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

The outlook for the German economy has become brighter again following the slowdown towards the end of 2012. Despite the continued existence of negative factors caused by the tensions in the euro area, the adjustment in the level of investment in machinery and equipment and exports is so far advanced that it could give way to a modest upturn. This is suggested, despite a few setbacks, by the improved expectations of enterprises. Although there has been no fundamental change in the underlying conditions, there has, above all, been no major deterioration either. Moreover, the world economy should pick up again in the course of this year.

In the first quarter of 2013, the incipient economic upturn was delayed by the especially persistent winter weather. In the second quarter, however, the improved underlying trend should come to the fore, reinforced by catch-up effects. If this happens, the German economy, despite the weak winter half year, may achieve economic growth of 0.3% (calendar-adjusted: 0.4%) on an annual average in 2013, compared with 0.7% (calendar-adjusted: 0.9%) in 2012. The cyclical trend, which is better described by the fourth-quarter annual rates, could increase initially from 0.3% in 2012 to 1.3% in 2013 and then to 1.5% in 2014. This would also give annual average GDP growth of 1.5% in 2014; aggregate capacity would be well utilised, the labour market would be buoyed by economic activity, and, given the currently planned fiscal policy course, the general government budget would be balanced.

Consumer price inflation (HICP) should moderate for a time, to 1.6% in 2013 and 1.5% in 2014, owing to the effect of declining crude oil and commodity prices. Despite waning negative external factors, the faster pace of increase in wages, however, is likely to push up the rate excluding energy to 1.8% in 2014 after 1.6% in 2013.

The risks to this forecast are largely on the downside. Much will depend on whether the economic situation stabilises in the euro-area crisis countries and whether expansionary forces will gain the upper hand there. A slackening of consolidation and reform efforts, on the other hand, could have a negative effect on the financial markets. If greater opportunities were to present themselves to the German economy, however, it is likely to be in a position to use them, since enterprises are mostly in good shape, provision of financial resources is abundant, and immigration is helping to counter shortages in the labour market.

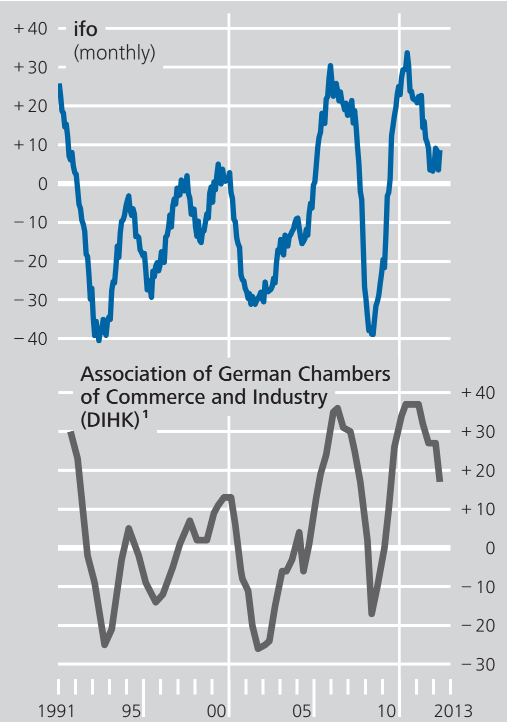
Current situation

Disappointing end to 2012 and start to 2013, but German economy still in good shape

The final quarter of 2012 saw economic output fall by 0.7% on the quarter after seasonal and working-day adjustment owing to declining exports and capital investment, which was more than twice as much as assumed in the December projection.[1] The first quarter of 2013, with an increase of no more than 0.1%, then brought no more than a subdued countermovement. Cyclical factors were not so much the key factor behind the slow pace of growth as exceptionally bad weather conditions. The large number of frost days held up construction and transport sector activity, especially in March. By contrast, business expectations are becoming perceptibly brighter again, pointing to a cyclical improvement. Although the assessment of the business situation is no longer quite so positive, the early summer survey of the Association of German Chambers of Commerce and Industry (DIHK) nonetheless showed that 85% of enterprises continued to assess their situation as good or satisfactory despite the economic slowdown having persisted for some time now. This, in turn, shows that the improved shape of the German economy allows it to cope well with periods of weakness and that second-round effects remain within narrow bounds.

Business situation

Balances



1 Results of the surveys carried out at the beginning of each year, in early summer and in autumn.

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Sharp fall in exports and corporate investment

It was mainly the after-effects of the escalation of the sovereign debt crises in the euro area and the associated adjustment recession in some partner countries that were weighing down the German economy towards the end of 2012. Despite ample funding resources and favourable financing conditions, a lack of prospects for sales in Europe as well as increasing economic policy uncertainty led enterprises to cancel or, at least, to suspend further investment plans in Germany. Although corporate investment rose again somewhat in the first quarter in seasonally and calendar-adjusted terms, it was still 5% down on the year. Against the backdrop of a perceptibly slower pace of global economic growth in the second half of last year, the volume of exports (as defined in the national accounts) declined by more than 4% in the final quarter of last year and the first three months of 2013. Before that, rising demand on the part of non-euro-area countries for German-made goods was more than offsetting reduced demand from the euro area. In line with exports and investment, imports were also cut back.

Domestic economy, too, with temporary weaknesses

Owing to temporary special factors, generally robust domestic economic activity did not have much to set against the weakness of the export-oriented sectors. The rather mild winter weather before the start of the new year was one reason for private consumption falling short of expectations in the final quarter of 2012, and the finishing trades suffered from the fact that homeowners were adopting a waiting attitude given the prospect of additional tax incentives for renovation projects.

1 See Deutsche Bundesbank, Outlook for the German economy – macroeconomic projections for 2013 and 2014, Monthly Report, December 2012, pp 13-24.

Although the very persistent cold weather conditions boosted households' consumption in the first quarter of 2013, it also acted as a brake on activities in the main construction sector.

Sharp rise in employment, slight increase in unemployment

Despite declining economic output, enterprises were recruiting more new staff again. In the final three months of 2012 and the first quarter of 2013, the seasonally adjusted number of employees subject to social security contributions went up by no less than 230,000, or ¾%, and there was also a noticeable increase in the total number of persons in work. This is likely to be due to the fact that the economic slowdown was confined to industry, while the services sector continued to expand. At the same time, unemployment increased somewhat.

Pay agreements at much the same level as last year

As in 2012, the agreements so far in the current pay round, which run for between one and two years, are aimed at increases in wages and salaries of just under 3% per year. The slightly accelerated growth in the services sector compared with previous years reflects the overall positive situation in the economy and on the labour market. In export-based industries, a great deal of importance continues to be attached to safeguarding well-paid jobs.

Slight easing of upward price pressure

As expected, consumer price inflation eased somewhat at the end of 2012 and in early 2013. The annual HICP rate, which fell from 2.0% in the final quarter of last year to 1.8% in the first quarter, was nevertheless higher than anticipated. This was chiefly due to the fact that chain-linking of differently calculated index series for accommodation services has been biasing the HICP upwards since January 2013.[2]

Major assumptions

Assumptions-based forecast

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 14 May 2013. The assumptions regarding sales markets in the euro area are derived from projections by the national central banks of the other euro-area countries.

Global economic growth strengthening slowly

Global economic activity, which lost momentum last year, has picked up again somewhat. Nevertheless, it is not just in the euro area that a high debt burden and the resulting consolidation pressure are holding back economic growth. Although the financial markets have become somewhat calmer, confidence has not yet been fully restored and heightened uncertainty is restricting the propensity to invest. Even so, the forces of growth should gradually gain the upper hand. It is expected that the cyclical upturn in the industrial countries will become perceptibly stronger, supported by a decidedly expansionary monetary policy, and that the emerging economies will be able to step up their pace of growth again. However, on an average of the current year, the global expansion, at 3%, will be still more or less as moderate as it was last year; next year, it could then be approaching the multi-year average, at 3¾%.

Prospect of improvement in the euro area

Euro-area economic output continued to contract in the first quarter of 2013. The negative effects of the debt crisis are still the predominant factor. Investment is being constrained not only by the persistently elevated level of uncertainty but also by marked capacity underutilisation in some countries. High unemployment is weighing on private consumption. At the same time, adjustment in cost structures is also progressing, and many enterprises successfully improved their market position abroad last year. It therefore appears likely that the euro-area economy will stabilise over the course of the year, followed by gradual recovery. After a contraction of economic output by 0.6% in 2013 (caused by a negative statistical carry-over and a weak start to the year), GDP growth of 1.1% in 2014 could ensue. A robust economic recov-

2 See Deutsche Bundesbank, The contribution of the accommodation services sub-index to explaining the current deviations between CPI and HICP inflation rates, Monthly Report, April 2013, p 7.

ery will continue to hinge on a continuation of consolidation and reform efforts so as to allow confidence in a sustainable improvement to grow.

Accelerating sales market growth

The sluggish pace of global activity has put a considerable damper on the growth of world trade, from which Germany has reaped great benefit in the past few years. It is particularly the global dent in industrial activity which has weighed on international trade. The expected acceleration of global economic growth is likely to be associated with an increase in the demand for industrial products, too. However, as in the previous year, world trade is expected to grow only by an annual average rate of 3% in 2013. Next year, the growth rate could accelerate to 6%, which would put it close to its multi-year average. Although German exporters are likely to benefit from the probable resurgence of economic growth among the emerging market economies and improved economic activity in the industrial countries, they are being hurt by the difficult conditions in the euro area, which, despite growing regional diversification, still accounts for nearly two-fifths of German exports. Germany's sales markets are likely to see growth of only 1¼% this year and possibly 4½% next year, which will put it markedly behind the growth of world trade. Each figure is just over 1 percentage point less than assumed in the December projection.

Euro appreciation

The euro appreciated significantly after publication of the December projection; it peaked in February but has gone back down since then. In the period that is relevant to the derivation of the exchange rate assumptions, the euro stood at US$1.31, 2¼% higher than assumed in the December projection. Measured by the effective exchange rate, which is relevant for foreign trade, the euro has appreciated by just under 4% since December.

Crude oil prices falling

Crude oil prices rose considerably in the winter months, though this increase was tempered by the appreciating euro. The situation has eased markedly in the past few months, however. Futures prices are pointing downwards across all delivery periods; therefore, an average price per barrel of Brent of US$105½ for the current year and US$100 for 2014 is being assumed in the current projection round. This corresponds largely to the assumptions in the December projection. In euro terms, prices will be 1¾% lower this year and 2¾% lower next year.

Other commodity prices lower, too

International food, beverages and tobacco prices dropped more sharply in the fourth quarter of 2012 and first quarter of 2013 than anticipated in the December projection. Although these prices are expected to go back up during the projection horizon, they will not reach the level assumed in December. The prices for all other commodities, under the influence of sluggish global economic activity, are once again likely to fall considerably in 2013 and then rise slightly in 2014. Throughout the projection horizon, these prices, too, will fail to reach the levels projected in December.

Little change in interest rates

Persistently weak economic activity in the euro area and the stubborn disruptions caused by the debt crises prompted the Governing Council of the ECB in early May to cut the interest rate on the Eurosystem's main refinancing operations to a new all-time low. This decision had little impact on expectations regarding the path of short-term interest rates. As before, an average three-month interest rate for unsecured transactions on the interbank market of 0.2% for the current year and 0.3% for 2014 is assumed. The yield on nine to ten-year German government bonds rose in the first quarter to a level slightly above December's projection. It is expected to go back down in the second quarter, however, followed by a slight increase over the rest of the projection horizon resulting from the yield curve. Overall, at 1.5% in 2013 and 1.8% in 2014, yields will remain 10 basis points behind the December assumptions in each of those years, still driven by increased demand for safe and liquid instruments.

The lending rates of German banks continued to ease slightly in the past few months. Consist-

Financing conditions remain favourable

ent with assumptions about the development of three-month interest rates and yields on long-term government bonds, a steady slight increase is expected to begin in the current year and continue throughout the projection horizon. However, lending rates for enterprises and consumers remain at a very low level. Banks once again eased their credit standards somewhat for loans to enterprises in the first quarter of 2013. According to the Bank Lending Survey, hardly any change in credit standards is expected for the second quarter. The share of enterprises which complain of constrained access to bank lending remains very low according to an Ifo Institute survey. On the whole, financing conditions are still being regarded as exceptionally favourable, with no worsening in sight over the projection horizon.

Fiscal policy measures slightly expansionary

For public finances, the projection incorporates all measures which have either already been approved by parliament or have, at least, been defined in detail and are likely to be implemented.[3] The measures included here will impose a limited burden on the general government budget in 2013 and will be close to neutral in 2014. The most substantial measure in terms of its fiscal impact will be the lowering of the statutory pension contribution rate from 19.6% to 18.9% at the beginning of this year. With regard to taxes, the shortfalls caused by the two-stage increase in the basic income tax allowance and the gradual changeover to a downstream taxation of pensions outweigh additional revenue obtained elsewhere. On the expenditure side, *inter alia* the abolition of the surgery visit charge and the introduction of the childcare supplement are imposing burdens.

Cyclical outlook[4]

Continuation of moderate expansion path; growth in the second quarter quite strong

In Germany, enterprises' business expectations have recovered from their trough in summer 2012. Enterprises are also assessing their medium-term outlook more optimistically. Although new orders received by industry showed, after seasonal adjustment, only a slight quarter-on-quarter gain in the first quarter of 2013, they picked up steam across the board over the course of the quarter. This means the conditions are in place for the German economy to continue down the path on which it had embarked in the first quarter of the year. Economic growth is likely even to be quite strong in the second quarter, as a large share of the weather-related output losses from the first quarter of the year will probably be recouped quickly. The growth rate is likely subsequently to ease markedly.

Major assumptions of the projection

Item	2011	2012	2013	2014
Exchange rates of the euro				
US dollar/euro	1.39	1.29	1.31	1.31
Effective 1	103.4	97.8	100.6	100.6
Interest rates				
Three-month EURIBOR	1.4	0.6	0.2	0.3
Yield on government bonds outstanding 2	2.6	1.5	1.5	1.8
Commodity prices				
Crude oil 3	111.1	112.0	105.5	100.0
Other commodities 4, 5	17.9	– 7.2	– 5.6	0.5
German exporters' sales markets 5, 6	5.2	1.2	1.2	4.4

1 Compared with the currencies of 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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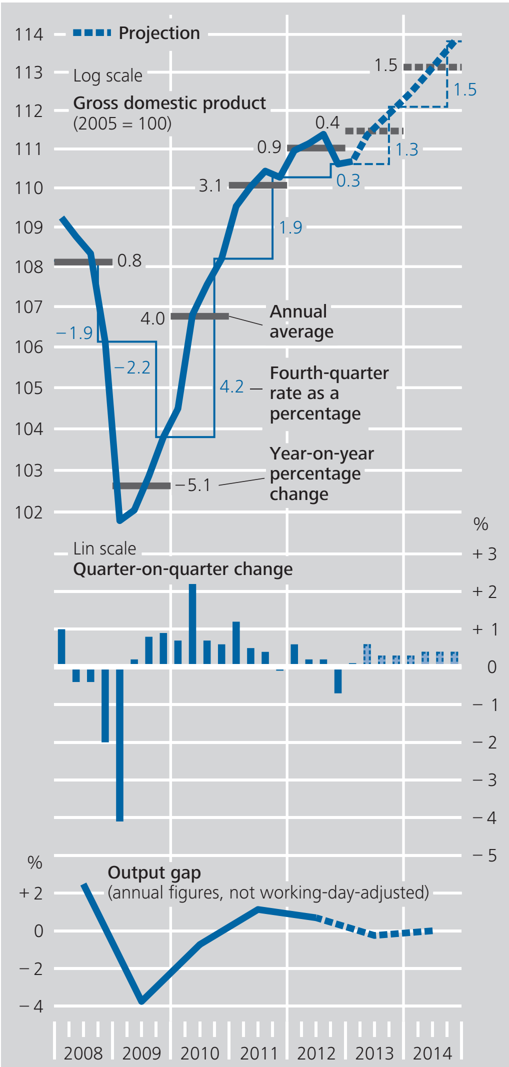
Slight acceleration of growth in 2014

Over the course of 2013, the German economy could grow at a rate of 1.3% owing to rising exports and a pick-up of domestic demand, putting it on par with potential output. This would result, despite the weak period of the fourth quarter of 2012 and first quarter of 2013, in average annual GDP growth of 0.3% for 2013 (0.4% after adjustment for calendar effects). Provided the pace of global economic activity accelerates and the euro-area crisis countries' economies gradually return to a path of expansion, GDP growth could improve

3 However, changes in the direction of fiscal policy are more probable following an election year, such as 2013.
4 The projection for Germany presented here was completed on 22 May 2013. It was incorporated into the projection for the euro area published by the ECB on 6 June 2013.

Aggregate output and output gap

Price, seasonally and working-day-adjusted



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to 1.5% over the course of the following year. In annual average terms, output growth would then also be 1.5% for 2014. On the whole, Germany's economy would consequently be operating in the area of normal aggregate capacity utilisation across the entire projection horizon. Compared with the December 2012 projection, this means a scaling back of growth expectations by 0.1 percentage point for 2013 and 0.4 percentage point for 2014. This is due mainly to downward revisions with regard to the external environment.

Exports overcome weakness

For Germany to undergo a sustained cyclical recovery, the weakness in exports has to be overcome, given the high degree of openness of its economy and also its pattern of specialisation. Both foreign orders, which were tending upward over the course of the first quarter, and the export expectations of German industry are pointing to an improvement in the situation. However, export expectations fell short of their multi-year average. This is consistent with the anticipated, and initially muted, growth of sales markets. Owing to product range effects – high-end, durable industrial goods which are currently in less demand are a particularly important element of German exports – Germany's sales abroad this year could even fall slightly short of last year's figures. This is being indicated, at least, by the sharp drop in exports as defined in the national accounts in the period spanning the fourth quarter of 2012 and first quarter of 2013. In the wake of a livelier global economy and the nascent recovery in the euro area, exports are then expected to grow more sharply, which means that average growth in exports of 4½% for 2014 appears to be possible. Export growth will be sustained in large part by increasing demand from outside the euro area; no meaningful stimuli from the euro area are expected until 2014 at the earliest.

Corporate investment has bottomed out

The adjustment in the level of corporate investment caused by an increase in perceived risk and a downward revision in the sales outlook for the euro area appears to have been completed in the first quarter of 2013. This is probably because replacement of fixed capital is now gaining in importance again. As industrial capacity utilisation rises, the propensity to invest should continue to increase, which would result in a perceptible growth stimulus in the coming year. However, the persistent economic policy uncertainty and the gloomier outlook for European sales markets are likely to stand in the way of exceptionally strong investment activity.

Residential construction remains high following further strong increases

Residential construction is benefiting not only from strong demand for safe capital investments but also from a primary increase in demand for housing, at least in urban centres.

This is indicated not least by rents for new lettings, which are rising, in some cases sharply. In this environment, the number of construction permits for multiple family dwellings, in particular, saw strong growth. Following major impediments to construction activity in the first quarter of 2013 caused by the especially long and cold winter, catch-up effects in the second and third quarters of the year are likely to give construction investment a major boost. Investment in residential property could subsequently continue to tend upwards but is likely to largely maintain its current elevated level. The long-term demographic outlook militates against a stronger construction boom.

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	– 0.4	0.6
Fourth-quarter rate[2]	1.9	0.3	1.3	1.5
Average annual GDP rate, working-day-adjusted	3.1	0.9	0.4	1.5
Calendar effect[3]	– 0.1	– 0.2	– 0.1	0.0
Average annual GDP growth[4]	3.0	0.7	0.3	1.5

Sources: Federal Statistical Office; 2013 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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Public sector investment returning to normal

Following the strong decline in 2012, caused by the expiry of the economic stimulus programmes, general government investment is expected to stabilise in the wake of higher spending on infrastructure in the current year and could then go back up in the following year.

Gross fixed capital formation will recover strongly in 2014

Despite increased investment in residential construction, gross fixed capital formation will still decline slightly overall by ½% on average in 2013 but is then looking at a strong 3¾% increase in 2014. The contribution of inventory investment to growth is likely to be neutral in 2013 and slightly positive in 2014.

Significant growth in private consumption

Private consumption is likely to generate significantly stronger momentum over the projection period than in the recent past. This is indicated by the upward trend in employment in connection with sharper increases in wages and the easing of price pressures. With an increase of ¾%, households' real disposable income should grow somewhat more strongly this year than last year. This increase could reach 1¼% next year. Furthermore, consumer sentiment has improved considerably as a result of brighter income prospects and reduced job uncertainty; this has been accompanied by a slight decrease in the saving rate. This is currently subject to opposing forces. Although the extraordinarily low interest rates imply a higher propensity to consume, at the same time, they reduce future income and expenditure opportunities if saving habits remain unchanged. The high levels of residential property acquisition at present may increase demand for durable consumer goods in the short term, but, looking ahead, is also likely to require households to make additional savings. This projection therefore assumes that the saving rate will not fall any further but will remain at a level of 10%. Private consumption would then grow by 1% this year and by 1¼% next year.

Government consumption likely to pick up

Growth rates in government consumption are expected to see a slight pick-up this year followed by a sharper increase in 2014. Healthcare spending is likely to experience accelerated growth again after the expiry of measures to reduce expenditure. Spending on personnel and intermediate consumption is also expected to expand more rapidly, not least due to the relatively favourable budget situation.

Significant increase in imports expected

As exports and investment in machinery and equipment recover, imports should rise again sharply. However, like exports, average imports in 2013 are likely to be affected by the weak final quarter of 2012 and first quarter of 2013, meaning there will be no increase year-on-year. We assume that if the German economy continues to specialise in an environment of growing international division of labour, the trend

Key figures of the macroeconomic projection

Year-on-year percentage change

Item	2011	2012	2013	2014
GDP (real)	3.0	0.7	0.3	1.5
GDP (real, working-day-adjusted)	3.1	0.9	0.4	1.5
Components of real GDP				
Private consumption	1.7	0.8	0.9	1.3
Government consumption	1.0	1.2	1.5	2.0
Gross fixed capital formation	6.2	− 2.5	− 0.4	3.8
Exports	7.8	3.8	− 0.8	4.6
Imports	7.4	2.2	0.0	6.0
Contributions to GDP growth[1]				
Domestic final demand	2.2	0.2	0.7	1.8
Changes in inventories	0.2	− 0.4	0.0	0.1
Net exports	0.6	0.9	− 0.4	− 0.4
Labour market				
Total number of hours worked[2]	1.4	0.4	0.0	0.4
Persons employed[2]	1.4	1.1	0.6	0.4
Unemployed persons[3]	3.0	2.9	2.9	2.9
Unemployment rate[4]	7.1	6.8	6.8	6.7
Unit labour costs[5]	1.4	2.9	2.5	1.6
Compensation per employee	3.0	2.5	2.2	2.7
Real GDP per person employed	1.6	− 0.4	− 0.3	1.1
Consumer prices[6]	2.5	2.1	1.6	1.5
Excluding energy	1.4	1.6	1.6	1.8
Energy component	10.0	5.6	1.5	− 0.6

Sources: Federal Statistical Office; Federal Employment Agency; 2013 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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towards a higher share of imports, particularly in exports and investment in machinery and equipment, will continue. Against this backdrop, imports could increase more sharply at 6% than exports next year. Enterprises in euro-area partner countries are likely to continue to play a disproportionately large role in the growth of German imports. This is suggested by the improvement in price competitiveness and the efforts of enterprises in these countries to tap new sales markets in light of weak domestic demand. Furthermore, German enterprises can use free capacities elsewhere. The current account surplus is likely to fall to 6½% of nominal GDP this year and to just under 6% next year due to livelier import activity.

Labour market

Rise in employment despite sluggish economic activity

Contrary to the assumptions of the December projection, and despite sales losses, enterprises hired large numbers of additional staff in the final quarter of 2012 and the first quarter of 2013. Structural improvements therefore appear to be outweighing economic pressures. Additional numbers of skilled workers migrating from abroad may have played an important role here. Business surveys indicate that although the positive employment trend could weaken, it essentially remains in place. After the number of persons in work rose by just over 1% in 2012, it could climb by just over ½% in 2013 and by just under ½% in 2014. However, there could be a further reduction in working hours due to the growing share of part-time work. This trend will probably be amplified through cyclical limitations and a negative calendar effect in 2013, but is likely to be balanced out in 2014 as economic conditions improve. The number of hours worked could therefore stagnate this year, but then increase again by just under ½%.

Immigration levels remain high

High levels of immigration are easing the supply shortages on the German labour market. Due to the difficult labour market situation in euro-area crisis countries and the continuing prosperity gap in central and eastern European countries, Germany will probably continue to see substantial migration gains in the next few years. It is unlikely that immigration will reach the levels seen in 2012, when almost 370,000 people migrated to Germany on balance, because this reflected one-off effects such as the granting of freedom of movement to the accession countries in spring 2011. However, a net inflow of 300,000 people per year may be expected for the projection period.

No change in unemployment

The general upward trend in employment is attributable to the fact that the number of unemployed persons did not rise more sharply despite the cyclical downturn. If economic momentum continues as expected over the projection horizon, unemployment figures as a whole are likely to remain largely unchanged. An average of 2.9 million people would therefore be expected to be unemployed in 2013 and 2014. This would be equivalent to unemployment rates of 6.8% and 6.7% respectively according to the national definition, and 5.3% and 5.2% as defined by the International Labour Organization (ILO).

Labour costs and prices

Wage agreements rise 3%

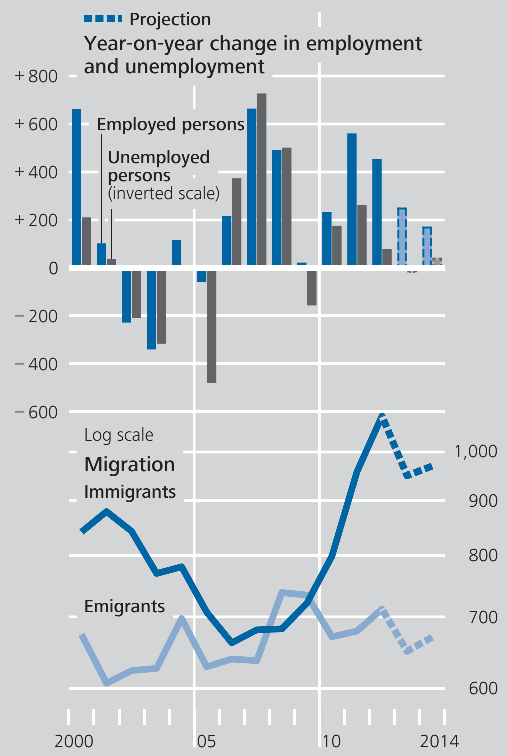
The 2012 and 2013 pay round settlements, which are mainly aimed at securing a wage increase of just under 3% per year, are having a larger and larger impact on the overall wage trend in the economy. The rise in negotiated rates of pay (as defined in the Bundesbank's negotiated pay rate statistics) is expected to increase from 2.5% in 2012 to 2.7% in 2013 and to 2.9% in 2014. Actual earnings are likely to grow somewhat more slowly than negotiated wages over the projection horizon due to working hours effects and smaller bonus payments. Reductions in social security contributions are also helping to slow the increase in labour costs. As a consequence, compensation per employee should rise 2¼% this year and 2¾% next year.

Sharp increase in unit labour costs, rise in labour's share in national income

Given the extremely subdued productivity growth, the trend in labour costs will make for a considerable increase in unit labour costs of 2½% this year and of just over 1½% next year, following a rise of almost 3% in 2012. This is mainly because of the decision of employers to hire more staff despite sluggish economic activity and deteriorating expectations. This reflects structural improvements on the labour market. As a result, the sharp rise in unit wage costs is expected to compromise margins and raise labour's share in national income again slightly. However, this will be countered in the short term by the improvement in the terms of trade

Employment and migration

In thousands



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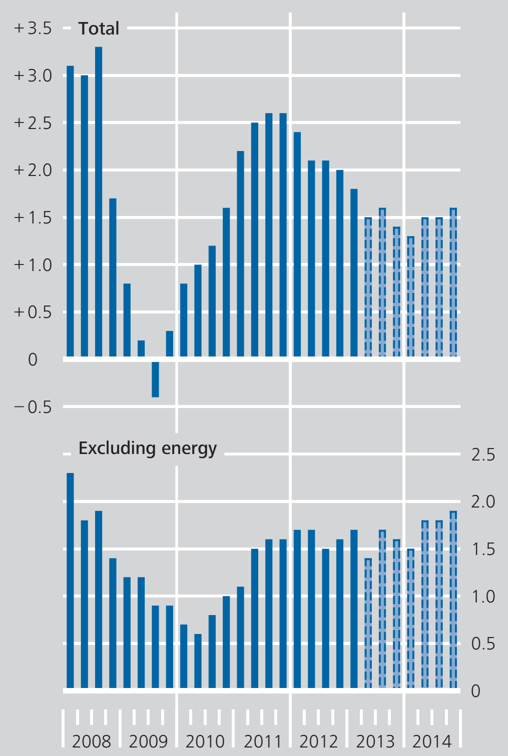
which is expected due to the sharp drop in crude oil prices in spring 2013. The GDP deflator is therefore likely to increase by 1¾% this year and 1½% next year, having risen by 1¼% in 2012. The trend towards increased domestically generated inflation would therefore continue over the projection horizon. In the medium term, a steady rise in wages of 3% is likely to lead to a 2% pa increase in the price index for domestic value added.

Pressure easing on consumer prices

However, pressure on consumer prices is initially expected to abate. The annual rate of HICP inflation could fall from 2.1% in 2012 to 1.6% this year and 1.5% next year. This is due in large part to the easing of prices on the international commodities markets. The significant drop in crude oil prices in particular – which are projected to continue to fall – is giving relief to households. The international markets should not generate any more marked inflationary effects in terms of food prices, either. Excluding energy, however, inflation is likely to increase from 1.6% this year

Price projection (HICP)

Year-on-year percentage change, quarterly



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to 1.8% next year. This is due mainly to the sharper acceleration in wages, which is raising costs and boosting demand. Cost considerations are likely to be particularly important in the area of public and private services, but also in the retail sector. Increases in income will tend to accelerate the rise in housing rents.

Public finances

Favourable conditions prevail

Last year, the general government fiscal balance continued to improve significantly, posting a small surplus for the first time since the pre-crisis year of 2007. However, with a GDP structure yielding more revenue due to the larger proportion of wages and salaries, as well as lower unemployment figures and interest rates, the conditions for public finances were significantly more favourable than in 2007. There are no signs of any major changes to the fiscal balance this year or next year if the current fiscal policy stance is maintained. However, considerable risks to public finances still exist overall, due mainly to uncertainties surrounding the debt crisis in the euro area.

Slight deficit again in 2013 following slowdown in growth

This year, the fiscal balance will probably initially slip slightly into deficit, because the positive cyclical component that prevailed last year is likely to be reduced. On the revenue side, with the current economic downturn it is assumed that the strong recovery in tax revenue, after the slump in the crisis year of 2009, has come to a halt. The (limited) cuts in taxes and social contributions will be largely compensated for by the growth structure, which will continue to yield a relatively high revenue, and fiscal drag[5], meaning that the revenue ratio is unlikely to change much despite the shortfalls. On the expenditure side, the measures adding to expenditure will be countered by the further reductions expected in interest expenditure resulting from favourable refinancing conditions. Nonetheless, the expenditure ratio is expected to rise as a result of weak nominal GDP growth in the denominator for cyclical reasons. Because the mildly expansionary policy will be offset by a further decline in interest expenditure, the cyclically adjusted balance remains almost unchanged as things stand.

Further improvement in 2014 if current policy stance maintained

If current fiscal plans are maintained, the fiscal balance could improve next year, resulting in another small surplus. The additional budgetary burdens caused by the new childcare supplement, for example, or in the areas of healthcare and residential long-term care, would be smaller overall than in 2013 and would be more than offset in particular by the continuous easing in interest expenditure. According to the projection presented here, the cyclical situation still has a neutral effect on public finances.

The comparatively stable development of the general government budget conceals contrast-

5 In this context, the term “fiscal drag” encompasses the (positive) revenue effect of bracket creep in income taxation and the (negative) impact of the fact that specific excise duties are largely independent of prices.

Decline in central, state and local government deficit compensates for reduction in social security funds' surpluses

ing developments at different levels of government and in social security funds. Social security funds will probably largely use up their very large surplus in the current year, mainly as a result of the lower pension contribution rate, a sharper increase in pension and healthcare expenditure and a shift in burdens from central government. By contrast, the budgets of the various levels of government are gradually improving owing to the shift in burdens and, in particular, to lower interest payments and fiscal drag.

Marked decline in debt ratio

In comparison to the pre-crisis year of 2007, the EDP debt ratio has risen sharply from 65.2% to 81.9%. Uncertainty about future developments is particularly high due to the debt crises. As things stand, the debt ratio is expected to fall significantly in 2013 and 2014. Although existing deficits at some levels of government and payments agreed as part of the euro-area assistance mechanisms will increase gross debt, according to this projection, these factors will be outweighed by the increase in nominal GDP in the ratio's denominator and the reduction of liabilities at the government-owned "bad banks".

Risk assessment

Risks in the real economy

This projection assumes that the economic situation will stabilise in the euro-area crisis countries and expansionary forces will gradually gain the upper hand. There are encouraging signs that this will happen. On the other hand, consolidation and reform efforts appear to be slackening. This could have a negative effect on the financial markets and further intensify the debt crises. Confidence would then be further eroded, which would also have negative consequences for the cyclical outlook for the German economy. The sustained global economic revival is another important prerequisite for the growth path presented here. However, some emerging market economies are showing cyclical slowdowns as well as structural distortions, which could impair demand for German products. The risks to this projection in the real economy are therefore largely on the downside. This goes hand in hand with the risk that further negative shocks will disrupt the stability of the labour market and trigger downward multiplier effects. However, if international and European developments are more positive than assumed in this projection, the German economy is likely to be in a position to use the opportunities that arise, since most enterprises are in quite good shape, provision of financial resources is abundant, and immigration is helping to counter shortages in the labour market.

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.

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Price projection risks

There is a certain contrast in the underlying conditions of this projection between the positive expectations for the global economy and the fall in crude oil prices derived technically from futures prices. In particular, the strong growth expected to take place in the emerging market economies has been accompanied by an increase in energy consumption in the past. The risks to consumer prices in the projection period are therefore more on the upside.