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EUROPEAN MARKET COMMENT: GERMANY—CAUGHT IN DEFLATION'S UNDERTOW

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Germany: Caught in Deflation's Undertow

Germany is caught in a swirl of disinflationary crosscurrents. Some of these pressures have their roots in the country's reunification with East Germany and its entry into the European Monetary Union (EMU), while others stem from cyclical pressures. The interplay between domestic and international forces will determine whether Europe's largest economy will go through only a brief deflationary scare or whether it—and its neighbors—will succumb to deflation's undertow.

Running on Empty

Inflation in Germany has crept up in recent months but from extremely low levels—from 0.8% for the year ending in June to 1.3% in October. In comparison, the inflation rate of the European Union is 2.3%, while the Continent's next two largest economies, France and Italy, have posted rates of 1.9% and 2.7% (see Table A). At the other end of the price spectrum, inflation rates in Spain and Ireland are running at the relatively torrid paces of 3.8% and 4.7% over the same time periods.

Germany's aggregate price level has sunk to such low levels largely because its economy is not firing on any cylinders, and the knock-on effects from the slumping economy are pressuring prices lower. Since the mid-1990s, Germany's economy has grown more slowly than that of the Continent on average, and it is expected to fall short for the next several years as well. For the year ending in the second quarter this year, German GDP contracted 0.1%, compared to 0.7% growth for the rest of the EMU (see Table B).

Anemic Domestic Demand

Over recent years, the contribution of domestic demand to Germany's economic growth has been almost half of that for the euro area. Weak consumer spending has been the primary culprit behind sluggish domestic demand, and this year it is expected to shrink 0.5%, the first time since 1982 that household spending has actually contracted.

Weakening Export Prices

While international trade has been a boon for Germany's economy in some areas, the appreciating euro does not bode well for export-oriented Germany. At the same time, import prices are falling relative to export prices, fanning worries of deflation. Burdened with the world's highest manufacturing labor costs, Germany is rapidly losing market share in its export markets.

Unsupportive Monetary Policy

With the European Central Bank (ECB) strictly adhering to its mandate of containing price pressures (its inflation target is 2%), the Continent has not enjoyed the economic fillip of lower policy interest rates. Not only is this lack of liquidity restricting Germany's growth potential, but low inflation has given it the highest real interest rates in the region, further intensifying deflationary pressures. Many critics argue that the ECB's 2% inflation target is more appropriate for economies that are growing more rapidly and experiencing higher inflationary pressures, such as Ireland and Spain, than for the more industrialized German economy where price levels are quite low.

Restrictive Fiscal Policy

With Germany's budget deficit estimated to reach 3.7% in 2002, to adhere to the EMU's Stability and Growth Pact it must forego further fiscal stimulus. To make matters worse, Germany's fiscal policy has just turned restrictive as freshly elected Chancellor Shroeder announced plans to substantially hike taxes.

A Brief Scare or Secular Morass?

Germany's economy is further hobbled by its ailing banking industry, labor market rigidities, and the EMU—all of which are pushing prices lower. In fact, pundits who worry that Germany will move into a sustained period of deflation ominously note how these rigidities parallel those of Japan's. However, fears of a sustained period of deflation appear overblown because the disparities between Germany and Japan are more telling than their superficial similarities.

Banking Crisis

Long suffering from over-capacity and over-capitalization, Germany's banking sector is currently reeling from near-crisis conditions. Poor profitability and shrinking capital is currently forcing the industry to tighten credit; in other words, growth is being squeezed just when the economy needs it the most. However, most of the industry's current problems do not point to a fragile financial system or imminent liquidity crisis. Instead, they arose from the equity market boom in the late 1990s when high investment banking revenues concealed the sector's structural problems and increased its cost base. Furthermore, Germany's banks are not riddled with nonperforming loans, nor have they created bubbles in real estate or credit to the extent experienced in Japan. That said, however, if domestic demand does not recover or if equity prices reverse their current rally and head back down, banks could further tighten credit conditions. German banks represent an important source of global finance, and a domestic profit squeeze or credit crunch could lead to tightening of credit around the world.

High Labor Costs and Unification with its Neighbors

Germany's low productivity and high labor costs have fueled its deflationary pressures by restricting the growth of employment and personal consumption. Chancellor Schroeder's apparent aversion to significant labor market reforms virtually ensures that these pressures will persist for years. The roots of high labor costs, high taxes, and high unemployment can partly be traced to the cost of its unification with East Germany and its overvalued real exchange rate when it entered the EMU. To regain its price competitiveness within the monetary union, aggregate price and wage levels in Germany must move lower relative to those in non-German countries. This adjustment process may entail years of disinflationary or deflationary pressures.

Demographic Pressures

Germany's working-age population is expected to decline by 0.2% annually until 2012 and by 0.5% per year through 2025. According to *The Bank Credit Analyst*, trend growth will continue to slow through 2012, even if labor productivity growth averages 1.5%. Furthermore, over the next 25 years, the number of people who will be eligible to retire will increase by about 45%, while the labor force will decline by 10%. This signals a significant rise in government spending on public pensions, as well as further declines in labor productivity and corporate profitability.

What About Inflation?

Despite these cyclical and secular deflationary forces, some pundits are more worried about the possibility of inflation. According to them, domestic demand and monetary stimulus today is much stronger compared with Germany's last deflationary scare in late 1998-early 1999 when inflation was running below 1%. They also argue that Germany does not have the preconditions for a prolonged period of deflation: its banks are not on the verge of collapse, nor is its exchange rate regime fixed (to the extent it is part of the euro), both of which prevent a quick adjustment to a deflationary shock.

Will Deflation Spread to Rest of Europe?

While the rest of Europe is not burdened with the same magnitude of deflationary forces as Germany, it will certainly be affected by weak regional and international economic conditions. Other European countries are vulnerable not only to Germany's economic weakness, but also to cyclical weaknesses unique to each economy and structural rigidities common to the region. Even if Germany does not fall into deflation, price levels will likely fall through the rest of the Continent, transmitted by the monetary union's strong trade, capital, and financial market linkages. Furthermore, the Continent's economy is weighed down by similar pressures as in Germany—domestic demand weakness, as well as strictures on fiscal and monetary stimulus. Inflation rates in France and Italy, while higher than Germany's, are still quite low by international standards, and a fall in economic growth could push prices into negative territory.

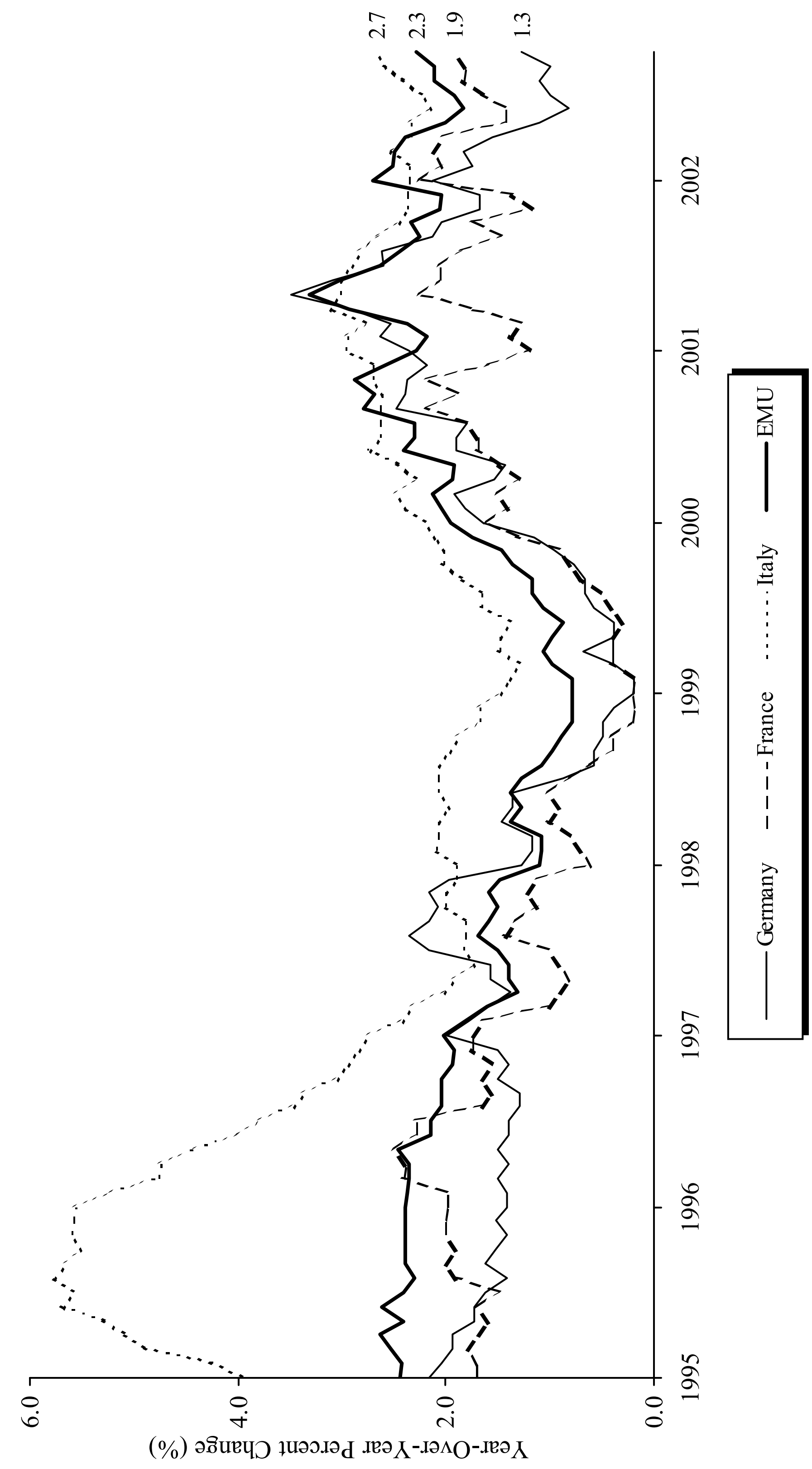
Sinking Into Deflation

It is quite likely that the lethal combination of domestic constraints, regional impediments, and the global economic slowdown will ensure that Germany suffers a prolonged period of economic malaise and deflationary pressures. However, the proximate cause will probably not stem from similar structural rigidities and economic imbalances that gave rise to Japan's lost decade of the 1990s. Germany's deflationary pressures are qualitatively different than those of Japan. However, if Germany's conventional drivers of economic growth continue to misfire and its economy sinks deeper, as it has in recent months, it could slide inexorably into deflation. Until Germany's relative price levels come into balance with the rest of the Continent and until it moves forward with significant structural reform, a period of deflation remains a distinct possibility: whether its duration will be brief or protracted depends on the depth of the current economic slowdown.

Table A

INFLATION IN THE EUROPEAN MONETARY UNION

January 1, 1995 - October 31, 2002

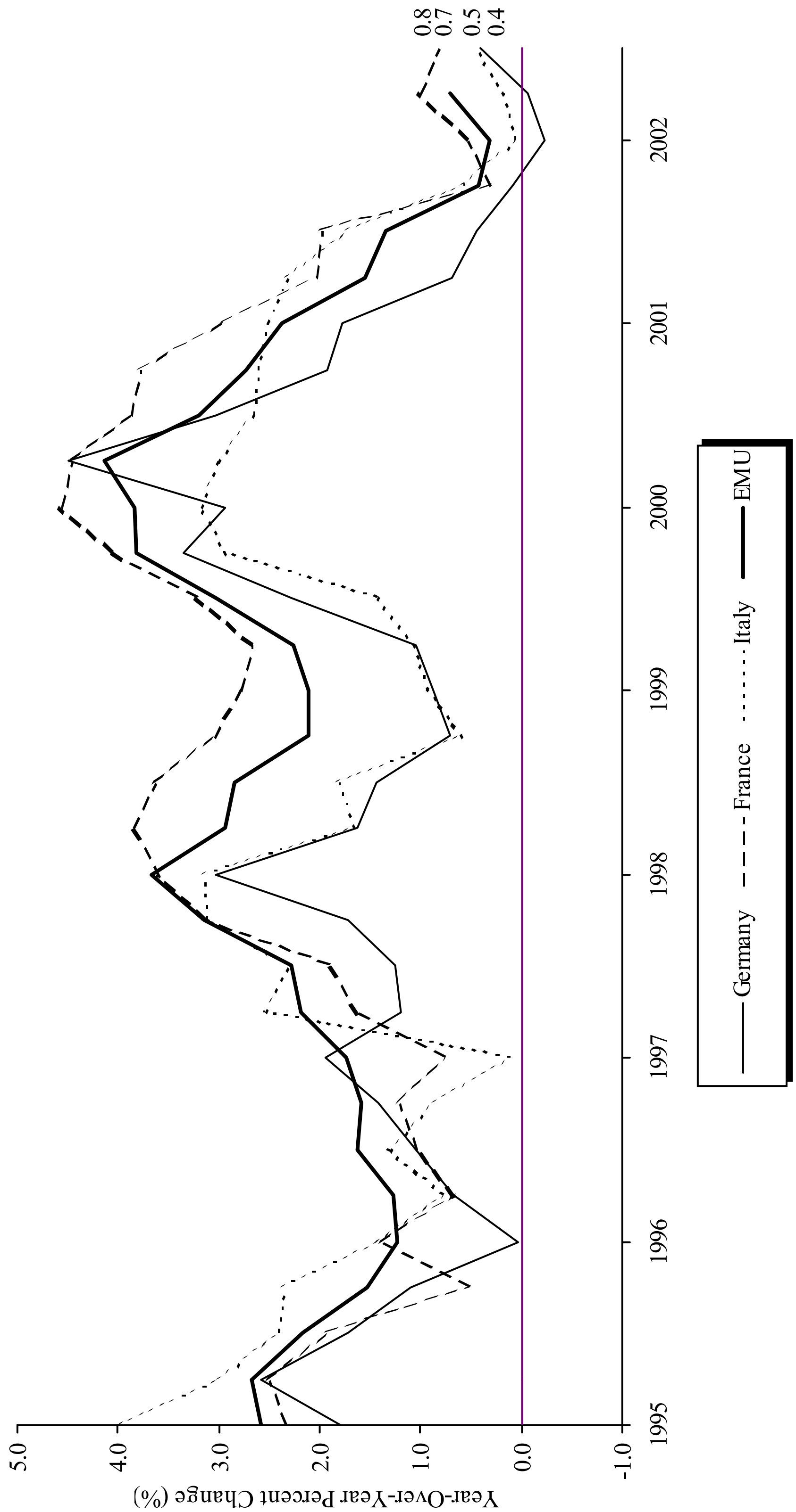


Source: Thomson Datastream.

Table B

GROSS DOMESTIC PRODUCT OF THE EUROPEAN MONETARY UNION

January 1, 1995 - September 30, 2002



Source: Thomson Datastream.

Note: EMU data are as of June 30, 2002.