Outlook for the German economy – macroeconomic projections for 2008 and 2009

The German economy got off to a very strong start to 2008. Growth is likely to be more subdued in the second and third quarters, however. As explained in this article, expansionary forces will pick up at the end of this year or early 2009 against the backdrop of a then more favourable global economic setting and a slowing rate of inflation. As far as it is possible to tell at present, this faster pace of growth will continue as an underlying trend in 2009. However, this quarterly pattern will not be reflected in the annual growth rates. According to these projections, overall economic growth will be 2¼% (2% calendar-adjusted) this year and 1½% (calendar-adjusted and unadjusted) in 2009. That would leave the economy well within the range of normal capacity utilisation with a balanced risk profile.

The price climate has become decidedly gloomier of late. Even with gradually receding price pressure in terms of the energy component and expected corrections to food prices, rates of consumer price inflation below 3% are unlikely before the end of 2008. The rate of price increase could ease to 2% in the course of 2009. The annual average rate of inflation (HICP) is therefore likely to be 3.0% in 2008 and 2.2% in 2009, with the upside risks prevailing.

Current situation

Strong GDP growth at the beginning of 2008 ...

The German economy experienced very strong, broad-based growth in the first quarter of 2008. Overall output rose by 1.5% on the quarter after adjustment for seasonal and calendar effects. Adjusted for the different number of working days, real gross domestic product (GDP) was 2.6% up on the year, compared with 1.8% in the preceding quarter. Overall economic output at the beginning of 2008 thus clearly exceeded the expectations expressed in the December 2007 forecast.[1] Industry, in particular, rapidly processed a large part of the surge in orders received in the fourth quarter of 2007 despite the early date of Easter, and, with scarcely any weather-related setbacks, the building industry was able to benefit from the improved business situation. Overall capacity utilisation has thus shown a sharp increase recently and is now probably well within the range of normal utilisation.[2]

... providing strong stimuli to the labour market ...

In line with this robust economic activity, the labour market has remained buoyant since the beginning of the year. Employment expanded rapidly – partly owing to the weather – and was 1.7% up on the year in the first quarter of 2008. At the same time, registered unemployment showed a further marked fall to a seasonally adjusted 3.36 million. The year-on-year decline amounted to 624,000. The seasonally adjusted unemployment rate, as defined by the Federal Employment Agency, was 8.0% in the first quarter, which was 0.5 percentage point lower than in the previous quarter and 1.5 percentage points down on the year. Over the past few months, developments in the labour market have proved to be noticeably more positive than forecast in December 2007, not least as a result of the ongoing progress made in reducing hard-core unemployment.

... accompanied by persistently high inflation

In the first quarter of 2008, consumer price inflation (as measured by the Harmonised Index of Consumer Prices (HICP)) was just as high as in the final quarter of 2007, at an annual rate of 3.1%. Whereas the rate of inflation at the end of 2007 was largely in line with expectations, the rate in the first quarter was 0.2 percentage point higher than forecast in December 2007. This was largely the result of sharply rising energy prices as well as a less favourable trend in food prices.[3]

Overall, the current situation for the forecast covering the period from the second quarter of 2008 to the end of 2009 is more favourable in terms of economic growth and the labour market and less favourable for consumer prices than anticipated in the December 2007 forecast.[4]

1 See Deutsche Bundesbank, Outlook for the German economy: macroeconomic projections for 2008 and 2009, Monthly Report, December 2007, pp 17-29.
2 For a detailed assessment of the current economic situation, see Deutsche Bundesbank, The economic scene in Germany in spring 2008, Monthly Report, May 2008.
3 From January 2008, the annual HICP rates differ from the December 2007 forecast not only as a result of unexpected price trends, but also owing to a different weighting scheme and various methodological changes. On this point, see Deutsche Bundesbank, Impact of the 2008 index recalculations on the national price index and the Harmonised Index of Consumer Prices, Monthly Report, April 2008, pp 32-33.
4 The forecast presented here was completed on 20 May 2008. The result of the GDP flash estimate of 15 May was therefore taken into consideration but not the information on the structure of economic growth in the first quarter of 2008 and the slight revisions to various national accounts variables for 2007, which the Federal Statistical Office published on 27 May 2008.

Important assumptions[5]

World economy and global trade

Global economic activity lost some momentum recently, albeit slowing from an extremely fast pace. This is particularly true of the US economy, which has recorded little growth since the fourth quarter of 2007. By contrast, there is still a rapid pace of growth in the emerging market economies of South and East Asia as well as in the oil-exporting countries of the Middle East. Global economic growth is likely to remain moderate as 2008 progresses and pick up again somewhat in 2009 with the assumed slight upturn in the USA. On an annual average, this seasonal pattern, based on the new purchasing power parities, results in global growth slowing from 4¾% in 2007 to just over 3½% in both 2008 and 2009, which means that it will drop somewhat below the fairly high multi-year average of 4%. This implies a downward correction of ½ percentage point annually compared with the assumptions on which the December 2007 forecast was based.[6] At the same time, it is assumed that the volume of global trade, which is also affected by the shifts in growth between the major economic areas, will expand by 5¼% and 5¾% respectively in 2008 and 2009, compared with 6½% in 2007. Growth in German exporters' sales markets is likely to be ½ percentage point lower than this in 2008 and almost 1 percentage point lower in 2009. Compared with the December 2007 forecast, export market growth has been revised downwards by 1 percentage point for 2008 and 1½ percentage points for 2009.

Major assumptions of the projection

Item	2006	2007	2008	2009
Exchange rates for the euro				
US dollar/euro	1.26	1.37	1.54	1.54
Effective 1	103.6	107.7	114.6	115.1
Interest rates				
Three-month EURIBOR	3.1	4.3	4.9	4.3
Yield on government bonds outstanding 2	3.8	4.2	4.2	4.4
Crude oil price 3	65.4	72.7	113.3	117.7
Other commodity prices 4, 5	25.1	18.0	22.8	6.6
German exporters' sales markets 5, 6	8.1	5.9	4.7	4.8

1 Compared with the EER-22 group of currencies; 1999 Q1 = 100. — **2** Yield on government bonds outstanding with a residual maturity of over nine and up to ten years. — **3** US dollars per barrel of Brent North Sea oil. — **4** In US dollars. — **5** Percentage year-on-year change. — **6** Working-day adjusted.

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Exchange rates

As usual, the technical assumption has been made that exchange rates in the forecasting period will remain constant at the average recorded for the first half of May. This implies a euro exchange rate of US$1.54, compared with a rate of US$1.37 on an annual average in 2007. The effective exchange rate of the euro against the euro area's 22 most important trading partners is expected to be almost 7% above the 2007 level over the forecast horizon. Compared with the December 2007 forecast, the assumption concerning the ex-

5 The assumptions concerning developments in global trade, interest rates, exchange rates and international commodities prices were determined jointly by the Eurosystem's experts. They are based on the information available up to 14 May 2008.
6 For better comparability, the global growth which formed the basis of the forecast of December 2007 was recalculated using the purchasing power parities updated by the IMF at the beginning of 2008.

change rate of the euro against the US dollar has been raised by US$0.08 and by 4¼% on a weighted average.

Interest rates

Following the market expectations observed in the first half of May, short-term interest rates, as measured by the three-month EURIBOR, will average 4.9% in 2008 and 4.3% in 2009. The market assessment of long-term government bond yields, at average figures of 4.2% this year and 4.4% in 2009, points to a slight acceleration, which can also be attributed to higher inflation expectations.

Spreads on loans to enterprises

The international financial markets experienced severe turmoil again in the first few months of this year. Spreads on some risky debt securities soared to new record highs. Towards the end of the first quarter, however, tensions eased somewhat. Spreads on BBB-rated corporate bonds were 250 basis points at the end of the period under review, compared with the March high of more than 300 basis points. Like the December projection, this forecast is based on the assumption that spreads on bank loans will remain elevated, which is reflected in higher costs of capital for enterprises.

Oil and other commodity prices

Based on forward prices in the first half of May, the price of a barrel of Brent crude oil on an annual average was assumed to be US$113.3 in 2008 and US$117.7 in 2009. Compared with the December 2007 forecast, this implies an upward correction to the average price of crude oil of almost US$25 per barrel for 2008 and US$34 for 2009. In US-dollar terms, other commodity prices (excluding energy) are expected to rise, in line with the assumption, by just under 23% in 2008, compared with the annual average for 2007, and increase by a further 6½% in 2009.

Public finances

In public finances, all measures were taken into consideration which have either been adopted or which have already been specified in sufficient detail and are likely to be approved. In particular, this includes the higher pension adjustments in mid-2008 and mid-2009 as well as the ¼ percentage point increase in the rate of contributions to the statutory long-term care insurance scheme to 1.95% on 1 July 2008. By contrast, no account was taken of the higher tax allowances expected as a result of the imminent recalculation of the socio-cultural minimum subsistence level.

Cyclical outlook

Better starting position, but less favourable environment

Taken on its own, the new exogenous dataset with noticeably lower growth in export markets, a considerably higher euro exchange rate as well as a significantly higher crude oil price, even in euro terms, signals that the December 2007 growth forecast needs to be revised downwards considerably. On the other hand, economic growth was extremely strong at the beginning of 2008 and far exceeded expectations. Despite the special factors favouring overall economic activity in the first quarter of 2008 and the usual lagged effects of important variables, there is some evidence that the German economy's intrinsic momentum or resilience has, to date, been underestimated. In addition, the financial markets could prove to be placing less of a burden on the real economy than some observers believe.

GDP with technical counter-reaction in second quarter of 2008

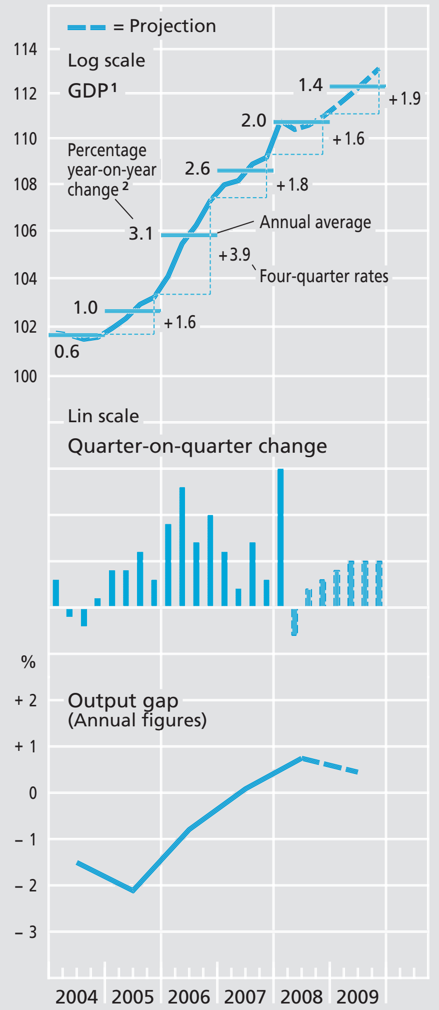
However, the level of overall output achieved in the first quarter of 2008 sets the bar high for the second quarter, particularly as the mild weather helped construction activity get off to a good start to the year. Moreover, a large amount of machinery was delivered and companies heavily stocked up their inventories of inputs and intermediary products. As a result, technical counter-reactions may be expected in the second quarter of the year, not only in construction investment, but also in machinery and equipment, and inventories. The baseline projection therefore assumes that real GDP in the second quarter of 2008 will show a slight decline on the quarter in seasonally and calendar-adjusted terms. However, even with this fairly cautious approach, GDP in the second quarter would still be significantly higher than anticipated in the December forecast.

Moderate growth over remaining forecasting period

With production expected to undergo a moderate upswing in the remainder of 2008, expansionary forces should gain momentum next year, possibly leading to real GDP then once more recording quarterly rates in the order of ½% as an underlying trend. This is suggested by the fact that, with the German economy remaining in robust shape, the impact of adverse external factors is on the wane. This applies both to the euro's recent appreciation with its moderate dampening effects on growth and to the price of oil and the resulting severe loss of purchasing power

Economic growth and output gap

2000 = 100, seasonally adjusted



1 Price-adjusted. — **2** Calendar-adjusted.

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(particularly among consumers). In addition, export market growth will probably pick up momentum again slightly. In this set of circumstances, there is much to indicate that private consumption, too, will gradually gain in importance and that overall economic growth will be broadly based and be quite balanced in structure, particularly in 2009. On an annual average and in calendar-adjusted terms, we expect real GDP to rise by 2.0% in

Technical components of the GDP growth projection

As a percentage or in percentage points

Item	2006	2007	2008	2009
Statistical overhang at the end of the previous year 1	0.6	1.4	0.6	0.2
Four-quarter rate 2	3.9	1.8	1.6	1.9
Average annual GDP rate, calendar-adjusted	3.1	2.6	2.0	1.4
Calendar effect 3	– 0.2	– 0.1	0.3	– 0.1
Average annual GDP growth, calendar-adjusted 4	2.9	2.5	2.3	1.4

1 Seasonally and calendar-adjusted index level in the fourth quarter of the previous year in relation to the calendar-adjusted quarterly average of the previous year. — **2** Annual rate of change in the fourth quarter, calendar-adjusted. — **3** As a percentage of GDP. — **4** Differences in the total due to rounding.

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2008 and 1.4% in 2009. Overall economic activity in the forecasting period should therefore be slightly above the potential growth path.[7] The fact that 2008 has more working days than 2007 means real GDP could increase 2.3% this year in calendar-year terms. Next year, by contrast, the calendar effect is negligible.

Cyclical profile of real GDP

However, the sharp variation in the average annual growth rates masks the underlying quarterly profiles. To gain an insight here, it is worth examining economic growth over the course of a year, which can be calculated based on a calendar-adjusted year-on-year comparison in the fourth quarter. This approach yields a growth rate of more than 1½% for 2008 and almost 2% for 2009. The moderate pace of economic growth in the remainder of 2008 is reflected via a smaller "statistical overhang" at the turn of 2008/09 in the average annual rate for 2009, which is ½ percentage point below its four-quarter rate.

Comparison with the December 2007 forecast

Growth is now expected to be 0.4 percentage point higher in 2008 than forecast in December 2007. This upward revision is the result of the significantly better GDP outcome for the first quarter and the associated economic assessment. Though the level of economic activity for the remainder of 2008 has also been revised upwards, the pace of growth is regarded as weaker given the unfavourable environment. The smaller "statistical overhang" means that average annual growth in 2009 is estimated to be 0.6 percentage point lower than in the last forecast, although the rate of expansion during 2009 was revised downwards only slightly.

Exports still on an upward trend

Despite the appreciation of the euro, growth in exports of goods and services was outpacing the expansion of Germany's sales markets up to the end of the period under review. However, lagged volume effects of the euro's appreciation are likely to result in exports to non-euro-area countries trailing behind market growth over the forecasting period.[8] This is largely offset by German exporters expanding their market share in the euro area, with their overall market position also likely, in fact, to improve further in 2008

7 See also Deutsche Bundesbank, Advances in strengthening the economy's growth potential, Monthly Report, October 2007, pp 35-45.
8 See also Deutsche Bundesbank, Macroeconomic effects of changes in real exchange rates, Monthly Report, March 2008, pp 33-46.

given the good start to the year. In calendar-year terms, we expect an increase in real exports of goods and services of 6¾% in 2008 and of 4¾% in 2009. With real overall demand forecast to increase by 3½% and more than 2½% respectively and given moderate import substitution effects, real imports are likely to expand by more than 6½% in 2008 and 5¾% in 2009. Foreign trade will therefore make a positive contribution to growth in 2008. At ½ percentage point in the baseline projection, this will be significantly lower than in the two preceding years, however. By contrast, net exports are expected to make a largely neutral contribution to growth in 2009.

Real investment still mainstay of growth

Gross fixed capital formation will remain a major mainstay of growth over the forecasting horizon even though its pace of expansion will slow perceptibly in 2009, albeit after three years of decidedly sharp growth. The moderate and partial correction in credit standards recently as well as the higher cost of debt financing do not present any major barrier to investment for most enterprises. This assessment is confirmed by the latest relevant surveys by the German Chamber of Industry and Commerce (DIHK) and the Ifo Institute. This is particularly true of small and medium-sized enterprises and reflects the commercial sector's improved credit quality. In addition, strong profitability over a period of several years means that German enterprises have ample internal funds. Commercial investment will remain on an upward trend, albeit at a reduced pace, with capacity expansion likely to remain a key incentive. Given a fairly relaxed budget situation, public sector invest-

Key results of the macroeconomic projection

Percentage year-on-year change

Item	2006	2007	2008	2009
GDP (real)	2.9	2.5	2.3	1.4
GDP (working-day adjusted)	3.1	2.6	2.0	1.4
Components of real GDP				
Private consumption	1.0	– 0.4	0.9	1.4
Government consumption	0.9	2.1	1.4	1.5
Gross fixed capital formation	6.1	5.0	4.8	2.2
Exports	12.5	7.8	6.7	4.7
Imports	11.2	4.8	6.6	5.7
Contributions to GDP growth 1				
Domestic final demand	1.8	1.0	1.7	1.5
Changes in inventories	– 0.1	– 0.1	0.1	0.0
Net exports	1.1	1.6	0.5	– 0.1
Labour market				
Total number of hours worked 2	0.5	1.7	1.6	0.4
Persons employed 2	0.6	1.7	1.4	0.4
Unemployed persons 3	4.5	3.8	3.3	3.2
Unemployed rate 4	10.8	9.0	7.8	7.6
Unit labour costs 5	– 1.1	0.2	1.4	1.8
Compensation per employee	1.1	1.0	2.3	2.8
Real GDP per person employed	2.2	0.8	0.9	1.0
Consumer prices 6	1.8	2.3	3.0	2.2
Excluding energy	1.0	2.1	1.7	1.6
Energy component	8.4	3.8	12.1	6.2

Sources: Federal Statistical Office; Federal Employment Agency (data as of February 2008); 2008 und 2009, Bundesbank projections. — **1** Percentage points. — **2** Workplace 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.

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ment will probably be stepped up noticeably in 2008 and 2009. By contrast, only subdued housing construction activity is to be expected. Overall, real gross fixed capital formation could increase by 4¾% in 2008 and 2¼% in 2009. The total capital stock – excluding housing – is therefore likely to expand at a rate of just under 2% overall in 2009 and therefore as sharply as, most recently, in 2000.

Slight pick-up in private consumption

High price inflation is currently placing a considerable damper on real private consumption. Moreover, soaring prices for some food items and further sharp energy price hikes severely affected consumers' price expectations in the fourth quarter of 2007 and also had a negative impact on their propensity to make major purchases. This resulted in the household saving ratio rising from 10¾% in the first three quarters of 2007 to 11¼% around year-end 2007/08. Household sentiment temporarily brightened somewhat, but, according to a GfK survey, recently became noticeably gloomier. This indicates that the propensity to save and consume will initially remain impaired. The fact that government subsidies for private pension provision were again increased in 2008 is likely to have a stabilising effect on savings. At just under 11%, the saving ratio during the forecasting period is therefore likely to be only slightly down on its previous level. The increase in private consumption will therefore be largely in line with the rise in disposable income of nominally around 3½% in 2008 and more than 3% in 2009. Ongoing employment growth, higher average compensation of employees and the increase in profit and investment income will contribute to this in equal measure. The anticipated decline in the rate of inflation will probably result in real private consumption expanding somewhat more sharply in 2009 (1½%) than in 2008 (just under 1%).

Further increase in employment and drop in unemployment

Economic growth will remain employment intensive in the forecasting period; there is therefore likely to be less and less leeway in working hours and ever fewer productivity reserves. As a result, the increase in hourly productivity – ¾% this year and 1% next year – will remain well below the average rate in the past ten years (+1½%). Assuming the economic growth projected here, the total number of hours worked will rise by 1½% and just under ½% respectively. The average number of hours worked per employed person will increase somewhat this year owing to the larger number of working days and will probably not change much next year given fairly minor shifts in the employment structure. The number of persons in work is therefore likely to increase by just under 1½% to 40.3 million in 2008 and rise by almost ½% again in 2009. For the forecasting horizon, it is assumed that the demographic decline in the working-age population will be offset by higher labour market participation and that migration effects will be negligible. Under these conditions, the number of registered unemployed could average some 3.3 million persons in 2008 and 3.2 million in the following year. The unemployment rate as defined by the Federal Employment Agency would therefore fall from 9.0% in 2007 to 7.8% in 2008 and 7.6% in 2009.

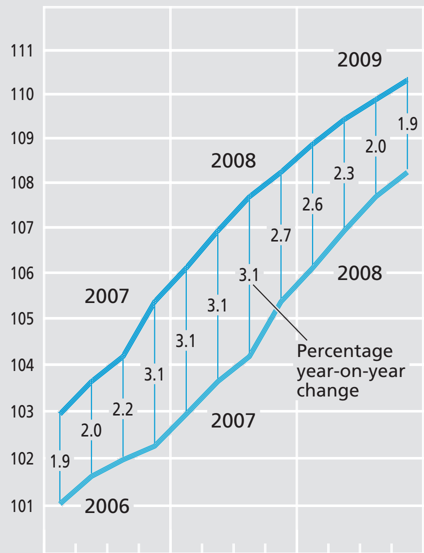
Labour costs and price outlook

Negotiated rates of pay and labour costs

The 2008 pay round has now largely been concluded. Of the major sectors, only retail and private banking have yet to reach an agreement. In the metal-working and electrical engineering industries, new negotiations are not scheduled until November. As expected, wage inflation accelerated mainly in the services sector, especially in the public sector, at the beginning of 2008. Pay settlements, which frequently run to 2009 and sometimes longer, were, in fact, somewhat higher than assumed in the December 2007 forecast. This was probably due in part to the unexpectedly positive developments in the labour market and in earnings. Negotiated rates of pay may therefore be expected to rise by, on average, 2¾% rather than 2½% in 2008 and 2009. The wage drift is likely to be largely neutral in both years given accelerated increases in negotiated rates of pay and fairly moderate economic growth. While lower social security contributions by employers will help ease wage costs in 2008, contributions are expected to go up slightly, on average, in 2009. The increase in labour costs, as measured by compensation per employee, will therefore accelerate from 2¼% in 2008 to 2¾% in 2009. Assuming productivity growth (per employee) of roughly 1%, unit labour costs could show a marked rise in the current year for the first time in some while, at 1½%. In the following year, they are expected to increase further, at 1¾%. As conditions in terms of pricing competitiveness have changed and input prices are rising fast, it will scarcely be possible to pass these costs through fully to sales prices. At just under 1¼%, the domestic value-added deflator will therefore increase more slowly than unit labour costs, at least in 2008. This means that enterprises, for the first time in years, will probably not be able to raise their profit margins further in 2008 and 2009.

Price projection*

2005 = 100, seasonally adjusted, quarterly, log scale



* Harmonised Index of Consumer Prices for 2007 to 2009 compared with 2006 to 2008. Year-on-year change calculated using unadjusted figures.

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Consumer prices in 2008 ...

The unfavourable consumer price trend – as measured by the HICP – with annual rates of 3% and more is likely to continue well into 2008. This can primarily be attributed to the sharp increase in crude oil prices. Given the assumed path of oil prices, inflation rates below 3% are not to be expected before the end of this year, with dampening baseline effects also playing a part in this. Consumer price inflation can now be expected to average 3.0% in 2008. This represents an upward revision of 0.7 percentage point compared with the December 2007 forecast,[9] largely due to higher crude oil prices. The unexpectedly large increase in food prices will also have a stronger adverse impact on the price climate on an annual average than forecast six months ago, despite some partial corrections that have already taken place or are still outstanding. By contrast, the price trend for goods (excluding energy and food) and services could be somewhat more favourable. Excluding energy, the latest inflation forecast, at 1.7% for 2008, is therefore largely in line with that of December 2007.

... and 2009

Consumer price inflation could moderate to just under 2% in the course of 2009 provided no further adverse factors emerge. This corresponds to an average annual inflation rate of 2.2% in 2009, which is also 0.7 percentage point more than was forecast in December 2007. As for 2008, the revision for 2009 is due almost exclusively to higher crude oil prices, ie the energy component of the HICP. Excluding energy, the annual inflation rate projection, at 1.6% in 2009, is largely unchanged from the last forecast. The slight flattening compared with 2008 is due solely to the weaker price trend for food. However, higher rates of inflation are expected for industrial goods (excluding energy) and services in 2009, mainly reflecting greater wage cost pressure.

Public finances[10]

Slight deterioration in the situation of public finances in 2008

The state of public finances is likely to deteriorate again somewhat in the current year. Following a small budget surplus in 2007, a marginal deficit is expected again for 2008. Although budgetary developments continue to be influenced by positive cyclical factors, structural factors are key. In particular, the business tax reform and the further reduction in the contribution rate to the statutory unemployment insurance scheme are leading to losses of revenue. Furthermore, not least owing to the turbulence in the financial markets, revenue from profit-related taxes is likely to see weak growth; this revenue has shown an extremely sharp increase in recent years and has probably been well above its trend value lately. However, there is a high degree of uncertainty in this area, especially given the difficulty of estimating the financial impact of the business tax reform. Overall, growth in government revenue is likely to be markedly weaker than GDP growth. There will probably be a decline in the expenditure ratio as well, albeit to a lesser extent than in the revenue ratio. Although there is likely to be a clear acceleration in the growth of government expenditure, this will, in all probability, again lag behind the increase in nominal GDP, especially on account of spending on provision for old age and in connection with unemployment.

There will probably be no major improvement in the public finance situation in the coming

9 As mentioned above, owing to various statistical changes to the HICP, the two inflation rate forecasts are not directly comparable from January 2008 onwards.
10 The account below is of the finances of general government as defined in the national accounts; this definition is also used largely as the basis for assessment of the Maastricht criteria. For a more detailed assessment of budgetary developments at central, state and local government level and of the social security funds, see Deutsche Bundesbank, Public finances, Monthly Report, May 2008, pp 65-74.

Hardly any improvement in budgetary position in 2009

year. On the revenue side, a certain amount of additional revenue owing to the effects of tax progression might help to counter continued subdued growth in revenue from profit-related taxes. On the whole, it may be assumed that the revenue ratio will stay roughly at the prior-year level since, on balance, no major tax or social security cuts have been implemented so far. Nevertheless, the impending recalculation of the socio-cultural minimum subsistence level can be expected to lead to an increase in the relevant tax allowances (and, in all likelihood, child allowance, too). Moreover, additional deficit-increasing measures are under discussion at present, and these also have to be taken into consideration in this context. Expenditure growth is likely to accelerate further. In particular, there could be a fairly sharp increase in healthcare spending owing to new arrangements for the remuneration of outpatient treatment. The government debt ratio, which stood at 65.0% at the end of 2007, is likely to fall to approximately 61% by 2009. The situation of general government nevertheless conceals the fact that some subsectors and, in particular, central government will still show considerable structural deficits in the coming year.

Risk assessment

Even though the baseline scenario presented here is the most likely development given the assumptions made, it is, naturally enough, fraught with risks and uncertainties which might lead to actual developments deviating from expected developments.[11] The risk factors involved are largely the same as those detailed in the December 2007 projection. Some of the risk potential identified earlier has been incorporated into the baseline, however. This applies to both global economic growth, which is now rated as weaker, and the technical assumptions on the exchange rates and crude oil prices.

Global growth

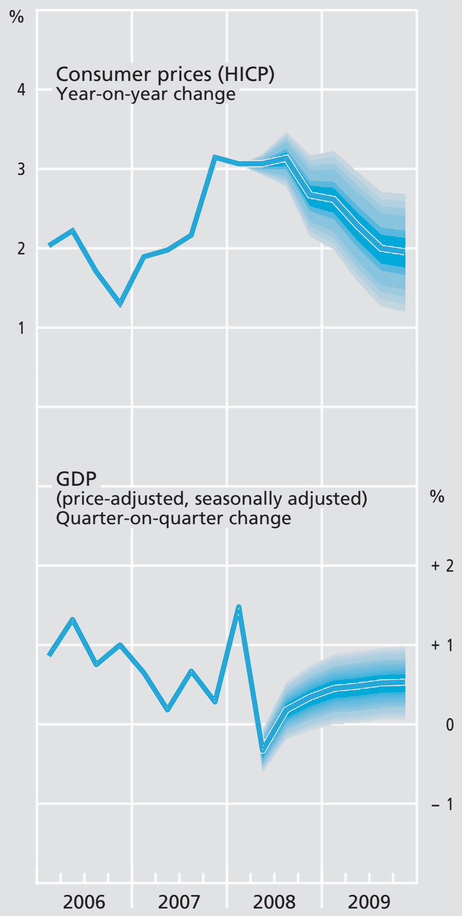
With adjustment of the baseline assumption on global growth, which has been revised downwards by ½ percentage point for both 2008 and 2009 from the December 2007 projection, the residual risk to the global macroeconomic outlook is likely to be rather limited. However, downside risks still exist in some economies which are currently undergoing a correction in their housing markets or in which such risks could materialise given earlier quite sharp rises in house prices. The underlying hypothesis that economic growth, especially in Asia, is being impaired only to a comparatively small extent by the slowdown in the US economy is also still in need of confirmation.

Exchange rates

The exchange rate of the euro has been on an upward trend for some years. This appreciation could continue, especially with other interest rate patterns or given a prolonged weakening of economic activity in the United States. On the one hand, this would harm the competitiveness of German enterprises in the international sales markets and encourage import substitution. On the other, it would tend to ease the domestic price climate and,

11 See also Deutsche Bundesbank, The uncertainty and risks involved in macroeconomic forecasts, Monthly Report, December 2007, pp 26-27.

Baseline and uncertainty margins of the projection *



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

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therefore, strengthen consumer demand at home.

Oil prices

The international oil markets remain a considerable factor of uncertainty. When this report went to press (5 June), the spot price for a barrel of Brent crude oil was US$2½ higher than in the projection assumption; in the case of longer-term forward quotations, the figure was as much as US$6 higher. If the price of crude oil were to stay at this level or, in fact, continue rising, there would be a further deterioration in the terms of trade leading to a matching dampening of domestic demand in Germany and rising inflationary pressure. Besides being a reflection of geopolitical tensions and speculative elements, the latter being difficult to assess, the high price of crude oil could be an indication that the global economy is still growing at a fast pace, with the resulting higher export demand – including from the oil-exporting countries – forming a partial counterweight to the loss of domestic purchasing power.

Financing conditions

Despite a number of positive signs, the turmoil in the financial markets has not yet been resolved. Risk premiums in the money market are still well above their levels before the onset of the financial market turbulence in the summer of 2007. Even so, credit conditions for enterprises in Germany have been tightened only slightly since the start of the turmoil and have not changed at all for households. Given the limited interest rate sensitivity of investments, there is some evidence that, given stable expectations, the income and goods cycle will not be severely impaired.

Robust economic activity in Germany

Account also has to be taken of the fact that growth in Germany exceeded expectations in the first quarter of 2008. Even though growth was positively influenced by special factors, it still shows in what better shape the German economy is at present. Given the large volume of industrial orders on hand – as revealed, say, by the order capacity index and the orders backlog according to the Ifo business survey – as well as the ongoing widespread positive outlook in the corporate sector, growth in the German economy in the near future could also be perceptibly stronger than expected in the baseline projection.

Balanced growth risks

The recently displayed intrinsic momentum or resilience of the German economy represents a clear counterweight to the risks, mainly in the international setting, which, taken by themselves, point to a preponderance of downside risks to economic growth. For this reason, the prospects of more favourable growth and the risks of a poorer performance currently appear roughly balanced.

Price risks on the upside

As in December 2007, the price projection is very much shaped by the technical assumption on oil prices. Perceptibly higher rates of inflation may be expected if the price of oil remains at its current high level or, in fact, rises even further. By contrast, a further appreciation of the euro could help alleviate the effect. With regard to food prices, the baseline projection assumes, in view of globally rising demand, only a temporary and incomplete downward correction. Seen in that light, it is fraught with certain downside risks. In particular, a sharp expansion in global agricultural production could involve stronger price adjustments. In terms of domestic conditions, however, upside price risks predominate. It is true that this projection is based on the assumption that higher wage costs will be passed on, to a certain extent, to prices, especially those of services. Given further increases in input prices, growing wage cost pressure might trigger new rounds of price increases. Overall, the upside risks to future price developments predominate in both the short and medium term.