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Economic forecast 2014

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1. GLOBAL ECONOMIC SITUATION AND OUTLOOK

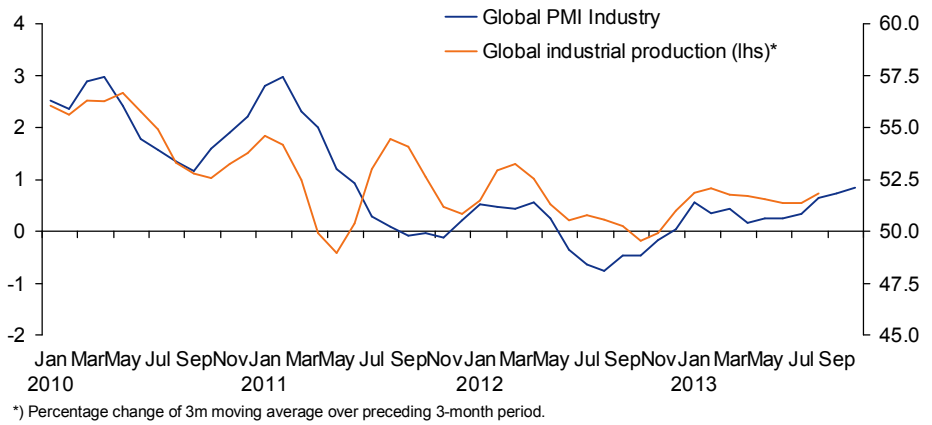
In spite of difficult conditions in individual countries, global economic activity proved on the whole encouraging during the first half year of 2013. After an indifferent start to the year the world economy gained momentum in the second quarter, thanks mainly to an improved picture in the industrial countries. Particularly encouraging was the return to positive GDP growth in the eurozone following six negative quarters. In the USA and the UK overall output picked up again after only tepid growth at the start of the year. In addition, the economic recovery in Japan continued on a broader footing thanks to the expansionary monetary and fiscal policy stance. By contrast, economic expansion in most emerging markets remained fairly subdued.

The financial markets took a hefty knock in the second quarter after the Fed sketched out a possible timetable for a gradual phasing-out of its bond-purchasing program. This not only pushed up yields in the USA, but above all exerted downward pressure on the currencies of those emerging markets with a dodgy economic scorecard. Countries with yawning current account deficits proved particularly vulnerable.

Chart 1

PMIs flag acceleration in global industrial production

Global industrial production and JP Morgan Global Manufacturing PMI



*) Percentage change of 3m moving average over preceding 3-month period.

Sources: Bloomberg, EcoWin, own calculations.

However, the real economy appears to have shrugged off any deterioration in financing conditions. The steady improvement in the global purchasing managers' index for the manufacturing sector in the course of the third quarter raises hopes that the pickup in economic activity will continue or even intensify in the second half of the year. Particularly encouraging is the fact that the more upbeat mood is now broad-based across all regions. Fears that the emerging markets will permanently undock from developments in the advanced economies now look unfounded. With the upward trend in global industrial production gathering pace, world trade is also likely to receive a boost. In the first half of the year expansion in global merchandise trade remained below the longer-term average, climbing at an annual rate of 2.9%.

For now at least, the biggest single risk to the global economy – fiscal gridlock in the US – has been defused. At the last minute a temporary solution was found covering both funding of the budget and the debt ceiling. Failure to reach agreement would have

triggered a recession in the US, dragging the world economy down with it. In our forecast we are assuming that a renewed crisis is avoided. In the interests of the USA and the world economy, the political forces are likely to find a compromise.

This document sets out our assessment of the economic prospects for individual regions and countries:

US

Despite the restrictive fiscal policy stance, which will drag down growth by a good 1.5 percentage points this year, real GDP grew at an average annualized rate of 1.8% in the first half of 2013. Although overall output expanded only marginally at the beginning of the year, the second quarter saw a renewed pickup in economic momentum. The main factor driving the relatively sound development of consumption was the fact that private households attempted to cushion the impact of tax and levy hikes at the beginning of the year by significantly cutting their savings rate

At the beginning of the second half of the year economic indicators pointed to a continued, albeit moderate, recovery. The partial government shutdown during the first half of October as a result of the political battle about the 2014 budget and the increase of the debt ceiling will put a damper on the pace of growth in the closing quarter. By contrast, the normalization of public sector output will provide a boost to growth in the first quarter of 2014.

Altogether there are a number of factors that should provide a lift to the economy in the coming year. For one, based on current legislation, the drag exerted by fiscal policy should have a less pronounced impact than this year. In addition the financial position of private households has improved, thanks to a reduction in debt levels and equity and real estate wealth gains. Consumers may, therefore, seize the moment and catch up on spending, e.g. in the automotive sector where the average age of the fleet has gone up. The problems facing the financial sector in the form of loan defaults and delayed payments have also eased gradually. And thanks to their above-average profit margins non-financial corporations remain in a sound position to finance investments from own resources.

To date the rapid growth of the energy sector has been providing a direct boost to investment activity thanks to its increased spending to tap energy sources. In addition, in the medium term, there will be a need to expand the energy transport infrastructure. Comparatively low energy costs in the US could also provide an incentive to invest in energy-intensive industries, such as the petrochemical industry. In 2012 US crude oil production reached the 6.5 mdb mark, whereas at 8.5 mdb crude oil imports plummeted to their lowest level in 15 years. According to estimates by the US Energy Information Administration, US oil production is likely to increase further by just under 30% to 8.4 mdb by 2014, with the result that higher domestic oil production would put a permanent lid on import growth. Accordingly, if exports accelerate as a result of the pickup in global trade, foreign trade should make a positive contribution to growth.

All in all, we are expecting economic growth of 1.6% for 2013, accelerating to 2.5% in 2014.

Euro area

After the political summer break, during the narrow window up to the election of the EU Parliament in May 2014, there are some significant items on the political agenda that will

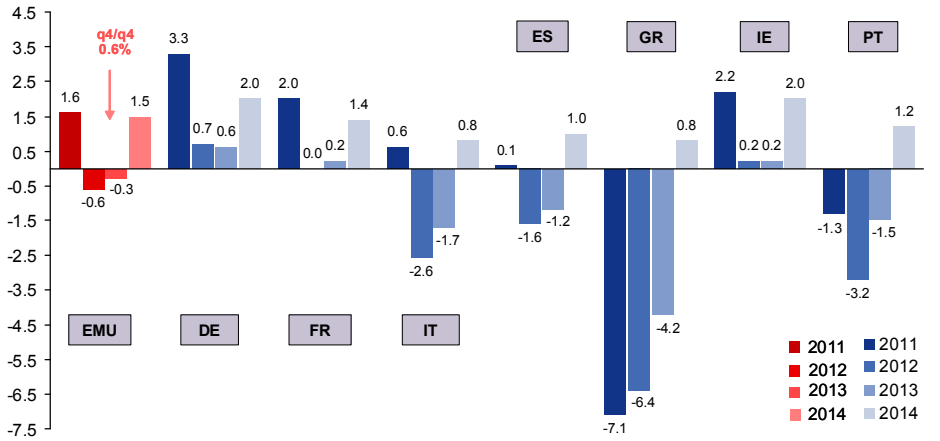
shape Europe's future. Pioneering decisions to be taken include paving the way for Ireland and Portugal to return to the capital market in as smooth a way as possible when aid programs are discontinued at the end of the year and in mid-2014 respectively, handling the Greek financing gap, as well as setting out, in greater detail, significant building blocks for a more crisis-proof, institutional foundation of the monetary union. The second pillar of the banking union in particular – a uniform mechanism for liquidation and restructuring – is still the subject of political debate. Another issue for negotiation at the EU summit in December is likely to be the question as to how the required reform momentum can be maintained in the member states against the backdrop of the subsiding euro debt crisis.

The end of the recession in the eurozone was one of the top economic news items this summer. And yet, what does it really mean if, after having contracted for six successive quarters, the EMU economy reports positive growth in one single quarter (Q2)? Is this a mere flash in the pan, a genuine ray of hope, a turn for the better or even the end of the crisis? We are of the view that a turning point has been reached, but would caution against excessive euphoria. Recent economic indicators support our view that growth will not be spectacular and that the pickup in the EMU economy is likely to remain moderate. For instance, the European Commission's economic sentiment index for the euro area increased for the sixth time in a row in October and at 97.8 points now stands just shy of its long-term average (100 points). Capacity utilization, by contrast, does not yet show a significant increase. In our view, in the second half of the year the EMU economy is likely to expand at a similar pace as during the second quarter, reporting moderate GDP growth to the tune of 1.5% in 2014.

Chart 2

Pace of growth likely to pick up in 2014

Real GDP growth (%)



Sources: Eurostat, own forecasts.

In the course of the economic recovery we expect to see growth differentials to significantly converge within the monetary union. Greece, Ireland, Portugal, Spain and Italy are likely to achieve positive economic growth next year. And yet, risks remain: political instabilities may yet crimp the zest for reform, national budget consolidation has not yet been completed, many of the structural reforms that have been initiated either need further adjustment or are tricky to implement, and all this against the backdrop of unemployment figures mired at an all-time high.

At 12.2% the EMU unemployment rate remained unchanged in September compared with the previous month. This may mean that the peak has been reached and, as a minimum, some degree of stabilization may ensue. Unlike the labor market, the drop in inflation rates buoys private consumption thanks to a rise in real disposable household income. In October the EMU rate of inflation fell to 0.7% according to initial Eurostat estimates. At present, the strength of the euro is one of the factors dampening inflation. Although the euro is likely to fall in value, we currently see no major inflation risks, the ECB's expansionary monetary policy notwithstanding. Following 1.4% the previous year we forecast an inflation rate of 1.3% for the euro area for 2014, which can still be considered compatible with the "lower limit" of the ECB's stability target.

At present, the ECB is concerned about money market interest rates, banking liquidity and lending growth. Firstly, excess liquidity has declined significantly as a result of premature repayments from the three-year tenders – it is possible that a "critical threshold" will soon be reached, with short-term interest rates (EONIA) likely to react. Secondly, the modalities of the Asset Quality Review and, following on from this, the results of some stress tests may put pressure on some banks. Thirdly, the gap separating the level of lending to the EMU private sector from last year's level continues to remain distinctly negative in September at -1.9%, largely as a result of lending to non-financial corporations, which was down by 3.5% on a year earlier. The recent outcome of the Bank Lending Survey was encouraging, but not yet reassuring. Although the EMU economy has embarked on a slow path towards recovery, the ECB will, in all likelihood, leave its forward guidance, which was first introduced in July, unchanged, i.e. it will continue to signal its readiness to lower the key interest rate and even offer, yet again, exceptionally long terms for refinancing operations. We expect the key interest rate to continue to remain at 0.5% until at least the fall of next year. (The ECB had guaranteed unlimited liquidity supply for refinancing operations until mid-2014).

Euro area: Economic indicators and forecasts*

		2012				2013				2014						
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2012	2013f	2014f
GDP real		-0.1	-0.3	-0.1	-0.5	-0.2	0.3	*0.2*	*0.3*	*0.5*	*0.4*	*0.4*	*0.4*	-0.6	*-0.3*	*1.5*
Private consumption		-0.4	-0.6	-0.1	-0.4	-0.3	0.1	*0.1*	*0.2*	*0.2*	*0.2*	*0.3*	*0.3*	-1.4	*-0.6*	*0.8*
Government spending		-0.3	-0.3	-0.2	0.1	0.0	0.4	*0.0*	*0.0*	*0.2*	*0.2*	*0.1*	*0.1*	-0.5	*0.2*	*0.5*
Investment		-1.2	-2.0	-0.4	-1.2	-2.3	0.2	*0.2*	*0.7*	*0.8*	*0.7*	*0.6*	*0.6*	-3.8	*-3.5*	*2.5*
Exports		0.8	0.9	0.7	-0.5	-0.9	2.1	*1.1*	*1.0*	*1.0*	*1.1*	*1.2*	*1.0*	2.7	*1.6*	*4.5*
Imports		0.0	-0.2	0.3	-0.9	-1.0	1.6	*1.2*	*0.8*	*0.7*	*1.0*	*1.1*	*1.0*	-0.8	*0.5*	*4.0*
Industrial production (excl. construction)		-0.5	-0.7	0.1	-1.9	0.2	0.7	*0.1*	*0.7*	*0.7*	*0.6*	*0.6*	*0.6*	-2.4	*-0.7*	*2.3*
Unemployment rate	%	10.9	11.3	11.5	11.8	12.0	12.1	12.2	*12.1*	*12.0*	*11.9*	*11.8*	*11.6*	11.4	*12.1*	*11.8*
Consumer prices	y-o-y	2.7	2.5	2.5	2.3	1.9	1.4	1.3	*0.8*	*1.0*	*1.1*	*1.3*	*1.7*	2.5	*1.4*	*1.3*
Producer prices	y-o-y	3.8	2.6	2.5	2.4	1.2	-0.1	-0.6	*0.0*	*0.5*	*2.0*	*2.4*	*2.3*	2.8	*0.1*	*1.8*
Current account balance	EUR bn, nsa	18.0	34.9	37.5	37.8	50.4	58.2	*50.0*	*40.0*	*45.0*	*45.0*	*40.0*	*35.0*	128.1	*198.6*	*165.0*
	% of GDP													1.4	*2.1*	*1.7*
Budget balance	% of GDP													-3.7	*-3.0*	*-2.5*

*) quarterly values: percentage change over previous period, seasonally adjusted, except where noted; annual GDP not adjusted; foreign trade incl.intra trade

f = forecast.

Emerging markets

Following the slowdown in growth seen last year, the emerging markets continued to record only moderate expansion, by their standards, in the first half of 2013. Much of the blame can be attributed to weak demand and austerity drives in the industrial countries. But home-made factors also played a role in a host of emerging countries. The BRIC

countries – Brazil, Russia, India and China – provide a good example. In Russia, for instance, the investment climate has deteriorated appreciably in recent years, undermined not least by the lack of legal security. Excluding the slump in investment following the Lehman blow-out in 2008, machinery and equipment investment this year will record the worst performance since the Russian crisis of 1998. India has also disappointed in recent quarters. Stubbornly high inflation is weighing on economic activity, as is political foot-dragging on the reform front. To make things worse, large holes in the current account and the government budget expose India to sudden swings in sentiment on the financial markets. This was seen in the summer when Fed hints about the timing of its planned tapering sent capital rushing for the exit – not least in India. Between June and August the Indian rupee was at times down by almost 18% against the US dollar, but has since managed to make up some of this loss.

Although the economic signals from the emerging markets are currently a pretty mixed bag, overall they do point to somewhat more spritely growth momentum. This applies in particular to China, where the economy already gained more steam in the third quarter. An acceleration is also evident in eastern Europe, with Poland, the largest eastern European EU member, experiencing solid private consumption. In addition, countries such as Poland, the Czech Republic and Hungary are increasingly benefiting from the pickup in the eurozone, eastern Europe's major trading partner.

Largely due to the economic revival in the euro area the eastern European region should grow more swiftly in the coming year than this year. We expect to see GDP growth of 2.7%, following on from a mere 1.5% this year. In Latin America, too, we forecast somewhat stronger growth for the coming year: 3.1% following on from a 2.7% increase in 2013. Mexico, in particular, should develop somewhat more strongly than this year, benefitting from the increased economic momentum in the US. In the Asia emerging markets, the picture is somewhat different. Here, we expect GDP growth of just over 6%, both this year and next. In fact, we currently do not see a great likelihood of higher growth rates in Asia. This is due, in no small part, to China's intention to make radical changes to its growth model, with the aims of the Chinese government including more balanced and sustainable economic growth. However, this is not a target that can be reached with the high single-digit or even double-digit GDP growth rates we have seen in the past.

All in all we expect the emerging markets to grow by 4.6% this year and 5% next year. In the medium term we expect to see GDP growth of just over 5% per year. By way of comparison: in the boom years between 2003 and 2007, the annual growth rate was still sitting at just over 7%. But even with the growth rates expected to tail off, the emerging markets will continue to make the biggest contribution to global economic expansion. Since they now have a much bigger slice of the global output cake than they did only six years ago, for example (2007: 29.6%, 2012: 38.1%; based on current exchange rates in each case), the emerging markets are now actually contributing even more to annual global growth than in the past, in spite of the ebb in momentum.

Growth rates in main economic regions

GDP, real % change over previous year

	2008	2009	2010	2011	2012	2013[1)]	2014[1)]
Industrialized countries	**-0.1**	**-3.7**	**2.6**	**1.4**	**1.3**	**1.0**	**2.0**
European Union	0.5	-4.6	2.0	1.8	-0.5	0.0	1.6
Euro area	0.3	-4.4	1.9	1.6	-0.6	-0.3	1.5
Germany	1.1	-5.1	4.0	3.3	0.7	0.6	2.0
USA	-0.3	-2.8	2.5	1.8	2.8	1.6	2.5
Japan	-1.0	-5.5	4.7	-0.6	2.0	1.8	1.5
Emerging markets	**5.9**	**1.2**	**7.3**	**6.2**	**4.5**	**4.6**	**5.0**
Asia	7.2	5.9	9.5	7.5	6.2	6.3	6.4
Latin America	4.2	-1.8	6.1	4.2	2.7	2.7	3.1
Central and Eastern Europe	5.9	-6.9	3.4	4.5	1.3	1.5	2.7
World	**1.7**	**-2.2**	**4.1**	**3.0**	**2.4**	**2.3**	**3.1**

1) forecast.

Sources: EcoWin, own forecasts.

At 2.3% global output will expand at a marginally weaker rate this year than last year. With the economy currently firming up in the advanced economies and the attendant upturn in the emerging markets, above all in eastern Europe, global output growth in 2014 is likely to be stronger than it has been this year. We expect a 3.1% rise (country weighting based on current exchange rates in each case).

Apart from our central premise that the eurozone will continue to get to grips with the sovereign debt crisis, our fairly upbeat outlook for 2014 rests on the following key assumptions:

- Growth in global merchandise trade will be just under 3% in 2013, accelerating to around 5% next year. This would still be well below the medium-term average of almost 6%.

- Crude oil prices (Brent) are expected to fluctuate between 100 and 110 USD/barrel during the forecast period. In the first ten months of this year they remained just above 109 USD/barrel on average. Neither our altogether rather moderate view of economic development nor the favorable supply situation as regards crude oil indicate a clear upwards trend for the oil price. The risk of a drastic price hike if the geopolitical risks escalate does, however, remain.

- Monetary policy on both sides of the pond will remain ultra-loose, with both the Fed and the ECB likely to keep rates close to zero until at least the middle of next year. However, a gradual tapering of quantitative easing in the coming quarters is on the cards should the Fed perceive that improvements on the US labor market are sustainable.

- The low valuation of the US dollar vis-à-vis the euro in recent weeks is likely to have been significantly driven by the Fed's decision, contrary to expectations, not to discontinue its bond purchasing program, as well as by the fiscal battle in the US. The dollar should gain in value vis-à-vis the euro, since the US economy is expected to outperform the rate of growth achieved by the eurozone and the Fed is probably more likely to correct is ultra-loose monetary policy earlier than the ECB. By the end of the forecast period, we expect the exchange rate to stand at 1.30 USD/EUR.

An explanatory and forecast model for the expenditure side of gross domestic product in the eurozone

Economic forecasts for the euro area can be drawn up by first creating forecasts for the individual EMU countries and then subsuming them in a "euro area" aggregate. This is how most expert forecasts are arrived at. However, economic development can also be predicted for the economic area in its entirety, usually by means of model-based forecasts. An introduction of our model-based approach to the eurozone follows below.

Our new explanatory and forecast model estimates the future development of the expenditure side of gross domestic product (GDP) for the euro area based on an aggregate of the individual countries. Our data pool consists of quarterly time series, adjusted by season and the number of working days, which are assessed in terms of constant prices of the year taken as a basis.

At first, based on regression equations, the development of the GDP expenditure side and other values to be forecast over the course of the last 13 years (2000 Q1 - 2013 Q1) is explained by means of selected exogenous variables (e.g. interest rates, financial assets, trade-weighted external value of the euro, etc.).

This allows us to draw up behavior equations for the expenditure components of GDP, i.e. for consumer spending, gross fixed capital formation, exports and imports, as well as changes in inventories. We have also worked out behavior equations for other variables such as available income, employment or the consumer price index, which are required for any forecast of consumer demand.

In a next step, the forecast regression relationships are combined with the definition equation for GDP in a closed model. Then expectations regarding the macroeconomic development need to be formed, so that they can be used as a basis for simulating the course of exogenous variables during the forecast period. Once external assumptions have been defined, the model can be used to draw up a macroeconomic forecast for the euro area for the current and the coming year.

To start with we assessed the model adjustment using an ex-post forecast for the years 2010 Q1 to 2013 Q1. The growth rates forecast by the model for 2010 turned out to replicate the actual rates of change of most GDP expenditure components reasonably well. Significant deviations were seen in the ex-post forecast of the annual growth rates for 2011. For the year 2012 the model forecast again approximates the actual rates of change rather well, overestimating the fall in GDP by a mere 0.1 percentage points.

Y/Y	Model	Actual[1)]	Model	Actual[1)]	Model	Actual[1)]
	2010		2011		2012	
Private consumption	0.6	1.0	-0.6	0.4	-0.9	-1.4
Gross fixed capital formation	0.4	-0.6	-0.2	1.9	-4.7	-3.8
Government consumption	0.6	0.6	-0.1	0.0	-0.6	-0.5
Exports	11.5	11.4	6.1	6.9	1.6	2.7
Imports	9.0	9.8	3.4	4.9	-0.4	-0.8
GDP real	**2.2**	**1.9**	**0.8**	**1.6**	**-0.7**	**-0.6**

1) Data as of: 8.10.2013

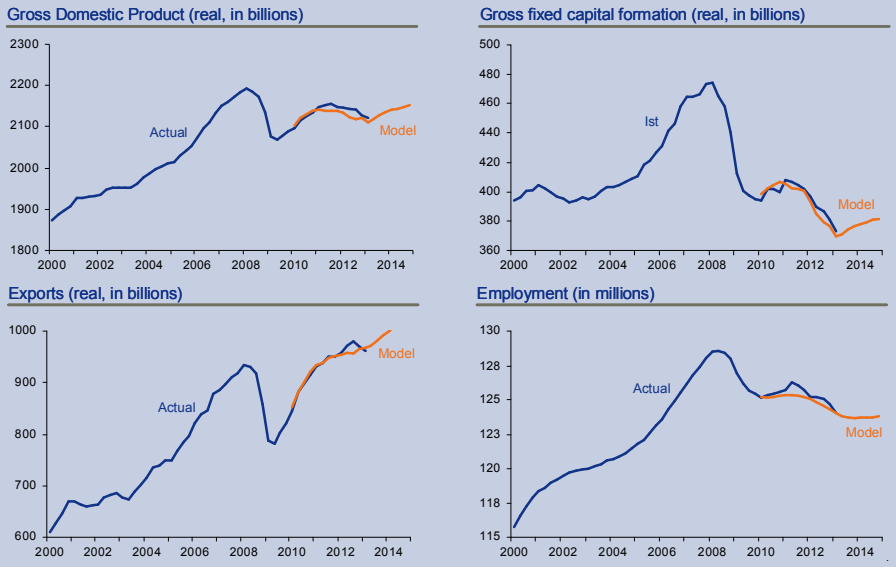
We forecast macroeconomic development for the period 2013 Q3 to 2014 Q4 - based on exogenous factors such as the oil price - using the model.

	Forecast model	
Y/Y	2013	2014
Private consumption	-0.1	0.2
Gross fixed capital formation	-2.7	1.9
Government consumption	0.3	0.5
Exports	2.2	3.6
Imports	0.8	3.2
GDP real	**0.0**	**1.1**

The change in gross domestic product forecast by the model for 2013 (-0.0%) is slightly above that included in our own forecast (-0.3%).

The forecast model is based on the assumption that economic subjects will not deviate, during the forecast period, from the behavior that was ascertained for the estimation period 2000 Q1 to 2013 Q1 and set out in behavior equations (Lucas critique). With the debt crisis triggering structural reforms in a series of EMU countries, changes in behavior appear likely. For the forecast period we expect to see the increasingly positive macroeconomic effects of these measures. As a consequence, in our economic forecast for 2014 we believe we are justified to expect growth to exceed the pure model result by 0.4 percentage points.

GDP expenditure components: Actual and model estimate



2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

2.1 Economy getting into stride

Following a lukewarm start to the year – also as a result of unusually unfavorable weather conditions – the German economy has gathered steam since the spring. Second-quarter growth of 0.7 percent was buoyed by catch-up effects in the construction sector, but further production increases are on the cards in the second half of the year. In industry, both the assessment of the current situation and business expectations have

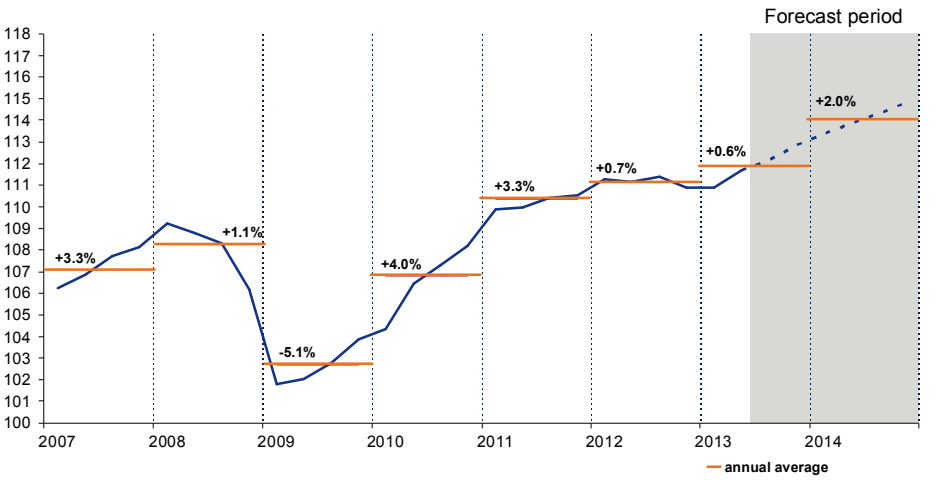
improved substantially since the end of last year. By contrast to this improvement in sentiment, hard indicators have only shown a comparatively modest upward trend so far. For instance, incoming orders in industry only exceeded second quarter figures by 0.6% in July and August. However, it is important to bear in mind that hard indicators have a tendency to lag behind survey results. We still expect a significant rise in industrial production in the second half of the year.

Both exports and domestic demand should provide a lift towards the end of 2013. The nascent pickup in the global economy and the stabilization in the eurozone will probably trigger appreciable increases in German exports. With construction order books brimming, a further expansion in output is likely. In the second half of the year disposable income looks set to rise more strongly than in the first half, buoying consumer demand. With capacity utilization somewhat higher, machinery and equipment investment is likely to pick up. All in all, gross domestic product growth is likely to come in at 0.4% in the third quarter and 0.6% in the final three months of the year. This would result in estimated average growth of 0.6% in 2013.

Chart: 3

German economy getting back into stride

Real GDP, index 2005 = 100



Sources: EcoWin, own forecasts.

The positive economic trend looks set to continue in 2014. With monetary policy still ultra-loose, the eurozone economy perking up, consolidation pressure in Germany low and the labor market robust, a solid foundation is there for stronger economic expansion after two years of modest growth. With a favorable global economic backdrop, the pace of growth in the German economy could reach 2.0% in the course of 2014. Thanks to the overhang at the beginning of the year this also corresponds to annual average growth of 2.0%.

Germany: Economic indicators and forecasts*

		2012				2013				2014						
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2012	2013f	2014f
GDP real		0.7	-0.1	0.2	-0.5	0.0	0.7	*0.4*	*0.6*	*0.5*	*0.4*	*0.4*	*0.4*	0.7	*0.6*	*2.0*
Private consumption		0.0	0.0	0.3	0.1	0.2	0.5	*0.1*	*0.3*	*0.5*	*0.4*	*0.4*	*0.5*	0.8	*0.9*	*1.5*
Government spending		0.4	-0.5	0.6	0.1	0.1	0.6	*0.1*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	1.0	*0.8*	*0.8*
Investment in machinery/equipment		-0.4	-3.7	-0.6	-0.3	-2.1	0.9	*1.5*	*1.5*	*2.0*	*1.5*	*1.5*	*1.5*	-4.0	*-2.0*	*6.6*
Construction		-0.5	-1.0	0.5	-1.0	-2.2	2.6	*2.0*	*0.5*	*0.3*	*0.4*	*0.4*	*0.4*	-1.4	*-0.2*	*3.0*
Domestic demand		-0.1	-0.5	0.0	0.0	0.2	0.6	*0.3*	*0.5*	*0.4*	*0.2*	*0.3*	*0.5*	-0.3	*0.7*	*1.6*
Exports		1.7	1.4	0.5	-1.6	-0.7	2.2	*1.0*	*1.3*	*1.3*	*1.5*	*1.0*	*1.0*	3.2	*1.0*	*5.3*
Imports		0.1	0.7	0.1	-0.9	-0.4	2.0	*0.9*	*1.2*	*1.3*	*1.2*	*1.0*	*1.2*	1.4	*1.3*	*5.0*
Industrial production (excl. construction)**		0.3	-0.2	0.3	-2.4	0.3	1.3	0.9	*1.7*	*1.2*	*1.0*	*1.1*	*0.9*	-0.1	*0.6*	*5.1*
Unemployment rate (EU def.)	%	5.5	5.5	5.5	5.4	5.4	5.4	5.3	*5.3*	*5.2*	*5.3*	*5.2*	*5.1*	5.5	*5.3*	*5.2*
Unemployment rate (nat. def.)	%	6.8	6.8	6.8	6.9	6.9	6.8	6.8	*6.9*	*6.8*	*6.8*	*6.7*	*6.7*	6.8	*6.9*	*6.8*
Employed persons (national def.)	y-o-y	1.4	1.2	1.0	0.9	0.6	0.6	0.6	*0.6*	*0.6*	*0.7*	*0.7*	*0.7*	1.1	*0.6*	*0.7*
Consumer prices	y-o-y	2.1	1.9	2.0	2.0	1.5	1.5	1.6	*1.4*	*1.5*	*1.5*	*1.5*	*1.9*	2.0	*1.5*	*1.6*
Consumer prices (HICP)	y-o-y	2.4	2.1	2.1	2.0	1.8	1.5	1.7	*1.4*	*1.3*	*1.4*	*1.5*	*1.9*	2.1	*1.6*	*1.5*
Producer prices	y-o-y	2.7	1.6	1.0	1.3	0.8	-0.1	-0.3	*0.1*	*0.6*	*1.7*	*2.3*	*2.0*	1.6	*0.1*	*1.7*
Current account balance	EUR bn	44.4	46.2	50.7	46.5	46.3	49.1	48.0	*48.0*	*47.0*	*47.0*	*46.0*	*46.0*	185.6	*191.4*	*186.0*
	% of GDP													7.0	*7.0*	*6.6*
Budget balance	EUR bn													2.3	*2.9*	*6.8*
(Maastricht-definition)	% of GDP													0.1	*0.1*	*0.2*

*) 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.

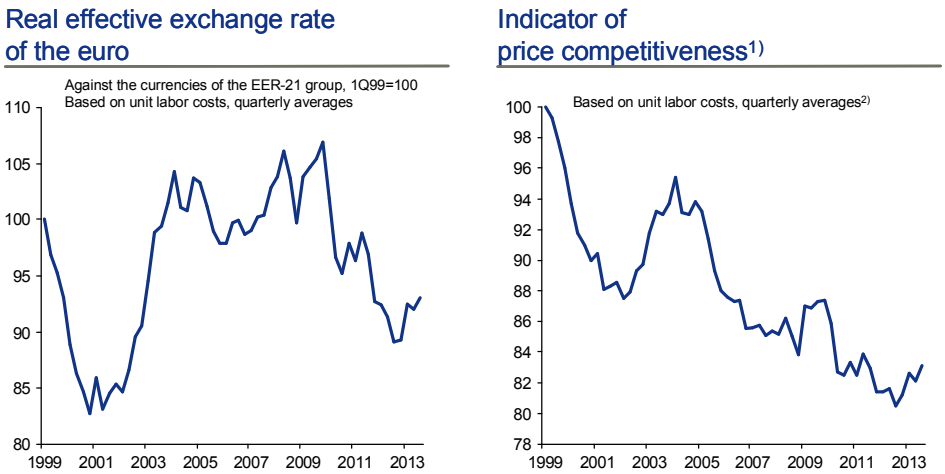
2.2 Exports gradually gaining momentum

As in 2012, the moderate expansion in global trade and the economic weakness in the eurozone have exacerbated the situation for German exports in 2013 so far. In the second quarter of 2013 the global trade volume only exceeded that of the same period a year earlier by just under 2%. During the first eight months of this year German exports to the euro area were down by 3.1% on the same period a year earlier. At present only approx. 37% of German exports go to the eurozone, compared to just under 41% in 2010.

Foreign demand has picked up somewhat in recent months. For instance in the three months of June/July/August incoming orders from abroad were up by well over 2% on the same period the previous year. Whereas we predict only a modest upward trend for orders from the eurozone in the coming months, countries outside of Europe are likely to provide a more marked impetus, particularly as regards American and Asian demand. Approximately 28% of all German exports are now destined for these two regions.

Although the price competitiveness of German exporters has slipped compared to last year, due to the appreciable rise in the effective exchange rate of the euro and the fairly steep rise in German unit labor costs, viewed long term it is still well above average. On the competitiveness side, therefore, the prospects are good that German exporters will benefit from the expected growth in world trade. The economic recovery in the eurozone removes one negative factor. With their focus on capital goods, German exporters could even enjoy an advantage given that the propensity to invest looks poised to rise again around the globe. German exports of goods and services are likely to increase by 5.3% real in 2014 after a mere 1.0% this year, and thus in line with the expansion in world trade.

Chart 4



1) A decline means an increase in competitiveness.
2) Q3 2013 estimate.

Source: Deutsche Bundesbank.

In 2013 and 2014 imports should develop pretty much in line with exports. Although a marked rise is on the cards in the second half of 2013, we nevertheless expect real imports to grow by only 1.3%. For 2014, however, we forecast a sizable increase of 5.0%.

With commodity prices on the decline, terms of trade, i.e. the relationship between export and import prices, have improved considerably in 2013 so far, providing a boost to the foreign trade surplus, a trend that is set to continue. For 2013 we therefore expect the current account surplus to come in at around EUR 191 bn, exceeding that of 2012 (EUR 185.6 bn). In 2014, however, commodity prices are likely to head north again, due to economic factors, thus causing terms of trade to deteriorate slightly. As a result we forecast a marginally lower current account surplus at about EUR 186 bn, which will nevertheless amount to 6.6% of GDP.

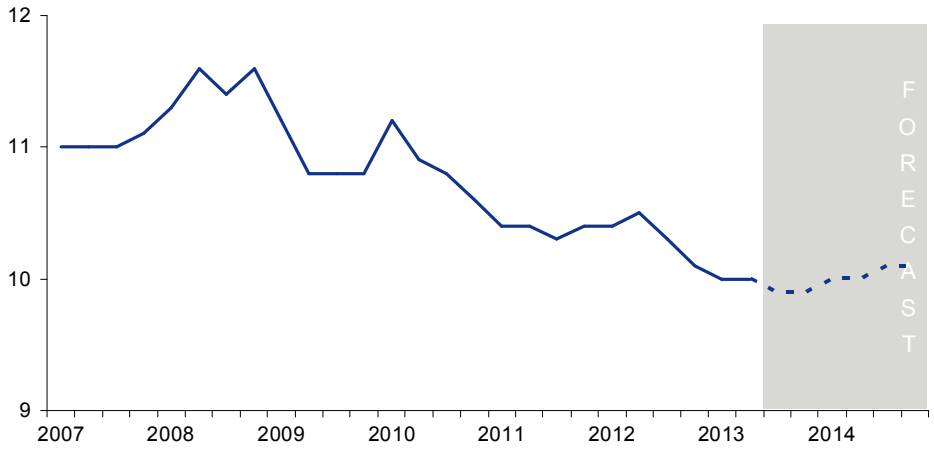
2.3 Greater propensity to consume, income growth slightly accelerated

Private consumption, which picked up by 0.7% during the first half of the year and 0.4% year-on-year in real terms, looks set to continue on its moderate expansion course. Although low inflation has helped to curb purchasing power losses in the year to date, the increase in disposable income in the first half of 2013 was only modest and real incomes were actually down slightly on a year earlier. That private consumption nonetheless recorded a real increase is attributable to a marked rise in the propensity to consume or, put differently, a drop in the propensity to save. However, in the second half of 2013 and particularly in 2014, the outlook for both income streams is brighter.

Chart 5

Germany: Private household savings rate down

in %, seasonally adjusted



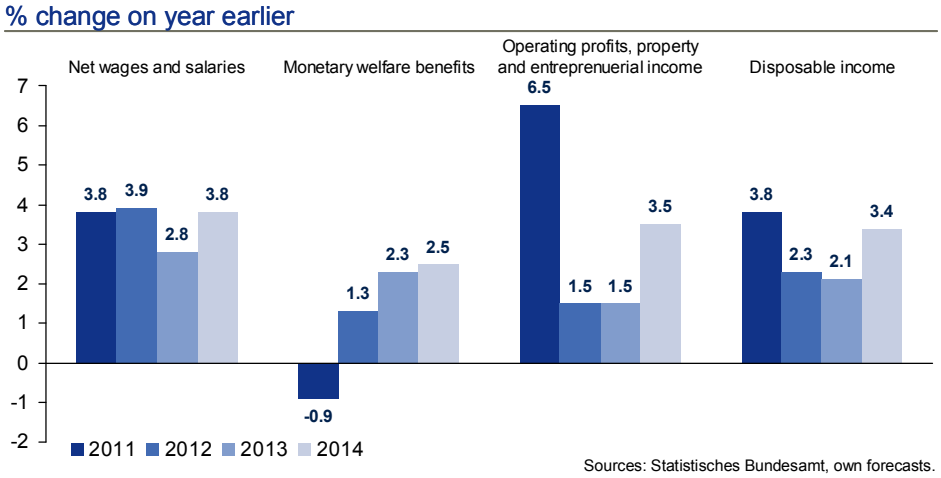
Sources: Statistisches Bundesamt, own forecasts.

During the course of 2013 the rise in income from employment should accelerate somewhat, reaching 3% for the year on average, with an estimated rise in employment by 0.7% and in actual earnings per employee by 2.4%. At the end of last year and the beginning of this year, a reduction in working hours for economic reasons had put pressure on the increase in actual earnings per employee. As a result of the economic recovery this negative factor for the development of income from employment should, however, disappear. An increase in overtime and a replenishing of working time accounts is likely. Since the increase in employment is set to continue and that in collectively bargained wages is likely to reach 2½ to 3%, we expect an increase in labor income to the tune of just under 4%. In view of the cut in pension insurance contributions and the increase in the basic tax allowance for income tax, net labor income is likely to rise in line with gross income in 2013 and 2014.

Monetary social benefits, which grew by 1.2% last year, are expected to rise by well over 2% this year and next. However, the increase in pensions will turn out to be lower in 2013 than in 2014 because a cut in pensions, which had been shelved in 2010, will come into effect this year. Entrepreneurial earnings and income from investments should only record a modest rise in 2013 at approx. 1.3% – not least due to meager interest income. As the economy recovers, we expect an increase in entrepreneurial earnings and investment income for 2014 to the tune of 3.5%.

Chart 6

Germany: Household incomes set to rise more strongly again in 2014



All in all disposable income is likely to increase by only 2.1% this year, with a substantially steeper rise of 3.4% on the cards next year thanks to a steeper rise in labor income, the prospect of higher pension adjustments and a slight acceleration in entrepreneurial earnings. The savings rate, which has been tending downwards since 2008 (11.5%), looks set to fall to around 10% in 2013 and 2014. There is no doubt that ultra-low interest rates are rendering savings less attractive than they used to be.

In view of an estimated rate of inflation of 1.5% this year and 1.6% next year and against the background of the expected income development and propensity to save, we forecast a rise in real private consumption of 0.8% this year and 1.5% next year.

2.4 Investment: Improvement on the horizon

Following a decline during the course of 2012 and at the beginning of 2013 the volume of gross fixed capital formation has been on the up since spring 2013, with the long and hard winter half of 2012/2013 causing an additional delay in investments. As a consequence we saw catch-up effects contributing to the resurgence of construction investment, which should continue to have a beneficial effect on investment activity during the rest of this year.

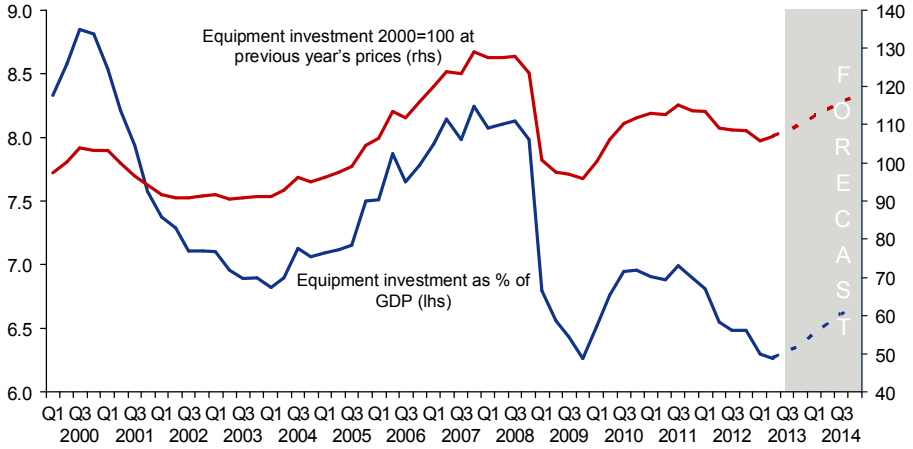
The pickup in capacity utilization and healthy corporate earnings figures provide a favorable backdrop for a further recovery in investment activity. Should the European debt crisis continue to subside and provided there is no renewed deterioration in the external environment, equipment investment is likely to move onto an expansion path. This can also be attributed to the fact that shelved investments are enacted once the economy picks up again. With financing conditions set to remain very favorable for a longer spell and companies able to draw on abundant equity financing and liquidity, we see good prospects that investment will regain more momentum over the forecast period.

Equipment investment contracted for six successive quarters and remains far below its pre-crisis level of 2008 despite a slight increase in the second quarter of 2013 (0.9% on the previous quarter) Due to the weak start to the year we expect equipment investment to drop by another 2.0% in 2013 as against 2012. In view of the need to catch up and the

improved overall framework, however, equipment investment should record a 6.5% rise in 2014.

Chart: 7

Germany: Investment stabilizing



Sources: Statistisches Bundesamt, own forecasts.

Since the last winter half-year led to exceptionally high losses in construction investment due to adverse weather conditions, during the second quarter of 2013 catch-up effects spawned positive growth rates of 3.2% for residential buildings and of 1.7% for non-residential buildings (in a quarter-on-quarter comparison). Although catch-up effects are set to make a positive impact during the third quarter as well, we expect construction investment to remain, on average, roughly on the same level in 2013 as in 2012. In 2014 we expect construction investment to be up by 3.0%, with a range of factors signaling stronger investment in residential construction than in non-residential construction.

Both the stable development on the labor market, as well as the stronger rise in disposable income, should encourage private households to purchase their own homes. Demand for housing is also set to continue to grow as a result of ongoing immigration. A continued rise in real estate prices, together with low mortgage rates, provides favorable conditions for residential construction.

The marked increase in the volume of incoming orders in the residential construction sector (Q2 2013 compared to Q1 2013: + 4.3%) testifies to an upward trend in residential construction activity, linked to a growing order backlog. We therefore expect residential construction to grow by 3-4% in real terms.

The decline in public-sector construction investment continued during the first half of 2013, although the -15.7% quarter-on-quarter slump in the first) was chiefly due to adverse weather conditions. Thanks to catch-up effects the second quarter of 2013 saw a slight recovery, recording a 2.6% increase compared to the second quarter of 2012. Repairs to public infrastructure as a result of flood damage should have a positive impact on public construction activity. Public-sector construction investment should also be buoyed by the fact that local authorities now enjoy a budget surplus (EUR 5.3bn during the first half of 2013), an indication that their reluctance to invest should slowly subside. In 2014 a marked increase in public-sector investment is on the cards.

Last year, sluggish economic development put a damper on commercial construction, causing it to contract by 2.1% in 2012 in a year-on-year comparison. The second quarter of 2013, too, saw the sixth successive decline in commercial construction investment (compared to the same quarter in 2012). With economic insecurities subsiding and companies' expectations brightening, there is a good prospect that commercial construction will record a modest rise in 2014.

2.5 Price development remains moderate

Following a 2% rise in consumer prices in 2012, the rate of inflation has remained below 2% throughout this year, recently coming in at a mere 1.2%, so that the rather expansive monetary policy did not result in an acceleration of inflation. However, the – albeit subsiding - insecurity as regards economic prospects has prevented monetary policy from unfolding its full impact on macroeconomic demand.

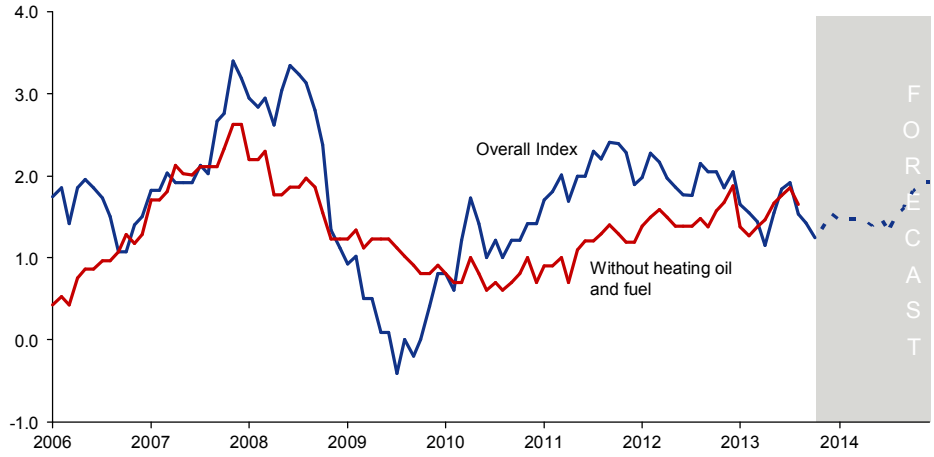
Special factors such as the discontinuation of the doctors' practice fee at the beginning of 2013 contributed to keeping inflation modest, with consumer prices for health care services falling by 3.7% (in a year-on-year comparison) The drop in the oil price calculated in euros also put the brakes on consumer prices, helping to curb fuel prices.

So far this year the marked increase in food and drink prices has put pressure on price developments, with consumer food prices at 3-4% above last year's levels at the beginning of the year and even recording a rise of more than 5% during the summer months. Resulting in a 12% increase in electricity costs for consumers in a year-on-year comparison, the EEG (Renewable Energy Act) levy, which was introduced at the beginning of the year, provided a further inflationary impetus.

Chart: 8

Germany: Inflation still low

% change on previous year



Sources: Statistisches Bundesamt, own forecasts.

Labor costs continued at the previous year's trend, recording growth rates of 3% in the first quarter of the year (as against the same quarter in 2012). However, the growth rate fell significantly in the second quarter of 2013, with the increase in collectively bargained wages slowing down considerably too (in the first quarter of 2013 +3% compared to the same quarter in 2012; +1.9% in the second quarter of 2013). The slowed increase in wage costs, too, leads us to expect a moderate price increase for the second half of the year, so that the rate of inflation should only come in at 1.5% in 2013 on average.

For 2014 we estimate labor costs to mount by around 3% and real GDP by around 2%. As a consequence we expect unit wage costs to increase by approx. 1%. Even if profit margins expand slightly – which is likely if the economy performs solidly – and household energy prices continue their upward trend, inflation should nonetheless come in at only 1.6% in 2014.

2.6 Stable job creation

Despite the lull in the economy in the winter of 2012/13 job creation in Germany was not interrupted. The number of people in work has been rising steadily month for month since late 2012, with this figure coming in at just under 200,000 more in August this year than in December 2012, even accounting for seasonal adjustments. While gross domestic product, after adjustments to reflect the number of working days, exceeded the corresponding prior year's level in the second quarter in 2013 by 0.5%, the increase in the number of people in work even amounted to 0.6%. Labor productivity (per person in work) actually decreased slightly. Put in positive terms this means that economic growth is rather labor-intensive.

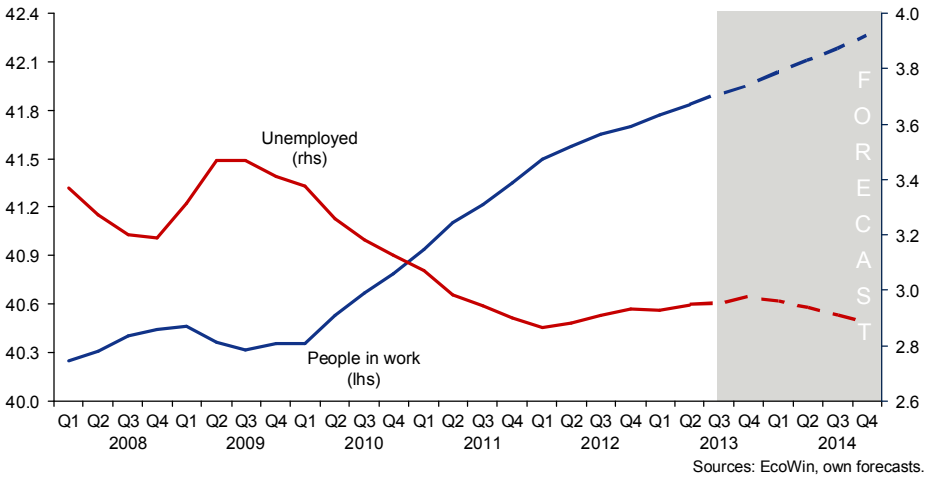
In view of the rising number of people in work so far notwithstanding modest capacity utilization levels, we are not expecting a further substantial acceleration in the rise in employment at the end of this year nor next year as the economy picks up. The number of people in work is likely to rise by more than 250,000 in 2013 and by around 300,000 in 2014.

Employment subject to social security contributions continues to grow more quickly (August 2013: +1.2%) than employment as a whole (August 2013: +0.6%). We expect this positive trend to continue. The strongest growth in jobs will be seen in business services and health and welfare.

Chart 9

Germany: Workforce and unemployed

Millions



Sources: EcoWin, own forecasts.

The rise in employment is still not being reflected in a corresponding drop in unemployment. This stems from the rising number of older people and women joining the workforce and the large immigration of workers from abroad. Both factors are more than offsetting the decline in the domestic working-age population.

The number of people out of work has edged up slightly in the course of the year so far. Towards the end of the year unemployment will probably stagnate and then fall slightly in the course of 2014. The average jobless total in 2013 will be 50,000 higher than in 2012 at 2.95 million. In 2014 the figure will fall by 30,000 to 2.92 million. Within the EU, Germany will continue to have the second lowest unemployment rate behind Austria.

2.7 Government finances remain sound

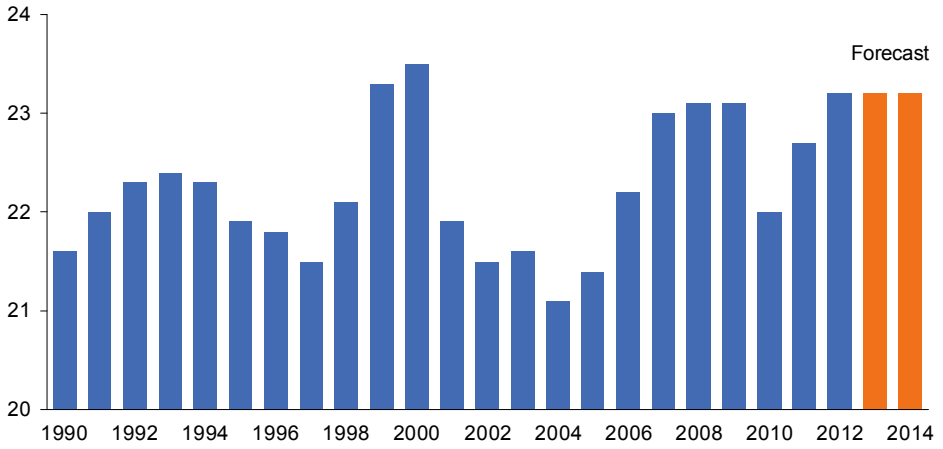
The German budget, which, at EUR 2.3bn, reported a modest surplus in 2012, should, based on the information available at present, remain in the black at around EUR 3bn in 2013 and approx. EUR 7bn in 2014. This estimate is based on the discretionary changes to taxes, social and government spending resolved for 2013 and 2014, but does not account for any potential changes put in effect by the future government.

Growth in government revenue is likely to be less pronounced in 2013, at 2.5%, than in 2012 (+3.2%) and 2011 (+6.2%). This is attributable in particular to sluggish economic growth and the decrease in the contribution rate to statutory pension insurance by 0.7 percentage points. Other minor reductions in the tax burden (basic tax allowance, contribution rate to pension insurance) at the beginning of next year notwithstanding, government income is set to climb more steeply in 2014 (+3.0%) thanks to the expected pickup in economic growth. We predict tax revenues to swell by 3.0% this year and 3.5% next year. This will mean that, in 2013 and 2014, the tax rate will remain roughly on the same high level as in 2012. Last year it recorded its third-highest value (1999: 23.3%, 2000: 23.5%) since German reunification at 23.2% of gross domestic product. This means that the government currently has plenty of money in the kitty to finance its tasks.

Chart 10

Germany: Tax ratio nearing peak

as % of GDP



Sources: Bundesfinanzministerium, own forecasts.

Government expenditure, which had contracted by 1.3% in 2011 and inched up by a mere 1.1% in 2012, looks poised to rise somewhat more quickly this year, coming in at an estimated 2.5%. Next year, we forecast an increase in government expenditure of 2.7%. Also as a result of a slightly larger workforce, the increase in expenditure for employee compensation is set to rise from 2.2% this year to 3.0% next year.

Monetary social benefits should see modest increases of 2.2% this year and 2.4% next year. In 2014 this trend will probably be more marked than this year, when a pensions cut was implemented that had been shelved back in 2010. However the positive development on the labor market helps to curb the increase in monetary social benefits. Following the appreciable reduction in public investment last year (-5.2%) and an expected slight pickup this year (+ 1.0%), thanks to local authorities having replenished their coffers and driven by the need for reconstruction after the floods, public investment looks set to stage a sizable comeback (+6%). Another factor slowing down government expenditure is the dwindling interest expenditure for sovereign debt.

The public expenditure ratio, which sank to just under 45% in 2012, should continue to chart a modest decline with 44.5% in 2013 and 44.2% in 2014, thus returning almost to the level seen before the global economic crisis in 2009.

Germany: Public-sector revenue and expenditure

in EUR bn	2010	2011	2012	2013[2)]	2014[2)]
Revenue	1089.8	1157.2	1193.8	1223.8	1260.1
of which:					
Taxes	549.9	592.8	617.7	636.2	658.5
Social contributions	421.2	437.0	448.9	457.9	469.3
Expenditure	1194.1	1178.7	1191.5	1220.9	1253.3
of which:					
Inputs	121.7	126.5	130.9	135.9	140.0
Employee compensation	195.7	199.5	203.8	208.3	214.6
Property income payable (interest)	63.5	65.7	63.8	61.6	60.3
Subsidies	28.8	27.2	24.6	24.6	24.6
Monetary welfare benefits	430.2	425.8	430.3	439.7	450.3
Welfare benefits-in-kind	203.0	207.5	213.1	222.1	229.4
Other current transfers	53.5	53.8	57.1	59.4	61.7
Gross investment	41.6	43.6	41.4	41.8	44.3
Financial balance	-104.3	-21.5	2.3	2.9	6.8
memorandum:					
State spending ratio[1)]	47.9%	45.2%	44.7%	44.5%	44.2%
Financial balance[1)]	-4.2%	-0.8%	0.1%	0.1%	0.2%

[1)] in relation to gross domestic product in current prices. Sources: Statistisches Bundesamt, own forecasts.

[2)] Prognosen basierend auf den für 2013 und 2014 beschlossenen Änderungen bei Steuern, Sozialausgaben und Staatsausgaben.

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This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an aging society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

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