

## 5. GERMANY

### Global downturn taking its toll

#### Marked deceleration of growth in 2008

After an exceptionally strong first quarter – largely thanks to favourable weather conditions boosting construction activity – real GDP contracted during spring. While this relapse was largely a technical correction following the strong growth at the beginning of the year, the worsening of the global economic environment has also clearly taken its toll. The slowdown of economic activity in key trading partners and a stronger euro have led to an abrupt deceleration of export growth. At the same time, high food and energy prices have weighed heavily on private consumption. As a result, household consumption is expected to decrease for a second year in a row. Moreover, the deterioration in the economic outlook – as reflected by rapidly weakening business confidence indicators – is also affecting investment plans and will drag down gross fixed capital formation. Therefore, real GDP is expected to contract further in the second half of the year, even though for the year as a whole real GDP growth will remain at around 1¾%.

#### Weaker exports and investment in 2009

The global financial crisis and adjustments in the housing sector in a number of countries have triggered a sharp deceleration of economic activity both inside and outside the EU. As a heavily export-oriented economy, Germany will be directly affected by this global downturn. Export growth is expected to decrease from 4½% in 2008 to around just 1% in 2009. While exports to some emerging markets may still hold up relatively well, this will be insufficient to compensate for the

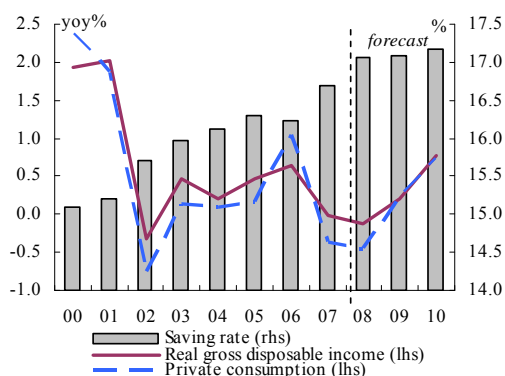
downturn in other key trading partners.

The weakened outlook for economic activity and exports together with tighter financing conditions in the wake of the financial crisis will dampen investment growth, despite the relatively sound financial position of German companies. Investment in equipment in particular will contract significantly in 2009, while construction investment may be slightly less affected, thanks notably to higher public investment in infrastructure. Altogether, gross fixed capital formation is thus expected to decrease by around 1¾% in 2009.

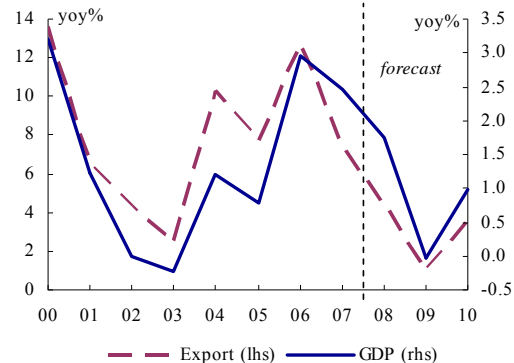
#### Subdued recovery of private consumption

High wage growth and strong employment creation in recent years should have laid the basis for a recovery of private consumption after more than five years of stagnation. However, the pronounced pick-up in inflation in 2008 has reduced real disposable incomes and weakened consumer confidence, leading to another year of negative growth in private consumption. On the back of falling inflation, high wage increases and a still fairly robust labour market, private consumption is set to expand in both 2009 and 2010. Nevertheless, the fallout from the global financial crisis and the downturn in consumer confidence imply a rather moderate recovery with annual growth rates expected to hover around ½% in both years. In combination with the weaker outlook for exports and investments, real GDP growth is therefore likely to stagnate in 2009.

Graph 3.5.1: Germany - Private consumption and real disposable income



Graph 3.5.2: Germany - Exports and real GDP growth



### Sounder fundamentals may facilitate recovery

Thanks to improved macroeconomic conditions Germany should be well placed for a relatively broad-based economic recovery once the negative impact of the global downturn recedes. As a result of very moderate wage increases in recent years, Germany has gained in price competitiveness. Temporarily higher wage growth over the forecast period will not substantially change this situation. German exports can therefore be expected to pick up when the world economy starts to rebound from the current downturn. In this case, the sound financial position of German companies and comparatively low reliance on outside financing should also be conducive to a recovery of gross fixed capital formation. Finally, structural improvements in the labour market and the associated reduction in unemployment should help underpin consumption. Hence, a certain recovery with real GDP growth of around 1% can be expected for 2010, provided that the main negative effects of the global financial crisis have been overcome by then.

### Labour market before the downturn

Employment growth has been buoyant in recent years, reflecting not only the cyclical upswing of economic activity, but also structural improvements following a series of labour market reforms. The unemployment rate has fallen from over 10% in 2005 to around 7½% in 2008. The economic slowdown in 2008 and 2009 will leave its mark on the labour market with temporarily higher unemployment and a decline in employment. However, in 2010 the labour market is set to recover somewhat as the economic situation improves.

### Inflation gradually receding despite wage pressures

Wage growth has picked up during 2008 due to strong job creation and also in compensation for very moderate wage increases in recent years. This trend will continue in 2009 despite the worsening of the economic situation, when wage growth is expected to peak at around 3%. With productivity growth decreasing slightly, nominal labour costs would increase noticeably stronger than in recent years, by around 2¾% in 2009 and 1½% in 2010.

Due to higher wage growth and lagged effects from high energy and food prices, core inflation is expected to increase temporarily. However, as the

impact of recent energy and food price hikes is petering out, headline inflation is set to gradually fall to below 2% in 2010 on the back of favourable base effects and falling oil prices.

### Strong tax revenues help to balance the budget in 2008

The general government budget is estimated to be in balance in 2008. The improvement can principally be ascribed to a rise in revenue, in particular from direct taxes, reflecting positive developments on the labour market. Tax revenues have also benefited from stronger wage increases. Importantly, the negative short-run effects of the company tax reform have not materialised to the extent expected. Nevertheless, the budget has been burdened by a reduction of the contribution rate to unemployment insurance. The increase in the contribution to long-term care insurance has served in turn to fund additional spending.

On the expenditure side, the further decline in the jobless rate has led to a reduction in spending on unemployment benefits. Still, an additional burden to the budget has resulted from the ad-hoc upward adjustment of the retirement benefits which went beyond the legislation in force since the 2004 pension reform. In addition, public sector wages have been raised at all levels of the government.

### Relative resilience in times of economic slowdown

Despite the marked economic slowdown, Germany's public finances are expected to remain relatively resilient in 2009. The general government balance is projected to relapse into a slight deficit of 0.2% of GDP. Tax revenue is likely to benefit from a still fairly robust labour market and expected substantial wage increases. However, higher wages are likely to dampen company profits, and hence profit-related taxes. The most significant budgetary measures are the increase in the rate of contributions to health-care insurance (from 14.9% to 15.5%) and a further reduction of the contribution rate to unemployment insurance (from 3.3% to 2.8%).

Total government spending will increase by 0.5 pp. of GDP on the back of additional expenditure in the health-care sector, increases in public sector wages and higher social spending (e.g. childcare and household allowances).

In 2010, the general government balance is projected to recede into a deficit of 0.5% of GDP. The key budgetary measure is the increase in the contribution rate to unemployment insurance (from 2.8% to 3.0% as of mid-year). On the no-policy-change assumption, other social contribution rates are forecast to remain unchanged. The budget is likely to be burdened by the tax deductibility of health-care insurance contributions to the order of around 0.3% of GDP. Finally, changes introduced in 2008 to adjust upwards the retirement benefits are expected to be reversed.

Moreover, both the 2008 and 2009 budgets will be burdened by the retroactive tax reimbursements resulting from the ruling of the European Court of Justice (ECJ) on taxation of foreign dividend income (with the total impact estimated at 0.2% of GDP). In 2009, a temporary budget relief of around 0.1% of GDP is expected from a reduction in Germany's contributions to the EU budget based on the Council decisions on own resources for the EU budget 2007-2013.

German public finances are also likely to be burdened by the rescue plan granted to troubled banks which are assumed to have a direct impact on the debt<sup>(1)</sup>. While their impact in 2008 on the

deficit remains still limited (0.06% of GDP), the effect on the debt was estimated at the time of the forecast at 1.6% of GDP. Nevertheless, the government debt ratio is projected to fall from 65% of GDP in 2007 to 62% of GDP by 2010.

The uncertainty surrounding the financial crisis may become a risk to Germany's public finances in the medium-term. In addition to the above mentioned direct effects, the budget might be affected indirectly through tax revenue losses, in particular from profit-related taxes.

- (<sup>1</sup>) The budgetary effects of the financial market stabilisation package from Oct. 2008 depend on the degree and timing of its utilisation which was unknown at the time of the forecast. Therefore, on the no-policy-change basis, they have not been included in the budgetary projection.

Table 3.5.1:

**Main features of country forecast - GERMANY**

	2007		Annual percentage change							
	bn Euro	Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at previous year prices	2422.9		100.0	1.4	0.8	3.0	2.5	1.7	0.0	1.0
Private consumption	1373.7		56.7	1.4	0.2	1.0	-0.4	-0.5	0.2	0.7
Public consumption	435.6		18.0	1.4	0.4	0.6	2.2	1.7	1.5	1.1
Gross fixed capital formation	453.5		18.7	0.4	1.1	7.7	4.3	4.3	-1.7	1.1
of which : equipment	189.4		7.8	1.0	6.0	11.1	6.9	5.4	-4.4	0.3
Exports (goods and services)	1137.2		46.9	5.8	7.7	12.7	7.5	4.4	1.0	3.6
Imports (goods and services)	966.2		39.9	4.9	6.5	11.9	5.0	3.8	1.3	3.7
GNI at previous year prices (GDP deflator)	2464.2		101.7	1.4	1.0	3.5	2.4	1.7	0.2	0.9
Contribution to GDP growth :										
Domestic demand				1.2	0.4	2.1	1.0	0.8	0.1	0.8
Stockbuilding				-0.2	-0.4	-0.1	0.1	0.4	0.0	0.0
Foreign balance				0.4	0.8	1.0	1.4	0.5	-0.1	0.2
Employment				-0.8	-0.5	0.2	1.6	1.2	-0.3	0.2
Unemployment rate (a)				8.3	10.7	9.8	8.4	7.3	7.5	7.4
Compensation of employees/f.t.e.				3.4	0.5	1.5	1.3	2.5	3.1	2.4
Unit labour costs whole economy				1.2	-0.8	-1.2	0.4	2.0	2.8	1.6
Real unit labour costs				-0.2	-1.5	-1.7	-1.4	0.0	0.7	-0.3
Savings rate of households (b)				-	-	16.2	16.7	17.1	17.1	17.2
GDP deflator				1.4	0.7	0.5	1.9	1.9	2.1	1.9
Harmonised index of consumer prices				-	1.9	1.8	2.3	3.0	2.1	1.9
Terms of trade of goods				0.7	-1.8	-1.8	0.8	-1.2	0.2	0.6
Trade balance (c)				3.7	7.1	7.1	8.4	8.5	8.6	8.9
Current account balance (c)				0.0	5.3	6.3	7.6	7.5	7.7	7.9
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				0.0	5.3	6.3	7.6	7.5	7.8	7.9
General government balance (c)				-2.6	-3.3	-1.5	-0.2	0.0	-0.2	-0.5
Cyclically-adjusted budget balance (c)				-2.6	-2.5	-1.6	-0.8	-0.8	-0.3	-0.4
Structural budget balance (c)				-	-2.6	-1.6	-0.5	-0.5	-0.3	-0.4
General government gross debt (c)				56.8	67.8	67.6	65.1	64.3	63.2	61.9

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.