Outlook for the German economy – macroeconomic projections for 2009 and 2010

The outlook for the German economy has worsened significantly following the renewed escalation of the financial crisis in autumn and the accompanying further deterioration in the world economy. A considerable decline in real economic activity in Germany may be expected for the winter half-year of 2008-09. The rescue actions that have now been launched in many countries have created a broad basis for stemming the global crisis of confidence. Nevertheless, the continuing adverse factors going into next year are to be rated as severe. The German economy is not expected to pick up again until the projected global economic upturn in 2010. In accordance with this baseline scenario, which is fraught with major uncertainty, price-adjusted gross domestic product (GDP) will decline by 0.8% in 2009 and go up by 1.2% in 2010.

Owing to price corrections for energy and food, HICP inflation will continue to ease initially, but will rise again from the fourth quarter of 2009 when base effects are no longer operative and higher wage costs increasingly make themselves felt given an improved economic situation. Accordingly, average annual inflation rates of 0.8% and 1.4% are to be expected for 2009 and 2010 respectively.

Current situation

Cyclical slowdown from mid-2008 ...

There has been a marked slowdown in the pace of economic growth in Germany since the middle of this year in the wake of the cooling of global economic activity. While the decline in overall output in the second quarter may be seen, to some extent, as a technical reaction to the extremely strong growth in the first quarter, the outlook has now deteriorated considerably both nationally and internationally. Sentiment in major sectors of the German economy has rapidly worsened. In the third quarter of this year, overall output in Germany fell in price, calendar and seasonally adjusted terms by 0.5% on the quarter and was no more than 0.8% up on the year in working-day-adjusted terms. By contrast, there has been a marked easing of the price climate. As a result of the sharp corrections in the international commodity markets, there was a perceptible fall in consumer inflation, which had peaked at a year-on-year rate of 3.5% in July.

In the third quarter, the disruptive factors stemming from the persistent and deep dislocations in the international financial markets were not yet having a direct impact on real activity in the German economy. At present, there is no indication, at least from the macro data, of any direct effects in the shape of generally restrictive lending by the banks. Fixed investment has maintained the cyclically high level of the second quarter – supported in some cases by well-filled order books – and, despite the considerable strain of losses in purchasing power, private consumption benefited on average in the third quarter from ongoing employment growth and the comparatively sharp rises in negotiated rates of pay. The fact that real GDP was considerably dampened in this period by the external side was due mainly to the high level of import activity, which was the result of a marked increase in domestic inventories. Moreover, exports of goods and services have been slipping somewhat since as long ago as the second quarter. Economic developments in the industrial countries as well as the emerging market economies and the central and east European transition countries are now displaying greater synchronicity again, with the latter having experienced some abrupt outflows of capital recently. As a result, the German economy's traditionally broadly based regional sales structure is able to perform its usual compensating function only to a very limited extent.

... but still no major effects on the labour market

Despite the marked economic downturn, the positive overall situation in the German labour market continued up to the end of the period under review. According to the estimates of the Federal Statistical Office, there was a further month-on-month rise in the number of persons in work in October with an increase of 518,000 on the year. There was a further fall of 10,000 in the seasonally adjusted unemployment figure to 3.15 million in November. Employment growth in major sectors has now come to a standstill, however, and firms' recruitment plans reflect a more cautious basic attitude.

Compared with the last projection of June this year, the basic situation has deteriorated considerably overall. The indicators currently

Basic situation overall considerably less favourable than in mid-year

suggest that overall output is likely to decline in the final quarter of the year, too.[1] The German economy will therefore be going into next year from an already depressed level and with considerable existing strains in terms of general sentiment. Nevertheless, domestic capacity utilisation, which reached a cyclically high level at the beginning of 2008, is unlikely to be indicating a cyclical cooling at present.

Major assumptions[2]

World economy

The slowdown in global expansion has been considerably intensified by the recent shocks to the global financial system – a slowdown that was already marked by the corrections in major real estate markets, high global inflationary pressure since the summer of 2007, and growing external imbalances in a number of emerging market economies. Developments in the industrial countries played the major part in this. Following positive growth in the first half of the year in the United States and the United Kingdom – countries with large financial sectors and severely ailing housing markets – the third quarter saw a decline in overall output. Furthermore, in Japan, the downward movement which began in the second quarter persisted at the start of the second half of the year. There was a perceptible slowdown in economic activity in a number of emerging market economies in the third quarter as well, however. Year-on-year GDP growth was noticeably weaker than before in China, for example. In addition, economies with sustained large current account deficits and substantial short-term external debt, some of which is in foreign currency, proved to be especially vulnerable to increased outflows of capital.

Major assumptions of the projection

Item	2007	2008	2009	2010
Exchange rates for the euro				
US dollar/euro	1.37	1.46	1.27	1.27
Effective 1	107.7	112.2	106.0	106.0
Interest rates				
Three-month EURIBOR	4.3	4.7	2.8	3.2
Yield on government bonds outstanding 2	4.2	4.0	3.8	4.1
Crude oil price 3	72.7	99.9	67.3	76.6
Other commodity prices 4, 5	17.1	10.7	– 18.3	5.8
German exporters' sales markets 5, 6	6.4	3.6	1.4	4.2

1 Compared with the 22 most important trading partners of the euro area (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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Developments in the first half of the year mean that the June forecast of global growth at 3½% can largely be maintained for the current year. The outlook for the coming year is now considerably less favourable, however. The current projection is based on the assumption that global economic output will increase by no more than just under 2% in 2009 and that growth will then probably pick up again to 3¼% in 2010 as the global econ-

1 See Deutsche Bundesbank, The current economic situation in Germany, Monthly Report, November 2008.
2 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 as of 17 November 2008.

omy gradually recovers. This signifies a downward revision of more than 1½ percentage points compared with the June forecast for 2009.

Global trade and international sales markets

Given these underlying conditions and taking due account of the fact that demand for internationally tradable goods reacts very sensitively to changing cyclical conditions, the volume of global trade – following an expansion of some 4¼% this year – could increase by only 2¼% in 2009 but go up by 5% again in 2010. For German exporters' sales markets, this assumption implies a calendar-adjusted expansion of 3½% in 2008 as well as 1½% and 4¼% respectively in 2009 and 2010. This means that German export growth is being revised downwards by more than 3 percentage points for 2009 compared with the last projection; this is a direct reflection of the considerable deterioration in the external sales outlook.

Exchange rates and interest rates

The projection is based on the technical assumption of a constant euro exchange rate over the forecasting horizon of US$1.27. This reflects the fact that the euro has depreciated sharply against the US dollar since July. The nominal effective exchange rate of the euro against the currencies of the 22 most important euro-area trading partners during the forecasting horizon is assumed to be 5½% below its average value for 2008. This signifies an improvement in the price competitiveness of the euro area. The interest rate assumptions derived from market expectations envisage an average level for the three-month EURIBOR of 2.8% in 2009 and 3.2% in 2010, compared with 4.7% this year. According to the current market assessment, the long-term yield on German government bonds is likely to fall slightly initially next year from 4.0% to 3.8%. For 2010, a further rise to an average of 4.1% is expected.

Cost of borrowing for enterprises

As in the June projection, due account was taken of the impact of the financial market crisis on the cost of enterprises' debt financing owing to additional interest rate premiums on loans to enterprises. The premiums are significantly larger again than in the June projection. This takes account, not least, of the fact that spreads on corporate bonds still rated as investment grade (BBB) shot up suddenly in September, reaching new highs in October.

Oil prices and other commodity prices

The spot price for crude oil has more than halved from its peak of almost US$147 per barrel (Brent) in July of this year. The forward prices for the next few months indicate the expectation of a countermovement. Accordingly, the projection is based on the assumption of an average annual oil price of US$67.3 in 2009 and US$76.6 in 2010. Given the exchange rate assumption, this means that, next year, the price of crude oil in euro terms is likely to be more than one-fifth below its average level for 2008. Compared with the June projection, the price assumptions for a barrel of crude oil have been revised downwards by US$46 for 2009 and more than US$40 for 2010. In the case of other commodities (excluding energy), the market players currently expect a price reduction of almost one-fifth for 2009 on an annual average. A rise of just under 6% is assumed for the following year.

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, the adjustments to the contribution rate of the Federal Employment Agency (3.3% in 2008, 2.8% from January 2009 to June 2010, and 3.0% thereafter) as well as the increase in the contribution rate to the statutory health insurance scheme with the introduction of the health insurance fund in 2009 (to 15.5%) have been included. Of chief significance among the fiscal measures are the recently agreed package of measures with the aim of bolstering the economy and the planned increase in income tax allowances for contributions to the health and long-term care insurance schemes from 2010. There will be a greater burden on the expenditure side resulting, in particular, from higher child benefit payments, increased healthcare spending owing to new arrangements for the remuneration of outpatient treatment and hospital financing, as well as the suspension of the "Riester factor" in the adjustment of pension payments. The ending of the grant to homebuyers will provide relief, however. These calculations are also based on a relatively sharp rise in government investment. Government support measures for financial institutions have been taken into account to a minor extent for 2008 as increasing the deficit.

Cyclical outlook

Change in underlying conditions compared with June projection

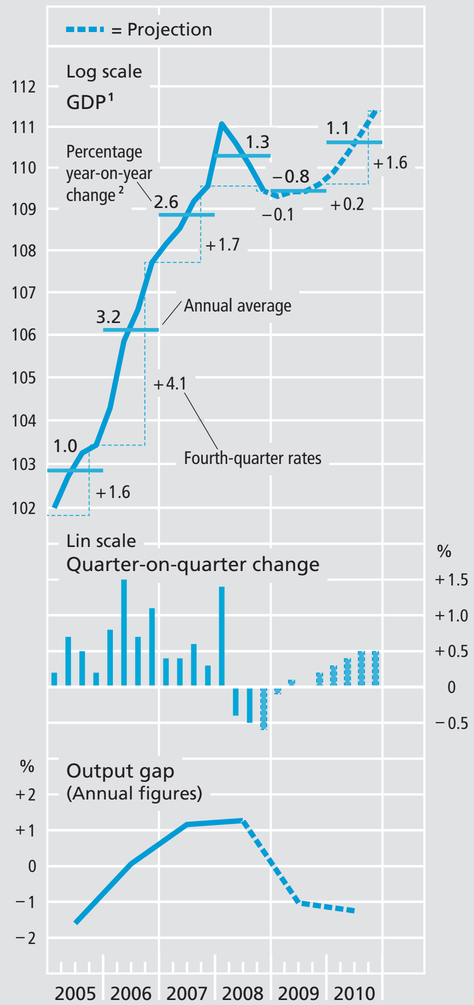
The marked changes in the underlying conditions, which have been incorporated into the assumptions, call for a significant revision of the baseline projection. Taken in isolation, a lower euro exchange rate, the sharp decline in the cost of oil, and the easing price pressure in the case of food are to be rated as positive factors for the economy as a whole. To a large extent, however, this development reflects the massive cooling of the global economy, which is also reflected in a sharp downward revision of German exporters' sales market growth. The German economy's historically high degree of openness, which is now over 85% of GDP, and its pattern of specialisation in the international division of labour mean that it is particularly influenced by changes in external conditions. It may be assumed that this dampening effect will clearly predominate. Moreover, negative confidence effects as well as gloomier sales prospects are likely to induce households and enterprises to be generally more cautious in their spending, even though there are few signs of credit supply constraints in Germany so far.

Indicators point to further GDP decline in the final quarter of 2008

Domestic final demand and the strong build-up of inventories were still countering the waning external impulses in the third quarter. This stabilising influence is likely to be weaker in the final quarter of this year, however. The persistent decline in the volume of industrial orders, which was illustrated recently by some large firms announcing that they would be closing some production locations temporarily, is likely to reinforce the decline in industrial output. This development could eventually have an impact on business-related services and the transport and logistics sector. Overall, a further perceptible cutback in

Economic growth and output gap

2000 = 100, seasonally adjusted



1 Price-adjusted. — 2 Calendar-adjusted.

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macroeconomic activity may be expected for the final quarter of 2008. This would place the German economy in a very difficult position starting out in the new year.

Extended cyclical slowdown

In line with the assumptions about the global economic setting, the baseline projection assumes that the cyclical slowdown in Germany will persist in 2009 but that there will be no further major cutbacks in production during the course of the year. Growth in the German economy is likely to return slowly to its potential only in the wake of a global economic upturn in 2010. Following a calendar-adjusted average annual increase of 1.3% in real GDP this year, overall output in 2009 could therefore fall by 0.8% on an annual average before an expected increase of 1.1% in 2010. In calendar-adjusted terms, this corresponds to rates of change of 1.6% for 2008, -0.8% for 2009, and 1.2% in 2010. The underlying flat trend in GDP over the four quarters of 2009 reflects the weakness of several demand components. The adverse external conditions will have an increased impact on investment. Private consumption is unlikely to provide any significant stimulus. Accordingly, there will be a marked fall in overall capacity utilisation. As a result, the German economy will experience a period of cyclical underutilisation in 2009 and 2010. In comparison with earlier cyclical downturns, the output gap up to the end of the forecasting horizon is not rated as exceptionally large, however.

Dampening effects of the external sector ...

The continuing fall in export orders since the beginning of the year was reflected in declining export business in the third quarter of 2008. The retarding effect stemming from world trade generally is likely to be reinforced by the profile of Germany's export goods. Owing to the major importance of capital goods, German exporters have been hit especially hard by the deterioration in the investment climate globally. While this range of goods largely shielded German exporters from price-related volume effects in times of a strong euro, the high cyclical volatility of investment means that exports are likely to prove to be particularly vulnerable to the worldwide economic slowdown.

Against this background, it may be assumed that, next year, German exporters will relinquish some of the market shares gained earlier. Overall, exports of goods and services could decline by ½% in price-adjusted terms, compared with growth of 4½% in 2008. In 2010, German exports are likely to grow in line with the sales markets as the world economy recovers. Imports will rise this year by approximately 4¾% in real terms. As a result, the external sector will, on an annual average, still make a slightly positive contribution to growth. Given an expected increase in real imports of ½% in 2009 and 4¾% in 2010, the baseline projection shows the external sector exerting a dampening impact on overall economic output next year before possibly making a positive contribution to GDP growth again in 2010.

... impacting on investment activity

The gloomier sales prospects for German enterprises and a recent considerable drop in capacity utilisation will put a noticeable damper on domestic investment activity. However, the higher cost of debt financing, as far as it concerns investment, is unlikely to have a major impact owing to the low demand for external financing. Moreover, non-financial enterprises' balance-sheet structures remain in a sound condition. There are indications of significant excess capacity only in some sectors. While fixed investment is likely to have risen again by 4½% this year, a decline of 3% is expected for 2009. The strongly cyclical spending on machinery and equipment, in particular, will have a negative impact on the overall result. Investment's contribution to growth is likely to remain largely neutral overall in 2010.

Technical components of the GDP growth projection

As a percentage or in percentage points

Item	2007	2008	2009	2010
Statistical carry-over at the end of the previous year 1	1.5	0.6	– 0.8	0.1
Fourth-quarter rate 2	1.7	– 0.1	0.2	1.6
Average annual GDP rate, calendar-adjusted	2.6	1.3	– 0.8	1.1
Calendar effect 3	– 0.1	0.3	– 0.1	0.1
Average annual GDP growth, calendar-adjusted 4	2.5	1.6	– 0.8	1.2

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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Developments in construction investment look set to be mixed. Not least because of accelerated investment in transport infrastructure, public sector construction is likely to provide some stimulus to the economy as a whole. Housing construction, by contrast, is likely to support growth only marginally during the forecasting horizon, with expected weak new construction activity possibly being compensated for by – in some cases, government-subsidised – activity in the finishing trades.

The anticipated pick-up in private consumption again failed to materialise this year.

Confidence and wealth effects placing a strain on private consumption

Income growth as a result of the improved labour market situation and a fairly substantial rise in wages was largely eroded by unfavourable price developments. Price stickiness means that there will be a certain time lag before the marked decline in the price of oil from the third quarter onwards and the corrections to the prices of agricultural products fully work their way through to consumer prices. The substantial fall in prices in the international stock markets have, moreover, resulted in considerable asset losses and are likely to limit the scope for expenditure on this front. However, the percentage of equities in households' total assets is small and spread rather unevenly.

What appears more important is the fact that the precautionary motive is becoming more prevalent again given the growing uncertainty about the future income situation. Households' savings ratio may therefore be expected to go on rising, namely from 11½% this year to 12% next year, despite the unfavourable return on financial assets. Given the gloomier economic outlook, this level is likely to be largely maintained over the forecasting horizon. This means that the projected improvement in real incomes is initially hardly likely to be reflected in higher private consumption. Having declined by ½% this year, private consumption will probably tend to stagnate with a flat profile over the four quarters of 2009 and not contribute perceptibly to growth until 2010 with a rise of 1¼%.

The labour market could have a stabilising effect in the current downturn, at least in the near future. Although employment generally reacts quite strongly – albeit with a time lag – to an economic slowdown, enterprises' plans do not yet appear to envisage any adjustments, at least not in terms of core staff. Instead, there are initially to be reductions in overtime and working hours accounts. In addition, some enterprises are planning to cut regular working hours. Ultimately, it may be assumed that a lot of companies will make use of short-time working benefits, which were recently extended from 12 to 18 months. Nevertheless, there could soon be severe cutbacks in temporary work, which has accounted for a considerable part of employment growth in recent years. Unlike before, temporary work agencies can now also apply for short-time working benefits, however. Overall, it may be assumed that the total number of hours worked will be adjusted to demand to a considerable extent via the time component initially.

Cutback in working hours slowing decline in employment for the present

Decline in employment

Assuming overall economic activity develops as projected and hourly productivity increases by just ¾% in 2009 and just over 1% in 2010, total hours worked could drop by 1½% next year and remain roughly unchanged in 2010. As much as two-thirds of the adjustment will probably be effected via the working time component in 2009. This means that employment would shrink by just ½%. Over the course of the year, however, the buffer effect of the working time component will decline, with the result that the number of persons in work is likely to be roughly 1% down on the year in the final quarter of 2009. In 2010, average working hours could continue to return to a normal pattern against the backdrop of the expected upturn in overall economic activity. The number of employed persons would then decline by ½% on an annual average.

Rise in unemployment

The official unemployment figure is likely to rise by an annual average of more than 100,000 in 2009 and 2010 with a slight decline in the supply of labour. According to the Federal Employment Agency's definition, this is equivalent to an unemployment rate of 8.1% and 8.5% respectively in 2009 and 2010, compared with 7.8% this year.

Labour costs and price outlook

Accelerated increase in negotiated wages

Since the June projection, wage agreements of importance for the economy as a whole have been concluded in the retail sector (delayed by one year) and in the metalworking and electrical engineering industries (effective into 2010). These agreements were largely in line with expectations. Negotiations in the private banking sector have not yet produced an agreement, which means that the rates of pay agreed in earlier rounds of wage negotiations will continue to apply for the time being in this industry. Overall, negotiated rates of pay are likely to rise significantly more rapidly in 2008 (2¾%) than in the previous year (+1½%). The rate of increase, which is largely determined by existing agreements, could likewise amount to 2¾% in 2009. The pace is subsequently likely to weaken again somewhat in 2010 in response to the change in macroeconomic conditions (+2¼%).

Key results of the macroeconomic projection

Percentage year-on-year change

Item	2007	2008	2009	2010
GDP (real)	2.5	1.6	– 0.8	1.2
GDP (working-day adjusted)	2.6	1.3	– 0.8	1.1
Components of real GDP				
Private consumption	– 0.4	– 0.4	0.1	1.3
Government consumption	2.2	2.2	1.8	1.9
Gross fixed capital formation	4.3	4.6	– 3.1	0.2
Exports	7.5	4.4	– 0.5	4.5
Imports	5.0	4.7	0.4	4.7
Contributions to GDP growth 1				
Domestic final demand	1.0	1.0	– 0.2	1.1
Changes in inventories	0.1	0.4	– 0.2	– 0.1
Net exports	1.4	0.2	– 0.4	0.2
Labour market				
Total number of hours worked 2	1.8	1.3	– 1.5	0.1
Persons employed 2	1.7	1.4	– 0.5	– 0.5
Unemployed persons 3	3.8	3.3	3.4	3.5
Unemployment rate 4	9.0	7.8	8.1	8.5
Unit labour costs 5	0.4	1.8	2.5	0.4
Compensation per employee	1.2	2.0	2.2	2.2
Real GDP per person employed	0.7	0.2	– 0.3	1.8
Consumer prices 6	2.3	2.8	0.8	1.4
Excluding energy	2.1	1.8	1.3	1.5
Energy component	3.8	9.6	– 2.6	0.2

Sources: Federal Statistical Office; Federal Employment Agency; from 2008 to 2010, Bundesbank projections. — **1** 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.

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Higher actual earnings

Nevertheless, the increase in actual earnings per employee of 2¼% will fall well short of the rise in negotiated rates of pay next year. For one thing, the gloomier macroeconomic situation is likely to mean that escape clauses are used more frequently. For another, enterprises will cut back working hours and introduce more short-time working. In 2010, a return to normal may be expected in this area, with the wage drift (on a monthly basis) possibly being neutral again as a result. While the sharp reduction in unemployment insurance contributions is lowering labour costs this year, the further reduction scheduled for 2009 will virtually be offset by higher contributions to the statutory health insurance scheme. This means that the average compensation per employee will rise somewhat more strongly than in 2008 despite a pronounced negative wage drift. In 2010, labour costs will continue to rise significantly.

Rising unit labour costs

As the working time component is strongly negative, productivity per person employed will decline somewhat in 2009. Unit labour costs could therefore even undergo somewhat stronger growth, at 2½%, than in 2008. The rate of increase is not likely to ease significantly until 2010. In view of the unfavourable economic setting, enterprises are, however, likely to have difficulties in fully passing on the higher costs to consumers. In fact, margins are likely to narrow in 2009 – even more so than in 2008. This will be slightly offset by the lower cost of imported commodities. In addition, the earnings situation had improved sharply in the years before. Prices could somewhat outpace unit labour costs again in 2010.

Consumer price inflation initially still declining ...

The decline in consumer price inflation that set in during the third quarter of 2008 will probably continue well into 2009 despite the depreciation of the euro. This is partly the result of price corrections for energy and food triggered by developments in the international commodities markets. Moreover, the steep rise in prices into the third quarter of 2008 has produced base effects that will increasingly compress the year-on-year rise in consumer prices in the following year. The annual rate of HICP inflation could drop to less than ½% around the middle of 2009, or even become negative. However, the medium-term price trend – as measured by annualised, seasonally adjusted quarter-on-quarter changes – will be in excess of 1% in the second half of 2009 and in 2010. Deflationary effects can therefore be ruled out as far as it is possible to tell at present.

... but subsequent marked increase again

From the fourth quarter of 2009 onwards, the annual rate of HICP inflation will increase again when the base effects cease to be operative. Furthermore, energy and food, in line with the assumptions, will become somewhat more expensive again. As the economic situation improves, the accelerated rise in wage costs is likely to make itself increasingly felt. As a result, inflation could be 1½% at the end of the forecasting horizon in the final quarter of 2010. Averaged over the year, consumer prices will probably rise by 2.8% in 2008. The difference of 0.2 percentage point compared with the June projection can be explained by the unexpected, sharp correction of crude oil prices from the middle of 2008 onwards. Differences are greater with regard to 2009, for which an inflation rate of 2.2%

was expected in the last projection. The current assessment is that the average rate of price increase could be less than 1%. Again, most of the projection revision is due to the changed outlook for energy prices. However, falling food prices since the autumn of 2008 are also curbing inflation. As a result, HICP inflation excluding energy is expected to rise by just 1.3% in 2009, compared with the earlier expectation of 1.6%. For 2010, consumer prices overall might increase by 1.4% based on current assumptions.

Public finances[3]

Public finances slightly improved in 2008

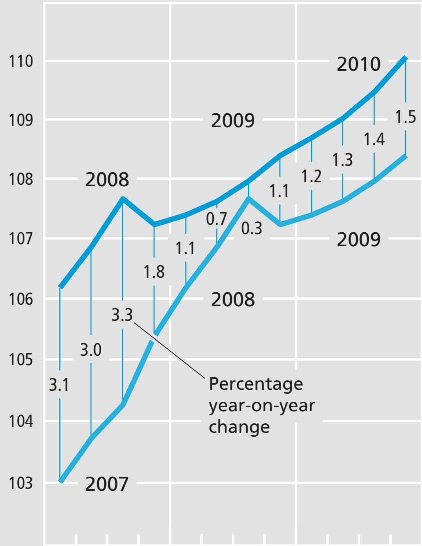
The general government budget is likely to close the year slightly in surplus in 2008, after already being almost balanced in 2007. A strong first quarter means that macroeconomic developments have also made a small contribution to this improvement. A moderate overall increase in expenditure, the ongoing positive underlying trend in terms of profit-related taxes and higher tax receipts as a result of tax progression effects are further factors. This more than offsets budgetary strains, particularly as a result of the business tax reform and the net reduction in social contribution rates.

Considerable forecast uncertainty

The macroeconomic environment and the revenues from the very volatile profit-related taxes represent considerable risks for further budgetary developments. Moreover, the impact of government aid to stabilise the banking system is particularly uncertain – not least in terms of statistical measurement.[4]

Price projection*

2005 = 100, seasonally adjusted, quarterly, log scale



* Harmonised Index of Consumer Prices for 2008 to 2010 compared with 2007 to 2009. Year-on-year change calculated using unadjusted figures.

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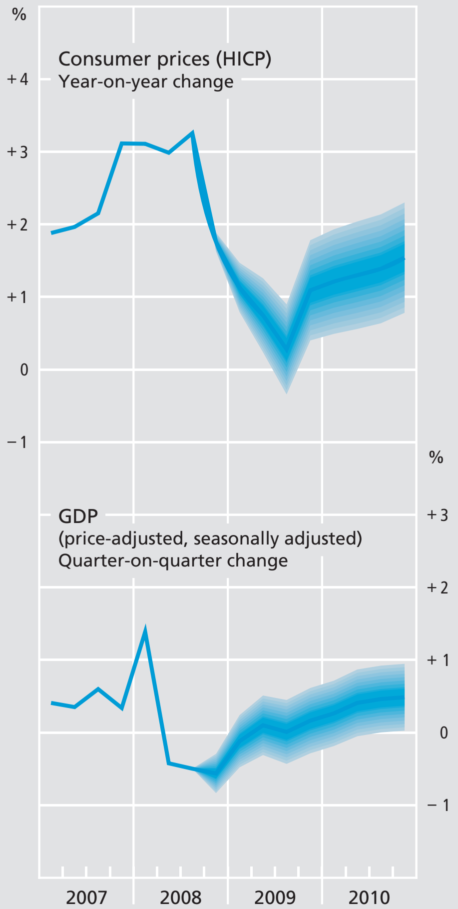
Significant deterioration in 2009

According to the current forecast, public finances will deteriorate perceptibly in 2009, with a deficit of almost 1% of GDP being likely. This can be attributed, for one thing, to the economic slowdown, though the demand and distribution structure is particularly favourable from a public finances perspective. For another, profit-related taxes are expected to decline noticeably from the extremely high level they reached in 2008.

3 The financial development of general government is described here as defined in the national accounts; this definition is also used largely as the basis for the fiscal criteria of the EC Treaty. For a more detailed analysis of developments including those at central, state and local government levels and in the social security funds, see Deutsche Bundesbank, Monthly Report, November 2008, p 62-75.
4 See also Deutsche Bundesbank (2008), op cit, p 64-65.

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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Virtually constant revenue ratio and perceptible rise in expenditure ratio

The revenue ratio could remain virtually unchanged as the declining trend in profit-related taxes will be offset by higher revenue resulting from faster growth in gross wages and salaries vis-à-vis GDP, the effects of income tax progression, and a restructuring of EU funding. On balance, legislative changes will play no role. By contrast, the expenditure ratio should rise significantly. The unfavourable course of economic development will lift the ratio both as a result of rising cyclical labour market expenditure and lower GDP growth in the denominator. On top of this, healthcare spending, in particular, will increase relatively sharply, as will investment.

Further deterioration 2010

Based on the legislative *status quo*, the deficit ratio should increase markedly again in 2010, moving towards 2%. As things currently stand, cyclical influences will remain negative. Furthermore, plans to increase income tax allowances for contributions to the health and long-term care insurance schemes as well as larger revenue losses as a result of the recently concluded package of measures to stimulate the economy will result in perceptible tax shortfalls. In addition, profit-related taxes might well continue to develop poorly. The general government debt ratio, which had fallen significantly to 65% in 2007, might increase again in the reporting period.

Risk assessment

Uncertainty extremely high

Macroeconomic forecasts are currently fraught with extremely high uncertainty in terms of the world economy. This is particularly true of mutual dependencies between the real economy and the financial sector. Numerous countries have now rapidly adopted large-scale rescue measures to avoid systemic risks. Additionally, central banks have sharply expanded their liquidity operations and cut their interest rates. Furthermore, a number of governments have launched economic stimulus packages.

Risks to economic growth ...

The impact of all these support measures on the real economy can be measured only partially. The hypothesis underlying the baseline projection is, firstly, that the situation in the financial markets will gradually ease and stabilise and, secondly, that, following subdued growth in 2009, the global economy will start to pick up again in 2010, partly as a result of the significantly expansionary macro policies. However, a time profile where the economic slump is significantly sharper in the short term, perhaps followed by a more rapid recovery from a lower level is by no means inconceivable. Nevertheless, the downturn in the global – and therefore also the German – economy might also persist for a noticeably longer period of time, especially as an endogenously sustained recovery of the global economy is unlikely to take place until the real estate markets in major industrial countries have consolidated and progress has been made on recapitalising and restructuring the international financial system. All of this suggests taking a fairly cautious view of the potential for a recovery during the forecasting horizon.

... and prices

The timeline in terms of cost and price developments also hinges crucially on the assumption that a recovery of the global economy will follow an economic downturn that is hard but still of limited duration. In this baseline scenario, the short-term price risks are probably more on the downside should the downward pressure on the real economy prove to be stronger than previously expected. If, by contrast, the economic downturn continues for a lengthy period, the rate of price increase could be weaker from the fourth quarter of 2009 onwards. First, there would be the expectation of lower price rises from the external side. Second, wage growth within Germany, and thus the domestic cost component, would probably be weaker.