Outlook for the German economy – macroeconomic projections for 2012 and 2013

The crisis in public finances in a number of euro-area countries, the ensuing uncertainty as well as the general economic slowdown are placing a strain on economic activity in Germany. Although the domestic conditions for an extended and broadly based upturn in Germany remain intact, its high degree of openness means that demand impulses from the main sales markets abroad are of major importance for the German economy.

Following a 3.0% rise in economic output in the current year, the pace of expansion in Germany is likely to fall perceptibly to 0.6% in 2012 as a result of a lean period during the winter months. This forecast assumes that there will be no further significant escalation of the sovereign debt crisis. Instead, the baseline scenario is predicated on investors' and consumers' uncertainty gradually receding somewhat. The German economy could then return to a sound growth path in the course of next year, based on a continuing expansionary monetary policy and faster global economic growth. Under these conditions, gross domestic product (GDP) could grow by 1.8% in 2013. Given an estimated potential growth of 1¼% per year, this means that the German economy would be operating, by and large, at normal capacity over the entire forecast horizon.

Consumer prices have risen sharply in the current year in line with the quite dynamic global and domestic activity. On an annual average, the cost of living is likely to go up by 2.5% on the year. For the two following years, noticeably lower rates of inflation of 1.8% and 1.5% respectively are likely. First, the rise in the cost of imported goods, especially for energy, should remain within narrow bounds. Second, domestic price pressure is likely to increase only moderately.

Uncertainty about future economic developments is extremely high at present. If the scheduled reforms succeed in overcoming the fiscal crisis and in allaying investors' caution in the near future, growth in Germany might be higher over the medium term than outlined here. Nevertheless, greater weight should be attached to the downside risks stemming from the sovereign debt crisis.

Current situation

Continuation of the economic upswing in the third quarter

In line with the expectations of the June projection, the German economy continued to pick up in the second and third quarters of 2011. A 0.3% increase in overall economic output in the second quarter was followed by growth of 0.5% in the third quarter. The comparatively weak second quarter has to be seen in connection with the preceding three-month period, in which GDP growth of 1.3% had been achieved owing in part to catching-up and backlog effects vis-à-vis the final quarter of 2010. Sharply expanding exports to non-euro-area countries were the main driving force behind the cyclical upswing in the second and third quarters of 2011. There was a further clear increase in exports to other euro-area countries as well. Positive corporate sentiment that lasted well into the summer and the high utilisation of industrial capacity gave impetus to investment. Spending on new machinery and equipment continued to rise, and construction investment largely held up at the level of the first quarter of 2011, which had been heightened by catching-up effects. By contrast, there was only subdued growth in private consumption after what was, admittedly, a strong rise in the final quarter of 2010 and the first three months of 2011.

Further improvement in the labour market situation

The situation in the labour market continued to improve in the wake of the upturn in economic activity. The unemployment rate, as defined by the Federal Employment Agency, has recently fallen to 6.9%, thus reaching its lowest level since German reunification. This was due to rising employment, which went up by 385,000, or 0.9%, in seasonally adjusted terms in the first three quarters of 2011. In most cases, jobs subject to social contributions were created. In terms of numbers, employment growth in manufacturing, business-related services (excluding temporary employment) and health and social services was most important. Since the beginning of the second quarter, there have been scarcely any further gains to be recorded in temporary employment, which had undergone sharp expansion in an earlier phase of the recovery.

The fact that the number of unemployed in the insurance system has been stagnating for some months suggests that the reserves for recruitment from within this group are largely exhausted. Further perceptible gains in employment are likely to be achievable only by a reduction in structural unemployment, an increase in labour market participation and more immigration. According to the available information, immigration has been subdued so far following the complete opening of borders with a number of EU partner countries in central and eastern Europe. Nevertheless, it seems quite plausible to assume that, in time, the – by international comparison – favourable employment and income opportunities that exist in Germany will be reflected in the migration movements.

High wage drift

While the rise in negotiated earnings in the second and third quarters of 2011 was somewhat weaker than expected, the increase in actual earnings exceeded expectations. This was due not only to a further normalisation of working hours but also to a number of large enterprises paying out high bonuses to their workforce, thus letting them have a share in their business success. In the pay negotiations, it became apparent in the second and third quarters of this year that the social partners were continuing to attach major importance to securing employment and that the relevant sectors' economic situation was therefore being taken into consideration in the agreements.

Marked price rise

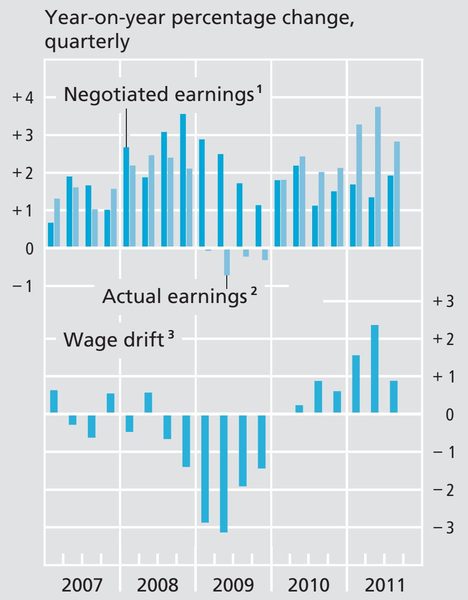
Consumer prices showed a marked rise in the second and third quarters of 2011, as was expected in the June projection. This was due chiefly not only to a further increase in the cost of energy sources but also to a perceptible rise in the prices of other industrial goods and of food. Services inflation accelerated somewhat, too, while the moderate upward trend in housing rents continued unchanged.

Major assumptions[1]

Subdued global economic growth

There is likely to be no more than a subdued expansion of the global economy in the final quarter of 2011 and the first quarter of 2012. A part in this is played by the more restrictive monetary and fiscal policies embarked on in a number of emerging market economies, which, in many cases, are also intended to counteract signs of overheating. Economic activity in the euro area is being dampened, in particular, by the sovereign debt crisis as well as the necessary structural adjustments. In the second half of next year, the pace of global expansion might pick up again provided – as is assumed in the present projection – that there are no negative shocks, say, in connection with the euro-area sovereign debt crisis, that trigger further losses of confidence.

Earnings and wage drift



1 Negotiated wages and salaries including fringe benefits and one-off payments on a monthly basis. — **2** Gross wages and salaries per employee (domestic concept). — **3** Ratio of actual earnings to negotiated earnings.

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Overall, global economic growth in the next two years is likely to be 3½% and just over 4% respectively. It may be expected, however, that the moderation in the case of the euro-area trading partners will be more pronounced and that the ensuing recovery will progress more slowly than in most other industrial countries. Owing to their close economic links with the euro area, this is likely to affect some central and east European trad-

1 The assumptions concerning developments in global trade, exchange rates, commodity prices and interest rates were determined by the Eurosystem's experts. They are based on the information available up to 18 November 2011.

Major assumptions of the projection

Item	2010	2011	2012	2013
Exchange rates of the euro				
US dollar/euro	1.33	1.40	1.36	1.36
Effective 1	104.6	104.6	103.7	103.7
Interest rates				
Three-month EURIBOR	0.8	1.4	1.2	1.4
Yield on government bonds outstanding 2	2.8	2.6	2.4	2.7
Commodity prices				
Crude oil 3	79.6	111.5	109.4	104.0
Other commodities 4, 5	37.1	17.8	– 7.3	4.3
German exporters' sales markets 5, 6	10.6	5.6	3.6	6.0

1 Compared with the 20 most important trading partners of the euro area (EER20 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 Year-on-year percentage change. — 6 Working-day-adjusted.

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ing partners quite strongly, too. US economic growth will probably remain moderate over the next few years. Structural factors, such as adjustments in the real estate markets, are likely to continue dampening the recovery. Added to this is the discontinuation of fiscal measures, which have thus far supported economic activity. In the emerging market economies of South and East Asia, whose markets have become considerably more important for German exporters over the past few years, the current slowdown is likely to be overcome as soon as the beginning of next year.

Expansion of world trade dampened

In line with the global growth profile, the expansion of world trade is likely to slow down to 5½% next year, but then pick up again to more than 7% in 2013. German exporters are likely to feel the weak demand in Europe keenly. In the coming year, growth in their sales markets, at 3½%, might therefore be noticeably more subdued than in the two years before. This constitutes a downward revision of more than 3 percentage points compared with the June projection. With the expected pick-up in the euro-area economy, the sales markets could then grow by 6% in 2013.

Downward revisions to the exchange rate assumptions

The euro was trading at US$1.36 in the period relevant to the derivation of the exchange rate assumption. The single currency has thus depreciated by around 5% against the US dollar since the June projection was finalised. Taking account of changes in its value against other currencies that are relevant to foreign trade, the depreciation of the euro averages 2¼%.

Falling commodity prices

Given a continuing supply shortage owing to the developments in Libya and reduced production in the North Sea, crude oil prices at times stood somewhat higher in the second and third quarters of the year than the assumptions of the June projection. Forward prices, which are relevant to the derivation of the future oil price path, continue to point to a steady decline, however. The present projection therefore assumes a crude oil price of US$109½ in 2012 and US$104 in 2013 for a barrel of Brent, compared with US$111½ on an annual average in 2011. The crude oil price for 2012 is thus somewhat above the assumptions of the June projection. The prices of other commodities were still slightly higher in early summer than the assumptions of the June projection. Nevertheless, overall, with their marked decline over the course of this year, they reflect the global moderation in growth that has already materialised and is still expected. On an annual average, this price reduction will not be apparent until 2012, when other commodity prices could fall by more than 7% after an 18% increase this year. Other commodity prices in 2012 are thus 10% lower than assumed in the June projection. A year-on-year increase of just over 4% is then assumed again for 2013.

Interest rate level markedly lower

The escalation of the sovereign debt crisis in the euro area has interrupted the expected normalisation of short-term interest rates. In the June projection, a steady rise in the three-month interest rate on unsecured transactions on the interbank market was assumed over the forecast horizon based on market data. For the present projection, market expectations following the policy rate cut in early November suggest a further decline in 2012, however, and thus a markedly (110 basis points) lower interest rate level for 2012 as a whole than in the June projection. On an annual average, rates of 1.2% are assumed for 2012 and 1.4% for 2013, compared with 1.4% in 2011.

Owing to the strong demand for secure and liquid paper, the yield on German government bonds with a residual maturity of nine to ten years fell to no more than 1.9% in November. Nevertheless, it is assumed that, over the next two years, there will be a steady increase from this perceptibly reduced level in comparison with the June projection assumptions. Following 2.6% on average this year (owing to the still higher yields in the first half of the year), long-term interest rates of 2.4% and 2.7% are assumed for 2012 and 2013 respectively. Much as in the case of short-term interest rates, the level in the coming year will thus be significantly (120 basis points) lower than was assumed in June.

Financing conditions for enterprises still relatively favourable

According to the Bank Lending Survey, credit conditions tightened somewhat on balance in the third quarter; however, the surveyed banks intend to leave their credit standards largely unchanged over the next three months. Although the balance of responses about credit conditions in the autumn survey of the German Chamber of Commerce (DIHK) published in October was negative, it did show signs of improvement. After a rise in the previous two months, the November Ifo Credit Constraint Indicator, too, shows a fall in the percentage of enterprises reporting that banks were more restrictive in their lending. On balance, the survey results therefore give no indication that credit standards will tighten considerably. These standards are set to remain relatively favourable over the next two years, although it will not quite be possible to maintain the current exceptionally low level.

Public finances in Germany

In public finances, the projections take into consideration all measures which have either been adopted or which have already been specified in sufficient detail and are likely to be approved.[2] Overall, the measures considered significantly lower the 2011 deficit, whereas the financial impact thereafter will be limited (easing the situation in 2012, straining the situation in 2013). With regard to social contributions, shortfalls as a result of a reduction of the contribution rate to the pension insurance scheme (2012 and 2013) as well as lower insolvency benefit contributions (suspension in 2011 and low rate in the years thereafter) outweigh higher contribution rates to the statutory health insurance scheme, Federal Employment Agency (as of 2011) and public long-term care insurance scheme (as of 2013). By contrast, in terms of taxes, additional revenue is recorded on the whole, chiefly from indirect taxes[3] but also owing to the phasing out of more generous depreciation allowances. On the expenditure side, the deficit-increasing assistance to financial institutions is expected to be low over the forecast horizon (still accounted for just under 1½% of GDP in 2010). In addition, many expenditure-related economic support measures are gradually being phased out, and spending is dampened somewhat by the central government's consolidation package and moderate pension growth in order to make up for previous deviations from the general formula. On the other hand, spending increases have been agreed in some areas – most recently transport infrastructure and public long-term care insurance.

Cyclical outlook[4]

Short-term cyclical outlook gloomy

Over the course of the past few months, the cyclical outlook has taken a turn for the worse, which means that the economic upturn in Germany is not likely to continue for the time being. Although no longer quite as favourable as in the past, enterprises still consider their economic situation to be good. However, they have, in particular, notably lowered their expectations of further economic growth. This is also reflected in the hard economic indicators. After another sharp rise in the volume of new orders for German industry in the second quarter of 2011 – *inter alia* owing to a substantial number of large orders, especially in other transport equipment – the third quarter saw a perceptible decline. Despite the pick-up in orders in October, this is likely to be reflected in industrial output in the final quarter of 2011 and the first quarter of 2012. Furthermore, industrial output – in seasonally adjusted terms – was significantly boosted in the third quarter as a number of automotive manufacturers forewent holiday plant shutdowns. As the output figure for October indicates, it is unlikely that this elevated level can be maintained. This is also suggested by a decline in capacity utilisation in the industrial sector from the third to the fourth quarter of 2011 recorded in the Ifo surveys. By contrast, con-

2 With regard to the decisions taken by the coalition committee at the start of November, changes to the public long-term care insurance scheme, which have been specified in greater detail for the most part, as well as the planned additional investment in transport have been taken into consideration. However, the projection does not include the income tax cut (insufficiently detailed at the time this projection was concluded) announced for 2013 (and 2014) but still hotly disputed by state governments whose approval is required or the childcare supplement (also lacking in detail).
3 In particular, 2011 has seen the introduction of taxes on nuclear fuel and air traffic as well as a bank levy to the Restructuring Fund. Furthermore, tobacco tax rates will increase gradually over the forecast horizon.
4 The projection presented here was completed on 25 November.

struction activity appears to be fairly robust and, as things stand, a number of other economic sectors will probably feel almost no effect from the economic slowdown. Overall, a cyclical sideways movement is expected for the final quarter of 2011 and the first quarter of 2012.

Upward trend in medium term

In line with Eurosystem experts' assumptions about global economic developments and forecasts of economic trends in the other euro-area countries, a recovery is expected to kick in from the second quarter of 2012 onwards, which could gradually strengthen. This is based on the idea that the fiscal and economic policy measures introduced in a number of partner countries are likely to gradually alleviate investors' and consumers' uncertainty. Under this condition – paired with the expansionary bias of monetary policy – the fourth-quarter GDP growth rate in Germany could total 1.3% in 2012, rising to 2.0% in 2013. On an annual average, the calendar-adjusted increase in economic output would thus be 0.8% in 2012 and 1.9% in 2013, compared with 3.0% in 2011. As there are fewer potential working days in 2012 and 2013 than in the respective year before, the unadjusted GDP rate would work out at 0.6% in 2012 and 1.8% in 2013. Compared with the June forecast, this represents a downward revision of the anticipated growth rate by 1.2 percentage points for 2012.

Capacity utilisation and potential growth

The process of economic recovery, which has extended into 2011, has not just returned GDP to pre-crisis levels, it has also closed the aggregate output gap. With estimated potential growth of around 1¼% per year, the projected baseline scenario would mean that the German economy is within the corridor of normal utilisation over the forecast horizon.

Technical components of the GDP growth projection

As a percentage or in percentage points

Item	2010	2011	2012	2013
Statistical carry-over at the end of the previous year 1	1.0	1.2	0.2	0.6
Fourth-quarter rate 2	3.8	2.0	1.3	2.0
Average annual GDP rate, working-day-adjusted	3.6	3.0	0.8	1.9
Calender effect 3	0.1	– 0.1	– 0.2	– 0.1
Average annual GDP growth 4	3.7	3.0	0.6	1.8

Sources: Federal Statistical Office; 2011 to 2013 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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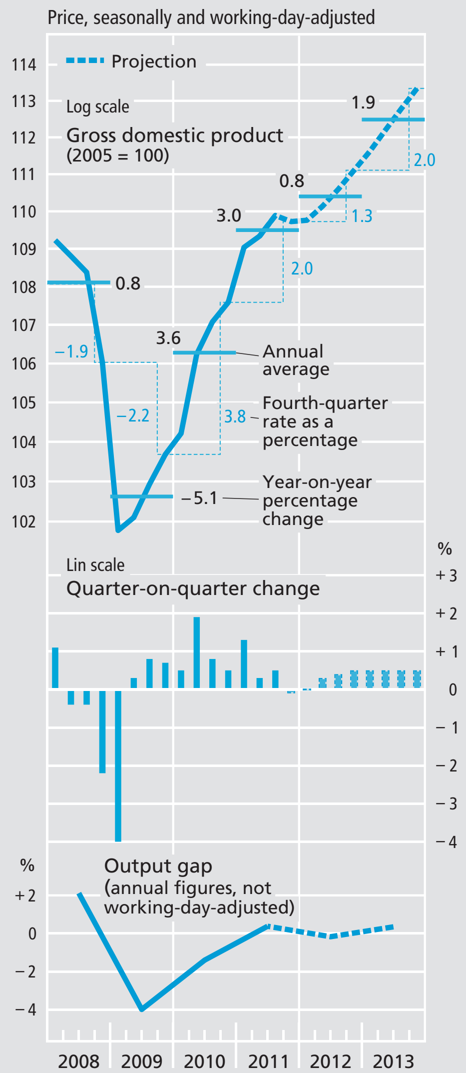
Increase in exports in line with growth in sales markets

The slower pace of global economic activity is likely to curb export growth in the winter half-year 2011-12. Orders received by industry from abroad fell perceptibly in the third quarter and, according to the Ifo business survey, enterprises' export expectations are now below their long-term average. However, the forecast upturn in global trade during 2012 is likely to breathe new life into German exports. This projection assumes that German exporters will more or less maintain their position on international sales markets and that exports will grow in line with the market. Over the forecast horizon, the range

Aggregate output and output gap



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of products demanded globally will thus probably no longer be as favourable as in 2010 and 2011, when there was a greater demand for high-quality intermediate and capital goods from international customers. On an annual average, this equates to an increase in real exports of 3¼% (3¾% after calendar adjustment) in 2012 and 5¾% (6% after calendar adjustment) in 2013, after growth of 8¼% in 2011.

Investment up again

In 2012, enterprises are not expected to invest in machinery and equipment to the extent that they did in 2010 and are doing in 2011. First, the investment postponed in the 2009 crisis year has probably now been made good. Second, the somewhat slower pace of global demand is reducing the need to invest in capacity extensions. Nevertheless, growth in spending on new machinery and equipment, and buildings in 2012 and 2013 is again likely to significantly outpace that in GDP. Enterprises plan to raise their investment budgets, and this is likely to be put into practice in the scenario described here. In addition, despite a forecast rise in interest rates, financing conditions for German enterprises are, on the whole, still favourable.

Construction stays buoyant

Over the forecast horizon, private housing construction is also set to benefit from low financing costs and the assumed ongoing uncertainty regarding alternative forms of investment. The resulting demand focuses mainly on apartments in multi-storey blocks. This can be seen in the statistics on building permits, which show that the number of permits granted for apartments in multi-storey blocks in the third quarter of 2011 rose by 35% year-on-year, compared with 3% for apartments in single-family and two-family houses. The Association of German Pfandbriefbanks *(Verband deutscher Pfandbriefbanken)* also reports that the rise in the price of apartments has been much sharper than for single-family houses.

Widespread uncertainty led to restrained inventory investment on the part of enterprises in the third quarter of 2011. According to the

Inventory investment dampens economic growth in 2012 and has neutral effect in 2013

baseline scenario, this is not expected to change in the final quarter of 2011 and the first three months of 2012. Thereafter, the incipient economic recovery will most likely mean that stockbuilding no longer has a dampening impact on economic growth. On an annual average, changes in inventories are thus likely to make a negative contribution to growth in 2012 and to have a predominantly neutral effect in 2013.

Savings ratio unchanged, private consumption with stable growth

Private consumption will probably continue to benefit from the favourable situation on the labour market and from a clear rise in income. Households' disposable income could go up by 3¼% in 2011, and 2¾% in both 2012 and 2013. This is due, first, to a perceptible rise in net earnings, with tax relief measures and lower social contributions offsetting almost all of the higher wage tax burden resulting from the effects of tax progression in 2012 and approximately 50% thereof in 2013. Second, income from entrepreneurial activity and capital is likely to again increase sharply. After a decline in monetary social benefits in 2011 only a moderate rise is on the cards for 2012 and 2013 – in particular due to continued favourable developments on the labour market. In the scenario assumed in this projection of a pause in growth restricted to the winter half-year 2011-12 and cyclical recovery thereafter, German households' savings ratio is expected to stay at its current level of 11% over the forecast horizon. With easing consumer price inflation, private consumption could rise by 1½% in 2011, 1¼% in 2012 and 1½% in 2013 in price-adjusted terms.

Key figures of the macroeconomic projection

Year-on-year percentage change

Item	2010	2011	2012	2013
GDP (real)	3.7	3.0	0.6	1.8
GDP (working-day-adjusted)	3.6	3.0	0.8	1.9
Components of real GDP				
Private consumption	0.6	1.4	1.2	1.4
Government consumption	1.7	1.3	1.5	1.8
Gross fixed capital formation	5.5	6.9	2.2	4.1
Exports	13.7	8.3	3.2	5.8
Imports	11.7	7.4	4.3	6.4
Contributions to GDP growth [1]				
Domestic final demand	1.6	2.3	1.4	1.9
Changes in inventories	0.6	– 0.1	– 0.4	– 0.1
Net exports	1.5	0.8	– 0.3	0.0
Labour market				
Total number of hours worked [2]	2.3	1.6	– 0.1	0.4
Persons employed [2]	0.5	1.2	0.3	0.4
Unemployed persons [3]	3.2	3.0	3.0	2.9
Unemployment rate [4]	7.7	7.1	7.0	6.8
Unit labour costs [5]	– 1.2	1.0	1.5	1.3
Compensation per employee	2.0	2.7	1.9	2.7
Real GDP per person employed	3.2	1.7	0.3	1.4
Consumer prices [6]	1.2	2.5	1.8	1.5
Excluding energy	0.8	1.4	1.5	1.6
Energy component	3.9	10.1	4.0	0.5

Sources: Federal Statistical Office; Federal Employment Agency; 2011 to 2013 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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Disproportionately large increase in imports

Due to the ever greater international division of labour, growth in imports will probably continue to significantly outpace that in aggregate demand over the forecast horizon. With aggregate demand increasing by 1¾% in 2012 and 3¼% in 2013, imports of goods and services could go up by 4¼% and 6½%, respectively, after recording a 7½% increase this year. This means that import growth will outstrip export growth for the next two years, which is mainly attributable to fairly robust domestic demand. The contribution of net trade to GDP growth would therefore be slightly negative in 2012 and neutral in 2013. The foreign trade balance (as a percentage of nominal GDP) should see only a minimal change over the forecast horizon. The current account surplus is thus expected to total 5¼% of GDP in both 2011 and 2012, increasing to 5½% in 2013. It would then still be significantly below the high of 7½% in 2007.

Moderate rise in employment …

Now that working hours have returned to normal, the impact of the sideways movement in economic activity in the fourth quarter of 2011 and the first quarter of 2012 on the labour market can be largely cushioned using the available flexible working time arrangements. No notable decline in employment is expected, as is also indicated by surveys on enterprises' staffing plans. In the services sector, especially health and social services, the sustained positive trend in employment is likely to continue. However, there could be adjustments in temporary employment, as developments in the past few months have already indicated. Given the usual lag vis-à-vis macroeconomic activity, a slight increase in employment is to be expected again from the end of 2012. On an annual average for 2012, the number of employed persons could rise by 0.3%, although in mathematical terms this increase would largely be carried over from 2011. A gain of 0.4% is expected in 2013. Once again, the main source of growth will probably be employment subject to social contributions, while the number of persons exclusively in low-paid part-time employment – assuming that the monthly wage ceiling for this category remains at €400 – is unlikely to see more than a marginal rise.

… and slight decline in unemployment

In the forecast period, developments in unemployment are likely to be largely in line with employment trends. However, a moderate increase in labour supply is likely to curb the decline in unemployment somewhat, with a slight rise in immigration and a further (albeit small) rise in labour market participation counteracting the decrease in the domestic labour force. On an annual average, this forecast expects the official unemployment figure to be just under 3.0 million in 2012. This corresponds to a rate of 7.0%. In 2013, the unemployment rate could be 0.2 percentage point lower and the number of unemployed persons may stand at 2.9 million.

Labour costs and prices

Stronger rise in negotiated wages

As the economy has recovered, growth in negotiated wages has steadily strengthened from a very low initial level. The upcoming wage negotiations will be influenced by the very successful business years 2010 and 2011, particularly in industry, on the one hand and by the gloomier outlook for 2012 on the other. All in all, growth in negotiated wages will therefore probably continue to increase but remain in a range that is compatible with price stability. Based on the agreements signed to date, an increase of 1.7% is to be expected for 2011, followed by 2.4% in 2012 and 2.6% in 2013.

Strong growth in actual earnings to ease off

The resounding success experienced by enterprises in 2010 is also behind the exceptionally strong wage drift, with actual earnings rising far faster (by 3.0%) than negotiated wages in 2011. Especially but not exclusively in the automotive industry, companies have allowed their employees to partake in their business success by awarding them bonus payments. Although most enterprises will also end this business year on a successful note, bonuses may be somewhat smaller in future. Particularly in the metalworking industry, part of the bonus payments in 2011 can probably be viewed as compensation for the fact that a wage agreement containing comparatively low negotiated rates has been in force for a long period of time. In effect, growth in actual earnings in 2012 could therefore be somewhat weaker than in negotiated wages. A slightly positive wage drift would be likely again in 2013.

Distinct rise in unit labour costs

Given a somewhat smaller burden from employer social contributions, wage costs per employee are likely to increase by 1.9% in 2012 and by 2.7% in 2013. The pause in growth in the fourth quarter of 2011 and the first quarter of 2012 and the lag in labour market adjustment suggest that productivity gains will be low next year. Unit labour costs are thus likely to rise considerably more sharply (by 1.5%) than in 2011. As growth in productivity returns to normal, the increase in unit labour costs will weaken slightly to 1.3% in 2013.

No widening of profit margins until 2013

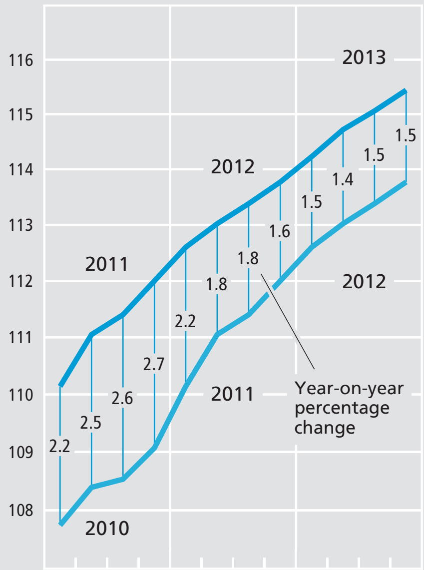
Following the discernible recovery of profit margins in 2010, the subdued pace of economic growth anticipated in 2012 means that margins are unlikely to widen again before 2013. Measured by the GDP deflator, the prices of domestically produced goods and services could go up by just over ¾% in 2011, by 1½% in 2012 and by 1¾% in 2013.

Significant weakening in consumer price inflation

Consumer price inflation has probably passed its peak and is likely to weaken perceptibly over the forecast horizon. On an annual average, the rate of inflation – as measured by the Harmonised Index of Consumer Prices (HICP) – will probably fall significantly to 1.8% in 2012 and moderate somewhat further to 1.5% in 2013. The main reason for this is the smaller contribution from energy. Despite lagged adjustments to gas prices and rising electricity prices, which are probably mainly due to an increase in network charges, energy price inflation should initially fall to 4% next year. In 2013, it is likely to reach a virtual standstill, at 0.5%. This projection assumes that crude oil prices will decline over the forecast horizon. For food, too, inflation is likely to gradually weaken in line with lower prices on the commodity markets. However, this movement will be offset to some extent by rising prices for tobacco products. For the other components (goods excluding energy, services), rising wages will probably cause a

Price projection*

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



* Harmonised Index of Consumer Prices. Year-on-year change calculated using unadjusted figures.

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slow increase in inflation. It is therefore assumed that, having gone up by 1.4% in 2011, prices excluding energy will rise by 1.5% in 2012 and by 1.6% in 2013.

Public finances[5]

Significant improvement in public finances in 2011

Having increased very sharply, reaching 4.3% in 2010, the deficit ratio in Germany is likely to fall significantly to around 1% in 2011. The favourable economic developments for the year as a whole are one important factor in this decline, and the cyclical component is now likely to be positive overall. Another factor is the fact that, as in previous upturns, tax revenue is growing much more strongly than macroeconomic reference variables would suggest. Looking at fiscal policy measures, it is currently expected that the very high capital transfers to support financial institutions in 2010 (just under 1½% of GDP) will largely cease to be a factor. Furthermore, the phasing out of parts of the economic stimulus programmes, central government's consolidation package and higher social contribution rates will ease the strain on the general government budget.

In combination with the relatively strong nominal GDP growth, the steep fall in the deficit is leading to a marked decline in the debt ratio, which had risen sharply to 83.2% by the end of 2010. The planned gradual reduction in risk assets and the associated liabilities taken on by the government sector to support the financial market could speed up this debt reduction, while additional assistance to individual euro-area countries have the opposite effect. All in all, the current government estimate of a debt ratio of around 81% at the end of 2011 appears plausible, although this is subject to considerable uncertainty, not least in connection with the sovereign debt crisis.

Deficit ratio virtually unchanged in 2012 and …

In 2012, the deficit ratio could remain virtually unchanged given the baseline forecast for macroeconomic conditions outlined above. In this scenario, the slowdown in economic activity would thus lead to a limited increase in the deficit. In structural terms, however, there could be a slight improvement – even though the consolidation path is now much less stringent compared with the

5 Developments are described using national accounts' definitions with a view to the Maastricht ratios. For a more detailed analysis, see Deutsche Bundesbank, Monthly Report, November 2011, pp 65-78.

original plans. In particular, temporary economic stimuli – especially the investment programmes, which were implemented with a sometimes substantial time lag – will continue to be phased out. Furthermore, a structural fall in unemployment figures and the gradual return of pensions to the path prescribed by the general pension formula could dampen the development of social payments.

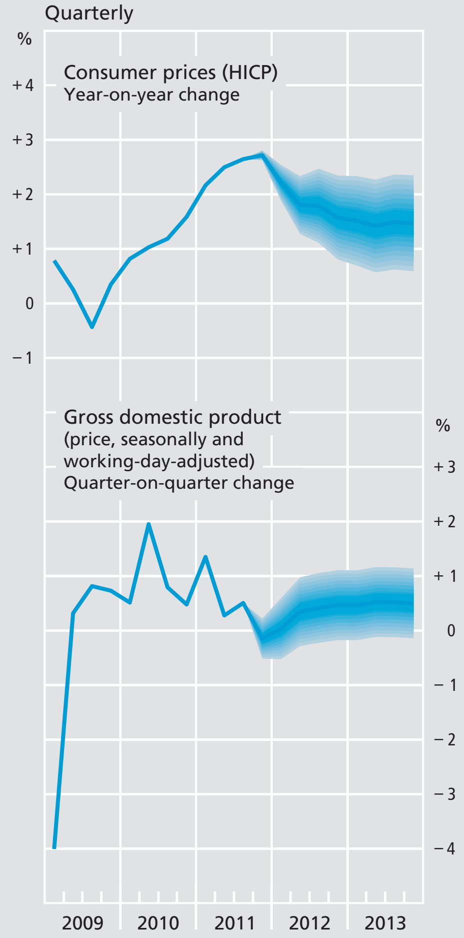
… barely any change on the cards for 2013, either

From today's perspective, the deficit could remain almost unchanged in 2013, too. No further structural deficit reduction is on the cards at present. On balance, the financial impact of the fiscal policy measures taken into account in this forecast – particularly the reduction in the pension contribution rate and the additional subsidies as part of the "energy concept" – will actually place something of a strain on the budget. This is without taking into consideration the further loosening of the fiscal policy stance (which is, however, limited according to current plans) scheduled for the year of the general election, which involves a tax cut and a childcare subsidy.

Considerable uncertainty regarding debt ratio

In the baseline scenario, there is also a perceptible decline in the debt ratio for 2012 and 2013. This is due to the expected considerable primary surpluses and relatively low average interest burden compared with nominal economic growth as well as the assumption that the continued reduction in the assets and liabilities taken on by the government sector to stabilise the financial market will exceed the increase resulting from assistance to individual euro-area countries. Uncertainty surrounding the European assistance programmes for euro-area countries[6] and the support for German financial institutions remains very high, however. Overall, despite generally being on a downward trend, the debt ratio will still be substantially above the

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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6 In particular, the additional assistance announced for Greece is not taken into account in the fiscal forecast given that the details have yet to be specified. For information on the decisions taken, see Decisions of the European Council and the Euro Summit of 26 and 27 October 2011, Deutsche Bundesbank, Monthly Report, November 2011, pp 66-67.

reference value of 60% at the end of the forecast horizon.

Risk assessment

Risks to economic growth

The baseline scenario in this forecast assumes that the uncertainty caused by the sovereign debt crisis will ebb somewhat, but that cautiousness among consumers and investors, which stems from a deep feeling of insecurity, will not be fully reversed. If the crisis can be overcome more swiftly and durably, economic growth in Germany could be stronger in the medium term than outlined in this forecast. A further escalation of the sovereign debt crisis would imply considerable downside risks, however. Furthermore, the pace of economic growth in several emerging market economies, which have recorded exceptional growth rates in recent years, could level off to a greater extent. This would hit Germany particularly hard given its dependency on exports.

Risks to price stability

Crude oil prices and exchange rates represent the main risks to price stability. Given the projected development in global economic activity, it is quite possible that crude oil prices will not fall significantly over time, instead remaining at a high level. However, a more pronounced slowdown in economic growth in some emerging market economies could depress oil prices more substantially.