

Association of German Economic Research Institutes

**Article**

## The World Economy and the German Economy in the Spring of 2005

Weekly Report

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## The World Economy and the German Economy in the Spring of 2005

An abridged version of the Evaluation of the Economic Situation by the following members of the Association of German Economic Research Institutes.

**DIW Berlin, Deutsches Institut für Wirtschaftsforschung**

**Hamburgisches Welt-Wirtschafts-Archiv (HWWA)**

**Ifo Institut für Wirtschaftsforschung at the University of Munich**

**Institut für Weltwirtschaft at the University of Kiel**

**Institut für Wirtschaftsforschung Halle**

**RWI Essen, Rheinisch-Westfälisches Institut für Wirtschaftsforschung**

Finalized in Kiel, April 22, 2005

## The World Economy

### Overview

World economic growth weakened over the course of last year. Nonetheless, the global economy remained strong, for favorable financing conditions, high corporate profits, and the rising value of assets bolstered private demand world wide. The impact of the economic slowdown varied across the individual regions of the world. While the pace of expansion remained brisk both in the USA and in the industrializing countries, output in the euro zone expanded only weakly, while it actually declined for a period in Japan.

Several different factors hampered the expansion of the world economy. The extremely sharp rise in commodity prices resulted in a pronounced drain on purchasing power in the importing countries. This effect was mitigated by the fact that demand for imports expanded significantly in the commodity-exporting countries as a result of the substantial rise in income there. In Japan and in the euro zone, moreover, exports were sharply curtailed by the depreciation of the US dollar against the yen and the euro. Finally, some countries adopted a less expansive economic policy stance. In China, administrative measures bridled the over-zealous investment boom.

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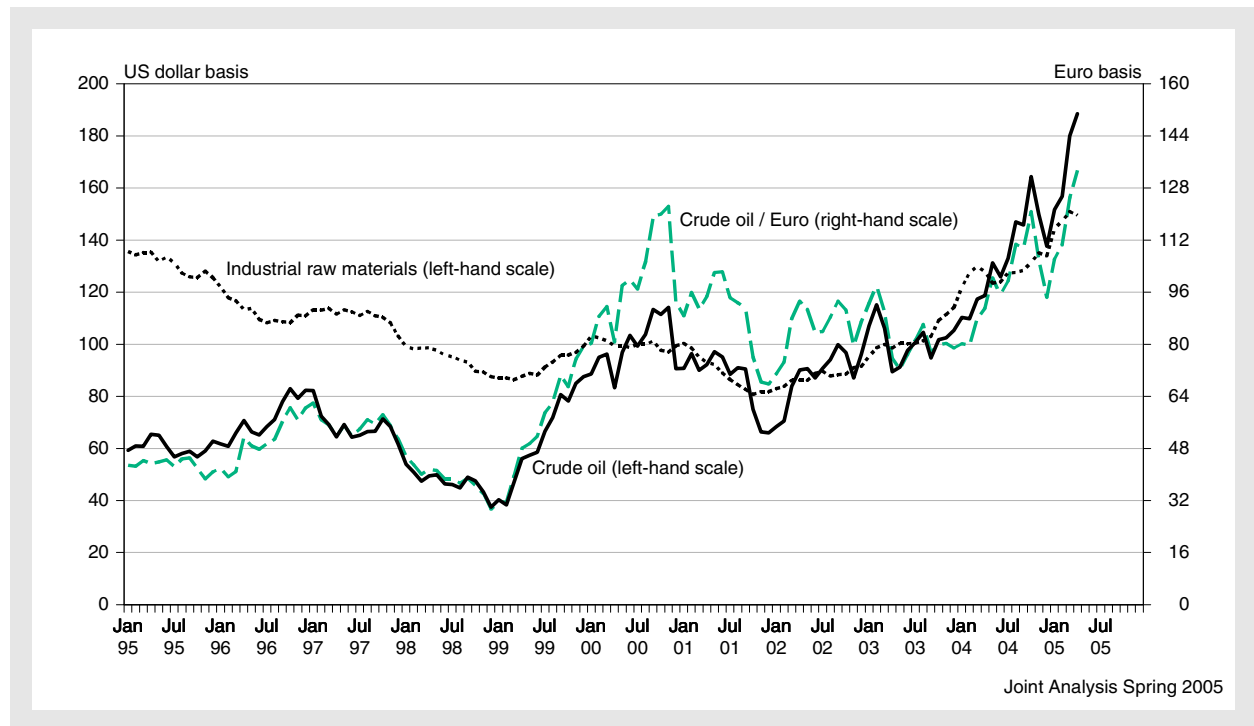
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Figure 1  
 HWWA Index for Crude Oil and Industrial Commodities, 1995 to 2005  
 2000 = 100



Source: HWWA (Hamburg Institute of International Economics).

In the USA, fiscal policy provided only weak impulses for growth, and the monetary policy reins were gradually tightened after the summer.

### Oil still costly

Crude oil prices rose again sharply at the beginning of 2005, having fallen for a brief period last fall. The prices for Brent oil climbed at times to heights well in excess of 50 US dollars, while prices for industrial commodities also rose once again (cf. figure 1). Unlike last year, this price rise was not alleviated in the euro zone by an appreciation of the euro.

The rise in commodity prices is a consequence of the enduring robust growth of the world economy. Raw material requirements, in particular, are expanding vigorously in the industrializing countries, and especially in China. Demand for a range of commodities increasingly pushed the limits of output capacity, but also those of the transport sector. This was particularly true for oil; in 2004, for the first time in three years and clearly in expectation of continued price rises, stocks were topped up again beyond what was needed to cover the rise in consumption (cf. table 1). Evidently only OPEC – and

especially Saudi Arabia – can now fall back on available capacities at short notice. In Iraq, where output still only amounts to half of the pre-war level of 2003, the possibility of a short-term expansion of supply is stymied for now by severe security problems.

Additional production capacities can only be built up gradually, and so high commodity prices are likely to persist for the present as demand remains lively. While there are indications that speculative buying has also contributed to the price increases on the commodity markets in recent months (and if this is the case, then prices could equally fall again rapidly), the high level of capacity utilization suggests that the situation is unlikely to ease in the near future. This is particularly true for the oil market. Where capacity utilization levels are high, the risk of greater production losses, for example in politically unstable regions such as the Middle East or Nigeria, will lead to price increases. The Institutes expect that, despite growing investment in production capacities, little will change in this situation for the present, and assume that the price of oil will amount to an average 50 US dollars per barrel this year and to an average 48 US dollars per barrel next year.

The price of oil would then be around 10 US dollars (i.e., 25%) higher than assumed in the Institutes' fore-

cast of last fall. According to the simulation calculations presented in the 2004 fall forecast, growth in the industrialized countries would be curtailed as a result by over 0.5 of a percentage point within two years.<sup>1</sup> In actual fact, this figure should probably be taken as the upper limit for the effect. One reason a more modest impact might be expected is that the price rise is currently occurring in the context of robust world economic growth. Moreover, it seems that the higher oil revenue is being used exceedingly rapidly to expand demand for imports. Finally, there are few indications of potential second-round effects, for example via accelerated wage growth. Inflation is therefore unlikely to rise in the long term, so that there is also no reason to expect a more restrictive monetary policy stance.

### Strong liquidity, high asset prices

The growth of the world economy was mainly propelled last year by a rise in asset prices. Share prices recovered appreciably from the low points reached in spring 2003. At the same time, property prices rose sharply in many regions, and especially in the USA, China, and some European countries (though not Germany), in some cases at rates exceeding 10%. But the prices of fixed-interest securities have also remained high and yields are therefore unusually low.

Interest rates on ten-year government bonds amount to only around 4.5% in the USA; the rates are almost one percentage point lower in the euro zone, and in Japan amount to a very low 1.5%. It is extraordinary to see such low capital market rates during the kind of advanced upswing currently taking place in the USA. After all, at this stage of a growth phase, inflationary expectations together with an improved return on capital should raise yields. If – in accordance with expectations theory – capital market rates are seen as an indicator of future money market rates and therefore ultimately of impending monetary policy, then they should also have risen substantially. This is especially true for the USA, where interest rate futures have been indicating for some time that market participants are expecting an interest rate hike.

The favorable trend for assets and the enduring low rate of interest on the capital markets can be explained in large part by the abundant amount of liquidity world wide. This in turn is a consequence of the fact that monetary policy has been expansive for a prolonged period;

<sup>1</sup> Cf. 'Oil-price rise to dampen world growth.' In: Working Party of the German Economic Research Institutes: 'The world and the German economy in the autumn of 2004.' In: *DIW Economic Bulletin*, vol. 41, no. 11, November 2004, p. 365.

Table 1  
Oil Market Supply and Demand, 2001 to 2004  
Million barrels per day

|                   | 2001  | 2002  | 2003  | 2004  |
|-------------------|-------|-------|-------|-------|
| Output            | 77.51 | 76.86 | 79.46 | 82.97 |
| Absolute change   | 0.03  | -0.66 | 2.6   | 3.51  |
| Percentage change | 0.0   | -0.9  | 3.4   | 4.4   |
| Consumption       | 78.10 | 78.44 | 79.89 | 82.63 |
| Absolute change   | 1.15  | 0.33  | 1.45  | 2.74  |
| of which: USA     | -0.05 | 0.11  | 0.27  | 0.48  |
| China             | 0.12  | 0.24  | 0.39  | 1.07  |
| Percentage change | 1.5   | 0.4   | 1.9   | 3.4   |
| Change in stocks  | -0.59 | -1.58 | -0.43 | 0.34  |

Source: Energy Information Agency.

real short-term interest rates in the USA, Japan, and the euro zone have amounted to zero for some time now. Investors' preference for longer-term assets has thus increased, and this has probably been responsible to a significant degree for the low capital market rates. The value of durable assets, especially property, has benefited particularly from the low interest rates. Investors' efforts to find profitable forms of investment also led until into the first quarter of this year to a decrease in risk premiums on the debt securities of companies with low creditworthiness and on government bonds from industrialized countries.

The exchange-rate policies of important emerging market countries – such as China – that have pegged their currencies more or less tightly to the US dollar also exerted downward pressure on capital market rates. The currencies of many of these countries repeatedly came under pressure to appreciate, especially in view of their high current account surpluses against the USA, and the central banks concerned responded by extensively buying dollars, which they invested in US government securities.

However, it was only possible for long-term rates to remain so low because inflationary expectations hardly increased at all, despite the global upswing. The scope for price increases in the industrialized countries remained marginal, in particular as a result of the competitive pressure from East Asian producers. In addition, the markets are evidently proceeding on the assumption that the major central banks will counteract the danger of inflation in good time.

## Cautious tightening of monetary policy reins, virtually neutral fiscal policy

Against a background of abundant liquidity and a strong economy, the U.S. Federal Reserve began to raise base rates in small steps last summer. The Fed will maintain this policy of cautious interest rate rises over the forecast period until the level of 4.5%, which will have a more or less neutral effect on the cycle, has been reached. The tightening of the monetary policy reins in the USA will also lead to higher interest rates in the remainder of the dollar area and will spread to the capital markets in other currency areas as a result of the international interest rate linkages. The ECB, by contrast, and in view of the current economic trend, has kept its interest rates constant to date, although for some time it has been pointing to the high rise in liquidity in the euro zone. Given that output growth is strengthening only gradually, the ECB is only likely to start raising interest rates during the coming year. The Japanese central bank will probably do no more than reduce the excess liquidity of the commercial banks; money market rates will remain close to zero. All in all, while monetary policy will remain distinctly expansive both in the euro zone and in Japan, developments in the USA will lead long-term interest rates to rise world wide. Therefore, in this respect, too, the monetary parameters will tend to become less favorable.

The government budgets are showing substantial deficits in some important countries, e.g., the USA, some of the EMU countries, and Japan. Given this situation, these countries intend to adopt a course of consolidation in the medium term. However, it appears that significant steps in this direction will not yet be taken over the forecast period. Fiscal policy in the industrialized countries will maintain a more or less neutral stance.

## Outlook: significant global economic expansion to continue

The growth of the world economy can be expected to continue at much the same pace as in the second half of last year, despite high prices for oil and commodities. This is suggested by the fact that financing conditions are still favorable, corporate profits are high in the industrialized countries, and the growth dynamic is strong in the developing countries. Assuming, as this forecast does, that exchange rates remain unchanged, then the divergences in the pace of growth of the different regions will diminish. Growth will gradually lose momentum in the growth centers of the USA and China, and also in many emerging market countries, but it will not come to a downturn. The main factor behind the lull in the USA will be the rise in interest rates, which will

curb private consumption, in particular. The increase in overall economic activity in Japan and the euro zone, by contrast, is likely to gain pace again to some extent. The rate of expansion will only barely exceed potential growth, however. As the dampening effects exerted by the exchange rates and by oil prices abate, the influence of the continued expansive stance of monetary policy will gain weight, and the growth of domestic demand will strengthen again.

All in all, real global GDP is likely to rise by 3% both this year and next year, following a very strong increase of 3.8% in 2004 (cf. table 1.2).<sup>2</sup> The high growth rate for world trade of 9% in 2004 will not be repeated, but trade will continue to expand briskly, at 7% this year and 6.5% in 2006. There will be little inflation growth, given that commodity prices will no longer rise to any notable extent and that wage growth will remain low as unemployment falls only marginally.

## Risks

However, the trend for the world economy is not free of risks. Thus, under the current circumstances there is great uncertainty about the development – both upward and downward – of the oil price. The imbalances in world growth, which have always been deemed a risk in past forecasts, have widened even further. This is made evident by the continued expansion of the USA's current account deficit. Given that such a high deficit can hardly be maintained in the long term, the rise could provoke a further loss of confidence in the US dollar. The consequences would be a renewed depreciation and sharper interest rate rises in the USA. The euro and the yen, in particular, would appreciate significantly, especially if China, as assumed here, maintains its currency peg to the dollar over the forecast period. Even if exchange rates remain at their current levels, long-term dollar interest rates could rise to a larger degree than assumed, for example if the East Asian countries were to invest their currency reserves less in long-term and more in short-term dollar securities than has been the case to date.

A significant rise in capital market rates in the USA would also affect other countries because of the international linkages between interest rates. Many industrialized countries would have to expect higher risk premi-

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<sup>2</sup> These rates refer to the group of countries listed in table 1.2, where the growth rates were weighted by 2003 nominal GDP in US dollars. They are not fully comparable with other figures on world economic growth, whose weighting is based on purchasing power parities and also include the rest of the world. Thus, the IMF states in its World Economic Outlook for last year that world economic growth will amount to 5.1%.

Table 2

## Real GDP, Consumer Prices and Unemployment Rates Around the World

|                                  | Weighting (GDP) (%) | GDP                             |      |      | Consumer prices |      |      | Unemployment rates (%) |      |      |
|----------------------------------|---------------------|---------------------------------|------|------|-----------------|------|------|------------------------|------|------|
|                                  |                     | Change (%) on the previous year |      |      |                 |      |      | 2004                   | 2005 | 2006 |
|                                  |                     | 2004                            | 2005 | 2006 | 2004            | 2005 | 2006 |                        |      |      |
| EU-25                            | 33.7                | 2.4                             | 1.7  | 2.2  | 2.0             | 2.0  | 1.7  | 9.0                    | 8.9  | 8.6  |
| Switzerland                      | 1.0                 | 1.7                             | 1.5  | 1.7  | 1.0             | 1.0  | 1.3  | 4.3                    | 4.1  | 4.0  |
| Norway                           | 0.7                 | 2.9                             | 2.6  | 2.7  | 0.6             | 1.8  | 2.1  | 4.4                    | 4.2  | 4.1  |
| Western and central Europe       | 35.3                | 2.4                             | 1.7  | 2.2  | 1.9             | 2.0  | 1.7  | 8.9                    | 8.8  | 8.5  |
| USA                              | 33.6                | 4.4                             | 3.5  | 3.1  | 2.7             | 2.8  | 2.7  | 5.5                    | 5.2  | 5.1  |
| Japan                            | 13.1                | 2.7                             | 1.0  | 1.9  | 0.0             | 0.0  | 0.2  | 4.7                    | 4.6  | 4.4  |
| Canada                           | 2.7                 | 2.8                             | 2.7  | 2.8  | 1.8             | 1.9  | 2.0  | 7.2                    | 7.0  | 6.9  |
| Industrialised countries         | 84.7                | 3.3                             | 2.3  | 2.5  | 1.9             | 2.0  | 1.9  | 7.1                    | 6.9  | 6.7  |
| Russia                           | 1.3                 | 7.1                             | 6.5  | 6.0  | 10.5            | 12.0 | 10.0 | 8.5                    | 8.0  | 7.8  |
| East Asia <sup>1</sup>           | 4.6                 | 5.6                             | 4.5  | 4.5  | .               | .    | .    | .                      | .    | .    |
| China                            | 4.8                 | 9.5                             | 8.5  | 8.0  | .               | .    | .    | .                      | .    | .    |
| Latin America <sup>2</sup>       | 4.5                 | 5.8                             | 4.5  | 4.5  | .               | .    | .    | .                      | .    | .    |
| Newly industrializing countries  | 15.3                | 7.0                             | 5.9  | 5.7  | .               | .    | .    | .                      | .    | .    |
| Total <sup>3</sup>               | 100.0               | 3.8                             | 2.9  | 3.0  | .               | .    | .    | .                      | .    | .    |
| Memo item:                       |                     |                                 |      |      |                 |      |      |                        |      |      |
| Weighted by exports <sup>4</sup> | 100.0               | 3.1                             | 2.3  | 2.7  | .               | .    | .    | .                      | .    | .    |
| World trade, real                | –                   | 9.0                             | 7.0  | 6.5  | –               | –    | –    | –                      | –    | –    |

1 Weighted average comprising: South Korea, Taiwan, Indonesia, Thailand, Malaysia, Singapore, Philippines. Weighted by 2003 GDP in US dollars. — 2 Weighted average comprising: Brazil, Mexico, Argentina, Columbia, Venezuela, Chile. Weighted by 2003 GDP in US dollars. — 3 Total of countries listed. Weighted by 2003 GDP in US dollars. — 4 Total of countries listed. Weighted by countries' shares in German exports in 2003.

Sources: OECD; ILO; IMF; Federal Statistical Office; Institutes' calculations; 2005 and 2006: Institutes' forecast.

ums. Moreover, higher US interest rates would result in lower valuations of assets such as shares and property. The rise in the U.S. savings ratio, which is on the hori-

zon anyway, would accelerate. The resulting weakening of domestic demand in the USA would also have repercussions for the rest of the world.



## The Economy of the European Union

### Slightly weaker growth in the euro zone

Growth in the euro zone has slackened perceptibly since summer 2004 (cf. figure 2). Real GDP expanded at a much slower pace in the second half of the year than in the first. Over 2004 as a whole, overall output rose by 2.1%; however, 0.2 of a percentage point of this rise must be attributed to the additional number of working days.

The main factor behind the weakening momentum was external trade. After exports had expanded robustly in the first half of the year, they grew at a slower pace in the second half of the year, which was probably due to a substantial extent to the appreciation of the euro. The growth in domestic demand, by contrast, accelerated slightly. While the rise in private consumption was curtailed by the unfavorable labor market situation (the unemployment rate remained entrenched at 8.8%), gross fixed capital formation increased again as interest rates remained low. Inflation accelerated on the basis of the energy price rises; on annual average, consumer prices rose by 2.1% on 2003 (cf. table 3).

The pace of expansion varied once again considerably across the individual member states. Among the

large countries, real GDP rose relatively marginally in Germany, Italy, and the Netherlands, while the increase was robust in France and Spain, not least because it was bolstered by rising real estate prices. In France, private consumption was also stimulated by government measures.<sup>3</sup>

### Fiscal policy almost neutral in the euro zone

The overall situation for public finances hardly improved at all in the euro zone last year as a result of the disappointing economic trend, and also given that corrections of previous years' accounting errors (some of which were deliberate – especially in Greece) resulted in a higher deficit. Germany, France, and Greece once again breached the Maastricht deficit limit of 3%, while Portugal and Italy only barely complied with it. The budget deficit in the euro zone as a whole amounted to 2.7% of GDP (cf. table 4).

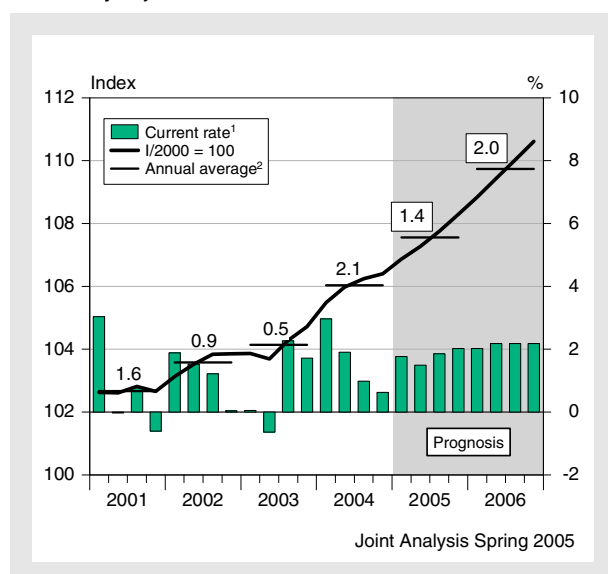
The updated stability programs envisage a steady decline in the public budget deficit for the euro zone as a whole (cf. table 5). Thus, a significant improvement is planned for the budget situation especially of those countries that have high deficits. However, these intentions are based on growth forecasts that in many cases – and not for the first time – already seem too optimistic for this year. Moreover, additional consolidation measures are expected, whose implementation is also doubtful because the resolutions agreed recently by the EU's finance ministers now permit a much less rigid interpretation of the Stability and Growth Pact.<sup>4</sup>

This year, the aggregate deficit ratio in the euro zone as a whole is likely to rise slightly, in part also because some countries will be implementing tax cuts. Next year, the deficit ratio will decline only slightly despite stronger growth. More intense budget consolidation is unlikely only on the basis of the reform of the Stability and Growth Pact, especially given that elections are due in some countries.

### Monetary parameters somewhat less favorable

The ECB maintained its expansionary monetary policy stance last year. Base rates have remained unchanged at the low rate of 2% since June 2003, and the three-month rate has been only slightly higher since the same date (cf. figure 3). In view of a current core inflation rate<sup>5</sup> of

Figure 2  
Real GDP in the Euro Zone  
Seasonally adjusted



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.  
Sources: Eurostat; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

<sup>3</sup> The French 'Law on Support for Consumption and Investment' raised the tax allowance for gifts and approved early access to tax-supported savings plans.

<sup>4</sup> Cf. the 'Fiscal Policy' section below for details.

Table 3

## Real GDP, Consumer Prices and Unemployment Rates in Europe

|                                  | Weighting<br>(GDP)<br>(%) | GDP                             |      |      | Consumer prices <sup>1</sup> |      |      | Unemployment rates <sup>2</sup> (%) |      |      |
|----------------------------------|---------------------------|---------------------------------|------|------|------------------------------|------|------|-------------------------------------|------|------|
|                                  |                           | Change (%) on the previous year |      |      |                              |      |      | 2004                                | 2005 | 2006 |
|                                  |                           | 2004                            | 2005 | 2006 | 2004                         | 2005 | 2006 |                                     |      |      |
| Germany*                         | 21.8                      | 1.6                             | 0.7  | 1.5  | 1.7                          | 1.7  | 1.5  | 9.5                                 | 9.8  | 9.3  |
| France                           | 16.0                      | 2.5                             | 1.9  | 2.2  | 2.3                          | 1.9  | 1.8  | 9.6                                 | 9.5  | 9.2  |
| Italy                            | 13.3                      | 1.2                             | 0.8  | 1.6  | 2.3                          | 2.1  | 2.1  | 8.1                                 | 7.8  | 7.6  |
| Spain                            | 7.6                       | 2.7                             | 2.6  | 2.7  | 3.0                          | 3.0  | 2.8  | 10.8                                | 10.0 | 9.7  |
| The Netherlands                  | 4.7                       | 1.4                             | 1.1  | 2.0  | 1.4                          | 1.5  | -2.5 | 4.7                                 | 4.7  | 4.5  |
| Belgium                          | 2.7                       | 2.9                             | 2.1  | 2.4  | 1.9                          | 2.0  | 2.0  | 7.8                                 | 7.8  | 7.5  |
| Austria                          | 2.3                       | 2.0                             | 2.1  | 2.4  | 1.9                          | 2.1  | 1.8  | 4.5                                 | 4.4  | 4.2  |
| Finland                          | 1.6                       | 4.2                             | 2.3  | 2.8  | 3.0                          | 3.0  | 3.0  | 10.4                                | 10.4 | 10.1 |
| Greece                           | 1.5                       | 3.7                             | 3.0  | 3.0  | 0.2                          | 1.0  | 1.5  | 8.9                                 | 8.6  | 8.4  |
| Portugal                         | 1.4                       | 5.4                             | 4.5  | 5.0  | 2.3                          | 2.1  | 2.3  | 4.5                                 | 4.2  | 4.0  |
| Ireland                          | 1.3                       | 1.0                             | 0.8  | 1.6  | 2.5                          | 2.1  | 2.0  | 6.7                                 | 6.8  | 6.7  |
| Luxembourg                       | 0.2                       | 4.2                             | 3.8  | 4.0  | 3.2                          | 2.8  | 2.1  | 4.2                                 | 4.1  | 4.0  |
| EMU countries <sup>3</sup>       | 74.5                      | 2.1                             | 1.4  | 2.0  | 2.1                          | 2.0  | 1.6  | 8.8                                 | 8.7  | 8.4  |
| United Kingdom                   | 16.3                      | 3.1                             | 2.8  | 2.6  | 1.3                          | 1.7  | 1.8  | 4.7                                 | 4.9  | 4.9  |
| Sweden                           | 2.7                       | 3.5                             | 2.8  | 2.6  | 1.0                          | 1.5  | 1.5  | 6.3                                 | 6.3  | 6.1  |
| Denmark                          | 1.9                       | 2.0                             | 1.7  | 2.1  | 0.9                          | 1.7  | 1.8  | 5.4                                 | 5.2  | 5.0  |
| EU-15 <sup>3</sup>               | 95.5                      | 2.3                             | 1.6  | 2.1  | 1.9                          | 1.9  | 1.7  | 8.0                                 | 7.9  | 7.7  |
| Poland                           | 1.9                       | 5.4                             | 4.2  | 4.5  | 3.6                          | 2.6  | 2.5  | 18.8                                | 18.0 | 17.8 |
| Czech Republic                   | 0.8                       | 4.0                             | 4.0  | 4.0  | 2.8                          | 1.8  | 2.4  | 8.3                                 | 8.3  | 8.3  |
| Hungary                          | 0.8                       | 4.0                             | 3.5  | 3.8  | 6.8                          | 3.5  | 4.0  | 5.9                                 | 6.3  | 6.2  |
| Slovakia                         | 0.3                       | 5.5                             | 5.0  | 5.0  | 7.5                          | 3.0  | 3.0  | 18.0                                | 17.5 | 17.0 |
| Slovenia                         | 0.3                       | 4.6                             | 3.6  | 4.0  | 3.6                          | 3.0  | 2.8  | 6.0                                 | 5.8  | 5.5  |
| Lithuania                        | 0.2                       | 6.7                             | 7.5  | 7.0  | 1.2                          | 2.3  | 2.0  | 10.8                                | 8.9  | 8.7  |
| Cyprus                           | 0.1                       | 3.7                             | 3.5  | 4.0  | 2.3                          | 3.0  | 2.3  | 5.0                                 | 5.5  | 5.2  |
| Latvia                           | 0.1                       | 8.5                             | 8.0  | 7.3  | 6.2                          | 5.5  | 4.0  | 9.8                                 | 9.5  | 9.0  |
| Estonia                          | 0.1                       | 6.1                             | 6.0  | 6.0  | 3.0                          | 3.0  | 2.9  | 9.2                                 | 8.0  | 7.5  |
| Malta                            | 0.0                       | 1.5                             | 1.7  | 2.0  | 2.7                          | 2.5  | 2.5  | 7.3                                 | 7.0  | 6.8  |
| Accession states                 | 4.5                       | 5.1                             | 4.4  | 4.6  | 4.3                          | 2.8  | 2.9  | 14.1                                | 13.5 | 13.3 |
| EU-25 <sup>3</sup>               | 100.0                     | 2.4                             | 1.7  | 2.2  | 2.0                          | 2.0  | 1.7  | 9.0                                 | 8.9  | 8.6  |
| Memo item:                       |                           |                                 |      |      |                              |      |      |                                     |      |      |
| Weighted by exports <sup>4</sup> | 100.0                     | 2.7                             | 2.3  | 2.6  | 2.2                          | 2.1  | 1.7  | -                                   | -    | -    |

1 EU-15: harmonized index of consumer prices (HICP). — 2 Standardized. — 3 Total of countries listed. GDP and consumer prices weighted by 2003 GDP in US dollars; unemployment rate weighted by 2003 labor force. — 4 Total of countries listed. Weighted by country's shares in German exports in 2003.  
Sources: OECD; ILO; IMF; Federal Statistical Office; Institutes' calculations; 2005 and 2006: Institutes' forecast.

1.4%, real short-term interest rates amount to 0.7% – half a percentage point higher than six months ago. The yield on ten-year government bonds in the euro zone has fallen by around half a percentage point to 3.7% over the last six months, having previously remained largely stable. It has fallen by around the same share in real terms and is currently extremely low in historical com-

parison. Interest rates on loans of up to 1 million euro to non-financial joint-stock companies have fluctuated around 4.8% over the last six months. The commercial banks relaxed their lending conditions once again at the end of 2004. The stock markets have made a further recovery over the last six months, with the EuroStoxx 50 index rising by 10%. All in all, the financing conditions of enterprises have improved slightly. The euro, which had appreciated in real effective terms by 2.7% in the summer half of the year, slightly increased its value once again in the last six months. While the monetary

<sup>5</sup> The core inflation rate is approximated here as the year-on rate of change of the Harmonized Index of Consumer Prices (HICP), not including energy, foodstuffs, alcohol, or tobacco.



Table 4

## Public Budget Indicators for the EMU Countries

|                            | Gross debt <sup>1</sup> |       |       |       |       | Financial balance <sup>1</sup> |      |      |      |      |
|----------------------------|-------------------------|-------|-------|-------|-------|--------------------------------|------|------|------|------|
|                            | 2002                    | 2003  | 2004  | 2005  | 2006  | 2002                           | 2003 | 2004 | 2005 | 2006 |
| Germany                    | 60.9                    | 64.2  | 66.0  | 67.4  | 68.5  | -3.7                           | -3.8 | -3.7 | -3.4 | -3.3 |
| France                     | 59.0                    | 63.9  | 65.6  | 66.5  | 67.0  | -3.2                           | -4.2 | -3.7 | -3.3 | -3.1 |
| Italy                      | 108.0                   | 106.3 | 105.8 | 106.0 | 105.5 | -2.6                           | -2.9 | -3.0 | -3.7 | -4.4 |
| Spain                      | 55.0                    | 51.4  | 48.9  | 46.5  | 44.0  | -0.3                           | 0.3  | -0.3 | 0.1  | 0.1  |
| The Netherlands            | 52.6                    | 54.3  | 55.7  | 57.5  | 57.0  | -1.9                           | -3.2 | -2.5 | -2.3 | -1.9 |
| Belgium                    | 105.4                   | 100   | 95.6  | 95.0  | 95.0  | 0.1                            | 0.4  | 0.1  | -0.3 | -0.4 |
| Austria                    | 66.7                    | 65.4  | 65.2  | 64.0  | 63.5  | -0.2                           | -1.1 | -1.3 | -2.0 | -1.8 |
| Greece                     | 112.2                   | 109.3 | 110.5 | 110.0 | 107.0 | -4.1                           | -5.2 | -6.1 | -5.0 | -4.1 |
| Finland                    | 42.5                    | 45.3  | 45.1  | 44.5  | 44.0  | 4.3                            | 2.5  | 2.1  | 1.7  | 1.7  |
| Ireland                    | 32.6                    | 32.0  | 29.9  | 29.0  | 28.5  | -0.4                           | 0.2  | 1.3  | -0.8 | -0.5 |
| Portugal                   | 58.5                    | 60.1  | 61.9  | 65.0  | 67.0  | -2.7                           | -2.9 | -2.9 | -4.8 | -4.3 |
| Luxembourg                 | 7.5                     | 7.1   | 7.5   | 7.6   | 7.8   | 2.3                            | 0.5  | -1.1 | -1.3 | -1.6 |
| EMU countries <sup>2</sup> | 69.5                    | 70.8  | 71.3  | 71.8  | 71.8  | -2.4                           | -2.8 | -2.7 | -2.8 | -2.7 |

1 As % of gross domestic product; apportionment according to Maastricht Treaty. — 2 Total of countries listed. Weighted by 2003 GDP in euro.  
Sources: Eurostat; European Commission; 2005 and 2006: Institutes' forecast.

conditions have worsened slightly as a result overall, they are still favorable when seen in historical comparison.

M3 money supply expanded over the course of 2004 at a rate of 6.4%. The rate of increase has weakened to an extent more recently, though at 5.7% in February (three-month average of the annualized change on the previous month), it still significantly exceeded the ECB

reference value of 4.5%. Open-account loans to the private sector expanded at an accelerated pace over the course of 2004. The rate of increase recently diminished slightly, and amounted to 6.6% in February (three-month average of annualized month-on-month change).

The ECB can be expected to slightly curtail the expansionary thrust of its monetary policy over the forecast period, also because the sharp increase in M3

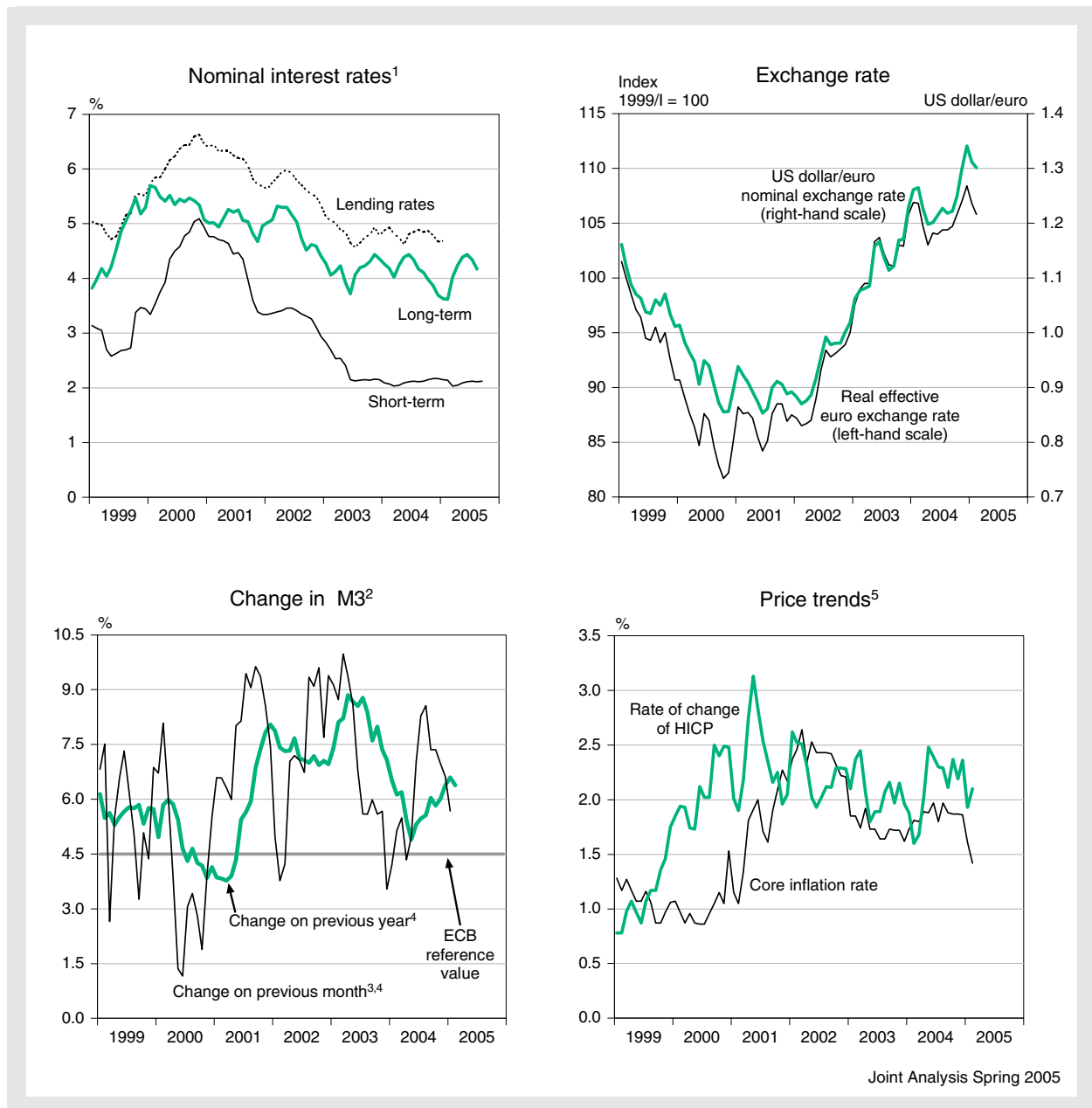
Table 5

## Key Indicators for the EMU Countries' Stability and Growth Programs

|                              | GDP growth |                           | National financial balance |      | Gross debt |       |
|------------------------------|------------|---------------------------|----------------------------|------|------------|-------|
|                              | 2004       | 2005 to 2008 <sup>1</sup> | 2004                       | 2008 | 2004       | 2008  |
| Germany                      | 1.6        | 1.9                       | -3.7                       | -1.5 | 66.0       | 65.0  |
| France                       | 2.5        | 2.5                       | -3.7                       | -0.9 | 65.6       | 62.0  |
| Italy                        | 1.2        | 2.2                       | -3.0                       | -0.9 | 105.8      | 98.0  |
| Spain                        | 2.7        | 3.0                       | -0.3                       | 0.4  | 48.9       | 40.0  |
| The Netherlands <sup>2</sup> | 1.4        | 2.2                       | -2.5                       | -1.9 | 55.7       | 58.3  |
| Belgium                      | 2.9        | 2.3                       | 0.1                        | 0.6  | 95.6       | 84.2  |
| Austria                      | 2.0        | 2.4                       | -1.3                       | 0.0  | 65.2       | 59.1  |
| Greece <sup>2</sup>          | 4.2        | 4.0                       | -6.1                       | -2.5 | 110.5      | 102.5 |
| Finland                      | 3.7        | 2.4                       | 2.1                        | 2.0  | 45.1       | 41.1  |
| Ireland <sup>2</sup>         | 5.4        | 5.2                       | 1.3                        | -0.6 | 29.9       | 30.0  |
| Portugal <sup>2</sup>        | 1.0        | 2.6                       | -2.9                       | -1.8 | 61.9       | 61.4  |
| Luxembourg <sup>2</sup>      | 4.2        | 3.8                       | -1.1                       | -1.0 | 7.5        | 4.5   |
| EMU countries                | 2.1        | 2.4                       | -2.7                       | -0.9 | 71.3       | 67.2  |

1 Annual average. — 2 Forecast period ends 2007.  
Sources: Eurostat; national Stability and Growth Programs; Institutes' calculations.

Figure 4  
The Monetary Situation in the EMU Countries



1 Short-term = three-month Euribor; long-term = 10-year government bonds; lending rates = enterprise loans with term of 1 to 5 years; prior to 2003: term of at least one year. —  
2 M3 = circulation of notes and coins, daily deposits, deposits with an agreed duration of up to two years; deposits with agreed notice period of up to three months; repo business, money market fund shares and papers; debt securities with maturity up to two years; Index, rates of change (%). — 3 Seasonally adjusted, annualised rate. — 4 Centered three-month moving average. — 5 HICP = harmonized index of consumer prices; core inflation rate = rate of change of HICP, excluding energy, foods, alcohol, tobacco.  
Sources: European Central Bank; Eurostat; German Bundesbank; Institutes' calculations.

money supply and the rapid growth in loans to the private sector imply medium-term risks for price stability. It will thus usher in the end of the long period of extraordinarily low interest rates and embark on a more neutral monetary policy course. However, given that growth in the euro zone will only begin to consolidate during the

course of this year, and that current wage growth does not indicate an acceleration of inflation, the bank is likely to wait until 2006 before turning the interest rate trend around. The Institutes expect that the ECB will raise base rates by a total of half a percentage point over the course of the coming year.

Table 6

**EMU Countries: Key Forecast Figures**

|                                       | 2003                            | 2004 | 2005 | 2006 |
|---------------------------------------|---------------------------------|------|------|------|
|                                       | Change (%) on the previous year |      |      |      |
| Real GDP                              | 0.5                             | 2.1  | 1.4  | 2.0  |
| Private consumption                   | 1.1                             | 1.2  | 1.3  | 1.7  |
| Government consumption                | 1.6                             | 1.6  | 1.2  | 1.3  |
| Gross fixed capital formation         | -0.4                            | 2.1  | 2.3  | 3.3  |
| Domestic demand                       | 1.2                             | 2.0  | 1.5  | 2.0  |
| Exports <sup>1</sup>                  | 0.4                             | 6.3  | 4.4  | 5.6  |
| Imports <sup>1</sup>                  | 2.2                             | 6.5  | 5.0  | 5.2  |
| External surplus/deficit <sup>2</sup> | -0.6                            | 0.1  | -0.1 | 0.3  |
| Consumer prices <sup>3</sup>          | 2.2                             | 2.1  | 2.0  | 1.6  |
|                                       | As % of nominal GDP             |      |      |      |
| Budget surplus/deficit <sup>4</sup>   | -2.8                            | -2.7 | -2.8 | -2.7 |
| Balance of payments                   | 0.3                             | 0.5  | 0.4  | 0.8  |
|                                       | As % of labor force             |      |      |      |
| Unemployment rate <sup>5</sup>        | 8.7                             | 8.8  | 8.7  | 8.4  |

1 Including intra-EMU trade. — 2 Contribution to growth. — 3 Harmonized index of consumer prices (HICP). — 4 Total government surplus/deficit. — 5 Standardised.

Sources: Eurostat; European Central Bank; Institutes' calculations; 2005 and 2006: Institutes' forecast.

**Low wage growth**

Wages rose moderately in the euro zone last year, with wages and salaries per employee increasing by around 1.8%. However, this overall trend masks substantial variation across the individual member states. In Spain, for example, wages and salaries per employee rose by 4.1%, while in Germany they remained practically stable.<sup>6</sup>

The sharp rise in the price of oil has as yet had little effect on the collective agreements that are currently in force. The only moderate economic recovery and the sustained high unemployment rate have curtailed wage growth. As growth consolidates increasingly, however, wage growth can be expected to accelerate on trend. In some countries, e.g., Spain (partially because of its indexing regulations), wages will continue to rise at well above average rates.

**Outlook**

The expansion of real GDP will remain moderate overall in the first half of 2005. Domestic demand is unlikely to grow to any great extent because of the dampening

<sup>6</sup> Cf. the 'Wages Policy' section below for details.

effect of the oil-price rise. Moreover, private consumption will increase only weakly because of the unfavorable labor market situation. As world economic expansion weakens, the pace of export growth will initially remain slow. The economic situation is likely to improve increasingly in the second half of the year, in part because the dampening impulses exerted by the oil-price rise will wear off. Private consumption will benefit in particular from this development. As sales and profitability prospects brighten up on the domestic market, enterprises will expand their investments more rapidly, given that financing conditions will remain favorable. In addition, the effects of the exchange rate rise will abate, leading to a probably stronger pace of expansion for exports. All in all, a 1.4% rise in real GDP can be expected in 2005 (cf. table 6). At the same time, unemployment will decrease slightly.

The economic recovery is likely to gain momentum next year. Private consumption will expand at a stronger rate in the context of falling unemployment. As capacity utilization rises and profits grow, the propensity of enterprises to invest will increase further. Exports are also likely to benefit from the fact that the world economic climate will remain favorable. All in all, real GDP will grow by 2.0% in 2006, and the unemployment rate is likely to fall to an annual average of 8.4%.

The rise in consumer prices will weaken only slightly this year because the increase in energy prices will slow only gradually. The HICP will exceed its 2004 level by 2.0% on average in 2005. The price increase will weaken in 2006 as a result of the declining pressure on prices from the commodity markets. All in all, the HICP is likely to rise by 1.6% next year. The inflation rate in the euro zone will also be reduced by a statistical effect – the restructuring of the price index in the Netherlands.<sup>7</sup>

<sup>7</sup> From 2006 onward, some components of Dutch health spending will no longer be included in the calculation of the Harmonized Index of Consumer Prices. This modification alone will reduce the inflation rate in the euro zone by 0.2 of a percentage point.

# The German Economy

## Overview

The German economy is in a lull in the spring of 2005. The very strong recovery seen in the first half of 2004 subsequently came to a halt.<sup>8</sup> The decisive causes were the slower pace of world economic growth, on the one hand, and the impact of the euro's appreciation, on the other. The domestic forces for growth remained weak, so there was no impulse to counterbalance the decline in export growth.

Thus, the weak basic economic trend persisted. Even the preceding massive demand impulse from abroad failed to provoke a sustained upswing. Final domestic demand, which had been in decline for three years, only stabilized in 2004. Practically no other country in the EU has seen such an unfavorable trend in recent years. The German economy is clearly suffering from a fundamental weakness.

<sup>8</sup> The fourth quarter of 2004 showed a slight fall in overall output compared to the preceding quarter. This decline probably understates the underlying growth trend because the calendar effects were probably not correctly eliminated.

The labor market situation has deteriorated to date in economic terms. While the total number of employed increased as a result of labor market policy measures, the number of insured employed, which better reflects the underlying labor market trend, fell once again. The rise in unemployment continued; the number of registered unemployed actually surged at the beginning of the year because the entry into force of the Hartz IV reforms led in particular to the inclusion on the register of social welfare beneficiaries who are fit for work.

Inflation has been characterized in recent months by the rise and fall in energy prices. The basic trend, however, was one of very moderate inflation, in part because as a consequence of the oil price rise, wage growth was restrained. Labor costs actually declined, while the sluggish pace of growth narrowed the scope for price increases. The burden from energy inflation will increase substantially this year. If the quantities imported remain the same as last year, then in 2005 around 16 billion euro more will have to be spent on energy imports than in 2004; this would correspond to three-quarters of a percent of nominal GDP (cf. table 7). The drain on income would thus be around three times as high as in 2004.

The basic economic trend will remain moderate in the first half of 2005. While the beginning of the year

Table 7  
Energy Import Bill<sup>1</sup>

|   | 2000     | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     |
|---|----------|----------|----------|----------|----------|----------|----------|
| <b>Crude oil</b>  |          |          |          |          |          |          |          |
| Billion euro  | 23.83    | 21.37    | 20.04    | 20.22    | 24.40    | 33.11    | 31.78    |
| Million metric tons                                     | 105.14   | 104.63   | 104.73   | 106.36   | 110.03   | 110.03   | 110.03   |
| Change (%) on previous year                             | 1.4      | -0.5     | 0.1      | 1.6      | 3.5      | 0.0      | 0.0      |
| Average price in euro                                   | 226.63   | 204.22   | 191.36   | 190.12   | 221.75   | 301.0    | 289.0    |
| Change (%) on previous year                             | 86.7     | -9.9     | -6.3     | -0.6     | 16.6     | 35.7     | -4.0     |
| US \$ per barrel  | 28.0     | 23.5     | 24.1     | 28.4     | 36.3     | 50.0     | 48.0     |
| Change (%) on previous year                             | 62.1     | -15.9    | 2.4      | 17.7     | 28.0     | 37.6     | -4.0     |
| Euro/US \$ rate   | 0.92     | 0.90     | 0.94     | 1.13     | 1.24     | 1.30     | 1.30     |
| <b>Fuels, natural gas</b>                               |          |          |          |          |          |          |          |
| Billion euro  | 20.80    | 22.09    | 23.95    | 27.74    | 28.66    | 36.19    | 41.97    |
| Million metric tons                                     | 101.70   | 98.80    | 116.56   | 139.85   | 133.76   | 133.76   | 133.76   |
| Change (%) on previous year                             | 1.8      | -2.9     | 18.0     | 20.0     | -4.3     | 0.0      | 0.0      |
| Average price in euro                                   | 204.53   | 223.60   | 205.51   | 198.37   | 214.0    | 271.0    | 314.0    |
| Change (%) on previous year                             | 87.4     | 9.3      | -8.1     | -3.5     | 8.0      | 26.3     | 16.0     |
| Energy imports in billion euro                          | 44.63    | 43.46    | 43.99    | 47.96    | 53.08    | 69.39    | 75.85    |
| Year-on change in billion euro                          | 21.14    | -1.17    | 0.53     | 3.97     | 5.12     | 16.31    | 4.45     |
| Nominal GDP   | 2 030.00 | 2 074.00 | 2 107.30 | 2 128.20 | 2 177.00 | 2 209.87 | 2 258.11 |
| Burden of higher energy imports as share of nominal GDP | -1.04    | 0.06     | -0.03    | -0.20    | -0.24    | -0.74    | -0.20    |

<sup>1</sup> The energy bill shows the additional burden resulting for Germany from the increase in the price of imported energy sources. It is based for the years 2005 and 2006 on the assumption that, (a) the quantities imported will not change, i.e., the same quantities (in metric tons) will be imported in 2005 and 2006 as in 2004, (b) the price of oil will amount to an average US-\$ 50 per barrel in 2005 and an average US-\$ 48 per barrel in 2006, and (c) prices for fuel and natural gas depend on the price of oil, with natural gas prices adjusting following a certain time delay.

Sources: BAFA; MVW; Federal Statistical Office; Institutes' calculations.

Table 8

## Key Forecast Figures for Germany

|  | 2001   | 2002   | 2003               | 2004   | 2005   |
|--|--------|--------|--------------------|--------|--------|
| Gross domestic product <sup>1</sup><br>change (%) on the previous year | 0.1    | -0.1   | 1.6                | 0.7    | 1.5    |
| Western Germany <sup>2, 3</sup>  | 0.0    | -0.2   | 1.6                | 0.7    | 1.5    |
| Eastern Germany <sup>3</sup>   | 0.7    | 0.2    | 1.5                | 0.7    | 1.5    |
| Labor force <sup>4, 5</sup> (in 000s)                                  | 38 696 | 38 314 | 38 442             | 38 731 | 39 067 |
| Unemployed (in 000s)   | 4 061  | 4 377  | 43 81 <sup>6</sup> | 4 844  | 4 518  |
| Unemployment rate <sup>7</sup> (%)                                     | 9.5    | 10.3   | 10.2               | 11.1   | 10.4   |
| Consumer prices <sup>8</sup><br>change (%) on the previous year        | 1.4    | 1.1    | 1.6                | 1.7    | 1.5    |
| Unit labor costs <sup>9</sup><br>change (%) on the previous year       | 0.8    | 0.7    | -1.1               | 0.0    | 0.0    |
| Public sector financial balance <sup>10</sup><br>Euro billion          | -77.5  | -81.3  | -80.3              | -76.1  | -74.0  |
| As % of nominal GDP  | -3.7   | -3.8   | -3.7               | -3.4   | -3.3   |
| Balance of payments (euro billion)                                     | 48.2   | 45.3   | 84.0               | 85.0   | 95.0   |

1 At 1995 prices. — 2 Including Berlin. — 3 As at April 2005. — 4 Domestic. — 5 The labor force data is based on Series 18 of the National Accounts, vol. 3 (data from IV/2004), as these are compatible with the current national accounts. — 6 From 2004 onward not including participants in aptitude testing and vocational training programs. — 7 Unemployed as % of domestic labor force (place of residence concept). — 8 Consumer price index (2000 = 100). — 9 Compensation of employees per employee created in the domestic economy as % of GDP at 1995 prices per member of labor force. — 10 National accounting definitions (ESNA 95).

Sources: Federal Statistical Office; Federal Labour Office; Federal States' Working Group on ESNA; German Bundesbank; 2005 and 2006: Institutes' forecast.

saw a surge in incoming orders in manufacturing industry, this trend was exaggerated by large orders. Demand has weakened significantly since then. The most recent survey figures indicate that the economy has not yet got back on its feet; the slight downward trend in business expectations in the industrial sector, which began around a year ago, has continued. The decisive factor behind the pessimism is probably the sharp rise in the oil price, which is diminishing the profits of enterprises and causing a drain on the real income of private households. All in all, domestic demand will initially expand at only a very moderate pace. Exports will also increase only very moderately at first because growth abroad will also be curbed by the higher energy prices.

The Institutes expect that the lull will be gradually overcome over the course of this year. The conditions for an economic recovery will then be largely favorable. Thus, the dampening influences exerted by the high oil price will abate, and the retarding effects of the preceding appreciation will wear off. In addition, the expansion of the world economy will proceed briskly. This will support the export economy and, as the price competitiveness of enterprises improves, German exporters' world market share will increase slightly. Domestic demand will be bolstered by the continued low interest rates. In particular, investments in machinery and equipment are likely to rise; however, the recession will continue in the construction industry. Private consumption will liven up to some extent, given that the situation

on the labor market is likely to stabilize in the winter half of the year. The economic recovery will strengthen slightly next year, and the real GDP growth rate will probably surpass the trend growth rate of around 1%. Thus, the output gap, which the Institutes currently estimate at around 1%, will diminish. Despite all of this progress, however, the employment situation will improve only marginally.

The Institutes' predict that real GDP will grow by only 0.7% this year (cf. table 8), while the growth rate adjusted for working-day effects will be 0.9%. The rise is likely to amount to 1.5% in 2006 (1.7% after the adjustment for working-day effects). These predictions are based on figures from the national accounts prior to the impending revision by the Federal Statistical Office. The Institutes expect that the revision will not change the GDP growth rates affirmed to date in any substantial way and that the point of departure for the forecast is therefore reliable (cf. box 1).

The Institutes believe that the risks for the forecast's accuracy are more or less evenly distributed. Thus, a somewhat more favorable growth trend is likely if the price of crude oil should decrease to a much greater extent than expected, for example because the influence of speculation on price formation diminishes, or because supplies increase more rapidly than predicted. As a consequence, the economy of other countries would also improve, providing a further boost for exports. Conversely, weaker expansion in the USA, caused for exam-

## On the Revision of the National Accounts, 2005

On April 28, 2005, the Federal Statistical Office published the results of a comprehensive revision of the National Accounts for the period 1991 to 2004. The most important methodological modifications are presented in the following.<sup>1</sup>

### Introduction of preceding year price basis

Up to now, the trend for real Gross Domestic Product (GDP) has been expressed in constant prices with respect to a base year (*fixed price basis*). The base year was usually updated every five years in order to take account of interim shifts in price ratios. The revised method expresses the short-term real GDP trend in terms of the preceding year's prices (*preceding year price basis*). The longer-term real trend in relation to a specific base year (reference year) is calculated by means of chain-linking, i.e., multiplication of the benchmark figures for the annual changes in volume, where the results can be expressed either as chain indices or as chain-linked absolute figures. By adopting these new methods, Germany is complying with international efforts to harmonize national accounting procedures.

The fact that the price base is updated annually means that there is no longer any need to correct and express past economic trends in real values, as was often necessary under the old system every time the base year was changed. However, one disadvantage of the new system is the fact that the chain-linked results are not additive, i.e., the sum of the chain-linked values of the GDP components in volumes is not equal to the value of chain-linked GDP. The same is true for the chain-linked interim aggregate and for chain-linked geographical data (federal/Land/EU level). In general, a residual emerges (i.e., the difference between chain-linked GDP and the sum of the chain-linked volumes of its components).

Test calculations carried out by the Federal Statistical Office show that the rates of change of real GDP in recent years based on the preceding year's prices deviate only marginally from those based on fixed prices, as has been the case to date.

<sup>1</sup> Cf. Federal Statistical Office, Meeting of Expert Committee on National Accounts of November 26, 2003, <http://destatis.de/basis/d/vgr/vgrrevision.php>.

### New method for calculating banking output

The value of the services provided by financial intermediaries (FISIM<sup>2</sup>), which had been booked under intermediate consumption to date (and therefore had no impact on the figures for domestic product and national income), will be allocated in future to the specific customers of financial intermediaries. As far as banking services are classified as private household or government consumption, domestic product or national income will increase. Where banking services are used by economic units in the production process, they will continue to be classified as intermediate consumption. This practice will have an effect in particular on the amounts of gross value added, gross domestic product, and gross national income. In addition, the interest rate flows in the calculation of income-based GDP will change, as will consequentially the figures for disposable income. The aggregates of savings and the financial balance will not be affected.

### Increased use of hedonic price indices

The Federal Statistical Office will also introduce the use in the national accounts of hedonic producer, import, and export price indices for selected computer products in order to be able to take better account of changes in the quality of these goods. Hedonic price measurement assumes that every product can be broken down into elementary attributes (product characteristics) and that each product's price is determined by the specific combination of these attributes. In the case of a personal computer, for example, the product characteristics might be the capacity of the memory, the size of the hard disk, and the frequency of the processor. In the first step of the hedonic calculation, a functional link is estimated between the price and the product characteristics of a commodity. In the second step, this link is used to calculate quality-neutral price indices. The switch to hedonic price indices is likely to express the real trend for IT investments somewhat more dynamically than to date, because under given nominal turnover, the price component falls more sharply (or rises less sharply) as changes in quality are better conveyed. As far as the expenditure in question concerns domestically produced goods, the growth rate for real GDP also rises gradually.

<sup>2</sup> Financial Intermediation Services Indirectly Measured.

ple by a more restrictive monetary policy, would dampen growth prospects world wide. Thus, the German economy would also gain less momentum. While these factors depend on developments abroad, the uncertainty regarding the future course of economic policy represents a risk for the domestic economy. Should the public gain the impression that further necessary reforms are not being tackled, for example because the measures agreed at the 'Jobs Summit' are not being implemented, then the expectations of investors and consumers would deteriorate, and this would slow the pace of recovery.

## Individual trends

### Exports will recover status of economic engine

Following robust growth in the first half of 2004, exports subsequently slowed down significantly. The main reason were the dampening effects of the appreciation of the euro and the somewhat slower tempo of the world economy. Exports to America and Asia, in particular, tended to be weak (cf. table 9). By contrast, exports to the countries that export commodities, and especially to the OPEC countries and Russia, remained on a pro-



Table 9

## German Exports by Region

Nominal exports (special trade)

| Country group                 | 2002         |           |                       | 2003         |           |                       | 2004         |           |                       |
|-------------------------------|--------------|-----------|-----------------------|--------------|-----------|-----------------------|--------------|-----------|-----------------------|
|                               | Euro billion | Share (%) | % of GDP <sup>1</sup> | Euro billion | Share (%) | % of GDP <sup>1</sup> | Euro billion | Share (%) | % of GDP <sup>1</sup> |
| EU-25                         | 407.8        | 62.6      | 19.3                  | 423.6        | 63.8      | 19.9                  | 468.5        | 63.9      | 21.5                  |
| of which: euro zone           | 276.3        | 42.4      | 13.1                  | 288.7        | 43.4      | 13.6                  | 319.0        | 43.5      | 14.7                  |
| new EU countries <sup>2</sup> | 53.5         | 8.2       | 2.5                   | 56.5         | 8.5       | 2.7                   | 61.7         | 8.4       | 2.8                   |
| NAFTA <sup>3</sup>            | 79.2         | 12.2      | 3.8                   | 71.4         | 10.7      | 3.4                   | 74.6         | 10.2      | 3.4                   |
| East Asia <sup>4</sup>        | 52.3         | 8.0       | 2.5                   | 54.6         | 8.2       | 2.6                   | 60.5         | 8.2       | 2.8                   |
| of which: China               | 14.6         | 2.2       | 0.7                   | 18.3         | 2.8       | 0.9                   | 21.0         | 2.9       | 1.0                   |
| Others                        | 112.0        | 17.2      | 5.3                   | 114.9        | 17.3      | 5.4                   | 130.0        | 17.7      | 6.0                   |
| Total                         | 651.3        | 100.0     | 30.9                  | 664.5        | 100.0     | 31.2                  | 733.5        | 100.0     | 33.7                  |

<sup>1</sup> As % of nominal GDP. — <sup>2</sup> Poland, Hungary, Czech Republic, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Malta, Cyprus. — <sup>3</sup> USA, Canada, Mexico. — <sup>4</sup> Japan, China, Hong Kong, Taiwan, Singapore, Thailand, Indonesia, Malaysia, Philippines, South Korea.  
Sources: Federal Statistical Office; Institutes' calculations.

nounced upward trend (cf. figure 4). Sales to the euro zone also continued to expand briskly, stimulated by the favorable competitive position.

The conditions for the export economy will be relatively favorable all in all throughout the forecast period. Although the pace of growth will slow, the world economy will still remain on an expansive trajectory. Growth in the rest of the euro zone, which – at a share of 44% – is Germany's most important trading partner, will actually increase slightly. A further appreciation of the euro and an accompanying renewed weakening of price competitiveness is not expected. Germany's competitive position is actually likely to improve further with respect to the remainder of the euro zone because of its lower inflation rate. All of these factors suggest that the export economy will soon gain momentum again. However, a perceptible acceleration cannot be expected until mid-2005, when the dampening effects of the euro's appreciation will have abated and growth will have consolidated in the remainder of the euro zone. All in all,

exports will rise by 4.1% on average in 2005 and by 6.4% on average in 2006 (cf. figure 5).

Imports expanded substantially last year. They will continue to grow over the forecast period, albeit at a somewhat more moderate pace than before. The main factor behind the slowdown will be that both domestic demand and exports – the import content of exports is relatively high – will initially expand only moderately. As the increase in business investments accelerates, imports will expand at a faster pace from mid-2005 onward because a substantial share of German machinery investments now originates abroad. All in all, imports will rise by 3.8% this year and by 5.7% next year (cf. figure 6). Net exports will continue to grow, although at half a percentage point in both 2005 and 2006, the contribution to growth will be much less substantial than in 2004 (1.1 percentage points).

Export prices rose to an extent over the course of 2004, but this was largely a consequence of the sharp rise in prices for steel and mineral-oil products. The

### Box 2

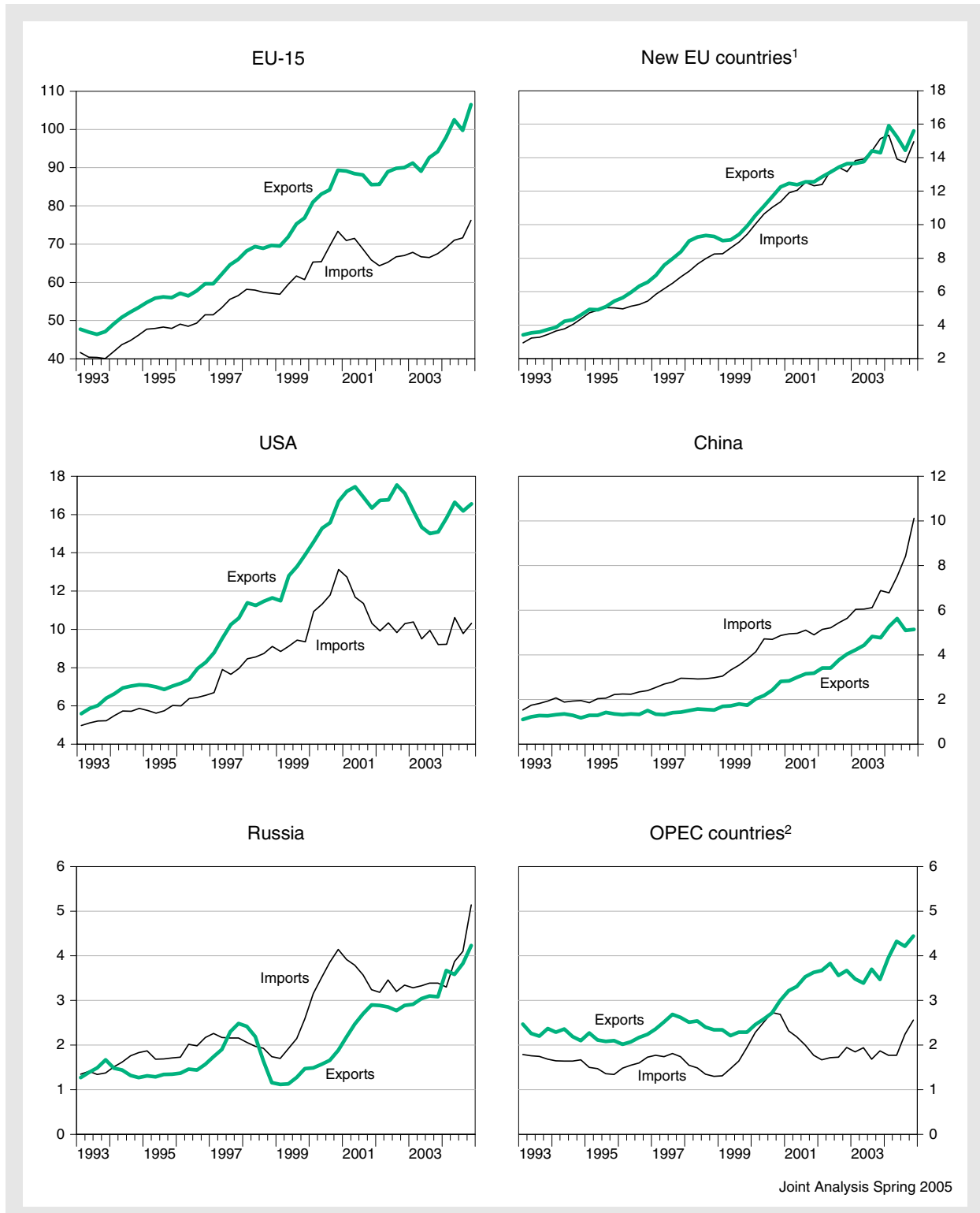
#### Assumptions underlying the forecast

This forecast is based on the following assumptions:

- The price of crude oil (Brent) will cost 50 US dollars on annual average in 2005 and 48 US dollars on annual average in 2006.
- World trade will expand by 7% this year and by 6.5% next year.
- The dollar/euro exchange rate will amount to 1.30 US dollars per euro over the forecast period. The German economy's price competitiveness will improve slightly.
- The European Central Bank will leave its main base rate unchanged at 2% this year and will raise it by 50 basis points over the course of 2006. Capital market rates will rise at a slightly faster pace.
- Negotiated hourly wages will increase by 1.5% on overall average this year and next year.
- Fiscal policy makers will implement their resolutions aimed at reducing the budget deficit. In addition, the reduction in corporation tax, income tax (via deductions for business tax), and inheritance tax, as well as the measures to finance these tax cuts, will enter into force on January 1, 2006, and the planned program to improve the transport infrastructure will be implemented.



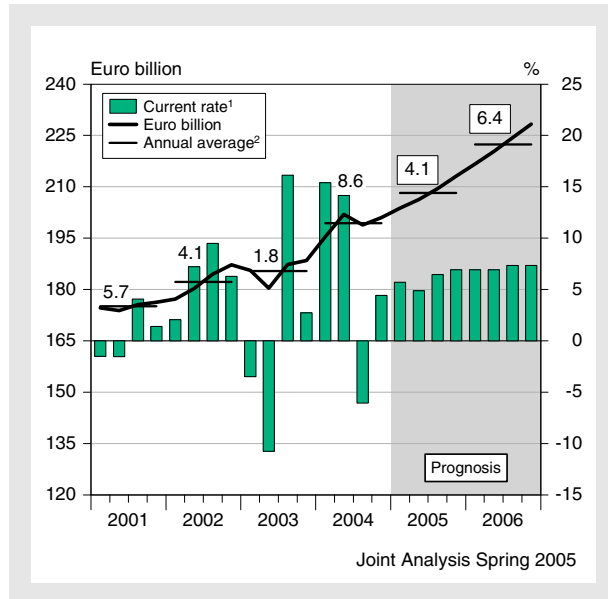
Figure 4  
**German Exports by Country and Region**  
 Special trade; seasonally adjusted quarterly values in billion euro



1 Poland, Hungary, Czech Republic, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Malta, Cyprus. — 2 Algeria, Libya, Nigeria, Venezuela, Iraq, Iran, Saudi Arabia, Kuwait, Qatar, United Arab Emirates, Indonesia.  
 Sources: Federal Statistical Office; Institutes' calculations.

Figure 5  
Real Exports

Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.  
Sources: Eurostat; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

effect of the euro's appreciation was overriding for the manufacturers of other products, who were forced to make price concessions. The pace of world growth will remain strong over the forecast period, and this will open up scope for price increases, assuming – as the Institutes do – that the euro does not appreciate any further; export prices will therefore rise slightly. Import prices rose sharply over the course of 2004, and the hike in commodity prices was only partially offset by the appreciation of the euro. The rise in import prices is likely to have accelerated sharply at the beginning of this year, partly because the increase in the price of oil and other commodities was no longer counterbalanced by relief provided by the exchange rate. As the price pressure exerted by the commodities markets abates, the rise in import prices will also weaken perceptibly over the forecast period. As import prices rise sharply, the terms of trade will show a pronounced deterioration on annual average in 2005 (cf. table 10). They will improve again slightly next year.

### Restraint in machinery investments will gradually diminish

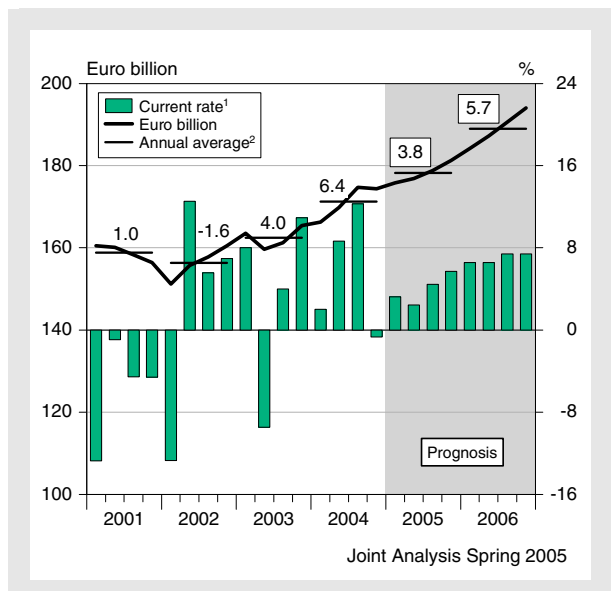
The year 2004 saw enterprises abandon their investment restraint and invest increasingly in machinery and equipment. The conditions for investment will remain

favorable over the forecast period. As growth strengthens, the sales prospects of enterprises will improve. Labor costs will rise only moderately, and interest rates will remain low. In addition, the burden on enterprises will be reduced by means of tax cuts and rescheduling of contributions for sickness benefit and dentures. Moreover, in the course of the upturn in the export economy, capacity utilization in industry rose once again to its average level for many years, so that expansion investments are increasingly on the agenda in this sector. However, a substantial share of the profits earned will probably initially continue to be used to pay off debts. Moreover, there are considerable differences across the various economic sectors and depending on enterprise size. Sales and profitability expectations have already brightened up appreciably in the export-oriented sectors, and profits have risen markedly. The prospects for the consumer-oriented sectors, by contrast, are improving only slowly.

In light of the disparate profit situations of enterprises, machinery investments will expand only slowly and not begin to accelerate until the latter half of this year. The fact that the domestic orders received by producers of investment goods have been stagnating for the last year also indicates that the propensity of enterprises to invest remains weak. Business expectations have also become gloomier – not least because of the high price of oil. Only the large orders received in the fourth quarter

Figure 6  
Real Imports

Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.  
Sources: Eurostat; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

Table 10  
Foreign Trade Indicators<sup>1</sup>

|                                  | 2001                            | 2002  | 2003 | 2004  | 2005  | 2006  |
|----------------------------------|---------------------------------|-------|------|-------|-------|-------|
|                                  | Change (%) on the previous year |       |      |       |       |       |
| Real exports <sup>2</sup>        | 5.7                             | 4.1   | 1.8  | 8.6   | 4.1   | 6.4   |
| Goods                            | 5.4                             | 3.2   | 2.6  | 10.1  | 4.6   | 6.4   |
| Services                         | 8.0                             | 10.2  | -3.0 | -1.0  | 0.8   | 6.2   |
| Real imports <sup>2</sup>        | 1.0                             | -1.6  | 4.0  | 6.4   | 3.8   | 5.7   |
| Goods                            | -0.2                            | -1.5  | 5.8  | 7.9   | 4.0   | 5.6   |
| Services                         | 5.7                             | -1.9  | -2.7 | 0.3   | 2.8   | 6.0   |
| Terms of trade                   | 0.0                             | 1.9   | 1.6  | -0.1  | -1.1  | 0.4   |
|                                  | Euro billion                    |       |      |       |       |       |
| Memo item:                       |                                 |       |      |       |       |       |
| Real net exports <sup>2</sup>    | 64.5                            | 103.1 | 91.5 | 114.2 | 121.3 | 134.0 |
| Nominal net exports              | 41.2                            | 94.8  | 92.2 | 114.1 | 114.2 | 131.5 |
| Balance of payments <sup>3</sup> | 3.3                             | 48.2  | 45.3 | 84.0  | 80.0  | 90.0  |

1 On national accounting definitions (ESNA 95). — 2 At 1995 prices. — 3 On balance of payments statistics definitions.  
Sources: Federal Statistical Office; German Bundesbank; Institutes' calculations; 2005 and 2006: Institutes' forecast.

of 2004, which will probably take the coming year to process, currently brighten the picture up to some extent. Investment in other equipment will expand to much the same extent this year as machinery investments. All in all, investment in machinery and other equipment is likely to rise by 3.8% this year and by 4.5% next year (cf. figure 7).

### Only weak consumption growth

Private consumption has been rising once again since the middle of last year, albeit only slowly. It received a boost from the tax cuts introduced at the beginning of this year; at the same time, however, rising energy prices diminished the purchasing power of private households. Moreover, the difficult situation on the labor market darkened the mood of consumers. Consumption growth is therefore likely to have remained weak.

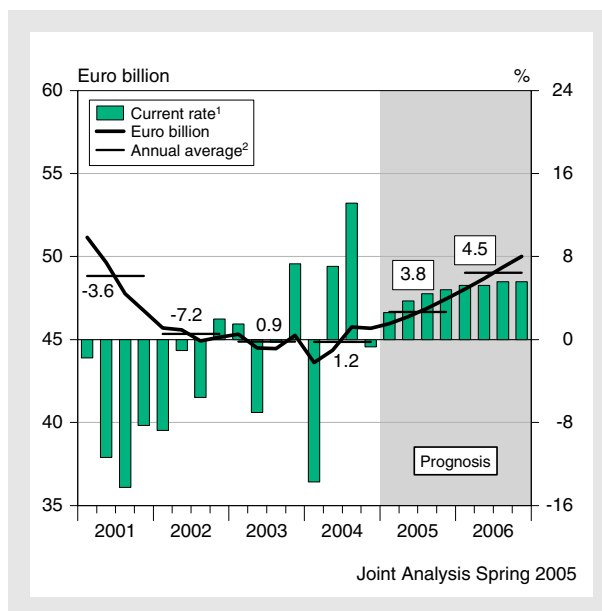
Private consumption will gain some degree of momentum over the further course of the year, and earned income will rise. The reasons are moderate growth in negotiated wages, a gradual improvement in the employment situation, and a slower reduction of non-tariff wage components. Net wages and salaries will increase at a slightly slower pace than previously, despite the tax cuts and the further reduction in contribution rates to statutory health insurance; in addition to

the rise by 0.25 of a percentage point in the contribution rates of the childless to nursing-care insurance, which entered into force at the beginning of this year, the principal additional burden is the fact that from mid-year onward, workers must finance contributions toward sickness benefit and dentures on their own. This results in an additional annual burden on workers of 4.5 billion euro and the same amount of relief for employers.

Monetary social benefits to private households will rise only very slightly because of reduced benefits and higher contributions for pensioners. Pensions will once again not be increased mid-year; the net pension amounts paid out will actually decrease as a result of the fact that pensioners are also subject to the additional contribution for dentures and sickness benefit. Likewise Unemployment Benefit II, which was introduced at the beginning of the year, will also lead on balance to benefit cuts.

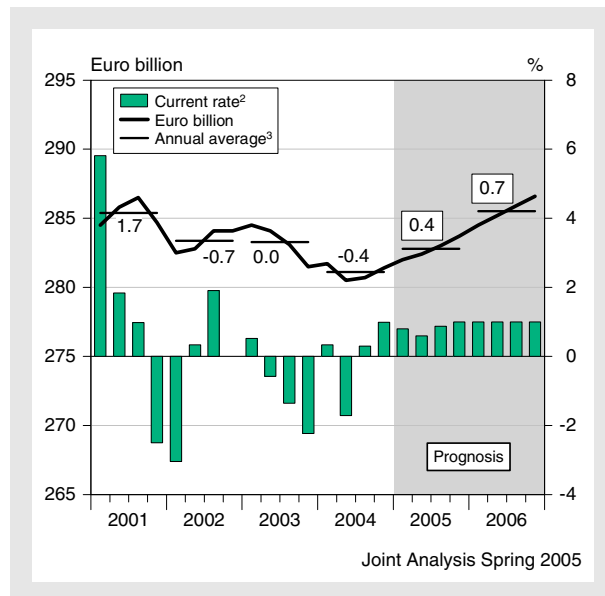
Income from self-employment and assets will rise at an accelerated rate as the economy picks up and also as a result of higher dividend and interest payments. All in all, at 2.1%, the disposable income of private households will rise at a sharper pace than the previous year; the real increase will amount to 0.4%. The savings ratio is likely to remain unchanged at 10.9%. While private pro-

Figure 7  
Real Investment  
in Machinery and Other Equipment  
Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.  
Sources: Eurostat; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

Figure 8  
**Real Private Consumer Spending<sup>1</sup>**  
 Adjusted for seasonal fluctuations and working days



1 Including private non-profit organizations. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Figures: change (%) on the previous year. Sources: Eurostat; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

vision for old age will gain significance as a reason for saving, as employment prospects become more favorable, the uncertainty of private households is likely to diminish. All in all, real private consumption will rise by 0.4% in 2005 (cf. figure 8).

Gross earned income will expand at a more substantial rate (1.6%) in 2006, in particular as a result of the growth in employment; net wages and salaries will increase at a weaker rate (1.1%), however, as a result of the progressive tax rate, even though contribution rates to statutory health insurance will fall slightly. Monetary social benefits will rise only very slightly once again, and pensions will again not be increased. All in all, the disposable income of private households will expand by 2.2% – similar to this year's figure. As the savings ratio remains unchanged and prices rise at a somewhat weaker rate, real private consumption will increase by 0.7% in 2006.

### Inflation will level off

Inflation strengthened to an extent as a result of external inflationary pressure and administrative measures and amounted to 1.8% in March compared with the previous year. The upward pressure on prices was exerted in particular by energy prices; excluding energy, the rise

in consumer prices amounted to only 1.2% in March. In addition, a renewed increase in tobacco tax entered into force at the end of last year; moreover, railway rates were increased, while radio and television license fees were raised at the beginning of April. The fact that inflation remained relatively moderate despite the not inconsiderable external impulses is largely a consequence of the continued weak growth in labor costs.

The increase in the cost of living is likely to remain moderate over the forecast period. The external impulses will become less significant if, as assumed in the forecast, prices for mineral oil and other commodities decline slightly over the course of the forecast period. However, the preceding price rises will continue to be passed on for some time. Tobacco tax will be raised once again in September. All in all, the average inflation rate will amount to 1.7% this year, and to 1.5% next year.

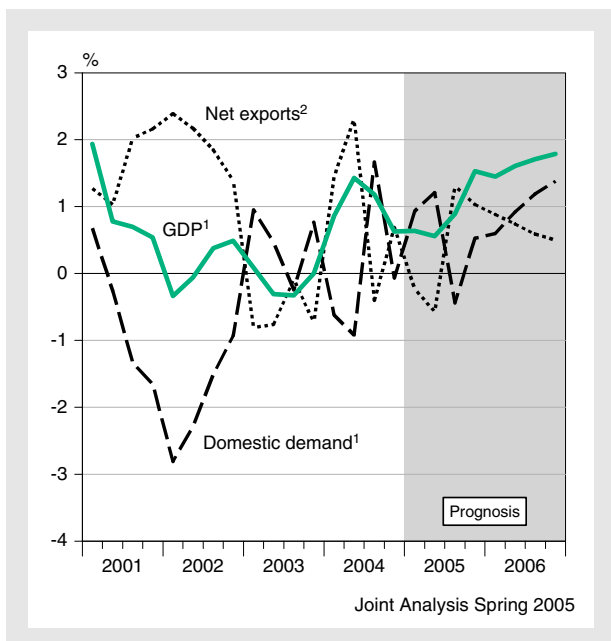
### Output growth will accelerate only gradually

The recovery of national output came to a halt in the second half of 2004. As external trade declined and domestic demand remained weak, GDP actually decreased slightly at the end of the year. However, the economic trend calculated for the final quarter of the year was probably understated, in the sense that the unusually high number of working days in December 2004 did not have the impact on output assumed in the adjustment for the working-day effect. By the same token, the rise in output in the first quarter of 2005 will be overstated. Following the revision for statistically determined distortions, national output is likely to have increased only slightly in the winter half of the year. The rise in output is likely to remain similarly low in the second quarter of 2005.

Output growth will accelerate slightly over the further course of this year (cf. figure 9). It will remain moderate, however, for the expansive forces in the domestic economy will strengthen only gradually. Industrial output is likely to rise at a modest pace. The recovery of domestic investment in machinery will boost manufacturing of machinery and equipment, whose expansion has been mainly driven by the external economy to date. Activity in the construction sector is likely to decline again sharply. Overall, the Institutes expect real GDP to increase this year by 0.7% (cf. figure 10).

The expansion of national output will accelerate in 2006. As overall demand rises, the upturn will spread. Industrial output will increasingly gain momentum; in addition, the decline in the construction sector will slow. A significant rise in value added in trade and among private service providers can be expected in the tertiary

Figure 9  
**GDP, Domestic Demand and Net Exports**  
 Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous year. — 2 Difference between real net exports in current quarter and equivalent quarter one year previously as % of real GDP in equivalent quarter one year previously (contribution to growth).  
 Sources: Eurostat; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

sector. All in all, GDP will rise by 1.5% in 2006 (cf. table 11).

### Little improvement on the labor market

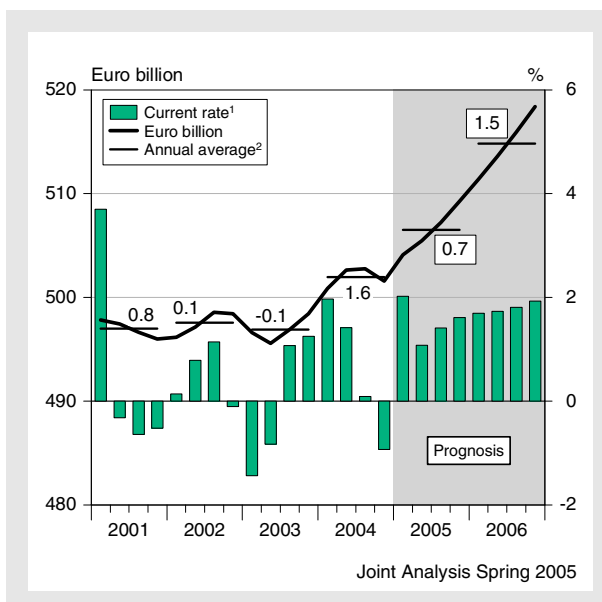
Developments on the German labor market have been substantially characterized in recent months by the effects of the government's labor market policy. Thus, last year's slight increase in the number of employed was based exclusively on the robust rise in 'minijobs' and 'Ich-AG' small businesses, and – in the last third of the year – also in non-profit employment opportunities ('supplementary jobs'). By contrast, the number of employees subject to mandatory social insurance, which currently reflects the underlying economic trend more accurately than the number of active members of the labor force, decreased further in 2004 – by 0.7% over the course of the year. However, the decline slowed in the second half of the year. The introduction of the Hartz IV reforms at the beginning of this year led statistical unemployment to soar, which also obscured the underlying economic trend.

While employment prospects will brighten up this year as the economic recovery continues, the growth

dynamic will actually be too weak to engender a rapid and profound improvement of the situation on the labor market. Nonetheless, the decline in the number of insured employees is likely to come to a halt during the second half of the year. This number can be expected to rise again in 2006 for the first time in five years, albeit only slightly (cf. table 12, figure 11). The number of active labor force members, by contrast, will continue to increase appreciably this year as a consequence of labor market policy (cf. figure 12). While the momentum will weaken among persons employed exclusively in a marginal capacity, this decline will be compensated by the brisk spread of 'supplementary jobs.' A further robust increase in 'Ich-AG' small businesses can also be expected. The volume of labor will almost stagnate this year (cf. figure 13). The rise in employment will slow again in 2006, however, as the number of persons founding their own businesses decreases and the number of 'supplementary jobs' rises only very slightly. The volume of labor will show a marginal increase.

The sharp rise in the number of employed has had very little impact on the number of unemployed. The main reason is that, on the one hand, a high share of minijobs have been occupied by individuals who were not previously registered as unemployed (pupils, students, housewives, and pensioners). On the other, unemployed people who take up marginal employment do not

Figure 10  
**Real GDP**  
 Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.  
 Sources: Eurostat; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

Table 11

### Contribution of Demand Components to Increase in GDP<sup>1</sup>

In percentage points

|                                 | 2004 | 2005 | 2006 |
|---------------------------------|------|------|------|
| Consumer spending               | -0.2 | 0.2  | 0.5  |
| Private households <sup>2</sup> | -0.2 | 0.2  | 0.4  |
| Government                      | 0.1  | 0    | 0.1  |
| Fixed capital formation         | -0.2 | 0.1  | 0.3  |
| Machinery and other equipment   | 0.1  | 0.3  | 0.4  |
| Construction                    | -0.3 | -0.2 | -0.1 |
| Change in stocks                | 0.7  | 0    | 0.1  |
| Domestic demand                 | 0.4  | 0.3  | 0.8  |
| External surplus/deficit        | 1.1  | 0.4  | 0.6  |
| Exports                         | 3.2  | 1.7  | 2.6  |
| Imports                         | -2.1 | -1.3 | -2.0 |
| GDP <sup>3</sup>                | 1.6  | 0.7  | 1.5  |

1 Cf. table 8 for definition. At 1995 prices; figures may not sum due to rounding. — 2 Including private non-profit organizations. — 3 Change (%) on the previous year. Sources: Federal Statistical Office; 2005 and 2006: Institutes' forecast.

lose their status as unemployed as long as they work less than 15 hours per week. The fact that the average number of unemployed was barely higher in 2004 than in 2003, despite a significant increase over the course of the year, is due alone to the fact that participants in aptitude testing and vocational training programs have no longer been counted as unemployed since the beginning of 2004. Under the old definition, the number of unemployed would have risen by almost 100 000.

The number of unemployed rose in the first three months of this year by around 480 000 (seasonally adjusted figure). This was mainly a result of the fusion of unemployment assistance and social assistance; the additional unemployed are mainly former beneficiaries of social assistance or family members of former beneficiaries of unemployment assistance who are seeking work. But even without the effects of the Hartz IV labor market reforms, the number of unemployed would have risen significantly.

The implementation of Hartz IV will continue to influence the trend for the number of unemployed for some time.<sup>9</sup> Because in those municipalities that have chosen the 'optional solution' (the local authority assumes full responsibility for Unemployment Benefit II) recipients of social assistance who are fit for work are not yet included in the unemployment statistics, a further rise in the number of unemployed is inevitable. This group, which is estimated by the Federal Labor

Office to amount to almost 90 000 persons,<sup>10</sup> is not likely to be included in the statistics until the second half of the year. On the other hand, revisions of the number of social assistance beneficiaries who are fit for work and who have already been counted are also likely; some of these are likely to be removed from the statistics when the figures are monitored again. Placement in 'supplementary jobs' will also reduce the number of unemployed over the course of the forecast period. A sharp decline in the number of unemployed can therefore be expected subsequent to mid-2005, and this decrease will persist next year, too. A turnaround in the unemployment trend can then be expected as the economic recovery continues.

### Slight decline in government budget deficit

The financial situation of the public budgets remained tight last year. While the state reduced its spending, government revenue also declined as tax cuts entered into force and the German Bundesbank transferred only minimal profits to the government compared to 2003. On balance, the public budget showed a deficit of 80 billion euro in 2004 and, at 3.7%, the deficit ratio once again greatly exceeded the limit laid down in the Maastricht Treaty.

Only a slight decline in the deficit ratio – to 3.4% – can be expected in 2005. While government spending is likely to rise by 0.4%, revenue can be expected to increase by 0.9%. Once again, tax revenue will be diminished by cuts in wage tax and assessed income tax – this time by 6 billion euro; in addition, there will be revenue losses of 1 billion euro as a consequence of the gradual transition to downstream pension taxation. The revenue from corporate and business tax, by contrast, will expand quite considerably as profits rise; moreover, the possibilities for carrying forward losses have been restricted, and individual tax concessions have been reduced. Taxes on turnover are likely to continue to grow only slowly because consumer spending will again expand only moderately. Revenue from mineral-oil tax is likely to fall again over the course of this year because

<sup>9</sup> This forecast is based on the assumption that, as a result of Hartz IV, the number of unemployed will be increased on balance in 2005 by an average 210 000. This calculation estimates the effects that increase unemployment at 445 000 and those that reduce unemployment at 70 000; additional employment-increasing effects amounting to 165 000 (without displacement effects) are assumed. For details of the effects of Hartz IV on unemployment and employment, cf. 'The world and the German economy in the autumn of 2004.' In: *DIW Economic Bulletin*, vol. 41., no. 11, November 2004, p. 397 ff.

<sup>10</sup> Cf. Bundesagentur für Arbeit: 'Der Arbeits- und Ausbildungsstellenmarkt in Deutschland.' *Monthly Report*, March 2005, p. 4.



Table 12  
**Labor Market Data**  
 Annual averages in 000s

|   | 2001   | 2002   | 2003   | 2004   | 2005   | 2006   |
|---|--------|--------|--------|--------|--------|--------|
| Germany                                       |        |        |        |        |        |        |
| Employment (domestic concept) <sup>1</sup>    | 38 863 | 38 642 | 38 265 | 38 396 | 38 681 | 39 017 |
| Employees                                     | 34 786 | 34 545 | 34 096 | 34 089 | 34 254 | 34 496 |
| Employment (national concept) <sup>1</sup>    | 38 922 | 38 696 | 38 314 | 38 442 | 38 731 | 39 067 |
| Employees                                     | 34 845 | 34 599 | 34 145 | 34 135 | 34 304 | 34 546 |
| of which:                                     |        |        |        |        |        |        |
| Insured employed                              | 27 901 | 27 629 | 27 007 | 26 573 | 26 440 | 26 477 |
| Exclusively marginally employed               | 4 126  | 4 147  | 4 319  | 4 735  | 4 905  | 5 058  |
| Supplementary jobs                            |        |        |        | 12     | 178    | 317    |
| Self-employed                                 | 4 077  | 4 097  | 4 169  | 4 307  | 4 427  | 4 521  |
| of which: Ich-AG                              |        |        | 41     | 154    | 265    | 250    |
| Net commuters                                 | 59     | 54     | 49     | 46     | 50     | 50     |
| Unemployed <sup>1</sup>                       | 3 853  | 4 061  | 4 377  | 4 381  | 4 844  | 4 518  |
| Unemployment rate <sup>2</sup>                | 9.0    | 9.5    | 10.3   | 10.2   | 11.1   | 10.4   |
| Unemployed (ILO) <sup>3</sup>                 | 3 109  | 3 438  | 3 838  | 3 920  | 4 106  | 3 825  |
| Unemployment rate (ILO) <sup>4</sup>          | 7.4    | 8.2    | 9.1    | 9.3    | 9.6    | 8.9    |
| Active labor market policy                    |        |        |        |        |        |        |
| Short-time working                            | 123    | 207    | 196    | 151    | 130    | 100    |
| Job-creation schemes                          | 220    | 180    | 145    | 119    | 70     | 50     |
| Full-time further vocational training         | 315    | 300    | 224    | 160    | 140    | 95     |
| West Germany <sup>6</sup>                     |        |        |        |        |        |        |
| Employment (domestic concept) <sup>1, 7</sup> | 31 138 | 31 037 | 30 745 | 30 855 | 31 081 | 31 347 |
| Unemployed                                    | 2 321  | 2 498  | 2 753  | 2 781  | 3 174  | 2 958  |
| Unemployment rate <sup>2</sup>                | 6.9    | 7.4    | 8.2    | 8.3    | 9.3    | 8.6    |
| Active labor market policy                    |        |        |        |        |        |        |
| Short-time working                            | 94     | 162    | 161    | 122    | 105    | 80     |
| Job-creation schemes                          | 38     | 30     | 29     | 24     | 15     | 5      |
| Full-time further vocational training         | 169    | 162    | 129    | 85     | 75     | 40     |
| East Germany <sup>6</sup>                     |        |        |        |        |        |        |
| Employment (domestic concept) <sup>1, 7</sup> | 7 725  | 7 605  | 7 520  | 7 541  | 7 600  | 7 670  |
| Unemployed <sup>1</sup>                       | 1 532  | 1 563  | 1 624  | 1 600  | 1 670  | 1 560  |
| Unemployment rate <sup>2</sup>                | 16.5   | 17.0   | 17.8   | 17.5   | 18.0   | 16.9   |
| Active labor market policy                    |        |        |        |        |        |        |
| Short-time working                            | 29     | 45     | 35     | 29     | 25     | 20     |
| Job-creation schemes                          | 182    | 150    | 116    | 95     | 55     | 45     |
| Full-time further vocational training         | 146    | 138    | 95     | 75     | 65     | 55     |

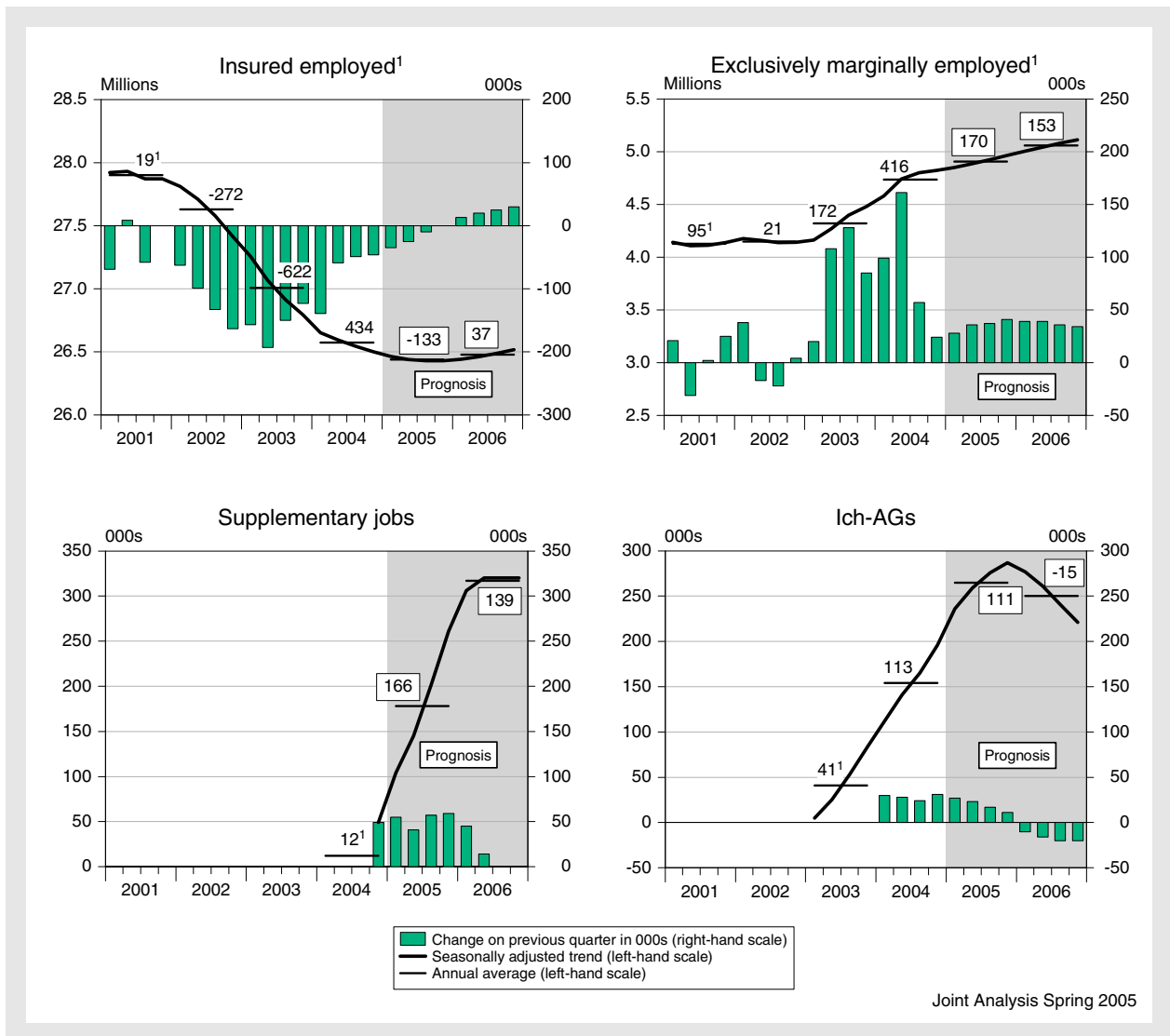
1 The labor force data is based on Series 18 of the National Accounts, Round 3 (data from IV/2004), because these are compatible with the current national accounts. — 2 From 2004 onward, not including participants in aptitude testing and vocational training programs. — 3 Unemployed (national concept) as % of domestic labor force (employed plus unemployed). — 4 ILO definition. — 5 Unemployed (ILO definition) as % of domestic labor force (employed plus unemployed). — 6 Western Germany: former West Germany excluding Berlin; Eastern Germany: former East Germany including Berlin. — 7 Institutes' estimate based on the results for the individual Länder of the 'Labor Force Estimations' of February/March 2005.  
 Sources: Federal Statistical Office; Federal Labour Office; joint federal and state government working group 'Labour Force Estimations' (data from February/March 2005); 2005 and 2006: Institutes' forecast.

the higher prices will lead to more thrifty behavior on the part of consumers, while more motorists living in the border areas of Germany will fill their gas tanks abroad. On the other hand, additional revenue will be created by the fact that tobacco tax rates will be raised once again.

In view of the expected income and employment trends, the revenue of the social insurance funds is also likely to show only a very slight increase, given that the average burden of contributions will decline slightly. While the contribution of childless individuals to nurs-



Figure 11  
Employment Trend by Sector



<sup>1</sup> Adjusted for seasonal fluctuations. — 2 Figures: change on preceding year in 000s.  
 Sources: Federal Labour Office; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

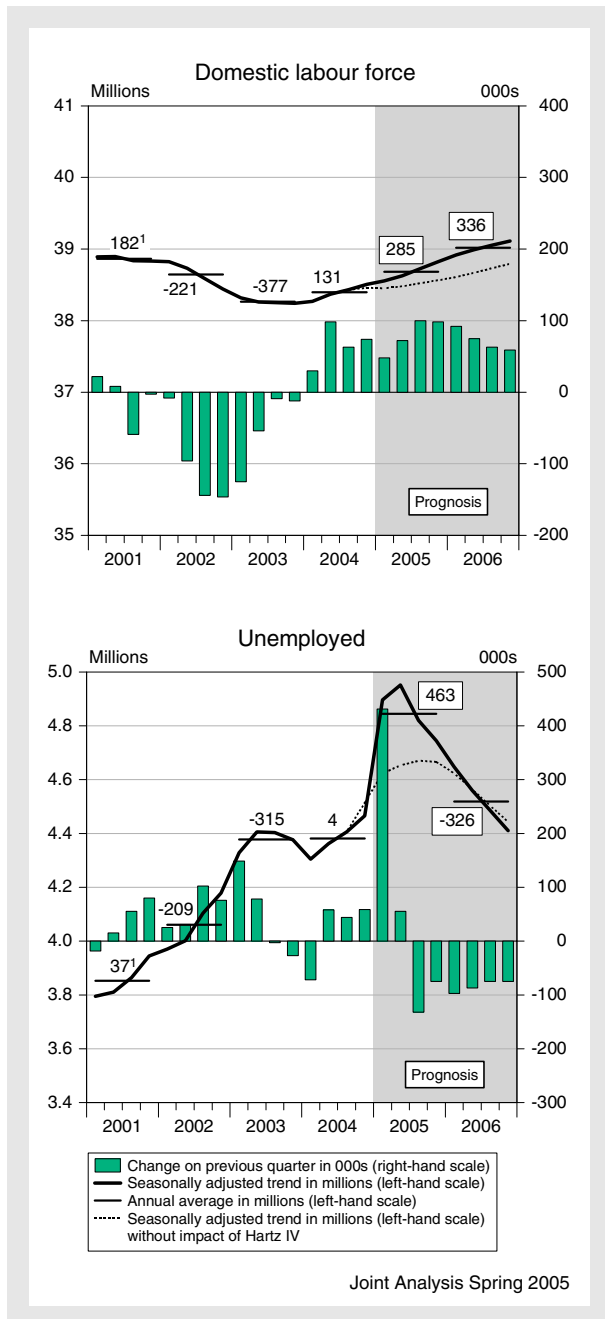
ing-care insurance was increased at the beginning of the year, the contribution rate to statutory health insurance will decrease to 14.1% over the course of the year, following a rate of 14.2% in 2004.

Government expenditure on personnel will fall by 0.5% as further staff is shed and collectively agreed wages probably rise only moderately. Spending on social benefits in kind will rise again, by contrast, having fallen in 2004 as a consequence of the reform of statutory health insurance. The labor market reforms are likely to lead to savings in themselves because they will slightly reduce spending per beneficiary. Nonetheless, labor market-related spending is likely to rise because a

higher number of beneficiaries can be expected than in 2004. While pensions will not be raised in mid-2005,<sup>11</sup> the number of pensioners is likely to increase further.

<sup>11</sup> The adjustment of old-age pensions takes place mid-year and depends on the preceding year's wage growth, on the change in the contribution rate to statutory pension insurance, on the change in the rate for authorized private additional provisions (the 'Riester pension'), and on what is known as the sustainability factor. The latter takes account of the ratio of the number of pensioners to that of contributors. When the result of the pension formula is a reduction in pensions, although the wages and salaries of insured employees rose the previous year, old-age pensions remain unchanged (in accordance with the clause that guarantees a minimum pension level); this is the situation in 2005 and 2006.

Figure 12  
Persons in Employment and Unemployed  
Seasonally adjusted<sup>1</sup>

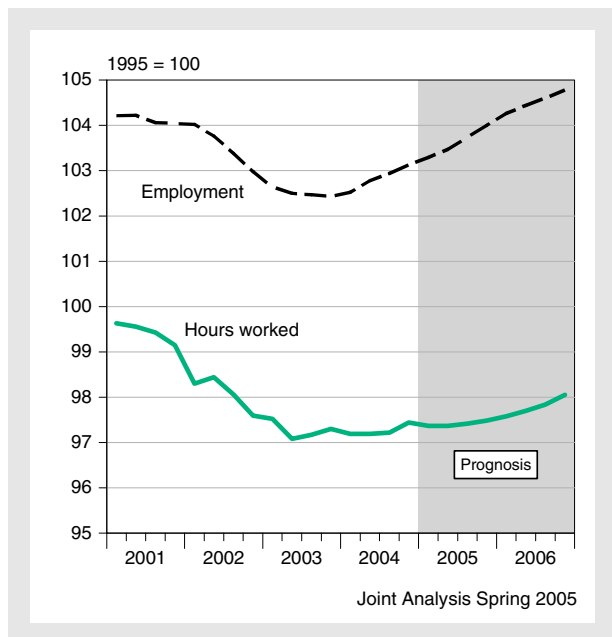


<sup>1</sup> Figures: change in original figures compared to previous year in 000s.  
Sources: Federal Statistical Office; Federal Labor Office; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

All in all, monetary social benefits will rise by 0.5%. Subsidies will also decline in 2005, in particular because of lower coal subsidies.<sup>12</sup>

Government investment is likely to fall again this year, albeit only slightly this time. Although the finan-

Figure 13  
Hours Worked<sup>1</sup> and Domestic Employment<sup>2</sup>



<sup>1</sup> Adjusted for seasonal fluctuations and working days. — <sup>2</sup> Adjusted for seasonal fluctuations.

Sources: German Bundesbank; Institute for Employment Research; Federal Statistical Office; Institutes' calculations; from 1st quarter 2005 onwards: Institutes' forecast.

cial situation of the local governments has stabilized – because revenue from local business tax is rising robustly and the Hartz IV reforms are probably reducing the burden on the budget – investment is rising only gradually. Government interest spending will be substantially higher this year than in 2004 because of the sharp rise in indebtedness. In addition, the government, especially, will benefit less in its debt rescheduling than in the past from the low level of interest rates and from the declining average interest return on debts resulting from a shorter term of maturity.

All of this would not lead one to expect a decline in the budget deficit. On the contrary, the deficit would rise to 3.8%. However, the burden on the public budgets will be eased by special factors. First, federal government subsidies to the pension fund for postal and telecommunications employees amounting to 5.5 billion euro will not be paid this year because this fund will be taking in earnings of this amount by selling some of its claims.<sup>13</sup> Second, some federal states will receive retrospective interest payments going back several years from their

<sup>12</sup> In 2004, and to a lesser extent also in 2003, subsidy rates were not adjusted downward in accordance with the sharp rise in world market prices for coal. As a result, the hard-coal mining sector received excessive financial assistance. The repayment of an estimated 0.8 billion euro will probably not take place until 2006.

Table 13  
**Selected Fiscal Policy Indicators,<sup>1</sup> 1992 to 2006**  
 As % of nominal GDP

|                   | Government receipts |           |                                | Government expenditure |                   |                  | Financial balance | Memo item: interest/tax ratio <sup>2</sup> |
|-------------------|---------------------|-----------|--------------------------------|------------------------|-------------------|------------------|-------------------|--|
|                   | Total               | Of which: |                                | Total                  | Of which:         |                  |                   |  |
|                   |                     | Taxes     | Social insurance contributions |                        | Interest spending | Gross investment |                   |  |
| 1992              | 45.5                | 22.8      | 17.6                           | 48.1                   | 3.3               | 2.9              | -2.6              | 14.3                                       |
| 1993              | 46.2                | 22.9      | 18.2                           | 49.3                   | 3.3               | 2.8              | -3.1              | 14.6                                       |
| 1994              | 46.6                | 22.9      | 18.6                           | 49.0                   | 3.3               | 2.7              | -2.4              | 14.6                                       |
| 1995 <sup>3</sup> | 45.9                | 22.5      | 18.8                           | 49.3                   | 3.7               | 2.3              | -3.3              | 16.3                                       |
| 1996              | 46.9                | 22.9      | 19.4                           | 50.3                   | 3.7               | 2.1              | -3.4              | 16.0                                       |
| 1997              | 46.6                | 22.6      | 19.7                           | 49.3                   | 3.6               | 1.9              | -2.7              | 16.1                                       |
| 1998              | 46.6                | 23.1      | 19.3                           | 48.8                   | 3.6               | 1.9              | -2.2              | 15.6                                       |
| 1999              | 47.3                | 24.2      | 19.0                           | 48.7                   | 3.5               | 1.9              | -1.5              | 14.4                                       |
| 2000 <sup>4</sup> | 47.1                | 24.6      | 18.6                           | 48.2                   | 3.4               | 1.8              | -1.2              | 13.7                                       |
| 2001              | 45.5                | 23.0      | 18.5                           | 48.3                   | 3.3               | 1.8              | -2.8              | 14.2                                       |
| 2002              | 45.1                | 22.7      | 18.5                           | 48.7                   | 3.1               | 1.7              | -3.7              | 13.8                                       |
| 2003              | 45.0                | 22.6      | 18.6                           | 48.8                   | 3.1               | 1.5              | -3.8              | 13.8                                       |
| 2004              | 43.8                | 22.1      | 18.2                           | 47.5                   | 3.0               | 1.4              | -3.7              | 13.7                                       |
| 2005              | 43.5                | 21.9      | 18.0                           | 47.0                   | 3.1               | 1.4              | -3.4              | 14.1                                       |
| 2005              | 42.9                | 21.7      | 17.8                           | 46.2                   | 3.1               | 1.4              | -3.3              | 14.2                                       |

<sup>1</sup> On national accounting definitions. — <sup>2</sup> Government interest spending as % of tax revenue. — <sup>3</sup> Excluding asset transfers linked to the assumption of the debts of the Treuhandanstalt (privatization agency) and the housing sector of the former GDR (-119.4 billion euro). — <sup>4</sup> Excluding receipts from the sale of UMTS licences (50.8 billion euro). Sources: Federal Statistical Office; Institutes' calculations; 2005 and 2006: Institutes' forecast.

Land banks on assets they had transferred to them; otherwise the European Union would view the agreements reached between the individual Länder and these banks as illicit subsidies. These payments will produce revenue of 3.3 billion euro this year, compared to 1.0 billion euro last year. However, these sums will be largely transferred back again to the Land banks in the form of share acquisitions. The Land banks' payments are counted as government revenue by the Federal Statisti-

cal Office, whereas only a small share of stock acquisitions is counted as government spending, so that these transactions result in a lower deficit. It is assumed here that Eurostat will consider this practice to be in keeping with the terms of the Maastricht Treaty. The budget deficit will then fall to 76 billion euro this year, which will amount to 3.4% of nominal GDP (cf. table 13).

A slight improvement in the government financial situation looks likely in 2006. The austerity course will basically be continued as regards public spending, but, at 0.9%, spending is likely to be increased at a slightly higher rate. The greatest spending block, monetary social benefits, will expand only slightly; one reason is that pensions will once again not be raised. Personnel spending will fall again, this time by 0.7%, as a result of the continued reduction in personnel; the fact that wages in eastern Germany will be brought closer to the western level will drive personnel costs upward. Social benefits in kind are likely to expand perceptibly. While the cost-cutting in the health system has sharply reduced the level of spending, these efforts will do little to curb the spending dynamic. Public investment spending will

<sup>13</sup> The pension fund for postal and telecommunications employees, which is classified under the private sector in the national accounts, is entitled until 2040 to contributions from the enterprises that have succeeded Deutsche Bundespost. These – together with allocations from the federal government – will serve to finance pensions. Some of these claims are to be sold in 2005 and the sales are expected to generate income of 5.5 billion euro, so that the federal government grant need no longer be paid. However, the federal government will have to make higher payments in future because the contributions by the enterprises that have succeeded Deutsche Bundespost will then be lower. Basically it is a matter of hidden debts on the part of the federal government, but on national accounting definitions the government budget deficit will be lower than otherwise in 2005. However, it is not yet clear whether Eurostat will accept this type of accounting.

Table 14

### Effects of Discretionary Measures on Taxes, Social Security Contributions, and Government Spending<sup>1</sup>

Increase (+) and decrease (–) in the tax burden on households in billion euro compared with 2004

|  | 2005             | 2006             |
|--|------------------|------------------|
| Reduction in income-tax rates (3 <sup>rd</sup> phase of tax reform)  | –6.2             | –6.3             |
| Reduction of tax concessions (e.g., grant for owner-occupied new housing) <sup>2</sup>   | 3.9              | 6.3              |
| Pension Income Act   | –1.0             | –1.3             |
| Increase in tobacco tax  | 0.7              | 1.1              |
| Reform of business tax   | 0.3              | 0.4              |
| Efforts to combat illicit employment   | 0.8              | 0.9              |
| Reduction of corporate tax rate from 25% to 19% <sup>3</sup>   | –                | –5.5             |
| Reduction of income tax for single-owner businesses and private companies (increase in deduction of business tax from income tax) <sup>3</sup>                 | –                | –0.5             |
| Reduction of inheritance tax where business is maintained <sup>3</sup>   | –                | –0.6             |
| Limits on loss settlement (ship and media funds), limits on possibilities for carrying losses forward ('minimum taxation'), etc. <sup>3</sup>                  | –                | 4.5              |
| Increase in contribution rate to nursing-care insurance for persons without children (aged 23 to 65)   | 0.7              | 0.7              |
| Increase in contribution rate to nursing-care insurance for pensioners   | 0.4              | 0.4              |
| Introduction of sustainability factor in pension adjustment formula  | 0.0 <sup>4</sup> | 0.0 <sup>4</sup> |
| Reduction of average contribution rate to statutory health insurance by 0.15 of a percentage point in 2005 and by a further 0.10 of a percentage point in 2006 | –1.5             | –2.5             |
| Contribution by pensions to financing dentures   | 0.3              | 0.6              |
| Hartz IV   | 1.0              | 2.0              |
| 'Future Education and Care' investment program   | –0.6             | –1.0             |
| Program to improve transport infrastructure <sup>3</sup>   | –                | –0.5             |
| ERP (European Recovery Program) innovation program for SMEs (interest rate subsidies) <sup>3</sup>   | .                | .                |
| Toll on goods vehicles (net of implementation costs)   | 2.4              | 2.6              |
| Total  | 1.2              | 1.3              |
| Memo item:   |                  |                  |
| Repayment of coal subsidies  | .                | 0.8              |
| Capitalization of claims on pension fund for postal and telecommunications employees   | 5.5              | .                |
| Repayments by Land banks, stocking up capital of Land banks <sup>5</sup>   | 2.2              | –1.0             |
| Remission of debts owed by Iraq and some other countries   | –1.7             | –1.2             |

1 Not including savings in budgetary implementation and not including 'hidden' tax increases; not including macroeconomic repercussions. — 2 Especially measures under the Supplementary Budget Act 2004, implementation of government protocol declaration on conciliation procedure regarding Tax Benefits Reduction Act, Tax Benefits Reduction Act 2003). — 3 Resolutions agreed at 'Jobs Summit.' — 4 No savings are made as a result of the clause guaranteeing a minimum pension level, as explained in the text above. — 5 Effect on national accounting definitions; reduction of burden on budget in 2004: 1 billion euro.

Sources: Federal Ministry of Finance; Institutes' calculations.

rise again for the first time in over a decade. This will be partly due to the fact that income from the autobahn toll on goods vehicles will be largely used to finance trans-

port projects. In addition, it was agreed at the 'Jobs Summit' to increase public spending on infrastructure. Interest spending will increase to much the same extent as in 2005.

A 1.9% rise in tax revenue is expected on the basis of the economic trend predicted here. Revenue losses can be expected as a result of the assumed reduction in corporation, income, and inheritance tax. While these cuts are intended to have a 'neutral effect on revenue', the Institutes believe the federal government's ideas in this regard are too optimistic. The government hopes, in particular, to obtain additional revenue from the fact that enterprises will pay tax domestically on more of their profits because of the low tax rates (3.5 billion euro) and that loss settlement by ship and media funds will be restricted (2.5 billion euro). It is assumed here that the additional income will amount to only 4.5 billion euro (cf. table 14). Revenue from direct taxes will increase (unlike in 2005) as a result – in addition to the progressive tax rate – of the sharply rising profits. Income from indirect taxes will increase at a stronger rate than this year as a consequence of the recovery of domestic demand.

Revenue from contributions to social insurance will rise at a somewhat weaker rate in 2006 (1.2%) than gross wages because contribution rates to health insurance will again fall slightly. The contribution rate to statutory pension insurance will probably remain constant; however, if benefit rights remain unchanged, this means that the government subsidy to pension insurance will have to be increased.

Under these assumptions, the budget deficit will amount to 74 billion euro next year, or 3.3% of nominal GDP. The share of GDP accounted for by taxes and social security contributions will continue to decline, as will the share accounted for by government spending. All in all, fiscal policy this year and next year is likely to be slightly restrictive; this will be due, in addition to the discretionary changes to legislation presented in table 3.8, to savings made in the implementation of the budget and to 'hidden' tax increases.

The budget deficit is likely to be considerably lower in 2005 on fiscal statistics definitions than on national accounting definitions because the government will see unusually high income from privatization and because Russia and Poland will be paying off loans. As a result, the government's (gross) debts will rise at a lower rate than in 2004. The debt ratio, at 67.5%, will still significantly exceed the limit of 60% laid down in the Maastricht Treaty. Income from privatization will fall sharply in 2006 so that the change in the financing deficit will be considered similar under both fiscal statistics and national accounting definitions, while the debt ratio will rise to 68.5%.

## Economic Policy

After a good first half-year in 2004 the economy in Germany cooled again noticeably as the year went on. This reflected changes in the external economic environment, while domestic demand was weak throughout the period. Only a moderate recovery is evident for the prognosis period as well, with growth rates modest by international comparison. In the other countries of the euro zone, where similar conditions apply in monetary policy and foreign trade and payments, growth is more dynamic, and although these disturbances have dampened expansion, they did not, as in Germany, cause stagnation.

All this shows that Germany's basic problem is not cyclical, it is a growth problem. The growth trend in Germany is low, and people are becoming increasingly aware of it; they now only expect a slight rise in their incomes in future and accordingly they are holding back with decisions on consumption and investment. For large sections of the population real incomes are already falling. In 2005 pensions will not be raised for the second time in succession, and actual earnings have hardly risen for some time. This will only change essentially in the next few years if a higher growth rate can be achieved. The reason for the depressed outlook for incomes is not only fiercer international competition, it is also inadequacies in the institutional and political framework conditions, and insufficient readiness to deal with these. Far-reaching reforms are needed to overcome the weakness in growth, and they need to be based on a logical general concept.

Basically the economic policy makers are aware of this, and the first steps in reform have been taken. Agenda 2010 is an attempt to strengthen the forces of growth. And the labor market reforms proposed by the Hartz Commission certainly point in the right direction. Moreover, Minister Presidents Koch and Steinbrück have also put forward proposals for a reduction in tax concessions and financial aids, which, if they were implemented in full, would permit the ratio of taxes and charges to be lowered. The problem of high and steadily rising subsidiary wage costs has also been tackled with the reforms to the health and pensions systems, and more far-reaching proposals are under discussion to change the system of social security. Finally, in view of international tax competition a reduction in corporate taxation has been announced, and comprehensive reform of income tax is being discussed.

So there are enough proposals on the table. Some have already been implemented, although often only inadequately. In many cases the mistake was made of selling individual reform measures as a recipe for suc-

cess in themselves, so implying that further measures were not necessary, or at least that they could be pushed to the back of the queue. In 2002, for example, the proposals from the Hartz Commission were proclaimed as a means of reducing the number out of work by 2 million, optimism which the Economic Research Institutes never shared.

Often reforms were watered down with exceptions. As soon as 'unpleasant' side effects became visible 'subsequent improvements' were announced, which only added to the uncertainty. It was not surprising, for example, that after social assistance for the employable was merged with unemployment assistance the number registering unemployed rose above the 5 million mark in the winter of 2004/2005. The Institutes pointed out that this would happen in their diagnosis of autumn 2004. But the policy makers had not prepared the general public sufficiently for this development, and they overreacted to the public debate.

Far-reaching reforms will be needed to solve the growth problem. In many areas the conditions for growth need to be improved. The basic direction of the reforms should be clear: the state must reduce its influence on economic development, reduce the state share of GDP and increase the scope for private initiative. It must increase individual responsibility and concentrate on giving only basic security. Public funds must be used more efficiently and competition must be made more important as a coordination mechanism.

The first steps in this direction have already been taken. Among other things, based on the proposals by Minister Presidents Koch and Steinbrück, a start has been made on reducing tax concessions and subsidies. However, the implementation of these proposals should be accelerated, and the measures should go further. In particular, the reduction in corporate tax levels that has been announced, and is overdue in view of international tax competition, should be taken as the opportunity to reduce tax concessions and so widen the tax basis. The possibility of raising revenue by raising other taxes should not be considered, nor should a permanently high level of new borrowing.

Sound public finances are essential if the reforms are to be successful. If people fear that the burden of charges will not fall in future because the budget deficits are bigger, indeed that they may actually rise again, they will lower their expectations and exercise appropriate restraint. In the present prognosis Germany is expected to miss the target for the deficit limit in the Maastricht Treaty again this year, so it is all the more urgent to present a realistic concept to reduce new borrowing. However, in the view of the Institutes the new version of the Stability and Growth Pact has made the conditions for this worse.



The introduction of the 'patchwork pension' and the requirement for patients to shoulder more of the costs in the health system are the first steps towards strengthening individual responsibility for social security. They will also help to lower subsidiary wage costs. Reforms that are necessary both with regard for the demographic development and for the efficiency of the social security system should give priority to the principle of private provision.

The aim of the labor market reforms is not only to make the labor market more flexible. The Hartz IV reform will end the coexistence of two systems of assistance for the long-term unemployed and so increase efficiency. Moreover, efforts are now concentrated more on integration in the regular labor market. As the last stage of the reforms only came into force in January 2005 it is not yet possible to assess the success of this policy. But it may reasonably be doubted whether the reforms are sufficient. The free-riding and displacement effects, to which the Institutes have drawn attention several times, will probably be considerable. Certainly the incentives to take a job have generally been increased through the more stringent criteria on what is acceptable employment, and through the shorter period for which unemployment pay can be drawn, which will come into force in 2006. But for many who are drawing Unemployment Benefit II there are still few incentives to try and integrate in the labor market.

Projects that are now being initiated with public private partnership also offer the prospect of greater efficiency. One example is the use of the revenue from the heavy lorry toll to fund the transport infrastructure. Firstly, such projects can help to effect a more economical use of funds, and secondly the method of financing projects dependent on their use is also likely to be more efficient. If this will help ease a bottleneck in infrastructure expansion, and if public investment rises again, these projects will in themselves be promoting growth.

The general public still has great reservations about increasing elements of competition in the public sector. This applies to university tuition fees, for example, although they could also increase efficiency, particularly if it can be certain that they will flow to the universities and not into the general state budget. Social concerns can be taken into account adequately if fees are charged for university courses, for instance with scholarships or student loans. In the interests of equality of opportunity, on the other hand, expenditure on school education should be increased, for the PISA study has shown that in the German education system the socially disadvantaged have fewer chances than those in many other countries.

These examples show that much has already been started. But there is no sign of a coherent concept to

overcome the low level of growth. Individual steps in reform, many of which are too timid, will achieve little, indeed they may be counterproductive. It is not surprising that Ich-AGs and mini-jobs, which were introduced as part of the labor market reforms, are being used in many branches as a welcome means of reducing labor costs, because a rigidly regulated labor market and restrictive legislation on wage agreements do not permit other forms of flexibilization. Moreover, changes in one policy field will enforce reforms in others. Deregulation and opening of the labor market often lead to falling wages. The redistribution needed to cover the living costs of the low paid should only be made through the tax and transfer system, as they can perform this function more efficiently than social insurance. However, even if higher priority is on principle given to individual responsibility, the social insurance system must provide basic security in cases of illness, unemployment and for old age, a net that catches everyone whose income is not sufficient to provide for their needs. Even these few examples underline the necessity for a comprehensive concept of reform.

If it proves possible to direct policy in this way, the weakness in growth in Germany can be overcome, indeed, it can be overcome within a manageable period. That is proved by experience in other European countries, like Ireland, Finland and Great Britain, that have been through similar changes. But the example of Germany in the 1980s also shows that a rise in growth can be achieved as part of successful consolidation of the public budgets, combined with tax reductions and flanked by a moderate wage policy.

## Fiscal policy

Fiscal policy in Germany is still in a difficult position. The consolidation of the budgets is not progressing – on the contrary, the budget deficit in relation to GDP was again higher than 3% last year, and in the view of the Institutes that will be the case in this prognosis period as well. The deficit is being reduced more slowly than planned in the current Stability Programme, where deficit ratios of 2.9% and 2.5% are forecast. But public indebtedness is rising rapidly. At the same time new risks keep emerging for the public budgets, e.g. if the labor market reforms cause a loss of revenue to the social insurance institutes owing to displacement effects. In addition, the state has not fulfilled its obligation to contribute to higher growth with higher investment for years. The scope for action in fiscal policy seems to be greatly restricted. But that is not, in fact, the case. Rather, a reliable course is needed to show how the state intends to make its contribution to growth and

how sustainability in fiscal policy is to be ensured. It looks as if the seriousness of the situation has not been sufficiently grasped. The main problem is that medium-term economic growth will probably be much lower than the Federal Government is assuming. So the problems will not 'solve themselves', that is through a powerful economic upswing which is said to be expected.

### Budget consolidation after the reform of the Stability and Growth Pact

In March 2005 the heads of state and government of the EU states agreed on reform of the Stability and Growth Pact. The document, which is still provisional,<sup>14</sup> confirms that members must aim to keep to the upper limits laid down in the Maastricht Treaty for the budget deficit (3% of GDP) and total indebtedness (60% of GDP); the central target of the Pact, namely a balanced budget in the medium term, is also expressly confirmed. That is welcome. However, the rules under which proceedings will be instigated for an excessive deficit are relaxed; moreover, longer periods are now allowed for a country to reduce an excessive deficit.

Specifically the Pact has been amended in the following essential points:

1. Deficit proceedings may not be instigated if a country's real GDP is falling or growing at an extremely low rate – measured by its production potential – over a longer period. Until now that only applied if real GDP fell by at least 2% within one year.
2. Apart from a severe cyclical downturn until now only extraordinary events, like natural catastrophes, could be cited as reasons to avoid deficit proceedings. Now countries whose deficit moves temporarily above the 3% mark can cite other reasons as well. They include the cyclical situation and the implementation of structural reforms, in particular measures to implement the Lisbon Agenda (research, development and innovation). Moreover, efforts at consolidation in 'good' times, the ability to service the national debt and the quality of public finance may all be taken into account. In addition, expenditure to serve the purposes of 'European integration' and 'international solidarity' can now be cited. Examples of this now being named in public discussion are the German contribution to the EU budget and the transfers during German reunification, or part of military expenditure and development aid.
3. The periods between the establishment of an excessive deficit and the correction measures needed have been extended; now, in 'special circumstances', an excessive deficit may be corrected up to two years after it occurs, instead of after one year as previously required. That period may actually be extended, if economic events occur that have a negative effect on the budget. But they are only to be taken into account if a country can prove that it has implemented the corrective measures recommended to it.
4. In fixing the medium-term objectives the special circumstances of individual countries are to be taken into account. Countries with a low debt ratio and/or high potential growth may in future show a deficit ratio of 1% in the medium term; countries with a high debt ratio and/or low potential growth – so presumably Germany too – have the medium-term objective of a balanced budget or even budget surplus. In the process of adjustment to the medium-term budget objectives a reduction in the structural deficit of 0.5 percentage points a year in relation to GDP should be the aim. But the efforts at consolidation should go further, if real GDP is higher than the production potential. In bad cyclical phases budget consolidation can be less.

Important changes still need to be concretized to make the rules transparent. Otherwise there would be considerable scope in budget supervision, and differing interpretations would be likely that would further restrict the ability of the Pact to function. For example, it should be clear that the many exceptions allowed do not permit the deficit limit to be shifted upwards at will. The 3% mark can always only be exceeded temporarily. Moreover, the states are allowed too much time to reach the medium-term objective of a balanced budget. For that reason cyclical 'good times' must not be so defined so generously that they very rarely occur. It must also be clear which estimate of potential is to be used to assess the economic situation. The German Government's estimate, for instance, is above the usual average, and it is also above that of the European Commission. Consequently the German Government would define 'good times' differently, and so undertake consolidation very much later – if, indeed, at all.

It remains questionable whether all these problems of interpretation can be solved. Every government will cite measures that they believe were necessary to strengthen growth or reform the social insurance system, and thus justify a higher deficit. That is the weakness of the 'reform', it makes the new interpretation almost arbitrary, because the formulations are, at any rate so far, very vague. Clauses allowing exceptions for expenditure relevant to growth would help to improve the expenditure structure, for in the past savings have

<sup>14</sup> So far only the document from the Ecofin Council, 'Improving the Implementation of the Stability and Growth Pact' is available. The final version, which will describe the practical implementation, is still awaited; it is to be made available by the end of June 2005.



frequently been at the expense of investment, not only in Germany. But this would reduce the pressure to cut back on consumption spending, and the budget deficit would grow. In addition, it will probably be hard to find clear criteria by which to decide which individual items of expenditure do promote growth and European integration. Every country will produce its own interpretation of this, and there could be no limit to creative accounting. In the interpretation of the German Government the costs of German unification come into this category. It is certainly correct to say that German state indebtedness is higher today because of this than it would be otherwise; and presumably that is also why the growth trend in Germany has flattened. But this is only a small part of the reason why the deficit rose to more than 3% and has persisted above that level in recent years. Altogether, the rules on exceptions are not specific enough; they leave considerable scope for interpretation and this softens the deficit criterion.

The Stability and Growth Pact did not fail in the past because the rules were wrong or unrealistic, it failed because governments were not willing to keep their promises.<sup>15</sup> This is where the problem that rules are difficult to enforce in any area of economic policy became manifest. The problem was worsened for the Stability and Growth Pact in that the governments themselves decide on the deficit proceedings. That does not mean that the rules cannot function. But the governments must want them to function. It is up to them now to return to a sound fiscal policy.

In all this the basic question of how to define a sound fiscal policy inevitably arises. It certainly goes far beyond the rules of the Stability and Growth Pact. One of the principles, for example, is that the state must limit its activities to its essential tasks, that is, primarily the provision of public goods. In financing its expenditure the state should ensure that taxes distort as little as possible. State indebtedness is certainly permissible, but it should not always be rising, and if possible it should not exceed a certain level in relation to GDP. That is precisely the point of the Maastricht Treaty and its reference figures. The figure of 60% for state indebtedness, for example, is accepted as a meaningful indicator even by critics of the Pact, and in Great Britain the aim of economic policy is actually to bring the debt level down to 40% in the medium term.

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<sup>15</sup> DIW Berlin and the IWH agree with the criticism of the reform of the Stability and Growth Pact, but they believe that the easing of the conditions is ultimately a reaction to a fault in the construction of the Pact to consolidate public finances. The deficit is endogenous, and it cannot be fully controlled by fiscal policy. As pointed out in earlier reports they therefore recommend giving priority to limiting the rise in expenditure.

For the policy pursued by the German Government all this means that the budget consolidation course must now be resumed and that the aim must be to balance the budget in the medium term. According to current estimates the present budget deficit, adjusted for cyclical factors, is a good 3% of GDP. That means that if the structural deficit is reduced by 0.5 percentage points a year more than six years would be needed to balance the budget. In the view of the majority of the Institutes the German Government should be more ambitious here,<sup>16</sup> for two reasons. Firstly, the debt ratio has moved further and further away from the reference figure of 60% in recent years and is now heading for 70%; secondly, it must be remembered that the high level of state indebtedness implicit in future obligations is not included in this calculation; and thirdly, in the next downswing the budget deficit could be so large that the automatic stabilizers cannot work because the deficit is already too close to the 3% mark.

The Institutes have repeatedly argued that the priority must be to cut state spending. As the burden of charges is already too high the deficit should be reduced by cutting consumption spending and subsidies. That would have a positive effect on the growth of the production potential. Hence, the Federal Government's intention to reduce the public sector share in the next few years is to be welcomed. But that will hardly be possible to the desired extent, as the assumptions on the level of economic growth to be expected in the medium term are in all probability too optimistic. It is still assumed in the Federal Government's latest Stability Programme that real GDP will grow on average by nearly 2% a year; a rise of 3% is assumed in nominal GDP, which is ultimately important for calculating the figures. This assumption is unrealistic. Against that background, too, the Ecofin Council has warned in the document on reform of the Stability and Growth Pact that caution is needed in the prognoses. The Institutes therefore recommend assuming in the planning that nominal GDP in Germany will grow by only slightly more than 2% in the medium term.

For the budget consolidation course that means that state expenditure should hardly rise at all in the next few years. In addition, the course of fiscal policy should not be made dependent on the cyclical situation. It is not possible to estimate for several years ahead which will be a good cyclical phase and which will not. It is often impossible to predict that for one year in advance, as shocks can always occur and make a prognosis appear obsolete. Whether a gap in output is positive or negative

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<sup>16</sup> DIW Berlin and the IWH regard limiting the rise in expenditure to 1.5% in the medium term as a more realistic approach in budget consolidation.

in a certain year, so whether a year is cyclically 'good' or 'bad', cannot even be stated with certainty with the current methods a year later. So non-cyclical expenditure should be limited more than planned in the medium term. If the economic development then proves worse than expected the actual budget deficit will be higher; that should then be accepted, there is no need to cut back expenditure ex post. Conversely, the deficit will be lower if the economic trend proves better than expected, and if the budget deficit is not excessive the automatic stabilizers can work freely.

### Fiscal policy in specific areas

The state budget deficit may be expected to fall to 3.4% this year and 3.3% next year – both in relation to GDP. However, this year the Federal Government is making use of 'creative accounting' by selling claims held by the Postal Workers Pension Fund; in addition, the repayment of 'financial aids' by the state banks is being announced as a contribution to consolidation. These are not suitable measures to consolidate the public budgets, because the sale of claims will involve higher expenditure in future, and most of the repayments of the financial aids will flow back to the state banks in the form of capital.

In 2005 and 2006 the pensions insurance system will face high deficits if no steps are taken to prevent this. One reason for this is that the sustainability factor introduced into the pensions formula to cut down the contribution rate cannot have an effect owing to the inclusion of a clause in the law to secure the level of pensions. The fact that from next year pensions adjustment will no longer be based on the rise in gross wages but the rise in incomes on which contributions are paid (which is generally lower) will not alter this.

If, as announced, the Federal Government wants to keep the pensions contribution rate stable in 2006, as well, to avoid a rise in subsidiary wage costs, the looming deficit must be warded off in some other way. Beside increasing the Federal grant, the main proposals under discussion are to end benefits not covered by the insurance, increase pensioners' contributions to health insurance and make another reduction in the fluctuation reserve. If this were lowered from 20% to 10% of one month's out-payments it would save the pensions fund around 1.5 billion euros. It would be better to look for potential savings on the expenditure side. Hence, in the view of the Institutes it would be meaningful to take up the Rürup proposal, which is that cuts in old age pensions that are prevented by this clause in the law should be made later, in years when pensions are rising. In that way the sustainability factor would have its full effect. Beyond that it is urgently necessary to raise the statu-

tory retirement age, and to do this very much more quickly than has evidently been envisaged so far, although that will only ease the burden on the pension insurance system in the longer term.

Investment spending by the state has been falling for years. Most recently depreciation was actually larger than gross investment, so the state capital stock has been shrinking. By international comparison, too, Germany is investing little in its state capital stock. The European average for the state investment ratio is 2.5%, in Germany it is one percentage point lower. That is counter to the requirements of growth policy, for insufficient infrastructure expenditure can put a brake on growth. That applies even more to expenditure to promote human capital, that is, expenditure on education and research. Although according to the new growth theory this area of expenditure is probably the most important factor in economic growth, particularly for so highly developed an economy as Germany, the value attached to this in German policy has fallen in recent years. An infrastructure campaign by the public sector is therefore urgently needed, above all a change to higher spending on education and research is required. However, in regard to human capital it is certainly not just a matter of spending more money. In particular, efficiency needs to be promoted, in the universities, for instance, by ensuring more competition there. It is in keeping with the principle of the market economy to permit university tuition fees and allow the universities themselves to decide on the level and use. The idea that is clearly widespread in policy making of allowing university tuition fees to 'save' state spending in this area is counterproductive.

Although the financial situation of the municipalities is improving and the Federal Government intends to provide additional funds for the infrastructure, only a moderate rise in public investment spending is to be expected in this prognosis period. Although the Federal Government is providing additional funds, the amount of investment expenditure already earmarked in the budget is lower, even though for the first time revenue from the heavy lorries toll is available to finance investment in the transport infrastructure. Investment by the municipalities will probably increase slightly, but they will only invest noticeably more if they receive more funds from the states or the Federal Government (through the states), either through a redistribution of tax revenue or in some other way. If the states are to avoid both a rise in their budget deficits and an increase in taxation budget funds must be restructured in favour of investment. Expenditure has been cut in many areas in recent years, and this may well have reduced the scope for restructuring; nevertheless, there is still considerable potential for savings here.

Subsidies as defined by the national accounts will fall in 2005 and 2006, according to the prognosis by the Institutes. That is to be welcomed, and the Institutes have repeatedly argued for a rapid reduction in subsidies in their reports. Now it is important to accelerate that process. The list of tax concessions is long, and the extent of financial assistance (not only on Federal level) is considerable. A concept for cutbacks is available in the list of possible savings put forward by Minister Presidents Koch and Steinbrück. It should be implemented rapidly, in order to strengthen the forces of growth. It is incomprehensible that financial aids and tax concessions that are harmful to growth cannot be abolished within a period of five years. It would be all the easier politically the more it is made clear that at the same time taxes are being reduced and expenditure on public investment increased. The possibilities for increasing the efficiency of the public administration should also be exploited.

The Federal Government has commissioned the Council of Experts for the Assessment of the Macroeconomic Development to evolve a concept for comprehensive reform of corporate taxation. A reform could come into force in 2007. The first steps are to be taken as early as 2006 – as envisaged in the agreements made at the 'Job Summit'. Corporation tax is to be lowered from 25% to 19%, and companies that are not liable for corporation tax will also pay less, as they will be able to offset more of their trade tax against their income tax. At the same time the assessment basis for income tax is to be widened by reducing the possibilities for shipping and media funds to offset losses.

Reducing the rate of corporation tax is a step in the right direction, and it is a suitable reaction to the greater intensity of international tax competition. It might well induce multinational companies to tax more of their earnings in Germany. And the measures to limit exploitation of the possibilities for saving tax through holdings in funds can easily be justified in regard to the tax system. Altogether, the effect on investment activity and growth would be positive.

However, the tax reduction must not be limited to corporations, the large number of unincorporated companies also need tax relief. Hence a comprehensive concept to reform income and corporation tax is needed. On principle, the tax paid on all types of income needs to be markedly lower. Not least because this would lead to considerable reductions in revenue, the Council of Experts presented the outline of a consistent concept at the end of 2003 for a dual income tax.<sup>17</sup> It provides for

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<sup>17</sup> Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2004): 'Erfolge im Ausland – Herausforderungen im Inland.'

income from labor and income from capital to be taxed separately. Income from labor should, as hitherto, be taxed progressively. Income from capital should be taxed at a low flat rate. One of the main reasons for the differentiation is that capital is mobile and in international tax competition it reacts strongly to differences in tax rates. In concrete terms the Council of Experts has proposed taxing capital income at max. 30%; the present rate on earnings by corporations amounts to around 38%. To enable the same rates to apply to capital income generated in partnerships or other unincorporated companies the intention is to separate income into capital income and 'entrepreneurial earnings'. It is the view of the Institutes that the Federal Government should adopt this proposal for reform. Once the Council of Experts has worked out the details of a reform draft in the course of the year a dual income tax should be introduced quickly.

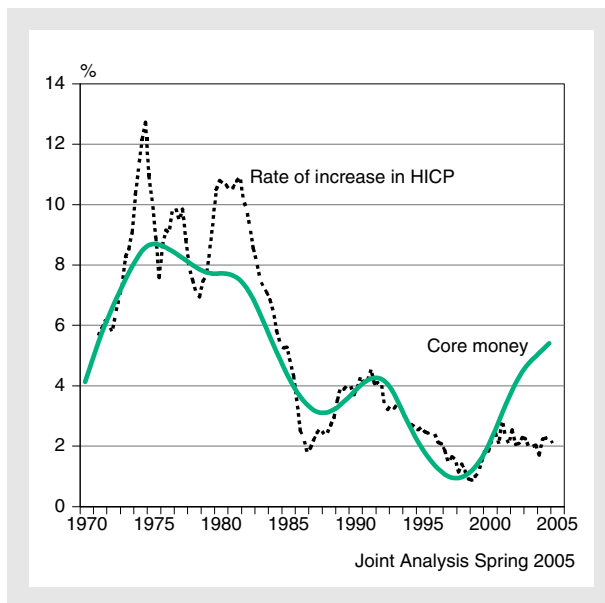
## Monetary policy

Monetary policy in the euro zone has been on an expansionary course for some considerable time. Both nominal and real short-term interest rates have been very low for a long time, and the growth rate in the money stock is clearly above the ECB's reference figure. Against that background it would be appropriate for the ECB to raise interest rates in this prognosis period, in order to counter the dangers to medium-term price stability – which have also been confirmed by more recent studies on the relation between growth in the money stock and inflation. However, the Institutes regard an increase in interest rates as only necessary next year, if the cycle has firmed in the euro zone. There are risks to the economic trend, not least from the monetary side. As pointed out in the first section of this report there is firstly still the risk of a drastic devaluation of the US dollar, which would also considerably dampen economic development in the euro zone. Secondly, capital market rates could rise in the United States much more strongly than assumed for this prognosis.

The high growth in the M3 money stock in recent years, and the consequent liquidity overhang, are often seen as risks to the stability of the price level. However, the relation between growth of the money supply and inflation is of a medium-term character.<sup>18</sup> In a more recent study Neumann and Greiber argue that only the trend component in the growth of M3 ('core money'), calculated using a statistical filter method, should be used to assess the risk of inflation.<sup>19</sup>

In fact, the data for the euro zone shows that the long-term components of both are correlated. That can

Figure 14  
**Core Money and the Rate of Increase in the HICP in the Euro Zone**



1 Note: Following Neumann and Greiber (see footnote 19) a value of 1.5 was assumed for income elasticity. The trend components of nominal money stock growth and real growth were approximated using a Hodrick-Prescott filter. Sources: ECB; Institutes' calculations.

also be shown in a spectral analysis calculation. The variation between growth in the money stock and inflation is broken down into the explanatory factors in fluctuations of varying frequency (spectra). The strength of the relation at each frequency can be measured by the coherence. It then becomes clear that the relation is only statistically significant from a frequency range of more

<sup>18</sup> McCandless and Weber show in a Panel study of more than 100 countries that in the long term there is a high correlation between the development of the money stock and the inflation rate. King confirms that relation and shows that the correlation is highest if the ten-year average of money stock growth rates and of inflation rates is used. Christiano and Fitzgerald confirm a stable long-term relation between the figures for the United States, and they also establish that the strength of the short-term correlation between the money stock and inflation has fallen there since 1960. See G.T. McCandless and W.E. Weber: 'Some Monetary Facts', in: *Federal Reserve Bank of Minneapolis Quarterly Review*, 19 (3), 1995, pp. 2/11; M. King: 'No Money, No Inflation - The role of Money in the Economy', in: *Bank of England Quarterly Bulletin*, Summer 2001, pp. 162-177; L.J. Christiano and T. Fitzgerald: 'Inflation and Monetary Policy in the 20th Century', in: *Federal Reserve Bank of Chicago Economic Perspectives*, no. 1, 2003, pp. 21/48.

<sup>19</sup> Core money is defined as the surplus of the trend component of nominal growth in the money stock M3 over the trend component of the development in real demand for money. The latter corresponds to the trend in real growth, weighted with the incomes elasticity of demand for money. See M.J.M. Neumann and C. Greiber: 'Inflation and Core Money Growth in the Euro Area.' *Deutsche Bundesbank Discussion Paper Series 1*, no. 36, Frankfurt a.M. 2004.

than 18 quarters onwards. This result supports the core money concept.<sup>20</sup>

It follows for monetary policy that temporarily exceeding the target path for growth in the money stock is not necessarily an indication of an inflationary development. However, deviations that affect the trend in growth in the money stock over several years are cause for concern. Since mid-2003 the core money rates have been above the ECB's reference figure, and most recently they have accelerated further (cf. figure 14). However, the fundamental problem remains that filter methods always involve considerable difficulties in measuring current data. The current trend component in growth in the money stock can therefore only be very vaguely determined. In the present situation it must also be taken into account that a major part of the acceleration in the growth of M3 in recent years was due to portfolio restructuring. This probably overexaggerated the trend component in growth in the money stock, measured as part of the core money concept. Nevertheless, the growth in core money does indicate risks to the stability of the price level in the medium term.

Altogether, the level of interest rates in the euro zone is currently unusually low. The question arises whether the change in the trend on the US capital markets, which has taken place against the background of the latest tightening of monetary policy in the United States, will also cause a rise in capital market rates in the euro zone.

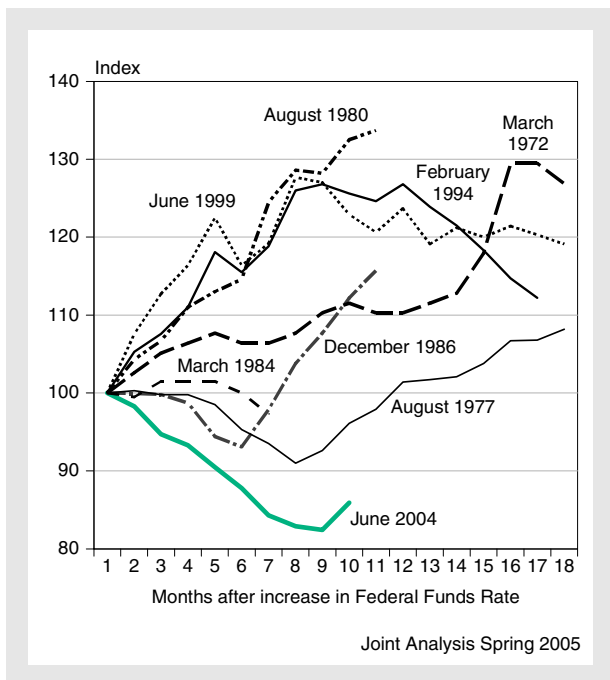
The experience of the last 35 years gives an uneven picture of the influence of increases in key rates in the United States on nominal capital market rates in Germany. Capital market rates in Germany did not rise in every phase of a rising Federal Funds Rate (cf. figure 15). The increases in the key rate in the United States in August 1977, March 1984, December 1986 and most recently June 2004 did not cause a significant rise in German capital market rates, indeed some of these actually fell. This can be seen as partly due to changes in the relevant German key rates. The Deutsche Bundesbank launched a phase of interest rate reduction in December 1997 and again in January 1987, while in October 1972, March 1979 and July 1984 German key rates were raised.

Unusually, American capital market rates went on falling for nine months after key rates started rising in June 2004. Only recently has a change to rising capital market rates become evident in the United States. However, capital market rates in Germany and in the euro

<sup>20</sup> Neumann and Greiber see a statistically significant relation between growth in the money stock and inflation only for cycles with a length of more than eight years. The result here, which is based on a longer period, indicates that rather shorter cycles of growth in the money stock of four to five years can have consequences for the inflation rate.



Figure 15  
**Changes in Capital Market Rates in Germany after Increases in Key Rates in the USA**



1 Federal Government bonds with nine to ten years remaining term.  
 Sources: Federal Reserve Bank of St. Louis; German Bundesbank; Institutes' calculations.

zone are likely to follow that trend even without increases in the ECB key rate, for they have shown a close relation with capital market rates in the United States since the early 1990s (cf. figure 16). An econometric study shows that since the early 1990s capital market rates in the United States and their counterparts in the euro zone have not been steadily divergent (cf. box 3). There can certainly be short-term deviations between interest rates in the euro zone and those in the United States, because capital market rates in the euro zone also react strongly to changes in money market rates in the euro zone.

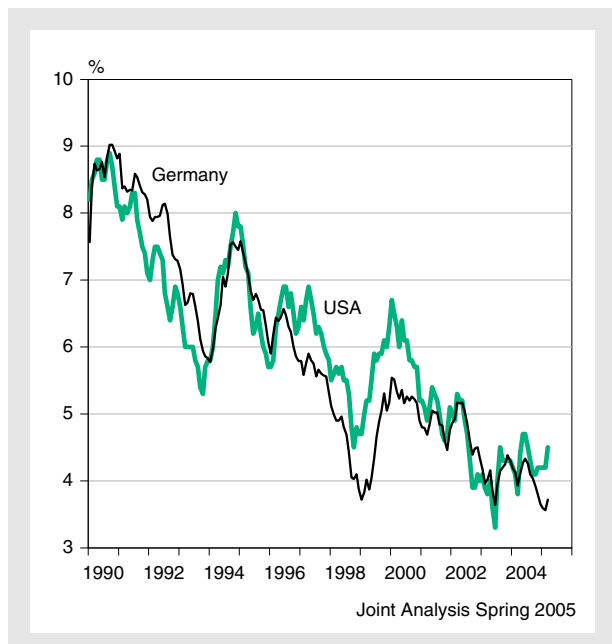
If, as has been expected for some time now, capital market rates in the United States do rise as monetary policy there is tightened further, the euro zone will not be able to withstand the impetus for long. Between autumn 1993 and autumn 1994 ten-year US capital market rates rose by altogether 2.5 percentage points. The yield on German Federal Government bonds with nine to ten years remaining term rose during the same period by 1.5 percentage points. According to the model calculations, in the short term a rise in euro zone rates of about half the rise in US rates could be expected, in the long term the effect would be stronger. In view of the very low level of capital market rates in the euro zone

the potential for a rise in interest rates is therefore great at present.

Occasionally concern is expressed that the ECB's uniform monetary policy, with interest rates identical throughout the currency union, could strengthen the divergences between the growth rates in real GDP in the member states, in view of the differences in national inflation rates. There are in fact still differences between the inflation rates in member states, for a variety of reasons, although they are much less than before the EMU convergence process started (cf. figure 17).

In this context correct measurement of the real interest rate level is important, not least for the empirical analysis. In the view of private households the nominal interest rate, with the (expected) rise in national consumer price indices, needs deflating. Figure 18 shows that German real interest rates, measured in this way, have generally been above those in the other big member states since the currency union began, while the Spanish were generally lower. So the situation is now the reverse of the period before introduction of the euro. In the view of a company investing, and selling its products throughout the euro zone, the rate of price increase that is relevant for deflating the nominal interest rate is calculated as the weighted average of its selling prices in each country. The rates of change in producer prices,

Figure 16  
**Long-Term Capital Market Rates<sup>1</sup> in the United States and Germany**



1 Federal Government bonds with nine to ten years remaining term or ten-year US Treasury bonds.  
 Sources: Federal Reserve Bank of St. Louis; German Bundesbank.

### The relation between capital market rates in the euro zone and the United States

In order to examine the role capital market rates in the United States play for capital market rates in the euro zone a simple dynamic regression model is specified. The level of the yield on nine to ten-year Federal Government bonds,  $r_t^{\text{€}}$ , that are used here to represent capital market rates in the euro zone, is explained by the level of money market rates in the euro zone or in Germany (represented by the 3-months Euribor or Fibor),  $i_t^{\text{€}}$ , and the level of ten-year US Treasury bills,  $r_t^{\text{US}}$ . The period extends from January 1993 to March 2005; tests suggest that the use of any period further back causes instabilities.

The equation is specified as an error correction model. It becomes clear that taking one lag into account is sufficient adequately to describe the dynamic of the data. The hypothe-

$$\Delta r_t^{\text{€}} = -0.035 - 0.064 (r_{t-1}^{\text{€}} - r_{t-1}^{\text{US}}) + 0.487 \Delta r_t^{\text{US}} + 0.182 (\Delta i_t^{\text{€}} - \Delta i_{t-1}^{\text{€}})$$

(3.48)      (3.58)                      (14.33)      (3.74)

$$R^2: 0.543 \quad DW: 1.94 \quad LM(12): 0.61$$

The equation explains rather more than half the monthly fluctuations in capital market rates in the euro zone. According to these estimates the capital market rate in the euro zone rises in the long term by one percentage point if the US capital market rate rises by one percentage point. In the short term, that is, in the month when the rate rises in the United States, the interest rate in the euro zone rises by 0.49 percentage points. However, further adjustment to the new long-term level is slow; that is indicated by the low adjustment coefficient of 0.064 (corresponding to an adjustment speed of about 15 months). A rise in money market rates in the euro zone by one percentage point is not reflected there in a rise in capital market rates in the long term; in the short term it does increase the capital market rate in the euro zone by just under 0.2 percentage points, but this is reversed again in the following month.

sis that money market rates in the euro zone do not have a long-term influence on capital market rates in the euro zone cannot be rejected. The same applies to the hypothesis that capital market rates in the euro zone and in the United States move exactly proportionate to each other over the long term. Altogether, therefore, we have the following specification. The values below the coefficients are t statistics and  $\Delta$  denotes the change in one variable from the previous month.<sup>1</sup>

<sup>1</sup>  $R^2$  shows the extent of the certainty of the estimate, DW is the Durbin-Watson test statistics and LM(12) is the marginal level of significance of a Lagrange multiplier test on auto-correlation up to the twelfth degree.

The estimate quantifies the relation between interest rates in the euro zone and the United States, and so it enables the development in capital market rates in the euro zone to be forecast for the immediate future in relation to the development in interest rates in the United States. The equation is only partly suitable as a longer term prognosis model. Firstly, there is only likely to be a close relation between the levels of nominal capital market rates in different countries if the developments in their national inflation rates are not too divergent. That was the case between Germany or the euro zone and the United States in the period examined. And it is probably the reason why the relations calculated do not remain stable if a longer period is chosen. Secondly, expectations of changes in exchange rates are not taken into account in the specification, although they ought to play a part, according to theoretical models of the relations between interest rates in different countries.

that are determined mainly by industrial goods, provide a suitable approximation for this. Figure 18 shows that the real interest rates in the individual countries calculated in this way have been moving within a very narrow band since the introduction of the common currency. In contrast to real interest rates based on consumer prices, a systematic trend is not evident in German real interest rates. Phases in which these were higher than in the other euro zone states alternated with phases in which they were lower. Cyclical developments in the member states have become more uniform since the currency union started, and production gaps have shown a largely parallel movement since that date (cf. figure 19).

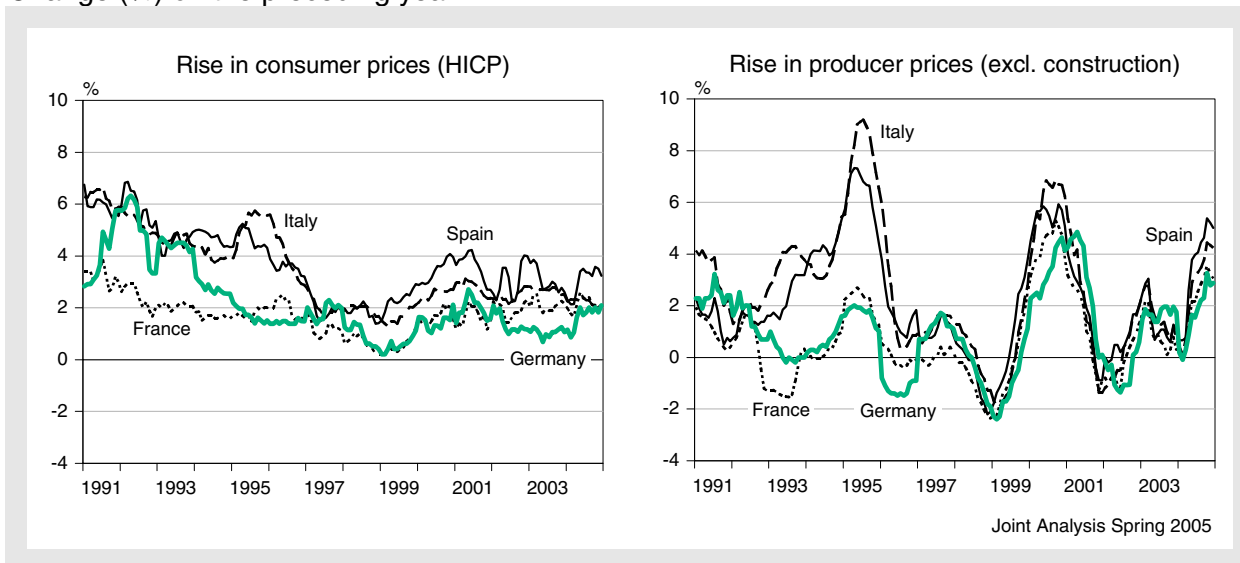
All in all it is not to be expected that the ECB's uniform monetary policy will lead to divergence of the eco-

nomie development in the euro zone countries in the long term.

### Labor market policy

The Federal Government's main aim is to reduce the high level of unemployment. It is relying for this primarily on labor market reforms and, in relation to this, a redirection of labor market policy. A number of measures have been taken in recent years which reached a conclusion for the present with the merger of unemployment and social assistance to make the new Unemployment Benefit II (Hartz IV), which came into force at the start of this year. The labor market reforms are setting

Figure 17  
**Indicators of Price Rises in the Euro Zone**  
**Change (%) on the preceding year**



Sources: OECD; Eurostat; ECB; Institutes' calculations.

new priorities. Instead of administering unemployment reintegration of the unemployed in the first labor market is to be the main concern. This is to be achieved with efficient placement and greater flexibility on the labor market – for instance, through partial relaxation of protection against unfair dismissal, easier conditions for short-term employment contracts and more stringent rules on acceptable employment; incentives will also be offered to create new jobs in the low wage segment. The package is flanked with reform of the social security systems, with the further aim of putting a brake on the spiralling subsidiary wage costs.

The measures that came into force in 2003 did bring a clear rise in the number of persons in employment in 2004. This was mainly due to the new regulation on mini-jobs, which came into effect in April 2003. Since then the number employed exclusively in mini-jobs has risen by about 620 000; if the second jobs held by persons paying statutory social insurance are included – they are not included in the statistics on persons in employment – the increase was actually nearly 1.4 million. The new promotion of self-employment also worked well. In March this year there were nearly 250 000 Ich-AGs. However, the personal service agencies (PSAs), which the Hartz Commission originally preferred, have made little difference. Participants currently number around 23 000. In autumn last year another instrument came into force with the creation of occasional work in non-profit organizations or for municipalities, with reimbursement of additional expenditure

incurred. These are known as 'supplementary jobs' or, popularly, 'One-Euro Jobs'<sup>21</sup> In March 2005 there were already 114 000 of these supplementary jobs.

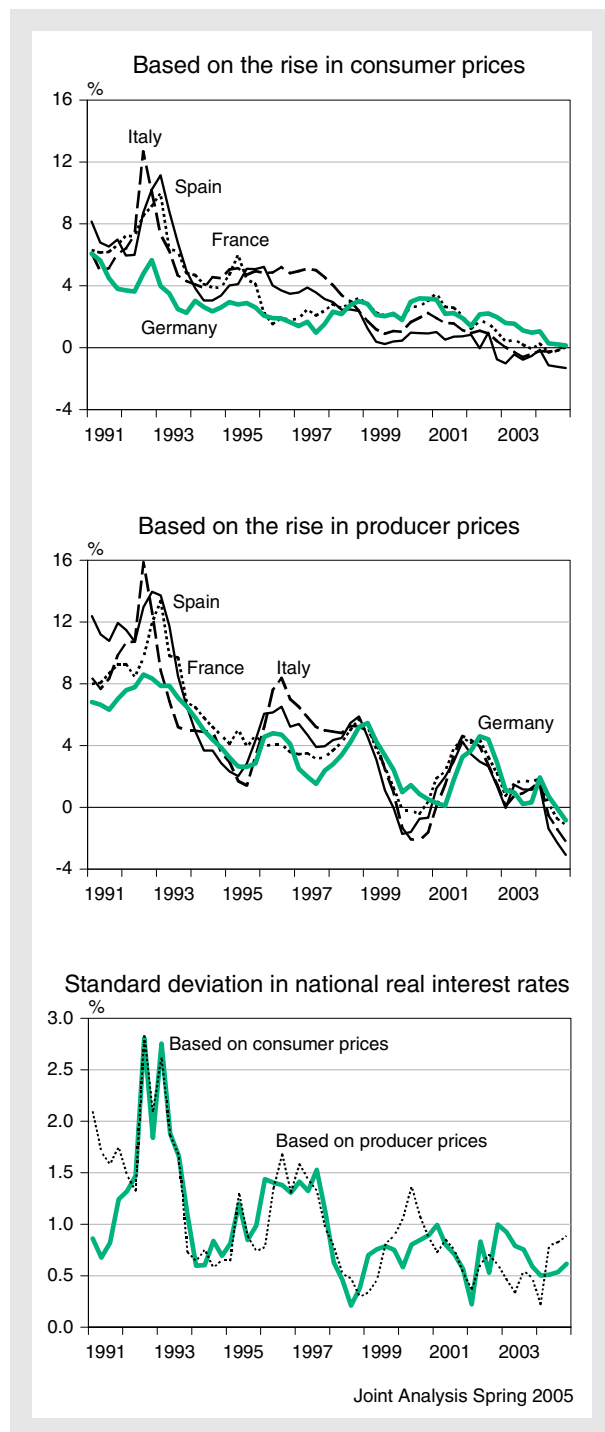
However, the rise in employment initiated by the labor market policy is not proof of its success. Rather, criteria like how permanent the new jobs prove to be, any possible displacement effects and the contribution made by these measures to integrating the unemployed into the first labor market, have to be taken into account. Doubts about durability do arise, as the Institutes have stressed several times, particularly in regard to the Ich-AGs. They are fuelled by the clear rise in the percentage of failures – in autumn last year there were at times nearly four outflows for ten inflows. A study by the IAB has shown that more than half those who ended their Ich-AG relapsed into unemployment. But one third did find jobs paying statutory social insurance,<sup>22</sup> although this does not tell us whether the previous period as self-employed was the key to obtaining this job. Since November last year what is known as a 'viability certificate' has been needed for the award of a grant to set up in business, but it remains to be seen whether that will suffice to reduce the percentage of those who give up on a more lasting basis.

<sup>21</sup> Occasional work for non-profit purposes, an instrument intended under Hartz IV to integrate long-term unemployed into the labor market, was also being used as part of the Labor Market Initiative.

<sup>22</sup> Cf. Frank Wiessner: 'Nicht jeder Abbruch ist eine Pleite', in: *IAB-Kurzbericht*, no. 2/2005, p. 3.



Figure 18  
Real Interest Rates in the Euro Zone



Sources: OECD; Eurostat; ECB; Institutes' calculations.

The strong rise in mini-jobs needs a more differentiated assessment, for these are by no means only jobs for a low hourly wage. The new regulation has certainly made such jobs more attractive, partly because they

offer a high degree of flexibility, not least in working time. The new regulation is also indirectly creating greater wage differentiation, and it has helped to shift jobs out of the black economy back into the 'official' economy. However, that has been achieved through subsidization, and in some cases this was considerable, especially the subsidization of secondary jobs for persons paying statutory social insurance. In turn this has created the wrong incentives in some cases. Under the present regulation it could be attractive for many to cut down the time they spend on the job covered by social insurance and more on a subsidized second job.

The strong increase in mini-jobs with a fall at the same time in employment covered by social insurance has nurtured the suspicion that these jobs are being displaced, so that ultimately the problems for the social insurance institutes are being intensified. Empirical studies on this are not yet available, but there are indications of possible displacement effects in individual economic sectors. The clear spread of mini-jobs in the hotel and catering trade and in the retail trade, with a clear fall at the same time in the number of jobs on which social insurance is payable, could support the substitution argument, at least for these sectors.<sup>23</sup> And a study by the Federal Employment Agency based on company data has shown that in many firms the rise in the number of mini-jobs was complemented by a fall in employment on which social insurance is payable. But it also shows that there was frequently a parallel development in the two types of employment.<sup>24</sup>

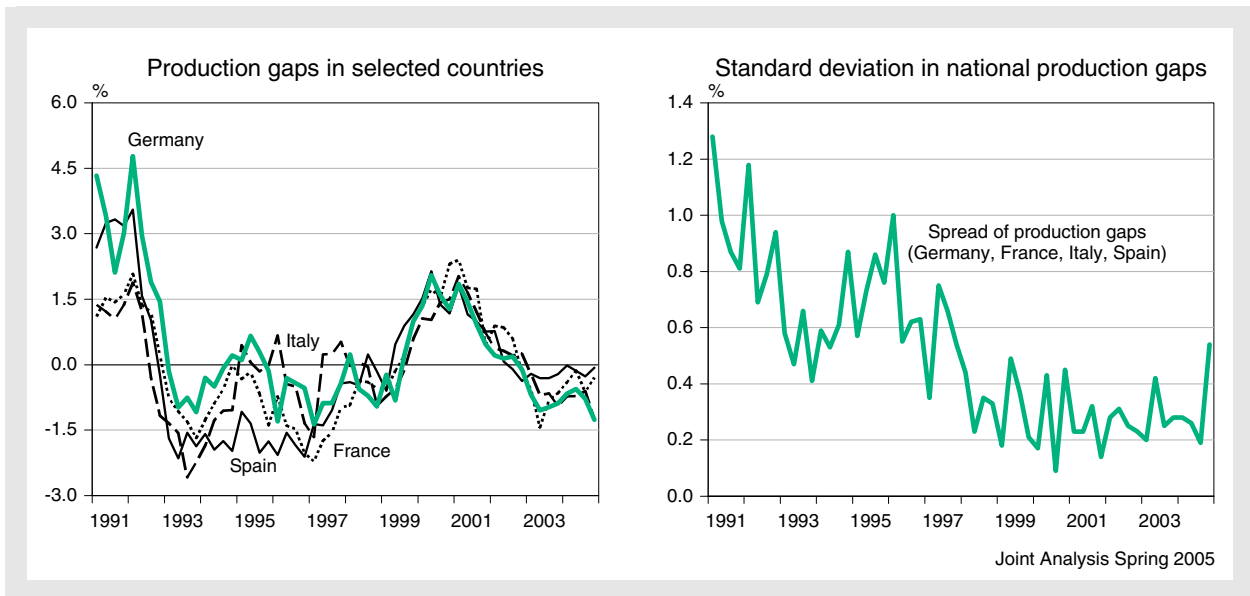
The danger of displacement is not only from mini-jobs, supplementary jobs can have a similar effect. The intention in Hartz IV was that supplementary jobs should actually only be for the long-term unemployed who are not expected to find a job on the general labor market within the foreseeable future. Moreover, the occasional work in a non-profit organization was also to be really 'supplementary' and for a limited period of time. This work is primarily intended to make the long-term unemployed employable again and so increase their chances of reintegration in the first labor market. It is also intended to test their willingness to work.

As the integration of the long-term unemployed in the first labor market is making only hesitant progress, owing to initial difficulties with the new measures and limited placement capacities, the instrument of supplementary jobs is likely to be handled liberally, this year particularly, in order to bring the number out of work, that has leapt up, down again rapidly. Up to 300 000 supplementary jobs could be provided this year with the funds available, and considerable displacement effects

<sup>23</sup> Cf. Deutsche Bundesbank: *Monatsbericht*, February 2005, p. 40.

<sup>24</sup> Cf. 'Mini- und Midijobs in Deutschland', Sonderbericht 2004.

Figure 19  
Production Gaps in the Euro Zone



Sources: OECD; Institutes' calculations.

are to be expected from this number. The Institutes therefore want to see the instrument used with restraint, limited to charitable work for the municipalities and charities, and coupled with a careful check on whether the work is really supplementary.

The labor market reforms have brought a clear increase in the number employed, but so far they have had little effect in bringing down unemployment. Above all, they have not adequately performed the 'bridge function' to the first labor market that was assigned to them, and they have hardly helped at all to make the border between the first and the second labor market more penetrable. That applies particularly to the new regulation on mini-jobs. According to the study by the RWI the share of persons on very low-paid work who had previously been registered unemployed was only just under 8%. Similarly, in March 2004 around 15% of persons on mini-jobs had been unemployed or looking for work before taking the job. That share has risen slightly since the reform in 2003, but the greater part of the growth in mini-jobs since then has been persons paying statutory social insurance who have taken on a second job.<sup>25</sup>

The Institutes have repeatedly stressed in their reports in recent years that the labor market reforms introduced by the Federal Government are steps in the

right direction. They are certainly likely to make placement more effective, intensify and shorten the process of job-seeking and so reduce the average length of unemployment. However, considerable time will be needed for them to take effect. But the Institutes have also repeatedly pointed out that the measures are not enough to increase flexibility on the labor market permanently and remove rigidities. Some of the measures actually point in the wrong direction in this regard, like the subsidization of secondary jobs for persons paying social insurance contributions already discussed. And the reforms still do not create enough incentives for the unemployed to take a job on the first labor market. The possibilities for persons drawing Unemployment Benefit II to earn in addition to the benefit are very restricted, and in some cases it is more attractive for them to take a supplementary job with a municipality or charity than a mini-job in the first labor market.<sup>26</sup> The improvements agreed at the 'Job Summit' will only slightly increase the incentives to take a low-paid job on the first labor market, for taxation above the free allowance, planned to be 100 euros, will still be very high – according to calculations by the IfW tax will be payable on 80% or more of earnings.

<sup>25</sup> Cf. M. Fertig, J. Kluge and M. Scheuer: 'Was hat die Reform der Minijobs bewirkt? Erfahrungen nach einem Jahr.' *RWI Schriften*, no. 77, Essen 2004, pp. 66 and 91.

<sup>26</sup> Cf. A. Boss and T. Blendner: 'Incentives to Work: The Case of Germany', *Kieler Arbeitspapier*, no. 1237, 2/2005.

## Federal Republic of Germany: Key National Accounts Data – Forecast for 2005 and 2006

|   | 2004    | 2005    | 2006    | 2005     |          | 2006     |          |
|---|---------|---------|---------|----------|----------|----------|----------|
|   |         |         |         | 1st half | 2nd half | 1st half | 2nd half |
| 1. Components of GDP                            |         |         |         |          |          |          |          |
| Change (%) on the previous year                 |         |         |         |          |          |          |          |
| Employed labor force (domestic)                 | 0.3     | 0.8     | 0.9     | 0.7      | 0.8      | 0.9      | 0.8      |
| Working hours per working day                   | -1.5    | -0.2    | 0.0     | -0.5     | 0.2      | -0.7     | 0.8      |
| Working days                                    | 1.5     | -0.7    | -0.7    | -0.1     | -1.2     | 0.0      | -1.3     |
| Labor volume by calendar month                  | 0.4     | -0.1    | 0.2     | 0.1      | -0.3     | 0.3      | 0.2      |
| Productivity <sup>1</sup>                       | 1.2     | 0.8     | 1.2     | 0.4      | 1.1      | 1.2      | 1.2      |
| Gross domestic product at 1995 prices           | 1.6     | 0.7     | 1.5     | 0.5      | 0.9      | 1.5      | 1.4      |
| 2. GDP by type of expenditure at current prices |         |         |         |          |          |          |          |
| a) Euro billion                                 |         |         |         |          |          |          |          |
| Consumption                                     | 1 677.5 | 1 705.4 | 1 738.1 | 829.1    | 876.3    | 846.4    | 891.7    |
| Private households <sup>2</sup>                 | 1 270.8 | 1 298.0 | 1 327.1 | 633.7    | 664.3    | 649.3    | 677.8    |
| Government                                      | 406.7   | 407.4   | 410.9   | 195.3    | 212.1    | 197.1    | 213.8    |
| Fixed capital formation                         | 378.6   | 383.5   | 391.5   | 182.0    | 201.5    | 186.1    | 205.4    |
| Machinery and equipment                         | 173.1   | 180.1   | 189.5   | 84.8     | 95.3     | 89.2     | 100.2    |
| Construction                                    | 205.5   | 203.4   | 202.0   | 97.2     | 106.2    | 96.9     | 105.1    |
| Change in stocks <sup>3</sup>                   | 6.9     | 7.5     | 8.8     | 16.8     | -9.4     | 15.3     | -6.5     |
| Domestic demand                                 | 2 062.9 | 2 096.3 | 2 138.3 | 1 027.9  | 1 068.4  | 1 047.8  | 1 090.6  |
| External surplus or deficit                     | 114.1   | 114.2   | 131.5   | 54.4     | 59.8     | 63.7     | 67.8     |
| Exports   | 834.8   | 874.7   | 943.2   | 425.7    | 449.0    | 459.9    | 483.3    |
| Imports   | 720.8   | 760.6   | 811.7   | 371.3    | 389.3    | 396.1    | 415.6    |
| Gross domestic product                          | 2 177.0 | 2 210.5 | 2 269.8 | 1 082.3  | 1 128.2  | 1 111.5  | 1 158.3  |
| b) Change (%) on the previous year              |         |         |         |          |          |          |          |
| Consumption                                     | 0.8     | 1.7     | 1.9     | 1.5      | 1.8      | 2.1      | 1.8      |
| Private households <sup>2</sup>                 | 1.2     | 2.1     | 2.2     | 1.9      | 2.4      | 2.5      | 2.0      |
| Government                                      | -0.5    | 0.2     | 0.9     | 0.4      | 0.0      | 0.9      | 0.8      |
| Fixed capital formation                         | -0.3    | 1.3     | 2.1     | 1.5      | 1.1      | 2.3      | 1.9      |
| Machinery and equipment                         | 0.9     | 4.0     | 5.2     | 5.0      | 3.2      | 5.2      | 5.2      |
| Construction                                    | -1.4    | -1.0    | -0.7    | -1.3     | -0.7     | -0.4     | -1.0     |
| Domestic demand                                 | 1.3     | 1.6     | 2.0     | 2.2      | 1.1      | 1.9      | 2.1      |
| Exports   | 8.5     | 4.8     | 7.8     | 3.5      | 6.1      | 8.0      | 7.6      |
| Imports   | 6.4     | 5.5     | 6.7     | 7.1      | 4.1      | 6.7      | 6.8      |
| Gross domestic product                          | 2.3     | 1.5     | 2.7     | 1.1      | 2.0      | 2.7      | 2.7      |
| 3. GDP by type of expenditure at 1995 prices    |         |         |         |          |          |          |          |
| a) Euro billion                                 |         |         |         |          |          |          |          |
| Consumption                                     | 1 519.7 | 1 524.1 | 1 533.9 | 747.5    | 776.7    | 752.9    | 781.0    |
| Private households <sup>2</sup>                 | 1 127.9 | 1 132.8 | 1 141.2 | 555.1    | 577.8    | 559.7    | 581.4    |
| Government                                      | 391.7   | 391.3   | 392.8   | 192.4    | 198.9    | 193.2    | 199.6    |
| Fixed capital formation                         | 385.8   | 388.3   | 394.0   | 184.2    | 204.1    | 187.1    | 206.9    |
| Machinery and equipment                         | 181.2   | 188.2   | 196.6   | 88.5     | 99.7     | 92.5     | 104.1    |
| Construction                                    | 204.6   | 200.2   | 197.4   | 95.8     | 104.4    | 94.6     | 102.8    |
| Change in stocks <sup>3</sup>                   | -3.5    | -3.5    | -2.2    | 8.8      | -12.4    | 7.3      | -9.5     |
| Domestic demand                                 | 1 901.9 | 1 908.9 | 1 925.7 | 940.5    | 968.4    | 947.3    | 978.4    |
| External surplus or deficit                     | 114.2   | 121.3   | 134.0   | 57.9     | 63.4     | 66.3     | 67.7     |
| Exports   | 803.9   | 837.2   | 890.7   | 409.3    | 427.9    | 436.4    | 454.2    |
| Imports   | 689.7   | 715.9   | 756.7   | 351.4    | 364.5    | 370.1    | 386.5    |
| Gross domestic product                          | 2 016.1 | 2 030.2 | 2 059.7 | 998.5    | 1 031.8  | 1 013.6  | 1 046.1  |
| Memo item: gross national product               | 2 011.3 | 2 025.5 | 2 055.0 | 991.5    | 1 034.0  | 1 006.6  | 1 048.4  |
| b) Change (%) on the previous year              |         |         |         |          |          |          |          |
| Consumption                                     | -0.2    | 0.3     | 0.6     | 0.1      | 0.5      | 0.7      | 0.6      |
| Private households <sup>2</sup>                 | -0.4    | 0.4     | 0.7     | 0.2      | 0.7      | 0.8      | 0.6      |
| Government                                      | 0.4     | -0.1    | 0.4     | -0.1     | -0.1     | 0.4      | 0.4      |
| Fixed capital formation                         | -0.9    | 0.7     | 1.5     | 0.9      | 0.4      | 1.6      | 1.4      |
| Machinery and equipment                         | 1.2     | 3.8     | 4.5     | 5.0      | 2.8      | 4.6      | 4.4      |
| Construction                                    | -2.6    | -2.2    | -1.4    | -2.7     | -1.7     | -1.2     | -1.5     |
| Domestic demand                                 | 0.4     | 0.4     | 0.9     | 1.0      | -0.2     | 0.7      | 1.0      |
| Exports   | 8.6     | 4.1     | 6.4     | 3.2      | 5.0      | 6.6      | 6.2      |
| Imports   | 6.4     | 3.8     | 5.7     | 5.0      | 2.7      | 5.3      | 6.0      |
| Gross domestic product                          | 1.6     | 0.7     | 1.5     | 0.5      | 0.9      | 1.5      | 1.4      |
| Memo item: gross national product               | 1.9     | 0.7     | 1.5     | 0.5      | 0.9      | 1.5      | 1.4      |

## Federal Republic of Germany: Key National Accounts Data – Forecast for 2005 and 2006

|  | 2004    | 2005    | 2006    | 2005     |          | 2006     |          |
|--|---------|---------|---------|----------|----------|----------|----------|
|  |         |         |         | 1st half | 2nd half | 1st half | 2nd half |
| 4. GDP by type of expenditure: price level of national expenditure (1995=100)<br>Change (%) on the previous year |         |         |         |          |          |          |          |
| Private consumption <sup>2</sup>   | 1.6     | 1.7     | 1.5     | 1.7      | 1.7      | 1.6      | 1.4      |
| Government consumption   | -0.8    | 0.3     | 0.5     | 0.5      | 0.1      | 0.5      | 0.5      |
| Fixed capital formation  | 0.5     | 0.6     | 0.6     | 0.6      | 0.7      | 0.7      | 0.6      |
| Machinery and equipment  | -0.3    | 0.2     | 0.7     | 0.0      | 0.4      | 0.6      | 0.8      |
| Construction   | 1.3     | 1.2     | 0.7     | 1.3      | 1.0      | 0.8      | 0.6      |
| Exports  | -0.1    | 0.6     | 1.4     | 0.2      | 1.0      | 1.3      | 1.4      |
| Imports  | 0.1     | 1.7     | 1.0     | 2.0      | 1.4      | 1.3      | 0.7      |
| Gross domestic product   | 0.7     | 0.8     | 1.2     | 0.6      | 1.1      | 1.2      | 1.3      |
| 5. Factor incomes in GNP<br>a) Euro billion  |         |         |         |          |          |          |          |
| Primary income of private households <sup>2</sup>  | 1 600.7 | 1 628.3 | 1 665.7 | 801.1    | 827.3    | 820.9    | 844.8    |
| Employer social security contributions   | 222.1   | 221.3   | 222.0   | 108.2    | 113.1    | 107.6    | 114.4    |
| Wages and salaries, gross  | 911.1   | 916.3   | 930.8   | 433.0    | 483.3    | 440.0    | 490.8    |
| Other primary income <sup>4</sup>  | 467.5   | 490.8   | 513.0   | 259.9    | 230.9    | 273.4    | 239.7    |
| Primary income of the other sectors  | 246.9   | 247.4   | 263.1   | 109.6    | 137.8    | 116.0    | 147.1    |
| Net national income (primary income)   | 1 847.6 | 1 875.8 | 1 928.8 | 910.7    | 965.1    | 936.9    | 991.9    |
| Depreciation   | 323.6   | 329.0   | 335.2   | 163.9    | 165.1    | 166.8    | 168.4    |
| Gross national product   | 2 171.2 | 2 204.7 | 2 264.0 | 1 074.5  | 1 130.2  | 1 103.7  | 1 160.3  |
| Memo item: national product at factor costs  | 1 615.6 | 1 639.9 | 1 688.2 | 793.8    | 846.0    | 817.9    | 870.3    |
| Entrepreneurial and property income  | 482.4   | 502.3   | 535.5   | 252.6    | 249.7    | 270.3    | 265.2    |
| Compensation of employees  | 1 133.2 | 1 137.6 | 1 152.7 | 541.2    | 596.4    | 547.6    | 605.2    |
| b) Change (%) on the previous year   |         |         |         |          |          |          |          |
| Primary income of private households <sup>2</sup>  | 0.5     | 1.7     | 2.3     | 1.8      | 1.7      | 2.5      | 2.1      |
| Employer social security contributions   | -0.1    | -0.4    | 0.3     | 0.4      | -1.2     | -0.6     | 1.1      |
| Wages and salaries, gross  | 0.1     | 0.6     | 1.6     | 0.3      | 0.8      | 1.6      | 1.6      |
| Wages and salaries, gross per employee   | 0.2     | 0.1     | 0.9     | -0.1     | 0.3      | 0.8      | 0.9      |
| Other primary income <sup>4</sup>  | 1.4     | 5.0     | 4.5     | 4.9      | 5.1      | 5.2      | 3.8      |
| Primary income of the other sectors  | 21.7    | 0.2     | 6.3     | -3.9     | 3.7      | 5.8      | 6.7      |
| Net national income (primary income)   | 2.9     | 1.5     | 2.8     | 1.0      | 2.0      | 2.9      | 2.8      |
| Depreciation   | 1.7     | 1.6     | 1.9     | 1.5      | 1.8      | 1.8      | 2.0      |
| Gross national product   | 2.7     | 1.5     | 2.7     | 1.1      | 2.0      | 2.7      | 2.7      |
| Memo item: national product at factor costs  | 3.0     | 1.5     | 2.9     | 0.9      | 2.1      | 3.0      | 2.9      |
| Entrepreneurial and property income  | 10.4    | 4.1     | 6.6     | 2.2      | 6.2      | 7.0      | 6.2      |
| Compensation of employees  | 0.1     | 0.4     | 1.3     | 0.3      | 0.4      | 1.2      | 1.5      |
| 6. Private households' incomes and expenditure <sup>2</sup><br>a) Euro billion                                   |         |         |         |          |          |          |          |
| Mass income  | 974.6   | 981.3   | 990.8   | 471.3    | 510.0    | 475.1    | 515.7    |
| Wages and salaries, net  | 600.3   | 608.0   | 614.8   | 284.4    | 323.7    | 287.1    | 327.8    |
| Monetary social benefits   | 454.4   | 456.8   | 458.5   | 229.0    | 227.9    | 229.6    | 228.9    |
| Minus: charges on social benefits,<br>consumption-related taxes  | 80.1    | 83.5    | 82.5    | 42.0     | 41.5     | 41.5     | 41.0     |
| Other primary income <sup>4</sup>  | 467.5   | 490.8   | 513.0   | 259.9    | 230.9    | 273.4    | 239.7    |
| Other transfers received, net <sup>5</sup>   | -35.3   | -35.5   | -36.0   | -17.3    | -18.3    | -17.5    | -18.5    |
| Disposable income  | 1 406.8 | 1 436.6 | 1 467.9 | 713.9    | 722.7    | 731.0    | 736.9    |
| Increase in claims<br>on company pension schemes   | 19.1    | 20.0    | 21.5    | 9.5      | 10.5     | 10.2     | 11.3     |
| Private consumption  | 1 270.8 | 1 298.0 | 1 327.1 | 633.7    | 664.3    | 649.3    | 677.8    |
| Current savings  | 155.2   | 158.6   | 162.2   | 89.7     | 68.9     | 91.9     | 70.3     |
| Savings ratio <sup>6</sup>   | 10.9    | 10.9    | 10.9    | 12.4     | 9.4      | 12.4     | 9.4      |

## Federal Republic of Germany: Key National Accounts Data – Forecast for 2005 and 2006

|   | 2004    | 2005    | 2006    | 2005     |          | 2006     |          |
|---|---------|---------|---------|----------|----------|----------|----------|
|   |         |         |         | 1st half | 2nd half | 1st half | 2nd half |
| b) Change (%) on the previous year                              |         |         |         |          |          |          |          |
| Mass income   | 1.1     | 0.7     | 1.0     | 0.4      | 1.0      | 0.8      | 1.1      |
| Wages and salaries, net   | 1.7     | 1.3     | 1.1     | 1.0      | 1.5      | 0.9      | 1.3      |
| Monetary social benefits  | 0.8     | 0.5     | 0.4     | 0.3      | 0.8      | 0.3      | 0.5      |
| Minus: charges on social benefits,<br>consumption-related taxes | 4.2     | 4.3     | -1.2    | 4.5      | 4.0      | -1.2     | -1.2     |
| Other primary income <sup>4</sup>                               | 1.4     | 5.0     | 4.5     | 4.9      | 5.1      | 5.2      | 3.8      |
| Disposable income   | 1.2     | 2.1     | 2.2     | 1.9      | 2.3      | 2.4      | 2.0      |
| Private consumption   | 1.2     | 2.1     | 2.2     | 1.9      | 2.4      | 2.5      | 2.0      |
| Current savings   | 2.7     | 2.2     | 2.3     | 2.4      | 2.0      | 2.5      | 2.0      |
| 7. Government revenue and expenditure <sup>7</sup>              |         |         |         |          |          |          |          |
| a) Euro billion   |         |         |         |          |          |          |          |
| Revenue   |         |         |         |          |          |          |          |
| Taxes   | 481.5   | 483.5   | 492.5   | 238.3    | 245.2    | 242.6    | 249.9    |
| Social contributions  | 396.5   | 398.4   | 403.3   | 193.6    | 204.8    | 196.2    | 207.2    |
| Property income   | 9.5     | 10.1    | 10.6    | 5.5      | 4.6      | 6.0      | 4.6      |
| Other current transfers   | 16.4    | 18.0    | 15.1    | 9.5      | 8.5      | 7.4      | 7.7      |
| Property income, transferred                                    | 9.4     | 9.2     | 9.3     | 5.0      | 4.2      | 5.1      | 4.2      |
| Sales   | 39.9    | 42.5    | 42.9    | 20.1     | 22.4     | 20.3     | 22.6     |
| Other subsidies   | 0.5     | 0.5     | 0.5     | 0.2      | 0.2      | 0.2      | 0.2      |
| Total revenue   | 953.6   | 962.2   | 974.2   | 472.2    | 489.9    | 477.8    | 496.4    |
| Expenditure   |         |         |         |          |          |          |          |
| Inputs <sup>8</sup>   | 250.2   | 254.2   | 259.1   | 121.6    | 132.6    | 124.0    | 135.2    |
| Compensation of employees                                       | 166.4   | 165.6   | 164.5   | 78.6     | 87.0     | 78.1     | 86.4     |
| Interest payments   | 66.2    | 68.0    | 69.8    | 34.0     | 34.0     | 35.2     | 34.6     |
| Subsidies   | 27.5    | 26.6    | 25.0    | 12.7     | 13.9     | 11.9     | 13.1     |
| Monetary social benefits  | 423.3   | 425.4   | 426.6   | 213.2    | 212.2    | 213.6    | 212.9    |
| Other current transfers   | 37.7    | 34.5    | 41.0    | 17.8     | 16.8     | 19.8     | 21.2     |
| Capital transfers   | 33.6    | 35.2    | 32.5    | 19.7     | 15.6     | 18.2     | 14.3     |
| Gross investment  | 30.6    | 30.3    | 31.3    | 13.1     | 17.2     | 13.5     | 17.8     |
| Net increase in non-produced capital goods                      | -1.5    | -1.5    | -1.5    | -0.8     | -0.8     | -0.8     | -0.8     |
| Total expenditure   | 1 033.9 | 1 038.3 | 1 048.1 | 509.9    | 528.4    | 513.5    | 534.6    |
| Deficit/surplus   | -80.3   | -76.1   | -74.0   | -37.6    | -38.5    | -35.7    | -38.3    |
| b) Change (%) on the previous year                              |         |         |         |          |          |          |          |
| Revenue   |         |         |         |          |          |          |          |
| Taxes   | 0.0     | 0.4     | 1.9     | 0.8      | 0.1      | 1.8      | 1.9      |
| Social contributions  | 0.4     | 0.5     | 1.2     | 0.2      | 0.8      | 1.3      | 1.2      |
| Property income   | -36.9   | 6.4     | 5.0     | 16.0     | -3.2     | 9.1      | 0.0      |
| Other current transfers   | 1.2     | 10.0    | -16.2   | 37.7     | -10.2    | -22.5    | -9.2     |
| Property income, transferred                                    | 7.2     | -2.4    | 1.6     | -2.7     | -2.1     | 2.4      | 0.7      |
| Sales   | -1.6    | 6.6     | 0.7     | 6.6      | 6.6      | 0.7      | 0.7      |
| Other subsidies   | -16.1   | -4.3    | 0.0     | 0.0      | -8.0     | 0.0      | 0.0      |
| Total revenue   | -0.4    | 0.9     | 1.2     | 1.4      | 0.4      | 1.2      | 1.3      |
| Expenditure   |         |         |         |          |          |          |          |
| Inputs <sup>8</sup>   | -0.4    | 1.6     | 1.9     | 1.6      | 1.6      | 1.9      | 1.9      |
| Compensation of employees                                       | -0.9    | -0.5    | -0.7    | 0.0      | -0.9     | -0.6     | -0.7     |
| Interest payments   | -0.8    | 2.7     | 2.6     | 3.8      | 1.6      | 3.5      | 1.8      |
| Subsidies   | -4.9    | -3.3    | -6.1    | -4.8     | -1.8     | -6.8     | -5.5     |
| Monetary social benefits  | 0.8     | 0.5     | 0.3     | 0.2      | 0.8      | 0.2      | 0.3      |
| Other current transfers   | -1.3    | -8.4    | 18.7    | -2.5     | -13.9    | 11.5     | 26.4     |
| Capital transfers   | -5.8    | 4.9     | -7.8    | 3.3      | 7.0      | -7.5     | -8.1     |
| Gross investment  | -4.0    | -1.1    | 3.2     | -2.0     | -0.3     | 3.3      | 3.1      |
| Total expenditure   | -0.5    | 0.4     | 0.9     | 0.6      | 0.3      | 0.7      | 1.2      |

1 Gross domestic product at 1995 prices per hour worked. — 2 Incl. private non-profit organizations. — 3 Incl. net increase in value. — 4 Self-employed income/operating profits plus property income received minus property income losses. — 5 Transfers received minus other transfers. — 6 Savings as a % of disposable income (including the increase in claims on company pension schemes). — 7 German government and social security funds. — 8 Incl. social benefits in kind and other production charges.

Sources: Federal Statistical Office (Series 18 of the National Accounts); Institutes' calculations; 2005 and 2006: Institutes' prognosis.

Supplement: Economic Indicators  
Weekly Report No. 14/2005  
(data as of 13 May 2005)



# Germany – Selected Seasonally Adjusted Economic Indicators<sup>1</sup>

|      |   | Orders in manufacturing (volume) <sup>2</sup> |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
|------|---|---|---------|-----------|---------|---------------|---------|----------|---------|-----------------------------|---------|-------|---------|---------------------------------|---------|---|---------|
|      |   | Unemployment                                  |         | Vacancies |         | Manufacturing |         |          |         | Intermediate goods industry |         |       |         | Durable goods consumer industry |         | Non-durable goods consumer industry (incl. semi-durable goods industry) |         |
|      |   |   |         |           |         | Total         |         | Domestic |         | Abroad                      |         | month |         | quarter                         |         | month   |         |
|      |   | month   | quarter | month     | quarter | month         | quarter | month    | quarter | month                       | quarter | month | quarter | month                           | quarter | month   | quarter |
|      |   | 2000 = 100                                    |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
|      |   | in 000s                                       |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
| 2003 | J | 4 317   | 391     | 385       | 98.1    | 93.3          | 104.2   | 97.6     | 99.4    | 97.6                        | 97.6    | 97.6  | 97.6    | 89.0                            | 98.6    | 98.6  | 97.6    |
|      | F | 4 364   | 379     | 385       | 98.4    | 94.7          | 103.0   | 96.8     | 100.4   | 96.8                        | 96.8    | 96.8  | 96.8    | 88.0                            | 100.0   | 100.0   | 97.6    |
|      | M | 4 390   | 372     | 385       | 94.6    | 90.6          | 99.6    | 94.9     | 95.2    | 94.9                        | 94.9    | 94.9  | 94.9    | 85.7                            | 94.3    | 94.3  | 97.6    |
|      | A | 4 406   | 365     | 359       | 96.9    | 92.7          | 102.0   | 96.1     | 98.4    | 96.1                        | 96.1    | 96.1  | 96.1    | 86.8                            | 96.5    | 96.5  | 96.6    |
|      | M | 4 400   | 352     | 359       | 93.1    | 91.7          | 94.8    | 93.6     | 93.1    | 93.6                        | 93.6    | 93.6  | 93.6    | 83.8                            | 95.6    | 95.6  | 96.6    |
|      | J | 4 383   | 345     | 342       | 97.3    | 93.0          | 102.7   | 96.0     | 99.5    | 96.0                        | 96.0    | 96.0  | 96.0    | 88.4                            | 97.7    | 97.7  | 96.6    |
|      | J | 4 388   | 346     | 342       | 97.3    | 93.0          | 102.7   | 96.0     | 99.5    | 96.0                        | 96.0    | 96.0  | 96.0    | 88.4                            | 97.7    | 97.7  | 96.6    |
|      | A | 4 393   | 341     | 342       | 97.3    | 92.3          | 103.6   | 97.2     | 98.4    | 97.2                        | 97.2    | 97.2  | 97.2    | 85.7                            | 97.7    | 97.7  | 96.7    |
|      | S | 4 395   | 337     | 337       | 98.7    | 94.3          | 104.3   | 98.6     | 100.2   | 98.6                        | 98.6    | 98.6  | 98.6    | 88.0                            | 95.8    | 95.8  | 96.7    |
|      | O | 4 399   | 332     | 331       | 99.7    | 94.8          | 105.8   | 100.1    | 100.5   | 100.1                       | 100.1   | 100.1 | 100.1   | 89.1                            | 98.5    | 98.5  | 96.7    |
|      | N | 4 396   | 330     | 331       | 100.1   | 95.7          | 106.8   | 100.8    | 101.5   | 100.8                       | 100.8   | 100.8 | 100.8   | 87.3                            | 95.8    | 95.8  | 97.5    |
|      | D | 4 380   | 324     | 324       | 100.5   | 93.8          | 108.9   | 101.6    | 101.1   | 101.6                       | 101.6   | 101.6 | 101.6   | 88.2                            | 98.4    | 98.4  | 97.5    |
| 2004 | J | 4 306   | 313     | 306       | 99.7    | 94.9          | 105.8   | 100.6    | 100.8   | 100.6                       | 100.6   | 100.6 | 100.6   | 87.5                            | 95.3    | 95.3  | 97.5    |
|      | F | 4 288   | 301     | 306       | 100.4   | 94.8          | 107.4   | 102.1    | 101.9   | 102.1                       | 102.1   | 102.1 | 102.1   | 87.3                            | 94.4    | 94.4  | 95.5    |
|      | M | 4 305   | 286     | 306       | 102.6   | 97.3          | 109.1   | 103.0    | 104.4   | 103.0                       | 103.0   | 103.0 | 103.0   | 88.0                            | 96.7    | 96.7  | 95.5    |
|      | A | 4 341   | 274     | 280       | 103.0   | 97.1          | 110.6   | 104.2    | 104.2   | 104.2                       | 104.2   | 104.2 | 104.2   | 88.1                            | 98.6    | 98.6  | 95.5    |
|      | M | 4 341   | 282     | 280       | 106.8   | 98.4          | 117.4   | 107.2    | 109.0   | 107.2                       | 107.2   | 107.2 | 107.2   | 90.3                            | 100.2   | 100.2   | 98.4    |
|      | J | 4 360   | 280     | 280       | 102.3   | 96.1          | 110.2   | 104.3    | 103.0   | 104.3                       | 104.3   | 104.3 | 104.3   | 89.0                            | 96.4    | 96.4  | 98.4    |
|      | J | 4 389   | 276     | 276       | 103.3   | 96.4          | 112.1   | 103.3    | 105.6   | 103.3                       | 103.3   | 103.3 | 103.3   | 87.3                            | 98.5    | 98.5  | 98.4    |
|      | A | 4 414   | 273     | 276       | 103.4   | 97.2          | 111.1   | 104.7    | 104.8   | 104.7                       | 104.7   | 104.7 | 104.7   | 87.7                            | 97.0    | 97.0  | 97.6    |
|      | S | 4 437   | 275     | 275       | 103.2   | 95.2          | 113.1   | 103.2    | 105.7   | 103.2                       | 103.2   | 103.2 | 103.2   | 84.9                            | 97.4    | 97.4  | 97.6    |
|      | O | 4 457   | 279     | 281       | 102.8   | 95.6          | 111.7   | 101.9    | 106.2   | 101.9                       | 101.9   | 101.9 | 101.9   | 83.7                            | 96.9    | 96.9  | 97.6    |
|      | N | 4 487   | 283     | 281       | 102.0   | 94.5          | 111.4   | 101.5    | 104.2   | 101.5                       | 101.5   | 101.5 | 101.5   | 85.4                            | 100.2   | 100.2   | 98.7    |
|      | D | 4 552   | 291     | 281       | 106.1   | 98.4          | 115.7   | 100.7    | 113.6   | 100.7                       | 100.7   | 100.7 | 100.7   | 84.0                            | 98.9    | 98.9  | 98.7    |
| 2005 | J | 4 739   | 307     | 318       | 105.0   | 96.1          | 116.2   | 103.6    | 108.2   | 103.6                       | 103.6   | 103.6 | 103.6   | 85.5                            | 103.3   | 103.3   | 103.9   |
|      | F | 4 843   | 326     | 318       | 103.7   | 94.1          | 115.7   | 100.9    | 107.6   | 100.9                       | 100.9   | 100.9 | 100.9   | 85.5                            | 103.9   | 103.9   | 103.9   |
|      | M | 4 909   | 353     | 318       | 105.2   | 95.7          | 117.2   | 101.7    | 109.9   | 101.7                       | 101.7   | 101.7 | 101.7   | 85.3                            | 104.3   | 104.3   | 103.9   |
|      | A | 4 881   | 377     | 318       | 105.2   | 95.7          | 117.2   | 101.7    | 109.9   | 101.7                       | 101.7   | 101.7 | 101.7   | 85.3                            | 104.3   | 104.3   | 103.9   |
|      | J |   |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
|      | J |   |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
| A    |   |   |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
| S    |   |   |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
| O    |   |   |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
| N    |   |   |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |
| D    |   |   |         |           |         |               |         |          |         |                             |         |       |         |                                 |         |   |         |

<sup>1</sup> Seasonally adjusted by the Berlin Method (BV4). With this method, the addition of new data can change previous seasonal adjustment patterns even if the original, unadjusted, figures remained unchanged. Quarterly figures are calculated from seasonally adjusted monthly figures. — <sup>2</sup> Also adjusted for working days.  
Sources: Federal Labour Office; Federal Statistical Office; DIW Berlin calculations.

