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Economic forecast 2012

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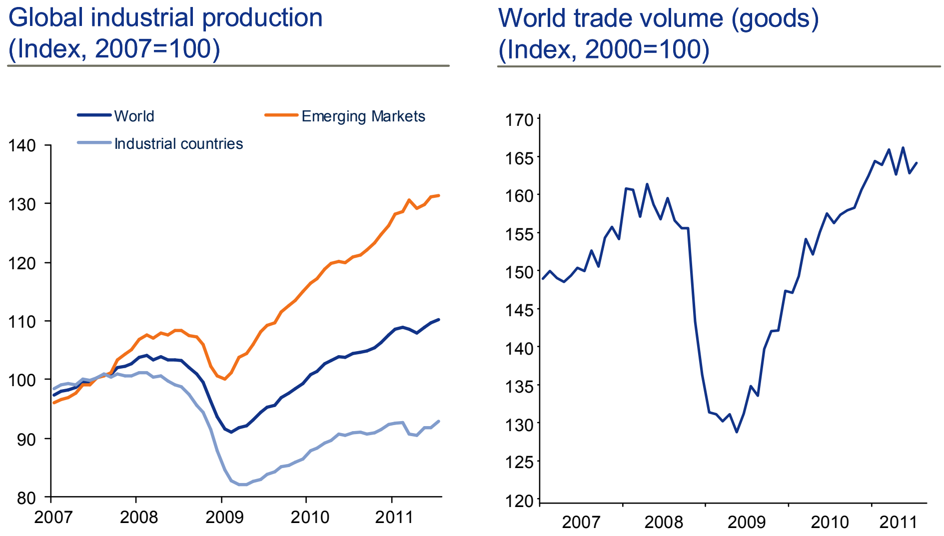
1. GLOBAL ECONOMIC SITUATION AND OUTLOOK

The first six months of 2011 brought a slowdown in momentum for the global economy. It was clear from the outset that, with (often hefty) budget deficits in industrial countries starting to be reined in and monetary policy gradually returning to normal, especially in the emerging markets, the swift pace of expansion seen in 2010 could not be maintained. But the early months of this year also saw additional dampening effects. In the industrial countries the erosion of purchasing power as a result of the pronounced rise in commodity prices precluded the transition towards more private demand-driven growth. In addition, production outages in Japan following the natural catastrophe and reactor accident in March had global repercussions, mainly via the disruption of supply chains. Industry was especially badly affected by the cloudier overall backdrop. The expansion of global industrial production ground to a halt in the second quarter. The widespread weakness spilled over into international trade which actually fell marginally on the first quarter.

Chart 1

Global economic momentum slowing



Source: CPB Netherlands Bureau for Economic Policy Analysis.

Now, in the middle of the second half of the year, concerns about the economy remain high. Although the normalization of production processes in Japan and the associated revival in production, especially in the vehicle construction segment, in other countries had laid a solid foundation for a recovery in industrial production, poorer survey results – in some cases signaling a marked deterioration – among the corporate sector and consumers alike, coupled with weaker labor market development, suggest that these signs of improvement could well prove to be short-lived.

The continued malaise on the financial markets, which largely reflects the lack of faith among market participants in the ability of major industrialized nations to restore sustainable government finances, is cause for concern. The downgrade of the US credit rating by a rating agency in August exacerbated the situation. Together with the debt crisis in some EMU countries, this has given rise to a very dangerous situation on the financial markets that is increasingly at risk of putting pressure on the economy as well. A whole number of parameters used to measure the level of tension in the financial system are now back to well above the long-term average. The combination of increased uncertainty and less favorable financing costs could deal a blow to real economic activity.

As a result, there is still an unusually high level of uneasiness about where the economy is headed. As things stand at present, there is no doubt that the downside risks to the global economy have the upper hand. Resolute economic policy action will play a key role in helping to ensure that the global economy continues on the path to recovery. Given the increasing ties between economies over the years, there is also a pressing need for greater international political coordination both between, and within, the world's major economic regions in general. In the private sectors of the economy, important prerequisites for a sustained global economic upturn have been intact of late. These include low inventory levels and the solid standing of the non-financial corporate sector, which is mirrored in profit margins that are well above-average in some countries.

This document sets out our assessment of the economic prospects for some of the world's key regions and countries:

USA

Economic development in the US came as a disappointment in the first half of the year. As part of the revision of the national accounts, the results of which were released at the end of July, the quarterly real GDP growth rate at the beginning of the year was reduced by around 1½ percentage points to only 0.4% (annualized rate). With the second quarter also characterized by weaker growth, this produced an average growth rate of less than 1%, largely owing to a decline in government spending and slower consumption growth.

In view of the stuttering economic recovery and with the unemployment rate still at a high level, the US government has proposed a whole range of economic policy measures. These initiatives are summarized in the "American Jobs Act" and will be financed, so the idea goes, using a combination of increased revenue and lower spending in the years to come. Effectively, implementation of the program would prevent fiscal policy from exerting a squeeze as early as next year. It is, however, unclear as yet whether President Obama will actually be able to win over Congress and have the Act approved and if so, which parts of the plans will get the green light. We expect that at least the reduction in social welfare contributions for employees that was resolved in late 2010 and the moves to extend the period for which the unemployed can collect transfer payments will be maintained. At the same time, the Fed remains keen to adopt a more expansionary monetary policy stance in order to beef up the recovery. The Fed's recent decision to rejig its government bond portfolio in favor of longer maturities and to reinvest capital returns from investments on the market for mortgage-backed securities should help to keep long-term interest rates low and make for a more favorable financing environment on the whole.

In this sort of interest rate environment, and given the added bonus of tax incentives and more resources for internal financing, corporate investment is likely to continue to provide positive economic impetus in general, especially given the need to modernize the capital stock. The willingness to invest should be spurred on by external trade. The appreciable drop in the real effective exchange rate over the past few quarters should have a positive impact in this respect, as experience shows that the full force of depreciation is only felt after a certain time delay. Underlying economic momentum is expected to remain below-average as we move into the winter half-year given the recent adverse development in the private consumption environment. First of all, the economic slowdown has curtailed job creation. Second, assets held in equities have been eroded by the turbulence on the financial markets in the course of the third quarter. Despite the relief offered by lower energy prices, we do not expect to see anything more than marginal growth in real consumer spending.

All in all, and on the back of the weak development at the start of the year, the US economy is expected to grow by only 1.6% this year. We expect to see an increase of 1.8% in 2012. If fiscal policy consolidation turns out to be more aggressive than expected, developments would likely be less favorable.

Euro area

After making a strong start to the new year with q-o-q growth to the tune of 0.8%, the economic recovery in the euro area tapered off in the second three months of the year (+0.2% q-o-q). While external trade once again delivered a positive contribution to growth, domestic demand proved weak, held back by the climb in commodity prices. Private consumption contracted by 0.2% q-o-q. At the same time, macroeconomic activity remained inconsistent throughout the single currency area. The Irish economy came as a positive surprise, with q-o-q growth of 1.6%.

The economic engine will continue to stutter in the second half of the year. The latest economic data and survey results, which are testimony to rising uncertainty and a loss of confidence, show that the growth outlook is being clouded not least by the tension on the financial market caused by the European sovereign debt crisis. Sentiment among consumers and companies alike has deteriorated drastically since the spring, hinting at comparatively weak domestic demand as the year progresses. At 95 points, the European Commission's Economic Sentiment Indicator for September was down on its long-term average of 100 points for the second time running. The purchasing managers' index for the entire private sector, which, at 49.2 points, slipped below the 50-point expansion threshold in September for the first time since 2009, also sends out a clear signal that quarterly growth will be weak in the second half of the year.

Hopes of a moderate economic recovery in the forecast period are, nevertheless, being fueled by the continued global growth, as well as by the ECB's determination to stick to its accommodative monetary policy. The policy of unlimited liquidity should continue to ensure that the European banking system does not face any restrictions on the liquidity side.

Consumer price inflation is expected to remain above the 2% mark for the rest of the year. In September, Eurostat put inflation at 3.0%, after the annual rate of inflation (HICP) had come in at 2.5% in August. Falling commodity prices and expectations of wage growth rates at a stable low level, against the backdrop of moderate economic growth, suggest that inflationary pressure should start to ease in 2012. As a result, we predict an inflation rate of 2.6% this year and 1.9% next year.

All in all, we expect to see a moderate upward economic trend in the eurozone in 2012, despite heightened downside risks. We forecast an increase in gross domestic product to the tune of 1.7% this year and 1.4% next year.

Emerging markets

Following what was very strong economic development on the Asian and Latin American emerging markets, in particular, last year, the growth momentum in these economies dropped down a gear in the first half of 2011. This is largely attributable to three factors: first, the "normalization" of global trade following the marked rebound in 2010 resulted in less brisk export demand. Second, the interruption of the international supply chains triggered by the natural and reactor catastrophe in Japan resulted in production losses - especially in Asia. Third, this economic slowdown is also due, not least, to economic policies introduced to tackle overheating in the domestic economy in many countries. The best example of this is China, where economic policy has been attempting, for some time now, to combat economic overheating (real estate boom, risk of a marked increase in non-performing loans following the excessive lending habits seen in recent years, considerable consumer price inflation).

Most of the current economic indicators suggest that the recovery will continue on the emerging markets, although the momentum of the recovery is likely to be comparatively moderate as we move into 2012. The purchasing managers' indices for numerous major emerging markets, for example, are currently sitting just above the 50-point expansion threshold. Values above the threshold point towards an expansion in economic activity, while values below the threshold signal that things are slowing down. The economic slowdown could prove to be particularly pronounced in Brazil, where the purchasing managers' index for the manufacturing industry has actually already slipped some way below the expansion threshold, recently coming in at 45.5 points. Brazil's industry is suffering, in particular, under the weight of a strong real. After what was initially a drastic slump in the external value of the Brazilian currency in the fall of 2008, the real continued to make gains in the period between early 2009 and August 2011. Given the most recent downward trend, however, the real has already fallen back considerably from its temporary high, which saw it gain more than 40% against the currencies of Brazil's main trading partners. Clearly driven by concerns regarding the economic outlook, the Brazilian central bank made a surprising move in late August by cutting its key interest rate by 50 basis points to the current level of 12%, even though consumer price inflation was recently far higher than the central bank's inflation target of 4.5% (with leeway of 2 percentage points in both directions) at a whopping 7.2% in a year-on-year comparison. Although the sort of interest rate turnaround seen in Brazil is still one of only a small number of exceptions in the emerging market world, monetary policy normalization does appear to at least be slowing in many other up-and-coming economies, particularly in Asia. The central banks of South Korea, the Philippines, Indonesia and Malaysia, for example, recently took a break from their cycle of rate hikes. In China's case, August was actually the first month since September 2010 in which the central bank lifted neither its key interest rate nor the minimum reserve ratio for banks. This is likely due mainly to the renewed marked increase in agitation on the international financial markets in recent weeks.

We do not expect to see any considerable economic slowdown, let alone a recession, on the emerging markets, a view that is supported, in particular, by the fact that the fundamental data remains very solid, meaning that many companies would have the fiscal policy room for maneuver to combat any imminent economic slowdown without running the risk of losing their own economic policy credibility. Next year is likely to see Asia remain the world's fastest growing region. We forecast economic growth of 7.3% compared with 7.8% this year, with the predicted slowdown by half a percentage points explained mainly by the assumed growth slowdown in China. The Latin American emerging markets are likely to achieve growth on a par with this year in 2012, with a predicted growth rate of just under 4%. In eastern Europe, growth in 2012 is expected to come in at 3.7%, slightly higher than this year's figure (+3.6%). The higher growth is, however, solely thanks to countries outside of the EU, such as Russia. In the eastern European EU countries, on the other hand, growth in 2012 is expected to be weaker, in some cases markedly so, than it was this year due to the restrained developments in the eurozone. All told, following economic growth of 6.1% this year, we predict GDP growth to the tune of 5.6% for the emerging markets next year.

So what does all of this mean for the global economy as a whole? After a 4.1% rise in global output last year, the figure is expected to come in at 2.9% in 2011 (country weighting based on current exchange rates in each case). Looking ahead to next year, we expect the global economy to expand by 3.1%. The fact that this growth rate is slightly higher than this year's is largely thanks to Japan, where we expect to see above-average growth – compared to the other industrialized nations - next year after this year's economic slump sparked by the catastrophe.

Growth rates in main economic regions

GDP, real % change over previous year

	2006	2007	2008	2009	2010	2011[1)]	2012[1)]
Industrialized countries	**2.7**	**2.4**	**-0.1**	**-4.0**	**2.6**	**1.4**	**1.8**
European Union	3.3	3.0	0.5	-4.2	1.8	1.8	1.5
Euro area	3.1	2.9	0.4	-4.1	1.7	1.7	1.4
Germany	3.7	3.3	1.1	-5.1	3.7	3.0	1.5
USA	2.7	1.9	-0.3	-3.5	3.0	1.6	1.8
Japan	2.0	2.4	-1.2	-6.3	4.0	-0.4	2.4
Emerging markets	**8.3**	**8.5**	**5.5**	**1.6**	**7.3**	**6.3**	**5.8**
Asia	9.7	10.7	6.9	5.9	9.5	7.8	7.3
Latin America	6.5	5.6	3.5	-3.1	4.9	4.5	3.5
Central and Eastern Europe	7.5	7.5	4.5	-6.1	3.2	3.6	3.7
World	**4.1**	**4.0**	**1.5**	**-2.4**	**4.0**	**2.9**	**3.1**

1) forecast.

Sources: EcoWin, own forecasts.

We have applied the following assumptions for the overall environment to our forecast:

- The Greek government will manage, with the help of the troika, to stabilize its economy in the course of 2012. The more flexible EFSF will be able to start work without any delays to speak of once it has been approved by all 17 national EMU parliaments. Furthermore, the other highly-indebted EMU countries will also exercise stringent budget discipline, clocking up robust consolidation successes. Against the backdrop of the above, the financial markets will gradually regain their composure and volatility will fall considerably.

- In the first half of 2011, global merchandise trade proved to be fairly volatile, not least due to the temporary interruption of the international supply chains. All in all, trade increased only slightly. Due to the very dynamic development at the end of 2010 and expectations of moderate expansion in the second half of this year, we forecast that global merchandise trade will grow by around 6% in 2011 as a whole. As far as next year is concerned, we believe that a muted increase of between 4% and 5% is on the cards.

- The oil price has proven to be very erratic in the course of this year to date, a trend that is certainly down to the political turmoil in North Africa and the Middle East. The price of Brent crude oil was recently fluctuating between around USD 105 and USD 120 a barrel, with the average price for 2011 likely to be around the USD 115 mark. In principle, the more moderate global growth prospects suggest that oil prices could start to head south. The uncertainty surrounding how the political situation will pan out in North Africa and the Middle East, however, is likely to remain on the scene next year, too. On the whole, we expect to see an oil price of between USD 90 and USD 110 next year.

- In line with the statement released by the US Fed in August 2011, in which it announced that it planned to keep key interest rates at a very low level until mid-2013 at the earliest, the Fed will not hike its key rate throughout the entire forecast period. With inflationary pressure gradually on the wane, the increased economic risks and the debt crisis in the euro area, the ECB is expected to keep its key interest rate unchanged at the current level of 1.5% until the end of 2012.

- The exchange rate between the US dollar and the euro fluctuated within a fairly narrow range of between 1.40 and 1.45 USD/EUR for much of this year. The escalation of the EMU sovereign debt crisis, coupled with mounting economic concerns, sparked a rapid downward spiral in September 2011, some of which, however, has already been compensated for in the meantime. A renewed plummet in the value of the euro towards the 1.25 USD/EUR mark cannot be ruled out in an environment that remains dominated by extremely jittery financial markets, as well as uncertainty as to how the debt crisis will unravel further. By the end of next year, we expect to see an exchange rate between the two currencies of 1.35 USD/EUR. The US dollar is likely to be hit not only by the ongoing need for consolidation in the US, but also by the progress we expect to see in the restructuring of EMU state finances.

2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

2.1 Upswing takes a breather

The German economy, which got off to such a storming start this year, had lost considerable momentum by the middle of the year. In this respect, however, it is worth taking into account that the weak growth in the second quarter of 2011 (+0.1% in a q-o-q comparison) was also due to special factors, such as a considerable decline in energy production and unusual weather conditions. As a result, it is too early to speak of a dip in growth. After all, in the second quarter of 2011, industrial production was up by around 2% on the first quarter and by an impressive 9% on the second quarter of 2010. The fact that business expectations in the corporate sector recently took a marked turn for the worse, however, is unsettling. In July, incoming orders in the industrial sector were a whole 1% down on the average monthly level for the second quarter of this year.

Although the risks to the economy have risen sharply in the shadow of the sovereign debt crisis, we are not interpreting the most recent developments as the start of a recession, but at most as a pause in growth. In fact it is more likely that the German economy will continue to see moderate growth in the second half of this year, a forecast that is backed up, first and foremost, by the continued favorable development on the labor market. Several tens of thousands of jobs are still being created month for month in the German economy. This generates income and, with underlying inflation heading down, also boosts purchasing power. A slump in consumption is therefore not very likely. For other domestic demand sectors the outlook is also broadly favorable. Exceptionally low borrowing rates are giving a substantial boost to construction activity. With capacity utilization high, investment demand can be expected to remain strong as long as we do not see a radical blow to confidence regarding the economic future.

The expansion in global trade should continue in the second half of 2011, driven in particular by impetus from the emerging markets. As a result, we do not expect any setback for Germany's exports at the moment. The average growth in real exports in 2011 is expected to come in at a generous 8%. All in all, the Germany economy is likely to grow by around 3.0% this year.

The economic outlook for 2012 is extremely uncertain from today's perspective. Nevertheless, we believe that the likelihood of economic consolidation in 2012 is greater than the risk that the economy will slip into recession. Private consumption, construction and equipment investment are likely to deliver moderate growth contributions in 2012. After a soft spot in the winter half-year 2011/2012, exports are likely to regain momentum in the further course of 2012 in line with world trade. A relatively low external value of the euro will help boost German exporters' price competitiveness. As exports start to bounce back, growth in gross domestic product is likely to accelerate again. On average, however, the German economy is likely to grow by only 1.5% in 2012.

Germany: Economic indicators and forecasts*

		2009				2010				2011				2012							
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010	2011f	2012f
GDP real		-4.0	0.3	0.8	0.7	0.5	1.9	0.8	0.5	1.3	0.1	*0.5*	*0.1*	*0.4*	*0.7*	*0.7*	*0.7*	-5.1	3.7	*3.0*	*1.5*
Private consumption		0.2	0.5	-0.7	-0.2	0.0	0.8	0.4	0.5	0.4	-0.7	*0.8*	*0.3*	*0.3*	*0.4*	*0.4*	*0.4*	-0.1	0.6	*1.2*	*1.2*
Government spending		1.6	0.7	0.6	0.4	0.9	-0.6	0.8	0.1	0.2	0.2	*0.0*	*0.0*	*0.2*	*0.3*	*0.2*	*0.2*	3.3	1.7	*0.7*	*0.6*
Investment in machinery/equipment		-19.2	-2.8	0.2	-1.1	4.1	5.2	4.9	2.6	2.1	1.7	*1.5*	*0.8*	*0.8*	*1.5*	*1.8*	*1.8*	-22.8	10.5	*10.2*	*4.3*
Construction		-1.4	-0.8	0.8	0.6	-2.5	6.6	-0.8	-2.5	7.0	-0.9	*0.0*	*1.0*	*1.0*	*1.0*	*1.0*	*0.8*	-3.0	2.8	*5.7*	*2.2*
Domestic demand		-1.3	-1.5	1.1	-0.6	1.3	1.3	0.2	0.6	1.1	0.4	*0.3*	*0.3*	*0.4*	*0.5*	*0.6*	*0.6*	-2.6	2.4	*2.5*	*1.4*
Exports		-10.3	-1.1	3.4	2.1	3.4	7.0	2.0	1.0	2.1	2.3	*1.5*	*0.5*	*0.8*	*1.5*	*1.5*	*1.5*	-13.6	13.7	*8.3*	*4.0*
Imports		-4.9	-5.4	4.4	-1.0	5.8	6.2	0.9	1.3	1.7	3.2	*1.2*	*1.0*	*1.0*	*1.3*	*1.5*	*1.5*	-9.2	11.7	*7.9*	*4.6*
Industrial production (excl. construction)**)		-12.6	-0.2	3.9	0.9	2.1	5.2	2.0	2.7	1.7	1.2	*0.3*	*1.0*	*1.1*	*0.9*	*0.7*	*0.7*	-16.2	10.9	*7.7*	*3.7*
Unemployment rate (EU def.)	%	7.6	7.8	7.9	7.7	7.5	7.2	6.9	6.6	6.3	6.1	*6.0*	*5.9*	*5.9*	*5.8*	*5.7*	*5.7*	7.7	7.1	*6.1*	*5.8*
Unemployment rate (nat. def.)	%	7.9	8.3	8.2	8.1	8.0	7.7	7.6	7.4	7.3	7.1	*7.0*	*6.9*	*6.8*	*6.8*	*6.7*	*6.6*	8.1	7.7	*7.1*	*6.7*
Employed persons (national def.)	y-o-y	0.5	0.1	-0.2	-0.3	-0.3	0.4	0.8	1.0	1.4	1.4	*1.3*	*1.2*	*0.9*	*0.6*	*0.5*	*0.5*	0.0	0.5	*1.3*	*0.6*
Consumer prices	y-o-y	0.8	0.3	-0.2	0.4	0.8	1.1	1.2	1.5	2.1	2.3	*2.4*	*2.1*	*1.8*	*1.8*	*1.9*	*2.1*	0.4	1.1	*2.2*	*1.9*
Consumer prices (HICP)	y-o-y	0.8	0.2	-0.4	0.3	0.8	1.0	1.2	1.6	2.2	2.5	*2.5*	*2.3*	*1.9*	*1.7*	*1.9*	*2.1*	0.2	1.2	*2.4*	*1.9*
Producer prices	y-o-y	0.9	-3.6	-7.4	-6.3	-2.6	1.1	3.6	4.7	6.1	6.0	*5.4*	*4.5*	*2.5*	*1.8*	*2.1*	*2.4*	-4.1	1.7	*5.5*	*2.2*
Current account balance	EUR bn	23.9	29.6	38.2	43.2	33.0	30.4	37.3	38.3	33.2	31.4	*29.4*	*31.4*	*32.4*	*32.4*	*33.4*	*33.4*	133.7	141.1	*125.4*	*131.6*
	% of GDP																	5.7	5.6	*4.9*	*5.0*
Budget balance	EUR bn																	-76.1	-106.0	*-26.0*	*-10.3*
(Maastricht-definition)	% of GDP																	-3.2	*-4.3*	*-1.0*	*-0.4*

*) quarterly figures: percentage change over previous period, seasonally and working day adjusted, except where noted, yearly figures: percentage change, not working day adjusted; **) yearly average working day adjusted.

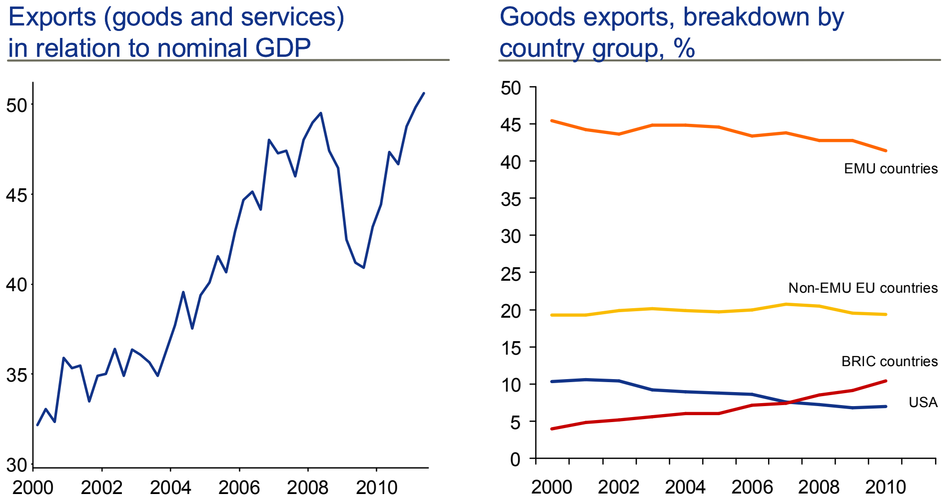
f = forecast.

2.2 Moderate export growth

Exports remained the driving force behind macroeconomic demand in the first half of 2011. At 2.1% and 2.3%, however, the increase in real terms was no longer as dynamic as it had been in the same quarters of the previous year, when catch-up effects in global trade fueled growth of 3.4% and 7.0%. Nevertheless, exports have since reached a ratio of 50.6% of nominal GDP, meaning that they have surpassed their pre-crisis high. The increase in the export ratio to the tune of just under 20 percentage points since 2000 highlights how reliant the German economy is on world trade.

Chart 2

Development of German exports

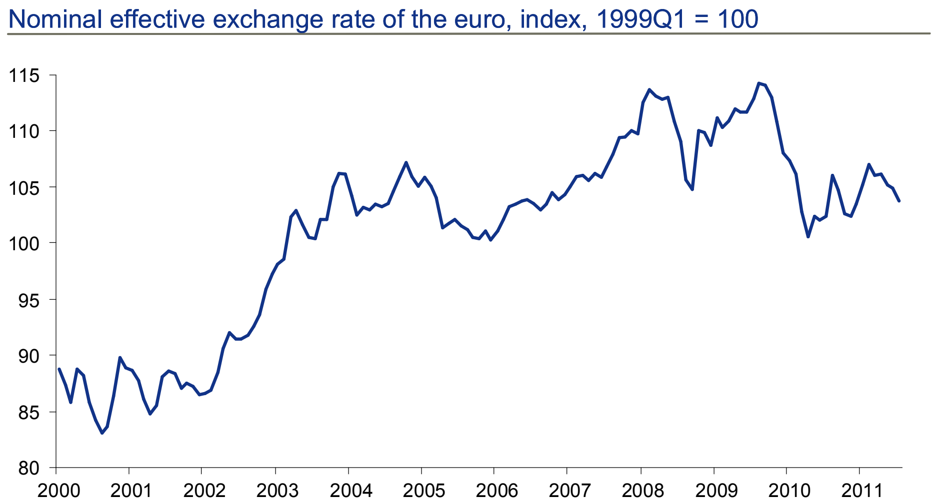


Sources: Bundesbank, Statistisches Bundesamt.

The overall conditions for the further development of German exports are to be seen as positive in general. First, the effective exchange rate of the euro is at a relatively low level. This, combined with the fact that unit wage costs have been on a favorable trend for many years now, means that Germany fares well in the price competitiveness stakes. Second, the German economy boasts a favorable export range, with a broad range of capital goods (such as machinery and electronic products) allowing for considerable momentum when it comes to exports to the emerging markets. The BRIC countries have upped their share of German goods exports from 3.9% in 2000 to 10.5% in 2010, while the proportion of exports destined for other EMU countries has dipped slightly. We expect this trend to continue in 2011 and 2012.

Chart 3

Euro heading down



Source: ECB.

Irrespective of these favorable overall conditions, however, slowing demand in a number of countries that buy German products is increasingly putting a damper on exports. Uncertainty regarding further economic development, particular in countries with high debt levels, is likely to translate into restrained demand among companies and households in these countries alike. The corporate sector's expectations for exports which, according to the Ifo economic test, are nowhere near as positive as they were only a few months ago, also point towards a slowdown in export momentum. All in all, we expect exports to return only moderate growth in the second half of 2011 and in early 2012, before gaining slight ground in the course of next year. Thanks to the impetus that came in the first half of this year, average export growth for 2011 will still come in at a strong 8.3%, whereas in 2012, it is expected to be roughly on a par with the increase in the global trade volume, growing by only 4.0%.

Chart 4

Terms of Trade

Index, 2005 = 100

Source: Deutsche Bundesbank.

At an estimated 7.9%, the increase in real imports in 2011 will be less pronounced than in 2010, when catch-up effects fueled an 11.7% rise in imports. The fact that performance remains strong is due, among other things, to greater imports of capital goods prompted by the momentum in equipment investment. Looking ahead to 2012, we expect the catch-up effects to die out, which, combined with the economic slowdown, is expected to result in import growth of only 4.6%. The relatively stable German domestic economy means that any slump is likely to be less hefty than is the case with exports. The terms of trade (real exchange relationship between exported and imported goods) have deteriorated considerably this year due to rising energy and commodity prices. In 2012, however, we expect import and export prices to move largely in synchrony. The deterioration in the terms of trade means that, irrespective of what remains dynamic export performance in 2011, the current account balance is likely to be down on the prior year figure of 5.6%, at 4.9% of GDP. In 2012, we are penciling in a figure of 5.0%.

2.3 Consumer demand providing a boost, but running short on momentum

Consumer demand, which got off to a fairly strong start this year, suffered a setback in the second quarter, mainly as a result of a loss of purchasing power triggered by climbing energy prices. A glance at the third quarter, however, reveals a recovery in private consumption again. The sustained improvements on the labor market mean higher income expectations which, in turn, increase the propensity to consume.

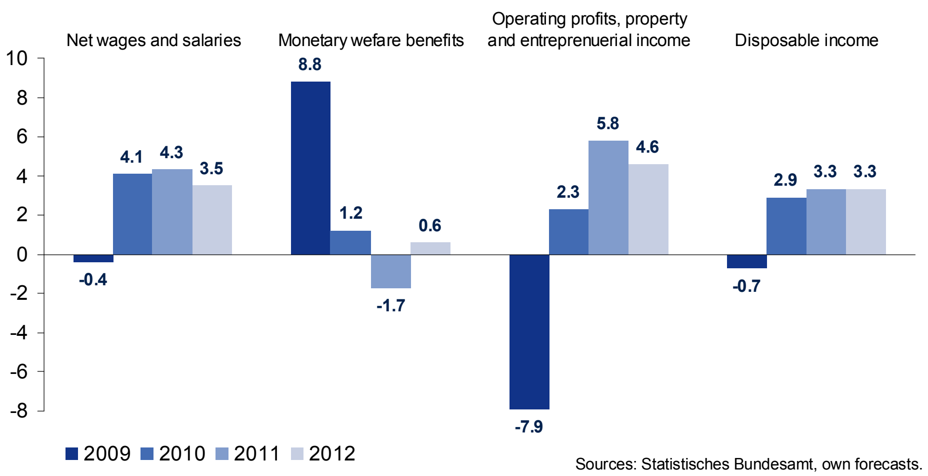
Labor income will rise by around 5% this year, the sort of increase that has not been seen for many years. This positive development is attributable to a 1½% increase in employment, as well as to an increase in actual earnings per employee of 3¾%. The good economic situation means that working hours per employee have increased considerably. Next year, and despite a stronger increase in contractual wages, the increase in actual earnings per employee is likely to come in at only 3¼%, because the situation will no longer be dominated by extra overtime and effects resulting from the reduction of shorter working hours models. With an expected increase in employment of a generous ½%, income from employment is expected to rise by just under 4% in 2012.

Given the continued rise in the overall tax burden, in particular due to the wage tax progression, but also due to higher social welfare contributions in 2011, growth in net income from employment will lag behind the increase in gross incomes, at 4¼% this year and 3½% next year. Falling unemployment and fewer shorter working hours models, coupled with what will only be a minimum increase in pensions, will bring monetary social benefits down by an estimated 1.7% in 2011, with social benefits in 2012 expected to be virtually unchanged as against 2011. The total of profit income and property and entrepreneurial income is expected to remain on a favorable trajectory. This year, we expect to see an increase of just shy of 6%, followed by a rise of around 4.5% next year.

Chart 5

Private household disposable income

% change on year earlier



All in all, we can expect to see the disposable incomes of private households climb by 3.3% in both 2011 and 2012. After stripping out expected inflation, this leaves real income growth of around 1% in 2011 and around 1½% in 2012. Low interest rates and a relatively favorable trend on the labor market suggest that consumption is likely to remain lively despite the uncertainty caused by the debt crisis. We estimate that the savings rate will dip marginally to 11.1% in 2011 from 11.3 percent in 2010, before picking up again slightly in 2012 to 11.3%. This means that real private consumption is set to rise by 1.2% in both 2011 and 2012, giving a real increase for three years in succession.

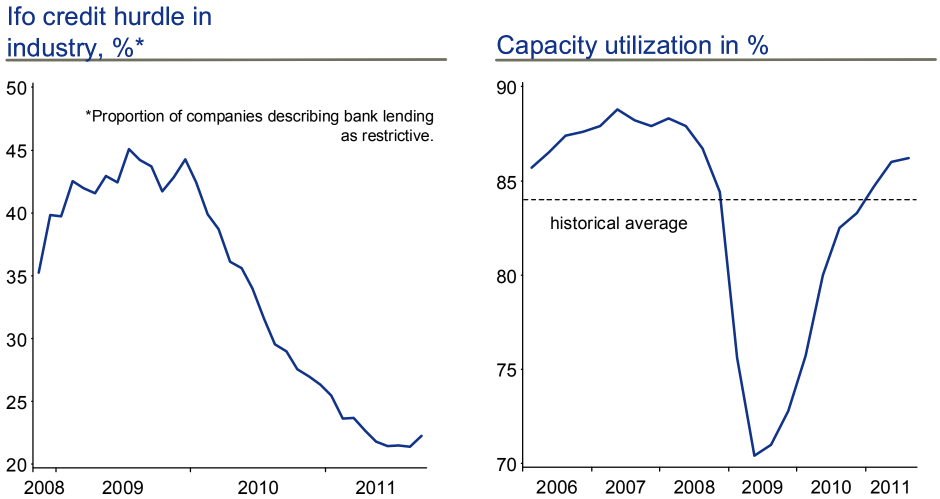
2.4 Investments offer room for improvement

As in 2010, equipment investment, which grew by 10.5% last year, remains one of the supporting pillars of the domestic economy in 2011 as well. In addition to equipment, construction investment is also a source of considerable impetus this year.

A whole number of good overall conditions, such as the favorable financing environment, suggest that the positive development in equipment investment will continue. Although September's Ifo business test shows that the credit hurdle has risen slightly, it is still at a low level. In the industrial sector, for example, only 22.2% of the companies surveyed described bank lending practices as restrictive, compared with 29% in the same month of last year. What is more, interest rates remain at a very low level, despite moves by the ECB to hike the key rate. We do not expect to see any further hikes in the foreseeable future given the recent deterioration in the economic outlook. Furthermore, the corporate sector is still reporting rising earnings. These not only make it easier for companies to finance their own investment projects, but also help improve corporate credit ratings. What is more, the high capacity utilization levels in the manufacturing industry should have a positive impact on equipment investment. According to the Ifo business survey, utilization levels were sitting at 86.2% in Q3, well above the average for the last ten years, namely 83%. Furthermore, at 7.5%, the investment ratio (equipment investment expressed as a proportion of nominal GDP) is still languishing just below the long-term average of 7.6%. From this perspective, the current situation still offers scope for an upward trend.

Chart 6

Investment backdrop still favorable



Source: Ifo.

The question as to how equipment investment will develop in the future, however, depends to a considerable degree on economic expectations. The slowdown in the global economy is having a negative impact on export expectations. Poorer unit sales forecasts and lower earnings estimates may prompt companies to postpone their investment projects. The situation is exacerbated further by concerns as to exchange rate developments and the next chapter in the European debt crisis. This means that, despite the predominantly positive overall environment, we are unlikely to see any real surge. While we expect equipment investment to grow by 10.2% in 2011, growth in 2012 is expected to be far more muted at an estimated 4.3%. In addition to the economic slowdown, this trend is also, however, attributable to the fact that the catch-up effects that emerged in 2010 in a drive to make up for 2009, when equipment investment plummeted by 22.8% year-on-year, will no longer be on the scene.

Declining Ifo test scores: sign of a recession?

The Ifo test is extremely significant as a leading indicator of economic development. The marked deterioration in the Ifo values since the spring of this year has sparked concerns that the economy may be teetering on the brink of another recession. An export setback could signal the end of the upswing.

The manufacturing industry remains the sector in Germany that is most sensitive to economic ups and downs. And it is for this sector, in particular, that the Ifo test has delivered a number of diverging pieces of information. To what extent can the estimates provided by the corporate sector allow conclusions to be drawn as to the development of industrial production? This is an issue that we have put under the microscope, using straightforward regression relationships. We have chosen to look not at the monthly change, but rather at changes in industrial production over a three-month period. Monthly fluctuations often prove to be coincidental, whereas changes over a three-month period send out important signals for economic trends. The same is true for the survey results in the Ifo test: monthly changes are highly volatile, while changes over a three-month period are of far greater informational value.

As a result, we have used the regression estimates to investigate the extent to which the three-month changes in business climate, business situation, business expectations, demand development, order backlog development, order backlog, inventory of finished goods, production development, production plans and export development explain and act as a forerunner to the three-month change in industrial production.

All of the Ifo test indicators are highly significant and, in respect of the best estimate in each case, precede the corresponding trend by one (business situation, order backlog, inventory of finished goods, production development) to three (business expectations, production plans) months. The explanatory value of the indicators expressed as a percentage, however, lies at only between 22% (demand development) and 52% (business situation).

Lead of Ifo business test with regard to industrial production*

Manufacturing sector	Lead time in months	Explanatory share in % (R^2)
Business climate	2	43.8
Business situation	1	51.9
Business expectations	3	26.5
Demand situation, development in prev. month	2	22.2
Order books, development in prev. month	2	30.0
Order books, assessment	1	50.3
Finished goods inventories, assessment	1	41.4
Production development in prev. month	1	28.3
Production plans	3	37.6
Export expectations	2	35.5

* in 3m rates of change

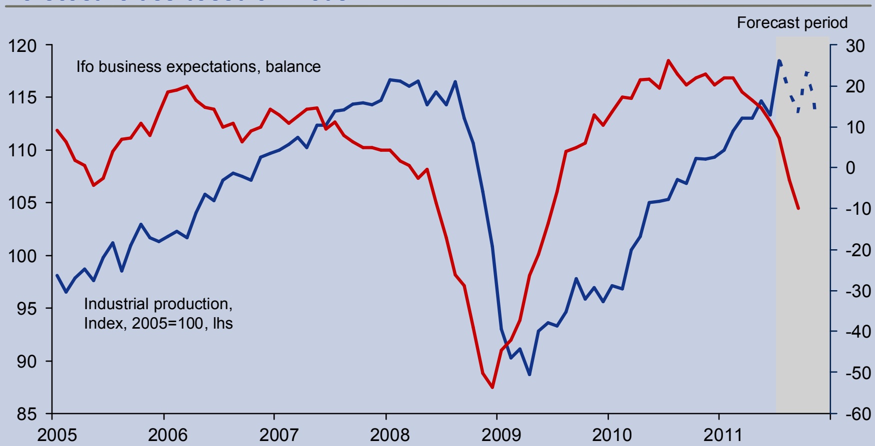
Indicators that crop up only one month in advance, however, are of only limited value as leading indicators of economic development, even if their explanatory value is fairly high, as is the case with the assessment of the business situation. As a result, we have opted to concentrate on business expectations, which surface three months in advance but have an explanatory value of only 26%. We suspect that it is not only the changes in the Ifo indicator, but also its level, that are significant for economic trends. This is borne out by the estimates. The changes in business expectations subject to a three-month delay and the level of business expectations, subject to a time lag of two months, explain around 43% of the changes in industrial production.

We have used this approach to arrive at a short-term forecast for German industrial production. At the moment, data on industrial production is available for the period up to July, while the results of the Ifo test are available for the period leading up to September, allowing us to forecast the change in industrial production for the period up to November using the estimate approach described above. Looking at the third quarter of this year, this approach points at industrial production that is up by around 2.5% on the second quarter. In the fourth quarter, however, industrial production (based on an extrapolation of October and November) is expected to slide by 1.2% compared with the high value achieved in the third quarter. Due to the strong industrial production, we can expect fairly robust growth in GDP (after seasonal and working day adjustments) of at least 0.5% in Q3, whereas GDP can be expected to stagnate in Q4 due to what is likely to be a sustained moderate upward trend in the service sectors. This is not tantamount to a macroeconomic recession.

Chart 7

Industrial production and Ifo business expectations

Forecast values based on model



Sources: Ifo, EcoWin, own calculations.

Construction investment got off to a flying start in 2011. Exceptionally favorable weather conditions paved the way for a strong increase to the tune of 7.0% in the first quarter. Bearing this in mind, the slight 0.9% dip in the second quarter comes as no surprise. Despite the slight slump in incoming orders in the commercial construction sector of late, the favorable financing conditions should allow further dynamic development in this segment, an assumption that is backed up by the increase in the number of building permits again in July. Public-sector construction, on the other hand, is unlikely to contribute much in terms of impetus. Although the financial situation of public-sector building contractors has improved thanks to higher tax revenues, the fact that the subsidies provided within the framework of economic stimulus package II are set to expire is likely to largely cancel out any expansive effects. The outlook for residential construction investment is rosy: the improved situation on the labor market has created greater income security for German households and the financing environment is favorable. What is more, a marked increase in real estate prices is emerging, starting at a low level. All in all, we expect construction investment to increase by 5.7% in 2011 and 2.2% in 2012.

2.5 External inflationary impetus on the wane

The surge in the price of commodities sent consumer price inflation on an upward spiral in Germany well into the summer months. Commodity prices are now starting to sag again – albeit from a high level. The sharp increase in import prices, which at times exceeded 10% year-on-year, would appear to have been stalled. Import prices are now around 1% down on the high they reached in March/April of this year, improving the prospects for more consumer price stability.

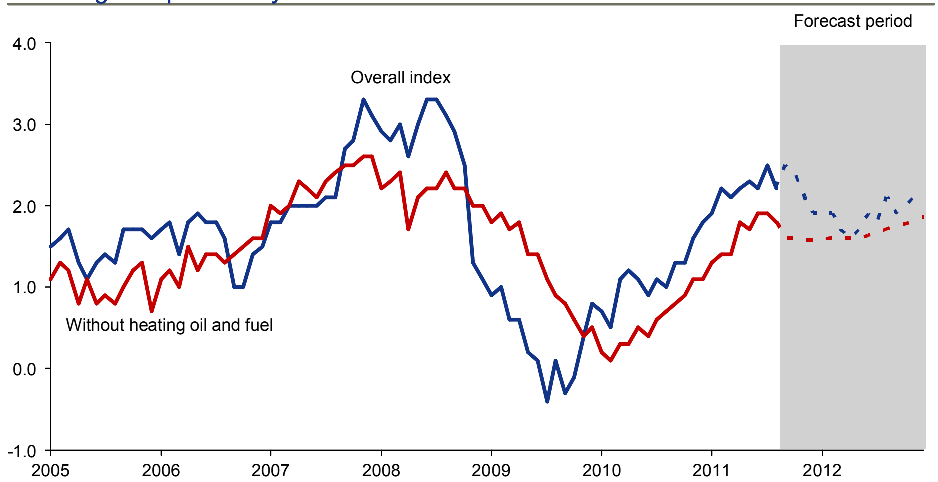
Until recently, energy was the main price driver among the consumables. Energy prices were recently (August 2011) up by 9.9% on the same month of last year. If we leave energy out of the equation, the rate of inflation recently came in at 1.4%.

From a purely domestic demand perspective, inflation is expected to be low, despite the relatively high levels of capacity utilization. In the first half of 2011, wage costs per unit of production were only just under 1% above the corresponding prior-year level, and are expected to rise by around 1% for 2011 as a whole, too.

Chart 8

Germany: Consumer prices

% change on previous year



Sources: Statistisches Bundesamt, own forecasts.

The increase in consumer prices, which has, on occasion, climbed as high as 2.4% this year, is expected to fall back to around the 2% mark by the end of 2011. Assuming that the oil price will not change to any considerable degree in 2012, we expect the rate of inflation to fluctuate between 1.6% and 2.1% in the course of 2012. Average inflation in 2012 is expected to come in at 1.9%.

2.6 Only slight slowdown in job creation

Despite the loss of economic momentum, the situation on the labor market has been improving up until now. In the first eight months of the year, the number of people out of work (in a seasonally adjusted calculation) has fallen by around 180,000, while the number of people in work has risen by 365,000. The above-average increase in employment compared with the decline in unemployment is likely to have something to do with the general increase in labor force participation, as well as the abolition of restrictions on the freedom of movement for eastern European EU members, coupled with the end of compulsory military and community service.

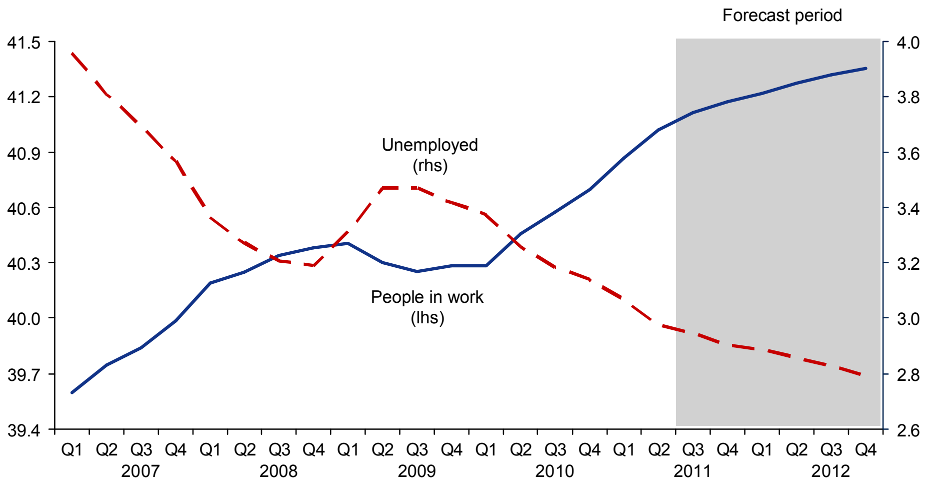
The number of people in work in August was up by 515,000 on a year earlier. The number of people in full-time posts that are subject to social security contributions was up by 365,000. Employment was on the up in the overwhelming majority of sectors. The manufacturing industry, commercial services, the supply of temporary labor and healthcare and social services registered increases in the number of people in work of over 100,000.

In the wake of the slowdown in the economy it cannot be ruled out that the reduction in unemployment will come to a halt in the coming months. Nonetheless, employment is likely to continue to point upwards. In the winter months 2011/2012 the jobless total will probably climb to 3.1 million to 3.2 million but fall back below the three million mark in the spring of 2012. As long as the economy does not take more of a knock than we expect, the labor market is likely to prove robust in 2011 as a whole. On average in 2012 we are penciling in a jobless total of around 2.85 million after 2.98 million this year. The drop in unemployment by around 130,000 in 2012 will go hand in hand with an average increase in employment of around 250,000..

Chart 9

Germany: Number of people in work and unemployed

millions



Sources: EcoWin, own forecasts.

In an international comparison, the German unemployment rate (ILO labor force concept) is currently extremely low at 6.1%. Austria, the Netherlands and Luxembourg are the only countries out of the EU's 27 members to have lower values at present. In 2012, we expect the German unemployment rate to come in at 5.8%.

2.7 Budget deficit continues to fall

New public-sector borrowing, which shot up last year to EUR 106bn (4.3% of GDP) on the back of an additional expenditure item (EUR 22.3bn for measures to prop up the banking sector during the financial crisis of 2009/2010)[1], is set to fall sharply this year, down to only around 1 percent of GDP.

Both the revenue and the expenditure side have their part to play in this favorable development. Tax revenues are expected to increase by 7-8% this year thanks to a greater increase in income from employment and solid corporate profits. Income from social welfare contributions will also benefit from the healthy economy, with an increase of 3½-4%. All in all, government revenue is expected to increase by an estimated 5½%. The largest item on the expenditure side, monetary social benefits, is expected to fall by 2% in 2011, thanks in particular to the improvements on the labor market. The fact that spending on subsidies is expected to fall is also encouraging. The government's spending on interest payments will reach the lowest level seen since 1994 at just under EUR 60bn, whereas spending on wages and salaries for state employees will chart a moderate increase of a substantial 2%. Since we hope that there will be no need for any additional expenditure items, government spending is expected to fall by 1.8% in 2011.

Germany: Public-sector revenue and expenditure

in EUR bn	2009	2010	2011	2012
Revenue	1066.0	1079.8	1138.7	1172.4
of which:				
Taxes	546.3	548.9	590.0	610.7
Social contributions	409.8	418.7	434.2	445.0
Expenditure	1142.1	1185.8	1164.7	1182.8
of which:				
Inputs	114.8	120.0	123.0	126.0
Employee compensation	189.7	194.5	198.8	203.8
Property income payable (interest)	63.8	61.9	59.7	58.5
Subsidies	27.1	27.2	26.1	26.1
Monetary welfare benefits	425.7	429.3	420.7	425.0
Welfare benefits-in-kind	197.9	203.0	207.0	211.1
Other current transfers	51.8	54.0	54.6	55.1
Gross investment	41.4	40.8	42.8	44.5
Financial balance	-76.1	-106.0	-26.0	-10.3
memorandum (in %):				
State spending ratio[1)]	48.1	47.9	45.4	44.8
Financial balance[1)]	-3.2	-4.3	-1.0	-0.4

[1)] in relation to gross domestic product in current prices. Sources: Statistisches Bundesamt, own forecasts.

The trend in the public-sector deficit in 2012 depends heavily on the economy. With moderate economic growth – as we expect to see – the underlying fiscal picture is likely to improve further. In 2012 we are penciling in an increase in revenue of 3% and an increase in spending of a good 1½%. As a result, the public-sector deficit will fall from EUR 26bn this year to around EUR 10bn next – that would be a mere 0.4% of GDP.

[1] This was triggered by new information on the values of the risk portfolio transferred by a bank to FMS Wertmanagement. This information was published for the first time on May 24, 2011 in the 2010 Annual Report of FMS Wertmanagement. The values were assessed as part of the decision taken by the European Commission on July 18, 2011 on the categorization of the bank's state support measures under competition law. On the basis of the Eurostat regulations dated July 15, 2009 on the statistical recording of public interventions during the financial crisis, an additional expenditure item totaling EUR 22.3bn had to be booked. This increases the 2010 deficit ratio by 0.9 percentage points. (excerpts from press release no. 315 of the German Federal Statistics Office (*Statistisches Bundesamt*) dated September 1, 2011).

3. OUTLOOK FOR MONETARY UNION

3.1 Overview of different scenarios

In our economic base scenario, we have assumed that the sovereign debt crisis will be successfully kept under control in the months ahead. Although markets will remain jittery, there will be neither a renewed banking crisis nor serious contagion of Italy or Spain. Despite repeated interjections calling for a stiffer haircut for Greece, the Troika will stick to its course and focus on the implementation of the promised reforms, the pact to involve private creditors will not be unraveled.

Although nobody believes that Greece is over the worst, there is some doubt as to whether further debt cancellation would be helpful. This sort of move would definitely not automatically improve Greece's growth prospects or make market participants any more willing to lend Greece new funds; the country would remain reliant on aid from the EFSF. Before debt relief could be considered, a situation would definitely have to be created in which the Greek state does not require any more loans, at least not to finance its current budget (excluding interest payments). Otherwise, the country will soon fall into the next trap of excessive debt. It is also very optimistic to assume that radical debt cancellation would calm the markets down. The situation in Greece would remain uncertain, and countries like Ireland and Portugal are still far from out of the woods yet. It does not take a vivid imagination to imagine that debt cancellation would be more likely to trigger a further loss of confidence, which would come part and parcel with renewed uncertainty. It is important to remember that even the involvement of private creditors did not help the markets to simmer down, but actually increased the risk premiums for Italy and Spain. As a result, the best option remains to provide further support, but at the same time to ensure that the (announced) reforms are really put into practice. There is no fast, easy solution for Greece. The country remains one of the euro area's open wounds. What is key is that we prevent the situation from spreading to other countries, particularly Italy and Spain.

There are two aspects suggesting that these two countries will be able to escape the orbit of the crisis. First, there is stringent budgetary discipline, which is leading to visible consolidation successes. Italy should be able to achieve a balanced budget by 2013, which would correspond to a primary surplus (current revenue higher than current spending excluding interest) of a substantial 5% of GDP. Spain is already well on the way to achieving its consolidation objectives as far as new borrowing is concerned. The country has taken measures that include cutting civil servants' salaries, lifting the retirement age from 65 to 67 and levying a wealth tax. Spain's debt level is expect to stabilize at around 70% of GDP over the next few years, a level that is, without a doubt, a sustainable one. Second, there are the endeavors to make the EFSF fully operational. We expect that the next few weeks will see a solution hatched on how to make the EFSF even more efficient - without jeopardizing independent monetary policy. We believe that an insurance solution will prevail as the most attractive concept. With recessionary fears on the wane, however, we do not believe that this tool will be used in the end.

Limiting the amount of speculation against Italy and Spain (and other eurozone countries) would already be a key step in the right direction to stamp out the fear of another banking crisis. The capital situation of Europe's banks is perfectly sufficient provided that we do not assume that significant write-downs will have to be made on their government bond holdings. In our view, precautionary capitalization measures, if necessary initiated by the state – such as those proposed by the IMF, for example – are futile. The idea that this could protect banks against the insolvency of a major euro area country appears unrealistic. On the contrary: any measure that could be interpreted as preparation for such a move would be more likely to send confidence plummeting further, triggering a downward spiral. The best help to give banks is to remove the Damocles sword of further debt reductions that is still hanging over their heads.

Against the backdrop of greater stability on the markets, policymakers can further pursue their master plan of a gradual deepening of the euro area. A number of important moves have already been taken: tightening up of the Stability and Growth pact, passing of the Euro Plus Pact and the establishment of an "economic government" for the euro area. In the main, this means that the euro area will continue on the path charted out for it by Maastricht: evolution as opposed to revolution. The fundamental structure of monetary union will remain untouched (for the time being): unlike with the common monetary policy, fiscal policy will remain in the hands of the individual member states. Based on the experience of the crisis, however, it can be assumed that serious steps will be taken to ensure fiscal policy discipline. In order to achieve this, elements of coordination, harmonization and control will have to be strengthened considerably. Ultimately, these measures can also be seen as preparing for what will ultimately be a fiscal and political union. Change by way of adjustment: if the new control mechanisms prove successful, the opposition to a partial transfer of fiscal policy decision-making powers should gradually diminish in the end.

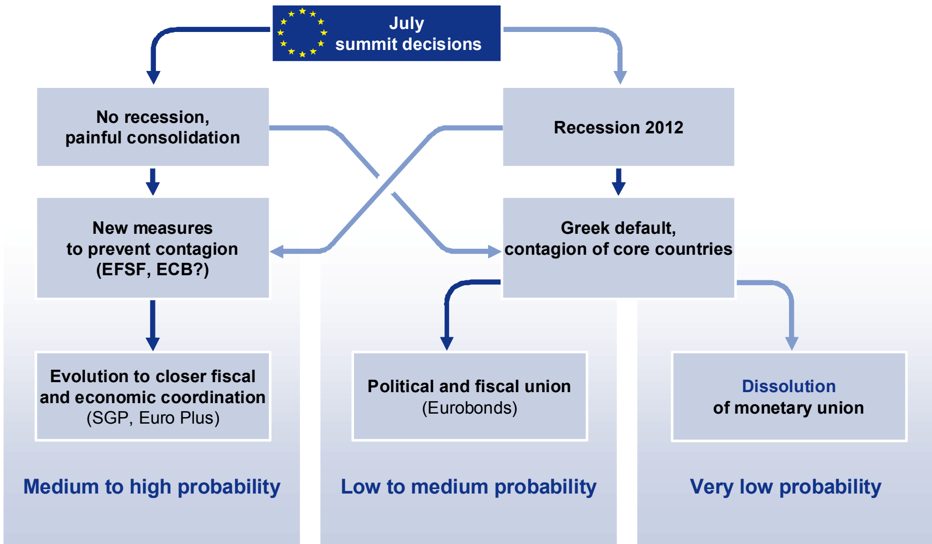
Even if we believe that this scenario of an evolutionary development of monetary union is the most likely one, other dramatic developments cannot, of course, be ruled out. This would be all the more true if the modest economic tailwind were to turn into a fierce headwind. If this were the case, the consolidation successes would lag behind expectations, with Greece in particular failing to meet its objectives. In the worst-case scenario, the country could be refused a tranche of aid payments as a result, resulting in sovereign bankruptcy. In the event of a recession, the effects would immediately spill over into other countries.

This exacerbation of the crisis – highlighting the failure of the approach deployed to date to tackle the crisis, namely via conditional loans – would promote the readiness on all sides for radical solutions. At any rate, the idea of large euro-zone countries such as Italy or Spain being financed by the ECB would be unlikely to be seen by anyone as a long-term, sustainable solution. At the same time, it would be clear that the new, expanded EFSF – without or without levers – would simply be overwhelmed by this task.

In this situation, we believe that the only options would be the dissolution of monetary union or the introduction of Eurobonds, i.e. the immediate communitization of debt in order to restore access to the capital markets for the affected countries. Monetary union would be forced to dive head first into fiscal and political union. The corresponding regulations that would call for changes to EU treaties and constitutions, could then follow later on. As an initial step, the issue of Eurobonds, on the other hand, would likely be a structured process, as with the issue of EFSF bonds.

The paradoxical thing about this is that, while Eurobonds might stabilize the eurozone in the short term, in the longer term they could provoke conflict and vanishing acceptance of the euro. If a swift, possibly overhasty, introduction of a European liability union is not matched by corresponding control and intervention rights, along with binding fiscal rules, the rejection front is likely to grow. The political debate would become more intense and would be conducted not only in parliament, but also "on the street", i.e. in elections. While the introduction of Eurobonds – at least in the short term – would be likely to have more of a positive impact on economic development by calming the markets down, even Eurobonds would not, by any means, rule out the possibility of the disintegration of monetary union in the long term. Since there is no doubt that the economic impact would be immense, however, we believe that this scenario is highly unlikely. Especially in those countries with weaker economies, there is a real will to maintain the euro, meaning that the partial assignment of rights to the EU would likely be acceptable. Hard-currency countries such as Germany, on the other hand, could expect long-term economic damage if they left the euro, meaning that they, too, would have a strong incentive to find negotiated solutions. We would now like to look at the impact of the scenario in which monetary union fails from a German perspective.

Scenarios: Evolution or radical change



3.2 Extreme scenario: disintegration of monetary union – economic consequences

The term "disintegration" can refer to a decision by one or more countries to leave the EMU, the continuance of a core monetary union or even the return of all EMU countries to their national currencies.

Below, we have opted to concentrate on the scenario in which a number of highly-indebted EMU countries leave the eurozone, ultimately leaving a core monetary union comprising Germany and a small number of other EMU countries, such as France, the Benelux countries and Austria. We have opted to set aside the legal issues, namely the extent to which the EU treaties would even allow such a scenario.

The economic costs incurred by Germany if the single currency area were to shrink would be immense. There would be pronounced devaluation trends in the countries leaving the EMU. In many cases, debt cancellation, with far-reaching restrictions on the movement of capital, would be necessary. As a result, it is highly likely that we would see

- a Europe-wide crisis in corporate financing and, finally, a global confidence and financial crisis. Even now, corporate surveys show that the turbulence associated with the debt crisis is putting huge pressure on economic expectations in the corporate sector and is evidently also putting more and more of a damper on economic activity. If several countries were to leave the euro area, both banks and non-financial companies would experience far more of a confidence shock than at present.

- an interruption in global trade flows . Foreign trade financing would be hindered by the banking crisis. What is more, the confidence shock would prompt many countries to postpone major investment projects or stretch them out over time, which would have a severe negative impact on the extremely capital goods-oriented German export economy.

- the massive appreciation of the "core euro" against most currencies. Countries under pressure to adjust would likely jump at the opportunity to achieve a lower external value.

While the economic consequences of the confidence and financial crisis could follow a similar pattern to that followed by the economic crisis in the wake of the Lehman insolvency – i.e. severe recession and an economic recovery after one or two years – appreciation and its consequences for the euro core would presumably have longer-term effects. We have estimated what impact the expected appreciation of the euro would have on Germany's growth and labor market. In our view, it is plausible to expect the "core euro" to appreciate by around 20% against all relevant currencies. The appreciation could be as much as 30-40% against the currencies of the highly indebted European countries, while we have assumed that the currency could appreciate by 10-15% against the US dollar. Even against currencies that are overvalued at present, such as the Swiss franc, the core euro would most likely gain considerable ground. The appreciation of the euro would make Germany far less competitive. With German trade flows accounting for a substantial 25% of total trade flows in the remaining euro area, a 20% increase in the trade-weighted external value of the euro would knock around 15% off the price competitiveness of German exporters. This means that the loss of price competitiveness would be around twice as hefty as that seen when the European Monetary System collapsed in 1992, sparking a short-lived but severe recession in Germany.

We have used an econometric estimate to calculate how elastic German exports are in adapting to changes in price competitiveness. Our estimate explains the German export value on the basis of the global trade volume and the indicator of price competitiveness (based on total unit sales deflators) in the period from Q2 2000 to Q1 2011.

The indicator of price competitiveness measures the trade-weighted external value of Germany's currency - i.e. the euro. Since the introduction of the euro, this external value for Germany has been subject to minimal fluctuation. On average, appreciation has not exceeded 3½% in any year since 1999.

The long-term elasticity of German exports with respect to global trade amounts to almost exactly one, meaning that Germany has not suffered any losses in its global trade share over the past eleven years. According to the estimate, the elasticity of German exports with respect to the indicator of price competitiveness is surprisingly high at around one, although the process of adjustment to changes in price competitiveness takes around five quarters. Any long-term appreciation in the trade-weighted external value to the tune of 20%, and an associated deterioration in price competitiveness of 15%, would therefore result in export losses of around 15% within the space of a year, at least insofar as there are no marked wage policy adjustments, which can be assumed to be the case in the short term. Since exports in Germany now account for 50% of GDP, export losses of 15% would slice 7.5% off GDP in the first instance. Various effects, however, would cushion the blow of such a slump. Exported goods increasingly contain intermediate goods imported from abroad. According to an analysis by the Rhineland Westphalia Institute for economic research (*Rheinisch-Westfälisches Institut für Wirtschaftsforschung* (RWI), economic reports (*Konjunkturberichte*), issue 2/2011, p. 76), imports account for 40% of exports on average, although the marginal import content of exports is as high as 50%. Consequently, a 15% drop in exports (compared with the base scenario) would mean that foreign trade would make a negative growth contribution corresponding to around half of the pure export effect. As a result, the lower external contribution would knock 3¾ percentage points off GDP growth.

It is, however, important not to ignore the possibility of a further channel through which appreciation could have an impact. Appreciation improves the terms of trade, i.e. the relationship between export and import prices. Declining import prices cut the costs incurred by companies and lessen the impact of inflation on private consumption. This increases income purchasing power, meaning that it results in real income gains. We have used an econometric explanation approach for consumer price inflation to calculate the extent to which appreciation would put a damper on inflation. 20% appreciation in the effective exchange rate results in a one-time reduction in inflation of almost 1.5 percentage points. Assuming that households do not change their savings behavior in spite of the crisis, the increase in purchasing power results in additional real consumer demand of almost 1½ percentage points and a contribution to GDP growth of 0.8 percentage points. Furthermore, we have assumed unchanged corporate investment activity in the first instance, which is fairly optimistic given the slump in foreign demand, despite the cost relief. All in all, we estimate that the appreciation would slice around 3 percentage points off GDP.

If the appreciation remains a long-term feature and there are no sustained wage policy adjustments, the growth losses would have an impact on the labor market. The growth loss would spark a corresponding downward trend in employment. Consequently, we could expect the appreciation of the euro to result in the loss of around 1 million jobs in the event that the eurozone were to shrink to become a core single currency area. This does not take account of the potential consequences of a disintegration of the euro, such as the effects of a banking crisis, disruption to trade flows and a global crisis of consequence. The estimated loss of 1 million jobs in Germany due to the disintegration of EMU would presumably only be the absolute minimum loss that the labor market could suffer.

These assessments are, as always, subject to the disclaimer provided below.

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