Outlook for the German economy – macroeconomic projections for 2010 and 2011

The German economy accelerated in the second quarter of 2010, after having temporarily lost momentum in the fourth quarter of 2009/first quarter of 2010 largely as a result of the particularly cold and snowy weather and the end of the car scrappage premium. As spring set in, the positive impetus emanating from the global economy increasingly prevailed. This impetus is likely to set the basic tone for economic developments during the forecasting period, based on the assumption that the uncertainty which the fiscal problems in a number of countries are creating on the financial markets remains limited. Real gross domestic product (not working-day-adjusted) could rise by 1.9% in 2010; growth is likely to be slightly lower the following year, at 1.4%, partly as a result of waning fiscal stimuli. While unemployment could rise slightly, this does not change the fact that the German labour market can still be regarded as extremely robust. The price outlook is largely determined by conditions on the international foreign exchange and commodities markets; domestic inflation will presumably remain muted for the time being. Consumer prices could rise by 1.2% this year, and 1.6% in 2011.

Current situation

Strong growth in the second quarter after muted 2009 Q4/ 2010 Q1

Although German economic growth fell short of expectations in the fourth quarter of 2009/ first quarter of 2010, monthly economic indicators point to a sharp revival in the second quarter of 2010. The temporary weakening of the economic recovery process can largely be attributed to temporary factors. Foremost are the phasing-out of the environmental premium, which had provided an incentive to scrap old cars and replace them with new vehicles, and the particularly cold and snowy winter weather, which mainly hurt the construction industry, but also affected the transport and, indirectly, the industrial sector. Nonetheless, the prospect of a sustained recovery of the German economy remains intact, as is evident from the upward trend in sentiment indicators, the robust labour market situation and the strong increase in new orders received by industry since the new year. Most were received from abroad, initially from non-euro-area countries and, more recently, increasingly from other euro-area countries. Within Germany, orders of capital goods picked up perceptibly in the first quarter of 2010. Most are likely to have been replacement purchases. With the exception of expenditure on new motor vehicles, which fell more rapidly than predicted in the December forecast, the basic trend in terms of private consumption remained robust.

Extremely stable labour market

Despite sluggish real economic growth, the labour market exceeded already optimistic expectations. Contrary to the December forecast, the official unemployment figure did not increase; in fact, it fell perceptibly. The slight decline in the labour force was a contributory factor, as were policy measures aimed at the labour market. Although job cuts continued in manufacturing, more jobs were created by service providers, notably in education, health and social work. According to the information available to date, many of these jobs are part-time positions. Because the return to normal working hours continued, particularly in industry, as the economic recovery gained momentum, the average number of hours worked per person and the total number of hours worked rose appreciably in seasonally adjusted terms, while aggregate employment remained roughly unchanged. Nonetheless, there are still considerable staff reserves in industry, which means that additional orders can be filled quickly with experienced staff.

New collective wage agreements aimed at safeguarding employment

As anticipated, this year's collective wage negotiations focused on safeguarding jobs. In the two largest German industries, chemicals and metal-working, the social partners agreed not to raise basic pay in 2010. Basic rates of pay in the metal-working industry will not be lifted until 2011, while the chemicals industry will negotiate a new collective wage agreement in 2011. In the public sector, central and local government employees have agreed moderate wage increases over a two-year period. For the economy as a whole, effective monthly earnings rose in the first quarter of 2010 – as anticipated in the December forecast – after having dropped in 2009 as working hours were cut in response to the crisis.

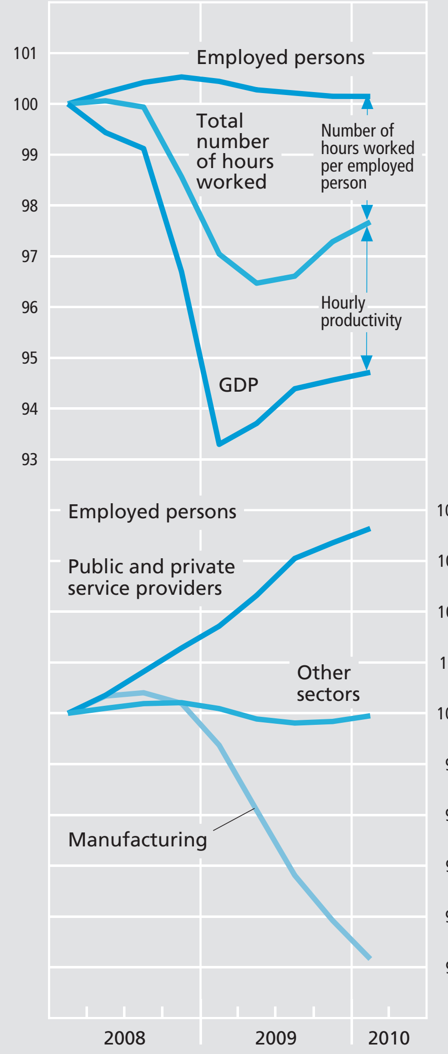
Price developments in recent months were driven by fluctuations in crude oil prices as

Inflation initially slightly weaker, later somewhat stronger than anticipated

well as the declining external value of the euro. While crude oil prices, as measured in US dollars, were initially lower than the assumptions made in the December forecast, which were derived from forward prices, they subsequently temporarily surged, before moderating at the current end. Exchange rates were gradually affected by the uncertainty spilling over from the difficult fiscal situation in several member states to the financial markets. As a result, the price, in euro, of a barrel of Brent crude was significantly higher in May 2010 than predicted in the December forecast, although US dollar spot prices were below the forward prices used at the time. However, as developments in the other main groupings of the Harmonised Index of Consumer Prices were somewhat more favourable than anticipated – partly as a result of the better measurement of price movements for seasonal goods and lower prices for some services – inflation remained just below the forecast level in the first quarter of 2010, at 0.8% year-on-year. Inflation did not exceed expectations until April/May, when it averaged 1.1%.

Employment patterns

2008 Q1 = 100, seasonally and working-day-adjusted



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Major assumptions[1]

Strong global economic growth

The global economy has recovered from the worldwide economic slump experienced around the new year 2008/2009 more quickly than widely anticipated. The exceptionally expansionary monetary and fiscal policy in a number of countries as well as the effect of the automatic stabilisers was a major factor. Global production is likely to rise by no less than 4% this year, driven in part by the inventory cycle. The fact that growth is expected to be only slightly lower in 2011, at 3½%, despite a gradual exit from non-standard monetary policy measures, increasing fiscal consolidation efforts and the fact that the inventory cycle will then no longer provide

1 The assumptions concerning developments in global trade, exchange rates, international commodity prices and interest rates were determined by the Eurosystem's experts. They are based on the information available up to 20 May 2010.

impetus underscores the growing underlying economic momentum. Global economic growth is strongest in the Asian area. Several Latin American countries are also expected to raise value added sharply. This will benefit exporters of commodities such as Australia or Russia. Among industrial countries, the United States are at the forefront of economic growth.

Significant increase in global trade

The recovery in global output has been accompanied by a perceptible revival in global trade, which had been particularly hard hit by the economic downturn. Although global trade volume is likely to outpace economic output this year and next, at 9% and 6% respectively, the intensity of global trade would even then remain below pre-crisis levels. Although regional growth differentials mean German industry's traditional sales markets are likely to achieve below-average growth, at 6¾% and 4½% respectively, they are nonetheless expected to grow more strongly than assumed in the December projection, particularly in 2010.

Depreciation of the euro

Over the forecasting horizon, the probably short-term dampening effect on the euro area of the additional fiscal consolidation efforts which a number of countries will be forced to make could be mitigated by the depreciation of the euro. However, the price component as a factor determining exports should not be overrated where Germany is concerned. The forecast presented here is based on the technical assumption of a constant euro/dollar exchange rate of US$1.26; that is 15½% less than stated in the December projection. Compared to the 21 most important euro-area trading partners, the single currency is seen 11¾% lower than had been assumed in December.

Commodity price expectations similar to December forecast

The latest spot and forward prices for crude oil and other commodities as measured in US dollars are largely in line with the expectations outlined in the December forecast, which were derived from forward prices in November 2009. The average price of a barrel of crude oil is assumed to be US$79.5 in 2010 and US$83.7 in 2011, after US$61.9 in 2009. This equates to a rise of 28½% and 5¼% respectively. Other commodity prices are seen appreciating by 18% on average in 2010. By the first quarter of 2010, industrial commodities prices, in particular, had almost recouped their recession-induced price losses. According to forward prices, prices should not increase much more in 2011 (+1¼%). The assumed marked depreciation of the euro means crude oil and commodity prices will presumably rise much more steeply in Germany than on the global markets.

More favourable financing conditions

Given the ongoing uncertainty on the financial markets and the sluggish economic recovery in the euro area, the Eurosystem's monetary policy remains extremely expansionary and will, the financial markets believe, remain so for longer than previously anticipated. Interest rate assumptions, which are derived from market data, therefore predict that the short-term lending rate (three-month Euribor) will be lower again this year, at 0.8%, than last year. An only slightly higher short-term interest rate of 1.1% is now assumed for 2011, compared with 2.4% in the December forecast. The yield on long-term German government bonds outstanding is likely to moderate to 3.0% this year and rise to just 3.4% next year. The December forecast had assumed a figure of 4.1% for 2011. As in previous projections, interest rate spreads on loans to enterprises were used to gauge the likely effects of the financial crisis on enterprises' borrowing. These spreads, too, have narrowed slightly compared to the last forecast. The finding of the Bank Lending Survey that credit standards have hardly been tightened in the last six months was likewise factored into the corporate financing projection. The Ifo credit crunch indicator was even signalling a slight easing as this report went to press. It is therefore assumed that financing conditions for enterprises will gradually improve over the forecasting horizon.

Major assumptions of the projection

Item	2009	2010	2011
Exchange rates for the euro			
US dollar/euro	1.39	1.30	1.26
Effective [1]	111.7	104.5	102.7
Interest rates			
Three-month EURIBOR	1.2	0.8	1.1
Yield on government bonds outstanding [2]	3.2	3.0	3.4
Crude oil price [3]	61.9	79.5	83.7
Other commodity prices [4, 5]	– 23.1	17.9	1.2
German exporters' sales markets [5, 6]	– 12.2	6.7	4.5

1 Compared with the 21 most important trading partners of the euro area (EER21 group of currencies); 1999 Q1 = 100. — **2** Yield on German government bonds outstanding with a residual maturity of over nine and up to ten years. — **3** US dollars per barrel of Brent crude oil. — **4** In US dollars. — **5** Percentage year-on-year change. — **6** Working-day adjusted.

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Public finances in Germany

In public finances, all measures are taken into consideration which have either been adopted or which have already been specified in sufficient detail and are likely to be approved. The measures in connection with the setting of the Federal budget for 2011 that were announced after the cut-off date of the projection were therefore not taken into account. The economic support measures implemented since the onset of the financial and economic crisis are particularly relevant. On top of tax relief in relation to the crisis (mainly lower income tax rates and corporate taxation), there will also be a considerable shortfall from higher tax allowances for contributions to the health and long-term care insurance schemes from 2010. In terms of social contributions, the rate of contribution to the health insurance fund will decrease this year on average. On the other hand, however, the statutory health insurers started levying additional contributions, and there was a one-off increase in the insolvency insurance premiums employers pay to the Federal Employment Agency. Next year, the increase in the contribution rate to the Federal Employment Agency to 3.0% at the beginning of the year as well as additional contributions to the statutory health insurers should generate additional revenues on a large scale. As regards spending, government investment, in particular, will rise appreciably this year as a result of the fiscal stimulus packages. Moreover, the increase in child benefit from 2010 onwards will generate additional expenditure, while the proceeds from the auction of mobile telephone licences should provide a one-off windfall of €4½ billion for government coffers in 2010.[2] As regards the government support measures for financial institutions that have already been announced and the recent decisions on aid for Greece, the assumption has been made that they will initially be reflected mainly in debt levels and barely in the deficit.

Cyclical outlook[3]

Moderate upward trend for underlying economic growth

The second and third quarters of 2010 will be dominated by catching-up effects in construction and industry. Given the good orders situation it is assumed that the construction industry will rapidly make up for the weather-related output losses at the beginning of the year. Industrial output is soon likely to catch up with rising orders. A strong boost to growth is therefore expected for the second quarter of 2010. In the third quarter, the positive underlying momentum could allow higher economic output at least to be maintained, although catching-up effects in construction are likely to have run their course by then. Provided the impact of the fiscal problems in a number of industrial countries on confidence remains limited, the cyclical upswing of the German economy should continue at a moderate pace thereafter.

Sharp rise in exports

The main driving force for the German economy will be the recovery of the global economy. Global growth is strongest in regions that do not traditionally constitute German enterprises' main sales markets, and the euro area could presumably lag behind global developments for some time to come, not least given the urgent need for fiscal consolidation. Nonetheless, it can be assumed that German exporters will increasingly expand into the South-East Asian growth markets in which they have gained a foothold in recent years. The same is also true of Germany's central and east European partner countries. Moreover, global demand will again focus more and more on the higher-quality capital goods in which German exporters specialise. In 2010, exports of goods and services are therefore likely to experience fairly strong growth of 8½%. For 2011, growth is forecast to come in at 5¼% as global economic growth is expected to be somewhat weaker. The export volume in 2011 would thus still not quite match that of 2008.

Domestic economy dominated by fiscal policy

Domestic economic developments will continue to be dominated by the impact of fiscal stimuli in 2010. Private motor vehicle registrations will be decidedly lower as the environmental premium for scrapping old cars meant many purchases were brought forward to 2009. However, the tax relief granted at the beginning of the year should support private consumption, and the public sector investment triggered by the fiscal stimulus programmes is likely to provide the construction industry with additional impetus. In 2011, however, public sector construction demand is likely to contract sharply, and overall tax and social security offtakes should rise. As a consequence, inflation-adjusted domestic

2 In the national accounts, purchases and sales of assets are netted out and recorded on the expenditure side.
3 The projection presented here was completed on 27 May 2010.

demand is expected to rise by just 1%, after +1½% this year.

Robust underlying trend of private consumption

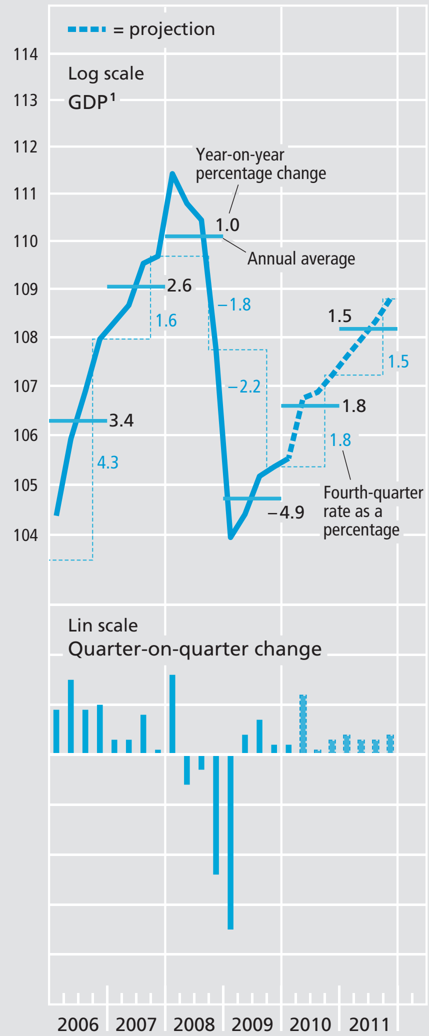
Given the various fiscal determinants in 2010, private consumption is likely to decline in real terms, although this is more a reflection of "withdrawal effects" stemming from the discontinuation of the environmental premium than the underlying cyclical trend. The savings ratio will probably go up to 11½% this year compared with the 2009 level, which was influenced by this special factor. A slight decline is expected for 2011 since the trend rise in the savings ratio is unlikely to continue, at least for the time being. Overall, private consumption could go down by just under 1% this year in price-adjusted terms but make this up again in the following year.

Increasing private investment, declining public investment

Corporate investment will pick up gradually. The focus initially is likely to be on investment in replacements which can no longer be deferred as well as on expenditure in connection with the introduction of new products. In view of a high degree of price competitiveness and unused capacity, neither rationalisation nor capacity expansion are likely to figure prominently as motives for investment at present. Private residential construction might benefit not only from low interest rates but also from the heightened uncertainty regarding alternative forms of investment. Public investment will go up probably by something like one-quarter in the current year as a result of the economic stimulus packages and contract by the same amount in 2011. The rise in public investment will be the main reason for the marked increase in the overall volume of investment in 2010. The current projection assumes an increase of 4%. In 2011, owing to the assumed accelerated pace of private fixed capital formation, last year's level should be maintained despite the foreseeable marked decline in public investment spending.

Aggregate output

2000 = 100, seasonally and working-day-adjusted



1 Price-adjusted.

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Expansionary impulses from the inventory cycle

Inventories will probably generate strong expansionary impulses this year, which will largely offset last year's negative contribution.

Technical components of the GDP growth projection

As a percentage or in percentage points

Item	2008	2009	2010	2011
Statistical carry-over at the end of the previous year 1	0.6	– 2.1	0.6	0.6
Fourth-quarter rate 2	– 1.8	– 2.2	1.8	1.5
Average annual GDP rate, working-day-adjusted	1.0	– 4.9	1.8	1.5
Calender effect 3	0.3	– 0.1	0.1	– 0.1
Average annual GDP growth 4	1.3	– 4.9	1.9	1.4

Sources: Federal Statistical Office; 2010 and 2011 Bundesbank projections. — 1 Seasonally and working-day-adjusted index level in the fourth quarter of the previous year in relation to the working-day-adjusted quarterly average of the previous year. — 2 Annual rate of change in the fourth quarter, working-day-adjusted. — 3 As a percentage of GDP. — 4 Discrepancies in the totals are due to rounding.

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First, stocks of raw materials and inputs are being built up again. Second, the reduction of excessive stocks of finished goods appears to have come to an end. Inventory investment may be expected to make a roughly neutral contribution in 2011.

Sharply rising imports, positive net exports

As it is specialised in high-quality finished goods, the German economy is dependent on an increased supply of raw materials, semi-finished goods and components for expanding its sales. For that reason alone, imports should increase sharply over the forecasting horizon. Capital goods, too, will be imported on a considerable scale, especially in the IT sector. Furthermore, imports account – directly or indirectly – for a large part of households' spending. The increase in imports of goods and services, at 8% in 2010 and 5% in 2011, will therefore probably be hardly any smaller than the rise in exports. The current account surplus, accompanied by matching net capital exports, could remain unchanged at not quite 5% of GDP. This would be due to a nominal net trade contribution to growth of 0.5 percentage point in 2010 and 0.4 percentage point in 2011.

Annual profile of economic growth

Economic output in Germany could increase overall by 1.9% in 2010 (not working-day-adjusted). At 1.4%, the increase is likely to be somewhat smaller in 2011, although this slight slowdown will be due more to waning stimuli from public finances and inventories than to an easing of the underlying pace of growth in the economy. Adjusted for the differing number of working days, this would give 1.8% in 2010 and 1.5% in 2011. Compared with the December 2009 projection, this results in an upward correction of 0.3 percentage point for 2010 and 0.2 percentage point for 2011. Despite considerable cyclical progress, this will not yet quite match the pre-crisis level of output.

Potential growth and output gap

At an average of more than 1½% annually, growth in economic output over the forecasting horizon is likely to be roughly twice as high as potential growth, which model calculations put at ¾% per year.[4] This is likely to close quite a bit, but not yet all of the overall output gap that opened up in the wake of the sharp contraction in the German economy in the final quarter of 2008 and the

4 For more details, see "To what extent has the potential output of the German economy been impaired by the economic and financial crisis? An interim assessment", Deutsche Bundesbank, Monthly Report, December 2009, pp 24-25.

first quarter of 2009. These statements are subject to the caveat that unobservable variables, such as potential growth and the output gap, are very difficult to gauge in real time, especially in times of major economic upheavals and uncertainties.

No fundamental change to be expected in the labour market situation

Given the expected upswing in the German economy in the second and third quarters of 2010, it is unlikely that enterprises will now make any lay-offs that they have not undertaken so far on a significant scale, even though there are still major levels of overstaffing. For some months now, leading short-term labour market indicators, such as the BA-X index for job vacancies and the Ifo employment barometer, have been showing that the situation on the labour is becoming increasingly brighter. Even though the transition from contractionary to expansionary territory cannot be defined precisely, these indicators provide a clear sign that there should be a slowing of job losses in trade and industry. Much the same is suggested by the influx of jobseekers who are not (yet) unemployed, which remains at a comparatively low level. Keeping on workers is being made easier for enterprises owing to the special regulations for short-time working benefits being extended up to the end of March 2012 and the supplementary collective pay agreements which allow further reductions in regular weekly working hours.

Significantly lower unemployment than in the December projection

Against this backdrop, the current projection assumes that the shedding of jobs in industry will gradually decelerate but that, not least owing to the need for fiscal consolidation, fewer new jobs will be created by public and

Key figures of the macroeconomic projection

Year-on-year percentage change

Item	2008	2009	2010	2011
GDP (real)	1.3	– 4.9	1.9	1.4
GDP (working-day-adjusted)	1.0	– 4.9	1.8	1.5
Components of real GDP				
Private consumption	0.4	– 0.1	– 0.9	1.1
Government consumption	2.1	3.4	2.2	1.7
Gross fixed capital formation	3.1	– 9.0	4.0	0.2
Exports	2.9	– 14.5	8.4	5.3
Imports	4.3	– 9.5	8.1	4.9
Contributions to GDP growth 1				
Domestic final demand	1.2	– 1.2	0.6	1.0
Changes in inventories	0.4	– 0.9	0.8	0.0
Net exports	– 0.3	– 2.9	0.5	0.4
Labour market				
Total number of hours worked 2	1.3	– 2.8	1.4	0.0
Persons employed 2	1.4	– 0.0	– 0.1	– 0.1
Unemployed persons 3	3.3	3.4	3.3	3.4
Unemployment rate 4	7.8	8.2	7.9	8.0
Unit labour costs 5	2.2	5.1	– 0.5	– 0.2
Compensation per employee	2.1	– 0.1	1.5	1.3
Real GDP per person employed	– 0.1	– 4.9	2.0	1.5
Consumer prices 6	2.8	0.2	1.2	1.6
Excluding energy	1.8	1.1	0.7	1.0
Energy component	9.4	– 5.4	4.8	5.8

Sources: Federal Statistical Office; Federal Employment Agency; 2010 and 2011 Bundesbank projections. — **1** In percentage points. — **2** Domestic concept. — **3** In millions of persons (Federal Employment Agency definition). — **4** As a percentage of the civilian labour force. — **5** Ratio of domestic compensation per employee to real GDP per person employed. — **6** Harmonised Index of Consumer Prices (HICP).

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private service providers. As a result, there could be a slight decline in overall employment. Working hours are likely to return gradually to normal. In both years of the forecasting horizon, the domestic supply of labour will be restricted only moderately by demographic factors. With regard to labour market participation, it is assumed that it will persist at the heightened level of 2009.[5] Allowing complete free movement for workers from the central and east European accession countries from May 2011 is likely to be reflected initially, above all, in the commuter balance, which already showed a clear rise in 2009 after certain regulations for seasonal workers were relaxed. Given these conditions, unemployment would increase slightly over the forecasting horizon. The unemployment rate could go up to 8.0%. A rise to more than 10% in 2011 was still assumed in the December projection.

Labour costs and price outlook

Moderate rise in labour costs

The rise in negotiated rates of pay should remain within comparatively narrow bounds in the immediate future. In 2010, for which collective pay agreements have mostly been concluded, the increase will amount to roughly 1½%, and it is unlikely to be much higher in 2011 either. The wage drift, calculated on an hourly basis, was positive last year mainly as a result of working hours being reduced through running down flexitime accounts and the use of short-time working. It is likely to turn negative. The rates of change in actual hourly wages, at -½% in 2010 and +1¼% in 2011, will therefore probably lag behind the rise in negotiated rates of pay. The fact that working hours are expected to return gradually to normal should largely offset this effect on a monthly basis. Changes to employers' social contributions are also foreseeable. As these are likely to have a more or less neutral effect on balance, compensation per employee and hour worked could, following a decline of ¼% in 2010, increase by 1¼% next year. Given an assumed increase in hourly productivity of ½% in 2010 and almost 1½% in 2011, unit labour costs would then go down somewhat but without offsetting the sharp rise in 2008-09. Profit margins are likely to recover noticeably, especially in the current year; a further improvement is assumed for 2011, although this, too, will still fail to match pre-crisis levels. The deflator of domestic production could go up by more than ½% per year.

Consumer price inflation affected by crude oil prices and exchange rates

Consumer price inflation will rise sharply from 2009 to 2010, chiefly owing to higher euro prices for energy and food, which showed a marked decline from the third quarter of 2008 well into the final quarter of 2009. The prices of other goods and services are tracking these movements with a time lag and with a clearly reduced amplitude. While – mainly energy but also food – prices will go

5 In contrast to earlier economic downturns, there has been no slackening of the propensity to participate in the labour force recently. This is probably due mainly to the fact that the formerly popular option of early retirement is largely unavailable. Moreover, the requirements profile of the new jobs in social services also appeals to women who have previously not actively been seeking work or who have been discouraged by failing to gain employment. This "mobilisation effect", atypically for the current economic situation, has driven up labour market participation.

up again this year following a decline in 2009, the rate of price increase for other goods and services will still show a marked fall. The improved cyclical setting and the depreciation of the euro mean that the core components are likely to come under stronger upward price pressure next year. Despite the expected moderate rise in crude oil prices, much the same applies to energy since experience shows that price developments in crude oil products have a lagged impact on gas prices and the shared costs of amenities. The rate of inflation could be 1.2% in 2010 and 1.6% in 2011 on an annual average.

Price projection*

2005 = 100, seasonally and calendar-adjusted, quarterly, log scale

* Harmonised Index of Consumer Prices for 2009 to 2011 compared with 2008 to 2010. Year-on-year change calculated using unadjusted figures.

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Public finances[6]

Further marked deterioration in the state of public finances in 2010

The government deficit ratio, which went up to 3.1% in 2009, will rise considerably in the current year, but probably remain below 5%. Despite higher-than-trend GDP growth, cyclical factors are of minor importance with regard to the change in the deficit as major macroeconomic reference variables for public finances (gross wages and salaries, private consumption) are rising less sharply.[7] The deterioration is due, first and foremost, to fiscal policy measures, chief among which are the various, mostly permanent tax relief measures and the temporary expansion of investment as part of the fiscal stimulus packages. Added to this are high increases in spending, mainly on health services. However, pension expenditure, for example, is also rising relatively strongly following the high pension increase in 2009 and on account of waived pension cuts in the current year. By contrast, the one-off proceeds from the auction of mobile telephone licences as well as the temporary increase in insolvency insurance premiums will have an alleviating effect. The debt ratio, which already jumped to more than 73% in 2009, not least owing

6 The financial development of general government is described here as defined in the national accounts; this definition is also used largely as the basis for the fiscal reference values of the Treaty on the Functioning of the European Union (TFEU). For a more detailed analysis of general government as well as central, state and local government levels and the social security funds, see Deutsche Bundesbank, Monthly Report, May 2010.
7 The disaggregated cyclical adjustment method of the ESCB is used to determine the impact of cyclical factors on public finances. See also Deutsche Bundesbank, A disaggregated framework for analysing public finances, Monthly Report, March 2006, pp 61-76; and C Bouthevillain et al, Cyclically adjusted budget balances: an alternative approach, ECB Working Paper Series No 77/2001.

to support measures for financial institutions, will show a further marked increase.[8]

Improvement in 2011 owing to discontinuation of temporary measures and economic recovery

There are signs that there will be a decline in the government deficit to a figure in the order of 4% in the coming year. Although the cited alleviating effects will not be repeated, various fiscal support measures will be discontinued. In particular, it is assumed that investment will decline significantly from the relatively high 2010 level and that budget management will be restrained overall. Furthermore, as things stand at present, a slightly positive cyclical influence on the deficit is to be expected. The debt ratio will nevertheless increase significantly, mainly owing to the sizeable deficit. In the following years, the deficit ratio could still go down somewhat as a result of some support measures being phased out and a continuing economic recovery, but the debt ratio would from today's perspective go on rising from its already high level. All in all, extensive permanent tax-relief measures and spending increases have been adopted since the onset of the crisis, and the scope for expenditure has become narrower owing to the GDP trend, which has now been revised downwards. This means that considerable additional consolidation efforts are necessary in order to meet the medium-term budgetary objectives in line with the national and international budgetary rules. In this context, note should also be taken of the high degree of uncertainty with regard to additional burdens stemming from support measures in the wake of the crisis.

Risk assessment

Considerable deterioration in public finances as a special risk factor

The exceptionally expansionary monetary policy, the measures to support the financial markets, the expansive fiscal policy in many countries and the effect of the automatic stabilisers have been major factors in the rapid stabilisation and incipient recovery of the global economy. The strain this imposes on public finances has itself now become a source of uncertainty in some countries, which is having a knock-on effect on the financial markets and threatens to hurt the real economy. The baseline scenario in this forecast is that the negative confidence effects of the considerable deterioration in public finances in a number of euro-area and non-euro-area partner countries, particularly for the financial markets, will be limited. In the main, this presupposes that credible measures for sustained fiscal consolidation are taken. Although this could, in individual cases, have restrictive effects which are not yet discounted in this forecast, these risks appear less serious than the massive confidence effects that could occur if there is no consolidation or consolidation is considered insufficient.

Upside risks for real economy in baseline scenario

Looking beyond these particular imponderables, a close eye must be kept on other risks. Currently, enterprises are very confident about the future as is evident in the stable

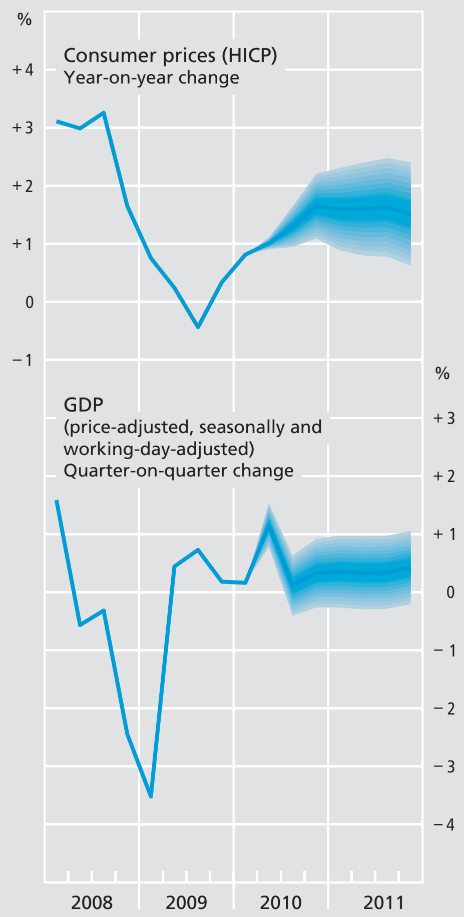
8 In the forecast, the debt ratio is also affected by the support measures for the financial sector in 2010, although Eurostat has not yet made a definitive decision on how they will be recorded. While the vast majority of the measures already known for 2010 will probably have an only minor impact on the national accounts deficit, they could considerably increase the level of government debt.

labour market situation. This optimism is based mainly on the fact that the German economy is now structurally fairly well placed after the, at times painful, adjustment process and the associated structural reforms in the first half of the decade. It is therefore conceivable that German exporters could benefit more from the global recovery, which might itself be somewhat stronger than forecast here, than assumed in the baseline scenario. This would provide domestic demand with an additional stimulus, particularly as financing constraints are likely to ease. From this perspective, economic growth in Germany could exceed these forecasts this year and next, which would also benefit the labour market.

Prices subject to short-term downside, longer-term upside risks

As regards consumer prices, the risks over the next two years are likely to depend mainly on developments in the international markets and on exchange rates. The steep rise in crude oil prices was recently interrupted by a pronounced downward correction, which has not been fully incorporated into these forecast assumptions. However, expected global economic growth is likely to boost demand for commodities, which could trigger stronger price increases than currently discounted in forward prices if supply proves inelastic. If price pressure increases and medium-term inflation expectations, which have to date been anchored at a low level, deteriorate, this would have a knock-on effect on wage negotiations and could itself cause higher prices. In the short term, the risks to price stability are therefore more likely to be to the downside, while potential upside risks dominate in the longer term. However, the latter should not have much impact on the figures for 2011.

Baseline and uncertainty margins of the projection *



* Uncertainty margins calculated on the basis of the mean absolute forecast error. The width of the band that is distributed symmetrically around the most probable value equals double the mean absolute forecast error.

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