



## Germany appears set for a Slowdown

Germany, the largest economy in the Euro zone, is delivering a strong performance in 2006. Real gross domestic product (GDP) is expected to grow by an annualized 2.5%, a record high in more than six years, based mainly on robust domestic spending. The labor situation has improved substantially over the last year with the unemployment rate tapering to 10.6% in July 2006, and reviving consumer confidence. Inflation remained close to target. In 2007, however, Germany is expected to lose momentum, slowing to about 1.3%, due to monetary and fiscal tightening.

The European Central Bank (ECB) has raised the overnight interest rate four times since December 2005 to the current level of 3.25% in October; another hike is expected in December. The government has approved an increase in the Valued Added Tax rate from 16% to 19% by January 2007 in an effort to narrow the budget deficit. It has been estimated that the German authorities have been spending an approximated 40 billion euros (US\$51 billion) more than it earns in taxes each year. Consequently, the government has agreed to up-tick VAT revenues as a solution to the current fiscal deficit problem instead of lowering expenditure.

The government also plans to reduce the compulsory contribution to public unemployment insurance from 6.5% to 4.5% of gross wages. In addition, contributions rates to the public health insurance and to public elderly pension system will be increased, escalating overall income taxation in 2007. In response to the revised fiscal announcement, GDP growth is expected to be lifted in the second half of 2006 as consumers take advantage of the pre-VAT lower prices before the VAT implementation.

A VAT system is basically a general consumption tax which is assessed on each stage of value added to the goods and services production and distribution line. The burden is borne ultimately on the final consumer. Implementing a VAT system helps in income tax administration and revenue collection. It also represents a very important revenue security tool against tax evasion since it is superior to a business tax or a sales tax. Another advantage is that VAT may be selectively applied to specific goods or business sectors.

From a broader perspective, the VAT system is usually regarded as a regressive tax since the financial burden

falls disproportionately on the poor since they spend a greater proportion of their income. The immediate period following a hike in the VAT rate may also amplify inflationary pressures if businesses seize the opportunity to hike prices even further, constraining the cost of living. It has also been argued that the VAT system places a greater burden on labor intensive industries compared to capital intensive industries since the former has a greater ratio of value added, and the VAT system taxes each stage of the production and distribution cycles. Even though the tax increase leaves Germany just below the European Union of average of 19.34% across the board, the reduction in social insurance contributions will not be able to compensate the negative effect of the significantly more restrictive fiscal policy. With reference to the EU Stability and Growth Pact, euro-zone members must not exceed a fiscal deficit of 3% of GDP. Germany has been in breach of this regulation every year for the past 4 years. The country's last tax hike took place eight years ago.

Thus, the reduction of the budget deficit is of high importance as Germany is expected to sell 239 billion euros of bonds next year, 24% less than this year. The tax hike is expected to boost tax revenue by 16.2 billion euros, stimulating the achievement of the net borrowing target of almost 22 billion euros, equivalent to 43% less than 2006. Total tax revenue from the federal, municipal and regional authorities may accumulate to 494.0 billion in 2007, compared to 465 billion euros this year, bringing down the budget deficit to 1.6% of GDP in 2007.

Europe's largest economy with a marked acceleration in 2006 is unfortunately expected to lose pace in 2007, dampening the German economic outlook.

**Table: Key Economic Data for Germany, 2001-2006**

	2002	2003	2004	2005	2006f
Real GDP growth (% y/y)	0.1	-0.2	1.1	1.2	1.9
Consumer Price Index (% y/y)	1.4	1.1	-4.6	2.0	2.0
Unemployment (% y/y)	9.8	10.5	10.6	11.7	11.0
Budget Balance (% of GDP)	-3.2	-3.6	-3.2	-2.7	-1.7
Current Account (US\$bn)	41.00	45.60	101.91	114.78	113.30
Exports (US\$bn, fob)	619.36	775.34	903.33	973.89	1,080.07
Foreign debt stock (US\$, end period)	480.2	491.3	510.6	521.0	530.6
As % of exports	0.77	0.63	0.57	0.53	0.49

Sources: IMF; Eurostat; Finance Ministry; BMI (estimate/forecast)

## FINANCIAL & ECONOMIC INDICATORS

As at 5<sup>th</sup> October 2006

Exchange Rate/US\$	Closing Value	Previous Week
Yen	117.71	117.81
Euro	1.27	1.27
Jamaica	65.96	66.10
Guyana	200.70	200.70

Commodity Prices	Closing Value	Previous Week
Crude oil (US\$/bbl)	60.03	62.76
Natural Gas (US\$/mmbtu)	4.69	4.15
Gold (US\$/Troy Ounce)	574.30	601.30

### Eurobond Indices (Returns, % YTD as of 05- Oct- 06)

Lehman Brothers Global Aggregate Index	2.64
JP Morgan EMBI+	0.17
CMMB Eurobond Index	0.84

Policy Interest Rates (%)	Closing Value	Previous Month
United States	5.25	5.25
Euro Zone	3.00	3.00
Japan	0.27	0.25
Brazil	14.25	14.25
Trinidad	8.00	7.75
Jamaica	11.95	11.95
Barbados	4.75	4.75

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	4.81	4.75
US 10-Yr Treasury	4.61	4.61
3-month UK Libor	5.11	5.07
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	13.65	13.76
TT 90-day T-Bill	6.60	6.60
Jamaica 90-day T-Bill	12.06	12.06
Barbados 90-day T-Bill	6.03	5.91

Sources: Bloomberg, CMMB Research Centre, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, [www.lehman.com](http://www.lehman.com)

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