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# ifo Pressemitteilung

## The German Economy in 2003/2004

There are only faint signals of a recovery of the world economy. But anyway: the termination of the Iraq war marked the end of a long phase of uncertainty that started with the events of 11 September 2001; in view of the dramatic decline of new infections, SARS is no longer in the headlines; and the Argentine crisis has been overcome. Petroleum prices are on the decline again, central banks have sharply reduced key interest rates, and the US government passed a gigantic Keynesian countercyclical fiscal programme resulting in a budget balance which has gone from a surplus of 1.2% to a deficit of 4.6% of GDP within four years. These are ingredients of a new demand-driven recovery of the world economy, as also reflected by the Ifo World Economic Climate, based on those survey responses received after the termination of the Iraq war. Although the continuing lethargy of the Japanese economy, the large current account deficit of the United States, and a new pessimism in the United Kingdom mar this picture, the retarding factors are likely to be less important, especially as they are for the most part longer-term structural phenomena that have little to do with the business cycle

The German economy has been in the doldrums for three years now. Following growth of only 0.6% in 2001 and 0.2% in 2002, gross domestic product will merely stagnate this year, according to the Ifo Institute's forecast.

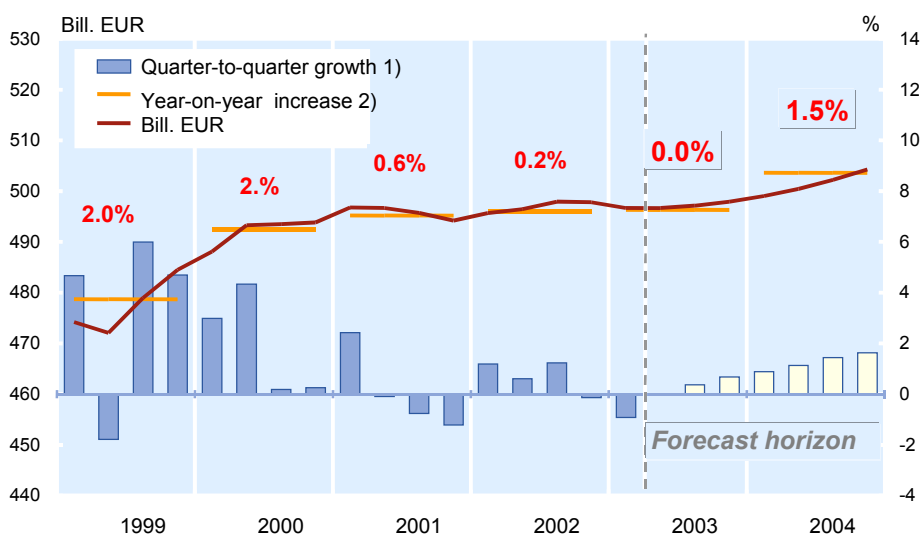
Although Germany will remain the economic laggard of Europe for structural reasons, it may also experience a slight cyclical recovery in the course of this year. Besides the improvement of the international

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economic environment, this is indicated above all by the marked increase in retail sales as well as the better figures of the just completed Ifo Spring Investment Survey, according to which the industrial firms plan to increase investment spending by 4% over last year. The marked improvement of the expectations component of the latest Ifo Business Survey is also among the positive indicators. The cyclical trough (measured by the deviation of GDP from trend) will not be reached, however, until the third quarter of 2004. In 2004 the growth rate of aggregate output will average 1.5%. Because close to 0.6 percentage points of this will be due to the extraordinarily large number of working days, the true cyclical increase of GDP will not even amount to one percent.

#### Real Gross Domestic Product in Germany

Seasonally and workday adjusted



1) Annualised (right hand scale).

2) Figures (left hand scale).

Source: Federal Statistics Office t; calculations and estimates of the Ifo Institute (Juni 2003).

Over the forecast horizon, the state of the labour market will remain dramatic: In 2003 the number of gainfully employed will be about 425,000 (1.1%) lower on average than in 2002 and will decline by another 75,000 next year. The number of unemployed is expected to rise by 390,000 to 4.45 million on an annual average. Next year,

4.6 million jobless must be expected, and the seasonal peak will amount to 4.9 million in winter. At 10.8%, the unemployment rate will mark its highest value since reunification. A turnaround in unemployment is not expected by the end of the forecast horizon.

One of the reasons for the Ifo Institute's forecast of a very slow recovery is the expectation that a further rise of the exchange rate of the euro is more likely than a decline. Firstly, the aversion of the international investors to continue financing the huge current account deficit of the United States will grow, demanding a depreciation of the dollar. Secondly, the world-wide run on the euro as an international transactions and reserve currency, especially in East and Southeast Asia, continues unabatedly.

Another reason is the still not overcome credit crisis of the big German commercial banks, which lost considerable parts of their equity in recent years and are now forced, among other things, to limit their credit volumes in order to achieve the core equity ratios demanded by the international rating agencies. A strong recovery is hardly likely because of the evident credit crunch of the big commercial banks.

The increase of the cost of living will remain extraordinarily modest because of, among other things, the euro appreciation over the forecast horizon. Consumer price inflation will average 0.9% in 2003, and only 0.8% in 2004. These are values, that in view of the structurally necessary adjustments of real wages and social transfers as well as in view of the profitability of investment spending continue to signal high potential risk for economic growth. Had the ECB eased monetary policy earlier than it did, and had it tolerated a higher rate of inflation in those countries whose price level was even lower than that of Germany, it would be easier for Germany today to gain a foothold again.

This year, fiscal policy will again miss the upper limit for the total government deficit set for the euro-area countries. Despite massive increases in taxes and duties, revenues are rising more slowly than expenditures, resulting in an increase of the budget deficit to around €80 billion (3.7% of GDP). Next year total government revenues are expected to rise a bit faster due to cyclical effects. Expenditures, in contrast, will rise much more slowly as monetary social transfers will expand considerably less than before and physical social services as well as labour costs are even likely to stagnate. The government budget deficit will fall to €70 billion (3.2% of GDP). In order to meet the deficit criterion, at least another €4.5 billion of expenditures would have to be cut in addition, according to this forecast.

Advancing the tax reform financed by borrowing would impart positive impulses, but this would violate the Stability and Growth Pact. According to this Pact, the 3% limit must not be exceeded unless the economy is shrinking by 0.75%. In view of the harmful consequences of the credibility of German economic policy that would result from a continued violation of the treaty, and also in view of the threatening penalties, only an advanced tax reform that is financed by expenditure cuts is possible and that only if the existing deficit has already been pushed below the critical limit through other spending cuts. Such a fully financed advancing of the tax reform would improve the structural conditions for long-term growth, but would be harmful for short-term economic activity, as it will initially result in net demand losses. That is why fiscal policy should be content to implement the next stages of the tax reform as originally planned.

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**Federal Republic of Germany  
Key Forecast Figures**

	2001	2002	2003 (1)	2004 (1)
Percentage change over previous year <sup>a)</sup>				
<b>Private consumption</b>	1,5	-0,6	1,0	1,3
<b>Government consumption</b>	0,8	1,5	0,4	-0,4
<b>Gross fixed capital formation</b>	-5,3	-6,7	-1,3	1,8
<b>Machinery and equipment,   other investment</b>	-4,4	-7,7	0,8	3,8
<b>Buildings</b>	-6,0	-5,9	-3,0	0,1
<b>Domestic demand</b>	-0,8	-1,5	0,6	1,5
<b>Exports of goods and services</b>	5,0	2,6	2,5	4,3
<b>Imports of goods and services</b>	1,0	-2,1	4,6	4,7
<b>Gross domestic product (GDP)</b>	0,6	0,2	0,0	1,5
<b>Employment<sup>b)</sup> (1.000 persons)</b>	38917	38688	38265	38190
<b>Unemployment (1.000 persons)</b>	3852	4060	4450	4600
<b>Unemployment rate<sup>c)</sup> (in %)</b>	9,0	9,5	10,4	10,8
<b>Consumer prices<sup>d)</sup> (% change on the previous year)</b>	2,0	1,4	0,9	0,8
<b>Unit wage costs<sup>e)</sup> (% change on the previous year)</b>	1,5	0,8	1,0	-0,3
<b>General government financial balance<sup>f)</sup> - DM billion</b>	-57,5	-76,2	-79,5	-69,9
<b>- in % of GDP</b>	-2,8	-3,6	-3,7	-3,2
memo item: <b>Real GDP in the EMU (% change on the previous year)</b>	1,4	0,8	0,6	1,7
<b>Consumer prices in the EMU<sup>g)</sup> (% change on the previous year)</b>	2,3	2,3	1,9	1,5
1) Forecast by the Ifo Institute.- a) At 1995 prices.- b) Domestic employment.- c) Unemployment as a % of labour force (employed and unemployed).- d) Consumer Price Index.- e) Gross wages and salary income created in the domestic economy per employee as a % of GDP at 1995 prices per employed person.- f) On national accounts definition (ESA 1995).-g) Harmonized index of consumer prices (HICP).				

Source: Eurostat, Federal Statistics Office, Federal Labour Office, forecast by the Ifo Institute.