

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

The German economy is currently experiencing a sharp recession. The economic downturn of the global economy, accompanied by an unexpectedly severe drop in global trade, has hit German industry hard. As a consequence, other sectors have also suffered and have cut back their investment plans. By contrast, the labour market response has been moderate to date.

With the gradual easing of tensions on the international financial markets, improved expectations and the extensive monetary and fiscal stimuli, the downward pressure on the German economy should ease during 2009. However, a real rebound rather than a mere bottoming-out is expected only in the course of 2010. According to this baseline scenario, which is associated with a high degree of uncertainty, real gross domestic product will contract by around 6% in 2009. In 2010, economic activity is expected to remain subdued, despite a slight revival in the course of the year. The price climate remains benign and supportive for economic activity. On an annual average, consumer prices are forecast to rise by ½% in 2010, following a stable price level this year.

## Current situation

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*Germany in severe recession in 2008 Q4/ 2009 Q1*

The German economy has entered a severe recession. In the first quarter of 2009, price-adjusted gross domestic product (GDP) dropped by 3.8% on the quarter after seasonal and calendar adjustment, having already suffered a considerable decline of 2.2% in the previous quarter. Year-on-year aggregate output therefore contracted by almost 7% in the first three months of 2009 in calendar-adjusted terms. The exceptionally strong cut-back in production can mainly be attributed to the sharp slump in world trade and the associated decline in global demand for German industrial products. For example, exports of goods and services were almost 10% down in seasonally and calendar-adjusted terms quarter on quarter in the first three months of the year, having already shrunk by 8% in the previous period. As a consequence, industrial investment was likewise sharply curtailed given significant capacity underutilisation and poor sales and earnings prospects. Furthermore, enterprises started to correct the involuntary build-up of inventories that occurred in the second half of 2008. Aggregate demand in the first quarter of 2009 was buoyed only by private and government consumption. This owed much to the “environmental premium” that since the end of January has been paid to households in Germany who buy a new passenger car and scrap their old one.

*Downside risks outlined in last forecast exceeded*

The decline in real economic activity in the fourth quarter of 2008 and the first quarter of 2009 was therefore much more pronounced than predicted in the baseline forecast of

December 2008.<sup>1</sup> For example, aggregate output in the first quarter of 2009 was more than 5% lower than expected. Although the risk of a significantly harsher economic downturn in the short term was recognised as an alternative scenario in the December projection, the rapid downward pace, especially in industry, came as a surprise. Even the alternative scenarios had not envisaged a downturn of this force, which is without historical parallel.

The renewed turmoil in the financial system in the wake of the insolvency of the Lehman Brothers investment bank rapidly spilled over to the real economy in numerous regions via several transmission channels. The general shock to confidence, in particular, aggravated the already perceptible slowdown in global activity. This had been presaged by corrections on major real estate markets, the increasing global inflationary pressure up to the third quarter of 2008 and growing external imbalances in a number of emerging market economies and developed into an exceptionally severe recession. Besides the industrialised countries, emerging market economies and developing countries, particularly central and east European countries, were also sucked into the maelstrom of the crisis. A defining feature of this global recession is not only its depth but also the high degree of synchronicity of the downward swings in the individual economies and regions, together with an abrupt contraction of demand for internationally tradable goods.<sup>2</sup>

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<sup>1</sup> See Deutsche Bundesbank, Outlook for the German economy – macroeconomic projections for 2009 and 2010, Monthly Report, December 2008, pp 17-29.

<sup>2</sup> See also Deutsche Bundesbank, Financial market shock and downturn in industrial output in advanced economies, Monthly Report, May 2009.

*Labour market  
response  
muted to date*

Shorter working hours have, to date, largely absorbed the impact of the sharp economic downturn on the labour market – as anticipated in the forecast of December 2008. Overtime and working time accounts were run down, and increasing use was made of short-time work. This resulted in a 3.4% decline in the calendar-adjusted number of hours worked per employed person since the first quarter of 2008. By contrast, the impact on employment has been very muted so far. According to initial estimates for the fourth quarter of 2008 and first quarter of 2009, which must be regarded as preliminary, employment actually rose by 43,000, or 0.1%, on the year. As a mirror image, average unemployment measured for the quarter was 53,000 lower than a year earlier. This was one reason why the decline in the total number of hours worked in the first quarter of 2009 was, at 3.3% on the year, smaller than the drop in aggregate value added despite the clear reduction in working hours. It is striking in the current phase that hourly productivity also fell markedly (-3.7%), while unit labour costs jumped (+8.7%). The wage ratio rose sharply. During the first five months of 2009, the labour market situation deteriorated perceptibly, however. The number of unemployed increased by 235,000 from December 2008 after seasonal adjustment, while the employment outlook, as expressed in the surveys conducted by the Ifo Institute and data on vacancies released by the Federal Employment Agency, became increasingly negative.

In the first quarter of 2009, consumer price

inflation, as measured by the Harmonised Index of Consumer Prices, flattened further; the annual rate fell to 0.8%, compared with 1.6% in the fourth quarter of 2008. The figure for the first quarter of 2009 was thus 0.3 percentage point lower than expected in the projection of December 2008. The main factor here were significantly lower energy prices.

Economic policymakers' response to the worsening financial and real economic crisis has been rapid and comprehensive. The European Central Bank lowered the interest rate for its weekly main refinancing operations in several stages from 4.25% to 1%. In addition, longer-term refinancing transactions were offered in the form of fixed-rate tenders with full allotment. This has stabilised the money market at a significantly lower interest rate level. In future, the Eurosystem will also buy covered bonds in order to bring about a further improvement in financing conditions in the banking sector. The Financial Market Stabilisation Fund (*Finanzmarktstabilisierungsfonds*) set up in October 2008 has already made a major contribution to stabilising Germany's financial system by offering guarantees and implementing measures to recapitalise banks. In addition, banks are to be given the option of offloading financial assets with severe impairment risk to special purpose vehicles ("bad banks"). Fiscal policy has not only allowed the automatic stabilisers to take full effect, it has also supported the operability of the German banking system through the financing offered by the Financial Market Stabilisation Fund. Moreover, the economic stimulus programmes I and II have strengthened consumers' purchasing power

*Favourable  
price  
developments*

*Large-scale  
monetary and  
fiscal policy  
measures*

through lower taxes and social contributions and higher social transfers, reduced the immediate labour market risk by stepping up subsidies for short-time work and supported the construction and automobile sectors, in particular, by means of sector-specific measures. Furthermore, large-scale loan and guarantee programmes have been set up for the business sector.

### Major assumptions<sup>3</sup>

*Global economy*

The baseline forecast presented here is predicated on the underlying hypothesis that the large-scale measures taken to support the financial markets, the exceptional monetary policy stimuli and the large-scale fiscal packages adopted in numerous countries will help stabilise the global economy in the course of 2009. The ensuing recovery will continue at a moderate pace in 2010. Following a 2% decline this year, global output could increase by 1¾% in 2010. International trade in goods and services is expected to exhibit an even more pronounced profile. As the slump in global demand has mainly affected internationally tradable goods, and cross-border sales have suffered disproportionately as a result of the numerous international production links, global trade is expected to shrink very much faster than output this year, at an estimated 13%. Bearing in mind, too, that demand for domestic goods should be the main beneficiary of the macroeconomic stimuli, the revival in external trade is likely to be fairly muted in 2010, at +1%. Germany's export markets are expected to contract almost as rapidly as global trade in 2009 and achieve

only a slight recovery in 2010. As compared with the projection of December 2008, the rate of change expected for German exporters' sales market volume has consequently been lowered by 14 percentage points for 2009 and 4 percentage points for 2010. This is a direct reflection of the huge deterioration in the external sales outlook.

As in previous projections, due account was taken of the impact of the financial market crisis on the cost of corporate debt financing by pricing in additional interest rate premiums on loans to enterprises. However, these are slightly lower than in the December forecast, reflecting the fact that slight tendencies towards stress relief have been evident of late. Moreover, account was taken of the finding of the Bank Lending Survey (BLS) that credit standards have recently been tightened across the board. For the projection period, it is assumed that the situation on the financial markets will gradually ease and that Germany will not experience a general credit crunch.

*Firms' cost of borrowing*

The projection is based on the technical assumption of an unchanged euro exchange rate of US\$1.34 over the forecasting horizon. The euro's nominal effective exchange rate against the currencies of the 21 most important trading partners of the euro area is assumed to be ½% below its average value for 2008. This signifies a slight improvement in the euro area's price competitiveness. The interest rate assumptions derived from market expect-

*Exchange rates and interest rates*

<sup>3</sup> The assumptions concerning developments in global trade, exchange rates, international commodity prices and interest rates were determined by the Eurosystem's experts. They are based on the information available up to 13 May 2009.

ations envisage an average level for the three-month EURIBOR of 1.4% in 2009 and 1.6% in 2010, compared with 4.6% last year. The long-term yield on German government bonds is likely to be 3.4% this year and 3.9% next year, according to the current market view.

*Oil prices and other commodity prices*

The spot price for Brent crude oil, which last year plummeted from just under US\$147 per barrel in July to US\$41 in December, has since climbed back up noticeably. Judging by forward prices, this tendency is likely to continue over the forecasting horizon. Accordingly, the projection is based on the assumption of an oil price of US\$54.5 in 2009 and US\$65.5 in 2010. Taking into account the exchange rate assumption, this means that, this year, the price of crude oil in euro terms will be almost two-fifths below its average level for 2008. The assumptions regarding the crude oil price in 2009 and 2010 are therefore more than US\$10 lower than in the projection of December 2008. For the other commodities (excluding energy), market players currently anticipate a drop in prices by one-fifth in 2009 on an annual average. A rise of just under 9% has been priced in for the following year.

*Public finances*

In public finances, all measures were taken into consideration which have either been adopted or which have been specified in sufficient detail and are likely to be approved. For example, the fact that the contribution rate to the statutory health insurance scheme, which was raised at the beginning of the year, will be lowered to 14.9% from July 2009 onwards was taken into account and the assumption made that many health insurance institutions will therefore charge addi-

**Major assumptions of the projection**

Item	2007	2008	2009	2010
<b>Exchange rates for the euro</b>				
US dollar/euro	1.37	1.47	1.33	1.34
Effective <sup>1</sup>	107.9	113.0	112.3	112.5
<b>Interest rates</b>				
Three-month EURIBOR	4.3	4.6	1.4	1.6
Yield on government bonds outstanding <sup>2</sup>	4.2	4.0	3.4	3.9
Crude oil price <sup>3</sup>	72.7	97.7	54.5	65.5
Other commodity prices <sup>4, 5</sup>	17.1	9.7	-20.2	8.8
German exporters' sales markets <sup>5, 6</sup>	6.7	2.2	-12.7	0.2

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

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ditional contributions, which will have to be borne in full by insurees (rather than being split with employers as is the case for regular contributions). In terms of the tax regime, due account was taken, *inter alia*, of the more generous depreciation allowances for enterprises and the gradual reduction in income tax rates which were agreed with the economic stimulus packages. Other important factors are the higher income tax allowances for contributions to health and long-term care insurance schemes from 2010 as well as the reintroduction of the original (more generous) commuting allowance.

On the expenditure side, the "environmental premium" for old cars, the budget for which has been increased from €1.5 billion to €5 billion, the one-off child bonus and various la-

bour market measures are having an impact. Account was also taken of the fact that government investment is being strongly expanded. Expenditure will be further boosted as a result of higher healthcare spending owing to the new arrangements for the remuneration of outpatient treatment and hospital financing as well as the suspension of the "Riester factor" in the pension adjustment formula, which was introduced to curb pension increases and is meant to reflect rising supplementary private pension provision by employees. Finally, the assumption was made that government support measures for financial institutions that have been announced to date will affect public debt levels in 2009 but not the deficit as defined under the Maastricht Treaty and will have virtually no further impact on public finances in 2010.

#### Cyclical outlook<sup>4</sup>

*Starting point significantly more unfavourable, but downward pressure easing*

The economic downturn in the fourth quarter of 2008 and first quarter of 2009 was much stronger than expected in the forecast of December 2008. However, there is now increasing evidence that recessionary tendencies have weakened in the second quarter of 2009. For example, according to the Ifo business survey, enterprises now view their outlook for the next six months significantly less pessimistically than at the turn of the year. In March, seasonally adjusted manufacturing orders from abroad experienced the first month-on-month increase in a long time. In February and March, goods exports were largely unchanged from January – following the sharp decline in the preceding months.

Besides the financial market indicators, there is therefore much to suggest that the pace of the economic downturn will slow noticeably after the first quarter. However, the extremely weak orders situation in manufacturing, the persistent downward movement in industrial investment and the possibly ongoing destocking of inventories are indications that the contractionary effects will, on balance, continue to dominate in the second quarter.

The downward slide in the German economy could bottom out in the third quarter of 2009. One indication is that the retarding factors from abroad are gradually receding. Another is that domestic demand is being supported by fiscal policy. Public construction investment, for example, will increase significantly, and private consumption will probably continue to make a contribution to stabilisation given lower direct taxes and social contributions and higher social benefit payments accompanied by a still favourable price climate.

*Stabilisation in the third quarter...*

A radical recovery looks unlikely in the near future, however. This year will see barely any expansionary stimuli from abroad, and the downward pressure on industrial investment will continue for some time. Although the external impulses could pick up in 2010, private

*... followed by prolonged sideways movement*

<sup>4</sup> The projection presented here was completed on 22 May 2009. The result of the GDP flash estimate of 15 May for the first quarter of 2009 was therefore included, but not additional information, in particular on the expenditure structure of GDP, which the Federal Statistical Office published on 26 May 2009. As no detailed information on the reasons for the slight downward revision of price-adjusted GDP in the fourth quarter of 2008 (from a seasonally and calendar-adjusted -2.1% on the quarter to -2.2%) was available when the projection was completed, this was also not factored in.

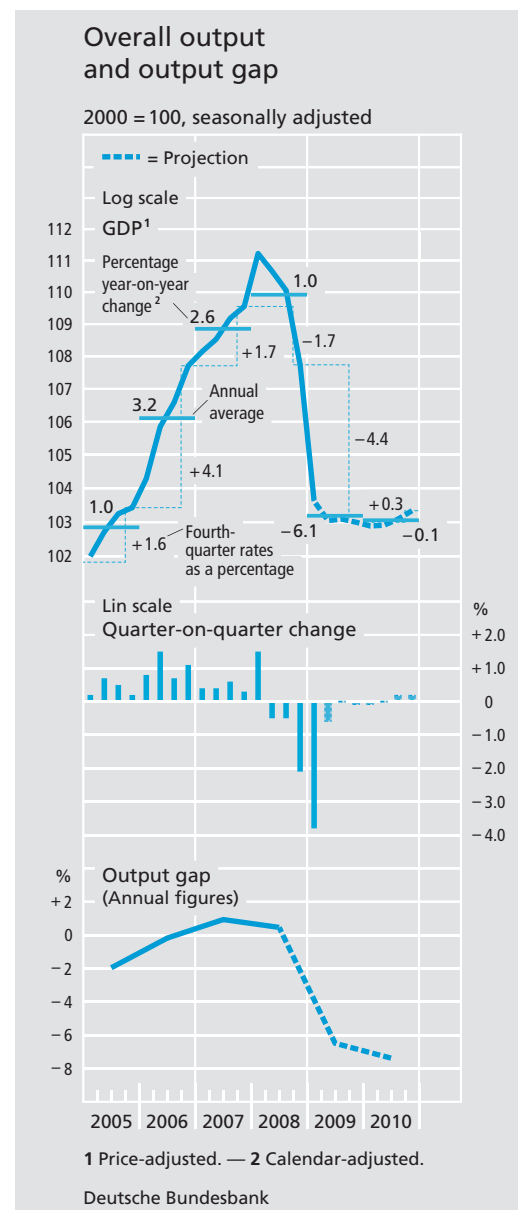
consumption is likely to be increasingly dogged by a lagged rise in unemployment. Overall, price-adjusted GDP could decline by 6.2% this year in calendar-year terms and stagnate throughout 2010 on an annual average, despite a slight upward movement over the course of the year.

*Very big output gap*

The sharp demand shock will inevitably impact on Germany's industrial output capacity. Capacity in important sectors of the economy will be gradually adjusted to lower demand by holding back extension investment projects and not realising some planned replacement investments. To a fairly small extent to date, production plants may also have become obsolete; as far as it is possible to tell at present, this is confined to just a few sectors. Over the forecasting horizon, the annual increase in potential output will consequently be lower than previously, at roughly 1%. Combining demand and supply effects, overall capacity utilisation is nevertheless likely to decline noticeably this year. On an annual average, capacity underutilisation, at 6½%, will probably far undershoot the lows of past recessions. Under the baseline scenario, the output gap will widen to almost 7½% next year.

*Exports: moderate recovery following slump*

Following plummeting exports in the fourth quarter of 2008 and first quarter of 2009, foreign demand for German products has now rallied somewhat. The severely depressed level at the beginning of the year means that real exports of goods and services this year are nevertheless likely to be almost 17% lower than in 2008. Exports would thus have shrunk even more than the contraction of the foreign sales markets overall. One ex-



planation for this is that the retarding effect emanating from global trade is being aggravated by the product profile of German export goods, which is dominated by capital goods (including passenger cars).<sup>5</sup> Next year, however, German export growth could slightly outpace that of the country's sales markets.

<sup>5</sup> See Deutsche Bundesbank, Financial market shock and downturn in industrial output in advanced economies, Monthly Report, May 2009.

### 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 <sup>1</sup>	1.5	0.6	-2.0	-0.2
Fourth-quarter rate <sup>2</sup>	1.7	-1.6	-4.4	0.3
Average annual GDP rate, calendar-adjusted	2.6	1.0	-6.1	-0.1
Calendar effect <sup>3</sup>	-0.1	0.3	-0.1	0.1
Average annual GDP growth, calendar-adjusted	2.5	1.3	-6.2	0.0

Source: Federal Statistical Office (data as of February 2009); 2009 and 2010 Bundesbank projections. — <sup>1</sup> 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. — <sup>2</sup> Annual rate of change in the fourth quarter, calendar-adjusted. — <sup>3</sup> As a percentage of GDP.

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*Sharp drop in industrial investment ...*

The muted or still uncertain sales outlook and the exceptionally high underutilisation of overall production capacity – also by historical standards – will severely dent industrial investment. Moreover, debt financing conditions are difficult, in some cases, although this has much less of an impact than weak demand, as external financing requirements are relatively small and the balance sheet structure of the non-financial corporate sector is sound. Overall, industrial investment may decline by some 15% in 2009 and a further 6% in 2010.

*... and strong boost to public investment*

The measures decided in the German government's two economic stimulus packages will lead to a big expansion of public construction investment over the forecasting horizon. As public construction represents just 6½% of

total fixed investment, it will not, however, be able to offset the drop in industrial investment. The exact timing of the additional public-sector investment to be made under the economic stimulus programme is still uncertain, moreover; nor is it evident how the criterion that such investment spending must be "additional" will be defined. Housing construction is also likely to remain fairly muted, so it must be assumed that total gross fixed capital formation will fall by 10% this year and a further 2¾% next year in price-adjusted terms.

The unexpectedly sharp drop in demand meant that numerous sectors of the economy experienced an involuntary build-up of inventories at the end of 2008 despite the prompt production cutbacks. Over the course of 2009, enterprises will consequently reduce stocks to desired levels. This will make a negative contribution to growth of ½ percentage point in 2009 and a positive contribution of ¼ percentage point in 2010.

Consumer spending by households will slightly buoy macroeconomic growth this year. Relief from direct taxes and social contributions and higher social transfers as well as the continuing benign price climate are having a positive impact on consumers' real disposable income. The environmental premium, which sharply boosted passenger car sales in the first few months of 2009, has been a key prop of consumer spending. Buoyant demand for motor vehicles will continue over the next few months. As this is likely to be partly funded by savings, the upward trend in the saving ratio observed in recent years is

*Dampening effect of destocking in 2009*

*Private consumption supportive in 2009, but negative in 2010*



likely to be interrupted this year. However, the positive impact of the environmental premium will gradually subside, and the effect will be reversed in 2010 at the latest. Moreover, private consumption is increasingly being depressed by rising unemployment; another negative factor is reduced property income, partly as a result of lower interest rates. Having risen by ¼% this year, real consumer spending is likely to fall by ¾% in 2010.

*Clear deterioration in labour market situation*

While the marked slowdown in macroeconomic activity has, to date, largely been absorbed by a decrease in the number of working hours and declining hourly productivity, enterprises will increasingly try to adjust labour input to the lower sales prospects. Accordingly, hourly labour productivity will pick up again during 2009. Nevertheless, it could decline by 2½% in 2009 on an annual average, before rising by 1¾% in 2010. Yet even in the last quarter of the forecasting horizon, labour productivity will still not have returned to the high it marked in the first quarter of 2008, as the share of value added in the particularly productive manufacturing sector will remain below normal. The total number of hours worked on an annual average could therefore contract by 3¾% in 2009 and a further 1½% in the following year.

*Effect of working time buffer waning*

Although use of short-time work, which is heavily subsidised, will continue to rise for the time being, it is improbable that average working hours will again drop as rapidly as they did in the last quarter of 2008 and first quarter of 2009. Instead, enterprises are likely to resort to a larger extent to waiving the op-

### Key results of the macroeconomic projection

#### Percentage year-on-year change

Item	2007	2008	2009	2010
GDP (real)	2.5	1.3	-6.2	0.0
GDP (working-day adjusted)	2.6	1.0	-6.1	-0.1
Components of real GDP				
Private consumption	-0.4	-0.1	0.3	-0.8
Government consumption	2.2	2.0	2.1	1.6
Gross fixed capital formation	4.3	4.4	-10.1	-2.7
Exports	7.5	2.7	-16.8	1.1
Imports	5.0	4.0	-9.0	0.0
Contributions to GDP growth 1				
Domestic final demand	1.0	1.1	-1.4	-0.6
Changes in inventories	0.1	0.5	-0.5	0.2
Net exports	1.4	-0.3	-4.3	0.4
Labour market				
Total number of hours worked 2	1.8	1.3	-3.7	-1.6
Persons employed 2	1.7	1.4	-0.9	-2.8
Unemployed persons 3	3.8	3.3	3.5	4.4
Unemployment rate 4	9.0	7.8	8.4	10.5
Unit labour costs 5				
Compensation per employee	1.2	2.0	0.0	1.4
Real GDP per person employed	0.7	-0.1	-5.4	2.9
Consumer prices 6				
Excluding energy	2.1	1.9	1.0	0.8
Energy component	3.8	9.4	-6.2	-1.4

Sources: Federal Statistical Office; Federal Employment Agency (data as of February 2009); 2009 and 2010 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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tion of hiring new staff (filling vacancies) and laying off existing workers. At the same time, working hours could start to return to their normal level towards the end of 2009. On an annual average, the number of people in work is expected to decline by 350,000 in 2009, ie by just under 1%. The following year, in accordance with the typically lagged labour market response, employment could well contract by a further 1.1 million, or 2¾%.

*Higher unemployment*

These much lower employment levels will not, however, be fully reflected in higher unemployment. First, the supply of labour is falling for demographic reasons. Second, the participation rate is likely to decline slightly for cyclical reasons. And third, changes in the methodology of recording persons formally on the books of private employment agencies will probably result in the number of those registered as unemployed dropping by some 200,000 by the fourth quarter of this year. Against this backdrop, unemployment can be expected to rise to 3.5 million persons on average in 2009 and 4.4 million in 2010. The unemployment rate as defined by the Federal Employment Agency would consequently rise from 7.8% in 2008 to 8.4% in 2009 and 10.5% in 2010.

### Labour costs and price outlook

*Slower growth in negotiated rates of pay*

Agreements in the 2009 wage round to date are increasingly reflecting the subdued economic situation, especially in manufacturing. By contrast, fairly high rates of wage increase were agreed in the services sectors, which have been less hard hit. Including the incre-

mental pay increases agreed last year, negotiated wages are likely to increase by 2¼% in 2009 on average, after 2¾% in 2008. In 2010, when the weight of the wage increases agreed while labour market conditions were still comparatively favourable will lessen, the increase could flatten to 1½%.

Weak demand means that manufacturing enterprises, in particular, will push for the option, contained in the collective wage agreements, to postpone pay rises or even reduce one-off payments. In the metal-working and electrical engineering industries, which have been particularly badly affected by the economic downturn, plant-level agreements are permissible, for instance, which could put off the 2.1% rise originally scheduled for May 2009 by up to seven months or reduce the lump-sum payment agreed for September 2009. In addition, bonus payments based on company performance will, in many sectors, be much lower or cancelled altogether. Two countervailing factors, on the other hand, are the depletion of working time accounts and employers' frequent tendency to top up short-time working pay. Both factors drive up wage costs per actual hour worked. On a monthly basis, the wage drift will be noticeably negative in 2009, however, given the distinct reduction in working hours, although the delayed negotiated wage increases will have to be implemented at a later date. Conversely, fewer and fewer payments will be made to top up short-time working money. As working hours pick up again, the pendulum will swing back the other way, resulting in a roughly neutral wage drift on a monthly basis in 2010.

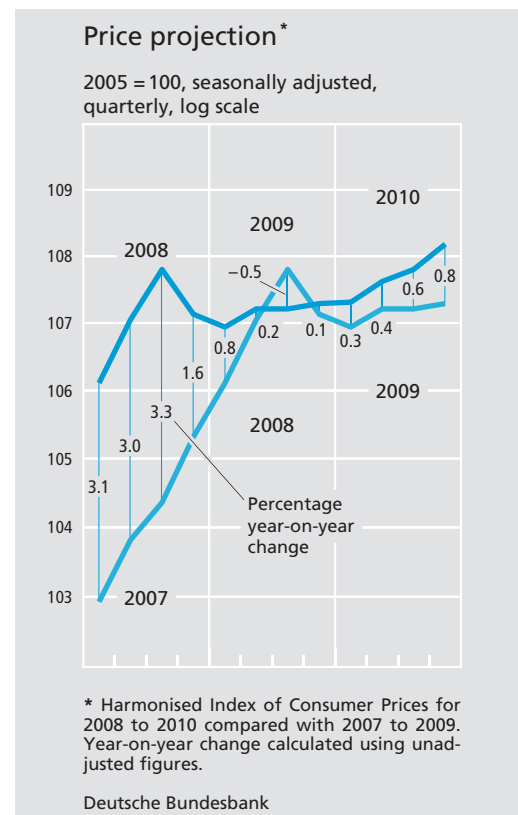
*Countervailing wage drift components*

*Initially sharp  
rise in unit  
labour costs*

Value added per person employed will decline markedly in 2009 given falling working hours and a decline in hourly productivity. The rise in unit labour costs will therefore more than double compared with 2008. The anticipated headcount reductions could boost labour productivity by 3% again in the subsequent year, and unit labour costs could fall by 1½%. Nevertheless, neither the sharp increase in unit labour costs in 2009 nor their reduction in 2010 will have any major impact on price developments. It is more likely that enterprises' earnings will bear the brunt given the extremely difficult economic environment. The expected job cuts will partially offset enterprises' distinctly lower profitability. Sales prices are unlikely to rise much over the entire forecasting horizon, mainly because profit margins will act as a buffer.

*Benign price  
climate*

Year-on-year consumer price inflation will temporarily enter negative territory over the next few months as a delayed reaction to the sharp increase in energy and food prices into the summer of 2008 and its subsequent partial correction. As the medium-term price trend – better reflected in seasonally adjusted quarter-on-quarter rates – will probably remain in positive territory, year-on-year rates should pick up again towards year-end. This is supported by the renewed upward tendency on the international energy and agricultural markets as well as the expected further rise in wage costs. On an annual average, consumer prices should remain virtually unchanged in 2009. In 2010, however, they could rise by ½%.



Compared with the December 2008 projection, this represents a downwards revision of ¾ percentage point for 2009 and just under 1 percentage point for 2010. A more benign price outlook for energy and, to a lesser extent, food and the less volatile components in the basket of goods are the main driving factors behind this. While price developments for industrial products were affected by the depreciation of the euro in the first half of 2009, economic factors should dominate later. Developments in prices for services and rents will be dampened by the more muted rise in wage costs and disposable income.

## Public finances<sup>6</sup>

*Dramatic deterioration in public finances in 2009*

The public finance situation will deteriorate dramatically in 2009, and the deficit ratio is likely to rise to over 3%. The effects of the automatic stabilisers, and thus cyclical factors, account for approximately two-fifths of the increase. However, the key macroeconomic categories involved, such as gross wages and salaries as well as private consumption, will be much less severely affected by the sharp recession than GDP. This therefore means that government revenue will contract less sharply owing to the cyclical downturn than the development of GDP would imply. However, the cyclically adjusted deficit will also rise considerably. This is due mainly to deficit-increasing measures, especially the fiscal stimulus packages, which will represent a total of around 1¼% of GDP in 2009. Moreover, revenue from profit-related taxes is likely to fall noticeably after having reached an exceptionally high level in 2008.

*Deficit and debt likely to rise substantially also in 2010*

The public finance situation will probably take another sharp turn for the worse next year. Even if the outlook for the economy brightens somewhat, the cyclical impact is still likely to lead to a further marked increase in the deficits especially as, in contrast to 2009, the overall GDP profile will probably be detrimental to public finances. Furthermore, fiscal policy measures, in particular greater tax deductibility of contributions to health and long-term care insurance schemes, will place a discernible burden on general government budgets, although several temporary stimulus measures will come to an end. In addition, revenue from profit-related taxes might well

continue to develop very poorly. The high expected deficits, the forecast drop in nominal GDP and the measures to support financial institutions are likely to dramatically push up the debt ratio over the forecasting horizon, which could reach a magnitude of 80% for the first time ever.

Public finances are making a substantial contribution to stabilisation in the current recession. In 2010, the fiscal stimulus, as measured by the change in the primary balance (deficit excluding interest expenditure) compared with 2008, could well reach around 6% of GDP, or €130 billion to €150 billion. Almost three-fifths of this could be attributable to the automatic stabilisers and the extraordinary drop in profit-related taxes, with more than two-fifths the result of discretionary measures and other structural changes. This does not yet include extensive measures to stabilise the financial sector.

*Public finances making major contribution to stabilisation*

## Risk assessment

Macroeconomic forecasts – in particular those relating to real economic developments – are currently subject to a very high degree of uncertainty. One reason for this is that the disruptions to the financial markets are only gradually receding, and it could take some time to cleanse banks' balance sheets. It will, however, be virtually impossible to normalise

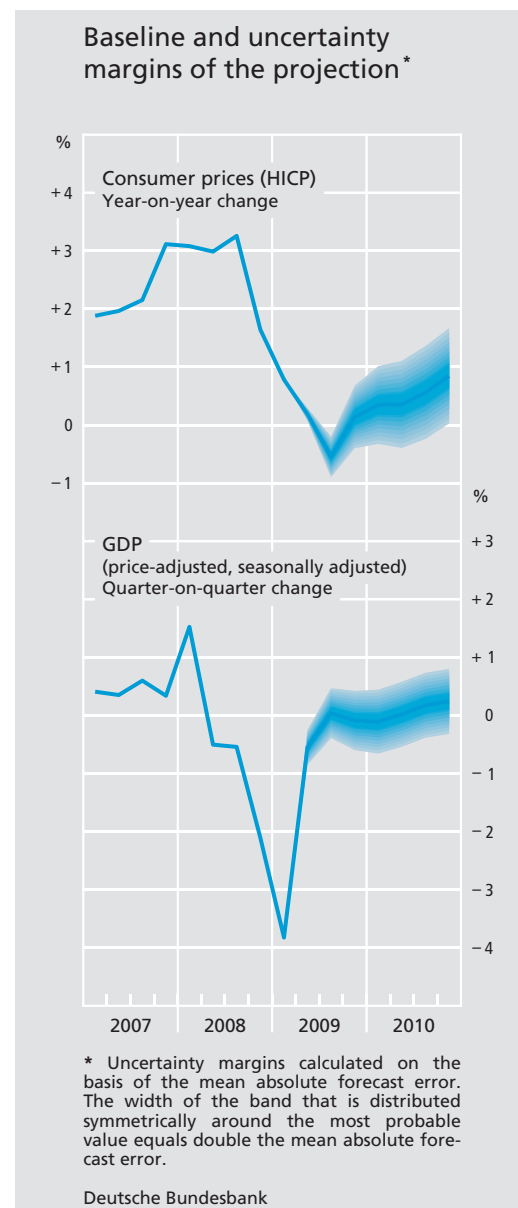
*Uncertainty still extremely high*

<sup>6</sup> 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 Maastricht criteria. 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, May 2009.

the financial and economic situation without re-establishing confidence. Although there are some indications at the current end that the global retarding effects have eased, the potential for a setback remains high. Experience of past recessions that were accompanied by financial crises shows that they tend to last for a long time, and recovery is usually slow.<sup>7</sup> The baseline forecast is based on such a pattern. This time, however, the financial market crisis is not confined to just one country or region, but represents a global event. What is more, the pattern of past cycles cannot be expected to recur unaltered in the current situation as important sectors of the global economy face the challenge of structural adjustment, and it is currently difficult to assess what new growth path the global economy may be heading for.

*Monetary and fiscal policy having stabilising effect*

In the current context, it is also difficult to assess the effectiveness of monetary and fiscal policy. The central banks have massively extended their liquidity operations, rapidly lowered interest rates to historical lows and have also started to intervene directly in the capital markets. All over the world, economic stimulus programmes including massive fiscal stimuli have been launched, and an unprecedented transfer of risk from the private to the government sector has been set in train. Overall, both policy areas should make a considerable contribution to stabilisation. The spectre of a downward economic spiral should therefore have been banished. Nevertheless, further negative surprises in the stricken banking sector or the still ailing financial markets cannot be ruled out, which impedes a stable recovery.



It is, however, quite possible that greater attention will now be paid to fundamentals following the severe slump in global output and world trade and the paralysing effect of the collapse of Lehman Brothers. In such a scenario, combined with stimuli from the inventory cycle, global economic activity might re-

*Chance of stronger recovery of global economy*

<sup>7</sup> See IMF, From Recession to Recovery: How Soon and How Strong?, World Economic Outlook April 2009, pp 103 ff.

cover more strongly. Economies focusing strongly on exports, notably of capital goods, would benefit greatly from such a scenario, just as they have been disproportionately hard hit by the steep decline in global trade. There is therefore a definite chance that Germany may regain some of the ground it lost in exports, and therefore output, in the fourth quarter of 2008 and first quarter of 2009 more rapidly than outlined in the baseline projection.

*Labour market  
and private  
consumption*

Employment has, to date, held up fairly well in Germany compared with the decline in macroeconomic activity. However, unemployment is expected to rise significantly over the forecasting period. This could be prevented only by a very rapid and strong revival of the global economy. Although there is some evidence that households, in periods of economic weakness, dip into their savings to avoid having to cut back on consumption too much, the rising risk of redundancy might prompt them to at least defer larger consumer purchases for reasons of caution. On balance, this would hurt private consumption more than anticipated.

In terms of real economic activity, the risk profile appears on the whole to be largely balanced in terms of potential downside risks and the chances of a more favourable development. However, the attendant level of uncertainty remains far higher than normal. This is the case not only because of the ongoing tensions in connection with the financial market crisis, but also because the timing of cyclical turning points and the strength of the subsequent recovery are particularly difficult to forecast.

*Risk profile for  
economic  
growth ...*

The risk assessment for cost and price developments is closely tied to the balance of risks to real economic activity. If the global economy experiences a "lean period" for much longer, imported inflation would probably be even weaker. If the global economy picks up significantly, on the other hand, prices of energy and other commodities, in particular, could rise more quickly than currently expected based on forward prices. Overall, however, the balance of risks in terms of inflation seems likewise to be largely balanced. A prolonged drop in the general price level is unlikely.

*... and price de-  
velopments*