Outlook for the German economy – macroeconomic projections for 2013 and 2014

The cyclical outlook for the German economy has dimmed. There are even indications that economic activity may fall in the final quarter of 2012 and the first quarter of 2013. The main factors in this are the adjustment recessions in the euro area, which are severe in some countries, and the slowing of the global economy. However, there are sound reasons to believe that the phase of weak economic momentum will not last very long and that Germany will soon return to a growth path. This presupposes that the global economy will pick up, that continued progress will be made under the reform process in the euro area and that no new major negative shocks will occur. But in view of the difficult economic situation in parts of the euro area and widespread uncertainty, economic growth is likely to be slower than previously expected. Nonetheless, the sound underlying health of the German economy suggests that it will overcome the temporary lull without major damage to the labour market, in particular.

Following a 0.7% expansion in real gross domestic product (GDP) in the current year, or 0.9% after adjustment for calendar effects, economic growth could decline to 0.4% on an annual average in 2013 (0.5% after adjustment for calendar effects), before strengthening to 1.9% in 2014. Subject to these prerequisites and assuming a slight downward path for crude oil prices, inflation in Germany should remain at a moderate level. An inflation rate (measured by the Harmonised Index of Consumer Prices) of 2.1% in 2012 could be followed by rates of 1.5% in 2013 and 1.6% in 2014. Excluding energy prices, the inflation rate would rise from 1.6% in 2012 to 1.8% in 2014 because of higher wage agreements. The general government budget looks set to be more or less balanced in the current year for the first time since the onset of the economic and financial crisis in 2008. It is likely, however, to show a marked deficit again next year in the wake of the economic slowdown. In cyclically adjusted terms the deficit ratio in 2013 and 2014 will probably remain more or less constant at around ½%.

The current projection is characterised by a high degree of uncertainty. It is quite conceivable that the euro area will recover sooner and the world economy will accelerate faster than assumed in this projection. In this case, the German economy, in view of its sound underlying health, may be expected to utilise the additional growth opportunities that arise. Downside risks nonetheless predominate. Should global economic growth remain below expectations or the debt crisis escalate further in some countries, it is probable that the German economy may follow a weaker course than the one assumed in the baseline scenario.

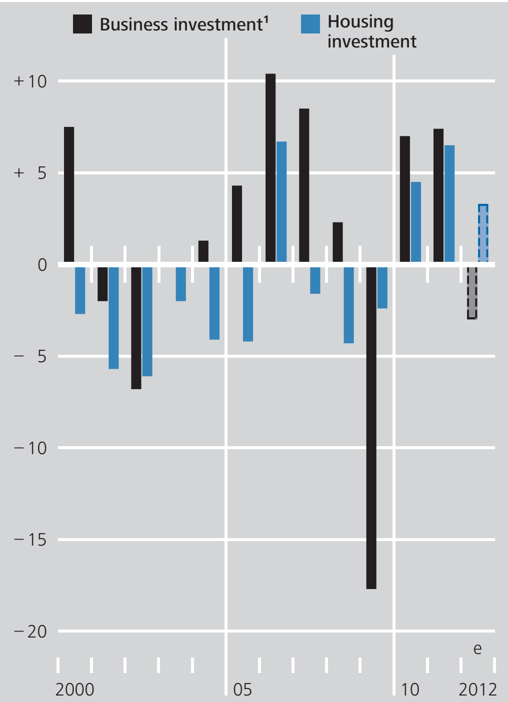
Current situation

Waning dynamics supported by exports

The expansion of real gross domestic product (GDP) in the second and third quarters of 2012, at a cumulative 0.5%, did not fully meet the expectations of the projection published in June.[1] This means that, since the sovereign debt crisis in the euro area worsened in the summer of 2011, economic growth in Germany has on average remained slightly below its estimated potential rate of 1¼%, despite exports continuing to rise markedly.[2] While goods shipments to euro-area partner countries stagnated, deliveries to countries outside the euro area rose by just under 5% in price-adjusted terms. Exports to the United States and to south and east Asian emerging economies were once again particularly dynamic. Without the strong market position enjoyed by German enterprises in these countries, German economic growth would thus probably have been still weaker.

Private investment

Year-on-year percentage change, price and calendar-adjusted



1 Machinery and equipment and other buildings and structures.

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Steep fall in business investment

Regardless of buoyant overall export activity, enterprises have reduced their investment budgets considerably, shrinking them by almost 5% in real terms over the course of the second and third quarters. This doubtless owes something to the accumulation of negative news from the euro area for a time and to the spillover of increased uncertainty into business investment decisions. As global growth likewise showed signs of slackening, a number of investment projects were postponed or cancelled altogether, despite the extremely favourable financing terms.

Recruitment plans also more cautious

Enterprises' recruitment plans were also marked by a greater degree of restraint. Employment growth weakened distinctly in the second and third quarters of 2012, and the demand for staff, measured by the number of new vacancies, declined considerably. Indeed, seasonally adjusted unemployment has even been going back up slightly since April.

But robust housing construction

In notable contrast to business investment, expenditure on housing construction rose considerably, although renovation projects were probably held back in anticipation of additional tax incentives. The construction of new buildings remained overwhelmingly focused on blocks of apartments. This accords with price trends on the property markets, which show a significant rise for flats in urban centres in particular. Demand in this segment is being bolstered by low interest rates in combination with the current climate of uncertainty.

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1 See Deutsche Bundesbank, Outlook for the German economy – macroeconomic projections for 2012 and 2013, Monthly Report, June 2012, pp 15-26.
2 It should be noted that the national accounts, unlike the foreign trade statistics, include non-cross-border transactions between residents and non-residents in exports and imports. This applies in particular to electricity and gas transactions (with the point of delivery in Germany or abroad involving no crossing of borders), which in the balance of payments are booked as supplementary trade items. The volume of such transactions has expanded considerably of late. However, the finding that exports have continued to rise markedly is also supported by the foreign trade statistics.

Consumption stable

On the other hand, private consumption, owing to weak growth, has fallen short of the expectations in the current year. Besides the ongoing problem of imprecise statistical recording of such spending, it should also be noted that disposable incomes have grown less strongly than was anticipated in the spring. Government consumption, too, is likely to have expanded more weakly in real terms than previously assumed.

Faster wage growth, moderate price rises

Collectively agreed wages should rise by 2.6% in the current year, as anticipated in the June projection. This represents a distinct acceleration over 2011, when they went up by 1.7%, and reflects the healthy overall situation of the economy and the labour market. The wage drift could turn out to be largely neutral, as fewer but in some cases larger bonuses have been paid than in 2011. The rise in consumer prices in 2012, at 2.1%, will probably be in line with the June projection. In addition to energy, it is mainly food that is driving the price rises. In services and rental housing, the rate of inflation has remained very muted.

German economy remains in good shape

Despite the negative influence of the adjustment recessions in the euro area, some of them severe, and the uncertainties resulting from the debt crisis, the German economy remains in good health. According to the autumn survey of the Association of German Chambers of Commerce and Industry (DIHK), almost nine out of ten enterprises rate their business situation as good or satisfactory. Neither households nor businesses have amassed debts to an extent which might cause concern, and the government budget is almost balanced. German firms have a presence in all major markets, and their cost/income ratios are satisfactory. The unemployment rate, at 6.9%, remains very much lower than in the previous decade, and employees, with a distinct increase in their disposable income, are participating in the business success. This would suggest that the German economy is well placed to see through the looming economic lull.

Orders received by industry

Volume, 2005 = 100, seasonally adjusted, quarterly, log scale

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Major assumptions

Assumptions-based projection

This projection is based on assumptions made by the Eurosystem's experts concerning global trade, exchange rates, commodity prices and interest rates. The assumptions are based on information available up to 16 November 2012. The assumptions regarding sales markets in the euro area are derived from projections for the other euro-area countries which are drawn up by the relevant national central banks.

Slower global economic growth

Growth in the world economy has weakened further in the current year. This is probably the result of global and, particularly, country-specific factors. First, the aftermath of the sharp rise in crude oil prices in 2011 is still being felt. The unresolved problems in public finances in a number of major industrial countries, as well as geopolitical conflicts in the Middle East and the Far East, have heightened uncertainty and dampened investment. The catch-up process in the emerging market economies appears to have slowed somewhat, at least for the time being, and also seems to be turning inward to an increased extent. However, given that some of the negative factors are of a temporary nature, global growth should slowly strengthen again. Leading indicators, such as the results of business surveys, also suggest this is the case. Nonetheless, the rate of expansion in the global economy, at 3¼% in 2013 and 4% in 2014, is likely to remain below the rates prevailing before the financial and economic crisis began.

Euro area still dominated by adjustment recessions

The economic evolution of the euro area continues to be shaped by the adjustment processes which are necessary in some countries. The contraction in economic activity threatens to be more severe and to last longer than previously anticipated. Furthermore, a crisis of confidence and financing problems in some countries are depressing business investment. Nonetheless, there are some clear signs of progress in the adjustment programmes of states particularly affected by the debt crisis. Current account deficits have shrunk markedly, and not simply because domestic demand in the crisis countries has been significantly constrained.[3] Adjustment in cost structures is also progressing, and there are increasing indications that enterprises in these countries are tapping new export markets. It therefore appears probable that the economic situation in the euro area will stabilise over the course of the coming year, and that a nascent recovery will follow, if only hesitantly at first. The precondition for this is that the sovereign debt and banking crises in the euro area do not further intensify and that consolidation and reform efforts continue.

Subdued sales market growth

World trade is currently being dampened by the global economic slowdown and a low trade intensity of growth. This is likely to be closely connected to the global weak cyclical momentum of industrial activity. World trade will probably expand in 2012 by no more than 3%. Over the projection horizon, the trade intensity of growth is expected to recover, though without returning to the very high level which prevailed before the financial and economic crisis. Thus, the volume of world trade may rise markedly, at rates of 4% in 2013 and 7% in 2014. The expansion of German exporters' sales markets will continue to be constrained by weak growth in the euro area. After expanding by 1% this year, market growth may strengthen to 2¼% next year and 5½% in 2014, although this would still be far less than anticipated in the June projection.

Further depreciation of the euro

The euro depreciated significantly during the summer months but later recouped most of these losses. The single currency was trading at US$1.28 in the period relevant to the derivation of the exchange rate assumptions, which constitutes a depreciation of no more than 1½% as against the June projection. Compared with other currencies that are relevant to foreign trade, the euro was 1¾% lower than the assumptions of the June projection.

Falling commodity prices

After the situation on the crude oil markets had eased, for a time distinctly, oil prices began to pick up again. Forward prices continue to point downwards, as they have done for some time now. The assumptions of US$111¾ for a barrel of Brent in the current year, US$105 in 2013 and US$100½ in 2014 are around 2½% lower than the assumptions made in the June projection. This equates to a decline of ¾% in euro terms.

By contrast, the increase in the prices of food, beverages and tobacco as well as agricultural commodities in the past few months was higher than projected in June. The price trend looks set to remain unfavourable in the near future, too. In the case of other commodities, however, the weaker economic activity is making itself felt. Overall, the prices of other commodities are likely to follow this year's steep falls by declining a little more next year. Only in

3 See Deutsche Bundesbank, Reducing current account deficits in peripheral euro-area countries, Monthly Report, November 2012.

2014 can prices be expected to rise again markedly on an annual average.

Marked further fall in interest rates

Weak economic activity in the euro area and the disruptions caused by the sovereign debt crisis prompted the Governing Council of the ECB in July to cut its key interest rates to a new historical low. As a result, expectations for the future path of short-term interest rates were lowered as well. The three-month interest rate derived from market data for unsecured transactions on the interbank market is 0.6% on average for the current year, 0.2% for 2013 and 0.3% for 2014. This is 20 basis points (for the current year) and no less than 50 basis points (for next year) lower than the assumptions made in the June projection. 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 was pushed down further still. It had already fallen significantly below the assumptions of the June projection in the third quarter. Although the yield curve implies that interest rates will resume an upward path starting in the final quarter of 2012, the yields of 1.5% on average this year, 1.6% for next year and 1.9% for 2014 fall short of the assumptions of the June projection by 30 and 50 basis points for the years 2012 and 2013 respectively.

Financing conditions still exceptionally favourable

Lending rates of German banks also eased further in the past months. Although a slight rise in bank interest rates over the projection horizon can be derived from the projected yield path for long-term government bonds, lending rates for business loans and consumer credit nonetheless look set to remain at very low levels in historical terms. Credit standards for loans to enterprises were tightened slightly in the third quarter, and the results of the Bank Lending Survey indicate that banks will tighten them further in the fourth quarter. The Ifo Credit Constraint Indicator, too, has risen slightly in the past months. However, the percentage of enterprises reporting that banks were restrictive in their lending is still very low, and the Credit Constraint Indicator is not far off its historical low. Overall, therefore, financing conditions can continue to be regarded as exceptionally favourable and can be expected to remain highly supportive of economic activity over the projection horizon as well.

Major assumptions of the projection

Item	2011	2012	2013	2014
Exchange rates of the euro				
US dollar/euro	1.39	1.28	1.28	1.28
Effective[1]	103.4	97.7	96.8	96.8
Interest rates				
Three-month EURIBOR	1.4	0.6	0.2	0.3
Yield on government bonds outstanding[2]	2.6	1.5	1.6	1.9
Commodity prices				
Crude oil[3]	111.1	111.7	105.0	100.5
Other commodities[4, 5]	17.9	− 7.5	− 1.5	3.3
German exporters' sales markets[5, 6]	5.3	1.1	2.3	5.6

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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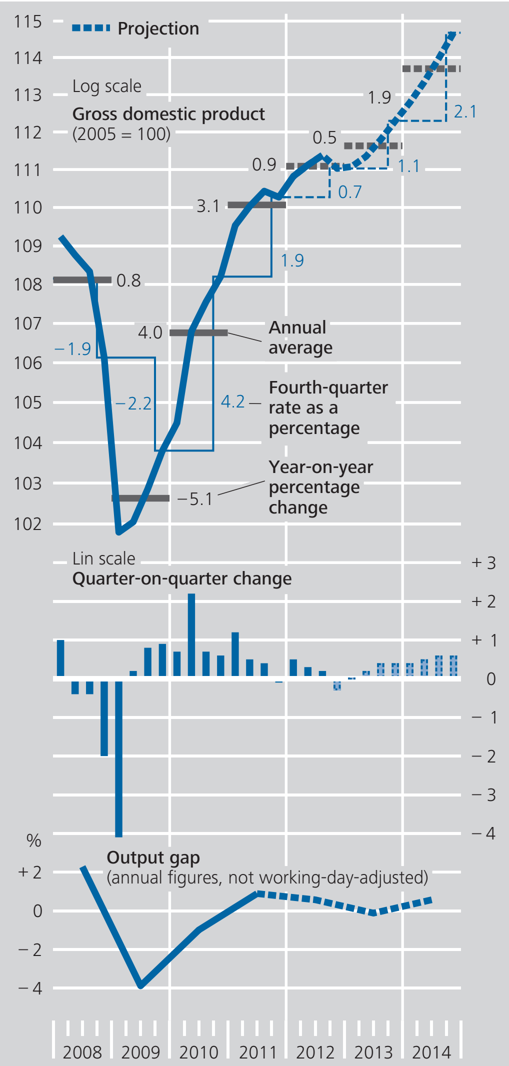
Fiscal policy measures in Germany perceptibly deficit-increasing

In the field of public finances, the projections take into consideration all measures which had either been adopted when the projection was finalised or which had already been specified in detail and are likely to be approved.[4] The measures considered here will place a limited but perceptible strain on the government budget in 2013 and 2014. The most substantial measure in terms of its impact is the lowering of the statutory pension contribution rate from 19.6% to 18.9% next year. Tax revenue is also set to drop slightly on balance owing to the assumed raising of the basic income tax allowance up to the minimum subsistence level. On the expenditure side, the measures tending to ease and

4 The recent decisions on the assistance programme for Greece have thus not yet been taken into account. The projection does not include various other measures that are currently going through the parliamentary process or are planned by the Federal Government either. These include, in particular, the adjustment of the income tax schedule to curtail cold progression, tax incentives for the restoration of buildings, and the granting of pension top-ups for low earners (deficit-increasing) as well as the tax repatriation agreement with Switzerland and the regular dividend payment by the public KfW banking group to central and state government (deficit-reducing).

Aggregate output and output gap

Price, seasonally and working-day-adjusted



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strain the budget will virtually balance each other out in 2013 and 2014. A capital transfer related to the resolution of the regional public bank WestLB has inflated expenditure in the current year, whereas no further transfers in support of German financial institutions have been assumed for the period thereafter. And the budgetary impact of the abolition of the homebuyer's grant for new homebuyers back in 2006 is continuing to decrease. By contrast, the latest government initiatives, such as the abolition of the quarterly charge for seeing a doctor or dentist and the introduction of the childcare supplement, will increase expenditure permanently.

Cyclical outlook[5]

Weak Q4 and Q1

Business prospects in the corporate sector have taken a turn for the worse over the past months, not just in the export-oriented sectors but also in those focused on the domestic economy. Firms' lowered expectations have been matched by a distinct drop in the volume of new industrial orders. The global economy has not provided any major impetus for some time now, demand from the euro area is diminishing considerably, and domestic orders are being squeezed by the fall-off in investment, in particular. Against this backdrop, a decline in aggregate output is therefore to be expected for the final quarter of 2012. Recently, however, expectations in the corporate sector have stabilised at a low level and even picked up again in some cases. Although this will probably not yet translate into an upturn in economic output in the first quarter of 2013, it might be possible to avoid a further decline. This assessment is based on the assumption that the winter will not be exceptionally harsh.

Growth gradually accelerating

Assuming that the global economy overcomes the dip in growth and there are no major negative shocks in the euro area, confidence should gradually be restored and demand from the euro area should at least not drop any further. Under these conditions, growth in Germany ought to pick up pace again. An increase in output of 0.7% over the course of 2012 could be followed by fourth-quarter annual rates of change of 1.1% in 2013 and 2.1% in 2014. This would equate to average annual GDP growth rates of 0.7% in the current year (working-day-adjusted: 0.9%), no more than 0.4% next year on account of the weak fourth quarter of 2012 and first quarter of 2013 (working-day-adjusted: 0.5%), and 1.9% in 2014. Compared with the June projection, the growth expectations for both the short and medium term have thus been clearly reduced.

5 The projection for Germany presented here was completed on 23 November 2012. It was incorporated into the projection for the euro area published by the ECB on 6 December 2012.

Largely normal capacity utilisation

Economic growth over the entire projection horizon could be roughly as strong as the increase in potential output over the same period, namely 1¼% per year. The rate of utilisation of production capacities would thus remain more or less normal. The expansion in potential output is based, not least, on the influx of labour from abroad. Growth rates are slightly lower than the estimate contained in the June projection owing to weaker investment.

Dip in exports short-lived

The expected upturn in economic activity will be fuelled by higher demand for German industrial goods from non-euro-area countries. A marked rise in demand from euro-area countries is only expected to materialise over the medium-term horizon. In particular, an upturn in investment should benefit the German economy. The anticipated dip in exports in the fourth quarter of 2012 and the first quarter of 2013 could limit export growth to 2% next year as against an increase of 4% in the current year. However, exports should rise by 6% in 2014, driven not only by expanding sales markets but also by the likelihood that the price competitiveness of German enterprises will probably not deteriorate significantly. The share of exports to non-euro-area countries should continue to increase over the entire projection horizon.

Business investment rising, housing investment slowing

Key assumptions behind this baseline scenario are that the debt crisis in the euro area does not escalate further, that the reform efforts are continued and that the adjustment recessions in the euro area come to an end soon. Under these conditions, confidence can be expected to gradually return. The exceptionally favourable financing conditions would then enable businesses to lift their investment levels. Housing investment would probably continue to benefit for a time from the heightened uncertainty, fuelling a further discernible increase in construction activity in 2013.[6] After that, the low interest rates would continue to have an expansionary effect, while the uncertainty effect that has been driving demand should become less pronounced. Under these conditions, housing construction in 2014 would grow only moderately from an elevated level. After contracting distinctly this year and stagnating next year, total fixed capital formation might expand sharply in 2014. Investment in inventories, too, is likely to make a marked contribution to growth in 2014.

Technical components of the GDP growth projection

As a percentage or in percentage points

Item	2011	2012	2013	2014
Statistical carry-over at the end of the previous year[1]	1.3	0.2	− 0.1	0.6
Fourth-quarter rate[2]	1.9	0.7	1.1	2.1
Average annual GDP rate, working-day-adjusted	3.1	0.9	0.5	1.9
Calendar effect[3]	− 0.1	− 0.2	− 0.1	0.0
Average annual GDP growth[4]	3.0	0.7	0.4	1.9

Sources: Federal Statistical Office; 2012 to 2014 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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Rising private consumption

Private consumption should pick up in the next two years after recording rather moderate growth of ¾% this year. While net wages and salaries in 2013 and 2014 will probably not rise as sharply as they have in 2012 on account of a slackening labour market, monetary social benefits look set to grow at a much faster rate owing chiefly to higher pension adjustments. As a result, the increase in households' spending power, measured in terms of their disposable income, is set to rise to 2½% and 3% in 2013 and 2014 respectively, thereby clearly outpacing this year's rise of 2%. Assuming that the saving ratio remains largely unchanged at 10¼% and price inflation eases, private consumption would rise in 2013 and 2014 by 1% and 1¼% respectively in real terms.

6 The backloading of housing renovations in anticipation of additional tax incentives is likely to stop sooner or later.

Key figures of the macroeconomic projection

Year-on-year percentage change

Item	2011	2012	2013	2014
GDP (real)	3.0	0.7	0.4	1.9
GDP (working-day-adjusted)	3.1	0.9	0.5	1.9
Components of real GDP				
Private consumption	1.7	0.7	1.0	1.3
Government consumption	1.0	1.1	1.8	2.1
Gross fixed capital formation	6.2	− 2.2	− 0.1	3.1
Exports	7.8	4.0	1.9	5.9
Imports	7.4	2.2	3.0	6.6
Contributions to GDP growth[1]				
Domestic final demand	2.2	0.2	0.9	1.7
Changes in inventories	0.2	− 0.5	− 0.1	0.2
Net exports	0.6	1.0	− 0.4	0.0
Labour market				
Total number of hours worked[2]	1.4	0.3	− 0.8	0.7
Persons employed[2]	1.4	0.9	− 0.1	0.4
Unemployed persons[3]	3.0	2.9	3.1	3.0
Unemployment rate[4]	7.1	6.8	7.2	7.0
Unit labour costs[5]	1.4	2.6	1.8	1.3
Compensation per employee	3.0	2.4	2.3	2.8
Real GDP per person employed	1.6	− 0.2	0.5	1.5
Consumer prices[6]	2.5	2.1	1.5	1.6
Excluding energy	1.4	1.6	1.4	1.8
Energy component	10.0	5.7	1.9	0.2

Sources: Federal Statistical Office; Federal Employment Agency; 2012 to 2014 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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Imports up again

The import volume has probably risen this year by no more than 2¼%, which is well below the growth in exports. This unexpected weakening of the import momentum is chiefly attributable to curtailed investment. Imports account for around half of domestic investment in machinery and equipment. Inventory destocking was probably an additional factor. The expected rise in domestic investment and exports should, in turn, boost imports. Added to this, the trend towards greater import intensity looks set to continue, particularly in the case of exports and of machinery and equipment. In contrast to its falling share of German exports, the euro area should maintain its relative share of German imports. The lack of domestic sales prospects is likely to motivate enterprises in the other euro-area countries to step up their export drive. Also, the unused capacities in these countries offer procurement possibilities for German enterprises. This is likely to be bolstered by an improvement in the euro-area states' price competitiveness. The calculated contribution of net exports to GDP growth, which will be very high in 2012 on account of the fall-off in domestic investment and inventory destocking, should turn negative in 2013 due to the relatively weak export dynamics and stabilising investment, and could prove neutral in 2014. The current account surplus, having risen to 6½% of GDP in 2012, would then narrow to 5¾% in the following years.

Labour market

Working hours as a cyclical buffer

The looming economic slowdown is not expected to lead to a considerable increase in unemployment. For one thing, the factors which led firms to maintain employment levels during the 2008-09 financial and economic crisis are largely still in place. Maintaining a force of highly skilled and motivated workers continues to be of major significance. For another, the collectively agreed mechanisms for reducing working hours can be activated by firms if necessary. Forgoing overtime, running down flexitime account balances, reducing regular working hours and, if need be, also resorting to short-time working will probably cushion much of the economic slowdown. This projection assumes that average working hours will be reduced by ¾% in 2013 but will then go back up by ¼% in 2014.

Moderate rise in employment …

The increase in employment is likewise not expected to continue at the robust pace seen in the past few years in isolation from the macroeconomic setting. Some of the exceptional factors that had supported the labour market during the 2008-09 economic crisis, namely the ongoing impact of the labour market reforms and additional demand for labour in educational and nursing care facilities, no longer apply to the same extent. Cyclical factors will therefore probably have an increasing influence on the labour market. Under the assumed economic scenario, the number of employed persons, after rising sharply again this year (+1%), could stay flat in 2013 and then grow moderately in 2014 (+½%).

… supported by immigration

Net immigration is likely to have once again risen markedly in 2012 to around 350,000 persons. More people have immigrated than last year; in addition, fewer people have emigrated from Germany in the light of the difficult economic situation in many European countries. Since the economic situation, and particularly the labour market situation, in the crisis countries is unlikely to drastically improve in the near term, continuing high levels of net immigration may be expected. In addition, in 2014 complete freedom of movement within the EU will be extended to cover Bulgarian and Romanian citizens as well. This projection therefore assumes a net influx of around 250,000 persons in both 2013 and 2014. Since migratory flows are usually oriented to the labour market, they are likely to offset partial shortages in the German labour market and thus stimulate potential growth.

No major shifts in unemployment

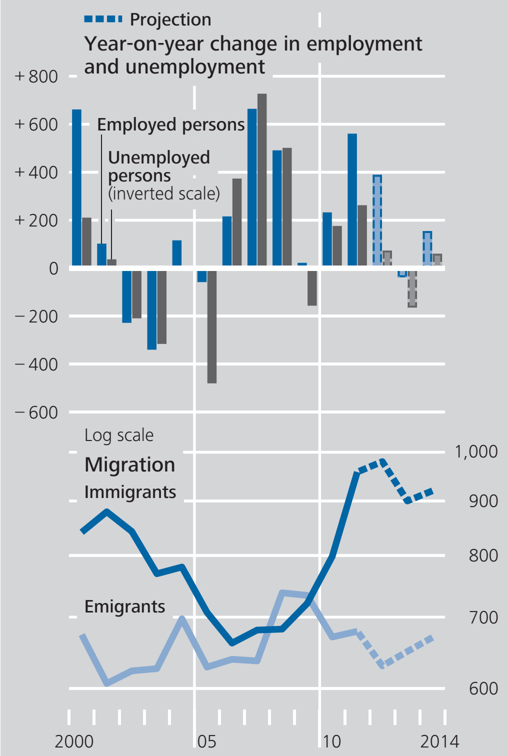
Against this background, unemployment could initially continue to rise slightly, though the increase is likely to mainly affect the first tier of unemployment benefits. The average unemployment rate for 2013 could run to 7.2%. That would be 0.4 percentage point above the cyclical low of 2012. As the economy improves, the unemployment rate should then drop to 7.0% in 2014. The standardised unemployment rate calculated according to the ILO conventions would first rise to 5.8% before then dropping back to 5.6%.

Labour costs and prices

The gloomier business outlook will probably have a tempering effect on the coming year's

Employment and migration

In thousands



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pay bargaining round. However, there will not be a return to the very low wage agreements of the past decade, given the considerably improved labour market situation. This projection presumes that negotiated wages will grow in the coming year by 2.7%, a rate similar to the current year. Only in 2014 might wage growth, at 3.0%, turn out to be more substantial. The wage drift on a monthly basis could well reverse and turn negative in 2013 owing to falling bonus payments and working hour reductions, which will involve losses in wages. A slightly negative wage drift could be in store for 2014 as well. Since social contributions will be lowered on balance in 2013, the rise in wage costs, measured as compensation per employee, will be limited to 2¼%. In 2014, it could then accelerate markedly to 2¾%.

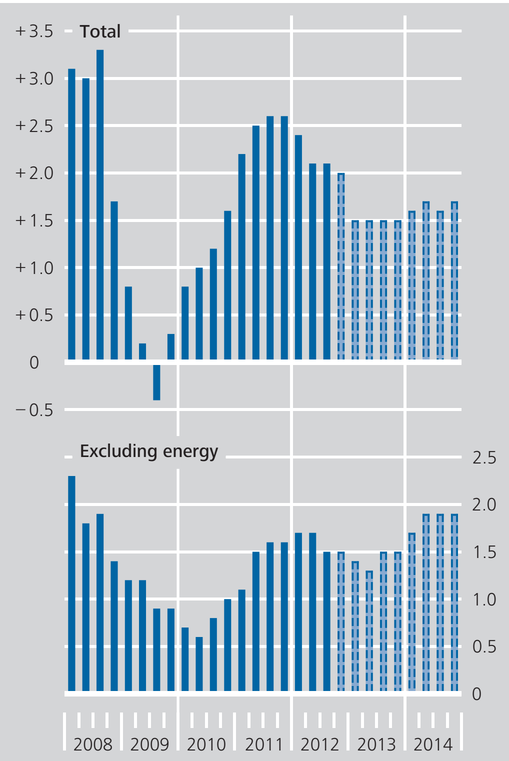
Basic pay rising faster, smaller bonuses

Unit labour costs will initially rise sharply

Given a constellation in 2012 of decelerating economic growth alongside still strongly expanding employment, productivity is declining on a monthly basis. Productivity will then go

Price projection (HICP)

Year-on-year percentage change, quarterly



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back up somewhat in 2013 as employment is likely to follow a flat path; in 2014, as economic activity picks up, productivity will partly make good the losses of the two preceding years compared to the trend. Unit labour costs are therefore likely to rise by 2½% this year. In the next two years their rate of growth will then subside to 1¾% followed by 1¼%.

GDP deflator slowly accelerating

Profit margins will once again contract markedly in 2012 and possibly tighten even further in 2013. For 2014, a recovery is expected, however. The GDP deflator could therefore rise both this year and next year by 1½%. In 2014, with the economy improving, the increase in the prices of domestically produced goods and services would accelerate to 1¾%.

Consumer prices influenced by countervailing factors

Whereas domestic inflation will probably slowly accelerate, the external component will probably ease under the impact of the assumed slightly declining path of crude oil prices. Energy prices will rise considerably, however, owing to the one-off strain imposed by the change of course in energy policy. Electricity prices are expected to shoot up by around one-tenth at the beginning of 2013, which will add 0.3 percentage point to consumer price inflation. The development of food, beverage and tobacco prices is likewise expected to remain unfavourable. Alongside rising price trends on the international markets, the further stages of the tobacco tax increase, scheduled for 1 January 2013 and the same date in 2014 as well, will tend to push up prices. Although a certain relief from external price pressures may be expected for other goods, increased pressure is likely to ensue from distribution costs owing to bigger pay increases in the retail trade. The remarkably low rates of price increase for services are initially expected to continue. This will reflect the impact of abolishing the surgery visit charge as of 1 January 2013, which *per se* will reduce inflation by 0.2 percentage point. The price trend for air travel and package holidays will also be more favourable than in 2012. On the other hand, inflation will probably accelerate in the case of domestic market-related services and housing rents. Overall HICP inflation could fall from 2.1% in 2012 to 1.5% in 2013 before then going back up slightly to 1.6%. Excluding energy, a 1.6% rate of inflation in the current year could be followed by 1.4% next year and 1.8% in 2014.

Public finances

Nearly balanced budget in 2012 …

The general government budget is expected to be close to balance in 2012 (2011: deficit of 0.8% of GDP) for the first time since the financial and economic crisis began in 2008. A chief reason for this is that, on an annual average, the economic slowdown has barely impacted on public finances, since two key variables – unemployment and employee compensation – have been affected only slightly by the slowdown so far. On balance, the markedly positive cyclical influence will not change in the current year, thus reducing the general government deficit level by an amount roughly similar to 2011.[7] One reason for the decline in the cyclically adjusted deficit is that revenue from profit-related taxes is rising much faster than is arithmetically implied by the current cyclical development (legislative changes are of lesser importance in this context). For another thing, low interest rates, moderate pension increases on the whole, further falling labour market spending and the expiry of the 2009 economic stimulus programme are curbing expenditure growth, thus offsetting burdens elsewhere, particularly the transfers in connection with the resolution of the public regional bank WestLB.

… but renewed rise in already very high debt ratio

The crisis-related developments since 2008 are continuing to make a distinct mark on government debt, however. The debt ratio is likely to once again rise perceptibly from its already high level of 80.5% in 2011 to somewhere around the 82% mark. This is due to the measures to contain the euro-area debt crisis and in connection with the liquidation of WestLB, though uncertainty about the exact effects on the public debt remains high. While gross debt in connection with financial market support measures in Germany and the euro-area assistance mechanisms is largely backed by claims, they are subject to marked risk.

Deficit expected again in 2013, owing particularly to cyclical fluctuations …

In the wake of the economic slowdown that is currently expected, a general government deficit is likely to reappear already in 2013. It might reach around ¾% of GDP and is mainly related to the disappearance of the positive cyclical component that has prevailed in 2012. By contrast, no significant change in the structural deficit is evident from a current viewpoint. On the one hand, the pension contribution rate will be lowered significantly owing to the considerable overshooting of the upper reserve limit at the end of 2012 and the moderate fiscal easing is being continued through new budgetary burdens that are not counterfinanced, such as the abolition of the surgery visit charge. On the other hand, interest expenditure is likely to fall, and no new capital transfers to prop up German financial institutions are currently planned. No major improvement in the structural deficit is in the offing for 2014 either. However, in the wake of accelerating economic growth, the deficit could go back down somewhat. Interest expenditure is likely to continue to decline, whereas fiscal measures will once again put a slight burden on public budgets.

… but partial recovery in 2014

Social security funds' surpluses being reduced; other public, deficits falling

In the coming two years, public budget developments will diverge. The currently high surpluses of the social security funds are likely to be depleted. One reason for this is the end of the positive cyclical impact. Another is the incremental reduction of the high statutory pension insurance fund reserves as the contribution rate will be reduced markedly at the beginning of next year, and expenditure is expected to grow faster. Signs point to renewed deficits in the statutory health insurance scheme, too. By contrast, the structural fiscal positions of central, state and local government are likely to improve, not least in the light of the requirements imposed by the national debt brakes. The reduction in central government grants to the social security funds will also cause a shift in burdens within general government.

Debt ratio to fall provided no new support measures are initiated

Despite the temporary economic lull, there are signs that the debt ratio will fall in the coming two years, since the state "bad banks" are to reduce their liabilities (and risk assets) and the budget deficits are likely to be relatively small. However, this is predicated on the assumption that there will be no additional support measures for German financial institutions or the euro area. All in all, public budgets and – as the past few years have shown – particularly the debt ratio are subject to considerable risks.

Risk assessment

Risks to economic growth

The relative calm in the financial markets since August has had no discernible impact so far on the business sentiment indicators; also, accord-

7 Factors indicating no change in the positive cyclical balance in 2012 include not only the stable development of the key budget variables but also the Bundesbank's latest calculation of the output gap.

Baseline and uncertainty margins of the projection*

As a percentage, quarterly

* 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.

Deutsche Bundesbank

ing to the DIHK autumn survey, firms see the economic policy framework as one of the biggest risks to their activity. This could indicate that uncertainty will not diminish quickly and that it may affect the behaviour of enterprises and households more substantively than assumed in this projection. In that case, although the real estate market boom could further intensify, the effect of this uncertainty on corporate investment, which is more important for medium-term potential growth, could be even stronger. There is no denying the possibility, either, that the painful adjustment processes in individual euro-area countries could last longer, with apathy spreading and the will to reform dissipating. In order to combat these dangers, it would certainly be helpful if further confidence-boosting decisions were to be taken soon. This applies to the euro area as a whole as well as to its individual member states. In the light of its high degree of openness and specialisation, Germany cannot prosper on its own; it has a particular interest in the prosperity of its partners.

However, a scenario in which good news prevails and confidence is regained more quickly than assumed in the baseline scenario is also quite conceivable. There are good grounds for believing that German enterprises would then use their good market position to capitalise on the resulting opportunities and that domestic investment would then pick up more strongly.

Risks to price stability

This projection is based on the assumption that the energy-intensive growth of the emerging market economies in the past will rebound strongly. This expectation stands somewhat in contrast to the slightly declining path of crude oil prices derived from forward prices. An increase in oil prices would have a direct impact on consumer prices and also cause production costs to rise. A depreciation of the euro, which could occur if doubts about the euro area's future viability increase, would have a similar effect. By contrast, a relatively lengthy slack economic period would dampen upward pressure on wages and prices.