

Joint Economic Forecast Spring 2011:

Upswing continues - European Debt Crisis still Unresolved

Press version

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Project group Joint Economic Forecast

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In spring 2011 the world economy is in an upswing phase, especially due to the momentum in the emerging economies. Germany too is experiencing a strong upturn. The institutes expect that German GDP will increase this year by 2.8% and by 2.0% next year. For 2011 and 2012, an unemployment rate of 6.9% and 6.5%, respectively, is forecast. Growth forces will gradually shift towards domestic demand. Wages will increase in the wake of the upswing, and the inflation rate will be relatively high at 2.4% in 2011 and 2.0% in 2012. Government net borrowing will amount to 1.7% in 2011 and in 2012 will decline to 0.9%, in relation to nominal GDP. The greatest forecast risks are international. If a reduction in the oil supply were to come about because of increasing unrest in the Arab world or if the European debt and confidence crisis were to worsen, this would have a clear effect on the economy. German economic policy is well-advised to maintain its consolidation course and to work for amendments to the European Stability Mechanism.

The world economy is buoyant in spring 2011. Especially in the emerging economies the economic momentum, after a phase of noticeably slower expansion in the summer half year of 2010, is strong once again. But also in the advanced economies, output and trade have picked up noticeably. However, the pace of the expansion in the US economy is still moderate in comparison with previous upswings, and in the euro area the picture is anything but uniform: with an upswing in Germany and some of its neighbouring countries and stagnation in the Mediterranean area.

At the present, world attention is still fixed on the natural and nuclear disasters in Japan. Normally, the macroeconomic effects of natural catastrophes are not very serious in industrialised countries. In this case, however, the institutes anticipate perceptibly higher production losses than after the Kobe earthquake in 1995. It will take some months before sufficient electricity capacities are restored and production bottlenecks are eliminated. However, effects on the economic activity in other parts of the world will be perceptible only in the short term.

The political unrest in Arab world is also having a disturbing effect. The unrest is of importance for world economic activity in that it represents a risk for the supply of the world economy with mineral oil. The recent rise in the oil price, however, is largely a reaction to the healthy state of the world economy. Only about 10 dollars per barrel is

attributable to increased supply risks. The effect of this on world economic expansion will only be weak.

Also prices for industrial raw materials and foodstuffs have increased strongly since summer 2010. A major cause of the strong price dynamics for raw materials is the still very low interest rates worldwide. In the US, the euro area, the UK and Japan, key lending rates have not yet been raised, even though the European Central Bank has hinted at such a hike. In contrast to monetary policy, fiscal policy is no longer expansive, since many fiscal-policy measures that had been taken to combat the financial and economic crisis have expired.

The world economic upswing will last throughout this year and in the coming year, but will weaken moderately. Especially in the emerging economies, economic policy-makers will further increase the degree of restriction in order to moderate the increase in prices. In the advanced economies, the recovery will continue since monetary policy will remain expansive and the dampening after-effects of the financial and economic crisis will slowly weaken. In total, world economic output should expand this year by nearly 3.5%. World trade is likely to grow at a quite strong pace of 9% this year and by 7% next year.

Germany too is experiencing a strong upswing in spring 2011. The weaker increase in aggregate output in the fourth quarter of 2010 was mainly due to the early onset of winter weather and is no indication of the growth forces having weakened. The upswing is being borne both by foreign as well as domestic demand. In manufacturing, incoming orders have increased strongly from all areas of the world. Enterprise assessments of the economic situation are as favourable as they were in the early years of reunification. The construction industry continues to profit from low interest rates. For the first quarter of this year, the current indicators point to a rise in GDP of 0.8%.

There is much evidence that the expansion will remain strong in the coming months. Important survey indicators are at their highest levels, international economic activity continues to be expansive and interest rates should remain low. In addition, employment and wages are increasing, which means further improvement in the earnings situation of private households.

For the forecast period a gradual shift in the growth forces is expected. Domestic demand will be dampened as a result of a slightly restrictive fiscal policy orientation and this year by the drain on purchasing power due to the strong increase in raw material prices. In contrast, however, the common European monetary policy will continue to have a very

expansive effect in Germany. This will stimulate investment activity. In home building the upward trend should continue. Investments in plant and equipment will be stimulated by the increasing capacity utilisation and the favourable financing conditions. Consumer spending will expand robustly due to increasing employment and higher wage income. Overall, domestic demand will grow at a nearly unchanged pace. In contrast, external trade will make a smaller contribution to the expansion than in 2010. As a result of the rapidly growing domestic demand, imports will expand more strongly than in the second half of 2010. At the same time, the growth in exports will slow temporarily. A contributing factor here is that German enterprises are likely to lose some of their price competitiveness due to a stronger increase in domestic unit wage costs. Not until the end of the forecast period will exports presumably expand again somewhat when the economies in the euro area and in the US grow at a slightly stronger pace.

All in all, the institutes expect that GDP will increase by 2.8% this year and by 2.0% next year. The 68% forecast confidence interval for 2011 lies between 2.0% and 3.6%.

In light of the strong economic upturn, the situation on the labour market will continue to improve. However, the increase in employment is likely to slow during the forecast period, since the expansion of production will abate somewhat and wage developments will lead to less stimulation of employment. The institutes expect an increase in the number of gainfully employed of 430,000 this year and 275,000 next year. For 2011 and 2012, an unemployment rate of 6.9% and 6.5%, respectively, is anticipated.

Because of the strong economy, the upsurge of prices and costs has accelerated. Inflation has been increasing already since mid-2010. In the first quarter of 2011, consumer prices were 2.1% higher than a year before. This is primarily a reflection of increasing prices for raw materials, especially for crude oil. But in the meantime, core inflation has also risen – price stability in Germany is being increasingly endangered by the low interest rates of the ECB.

With increasing employment and declining unemployment, shortages are arising in more and more segments of the labour market, for which reason the rise in actual earnings might accelerate. Although cost pressure from the raw materials markets will abate during the forecast period – under the assumption of unchanged raw materials prices – the internal upsurge in prices will amplify. In total the institutes expect an inflation rate of 2.4% for this year and 2.0% for the next.

The continuing strong economic activity and the budget consolidation measures will lead to a clearly improved situation for public finances. For 2011 a government budget deficit of 45 billion euros is expected, which should fall to 23½ billion euros in 2012. In relation to nominal GDP, the deficit will be 1.7% in 2011 and 0.9% in 2012. Since the output gap will be slightly positive in 2012, this implies a structural deficit of about 1%, after 1½% in 2011.

Risks come particularly from the international environment. A further noticeable rise in the price of raw materials, in particular if this is due to a supply shortage as a result of an escalation of the situation in the Arab world, could clearly dampen the expansion both nationally and internationally. Also the situation of the public finances of many countries in the euro area is still strained. An escalation of the debt and confidence crisis could place considerable burdens on the German economy.

However, there is also the possibility that the expansion will turn out to be stronger than we forecast here. In many countries, interest rates are at historically low levels. In light of this, both world economic activity and economic activity in Germany could expand more strongly than our forecast expects. Noticeably stronger economic activity would lead, sooner or later, to a greater surge in prices, which could touch off a wage-price spiral.

After the abandonment of the no-bail-out principle anchored in the Maastricht Treaty, the European Union has been seeking a new institutional framework for fiscal policy. On 24/25 March 2011, the European Council decided on measures aimed at increasing fiscal discipline, avoiding so-called macroeconomic imbalances and expanding economic-policy coordination. In addition, the current rescue package for the troubled euro countries will be replaced in 2013 by the European Stability Mechanism (ESM). The clear commitment to rigorous fiscal consolidation is a good thing. Also the approach of the Euro-Plus Pact of systematically discussing economic developments in the member states of the currency union and identifying problems is sensible in that it will increase transparency and possibly create pressure for political action. It is particularly to be welcomed that the responsibility for sound economic policy will ultimately remain with the national governments. This should also imply, however, that the countries bear the financial consequences of their economic-policy actions. The arrangements adopted for ESM give rise to doubts on this point, however. Instead, the current arrangements give reason to expect that the creditors will not share in the costs even when a country is faced with serious financing problems; this should be the case, however, so that the markets evaluate the risks appropriately. A participation of the capital providers is only credible if a government default does not lead to larger disturbances on the financial markets or in the banking system. In order to achieve this, a preordained insolvency procedure for states is necessary. The route

chosen for the ESM does not assure this and it can ultimately lead to a considerable weakening of the solidarity of the financially sounder countries. The institutes therefore recommend that the federal government strive to achieve changes in the ESM with the goal of creating an operative and incentive-compatible insolvency mechanism for states.

In Germany the public-finance situation has clearly relaxed; already in 2011 the 3% deficit mark will not be exceeded. In addition to the strong economy, the consolidation measures will also contribute to this. The maximum net borrowing of the federal government set on the basis of the 2010 budget planning appears high from the present perspective and could be significantly undercut. This could arouse demands for spending increases or tax reductions. It is important, nevertheless, that the consolidation course be retained in the coming years. Extensive tax cuts are presently not advisable insofar as they are not offset by corresponding spending cuts. The gain in efficiency would be offset by a weaker robustness if the tax cuts mean that the public debt ratio is not further reduced.

Thus, in the coming years restrictive impulses will emanate from fiscal policy. These impulses will have to be much stronger in other euro countries than in Germany. This also has implications for monetary policy. An underutilisation still prevails in the euro area. Also monetary indicators and inflation expectations give no reason for assuming direct dangers for price stability. With an increasing closing of the output gap, interest rate adjustments may indeed become necessary. However, the ECB is well-advised to exercise some caution in light of the heightened insecurity that still prevails.

Federal Republic of Germany Key Forecast Figures

	2009	2010	2011 (1)	2012 (1)
Percentage change over previous year ^{a)}				
Private consumption	-0,2	0,4	1,2	1,2
Government consumption	2,9	2,3	1,3	1,2
Gross fixed capital formation	-10,1	6,0	5,6	4,7
Machinery and equipment,	-22,6	10,9	10,5	7,6
Buildings	-1,5	2,8	2,2	2,4
Other investment	5,6	6,4	6,3	6,5
Domestic demand	-1,9	2,5	1,8	1,8
Exports of goods and services	-14,3	14,1	9,8	6,5
Imports of goods and services	-9,4	12,6	8,2	6,7
Gross domestic product (GDP)	-4,7	3,6	2,8	2,0
Employment ^{b)} (1.000 persons)	40271	40483	40913	41188
Unemployment (1.000 persons)	3415	3238	2888	2709
Unemployment rate ^{c)} (in %)	8,1	7,7	6,9	6,5
Consumer prices ^{d)} (% change on the previous year)	0,4	1,1	2,4	2,0
General government financial balance ^{e)} - EUR billion	-72,7	-82,0	-45,1	-23,5
- in % of GDP	-3,0	-3,3	-1,7	-0,9
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Real GDP in the EMU (% change on the previous year)	-4,0	1,7	1,7	1,6
Consumer prices in the EMU ^{f)} (% change on the previous year)	0,3	1,6	2,4	1,6
1) Forecast of the Institutes. c) Federal Employment Agency concept.- d) Consumer price index (2005=100).- e) On national accounts definition (ESA 1995).-f) Harmonized index of consumer prices (HICP, 2005=100).				

Source: Eurostat, Federal Statistical Office, Federal Employment Agency, forecast of the Institutes.