

**Embargoed until 21 December 2004, 10.00 hours**

**Press release of the Ifo Institute**

**Economic forecast for 2005**

**“Decoupled from world economic activity”**

The world economy is booming at a pace not experienced for 28 years, but the German economy is not participating. There is indeed an upturn in Germany, but it has been disappointingly weak in view of the strong ties between the German and the world economies. Germany has become decoupled from world economic activity and continues to lag behind the growth average of the old EU countries. In total, real GDP in 2004 will be only 1.7% higher than in 2003, according to present estimates, with 0.5 percentage points attributable to the special effect of extra working days.

If the number of working days this year had been as high as last year, economic growth would have been a mere tenth of a percentage point more than the growth rate of Italy and Portugal, the poorest growth performers in the EU in 2004. All things considered, Germany has remained at the bottom of the growth table since the mid-1990s. From 1995 to 2004 no other country in central or western Europe grew at a slower pace. For the past decade Germany has been trapped in a fundamental growth crisis, whose end is not in sight.

Only exports performed favourably in 2004. Boosted by world economic activity, exports grew by an impressive 9.3% in real terms. For many it is puzzling why this growth has had such little effect on GDP as a whole. One explanation is that a portion of these exports consist of imported intermediate products as well as imported merchandise, and as such are self-balancing items. According to information from the Federal Statistical Office, additional exports only lead to 45% of additional domestic added value; 55% of marginal exports are export-induced imports (bazaar effect). The other

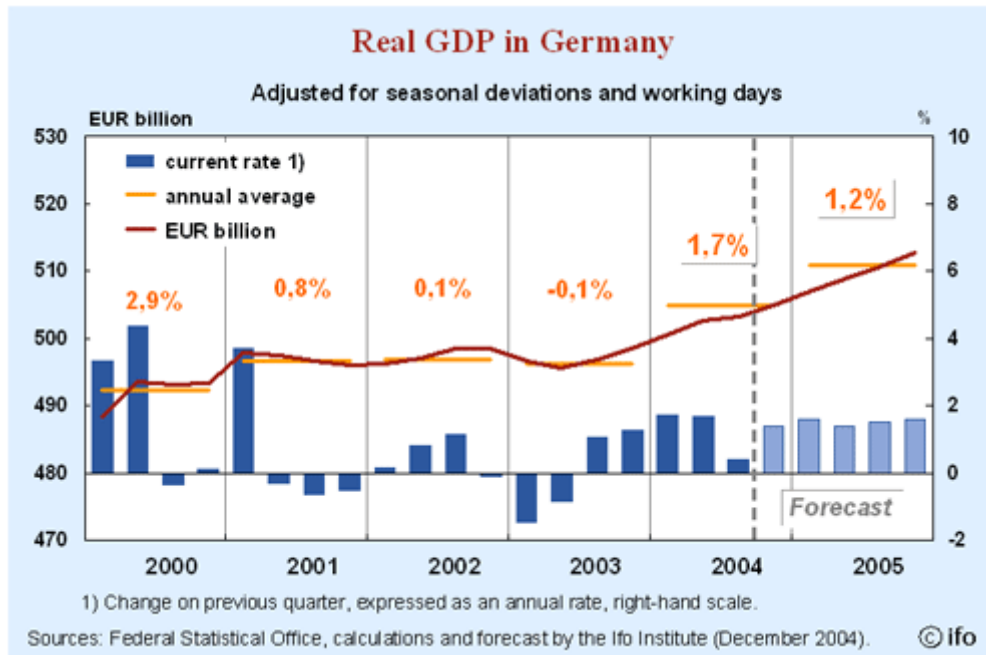
explanation is shrinking domestic demand. Private consumption decreased by 0.3%, and gross fixed capital formation decreased by 0.5%.

A common explanation for the weak domestic demand is the high level of German labour costs, which hold the top position in the world behind Norway and increasingly impair the competitiveness of German workers, especially when faced by the low wage competition in Eastern Europe and Asia. Firms safeguard their competitiveness by shifting production and jobs to low wage countries. In Germany they are investing less and less. Employees are afraid of losing their jobs and are hesitant to buy durable consumer goods. The weak domestic demand is a direct reaction to Germany's locational problems.

Despite the structural weaknesses of the German economy, which are far from being overcome, the economic outlook depends largely on the development of world economic activity. According to the results of the Ifo World Economic Survey (WES), a poll of 1,200 experts in 90 countries, the Ifo indicator for the current state of the world economy continued to improve into the fourth quarter, but the economic expectations have clearly fallen since mid-year. The climate index itself, consisting of these two components, sank in the fourth quarter and is not as far above the long-standing average as was recently the case.

For this reason we expect a weakening of world economic growth in 2005, although this weakening will not yet constitute a downturn. The world economy will continue to grow at a fast albeit reduced speed. In this respect, the general conditions of the world economy will remain relatively favourable for the German economy as well.

Nevertheless, the economic picture will only brighten slowly in Germany. Investments will grow but at a weaker pace compared to previous upturns, and private consumption will revive somewhat. Exports will grow at only half the pace of this year. In 2005 real GDP will increase by 1.2%, or, adjusted for calendar variations, by 1.4%. Since trend growth for economic output in Germany lies at only 1%, an improvement in the aggregate operating rate is predicted for the forecast period. Inflation next year at 1.4% will be lower than for this year (1.6%).



The situation in the labour market will remain tight in spite of the slight economic recovery. Although the number of employed persons has risen since the beginning of the year, the number of employees subject to social insurance contributions has fallen. Next year the number of employed persons will increase as the economic recovery continues. On average for 2005, it will increase by an estimated 145,000 persons (2004: 58,000), without taking into account the effects of the Hartz IV reforms.

In the course of 2003 and including January 2004, the number of unemployed persons declined by 230,000 persons as a result of statistical adjustments and an altered delimitation of unemployment in the official calculations. In the meantime, unemployment has increased, however, in spite of the many mini-jobs and *Ich AGs* (one-person businesses) that have been created. Not until the early summer of 2005 will seasonally adjusted unemployment begin to decline. On average for 2005, the number of unemployed will be around 85,000 higher than in 2004 if the effects resulting from Hartz-IV are not taken into account. The unemployment rate will be 10.4%, on average, for 2005 (2004: 10.3%).

If the effects of the introduction of the unemployment benefit reforms (*Arbeitslosengeld II*) are taken into consideration, official unemployment will initially increase sharply, as unemployed social welfare recipients who have not been looking for jobs

will be included among the unemployed. The 5 million mark of official unemployment will thus be exceeded in February 2005. In the further course of the year, this enlarged number of unemployed will again decline, seasonally adjusted. On average for 2005, the number of unemployed will probably be 225,000 higher than in 2004, taking into account the effects of the Hartz IV reforms. This means that with the introduction of the unemployment benefit reforms, official unemployment will increase by 140,000, without taking second-round effects into account.

The effects of Hartz IV will only gradually unfold but then all the more noticeably. These effects are of a structural not a cyclical nature. Their nature is basically that the state reduces the wage competition contained in its wage substitution system and induces those affected to be satisfied with lower wages. At lower wages, businesses will find it worthwhile to create new jobs.

The additional earning options are limited under the new unemployment benefit system so that people receiving the second stage of unemployment benefits who take on employment will still have extremely high wage expectations. Only a wide-scale introduction of 1 euro jobs in association with a consistent application of reasonability requirements will be able to induce the desired mobilisation effects despite the limited additional earning options. De facto this means that for the second stage of unemployment benefits one will have to work for the state and that one will receive much less than these unemployment benefits when one does not work. Both will increase the willingness to take on jobs at lower wages in the private sector.

Hans-Werner Sinn

President

Ifo Institute for Economic Research

## Federal Republic of Germany Key Forecast Figures

	2002	2003	2004 (1)	2005 (1)
Percentage change over previous year <sup>a)</sup>				
Private consumption	-0,7	0,0	-0,3	0,8
Government consumption	1,9	0,1	0,1	0,4
Gross fixed capital formation	-6,4	-2,2	-0,5	1,0
Machinery and equipment, other investment	-7,2	-0,9	1,3	3,8
Buildings	-5,8	-3,2	-2,0	-1,5
Domestic demand	-1,9	0,5	0,6	0,9
Exports of goods and services	4,1	1,8	9,3	5,0
Imports of goods and services	-1,6	4,0	7,1	4,8
Gross domestic product (GDP)	0,1	-0,1	1,7	1,2
Employment <sup>b)</sup> (1.000 persons)	38696	38314	38372	38517
Unemployment (1.000 persons)	4061	4377	4379	4466
Unemployment rate <sup>c)</sup> (in %)	9,5	10,3	10,3	10,4
Consumer prices <sup>d)</sup> (% change on the previous year)	1,4	1,1	1,6	1,4
General government financial balance <sup>f)</sup> - DM billion	-77,5	-81,3	-85,6	-70,0
- in % of GDP	-3,7	-3,8	-3,9	-3,1
memo item:				
Real GDP in the EMU (% change on the previous year)	0,9	0,5	1,8	1,5
Consumer prices in the EMU <sup>g)</sup> (% change on the previous year)	2,3	2,1	2,1	2,0
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.