Focus Germany

ECB helps industry and boosts property prices

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Fewer insolvencies in German industry. The 2008/2009 economic and financial crisis caused the number of insolvency proceedings instituted to increase by 48% in 2009 alone. However, the number of insolvencies has been following a downward trend since then. As a result, fewer proceedings were instituted in 2015 than in 2008 across nearly all sectors of industry. The prospects for this trend continuing in 2016 are good. Over the past few years, the number of insolvencies in any given industry has been significantly influenced by the prevailing economic conditions in that industry and – related to this – the value of the euro against the currencies of major trading partners.

More rapid growth in the volume of mortgage lending in the coming years – rising macroprudential risks. There is a high level of excess demand in the housing market and it has grown in recent years. Demand for credit is also growing at a correspondingly rapid pace. The supply of credit could be boosted by further monetary stimulus. In the medium term, more buoyant lending is likely to increase interest rate risk. However, if lending growth remains low, there will be increased risk of overvaluations and a house price bubble due to the high level of excess demand. This is particularly true when little new housing is financed and lending is largely for existing property.

Housing market more attractive than the office market in the short term; prices and rents likely to converge in the long term. In the long term residential and office rents are likely to follow a similar trend, because interacting factors in the two markets as well as substitution effects suggest the existence of a state of equilibrium. Given the high level of excess demand in the housing market and the fact that office buildings are being converted to residential buildings, office space is also likely to be in short supply in the coming years. As a result, rents in the office market can be expected to rise more strongly, and could – for a time – outstrip the rise in rents in the housing market. At present, housing rents in many German cities are higher than average office rents outside city centres, although office rents had mostly been more expensive since German reunification.

The View from Berlin. Chancellor Merkel: Troubleshooter and moderator. Merkel's term has been dominated by crisis management ever since she assumed office in November 2005. With the European agenda, again, being loaded with sensitive topics like Brexit, a possible resurgence of the refugee challenge or the political risk around the constitutional reform referendum in Italy, the German domestic policy agenda is being pushed back. A string of recent polls shows that Merkel has largely recovered from the drop of her popularity at the start of the year and that her conservative party is stabilising. Nonetheless, Merkel is likely to focus her attention on domestic topics as much as on European ones in the upcoming months given the looming federal elections in autumn 2017.

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2015	2016F	2017F	2015	2016F	2017F	2015	2016F	2017F	2015	2016F	2017F
Euroland	1.6	1.6	1.1	0.0	0.2	1.2	3.2	2.6	2.0	-2.1	-2.0	-1.9
Germany	1.7	1.7	1.3	0.2	0.5	1.5	8.5	8.1	7.6	0.7	0.0	-0.2
France	1.2	1.5	1.3	0.1	0.2	1.0	-0.2	-0.3	-0.3	-3.5	-3.3	-2.9
Italy	0.8	0.9	0.4	0.1	0.0	1.1	2.2	2.6	1.9	-2.6	-2.5	-2.4
Spain	3.2	2.8	1.7	-0.6	-0.4	1.3	1.4	1.1	0.3	-5.1	-4.0	-3.6
Netherlands	2.0	1.3	0.9	0.2	0.2	1.1	8.6	10.5	10.2	-1.8	-1.8	-1.8
Belgium	1.4	1.2	0.9	0.6	1.7	1.8	0.0	1.0	0.8	-2.6	-2.7	-2.5
Austria	0.8	1.1	1.1	0.8	1.1	1.7	2.6	2.7	2.7	-1.2	-1.6	-1.5
Finland	0.2	1.1	0.7	-0.1	0.5	1.2	0.1	0.2	0.1	-2.7	-2.4	-2.4
Greece	-0.3	-0.7	1.2	-1.1	-0.3	0.7	0.0	1.0	0.9	-7.2	-3.7	-2.0
Portugal	1.5	1.0	1.1	0.5	0.8	1.3	0.6	1.0	0.7	-4.4	-2.8	-2.8
Ireland	26.3	5.0	2.9	0.0	0.3	1.4	10.2	4.0	2.9	-2.3	-1.1	-1.1
UK	2.2	1.7	0.9	0.0	0.7	2.2	-4.7	-4.0	-3.5	-4.3	-3.0	-3.0
Denmark	1.0	1.1	1.8	0.5	0.4	1.6	7.0	7.0	7.0	-2.5	-2.5	-2.0
Norway	1.1	0.8	1.8	2.2	2.9	2.4	9.0	6.5	6.5	9.0	6.5	6.5
Sweden	3.9	3.3	2.4	0.0	1.0	1.5	5.9	5.7	5.5	-0.8	-1.0	-0.5
Switzerland	0.9	1.0	1.5	-1.1	-0.7	0.3	11.4	9.0	8.0	0.3	-0.5	-0.5
Czech Republic	4.3	2.6	2.7	0.3	0.7	1.6	0.9	1.1	0.5	-1.9	-1.4	-1.6
Hungary	2.9	2.4	2.5	-0.1	0.5	1.9	4.4	4.2	3.0	-2.0	-1.9	-2.7
Poland	3.6	3.6	3.3	-0.9	-0.7	1.1	-0.2	-0.7	-1.6	-2.6	-2.9	-3.0
United States	2.4	1.5	1.7	0.1	1.4	2.0	-2.4	-2.4	-2.6	-2.4	-2.9	-2.9
Japan	0.6	0.2	1.1	0.8	-0.1	0.8	3.3	3.7	3.2	-4.0	-4.0	-3.8
China	6.9	6.6	6.5	1.4	1.8	1.8	2.8	2.8	2.4	-3.5	-4.0	-4.0
World	3.1	3.0	3.4	3.4	4.4	4.7						

*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

						2015				2016			
	2013	2014	2015	2016F	2017F	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F
Real GDP	0.3	1.6	1.7	1.7	1.3	0.3	0.4	0.3	0.3	0.7	0.1	0.5	0.4
Private consumption	0.6	0.9	2.0	1.8	1.3	0.4	0.1	0.6	0.4	0.4	0.2	0.5	0.4
Gov't expenditure	0.8	1.7	2.5	2.8	1.8	0.4	0.7	1.3	0.9	0.5	0.7	0.8	0.8
Fixed investment	-1.3	3.5	2.2	2.7	1.2	1.7	-0.4	-0.3	1.4	1.8	-0.5	0.2	0.3
Investment in M&E	-2.3	4.5	4.8	3.0	0.0	1.9	0.5	-0.8	1.0	1.9	-0.5	0.6	0.1
Construction	-1.1	2.9	0.3	3.0	2.2	1.8	-1.3	-0.3	2.0	2.3	-0.9	-0.2	0.4
Inventories, pp	0.6	-0.3	-0.5	0.1	0.0	-0.1	-0.3	0.0	0.1	0.1	0.0	0.0	0.0
Exports	1.6	4.0	5.4	2.5	2.8	1.5	1.8	0.2	-0.6	1.0	0.8	1.1	0.5
Imports	3.1	3.7	5.8	4.0	3.2	2.1	0.5	1.1	0.5	1.4	1.0	1.1	0.6
Net exports, pp	-0.5	0.4	0.3	-0.5	0.0	-0.2	0.6	-0.3	-0.5	-0.1	0.0	0.1	0.0
Consumer prices*	1.5	0.9	0.2	0.5	1.5	0.0	0.5	0.1	0.3	0.3	0.1	0.7	1.1
Unemployment rate, %	6.9	6.7	6.4	6.2	6.6	6.5	6.4	6.4	6.3	6.2	6.1	6.2	6.4
Industrial production	0.1	1.5	0.5	1.3									
Budget balance, % GDP	-0.1	0.3	0.7	0.0	-0.2								
Public debt, % GDP	77.2	74.7	71.2	69.4	67.4								
Balance on current account, % GDP	6.5	7.3	8.5	8.1	7.6								
Balance on current account, EUR bn	190	213	257	255	247								

*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

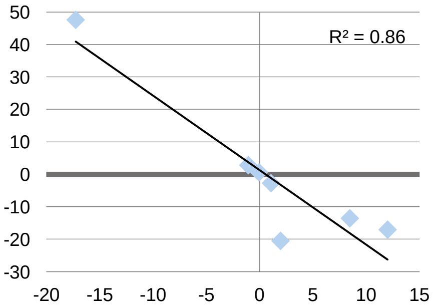
Fewer insolvencies in German industry

— The 2008/2009 economic and financial crisis caused the number of insolvency proceedings instituted to increase by 48% in 2009 alone. However, the number of insolvencies has been following a downward trend since then. As a result, fewer proceedings were instituted in 2015 than in 2008 across nearly all sectors of industry.

— The prospects for this trend continuing in 2016 are good. Over the past few years, the number of insolvencies in any given industry has been significantly influenced by the prevailing economic conditions in that industry and – related to this – the value of the euro against the currencies of major trading partners.

Strong correlation* 1

X: Manufacturing output in Germany, real terms, % yoy; Y: Insolvency proceedings** in German manufacturing, % yoy



* Chart displays correlation from 2009 to 2015

** i.e. the number of insolvency proceedings instituted

Sources: Federal Statistical Office, Deutsche Bank Research

The 2008/2009 global economic and financial crisis had a huge impact on the insolvency statistics for German industry. In 2009 alone, the number of insolvency proceedings instituted in Germany's manufacturing sector rose by 48%. At the same time, the country's industrial output contracted by more than 17% in real terms. However, the rapid recovery of the economy as a whole in 2010 and 2011 caused the number of insolvencies in German industry to fall significantly again – by 17% and 13.5% respectively. This was accompanied by expansion of industrial output by 12% and 8.5% in real terms. Since then, this pattern – a rise in insolvencies for industry during periods when output is falling, and vice versa – has continued:

— German industrial output declined slightly in both 2012 and 2013, while there was a small increase in the number of insolvency proceedings instituted.

— The opposite happened in 2014 and 2015: manufacturing went up by 2% and 1.1% respectively; at the same time, the number of insolvencies in German industry went down by 20.5% and 2.7%.

Overall, the number of insolvency proceedings instituted in Germany's manufacturing sector in 2015 was 15% below the number in 2008 and almost 43% below the number in 2009. All in all, this shows a very encouraging trend.

It is unsurprising that the number of insolvencies in manufacturing is influenced by the prevailing economic conditions in each sector. Economic performance of course depends on many factors that, in turn, also have a direct or indirect impact on the number of insolvencies. One such factor is the exchange rate. Between the end of 2008 and the end of 2009 and from mid-2012 to the end of 2013, the euro appreciated by an average of approximately 8% and more than 10% respectively against the currencies of Germany's trading partners, making German companies less competitive abroad in terms of price. This is likely to be a (further) reason why the number of insolvency proceedings instituted rose in 2009 and in 2012 and 2013. The euro's appreciation also adversely affected German exports in those years.

Conversely, the depreciation of the euro by roughly 13% between early 2014 and early 2015 probably contributed to the aforementioned exceptionally sharp fall (20.5%) in the number of insolvencies in industry during 2014.

Producer prices also have a degree of influence on profitability and thus on the number of insolvencies in industry. However, there is not a clear empirical correlation in the period under analysis here. In 2009, producer prices decreased – which is consistent with the increase in insolvencies. Producer prices then recovered again between 2010 and 2012, and have shown a slight downwards trend since then. By contrast, there was a drop in the number of insolvency proceedings instituted in 2014 and 2015.

The number of insolvency proceedings instituted (according to insolvency statistics) compared with the number of VAT-registered companies (according to

VAT statistics) gives the 'insolvency ratio'. This ratio reflects the generally positive trend observed over the past few years. In 2009, the insolvency ratio was 1.08%. By 2014 (more recent figures are not yet available), it had fallen to 0.66%.

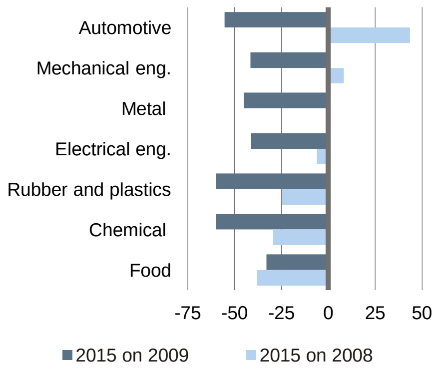
A mixed picture at sectoral level

The trend outlined above for the institution of insolvency proceedings in manufacturing can also broadly be seen in many sectors of German industry. Nevertheless, individual years exhibit major variations in the rate at which the number of insolvencies has changed. Some of this significant fluctuation is due to the fact that the total number of insolvency proceedings instituted in individual sectors is very low.

A look at the large sectors of industry reveals that in 2009, a year of recession, the increase in insolvency proceedings was the most pronounced for automotive including component suppliers (up by 222%), rubber and plastics (up by 88%), mechanical engineering (up by 85%) and metal (up by 83%). That same year also saw disproportionately strong decreases in domestic output for each of these sectors. The aforementioned appreciation of the euro adversely affected the automotive and mechanical engineering sectors, which are particularly export-driven. All sectors then experienced two years of – in some cases significant – falls in the number of insolvencies, thereby reflecting the trend in manufacturing as a whole. However, the food industry exhibits a different trend, with the number of insolvency proceedings in fact declining by almost 8% in 2009. The recession in Germany did not lead to a rise in insolvencies in the food industry because the price elasticity of demand for food is low. The exchange rate is also less relevant. Nonetheless, the number of insolvencies in this industry went up slightly in 2010.

In many sectors fewer insolvencies than pre-crisis 2

Number of insolvency proceedings instituted in German industry, change in %



Sources: Federal Statistical Office, Deutsche Bank Research

There is no consistency to the pattern of the number of insolvencies across all sectors of industry in the years 2012 to 2015. Only the general trend pointed in the same direction: in 2015, the number of insolvencies was below the 2009 level across all sectors. And this is also true for most sectors when the number of insolvencies in 2015 is compared with those in 2008. However, there are a number of notable exceptions. The number of insolvencies in the automotive industry in 2015 was still more than 43% higher than in 2008; the corresponding number for the mechanical engineering sector was more than 8% higher. The number in the metal industry in 2015 was almost as high as in 2008. To be fair, an assessment of the number of insolvencies in the automotive industry needs to take into consideration that, in absolute terms, there were only 33 insolvency proceedings instituted in 2015 and thus 'only' ten more than in 2008.

A final look at the insolvency ratios in 2015 reveals that, among the major sectors of industry, mechanical engineering was above average at 0.91%. By contrast, the construction materials industry (0.36%), the pharmaceutical industry (0.43%) and the chemical industry (0.55%) registered relatively low insolvency ratios.

Overall, the impact of the global economic and financial crisis on the insolvency statistics for German industry has now largely dissipated. In 2015, almost all sectors reported fewer insolvencies than in 2008. The prospects for a further fall in insolvencies in German industry in 2016 are good. And indeed, the number of proceedings instituted in the first quarter was almost 5% down on the corresponding prior-year period. Nevertheless, risks still remain. These include the appreciation of the euro and – very much related to this – an economic slowdown. Both of these risks have increased following the vote for Brexit.

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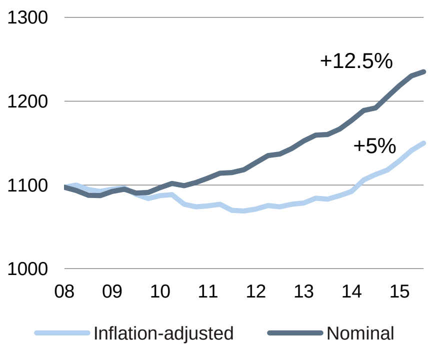
More rapid growth in the volume of mortgage lending in the coming years – rising macro-prudential risks

Mortgage loans 1

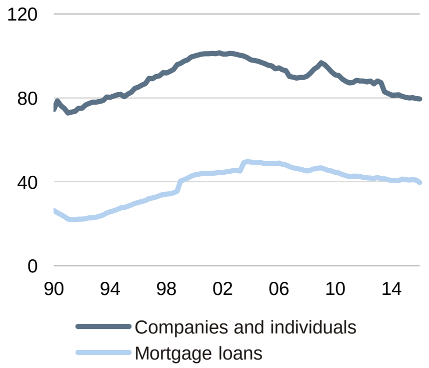
EUR billion



Sources: Bundesbank, Deutsche Bank Research

Germany: Lending volume 2

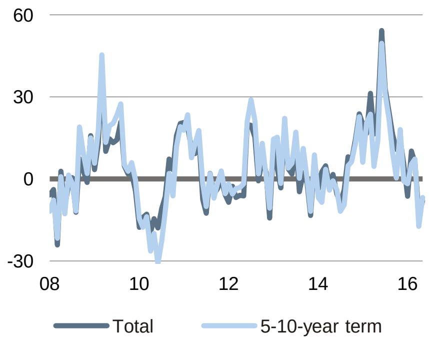
% GDP



Sources: Bundesbank, Deutche Bank Research

New lending business 3

% yoy



Sources: Bundesbank, Deutsche Bank Research

— Despite prices rocketing, the pace of growth in new lending business has been very subdued in the current house price cycle from 2009 to date. Lending growth only increased significantly over the summer months of last year – peaking at a year-on-year growth rate of 50%. The introduction of the Mortgage Credit Directive (MCD) in March of this year then depressed lending again. However, because this decline was mainly attributable to extensive measures taken by banks to adapt to the MCD, we are expecting a rapid recovery.

— The current real estate and macroeconomic environment remains benign. There is a high level of excess demand in the housing market and it has grown in recent years. Demand for credit is also growing at a correspondingly rapid pace. The supply of credit could be boosted by further monetary stimulus. We expect the bond-buying programme that currently ends in March 2017 to be extended.

— In the medium term, more buoyant lending is likely to increase interest rate risk. However, it will remain manageable if the following three conditions are met: repayment ratios are conservative, mortgage lending values are low and new business is such that it helps to create new housing. Nevertheless, if lending growth remains low, there will be increased risk of overvaluations and a house price bubble due to the high level of excess demand. This is particularly true when little new housing is financed and lending is largely for existing property.

Changes in loan book since 2009

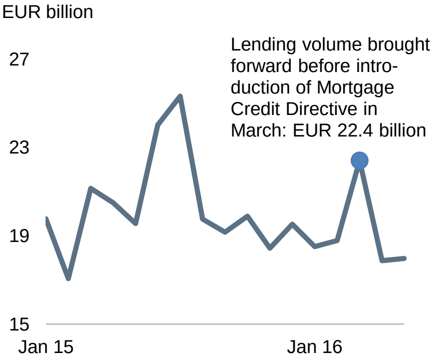
In the current house price cycle from 2009 to date, the German mortgage market has been dominated by the conservative behaviour of banks and borrowers. Despite prices surging by around 35% across Germany, the loan book has only grown slightly (by 5% when adjusted for inflation; by 12.5% nominally). The

cycle could even be described as credit-free until 2014, because the slight increase in new lending to that point was offset by higher repayment rates and inflation. The ratio of debt to GDP also reflects the weak level of lending growth. For example, the volume of mortgage lending relative to GDP fell from 47% in 2009 to less than 40% in 2016. Not until 2015 did strong growth in new lending result in a year-on-year rise of 3.5% in the volume of German mortgage loans.

High level of new lending growth in summer of 2015

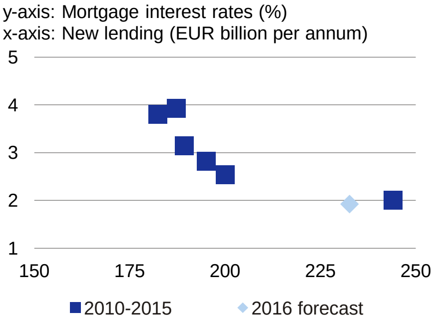
As mentioned above, new business rocketed last year – in some of the summer months it grew by a year-on-year rate of 50%. This trend was possibly driven by the fall in five and ten-year mortgage rates. The average mortgage rate fell to an all-time low of 1.6% in May 2016 from around 2% in 2015, which was about 0.5 percentage points lower than the average for 2014. The political uncertainty in Greece could also have been a further reason for the strong growth in lending. It might have resulted in a renewed flight to safety and prompted foreign capital flows into the German housing market, thereby also stimulating domestic lending. This is consistent with the particularly rapid rise in prices in the summer of 2015, which peaked at a year-on-year rate of 8%.

New lending per month 4



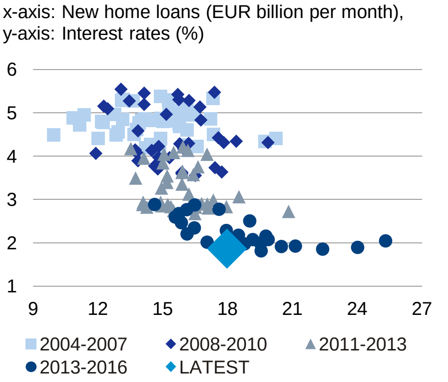
Sources: ECB, Deutsche Bank Research

Interest rates and new lending 5



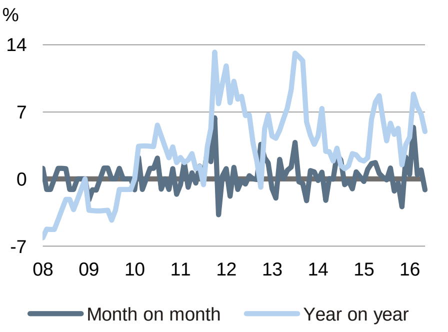
Sources: Bundesbank, Deutsche Bank Research

Rapid growth in new home loans 6



Sources: Bundesbank, Deutsche Bank Research

Monthly house price growth 7



Sources: Hypoport, Deutsche Bank Research

Mortgage Credit Directive curbs lending

The Mortgage Credit Directive (MCD), which came into force on March 21, 2016, initially led to lending throughout Germany being brought forward. As a result, new mortgage lending business rose to EUR 22.4 billion in March – an increase of 20% on February. By contrast, new business was much more muted in April and May and fell below EUR 18 billion, the lowest figure since early 2015. This sluggish trend is not surprising because the MCD is making it necessary to restructure lending procedures. The sales reforms requiring a certificate of competence for advisors, the separation of referrals, intermediaries who provide customer advice and intermediaries who do not, and extensive information obligations are likely to w the main burdens for now. However, some press reports are suggesting that there will be a permanent decline in lending[1], to older borrowers for example, although solutions within the scope of the new rules are likely to be found in many cases. It is merely a learning process that is required. The bank lending survey (BLS) in the first quarter made it possible to identify this development at an early stage as the survey participants were already expecting lending standards to be stricter in the second quarter. According to the BLS, these standards are also likely to take their toll in the third quarter, but we assume that the switch to the MCD will largely be completed during the second half of the year and new lending business will then start to recover again.

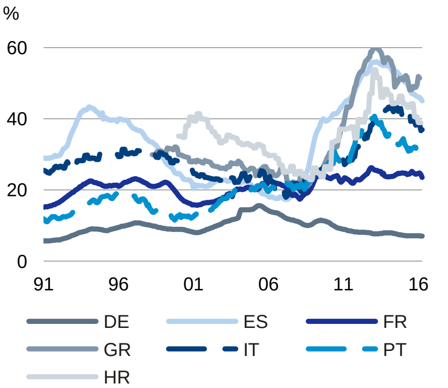
Arguments in favour of a recovery in new lending business

Firstly, the reduction in the ECB deposit rate to minus 0.4% in March of this year is likely to leave little scope for the ECB to make further rate cuts, given the current environment for banking and the financial markets. Secondly, the expansion of the ECB's bond-buying programme in June 2016, from EUR 60 billion to EUR 80 billion a month, has helped the yield curve for Bunds with terms of up to 15 years to slide into negative territory. Interest rates are likely to remain low, as we expect the bond-buying programme, which currently ends in March 2017, to be extended in the coming months. Thirdly, last summer's lending growth mentioned above already shows the extent of the non-linear response of new business to falling mortgage rates (chart 6). So far in 2016, the average mortgage interest rate for new business has again remained well below 2%, and stood at 1.6% in May. The lowest mortgage offer available, i.e. the best interest rate from Dr. Klein[2], regularly hits new lows and is currently 0.7% for a five-year fixed-interest period, a trend that may possibly revive lending business. Fourthly, as was the case last year during the Greek crisis, prices are again likely to be driven by moments of crisis this year, thus stimulating lending. At the turn of the year following the Fed's interest rate hike in December, global financial market volatility increased sharply, prompting a 5% month-on-month rise in German house prices in February (equivalent to a year-on-year rise of almost 9%). House prices then held steady until May (the last month observed). Given the renewed volatility in the financial markets following the vote in favour of Brexit, it would not be surprising if German house prices picked up again in June and July, particularly in and around Frankfurt. This plethora of reasons suggests to us that new lending will grow relatively rapidly. However, this recovery is only likely to become apparent during the second half of the year due to the current dampening effect of the MCD.

1 IW Köln (2016). "Wir sehen immer nur die Risiken".
2 See www.drklein.de.

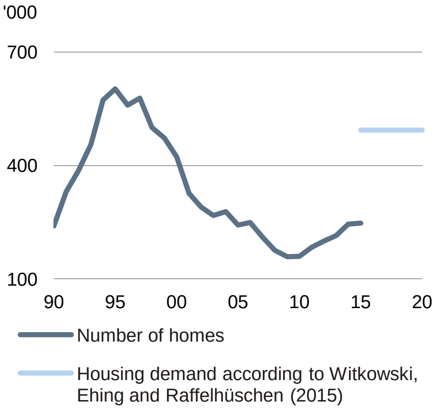
Impact on the loan book to 2020

Youth unemployment 8



Sources: Eurostat, Deutsche Bank Research

Building completions vs housing demand 9



Source: German Federal Statistical Office

New lending to finance new housing vs existing property 10

Sources: Bundesbank, Hypoport, Deutsche Bank Research

Although 247,700 homes were completed in 2015, there is much greater demand. As a result, excess demand is likely to have risen again and will probably take several years to disappear. Given the buoyancy of the economy, particularly the sharp rise in employment and the low unemployment rates, the migration of labour and refugees to Germany is likely to continue. Young workers in particular may well regard our youth unemployment rate of 7% as a promise of a better future. To put that into context, youth unemployment rates in Portugal, Italy, Croatia, Spain and Greece are between 30% and 50%, and even in France the rate of 23.5% is more than three times that in Germany. As a result, migration flows to Germany are likely to continue, with a further rise in demand for housing – some studies calculate that almost 500,000 homes need to be built every year.[3] Given that demand for loans is correspondingly high, the future trend in the lending volume and the associated macroprudential risks largely depend on bank lending. We believe it is useful to distinguish between three different scenarios.

(1) In the first scenario, the banks massively increase the supply of credit but mainly make loans for purchases of existing property. In this scenario, the excess demand in the housing market does not diminish. Price growth is fuelled by lending, further increasing the risk of overvaluations and then also the risk of house price bubbles towards the end of the decade. As a result, the macroprudential risks for the banks' loan books would also increase.

(2) In the second scenario, the banks remain risk averse and do not increase the supply of credit. Although this limits the risk in their loan books in the short term, it may create a catapult effect. Because the excess demand in the housing market is likely to rise further as a result, there will be a corresponding increase in pricing pressure and a sharp escalation in the risks of overvaluations and a house price bubble at the end of the decade.

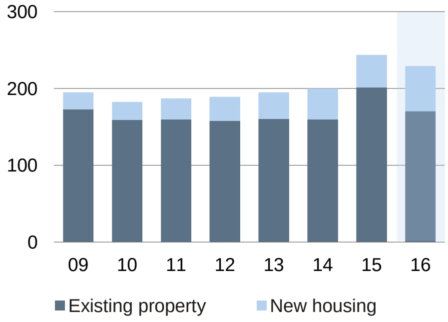
(3) In the third scenario, the banks help to kick-start house building by lending more, and thereby assist in reducing the excess demand in the housing market. There is less pressure on house prices and the risk of huge overvaluations falls. However, interest rate risk rises in this scenario, because years of low capital-market interest rates are gradually reducing the average mortgage interest rate in Germany's loan book. At the end of the decade, average mortgage interest rates could even fall below 2% from their current level of around 4–5%. Sharp rises in interest rates could then potentially bring about macroprudential risk.

These three scenarios describe the fundamental policy decisions faced by banks and regulators. From a macroprudential perspective, the most favourable scenario is probably the third, as heightened interest rate risk is fairly tolerable compared with the risks created by a house price bubble. This particularly applies to Germany because the bulk of loans that are granted have fixed interest rates and long maturities. The negative impact of heightened interest rate risk on banks' balance sheets can be mitigated by means of conservative minimum-repayment ratios and mortgage lending values. Banks and regulators should focus on financing new housing in order to reduce the pricing pressure in the housing market. In the current cycle, which is almost credit-free, this may be the most important macroprudential indicator, because financing new homes is the only way to bring down pricing pressure. By contrast, lending for purchases of existing property drives prices up. Official lending statistics could also be improved in this respect, as the monthly figures only show total new lending. According to our calculations, lending to finance new housing has gradually

[3] Witkowski, Ehing and Raffelhüschen (2016). Zur Wirkung der „Flüchtlingskrise" auf die langfristige Wohnimmobiliennachfrage in Deutschland.

New lending to finance new housing vs existing property 11

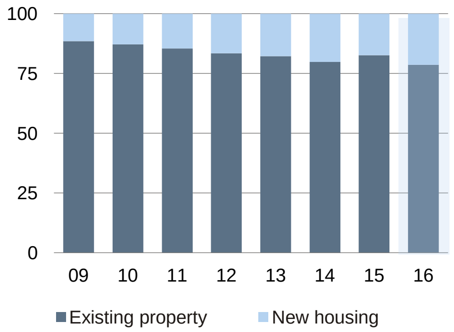
EUR billion



Sources: Bundesbank, Hypoport, Deutsche Bank Research

New lending to finance new housing vs existing property 12

%



Sources: Bundesbank, Hypoport, Deutsche Bank Research

increased in the current cycle and the total of more than EUR 40 billion in 2015 is double that of 2009, although it still only represents 20% of total new business (chart 12). The majority of loans continue to be for the financing of existing property and therefore tend to contribute to further price rises.

Summary

There are good reasons to expect more rapid growth in lending in the coming years. In the short term, expansionary monetary policy and capital flows towards safe havens, induced by the increased uncertainty, are likely to provide stimulus, although the introduction of the Mortgage Credit Directive (MCD) is exerting a temporary dampening effect. In the long term, i.e. in the coming years, the high level of excess demand in the housing market is likely to provide strong impetus for lending. The macroprudential risks this may create are likely to remain manageable even if prices continue to rise, particularly if the following three conditions are met: repayment ratios are conservative, mortgage lending values are low and new business is such that it helps to create new housing.

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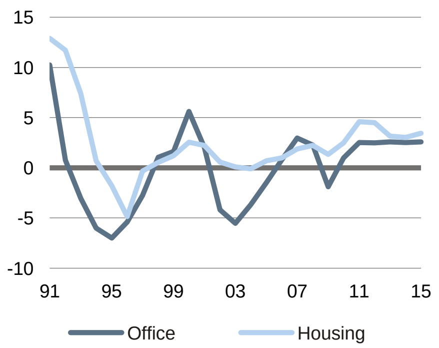
Housing market more attractive than the office market in the short term; prices and rents likely to converge in the long term

Germany, 1991–2015: Change in rental prices 1

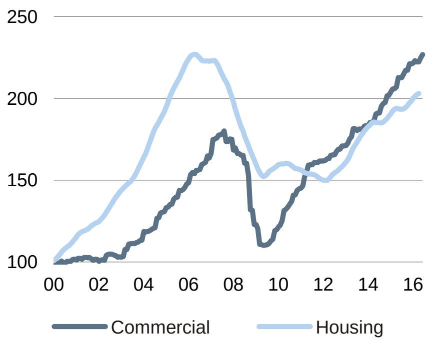
% yoy



Sources: Riwis, Deutsche Bank Research

US, 2000–2016: Real estate prices 2

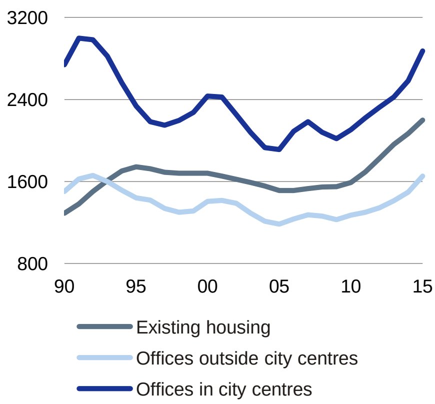
2000=100



Sources: GSA, Case&Shiller, Deutsche Bank Research

Germany, 1990–2015:
Office and housing prices 3

EUR per m²



Sources: Riwis, Deutsche Bank Research

— In the current real estate cycle from 2009 to date, residential rents have risen more strongly than office rents. The high level of excess demand in the housing market as well as the fairly high vacancy rate in the office market may explain this divergence, which is likely to persist in the near term.

— In the long term, however, residential and office rents are likely to follow a similar trend, because interacting factors in the two markets as well as substitution effects suggest the existence of a state of equilibrium. Given the high level of excess demand in the housing market and the fact that office buildings are being converted to residential buildings, office space is also likely to be in short supply in the coming years. As a result, rents in the office market can be expected to rise more strongly, and could – for a time – outstrip the rise in rents in the housing market.

— At present, housing rents in many German cities are higher than average office rents outside city centres, although office rents had mostly been more expensive since German reunification. They will probably come into line, largely as a result of sharper rises in office rents.

Interdependencies between housing and office markets

The global financial crisis in 2008 originated in the US housing market, but house prices were not the only prices to collapse in the US, those for office buildings followed suit after a certain time lag. Similarly sharp fluctuations were observed in both real estate markets in European countries. They do not only tend to follow parallel trends in times of crisis, the same also applies to normal economic and real estate cycles when the following interdependencies between housing and office markets can be observed:

— Long-term convergence of rent and price changes

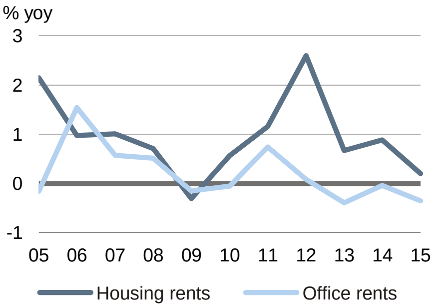
— Growth rates can diverge or even move in opposite directions in the short term

— Many regional and local factors – e.g. university towns

1. Reasons for long-term convergence

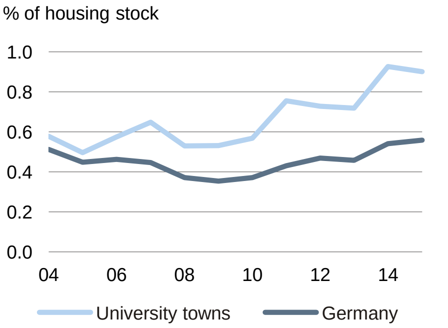
The main reasons for long-term convergence are common factors affecting both markets. In the current real estate cycle from 2009 to date, the macroeconomic environment, such as high employment and rising wages, has increased demand in both markets. The same applies to loan growth and borrowing conditions. The increased interest in real estate as an asset class shown by institutional investors, insurance companies and pension funds is likely to contribute to the similarity of expected risk-adjusted returns, and therefore of rent and price changes, in the housing and office markets. The economic policy environment and the general regulatory principles currently adopted are also helping the two markets to synchronise. In addition to common factors, substitution effects are also contributing to the long-term convergence of the markets. In the current cycle, many municipal authorities have created additional housing by converting commercial property, resulting in lower vacancy rates in the office market due to the strong demand for housing. At present, the shortage of building land is probably one of the most important price drivers for both markets. The incentive to develop unused building land for maximum profit is

18 university towns vs. Germany: Difference in rental movements 4



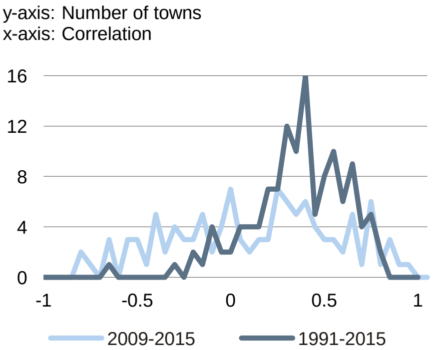
Sources: Riwis, Deutsche Bank Research

18 university towns vs. Germany: New homes completed 5



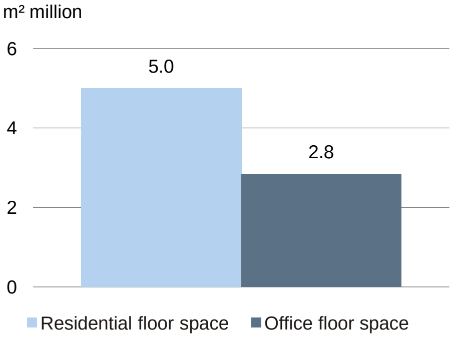
Sources: BulwienGesa, Deutsche Bank Research

Histogram: Correlation between housing and office rents 6



Sources: BulwienGesa, Deutsche Bank Research

New building, 2015: Residential vs office floor space 7



Sources: German Federal Statistical Office, Deutsche Bank Research

boosting supply in the more expensive market and lessening pressure on prices, which is contributing to the long term convergence of the markets. Finally, construction itself produces substitution effects, because the manpower and machinery that are building homes are not building offices. Common factors and substitution effects tend to require many years to approach an equilibrium. This is partly due to the large number of regulatory and legislative interventions, primarily in the housing market. Even before the introduction of the rent cap, rent controls based on the average local rent had curbed rent rises in the housing market.

2. Reasons for short-term divergence

The arguments in favour of long-term convergence are countered by a series of short-term factors. Inelastic supply, which is typical for all real estate markets, almost inevitably leads to cyclical divergence when there are temporary differences in the level of demand for office space and housing. For example, migrants with low education levels initially create more demand for housing than for offices because they are only available to the labour market after a long period of training. As a result, housing rents rise more strongly than office rents until the supply of housing exceeds demand after a few years, and the pressure on rents abates. At the same time, the migrants' skill levels are potentially higher, which increases demand for office space. It is then possible for the growth in rental prices in the office market to outstrip the growth in rental prices in the housing market, and for the short-term divergences to diminish or even reverse.

3. Many regional and local factors

Over and above their shared characteristics and the general differences between the two markets, features specific to particular regions and cities can arise in the residential and office real estate markets. After German reunification, for example, features of this type were observed in many east German towns and cities. From 1991 to 2015, there were 13 towns and cities with a negative correlation, i.e. a long-term divergence, between housing and office rents (chart 6). This is partly attributable to special factors following reunification. Rents in the east German housing market rose sharply, with annual increases of 5% in Dresden, Greifswald and Leipzig and as much as 6% in Potsdam between 1991 and 2015. Because rents had been very low in eastern Germany, transitional arrangements were made so as to prevent even higher rent rises. At the same time, office rents fell almost without interruption due to high vacancy rates resulting from the demise of east German industry and the state subsidised building boom. Across Germany as a whole, the average correlation between housing and office rents was well above zero (mean: 0.4) from 1991 to 2015, based on 126 towns and cities (bulwiengesa). As expected, it is lower (0.12) in the current cycle from 2009 to date, which reflects the fact that growth in the housing market is currently strong and growth in the office market is relatively weak.

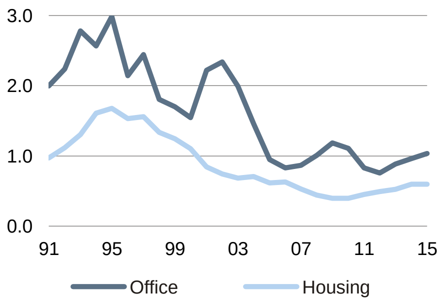
Recent example of local factors: university towns

In recent years, an unusual situation – caused by the high demand for housing resulting from years in which there were double the usual number of school leavers – has also been observed in university towns[4]. As a result, the annual

[4] We include Marburg, Tübingen, Erlangen, Würzburg, Göttingen, Darmstadt, Passau, Jena, Regensburg, Aachen, Greifswald, Konstanz, Mainz, Siegen, Trier, Bamberg, Bayreuth in these towns and cities because they all have a ratio of students to total population that is greater than 18%.

Germany: New building ratios 8

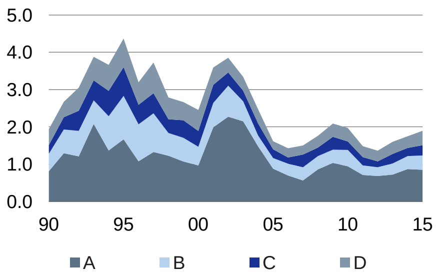
% of existing stock



Sources: Riwis, Deutsche Bank Research

A-, B-, C-, D-cities: New office space 9

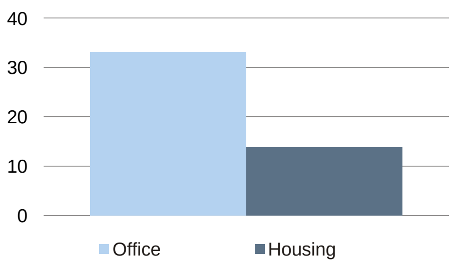
m² million



Sources: Riwis, Deutsche Bank Research

New building, 2015: Significance of A-cities 10

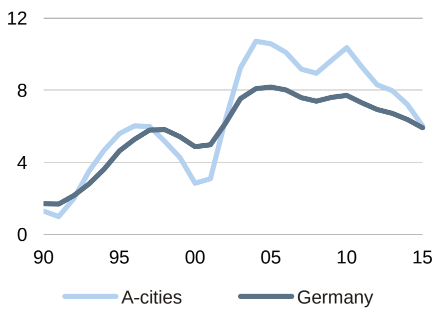
% of Germany as a whole



Sources: Riwis, German Federal Statistical Office, Deutsche Bank Research

Office vacancy rates 11

%



Sources: Riwis, Deutsche Bank Research

influx in these towns rose by 50% (the average for 2011–2014 was 180,000 per annum compared with 115,000 per annum for 1990–2010) and the number of university entrants grew by more than 35% per annum (the average for 2011–2013 was 82,300 per annum compared with 60,700 per annum for 2000–2010). Consequently, there was a disproportionately high increase in housing rents in university towns compared with Germany as a whole. In the period 2011 to 2014, the average rise of 5¼% per annum in university towns was higher than the rate for Germany as a whole (4¼% per annum). In 2015, the number of school leavers normalized again and so did demand. As expected, demand for office space was virtually unaffected by these developments and office rents in university towns remained in line with the German average (chart 4). The upward pressure on housing rents in university towns was also short-lived due to brisk construction activity, with 0.8% of their housing stock having been completed each year since 2010, compared with the German average of 0.5%. In university towns, conversion projects also met the strong demand for housing.

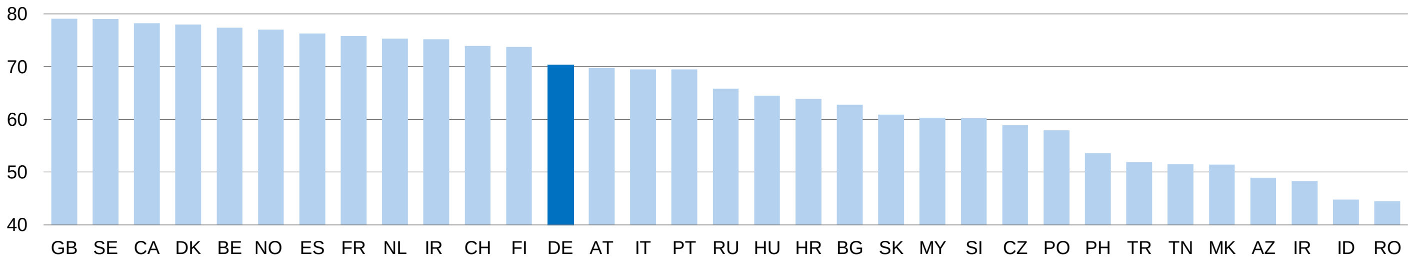
Comparison of supply in office and housing markets

Statistics since German reunification (charts 7 to 11) reveal that the creation of office space and housing has the following characteristics. Firstly, construction of new housing significantly exceeds that of office space in absolute terms. In 2015, for example, the total floor area built for housing in Germany was 5.0 million square metres compared with 2.8 million square metres for office space. Secondly, significantly more new office space has been built when viewed as a percentage of existing stock. In 2015, the proportion of office space was around 1%, compared with just 0.6% of housing. As a rule of thumb, around twice as much office space as housing is completed every year, when expressed as a percentage of existing stock. The difference is partly explained by the fact that offices have a shorter life span and tenants have specific requirements, but misplaced incentives and miscalculations following reunification also created an excess supply. Thirdly, the shorter life span of offices also explains why they are more sensitive to economic conditions. The supply of newly created offices increased rapidly both after reunification and in the late 1990s, while house building responded much more slowly to economic changes. Fourthly, new office space tends to be created in cities, while new housing is largely built in rural areas and small towns. In 2015, around one third of office space was completed in the A-cities (Berlin, Düsseldorf, Frankfurt am Main, Hamburg, Cologne, Munich and Stuttgart) and more than 45% was completed in the B-, C-, and D-cities. By contrast, over two thirds of residential construction took place in relatively small towns and in the countryside, while only around 15% of annual housing starts in Germany were in the A-cities, and a combined total of around 20% in the B-, C- and D-cities. This regional distribution also reflects the inelastic housing supply, because the proportion of German housing starts attributable to the 126 most important towns and cities (A-, B-, C- and D-cities) has only risen slightly in recent years, despite rocketing prices.

Owing to the high level of excess demand and very low vacancy rates in the housing market (the CBRE vacancies index for Germany as a whole stood at 3% in 2014 while it was well below 1% in many cities), office buildings in many cities have been converted and re-used as housing. Because of this, and due to rather subdued construction activity in the office market, office vacancy rates are declining. At the beginning of the cycle, office vacancy rates were around 10% in the A cities and 8% in Germany as a whole. In 2015, office vacancy rates were around 6% in both the A-cities and in Germany as a whole. If the real estate cycle continues for another few years, office vacancy rates are likely to fall below the base vacancy rate (which practitioners often put at 5%), triggering significant demand for new builds. However, this is likely to be distributed

Employment in service sector 12

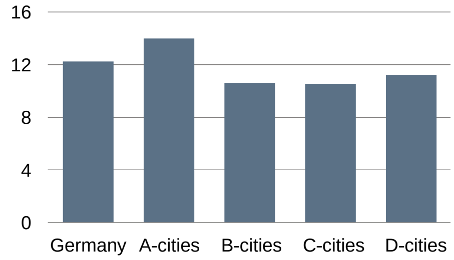
% of total workforce



Sources: World Bank, Deutsche Bank Research

Employees paying social security contributions in Germany and A-, B-, C- and D-cities, 2009–2015 13

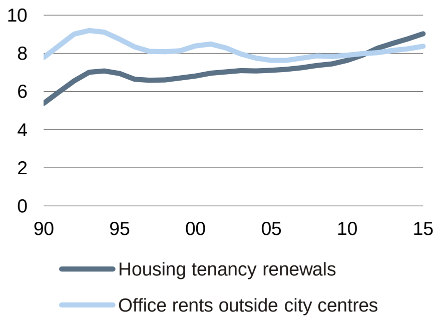
%, change since 2009



Sources: Riwis, Deutsche Bank Research

Western Germany: Average rents 14

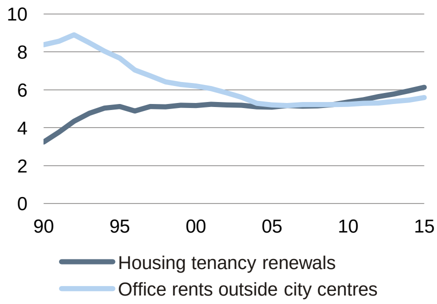
EUR per m²



Sources: Riwis, Deutsche Bank Research

Eastern Germany: Average rents 15

EUR per m²



Sources: Riwis, Deutsche Bank Research

unevenly across regions, because vacancy rates in Berlin, Munich and Stuttgart are well below 5%, but they are still in double figures in Frankfurt. The primary reasons for this are overcapacity in the urban periphery and the falling number of bank employees since the financial crisis.

Demand for office space likely to pick up

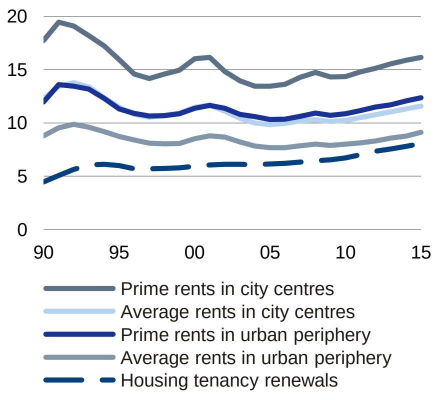
The vote in favour of Brexit may well increase demand for office space, primarily in and around Frankfurt, thereby helping to reduce overcapacity. There is likely to be a shortage of supply throughout Germany in the future, also because overall demand for office space is continuing to pick up. In many towns and cities, the number of people in employment has risen sharply during the current cycle from 2009 to 2015. The employment growth rate in the major cities has been particularly high (14%) and has outstripped the growth rate for Germany as a whole (12%), a trend that is continuing in 2016. In May, the number of people in employment was up by 1.3% year on year (rising to 43.5 million) and the number of people in employment paying social security contributions was up by 2.2% (to 31.3 million). The strong domestic economy is likely to result in a disproportionately strong increase in the number of office workers. Because Germany's service sector is smaller than that of other countries, there could be catch-up effects. Only 70% of those employed in Germany work in the service sector, while the ratio in its neighbouring countries of Belgium, France and the Netherlands is 75% and in the UK it is almost 80%.

Equilibrium between housing and office markets

The reasons for a long-term convergence between office and housing markets mentioned above imply the existence of an equilibrium, i.e. a long-term link between potential returns, whereby investors are indifferent to which of the two markets they invest in. Extensive analysis of such an equilibrium would require longer time series for rents and prices incorporating several cycles, as well as risk-adjusted return trends and explanatory variables. For the sake of simplicity, we only compare rents in this article. The best comparisons for housing and office markets are provided by rents when renewing tenancies in the housing market and average office rents outside city centres. Charts 14 and 15 show that office rents were far higher than housing rents in 1990. While office rents were around EUR 2 per square metre higher than housing rents in western Germany, the difference in the east was twice as much. Office and housing rents subsequently converged in both east and west. The convergence was driven by the tendency for housing rents to rise and the fact that most office rents remained static or declined. In view of the initially disappointing performance of the east German economy, the construction boom in the 1990s created a huge surplus of office space, thus limiting the scope for rent rises. In the current cycle, housing rents have risen at a faster pace than office rents, so

Germany, 1990–2015: Office rents 16

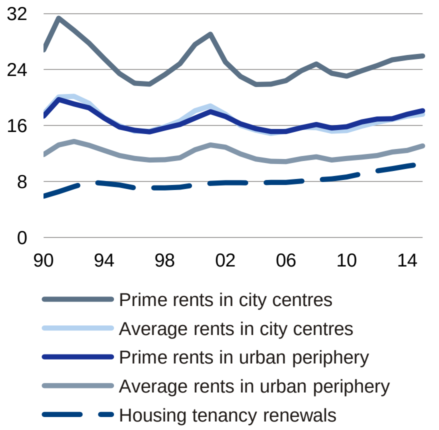
EUR per m²



Sources: Riwis, Deutsche Bank Research

A-cities, 1990–2015: Office rents 17

EUR per m²



Sources: Riwis, Deutsche Bank Research

housing rents are now almost 10% higher than office rents in both eastern and western Germany. The high level of excess demand in the housing market and the oversupply in the office market are now likely to result in further divergence – i.e. housing rents growing more strongly than office rents. In the coming years, however, the office market could start to recover as office space becomes more scarce. Lower vacancy rates in the office market have already accelerated rental growth. In 2016, average office rents outside city centres were up by 4% year on year, the sharpest increase since 2000. Based on historical trends and the growth rates described, the equilibrium rents in both the housing and the office markets are likely to be at a similar level.

Comparison of different office markets and urban locations

The statements we have made about average office rents outside city centres are likely to be equally applicable to other urban locations. The RIWIS (Regional Property Market Information System) database produced by bulwiengesa includes average and prime rents outside city centres as well as average and prime rents for city-centre locations. A close correlation for all four time series can be identified throughout Germany. From 1990 to 2015, the correlations among them were higher than 0.8 and they were between 0.6 and 0.7 for tenancy renewals in the housing market. Prime rents in city-centre locations were an exception, although their correlation of 0.5 with housing rents is still considerable. Very similar correlations also emerge when housing and office markets in the A-cities are compared. Consequently, our statements about the long-term convergence of office and housing rents are probably valid for different urban locations.

Summary

Owing to high demand, housing rents have risen fairly rapidly in recent years, while the high level of overcapacity has depressed the increase in rents in the office market. However, vacancy rates in the office market in many towns and cities have declined as a result of the strong economic situation as well as conversions and change of use. Consequently, if vacancy rates continue to decline, growth in office rents is likely to be much more rapid in several years' time than it is today, and it could then outstrip growth in housing rents.

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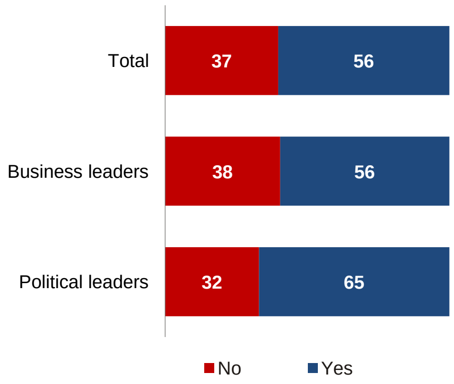
The view from Berlin

Chancellor Merkel: Troubleshooter and moderator

Should the EU deprive Britain of all the benefits of EU membership? 1

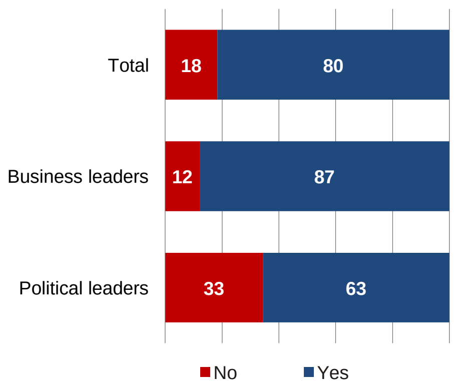
%



Source: Frankfurter Allgemeine Zeitung, 20 July 2016

Does the EU have to be comprehensively reformed to prevent further exits? 2

%



Source: Frankfurter Allgemeine Zeitung, 20 July 2016

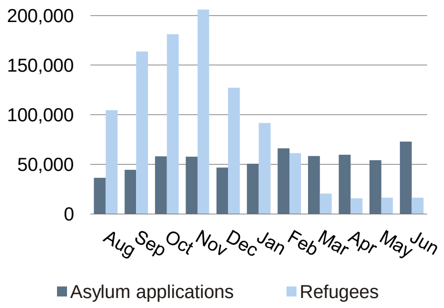
Chancellor Merkel's term has been dominated by crisis management ever since she assumed office in November 2005 – starting with the financial crisis and its fallout on Europe that merged into the euro area debt crisis with the bailout of Greece, the Russia-Ukraine conflict, the refugee and migration problems and, most recently, Brexit and its challenge to the European integration project. The economic and political stability of Germany over the last few years has allowed Merkel to focus on these challenges, which often required leadership and moderation of differing interests in Europe (and at home) at the same time.

Managing the UK's departure from the EU will have top priority for the time being. The first visit abroad by the new British prime minister Theresa May was to see Merkel in Berlin, followed by a meeting with French president Hollande in Paris. While the atmosphere was said to be constructive and Merkel was ready to concede May sufficient time to sort out the British negotiation stance, she indicated that her patience was limited and putting member states and business in limbo should be in no-one's interest. Merkel also re-emphasised that there will be no formal or informal negotiations before Art. 50 TEU has been triggered and that constraints on free movement of labour would mean less access to the single market. PM May underlined that the British people expected control of the movement of labour and that the major goal was to achieve the right deal in trade in goods and services for the UK.

The first sign of the UK scaling back its role in EU affairs as it prepares for leaving is its decision to relinquish its upcoming six-month EU presidency in H2 2017. It is expected that the EU will shift its schedule of rotating EU presidencies and bring forward the Estonian presidency from H1 2018 to fill in for the second half of 2017. The role of holding the presidency has become somewhat less important since the EU created a permanent president of the European Council (currently Donald Tusk). However, the rotating presidency can play a crucial role in setting the agenda and chairing the ministers' meeting. The change in schedule means that in these demanding times the EU is now set to have five consecutive presidencies (starting H1 2017) held by (relatively) inexperienced EU member states (Malta, Estonia, Bulgaria, Austria and Romania). It is the first time for all of them except Austria, which stands out for previous experience.

The chancellor's constructive approach to Brexit negotiations is based on Germany's interest in upholding the strong trade and investment ties with the UK and helped by the fact that Merkel is not under comparable levels of domestic anti-EU sentiment as Hollande. Actually, the position of the euro-sceptic AfD party has weakened across all polls whereas support for Germany's EU membership has risen further post-UK referendum with 78% of those surveyed wanting to see Germany remain a member. This is notwithstanding the fact that a majority also sees the need for broader reforms to make EU politics sustainable and regrets the UK leaving. However, this environment is unlikely to mean the German government will be particularly lenient in the upcoming talks as it feels responsible for constructing a joint bargaining position among the EU-27, implying that more hawkish stances of other EU members need to be respected. Thus, while the Berlin-Paris axis has gained additional importance as a result of the UK vote, it would be misleading to proclaim Germany as the EU's one and only power centre as some foreign observers do. Separately, a survey among decision-makers in business, politics and administration (by the Allensbach Institute for the FAZ) shows that even a majority in business thinks that the UK ought to be deprived of the benefits of

Asylum applications & registered refugees in the EASY system* 3

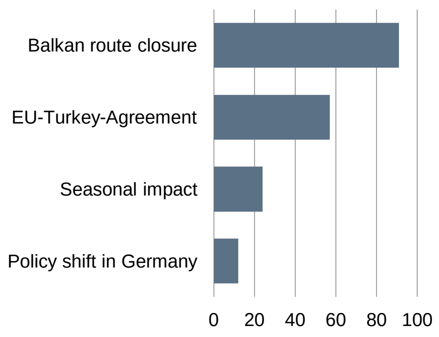


* Preliminary registrations that may include double count

Sources: BAMF, Eurostat

German business and political leaders' views on the refugee crisis 4

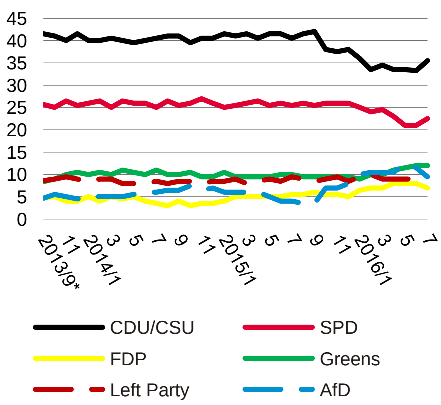
Question: What was the decisive factor for the decline in the refugee influx? % of those asked



Source: F.A.Z.-Capital-Elite-Panel, IfD Allensbach

German parties' popularity 5

Results of the Allensbach survey, %



* Result of the Federal election

Source: IfD Allensbach

EU membership (see chart). Given that the UK is the third largest export market for Germany it is quite surprising that only 15% of the business leaders surveyed expect Brexit to have a strong negative impact on the German economy while 58% thought that for the British economy.

During preparations for the complex Brexit negotiations the refugee issue is likely to return to the political agenda soon. The failed coup attempt in Turkey has fuelled concerns on the side of the EU over the sustainability of the EU-Turkey Agreement on refugees and migration – an agreement hammered out on Merkel's initiative and representing an important pillar of the EU's migration strategy. The influx of refugees to Europe and thus Germany has markedly decreased in recent months. The monthly influx to Germany peaked last November (200,000) and has been levelling out since April at around 16,000. The downturn of the arrivals in Greece has been even more pronounced. In the past four weeks from 14 June until 11 July (the agreement took effect on April 4, 2016) only about 1,700 refugees arrived in Greece. In May 2016 the UNHCR recorded nearly the same figure. This is an enormous downturn compared to last autumn when the numbers peaked at 212,000 in October. However, opinions diverge on what measure taken since the beginning of this year made the decisive impact – not only in political circles but also among decision-makers in business. According to the above-mentioned survey 91% of German business leaders regard the border closures along the Balkan routes as *the* reason for the turnaround, while still a majority of 57% of the managers think that the agreement triggered the decline in refugee numbers. Just 12% see it as a result of the German government's swing towards a more restrictive asylum policy.

The managers also reject with 59% the major component of the agreement, visa-free travel for Turkish citizens in Europe. And we believe that the likelihood of its implementation has decreased already. Since Turkey was not able to meet the preconditions for liberalisation by end-June, the EU postponed the targeted deadline until October. Amongst these preconditions the EU's call for Turkey's clear commitment to the principles of the rule of (democratic) law and especially a reform of the Turkish anti-terror legislation rank high, but we believe Turkey's complying with these pledges has become even more unlikely in the current political environment. Thus, the prospect of Brussels granting visa-free travel for Turkish citizens seems even further away, putting another question mark behind the success of the agreement. The German managers, too, voice doubts about the agreement's prospects and 63% subsequently expect an increase in the refugee influx. The EU, meanwhile, has adopted a moderate wait-and-see stance towards the failed coup attempt in Turkey as the statement by the EU foreign ministers' meeting from last week indicates. Turkey's position as a candidate for EU membership has not been questioned fundamentally by EU politicians and German senior officials but any progress in the accession talks is unlikely to occur soon.

With the European agenda loaded with sensitive topics like the Brexit management, a possible resurgence of the refugee challenge and the political risk around the constitutional reform referendum in Italy, the German domestic policy agenda is being pushed back. However, positioning for the 2017 federal elections is already under way and will gather speed towards year-end. A string of recent polls show that Merkel has largely recovered from the drop in her popularity at the start of the year and that her conservative party is stabilising. The violent attacks in the recent days, though, pose political risks for Merkel and might support the AfD which has weakened over the last months due to its infighting. Thus, Merkel is likely to focus her attention on domestic topics as much as on European ones in the upcoming months.

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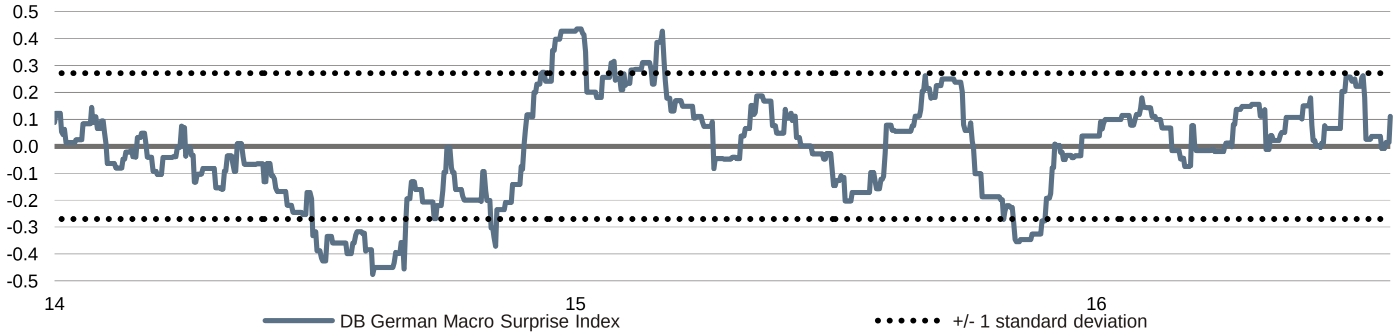
DB German Macro Surprise Index

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.[5]

DB German Macro Surprise Index

Average of last 20 z-scores of data surprises



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

Sources: Bloomberg Finance LP, Deutsche Bank Research

Last 20 published economic data for Germany

Bloomberg Tickers	Indicator	Reporting month	Publication date	Current value	Bloomberg consensus	Surprise	Standardised surprise	Quantile rank
GRIPIMOM Index	Industrial production (% mom)	4 2016	07.06.16	0.5	0.7	-0.2	-0.1	0.5
GRCAEU Index	Current Account Balance (EUR bn)	4 2016	09.06.16	28.4	21.0	7.4	1.8	1.0
GRCP20YY Index	CPI (% yoy)	5 2016	10.06.16	0.1	0.1	0.0	0.3	0.3
GRZEWI Index	ZEW Survey Expectations	6 2016	21.06.16	19.2	4.8	14.4	1.7	0.9
GRZECURR Index	ZEW Survey Current Situation	6 2016	21.06.16	54.5	53.0	1.5	0.1	0.5
GRIFPBUS Index	IFO Business Climate	6 2016	24.06.16	108.7	107.4	1.3	0.9	0.8
GRIMP95Y Index	Import Price Index (% yoy)	5 2016	28.06.16	-5.5	-5.8	0.3	0.6	0.8
GRUECHNG Index	Unemployment Change (000's mom)	6 2016	30.06.16	-6.0	-5.0	1.0	-0.2	0.4
GRFRIAMM Index	Retail Sales (% mom)	5 2016	30.06.16	0.7	0.6	0.1	0.4	0.7
MPMIDEMA Index	Markit Manufacturing PMI	6 2016	01.07.16	54.5	54.4	0.1	0.1	0.5
MPMIDESA Index	Markit Services PMI	6 2016	05.07.16	53.7	53.2	0.5	0.6	0.7
GRIORTMM Index	Factory Orders (% mom)	5 2016	06.07.16	0.0	1.0	-1.0	-0.5	0.3
GRIPIMOM Index	Industrial production (% mom)	5 2016	07.07.16	-1.3	0.1	-1.4	-1.1	0.1
GRCAEU Index	Current Account Balance (EUR bn)	5 2016	08.07.16	17.5	24.6	-7.1	-2.5	0.0
GRCP20YY Index	CPI (% yoy)	6 2016	12.07.16	0.3	0.3	0.0	0.3	0.3
GRZECURR Index	ZEW Survey Current Situation	7 2016	19.07.16	49.8	51.8	-2.0	-0.4	0.3
GRZEWI Index	ZEW Survey Expectations	7 2016	19.07.16	-6.8	9.0	-15.8	-1.9	0.0
MPMIDEMA Index	Markit Manufacturing PMI	7 2016	22.07.16	53.7	53.4	0.3	0.3	0.7
MPMIDESA Index	Markit Services PMI	7 2016	22.07.16	54.6	53.2	1.4	1.5	0.9
GRIFPBUS Index	IFO Business Climate	7 2016	25.07.16	108.3	107.5	0.8	0.5	0.7

Sources: Bloomberg Finance LP, Deutsche Bank Research

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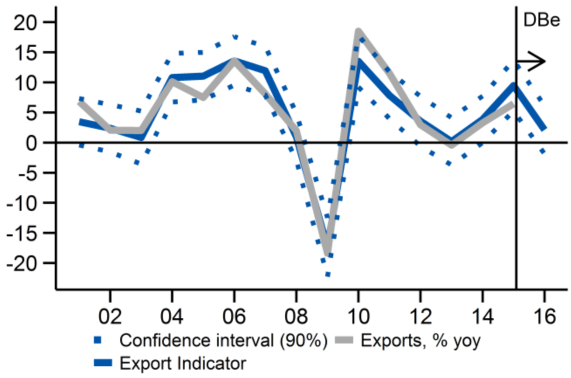
[5] See for details Focus Germany. August 4, 2014.

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

The Export Indicator identifies the effects on German exports of changes in global demand on the one hand, and currency movements on the other (price impact).[6]

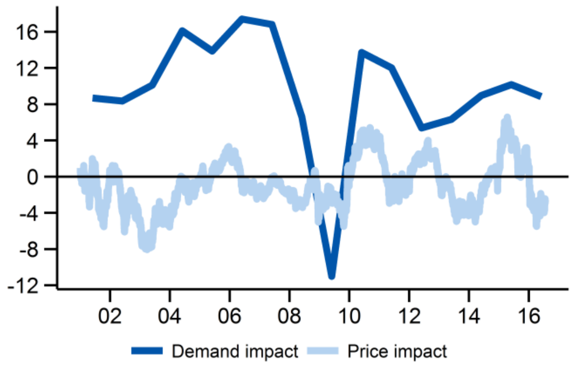
Export Indicator points to weaker export growth in 2016

% yoy



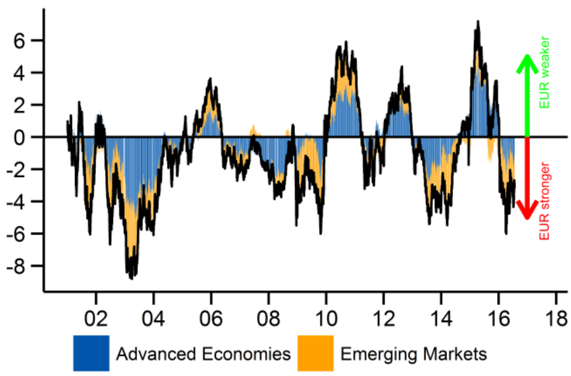
Demand and price impact weaker in 2016

% yoy



Price impact turns distinctly negative in 2016

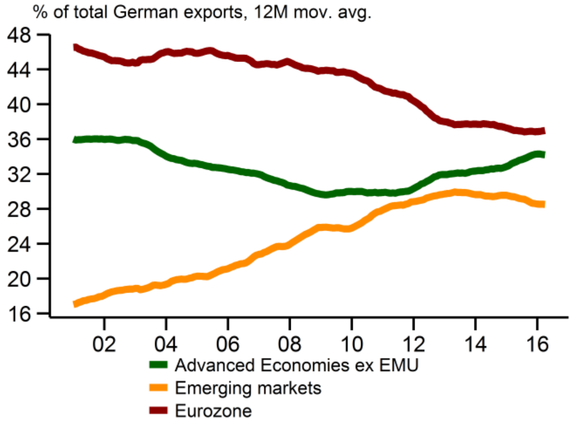
% yoy



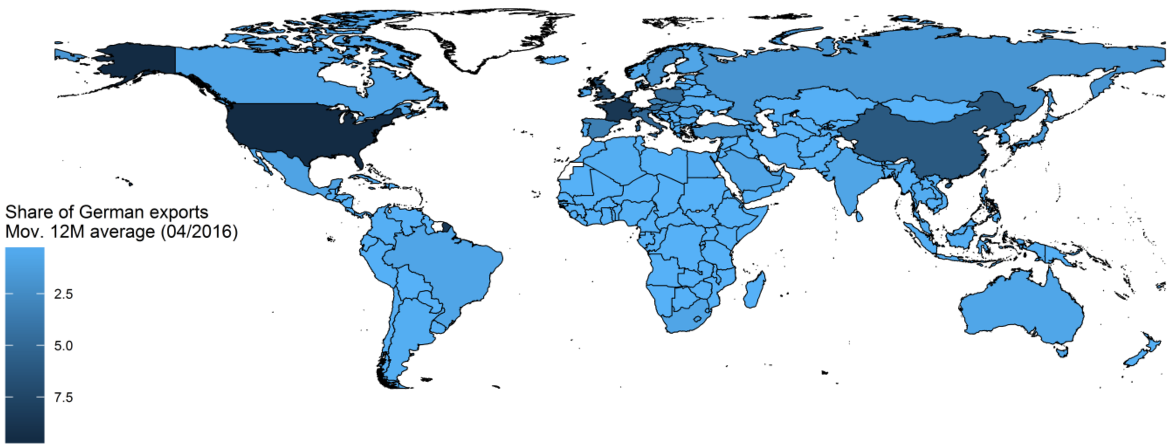
Weighed EUR yoy change using German export destination shares

Importance of Non-EMU advanced economies strongly up

% of total German exports, 12M mov. avg.



German exports focus on Europe, the USA and China



Sources: Eurostat - Comext, Deutsche Bank Research

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

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

Date	Event	Remarks
Until 4 Sep	German Bundestag	Parliamentary summer break
4 Sep	State elections in Mecklenburg-West Pomerania	In the state currently run by a SPD-CDU government a neck-and-neck race between both parties is likely. However, it is open whether they will be able to form a coalition again, given the AfD's strength.
4-5 Sep	G20 Head of States and Governments Summit, Hangzhou (China)	Among others debates on strategies for economic growth such as innovative growth (e.g. digital economy), structural reforms, global trade growth, principles for global investment policies and on deepening the reform of the international financial architecture.
8 Sep	ECB Governing Council meeting, press conference	The tone at the July ECB meeting suggests the door is open to further monetary policy easing. A deposit rate cut would not be appropriate given the pressures on banks. However, ECB confidence in QE continues. In September we expect a 9-12 month extension of QE plus complementary measures to ensure sufficient eligible assets.
9-10 Sep	Eurogroup and ECOFIN, Brussels	Greece – state of play, quality of public finances – spending reviews, preparation of the G7 meeting, including a discussion of exchange rate developments, among others.
16 Sep	(Informal) European Council, Bratislava	Discussions on the future of the EU, consequences of the British EU referendum.
18 Sep	State elections in Berlin	Surveys indicate that the SPD-CDU coalition is likely to lose its majority. A strong AfD result could make it difficult to establish a new government as three parties might have to join forces.
10-11 Oct	Eurogroup and ECOFIN, Brussels	Financial & macroeconomic stability developments in the euro area, thematic discussion on growth and jobs: Health- and long-term care.
20 Oct	ECB Governing Council meeting, press conference	Review of the monetary policy stance.
20-21 Oct	European Council, Brussels	Poss. migration crisis – state of the implementation of the EU-Turkey Agreement among others, outcome of the British EU referendum.

Source: Deutsche Bank Research

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Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
28 Jul 2016	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	July	0.3 (0.4)	0.1 (0.3)
28 Jul 2016	10:00	Unemployment rate (%, sa)	July	6.1	6.1
29 Jul 2016	8:00	Retail sales (Index, sa), pch mom	June	-0.5	0.7
5 Aug 2016	8:00	New orders manufacturing (Index, sa), pch mom	June	-0.5	0.0
8 Aug 2016	8:00	Industrial production (Index, sa), pch mom	June	1.0	-1.3
9 Aug 2016	8:00	Trade balance (EUR bn, sa)	June	22.0	22.2
9 Aug 2016	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	June	0.1 (-0.9)	-1.9 (-1.8)
9 Aug 2016	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	June	0.3 (-1.7)	0.1 (-2.3)
12 Aug 2016	8:00	Real GDP (Index, sa), % qoq	Q2 2016	0.1	0.7
23 Aug 2016	9:30	Manufacturing PMI (Flash)	August	53.0	53.7
23 Aug 2016	9:30	Services PMI (Flash)	August	54.0	54.6
25 Aug 2016	10:30	ifo business climate (Index, sa)	August	107.5	108.3
30 Aug 2016	8:00	Import prices (Index, sa) pch mom (yoy)	July	0.0 (-3.9)	0.5 (-4.6)

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

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German data monitor

	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Feb 2016	Mar 2016	Apr 2016	May 2016	Jun 2016	Jul 2016
Business surveys and output											
Aggregate											
Ifo business climate	108.4	108.7	106.7	107.7		105.8	106.8	106.7	107.8	108.7	108.3
Ifo business expectations	102.7	104.3	100.5	101.8		99.0	100.2	100.5	101.7	103.1	102.2
Industry											
Ifo manufacturing	103.1	103.3	100.5	101.8		99.5	100.4	100.9	101.6	103.0	102.4
Headline IP (% pop)	-0.1	-0.4	1.8			-0.6	-1.1	0.5	-1.3		
Orders (% pop)	-2.0	0.6	0.8			-0.8	2.6	-1.9	0.0		
Capacity Utilisation	84.3	84.4	85.1	84.4	84.7						
Construction											
Output (% pop)	-0.6	3.5	1.4			4.4	-5.1	-3.7	-0.3		
Orders (% pop)	0.7	10.2	6.3			-1.9	-0.2	-0.9	3.5		
Ifo construction	121.4	123.3	122.5	124.5		122.9	122.4	123.1	124.9	125.6	126.0
Consumer demand											
EC consumer survey	-0.3	-4.4	-6.1	-3.2		-6.4	-6.2	-4.8	-3.2	-1.6	
Retail sales (% pop)	0.6	0.2	0.4			0.1	-1.1	0.0	0.7		
New car reg. (% yoy)	6.1	5.7	4.5	9.4		12.1	0.0	8.4	11.9	8.3	
Foreign sector											
Foreign orders (% pop)	-3.8	0.2	2.1			-2.1	4.4	-4.3	1.4		
Exports (% pop)	-1.0	-0.6	0.4			1.3	2.1	0.1	-1.9		
Imports (% pop)	0.9	-0.8	-0.2			0.1	-2.5	-0.3	0.1		
Net trade (sa EUR bn)	60.3	60.6	62.1			19.8	23.8	24.1	22.2		
Labour market											
Unemployment rate (%)	6.4	6.3	6.2	6.1		6.2	6.2	6.2	6.1	6.1	
Change in unemployment (k)	-3.3	-24.3	-39.3	-30.3		-10.0	-2.0	-17.0	-10.0	-6.0	
Employment (% yoy)	0.9	1.0	1.3			1.3	1.2	1.3	1.3		
Ifo employment barometer	108.1	109.7	108.4	108.2		108.0	107.5	108.3	108.3	108.0	
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	0.0	0.2	0.1	0.0		-0.2	0.1	-0.3	0.0	0.2	
Core HICP (% yoy)	1.0	1.2	1.1	1.0		0.8	1.3	0.7	1.1	1.2	
Harmonised PPI (% yoy)	-1.7	-2.3	-2.8	-2.6		-3.0	-3.1	-3.1	-2.7	-2.2	
Commodities, ex. Energy (% yoy)	-8.7	-12.6	-14.6	-6.5		-15.8	-11.2	-8.5	-6.9	-3.9	
Oil price (USD)	51.3	44.8	35.1	46.9		33.6	39.8	43.2	47.7	49.9	
Inflation expectations											
EC household survey	4.9	4.0	5.3	3.6		5.4	4.3	3.0	1.9	5.9	
EC industrial survey	0.8	1.5	-2.4	1.7		-2.9	-3.5	-0.5	2.4	3.2	
Unit labour cost (% yoy)											
Unit labour cost	1.7	1.5	2.1								
Compensation	2.7	2.5	2.4								
Hourly labour costs	2.6	1.4	3.2								
Money (% yoy)											
M3	8.2	9.2	7.8			8.2	7.8	7.1	7.2		
M3 trend (3m cma)						8.3	7.7	7.3			
Credit - private	2.5	2.7	2.0			2.3	2.0	2.5	2.7		
Credit - public	11.1	11.7	-9.1			4.6	-9.1	-5.0	1.4		

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

Financial forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	0.375	-0.10	0.00	0.50	-0.75	-0.50	0.05	0.50	1.50	0.90	0.05
Sep 16	0.375	-0.20	0.00	0.10	-0.75	-0.50	0.05	0.25	1.50	0.90	0.05
Dec 16	0.625	-0.20	0.00	0.10	-0.75	-0.50	0.05	0.25	1.50	0.90	0.05
Mar 17	0.625	-0.20	0.00	0.10	-0.75	-0.50	0.05	0.25	1.50	0.90	0.05
3M interest rates, %											
Current	0.65	0.06	-0.30	0.56							
Sep 16	0.58	0.05	-0.30	0.24							
Dec 16	0.83	0.05	-0.30	0.24							
Mar 17	0.83	0.05	-0.35	0.24							
10J government bonds yields, %											
Current	1.55	-0.22	-0.12	0.83							
Sep 16	1.25	-0.15	-0.10	0.90							
Dec 16	1.25	-0.15	0.00	1.00							
Mar 17	1.25	-0.10	0.10	1.05							
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	1.10	104.40	0.84	0.76	1.09	9.28	7.44	9.44	4.36	313.16	27.02
Sep 16	1.08	97.00	0.88	1.23	1.10	9.24	7.46	9.20	4.34	318.08	27.10
Dec 16	1.05	94.00	0.91	1.15	1.12	8.90	7.46	9.00	4.30	320.00	27.10
Mar 17	1.01	94.00	0.88	1.15	1.16	8.80	7.46	8.94	4.23	321.25	27.10

Sources: Bloomberg, Deutsche Bank

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