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Business cycle

Focus Germany

Growth and fiscal outlook: Risks remain

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Authors
Dieter Bräuninger
+49 69 910-31708
dieter.braeuninger@db.com

Jochen Möbert
+49 69 910-31727
jochen.moebert@db.com

Heiko Peters
+49 69 910-21548
heiko.peters@db.com

Oliver Rakau
+49 69 910-31875
oliver.rakau@db.com

Stefan Schneider
+49 69 910-31790
stefan-b.schneider@db.com

Editor
Stefan Schneider

Deutsche Bank AG
Deutsche Bank Research
Frankfurt am Main
Germany
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

www.dbresearch.com

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Q2 GDP downward revision; downside risks to H2. Q1 GDP growth (+0.7% qoq vs. +0.3%) was exclusively driven by strong domestic demand growth, which contributed 0.8 pp to headline growth. We revise down our Q2 GDP growth forecast from 0.3% to 0.1% as we expect material payback for Q1 strength. While we remain optimistic with regards to the labour market, we think that the impetus from low oil prices to real incomes is fading. In addition, the mild winter has allowed construction work to be brought forward, albeit the payback might be limited by the strength of underlying construction demand. Given weak export sentiment, falling investment goods orders and lower capacity utilisation, we think investment in machinery & equipment is going to weigh on Q2 growth. We maintain our 2016 GDP forecast (1.7%), though. Risks remain skewed to the downside, especially looking at the modest downtrend and low levels of global (manufacturing) PMI. Moreover, our China economist sees a growth slowdown in H2 2016, and our US economists do not sound optimistic with regards to a material growth pick-up following the weak Q1.

Healthy medium-term fiscal outlook is little relief for demographic burden. Despite spending on refugees, the German national budget generated a surplus of 0.7% of GDP in 2015, the largest since 2000. Furthermore, all federal, regional and local authorities and the social security system reported surpluses for the first time since reunification. The level of public debt fell once more to its current level of 71.2% of GDP. If the strong rate of economic growth is maintained, it will continue to contract and could even fall to 60% – the upper limit in the Maastricht Treaty – by the end of the decade. By contrast, the level of public debt in the other populous eurozone countries is scarcely expected to decline in the coming years. However, the healthy short and medium-term fiscal outlook only marginally reduces the need for the reform of public finances. The particularly rapid pace at which Germany's population is ageing by international standards is likely to place a massive burden on the social security system, making significant reforms essential. Unfortunately, current political debate – more than a year ahead of the Bundestag elections – is moving in the opposite direction.

The view from Berlin. Grand coalition quandary. The grand coalition has run out of steam and is unlikely to push through further reforms. Instead the political parties have started to define their campaign strategies for the federal election in autumn 2017. Though neither the protagonists in Berlin nor the electorate would like to see another CDU/CSU-SPD coalition in the next term, the strengthening of the AfD could force both camps into such an unwanted alliance again. Currently, the media focus on the intense bickering within the CDU/CSU as representatives from both sister parties have tried to pin the blame for the parties' declining popularity on each other.

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2015	2016F	2017F	2015	2016F	2017F	2015	2016F	2017F	2015	2016F	2017F
Euroland	1.5	1.5	1.5	0.0	0.1	1.3	3.2	2.6	2.2	-2.1	-2.0	-1.7
Germany	1.7	1.7	1.6	0.2	0.6	1.5	8.3	8.1	7.8	0.7	0.0	0.0
France	1.2	1.2	1.5	0.1	0.2	1.1	-0.2	0.1	0.3	-3.5	-3.3	-2.9
Italy	0.8	1.1	1.1	0.1	0.1	1.3	2.2	2.6	2.3	-2.6	-2.5	-2.1
Spain	3.2	2.7	2.2	-0.6	-0.6	1.5	1.4	1.1	0.6	-5.1	-4.0	-3.3
Netherlands	2.0	1.2	1.3	0.2	0.0	1.3	9.1	10.6	10.7	-1.8	-1.7	-1.6
Belgium	1.4	1.0	1.2	0.6	1.0	1.7	0.0	1.0	1.0	-2.6	-2.7	-2.3
Austria	0.8	1.1	1.4	0.8	1.1	1.8	2.6	2.7	2.8	-1.2	-1.6	-1.4
Finland	0.5	0.6	1.0	-0.1	0.2	1.3	0.1	0.3	0.4	-2.7	-2.6	-2.1
Greece	-0.3	-1.0	1.6	-1.1	-0.3	0.8	-0.1	1.0	1.2	-7.2	-3.7	-1.8
Portugal	1.5	1.3	1.5	0.5	0.3	1.4	0.6	1.0	0.9	-4.4	-2.8	-2.6
Ireland	7.8	3.8	3.2	0.0	0.3	1.7	4.5	4.0	3.5	-2.3	-1.1	-0.6
UK	2.3	1.7	2.1	0.0	1.1	1.9	-4.7	-4.0	-3.5	-4.3	-3.0	-2.0
Denmark	1.2	1.4	1.8	0.5	1.1	1.7	7.0	7.0	7.0	-2.5	-2.5	-2.0
Norway	1.1	1.0	2.0	2.2	2.5	2.3	9.0	6.5	6.5	9.0	6.5	6.5
Sweden	3.9	3.4	2.5	0.0	0.9	1.8	5.9	5.7	5.5	-0.8	-1.0	-0.5
Switzerland	0.9	1.3	1.5	-1.1	-0.5	0.2	11.4	9.0	8.0	0.3	-0.5	-0.5
Czech Republic	4.3	2.6	3.2	0.3	1.0	1.7	1.6	1.2	0.8	-1.9	-1.4	-1.2
Hungary	2.9	2.4	3.1	-0.1	0.4	1.4	4.4	4.2	3.5	-2.0	-1.9	-2.5
Poland	3.6	3.6	3.5	-0.9	-0.6	1.2	-0.2	-0.8	-0.7	-2.5	-2.9	-3.0
United States	2.4	1.4	2.1	0.1	1.3	1.9	-2.4	-2.7	-3.0	-2.4	-2.9	-2.9
Japan	0.6	0.2	0.5	0.8	0.0	1.7	3.3	3.6	3.5	-4.2	-4.3	-3.7
China	6.9	6.7	6.7	1.4	1.8	1.8	2.7	2.7	2.5	-3.5	-4.0	-4.0
World	3.1	3.0	3.6	3.3	3.7	4.0						

*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

						2015				2016			
	2013	2014	2015	2016F	2017F	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F
Real GDP	0.3	1.6	1.7	1.7	1.6	0.3	0.4	0.3	0.3	0.7	0.1	0.5	0.5
Private consumption	0.6	0.9	2.0	1.8	1.3	0.4	0.1	0.6	0.4	0.4	0.2	0.5	0.4
Gov't expenditure	0.8	1.7	2.5	2.8	1.8	0.4	0.7	1.3	0.9	0.5	0.7	0.8	0.8
Fixed investment	-1.3	3.5	2.2	2.8	1.7	1.7	-0.4	-0.3	1.4	1.8	-0.5	0.2	0.5
Investment in M&E	-2.3	4.5	4.8	3.2	1.4	1.9	0.5	-0.8	1.0	1.9	-0.5	0.6	0.6
Construction	-1.1	2.9	0.3	3.0	2.2	1.8	-1.3	-0.3	2.0	2.3	-0.9	-0.2	0.4
Inventories, pp	0.6	-0.3	-0.5	0.1	0.0	-0.1	-0.3	0.0	0.1	0.1	0.0	0.0	0.0
Exports	1.6	4.0	5.4	2.8	4.4	1.5	1.8	0.2	-0.6	1.0	0.8	1.3	1.0
Imports	3.1	3.7	5.8	4.3	4.7	2.1	0.5	1.1	0.5	1.4	1.0	1.3	1.0
Net exports, pp	-0.5	0.4	0.3	-0.5	0.2	-0.2	0.6	-0.3	-0.5	-0.1	0.0	0.1	0.1
Consumer prices*	1.5	0.9	0.2	0.6	1.5	0.0	0.5	0.1	0.3	0.3	0.2	0.9	1.2
Unemployment rate, %	6.9	6.7	6.4	6.3	6.8	6.5	6.4	6.4	6.3	6.2	6.2	6.4	6.5
Industrial production	0.1	1.5	0.5	1.3									
Budget balance, % GDP	-0.1	0.3	0.7	0.0	0.0								
Public debt, % GDP	77.2	74.7	71.2	69.3	67.1								
Balance on current account, % GDP	6.5	7.3	8.3	8.1	7.8								
Balance on current account, EUR bn	182	212	249	254	254								

*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

Q2 GDP downward revision; downside risks to H2

— Q1 GDP growth (+0.7% qoq vs. +0.3%) was exclusively driven by stable domestic demand growth (+0.8% vs. +0.9%), which contributed 0.8 pp to headline growth. Domestic demand growth was supported by the healthy labour market with ongoing strong immigration-driven employment and wage gains. Moreover, investment benefited from the pick-up in exports and capacity utilisation, refugee-related government investment and strong underlying residential construction as well as seasonal factors.

— The acceleration in headline GDP growth relative to Q4 was due to – in addition to seasonal factors – less headwind from net exports (-0.1 pp vs. -0.5 pp) as exports recovered (+1.0% vs. -0.6%) after having been weighed down by weak global trade and especially weak demand from OPEC.

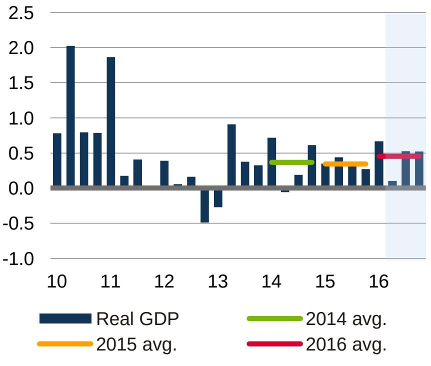
— We revise down our Q2 GDP growth forecast from 0.3% to 0.1% as we expect material payback for Q1 strength. While we remain optimistic with regards to the labour market, we think that the impetus from low oil prices to real incomes is fading. In addition, the mild winter has allowed construction work to be brought forward, albeit the payback might be limited by the strength of underlying construction demand. Given weak export sentiment, falling investment goods orders and lower capacity utilisation, we think investment in machinery & equipment is going to weigh on Q2 growth.

— Our fundamental assessment of Germany's 2016 growth outlook remains broadly unchanged, though. Taken together Q1 and Q2E 2016 would still show faster growth than H2 2015 and our 2016 forecast remains unchanged (1.7%). We still see growth this year strongly tilted towards domestic demand, especially consumption, while net exports should be a non-negligible drag as slow global growth and a stronger euro should weigh on export growth and import growth remains strong.

— Our risk assessment is also unchanged: we see upside risks to our domestic demand forecast (construction, private and government consumption) and downside risks to our export and investment in machinery & equipment forecasts (downside risks to H2 global growth expectations, uncertainty due to geopolitical risks). All in all, risks are skewed to the downside, especially looking at the modest downtrend and low levels of global (manufacturing) PMI. Moreover, our China economist sees a growth slowdown in H2 2016, and our US economists do not sound optimistic with regards to a material growth pick-up following the weak Q1.

Ongoing solid GDP growth 1

Real GDP, % qoq



Sources: Federal Statistical Office, Deutsche Bank Research

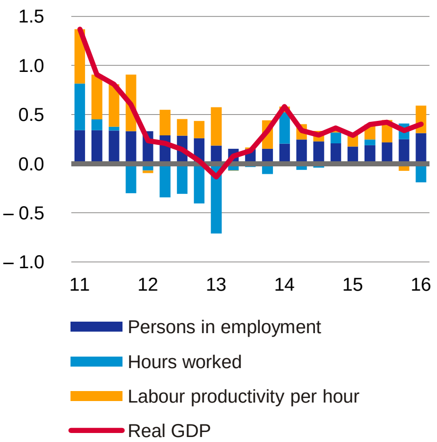
Q1 GDP details: Ongoing domestic strength with less external headwind

GDP growth in Q1 (+0.7% qoq vs. +0.3% prev.) was again dominated by domestic demand, which grew at a rapid rate for the third straight quarter (+0.8% vs. +0.9%) and contributed 0.8pp to headline growth. The composition of domestic demand growth changed little, with private and government consumption as well as machinery & equipment and construction investment all strong, adding between 0.1 pp to 0.2 pp to headline growth.

The acceleration of headline GDP relative to Q4 was due to – in addition to seasonal factors – less headwind from net exports (-0.1 pp vs. -0.5 pp) as exports recovered (+1.0% vs. -0.6%) after having been weighed down by weak global trade, especially weak demand from OPEC. Imports picked up (+1.4% vs. 0.5%) thanks to stronger exports pushing up demand for intermediate goods and robust domestic demand.

Strong employment growth 2

% qoq, 4 quarter moving average



Sources: Federal Statistical Office, Deutsche Bank Research

The forces driving domestic demand remained broadly the same:

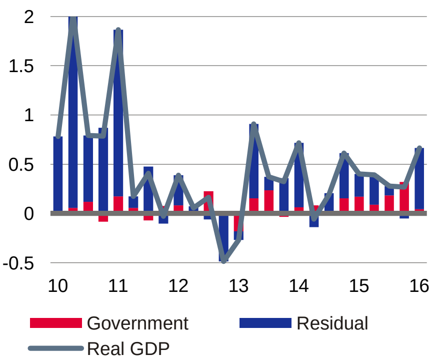
— Healthy labour market: private consumption (+0.4% qoq unchanged) benefited from strong disposable income growth (+2.5% yoy vs. +2.8%) that was materially tilted towards wage income (gross wages +4.2% vs. +4.1%) whereas profits and property income remained subpar (+0.8% vs. -1.0%). This is a sign of the strong labour market with the highest quarterly employment gain (+0.4% qoq) since Q1 2008 and the ongoing strength of gross wage growth per employee (+2.4% yoy vs. +2.5%) since Q2 2012. The employment gains are due to the integration of immigrant workers, probably primarily from Eastern and Southern Europe. The saving rate dropped back towards about its historical average (9.6% vs. 10%) after the peak impetus from lower oil prices to real incomes likely passed.

— Strong government spending: government consumption remained robust (+0.5% qoq vs. +0.9%). Here the strong refugee influx is likely to have left a hefty imprint – and while the influx has slowed materially recently, the gradual integration of the refugees into the labour market (e.g. integration and language courses) is likely to keep this component well supported. In addition, government investment remained healthy, too. While it fell (-2.0% qoq) this comes after hefty gains of 7.1% and 2.8% in the previous quarters. This is likely driven by higher military spending, refugee-related residential investment and general infrastructure spending. While there was some payback on a quarterly basis within these components, the general uptrend seems to be intact.

— Private investment benefited from strong construction demand and high capacity utilisation. Private investment in machinery & equipment rose a robust 3.0% qoq (vs. -0.5%). Private construction investment picked up further (+2.6% vs. +1.6%).

Q1 2016 Strong private sector 3

Contribution to real GDP growth, qoq, %-points



Sources: Federal Statistical Office, Deutsche Bank

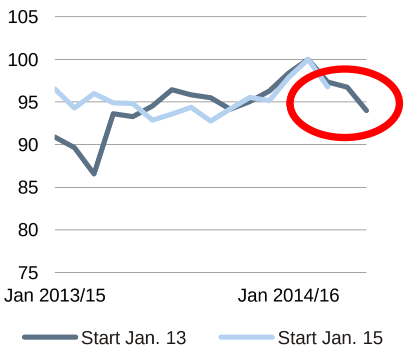
Q2 outlook: Payback for Q1 investment strength and fading oil impetus

We revise our Q2 GDP forecast down from +0.3% qoq to +0.1% following the stronger than initially expected Q1. This is not a change in our assessment of the underlying growth trend. Instead, we think that Q2 will bring a payback for the strong Q1. We had written about upside risks to our Q1 forecast due to one-off factors. These have materialised. Taken together, Q1 and Q2 should still show average quarterly gains of 0.4% qoq – slightly faster than H2 2015.

We see the payback primarily in construction and machinery & equipment spending. In Q1 total construction grew 2.3% qoq. This was the fastest rate since Q1 2014. Just like then, the mild winter played an important role. This is supported by construction companies' assessments of the weather, with the construction PMI pointing to a strong slowdown in Q2. Moreover, there is a negative statistical carry-over in Q2 from Q1 as March construction activity was 1.5% below the high Q1 average.

Further payback in April? 4

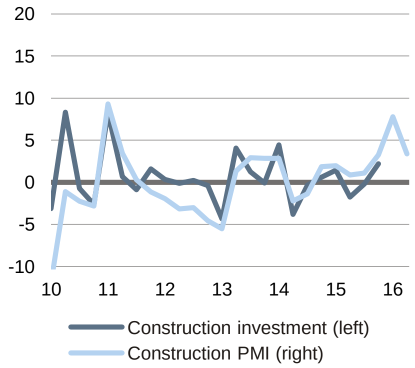
Construction output, real, Feb 2014 & 2016=100



Sources: Federal Statistical Office, Deutsche Bank Research

Construction: Weaker Q2 5

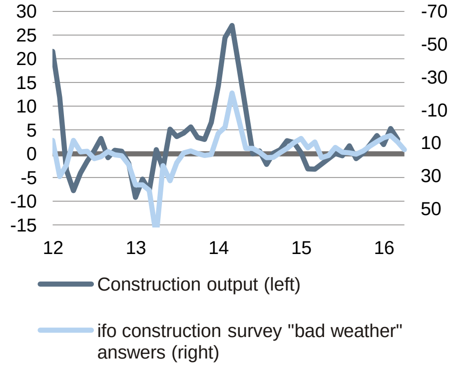
% qoq (left), index (right)



Sources: Federal Statistical Office, Markit

Fading weather effect 6

% yoy, 3M mov. avg. (left); balance of opinion (right, inverted)

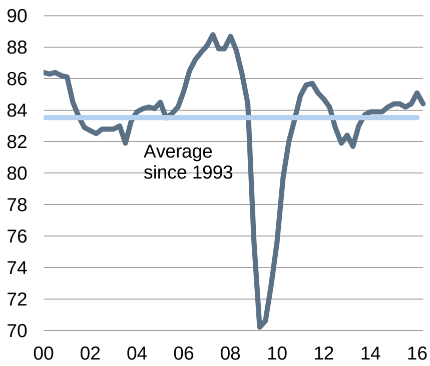


Sources: ifo, Federal Statistical Office

Strength in machinery & equipment investment in Q1 (+1.9% vs. +1.0%) was related to capacity utilisation rising to above 85% thanks to stronger external demand. However, since then capacity utilisation has dropped again (84.4%). Moreover, domestic orders of investment goods point to a quarterly decline in machinery & equipment investment in Q2. Finally, early indicators of external demand, like ifo export expectations, have weakened.

Weaker capacity utilization 7

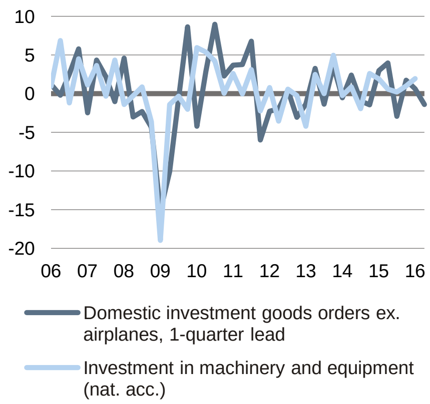
Manufacturing, %, sa



Source: ifo

Investment goods orders fell 8

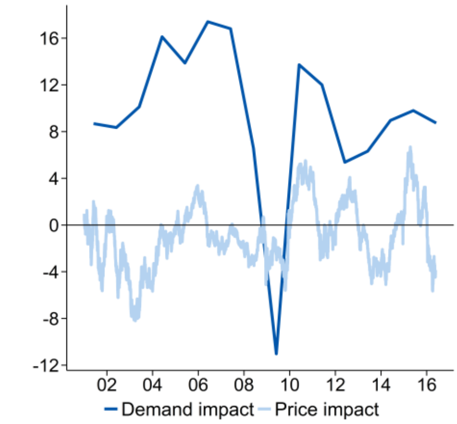
Real, % qoq



Source: Federal Statistical Office

Demand & price impact… 9

…on German exports (+) pos. / (-) neg.



Sources: Eurostat, Deutsche Bank Research

Finally, we think private consumption growth could temporarily be hit by the negative effect of rising oil prices on real disposable income. In the last two years there was a strong inverse correlation between the two time series (chart 12). Case in point, we increased our 2016 forecast for the CPI (nat. definition) from 0.3% to 0.6%

H2: Domestic upside vs. external downside risks

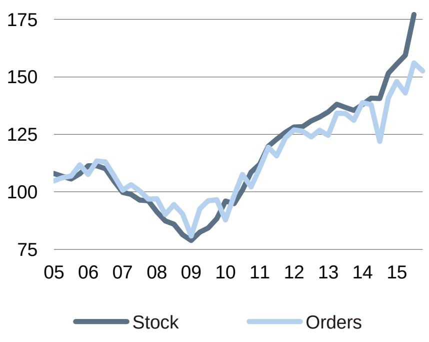
We are optimistic that the German economy will accelerate again after Q2 given its underlying robustness. We stick to our forecast of high quarterly rates of 0.5% for Q3 and Q4. As a result our 2016 GDP forecast is unchanged at 1.7%.

Our assessment of the composition of 2016 growth remains largely unchanged (chart 14). Domestic demand and especially private consumption (+1.8% yoy) and government consumption (+2.8%) should be the primary growth drivers.

Investment growth should be solid (+2.8%) mainly due to the strong start to the year. However, net exports should be a drag on headline GDP growth (-0.5 pp). Our fiscal forecast is still for a balanced budget this year and next.

Residential construction: Booming orders 10

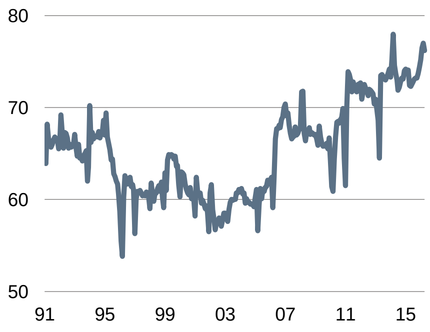
2010=100, calendar and seasonally adjusted



Sources: Destatis, Deutsche Bank Research

Capacity utilisation close to highs 11

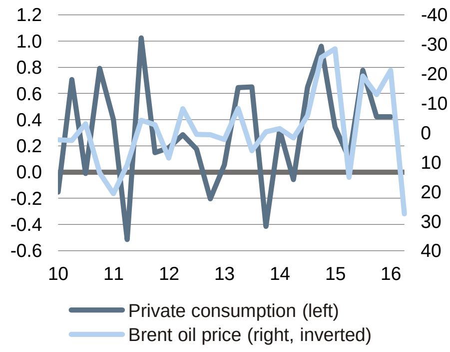
Construction, %



Sources: ifo, Deutsche Bank Research

Real private consumption & oil 12

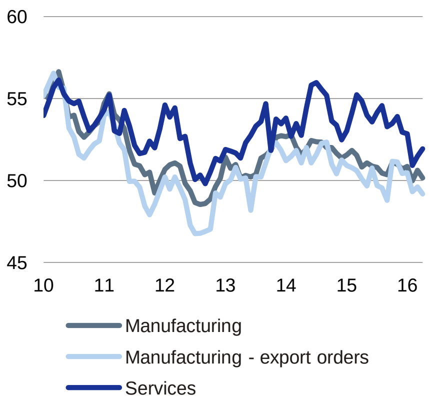
% qoq



Sources: Federal Statistical Office, Bloomberg Finance LP

Global PMIs: Weak outlook 13

Index, sa



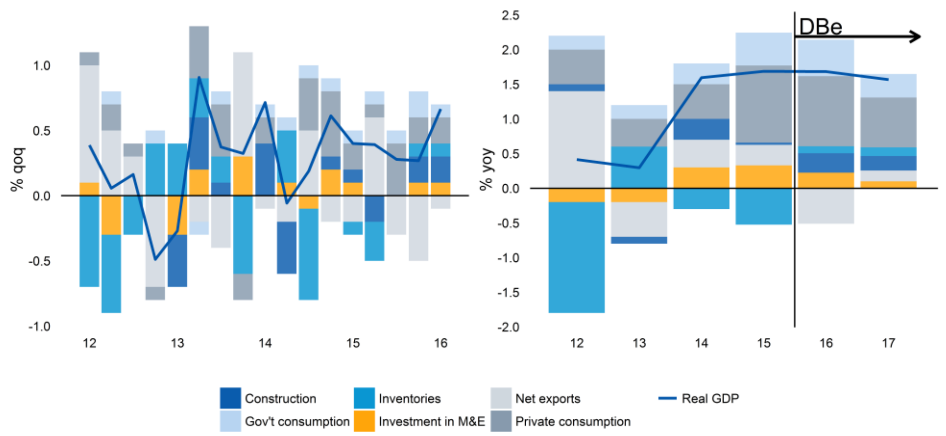
Source: Markit

Our risk assessment is also largely unchanged. We see upside risk for domestic demand, especially in the construction sector, where surging orders over the last few months have pushed up the backlog considerably. However, our concern is that already high capacity utilisation in the construction sector could limit the impact and/or delay it until later in 2016.

Risks to our export outlook and in extension to the machinery & equipment outlook are tilted to the downside, though. Judging by the global manufacturing PMI and its export order component, global trade is unlikely to pick up soon and it is thus likely to stay lower than global growth. This could weigh on German exports more than we currently forecast. German industry could as a result restrict its investment spending. Ample (geo-) political risks especially in the middle of the year could add to the lack of animal spirits.

GDP forecast 14

Contribution to real GDP growth (qoq or yoy), percentage points



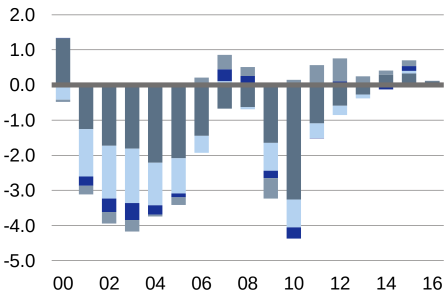
Sources: Federal Statistical Office, Deutsche Bank Research

Heiko Peters (+49 69 910-21548, heiko.peters@db.com)
Oliver Rakau (+49 69 910-31875, oliver.rakau@db.com)

Healthy medium-term fiscal outlook is little relief for demographic burden

Total government budget balance 1

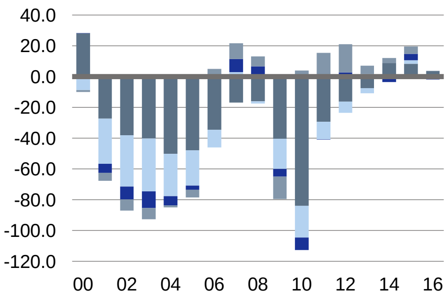
% of GDP



Sources: Bundesbank, Deutsche Bank Research

Total government budget balance 2

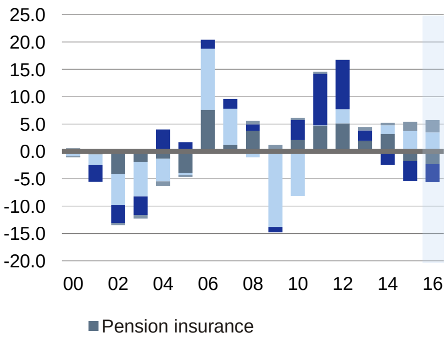
EUR bn



Sources: Bundesbank, Deutsche Bank Research

Social security system 3

EUR bn



Sources: Bundesbank, Deutsche Bank Research

— Despite spending on refugees, the German national budget generated a surplus of 0.7% of GDP in 2015, the largest since 2000. Furthermore, all federal, regional and local authorities and the social security system reported surpluses for the first time since reunification.

— The level of public debt fell once more to its current level of 71.2% of GDP. If the strong rate of economic growth is maintained, it will continue to contract and could even fall to 60% – the upper limit in the Maastricht Treaty – by the end of the decade. By contrast, the level of public debt in the other populous eurozone countries is scarcely expected to decline in the coming years.

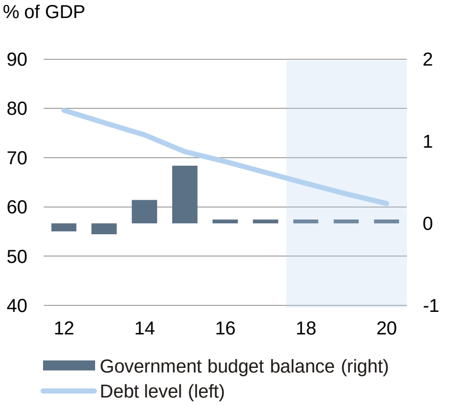
— However, the healthy short and medium-term fiscal outlook only marginally reduces the need for the reform of public finances. The particularly rapid pace at which Germany's population is ageing by international standards is likely to place a massive burden on the social security system, making significant reforms essential. Unfortunately, current political debate – more than a year ahead of the Bundestag elections – is moving in the opposite direction.

Comfortable budgetary situation despite extra spending

Despite extra spending resulting from the refugee crisis, the national budget generated a surplus of 0.7% of GDP in 2015, the largest since 2000. In addition, all federal, regional and local authorities and the social security system reported surpluses for the first time since reunification. Almost half of the surplus, 0.33% of GDP, was attributable to the federal German government. This large surplus enabled a reserve of EUR 12.1 billion to be set aside for receiving and housing refugees in the coming years. Based on Federal Ministry of Finance calculations, which put the total costs resulting from the migrant crisis at a minimum of EUR 16 billion a year, this reserve is likely to run out in the next few years. If around half a million new migrants come to Germany this year, as the German government expects, and the cash and non-cash benefits per refugee per year are assumed to be around EUR 12,000, the cost for new arrivals alone would be EUR 6 billion. To date, the German government has only promised the federal states and local authorities EUR 4.5 billion for expenditure in connection with the migrant crisis, and has budgeted a further EUR 3.5 billion for integration measures such as language courses. This means that the German government's actual expenditure could be significantly higher than it had previously budgeted for. Even taking into account this potential extra spending, we believe the German government's budget for 2016 will be slightly in surplus, because the upward trend on the revenue side seen in recent years is continuing. In the first quarter of this year, there was a further sharp quarter-on-quarter rise in tax revenue, and the robust economic situation makes it likely that tax revenue for the year as a whole will continue to grow rapidly.

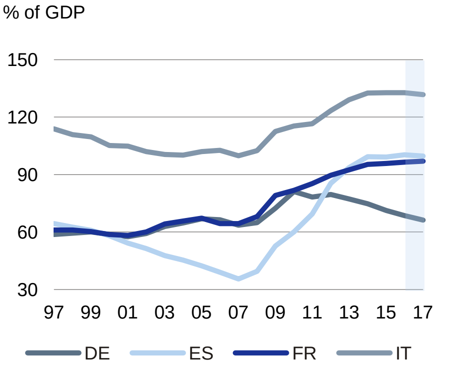
The federal states' budget revenue also increased significantly in the first quarter. Given the strong correlation with total tax revenue, local-authority revenue is also likely to have risen. However, expenditure for refugees will probably have a severely negative impact on the budget of the Länder (federal states) and municipalities, which is why we are forecasting a full-year deficit of EUR 1.0 billion for both regional authorities, despite planned central government funding running into the billions and the potential for further federal government subsidies.

Budget balance and public debt 4



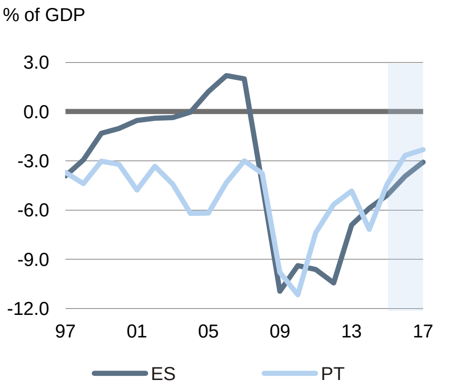
Sources: German Federal Statistical Office, Deutsche Bank Research

Public debt levels 5



Source: Eurostat

Total government budget balance 6



Source: Eurostat

The upward trend in government revenue at the beginning of the year is also reflected in the social security system (pension, healthcare, long-term care and unemployment insurance). The primary reason for the increase in revenue was the rising number of people in employment, but we are only expecting a marginal annual surplus of EUR 0.1 billion because spending is rising at a faster pace. Care for refugees will largely be at the expense of the health insurance funds and will presumably contribute to another year of deficit. Consequently, we expect the health insurance funds to remain in deficit, as was the case last year, with a deficit of more than EUR 3 billion in 2016. By contrast, the amount spent by the German Federal Employment Agency (BA) on refugees, particularly for language courses, is likely to be of little consequence, thanks to the robust budgetary situation. Given the continuing strength of the economy, the BA is likely to generate a surplus of EUR 3.5 billion. If these large surpluses persist into the next few years, the comfortable cash situation might enable contribution rates to be reduced. The pension insurance fund's budget balance had improved in the first quarter of 2016 compared with the prior-year period, although its expenditure is set to go up when pensions are increased from July 1 this year (rises of 4.25% in western Germany and 5.95% in the east). As a result, we believe the pension insurance fund will be in deficit by EUR 2.3 billion for the year as a whole. By contrast, the long-term care insurance scheme is likely to be in surplus again (by EUR 2.2 billion), having already reported a surplus of EUR 1.7 billion last year. Here too, the strong economic situation as well as the increase in contribution rates in 2015 had a positive impact.

Further improvement in Germany's medium-term outlook

The higher-than-expected surplus in 2015 also cut the current level of public debt to 71.2% of GDP (at the year end). Assuming that there is a balanced budget and nominal GDP growth is around 3% p.a. until 2020, which is approximately equivalent to the growth rate in recent years, the level of debt is likely to fall to close to 60%. In subsequent years, it could then comply with the upper limit agreed in the Maastricht Treaty for the first time since 2002. Germany could therefore extend its lead over the major eurozone countries, because the European Commission is predicting that debt ratios will only change marginally by 2017 (France: 97.0%, up by 1.2% on 2015; Italy: 131.8%, down by 0.9% and Spain: 99.6%, up by 0.4%). Given the reform fatigue in these countries, a reversal of this trend is scarcely foreseeable in the near future. In fact, the European Commission's generous interpretation and lenient assessments mean that non-compliance with the Fiscal Compact is tolerated, with the Spanish and Portuguese government deficits, for example, having exceeded the 3% limit agreed in the Fiscal Compact since 2008. Although the Fiscal Compact permits a penalty to be imposed in this scenario, the European Commission has neither made use of this, nor considered this lever to be a political option. National deficits will become a particular European problem at the time when the current economic cycle comes to an end and further expansion of the present fiscal and monetary operational framework is required. Many observers look upon monetary public-sector financing, often termed helicopter money, as the probable policy option at that point.

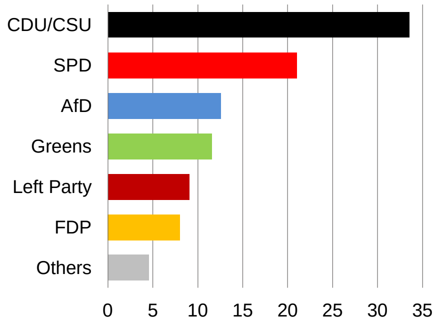
Long-term outlook: reform still urgently required

In the coming decades, many countries will have better demographic prospects than Germany. Because the German population is ageing very rapidly, major fiscal reforms are on the horizon. Even the positive medium-term outlook does little to mitigate the challenges faced. Current long-term projections indicate a sharp decline in the population, with the total down to 70 million by 2060 in the best-case scenario, and as low as around 60 million in the worst case. In either case, unless there are reforms, social security contributions, which are currently less than 40% of gross pay liable to contributions, are likely rise to a level that is substantially above 40%. At the same time, the number of people in employment is expected to gradually start shrinking after 2020 – from more than 43 million today to as few as 30 million in 2060. Despite the positive medium-term outlook, we therefore expect the ratio of pensioners to the working population to continue rising massively, with a correspondingly urgent need for political action to guarantee that public finances remain robust. As well as maintaining the conservative fiscal policy, it would be wise to introduce sustainability components into the social security system, with the highest priority given to pension reform so as to close the yawning pension-insurance sustainability gap. But at the moment – more than a year ahead of the next Bundestag elections in autumn 2017 – the debate is moving in the opposite direction.

Jochen Möbert (+49 69 910-31727, jochen.moebert@db.com)

Popularity of political parties in DE, according to the Allensbach survey 1

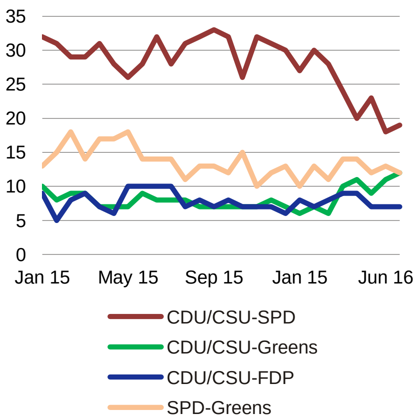
As of mid-May 2016, %



Source: IfD Allensbach

The Germans' favourite government coalition 2

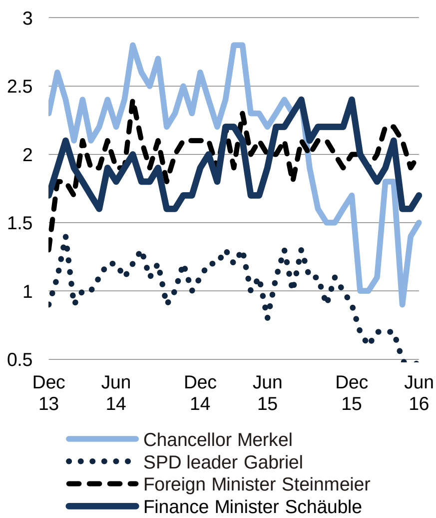
% of those asked



Source: Forschungsgruppe Wahlen, ZDF Politbarometer

Major politicians' approval ratings 3

Approval rating for the respective politician on a scale from -5 to +5



Source: Forschungsgruppe Wahlen, ZDF Politbarometer

The view from Berlin

Grand coalition quandary

Last week the CDU/CSU/SPD coalition government demonstrated harmony during its off-site meeting at the Meseberg castle and – among others – agreed on a new refugee integration law. Beyond that, though, the grand coalition has run out of steam and the partners are unlikely to push through further reforms. More so: The political parties have already started to define their key topics and strategies for the imminent campaign for the 2017 federal election. The parties are likely to proceed with a side glance to the result of the recent presidential election in Austria. There the green politician Van der Bellen managed a narrow victory over the right wing candidate Hofer in the 2nd. round, while the government coalition parties' candidates clearly failed in the 1st. round of the election already. This indicates that a long-lasting grand coalition can weaken both partners, especially when they have lost sight of their traditional core electorate.

However, the situation in Germany is different. Here, the CDU/CSU and the SPD are not as closely and lasting tied together as the ÖVP und SPÖ in Austria. In addition, the populist AfD is a political newcomer compared to the long established FPÖ which took even part in the Austrian government coalition from 1999 to 2005. Nevertheless, concerns have grown among the government camp in Germany that an ongoing rise of the AfD will further weaken their parties. In the end, this could force conservatives and social democrats into a renewed "grand coalition" in the 2017 elections, given that other coalition alternatives might miss the majority in the parliament – a scenario that neither the protagonists in Berlin nor the German public (19% only) would like.

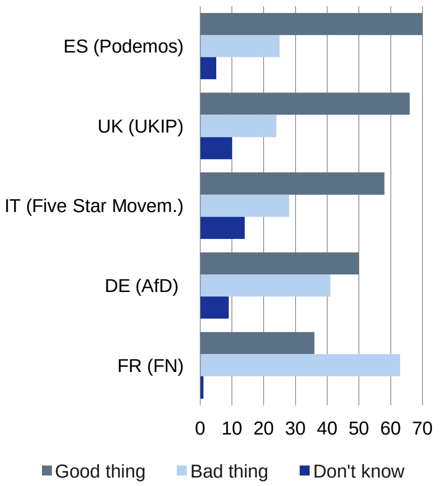
To prevent such an outcome the established parties are likely to focus their election campaign on reliable topics to please their constituencies. For the CDU budget and tax policies (in the sense of lowering the tax burden) would fit into such a strategy. The CDU has frequently rejected tax hikes and advocated a balanced budget and the party sells the fact that in 2016 the federal budget will be balanced for the third year in a row as its merit. This situation enables the conservatives to bring Finance Minister Schäuble, at present the CDU's most popular character, more into the limelight without undermining Chancellor Merkel's authority. Like in the 2013 campaign the Chancellor could again be the CDU's trump card as the guarantor for unity and stability in Europe – provided we will neither see a Brexit nor a re-escalation of the refugee crisis.

The CSU is already promoting classical conservative issues like internal security, support for families and limits on the influx of refugees. Thus the CDU's Bavarian sister party is on a tightrope walk. On the one hand these are issues also addressed by the AfD so that the CSU might further strengthen the populists. On the other hand this could be interpreted as a challenge to Chancellor Merkel and thus prove to be counterproductive for the whole CDU/CSU camp. CSU leader Horst Seehofer is even floating considerations of a separate CSU election campaign – considerations that have come up occasionally (with the heights of a rift between the two coalition partners CDU and CSU in the 1977s and mid 1980s) but have never been realised for various reasons. Recently the bickering has intensified as representatives from both camps have tried to pin the blame for their parties' declining popularity on the other side, respectively.

For the SPD 'social justice' continues to rank high on the agenda with a strong perception that the current focus on balanced budgets is detracting from this pressing issue. However, as the grand coalition has already implemented some of the party's former pet projects like the minimum wage it is open how the SDP will be able to flash out this buzzword. Advocating the (long pending) introduction of a financial transaction tax, let alone a hike of the heritage tax or the wealth tax is unlikely to thrill the electorate and the call for higher pensions from the public pension scheme could cut both ways as primarily the younger employees, i.e. potential SPD voters, too, would have to pay for it. Nevertheless, the SPD's left wingers whose influence could rise, given the SPD's poor showing in recent surveys (19% to 21%), will continue to call for more income and wealth redistribution and thus hurt the cooperation among the government coalition. Furthermore, the SPD cannot stop the debate on its candidate for chancellor. While SPD leader Gabriel has already declared that he is willing to run the final decision appears to be left until spring 2017 when the important, SPD-run German state North Rhine-Westphalia is going to the polls. Nonetheless, not only the media but also party officials serve up this topic again and again.

Raising issues 4

"Do you think that the rise of nontraditional political parties such as (...) is a good thing because these parties raise important issues that are ignored by the traditional parties OR a bad thing because these parties are too extreme?", in %



Source: Pew Research Center, Spring 2015 Global Attitudes Survey

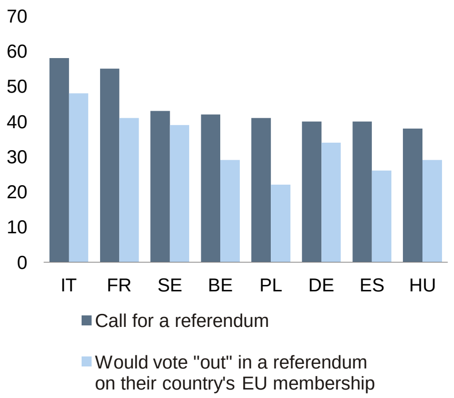
The Greens have to decide to what extent they will orientate their campaign towards a possible coalition with the CDU/CSU. As Chancellor Merkel and her party have promoted the energy turnaround and a modern family policy for quite some time now, these initially green topics are no longer at issue. Instead tax and social policy measures are debated, though much more from an inter-generational point of view than in the CDU/CSU with its voter structure leaning towards older generations. If the Greens continue to stress their call for a wealth tax or a basic flat rate pension, they could find it hard to join a coalition with the CDU/CSU without losing credibility.

For the Left the balancing act of being a governing or government coalition party in East German states on the one hand and a protest party on the other hand has become more and more difficult. This is all the more true since even the Left lost voters to the AfD which has emerged as a new protest party.

Following its success in the recent state elections the AfD's popularity has stabilised at low double-digit figures in national polls. At present, it even ranks third ahead of the Greens. The party's potential is unclear, though. In a recent survey (Allensbach Institute) 68% of those asked have doubted that the AfD is "a normal democratic party". In 2015 the respective figure still was 62%. However, a relative majority of nearly 50% thinks that the rise of a non-traditional party like the AfD that raises important issues ignored by the traditional parties is a good thing. This seems to be a reflection of a broader, cross-European sentiment. In several other European countries this attitude seems to drive the support for populist parties as well – mostly resulting in even higher support for the respective populist parties from the right or the left. However, in most countries only a minority would vote "out" in a referendum on the EU.

Who wants a referendum on the EU and would vote "out"? 5

% of population



Source: Ipsos Global, 04/2016

The FDP is in a relatively favourable position. It does not attract the media's attention like the populists or the other traditional parties as it is not represented in the Bundestag and has only recently managed to take a respectable number of seats in state parliaments again after a series of election defeats. But this also has been an opportunity for the Liberals to fully concentrate on their comeback. The results of the state elections this March as well as recent surveys indicate that the party has taken the opportunity. In its campaign the FDP is likely to put emphasis on issues like the reduction of red tape and of taxes and the enhancement of the education system, i.e. issues that are highly compatible to the CDU's ideas.

Before the start of the election campaign the parties have to participate in further state elections. The elections in Mecklenburg-West Pomerania and in Berlin on September 4 and 18, respectively, will be of minor importance only, in contrast to the one in North Rhine-Westphalia on 14 May 2017. There about 20% of the German electorate will cast their ballot. Therefore, the election result will not only be interpreted as a reflection of the political climate in this state currently run by a SPD-Green government but also as a forerunner of the things to come in Germany in autumn 2017. After May 14, however, it might be too late for the parties to successfully launch new topics or to exchange leading personnel.

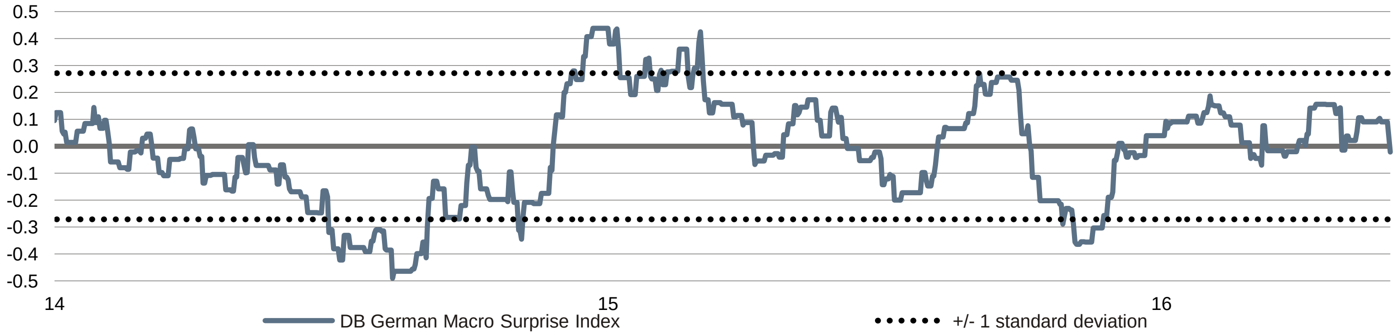
Dieter Bräuninger (+49 69 910-31708, dieter.braeuninger@db.com)
Barbara Böttcher (+49 69 910-31787, barbara.boettcher@db.com)

DB German Macro Surprise Index

The DB German Macro Surprise Index compares published economic data with market forecasts and thus provides clues as to the direction of future forecast revisions.[1]

DB German Macro Surprise Index

Average of last 20 z-scores of data surprises



Values above (below) 0 indicate the data came in better (worse) than expected

Sources: Bloomberg Finance LP, Deutsche Bank Research

Last 20 published economic data for Germany

Bloomberg Tickers	Indicator	Reporting month	Publication date	Current value	Bloomberg consensus	Surprise	Standardised surprise	Quantile rank
GRIFPBUS Index	IFO Business Climate	4 2016	25.04.16	106.7	107.1	-0.4	-0.4	0.3
GRIMP95Y Index	Import Price Index (% yoy)	3 2016	27.04.16	-5.9	-6.2	0.3	0.6	0.8
GRUECHNG Index	Unemployment Change (000's mom)	4 2016	28.04.16	-16.0	0.0	16.0	0.4	0.7
GRFRIAMM Index	Retail Sales (% mom)	3 2016	29.04.16	-1.4	0.4	-1.8	-1.1	0.1
MPMIDEMA Index	Markit Manufacturing PMI	4 2016	02.05.16	51.8	51.9	-0.1	-0.1	0.3
MPMIDESA Index	Markit Services PMI	4 2016	04.05.16	54.5	54.6	-0.1	-0.1	0.5
GRIORTMM Index	Factory Orders (% mom)	3 2016	09.05.16	1.9	0.6	1.3	0.6	0.7
GRCAEU Index	Current Account Balance (EUR bn)	3 2016	10.05.16	30.4	25.0	5.4	1.3	0.9
GRIPIMOM Index	Industrial production (% mom)	3 2016	10.05.16	-1.3	-0.2	-1.1	-0.9	0.2
GRCP20YY Index	CPI (% yoy)	4 2016	13.05.16	-0.1	-0.1	0.0	0.3	0.3
MPMIDEMA Index	Markit Manufacturing PMI	5 2016	23.05.16	52.4	52.4	0.0	0.0	0.5
MPMIDESA Index	Markit Services PMI	5 2016	23.05.16	55.2	55.2	0.0	0.0	0.5
GRGDPPGQ Index	GDP (% qoq)	3 2016	24.05.16	0.7	0.7	0.0	-0.1	0.4
GRZECURR Index	ZEW Survey Current Situation	5 2016	24.05.16	53.1	49.0	4.1	0.5	0.7
GRZEWI Index	ZEW Survey Expectations	5 2016	24.05.16	6.4	12.0	-5.6	-0.7	0.2
GRIFPBUS Index	IFO Business Climate	5 2016	25.05.16	107.7	106.8	0.9	0.6	0.7
GRIMP95Y Index	Import Price Index (% yoy)	4 2016	30.05.16	-6.6	-6.2	-0.4	0.0	0.4
GRCP20YY Index	CPI (% yoy)	5 2016	30.05.16	0.1	0.1	0.0	0.3	0.3
GRFRIAMM Index	Retail Sales (% mom)	4 2016	31.05.16	-0.9	0.9	-1.8	-1.1	0.1
GRUECHNG Index	Unemployment Change (000's mom)	5 2016	31.05.16	-11.0	-5.0	6.0	0.0	0.5

Sources: Bloomberg Finance LP, Deutsche Bank Research

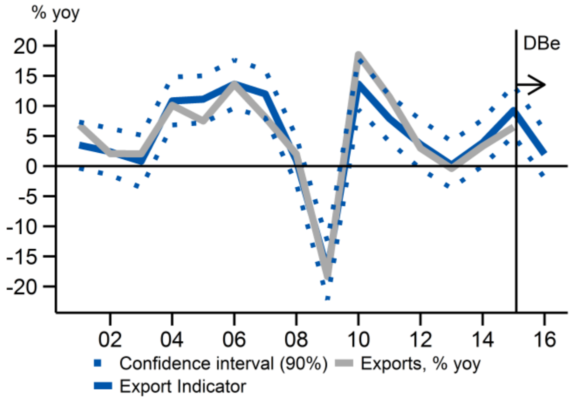
Heiko Peters (+49 69 910-21548, heiko.peters@db.com)

[1] See for details Focus Germany. August 4, 2014.

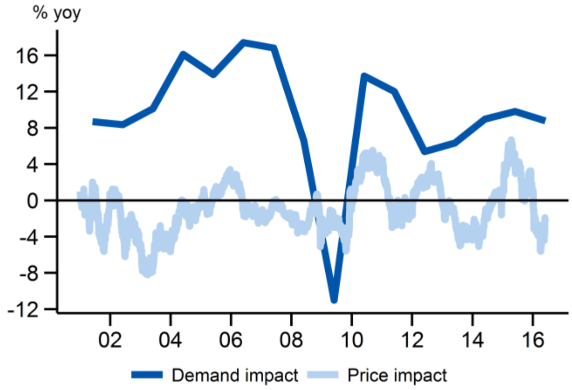
Export Indicator 2016: Demand impact remains weak – price impact turns negative

The Export Indicator identifies the effects on German exports of changes in global demand on the one hand, and currency movements on the other (price impact).[2]

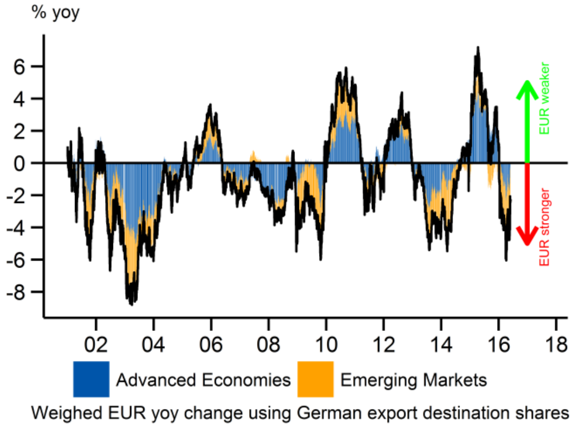
Export Indicator points to weaker export growth in 2016



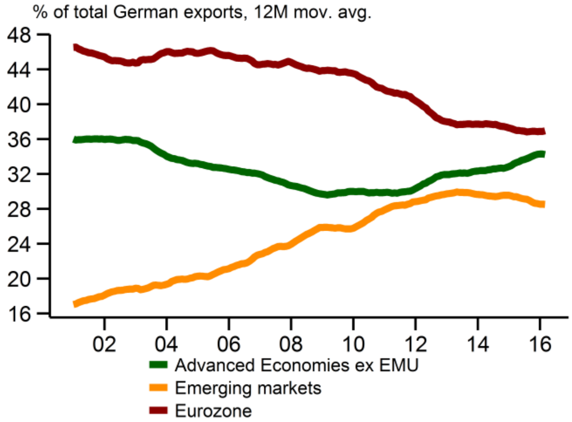
Demand and price impact weaker in 2016



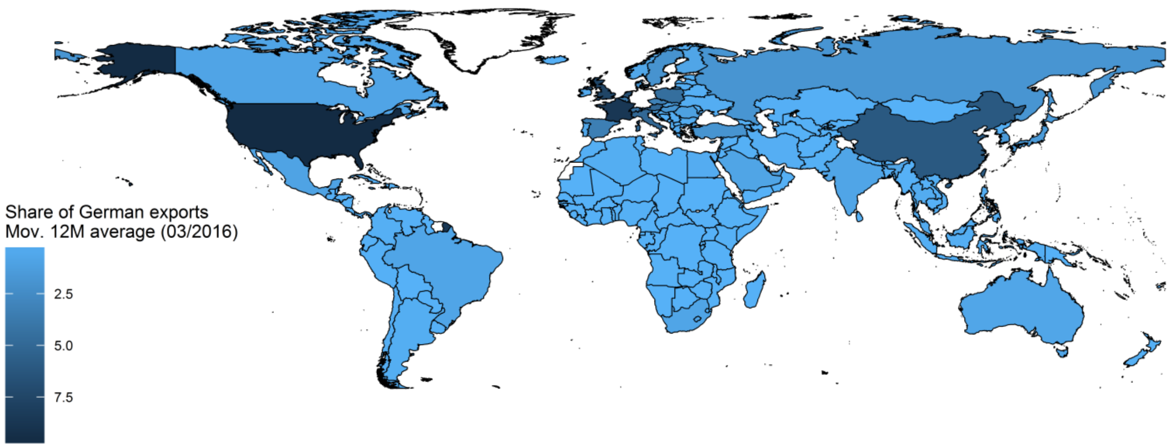
Price impact turns distinctly negative in 2016



Importance of Non-EMU advanced economies strongly up



German exports focus on Europe, the USA and China



Sources: Eurostat - Comext, Deutsche Bank Research

Heiko Peters (+49 69 910-21548, heiko.peters@db.com)

[2] See for details Focus Germany. March 3, 2016.

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

Date	Event	Remarks
16-17 Jun	Eurogroup and ECOFIN, Luxembourg	(Poss.) implications of the spring forecast for the Excessive Deficit Procedure and the Innovation Partnerships EDPs/EIPs, situation in Greece, work programme for II/2016.
21 Jun	German Federal Constitutional Court, Karlsruhe	Pronouncement of the judgement on the ECB's OMT bond-buying programme.
28-29 Jun	European Council, Brussels	(Poss.) debates on the outcome of the EU referendum in the UK (scheduled on June 23), migration crisis, especially state of the implementation of the EU-Turkey Agreement.
11-12 Jul	Eurogroup and ECOFIN, Brussels	Poss. situation in Greece, fiscal policy implications of the refugee crisis and of the outcome of the EU referendum in the UK.
11 Jul - 4 Sep	German Bundestag	Parliamentary summer break
21 Jul	ECB Governing Council meeting, press conference	Review of the monetary policy stance.
23-24 Jul	G20 Finance Ministers and Central Bank Governors, Chengdu (China)	State of the global economy and the global financial markets, Multilateral Development Banks and infrastructure investment, international tax matters, among others.
4 Sep	State elections in Mecklenburg-West Pomerania	In the state currently run by a SPD-CDU government a neck-and-neck race between both parties is likely. However, it is open whether they will be able to form a coalition again, given the AfD's strength.
8 Sep	ECB Governing Council meeting, press conference	Review of the monetary policy stance. Possibly prolongation of the QE programme.
18 Sep	State elections in Berlin	Surveys indicate that the SPD-CDU coalition is likely to lose its majority. A strong AfD result could make it difficult to establish a new government as three parties might have to join forces.

Source: Deutsche Bank Research

Dieter Bräuninger (+49 69 910-31708, dieter.braeuninger@db.com)

Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
6 Jun 2016	8:00	New orders manufacturing (Index, sa), pch mom	April	-1.2	1.9
7 Jun 2016	8:00	Industrial production (Index, sa), pch mom	April	0.7	-1.3
9 Jun 2016	8:00	Trade balance (EUR bn, sa)	April	23.1	23.8
9 Jun 2016	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	April	1.1 (2.0)	1.9 (2.2)
9 Jun 2016	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	April	2.1 (0.6)	-2.3 (-2.6)
23 Jun 2016	9:30	Manufacturing PMI (Flash)	June	52.0	52.1
23 Jun 2016	9:30	Services PMI (Flash)	June	55.0	55.2
24 Jun 2016	10:30	ifo business climate (Index, sa)	June	107.0	107.7
29 Jun 2016	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	June	0.2 (0.4)	0.3 (0.1)
29 Jun 2016	8:00	Import prices (Index, sa) pch mom (yoy)	May	0.6 (-5.9)	-0.1 (-6.6)
30 Jun 2016	8:00	Retail sales (Index, sa), pch mom	May	0.5	-0.9
30 Jun 2016	10:00	Unemployment rate (%, sa)	June	6.1	6.1
12 Aug 2016	8:00	Real GDP (Index, sa), % qoq	Q2 2016	0.1	0.7

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

Heiko Peters (+49 69 910-21548, heiko.peters@db.com)
Oliver Rakau (+49 69 910-31875, oliver.rakau@db.com)

German data monitor

	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Dec 2015	Jan 2016	Feb 2016	Mar 2016	Apr 2016	May 2016
Business surveys and output											
Aggregate											
Ifo business climate	107.2	108.2	108.4	108.6	106.7	108.6	107.4	105.8	106.8	106.7	107.7
Ifo business expectations	102.7	102.8	102.7	104.3	100.5	104.5	102.4	98.9	100.1	100.5	101.6
Industry											
Ifo manufacturing	102.7	103.9	103.1	103.3	100.5	103.7	101.7	99.4	100.4	100.8	101.5
Headline IP (% pop)	0.0	0.2	-0.1	-0.3	1.8	0.0	2.8	-0.7	-1.3		
Orders (% pop)	-1.1	1.8	-2.0	0.6	0.6	-0.5	0.5	-0.8	1.9		
Capacity Utilisation	84.4	84.4	84.2	84.4	85.1						
Construction											
Output (% pop)	0.3	-1.7	-0.6	3.5	1.7	0.5	-0.5	4.4	-4.4		
Orders (% pop)	6.2	-3.4	0.6	10.2	6.4	2.2	1.7	-1.5	-0.5		
Ifo construction	118.9	120.0	121.4	123.4	122.6	123.2	122.4	122.9	122.4	123.0	124.7
Consumer demand											
EC consumer survey	1.0	3.0	-0.3	-4.4	-6.1	-4.2	-5.8	-6.4	-6.2	-4.8	-3.2
Retail sales (% pop)	1.7	0.2	0.5	0.3	0.4	0.8	-0.1	0.4	-1.4	-0.9	
New car reg. (% yoy)	6.4	4.2	6.1	5.7	4.5	7.7	3.3	12.1	0.0	8.4	
Foreign sector											
Foreign orders (% pop)	-3.3	4.5	-3.8	0.2	2.1	0.0	1.9	-2.1	4.3		
Exports (% pop)	1.8	2.8	-1.0	-0.6	0.4	-1.5	-0.4	1.3	1.9		
Imports (% pop)	1.7	1.2	0.9	-0.8	-0.3	-1.7	1.1	0.1	-2.3		
Net trade (sa EUR bn)	60.0	65.3	60.3	60.6	62.5	20.1	18.8	20.0	23.8		
Labour market											
Unemployment rate (%)	6.5	6.4	6.4	6.3	6.2	6.3	6.2	6.2	6.2	6.2	6.1
Change in unemployment (k)	-38.0	-24.7	-3.0	-24.0	-40.3	-15.0	-18.0	-10.0	-3.0	-16.0	-11.0
Employment (% yoy)	0.7	0.7	0.9	1.0	1.3	1.1	1.3	1.3	1.2	1.3	
Ifo employment barometer	107.7	108.0	108.1	109.8	108.4	110.5	109.7	108.0	107.4	108.2	108.2
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	-0.1	0.4	0.0	0.2	0.1	0.2	0.4	-0.2	0.1	-0.3	
Core HICP (% yoy)	1.0	1.1	1.0	1.2	1.1	1.0	1.1	0.8	1.3	0.7	
Harmonised PPI (% yoy)	-2.0	-1.4	-1.7	-2.3	-2.8	-2.3	-2.4	-3.0	-3.1	-3.1	
Commodities, ex. Energy (% yoy)	2.3	-0.5	-7.0	-12.0	-14.4	-12.8	-15.5	-14.9	-12.8	-11.6	-8.4
Oil price (USD)	55.1	63.7	51.3	44.8	35.1	39.0	31.9	33.6	39.8	43.2	
Inflation expectations											
EC household survey	0.5	6.1	4.9	4.0	5.3	5.0	6.3	5.4	4.3	3.0	1.9
EC industrial survey	-0.4	1.5	0.8	1.5	-2.4	0.6	-0.8	-2.9	-3.5	-0.5	2.4
Unit labour cost (% yoy)											
Unit labour cost	1.7	1.8	1.7	1.5	2.1						
Compensation	2.4	2.8	2.7	2.5	2.4						
Hourly labour costs	2.3	2.5	2.6	1.4	3.2						
Money (% yoy)											
M3	7.3	7.5	8.2	9.2	7.8	9.2	9.0	8.2	7.8	7.1	
M3 trend (3m cma)						9.2	8.8	8.3			
Credit - private	2.6	2.1	2.5	2.7		2.7	2.2	2.3	2.0		
Credit - public	32.3	12.2	11.1	11.7		11.7	-3.3	4.6			

% pop = % change this period over previous period.
Sources: Deutsche Bundesbank, European Commission, Eurostat, Federal Employment Agency, German Federal Statistical Office, HWWI, ifo, Markit

Financial forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	0.375	-0.10	0.00	0.50	-0.75	-0.50	0.05	0.50	1.50	1.05	0.05
Jun 16	0.375	-0.10	0.00	0.50	-0.75	-0.50	0.05	0.25	1.50	0.75	0.05
Sep 16	0.375	-0.20	0.00	0.50	-0.75	-0.50	0.05	0.25	1.50	0.75	0.05
Dec 16	0.625	-0.20	0.00	0.50	-0.75	-0.50	0.05	0.25	1.50	0.75	0.05
3M interest rates, %											
Current	0.63	0.06	-0.26	0.59							
Jun 16	0.58	0.10	-0.25	0.64							
Sep 16	0.58	0.05	-0.25	0.68							
Dec 16	0.83	0.05	-0.25	0.94							
10Y government bonds yields, %											
Current	1.77	-0.09	0.12	1.40							
Jun 16	1.75	-0.05	0.20	1.50							
Sep 16	1.75	-0.10	0.35	1.70							
Dec 16	1.75	-0.10	0.45	1.80							
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	1.14	108.45	0.79	0.69	1.11	9.26	7.44	9.35	4.42	314.50	27.03
Jun 16	1.06	105.00	0.77	1.38	1.11	8.99	7.46	9.67	4.26	317.50	27.10
Sep 16	1.03	109.00	0.77	1.34	1.12	8.88	7.46	9.63	4.26	318.75	27.10
Dec 16	1.00	112.00	0.78	1.28	1.12	8.75	7.46	9.57	4.25	320.00	27.10

Sources: Bloomberg, Deutsche Bank

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