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Economic forecast 2018

German economy heading for boom

Allianz

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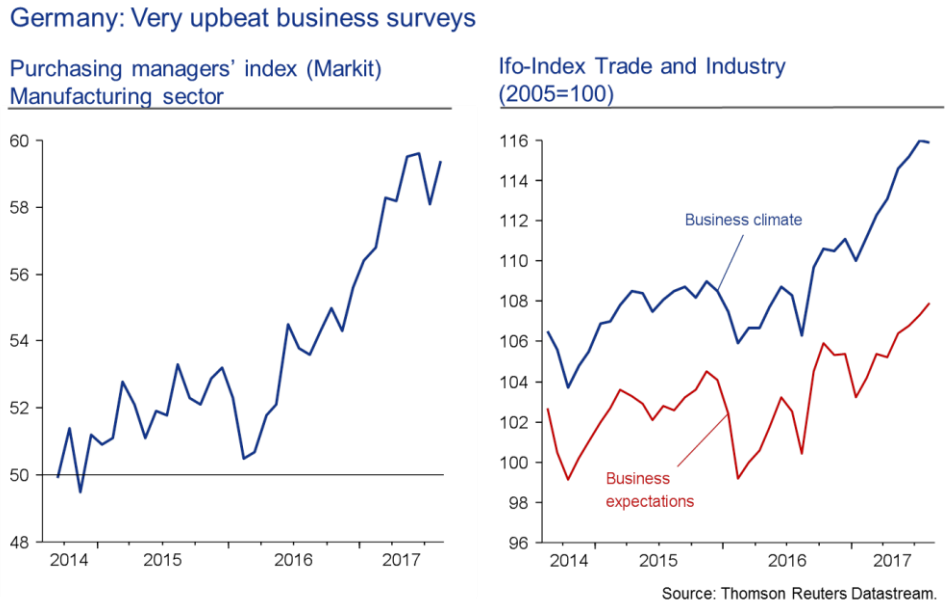
German economy heading for boom

- The German economy clearly moved up a gear in the first half of 2017. At an annual rate, real gross domestic product (GDP) growth came in at 2.7%, the strongest since the first half of 2011. It can be assumed that healthy economic growth will continue in the second half of the year as well, although GDP growth rates are likely to be somewhat more moderate than in the first six months.
- The export engine, which at times had spluttered, is purring again in 2017. We expect real exports to grow by 4% in 2017. Germany should more or less maintain its share of world trade. The outlook for 2018 is pretty much the same, with real exports expected to grow by just under 4%.
- Since the global economic crisis of 2008, German economic growth has been driven largely by private and public consumption. Over the same period, cumulative gross investment has made virtually no contribution to growth. This year, however, the prospects are good that both construction and machinery investment will provide a substantial boost to growth. Rising capacity utilization, the improved equity bases and healthy liquidity positions of companies, and favorable financing conditions should at last give a lift to machinery and equipment investment.
- In price-adjusted terms, German gross domestic product looks set to grow by 2.0% in 2017 (by as much as 2.2% in working-day adjusted terms), and hence slightly above the growth rates of 1.7% to 1.9% seen in the last three years. Looking ahead to 2018, economic momentum is likely to continue broadly undiminished. While real private consumption is likely to rise more slowly in 2018 than in 2017, as a result of slightly lower growth in real earnings, we expect the average real growth rate of machinery investment to double in 2018 versus 2017. The upturn in investment is thus under way. In 2018 we expect real GDP to grow once again by 2.0%.
- Inflation in Germany remains subdued. Despite healthy business activity and low unemployment there is no sign of a sustained pickup in inflation. The Phillips curve connection, which captures the negative correlation between unemployment and inflation, is of no notable relevance for Germany at present.

The starting position

The German economy clearly moved up a gear in the first half of 2017. At an annual rate, real gross domestic product (GDP) growth came in at 2.7%, the strongest since the first half of 2011. Highly upbeat business surveys confirm this picture. The ifo Business Climate index for industry and trade has been recording its highest readings since German reunification, while the Purchasing Managers' Index was also at a very high level.



Private and public consumption – to which the entire economic growth of 1.9% in the previous year could be attributed, with contributions to growth from gross investment and net exports amounting to zero – once again provided considerable economic impetus, particularly in the second quarter of this year. However, the upturn in 2017 is significantly broader than in 2016. In addition to expanding building activity vigorously, machinery investment is also now finally on the increase. The export economy, which is benefiting from economic recovery in the eurozone as well as renewed higher growth in emerging markets, has also significantly strengthened.

Likewise, so far in 2017 the labor market also appears in very good shape. In the first seven months of this year, the number of people employed, on a seasonally adjusted basis, rose by 363,000, while the number of people unemployed, seasonally adjusted, fell by 97,000 in the first eight months. The decline in unemployment was not necessarily to be expected, since there are now more and more refugees entering the labor market and the potential labor supply, also boosted by immigration from EU member states, is increasing substantially. A sharp rise in jobs liable to social security contributions is particularly welcome. Growth compared to the previous year amounted of late to 809,000 people (+2.6%), with 269,000 additional employees originating from so-called migration countries. Non-European asylum source countries accounted for 55,000 people in this increase.

It can be assumed that Germany's healthy economic development will continue into the second half of 2017 as well, although GDP growth rates are likely to moderate again compared to the first six months. Capacity utilization is expected to rise further.

The international context

We have based our economic forecast on the following general assumptions and conditions:

- The recovery in world trade that began at the end of 2016 has continued in the year to date. Various leading economic indicators, such as the 'export orders' sub-indicator of the Purchasing Managers' index of large economies, point to sustained dynamic international trade. After an increase of just 2% in the previous year, for the full year 2017 we expect an increase in global trade in goods and services of around 4% in real

terms. For the following year we see a rise of a similar magnitude. We do not foresee a substantial expansion of protectionist policies at a global level.

- Since the start of 2017, Brent Crude has essentially moved in a range between $46 and $54 a barrel. Higher growth momentum at a global level fundamentally supports the assessment that oil prices will rise. However, for the time being the continued high level of inventories will prevent a further marked increase. In the medium term, the potential for a sharp increase in oil prices appears equally limited, since with prices already in the $50-$65/barrel range, supply from flexibly operating companies in US non-conventional oil production is likely to increase. We expect a moderate rise in the oil price over the full forecast horizon. For the end of 2018 we see a Brent Crude price of just under $60/barrel (forecast end of 2017: $53/barrel).

- If the US economy remains robust, the US Federal Reserve will continue the normalization of its monetary policy and raise its key interest rate for a third time this year, by a further 25 basis points, before the end of 2017. In 2018 we expect the cycle of moderate monetary policy tightening to continue. Meanwhile, the Fed has also confirmed its intention to shrink its balance sheet. Provided that the economy develops as it expects, the Fed will start doing so this year. It will not directly sell the bonds it accumulated as part of its securities-buying program from 2008-2014, but instead will gradually reduce the volume of reinvestment resulting from bonds maturing.

- Despite an improved economic picture in the eurozone, it is likely that the ECB will only withdraw from its ultra-loose monetary policy in tiny steps. In October at the latest, the Central Bank will probably announce a further reduction in its bond purchases from January 2018 onwards (we expect a level of EUR 40bn per month). Tapering should be concluded by the middle of next year. In the second half of 2018, we expect a slight increase in the negative deposit rate. The first increase to the refinancing rate should then follow at the start of 2019.

Growth rates in main economic

GDP, real % change over previous year

	2012	2013	2014	2015	2016	2017f	2018f
Industrialized countries	**1.2**	**1.2**	**1.9**	**2.2**	**1.6**	**2.0**	**1.9**
European Union	-0.5	0.2	1.7	2.2	1.9	2.1	1.8
Euro area	-0.9	-0.2	1.2	1.9	1.7	2.1	1.8
Germany	0.5	0.5	1.9	1.7	1.9	2.0	2.0
USA	2.2	1.7	2.6	2.9	1.5	2.0	2.2
Japan	1.5	2.0	0.3	1.1	1.0	1.7	0.9
Emerging markets	**5.0**	**5.1**	**4.5**	**4.1**	**4.0**	**4.5**	**4.6**
Asia	6.4	6.5	6.3	6.0	6.0	5.9	5.7
Latin America	2.6	2.8	0.8	-0.5	-1.4	1.2	2.2
Central and Eastern Europe	2.1	1.5	1.6	-0.1	1.3	2.7	2.6
World	**2.6**	**2.7**	**2.9**	**2.9**	**2.5**	**3.0**	**3.0**

f = forecast.

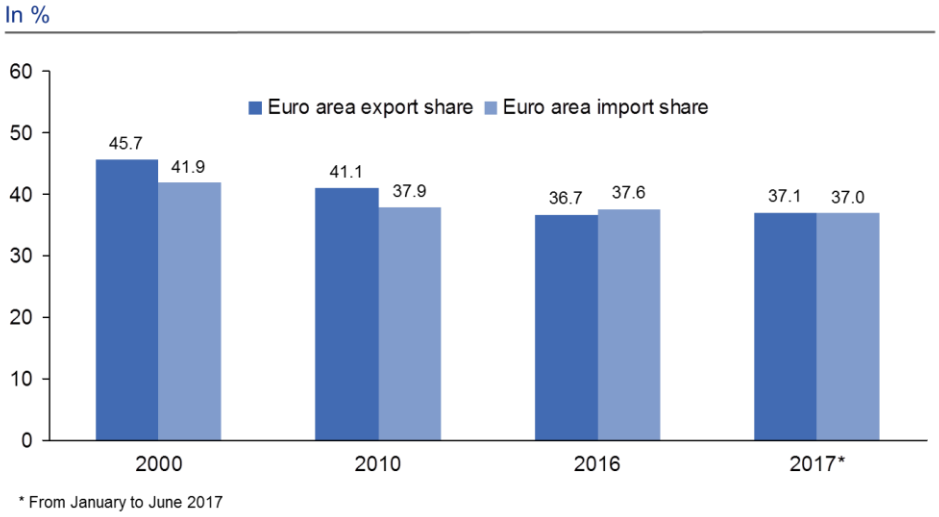
- Over recent months the euro has gained significantly against the US dollar, appreciating just over 10% since the start of 2017. It is possible that the US dollar could be boosted again during the course of the expected further normalization of monetary policy in the US. However, the Fed will need to proceed with caution in its tightening policy in order to avoid an undesirable strengthening of the currency, in view of the

repercussions on inflation and economic activity as a whole. On the other hand, the euro should benefit from the eurozone's sustained robust economic development as well as from the ECB's expected gradual withdrawal from its bond-buying program. Overall, it is our view that, subject to fluctuations, the euro will move more or less sideways against the US dollar during the forecast period. By the end of 2018, we envisage a USD/EUR rate of 1.15.

Exports once again an economic engine

The export engine, which spluttered occasionally during the second half of 2015 and in 2016, is purring again in 2017. In the first seven months of this year, the volume of new orders from abroad in the manufacturing sector was 3.9% higher than the corresponding period in 2016. In 2016 the increase amounted to only 2.0%, and in 2015 barely 0.9%. Furthermore, in the first seven months of 2017 orders from the eurozone rose by 6.3%. For now at least, this should end the slide in the eurozone's importance for the German export economy, which to a large extent was the result of the prolonged economic crisis in important neighboring countries.

Euro area share in German foreign trade declining



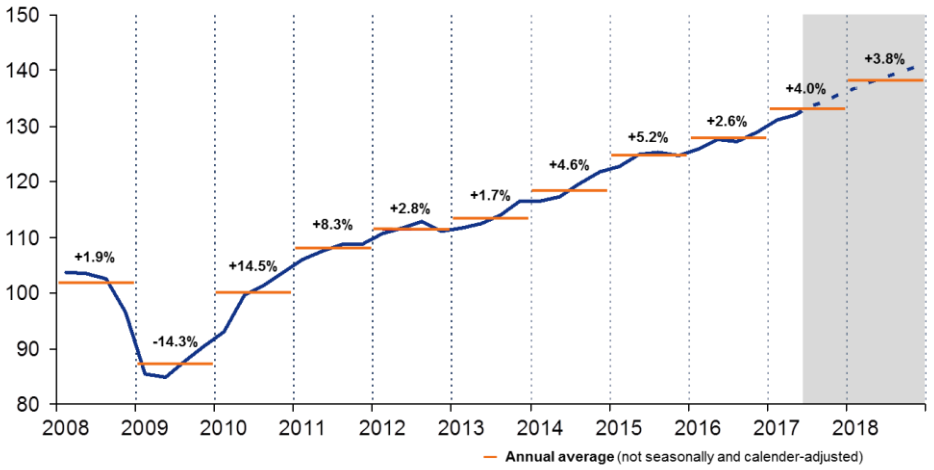
Source: Federal Statistical Office.

German companies recorded above-average increases in exports in the first half of 2017, particularly to Asia. In the first six months export sales to China rose by 13.4%, to India by 11.7% and to Japan by 10.6% compared to a year earlier. So far in 2017, the only notable declines in German exports were those to the UK, Brazil and Turkey.

We estimate that the volume of global trade in goods and services will expand by around 4% this year, following weak growth in 2015 and 2016. We expect real German exports to grow by 4.0% in 2017. Germany should thus more or less maintain its share in world trade. The outlook for 2018 is similar; we estimate growth in real German exports of around 3.8%. Although the trade-weighted exchange rate of the euro has risen by around 5% compared to the early months of this year, the impact on exports should be limited, since German exporters are still reasonably price competitive.

Exports remain on the up

Exports, seasonally and calender-adjusted, index (2010 = 100), at previous year's prices



Sources: Thomson Reuters Datastream, own forecasts.

As a result of the robust domestic economy, for the third successive year real imports in 2017 are expected to record a higher growth rate, estimated at 4.5%, than real exports. For 2018 we forecast growth of 4.4% in real imports.

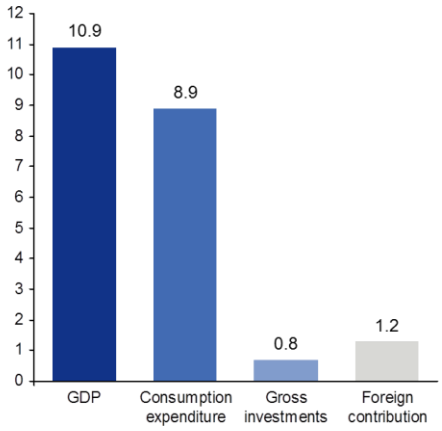
Furthermore, given that the terms of trade – the ratio of export to import prices – have deteriorated in 2017, the trade and current account surpluses will fall at least slightly against their record values in the prior year. We estimate the 2017 current surplus at EUR 243bn (7.5% of GDP), following EUR 262bn in the previous year (8.3% of GDP).

Domestic economy key pillar of the upturn

Since the global economic crisis of 2008, German economic growth has been driven largely by private and public consumption. The chart on cumulative contributions to growth shows that real consumer spending is responsible for around four fifths of the GDP increase since 2008. Over the same period, cumulative gross investment has made virtually no contribution to growth. This year, however, the prospects are good that both construction and machinery investment will provide a substantial boost to growth.

Germany: Cumulative growth and contributions of different components since 2008*

In percentage points



* Annual average 2017 on annual average 2008

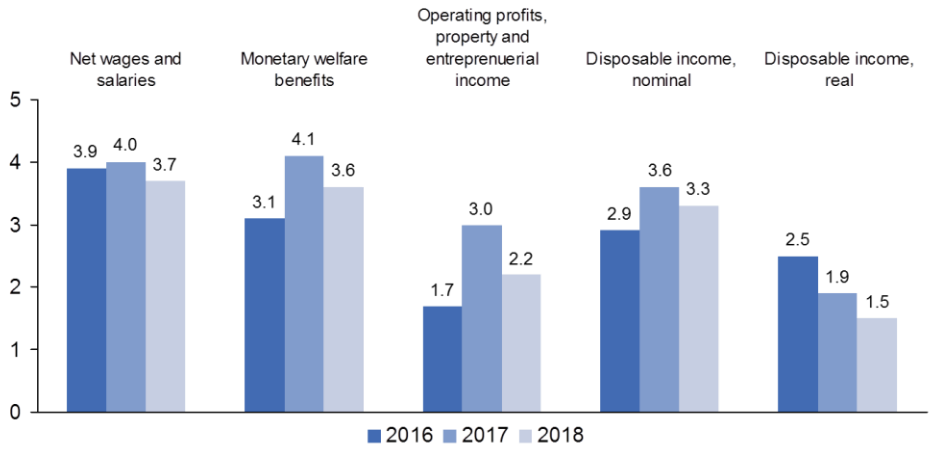
Sources: Federal Statistical Office, own forecasts.

Private consumption continues to underpin economy

Real private consumption, which with 0.4% growth expanded only moderately in the first quarter of 2017, picked up in the second quarter of this year with growth of 0.8%. For 2017 as a whole, we now see average growth of 1.8% in real private consumption, following growth of 2.1% in the preceding year. The dynamic increase in employment, stable development of earned income, and substantially rising monetary welfare benefits due partially to marked pension increases, are contributing to increased growth of roughly 3.6% in disposable income in 2017, representing the steepest rise in household income since 2001. The fact that real consumer demand is rising a little less in 2017 than in 2016 can be attributed to a steeper rise in prices of 1.7% against 0.5% in the previous year, and a slight pickup in the savings ratio to 9.8% from 9.7% last year.

Strong growth of nominal income in 2017

% change on previous year

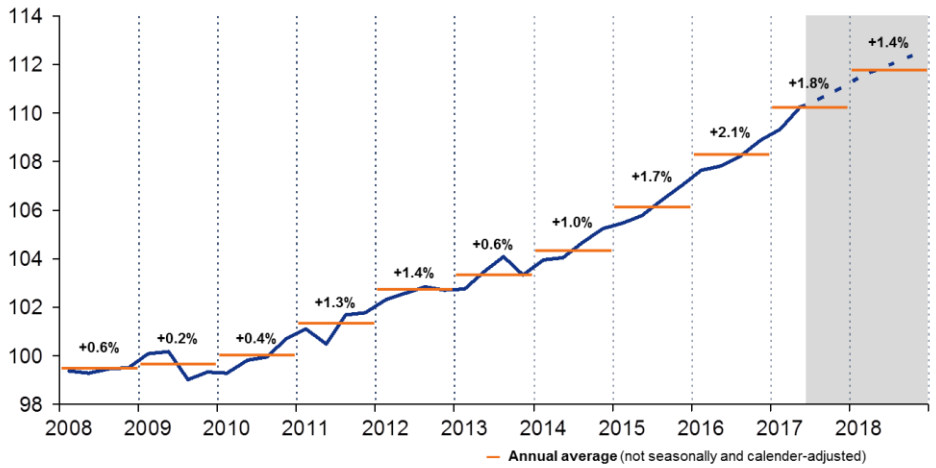


Sources: Federal Statistical Office, own forecasts.

A further increase in consumer demand is anticipated in 2018. We forecast 3.3% growth in disposable income, an inflation rate of 1.8% and a fractionally higher savings ratio than 2017 of 9.9%. This leads us to expect growth in real consumption of 1.4% in 2018. The slightly reduced increase in disposable income in 2018 versus 2017 is predominantly the result of slower employment growth.

Consumption buoying the economy

Private consumer spending, seasonally and calender-adjusted, index (2010 = 100), at previous year's prices



Sources: Thomson Reuters Datastream, own forecasts.

Public consumption still rising, albeit more slowly

Real consumption recorded vigorous growth in both of the last two years, due in particular to additional expenditure for refugees (2015: +2.9%, 2016: +3.7%). With smaller numbers of newly arrived refugees, this spending momentum should slow. This should be particularly reflected in smaller increases in government inputs and welfare benefits in kind in 2017 and 2018.

However, overall public spending should continue to increase appreciably. We forecast growth in real public consumption of 1.8% in 2017 and 2.0% in 2018. Public expenditure in this case includes areas where there is a trend towards significant spending such as healthcare. In addition, the improved financial situation for local government budgets in particular should once again encourage a greater propensity to spend.

Building boom

The construction industry is currently experiencing a boom. The ifo Business Climate index for construction is at a record high, with all areas of building – residential, commercial and public construction – growing. In view of extremely low interest rates, robust development in household income and high housing demand, rising capacity utilization and a healthy financial position in the corporate sector, as well as the need to maintain and expand infrastructure, an end to the construction sector's economic momentum is not yet in sight. We estimate growth of 4.3% in real building investment in 2017 and of 3.7% in 2018, following growth of 2.7% last year. Bottlenecks are likely to prevent higher growth rates.

In the first half of 2017, real investment in residential construction exceeded prior year levels by 4.9%. For 2017 as a whole, we also expect growth of around 5%, while growth next

year should be at around 4%. Demand for housing construction is likely to be boosted not only by the favorable labor market, income development and sharply rising housing demand, particularly in large towns and cities, but also by expectations of increases in property valuations.

New orders in commercial construction have been increasing substantially for a good year and a half. Consequently, 2017 should see a significant real increase in commercial building investment for the first time in a number of years. We forecast growth in commercial building investment of around 3% in 2017 and around 3.5% in 2018. At many companies, the need to expand their capacity via construction projects is likely to become increasingly important.

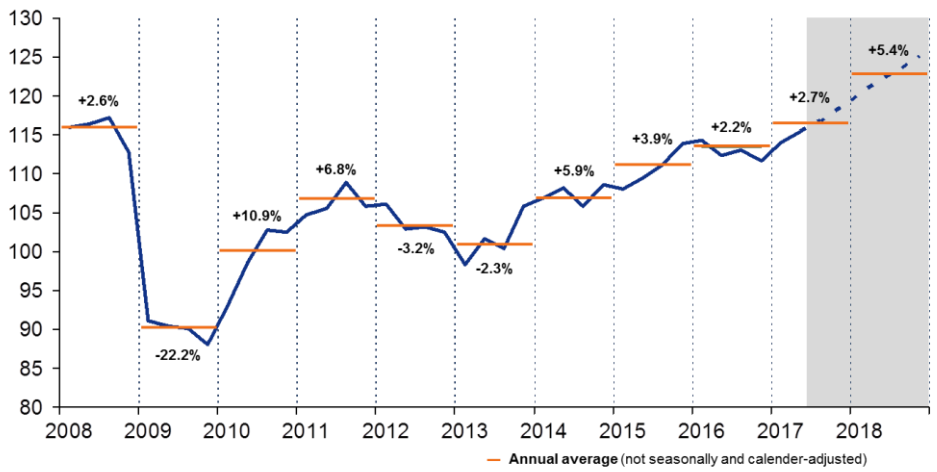
Public building investment, which in real terms rose by 2.3% in 2016, is set to rise by around 3% a year in 2017 and 2018. In public construction, demand is being driven by improved local government finances, some federal government investment initiatives and the undisputed need for more infrastructure investment.

Machinery investment finally on the increase

Rising capacity utilization, the improved equity bases and healthy liquidity positions of companies, and favorable financing conditions should at last give impetus to investment in machinery and equipment – the biggest problem among the demand components of GDP. This does now appear to be the case. Although in the first half of 2017 there was a real increase of only 1.2% compared to the prior year period, in the second half of this year the comparison should be considerably more favorable, due to declining machinery investment throughout the course of 2016. For 2017 as a whole we are expecting growth of real investment in machinery and equipment of 2.7% and for 2018 of 5.4%. This means that the investment level will at last exceed the level prior to the 2008/2009 global financial crisis.

Upward trend in investment activity gathering pace

Machinery & equipment investment, seasonally and calender-adjusted, index (2010 = 100), at previous year's prices



Sources: Thomson Reuters Datastream, own forecasts.

Economic growth still at 2%

In price-adjusted terms, German gross domestic product looks set to grow by 2.0% in 2017 (by as much as 2.2%, in working-day adjusted terms), and hence slightly above the growth rates of 1.7% to 1.9% seen in the last three years. Looking ahead to 2018, economic momentum is likely to continue broadly undiminished. While real private consumption should expand at a slightly slower pace in 2018 than in 2017, as a result of a somewhat smaller rise in real income, we expect the average real growth rate of machinery investment to double in 2018 versus 2017. The upturn in investment is thus under way. In real terms, domestic demand is thus expected to rise by 2.0% in 2018. In 2018, the balance of trade is once again expected to make virtually no appreciable contribution to growth in numerical terms, since real imports are likely to record a somewhat higher growth rate than real exports. Overall this will lead to growth in real gross domestic product of 2.0% in 2018.

Germany: Economic indicators and forecast*

		2015				2016				2017				2018							
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2015	2016	2017f	2018f
GDP real		0.1	0.4	0.3	0.4	0.6	0.5	0.3	*0.4*	*0.7*	*0.6*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.4*	1.7	1.9	2.0	2.0
Private consumption		0.2	0.3	0.6	0.6	0.6	0.2	0.4	*0.6*	*0.4*	*0.8*	*0.3*	*0.4*	*0.4*	*0.3*	*0.3*	*0.3*	1.7	2.1	1.8	1.4
Government spending		0.7	0.5	1.0	0.9	1.5	0.7	0.2	*0.5*	*0.2*	*0.6*	*0.6*	*0.5*	*0.5*	*0.5*	*0.5*	*0.3*	2.9	3.7	1.8	2.0
Investment in machinery/equipment		-0.5	1.2	1.5	2.6	0.4	-1.8	0.7	*-1.3*	*2.1*	*1.2*	*1.2*	*1.5*	*1.5*	*1.3*	*1.3*	*1.3*	3.9	2.2	2.7	5.4
Construction		-1.3	-1.1	0.1	2.4	2.0	-1.8	0.2	*1.0*	*3.4*	*0.9*	*0.2*	*1.0*	*1.4*	*1.2*	*1.0*	*1.0*	-1.4	2.7	4.3	3.7
Domestic demand		0.6	-0.2	0.7	1.0	0.9	-0.2	0.8	*0.8*	*0.1*	*1.0*	*0.4*	*0.5*	*0.5*	*0.5*	*0.5*	*0.4*	1.6	2.4	2.0	2.0
Exports		0.7	1.7	0.3	-0.5	1.0	1.3	-0.2	*1.3*	*1.6*	*0.7*	*1.4*	*1.2*	*1.0*	*0.9*	*0.9*	*0.9*	5.2	2.6	4.0	3.8
Imports		2.0	0.4	1.1	0.7	1.7	-0.2	0.7	*2.5*	*0.4*	*1.7*	*1.3*	*1.3*	*1.1*	*1.1*	*1.0*	*1.0*	5.6	3.9	4.5	4.4
Industrial production (excl. construction)**		-0.3	0.7	-0.1	-0.4	1.4	-0.4	0.2	*0.2*	*0.9*	*1.6*	*0.1*	*0.5*	*0.5*	*0.4*	*0.3*	*0.3*	1.2	1.1	2.5	1.9
Unemployment rate (EU def.)	%	4.8	4.7	4.6	4.5	4.4	4.2	4.1	*4.0*	*3.9*	*3.7*	*3.7*	*3.7*	*3.6*	*3.7*	*3.6*	*3.6*	4.6	4.2	3.8	3.6
Unemployment rate (nat. def.)	%	6.5	6.4	6.4	6.3	6.2	6.1	6.1	*6.0*	*5.9*	*5.7*	*5.7*	*5.7*	*5.6*	*5.6*	*5.5*	*5.5*	6.4	6.1	5.8	5.6
Employed persons (national def.)	y-o-y	0.7	0.8	1.0	1.2	1.4	1.3	1.3	*1.4*	*1.5*	*1.5*	*1.5*	*1.4*	*1.2*	*1.2*	*1.2*	*1.2*	0.9	1.3	1.5	1.2
Consumer prices	y-o-y	0.0	0.5	0.1	0.3	0.3	0.1	0.5	*1.1*	*1.9*	*1.7*	*1.7*	*1.6*	*1.5*	*1.8*	*1.9*	*2.0*	0.3	0.5	1.7	1.8
Consumer prices (HICP)	y-o-y	-0.1	0.4	0.0	0.2	0.1	0.0	0.4	*1.0*	*1.9*	*1.6*	*1.7*	*1.7*	*1.6*	*2.0*	*1.9*	*2.0*	0.1	0.4	1.7	1.9
Producer prices	y-o-y	-2.0	-1.4	-1.7	-2.3	-2.8	-2.7	-1.7	*0.2*	*2.8*	*2.9*	*2.6*	*2.0*	*1.3*	*1.6*	*1.9*	*2.0*	-1.9	-1.7	2.5	1.7
Current account balance	EUR bn	61.8	63.4	69.8	66.0	67.7	69.3	61.9	*62.0*	*64.5*	*58.0*	*61.0*	*60.0*	*59.0*	*58.0*	*57.0*	*56.0*	260.0	262.4	243.4	230.0
	% of GDP																	8.5	8.3	7.5	6.9
Budget balance	EUR bn																	19.4	25.7	30.3	31.9
(Maastricht-definition)	% of GDP																	0.6	0.8	0.9	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.

There are currently no apparent major risks to the positive economic development continuing. There is little threat of headwinds from financial and monetary policy. Monetary policy will remain expansive, even if the bond-buying program comes to an end. There is no consolidation pressure in fiscal policy. Levels of household and corporate debt are relatively low in Germany, such that no consolidation efforts are necessary in the private sector. Indeed, there is scope for higher rises in income.

Inflation remains subdued

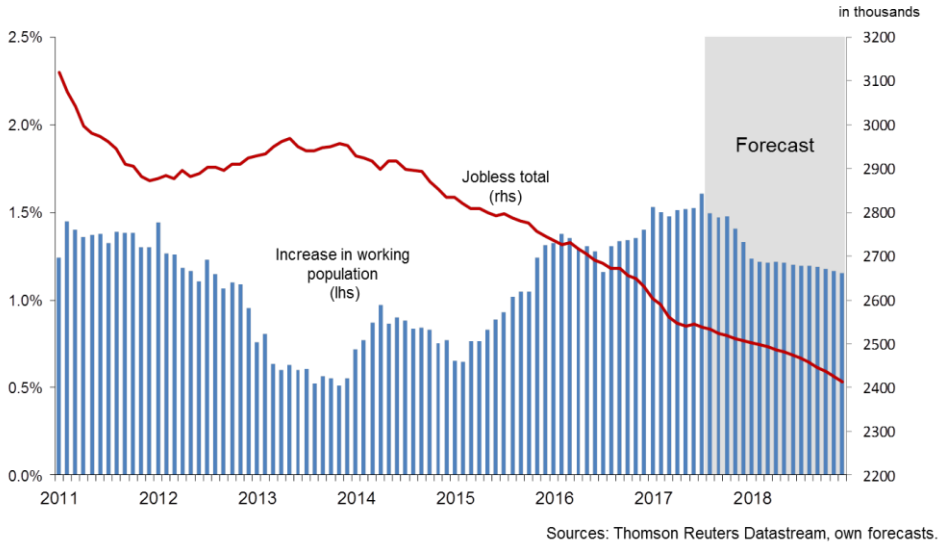
Inflation in Germany remains subdued. Despite a favorable economic situation and low unemployment, there are still no signs of a sustained pickup in the inflation rate. The Phillips curve, which captures the negative correlation between unemployment and inflation rates, has no notable empirical relevance to Germany at present. This is essentially due to the fact that wage growth in Germany has not yet appreciably picked up, in spite of falling unemployment. This means that in 2017 real wages per employee are likely to increase by a good 2.5%, following rises of 2.4% in 2016 and 2.8% in 2015. One reason for the moderate rise in wages in recent years is heavy labor migration to Germany, especially from the EU, which has led to a sharp increase in the labor force. Moreover, inflation rates combined with the fall in commodity prices have severely dampened inflation expectations, which are of considerable importance in wage negotiations.

As the labor force is set to increase at a slower pace in the future than in recent years (and in the medium term will probably even fall), and inflation expectations should normalize again, actual earnings are expected to grow more strongly. However, we do not see this leading to a sustained acceleration in inflation in 2018. According to our estimates, the consumer price index will rise by 1.7% this year and 1.8% next year. Commodity prices should have only a limited impact on the inflation rate.

Good labor market trends thanks to sustained rise in employment

The upturn in the labor market is continuing. Following a rise of 568,000 in the number of people in employment already in the previous year, the increase in 2017 is expected to be even higher, at 650,000. This equates to an average growth rate of 1.5% (2016: 1.3%). The increase in employment continues to be driven exclusively by the strong increase in jobs liable to social security contributions. The number of self-employed workers, as well as the number of workers exclusively in marginal employment, is likely to fall slightly in 2017. However, in 2018 the healthy growth in the employment level will decelerate slightly. We expect an increase in the region of 530,000. This equates to an average growth rate of 1.2%.

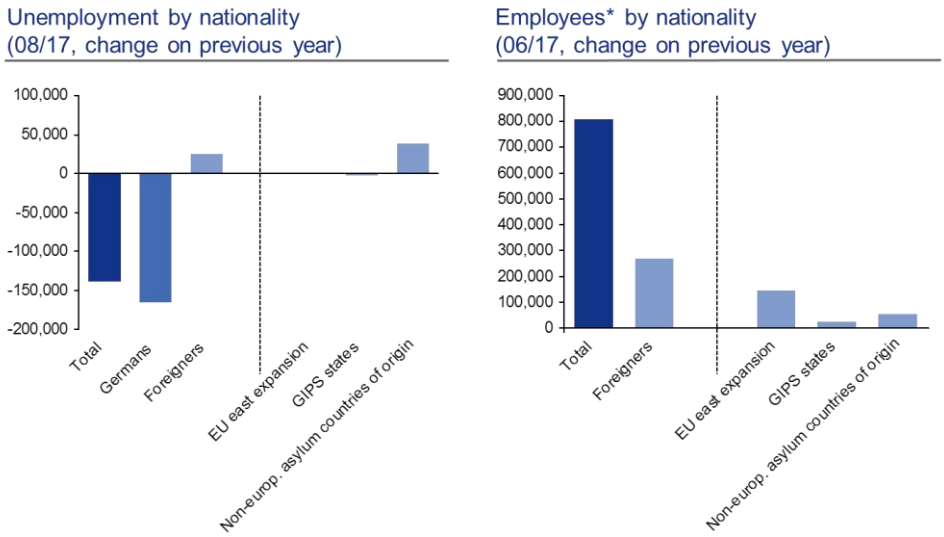
Germany: Strong rise in employment



Sources: Thomson Reuters Datastream, own forecasts.

The high growth in employment in the current year is further reducing the number of people out of work despite a substantial increase in the workforce (i.e. people in work plus people who are unemployed). In this regard, migration continues to have a considerable influence on developments in the German labor market, since the working-age population is growing significantly as a result of immigration from other EU member states as well as refugee migration. Refugees who have obtained a residence permit usually only enter the labor market after a significant delay, as a result of training and integration measures. Accordingly, this means that the workforce is once again growing more strongly in 2017 than in 2016, despite the fact that immigration is no longer as high. The success of labor market integration is mixed. It takes a long time for refugees to be integrated into the labor market due in part to a lack of proof of their qualifications as well as poor knowledge of the language. Following a decline of 104,000 in the number of people unemployed in 2016, in the current year the number is expected to fall by roughly 146,000 to 2,543,000. For 2018 overall, we expect the average number of people unemployed to decline by a further 80,000.

Germany: Impact of immigration on labor market



* Jobs subject to social insurance contributions

Source: Federal Labor Office.

Further government budget surpluses

In 2017, the expected government budget surplus is set to reach a new all-time high of EUR 30.3bn; there were already surpluses in the last three preceding years. This is attributable in part to a lower increase in government spending, due in particular to lower additional spending in relation to refugees. Revenues are continuing to enjoy robust growth (+4.0%) as a result of the positive macroeconomic developments, albeit at a slightly lower rate than 2016 (+4.4%). For 2018 we expect a government budget surplus of the same order of magnitude as this year. For the purposes of this forecast we have factored in only fiscal policy measures that have already been decided. However, in view of the upcoming Bundestag elections in a few weeks' time, there is some uncertainty around this.

In light of the buoyant economy and labor market, a rise in tax revenues of 4.5% is expected in 2017 (2016: +4.9%). Despite tax relief measures in relation to income tax and increases in the tax-exempt child tax allowance and child benefit, income tax on wages is rising considerably. Increased income from sales taxes, driven by healthy development in domestic demand, is also contributing to this. Social security contributions are likely to rise by 4.2% in the current year, driven by growth in jobs liable to social security contributions combined with the growing rate of contributions to long-term care insurance, although this is slightly down on the previous year (+4.6%). At 3.4%, growth in income in the coming year is likewise expected to be more subdued than this year.

Germany: Public-sector revenue and expenditure

in EUR bn	2012	2013	2014	2015	2016	2017f	2018f
Revenue	1220.9	1259.0	1308.3	1354.3	1414.2	1470.8	1521.4
of which:							
Taxes	620.5	646.3	668.7	698.0	732.0	764.9	793.2
Social contributions	454.3	465.0	482.0	500.8	523.8	545.8	566.5
Expenditure	1221.8	1263.0	1298.8	1334.9	1388.6	1440.5	1489.5
of which:							
Inputs	126.5	133.0	137.4	142.2	150.0	154.5	159.1
Employee compensation	212.3	217.8	224.0	229.2	236.5	244.8	253.3
Property income payable (interest)	63.1	55.5	51.2	46.4	41.6	39.5	38.7
Subsidies	24.6	25.8	26.4	27.0	27.8	28.4	28.9
Monetary welfare benefits	430.3	438.7	451.3	469.9	486.3	506.7	525.5
Welfare benefits-in-kind	215.3	227.7	239.7	252.4	268.6	279.3	290.0
Other current transfers	57.7	74.2	73.2	74.8	75.7	77.2	84.9
Gross investment	61.5	60.1	60.0	64.2	66.8	69.5	73.0
Financial balance	-0.9	-4.0	9.5	19.4	25.7	30.3	31.9
memorandum:							
State spending ratio[1)]	44.3%	44.7%	44.3%	43.9%	44.2%	44.4%	44.5%
Financial balance[1)]	0.0%	-0.1%	0.3%	0.6%	0.8%	0.9%	1.0%

[1)] in relation to gross domestic product in current prices.

Sources: Statistisches Bundesamt, own forecasts.

Government spending in 2017 is expected to increase by 3.7%, hence less pronounced than in 2016 (+4.0%). The main reason for this is a reduction in the influx of refugees. Related expenditure is much lower this year; the main costs that have been decreased relate to accommodation and care in 'preliminary reception centers', which is reflected in a substantially lower increase in government inputs (+3.0%) in comparison to the prior year (+5.5%). Welfare benefits in kind should also no longer exhibit the high growth rates of previous years caused by refugee migration. Despite the expansion in long-term care insurance benefits in the context of Germany's Second Long-Term Care Strengthening Act, an increase of roughly 4.0% is expected this year (2016: +6.4%). At 4.2%, monetary welfare benefits will see stronger increases than in 2016. The main factors responsible for this are increases to social benefits and further growth in the number of asylum seekers entitled to political asylum during this year and hence also entitled, among other things, to draw class II unemployment benefits. Furthermore, the German Federal Constitutional Court has ruled that tax levied on nuclear fuel is not in accordance with the German constitution. The reimbursement of the EUR 7.1bn taxes already paid, plus interest, will thus significantly raise expenditure this year (classified as 'Other'). Government interest expenditure is the only expenditure item to shrink again in 2017, with an estimated decrease of 5.0% (2016: -10.4%).

For the coming year we see expenditure increases of around 3.4%. This should mean that as early as 2018, the growth rates for government revenues will no longer be able to keep pace fully with expenditure, despite the buoyant state of the economy. Given that in a few years' time there will already be an increased burden on government finances due to an aging population, an expected gradual increase in interest expenditure again and the need for tax breaks, the expected increases in expenditure are not in line with a lasting consolidation strategy.

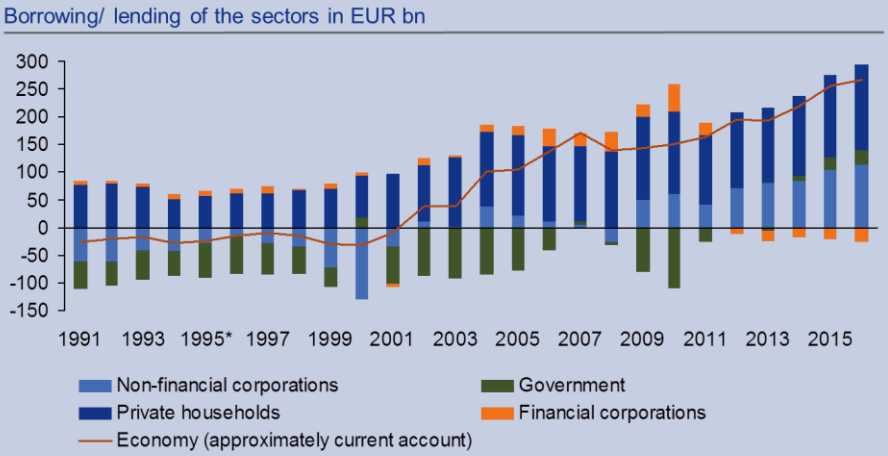
Digression

Current account surplus as a result of higher savings by companies

There has been intense controversy for some time regarding the causes of the German current account surplus. Does it reflect the high competitiveness of the German economy, with Germany delivering more goods overseas than it receives from abroad, or is it because Germany lacks appeal as a place of investment, whereby investing overseas is seen as more profitable than investing domestically? In a recent study (Klaus Borger, *Leistungsbilanz Überschuss reduzieren, Deutschland stärken* ("Current account: reduce the surplus, strengthen Germany"), KfW Research, Fokus Volkswirtschaft, No. 178, 8 August 2017), KfW looked at changes in the financial balances of economic sectors (net investment less savings) as a potential cause of the increase in the current account balance.

By definition, the current account balance results from the sum of the financial balances of households, non-financial corporations, financial institutions and the government. We share KfW's analysis that non-financial companies account for the "lion's share" of the increase in the current account surplus. While in the 1990s high financial deficits at companies were the norm, since 2002, with the exception of 2008, companies have reported net financial surpluses. They were limited until the financial and economic crisis of 2008/2009, but since then have grown steeply, in 2016 reaching their highest level so far, EUR 113.6bn (2.9% of GDP). The argument that in Germany the financial surplus of households – reasonable particularly given pension provisions – is being absorbed by the domestic corporate sector for the purposes of investment, such that in conjunction with a balanced government budget an equally balanced current account results, is currently clearly flawed. With the exception of financial corporations, all sectors are in surplus, which in 2016 meant a current account surplus of 8.3% of GDP.

Germany: Businesses have enjoyed high financial surpluses in recent years



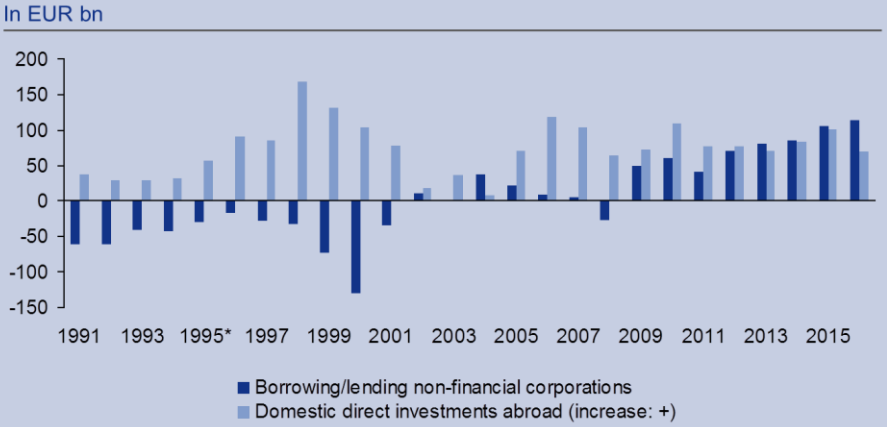
* Corrected net effect of assumption of Treuhandanstalt debt

Source: Federal Statistical Office.

Given the fact that German companies have recorded high savings surpluses since the 2008/2009 crisis, it can be concluded that they are investing less domestically than their corresponding amounts of profit and depreciation. However, this still reveals nothing about the causes. The frequently expressed hypothesis that Germany is unattractive as a place to invest compared to international peers has thus not been

proven. Only if German companies were to make high and increasing direct investments abroad would this be an indication of a pronounced weakness in Germany as a business location. Indeed, at first glance this may appear to be the case. Net direct investment of German companies overseas amounted to EUR 69.3bn in 2016. In previous years, direct investment overseas actually rose even more strongly. However, a further look at the statistics reveals that German companies had already made considerable investments overseas in the 1990s and at the start of the last decade – so at a time when domestic investment still clearly exceeded companies' savings. It is likely that the reason for the sustained high foreign investment is the strong internationalization strategy of German companies, thus actually reflecting Germany's strength as a location rather than its weakness.

Germany: Lively business investment abroad for many years



* Corrected net effect of assumption of Treuhandanstalt debt

Source: Federal Statistical Office.

But why then have companies been reluctant to invest at home for almost ten years now? There is no simple answer to this. It is highly likely that the numerous economic and political uncertainties of recent years have all contributed to companies expanding their capacity only with the utmost caution. In our view, a further factor is that the extremely moderate economic upturn of the past few years has made only a small expansion of capacity necessary. Also important is the argument put forward by KfW that companies have strengthened their capital bases in order to satisfy the increased credit requirements of regulators. Another theory not to be dismissed is that new digital technologies save on capital and thus reduce investment expenditure.

All in all, however, we are cautiously optimistic that the current acceleration in the upturn is also stoking the willingness to invest and that in the course of this, both the net savings of companies and the current account surplus will gradually fall. Initial indications suggest that the German current account surplus this year will be EUR 10 to €20bn lower than in 2016.

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