The Recovery Takes Shape

Ifo Economic Forecast 2004

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The world economic recovery finally began to take shape in 2003. The Ifo World Economic Climate (WES), an index based on a survey of 1200 experts in 90 countries, has been above its historical average since the Spring of this year. In the fourth quarter, also the assessments of the current situation of the world economy improved for the first time in many months.

Historically low interest rates and the massive budget deficit of the US, which alone has increased private disposable income by some 700 billion dollars, are showing international multiplier effects, as described in textbook Keynesianism.

The war in Iraq is over, Argentina has overcome its crisis, and SARS is no longer retarding the upswing in Asia. The stock market indexes are rising again. Consumer confidence is growing. New risks, like the recent terrorist attacks in Turkey, have moved into the background.

The signals for the German economy are also green. After three years of stagnation, economic activity has revived since mid-2003. Both in the producing sector and in the large service sector, value added increased in the third quarter. Incoming orders in manufacturing have been growing appreciably since mid-year, both for domestic and international orders. All main industry groups have profited, especially the manufacturers of consumer goods. For the whole calendar year, a small increase in value added over the previous year was achieved in most business sectors (manufacturing +0.2%, services +0.5%). Only construction was clearly behind the production levels of 2002 with a minus of 4%, although here too, after a sharp decline at the beginning of the year, output expanded in the further course of the year. All in all, GDP will just about equal the value of the previous year.

According to the December results of the Ifo Business Survey for Germany, released yesterday, the rise in the business climate index in manufacturing is now in its seventh month. The surveyed firms also continue to expect a recovery of exports. The broad-based improvement of the business climate index signals that the economic recovery is making progress.

It is particularly important that for the third time in succession, the assessments of the current business situation have improved. The business-situation indicator of the Ifo Institute contains the most current "hard" business-cycle information for Germany, and it is clearly pointed upwards.

The survey information on the business situation is not a "confidence" measurement, as is frequently mistakenly presumed. In contrast to the Ifo World Economic Survey and other business-cycle indicators, it is not the result of an expert survey but stems from the poll of the actual situation in 7000 German firms. The improvement of the business situation shows that the rise of the Ifo climate index is no longer solely based on an improvement of the business expectations, as had long been feared. Instead, the economic upswing that started in the US and Asia has now clearly taken hold in Germany as well.

The economic outlook of the Federal Republic of Germany have not been this favourable in a long time, especially since the recent agreement among the parties in Parliamentary conference committee have cast a better light on the ability of the country to implement reforms.

In total, output will expand at a moderate but steady pace in 2004. According to the forecast of the Ifo Institute (see G. Flaig, W. Nierhaus et. al., *Ifo Konjunkturprognose 2004: Erholung hat begonnen*), industry will profit from expanding world economic activity, with production expanding by more than 3%. In construction, after long years of contraction, a perceptible increase is expected for the first time since 1994, amounting to 0.5%. In the tertiary sector the situation will be mixed. In the area of financial services, leasing and business-service providers, expansion will accelerate in line with the general economic improvement. In contrast, partly because of the cuts in government spending and health reforms, value added of the public- and private-sector service providers will decline slightly.

Special stimulus will come from exports, since they will be driven by the healthy world economic activity. Growth here is estimated at 5.7%, which will be a boost to manufacturing. Increasing exports will, of course, be offset by rising imports (+ 4.4%), because part of the value of exports consists of imported intermediate products and because private households will expand consumption of imported goods because of their increasing incomes and the stronger euro.

Export activity remains an uncertainty factor in this forecast since it is not clear how strong the euro will become. The Ifo Institute expects a euro exchange rate on the dollar of about 1.25 for the year. This exchange rate forecast, which is much higher that the OECD's purchasing power parity, is based, among other things, on the continuing demand for euro cash in Eastern Europe and other parts of the world. The future of the price of crude oil is also unsure. This forecast assumes a price of about 30 dollars per barrel.

Little stimulus will come for investments in plant and equipment; the growth here of only 0.7% is so low since investors are increasingly moving into the low-wage countries of Eastern Europe that will join the EU in May 2004.

On the whole, real GDP in 2004 will increase by 1.8%.

Of this growth, 0.2 percentage points will stem from the partial, pre-scheduled implementation of the third stage of the 2000 tax reform, which in comparison to the initial plan will hardly have a weaker economic effect because about 8 billion of 9 billion euro (instead of initially planned 10 billion of 16 billion euro) will not be financed by cuts in government spending or by increases in other taxes. About 3 billion euro will be debt financed according to the compromise reached in the Parliamentary conference committee, and 5 billion euro is to be financed by net profits from privatisation. Both forms of financing hardly differ, neither from a legal nor from an economic viewpoint. They both imply a Keynesian demand impulse that stimulates economic activity, they both will contribute to future violations of the Stability and Growth Pact, and they both will increase the burdens that future generations in Germany will have to bear.

About 0.5 percentage points of GDP growth will come from the fact that in 2004 there will be an average of 3.3 more working days than in 2003. Growing demand will result in the use of these additional working days for increased production.

The situation on the labour market remains precarious. The number of people in employment fell, on average, by almost half a million in 2003 . The number of unemployed grew by more than 300,000. Unlike previous periods of economic weakness, this time the employment numbers in the services also fell.

Nonetheless, the trough of labour market developments has not been reached. Germany is in its fourth cycle of unemployment increases. The first cycle lasted from 1970, when there were only 150,000 unemployed, until 1980; the second cycle went from 1980 to 1991; and the third one from 1991 to 2001. The fourth cycle started in 2001. Regardless of these cycles, during this period west German unemployment rose along a linear trend whose end is not in sight, among other things because the effects of Eastern European low-wage competition on the investment decisions of German firms cannot be forecast.

Assuming double the convergence speed observed in Western Europe in the past (2%), Polish hourly wage costs will have reached just one third of the west German level by 2010 and about half by 2020.

The improvement in economic activity is not expected to cause a rapid recovery of the labour market. In view of the decline in job openings until recently, employment is expected to continue falling in the early months of 2004, albeit not so fast as recently. To be sure, labour market policy is supporting the employment of people who are not eligible for wage replacement benefits by the promotion of self employment (Ich AG), the establishment of Personal Service Agencies and the promotion of mini jobs and midi jobs. Nonetheless, a gradual increase of seasonally adjusted employment figures cannot be expected until the middle of 2004 when the economic recovery will be on solid ground. This will not prevent that, on average for the year, another reduction of employment of about 170,000 people will be recorded. The number of total hours worked, however, will gradually increase next year because there will be more working days, because short-time working will decline, and because working-time accounts will be filled again.

The slight reduction in seasonally adjusted unemployment since 2003 should not be interpreted incorrectly. It is primarily based on changes in the statistics and has no economic significance. Thus the unemployed have been monitored more closely since April, and they are expected to take a more active part in finding work. As a result, many have not reported that they are unemployed. A even stronger effect will occur on 1 January 2004 when unemployed persons that participate in state-supported training measures to improve their employment chances will no longer be counted among the unemployed. With this new definition of unemployment, a sudden reduction of 100,000 in the jobless numbers will occur.

On average for 2003, the number of unemployed increased to 4.38 million, in spite of a statistical adjustments of around 320,000, and in 2004 decline of 80,000 for the year to 4.3 million is expected. For the above-mentioned reasons, this does not sound the all-clear for the labour market. The German economy will not recover merely by hiding its unemployment.

With the public finances, no lasting improvement is in sight. The budget deficit increased in 2003 to 4% of GDP, one percentage point higher than allowed by the Stability and Growth Pact. Solely because of exceeding of the budget deficit limit, the deficit at 85.3 billion euro is above the interest burden of the state, which stands at 67 billion euro. If the government restricted itself to new net borrowing of 63.9 billion euro, it would have no net easing from the indebtedness.

The gap between interest payments and the allowed new net borrowing will grow in the coming years because the nominal growth of GDP will be much too small to prevent a further increase in the national debt in light of the high new net borrowing. In addition long-term interest rates for government bonds will certainly increase in the course of the economic recovery. Again, the violation of the Stability and Growth Pact alone will open up the possibility to cover the interest burden on the national debt by selling off state assets and by new borrowing and additionally to book a surplus. The Ifo Institute expects a budget deficit to GDP ratio of 3.5% for 2004. This all shows that Germany still faces a fundamental reform of its national finances.

With regard to the fact that the hidden national debt in the form of the already existing claims for statutory and government officials' pensions is already nearly 300 percent of the national product, the government must be urgently warned not to continue its debt policies. To be sure, the borrowing will help to stimulate economic activity and to ignite Keynesian brush fires. However, Germany's structural problems are much too great to be helped by such brush fires.

Federal Republic of Germany
Key Forecast Figures

	2001	2002	2003 (1)	2004 (1)
Percentage change over previous year[a)]				
Private consumption	1,4	-1,0	-0,1	1,3
Government consumption	1,0	1,7	0,6	-0,5
Gross fixed capital formation	-4,2	-6,7	-3,5	0,8
Machinery and equipment, other investment	-3,6	-7,6	-3,5	0,7
Buildings	-4,8	-5,8	-3,5	1,0
Domestic demand	-0,8	-1,6	-0,1	1,2
Exports of goods and services	5,6	3,4	1,5	5,7
Imports of goods and services	0,9	-1,7	1,4	4,4
Gross domestic product (GDP)	0,8	0,2	0,0	1,8
Employment[b)] (1.000 persons)	38911	38671	38190	38021
Unemployment (1.000 persons)	3852	4060	4378	4296
Unemployment rate[c)] (in %)	9,0	9,5	10,3	10,2
Consumer prices[d)] (% change on the previous year)	2,0	1,4	1,1	1,2
Unit wage costs)[e)] (% change on the previous year)	1,3	0,7	0,7	-0,7
General government financial balance[f)]				
- DM billion	-58,9	-74,3	-85,3	-75,8
- in % of GDP	-2,8	-3,5	-4,0	-3,5
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Real GDP in the EMU (% change on the previous year)	1,6	0,9	0,5	2,0
Consumer prices in the EMU[g)] (% change on the previous year)	2,3	2,3	2,1	1,7

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 Statistical Office, Federal Labour Office, forecast by the Ifo Institute.