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Economic Trends 2005/2006

'Arbeitskreis Konjunktur' at DIW Berlin
(Study Group 'Business Cycle')

The World Economy

Temporary slowdown in world economic growth

The world economy, which initially had expanded at an exceptionally dynamic pace, lost momentum over the course of 2004. The growth rate slowed in the USA, in particular, where the economy had previously been on an extremely robust upward trajectory, and it also slowed in Asia. In the European Union, the pace of expansion remained only modest.

The main factor behind the slower pace of world growth was the tightening of the economic policy reins. Although the monetary conditions continued to stimulate growth in the USA, a more restrictive monetary policy stance was adopted, and as the impetus exerted by fiscal policy abated, the impact of economic policy was less expansive than in 2003. The measures adopted in China in an endeavour to steer the overheated economy into calmer waters appear to be succeeding. And the sharp increase in the price of oil also curbed world economic growth.

However, the price thrust caused by the rise in oil prices did not lead to supplementary wage demands; there is thus no reason to expect second-round effects that would provoke a counter-reaction from monetary policy. On the DIW Berlin's view, the situation on the crude oil markets suggests that the price growth will soon ease off. It is assumed in this forecast that the price of oil will decline over the forecast period and amount to an average US $ 33 per barrel (North Sea Brent) in 2005 and 2006.[1]

Subsequent to the momentary slowdown, the world economy will gradually strengthen again over the forecast period. While the pace of expansion will be somewhat slower in the USA, where private consumer spending will increase less rapidly and the savings ratio will therefore rise slightly, in Europe, by contrast, the forces for economic growth will become stronger as time goes on. The pace of growth will diminish in Asia, though it will still remain robust (cf. tables 1 and 2).

There are various risks, however. These include, in particular, the exchange-rate trend for the US dollar against the world's most important

[1] For the impact on economic growth of changes in the price of oil, cf. 'Economic Trends 2004/2005'. In: *DIW Economic Bulletin,* vol. 41, no. 8, August 2004, pp. 245-272.

Table 1

Real GDP, Consumer Prices and Unemployment Rate in Selected Countries

	Weight (%)		GDP			Consumer prices[1]			Unemployment rate[2]		
			Change (%) on the previous year						(%)		
	GDP	German exports	2004	2005	2006	2004	2005	2006	2004	2005	2006
Germany	8.7	–	1.8	1.8	2.0	1.6	1.6	1.4	9.6	9.5	8.6
France	6.4	13.1	2.2	2.1	2.5	2.3	1.8	1.6	9.5	9.4	9.2
Italy	5.3	9.2	1.3	1.6	1.9	2.2	2.2	1.8	8.4	8.2	8.1
Spain	3.0	6.1	2.6	2.6	3.0	3.0	2.9	2.4	10.8	10.3	10.1
Netherlands	1.9	7.7	1.2	1.4	2.2	1.4	1.4	1.2	4.7	4.7	4.4
Belgium	1.1	6.3	2.7	2.5	2.6	1.9	2.1	1.8	7.8	7.9	7.7
Austria	0.9	6.6	1.8	2.4	2.2	1.9	1.6	1.2	4.5	4.4	4.1
Greece	0.6	1.0	4.0	1.5	3.0	3.0	2.7	2.6	9.2	9.5	9.4
Finland	0.6	1.3	3.1	3.3	3.0	0.2	1.6	1.5	8.9	8.6	8.5
Ireland	0.6	0.7	5.5	4.0	4.1	2.3	1.9	2.2	4.5	4.2	4.1
Portugal	0.5	1.2	1.2	1.3	2.4	2.5	2.4	2.3	6.6	6.7	6.5
Luxembourg	0.1	0.6	3.5	4.0	4.2	3.2	3.2	2.5	4.2	4.2	4.0
EMU countries[3]	29.7	–	2.0	2.0	2.4	2.1	2.1	1.7	8.9	8.7	8.3
EMU countries excl. Germany[3]	21.0	–	2.1	2.1	2.5	2.3	2.1	1.8	8.5	8.4	8.2
EMU countries excl. Germany[4]	–	53.8	2.0	2.1	2.4	2.1	2.0	1.7	–	–	–
Great Britain	6.5	10.4	3.2	3.0	2.7	1.6	1.8	1.9	4.9	4.9	4.9
Sweden	1.1	2.7	3.5	3.0	2.6	1.2	1.8	1.9	6.2	5.9	5.2
Denmark	0.8	2.1	2.3	2.5	2.2	1.6	1.7	1.9	5.7	5.3	5.0
EU-15[3]	38.0	–	2.3	2.2	2.4	1.9	1.6	1.7	8.0	7.9	7.6
Poland	0.8	3.1	5.4	3.5	4.3	3.8	4.3	2.7	18.8	18.3	18.0
Czech Republic	0.3	3.1	3.6	4.0	4.5	2.7	1.8	1.8	8.4	8.3	8.0
Hungary	0.3	2.2	4.0	3.5	4.2	6.8	5.1	4.0	5.9	6.2	5.9
Slovakia	0.1	1.0	5.4	5.2	4.6	7.5	3.0	2.5	18.1	17.4	17.0
Slovenia	0.1	0.5	4.6	4.2	4.3	3.5	2.8	2.7	6.0	5.8	5.6
Lithuania	0.1	0.3	6.6	7.9	7.5	1.2	3.5	3.2	10.9	9.7	9.2
Cyprus	0.0	0.1	3.8	3.7	4.3	2.0	2.5	2.5	5.0	5.2	4.8
Latvia	0.0	0.2	8.5	7.5	7.8	6.2	5.8	5.0	9.8	9.5	9.0
Estonia	0.0	0.1	6.2	6.0	5.7	2.9	3.0	2.7	9.2	8.0	7.7
Malta	0.0	0.1	1.0	1.5	1.8	2.7	2.0	1.8	7.3	6.9	6.8
EU-25[3]	39.8	–	2.4	2.3	2.5	2.0	2.0	1.8	9.0	8.9	8.5
Switzerland	1.2	4.9	1.5	1.8	1.8	0.4	0.8	0.8	4.2	3.8	3.6
Norway	0.8	0.8	3.3	2.8	2.5	0.5	1.8	2.0	4.3	4.1	4.0
Western and central Europe[3]	41.8	–	2.4	2.3	2.5	2.0	1.9	1.7	8.9	8.7	8.4
USA	39.6	11.6	4.4	3.4	3.1	2.7	2.7	2.3	5.5	5.1	4.9
Japan	15.6	2.2	2.9	1.5	2.6	–0.2	0.0	0.1	4.7	4.5	4.3
Canada	3.1	0.9	3.0	3.4	3.2	1.8	1.9	1.8	7.1	6.9	6.8
Non-European industrial countries[3]	58.2	–	3.9	2.8	3.0	1.9	2.0	1.7	5.4	5.0	4.9
Non-European industrial countries[4]	–	14.7	4.1	3.1	3.0	2.2	2.3	1.9	–	–	–
Total[3]	100.0	–	3.3	2.6	2.8	1.9	2.0	1.7	7.1	6.8	6.6
Total excl. Germany[3]	91.3	–	3.4	2.7	2.8	1.9	2.0	1.7	6.8	6.5	6.4
Memo item: Total weighted by exports[4]	–	100.0	2.8	2.6	2.7	2.2	2.1	1.8	–	–	–

1 EU-15 and Norway: harmonised index of consumer prices. — 2 Standardised. — 3 Total of countries listed. GDP and consumer prices weighted by 2003 GDP in US dollars; unemployment rate weighted by 2003 labour force. — 4 Total of countries listed. Weighted by country's shares in German exports 2003.
Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW Berlin calculations; 2004 to 2006: DIW Berlin estimate and prognosis.

Table 2

Trends in GDP Components in Selected Countries

Real change (%) on the previous year

	Private consumption			Government consumption			Gross fixed investment			Goods and services					
										Exports			Imports		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
Germany	–0.3	0.9	1.1	–0.4	0.2	1.0	–0.3	2.0	3.2	9.4	5.7	5.2	7.9	4.7	4.5
France	2.1	2.0	2.4	2.5	1.8	1.9	2.8	3.5	4.0	3.2	4.4	4.7	7.5	4.4	3.9
Italy	1.2	1.4	1.8	0.4	0.8	1.2	2.6	3.1	3.3	4.2	6.3	4.3	2.9	5.5	4.8
Spain	3.3	2.9	3.0	4.3	4.0	4.1	4.3	3.5	2.9	5.5	8.5	5.5	9.3	9.1	5.2
Netherlands	0.1	0.7	1.7	0.3	0.6	0.5	0.3	0.8	4.0	6.3	5.7	4.6	5.3	5.2	4.5
Belgium	2.2	2.5	2.7	3.0	2.5	2.3	4.3	4.4	4.7	5.4	7.2	5.4	6.8	7.8	5.7
Austria	1.4	2.2	2.6	0.2	0.6	0.8	1.3	3.4	4.1	6.9	5.0	4.2	5.2	4.5	4.1
Finland	2.5	2.7	2.6	1.0	1.4	1.6	4.9	4.0	4.1	2.4	4.2	4.3	0.7	4.4	5.0
Greece	3.5	3.5	3.0	0.2	–0.5	0.5	6.0	–3.0	4.0	3.8	3.5	3.5	3.1	2.5	3.0
Portugal	2.3	2.1	2.4	0.8	0.8	0.7	2.1	1.5	2.6	6.1	3.2	4.6	7.3	2.2	3.2
Ireland	2.3	2.0	2.9	3.4	4.1	4.1	8.2	7.3	5.3	5.2	8.3	10.6	2.2	11.5	12.4
Luxembourg	3.0	3.5	4.0	3.5	3.0	3.0	7.0	8.0	8.0	5.7	6.0	6.0	6.0	6.5	6.5
EMU countries[1,2]	1.1	1.7	2.0	1.4	1.3	1.6	1.6	2.9	3.7	6.2	5.8	5.0	6.5	5.5	4.6
EMU countries excl. Germany[1,2]	1.9	2.0	2.3	1.8	1.7	1.8	2.8	3.1	3.7	4.8	5.9	4.9	5.9	5.8	4.7
Great Britain	3.1	2.7	2.3	4.6	3.5	2.9	6.2	4.0	2.5	2.1	4.0	2.6	4.4	3.6	2.5
Sweden	2.5	3.0	3.0	1.0	1.0	1.0	2.5	6.0	6.0	9.5	7.5	6.0	6.0	8.0	6.5
Denmark	3.2	3.0	2.5	0.5	0.5	0.5	2.3	3.5	3.0	5.5	5.0	4.5	6.0	5.5	4.5
EU-15[1]	1.7	1.9	2.1	1.8	1.6	1.8	2.8	3.0	3.5	5.8	5.6	4.7	6.1	5.3	4.4
Poland	3.7	3.8	4.6	–0.3	–0.2	0.3	3.8	4.8	7.5	7.0	4.6	6.4	5.8	6.6	7.8
Czech Republic	2.7	3.5	4.0	–3.0	–1.1	1.4	9.7	7.1	5.0	20.1	7.5	6.0	18.3	6.7	5.4
Hungary	4.0	3.5	3.9	–0.8	0.6	1.4	11.5	6.0	5.0	13.1	6.5	6.4	14.6	5.8	5.9
Slovakia	3.5	4.0	4.1	0.7	2.7	3.6	4.1	5.5	5.8	10.0	7.0	8.7	11.9	6.6	7.8
Slovenia	3.6	4.1	4.4	1.5	2.2	2.8	6.4	4.9	5.7	11.5	6.2	5.5	11.0	5.9	4.9
Lithuania	8.8	7.7	8.0	3.1	4.7	5.5	11.8	9.5	8.2	4.7	9.0	8.3	12.8	7.2	6.5
Cyprus	4.4	4.1	4.5	4.0	2.4	4.1	11.9	5.6	6.0	5.9	4.3	4.8	10.1	2.9	5.0
Latvia	8.8	8.0	8.2	2.8	4.8	5.0	19.6	15.3	9.7	7.8	9.1	9.2	16.4	9.7	9.5
Estonia	6.3	6.2	6.1	4.7	4.9	4.9	7.6	8.0	8.2	19.8	9.7	8.7	16.4	9.1	8.2
Malta	0.5	1.2	1.5	0.5	0.5	0.5	6.0	2.0	1.0	1.8	2.8	2.8	1.5	2.5	2.5
EU-25[1]	1.8	2.0	2.2	1.7	1.6	1.7	3.0	3.2	3.6	6.2	5.7	4.8	6.6	5.4	4.5
Switzerland	1.5	1.8	1.7	0.5	0.5	0.5	3.0	3.0	2.5	5.0	5.5	4.5	6.0	6.3	5.2
Norway	4.9	4.5	3.8	2.0	2.0	2.0	2.5	3.0	2.5	4.5	4.5	4.0	5.8	6.0	5.0
Europe[1]	1.8	2.0	2.2	1.7	1.6	1.7	3.0	3.2	3.5	6.1	5.6	4.8	6.5	5.4	4.6
USA	3.7	3.1	2.6	1.9	2.9	3.0	9.2	7.6	6.0	8.7	6.8	6.7	10.1	7.8	6.6
Japan	1.9	1.8	2.6	2.4	–0.3	–0.3	2.0	2.1	3.7	14.0	4.5	6.5	8.5	6.4	5.8
Canada	3.3	3.2	3.1	2.8	3.2	3.2	6.2	5.5	4.7	7.7	7.0	5.8	8.4	9.3	6.5
Non-European industrial countries[1]	3.2	2.8	2.6	2.1	2.0	2.1	6.7	5.8	5.2	10.0	6.2	6.5	9.6	7.7	6.4
Total[1]	2.7	2.5	2.5	1.9	1.8	1.9	5.2	4.7	4.5	7.4	5.8	5.3	7.7	6.3	5.3
Total excl. Germany[1]	3.0	2.7	2.6	2.1	1.9	2.0	5.7	4.9	4.6	7.0	5.8	5.3	7.6	6.5	5.4

1 2003 weights on dollar basis at 2003 exchange rates (annual average); exports and imports: weighted average of the countries concerned. — 2 Exports and imports incl. intra-EMU trade.
Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW Berlin calculations; 2004 to 2006: DIW Berlin estimate and prognosis.

Table 3
Real GDP and Consumer Prices in Selected Asian Economies

	Weight (%) GDP	GDP				Consumer prices[1]			
		Change (%) on the previous year							
		2003	2004	2005	2006	2003	2004	2005	2006
Indonesia	7.5	4.5	5.0	4.5	5.0	6.7	6.0	5.5	5.5
Malaysia	4.6	5.3	7.2	6.0	6.0	1.2	1.3	1.5	1.5
Singapore	4.4	1.1	7.8	4.0	4.5	0.5	1.9	1.5	1.5
South Korea	21.8	3.1	5.0	4.5	5.0	3.5	3.7	4.0	4.0
China	61.6	9.1	9.4	8.0	8.5	1.2	4.5	5.0	5.0
South-east Asia[1]	100.0	6.9	7.9	6.7	7.2	2.1	4.2	4.5	4.5

1 Sum for countries listed. Weights: 2001 GDP in US dollars.
Sources: National and international statistics; DIW Berlin calculations; 2004 to 2006: DIW Berlin estimate and prognosis.

currencies and also the trend for the price of oil. The USA's high and still-rising current account deficit is being monitored with concern on the financial markets. Resulting portfolio restructuring has reinforced the upward pressure on the euro and in itself constitutes a burden on the competitiveness of European exporters. This forecast is based on the assumption that the euro/dollar exchange rate will remain fixed at just over US $ 1.30 per euro. In other words, the upward trend will come to a halt during the forecast period. One of the important factors behind this development are improved capital market yields as interest rates rise. Moreover, the US dollar has already appreciated substantially in recent years – by a hefty 20% in nominal effective terms over the last two years. This has substantially increased the competitiveness of US enterprises, although the improvement has not yet been reflected in the current account. Experience has shown, however, that a currency depreciation initially has a negative effect on the foreign trade position because import prices adjust more quickly than the volume of goods exported can be expanded. Taking this effect into consideration, the US current account deficit is likely to fall over the medium term as a share of GDP by about 1 percentage point on the current figure.

The oil-price trend poses another risk. The DIW Berlin believes that the current oil price is still excessive in that it is based in part on speculative activity and is therefore not in line with its fundamental determinants. Given that there is adequate capacity, that stocks have increased and that the pace of world economic growth has slowed, the authors believe that the boom will come to an end and that the price of crude oil will decline again. If, however, there is renewed speculation or if, indeed, productive activities were to be significantly impeded by terrorist attacks, then the recovery of the world economy would be jeopardised.[2]

Weaker momentum in Asia

Asia is currently one of the regions experiencing the strongest pace of overall economic growth (cf. table 3).[3] However, the rate of expansion has recently slowed in this part of the world. This also applies to Japan, where output almost stagnated in the summer of 2004.[4] In the second quarter, GDP actually declined slightly as government investment dropped sharply (cf. figure 1). The domestic economy has now recovered again to some extent, however. Both investment and private consumption are expanding, albeit at subdued rates. Domestic investors are evidently availing of the increasingly open access to loans. The moderate improvement on the labour market has clearly boosted consumer confidence. Exports are rising at only a very restrained pace, however, as the appreciation of the yen and the weakening world economy have curtailed demand for Japanese products.

Consumer prices rose in October on the previous month; however, when food prices are excluded from the calculation, consumer prices continue to show a slight

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2 In order to estimate the effects of unfavourable exchange-rate and oil-price trends, the NiGEM model was used to simulate a scenario of this kind. The results can be viewed in the chapter 'The German Economy', box 2, page 14.

3 The forecast was drawn up prior to the tsunami disaster of 26 December 2004 and therefore does not give consideration to the consequences of this event.

4 The method used to measure GDP and its components in Japan was recently significantly revised. The GDP deflator and the way in which it is constructed were altered very substantially (for details, cf. http://www.esri.cao.go.jp/jp/sna). The new statistical procedure has resulted in much lower GDP growth rates for the last three years. According to the 'old' figures, GDP grew at an annual rate of 7.6% in the fourth quarter of 2003. The revised figures indicate a growth rate of 3.6%. Thus, the growth rate based on the forecasts to date for 2004 has diminished substantially.

decline. The Japanese central bank intends to maintain its policy of 'easy money' until the deflationary trend can be considered overcome. Given that the strong yen tends to exert a downward pressure on prices, there is no reason to expect a change in monetary policy for the present.[5]

Japanese fiscal policy is geared towards pushing forward the consolidation of the public budgets. Up to now, the restriction of the deficit to around 7% of GDP has been primarily due to the influence of the automatic stabilisers. Further-reaching measures would be required if the public sector's deficits are to be reduced more rapidly. Whenever more forceful measures have been implemented in the past, however, they have frequently stifled growth. Fiscal policy can at most be expected to have a slightly restrictive effect over the forecast period.

The Japanese economy will continue to expand overall. The first dampening impulse will come from abroad when the slowdown in overall momentum makes itself felt in the region. This effect, as well as the effect emanating from the yen's appreciation, will then gradually abate. The improved level of consumer confidence will help to maintain private consumption on an upward trajectory. The pace of private-sector investment will accelerate over the forecast period, not least because financing conditions have improved. All in all, GDP will increase by 1.5% this year and by 2.7% in 2006. At the same time, the unemployment rate will fall – though not until next year – to an estimated 4.3%. The decline in consumer prices will ease off over the course of the forecast period.

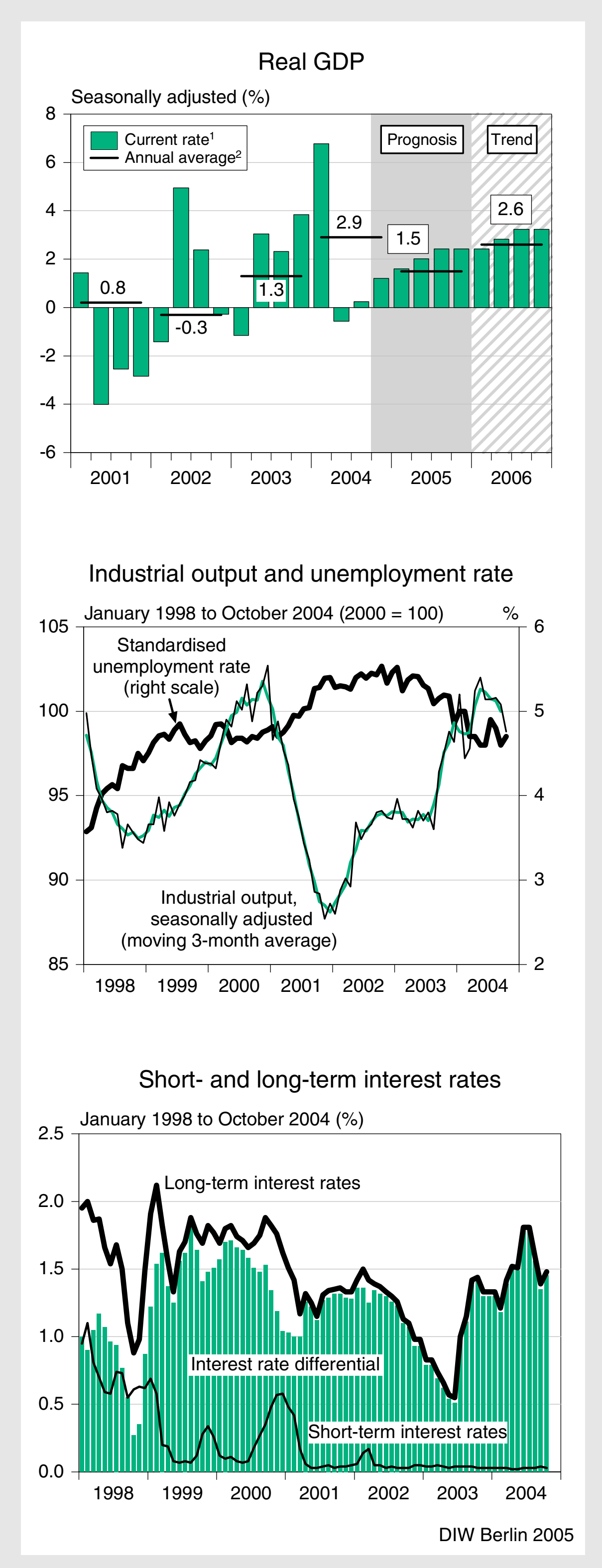
In China, the economy continued to expand robustly overall, with GDP increasing between January and September 2004 at a rate of 9.5% compared to the same period the previous year. The strong momentum is mainly based on external demand.

The Chinese economy is manifesting some symptoms of overheating, however. Inflation has risen significantly, and both the energy supply and commodities have been subject to shortages. Economic policy makers in China are attempting to react to the overheating. In fact, the government has decided to restrict the volume of credit and to raise interest rates. The present forecast is based on the assumption that this policy will be maintained and that China will experience a soft landing over the course of the forecast period. All in all, the Chinese economy will grow by 8.0% this year and by 8.5% in 2006.

The remaining Asian emerging countries also expanded rapidly in 2004. Export growth, which was robust anyway, was additionally stimulated by a rela-

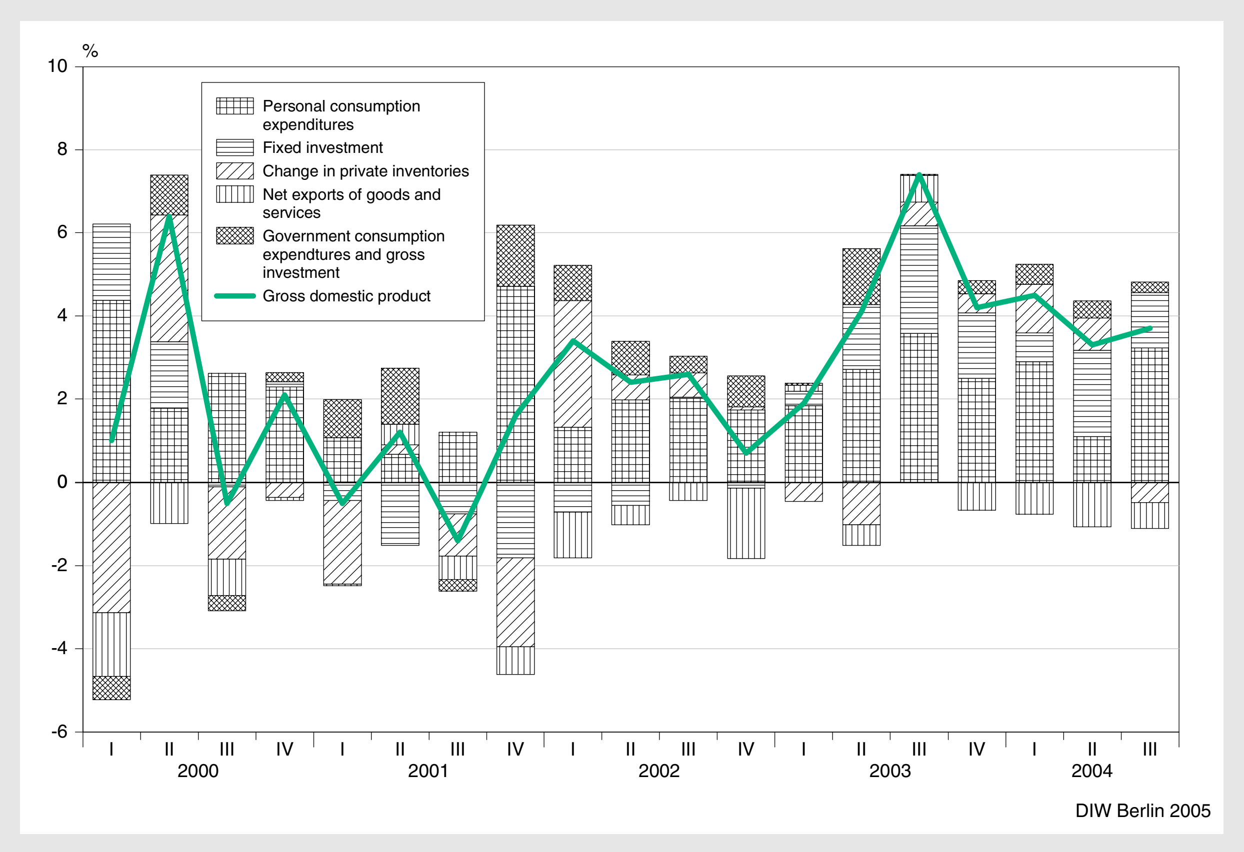
[5] This is a combined policy of zero interest rates and a generous supply of liquidity for the commercial banking sector.

Figure 1
Japan



1 Change (%) on the previous quarter, annualised rate. — 2 Change (%) on the previous year.
Sources: OECD; DIW Berlin calculations.

Figure 2
USA: Contributions of Components to Real GDP Growth



Sources: BEA; DIW Berlin calculations.

tively expansive monetary policy stance. As a consequence, both investment and private consumer spending also showed vigorous growth.

Although these countries will be affected by the slowdown in China over the forecast period, domestic factors such as the favourable financing conditions for investments will have a stabilising effect. Given this context, the prospects are auspicious for these countries over the forecast period.

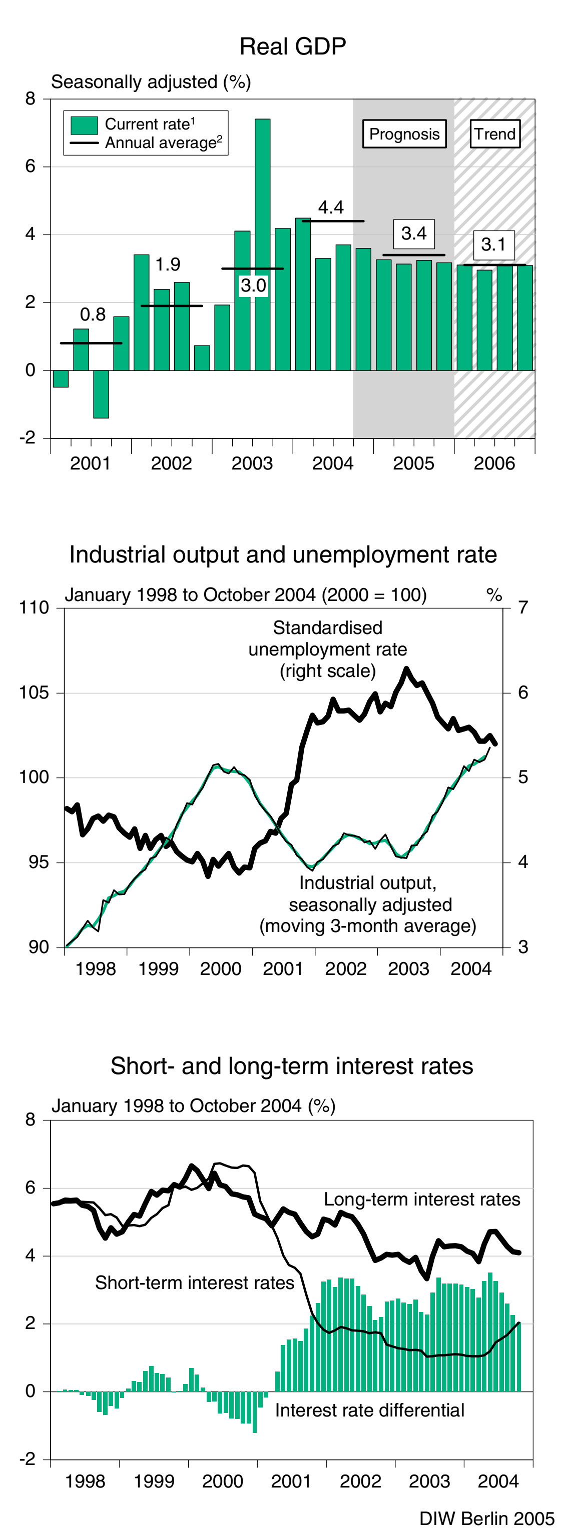
USA: economy enters calmer waters

The pace of overall economic expansion has slowed down in the USA since the beginning of the year, although the latest figures for output growth showed an annual rate of increase of 4%. The pillars that have supported growth in the USA – on the latest figures – have been a solid upward trend for private consumption and a substantial increase in private-sector investment in machinery and software (cf. figure 2), despite the fact that the strength of the impetus exerted by fiscal policy has diminished. Government investment and consumption spending also boosted growth last year.

Economic policy in the USA reduced the strength of its expansive drive last year, although the stance taken continues to act in support of economic growth. The US Federal Reserve has gradually raised the Federal Funds Rate by 1.25 percentage points since the middle of the year. The short-term interest rate last stood at 2.25% and was thus still very low when seen in historical perspective; short-term interest rates were negative in real terms, as they already have been for the last three years. As a result, the expansive impulse exerted by monetary policy remains substantial. Fiscal policy is also growth oriented, in particular by way of the after-effects of the tax reform. Even when these impulses abate, the fiscal policy course will remain expansive. Government purchases of armaments, in particular, will continue to exhibit very sizeable growth.

The upward trend in the USA will continue over the forecast period at a slightly reduced pace (cf. figure 3). Private consumer spending will expand at a slightly

Figure 3
USA



1 Change (%) on the previous quarter, annualised rate. — 2 Change (%) on the previous year.
Sources: OECD; DIW Berlin calculations.

slower pace than the average in recent years. The savings ratio of private households is unlikely to decline any further, rather may increase slightly. In addition, rising interest rates will curtail investment in housing construction, which was booming up to summer 2004. Investment in machinery will also expand at a somewhat slower pace than last year. In addition to rising interest rates on the capital markets, another factor behind the slowdown will be the expiry of tax concessions that last year had provided an incentive to bring forward planned investments to 2004. Employment growth will proceed at a moderate pace.

As oil prices rose and the US dollar depreciated, inflation continued to accelerate. The rise in productivity, which was substantial until only recently, diminished sharply, however. The result will be a more rapid rise in unit labour costs and consequently higher cost pressure on enterprises. As a result, the inflation rate will decline only slowly. Falling oil prices and the fact that the US dollar will not depreciate any further over the forecast period will in themselves have a dampening effect on price growth.

All in all, GDP will rise by 3.4% in the USA in 2005, following a 4.4% increase in 2004. Growth is likely to slow down to some extent (3.1%) in 2006. The inflation rate will amount to 2.7% this year – the same figure as last year – and will fall to 2.3% in 2006.

Moderate Recovery in the EU

Investment-driven growth in the new EU member states

At an annualised rate of 4% in the third quarter of 2004, growth in the EU's new member states was once again more dynamic than in the euro zone as a whole, although the pace was slightly slower than in the second quarter of the year. The highest growth rates were recorded in the Baltic countries. The robust growth rates have been accompanied by a strong increase in industrial output.

Growth is still primarily driven by domestic demand. While the growth rates for private consumption declined slightly on trend, most countries are experiencing an investment boom based both on foreign direct investment and on infrastructure projects. Several countries showed double-digit year-on growth rates for real capital investments. Export growth slowed down in the third quarter, although the rates of expansion remained strong. This development was probably not only related to the high oil price and the weaker pace of world economic growth, but was also determined by the exchange-rate trends. The currencies of some countries have appreciated in nominal terms in recent months. This was most evident in Poland, where the zloty has appreciated by almost 10% against the euro since the beginning of 2004. The rise in imports was weaker in the third quarter than in the second. The reason was the tendency to anticipate purchases from abroad in advance of the harmonisation of the external tariffs in the EU – this effect led to a rise in imports in the second quarter of the year, especially those from non-EU countries. The enlargement of the EU led to an overall shift in trade flows because the accession countries are now increasingly importing goods and services from the 'old' member states. Except in just a few cases, the result has been a substantial deterioration in the trade balance of these countries against the old member states, while the balance against non-EU countries has improved.

The high growth rates contributed in the Baltic countries, in particular, to a decline in the unemployment rate; nonetheless, unemployment in the new member states still frequently exceeds the EU average. In the central European countries, employment rose only marginally, if at all. The strong growth rates are still principally the result of strong productivity growth.

Inflation rates rose sharply in all countries over the course of 2004, largely because of adjustments in indirect taxes and regulated prices, and also because of the oil-price rise. Country-specific determinants such as the unexpected price hikes for foodstuffs in Poland and the strong economy in Latvia were an additional factor.

Growth in the new member states will continue to exceed the EU average over the forecast period. However, 2005 will bring a temporary slowdown, especially in Poland, where the sharp appreciation of the zloty will curb export growth. Private consumption will be curtailed by the persisting strained situation on the labour market; moreover, the restrictive monetary policy stance maintained in 2004 will impede a more robust recovery in investments. The other new member states will grow at much the same pace as before. The Baltic states, in particular, will face the risk of high and rising current account deficits. The Latvian economy is threatening to overheat.[6] In Hungary, more intense efforts to consolidate the public budget and a reduction in the current account deficit could become necessary over the forecast period, and this would result in greater losses in growth. All in all, real GDP in the new member states can be expected to show a weighted increase of 4% in 2005 and of 4.5% in 2006.

After a temporary further increase in inflation rates at the beginning of 2005, the rise in prices will become noticeably weaker. Having increased by 4.2% in 2004, prices will rise by 3.7% in 2005 and by 2.8% in 2006. Unemployment rates will decline only slightly. The Baltic countries will be the exception in this regard: here, the high growth rates will go hand in hand with a perceptible decline in unemployment.

Euro zone: temporary slowdown in growth

The third quarter of 2004 also saw a weakening of growth in the euro zone; real GDP rose at an annualised rate of 2.2% on the previous quarter, following a 2.0% increase in the second quarter of the year. The main reason was the deterioration in the external conditions, in particular the appreciation of the euro against the US dollar and the renewed increase in the price of oil (cf. figure 4).

Growth in the third quarter was boosted by domestic demand, which showed an increase of 4.4% on the previous quarter. Without taking account of the build-up of stocks, this amounts to an increase of 1.6% – the highest

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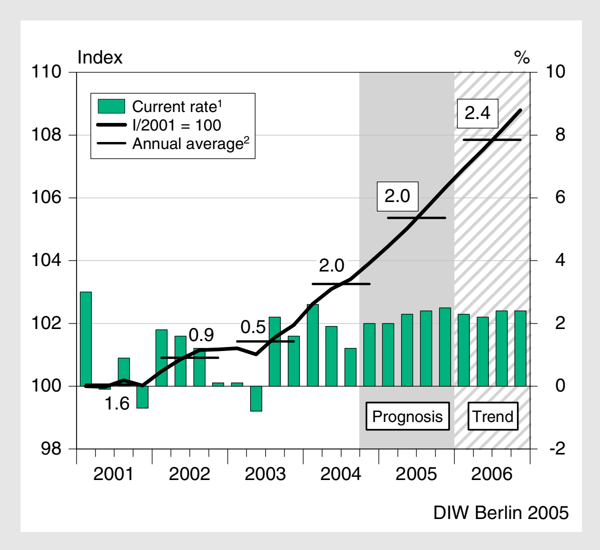
[6] In addition, in preparation for participation in the ERM II exchange-rate mechanism, at the beginning of 2005 the Latvian lat's exchange-rate peg to the Special Drawing Rights basket of currencies will be switched to the euro as anchor currency. In recent months, as the US dollar has depreciated, the lat has also depreciated in nominal terms against the euro; this has limited the negative impact of the higher inflation rate on the real exchange rate against the euro zone. The stabilisation of the exchange rate from January 2005 onwards could thus further exacerbate Latvia's negative foreign trade balance.

Figure 4
Real GDP in the Euro Zone
Seasonally adjusted



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Change (%) on the previous year.
Sources: Eurostat; DIW Berlin calculations.

since the beginning of 2003. While private consumption rose only very moderately, capital investments (especially investment in machinery) increased relatively robustly. Stock-building, which was related to the substantial expansion of imports, contributed significantly to the growth rate. The external balance was markedly negative in the third quarter, and the rise in imports was thrice as high as that for exports. The foreign trade balance – calculated in nominal terms – also deteriorated perceptibly in the third quarter. This was due only to a minor extent to the trade balance with the USA; the trade deficit with the oil-exporting countries and with China increased, by contrast. The trade gap with China is now almost of the same magnitude as the trade surplus with the USA.

Employment rose slightly in the euro zone in the third quarter of the year. The unemployment rate remained unchanged at almost 9%. As a result of the more robust rate of economic growth in 2004 and the extremely moderate rate of wage growth, the increase in unit labour costs slowed down perceptibly.

Inflation amounted to 2.4% in October 2004; it has exceeded the European Central Bank's reference value of 2% since the middle of the year. The renewed rise in the rate of inflation is mainly a consequence of the higher prices for energy and of administrative measures such as increases in indirect taxes and duties.

In addition to the European Commission's leading indicator for growth, the confidence indicators and industrial output, especially, also suggest that growth has picked up once again in the euro zone. GDP growth amounted to 2.0% for 2004 as a whole, and this figure also corresponds to the growth in domestic demand.

The repercussions of the high oil price and the temporary slowdown in world economic expansion will curtail growth to some extent over the coming months. Growth will be largely borne by domestic demand in 2005. The relatively favourable earnings expectations in the euro zone will facilitate a noticeable rise in investment. While private consumption will increase only moderately, it will do so at higher rates than previously. Real GDP is likely to rise in the euro zone in 2005 by an average 2%; a somewhat higher increase (2.4%) can be expected in 2006 in view of the foreseeable stronger rate of world economic expansion (cf. table 4).

The harmonised price index will rise by an annual average 2.1% in 2005 and by 1.7% the following year. The rise will mainly be a consequence of energy price growth. Prices will not be subject to any pressure from wage growth, and second-round effects based on the oil-price rise are unlikely. Unit labour costs can be expected to rise by about 1%. Next year, the increase is likely to be somewhat sharper, rising to an annual average of 1.5%. Employment will remain on a growth trajectory over the next two years, but the increase will not be strong enough to reduce the unemployment rate to any

Table 4
EMU Countries: Key Forecast Figures

	2002	2003	2004	2005	2006
	Change (%) on the previous year				
Real GDP	0.8	0.5	2.0	2.0	2.4
Private consumption	0.6	1.0	1.1	1.7	2.0
Government consumption	3.0	2.0	1.4	1.3	1.6
Gross fixed capital formation	–2.8	–0.5	1.6	2.9	3.7
Construction	–1.9	–0.5	0.5	1.6	3.1
Machinery and other equipment	–3.7	–0.5	2.6	4.2	4.5
External surplus/deficit[1]	0.5	–0.7	0.1	0.2	0.2
Consumer prices[2]	2.3	2.1	2.1	2.1	1.7
Unit labour costs	2.3	2.2	0.8	1.0	1.3
	As % of nominal GDP				
Budget surplus/deficit[3]	–2.2	–2.7	–2.9	–2.6	–2.4
Current account balance	0.8	0.4	0.5	0.8	1.0
	As % of labour force				
Unemployment rate[4]	8.4	8.9	8.9	8.7	8.3

1 Contribution to GDP growth. — 2 Harmonised index of consumer prices. — 3 Total government surplus/deficit. — 4 Standardised.
Sources: National and international statistics; DIW Berlin calculations; 2004 to 2006: DIW Berlin estimate and prognosis.

conspicuous extent; it will amount to an average 8.7% this year and an average 8.3% in 2006.

Fiscal policy in the euro zone: slightly restrictive stance

The public budgets in the euro zone were somewhat more strained again last year. The aggregate deficit rose to 2.9% of GDP, having reached 2.7% in 2003 (cf. table 5). Germany, France and Greece have been breaching the Maastricht criteria for some time now; Portugal and, most recently, Italy have now joined them, while the Netherlands appear to have only just fulfilled the deficit criterion again last year. With the exception of Italy and Portugal, the situation in these countries will improve only very slightly this year. In view of this situation, the European Commission has now proposed a looser interpretation of the Stability and Growth Pact and suggested that countries in difficulty should be given more time to implement adjustment measures.

In view of the only moderate degree of economic recovery, little progress will be made as regards fiscal policy consolidation. The deficit ratio will fall to around 2.6% this year and to 2.4% next year; fiscal policy will have a slightly restrictive effect. The two largest economies in the EU, Germany and France, are likely to succeed in fulfilling the Maastricht criteria.

More restrictive monetary conditions

Short-term (three-month) interest rates in the euro zone have amounted to 2.1% – which corresponds to almost 0% in real terms – for the last 18 months now. Long-term rates – measured as the yield on ten-year government bonds – recently amounted to almost 4% (less than 2% in real terms). This is a historically low level, and it shows that interest rates themselves are stimulating the economy in the euro zone. However, the successive upward revaluations of the euro have dampened growth. At over US $ 1.30 per euro on the most recent figures, the exchange rate is almost 10% higher than in summer 2004. Since then, the monetary parameters have become more restrictive (cf. figure 5).

The expansion of lending to the private sector accelerated slightly in the second half of 2004. The volume of new loans grew by 6.8% on recent figures, and therefore more rapidly by over one percentage point than at the beginning of the year. At 7.8%, growth in lending to private individuals expanded even more briskly. Loans to the business sector, at 5.2%, also expanded more robustly.

Table 5

Public Budget Financial Balance[1] for the EMU Countries

	2001	2002	2003	2004	2005	2006
Germany	–2.8	–3.7	–3.8	–3.8	–3.1	–2.5
France	–1.5	–3.2	–4.1	–3.8	–3.4	–3.0
Italy	–2.6	–2.3	–2.4	–3.2	–3.6	–3.8
Spain	–0.4	0.0	0.4	–0.5	0.5	0.0
Netherlands	0.0	–1.9	–3.2	–3.0	–2.5	–2.2
Belgium	0.5	0.1	0.4	–0.3	–0.4	–0.5
Austria	0.3	–0.2	–1.1	–1.4	–2.0	–1.8
Finland	5.2	4.3	2.3	2.2	2.1	2.2
Greece	–3.7	–3.7	–4.6	–5.8	–4.2	–3.6
Portugal	–4.4	–2.7	–2.8	–3.5	–3.8	–3.9
Ireland	0.9	–0.2	0.1	–0.4	–0.5	–0.5
Luxembourg	6.4	2.8	0.8	–0.9	–1.5	–2.0
EMU countries[2]	–1.6	–2.3	–2.7	–2.9	–2.6	–2.4

1 As % of gross domestic product; apportionment according to Maastricht Treaty. — 2 Total of countries listed. Weighted by 2003 GDP in euro.
Sources: ECB; Eurostat; European Commission; 2004 and 2006: DIW Berlin estimate and prognosis.

This forecast is based on the assumption that in view of the dampening effect of the rise in exchange rates, the ECB will maintain its chosen course throughout 2005 at the least and thus leave interest rates at their current level. A gradual increase in interest rates can be expected in 2006 at the earliest.[7]

Growth in Great Britain continues to exceed EU average

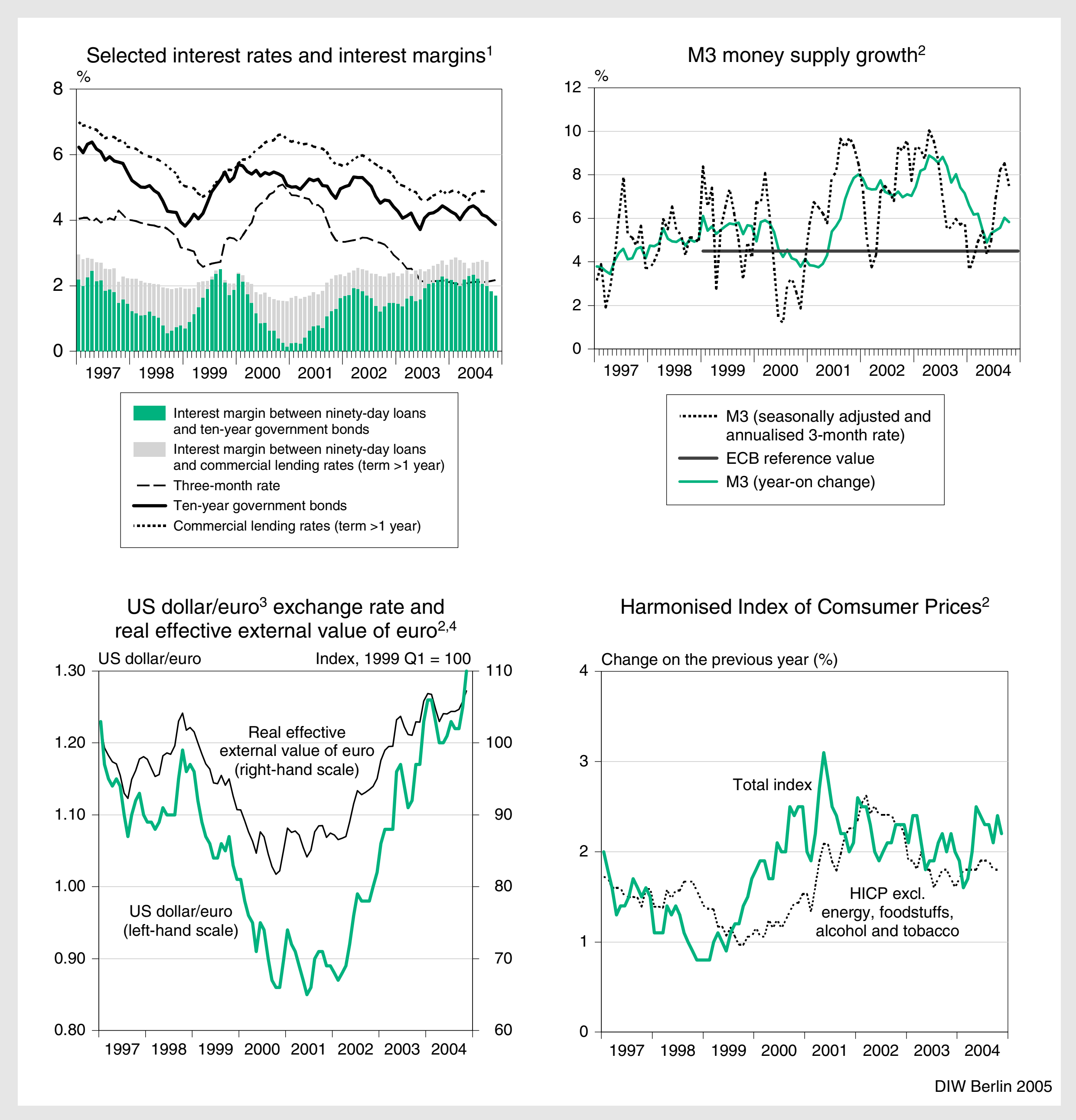
The robust upturn in Great Britain weakened somewhat in the second half of 2004; this was in reaction to the fact that economic policy has been less expansive for some time now (cf. figure 6). In particular on the basis of concern about the boom on the property market, the Bank of England had raised base rates perceptibly during the previous year and a half; subsequently, long-term interest rates also rose substantially. The upward price trend on the property market has since eased, without the widely feared crash having ever materialised. As employment prospects remain favourable, the increase in real disposable income is still significant, and private consumption growth has been curtailed only slightly. Overall capacity utilisation remained high, and business investments continued to rise.

[7] Cf. the relevant section in the Economic Policy chapter of this report for the monetary policy recommendations.

Figure 5

The Monetary Situation in the Euro Zone

January 1997 to November 2004



1 Lending rates from January 2003 onwards: 1 to 5 years, up to 1 million euro, new business, up to September 2004. — 2 Up to November 2004. — 3 Preceding 1998 exchange rate between US dollar and synthetic euro. — 4 Compared with a wide group of countries, based on consumer prices.
Sources: European Central Bank; Eurostat; DIW Berlin calculations.

As government spending rises robustly, fiscal policy is still on an expansive course; however, spending growth is abating, and the economic policy impulses are therefore decreasing. The pace of growth will diminish slightly as the world economy expands less rapidly. Economic growth will remain strong, however, compared to the other large EU economies, amounting to 3% this year and to 2.7% in 2006. Unemployment will remain entrenched at a low level. The inflation rate (HICP) is likely, at almost 2%, to amount to close to the Bank of England's target level.

The German Economy

Prospect of recovery

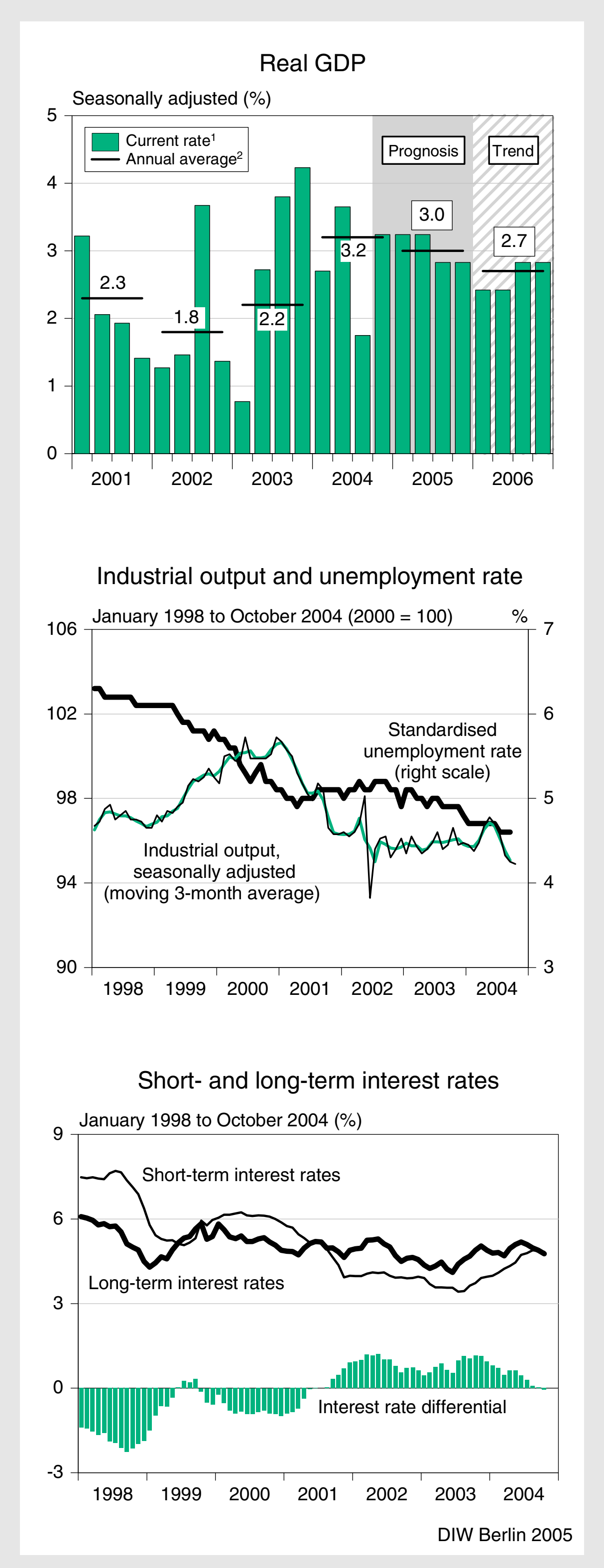
The German economy emerged from stagnation last year. As has been the case in previous upturns, the increase in external demand was once again the driving force behind the stronger macroeconomic growth. Initially, German exporters sold more goods on the US market, and this impetus was reinforced by a robust rise in demand from East Asia, especially from China. Sales to other European countries, which together account for over half of all German exports, grew in significance over the further course of the year. The growth dynamic was only very slightly curtailed by the marked appreciation of the euro at the beginning of 2004 (cf. figure 7 and table 7).

On the domestic demand side, by contrast, prospects remained gloomy. The main reasons were the acute job uncertainty overshadowing the labour markets and the extremely weak rate of income growth. The real value of disposable income increased only very slightly as a result of substantial cost saving through reductions of non-negotiated wage components and the decision by wage bargainers not to seek productivity-based wage increases. In addition, there was a further rise in the savings ratio, which was probably due in part to the expectation of further cuts in the course of the labour market reform (Hartz IV). Together, all of these factors led to a slight fall in private consumer spending.

Investment growth was also only moderate. Investors' expectations of profitable business investment opportunities were only gradually borne out over the course of the year. Capacity utilisation only recently began to rise again, as did investment activity.

The conditions are favourable this year for a steady upward growth trend. Exports will continue to bolster macroeconomic expansion, even if the force of the impetus will abate to some degree. The fact that growth will be becoming increasingly robust in the other countries of Europe will have a positive effect. While the labour market and social security reforms will improve supply conditions, in a large, open economy, this alone will not suffice to generate adequate growth if investment does not also expand dynamically. But investments can only grow when the sales expectations of enterprises become more favourable – a prerequisite that is only partially given in Germany at the moment. Thus, the continued weak rate of wage growth and the only slight waning of job uncertainty suggest that private consumption will remain the German economy's Achilles' heel this year, too. However, as employment rises again, private consumption will also stabilise (cf. figure 8).

Figure 6
Great Britain



1 Change (%) on the previous quarter, annualised rate. — 2 Change (%) on the previous year.
Sources: OECD; DIW Berlin calculations.

Assuming that the euro exchange rate will stay at the current level, exports will remain the driving force behind growth. As interest rates remain low, there will be greater motivation to expand capacities. Profit incomes increased significantly last year. A perceptible reduction in the burden of costs as demand rises and ongoing favourable refinancing conditions indicate that profits will rise this year, too. All in all, the economy will continue to gain pace this year; macroeconomic performance is likely to increase by 1.8% on annual average.

Next year the domestic forces for growth can be expected to strengthen, while the stimulus exerted by exports and investments will weaken. Real GDP will increase by 2%.

Exports: stable at high level

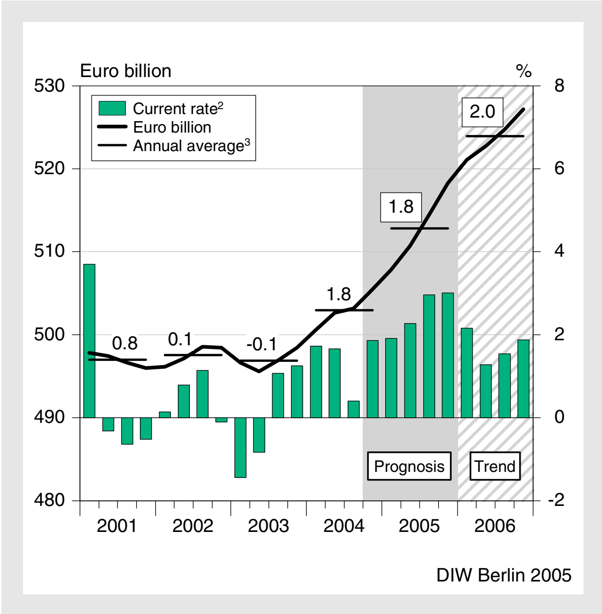
German goods exports expanded extremely substantially in the first three quarters of last year. The growth in exports to the euro zone, which – accounting for a share of around 44% – is by far the most important sales market for German products, was particularly positive. Exports to the countries of Central and Eastern Europe also rose significantly once again. The increases in visible trade with Poland, but also with Russia (which had benefited from the sharp rise in oil prices) were especially sizeable. Goods exports to South-east Asia also increased amply. Consignments to China and Japan, Germany's most important trading partners in Asia, grew enormously. In trade with Asia, the impulses exerted by the dynamic economic growth in this region more than offset the negative effects of the euro's appreciation. Exports to the USA, by contrast, were curbed by the strong value of the euro (cf. figure 9).

The conditions for the German export economy will remain favourable over the forecast period. While world economic growth will lose momentum to some extent, and the preceding appreciation of the euro will continue to exert a dampening effect, the resulting fall in demand will still be offset by the EMU countries, which will increasingly demand investment goods over the course of the moderate economic recovery in the euro zone. German exporters' trump card is and will remain their high level of competitiveness, which is likely to further improve over the forecast period. Against this background, robust export growth can be expected both this year and next year. Export growth is likely to amount to 5.7% on annual average in 2005, and to an annual average 5.2% in 2006 (cf. figure 10).

Figure 7

Real Gross Domestic Product in Germany

Adjusted for seasonal and working days effects[1]



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.
Sources: Federal Statistical Office; DIW Berlin calculations.

Imports: moderate growth

Goods imports also expanded substantially in the first three quarters of last year, albeit at a much weaker rate than exports. Demand for imports will be stimulated

Box 1

Assumptions underlying the prognosis

- The price of crude oil will amount to around US $ 33 per barrel both this year and next year.
- The euro/dollar exchange rate will remain at a level of US $ 1.30 per euro over the forecast period.
- The European Central Bank will leave base rates at their current level this year; a slight rise in interest rates can be expected in 2006 at the earliest.
- Negotiated wages will rise by around 1.6% this year and by around 1.8% next year.

Box 2

Simulation results

As outlined in the introduction to this report, the primary risks to the accuracy of the forecast are found in the exchange rate trend for the US dollar and in the effects of a higher oil price rise than assumed (or a renewed oil price rise). In order to estimate the effects of a different trend to that described here, the NiGEM model was used to carry out a simulation calculation in which a permanently lower exchange rate for the US dollar (US $ 1.50 per euro) and a permanently higher oil price (US $ 50 per barrel) were assumed.

The NIGEM model is a macroeconometric multi-country model. It contains blocks for all the OECD countries, for the new Central and Eastern European EU countries, and for China, and regional blocks for East Asia, Latin America, Africa and the OPEC countries. The model is based on a neo-Keynesian model, in which the economic units make decisions on the basis of forward-looking expectations, but nominal and real rigidities render the adjustment process extremely slow. The main indicators determined by forward-looking decision-making are interest rates, prices, exchange rates and asset prices. The results of the simulations show that under a scenario of this kind, GDP in Germany and in the euro zone would be almost 1% lower in the first year than under the base scenario, while prices would be slightly lower. No monetary policy reaction was assumed in the simulation. Likewise, no consideration was given to the possibility of over-reactions on the financial markets.

Table 6

Results of Simulation

Deviations (%) from base simulation

	Euro zone		Germany	
	GDP	Consumer prices	GDP	Consumer prices
Year 1	–0.9	–0.5	–0.9	–0.3
Year 2	–0.8	–0.8	–0.7	–0.5
Year 3	–0.5	–0.9	–0.5	–0.8

Source: DIW Berlin calculations.

both by exports, which contain a large import component, and by private consumption over the forecast period. All in all, imports will grow in real terms by 4.7% this year and by 4.5% in 2006.

Both export and import prices will rise only slightly over the forecast period. The terms of trade will therefore remain more or less unchanged (cf. figure 11).

Private consumption: only moderate growth

Private consumption stagnated in Germany over the course of last year. The main contributing factors were the decline in employment and the trend for disposable income. While private consumption recovered to an

Table 7

Contribution to Growth in Real GDP

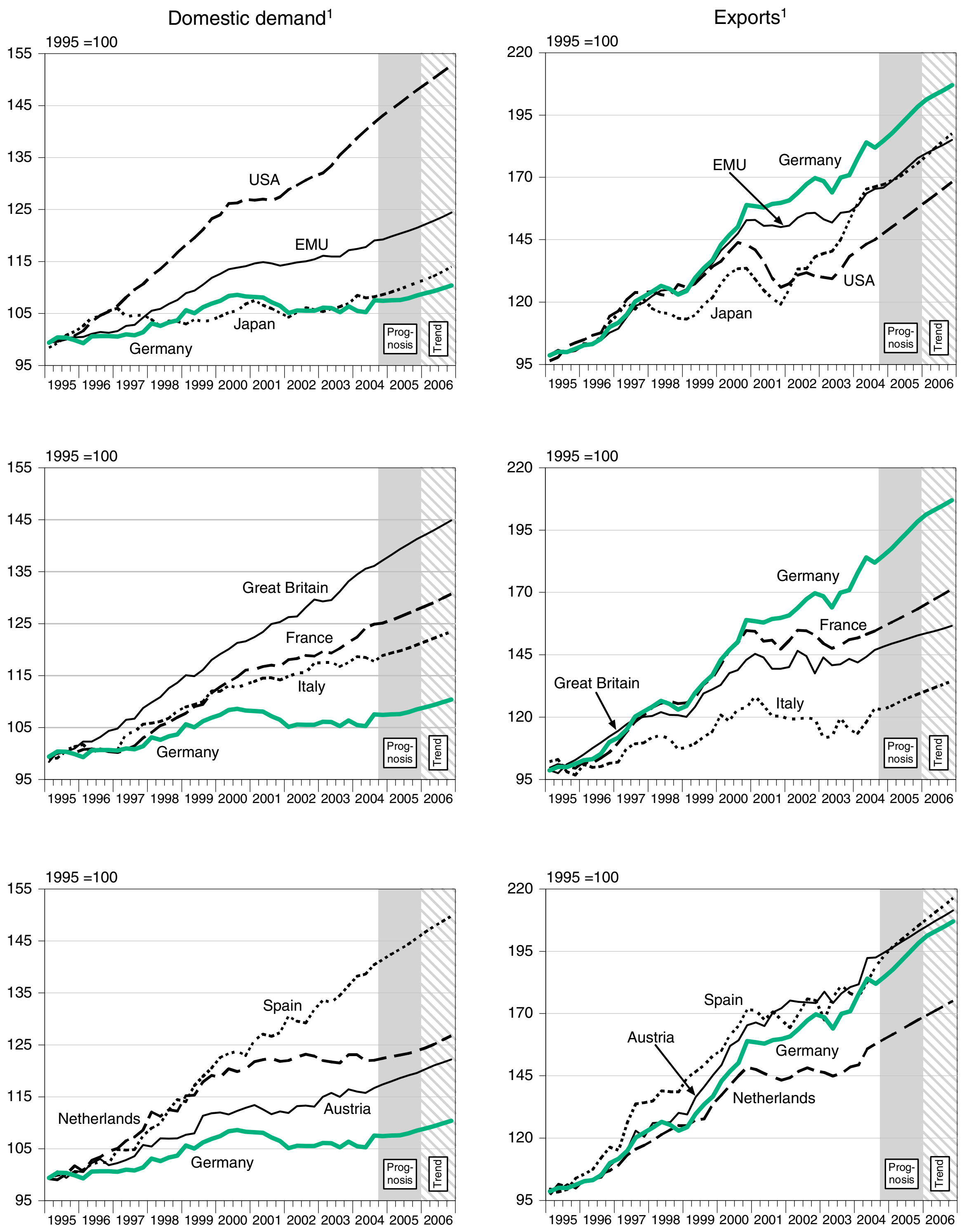
In percentage points

	DIW estimate July 2004[1]		DIW estimate January 2005[2]		Difference between estimates	
	2004	2005	2004	2005	2004	2005
Private consumption	0.2	0.7	–0.2	0.5	–0.4	–0.2
Government consumption	–0.4	–0.2	–0.1	0.0	0.3	0.2
Machinery	0.3	0.5	0.1	0.5	–0.2	0.0
Other equipment	0.1	0.1	0.0	0.1	0.0	0.0
Construction	0.0	0.1	–0.2	–0.2	–0.3	–0.3
Investment in stocks	0.4	0.1	1.2	0.2	0.8	0.1
Domestic demand	0.6	1.4	0.0	1.1	0.2	–0.2
Exports	3.2	2.6	3.5	2.3	0.3	–0.4
Imports	1.9	1.8	2.6	1.6	0.6	–0.2
Trade surplus/deficit	1.3	0.8	0.9	0.6	–0.4	–0.2
GDP	1.8	2.1	1.8	1.8	0.1	–0.4

Figures may not sum due to rounding.
1 Data as at June 2004. — 2 Data as at December 2004.
Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 8

Domestic Demand and Exports by International Comparison

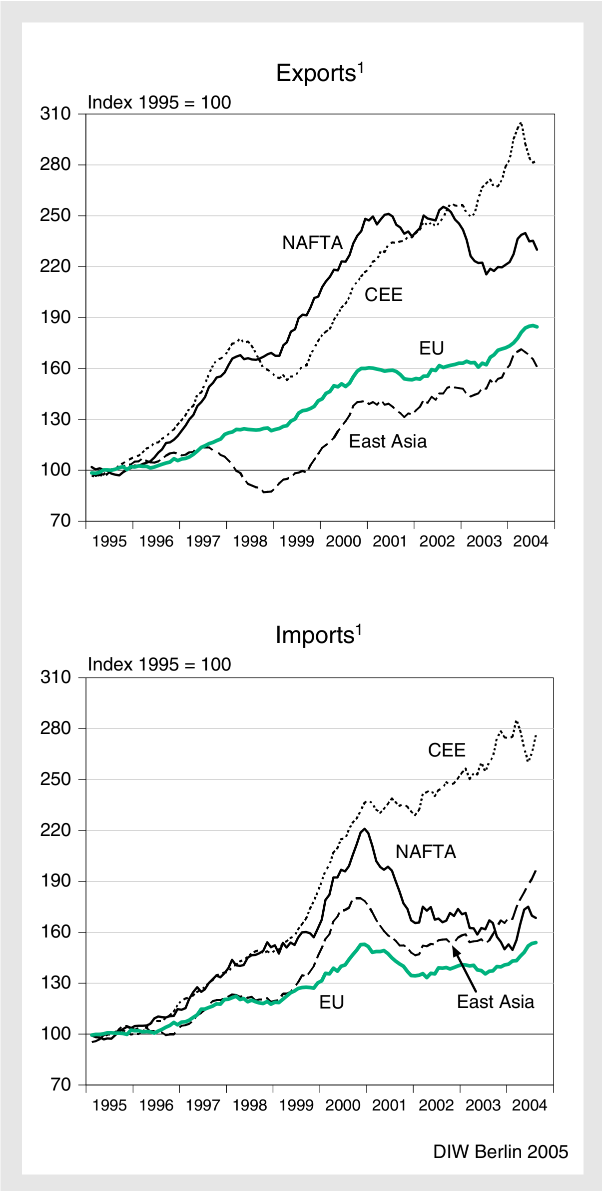


DIW Berlin 2005

1 Seasonally adjusted, at constant prices.
Sources: OECD; Federal Statistical Office; DIW Berlin calculations.

Figure 9

Regional Trends for German Foreign Trade



1 Special trade, nominal; seasonally adjusted according to Berlin method (BV4); moving three-month average.
Sources: Federal Statistical Office; DIW Berlin calculations.

extent towards the end of the year, a robust upward trend failed to materialise. Private consumption declined in 2004 by 0.3% in real terms.

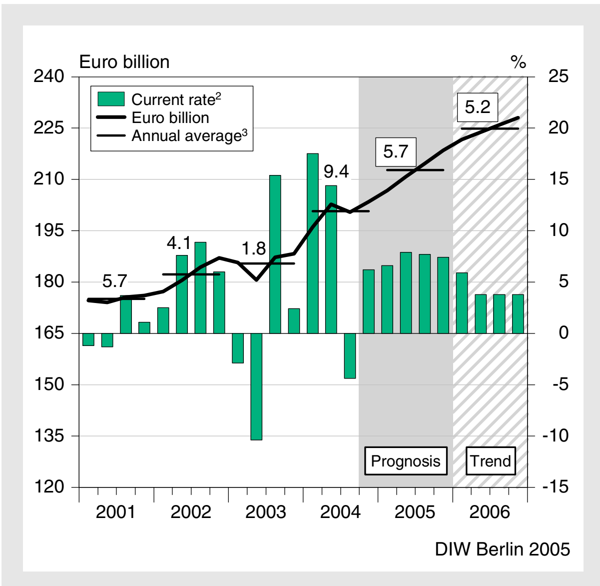
Employment will recover this year, and this is likely to have a positive impact on consumption prospects. Effective earnings will expand at a somewhat stronger rate than previously so that the gross wage and salary bill per employee, at 0.9%, will increase at a moderately faster rate. Because of the renewed reduction of the tax scale alone, net wages and salaries will increase by around 6.5 billion euro. Above-average incomes will enjoy the greater benefit from the reduction in the tax burden, so some of the relief will actually flow into savings instead of boosting private consumption. The gradual transition to deferred taxation of pensions (under the Retirement Income Act) will further reduce the burden on incomes. However, this reduction will be counterbalanced by some significant additional burdens. For example, since the beginning of this year, childless individuals are subject to a higher contribution rate to long-term care insurance. The mid-year adjustment of pension levels will not lead to higher pension payments because gross wages and salaries stagnated last year. Dependent employees are facing a rise in health-insurance contribution rates because the new regulation on dentures, which will come into force in mid-2005, will raise their rates by 0.45 percentage points; employer rates will fall by the same amount. The restructuring of unemployment assistance and social assistance will lead to additional benefit cuts. On balance, disposable income will increase by 2.3%; there will be an above-average rise in the income of the self-employed and in income from assets. A similar trend can be expected for nominal consumer spending, so that the savings ratio will fall marginally. In real terms, private consumer spending will increase by 0.9%.

The moderate increase in employment is likely to strengthen private consumer spending over the coming

Figure 10

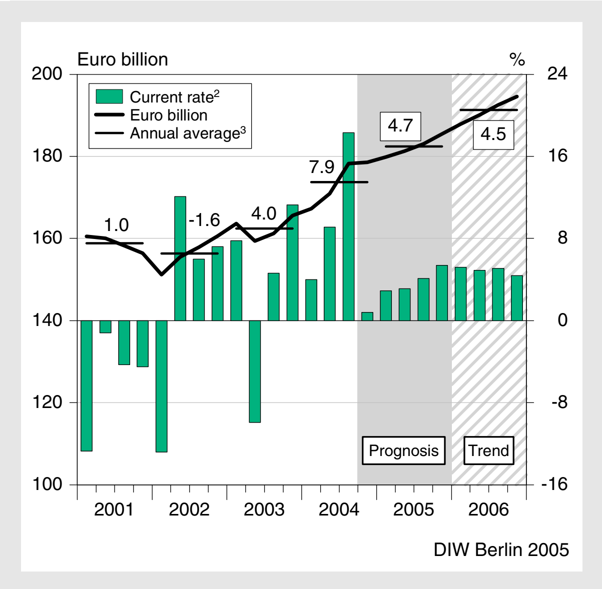
Real Exports

Adjusted for seasonal and working days effects[1]



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.
Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 11
Real Imports
Adjusted for seasonal and working days effects[1]



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.
Sources: Federal Statistical Office; DIW Berlin calculations.

year. The growth rate for effective earnings will remain modest at 1.4% and will not be offset by additional tax burdens or cuts. The rise in consumer prices is likely to be marginally weaker. All in all, an increase of 1.1% in real private consumption can be expected in 2006 (cf. figure 12).

Inflation to remain weak

Consumer prices were mainly affected last year by the increase in the price of heating oil and fuels and by the sharp rises in administered costs. Prices for heating oil and fuels rose by almost 15% over the course of the year. All in all, the annual inflation rate amounted to 1.6%.

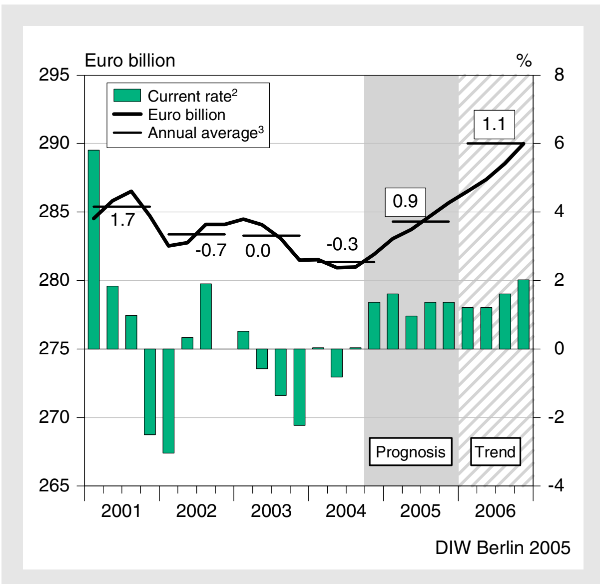
The energy supply will be a source of sharp price rises this coming year. Gas prices, which adhere to oil-price trends following a time lag, will be substantially increased. In addition, Deutsche Bahn railways will be raising prices for local and long-distance travel, while September will bring a further increase in tobacco tax. The economic development will not exert any inflationary pressure, however. Competitive pressure will remain high. Labour costs will rise only slightly, while unit labour costs will fall. The inflation rate will therefore increase slightly at the beginning of the year, but the rate of increase will decline again over the further course of the year. All in all, the consumer price index will rise by 1.6% this year and by an estimated 1.4% next year.

Growth in machinery investments

For the first time since 2001, last year brought an upturn in investments by enterprises in machinery and other equipment. The increase in exports and the low interest rates had a positive impact on investment activity. The level of growth (2%) was only weak, however, because domestic demand was persistently weak and capacity utilisation remained low, especially in manufacturing industry. The oil-price hikes also unnerved investors (cf. figure 13).

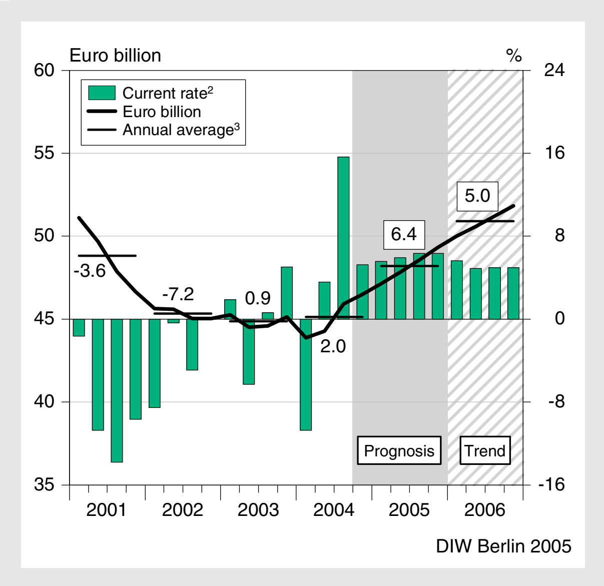
Machinery investments are likely to increase markedly over the course of the coming year. The impetus will be provided by the high demand from abroad, but also by private consumption. High enterprise profits, low interest rates and robust share prices will facilitate financing of investments. Falling unit labour costs and the stabilisation of the oil price will also have a positive impact on investment activity. Investment in other equipment, which has been stable in recent years, will increase further this year. Investment in machinery and

Figure 12
Real Private Consumption of Private Households
Adjusted for seasonal and working days effects[1]



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.
Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 13
Real Investment in Machinery and Other Equipment
Adjusted for seasonal and working days effects[1]



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.
Sources: Federal Statistical Office; DIW Berlin calculations.

other equipment will rise on average in 2005 by 6.4%, while an increase of 5% can be expected in 2006.

Construction sector likely to stabilise

The decline in building investments persisted in 2004, but the pace of the decline diminished (–2.2%). Investments in commercial construction fell in particular. Although mortgage rates are favourable, excess capacities and therefore vacancies in office and commercial buildings are still deterring enterprises from investing. The weak level of income growth in private households is also curbing growth in the building industry.

Investment in housing construction declined only marginally last year (–0.5%). The conditions for investment are likely to gradually improve over the forecast period. The slightly improved labour market situation and rising disposable income will have a positive impact on owner-occupied housing construction. Market prices for apartments and for single-family houses are already rising again in some cities and conurbations, and the financing conditions will remain favourable. Thus, the numerous construction projects for which permits have already been obtained in advance of the planned abolition of the subsidy for owner-occupied housing construction will be carried out in this period. This will lead to a temporary stabilisation of investment in housing construction. Nonetheless, the unfavourable demographic trend will increasingly impede a sustained recovery of building demand in this area.

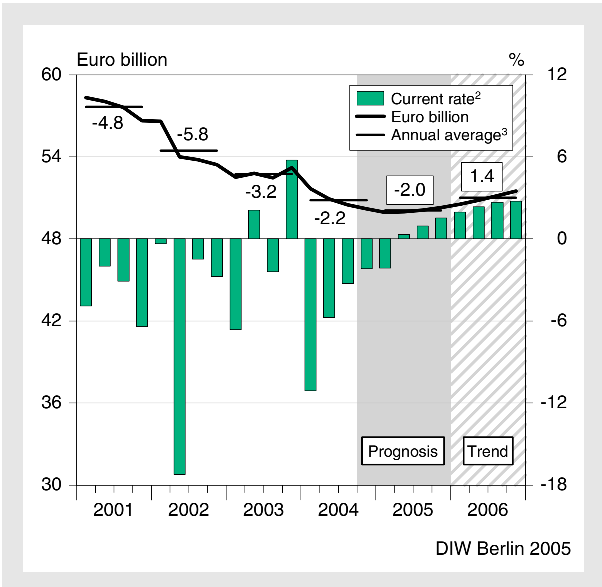
The vacancies and the resulting supply surpluses in commercial construction will have to be reduced before rising demand leads to new building activity. The number of building permits granted and the incoming orders received indicate that the commercial construction sector will remain weak and cannot be expected to stabilise before the second half of this year. The strained budget situation at local government level will lead to a further, if much less severe, decline in public investment in construction.

All in all, building investments will decline by an annual average 2.2% in 2005, but 2006 will bring an increase of 1.4% (cf. figure 14 and table 8).

Little improvement on the labour market

The expansion of national output has not yet eased the situation on the labour market (cf. figure 15). The reason is not only the rise in productivity, but also the fact that a substantial share of the additional economic perform-

Figure 14
Real Investment in Construction
Adjusted for seasonal and working days effects[1]



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.
Sources: Federal Statistical Office; DIW Berlin calculations.

Table 8
Building Investment[1] in Germany

	2003	2004	2005	2006
	Euro billion			
Housing	121.1	120.6	118.3	120.6
Non-residential[2]	89.0	84.9	83.1	83.7
Government	26.5	24.8	24.1	23.7
Other sectors	62.5	60.1	59.0	60.0
Total[3]	210.1	205.5	201.5	204.3
	Change (%) on the previous year			
Housing	–2.7	–0.5	–1.9	2.0
Non-residential[2]	–4.0	–4.6	–2.0	0.6
Government	–10.4	–6.6	–2.5	–1.7
Other sectors	–1.0	–3.8	–1.9	1.6
Total	–3.2	–2.2	–2.0	1.4

Figures may not sum due to rounding.
1 At 1995 prices; on national accounting definitions (ESNA 95). — 2 Building construction and civil engineering for the public and private sectors.
Sources: Federal Statistical Office; 2004 and 2005: DIW Berlin estimate and prognosis.

ance was achieved on the basis of an increase in annual working time. Last year the number of unemployed (seasonally adjusted figure) rose constantly. However, the trend was distorted by statistical effects.[8]

Not only the number of registered unemployed has increased, but also the number of employed, albeit only slightly. The structural transformation of employment continued, now driven forward in particular by the labour market reforms. For instance, marginal employment gained further in importance, while the number of full-time employees declined once again in 2004. Even manufacturing industry – the driving force behind the economic recovery because of its strong export component – failed to show any noticeable expansion in the number of employees on the most recent figures. While capacity utilisation has increased, it has not yet reached a level that would necessitate new recruitments.

Marginal employment has been rendered more attractive since spring 2003 by the new regulation exempting earnings from so-called mini-jobs from taxation and social insurance contributions and raising the maximum wage limit from 325 to 400 euro. The legislative changes also boosted the expansion of mini-jobs in 2004. In addition, the aid provided for business start-ups by the unemployed began to show its effects, so that the number of new 'Ich-AG' firms funded under this scheme increased. The reforms therefore led to significant changes on the labour market. However, one change was a growing decline in insured employment, meaning that policy makers have accepted a weakening of the existing system of social security (cf. figure 16). If, on balance, the volume of labour increased somewhat in 2004, this was simply due to the higher number of working days.

It has been difficult for a number of years to estimate the trends for employment and registered unemployment because of the labour market reforms and their impact on statistical data. And the difficulties have been exacerbated this year by the entry into force of the Fourth Law on Modern Services on the Labour Market (Hartz IV) (cf. box 3). And yet the prospects are unambiguous: There is no reason to expect a significant improvement in the labour market situation this year, either. The pace of economic growth is not strong enough to exert a positive impact of this dimension, and the number of employed will increase at only a slightly stronger pace than last year. Given that growth in demand for labour always lags behind output growth, the increase in employment will accelerate to some extent only towards the end of the year.

It is difficult to say whether the trend increase in self-employment will continue at its current pace. This applies in particular to the Ich-AGs, for these will be monitored more closely from the end of 2004 onwards, for example with respect to the viability of their business concept and to the ascertainment that a self-employed activity has genuinely been taken up. In addition, probably more than a few recipients of unemployment assistance were able to establish that they will not qualify for unemployment benefit and consequently founded an Ich-AG last year in order to at least receive the aid provided under this scheme.

The number of jobs for dependent employees can be expected to increase, especially in the low-wage sector, and the increase will be in the form of so-called 'one-euro jobs'. Marginal employment is also likely to increase, although for the recipients of the new Unemployment Benefit II who were working in marginal jobs in the private sector up to now, mini-jobs will be made unattractive by the fact that a higher share of the wages earned in this way will now be offset against their benefit. By contrast, regular dependent employment will continue to expand at only a weak rate.

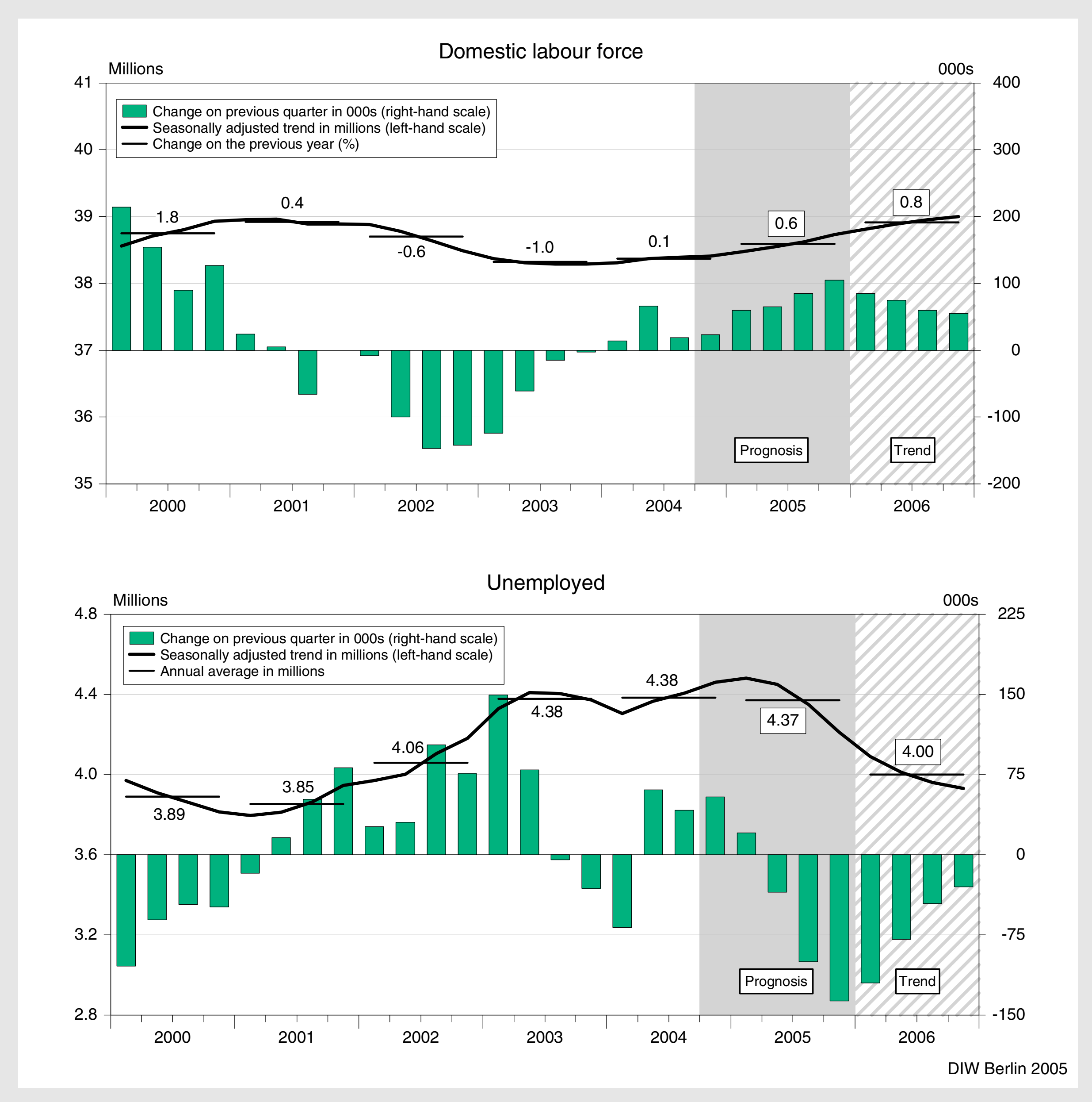
The overall increase that can be expected in the number of employed will be accompanied by only a moderate degree of expansion in the volume of labour.

8 The unemployment statistics were substantially revised in 2003, with the result that a large number of individuals were removed from the unemployment register either because they were classified as unfit for work or unwilling to work or because they continued to claim an early retirement pension on the basis of their age.

Figure 15

Persons in Employment and Unemployed

Seasonally adjusted[1]



1 On the basis of X-12-ARIMA.
Sources: Federal Statistical Office; Federal Labour Office; DIW Berlin calculations.

Because of the lower number of working days compared to last year, this year will actually bring a reduction in working time; the number of free working days due to holidays will return to a normal level.

The rise in employment is likely to accelerate somewhat in 2006. While output growth will not gain momentum, capacity utilisation will increase and a somewhat more robust rise in personnel is likely. Because the growth rate for output will only slightly exceed that for productivity, once again the situation on the labour market can be expected to improve only slightly, although the volume of regular employment relationships will probably expand at a faster pace than to date. The number of registered unemployed will probably fall below 4 million (seasonally adjusted figure) only at the end of the forecast period.

Box 3

The difficulty of estimating the impact of the fourth law on modern services on the labour market (Hartz IV)

The fusion of unemployment assistance *(Arbeitslosenhilfe)* and social assistance *(Sozialhilfe)* under a single benefit entitled 'Unemployment Benefit II' at the beginning of 2005 will have significant consequences for the labour market, but in particular for the unemployment statistics.[1] Under the new regulation, persons currently drawing social assistance (ongoing income support) will be considered eligible for Unemployment Benefit II if they are available to work on the labour market. This might lead to an increase in the number of registered unemployed, but whether it will actually come to this and how large the rise might be is difficult to assess. Current recipients of social assistance who are fit for work are already obliged to register as unemployed at the employment service. And, as evaluations of data on social assistance show, a large share of beneficiaries is actually registered as unemployed. There are also people who are working and at the same time receiving supplementary social assistance. The number of registered unemployed should therefore increase at the very most by the number of recipients of social assistance who are not registered as unemployed. But a large number of these people are not fit for work for reasons of age (over-65s or under-15s), because they are in vocational training, or because they are ill or disabled. More than a few of the remaining social assistance beneficiaries are not available to the labour market because they are bound to their homes by caring for a family member. When all of these categories are excluded, estimates to date suggest that between just less than 200 000[2] and around 300 000[3] people could be made available the labour market.

Amongst those currently drawing unemployment assistance and those whose entitlement to current unemployment benefit will expire in the future, there are likely to be some who will not be eligible for Unemployment Benefit II, for example because the calculable income in their household exceeds the maximum limits or because they are in possession of assets. Of the applications for Unemployment Benefit II processed by October 2004, 7% were turned down on the basis of failure to meet the necessary criteria. However, it is likely that the comparatively 'simple' applications were dealt with up to that date. Applicants who are close to or in excess of the maximum limits for income or assets will probably have submitted their applications late or not at all. Thus, the share of recipients of unemployment assistance who will not be granted the new benefit is probably higher. It is likely that quite a few unemployed who will not be eligible for Unemployment Benefit II will drop out of the statistics altogether in future because there is not enough incentive for them to register once again as unemployed. The introduction of one-euro jobs will also have an effect on the number of registered unemployed because people who work more than 15 hours a week in this kind of employment relationship will no longer be considered unemployed under the relevant regulation.

The dimension of the effect of these opposing factors on the number of unemployed remains to be seen. In the past, the number of registered unemployed was already a problematic indicator for measuring under-employment, and the most recent labour market reform renders it even less suitable than before. Thus, persons who are actually unavailable to the labour market should be subtracted from the number of registered unemployed. And those unemployed who are not registered but are looking for work would have to be added on. The same applies to those who, in the absence of work, are participating in further training measures, and for those who have taken on employment with shorter working hours than they really wanted. From this year on, the monthly data from the official Labour Force Survey, which is based on the ILO's definition of unemployment, should shed more light on the actual extent of under-employment.

[1] Cf. Helmuth Rudolph: 'Aktualisierte Schätzungen zum Start von ALG II'. In: *IAB Kurzbericht,* no. 11/2004. Also cf. Hilmar Schneider et al.: 'Beschäftigungspotentiale einer dualen Förderstrategie im Niedriglohnbereich'. In: *IZA Research Report,* no. 5/2002.

[2] Cf. H. Schneider et al., loc. cit. Their calculations are based on social assistance data from 2001; however, they took a broad range of characteristics into consideration that suggest less availability to the labour market.

[3] Cf. H. Rudolf, loc. cit., based on the social assistance data from 2003.

Public budgets: significant decline in deficit ratio – extremely restrictive fiscal policy stance

Despite better growth performance and significant consolidation efforts on the spending side, the financial situation in the public budgets did not improve over the past year. On national accounting definitions, the deficit of the federal government, *Länder,* local authorities and social security funds increased slightly once again, from 81 to 83 billion euro, which corresponded to 3.8% of nominal GDP.

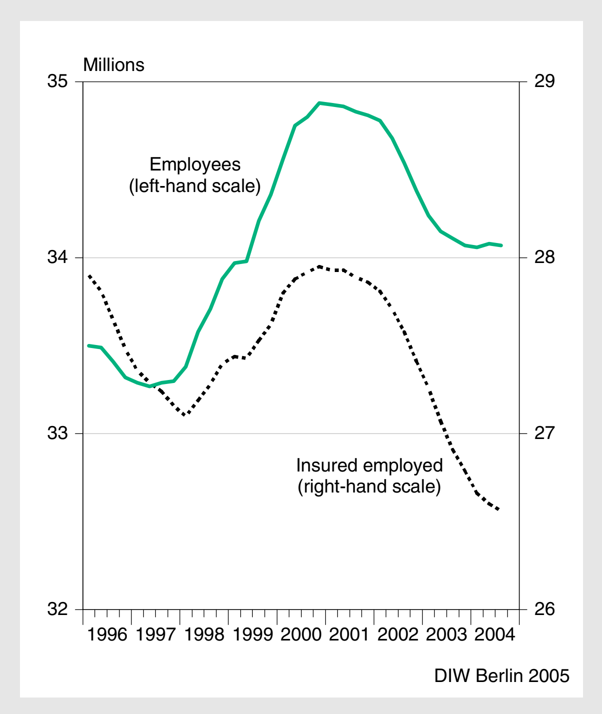
The reasons for the renewed failure to meet the deficit limit laid down in the Stability and Growth Pact included not only the hefty tax cuts (15 billion euro),[9] but also the fact that the economic recovery has led only in part so far to higher tax revenue. The recovery was mainly driven by exports, which are not subject to turnover tax; in addition, earned income and employment

[9] Measures aimed at offsetting the resulting revenue losses included the abolition of tax concessions and the introduction of a tax amnesty intended to encourage the taxable repatriation of illicit funds deposited abroad. However, at just less than 1 billion euro, the income was much less substantial than initially anticipated by the German government. Additional revenue from tobacco tax was also lower than expected.

Figure 16

Domestic Employees and Insured Employed[1]

Seasonally adjusted



1 New statistical procedure since June 1999.
Sources: Federal Statistical Office; Institute for Employment Research (IAB); Federal Labour Office.

failed to rise. However, taxes on profits brought substantial increases in revenue. There were significant losses in property income received because the profits transferred by the German Bundesbank to the federal budget were minimal. The stagnation of earned income meant that social security contributions also barely increased. All in all, government income declined by 0.3% on 2003. And, for the first time in the history of the Federal Republic of Germany, spending also declined (–0.2%). Not only government investment spending, but also subsidies and the relatively substantial wage and salary expenses in the public sector were reduced. Above all, however, the savings made in the course of the health reform made themselves felt.

The austerity course in the public budgets will be continued this year, and spending is likely to decrease again slightly (–0.1%). The fusion of unemployment assistance and social assistance for those who are fit for work will be a particular source of savings; the criteria as to what constitutes a 'reasonable' job offer have been tightened up, as has the procedure for means testing. The forecast estimates that spending will decrease by 2 billion euro. On balance, a decline of 0.7% in monetary social security benefits, which account for the most significant outlay on the spending side, is forecast. The trend will also be curbed by the fact that pensions will not rise. However, because of stagnating gross income last year, the 'sustainability factor', which would have curtailed pension spending, will not take effect.[10] The impact of the measures taken under the health reform will presumably persist so that only a small increase can be expected in social benefits in kind. However, the introduction of mandatory insurance for persons receiving Unemployment Benefit II will burden the statutory health insurance funds with additional expenditure because only minimum contributions are paid for these beneficiaries.

Further cuts in subsidies are likely, especially those granted to the coal-mining industry. The high prices on world markets are significant in this respect, for part of the coal subsidy is intended to offset the difference between domestic production costs and world market prices. Personnel spending in the public sector is likely to rise only slightly (0.8%). Jobs will continue to be shed as negotiated wage rises remain moderate, even if this process will be curtailed by the fact that additional jobs will be created in the unemployment insurance sector so that the recipients of Unemployment Benefit II can be given better care. A further reduction in special payments can also be expected.

Despite the high government deficit, the rise in interest rates will remain minimal (almost 2%). The volume of refinancing is still very high, and high-interest old debts are being replaced by new loans subject to lower interest rates. This effect will more than offset the interest load generated by the new debts. Lower spending than last year can be expected for government asset transfers and for public investment. For instance, the federal government will reduce its subsidies to Deutsche Bahn railways and cuts are also foreseen for regional support measures. The downward trend in direct public investment that has persisted for years will probably not be halted, but it is likely to slow down to some extent. One reason is the sharp rise in business tax revenue received by the local authorities. In addition, the financial strain on local governments has been eased by the fact that the share of revenue they are obliged to devolve to the *Länder* and federal government has been reduced. Efforts can also be expected at all levels of the budget to recoup some of the loss in revenue caused by the tax reform by means of cuts in flexible spending, in other words investment. In addition, the federal government will also have to cope with the debacle of the failed introduction of the autobahn toll for heavy goods vehicles.

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10 This factor does take effect if, as a result, the pension would not only not rise, but would actually be reduced.

Although the final phase of the tax reform will enter into force in 2005, an increase of 1.7% in tax revenue is forecast. Income-tax cuts will amount to 9 billion euro, and further revenue losses (1 billion euro) can be expected as a result of the gradual transition to deferred pension taxation. Little cyclically determined additional revenue can be expected from wage tax because wages and employment will grow only moderately, and the expansion of marginal employment is likely to generate very little additional income. By contrast, taxes on profits, and especially corporation tax, will continue to rise rapidly. Turnover tax is likely to increase at a somewhat weaker pace than the overall tax base because the economic recovery will continue to be borne by exports and increasingly also by private-sector investment, neither of which are subject to turnover tax. Specific excise duties can be expected to show moderate growth. Tobacco tax was raised again at the end of last year, and the decline in revenue from mineral-oil tax is likely to come to a halt as falling oil prices and the economic recovery boost demand.

Social security contributions will rise only very slightly, mainly as a result of the weak growth in income and employment. And other revenue will also rise only modestly. One reason is that as a result of the exchange-rate trend for the dollar, the profit transferred to the government budget by the German Bundesbank will again be quite negligible (1 billion euro). The system of national accounting will not take account of earnings from privatisations planned this year by the German government in order to be able to present a budget in line with constitutional provisions; however, this amounts to no more than restructuring of assets anyway. But the deficit will actually be reduced when, as planned, the long-term claims of the pension fund for postal and telecommunications employees on these companies are sold off and the proceeds are used to pay the pensions due from this fund in the coming years. The federal government will be saved the cost of subsidies to this pension fund during this time, but its future obligations will then be all the more substantial. This forecast does not take account of the related potential savings of around 5 billion euro, nor does it consider the repayment of aid amounting to over 4 billion euro which, under EU jurisdiction, was wrongfully granted by the Land budgets to the Land banks.[11]

The government policy of austerity can be expected to reduce the budget deficit to just under 70 billion euro this year – despite the fact that further tax cuts will enter into force. The deficit ratio will fall to an estimated 3.1% of nominal GDP; when the special factors mentioned above are taken into account (reimbursement of subsidies, sale of pension claims), the deficit ratio will have been reduced to well below 3%. In any case, fiscal policy will exert significant restrictive effects on economic growth because the expansive impetus received from the tax cuts will be more than offset by savings on the spending side. According to the DIW Berlin's stimulus concept,[12] the dampening effect will amount to at least 15 billion euro or 0.8% of nominal GDP (cf. table 9).

Under the expected macroeconomic conditions and under the assumption that fiscal policy will continue to pursue the path of austerity, a further perceptible decline in the government deficit can be expected in 2006. The estimates suggest a decrease in the order of 58 billion euro or 2.5% of nominal GDP.

Tax revenue will begin to expand again at a somewhat more robust pace (2.5%) as the economy livens up. In addition to taxes on profits, wage tax will generate substantial additional revenue because there will be no further tax cuts and progressive income-tax rates will take full effect again. However, it must also be expected in 2006 that the upturn on the labour market will be borne by mini-jobs, and this will dampen revenue from wage tax. The same applies to the trend for social security contributions (1%). Consumption-based taxes are likely to rise at a rate of 2%.

An increase of 0.7% is forecast for government spending. Monetary social benefits are likely to stagnate, while pension payments will expand only weakly. Social benefits in kind will rise relatively robustly because efforts to contain costs in the health system will no longer exert the same dampening effect as previously. Very moderate wage growth can be expected once again in the public service, and the number of public-sector jobs is likely to decline further. Despite the high level of new debt, interest spending will again rise only moderately because of the high volume of debt rescheduling; this effect will become less significant in the coming years. The improved financial situation of the local governments is likely to bring the decline in public investment to a halt, although the level of investment will still remain very low. Government activity will also exert a dampening effect on overall demand in 2006 – at a magnitude of 17 billion euro or 0.8% of GDP.

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[11] Such repayments are entered in the national accounts as received transfers of assets by the state. The *Länder* intend to immediately retransfer these funds back to the Land banks as equity interest. Equity participation is factored out of the national accounts but is taken into account in the financial statistics.

[12] Demand impulses are defined as deviations of revenue and expenditure from their actual levels the previous year, extrapolated by the medium-term trend for nominal GDP. All changes in government activity, in other words both discretionary measures and changes based on the effects of automatic stabilisers, are considered relevant to demand.

Table 9

Government Demand Impulses[1, 2] (Local Authorities and Social Insurance Funds)

+ expansion / – contraction; euro billion

	1997	1998	1999	2000	2001	2002	2003	2004[3]	2005[3]	2006[3]
Taxes										
Real volume	422.04	443.64	476.04	495.83	473.96	475.93	481.09	479.06	488.61	501.10
Neutrality line	429.86	435.10	455.40	487.60	508.17	485.26	485.28	490.90	489.20	499.64
Difference	7.82	–8.54	–20.64	–8.23	34.21	9.33	4.19	11.84	0.59	–1.46
Social security contributions										
Real volume	366.56	370.42	373.74	376.37	381.85	387.27	393.75	394.64	397.68	402.34
Neutrality line	365.31	377.90	380.24	382.82	385.74	390.96	394.88	401.78	403.00	406.65
Difference	–1.25	7.48	6.50	6.45	3.89	3.69	1.13	7.14	5.32	4.31
Other revenue										
Real volume	78.04	78.95	79.28	77.20	80.44	80.49	78.35	74.07	75.18	76.47
Neutrality line	84.60	80.45	81.04	81.21	79.12	82.36	82.07	79.95	75.64	76.88
Difference	6.56	1.50	1.76	4.01	–1.32	1.87	3.72	5.88	0.46	0.41
Total revenue										
Real volume	866.64	893.01	929.06	949.40	936.25	943.69	953.19	947.77	961.47	979.91
Neutrality line	879.76	893.45	916.68	951.63	973.03	958.58	962.23	972.62	967.84	983.17
Difference	13.12	0.44	–12.38	2.23	36.78	14.89	9.04	24.85	6.37	3.26
Purchase of goods and services										
Real volume	234.83	237.00	241.63	243.76	246.70	252.24	252.93	251.25	252.94	254.67
Neutrality line	243.48	242.09	243.28	247.50	249.83	252.58	257.20	258.09	256.57	258.65
Difference	–8.65	–5.09	–1.65	–3.74	–3.13	–0.34	–4.27	–6.84	–3.62	–3.98
Income from property (interest spending)										
Real volume	68.10	69.75	68.87	68.39	67.72	65.22	66.23	67.60	68.85	70.30
Neutrality line	69.34	70.21	71.60	70.54	70.09	69.34	66.50	67.58	69.03	70.40
Difference	–1.24	–0.46	–2.73	–2.15	–2.37	–4.12	–0.27	0.02	–0.18	–0.10
Transfers										
Real volume	578.98	593.28	610.20	624.00	644.54	666.10	683.03	680.92	677.18	680.85
Neutrality line	590.14	596.89	609.01	625.02	639.53	659.91	679.19	696.95	695.34	692.46
Difference	–11.16	–3.61	1.19	–1.02	5.01	6.19	3.84	–16.03	–18.16	–11.61
Gross investment										
Real volume	35.50	35.74	37.67	36.33	35.86	34.31	31.10	30.54	29.85	29.80
Neutrality line	40.24	36.60	36.69	38.59	37.23	36.72	34.98	31.73	31.19	30.52
Difference	–4.74	–0.86	0.98	–2.26	–1.37	–2.41	–3.88	–1.19	–1.34	–0.72
Total spending										
Real volume	917.41	935.77	958.37	972.48	994.82	1017.87	1033.29	1030.31	1028.82	1035.62
Neutrality line	943.21	945.79	960.57	981.65	996.68	1018.54	1037.87	1054.35	1052.12	1052.04
Difference	–25.80	–10.02	–2.20	–9.17	–1.86	–0.67	–4.58	–24.04	–23.30	–16.42
Demand impulses incl. interest spending	–12.67	–9.58	–14.58	–6.94	34.92	14.21	4.46	0.81	–16.93	–13.16
Demand impulses excl. interest spending	–11.43	–9.12	–11.85	–4.79	37.29	18.33	4.73	0.79	–16.75	–13.06

1 Based on the medium-term trend for nominal GDP. — 2 Excluding transactions with the rest of the world. — 3 DIW Berlin estimate.
Sources: Federal Statistical Office; DIW Berlin calculations.

Table 10

Key Forecast Figures for Germany

	2001	2002	2003	2004	2005	2006
Gross domestic product[1] (percentage change over previous year)	0.8	0.1	–0.1	1.8	1.8	2.0
Western Germany	1.0	0.1	–0.2	1.8	1.8	2.0
Eastern Germany (excluding Berlin)	–0.2	0.1	0.2	1.2	1.4	1.5
Gainfully employed[2] (in 000s)	38 923	38 696	38 316	38 370	38 586	38 906
Unemployed (in 000s)	3 853	4 060	4 377	4 383	4 375	4 003
Unemployment rate[3] (as a percentage)	9.0	9.5	10.3	10.3	10.2	9.3
Not gainfully employed[4] (in 000s)	3 109	3 438	3 838	3 925	3 924	3 552
Percentage not gainfully employed[5]	7.4	8.2	9.1	9.3	9.2	8.4
Consumer prices[6] (percentage change over the previous year)	2.0	1.4	1.0	1.6	1.6	1.4
Unit labour costs[7] (percentage change over the previous year)	1.3	0.8	0.7	–1.4	–0.7	–0.2
Public sector financial balance[8]						
Euro billion	–58.6	–77.5	–81.3	–82.7	–69.5	–58.2
As % of nominal GDP	–2.8	–3.7	–3.8	–3.8	–3.1	–2.5

1 At 1995 prices. — 2 National (annual average based on quarterly figures). — 3 Unemployed as a percentage of the national workforce. — 4 In accordance with the convention of the International Labour Organization (ILO). — 5 Persons not gainfully employed as a percentage of the national workforce. — 6 Price index for the cost of living of all private households. — 7 Labour costs (compensation of employees per employee) in relation to labour productivity (gross domestic product at 1995 prices per person gainfully employed). — 8 As defined by the national income and expenditure accounts (ESVG95 – Europäisches System volkswirtschaftlicher Gesamtrechnungen – European System of Integrated Economic Accounts).
Sources: Federal Statistical Office; German Bundesbank; DIW Berlin calculations; 2004 and 2006: DIW Berlin estimate and prognosis.

Eastern Germany

The picture of a divided economic development is evident in the eastern German economy, too, although it is more sharply delineated in the new *Länder*. Industrial output accelerated further last year, again growing at a stronger rate than in western Germany. As in the western part of the country, the impetus in the east was also mainly provided by foreign demand, but domestic demand also increased. Growth can be expected to continue this year, as is indicated by the increase in incoming orders. In addition, the stronger investment dynamic will have a positive effect on the relatively small eastern German industrial sector.

Output in the construction sector weakened further. In 2004, it thus continued its downward slide for the tenth year in a row, even if the pace of the decline diminished. The development varied across the different branches of the industry. Civil engineering enjoyed a favourable trend, while structural engineering continued to decline. Public-sector spending on building fell as in previous years – a tendency that reflects the strained financial situation in the eastern German local governments, but also the fact that the funds made available under Solidarity Pact II are only partly being spent on investment. The sharp decline in housing construction was greatly curtailed, for building output was brought forward by the discussion about the abolition of the subsidy for owner-occupied housing construction. Next year, a stronger decline in demand can be expected in this segment of the market. Public investment spending is likely to decrease further. There is also no sign of a turnaround in commercial construction, as is indicated by the high volume of vacancies overall. In general, construction demand will be curtailed by the decline in the population.

The demographic trend will also have a negative effect on retail trade and consumer-oriented services. This probably contributed to the fact that there was less activity in both the retail trade and the hospitality industry in 2004 than in the previous year. In addition, spending was probably curtailed by the planned introduction of Unemployment Benefit II. The new benefit will have a much stronger effect in eastern than in western Germany; the number of persons drawing unemployment assistance in the new federal states is currently over three times as high per capita as in western Germany.

Economic performance in eastern Germany only increased by less than 1.5% in real terms in 2004; growth is likely to be of a similar magnitude this year and next year (cf. table 10). Given that productivity is rising relatively robustly in eastern Germany, employment will continue to fall – at least on the regular labour market.

Economic Policy

The challenges facing economic policy would appear to have lessened with the cyclical recovery. The rise in the oil prices certainly put a strain on almost every economy but this eased again in the course of the year. So the dampening was only temporary, particularly as the oil-producing countries are expected to spend their extra income, which will stimulate world trade. There are greater risks to the German economy from the rise in the external value of the euro. So far the upward trend has been fuelled by exports, but any further rise in the euro would put increasing pressure on the competitiveness of German companies on international markets, and jeopardise the cyclical upswing.

Exports are still the driving force of the economic recovery, and the stimulus from abroad will only gradually spread to the other demand components. Investment activity will benefit particularly; however, it will not develop the dynamic of earlier upswing phases. Domestic demand, especially private consumption, is still weak, and here the stagnation in mass incomes is having an effect, particularly as the wage restraint being practised throughout the economy, and which is particularly apparent in the negative drift of collectively agreed and actual wages, is not bringing a rise in employment. The outlook on the labour market is still gloomy, another important reason why consumer confidence in the future has been very slow to improve. In the immediate future private households will not feel encouraged to reduce their savings ratio, which persists on a high level. Nor is demand from the state for goods and services providing positive impetus. The tax cuts are increasing disposable incomes, but these expansionary effects are well outweighed by the cutbacks in state expenditure.

On no account must the economic policy decision-makers allow themselves to be tempted into inactivity by the cyclical recovery – the risks from the weakness of domestic demand are too great. Altogether it is to be expected that economic policy will not provide the stimulus to domestic demand needed to create a self-sustaining upswing. Incomes policy is still restrictive and wage policy abandoned productivity-orientation a long time ago. This is easing the cost burden on companies and the pressure on prices, but real wages are also lagging behind the progress in productivity, and this is holding back demand in Germany. The lower rate of price increases will not be without effect on real interest rates, which will rise slightly further, and so weaken investment activity.

The strong rise in the external value of the euro and the weakness in domestic demand to date in large parts of Europe require a response from monetary policy. Monetary conditions have become more stringent for all the countries in the EU, and the medium-term inflation outlook is clearly below the ECB's target. This offers scope for easing monetary policy, but with the ECB's practice hitherto the prospects of such a step are very slight. All the more reason for action to be taken in fiscal policy. However, it, too, is bound by the strict rules of the European currency union, and in fact the scope for fiscal policy was fully utilised a long time ago in the persistent stagnation, and it is becoming increasingly evident that the Stability and Growth Pact is more of a hindrance than a help to economies in overcoming a long-lasting crisis. Insofar the start of discussion over reform in recent months was in itself progress, and the rigid rules have been interpreted more flexibly now in practice as well.

European monetary policy – a more expansionary course justified

Despite the unusually heavy strain imposed last year by the rise in the prices of crude oil and raw materials the rise in consumer prices will be astonishingly little above the ECB's target figure this year. So there is no risk of inflation, and no sign of second round effects from the leap in prices, which with rising wages pressure could start an inflationary trend. Beside the rise in energy prices the inflation rate in many countries is determined by administered price rises and the underlying dynamic in inflation is less. Moreover, as the surge in raw materials prices ebbs again the pressure on prices from this side will lessen markedly.

In addition, monetary framework conditions have been worsening steadily for a long time owing to the rise in the external value of the euro – particularly against the US dollar. This development in the exchange rate is making industry in the euro zone less competitive and in itself putting a strain on the upswing, which, with the slackness in domestic demand is only slowly gathering momentum.

No further appreciation of the euro is assumed in this prognosis. Nevertheless, the question is being debated in public whether, in view of the appreciation pressure in recent months, there is need for action by the ECB. On principle a central bank has two options in such a situation if it wants to reduce movements in the exchange rate and ease the upward pressure on the currency: it can intervene in the foreign exchange markets or it can change interest rates. One-sided intervention can be successful if the intervening central bank holds a currency whose value is expected to rise, and the increase in the money stock is not being sterilised. The disadvantage of intervention is that in such a case no contribution of note is made to reducing disequilibria in the world economy. Sooner or later, therefore, the tensions in the international exchange rate structure could increase.

The other option is to pursue an interest rate policy that will underpin the economic development with inflation rates in line with the target. At present there is another argument in favour of low interest rates in this prognosis period, beside the low level of inflation and the high levels of unutilised capacities to date: The change over which will shortly be made in some countries in the euro zone in calculating the price index to what are known as hedonic indices, which take much better account of quality improvements, will probably mean that the inflation rates so measured will be lower than forecast here. This effect cannot be exactly predicted at present, but it is an additional argument in favour of utilising the scope in monetary policy.

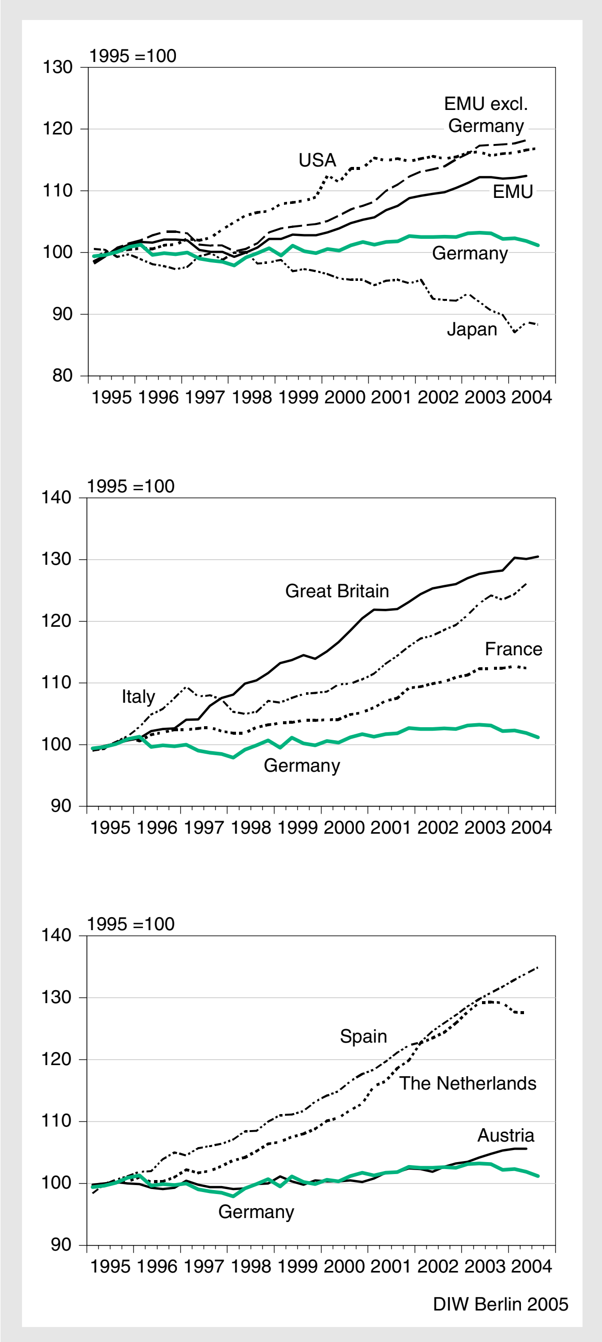
Wage policy considerations

Unit wage costs have remained constant in Germany in the last ten years, as a result of low wage rises, while in the United States and the rest of the European Currency Area (EMU) they have risen by 17% and 18% respectively. Since the start of EMU six years ago Germany has greatly increased its price competitiveness against the rest of the currency area (cf. figure 17). Within a single currency area nominal exchange rate corrections are no longer possible, so differences in the developments in unit wage costs and prices are fully reflected in trade between the member states. Hence, Germany's implicit real external value is steadily decreasing against its trading partners, and its competitiveness is steadily increasing. The German surplus on goods trade within the EMU has risen in the course of this development from 1998 to 2004 by around 50 billion euros (from 28 billion euros to an estimated 80 billion). At the same time the German deficit on trade in services with the other EMU member states has remained almost constant in recent years, at around 30 billion euros a year. Germany has regained its leading position in exports, but it is lagging behind the EMU in economic growth. How does this fit together?

Below-average wage rises do improve international competitiveness, so they help exports and hamper imports. But they also play a big part in holding down domestic demand. The external and internal developments are no longer in balance. Within a single currency area the central bank can only orient to the average price and economic development in fixing its monetary

Figure 17

Unit Labour Costs[1]
in International Comparison



1 Gross income from dependent employment as a share of real GDP; seasonally adjusted.
Sources: OECD; Federal Statistical Office; DIW Berlin calculations.

policy. Before the start of the currency union the Deutsche Bundesbank could acknowledge moderate wage and price increases by keeping interest rates low. In the EMU the ECB cannot sanction individual countries for failing to meet the inflation target, so countries with above-average wage and price increases, like Spain, profit from their low real interest rates, indeed some are negative rates. A high level of domestic demand and a low level of real interest rates are the main reasons for the powerful economic growth in these countries. In countries with below-average wage and price rises and high real interest rates, like Germany, on the other hand, growth is held back. So monetary policy has a procyclical effect for some countries.

This development is strengthened by the rules of the Stability and Growth Pact. Countries with low growth rates and low inflation rates quickly reach the upper limit for the budget deficit and are then forced to economise on public spending or raise taxes. In itself that depresses growth and prices further. Countries with a high growth rate and higher inflation rates do not have to economise, although in a good cyclical situation that would be in the interests of the entire currency area. With procyclical public budgets they actually strengthen the tendencies to growth and inflation. Some countries with above-average growth rates, like Spain, benefit further because on balance they are receiving financial support, while in Germany, a net contributor to the EU, the public budgets are even further constricted by the outflow of funds.

Now in itself the development in price competitiveness counteracts the divergent trends within the currency union. A positive net effect on economic development results mainly for small and very open economies, where exports and imports account for a bigger share in GDP. Larger and less open economies like Germany, on the other hand, cannot pursue that path successfully, because the restrictive effects of low wages on domestic demand are too high. In addition, developments in large economies have considerable repercussions on the entire currency area.

According to the prognosis presented here wage rises in Germany will remain below the EMU average in the next two years as well. Hence German competitiveness within the EMU will increase further. But this will also prevent the present strong stimulus from abroad from providing the necessary impetus to the domestic economy. The growth in private households' disposable incomes will not be fuelled by wages in this prognosis period but by the strongly rising incomes to the self-employed, who are the group with the above-average savings rate. So in the main the moderate cyclical trend, fuelled by foreign trade, will continue. Germany will make little contribution from its own growth rate to growth in the EMU. The worsening competitiveness of most of the other EMU member states will increasingly hamper growth in these countries as well, and Germany will not be able to act as driving force in their stead.

The guideline for wage policy in Germany and the other EMU member states should be the ECB's target inflation rate of 2% and the average growth in productivity in the individual countries. Countries catching up economically, with above-average productivity increases, will thus also be able to afford higher nominal and real wages, without excessive price increases. Administratively induced price rises will, however, correspondingly narrow the scope for wage rises, and on no account must increases in the oil price be taken as the reason for additional wage increases. Otherwise the ECB's inflation target would be jeopardised. If this wage guideline is followed conflict between wage policy and monetary policy would be impossible, even on federal state level, and not only – more by chance – on EMU level, as has been evident in recent years.

For Germany, with adherence to this wage guideline and taking administrative price rises and changes in contribution rates into account, there would be arithmetical scope for actual hourly wage rises of about 3% a year. However, this prognosis is based on wage rises of only a good 1%. Deviations from the wage line are always appropriate if they serve to correct larger deviations in the wage trend in the past and/or entry into EMU at the wrong exchange rate. Wage rises below this guideline at the start of EMU can be said to be justified in view of the powerful wage rises that resulted directly from German unification (especially in east Germany), the strong increases in social insurance contribution rates to finance a large part of the costs of German unification (increase in labour costs) and what may be assumed to be entry to EMU at too high a rate for the D-Mark. In view of the correction that has now made there is no further justification for lagging behind the trend. Otherwise low wage rises and a weak domestic economy in Germany will jeopardise the cyclical recovery throughout the euro zone. The special feature of wages, in being both a cost component and an income component, cannot be ignored. It may be that wage reductions in some firms help to secure jobs and can postpone outsourcing, but they are not a recipe for an entire economy. Lower wages do lower costs, but they also hold down domestic demand. In the case of Germany the increases in exports so induced cannot compensate for this decline.

The contradiction that is thought to exist between the constant demand for lower costs and the need to stabilise incomes cannot be solved in Germany by lowering wages, it should be tackled by lowering social insurance contribution rates and compensating for the loss of revenue with higher taxes – especially higher VAT. Fiscal policy can still correct the mistake made in financing German reunification by removing the increases to contribution rates introduced in recent years for both employers and employees. That would greatly ease the strain on labour costs.

The heavy costs of German reunification should have been financed right from the start through direct and indirect taxation and not through the social insurance systems. Reunification was a task for society as a whole and not just those paying social insurance on their earnings from employment. The big increase which this caused in benefits provided by the social insurance system but not covered by the contributions was out of line with the system. The increases in the contribution rates introduced at that time also punished companies for using the factor labour. If contribution rates were lowered the use of more labour would be worthwhile to them again.

This way of lowering labour costs has clear advantages for the economy as a whole compared with a wage reduction strategy. No induced price effects of any note are to be expected, particularly with the present weakness in the domestic economy, because if contribution rates are lowered unit wage costs to the employers will fall, and this has a compensatory effect on the price increases caused by higher VAT. Not only the export industry profits from lower contribution rates – with higher VAT at the same time. With labour costs relatively lower companies can produce for the domestic market as well at lower cost and so more competitively, because VAT is charged at the same rate on imported goods and services as on domestic products. Finally, demand in the economy as a whole would not be weakened because the revenue from contributions would simply be replaced by tax revenue.

Even the price increases induced by higher VAT would not cause problems because after contribution rates were reduced persons in employment paying social insurance contributions would have higher net incomes. However, the net incomes of officials and the self-employed would not directly change. The incomes of the recipients of transfer payments (pensioners and the unemployed) would react partly and after a timelag to the improvement in net incomes to the employed. Altogether mass incomes would thus rise. Unlike the strategy of under-average wage rises pursued so far in Germany this method would stabilise domestic demand, increase international competitiveness and reduce the costs of the factor labour, at one and the same time.

Fiscal policy: brake, but no more than planned

The difficult situation for the public budgets is mainly due to the persistent economic stagnation. The revenues to the public authorities have been much lower than planned in recent years, moreover much more has had to be spent on labour market policy measures than expected. But the fiscal policy decision-makers have not allowed these automatic stabilisers to develop their full potential, they have responded to the cyclical need for higher spending by cutting back on discretionary items of expenditure to limit the growth in the state deficits. This has particularly affected public investment, which is still the most flexible type of expenditure, and with a timelag state consumption, subsidies and social benefits. Part of the tax reductions has been financed by cutbacks in expenditure. In the end effect some of the expansionary effects of the tax reduction policy have been considerably reduced, so that the aim of keeping the deficit ratio below the upper limit of 3% of nominal GDP laid down in the Stability and Growth Pact could not be achieved.

Yet once again it was clear that in a period of stagnation, and certainly in a recession, fiscal policy is not in a position to advance the consolidation of the public budgets. Particularly in such a phase private demand is not robust enough to withstand shocks from negative fiscal policy in the form of expenditure cuts or higher charges; further macroeconomic losses are inevitable.

A credible consolidation concept must therefore always have the macroeconomic effects and repercussions in view. Efforts to pursue a deficit target in isolation will not be successful, because the deficits in the public sector always – automatically, one could say – occur as a result of the surpluses in the other sectors. In normal economic times it is mainly companies that borrow in order to invest in real assets. But from the year 2000 the corporate sector has not only been reducing its indebtedness, companies have actually built up their own surpluses. Any attempt by the state to reduce its financing deficit in such a constellation will destabilise the situation further, it will reduce value creation and employment in the other sectors, and ultimately companies will have to respond with disinvestment, that is by reducing stocks. An attempt at consolidation would be successful if, at the same time, companies would invest more and private households consume more. That is the constellation in an upswing scenario. Or it could be assumed that private households would respond to less state spending by increasing their spending, because they are expecting lower taxes and higher net incomes in future. But what would cause them to expect taxes to fall in the long term? It would be just as rational to see the negative effect on demand from the fiscal policy shock as just that and anticipate it.

Recent years have shown that it is not possible to consolidate public finances in a period of stagnation; nor is such an objective desirable in the economic view. Now during the past year it has been possible to overcome the persistent economic stagnation and the economy is recovering – however only at moderate speed. So far fiscal policy has refrained from intensifying its already restrictive course with further programmes of cutbacks, but many are demanding additional efforts at saving in view of the targets in the Stability and Growth Pact. They want to see the deficit brought down below the 3% limit as soon as possible.[13] Against this it can be argued that the success of consolidation measures very decisively depends on whether the consolidation starts at the 'right' time. The time is right when the economic upswing has firmed.

Japan is a warning example of what the consequences can be of starting to consolidate state finances too early. In Japan the upswing was halted too soon several times with fiscal policy measures, and the deficits rose to a worrying level because the economy could not gather pace. The United States is an example of the opposite. The budget consolidation only started in 1994, that is, two years after the end of the recession. It was very successful because a sustained growth process had started. The upswing was strong enough to enable the high deficits to be reduced relatively without friction, and surpluses were achieved. In the initial phase fiscal policy supported the upswing, most importantly in combination with an expansionary monetary policy. Great Britain can point to similar success in economic policy. And finally we can point to the upswing in the late 80s in Germany, when again an expansive policy-mix enabled an upswing to gather momentum, and as a consequence the state achieved a budget surplus (in 1989).

If policy is not to risk losing public confidence it should concentrate, in setting targets, on those aggregates which it can directly control itself. DIW Berlin has repeatedly pointed to the difficulties for policy if it orients to deficit targets – in the form of deficit ratios. The level of the deficits depends on the level of expenditures and revenues. The latter largely depend on the economic development in the short term. So in naming deficit ratios policy is setting itself targets which it can only conditionally reach with the instruments of revenue and expenditure policy available to it. Failure to meet the target is virtually preprogammed. That also applies if a distinction is drawn between structural and cyclical deficits, particularly as the method of distribution between the two components is difficult and not suitable for policy recommendations. Hence policy should focus more on the expenditure side and set a binding expenditure line.[14] The line should be oriented to the trend in nominal GDP, and the interaction of the macroeconomic development and state expenditure should be taken into account. More investment in human capital, for example, will improve the supply conditions in an economy and increase its growth potential.

If the deficit[15] is regarded as too high for policy an expenditure line must be fixed that will remain lower than the trend rate in nominal GDP beyond the cycle. DIW Berlin has several times stated its preference for an expenditure line slightly below the macroeconomic trend. If state expenditure were to rise in the next few years at a rate of 1.5% a year that would also be a rather restrictive course – the trend rate is clearly higher. But policy would have greater scope for action than assumed in this prognosis, in particular, public expenditure on infrastructure and human capital could be increased. This would also counter the danger of the temptation to try and reduce the deficits too soon and too much. The cost of such a strategy would be a slightly slower reduction in the deficits; the gain would be a positive effect on growth. Assuming a nominal rise in GDP of 3% p.a., a nearly balanced state budget could be expected in 2010. In 2006 the deficit would be below 3%. For the rest, in view of the development in recent years the question arises whether the limits for borrowing laid down in the Maastricht Treaty are based on the assumption of too high growth rates, or whether economic policy is not itself to blame for not fully exploiting its scope for action.

The consolidation of the public budgets is linked to the question of how efficient the tax system is and how much it yields. There are repeated complaints of the political difficulties in the way of attempting to reduce tax concessions. But in the economic view there are seldom reasons to maintain these privileges. Almost more serious are the shortfalls from tax evasion, in particular turnover tax fraud. It is estimated that this costs the German fiscal authorities just under 18 billion euros a year. That is roughly the entire revenue from corporation tax, or the yield from increasing VAT by two percentage points. That would in itself be a considerable contribution to covering the change in social insurance contribution financing proposed in the wage policy recommendations.

The latest measures by the Federal Government to combat tax evasion are having only a limited effect. All the more intensively should the efforts be continued to

[13] The majority of the economic research institutes hold this view, cf. 'Evaluation of the Economic Situation', in: 'The German Economy hn the Autumn of 2004', in: *DIW Berlin Economic Bulletin,* vol. 41, no. 11, November 2004, http://www.diw.de/english/produkte/publikationen/bulletin/docs/eb04/n04_11nov_2.html.

[14] This concept is described in more detail in 'Economic Trends 2004/2005', loc. cit.

[15] The expenditure target and the deficit target will only be equivalent with given revenues (and so with a given economic development).

change the turnover tax laws and move from the principle of tax owed to the principle of tax paid, both in the incurrence of tax liability and in deductions from the advance payments. Under the tax owed principle the advance tax payment is already reimbursed when the company has received the pre-product and not only when it has paid the bill. The huge tax losses occur not only when companies become insolvent but also, indeed mainly, because sham or 'carousel' transactions are carried out.[16]

All in all the cyclical improvement and the transition to a firmer upwards development offer fiscal policy the chance to make notable advances in consolidating public finances. Fiscal policy is in any case restrictive, and for that reason it must be urged not to embark on another programme of economising. That would be fatal for the recovery process in the economy. On the contrary, investment in the infrastructure and in human capital should be increased.

[16] For example, goods are channelled through the EU along a chain of fictitious firms. A tax-free transaction within the EU is followed by a domestic transaction that qualifies for deduction from the advance tax payment. The fictitious firms are reimbursed for the advance tax without themselves paying tax. Before the tax authorities can identify the phoney transactions as such the fictitious firms have disappeared.

Box 4

Plea for a Sustainable Fiscal Policy[1]

Oswald Metzger, Distinguished Fellow, DIW Berlin

The Present Situation

The public budgets in Germany have slipped into structural disequilibrium. In good and in poor economic times expenditure has been generated and benefits promised with no regard for whether they could be financed, and now they are increasingly restricting the scope for action by the state.

Firstly, more and more of the burden of the massive expansion of explicit state borrowing was pushed off into the future. Now indebtedness has reached so high a level that new borrowing no longer brings fiscal relief. New borrowing serves mainly to pay the interest on old debts.

Secondly, in the last few decades there have been huge increases in implicit borrowing. This is a result of the benefits promised for public officials' pensions and in the statutory pension, health and care insurance systems. As these have to be financed from the value being created by the actively earning generation, the demographic change means that these promises are simply handing out masses of blank cheques that are not covered. The full effect will only felt by the social insurance systems from 2010, when the people in the high birth rate years begin to leave working life.

Not without reason did the Council of Experts in its Report of Autumn 2003 add to the figure of 1300 billion euros for explicit indebtedness implicit indebtedness of 5700 billion euros. This makes Germany's true level of borrowing well over three times the annual output of our economy. We are sinning against future generations because we are fritttering away their scope for action now.

That the fatal shifting of the load in past decades is already affecting us is evident from the structural analysis of the Federal budget (cf. figure 1). The expenditure on pensions, maintenance and interest is accounting for an ever greater share. From 2010 demographic change will cause a further rise. The slight fall next year is only an accounting technicality. It is the result of the balance sheet contraction for post office pensions. The sale of claims will mean lower expenditure in 2005, but in return the Federal Government has agreed to waive revenues from the successor enterprises to the post office for decades, although so far they have provided about one third of the funds needed for their 'post pensioners'. In future the Federal Government will be solely responsible for these payments, and this is a prime example of non-sustainable fiscal policy.

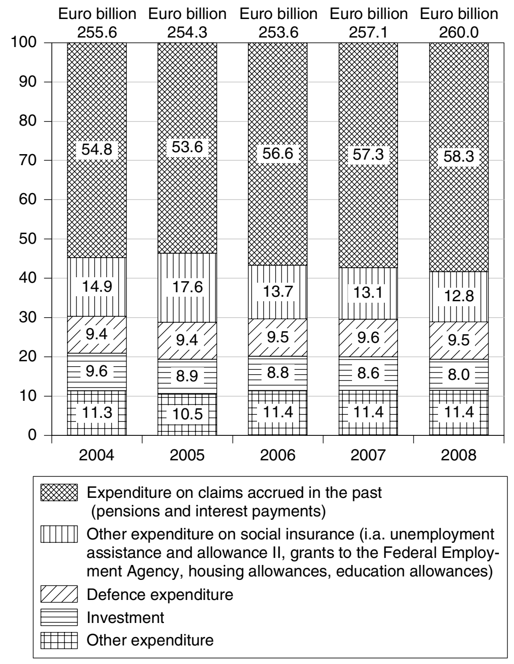
It is also evident in the effect of the high German labour costs in destroying jobs, costs that any employee can read off from the gap that has been widening for decades between his gross and his net earnings. The gap was already widening steadily in the old Federal Republic. The mistake of financing reunification through the social insurance systems increased the tempo dramatically. A fatal consequence of the high labour costs is significant under-employment among the low skilled. This is increased by insufficient wage differentials in the collective agreements and it is flanked with excessive social transfers by the state to persons capable of working.

The consequences of this structural unemployment in turn affect the public budgets. The Federal grant to the Federal Employment Agency and the unemployment assistance, which is financed out of tax revenue (until end-2004) correlate with the level of unemployment. The municipal authorities responsible for paying social assistance are groaning under the burden, which is expanding at an alarming rate owing to the high level of structural unemployment. And for many years consumption expenditure has been displacing investment in the fixed assets and human capital stock of our economy. Infrastructure tasks, and education and research, are underfunded. How strongly the share of social expenditure in Federal tax revenues has risen in the last thirteen years, for example, can be seen in figure 2. The extreme rise in the share of the statutory pension insurance financed from tax revenue is particularly striking.

Figure 18

Federal Budget Expenditures

As %



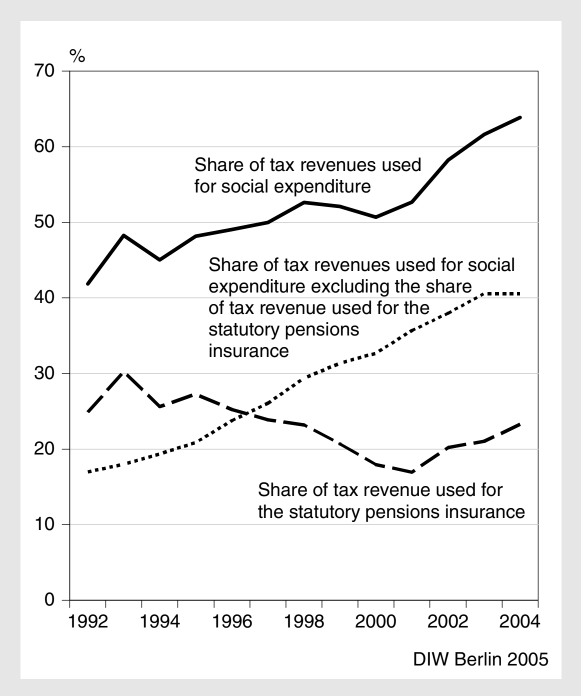
DIW Berlin 2005

1 (2004: debit side supplement; 2005: debit side after Budget Committee; 2006 to 2008: Financial Plan).
Sources: own calculations using the results of the Federal Ministry of Finance.

[1] See also Oswald Metzger: 'Einspruch! Wider den organisierten Staatsbankrott', Goldmann Verlag, Munich 2004.

Box 4 continued

Figure 19
Social Expenditure in Relation to Federal Tax Revenues



Sources: own calculations using the results of the Federal Ministry of Finance.

General framework conditions

A fiscal policy that is sustainable over the long term must achieve *surpluses* in good economic times so that the automatic stabilisers can work in the recession without immediately driving up the public deficit, which is against the aims of the European Stability and Growth Pact. The brake on borrowing in the Constitution (Art. 115) has been unable to combat state indebtedness. In the past this limit for borrowing has repeatedly been ignored, and it is happening again now. I want to see a *ban on borrowing laid down in the Constitution*, with only one exception permitted. In a recession cyclical revenue shortfalls and extra expenditure for the labour market can be financed with overdraft loans, but these must be paid back by the end of the cycle. An alternative would be the method suggested by DIW Berlin, to fix a line for expenditure in a budget law covering several years.

All public budgets are in a tight corset of rising expenditure on interest payments, pensions and social benefits. Owing to the demographic development and structural unemployment this expenditure will grow in future at a stronger rate than nominal GDP. Hence an expenditure line designed for the consolidation of all the public budgets, and which is set at half the level of nominal GDP, for example, could never be maintained without structural reforms to the labour market, the public service legislation (officials' pensions, supplementary pensions for blue and white collar workers, de facto jobs for life in the public service) and the social insurance systems.

Permanent public officials

Unless they cease to be responsible for the permanent public officials the *Länder* will face expenditure on pensions rising at an above-average rate. Expenditure per pensioner is rising strongly because a growing number of officials from the senior ranks are retiring, while the number employed in the lower and middle ranks is falling strongly. Growing costs for health care also affect the public budgets indirectly through the status of officials, because in the case of actively employed officials the supplementary benefit covers half the sickness costs and is financed from tax revenue – for pensioners as much as 70%. As this will not be sufficient the pension reforms must be applied to officials as well.

Pensions insurance

Longer life expectancy and the tendency to work less and less have direct repercussions on the public budgets. Pensioners pay less tax and they also require additional benefits. For that reason the structural rise in expenditure in the Federal budget for the grant to the statutory pensions insurance can only be reduced by gradually raising the retirement age for receipt of a statutory pension to 67 from the next decade, and adjusting the deductions for early retirement to 0.5% to 0.6% per month, the correct figure by actuarial calculation.

Health insurance

The ageing of the population and medical progress are causing rising health care costs. Health care is one of the growth markets of the future and it should be run on market economy lines, with competition. The principle of payment per item and service must be replaced by the principle of cost reimbursement. Cost transparency will make the system more efficient. If health costs continue to rise in the long term despite all the cost efficiency, and if this is not to cause further structural rises in the cost of the factor labour, the costs of health care must in future be uncoupled from labour costs. That is only possible with a personal premium system in which every adult is insured. Social compensation for children and people whose income is below the acceptable relative threshold for charges must come from tax revenue. That is not only socially more fair, because unlike the present system those who can afford more will be paying more towards social compensation in health care – it will also help the labour market because its cost burden will fall.

Care insurance

Care insurance has reduced solidarity within our society. The costs are being socialised and inheritances spared. The continued trend to single households will in the medium and long term lead to a clear rise in the number of single persons needing stationary care. The cost pressure in care insurance is heavier than in any other branch of social insurance, and it will enforce contribution rates of around 5% in the next twenty years. This is systematically making labour more expensive. We must tackle changing the system of care insurance and move to an obligatory insurance system with capital cover. Many persons now receiving care allowances have made no or very little contribution themselves, so they have not acquired rights of any size and it is still possible to change the system.

Box 4 continued

University tuition fees

The time spent at university in Germany is too long compared with the European average (nearly one and a half years longer). University tuition fees are a proven means of improving the quality of education and training and reducing the time spent at university, because they are so designed that social background does not constitute a barrier to access. Certainly the present absence of tuition fees in Germany has not brought an above-average percentage of students from the lower income groups into the universities, on the contrary, countries that charge university tuition fees have greater permeability for gifted young people from low income families than Germany, where no tuition fees are charged, largely for social policy reasons. Tuition fees can also make a structural contribution in that graduates will enter working life sooner, and this will increase the volume of labour in a life cycle.

The labour market

All these social insurance reforms will work structurally to prevent an increase in labour costs for demographic reasons, and so they will tend to strengthen growth and employment. In order to make the labour market more flexible, however, further cautious relaxing of the strict rules on protection against dismissal could be tackled. Although we have very stringent regulations against dismissal, both in legislation and in collective wage agreements, Germany has clearly fewer people over 55 still working than other countries. To find a 'socially acceptable' way of evading the protective legislation companies and trade unions have, in many cases, made agreements at the expense of third parties, specifically unemployment and pensions insurance. The practice of paying off older workers has hugely increased the labour and social costs in our economy.

The revenue side of a sustainable fiscal strategy

A sustainable fiscal policy requires appropriate state finance from tax revenue. The tax ratio in the economy as a whole, which was between 23% and 24% of GDP in Germany for decades, has fallen markedly in recent years. Tax concessions, half-hearted tax reforms and the greater opportunities internationalisation offers for constructing a favourable tax position have undermined the assessment thresholds for direct taxation, and they are also affecting value added tax. Structural reforms are still urgently needed; the Red-Green tax reforms were only the beginning.

In direct taxation the concern is still to spread the burden on incomes more equally. Tax concessions and other exemptions must be ended, as must the failure to collect taxes due from companies and on capital income. In return the high rates on incomes and profits could be reduced, which will reduce the incentive to exploit tax loopholes and improve Germany's position as a business location.[1] Trading tax should be put on a broader basis like a value creation tax, as part of fundamental reform of municipal finance, or integrated into income and corporation tax.[2] Asset-related taxes, which are low in Germany by international comparison, would be most suitable for increases. Municipal land and buildings tax and inheritance tax could be named, for their assessment bases need urgent reform. Reintroducing net worth tax, on the other hand, would not be a meaningful alternative, as it is very cost-intensive to collect and the constant 'taxation of the substance' of companies or financial assets raises many questions in tax policy and economy policy.[3]

Indirect taxation of consumption should also be increased at the expense of direct taxation. VAT fraud is evidently proliferating and needs to be stopped. Increasing VAT should not be taboo, if the social compensation needed to finance a competition-oriented health care system, that will uncouple health care costs from labour costs, has to be paid for out of tax revenue. Ecological tax reform is better than its reputation, but it still needs improving. The tax rates should be oriented more to environmental policy objectives and the general tax reduction for industry reduced further.

Epilogue

Experience has shown that shifting the load into the future is still the easiest route for fiscal policy. But it is unrealistic to hope for better times economically to make consolidation easier. The year 2000 showed that even real growth of nearly 3% seduces politicians into tax concessions (increasing the global commuters' allowance) and can completely block the willingness to reform (the gentle hand policy). If the structural faults in our social insurance system, in public service law and the cartelised labour market are not tackled the public budgets cannot be consolidated sustainably in growth periods either. That is my experience from eight years of Federal budget policy – as speaker on budget policy both in the Opposition and in the Government.

I have kept the very simple request for more cost transparency from the state to the last. We need a commercial accounting system in the public sector as well. This would entail making provision for future pension payments to officials, for example, which would show the true costs. Other inefficiencies in the state would also be revealed – as taxpayers we have been paying for these. No efficiency without cost transparency – that principle applies to many reform building blocks in our economy.

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[1] Stefan Bach, Peter Haan, Hans-Joachim Rudolph and Viktor Steiner: 'Reformkonzepte zur Einkommens- und Ertragsbesteuerung: Erhebliche Aufkommens- und Verteilungswirkungen, aber relativ geringe Effekte auf das Aurbeitsangebot', in: *DIW Berlin Wochenbericht,* no. 16/2004 (*http:www.diw.de/deutsche/produkte/publikationen/wochenberichte/doos/04-16.pdf*).

[2] Stefan Bach and Dieter Vesper: 'A Crisis in Finance and Investment – Local Government Finance Needs Fundamental Reform', *DIW Berlin Economic Bulletin,* vol. 39, no. 9, September 2002.

[3] Stefan Bach, Peter Haan, Ralf Maiterth and Caren Sureth: 'Modelle für die Vermögenbesteuerung von natürlichen Personen und Kapitalgesellschaften – Konzepte, Aufkommen, wirtschaftliche Wirkungen', in: DIW Berlin: Politikberatung kompakt 1 (*http://www.diw.de.deutsch/produkte/publikationen/diwkompakt/docs/diwkompakt_2004-001.pdf*).

Appendix 1

Federal Republic of Germany
Key National Accounts Data – Estimate and Forecast for 2004 to 2005

	2003	2004	2005	2004		2005	
				1st half	2nd half	1st half	2nd half
				1. Components of GDP Change (%) on the previous year			
Employed labour force (domestic)	–1.0	0.1	0.6	0.0	0.3	0.4	0.7
Working hours	0.1	–0.6	0.5	–0.2	–1.1	0.0	1.0
Working days	0.1	1.5	–0.7	1.4	1.7	–0.1	–1.2
Labour volume (by calendar month)[1]	–0.8	1.0	0.4	1.2	0.9	0.3	0.4
Productivity[2]	0.7	0.7	1.4	0.5	0.9	1.1	1.6
Gross domestic product at 1995 prices	–0.1	1.8	1.8	1.7	1.8	1.5	2.0
				2. GDP by type of expenditure at current prices a) Euro billion			
Private consumption[3]	1 255.3	1 272.5	1 300.2	622.4	650.1	635.1	665.1
Government consumption	408.5	405.0	408.7	194.0	211.1	195.1	213.6
Fixed capital formation	379.8	379.3	389.1	179.4	199.9	183.8	205.3
Machinery, equipment and other	171.5	172.9	184.5	80.4	92.5	86.2	98.3
Construction	208.3	206.4	204.7	99.0	107.4	97.6	107.1
Change in stocks[4]	–7.6	17.6	25.9	11.0	6.7	29.3	–3.4
Domestic demand	2 036.0	2 074.4	2 123.9	1 006.7	1 067.7	1 043.3	1 080.6
Net exports	92.2	114.2	128.6	64.1	50.1	59.3	69.3
Exports	769.3	840.3	897.3	412.5	427.7	435.2	462.1
Imports	677.1	726.1	768.8	348.5	377.6	375.9	392.9
Gross domestic product	2 128.2	2 188.6	2 252.5	1 070.8	1 117.8	1 102.6	1 149.9
				b) Change (%) on the previous year			
Private consumption[3]	1.1	1.4	2.2	1.0	1.7	2.0	2.3
Government consumption	0.8	–0.9	0.9	–0.2	–1.4	0.6	1.2
Fixed capital formation	–3.1	–0.1	2.6	–0.7	0.4	2.5	2.7
Machinery, equipment and other	–2.8	0.8	6.7	–1.8	3.3	7.2	6.3
Construction	–3.3	–0.9	–0.8	0.2	–2.0	–1.4	–0.3
Domestic demand	1.2	1.9	2.4	0.6	3.1	3.6	1.2
Exports	1.0	9.2	6.8	9.2	9.3	5.5	8.0
Imports	1.5	7.2	5.9	3.3	11.1	7.9	4.0
Gross domestic product	1.0	2.8	2.9	2.9	2.8	3.0	2.9
				3. GDP by type of expenditure at 1995 prices a) Euro billion			
Private consumption[3]	1 132.5	1 128.9	1 138.9	554.2	574.7	557.4	581.5
Government consumption	390.2	388.5	389.2	192.0	196.4	191.9	197.3
Fixed capital formation	389.1	388.0	395.7	183.2	204.8	187.1	208.6
Machinery, equipment and other	179.0	182.5	194.2	84.4	98.1	90.9	103.3
Construction	210.1	205.5	201.5	98.8	106.7	96.2	105.3
Change in stocks[4]	–18.1	4.9	9.1	2.8	2.1	14.6	–5.5
Domestic demand	1 893.7	1 910.3	1 932.8	932.3	978.0	951.0	981.8
Net exports	91.5	109.9	122.9	60.6	49.3	56.4	66.5
Exports	740.0	809.5	855.5	397.6	411.9	416.5	439.1
Imports	648.5	699.6	732.7	336.9	362.6	360.0	372.6
Gross domestic product	1 985.2	2 020.1	2 055.7	992.9	1 027.2	1 007.4	1 048.3
				b) Change (%) on the previous year			
Private consumption[3]	0.0	–0.3	0.9	–0.5	–0.1	0.6	1.2
Government consumption	0.1	–0.4	0.2	0.1	–1.0	0.0	0.4
Fixed capital formation	–2.2	–0.3	2.0	–0.6	0.0	2.1	1.9
Machinery, equipment and other	–0.9	2.0	6.4	–0.6	4.3	7.7	5.3
Construction	–3.2	–2.2	–2.0	–0.6	–3.6	–2.7	–1.3
Domestic demand	0.5	0.9	1.2	–0.2	1.9	2.0	0.4
Exports	1.8	9.4	5.7	10.0	8.8	4.8	6.6
Imports	4.0	7.9	4.7	5.5	10.1	6.9	2.8
Gross domestic product	–0.1	1.8	1.8	1.7	1.8	1.5	2.0

Appendix 1 (contd)

Federal Republic of Germany
Key National Accounts Data – Estimate and Forecast for 2004 to 2005

	2003	2004	2005	2004		2005	
				1st half	2nd half	1st half	2nd half
4. GDP by type of expenditure: price level of domestic demand (1995 = 100)							
b) Change (%) on the previous year							
Private consumption[3]	1.0	1.7	1.3	1.5	1.8	1.5	1.1
Government consumption	0.7	–0.4	0.7	–0.3	–0.5	0.6	0.8
Fixed capital formation	–0.9	0.2	0.6	–0.1	0.4	0.3	0.8
Machinery, equipment and other	–1.9	–1.1	0.2	–1.2	–1.0	–0.5	0.9
Construction	–0.1	1.3	1.2	0.9	1.7	1.3	1.0
Exports	–0.8	–0.1	1.0	–0.8	0.4	0.7	1.4
Imports	–2.4	–0.6	1.1	–2.1	0.9	1.0	1.2
Gross domestic product	1.1	1.1	1.1	1.1	1.0	1.5	0.8
5. Origin and distribution of income							
a) Euro billion							
Compensation of employees	1 132.2	1 132.2	1 141.7	538.0	594.2	540.6	601.1
Wages and salaries, gross	909.8	910.3	922.2	431.0	479.3	434.8	487.4
Wages and salaries, net	590.5	601.3	611.6	281.1	320.1	283.8	327.8
Entrepreneurial and property income, gross	437.1	492.1	532.8	249.4	242.7	270.2	262.6
National income	1 569.3	1 624.3	1 674.5	787.4	836.9	810.8	863.7
Depreciation	318.3	322.3	328.3	161.0	161.3	163.6	164.6
Indirect taxes minus subsidies	226.7	230.3	237.9	114.6	115.7	118.7	119.2
Gross national income	2 114.2	2 176.9	2 240.6	1 063.0	1 113.9	1 093.1	1 147.5
b) Change (%) on the previous year							
Compensation of employees	0.2	0.0	0.8	0.1	–0.1	0.5	1.2
Wages and salaries, gross	–0.2	0.1	1.3	0.3	–0.1	0.9	1.7
Wages and salaries, net	–0.8	1.8	1.7	1.9	1.8	0.9	2.4
Wages and salaries, gross per employee	1.2	0.3	0.9	0.7	–0.1	0.7	1.1
Wages and salaries, net per employee	0.5	2.0	1.4	2.3	1.8	0.8	1.9
Entrepreneurial and property income, gross	3.5	12.6	8.3	13.5	11.7	8.4	8.2
National income	1.1	3.5	3.1	4.0	3.1	3.0	3.2
Depreciation	0.5	1.3	1.8	1.1	1.4	1.6	2.1
Indirect taxes minus subsidies	3.2	1.6	3.3	1.3	1.9	3.5	3.0
Gross national income	1.2	3.0	2.9	3.2	2.7	2.8	3.0
6. Private households' incomes and expenditure							
a) Euro billion							
Mass income	964.4	976.1	982.8	468.7	507.4	469.9	512.9
Wages and salaries, net	590.5	601.3	611.6	281.1	320.1	283.8	327.8
Monetary social benefits	450.8	455.5	453.3	228.0	227.5	227.2	226.1
Minus: charges on social benefits[5]	76.9	80.6	82.0	40.4	40.2	41.0	41.0
Other primary income[6]	460.8	468.6	488.1	249.5	219.1	260.6	227.5
Other transfers received, net[7]	–35.4	–35.2	–33.1	–17.1	–18.1	–16.0	–17.1
Disposable income[8]	1 389.8	1 409.5	1 437.9	701.1	708.4	714.5	723.4
Memo item: increase in claims on company pension schemes	16.6	18.4	20.4	8.9	9.6	9.9	10.6
Private consumption[3]	1 255.3	1 272.5	1 300.2	622.4	650.1	635.1	665.1
Current savings	151.1	155.5	158.1	87.5	67.9	89.2	68.8
Savings ratio[9]	10.7	10.9	10.8	12.3	9.5	12.3	9.4
b) Change (%) on the previous year							
Mass income	0.5	1.2	0.7	1.3	1.1	0.3	1.1
Wages and salaries, net	–0.8	1.8	1.7	1.9	1.8	0.9	2.4
Monetary social benefits	2.6	1.0	–0.5	1.3	0.8	–0.4	–0.6
Minus: charges on social benefits[5]	2.4	4.9	1.7	5.8	4.0	1.5	2.0
Other primary income[6]	1.0	1.7	4.2	0.7	2.9	4.5	3.8
Disposable income[8]	1.2	1.4	2.0	1.0	1.8	1.9	2.1
Private consumption[3]	1.1	1.4	2.2	1.0	1.7	2.0	2.3
Current savings	3.3	2.9	1.7	2.5	3.4	1.9	1.3

Appendix 1 (contd)

Federal Republic of Germany
Key National Accounts Data – Estimate and Forecast for 2004 to 2005

	2003	2004	2005	2004		2005	
				1st half	2nd half	1st half	2nd half
	7. Government revenue and expenditure[10] a) Euro billion						
Revenue							
Taxes	481.6	480.9	489.2	236.5	244.4	241.1	248.1
Social contributions	394.8	396.4	399.4	192.5	203.9	193.0	206.4
Property income	15.0	10.8	10.8	5.0	5.8	5.2	5.6
Other current transfers[11]	66.1	66.3	66.7	31.2	35.1	31.2	35.5
Total revenue	957.5	954.3	966.1	465.1	489.2	470.4	495.7
Expenditure							
Inputs[12]	251.3	249.0	250.8	119.5	129.4	120.4	130.4
Compensation of employees	167.9	166.8	168.1	78.1	88.7	78.6	89.5
Property income, transferred	66.7	67.6	68.9	32.8	34.8	33.4	35.5
Subsidies	28.9	28.0	26.9	13.4	14.6	12.8	14.1
Social benefits	419.8	424.3	421.4	212.2	212.1	211.7	209.8
Private households	415.2	419.5	416.6	209.8	209.7	209.2	207.4
Rest of the world	4.6	4.8	4.9	2.4	2.4	2.5	2.4
Other current transfers	38.2	37.8	38.3	17.9	19.9	18.1	20.3
Capital transfers	35.6	34.4	32.7	19.1	15.4	18.0	14.7
Gross investment	31.9	30.5	29.9	13.4	17.2	13.0	16.9
Net increase in non-produced capital goods[13]	–1.4	–1.5	–1.4	–0.7	–0.8	–0.7	–0.8
Total expenditure	1 038.9	1 037.0	1 035.6	505.7	531.3	505.3	530.3
Deficit/surplus	–81.3	–82.7	–69.5	–40.6	–42.2	–34.8	–34.7
	b) Change (%) on the previous year						
Revenue							
Taxes	0.8	–0.1	1.7	0.3	–0.6	2.0	1.5
Social contributions	1.4	0.4	0.8	0.1	0.6	0.3	1.3
Property income	–13.9	–28.5	0.4	–48.3	6.6	4.8	–3.4
Other current transfers[11]	1.0	0.3	0.6	–1.6	2.0	–0.1	1.2
Total revenue	0.8	–0.3	1.2	–0.9	0.2	1.1	1.3
Expenditure							
Inputs[12]	1.3	–0.9	0.8	–0.6	–1.2	0.7	0.8
Compensation of employees	0.0	–0.7	0.8	–0.1	–1.2	0.6	1.0
Property income, transferred	1.1	1.4	1.8	–1.5	4.3	1.9	1.8
Subsidies	–6.3	–3.2	–3.9	–3.0	–3.5	–4.4	–3.5
Social benefits	2.5	1.1	–0.7	1.3	0.8	–0.2	–1.1
Private households	2.6	1.0	–0.7	1.3	0.8	–0.3	–1.1
Rest of the world	–3.9	4.1	0.6	4.7	3.5	0.4	0.8
Other current transfers	7.4	–1.0	1.4	–3.8	1.7	1.1	1.7
Capital transfers	2.8	–3.4	–5.0	–3.7	–2.9	–5.7	–4.2
Gross investment	–11.2	–4.2	–2.3	–4.6	–3.9	–2.9	–1.7
Net increase in non-produced capital goods[13]	–	–	–	–	–	–	–
Total expenditure	1.1	–0.2	–0.1	–0.2	–0.1	–0.1	–0.2

1 Calculations by the Institute for Research on Employment and by the DIW Berlin. — 2 Gross domestic product at 1995 prices per hour worked. — 3 Incl. private non-profit organisations. — 4 Incl. net increase in value. — 5 Incl. consumption-related taxes. — 6 Self-employed income/operating profits plus property income received minus property income losses. — 7 Transfers received minus other transfers. — 8 Expenditure concept. — 9 Savings as a percentage of disposable income. — 10 Federal, state and local government and social security funds. — 11 Other current transfers. Capital transfers. Sales and other subsidies. — 12 Incl. social benefits in kind and other production charges. — 13 Incl. one-off receipts from the sale of UMTS licences.

Sources: Federal Statistical Office (Series 18 of the National Accounts); DIW Berlin calculations.

Supplement: Economic Indicators
Weekly Report No. 1/2005
(data as of 12 January 2005)

Germany – Selected Seasonally Adjusted Economic Indicators[1]

		Unemployment		Vacancies		Orders in manufacturing (volume)[2]													
						Manufacturing						Intermediate goods industry		Capital goods industry		Durable consumer goods industry		Non-durable consumer goods industry (incl. semi-durable goods industry)	
						Total		Domestic		Abroad									
		in 000s				2000 = 100													
		month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter
2002	J	3 970		471		95.7		93.8		98.0		93.9		96.6		94.1		100.2	
	F	3 963	3 965	474	473	95.0	96.5	91.9	93.4	98.9	100.3	95.2	95.5	94.5	96.8	94.7	95.1	97.9	100.7
	M	3 961		474		98.9		94.6		104.2		97.5		99.3		96.4		104.0	
	A	3 972		473		96.2		92.6		100.7		95.8		96.3		94.0		99.2	
	M	4 026	4 005	469	470	99.0	97.5	93.2	93.2	106.2	102.7	97.1	96.6	100.8	98.1	96.1	96.0	98.9	98.6
	J	4 075		462		97.1		93.9		101.1		96.9		97.1		97.9		97.9	
	J	4 090		450		97.6		93.9		102.2		96.8		98.7		90.7		98.6	
	A	4 106	4 099	442	446	97.9	97.8	93.9	93.8	102.9	102.8	96.6	97.0	99.5	98.9	91.9	91.2	97.3	98.8
	S	4 126		428		97.9		93.6		103.3		97.6		98.4		91.1		100.3	
	O	4 160		418		97.8		93.6		103.0		96.9		99.2		89.8		97.8	
	N	4 206	4 185	408	413	98.3	97.2	93.4	93.3	104.4	102.0	97.6	96.9	99.3	97.9	90.9	90.1	100.0	98.3
	D	4 251		399		95.4		92.8		98.5		96.2		95.0		89.7		97.0	
2003	J	4 319		391		98.2		93.3		104.2		97.6		99.5		89.0		98.6	
	F	4 367	4 336	379	385	98.5	97.1	94.8	92.9	103.0	102.3	96.8	96.5	100.4	98.4	88.1	87.6	100.0	97.6
	M	4 392		372		94.7		90.7		99.7		95.0		95.3		85.8		94.4	
	A	4 409		366		97.0		92.8		102.2		96.2		98.6		86.9		96.7	
	M	4 402	4 400	353	359	93.2	95.8	91.8	92.5	94.9	100.0	93.8	95.4	93.2	97.1	84.0	84.6	95.8	96.8
	J	4 384		346		97.3		92.9		102.7		96.1		99.4		83.0		97.8	
	J	4 390		346		97.3		92.9		102.7		97.6		97.9		88.6		96.6	
	A	4 393	4 390	341	343	97.1	97.6	92.1	93.0	103.3	103.4	97.2	97.8	97.9	98.6	85.6	87.3	97.7	96.6
	S	4 392		337		98.5		94.0		104.1		98.5		99.9		87.9		95.5	
	O	4 388		331		99.5		94.6		105.5		100.0		100.2		88.9		98.4	
	N	4 376	4 379	329	330	99.7	100.2	95.6	94.9	104.9	106.8	100.7	100.6	100.8	101.4	87.1	88.0	95.5	97.3
	D	4 354		321		101.4		94.5		110.1		101.1		103.4		87.8		98.1	
2004	J	4 315		312		99.6		94.8		105.5		100.8		100.3		87.5		95.3	
	F	4 310	4 321	301	306	99.9	100.8	94.2	95.6	107.1	107.4	101.7	102.0	100.6	102.0	87.3	87.7	94.1	95.5
	M	4 322		287		103.1		97.8		109.5		103.4		105.0		88.4		97.1	
	A	4 337		279		103.4		97.3		111.0		104.6		104.5		88.4		99.1	
	M	4 345	4 341	283	282	107.5	104.4	98.8	97.4	118.5	113.2	107.9	105.6	109.7	105.7	90.9	89.4	100.9	98.8
	J	4 363		282		102.3		96.1		110.2		104.4		103.0		88.9		96.5	
	J	4 392		277		103.2		96.2		112.0		103.3		105.3		87.6		98.7	
	A	4 413	4 400	274	277	103.0	103.0	96.8	95.9	110.7	111.9	104.5	103.6	104.1	104.9	87.4	86.6	97.0	97.6
	S	4 428		275		102.8		94.8		112.8		103.1		105.1		84.8		97.0	
	O	4 434		278		102.4		95.3		111.2		101.9		105.4		83.5		96.8	
	N	4 448	4 448	278	278	101.5		94.2		110.6		101.7		103.1		84.8		99.7	
	D	4 496		281															

1 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. — 2 Also adjusted for working days.
Sources: Federal Labour Office; Federal Statistical Office; DIW Berlin calculations.

Germany – Selected Seasonally Adjusted Economic Indicators[1] (continued)

		Employment in mining and manufacturing		Manufacturing output[2]										Retail trade turnover		Foreign trade (Special trade)[2]			
				Manufacturing		Capital goods industry		Durable consumer goods industry		Non-durable consumer goods industry (incl. semi-durable goods industry)		Construction industries				Exports		Imports	
		in 000s		2000 = 100												Euro bill.			
		month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter	month	quarter
2002	J	6 290		98.5		100.3		95.4		98.7		91.3		99.8		52.5		41.8	
	F	6 272	6 288	97.9	99.0	98.5	100.1	93.2	94.4	98.5	99.4	93.8	93.0	100.3	100.3	53.3	161.2	43.0	129.0
	M	6 256		100.6		101.5		94.6		101.1		93.8		100.8		55.5		44.2	
	A	6 240		97.4		99.9		91.5		95.8		90.4		100.1		53.1		42.5	
	M	6 225	6 233	98.4	98.5	99.4	100.8	89.8	91.7	98.7	97.3	88.4	89.0	99.5	99.8	53.2	161.4	42.4	128.8
	J	6 211		99.7		103.0		93.8		97.5		88.3		99.9		55.1		43.8	
	J	6 199		99.3		101.2		91.1		97.4		87.6		101.2		53.8		42.8	
	A	6 187	6 193	99.9	99.8	102.2	101.8	90.9	91.1	97.6	97.9	87.4	87.5	101.4	100.8	55.1	164.4	44.2	131.3
	S	6 177		100.2		101.9		91.2		98.7		87.5		100.0		55.5		44.3	
	O	6 169		99.3		101.2		90.2		97.8		85.9		100.6		55.5		44.2	
	N	6 157	6 163	100.0	99.5	101.9	101.5	90.4	89.7	99.0	98.1	86.5	85.3	100.3	99.9	56.3	166.9	43.7	132.7
	D	6 148		99.3		101.2		88.6		97.6		83.3		98.8		55.1		44.7	
2003	J	6 191		99.7		102.4		88.1		97.5		85.6		101.0		55.5		45.6	
	F	6 181	6 177	100.1	99.3	104.1	102.3	89.1	87.7	97.5	97.0	81.1	83.8	101.0	100.2	55.5	165.0	44.8	135.4
	M	6 172		98.0		100.4		85.9		96.1		84.8		98.8		54.0		45.0	
	A	6 160		99.8		101.7		87.8		99.1		86.7		100.8		54.4		44.5	
	M	6 151	6 156	97.9	98.6	100.4	100.3	85.9	85.8	95.9	97.6	84.8	85.7	101.4	100.4	54.3	163.5	44.2	133.1
	J	6 140		98.0		98.7		83.8		97.9		85.5		99.0		54.9		44.5	
	J	6 130		99.7		102.3		88.8		97.8		86.4		99.6		55.8		44.2	
	A	6 117	6 124	98.2	98.8	99.9	101.0	85.3	86.8	97.3	97.1	83.6	84.8	98.1	99.4	55.6	168.1	44.2	132.5
	S	6 109		98.4		100.7		86.3		96.1		84.4		100.4		56.7		44.1	
	O	6 098		100.4		102.7		87.5		97.7		84.2		100.4		55.6		44.5	
	N	6 092	6 096	101.0	100.8	104.6	103.7	87.3	87.7	96.9	97.5	83.6	84.6	97.8	99.7	57.0	170.2	46.1	135.6
	D	6 086		100.9		103.9		88.2		97.7		85.9		101.0		57.6		45.0	
2004	J	6 042		100.9		102.9		88.3		98.0		82.8		98.9		58.6		45.2	
	F	6 034	6 045	100.9	101.3	102.0	103.5	87.4	88.6	97.7	97.7	86.2	83.4	98.4	99.3	58.4	176.7	45.9	136.2
	M	6 029		102.2		105.8		90.1		97.4		81.3		100.7		59.7		45.1	
	A	6 027		102.9		106.2		89.7		97.8		80.3		99.0		61.8		47.1	
	M	6 020	6 023	106.0	104.2	109.8	108.2	93.1	91.1	100.4	98.5	82.4	81.2	95.9	98.5	63.8	185.9	49.2	142.9
	J	6 017		103.8		108.5		90.5		97.2		80.9		100.7		60.3		46.5	
	J	6 010		102.9		106.1		87.7		98.0		78.7		98.6		61.3		49.4	
	A	6 011	6 012	104.0	103.6	107.9	107.4	88.1	87.4	98.0	98.2	80.7	79.4	98.2	98.3	60.7	182.5	48.5	147.4
	S	6 010		104.0		108.3		86.5		98.5		78.9		98.2		60.5		49.5	
	O	6 006		103.1		107.7		84.3		96.9		77.6		96.6		62.8		49.8	
	N	5 998		101.7		104.1		83.6		97.2		77.5		98.3		62.1		49.7	
	D																		

1 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. — 2 Also adjusted for working days.
Sources: Federal Labour Office; Federal Statistical Office; DIW Berlin calculations.