Focus Germany

So far, so good

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Private consumption in 2014: Still a pillar of growth at 1.2%. The wage agreement in the chemical sector with a pay increase of 3.7% for 14 months was a strong signal. In the public sector the increase was a very decent 3%. However, it is unlikely that the other 8m employees, where contracts are up for negotiation will get pay increases near the chemical sector's wage hike. Still, negotiated wages should rise by 2.6% in 2014 and thus somewhat faster than in 2013 (2.2%). Given the continued strong employment build-up and slight increase in hours worked disposable income should grow by 2.5% even though monetary social benefits and income from self-employment and from investment are expected to rise only at a sub-par rate. Due to the falling inflation rate this allows real private consumption to rise by 1.2% in 2014, and might even have some upside potential. Consumption will, thus, remain the pillar of overall growth.

The federal budget target: No new debt from 2015. From 2015 the federal government plans to deliver a balanced budget with no net borrowing. This year the federal budget will already run a structural surplus. The additional spending agreed during coalition talks can be funded – at least in this legislative period – without new borrowing via higher revenues, the release of reserves and the shifting of funds between the federal budget and the social security schemes. Social security contribution rates will be raised significantly during the next legislative period at the latest. Budgetary risks arise from higher interest rates and a weakening economy, as the budget includes barely any reserves for them while being exposed to potential additional spending on adjustments that need to be made to the minimum subsistence level (basic personal allowance) and children's allowance or for increases that need to be made to infrastructure spending. Budget surpluses which, given the good economic situation and the grand coalition's broad majority, would have been possible and necessary in view of the tangible demographic burden that will materialise from the end of the decade have fallen victim to the special interests of the coalition parties.

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	1.5	1.3	0.8	1.3	2.4	2.4	2.1	-3.1	-2.5	-2.1
Germany	0.4	1.5	2.0	1.5	1.2	1.5	7.5	7.5	7.3	0.0	0.1	0.1
France	0.3	1.0	1.4	1.0	1.0	1.1	-1.7	-1.5	-1.3	-4.3	-3.6	-3.1
Italy	-1.8	0.6	1.1	1.3	0.7	1.2	1.0	1.2	1.2	-3.0	-2.9	-2.6
Spain	-1.2	0.7	1.5	1.5	0.5	1.1	0.8	2.1	2.5	-7.1	-5.8	-4.5
Netherlands	-0.8	0.9	1.4	2.6	0.5	1.2	10.4	10.5	11.0	-2.5	-3.1	-2.9
Belgium	0.2	1.4	1.6	1.2	1.1	1.5	-1.6	-2.0	-1.0	-2.6	-2.5	-2.6
Austria	0.4	1.4	1.8	2.1	1.5	1.7	2.7	3.6	3.7	-1.5	-2.8	-1.5
Finland	-1.4	0.3	1.4	2.2	1.6	1.8	-1.1	0.0	0.3	-2.1	-2.1	-1.6
Greece	-3.9	1.0	2.2	-0.9	-0.8	0.1	0.8	1.0	1.5	-12.7	-1.6	-0.9
Portugal	-1.4	1.4	1.1	0.4	0.3	0.9	0.5	1.0	2.0	-4.9	-4.2	-3.0
Ireland	-0.3	1.8	2.2	0.5	0.5	1.2	6.6	7.0	7.0	-7.2	-4.7	-2.6
UK	1.7	2.9	2.2	2.6	1.6	1.8	-4.4	-2.7	-2.6	-5.8	-4.7	-3.8
Denmark	0.4	1.4	1.5	0.8	1.4	1.8	7.3	6.5	6.5	0.0	-1.5	-2.0
Norway	2.1	2.5	2.6	2.1	1.9	2.1	10.6	11.5	11.5	7.6	9.5	10.5
Sweden	1.5	2.7	3.0	0.0	0.5	1.8	6.2	5.6	5.5	-3.6	-1.6	-0.8
Switzerland	2.0	1.8	2.0	-0.2	0.4	0.8	12.5	12.5	12.5	0.4	0.0	0.0
Czech Republic	-0.9	2.0	2.5	1.4	1.0	2.0	-0.6	-1.0	-1.4	-2.7	-2.8	-2.7
Hungary	1.1	2.1	2.2	1.7	0.7	2.8	2.1	1.9	1.4	-2.2	-2.9	-2.7
Poland	1.6	3.0	3.9	0.9	1.5	2.3	-1.5	-2.2	-1.9	-4.5	4.3	-3.1
United States	1.9	3.1	3.8	1.5	2.1	2.3	-2.3	-2.4	-2.4	-4.0	-2.9	-2.5
Japan	1.5	0.4	1.4	0.4	3.0	1.7	0.7	0.8	1.8	-9.2	-7.2	-5.6
World	2.8	3.4	3.9	3.2	3.5	3.6						

*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	1.2	1.2	1.1	1.2
Unemployment rate, %	7.1	6.8	6.9	6.6	6.4	6.9	6.9	6.8	6.9	6.7	6.6	6.5	6.5
Industrial production	7.4	-0.4	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	78.4	76.0	73.3								
Balance on current account, % GDP	6.8	7.4	7.5	7.5	7.3								
Balance on current account, EUR bn	178	199	206	212	212								

*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

Private consumption in 2014: Still a pillar of growth at 1.2%

— The wage agreement in the chemical sector with a pay increase of 3.7% for 14 months was a strong signal. In the public sector the increase was a very decent 3%. However, it is unlikely that the other 8m employees, where contracts are up for negotiation will get pay increases near the chemical sector's wage hike.

— Still, negotiated wages should rise by 2.6% in 2014 and thus somewhat faster than in 2013 (2.2%).

— Given the continued strong employment build-up and slight increase in hours worked disposable income should grow by 2.5% even though monetary social benefits and income from self-employment and from investment are expected to rise only at a sub-par rate.

— Due to the falling inflation rate this allows real private consumption to rise by 1.2% in 2014, and might even have some upside potential. Consumption will, thus, remain the pillar of overall growth.

With a share of roughly 57.5%, private consumption is the largest expenditure component of GDP. As a result, any forecast of overall economic growth must focus on private consumption. While the OECD and the European Commission tend to overstate real consumption growth, we have been slightly too cautious in recent years. This was true especially of the years 2010 and 2011, when our forecasts for consumption growth were 0.5 of a percentage point too low on average, and less so of 2012 and 2013. At the end of 2011 we had expected an increase in real consumption spending of 0.7% for 2012, while the Commission's forecast was for 1.1%. Actual consumption growth then came to 0.8%. At the end of 2012, the OECD and the Commission forecast an increase of 1.4% and 1.0%, respectively, while we put consumption growth at 0.6% (the actual figure for 2013 then came in at 0.9%). For the current year, we expect private consumption to expand by 1.2%, whereas the Commission has published a forecast of 1.5% and OECD even of 1.8%. Forecasters surveyed by Consensus Economics look for consumption growth of 1.4% on average, with the scope of the forecasts ranging from just under 1% to 2.2%. Are we slightly too pessimistic for 2014 (again)? In the following we shall therefore discuss our evaluation of income developments for the current year, which forms the basis of our consumption forecast.

Continuing growth momentum supports employee pay

Over the past four years, net income from dependent employment was the most important driver of disposable income. On average, approximately 60% of income growth was attributable to income from dependent employment. This was the result of a mainly immigration-induced jump in employment which more than offset the decline in the number of hours worked per employee in some sectors. Hourly wages also rose markedly.

This picture is unlikely to change this year. As in 2013 we expect employment to expand by 0.8%. Thanks to accelerating global demand hours worked per employee will likely rise again, too (+0.1% after -0.3% in 2013).

2014 wage round: Stronger real increase than in 2013

Negotiations in this year's wage round have yielded the first two major results for. In early February wage increases in the order of 3.7% for the next 14

Income calculation in the national accounts

Disposable household income totalled almost EUR 1,720 bn in 2013. It is derived from three major sources: 1. income from dependent employment (employee remuneration), 2. public and private transfer payments (monetary social security benefits) and 3. income from self-employment and investment.

— At approx. EUR 1,420 bn, income from dependent employment, i.e. employee remuneration, accounted for 82% of disp. income. This figure includes all payments received by gainfully employed persons resulting from their employment contracts and is based on the number of workers, hours worked and wages paid. After deduction of social security contributions and income tax, net wages and salaries account for 45% (EUR 773 bn) or not quite half of total income.

— Monetary social security benefits contributed 28.5% (just under EUR 490 bn) to income in 2013. This share has been more or less unchanged since the end of the 1990s, with only slight cyclical fluctuations. 50% of all monetary social security benefits are payments from the statutory pension system alone – and the share is rising.

— Income from self-employment and investment amounted to EUR 610 bn or 35.5% of disposable income in 2013. In a long-term comparison, this volatile income component has gained in importance but has been hurt by the effects of the financial crisis.

Disposable income is either consumed (approx. EUR 1,572 bn) or saved (just under EUR 175 bn).

Income calculation in the national accounts 1

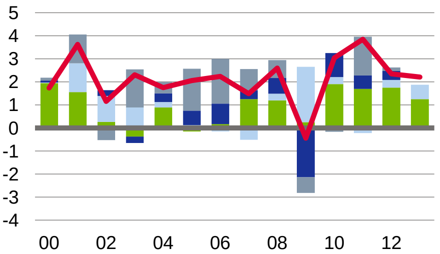
2013, EUR bn

Employee remuneration	1416.1
- Employers' social security contrib.	255.2
= Gross wages and salaries	1160.9
- Employees' social security contrib.	200.8
- Income tax	187.2
= Net wages and salaries	772.8
+ Monetary social security benefits	489.4
- Other deductions	92.0
= Mass incomes	1170.2
+ Operating surpluses, income from self-employment and investment	609.7
+ Other transfers received minus transfers paid	-62.9
= Disposable income	1716.9
+ Increase in claims on corporate pension benefits	29.7
- Private consumption spending	1572.4
= Savings	174.2
Savings ratio (%)	10.0

Source: Federal Statistical Office

Employees drove increase in income 2

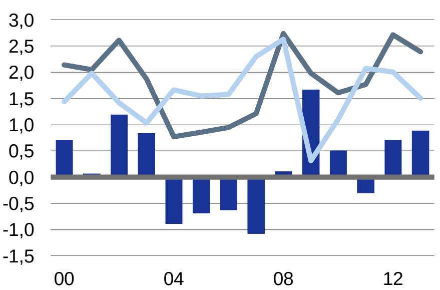
Contribution to nominal disposable income growth, pp



Source: Federal Statistical Office

Real wages: Nearly 1% plus in real terms in 2013 3

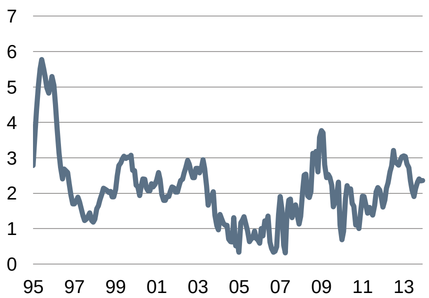
% yoy; negotiated hourly wages incl. benefits



Source: Federal Statistical Office

Wage growth below 2% in mid-2013 4

Negotiated hourly wages incl. benefits, % yoy, 3M mov. avg.



Source: Deutsche Bundesbank

months have been agreed for the over 500,000 employees of the chemicals industry – one of Germany's key industries. To be sure, wage agreements in the key sectors are often said to have a signal effect. We consider it unlikely, though, that a similar result can be achieved for the remaining approx. 10 million employees (of a total of 40 million) whose collectively negotiated contracts expire in 2014. In early April a wage agreement for the approx. 2m people employed by the federal government and local authorities was reached. Their wages are set to increase by 3% (or at least EUR 90 per month) in 2014 and by 2.4% in 2015 – an average of 2 ¾%. Employees of Deutsche Telekom are set to receive a wage increase of 2.9% in 2014 and of 2.1% in 2015. In total, collective wages look set to rise slightly more this year than last on an annual average – especially when calculated on a real term basis.

Underlying wage dynamics intact

At 2.4% in 2013, nominal collectively agreed wages were up slightly less strongly than in 2012 (2.7%), falling short of many observers' expectations. But the wage increase was still the third highest of the last 10 years and came in well above that period's average (1.7%). Thanks to considerably weaker inflation, employees enjoyed an additional, appreciable increase in their real wages (0.9%) – the second highest increase of the last 10 years – after 0.7% in the preceding year. Moreover, collective increases were curbed on an annual average in 2013 by special effects in the agreements (such as "zero months"), while the underlying dynamics remained intact and strong[1].

But wage dynamics waned particularly around the middle of last year, due above all to the collectively agreed zero months designed to postpone the companies' burdens resulting from higher wages. Most wage increases thus were scheduled for the second half of the year. In the very important metal and electrical engineering sectors (employing a total of 3.4 million people) for instance, two zero months pushed the 3.4% wage increase from May into July. In addition, a number of wage agreements struck in 2012 for a longer period of time specified a second, slightly lower wage increase for 2013, which dampened the overall increase registered last year.

Real 2014 wage increase probably higher again than in 2013

The remainder of the 2014 wage round is likely to be dominated by negotiations for the 670,000 construction workers. At the end of December collective wage agreements will expire for 3.4 million employees in the metal and electrical engineering industries and more than 800,000 civil servants at the state level. This means, however, that the outcome of negotiations in these large sectors will only affect wage developments in 2015.

The overall economic environment looks rosier this year than last. However, the collective wage dynamics can be explained rather well by last year's development of inflation and productivity and this year's unemployment. Both inflation and productivity growth slowed in 2013 and are thus dampening the unions' clout in negotiations, while low and probably declining unemployment figures this year have a strengthening effect, as they are a yardstick for the scarcity of labour. Our model based on these factors suggests a 2.8% rise in collective wages this year (2013: 2.3%) and thus underlying dynamics similar to last year.

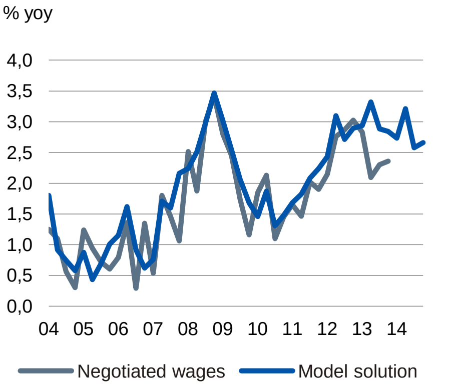
However, we believe that our model – just like over the last months – slightly overstates actual developments. Wage increases already agreed in 2013 for

[1] Hence, the average collectively agreed wage increases (weighted for employment) came to just over 3% in 2013, as in 2012, based on data provided by WSI-Tarifarchiv.

2014 came to an average of 2.3%. These affected over 6 million employees – roughly as many as those for whom new agreements are to be negotiated this year. Overall our forecast for collective wage increases comes to 2.6% in 2014. This figure is also the basis for our forecast of overall wage increases even though only 50% of all employees are still covered by collective bargaining.[2] Based on our estimate of an inflation rate of 1.2%, wages would rise by 1.4% in real terms – and thus by considerably more than last year's 0.9%. With the exception of 2009 this would be the highest level of the last 15 years.

2014 likely to see high net wage increases

Collective wages: Forecast model points to another decent uptick in 2014 5



Sources: Deutsche Bank Research, Deutsche Bundesbank, Federal Statistical Office

Based on the development of collective wages and employment described above and assuming that hours worked per employee will rise only marginally (+0.1%), we arrive at an increase in total employee remuneration of 3.5% in 2014. This is markedly higher than last year (2.8%) but less pronounced than in 2011 (4.4%) and 2012 (3.9%), as employment growth was higher at the time. At 3%, net wages and salaries are also likely to rise faster in 2014 than last year (2.8%). However, the increase is less pronounced as the income ceilings for social security contributions have been raised and cold tax progression[3] will also leave its mark.

Allocation-neutral scope exceeded again

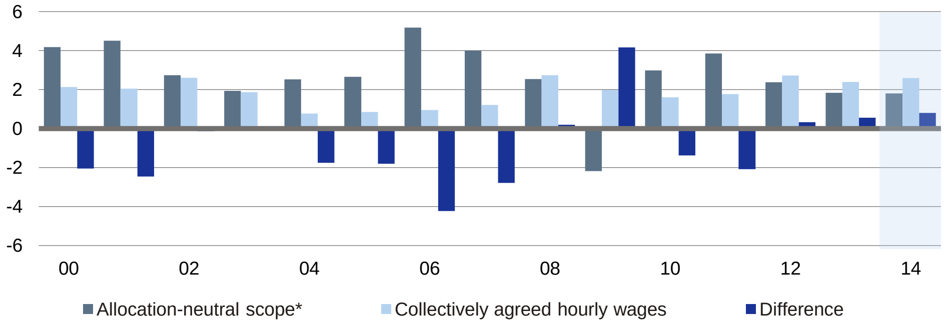
An average 2.6% increase in collective wages would mean that the employers and trade unions have more than exploited their allocation-neutral scope for the third consecutive year. The allocation-neutral scope is the sum of the growth rates of productivity and consumer prices. It serves as a benchmark in collective wage bargaining. The wage increase indicated by our model suggests that the higher corporate profits due to higher prices and increased productivity would be redistributed slightly to the employees' benefit. This also implies that unit wage labour costs would rise again. With wage costs up by 3.5% and an estimated economic growth rate of 1.5%, unit labour costs would rise by 2% in 2014 but the increase would be smaller than in the preceding years (2013: 2.4%; 2012: 2.8%). However, the degree of redistribution is still moderate compared with the positive development enjoyed by companies since 2000, when only part of the allocation scope was exploited. Moreover, unemployment is at a low level currently and there actually are labour shortages for certain qualifications.

[2] According to the Institute for Employment Research (IAB), only about 50% of all employees are still subject to collective wage bargaining on a sector level, compared with almost 70% in the mid-1990s. In 2013, relatively low wage increases for employees not covered by collective bargaining somewhat dampened overall wage dynamics.

[3] Tax brackets are not inflation indexed in Germany. Thus, higher wages automatically lead to rising marginal income tax rates.

Allocation-neutral scope: Probably over-exhausted again in 2014 6

Hourly basis, nominal, % yoy



* Inflation rate + productivity growth

Sources: Federal Statistical Office, DB Research

Minimum wage harbours great uncertainty and will probably send wages considerably higher

The grand coalition's intention of introducing a minimum wage has markedly raised the degree of uncertainty in forecasting wage developments for 2015 and beyond, and could even make itself felt in the current year.[4] According to the plans outlined to date, the minimum wage would take effect at the start of 2015. Up until the end of 2016, exceptions will be made for sectors that already foresee a lower minimum wage in their collective agreements according to the "Arbeitnehmerentsendegesetz" (German law on the posting of workers). From the start of 2017 the statutory minimum of EUR 8.50 will be in effect throughout Germany, with some limited exceptions for interns, young professionals and long-term unemployed. The cabinet agreed the legislation in early April with a view to introducing the minimum wage at the start of 2015.

As it is still uncertain what exceptions or special and transitional regulations will be included (the law was passed by the cabinet but not yet by the parliament), it is impossible today to quantify the number of workers subject to the minimum wage. It could come to more than 4 million (of a total of approx. 37 million). What could be of greater importance, however, is whether and, if so, how many sectors would agree a lower sector-specific minimum wage in order to shape the transition period until 2017. The greatest incentives should be found in sectors in which the gap between current wages and the EUR 8.50 level is greatest, and hence also the cost shock for companies and the risk of job losses. However, this discussion will probably only pick up speed after the legislative process, i.e. in the second half of the year.

There is likely to be a considerable increase in hourly wages in 2015. A (much simplified) model calculation: Assuming a number of 4 m affected (over 10% of all employees) for who wages rise by 35% on average. This would push up hourly wages for all employees by over 6% if all other persons whose hourly wage exceeds the EUR 8.50 minimum received an increase of 2.5%. Depending on the scope of the negative employment effect – as a result of job cuts or the fact that no new jobs are being created we would have to expect that 450,000 to 1 million jobs would be lost on a medium-term horizon – the increase would be higher, as persons earning lower hourly wages would no longer appear in the statistics – the effect on disposable income is much more uncertain though. Nonetheless, the number and design of transitional

[4] For a more detailed discussion of the minimum wage, see Schneider, S. (2013). Minimum wage at EUR 8.50: The wrong policy choice. Deutsche Bank Research. Standpunkt Deutschland. November 1, 2013. Frankfurt.

arrangements as well the overall number of affected employees may also lead to a smaller increase in hourly wages. Also, we would expect such a drastic increase for the lower income groups to restrict the scope for higher-income earners so that a redistribution would take place between these groups, with the average wage increase being dampened.

Wage negotiations in selected* sectors 7

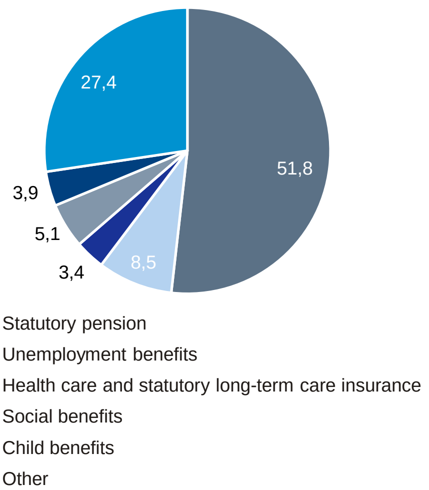
Sector	Expiry date	Wage demands	Result	Employees
Chemicals (North Rhine, Hesse, Rhineland-Palatinate)	Dec 31, 2013	Remuneration: 5.5%	3.7%, one zero month and 14 months duration	236,200
Printing (west and east)	Dec 31, 2013	Remuneration 5.5% from Jan 1, 2014; duration: 12 months		153,100
Chemicals (Schleswig-Holstein, Hamburg, Lower Saxony, Bremen, Westphalia, Baden-Wuerttemberg, Bavaria, west Berlin)	Jan 1, 2014	Remuneration: 5.5%	3.7%, one zero month and 14 months duration	248,400
Civil service (mainly at federal and municipal levels)	Feb 28, 2014	Remuneration: EUR 100 for all groups plus 3.5% from Mar 1, 2014	2014: +3.0% (or at least Eur 90/month); 2015: +2.4%	1,625,000
Construction (west and east)	Apr 30, 2014	Remuneration: 7.0%		667,400
Banking (excl. cooperative banks, east and west)	Apr 30, 2014	Basic amount of EUR 100 plus 3.5%		243,800
Wood and plastics processing (various regions)	Apr 30, 2014	-		181,900
Hotels and catering (North Rhine-Westphalia)	Apr 30, 2014	-		111 500
Private transport (North Rhine-Westphalia, southern Baden	May 31, 2014	-		154,600
Iron and steel (Bremen, Lower Saxony, North Rhine-Westphalia, east)	May 31, 2014	-		101,500
Deutsche Bahn AG (west and east)	Jul 31, 2014	-		134,000
Hotels and catering (Bavaria)	Jul 31, 2014	-		127,800
Private transport (Bavaria)	Sep 30, 2014	-		113,700
Metal and electrical engineering (west and east)	Dec 31, 2014	-		3,443,300
Civil service (federal states excl. Berlin, west and east)	Dec 31, 2014	-		816,200

Negotiations for more than 100,000 employees
Sources: WSI-Tarifachiv, Deutsche Bank Research

Monetary social security benefits higher again in 2014

Statutory pension is largest item 8

Share in monetary social benefits, 2012, %



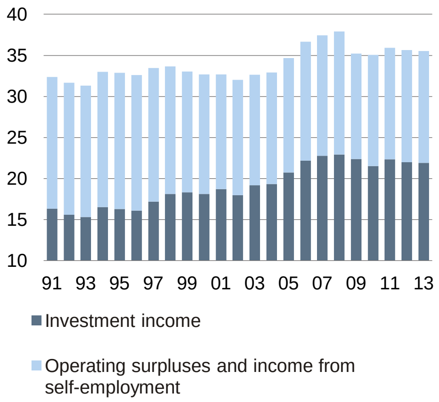
Source: Federal Statistical Office

Monetary social security benefits include cash benefits paid by the social security system, benefits from private insurance schemes and benefits paid by employers (i.a. wage payments in case of illness, accident or maternity as well as pensions, also for surviving dependents) as well as other cash benefits paid by the state or non-profit institutions. With a share of almost 30% in disposable incomes, these benefits represent a major income component. In 2013 they rose by 2.2% to almost EUR 490 bn, due mostly to developments in the statutory pension system and unemployment. In 2014 pension incomes, which account for half of all monetary benefits, look set to increase markedly. This is due to the planned massive increase in statutory pension benefits (e.g. the so-called pensions for older mothers and deduction-free pension at the age of 63 after 45 years of contributions). In addition, the 2014 annual pension adjustment on the basis of wage developments in the preceding year is not dampened by special factors anymore. Thus, pensions for people in Western Germany will rise by 1.7% in mid-2014, while those for people in Eastern Germany will rise by 2.5%. Our forecast is for a decline in unemployment from 6.9% to 6.6% in 2014, suggesting a dampening effect on monetary social security benefits. But as the regular rates of unemployment support were raised in tandem on January 1, 2014 the effect will probably be limited. All in all, monetary social security benefits look set to rise by 2 1/2% to 3% in 2014.

Income from self-employment and investment income: Noticeable impact of the financial and Euro crisis

Income from self-employment and investment 9

Share in disposable income, %



Source: Federal Statistical Office

Besides the above-mentioned income from dependent employment and monetary social security benefits, another component of disposable household income is income from self-employment. This consists of operating surpluses and income from self-employment and investment. Together, they came to just over EUR 606 bn in 2013 and this accounted for almost 36% of disposable income, with operating surpluses and income from self-employment amounting to EU 232 bn and investment income to EUR 374 bn.

Operating surpluses and income from self-employment comprise remuneration for entrepreneurial performance, notional entrepreneur remuneration and the remuneration for employing one's own or third-party physical capital. Investment income results from the temporary provision of funds. These include interest income, dividends and other company distributions, income from patents, licenses and other assets as well as net income from the leasing of property.

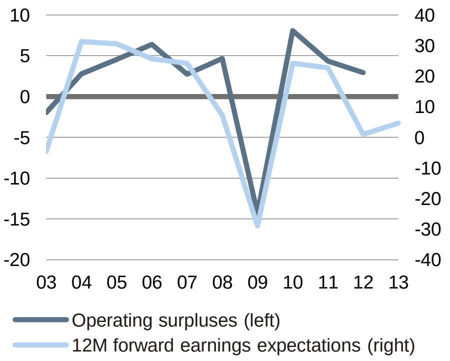
Investment income has grown noticeably in importance over the last few years. Its share in disposable income grew by 6.6 percentage points from 15.3% to 21.9% between 1993 and 2013. By contrast, the share of operating surpluses and income from self-employment fell by 2.4 pp from 16% to 13.6%. Both investment income and operating surpluses as well as income from self-employment suffer from the impact of the financial- and the following Euro crisis. Since 2009 they have been rising only below average. The development of operating surpluses and income from self-employment can be described relatively well by 12-months profit expectations, and the development of investment income correlates rather well with dividend payments by DAX-listed companies and – over the last 10 to 15 years – with changes in the median interest rate derived from interest on bank deposits and government bond yields.

At present, earnings expectations for the DAX-listed companies surpass the pre-year level by close to 7% on a 12-month horizon. In view of the close correlation between earnings expectations and economic growth, we do not look for a strong upturn in profits in the further course of the year. Until recently there were still small “downgrades”. Correspondingly, operating surpluses and income from self-employment are likely to pick up only moderately by roughly 2% this year.

Companies' disbursement plans for dividends, which form a relevant part of investment income, currently suggest a percentage increase in the upper single digits, following an increase in total dividend payments by the DAX-listed companies of just under 0.5% last year. On the fixed income side, yields at the long end of the market will probably pick up slightly in the further course of the year, such as 10Y Bund yields which we expect to rise from currently slightly over 1.5% to 2.2% by year-end. This positive effect on household interest income, however, is offset by the fact that bonds with high coupons remaining in the portfolio will steadily reach maturity, which will tend to weigh on interest income. Also, as monetary policy looks set to remain extremely expansionary for a long time to come, deposit rates will remain low for the foreseeable future. All in all, we think that investment income will rise by no more than the pre-year figure (roughly 2%) this year, too.

Operating surplus, self-employed income & earnings expectations 10

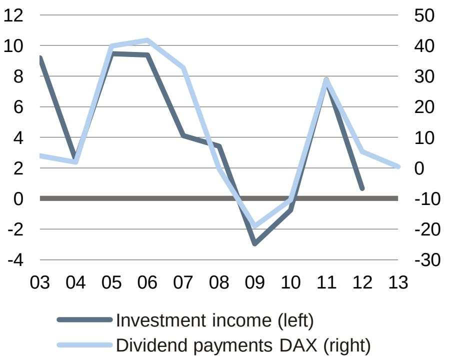
% yoy



Sources: Federal Statistical Office, Consensus, Deutsche Bank Research

Investment income & dividend payments 11

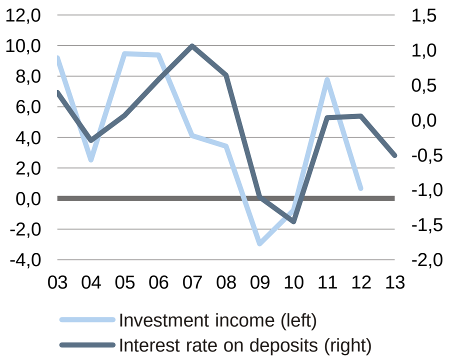
% yoy



Sources: Federal Statistical Office, Reuters, Deutsche Bank Research

Investment income & deposit interest rate 12

% yoy (left), pp (right)

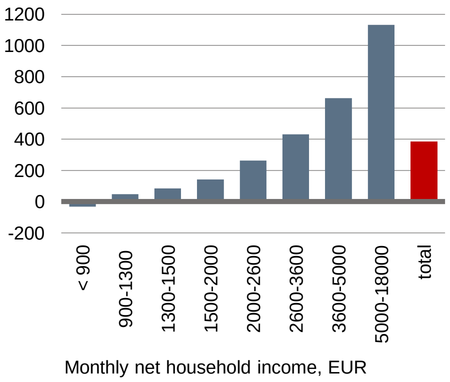


Sources: Federal Statistical Office, Deutsche Bundesbank, Deutsche Bank Research

But even if income from self-employment and investment were to pick up more strongly than assumed, the impact on private consumption would be rather small. This type of income is generated especially by high-income households with their above-average savings ratio. According to the income and consumption sample (EVS) of 2008, households with a net income in excess of EUR 3,600 per month generated almost one-third of this income by means of self-employment and investment, while for households with net incomes of EUR 1,300 to EUR 1,500 the share is only 10%. Moreover, households with the highest net incomes (in excess of EUR 3,600 per month) also boast a savings ratio of almost 20%, which is roughly double the average.

Income from investment by income bracket 13

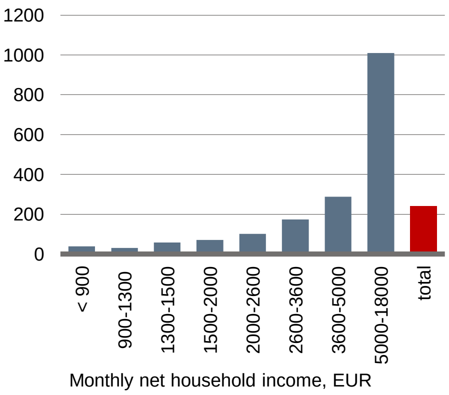
EVS 2008, EUR per month



Source: Federal Statistical Office

Income from self-employment by income bracket 14

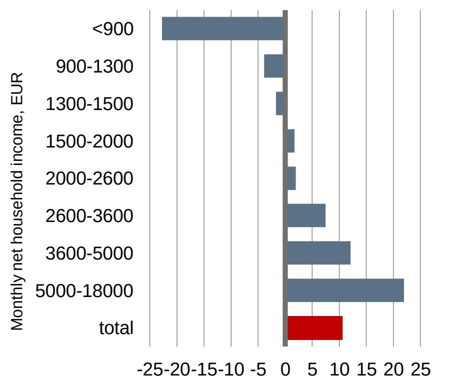
EVS 2008, EUR per month



Source: Federal Statistical Office

Income-specific savings ratio 15

EVS 2008, %



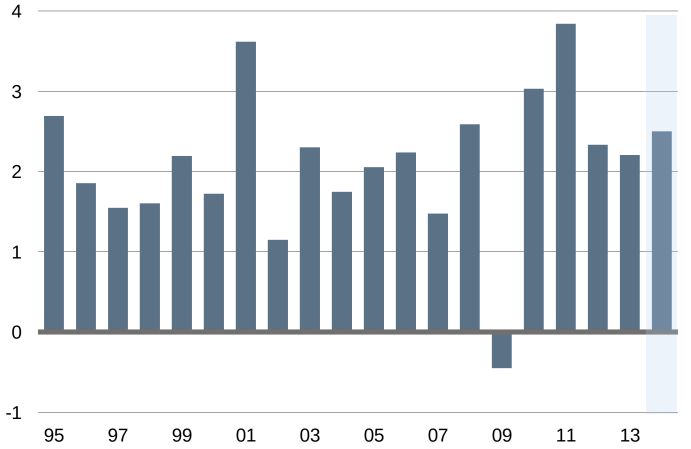
Source: Federal Statistical Office

Disposable income up 2.5% in 2014

Thanks to the development of the individual income components described above, household disposable income is likely to expand by approx. 2.5% in 2014. This is slightly higher than the pre-year level (2.2%) but does not match the catch-up momentum of the post-recession years (2010-2012 average: 3.1% p.a.). Once again, net wages and salaries will probably contribute more than 50% and thus a disproportionately large part to overall income growth. By contrast, operating surpluses and income from self-employment and investment look set to rise at a slightly slower pace than average.

Disposable income growth slightly higher in 2014 16

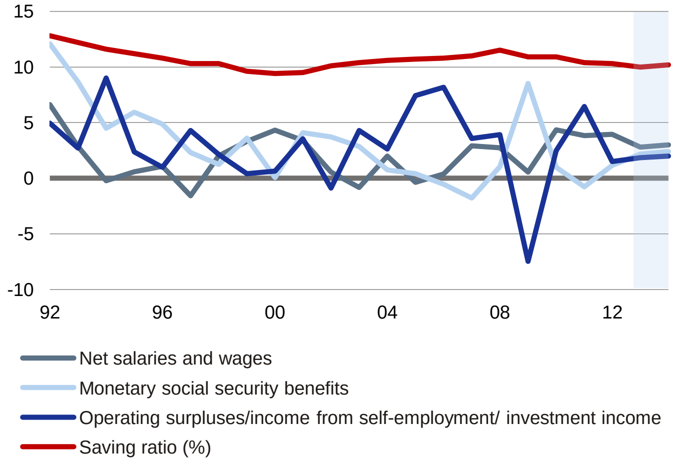
Nominal disposable income, % yoy



Sources: Federal Statistical Office, Deutsche Bank Research

Income in 2014: Broadly based moderate acceleration 17

Nominal, % yoy

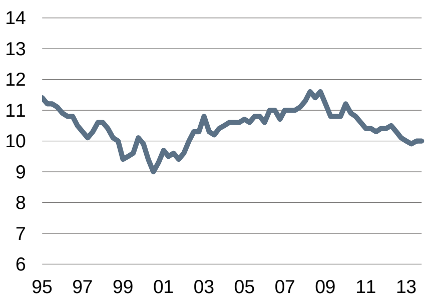


Sources: Federal Statistical Office, Deutsche Bank Research

Slightly higher savings ratio thanks to rising interest rates

Savings ratio stabilised in 2013 18

Savings rate, households, %, sa

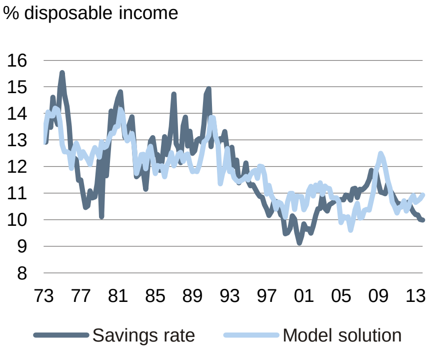


Source: Federal Statistical Office

Over the last few years, the savings ratio has come down noticeably in Germany. It fell from a high of 11.5% in 2008 to 10% in 2013. This has provided a further boost to consumption beyond income developments. Surely, a major reason for the declining savings ratio was the low level of interest rates – particularly the decline in real yields which even meant negative returns for short-term investments (i.e. for savings deposits) – as well as the positive labour market dynamics. Last October we analysed the correlation between the savings ratio and real yields, unemployment as well as consumer confidence and found a negative correlation between real interest rates and the savings ratio.[5] Based on our interest rate outlook there is a lot to suggest the savings ratio has bottomed out. According to our interest rate strategists, yields on 10Y German Bunds will rise from just over 1.5% currently to more than 2% at year-end. With inflation remaining moderate at 1.2%, real yields would amount to 0.5% after averaging 0% in 2013. Hence, saving would become – at least slightly – more attractive again. The slightly improved unemployment rate (2014e: 6.7%; 2013: 6.9%), however, will probably have a slightly dampening effect only. All in all the savings ratio could rise from 10% to 10.2% in 2014.

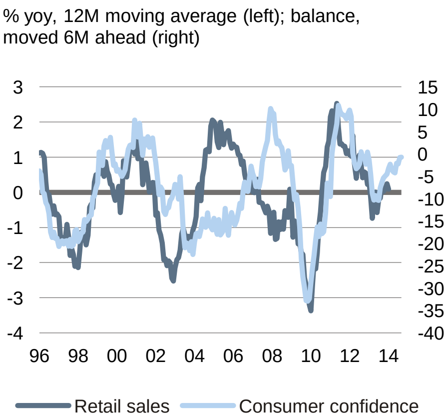
[5] For a detailed report on the correlation between the interest environment and households' propensity to save, see Gräf, B. and Rakau, O. (2013). Low interest rates curbing households' propensity to save. In: Deutsche Bank Research. Focus Germany. October 1, 2013.

Germany: Savings ratio & model solution 19



Sources: OECD, IMF, European Commission, Deutsche Bank Research

Consumer confidence: Strong retail sales ahead, but no spectacular increase 20



Sources: Federal Statistical Office, European Commission

2014: Private consumption up 1.2% in real terms

Overall our analysis of the income outlook for German households paints a very positive picture. Disposable income is rising across the board, and at 2.5% this increase is even stronger than last year. The savings ratio, too, looks set to edge up to 10.2%. Real household consumption receives an additional boost from the renewed slowdown in the pace of inflation. We see annual average inflation in 2014 at no more than 1.2% (2013: 1.5%; 2012: 2.0%). As a result, private consumption will likely expand by 1.2% in real terms in 2014, and might even have some upside potential. This increase would once again be stronger than in the two preceding years, when real consumption spending rose 0.9% (2013) and 0.8% (2012).

In light of recurring news about new record highs especially in the monthly readings of the "GfK-Konsumbarometer", our forecast of "only" 1.2% may seem surprisingly low. The correlation between data on consumer confidence and real consumption growth is not that strong, however, so its usefulness for quantitative forecasts is rather limited. Even in cases in which the correlation between consumer sentiment and hard data is stronger it looks as though there is a lid on consumption growth also this year. The consumer confidence index issued by the European Commission, for instance, currently points to an acceleration of real growth in retail sales towards somewhat above 1%.

We completely agree with the consensus that private consumption will once more be the most important pillar of overall economic growth in 2014. Given the currently positive employment and wage momentum there might even be some upside potential to our forecast. Our forecast hovers around the lower end of expectations, though. Taking into account that our inflation expectations are also at the lower end of the spectrum, the gap in the nominal calculation becomes obvious. This is the result of, for one thing, our forecast for a slightly higher savings ratio and, for another, our cautious forecast for income from self-employment and investment. In light of our GDP growth forecast of 1.5% compared with a consensus view of 1.8%, this is hardly surprising though. In the final analysis, however, these differences are negligible in view of the existing forecast uncertainty. They fall within the model's margin of error and represent no major change in the positive consumption and income outlook.

Income calculations & consumption 21

% yoy, nominal	2012	2013	2014F
Employees	1.2	0.8	0.8
Hours worked per employee	-0.6	-0.3	0.1
Gross hourly compensation	3.3	2.2	2.6
Negotiated wages per hour	2.7	2.4	2.6
Wage drift	0.6	-0.2	0.0
Employee compensation	3.9	2.8	3.5
Net wages and salaries	3.9	2.8	3.0
Monetary social benefits	1.2	2.2	2.3
Operating surpluses and income from self-employment and investment	2.9	1.9	2.0
Disposable income	2.3	2.2	2.5
Saving rate, %	10.3	10.0	10.2
Private consumption	2.4	2.5	2.3
Private consumption, real	0.8	0.9	1.2

Sources: Federal Statistical Office, Deutsche Bank Research

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The federal budget target: No new debt from 2015

— From 2015 the federal government plans to deliver a balanced budget with no net borrowing. This year the federal budget will already run a structural surplus.

— The additional spending agreed during coalition talks can be funded – at least in this legislative period – without new borrowing via higher revenues, the release of reserves and the shifting of funds between the federal budget and the social security schemes. Social security contribution rates will be raised significantly during the next legislative period at the latest.

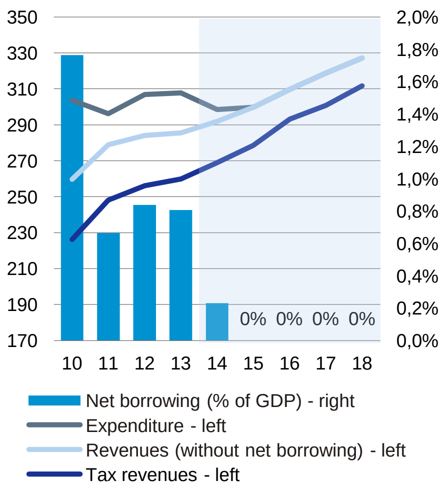
— Budgetary risks arise from higher interest rates and a weakening economy, as the budget includes barely any reserves for them while being exposed to potential additional spending on adjustments that need to be made to the minimum subsistence level (basic personal allowance) and children's allowance or for increases that need to be made to infrastructure spending.

— Budget surpluses which, given the good economic situation and the grand coalition's broad majority, would have been possible and necessary in view of the tangible demographic burden that will materialise from the end of the decade have fallen victim to the special interests of the coalition parties.

In mid-March the federal government unveiled the cabinet resolution for the 2014 federal budget[6] as well as the 2015 benchmark resolution and the fiscal planning until 2018. For the first time since 1969 finance minister Wolfgang Schäuble could deliver a federal budget containing no new debt in 2015. Balanced budgets are also planned for the following years in this legislative period. An examination of the overall fiscal path on which the grand coalition has embarked does, however, cast this success in a different light. Despite continually rising tax revenues (growth of nearly 4% p.a. is factored in) the government will have to resort to extensive reshuffling of departmental budgets in order to ensure a balanced budget over the coming years on account of the additional spending agreed in the coalition talks. The major expenditure increases associated with many of the measures agreed will, however, not materialise until the next legislative period (after 2017). Those responsible for the fiscal planning have therefore – after closer inspection – left themselves open to accusations of adopting a spirit of “après nous le déluge”.

Federal budget 1

EUR bn., financial statistics (cash basis), actual and forecast according to federal budget plan



Source: Federal Ministry of Finance

In 2014 federal government spending will probably fall to EUR 298.5 bn before rising sharply again from 2016, according to the planning, by an average of 3% p.a. to EUR 327 bn by 2018. The decline in spending from EUR 310 bn in 2013 to EUR 298.5 bn in 2014 is thus only a short-term phenomenon. Also, it is due in large part to one-off effects (non-recurrence of supplementary expenditure for the ESM and EIB, flood relief fund).

The additional spending agreed as part of coalition talks totalling some EUR 23 bn over the course of the legislative period is mainly funding for the individual Länder for day nurseries, kindergartens, schools and universities (EUR 6 bn), research (EUR 3 bn), development aid (EUR 2 bn in total), municipal authorities (integration assistance of EUR 1 bn p.a.) and transport infrastructure (EUR 5 bn). It remains unclear, however, how the EUR 5 bn p.a. promised in future to the municipal authorities to aid the integration of disabled people is factored into the fiscal planning.

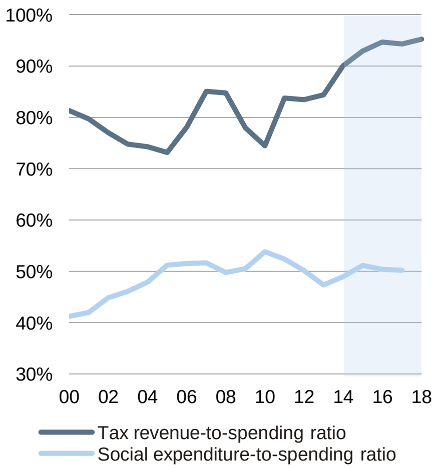
[6] The document in question is the second draft of the government's 2014 budget. The first one came from the old CDU/CSU and FDP government. The changeover to the grand coalition made up of the CDU/CSU and SPD means that the old 2013 budget had been maintained.

Federal budget to be balanced by raiding the social security coffers

This additional expenditure means that the surpluses from 2016 which were still being projected last year will not materialise, although a further increase in tax revenues from 2015 has also been factored in. In January the new federal government raised its forecasts for real GDP growth this year from 1.7% to 2% and for 2015 from 1.4% to 1.8%. This will not, however, be sufficient. Further budgetary interventions are required to make the sums add up. The pension insurance changes (e.g. retirement at 63, higher pensions for mothers whose children were born before 1992) are barely reflected in the federal budget. The resulting burdens – which will initially be moderate – will be borne above all by the members of the scheme while the federal grant to the pension insurance scheme will only increase modestly (EUR 2 bn p.a.). Still, given these measures the rapid growth in these expenditure items will be inadequate in the medium to long term.

Higher tax revenues and higher social security spending in federal budget 2

Taxes and social expenditure as share of total federal spending



Source: Federal Ministry of Finance

At the start of this year a first move was already made with the planned statutory reduction in the contribution rate from 18.9% to 18.3% not being implemented. So expenditures of the pension system not resulting from earlier contributions will again become intransparently funded, i.e. not properly via the budget. Initial estimates suggest that the pension insurance scheme will incur additional costs totalling EUR 60 bn by 2020 (i.e. EUR 9 bn p.a.). This does not even take into account the planned pension for low-income workers. Health insurance will also not go unscathed – the federal grant will be cut by some EUR 3 bn in each of the next two years. The reserves will be returned to the health insurance scheme from 2017 at the earliest. Children's allowance will therefore – contrary to earlier indications – probably not be raised until later (2016 at the earliest). These measures show that without extensive reshuffling between the budget and the social security schemes it would not be possible to increase spending and balance the budget.

Keys to balancing the budget – economic growth, debt brake and new budget process

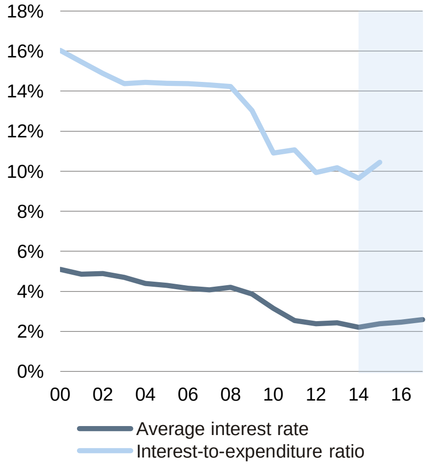
Given the frequently large federal budget deficits in the past the planned balanced budgets from 2015 constitute a major success. In all probability the federal budget will already achieve structural balance this year. Apart from the flourishing economy and high employment other major factors contributing to this success are the debt brake and the new “top-down” budgeting methodology. The latter sets out target figures for the ministries via the benchmark resolution. In addition, the federal finance minister has managed to rein in the desires induced by the tax revenue bounty by incorporating relatively pessimistic revenue forecasts and provisioning items into the budget (global additional expenditure is the watchword).

The economy and interest rates harbour major budget risks

The balanced budget is, however, subject to – obvious – risks. An economic slump with falling tax revenues and higher social spending or sharply rising interest rates would blow a hole in the budget overnight – not even mentioning other events – such as the financial crisis which torpedoed then finance minister Peer Steinbrück’s attempt to balance the budget. To make it clear, the federal government is currently paying an average of just over 2% interest on its total debt, instead of 4.4% as was the case in 2004. The interest expenditure ratio, i.e. the interest payments relative to the total spending by the federal government, has dropped to a post-unification low. Instead of having to spend 20% of tax revenue on interest service, as was the case ten years ago, the

Consolidation sucess also dependent on interest rate devlopment 3

Interest expenditure as % of debt, interest expenditure as % of total expenditure



Source: Federal Ministry of Finance

federal government now only has to spend 10%, although the debt level has risen by 50% since then (including supplementary budgets). A small increase in the interest burden over the coming years is factored into the budget planning (the average interest rate that the federal government has to pay on its entire debt – based on the interest payment and loan assumptions made in the fiscal planning – is projected to climb from about 2.2% to around 2.5%). In contrast to previous fiscal planning processes, however, this "provision for a rainy day" is much smaller.[7]

Spending increases instead of debt repayment

In view of the continued positive revenues and the surpluses that were still planned in the middle of last year it would actually have been time to pay off some debt given an asymmetric fiscal policy and the demographic burdens that will materialise from 2020. This objective has unfortunately been cast aside. If this is accepted and the need for fiscal policy to be focused on new areas is advocated, the question that arises is how potential surpluses and financial reserves in the public purse can best be used. The grand coalition has unfortunately decided in particular to expand statutory pension insurance benefits without ensuring their long-term funding. The full costs of this will squarely hit the federal budget and the members of the scheme at the latest during the next legislative period.

Tax relief for lower incomes and infrastructure investments would have been better spending areas

International organisations (the IMF and the OECD) are calling for public-sector investment in education and infrastructure to be raised significantly. Even though international and historical comparisons of investment ratios, on which these proposals are based, are questionable in part and investment yields need to be treated with caution, there are certainly sensible investments to be made in the areas of education, energy and transport infrastructure.

Moreover, given the expected additional revenues a certain degree of relief for taxpayers – especially those on low and middle incomes – would be appropriate. After all, apart from small adjustments the income tax rates have now remained unchanged for nearly 10 years. This would also mean that it is time to mitigate the impact of cold progression, i.e. the additional tax burden caused by inflation, by adjusting the tax rate. Reducing the difference between gross pay and net pay is what many people called for in the past. Since 2010 the burden on taxpayers as a result of cold progression has risen by EUR 3 bn per year. This year the finance minister is already going to see over EUR 9 bn more flow into the tax coffers than in 2010. This effect hits those on low and middle incomes especially hard, since the tax rate increases particularly sharply as their income rises.

The transparency concerning this development is – at the latest – likely to rise with the report on cold progression scheduled for publication in the autumn and thus the public pressure on policymakers to take action in this respect is also likely to grow. The negative impact has moreover been intensified further by the raising of the basic allowance and the failure to adjust the basic parameters for the progression zones in previous years. Correcting this problem of the income tax scale is, however, expensive. In addition, this also impinges upon the tax receipts of the Länder and the municipalities. Therefore, adjusting tax rates will

[7] If we compare, for example, the fiscal planning until 2017 (from 2013) with the fiscal planning until 2016 (from 2012), total interest expenditure as the provision for a rising interest rate level is projected to be around EUR 20 bn lower.

require tough negotiations between the federal government and the Länder, which could end up with the Länder receiving a larger slice of the tax cake (e.g. by incorporating the solidarity surcharge into income tax). Since a reorganisation of federal finance relations is on the grand coalition's to-do list anyway, it should, however, be possible to reach an agreement. The extent to which the public purse benefits from the rise in overall tax revenues is already made clear by the federal government's tax expenditure ratio: taxes relative to expenditure have reached a record high since reunification of 90% (the average since 1991 is about 80%). Looked at in isolation, it is to be welcomed that a higher share of expenditure is covered by taxes. However, this achievement is rendered less impressive by the sharp increase in federal spending.

To conclude, instead of pandering to special interests that in part are diametrically opposed to tackling macroeconomic challenges, a further reduction in public debt would have been the better option. Since the political will to do this evidently did not exist, a partial expansion in public investment and the reduction of cold progression would have been a better use of resources. Besides the regular review of the subsistence level of income that is scheduled for the autumn, which will probably indicate that among other things the children’s allowance and the basic allowance will probably have to be raised from 2015, the negative impact of the introduction of a minimum wage and further labour market regulation can probably be expected to considerably exacerbate the financial situation of the social insurance schemes. It is doubtful whether the government will then still be able to keep its election promise not to raise taxes.

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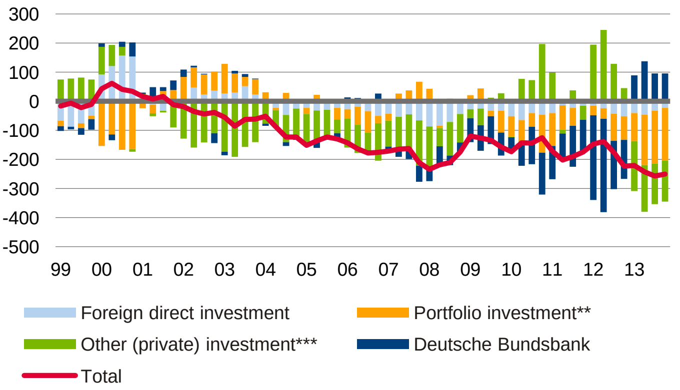
Chart of the month

Germany's capital account

Balance, EUR bn*, mov. 4Q sum

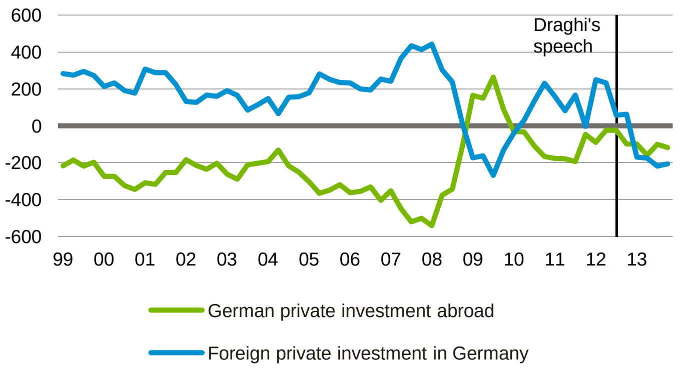


*Capital inflows (+) and outflows (-); **incl. financial derivatives; ***excl. Bundesbank

Sources: Deutsche Bundesbank, Deutsche Bank Research

Portfolio and other (private) investment

EUR bn*, mov. 4Q sum, excl. foreign direct investment and Deutsche Bundesbank



*Capital inflows (+) and outflows (-)

Sources: Deutsche Bundesbank, Deutsche Bank Research

Capital flows back to normal in 2013

Germany's capital account and its components have been a reflection of the euro crisis and especially investors' at times extreme risk aversion as well as safe-haven capital flows over the last few years. German private investors increasingly scaled down their new investment (excl. direct investment) abroad in the course of 2011/12. In mid-2012 total new investment over the preceding four quarters amounted to approx. EUR 24 bn – one-eighth of the mid-2011 figure. At the same time, international investors continued to invest large amounts in Germany, which was considered to be a safe haven. In mid-2012, net capital inflows from foreign investors over the four preceding quarters had exceeded EUR 200 bn (right-hand chart). This development should have led to a substantial narrowing of the German capital account deficit. However, the decline was limited as the Bundesbank "stepped in" and extended large-scale credit through EMU's payments system to the ECB and thus indirectly to the peripheral countries (Target2 debate; left-hand chart, dark blue columns).[8]

A turnaround began with Mario Draghi's promise to do "whatever it takes" to save the euro area and the subsequent announcement in August 2012 of the OMT programme. Perceived risks decreased and further support came from the stabilisation of the euro-area economy. Instead of net capital inflows from abroad in the order of EUR 200 bn, like in mid-2012, Germany registered capital outflows to the tune of EUR 200 bn at the end of 2013 (mostly outflows of short-term foreign funds from German banks). German private investors also channelled funds abroad (mostly portfolio investments). By the end of 2013, they had invested almost EUR 120 bn in foreign countries over the preceding four quarters. Correspondingly, (public) lending by the Bundesbank declined. We expect this normalisation to continue in 2014. All in all, Germany's net capital exports rose to 9.2% of GDP in 2013 (from 8.4% in 2012) and thus exceeded the much-discussed current account surplus of 7 1/2% of GDP.

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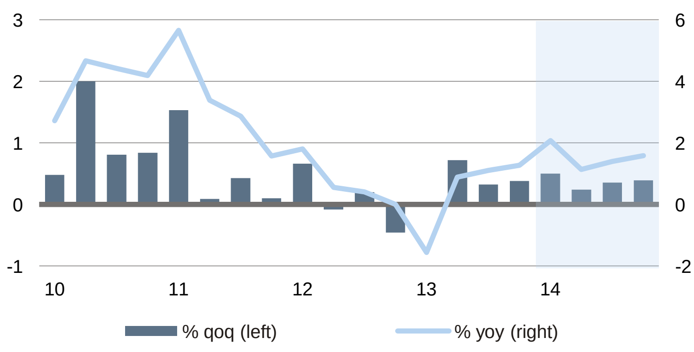
[8] See Peters, Heiko and Oliver Rakau (2012). Focus Germany: Euro crisis tightening its grip. Deutsche Bank Research.

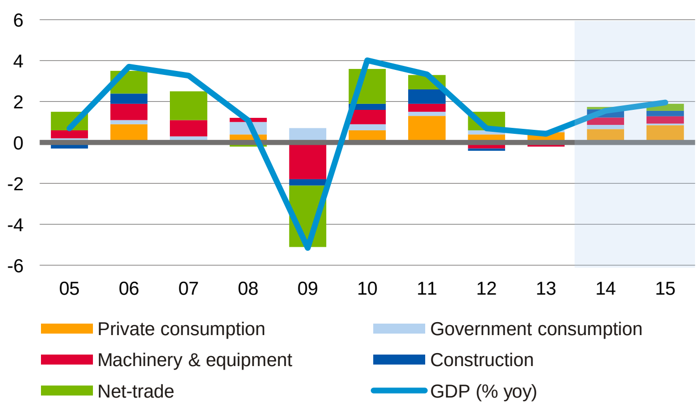
Chartbook – Total economy

- German real GDP rose by 0.4% yoy in 2013. The slowdown compared to 2012 (+0.7%) was especially due to the weak winter half 2012/2013. After that quarterly growth accelerated. In Q3 (+0.3% qoq) and especially Q4 (+0.4%) GDP grew somewhat faster than its potential rate of a good ¼%.
- In Q4 growth was buoyed by net exports (adding 1.1%-points). Investment contributed only marginally to growth and consumption not at all. Inventories weighed strongly on growth – due to statistical reasons this number should be interpreted with caution. The disappointing dynamic of domestic demand should not mark a change of trends.
- Sentiment indicators, the strong Jan./Feb. retail sales and Jan. industrial production point to a further growth acceleration in Q1. We forecast 0.5% qoq but see marked upside risks. The increase in dynamic is due above all to the mild winter that benefits e.g. construction activity. In Q2 there should be some pay-pack (+0.2%).
- Expectations of a weaker Q2 are also supported by the declines in the construction sector's expectations. In contrast, the ifo index for the total economy and the PMI rose strongly in April making up for the in parts strong declines in March. Effects from the Russia/Ukraine tensions are not apparent as of yet. All told, sentiment points to a very robust domestic economy. The uncertainties over the events in Eastern Europe and the so far relatively weak sentiment data in China cloud the outlook for the external sector. In contrast, the US economy seems to rebound from the strong snow fall impacted Q1.
- Thanks to average quarterly growth rates of 0.4% qoq GDP should expand by 1.5% in 2014. Domestic demand should be the major growth pillar, just like in 2013. Private consumption (+1.2% yoy) should provide impetus thanks to the positive labour market dynamic. Construction spending and investment in machinery & equipment should grow decently. Net exports are set to contribute weakly to overall growth as rising imports largely neutralise the rise in exports.

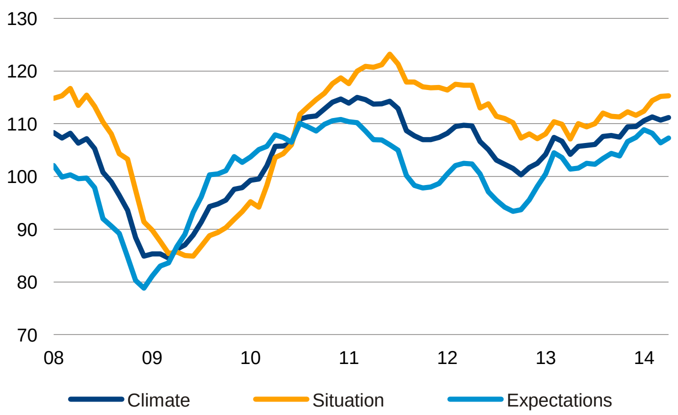
Real GDP growth



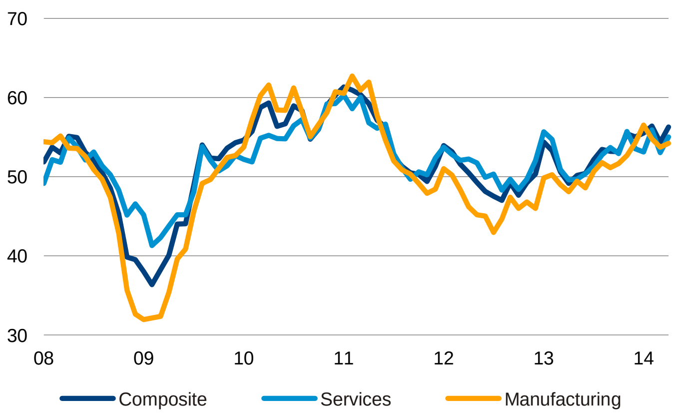
Contribution to real GDP growth (%-points)



ifo index - total economy (2005=100)



Purchasing manager index



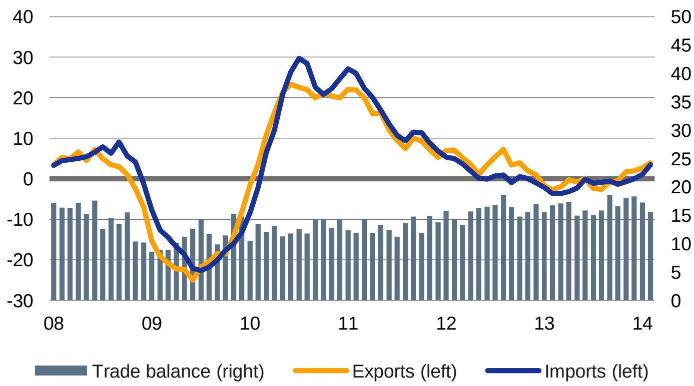
Sources: Federal Statistical Office, Markit, ifo, Deutsche Bank Research

Chartbook – Foreign trade

- Foreign trade was weak in 2013. Goods exports fell 0.2% and imports by a good 1%. Around mid-2013 the trough was reached and a moderate recovery started. In February 2014 German exports were up 4.0% yoy (3M mov. avg.) and imports by 3.4%. The acceleration is partly due to weakness early last year. Thanks to a relatively stronger recovery of exports the monthly trade balance rose to up to EUR 18 bn in H2. However, recently the seasonal-adjusted trade balance was down and amounted to EUR 15.7 bn in February 2014.
- The improvement in exports is regionally broad-based. Exports to EMU were up 3.5% yoy (export share 2013: 37%) as the region emerged from recession. The plus for US exports (share: 8%) was even higher at 6.3%. Exports to Asia were up 4.2% yoy (share: 16%).
- It is foremost the recovery in automobile exports that drives the rebound (Feb.: +7.4% yoy). Especially in the European car market should be some pent-up demand after years of restraint domestic demand. External deliveries in the other German export engine, mechanical engineering, were up only slightly in yoy-terms (+0.7% yoy). Foreign demand in the metal industry (-5.8% yoy) has not started to recover yet.
- Leading indicators like ifo export expectations point to a temporary acceleration in exports. However, they have weakened substantially lately. This could be connected to the political tensions in Eastern Europe. Depending on the extent of European sanctions against Russia German exports could be dampened. Russian exports stood for 3.3% of overall German exports in 2013. In addition, US and Chinese data was mixed to weak lately. In case of the US this weakness seems to be over. Chinese data remains mixed for now.

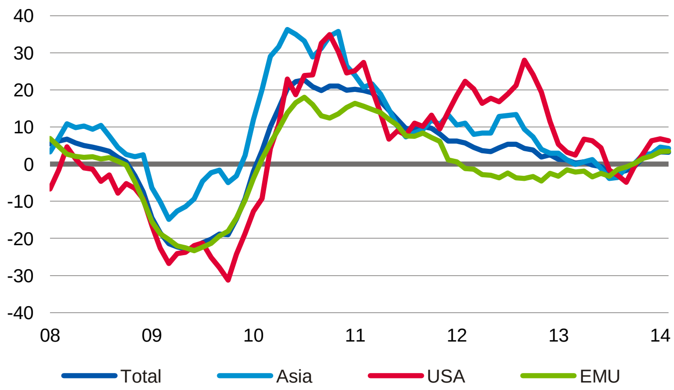
Merchandise trade

% yoy, 3M mov. avg. (left); EUR, bn (right)



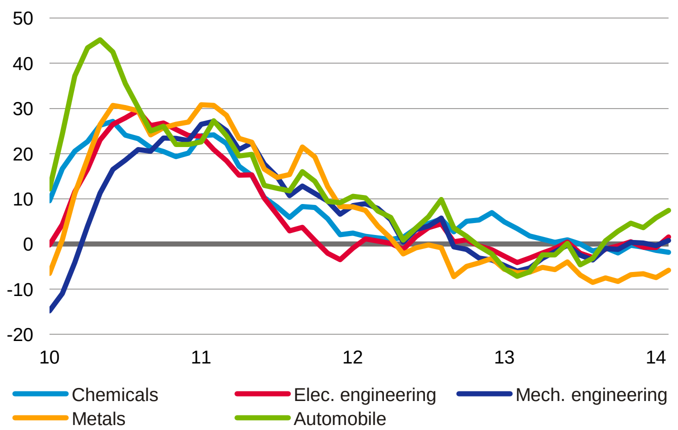
German exports by region

% yoy, 3M mov. avg.



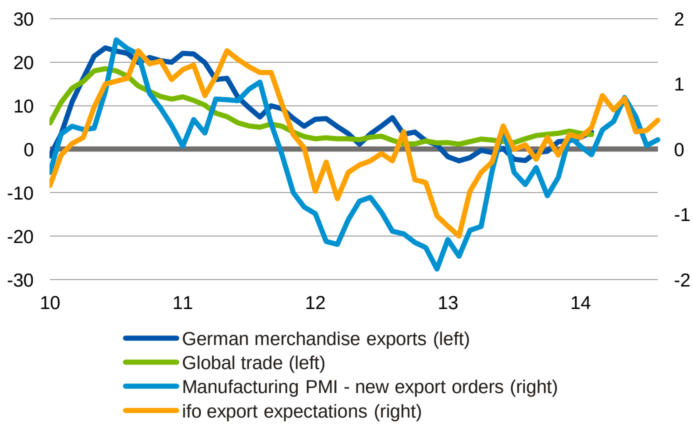
Exports by sector

% yoy, 3M mov. avg.



Exports and leading indicators

% yoy, 3M mov. avg. (left); Standardized values (right, 4M lead)



Sources: Federal Statistical Office, Markit, ifo, Deutsche Bank Research, CPB

Chartbook – Industry

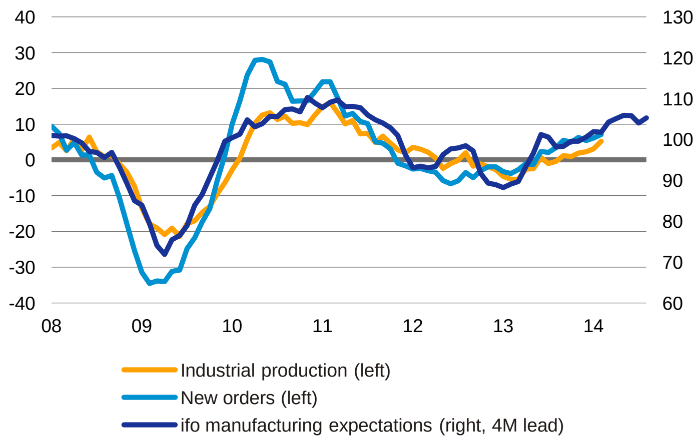
— The German industry increasingly benefits from the recovery of the global economy over the course of 2013. In part due to big-ticket orders especially of air planes total orders were up 7.1% yoy in February (3M mov. avg.). Even excluding big-ticket orders the increase was substancial (+6.3%). Production (+5.2%) so far does not fully reflect higher order volume. In addition, construction activity went up markedly in Dec and Jan and remained on a high level in Feb supported by the favourable weather conditions.

— The ifo index and the PMIs point to a further improvement for industrial production in the very short-run and a deceleration over the course of Q2 with (so far limited) downside risk that have appeared for foreign traction.

— Of the largest industrial sectors the automobile industry should achieve the highest growth rate in 2014. We expect an increase of 5% in real terms. The essential driver behind this is the recovering demand for cars in Western Europe, where German manufactures have a market share of about 50%. In mechanical engineering we see a production increase of 4%. The sector should benefit from foreign demand and the increasing inclination of domestic companies to invest. The same arguments hold for electrical engineering, where domestic production could grow 3.5%. The chemical sector could see growth of 3%, but the sector is benefitting from a large statistical carry-over effect and production is set to show a weak dynamic on a month-on-month basis. The food industry – a very stable sector as it is – could see production grow moderately (+1%). All told, the manufacturing output should expand by about 4% in real terms in 2014 (after -0.1% in 2013).

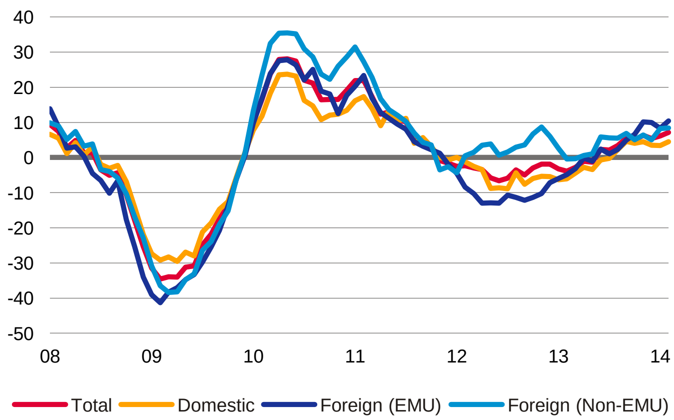
Industrial production, new orders & ifo expectations

% yoy, 3M mov. avg. (left); index (right)

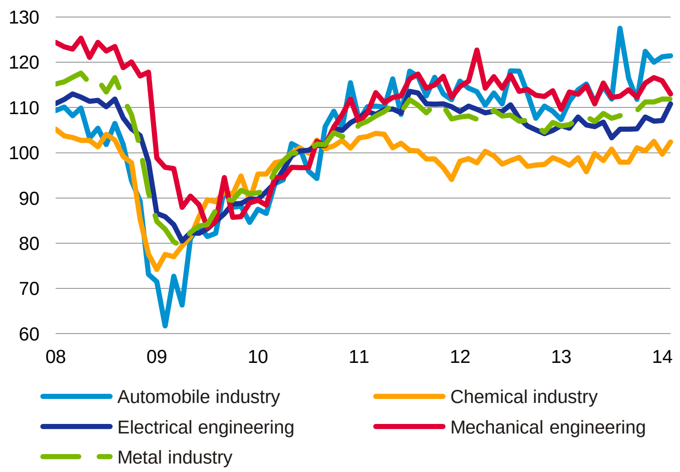


New manufacturing orders by region

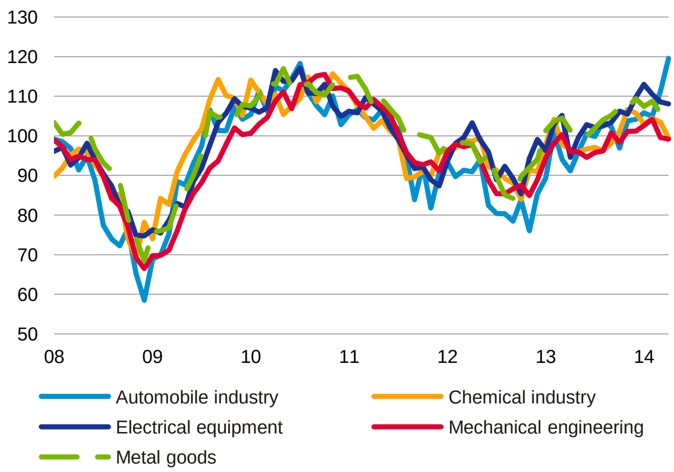
% yoy, 3M mov. avg.



Production of largest industrial sectors (2010=100, sa)



ifo business expectations of the largest industrial sectors (2005=100)



Sources: Federal Statistical Office, ifo

Chartbook – Domestic economy

— The cyclical recovery since spring 2013 has increasingly been reflected in upwards momentum on the labour market towards the end of 2013 and has lately been further supported by the mild winter. The number of unemployed fell by 18 ths. mom on average over the last three months and thus stands markedly below its previous year's level. The unemployment rate at 6.7% remained unchanged in April, though. The employment build-up also improved (3M mov. avg.: +47 ths. mom; +0.8% yoy). Due to immigration and rising employment rates employment continues to increase by more than unemployment decreases. Leading indicators (ifo employment barometer/PMI) suggest that the positive trend should continue in the next few months. The unemployment rate should fall to 6.6% in 2014 after 6.9% in 2013.

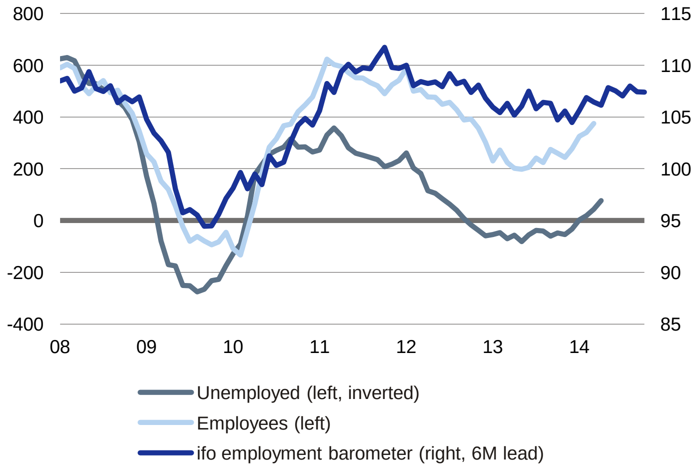
— Retail sales were up by 0.3% yoy (3M mov. avg.) in March and continued their moderate and volatile upward trend. As usual the sector's dynamic lags behind the one of private consumption (Q4: +1.0% yoy). The record level of the Gfk consumer climate (highest since early 2007) and EC consumer confidence (highest since mid-2011) as well as the positive labour market suggest a modestly increasing trend of retail sales.

— After weakness in 2013 investment in M&E and construction spending should pick up again this year. Thanks to more dynamic domestic demand and better global growth investment in machinery & equipment could grow by 5% (2013: -2.4%). Domestic orders of investment goods, however, so far do not point to a marked acceleration.

— The construction sector benefits from high net immigration and rising disposable income that give impetus to housing demand. Construction activity (Feb.: +8.5% yoy, 3M mov. avg.) and orders (+16.3%) are markedly higher than last year. Construction spending could grow by 4.5% in real terms in 2014 (2013: +0.1%).

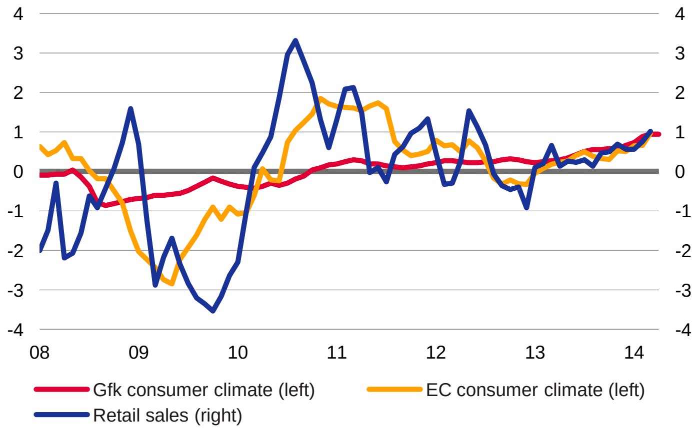
Unemployment barometer, employment and unemployment

'000 yoy (left); index (right)



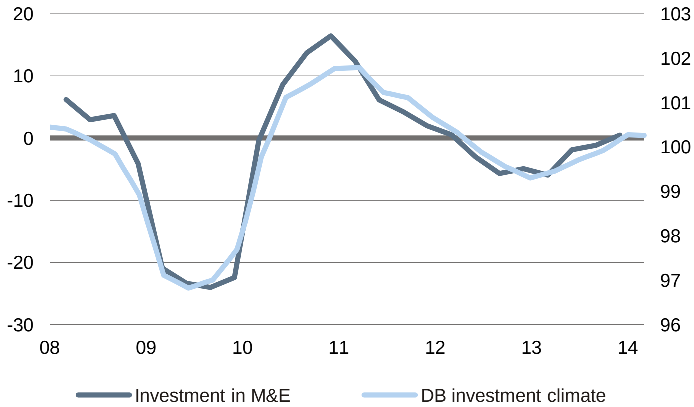
Retail sales and consumer confidence

Normalized data (left), % yoy, 3M mov. avg. (right)



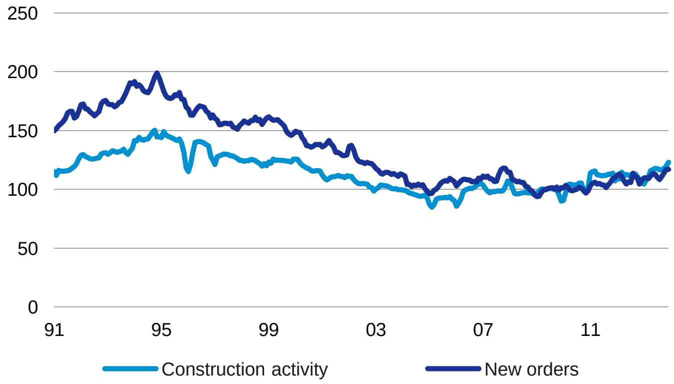
Investment in machinery & equipment and DB investment climate

% yoy (left); index normalized to 100 (right)



Construction activity and new orders

2010=100, 3M mov. avg.



Sources: Federal Statistical Office, Deutsche Bank Research, Gfk, EU Commission, ifo

Chartbook – Financial markets

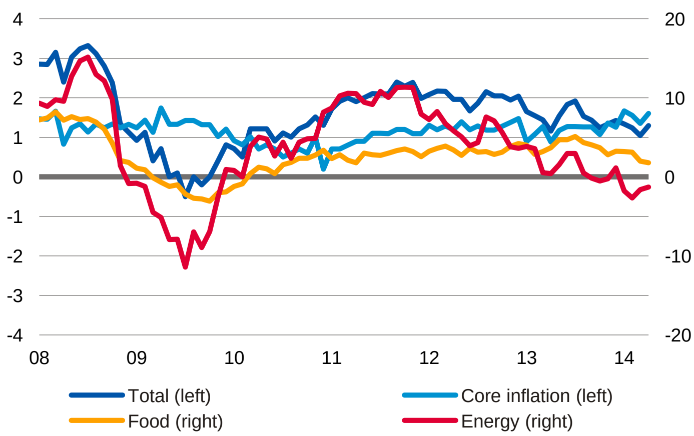
— In April the inflation rate inched up to 1.3% as base effects due to different locations of Easter in 2013 and 2014 reversed. In March inflation had slowed to 1.0% – the lowest rate since August 2010. Food prices continued to slow in April (+1.8%; Aug 2013: 5.7%). Energy prices remained below last year's levels (-1.3%) and have been on a downtrend since end-2011. Core inflation probably inched back to 1.6%. The inflation trend remains extremely muted and is unlikely to accelerate much in 2014. We expect an annual average inflation rate of 1.2%.

— At the ECB's April press conference which did not reveal any new policy measures Draghi sounded a lot more dovish. He announced that the governing council is "unanimous in its commitment to using also unconventional instruments within its mandate to cope effectively with risks of a too prolonged period of low inflation". Although the trigger for action (e.g. lower than expected inflation or inflation dampening EUR strength) and the specific action (purchase of private or public assets) were left unclear, quantitative easing measures from the ECB seem to have become a much more real option. We expect a limited action targeted at liquidity in June and the announcement of a private asset purchase program in September.

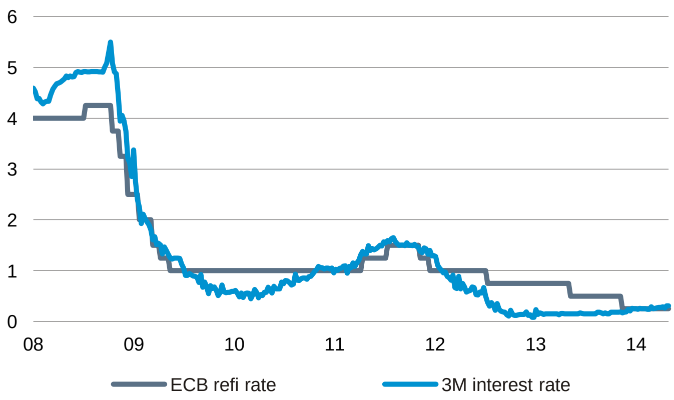
— Given diverging interest rate and growth expectations for EMU and the US the yield spread between 10Y US treasuries and German Bunds has nearly doubled since mid-2013 to a good 1pp as of late. In contrast, an improved economic outlook and continued policy accommodation have lowered the peripheral's spread vs. Germany to a good 1.5% (mid-2013: around 3pp).

— The diverging expectations for EMU and the US are also reflected in our expectations for the USD/EUR exchange rate. The USD should appreciate markedly over the course of 2014, though the opposite happened until recently. The USD/EUR is currently at nearly 1.39.

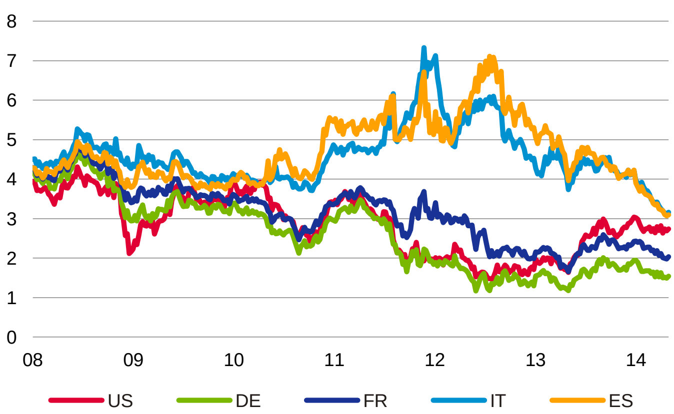
Consumer prices (% yoy)



EMU: Refi rate & 3M interest rate (%)

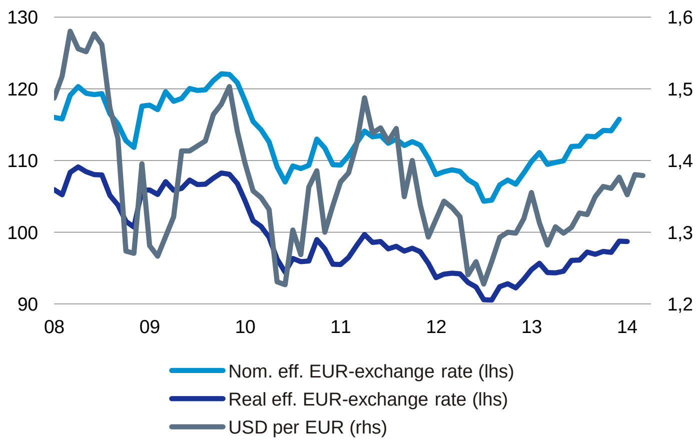


10Y government bond yields (%)



Exchange rate development for the EUR

1999Q1=100 (left), USD per EUR (right)

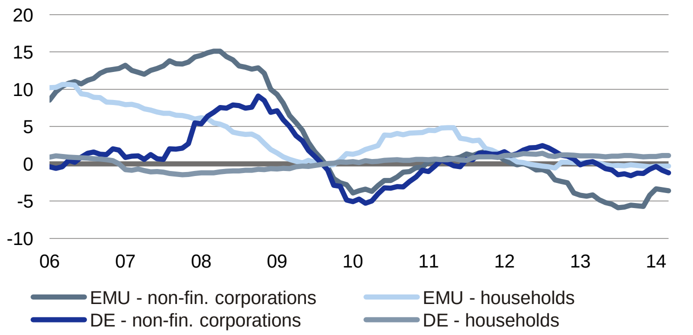


Sources: Federal Statistical Office, ECB, EU Commission, Global Insight, Reuters, Deutsche Bank Research

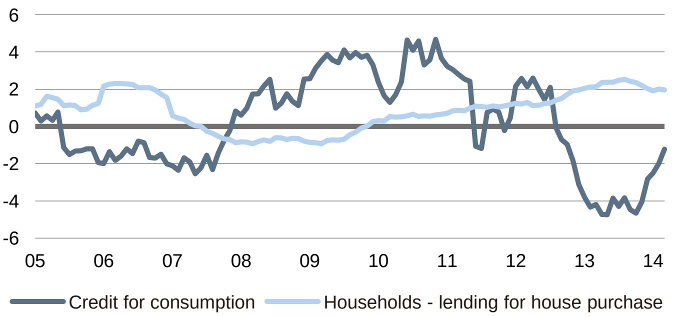
Chartbook – Lending

- Lending to corporates remained weak in 2013 with the declines 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. At the start of 2014 the downward movement slowed (-3.6% yoy March for Eurozone) but lending still has not turned the corner. Lending to German corporates decreased by 1.2% (yoy) in March.
- Households in the Eurozone also continue deleveraging (-0.3% yoy). By contrast, lending to households in Germany continues to rise: March records +1.1%.
- The stable but moderate credit growth in Germany is mainly driven by growth in mortgage lending. March (+2% yoy) is basically unchanged from last year's developments. Given the low mortgage rates (Feb. 2.8%), credit growth still remains rather modest, which partly reflects portfolio shifts by households and local supply shortages. Consumer credit remained restrained (March -1.2% yoy).
- For companies in Germany, financing conditions continue to be favourable. Interest rates for corporate credit remained at 3% in February.
- Less than a fifth of companies from industry and trade currently see credit constraints: in April only 18.2% of respondents reports restrictive access to credit – a record low. Similarly, construction companies report relatively favourable conditions. Only 23.8% note credit constraints, i.e. even slightly less than in 2013 (yearly average: 24.7%). This contrasts with the subdued growth of lending volumes to corporate in Germany.

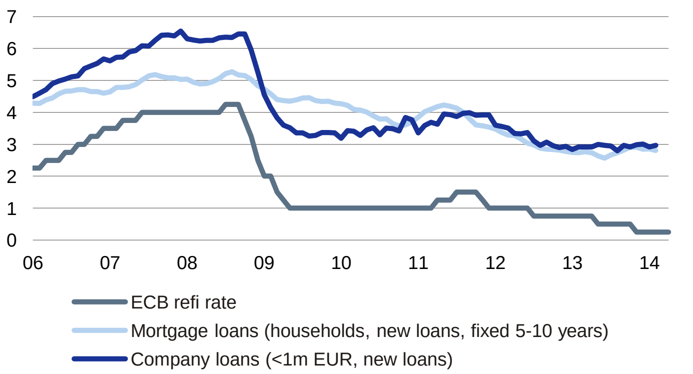
Lending to the private sector (% yoy)



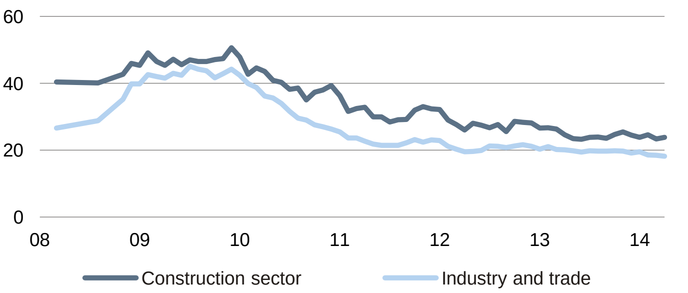
Loans to households (% yoy)



Interest rates (%)



Companies' view on access to credit



Credit constraints: Percentage of companies reporting restrictive access to credit. Higher values indicate more restrictive access to credit from companies' perspective

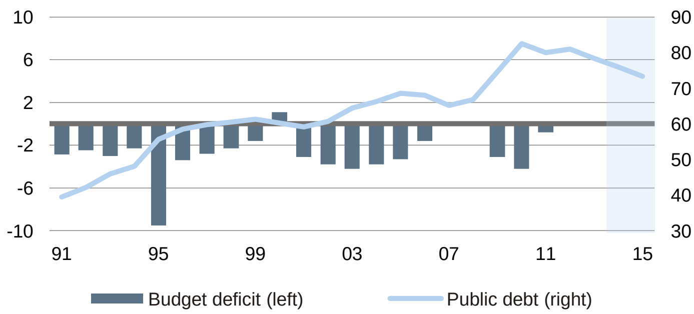
Sources: ECB, ifo, Deutsche Bank Research

Chartbook – Public finances

- In 2013 Germany was – apart from Luxemburg – the only eurozone country without a deficit. But the federal government and the Länder still report deficits. The general budget only showed a small plus thanks to surpluses in municipalities and the social security system.
- The German government debt ratio stood at 78.4% of GDP 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 anticipate the debt level to 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.
- Recently growth of tax revenues has increased courtesy to the strong economy. Especially the income tax contributes to this development.

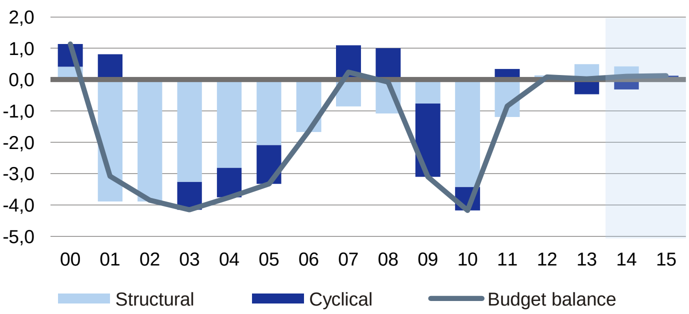
Public debt and public deficit

as % of GDP



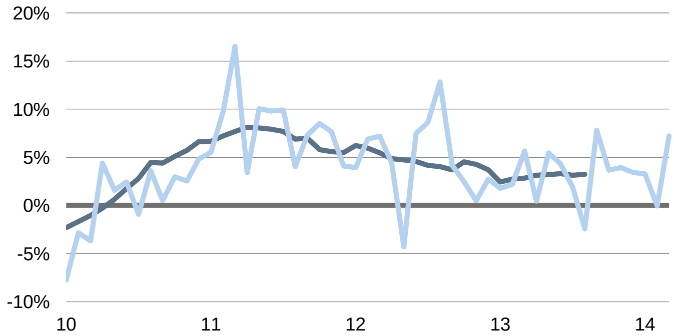
Budget balance

General Government, % of GDP



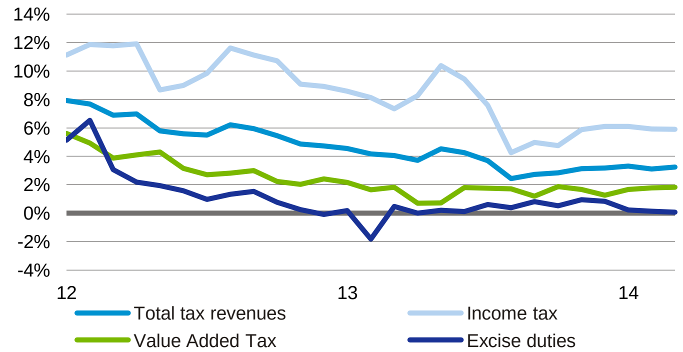
Tax revenues

Monthly data, yoy and yoy 12 months moving average



Development of important taxes

Change yoy, 12 months moving average



Sources: Deutsche Bank Research, European Commission, Bundesbank

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

Date	Event	Remarks
5/6 May	Eurogroup/ECOFIN meeting	Debate on the economic situation in the euro area. Macro-imbalances procedures. Banking Union.
6-8 May	Meeting working group tax estimation, Berlin	The tax experts from various institutions are unlikely to present surprising estimates. As the federal government has slightly increased its GDP forecast in January, the experts will probably accordingly increase their estimates on the tax receipts. However, at least the government's financial planning has already anticipated this.
8 May	Meeting of the ECB Council, press conference, Brussels	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 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, Brussels	Informal dinner.
28 May	Meeting of the Stability Council, Berlin	Presumably debate on compliance with the debt brake and on the budget and debt restructuring procedures which are imposed on some Länder, e.g. Bremen and Saarland.
4/5 June	G7 leaders' summit, Brussels	Originally scheduled as a G8 summit in Sochi, Russia, which was cancelled following a G7 meeting focused on the Ukraine crisis on 24 March. G7 leaders suspended Russia’s membership.
5 June	Meeting of the ECB Council, press conference	Review of the monetary policy stance.
19/20 June	Eurogroup/ECOFIN meeting	European semester – discussion on SCPs and euro area specific recommendations, IMF Art. IV consultation with the euro area, Greece adjustment programme, Banking Union and euro area aspects.
26/27 June	European Council, Brussels	Presumably among others economic situation in the EU and foreign relations (e.g. Ukraine crisis).

Source: Deutsche Bank Research

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Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
7 May 2014	8:00	New orders manufacturing (Index, sa), pch mom	March	-0.8	0.6
8 May 2014	8:00	Industrial production (Index, sa), pch mom	March	0.2	0.4
9 May 2014	8:00	Trade balance (EUR bn, sa)	March	15.9	15.6
9 May 2014	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	March	-1.0 (1.7)	-1.4 (3.5)
9 May 2014	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	March	-1.5 (3.8)	0.4 (5.8)
15 May 2014	8:00	Real GDP (Index, sa), % qoq	Q1 2014	0.5	0.4
22 May 2014	9:30	Manufacturing PMI (Flash)	May	53.7	54.2
22 May 2014	9:30	Services PMI (Flash)	May	54.5	55.0
23 May 2014	10:30	ifo business climate (Index, sa)	May	110.5	111.2
28 May 2014	10:00	Unemployment rate (%, sa)	May	6.6	6.7
30 May 2014	8:00	Import prices (Index, sa) pch mom (yoy)	April	-0.5 (-2.7)	-0.6 (-3.3)
30 May 2014	8:00	Retail sales (Index, sa), pch mom	April	0.5	-0.7
2 Jun 2014	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	May	0.4 (1.3)	0.3 (1.0)

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	2.50	0.05
Jun 14	0.125	0.10	0.25	0.50	0.00	0.75	0.20	1.50	2.50	2.50	0.05
Sep 14	0.125	0.10	0.25	0.50	0.00	0.75	0.20	1.50	2.50	2.60	0.05
Mar 15	0.250	0.10	0.25	0.50	0.00	0.75	0.30	1.50	3.50	3.25	0.05
3M interest rates, %											
Current	0.23	0.21	0.35	0.53							
Jun 14	0.35	0.20	0.35	0.52							
Sep 14	0.35	0.20	0.38	0.52							
Mar 15	0.35	0.20	0.40	0.52							
10Y government bonds yields, %											
Current	2.67	0.62	1.50	2.69	0.89	1.97	1.59	2.86			
Jun 14	2.50	0.60	1.85	2.90	1.10	2.40	1.90	3.10			
Sep 14	3.00	0.70	2.05	3.00	1.25	2.55	2.10	3.20			
Mar 15	3.25	0.80	2.35	3.30	1.45	2.80	2.45	3.30			
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	1.38	102.58	0.82	1.68	1.22	9.04	7.46	8.28	4.19	309.18	27.44
Jun 14	1.32	109.00	0.82	1.61	1.25	8.70	7.46	8.35	4.09	303.80	27.00
Sep 14	1.29	112.00	0.81	1.59	1.26	8.58	7.46	8.28	4.00	297.50	27.00
Mar 15	1.20	116.00	0.80	1.50	1.27	8.35	7.46	8.00	3.98	301.50	27.00

Sources: Bloomberg, Deutsche Bank

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German Data Monitor

	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Nov 2013	Dec 2013	Jan 2014	Feb 2014	Mar 2014	Apr 2014
Business surveys and output											
Aggregate											
Ifo business climate	105.3	107.2	108.8	110.9		109.4	109.5	110.6	111.3	110.7	111.2
Ifo business expectations	101.8	103.4	106.0	107.8		106.6	107.4	108.9	108.2	106.4	107.3
PMI composite	49.9	52.9	54.5	55.4		55.4	55.0	55.5	56.4	54.3	56.3
Industry											
Ifo manufacturing	100.4	102.7	104.5	106.9		105.2	105.2	106.3	107.3	107.0	107.5
PMI manufacturing	48.7	51.2	52.9	55.0		52.7	54.3	56.5	54.8	53.7	54.2
Headline IP (% pop)	1.5	0.8	0.5			2.3	0.1	0.7	0.4		
Orders (% pop)	1.0	1.5	2.3			0.7	0.1	0.1	0.6		
Capacity Utilisation	82.1	83.2	83.2	83.4	84.3						
Construction											
Output (% pop)	10.9	1.4	0.0			1.2	2.1	3.1	2.4		
Orders (% pop)	1.5	-1.1	3.5			5.6	-1.5	4.3	-3.1		
Ifo construction	123.7	120.4	121.2	122.6		121.0	123.6	124.2	123.1	120.6	120.7
Services											
PMI services	49.9	52.6	54.1	54.0		55.7	53.5	53.1	55.9	53.0	55.0
Consumer demand											
EC consumer survey	-4.2	-3.2	-2.8	0.3		-2.1	-2.2	-0.8	-0.7	2.3	3.1
Retail sales (% pop)	0.2	-0.2	-0.2	1.3		1.0	-1.6	2.0	0.4	-0.7	
New car reg. (% yoy)	-3.7	-1.4	1.6	2.8		-2.0	5.4	-2.0	4.3	5.4	
Foreign sector											
Foreign orders (% pop)	2.8	0.6	3.9			-0.4	1.8	-1.3	0.2		
Exports (% pop)	0.5	0.2	1.7			0.7	-0.9	2.2	-1.4		
Imports (% pop)	1.2	-0.3	0.5			-1.2	-1.4	4.1	0.4		
Net trade (sa EUR bn)	48.1	49.4	53.0			18.1	18.3	17.3	15.6		
Labour market											
Unemployment rate (%)	6.9	6.8	6.9	6.7		6.9	6.8	6.8	6.7	6.7	6.7
Change in unemployment (k)	23.0	1.0	13.3	-54.7		7.0	-19.0	-29.0	-16.0	-14.0	-25.0
Employment (% yoy)	0.5	0.6	0.6	0.8		0.6	0.7	0.8	0.8	0.9	
Ifo employment barometer	104.9	106.3	107.2	107.5		107.8	107.5	107.0	108.0	107.4	107.4
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	1.5	1.7	1.3	1.0		1.6	1.2	1.2	1.0	0.9	1.1
Core HICP (% yoy)	1.0	1.2	1.1	1.1		1.7	0.7	1.2	1.2	0.9	
Harmonised PPI (% yoy)	-0.1	-0.3	-0.7	-1.0		-0.8	-0.5	-1.1	-0.9	-0.9	
Commodities, ex. Energy (% yoy)	-7.0	-12.2	-10.4	-11.1		-9.8	-10.2	-11.0	-11.0	-11.3	
Oil price (USD)	102.5	110.4	109.3	108.2		108.0	110.8	108.3	108.9	107.5	
Inflation expectations											
EC household survey	22.5	26.2	25.5	22.0		24.6	25.5	24.0	22.0	19.9	18.0
EC industrial survey	-0.6	2.8	6.1	5.6		5.8	8.6	7.8	4.8	4.1	2.5
Unit labour cost (% yoy)											
Unit labour cost	1.5	1.3	1.0								
Compensation	1.7	2.2	1.8								
Hourly labour costs	1.1	1.3	1.7								
Money (% yoy)											
M3	3.8	2.4	2.7	3.4		1.3	2.7	3.1	3.9	3.4	
M3 trend (3m cma)						2.0	2.4	3.2	3.5		
Credit - private	1.3	-4.0	-3.1			-3.9	-3.1	-3.8	-3.9		
Credit - public	-22.4	-17.7	-17.1			-12.7	-17.1	-5.8	-5.8		

% 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

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