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Economic forecast 2011/2012

# Working Paper

## No. 146

### Economic forecast 2011/2012

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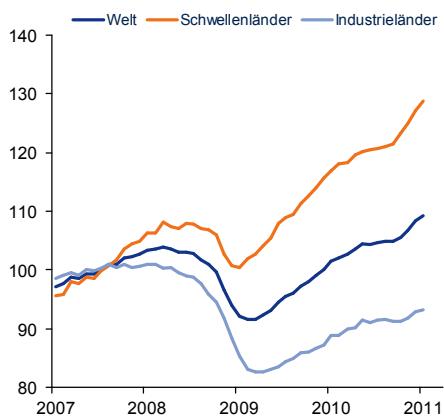
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**1. GLOBAL ECONOMIC SITUATION AND OUTLOOK**

Despite the unwinding, and in some cases already the reversal, of fiscal policy stimulus measures, the global economy continued to firm up appreciably last year. The concerns as to the sustainability of the economic recovery that started to bubble up in the summer months proved to be unfounded. In fact, global industrial production and world trade had gained considerable momentum again by the end of 2010. This trend was fairly broad-based. After industrial production had already clambered back to its pre-crisis high by the spring, the international exchange of goods had also made a return to its pre-crisis strength by the close of the year. All in all, the emerging markets – spearheaded by the Asian economies – once again led the growth field in 2010. The recovery witnessed in most of the world's large industrial countries, on the other hand, remained a relatively subdued affair, meaning that macroeconomic production capacity utilization remained on the low side. The varied nature of the global recovery is ultimately due to the different impact the financial crisis had on individual economies.

Chart 1

**Buoyant global production and world trade in early 2011****Global industrial production  
(Index, 2007=100)****World trade volume (goods)  
(Index, 2000=100)**

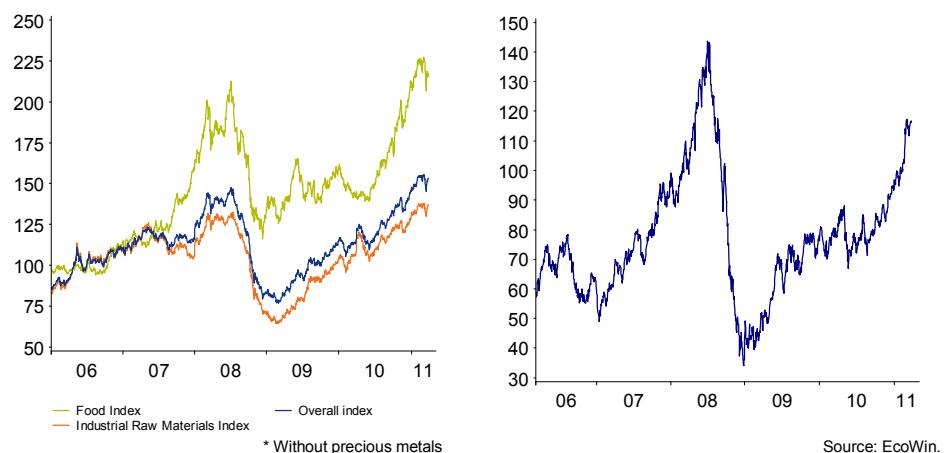
Source: CPB Netherlands Bureau for Economic Policy Analysis.

The sustained trend towards economic improvement came hand-in-hand with a marked increase in commodities prices, particularly in the second half of 2010 and most notably affecting prices for food, drink and tobacco. This upward pressure was not, however, solely the result of cyclical or structural factors relating to the increasing clout of the emerging markets on the global economic stage. Supply bottlenecks triggered by weather conditions, which normally spark only temporary inflation, were also to blame.

Chart 2

### Broad-based rise in commodity prices

**HWWI-commodity price index  
without energy\* (USD-basis, 2006=100)**    **Crude oil, Brent (USD/barrel)**



Source: EcoWin.

Faced with a considerable difference in positions in the economic cycle and heightened price risks, different monetary policy requirements increasingly started to emerge. This meant that, both in some industrial countries and on fast-growing emerging markets, monetary policy became less accommodative in the course of 2010. Interest rate hikes, however, were moderate in some countries, not least in an attempt to thwart any significant appreciation in their own currencies. All the same, the changes to exchange rate structures are helping to foster more balanced global economic growth on the whole.

At the start of this year, the global economy is battling with a whole number of trends that all seem to be pulling in different directions. On the positive side there is the further improvement in business surveys on the whole, reflecting not least the very healthy state of order books. It is also encouraging that higher overall output has eased the situation on labor markets further. On their own, these trends would point to broader-based growth.

But on the other side there is now a whole bundle of negative supply and demand-side factors which in total pose a substantial risk to the world economy going forward. These include

- a possible further spike in oil prices triggered by the political turmoil in North Africa and the Middle East
- deterioration on the price front in the emerging markets (particularly in China)
- the need for budgetary consolidation in the eurozone, but also in the USA
- the natural catastrophes in Japan and the associated nuclear reactor accident (see box)

## Japan: The economic repercussions of the natural catastrophes and the reactor accident

On March 11, Japan was hit by natural catastrophes on a huge scale. Any estimates as to the economic consequences of the tragic events are still based on very limited information, meaning that they have a cloud of considerable uncertainty hanging over them. It is still only possible to look at the macroeconomic impact of the earthquake, the tsunami and the nuclear accident in scenario-based assessments that depend on the extent of the nuclear radiation spread. The economic repercussions hinge on the intensity of the nuclear contamination, as well as on how long any restrictions imposed on the electricity supply last.

**Scenario 1:** If the leakage of radioactivity can be broadly contained and kept away from the conurbations, the loss of output will be largely confined to the regions in the north-east of Japan directly affected by the earthquake. The three or four prefectures worst hit account for 4-6% of Japan's overall economic output. The situation will, however, be exacerbated by the rationing of electricity and the damage to transport routes, which will have a negative impact on production in other regions as well. Companies could see a gradual improvement in their power supply situation emerge in the course of the second quarter. The inevitable disruption to economic activity in the immediate wake of a natural disaster is normally accompanied in the longer term by additional demand as destroyed economic assets are rebuilt. In this scenario, the economy is likely to receive an appreciable boost in the second half of this year from the reconstruction work which is likely to stretch over several years. The scale of the additional demand can be estimated by looking at the losses of real assets. In an initial, preliminary estimate, the government put the corresponding losses at between 16 trillion and 25 trillion yen (3½% - 5½% of nominal GDP). This would mean that the damage would be around twice as substantial as that caused by the earthquake in Kobe in 1995. What is more, overall output is expected to fall in the first half of the year - unlike in 1995.

**Scenario 2:** If the radioactivity spreads further across the country, this would necessitate sweeping protective measures for the population in conurbations. Uncertainty about how the contamination might unfold is great, not least because it depends on meteorological conditions. In the event of an uncontrollable meltdown in several reactors, large-scale contamination of the soil, air and water with radioactive particles would be the likely upshot. The regions around the nuclear plants would be unusable for an extended period and public and economic life in and around Tokyo could possibly grind to a halt for days or weeks, depending on the air currents. Companies could also find themselves faced with an insufficient power supply stretching over a period of several months. In this event Japan would face major economic difficulties and overall output would plummet in 2011. The loss of economic assets would be still more pronounced as even only partially damaged equipment would be unusable for a longer period. Such a scenario would be characterized by ongoing support measures from the central bank and financial assistance from the state for companies and their employees. Government debt would soar.

Such a scenario would also spill over into the world economy via various channels. The risk of an extended standstill in production would send shockwaves through the financial markets. In view of the widespread uncertainty and risk aversion, interest rates on dollar and euro bonds could fall slightly. Given the close links between the Asian economies, international production chains would also be significantly disrupted, at least temporarily. Lingering supply problems in Japan would allow competitors on the world markets to expand their market shares at the expense of Japanese rivals. And we should also bear in mind that we could see a rethink on the energy policy front in many countries. The rejigging of the energy mix would render parts of the capital stock obsolete and generate costs. It also cannot be ruled out that the drop in oil and gas prices will be only very brief and that they will soon return to their upward trajectory as they (re-)assume an enhanced role in the production of energy.

So looking back, the uncertainty surrounding economic developments has increased considerably in the space of only a few weeks. The key question is whether the global economy will have the resilience to weather these difficulties. This document sets out our assessment of the economic prospects for some of the world's key regions and countries:

## USA

After getting back into stride in the closing quarter of 2010 with growth of 3.1% (annualized), US economic indicators at the beginning of 2011 are sending out mixed signals. Both the purchasing managers' index for the manufacturing industry and the index for the wider service sector, for example, have rallied to new highs for the current cycle, signaling above-average growth. By contrast, sluggish construction activity and a more downcast consumer economy suggest that the pace of growth is not picking up any further, at least not at the moment. These developments would appear to be attributable to adverse weather conditions and to the sharp increase in gasoline prices. The oil price surge has more or less canceled out the favorable impact on the real incomes of private households of the net tax relief passed in December.

The portents for how things look set to develop further as the year progresses are a mixed bag. The economic policy debate is focusing increasingly on public spending cuts. It seems likely that, in the course of the imminent negotiations on raising the ceiling for government debt, the US government and Congress will take further steps to accommodate the Republican majority in the House of Representatives, which is calling for spending cuts in the current year. This, coupled with the ongoing consolidation efforts at state and municipal authority level, suggests that government spending will dip at least slightly this year.

By contrast, the conditions for solid private demand appear to have improved. The manufacturing sector is positive as regards incoming orders from abroad, which recently climbed towards the sort of highs seen in the late 1980s. This trend will certainly be bolstered by the low real external value of the US dollar, which was recently down by almost 15% on its long-term average. Given favorable unit sales prospects, the outlook for sustained brisk activity in equipment investment is bright, especially given the need for modernization. What is more, leading indicators are pointing towards an end to the downturn in the commercial construction segment and to more job creation. With a financing surplus corresponding to around 5% of their disposable income, private households can now forge ahead with efforts to improve the state of their household

balance sheets, laying a more solid foundation for a continued upward trend in consumer spending.

In an environment characterized by increased risks and against the backdrop of low inventory levels, improved loan availability and a need for both consumers and corporate investment to catch up, we believe that a continued, albeit moderate, recovery is on the cards for this year. All in all, the US economy is expected to achieve average growth of 2.7% for the year as a whole. In 2012, we expect to see growth to the tune of 2.5%.

### Euro area

With quarterly growth rates of 0.3% in the second half of 2010, the euro area economy remained on the growth path, expanding by a total of 1.7% in 2010 as a whole.

Despite the damper placed on the economy in the form of consolidation moves launched by a number of those member states that were hit hard by the sovereign debt crisis, the moderate upward economic trend is expected to continue in the period covered by our forecast. The most recent economic data and survey results (e.g. purchasing managers' indices, EU Commission's Economic Sentiment Indicator) suggest sustained positive economic momentum in the euro area.

In this respect, economic growth in the euro area is expected to rest on several pillars: eurozone exports will benefit from what is likely to be a continuation of solid global trade. In addition to export demand, private domestic demand is expected to make an increasing contribution to GDP. The fact that the ECB's monetary policy approach is likely to remain loose, even if no longer ultra-loose, is expected to play a positive role in this regard. In addition, business surveys for the euro area manufacturing industry show that the shortage of equipment has pushed further into the spotlight as a factor that is hindering production. A solid increase in equipment investment therefore looks likely. Private consumption is expected to be shored up by slight improvements on the labor market, although it could well come under pressure due to rising inflation at the same time. After all, rising commodities prices are likely to mean that consumer price inflation will continue to linger above the 2% mark this year. Looking at 2011 as a whole, we expect to see an annual average inflation rate of 2.3%, followed by a declining trend (to 1.9%) in the euro area the following year.

The structural reforms that have been initiated should help narrow the growth gap in the euro area both this year and, in particular, in 2012. On the whole, we believe that the economic recovery will continue in the euro area. Following real GDP growth of 1.6% this year, we predict growth to the tune of 1.7% next year.

### Emerging markets

Most of the emerging markets of Asia and Latin America reported robust economic growth last year. In eastern Europe, on the other hand, the economic recovery that followed the global financial and economic crisis was relatively subdued and the work involved in getting to grips with the macroeconomic upheaval in some countries in the region continued to put pressure, sometimes considerable pressure, on economic development. As far as this year is concerned, current economic indicators, such as the purchasing managers' indices for the manufacturing sector, generally point towards a continued upward trend for the emerging markets. Although economic growth in Asia – largely due to the intentional policy effort to slow the Chinese economy – is likely to be almost 2 percentage points lower this year than it was in 2010, at around 7½%, Asia

remains the world's fastest-growing emerging market region by far. Latin America will probably follow in second place, with GDP growth in the region of 4½%. Eastern Europe is likely to come in bottom of the league for the third consecutive time, with growth of just under 4%. On the whole, we expect to see economic growth of around 6% for the world's emerging markets both this and next year, compared with 7.3% in 2010. In this respect, the growth differentials between the individual regions are likely to narrow considerably, especially so this year.

There is no doubt that the risks hovering over the economic future have been mounting over the past few weeks and months, not only in the emerging markets. The increased price pressure in many emerging markets, for example, is proving cause for concern. Although the hefty increase in commodity prices, particularly in the prices of energy and agricultural commodities, is being felt in the industrial countries as well, the fact that consumers in emerging markets tend to spend a far greater proportion of their disposable income on foodstuffs than their counterparts in industrial countries means that the increase in food and drink prices has a far greater impact on consumer price inflation in up-and-coming economies than it does in industrial countries. Central banks in many of the countries affected currently find themselves in a quandary: they should be doing more in the way of hiking key rates to counter the increase in domestic price pressure, but know that if they do, these economies will become even more attractive to foreign investors due to interest rates, which are already higher than in the industrial countries as things stand at the moment. This would put further upward pressure on their currencies. If, however, the central banks prove too sluggish in responding, or if their response is too moderate, there is a risk that they will end up having to take action that is all the more drastic, which may send the economy into a downward spiral.

Another economic risk lies in the earthquake disaster and nuclear accident in Japan. The economic consequences of these events could hit Asia's emerging markets particularly hard. Given the close links between the Asian economies, any prolonged production downtime in Japan could throw the international production chains out of kilter. The countries that would be dealt the heaviest blow in this scenario would be South Korea and some ASEAN states. Let's take two figures as an example: around 15% of South Korea's imports originate in Japan. These imports are worth more than 6% of South Korean GDP. A significant portion of these imports relate to components and intermediates that are used for the country's own export production and cannot, presumably, be sourced from anywhere else without further ado. A relatively brief period of production downtime in Japan would be unlikely to have any major negative impact on macroeconomic growth in those countries that are heavily reliant on Japanese imports this year, because the catch-up effects that would be witnessed in the remainder of the year would probably make up for any temporary slump in exports. If the production downtime proves to be more prolonged, however, we do not believe that Asia would be able to deliver on our current growth forecast.

So what does all of this mean for the global economy as a whole? After a strong 4% rise in global output last year, the increase this year and next is expected to be slightly more modest at 3.4% (country weighting based on current exchange rates in each case). The growth slowdown will be slightly more pronounced in the emerging markets than in the industrial countries as a result of the expected developments in Asia and Latin America.

If Japan is confronted with a real recession, growth would be lower. But such a scenario is unlikely to spark a global recession. This could be the case if, for example, the political tension in North Africa and the Middle East were also to send oil prices soaring.

## Growth rates in main economic regions

GDP, real % change over previous year

	2006	2007	2008	2009	2010	2011 <sup>1)</sup>	2012 <sup>1)</sup>
<b>Industrialized countries</b>	<b>2.7</b>	<b>2.4</b>	<b>0.1</b>	<b>-3.7</b>	<b>2.5</b>	<b>2.1</b>	<b>2.2</b>
European Union	3.3	3.0	0.5	-4.2	1.8	1.8	1.8
Euro area	3.1	2.9	0.4	-4.1	1.7	1.6	1.7
Germany	3.4	2.7	1.0	-4.7	3.6	2.9	1.7
USA	2.7	1.9	0.0	-2.6	2.9	2.7	2.5
Japan	2.0	2.4	-1.2	-6.3	3.9	0.7	2.4
<b>Emerging markets</b>	<b>7.9</b>	<b>8.3</b>	<b>5.5</b>	<b>1.4</b>	<b>7.3</b>	<b>6.0</b>	<b>5.9</b>
Asia	9.7	10.7	6.9	5.9	9.5	7.6	7.3
Latin America	5.4	5.8	4.2	-1.8	6.1	4.4	4.3
Central and Eastern Europe	7.5	7.5	4.5	-6.1	3.2	3.8	4.1
<b>World</b>	<b>4.1</b>	<b>4.1</b>	<b>1.7</b>	<b>-2.1</b>	<b>4.0</b>	<b>3.4</b>	<b>3.4</b>

1) forecast.

Sources: EcoWin, own forecasts.

We have applied the following assumptions for the overall global environment to our forecast:

- Following the strong recovery in global trade to the tune of 15% last year, global trade is expected to see further strong growth of between 8% and 10% in 2011 as well, not least thanks to the dynamic development at the end of 2010. Looking ahead to next year, we then expect to see an increase that will be more in line with the expansion of global output, and predict growth of between 6% and 8%.
- On the basis of a continued, albeit more moderate, global economic recovery, we expect to see the prices for industrial metals edge up slightly. As far as agricultural commodities are concerned, however, we believe that there is potential for limited downward price corrections, not least due to the price rally affecting individual commodities in the wake of failed harvests last year. Crude oil has been becoming considerably more expensive since the middle of 2010. WTI crude oil is currently trading at a price that is almost 30% higher than a year earlier. The uncertainty surrounding how the situation will pan out in North Africa and the Middle East is likely to remain on the scene throughout 2011. The constant back-and-forth between news that pushes prices up and news that pushes prices down will create a very volatile climate. WTI crude oil is likely to cost around USD 110 a barrel on average both this and next year.
- In all probability, the ECB will start normalizing its monetary policy sooner than the US Fed does, although we expect the normalization process to be a very gradual one. A sharp and swift turning of the interest rate screw is still being hindered by the current debt crisis in some EMU member states, and in particular by the problems facing banks in the affected countries. We expect to see key rates of 1.5% in the euro area by the end of 2011. By the end of next year, rates are forecast to come in at 2%.
- The euro has been continuously gaining ground against the US dollar in recent months, a trend that is unlikely to change to any considerable degree before the year is out. The US dollar is likely to be hit not only by the ongoing need for consolidation

in the US, but also by the progress we expect to see in the restructuring of EMU state finances. The fact that the ECB appears likely to start raising key interest rates before the Fed does also suggests that the US dollar will err on the side of weakness. By the end of 2011, one euro is expected to cost 1.45 US dollars. Looking ahead to 2012, we largely expect to see a sideways movement in the exchange rate between the two currencies.

## 2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

### 2.1 Buoyant economic momentum initially

The German economy is ticking over nicely. Industrial capacity utilization is now well above its long-term average and industry is as upbeat about the current situation as it was at the peak of the last upswing in late 2006/early 2007, the services sector even more so. Companies have been recruiting heavily as a result; the number of people in work in the economy as a whole has risen by more than 1% over the past year.

The early onset of a severe winter, however, meant that the economy returned only moderate growth of 0.4% quarter-on-quarter in the last three months of last year. Looking at the first quarter of 2011, growth momentum appears to be moving up a few gears. Business surveys suggest that both production and incoming orders were clearly on the up at the beginning of this year. In Q1, GDP is expected to edge up by around one percent compared with the closing quarter of 2010, which corresponds to growth of 4½% in a year-on-year comparison. This means that the German economy has started the new year with considerable momentum behind it, although growth rates are expected to taper off as the year progresses, dragged down by the increase in oil prices.

Exports, which had already bounced back to their 2008 pre-crisis level by the end of 2010, are expected to continue to provide substantial impetus in the first instance. Companies remain very optimistic in their export outlook. As we move further into 2011 and 2012, however, it is doubtful whether export demand will continue to show the same kind of impressive development seen over the last few quarters. If – as is to be expected – global growth gradually loses momentum, it will pull German export growth down along with it.

Domestic demand is likely to continue to flourish both this and next year, with the very positive developments on the labor market set to play a decisive role in this development. Marked employment growth will boost income development and the resulting increase in purchasing power will bolster domestic demand. This means that the overall conditions for better consumer demand are looking positive, although it is important to bear in mind that rising commodity prices will erode part of this additional purchasing power. All in all, 2011 is likely to see the first significant expansion in private consumption since 2006. Investment demand is expected to provide even more impetus. The sharp rise in capacity utilization coupled with solid corporate earnings will spur on equipment investment, in particular.

## The economic impact of rising oil prices

Oil prices, which averaged around USD 80 a barrel last year, are likely to rise to an average of USD 110 a barrel this year, adding a whopping EUR 20bn to Germany's oil import bill. The associated loss of purchasing power will be cushioned by the fact that companies are evidently proving successful in factoring part of the cost increases into the prices of export goods. Although import prices were recently 11.9% higher than one year ago, export prices also rose by a far from insignificant 5.4%. Consequently, the deterioration in the terms of trade (relationship between export and import prices) sparked by the oil price hike is likely to trigger real income losses at domestic companies and households of an estimated EUR 15 – 20bn (0.6%-0.8% of GDP). Experience has, however, shown that real demand from companies and households tends not to fall proportionately. Instead, they generally reduce the amount of money they channel into savings. This explains why we have put the loss of real GDP growth at only 0.5 percentage points.

A similar conclusion is reached if we assume that the solid economic environment will allow companies to include the oil price-induced cost increases in the prices of consumer goods (and export goods) in full, meaning that the only area of the domestic economy that will feel the strain will be consumer demand. The resulting consumer price inflation in this scenario would come in at a substantial 1 percentage point in 2011 on average. Taking into account a slight drop in the savings rate, real consumer demand would likely contract by just shy of 1 percentage point. The real consumption losses would slice an estimated 0.5 percentage points off the GDP growth rate.

All in all, the rise in oil prices can definitely be considered significant to economic momentum, although it is not expected to put any sustained damper on the upswing. The story would be different if prices were to rise to USD 150 a barrel or even higher, in which case we would expect to see a major impact on the economy.

## Germany: Economic indicators and forecasts\*

	2009				2010				2011				2012				2009	2010	2011f	2012f	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4					
GDP real	-3.4	0.5	0.7	0.3	0.6	2.2	0.7	0.4	1.0	0.8	0.3	0.2	0.5	0.6	0.6	0.6	-4.7	3.6	2.9	1.7	
Private consumption	0.2	0.5	-1.2	0.0	0.2	0.4	0.5	0.2	0.4	0.6	0.2	0.2	0.4	0.4	0.4	0.4	-0.2	0.4	1.5	1.2	
Government spending	1.1	0.6	0.8	-0.3	1.9	-1.0	1.5	0.6	0.1	0.0	0.0	0.0	0.2	0.3	0.2	0.2	2.9	2.3	1.0	0.6	
Investment in machinery/equipment	-19.3	-2.7	0.8	-1.4	5.2	4.1	5.0	2.6	2.5	2.5	1.5	1.5	1.5	1.5	1.3	1.3	-22.6	10.9	11.2	5.4	
Construction	0.9	-0.2	0.5	-0.7	-0.8	7.0	-0.8	3.9	2.5	2.0	0.2	0.3	0.5	1.0	1.0	0.8	-1.5	2.8	2.3	2.0	
Domestic demand	-1.0	-0.8	0.9	-1.5	1.9	2.1	0.0	-0.4	0.9	0.7	0.3	0.2	0.5	0.5	0.5	0.5	-1.9	2.5	1.9	1.4	
Exports	-10.2	-1.4	3.2	2.7	2.2	7.6	2.7	2.5	2.8	2.0	1.0	1.0	1.5	1.8	1.5	1.5	-14.3	14.1	10.3	5.0	
Imports	-5.3	-4.6	4.1	-1.6	5.5	7.9	1.4	0.9	3.0	2.0	1.2	1.2	1.5	1.8	1.2	1.2	-9.4	12.6	8.9	5.1	
Industrial production (excl. construction)**)	-12.6	-0.3	3.7	1.2	2.3	5.1	1.7	2.7	1.6	1.8	1.2	1.0	1.1	0.9	0.7	0.7	-16.2	10.9	8.4	4.3	
Unemployment rate (EU def.)	%	7.3	7.6	7.6	7.5	7.3	6.9	6.7	6.6	6.4	6.2	6.1	6.0	5.9	5.8	5.7	7.5	6.9	6.3	5.9	
Unemployment rate (nat. def.)	%	7.9	8.3	8.3	8.1	8.0	7.7	7.6	7.5	7.3	7.1	6.9	6.8	6.7	6.6	6.5	6.4	8.2	7.7	7.0	6.5
Employed persons (national def.)	y-o-y	0.4	0.0	-0.2	-0.3	-0.2	0.5	0.8	1.0	1.2	1.0	0.9	0.8	0.7	0.6	0.5	0.5	0.0	0.5	1.0	0.6
Consumer prices	y-o-y	0.8	0.3	-0.2	0.4	0.8	1.1	1.2	1.5	2.1	2.3	2.4	2.1	1.8	1.6	1.9	2.1	0.4	1.1	2.2	1.8
Consumer prices (HICP)	y-o-y	0.8	0.2	-0.4	0.3	0.8	1.0	1.2	1.6	2.2	2.4	2.5	2.2	1.8	1.6	1.9	2.1	0.2	1.2	2.3	1.9
Producer prices	y-o-y	0.9	-3.6	-7.4	-6.3	-2.6	1.1	3.6	4.7	5.7	4.7	4.3	3.7	2.3	2.4	2.4	2.4	-4.1	1.7	4.6	2.4
Current account balance	EUR bn	24.2	29.3	38.3	43.0	33.4	30.2	37.6	38.3	35.0	31.0	29.0	31.0	32.0	32.0	33.0	33.0	133.7	141.4	126.0	130.0
	% of GDP																	5.6	5.6	4.9	4.9
Budget balance (Maastricht-definition)	EUR bn																	-72.7	-82.0	-50.0	-27.0
	% of GDP																	-3.0	-3.3	-1.9	-1.0

\* quarterly figures: percentage change over previous period, seasonally and working day adjusted, except where noted, yearly figures: percentage change, not working day adjusted; \*\*) yearly average working day adjusted.

f = forecast

All in all, the outlook for the German economy remains upbeat despite these risks. The drag on economic momentum from government consolidation measures and the impending change of course in monetary policy will be only slight. We predict that the German economy will grow by an average of 2.9% in 2011. However, due mainly to the slowdown in world trade and high commodity prices, German economic growth in 2012 is likely to be lower than this year. We predict real GDP growth to the tune of 1.7% in 2012. The underlying improvement on the labor market could nonetheless continue, with the jobless total likely to fall to around 2.5 million by the end of 2012.

## 2.2 Private consumption on the up – in spite of high energy prices

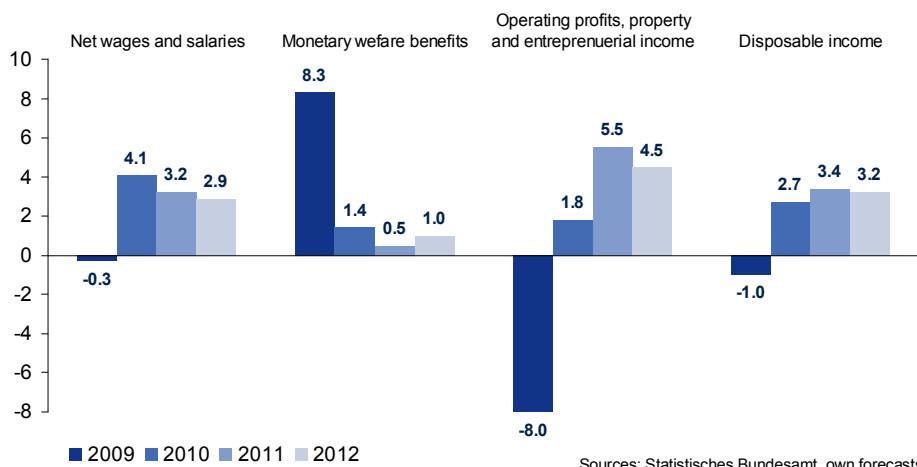
Private consumption has been a source of disappointment for years now, showing real growth of only 3.8% within a ten-year period – from 2000 to 2010. Things, do, however appear to be changing for the better. The recovery on the labor market is creating purchasing power, although the most recent surge in energy prices has blurred the outlook slightly again.

Given employment growth of around 1% and an increase of approximately 3% in actual earnings per employee, buoyed by an increase in overtime hours, gross labor income will rise by around 4% this year. Looking at net labor income, which climbed by 4.1% in 2010, however, the development is expected to be slightly less pronounced this year, which is due for one thing to higher contributions to unemployment and health insurance. The latter, in particular, are expected to carve a greater chunk out of net income in the future due to the additional contributions borne solely by employees. For another, 2011 will not see a repeat of the wage tax relief offered in 2010. Consequently, our calculations point towards an increase in net labor income of 3.2% for 2011 and 2.9% for 2012. Monetary welfare benefits will creep up only slightly, namely by +0.5% in 2011 and +1% in 2012. This is due to the decline in shorter working hours models, falling unemployment and the small increase in pensions.

Chart 3

### Private household disposable income

% change on year earlier



Sources: Statistisches Bundesamt, own forecasts.

All in all, mass income (income from wages and welfare benefits) is expected to increase by 2½% in 2011 and 2012. Profit income is now clearly on the rise again. After sliding by 8% in 2009 and making a slight recovery of 1.8% in 2010, property, entrepreneurial and investment income is expected to grow by 5.5% in 2011 and 4.5% in 2012.

All in all, we can expect to see the disposable income of private households climb by 3.4% in 2011 and by 3.2% in 2012. Given expected inflation of 2.2% this year and 1.8% next year and the resulting erosion of purchasing power, real incomes are set to increase by 1.2% in 2011 and 1.4% in 2012. According to a survey conducted by the market research company Gesellschaft für Konsumforschung (GfK), the consumer climate is currently fairly positive despite the rise in energy prices, which suggests that consumers are in spending mode. Rising interest rates, however, could push the propensity to save back up. In 2011, we expect to see only a slight dip in the savings rate (2010: 11.4%). In real terms, private consumption is likely to increase by 1.5% in 2011. In 2012 we forecast a further increase of 1.2%. Private consumption could thus become a mainstay of the domestic economy.

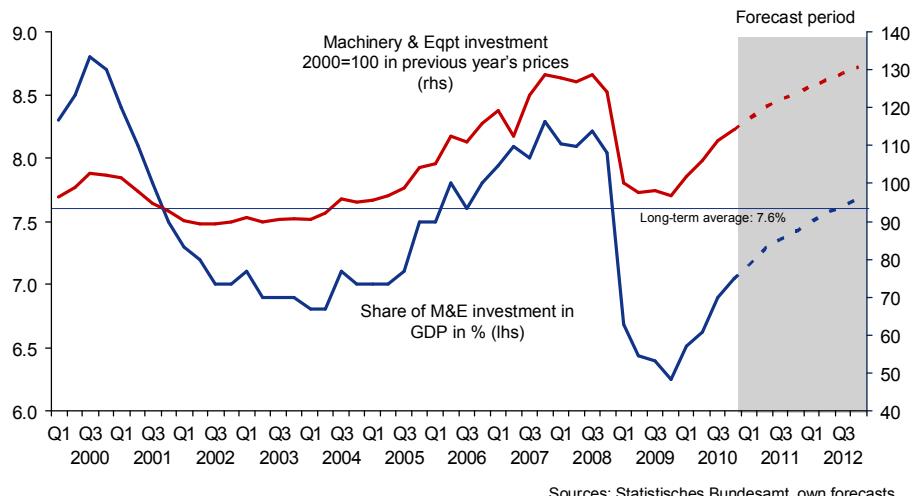
### 2.3 High capacity utilization to provide a real boost to investment

As in 2010, the driving force behind domestic demand will continue to lie in investment activity, in particular with respect to corporate equipment investment. This grew by 10.9% in 2010 after taking a 22.6% year-on-year nosedive in the crisis-ridden 2009.

This year is likely to see a repeat of the positive trend. According to a survey conducted by the German Chamber of Industry and Commerce (DIHK) on the economic situation and outlook at the beginning of 2011, 31% of companies want to invest more in 2011 than they did last year, and only 14% plan to invest less. In the survey conducted last fall, these figures were still sitting at 29% and 15% respectively. Many companies have recently been operating at their capacity limits and their order books for this year are already bursting at the seams. Both domestic demand and demand from abroad remain consistently high. This has now prompted the corporate sector to start forging ahead with capacity expansion measures. After all, interest rates remain extremely low and are expected to remain low for the time being, despite the adjustments that are on the horizon for this year. What is more, the financing options open to companies have improved considerably thanks to the increase in earnings witnessed in 2010. On the one hand, it is easier for companies to make investments under their own steam and on the other, they can benefit from a marked improvement in the credit ratings that are taken into account for credit financing. All in all, equipment investment is expected to grow by just over 11% this year. We expect to see an increase of 5.4% in 2012. The scope of expansion investments is likely to increase further, although the investment catch-up effects witnessed in the aftermath of the crisis will gradually disappear. Consequently, the volume of equipment investment is likely to have overtaken the value reached before the recession by as early as late 2012. At 7.7% by the end of 2012, the investment ratio (nominal equipment investment as a % of GDP) would be just above its average over the past 20 years.

Chart 4

### Investment volume and investment ratio



Sources: Statistisches Bundesamt, own forecasts.

Construction investment grew by just under 3% last year, with the residential construction segment returning particularly strong performance, with growth of 4.3%. Hopes of sustained positive development in the residential construction sector are fueled by the fact that job security and income expectations now also feature on the list of positive factors, as does the fact that interest rates remain low. Furthermore, the current increase in real estate prices serves as an additional incentive for investors in the residential construction sector. As a result, we expect to see this sector grow by between two and three percent both this and next year. The commercial construction segment is also expected to show fairly robust development in the medium term thanks to the high capacity utilization levels in the corporate sector described above. This is not expected to change to any significant degree in the foreseeable future. According to February's Ifo test, business expectations in the commercial construction segment have not been this good in 20 years. This is likely to see the segment expand by a good two-and-a-half to three percent. Next year, we expect the growth rate to be even higher, as the commercial construction segment tends to lag well behind any acceleration in economic growth. As more and more of the public investment initiatives launched as part of economic stimulus programs start to expire, and with the municipal authorities, the biggest public-sector building contractor, feeling the strain of tight budgets, the public-sector construction segment is expected to have a dampening effect in the period covered by our forecast. We predict a decline of up to 1% this year and a further drop of up to 3% next year. All in all, construction investment is expected to grow by 2½% this year, and, in spite of everything, by around 2% in 2012.

## 2.4 Exports continue to rise

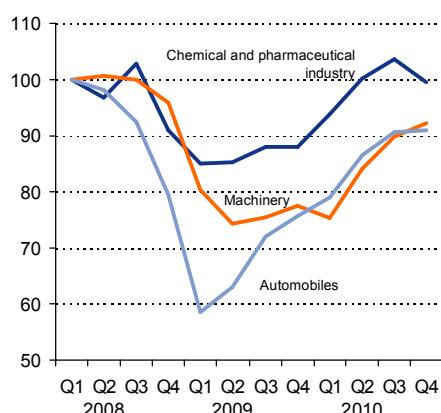
Although the economic recovery in 2010 was broad-based, it was exports that provided by far the most substantial growth impetus. Exports were up by 14.1% as against 2009, bringing them back up to the volume seen prior to the recession. The figures do, however, vary from product group to product group. By the end of 2010, exports of chemical and pharmaceutical products were already back at their early 2008 level in terms of value. Exports in the automotive industry, however, which was hit particularly hard by the crisis, are still hovering at only just over 90% of the level seen in Q1 2008. The situation in the engineering sector is only marginally better.

Looking at exports by region, Asia's ascent in the significance stakes – a trend that has been visible for some time now – is continuing unabated. Exports to the Far East are already 25% higher than they were in Q1 2008, whereas exports to other EU countries and to the US still fall short of this level by almost 7% and 13% respectively. Since 2000, the share of German exports destined for other EU countries has slid from 64.8% to 60.8% in 2010. Only 6.8% of exports were set for the US in 2010, compared with 10.3%. By contrast, the share of exports sent to Asia has risen from 10.5% to 15.5% over the ten-year period.

Chart 5

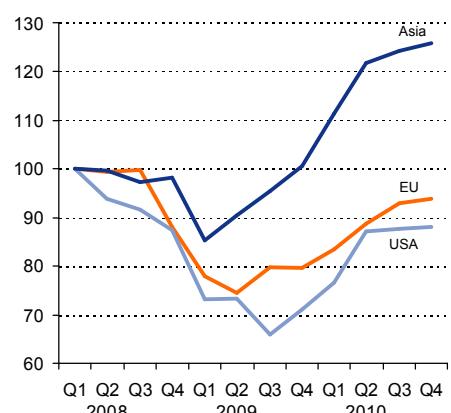
### Development of exports

#### By sector\*



\* ) Index, Q1 2008 = 100.

#### By region\*



Source: Deutsche Bundesbank.

We expect to see another respectable increase in exports this year. The first three months of this year saw the Ifo global economic climate test rise to the highest level seen since the summer of 2007 after a decline in the fourth quarter of 2010. Business expectations showed a particularly marked improvement. We believe that demand from the emerging markets, particularly for capital goods, will continue to rise strongly, with demand from the US also expected to pick up. We also expect the external value of the euro, weighted to reflect the currencies of the region's main trading partners, will chart only a moderate increase, meaning that any dampening impact on German exports is expected to be limited. As a result, the growth rate for 2011 will remain in the double digits at 10.3%, but the sort of growth witnessed in 2010 will not be repeated. Next year, when the catch-up effects in global trade in the wake of the recession are likely to have virtually disappeared, we are looking at more moderate growth of 5.0%.

Imports also showed strong growth last year, up by 12.6% on 2009 in terms of volume. In particular, companies have been building up stocks of intermediate products in the aftermath of the recession. Since this demand is expected to taper off somewhat, overall import growth is also expected to be somewhat lower this year. At present, we expect to see volume growth of 8.9% in 2011 and 5.1% in 2012. All in all, real exports and imports look set to grow at similar rates over the next two years. The main issue surrounding imports will be the development in energy and commodity prices this year. Indicators such as the HWI commodity price index (excl. energy) had recently surpassed the level seen in July 2008 again. The recent increase in crude oil prices is also expected to push German import prices up. Although export prices have been on a clear upward trend of late, Germany will be confronted with a marked deterioration in the terms of trade (real exchange relationship between exported and imported goods) in 2011. This means that, in nominal terms, import growth will outstrip export growth, forcing a slight downward correction to the current account surplus. After a surplus of 5.1% of GDP in 2010, we expect to see a figure of only around 4.7% in 2011 and 2012.

Chart 6

### Terms of trade (relation between export and import prices)

Index, 2005 = 100



### 2.5 Significant external inflationary impetus, but only moderate increase in consumer prices

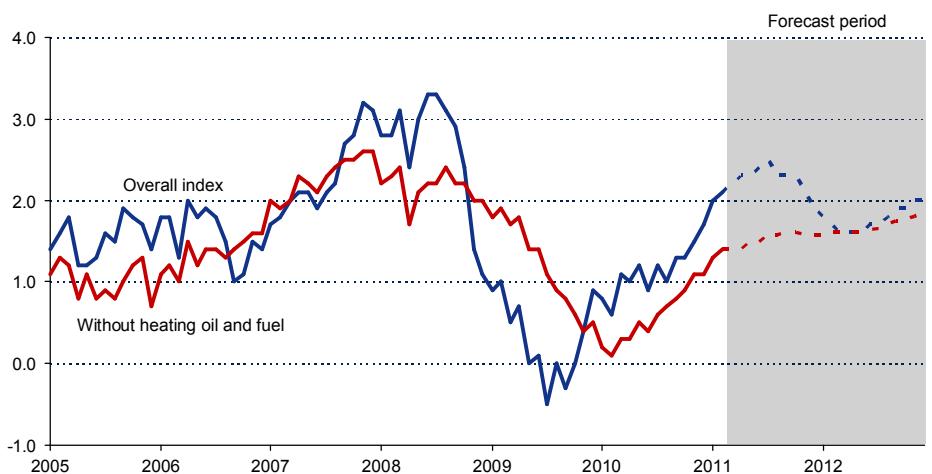
Although deflationary concerns repeatedly reared their ugly heads in 2010, inflation is now clearly the order of the day. The surge in commodity prices is exerting a marked external inflationary impetus.

Foodstuff prices on the global markets are now well up on the previous high seen in 2008. What is more, the HWI commodity price index shows that industrial commodity prices have also exceeded their level of mid-2008 again. The price of crude oil may not have returned to the extreme peak witnessed in 2008, but it has, nonetheless, also shot up by around 50% in the period from mid-2010 to March 2011. This trend has caused German import prices to skyrocket, putting them up by 11.9% in a year-on-year comparison in February of this year. Imported energy was almost 35%, grain 72% and iron ore as much as 89.4% more expensive than they were one year ago.

Chart 7

## Consumer prices

### % change on previous year



Sources: Statistisches Bundesamt, own forecasts.

It is clear that such a surge in import prices will have an increasing impact on consumer price inflation as well. The rate of inflation for private consumption recently stood at 2.1%. Taking energy out of the equation, this figure would have come in at only 1.1%. Prices for consumer durables remain stable, and the increase in services prices, too, is still sitting at only 1%.

Despite the surge in commodity prices, no general wave of inflation is looming. Although the higher energy costs will also mean that additional costs for energy-intensive finished goods will have to be passed on, any cost pressure on the domestic economy remains within narrow bounds. Overall unit wage costs, which dropped by 1.1% in 2010, are expected to rise by 1% at most this year. Provided that 2011 does not feature any further oil price hikes to speak of, the acceleration in consumer price inflation will not continue as the year progresses. Based on an oil price of around USD 110 a barrel, the average inflation rate for 2011 is estimated to come in at 2.2%. It could dip back marginally below the 2% mark next year.

## 2.6 Considerable job creation – fewer than three million people out of work

The German labor market has been on the rebound for more than a year now. The number of people in work has risen by almost 500,000 since the start of 2010, while the number of people out of work has fallen by around 300,000. The fact that the drop in unemployment is less pronounced than employment growth is somewhat surprising if we consider that the number of people of working age is on the decline. There are a number of indicators hinting at an increase in labor force participation among older people, in particular.

Almost all labor market indicators currently suggest a positive trend. Shorter working hours models are on the decline, the number of vacant positions is rising fast and, recently, the jobs index published by the German Employment Agency (*Bundesagentur für Arbeit*) actually topped the high it had reached in the course of the last boom in 2007.

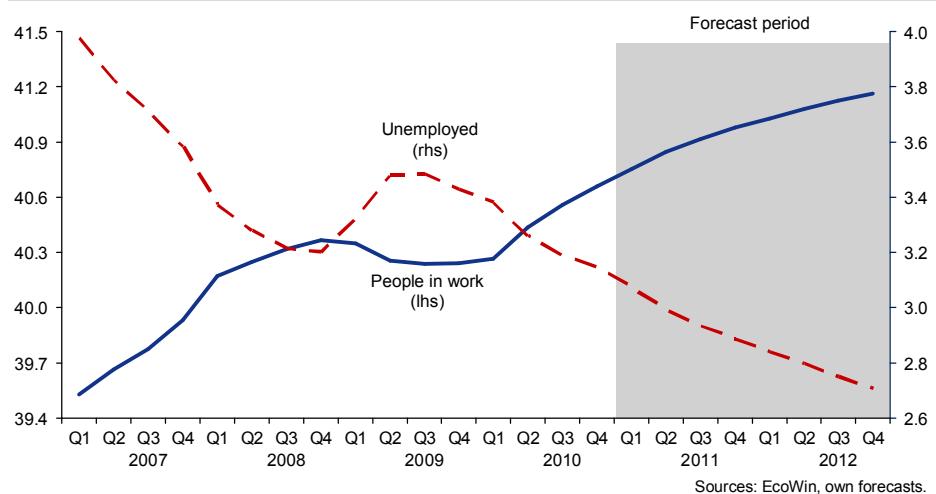
Employment is now growing in almost all sectors. Even in the industrial sector, employment figures are once again up in a year-on-year comparison (+0.6%). Public administration is one of the few sectors where employment levels are slipping slightly (-0.4%).

The positive developments on the labor market will, in all likelihood, continue as 2011 progresses. We estimate that the number of people in work in 2011 will increase by around 400,000 and that the unemployment figure will drop by around 270,000. This means that we expect the workforce to increase again by 130,000. In addition to the general trend towards higher labor force participation, this is also likely to be due to the abolition of the restrictions on the freedom of movement for eastern European EU members, increasing the number of cross-border workers coming into Germany.

Chart 8

### Germany: Number of people in work and unemployed

**millions**



Sources: EcoWin, own forecasts.

For the first time in around 20 years, the average number of people out of work is expected to fall below the three million mark in 2011, dropping to 2.97 million. The labor market is expected to continue to improve in 2012 as well. Given that the momentum of the upswing is expected to be less dynamic, however, the drop in unemployment is expected to slow down a gear in 2012. In 2012, the average jobless total is likely to fall by around 200,000 to 2.77 million.

### 2.7 New government borrowing below the 2% mark

The marked recovery has fueled far better budgetary development than was originally expected. Whereas in early 2010, the federal government was still reckoning with a budget deficit of 5.5% of GDP in 2010, the actual deficit came in at only 3.3%:

New borrowing is likely to fall sharply this year. The upswing is continuing, fueling a strong rise in tax revenue, which we expect to come in at 4½% in 2011. Furthermore, the improvement on the labor market is helping to curtail the scale of government transfer payments. In addition, we have the consolidation measures agreed in last summer's "Package for the Future". The scope of the consolidation measures amounts to an estimated 0.6% of GDP. All in all, government revenue, including social insurance, is likely to increase by just under 4% in 2011, whereas government spending is expected to increase only marginally (+0.8%).

As a result, new borrowing is set to fall from EUR 82bn last year to around EUR 50bn this year. In terms of GDP, the government deficit will come in at only 1.9%. This means that Germany would get back within the Maastricht deficit ceiling earlier than demanded by the EU deficit procedure. And also with regard to the national debt brake, which stipulates broadly balanced budgets from the middle of the decade, headway looks to be ahead of plan.

Provided that the German economy achieves moderate growth in 2012 – which is what we expect to happen – new government borrowing can be expected to remain on a downward trend. The scope of the government's consolidation measures (compared with 2010) will increase further to 0.8-0.9% of GDP in 2012. At 3-3.5%, the increase in government revenue is once again expected to considerably outstrip the increase in government spending (+1-1.5%) in 2012. This will result in a government deficit corresponding to only 1.0% of GDP in 2012. The fiscal scope for tax cuts should therefore be substantially higher.

### 3. Medium-term growth prospects for the German economy

The German economy currently appears in a very flattering light. After being frequently dubbed the "sick man of Europe" only a few years back, Germany, it is claimed, can now look forward to "seven plenteous" or even "golden" years. The term "golden years" could be taken to mean sustained, inflation-free growth of 2% a year or more, and a steady decline in unemployment. These positive medium-term prospects, however, stand in stark contrast to the much touted belief that the economic and financial crisis of 2008/09 has put a damper on production potential growth. The joint forecast produced by the research institutes in the fall of 2010 puts current German production potential growth at only 1.3%. President of the German Bundesbank Axel Weber cited economic growth of 1% as a good ballpark figure for the country's medium-term growth potential. So maybe the times ahead for Germany are not quite as "golden" after all?

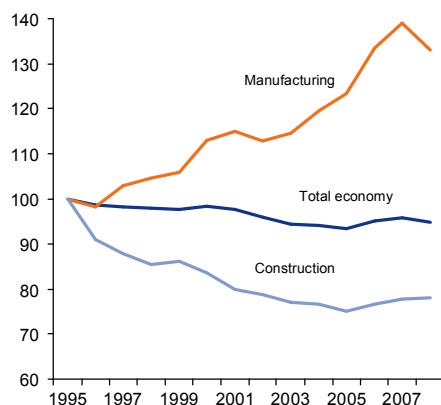
The estimate of production potential is based on the factors of labor and capital, as well as their productivity. Germany's labor volume trend is limited due to demographic patterns. But the capital stock has also expanded only moderately of late. In the second half of the 1990s, annual growth in capital stock (in terms of gross fixed assets based on 2000 prices) was still consistently above the 2% mark. Recently, the same figure has been sitting at only around 1.5%. This slower expansion in capital stock is largely the result of a relatively low investment rate. Despite the strong pickup in investment activity since 2009, equipment investment is not expected to climb back to the 20-year average proportion of the GDP until 2012.

The role that capital stock plays in determining production potential depends, however, not only on its sheer size, but also on its productivity in the production process. This is where astonishing changes have taken place: whereas in the 1960s and 1970s, capital productivity (ratio of price-adjusted GDP to capital stock based on 2000 prices) was still clearly headed south (cf. pp. 63 et seq. of the 1986/87 annual expert opinion produced by the panel of experts on macroeconomic developments known as the "Sachverständigenrat"), this trend has been slowing considerably since the mid-1990s. Ever since 1995, capital productivity has been contracting at an average rate of only 0.4% a year. A look at the individual sectors paints an even more interesting picture.

Chart 9

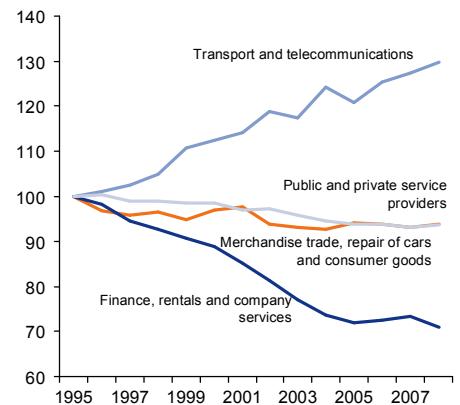
### Capital productivity\* by sector

Index 1995 = 100



\* ) Relation of GDP (price adjusted, chain index 2000 = 100) to capital stock in prices of 2000.

Index 1995 = 100



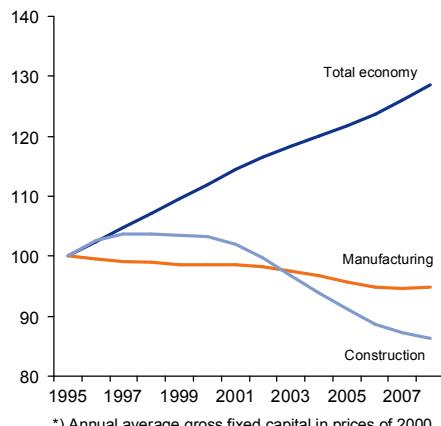
Source: Statistisches Bundesamt.

Capital productivity has still been on the decline in a number of service industries, as well as in the construction sector, over the past decade and a half. The trend in the transport and telecommunications industries, however, and in particular in industry, has been a different one. Here, capital productivity has been on a steep upward path since 1995. This suggests that these sectors have managed to use technological progress to achieve significant capital savings, with increasing digitalization likely to have played a pivotal role in this trend. It is, nonetheless, astonishing that the capital stock in the industrial sector has not grown at all since the mid-1990s, whereas the service sectors can boast what is, in some cases, substantial growth. What is more, capital intensity (capital stock per person in work) in the industrial sector has charted only an insignificant increase over the last fifteen years.

Chart 10

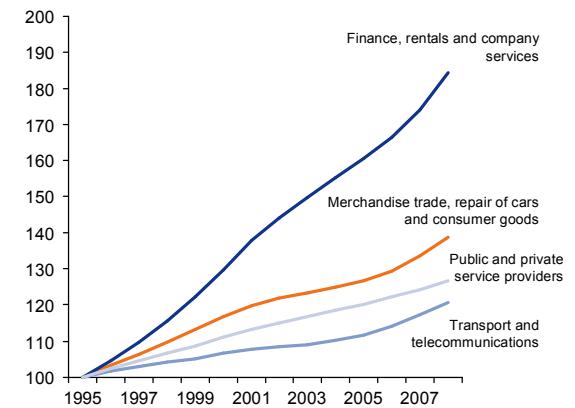
### Capital stock\* by sector

Index 1995 = 100



\* ) Annual average gross fixed capital in prices of 2000.

Index 1995 = 100



Source: Statistisches Bundesamt.

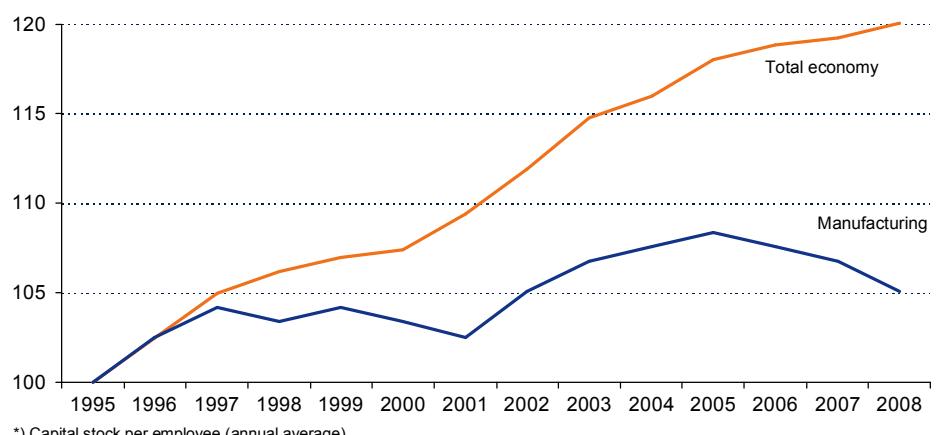
This means that labor has only been substituted by capital to a limited extent. This suggests that the increase in capital productivity is not only the result of technological advances, but rather that industry has also distanced itself from the trend towards

above-average growth in the capital employed. We believe that the wage restraint exercised since the late 1990s is a key factor in this equation. It has slowed the process that sees labor being substituted by capital and favors relatively labor-intensive growth in Germany.

Chart 11

### Capital intensity\* in Germany

Index 1995 = 100



Source: Statistisches Bundesamt.

Given the moderate growth in capital stock but relatively favorable development in capital productivity in the German economy, the question naturally arises as to what the growth prospects would be if companies were to start investing far more again and, in particular, if the industrial segment were to start expanding its capital stock again. The answer is clear: Germany could achieve far higher growth and might even be able to offset the dampening effects of demographic changes on economic growth.

So what is the growth outlook for the next few years based on realistic assumptions? In order to investigate this, we have used a growth accounting approach similar to that used both by the research institutes in their fall 2011 expert opinion and by the European Commission<sup>1</sup>.

Economic growth is broken down into the contributions made by labor, capital and a residual amount. This residual amount - known as the "Solow residual" or total factor productivity - stands for the element of economic growth that cannot be explained by growth in employment and the capital stock. As in the method applied by the European Commission, we have assumed a Cobb-Douglas production function in which the output elasticities of labor and capital correspond to the distribution shares (wage share, profit share). To specify the "capital" factor, we have used gross fixed assets based on 2000 prices. As far as labor is concerned, we have opted to look at the volume of labor, which can be split into the following categories: population of working age, share of workforce as a proportion of the population of working age, share of the people in work as a proportion of the population of working age and average working hours per individual in work.

<sup>1</sup> F. D'Auria, C. Denis, K. Havik, K. Mc Morrow, Ch. Planas, R. Raciborski, W. Röger und A. Rossi (2010), The production function methodology for calculating potential growth rates and output gaps. European Commission, Economic Papers 420, Brussels.

The average changes in these parameters in the period from 1995 to 2010 are shown in the table. The growth contributions made by the capital stock and the volume of labor derived from this information allows us to draw conclusions as to the development in total factor productivity. For the period specified, total factor productivity growth comes in at an average of only 0.7%. The joint forecast produced by the research institutes in the fall of 2010 also puts total factor productivity growth at 0.7% for the period from 1995 to 2009.

This growth accounting process shows that a whole number of factors influence how production potential develops. Consequently, it is safe to say that an economy's growth potential is by no means a foregone conclusion, but can be influenced in a whole manner of ways.

### Production potential and its determinants

1995-2015; annual average change in %

	1995-2010 <sup>1)</sup>	Growth contribution <sup>2)</sup>	2011-2015	Growth contribution
Production potential	1.2		1.6	
Capital stock <sup>3)</sup>	1.9	0.6	1.8	0.6
Labor volume	0.0	0.0	0.5	0.3
Population of working age	-0.2		-0.4	
Share of workforce <sup>4)</sup> in population of working age	0.6		0.6	
Share of economically active persons in workforce	0.1		0.5	
Average working time per employee	-0.5		-0.2	
Total factor productivity	0.7	0.7	0.7	0.7

1) Actual GDP growth

2) Cumulated growth contribution 1.3 instead of 1.2 due to rounding

3) Average change in gross fixed assets at 2000 prices (up to 2009)

4) Employed and unemployed

Sources: Institutes' Report Fall 2010, own calculations and estimates.

Looking at the period from 2011 to 2015, we have estimated the likely development in those factors determining production potential so as to be able to arrive at a forecast for German economic growth. Like the economic research institutes, we have used the projections published by the German Federal Statistics Office (*Statistisches Bundesamt*) on the development in the population of working age. Fewer restrictions on movement within Europe could, however, mean that the working-age population will not shrink by quite as much as 0.4% after all. Labor force participation has been rising by an average of 0.6% a year since 1995. Given the moves to lift the retirement age and in light of the increasing labor force participation among older employees, this trend is likely to continue more or less unchanged. We predict a 0.6% annual increase in labor force participation between 2011 and 2015. The number of people in work as a proportion of the workforce will increase to the same extent as the unemployment rate falls. The German labor market is expected to remain robust over the next few years – at least provided that we are spared any global economic horrors. We expect to see the unemployment rate fall by 0.5 percentage points a year. The further development of working hours per person in work remains the subject of considerable uncertainty.

Although an increase in part-time work is also expected to reduce working hours, the decline in working hours seen in recent years is no longer as pronounced as it was in the 1990s. When the economy has been performing well, the decline in working hours has sometimes been stopped in its tracks entirely. In the future, the working hours of full-time employees could even edge up slightly on the whole. Looking at the period from 2011 to 2015, we estimate an annual decline in working hours per person in work of only 0.2%.

Solid corporate earnings, relatively high capacity utilization levels and the fact that Germany has become more attractive to foreign investors as a business location suggest that investments will remain on an upward path. We expect the increase in capital stock to be more substantial than it has been in recent years and predict an average annual growth rate of 1.8% between now and 2015. Looking at the future development in total factor productivity, we have assumed the same growth seen in the past at 0.7%, because there are no clear arguments suggesting that this trend will accelerate.

These forecasts lead us to the conclusion that the growth contribution made by capital will come in at 0.6% over the next few years, while labor will contribute 0.3% and factor productivity 0.9%. This produces a production potential growth rate of 1.6% from 2011 to 2015. Compared with average annual economic growth of 1.2% in the period from 1995 to 2010, this would certainly be an encouraging development, and would probably see the German economy outperform a whole number of other industrial countries. Given the German economy's reliance on exports, however, this scenario is subject to the proviso that the global economy is spared any lasting shocks.

Our conclusion: in spite of the demographic trends, the German economy has a good chance of reporting higher growth than it has over the past fifteen years. To describe the times ahead as a period of "golden years", however, would be taking things too far. In order to ensure that the economy's production potential can be exploited, a number of conditions will be needed, not least a consistent economic policy with a mission to reform.

These assessments are, as always, subject to the disclaimer provided below.

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Allianz SE is one of the leaders of the insurance sector in the Dow Jones Sustainability Index, listed in FTSE4GOOD and in the Carbon Disclosure Leadership Index (Carbon Disclosure Project, CDP6).

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The statements contained herein may include statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. In addition to statements which are forward-looking by reason of context, the words "may", "will", "should", "expects", "plans", "intends", "anticipates", "believes", "estimates", "predicts", "potential", or "continue" and similar expressions identify forward-looking statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (i) general economic conditions, including in particular economic conditions in the Allianz Group's core business and core markets, (ii) performance of financial markets, including emerging markets, and including market volatility, liquidity and credit events (iii) the frequency and severity of insured loss events, including from natural catastrophes and including the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the Euro/U.S. Dollar exchange rate, (ix) changing levels of competition, (x) changes in laws and regulations, including monetary convergence and the European Monetary Union, (xi) changes in the policies of central banks and/or foreign governments, (xii) the impact of acquisitions, including related integration issues, (xiii) reorganization measures, and (xiv) general competitive factors, in each case on a local, regional, national and/or global basis.

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