Focus Germany

2% GDP growth in 2015 despite adverse employment policy

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GDP outlook: 2014 unchanged at 1 ½%, 2015 revised to 2%.

The details of the 0.4% qoq GDP increase released this week have not altered our GDP forecast of 1.5% for 2014. If anything, they have added to our suspicion that current surveys (corporate and consumer) might paint a too rosy picture. However, we see the growth composition now slightly more tilted towards domestic demand. We have turned somewhat more optimistic with regard to 2015, increasing our GDP forecast from 1.4% to 2.0%, which is again the result of somewhat more optimistic forecasts for private consumption and investment spending, but above all, we still expect a return to a sizeable growth contribution from net exports.

Slowdown in most vulnerable emerging markets not a risk to German export recovery.

German export growth is set to jump in line with the prospective recovery of the global economy, surging to about 6% in 2014 and rising further to roughly 7% in 2015. Thanks to robust demand at home and as a result of higher exports, imports are likely to increase by just over 6 ½% in 2014 and climb to slightly above 7% in 2015. Net exports will probably have a slight positive impact on GDP growth in 2014. In 2015, they should generate about 20% of GDP growth of 2%. This means that domestic demand should remain the main driver of growth. Risks in emerging markets have come to the fore again, partially due to potential vulnerability to Fed tapering. Should this group of countries – which we have identified on the basis of their high external financing requirements – slow down materially, this should not pose any danger to Germany's export recovery. These economies constitute a relatively small share of the world economy (4%) and have minor significance as German export destinations.

Temporary work: Success story with an uncertain outcome.

The planned measures constitute a reversal regarding the regulation of temporary employment. The aim is amongst others to limit the duration of a work assignment to 18 months. We consider this to be wrong, as it considerably reduces the employment opportunities of problem groups that have hitherto been the main beneficiaries of the Hartz reforms' deregulation of temporary work. We also regard the decision as wrong from a macroeconomic point of view. After all, temping has made a major contribution to making the labour market more flexible. This has formed the foundation for Germany's rise from being the "sick man of Europe" to an economic role model. The success story of temporary work to date therefore faces an uncertain dénouement.

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Euroland	-0.4	1.1	1.4	1.3	1.0	1.4	1.9	1.7	1.7	-3.1	-2.4	-2.0
Germany	0.4	1.5	2.0	1.5	1.2	1.5	7.3	7.3	7.1	0.0	0.1	0.1
France	0.3	1.0	1.6	1.0	1.3	1.2	-1.7	-1.5	-1.3	-4.1	-3.6	-3.1
Italy	-1.9	0.7	0.7	1.3	1.0	1.4	0.6	1.4	1.9	-3.0	-2.9	-2.9
Spain	-1.2	0.8	1.2	1.5	0.8	1.1	1.4	2.1	2.5	-6.6	-5.8	-4.5
Netherlands	-0.8	0.7	1.3	2.6	1.0	1.5	10.3	10.5	11.0	-3.9	-3.3	-3.0
Belgium	0.2	1.2	1.6	1.2	1.3	1.5	-2.5	-2.0	-1.0	-2.8	-2.7	-2.6
Austria	0.4	1.4	1.8	2.1	1.5	1.7	2.7	3.0	3.0	-2.1	-1.8	-1.6
Finland	-1.3	0.8	1.4	2.2	1.7	1.8	-1.3	-1.1	-0.8	-2.3	-2.1	-1.9
Greece	-4.3	0.8	2.0	-0.9	-0.6	0.2	-0.5	0.5	1.0	-13.5	-2.0	-1.0
Portugal	-1.4	0.8	0.9	0.4	0.6	1.0	0.0	1.0	1.5	-5.7	-4.5	-3.5
Ireland	0.2	1.8	2.2	0.5	0.8	1.1	5.0	4.5	4.0	-7.4	-4.9	-2.8
UK	1.8	2.7	2.0	2.6	1.8	1.7	-4.1	-3.5	-3.1	-6.1	-4.7	-4.1
Denmark	0.4	1.8	1.5	0.8	1.5	1.9	6.5	6.0	5.5	-1.5	-2.0	-2.5
Norway	0.8	2.5	2.7	2.1	2.0	2.1	12.0	11.5	11.2	11.0	10.5	10.0
Sweden	0.9	2.4	2.8	0.0	1.0	2.1	6.2	5.6	5.2	-1.5	-1.0	-0.5
Switzerland	2.0	2.1	2.0	-0.2	0.4	0.8	11.9	11.5	11.5	0.7	0.8	0.9
Czech Republic	-1.3	1.7	2.2	1.4	1.1	2.0	-0.6	-1.1	-2.5	-3.0	-2.7	-2.6
Hungary	1.0	1.8	2.0	1.7	1.5	2.7	2.2	2.0	1.5	-2.5	-2.9	-2.7
Poland	1.6	3.0	3.9	0.9	2.0	2.7	-1.5	-2.2	-1.9	-4.8	4.0	-3.1
United States	1.9	3.3	3.8	1.5	2.3	2.3	-2.7	-2.3	-2.4	-3.8	-3.2	-2.0
Japan	1.6	0.5	1.3	0.4	3.0	1.7	0.7	0.7	1.7	-9.1	-7.1	-5.6
World	2.8	3.7	3.9	3.2	3.8	3.7						

*Consumer price data for European countries based on harmonized price indices except for Germany. This can lead to discrepancies compared to other DB publications.
Sources: National Authorities, Deutsche Bank

Forecasts: German GDP growth by components, % qoq, annual data % yoy

						2013				2014			
	2011	2012	2013	2014F	2015F	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F
Real GDP	3.3	0.7	0.4	1.5	2.0	0.0	0.7	0.3	0.4	0.5	0.2	0.4	0.4
Private consumption	2.3	0.8	0.9	1.2	1.5	0.3	0.6	0.2	-0.1	0.4	0.4	0.5	0.5
Gov't expenditure	1.0	1.0	0.7	1.0	0.4	0.2	-0.4	1.2	0.0	0.2	0.2	0.2	0.2
Fixed investment	6.9	-2.1	-0.7	4.2	3.5	-1.4	1.2	1.3	1.4	1.4	0.9	1.0	0.9
Investment in M&E	5.8	-4.0	-2.4	5.2	5.1	-1.4	0.5	0.1	1.4	1.5	1.5	1.5	1.5
Construction	7.8	-1.4	0.1	4.5	2.8	-1.5	1.7	2.1	1.4	1.3	0.5	0.5	0.5
Inventories, pp	-0.1	-0.5	-0.1	-0.2	0.1	0.3	-0.1	0.0	-0.8	0.4	0.0	0.1	0.0
Exports	8.0	3.2	0.8	5.8	6.8	-1.0	2.4	0.2	2.6	0.9	1.4	1.2	1.5
Imports	7.4	1.4	0.9	6.5	7.1	-0.5	1.9	0.8	0.6	2.0	2.0	2.0	1.8
Net exports, pp	0.7	0.9	0.0	0.1	0.4	-0.3	0.3	-0.3	1.1	-0.4	-0.2	-0.3	-0.1
Consumer prices*	2.1	2.0	1.5	1.2	1.5	1.5	1.5	1.6	1.3	1.3	1.2	1.1	1.2
Unemployment rate, %	7.1	6.8	6.9	6.7	6.5	6.9	6.9	6.8	6.9	6.8	6.7	6.6	6.6
Industrial production	7.4	-0.5	0.0	4.1	3.0								
Budget balance, % GDP	-0.8	0.1	0.0	0.1	0.1								
Public debt, % GDP	80.0	81.0	79.4	76.9	74.2								
Balance on current account, % GDP	6.2	7.0	7.3	7.3	7.1								
Balance on current account, EUR bn	161	187	201	206	207								

*Inflation data for Germany based on national definition. This can lead to discrepancies to other DB publications.
Sources: Federal Statistical Office, German Bundesbank, Federal Employment Agency, Deutsche Bank Research

GDP outlook: 2014 unchanged at 1 ½%, 2015 revised to 2%

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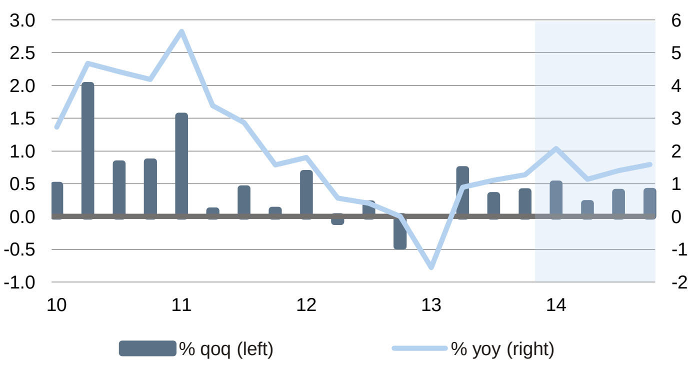
Q4 GDP driven by exports (+) and inventories (-)

The recovery in export orders during H2 2013 is reflected in a larger-than-expected increase in exports (2.6% qoq after 0.2% in Q3). Since import growth slowed further (0.6% after 0.8%) net exports contributed a whopping 1.1 percentage points to growth after a negative impact of 0.3 pp in Q3. This was largely offset by a decline in inventories, which dampened growth by 0.8 pp. Inventories are prone to revisions as further information about other demand components becomes available; moreover, the massive reduction is at odds with the inventory assessments in the ifo survey, where the balance between too high and too low has fallen in recent months. In line with weak retail sales but still somewhat surprisingly private consumption dropped 0.1% after a modest 0.2% increase in Q4.The mild winter weather might have reduced energy expenditures, but overall the sluggish trend still seems to support our cautious assessment of the German consumer, notwithstanding the continued increase in consumer confidence. Construction investment (1.4%) might also have marginally benefited from favourable weather conditions. Investment in machinery saw its first decent qoq increase (1.4%) after inching up marginally in Q2 and Q3, thereby ending its streak of a 6 quarterly declines.

Growth stabilised near potential rate in H2 2013 1

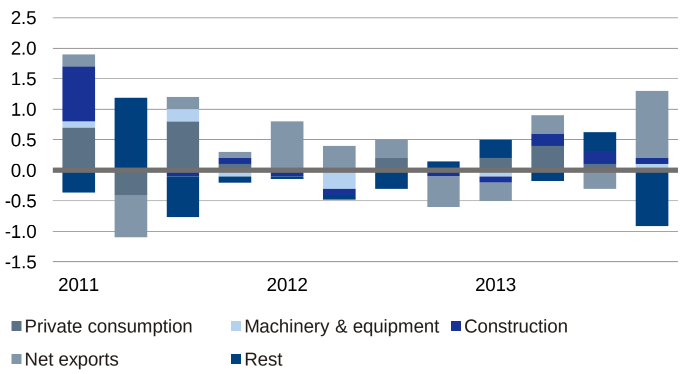
Real GDP growth; sa (left); nsa (right)



Sources: Federal Statistical Office, DB Research

No growth contribution from consumption in Q4 2

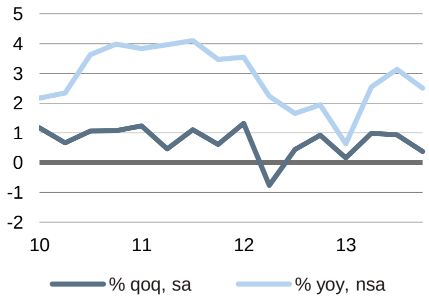
Growth contribution to real GDP growth, qoq, pp



Sources: Federal Statistical Office, DB Research

Disposable income with year-end weakness 3

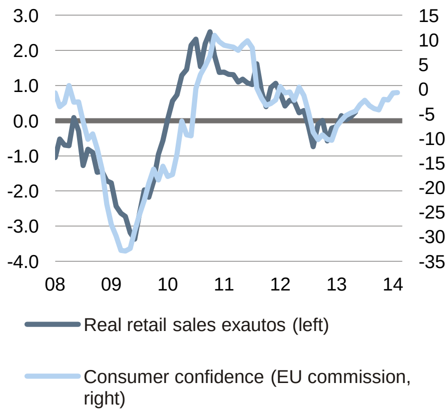
Disposable income of households, nominal



Source: Federal Statistical Office

Consumer confidence points to accelerating retail sales 4

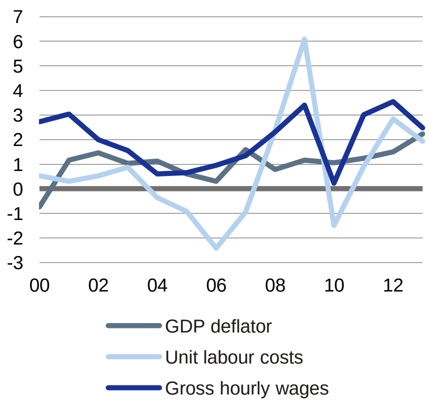
nsa, % yoy 12M moving average (centered, left), % (right)



Sources: Federal Statistical Office, EU Commission

Subdued price dynamics in 2013 5

% yoy



Source: Federal Statistical Office

Income growth has remained weak in 2013

Nominal disposable income expanded by 2.2% in 2013 (2.3% in 2012), but was less dynamic towards year-end. While net wages & salaries expanded by 2.8%, profits rose by 1.9%. Interestingly, gross wages and salaries per employee expanded by 2.2%, which leaves a real increase of ¾%, which is at odds with the Statistical Office's earlier report of a decline in German real wages in 2013 (which might ultimately be revised upwards). With the private consumption deflator remaining at 1.6%, the marginal higher increase in private consumption (0.9% after 0.8% in 2012) was financed by a drop in the savings ratio from 10.3% to 10.0%.

Subdued price trends – but no deflation

The increase in hourly gross wages slowed from 3.5% to 2.5%. As a result hourly unit labour costs growth fell to 2% (2.8%), despite slightly weaker productivity growth (0.3% after 0.5%). All in all, this paints a picture of very weak domestic price pressure, but does not show any imminent deflation risks. The GDP deflator even rose from 1.5% in 2012 to 2.2%. This is, however, the result of a substantial improvement in the terms of trade (1.4% after -0.4%). The deflator for final domestic uses remained unchanged at 1.7%.

Q1 GDP likely to be strong

All confidence surveys (ifo, composite PMI and consumer confidence) have continued their upward trend in Jan/Feb. While models based on these surveys have overestimated Q4 GDP growth by between ¼ and ½ percentage points, the further improvement should at least provide support for our view that GDP growth will accelerate to around ½%. There might be even some upside risk given the extremely mild weather in Q1 and extra shifts in the automobile sector. However, there will be some payback in Q2.

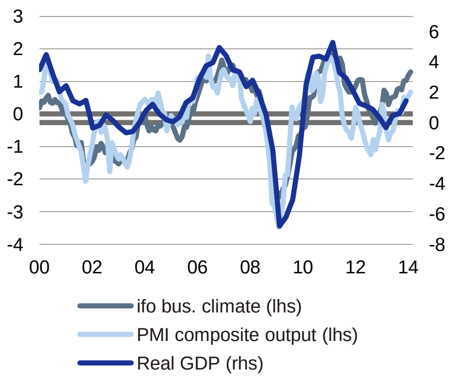
2014 GDP at 1.5% despite stronger private consumption

Given higher wage increases in sectors with strong cyclical positions such as the chemical sector and likely in the construction sector, income growth should be somewhat higher in 2014. Most importantly, the lower inflation rate – we have cut our CPI forecast for 2014 to 1.2% from 1.5% – will yield an increase in real disposable income of around 1 ¼ to 1 ½%, which should allow for a 1.2% rise in real private consumption. However, we no longer expect a noticeable growth contribution from net exports. While we increased our forecast for exports marginally, we now believe that higher private consumption and the strong reduction in import prices (deflator -1.8% in 2013) will add about ½ percentage point to our previous import forecast.

GDP growth for 2015 revised upwards to 2%

Domestic demand should continue to expand by between 1 ½% and 1 ¾% in 2015. Private consumption, should – driven by solid employment and wage growth – expand by around 1 ½%. In addition, the acceleration of global growth towards its trend rate during 2014 and beyond combined with a strengthening USD – our fx-team predicts a USD/EUR rate of 1.10 at the end of 2015 – should result in a further acceleration of exports, so that net-exports should add about ifo has overstated GDP growth lately 6

Germany; standardized values (lhs); % yoy (rhs)

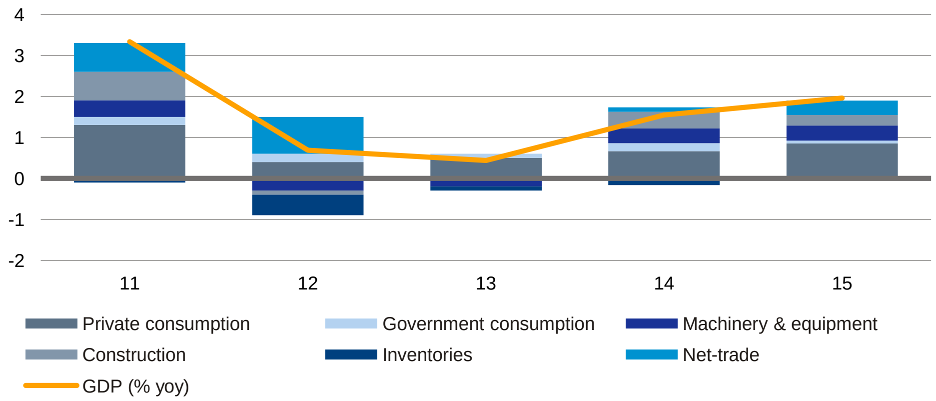


Sources: Federal Statistical Office, Markit, ifo, DB Research

0.4 percentage points to growth. All in all, GDP growth in 2015 will be well above its trend rate of 1 ¼%.

Consumption remains major growth pillar in 2014 & 2015 7

Contribution to real GDP growth, yoy, pp



Sources: Federal Statistical Office, Deutsche Bank Research

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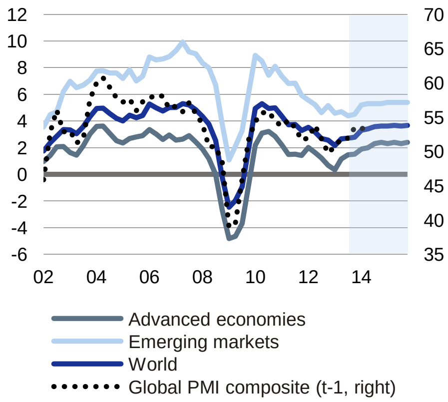
Global growth bottomed out in Q1 2013 | 1

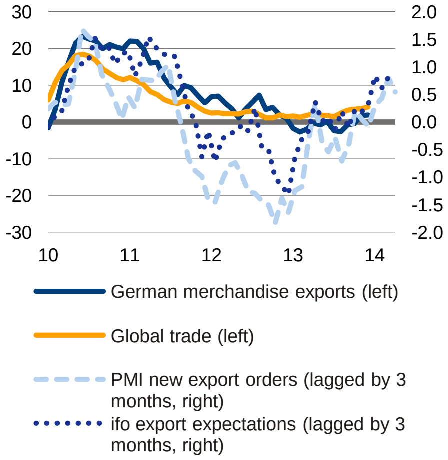
% yoy



Sources: IMF, Deutsche Bank Research

German exports should pick up in coming months | 2

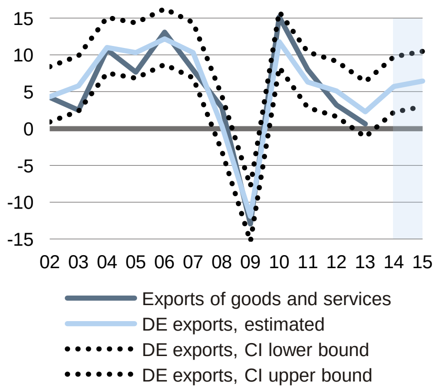
% 3M mov avg yoy (left),
Standardised values (right)



Sources: Deutsche Bundesbank, ifo, Markit, CPB, Deutsche Bank Research

Acceleration of the world economy pushing up German exports | 3

% yoy



CI: 90% confidence interval

Source: Deutsche Bank Research

Slowdown in most vulnerable emerging markets not a risk to German export recovery

— German export growth is set to jump in line with the prospective recovery of the global economy, surging to about 6% in 2014 and rising further to roughly 7% in 2015.

— Thanks to robust demand at home and as a result of higher exports, imports are likely to increase by just over 6 ½% in 2014 and climb to slightly above 7% in 2015.

— Net exports will probably have a slight positive impact on GDP growth in 2014. In 2015, they should generate about 20% of GDP growth of 2%. This means that domestic demand should remain the main driver of growth.

— Risks in emerging markets have come to the fore again, partially due to potential vulnerability to Fed tapering. Should this group of countries – which we have identified on the basis of their high external financing requirements – slow down materially, this should not pose any danger to Germany's export recovery. These economies constitute a relatively small share of the world economy (4%) and have minor significance as German export destinations.

The cooling of the global economy, and the further sluggish growth of the eurozone economy in particular, weighed on Germany's export growth in 2013. With the world economy having reached a cyclical low in Q1 2013, signs of a recovery started to appear. Nonetheless, exports expanded by only 0.8% in real terms on an annual average (after 3.2% in 2012). Sentiment indicators are pointing to a further recovery over the next few months. As the global economy is expected to accelerate towards its trend growth rate in the course of 2014, export trade is thus likely to gather steam. The emerging markets will probably remain the main growth driver in the world economy, and among the developed markets the US will probably stage the best performance. On the basis of the historical correlation between Germany's goods and services exports and economic growth in the developed and emerging markets as well as a competitiveness indicator[1] it is possible to forecast the growth of exports up to 2015 with the use of our respective forecasts for these variables.[2] So Germany's real export growth is set to accelerate to about 6% in 2014 and pick up further to roughly 7% in 2015.

Import growth driven by robust domestic demand and higher exports

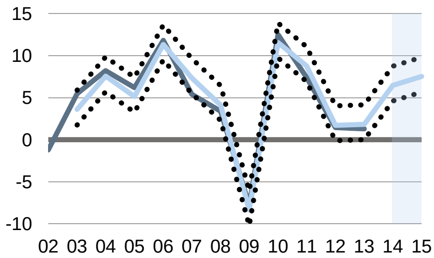
Real imports increased at a slower pace in 2013 (0.9%) as in the previous year. However, imports of goods and services were down in nominal terms. The import deflator has fallen by 1.9% especially due to the drop in commodity prices.

While the robust consumer demand at home ensured relatively stable demand for consumer goods from abroad, the import performance of intermediate goods and capital goods was below average owing to the still lacklustre growth of demand for capital goods and exports. Exports, in particular, have had an impact on the development of imports (bazaar economy) via the uptrend in the

[1] The ECB's harmonised competitiveness indicator was used as the yardstick for Germany's price and cost competitiveness. For details see ECB (2014), Statistics Pocket Book, February 2014, Table 11.6.

[2] See the table below for the regression results.

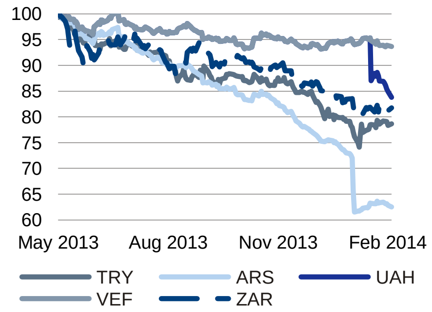
Pick up of imports due to solid domestic demand and acceleration of exports 4



CI: 90% confidence interval

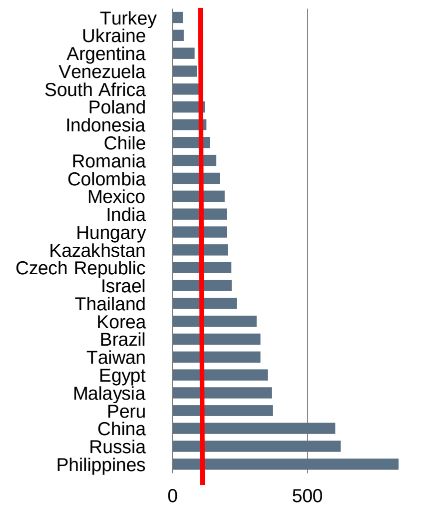
Source: Deutsche Bank Research

Marked exchange rate depreciation of vulnerable EMs vs. EUR 5



Sources: ECB, Deutsche Bank Research

EM reserve adequacy ratios 6



Source: Deutsche Bank Research

share of foreign value added registered since the mid-1990s. The foreign value-added share in German exports was just under 30% in 2009 (1995: 19%).

Taking the correlation between imports and a proxy for domestic demand for imports (the sum of private-sector consumption and investment), exports and a competitiveness indicator enables a good depiction of import development over time.[3] The import forecast is performed using the historical correlations and our forecasts for the variables used. It suggests that import growth will accelerate to just over 6 ½% in 2014 and to slightly above 7% in 2015.

Net exports likely to make noticeably positive contribution to growth again in 2015

Net exports are likely to have a slight positive impact on GDP growth in 2014 and make a positive contribution equalling roughly ½ of a percentage point in 2015. In 2013, net exports had a neutral impact on growth. This means that the key driver for our forecasts of 1.5% GDP growth in 2014 and 2.0% in 2015 is still domestic demand – just as it was in 2013.

Slowdown in most vulnerable emerging markets would have only minor impact on German exports

One risk to our forecast recovery of German exports is a weakening of economic growth in a few emerging markets. Following initial indications by then-Fed chairman Ben Bernanke in May 2013 – that the Fed might start tapering – there was a trend reversal in the international interest rate cycle. Several emerging markets were caught off guard by abrupt and massive capital outflows. This led to a relatively pronounced bout of currency depreciation. True, the situation eased temporarily thanks to the fact that the Fed initially remained committed to its quantitative easing programme. However, at its meeting in December it announced the beginning of tapering, lowering the volume of its monthly asset purchases by USD 10 bn in January and February, respectively, to USD 65 bn at present. In combination with country-specific problems this again stoked the volatility in some of the emerging markets. We do not expect to see a full-fledged crisis in the emerging markets. A few emerging economies – those with a small volume of foreign exchange reserves in particular – are currently in a difficult situation, though. Moreover, the emerging markets with pronounced political uncertainty, weak fundamentals and little reform zeal will probably continue to face major challenges.[4]

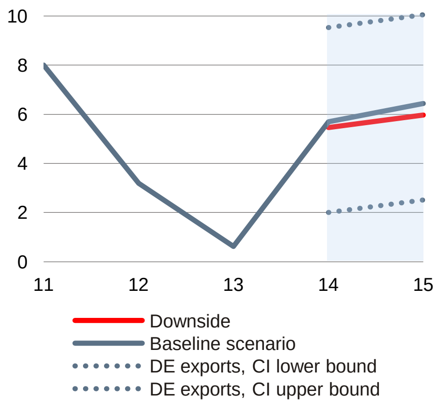
The countries potentially vulnerable to the risk of capital outflows are those whose foreign exchange reserves are smaller than the sum of their short-term foreign debt and current account deficits.[5] According to this indicator these countries are at present, Turkey, Ukraine, Argentina, Venezuela and South Africa (see chart 6).

In the following, we examine a downside scenario to see what a slowdown in the five most vulnerable emerging markets would mean for the German economy. It is assumed in this scenario that the currencies of the five countries

[3] See the table below for the regression results.
[4] See Canonero, G., Baig, T., Burgess, R. (2014). Vulnerabilities, Policy Inaction, and Stigma in the Recent EM Selloff. Deutsche Bank Research. Special Report. February 13, 2014.
[5] See Burgess, R. (2014). Turkey: CBT intervenes but reserves are too low to sustain this for long. Deutsche Bank Research. Data Flash. January 23, 2014.

Downside scenario for German exports 7

% yoy



Sources: Federal Statistical Office, Deutsche Bank

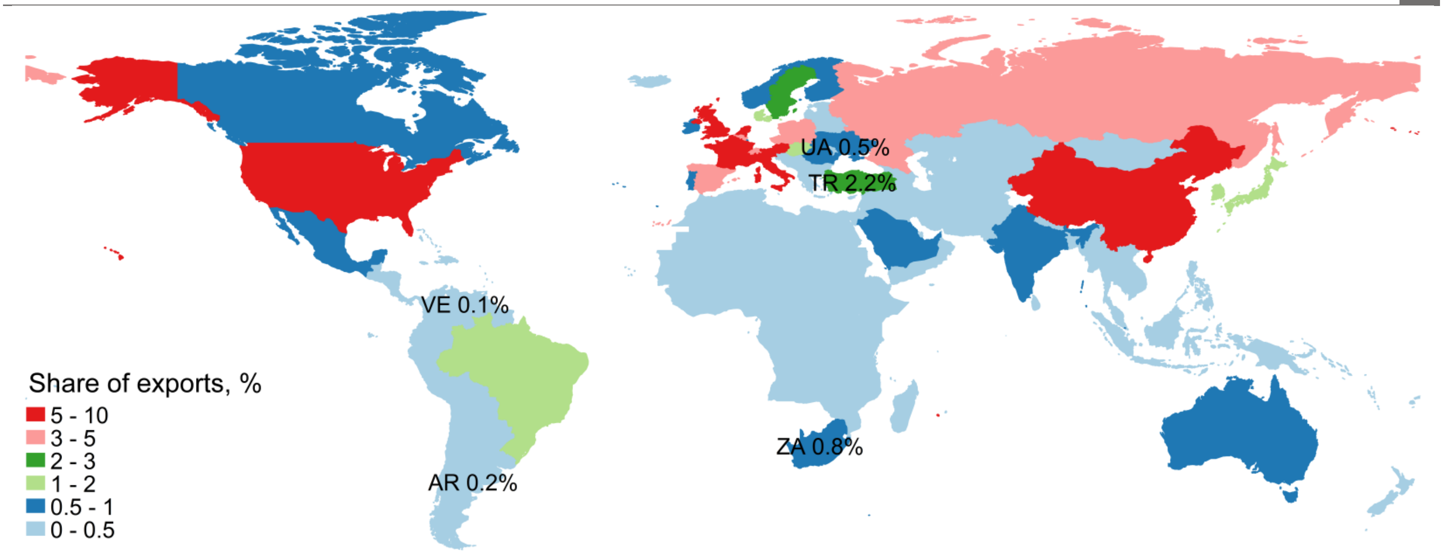
continue to depreciate and growth halves in comparison with our baseline scenario:

— We assume that the currencies of the five countries depreciate by 20% in 2014 and 2015, respectively. Since May 2013 these countries' currencies have depreciated by roughly this amount on a weighted average. Despite the relatively sharp depreciation the German competitiveness indicator falls only moderately, since the five countries' trade weight is relatively low.

— The share of the five most vulnerable emerging markets in global GDP is relatively minor at roughly 4%, so an assumed reduction by half of the growth rates[6] of these five countries would bring down the growth of the emerging markets as a whole by only about 0.1 of a percentage point in 2014 and 2015, respectively.

Germany's few trade ties with the five most vulnerable emerging markets and the relatively low importance of these economies for the global economy result in the fact that the assumed slowdown in these countries would have an only minor impact on the German economy in the observed downside scenario. The contribution of net exports to GDP growth would fall by 0.1 of a percentage point in 2014 and 0.2 of a point in 2015.

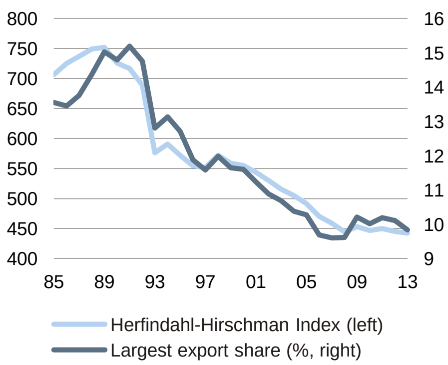
German exports by country 8



Sources: IMF, Deutsche Bank Research

German regional export diversification increased significantly 9

Herfindahl-Hirschman Index (left); % of total exports (right)



Sources: IMF, Deutsche Bank Research

A broad based weakness in emerging markets would have a more pronounced negative impact on German exports. A growth slowdown by 1 pp in emerging markets, for example, would lower German exports by about 0.9 pp.

German exports are relatively invulnerable to regionally limited demand slumps, and their vulnerability has fallen considerably since the early 1990s thanks to increased regional diversification among the target countries across the board. However, the vulnerability of the German economy to a global downswing has risen owing to a pronounced increase in its degree of openness: the export share in German GDP has doubled to over 50% since 1991. About 70% of German exports are going to advanced economies.

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6 In the baseline scenario the GDP-weighted growth rates for the five countries are around 1.0% in 2014 and 3.1% in 2015.

Regression results for German exports 10

Exports (real, goods and services)	Coef.	t	P>|t|
GDP growth			
Advanced economies ex Germany	3.03	6.39	0.00
Emerging markets	0.87	2.12	0.04
ECB real competitiveness indicator (lag 1Q)	-0.49	-2.76	0.01
Constant	-5.04	-2.36	0.02
R-squared		0.75	
Durbin-Watson statistic		1.89	
Observation period		Q1 2001 - Q4 2013	

Source: Deutsche Bank Research

Regression results for German imports 11

Imports (real, goods and services)	Coef.	t	P>|t|
Exports	0.43	10.15	0.00
Domestic import demand*	1.33	8.81	0.00
ECB real competitiveness indicator (lag 5Q)	0.26	2.52	0.02
Constant	1.58	3.42	0.00
R-squared		0.90	
Durbin-Watson statistic		1.85	
Observation period		Q1 2001 - Q4 2013	

* Private consumption + Investments
Source: Deutsche Bank Research

Temporary work:
Success story with an uncertain outcome

- The planned measures constitute a reversal regarding the regulation of temporary employment.
- We consider this to be wrong, as it considerably reduces the employment opportunities of problem groups that have hitherto been the main beneficiaries of the Hartz reforms' deregulation of temporary work.
- We also regard the decision as wrong from a macroeconomic point of view. After all, temping has made a major contribution to making the labour market more flexible. This has formed the foundation for Germany's rise from being the "sick man of Europe" to an economic role model.
- The success story of temporary work to date therefore faces an uncertain dénouement.

According to the coalition agreement between the CDU/CSU and the SPD precarious employment is to be more tightly regulated once again. This also applies to temporary employment, where the aim is to limit the duration of a work assignment to 18 months, with temporary workers to receive the same pay as permanent employees after 9 months at the latest. A permanent regular job is undoubtedly preferable to temporary work from an individual point of view. We nevertheless consider tighter regulation to be wrong, as it considerably reduces the employment opportunities of problem groups that have hitherto been the main beneficiaries of the Hartz reforms' deregulation of temporary work (or "temping"). The intention expressed in the coalition agreement to "open up new opportunities for the low-skilled and the long-term unemployed" will in our opinion be thwarted by the planned regulation.

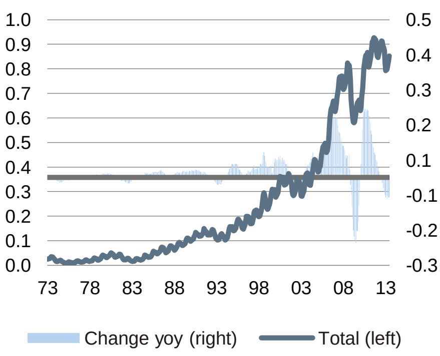
Tighter regulation of temping also contradicts the coalition agreement's opening declaration about the labour market, which states that the coalition parties "want to create the framework to enable the economy to be competitive, innovative and flexible in the global labour market". It is doubtful whether the planned regulation will promote "flexibility" and thereby boost the competitiveness of the economy. Accordingly, we also regard the decision as wrong from a macroeconomic point of view. After all, temping has made a major contribution to making the labour market more flexible. This has formed the foundation for Germany's rise from being the "sick man of Europe" to an economic role model. The success story of temporary work to date therefore faces an uncertain dénouement.

Temporary employment

Since 1972 temporary employment in Germany has been governed by the Employee Transfer Act (AÜG). It is characterised by a triangular relationship between the temporary worker (or temp), the temporary employment agency (or temp agency) and the hiring company. The temp agency pays the temporary worker and provides the hiring company with a worker for the purpose of performing a work assignment. The terms temporary work and employee transfer are used interchangeably. Whereas the first drafts of the Employee Transfer Act provided for strict regulation of this sector, from 1985 onward deregulation began to increase. Temporary work is supposed to be used mainly to cope with peaks in demand or staffing shortages. The intention was to manage cyclical fluctuations not by using overtime but by creating additional jobs, and that companies convert these initially temporary jobs into regular jobs at a later stage. Almost all temporary workers are obliged to pay social security contributions. Moreover, since 2012 a statutory minimum wage has been in force. It was last raised in January 2014, to EUR 8.50 per hour in west Germany and EUR 7.86 in east Germany. By 2016 it is supposed to rise to EUR 9 (west) and EUR 8.50 (east).

Temporary employment 1

Million



Source: Federal Employment Agency

Deregulation in the past …

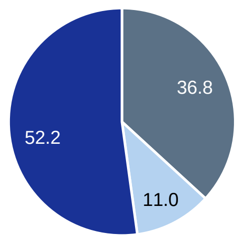
The planned regulatory measures constitute a reversal in the direction of temporary employment legislation, which has been gradually deregulated since 1985. The Hartz reforms represent the biggest milestone in the history of deregulation. As part of the Hartz I reforms the AÜG was comprehensively amended and its provisions were relaxed. As of January 1, 2003 the ban on fixed-term employment (without an objective reason a temporary employment contract could not be renewed), the ban on synchronisation (ban on temp agencies taking on temporary staff only for a single work assignment) and the rehiring ban (within 3 months of being dismissed a temporary worker may not be employed by the same temp agency) were all abolished. The then statutory maximum duration for temporary employment of 24 months was also rescinded.

… led to a real boom in temporary work …

As regulation receded the temping sector underwent a real boom in employment. Whereas in January 1992 the temping sector barely existed and had only around 120,000 employees, this total tripled in the following 10 years. Temping has also undergone remarkable growth since 2003. Since the implementation of the Hartz I provisions in January 2003 the number of employees tripled yet again to its peak of 927,000 in August 2011. Since then there has been a discernible decline. However, this is due more to a temporary cyclical downturn, especially as the number of employees remains high at around 850,000.[7]

Previous activity of temporary workers 2

December 2012, %



Source: Federal Employment Agency

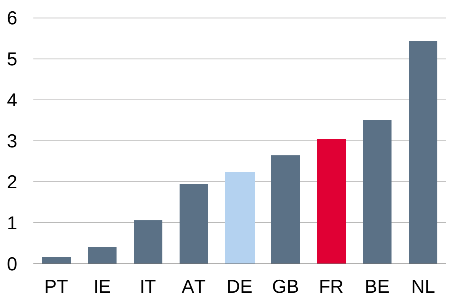
The most important reason why firms have made increased use of temps is the greater staffing flexibility, especially given the strict terms that apply to standard employment contracts. When the economic situation is uncertain companies are reluctant to take on additional staff or enter into long-term employment contracts. The other advantages of temp work for companies are the lighter administrative workload, lower hiring costs, the end of dismissal periods and labour law disputes and – where applicable – sick pay or compensatory salary. In addition, the pay is lower on average.

… with positive effects on problem groups …

Germany's transformation from being the "sick man of Europe" into a jobs miracle is due in no small part to the unparalleled growth in employment in the temping segment. Nearly one-fifth of the total increase in employment between 2003 and 2012 came in the temping segment, and this occurred although temporary workers only make up around 2 ¼% of the entire workforce. Higher rates can be found in the Netherlands (5.4%), Belgium (3.5%), France (3.1%) and the UK (2.7%), while the share in Austria is roughly the same as in Germany, and temping is negligible in Portugal and Ireland.

Temporary employment in Europe 3

Share of workforce, 2011, %



Source: Eurostat

Temporary work's intended impact of (re)integrating so-called risk groups into working life was also achieved. Over 52% of temporary workers were unemployed immediately before they started their temporary job and 11% never had a job before. Over 8% of temporary workers were previously long-term unemployed (longer than 1 year).

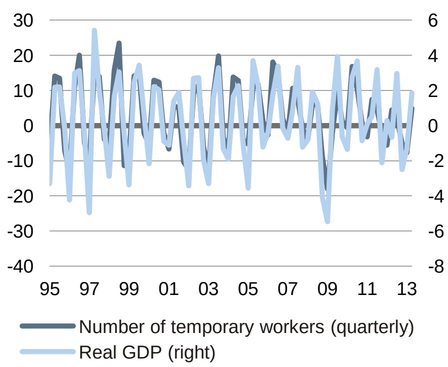
Also, a look at qualifications illustrates the particular structure of temping and the opportunities it provides for those groups that tend to be disadvantaged in the labour market. The educational structure in the temporary work segment differs significantly from the overall average. It is comparatively rare for workers in the temporary segment to have graduated from a technical college or a university (3% of temp workers compared with 13% of all workers obliged to pay social security contributions), whereas employees without vocational training are overrepresented (22% compared with 12%).

…but also led to heated debate about its impact

Temporary work provides many unemployed people with a good opportunity to re-enter the labour market or take their first steps in it. It is, however, also highly cyclical, which was also the intention when it was designed. Since companies have much stronger legal responsibilities towards their regular workforce, when order volumes rise they often start by using the opportunity to take on a temp. In turn, however, these employees are also dismissed more quickly as soon as the economic outlook deteriorates. In fact, GDP and temporary worker growth have been strongly correlated for several years. This shows that deregulation fulfilled

7 See also: Bundesagentur für Arbeit (2013). Zeitarbeit in Deutschland – Aktuelle Entwicklungen. Arbeitsmarktberichterstattung – July 2013.

Temporary employment & economic growth 4



Sources: Federal Employment Agency, Federal Statistical Office

the hopes of the reformers that companies would tackle cyclical fluctuations not by using overtime and its reduction, but by hiring additional workers. Whereas between 1980 and 1990 – a period that was marked by relatively strict regulation – the correlation was only 0.12, since 2003 GDP and temporary work growth have moved practically in step (correlation: 0.85). In addition, the relatively short duration of the temporary employment contract of less than 3 months in around 50% of cases together with the use of temps as stopgaps (for those on holiday or on maternity leave) indicates the key role that temporary employment plays in ironing out cyclical fluctuations and subsequently enables companies to deploy labour more efficiently. Workers, by contrast, frequently take a negative view of the highly cyclical nature of temporary work. For many workers job security is of primary importance[8]. Furthermore, critics bemoan the differences in pay, which see temps earning less on average than comparable permanent employees, as well as the less generous company benefits they receive. Overall, they say that temporary workers do worse than the regular workforce, which is what makes this employment model so precarious.

Nevertheless, the German Trade Union Confederation’s claim that temps only earn half as much as permanent employees is probably exaggerated. Joachim Möller, an IAB (Institute for Employment Research) employee, points out that temps on average are younger, often have no work experience, are more likely to have a work record that features interruptions and unemployment, that they often do unskilled or semi-skilled work and in 50% of cases the job lasts less than 3 months, which partially explains the difference in pay. He estimates that the difference in pay is closer to 20% rather than 50%.[9] An SOEP-based calculation made by Deutsche Bank Research arrives at a pay differential of around 30%.[10] The demands to harmonise pay accordingly are understandable, but they reduce the opportunities for unemployed people to use temporary work as a means of finding a permanent job.

In this connection we should also ask which alternatives are open to temporary workers. Of course a permanent job is preferable to a temporary position, but does this also hold for being unemployed? Psychologically speaking the stigma of unemployment alone is a considerable burden for many people.

The German Council of Economic Experts (Sachverständigenrat)[11] has also investigated the criticism of temporary employment. Overall, it comes to the conclusion that temping generally smoothes entry into the primary labour market and is “definitely… better than unemployment”.

50% of temporary work is the product of substitution

Economically speaking, the issue is to what extent temporary work acts as a launchpad to regular employment (bridge function), whether a temporary worker is taken on permanently by the firm that provided the temporary job (sticking function) and also to what degree new jobs are created with the aid of temporary work. The latter should not be underestimated by any means. An IAB report[12] comes to the conclusion that temporary work makes a major contribution to boosting employment, but that it has also displaced other forms of employment. According to IAB calculations around half of additional

[8] See Towers Watson (2012). Global Workforce Study. Ergebnisse für Deutschland 2012/2013. Geld, Karriere, Sicherheit? Was Mitarbeiter motiviert und in ihrem Unternehmen hält.
[9] See Jahn, E. (2011). Entlohnung in der Zeitarbeit. Auf die Mischung kommt es an. IAB-Forum 1/2011.
[10] See Peters, H. (2012). Pluralisation of forms of employment yielding positive effects on labour market. Current Issues. May 9, 2012. Deutsche Bank Research.
[11] See Sachverständigenrat (2011). Jahresgutachten 2011/12. Verantwortung für Europa wahrnehmen.
[12] See Jahn, E., Weber, E. (2013). Zeitarbeit. Zusätzliche Jobs, aber auch Verdrängung. IAB-Kurzbericht. 2/2013.

temporary employment comes from substitution effects. The remaining 50% creates additional jobs, however. This means that an increase in temporary workers of 200,000 – as occurred in 2011 for example – generates 100,000 new jobs. A report by the Institut zur Zukunft der Arbeit also comes to the conclusion that flexible forms of employment such as temping have often helped to boost employment as well as destroy regular employment. This is shown above all by the fact that the share of the workforce in full-time employment has indeed risen slightly since the reforms.[13]

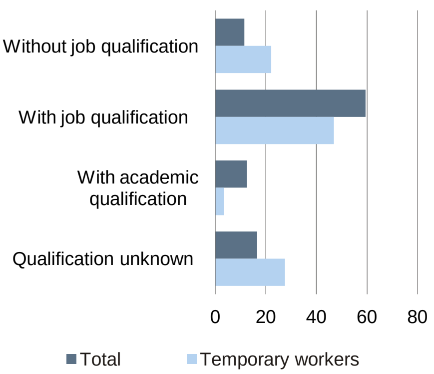
With regard to the bridge function, Möller[14] comes to the conclusion that around 7% of the previously unemployed who become temps are in employment two years after their temporary work assignment and are thus no longer temporary workers. He estimates that the sticking effect, i.e. the proportion of temporary workers who are subsequently employed directly by their temporary employer, ranges between 7% and 15%.

Temporary work effects also discernible in productivity growth

Temp work primarily benefits fringe groups that are often overrepresented among temporary workers. When firms select their permanent employees they assess the fit of applicants' qualifications, and the length of time that an applicant may have been unemployed is also a factor of no little insignificance. According to an IAB report[15], people who have been unemployed for longer than one year are taken into consideration as future members of staff by a mere 33% of companies. By contrast, 39% rule out the long-term unemployed from the application process from the very start and consider only candidates who have never been unemployed at all or only unemployed for a few months. The long-term unemployed generally have fewer opportunities to re-enter the job market, not least because their human capital declines while they are unemployed – in other words, they become less productive. If a company has the possibility to hire a long-term unemployed person – who is otherwise regarded as more disadvantaged – for a temporary position, this company is more prepared to consider the applicant since the person can be replaced more easily and more quickly than a permanent employee. The success of this form of employment is reflected in the development of labour productivity. Statistics show that the integration into the labour market especially of the low-skilled, as has occurred in the temporary work sector, has dampened the growth in labour productivity.

Employees by job qualification 5

March 2013, %



Source: Federal Employment Agency

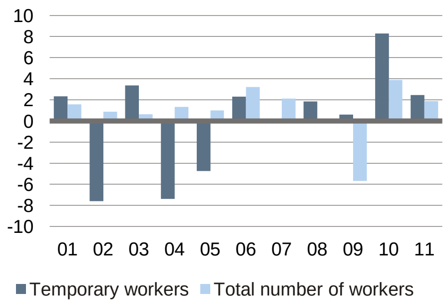
Significant shifts in the make-up of temporary workers

It is difficult to measure the labour productivity of temporary staff as they are paid by their agency but work in virtually every type of business. In recent years the areas where temps are employed have gravitated markedly away from the metals, electrical and chemical industries towards the auxiliary personnel and services segments. Whereas the latter had only constituted 55% of all temps combined in the year 2000, the share had risen to 63% by 2011[16]. Over the same period the temporary employee share in the metals, electrical and chemicals industries fell by 10 percentage points from 36% to around 26%. Workers in these industries should have enjoyed better training and also frequently deliver higher labour productivity due to the more complex nature of their work. Also, the labour market biographies of temporary employees have

[13] See Eichenhorst W., Tobsch V. (2014). Flexible Arbeitswelten. IZA Research Report No. 59.
[14] See Möller, J. (2011). Mythen der Arbeit. Leiharbeiter bekommen nur den halben Lohn – stimmt's? In: Spiegel Online. September 28, 2011.
[15] See Moertel, J., Rebien, M. (2013). Personalauswahl. Wie Langzeitarbeitslose bei den Betrieben ankommen. IAB-Kurzbericht. 9/2013.
[16] It is not possible to make a comparison with the figures for 2012 as changes in the data collection methodology led to interruptions in the time series from June 2011.

Germany: Productivity growth 6

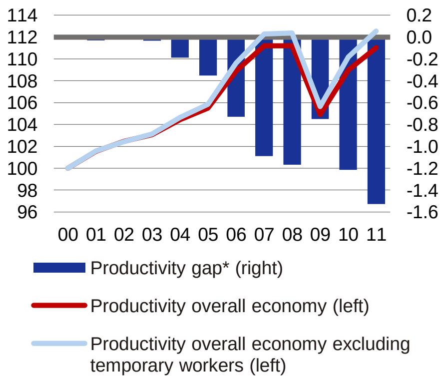
Real gross value added per employee, change % yoy



Source: Eurostat

Germany: Productivity growth 7

Real gross value added per employee, 2000 = 100 (left), percentage points (right)

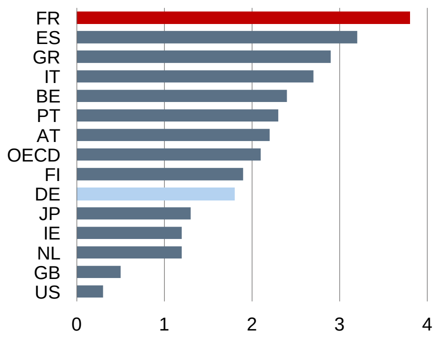


*) Productivity growth overall economy – Productivity growth excluding temporary workers

Source: Eurostat

OECD regulation index for temporary work 8

2013, scale 0-6



Source: OECD

changed over the years. Above all, the share of those who have never had a job before has increased. From December 2002, that is prior to the introduction of the Hartz reforms, until 2012 their share of all temporary workers rose from about 9% to 11%. This group should be expected to be less productive not least because of their lack of working experience.

Our approach of estimating the productivity of temps by dividing gross value added of temp agencies by the number of employees can thus at best provide a rough approximation. Moreover, this measure is suffering from a bias since temps might only work temporary within a "lending period". Our calculation is based on the assumption that the remuneration of the temp agencies reflects the productivity of the temporary employees. For our sectoral productivity calculation we have divided real gross value added by the number of employees. As the basis for the temporary employees sector we have used the economic segment N78 "Placement and hiring of labour". This also includes the placing of workers but the fact that temporary workers make up more than 95% of the employees in this segment makes them the dominant element. In 2011, for instance, out of the total of 921,000 workers in this sector 882,000 were temporary employees.

Productivity of temps only 50% of the average

In 2011 the real gross value added per employee and thus the productivity of the business segment "Placement and hiring of labour" came to just around 48% of the productivity in the economy as a whole. In addition, productivity in the temporary work segment was virtually flat between 2000 and 2011, while it grew by 11% in the economy as a whole. This suggests there has been extensive integration of low-skilled workers, which was also the intention with the creation of a low-wage sector and dampened macroeconomic productivity growth. Without the expansion of temporary work macroeconomic productivity would have grown by an additional 1.5 percentage points between 2000 and 2011. This productivity gap has largely opened up since 2003, when the Hartz reforms came into effect. Driven by the Hartz reforms, many unemployed people have found their way back into work. Since the previously unemployed are often less productive, their integration into the labour market does indeed boost employment, but it also weighs on productivity growth.

In contrast to Germany, France has seen its aggregate labour market productivity grow very uniformly, both including and excluding the hiring and placement of labour. In France the temporary employment sector has in many respects, however, already been heavily regimented for several decades and has the strictest regulation in Europe according to the OECD. While for example in Germany the equal pay principle can be circumvented by using individual contracts, it is implemented rigorously in France. Furthermore, temps there receive a so-called "precariousness bonus" equalling 10% of their pay as compensation for their lack of entitlement to holidays. Given these costs it appears plausible that after surging initially in the previous decade the number of temporary workers in France remained more or less flat at over 800,000, whereas overall employment increased by nearly 5.5%.

Conclusion: Success story could come to an end

If the coalition agreement proposals to regulate the temporary employment sector are implemented, this could considerably impair the positive employment growth. In the light of past experience companies will thus probably hire considerably fewer temps. The hardest hit will be the problem groups in the labour market (including the low-skilled and the long-term unemployed), and they will remain trapped in unemployment. We do not see the coalition's regulatory proposals opening up new opportunities for the long-term unemployed. This means there is a danger that the “temporary employment” success story in Germany will come to an end.

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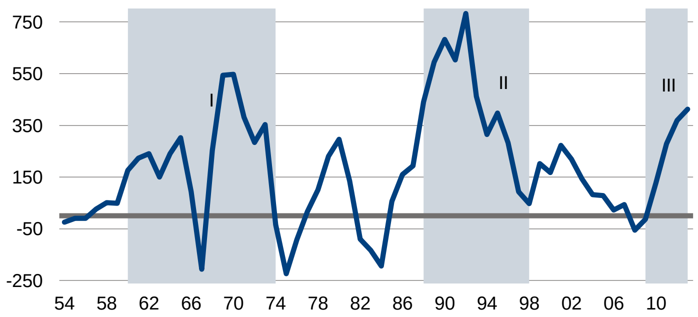
Chart of the month

Net immigration 2013 at highest level since 1993

'000 persons (2013 - projection)

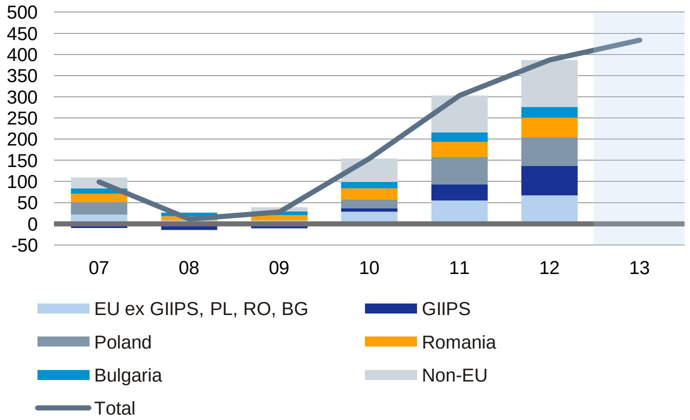


I: Recruitment of guest workers, II: Immigration from Eastern Europe after the fall of the Iron Curtain (especially ehtnic Germans from Eastern Europe and the former Soviet States), III: Increased net immigration due to the eurozone crisis and the opening up of the German labour market to workers from Eastern Europe

Sources: Federal Statistical Office, Deutsche Bank Research

Significant increase in net immigration especially from Eastern Europe and GIIPS since 2010

Thousand persons



Sources: Federal Statistical Office, Deutsche Bank Research

Highest net immigration since the start of the 1990s

As in the two preceding years, net immigration to Germany probably rose markedly in 2013 and is estimated to have reached its highest level since 1993 at more than 400,000 persons.

For a large part this is due to the strong increase in immigration from Eastern Europe and the countries of Europe's periphery triggered by Germany's thriving labour market.

Net immigration from Eastern Europe, particularly Poland, Romania and Bulgaria, rose from just over 20,000 persons in 2009 to approx. 140,000 persons in 2012 – caused above all by better earnings prospects in Germany and tight labour markets in other European countries. Wage levels in the immigrants' home countries are markedly lower than in Germany (2013: Bulgaria 16%, Romania 22%, Poland 31%). Germany's labour market was opened up to Polish nationals already in 2011 – as well as to workers from seven other eastern European countries which had joined the EU in 2004. From 2014 on Bulgaria and Romania, which joined the EU in 2007, also enjoy full labour mobility. However, the facts do not support the negative perception often voiced in public debate that immigrants from these countries are poorly qualified, crowd out local workers as a result of wage dumping and exploit Germany's social security system. The immigrants are skilled workers and better integrated into the labour market than other nationals. Moreover, they are relatively young, which has a positive effect on Germany's pension system.[17]

Since the start of the global economic and financial crisis and the subsequent euro-area crisis the situation in the peripheral countries' labour markets has deteriorated dramatically. As a result of the catastrophic situation in some of the countries the level of net immigration to Germany has risen markedly, but with net immigration of roughly 70,000 persons from the GIIPS countries in 2012, it is still at a relatively low level given the 11.7 million unemployed in these countries.

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[17] See Brücker et al. (2013). Arbeitsmigration oder Armutsmigration? IAB-Kurzbericht 16/2013 and Statistisches Bundesamt (2014). Zuwanderung aus Bulgarien und Rumänien: Hohe Akademikerquote. Destatis im Fokus.

Besides higher labour participation rates, the strong increase in net immigration to Germany was one of the main reasons why employment reached a record high of 41.8 million persons in 2013 (an increase of 232,000 persons) and unemployment also rose by 53,000 to 2.95 million persons. These figures reveal budding problems of mismatches regarding regions and qualifications.

We expect net immigration to remain at a high level over the next few years. Germany's buoyant business activity will probably lead to a further increase in the demand for labour, and the increase in employment witnessed since 2010 is likely to continue to outstrip the development of unemployment.

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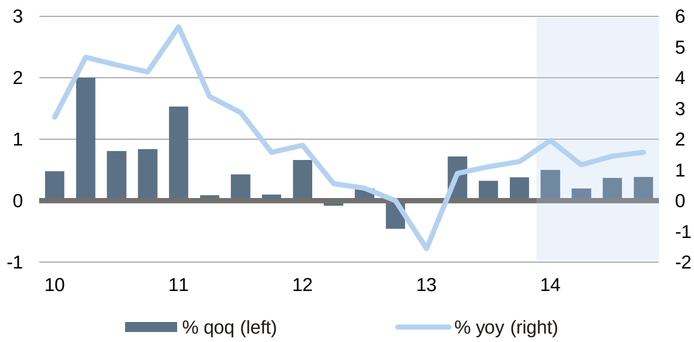
Chartbook

Real GDP growth



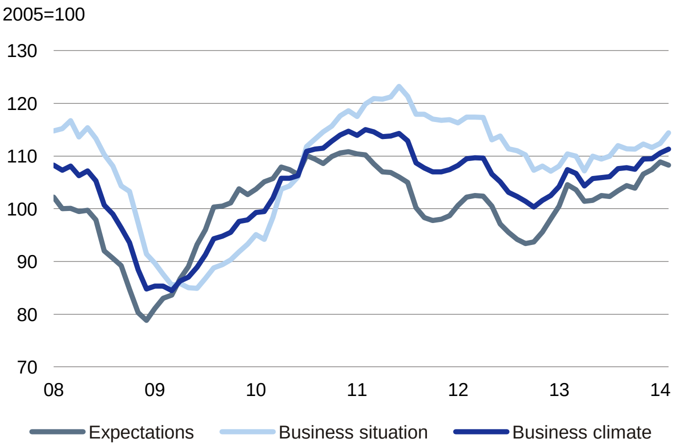
Sources: Federal Statistical Office, Deutsche Bank Research

— German real GDP grew by 0.4% in 2013. The slow-down compared to 2012 (0.7%) is due to the weak winter-half 2012/2013. In Q3 (+0.3%) and Q4 2013 (+0.4%) growth hovered somewhat above potential of a good ¼% qoq.

— In Q4 net exports were the main growth driver (adding 1.1pp). Investments contributed little and consumption not at all. Inventories weighed strongly on Q4 growth, but this revision-prone number has to be interpreted with caution. The weakness in final domestic demand should not mark a reversal of its upward trend.

— Thanks to average quarterly growth of 0.4% qoq GDP should expand by 1.5% in 2014.

Ifo index - total economy



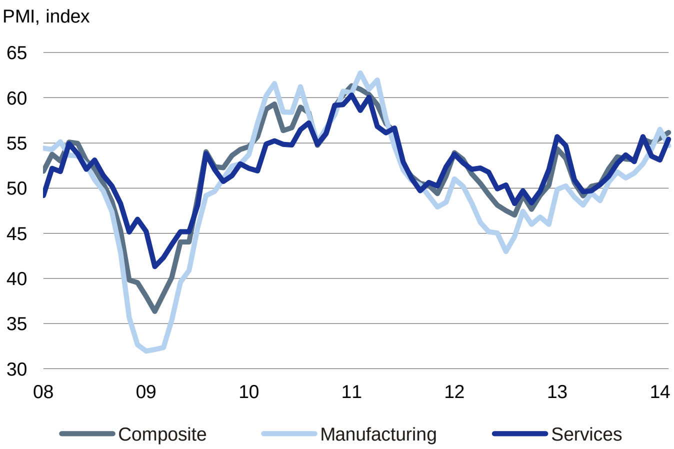
Source: ifo

— The ifo index rose further in February and is at a 30-months high. Business expectations moderated after three strong increases before, which should at least partly be explained by recent (likely temporary) weakness in China and the US. In contrast, the assessment of the current situation was markedly up.

— In manufacturing and retailing the business climate improved thanks to much better business situation. In the construction sector and wholesaling the business climate fell.

— The ongoing strength of businesses' assessment of their current situation suggests that the German economy started well into 2014. The ifo points to around 1% qoq GDP growth in Q1, but it tended to strongly overstate growth lately. We expect 0.5% qoq growth.

Purchasing manager index



Source: Markit

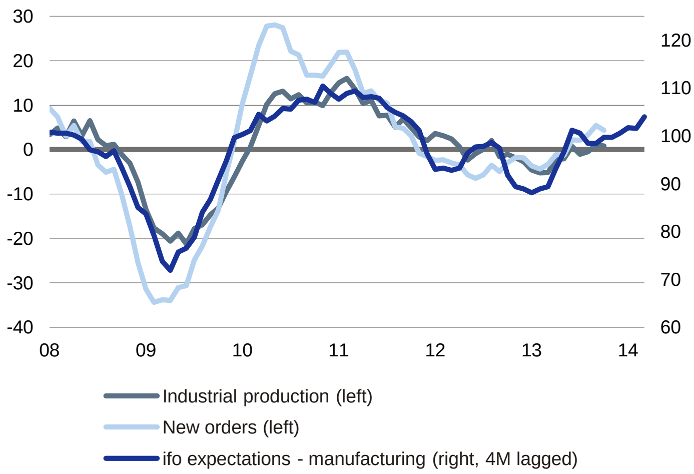
— The composite PMI like the ifo rose in February and stands at a 32-months high. The manufacturing PMI fell (54.7 vs 56.5 prev.) after strong gains in the previous three months. In contrast, the services PMI jumped (55.4 vs 53.1) making up for the losses in Dec. and Jan. Both indices are well in expansionary territory.

— According to the PMI survey the industry experienced a slowdown in production growth (57.6 vs 60.4), order intake (57.2 vs 59.7) and employment dynamics (50.0 vs 53.1).

— In the services sector the order intake (52.6 vs 50.1), expectations (62.7 vs 59.9) and employment (54.2 vs 51.5) rose strongly.

Industrial production, new orders and ifo expectations

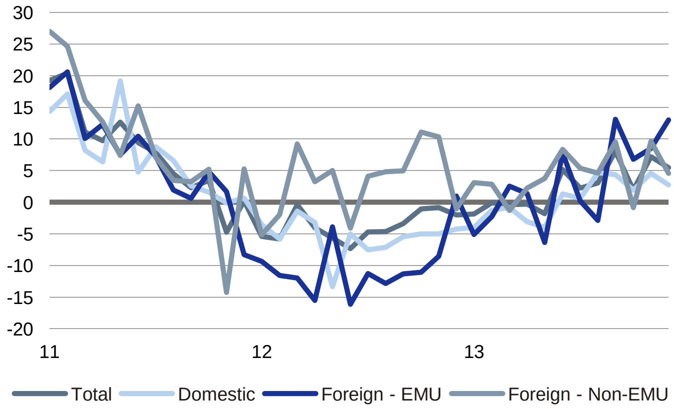
% yoy, 3M moving average (left); 2005=100 (right)



Sources: Federal Statistical Office, ifo

New manufacturing orders

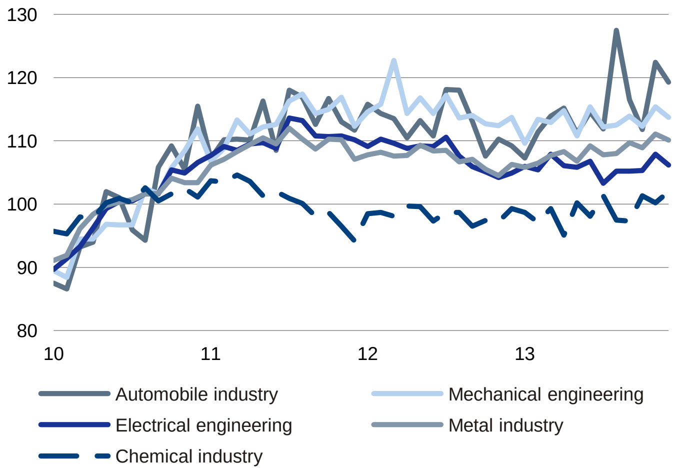
% yoy



Source: Federal Statistical Office

Production of largest industrial sectors

2010=100, sa



Source: Federal Statistical Office

— Over the course of 2013 the industry increasingly benefitted from the recovery of the global economy. Thanks to big ticket orders the order intake was up by nearly 5% yoy in November (3M moving average). The production recovery has been less pronounced (+2.1%) as of yet. Both – ifo and the PMI – as well as the increasing gap between orders and production point to a further output acceleration.

— Declining by 0.6% mom production ended the year on a weak note. On average Q4 still showed a small plus (0.2%), though. In addition, bridging day effects have played a role in December. This is reflected in the manufacturing sectors production decline (-0.5%). The decrease in energy output (-2.6%) and the increase in construction (+0.5%) are signs of the diverging effects of the mild winter weather.

— Like industrial production new orders weakened at year-end (Dec.: -0.5% mom). The underlying dynamic remained positive, though. Core orders (ex. big ticket items like air planes) rose 0.5%. The volatile “other transport equipment” orders fell by over 13%. In Q4 total orders rose a solid 1.2%.

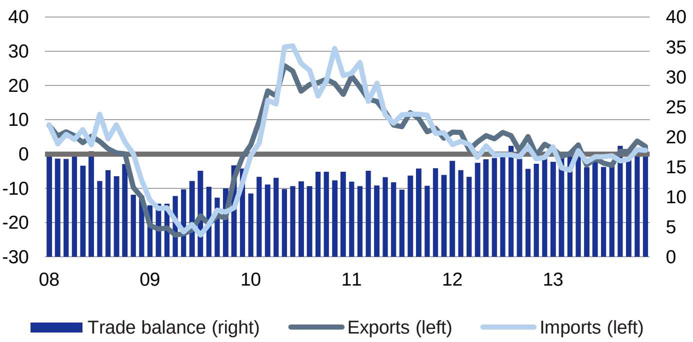
— Orders have improved across regions. Especially orders from EMU countries (+9.5% yoy, 3M moving average) have risen well above last year’s levels – a sign of the cyclical stabilization. The order increase from other foreign countries stood at 4.3%. Domestic orders (+2.7%) remained relatively weak.

— Domestic production of the early-cycle German industries has trended upwards in the last few months despite strong volatility. The automotive industry, in particular, has exhibited noticeable fluctuations (delay of vacation shutdowns).

— Against the backdrop of stronger overall growth, we expect an upward trend production during 2014. We project the automotive industry to experience the strongest production increase (+5% in real terms). This development is mainly driven by auto demand in Western Europe. Similarly, mechanical engineering (+4%) and electrical engineering (+3.5%) are likely to benefit from the favourable economic environment. As an important supplier for the production of investment goods, the metal industry (+4%) should benefit, too. The chemicals industry, in turn, will probably grow by “only” 3% in 2014.

Merchandise trade

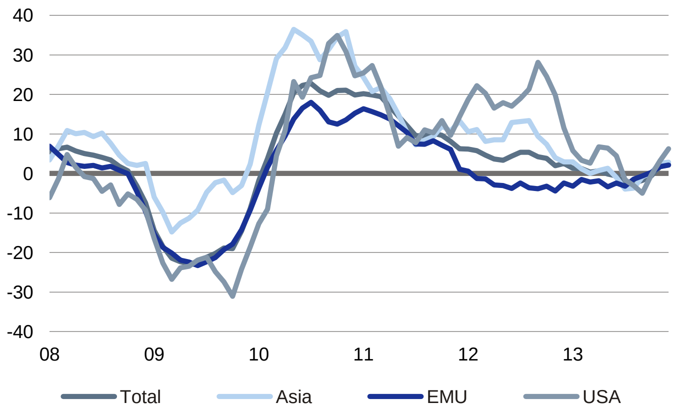
% yoy (left), EUR bn (right)



Source: Deutsche Bundesbank

German merchandise exports by destination

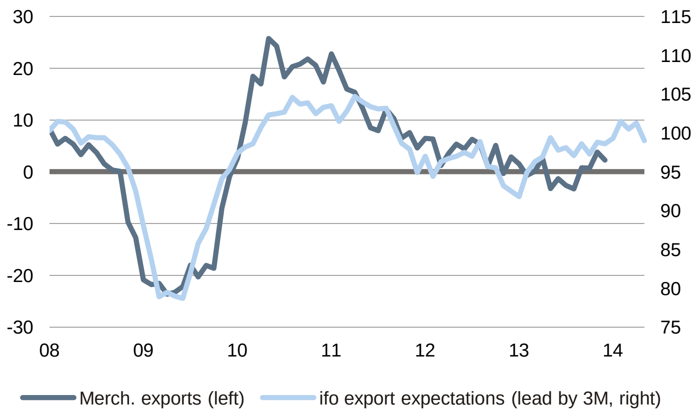
Merchandise exports, % yoy, 3M moving average



Source: Deutsche Bundesbank

Exports & ifo export expectations

% yoy (left), index (right)



Sources: Deutsche Bundesbank, ifo

— The year-end weakness of monthly activity indicators also showed up in German trade data. Goods exports fell by 1.0% mom and imports by 1.4%. Thus, the trade balance surplus rose slightly to EUR 18.1 bn from EUR 18.0 bn. The weak (nominal) import demand in Nov./Dec. is probably related to low oil prices and low demand for e.g. heating fuel (thanks to mild weather).

— Due to the weak December the yoy-comparison moderated again. In total, the foreign trade dynamic remains weak. Exports were up a good 2% yoy and imports by 1%. The improvement in the last few months was supported by a base effect as im- and exports fell strongly at the end of 2012.

— In 2013 goods exports fell by 0.2% (2012: +3.2%) and imports by 1.1% (+0.4%). The trade balance surplus rose from EUR 190 bn to EUR 198 bn.

— Rising foreign orders and the general optimistic assessments of external demand in ifo/PMI show that the strengthening of the global economy will make itself increasingly felt in German exports.

— The export recovery is supported by demand from all major export destinations. Even exports to EMU added to the recovery after having shrunken for nearly two years.

— Since the start of the euro crisis the share of EMU exports in total German exports has fallen by nearly 10pp to around 37% lately (Asia 16% and the US 8%).

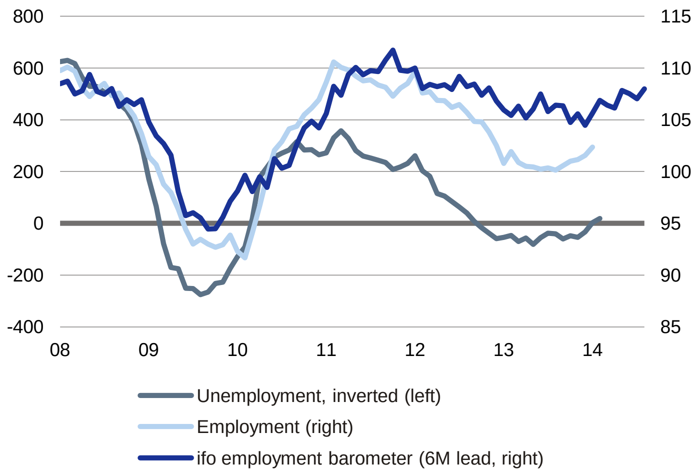
— In February ifo export expectations fell markedly after having followed an upward trend before. This should be related to the (probably temporary) weakness in the US (weather) and in China (new year's festivities) and thus not mark a trend reversal.

— Despite their February decline ifo expectations still point to accelerating exports in the coming months. In addition, new export orders according to the PMI also support an improvement in the months ahead, notwithstanding their blip in February.

— German imports should improve, too given decent real income increases for households as well as rising demand for intermediate goods.

Unemployment, employment and ifo employment barometer

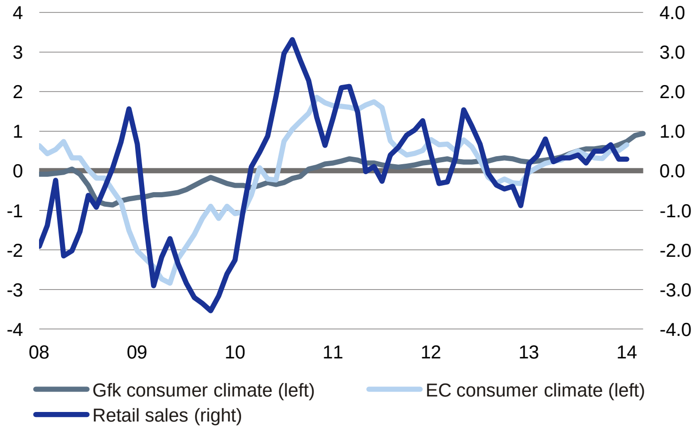
'000 yoy (left); index (right)



Sources: Federal Statistical Office, Federal Employment Agency, ifo

Consumer confidence and retail sales

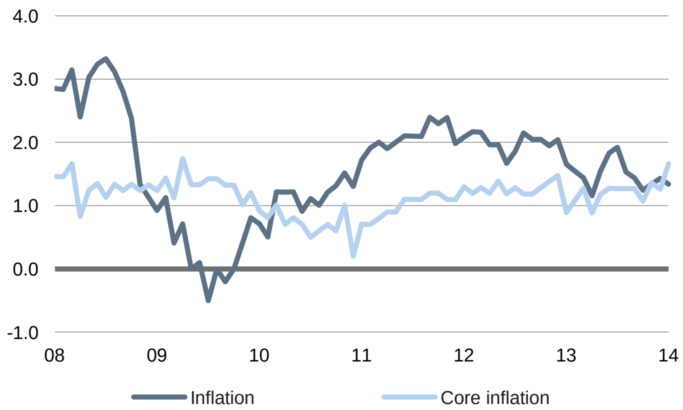
normalized data (left); % yoy, 3mma, nsa (right)



Sources: Destatis, European Commission, Gfk, Deutsche Bank Research

Inflation rate and core inflation rate

% yoy



Sources: Federal Statistical Office

— The improvement of the German labour market that started towards the end of 2013 continued in early 2014. In recent months, it was further supported by the mild winter weather as the economic recovery that started in spring 2013 is making itself increasingly felt. In February unemployment fell by 14k mom. This is the third marked decrease in a row (average of 20k). The unemployment rate stayed at 6.8%.

— Employment rose a strong 44k mom in January (3M average +34k), which brought the yoy-rate to +0.7%. Due to immigration and the rising participation rate the employment gains are not reflected in a proportional decline in unemployment.

— Leading indicators (ifo and PMI) point to a positive development over the next few months. The unemployment rate should decline to 6.7% in 2014 after 6.9% in 2013.

— Retail sales rose markedly in January (+2.5% mom) and thereby made up for the pronounced December weakness (-2.1%). Despite the strong January the increase compared to January 2013 was meager 0.3% (3M moving average).

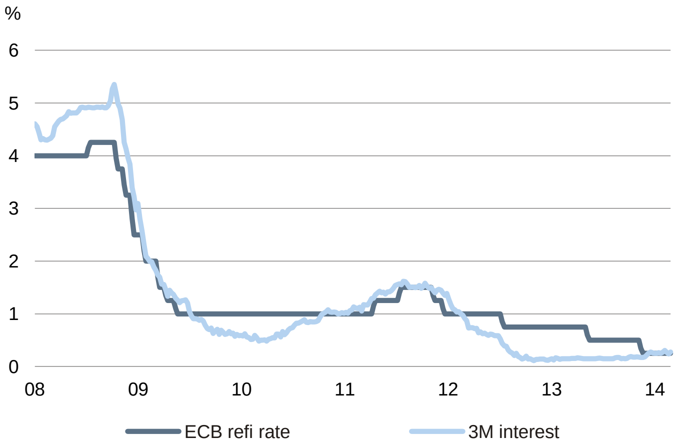
— The Gfk consumer climate and the European Commission's consumer confidence point to stronger sales in the coming months.

— This expectation is supported by the income growth of private households. We expect nominal disposable incomes to increase at least 2% thanks to rising employment and decent hourly wage growth.

— Inflation fell back to 1.2% yoy in February (Jan: 1.3%; Dec: 1.2%). Energy prices were again the main driver (-2.7% vs -1.8% prev.). Services (1.8 vs 1.9% prev.) and food inflation (3.5% vs 3.6% prev.) slowed slightly. Core inflation probably also declined slightly (1.6%).

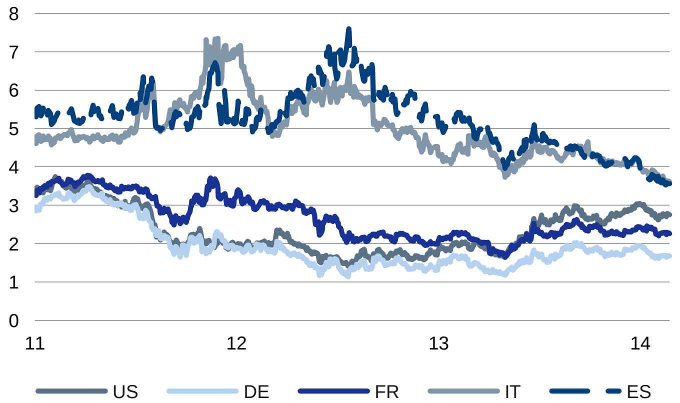
— Consumer prices increased by 1.5% in 2013 (2012: 2.0%). Despite the continued economic recovery, we expect inflation to show a renewed decline in the current year (2014F: +1.5%) due to low capacity utilization, stable commodity prices and low global price pressure in general.

EMU: Refi rate & 3M Interest



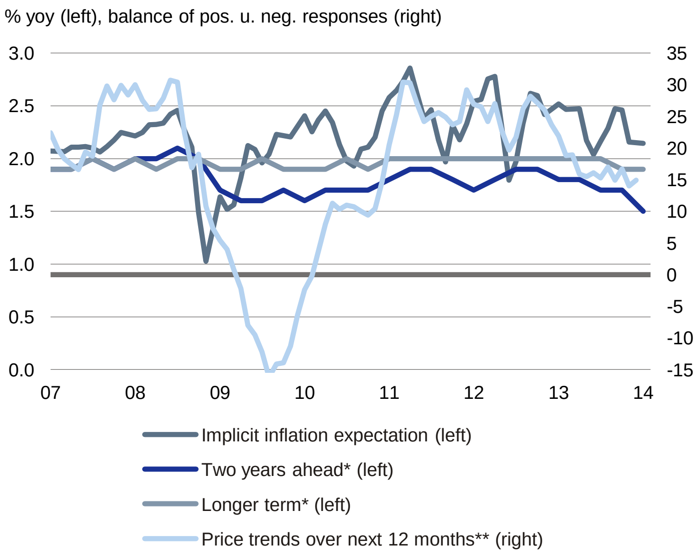
Sources: ECB, Global Insight

10Y government yields



Source: Global Insight

Inflation expectations Eurozone



* ECB Survey of Professional Forecasters, ** EC Consumer Survey

Sources: ECB, EU Commission, Bloomberg

— On 6 November the ECB unexpectedly lowered its refi rate by 25 bp to the new historic low of 0.25% due to concerns about deflation. In addition, the ECB announced to continue its full allotment scheme until mid-2015.

— After the ECB's February press conference Draghi put emphasis on the uncomfortably low inflation rate and the subdued medium-term outlook. However, due to uncertainty of the outlook, the political sensitivity of further unorthodox measures and the upcoming inflation forecast for 2016 to be released in March the ECB played for time and did not change its monetary stance.

— We expect a further modest easing of policy around end-Q1 probably due to lingering concerns about deflation. This could happen through another interest rate cut or liquidity measures. The probability of a more substantial policy like QE – similar as in the US and UK – has probably decreased again after the German constitutional court's ruling.

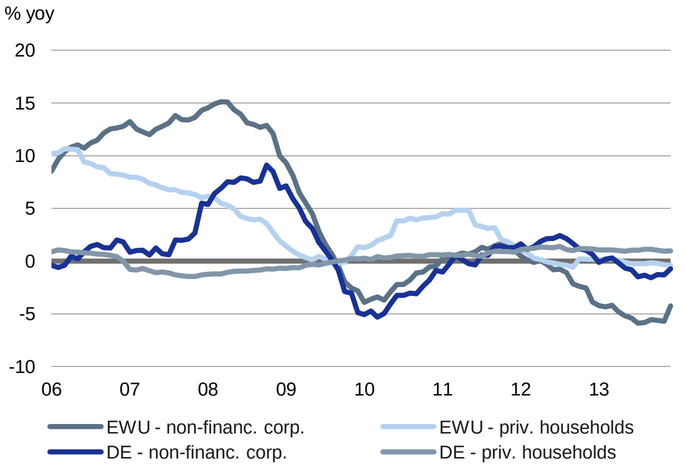
— Due to the diverging interest rate and growth expectations between the US and the euro area the yield spread between 10Y US treasuries and German bunds has roughly doubled since mid-2013 and currently stands at around 1pp.

— Peripheral spreads versus Germany have come down to just below 2pp recently – markedly below previous year's level (about 3pp). This development has been supported by the improved economic indicators and the hope for a further economic recovery in the euro area. Ireland and Spain successfully tapped the market after leaving the rescue programmes in December and January, respectively. Strong indications from the ECB that it will maintain its expansionary stance for a prolonged period have probably supported the spread convergence.

— Contrary to the debate about the threat of deflation – nourished by the ECB – the long-term expected inflation rate (5 years) of private forecasters in the ECB survey remains firmly anchored at just below 2%. The expected inflation rate in 2 years, however, fell to 1.5%, which could impact the ECB's inflation forecast for 2016.

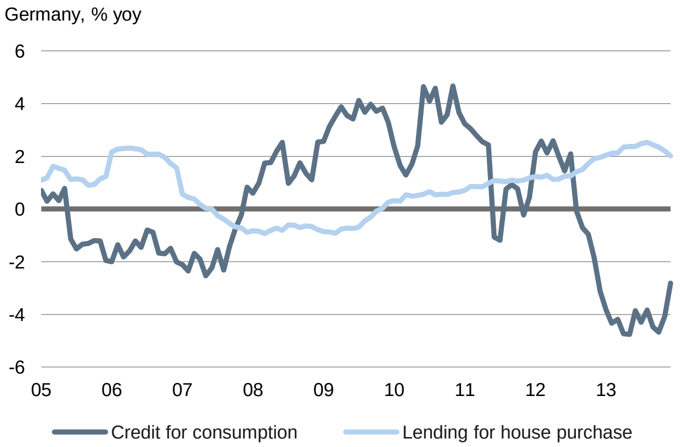
— The implied inflation rate for the next 10 years – calculated as the difference between the yield of 10Y German government bonds and the yield of inflation-protected bonds – has hovered between 2 and 2 ½% since the beginning of 2011.

Loans to the private sector



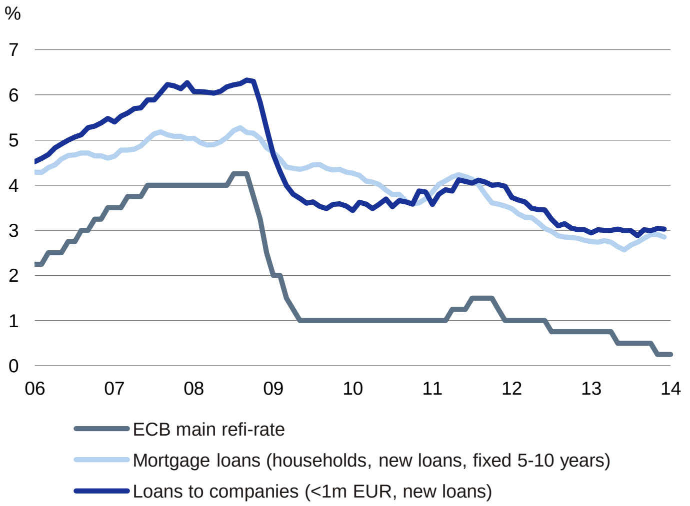
Source: ECB

Loans to households



Source: ECB

Interest rates



Sources: ECB, Deutsche Bundesbank

— Lending to corporates remained weak in 2013 with cuts being more pronounced in the Eurozone than in Germany. While reductions in Germany reflect a mix of modest investment activity and firms' use of alternative means of financing, the drop in the Eurozone is the result of ongoing deleveraging processes.

— However, declines somewhat slowed in December: –4.3% in the Eurozone and –1.3% compared to –5.7% and –1.3% in November.

— Households in the Eurozone also continue their deleveraging: – 0.4% in December. Total outstanding credit volumes shrank by 11 bn (Jan.-Dec.). Germany stands against the trend with credit to households growing again 1% yoy in December mainly driven by mortgage lending.

— Different types of lending to households in Germany show divergent trends. While mortgage lending continues with solid growth, consumer credit remains rather subdued.

— In total, mortgage lending increased by about 20 bn Jan. to Dec. 2013. Despite the low interest rates, growth remained rather modest at rates slightly above 2% (yoy) in 2013, which partly reflects portfolio shifts by households and local supply shortages. In 2013 growth rates peaked in summer (July/August: +2.5%) but decelerated somewhat in Q4 (Dec.: +2% yoy).

— Consumer credit remained restrained in 2013 with households rather relying on savings to finance their purchases and the overall modest increase in private consumption. However in December (–2.8% yoy), cuts were less pronounced than throughout the year.

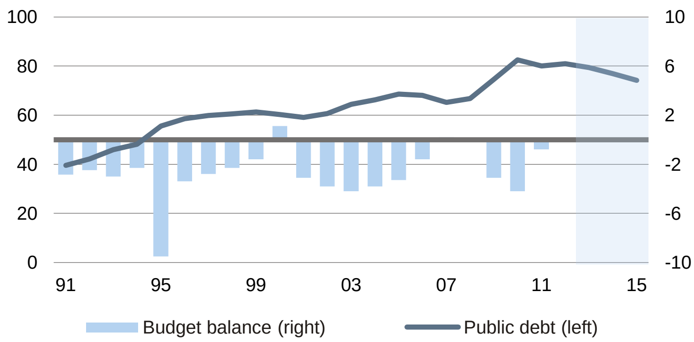
— Interest rates for mortgages and corporate credit remained at historic lows in 2013 with the ECB's rate cut in November reinforcing these conditions.

— Rates for mortgages stood at 2.8% on average in 2013. While last year's low point was reached in June (2.6%). Rates picked up slightly in autumn but then dropped again at the end of the year reflecting the ECB's rate cut (Q4 at 2.9% with Dec. slightly below average).

— Lending rates to corporates remained at 3% in December. Yearly averages also stood at 3% showing little volatility.

Public debt and deficit

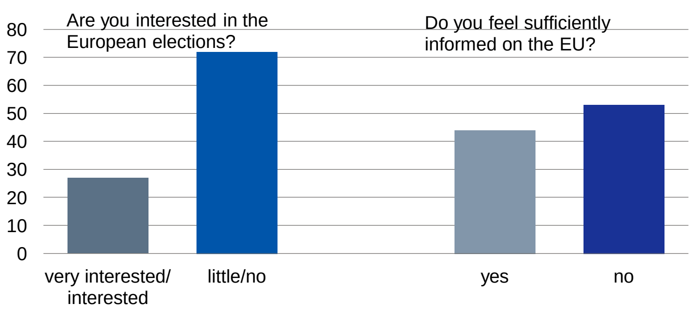
% GDP



Sources: Federal Statistical Office, Deutsche Bank Research

Up to now only little interest in the European elections in Germany

In %



Sources: ZDF Politbarometer, Deutsche Bank Research

— With a balanced budget in 2013 Germany was the only eurozone country without a deficit. But the federal government and the Länder still report deficits. The total general budget only showed a small surplus thanks to surpluses in municipalities and the social security system.

— German government debt ratio will lie well above 79% at the end of 2013. The positive development was partly attributable to growing revenues, but also to the fact that the bad banks continue to run down their portfolios.

— General government debt is set to decline further during the next years. So far, the federal government and the EU Commission anticipated that the debt level will fall below 70% of GDP by 2017. However, this forecast rests on the scenario that the course of the new coalition will not lead to a substantial rise in expenditures. The plans of the new government, especially concerning the envisaged changes in the pension system which will add about 0.5% of GDP to the public debt by 2017, cast doubts on the sustainability of the adjustment path.

— To date the European elections have not aroused much public interest in Germany. This is accompanied by a marked information deficit about the EU.

— Current surveys on the European elections hardly differ from the results of the federal elections last September. The CDU currently gains 40% of the vote, the SPD 24%, the Left 8% and the FDP 4%. Only the Greens with 12% and the AfD with 6% are able to gain higher shares than in the federal elections.

— According to a recent ruling of the Federal Constitutional Court there will be no minimum vote threshold in Germany for candidates to enter the next European Parliament. Therefore, the FDP and the AfD should easily gain seats.

Germany: Events of economic-, fiscal- and euro-politics

Date	Event	Remarks
6 Mar	Meeting of the ECB Council, press conference	We believe, on balance, the ECB eases policy in March.
10/11 Mar	Eurogroup/ECOFIN meeting	Portugal: 11th review and (poss.) exit strategy, EDP implications based on the Com. winter forecast, Stability and Growth Pact implementation, other euro area aspects.
18 Mar	German Constitutional Court judgment on complaints against ESM	It is to be expected that ESM will be deemed constitutional. The complaints against the ECB's OMT were forwarded to the European Court of Justice.
20/21 Mar	European Council	European semester, growth and jobs, EU 2020 targets (employment, R&D, climate, education, social inclusion). Industrial competitiveness.
3 Apr	Meeting of the ECB Council, press conference	Review of the monetary policy stance
5/6 May	Eurogroup/ECOFIN meeting	Debate on the economic situation in the euro area. Macro-imbalances procedures. Banking Union.
8 May	Meeting of the ECB Council, press conference	Review of the monetary policy stance.
22 - 25 May	European Parliament (EP) elections	European elections could lead to an unprecedented share of eurosceptic parties. As the German Constitutional Court has recently declared the 3 percent threshold void, smaller parties could succeed, while established German parties will probably lose seats in the EP.
27 May	European Council	Informal dinner.

Source: Deutsche Bank Research

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Focus Germany

Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
6 Mar 2014	12:00	New orders manufacturing (Index, sa), pch mom	January	-2.0	-0.5
7 Mar 2014	12:00	Industrial production (Index, sa), pch mom	January	1.5	-0.6
11 Mar 2014	8:00	Trade balance (EUR bn, sa)	January	16.8	18.1
11 Mar 2014	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	January	1.6 (2.8)	-1.0 (2.2)
11 Mar 2014	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	January	3.9 (2.1)	-1.4 (1.0)
24 Mar 2014	9:30	Manufacturing PMI (Flash)	March	55.0	54.7
24 Mar 2014	9:30	Services PMI (Flash)	March	55.7	55.4
25 Mar 2014	10:30	ifo business climate (Index, sa)	March	111.5	111.3
28 Mar 2014	8:00	Import prices (Index, sa) pch mom (yoy)	February	0.2 (-2.4)	-0.1 (-2.3)
28 Mar 2014	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	February	0.4 (1.2)	0.5 (1.2)
31 Mar 2014	8:00	Retail sales (Index, sa), pch mom	February	-0.5	2.5
1 Apr 2014	10:00	Unemployment rate (%, sa)	March	6.7	6.8
15 May 2014	8:00	Real GDP (Index, sa), % qoq	Q1 2014	0.5	0.4

Sources: Deutsche Bank Research, Federal Statistical Office, Federal Employment Agency, ifo, Markit

Financial Forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	0.125	0.10	0.25	0.50	0.00	0.75	0.20	1.50	2.50	2.70	0.05
Mar 14	0.125	0.10	0.15	0.50	0.00	0.75	0.20	1.50	2.50	2.75	0.05
Jun 14	0.125	0.10	0.15	0.50	0.00	0.75	0.20	1.50	2.50	2.75	0.05
Dec 14	0.125	0.10	0.15	0.50	0.00	0.75	0.20	1.50	3.50	3.00	0.05
3M interest rates, %											
Current	0.24	0.21	0.29	0.52							
Mar 14	0.35	0.20	0.20	0.52							
Jun 14	0.35	0.20	0.20	0.52							
Dec 14	0.35	0.20	0.20	0.52							
10J government bonds yields, %											
Current	2.63	0.59	1.57	2.67	0.95	2.13	1.56	2.77			
Mar 14	2.50	0.70	1.70	2.90	1.00	2.40	1.85	3.00			
Jun 14	2.75	0.60	1.90	3.00	1.10	2.50	2.05	3.20			
Dec 14	3.25	0.70	2.20	3.25	1.25	2.70	2.35	3.40			
Exchange rates											
	EUR/USD	USD/JPY	EUR/GBP	GBP/USD	EUR/CHF	EUR/SEK	EUR/DKK	EUR/NOK	EUR/PLN	EUR/HUF	EUR/CZK
Current	1.37	102.37	0.82	1.67	1.22	8.91	7.46	8.27	4.19	310.90	27.34
Mar 14	1.35	106.00	0.83	1.63	1.23	8.85	7.46	8.40	4.14	308.60	27.00
Jun 14	1.32	109.00	0.82	1.61	1.25	8.70	7.46	8.35	4.09	303.10	27.00
Dec 14	1.25	115.00	0.80	1.56	1.27	8.45	7.46	8.20	4.00	292.00	27.00

Sources: Bloomberg, Deutsche Bank

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German Data Monitor

	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Sep 2013	Oct 2013	Nov 2013	Dec 2013	Jan 2014	Feb 2014
Business surveys and output											
Aggregate											
Ifo business climate	106.1	105.3	107.2	108.8		107.8	107.5	109.4	109.5	110.6	111.3
Ifo business expectations	102.9	101.8	103.4	106.0		104.4	103.9	106.6	107.4	108.9	108.3
PMI composite	52.8	49.9	52.9	54.5		53.2	53.2	55.4	55.0	55.5	56.1
Industry											
Ifo manufacturing	101.1	100.4	102.7	104.5		103.5	103.1	105.2	105.2	106.3	107.3
PMI manufacturing	49.7	48.7	51.2	52.9		51.1	51.7	52.7	54.3	56.5	54.7
Headline IP (% pop)	0.3	1.4	0.8	0.2		-0.7	-1.1	2.4	-0.6		
Orders (% pop)	0.5	1.4	1.7	1.2		3.1	-2.2	2.4	-0.5		
Capacity Utilisation	82.5	82.2	83.2	83.2	83.4						
Construction											
Output (% pop)	-5.6	10.6	1.4	0.2		0.1	-1.4	1.3	2.8		
Orders (% pop)	0.4	1.2	-1.2	2.8		-2.6	3.9	4.7	-0.4		
Ifo construction	125.4	123.7	120.4	121.2		119.1	119.1	121.0	123.6	124.3	123.2
Services											
PMI services	53.8	49.9	52.6	54.1		53.7	52.9	55.7	53.5	53.1	55.4
Consumer demand											
EC consumer survey	-6.5	-4.2	-3.2	-2.8		-4.0	-4.2	-2.1	-2.2	-0.8	-0.7
Retail sales (% pop)	1.0	0.1	-0.3	-0.5	1.4	0.0	-0.5	1.0	-2.1	2.5	
New car reg. (% yoy)	-10.5	-3.7	-1.4	1.6		-1.2	2.3	-2.0	5.4	-2.0	
Foreign sector											
Foreign orders (% pop)	-0.8	3.3	1.0	2.7		6.3	-2.4	2.3	0.4		
Exports (% pop)	0.1	0.4	0.2	1.6		1.4	0.3	0.7	-1.0		
Imports (% pop)	-1.2	1.2	-0.3	0.5		-1.9	3.0	-1.2	-1.4		
Net trade (sa EUR bn)	49.9	48.1	49.3	52.6		18.5	16.5	18.0	18.1		
Labour market											
Unemployment rate (%)	6.9	6.9	6.8	6.9		6.9	6.9	6.9	6.8	6.8	6.8
Change in unemployment (k)	5.3	19.0	2.7	14.0		22.0	-1.0	6.0	-18.0	-28.0	-14.0
Employment (% yoy)	0.6	0.5	0.5	0.6		0.5	0.6	0.6	0.6	0.7	
Ifo employment barometer	106.2	104.9	106.3	107.2		106.4	106.1	107.8	107.5	107.0	108.0
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	1.8	1.5	1.7	1.3		1.6	1.2	1.6	1.2	1.2	1.0
Core HICP (% yoy)	1.4	1.0	1.2	1.1		1.3	1.0	1.7	0.7	1.2	
Harmonised PPI (% yoy)	0.8	-0.1	-0.3	-0.7		-0.5	-0.7	-0.8	-0.5	-1.1	
Commodities, ex. Energy (% yoy)	-3.5	-7.0	-12.2	-10.4		-11.4	-11.3	-9.8	-10.2	-11.0	
Oil price (USD)	112.6	102.5	110.4	109.3		111.9	109.2	108.0	110.8	108.3	
Inflation expectations											
EC household survey	26.6	22.5	26.2	25.5		26.8	26.5	24.6	25.5	24.0	22.0
EC industrial survey	3.7	-0.6	2.8	6.1		4.3	3.8	5.8	8.6	7.8	4.8
Unit labour cost (% yoy)											
Unit labour cost	4.0	1.5	1.3	1.0							
Compensation	2.1	1.7	2.2	1.8							
Hourly labour costs	4.8	1.1	1.3	1.7							
Money (% yoy)											
M3	5.4	3.8	2.5	2.7		2.5	1.9	1.3	2.7		
M3 trend (3m cma)						2.5	1.9	2.0	2.0		
Credit - private	-0.2	1.3	-4.0	-3.1		-4.0	-4.3	-3.9	-3.1		
Credit - public	-18.7	-22.4	-17.7	-17.1		-17.7	-18.9	-12.7	-17.1		

% pop = % change this period over previous period.

Sources: Deutsche Bundesbank, European Commission, Eurostat, Federal Employment Agency, German Federal Statistical Office, HWWI, ifo, Markit

Deutsche Bank
Research

Focus Germany

Focus Germany is part of the Current Issues series and deals with macroeconomic and economic policy issues in Germany. Each issue also contains a timetable of financial and economic policy events as well as a detailed data monitor of German economic indicators. Focus Germany is a monthly publication.

- Onward and upward .... January 27, 2014
- Launchpad to the past .... November 29, 2013
- Exuberance and fear .... October 31, 2013
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