



Germany: St. Nicholas and Knecht Ruprecht

December 5, 2011

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All eyes on Germany while the German internal political debate is raging whether Germany should take a leadership role against the backdrop of the European government bond crisis, the rest of the eurozone – if not the world – believes that Germany holds the key to solving the ever more pressing European debt crisis. Politicians in problem countries as well as financial commentators sound increasingly frustrated that Germany is not doing what is so obvious to them: agree to Eurobonds, accept the enlargement of the ECB's Securities Markets Programme and use the fiscal room for manoeuvre to stimulate domestic demand. Maybe it's due to the season that this sounds more like a Christmas wish list to Germans, while Germans look more and more like Scrooge to the rest of the world. Or like Knecht Ruprecht, a figure well known in the German-speaking world as St. Nick's helper who punishes those who have not behaved during the year. Despite the surge in interest rates in the latest European debt auctions the wish list is unlikely to be fulfilled before the non-German-speaking part of the eurozone accepts that there is also this – probably German – Knecht Ruprecht who punishes fiscal misbehaviour. Hopes that Germany will miraculously realise its own questionable behaviour and, like Scrooge, try everything to atone for it by making others happy certainly do belong to the realm of fairytales. In the real world of European politics we are more likely to observe the continuation of the game of chicken, where Germany and other stability-oriented EMU countries will have to decide how much pain they are prepared to impose on budget offenders and, via the negative economic spill-over effects, on themselves before the rules are updated in a satisfactory manner that forces the offenders to become more cooperative partners. However, the truth is that cooperative behaviour ultimately requires trust and cannot be enforced by rules alone.

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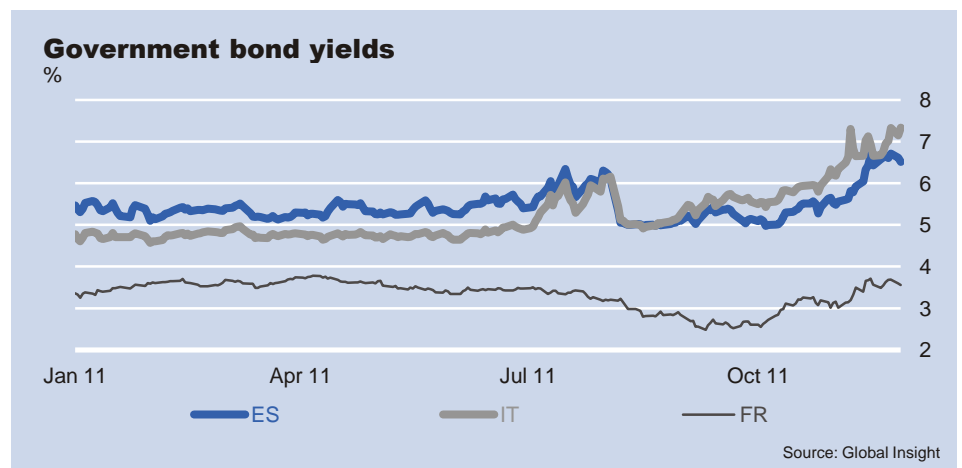
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Economic Forecasts

	Real GDP (% growth)			Consumer Prices (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
	Euroland	1.8	1.6	-0.5	1.6	2.7	1.9	-0.5	-0.7	-0.3	-6.3	-4.2
Germany	3.7	3.1	0.0	1.1	2.3	1.5	5.7	5.4	4.8	-4.3	-1.3	-1.3
France	1.4	1.6	-0.3	1.6	2.2	1.8	-1.8	-2.8	-2.6	-7.1	-6.0	-5.4
Italy	1.3	0.5	-1.1	1.5	2.7	2.3	-3.5	-3.8	-3.0	-4.6	-4.0	-2.5
Spain	-0.1	0.6	-0.9	2.0	3.1	1.4	-4.6	-3.9	-3.3	-9.3	-6.8	-6.0
Netherlands	1.6	1.9	-0.5	0.9	2.5	2.0	6.7	7.0	8.0	-5.1	-3.4	-3.5
Belgium	2.3	1.9	-0.6	2.3	3.4	2.0	2.4	2.0	2.0	-4.1	-3.9	-5.0
Austria	2.3	2.8	-0.5	1.7	3.6	2.1	2.9	2.5	2.5	-4.4	-3.2	-3.2
Finland	3.6	2.9	0.0	1.7	3.3	2.3	1.8	2.0	2.0	-2.5	-1.5	-1.5
Greece	-3.5	-5.3	-3.0	4.7	3.1	1.3	-11.8	-9.0	-7.0	-10.6	-9.5	-6.6
Portugal	1.4	-1.5	-2.9	1.4	3.6	2.5	-9.8	-8.0	-6.5	-9.8	-6.5	-6.4
Ireland	-0.4	1.5	0.2	-1.6	1.2	1.5	-0.7	0.0	0.5	-31.3	-10.5	-9.1
United Kingdom	1.8	1.1	1.3	3.3	4.5	3.2	-2.5	-2.5	-2.4	-10.3	-8.2	-6.9
Denmark	1.7	1.4	1.2	2.3	2.6	1.9	5.5	5.8	5.6	-5.3	-1.6	-0.8
Norway	0.3	2.2	1.3	2.4	1.6	1.8	12.3	12.8	13.8	10.6	9.1	10.8
Sweden	5.4	4.1	1.3	1.3	2.7	2.0	6.3	6.5	6.0	-0.1	1.9	3.0
Switzerland	2.7	2.0	1.0	0.7	0.7	0.7	15.6	13.8	13.5	0.8	1.0	1.3
Czech Republic	2.2	2.0	1.6	1.5	1.9	3.6	-3.3	-3.1	-2.8	-4.8	-4.3	-3.8
Hungary	1.2	1.4	1.6	4.9	3.9	3.9	1.1	0.6	0.3	-4.3	1.4	-3.0
Poland	3.8	3.6	2.6	2.6	4.1	2.4	-4.5	-5.0	-4.2	-7.9	-5.5	-4.6
United States	3.0	1.8	2.3	1.6	3.3	3.2	-3.2	-3.1	-2.7	-8.8	-8.5	-6.2
Japan	4.1	-0.4	0.5	-0.7	-0.3	-0.3	3.6	2.2	1.9	-8.7	-8.7	-9.1
World	5.1	3.7	3.5	3.2	4.4	3.4						

 Sources: National Authorities, Deutsche Bank **1**
Forecasts: German GDP growth by components, % qoq

	2010				2011				2012				2010	2011F	2012F
	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Real GDP	0.5	1.9	0.8	0.5	1.3	0.3	0.5	0.0	-0.2	-0.1	0.4	0.5	3.7	3.1	0.0
Private consumption	0.0	0.8	0.4	0.5	0.5	-0.6	0.8	0.1	0.2	0.1	0.2	0.0	0.6	1.4	0.7
Gov't expenditure	0.9	-0.6	0.8	0.1	0.2	0.6	0.6	0.1	0.2	0.2	0.0	0.0	1.7	1.3	0.8
Fixed investment	0.2	5.7	1.6	-0.2	4.1	0.4	0.9	0.6	0.0	-0.2	0.5	0.4	5.5	7.1	0.0
Inventories, pp	1.1	-0.1	-0.5	0.2	0.0	0.3	-0.4	0.0	0.0	0.0	0.0	0.0	0.6	0.0	-0.1
Exports	3.4	7.0	2.0	1.0	1.6	2.8	2.5	0.5	-1.0	-0.3	1.5	2.0	13.7	8.7	1.8
Imports	5.8	6.2	0.9	1.3	1.0	2.9	2.6	1.0	-0.4	0.0	1.3	1.3	11.7	7.8	3.0
Net exports, pp	-0.7	0.7	0.6	-0.1	0.4	0.1	0.1	-0.2	-0.3	-0.2	0.2	0.4	1.4	0.9	-0.4

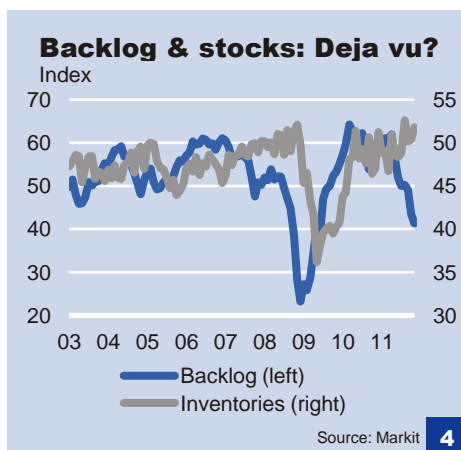
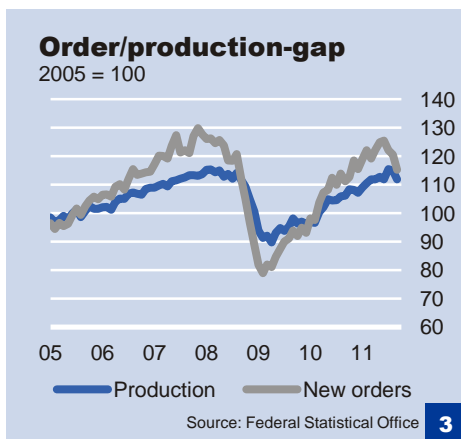
 Sources: Federal Statistical Office, DB Research **2**



Technical recession

- While GDP growth picked to 0.5% qoq in Q3, survey indicators as well as trends in monthly activity data suggest that Germany is heading for a technical recession.
- The contractionary impulse comes mainly through the export channel. With 60% of Germany's exports going to Europe, which is suffering from fiscal consolidation and financial market turmoil, we expect exports to expand a meagre 1 ¾% in 2012, while net exports will dampen growth by ½ percentage point.
- Domestic demand will provide little counterbalance. With capacity utilisation already falling German entrepreneurs' animal spirits should suffer from weaker external demand and increased volatility. Investment in machinery and equipment will shrink by 1% after mustering a 9% increase in 2011.
- With unemployment rising during 2012 by around 100k and softer wage growth given less overtime and bonus payments, real private consumption growth should slow from this year's 1 ½% to ¾% in 2012, despite inflation slowing to 1 ½%.
- After stagnation in Q4 we expect GDP to contract slightly in Q1 and Q2 2012, before recovering modestly in the second half of the year. This will result in annual average GDP growth of 0% in 2012 after around 3% in the current year.

In the August edition of Focus Germany we predicted that Germany would no longer be the "island of the blessed" and that the economy would slow sharply towards year end, after temporary growth acceleration in Q3. Q3 GDP indeed increased by 0.5% following an upward revision of Q2 to 0.3%, at the same time the downward trend in sentiment indicators has become quite scary, notwithstanding the unexpected small rise in the November ifo business climate. In addition, monthly activity indicators such as production and order intake weakened substantially during the course of Q3.



How bad will it get?

Looking at the current level of the ifo index (106.6), which is still much higher than its long-term average of 100, there seems little reason to panic, with expectations even a mere 3 points below their long-term average. But a closer look at some more monthly indicators provides a more hinky picture. The collapse in the gap between new orders and current production, for example, bears some resemblance to 2008/09.

The level of the manufacturing PMI in November is roughly compatible with a ½% qoq decline in GDP. Trends in the PMI's sub-components again reveal some similarity with 2008/09. In particular, the combination of a high level of finished stocks with a rapidly melting order backlog. The fact that the services PMI inched up slightly in October and November to stand at 51.4 offers little comfort, as it was mainly driven by the completion of ongoing projects, while the order backlog has been shrinking rapidly.

Why Germany?

This sharp slowdown has still not been fully registered by the government or the general public. After all, hasn't German employment been enjoyed new all-time-highs until recently and isn't the German export sector still doing great? Granted, compared to its European peers the German economy seems to have minor

problems. There has been no property boom prompting excessive borrowing by households. Therefore, they have no need to consolidate their financial balances. Public finances are well in check – at least relative to most other industrialized countries. This year and next year the deficit should hover around 1 ¼% of GDP, with the debt-to-GDP ratio just over 80%. Finally, German workers are super-competitive, so there is no need for wage cuts or massive layoffs, as in southern Europe for example.

Germany's strong export dependence, a huge advantage during the 2010/11 global upswing, is becoming its Achilles heel again. Even after subtracting imported semi-finished products German exports account for slightly more than a quarter of GDP. In the last decade net exports contributed an average 0.65 of a percentage point to Germany's annual GDP growth of 1.1%.

With 60% of German exports going to other EU member states and 40% to EMU countries the massive deceleration in EMU activity is taking a substantial toll on German exports. Granted, the importance of Asia as a German export destination has risen to more than 15%, but even China's share of 6% is merely the same as Austria's and is only fractionally higher than Belgium's share of 4.8%.

Admittedly, the 3.8% decline in Q3 foreign order intake compared to Q2 was heavily influenced by big-ticket orders during the summer, but even compared to Q1, Q3 orders were down 1.7%. Given that our assumptions are a ¾% contraction in EMU GDP (ex Germany), an – at least – temporary deceleration in China and ongoing sluggish growth in the US; German exports should grow by a meagre 1 ¾% in 2012 after 8 ¾% in the current year. Net exports should dampen growth by almost ½ percentage point after contributing close to 1 percentage point in 2011.

Will domestic demand provide a counterbalance?

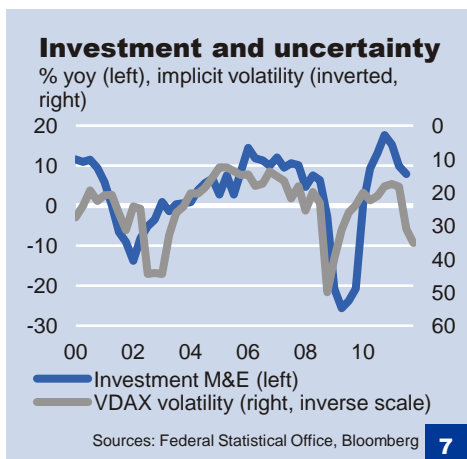
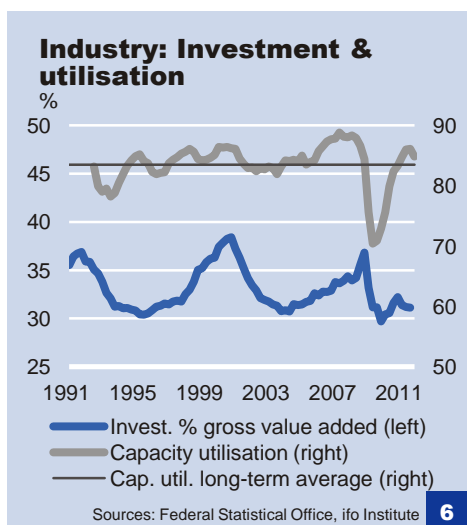
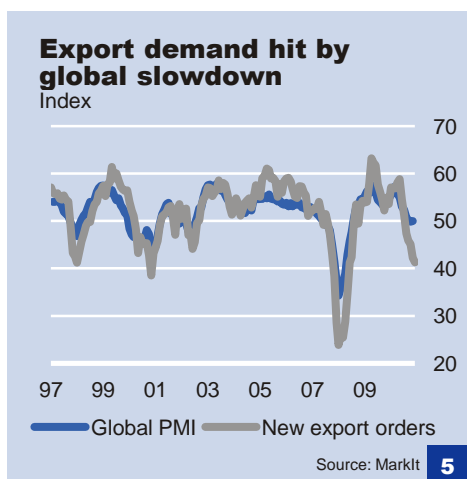
In 2010 and 2011 domestic demand contributed more than 2 percentage points to GDP. Going forward, the key question therefore is whether the contribution will remain at a similar level, thereby cushioning the external drag or whether it will be tugged lower, too.

Investment in machinery and equipment to shrink in 2012

Investment in machinery and equipment increased by a healthy 2.9% in Q3 (7.9% yoy), with investments in corporate car fleets being an important driver.

The still low ratio of investment to gross value added in industry does not necessarily suggest that the investment cycle has run its course, although the decline in Q4's capacity utilization shows there is limited necessity for capacity expansion. The extreme uncertainty with regard to the further development of the eurozone government debt crisis and the cyclical developments in the euro area and other parts of the world are, however, likely to provide a double whammy for entrepreneurs' animal spirits.

Add to this the sharp downward correction in earnings expectations – the yoy increase in the Dax 12-month forward earnings dropped to 4.9% in November from 36% at the beginning of the year – and the chances are that investment spending will slow sharply. We expect a contraction in investment in machinery and equipment of 1% in 2012 after a 9% expansion in the current year. In contrast to other EMU countries, financing constraints due to dried-up funding markets for banks are not an issue in Germany – at least to date. In the third



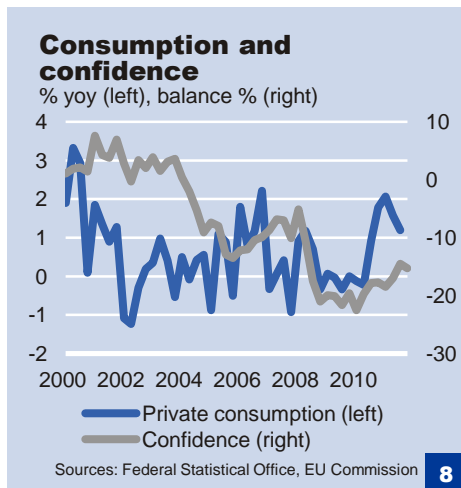


quarter the annualized, 3M-rate for lending to non-financial corporations actually inched up slightly. Given the still cash-rich situation of many German corporates and the fact that in particular savings banks and cooperatives are expanding their lending volumes at a steady rate of 3-4%, courtesy of their large deposit base, a credit crunch does not seem to be in the cards for Germany.

Private consumption: Slowing but growing at least

Private consumption provided a pleasant surprise in Q3, expanding by 0.8% qoq (1.2% yoy). This was in part due to robust income growth. Households' disposable income continued to expand by ¾% qoq, courtesy of still strongly expanding profit and investment income and slower inflation. However, the increase has also to be seen against the 0.6% drop in consumption in Q2. For example, expenditure for energy increased strongly in Q3 as households could no longer delay the refilling of their heating oil tanks. The decline in consumer confidence surveys in recent months should be a warning that the Q3 consumption momentum is unlikely to be maintained.

Since confidence peaked in June, households' expectations with regard to the overall economy and the labour market have become more clouded, although the overall index is still above its long-term average. Indeed, after falling for 19 months in a row German unemployment inched up by 10k in November. We expect the unemployment rate to rise further – at least during the first half of 2012 – causing the unemployment rate to reach an annual average of 7.2% after 7.1% in 2011. Increases in overtime and generous bonus payments in the metal, electrical and chemicals industries, which have spurred income growth in recent months, will taper off in 2012. The massive deterioration in external demand will turn the 2012 wage round almost into a damp squib – at least compared to expectations prevailing a few months ago. Growth in household nominal disposable income should therefore slow from just 3% in 2011 to just above 2% in 2012. Even with inflation falling to around 1 ½%, this will result in private consumption growth slowing to ¾% after 1 ½% in 2011.



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GDP to stagnate in 2012 after a good 3% in 2011

All in all, the growth contribution from domestic demand should shrink to a meagre ½ percentage point after around 2 percentage points in the current year, thus only partly offsetting the negative growth contribution coming from net exports. We have therefore made a further downward revision to our outlook and are now expecting a technical recession in H1 2012. Even with some modest recovery in H2 this means that GDP will stagnate in 2012 after reaching a good 3% in 2011.

Policy: Playing the game of chicken between a rock and a hard place

Obviously the German government is maxing the last ace left up its sleeve – Eurobonds or ultimately fiscal union with joined liabilities – to the limit. It is well aware of the dilemma that once German fiscal autonomy and its advantage of low refinancing yields has been surrendered, the stick forcing other countries to more cooperative behaviour will be gone. Therefore German politicians want to have guarantees that other governments will remain prudent in future. The fact that promises, pacts and paragraphs are no guarantee can be seen from Germany's own behaviour, when it together with

France unhinged the Stability and Growth Pact in 2003, after it forced the pact upon countries at the start of EMU – because it ultimately did not trust them. Given European reality it is hard to image how a “reach-through” in national fiscal policy should actually work if push comes to shove. Basically, Germany's position is unsustainable. Either you trust your partners and are prepared to give this advance concession or you have to pull the plug. The first route is hard to take given the resistance in parts of the governing coalition and the constitutional court ruling, the second one is an absolute no-go for Germany's export-dependent economy. This dilemma is intensified by the fact that the longer the German government plays this game of chicken, the more the ECB is forced to load southern European bonds on its balance sheet, which is also extremely unpopular in Germany, too. Germany therefore does not have the luxury of waiting for the proof of other countries' commitment to stability-orientated fiscal policy, in which case the financing problems would have disappeared anyhow. Finally, the clear indication that European governments do not really trust each other when it comes to fiscal prudence is probably the ultimate justification for investors to steer clear. Given that the German government's view is that both options – Eurobonds and “unlimited ECB buying” – should be avoided like the plague, it will probably try to maintain the status quo, i.e. by sitting on the fence, for as long as possible.

Germany: Economic forecast

% yoy	2009	2010	2011F	2012F
Real GDP	-5.1	3.7	3.1	0.0
Private consumption	-0.1	0.6	1.4	0.7
Gov't expenditure	3.3	1.7	1.3	0.8
Fixed investment	-11.4	5.5	7.1	0.0
Investment in M&E	-22.8	10.5	8.9	-1.0
Construction	-3.0	2.2	5.6	1.4
Inventories, pp	-0.9	0.6	0.0	-0.1
Exports	-13.6	13.7	8.7	1.8
Imports	-9.2	11.7	7.8	3.0
Net exports, pp	-2.8	1.4	0.9	-0.4
Consumer prices	0.2	1.1	2.3	1.5
Budget balance, % GDP	-3.0	-4.3	-1.3	-1.3
Unemployment rate, %	8.2	7.7	7.1	7.2
Balance on current account % GDP	5.6	5.7	5.4	4.8

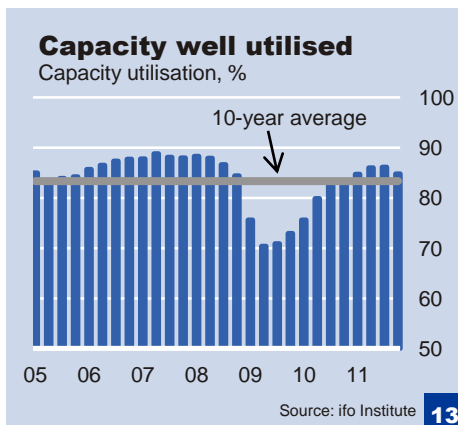
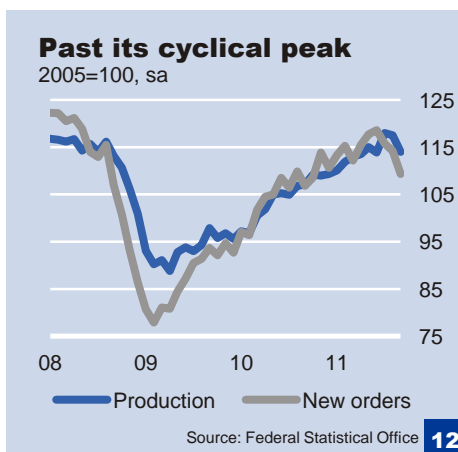
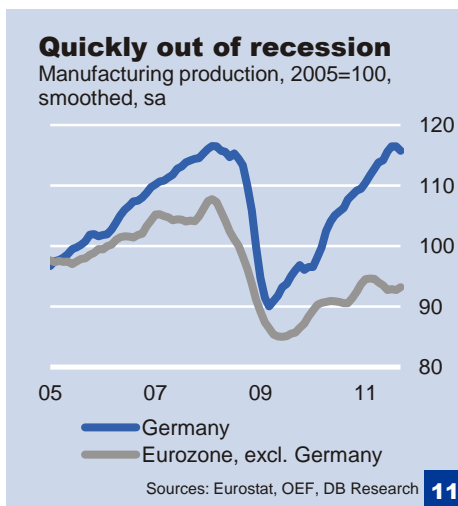
Sources: Federal Statistical Office, DB Research **10**

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German industry: Production to stagnate at high level in 2012

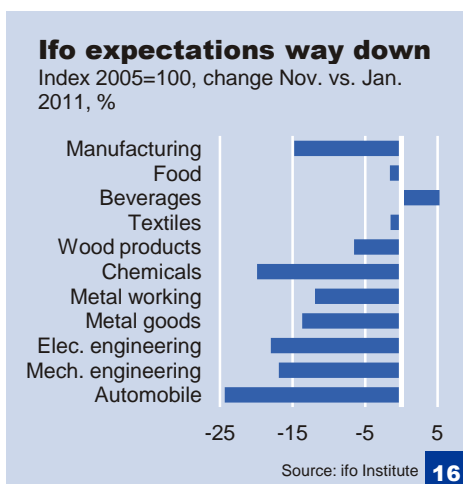
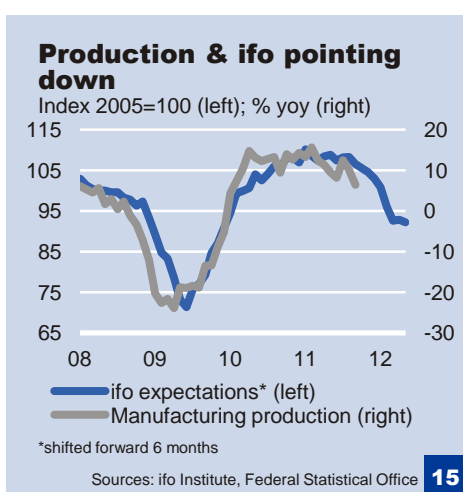
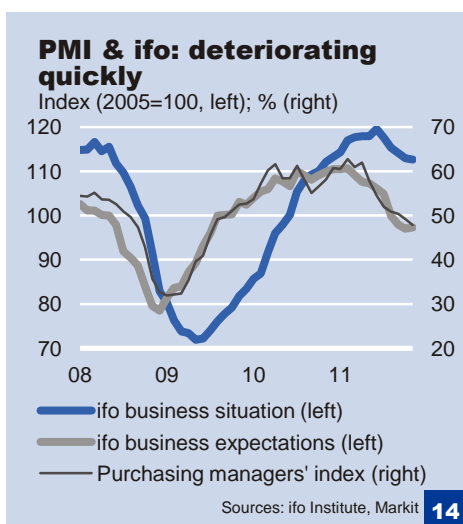
- German industry has recently passed its cyclical peak as production in manufacturing has declined by 3% in the last two months (Sep. vs. Jul.) and new orders have dropped by nearly 6% during that period, ending the strong recovery in manufacturing after 2 ½ years.
- The macroeconomic environment also worsened. We now expect a mild recession in the euro area and a slowdown in world growth which clouds the outlook for Germany's export-dependent manufacturing sector.
- In light of the macroeconomic woes our previous forecast for manufacturing output of +10% in 2011 and +2% in 2012 now looks too optimistic. We have revised it to +9% in 2011 and +0% in 2012. This implies further month-over-month declines going into next year and a modest recovery in H2 2012.
- Export-driven capital goods sectors like mechanical and electrical engineering as well as their supplier industries are being negatively affected as lower capacity utilisation and diminished business confidence have become a drag on new investment spending. More domestically oriented consumer industries should do somewhat better given the modest increase in private consumption.



German industry was affected strongly by the economic crisis in 2008/2009 when production and orders plummeted to 2003 levels. However, after the cyclical trough was reached in early 2009 German industrial production has recovered very quickly and much faster than in the euro area as a whole as German manufacturing benefited considerably from the recovery in world trade.

In numbers: Manufacturing output slumped by 17.3% in 2009 which was by far the biggest drop in production since reunification. This ended a long expansion phase in which annual growth averaged 4.2% between 2002 and 2008. However, over the last one and a half years German manufacturing has recovered quickly from the recession. This has been possible thanks to monetary and fiscal stimulus as well as buoyant demand from many emerging markets, not least because of infrastructure programmes launched as a response to the crisis. Also, German industry offers good quality products that are sought after around the world. This drove up German exports and domestic investment in machinery and equipment which grew by 13.7% and 10.5% in 2010, respectively. German manufacturing was the principal beneficiary of the swift turn-around in the global economy. Its production expanded by 12% in 2010 and continued to grow strongly this year: year-to-date production is up by 11%, taking it near its peak level of 2008; capacity utilisation is currently somewhat higher than its long term average (84.8% vs. 83.4%); and with 2.9 months of orders on hand it is at its long-term average.

The pace of the recovery had been slowing since early 2011, though, as the inventory cycle as well as the effects of expansionary policy measures petered out and growth in the euro area started to slow. Therefore, we had already forecast a pronounced slowdown in manufacturing two months ago. We expected production to grow by 10% in 2011 and by around 2% in 2012. However, as the sovereign debt crisis in Europe escalated, fiscal policy was tightened further



and growth in Europe nearly ground to a halt over the last few months, the trend in German manufacturing has been reversed.

Manufacturing performed worse than we had initially expected. German manufacturing output decreased by 3% in the last two months (Sep. vs. Jul.) while new orders fell by nearly 6% in that time. We had originally forecast production to remain roughly stable in the last quarter of 2011. In addition, assessment of the current business situation has declined by over 6% since June and ifo business expectations have already been deteriorating since February. They have come down from near-record levels to a level last seen in mid-2009 (though the momentum was in the opposite direction). Moreover, while industry and especially SMEs have pointed to their high order backlog as a reason for optimism, they are now witnessing their order backlog melting rapidly.

Changes in the ifo expectations index lead changes in manufacturing production by around 6 months and the correlation between the two time series is 0.8. Taking this into account, production could decrease by another 2% by December. This suggests that annual growth in 2011 is likely to come in at +9%, somewhat lower than our previous forecast.

Following this argument monthly production is likely to decline further in early 2012. However, we expect production to turn around again sometime around mid-2012. Growth is likely to be muted, though, as GDP growth across the developed world will be weak. For instance, we expect euro area GDP to fall by 0.5% while Germany's GDP could stagnate in 2012. Furthermore, growth in the developing world – a major driving force for German exports – will also slow. All in all, manufacturing output is likely to stagnate or expand only slightly next year, while downside risks remain high.

There is a stark contrast between changes in expectations in more domestically oriented consumer goods sectors compared to sectors producing capital goods and their supplier industries:

- Business expectations in mechanical engineering have seen some of the largest drops among all German industrial sectors since January. Furthermore, expectations in electrical engineering have also declined much stronger than in the food sector for instance. (Bear in mind, though, that they started falling from levels higher than during the boom in 2006/2007, just like in many other sectors.) The capital goods sectors are highly dependent on investment spending abroad, especially in quickly growing emerging markets. In total, we expect production growth to be in the low single digits (at best).
- Expectations in the German automobile sector fell more strongly compared to January than in manufacturing as a whole. With an export share of 63% the sector is particularly exposed to the effects of slowing global growth. In addition, government programmes supporting car sales have run out in several important markets in the course of 2011 and even sales of premium cars in China – a long-time driver – have trended sideways since mid-2011. However, the important German market could provide some support as new car registrations could increase slightly.
- Supplier industries like chemicals and metals are also faced with clouded expectations which actually started falling 2-3 months before the overall index began its decline. This is due to weaker demand from domestic clients in the automobile and engineering



sectors. Companies from these industries cut their order volumes early to keep inventories lean in the face of slowing demand. This will be a big drag on production in supplier industries next year. Even before our forecast revision we expected no more than 1% growth. Now production looks set to stagnate (at best).

- In contrast to the much muted outlook for the above industries production in the more domestic and consumer oriented industries like food and beverages should hold up reasonably well. First, their production is less sensitive to cyclical developments as it is mostly made up of everyday goods. Second, we expect the German labour market to remain relatively stable in 2012 which will allow private consumption to grow moderately. This positive outlook is also reflected in these sectors' expectations which have only declined somewhat since January or even increased. The consumer-oriented sectors are not large enough to provide a meaningful impulse for overall manufacturing, though.

Overall, German manufacturing is facing stagnation in 2012. However, it is important to realise that zero growth would still leave German industry close to the record production levels of 2008 and far from the very low capacity utilisation levels of 2009. On the other hand, the current strong downward momentum for example in global PMIs shows that the risks to this forecast are skewed to the downside.

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Public finances: No time to relax

- Thanks to continued buoyant tax receipts, falling expenditure thanks to the very positive labour market situation and statistical one-off effects the general government deficit will fall by more than 3 percentage points this year to about 1.3% of GDP. The debt-to-GDP ratio will also move towards 81% again.
- On account of the marked economic slowdown in 2012 the growth in revenues will, however, be curtailed and the deficit will not shrink further in 2012.
- The federal and *Länder* governments still have structural budget deficits. In light of the hitherto extraordinary increase in tax receipts combined with the simultaneously poorer economic outlook the austerity measures should be more ambitious – also given the role of budget policy of serving as a blueprint for Europe.
- The debt brake is already having an effect – but it requires more concrete application in practical fiscal policy to be more effective.
- For public-sector budgets there are a number of short-term risks arising from the debt crisis in Europe and the US (due to rising interest rates and payments under the terms of the bailout mechanisms). In the longer term demographic developments threaten to increase the strain on social security expenditure.

Total debt and deficit falling

In 2010 the general government deficit still came to 4.3% of GDP (eurozone: 6.2%) and debt rose to a new record level of more than 83% of GDP. The continued economic recovery this year and the (timid) consolidation (2010 austerity package, expiry of the stimulus programmes) will, however, have a positive impact on public-sector budgets.

In 2011 the financial balance will fall to around 1% (eurozone: 4.1%) and the debt level will move towards 81%. Significant statistical effects from the supplementary budgets are a major factor in both the deficit and the debt levels. These are the result especially of the assumption of liabilities in connection with the support for financial institutions (e.g. the Hypo Real Estate [HRE] bad bank). On the one hand, the previous year's deficit was revised upwards by 1 percentage point from 3.3% to 4.3% because of additional transfers of capital to the HRE bad bank. On the other hand, well over 10 percentage points of the current debt level can also be explained by the assistance measures for financial institutions.¹

In the past few years it has therefore become increasingly rare that the change in the debt-to-GDP ratio can be explained by financial balances. The financial balance has also been heavily influenced by the support measures. Overall, however, the effects will probably diminish as assets are liquidated – since the liabilities are set against risk assets (e.g. in the form of credit claims) that can be utilised gradually. Nevertheless, the state's guarantee acceptance within the framework of the European bailout mechanisms² could

Financial balance and debt ratio

As % of GDP

	2011	2012	2013
Financial balance	-1.3	-1.3	-1.0
Debt ratio	81.5	81.6	80.7

Source: DB Research

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¹ The original amount was nearly 13 percentage points, but it was reduced by more than 2 percentage points to over 10% of GDP due to the "accounting error" made public in October.

² This includes the EFSF and the ESM as well as the direct commitments to Greece. In the budget law more than EUR 233 bn of guarantees are set aside for these items. In addition there are guarantees to international funding institutions (e.g. the



certainly have a negative impact on the debt level and the deficit – albeit to an extent that is currently very difficult to define.

Tax receipts continue to grow

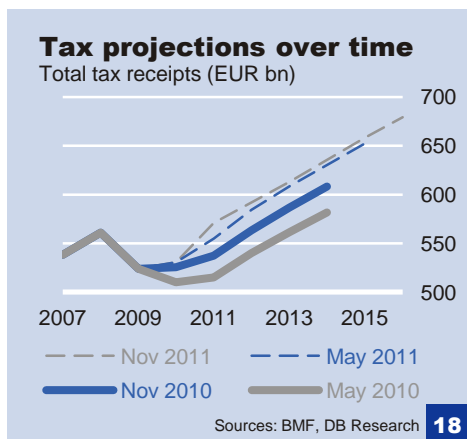
Of the improvement of more than 3 percentage points in the deficit in 2011 compared with 2010 around 1 point is attributable to the cyclical development and 2 points are of a structural nature (the latter is divided 50/50 between consolidation and the outlined statistical one-off effects). The 2011 budget thus has a fiscal tightening impact compared with 2010 (between 0.8 and 1 percentage point of GDP). The tightening effect should, however, dissipate further in 2012 as it is already foreseeable that the savings contained in the austerity package passed in June 2010 will not come into full effect. The marked weakening of the economy and the let-up in efforts to cut spending and/or taxes will probably result in the deficit in 2012 being similar to that in 2011. The structural deficit will only narrow by about half a percentage point.

The austerity package provided for spending cuts of nearly EUR 20 bn in 2012 and more than EUR 25 bn in 2013 compared with 2010. However, a series of measures contained therein are only partially incorporated in the financial framework or not at all. These include among other things the declining revenues from nuclear fuel rod tax as a result of the decision to abandon nuclear power, lower savings from the reform of the army (Bundeswehr) and income from a potential financial transaction tax. The sum total of all the differences in 2012 comes to over EUR 8 bn and thus nearly half of the originally planned EUR 20 bn. In 2011 the structural deficit will remain at around 1.5% of GDP.

The deficit will largely accrue at the federal government level and to a certain degree at the Länder level as a group. The municipalities as a whole are even heading for virtually a balanced budget and the social insurance schemes are set to report surpluses. There are, however, considerable differences in the financial situations of the individual municipalities and the Länder (besides cyclical problems a number of Länder and municipalities also have apparent major structural financial problems). The positive trend among the social insurance schemes is largely to be explained by the increase in contribution rates at the start of the year for unemployment insurance (+0.2 percentage points) and health insurance (+0.6 percentage points) as well as from rising revenues and falling expenditure due to the increase in employment. As things currently stand, however, these will be offset in 2012 by the reduction in pension contributions (-0.3 percentage points) as well as rising expenditure on long-term-care insurance (due to the expansion of benefits).

The above-mentioned favourable economic development to date is reflected mainly in government revenues and of course in tax receipts. Government revenues have risen by over 5% in 2011 and thus by more than at any time since the mid-1990s. At present the federal, Länder and municipal governments are benefiting from a sustained strong increase in tax receipts, with increases of well over 5% in both income tax and value added tax. Leaving aside the changes in tax legislation the tax receipts are still growing faster than the general economic indicators. In 2011 and thus two years earlier than was still being forecast in May 2010 total tax receipts

IMF) of theoretically a good EUR 60 bn. Together they are equivalent to roughly 12% of gross domestic product or total federal budget expenditure.



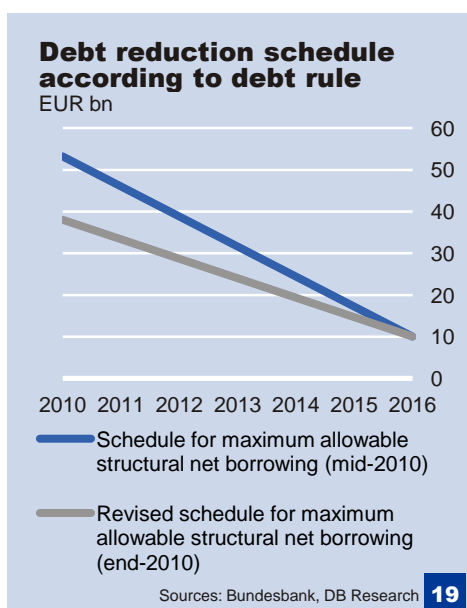
have thereby already reached their pre-crisis levels. To put it differently, the public sector will be able to record its highest ever tax receipts this year.

Tax revenues will, however, increase more slowly. According to the November tax projection, the state can expect an average increase in tax receipts of around 3.5% p.a. over the coming years. However, the growth forecasts made by the issuers of the tax projections (real growth 2012: 1%; real growth 2013: 1.6%) are more optimistic than ours. Besides the cyclical trend another source of dampening could be the modest income tax reduction (total volume of EUR 6 bn), which is planned for 2013/14 but has not yet been passed (by the Bundesrat). The Federation would shoulder the main burden to relieve the Länder.

Reduction in the structural deficit could be more ambitious

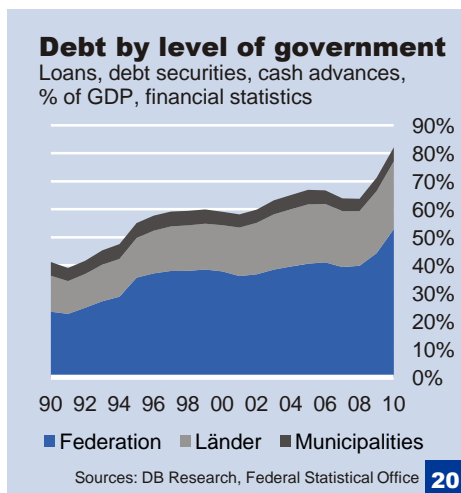
With a debt limit for the federal budget in force for the first time in 2011 the Federation's structural deficit is to be reduced during a transitional period in equal steps (reduction schedule) to a maximum of 0.35% of nominal GDP – this is equivalent to about EUR 10 bn at present – by 2016. The blanket ban on Länder taking on structural debt does not apply until 2020. Within the framework of stricter budget monitoring by the Stability Council, however, a number of Länder must already reduce their structural debt or in the case of severe distress (e.g. Bremen and Saarland) fundamentally reform their budgets on the basis of restructuring programmes.

According to these arrangements, in times of normal cyclical activity and across economic cycles the budgets are supposed to be nearly in equilibrium. In practice, the permissible level of new debt is calculated by factoring in a cyclical component, and adjustments are made for financial transactions³. Budget differences are to be posted to a control account and these debts are to be run down on the basis of a redemption plan.



The schedule for the reduction of the Federation's structural deficit up to 2016 was chosen to enable budget consolidation in a manner compatible with the business cycle. The base year for the calculation of the starting value of the structural deficit is 2010. During the drafting stage for the 2011 budget (mid-2010) this starting value was put at EUR 53 bn. By the end of 2010 (and thus still during the 2011 budget drafting phase), however, it emerged that instead of the estimated EUR 53 bn the structural deficit probably totalled less than EUR 40 bn. This remarkable improvement (the 2011 structural deficit might even further fall to somehow around EUR 30 bn.) is thanks to the unexpected growth surge and therefore to a significant part attributed to cyclical factors which – due to methodological problems to differentiate between cyclical and structural factors – were not pick up all in the calculated cyclical component but in the structural component. So the further reduction of the structural deficit in 2011 is to a significant part the result of windfall gains. Nonetheless, this starting value was not adjusted to the downside as called for by various parties (including, among others, the Bundesbank and the German Council of Economic Experts). Rather, it is now the basis for the reduction schedule up to 2016.

³ When doing so, the revenue side is adjusted for receipts from the disposal of capital stakes, loans redeemed and public-sector borrowings, and the expenditure side for the acquisition of capital stakes, loans disbursed and redemption payments to the public sector.



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While the higher designated starting value does not materially change the target for the debt ceiling level from 2016, the higher absolute starting value does influence the budget up to 2016 as a basis effect, suggesting to a certain degree that extensive consolidation moves are already afoot. As regards the targeted objective (EUR 10 bn), however, the reduction or change in structural new debt in 2012 and 2013 is not as pronounced as actually would have been necessary on the basis of a revised estimate. As a result, the consolidation pressure is increasingly shifted to subsequent years. Against the backdrop of the savings already provided for in the austerity package valid from 2013, this will not be an easy job for the next legislative period. True, related expenditure cuts have been factored in, but hitherto they are only of a global, unspecified nature.

While the federal government has factored in nearly EUR 49 bn as net borrowing in the draft budget for 2011, it looks as if the actual figure will fall far short of this value and presumably be more likely to total EUR 20-25 bn. But even the higher value of EUR 49 bn is less than the constitutionally permissible limit. This holds equally for 2012 and 2013, in which the readings are even set to undershoot the limit by far. But this is partly due to the simple fact that the non-revised reduction schedule is “easier” to meet. It is scarcely because the Federation’s consolidation efforts are extraordinarily successful. Taking the envisioned maximum allowable structural deficit of 0.35% of GDP as the yardstick today, the current budget exceeds this limit by more than one full percentage point.

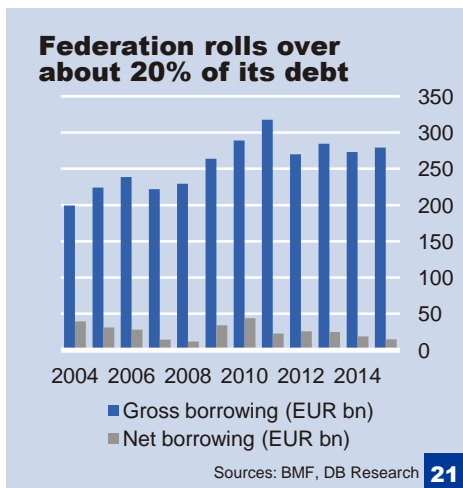
The steadily increasing debt burden in Germany has led to a tangible loss of scope for fiscal action – this is clearly visible in the wake of the financial and economic crisis. However, the debt brake is an effective way to stop this increase. Allowing a transition period up to 2016 was necessary solely for political and economic reasons, since otherwise the debt brake would never have been adopted by the current generation of policymakers.

Despite a host of weaknesses in its implementation (such as the calculation of the structural component, the complex methodology followed in the budget process in practice and latitude for fiscal manoeuvring) and no doubt the resultant need to more narrowly specify – if not correct – certain arrangements, the debt brake is already starting to make itself felt. Nevertheless, it would not have been a bad idea in the current situation to be more ambitious with consolidation efforts – especially as the model and the related policy are meant to serve as a blueprint for Europe.

Risks – the federal budget in detail

The still encouraging development of the public budgets outlined thus far is subject to a caveat: the ongoing process of debt crisis management in Europe and the United States, and thus a very dynamic environment. If the crisis increasingly spills over to the real economy, the revenue situation will deteriorate. Furthermore, in such an environment the guarantees undertaken could translate into sizeable burdens.

According to the Federation’s financial framework, its expenditures should increase by only about 1% p.a. on average over the coming four years in nominal terms, and thus in fact decline in real terms.⁴ However, nearly two-thirds of federal budget funds go towards social security and interest payments. The bulk of spending by far is on social security. The social expenditure ratio (social-security spending as a percentage of total expenditures) recently reached a new peak at just over 53%. Some 60% of all tax revenues will be earmarked for social-security purposes in the years ahead.



While interest expense is the second-largest cost item, that share of total expenditures recently hit a new low at close to 11%. This also holds for the ratio of interest expense to tax revenues at just over 14% of late (for the Länder and the municipalities it had fallen to merely 8.5% at the latest reading). There are two reasons for this – one is that interest rates for federal borrowing have recently fallen to historically low levels. The other is that at last count total expenditures had increased, these being the denominator of the ratio. This means that changes in interest rates are a budget risk that should not be underrated. As things stand today, a permanent one-percentage-point increase in interest rate levels would trigger an additional burden in the subsequent year totalling EUR 3 bn which would successively continue to grow. In the process, this would merely boost the total average interest burden on federal debt by roughly 0.2 of a percentage point. The average interest on federal debt has always fluctuated. In 2010, the average rate on federal debt was about 3.1%; back in 2002 it came to around 4.9%. Incidentally, the government’s financial framework anticipates a noticeable increase in interest payments.

On paper, therefore, the Federation is currently left with less than 20% of total tax revenues at its disposal for areas other than social security or debt service (interest payments). So these expenditures are a variable that can only be changed significantly over a long-term horizon. At this juncture it becomes eminently clear how important it is to limit the scale of new borrowing via the debt brake. For in view of the demographic trend it is precisely expenditures on social security that will confront the German (and the other European) budget(s) with major challenges.

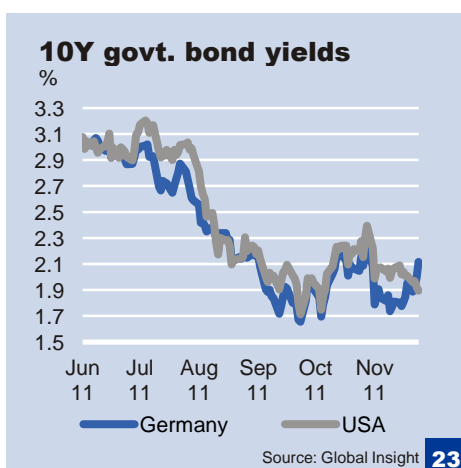
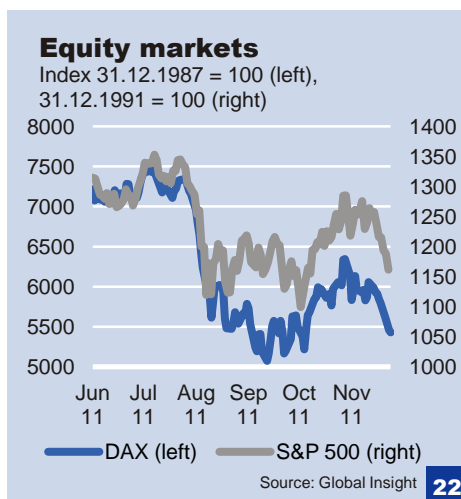
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⁴ Furthermore, scenario analyses show that if the three levels of government kept the total growth of spending constant at 1% and if tax revenues developed in line with the official estimate issued in November, the public sector could spend over EUR 10 bn more per year and nevertheless (on otherwise constant revenues) reduce the general government deficit to almost zero.



Will demographics push down stock prices in the long run?

- According to the life-cycle hypothesis, younger households build up savings during their working life and dissave to keep consumption stable in the lower-income retirement phase.
- This also means that younger households accumulate wealth, while older households sell assets.
- A recent report finds a strong correlation between stock market performance and demographic developments in the US, apparently confirming the life-cycle hypothesis.
- Therefore lower price-earnings ratios for the US stock market over a longer-term horizon seem possible.
- No correlation can be proven empirically between population structure and stock market performance in Germany.
- But due to the strong dependence on the US stock market, German equities are also likely to see P/E ratios fall on the back of an ageing US society.



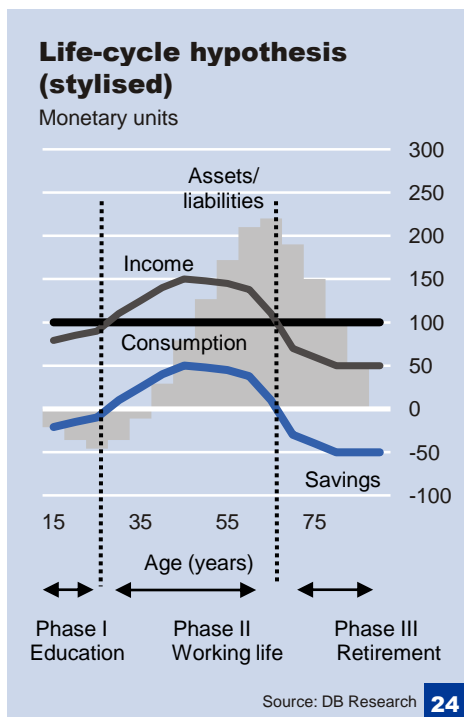
The economic slowdown, fears of a double-dip recession and rising uncertainty surrounding the sovereign debt crisis in the eurozone's peripheral countries have triggered a fall in stock prices in many industrial countries. Even extremely accommodative monetary policy at historically low interest rate levels as well as large-scale bond purchases by major central banks intended to push long-term yields down further and thus create incentives for investors to shift their funds into more risky assets have been unable to prevent the downward trend in equities. Since mid-July 2011, for instance, the DAX has at times lost over 30% and the S&P 500 more than 15%. Will we have to get used to such developments or at least to a downward trend, once the demographically-induced asset meltdown – discussed in many publications – sets in? A recent survey by the Federal Reserve Bank of San Francisco⁵, which a German newspaper over-dramatically translated into "Demographic shock in store for US stock prices"⁶, suggests that US equity markets are facing headwinds in the long run triggered by demographic changes. Will we really see a massive asset meltdown once the baby-boomer generations retire and sell off their equity portfolios, or is this fear exaggerated?⁷

Our report shows that for Germany - unlike the US – no empirical correlation can be found between population structure and stock market performance. Against this backdrop a demographically-induced asset meltdown does not seem on the cards automatically for the coming decades. This is supported by the fact that older households in Germany have the highest share of equities in their

⁵ Liu, Z. and Spiegel, M.M. (2011). Boomer Retirement: Headwinds for U.S. Equity Markets? FRBSF Economic Letter, 2001-26, August 22, 2011.

⁶ US-Aktien vor Demografieschock. Financial Times Deutschland, August 24, 2011.

⁷ See also Börsch-Supan, A., A. Ludwig, and J. Winter (2003). Ageing, the German rate of return and global capital markets. Deutsche Bank Research. Current Issues, December 4, 2003 and Poterba, J.M. (2001) Demographic structure and asset returns. The Review of Economics and Statistics, Vol. LXXXIII, No. 4, pp. 565-584. According to Börsch-Supan, the demographics-induced decline in returns is very limited as asset sales do not occur at the same time but over a prolonged period and the following generations are likely to save more as a result of markedly lower pension levels, which increases demand for investment products. Poterba points to the fact that it is difficult to prove the theoretically expected results in a robust relationship, which in his view could be attributable to the fact that the effects are too insignificant and are masked by other factors.

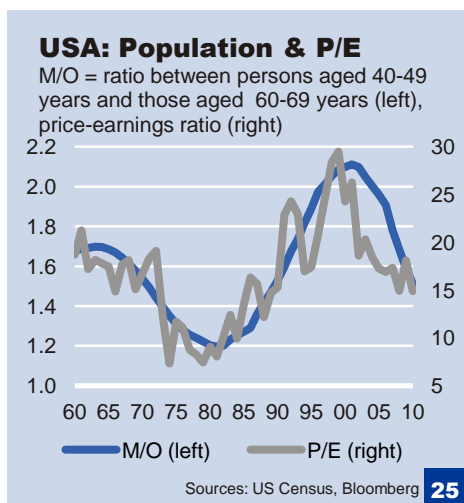


financial portfolios. It also suggests that older people do not sell equities to free up money for consumption but keep their stock holdings with a view to passing them on to their heirs or as a precautionary measure in case they live longer than expected. Equally, demand from abroad and higher individual demand on the part of the following generations are likely to limit potential stock price declines. However, one should bear in mind that as a result of the strong connection between equity market performance in the US and Germany there will likely be contagion effects in Germany in the event of a demographically-induced price decline in the US, even if national characteristics in Germany make a demographics-related asset meltdown improbable.

The theoretical background: The life-cycle hypothesis

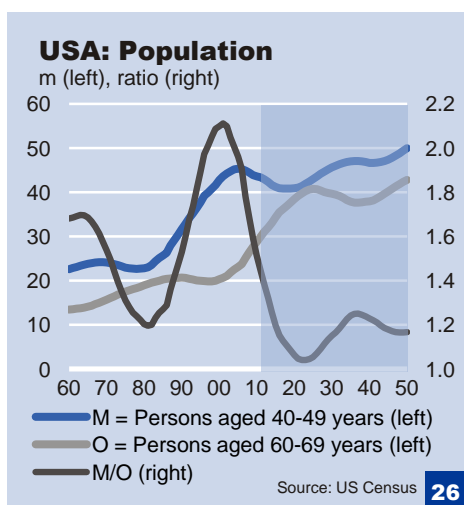
According to the life-cycle hypothesis developed in the 1950s by Ando und Modigliani⁸ households seek to maximise their utility from the consumption of goods and services across their entire lifetime. It follows that saving enables households to make consumption independent of their income distribution over time and thus enables them to maintain constant living standards throughout their life cycle. During their working life, people build up wealth before selling it off again in their retirement phase – characterised by lower incomes – to finance consumer purchases. This means that current consumption is postponed until a future date.

Age plays an important role in determining the structure of a household's investment portfolio. It can be assumed that older people are generally less inclined to invest in riskier asset classes than younger people as there is only limited time for the older generation to compensate for potential losses. Also, it is assumed that older people swap riskier assets for low-risk assets at an early stage, i.e. before retiring. Correspondingly, the population structure, i.e. the ratio of working households to retired households, plays an important part in the development of asset prices. If, in a society, there are just as many households building up wealth as there are retired households selling off their assets, demographic change would have no effect on asset prices. If there are more older people, however, demand for equities and thus stock prices would enter a downward trend. If a society has very big birth cohorts, such as the baby-boom generations, all of which will retire from working life within a short space of time and swap their equities for liquid and risk-free assets, the much feared asset meltdown could occur, according to the theory.

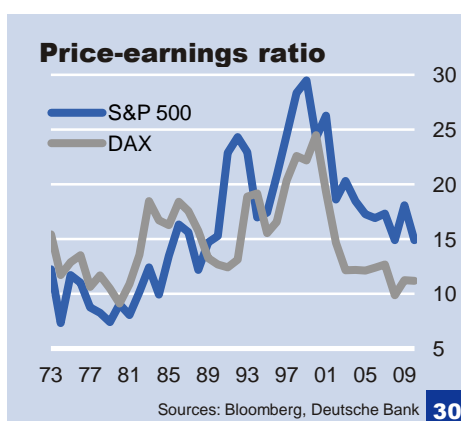
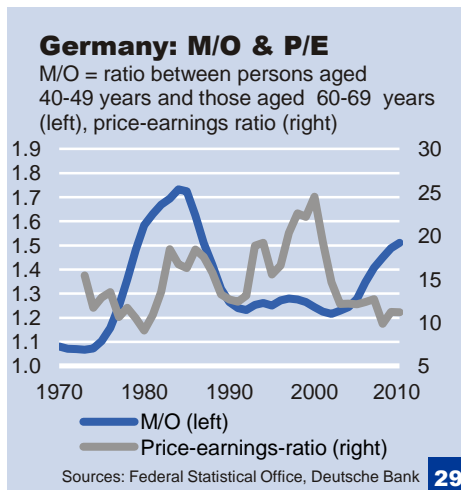
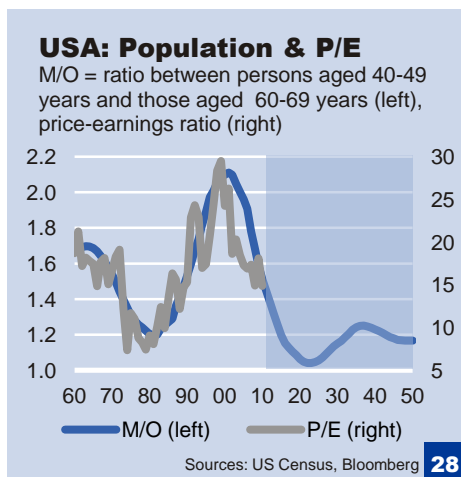
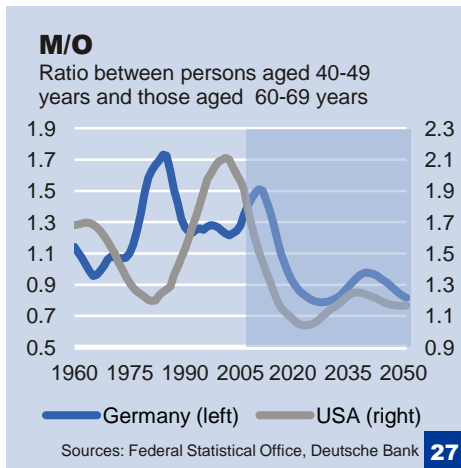


Baby-boomer generations & stock prices in the US: Strongly correlated

A look at both demographic developments in the US and equity market performance, measured by the S&P 500 P/E ratio, reveals a strong correlation between the two over the last five decades. To characterise the demographic development, the structure of the population, i.e. the ratio between those aged 40 to 49 (M) and those aged 60 to 69 (O), is examined.⁹ This makes sense for an economic analysis as these groups are likely to be the most relevant for the performance of stock markets – those aged 40 to 49 as regards buying equity, and those aged 60 to 69 and in the run-up to



⁸ Ando, A. & Modigliani, F. (1963), The "Life Cycle" Hypothesis of Saving: Aggregate Implications and Tests, in: *American Economic Review* 53 (1), pp. 55–84
⁹ See also Liu, Z. and Spiegel, M.M. (2011). Boomer Retirement: Headwinds for U.S. Equity Markets? FRBSF Economic Letter, 2001-26, August 22, 2011.



retirement as regards selling stocks. The ratio of these two groups initially fell from the 1960s to the mid-1980s, as the number in the 60 to 69 cohort had risen, while the group aged 40 to 49 virtually stagnated, which seems to be a reflection of the impact of World War II on population structures. From the mid-1980s to the early 2000s the strong baby-boomer generations, i.e. the cohorts born between 1946 and 1964, dominated. The M/O ratio had risen markedly in this period and peaked at the start of the year 2000. Since then, the ratio has been falling as the first baby-boomer cohorts turned sixty in the mid-2000s and are now growing into the group aged 60 to 69.

The P/E ratio of the S&P 500 moved more or less in line with the ratio between the demographic cohorts M and O, albeit with higher volatility. The correlation coefficient between the two is 0.82 for the period between 1960 and 2010. Some studies put the strong increase in the P/E ratio from 1980 to 2000 down to the fact that the strong baby-boomer generations had reached the main savings phase and thus invested in equities.¹⁰

Demographic headwinds for the S&P 500 in the long term

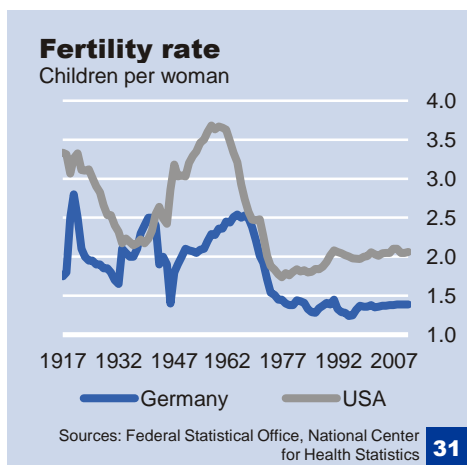
A comparison of the demographic M/O ratio with stock market performance in the US seems to confirm the theory that equity purchases and sales and thus stock prices are determined by the ratio between the relevant cohorts. If this actually is the case, the demographic outlook does not bode well for the stock markets. According to population projections by the US Census Bureau, the ratio between the group aged 40 to 49 and those aged 60 to 69 will fall by 2020 to a level unseen since the 1960s and then hover around this low level for a prolonged period of time. A similar development is expected in Germany, too. Correspondingly, the S&P 500 P/E ratio could decline from around 15 in 2010 to 5 in 2020, finding its footing at roughly 10 on a longer-term horizon. This would be clearly below the 1960 to 2010 average of slightly over 16 ½ and the peak of nearly 30 reached in mid-1999. Do we have to expect the same kind of trajectory also for the German stock index, the DAX?

DAX performance & demographic development: No correlation

In contrast to the US, there is no evidence of a clear correlation between Germany's population structure¹¹ and the DAX P/E ratio. For the period between 1973 and 2010 the correlation coefficient is -0.07, even suggesting an extremely weak negative correlation and contradicting the life-cycle hypothesis at least in Germany. While the DAX P/E ratio moved more or less in line with the S&P 500 P/E ratio the development of Germany's population structure differed considerably from that of the US, which can be attributed to the dramatic effects of WWII on the German population and the delayed increase in the fertility rate compared with the US. While the fertility

¹⁰ Vgl. Bakshi, G.S. and Z. Chen (1994). Baby Boom, Population Aging, and Capital Markets. *Journal of Business*, Vol. 67 (2), pp. 165-202.

¹¹ As in the case of the US, we used the numbers of those aged 40 to 49 and those aged 60 to 69, i.e. the M/O ratio. As the 60 to 69 cohort in Germany already includes many retirees and the cohorts examined do not depict the typically strongest savers or those entering retirement shortly, we also examined the correlation between the P/E ratio and the ratio of those aged 35 to 44 to those aged 55 to 64. For these two groups the correlation coefficient is even more strongly negative (-0.65).



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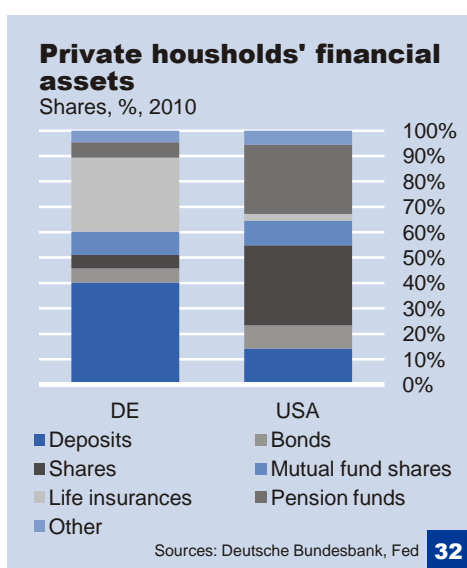
rate in the US had risen noticeably shortly after WWII – markedly exceeding 3 already in 1947 – the fertility rate in Germany only returned to reproduction level, i.e. an average of slightly over 2 children per woman of child-bearing age which ensures a stable population, in the early 1950s. Moreover, the rise in the fertility rate in Germany was much less pronounced than in the US. In Germany, the fertility rate peaked at just over 2.5 in 1964, while in the US almost 3.7 children were born to every woman of child-bearing age in 1959.

Investment behaviour markedly different

The fact that stock market performance and demographics were more clearly in line in the US than in Germany may also be due to differences in investment behaviour. Equity markets play a minor role in building up household wealth in Germany. This is reflected in the low share of directly held equities in households' total financial assets of only a good 5%, while the figure is nearly one-third in the US.¹² To be sure, the ratio of equity investment in Germany stood at 14.5% at the peak of the dotcom bubble in the spring of 2000. But this increase was almost entirely attributable to soaring stock prices and thus the overall value of equity holdings. Equities held by households rose by EUR 310 bn to EUR 480 bn between 1995 and end-1999. In the same period net equity purchases by households only came to EUR 33 bn, which means that nearly EUR 280 bn was thanks to an increase in value.

In light of the large share of German households' claims on insurance companies in their total financial assets (2010: just over 29%) one could assume that households tend to hold equity not directly but rather via indirect investment in the form of equity funds or life insurance policies. Of the investment funds worth EUR 431 bn (or over 9% of total financial assets) held at end-2010 only about one-third are equity funds. A look at insurance companies' stock of capital investments also reveals that, at 3.3%, the equity ratio is both declining (in 2006 it was still 8.8%) and relatively low. Hence, German households seem to attach little significance to equities as long-term investments to keep up living standards during retirement, so any demographically-induced sell-off will likely be very limited.

This assumption is supported by the fact that especially older people have the highest equity ratio in their financial assets, which seems to suggest that leaving an inheritance and safeguarding their own financial security are the main investment motives. According to a random sampling of income and consumption conducted in Germany in 2008, households in which the head of the household is between 70 and 80 years old have the second highest financial assets (an average EUR 62,700, outstripped only by the 55 to 65 age group with EUR 68,200 per household) and, at 13.7%, the highest equity ratio. On top of that, the equity ratio of the older age groups had even increased compared with the previous sample in 2003, which is most likely a reflection of the strong price gains in the stock markets from 2003 to 2008. The increase in the equity ratio, however, was disproportionately strong in the older age groups,



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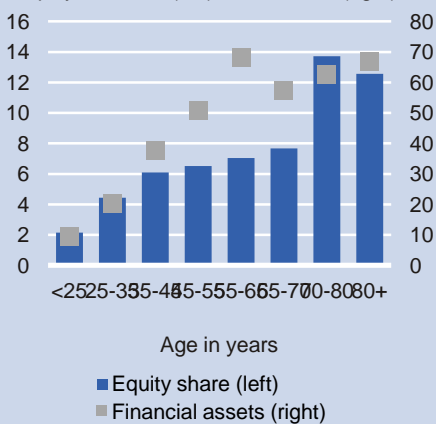
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¹² Germans' largely different investment behaviour is probably also due to the fact that the state's statutory pension scheme ensures greater financial security during retirement. Roughly 80% of a retired person's income still comes from the pay-as-you-go pension system. As a result, there are fewer incentives for German households than for Americans to accumulate wealth and add to it by means of riskier investments. While German households hold financial assets in the order of approx. 290% of disposable income, the figure is in excess of 430% for US households.



Germany: Age specific financial assets and equity shares

Equity share, % (left), 1,000 EUR (right)

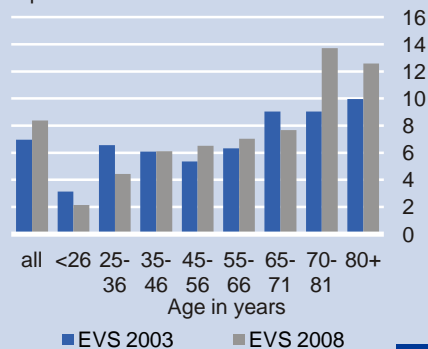


Source: Federal Statistical Office (EVS 2008)

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Germany: Equity share of private households

Equities as % of total financial assets



Source: Federal Statistical Office

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Pairwise Granger causality tests

Sample: 1972M12 2011M08

Lags: 3

Null hypothesis	Obs	F-Statistic	Prob.
DAX does not Granger Cause SP500	460	0.218	0.884
SP500 does not Granger Cause DAX		8.200	0.000

Source: DB Research

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while it was only small for the younger age groups or even declined for some cohorts.

No risk for Germany's stock markets then? Yes, there is!

Does this mean we are out of the woods as national characteristics are making a demographically induced asset meltdown look unlikely? Unfortunately, no. Germany's stock market performance is highly dependent on the US stock markets. Even at a short glance, the close correlation is obvious between the S&P P/E ratio and the DAX. The correlation coefficient between the two is 0.65 for the period 1973 until 2010 and even 0.8 for the time since German unification. In addition, a Granger causality test shows high statistical significance for the fact that US stock market performance determines performance in Germany. An explanation for the interdependence of two stock markets is the law of one price which implies that the same goods – in the case of a share the right to receive future profits - must have the same price - in this case the share price. The direction of the dependence is explained by the size of the US equity market. At the end of 2010, US stock markets (with a volume of USD 17,300 bn) accounted for nearly one-third of global stock market capitalisation, while the share of Deutsche Börse only came to slightly over 2 ½%. While the US stock market is able to absorb changes in smaller markets without major adjustments, this is hardly possible the other way round. Owing to institutional particularities, exchange rates and limited capital mobility, however, the levels of P/E ratios between countries may vary, but their movements should be roughly in line. We therefore expect the German P/E ratio to fall should the US ratio decline on demographic developments there. In economic terms this seems to make sense: owing to the German economy's high degree of openness, globalised financial markets and the size of the US stock market, Germany will probably not be able to decouple from this potential development.

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