

## Outlook for the German economy – macroeconomic projections for 2011 and 2012

The recovery of the German economy has evolved into a broad-based upturn. Overall production capacity utilisation has returned to normal levels. Enterprises are hiring new staff, buying new equipment and building new premises in preparation for a further expansion of their activities. Residential housing construction is receiving new stimuli. Moreover, private consumption spending is rising. The rate of wage increase is accelerating, but remains compatible with macroeconomic stability. There has been a further reduction in structural unemployment, and Germany is becoming increasingly attractive for foreign workers. The prospects of the German economy experiencing a lengthy period of expansion are therefore rising. This should considerably facilitate the urgently needed consolidation of public budgets.

After economic output rose by 3.6% in 2010, economic growth could reach 3.1% this year. In 2012, it could then slow to 1.8% given above-average capacity utilisation and waning economic catching-up effects for investment. Adjusted for a negative working-day effect, this would equate to a gain of 2.0%. Growth would therefore far exceed potential growth again in 2012. Survey results appear to indicate that German economic growth could even exceed the forecasts in this baseline scenario. Conversely, any major disturbances in the global and European environment would place a major damper on the fairly strong economic upwards movement.

This forecast assumes that German enterprises can increase market share on their international sales markets in the current year only. Given the strong momentum of global trade, exports remain the most important pillar of the economy. In clear contrast with the upturn of the last decade, the domestic economy has a much larger role to play this time, however, thanks to the improved overall constitution of the German economy.

Consumer price inflation accelerated appreciably at the beginning of 2011 following initially sharply higher oil prices. Crude oil prices are expected to ease slightly over the forecast horizon. As the economic recovery gathers pace, however, prices for goods and services, which are determined to a greater extent by domestic factors, will accelerate. This forecast anticipates an increase in consumer prices as defined by the Harmonised Index of Consumer Prices (HICP) of 2.5% this year and 1.8% next year. Excluding energy, the rate of increase would work out at 1.5% and 1.6% respectively.

## Current situation

---

*Short-term growth profile dominated by weather effects*

In the final quarter of 2010 and first quarter of 2011, the German economy performed much better than expected in the forecast published last December. While the economic recovery process had been expected to slow significantly, albeit temporarily, the underlying economic trend is actually unlikely to have lost much momentum. Overall economic growth in the fourth quarter of 2010 was, at 0.4%, as low as anticipated, but this was mainly due to the particularly harsh winter weather, which had set in early, in November, and continued throughout December. Had it not been for the associated damper, in particular on the construction industry and transportation, growth would probably have been appreciably stronger. Given normal seasonal weather conditions in the first quarter of 2011, overall economic activity not only returned to its normal level; work was also carried out that had been postponed in the last quarter of 2010. These catching-up and backlog effects mean that the 1.5% GDP growth rate for the first quarter of the year quite considerably overstates the underlying cyclical trend. In addition, the high outcome for the first quarter of 2011 could be partly due to statistical inaccuracies.

*Underlying cyclical momentum underestimated*

Regardless of these uncertainties there is, nonetheless, no doubt that the December forecast underestimated underlying cyclical momentum. This applies to external and domestic economic stimuli alike. Initially, the damper on foreign demand was weaker than expected. Exports in the final quarter of 2010 and first three months of 2011 therefore rose

more sharply than anticipated. The greater utilisation of production capacity that this entailed and the further improvement in the business climate are likely to have been key reasons for the unexpectedly sharp increase in spending on new machinery and equipment. Private consumption benefited from the extraordinarily positive labour market developments and rose more quickly than anticipated.

In addition, spending on new residential property was much higher than expected. While investment in existing properties dominated in recent years, investment in new buildings is now more important again for the first time in a long while. A clear recovery can be seen in the construction not only of single-family homes, but also, in particular, of apartment buildings. The additional demand is largely developing in urban areas, which is in line with the above-average inflation in real-estate prices there. This development is likely driven by positive earnings and income developments as well as favourable financing conditions on the one hand and, above all, optimistic expectations on the other. Moreover, doubts about the soundness of alternative investment forms may be another contributory factor.

*New stimuli for residential construction industry*

The residential construction industry in particular could benefit from increased immigration to Germany. In 2010, net immigration to Germany totalled almost 130,000 persons after two years without any major net immigration.<sup>1</sup>

*Increased immigration to Germany*

---

<sup>1</sup> The statistical picture could be distorted by the clean-up of the population registers in 2008 and 2009 when people who had moved away in earlier years without reporting it were removed from the registers.

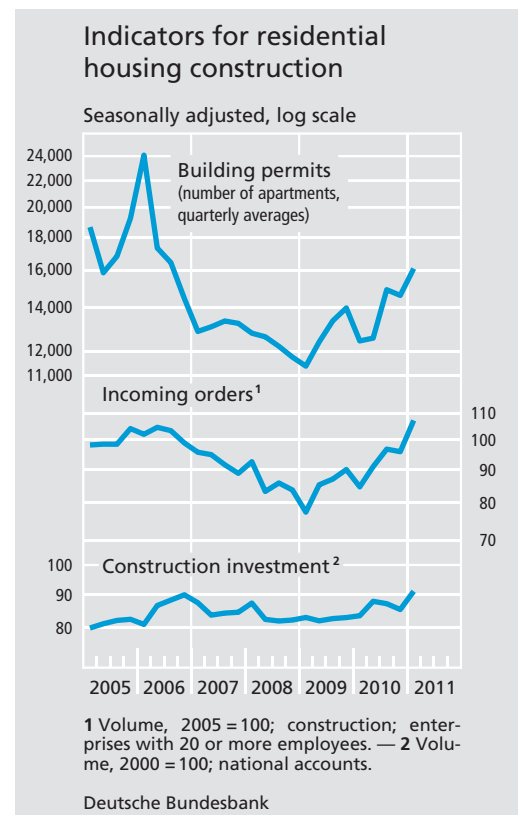
This suggests that Germany has become more attractive for foreign workers again. With complete free movement for workers from the EU 8 countries since May of this year, the flow of workers could increase appreciably further.<sup>2</sup> This forecast assumes a net inflow of 150,000 persons in 2011 and 170,000 persons in 2012, of which some 100,000 could, in each case, come from the EU 8 countries.

*Still extremely favourable labour market developments*

There are no signs that increased immigration has hurt the labour market. In fact, both the increase in employment and the decline in unemployment in the latter part of 2010 and early part of 2011 again exceeded expectations at a seasonally adjusted +256,000 and -124,000 respectively.<sup>3</sup> Hours worked, which were reduced after production slumped in 2009, have largely returned to normal.

*Rising incomes, ...*

Employees are, moreover, benefiting from the positive economic situation in the form of sharply higher earnings. Although the year-on-year rise in negotiated wages (+1.7%) was still very moderate in the first quarter of 2011, as it was based on wage settlements reached during the economic crisis, actual earnings on a monthly basis were 2.8% higher. It should be noted in this context that the average number of hours worked rose by 1.7% year on year. On an hourly basis, actual earnings therefore rose much less sharply than negotiated wages, at 1.0%. Contributory factors were a reduction in short-time work and replenishing of working time accounts. The wage agreements newly concluded in the final quarter of 2010 and first quarter of 2011 reflect the considerably im-



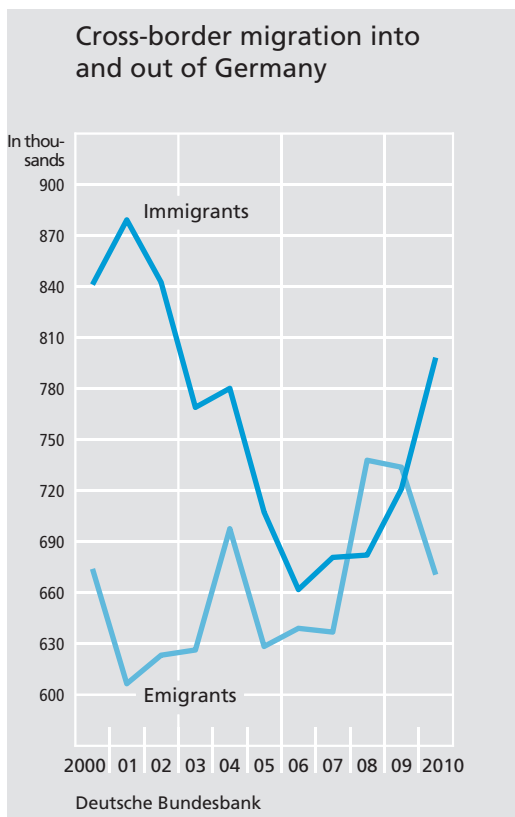
proved economic and labour market situation and include large wage increases, on average – although there are remarkable differences between the various sectors of industry.

Consumer price inflation has picked up perceptibly. Driven by surging crude oil prices, consumer energy prices rose by 7.5% in the space of half a year. That was the most important factor in the increase in annual HICP inflation to 2.2% in the first quarter of 2011. The December projection had assumed a rate of 1.7% given a much flatter path for crude oil prices. Excluding energy, the rate of price increase was 1.1%, compared with 0.9% in

*... but prices also rising sharply*

<sup>2</sup> See also Deutsche Bundesbank, The possible growth effects of increased immigration from the new EU member countries, Monthly Report, May 2011.

<sup>3</sup> In each case, average of the first quarter of 2011 compared with the average of the third quarter of 2010.



the forecast. This shows that the influence of cyclical factors on price developments had also been somewhat underestimated. By April, the rate of HICP inflation had risen to 2.7%, before moderating to 2.4% in May.

#### Major assumptions<sup>4</sup>

*Global economic tendencies*

Although global economic growth slowed perceptibly following the economic catching-up process in the final months of 2009 and early part of 2010, the prospect of further global expansion is still intact. On a trend basis, the pace of growth is likely to ease in a number of those emerging economies that are already more advanced in the economic cycle. In some cases, such countries are even displaying signs of overheating. By contrast,

in the industrial countries, cyclical growth forces are increasingly likely to override the late after-effects of the global financial and economic crisis. Moreover, progress should be made on the structural adjustments necessary for sustainable growth. The tragic events in Japan are unlikely to have a lasting detrimental impact on the global economy. Overall, global economic growth could slightly exceed 4% in both years covered by the forecast horizon.

*Global trade and sales markets*

With increasing specialisation and division of labour, global trade should continue to expand at an above-average rate of almost 8% a year. The emerging market economies account for a considerable portion of this growth although the pace of expansion is expected to slow there. By contrast, the industrial nations are likely to see weaker trade growth despite stronger expansionary forces. German exporters should continue to benefit from their presence in the new growth regions. The volume of the German sales markets could therefore swell by 7½% this year and a further 7% in 2012, after +10½% in 2010.<sup>5</sup>

*Exchange rates*

The euro has appreciated further against the US dollar since the forecast round last autumn. In the period that is relevant to the derivation of the exchange rate assumption,

<sup>4</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 18 May 2011.

<sup>5</sup> The sales markets were recalculated based on updated information on market shares, which explains a considerable proportion of the discrepancies compared with the December forecast results.

the euro stood at US\$1.43, compared with US\$1.39 in the December forecast, which equates to a gain of just under 3%. However, the single currency lost some ground against other currencies, meaning that the effective euro exchange rate, which is relevant for foreign trade, remained largely unchanged.

*Commodity prices*

As early as December 2010, particularly cold winter weather in the northern hemisphere meant that crude oil prices exceeded the expectations derived from the forward prices in the first two weeks of November. With the unrest in a number of Arab countries, the gap widened. Averaged over the first quarter of 2011, market prices were already one-fifth above the forecast assumption valid at the time. In April, too, prices rose sharply further. It was not until May that a downwards correction took place, probably due to weakening demand. The current forecast assumes that the average crude oil price will be US\$111 per barrel of Brent in 2011 and US\$108 per barrel in 2012. That is 25% and 20% respectively more than in the December forecast. Other commodity prices, which, unlike crude oil prices, had already returned to pre-crisis levels – as measured in US dollars – in the third quarter of last year, were largely in line with the expectations derived from forward prices in the final part of 2010 and early part of 2011. The assumed rates of increase of 20% for 2011 and slightly more than 1% for 2012 differ only slightly from the December forecast.

*Interest rates and financing conditions*

Short-term interest rates rose slightly more quickly than predicted in the December forecast given the ongoing normalisation of the

**Major assumptions of the projection**

Item	2009	2010	2011	2012
<b>Exchange rates of the euro</b>				
US dollar/euro	1.39	1.33	1.42	1.43
Effective <sup>1</sup>	111.7	104.7	105.5	106.0
<b>Interest rates</b>				
Three-month EURIBOR	1.2	0.8	1.6	2.3
Yield on government bonds outstanding <sup>2</sup>	3.2	2.7	3.3	3.6
<b>Commodity prices</b>				
Crude oil <sup>3</sup>	61.9	79.6	111.1	108.0
Other commodities <sup>4, 5</sup>	-23.0	37.1	20.4	1.2
German exporters' sales markets <sup>5, 6</sup>	-11.7	10.4	7.5	6.9

<sup>1</sup> Compared with the 20 most important trading partners of the euro area (EER20 group of currencies); 1999 Q1 = 100. — <sup>2</sup> Yield on German 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> Year-on-year percentage change. — <sup>6</sup> Working-day-adjusted.

Deutsche Bundesbank

money market, the fact that a normalisation of the still expansionary key interest rates has meanwhile been initiated and the market's expectations of further adjustments to key interest rates. For the current forecast round, a short-term interest rate derived from market data (three-month interest rate on unsecured transactions on the interbank money market) of 1.6% is assumed for 2011 (up from 1.4%) and 2.3% for 2012 (after 1.7%). Given healthy economic prospects, long-term interest rates have also risen. On an annual average for 2011, German government bonds with a residual maturity of over 9 and up to 10 years are expected to yield 3.3%, compared with 2.9% in the December projection. The figure for 2012 is now 3.6% (compared with 3.3% in December). Financing costs for German corporates in the longer-term seg-

ment are higher than assumed in the December projection, although the revision is smaller than for government bonds. According to the Bank Lending Survey, banks relaxed their credit standards appreciably in the first quarter of 2011. The ifo credit constraint indicator, too, signals a further improvement. It is assumed that this development will continue over the forecast horizon.

*Public finances  
in Germany*

In public finances, the projections take into consideration all measures which have either been adopted or which have already been specified in sufficient detail and are likely to be approved. On the revenue side, increases in taxes and social contributions at the beginning of 2011 dominate. With regard to social contributions, additional revenue as a result of higher contribution rates to the statutory health insurance scheme but also to the Federal Employment Agency outweighs the shortfall, in particular as a result of the lower contribution rate for insolvency benefit payments.<sup>6</sup> In terms of indirect taxes, the central government's consolidation package will lead to higher revenues in the current year.<sup>7</sup> On the expenditure side, it is assumed that capital transfers to financial institutions will be fairly small over the forecast period; these had accounted for some ½% of GDP last year. In addition, most expenditure-related economic support measures will be gradually phased out, and social spending will be dampened somewhat by the consolidation package, the healthcare reform and the fact that those pension cuts that were in principle deemed necessary but waived owing to the safeguard clause will be clawed back by halving the calculated pension increase from mid-

2011. On the other hand, spending increases have been agreed, especially in relation to education and unemployment benefit II.

### Cyclical outlook<sup>8</sup>

Having got off to a strong start in the first quarter of 2011, GDP growth is likely to be much more muted in the second quarter of the year. That should not, however, be interpreted as an economic slowdown. It would actually reflect the strong influence of catching-up and backlog effects in the first quarter. Nonetheless, given that overall capacity utilisation has returned to normal, the still relatively high underlying pace of economic growth is likely to ease gradually. For full-year 2011, the calendar-adjusted fourth-quarter GDP growth rate could total 2.6%, after 3.8% in 2010. On an annual average, this would – given a considerable carry-over effect from the previous year – equate to an increase in real economic output of 3.1% in calendar-adjusted terms, after 3.5% the previous year. In 2012, the fourth-quarter rate would, according to this projection, fall further to 2.2%, yielding annual average working-day-adjusted GDP growth of 2.0% given a carry-over effect of 0.6%. As the number of potential working days is lower in

*Underlying  
trends and  
growth profile*

<sup>6</sup> The discontinuation of government pension contributions for recipients of unemployment benefit II also lowered revenues. However, at the general government level, this has no impact on the deficit, as it also reduces the Federal Government's spending.

<sup>7</sup> This package contains a new nuclear fuel tax as well as an air traffic tax, a gradual increase in tobacco tax and a reduction in electricity and energy tax concessions. Moreover, a bank levy (annual contribution by credit institutions to the Restructuring Fund) was introduced.

<sup>8</sup> The projection presented here was completed on 24 May 2011.

*Capacity utilisation and potential growth*

2012 than in 2011, the unadjusted annual average GDP rate would work out at 1.8%, after 3.1% and 3.6% respectively in the two preceding years. As compared with the December forecast, this represents an upwards revision of the anticipated growth rates by 1.1 percentage points for 2011 and 0.3 percentage point for 2012.

According to current data, Germany's economic output returned to pre-crisis levels in the first quarter of 2011. Moreover, the aggregate output gap, which had opened up during the crisis, should largely have closed. Capacity utilisation in industry and of plant and equipment in the construction sector is above its long-term average, employment is at a new high for unified Germany, enterprises' profitability is likely close to pre-crisis levels again, and wages and prices are rising discernibly. This overall macroeconomic picture is not compatible with the diagnosis of persistent and significant overall capacity underutilisation.

These findings are also an indication that potential growth temporarily weakened to ¾% as a result of the crisis.<sup>9</sup> Potential output will probably grow by 1.1% in 2011 and 1.3% in 2012. This is due not only to a renewed increase in investment activity but also to declining structural unemployment and rising immigration levels. Despite expanding potential growth, overall capacity utilisation over the forecast horizon is expected to go up significantly and be clearly in excess of the long-term average at the end of this period.

**Technical components of the GDP growth projection**

As a percentage or in percentage points

Item	2009	2010	2011	2012
Statistical carry-over at the end of the previous year <sup>1</sup>	-1.9	0.9	1.2	0.6
Fourth-quarter rate <sup>2</sup>	-2.0	3.8	2.6	2.2
Average annual GDP rate, working-day-adjusted	-4.7	3.5	3.1	2.0
Calendar effect <sup>3</sup>	-0.1	0.1	-0.1	-0.2
Average annual GDP growth <sup>4</sup>	-4.7	3.6	3.1	1.8

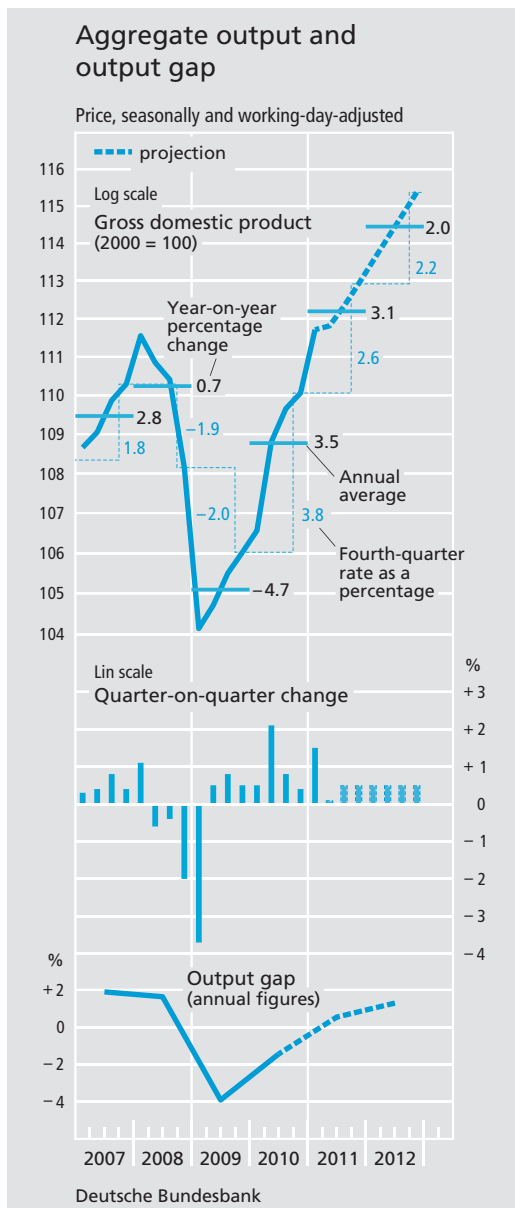
Sources: Federal Statistical Office; 2011 and 2012 Bundesbank projections. — <sup>1</sup> Seasonally and working-day-adjusted index level in the fourth quarter of the previous year in relation to the working-day-adjusted quarterly average of the previous year. — <sup>2</sup> Annual rate of change in the fourth quarter, working-day-adjusted. — <sup>3</sup> As a percentage of GDP. — <sup>4</sup> Discrepancies in the totals are due to rounding.

Deutsche Bundesbank

In the forecast period, exports are likely to remain the most important mainstay of Germany's economy. The exports outlook for German enterprises remains on a clear upward trend although growth is not expected to be as strong as in 2010, when exports expanded at a much faster pace (almost 15%) than the sales markets (just over 10%). This reflects the fact that the demand for high-quality capital goods surged globally following the crisis, when procurement was put on hold. This product range effect is expected to continue in 2011, albeit in a much weaker form. If sales markets expand by 7½%, exports could thus grow by a little more than 8%.

*Exports continue to rise sharply*

<sup>9</sup> For more details, see Deutsche Bundesbank, To what extent has the potential output of the German economy been impaired by the economic and financial crisis? An interim assessment, Monthly Report, December 2009, pp 24-25.



The positive product range effect will probably be largely exhausted in 2012. Furthermore, the high utilisation of tangible fixed assets is likely to be felt. As a result, assuming market growth of 7% (after calendar adjustment), this outlook puts growth in exports at a similarly strong pace in 2012 (6½% unadjusted, 7% after calendar adjustment).

In sharp contrast with the upturn of the last decade, the domestic economy looks like having a much larger role to play this time, however, thanks to the improved overall constitution of the German economy. Enterprises' profitability has already regained a very elevated level, financing conditions remain favourable and, relatively speaking, enterprises and households have only minor debt problems. Moreover, employment is rising perceptibly. Although the proportion of temporary employment contracts and temporary work has gone up, fear of unemployment has eased considerably on the whole. All of these factors encourage households and enterprises to make longer-term plans.

*Clear stimuli from domestic economy*

This can most clearly be seen in enterprises' investment planning. According to surveys, they plan to top up their investment budget for 2011 by a sizeable amount. For the first time in years, investment is to focus more heavily on capacity expansion. In price-adjusted terms, spending on new machinery and equipment could see a 12½% rise in 2011 and then go up from this high level by a further 7½% in 2012. At 6½%, housing investment is also expected to expand considerably in 2011. This item proved to be relatively robust, not just during the economic crisis, and saw a clear increase of 4¼% in real terms as early as 2010. A further rise of almost 2% is expected for 2012. The only sharp decline on the horizon in 2012 is in public investment, which had been stepped up from an already high level during the crisis, in particular to support the construction sector. All in all, after growth of 8% in 2011, the overall investment volume is expected to

*Sharp increase in fixed capital formation*



increase by only 3½% (4% after calendar adjustment) in 2012.

*Private  
consumption  
higher*

Given rising income and improvements on the labour market, private consumption is expected to pick up considerably despite a clear increase in prices. Households' disposable income could go up by 3½% this year and 3% next year due to a perceptible rise in net wages and salaries – despite higher effective taxes and social contributions – as well as in income from entrepreneurial activity and capital assets. By contrast, monetary social benefits received are expected to remain more or less the same owing, among other things, to a decline in unemployment. No major developments are expected in household saving. The savings ratio, which climbed from 11.1% to 11.4% in 2010 once the premium for scrapping old privately used cars had expired, is expected to again fall slightly to 11.2%. This would mean an increase of 1½% in real terms in private consumption spending in both 2011 and 2012.

*Sharp rise in  
imports*

The import forecast is based on the assumption that the trend increase in the share of imports in exports and in investment in machinery and equipment will continue. However, it is possible that growth in imports will nevertheless lag behind growth in exports in 2011 as demand is more closely focused on components with a relatively low import intensity, such as construction investment. If the importance of these components wanes in relative terms in 2012 as predicted, the percentage increase in imports would be greater than that in exports. For this reason, this forecast envisages an increase in imports

### Key figures of the macroeconomic projection

#### Year-on-year percentage change

Item	2009	2010	2011	2012
GDP (real)	- 4.7	3.6	3.1	1.8
GDP (working-day-adjusted)	- 4.7	3.5	3.1	2.0
Components of real GDP				
Private consumption	- 0.2	0.5	1.6	1.5
Government consumption	2.9	1.9	2.1	1.3
Gross fixed capital formation	- 10.1	6.0	7.9	3.4
Exports	- 14.3	14.7	8.3	6.3
Imports	- 9.4	13.0	7.3	7.2
Contributions to GDP growth 1				
Domestic final demand	- 1.5	1.7	2.7	1.8
Changes in inventories	- 0.3	0.6	- 0.5	0.1
Net exports	- 2.9	1.3	0.8	- 0.1
Labour market				
Total number of hours worked 2	- 2.5	2.7	1.6	0.5
Persons employed 2	0.0	0.5	1.2	0.8
Unemployed persons 3	3.4	3.2	2.9	2.8
Unemployment rate 4	8.1	7.7	7.0	6.5
Unit labour costs 5				
Compensation per employee	0.2	2.0	2.7	2.7
Real GDP per person employed	- 4.7	3.1	1.8	1.0
Consumer prices 6				
Excluding energy	1.1	0.8	1.5	1.6
Energy component	- 5.4	3.9	9.6	2.8

Sources: Federal Statistical Office; Federal Employment Agency; 2011 and 2012 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).

Deutsche Bundesbank

of 7¼% in both 2011 and 2012. The trade surplus (as a percentage of nominal GDP) would thus see only a minimal change on 2010 in both of these years.

*Employment continues to rise noticeably...*

In line with their investment plans, enterprises are taking on more staff, in part using the services of temporary employment agencies which, in turn, recruit staff from the labour market. According to surveys, enterprises still need to hire many more workers and, in the first quarter of 2011, the number of vacancies passed the one million mark. The complete opening of the German labour market to workers from the central and east European accession countries (with the exception of Bulgaria and Romania), the trend towards growing labour market participation levels and the suspension of German national service should make it easier for enterprises to fill these vacancies. Temporary employment and fixed-term employment options lower enterprises' risks, especially with regard to persons who are disadvantaged on the labour market. This forecast assumes that employment figures will expand by 1.2% in 2011 and 0.8% in 2012. The average number of hours worked is expected to increase again slightly in 2011 to then converge towards the longer-term, slightly negative trend in 2012 due to the growing share of part-time work.

*... and unemployment to decline*

In line with the positive trend in employment, unemployment will probably decline noticeably. After the number of persons registered as being out of work already slipped below 3 million in seasonally adjusted terms in April 2011, this figure is expected to fall to 2.75 million on an annual average for 2012.

The unemployment rate would then amount to 6.5%. A low of this magnitude has not been seen in western Germany since the unification boom. The decline in unemployment is likely to be chiefly structural. This is indicated by the rates of transition from unemployment to employment which have been rising sharply since 2006 and can, in turn, be attributed to the labour market reforms in the first half of the last decade.

### Labour costs and price outlook

---

New collective pay agreements reached in the final quarter of 2010 and the first quarter of 2011 stipulate rates of increase of the like last seen just before the crisis. Negotiated wages are thus in step with the economic recovery. Those collective wage negotiations that are yet to be concluded and those that are still pending are also expected to result in rather high negotiated rates both in 2011 and in 2012. The wage bargainers are likely to keep in mind the particular features of each economic sector, as they have done in previous negotiations. This forecast therefore assumes that, even if conditions on the labour market are extremely favourable, wage policy will generally remain employment-friendly and thus attach a great deal of importance to maintaining the competitiveness of internationally active enterprises. While this took the form of very low wage growth during much of the previous decade, higher growth rates are possible now that the economic environment is more favourable. The service sectors, which are affected more by the domestic economy, including the public

*Delayed increase in negotiated wages*

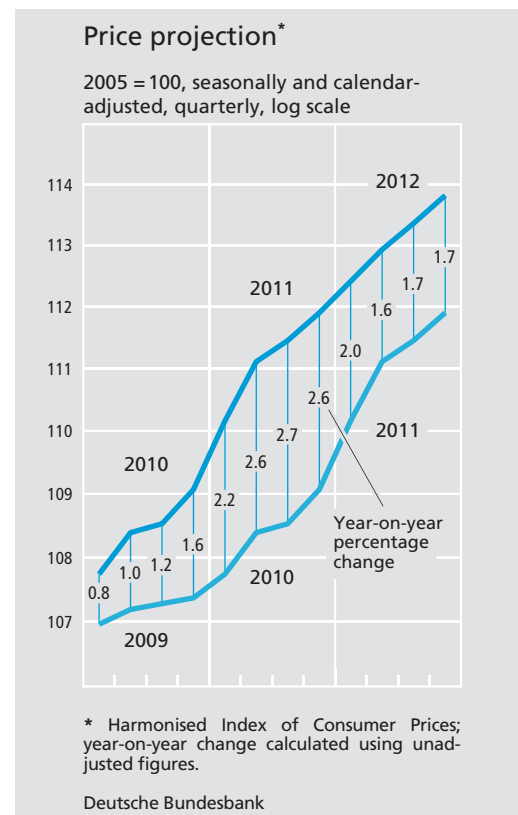
sector, are expected to follow the industrial sector's example with a certain time lag. However, due to the continued impact of older agreements and the base effects of one-off payments, the growth of negotiated wages will probably fall short of the new agreements at just under 2% in 2011 and 2½% in 2012. These will probably not take full effect until 2013.

*Positive wage drift, clear rise in actual earnings and unit labour costs*

The positive economic situation is likely to enable many enterprises to pay their employees a profit-sharing bonus. Any scope factored into collective wage agreements is also expected to result in an earlier, or even a larger, wage increase more frequently than in the past. Furthermore, paid overtime is also forecast to continue to increase. Actual earnings are thus set to rise at a more rapid pace than negotiated wages. On an hourly basis, the further decline in short-time work and the replenishing of working time accounts that were depleted during the crisis are likely to continue to offset the positive wage drift in 2011 compared with 2010. If the burden from employer contributions to social security funds remains broadly unchanged, wage costs per employee will potentially increase by 2.7% in both 2011 and 2012. Assuming a productivity gain of 1.8% in 2011 – due, not least, to a further rise in the average number of hours worked – and 1.0% in 2012, unit labour costs would rise by 0.8% and 1.7%, respectively.

*Increase in profit margins now only moderate*

Profit margins, which were depressed during the crisis, will probably continue to recover; however, given the yield level that has already been reached again, at only a greatly



reduced rate. Measured by the GDP deflator, the prices of domestically produced goods and services could go up by just under 1% in 2011 and 1¾% in 2012.

In 2011, consumer budgets will be strained predominantly by the marked rise in energy prices. On an annual average, energy is expected to be almost 10% more expensive; assuming an average share of one-tenth of the consumer's budget, this means a 1 percentage point contribution to inflation. Due to the lagged effects of higher crude oil prices on gas prices and the shared cost of amenities as well as to continually rising costs for a more environmentally friendly generation of electricity, energy prices will probably increase disproportionately in 2012, too – al-

*Sharp rise in energy prices*

though, at just under 3%, at a much weaker rate than in 2011.

*Other goods and services more and more expensive*

The economic recovery is also making its presence known in the prices of other goods and services, whereby it is not always possible to draw a clear distinction between external and domestic influences, especially as the German economy is developing in line with the global economy. At any rate, import prices and domestic producer prices of industrial goods have been characterised by a similarly sharp increase. The impact of global markets on some agricultural prices can also be clearly felt. Furthermore, rising wages and improved demand are likely to trigger a somewhat stronger increase in the prices of services and in housing rents. Overall, measured by the HICP, consumer prices are expected to increase by 2.5% in 2011 and then by 1.8% in 2012.

### Public finances<sup>10</sup>

*Significant improvement in public finances if course is held*

The public finance situation deteriorated sharply in the last two years. In 2010, the general government deficit ratio was 3.3% and, at 83.2%, the debt ratio reached a new record level.<sup>11</sup> A step-by-step recovery now looks likely provided the fiscal stance is not eased and additional burdens as a result of the financial and sovereign debt crisis remain strictly limited. Consolidation will be facilitated by the highly favourable economic conditions from which general government budgets will benefit not only in cyclical terms but also in the form of lower structural un-

employment and a renewed rise in rates of potential growth.

The deficit ratio could fall below 2% in 2011. This will be aided in roughly equal parts by the ongoing cyclical recovery and a clear structural improvement. By contrast, the absence of the one-off effects recorded in 2010 (proceeds from the radio frequencies auction, higher insolvency benefit contributions) will have a negative impact. On the revenue side, the structural factors include increases in social contributions and indirect taxes. The expected marked reduction in the structural expenditure ratio is mainly attributable to the fact that the transfer of capital to financial institutions is now assumed to be only relatively low. In addition, the expenditure trend is likely to be slightly restrictive due to the phasing out of some economic stimuli (in particular, measures to support the labour market) and to central government's consolidation package.

*Deficit ratio could fall below 2% in 2011 ...*

As things currently stand, a further deficit reduction is envisaged for 2012 although, unlike in 2011, the economic cycle will probably have only a slightly positive impact. The (structural) revenue ratio may remain largely unchanged, while the structural expenditure ratio may decline somewhat more sharply

*... and the improvement could continue in 2012 in a weaker form*

<sup>10</sup> The financial development of general government is described here as defined in the national accounts; this definition is also largely used as the basis for the fiscal reference values of the FEU Treaty (also known as the Maastricht criteria). For a more detailed analysis for general government as well as central, state and local government levels and the social security funds, see Deutsche Bundesbank, Monthly Report, May 2011.

<sup>11</sup> This figure includes debt in connection with support measures for financial institutions since 2008 of 13½% of GDP. Although these are largely offset by financial assets, the related risks are high.

than in 2011. This is due, in particular, to slow pension growth, which is expected under current regulations, as well as to lower spending on the labour market as a result of a structural decline in the number of persons out of work. Moreover, temporary measures to support the economy are coming to an end. This is especially true for the investment programmes under the government economic stimulus packages which, once again, have demonstrated a particularly pronounced time lag. All in all, the government budget will still post a clear structural deficit next year in an environment where overall capacity utilisation is above average. Thus, further consolidation is necessary to achieve the medium-term objective of a (close-to-) balanced budget and to provide for the upcoming demographic burdens in the years ahead.

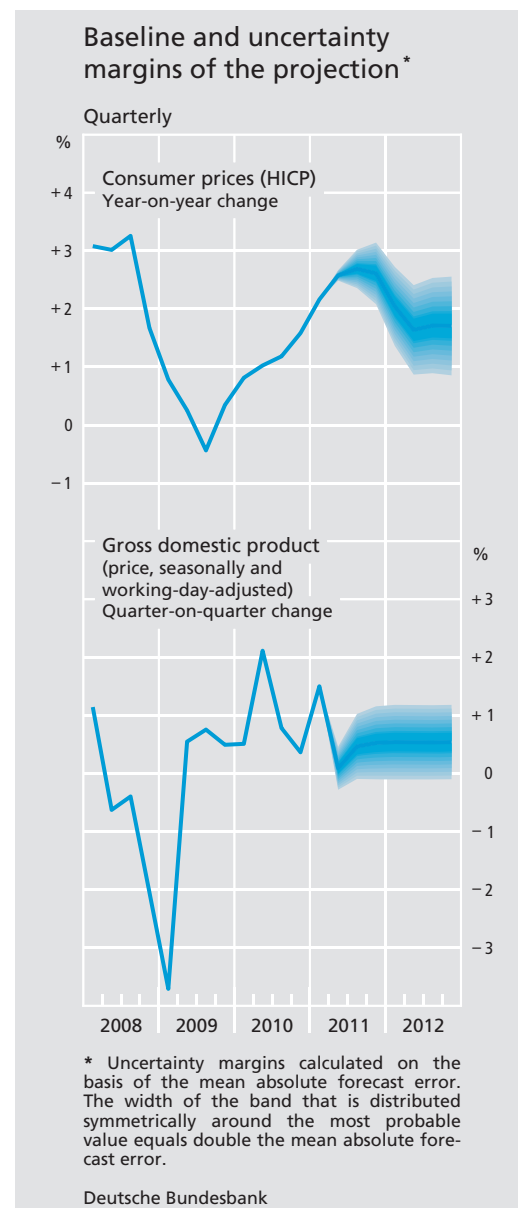
*Considerable uncertainty with regard to debt ratio*

Uncertainty with regard to the development of the debt ratio is still high. Taken in isolation, lower deficits coupled with relatively high nominal GDP growth bring about a decline. However, sizeable risks exist in connection with the European aid programmes for euro-area countries and support measures for German financial institutions.

### Risk assessment

*Real economic risk profile*

The baseline scenario presented here assumes smooth global economic development in which the German economy participates successfully thanks to its openness. Growth is being slowed by an increasing utilisation of overall capacity. The projected rise in short



and long-term interest rates prevents signs of overheating.

It is conceivable that, under these conditions, the market share gains of German enterprises will be larger than those in the forecast's main scenario, at least in the short term. It is also possible that the domestic component will receive more of an impetus than assumed here. High GDP results for the first quarter of

2011, which are difficult to interpret, may be an indication of this.

In the medium term, an increase in fixed capital formation and immigration could strengthen potential output to such a degree that tension-free growth would be possible even at a more rapid pace of expansion. If the expected interest rate rise does not occur, there could be a boom in the construction sector in particular, but it will not be particularly sustainable. Major disruptions in global economic development would probably have a direct effect on the German economy. Uncertainty on the financial markets is up again given the difficult situation of public finances in a number of industrial countries.

*Risks to price stability*

With regard to price stability, short to medium-term risks are primarily connected

with the international commodity markets. Commodity prices have already returned to a high level, and crude oil prices are still likely to contain a certain risk premium despite the latest corrections. However, a sharper rise cannot be ruled out given the almost unchecked economic expansion of the emerging market economies. This will be especially likely if the industrial countries as a whole recover at a faster-than-expected pace. If overall economic growth in Germany in a low interest rate environment proves to be much higher than in our projection and continues across the forecast horizon, in the context of only a moderate increase in growth rates of potential output, there is a risk of medium to long-term signs of overheating. This would be detrimental to price stability.