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## This Issue

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gives his view.

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# Market View

## German Economy Faces Long Term Adjustment

**There is an underlying assumption in financial markets that if and when a war with Iraq is concluded successfully, there will be a turnaround in financial market sentiment and in economic performance among the major players in the global economy.**

However, the lifting of the cloud associated with the threat of war with Iraq will do little to help countries suffering longer term structural problems. Two countries that stand out are Japan and Germany.

German GDP growth averaged a meagre 0.2% and 0.6% in 2002 and 2001 respectively. Private consumption contracted last year

while there was a very sharp fall in spending on fixed investment. GDP growth remained positive, though, as a sharp decline in imports produced a marked improvement in the net export position. There are hopes for an upturn in the economy in 2003. Recent improvements in the Ifo, PMI and ZEW sentiment indices were taken as positive signs.

However, a broad batch of data released last week suggest that, if anything, the German economy may be slipping into recession. Retail sales fell by 0.7% in December following a decline of 2.5% in November. The PMI for services fell for a sixth consecutive month in January to a new low of 43.9. Manufacturing orders fell by 4.1% in December, their biggest monthly decline since 1995. Most worryingly, overseas orders slumped, undermining hopes for an export led upswing in activity.

Furthermore, the number out of

work increased by 62,000 in January following a rise of 35,000 in December, pushing unemployment to its highest level in five years. Meanwhile, the number at work is down some 1% on the levels of a year ago. There is little doubt that tax increases, high oil prices and the appreciation of the euro are all weighing on activity.

However, the weak performance of the German economy is nothing new. It has registered a growth rate in excess of 2% in just one year during the last decade. Furthermore, Germany has been a marked underperformer within the eurozone since the mid-1990's. GDP growth in Germany has averaged 1.4% since 1996, compared to 2.6% for the rest of the eurozone. This suggests that the reasons for the poor performance of the German economy stem from domestic causes and cannot be put down to cyclical or external factors.

We would identify three such factors in particular. First, the deadweight of the East German economy which has been

virtually stagnant since 1996. The unemployment rate in East Germany is running at over 18% compared to 8% in West Germany. The East German economy is very uncompetitive. This is mainly attributable to the one-for-one currency conversion rate adopted at the time of reunification and subsequent very high wage inflation.

Second, the large fiscal transfers to East Germany have placed a heavy burden on taxpayers. This has sapped growth in disposable income and consumer spending power and limited the resources available for investment in the productive West German economy.

Third, Germany is constrained by structural rigidities that impact on virtually all areas of economic activity. Chief amongst these is the highly inflexible labour market. It is characterised by strong employment protection legislation and outmoded customs and practices. Meanwhile, the goods and services markets are weighed down by a maze of rules and regulations. The German

economy is also hamstrung by the interaction of a generous social security and pension system and high taxes which act as a major disincentive to growth in employment and output.

There seems to be little political appetite in Germany to tackle these problems. The experience of other countries (e.g. UK, Ireland, New Zealand) suggests that an economic crisis is required to force through painful reforms. Germany is not at this stage. It suggests that the economy will continue to perform poorly in the coming years. It also implies that it will remain vulnerable to shocks, such as a sharp spike in oil prices or rapid currency appreciation.

Germany makes up one-third of the eurozone economy. Thus, it has a major bearing on the economic performance of the eurozone region as a whole. With Germany facing possible recession, it is not surprising that Wim Duisenberg indicated at last week's ECB press conference that the downside risks have increased for the eurozone economy. The ECB, though, is

reluctant to ease policy further at present. It feels that this “would be a drop that would drown in the sea of uncertainties” and thus, have little impact on activity.

His comments, however, reinforced expectations that the ECB will cut rates later in the spring, possibly in the aftermath of a war with Iraq. We expect a cut of 0.5%, taking the refinancing rate down to 2.25%. The long-term impediments to growth in Germany, combined with the expected decline in eurozone inflation to under 2% this year, suggest that official eurozone interest rates will remain low for a prolonged period of time.

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