



**Leibniz Institute for Economic Research**  
at the University of Munich

**Ifo Economic Forecast 2011/2012:**

**Debt Crisis Curbs German Economy**

Press release

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## **Ifo Economic Forecast 2011/2012: Debt Crisis Curbs German Economy**

**Gross domestic product in Germany increased significantly until recently. The Ifo Business Climate Index and other leading indicators show, however, that the German economy is facing a downturn. The weakening world economy and the European debt crisis are the main factors behind this. The dependency of economic developments on the decisions made by Europe's politicians complicates the forecast considerably by making radically different plausible scenarios possible. Based on the assumption that the euro crisis does not worsen and that Italy in particular can continue to finance itself via the capital market, it should be possible to avoid a recession in Germany. Germany's GDP is nevertheless only expected to increase by 0.4% in 2012. Growth in employment is therefore expected to slow significantly. Supported by demographic factors, however, the number of unemployed should still decrease by around 140,000.**

The pace of world economic growth has slowed in recent months. According to the results of the Ifo World Economic Survey, the Ifo global economic climate has deteriorated in all major economic regions. The slump in sentiment echoes the massive increase in uncertainty with regard to the outlook for the world economy in autumn 2011. This uncertainty is likely to be one of the central stress factors impacting economic activity in the forecast period.

The uncertainty stems from several factors that mutually reinforce each other to some extent. The massive slump in sentiment on the part of private-sector economic players may not least be attributed to the failure of attempts to date to find a long-term solution to the sovereign debt crisis in the Eurozone. The growing danger of the debt crisis degenerating into a Europe-wide banking and economic crisis, which also has a negative impact on other regions of the world, has led to a rapid rise in the volatility of the financial markets. The fact that economic policy's ability to combat further crises is very limited in the majority of industrialized countries is fuelling concern. Indeed, the high level of government debt in many places makes it nearly impossible to implement far-reaching measures to support the banking sector or to stimulate economic activity. Moreover, the base interest rates in almost all developed economies are currently at a very low level, which greatly reduces the leeway enjoyed by their central banks.

The development of the global economy in the forecast period critically depends on whether the European debt crisis can be politically mastered. This forecast is based on the assumption that it is possible to reassure the financial markets in a sustainable manner, thereby avoiding any further escalation of the crisis. This requires sufficiently strong efforts to restructure state finances in many Eurozone member states. This means not only a complete implementation of the austerity and reform programmes that have already been announced, but also requires an additional and noticeable intensification of fiscal consolidation to be undertaken. Under these conditions no further "haircuts" are to be reckoned with and the European single currency should remain stable. It is accordingly to be hoped that the uncertainty prevailing at present will slowly dissipate over the course of the year ahead.

There are, however, absolutely no guarantees that the baseline scenario depicted above will materialize. The probability of the most important risk scenario occurring, namely that political resolve to implement far-reaching reforms in large countries like Italy and Spain weakens, or that these reforms are not deemed credible and effective by investors, is by no means negligible either. In such a situation various economic policy reactions are conceivable, including the assumption of public debts by the Community or the unlimited purchase of government bonds by the ECB. All of these reactions carry high risks for economic activity and mid-term economic development and call into question the continued existence of monetary union.

According to the *baseline scenario*, the expansion of the world economy in the forecast period will slow noticeably. Uncertainty should worsen financing conditions for banks and companies worldwide, leading to the deferment of much consumption and investment expenditure into the bargain. The poor financial situation of private households in the USA, as well as that of those in some European countries, will continue to require a high savings ratio, and should have a very negative impact on private consumption as a result. In the end, financial policy in Europe and the USA will be clearly oriented towards contraction. The negative fiscal impulse will be particularly strong in several of the Eurozone countries threatened by the debt crisis, whose economic output looks set to shrink in the year ahead.

The economic dynamics in the growth economies will be curbed by weakening economic activity in industrialized economies. However, the endogenous domestic dynamics as well as recent monetary policy, which has once again become more expansive, will mean that the growth economies will post high production increases with positive contributions to growth by net imports. They should, in turn, represent a stabilizing element for the world economy.

In line with the baseline scenario, we assume that consumer and producer confidence in developed economies will recover a little in the second half of 2012, which should somewhat revive the world economy towards the end of the reporting period. Overall, total economic output for this year and next year only looks set to increase slightly by 3.8% and 3.3% respectively. World trade will expand by 6.2% in 2011 accordingly, before growth weakens to 3.9% in the year ahead. In view of global economic weakening in forthcoming quarters and the successive weakening of price increase impulses driven by higher commodity prices in the first half of 2011, the increase in prices in all regions of the world will fall. The inflation rate in the growth economies will nevertheless remain at a significantly higher level than in industrialized countries.

In *Germany* total economic output increased significantly until recently. In the third quarter of 2011 real gross domestic product adjusted for seasonal and calendar effects increased at a current annual rate of 2.0%. Compared to the previous year, this figure increased by 2.5%. German economic activity continues to be supported by domestically-oriented forces.

The upturn in Germany will not continue in the forecast period and economic activity may presumably even experience a downturn over the winter. We expect the slower pace of the world economy, and particularly the manifold consolidation and austerity efforts in the Eurozone as a reaction to the sovereign debt crisis, to have a major negative impact on exports. Falling total capacity utilisation resulting from weaker production volumes combined with great uncertainty will also curb investment in equipment. Private consumption, on the other hand, which tends to lag behind cyclically, will be supported by the strong employment market and the favourable income situation and looks set to grow robustly. Nurtured by low interest rates and the uncertainty of investors with regard to international financial investments, demand for

residential buildings will also increase. As a result, Germany, – unlike many of its European partner countries, – is not expected to experience a recession. This critically depends, however, on the baseline scenario underlying the forecast and on the assumption that no very far-reaching bail-out initiatives take place, as the latter would destroy any benefits derived from low interest rates. Moreover, it follows under the conditions of the baseline scenario that the world economy will slowly pick up again, which should support German exports. German companies should also then gradually regain confidence, so that corporate investment can slowly be ramped up. In view of robust consumer demand and should residential building construction activity remain strong, gross domestic product in the second half year of 2012 is expected to increase by approximately the rate of production potential of around an annualized 1.25%. Overall gross domestic product should grow by 3.0% in 2011, but is only set to increase by 0.4% in 2012.

Against this backdrop, the increase in employment figures will slow down. Annual average employment figures are set to increase by around 210,000 or 0.5% in 2012. Due to demographic factors, the annual average number of unemployed is expected to fall by around 140,000 to around 2.8 million. This corresponds to an unemployment rate of 6.7%. In the wake of weaker economic activity, the pace of price increases should slow, meaning that an annual average inflation rate of 1.8% is to be expected for 2012. The public budget deficit as a percentage of nominal gross domestic product is expected to total 0.9% in the year ahead.

We would like to emphasize that macro-economic uncertainty, not least due to the political situation, is extremely high at present. Even small deviations from its planned policy of consolidation on the part of Italy could lead to fresh upheavals in the already tense financial markets and to political reactions that are almost impossible to assess. Such events could quickly make the assumptions underpinning this forecast obsolete. From a technical point of view, the probability of the baseline scenario occurring is considerably lower than in normal forecast situations. At this point – unlike in our previous forecasts – we do not specify any interval forecast.

## Federal Republic of Germany Key Forecast Figures

	2009	2010	2011 (1)	2012 (1)
Percentage change over previous year <sup>a)</sup>				
Private consumption	-0.1	0.6	1.4	1.2
Government consumption	3.3	1.7	1.2	1.2
Gross fixed capital formation	-11.4	5.5	6.9	2.2
Machinery and equipment,	-22.8	10.5	8.8	2.8
Buildings	-3.0	2.2	5.7	1.6
Other investment	0.6	4.7	4.6	4.6
Domestic demand	-2.6	2.4	2.3	1.2
Exports of goods and services	-13.6	13.7	8.4	2.8
Imports of goods and services	-9.2	11.7	7.6	4.6
Gross domestic product (GDP)	-5.1	3.7	3.0	0.4
Employment <sup>b)</sup> (1.000 persons)	40362	40553	41060	41270
Unemployment (1.000 persons)	3415	3238	2975	2835
Unemployment rate <sup>c)</sup> (in %)	8.1	7.7	7.1	6.7
Consumer prices <sup>d)</sup> (% change on the previous year)	0.4	1.1	2.3	1.8
General government financial balance <sup>e)</sup>				
- EUR billion	-76.1	-106.0	-27.5	-24.5
- in % of GDP	-3.2	-4.3	-1.1	-0.9
memo item:				
Real GDP in the EMU (% change on the previous year)	-4.2	1.8	1.5	-0.2
Consumer prices in the EMU <sup>f)</sup> (% change on the previous year)	0.3	1.6	2.6	1.2
1) Forecast of the Ifo Institute. 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 Ifo Institute.