



Current Issues
Business cycle

Focus Germany

Further disappointments

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Content	Page
Forecast tables	2
German GDP growth: Below 1% in 2015	3
German industry: Temporary slowdown	5
German construction: Robust investment, but price momentum slowing	8
Inheritance tax: Constitutional Court ruling likely to weigh harder on business heirs	15
25 years after the fall of the Berlin Wall: "Blooming landscapes" only in part	20
Chart of the month	25
DB German Macro Surprise Index	26
Chartbook	27
Event calendar	34
Data calendar	35
Financial forecasts	35
Data monitor	36

German GDP growth: Below 1% in 2015. We have cut our German GDP growth forecast from 1.5% to 1.3% for 2014 and further from 1.5% to 0.8% for 2015. We do not see Germany falling into a technical recession in Q3. But the 6 month slump of the ifo index has increased the risk that we might see a negative GDP print in Q4 2014 or Q1 2015. The positive effect of weaker oil prices will be offset by wage growth slowing from 3% plus this year towards 2% in 2015, as export-orientated sectors will respond to weaker external demand.

German industry: Temporary slowdown. Following weak performance in winter half-year 2014/15 industrial production is likely to return to a moderate uptrend in the course of 2015, resulting in expansion of roughly 1.5% in real terms in 2014 and about ¾% in 2015. The only moderate growth of industry is primarily attributable to the currently subdued level of business activity and external shocks. Nonetheless, structural factors are going to regain importance. Many of the recently adopted measures will erode Germany's international competitiveness as an industrial location.

German construction: Robust investment, but price momentum slowing. Scarcity of supply is the key attribute of the current German real estate cycle. It seems likely to persist in the years ahead. House prices still have the biggest potential in the real estate market. Completions are on the rise and construction investments should continue to grow strongly in 2014 and 2015. Construction investments should also rise in the public and the commercial sector.

Inheritance tax: Constitutional Court ruling likely to weigh harder on business heirs. The Court's ruling could lead to more restrictive regulations on business assets in cases of inheritance and gift-based transfers. The tax burden on business heirs and Germany's small and medium-sized enterprises (the Mittelstand) could increase. The potential burden hinges partly on what tax volume the government would like to generate.

25 years after the fall of the Berlin Wall: "Blooming landscapes" only in part. After the initial massive catch-up process, the real economic convergence of the east German economy has been stalling since the mid-2000s. In view of the continuing massive support of the east German Laender (federal states), the stalling convergence suggests continuing structural differences between the old and the new Laender.



Focus Germany

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Euroland	0.7	1.0	1.4	0.5	1.1	1.5	2.5	2.1	1.6	-2.6	-2.5	-2.1
Germany	1.3	0.8	1.2	1.0	1.2	1.5	7.2	6.4	6.2	0.0	-0.5	-0.8
France	0.4	0.9	1.5	0.6	0.9	1.5	-1.8	-1.8	-1.5	-4.4	-4.3	-3.8
Italy	-0.4	0.4	0.7	0.2	0.8	1.2	1.6	1.6	1.5	-3.0	-2.9	-2.7
Spain	1.2	1.9	1.8	-0.1	0.8	1.4	0.4	0.5	0.7	-5.6	-4.6	-3.3
Netherlands	0.7	1.7	1.1	0.5	1.1	1.5	10.9	11.4	11.5	-2.5	-2.0	-1.9
Belgium	1.0	1.0	1.6	0.7	1.3	1.5	-1.0	-0.8	-0.5	-2.5	-2.3	-2.2
Austria	0.8	1.3	1.8	1.5	1.7	1.7	2.7	2.9	3.1	-3.0	-1.8	-1.2
Finland	-0.4	0.6	1.6	1.1	1.2	1.4	-2.0	-1.7	-1.3	-2.4	-1.8	-1.1
Greece	-0.2	2.1	2.7	-1.0	0.4	0.9	1.0	1.5	1.5	-1.8	-0.6	0.1
Portugal	1.0	1.1	1.7	-0.1	0.9	1.3	1.0	1.0	1.0	-4.2	-3.3	-2.7
Ireland	3.7	2.5	3.7	0.4	1.1	1.6	6.5	7.0	7.0	-4.0	-2.7	-2.5
UK	3.1	2.5	2.3	1.7	1.9	2.0	-4.0	-3.2	-3.0	-4.6	-3.5	-2.1
Denmark	1.0	2.0	1.8	1.0	1.5	2.0	6.7	6.4	6.0	0.0	-1.0	-2.0
Norway	2.4	2.5	2.5	1.8	2.2	2.0	11.0	10.5	10.0	7.0	6.7	6.5
Sweden	2.2	2.6	2.5	0.2	1.5	2.0	6.0	5.5	5.0	-1.5	-1.0	-0.5
Switzerland	1.3	1.8	2.0	0.0	0.3	0.6	12.0	11.0	10.5	0.0	0.2	0.5
Czech Republic	2.4	2.6	2.8	0.4	1.8	2.0	-1.5	-1.4	-1.5	-2.6	-2.5	-2.4
Hungary	3.4	2.7	3.0	0.2	2.6	3.3	1.6	1.5	1.5	-2.9	-2.7	-2.8
Poland	3.1	3.5	3.8	0.2	1.1	2.3	-1.8	-2.0	-2.2	4.3	-2.9	-2.8
United States	2.3	3.5	3.1	1.8	2.2	2.4	-2.5	-2.5	-2.6	-2.9	-2.5	-2.8
Japan	1.0	1.3	1.4	2.9	1.7	1.8	0.2	1.4	2.1	-7.0	-6.1	-4.6
China	7.3	7.0	6.8	2.2	2.6	3.0	3.1	3.4	3.3	-2.1	-2.5	-3.0
World	3.2	3.7	3.8	3.5	3.7	3.7						

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

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

	2012					2013					2014			
	2012	2013	2014F	2015F	2016F	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	
Real GDP	0.4	0.1	1.3	0.8	1.2	-0.4	0.8	0.3	0.4	0.7	-0.2	0.1	0.0	
Private consumption	0.7	0.8	0.9	1.1	1.0	0.2	0.6	0.7	-0.8	0.8	0.1	0.3	0.3	
Gov't expenditure	1.2	0.7	0.8	0.6	0.3	0.0	0.0	0.6	-0.1	0.4	0.1	0.2	0.2	
Fixed investment	-0.7	-0.7	3.1	1.7	2.3	-2.5	2.2	0.8	1.1	2.9	-2.3	0.0	0.3	
Investment in M&E	-2.9	-2.7	3.4	1.4	4.0	-3.7	2.3	-0.5	2.1	2.1	-0.4	0.0	-1.0	
Construction	0.6	-0.1	3.2	2.4	2.3	-2.8	3.0	1.8	0.7	4.1	-4.2	-0.1	1.0	
Inventories, pp	-1.4	0.2	0.3	0.1	-0.2	0.2	-0.1	0.0	0.2	-0.2	0.4	0.1	0.0	
Exports	2.8	1.6	3.1	3.9	5.2	0.7	1.4	0.7	1.7	0.0	0.9	0.5	0.5	
Imports	0.0	3.1	4.3	5.3	5.4	1.2	1.3	1.7	0.7	0.5	1.6	1.0	1.2	
Net exports, pp	1.3	-0.5	-0.2	-0.3	0.2	-0.2	0.2	-0.4	0.5	-0.2	-0.2	-0.2	-0.3	
Consumer prices*	2.0	1.5	1.0	1.2	1.5	1.5	1.5	1.6	1.3	1.2	1.1	0.8	0.8	
Unemployment rate, %	6.8	6.9	6.7	6.8	7.1	6.9	6.9	6.8	6.9	6.8	6.7	6.7	6.7	
Industrial production	-0.4	0.1	1.8	1.0	0.0									
Budget balance, % GDP	0.1	0.0	0.0	-0.5	-0.8									
Public debt, % GDP	81.0	78.4	74.2	72.6	71.0									
Balance on current account, % GDP	7.1	6.8	7.2	6.4	6.2									
Balance on current account, EUR bn	196	192	207	190	189									

*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

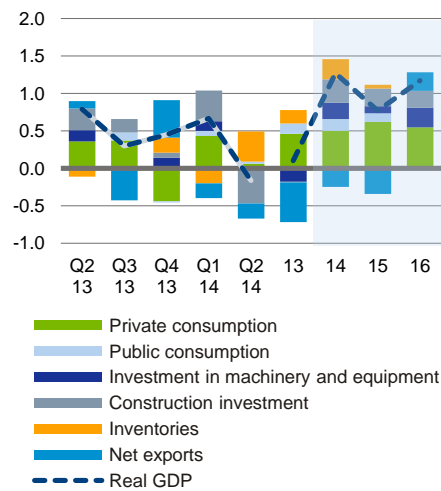


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Domestic economy the main growth driver

1

Contributions to real GDP growth, qoq, pp

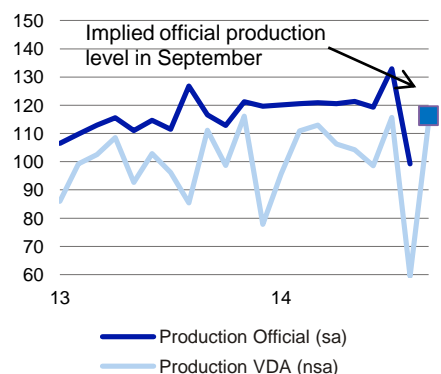


Sources: Federal Statistical Office, Deutsche Bank Research

Auto production: VDA data points to strong increase of "official" auto production in September

2

2010=100

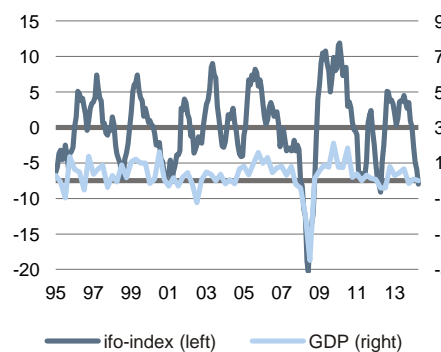


Source: Federal Statistical Office

Ifo slumps and GDP growth

3

6 month change (left); % qoq (right)



Sources: Thomson Reuters, Deutsche Bank Research

German GDP growth: Below 1% in 2015

- We have cut our German GDP growth forecast from 1.5% to 1.3% for 2014 and further from 1.5% to 0.8% for 2015, due to the weaker international environment.
- We do not see Germany falling into a technical recession in Q3. But the 6 month slump of the ifo index has increased the risk that we might see a negative GDP print in Q4 2014 or Q1 2015.
- The positive effect of weaker oil-prices will be offset by wage growth slowing from 3% plus this year towards 2% in 2015, as export-orientated sectors will respond to weaker external demand.

Robust private consumption to facilitate (minimal) GDP growth in Q3

Well, we continue to predict that Germany will not fall into a technical recession as Q3 GDP should still muster a rise, after the 0.2% drop in Q2, but probably by the skin of its teeth. A key factor will be the hoped-for rebound in September IP, following the holiday-distorted 4% slump in August (released on November 7). We expect a substantial recovery as already indicated by the September output data of German car producers. Still, the further deterioration in the confidence data, notwithstanding the modest improvement in the preliminary manufacturing PMI in October, does suggest that the underlying momentum of the economy is weak, despite the robust expansion of private consumption. In addition, the expected technical correction of the negative impact of the seasonal adjustment on Q2 construction spending (worth about ¼ of a percentage point (pp) of GDP) does not seem ready to materialise. Except for building permits all other monthly indicators of construction activity have remained weak in July and August. Therefore, we have lowered our GDP forecast for Q3 to 0.1% (from 0.4%).

Beyond Q3 the unabated decline of the ifo index (9 points during the last 6 months) does not bode well. During the last two decades the index only showed such downward momentum between H2 2008 and H1 2009 and in H2 2012, with quarterly GDP moving into the red each time. Unfortunately, there is sufficient evidence to corroborate the gloomy results of such number-crunching exercises. Our Emerging Markets colleagues have revised their forecasts for next year for China, Russia in particular to the downside and have become gloomier regarding Brazil following the elections. The lacklustre performance of the BRIC economies is already quite evident in German exports. While overall nominal exports were still up 2.8% yoy between January and August, deliveries to the 4 BRIC economies (accounting for close to 11 ½% of total goods exports) were down by ½% (although exports to China are still growing at a 10% clip).

Despite the Q3 GDP growth of 3.5% which might even be revised higher with the second print, it is questionable whether the US alone can do the heavy lifting for the world economy. Recent disappointing data and renewed political quarrels which are unlikely to dissipate anytime soon suggest that Germany's European partners will not provide any tailwind. All these issues are evident in the failure of world trade to gain any traction. In the first eight months world exports were flatlining. The year-on-year increase in real world trade stands at 2.6% (Jan/Aug), which is less than the still expected increase in global GDP for the whole year. An underperformance of world trade has in recent decades only coincided with global recessions and is certainly a massive burden for Germany's export-oriented economy.



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Global trade and German exports

4



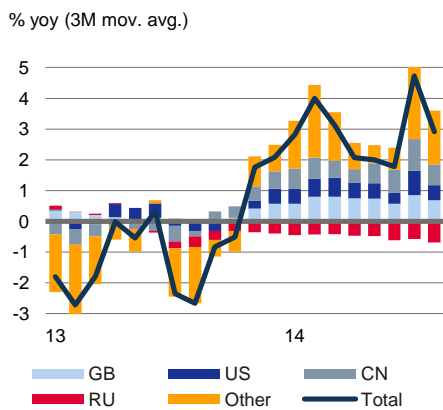
Sources: Deutsche Bundesbank, CPB

Tailwind from lower oil prices?

One positive development for the German and the world economy as a whole is the mainly supply-driven strong drop in oil prices. Since hitting USD 115.50 in June Brent has dropped to around USD 87/bbl. Even taking the depreciation of the EUR versus the USD into account, which was driven by the anticipated decision of the Fed to end its asset purchases by the end of October and the unexpectedly hawkish tone of the accompanying Fed statement, oil prices are still down by almost 20% versus their June peak and around 15% yoy. We are forecasting oil prices to stay below USD 90/bbl in 2015, which implies a 15% decline versus the 2014 average. This should – ceteris paribus – provide a boost of a good ¼ pp to the global economy, as the savings in the oil-importing countries do have higher demand effects, in particular with regard to private consumption, than the corresponding losses in oil-exporting countries. This demand effect adds about ½ pp to German exports (using standard elasticities, although the discussion above suggests that they might be lower currently). The bigger impact will of course come through the income effect courtesy of the 0.2 pp lower inflation rate. These back-of-the-envelope calculations point to a boost to German GDP through lower oil prices of just under 0.2 pp¹.

Demand from GB, US and (still) CN support German exports

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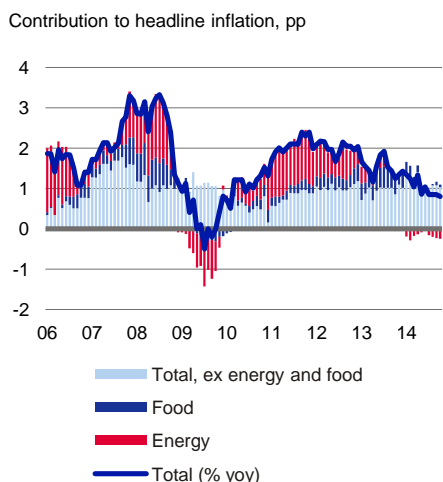
Sources: Federal Statistical Office, Deutsche Bank

Weaker global environment to limit domestic demand growth

Unfortunately, the positive effect of lower oil prices on global GDP and German exports, which enjoy an additional boost from the lower EUR (as calculated above), is more than eliminated by the downward revisions to our global GDP forecasts in recent weeks, reaching close to ½ pp – which of course have taken into account or were in fact even triggered (Russia) by our lower oil price forecast. All in all this will shave 1 ¼ pp off German exports, which will translate into weaker investment spending, given the close correlation between these two demand components. But when all is said and done, even the real income effect of the reduced inflation rate might be more than offset by lower wage increases in 2015 than initially thought. Collective wage agreements have been running north of 3% this year. The clear deterioration of the export outlook should push settlements back towards 2% in 2015. Together with a more clouded labour market outlook, not least because of the introduction of the minimum wage, this will make itself felt in real income and hence private consumption.

Energy component dampens inflation

6



Sources: Federal Statistical Office, Deutsche Bank Research

All in all GDP will probably stagnate in the winter half-year. Given the sharp drop in the ifo index in recent months discussed above, we could easily see a negative print in at least one quarter. Even with acceleration towards trend growth in the rest of 2015 this will result in an annual growth rate of 0.8% in 2015 after 1.3% in the current year.

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¹ Peters, H. (2102). Potential oil price shock boosting downside risks for German economy. Deutsche Bank Research. Current Issues. March 2012.

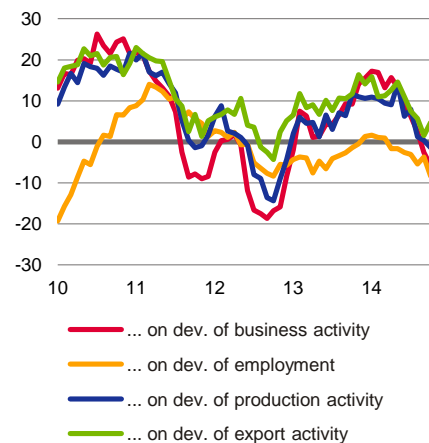


German industry: Temporary slowdown²

German industry: Decline in sentiment indicators

1

Company expectations, balance of positive and negative company reports



Source: ifo Institute

Moderate uptrend following dip in 2015

2

Manufacturing, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Good employment situation

3

Employees in the manufacturing industry, Germany, m



Source: Federal Statistical Office

- Following weak performance in winter half-year 2014/15 industrial production in Germany is likely to return to a moderate uptrend in the course of 2015, resulting in expansion of roughly 1.5% in real terms in 2014 and about ¾% in 2015. This means the generally muted dynamics of industrial performance in evidence since 2011 would continue in 2015. Industry's share in total German gross value added (2013: 21.8%) will probably decline slightly again, as in 2012 and 2013.
- We expect both the automotive industry and mechanical engineering to increase their output by roughly 1% in 2015. While mechanical engineering should thus slightly improve its performance over 2014 (stagnation), the auto industry should see its growth cool noticeably (2014: +4%). Electrical engineering is poised for a round of stagnation in 2015 – following a 1.5% increase in 2014. Chemicals production is likely to add 2.5% in 2015; however, this would "only" neutralise the setbacks in 2014.
- The only moderate growth of industry is primarily attributable to the currently subdued level of business activity and external shocks. Nonetheless, structural factors are going to regain importance. This is a job for Germany's politicians in particular. Many of their recently adopted measures will erode Germany's international competitiveness as an industrial location.

Manufacturing: Output set to grow by ¾% in 2015

Over the past few months manufacturing performance was partly shaped by geopolitical risks and the darkening macroeconomic environment; these factors will also have an impact on the short-term outlook. At the latest reading, order intake and production were very volatile, though this is mainly attributable to one-off effects in the automotive industry (shift in the holiday-related factory shutdown period). All in all we reckon that industrial production will fall slightly in Q4 2014 versus Q3 in seasonally adjusted terms, and roughly flatline in Q1 2015 versus Q4. The expectations component of business sentiment has declined recently, pointing to subdued performance. Domestic industrial output should start to pick up again from roughly the second quarter of 2015, with stimuli likely coming both from abroad and from the home market.

The production scenario outlined above will probably lead to a roughly 1.5% (real) increase in manufacturing output in Germany for 2014 as a whole. Considering that industry had started 2014 with a statistical overhang and the growth expectations at the time were still mostly positive, in the end this could almost be classed as a disappointment. The year 2014 provides another example of how largely unpredictable external shocks (Ukraine crisis) can impact actual economic performance and make it difficult to forecast.

Germany's manufacturing industry is set to start 2015 with a slight statistical underhang. As a result, domestic output is likely to grow by "only" about ¾% in real terms for the year as a whole, even though we still expect an upswing to kick in from about Q2; if the recovery materialised later, however, the growth rate would even be lower. The generally very muted dynamics of industrial activity in evidence since 2011 would finally continue in 2015. In such a growth environment it would already be an achievement if the currently high employment level in German industry could be maintained. At present, some 5.2 million people are employed in the manufacturing sector; this reading is 4% higher than the long-term median. The share of industry in total gross value

² See Auer, Josef et al. (2014). German industry: Output growth to remain shy of 1% in 2015. Current Issues. Frankfurt am Main.

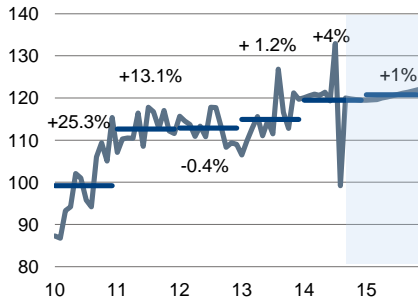


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Growth slowing noticeably

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Automotive industry, real production index, 2010=100, seasonally adjusted

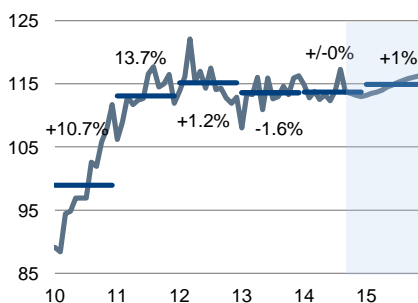


Sources: Federal Statistical Office, Deutsche Bank Research

Still low momentum

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Mechanical engineering, real production index, 2010=100, seasonally adjusted

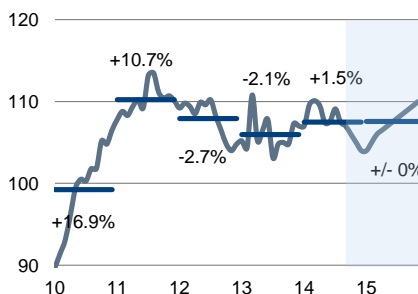


Sources: Federal Statistical Office, Deutsche Bank Research

Return to uptrend during 2015

6

Electrical engineering, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

added in Germany is probably going to continue to decline for the years 2014 and 2015 (as already in 2012 and 2013), even though German industry is in a much better position than the rest of Europe. Germany reported a 21.8% share in 2013; the EU average was only about 15%.

Major sectors: 2015 to see production ranging from stagnation to moderate growth

In the automotive industry, foreign demand is the main factor underpinning Germany's good 2014 performance. The stimuli from abroad will probably lose some of their intensity as the year progresses. However, our forecast looks for full-year production to increase by no less than 4% or so. This is the best result among the major branches of industry. Foreign demand is probably going to lose momentum again in 2015. The geopolitical risks and domestic policy issues are already severely testing the tentative recovery of car sales in the euro area again. While we do not expect car demand in the eurozone to shift back into reverse, the growth rate will probably persist in the low single-digit range. In Germany, new car registrations are scarcely likely to climb faster. The value of auto exports to the United Kingdom, the United States and China is likely to grow much more slowly in 2015 than in 2014, especially since the US and China are increasingly being supplied from local production. At the end of the day, the German auto industry will probably only manage to boost output by about 1% in real terms on average in 2015.

This year, Germany's mechanical engineers are feeling the reluctance of key user industries to invest and are also particularly noticing the effects of the Russia-Ukraine conflict (Russia is an important buyer market for German machinery). Their domestic output will probably roughly stagnate in real terms in 2014 as a whole. For 2015, assuming an easing of the current regional conflicts and hence a more stable global economy, we expect mechanical engineering business to gradually start picking up again in the course of the year. Mechanical engineers, who rely on investment activity in the constituent segments of their own sector and in other branches of industry including mining and construction, will probably start into 2015 without a statistical overhang. However, in the absence of political irritations in particular, there are good chances of order intake developing more favourably. An improving propensity to invest would play to German mechanical engineers' advantage, as this could help them to achieve a net increase in domestic output of 1%. One advantage for the domestic sector is that it could probably operate in a still favourable interest environment again in 2015. Furthermore, the cheaper euro in relation to the US dollar will stimulate the again better prospects for US sales.

Electrical engineering is poised to raise domestic output by about 1.5% in real terms in 2014, with the sector benefiting from its dynamic growth at the start of the year. Recently, though, orders and also sentiment indicators have been trending south. Our forecast for 2015 is that output will flatline, even though production should tend to increase again in the course of the year.

In the chemicals industry, output already started to fall in the early part of 2014, so the sector is likely to post a decline of 2.5% for the full year. Production has started to show signs of creeping up again lately, though. For 2015 there are good prospects of the chemicals industry neutralising its setbacks from 2014 – thanks to increasing demand from key European markets and the US.



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Forecast for the major industrial sectors

7

Industry	NACE	Gross value added EUR bn, 2012	Export ratio %, 2013	Business climate* Diff. yoy, Net points	Capacity utilisation* Diff. yoy, pp	Producer prices Last 12M, % yoy	Production			
							2012	2013	2014	2015
							% yoy	% yoy	% yoy	% yoy
Food	10	26.3	21.9	-17.4	-0.7	0.2	0.0	-0.2	0.0	0.5
Textiles	13	3.2	47.7	-17.6	-12.1	0.6	-7.4	-0.6	2.5	0.5
Paper	17	9.5	40.6	-10.9	-0.8	0.1	-2.1	-1.4	1.0	0.5
Chemicals	20	34.7	56.4	-10.9	-0.8	-2.2	-2.8	0.5	-2.5	2.5
Pharmaceuticals	21	16.6	68.6	-29.3	4.1	0.2	-2.4	5.3	4.0	2.0
Plastics	22.2	16.9	38.3	-5.8	-2.4	0.8	-1.2	1.6	1.5	-2.5
Building materials	23	12.6	29.9	-13.8	-1.2	0.7	-4.4	-0.5	2.0	0.0
Metals production	24	18.7	38.8	-11.0	-2.5	-4.1	-3.7	-0.6	1.0	0.0
Metal products	25	37.8	33.2	-5.7	1.7	-0.4	-1.5	1.1	3.0	-1.0
Electrical engineering	26+27	57.5	54.4	-7.6	1.5	0.0	-2.7	-2.1	1.5	0.0
Mechanical engineering	28	75.6	62.6	-16.2	-0.1	1.2	1.2	-1.6	0.0	1.0
Automotive	29	78.2	64.9	-9.3	3.3	0.1	-0.4	1.2	4.0	1.0
Manufacturing	10-33	499.6	48.2	-10.2	0.4	-0.1	-1.1	-0.1	1.5	3/4

*Latest figure available

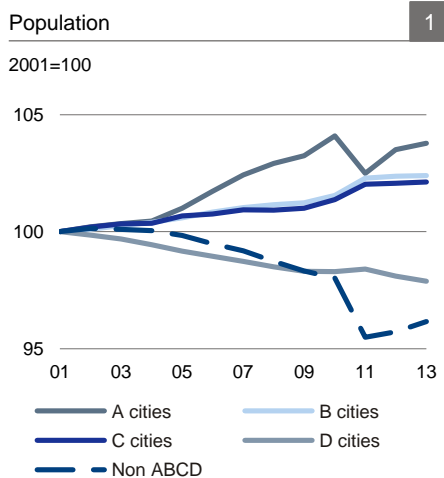
Sources: Federal Statistical Office, Deutsche Bank Research

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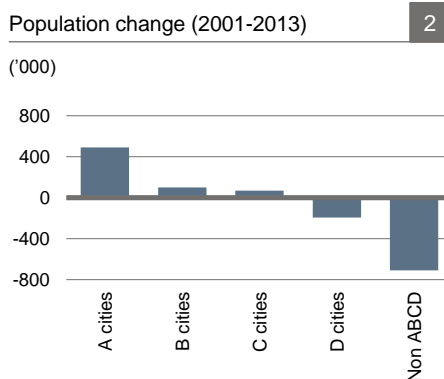
German construction activity: Robust investment, but price momentum slowing

- Scarcity of supply is the key attribute of the current German real estate cycle. It seems likely to persist in the years ahead. The stricter rent control envisaged by the grand coalition does not help solve the problem but could cement the supply bottleneck.
- House prices still have the biggest potential in the real estate market despite the dynamic price development in the last years. Completions and construction investments should continue to increase strongly in 2014 and 2015.
- Construction investments should also rise in the public and the commercial sector. Commercial real estate should benefit from the development in the residential market and the positive economic environment. Public construction investment should get additional impulses, courtesy the debate over the modernisation of Germany's infrastructure.
- Overall, the German real estate market remains attractive due to high employment, low unemployment rates, immigration, low interest rates, a supply bottleneck, low valuations, conservative bankers and borrowers and low loan losses. These economic data forms the solid basis for our expectation that prices continue to trend higher.



N.B.: Slump linked with Census 2011

Sources: BulwienGesa, Deutsche Bank Research



Sources: BulwienGesa, Deutsche Bank Research

Germany's real estate market has seen little change this year in relation to previous years. Strong demand remains set against an inelastic, limited supply, driving up prices. However, prices are currently rising with slightly less momentum than in the past few years. Does this mean there is a trend reversal in the offing? No. The macroeconomic environment remains extremely favourable. Monetary policy is doveish, the labour market is in good shape and there is a high inflow of immigrants to Germany. German houses are still very affordable, and anecdotal evidence indicates that the German real estate markets are attracting foreign and institutional investors. The biggest risk continuing to hover over the market is the prospect of political intervention, the proposed cap on rents in particular. Since it does not eliminate the supply bottleneck but cements it in place no less, we expect a continuation of rising prices and additional investment for the time being.

Labour market and immigration boosting demand for construction

A robust labour market is continuing to drive demand for housing. The unemployment rate has fallen to 6.7% this year and persisted there over the past few months despite less dynamics in the economy. Employment is breaking one record after another and hit 42.7 m in August, an increase of 280,000 since the year began. This means that employment increased faster in the first eight months of 2014 than in 2013 as a whole (+230,000).

The strong labour demand is being met by immigration to Germany. In 2013, Germany reported net immigration of 437,000 persons. This is the highest reading in 20 years. Most of the immigrants are from eastern and southern European countries (table 3). The stimuli should continue for a while, even though the gradual stabilisation of the labour markets in the EMU countries of origin will probably start to stem the inflow.

Most of the immigrants head for the economically thriving metropolitan areas. The booming labour market has a magnetic effect on German residents though, too, as they are also flocking to the growing metropolitan areas. As a result, since 2001 the combined population of all the A-rated cities (Berlin, Dusseldorf,



Frankfurt, Hamburg, Cologne, Munich and Stuttgart) has increased by roughly 500,000, while the B-rated cities are up by 100,000 and the C-rated cities by 100,000, whereas the D-rated cities have lost 200,000 and the other (non-ABCD) cities around 700,000. These divergences in population development are also feeding through to housing demand and to the price spreads.

Immigration by country of origin in 2013

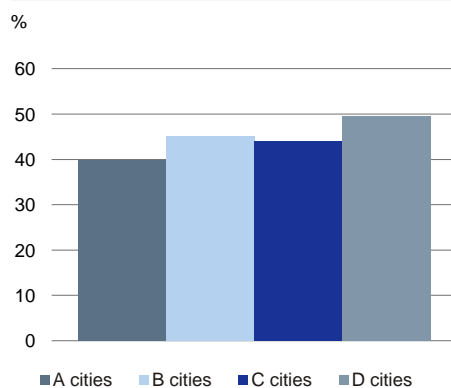
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	Immigrants ('000)	GDP per capita EUR '000	Unemployment rate (%)
Poland	72.9	10.1	12.5
Romania	50.3	6.7	5.2
Italy	32.9	25.6	12.5
Hungary	24.3	9.9	8.1
Spain	24.0	21.7	24.6
Bulgaria	21.8	5.7	11.9
Greece	20.6	16.4	26.9
Russian Federation	18.6	11.0	6.0
Syria, Arab Republic of	17.0	2.0	n.a.
Croatia	12.5	10.1	16.8
Total	437.3		

Sources: Federal Statistical Office, Deutsche Bank Research

Age dependency ratio (2011):
60+ cohort to 20-60 cohort

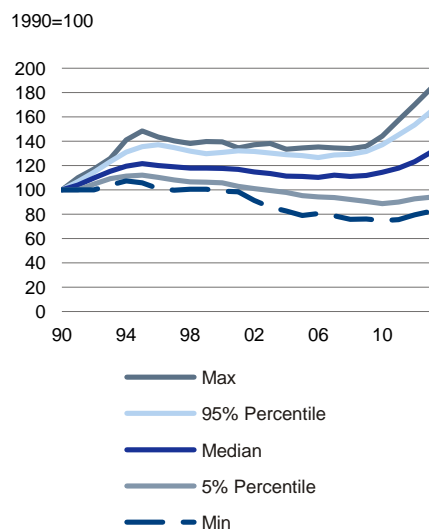
4



Sources: Federal Statistical Office, Deutsche Bank

House prices in cities (1990-2013)

5



Sources: BulwienGesa, Deutsche Bank Research

Migration partly explains the differences in age structures in the various regions. The age ratio, defined as the number of people over 60 in relation to those aged 20-60, is much smaller in A cities – i.e. the population is younger – than in B, C and D cities (chart 4), which means the price divergence should become more pronounced between economically strong and economically weak regions in future.

Low interest levels widen investor base without expansion of construction loans

Another driver pushing demand is the further decline in interest rates. According to the ECB, German long-term lending rates for newbuild construction are less than 2.5% at present and thus more than 40 basis points below the level at the start of the year (2.9%). Given the still declining yields on German sovereign bonds, now less than 0.9%, and a long-term average spread of around 100 basis points, construction loan rates could fall further. However, the real estate industry itself is increasingly emphasising the risks inherent in interest rate movements which could emerge in future on further declining rates, so the adjustment to lower sovereign yields could perhaps take place only slowly or yields could in fact persist at the current level.

The interest rate elasticity of demand for loans remains low. Over the past few years the strong decline in rates did not lead to a pronounced jump in lending volume. Lending to German households and domestic companies has been falling in 2014 on the whole. And while the volume of mortgage loans is creeping up, it is actually shrinking in inflation-adjusted terms – despite low inflation. This is partly because borrowers have sharply upped the rate at which they are repaying their loans. The total burden on borrowers, i.e. interest and amortisation combined, has thus declined only slightly over the past few years. Taking other criteria, too, such as the constantly high share of long-term fixed-rate loans and the little changed level of loan to value ratios, it may be seen that the construction loan market remains as conservative as ever.

This dovetails with the Bank Lending Survey forecast that the volume of lending is likely to trend down in the coming months. In the third and fourth quarter, the anticipated demand for loans dropped, while the credit supply on offer persisted

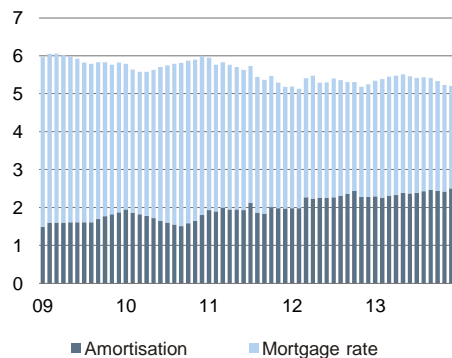


Focus Germany

Mortgages: Interest and amortisation

6

As % of total loan



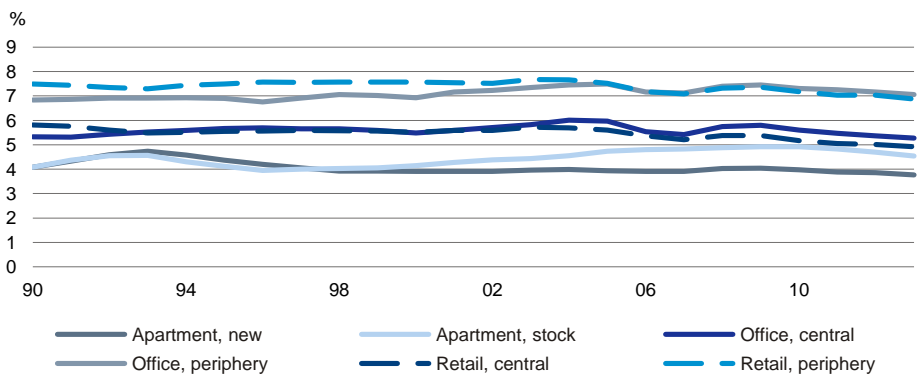
Sources: ECB, Dr. Klein, Deutsche Bank Research

at a low level. Germans' borrowing habits are not likely to change much in future. Besides, if so, the financial supervisor (AFS) would presumably respond promptly with countermeasures.

Indirectly, the globally low interest rate level continues to be a main driver of house prices and thus also an important explanatory factor for our investment forecast. The low interest level has significantly broadened the investor base and thus been instrumental in tightening supply and driving prices. Hence, national and international institutionals are continuing to take great interest in German real estate. The falling but still attractive yield levels are fundamental for their investment decisions, and volatility remains relatively low (chart 7). The way prices and rents have been developing in 2014 suggests that rental yields have fallen again though.

1991-2013: Annual rental yields

7

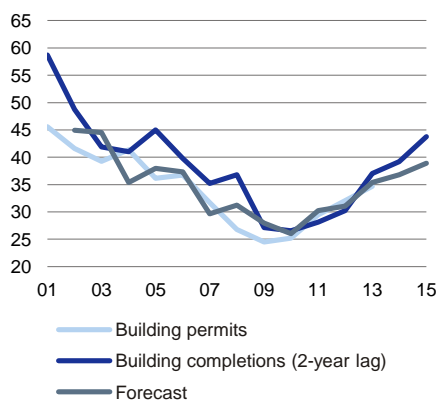


Sources: BulwienGesa, Deutsche Bank Research

2-year lag
Completions: Residential construction

8

EUR bn



Sources: Federal Statistical Office, Deutsche Bank Research

Construction indicators pointing to expansion of supply

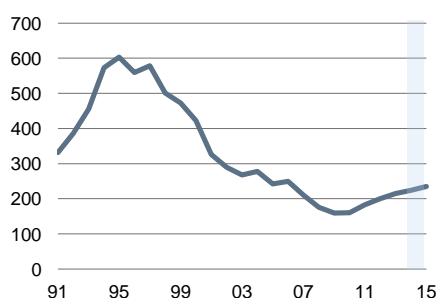
Many indicators suggest that construction investment – following the weather-related slump in Q2 – is set to pick up again. Many indicators of the ifo business survey for the construction industry, for instance, are at high levels relative to their own history and in some cases are in fact near or at peak levels. The two indicators "order backlog" and "order backlog versus the previous month" (latest month: September) are at the 75% quartile, with the range of the order backlog and capacity utilisation in the upper 5% percentile.

The favourable assessment of the ifo climate survey is generally corroborated by the order backlog reported in the Federal Statistical Office data. While incoming orders fell during the summer months on the year-earlier reading, this is probably due to a holiday effect and moreover follows the strong weather-related increase in order intake during the winter half-year 2013/14. Besides, the slight decline in the total order backlog is mainly attributable to civil engineering and road work, whereas the backlog in building construction – residential construction in particular – is expanding at a high level.

Building completions: Houses

9

Total houses ('000)



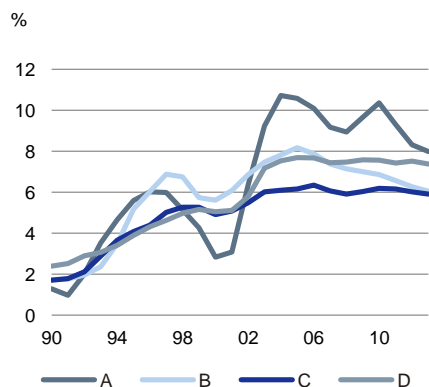
Sources: Federal Statistical Office, Deutsche Bank Research

The building permits trend also gives us reason to presume that the recent decline in order intake is really only a temporary dip and that order backlogs will rise to even higher levels. In 2014, building permits are already up 4% altogether on the 2013 average, with residential construction and commercial construction in particular posting increases of over 6-7%. Only building permits in the public sector have fallen noticeably (-13.2%). As the recent debate all about improving Germany's infrastructure suggests that some impetus may be forthcoming, the outlook is better than the current data. This points to potential for even higher order backlogs across all segments of the construction sector (residential, commercial and public).



Office market: Vacancies

10



Sources: BulwienGesa, Deutsche Bank Research

2014/15: Completions continuing to climb

The order situation and building permits imply a further increase in building completions. In the current cycle, building permits have a lead on completions of roughly two years. The correlation is very close for residential construction in particular (chart 8); in the past, building permits were invariably higher than completions. The costs of building permits were estimated at about EUR 70.3 bn in 2012, and around EUR 76.7 bn in 2013. According to our models, this corresponds to building completions of EUR 65.8 bn (+3% yoy) in 2014 and EUR 68.4 bn (+3.8%) in 2015 (see table 11 for details). Correspondingly, we expect the number of housing completions to rise to 225,000 in 2014 and to 236,000 in 2015.

Building permits and building completions

11

	Total		Residential construction	
	EUR bn	% yoy	EUR bn	% yoy
Building permits				
01.01.2012	70.3	3.6	39.2	5.8
01.01.2013	76.7	9.1	43.7	11.7
01.01.2014	79.9	4.2	46.7	6.8
Building completions				
01.01.2012	58.9	4.7	32.0	8.7
01.01.2013	63.9	8.6	34.7	8.4
01.01.2014	65.8	3.0	36.8	6.0
01.01.2015	68.4	3.8	38.9	5.7

Construction investment 2014/15

12

% yoy	2014	2015
Residential	3.8	2.6
Commercial	2.6	1.4
Public sector	2.3	3.9
Total	3.3	2.4

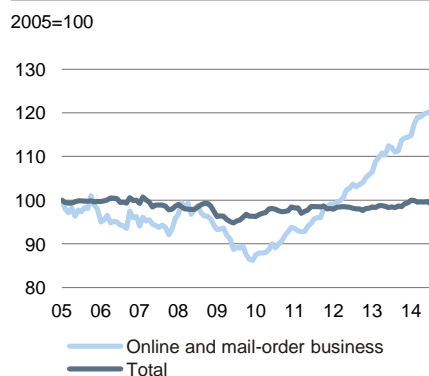
Source: Deutsche Bank Research

	Commercial construction		Public sector	
	EUR bn	% yoy	EUR bn	% yoy
Building permits				
01.01.2012	23.6	3.4	7.6	-6.0
01.01.2013	23.7	0.5	9.3	22.5
01.01.2014	25.2	6.2	8.0	-13.2
Building completions				
01.01.2012	0.0	0.0	0.0	0.0
01.01.2013	18.2	7.5	8.7	-12.1
01.01.2014	20.2	0.7	8.8	-3.2
01.01.2015	20.6	2.0	8.9	0.1

Sources: Federal Statistical Office, Deutsche Bank Research

Retail sales

13



Sources: Federal Statistical Office, Deutsche Bank

Construction investment up significantly

Considering the above discussion of the market situation with high order backlogs, a further increase in building permits and our expectation of an increase in building completions, we forecast that construction investment will grow by 3.3% yoy in 2014 and 2.4% in 2015. (N.B.: Near term we predict flat investment activity for Q3 2014 on the prior quarter owing to the current restraint in construction industry output.) In 2014, because of the H1 performance and the positive growth overhang, residential construction is set to make a very major contribution to growth. However, unlike in the previous years, the other construction segments also look set to make positive contributions.

Commercial construction benefited like residential construction from the robust health of the economy from mid-2013, with housing and office space competing in many metropolitan areas for the existing capacities. A look at numerous cities shows that vacant office space is starting to be turned into housing. This has

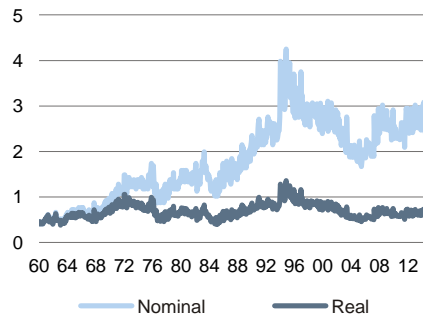


Focus Germany

Building permits: Commercial construction

14

EUR bn per month



Sources: Deutsche Bundesbank, Deutsche Bank Research

considerably helped to drive down vacancies in the office market and could trigger further investment impulses.

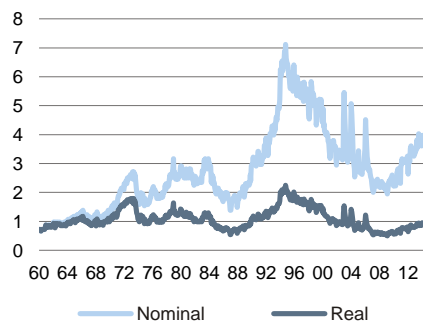
Construction investment should also rise in the retail segment on account of the scarcity of housing and commercial space in the metropolitan areas. This follows not only from the increased migration to the metropolitan areas, but also from the positive development of private consumption, which has become one of the German economy's key growth drivers. In this context, the boom in online retail business should unleash particularly strong investment in logistics real estate.

In the public sector, the improved financial health of the municipalities over the past two years has lifted their investment potential. So far, however, this has not yet fed through to higher building permits. Nonetheless, given the ongoing debate over the modernisation of Germany's infrastructure we forecast a substantial increase in public construction investment in 2015.

Building permits: Residential construction

15

EUR bn per month



Sources: Deutsche Bundesbank, Deutsche Bank Research

Rent cap cements scarcity of supply

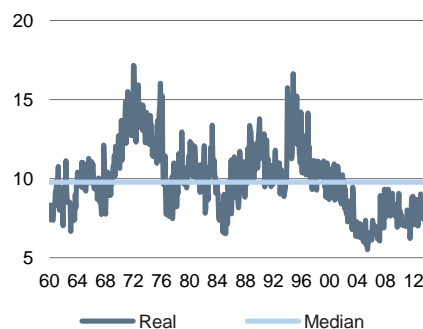
Academic literature provides virtually no clear statements on the impact of rent caps. Much depends on the details, which in local markets are often regulated by cities and municipalities. This is also the case with the current federal government bill, the details of which need to be adopted by the Bundesrat – the second chamber of parliament – before year-end in order for it to take effect at the start of the coming year.

There is a possibility, however, that all the debate over the draft proposal has already caused some investment to be postponed. This could also happen in the coming year if there are legal battles between tenants and landlords over differing interpretations of a "tight housing market", which is to be governed by the law, or else if there are squabbles over "usual local rent levels". In any event, even if this bill does not counteract the OECD's recommendation to bring about a structural increase in supply elasticity in the construction sector, it will simply ignore it.

Real building permits per capita: Commercial construction

16

EUR per capita



Sources: Deutsche Bundesbank, Deutsche Bank Research

The macroeconomic situation of construction firms

Construction firms have benefited again in 2014 from the positive price and investment trends. 2014 turnover is up more than 6% on the year with little variation across the three segments (residential, commercial and public sector). Moreover, the companies approached in the ifo business survey are certainly also benefiting from the trends of the past few years. For instance, the degree of cost coverage on prices charged is in the upper quartile relative to historical data, and the respondents are equally adamant that there is no lack of funding available.

One obstacle to greater profitability and thus to higher investment in construction and faster expansion of the housing stock could be the labour supply, however. The share of companies reporting a shortage of labour is very high and the number of employees in the construction sector is growing only modestly, accordingly. Over the past five years the number of employees has increased by only 1% per year, and the number of hours worked by roughly 2%. This suggests that a training initiative and qualified inflow of migrant skilled workers and tradespeople could help raise supply elasticity, as called for by the OECD, and reduce the scarcity of housing.

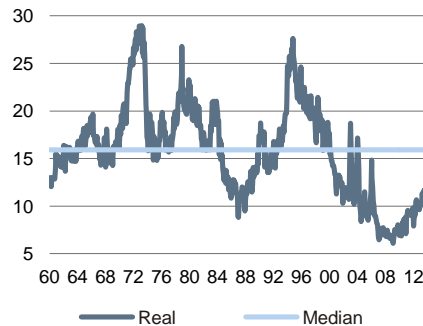


Focus Germany

Real building permits per capita:
Residential construction

17

EUR per capita



Sources: Deutsche Bundesbank, Deutsche Bank Research

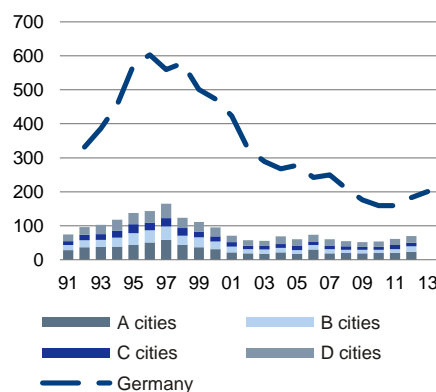
History shows that housing supply has still not returned to normal

Long-term time series help to put the current picture into better perspective. Nominal building permits per month are at high levels both in commercial and in residential construction. And real, i.e. inflation-adjusted building completions (August 2014) have been more than 10% lower than the long-term average values since German reunification and still more than 5% below the averages since 1960. Real building permits per capita are even more significantly lower than their long-term averages. This, too, suggests that the current market situation is mainly marked by a scarcity of supply.

Building completions

18

Number of houses ('000)



Sources: BulwienGesa, Federal Statistical Office, Deutsche Bank Research

Which cities are boosting their housing supply?

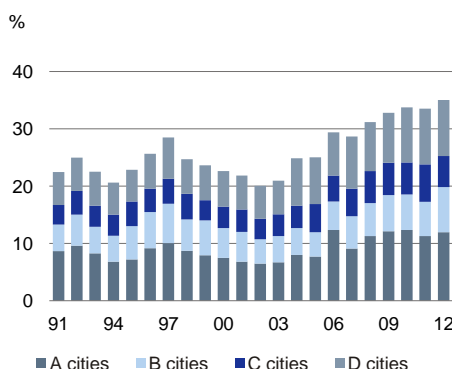
Activity in the current real estate cycle is spread very unevenly across Germany's regions. For example, the metropolitan areas are experiencing a boom that is also benefiting regions which are economically strong and have good transport links. At the same time, the prices in more rural, economically weaker regions are tending to develop moderately or are even falling further. These differing price signals have still scarcely fed through in the shape of differing building completion data, which ought to underpin the continuation of the price trends in the large cities.

Significance for prices

The national real estate indices have recovered by around 20% from their lows of the past five years. By contrast, prices have risen by over 40% in the major cities. The most important German real estate price indices have started to flatten slightly of late. However, the trend in the big cities in particular appears to be unbroken given the scarcity of supply in these markets.

Shares in building completions
across Germany

19



Sources: BulwienGesa, Federal Statistical Office, Deutsche Bank Research

The main affordability indices continue to suggest that the housing market is undervalued. For instance, the ratio of house prices to income is 14.7% below the long-term average, and the ratio of house prices to rents is 12% below the long-term average. Interest and amortisation rates are low compared to disposable income by international standards. In Germany, in contrast to many other households, this also applies to low-income households. For the banking sector as a whole the share of non-performing loans has gradually fallen, from 3.3% in 2009 to 2.7% in 2013. A decrease in non-performing loans can, in longlasting upswings, also point to market overheating. However, given the downtrend in lending growth in the current cycle in Germany, this is very unlikely to be the case.

What this boils down to is that all the prerequisites are in place for further rising prices. As we stated for previous years, we expect to see prices increase again in 2015. Considering the current low price momentum, though, our forecast is not as conservative as in earlier years.

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House price forecast for 2015

20

% yoy	Single-family house	Terraced house, newbuild	Terraced house, stock	Apartment, newbuild	Apartment, stock	Rents, newbuild	Rents, stock
Nation-wide	3.00	3.50	2.50	5.00	4.00	3.00	1.80
A cities	4.00	3.75	3.75	7.50	6.00	3.30	2.50

Source: Deutsche Bank Research

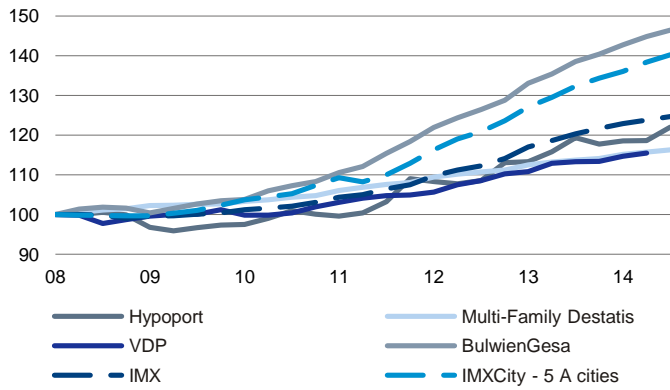


Focus Germany

House prices: National indices and city indices

21

Q1 2008=100



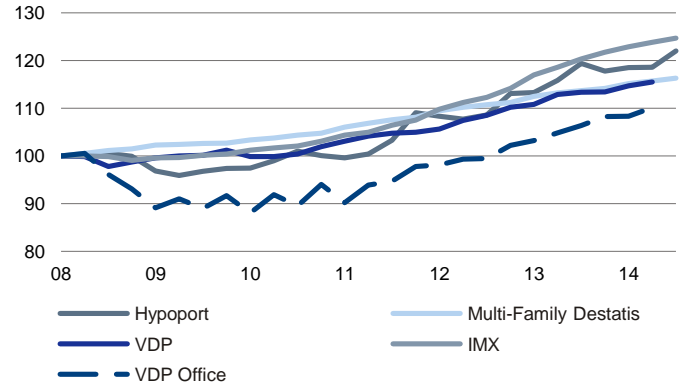
Indices consist of several subindices grouped together according to the Bundesbank weighting system.

Sources: See legend, Deutsche Bank Research

Office and house prices: National indices

22

1Q08=100



Indices consist of several subindices grouped together according to the Bundesbank weighting system.

Sources: See legend, Deutsche Bank Research



Inheritance tax: Constitutional Court ruling likely to weigh harder on business heirs

- The proceedings of the Constitutional Court hearing on July 8, 2014 showed that the judges had doubts about the tax relief, allowances and exemptions currently applicable to business assets.
- The Court is expected to hand down its ruling in late autumn. This could lead to more restrictive regulations on business assets in cases of inheritance and gift-based transfers. In this event, the tax burden on business heirs and Germany's small and medium-sized enterprises (the Mittelstand) will increase.
- The scale of the potentially heavier burden hinges partly on how restrictive the Court's specifications will be and partly on how the government would actually want to change the inheritance and gift tax in view of the revenue volume to be generated.

Prerequisites for tax allowances and exemptions on business assets

1

85% tax exemption (regular exemption ex officio):

- So-called administrative assets may not exceed 50% of the business assets – otherwise the full amount is taxable
- The payroll must add up to 400% of the starting level within five years of the asset transfer – falling short of this level leads to a pro rata loss of the exemption
- In the case of disposals and mergers within the five-year period a (pro rata) share of the tax must be paid retroactively. Exceptions are possible on reinvestments

100% exemption (on application):

- Administrative assets must not exceed 10% of the business assets
- The payroll must not be less than 700% of the starting level in seven years
- Disposals and mergers are not permissible within a seven-year period.

The payroll regulations are not reviewed until after the respective periods, i.e. the exemption is effective immediately at first. See Section 13a of the ErbStG.

This is already the third time that a Constitutional Court decision on inheritance tax is pending after rulings in 1995 and 2006. Even though the details of the respective points at issue differed (i.e. in the legal sense), in principle it was invariably the identical question being asked: how unequally may diverse assets be taxed in the case of a transfer by reason of succession or donation? While the previous decisions focused on the unequal valuation of different assets (such as real estate, business assets or financial assets)³, this time the issue is how extensively business assets may be exempted from the inheritance and gift tax.⁴ The current regulation has only been in force since 2009.

The new German Inheritance and Gift Tax Act (ErbStG) in force since the start of 2009 brought about – in some cases – not only higher tax rates (in tax classes II and III) but both considerably higher allowances as well as significantly higher valuations of real property and business assets.⁵ These asset classes are now valued at higher levels and thus closer to market values in respect of inheritance tax than they used to be (for property assets this also applies to the real property transfer tax). Initial empirical studies show that after the new legislation on valuation came into effect the values calculated for tax purposes may prove in some cases to be considerably higher than the market prices and fair market values.⁶

Under the current rules 85% or even 100% of companies (i.e. business assets) can be transferred without attracting tax. For this to happen, certain prerequisites must be met: first, the business must be continued as a going concern for a certain period of time and, second, the total payroll must be largely maintained (i.e. there must not be any large-scale job cuts [see Box 1]). In this context, the exempted assets must be ring-fenced from non-exempted assets (administrative assets).

³ Under the old regulations (up to 2008) business assets were favoured especially by the very low valuation rates. A key part of the Constitutional Court decision was that potential steering functions of the tax not be shown in the valuation of the assets but instead openly and transparently in direct exemptions.

⁴ From a constitutional standpoint, the question raised is from what point the unequal treatment can no longer be reconciled with the principle of equality anchored in Germany's Basic Law.

⁵ See Houben & Maiterth (2013), Erbschaftsteuer als Reichbesteuerung mit Aufkommenspotenzial, p. 9ff.

⁶ See: Müller/Sureth (2011). Marktnahe Bewertung von Unternehmen nach der Erbschaftsteuerreform? In: zfbf 63/11.



An overview of inheritance and gift tax – what is taxed and how is it valued?

2

German inheritance tax is levied as a hereditary succession tax – as is the case in most countries of continental Europe – meaning that the tax obligation arises via the increase in the wealth of the recipient (heir or donee). In contrast, in Anglo-American countries the entire estate of the testator is taxed, regardless of how this is distributed among the beneficiaries (this concept is referred to as estate tax).

Fundamentally, all types of asset are liable for taxation, i.e. land and property assets, real estate, pecuniary and financial assets, other private assets and, naturally, also business assets. In this context, all related liabilities and debts may be deducted from the total value first. It is not until the final step that tax allowances and deductions, i.e. exemptions, are applied before the going tax rate is applied to the remaining value.

The assets to be transferred and taxed are valued on the basis of the valuation law reformed in 2009. The objective is to make an assessment that approximates the market value of the assets as closely as possible. This becomes a difficult matter if – for example in the case of business assets – no market prices exist. Fundamentally, three different valuation methods may be applied – i.e. depending on the asset in question. The valuation does not focus on the total value of the individual assets, but instead on the business as a whole. This value (referred to as the income value) is the current value of future cash flows.⁷

Even though all the methods generally apply uniformly to all legal entities, there are nonetheless differing charges depending on the legal form, since there are differences between natural persons and joint stock corporations in the extent to which assets may be included as company assets.

The tax rate is doubly progressive. The reason is that it forms a matrix of three classes that are geared to the recipient's relationship with the deceased or donor, with the tax rate rising on an increase in the assessment base within the classes. The tax rates range from 7% to 50%.

Furthermore, various tax allowances exist whose level is similarly dependent on the recipient's relationship with the deceased or donor.

Tax rates (since 2010)

3

Taxable value received, totalling up to EUR	Tax class I	Tax class II	Tax class III
75,000	7%	15%	30%
300,000	11%	20%	30%
600,000	15%	25%	30%
6,000,000	19%	30%	30%
13,000,000	23%	35%	50%
26,000,000	27%	40%	50%
over 26,000,000	30%	43%	50%

Source: German Finance Ministry

Tax-free allowances (since 2011)

4

Tax class	Beneficiaries	Allowance
I	Spouse and registered partner	500,000
	Children, step-children, children of deceased children or step-children	400,000
	Grandchildren	200,000
	Parents and forebears in case of transfer by reason of death	100,000
II	Parents and grandparents (transfer by gift, not under Tax class I)	20,000
	Brothers and sisters	
	Nephews and nieces	
	Step-parents, children-in-law, parents-in-law	
	Divorced spouse or partner from an annulled registered partnership	
III	All other donees and recipients (e.g. aunts, uncles); donations for specific purposes	20,000

Source: German Finance Ministry

The current tax law benefits not only business assets (i.e. sole proprietorships and stakes in partnerships)⁸ but also stakes in (joint stock) corporations on shareholdings of over 25%.⁹ There is no cap on the exemption for business assets. A further benefit is that the part of the business assets that does not fall under the exemption rules (Box 1) only has to be taxed at the lower rates of tax class I. Moreover, a tapered deduction also exists. In effect, this enables business assets of up to EUR 1 m to be transferred without attracting tax. In addition – depending on the recipient's relationship with the deceased or donor – there are also personal tax allowances (ranging up to EUR 500,000).¹⁰

Administrative assets include, for example, property turned over to third parties for their use, stakes in joint stock corporations of less than 25%, art objects as well as securities and similar receivables if they do not serve a (financial) company's main business objective. This aspect is particularly relevant for the case being heard by the Federal Constitutional Court because it represents a pillar of the action filed.¹¹ Strategic tax optimisation (so-called "Cash GmbHs")¹² enabled liquid funds to be declared as "nicht schädliches"¹³ Verwaltungsvermögen" (roughly: not harmful administrative assets) so that these could be transferred in their entirety without incurring tax after seven years (avoiding the

⁷ See also: Gutachten Beirat BMF (2012). S. 22.

⁸ This includes agricultural and forestry assets. See Section 13b of the ErbStG.

⁹ The latter also applies to indirect holdings, inter alia, but a pooling agreement is required.

¹⁰ Furthermore, firms with less than 20 employees do not have to comply with the payroll rule. See Section 13a of the ErbStG. While this applies to 90% of all companies, the remaining companies employ 60% of all workers and generate 80% of total company revenues.

¹¹ The respective action was started by the Federal Fiscal Court with a decision from the year 2012.

¹² For more on this and what follows see Bach et al. (2014), Aufkommens- und Verteilungswirkungen von Reformalternativen für die Erbschaft- und Schenkungsteuer, p. 14.

¹³ The term "harmful" focuses on the fact that the law distinguishes between business assets (or in economic terms: productive assets) and administrative assets. But it is precisely the latter that are not meant to be favoured under the Inheritance and Gift Tax Act. The term "not harmful" focuses on the fact that under certain conditions administrative assets and/or shares of the same may be exempted from tax after all and thus included as part of the actual business assets.



payroll rule). However, since this loophole was plugged in June 2013, a key part of the current action before the Court is no longer at issue.¹⁴

Therefore, the Constitutional Court must decide above all whether the special treatment based on the two exemption rules (see Box 1) goes too far. However, given the existing rules, the Court has considerable room for manoeuvre in its decision. Therefore, it is currently unclear how exactly the Constitutional Court will spell out its specifications for the government authorities. The tax exemptions are not likely to be abolished altogether. A tightening of the regulations will probably lead to a heavier tax burden, though, especially because of the higher valuation of business assets since 2009. However, politicians can exert their influence here by changing the tax rates imposed. The target of the reform in 2009 was to secure a revenue volume of roughly EUR 4 bn. Today, too, at least maintaining if not increasing this volume will probably play an important part – especially since all inheritance and gift tax revenue accrues to the Länder (federal states) and they are pushing for a bigger piece of the pie in the current negotiations on a reform of federal finances in Germany.

Exemptions for business assets highly contentious from an economic perspective

It is currently impossible, for the reasons outlined, to make a more accurate assessment of the potential impact on businesses. However, large family businesses would be hit particularly hard by a reorganisation of the tax regime, since *ceteris paribus* (i.e. barring adjustments of tax allowances and/or tax rates) the valuation of business assets can now even exceed fair market value due to the new tax rules effective since 2009.

The Mittelstand is quite rightly regarded as a special source of pride in Germany as a business location because it stands for economic stability and continuity as well as a sense of entrepreneurial activity assuming responsibility for the common good.¹⁵ An exemption for reasons of the common good is permissible under the Constitution if it is a matter of protecting jobs and/or for the sake of investment activity. It is argued that an effective exemption rule for business assets eases the transition from generation to generation and thus secures jobs while not choking off funds for investment. The latter occurs in particular if inheritance and gift tax (as a capital levy) drains liquidity from a business in the event that company earnings or assets have to be used (e.g. via divestiture) in order to settle the tax debt.

From an economic perspective, however, repercussions for jobs and liquidity withdrawals are contentious points.¹⁶ A strict separation between various types of asset can never really be achieved. The unequal treatment of asset categories leads to distorted investment decisions when considering various investment alternatives and thus also to the dominance of tax aspects in company strategy. The complaints about a liquidity drain can at least be partly defused by deferral rules or borrowing. Asymmetrical information or a lack of information in the capital markets may preclude such an approach, though.

¹⁴ Since then, payment instruments, company credit balances, pecuniary receivables, and other receivables if these represent over 20% of the business assets (Section 13b (2) 4a of the ErbStG) are deemed to be harmful administrative assets.

¹⁵ Special features pointed out in this context include financing practice, innovation activity, form of business organisation, strategic management, regional roots, emotional ties to the firm and the longevity of family businesses.

¹⁶ See Gutachten Beirat BMF (2012), p. 26ff. and Stiftung Familienunternehmen/ifo (2014), p. 3. This becomes immediately visible by the fact, among others, that for reasons of European law the exemption for business assets also includes assets located in other EU countries, which may only indirectly protect jobs in Germany.



Focus Germany

As a rule, business assets tend to enjoy preferential treatment internationally

5

The preferential treatment of business assets tends to be the rule rather than the exception across Europe. The exemptions are usually linked, as in Germany, with certain prerequisites (mainly to continue business for a minimum period or retain a minimum stake). Significant valuation discounts (over 50%) are found, for example, in Finland, France, Ireland, Italy, the Netherlands, Poland, Spain and the United Kingdom. Belgium has a special tax rate of 3%.

A host of countries imposes no inheritance or gift tax. These include Sweden, Austria, Slovakia, New Zealand and Canada, among others. A number of countries grant a full exemption to spouses (e.g. DK, FR, IE; LU and UK) and in some of them also to their direct descendants (e.g. Poland, Slovenia, Czech Republic).

A survey of family businesses conducted by the ifo Institute in February 2014 found that roughly two-thirds of Germany's family businesses believe they will have to reduce their investment activity without the exemption.¹⁷ Nearly 50% stated that in this event they would also have to cut jobs. Nearly 40% of the companies that had experienced a case of asset transfer by reason of inheritance or gift thought that without the applicable exemptions they would have had to sell the company or at least parts of it. A survey conducted jointly by the BDI (Federation of German Industries) and Deutsche Bank found as well that nearly two-thirds of companies complained about the added bureaucratic expense caused by the Inheritance and Gift Tax Act.¹⁸

Preferential treatment of business assets

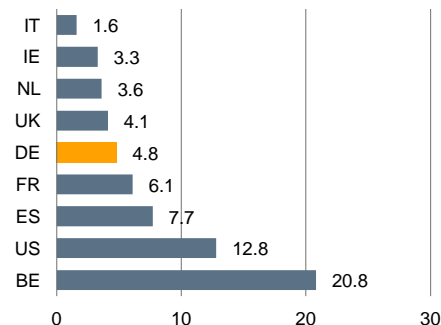
An international comparison of the tax burden on business assets is very difficult because of the very diverse valuation methods and asset transfer schemes. Exemptions on business assets are also to be found in a number of countries, though (see Box 5).

If one compares the effective tax burden on family businesses using the example of a typical family business that is large by European standards¹⁹ and which is liable for inheritance and gift tax in various countries (enabling depiction of all regulations such as valuation methods, tax allowances, tax rates), then Germany ranks in a midtable position according to ZEW model calculations (see Chart 6). The tax burden is higher in Belgium, the United States, Spain, France, Denmark and Finland, and lower in the United Kingdom, the Netherlands, Ireland and Italy. However, a number of countries do not impose any inheritance and gift tax at all (see Box 5).

Comparison of effective inheritance tax burden on family business assets

6

2012, EUR m, assuming total assets of EUR 126 m



Sources: ZEW/Stiftung Familienunternehmen, Deutsche Bank Research

In a comparison of tax burdens it should be noted, too, that other countries have a number of taxes that may substitute for inheritance and gift tax. Like the inheritance and gift tax, these are geared to a company's (asset) stock or to a transfer of company assets. These include pure-play wealth taxes such as in Switzerland and France, taxes on immovable assets (above all real property tax), taxes on financial and capital transactions (e.g. real property transfer tax, capital transaction taxes). Therefore, comparison of levies on capital based on OECD figures are usually difficult to perform or are little revealing.

¹⁷ See Stiftung Familienunternehmen/ifo (2014).

¹⁸ BDI/Deutsche Bank (2013), Die größten Familienunternehmen in Deutschland.

¹⁹ The ZEW calculations assume that, among other things, the firm has total assets of around EUR 126 m and a year-end result of about EUR 4 m. In individual cases, however, the tax burden strongly hinges on the type of legal entity and the recipient's relationship with the deceased or donor. The value cited above is an average figure (weighted index). In an international comparison, sole proprietorships in Germany are better off than joint stock corporations, for instance. See ZEW (2013), Länderindex der Stiftung Familienunternehmen, 4. Auflage.



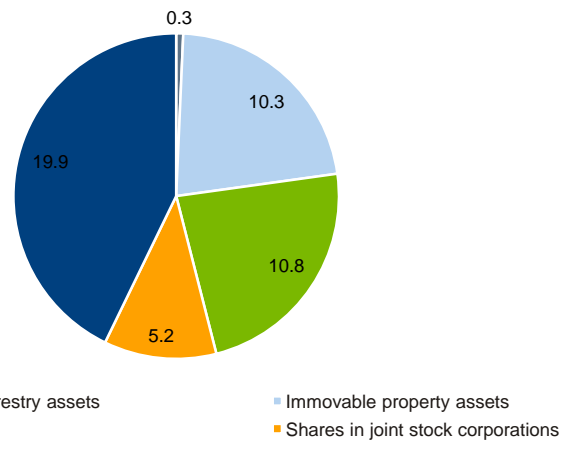
Consequences of potential abolition or overhaul

The scale of business assets transferred in Germany has fluctuated heavily over the past few years. In the past three years the share of business assets in all taxable receipts²⁰ fluctuated between 20% and 40%. In 2013, the absolute value totalled roughly EUR 10 bn at the last reading (see Chart 7), and just over EUR 19 bn in 2012. In this context it is worth mentioning that after the 2009 reform heavy availment was made of the exemption rules (see Chart 8).²¹ This is presumably due to the fact that many gifts were postponed in anticipation of the more favourable rules taking effect in the wake of the reform (2009). At the same time, the Federal Fiscal Court ruling of 2012 probably motivated many company owners to pull their asset transfers forward.²²

Transferred assets, 2013

7

Taxable value received greater than zero, without deductions for liabilities and allowances, EUR bn



Sources: Federal Statistical Office, Deutsche Bank Research

Heavy availment of tax exemptions

8

Tax exemptions pursuant to Section 13a of the Inheritance and Gift Tax Act (ErbStG), including business assets and shares in joint stock corporations in particular



*Taxable value acquired greater than zero

Sources: Federal Statistical Office, Deutsche Bank Research

Considering the proceedings of the Federal Constitutional Court hearing in July 2014 it is likely the Court will find that the currently applicable rules go too far. It is currently impossible to forecast how restrictive the Court's specifications for the government authorities will be. Nonetheless, the burden on the Mittelstand is likely to increase – even if the government seeks to cushion the impact. Whether the extra burdens will reach a scale that leads to consequences for companies – as suggested in surveys among them – may be viewed with a critical eye, though. One possible alternative to the current exemption of business assets often brought into the equation is a broadened assessment base with low tax rates. DIW simulations modelled on microdata from the past²³ show in this case, however, that a broadening of the assessment base via abolition of the exemptions is not sufficient to generate an identical or higher revenue volume with a low tax rate of say 10%. For this to happen, the personal tax allowances, for instance, would also have to be reduced significantly.

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²⁰ Only when taxable value received greater than zero. Taxable value received before deductions or allowances.

²¹ Note, though, too that business assets have much higher valuations since the 2009 reform.

²² Federal Statistical Office simulations modelled for the Finance Ministry quantify the reduction of revenue due to tax exemptions for business assets, ceteris paribus, at about EUR 4.8 bn per year on average between 2009 and 2012. BMF (2014). For more details see Letter to the Federal Constitutional Court for the hearing on the inheritance and gift tax on July 2014.

²³ See Bach et al. (2014), Aufkommens- und Verteilungswirkungen von Reformalternativen für die Erbschaft- und Schenkungsteuer. DIW, especially p. 57ff.

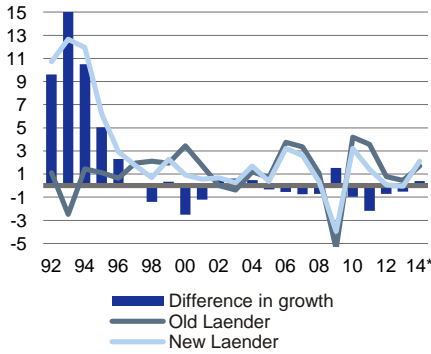


Focus Germany

Convergence of East German economy stopped by the end of the 1990s

1

Real GDP-growth, % yoy, pp



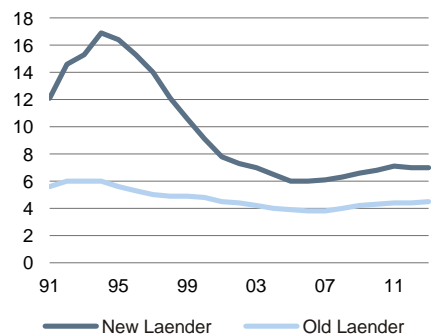
* H1 2014

Sources: Statistical Offices of the Federal States, Deutsche Bank Research

Temporary building boom in early 1990s in the New Laender

2

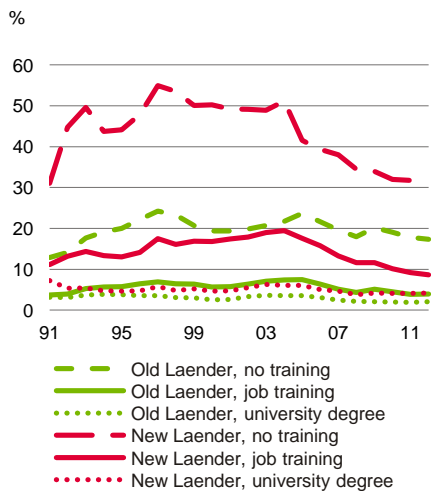
Construction, % of gross value added



Source: Statistical Offices of the Federal States

Significant higher unemployment rate in the New Laender

3



Source: IAB

25 years after the fall of the Berlin Wall: "Blooming landscapes" only in part

- After the initial massive catch-up process, the real economic convergence of the east German economy has been stalling since the mid-2000s. The success regarding the convergence of living conditions was mainly reached via transfer payments, which largely materialised via social security funds.
- In view of the continuing massive support of the east German Laender (federal states), the stalling convergence suggests continuing structural differences between the old and the new Laender.
- True, the east German economy is likely to grow slightly more strongly than the west German economy this year, as the relatively weak development of capital spending and exports so far this year mainly hits west German companies with strong export businesses. However, in 2015, the introduction of the minimum wage of EUR 8.50 should affect the east German economy particularly strongly and raise the already relatively high unemployment among unskilled workers.
- The fact that, despite massive financial support and an identical legal framework, structural factors in east Germany prevent further convergence underscores the necessity of reforms, also with a view to the current situation in the euro area. The convergence in the real economy in the euro area since 1999 is attributable mainly to the catch-up process of the east European countries. Without a fiscal union and in view of limited labour mobility, higher adjustment flexibility in the other European countries is required.

"Blooming landscapes" came only later and not everywhere

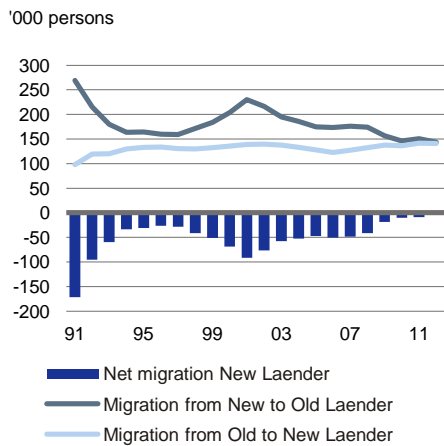
On November 9, 2014 the 25th anniversary of the fall of the Berlin Wall will be celebrated, the event which symbolises the end of the German Democratic Republic (GDR) and marks the beginning of the reunification process with the Federal Republic of Germany (FRG). The economic, monetary and social union took effect on July 1, 1990 and on October 3, 1990 reunification occurred. 25 years later, the public in west Germany and especially in east Germany still assess reunification positively. However, the economic challenge in view of the much more desolate state of the east German economy than presumed proved to be more protracted and above all much more expensive than anticipated. The expectation of the former Chancellor Helmut Kohl that the new Laender would soon change into blooming landscapes worth living and working in has not been fulfilled until this very day. Many for political reasons probably unavoidable strategic steps have ultimately made the adjustment process more difficult and, besides the adverse initial conditions, contributed to the fact that no full-scale adjustment of real-economy levels has been reached so far. The changeover to the common currency at parity and the sharp increase in wages due to the politically demanded conversion of wages as quickly as possible undermined the – right from the start – low international and intra-German competitiveness of the majority of east German companies. At the end of 1990 output was over 50% and employment roughly 30% below the level of the preceding year.²⁴ Following this reunification shock the far-reaching restructuring process began in the east German economy. This was supported by massive transfer payments, subsidies and tax relief. As a result of the initially state-supported construction boom and the powerful development of consumption – benefiting

²⁴ Akerlof et al. (1991). East Germany in from the Cold: The Economic Aftermath of Currency Union. Brookings Papers on Economic Activity 1991 (1).



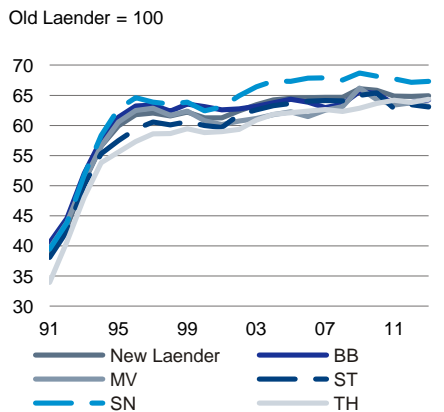
Focus Germany

Particularly high emigration from New Laender in early 1990s and 2000s 4



Source: Federal Statistical Office

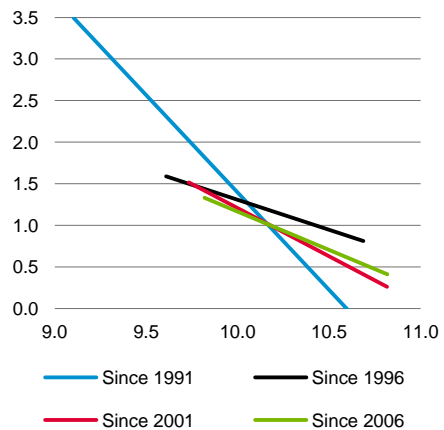
Convergence of real GDP per capita stopped in the middle of the 2000s 5



Source: Statistical Offices of the Laender

Beta-Convergence in Germany 6

y-axis: average growth since the resp. starting point; x-axis: log(GDP per capita)



Sources: Statistical Offices of the Laender, Deutsche Bank Research

mainly west German suppliers, however – the east German economy expanded much more strongly than the west German economy up to the mid-1990s. Nevertheless, since then, growth of the east German economy has been outperformed by the west almost without exception.²⁵ True, the new Laender should grow slightly more strongly than the old Laender this year. However, this is no indication of new dynamics but attributable to this year's disappointing export performance against the backdrop of numerous geopolitical risks and weak economic growth in the euro zone and China. These also weigh on capital spending and hit east Germany less as a result of their lower degree of openness.

High transfers from west to east

German unity will probably have cost just below EUR 2 trillion until the end of this year and is a driver for the increase in all-German debt since the early 1990s.²⁶ Close to 60% of these costs is financed by transfers within the pay-as-you-go welfare system. The remaining 40% consists of direct transfers, such as the fiscal equalisation scheme, the solidarity pact, growth-oriented federal funding and the investment allowance. Since the start of the 1990s, east Germany's dependence on transfer payments²⁷ has declined from around 35% of nominal GDP to just above 20% but remains at a relatively high level.²⁸ In addition, the shift to the detriment of social security budgets is a negative factor. While their share in gross transfers paid in the first five years after reunification was still just below 54% on average, it grew to an average of roughly 65% on average in the last five years.

Economic convergence stopped in the mid-2000s

The initial slump of the east German economy and the prospects for markedly higher wages in west Germany led to strong migration movements especially of younger and highly qualified employees from the new to the old Laender.²⁹ This first wave of migration together with strong real growth of the east German Laender supported by massive transfer payments ensured that per capita GDP in the east German Laender rose from a level of roughly 40% of the west German level in the early 1990s to close to 60% in the mid-1990s. The second wave of migration at the start of the 2000s led to a further convergence of GDP per capita, which, however, is hovering at roughly 65% of the level of the old Laender since then.

How the convergence in the real economy has developed between all 16 Laender will be examined on the basis of two convergence concepts in the following. A distinction is made between the absolute (beta-convergence) and the relative convergence (sigma-convergence). On the basis of the beta-convergence it is analysed whether there is a catch-up process of the poorer Laender. The sigma-convergence indicates how the differences between all the Laender change over time.³⁰

²⁵ Gräf, B. (2012). All quiet on the eastern front, Deutsche Bank Research, Focus Germany, December 3, 2012.

²⁶ Gross transfers minus taxes and social security contributions. Ifo Institute Dresden, IWH, calculations of Deutsche Bank Research

²⁷ Transfer dependence is defined as net total expenditure in relation to nominal GDP.

²⁸ Lehmann, R., Ragnitz, J. (2012). Die Transferleistungen zugunsten der ostdeutschen Bundesländer – Status quo und Ausblick. ifo Schnelldienst 3/2012 (65. pp. 25-30.

²⁹ Schneider, L. (2005). Ost-West-Binnenwanderung: Gravierender Verlust an Humankapital, Wirtschaft im Wandel, Jg. 11 (10), pp. 309-314

³⁰ Both convergence concepts are closely correlated. Under formal aspects, beta-convergence is a necessary but not a sufficient condition for sigma-convergence.

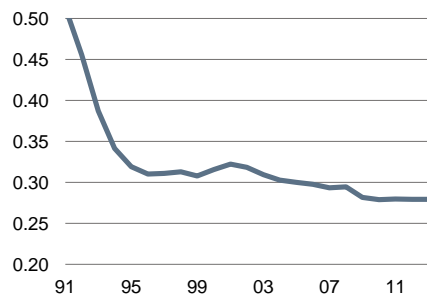


Focus Germany

Sigma-Convergence

7

Standard deviation of log(GDP per capita)

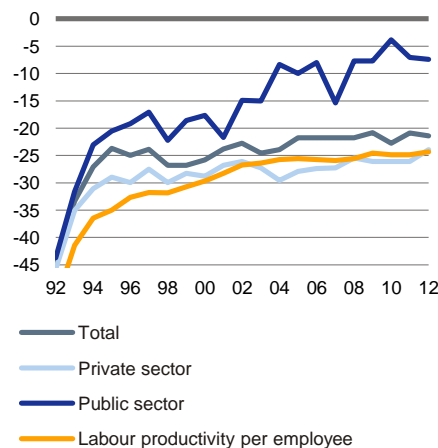


Sources: Statistical Offices of the Laender, Deutsche Bank Research

Wage convergence more advanced in public vs. private sector

8

% Monthly gross wage gap East vs. West

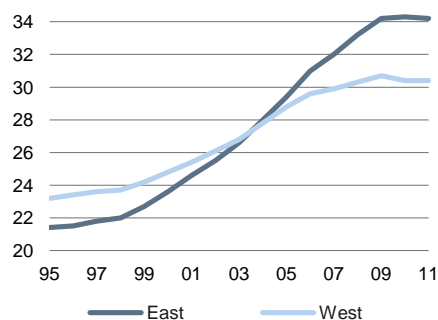


Sources: SOEP, Deutsche Bank Research

Emigration exacerbates the demographic problem in the New Laender

9

% (population 65+ per 100 employable persons)



Source: INKAR 2013

Beta-convergence occurs if the Laender with an initially low GDP per capita grow most strongly und thus a negative correlation exists between average growth rates and the log of GDP per capita of the individual Laender. The fact that beta-convergence exists is reflected in the negative slope of the trend line in chart 6. Following the initially marked convergence of the new Laender to the level of the old Laender, the convergence speed has declined distinctly, however, which is reflected in the lower gradient.

Sigma-convergence exists if there is a convergence of the level of GDP per capita among the 16 Laender over time. Convergence is a reality when the standard deviation of the log of GDP per capita between the Laender declines over time. Between the 16 Laender, a noticeable convergence took place in the real economy. At the beginning of the 1990s, this was the result of the rapid convergence process between the old and the new Laender which came to a standstill in the mid-2000s. However, the slight drifting apart between the Laender at the end of the 1990s and the continuing moderate convergence in the real economy until the end of the 2000s was due to a convergence in west Germany.

Continuing regionally different living conditions are not a typically German phenomenon, though. Compared to other large European countries, regional differences in German production per capita are currently roughly comparable to those in Spain and France. Since 2000, regional differences in these three countries have narrowed. By contrast, the differences between the regions in Italy and the UK are much more pronounced so that no or only low convergence takes place.³¹ However, as a result of German history, the continuing differences attract greater attention than in other countries.

Wage gap of roughly 25% from the early 2000s in line with productivity gap

Due to corporate restructuring and the convergence of wages contrary to economic necessities in the 1990s, the labour-market situation has clearly darkened. This is illustrated in chart 8 which in comparison to labour productivity shows a much stronger wage convergence until the beginning of the 2000s. The catastrophic situation on the labour market – the unemployment rate rose from 12% to roughly 20% and for people without any qualification even over 50% in the early 2000s – increased pressure on trade unions to give up their course of wage convergence as quickly as possible. Thus, wage convergence almost came to a standstill.³²

However, there is a perceptible difference between the convergence of wages in the public sector and the private sector. In public service, which is protected from competition, wages converged much more strongly in accordance with the wishes of politicians and trade unions. The wage gap narrowed from roughly 45% at the beginning of the 1990s to only slightly over 5% in 2012. However, as the cost of living in the new Laender is far below that in the old Laender this convergence financed from public funds should be evaluated very critically.

In the private sector, on the contrary, wage convergence came to a halt – so did convergence in the real economy – in the mid-2000s at a wage difference of around 25%. This is roughly in line with the productivity gap. Since 2005, the east German labour market was able to benefit from the increasing orientation of wages to east German productivity, and joblessness distinctly declined.

³¹ See also Chart of the Month "Regional convergence in Europe: No progress in Italy and the UK" on p. 25.

³² Peters, H. (2013) Convergence in pay between east and west Germany at a standstill since the early 2000s, Deutsche Bank Research, Focus Germany, April 29, 2013.

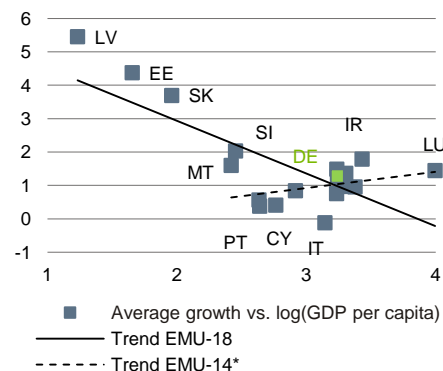


Focus Germany

Beta-Convergence within the Euro-zone: driven by Eastern Europe

10

y-axis: average growth since 1999;
x-axis: log(GDP per capita) in 1999



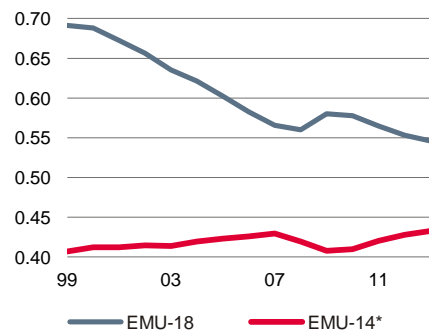
* EMU-18 without EE, LV, SK, SI

Sources: Eurostat, Deutsche Bank Research

Sigma-Convergence within the Eurozone: driven by Eastern Europe

11

Standard deviation of log(GDP per capita)



* EMU-18 without ES, LV, SK, SI

Sources: Eurostat, Deutsche Bank Research

However, the unemployment rate remained strongly above that in the old Laender.

Continuing large challenges for the east German economy – minimum wage to have strongly negative effect

The situation in the new Laender has improved strongly compared to the catastrophic situation in the GDR shortly before reunification. The development of the last 25 years shows, however, that the convergence of living conditions between regions cannot be reached overnight and that owing to different historical development paths and resultant factor endowments a full-scale convergence can probably only be attained at prohibitively high costs. Furthermore, the development between the two regions underscores that the cost of wrong economic-policy decisions turns out very high. The corrections of the overly high wage increases in the 1990s, which led to a collapse of the labour market, and of the building boom induced by the government in the early 1990s took many years. What is more, transfer payments cemented the dependence of the east German economy. In retrospect, the policy of convergence was focused much too much on the demand side and transfer payments instead of creating favourable prerequisites as a location for business via reforms on the supply side.

The stalling of convergence in the real economy since the mid-2000s underscores the continuing strong structural differences, such as the lack of adequate jobs in the high-wage segment in east Germany. Despite the continuing massive support of the new Laender, no further convergence was attained. In 2015, the introduction of the minimum wage of EUR 8.50 should affect the east German economy particularly strongly, though, and raise the already relatively high unemployment among unskilled workers. The biggest intrusion into the wage structure will be in Mecklenburg-Western Pomerania and Saxony where the minimum wage is roughly 70% of the median hourly wage and thus the distance to the median wage is much smaller than in the remainder of the country (50%).³³ Furthermore, in the medium term the demographic challenge will be much more pronounced for the new Laender as a result of the exodus mainly of younger and more highly qualified persons.

German experience strengthens demands for structural reforms all over Europe

If one takes the above-mentioned convergence criteria as a basis and uses them for the euro area, a lack of convergence is reflected here as well. True, the measures for beta and sigma convergence have improved distinctly since 1999. But this is attributable to the catch-up process of the east European countries. By contrast, the "old" EMU states even show diverging tendencies according to the sigma-convergence.

The experience with German monetary union shows how difficult and lengthy convergence processes of regions with different starting positions can be even with massive (fiscal) support and high migration movements. At the same time, it underscores how disastrous the repercussions of wrong economic-policy decisions are. Within the eurozone, the readiness for a fiscal union is relatively low and labour mobility is limited due to lacking country-specific knowledge – e.g. special features of the labour market, language skills and corporate attitudes and practices. Thus, for the cohesion of monetary union to succeed,

³³ Peters, H. (2014). Minimum wage of EUR 8.50 per hour: Grand Coalition on the wrong track. Deutsche Bank Research. Focus Germany. June 4, 2014.



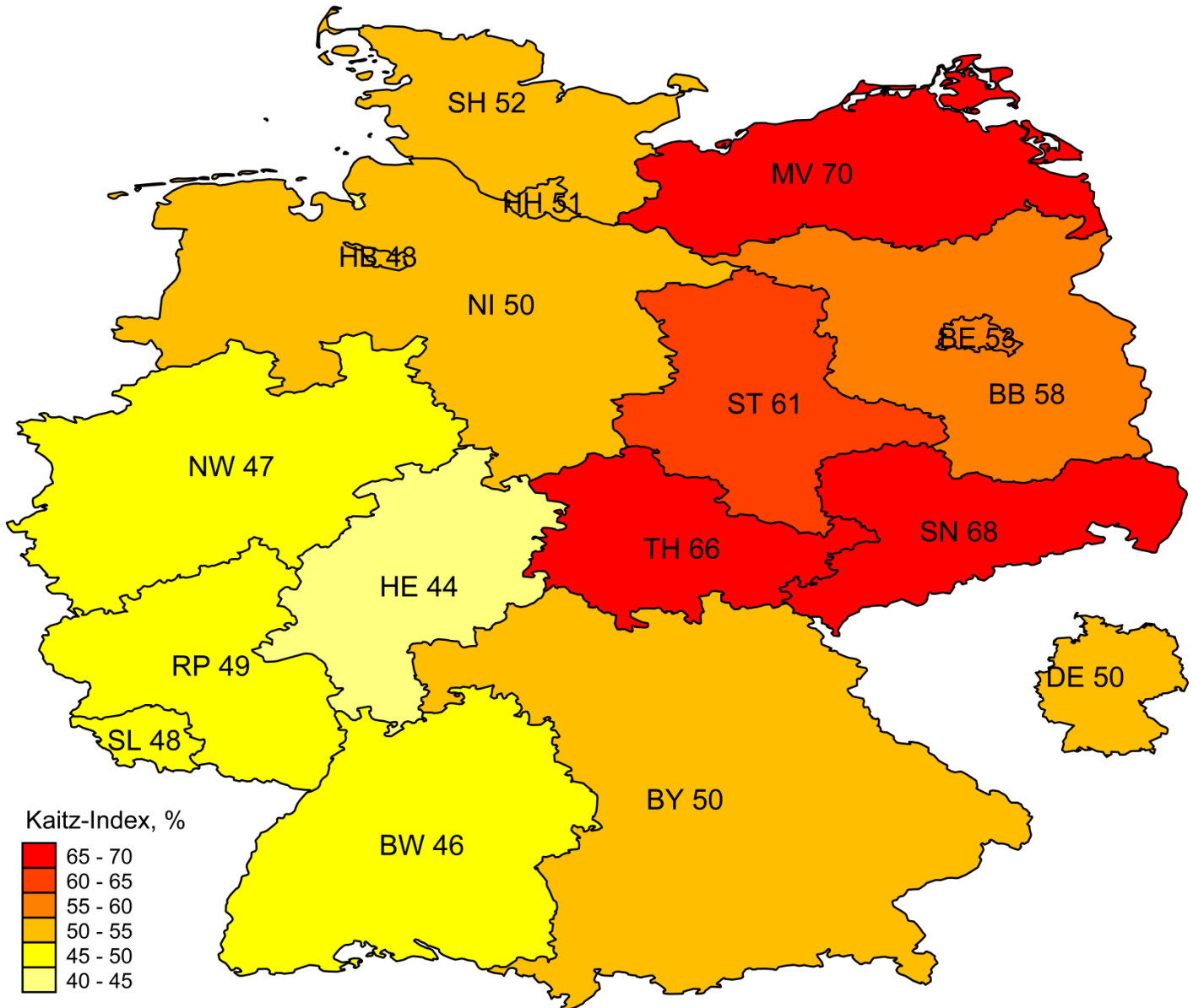
the required adjustments to country-specific shocks have to take place within the individual countries and bold structural reforms have to be pushed through.

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Marcel Engelhardt

Negative employment effects of minimum wage introduction mainly in east Germany

12

Minimum wage of EUR 8.50 per hour as % of median wage of full-time employee



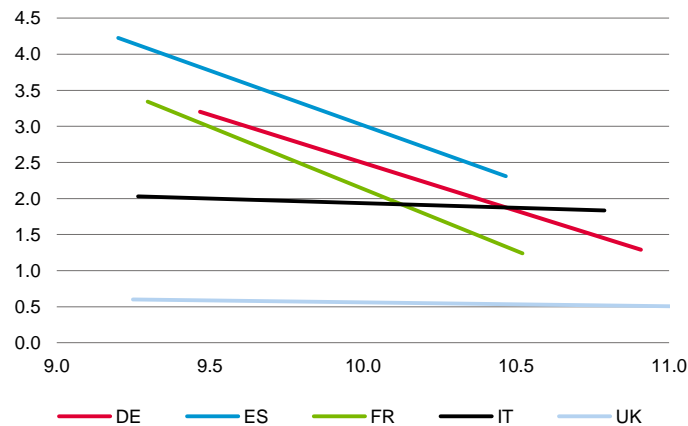
Sources: SOEP, Deutsche Bank Research



Chart of the month

Beta-Convergence of European countries

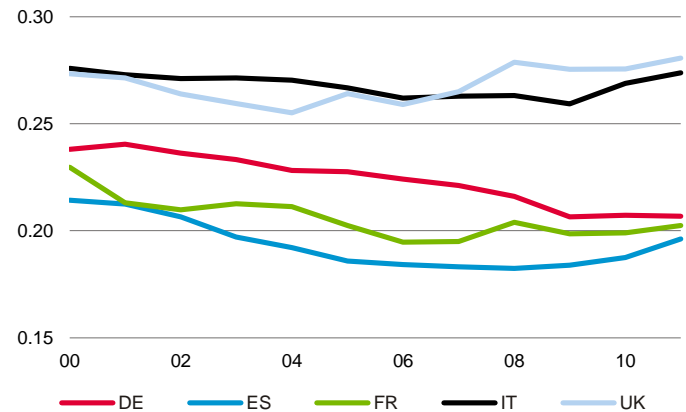
Average growth between 2000 and 2011;
x-axis: log(GDP per capita) in 2000



Sources: Eurostat, Deutsche Bank Research

Sigma-Convergence

Standard deviation of log(GDP per capita)



Sources: Eurostat, Deutsche Bank Research

Regional convergence in Europe: No progress in Italy and the UK

The article entitled “25 years after the fall of the Berlin Wall: Blooming landscapes only in part” in this edition of Focus Germany underscores that while there has been some convergence in living conditions between east and west Germany since reunification, the process of real economic convergence came to a standstill in the mid-2000s. The differences between east Germany and west Germany have remained sizeable, accordingly. In a comparison of the five largest countries of the EU, however, Germany ranks quite well on the reduction of regional differences.

While the regions within Germany, Spain and France showed convergence in real economic terms between 2000 and 2011, the regional differences³⁴ in Italy and the United Kingdom remained largely unchanged. The two charts of country performance use the concepts of absolute (beta) and relative (sigma) convergence already discussed. In the case of beta-convergence it clearly emerges that the regions of Italy and the UK with their lower starting level posted no significantly higher growth rates on average than regions with a higher starting level. In Germany, Spain and France, by contrast, there is a very distinct negative correlation – i.e. absolute convergence.

Our analysis of sigma-convergence confirms the findings. While the standard deviation of log GDP per capita within Italy and within the United Kingdom decreased only slightly or even increased and thus left these countries hovering at the year 2000's already much higher level,³⁵ this metric decreased noticeably in the other three countries.

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³⁴ The calculations were based on Eurostat data from the NUTS 2 level. In Germany's case, this pertains to the administrative districts referred to as "Regierungsbezirke", city-states and territorial states with no further subdivision for statistical purposes.

³⁵ The structurally higher standard deviation in Italy may be partly explained by a strong separation between the economically powerful northern regions and weak southern regions and in the United Kingdom by a concentration of economic power in London as a financial centre.



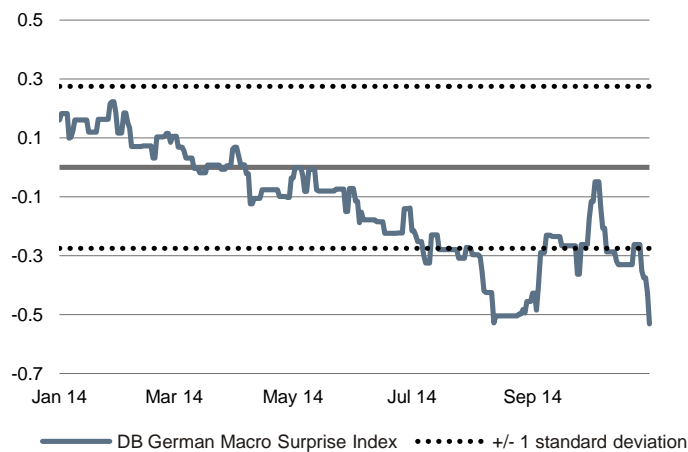
Focus Germany

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.³⁶

DB German Macro Surprise Index

Average of last 20 z-scores of data surprises

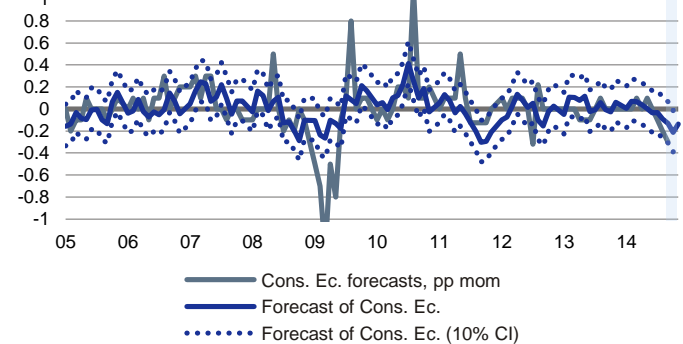


Values above (below) 0 indicate the data came in better (worse) than expected

Sources: Bloomberg Finance LP, Deutsche Bank Research

DB German Macro Surprise Index: Downside-risks for GDP forecasts

Monthly revisions of Consensus Economic Forecasts (pp); Average of previous 20 z-scores



CI: 10% Confidence Intervall

Sources: Consensus Economics Inc., 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
GRZECURR Index	ZEW Survey Current Situation	9 2014	16.09.14	25.4	40.0	-14.6	-2.1	0.0
GRIFPBUS Index	IFO Business Climate	9 2014	24.09.14	104.7	105.8	-1.1	-1.0	0.1
GRIMP95Y Index	Import Price Index (% yoy)	8 2014	26.09.14	-1.9	-2.0	0.1	0.4	0.7
GRFRIAMM Index	Retail Sales (% mom)	8 2014	30.09.14	1.5	0.5	1.0	1.1	0.9
GRUECHNG Index	Unemployment Change (000's mom)	9 2014	30.09.14	9.0	-2.0	-11.0	-0.6	0.2
MPMIDEMA Index	Markit Manufacturing PMI	9 2014	01.10.14	49.9	50.3	-0.4	-0.4	0.2
MPMIDESA Index	Markit Services PMI	9 2014	03.10.14	55.7	55.4	0.3	0.4	0.7
GRIORTMM Index	Factory Orders (% mom)	8 2014	06.10.14	-5.7	-2.5	-3.2	-1.5	0.1
GRIPIMOM Index	Industrial production (% mom)	8 2014	07.10.14	-4.0	-1.5	-2.5	-2.1	0.0
GRCAEU Index	Current Account Balance (EUR bn)	8 2014	09.10.14	10.3	13.8	-3.5	-1.5	0.1
GRZEWI Index	ZEW Survey Expectations	10 2014	14.10.14	-3.6	0.0	-3.6	-0.4	0.3
GRZECURR Index	ZEW Survey Current Situation	10 2014	14.10.14	3.2	15.0	-11.8	-1.7	0.0
GRCP20YY Index	CPI (% yoy)	9 2014	15.10.14	0.8	0.8	0.0	0.3	0.4
MPMIDEMA Index	Markit Manufacturing PMI	10 2014	23.10.14	51.8	51.8	0.0	0.0	0.5
MPMIDESA Index	Markit Services PMI	10 2014	23.10.14	54.8	54.8	0.0	0.0	0.5
GRIFPBUS Index	IFO Business Climate	10 2014	27.10.14	103.2	104.5	-1.3	-1.1	0.1
GRIMP95Y Index	Import Price Index (% yoy)	9 2014	28.10.14	-1.6	-1.9	0.3	0.6	0.8
GRUECHNG Index	Unemployment Change (000's mom)	10 2014	30.10.14	-22.0	4.0	26.0	0.8	0.8
GRCP20YY Index	CPI (% yoy)	10 2014	30.10.14	0.8	0.9	-0.1	-0.3	0.2
GRFRIAMM Index	Retail Sales (% mom)	9 2014	31.10.14	-3.2	-0.9	-2.3	-1.5	0.1

Sources: Bloomberg Finance LP, Deutsche Bank Research

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³⁶ See for details Focus Germany. August, 4 2014.

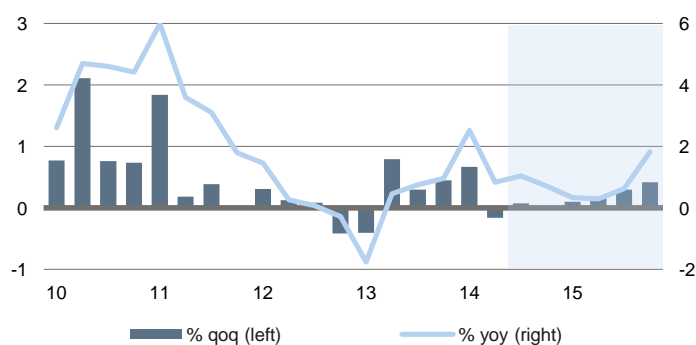


Focus Germany

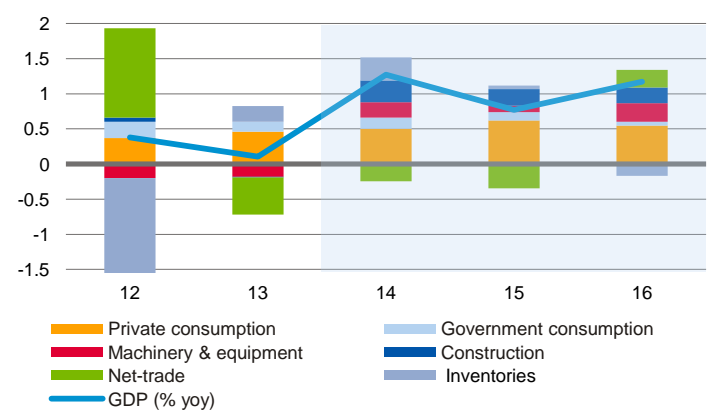
Chartbook – Total economy

- The 0.2% qoq Q2 2014 GDP decline implied a much bigger payback for the strong Q1 (+0.7%) than expected. Some 0.3 to 0.4 pp of this distinctive quarterly profile are due to the mild winter that boosted Q1 construction (+4.1%). With the usual spring acceleration not materialising the seasonal adjustment caused a significant decline in Q2 (-4.2%). Private consumption corrected after its Q1 surge (+0.1% qoq vs +0.8%), which was probably in part due to a lump-sum payment in the large retail sector in January. In H1 domestic demand was the only contributor to growth. In contrast, net exports were a drag in Q1 and Q2 (each -0.2 pp).
- German GDP in Q3 will probably have grown slightly courtesy of robust private consumption. Construction investment probably stagnated. Continued weakness of exports due to geopolitical risks and the poor global trade development was a drag for investments in machinery and equipment so far this year.
- In addition to the ongoing geopolitical risks (above all the Ukraine-Russia crisis) sentiment is coming under increasing pressure and question marks are hanging over the expected cyclical upturn, in part given the sluggish pace of reform in several eurozone countries. Disappointing economic performance in France (9% of Germany's total exports in H1 2014) and Italy (5% of exports) as well as the collapse in exports to Russia (3% of exports) are weighing more and more heavily on German exports. In this uncertain environment companies are likely to adopt a wait-and-see attitude and postpone some of their planned investments. Therefore, we expect growth to be weak in the winter half-year.
- On account of these factors and the lowered global growth forecasts for 2015 and 2016, we have scaled back our growth forecasts. We now expect the German economy to expand by 1.3% this year, 0.8% in 2015 and 1.2% in 2016 (prev. 2014 and 2015: 1.5%, 2016: 1.4%).

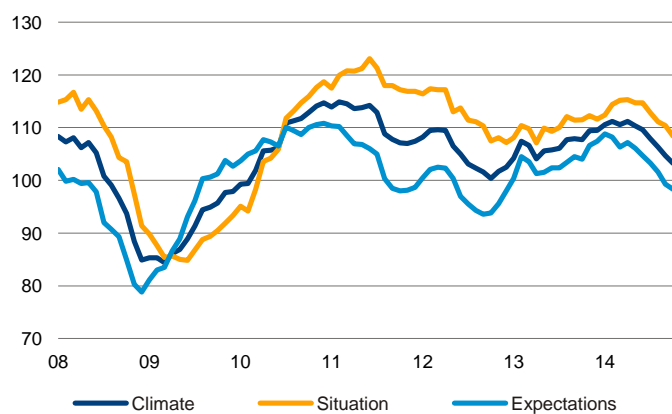
Real GDP growth



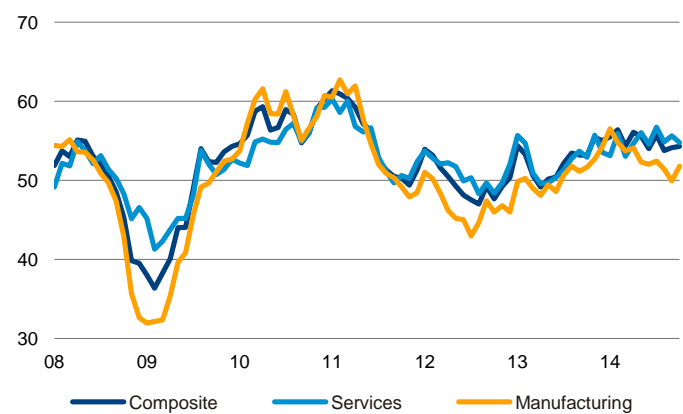
Contribution to real GDP growth (%-points)



ifo index - total economy (2005=100)



Purchasing manager index



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

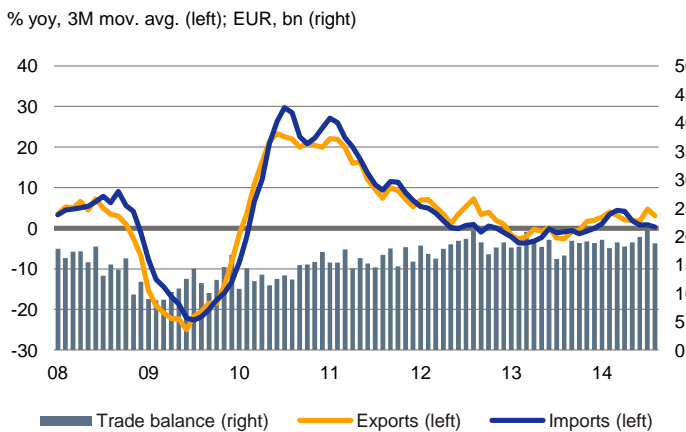


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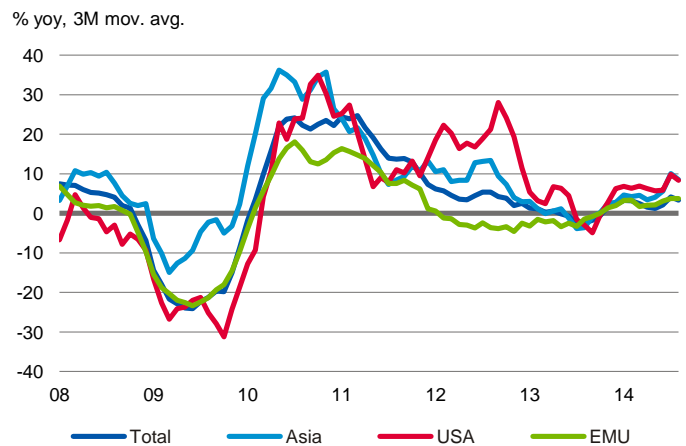
Chartbook – Foreign trade

- Foreign trade disappointed strongly recently. Exports declined by 5.8% mom in August pushing the year-on-year rate down to 3% (all 3M mov. avg.). However, the August numbers were heavily distorted by a distinct seasonality. Imports developed also weak (+0.3% yoy), which was probably partly due to weak commodity prices. The trade surplus was down to EUR 18.8 bn (3M mov. avg).
- Demand for German goods slowed across all major regions in August, but the year-on-year rates remained in part relative high in positive territory (Asia: 9%, US: 8%, EMU: 4%).
- It was foremost the counter-movement in automobile exports in August (negative one-offs: holiday effect, re-tooling of production lines for new models) that drove the fall in exports. The other German export engine, mechanical engineering, was stuttering. Foreign demand in the metal industry remained weak.
- Leading external trade indicators improved, but are still on a low level and are pointing to a continued weak export development. The unresolved Ukraine-Russia crisis and the clouded growth outlook for some major German trading partners – esp. China, France, Italy – will probably continue to be a drag. Thanks to the moderate recovery of the world economy next year – driven by solid US growth – and the weaker EUR, we expect a moderate recovery of exports with risks to the downside. Imports will probably grow relatively strong thanks to robust domestic demand. Therefore, net exports will probably dampen GDP growth (growth contribution: 2014F: -0.2 pp; 2015F: -0.3 pp).

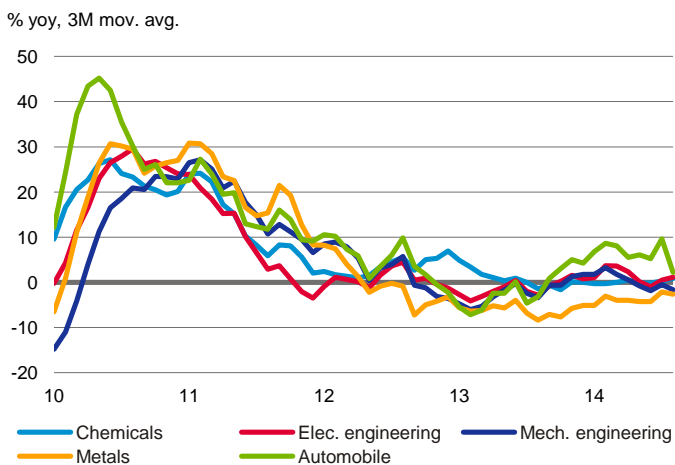
Merchandise trade



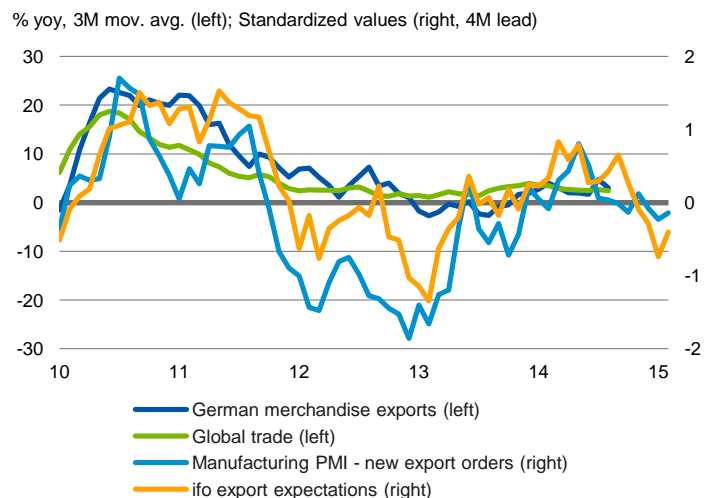
German exports by region



Exports by sector



Exports and early indicators



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

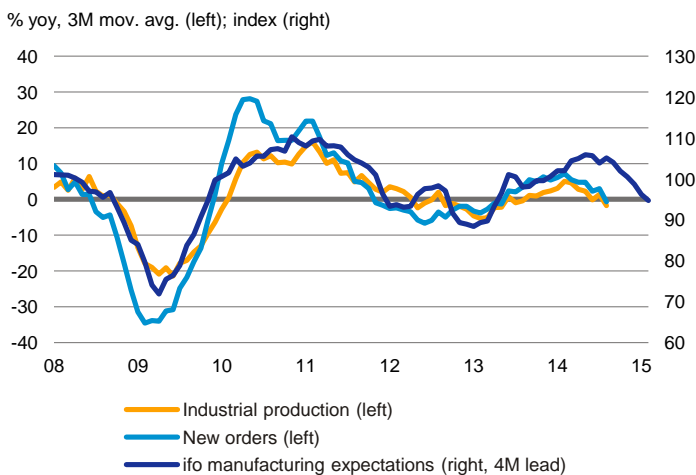


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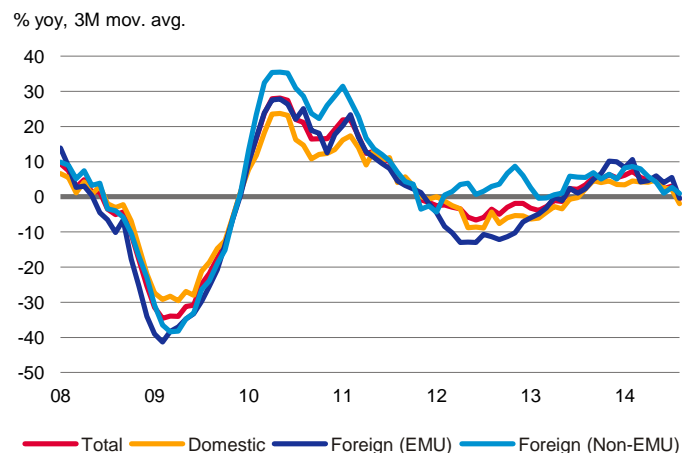
Chartbook – Industry

- As exports, industrial production growth disappointed in August (-4.0% mom; 3M mov. avg.: -1.7% yoy). However, these numbers overstate the weakness of underlying momentum for German industrial goods as the holiday effects and introduction of new models in the auto sector not only impacted auto production but induced second-round effects on the auto sector's suppliers. These negative effects should dissipate again over the next few months. This is already obvious from the auto production numbers from the VDA for September.
- The ifo index disappointed strongly in October, especially in the light of the upside surprise from October PMIs for the manufacturing sector. On current levels both suggest that industrial growth should remain weak in Q4.
- We revised our 2014 forecast for industrial production in Germany down to 1.5% in real terms. The large industrial sectors are characterised by a heterogeneous development. The automobile industry should achieve the highest growth rate in 2014. We still expect an increase of 4% in real terms thanks to a strong H1. Production in the mechanical engineering industry is likely to stagnate at best. More than others, this sector feels the consequences of the Ukraine crisis. The crisis has also dampened business sentiment in Germany which negatively affects the propensity to invest. Domestic production in the electrical engineering industry and the metal industry could grow 1.5% and 2% respectively. In the chemical sector, however, domestic production is expected to decline by 2% after disappointing results in the first half of 2014. The food industry could see production stagnating in 2014. In 2015, manufacturing output in Germany should expand by a mere ¾% in real terms. Production results in the major sectors could range from stagnation to moderate growth.

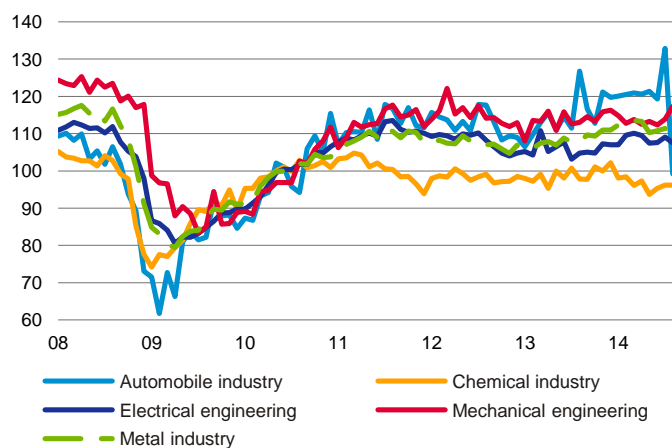
Industrial production, new orders & ifo expectations



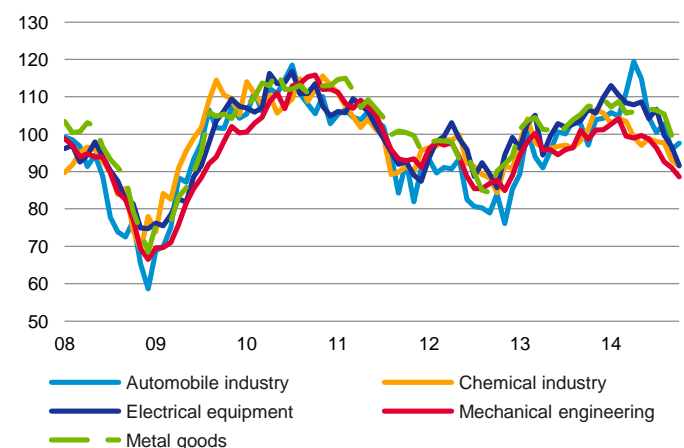
New manufacturing orders by region



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



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



Sources: Federal Statistical Office, ifo

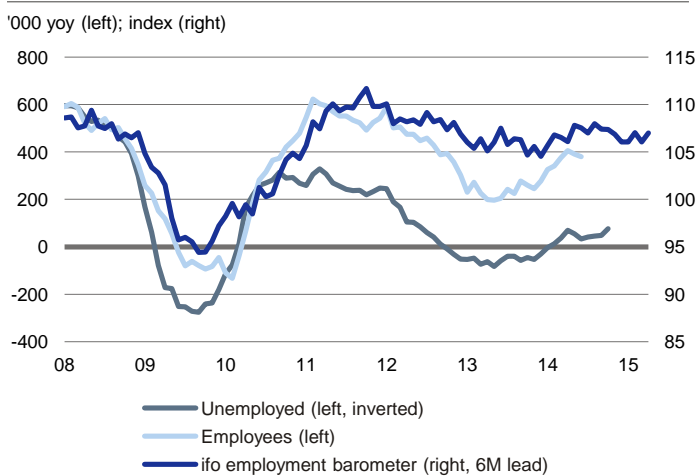


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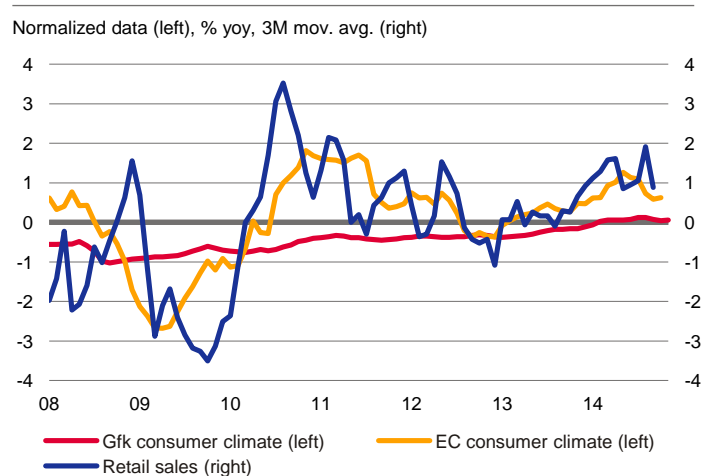
Chartbook – Domestic economy

- The German labour market maintained its overall good shape in October. Unemployment fell by 22k mom. This was, however, partly due the late timing of school holidays. Employment growth continued to be mainly driven by the integration of immigrants into the German labour market which highlights mismatch problems of the domestic labour force. The outperformance of employment relative to unemployment continues due to almost 350,000 additional persons that entered the German labour market this year mainly thanks to high net migration. Early indicators suggest a modestly positive development over the next few months. The unemployment rate should fall to 6.7% in 2014 (2013: 6.9%). In 2015 we expect the unemployment rate to increase slightly to 6.8% due to the weak economic situation and the negative impact from the minimum wage.
- Retail sales collapsed 3.2% mom in September pushing the 3M mov. avg. year-on-year rate down to 0.8%. However, this year's September data was heavily distorted due to the late timing of school holidays. The good weather was also a drag, because it probably pushed the typical purchases of autumn fashion from September into Q4. This is hinted by the drop of the sales volumes for textiles, clothing, footwear and leather goods (-7.3% yoy, Jan-Sep. +0.7% yoy). In addition, German retail sales are quite volatile. Thus, we see consumption as one of the strongholds of the economy.
- After weakness in 2013 investment in M&E and construction spending should moderately contribute to growth again this year. Domestic investment goods orders and capacity utilization currently point to a continued weakness in the remainder of 2014. Investment in M&E should still rise by roughly 3½% yoy in 2014 (2013: -2.7% yoy) and about 1 ½ % in 2015.
- The construction sector benefits from high net immigration and rising disposable income propelling housing demand. Construction spending could grow by about 3% in real terms in 2014 and 2 ½% in 2015 (2013: -0.1%).

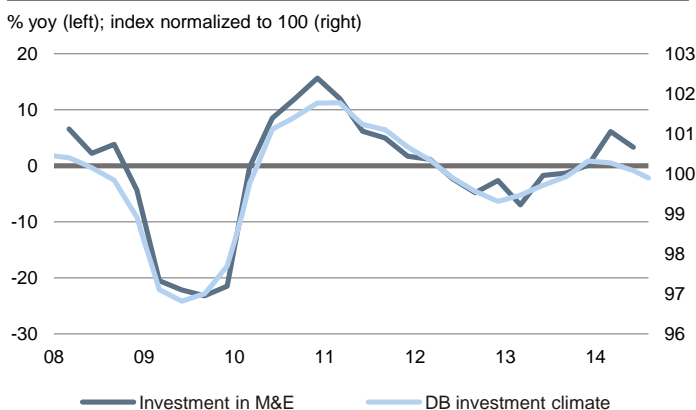
Unemployment barometer, employment and unemployment



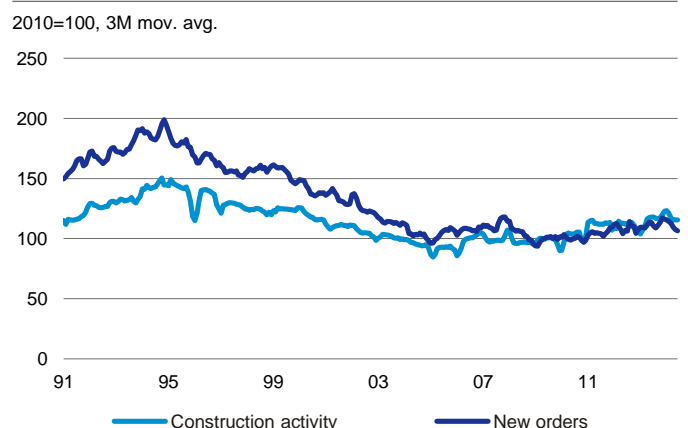
Retail sales and consumer confidence



Investment in machinery & equipment and DB investment climate



Construction activity and new orders



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

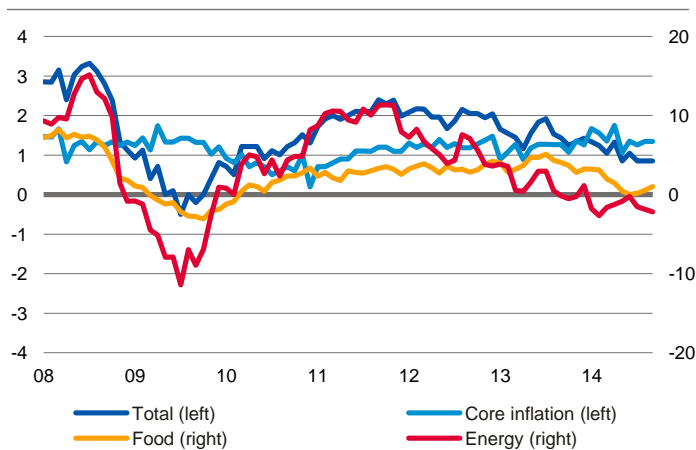


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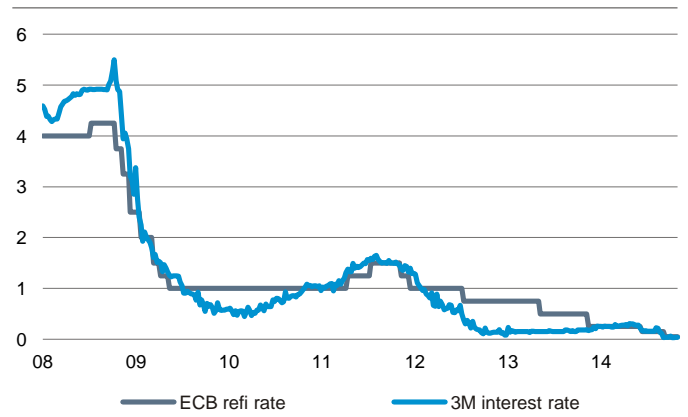
Chartbook – Financial markets

- According to the preliminary data for October inflation stood at 0.8% yoy. The fall in the oil price continued to weigh on energy prices (-2.3% yoy vs prev. -2.2% yoy). Food inflation remained modest (+0.7% yoy vs 0.9% yoy). Core inflation remained at 1.3% yoy in October after some volatility earlier in the year. While the downtrend in oil prices is set to dampen energy inflation, the food producers' price expectations suggest that food inflation could pick up further in the coming months. Also, the expected weakness of the Euro and the introduction of the minimum wage will push up prices. Our inflation forecast is 1.0% for 2014 and 1.2% for 2015.
- Fearing a negative feedback loop between declining current inflation, a disanchoring of inflation expectations and still weak banking system restricting the supply of credit, the ECB has become more expansionary in recent. It started the covered bond purchase programme (CBPP3) recently and will begin purchasing non-financial private sector assets under an ABS purchase programme (ABSPP) later in Q4. Objectives are credit easing and weakening the EUR by expanding the balance sheet to early 2012 levels. However, we expect these measures to reach about half of the targeted of EUR 1 trillion. Therefore, we expect the ECB to initiate "broad-based asset purchases", which will include government bonds, within the next six months.
- Given diverging interest rate and growth expectations for EMU and the US, the yield spread between 10Y US treasuries and German Bunds has widened further to over 150 pp as of late.

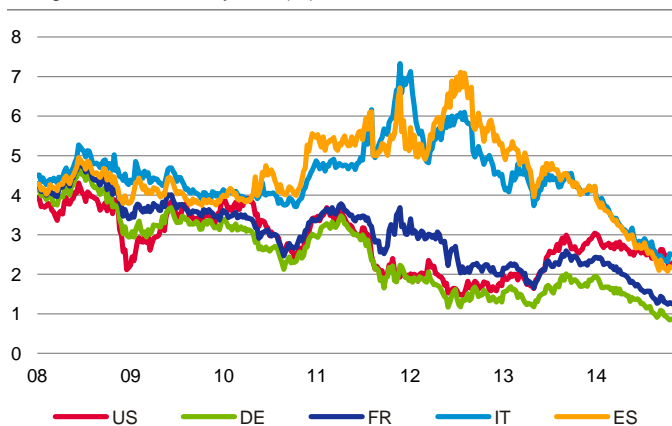
Consumer prices (% yoy)



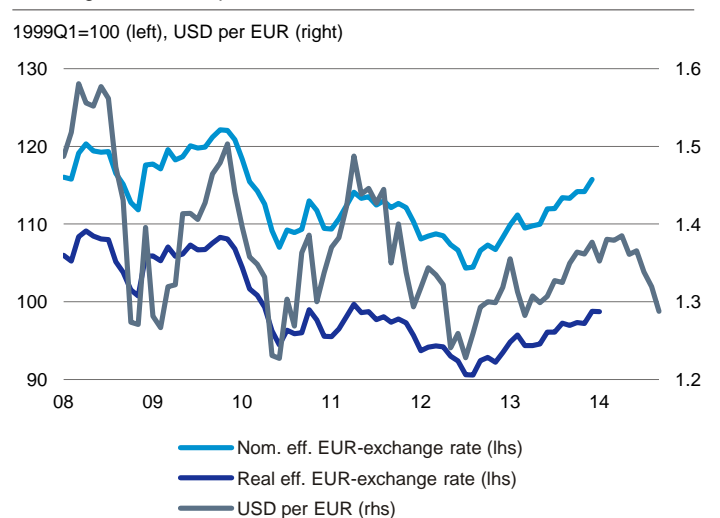
EMU: Refi rate & 3M interest rate (%)



10Y government bond yields (%)



Exchange rate development for the EUR



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

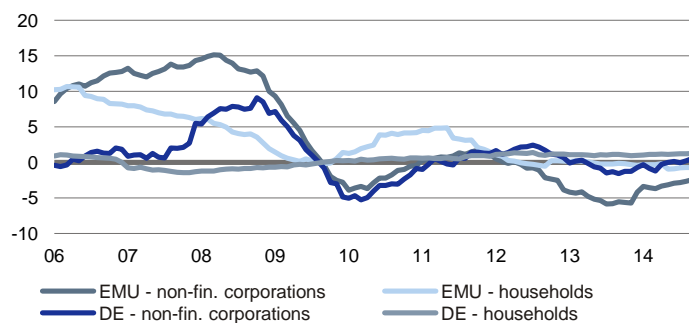


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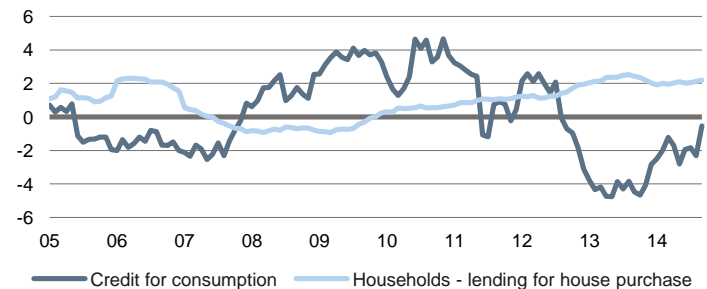
Chartbook – Lending

- During 2014, shrinking processes for credit to corporates have become somewhat less pronounced in the eurozone. With -2.5% yoy, September records the smallest reduction since the start of the year. Credit to corporates in Germany shows signs of stabilization in Q3, even mustering small yoy growth recently (September: +0.5% yoy, largest increase since the start of the year).
- Household deleveraging in the eurozone continues weighing on new borrowing (September: -0.7% yoy). By contrast, lending to households in Germany continues to rise (September: +1.2%).
- The moderate credit growth in Germany is solely driven by mortgage lending. September +2.2% yoy. Increases in mortgage credit have remained around 2% this year, in line with developments in 2013. Given the low level for mortgage rates (further drop in August to 2.4%), credit growth remains rather modest, which partly reflects portfolio shifts by households and local supply shortages. Consumer credit shrank only slightly (August: -0.5% yoy). Rising real incomes reduce the need to finance consumption via credit for many households translating into restrained credit demand despite the low interest rates.
- Interest rates for corporate credit decreased by 5 bps to about 2.8% in August. With key official rates at new historic lows (further decrease to 0.05% in September), favourable interest rates for German companies persist.
- Credit conditions for German corporates continue to be very favourable, even further improving slightly in October: only 17.7% of companies from industry and trade (September 18.4%) and some 21% of construction companies (September: 21.4%) report restrictive access to credit. On balance, alternative financing options of enterprises continued to dampen corporate loan demand though to a lower extent most recently.

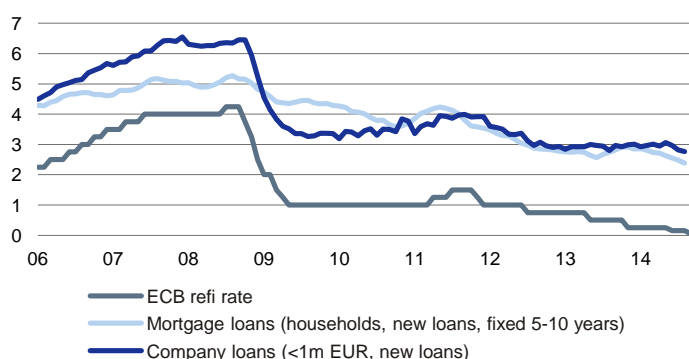
Lending to the private sector (% yoy)



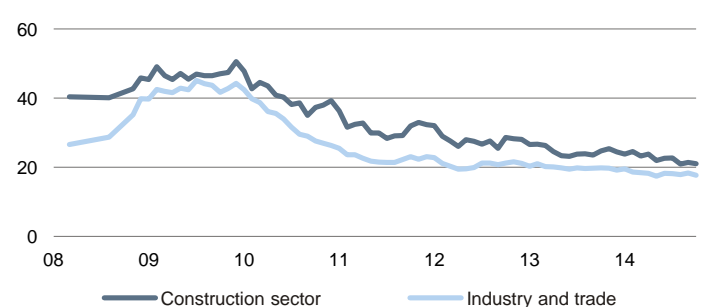
Loans to households (% yoy)



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

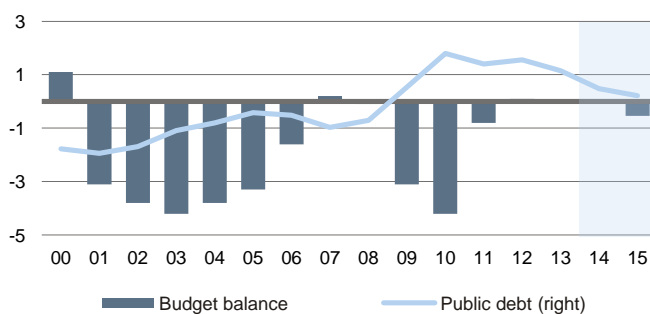


Chartbook – Public finances/Politics

- In 2013 the general budget only edged into the black thanks to the surpluses generated by the municipalities and the social-security scheme. The general budget for 2014 is projected to close to balance. But in 2015 the budget situation is set to deteriorate due to now weaker than hitherto expected economic growth and slightly higher unemployment, caused among other things by the introduction of a minimum wage. As a result the general government budget will report a deficit of round about 0.5%. The German public debt ratio stood at 75.4% of GDP at the end of Q2 2014 (Q4 2013: 76.9%). The still relatively positive development reflects the small surplus in 2013 due to continuously rising revenues. In addition, refinancing costs continue to remain low. General government debt in Germany is set to decline further during the next few years, despite weaker growth dynamics. The fact that the bad banks continue to run down their portfolios will alone cut debt by 0.5% of GDP p.a.
- In September, total tax revenues climbed by 4.8% yoy. From January until September, total tax revenues were about 3% higher than in the same period a year earlier (and thus currently only slightly below the forecast for the whole year [3.4%]). Hence the solid growth of tax revenues continues this year. Income tax is a major contributor to this development. On a cumulative basis it is over 4% higher than in the same period last year. However, the different components of income tax develop differently. The final withholding tax on interest income and the non-assessed tax on earnings (which largely corresponds to the withholding tax on dividends) are still lower on a cumulative basis than in the corresponding pre-year period. Regarding the final withholding tax the continuing low interest rate environment has a negative impact on the revenues. On the other hand even the revenues of the highly profit-dependent corporation tax now lie (on accumulated basis) above the pre-year period – thanks to unexpected prepayments for Q4 and higher back-payments for previous years. Due to the still favourable situation on the labour market and strong wage gains also the revenues of the wage tax, the most important component of the income tax, are 6% (cumulated until September) over the pre-year period. So does the VAT with a growth of 3%, main driver for this was the domestic VAT, the import VAT stagnated recently.

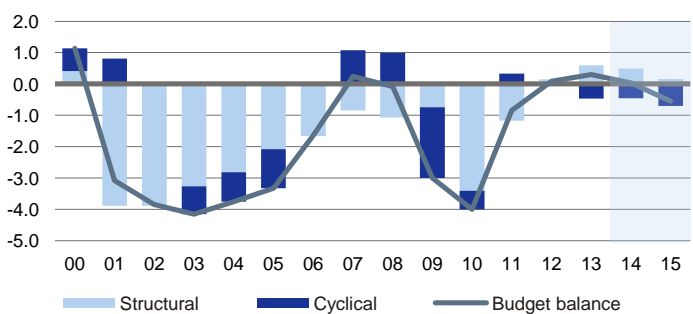
Public debt and budget balance

General government, as % of GDP



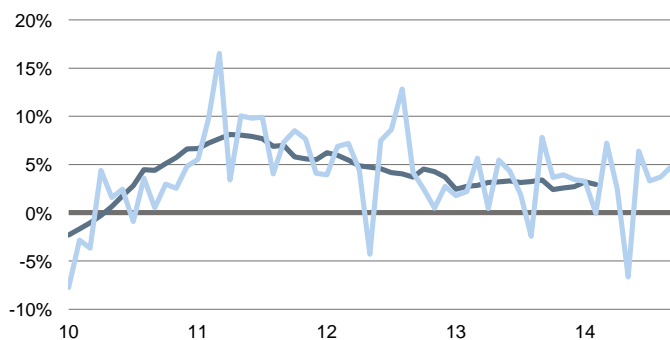
Budget balance

General government, % of GDP



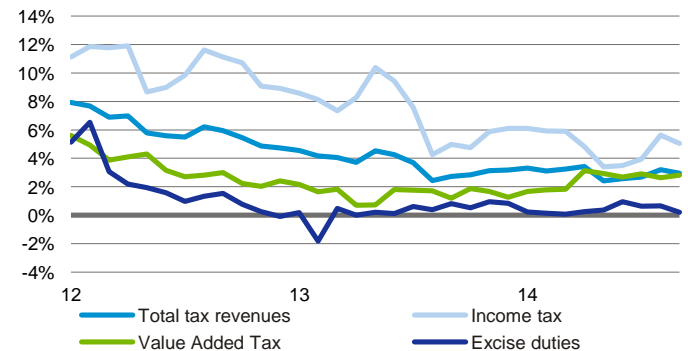
Tax revenues

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



Focus Germany

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

Date	Event	Remarks
4 Nov	ECB assumes Single Supervisor role	Following the publication of the results of comprehensive assessment exercise and 12 months after the SSM regulation came into force the ECB will assume its full supervisory tasks over the largest 128 euro area banks.
4/6 Nov	Tax estimate in Germany	Tax estimates for the current year and until 2019 are the basis for budgetary planning of the 2015 and 2016.
6 Nov	ECB Governing Council meeting, press conference	Review of the monetary policy stance.
12 Nov	Annual Growth Survey: New Forecasts by the European Commission	The European Commission will outline the economic reform priorities for the EU for 2015 in the light of its growth forecasts. Given the weak economic outlook we expect that the Commission will signal some flexibility with regard to austerity targets. The Commission will also publish its assessment on macroeconomic imbalances (alert mechanism report) in EU and EMU on the same day.
14 Nov (tbc)	Commission comments on draft budgetary plans of EMU countries for 2015	No rejection of national draft budgets. The assessment will also be taken into consideration when the Commission assesses the countries' compliance with the country-specific provisions set out under the Excessive Deficit Procedure in April.
21 Nov	Eurogroup on draft budgetary plans	The Eurogroup will review the Commission's assessment on draft budgetary plans and the fiscal stance across the euro area.

Source: Deutsche Bank Research

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Focus Germany

Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
6 Nov 2014	8:00	New orders manufacturing (Index, sa), pch mom	September	1.5	-5.7
7 Nov 2014	8:00	Industrial production (Index, sa), pch mom	September	2.5	-4.0
7 Nov 2014	8:00	Trade balance (EUR bn, sa)	September	21.7	18.8
7 Nov 2014	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	September	2.5 (1.0)	-5.8 (-0.1)
7 Nov 2014	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	September	-0.1 (-1.2)	-3.3 (-3.0)
14 Nov 2014	8:00	Real GDP (Index, sa), % qoq	Q3 2014	0.1	-0.2
20 Nov 2014	9:30	Manufacturing PMI (Flash)	November	50.8	51.4
20 Nov 2014	9:30	Services PMI (Flash)	November	55.0	54.8
24 Nov 2014	10:30	ifo business climate (Index, sa)	November	103.0 103.2	-0.3 (0.8)
27 Nov 2014	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	November	0.2 (0.8)	-0.3 (0.8)
27 Nov 2014	10:00	Unemployment rate (%), sa)	November	6.7 6.7	0.3 (-1.6)
28 Nov 2014	8:00	Import prices (Index, sa) pch mom (yoy)	October	-0.9 (-1.8)	0.3 (-1.6)
28 Nov 2014	8:00	Retail sales (Index, sa), pch mom	October	3.5 -3.2	-0.2 0.0

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	0.05	0.50	0.00	0.00	0.20	1.50	2.00	2.10	0.05
Dec 14	0.125	0.10	0.05	0.50	0.00	0.00	0.20	1.50	1.75	2.10	0.05
Mar 15	0.250	0.10	0.05	0.75	0.00	0.00	0.20	1.50	1.75	2.10	0.05
Sep 15	1.000	0.10	0.05	1.00	0.00	0.00	0.20	1.50	2.00	2.60	0.05
3M interest rates, %											
Current	0.23	0.20	0.09	0.55							
Dec 14	0.35	0.20	0.10	0.55							
Mar 15	0.35	0.20	0.10	0.80							
Sep 15	1.30	0.20	0.10	1.05							
10Y government bonds yields, %											
Current	2.31	0.60	0.85	2.25	0.56	1.17	1.09	2.06			
Dec 14	2.35	0.55	1.00	2.40	0.70	1.75	1.50	2.75			
Mar 15	2.50	0.65	1.20	2.70	0.80	1.90	1.60	2.93			
Sep 15	2.70	0.70	1.50	3.10	1.00	2.20	1.80	3.32			

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	1.25	110.57	0.78	0.63	1.20	9.21	7.44	8.49	4.19	308.00	27.77
Dec 14	1.25	112.00	0.77	1.62	1.22	8.95	7.46	8.00	4.13	315.00	27.00
Mar 15	1.22	114.00	0.76	1.61	1.23	8.90	7.46	7.95	4.08	318.60	27.00
Sep 15	1.18	118.00	0.74	1.59	1.25	8.80	7.46	7.85	4.03	323.50	27.00

Sources: Bloomberg, Deutsche Bank

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Focus Germany

German Data monitor	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	May 2014	Jun 2014	Jul 2014	Aug 2014	Sep 2014	Oct 2014
Business surveys and output											
Aggregate											
Ifo business climate	108.9	110.8	110.4	106.3		110.3	109.6	107.9	106.3	104.7	103.2
Ifo business expectations	106.0	107.8	106.0	101.4		106.1	104.7	103.3	101.6	99.3	98.3
PMI composite	54.5	55.4	55.2	54.5		55.6	54.0	55.7	53.7	54.1	54.3
Industry											
Ifo manufacturing	104.6	106.8	106.5	102.1		106.8	105.2	103.6	102.2	100.6	98.4
PMI manufacturing	52.9	55.0	52.8	51.3		52.3	52.0	52.4	51.4	49.9	51.4
Headline IP (% pop)	0.5	1.1	-1.1			-1.6	0.4	1.6	-4.0		
Orders (% pop)	2.1	0.1	-0.3			-1.3	-2.5	4.9	-5.7		
Capacity Utilisation	83.3	83.5	84.3	84.0	83.7						
Construction											
Output (% pop)	-0.5	5.1	-6.0			-2.3	3.3	-1.4	-2.3		
Orders (% pop)	2.9	1.6	-5.0			-5.1	-6.4	5.9	-2.2		
Ifo construction	121.3	122.6	120.5	119.1		120.3	120.5	119.3	119.5	118.4	118.3
Services											
PMI services	54.1	54.0	55.1	55.7		56.0	54.6	56.7	54.9	55.7	54.8
Consumer demand											
EC consumer survey	-2.8	0.3	4.3	1.0		5.5	4.3	3.9	0.3	-1.1	-0.7
Retail sales (% pop)	0.1	1.5	-0.4	-0.4		-0.3	1.1	-0.9	1.5	-3.2	
New car reg. (% yoy)	1.6	2.8	-0.3	4.1		5.2	-1.9	6.8	-0.4	5.2	
Foreign sector											
Foreign orders (% pop)	3.7	-1.3	0.2			-0.4	-3.2	7.5	-8.4		
Exports (% pop)	1.6	0.3	0.0			0.3	0.9	3.2	-5.8		
Imports (% pop)	-0.3	0.5	-0.3			-0.6	-0.1	1.4	-3.3		
Net trade (sa EUR bn)	56.7	56.3	57.0			18.9	19.9	21.9	18.8		
Labour market											
Unemployment rate (%)	6.9	6.8	6.7	6.7		6.7	6.7	6.7	6.7	6.7	6.7
Change in unemployment (k)	15.3	-44.3	-19.0	3.0		24.0	6.0	-12.0	0.0	9.0	-22.0
Employment (% yoy)	0.5	0.7	0.9	0.9		0.9	0.9	0.9	0.9	0.9	
Ifo employment barometer	107.1	107.5	106.8	106.4		106.9	106.1	106.1	107.0	106.1	107.0
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	1.3	1.0	0.9	0.8		0.6	1.0	0.8	0.8	0.8	0.7
Core HICP (% yoy)	1.1	1.1	1.1	1.2		0.7	1.1	1.2	1.2	1.2	1.2
Harmonised PPI (% yoy)	-0.7	-1.0	-0.8	-0.8		-0.8	-0.7	-0.8	-0.8	-1.0	
Commodities, ex. Energy (% yoy)	-10.4	-11.1	-4.9	-1.8		-5.4	-3.5	-3.0	-1.3	-1.1	
Oil price (USD)	109.3	108.2	109.7	102.0		109.6	111.8	106.9	101.6	97.4	
Inflation expectations											
EC household survey	25.5	22.0	16.9	13.4		18.1	14.6	15.3	14.8	10.0	11.1
EC industrial survey	6.1	5.6	2.3	4.2		1.9	2.6	3.3	4.1	5.2	4.7
Unit labour cost (% yoy)											
Unit labour cost	1.5	1.4	0.9	2.1							
Compensation	1.9	2.0	2.8	2.5							
Hourly labour costs	1.4	2.2	1.0	2.4							
Money (% yoy)											
M3	2.7	3.5	4.2	4.8		4.4	4.2	4.4	5.0	4.8	
M3 trend (3m cma)						4.1	4.3	4.5	4.7		
Credit - private	-3.1	-3.6	-3.5			-3.2	-3.5	-2.8	1.0		
Credit - public	-17.1	-1.5	9.7			-2.3	9.7	11.4	5.1		

% pop = % change this period over previous period.

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

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