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

Following a temporary weak phase, economic activity has picked up again in Germany. Although the adjustment recession in some euro-area countries and the loss of confidence caused by the sovereign debt crisis have left their mark, the good structural position of the German economy and robust global economic developments have kept the upper hand. A high employment rate and strong wage increases combined with the essentially sound outlook for the future are not only supporting domestic economic activity; they are also making Germany more attractive to immigrants. Unusually favourable financing conditions, reflecting both the Eurosystem's expansionary monetary policy stance and safe haven effects, are boosting the driving forces of growth. While the importance of euro-area countries as importers of German products is continuing to wane and that of non-euro-area countries to rise, imports from within the euro area are likely to increase more rapidly. This is due not only to direct supply and demand effects but also, in part, to shifts in relative prices.

This year, growth in gross domestic product (GDP), at 1.0% (or 1.2% after calendar adjustment), will probably almost match the estimated potential rate of 1¼%. Provided that the world economy continues to recover and the financial and sovereign debt crisis does not escalate, real growth could increase to 1.6% (1.7% after calendar adjustment) in 2013. Assuming that crude oil prices decline moderately, consumer prices look likely to ease. The overall cost of living will probably increase by 2.1% this year and by 1.6% in 2013; excluding energy, it appears likely to rise from 1.6% to 1.8%.

The risks to this scenario are mostly external. If the weaker activity in the euro area – which is already included in the estimate – were to be compounded by a perceptible dampening of economic activity in non-euro-area countries, this would have a severe impact on the German economy because it is so open. In view of the political situation in Greece and the problems in the Spanish banking sector, further developments in the euro-area sovereign debt crisis are another source of uncertainty. Should the resulting renewed tensions in the financial markets prove not to be temporary and economic activity in the hardest hit euro-area countries turn out to be weaker than already assumed in the baseline scenario, this would place a noticeable strain on Germany. However, domestic growth could prove to be even stronger given the exceptionally favourable financing conditions.

All in all, this projection is therefore subject to exceptionally high uncertainty and risk.

Current situation

Differing economic developments

At present, there are three main factors influencing the German economy. Demand for German products from within the euro area has fallen discernibly as a result of the adjustment recession in some euro-area countries. By contrast, the world economy has regained its footing after tensions eased in the second half of 2011. This has led to a corresponding increase in demand from non-euro-area countries. Finally, the positive labour market situation and very favourable financing conditions are generating important stimuli for domestic demand. Whereas downward influences predominated in the final quarter of 2011, expansionary forces regained the upper hand in early 2012 – sooner than many expected. All in all, developments in the German economy were somewhat better in the 2011-12 winter half-year than anticipated in the December projection, with a slight decline of 0.2% in real GDP in the fourth quarter of 2011 and a clear increase of 0.5% in the first quarter of 2012 (after seasonal and calendar adjustment in both cases).[1] At the same time, the heightened uncertainty has left its mark. While residential investment increased substantially, investment in machinery and equipment fell below the level recorded in summer 2011. Despite the favourable underlying conditions, private consumption saw only very tentative growth, partly because of energy price rises, which undermined purchasing power.

German economy's resilience to crises

One reason why the German economy has not so far been hit harder by the crisis in some of the euro-area countries is that it has diversified sales markets. Twenty years ago, more than half of Germany's goods exports went to today's euro-area countries, compared with just under two-fifths in 2011.[2] Notably, the countries most affected by the crisis (Greece, Portugal, Ireland, Spain and Italy) receive only 11% of Germany's exports (compared with 16% in 1991). Another reason is that the German economy is benefiting from the Eurosystem's very expansionary monetary policy. In addition, Germany is experiencing pronounced short-term safe haven effects, which are additionally driving down interest rates for the public and private sectors alike. Above all, confidence in the German economy's adaptability and resilience to crises remains high; the way in which it overcame the severe economic slump in 2008-09 has also left a lasting impression on sentiment in this regard.

Employment growth increasingly stemming from immigration

Employment growth in the final quarter of 2011 and the first quarter of 2012, at a seasonally adjusted 318,000 (or 0.8% on the third quarter of 2011), not only far outdid expectations – it was also much stronger than the decline in registered unemployment, which came to a mere 80,000. The fall in unemployment appears to have largely ground to a halt, particularly within the insurance system, which includes most of the more short-term unemployed. Although the long-term unemployed are now benefiting more from the improved labour market situation, mobilising this potential is apparently still proving a difficult task. Instead, those who were not previously registered as job seekers are now taking up new job opportunities. In addition, more labour force members are coming to Germany from abroad. For 2011 as a whole, net migration rose to around 280,000 persons because of increased immigration, mainly from other EU countries. Most of the additional jobs are subject to social security contributions. In line with the German economy's growing domestic focus, employment increased mainly in the services sectors, which tend to be dominated by the private sector.

Much higher wage agreements

In view of enterprises' outstanding profitability and the low rate of unemployment, trade unions have been making higher wage demands. More of their demands than usual have been

1 See Deutsche Bundesbank, Outlook for the German economy – macroeconomic projections for 2012 and 2013, Monthly Report, December 2011, pp 15-28.
2 At the same time, the overall ratio of foreign trade to Germany's GDP increased sharply, whereas the value added content of exports declined. The crucial factor is the presence of a large number of German enterprises in markets outside the euro area.

met given the adequate, albeit far from spectacular, business outlook. This is particularly true of the metalworking industry, where basic rates of pay will be raised by 4.3% for a period of 13 months, but also of Deutsche Telekom, which will increase them by a cumulated 6.6% over 24 months. The public sector (with a cumulated rise of 6.4% over two years for central and local government) and hotels and catering (with a cumulated increase of 6.4% over two years in North Rhine-Westphalia) have likewise been affected by this development. Collective wage agreements have generally been much higher than in recent years. The resulting increase in wage costs will probably generate additional price rises in certain areas, though without jeopardising the objective of price stability overall.

Inflation strong in 2011 Q4-2012 Q1

At 2.5%, annual HICP inflation in the fourth quarter of 2011 and the first quarter of 2012 matched the level expected in the December projection. While the rate increased somewhat for food and other goods, energy price inflation fell only slightly from its previous high level. The rate of inflation for services was somewhat lower because of special factors (notably in financial services).

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 May 2012. Recent developments such as the continued depreciation of the euro and the further decline in yields on German government bonds were not therefore included in the projection. The assumptions regarding sales markets in the euro area are derived from projections for the other euro-area countries.

Pick-up in global economy

Following the strong economic recovery in 2010, growth in the world economy slowed perceptibly in 2011. This should be regarded, in part, as a return to normal following a catch-up period, although one-off effects from the earthquake in Japan and flood damage in Thailand also played a role. The sharp rise in commodity prices and growing uncertainty in the financial markets likewise had a dampening effect, however. The rebound in global economic activity in the first quarter of 2012 was mainly driven by the emerging economies and, to a lesser extent, the industrial countries. The emerging economies were influenced not only by an easing of the aforementioned one-off effects but also, among other factors, by looser monetary policy; several emerging economies had previously tightened their monetary policy stance to combat overheating. Economic growth in the industrial countries is likely to increase again gradually but remain subdued overall. The impact of expansionary monetary policy will contrast with opposite effects arising from indispensable fiscal consolidation, corporate restructuring and a retrenchment of private debt in a number of countries. Overall glo-

Major assumptions of the projection

Item	2010	2011	2012	2013
Exchange rates for the euro				
US dollar/euro	1.33	1.39	1.30	1.30
Effective 1	103.6	103.4	98.9	98.6
Interest rates				
Three-month EURIBOR	0.8	1.4	0.8	0.7
Yield on government bonds outstanding 2	2.8	2.6	1.8	2.1
Commodity prices				
Crude oil 3	79.6	111.0	114.6	107.9
Other commodities 4, 5	37.1	17.9	– 8.0	1.6
German exporters' sales markets 5, 6	11.2	5.0	2.1	5.1

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

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bal growth, at just over 3% in 2012 and just under 4% in 2013, should therefore be much weaker than in 2010 or in the period immediately preceding the global financial and economic crisis.

Adjustment crises dampening growth in euro area

Despite euro-area countries accounting for lower shares in Germany's exports in recent years, developments in their economies remain particularly important for Germany. The need for adjustment in the countries most affected by the sovereign debt crisis has proved to be greater than initially expected and is compounded by difficult conditions in some of these countries' banking sectors. However, in the course of 2012 – or in 2013 at the latest – economic activity should at least stabilise provided that these countries succeed in implementing a credible fiscal consolidation strategy and, where necessary, in restructuring and recapitalising their banking sectors in order to build confidence.

Subdued but adequate growth in sales markets

In line with the expected global economic developments, world trade should regain momentum in the course of 2012, although the expansion expected for this year (4½%) and the next (6½%) is likely to be smaller than before the financial and economic crisis. The rather weak economic activity in the euro area will probably affect the entire forecast horizon. This will be partly offset by the fact that import demand from outside the euro area is likely to be rather brisk. The Asian emerging economies in particular are increasingly bolstering growth in sales markets, which could be confined to 2% in 2012, not least because of the weak start to the year, but may reach 5% in 2013. Even so, this is much lower than assumed in the December projection.

Depreciation of the euro

Compared with last autumn's projection, the euro depreciated a further 4½% against the US dollar up to the closing date for this projection's assumptions. It was trading at US$1.30 in the relevant period for deriving the exchange rate assumption. The euro's effective exchange rate, which is relevant to foreign trade, also saw a considerable decline. The euro has since continued to weaken substantially.

Fall in commodity prices expected

Up to the beginning of 2012, crude oil prices were below the assumptions in the December projection (derived from forward prices observed in the first two weeks of November), whereas they significantly exceeded these assumptions in the first quarter of 2012 because of temporary supply disruptions and the escalating conflict in the Persian Gulf. However, forward prices pointed noticeably downwards across the whole maturity spectrum. This projection predicts a price per barrel of Brent crude oil of US$114½ for 2012 and US$108 for 2013 – nearly 5% and just over 3½% higher, respectively, than in the December projection. The crude oil price has since fallen to less than US$100. At the same time, the forward price curve has flattened out. Developments in other commodity prices in the fourth quarter of 2011 and the first quarter of 2012 largely met the expectations in the last projection. Even so, the rise in prices for agricultural commodities was somewhat sharper than anticipated in December. In line with the rather weak global growth, other commodity prices could experience a year-on-year decline of 8% in 2012. A rise of just over 1½% is expected for 2013.

Further decline in interest rates, …

In the second half of 2011, euro-area activity cooled off noticeably and the sovereign debt crisis intensified, which led the Eurosystem to cut its key lending rates in mid-December to an all-time low and to conduct very long-term refinancing operations in order to ensure that the banking system was supplied with adequate liquidity. These measures, along with renewed tension in the financial markets, considerably lowered expectations regarding short-term interest rates. Using market data, the projection derives a three-month rate for unsecured interbank lending of 0.8% for 2012 (40 basis points below the December projection) and 0.7% for 2013 (-70 basis points).

Yields on German government bonds are being pushed down by the strong demand for safe, liquid instruments. Up to April, the yield on bonds with a residual maturity of nine to ten years fell to a mere 1.6%, well below the assumptions in the December projection. Although it will rebound according to the technical assumptions, it will average 1.8% for 2012 as a whole and 2.1% in 2013, 60 basis points below the assumption in the December projection for each of those years. The yield has since gone down to 1.1%, however.

… making financing conditions extremely favourable

In the first quarter of 2012, German banks' lending rates, too, dropped below their already-low level of the second half of 2011. Although banks tightened their credit standards for loans to enterprises in the first quarter, according to survey results an easing is already likely for the second quarter. The ifo Credit Constraint Indicator accordingly hit a new all-time low in April. Financing conditions are expected to remain very favourable throughout the forecast horizon.

Fiscal policy measures in Germany slightly deficit-increasing

For public finances, the projections incorporate all measures which have either been approved by parliament or have already been defined in detail and are likely to pass the legislative process.[3] The included measures will initially reduce the fiscal deficit slightly in 2012 before then imposing a somewhat heavier burden on government budgets in 2013. With regard to social security contributions, rule-based reductions in the contribution rate to the statutory pension insurance scheme in 2012 and 2013 will cause shortfalls, whereas the financial effects of various tax-related measures (particularly surpluses caused by the expiry of depreciation allowances and shortfalls caused by the income tax cuts planned for 2013) will nearly cancel each other out. The expenditure side, by contrast, is dominated by the relief created, in particular, by the expiry of the homebuyers grant and the investment programmes to cushion the impact of the 2008-09 crisis. Various government projects will also lead to increased expenditure, however. For instance, the "energy U-turn" envisages increased spending on measures, in particular, to reduce energy consumption and to expand the use of renewables via the new "Energy and Climate Fund". The Federal Government's budget plans also include, not least, increased spending on education and research (notably the "education package") and higher investment in infrastructure.

Cyclical outlook[4]

Muted growth over rest of 2012

Since the adjustment crises in the euro area will probably persist for the time being, economic growth in Germany is likely to initially be muted, despite accelerated global economic growth and robust domestic activity. The GDP figures for the first quarter of 2012 should therefore not be regarded in isolation as an indicator of the current cyclical trend, but rather seen in connection with the slight GDP decline in the final quarter of 2011. If both quarters are

3 For 2013, the Federal Government is planning various new measures (especially the childcare supplement and an adjustment of payments between the Federal budget and the social security funds) which had not yet been sufficiently specified upon completion of the projection. Already included, by contrast, is the reduction in income tax rates, which was adopted by the Bundestag but initially rejected by the Bundesrat and then sent to the mediation committee; this will result in a shortfall in tax receipts of around €2 billion in 2013.
4 The forecast presented here was completed on 24 May 2012.

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	0.5
Fourth-quarter rate[2]	3.8	2.0	1.5	2.0
Average annual GDP rate, working-day-adjusted	3.6	3.1	1.2	1.7
Calendar effect[3]	0.1	– 0.1	– 0.2	– 0.1
Average annual GDP growth[4]	3.7	3.0	1.0	1.6

Sources: Federal Statistical Office; 2012 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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taken together, this produces the picture of a perceptible slowdown in economic growth compared with the previous quarters. This is also shown by the forward-looking indicators in the ifo Business Survey. Although enterprises' expectations have rebounded from their temporary low in autumn of last year, they have not yet returned to their highs prior to the intensification of the sovereign debt crisis; moreover, they sagged again perceptibly in May. Industrial new orders, which lead industrial output by about one quarter, fell once again slightly on the heels of an already weak fourth quarter of 2011. However, growing demand for intermediate goods suggests that the downturn in the manufacturing industry will not persist. In addition, there is an underlying trend towards strong growth in demand for construction. In the short term, the construction industry could benefit from catch-up effects, as the weather-related reductions in construction output in February were not completely offset in March. Germany's economic output could therefore grow over the course of 2012 at a rate of 1.5%, as against 2.0% over the course of 2011.[5] This would result in annual average growth of 1.0% and, after adjustment for working-day variations, 1.2%, as against 0.6% and 0.8%, respectively, in the December projection. This upward revision is largely due to economic developments surpassing expectations in the first quarter of 2012, mostly because of strong demand from outside the euro area.

Acceleration of growth in 2013

How quickly the German economy will be able to break with the subdued underlying cyclical trend will also depend on how quickly the situation in the crisis countries stabilises and expansionary forces in the euro area regain the upper hand. Eurosystem experts project that this could be the case in 2013. Consequently, along with a further strengthening of the global upswing and lively domestic activity, euro-area demand for imports could increase. Under those circumstances, the German economy, as already assumed in the December projection, could grow at a rate of 2.0% over the course of the year. The downward correction of the mean annual growth rate from 1.8% to 1.6% (or 1.9% to 1.7% after calendar adjustment) is the outcome of a smaller statistical carry-over at the end of 2012, with the pattern over time largely unchanged.

Normal overall capacity utilisation

Given the assumed cyclical pattern, overall capacity utilisation is likely to be normal. Expected immigration and the accelerating formation of fixed capital over the forecast horizon are likely to ensure that potential output will grow at an annual rate of 1¼% to 1½%, leading to a slight overutilisation at the end of the projection period.[6]

Resurgent growth of exports

In keeping with trends in the sales markets, export growth is likely to subside this year but then rebound significantly in 2013 following the incipient recovery of activity in the euro-area crisis countries and the global economy.

5 The "fourth-quarter-to-fourth-quarter" rate measures the change in GDP between the fourth quarter of the previous year and the fourth quarter of the current year. It is the outcome of cumulative quarterly growth rates of the year under review and therefore provides a more precise picture of economic developments within a year than the annual average growth rate, which also includes the statistical carry-over from the preceding year.
6 For more information, see Deutsche Bundesbank, Potential growth of the German economy – medium-term outlook against the backdrop of demographic strains, Monthly Report, April 2012.

The strong market share gains seen in 2011 could continue initially but then weaken. Despite the expected increase in the prices of domestically produced goods and services, German firms' price competitiveness is likely to improve further in 2012, especially vis-à-vis non-euro-area countries, and to change little in 2013. On the whole, exports could grow by 3¼% this year and by 5½% in 2013 following a rise of 8¼% in 2011, a year which, however, was still characterised by catch-up effects.

Investment in machinery and equipment set to accelerate

Investment activity in machinery and equipment lost steam in the fourth quarter of 2011 and first quarter of 2012 despite exceedingly favourable financing conditions. Gloomier expectations are one likely factor. With sales prospects limited, capacity extensions do not appear to be as urgent as before. In addition, enterprises were perceptibly nervous, which caused them to delay projects. Now that the global economy is beginning to gather momentum, the capacity extension motive could become more important again. Provided the euro-area sovereign debt crisis does not escalate, the importance of the precautionary motive should diminish, and postponed projects should be launched. The baseline forecast therefore shows a pick-up in investment in machinery and equipment from mid-2012 onwards, which means that, after stopping for a pause, the investment upswing is likely to continue, with the help of the very favourable financing conditions.

Residential construction lively

Along with extremely favourable financing conditions, the uncertainty that accompanied the intensification of the sovereign debt crisis is likely to have been one of the drivers of the surging demand for residential real estate. In the September 2011 to March 2012 period, the number of dwellings covered by new construction permits and the estimated costs were up by just over 9% from the comparable period a year earlier. Dwellings for three families and more and owner-occupied housing in urban areas showed particularly strong growth. This is consistent with observed property prices.

Aggregate output and output gap

Price, seasonally and working-day-adjusted

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Apartments are particularly well suited as investment vehicles, whereas owner-occupiers tend to be more interested in single-family houses, for which demand is lower. These are signs that not only the desire for more living space but also investment considerations are playing a substantial role. It is assumed that this strong demand will gradually be translated into construction output; significant bottlenecks are unlikely given unused capacity in other euro-area countries. The market for construction services is already highly international today, although there is also a sizeable local component for smaller projects.

Key figures of the macroeconomic projection

Year-on-year percentage change

Item	2010	2011	2012	2013
GDP (real)	3.7	3.0	1.0	1.6
GDP (working-day-adjusted)	3.6	3.1	1.2	1.7
Components of real GDP				
Private consumption	0.6	1.4	1.3	1.5
Government consumption	1.7	1.1	2.2	2.3
Gross fixed capital formation	5.5	6.4	1.5	4.5
Exports	13.7	8.2	3.2	5.5
Imports	11.7	7.8	4.0	7.2
Contributions to GDP growth 1				
Domestic final demand	1.6	2.1	1.4	2.1
Changes in inventories	0.6	0.2	− 0.2	0.0
Net exports	1.5	0.7	− 0.2	− 0.5
Labour market				
Total number of hours worked 2	2.3	1.6	1.2	0.2
Persons employed 2	0.5	1.3	1.2	0.7
Unemployed persons 3	3.2	3.0	2.8	2.7
Unemployment rate 4	7.7	7.1	6.7	6.5
Unit labour costs 5	− 1.2	1.4	2.8	1.8
Compensation per employee	2.0	3.0	2.6	2.8
Real GDP per person employed	3.2	1.6	− 0.2	1.0
Consumer prices 6	1.2	2.5	2.1	1.6
Excluding energy	0.8	1.4	1.6	1.8
Energy component	3.9	10.0	5.1	0.4

Sources: Federal Statistical Office; Federal Employment Agency; 2012 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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Household consumption pointing upwards

Household consumption, having broken away from the previous decade's extremely sluggish underlying trend in 2011, could well continue to rise perceptibly during the forecast period. The groundwork for this was laid by the favourable employment and income outlook. In addition, social security contributions are to be eased; therefore, net wages and salaries can be expected to rise by 4% in both 2012 and 2013. Because of weaker growth in other incomes and social benefits – under prevailing law, pension increases will be muted – disposable incomes could rise by just under 3% this year and slightly more than that next year. With the household saving rate more or less unchanged at 11% and falling consumer price inflation, the result would be an increase in real household consumption spending of 1.3% this year and 1.5% next year. This assessment is supported by consumer climate surveys, which have been pointing upwards for quite some time.

Sharply rising imports, including from euro area

The rather strong export growth and expansion of domestic demand will also cause imports to pick up considerably. It may be assumed that the trend over the previous years of rising import intensity will continue. This is partly a counterweight to growing export intensity and reflects the increasing internationalisation and specialisation of the German economy. Given an increase of nearly 2% in overall demand, imports could rise by 4% in 2012 and, if demand grows by 3½%, by 7¼% in 2013. Whereas non-euro-area countries accounted for a disproportionately large share of import growth in the past, in the coming years euro-area partners are likely to derive greater benefit from import growth. Not only pressure on enterprises in those countries to open up new sales markets but also price effects are likely to play a role. The price competitiveness of the other euro-area countries is likely to improve vis-à-vis both Germany and the rest of the world. The contribution to GDP growth of net exports in an accounting sense, unadjusted for any other factors, is likely to be in negative territory in the forecast period. However, this definitely does not imply that foreign trade will not give any impetus to cyclical developments. As was shown by the period spanning the fourth quarter of 2011 and first quarter of 2012, Germany's economy remains highly dependent on the global economy. Germany's current account surplus could fall from 5¾% in 2011 to 5¼% in 2012 and then to 5% in 2013.

Labour market

Employment rising more slowly

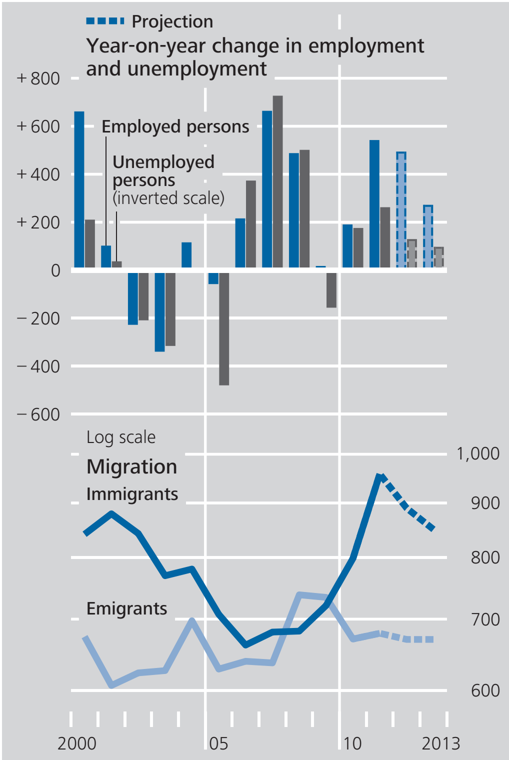
According to forward-looking labour market indicators such as the ifo employment barometer and the Federal Employment Agency's BA-X job index, employment should continue to grow, albeit at a considerably slower pace. Not only is the cyclical momentum weaker, but easily mobilised domestic labour reserves are probably now largely exhausted. However, the over-60 age cohort, in particular, holds considerable potential. Given the large gap between labour market situations in the euro area, more workers are likely to make use of their freedom of movement than previously. Following net immigration of around 280,000 people in 2011 (due also to the complete opening of labour markets to all central and eastern European accession countries apart from Bulgaria and Romania), a largely job-market-oriented net influx of 220,000 is projected for this year and 180,000 for next year. Increased immigration and rising participation in the labour force should make it possible to increase employment in those years by 490,000 (1.2%) and 270,000 (0.7%), respectively. The bulk of these new jobs will probably be additional positions subject to social security contributions. The importance of temporary work, low-paid part-time employment and employment opportunities ("one-euro jobs") is likely to diminish further. Average hours worked could resume their falling longer-term trend, which is being driven in particular by a rising rate of part-time work. Hours worked would then increase by 1.2% this year and by 0.2% in 2013.

Decline in unemployment now only moderate

Given the low level already attained, the number of unemployed persons is now likely to decline only slightly. The projections foresee a fall of 130,000 in 2012 (predominantly due to a statistical carry-over from 2011) and of 100,000 in 2013. This decline will probably be focused on the second tier of unemployment benefits. A number of the long-term unemployed will find paid employment and others will retire. Furthermore, fewer short-term unemployed are expected to become long-term unemployed. The overall unemployment rate could fall from 7.1% in 2011 to 6.7% in 2012 and 6.5% in 2013. This would mean a reduction of 5.2 percentage points since its last high in 2005. The situation looks similar if the figures are calculated in line with the ILO's standardised unemployment rates – namely a decline from 5.9% in 2011 to 5.4% in 2013.

Employment and migration

In thousands



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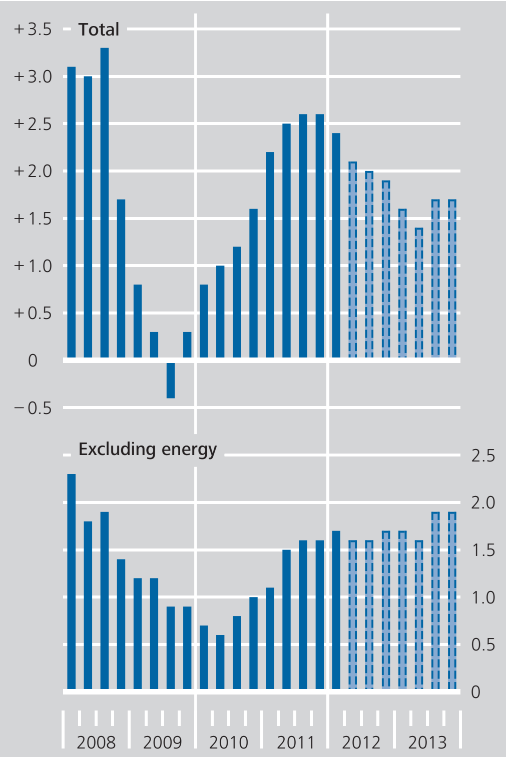
Labour costs and prices

Perceptibly sharper increase in labour costs …

In the 2012 wage round, wage bargainers have so far agreed on sharp increases in rates of pay that, in many cases, extend into 2014. The vast majority agreed permanent percentage increases. The one-off lump sum payments, which are often agreed in times of pronounced wage moderation, no longer featured on the agenda. On the basis of the agreements concluded to date and the additional estimates for the sectors and districts where an agreement is still pending, negotiated pay rates are expected to increase by 2.6% in 2012, when wage agreements from previous years are still having an impact. In 2013, when the full effect of the new agreements will be felt, the rates may in-

Price projection (HICP)

Year-on-year percentage change, quarterly



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crease by 3.1%.[7] As in 2011, high premium payments are also expected in a number of segments of the private sector in 2012, making it unlikely that the increase in actual earnings will lag behind negotiated wages. However, the rise in labour costs – measured in terms of compensation per employee – will be curbed by a rule-based reduction in contribution rates to the statutory pension insurance scheme. Given slower economic growth in productivity – employment is still expanding rapidly, whereas GDP growth is only moderate – unit labour costs are expected to record a very clear rise (2.8%) in 2012. In 2013, assuming growth in productivity returns to normal, this increase is forecast to amount to 1.8%.

… and the GDP deflator

The particularly sharp increase in unit labour costs in 2012 is likely, to a considerable extent, to have a detrimental effect on margins. Nevertheless, this should not prevent the GDP deflator from rising at a much stronger pace (1.4%) than in previous years. Profit margins are then expected to improve somewhat in 2013. The increase in the GDP deflator could then be even stronger (1.8%). Germany has not seen such a rise in the prices of domestically produced goods and services (more than 3% in two years) since the mid-1990s.

Consumer price inflation easing

Consumer price inflation will ease initially, however. While energy prices are likely to persist at a rather high level, they will probably not rise any further. The technical assumptions for the energy component imply a rise of just over 5% on average in 2012; however, these calculations are based on developments in the final quarter of 2011 and the first quarter of 2012. In 2013, the rate could then fall below 1%. In contrast, the pace of growth for the other components of the consumer price index is expected to accelerate moderately from 1.6% in 2012 to 1.8% in 2013. The effect of broad-based wage growth, which is quite substantial compared with previous years, is likely to be felt predominantly in the price of services but also in the profit margins on food and other goods. In the case of housing rents, heightened demand fuelled by improved income is set against greater supply due, *inter alia*, to especially low interest rates. Rents are expected to rise at a faster pace – those for new lettings in a number of cities are already going up rapidly; however, the upward pressure is likely to remain within rather narrow bounds. By contrast, administrative and tax measures will probably play only a very minor role over the forecast horizon. While abolishing student tuition fees in Baden-Württemberg and Hamburg will ease consumer price inflation somewhat, additional increases in tobacco tax will have the opposite effect. The energy U-turn is expected to place a considerable strain on the price situation. Overall, HICP inflation could fall from 2.5% in 2011 to 2.1% in 2012 and 1.6% in

7 The agreement reached in the chemicals industry after this projection was completed (4.5% over 19 months) is consistent with these developments. The same is true of the agreement concluded with Volkswagen (4.3% over 13 months).

2013. At the end of 2013, inflation could total 1.7% overall and 1.9% excluding energy.

Public finances

Favourable conditions for consolidation, but risks persist

On the back of economic recovery and now only small strains from measures to support financial institutions, the government deficit ratio in Germany declined clearly to 1% in 2011. Over the forecast horizon, too, conditions for consolidating public finances are expected to be quite favourable in the baseline scenario. For instance, the macroeconomic aggregates which are of particular significance for revenue (gross wages and salaries as well as nominal private consumption) are set to expand at a relatively sharp pace, whereas the already rather low unemployment figures are forecast to decline a little further still. This situation will be additionally boosted by a lighter refinancing burden for government debt. However, the European sovereign debt crisis also continues to pose a significant threat to public finances – both directly (owing to new support measures) and indirectly (as a result of the economic outlook).

Further decline in deficit in 2012, but …

The deficit ratio is likely to decline further in 2012, albeit to a limited extent, and is forecast to fall to around ½%. The cyclical influence is expected to be more or less neutral.[8] The revenue ratio could rise again slightly. The ratio-augmenting effect of the growth structure, which is favourable for government revenue, is greater than the strains, such as lowering the pension contribution rate (by 0.3 percentage point to 19.6%). A slight decline in the expenditure ratio is on the cards. This decline is due, in particular, to the limiting of the pension increase stemming from previous reform measures, the fall in unemployment, interest cost savings as a result of the favourable refinancing conditions as well as to the complete phasing out of the investment programmes introduced during the 2008-09 crisis.

… very high debt ratio likely to increase again

The debt ratio, by contrast, could increase again, having fallen to 81.2% in 2011. The drop in the ratio due to the low deficit compared with nominal GDP growth and the redemptions envisaged in principle in connection with the "bad banks" will be offset by additional debt for assistance provided to euro-area countries and the capital injection to the European Stability Mechanism (ESM). Furthermore, the government sector could assume further assets and liabilities in connection with financial market support measures.[9]

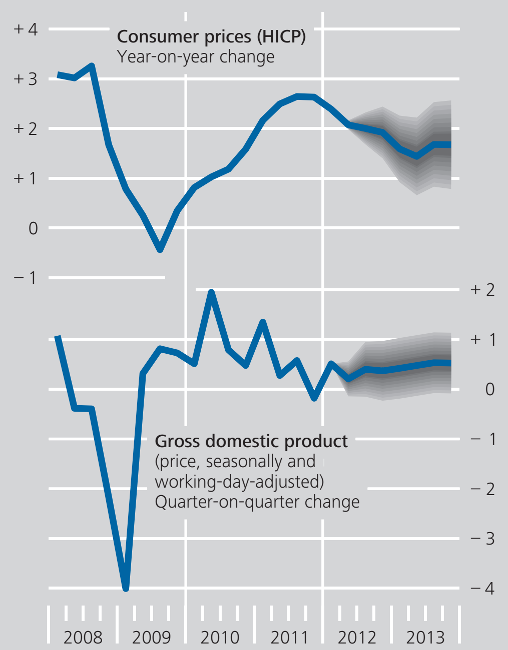
Decline in debt ratio in 2013 but hardly any change in deficit ratio

As yet, there are no signs that the deficit reduction will continue in 2013. As is already the case this year, the cyclical influences could be very limited. With regard to social contributions, the further cut in the pension contribution rate to comply with the upper reserve limit is likely to be greater than in 2012. However, the resulting fall in the revenue ratio will probably be more or less offset on the expenditure side by a continuation of the factors that are reducing the ratio of social and interest expenditure to GDP. Yet the debt ratio may drop perceptibly in 2013. In general, the situation of a relatively low deficit coupled with solid nominal economic growth, and redemptions envisaged in connection with the "bad banks" is paving the way for a downward trend. However, this trend could be counteracted by additional debt-level-increasing measures, over and above those already planned, in connection with the sovereign debt crisis (such as EFSF loans or capital injections to the ESM) or with additional support measures for German financial institutions.

8 The cyclical adjustment procedure applied here calculates the cyclical effect using the deviation from trend of those macroeconomic reference variables that are of relevance for public finances, and arrives at results that differ from those obtained under the approach applied by the German government when calculating the debt brake.
9 This is under discussion, in particular, in the context of the dissolution of WestLB.

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

Risk assessment

Risks to economic growth

The baseline scenario in this projection is based on the assumption that the adjustment recession in some euro-area countries will initially continue and uncertainty will persist but that the euro-area sovereign debt crisis will not escalate. Given their diversification of sales markets and favourable balance sheet structures, German enterprises appear to be in good shape on the whole. Nevertheless, if, in addition to the euro-area crises, the major non-euro-area countries were to suffer a more pronounced economic slowdown or the situation in the euro area were to take another substantial turn for the worse, this would place a considerable strain on German enterprises. In such an unfavourable scenario, the expansion of Germany's domestic economy cannot simply be extrapolated; it is highly dependent on foreign trade – both directly (via income effects) and indirectly (via confidence effects).

Yet it is also possible that the external conditions will prove to be more favourable and that the uncertainty stemming from the financial and debt crisis will ease sooner than expected. Given the very low interest rates and the extremely favourable financing conditions, the domestic economy could then also expand at a faster pace and build up greater intrinsic momentum. However, in some sub-sectors, this could also be associated with structural distortions.

Risks to price stability

The inflation profile in this projection is mainly influenced by technical assumptions for crude oil prices and exchange rates. It is conceivable that the assumed rather sharp expansion of the global economy will be accompanied by higher crude oil prices in the medium term. If the euro depreciates further, this could aggravate the price climate, at least temporarily. With regard to domestically generated inflation, the wage agreements from the first half of 2012 seem to suggest a moderate rise, which could entail upside risks given the very low interest rates.