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German exporters facing strong headwind despite softer euro

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German exporters facing strong headwind despite softer euro. The combination of the structural global trade slowdown, increased localization of production, demographic changes in Germany, the impact of recent economic policy decisions and further toughening of international competition are likely to be a considerable challenge over the medium term. Thus, the domestic economy will play a bigger role again. We see this as a natural reaction of an economy to changes in the (global) business environment. Government policies can help ease the transition. German exporters could become even more globally active firms over the medium term. The specific reactions will vary by sector, though. The earnings generated by these firms around the globe are likely to be a blessing for an aging and more domestically driven economy in the decades ahead.

2015 marked by domestic strength and volatile H1. Thanks to improving sentiment, the impetus from lower oil prices and government giveaways to real incomes and the lower EUR to exports German GDP should rise by 2% in 2015. Growth should be broad-based but strongly tilted towards private consumption. Compared to our last forecast we primarily changed the quarterly profile. We now expect that construction investment will be pulled forward into Q1 due to the mild winter pushing Q1 GDP growth to a strong 0.8% qoq. In Q2 negative payback for this is likely to bring growth to 0.2% – just like last year's pattern.

Germany: Government sets course for higher investment with new budget. The government's supplementary budget for the Federal government for 2015, the draft budget for 2016 and the medium-term planning until 2019 includes as a primary policy measure a substantial increase of public (infrastructure) investment. Until 2019 this amounts to EUR 13.5 bn in part by providing co-financing to municipalities. This goes a long way toward plugging the investment needs we had previously identified, should help in the talks with the EU Commission about Germany's large current account surplus and could be a modest plus for intra-EMU-re-balancing.

The view from Berlin. The mood of the German public towards Greece has changed. Now, a majority is in favour of Greece exiting the euro area, with the figures resembling polls from end-2011. While Berlin wants to keep Greece in the euro and Chancellor Merkel is conciliatory in her rhetoric, the German government is deferring to the Eurogroup as the decision maker. However, not only the broader public but also members of Merkel's conservative CDU/CSU are venting discontent about Greek politics. A potential new bail-out package might become an uphill struggle in the conservative part of the coalition.

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
Euroland	0.9	1.4	1.6	0.4	0.0	1.4	2.4	3.3	2.6	-2.5	-2.1	-1.7
Germany	1.6	2.0	1.7	0.9	0.0	1.5	7.6	8.3	8.2	0.6	0.6	0.7
France	0.4	1.1	1.6	0.6	0.1	1.1	-1.0	-0.5	-0.8	-4.4	-4.0	-3.4
Italy	-0.4	0.6	1.3	0.2	0.1	1.1	1.8	2.5	2.7	-3.0	-2.7	-2.2
Spain	1.4	2.5	2.3	-0.2	-0.6	1.5	0.1	0.7	0.5	-5.6	-4.5	-3.7
Netherlands	0.8	1.7	1.1	0.3	0.0	1.3	10.9	11.4	11.5	-2.5	-2.0	-1.9
Belgium	1.0	1.3	1.6	0.5	0.2	1.6	1.0	1.5	1.2	-3.0	-2.7	-2.2
Austria	0.3	1.2	1.8	1.5	0.7	1.7	0.7	1.2	1.5	-2.3	-1.6	-1.2
Finland	-0.1	0.8	1.4	1.2	0.1	1.3	-1.9	-1.5	-1.3	-3.4	-3.3	-2.8
Greece	0.7	0.8	3.2	-1.4	-1.6	1.0	1.0	1.5	1.2	-3.5	-0.7	-0.7
Portugal	0.9	1.6	1.6	-0.2	0.1	1.3	0.5	1.0	0.7	-5.0	-3.1	-2.5
Ireland	4.8	3.7	3.5	0.3	0.1	1.8	4.5	5.0	4.5	-4.0	-2.8	-2.5
UK	2.6	2.4	2.3	1.5	0.4	1.9	-5.3	-4.1	-2.9	-5.0	-4.0	-2.0
Denmark	1.0	1.7	1.8	0.6	1.0	1.5	6.2	6.0	6.0	-1.0	-2.5	-2.5
Norway	2.3	2.0	2.2	2.0	2.0	2.0	8.5	8.0	7.5	9.1	9.0	8.5
Sweden	2.3	2.8	2.8	-0.2	0.5	1.5	6.3	5.5	5.0	-1.9	-1.2	-0.6
Switzerland	2.0	1.0	1.0	0.0	-0.8	-0.4	8.0	8.5	8.5	0.2	0.5	0.5
Czech Republic	2.0	2.6	2.5	0.4	0.3	1.9	-1.0	-0.8	-0.6	-1.3	-2.1	-2.2
Hungary	3.6	2.7	2.4	-0.2	-0.3	2.5	3.6	3.5	3.5	-2.9	-2.7	-2.4
Poland	3.3	3.4	3.5	0.0	-0.4	1.5	-1.3	-1.3	-1.5	-3.4	-2.9	-2.7
United States	2.4	3.3	3.1	1.6	0.6	2.6	-2.6	-2.8	-3.5	-2.9	-2.6	-2.9
Japan	0.0	0.9	1.8	2.7	0.7	0.9	0.6	3.5	3.4	-5.9	-5.3	-4.4
China	7.4	7.0	6.7	2.0	1.8	2.7	3.1	3.4	3.3	-2.1	-3.0	-3.0
World	3.4	3.4	3.7	3.7	3.3	3.7						

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

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

						2014				2015			
	2012	2013	2014	2015F	2016F	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F
Real GDP	0.4	0.1	1.6	2.0	1.7	0.8	-0.1	0.1	0.7	0.8	0.2	0.4	0.3
Private consumption	0.7	0.8	1.2	2.3	1.0	0.6	0.0	0.8	0.8	0.6	0.5	0.4	0.3
Gov't expenditure	1.2	0.7	1.1	1.0	0.4	0.1	0.6	0.6	0.2	0.1	0.2	0.3	0.2
Fixed investment	-0.7	-0.6	3.4	2.7	1.7	3.0	-1.7	-1.2	1.2	3.1	-2.0	1.0	0.6
Investment in M&E	-3.1	-2.4	4.3	3.9	3.5	2.0	0.6	-1.4	0.4	2.0	0.0	2.0	1.0
Construction	0.6	-0.1	3.6	3.1	1.1	4.5	-3.7	-1.5	2.1	5.0	-4.0	0.7	0.6
Inventories, pp	-1.4	0.2	-0.4	-0.3	0.1	-0.1	0.1	-0.5	-0.2	0.0	0.1	0.1	0.0
Exports	2.8	1.6	3.9	4.4	5.1	-0.4	1.0	2.0	1.3	-0.2	1.3	1.0	1.2
Imports	0.0	3.1	3.4	4.5	4.5	-0.3	1.2	1.3	1.0	0.3	1.2	1.5	1.5
Net exports, pp	1.3	-0.5	0.4	0.3	0.6	-0.1	0.0	0.4	0.2	-0.2	0.1	-0.1	-0.1
Consumer prices*	2.0	1.5	0.9	0.0	1.5	1.2	1.1	0.8	0.5	-0.3	-0.1	0.1	0.5
Unemployment rate, %	6.8	6.9	6.7	6.5	6.6	6.8	6.7	6.7	6.6	6.5	6.4	6.4	6.6
Industrial production	-0.4	0.1	1.5	1.8	1.8								
Budget balance, % GDP	0.1	0.1	0.6	0.6	0.7								
Public debt, % GDP	79.0	76.9	73.3	69.3	65.8								
Balance on current account, % GDP	6.8	6.5	7.6	8.3	8.2								
Balance on current account, EUR bn	187	182	220	250	255								

*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

German exporters facing strong headwind despite softer euro

— The German manufacturing sector is excellently placed and is highly competitive on the international stage. However, the combination of the structurally slower growth in world trade and the insufficient progress made with its liberalisation, increasing localisation of production by German manufacturers, demographic change in Germany (stronger wage pressure), the deterioration in the policymaking environment in Germany and continually intensifying international competition is likely to pose a major challenge to German exporters in the medium term at the latest.

— The structural headwind can in any case only be subdued via domestic economic policy. Recently, however, an additional strong headwind has in fact been generated. We have criticised the German government's economic policy in recent years on many occasions.

— At the sector level there have been mixed responses by companies to growing globalisation. The automotive industry has aggressively pursued a two-pronged strategy comprising modernisation of its domestic factories and export expansion, on the one hand, and vastly increasing production outside Germany, on the other. The mechanical engineering sector continued to have a relatively high share of domestic value added. In the electrical engineering sector there was a shift towards capital goods. The chemicals industry is the only one of the traditional export sectors where there has been a constant decline in the real capital stock in Germany of late. The reluctance to invest has probably been mainly due to high energy prices and uncertainty about the future direction of energy policy.

— The domestic economy is likely to play a larger role again in future. This need not be a big deal, although such a policy is likely to cause concern among some politicians and the general public. Rather, this is the natural reaction of an economy to a changing economic and political environment.

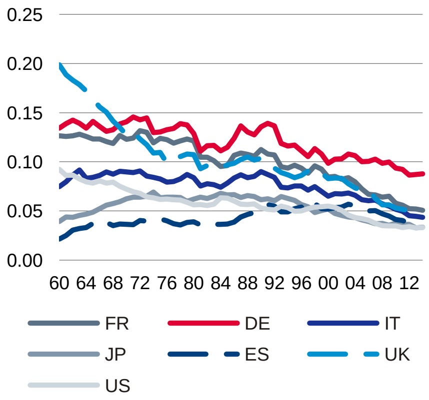
— Appropriate measures should be taken to counteract the serious headwind, so that the basically good situation for export-intensive German firms is not needlessly undermined. Although it is unlikely that politicians will cancel their big “flagship projects”, this makes it all the more important not to further escalate the situation and to maintain the flexibility that still exists in the labour market, for instance. It is also important to bolster the entire education system even further. German companies would also receive an additional boost from a successful conclusion of the ongoing trade agreement negotiations (above all TTIP).

— The German export sector has successfully faced up to global challenges again and again. To take the sting out of the demographic challenges employee productivity could be boosted by increasing the level of automation. More targeted immigration, longer working lives and higher female participation rates could increase the size of the potential labour force.

— Companies are likely to continue extending their global value chains and foreign manufacturing operations. In the medium term this could prompt German exporters to become even more global. The resulting profit streams could become a blessing for an ageing and more domestically oriented German economy in the coming decades.

Gemany's world trade share: High and comparatively stable 1

Per capita share in world trade, % per 1m population



Sources: European Commission (AMECO), Deutsche Bank Research

Good current position provides scope for adjustment

The global economy is a highly dynamic system that is constantly changing. Over the last 20 to 30 years globalisation has been driven by the integration of numerous emerging markets – especially China and India as well as the Eastern European economies – into the global economy, as well as by the far-reaching advances in information and communication technologies (ICT), which enabled global value chains to be established. In this environment the highly export-dependent German manufacturing sector positioned itself excellently in the 2000s. The German export sector managed to hold its own despite the challenging developments since the onset of the global economic crisis and the subsequent euro crisis, which hit Germany particularly hard because of its extensive trade links with the currency area.

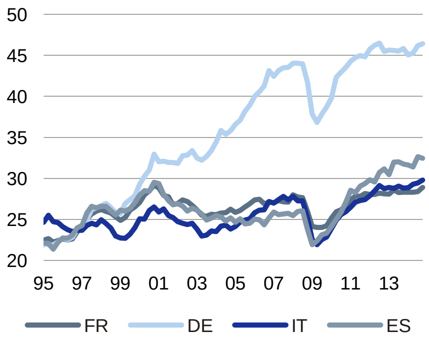
Admittedly, Germany's share of world trade has fallen from over 11% in the early 1990s to just over 7% in 2014. However, this is nevertheless remarkable compared to other developed economies and given the rise of Asia and in particular China. If we also factor in the comparatively weak domestic population development, it becomes even clearer how strongly the German export business differs from that of the other major developed economies: the share of global trade of a German is roughly twice as high (see chart 1) as in other industrialised nations.

Within Germany, too, the export business is prominent. Based on the manufacturing sector, the share of total value added since the mid-1990s has remained steady at around 22%. In the eurozone the share has fallen from over 20% to nearly 16%. The German manufacturing segment generates roughly 50% of its revenues directly with foreign customers. However, the indirect export share is much higher due to close supply links within the industry and because of the recourse to domestic service companies. This is highlighted by the fact that the export dependency ratio of German GDP is 27% and that about 25% of German employment is reliant on exports.[1]

However, the combination of the structurally slower growth in world trade and the insufficient progress made with its liberalisation, increasing localisation of production by German manufacturers, demographic change in Germany (stronger wage pressure), the deterioration in the policymaking environment in Germany and continually intensifying international competition is likely to pose a major challenge to German exporters in the medium term at the latest. The excellent position that German manufacturers find themselves in does provide scope for the companies themselves to implement adjustment measures. This of course also applies to German policymakers. Their latest big reform projects – the pensions package and labour market initiatives – are steps in the wrong direction, however. How strongly and via which channels German exporters might at all be hit by these altered policy conditions and which adjustment strategy they choose depends on many factors.

German economy has opened up much more than other large EMU economies 2

% GDP (nominal)



Sources: Eurostat, Deutsche Bank Research

German export industry is different

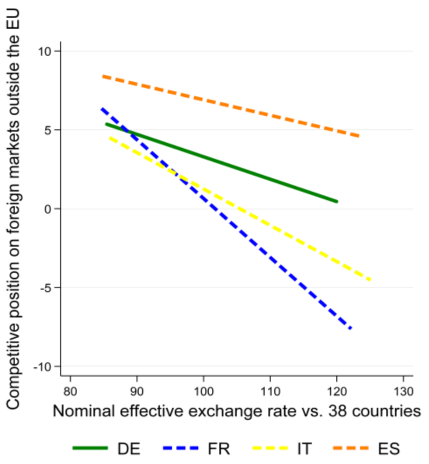
Since the early 1990s German companies have been more active than their counterparts in other developed economies in exploiting the opportunities provided by the developments in ICT and the opening-up of Eastern Europe. They have rapidly built up global value chains in order to cut costs by utilising economies of scale and comparative advantages. Furthermore, they have constructed production facilities abroad in order to satisfy local demand better by tapping local (frequently cheaper) production factors and country-specific expertise, which has also boosted their local brand perception and was partly

[1] See Globalisation Indicators of the Federal Statistical Office. Data refers to 2010.

also required for regulatory reasons. Moreover, they benefited from the aspiring emerging economies wanting precisely those capital goods in which German manufacturers had a strong market position.

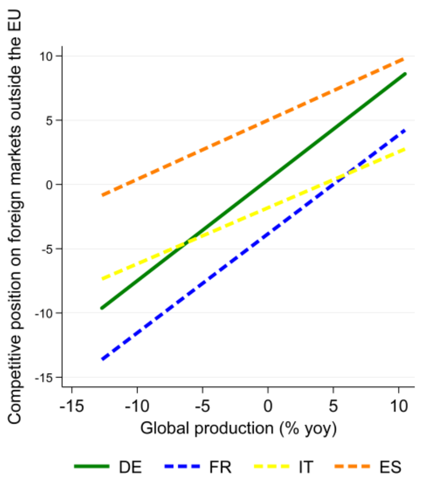
The resulting sharp increase in German exports led to the openness of the German economy rising constantly. At 45% it is much higher than that of other large developed economies (OECD countries less then 30%). The excellent positioning of German firms ensured that the weak demand from the eurozone since the beginning of the sovereign debt crisis was more than cancelled out by the rise in exports to third countries. In the meantime some 65% of exports are supplied to countries outside the eurozone, 10 percentage points higher than at the end of the 1990s.

German competitiveness less dependent on effective exchange rate ... 3



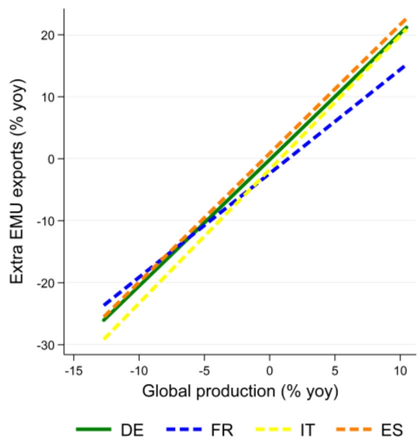
Sources: European Commission, ECB, Deutsche Bank Research

… and more on global production 4



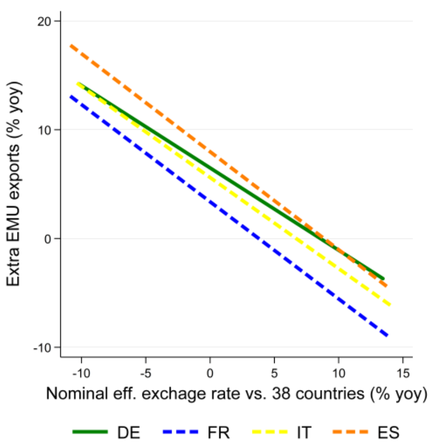
Sources: European Commission, CPB, Deutsche Bank Research

German extra-EMU exports depend relatively heavily on global production … 5



Sources: Eurostat, CPB, Deutsche Bank Research

… but less so on the effective exchange rate 6



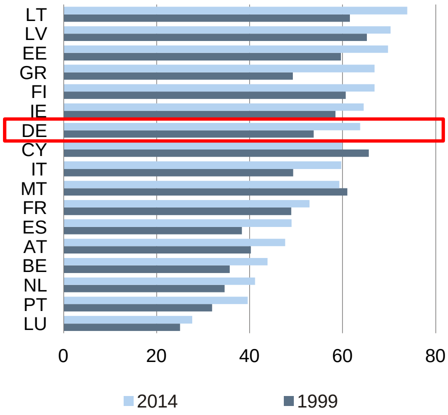
Sources: Eurostat, ECB, Deutsche Bank Research

The high level of openness means that the German economy benefits more than other countries during good times from the global economy, but in turn when there is a downturn it is hit much harder – as shown by the 18% slump in German exports in the crisis year 2009. The moderate global upturn expected during the course of 2015 is likely to be more beneficial for German exporters than for their counterparts in the other major eurozone nations (France, Italy and Spain), as investment demand rises again when the economy picks up and the interconnectedness of the manufacturing sector means the production of intermediate goods is also likely to accelerate. The shares of exports constituted by capital goods and intermediate goods in Germany are relatively high at 45% and 31% respectively.

The major importance of often customer-specific capital goods for German exports relieves the price pressure on many companies in international competition. The demand for special machinery or premium cars is less price elastic than with standardised consumer goods. Exchange rate shifts are thus less relevant in this segment, especially as there are often no substitute products for many German export products – at least in the short term. Evidence of this is provided by the self-assessment of companies that participate in the quarterly “European Commission Business and Consumer Surveys” for the manufacturing sector and are questioned about their “competitive situation in the last 3 months outside the EU”. In Germany there is a much weaker correlation between companies' assessment of the competitive situation and the

Importance of extra-EMU exports rose strongly 7

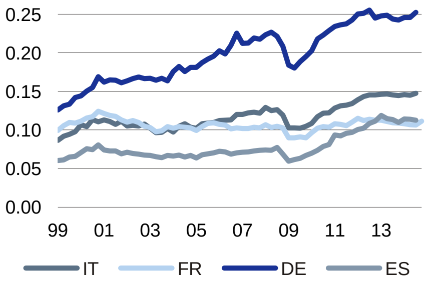
% of total exports



Sources: Eurostat, Deutsche Bank Research

Extra-EMU exports have relatively strong influence on German GDP growth 8

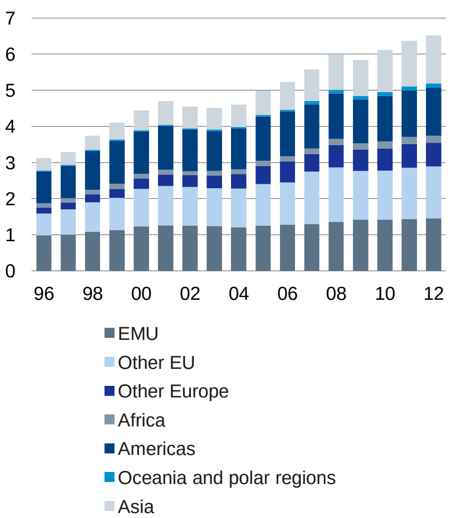
Impact of a 1% increase in extra-EMU exports on GDP growth, pp



Sources: Eurostat, Deutsche Bank Research

Employment in foreign subsidiaries of German companies 9

No of people (million)



Source: Deutsche Bundesbank

exchange rate level. This is also the case in Spain. In France and Italy, however, the correlation is much stronger.[2]

The correlation between the competitive situation and global output, by contrast, is much stronger in Germany than in other major eurozone nations. This shows the reliance of German exports on the spread of globalisation, which accompanied strong growth in global trade.

We also find that the correlation between the change in exports to countries outside the eurozone and global production is stronger than in the other major eurozone countries and the correlation with the nominal exchange rate is weaker.

The lesser significance of the exchange rate is probably also a reflection of the fact that many German firms (especially those in the automotive industry) were particularly active in setting up global value chains and expanding local manufacturing. German firms are thus used to responding to exchange-rate-driven “disruptions” to their complex production structures spanning numerous countries and are constantly optimising them.[3] The import share of German exports in 2010 was 43.4%.[4]

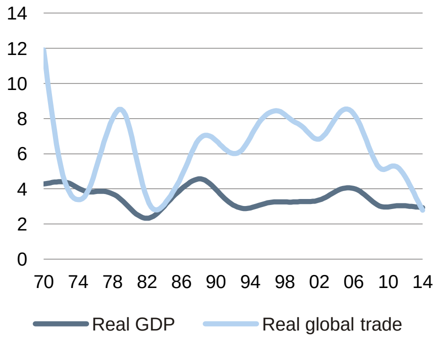
Structural changes dampen foreign demand

Given the major significance of exports the structural changes that we expect in world trade and which we outline below are – all things being equal – likely to impact negatively on German exports. True, world trade did recover relatively strongly straight after 2009. Since 2012, however, global trade has been anaemic and in contrast to the development during the past decades it has grown even slower than global GDP. The less dynamic growth since 2012 points towards structural changes that hit German exports in particular: the expansion of global value chains has lost momentum of late and may even have reached a plateau for the time being. China will be less of a catalyst for world trade than in previous years because of its stronger domestic focus. And the negotiations on new major trade agreements are proving increasingly problematic – especially with respect to the removal of non-tariff trade restrictions and agreement on international standards. Since the mid-1990s there has been fragmentation with respect to trade agreements because of the logjam in international negotiations at the WTO level. As a result the number of regional trade agreements (RTAs), which are always only a second-best solution, has risen rapidly. At present the focus is on mega-RTAs between the US and the EU (Transatlantic Trade and Investment Partnership – TTIP) and in the Asian region (Trans-Pacific Partnership – TPP). If TTIP is implemented in full it should give the German export business a fresh boost. If, by contrast, agreement on the Asian TPP is reached first, then Germany will – as a third country – probably be negatively impacted by the agreement's diversionary effect on trade. The EU's negotiations with, for instance, India and a number of ASEAN nations are progressing only slowly. In addition, the G20 nations have approved partly new restrictive trade measures. Global trade growth should therefore be relatively modest in the next few years, too, especially compared with the dynamism of the pre-crisis years.[5]

[2] See also Focus Europe, January 25, 2013, Deutsche Bank Research.
[3] Global value chains secure competitive advantages for German companies. Deutsche Bank Research. Focus Germany, July 1, 2013.
[4] See Globalisation Indicators of the Federal Statistical Office.
[5] Structural downshift in global trade burdens growth outlook. Deutsche Bank Research. Focus Germany. December 2, 2014. Similar arguments are also made by the IMF: Constantinescu, C. (2015). The Global Trade Slowdown: Cyclical or Structural? IMF Working Paper. January 2015.

Global trade no longer growing faster than global GDP 10

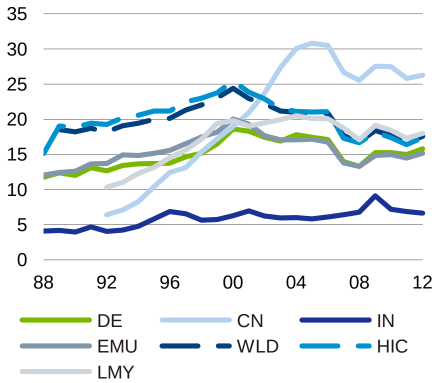
Trend, % yoy, quarterly numbers, HP-filtered



Sources: Deutsche Bank Research, IWF-IFS

China quickly climbing up the value chain 11

High-technology exports, % of manufactured exports

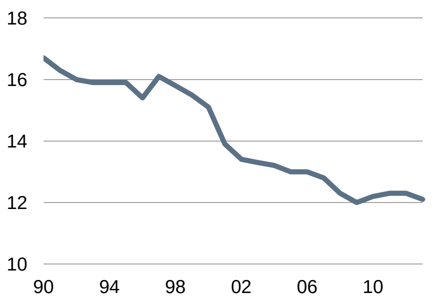


WLD = World, HIC = High income countries, LMY = Low–medium income countries

Sources: World Bank, Deutsche Bank Research

Manufacturing in the US: Downside trend stopped 13

Manufacturing as % of GDP



Source: Bureau of Economic Analysis

German export growth is, however, heavily dependent on high volume growth in world trade. As shown above, this dependency is much more pronounced than in other countries. That is why a lasting loss of momentum, which we expect to set in, would bring with it a clear headwind for the German export sector. At the EU level efforts need to be made to liberalise world trade further. This would make it easier for companies from Germany to open up markets that will grow faster than Europe in the coming years. If we consider for example that German exports to Denmark with its 5.6 million inhabitants were nearly twice as high in 2014 as those to India (with more than 1.2 billion inhabitants), then this makes clear the huge potential that lies in such countries which currently often still protect their markets via tariffs and other measures and are barely tapped by the German export industry.

The competition never sleeps

In future the international competition for German companies will intensify further. The large emerging markets will step up their efforts to climb the value chains. In this respect China's development is impressive; its share of high-tech goods has risen from 6% in the early 1990s to 25% in the meantime. In the manufacturing sector the share of global exports climbed to 17.5%, whereas in 1980 it was still less than 1%. China's entry into the WTO at the end of 2001 was a key driver. There is also the integration of the second-tier emerging markets (e.g. Thailand, Indonesia, Malaysia, the Philippines and Vietnam) into the global economy, which in the Asia region is frequently driven by production ties with Japan or China.

China increased global trade share esp. in manufacturing 12

% of world exports (2013)	1980	1990	2000	2013
Agricultural products				
China	1.5	2.4	3.0	4.0
Extra-EU			10.0	10.0
US	17.0	14.3	13.0	10.1
Manufacturing				
China	0.8	1.9	4.7	17.5
Extra-EU			14.1	15.0
US	13.0	12.1	13.8	9.5
Automotive products				
China	0.0	0.1	0.3	3.4
Extra-EU			12.2	18.7
US	11.9	10.2	11.7	10.0

Source: WTO, International Trade Statistics 2014

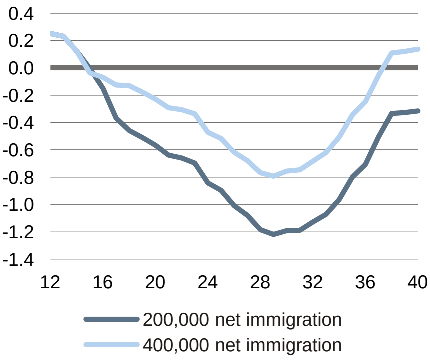
Competition from the US is likely to increase due to a possible reindustrialisation resulting from low energy costs. The sharp decline in energy costs triggered by the fracking boom led to a shift in cost ratios partly in favour of domestic production (see below in section on the chemicals industry). Installing the facilities that had previously been completely relocated abroad is however a complex challenge, as the skilled personnel required would have to be trained and the necessary expert knowledge would have to be reacquired, having partly been lost when the full relocation took place. Nevertheless it is apparent that the manufacturing share of the US economy is no longer declining and many global firms – not only from energy-intensive sectors – are investing more in the US once again.

In the eurozone the environment is set to remain difficult over the next few years, too, and demand is likely to be dampened because of deleveraging in the private and public sector. In the medium term the companies in other eurozone countries might nevertheless benefit from a resurgence of their home markets and the (hoped-for) improvement in the overall environment as a consequence of supply-side structural reforms. For instance Spain, which was comparatively active in implementing reforms, is currently exporting 15% more than its pre-crisis high in real terms – as is the case with German exports. This is due in no small measure to the fact that the lead which Germany enjoys on unit wage costs, for example relative to Spain, has fallen for some time. The competition for German firms is thus set to intensify again (at least moderately) also in the eurozone, even though many German companies themselves are represented with production facilities in the countries concerned. As such, the increasing competitiveness in some eurozone nations could intensify the intra-group competition between individual facilities.

Demography and the good cyclical situation generate wage pressure

Working-age population shrinking fast 14

Population, 15-65 years, % yoy



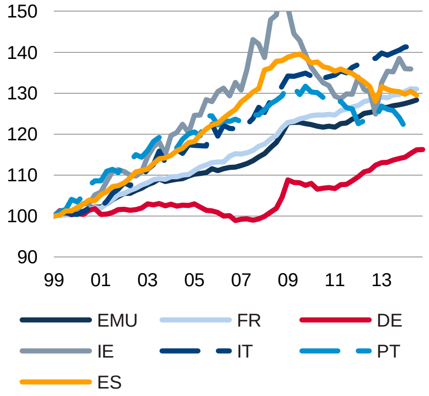
Sources: Federal Statistical Office, Deutsche Bank

Furthermore, demographic change in Germany will yield increasingly negative outcomes in the coming years. True, the recently high net migration to Germany is most welcome.[6] It is probably temporary in part, however, and can at best dampen demographic change and especially the decline in the working-age population at best. But even if there is average net migration of 200,000 people per year and a huge increase in participation rates (higher labour participation by women, older people and ethnic minorities) to the average of the three developed economies with the highest rates, this will not be sufficient to offset the negative demographic effect over the long term.[7] This will not only hold back domestic demand, it will also bring negative consequences for the supply side of the economy. The potential labour force is set to decline by 2030 by considerably more than 0.5% per year (!) or a total of more than 10%. By contrast, the size of the population will fall only slightly in this period.[8] Given the shrinking potential labour force Germany cannot afford to allow around 10% of pupils to end their schooling without a school-leaving qualification.

Not only the absolute size of the labour force is set to decline. In addition, the labour-intensive services for an ageing population will probably occupy a lot of workers and thus pose added competition for industrial employers, though the latter's high productivity allows them to pay higher wages, increase the automation of manufacturing even further or step up the outsourcing of labour-intensive manufacturing tasks and hire international top talent.

Germany still enjoys cost advantage 15

Unit labour costs, total economy, Q1 1999=100



Source: OECD

The mobility of the available labour between these very different sectors of the economy is by no means straightforward; over the medium term, however, different prospects can certainly influence the education and training decisions made by young people. The oft-mentioned “skill shortage” will thus probably intensify for years to come. Although this term is neither clearly defined nor undisputed, at the very least there will be an increase in the partly regional and sector-specific shortage of labour and the shortage of certain qualifications.

In this environment and combined with the currently glowing health of the German labour market wage pressure could increase over the coming years. After wage growth hit bottom in 2004/05 it picked up gradually despite the intervening crisis. Since 2010 effective wages have risen by an average of 2.5%

[6] Temporary immigration boom: A wake-up call for politicians? Deutsche Bank Research. Standpunkt Deutschland. July 28, 2014.
[7] Trend growth of employment: Negative in the longer term. Focus Germany.
[8] Assumption: 200,000 immigrants per year.

p.a. compared with only 1.2% p.a. between 2000 and 2008. The 3.2% rise in collective wages in 2014 was actually the highest increase in the last 20 years and a similar increase is also on the cards for 2015.[9] At the same time unemployment is at a record low (since reunification) and should continue falling in the next few months. Employment and the number of vacancies are at record highs and are climbing.

Given these circumstances German wage growth can almost still be described as modest. The relatively low dependency of developments in pay and prices on the labour market situation marks Germany out internationally.[10] This is also the case for the basically good relations that have existed for years between unions and employers in the manufacturing sector in particular. If there should be no appreciable change in this, this could somewhat constrain the coming wage pressure. However, this would not make any difference to the lack of skilled personnel, which will strengthen the negotiating position of employees (or at least certain employees). Furthermore, aggregate productivity growth for Germany has recently been well below the pre-crisis trend and for the time being is also unlikely to accelerate appreciably, which is partly attributable to job creation in the service sector above all. German unit wage costs will therefore pick up considerably over the short term, and the lead over many European neighbours that had been built up over the years is likely to shrink.

Economic policy has undermined general conditions of late

The above-mentioned structural headwind can only be muted via domestic economic policy. Recently, however, an additional strong headwind has in fact been generated. We have sharply criticised the German government's economic policy in recent years on many occasions.[11] In our opinion the grand coalition has weakened potential growth in Germany by making decisions for social policy reasons and also reduced the incentive to invest in particular.[12]

The pensions package not only saddles future generations with high costs, it also imposes a short-term burden on the labour supply by incentivising retirement at 63, as many experienced and highly productive workers will abruptly exit the labour market. According to a conservative Bundesbank estimate the option of retirement at 63 will reduce potential economic output by ½% until 2016.[13]

The introduction of the minimum wage and the stricter regulation of temporary work[14] starkly contradict the labour market reforms of the mid-2000s, which laid the foundations for today's very good labour market situation and considerably boosted companies' external flexibility via the deregulation of temporary work and service contracts.[15] True, there are cases in which the opportunities offered by temporary work and service contracts are abused. This may not, however, be used as an argument for completing a volte-face. The minimum wage is likely to play a part in the growth of employment for low-skilled workers coming to a standstill over the medium term and structural unemployment rising.[16]

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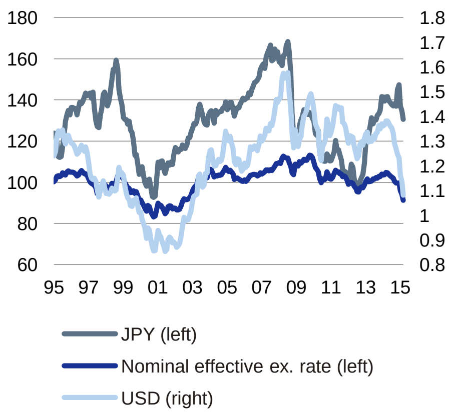
9 Stronger growth and wages – little reaction from savers. Deutsche Bank Research. Focus Germany. March 2, 2015.
10 Schneider, S. (2014). Higher German inflation: Mission impossible? Deutsche Bank Research. Current Issues. October 29, 2014.
11 Grand coalition – poor policies. Deutsche Bank Research. Focus Germany. December 16, 2013.
12 Case for higher investment in infrastructure – despite questionable "gap analysis". Deutsche Bank Research. Standpunkt Deutschland. December 5, 2014.
13 Monthly Report. December 2014. 66. Jahrgang. No 12. 12/12/2014. Deutsche Bundesbank.
14 Temporary work: Success story with an uncertain outcome. Deutsche Bank Research. Focus Germany. February 28, 2014.
15 Pluralisation of forms of employment yielding positive effects on labour market. Deutsche Bank Research. Focus Germany. May 9, 2012.
16 Strong domestic economy to suffer from good intentions. Focus Germany. June 4, 2014.

Energy policy should also grant rebates to particularly energy-intensive firms in future, at least as long as other countries shy away from ambitious energy and climate policy goals. Given Germany's own energy and climate policy objectives this is a difficult balancing act, but imposing a unilateral burden on energy-intensive sectors would be counterproductive. After all, insufficient investment in these sectors could in the medium term also reduce the innovation capability of client industries and hamper the integrated industrial value chain in Germany – an important locational advantage.[17] Despite a certain amount of progress the reform of the "Energiewende", Germany's transition to renewable sources of energy, has not provided sufficient (long-term) investment certainty and the lack of market mechanisms is likely to result in constantly high or rising prices.[18]

Falling euro could boost exports (moderately) for years to come

EUR weakness most pronounced vs. USD 16

Exchange rate vs. EUR



Source: ECB

The European Central Bank's current monetary policy and the prospect of years of divergence between European and US monetary policy in particular are likely to weaken the euro in the short to medium term. While the Federal Reserve is currently debating whether to hike key rates before the end of 2015, the ECB massively expanded its quantitative easing programme in March and plans to let it run until at least October 2016. As a result, the euro fell to a 12-year low against the US dollar on March 13, 2015, of USD 1.05, recovering slightly to about USD 1.10 at the latest reading. While exchange rate forecasts are particularly fraught with uncertainties, considering the fundamental factors (growth and interest rate spreads) we contend that the euro could be trading at parity to the US dollar at end-2015, USD 0.90 at end-2016 and no more than USD 0.85 at end-2017.

Nonetheless, German exporters will probably be less impacted than these figures suggest at first glance: the euro weakness is not nearly as pronounced versus the currencies of other major trading partners since the central banks of those countries, in contrast to the Fed, are also likely to pursue less restrictive monetary policy. Furthermore, in the first part of this report we pointed out that German export products are, on average, less vulnerable to exchange rates than those of other export nations. Generally, though, the exchange rate ought to slightly mute the negative impact of other factors.

German exporters shifting down a gear

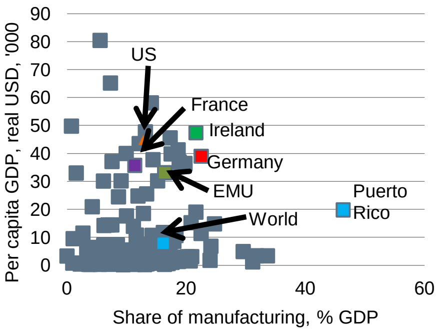
In our opinion, there is a preponderance of arguments suggesting that German exporters will achieve lower growth rates in future than in the heady days of the globalisation boom. Taking plausible assumptions as the basis for the parameters defined above, German exports could post average growth of just over 4% in the next few years.

[17] See Heymann, Eric and Hannah Berscheid (2013). Carbon leakage: A barely perceptible process. Deutsche Bank Research. Current Issues. Frankfurt am Main.
[18] Energiewende 2.0 – don't risk competitiveness. Deutsche Bank Research. Standpunkt Deutschland. November 26, 2013.

Is this a (macroeconomic) problem at all?

From a macroeconomic perspective, less dynamic export growth relative to domestic growth does not have to be considered a serious issue. On the contrary: a constant sectoral shift is a natural feature of an economy whose macroeconomic and political parameters (e.g. demographics, structural foreign demand, technology, location costs) are in flux.

Germany stands out 17



Avg. of the last 3 available years, mostly 2013

Sources: Deutsche Bank Research, World Bank

At any rate, the German economy has a very large industrial sector, especially when set against its advanced state of development. In other advanced economies, increasing wealth has usually gone hand in hand with a rise in the share of the service sector. The adjacent chart shows that Germany and Ireland stand out as countries with a high share of value added generated by the manufacturing sector in tandem with high GDP per capita. Germany has an industrial share of about 22% (France: 11%; EMU: 16%; US: 12%). However, the US, the UK, Sweden, Denmark and Austria are good examples of countries that feature both a lower industrial share and higher GDP per capita than Germany. France, for example, has only half as much industry and at the same time only moderately lower per capita GDP, if the large differences in the world are factored in. So it emerges that different countries can pursue very differing "business models".

Germany's demographics provide a further argument. Germany has one of the most rapidly ageing societies in the world. The very high savings ratio of German households reflects the level of retirement provision. Recently we pointed out that the savings ratio will probably trend south going forward, as soon as the increasing share of pensioners start to consume their savings or at least cut back their savings ratio.[19] Savings have largely been invested abroad in view of the long-term prospects of higher returns and growth outside Germany. This capital export inevitably went hand in hand with sizeable current account surpluses that in Germany's case were generated on trade surpluses – more goods were exported than were imported. If ageing Germans save less in future, Germany will also post smaller trade surpluses, which implies (relatively) higher growth of the domestic economy vis-à-vis the external economy.[20]

Politics: Shape the changes, but neither by force nor impediment

From a political viewpoint, though, it is vital that adjustments for such sectoral changes are not enforced without specific need, since abrupt company responses would probably entail higher macroeconomic costs than would a gradual shifting of the balance that is attributable to market developments and not changes in the political environment. An economic policy that fails to take account of the fundamental transmission channels of various dynamic global changes would be counterproductive. Via intensive support and corresponding educational measures it should be possible to alleviate the negative effects of structural changes and thus increase the mobility of workers between sectors and regions. Moreover, it is important that companies can rely on a properly established, sustainable economic policy environment – the example of the Energiewende already cited is a negative case in point. Policymakers should seek to recognise international shifts early on and adjust the policy environment accordingly. Properly engineered structural reforms can achieve fundamental changes where needed, as the German labour market reforms implemented in the mid-2000s have shown.

[19] Schneider, S. (2015). Stronger growth and wages – little reaction from savers. Deutsche Bank Research. Focus Germany. March 2, 2015.
[20] ZEW (2012). Sparen und investieren vor dem Hintergrund des demographischen Wandels. Endbericht an das Bundesministerium der Finanzen.

Company responses

On the company side there are numerous ways in which firms can respond in order to master the challenges of international competition that they will also face in future. In many cases these possibilities are obvious, but in practice it is often not easy to implement them.

In response to shifts in cost ratios, e.g. as triggered by the Energiewende or the introduction of the minimum wage, companies can seek to shift (even more) production abroad in order to reduce their overall cost burdens via lower energy costs there (e.g. in the US) or else via lower wage costs (emerging markets). Similarly, the better long-term growth prospects in emerging markets – driven to a major extent by demographic factors – as well as existing customs tariffs and non-tariff trade barriers suggest that in future foreign markets will be served at least partly by local production sites.

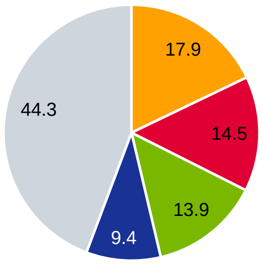
German companies can take various steps to cope with the demographic challenges in their home market. If the captains of German industry hope to remain innovation leaders in many segments, the respective companies will have to intensify their efforts to attract the best talents available. This applies not only to the traditional vocations, which lay the foundation for a pool of skilled workers, master craftspeople and other production-related activities, but also to academic careers. Companies could do more than they have up to now to secure their next generation of workers, for example by offering more scholarships and bursaries for German and foreign students. To this end, of course, the prerequisites will also have to be created so that students from outside Europe are allowed to stay and work on a permanent basis after completing their studies in Germany. In-house skills upgrading will rise in importance so that employees' productivity can be maintained/boosted across their working life. Also, (even more) flexible working time models designed to boost the labour participation of women and older people may help to ease the anticipated labour shortage. Of course, this will in some cases also bring a substantial need for adjustments in internal company processes – not least with regard to openness, e.g. making English a company's operating language. One advantage of manufacturing industry vis-à-vis many service industries in the war for talent is that the former (currently) pays higher wages and salaries.

In response to the growing competition from the emerging markets and the way they are climbing up the value chains, German suppliers will probably seek to remain innovation leaders, continually optimise their production processes and stand out from the competition with products that meet top quality standards.

In the following we shall look at how differently Germany's chief export sectors are being hit and at how individual sectors have already responded to globalisation or are expected to do so.

Four sectors account for more than 50% of German exports 18

Share of certain sectors in total German exports, 2014, %



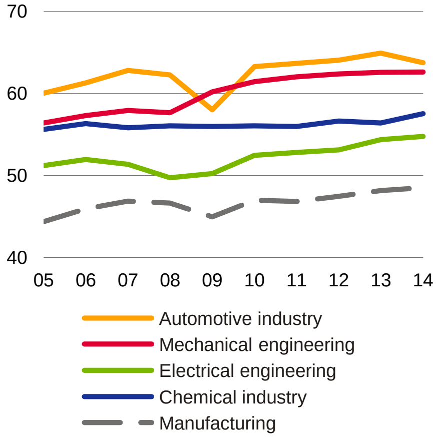
Source: Federal Statistical Office

German export model under pressure structurally – the sector perspective

Nearly all sectors of German industry have increased their export ratio over the past ten years. Among the "traditional" export sectors, other transport equipment (including aircraft, ships) was able to expand its export share the most, by close to 14 percentage points (exports to EMU and non-EMU countries). In the pharmaceuticals industry (+10.7 pp) and mechanical engineering (+6.2 pp), too, export business jumped considerably in the given period. All in all, pharmaceuticals recorded the highest export ratio of all the sectors of industry in 2014, at 68.6%. Following on its heels come other transport equipment (65.4%), the automotive industry (63.7%), mechanical engineering (62.6%), chemicals (57.5%) and electrical engineering (54.7%). The metals (36.9%) and the rubber

Export ratio on the rise 19

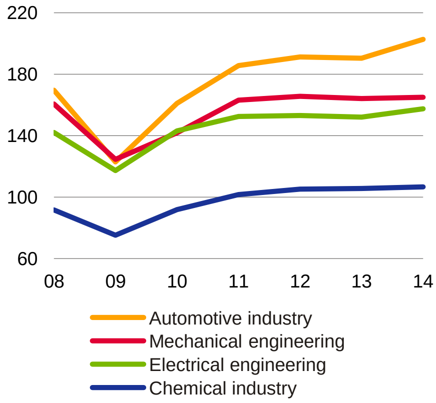
Foreign revenue as a percentage of total revenue by sector, Germany, %



Source: Federal Statistical Office

Momentum flattens out of late 20

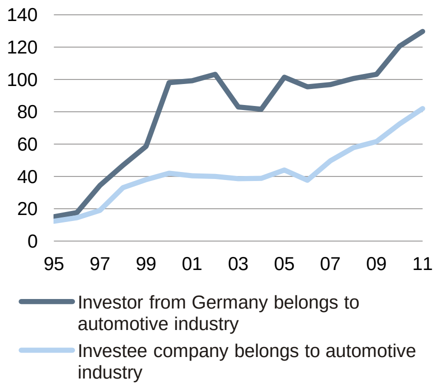
Nominal exports from Germany by sector, EUR billion



Source: Federal Statistical Office

German investors from the automotive industry very active abroad 21

Stock of foreign direct investment by German companies, automotive industry, EUR billion



Source: Deutsche Bundesbank

and plastics (40.4%) industries post below-average export ratios. Note here, however, that these sectors ship a significant share of their output to domestic factories of the export-intensive sectors mentioned above. On balance, the high (direct and indirect) export ratios reflect the pronounced international competitiveness of German industries.

A look at the export trend at sector level shows, however, that nearly all the export-intensive sectors have seen a slowing of growth since about 2011/12 – and significantly so in some cases. In 2014, the mechanical engineering sector's nominal exports in fact fell slightly short of the 2012 reading. In the automotive, electrical engineering and chemicals industries, the average growth rates for nominal exports have also eased noticeably over the past two to three years. Generally speaking, the pattern is also to be recognised at the sector level: a robust recovery of export trade in 2010 and (partly) in 2011 was followed by a significant cooling of the dynamics.

Industrial sectors responding differently to globalisation

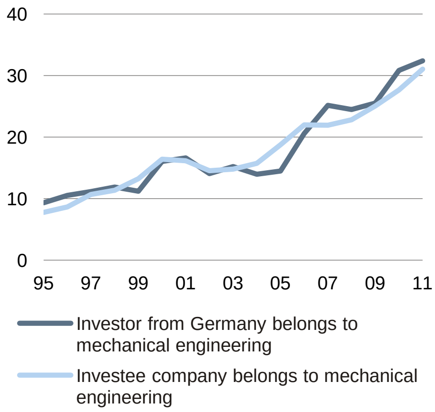
The key question now is whether the lower export growth in Germany's major branches of industry over the past few years is mainly due to the cyclical weakness of demand in the eurozone and several other countries and thus of a temporary nature, or whether the export engine is going to stutter more often in the respective sectors in future on account of structural changes. It is not easy to answer this question, especially since individual industries have in the past responded differently to globalisation or taken differing proactive approaches to the phenomenon. Furthermore, the sectors face various challenges on their home turf as well. All of Germany's traditional export sectors at least have in common that they have increased the stock of their foreign direct investments over the past few years. It is only natural that these investments compete with investments in Germany.

Automotive industry driving globalisation

In recent years, Germany's automotive industry has pursued a two-pronged globalisation strategy. For one thing, sector members have boosted their exports from Germany and regularly invested in the modernisation of their domestic plant. The close ties between automakers, suppliers, equipment companies, universities and other research institutes as well as logistics companies have played a major role in ensuring that Germany holds its own as a car producing location in global competition despite having to shoulder wage costs that are high by international standards. The basic prerequisite for the success of the past few years, of course, is the product range, which currently appeals to customer tastes worldwide. For another, the German automotive industry has substantially boosted its foreign production capacities in recent years; this applies to the automakers and (major) parts suppliers alike. Not only cheaper location costs abroad and various trade restrictions but in most cases also the ability to serve the local market have been the crucial motives. Nearly all the German-badged cars rolling off the assembly lines in China (to date) are being sold in that country. The sector's foreign output has grown very much more rapidly than domestic output and than exports from Germany. Nevertheless, the automotive industry has also been able to boost its exports to countries with significant local production, for example because engines, parts and components from Germany are being shipped to these countries. Moreover, it is not possible to build every model of car in all the important sales markets, which is why car and truck exports have invariably remained a key pillar of the sector's business.

Quite steady increase 22

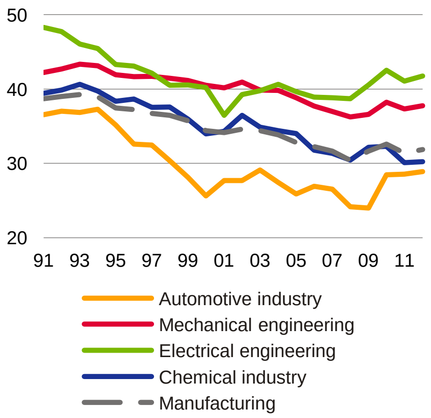
Stock of foreign direct investment by German companies, mechanical engineering, EUR billion



Source: Deutsche Bundesbank

High share of gross value added in the electrical and mechanical eng. industry 23

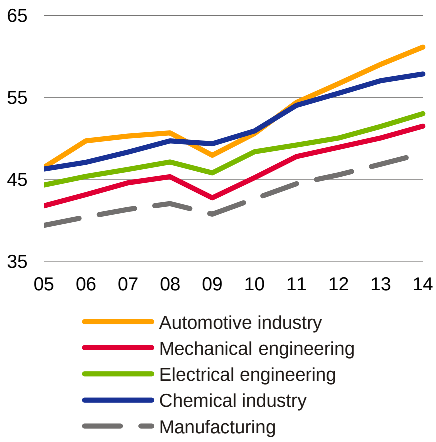
Share of gross value added in production value by sector, Germany, %



Source: Federal Statistical Office

Export sectors pay above average 24

Annual gross wages and salaries per employee, thousand EUR



Source: Federal Statistical Office

Most of the German auto industry's investment in expansion will continue to be made outside the country in the coming years. These investments will boost internal competition between individual car factories and may therefore crimp Germany's export potential. On a medium-term horizon, for example, the rising demand for cars in the ASEAN member countries could largely be met by deliveries from German car factories in China (or directly in the ASEAN states) instead of from Germany. Furthermore, this idea receives underpinning from the fact that Germany's trade with these countries, and India, is hampered by tariffs and non-tariff barriers. Nonetheless: the German automotive industry is continually investing heavily in domestic factories and research facilities; Europe remains an important auto market; setting up a car factory does not pay off in every growth market; and Germany will retain many of its strengths as a production and research location. Therefore, the value of the sector's exports from Germany are poised to grow further in future. The growth dynamics will probably weaken noticeably over time, however. High capacity utilisation is necessary in Germany though in order to offset disadvantages in, say, absolute wage costs. Flexible working time models will therefore remain essential (not only) for the automotive industry.[21]

Mechanical engineering exhibits very high degree of domestic value added

Compared with the automotive industry, Germany's mechanical engineering industry features a higher degree of domestic value added. Sector members tend to be small or medium-sized enterprises. While mechanical engineering has also boosted foreign direct investment in recent years, many companies in this sector continue to produce most (if not all) of their output in Germany, even though it is not uncommon for them to be world market leaders in their niche. One key factor in this regard is that the German mechanical engineers focus on special machinery. This focus also reduces the price pressure in the sector, even though other (relative newcomer) nations such as China are keen to bulldoze their way into these segments. The globally growing demand for machinery will continue to benefit Germany as a production location. Nevertheless, Germany's mechanical engineers will increasingly set up own their production sites in key sales markets in the years ahead, because this is being demanded by customer industries and this makes it easier to offer related value-added services. It applies here, too, that such a trend – ceteris paribus – will tend to reduce the potential for exporting goods from Germany in future.[22]

Moreover, mechanical engineering, with its SME structures, could be hit harder by the demographic challenges discussed above than, for example, the large automakers. For instance, there are significant wage differences within the industry. Among the major automakers wages are systematically higher than the levels found among the small and medium-sized mechanical engineering firms. In addition, the latter are often located in rural areas, thus possibly making it more difficult in some cases to attract foreign skilled workers who are more likely to move to larger cities in recent years.

Electrical engineering concentrates on capital goods

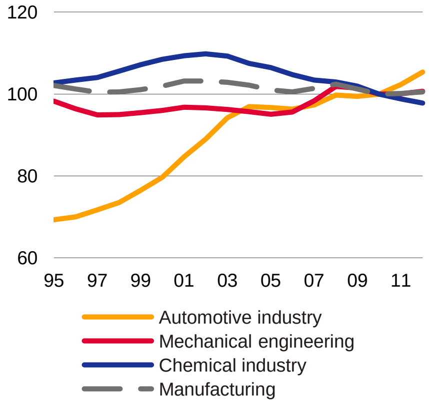
Germany remains an important production location also for the electrical engineering industry. However, over the past few decades there has been a shift between certain segments in the sector. On a long-term comparison, output

[21] See also Heymann, Eric (2014). The future of Germany as an automaking location. Deutsche Bank Research. Current Issues. Frankfurt am Main.

[22] See Auer, Josef, (2014). New growth opportunities for Germany's engineering sector. Technology leadership and outward investment. Deutsche Bank Research. Current Issues. Frankfurt am Main.

Capital stock in the automotive industry growing fast 25

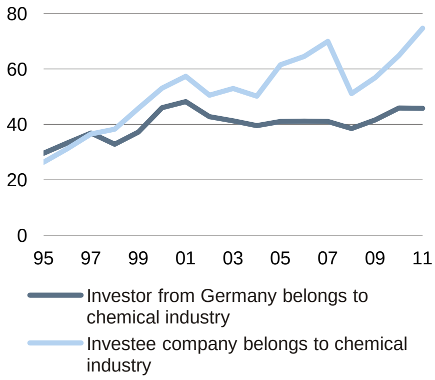
Real net fixed assets, Germany, 2010=100



Source: Federal Statistical Office

Foreign chemical companies are attractive for German investors 26

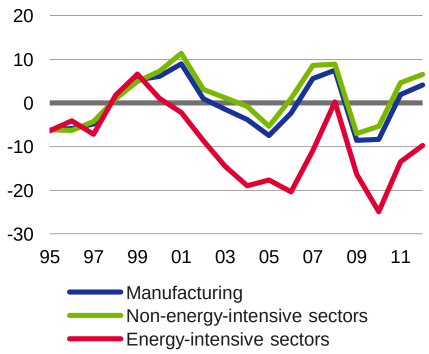
Stock of foreign direct investment by German companies, chemical industry, EUR billion



Source: Deutsche Bundesbank

Energy-intensive industries invest less 27

Nominal net capital expenditure as a percenatge of nominal gross capital expenditure in Germany



Source: Federal Statistical Office

of electronic household appliances and consumer electronics has fallen, with cost aspects (wages) as well as stiff competition from Asia playing a major role. By contrast, domestic production of, say, energy technology, measuring and monitoring equipment, and medical and optical equipment has been increasing over the long term, with foreign demand being a major driver. Of course, electrical engineering companies have also steadily boosted their activities abroad; this applies to the major players in the sector in particular. Since technological advances within the sector are more rapid and product cycles in certain segments shorter than in other sectors, products that are successful today may fall out of market favour after just a short time; this holds for consumer-related products in particular. This may well have been the reason that in Germany the sector started to focus more heavily on capital goods. If German electrical engineers remain innovative in this segment, the export model should continue to function in the years ahead. Further intensifying competition from Asia and the US as well as German companies' increasing drive to shift production to offshore sites suggest, however, that in this case too one should expect a reduction of export growth potential.

Chemicals industry cutting back investment in Germany

The chemicals industry is the only one of Germany's traditional export sectors in which the real capital stock has steadily decreased in Germany over the past few years on account of insufficient investment – while at the same time exports and output have increased.[23] Since chemicals is one of the most energy-intensive sectors, the high energy prices in Germany and – even more so – the uncertainties surrounding the future design of German energy policy were probably the key driving forces at play. Germany's big chemicals players stated explicitly that the latest foreign investments in the US were to be explained by the lower energy prices and more reliable policy environment there; this is very clearly a case of foreign investment substituting for higher investment in Germany. At present, little suggests that the chemicals investment climate in Germany is about to change fundamentally in the short to medium term. There is too much uncertainty surrounding the further development of the Energiewende, although of course investment decisions are never made on a monocausal basis and the sectors certainly still have considerable investment at current locations in Germany. Nevertheless, the sector will face mounting difficulties in efforts to sustainably boost domestic output and exports if its investment in Germany continues to fall short of writedowns. Thus, chemicals is among the sectors in which the currently successful export model may come under pressure most rapidly.

Real capital stock in the other energy-intensive sectors of industry (paper, building materials, metals production) has fallen in Germany over the past few years. The export ratio in these sectors is lower than the total manufacturing sector average and has remained relatively constant in recent years. If investment activity remains too low to prevent substantial erosion of the asset base in these sectors in Germany going forward, this would have a negative impact on advances in productivity, innovativeness, potential output and export activity.

[23] For more on this topic and what follows see Heymann, Eric (2014). Capital investment in Germany at sectoral level. Service providers continue to expand while industry contracts slightly. Deutsche Bank Research. Current Issues. Frankfurt am Main.

Conclusion: Beware of squandering German exporters' good starting position

Given the developments we discussed above, the domestic segment will probably account for a growing share of Germany's overall economy in future. Despite the scepticism that presumably prevails among the general public and politicians in Germany this need not be a cause for concern. Rather, this is the natural reaction of an economy to changing macroeconomic and political parameters – particularly in view of the striking demographic trends facing Germany. In addition, a less export-dependent economy in Germany would be less vulnerable to cyclical fluctuations in the medium to long term. From a corporate and political standpoint it is vitally important that this change evolves gradually and is not driven by misguided policy decisions. This could cause major macroeconomic repercussions.

In order not to needlessly squander the good starting position of the country's export heavyweights, appropriate measures should be taken to counteract the serious headwinds from inside and outside Germany. From a political angle it is unlikely that the major "flagship projects" – e.g. retirement at 63 and the minimum wage – will be abandoned. However, it is now crucial that Germany's minimum wage commission does not decide on excessive increases, as this would harbour the risk of triggering additional negative effects. Wage-negotiating parties should act with circumspection and, given the prospect of skilled labour shortages ahead, not be tempted to make such excessive demands that this abruptly reduces companies' competitiveness.

Moreover, efforts should be made to uphold the still existing external labour market flexibility via temporary work and service contracts. To cushion the effects of an intensifying demographic shift due to the retirement at 63 option, foreign skilled workers should be allowed more flexible access to the labour market. Furthermore, it is important to further upgrade the education system, with more resources being made available for the early-childhood phase and for state-of-the-art research as well as lifelong learning programmes.

German companies could also receive an additional boost from a successful conclusion of the ongoing negotiations on trade agreements, especially TTIP.

Companies will probably continue on the successful path of the past several decades. They have had repeated success in facing up to the global challenges. To take the sting out of the demographic challenges employee productivity can be raised by increasing the level of automation and participation rates can be increased via more flexible working-hours arrangements. Also, companies are likely to continue extending their global value chains and expanding their foreign manufacturing operations.

This will lead in the medium term to German companies with a heavy export bias focusing even more strongly on becoming global players, using their product(ion) expertise where this is most profitable and marketing their products around the world. The resulting profits could become a blessing for an ageing, more domestically oriented German economy in the coming decades.

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2015 marked by domestic strength and volatile H1

— Thanks to improving sentiment, the impetus from lower oil prices and government giveaways to real incomes and the lower EUR to exports German GDP should rise by 2% in 2015.

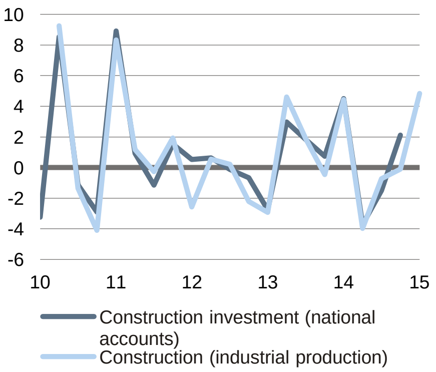
— Growth should be broad-based but strongly tilted towards domestic demand and especially private consumption, while exports and equipment investment should continue to lag well behind pre-crisis trends.

— Compared to our last forecast[24] we primarily changed the quarterly profile. We now expect that construction investment will be pulled forward into Q1 due to the mild winter pushing Q1 GDP growth to a strong 0.8% qoq. In Q2 negative payback for this is likely to bring growth to 0.2% – just like in last year.

Growth outlook brightened lately

Construction to add strongly to Q1 2015 GDP? 1

Real, % qoq (quarter-to-date)



Source: Federal Statistical Office

In the past few months the outlook for German GDP growth brightened sharply thanks to the significant oil price induced boost to consumption and the markedly weaker effective exchange rate due to the ECB's action. Also, Q4 2014 growth was stronger than expected. On the back of this we recently raised our 2015 GDP forecast to 2.0% (end-2014: 1.0%; end Jan 2015: 1.4%), which is above potential growth and consensus, making Germany one of EMU's growth engines.

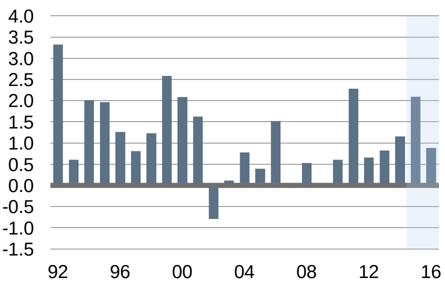
Strong winter half 2014/15

Thanks to solid Q4 GDP growth of +0.7% qoq 2014 ended on a high note after stagnation over the summer. In addition, we expect another strong expansion of 0.8% in Q1 2015. We believe this overstates the underlying momentum, though, as the government's pension package amplified the stimulus to real disposable income from the oil price drop in Q4, while construction investment benefitted from the mild winter (avg. temperature in Jan/Feb 15: 3.3 °C vs avg. Jan/Feb since 92: 1.1 °C). Thus, in a repetition of last year's pattern, we suspect that Q2 GDP (+0.2%) will show a marked counter movement, but still produce a solid domestically driven H1.

90% of growth to come from domestic economy

Consumption: Substantial growth in 2015 2

Private consumption, real, % yoy



Sources: Federal Statistical Office, Deutsche Bank Research

The domestic economy should contribute 90% of 2015 growth. Especially private consumption should accelerate strongly to over 2% yoy in 2015 thanks to the significant stimulus from the lower oil prices, the favourable labour market situation with ongoing employment growth, elevated net migration to Germany and the strongest real wage increases of the last 20 years. These factors and historical low interest rates for mortgage lending are also supporting a solid pace of construction investment (+3%).

Exports are expected to gradually accelerate

Thanks to the sharp depreciation and the expected moderate recovery of the world economy in the rest of this year exports should grow by 4.4% and, thus, somewhat faster than last year. However, the in our view structural sluggishness

[24] Focus Germany. March 2 2015.

of world trade should limit the scope of the export recovery. This will keep capacity utilization close to its long-term average and growth of equipment investment below 4%. Nevertheless, the current account surplus is expected to increase to over 8% of GDP this year – in large partly due to weak import prices (e.g. oil) – despite the pick-up of imports to 4.5% in real terms.

Fiscal policy targets more investment

The persistently high German current account is a thorn in the side of the EU Commission and other EMU countries. Many see it as an obstacle to faster intra-EMU rebalancing. Probably in part to preempt the discussion (likely to re-surface during the annual macroeconomic imbalances procedure) the Grand Coalition's fiscal plans included a substantial increase in infrastructure spending until 2019. However, this is financed by higher revenues, the windfall from lower interest rate expenditure and lower spending elsewhere limiting the impetus to domestic demand and keeping the budget balanced in the government's plans until 2019.

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Government sets course for higher investment with new budget

— On Wednesday, March 18, the cabinet adopted Finance Minister Schäuble's supplementary budget for the federal government for 2015, the draft budget for 2016 and the medium-term planning until 2019.

— The major policy measure, albeit already known, is a substantial increase in public (infrastructure) investment. Such investment will total EUR 13.5 bn up to 2019, partly taking the shape of co-financing for municipalities. This goes a long way towards meeting the investment needs we had previously identified. In addition, development aid and the Bundeswehr will each receive an additional EUR 8 bn.

— These measures should help the government in its talks with the European Commission about Germany's large current account surplus as initial reactions from the Commissioner for Economic and Financial Affairs, Pierre Moscovici, suggest. However, the sums involved are not large (less than 0.2% of GDP p.a.) and are to be financed by higher revenues and lower interest expenditure as the government plans a balanced budget up to 2019. Thus, this is likely to be only a modest plus for EMU re-balancing. However, other government policies will work through the social security system instead of the federal budget and add further impetus to domestic strength, mildly supporting domestic demand.

Fiscal and current account surpluses are thorn in the side of EU Commission and other EMU countries

German economic policy is a contentious issue in Europe at present. Especially the large current account surplus is seen as an obstacle to faster rebalancing inside the euro area. In Focus Europe (March 6) we suggested that the current German wage dynamics should help to narrow the surplus somewhat in the medium term. However, it is unlikely to be enough of a reduction to convince the Commission, which will likely ask for further steps to bring down the surplus from our forecast of 8.4% of GDP (2015F; 2014 about 7 ½%) towards the upper bound defined in the macroeconomic imbalances procedure (6%) that is currently underway. Looking at the in-depth country report they will probably suggest a boost to public (infrastructure) investment. Many countries seem to feel that a balanced budget in Germany is inappropriate given the current situation in Europe with Germany as its economic powerhouse. The hope is that a less restrictive fiscal policy / higher investment in Germany would give some additional impetus to the economic recovery now unfolding in the euro area. It was under these circumstances that the cabinet adopted Finance Minister Schäuble's supplementary budget for the federal government for 2015, the draft budget for 2016 and the medium-term planning until 2019.

Direction of additional infrastructure investments

The major policy initiative is a substantial increase in infrastructure investment. We have written about this proposal before. To this end:

— The additional fiscal resources relative to earlier plans amounting to EUR 3.5 bn higher revenue and EUR 700 m lower interest expenditure in 2015 will largely be put into a special fund to support infrastructure investment in financially weak municipalities over the course of 2015-2018. Up to 90% of each investment project can be co-financed by the fund depending on how precarious the municipality's situation is. This is understandable from a political and redistributive point of view. Moreover, municipalities are responsible for a large share of the public infrastructure with many of them indeed financially weak. It is less understandable from an economic point of view, though, as the rate of return on the infrastructure projects does not play a role in the decision and it fundamentally changes little about the financial outlook of the weak municipalities.

— In addition, the federal government will invest a cumulative additional EUR 10 bn from 2016 to 2018. Of this total, EUR 7 bn is for already specified uses, with EUR 4.3 bn to go to public transport infrastructure (largely motorways) and digital infrastructure (e.g. supporting broadband expansion in rural areas where it is often not profitable otherwise). The remaining EUR 3 bn is to be allocated to the various ministries and used for investment purposes.

While there can be endless debates over the usefulness of specific investment projects, we would judge the direction to be largely correct. Furthermore, the amount goes a long way towards filling the investment needs in the public sector we previously identified (EUR 5-10 bn more p.a.)[25]. Also keep in mind that the federal government is only responsible for a small share of public infrastructure so the focus on strengthening investment in municipalities also looks appropriate in general. Other observers are calling for substantially more investment. We clearly disagree, especially in view of the demographic outlook and the calculation methods used.

It is likely that the cumulative EUR 8.3 bn from 2016 to 2019 being allocated additionally towards development aid could also be counted towards a "reduction of the current account surplus". In any case, this could be seen as a further sign that Germany is increasingly expanding its more assertive role in the geopolitical arena. The additional defence expenditure of EUR 8 bn for the Bundeswehr until 2019 also has to be seen in this context. The extra EUR 1.8 bn for domestic security was explicitly justified by referring to the terrorist attack in Paris in January 2015.

Balanced budget good for CDU and further investments good for SPD – limited economic impact

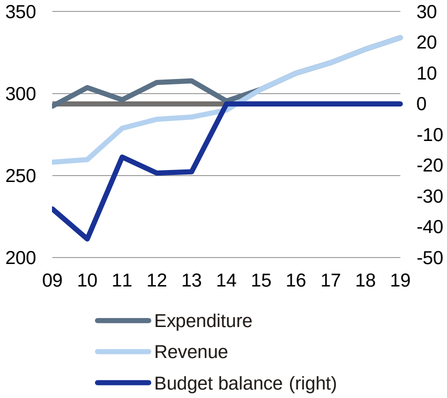
From a domestic political perspective, the partners in Germany's ruling coalition can be happy. The Social Democrats under Sigmar Gabriel can point to higher investment. They are generally proponents of the "investment gap" narrative. In addition, the support for municipalities, which − when all transfers and other financial relief are taken together − could amount to EUR 25 bn up to 2019 (an exaggeration in our view), also tends to benefit the financially weak municipalities that, on average, are more often led by the Social Democrats or located in states governed by the SPD. The CDU, under Chancellor Merkel and especially Finance Minister Schäuble, can point to the target of a balanced budget in every year up to 2019. In 2015 there might even be some limited upside given our GDP forecast of 2% growth compared to the government's 1.5%. On the other hand, they calculated with a CPI of 0.8% compared to our expectation of consumer prices being nearly unchanged. Therefore, risks look roughly balanced.

Referring to the cabinet's approval of the budget legislation, Schäuble said: "The benchmark figures decision opens up a new chapter in German budget policy. We are significantly increasing investment without taking on new debt. In this

[25] Standpunkt Deutschland. 5 December 2014.

Supplementary budget 2015 and draft budget 2016 1

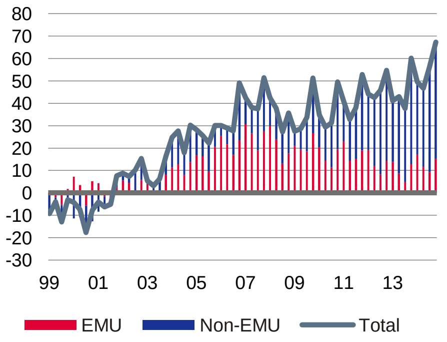
Central government, EUR bn



Source: Federal Finance Ministry

Germany's surplus vs EMU well below pre-crisis levels 2

Current account balance, EUR bn



Source: Deutsche Bundesbank

way, we are improving the structure of the budget and making Germany fit for the future."[26]

From a European perspective the news is mixed. Obviously, the infrastructure investment package is the major point of interest and is being strongly emphasised by the coalition as well as featuring prominently in the media. Pierre Moscovici, the French EU Commissioner responsible for fiscal policy, said that the German government proposal went in the right direction, though more could be done. This could suggest that risks of any near-term escalation over this issue are small. We argued in early March that it would be difficult to be too hard on Germany anyway given the leeway just given to Italy/France.

However, at about EUR 3-4 bn a year the package equals less than 0.2% of GDP and contains a lot of domestic value added, limiting the stimulative effect on the euro area. Moreover, it is to be financed by lower interest expenditure, lower spending elsewhere and higher revenue, given that the budgets of the next few years are planned to be in balance just like in last year's medium-term planning. Another way of saying this: putting last year's expenditure and revenue streams for 2016-2018 next to this year's, the numbers are nearly identical.

On the other hand, the above discussion has been focused on the federal budget, while the grand coalition's latest policy measures are often meant to work through the social security system. For instance, the option of early retirement at 63, higher pensions for some mothers and a general pension increase stimulated disposable income in H2 2014. Such monetary social benefits added EUR 4.1 bn to the disposable income growth of EUR 9.5 bn. In the previous six years they accounted for less than a third. This comes on top of the already solid income gains driving German consumption to above 2% growth in 2015. Moreover, this strength of German consumption is partly helping to weaken Germany's current account surplus vis-à-vis other EMU countries as the chart shows, while the total surplus has continued to rise, supported by weak commodity prices.

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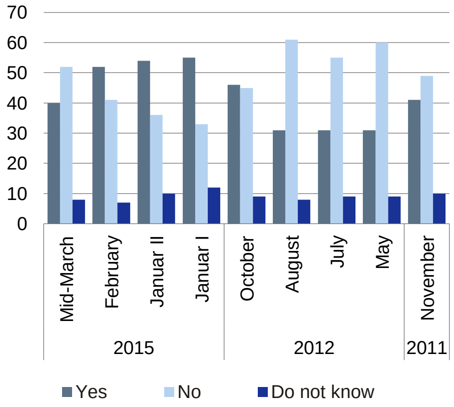
[26] http://www.bundesfinanzministerium.de/Content/EN/Pressemitteilungen/2015/2015-03-18-draft-supplementary-budget-2015-benchmark-figures-2016.html

The view from Berlin

In – out – in between: What is the mood about Greece?

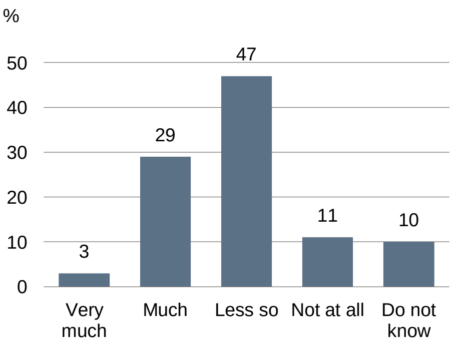
Germans now favour a Greek exit 1

Share of answers to: "Greece should stay in the Euro ...", %



Source: ZDF Politbarometer

A Greek default would harm Germany economically … 2



Source: ZDF Politbarometer (March 13, 2015)

The first bilateral meeting between Chancellor Merkel and Greek Prime Minister Tsipras was reportedly one of mutual goodwill, but – as expected – did not significantly narrow differences on the economic reforms Greece must implement to receive the tranches from the current programme needed to fulfil its obligations. In her state-of-the-union address before the European Summit recently Merkel reiterated that if the euro fails, Europe would fail, and emphasised that Berlin still wants to keep Greece in the euro area. In her view, beyond its economic role the euro is a symbol of European concord.

However, while Merkel’s tone is more conciliatory than the rhetoric of Finance Minister Schäuble, any flexibility beyond the Eurogroup agreement from February 20 remains constrained by (i) her own party, the CDU/CSU, where influential party members take a more critical stance towards the Greek government and its willingness to comply with commitments; (ii) the existence of the eurosceptic AfD party, even though it does not seem to be able to leverage the conflict between Greece and the Eurogroup for its own purpose; and (iii) broader public opinion.

The public mood towards Greece has changed recently with 52% of Germans now in favour of a Greek exit. This is even higher than back in 2011 when the crisis was more virulent. Roughly 80% think that Greek politicians are not acting seriously in talks with their European partners. The same percentage does not believe Greece will implement reforms but that this should remain the precondition for further financial support. The debate over WW II reparations might have also influenced public opinion as until February there was still a slight majority in favour of Greece’s euro membership.

Nonetheless, the German public seems to buy the argument put forward by some observers that a Greek exit and/or default is not going to put the euro area and the German economy in particular under severe stress (see chart). Only a third expects a very strong impact while almost half of those polled consider it less substantial. This is surprising given the fact that Germany has direct exposure vis-a-vis Greece through bail-out packages of roughly EUR 60 bn – not to mention TARGET and the impact for the euro area as a whole which will again have repercussions on Germany. While a complete write-off would not derail Germany’s public finances altogether, it would have to be compensated somehow given the rules of the German debt brake, meaning that the impact would be felt by the individual taxpayer.

This ambiguity over Greece and possible costs might to a certain extent facilitate a decision by the German government on further transfers to Greece, which will probably be needed regardless of the way taken. In the context of the extension of the current programme, Finance Minister Schäuble has already indicated that the German Bundestag might be asked to approve a third programme for Greece before the summer break. While passing the Bundestag should not be a problem in principle given the governing coalition’s 80% majority, an increasing number of MPs from Merkel’s CDU/CSU is venting its discontent with this policy course - 29 of them voted against the extension. This number is likely to increase in the event of a new bail-out package, putting Merkel and Schäuble in a difficult position should the new package not provide a credible link between fiscal transfers and modernisation of the Greek economy.

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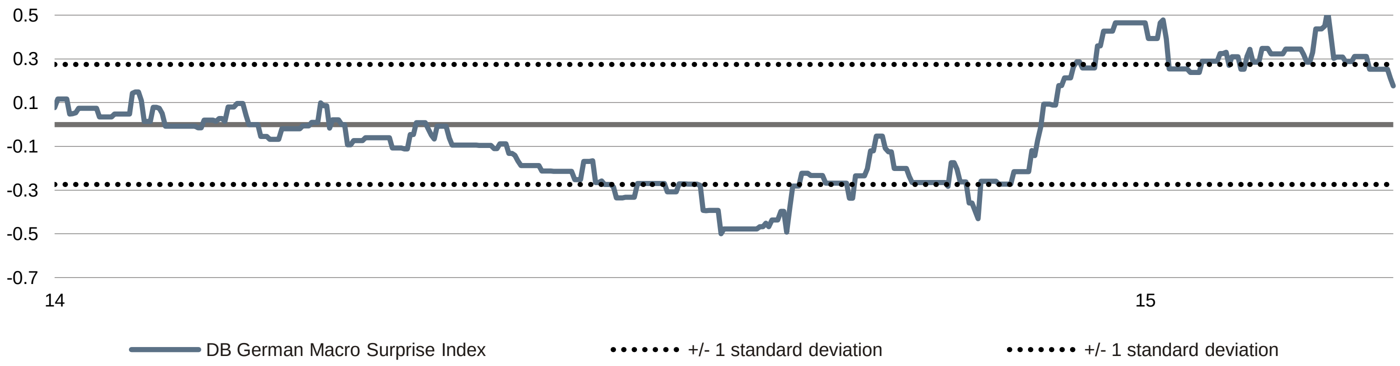
DB German Macro Surprise Index

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.[27]

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
GRCAEU Index	Current Account Balance (EUR bn)	12 2014	09.02.15	25.6	20.8	4.8	1.1	0.8
GRCP20YY Index	CPI (% yoy)	1 2015	12.02.15	-0.4	-0.3	-0.1	-0.3	0.2
GRZEWI Index	ZEW Survey Expectations	2 2015	17.02.15	53.0	55.0	-2.0	-0.2	0.4
GRZECURR Index	ZEW Survey Current Situation	2 2015	17.02.15	45.5	30.0	15.5	2.1	1.0
GRIFPBUS Index	IFO Business Climate	2 2015	23.02.15	106.8	107.7	-0.9	-0.8	0.2
GRGDPPGQ Index	GDP (% qoq)	12 2014	24.02.15	0.7	0.7	0.0	-0.1	0.3
GRUECHNG Index	Unemployment Change (000's mom)	2 2015	26.02.15	-20.0	-10.0	10.0	0.2	0.6
GRIMP95Y Index	Import Price Index (% yoy)	1 2015	27.02.15	-4.4	-4.6	0.2	0.5	0.8
MPMIDEMA Index	Markit Manufacturing PMI	2 2015	02.03.15	51.1	50.9	0.2	0.2	0.6
GRFRIAMM Index	Retail Sales (% mom)	1 2015	03.03.15	2.3	0.4	1.9	1.7	1.0
MPMIDESA Index	Markit Services PMI	2 2015	04.03.15	54.7	55.5	-0.8	-0.8	0.2
GRIORTMM Index	Factory Orders (% mom)	1 2015	05.03.15	-3.9	-1.0	-2.9	-1.4	0.1
GRIPIMOM Index	Industrial production (% mom)	1 2015	06.03.15	0.6	0.5	0.1	0.1	0.6
GRCAEU Index	Current Account Balance (EUR bn)	1 2015	09.03.15	16.8	16.5	0.3	-0.3	0.4
GRCP20YY Index	CPI (% yoy)	2 2015	12.03.15	0.1	0.1	0.0	0.3	0.4
GRZEWI Index	ZEW Survey Expectations	3 2015	17.03.15	54.8	59.4	-4.6	-0.5	0.3
GRZECURR Index	ZEW Survey Current Situation	3 2015	17.03.15	55.1	52.0	3.1	0.3	0.7
MPMIDEMA Index	Markit Manufacturing PMI	3 2015	24.03.15	52.4	51.5	0.9	0.8	0.9
MPMIDESA Index	Markit Services PMI	3 2015	24.03.15	55.3	55.0	0.3	0.4	0.7
GRIFPBUS Index	IFO Business Climate	3 2015	25.03.15	107.9	107.3	0.6	0.3	0.6

Sources: Bloomberg Finance LP, Deutsche Bank Research

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

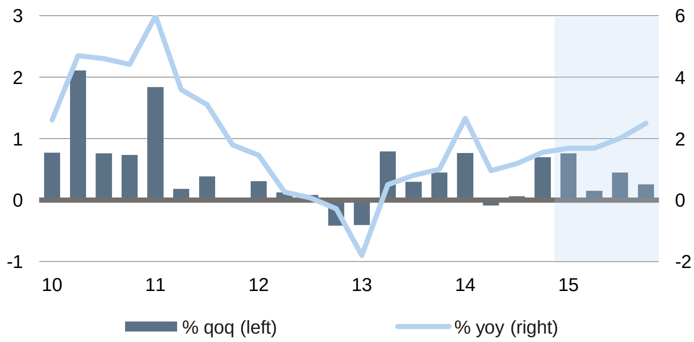
Chartbook – Total economy

— After stagnation during summer, the German economy accelerated markedly to 0.7% qoq in Q4 2014 – the strongest quarterly growth among the largest industrial countries. GDP grew by 1.6% on an annual average in 2014. This is a marked acceleration relative to the weak economic growth seen in 2012 (+0.4%) and 2013 (+0.1%). The main growth driver was private consumption thanks to the good shape of the labour market. The number of employed persons increased to the historical peak of 42.7 million and disposable income grew by a solid 2.4%. Investments expanded only moderately due to elevated geopolitical risks and disappointing world trade. Net exports also contributed somewhat to Q4 GDP growth.

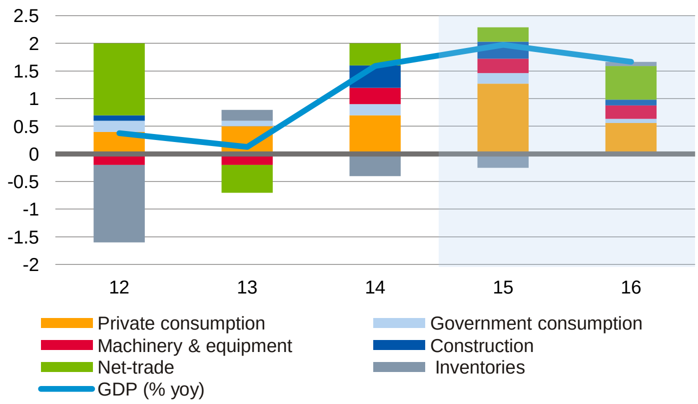
— Sentiment indicators improved recently. They are pointing to strong GDP growth in Q1 2015 of about ½% qoq. Favourable for the German economy are the slump of oil prices and the strong depreciation of the EUR. In addition, the mild winter will likely allow construction investment to be pulled forward adding strongly to Q1 GDP growth. The ongoing elevated geopolitical risks – esp. the Ukraine-Russia crisis – continue to be a drag. The ifo index increased for the fifth month in a row in March. The composite PMI increased strongly lately rising to the highest level since August 2014. Increasingly this is also driven by the manufacturing PMI, while previously it was mostly supported by the domestically oriented services sector.

— Thanks to the high starting level for 2015 provided by Q4, the slump of oil prices and the weakening of the EUR, we expect the German economy to expand by 2.0% in 2015. Our forecast for 2016 is 1.7%.

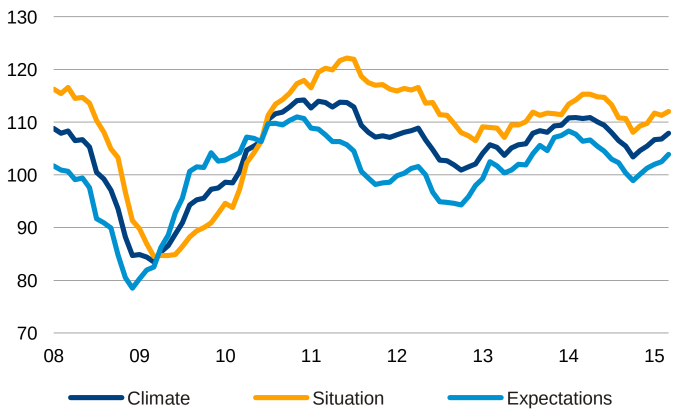
Real GDP growth



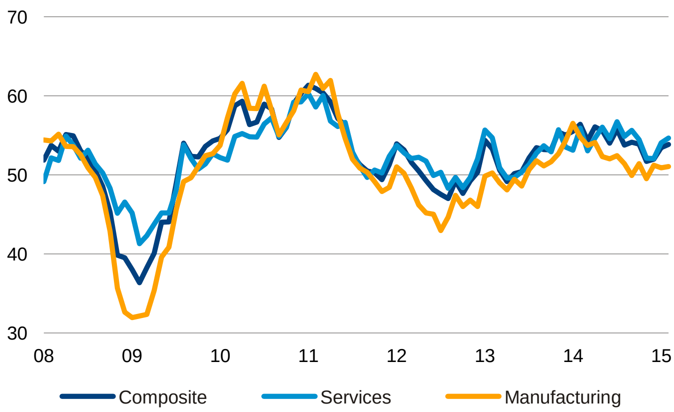
Contribution to real GDP growth (%-points)



ifo index - total economy (2005=100)



Purchasing manager index



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

Chartbook – Foreign trade

— German trade numbers surprised to the downside in January falling much more than expected. Exports were down 2.1% mom, but this comes after a 2.8% increase in December. In the previous months growth was also solid. Thus, exports were up 1% in the last three months compared to the previous three months. Partly due to the weak oil prices imports fell again in January (-0.3% mom vs -0.7% mom in December). The trade balance weakened somewhat, but remained high.

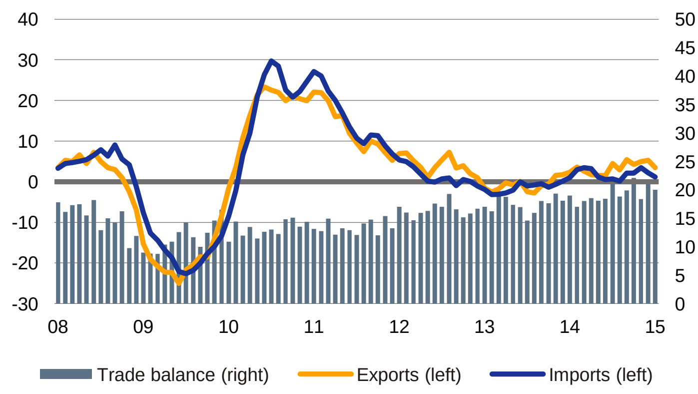
— The 3 months average showed a 3% yoy export increase. Demand from the US and Asia remained high and exports to these destinations were up 9% yoy (3M mov. avg.) and 8%, respectively. Exports to EMU dampened (+3% yoy).

— Growth of automobile exports was relatively strong with 5% yoy (3M mov. avg.). Due to one-offs (holiday effect, re-tooling of production lines for new models) the monthly volatility was elevated in recent months. Exports of the electrical engineering industry were up by 6% yoy. Export growth was negative in mechanical engineering (-1.5%), chemicals (-1.0%) and the metal industry (-0.2%).

— Leading export indicators increased in February / March, but remained on a relatively low level pointing to a moderate development in the coming months. The unresolved Ukraine-Russia crisis and the clouded growth outlook for major German trading partners – esp. China, France, Italy – will probably continue to be a drag. Thanks to the moderate recovery of the world economy in the further course of this year and the weaker EUR, we expect a gradual recovery of exports. Imports will probably grow relatively strongly thanks to robust domestic demand.

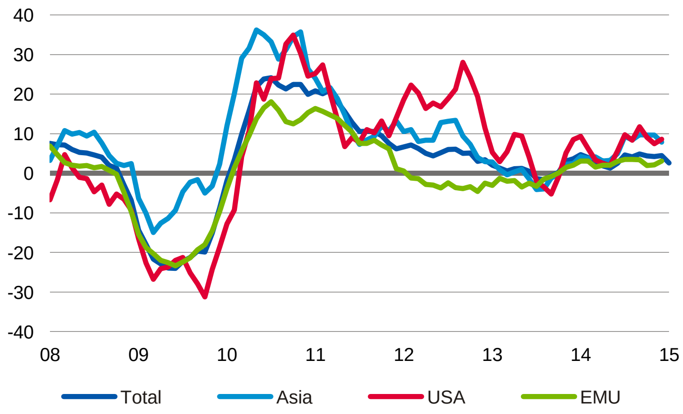
Merchandise trade

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



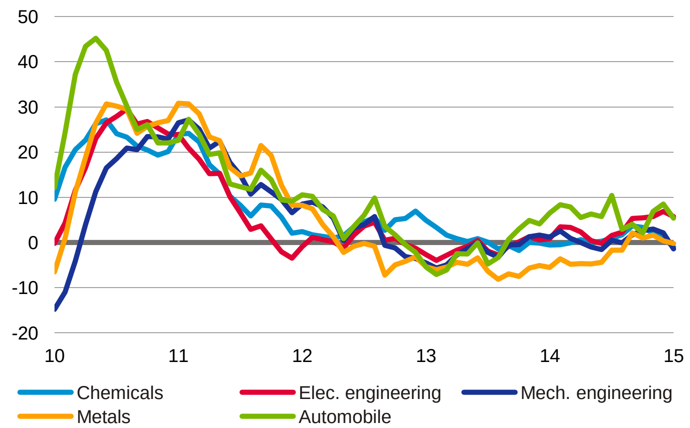
German exports by region

% yoy, 3M mov. avg.



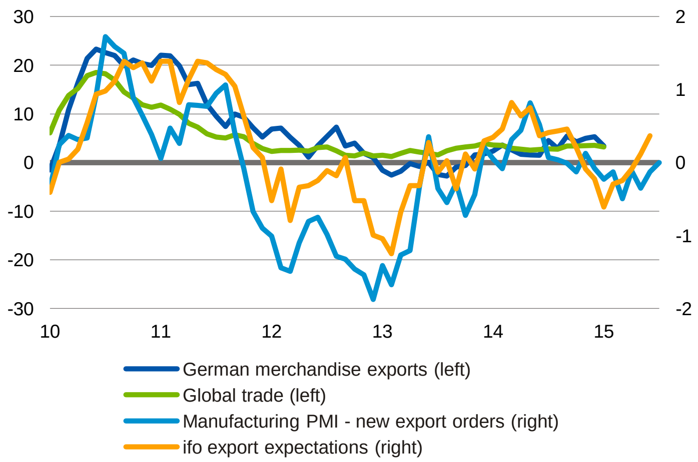
Exports by sector

% yoy, 3M mov. avg.



Exports and early indicators

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



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

Chartbook – Industry

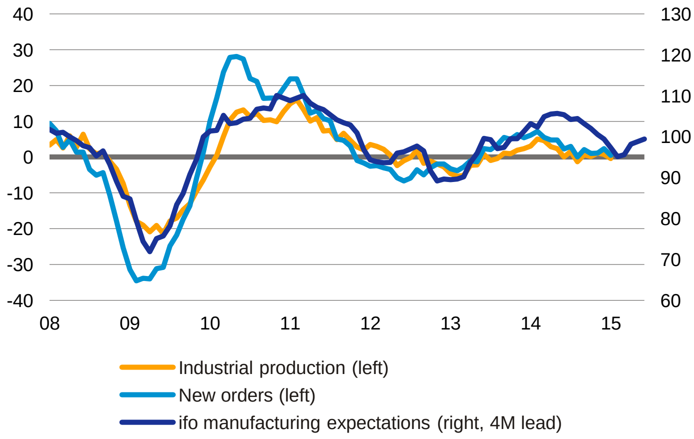
— Industrial production grew quite strongly in January (+0.6% mom). In addition, the December figure was revised up markedly. While manufacturing output stagnated in January, especially construction added strongly to overall growth (+5%) as the mild winter allowed investment to be pulled forward. This points to a robust start to the year for the German economy.

— The improvement in the manufacturing ifo and PMI as well as the further rise of capacity utilization in Q1 all point to a continuation of the industrial recovery, though they all are only consistent with moderate output growth in Q1.

— In the course of 2015 industrial production in Germany is likely to record an uptrend. The weaker EUR and falling oil prices provide significant impetus. We expect German industrial production to increase by 1.5% in 2015 in real terms (2014: 1.9%). Somewhat stronger than expected production results in Q4 2014 support our assessment. We expect both the automotive industry and mechanical engineering to increase their output by roughly 2% in 2015. While mechanical engineering should thus improve its performance over 2014 (+0.8%), the auto industry should see its growth cool (2014: +4.5%). Production in the electrical engineering industry is expected to grow by 1.5% – following a 2.5% increase in 2014. Production in the metals industry is expected to increase by more than 1% in 2015 after a relatively strong plus last year (+3.2%). Chemicals production is likely to add 1.5% in 2015; however, this would not neutralise the setbacks in 2014 (-2.9%). Food production could increase by 0.5% in 2015 (2014: +0.1%).

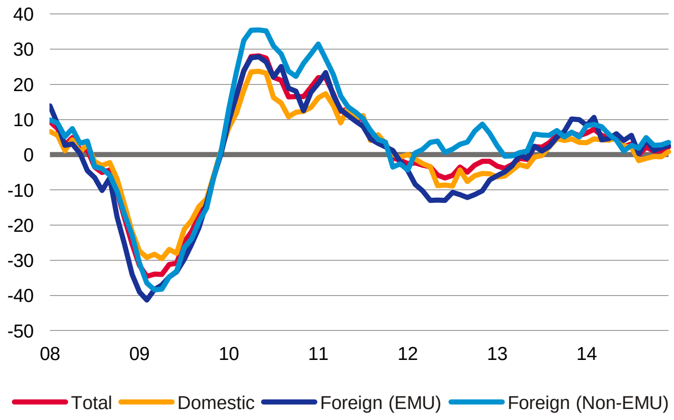
Industrial production, new orders & ifo expectations

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

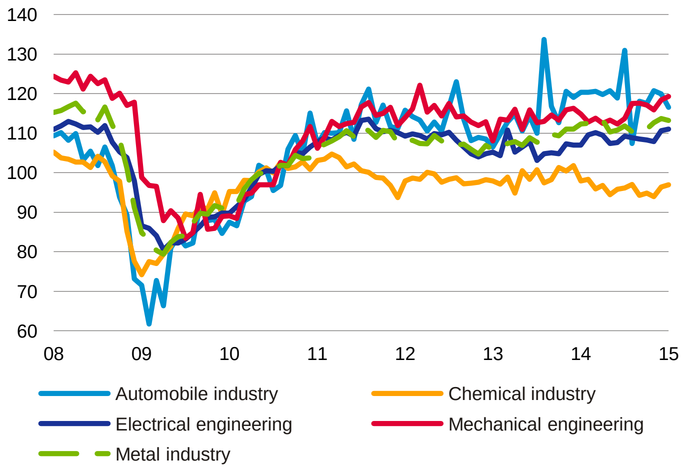


New manufacturing orders by region

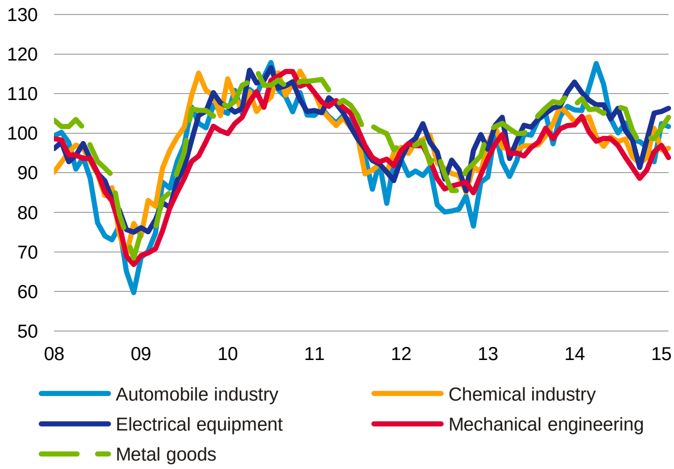
% yoy, 3M mov. avg.



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



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



Sources: Federal Statistical Office, ifo

Chartbook – Domestic economy

— The German labour market showed ongoing strength in February. Unemployment was down (-20k mom). Strong employment growth continued to be mainly driven by the integration of immigrants into the German labour market which highlights mismatch problems of the domestic labour force. The outperformance of employment relative to unemployment continues due to somewhat above 300,000 additional persons having entered the German labour market mainly thanks to high net migration. Early indicators suggest a positive development over the next few months. During the rest of the year the likely negative impact from the minimum wage on employment will become more and more visible. The unemployment rate should fall to 6.5% in 2015 (2014: 6.7%).

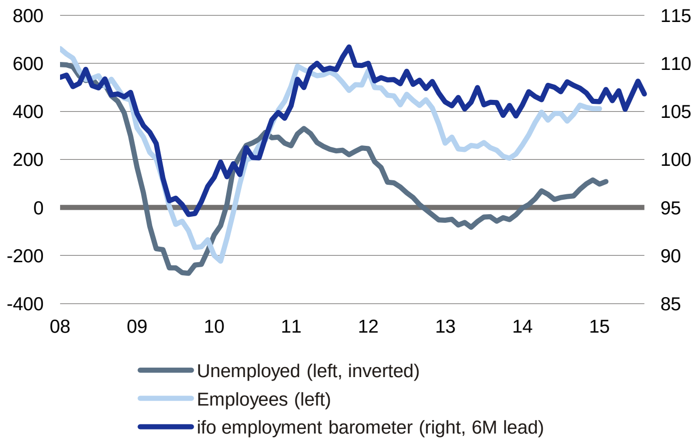
— Real retail sales rose strongly in January (+2.9% mom). This was the fourth consecutive increase, which only happened four times since 1994. On average sales were up 3% yoy. Continuous employment build-up, solid wage increases and the falling oil price all contributed to this. The 4% jump compared to December 2013 was in part due to 2014 one additional working day. All told, retail sales rose by 1.5% in 2014 and thus somewhat stronger than private consumption (+1.2%), which only happened four times since 1995. Consumer confidence indicators have turned late-2014 and suggest a continued moderate uptrend in sales.

— Investment in machinery & equipment and construction spending are expected to contribute to growth in 2015. Domestic investment goods orders and capacity utilization currently point to a moderate recovery in Q1. During the rest of the year, we expect investment in M&E to pick up and to grow by around 4% on annual average in 2015.

— The construction sector benefits from high net immigration and rising disposable income propelling housing demand. Construction spending could grow by about 3% in real terms in 2015. But monthly indicators for construction activity were relatively weak recently despite robust business sentiment.

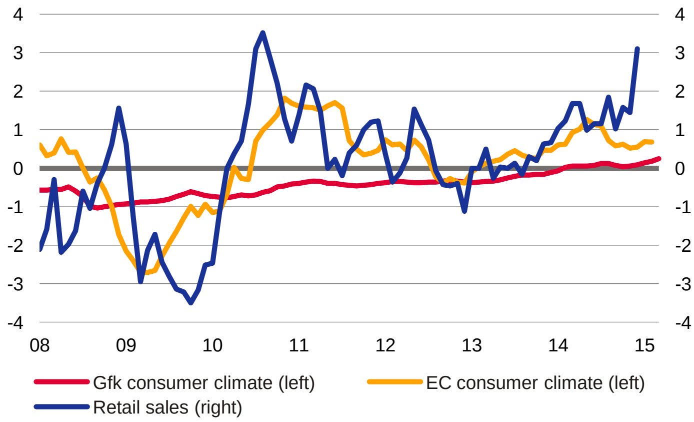
Unemployment barometer, employment and unemployment

'000 yoy (left); index (right)



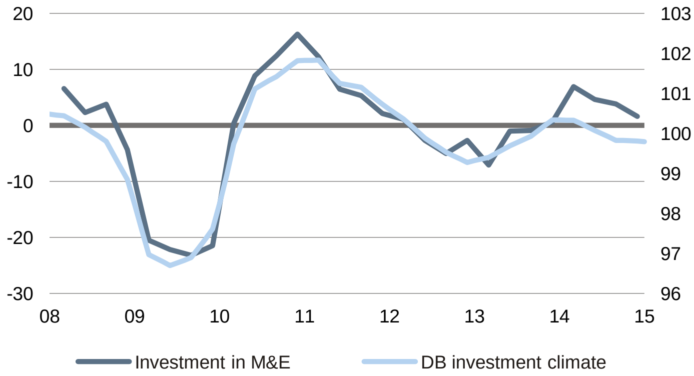
Retail sales and consumer confidence

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



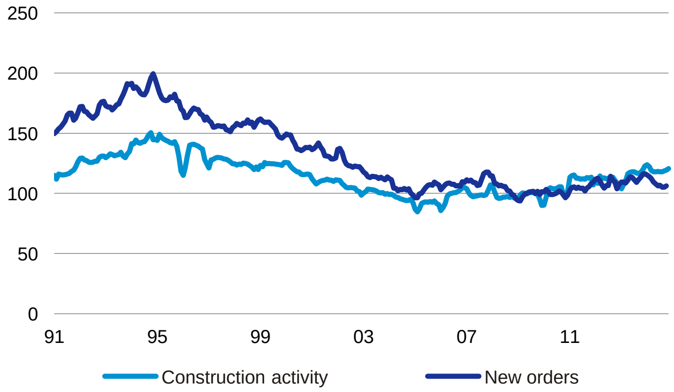
Investment in machinery & equipment and DB investment climate

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



Construction activity and new orders

2010=100, 3M mov. avg.



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

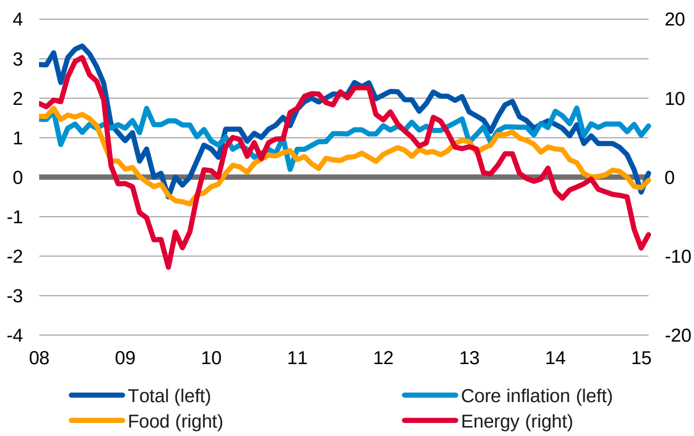
Chartbook – Financial markets

— After a temporary dip below zero German inflation recovered in February. According to preliminary information the inflation rate stood at 0.1% yoy after -0.4% previously. Thanks to the partial recovery of oil prices energy prices were less negative in yoy-terms compared to January (-7.3% vs -8.4% prev.). Food prices also rose (-0.4% yoy vs -1.3%). As expected core inflation recovered in February likely to 1.3% after it had fallen to 1.1% in January. It is likely to have benefited from the rebound in prices for package holidays. Over the next months inflation is predicted to hover near 0% due to ongoing weakness of energy prices. In contrast, core inflation could potentially receive some impetus from second-round effects due to the introduction of the minimum wage in January 2015.

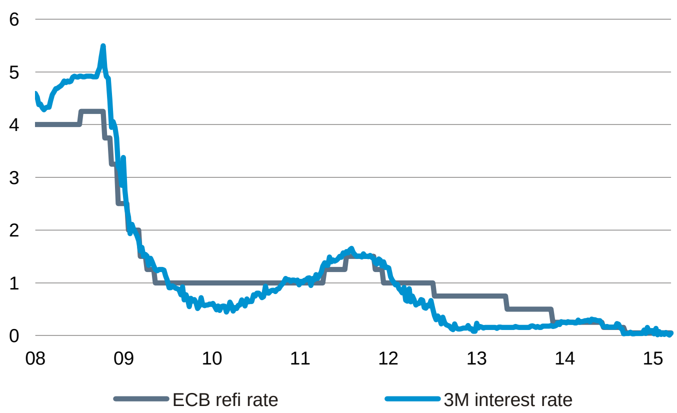
— Fearing a negative feedback loop between declining current inflation, a disanchoring of inflation expectations and the still weak banking system restricting the supply of credit, the ECB decided at its meeting in January to extend its asset purchases significantly and to lower the interest rate for the TLTROs. In March the ECB started to buy bonds issued by euro area central governments, agencies and European institutions in addition to the already started purchases of covered bonds and ABS. The total purchase volume will be EUR 60 bn per month and run at least until September 2016. Objectives are credit easing and weakening the EUR by expanding the balance sheet by EUR 1.1-1.2 trillion.

— Given the extremely expansionary monetary policy stance of the ECB interest rates of 10Y gov't bonds declined further. The yield for 10Y German govt. bonds fell significantly to currently about 0.2%. The yield spread between 10Y US treasuries and German Bunds was around 1.8 pp as of late.

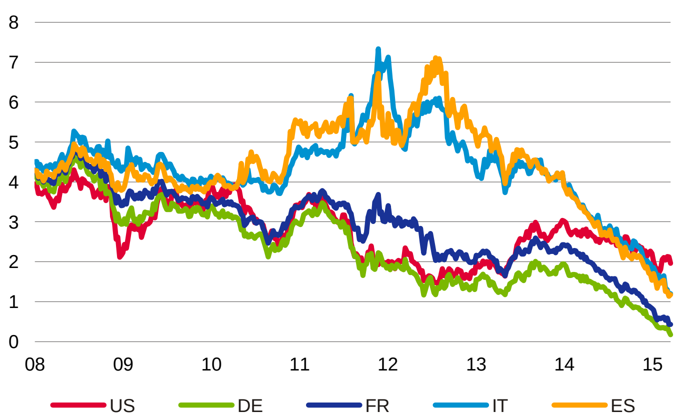
Consumer prices (% yoy)



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

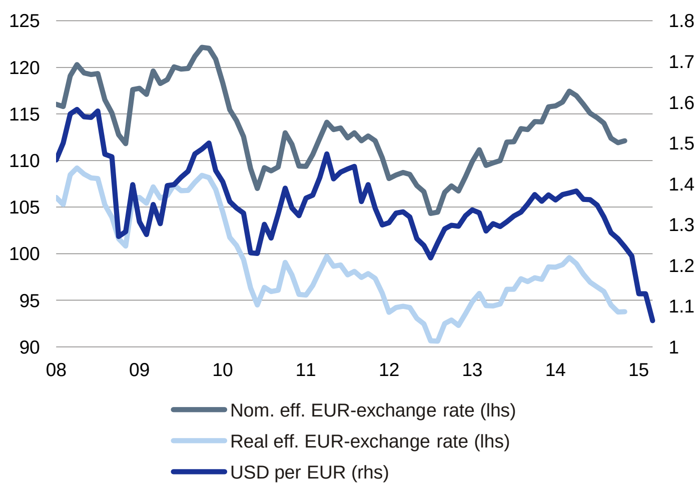


10Y government bond yields (%)



Exchange rate development for the EUR

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

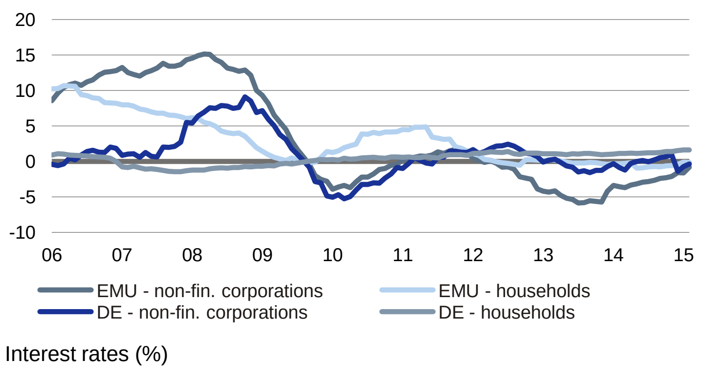


Sources: Federal Statistical Office, ECB, EU Commission, Global Insight, Reuters, Deutsche Bank Research

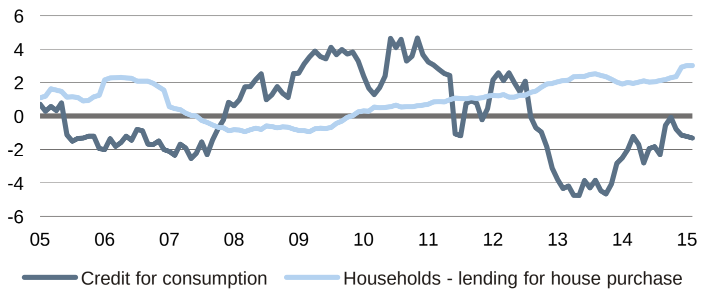
Chartbook – Lending

- Credit to corporates in the euro area has been shrinking since March 2012. However, during 2014 reductions have become less and less pronounced (for comparison: Feb. 2014: -3.6%, mid-2013: -5.9%). February 2015 also saw a further drop but for the first time since mid-2012 at less than 1% (-0.8% yoy). Smaller reductions of course reflect the accumulated cuts which have already taken place as well as improving growth prospects for the euro area.
- Credit to households in the euro area remained stable in February 2015 (again -0.1% yoy). Here, shrinking has become less pronounced during the 2^{nd} half of 2014 (for comparison: -0.8% in July 2014).
- Credit conditions for German corporates continue to be very favourable. Interest rates for corporate credit are at 2.6% (January). In February 2015 the share of companies reporting restricted access to credit reached a new record low. Only 16.2% of companies from industry and trade (Jan.: 17.1%) report restrictive access to credit. Similarly, credit conditions for construction companies are very benign, even though February saw a slight increase of firms reporting restrictive access to credit (22.2% after 20.9% in Jan.). Access to credit is substantially easier than 5 years ago when the shares of corporates reporting restrictive access were more than twice as high. Despite the very good conditions, credit growth remained subdued in 2014. After slight growth in yoy comparison in autumn, latest drops however also reflect statistical reclassifications (Feb. 2015: -0.4%, Jan. and Dec. also with decreases). The restrained demand for credit by German corporate also reflects the rise of alternative financing options such as issuing corporate bonds where volumes have more than doubled since 2008.
- Lending to households in Germany continues to rise modestly (Feb.: +1.6% yoy). Growth in mortgage credit continues to drive total increases and has been picking up somewhat driven by the further drop in interest rates (new record low for mortgage rates in Jan. at 2%) during the second half of the year. For the past three months mortgage growth has been around 3% yoy.
- Given the very low interest rates overall credit growth might still appear rather moderate. Rising real incomes reduce the need to finance consumption via credit for many households translating into moderate credit demand despite the ultra-low interest rates. Consumer credit again decreased in February (-1.6% yoy).

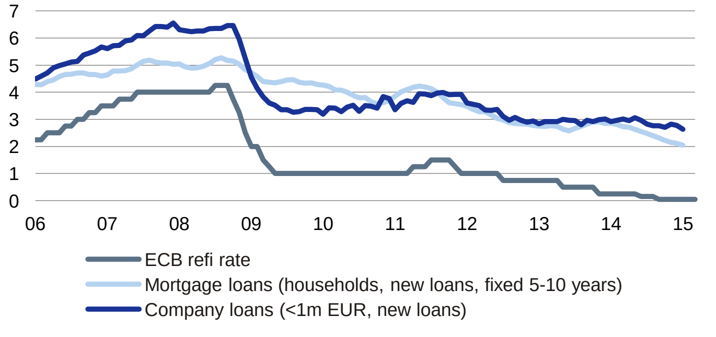
Lending to the private sector (% yoy)



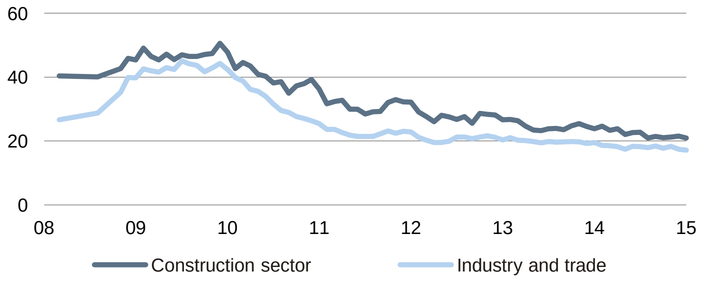
Loans to households (% yoy)



Interest rates (%)



Companies' view on access to credit



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

Sources: ECB, ifo, Deutsche Bank Research

Chartbook – Public finances

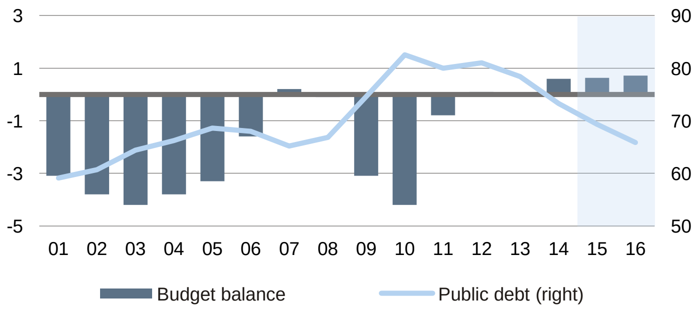
— As in 2013 (0.1%), the general government budget closed with a small surplus in 2014 (0.6%). The budget situation is unlikely to change appreciably in 2015 and should see a comparable surplus again at year-end. This will be driven mainly by the still good revenue prospects in view of the favourable economic outlook. The robust growth of revenues will probably suffice in the current year to compensate for a number of measures representing fiscal burdens, such as the introduction not only of the nationwide minimum wage but also retirement at 63 and higher pensions for mothers whose children were born before 1992. The financial buffer provided by the social security system will continue to shrink, though, owing to the broader spectrum of benefits offered. One of the causes of the steadily higher revenue volume is that for several years there has basically been no change in the income tax scale. This heightens the fiscal drag of what is known in Germany as "cold progression". Changes in this area are currently a controversial issue. As the report on the minimum subsistence level has been now tabled it is necessary to adjust the personal tax allowance anyway.

— One year earlier than anticipated, the German government has already been able to close 2014 with a balanced budget. The budget is forecast to be in equilibrium again in 2015-2019 by the government. The chances of this happening are good in 2015 as long as there are no major unforeseen extra burdens on the budget – as would be the case, for instance, in the event of a potential renewed haircut on Greek debt. The municipalities and social security closed 2014 in the black again, too – however, the surplus was much smaller than in 2013. Also the aggregate Länder budgets showed a small surplus for the first time in quite a while. Within the Länder group – as among the municipalities – the situation remains very mixed, however. A host of Länder are deep in the red, while others report surpluses and can reduce their debt. In 2014, not only the general budget but also the Federation budget was structurally balanced for the first time in a long time. This means that since 2012 these have already complied continuously with the regulations for the debt brake that will apply in full force from 2016.

— Public debt (under the Maastricht definition) equalled only 74.8% of GDP at the end of Q3 2014 (down from 76.9% in Q4 2013). Over the next few years sovereign debt is likely to steadily decrease further on a continuation of the economic dynamics. The fact that the bad banks continue to run down their portfolios will alone cut debt by an additional roughly 0.5% of GDP p.a. This suggests that the debt ratio could slip back under 70% of GDP for the first time since 2008 as early as this year.

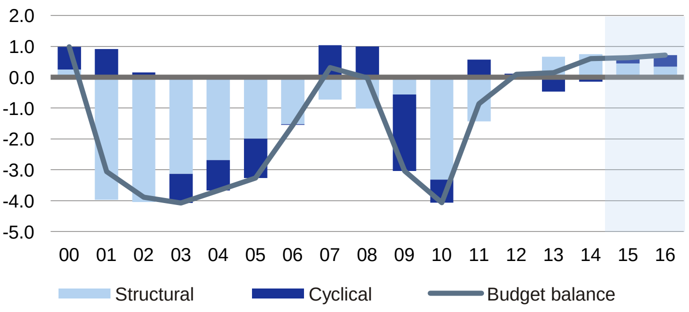
Public debt and budget balance

General government, as % of GDP



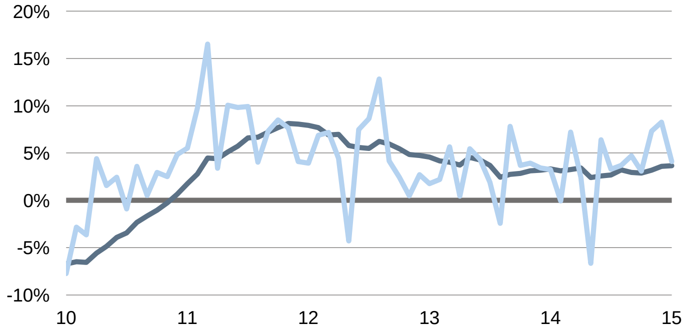
Budget balance

General government, % of GDP



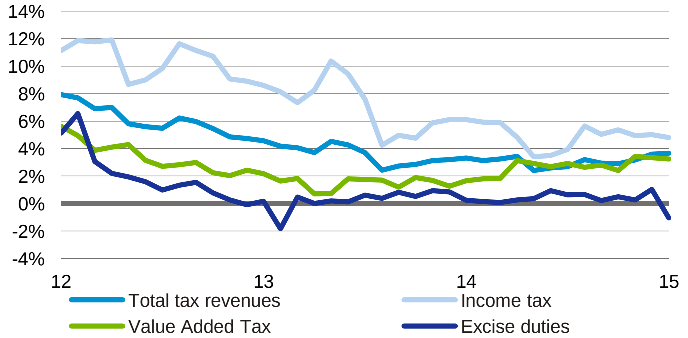
Tax revenues

Monthly data, yoy and yoy 12 months moving average



Development of important taxes

Change yoy, 12 months moving average



Sources: Deutsche Bank Research, European Commission, Bundesbank

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

Date	Event	Remarks
15 April	ECB Governing Council meeting, press conference	Review of the monetary policy stance.
17 to 19 April	G20 Finance Ministers and Central Bank Governors Meeting and spring meeting of IMF and World Bank, Washington	Debates on the global economy and the world's financial markets.
24 to 25 April	Eurogroup and informal ECOFIN meeting, Riga	Financial and macroeconomic stability developments in the euro area, including monitoring of individual Member States, situation in Greece.
10 May	State election in Bremen	According to press reports the red-green coalition government is likely to gain a marked majority again.
11 to 12 May	Eurogroup and ECOFIN meeting, Brussels	Economic situation in the euro area – Commission spring forecast, inflation and exchange rate developments, discussion on growth and jobs – implementation of euro area recommendations, among others.
27 May	G7 Finance Ministers and Central Bank Governors Meeting, Dresden	International financial markets architecture, strengthening of international trade, possibly situation in the Ukraine.
3 June	ECB Governing Council meeting, press conference	The Council is fully committed to the plan to purchase EUR 60 bn of securities per month until September 2016 and possibly beyond.

Source: Deutsche Bank Research

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Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
31 Mar 2015	8:00	Retail sales (Index, sa), pch mom	February	-1.7	2.3
31 Mar 2015	10:00	Unemployment rate (%, sa)	March	6.5	6.5
8 Apr 2015	8:00	New orders manufacturing (Index, sa), pch mom	February	1.9	-3.9
9 Apr 2015	8:00	Industrial production (Index, sa), pch mom	February	0.2	0.6
9 Apr 2015	8:00	Trade balance (EUR bn, sa)	February	17.6	20.0
9 Apr 2015	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	February	-2.2 (0.9)	-2.2 (0.9)
9 Apr 2015	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	February	0.5 (0.3)	-0.5 (-0.2)
23 Apr 2015	9:30	Manufacturing PMI (Flash)	April	52.5	52.4
23 Apr 2015	9:30	Services PMI (Flash)	April	55.0	55.3
24 Apr 2015	10:30	ifo business climate (Index, sa)	April	108.0	107.9
29 Apr 2015	8:00	Import prices (Index, sa) pch mom (yoy)	March	0.3 (-2.7)	1.4 (-3.0)
29 Apr 2015	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	April	0.5 (0.4)	0.9 (0.1)
13 May 2015	8:00	Real GDP (Index, sa), % qoq	Q1 2015	0.8	0.7

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

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Financial forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	0.120	0.10	0.05	0.50	-1.25	-0.25	0.05	1.25	1.50	1.95	0.05
Jun 15	0.125	0.10	0.05	0.50	-0.75	-0.25	0.05	1.25	1.50	1.85	0.05
Sep 15	0.500	0.10	0.05	0.50	-0.75	-0.25	0.05	1.25	1.50	1.85	0.05
Dec 15	0.750	0.10	0.05	0.50	-0.75	-0.25	0.05	1.25	1.50	1.85	0.05
3M interest rates, %											
Current	0.35	0.15	0.02	0.57							
Jun 15	0.75	0.15	0.00	0.59							
Sep 15	1.30	0.15	0.00	0.59							
Dec 15	1.35	0.15	-0.10	0.60							
10J government bonds yields, %											
Current	2.00	0.33	0.22	1.58							
Jun 15	2.50	0.50	0.30	1.60							
Sep 15	-	0.55	0.40	1.80							
Dec 15	2.65	0.60	0.40	2.00							
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	1.09	119.30	0.74	0.67	1.05	9.26	7.47	8.60	4.07	299.65	27.38
Jun 15	1.04	121.00	0.71	1.47	1.07	9.00	7.46	9.00	4.08	310.50	27.50
Sep 15	1.02	123.00	0.71	1.43	1.09	9.00	7.46	9.00	4.03	311.00	27.50
Dec 15	1.00	125.00	0.74	1.36	1.10	8.90	7.46	8.90	4.08	315.00	27.50

Sources: Bloomberg, Deutsche Bank

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German data monitor

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Oct 2014	Nov 2014	Dec 2014	Jan 2015	Feb 2015	Mar 2015
Business surveys and output											
Aggregate											
Ifo business climate	110.8	110.1	106.7	104.5	107.1	103.4	104.6	105.5	106.7	106.8	107.9
Ifo business expectations	107.5	105.5	101.9	100.1	102.8	98.9	100.1	101.3	102.0	102.5	103.9
PMI composite	55.4	55.2	54.5	52.5	54.2	53.9	51.7	52.0	53.5	53.8	55.3
Industry											
Ifo manufacturing	106.9	106.3	102.8	99.7	102.8	98.6	99.4	101.1	102.2	102.3	103.8
Headline IP (% pop)	1.0	-1.0	-0.2	0.7		0.4	0.1	1.0	0.6		
Orders (% pop)	0.1	-0.2	0.1	2.1		2.8	-2.2	4.4	-3.9		
Capacity Utilisation	84.0	83.9	83.8	84.2	84.6						
Construction											
Output (% pop)	5.7	-4.7	-0.1	1.3		-0.1	0.7	1.2	1.0		
Orders (% pop)	0.8	-4.5	-2.4	-0.1		1.8	0.3	1.0	9.8		
Ifo construction	122.7	119.9	120.3	120.3	118.7	120.8	120.7	119.5	119.2	119.1	117.9
Consumer demand											
EC consumer survey	0.3	4.3	1.0	-1.2		-0.7	-1.6	-1.4	0.0	-0.1	
Retail sales (% pop)	1.9	-0.2	0.0	1.6		2.0	0.3	1.1	2.3		
New car reg. (% yoy)	2.8	-0.3	4.1	2.7		3.7	-1.8	6.7	2.6	6.6	
Foreign sector											
Foreign orders (% pop)	-1.2	0.2	1.7	2.0		0.4	-0.3	3.8	-4.8		
Exports (% pop)	0.1	0.4	2.3	1.6		1.2	-2.8	2.8	-2.2		
Imports (% pop)	0.6	0.0	0.7	1.0		-1.5	1.3	-1.0	-0.5		
Net trade (sa EUR bn)	54.0	55.0	59.9	62.3		22.1	18.4	21.8	20.0		
Labour market											
Unemployment rate (%)	6.8	6.7	6.7	6.6		6.6	6.6	6.5	6.5	6.5	
Change in unemployment (k)	-41.0	-19.0	1.7	-38.0		-24.0	-16.0	-26.0	-10.0	-20.0	
Employment (% yoy)	0.7	0.9	0.9	1.0		1.0	1.0	1.0	1.0		
Ifo employment barometer	107.6	106.8	106.5	106.3		107.1	105.2	106.7	108.1	106.8	
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	1.0	0.9	0.8	0.4		0.7	0.5	0.1	-0.5	-0.1	
Core HICP (% yoy)	1.1	1.1	1.2	1.1		1.1	0.9	1.2	0.8	1.0	
Harmonised PPI (% yoy)	-1.0	-0.8	-0.8	-1.2		-1.0	-0.9	-1.7	-2.2	-2.1	
Commodities, ex. Energy (% yoy)	-11.1	-4.9	-1.8	0.9		0.9	1.7	0.1	2.3	1.4	
Oil price (USD)	108.2	109.7	102.0	76.4		87.3	78.8	63.1	49.7		
Inflation expectations											
EC household survey	22.0	16.9	13.4	8.6		11.1	8.5	6.2	0.5	-0.7	
EC industrial survey	5.6	2.3	4.2	2.1		4.7	3.2	-1.5	-1.2	-0.1	
Unit labour cost (% yoy)											
Unit labour cost	0.8	2.0	2.0	1.7							
Compensation	2.8	2.5	2.5	2.3							
Hourly labour costs	0.8	2.3	2.1	1.6							
Money (% yoy)											
M3	3.8	4.5	4.7	4.7		4.0	5.1	4.7	5.9		
M3 trend (3m cma)						4.6	4.6	5.2			
Credit - private	-3.6	-3.5	1.4	1.7		1.2	1.5	1.7	2.1		
Credit - public	-1.5	9.7	5.9	12.6		5.1	3.6	12.6	19.0		

% 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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