-boeckler.de]
Austrian Institute of Economic Research (WIFO) [www.wifo.ac.at]
- **RWI Essen** [www.rwi-essen.de]
for the medium-term forecast in co-operation with:
Institute for Advanced Studies, Vienna [www.ihs.ac.at]

Summary: Hesitant Recovery, Growing Government Indebtedness

In autumn 2009 the low point of the worst economic recession since the Second World War seems to be behind us. There are many indicators for a recovery of economic activity. The situation on the world financial markets has improved considerably, confidence indicators are pointed upwards, new orders received have increased and rises in production are widespread. World trade, which had declined into the early months of the year, increased clearly in the summer. In a number of emerging economies, especially in the Asian region, aggregate economic output was clearly expanding already in the second quarter.

A major contributor to the turnaround was the stabilisation on the financial markets that occurred in the early months of the year as a result of massive intervention of central banks as well as the announcement of state support programmes and guarantees for the financial sector. In the meantime, investors' risk propensity has grown strongly, as indicated by the increase in prices on the international stock markets but also by the decrease in risk premiums on corporate bonds and on the government bonds of the emerging economies. In the real economy the positive effects of government stimulus programmes are also being felt.

However, experience with past phases of weak economies shows that recovery is usually slow in the case of recessions that are accompanied by bank and real-estate crises. For this reason the institutes making this forecast expect economic growth to be moderate worldwide in the coming year, since the problems in the international financial system have not yet been overcome. Moreover, the favourable effects of energy price developments on consumption and corporate profits in the industrial countries are reversing with an oil price of 75 dollars a barrel, which is assumed in this forecast. In addition, the effects of fiscal-policy stimulus will weaken in the course of the coming year. Finally, in many countries employment has not yet adjusted to the clear declines in production. Here, even with a noticeable expansion in production, unemployment will rise for some time, which will have a dampening effect on disposable income and domestic demand.

Total economic output in the industrial countries will expand, on average for 2010, at the very modest rate of more than 1%, after a decline of a good 3.5% this year. Although this will also dampen the recovery in the emerging economies, these countries should initially prove to be the engines of world economic activity, also since the conditions for the emerging economies on the international capital markets are again quite favourable. On the whole we expect that the decline in world output of 2.5% this year will be followed by an increase of 2% next year. World trade will drastically decline for 2009 at a rate of 10.5% to be followed by a 5.5% increase in 2010. The rise in consumer prices will be quite low worldwide due to the low economic capacity utilisation rates, and the core rate is likely to fall even further. However, the clearly higher price of oil as well as increasing prices for other industrial raw materials will result in a higher overall inflation rate for 2010 compared to this year.

In Germany, economic activity also stabilised in the summer of 2009, albeit at a clearly reduced level of output. The worldwide financial crisis hit the economy full force last winter. The spreading crisis of confidence led to a collapse in foreign orders and to an unprecedented plunge in industrial production. The stabilisation that subsequently occurred is primarily attributable to the massive economic-policy intervention since autumn 2008. Worldwide, central banks lowered their lending rates and supplied the banks with virtually unlimited liquidity in order to replace the dried out interbank markets. Parallel to this, governments supported stressed banks with guarantees and capital injections, and increased the guarantees for private bank deposits. In Germany, this also averted a looming collapse of the banking system. Moreover, the government implemented numerous measures to stabilise the economy. As a result, the confidence of the financial market participants grew again and also the nonfinancial firms saw their future with increasingly less pessimism.

In the second quarter of 2009, GDP increased again somewhat, with considerable support from private consumer demand. Falling energy prices, higher pay agreements of the past year, tax cuts, higher transfers and certainly also the car scrappage scheme led to a noticeable expansion in household spending. The shortened hour work scheme was also certainly responsible for the relative stability on the labour market. For the third quarter the leading indicators point to a quite robust recovery of economic activity. However, the momentary recovery is not likely to be sustainable. There are considerable retarding forces that stand in the way of a rapid recovery.

True, there are growing indications that German exports, which have been particularly hard-hit by the worldwide recession, are recovering. However, the outlook for the industrial countries remains dampened and shows no signs of a strong, export-driven growth. Moreover the situation on the labour market is expected to worsen. In light of the deep recession, the labour market situation is currently still quite favourable. A reduction in jobs that would correspond to the decline in production has been prevented up till now by the intensive use of shortened working hours and overtime accounts. As a result, however, labour costs have risen rapidly, which has massively affected firms' profitability. For this reason a reduction in the use of the shortened working hours scheme and thus an increase in unemployment is to be expected. The decline in employment should climax at the beginning of the coming year, continuing with decreasing intensity to the end of the year.

The financing conditions in Germany have also worsened since the beginning of the financial crisis. The granting of credit to nonfinancial firms has only increased slowly since the end of last year and has recently been clearly declining. To be sure, primarily business-cycle factors are largely behind this, so that there is currently no credit crunch in Germany. However, the financing conditions are likely to worsen further during the forecast period. An indication of this is that the banks are facing considerable write-offs on risk papers and corporate loans, by which further capital losses are foreseeable. Since in addition the likelihood is increasing that some commercial loans will not be paid back, the banks will further tighten their lending policies.

For these reasons, the institutes expect that the German economy – after the strong increase in output in the third quarter of 2009 – will only slowly move out of the crisis. For the fourth quarter of 2009, only a very slight output plus is anticipated. For the year as a whole, this results in a decline in GDP of 5.0%.

For the coming year the institutes expect an only hesitant recovery. Because of the still weak expansion of the world economy, German exports will only increase at a moderate pace. Domestic demand is expected to grow only very slowly. Firms' readiness to invest will remain weak because of the only slightly improved turnover outlook and because of the more unfavourable financing conditions. Private consumption will be burdened more and more by the worsened situation on the labour market. Endogenous growth forces will only gradually become evident, so that the economy will remain dependent on economic-policy support during the forecast period. All in all, the institutes anticipate a 1.2% growth in GDP for 2010. The number of unemployed will rise, on average for the year, to 4.1 million.

As a result of weak economic activity, consumer prices are hardly expected to increase. To be sure, more expensive crude oil, as has been observed in past months, will continue to impact energy costs. However, because of the poor demand situation, core inflation will continue to weaken. On average for 2010, a price increase of 0.6% is expected.

The recession will impose a considerable strain on public budgets. Lowered taxes and revenue receipts face off with cyclically necessary increases in expenditure and the costs of the stimulus programmes. In 2009, the deficit rate will increase to 3.2%. In the coming year, expenditures will increase at a slower pace, but government revenues in the wake of tax cuts and declining employment will continue to decline. For 2010 the institutes expect a deficit rate of 5.2%.

Considerable risks come from the fact that new turbulence in the international financial and banking system can by no means be ruled out. It is expected that banks will have to carry out considerable write-offs and valuation adjustments of toxic assets and in their credit portfolios. Setbacks on the stock markets could exert additional pressure on the equity capital situation of the banks. This could lead to a renewed loss of confidence on the capital markets and impact the real economy. Thus there is considerable danger that the already increasingly restrictive financing conditions of businesses may result in a credit crunch that will considerably restrain the cyclical recovery. There is, however, also the likelihood that the worldwide recovery will be much faster than assumed in this forecast, as we have seldom seen such targeted measures to stabilise the economy as we currently have.

Economic policy faces considerable challenges. To prevent a credit crunch, the question of how to solve the problem of the undercapitalisation of the banking sector must be addressed. The institutes propose that the federal government demand of the banks that their capital ratio at a predetermined date exceed a value that is clearly above the current level and allows scope for future credit grants. In the case that individual banks cannot reach this target within a reasonable time, they must accept SoFFin intervention in order to meet the demands.

Monetary and fiscal policy are currently on an extremely strong expansion course. Monetary policy has injected considerable amounts of liquidity into the market, and fiscal policy with its stimulus programmes and other measures has built up considerable debt. The institutes advise economic-policy makers to devise strategies now as to how the extraordinary measures with which the financial crisis and the recession have been combated are to be brought to an end, to make sure there are no negative effects on the overall economic development.

There are of course differences in how monetary policy withdraws and retreats in fiscal policy. In principle it is very easy for the European Central Bank to return to normal, as it must only let the expansive measures expire and reabsorb the liquidity it created. This correction could be rapid if necessary and there is also enough confidence in the ECB that it can succeed. If liquidity is absorbed smoothly, the goal of price stability will not be impaired by the very expansive monetary policy that was applied in the crisis.

In contrast, a retreat from the expansive fiscal policy is incomparably more protracted, since a removal of the structural deficit is not achievable in a short time; a government can always bow to the pressure of not or only half-heartedly pursuing the goal. Regardless of this, the high structural budget deficit must be clearly reduced in order to lower the debt ratio and to place public finances on a sound basis. This is required by the rules of the European Stability and Growth Pact as well as by the debt limitations contained in the German constitution.

The reduction of the structural deficit should begin in 2011, at which point economic activity is likely to have been stabilised. We must proceed in such a way that growth and employment is promoted or at least not hindered. Stronger burdens from taxes and social fees would increase labour costs and dampen the demand for labour. In addition, incentives to work and to invest would be weakened. All this is counterproductive in the medium term for reaching the economic-policy goals. For this reason the federal government should focus on the expenditure side and on tax benefits in its efforts at budget consolidation. A focus on spending does not mean that this must be cut but that its increase should be curbed. Since there is considerable leeway in the reduction of subsidies as well as for savings in the area of personnel and material costs, investment spending can even be expanded, which will improve conditions for growth.

The tax cuts that are currently being discussed would prove to be very expensive in the long term if they are debt financed. Because of the increased debt, interest payments would grow and interest rates perhaps as well. For this reason any tax cuts must be financed. This would be possible in principle, as the consolidation potential described by the institutes shows, but would presuppose a very ambitious savings policy.