Deutsche Bank
DB Research

Current Issues
Business cycle

Focus Germany

Germany after the elections

October 1, 2013

Authors
Klaus Günter Deutsch
+49 30 3407-3682
klaus.deutsch@db.com

Bernhard Gräf
+49 69 910-31738
bernhard.graef@db.com

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

Frank Zipfel
+49 69 910-31890
frank.zipfel@db.com

Editor
Bernhard Gräf

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

www.dbresearch.com

DB Research Management
Ralf Hoffmann

Content Page

Governing in Germany: From victory celebrations to a centrist coalition. After the strong showing of the conservatives in the federal elections, Germany is moving in big steps towards a centrist coalition government consisting of CDU/CSU and SPD. There are at least three reasons for this course of action: the "energy turnaround", the renegotiation of fiscal federalism and banking policy, all call for a tight coordination between the federal level and the 16 states, nine of which are governed by SPD-led coalitions. Upcoming decisions in euro area management would benefit from a solid majority in the parliament, too. The CDU/CSU will have to provide substantial concessions to the SPD to make it happen. We expect this to happen.

General budget 2013: Shades of the black. Fiscally Germany again sets apart from the rest of the EU member states. We expect Germany's general budget to be in equilibrium or even slightly in surplus in the current year (under the Maastricht definition) alongside a decline in general government debt to just under 80% of GDP.

Low interest rates curbing households' propensity to save. Whenever discussions arise over the impact of the extremely low interest rates that followed in the wake of the financial and sovereign debt crises, they usually centre on the negative consequences for savers, government's savings on debt service, the problems facing life insurance companies and occupational pension funds in their efforts to generate the returns necessary to meet their obligations, and the misallocation of capital in corporate investment activity. However, interest rates also influence whether households decide to save their money or spend it on consumption. To conduct this analysis we estimated macroeconomic savings functions. For many countries – Germany in particular – we found a positive correlation between the real rate of interest and the savings rate. Low interest rates thus tend to curb households' propensity to save.

Food prices driving up inflation (at least a little). Inflation in Germany has slowed from its last peak in November 2011 and is on a relatively moderate track all in all, helped in particular by declining oil prices. In contrast food prices have increasingly added to inflation since 2011. German inflation was somewhat above the EMU average over the last few months. This is the first time since 2007. Given the euro area members' very different economic situations and the stable outlook for commodity prices, Germany's rate of price increase looks set to remain above the low euro area average for some time to come. At 1.6% in both 2013 and 2014, the German inflation rate looks set to come in a tad higher than the euro area average (1.5% and 1.4%, respectively) but will still be clearly below 2%.

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Euroland	-0.2	1.2	1.4	1.5	1.4	1.5	1.8	1.4	1.3	-2.9	-2.4	-2.0
Germany	0.5	1.5	1.4	1.6	1.6	1.8	7.1	7.0	7.1	0.0	0.2	0.4
France	0.2	1.3	1.9	1.1	1.5	1.3	-1.7	-1.5	-1.3	-4.1	-3.3	-2.9
Italy	-1.7	0.6	0.5	1.5	1.5	1.5	0.6	1.3	1.8	-3.2	-2.9	-2.9
Spain	-1.5	0.5	1.3	1.7	1.1	1.2	1.2	1.5	1.8	-6.5	-5.3	-4.0
Netherlands	-1.1	0.4	1.2	2.8	1.8	1.8	12.8	11.7	12.3	-3.9	-3.3	-3.0
Belgium	0.1	1.2	0.9	1.2	1.4	1.6	-0.5	0.5	0.5	-3.0	-2.9	-2.7
Austria	0.4	1.4	1.8	2.1	1.7	1.8	3.2	3.5	3.5	-2.1	-1.8	-1.6
Finland	-1.0	0.9	1.5	2.4	2.0	1.9	-0.8	-0.4	0.7	-2.7	-1.8	-0.7
Greece	-4.3	0.8	2.0	-0.6	-0.4	0.0	0.0	1.0	2.0	-4.5	-3.4	-2.5
Portugal	-1.7	0.8	0.7	0.6	0.9	1.1	0.5	1.5	2.0	-5.4	-4.4	-3.3
Ireland	0.5	2.0	0.6	0.8	1.1	1.3	3.5	4.0	4.0	-7.4	-4.9	-2.8
UK	1.5	2.5	2.0	2.7	2.2	2.0	-3.5	-3.2	-2.8	-6.0	-4.8	-4.1
Denmark	0.2	1.8	1.5	0.7	1.5	1.9	6.3	6.1	6.0	-2.0	-1.8	-1.5
Norway	1.8	2.4	2.6	2.3	2.6	2.0	12.5	12.0	11.5	11.0	10.5	10.0
Sweden	0.7	2.3	2.5	0.1	1.1	2.0	6.5	6.0	6.0	-1.5	-1.0	0.5
Switzerland	1.9	2.0	2.0	-0.1	0.5	1.0	12.5	12.1	11.8	0.7	0.8	1.0
Czech Republic	-0.3	2.0	2.8	1.5	1.8	2.0	-2.3	-2.5	-2.5	-3.1	-2.7	-2.6
Hungary	0.4	1.1	1.7	1.8	1.8	3.1	1.2	0.5	0.2	-2.7	-2.9	-2.7
Poland	1.0	2.5	2.8	1.1	2.1	2.4	-1.0	-2.2	-2.8	-3.6	-3.3	-3.1
United States	1.8	3.2	3.5	1.7	2.6	2.3	-3.2	-3.0	-3.1	-3.8	-3.1	-2.0
Japan	1.8	1.0	1.2	0.2	2.7	1.5	1.6	2.9	3.8	-9.3	-7.4	-6.0
World	2.8	3.8	3.9	2.9	3.5	3.4						

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

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

						2012				2013			
	2011	2012	2013F	2014F	2015F	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F
Real GDP	3.3	0.7	0.5	1.5	1.4	0.7	-0.1	0.2	-0.5	0.0	0.7	0.3	0.3
Private consumption	2.3	0.8	0.9	1.0	0.8	0.0	0.0	0.3	0.1	0.2	0.5	0.4	0.3
Gov't expenditure	1.0	1.0	0.8	0.7	0.2	0.4	-0.5	0.6	0.1	0.1	0.6	0.1	0.1
Fixed investment	6.9	-2.1	-1.2	3.4	2.8	-0.4	-1.9	0.1	-0.6	-2.1	1.9	0.4	0.6
Investment in M&E	5.8	-4.0	-2.5	4.1	3.7	-0.4	-3.7	-0.6	-0.3	-2.1	0.9	0.5	1.0
Construction	7.8	-1.4	-1.1	2.2	2.5	-0.5	-1.0	0.5	-1.0	-2.2	2.6	0.3	0.3
Inventories, pp	-0.1	-0.5	0.2	0.0	0.0	-0.1	-0.1	-0.3	0.1	0.4	-0.1	-0.1	0.0
Exports	8.0	3.2	1.7	6.5	6.0	1.7	1.4	0.5	-1.6	-0.7	2.2	2.0	2.3
Imports	7.4	1.4	2.5	6.7	6.0	0.1	0.7	0.1	-0.9	-0.4	2.0	2.3	2.7
Net exports, pp	0.7	0.9	-0.2	0.3	0.5	0.8	0.4	0.3	-0.5	-0.2	0.2	0.0	0.0
Consumer prices*	2.1	2.0	1.6	1.6	1.8	2.1	1.9	2.0	2.0	1.5	1.5	1.7	1.6
Unemployment rate, %	7.1	6.8	6.8	6.6	6.6	6.8	6.8	6.8	6.9	6.9	6.8	6.8	6.8
Budget balance, % GDP	-0.8	0.2	0.0	0.2	0.4								
Balance on current account, % GDP	6.2	7.0	7.1	7.0	7.1								

*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, DB Research

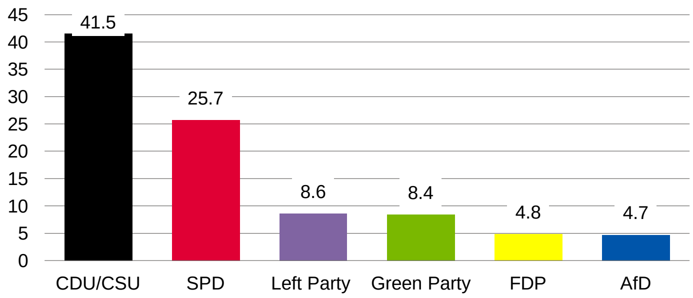
Governing in Germany

From victory celebrations to a centrist coalition

Prior to the elections for the 18th German Bundestag we argued in many articles that the CDU/CSU would very probably do well but would not be able to govern without a coalition partner. Depending on the election outcome the candidates for the position of coalition partner would be the FDP, the SPD and the Greens. The FDP's exit from the Bundestag did indeed surprise many observers, including us, given that the FDP has hitherto always been represented in the Bundestag. A continuation of the centre-right coalition is thus impossible. We had, however, already argued for quite some time that ultimately a coalition between the CDU/CSU and the SPD was the most likely outcome. We stand by our view now that the election is over. Why?

Election results 1

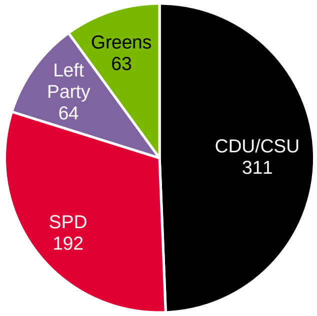
Preliminary official share of votes (in %)



Source: ARD

Distribution of seats in the German Bundestag 2

(absolute majority 315 out of 630)



Source: ARD

The argument in favour of such a coalition is the greater substantive overlap between the CDU/CSU and the SPD on numerous issues than between the CDU/CSU and the Greens. However, the main argument in favour of such a coalition is that the three key tasks that the next government will have to address all require a large degree of coordination between the federal and Länder government levels. From the CDU/CSU point of view this would be much easier to manage with a Bundesrat dominated by the SPD – albeit not with a majority of seats – than from a coalition with the Greens in which every single agreement reached between the coalition partners would require the accommodation of the SPD state premiers in the Bundesrat. In a coalition with the SPD the coordination between the federal and Länder governments would be much easier, especially with the nine Länder that are currently governed by the SPD, and it would have to be done by the SPD itself. This would internalise the coordination and considerably bolster an SPD vice-chancellor's standing in the cabinet.

We therefore expect a “centrist coalition” to be formed. The term “grand coalition” does not really chime with the very contrasting electoral outcomes for the CDU/CSU and the SPD, whose second vote readings differed by 15.8 percentage points or 6.9 million votes (in 2005 the difference was a mere percentage point); the difference between the first votes was also 6.9 million, but the CDU/CSU won 236 direct mandates, whereas the SPD garnered only 58 (Left 4, Greens 1).

This “centrist coalition” can be reflected upon from different angles. Which overarching motto should this coalition pursue? How are the coalition partners already positioning themselves for the next elections to the Bundestag? Who are the corresponding personalities that should be selected for the leadership positions in government, the parliamentary grouping and the party? How will compromises be reached on the issues that await the next government? What will be included in the coalition agreement?

And finally, what will be the main tasks that this government has to complete? In our opinion this question is the best starting point for gauging how the government will be formed. We believe there is a lot to suggest that the "centrist coalition" will shape the legislative issues requiring regulation for which decisions require the broad support of the individual Länder. This applies to the federal financial constitution 2020, energy policy and European policy. All three policy areas require a robust compromise that recognises the key interests of the federal and Länder governments. Furthermore, the government will continue to pursue long-term fiscal consolidation, the gradual adjustment of the welfare state to changed demographic and economic parameters and the gradually stronger orientation of public expenditure to "growth-friendly" objectives, i.e. education, research, transport infrastructure and other infrastructure such as broadband. And finally, the SPD will only then consider itself ready to enter a coalition with the politically superior CDU/CSU if it is given the binding promise of an emblematic success in advance. It is not difficult to recognise that this will be a statutory minimum wage.

But let's take one thing at a time. The three coordination topics are the federal financial constitution, the energy turnaround and European policy.

— The current legal framework for the federal financial constitution of the Federal Republic of Germany applies until 2019. However, especially since the debt brake becomes binding on the Länder in 2020 the federal and Länder governments would like to know several years in advance where which revenues will be coming from and how precise the spending guidelines in the years shortly before then are meant to be, an agreement will have to be reached by 2017 at the latest. Since the parties are loath to embark on an electoral campaign with such operations pending in the engine room of federalism, all the signs are that an agreement has to be reached by 2016. This date sounds further away than is really the case. After all, (i) the interests of the donor Länder Bavaria and Hesse, which have filed complaints with the Constitutional Court in protest at certain aspects of German federalism, have to be reconciled with the starkly contrasting interests of the many recipient Länder to the north and the east; (ii) the funding of the financially weak Länder, which are mainly – but not only – located in east Germany, will have to be resolved sensibly as they will continue to depend heavily on transfers primarily due to demographic and structural economic factors over the long term, too; and (iii) an agreement that is solely to the detriment of the federal government is impossible, even though 16 Länder premiers could easily agree on this. Given the complicated relations – also of a partisan nature – between north and south, east and west, SPD, Left, CDU/CSU and Greens, no-one should believe that this can be put on the back burner. The debt brake, which permits a maximum structural deficit of 0.35% of GDP for the federal government from 2016 and no structural debt whatsoever for the Länder from 2020, will provide a massive boost to this. It is also obvious that some clearing-up has to be done. One of these tasks is what is to be done with Länder or city-states that have excessive debt levels, as well as the question of how municipal governments in a particularly precarious financial situation can be returned to a sound footing. It will not be possible to do the clearing-up without some degree of partisan conflict between the CDU and the SPD.

— A more urgent matter is getting to grips with the so-called "Energiewende", or energy policy turnaround. One might think that the return to the status quo from before the CDU/CSU/FDP government's extension of nuclear plant operating lives should not be a problem for the economic agents; however, it is no secret that this is not the case. The wait-and-see attitude on investment in Germany is partly due to several policy U-turns and malfunctions, and the international competition – in the solar industry, for instance – has done the rest. To date, Germany's federal government has obviously not been up to the job of managing the upheaval in the energy sector, given the extremely diverse energy supply systems in the 16 Länder. The nuclear exit and dealing with some of the follow-up costs involved in the generating companies' own decommissioning of the reactors as well as the development of alternative energy sources are continually raising price, cost and distribution issues that can apparently no longer be resolved using an incremental approach. Rather, what seems to be needed is a coordinated approach, not only with regard to systemic issues – market design, grids, storage facilities and capacity markets – but also with regard to a series of other key parameters – an incentive system for renewable energy sources; scarcity in EU emissions trading, and abandonment or else long-term maintenance of a minimum stock of fossil-fuelled generating stations. In this context, it will not suffice to reach unanimity within the federal government, but there will have to be a sensible de facto combination of the action plans of all the 16 Länder, the federal government and fundamentally also Germany's Federal Network Agency. It should also be borne in mind that two of the four energy utilities affected are domiciled in the state of North Rhine-Westphalia, so this state takes particular interest in the energy portfolio.

— Thirdly, European policy was shifted to the back burner only temporarily because of the German elections. Now, one might say this is not of any concern to the Länder. Anybody who thinks that is mistaken. The road to the European Central Bank's Single Supervisory Mechanism is paved with the ECB audit and the EBA stress tests along the way. If this process uncovers shortcomings in the German banking system that cannot be eliminated by the banks on their own via countermeasures at the operating level and recourse to the equity and debt markets, the political authorities will be compelled to legislate a solution. This may not only affect the Länder as owners of the Landesbanks but also the federal government, which would have to launch capital and liquidity measures via Soffin, the country's Financial Market Stabilisation Fund. It would be foolish to believe that nothing between the federal government and the Länder needed sorting out.

Potential timetable for the formation of a CDU/CSU/SPD coalition 3

End Sep. - mid Nov.	Exploratory talks between CDU/CSU and SPD, followed by negotiations on a coalition agreement
Oct. 22	Latest date for the constituent meeting of the newly elected Bundestag
Mid Nov.	Possible vote by SPD members on the outcome of coalition agreement negotiatons
Nov. 14-16	SPD party convention in Leipzig. Delegates could finally decide on the coalition agreement.
Nov. 18	Possible date for the election of the chancellor (Angela Merkel)

Unavoidable issues play an important part in politics, but naturally so do issues regarded as desirable. The SPD has announced two wishes: first, it would like to raise taxes a bit in order to fund slightly higher public spending (on education, infrastructure, municipal issues and debt reduction). Secondly, it would like to enact a statutory minimum wage. The CDU and CSU have refrained for some time from expressing many wishes – with the exception of CSU leader Horst Seehofer's call for user financing for transport infrastructure investments. Otherwise, the CDU/CSU would like to lower taxes once again (e.g. for families, via a higher tax exemption), improve the standing of certain mothers in the pension system and combat "cold progression" via an across-the-board tax cut. What is nice about these diverse wishes is that nearly all of them can be shared, i.e. there is room for compromise. It ought to be possible to find a little more money in the federal budget for education, infrastructure, motorways, municipalities, mothers with children born before 1992 and people requiring long-term care in general in a new four-year funding scenario. After all, the scope for this is gradually increasing in the shape of a few billion euros of unappropriated windfall revenues.

The only serious wish that cannot be shared is the SPD's call for a statutory minimum wage, which contrasts with the CDU/CSU's preference for numerous (collectively agreed) minimum wages at the sector level. Now, not a lot of imagination is required to guess the way ahead: binding phasing-in plans via collective negotiations, statutory clawback options, scheduled review dates and the threat of government action will pave the way. The last "grand coalition" had its Franz Müntefering, (vice-chancellor and labour minister from the SPD), who started the reorganisation at the lower end of the labour market; the last government continued on this path under Ursula von der Leyen (CDU); the "centrist coalition" will very probably perform the third and final act on the road to a minimum wage. The dispute will probably be decided not so much by the question of "whether" as "who" – that is, who will be able to reap the political dividends.

Klaus Günter Deutsch (+49 30 3407-3682, klaus.deutsch@db.com)

General budget 2013: Shades of the black

Going by the Maastricht definition, the general government budget already showed a slight surplus in 2012 (0.1% of GDP) – there was even a surplus in structural terms at 0.3% of GDP. In fact, according to the German government's forecast, the structural surplus is set to continue widening in the years ahead. Fiscally, this again sets Germany apart from the rest of the EU member states. Under the Maastricht definition we expect Germany's general budget to be in equilibrium or even slightly in surplus in the current year alongside a decline in general government debt just under 80% of GDP.

This year is again expected to see stable growth on the revenue side of the budget – despite moderately-paced GDP expansion – owing to the still steady growth of key macroeconomic aggregates such as employment, gross wages and private consumption. According to provisional figures, the general government budget closed at the end of H1 2013 with a slight surplus of 0.6% of GDP (Maastricht definition).

Fiscal development 1

as % of GDP

	2012	2013	2014
Deficit	0.2	0	0.2
Debt	81.2	79.7	77.1

Sources: DB Research, BMF

The still comfortable situation on the revenue side is mainly due to steadily growing tax receipts. From January to August total general tax revenues (excluding municipalities) were up 2.6% on the year-earlier reading and thus nearly as high as originally estimated for the full year.[1] This means that the full-year revenue increase in 2013 is even likely to outstrip the May forecast of +2.5%.

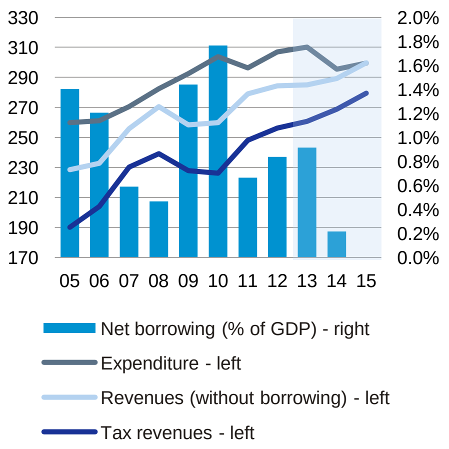
However, the financial situation of the three levels of government and of the social security system is very mixed. While the federal government and the Länder (according to the financial statistics) will still have to reckon with a deficit this year (federal government: roughly EUR 25 bn and Länder around EUR 6 bn), the municipalities and the social security system will probably again achieve a surplus.

Federal government reducing deficit further

Falling interest payments, a curb on spending increases (from 2005 to 2009 federal expenditures still grew at an average of 3% per year, but from 2009 to 2013 at only 1.9%) and steadily growing tax receipts have helped the federal government to curtail the expansion of the deficit in spite of the supplementary budget. This was aided by the reductions in the subsidies to the statutory health insurers and the Federal Employment Agency (last: temporarily).

Development of Federal Budget 2

EUR bn, financial statistics (cash basis), actual and target according to federal budget plan



Sources: BMF, DB Research

Social security still in surplus

Contrasting effects are to be seen with regard to the social security system. For example, the statutory pension system reports a small deficit for the first half of the year. The main reason for the weaker H1 performance was the reduction of the contribution rate from 19.6% to 18.9% and lower federal subsidy linked to it. However, this is set against both the raising of the pensionable income ceiling and the relatively small pension increase of 0.25% (partly due to retroactive pension cuts) in west Germany. In combination with the usual seasonal developments – as with tax receipts, the inflows are, as a rule, much better in the second half of the year than in the first – the social security system will probably record a surplus for the year as a whole. The story is similar for long-term care. The boosting of the contribution rate from 1.95% to 2.05% and the rise in the respective income ceiling more than offset the resolutions to expand

[1] The recently announced downturn in August is mostly attributable to one-off effects.

Social security contribution rates 3

as %	
Statutory pension	18.90
Unemployment insurance	3.00
Long-term care	2.05
Statutory health care	15.50

Sources: BMAS

the spectrum of benefits, so a surplus is to be expected at year-end here, too. The situation of the statutory health insurers is more demanding. Compared with one year ago it has deteriorated noticeably – this is attributable to the sharp increases in expenditure and cutbacks in federal budget subsidies. Nonetheless, in view of higher revenues and existing reserves a surplus might be possible for the year thanks to the usual seasonal phenomenon of higher revenues in H2. The financial situation of the Federal Employment Agency has also worsened because of the reduction of the federal subsidy. This means that incentives and/or redistribution measures that hitherto have been funded by the subsidy and thus from taxes will increasingly have to be covered by social security contributions in future. If the employment level remains stable the Federal Employment Agency could nonetheless end 2013 with a balanced budget. On a medium-term horizon, by contrast, it looks as if the changes to the financial flows between the federal government and the Federal Employment Agency along with the currently low 3% contribution rate might no longer suffice structurally to generate the latter's revenues.

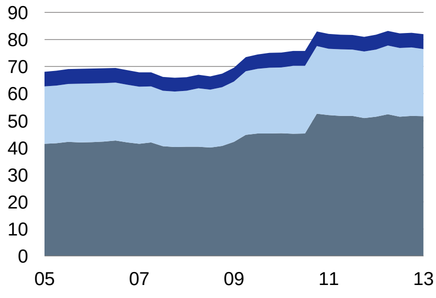
Still a deficit at the Länder level

The Länder have budgeted to end this year with a deficit of EUR 13 bn. Nevertheless, given the good tax receipts and despite a big jump in expenditures (e.g. due to higher spending on personnel as a result of higher collective wage
settlements), the deficit is probably only going to be half as large as forecast. As with the municipalities, the situation of the individual Länder is mixed, though. Four Länder (Berlin, Bremen, Saarland and Schleswig-Holstein) are still in the throes of the budget restructuring procedure under the supervision of the Stability Council. At the May meeting, however, they were given satisfactory marks for their efforts towards deficit reduction; still, it was a tight squeeze for Bremen and Saarland.

Balanced budget and falling debt

Public debt 4

as % of GDP, Maastricht figures



Sources: Deutsche Bundesbank, DB Research

All in all, it is therefore to be expected that the general government budget could show a slight surplus for 2013 as a whole. And assuming that the political authorities make no fundamental changes to their financial planning, a surplus may be on the cards again for 2014. The positive budget trend also has an impact on the debt level. At the end of 2012 the general government debt was still equal to 81.2% of GDP. Of this 81.2% at end-2012 some 13.5 percentage points were attributable to the effects of financial market support (11%) and the sovereign debt crisis (2.5%). As the Bad Banks continue to run down their portfolios, the full year should see another decline (probably by as much as 1.5 pp of GDP) in the debt level – so it is likely to sink just under 80% by year-end. This is also suggested by the German Finance Agency's revised debt plan for Q4 of this year. If the European sovereign debt crisis does not worsen, the debt level is likely to fall steadily in the course of the coming years. On this assumption[2], the federal government in fact anticipates that the debt level will decline to less than 70% of GDP by end-2017.

[2] Moreover, this is based on a very realistic assumption of 3% nominal GDP expansion on average.

New budget strains are likely following formation of new government

Germany's new government seems to have medium-term prospects of relatively well-filled coffers. Considering the possible formation of a "grand coalition" consisting of the CDU/CSU and SPD, look for extensive (financial) compromises which, in all probability, are going to weigh on the federal budget. Against the backdrop of potential further strains from the European bailout mechanisms and rising interest expenditure, the scope for additional spending seems nonetheless to be rather modest and is set to total just over EUR 10 bn p.a. in the next two to three years. This total results from the safety buffer achieved – according to the current financial planning! – to the upper limit of structural debt valid from 2016 of 0.35% of GDP and targeted structural surpluses in the federal budget. All indications are that the CDU and the CSU would not be inclined to let the coalition talks fail only because of a "no" in principle to a higher peak (income) tax rate.

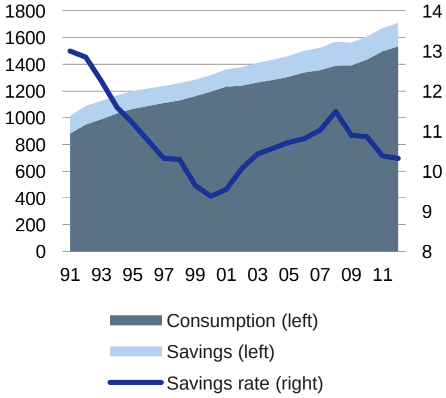
Frank Zipfel (+49 69 910-31890, frank.zipfel@db.com)

Low interest rates curbing households' propensity to save

Whenever discussions arise over the impact of the extremely low interest rates that followed in the wake of the financial and sovereign debt crises, they usually centre on the negative consequences for savers, government's savings on debt service, the problems facing life insurance companies and occupational pension funds in their efforts to generate the returns necessary to meet their obligations, and the misallocation of capital in corporate investment activity. However, the actual effects are far more complex, because interest rates also influence whether households decide to save their money or spend it on consumption. In the edition of this series published at the start of September we analysed how German households altered their portfolio allocation in reaction to the financial crisis. Now we will concentrate on the effects of low interest rates on their savings decisions. To conduct this analysis we estimated macroeconomic savings functions for selected countries. For many countries – Germany in particular – we found a positive correlation between the real rate of interest and the savings rate. Low interest rates thus tend to curb households' propensity to save.

Germany: Household consumption & savings 1

EUR (left), % disposable income (right)



Source: Federal Statistical Office

A bit of theory for the record: The neoclassical approach of intertemporal budget optimisation

In principle, households have to decide how they want to split their disposable income between consumption and savings. This applies not only with regard to a single period but also to an individual's entire lifetime. In this last case, that is the decision on optimising the utility of consumption and savings over several periods, the interest rate plays a crucial role. The reason is that the interest rate is not only the price of capital but also the price of time when households have to make intertemporal choices on whether to save or spend. According to neoclassical theory, households optimise their welfare and/or the utility they derive from consumption over their entire lifetime. They spread their consumption across all the periods of their life in such a way that their total utility is maximised.

Time preference is the key parameter …

Time preferences play a key role in this context. People usually prefer present consumption to future consumption, i.e. they attach greater value to a currently consumable good than to one that will only be consumed in the future.[3] This appears to be quite plausible. Children are probably the people with the highest time preference, because when asked whether they would prefer to eat Jelly Babies today or tomorrow, they almost invariably answer the same way: now![4] This example is certainly not universally applicable to all people; however, it does a pretty good job of illustrating how time preferences work.

The force of the time preference is described by the time preference rate, which says how much more of a good an individual would like to have in future in return for delaying consumption of this good in the present period. Here's an

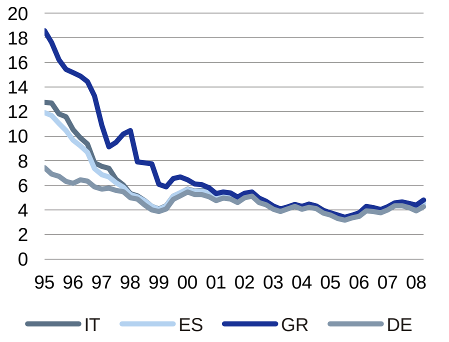
[3] The first deliberations on time preference are attributed to Eugen von Böhm-Bawerk, a founder of the Austrian School, who spoke of the "principle of positive time preference". See Böhm-Bawerk, E. von (1889). Capital and Interest.

[4] This was demonstrated by Walter Mischel in an experiment that has become known as the "Stanford Marshmallow Experiment". See Mischel, W., Ebbesen, E.B., Raskoff Zeiss, A. (1972). Cognitive and attentional mechanisms in delay of gratification. In: Journal of Personality and Social Psychology.

example: if the time preference rate is 5%, the household is only prepared to postpone consumption of a good in the current period to the next period if he can then obtain 5% more of the good. To explain such conduct, reference is often made to human impatience and short-sightedness as well as to the uncertainty about what the future holds. Households' time preference rate is often deemed in the literature to be equal to the long-term real rate of interest.

Govt. bond yield development 1995 - 2008 | 2

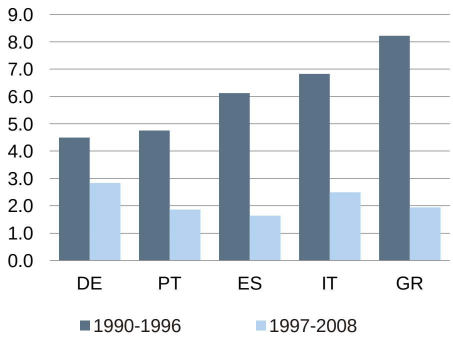
Long-term govt. bond yield, %



Source: IMF

Real 10Y govt. bond yields | 3

Yield-inflation, % p.a.



Source: IMF

… but difficult to measure in the overall economy

The equality of the time preference rate and the long-term real rate of interest can be derived from the results of intertemporal consumption decisions by using a simple microeconomic budget model.[5] However, what sounds entirely plausible for one individual creates substantial problems when applied to a whole society. The aggregation of individual time preferences to form a time preference for society as a whole is, accordingly, a matter of dispute. Furthermore, it is unclear which long-term real rate of interest (for example, the lending rate or long-term government bond yield) is meant.[6] Moreover, the neoclassical approach is increasingly being called into question not least because lately in particular there has been criticism of its assumptions. As an example, neoclassical theory assumes that households behave rationally and are fully informed with perfect foresight, i.e. that they are "homo economicus".[7]

Incentives and false incentives

Nonetheless, several fundamental ideas of this approach appear to us to be interesting and helpful for our further analysis. Like other prices, interest rates set incentives and have a steering and coordinating function. High interest rates make it less appealing to take out a loan for current consumption and similarly make it more appealing to postpone consumption and accumulate savings. Conversely, low interest rates set incentives to save less and borrow more money in the present. Some examples that show how major false incentives can arise are the surge in household borrowing activity on the southern periphery of Europe when real interest rates there plunged and/or temporarily even turned negative as a consequence of rate convergence in the run-up to the launch of the euro and because ECB monetary policy for these countries was too loose.

Dramatic decline in rates …

In the run-up to the euro launch the nominal yields of government bonds issued in the southern peripheral countries converged with the yield levels of German

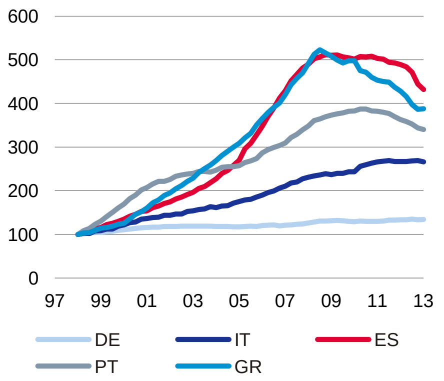
5 By using a simple, microeconomic, two-period standard household model it is possible to prove that in a case of intertemporal budget optimisation the ratio of the marginal utility of current consumption to future consumption is equal to the ratio of goods prices in periods 1 and 2. However, the price ratio is equal to the interest rate, so in the intertemporal budget optimum the individual time preference rate has to equal the interest rate. See, for example, Varian, H.R. (1984). Grundzüge der Mikroökonomik. Economically, it may be argued that with a satisfactorily large enough number of savers and investors the aggregated marginal time preferences are identical to the social and/or societal time preference rates. In turn, given a fully efficient capital market, this is identical to the capital market rate, i.e. the rate of return on investments, and the marginal time preference of savers, i.e. the reward for waiting. Thus the capital market rate is the variable that squares the differing individual time preferences. See Zimmermann, K. (1985). Zeitpräferenzen. Ein interdisziplinärer Ansatz in Theorie und Empirie. WZB discussion papers.

6 In the underlying budget model there is only a market interest rate, so the equivalence of the time preference rate and this real interest rate is clearly unmistakable. In reality, though, there are both debit interest and credit interest rates. This means it is unclear which rate of interest should be used as the discount factor.

7 See, for example, Schneider, S. (2010). Homo economicus – or more like Homer Simpson? Deutsche Bank Research. Current Issues. June 29, 2010.

Bank loans to private households & non-financial corporations 4

Q1 1998 = 100



Source: ECB

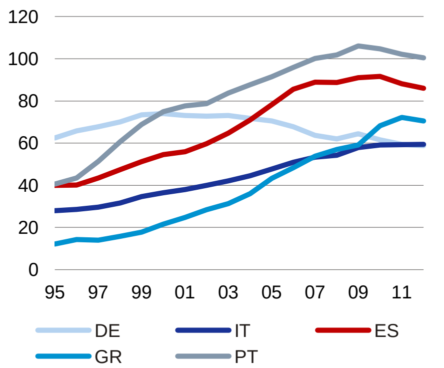
government bonds (chart 2). While the yield on long-term Greek government bonds still exceeded 18 ½% in 1995, it was down to 5% by 2001, thus hovering at barely 50 basis points over comparable German Bunds. Italian and Spanish yield spreads also narrowed in this period by nearly 8 and 7 ¾ percentage points (pp), respectively, to only about 30 basis points to Bunds, and more or less remained at this low level until the financial crisis erupted in autumn 2008.

In real terms, that is when inflation – which was higher in southern Europe than in Germany – is subtracted from nominal interest rates, the effect was similar. While the real yield of Greek government bonds still averaged over 8% between 1990 and 1996, it was down to close to 2% between 1997 and 2008, and thus nearly 1 pp below comparable German rates. In Portugal, Spain and Italy, too, the real yields of long government bonds were also noticeably lower than German yields in this latter period, after being between 2 and 3 pp higher previously (chart 3).

… caused a credit and real estate boom in the periphery

Household debt 5

% GDP, 1995 = 100

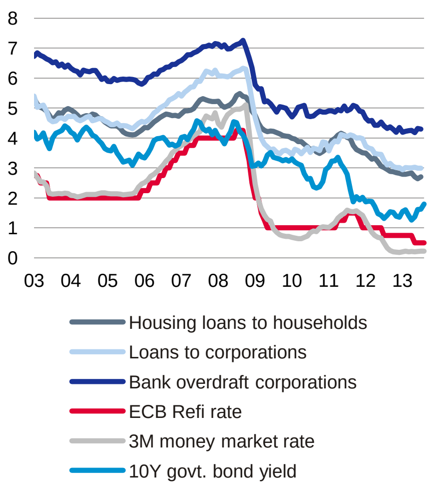


Source: National central banks

Low real interest rates created a major incentive to borrow, though, a trend which was mainly to be observed in the southern peripheral countries. The volume outstanding of bank loans to the private sector (households and companies) rose five-fold in Greece and Spain from 1997 to 2008, nearly four-fold in Portugal and more than two-fold in Italy (chart 4). The overwhelming majority of the funds borrowed flowed into the real estate sector, driving the property boom in those countries. Household debt has jumped in Greece from slightly over 10% of GDP in 1995 to over 70% recently, and the reading in Spain is up from 40% of GDP then to over 90% at times now. This impressively highlights the massive false incentives of low real rates of interest. Germany provides a good example of how fundamentally justified real interest rates guard against such misguided developments. In Germany, real yields also fell between 1997 and 2008 by over 1 percentage point; however, at close to 3% they had still been relatively high and in line with the country's economic fundamentals. For this reason there were no particular incentives for German households to borrow excessively and invest in the real estate sector. Thus, German households' debt increased by merely 1.6% per year from 1997 to 2008, which was roughly ¾ pp p.a. below the increase in nominal GDP, so their debt declined during this period from 68% to 62% of GDP (chart 5). Against this backdrop, it is easy to see why Germans did not experience a property market boom like many of their neighbours and now are not compelled to grapple with correspondingly sharp adjustments.

Germany: Interest rate development 6

%



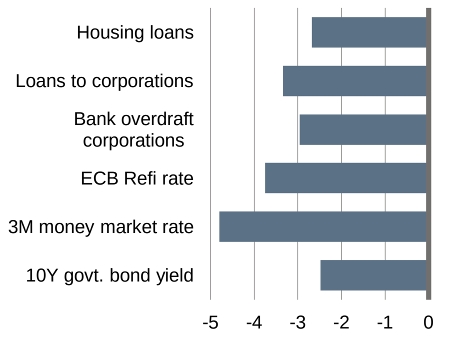
Sources: ECB, Global Insight

Low interest rates after extremely expansionary monetary policy also in Germany

Due to the extremely loose monetary policy pursued in response to the financial and sovereign debt crises, Germany also saw a steep fall in lending rates (chart 6). The ECB lowered its key refinancing rate over time from 4.25% to the record low of 0.50%. In this process, mortgage rates for housing loans have declined by nearly 2 ¾ pp since the outbreak of the financial crisis in September 2008, to about 2.8% at last reading, and the interest rate for corporate loans is now almost 3 ½ pp lower than it was in September 2008 (chart 7). On a current inflation rate of 1.5% this means a real interest rate of just short of 1 ¼% for mortgage loans and 1 ½% for corporate loans. In September 2008 the real mortgage rate still came to nearly 2 ¾% (inflation was nearly twice as high at the time), and the real interest rate for corporate loans was nearly 3 ½%.

Germany: Interest rate development 7

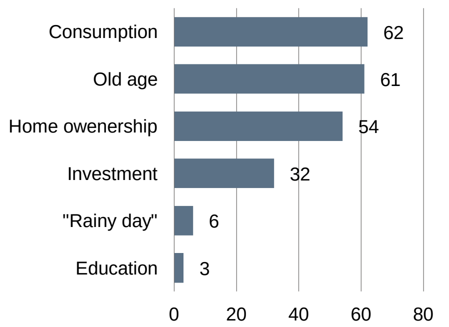
Change from September 2008 to July 2013, pp



Source: ECB

Households' motive for saving 8

Responses to the question: What are you saving for at present? Share in %

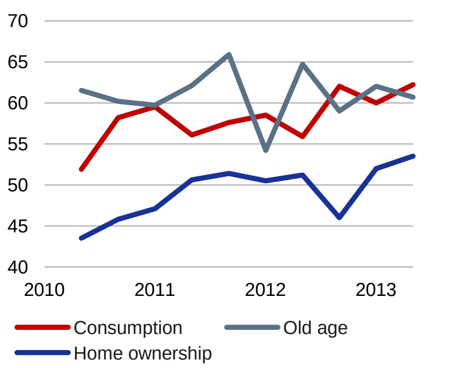


Representative TNS Infratest survey conducted in summer 2013 among 2,006 respondents aged 14 and older

Source: Association of Private Bausparkassen

Households' motives for savings 9

% of respondents



Representative TNS Infratest survey among 2,006 respondents aged 14 and older

Source: Association of Private Bausparkassen

The incentives to borrow money that go hand in hand with low interest rates are correspondingly high, and the prerequisites for misguided developments thus also exist in Germany. However, such negative trends are not to be seen at present – not even in the real estate sector – considering the currently still extremely moderate credit growth. Corporate loan volumes are currently 1.5% down on the year-earlier level, and consumer loans have declined sharply (-4% yoy). Only mortgage loans are currently on the rise. The credit growth in this segment has been very modest, though, running at 2.5%. Nevertheless, even if the low interest rates currently still show no sign of any significant impact on borrowing, they could certainly trigger effects on households' propensity to save.

Chief savings motive: Future consumption, followed by provision for old age

A household saves money to be able to afford future consumption (major purchases, among others), for old-age provision, the construction and/or renovation of residential property, investment purposes (to generate interest income and build one's estate), a "rainy day" and education, particularly of one's children (chart 8).[8] According to a survey conducted by Infratest on behalf of the Association of Private *Bausparkassen* (building societies) in summer 2013, future consumption and old-age provision are the most important savings motives for households, followed by home ownership and investment. The survey finds that saving for a rainy day and education play only minor roles. Future consumption, i.e. mostly major purchases, has gained in significance in household preferences and has lately become the leading savings motive; as recently as 2010 provision for old age was still the dominant motive by far (chart 9).

What are the potential reactions to changes in interest rates?

The reactions with regard to households' propensity to save that theoretically are to be expected when interest rates change are not as unequivocal as a look at time preferences alone might suggest. On the one hand, lower interest rates could lead to a lower propensity to save if yield is the most important consideration when savings decisions are made. If interest rates fall and thus the return on savings deposits, households' propensity to save would also decline.

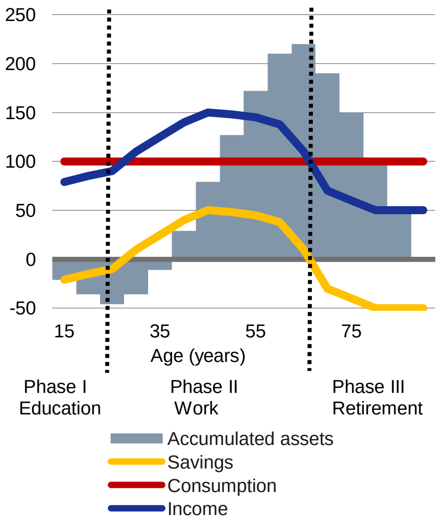
On the other hand, though, if households acted in accordance with the life-cycle hypothesis, they would, by contrast, boost their saving efforts. According to the life-cycle hypothesis developed in the 1950s by Ando and Modigliani[9], households seek to maximise their utility from the consumption of goods and services across their entire lifetime. To do this, households attempt to achieve a certain level of wealth during their working lives so they can tap into it during their retirement phase when they have less current income. This is on the assumption that bonds are the only instrument to accumulate wealth. It follows that saving enables households to make consumption independent of their income distribution over time and thus enables them to maintain a constant living standard throughout their life cycle (chart 10). Lower interest rates mean, however, that the required wealth can only be achieved by boosting the volume

[8] See Börsch-Supan, A. and L. Essig (2002). Sparen in Deutschland. Ergebnisse der ersten SAVE-Studie, sowie MEA Policy Brief no 5 (2008). Das Sparverhalten der deutschen Haushalte – Wie viel, warum und wie spart man in Deutschland. MEA Mannheim Research Institute for the Economics of Aging, and TNS Infratest (2013). Wofür sparen Sie aktuell Geld? Survey conducted for the Association of Private *Bausparkassen* polling 2,006 people over 14 years of age.

[9] Ando, A. & Modigliani, F. (1963), The "Life Cycle" Hypothesis of Saving: Aggregate Implications and Tests, in: American Economic Review 53 (1), pp. 55-84.

Stylised illustration of life-cycle hypothesis 10

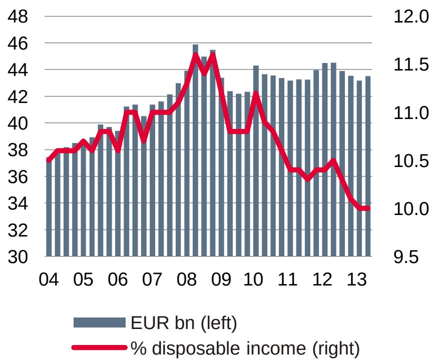
Monetary units



Source: DB Research

Households' savings 11

EUR bn (left), % disposable income (right) sa



Source: Federal Statistical Office

of savings on account of the smaller interest and compound interest effect. These effects have a substantial impact. In order to obtain the same amount of capital at the end of a 20-year saving period when the average interest rate is 1 pp lower (2% instead of 3% p.a.), it would be necessary to save for over 2 ½ years longer or else boost the amount saved by nearly 12% per year.

What do the surveys say?

A look at surveys on how people reacted to the financial crisis could provide indications of what "type of household" is most prevalent in Germany. A study[10] conducted by the MEA Mannheim Research Institute for the Economics of Aging in 2009 found that nearly 12% of a total of 2,222 households surveyed claimed that in reaction to the financial crisis they saved more, while over 7% of those polled said they would save less. Asked why they wanted to save more, the respondents said that they wanted to make up for their previously suffered losses of wealth. So the score is 1-0 to the life-cycle hypothesis.

By contrast, a survey conducted by TNS Infratest on behalf of the Association of Private *Bausparkassen* in summer 2013 reached the opposite conclusion. It found that only nearly 9% of the 2,006 respondents wanted to increase the amount they were saving, while 14% wanted to reduce this share. As the financial crisis, and thus the period of low interest rates, drags on, the share of those who say they want to save less has increased – at mid-2010 this share was still merely 12% or so.[11] This certainly cannot be attributed solely to the development of interest rates. During the survey, the main reason given for saving less was the rising cost of living. So the score is equalised at 1-1. The surveys thus do not give any definitive answer to the question of which "type of household" is more prevalent in Germany.

What do the facts say?

After having risen nearly continuously in the years prior to the financial crisis and peaking in Q2 2008 at close to EUR 46 bn, or 11.6% of disposable income, German households' savings have since hovered in a narrow corridor ranging around EUR 43 ½ bn per quarter (chart 11). Relative to disposable income, savings have fallen since autumn 2009, to 10% at last reading, in the face of almost steadily increasing income. Households thus do not appear to be behaving in line with the life-cycle hypothesis, unless they already consider their current wealth to be so high that even a lower propensity to save would suffice to secure their standard of living after they retire. Considering the shift in demographics and the related likelihood of a decline in the level of the statutory pension, though, such an assessment does not seem very realistic to us.

And what do our models say? Savings rate in Germany correlates positively with real rate of interest

To address the question of how the extremely low interest rates impact on households' propensity to save we devised a model of the macroeconomic savings function. Certainly, caution is advised when interpreting the results. For example, when an empirical model is used to reflect the average savings pattern during the period analysed, it can only be used to forecast the future pattern if

[10] See Börsch-Supan, A., Bucher-Koenen, T. and Ziegelmeyer, M. (2009). Deutsche Privathaushalte in der Finanz- und Wirtschaftskrise – Betroffenheit und Reaktionen. MEA Mannheim Research Institute for the Economics of Aging.

[11] See Verband der Privaten Bausparkassen (2013). Sparklima – Das Sparverhalten der Bundesbürger. Ergebnisse der 48. Umfrage von TNS Infratest. June 2013.

structures remain constant. It is still unclear whether the financial crisis may have led to a structural break in households' saving behaviour. Given the stable economic environment, as shown for example by the unbroken GDP growth trend and the still robust labour market along with sound income generation, however, there is little to suggest an abrupt change in the pattern of how German households decide to either spend their money or save it.

Regression results 12

Sample: Yearly data for 40 periods from 1973 to 2012

Dependent variable: Savings rate, %

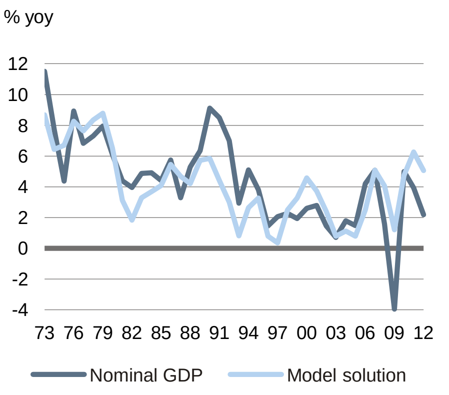
Variable:	Real interest rate				Nominal interest rate			
	Coefficient	t-Value	p-Value	R^2	Coefficient	t-Value	p-Value	R^2
Germany	0.32	2.347	0.023	0.127	0.50	7.716	0.000	0.610
France	-0.89	4.175	0.000	0.333	-0.38	3.732	0.001	0.268
Italy	2.85	5.014	0.000	0.398	1.30	11.908	0.000	0.789
UK	-0.44	3.125	0.004	0.228	0.75	8.816	0.000	0.672
USA	0.55	1.896	0.063	0.086	0.75	7.667	0.000	0.607

Source: DB Research

A simple regression between households' savings rate and the real yield of long-term government bonds, which we took as an approximation of the relevant interest rate for savings and investment decisions, shows a positive correlation for Germany for the period from 1973 to 2012. Granted, the correlation is only weakly significant. Two other countries that we analysed, the United States and Italy, also have a positive correlation, while in France and the United Kingdom the savings rate correlates negatively with the real rate of interest (chart 12). It would thus appear that for German, American and Italian households the attractiveness of the return that can be generated on their savings plays the key role in their savings decisions, while French and British households tend to act in accordance with the life-cycle hypothesis which says that savings are used to smooth the pattern of their consumption over time. Statistically much more significant correlations emerge if the nominal rates of return are used instead of real rates, as shown by the considerably higher coefficient of determination (R^2) of our models. Estimates based on real interest rates have an R^2 of between 9% and 40%, while those based on nominal rates are between 27% and 80%.

Do households succumb to money illusion?

Germany: Nominal GDP, unemployment rate & consumer confidence 13



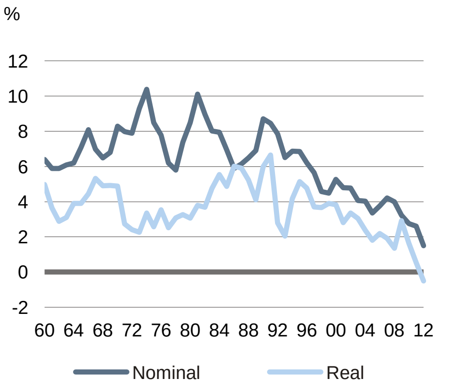
Model solution: Regression results on the basis of unemployment rate and consumer confidence

Sources: OECD, European Commission, DB Research

The much more significant estimates on the basis of nominal rates point to the possibility of money illusion among households, i.e. they appear to ignore inflation when making their savings decisions and use nominal returns on investments as their benchmark. No doubt it is correct that people find it simpler to focus on nominal values, such as wages or goods prices, than on inflation-adjusted ones. Nevertheless, the outcome does not seem entirely plausible. After all, inflation is a permanent process, so when households are making their decisions they would have to take notice of it at least with a time lag. However, the simple procedure we chose to adjust for inflation – nominal interest rates minus current inflation rates – could lead to distortions, since the nominal return of a bond with a residual time to maturity of 10 years would actually have to be adjusted for the inflation rates over those 10 years. This suggests that a household would have to know the pace of inflation in the following 10 years and set it against the bond's income stream. In theory, truly enough, households are deemed to have perfect foresight. In reality, though, this is impossible, so we have fallen back on a simple inflation adjustment geared to the current rate, which in our opinion is very likely to closely approximate households' actual behaviour. However, probably the most important reason – in our opinion – for the differing levels of significance found in the simple regressions is that not only interest rates but also other factors play a key part in households' savings decisions.

An expanded model for explaining the propensity to save ...

Germany: Nominal & real govt. bond yields 14

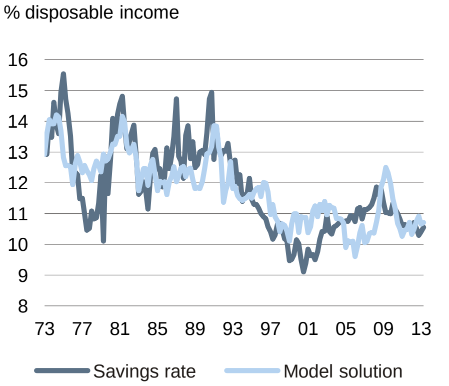


Sources: IMF, Federal Statistical Office

For the reasons stated above we decided to create an expanded model to explain the savings rate which factors in not only the real yield of long-term government bonds but also the unemployment rate and consumer confidence. We used the unemployment rate because it also covers other motives for saving. The sign of the coefficient determined by the model can theoretically be either negative or positive, depending on whether households are more inclined to dip into their savings to smooth their consumption over time when unemployment rises and thus incomes decline (negative) or else save more for reasons of prudence (positive). We factored in consumer confidence as an approximation of economic growth. Assuming that less money is saved, at times at least, when the economy is running smoothly, our estimate of consumer confidence would have to have a negative polarity sign. Moreover, the two variables, i.e. the unemployment rate and consumer confidence, are pretty good in explaining the development of nominal gross domestic product (GDP) and thus of a household's income development and ability to save (chart 13).[12] If the hypothesis is true that saving becomes more attractive when interest rates rise and vice versa, the polarity sign of the long-term real rate of return would have to be positive. The model is based on quarterly data for the period from 1973 to 2012.

… confirms positive correlation between real yield and savings rate

Germany: Savings rate & real interest rate 15



Sources: OECD, IMF, European Commission, DB Research

Our regression model does a good job of describing how the savings rate developed over the past 40 years (chart 15). The model shows that the coefficient for the unemployment rate has a negative sign – that households thus fall back on their savings when unemployment increases – and the other coefficients show the required polarity. All the variables used are highly significant in statistical terms (chart 16). This holds not only for the unemployment rate and consumer confidence but also for real yields (unlike in the simple model). Thus, the result of the simple model found at the outset is confirmed: the savings rate is positively correlated with the real rate of interest, which suggests that German households have a propensity to save that is attuned to the real yield on their investments. So, in the long run, low real rates of interest curb the propensity to save and hence change households' intertemporal decisions on whether to save their money or spend it on consumption. This result also applies to the US, Italy and Spain – but not to France.[13]

The question of whether German households really succumb to money illusion cannot be answered using the expanded model. The explanatory value of the expanded model based on nominal interest rates is scarcely higher than that based on real interest rates. It would thus appear that German households are ambivalent about nominal and real interest rates.

[12] For the period from 1973 to 2012, an estimate of nominal GDP growth by means of the unemployment rate and consumer confidence produces a correlation coefficient of 0.67, and both dependent variables are highly significant statistically in view of their p and t values.

[13] We have developed expanded models to estimate the macroeconomic savings rate of these countries as well.

Regression summary 16

Dependent variable: Savings rate of German households, %
Sample: Quarterly date for 160 periods from Q1 1973 to Q4 2012

Variable	Coefficient	t-Value	p-Value
Real govt. bond yield, %	0.34	7.241	0.000
Unemployment rate, %	-0.33	12.422	0.000
Consumer confidence	-0.05	5.684	0.000
Constant	13.08	47.681	0.000
R^2 adjusted	0.56		
D.W.	1.14		

Source: DB Research

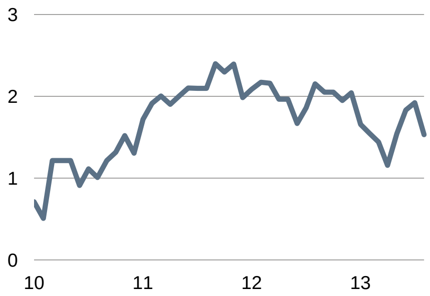
Bernhard Gräf (+49 69 910-31738, bernhard.graef@db.com)
Oliver Rakau (+49 69 910-31875, oliver.rakau@db.com)

Food prices driving up inflation (at least a little)

- Inflation in Germany has slowed from its last peak in November 2011 and is on a relatively moderate track all in all, helped in particular by declining oil prices. During the current year, though, consumer price inflation has already moved up and down considerably. These fluctuations can be attributed mainly to a basis effect pushing up energy prices. Core inflation has been low so far in 2013, at less than 1.4%, in part due to the abolition of the quarterly consultation fee charged by medical practices.
- Unlike energy prices, food prices have moved in only one direction since 2011. After 2.2% and 3.4% in 2011 and 2012, respectively, food prices were up by 5.7 % yoy in July 2013. Hence, food prices were responsible for over a quarter of overall inflation between January and August 2013. However, the peak has probably been reached or even passed, as world market prices for food are on the decline and one-off effects will probably be priced out.
- Inflation has also picked up slightly in the rest of the monetary union since April. The acceleration there has been less pronounced than in Germany, though. In August, the German rate of inflation exceeded the euro area average for the fourth consecutive month. The last time this was the case was in 2007.
- Given the euro area members' very different economic situations, Germany's rate of price increase looks set to remain above the euro area average for some time to come. However, this is the result of very low inflation rates in the rest of EMU and not of runaway inflation in Germany. Due to only moderate domestic growth and relatively stable commodity price forecasts for the world market, the inflation outlook remains subdued for the next two years. At 1.6% in both 2013 and 2014, the German inflation rate looks set to come in a tad higher than the euro area average (1.5% and 1.4%, respectively) but will still be clearly below 2%.

German inflation 2013: Ups and downs 1

National consumer price index, % yoy



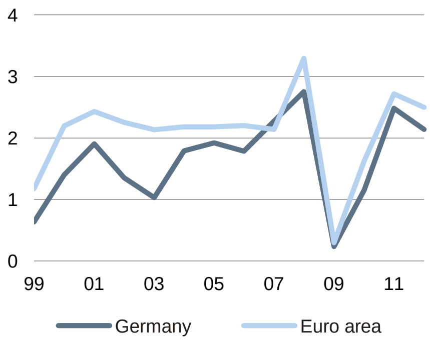
Source: Federal Statistical Office

Temporary "acceleration of inflation" around mid-year 2013

Since its last peak of 2.4% in November 2011, the rate of price increase in Germany has been on a decelerating trend. Consumer prices are currently only 1.5% higher than one year earlier. Nonetheless, price developments have been paid a certain degree of attention this year because of the considerable fluctuations. Inflation still stood at 2.0% yoy in December 2012. It subsequently dropped to 1.2% by April, only to return to 1.9% in July and fall back to 1.5% in August and 1.4% in September. The increase, in particular, met with strong (media) interest. According to Spiegel Online (a German online news portal), an inflation rate of 1.9% was only slightly below the "critical threshold" of 2%, or "dangerously close to the two percent mark" (Focus Online, another German online news portal), which implied that price stability was in jeopardy. However, at an average 1.5% p.a., inflation in Germany has been clearly below the 2% mark since the euro was launched and was lower than the inflation in EMU as a whole except for 2007.[14]

German inflation below EMU average, except for 2007 2

Harmonised consumer price index (HICP), % yoy



Source: Eurostat

As regards the current situation, the upturn in inflation registered this summer is not an extraordinary development. After all, a rise in inflation of at least 0.7% within a period of three months has been registered thirteen times in the euro area over the last twelve and a half years.

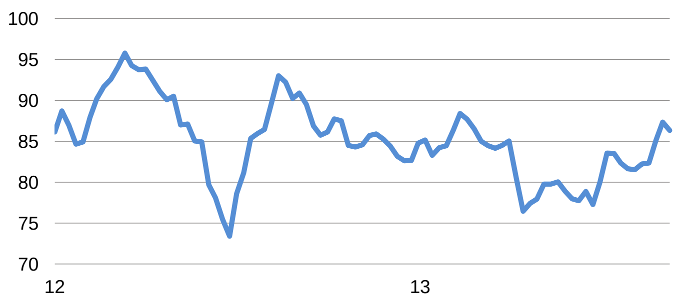
[14] According to the national definition of the consumer price index, Germany's annual inflation rate between 1999 and 2012 was 1.5%. Under the European definition, the figure was 1.6% p.a. Inflation in the monetary union as a whole stood at 2.1% p.a.

Basis effect in energy prices impacting inflation in 2013

The main reason for the development of inflation this year is a pronounced basis effect in the energy sector. Such effects occur if the pre-year comparison shows major differences due to price movements in the preceding year despite currently only small changes. In 2012, for instance, the oil price fell from just over EUR 90 per barrel in April to below EUR 75 in June and subsequently rose to in excess of EUR 90 by mid-August. In the current year, oil prices have been more stable in general. However, there have been quite strong fluctuations in year-over-year comparisons due to the basis effect. This is also reflected in energy prices, as measured in the consumer price index. In a month-over-month comparison, the correlation of the rates of change is slightly over 0.7. The rise in energy prices slowed to roughly ½% yoy in March, after almost 4% previously, and picked up again around mid-year before it began to fall again very recently (chart 4). Energy prices are responsible for about half of the ups and downs in consumer prices described above (chart 10).

Oil price: Heavy fluctuations around mid-2012 3

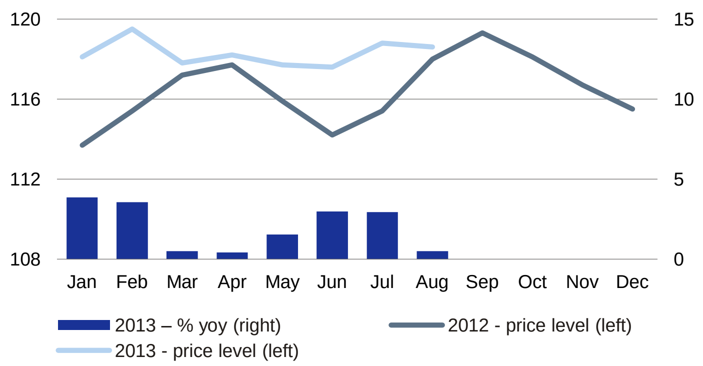
Oil price (Brent), EUR per barrel, weekly averages, converted with EUR/USD exchange rate



Source: WEFA

Energy inflation: Fluctuations due to base effect 4

Energy prices, national consumer prices, 2010=100, nsa



Source: Federal Statistical Office

Renewables levy has price-pushing effect

Fuels have highest weighting in energy prices 5

Weighting in consumer price index, %

	2005	2010
Energy	9.6	10.7
Fuels	3.6	3.9
Electricity	2.5	2.6
Natural gas	1.3	1.4
Liquid fuels	0.9	1.1
Solid fuels	0.1	0.1
Central heating, district heating and other	1.2	1.5

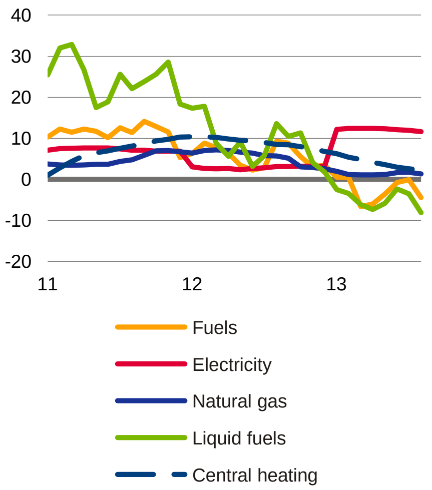
Source: Federal Statistical Office

Motor fuels have a weighting of just over one-third in energy prices for consumers. Natural gas and heating oil are weighted at 14% and 10%, respectively. These three components depend heavily on the world market prices for natural gas and oil. The correlation between fuel prices and the oil price is 0.9, for instance. Electricity and expenditure on central heating are weighted at 25% and 14%, respectively. These prices are less dependent on the price of oil.

The basis effect described above for oil prices could have dampened (energy) inflation even more strongly. In the current year, still rising electricity prices have counteracted the oil price basis effect. This reflects the increase in the renewables levy of early 2013 stipulated in the Renewable Energy Sources Act (EEG). The levy was raised from 3.6 to 5.2 cents/kWh in January 2013, which resulted in electricity prices soaring by 9.9% mom in January 2013. Without this jump, inflation would probably have slowed to 1.4% rather than 1.7% (December: 2.0%). According to press reports, the levy will likely be hiked once again in January 2014, from 5.3 to 6.2 cents/kWh. This would probably mean another, albeit smaller, increase in consumer electricity prices at the beginning of 2014.

Renewable nergy surcharge driving up electricity prices 6

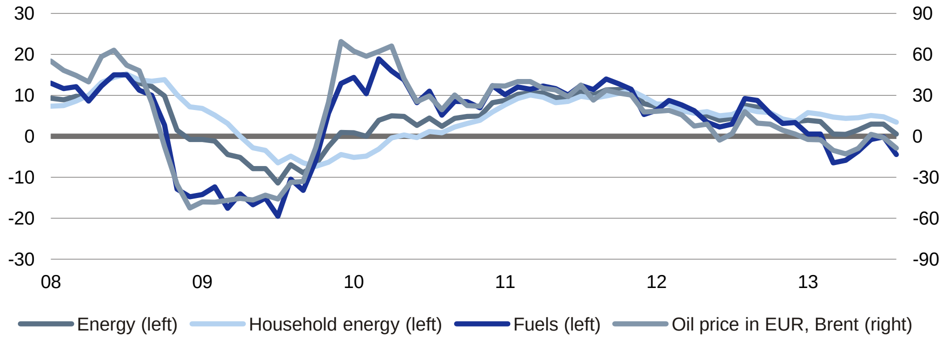
Energy prices, % yoy



Source: Statistisches Bundesamt

Renewable energy surcharge kept energy inflation up in 2013 7

National consumer prices, % yoy (left); World market prices, % yoy (right)



Source: Federal Statistical Office

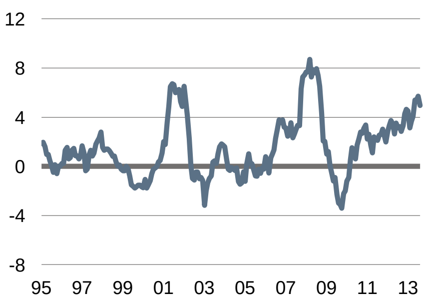
Food prices: On an upward trajectory since 2010

Beside the basis effect and the EEG-driven increase in energy prices, consumer price inflation has been driven by food prices over the last few months. In July, food prices were up 5.7% yoy and thus reached the highest level recorded since September 2008. In August and September, the rate of change also declined only slightly, to 4.9% and 4.7%, respectively. In the first eight months of the year, prices were 4.6% higher on average than in the pre-year period and thus rose considerably more strongly than energy prices (2.0%), which had still been substantially higher in the two preceding years.

However, food prices had also registered a similarly pronounced increase in 2001 and 2008 at an average of 5.0% in 2001 and 6.3% in 2008, respectively. The duration of the price increase, however, is more unusual. In both 2001 and 2008, food prices had picked up markedly over a short period of time. By comparison, the current upward movement has lasted for much longer already, and the acceleration of inflation has been of a more gradual nature (chart 8).

Food prices currently on the rise but less strongly than in 2008 8

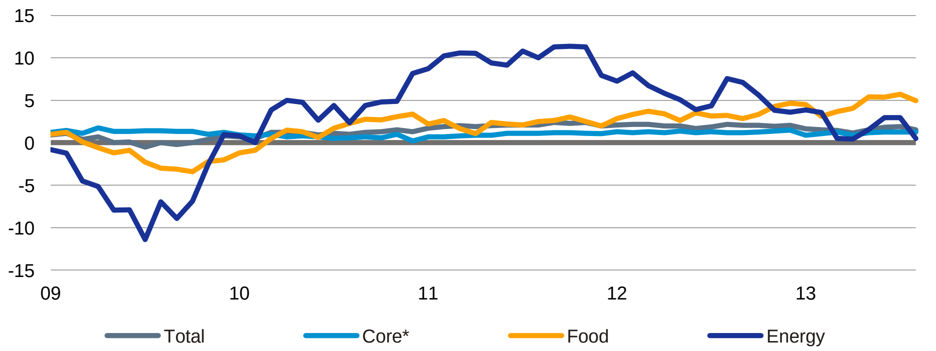
Food prices, national consumer price index, % yoy



Source: Federal Statistical Office

Inflation: Food price inflation trending upwards since 2010 9

National consumer prices, % yoy



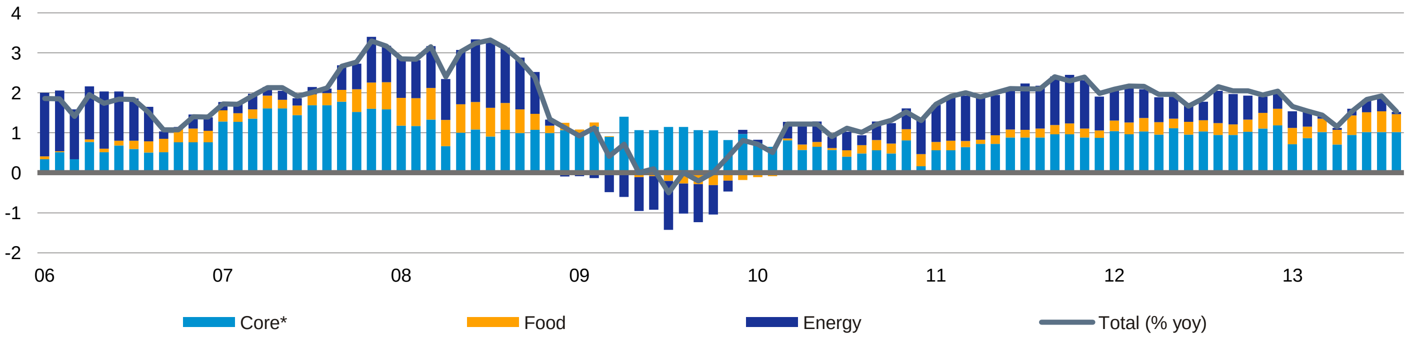
* excluding energy and food

Source: Federal Statistical Office

With a weighting of 9.1% in the consumer price index, food prices are nearly as significant as energy prices (10.7%). As a result of this upward trajectory, food has increasingly added to inflation. In 2011, 0.2 of a percentage point, or just under 10% of overall inflation (2.1%), was attributable to food. Last year the figure was 15% (2.0%). In the current year, the contribution has so far come to 25% (1.6%). However, food prices had already had a similarly large share in 2001 (23%) and 2008 (22%).

Food prices accounting for larger share of overall inflation lately 10

Contribution to inflation rate, year-on-year, %-points



* excluding energy and food

Sources: Federal Statistical Office, DB Research

Just like energy prices, food prices are also highly dependent on world market prices. The connection between world market prices for food and food prices in the consumer price index, however, is considerably weaker than that between oil prices and (consumer) energy prices. The correlation of the rates of change amounts to 0.4, compared with 0.9 for energy prices. The correlation between world market prices and German producer prices for food is 0.6. This weaker correlation compared with energy prices is probably due to the greater depth of production and/or the larger number of processing stages which are required for food and thus call, for instance, for more labour input, which leads to a decline in the relative share in costs of commodities/raw materials. In the production of food and animal feed, 12.1% of the gross production value is accounted for by labour costs and 59% by material inputs. In coking and petroleum processing, the share of labour costs is a mere 1.3% and that of materials 67.4%[15]. Other factors, such as pricing power, also come into play. The German food retail trade, for instance, is considered highly competitive.

Current increase in food prices merely a catching-up effect?

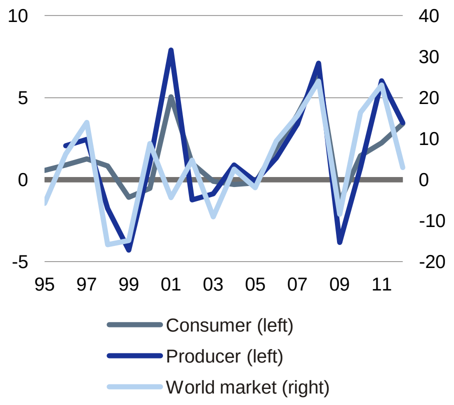
Given the existing statistical correlation with world market prices for food and the 9.3% drop registered so far this year, the persistent price uptrend at the consumer level seems surprising at first glance. However, it should be seen in the context of price developments over the last four years. During the crisis, consumer prices for food had not fallen quite as strongly as suggested by world market and producer prices, and in the subsequent recovery phase the upturn in prices was also more moderate than could have been assumed on the basis of the average correlation. World market and producer prices, for instance, soared in 2011 (+23.1% and +6%, respectively). By contrast, consumer prices only

[15] The data on costs are taken from the 2011 cost structure statistics of Germany's manufacturing industry. Material costs in mineral oil processing also include the share of cost taxes which should be coupled to a large extent to oil consumption via fuel tax.

added 2.2%, while - based on past correlations - producer prices had suggested double this figure (correlation: 0.8). This leads us to assume that the persistent upward trend at the consumer level is in part due to a catching-up effect as producers and retailers both did not pass on higher purchasing costs immediately or fully.

Food prices: Out of line in 2011 and 2012 | 11

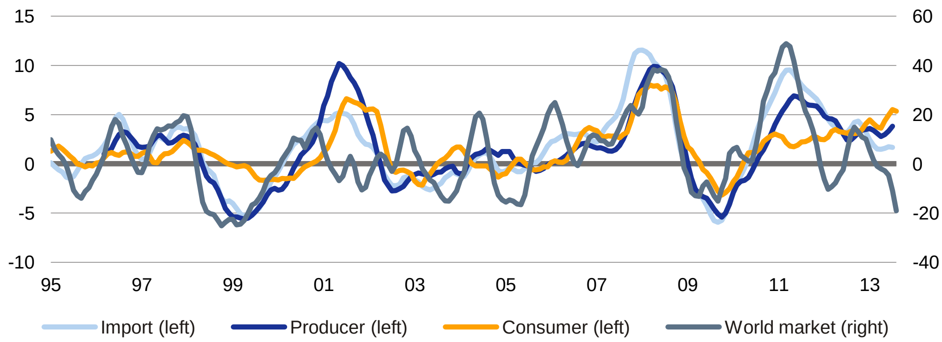
Food prices, % yoy



Sources: HWWI, Federal Statistical Office

Food prices: Strong increase in 2011 world market prices reflected only partly in consumer prices | 12

Food prices, % yoy, 3M mov. average

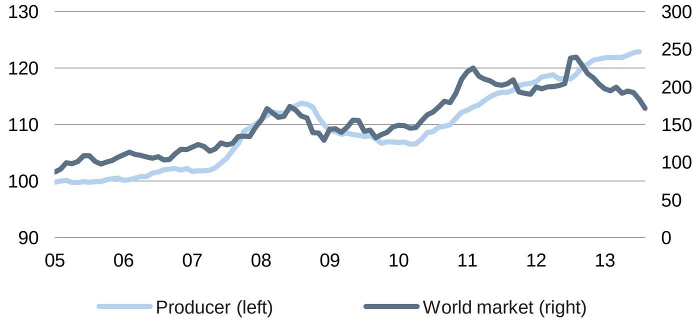


Sources: HWWI, Federal Statistical Office

This argument can be illustrated better with the help of rates of change rather than price levels. Chart 13, for instance, shows that in 2010 and 2011 producer prices initially closed the gap to consumer prices and then were roughly parallel up to the end of 2012. Only since the beginning of 2013 have consumer prices risen disproportionately faster than producer prices. The ensuing gap cannot be explained with catching-up effects. Correspondingly, either other costs in food retailing or profit margins must have risen. Rising electricity prices could deliver a partial explanation, as refrigeration and lighting produce high electricity bills. Wage developments in the retailing sector, by contrast, cannot serve as an explanation. The gap between producer and consumer prices has already narrowed again, though, due to slightly lower consumer prices. This suggests that the food price surge has probably passed its peak. A gap had already emerged at the end of 2012 between world market prices and producer prices (chart 14) which has widened further until recently. This implies that producers are either affected by rising costs which are not registered in world market prices, or that they were able to raise their sales prices substantially without cost pressure, which is not supported by sluggish consumption growth, though.

Food prices: World market prices should curb producer price increase | 13

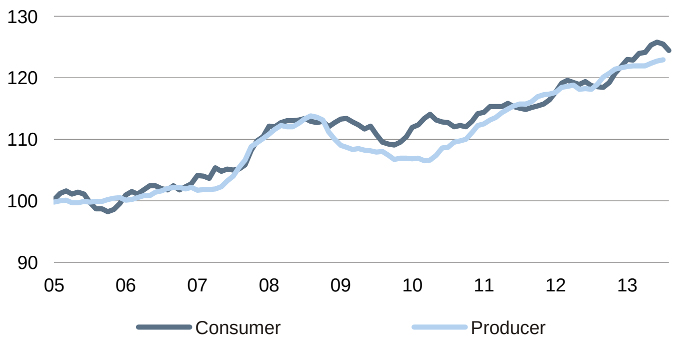
Food prices, 2005=100



Sources: HWWI, Federal Statistical Office

Food price: Gap to producer prices has narrowed again recently | 14

Food prices, 2005=100



Sources: HWWI, Federal Statistical Office

Meat (products) with highest weighting in food prices 15

Weighting in consumer price index, %

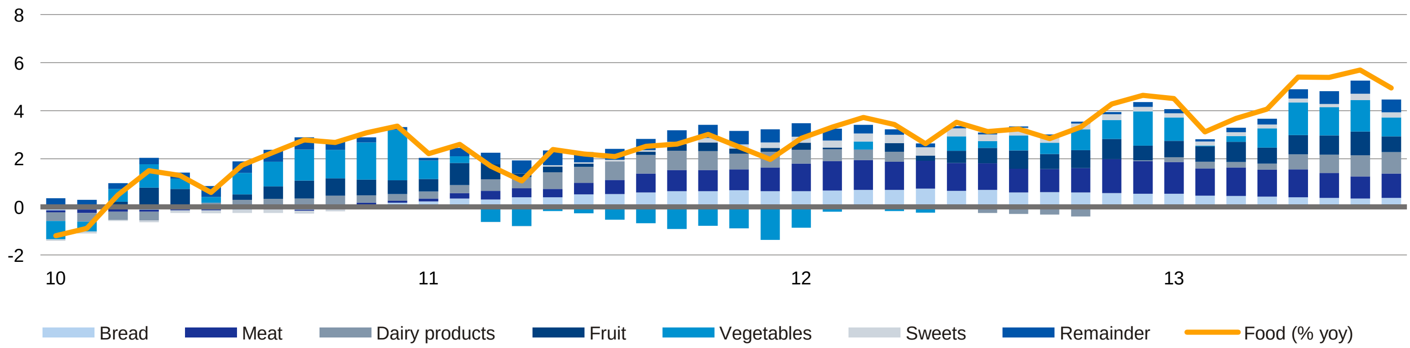
	2005	2010
Food	9.0	9.1
Bread and cereal products	1.6	1.7
Meat and meat products	2.2	2.1
Fish and fish products	0.3	0.4
Dairy products and eggs	1.4	1.4
Edible fats and oils	0.3	0.3
Fruit	0.9	0.9
Vegetables	1.1	1.1
Sugar, jam, honey and other sweets	0.8	0.8
Food, not otherwise specified	0.4	0.4

Source: Federal Statistical Office

The index of world market prices used is based on cereals, oil seed crops (mostly soy) and non-essential foodstuffs such as coffee, cocoa, tea and sugar. Hence the index does not reflect movements in vegetable, meat and fruit prices, which are less dependent on the world market. According to the Federal Ministry of Food, Agriculture and Consumer Protection, the vegetable market has been affected by idiosyncratic effects in 2013. At times, the market has been slightly undersupplied and prices for most crops have been high as, on the one hand, important suppliers from the Mediterranean region had curtailed deliveries according to plan and, on the other, weather conditions had delayed the start of the domestic harvest.[16] The flood around the middle of the year probably had an impact as well. Germany only grows 37% of its vegetable consumption, which is a relatively low ratio (overall self-sufficiency ratio is approx. 80%).[17] This has also been reflected in consumer prices for vegetables this year. The rise in vegetable prices has increasingly contributed to the increase in food prices since mid-2013. Vegetables have thus taken the place of meat, whose contribution to food price inflation has gradually declined since the end of 2012. In its agriculture report, the government also points out that the situation has normalised in part around mid-2013 but stresses that the outlook for the autumn harvest remains below average. This suggests there will be no imminent slowdown in the price increases in the vegetable market.

Food prices in 2012 and 2013: Vegetables and meat important price drivers 16

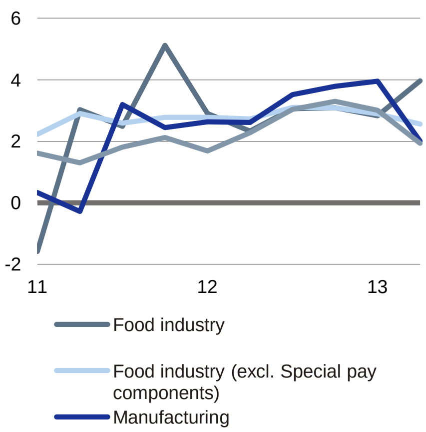
Contribution to food price inflation, yoy, %-points



Sources: DB Research, Federal Statistical Office

Special pay components added to wage growth in food industry in Q2'13 17

Negotiated hourly wages, incl. specoal pay components, % yoy



Source: Federal Statistical Office

Wage developments in the food production sector are probably another reason for the gap between world market and producer prices. Hourly wages (including special pay components) were up by 4% yoy in Q2 2013 after rising 2.8% in the preceding quarter. In the overall economy and in manufacturing, wages rose more slowly in Q2. Excluding special pay components, however, the increase in hourly wages was also smaller in the food industry. Hence, the cost-pushing effect is probably of a temporary nature.

The movements in food prices in 2011 and 2012 can thus be explained by catching-up effects as higher world market prices were not passed immediately to the customers but rather gradually. This year weather effects have pushed up vegetable prices substantially, driving up food prices as a whole. Moreover, higher electricity prices could have led to rising costs for food retailers. Rising wage costs have recently driven a wedge between producer and world market prices. Assuming that these effects will peter out over the next few months and not re-emerge next year, the hefty drop in world market prices for food is likely to have a gradual dampening effect.

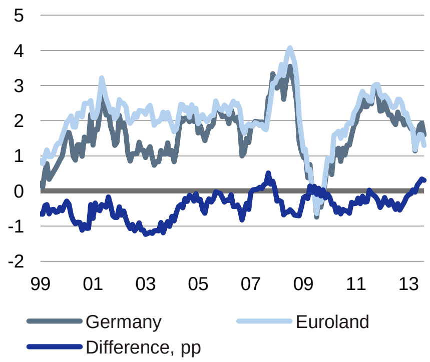
---

[16] Ernte 2013: Mengen und Preise. Federal Ministry of Food and Agriculture. August 29, 2013.
[17] Landwirtschaft verstehen. Fakten und Hintergründe. Federal Ministry of Food, Agriculture and Consumer Protection. May 2013.

German inflation above EMU average

German inflation low, but above EMU average lately 18

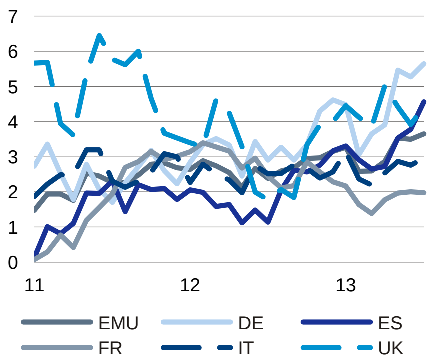
Harmonised consumer prices, % yoy



Sources: Eurostat, DB Research

Food prices in 2013: Strongest increase in Germany recently 19

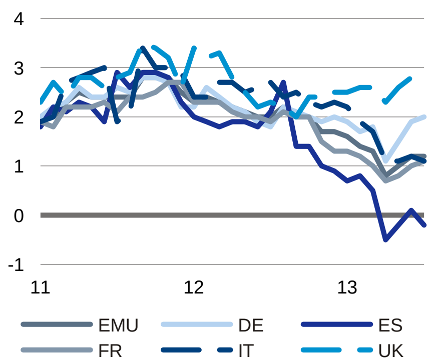
Harmonised consumer prices, food, % yoy



Source: Eurostat

Inflation: Prices rising faster lately in Germany than in EMU 20

Harmonised consumer price index, constant tax rates, % yoy



Source: Eurostat

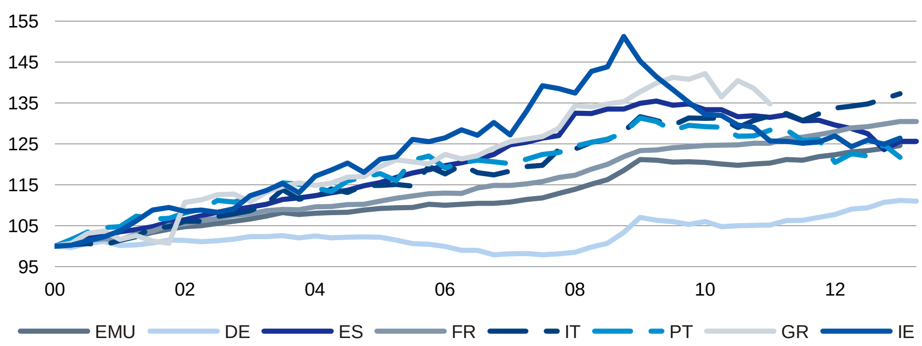
One aspect of the developments of the last few months which has been paid little attention is the relative level of German inflation. Since May 2013 Germany's rate of inflation has been slightly higher than the EMU average. The figures quoted on Germany in this paragraph differ somewhat from previously used data, as they are based on the harmonised statistical definition of European consumer prices. According to these figures, Germany recorded an inflation rate that exceeded the EMU rate by 0.3 of a percentage point (average of the last four months).In September it came to 1.6% compared with the 1.1% euro area average. The last time German inflation exceeded the Euroland average for several months was in 2007. In that year Germany's (harmonised) inflation rate stood at 2.3% compared with 2.1% for the monetary union. In all other years since the launch of the euro German inflation has been below the EMU average.

Price inflation in the other major EMU countries also picked up from its lows over the last few months. However, the increase there was more moderate than in Germany, which among other things was also due to food prices (chart 18). The divergence in inflation trends is particularly obvious when VAT increases such as the recent one in Spain are excluded from the calculation. On this basis (chart 19) inflation in Germany came to 2% in July, while it was no more than 1.2% on average in EMU as a whole. In Spain, it was even slightly negative (-0.2%). In both France and Italy, the figure was 1.1%.

As Germany's economic situation differs very much from that of many other euro area member states, this trend is likely to continue over the next few months – despite volatile monthly data – with consumer prices in Germany expected to rise more strongly than the EMU average. Especially the very high unemployment rates in some euro area countries look set to put the brakes on inflation, while Germany is much better off with its high and rising participation rates and low unemployment.

Unit labour costs started falling in several EMU countries 21

Unit labour costs, 2000=100, sa



Source: OECD

Inflation outlook for Germany: Moderate

Compared to many other EMU countries Germany has a more upbeat economic prospect. The overall inflation outlook is moderate, though. This refers to both core inflation and energy and food prices driven by the world markets. We expect the German inflation rate (in the national definition) to reach 1.6%[18] in both 2013 and 2014. For the euro area as a whole our inflation forecast for both this year and next is 1.5%.

Our strategists anticipate a broad sideways movement or even a declining trend for global commodities prices up until the end of 2014. Hence, given the US dollar's only moderate appreciation versus the euro, the effects on German consumer prices are likely to be limited. The price of crude oil (Brent blend) averaged USD 103.50 per barrel in Q2 and will probably only edge up to USD 108 in Q4 2014 as the world economy will take some time to return to its trend growth path despite current expectations of a moderate acceleration, which will limit demand for commodities. To be sure, uncertainty surrounding the Syria crisis and delivery bottlenecks in Libya have recently pushed the oil price up to USD 110. But this looks set to be a temporary phenomenon. World market prices for food are likely to come down over the next few quarters. The price of wheat, for instance, is expected to fall by approximately 30% between Q2 and Q4 2013.

Core inflation will likely be dampened by a number of factors this year and next. In light of Germany's moderate economic growth, capacity utilisation is unlikely to exceed its historical average, which limits producers' pricing power. Moreover, the solid wage increases of the last two years look set to have reached their peak. Collectively negotiated hourly wages grew by 1.7% and 2.7% in 2011 and 2012, respectively. Q2 2013 saw wage growth slow to 2.2%. We expect wages to develop favourably in 2014, too. But the momentum is unlikely to be higher than in 2012. This year, core inflation is being dampened additionally by the abolition of the quarterly consultation fee charged by medical practices. All in all, Germany enjoys a stable inflation outlook.

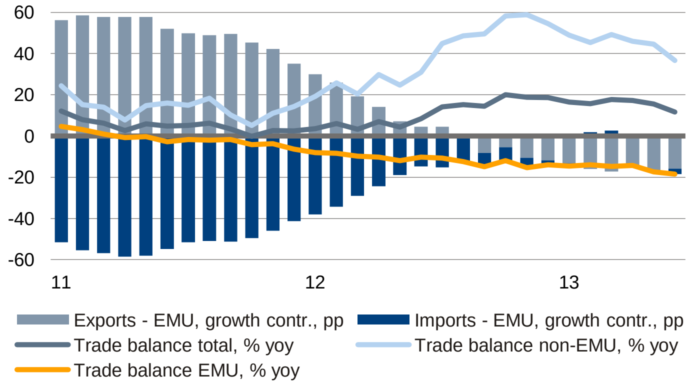
Oliver Rakau (oliver.rakau@db.com, +49 69 910-31875)

[18] On the basis of harmonised European consumer prices, Deutsche Bank's inflation forecast for 2013 and 2014 is 1.7% and 1.8%, respectively.

Chart of the month

German trade surplus with EMU falling mainly due to exports since H2 2012

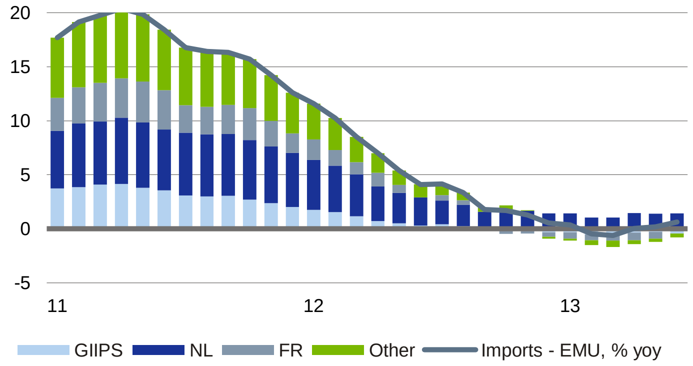
% yoy, growth contribution to the change of the trade balance yoy (pp), 12-month moving average



Sources: Federal Statistical Office, DB Research

Germany's demand for goods from other EMU countries relatively stable due to robust domestic demand

Imports % yoy, growth contribution to the change of imports yoy (pp), 12-month moving average



Sources: Federal Statistical Office, DB Research

Decline in bilateral trade imbalances: Change of drivers

The current account imbalances within the eurozone continue to decline. At EUR 116 bn, the German trade surplus vis-à-vis the eurozone reached its peak in 2007. Since then, it fell by roughly 40% until 2012. This was mainly due to the robust German import demand. Imports from the euro area rose by over 10%, more than two-thirds of which contributed to the decline in the bilateral trade balance with the euro area. Exports to EMU countries – above all the peripheral countries – weakened (-3%).

So far this year, Germany's trade surplus vis-à-vis the EMU countries has continued to fall; in July, it was about 20% (12M moving average) down on the pre-year level. Since H2 2013, however – contrary to the preceding development – this is almost exclusively attributable to the weakening of exports to the euro area yoy. True, imports have been stagnating since the end of last year. Stable demand for products from other EMU countries is supporting the tentative start to economic recovery in these countries, though.

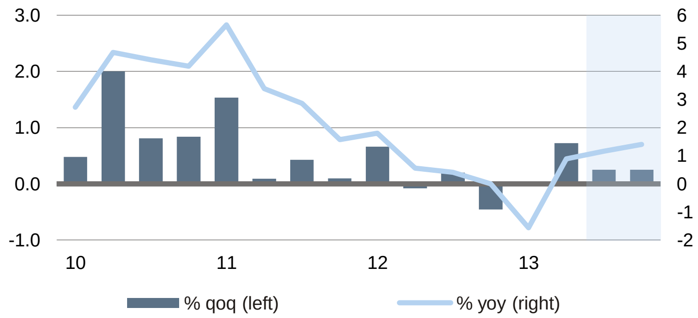
By contrast, German companies continue to increase their exports to non-EMU countries. From 2007 to 2012, exports to these countries rose by roughly 25%. Relative to this, imports from non-EMU countries increased by only 20%, so that the trade surplus vis-à-vis non-EMU countries continued to widen and, at EUR 120 bn in 2012, reached its peak to date. So far this year, the German trade surplus vis-à-vis non-EMU countries – in part due to the oil price which was lower than last year – rose relatively strongly and should in 2013 even exceed the record level of the previous year.

The increase in the trade surplus vis-à-vis non-EMU countries should be larger than the decline in the surplus vis-à-vis EMU countries. Thus, at just below EUR 200 bn, the total German trade surplus is likely to rise to a new record high.

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

Chartbook: Business cycle (1)

Real GDP growth

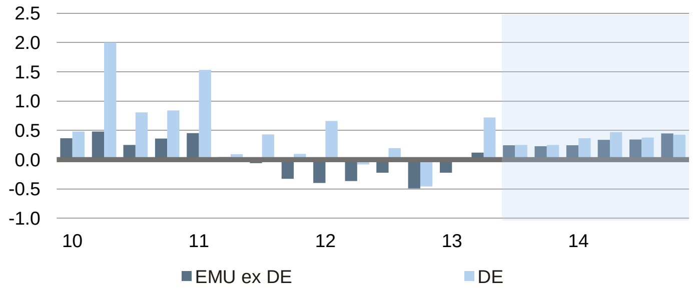


Sources: Federal Statistical Office, DB Research

- In Q2 GDP grew by 0.7% qoq and thereby ends the growth weakness of the winter half. In parts growth was driven by catch-up and special effects. GDP growth should be weaker in the current quarter as orders and industrial production were weak in July. We expect 0.3% GDP growth in Q3 which is also supported by the Q3 average of the composite purchasing manger index.
- We expect real GDP to grow +0.5% in 2013 and 1.5% in 2014.

GDP growth: DE vs EMU

% qoq

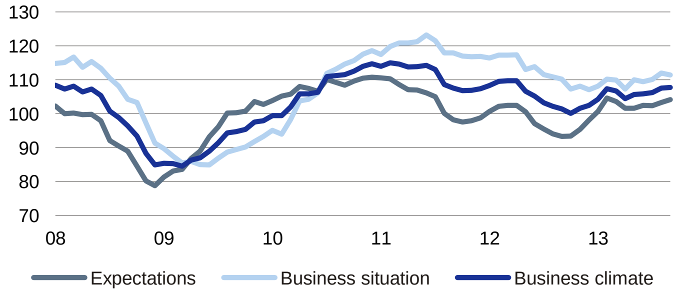


Source: Eurostat

- Euro area GDP grew by 0.3% qoq in Q2 ending the 6-quarter recession. Germany (+0.7% qoq) and France (+0.5%) contributed strongly. In Italy (-0.3%) and Spain (-0.1%) the GDP contraction became less severe.
- Considering the remaining adjustment needs in several EMU countries and almost stagnant global trade the EMU economy should barely grow in H2.
- Despite modestly positive growth, in H2 EMU GDP should decline again in 2013 (2012: -0.6%). However, due to higher than expected Q2 growth we lifted our forecast to -0.2% from -0.6%.

Ifo index - total economy

2005=100

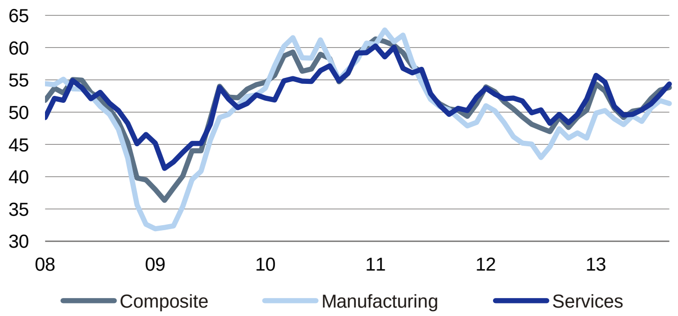


Source: ifo

- In September the ifo index rose slightly (107.7 after 107.6) to stand at the highest level since April 2012. The fifth consecutive increase resulted from expectations rising (104.2 after 103.3), while the current situation was a bit less positive (111.4 after 112.0).
- The increase of the ifo was driven by the better business climate in manufacturing, which also rose for the fifth month running thanks to higher expectations. Contrary to that the construction ifo has been falling since April, although it still stands well above its historic average. The weaker business climate in wholesaling was compensated by a more optimistic assessment in the retailing sector.

Purchasing Manager Index

PMI, index

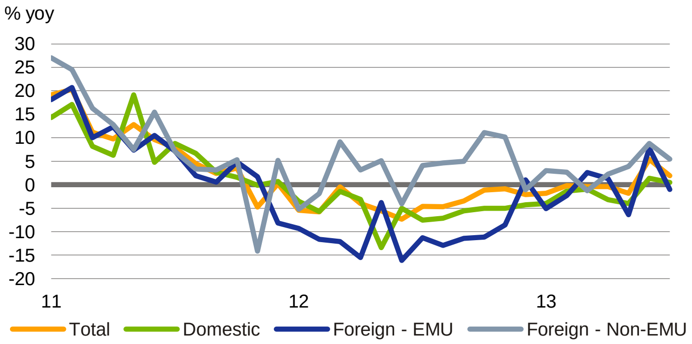


Source: Markit

- The composite PMI rose slightly in August to stand at the highest level since January 2012 (discounting the strong January 2013). While the index of the more domestic oriented services sector improved markedly (54.4 vs. 52.8), the index in the export dependent industry fell (51.3 vs. 51.8).
- In the industrial sector production as well as orders decelerated but remained in expansion territory, while employment was stuck slightly in negative territory.
- In the services sector order intake, backlog and employment growth accelerated.

Chartbook: Business cycle (2)

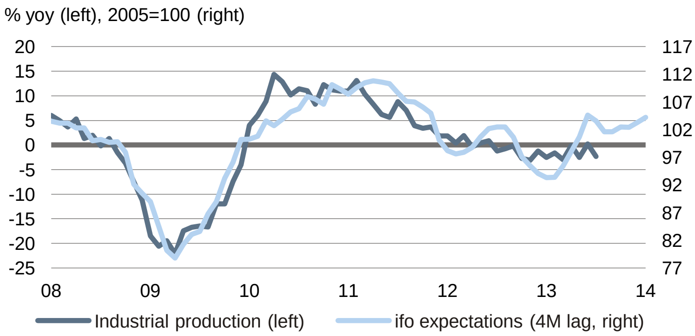
New manufacturing orders



Source: Federal Statistical Office

- In July orders fell by 2.7% compared to June after they had risen by a strong 5% in June. Excluding big-ticket orders the increase in June was 1.2% and the fall in July was 2.7%.
- Thanks to the moderate upwards trend in orders over the last few months orders were nearly 4% higher in June/July. This, however, can largely be explained by orders of airplanes at the Airshow in Paris in those months. All told the order level remains low.
- Ifo and PMI point to an upward trend in orders. However, surveys have painted a too rosy picture lately. Therefore, we only expect a moderate improvement in orders.

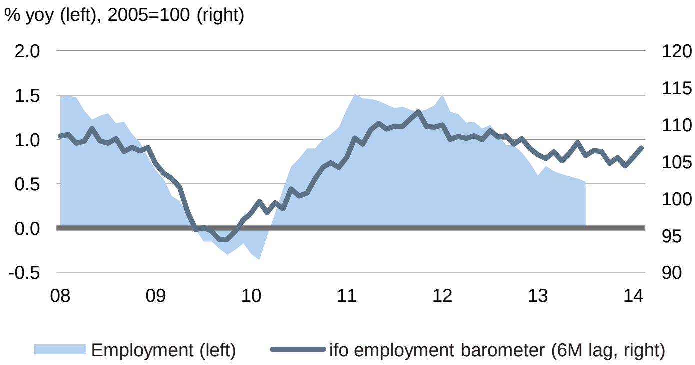
Industrial production and ifo expectations



Sources: ifo, Federal Statistical Office

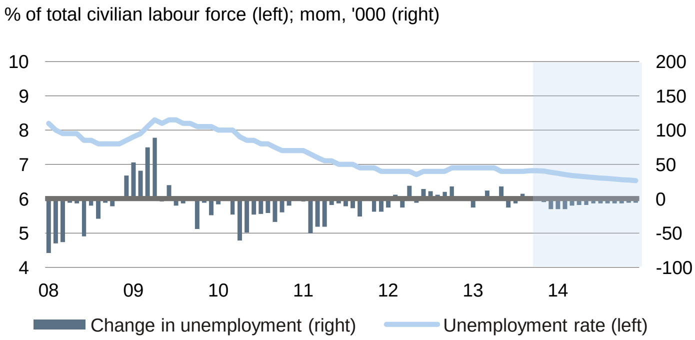
- Falling by 1.7% mom in July industrial production had a weak start into Q3. However, with four production increases in the last six months the industrial recovery seems to be intact. Over the last three months production was on average 1% higher than a year ago.
- The weakness in July was primarily due to the 2.1% production drop in manufacturing with pronounced weakness in investment goods (-3.4%). Construction output rose in July for the second months running.
- Sentiment, capacity utilization as well as the somewhat better global growth prospects all point to a continued, albeit moderate, industrial recovery in H2.

Employment and ifo employment barometer



- The weak economic development in the winter half (GDP growth Q4 -0.7% qoq; Q1 +0.1% qoq) currently weighs on the labour market which follows economic activity.
- Employment growth slowed to 0.5% yoy in July 2013. The level of employees subject to social security payments is up 1.2% yoy.
- Given the continued healthy mom-increases (+23,000 on average from January to July) employment marks record highs (41.8 m).

Unemployment



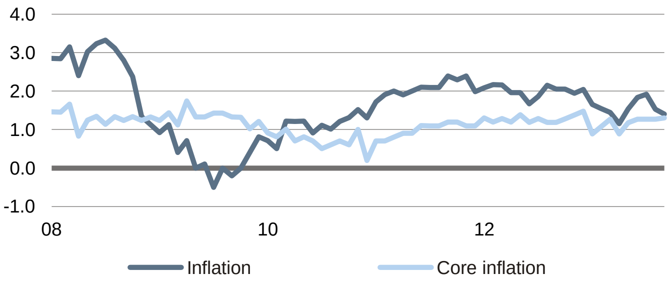
Sources: Federal Employment Agency, DB Research

- In August the number of unemployed rose slightly by 7k after it had fallen by 7 and 12k in the two months before. The unemployment rate stayed at 6.8% for the fourth month running.
- Leading indicators were above their Q2 averages in July and August. They more or less point to a sideways trend in the coming months. We expect the labour market to improve in autumn 2013. The unemployment rate should average 6.8% in 2013 after 6.8% in 2012.

Chartbook: Business cycle (3)

Inflation rate and core inflation rate

% yoy (core inflation only available since 2011 due to alteration in statistical collection)



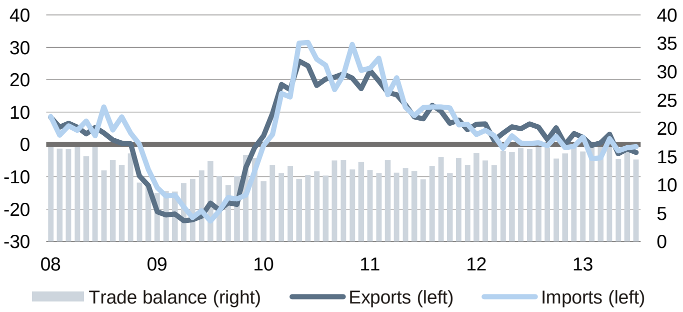
Sources: Federal Statistical Office

— Inflation fell to 1.4% yoy in September (Aug. 1.5%; July 1.9%). The drop was primarily due to the slowdown in the energy prices increase from 3.0% in June to -0.2%, which resulted from a base effect. Food prices also slowed somewhat in September to 4.7% (Aug. 4.9%; July 5.7%). Core inflation remained low at 1.3%.

— Given the moderate GDP growth, the expected stability of commodity prices and slowing wage growth, consumer price inflation will probably be muted over the coming month. We recently raised our inflation forecast for 2013 to 1.6% as food prices remained stronger than we had previously assumed.

Merchandise trade

% yoy (left), EUR bn (right)



Source: Deutsche Bundesbank

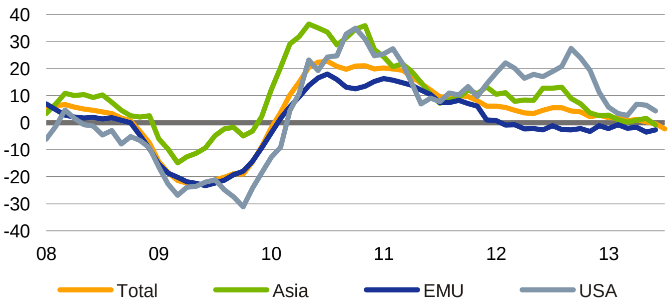
— The trade balance declined markedly in July to EUR 14.5 bn from EUR 15.8 bn in June. Exports fell by 1.1% mom while imports rose by 0.5%.

— In the last three months the trade balance averaged EUR 15 bn compared to EUR 17.4 bn in Feb-Apr. This was due to the weakness in exports (-1%) and strength in imports (+2%) in that time.

— Foreign trade in H1 was weak with export and import growth rates fluctuating around the no-change line. Growing by 1.9% yoy in H1 world trade also remained weak (2012: +1.9%; 2011: +5.9%).

German merchandise exports by destination

Merchandise exports, % yoy, 3M moving average



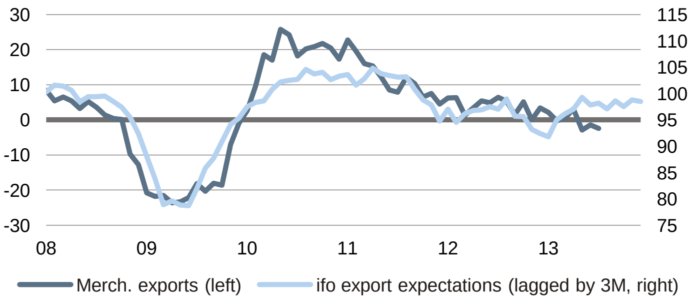
Source: Deutsche Bundesbank

— German exports moved broadly sideways lately as exports to Asia (especially China) and the US slowed strongly since mid-2012 no longer overcompensating declining exports to EMU.

— Since the onset of the euro crisis EMU's share in German exports has dropped by almost 10 percentage points to around 37% (Asia 16% and the US 8%), as the crisis economies have reduced their imports from Germany significantly since 2008 (2012 Spain: -36%; Italy: -10%; Portugal: -24%).

Exports & ifo export expectations

% yoy (left), index (right)



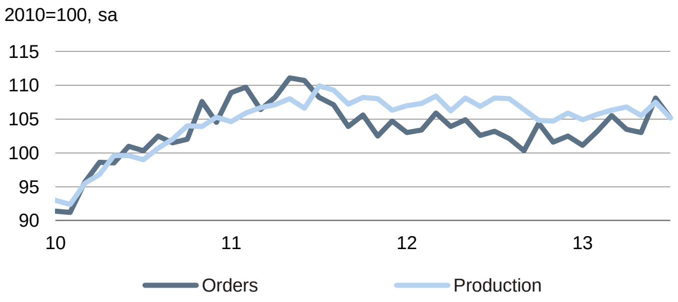
Sources: Deutsche Bundesbank, ifo

— Ifo export expectations have broadly moved sideways since early 2013 and were somewhat above their long-term averages. New export orders according to the PMI also stood in expansionary territory. Ifo expectations have lately overstated export growth, however. Therefore, we do not expect export growth to pick up markedly over the coming months.

— In the coming months German import growth might be higher than export growth due to the small increase of commodity prices, the end of destocking, the high level of employment and increases in real income.

Chartbook: Sectors

Manufacturing: Output and order intake



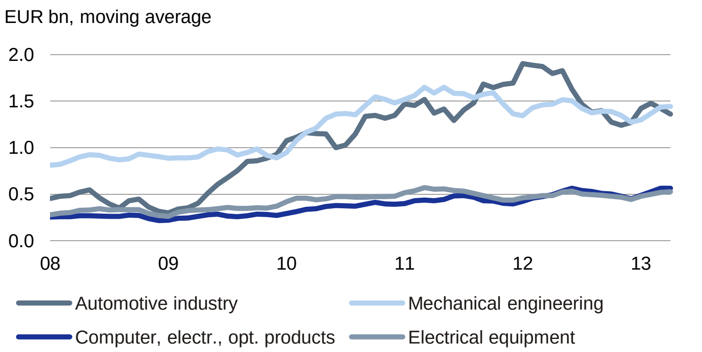
Source: Federal Statistical Office

— The Federal Statistical Office recently conducted a comprehensive data revision. After this revision industrial production in Germany was 0.2% lower in May-July 2013 compared to the average level of the preceding period. The order intake rose by 1.2% in real terms in the same period.

— Demand from outside Europe has developed better for a considerable time than demand from EMU countries. A decline was recorded in either case at the latest reading.

— Mainly due to the above mentioned data revision we changed our forecast for industrial production in Germany from +1% to stagnation (2012: -1%).

German exports to China by sector

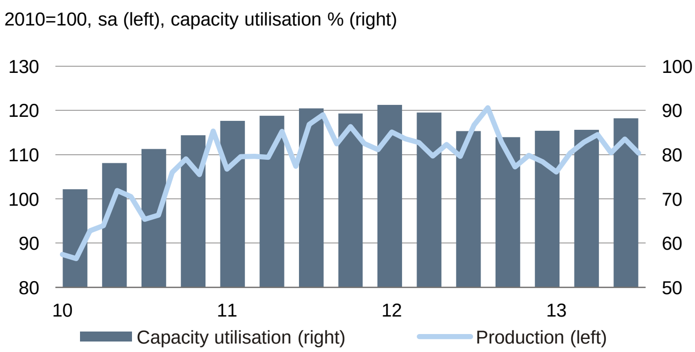


Source: Federal Statistical Office

— China has gained in importance as an export market for the German industry during the last few years. The highest export volume is recorded by the automotive industry and the mechanical engineering industry.

— Exports of the mechanical and the elctrical engineering industry have risen since the beginning of 2013. Thus, they should support domestic production in both sectors in 2013; this holds also for 2014 when the economic situation in China is expected to improve. The automotive industry benefits from rising exports to the US and UK in 2013. The Chinese market, however, is increasingly catered for by German companies' local production sites.

Car industry: Production and capacity utilisation



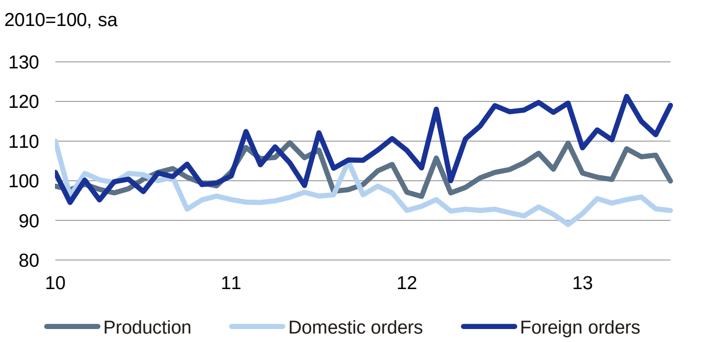
Sources: Federal Statistical Office, ifo

— The most extensive data revision took place in the German automotive industry. Production index is now "only" 2.8% higher in Q2 2013 compared to the level of Q1 2013. Before the data revision the reading was 11%.

— Based on the latest data revision we now expect automotive production in Germany to stagnate in 2013. Before the revision our forecast was +4%.

— Business expectations remain in the positive area. Capacity utilisation has increased for the third time in a row in Q3 2013.

Pharmaceutical industry: Production and order intake



Source: Federal Statistical Office

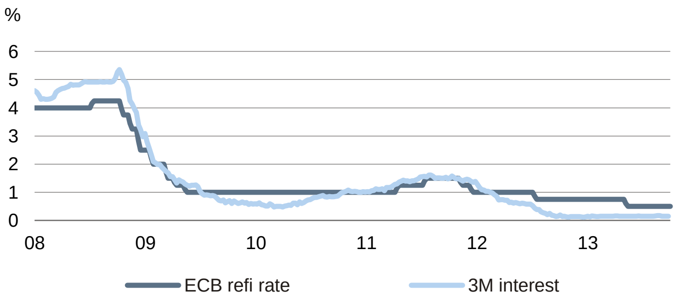
— The German pharmaceutical industry has been growing mainly due to foreign demand during the last few years. The domestic market has shown a weaker development due to stricter regulation.

— Order intakes in the pharmaceutical industry have sent mixed signals since the beginning of 2013. In May-July they came in slightly below the average level of the three preceding months. Foreign orders developed better than domestic demand of late.

— All in all, we expect output in the pharmaceutical industry to increase by 1% in full year 2013 (2012: -2.4%).

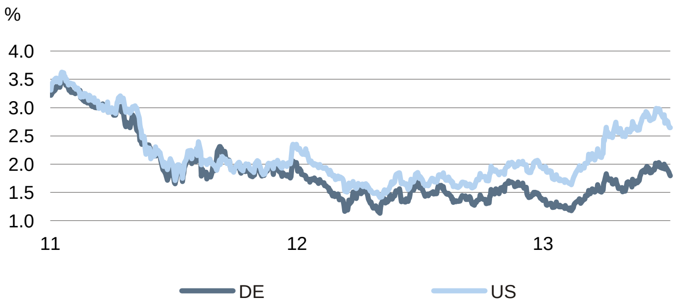
Chartbook: Financial markets (1)

EMU: Refi rate & 3M Interest



Sources: ECB, Global Insight

US and German government bonds: 10Y yields

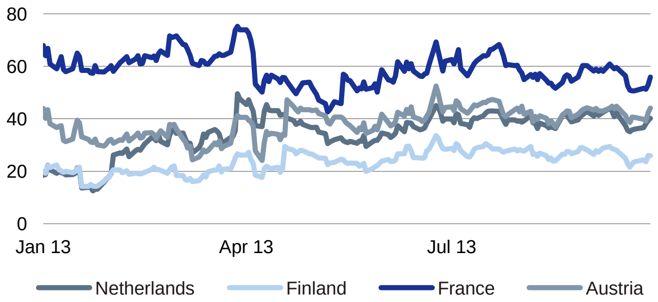


Source: Global Insight

- According to the press conference announcements of ECB president Draghi in September the economic recovery of EMU – despite more positive data releases recently – is still at the beginning. This is supported by the slightly lowered GDP forecasts for 2014 (1%).
- Additionally Draghi pointed out that the falling excess liquidity is a positive signal and reflects a lower fragmentation of financial markets within EMU. If falling too strong, the ECB stands ready to act which points to a preference for a further LTRO compared to a lowering of the key interest rate.
- The message that the ECB will continue its loose monetary policy for an extended period is still valid.
- Contrary to market expectations the Fed decided not to start to slow down its monthly asset purchases of USD 84 bn on its September meeting. As a consequence, 10Y treasury yields were down by 40 bp to 2.6% recently.
- This led German bund yields to fall to currently 1.8%. Due to the stronger decline of 10Y treasury yields the US/German yield spread decreased to about 80 bp.

EMU: Bond yield spreads (i)

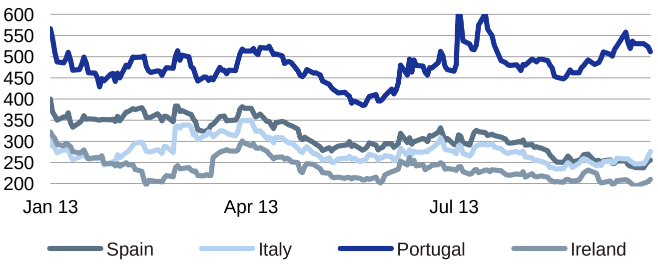
Versus German govt. bond yield, basis points



Source: Global Insight

EMU: Bond yield spreads (ii)

Versus German govt. bond yield, basis points

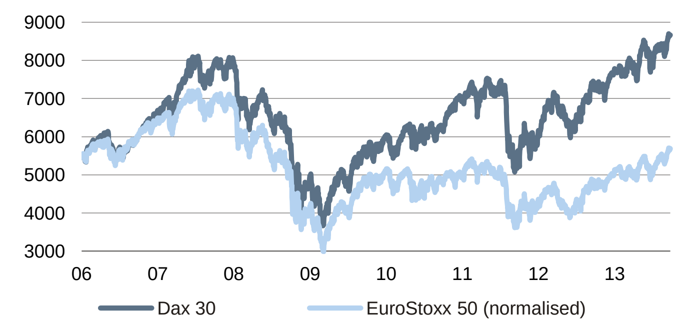


Source: Global Insight

- Triggered by the Fed's decision to postpone the beginning of tapering the global interest rate cycle fell moderately again.
- Compared to the German bund the yields of other EMU core countries fell slightly stronger pushing the spreads versus Germany moderately down.
- Peripheral spreads have narrowed. Especially since July better economic indicators and hopes that the EMU recovery will continue have also had a dampening effect on spreads.
- While the spread in Spain, Italy and Ireland fell relatively strong, it increased again above 500 bp in Portugal.

Chartbook: Financial markets (2)

Equity indices

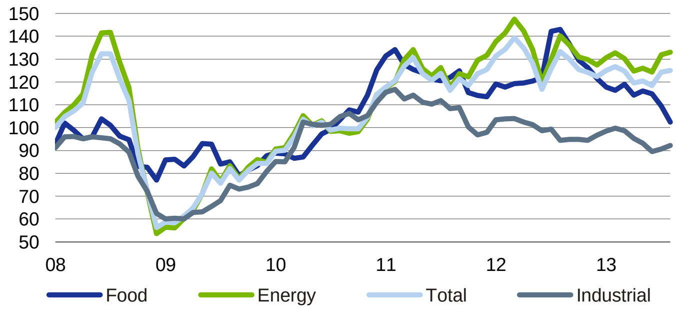


Sources: Global Insight, DB Research

— The not taking place of an US-lead attack on Syria and better economic data led the DAX and the EuroStoxx600 to increase to about 8600 and 310, respectively.

Raw material prices

HWWI index, 2010=100, based on EUR



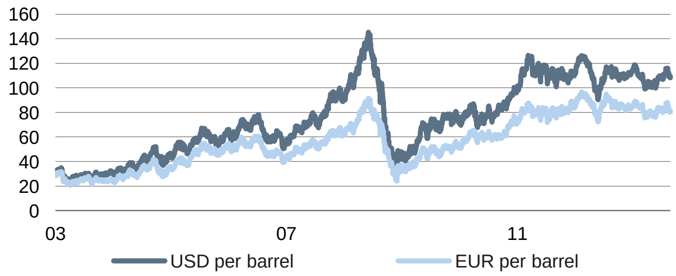
Source: HWWI

— Raw material prices have dropped strongly until the start of July given concerns about Chinese growth and the debate about Fed tapering, based on the perceived link between QE and inflows into commodities. Since we expect China and the global economy to pick up somewhat in H2 raw material prices could see a modest increase again. First signs of that emerged when metal prices reacted to better data out of China. Due to worries over Syria the oil price rose strongly recently.

— By contrast, food prices have dropped markedly since the peak of August last year. Although the decline has slowed in H1, food prices decreased again since mid-2013. They are currently almost 30% lower than a year ago.

Oil price

Brent Blent, USD or EUR per barrel



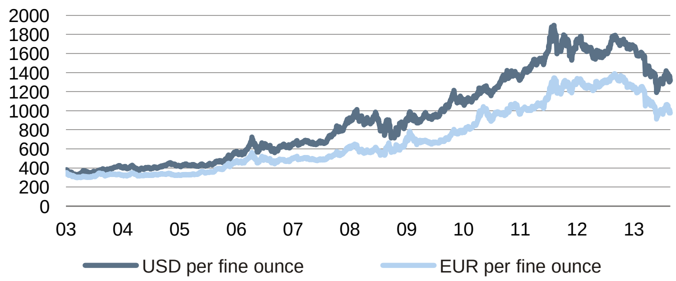
Sources: Global Insight, Reuters, DB Research

— Due to events related to Syria the oil price rose strongly to USD 115 per barrel at end-August. Prior to that already the lingering unrest in Egypt given its control over the Suez Canal and supply shortages in Libya also weighed on prices. Recently lower worries about Syria led oil prices to fall again. Currently the oil price amounts with slightly below USD 110 per barrel Brent to the previous year's average.

— Due to the strong increase of oil supply thanks to the expansion of production of shale oil in the US our commodities analysts expect an oil price of USD 110 per barrel Brent at Q4 2013.

Gold price

USD or EUR per fine ounce



Sources: Global Insight, Reuters, DB Research

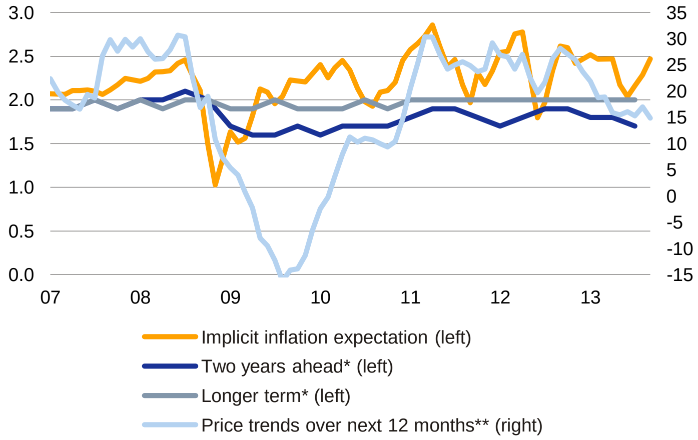
— Gold as a safe haven has become more expensive lately with the price rising to above USD 1,300 per fine ounce due to the increased uncertainty. Still the price remains around 25% below last year's high (Oct, 4, 2012; USD 1,792 per fine ounce). Higher real interest rates, stronger expected USD and abating concerns about inflation weigh on gold prices.

— Our commodities analysts expect the gold price to amount to USD 1,350 per fine ounce at Q4 2013. Nevertheless, the gold price is expected to decline yoy (eop) by the fastest pace since 1997.

Chartbook: Financial markets (3)

Inflation expectations Eurozone

% yoy (left), balance of pos. and neg. responses (right)



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

Sources: ECB, EU Commission, Bloomberg

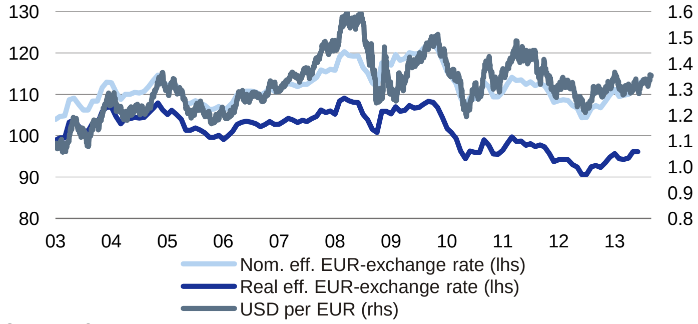
— Contrary to lingering inflation concerns in the general public the private forecasters of the ECB survey expect no increase of the EMU inflation rate. The expected inflation rate in 2 years has fallen from 1.8% to 1.7%, while it held steady at 2.0% in 5 years.

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

— However, the "implicit inflation expectation" may be biased. On the one hand the current real interest rates close to zero earned on an inflation protected bond are hard to reconcile with economic considerations. On the other hand nominal bond yields are depressed by massive purchases of several major central banks and still persistent flight to quality.

Exchange rate development for the EUR

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



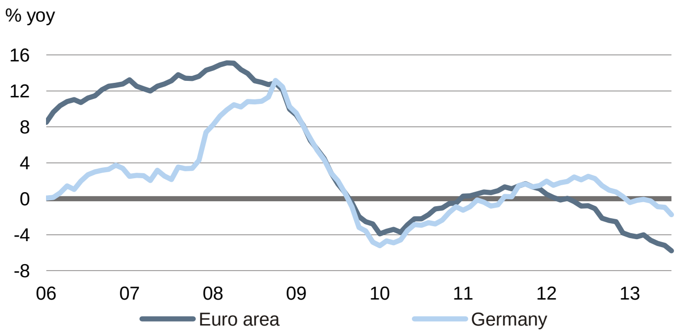
Sources: ECB, Reuters

— After peaking at 1.37 in February EUR/USD has moved in a narrow 1.28-1.35 range during Q2. Recently, the partly contradictory comments by the Fed led to a relative volatile sideways movement.

— The USD should strengthen in H2 2013 due to the higher growth rate of the US economy of around 3% and Fed tapering later this year. According to our FX strategists the USD will probably appreciate to EUR/USD 1.20 end-Q4. They see the emerging strength of the USD as the beginning of a multiyear uptrend and forecast that the USD will reach parity to the EUR by 2017.

Chartbook: Financial markets (4)

Loans to companies



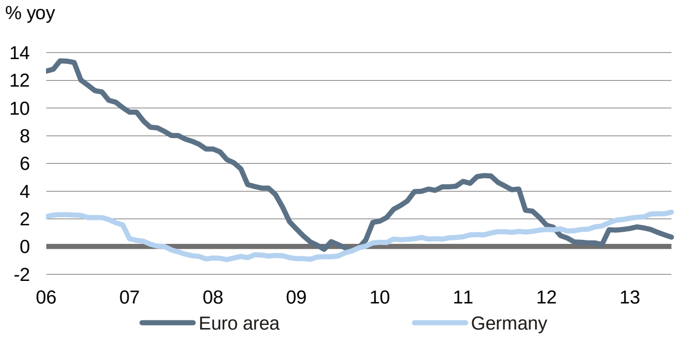
Sources: ECB, DB Research

— The decline in lending to German corporates has gained momentum in July (-1.8% yoy).

— The substitution effect of the debt capital markets combined with low investment activity seems to be reflected in lending volumes.

— Reduction of corporate lending in the euro area continues at accelerated pace (-5.8% yoy in July up from -5.2% in June) – mainly reflecting the difficult macroeconomic situation and ongoing deleveraging in countries strongly affected by the crisis.

Mortgage volumes



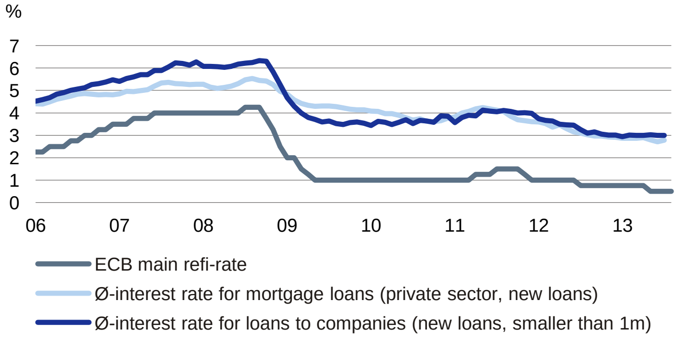
Sources: ECB, DB Research

— In Germany, solid growth in mortgage lending persists in July with a further +2.5% yoy. Growth has been accelerating since Q2 2012 and by now clearly stands at pre-crisis levels.

— Low interest rates coupled with stable income and labour market conditions bolster property demand by house-holds.

— German mortgage growth remained clearly above the euro area average (0.7% yoy in July).

Interest rates

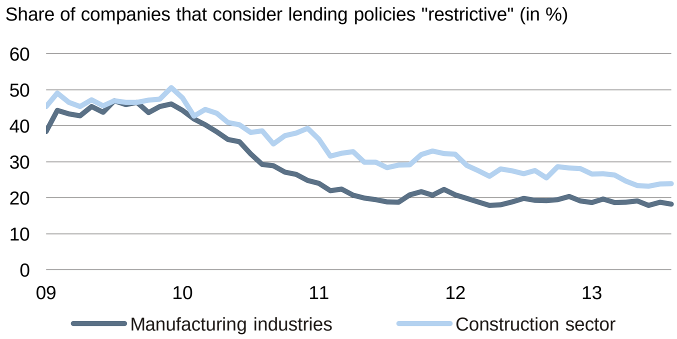


Sources: ECB, Bundesbank

— Interest rates for mortgages and loans to corporates have remained at historic lows. Interest rates for loans to companies continued to stand at 3% in July. Mortgage rates increased slightly (+0.1 pp compared to the previous month) and stood at 2.8%.

— The low interest rate environment makes for lower refinancing costs and allows banks to pass on favourable conditions to their clients.

Lending standards



Source: ifo

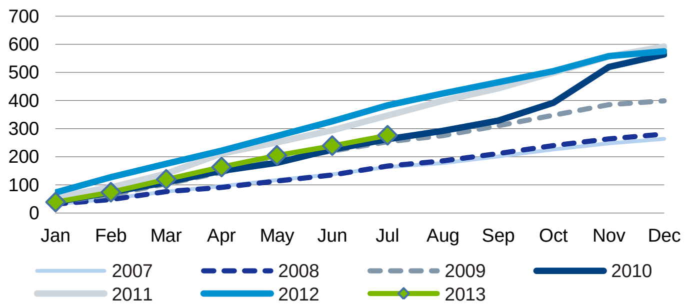
— Corporates on average continued to report no problem with credit supply.

— The share of corporates that consider lending policies restrictive remained at very low levels in August. Perceptions by construction industries remained almost unchanged (+0.1 pp compared to previous months). Manufacturing companies report a further slight easing (-0.6 pp compared to previous month), i.e. credit supply conditions are almost as benign as last May when they reached a historic low.

Chartbook: Financial markets (5)

Gross issuance of public debt securities

Cumulative issuance volume, EUR bn



Sources: Bundesbank, DB Research

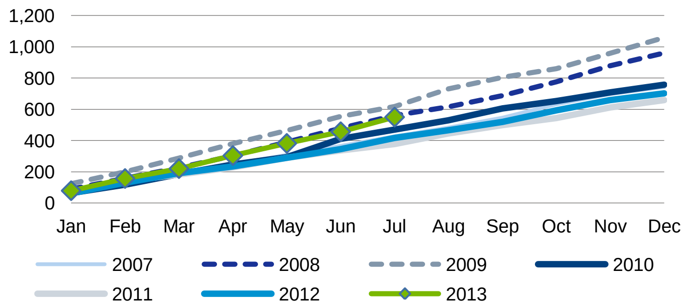
— Debt security issuance of German public sector remained subdued. Germany's Länder and the federal government issued around EUR 37 bn in July.

— The cumulative issuance to date remained only at some EUR 276 bn.

— With interest rates and global markets slowly normalising, German public sector bonds seem to benefit to a lower extent from the safe-haven effect which boosted markets during the previous years.

Gross bank debt issuance

Cumulative issuance volume, EUR bn



Sources: Bundesbank, DB Research

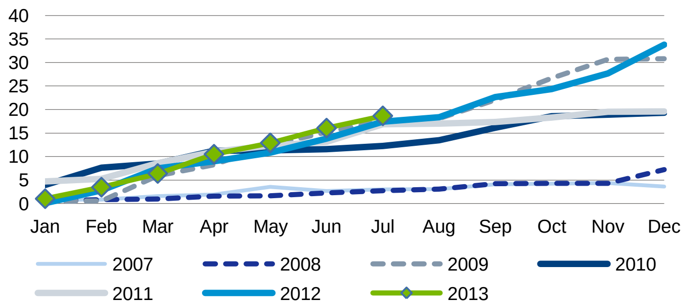
— Bank bond issuance in July stands at around EUR 94 bn, the highest level of the last 3 years.

— German banks have generated EUR 550 bn on bond markets in the first seven months of 2013, the highest value for this period since 2009. Bank bond issuance in the rest of Europe shows decreasing tendencies, though.

— Improved balance sheet and capital structure that led to tighter financial bond spreads helped banks to raise funding on the debt capital markets, while at the same time, deleveraging reduce the funding needs.

Gross non-bank corporate debt issuance

Cumulative issuance volume, EUR bn



Sources: Bundesbank, DB Research

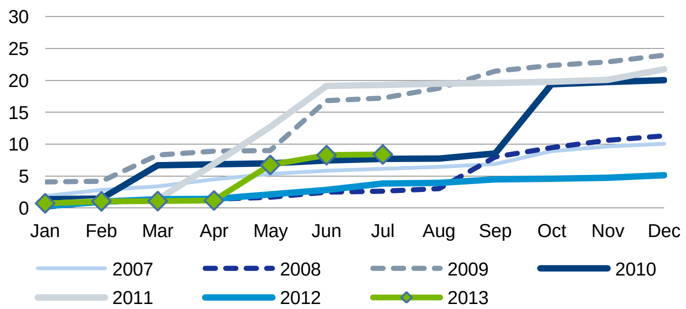
— Corporations continued to tap the bond markets extensively, with issuance volume of EUR 2.6 bn in July, slightly below the average of 2013.

— Cumulative issuance activity in 2013 amounted to EUR 18.5 bn marking the highest issuance observed year-to-date.

— Debt capital markets seem to play an increasingly important role in corporate financing.

Gross equity issuance

Cumulative issuance volume, EUR bn



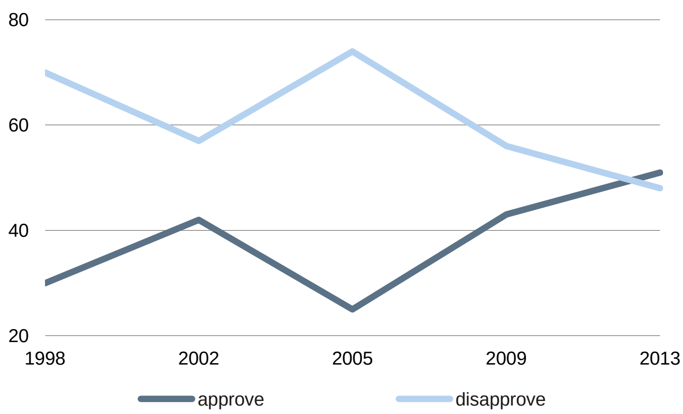
Sources: Bundesbank, DB Research

— Equity issuance has tumbled considerably in July. Companies issued only EUR 109 m equity, the lowest issuance in a given July to date.

— With the considerable cooling down in issuance activity in July, stock issuance lost pace and stabilised at some EUR 8 bn year-to-date.

Chartbook: Economic policy

Approval of incumbent government at time of federal elections



Source: Infratest dimap

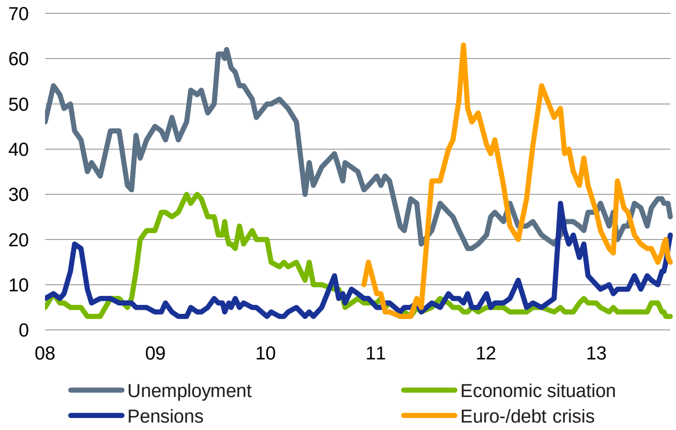
— The good election result for Angela Merkel's Christian Democrats (CDU/CSU) is reflected in high approval rates for her government.

— Looking at the previous federal elections, governments with low approval rates clearly lost the elections in 1998 and 2005. However, also in comparison to the elections of 2002 and 2009, when Chancellors Schröder and Merkel were re-elected, the approval rate of Angela Merkel's government was unusually high in 2013.

— In contrast to the previous elections, there was a majority of 51% who expressed approval with the incumbent government in 2013. Chancellor Merkel's CDU even reached an approval rate of 57%, compared to only 12% for her coalition partner FDP.

Most important political issues in Germany

two possible mentions



Source: Forschungsgruppe Wahlen

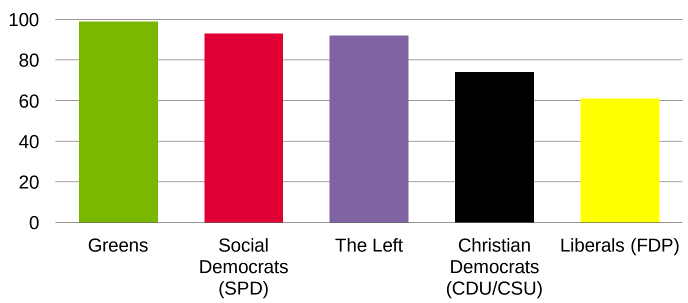
— While until early 2013 the crisis in the Euro area was the dominant political issue for German voters, it has since then receded to the background.

— When asked about the two main issues for German politics, unemployment was mentioned by 25% of the respondents as number one despite the currently robust labour market.

— The second most frequently mentioned issue was the sustainability of the pension system (21%). The Euro crisis was singled out by only 15%, down from more than 50% in mid-2012.

Party voters in favour of introducing a national minimum wage

in %



Source: Infratest dimap

— The introduction of a national minimum wage, which is favoured by the parties on the political left and the Greens, could become an important issue during the next electoral term.

— The Liberal Democrats (FDP), who opposed minimum wages on the grounds of possible negative employment effects, are no longer represented in the Bundestag. Even among the CDU/CSU voters a majority of 74% favours the introduction of a nation-wide minimum wage. Among the voters of Angela Merkel's potential coalition partners, the SPD and the Greens, even more than 90% are in favour of a national minimum wage.

Contact persons for our chartbooks:

Business cycle and financial markets:
Heiko Peters (+49 69 910-21548, heiko.peters@db.com)
Oliver Rakau (+49 69 910-31875, oliver.rakau@db.com)
Jan Schildbach (+49 69 910-31717, jan.schildbach@db.com)

Sectors:
Antje Stobbe (+49 69 910-31847, antje.stobbe@db.com)

Economic policy:
Dieter Bräuninger (+49 69 910-31708, dieter.braeuninger@db.com)
Frank Zipfel (+49 69 910-31890, frank.zipfel@db.com)

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

Date	Event	Remarks
2 Oct	Meeting of the ECB Council and press conference in Paris	Review of the monetary policy stance.
11-13 Oct	Annual meetings of the World Bank and the IMF	Discussion on the outlook for the global economy and developments in financial markets.
14/15 Oct	Eurogroup/ECOFIN meeting	Review of Spanish bank recap programme and reform progress in crisis countries; preparation of the European Council.
19/20 Oct	Federal party convention of the Greens in Berlin	Election of the party leadership. Discussions on the course of the party
22 Oct	Latest date for the constituent meeting of the newly elected Bundestag	According to the basic constitutional law the Bundestag has to hold its constituent meeting 30 days after the election day (Sep 22) at the latest.
24/25 Oct	European Council in Brussels	EU leaders' summit on social policies. Furthermore, debates on competitiveness, employment and growth in the EU.
7 Nov	Meeting of the ECB Council, press conference	Review of the monetary policy stance.
14-16	SPD federal party convention in Leipzig	Election of the party leadership.
21/22 Nov	Eurogroup/ECOFIN meeting	Discussion of EU autumn forecasts, state of implementation of ESM bank recapitalization and SSM.

Source: DB Research

Dieter Bräuninger (+49 69 910-31708, dieter.braeuninger@db.com)
Nicolaus Heinen (+49 69 910-31713, nicolaus.heinen@db.com)

Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
1 Oct 2013	10:00	Unemployment rate (%, sa)	September	6.8	6.8
8 Oct 2013	8:00	Trade balance (EUR bn, sa)	August	16.7	14.6
8 Oct 2013	8:00	Merchandise exports (EUR bn, sa), pch mom (yoy)	August	1.7 (-2.4)	-1.1 (-2.5)
8 Oct 2013	8:00	Merchandise imports (EUR bn, sa), pch mom (yoy)	August	-0.9 (-1.6)	0.3 (-0.8)
8 Oct 2013	12:00	New orders manufacturing (Index, sa), pch mom	August	-1.5	-2.7
9 Oct 2013	12:00	Industrial production (Index, sa), pch mom	August	0.7	-1.7
15 Oct 2013	8:00	Import prices (Index, sa) pch mom (yoy)	August	0.1 (-3.8)	0.3 (-2.6)
-	9:30	Manufacturing PMI (Flash)	Oktober	52.0	51.3
-	9:30	Services PMI (Flash)	Oktober	54.0	54.4
25 Oct 2013	10:30	ifo business climate (Index, sa)	Oktober	108.0	107.7
30 Oct 2013	14:00	Consumer prices preliminary (Index, sa), pch mom (yoy)	Oktober	0.1 (1.5)	0.0 (1.4)
31 Oct 2013	8:00	Retail sales (Index, sa), pch mom	September	0.8	0.5
14 Nov 2013	8:00	Real GDP (Index, sa), % qoq	Q3 2013	0.3	0.7

Sources: DB Research, Federal Statistical Office, Federal Employment Agency, ifo, Markit

Financial Forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	0.125	0.10	0.50	0.50	0.00	1.00	0.20	1.50	2.50	3.60	0.05
Dec 13	0.125	0.10	0.50	0.51	0.00	1.00	0.30	1.50	2.50	3.20	0.05
Mar 14	0.125	0.10	0.50	0.51	0.00	1.00	0.30	1.50	2.50	3.00	0.05
Sep 14	0.125	0.10	0.50	0.60	0.00	1.25	0.40	1.75	2.50	3.00	0.05
3M interest rates, %											
Current	0.25	0.23	0.22	0.52							
Dec 13	0.35	0.20	0.25	0.55							
Mar 14	0.35	0.20	0.30	0.55							
Sep 14	0.35	0.20	0.40	0.55							
10Y government bonds yields											
	Yields, %				Spreads vs. EMU, pp						
Current	2.62	0.68	1.73	2.53	-0.75	0.67	0.17	1.15			
Dec 13	2.50	0.90	2.20	3.00	-0.70	0.25	0.25	0.65			
Mar 14	2.75	0.80	2.30	3.25	-0.65	0.20	0.30	0.70			
Sep 14	3.00	0.90	2.50	3.75	-0.65	0.20	0.30	0.75			
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	1.35	98.93	0.84	1.61	1.23	8.70	7.46	8.10	4.24	299.63	25.69
Dec 13	1.20	110.00	0.85	1.41	1.25	8.25	7.46	7.25	4.15	290.00	25.70
Mar 14	1.19	111.00	0.86	1.39	1.25	8.13	7.46	7.20	4.11	287.50	25.53
Sep 14	1.17	114.00	0.84	1.40	1.24	7.95	7.46	7.10	4.04	282.50	25.18

Sources: Bloomberg, Deutsche Bank

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

German Data Monitor

	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Apr 2013	May 2013	Jun 2013	Jul 2013	Aug 2013	Sep 2013
Business surveys and output											
Aggregate											
Ifo business climate	102.3	101.4	106.1	105.3	107.2	104.4	105.7	105.9	106.2	107.6	107.7
Ifo business expectations	94.3	95.6	103.0	101.9	103.3	101.6	101.6	102.5	102.4	103.3	104.2
PMI composite	47.9	49.1	52.8	49.9	53.1	49.2	50.2	50.4	52.1	53.5	53.8
Industry											
Ifo manufacturing	96.4	95.1	101.1	100.5	102.7	99.3	100.7	101.5	101.6	103.1	103.5
PMI manufacturing	45.0	46.3	49.7	48.7	51.3	48.1	49.4	48.6	50.7	51.8	51.3
Headline IP (% pop)	0.3	-2.5	0.1	1.3		0.9	-1.2	2.0	-1.7		
Orders (% pop)	-1.9	0.9	0.4	1.5		-1.9	-0.5	5.0	-2.7		
Capacity Utilisation	83.6	82.1	83.2	82.7	83.6						
Construction											
Output (% pop)	0.5	-2.3	-6.6	11.4		15.7	-1.0	3.2	0.3		
Orders (% pop)	-1.2	2.2	2.4	0.3		0.7	0.5	5.1	2.3		
Ifo construction	118.1	117.7	125.7	123.8	120.4	124.5	123.5	123.4	121.9	120.2	119.0
Services											
PMI services	49.4	50.0	53.8	49.9	52.8	49.6	49.7	50.4	51.3	52.8	54.4
Consumer demand											
EC consumer survey	-7.9	-10.0	-6.5	-4.2	-3.2	-4.9	-4.5	-3.2	-2.3	-3.4	-4.0
Retail sales (% pop)	-0.4	-0.8	1.5	-0.1	-0.4	0.3	0.9	-1.1	-0.2	0.5	
New car reg. (% yoy)	-7.0	-6.2	-10.5	-3.7		3.8	-9.9	-4.7	2.1	-5.5	
Foreign sector											
Foreign orders (% pop)	-1.4	2.2	-1.0	3.6		-1.2	0.5	6.1	-4.5		
Exports (% pop)	1.1	-2.0	0.4	0.1		1.4	-2.0	0.6	-1.1		
Imports (% pop)	0.3	-1.0	-1.0	1.3		1.2	1.4	-1.0	0.3		
Net trade (sa EUR bn)	50.6	47.1	50.5	48.0		17.5	14.6	15.9	14.6		
Labour market											
Unemployment rate (%)	6.8	6.9	6.9	6.8		6.9	6.8	6.8	6.8	6.8	
Change in unemployment (k)	25.7	28.7	-8.0	19.7		4.0	18.0	-13.0	-7.0	7.0	
Employment (% yoy)	1.1	0.9	0.6	0.6		0.6	0.6	0.6	0.5		
Ifo employment barometer	105.9	106.3	106.2	104.9	106.3	104.7	105.6	104.4	105.6	106.8	106.4
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	2.1	2.0	1.8	1.5	1.7	1.1	1.6	1.9	1.9	1.6	1.6
Core HICP (% yoy)	1.2	1.3	1.4	1.0		0.6	1.1	1.2	1.2	1.2	
Harmonised PPI (% yoy)	1.4	1.5	1.1	0.3		0.1	0.2	0.6	0.5		
Commodities, ex. Energy (% yoy)	-4.5	0.7	-3.5	-7.0		-6.2	-6.7	-8.2	-13.7	-11.5	
Oil price (USD)	109.7	110.1	112.6	102.5		102.0	102.6	103.0	107.9	111.3	
Inflation expectations											
EC household survey	27.0	31.2	26.6	22.5	26.2	25.4	21.6	20.6	23.5	28.2	26.8
EC industrial survey	0.8	2.9	3.7	-0.6	2.8	-0.4	-1.8	0.5	1.3	2.8	4.3
Unit labour cost (% yoy)											
Unit labour cost	3.3	3.1	4.0	1.4							
Compensation	2.7	2.9	2.2	1.6							
Hourly labour costs	3.7	3.7	4.2	1.1							
Money (% yoy)											
M3	6.9	6.0	5.3	4.2		5.6	4.6	4.2	2.1	-1.4	
M3 trend (3m cma)						5.2	4.8	3.6	1.6		
Credit - private	0.6	-0.4	-0.2			-0.2	-0.1	1.3	-0.5		
Credit - public	10.4	13.5	-18.7			-13.2	-23.1	-22.4	-25.1		

% 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
DB 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.

Our publications can be accessed, free of charge, on our website www.dbresearch.com You can also register there to receive our publications regularly by E-mail.

Ordering address for the print version:
Deutsche Bank Research
Marketing
60262 Frankfurt am Main
Fax: +49 69 910-31877
E-Mail: marketing.dbr@db.com

Available faster by E-mail:
marketing.dbr@db.com

Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

Print: ISSN 1612-314X / Internet/E-mail: ISSN 1612-3158