Deutsche Bank
Research

Current Issues
Business cycle

Focus Germany
Onward and upward

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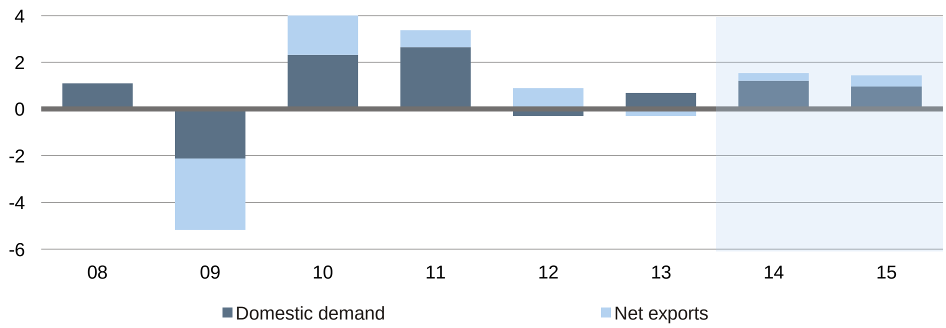
Despite the challenging international environment, the German economy performed well in 2013. Economic momentum even picked up, and Germany reached its potential rate in the second half of the year. Gross domestic product (GDP) only grew by 0.4% in real terms on an annual average, however, reflecting the extremely weak starting point. It is gratifying to note that domestic demand became a pillar of growth after 2012, when economic growth was still driven exclusively by net exports. We expect this momentum to continue during the current year and see economic growth in the order of 1.5%. Continuously strong private consumption and a rise in investment in machinery and equipment for the first time in two years are expected to lay the foundation for this solid performance. Moreover, we expect net exports to rise slightly as well in light of a global economic recovery. The labour market will remain a fundamental pillar of domestic demand also in 2014. Employment is likely to rise further and the number of unemployed looks set to fall back below the 2.9 million mark this year. With oil prices still relatively stable and tame domestic price developments, we expect the rate of inflation to come in at roughly the pre-year level of 1.5% on average in 2014. After a nearly balanced public-sector budget in 2013 a slight surplus seems to be in store for 2014, and public debt will likely fall in the direction of 76% of GDP, down from 81% at the end of 2012. In an international comparison this is an extraordinarily positive development.

Germany: Contributions to growth 1

Percentage points



Sources: Federal Statistical Office, Deutsche Bank Research

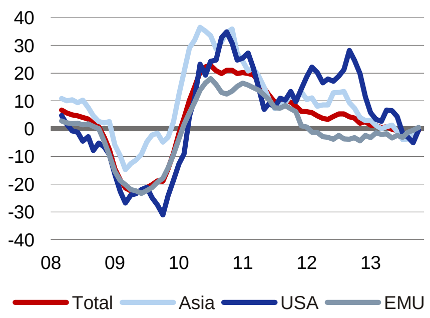
A look back: 2013 saw change in growth drivers

Germany coped well with the weakness experienced in the 2012/13 winter half and returned to a growth path in spring 2013, the adverse international environment notwithstanding. The drivers of growth changed, however. The lack of growth impetus from abroad was more than offset by domestic demand, particularly private consumption which expanded by almost 1% in real terms. This strength was based on a stable labour market. The number of persons in gainful employment rose by more than 230,000 or 0.6% in 2013, and hourly wages increased by 2.3%. Investment in machinery and equipment, which had previously shrunk in six consecutive quarters, started to pick up again slightly from Q2 2013.

By contrast, exports were rather disappointing. Against the backdrop of the recession in the euro area's southern periphery and weak growth in France, German exports to other EMU members were down in 2013, too. Moreover, demand from other major destination countries slowed noticeably, pushing down Germany's exports recently below their pre-year level. As a result, the contribution of net exports to economic growth was slightly negative last year and weighed on growth, whereas net exports had still been the backbone of growth in 2012 and domestic demand had waned.

German exports by regions 2

3M moving average, % yoy



Source: Deutsche Bundesbank

World economy: Upswing to continue

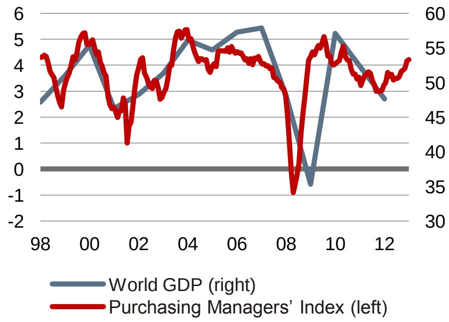
Signs are mounting, however, that the international environment is improving. Industrial output, for instance, especially in Asia's emerging markets, has picked up over the last few months, and there has been a noticeable boost to confidence as reflected in purchasing managers' surveys. We therefore expect the upswing to take hold almost everywhere and global economic growth to accelerate by roughly one percentage point to 3 ¾% this year. This would put it slightly above the average registered over the last three decades.

US: Doing better than expected

In 2013 the US economy managed to cope better than expected with the automatic cuts to public spending (sequestration) and the effects of the political turmoil surrounding a higher debt ceiling which led to a two-week shut-down of public facilities. Furthermore, the US congress recently agreed a budget for 2014 removing the previously existing uncertainty from this angle. We expect the US economy to grow by about 3 ½% this year (2013: around 2%) thanks to an improving labour market and the recent stronger increase in real incomes. This is helped by the Fed's still extremely expansionary monetary policy, as the central bank is seeking to scale down its bond purchasing programme soon but is likely to keep the key interest rate unchanged for a longer period of time.

Global growth & confidence 3

% yoy (left), index (right)



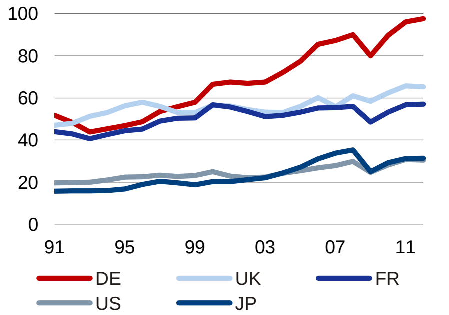
Sources: IMF, Markit

Transmission effects reinforced by globalisation

Stronger growth in the US has noticeable consequences for the German economy. As a result of Germany's increasing integration into the world economy, its dependence on economic activity in other countries has risen markedly. The openness of the German economy, measured by the share of exports and imports of goods and services in GDP, has almost doubled since

Openness 4

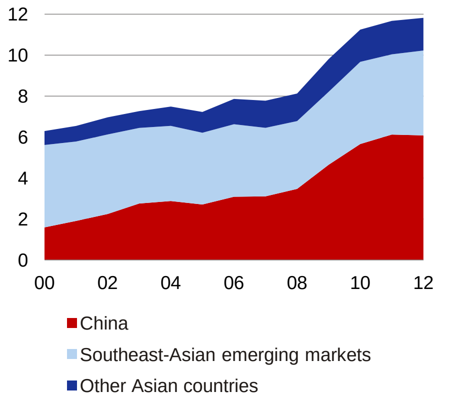
Exports and imports of goods & services, % of GDP



Sources: Federal Statistical Office, OECD, BEA

German exports to Asia 5

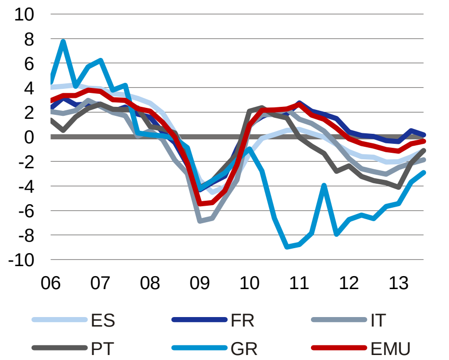
Share in total exports, %



Source: Deutsche Bundesbank

EMU: Economic growth 6

Real GDP, % yoy



Source: Eurostat

1991, to just under 100%. Among the G7 countries, Germany is by far the most integrated economy internationally.

According to several analyses, roughly half of all fluctuations in US growth rates are transmitted to Germany. This occurs via direct trade relations as well as third-market effects, via changes in confidence on the part of companies and households and via the financial markets which have become heavily interlinked. Hence, Germany's financial markets are dominated to a large extent by the US markets. In turn, developments in the financial markets influence private consumption via wealth effects and investment via the interest rate channel. The studies find that an acceleration of growth by 1 percentage point in the US will exert its full effect after approx. four quarters and push up Germany's GDP by approximately half of a percentage point.[1]

Emerging markets: Looking up, but to different degrees

Based on more buoyant growth in China, we also expect the emerging markets to experience more dynamic activity in 2014. The latest economic indicators paint an optimistic picture, especially for Asia's emerging markets. Industrial output there is rising faster again and in autumn 2013 exceeded its pre-year figure by 8%. Hence, we expect overall economic growth in the countries of Asia (excluding Japan) to come in at just under 7% this year, i.e. approx. one percentage point higher than in 2013. We put China's economic growth rate at 8.6%, following 7.7% in 2013.

China and other Asian emerging markets are becoming increasingly important for German business. Since 1990 German exports to China have grown more than twenty-seven-fold, and the country's share in total exports has risen from 0.7% at the beginning of the 1990s to a good 6% at present. This puts China in fifth place among the major destination countries, after France (with a 9.5% share), the US (just under 8%), the UK and the Netherlands (each around 6.5%). Nearly 12% of Germany's exports currently go to the Asian emerging markets. Their share is thus twice as high as in the year 2000.

Latin America will likely see considerably weaker growth momentum, given structural problems for instance regarding productivity and competitiveness, while eastern Europe will probably register an acceleration of growth similar to that in Asia, supported by the strength of the Russian economy and the region's close ties to Germany.

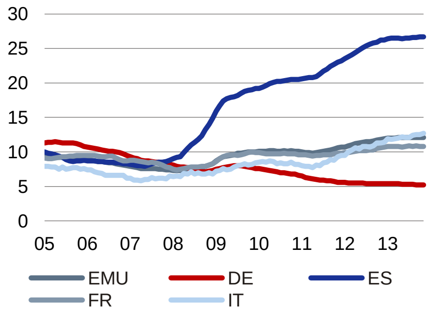
Euro area: Emerging from the recession

In the euro area, Spain and Portugal emerged from the recession in the second half of 2013, and in both Italy and Greece economic activity is shrinking much more slowly now. We expect this improvement to continue in the current year and all euro-area members to return to a modest growth path. Besides cyclical arguments, this is suggested above all by a less pronounced fiscal drag. For the euro area as a whole, the European Commission only expects a reduction in the structural budget balance and thus a dampening effect on growth of 0.3% of GDP, after as much as 1% of GDP in 2013. All in all, the euro-area economy will likely expand by around 1% in 2014, after shrinking by 0.4% in the preceding year. For France, we forecast growth in the order of just below 1%, and for Italy

[1] See also: Gräf, B., H. Peters, O. Rakau (2013). Germany, the US and China: Tango for three? Deutsche Bank Research. Focus Germany. November 29, 2013.

EMU: Unemployment 7

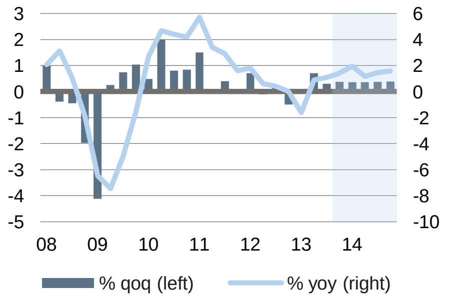
Harmonised unemployment rates, %



Source: Eurostat

Germany: Economic growth 8

Real GDP, % qoq (left), % yoy (right)



Sources: Federal Statistical Office, Deutsche Bank Research

Economic growth 9

Real GDP, % yoy	2012	2013F	2014F	2015F
USA	2.8	2.0	3.5	3.8
Japan	1.4	1.5	0.7	1.3
Euroland	-0.6	-0.4	1.0	1.4
Germany	0.7	0.4	1.5	1.4
France	0.0	0.2	0.9	1.6
Italy	-2.6	-1.8	0.6	0.7
Spain	-1.6	-1.3	0.6	1.2
Netherlands	-1.3	-1.1	0.7	1.3
Greece	-6.4	-4.3	0.8	2.0
Portugal	-3.2	-1.6	0.8	0.9
Ireland	0.1	0.2	1.8	2.2
UK	0.3	1.5	2.7	2.0
Asia (ex. Japan)	6.0	5.9	6.9	6.8
China	7.8	7.7	8.6	8.2
India	4.1	4.3	5.5	6.0
Eastern Europe	2.7	2.3	2.8	3.4
Latin America	2.8	2.3	2.7	3.1
World	3.0	2.8	3.8	4.0

Sources: IMF, Deutsche Bank Research

and Spain of only 0.6%. Spain will likely feel the dampening effects on growth of structural adjustments, especially in the construction sector, and of the resulting high unemployment in excess of 25% for several years to come. The Greek economy, too, may expand again this year. Supported by a still dynamic tourism sector and some positive impetus from exports and investment, real GDP could probably grow slightly by 0.8%, after shrinking by 4.3% in 2013. Consumption continues to dampen growth in Greece, as it looks set to shrink again in 2014 with incomes on the decline.

Germany: Fastest-growing nation in the eurozone again

In the second half of 2013, German growth was roughly in line with its potential (+0.3% qoq, or an annual rate of 1 ¼ %). We assume Germany will be able to at least keep up this momentum or even achieve a slight improvement. With quarterly growth rates at roughly 0.4%, this would mean an annual average of 1.5%. Germany would thus once again be the growth leader among the larger euro-area members. Also, it would enjoy a more broadly based upswing as not only domestic demand but also foreign demand would make a contribution to growth.

Economic policy assumptions: Fiscal policy to be neutral, monetary policy still loose

Our growth forecast is based on the assumption that fiscal policy this year will not have any dampening effects on growth. Hence, the structural budget surplus of the public sector as a whole, i.e. the budget balance excluding cyclical effects, looks set to hover around its pre-year level of just below ½% of GDP. Last year, the fiscal reins were tightened somewhat, so the structural budget surplus rose by a good ¼ of a percentage point, with corresponding dampening effects on growth.

ECB commits itself for the first time ...

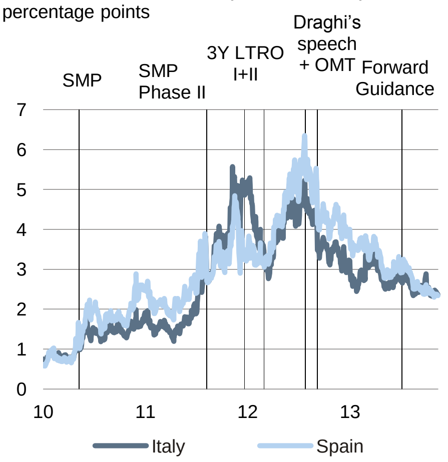
Even though economic activity in the euro area stabilised in the course of 2013, bank lending remained extremely weak and the situation in the financial markets tense. This led the European Central Bank (ECB) to stick to its accommodative monetary policy. On November 7 it even lowered its key interest rate to a historic low of 0.25%. Already in July 2013, the central bank had ventured into new territory by announcing its intention to keep its key rates at its current level or even lower for a prolonged period of time. This commitment also referred to as "forward guidance", put an end to the central bank's 14-year-long mantra to never commit itself. It was intended to support market expectations of very low interest rates for a prolonged period despite slightly better economic data and concern that US monetary policy could become less stimulating.

... and keeps markets calm

Over the past two years, the ECB has played an increasingly important role in stabilising the economies and financial markets of Europe. It gradually developed an increasingly large box of monetary tools, which also included

Yield spread versus Germany 10

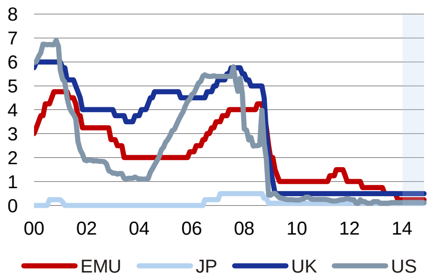
Government bonds with 10 years to maturity, percentage points



Sources: Bloomberg, Deutsche Bank Research

Key interest rates 11

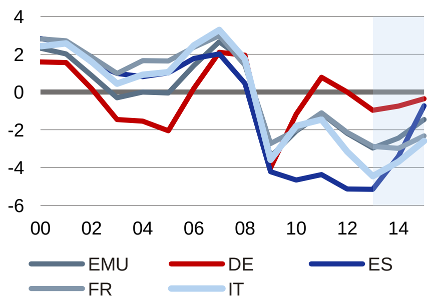
%



Sources: National central banks, Deutsche Bank Research

EMU: Capacity utilisation at macroeconomic level 12

Overall under- (-) and overutilisation (+), % of potential GDP



Source: EU Commission

unconventional measures. It was in particular the pledge by ECB President Mario Draghi that the European Central Bank would do whatever it takes to preserve the euro, and the subsequent announcement of its bond purchase programme (OMT – Outright Monetary Transactions) which has not yet been put to use, that has led to an appreciable decline in risk and has brought calm to financial markets since mid-2012. Risk premiums on Italian and Spanish bonds compared with German paper have since been reduced by about half; in July 2012 holding Spanish government bonds still required a risk premium in excess of 5%. This period of calm in the markets was to allow the crisis countries to implement structural adjustment measures, boost their economies' competitiveness and achieve long-term debt sustainability.

But the ECB's measures did not meet with unreserved support. Especially in Germany it was seen as problematic that the relative calm in the financial markets and the fact that an economic recovery also began to take hold reduces the reform pressure on the countries of the periphery. Also, concern has been voiced that the long phase of low interest rates is placing undue strain on German savers and facilitates the emergence of price bubbles in the German real estate market. However, there is a lot to suggest that the current economic situation in EMU does in fact justify extremely low interest rates. In 2012, the capacities of the euro-area economy were underutilised by about 2% of GDP. Given the renewed GDP decline in 2013, this underutilisation probably rose to approx. 3%. At 4-5%, Spain and Italy registered markedly higher underutilisation than the EMU average. Capacity utilisation in France was more or less in line with the EMU average, and even the German economy still showed slight underutilisation in 2013.

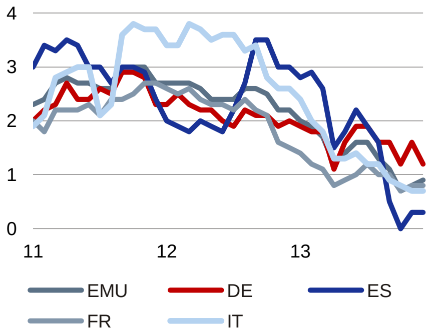
Deflation in the euro area? Not really!

As the reason for its November 2013 rate cut the ECB cited first and foremost the change in the inflation outlook. EMU inflation had fallen substantially in October 2013, to 0.7%. This was its lowest level since 2009. In some countries such as Greece, Ireland and Cyprus, consumer prices were even below their pre-year levels. To be sure, this marked the lowest point, as inflation picked up slightly afterwards. Nonetheless, Mario Draghi explained that there was risk of a prolonged period of low inflation in the euro area which called for an even more accommodative policy to get inflation to the ECB target of just under 2% over the medium term.

Some experts have even referred to the weak price developments as deflation. However, Mario Draghi correctly pointed out that talk of deflation was not yet justified as prices were neither declining in a sufficient number of countries nor across many groups of goods. Low rates of price increase are even welcomed in the peripheral countries, in particular, as they are a sign that competitiveness is being regained, which is a necessary development. Inflation expectations, which are important for medium-term price developments, also remain tightly anchored at 2%. In addition, the currently low inflation rates reflect the high degree of underutilisation in the economy as well as stable or even falling commodity prices. It is expected that the slowly progressing economic recovery will also lead to a stronger increase in prices. Therefore, deflation warnings seem exaggerated at this juncture.

EMU: Inflation 13

Harmonised consumer price index, % yoy



Source: Eurostat

Interest rates to remain low for the foreseeable future

Even if deflation is no cause for concern, the ECB will likely keep its main refinancing rate at its current level or even lower until well into 2015 in order to support bank lending and investment and foster economic recovery. We also believe the ECB could take additional measures e.g. to boost banking sector liquidity, for instance by longer-term refinancing operations. Nonetheless, we expect euro-area growth to remain weak not least due to still necessary debt reduction in the private and public sectors, and economic capacities to remain underutilised in the euro area also in 2015. Correspondingly, euro-area inflation will likely hover between 1% and 1.5% this year and next.

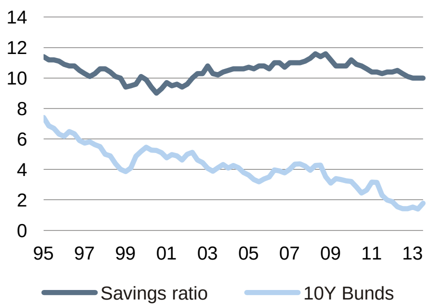
This should also limit any increase in long-term government bond yields of EMU member states triggered by rising US yields, especially as the ECB is prepared to use unorthodox measures such as bond purchases to restrict a yield increase in the periphery, which is unjustified in its view. We therefore expect a certain normalisation of bond yields to only slightly over 2 ¼% for German Bunds on a 12-month horizon.

Our forecast for Germany in detail

Private consumption to remain most important pillar of growth

Germany: Savings ratio & 10Y government bond yields 14

%

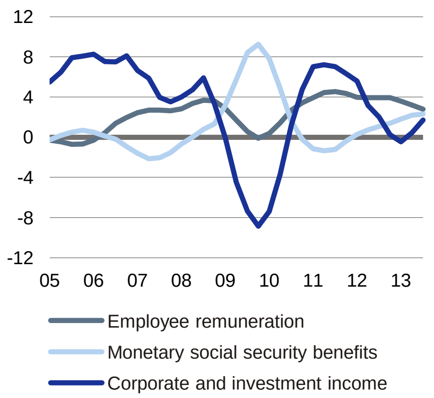


Sources: Federal Statistical Office, Global Insight

Private consumption will continue its robust development of the last few years. Following an increase of almost 1% in real terms in 2013, consumption could grow by roughly the same degree this year as well. Current developments are broadly based thanks to positive wage growth and an ongoing uptrend in employment and could even pick up speed in the further course of the year thanks to a stronger rise in corporate and investment income and forthcoming pension increases. Nominal disposable income will likely rise by approx. 2 ¾% in 2014, following just over 2% last year. There is some scope for a slightly higher savings ratio, which fell last year due to low interest rates to its weakest level since 2002 (10%).[2] Also, households became increasingly risk-averse regarding their investments in the course of the financial and sovereign debt crises, achieving low returns on financial assets. This undermines the establishment of personal provision for old age needed to cushion the demographic effects.[3]

Germany: Income growth 15

% yoy, 3Q mov. avg.



Source: Federal Statistical Office

Labour market: Further improvement put at risk

The robustness of consumption is due not least to an extremely stable labour market. Even though the rate of unemployment edged up from 6.8% to 6.9% in 2013 on weak business activity at the start of the year, this was still the second lowest reading since German unification. Also, unemployment will probably fall

[2] See also: Gräf, B., O. Rakau (2013). Low interest rates curbing households' propensity to save. Deutsche Bank Research. Focus Germany. October 1, 2013, and: Gräf, B., S. Schneider (2012). Prolonged period of low interest rates: risks and side effects for Germany. Deutsche Bank Research. Focus Germany. August 22, 2012.

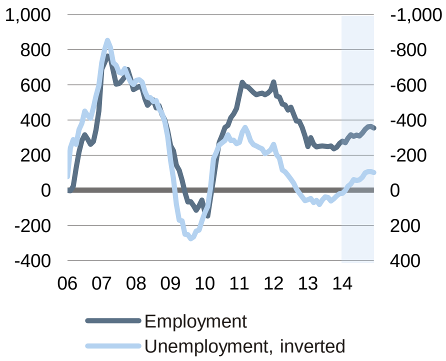
[3] See also: Gräf, B., O. Rakau (2013). Investment behaviour of German households: Markedly higher risk aversion in the course of financial crisis. Deutsche Bank Research. Focus Germany. September 2, 2013.

back to 6.7% in 2014 thanks to stronger economic growth. This expectation is based on recently improved assessments of the situation by businesses.

The uptrend in employment looks set to continue. We think the number of persons in employment will rise by more than 300,000 or approx. 0.75% this year; in 2013 roughly 230,000 people found new employment. The level of employment would thus reach a new record high, thanks primarily to high net immigration. After 206,000 persons in the first half of 2013 and an expected figure of over 400,000 in the full year (around 0.5% of the total population), immigration will probably hover around that level also in 2014. Immigrants are finding their way to Germany mostly from eastern European EU countries, facilitated not least by full labour mobility taking effect from 2014.

Germany: Labour market 16

yoy change, '000



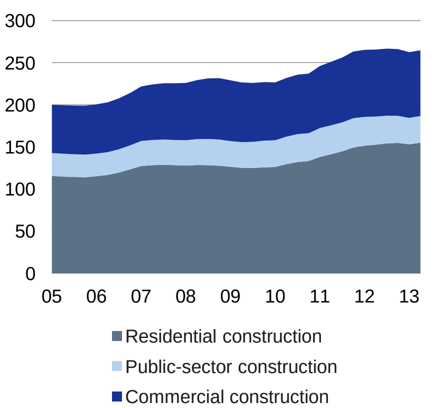
Sources: Federal Statistical Office, Federal Employment Agency, Deutsche Bank Research

In a European comparison, the situation in the German labour market is unique. There are substantial risks, however. In contrast to the last few years, economic imponderables play a minor role compared with the political risks resulting from the envisaged changes to labour market regulation. For instance, the ruling grand coalition intends to place restrictions on successful labour market instruments introduced in the framework of Agenda 2010. These include restrictions on temporary employment and staffing services (Leiharbeit) as well as contracts for work and labour (Werkverträge). Staffing services accounted for roughly one-fifth of the employment increase between 2005 and 2011, but began to decline recently. The flexibility gained from these instruments, particularly in phases of weak economic activity, will probably partly be lost again, which would dampen employment dynamics. More important, however, is the planned uniform minimum wage of EUR 8.50 per hour which, on a medium-term horizon, could come at a cost of between 450,000 and up to one million jobs.[4] If employment reacts as we expect it to, the hoped-for increase in purchasing power would probably not materialise at all. Our concern centres first and foremost on the level of the minimum wage. Relative to the median wage, it is roughly in line with the minimum wage in France, where significant employment losses occurred. The so-called "problem groups", which were among the main beneficiaries of the Agenda 2010 reforms, would be affected particularly adversely by the minimum wage.[5]

A similarly sceptical view has been voiced by the German Council of Economic Experts. In its Annual Report 2013/14 it warns against a "backward-looking economic policy" and especially against the Agenda 2010 reforms being watered down. This is important particularly in view of demographic trends in Germany. Already from 2020, when the baby-boomer generation retires and will not be replaced fully by the smaller birth cohorts that follow, the labour force potential will begin to shrink appreciably.[6] The lack of skilled labour and the problem of finding successors will become increasingly important.[7]

Germany: Construction investment 17

EUR bn, mov. Q4 total



Source: Federal Statistical Office

Residential construction expanding strongly

Construction investment became a pillar of domestic demand in the second half of 2013. After the construction industry had a bad start into the year due to the long and cold winter, registering a pronounced decline in the first quarter, construction investment picked up from approximately the middle of the year.

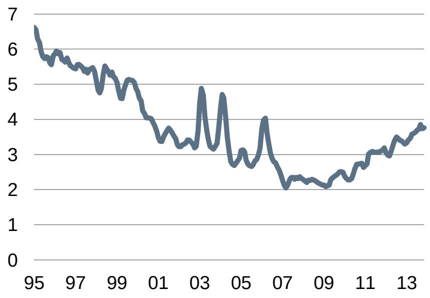
4 For more on this topic see Schneider, S. (2013). Minimum wage at EUR 8.50: The wrong policy choice. Deutsche Bank Research. Standpunkt Deutschland.
5 See also: Gräf, B., H. Peters (2013). Labour market: Still picking up. Deutsche Bank Research. Focus Germany. October 31, 2013.
6 See also Gräf, B. (2011). The German labour market: Demographic shift poses formidable challenges. Deutsche Bank Research. Current Issues. August 23, 2011.
7 See also Bräuninger, D. (2013). Medium-sized enterprises and demographics: Increasing pressure to take action. Deutsche Bank Research. Current Issues. May 5, 2013.

Residential construction, which stands for almost 60% of total construction investment, developed favourably, as did public-sector construction (with a share of over 10%). Investment rose by around 1% in both sectors. By contrast, commercial construction investment (with a share of 30%) declined by roughly 2%, reflecting among other things poor capacity utilisation in industry and the fact that investment was held back because of the euro crisis. Annual figures in public-sector construction were depressed by a massive weather-induced slump in the first quarter of 2013, which was more than offset by the impetus stemming from reconstruction measures following the spring floods.

The economic environment continues to be conducive to investment in residential construction. Besides low financing costs, extremely low investment yields which will probably continue to drive portfolio restructuring into real assets, the robust labour market, favourable income prospects and high net immigration all suggest strong demand for residential properties for some time to come. The increase in building permits in the residential sector also points to an increase in residential construction investment this year of roughly 4% compared with 2013. Commercial construction will likely receive a boost from accelerating economic growth and rise by roughly 2%. In the further course of the year, public-sector investment also looks set to grow more dynamically. This development is supported by, among other things, an improved fiscal situation for municipalities, which are responsible for about half of all public construction. All in all, public-sector construction investment will likely rise by well over 5% on an annual average in 2014.

Germany: Residential building permits 18

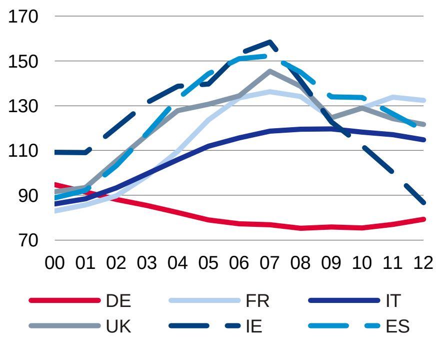
EUR bn, sa, mov. 3M average



Source: Deutsche Bundesbank

Property prices 19

House prices in relation to disposable incomes, long-term average = 100



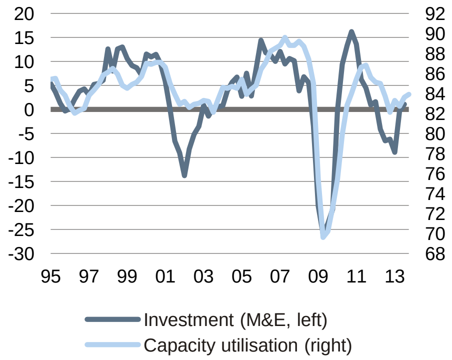
Source: OECD

Still no bubble in the property market!

At approx. 5% in 2013, residential property prices continued on the upward trend in place since 2010, albeit at a slighter slower pace. Especially in the attractive conurbations, property continued to attract strong interest. There, prices were up considerably more strongly than average (by just under 10%). In its monthly report of October 2013, the Bundesbank even warned of an overvaluation relative to fundamentally justified levels of up to 20% for property in attractive urban locations, and pointed to the risk that higher price dynamics could spread to the surrounding towns and cities. However, we believe this warning to be premature and regard the recent increase in real house prices as a sign of a return to normal, following their 15-year decline. Moreover, house prices in Germany have so far remained clearly behind international price cycles[8] and thanks to substantially rising disposable incomes real estate has remained very affordable by both historical and international standards.

Investment & capacity utilisation 20

% yoy (left), % (right)



Sources: Federal Statistical Office, ifo

Ongoing recovery of investment in machinery and equipment

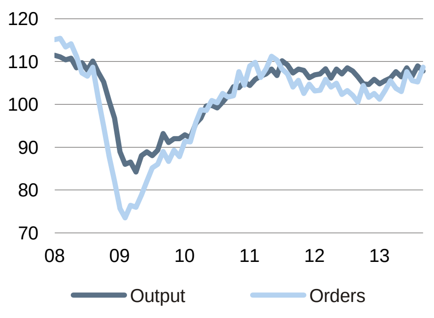
After six consecutive quarterly declines for a total of almost 8%, investment in machinery and equipment has risen modestly since spring 2013. However, the increase has failed to fully compensate for the weak starting point, so investment in machinery and equipment fell by slightly more than 2% on average in 2013. Given still low financing costs, the calming of sentiment in connection with the euro crisis and the expected global economic recovery, we assume investment activity will continue to recover this year and investment in machinery and equipment will rise by approximately 4 ¼%. This expectation is

[8] See also Möbert, J. and H. Peters (2013). German house prices in perspective. Deutsche Bank Research. Focus Germany. October 31, 2013.

supported by the latest increase in capacity utilisation, which at the end of 2013 was back at the average level registered since 1985.

Upward trend 21

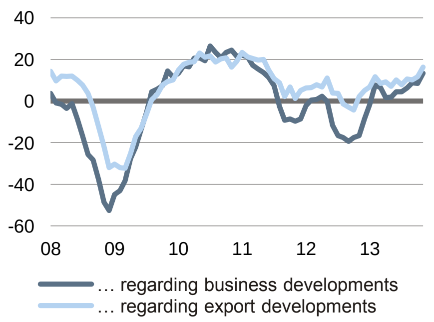
Manufacturing output and orders, sa, DE, 2010=100



Source: Federal Statistical Office

Optimistic outlook 22

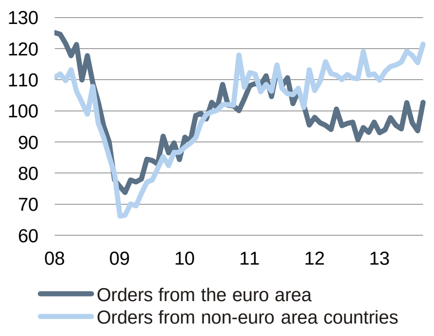
Expectations of industrial companies, balance of positive and negative reports, DE



Source: ifo

Diverging developments 23

Foreign orders in manufacturing, DE, 2010 = 100



Source: Federal Statistical Office

German industry to pick up considerable speed in 2014

Manufacturing output probably stagnated in 2013 (in price-adjusted terms) after shrinking by 1% in 2012. True, output trended upward in the course of last year. But owing to relatively low capacity utilisation at the start of 2013 this did not suffice to achieve an increase on an annual average. Foreign demand provided a stronger boost last year. Foreign orders are likely to have risen by 2% in real terms in 2013. It was above all the countries outside the European Monetary Union that acted as drivers of demand as they absorbed an additional 4% or so of German industrial products. By contrast, demand from EMU member states remained relatively weak in 2013. Domestic orders probably decreased slightly last year.

For 2014 we expect German manufacturing to perform considerably better.[9] Production is estimated to rise by 4% in real terms. We base our optimistic assessment on several factors. For one thing, the EU economy looks set to return to a growth path after a number of sluggish years. As Germany's economy still sells 57% of its exports to the EU and produces internationally competitive goods, domestic companies should benefit from this upturn. Also, business activity is picking up in the US and China as well. And finally, domestic demand also looks set to gain momentum in Germany, which is reflected among other things in rising investment activity. Our expectations are confirmed by business expectations in the industrial sector, which have been in positive territory since February 2013 and rose around the end of 2013.

Among the larger sectors, automobiles may be able to achieve the highest growth rates in 2014. We believe the automotive sector, which also includes suppliers, will be able to expand its output by 5% (2013: 1%). A major driver is demand for cars in western Europe, which is expected to rise this year for the first time since 2009. Besides the general economic upswing this is due above all to pent-up demand. In 2013, new car registrations came in below the 15-year average for the sixth consecutive time. In 2014, demand will probably continue to rise in many car markets outside Europe, too, even though the pace of growth looks set to slow in the US and China, for instance. On balance, 2014 will see domestic German car production benefit from rising foreign demand, given its high export ratio of 64% and the international popularity of German makes. Finally, new car registrations in Germany are also expected to pick up by about an estimated 3%. We expect the increase in demand from commercial customers to be slightly stronger than from private customers.

Also, the German mechanical and electrical engineering sectors will likely feel the stimulus of rising foreign demand. While the countries outside the EU have become increasingly important as sales markets over the last few years, the two sectors will likely receive considerably more orders from the EU member states in 2014. Both sectors also stand to benefit from a higher domestic propensity to invest. Mechanical and electrical engineering will probably rise by 4% and 3.5%, respectively, in real terms in 2014, after registering declining output in 2013. On a medium to long-term horizon, both industries will benefit from the fact that their products will be increasingly sought after thanks to global trends such as energy and resource efficiency, urbanisation and industrialisation as well as digitisation.

[9] See also Auer, J. et al (2013). German industry: Tangible production growth in 2014. Deutsche Bank Research. Current Issues. November 15, 2013.

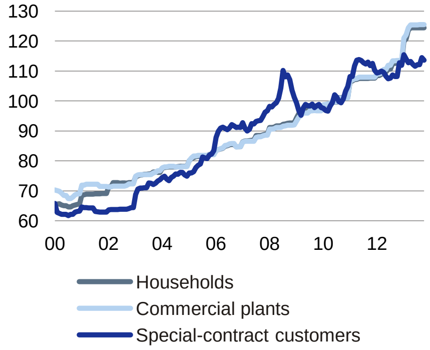
One of the major challenges facing the companies is finding a sufficient number of qualified staff.

The metal industry, an important supplier to car manufacturers as well as mechanical and electrical engineering companies will receive a boost from the buoyant activity in these customer groups. We assume the metal industry can expand production by 4% this year; this would be a considerable improvement over 2013, when it virtually stagnated. The chemicals industry – usually an early-cycle sector – only experienced a recovery as late as in 2013. For 2014 we look for a moderate upward trend, with demand from western Europe picking up here, too. All in all, production will likely increase by 3%.

The food industry looks set to achieve stable production figures again in 2014 compared to other sectors. We expect production growth of 1%. The sector is characterised by the fact that it benefits disproportionately little from a general economic upturn, but usually emerges unscathed from recession phases. Unsatisfactory corporate earnings continue to pose problems for the sector which consists mostly of small and medium-sized enterprises. The scope for price increases is limited in light of fierce competition and the market clout of the food retailers.

Electricity prices up strongly 24

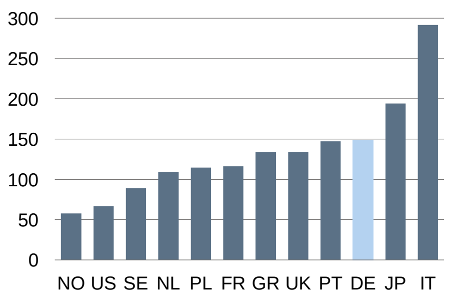
Producer price index electricity (for different customer groups), 2010=100



Source: Federal Statistical Office

High electricity prices in Germany 25

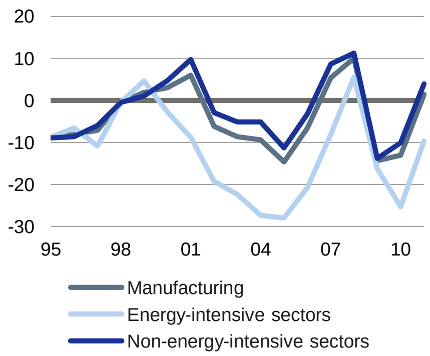
USD per MWh, 2012



Source: IEA

Sluggish investment 26

Share of net fixed capital formation in gross fixed capital formation, %



Source: Federal Statistical Office

Energy policy: Focus must be shifted to economic sustainability

Due primarily to the increasing use of renewable energies, which is supported by means of the EEG levy, Germany's "Energiewende" entails rising electricity prices. Since 2007 alone, electricity prices have risen by 20-40%. This is causing growing difficulties for energy-intensive sectors even though many companies with high energy consumption still enjoy special (discounted) rates. Industrial electricity prices in Germany are among the highest in Europe and exceed the US level by 150%. There, gas prices too are considerably lower than in Germany and Europe as a result of unconventional gas deposits[10].

Germany is increasingly losing out when it comes to investment decisions to be made by energy-intensive companies, in particular. After all, when (energy-intensive) companies invest in new plant and want to reap the benefits for 20 to 30 years, not only their expectations regarding energy prices but also the security of supply and the reliability of the energy policy framework are decisive factors. In this respect, Germany is not doing too well at present. Moreover, heavy burdens on energy-intensive businesses also have negative repercussions for downstream industries which themselves are not energy-intensive producers (e.g. auto industry, mechanical and electrical engineering). To be sure, there is considerable potential to save energy in all sectors, which could be tapped into at a reasonable cost and in part supported by the KfW (Kreditanstalt für Wiederaufbau, Reconstruction Loan Corporation). Furthermore, energy-efficient production processes and products are becoming increasingly important advantages in international competition. Hence, price signals are of importance but a further one-sided increase in energy costs in Germany would weaken the country as a production location.

The new German government recognized the problem of rising energy prices and intends to place greater emphasis among others on economic efficiency in the subsidisation of renewable sources of energy. Exceptions are to be re-examined, with energy-intensive companies competing internationally likely to continue to enjoy special conditions (and rightly so). However, the measures

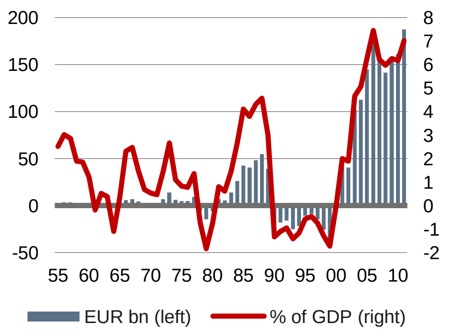
10 See Auer, Josef et al. (2013). Energiewende 2.0 – don't risk competitiveness. Standpunkt Deutschland. Deutsche Bank Research.

Commodity price forecasts 27

		2012	2013	2014F
Brent blend	USD/b	112	109	98
Aluminium	USD/t	2049	1874	1813
Copper	USD/t	7958	7331	7075
Nickel	USD/t	17519	15362	15000
Zinc	USD/t	1948	1957	2050

Sources: IMF, Deutsche Bank

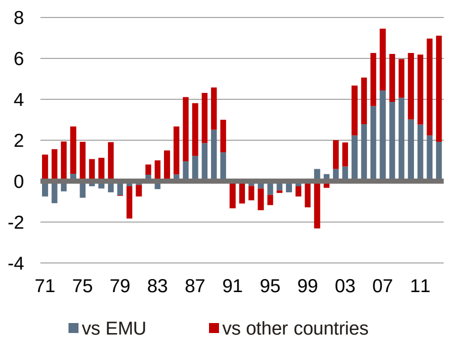
Germany: Current account balance 28



Sources: Deutsche Bundesbank, Federal Statistical Office

Germany: Balance on current account 29

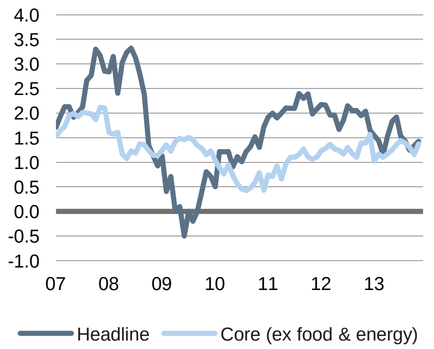
% GDP



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

Germany: Inflation 30

% yoy



Sources: Federal Statistical Office, Deutsche Bank Research

expected to be taken by the new government will only contribute to keeping future price increases under control. Hence the debate about costs surrounding the Energiewende will continue.

Net exports to contribute to growth again in 2014

In the course of the global economic recovery German exports are also likely to rise more strongly. According to IMF estimates, world trade will expand by roughly 5% this year, after just under 3% in 2013. At approx. 5.6%, German exports of goods and services will probably grow somewhat more strongly than world trade, this being attributable to the weak pre-year development, however, when price-adjusted exports only rose by less than 1%. In real terms, imports are expected to rise by as much as 6% this year. For one thing, domestic demand remains dynamic; for another, exports also provide stronger impetus for German import demand, which had risen somewhat more strongly in 2013 (1.5%) in light of the increase in the foreign share in value added to approx. 30%. Hence, net exports will contribute 0.25 of a percentage point to economic growth this year, after having shaved 0.3 pp off growth in 2013.

The current account, i.e. the difference between exports and imports of goods and services, looks set to post a surplus again this year, which will come in around the pre-year level (EUR 185 bn or 7% of GDP). Germany was recently criticised by the IMF, the US treasury and the European Commission for its high current account surplus as it was set to pose a risk to the world economy and an obstacle to reducing current account deficits in the euro area. We think this criticism is unfounded, however, as the German surplus has accumulated mostly vis-à-vis countries outside EMU and as the bilateral current account surplus with the monetary union has halved to 2% of GDP in the past few years. Moreover, Germany's export success is not the result of misguided policies, but rather of millions of individual decisions made by foreign consumers and companies who prefer German products to their own or those made by Germany's competitors. The critics call it "wage dumping". However, German wages – which have so far been mostly the result of private-sector wage agreements – rose over the last two decades within a framework defined roughly by productivity growth and inflation, and are still at the upper end of the range in an international comparison. It is hardly fair, though, to blame Germany for the fact that employees and employers in other countries felt for years they could ignore the rule of productivity-oriented wage policy and took out unsustainable amounts of debt based on hopes of a never-ending increase in the value of their real estate. Neither is the high current account surplus the result of excessively low demand for foreign goods on the part of German consumers. German imports (in real terms) and global exports moved more or less in line over the past decades.

Inflation: Still low

Driven above all by lower oil prices (on a year-on-year basis) and slightly weaker price pressure on food, inflation slowed markedly at the end of 2013 and fell to an annual average of 1.5%, following 2.0% in 2012. For the current year we expect a price increase of a similar order with some risks more to the downside. There is no sustained wage pressure; at best the output gap will be closed this year; and the price-driving effects we expect to emanate from the weaker euro will probably be offset by lower oil prices and falling agricultural commodities prices across the board. Given the stronger US economy and interest rates in the US rising earlier and faster, we think the euro will depreciate somewhat versus the US dollar. We put the USD/EUR exchange rate at 1.25 at year-end. On a longer-term horizon, inflationary dangers lurk in monetary policy, which is suitable for the euro area as a whole but too expansionary for Germany.

Slight budget surplus

Public-sector finances developed quite satisfactorily over the past few years. Last year the public-sector budget was nearly balanced after it had ended with a modest surplus in 2012. Public debt fell below the 80%-of-GDP mark around mid-2013, while most euro-area members were struggling with rising debt ratios. This year chances are that another budget surplus will be achieved. According to the latest official tax estimate, revenues will continue to soar and the increase in pensions and expenditures resolved in the coalition agreement are having a limited effect only, at least on the 2014 budget. As the grand coalition respects the debt brake anchored in the constitution, surpluses are to be expected beyond 2014, even though these will probably be smaller than previously assumed. The progressing reduction in Bad Bank portfolios will lead to a steadily declining debt level. The debt-to-GDP ratio could drop to 76% in 2014. However, in light of the coalition agreement doubts are warranted with regard to the coalition's aim of undercutting the 70% mark by end-2017. The coalition intends to hugely increase pension benefits and slightly expand public spending. In addition, it wants to introduce stricter regulation on several successful labour market instruments such as temporary employment and staffing services as well as contracts for work and labour, which would restrict labour market flexibility and amount to a launchpad to the past.

Germany: Economic forecast 31

	2012	2013F	2014F	2015F
Real GDP	0.7	0.4	1.5	1.4
Private consumption	0.8	0.9	0.9	0.8
Gov't expenditure	1.0	1.1	0.7	0.1
Fixed investment	-2.1	-0.8	4.0	2.9
Investment in M&E	-4.0	-2.2	4.2	3.6
Construction	-1.4	-0.3	3.0	2.8
Inventories, pp	-0.5	0.0	0.0	0.0
Exports	3.2	0.6	5.6	5.9
Imports	1.4	1.3	6.1	6.0
Net exports, pp	0.9	-0.3	0.2	0.4
Consumer prices	2.0	1.5	1.5	1.8
Public debt, % GDP	81.0	79.6	77.2	74.7
Unemployment rate, %	6.8	6.9	6.7	6.6
Budget balance, % GDP	0.1	-0.1	0.1	0.2
Balance on current account, EUR bn	187	193	193	200
Balance on current account, % GDP	7.0	7.1	6.9	6.9

Sources: Federal Statistical Office, German Bundesbank, Federal Employment Agency, Deutsche Bank Research

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Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Euroland	-0.4	1.0	1.4	1.3	1.0	1.4	1.9	1.7	1.7	-3.1	-2.4	-2.0
Germany	0.4	1.5	1.4	1.5	1.5	1.8	7.1	6.9	6.9	-0.1	0.1	0.2
France	0.2	0.9	1.6	1.0	1.3	1.2	-1.7	-1.5	-1.3	-4.1	-3.6	-3.1
Italy	-1.8	0.6	0.7	1.3	1.0	1.4	0.6	1.4	1.9	-3.0	-2.9	-2.9
Spain	-1.3	0.6	1.2	1.5	0.8	1.1	1.4	2.1	2.5	-6.6	-5.8	-4.5
Netherlands	-1.1	0.7	1.3	2.6	1.0	1.5	10.3	10.5	11.0	-3.9	-3.3	-3.0
Belgium	0.2	1.2	1.6	1.2	1.3	1.5	-2.5	-2.0	-1.0	-2.8	-2.7	-2.6
Austria	0.4	1.4	1.8	2.1	1.5	1.7	2.7	3.0	3.0	-2.1	-1.8	-1.6
Finland	-1.3	0.8	1.4	2.2	1.7	1.8	-1.3	-1.1	-0.8	-2.3	-2.1	-1.9
Greece	-4.3	0.8	2.0	-0.8	-0.6	0.2	-0.5	0.5	1.0	-13.5	-2.0	-1.0
Portugal	-1.6	0.8	0.9	0.4	0.6	1.0	0.0	1.0	1.5	-5.7	-4.5	-3.5
Ireland	0.2	1.8	2.2	0.5	0.8	1.1	5.0	4.5	4.0	-7.4	-4.9	-2.8
UK	1.5	2.7	2.0	2.6	2.1	1.9	-4.1	-3.5	-3.1	-6.1	-4.7	-4.1
Denmark	0.4	1.8	1.5	0.8	1.5	1.9	6.5	6.0	5.5	-1.5	-2.0	-2.5
Norway	1.9	2.5	2.7	2.1	2.0	2.1	12.0	11.5	11.2	11.0	10.5	10.0
Sweden	0.9	2.4	2.8	0.0	1.0	2.1	6.2	5.6	5.2	-1.5	-1.0	-0.5
Switzerland	2.0	2.1	2.0	-0.2	0.4	0.8	11.9	11.5	11.5	0.7	0.8	0.9
Czech Republic	-1.2	1.7	2.2	1.4	1.1	2.0	-0.6	-1.1	-2.5	-3.1	-2.7	-2.6
Hungary	0.7	1.8	2.0	1.7	1.5	2.7	2.2	2.0	1.5	-2.5	-2.9	-2.7
Poland	1.4	3.0	3.9	0.9	2.0	2.7	-2.2	-2.6	-2.3	-4.8	4.0	-3.1
United States	2.0	3.5	3.8	1.5	2.5	2.3	-3.0	-2.7	-2.8	-3.8	-3.1	-2.0
Japan	1.5	0.7	1.3	0.3	2.8	1.6	0.8	1.2	2.2	-9.1	-7.5	-6.1
World	2.8	3.8	4.0	3.0	3.4	3.4						

*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

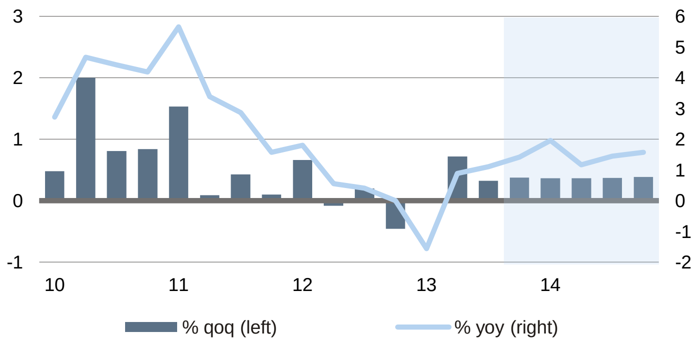
Forecasts: German GDP growth by components, % qoq, annual data % yoy

	2011	2012	2013	2014F	2015F	2013 Q1	2013 Q2	2013 Q3	2013 Q4F
Real GDP	3.3	0.7	0.4	1.5	1.4	0.0	0.7	0.3	0.3
Private consumption	2.3	0.8	0.9	0.9	0.8	0.3	0.6	0.1	
Gov't expenditure	1.0	1.0	1.1	0.7	0.1	0.1	-0.2	0.5	
Fixed investment	6.9	-2.1	-0.8	4.0	2.9	-1.9	1.6	1.6	
Investment in M&E	5.8	-4.0	-2.2	4.2	3.6	-1.6	1.2	0.5	
Construction	7.8	-1.4	-0.3	3.0	2.8	-2.3	1.9	2.4	
Inventories, pp	-0.1	-0.5	0.0	0.0	0.0	0.4	-0.3	0.2	
Exports	8.0	3.2	0.6	5.6	5.9	-1.0	2.4	0.1	
Imports	7.4	1.4	1.3	6.1	6.0	-0.6	1.9	0.8	
Net exports, pp	0.7	0.9	-0.3	0.2	0.4	-0.2	0.3	-0.4	
Consumer prices*	2.1	2.0	1.5	1.5	1.8	1.5	1.5	1.6	1.3
Unemployment rate, %	7.1	6.8	6.9	6.7	6.6	6.9	6.9	6.8	6.9
Industrial production	7.4	-0.4	-0.2	3.8	3.0				
Budget balance, % GDP	-0.8	0.1	-0.1	0.1	0.2				
Public debt, % GDP	80.0	81.0	79.6	77.2	74.7				
Balance on current account, % GDP	6.2	7.0	7.1	6.9	6.9				
Balance on current account, EUR bn	161	187	193	193	200				

*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

Chartbook

Real GDP growth



Sources: Federal Statistical Office, Deutsche Bank Research

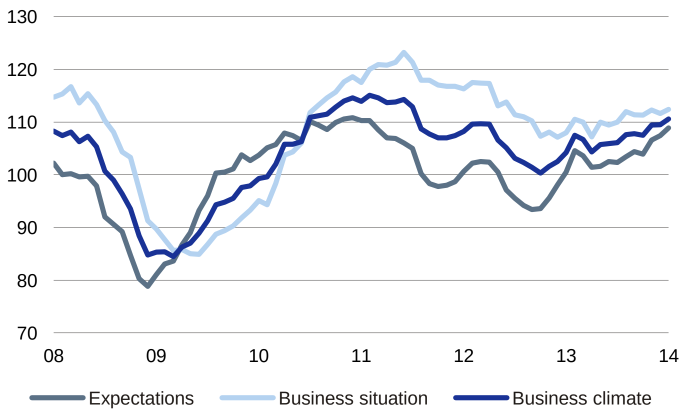
— According to preliminary numbers German real GDP grew by 0.4% in 2013. The slowdown compared to 2012 (0.7%) was primarily due to the weak winter half 2012/13. In H2 2013 growth stabilized at around its potential rate.

— Growth was solely driven by domestic factors – foremost private consumption – which added 0.7 pp to annual 2013 GDP growth. In contrast, net exports shaved off 0.3 pp. Investment spending fell moderately. In 2012 net exports were still the dominating growth driver.

— Thanks to stable quarterly growth rates of around 0.4% qoq annual GDP should expand by about 1.5% in 2014.

Ifo index - total economy

2005=100



Source: ifo

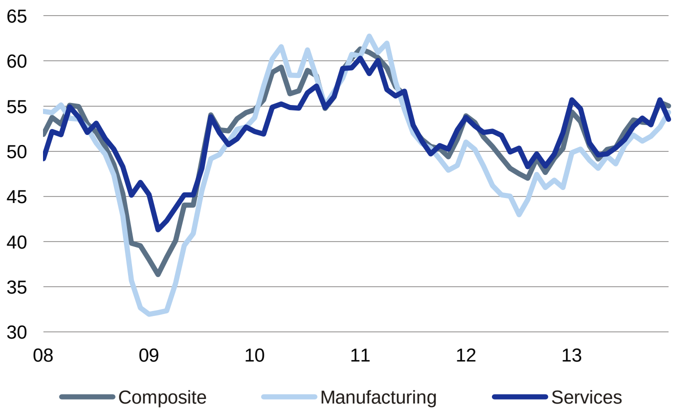
— In January the ifo index rose to its highest level since mid-2011 continuing its upward trend that started in April 2013. Lately the sentiment improvement was driven by rising expectations (highest value since early-2011) whereas the assessment of the current situation roughly stagnated on a high level.

— Behind the improvement in H2 were rising sentiment and export expectations in the manufacturing sector. This supports our expectation that the German economy should have a good start into 2014 and that growth should be fuelled by domestic as well as foreign demand.

— However, the ifo index has overstated actual growth lately. For instance, it suggested 0.9% qoq GDP growth for Q4 2013 – more than double the – likely – actual growth rate.

Purchasing manager index

PMI, index



Source: Markit

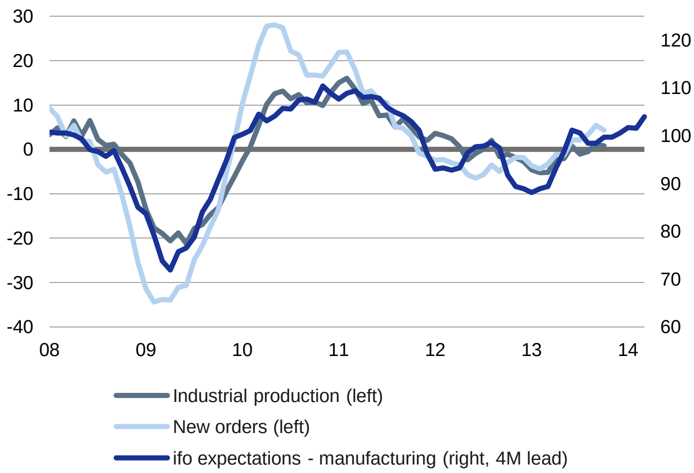
— The composite PMI's increase (55.9 vs 55.0 prev.) surprised positively in January. The rise was nearly exclusively due to the strong manufacturing sector (56.3 vs 54.3). In contrast, the services sector's PMI was nearly unchanged (53.6 vs 53.5). The export dependent manufacturing PMI was higher than the services index for the second month running after two years with the services sector leading. This suggests that German GDP growth should receive more impetus from abroad.

— According to the PMI survey the industry benefited from strong production growth (60.4 vs 57.9) and higher order intake (total: 59.0 vs 56.6; foreign: 57.0 vs 54.7).

— The survey results in the services sector were mixed: while the order intake slowed markedly (50.7 vs 52.5), business expectations rose (58.8 vs 57.2).

Industrial production, new orders and ifo expectations

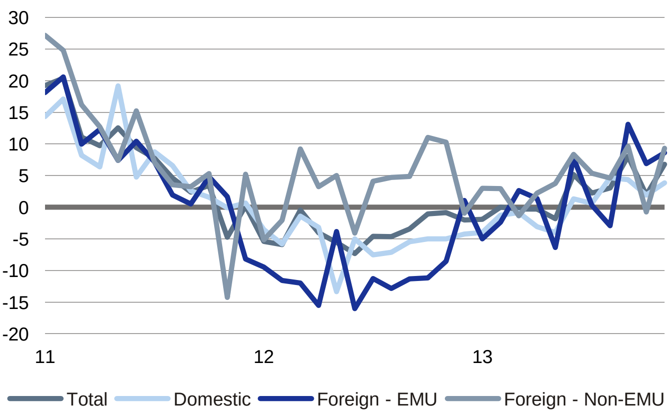
% yoy, 3M moving average (left); 2005=100 (right)



Sources: Federal Statistical Office, ifo

New manufacturing orders

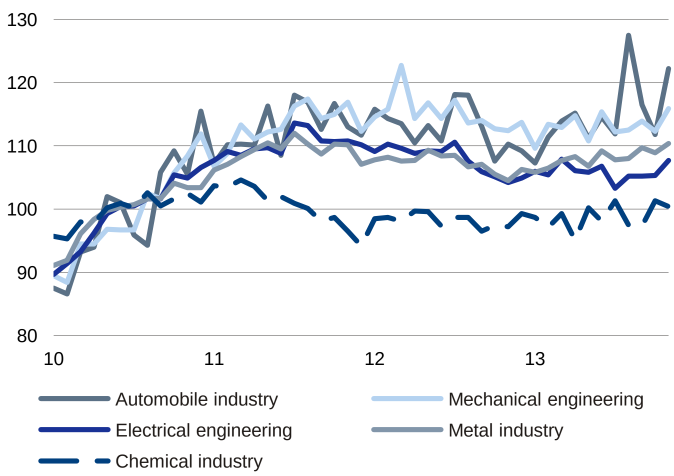
% yoy



Source: Federal Statistical Office

Production of largest industrial sectors

2010=100, sa



Source: Federal Statistical Office

— Over the course of 2013 the industry increasingly benefitted from the recovery of the global economy. Thanks to big-ticket orders the order intake was up by over 5% yoy in November (3M moving average). The production recovery has been less pronounced (+1.8%) as of yet. Both – ifo and the PMI – point to a further acceleration.

— In November industrial production rose 1.9% mom making up for the previous months' weakness (-1.2% after -0.6%). This was due to manufacturing output (+3.1%). In contrast, energy production (-3.3% vs -2.4% prev.) suffered from the effects of the mild weather. Reporting slower activity for the fourth consecutive month the construction sector continued its disappointing performance.

— New orders continued their volatile upward trend in November (+2.1% mom vs -2.1% prev.). Rising by 3.0% core orders more than made up for the previous month's weakness (-2.2%). The volatile order component "other transport equipment" (airplanes, ships and trains) which is strongly affected by big-ticket orders suffered from a payback of the October surge in November and thereby weighed on total orders.

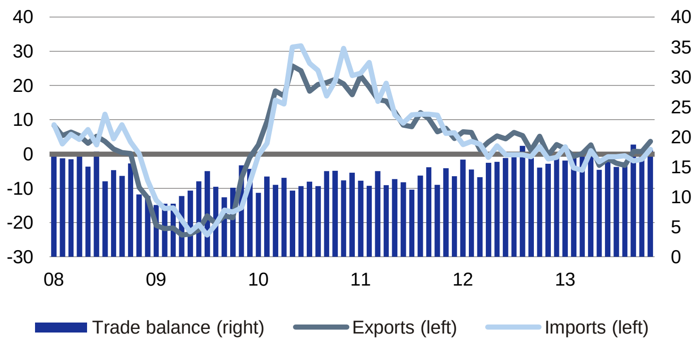
— Orders have improved across regions. Especially orders from EMU countries (+9.4% yoy, 3M moving average) have risen well above last year's levels – a sign of the cyclical stabilization. The order increase from other foreign countries stood at 6.0%. Domestic orders (+3.3%) remained relatively weak.

— Domestic production of the leading German industries has trended upwards in the last few months, showing marked ups and downs. The automotive industry, in particular, has exhibited noticeable fluctuations (delay of vacation shutdowns).

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

Merchandise trade

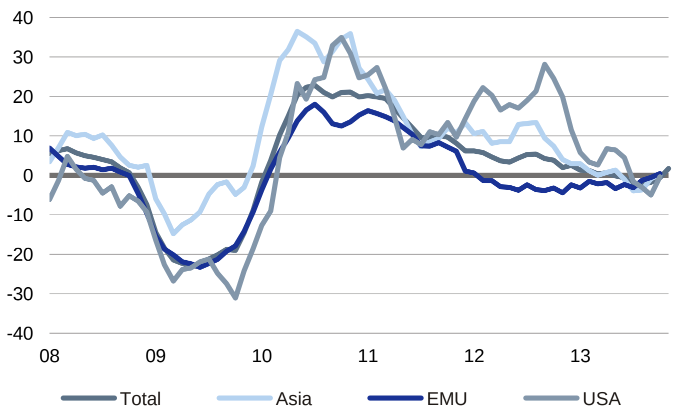
% yoy (left), EUR bn (right)



Source: Deutsche Bundesbank

German merchandise exports by destination

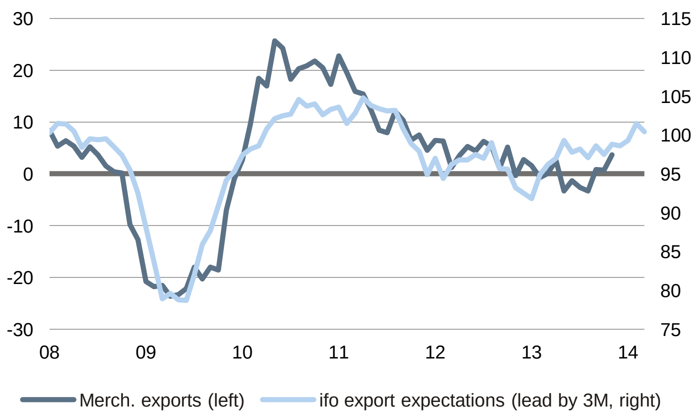
Merchandise exports, % yoy, 3M moving average



Source: Deutsche Bundesbank

Exports & ifo export expectations

% yoy (left), index (right)



Sources: Deutsche Bundesbank, ifo

— The German trade balance surplus rose to EUR 17.8 bn in November – the third-highest value in the last five years. Exports rose slightly (+0.3% mom) – the fourth consecutive rise. Imports fell (-1.1%), but had risen strongly in the preceding month (+3.0%). The import weakness in November was probably in part due to lower prices and low demand for e.g. heating fuel (thanks to mild weather).

— In November exports (+3.7% yoy) and imports (+1.3%) were up relatively strongly on a year ago. Previously the growth rates were negative or only slightly positive. However, the improvement was strongly supported by a base effect as im- and exports fell strongly in November 2012 due to the faltering economy.

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

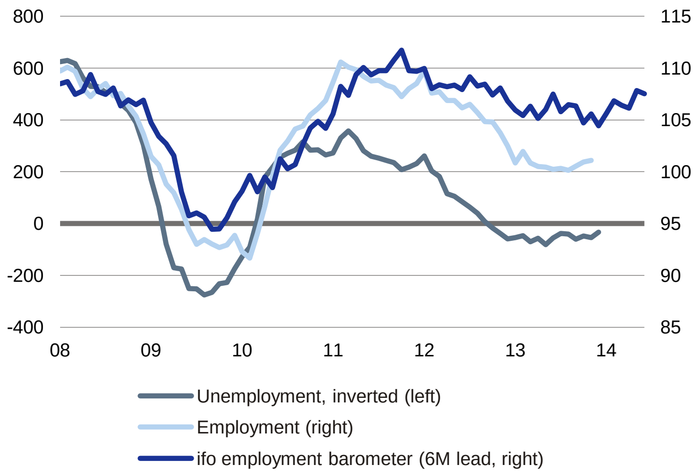
— Since the start of the euro crisis the share of EMU exports in total German exports has fallen by nearly 10 pp to around 37% lately (Asia 16% and the US 8%).

— In December ifo export expectations fell. They remained markedly above the levels observed in mid-2013, though. At the current level they continue to point to a further export acceleration. However, in H1 2013 export expectations strongly overstated actual export growth. Details of the PMI survey as well as our expectations for US and Chinese growth also support our forecast of accelerating exports.

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

Unemployment, employment and ifo employment barometer

'000 yoy (left); index (right)



Sources: Federal Statistical Office, Federal Employment Agency, ifo

— The German labour market ended 2013 on a positive note as the economic recovery that started in spring 2013 is making itself felt. In December unemployment fell by 15k. In the previous four months it had risen by on average 10k. The unemployment rate stayed at 6.9%.

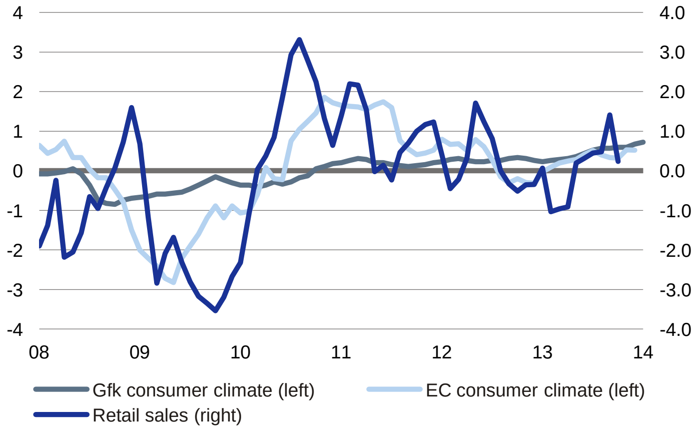
— In 2013 the unemployment rate averaged 6.9% – slightly up from 6.8% in 2012. Thanks to the strengthening economy it should fall back to 6.7% in the current year.

— The employment upbuild continued in November with an increase of 26k after 31k in October. As a result employment was up 0.6% yoy. Due to immigration and the rising participation rate employment rose strongly in 2013.

— Leading indicators (ifo and PMI) point to a modestly positive development over the next few months.

Consumer confidence points to continued uptrend in retail sales

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



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

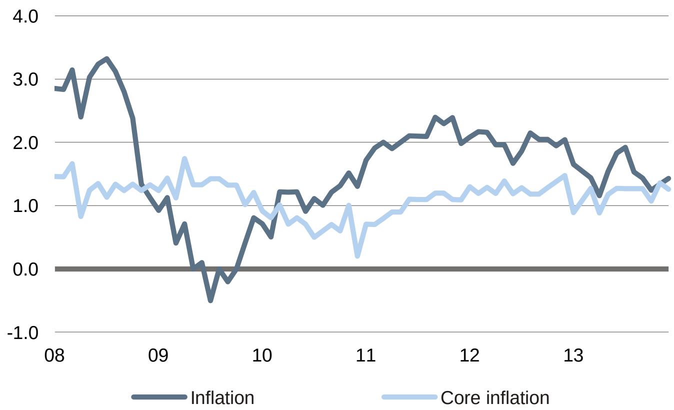
— Retail sales went up by 0.8% mom in November (Oct.: -0.7%). Compared to the previous year retail sales increased by only 0.3% from January to November. As usual, the increase of retail sales was lower than consumption growth (2013: +0.9%).

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

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

Inflation rate and core inflation rate

% yoy

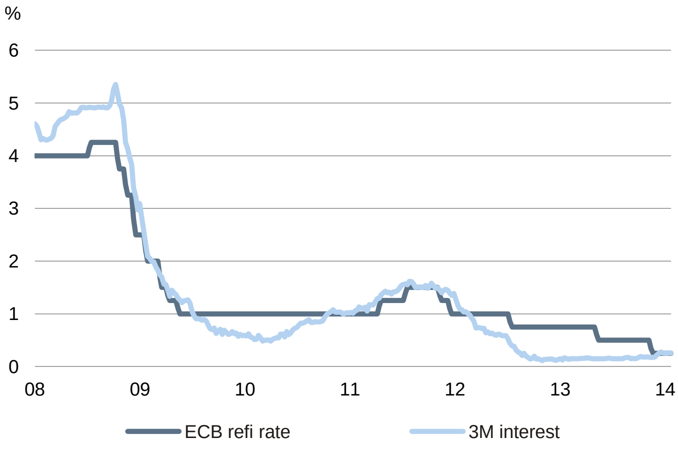


Sources: Federal Statistical Office

— Inflation inched up from 1.3% to 1.4% yoy in December but remained subdued. Food (+3.2% vs 2.8%) and energy price inflation (+1.1% vs -0.3%) were behind the increase. Core inflation fell slightly (1.3% vs 1.4%).

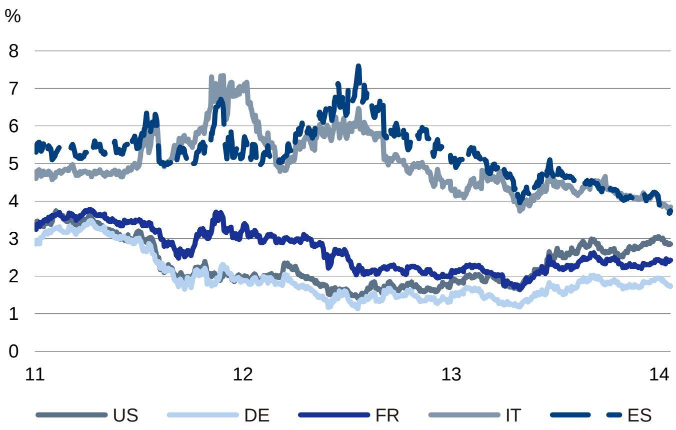
— Consumer prices increased by 1.5% in 2013 (2012: 2.0%). Despite the continued economic recovery, we expect inflation to remain subdued in the current year (2014F: +1.5%) due to low capacity utilization, stable commodity prices and low global price pressure in general.

EMU: Refi rate & 3M Interest



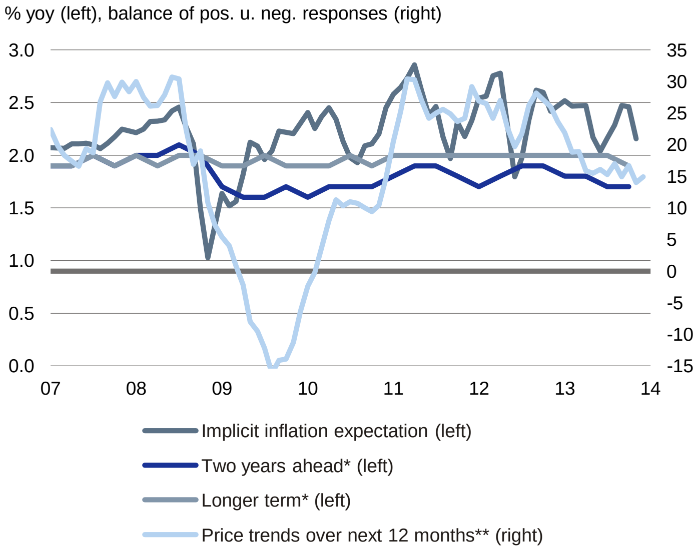
Sources: ECB, Global Insight

10Y government yields



Source: Global Insight

Inflation expectations Eurozone



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

Sources: ECB, EU Commission, Bloomberg

— On 6 November 2013 the ECB unexpectedly lowered its refi rate by 25 bp to the new historic low of 0.25% due to concerns about deflation. In addition, the ECB announced to continue its full allotment scheme until mid-2015.

— The ECB did not change its monetary stance in January. However, Mario Draghi used the press conference for a strong verbal intervention. He made it clear that the ECB would be ready to use additional instruments in the following two scenarios: i) an unwarranted tightening of the short-term money markets or ii) a worsening of the ECB's medium-term outlook for inflation.

— We expect a further modest easing of policy around end-Q1 probably due to lingering concerns about deflation. The probability of a more substantial policy like QE – similar as in the US and UK – has probably increased somewhat given Mr. Draghi's statement at the press conference.

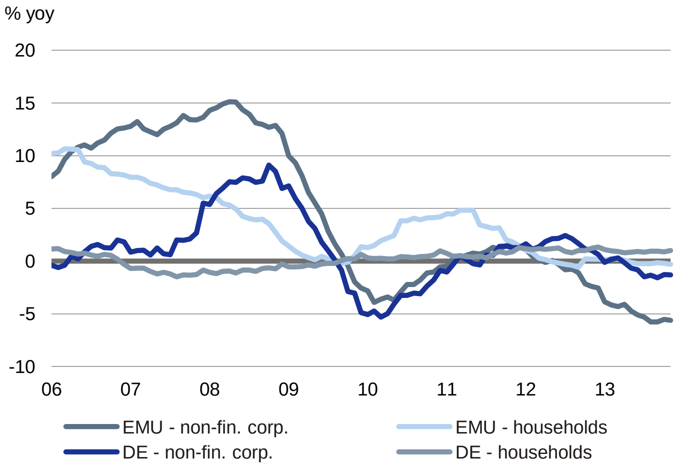
— Against the backdrop of the diverging growth expectations between the US and the euro area the yield spread between 10Y US treasuries and German bunds has roughly doubled since mid-2013 and currently stands at around 1 pp.

— Peripheral spreads versus Germany stabilized at about 2 pp recently – markedly below previous year's level (about 3 pp). This development has been supported by the improved economic indicators and the hope for a further economic recovery in the euro area. Strong indications from the ECB that it will maintain its expansionary stance for a prolonged period have probably supported the spread convergence.

— Contrary to the debate about the threat of deflation – nourished by the ECB – the long-term expected inflation rate (5 years) of private forecasters of the ECB survey remains firmly anchored at about 2%. The expected inflation rate in 2 years is at 1.7%.

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

Loans to the private sector

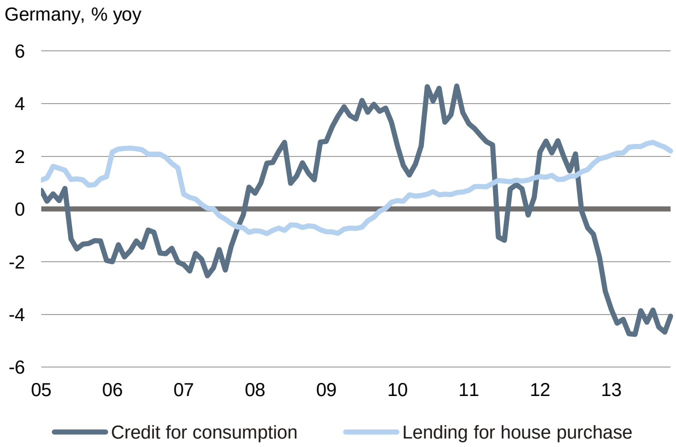


Source: ECB

— Lending to corporates remains weak. Reductions are particularly pronounced for the euro area (-5.7% in November) due to continuous pressure for deleveraging. In Germany, lending to corporates also shrank (-1.3% in November) but reductions are less pronounced reflecting a mix of modest investment activity and firms using alternative means of financing, e.g. corporate bonds.

— Lending to households also shows a modest performance. Households in the euro area continue to cut down on debt (-0.3%). Credit to households in Germany records growth at about 1% mainly driven by mortgage lending.

Loans to households



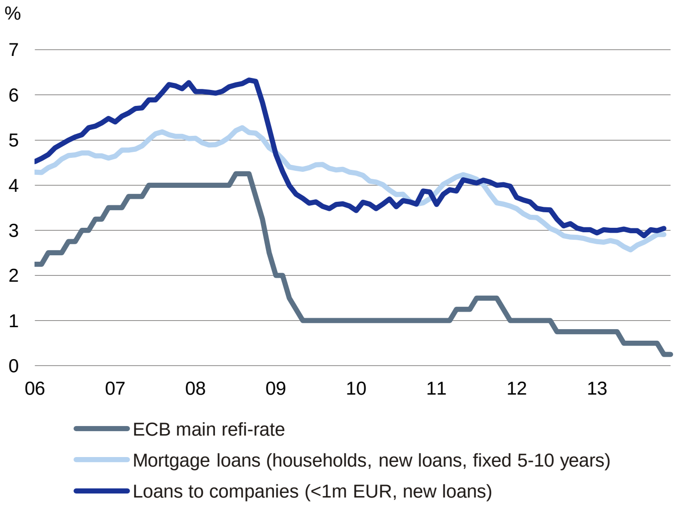
Source: ECB

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

— Mortgage lending has grown at rates above 2% (yoy) throughout 2013. In November, volumes recorded +2.2% – which is less dynamic than in summer (July/August: +2.5%) but still solid. Deceleration reflects the slight increase in mortgage rates in Q3 as well as local supply shortages. In total, mortgage lending increased by 20 bn Jan.-Nov. 2013.

— Consumer credit remains restrained in 2013 with reductions in November by 4.1% (yoy). Households rather rely on savings to finance their purchases.

Interest rates



Sources: ECB, Deutsche Bundesbank

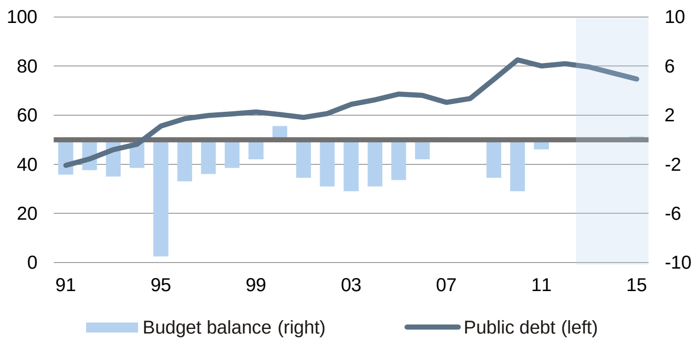
— Interest rates for mortgages and corporate credit remain at historic lows in 2013 with the ECB's rate cut in November reinforcing these conditions.

— Rates for mortgages stood at 2.7% on average during the first three quarters in 2013. While last year's low point was reached in July (2.6%) and rates had picked up slightly in autumn, they remained stable at 2.9% in November. Low interest rates have contributed to rising demand for mortgage credit in 2013.

— However, for lending to corporates stable low rates (November again at 3%) are not associated with rising demand for credit.

Public debt and deficit

% GDP



Sources: Federal Statistical Office, Deutsche Bank Research

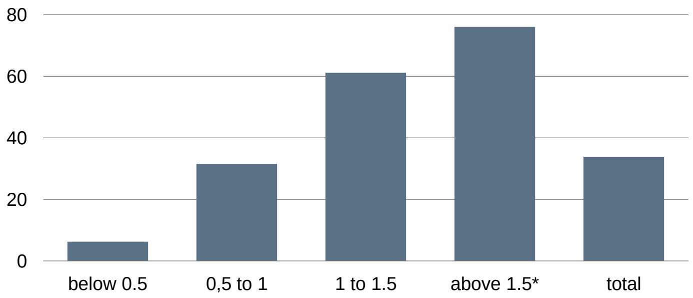
— In 2013 Germany recorded a small fiscal deficit. The fiscal balance of -0.1% of GDP compares to a surplus of 0.1% in 2012.

— With currently 79.6% of GDP, general government debt has again fallen below 80% in the course of 2013. The positive development was partly attributable to growing revenues, but also to the fact that the bad banks continue to run down their portfolios.

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

Primarily skilled workers eligible to early retirement at 63

New retirees who have been in the workforce for at least 45 y* with respect to their former income, measured in average earning points**, shares in %



* Here including some years of education. Thus these data might include academics, who will not be eligible to early retirement. **1 pt corresponds to the avr. wage income.

Sources: Deutsche Rentenversicherung, Deutsche Bank Research

— The grand coalition's plan to reduce the retirement age to 63 for employees who have been in the workforce for at least 45 years – one of the SPD's pet projects – will primarily benefit skilled workers, i.e. workers who have entered the labour market at the age of 16 to 18 and then – usually after an apprenticeship – have earned above-average wages.

— Taking new pensioners in 2011 as a proxy the share of those eligible to the planned early retirement option was about 75% for the group with the highest former labour income. In contrast, the ratio for those who formerly earned wages far below average was only about 6%, while the respective share among all new retirees was one third. Thus the grand coalition will re-open the door to early retirement especially for those qualified workers who are needed to secure the competitiveness of the German economy and to properly finance the expensive social system.

— From a social policy point of view the plan is all the more questionable, as the individual life expectancy and thus the duration of the pension benefit period is highly correlated to a person's income. (In the graph income is measured in average earning points per year. 1 pt means that an individual has on average earned the average wage during his career and respective multiples for other values.)

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

Date	Event	Remarks
27/28 Jan.	Eurogroup/ECOFIN meeting	Debates on ESM, e.g. direct recap operational framework, review of adjustment programmes for Greece and for Portugal, review of financial sector programme for Spain, Banking Union/euro area aspects.
6 Feb.	Meeting of the ECB Council, press conference	Review of the monetary policy stance.
13/14 Feb.	European Council	Industrial competitiveness
17/18 Feb.	Eurogroup/ECOFIN meeting	Economic situation in the euro area – broad outline of the Commission winter forecast, (tentative) programme exit strategy for Portugal, Banking Union/euro area aspects.
22/23 Feb.	Meeting of G20 Finance Ministers and Central Bank Governors in Sydney	Australian presidency has made it a priority to complete financial reforms in four areas: building the resilience of banks, helping prevent and manage the failure of globally important financial institutions, making derivatives markets safer and improving oversight of the shadow banking sector.
Feb.	EC winter economic forecasts	European Commission to publish the winter edition of its European Economic Forecasts. In 2013 they were released on 22 Feb.
6 Mar.	Meeting of the ECB Council, press conference	We continue to expect easier policy around end-Q1, with the next move something modest in terms of impact. But the January press conference signals that the probability of a more substantial policy like QE is not zero and is rising.
10/11 Mar.	Eurogroup/ECOFIN meeting	Portugal: 11th review and (poss.) exit strategy, EDP implications based on the Com. winter forecast, Stability and Growth Pact implementation, other euro area aspects.
20/21 Mar.	European Council	European semester, growth and jobs, EU 2020 targets (employment, R&D, climate, education, social inclusion).

Source: Deutsche Bank Research

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Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
30 Jan 2014	8:00	Import prices (Index, sa) pch mom (yoy)	December	-0.4	0.1
30 Jan 2014	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	January	-0.5 (1.4)	0.4 (1.4)
30 Jan 2014	10:00	Unemployment rate (%, sa)	January	6.8 (0.0)	6.9 (0.0)
31 Jan 2014	8:00	Retail sales (Index, sa), pch mom	December	0.3	0.8
6 Feb 2014	12:00	New orders manufacturing (Index, sa), pch mom	December	-0.5	2.1
7 Feb 2014	12:00	Industrial production (Index, sa), pch mom	December	0.5	1.9
7 Feb 2014	8:00	Trade balance (EUR bn, sa)	December	18.3	17.8
7 Feb 2014	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	December	1.0 (4.6)	0.3 (3.7)
7 Feb 2014	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	December	0.7 (3.3)	-1.1 (1.3)
14 Feb 2014	8:00	Real GDP (Index, sa), % qoq	Q4 2013	0.3	0.3
-	9:30	Manufacturing PMI (Flash)	February	56.0	56.3
-	9:30	Services PMI (Flash)	February	54.0	53.6
27 Feb 2014	10:30	ifo business climate (Index, sa)	February	110.5	110.6

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

Financial Forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	0.125	0.10	0.25	0.50	0.00	0.75	0.20	1.50	2.50	2.85	0.05
Mar 14	0.125	0.10	0.25	0.50	0.00	0.75	0.20	1.50	2.50	2.70	0.05
Jun 14	0.125	0.10	0.25	0.50	0.00	0.75	0.20	1.50	2.50	2.70	0.05
Dec 14	0.125	0.10	0.25	0.50	0.00	0.75	0.20	1.50	3.50	2.70	0.05
3M interest rates, %											
Current	0.24	0.22	0.30	0.52							
Mar 14	0.35	0.20	0.25	0.52							
Jun 14	0.35	0.20	0.25	0.52							
Dec 14	0.35	0.20	0.35	0.52							
10Y government bonds yields, %											
Current	2.75	0.66	1.71	2.81	1.07	2.31	1.82	2.92			
Mar 14	2.50	0.80	1.85	2.90	1.00	2.40	1.85	3.00			
Jun 14	2.75	0.70	2.00	3.00	1.10	2.50	2.05	3.20			
Dec 14	3.25	0.80	2.25	3.25	1.25	2.70	2.35	3.40			
Exchange rates											
	EUR/USD	USD/JPY	EUR/GBP	GBP/USD	EUR/CHF	EUR/SEK	EUR/DKK	EUR/NOK	EUR/PLN	EUR/HUF	EUR/CZK
Current	1.37	103.47	0.82	1.66	1.23	8.79	7.46	8.33	4.17	303.62	27.49
Mar 14	1.35	106.00	0.83	1.63	1.23	8.85	7.46	8.40	4.12	291.30	27.00
Jun 14	1.32	109.00	0.82	1.61	1.25	8.70	7.46	8.35	4.08	287.50	27.00
Dec 14	1.25	115.00	0.80	1.56	1.27	8.45	7.46	8.20	4.00	280.00	27.00

Sources: Bloomberg, Deutsche Bank

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German Data Monitor

	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Aug 2013	Sep 2013	Oct 2013	Nov 2013	Dec 2013	Jan 2014
Business surveys and output											
Aggregate											
Ifo business climate	101.5	106.1	105.3	107.2	108.8	107.6	107.8	107.5	109.4	109.5	110.6
Ifo business expectations	95.8	102.9	101.8	103.4	106.0	103.4	104.4	103.9	106.6	107.4	108.9
PMI composite	49.1	52.8	49.9	52.9	54.5	53.5	53.2	53.2	55.4	55.0	55.9
Industry											
Ifo manufacturing	95.2	101.1	100.4	102.7	104.5	103.1	103.5	103.1	105.2	105.2	106.3
PMI manufacturing	46.3	49.7	48.7	51.2	52.9	51.8	51.1	51.7	52.7	54.3	56.3
Headline IP (% pop)	-2.5	0.2	1.5	0.7		1.6	-0.6	-1.2	1.9		
Orders (% pop)	0.8	0.5	1.4	1.7		-0.2	3.1	-2.1	2.1		
Capacity Utilisation	81.4	82.5	82.1	83.2	83.2						
Construction											
Output (% pop)	-1.2	-5.6	10.6	1.4		-0.8	0.1	-1.4	0.7		
Orders (% pop)	3.6	0.4	1.2	-1.2		-6.2	-2.6	3.9	4.7		
Ifo construction	117.8	125.5	123.7	120.4	121.2	120.3	119.1	119.1	121.0	123.6	124.3
Services											
PMI services	50.0	53.8	49.9	52.6	54.1	52.8	53.7	52.9	55.7	53.5	53.6
Consumer demand											
EC consumer survey	-10.0	-6.5	-4.2	-3.2	-2.8	-3.4	-4.0	-4.2	-2.1	-2.2	
Retail sales (% pop)	-0.6	1.3	-0.1	-0.1	-0.1	0.3	0.1	-0.7	0.8		
New car reg. (% yoy)	-6.2	-10.5	-3.7	-1.4	1.6	-5.5	-1.2	2.3	-2.0	5.4	
Foreign sector											
Foreign orders (% pop)	1.9	-0.9	3.4	1.0		-2.0	6.3	-2.2	2.2		
Exports (% pop)	-2.4	0.2	0.1	0.4		1.0	1.6	0.3	0.3		
Imports (% pop)	-0.8	-1.2	1.2	-0.3		0.1	-1.9	3.0	-1.1		
Net trade (sa EUR bn)	47.0	50.1	47.8	49.5		15.8	18.7	16.7	17.8		
Labour market											
Unemployment rate (%)	6.9	6.9	6.9	6.8	6.9	6.8	6.9	6.9	6.9	6.9	
Change in unemployment (k)	23.0	-1.0	19.0	5.3	19.7	7.0	23.0	1.0	9.0	-15.0	
Employment (% yoy)	0.9	0.6	0.5	0.5		0.5	0.5	0.6	0.6		
Ifo employment barometer	106.2	106.2	104.9	106.3	107.2	106.9	106.4	106.1	107.8	107.5	
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	2.0	1.8	1.5	1.7	1.3	1.6	1.6	1.2	1.6	1.2	
Core HICP (% yoy)	1.3	1.4	1.0	1.2	1.1	1.2	1.3	1.0	1.7	0.7	
Harmonised PPI (% yoy)	1.3	0.8	-0.1	-0.3	-0.7	-0.5	-0.5	-0.7	-0.8	-0.5	
Commodities, ex. Energy (% yoy)	0.7	-3.5	-7.0	-12.2	-10.4	-11.5	-11.4	-11.3	-9.8	-10.2	
Oil price (USD)	110.1	112.6	102.5	110.4	109.3	111.3	111.9	109.2	108.0	110.8	
Inflation expectations											
EC household survey	31.2	26.6	22.5	26.2	25.5	28.2	26.8	26.5	24.6	25.5	
EC industrial survey	2.9	3.7	-0.6	2.8	6.1	2.8	4.3	3.8	5.8	8.6	
Unit labour cost (% yoy)											
Unit labour cost	3.1	4.1	1.6	1.1							
Compensation	2.8	2.2	1.8	1.8							
Hourly labour costs	3.7	4.7	1.3	1.0							
Money (% yoy)											
M3	6.9	5.4	3.8	2.5		3.0	2.5	1.9	1.3		
M3 trend (3m cma)						2.8	2.5	1.9	1.5		
Credit - private	-0.4	-0.2	1.3			-4.2	-4.0	-4.2	-4.0		
Credit - public	13.5	-18.7	-22.4			-24.1	-17.7	-18.9	-11.8		

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

Deutsche Bank
Research

Focus Germany

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

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