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Economic forecast 2013/2014

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1. GLOBAL ECONOMIC SITUATION AND OUTLOOK

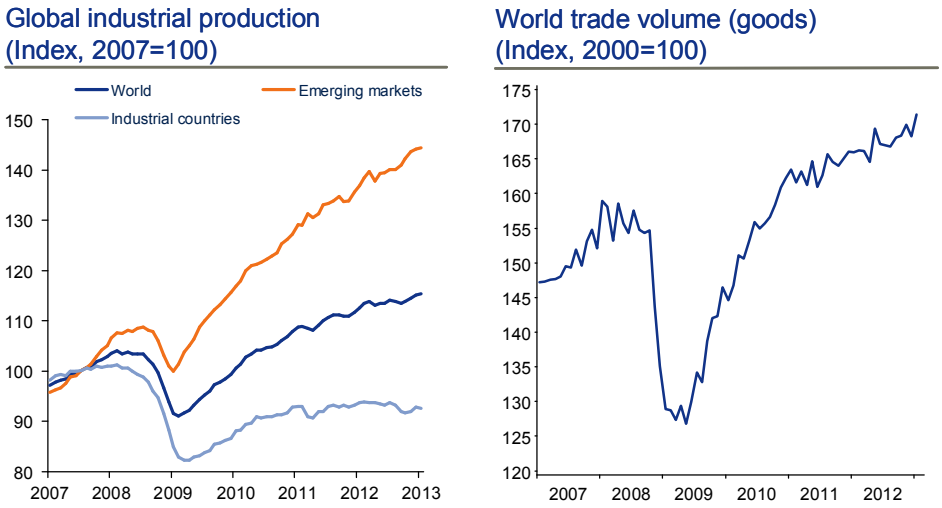
The global economy continued to lose momentum in 2012, with global output up by only 2.3% on average during the year. This was accompanied by a further slowdown in global goods trade, which returned average annual growth of only 2.3%, not even half the level achieved a year earlier (6%).

There is no doubt that the restrictive fiscal policy approach taken by many of the world's industrialized nations is one of the main factors behind the weak overall global economic development. The exacerbation of the European sovereign debt crisis in the summer of 2012 once again brought the growth-inhibiting effects emanating from Europe and weighing on the global economy to the fore. The uncertainty sparked by the debt crisis presumably also contributed to the reluctance to invest.

The ECB responded decisively to the escalating crisis in a quest to keep the eurozone together. The announcement of a second bond-purchasing program (OMT - Outright Monetary Transactions), which has not yet been activated, went some way to relieving the stress on the eurozone financial markets and prompted a general upturn in sentiment on the financial markets in the course of the second half of 2012. Other central banks ploughed ahead with their expansionary monetary policies, and some emerging markets implemented stimulating fiscal policy measures.

Chart 1

Global economic momentum very subdued



Source: CPB Netherlands Bureau for Economic Policy Analysis.

At the end of 2012, the economic picture was still very mixed. Although global industrial production and international merchandise trade picked up again somewhat – having practically stagnated in the spring/summer – the improvement was – as is revealed by a look at country groups - largely the result of greater momentum in the Asian emerging markets.

However, of late there has been evidence of an expansion in production on a broader front. Following a continuous decline since the second quarter of 2012, overall industrial production in the advanced economies is likely to rise again in the first quarter of this year. And world trade is also displaying clear signs of picking up, with provisional figures flagging a strong 1.9% rise in January.

Nonetheless, 2013 is not likely to be a doddle either. Although considerable progress has been made in correcting erstwhile adverse trends, in many cases the adjustment process is not yet over. Above all the ongoing consolidation of public sector finances in the industrial countries, but also the need for structural adjustments in a number of emerging markets, will thwart buoyant economic momentum.

The ability of a host of economies, particularly among the industrial countries, to cope with shocks looks very limited. The eurozone debt crisis still harbors risks for global growth. Although there is much to suggest that the let-up in the European debt crisis is set to last, undeniable risks still lurk – for instance, waning zest for reform. Finally, rising geopolitical tensions, such as the row over the Iranian nuclear program, could exert a considerable drag on the global economy, not least if these send crude oil prices skywards.

Below we set out our assessment of the economic prospects for individual regions and countries:

USA

The US economy continued on a moderate growth path in 2012, clocking up expansion to the tune of 2.2%. Compared with the growth achieved a year earlier, however, the economy appeared to be on a more solid footing. This was helped along by the emergence of a recovery on the housing market. After the past few years were dominated by a sharp downward correction, 2012 saw residential construction investment make a positive contribution to growth again for the first time since 2005. House prices also started to bounce back. According to the S&P Case-Shiller house price index, residential property prices rose by a good 7% in the course of 2012. However, government spending cuts continued to exert a drag.

The measures aimed at reining in public budget deficits will keep the handbrake on growth this year, too. The increases in taxes and levies passed at the start of the year, in particular the renewed hike in welfare contributions for employees, and the spending cuts set out in the Budget Control Act, which came into force on March 1, are likely to exert a fiscal drag of around 1.5 percentage points.

Despite the tight hold on the fiscal policy reins, the economic indicators painted a surprisingly positive picture of economic momentum at the start of this year. To some extent, however, the factors behind this trend will prove to be short-lived. The recent expansion in inventories, for example, is likely to be a backlash against the excessive rundown seen in the closing quarter of 2012. So in this respect, we can expect growth to initially slow down again in the second quarter as the public spending cuts really start to bite.

Nevertheless, the forces driving the economy up are likely to maintain the upper hand. First of all, we predict that residential construction will once again rack up double-digit growth this year. Housing starts are still around 40% below the longer-term requirement, which is based, in particular, on the number of new households being formed and housing replacement needs. Second, leading indicators are pointing towards livelier construction activity in the commercial segment. One positive aspect is the fact that the more vibrant construction activity over the past few months has resulted in more jobs being created in this sector.

Fiscal policy is one element of uncertainty that is still dangling over future development. The next few months are set to see another decision on the raising of the government debt ceiling. Given the high knock-on costs, it is hard to imagine that the debt ceiling will not be raised, but it is virtually impossible to gauge on what terms Congress will reach an agreement, and when this will happen. If the political uncertainty mounts, the private sector might increasingly be inclined to put off spending.

All in all, we expect to see economic growth of 1.8% this year and 2.4% next year.

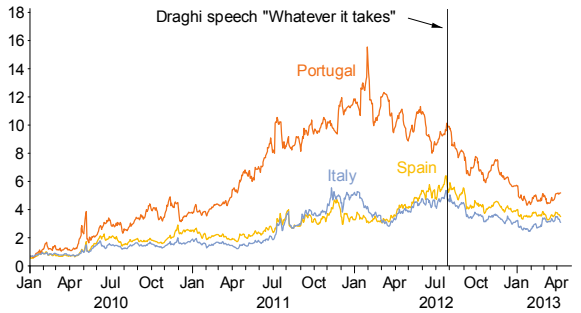
Euro area

Up until the Italian elections and the Cyprus imbroglio, the financial markets were showing clear signs of a let-up in the euro debt crisis: lower yield spreads in the EMU problem countries, the successful issuance of ten-year Irish government bonds, confirming that market access had been restored, increasing cross-border activity, lower TARGET2 balances and a reduction in the ECB's balance sheet. Although uncertainty appears to have risen again, we expect the crisis to continue to abate. The responsible players, primarily the ECB, have so far shown a marked determination to preserve the euro and the eurozone. The adjustment progress made by those member states at the center of the crisis is striking. If necessary, the political decision-makers are likely to continue adopting unconventional approaches in the future, too.

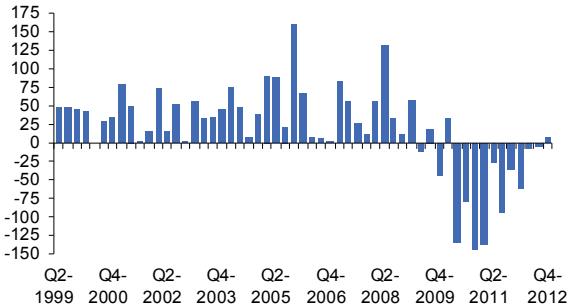
Chart 2

EMU: Financial markets with signs of normalization

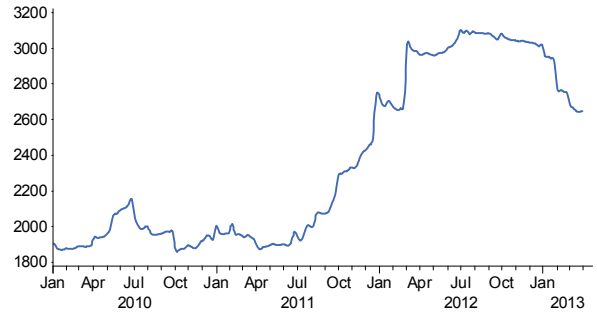
Yield spread over 10y German government bonds, percentage points



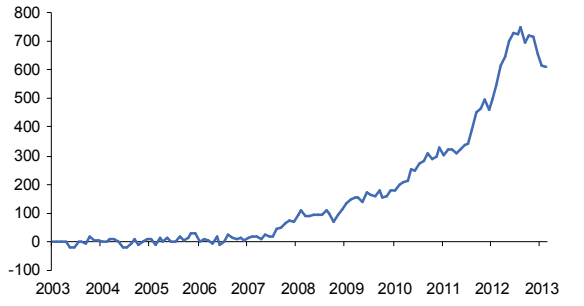
Change in net outstanding cross-border financing in the euro area in EUR bn (q-o-q)



Total assets of the Eurosystem, EUR bn



Net claims of Bundesbank within the Eurosystem (TARGET2), EUR bn



Sources: Deutsche Bundesbank, EcoWin.

Leading indicators such as the purchasing managers' index and the Economic Sentiment Indicator recorded by the European Commission suggest that GDP development in the months from January to March 2013 will be an improvement on the closing quarter of 2012, when real GDP contracted by 0.6% on the previous quarter. The eurozone is, however, expected to have stagnated, at best, in the first three months of the year. Industrial production got off to a disappointing start to the new year, dipping by 0.4% compared with December.

Although we are more optimistic than the ECB, for example, with our forecast of zero GDP growth for 2013 as a whole after a contraction of 0.5% in 2012, we also believe that the economic upswing will not become genuinely visible until next year, when we expect GDP to grow by 1.5% and the growth differentials between the individual EMU members to become far less pronounced. We believe that the improved competitiveness thanks to structural reforms will only be partially eroded by the higher valuation of the euro compared with mid-2012 and that it will provide a boost to export demand. The current account surplus for the euro area as a whole is likely to rise further (2013e: 1.5% of GDP). Although domestic demand is not expected to make a positive growth contribution until next year, private consumption should start to benefit from lower rates of inflation and the positive impact that these will have on real disposable household incomes this year, while investment activity is likely to be bolstered by the continuation of the ECB's expansionary monetary policy. The drag on the economy from necessarily tight fiscal policy is likely to ease gradually in 2013 and 2014.

Given the fragile state of the European economy, the economic policy debate has shifted from focusing exclusively on the continuation of the consolidation efforts, to adding growth initiatives (not large-scale economic stimulus programs) into the mix where possible. A new acronym is starting to be thrown around for a supposed quartet of crisis candidates: FISH, namely referring to France, Italy, Spain and Holland. Even "fiscal policy hawks" like the Netherlands are looking to extend consolidation deadlines. The EU can be expected to make further concessions such as those made for Portugal of late, possibly also regarding France. Since youth unemployment, in particular, is becoming more and more of a focal point, the European Council agreed on a "youth guarantee" at its February summit, the idea being to guarantee jobseekers aged under 25 a job or further training within a period of four months.

In February, the seasonally adjusted unemployment rate in the eurozone stood at 12.0%. Given that the EMU labor market is still in poor shape, we do not expect to see any cost surge from the domestic economy, e.g. sparked by substantial wage increases in the euro area, in the foreseeable future. Combined with subdued external price pressure and dwindling inflation on energy and food prices, the EMU inflation rate is more likely to fall short of the ECB's price stability target than it is to overshoot it in the immediate future. In 2014, the EMU inflation rate is predicted to slip further to 1.6%, compared with 1.7% this year. This is one argument against any early move by the ECB to tighten the monetary policy reins, together with the fact that the economic recovery has still to get off to a convincing start, the European banking system remains fragile and SMEs are faced with challenging lending conditions. While the return of funds from the ECB's three-year tenders marks a step out of crisis mode, it is not an active move on the part of the ECB, which is likely to stick to its policy of unlimited liquidity supply and keep the key interest rate at the current level of 0.75% until at least the end of 2013.

Moves to normalize interest rate policy should, however, preferably come sooner rather than later, because keeping negative real interest rates as a permanent feature results in the misallocation of resources: this would devalue savers' real assets and create false assumptions for corporate investment decisions, because it would create a scenario in which even projects resulting in a loss of value – i.e. returns that are below the rate of inflation – would be eligible for funding. In order to prevent financial market bubbles and keep inflation expectations well anchored, it is extremely important that a decision is made to break with the ultra-loose monetary policy at the right time. On the whole, however, there is a risk that monetary policy will remain expansionary for too long across the globe. If the euro exchange rate surges, the ECB's hands could be tied if other major central banks opt to remain in crisis mode (for too long).

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	-0.2	-0.1	-0.6	*0.0*	*0.3*	*0.3*	*0.3*	*0.5*	*0.4*	*0.4*	*0.4*	-0.5	*0.0*	*1.5*
Private consumption		-0.2	-0.5	-0.1	-0.4	*0.0*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.3*	*0.3*	-1.2	*-0.2*	*0.9*
Government spending		0.2	-0.1	-0.1	-0.1	*-0.1*	*0.0*	*0.0*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	-0.1	*-0.2*	*0.0*
Investment		-1.4	-1.7	-0.8	-1.1	*-0.3*	*0.5*	*0.6*	*0.5*	*0.4*	*0.5*	*0.6*	*0.6*	-3.9	*-1.2*	*2.0*
Exports		0.5	1.6	1.0	-0.9	*0.8*	*1.0*	*1.0*	*0.8*	*1.2*	*1.2*	*1.3*	*1.0*	2.9	*2.5*	*4.4*
Imports		-0.4	0.6	0.1	-0.9	*0.7*	*0.8*	*1.0*	*0.8*	*0.7*	*1.0*	*1.2*	*1.0*	-0.9	*1.5*	*3.7*
Industrial production (excl. construction)		-0.5	-0.5	0.1	-2.1	*0.1*	*0.8*	*0.6*	*0.5*	*0.7*	*0.6*	*0.6*	*0.6*	*-2.3*	*-0.5*	*2.5*
Unemployment rate	%	10.9	11.3	11.5	11.8	*12.0*	*12.2*	*12.2*	*12.2*	*12.0*	*11.9*	*11.8*	*11.6*	11.4	*12.2*	*11.8*
Consumer prices	y-o-y	2.7	2.5	2.5	2.3	1.9	*1.8*	*1.6*	*1.4*	*1.5*	*1.5*	*1.5*	*1.7*	2.5	*1.7*	*1.6*
Producer prices	y-o-y	4.0	2.7	2.6	2.4	*1.3*	*1.7*	*1.8*	*2.4*	*2.6*	*2.4*	*2.1*	*2.0*	2.9	*1.8*	*2.3*
Current account balance	EUR bn, nsa	21.6	26.6	30.2	39.9	*35.0*	*35.0*	*40.0*	*35.0*	*40.0*	*40.0*	*35.0*	*35.0*	118.3	*145.0*	*150.0*
	% of GDP													1.2	*1.5*	*1.5*
Budget balance	% of GDP													*-3.0*	*-2.5*	*-2.0*

*) 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

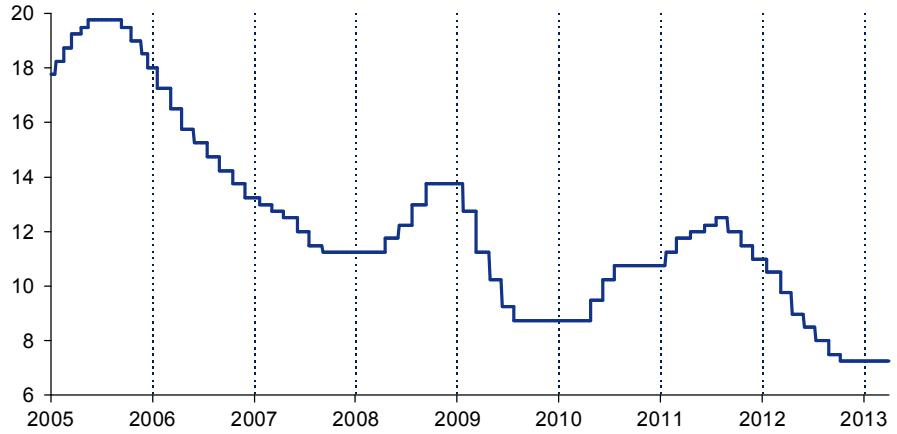
Growth in the up-and-coming economies of Asia, Latin America and eastern Europe slowed appreciably last year. All in all, the emerging markets saw their real gross domestic product increase by 4.5%, compared with average growth to the tune of more than 6% over the past ten years. The most pronounced economic slowdown has emerged in eastern Europe, a region that is clearly feeling the heat of the economic slump triggered by the sovereign debt crisis in the euro area, its main export market. In countries like Hungary and Slovenia, economic development is also feeling the strain of macroeconomic imbalances and the resulting need for consolidation. Latin America paints a very mixed picture: while Mexico, Chile and Peru are enjoying robust growth, Brazil – the region's largest economy – is wavering, with GDP growth in 2012 coming in at only 0.9%. One reason for this is doubtlessly the end of the consumer loan boom, which has been giving a substantial boost to private consumption over the past few years. Whereas at the end of 2007, private household debt equated to a fairly moderate 29% of disposable income, this figure had risen to as much as 43.5% by the end of 2012. Private consumption only rose by 3.1% in 2012, the smallest increase in ten years. Asia, too, painted anything but a homogenous economic picture in 2012. Whereas the south-east Asian economies, mainly Indonesia, the Philippines and Thailand, achieved strong growth, the GDP growth of the regional heavyweights, China and India, dropped off. India's growth rate was almost half that seen a year earlier (2012: +4.1%, compared with 7.5% in 2011) owing to a number of factors including structural problems, which put more pressure on investment activity, and weak export demand.

Current economic indicators, such as the purchasing managers' indices, suggest that growth will pick up a little on the emerging markets over the months to come. The expansionary monetary policy approach taken by many countries last year should stimulate economic development as the year progresses. The Brazilian central bank, for example, cut its key interest rate by a total of 375 basis points in 2012 to a new all-time low of 7.25%. Fiscal policy is also expected to provide growth impetus in numerous emerging markets. The economic stimulus program launched by the Chinese government last year, for example, is likely to continue bearing fruit well into this year. One of the aims of the program is to promote extensive infrastructure investments in the railways. Last but not least, those emerging markets that are heavily reliant on exports look set to reap particular benefits from the revival in global trade that is on the cards.

Chart 3

Brazil: Record low interest rates should stimulate economy

Key interest rate (Selic target rate)



Source: EcoWin.

The Asian emerging markets are expected to grow by 6.7% in 2013, a slight pick-up compared with last year, when growth came in at 6%. This is due not only to the acceleration in economic activity in China, but also to the latest reforms ushered in in India, which have helped to bring about a vast improvement in sentiment in the industrial sector. Macroeconomic activity in the region's second-largest economy is certainly likely to benefit from this. Looking ahead to 2014, we expect the Asian emerging markets to achieve GDP growth of 6.5%. Driven largely by the expected economic recovery in Brazil, growth in the Latin American emerging markets is expected to pick up from 2.7% last year to 3.6% in 2013. We predict that 2014 will bring a further acceleration, with the growth rate edging up to 4.1%. Given the zero growth forecast for the eurozone, this year's economic outlook for eastern Europe is subdued. We expect GDP to grow by 2.5% (2012: 2.1%), rising again to a more substantial 3.5% in 2014.

All in all, we expect the emerging markets to grow by 5.2% in 2013, as against 4.5% last year. We predict growth rates in a range between 5% and 5.5% for the years to come, too.

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**	**-3.8**	**2.6**	**1.4**	**1.2**	**1.1**	**2.0**
European Union	0.3	-4.3	2.1	1.6	-0.3	0.3	1.6
Euro area	0.3	-4.3	2.0	1.5	-0.5	0.0	1.5
Germany	1.1	-5.1	4.2	3.0	0.7	1.0	2.1
USA	-0.3	-3.1	2.4	1.8	2.2	1.8	2.4
Japan	-1.0	-5.5	4.7	-0.6	2.0	0.9	1.5
Emerging markets	**5.5**	**1.3**	**7.5**	**6.1**	**4.5**	**5.2**	**5.3**
Asia	6.9	5.7	9.8	7.5	6.0	6.7	6.5
Latin America	4.2	-1.8	6.1	4.2	2.7	3.6	4.1
Central and Eastern Europe	4.5	-6.2	3.4	3.9	2.1	2.5	3.5
World	**1.5**	**-2.2**	**4.2**	**2.9**	**2.3**	**2.5**	**3.2**

1) forecast.

Sources: EcoWin, own forecasts.

Overall, we estimate that global output will grow by 2.5% in 2013 (country weighting based on current exchange rates in each case). The slight acceleration in growth will be due, in particular, to slightly stronger growth in the emerging markets. In 2014, the global economy looks set to expand by 3.2% as the economy starts to improve in the industrialized nations.

In addition to the central assumption that the EMU sovereign debt crisis will continue to abate, our economic forecast also rests on the following other overall conditions:

- The global goods trading volume will show more dynamic development in 2013. Nevertheless, growth will remain well below the medium-term average of a good 6%, at between 3% and 4%. Looking ahead to next year, we expect to see a further recovery and an increase in global trade of between 5% and 6%.

- Crude oil prices (Brent) are expected to fluctuate between 100 and 120 USD/barrel during the forecast period. The price had been fluctuating at around USD 110 a barrel since mid-2012. The fact that global economic activity remains on the sluggish side tends to suggest that we will not see oil prices start to climb to any considerable degree. The risk of a drastic price hike if the geopolitical risks escalate does, however, remain.

- Monetary policy in both the US and the euro area is likely to remain very loose next year. The first corrections to the ECB's monetary policy focus could come at the end of the forecast period. The US central bank could at least reduce the volume of its securities purchases in the event of convincing evidence of an improvement on the labor market and/or adverse effects resulting from this program.

- Following the surge at the start of the year, we expect to see a USD/EUR exchange rate of just under 1.30 as this year progresses. This means that, on average, this year is unlikely to bring any changes compared with 2012 (1.29 USD/EUR). In the course

of 2014, the euro should gradually firm up and gain an average of around 2¼% against the US dollar during the year.

2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

2.1 Barren patch short-lived

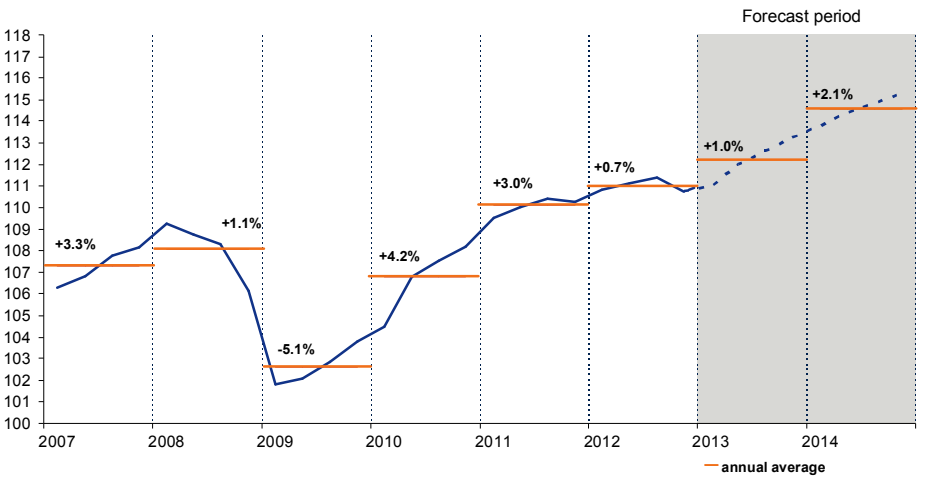
The drop in gross domestic product by no less than 0.6% at the end of 2012 has impaired the economic picture at the start of 2013. In the fourth quarter of 2012 gross domestic product was 0.3% below the 2012 annual average. This "underhang" means that, even if the economy does pick up strongly in the course of this year, (annual average) growth will be only modest.

That's the bad news, but the good news is: there are now clear signs that the economy is gathering speed. Industrial business expectations are now substantially more upbeat than a few months ago. The assessment of the current situation – more of a lagging indicator – has already perked up slightly. New orders rose appreciably in February and industrial production at the start of this year was more or less in line with its fourth quarter 2012 level. The rundown of involuntary inventories now seems to be over. The retail sector got off to an extremely good start to the year, with real sales in January and February 2.3% up on the fourth quarter average. All in all, we believe that the German economy already grew again slightly in the first quarter of 2013. We have taken into account that construction activity took a stronger hit than normal from the exceptionally severe winter. But the shortfalls will be made up again in the second and third quarters, providing an additional lift to growth.

Chart 4

German economy resumes growth

Real GDP, Index, 2005 = 100



Sources: EcoWin, own forecasts.

Domestic demand is likely to provide a positive fillip in the coming months. Alongside construction, private consumption also looks set to gather momentum. Swifter growth in labor income, ongoing job creation and declining inflation are all helping to boost real private household income. The pronounced restraint on the investment front triggered in 2012 by the debt crisis is likely to evaporate gradually. If the thaw on the financial

markets remains in place, we could actually see a strong rebound in investment demand in the course of 2013.

In 2013 exports are likely to provide a substantially stronger boost than in 2012. With the expected pickup in world trade and the ongoing healthy price competitiveness of German exporters, an appreciable rise in foreign demand is on the cards.

All told, we estimate that the German economy will grow by a good 2% in the course of 2013, giving annual average gross domestic product growth of 1.0%. Provided there are no extreme shocks, we see no reasons why the upswing should not continue in 2014 as well: Monetary policy remains expansionary overall, the pressure to consolidate in key partner countries is starting to ease, and there is still potential on the domestic demand front. For 2014 we are forecasting economic growth of 2.1%.

Germany: Economic indicators and forecasts*

		2011				2012				2013				2014							
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013f	2014f
GDP real		1.2	0.5	0.4	-0.1	0.5	0.3	0.2	-0.6	*0.2*	*0.9*	*0.6*	*0.6*	*0.5*	*0.5*	*0.4*	*0.4*	3.0	0.7	*1.0*	*2.1*
Private consumption		0.7	-0.5	1.3	-0.3	0.2	0.2	0.0	0.1	*0.3*	*0.4*	*0.3*	*0.3*	*0.5*	*0.4*	*0.4*	*0.5*	1.7	0.6	*0.9*	*1.6*
Government spending		0.1	0.6	0.2	0.5	0.6	-0.3	0.7	0.4	*0.2*	*0.2*	*0.1*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	1.0	1.4	*1.0*	*0.7*
Investment in machinery/equipment		0.9	1.1	1.6	-0.3	-1.1	-3.0	-2.2	-2.0	*1.0*	*1.5*	*1.5*	*1.5*	*2.0*	*1.5*	*1.5*	*1.5*	7.0	-4.8	*-0.3*	*6.7*
Construction		7.2	-0.4	-0.7	1.4	-0.8	-1.4	0.7	-0.1	*-1.5*	*3.5*	*0.8*	*0.5*	*0.3*	*0.4*	*0.4*	*0.4*	5.8	-1.5	*1.4*	*2.6*
Domestic demand		0.9	1.2	0.1	-0.1	-0.2	-0.4	-0.3	0.2	*0.0*	*0.8*	*0.4*	*0.4*	*0.4*	*0.3*	*0.3*	*0.5*	2.6	-0.4	*0.8*	*1.7*
Exports		2.7	0.5	2.1	-0.5	0.7	3.3	1.5	-2.0	*1.5*	*1.5*	*1.4*	*1.3*	*1.3*	*1.5*	*1.0*	*1.0*	7.8	3.7	*3.6*	*5.4*
Imports		2.3	2.2	1.7	-0.4	-0.7	2.3	0.6	-0.6	*1.2*	*1.4*	*1.3*	*1.2*	*1.3*	*1.2*	*1.0*	*1.2*	7.4	1.8	*3.5*	*5.0*
Industrial production (excl. construction)**		1.6	1.0	1.8	-1.7	-0.2	-0.2	0.8	-3.0	*1.1*	*0.9*	*1.1*	*1.5*	*1.4*	*1.0*	*1.1*	*0.9*	8.0	-0.6	*1.0*	*5.1*
Unemployment rate (EU def.)	%	6.3	6.1	5.8	5.7	5.6	5.5	5.5	5.4	*5.4*	*5.4*	*5.3*	*5.3*	*5.2*	*5.1*	*5.1*	*5.0*	6.0	5.5	*5.3*	*5.1*
Unemployment rate (nat. def.)	%	7.3	7.1	7.0	6.9	6.8	6.8	6.8	6.9	*6.9*	*6.8*	*6.8*	*6.7*	*6.7*	*6.5*	*6.5*	*6.4*	7.1	6.8	*6.8*	*6.5*
Employed persons (national def.)	y-o-y	1.5	1.4	1.3	1.4	1.4	1.2	1.1	0.8	*0.6*	*0.6*	*0.5*	*0.6*	*0.6*	*0.6*	*0.7*	*0.7*	1.4	1.1	*0.6*	*0.7*
Consumer prices	y-o-y	1.9	2.0	2.2	2.2	2.1	1.9	2.0	2.0	*1.5*	*1.6*	*1.5*	*1.5*	*1.8*	*1.9*	*2.0*	*2.1*	2.1	2.0	*1.6*	*1.9*
Consumer prices (HICP)	y-o-y	2.2	2.5	2.6	2.6	2.4	2.1	2.1	2.0	*1.8*	*1.8*	*1.8*	*1.8*	*1.8*	*1.9*	*2.0*	*2.1*	2.5	2.1	*1.8*	*2.0*
Producer prices	y-o-y	6.1	6.0	5.6	4.8	3.3	2.0	1.4	1.5	*1.4*	*1.8*	*2.1*	*2.1*	*2.0*	*2.2*	*2.4*	*2.4*	5.6	2.0	*1.8*	*2.2*
Current account balance	EUR bn	44.1	37.5	40.1	39.5	44.8	45.9	50.3	46.2	*45.0*	*44.0*	*44.0*	*45.0*	*44.0*	*43.0*	*42.0*	*42.0*	161.1	187.2	*178.0*	*171.0*
	% of GDP																	6.2	7.1	*6.5*	*6.1*
Budget balance	EUR bn																	-19.6	4.2	*8.4*	*20.7*
(Maastricht-definition)	% of GDP																	-0.8	0.2	*0.3*	*0.7*

*) 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 Export engine getting back into gear

Last year, German goods exports increased by 3.7% in real terms, outperforming global trade by almost 1½ percentage points (2012: +2.3%). The regional export structure, however, which focuses on Europe, was a drawback. As a result, this slight gain in the real share of global trade is all the more testimony to the high price competitiveness of German exporters. Based on the relative development of unit labor costs, German exporters are currently a good 20% more competitive than they were back when the euro was launched, despite the appreciation in the euro since mid-2012.

Over the past few months, companies have started to be much more optimistic in their export outlook, although this is yet to have any sustained impact on the development of incoming orders from abroad. Although these orders were up by almost 2% in Q4 2012 on the previous quarter, January of this year brought another setback (-3.6% on the average for the fourth quarter). Over the next few months, we expect the demand from the eurozone to stabilize further and to see a marked revival in demand from outside the eurozone.

Germany's exports also look set to benefit from their goods structure. Around 63% of exports come from the engineering, automotive and chemicals sectors. In the expanding emerging markets, these are goods categories that are especially likely to see rising demand.

We estimate that German exports will gain almost 6% in real terms in the course of this year, climbing by a good 3½% in 2013 on average. This means that the country's exports can likely continue to keep pace with the expansion in world trade. In 2014, we then expect to see German exports rise by almost 5½%, assuming that we are spared any marked swings in the external value of the euro.

External value of the euro and exports

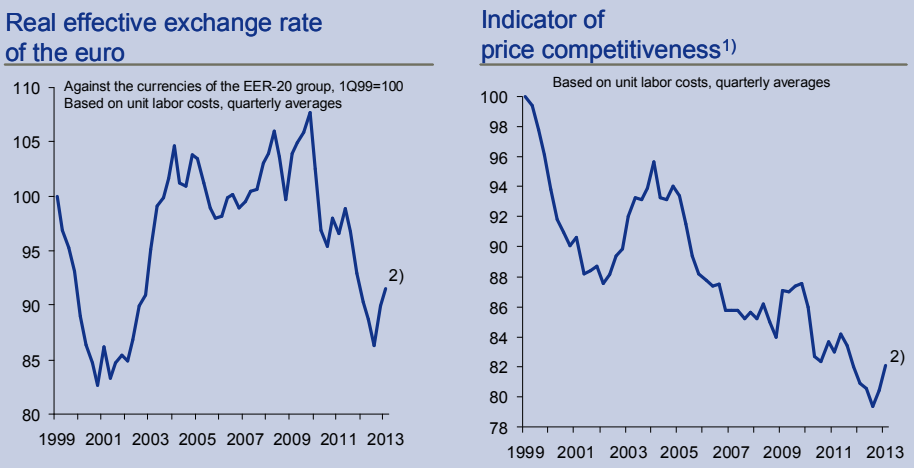
When the euro gained around 7% against the currencies of the region's main trading partners between the summer of last year and the end of January 2013, there were mounting concerns that this would slam the brakes on the export development of EMU countries and deal a further blow to the economy. Although the euro has slipped back a bit since then, it is still a good 4% up on the summer 2012 value.

So how dependent are exports on exchange rate developments and how sensitive are they to changes in price competitiveness? We have taken an econometric approach to real eurozone exports to estimate their elasticity in respect of the real effective euro exchange rate (based on unit labor costs). In addition to the exchange rate, global trade served as the second explanatory parameter in the logarithmic approach. We also estimated the elasticity of real German exports in adapting to changes in the country's price competitiveness. In this estimate, however, we have opted not to use the real exchange rate, but rather the indicator of Germany's price competitiveness (based on unit labor costs), because it reflects not only changes in the real external value of the euro, but also changes in the relative development of unit labor costs compared with eurozone partner countries, making it a more comprehensive indictor of price competitiveness.

The estimates performed for the period from Q1 2000 to Q3 2012 show that changes in price competitiveness do not – as was to be expected – leave their mark on exports with immediate effect. We arrive at the best estimates if we assume an adjustment period of five quarters for the eurozone and Germany.

As far as the euro area is concerned, we calculated a (highly significantly negative) elasticity of real exports in respect of the real effective exchange rate of 0.30. This means that every 1% increase in the real exchange rate slices a total of 0.3% off real exports after a period of five quarters. When evaluating the elasticity levels, which appear to be fairly low at first glance, it is, however, important to bear in mind that the national accounts define real eurozone exports as including trading between EMU countries, which is hardly influenced by fluctuations in the real external value, or at least not directly.

Chart 5



1) A decline means an increase in competitiveness.
2) Q4 2012 and Q1 2013 estimate.

Sources: Deutsche Bundesbank, own calculation.

For Germany, we arrive at a (highly significantly negative) elasticity of real exports in respect of the price competitiveness indictor to 0.80. This means that, within the space of five quarters, a 1% deterioration in price competitiveness shaves 0.8% off real German exports. This fairly high elasticity level does, however, have to be viewed against the backdrop of the fact that the price competitiveness indicator is generally subject to much less fluctuation than the real external value, because it only takes account of fluctuations in the real external value of the euro in line with the proportion of extra-EMU exports. The real euro exchange rate, for example, climbed by 6.7% in the period from August 2012 to February 2013, while Germany's price competitiveness indicator only edged up by 3.4%.

We have used our econometric approach to calculate forecasts for euro-area and German exports, in order to allow us to better judge the impact of the current euro exchange rate. It was assumed that global trade will grow by 4%, in real terms, in 2013 and by 5% in 2014. As far as the external value of the euro and the indicator of price competitiveness are concerned, we continued to apply these at the level seen in the first quarter of this year until the end of 2014. The results suggest fairly rosy export prospects. Based on the overall conditions set out above, eurozone exports are likely to rise by 5.7% in 2013 and by 4.1% in 2014. The expected increase in German exports comes in at 5.3% in 2013 and at 4.5% in 2014. So the current external value does not appear to be putting exports under any strain. This should not actually come as any surprise, because the external value of the euro is currently lower than it was in 2010 and 2011, and even in 2012, there were only temporary blips when the external value dipped to below the level seen at present.

It is important to point out that our export forecast is slightly lower than the forecast produced by following the econometric approach, because export development is likely to lag behind global trade growth due to the regional external trade structure of the EMU countries.

Imports, which increased by a meager 1.8% last year in real terms, are likely to pick up speed again in 2013, growing by 3.5% on the back of an improved domestic economy. In 2014, the growth rate could climb to as high as 5%. This means that export and import volumes will more or less keep pace with each other in 2013 and 2014. Since we do not expect to see any major shifts in the terms-of-trade (the relationship between export and

import prices) either, the foreign trade surplus should continue to linger at its high level in the main, or even drop again slightly. We expect to see a current account surplus of 6.5% of GDP in 2013 and 6.1% in 2014 compared with 7.1% last year.

2.3 Private consumption on a moderate upward trend

Last year, private consumption rose by only 0.6% in real terms, compared with an increase of 1.7% in 2011. This is largely because disposable incomes climbed by only 2.2% in 2012 as opposed to by 3.2% in 2011. With an average inflation rate of 2.0%, 2012 brought only very slight growth in real income as a result.

This year, the outlook for rising real incomes has improved a little again. Inflation is expected to be slightly lower than it was last year, at 1.7%. As far as disposable income is concerned, we expect to see an increase of 2.6%, slightly ahead of 2012. In 2014, the growth in disposable income could climb to as high as 3.5%, laying the foundation for a marked revival in consumer demand.

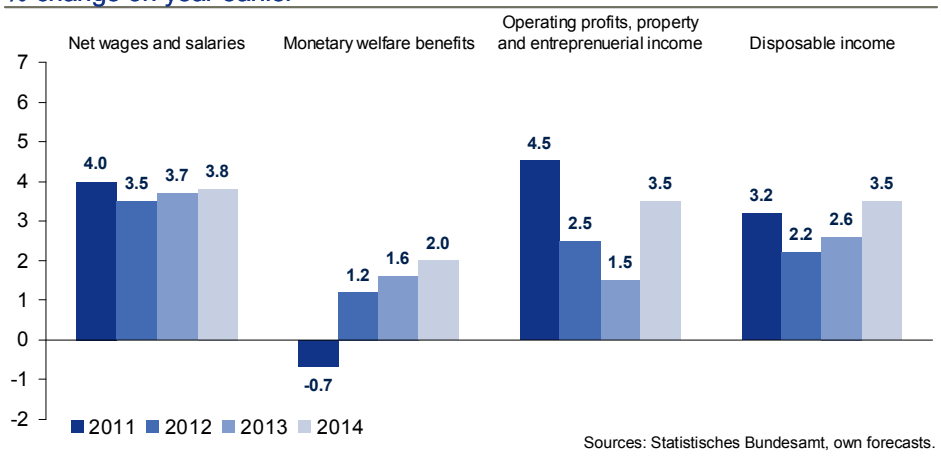
Actual earnings per employee, which rose by 2.7% in 2012, are likely to grow by more than 3% this year. Despite lower employment growth than in 2012, total net income from employment is expected to slightly outperform the rate of growth seen in 2012 (+3.5%) at 3.7% in 2013 – bolstered by the cut in pension insurance contributions and the modicum of wage tax relief.

The increase in income from employment is expected to pick up even more speed next year, with net growth of almost 4% on the cards in 2014.

Chart 6

Stable increase in private household income

% change on year earlier



Sources: Statistisches Bundesamt, own forecasts.

As far as monetary social benefits, such as pension and unemployment benefit, are concerned, we expect to see growth of 1.6% in 2013 and 2.0% in 2014 after an increase of only 1.2% last year. Property and entrepreneurial income, which fell in 2012, due in particular to economic factors, is likely to chart an increase of only 1.5% in 2013. We predict growth of 3.5% next year.

The outlook of higher income growth and lower inflation in 2013 compared with 2012 will promote a more favorable development in the real incomes of private households. After the minimal increase in real incomes of 0.2% in 2012, we expect to see growth of

0.9% in 2013. With disposable incomes set to rise by 3.5% and an inflation rate of 2.0%, the increase in real incomes in 2014 is likely to accelerate further to 1.5%. Since we do not expect to see any notable change in the savings rate (2012: 10.3%), we expect to see stronger consumer demand in line with real income development. In real terms, private consumption is likely to increase by 0.9% in 2013 and by 1.6% in 2014, compared with 0.6% last year.

2.4 Investment emerging from the trough

Gross investment (including inventory investment) contracted considerably last year in terms of volume, slipping by 5.4%. They are the only component on the expenditure side of gross domestic product that has yet to bounce back to the level seen before the economic crisis of 2008/2009.

Most recently, the downward trend was particularly pronounced for equipment investment, which was down by no less than 9.3% year-on-year in Q4 2013. At 6.4%, equipment investment, expressed as a proportion of GDP, has fallen back close to the low level seen in late 2009 (6.3%). This slump in equipment investment comes as something of a mystery in an environment characterized by very favorable financing conditions, fairly solid earnings and only a moderate drop in capacity utilization. It would appear that the uncertainty surrounding the economic outlook sparked by the debt crisis has prompted companies to be extremely reluctant to invest.

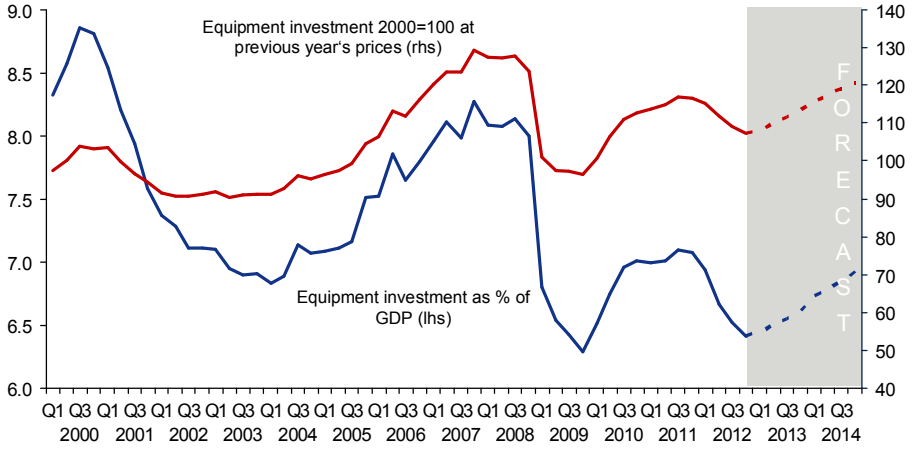
Now that the tension surrounding the debt crisis has eased considerably, we feel that the recovery in investment demand should be on the agenda this year. The recovery will certainly not be hindered by the financing options and conditions. In the course of 2013, we expect to see equipment investment rise by 5 to 6%, which does, however, still entail a slight drop of 0.3% over 2013 on average. 2014 is expected to bring growth on a scale of between 6½ and 7% – provided that the sovereign debt crisis continues to abate.

Although construction investment dipped slightly last year (-1.5%), the outlook for the construction industry remains positive. The main reason behind the negative growth in construction activity in 2012 was the expiry of the economic stimulus programs, sending public-sector construction south by 11%.

After two years of robust growth, the residential construction segment edged up only slightly in 2012, with real growth of 0.9%. The chances of a marked increase in 2013, however, are looking good. The number of residential construction permits issued has risen again and incoming orders in the residential construction segment have continued to climb. Favorable financing conditions, the need for residential space created by immigration to Germany and the prospect of rising property values should ensure that the residential construction segment remains on an upward trajectory even beyond 2013. We expect to see residential construction investment grow by 2.5% in both 2013 and 2014.

Chart 7

Germany: Investment ratio very low



Sources: Statistisches Bundesamt, own forecasts.

Commercial construction investment, which fell by 1.8% last year, is predicted to stagnate, at best, in 2013. The demand for expansion investments is currently too low in view of the drop in capacity utilization, although this is likely to change looking ahead to 2014. A return to a higher capacity utilization rate and more buoyant investment demand in general should set the stage for moderate growth in commercial construction investment (to the tune of 2-3%) again in 2014.

Public-sector construction is expected to develop in tandem with commercial construction. Following stagnation this year, we expect to see growth of 2-3% in 2014. Municipalities should see their financial situation gradually start to become more comfortable, which should prompt a slight revival in municipal investment activity. The need for public-sector infrastructure investment is fairly considerable anyhow.

All in all, construction investment looks poised to rise by 1.4% this year and 2.6% next year. So given the moderate pace of growth, we do not believe that the construction segment is at risk of overheating.

2.5 Moderate inflation

Fears of galloping inflation on the back of the ECB's expansionary monetary policy have proven to be unfounded so far. In February and March 2013, consumer prices were up by 1.5% and 1.4% on the previous year respectively. So given that the inflation rate was still sitting at 2.1% in December 2012, this is testimony to waning inflationary pressure. The greatest inflationary impetus is currently coming from food and drink (March 2013: +3.7%, February 2013: 3.1%). The upward trend in energy prices, on the other hand, has flattened out considerably (March 2013: +0.5%).

Import prices are now helping to keep a lid on inflation (January 2013: -0.8%, February 2013: -1.6% on a year earlier). The import price index has been down on the prior-year level since the start of 2013, doubtlessly aided by the increase in the external value of the euro in the second half of 2012.

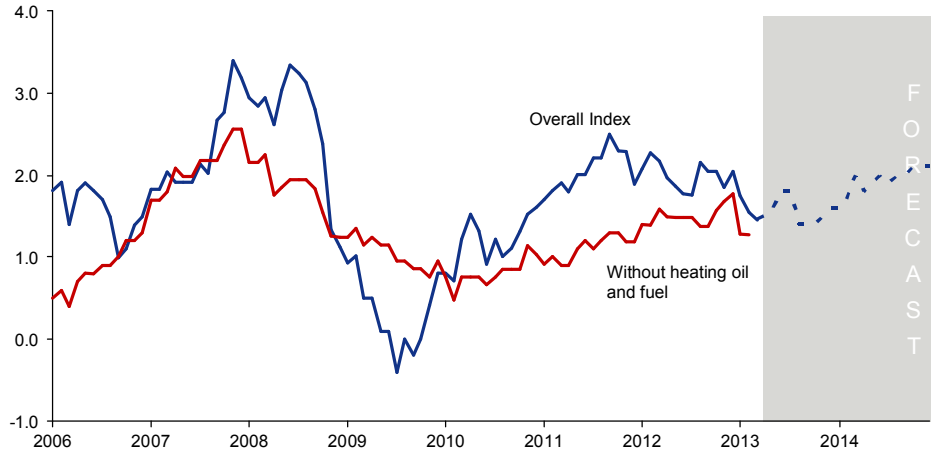
Energy prices, which have a major impact on the development of the import price index, fell in February 2013 by 4.8% in a year-on-year comparison. The prices of commodities and primary products were also headed south (iron ore: -15.7%, hard coal: -14.9%). The question as to how import prices will develop in the future depends to a considerable

degree on the global economy and the external value of the euro. Although the euro recently lost further ground, we do not expect to see any massive exchange rate shifts and expect the moderate upturn in global economic activity to keep any significant external inflationary impetus at bay.

Chart 8

Germany: Inflation set to remain subdued

% change on previous year



Sources: Statistisches Bundesamt, own forecasts.

Out of the domestic economy price determination factors, the development in unit labor costs plays an important role. Unit labor costs moved up by 2.8% last year. In 2013, we predict that labor income will grow by 3.4% and real GDP by 1.0%. This means that at 2.4%, the increase in unit labor costs will be slightly less pronounced than in 2012. Although growth in labor income looks set to step up a gear again (2014: +4.0%), unit labor costs are expected to grow by only just under 2% in 2014 thanks to strong economic growth (+2.1%).

On average, we expect 2013 to bring an inflation rate of only 1.6% thanks to external effects that will put a damper on prices. The rate of inflation is expected to stand at 1.9% next year.

2.6 Ongoing job creation

Despite the decline in gross domestic product in the fourth quarter of last year employment rose further at the end of 2012 and in early 2013. Taking January and February of this year together, the increase was no less than 74,000.

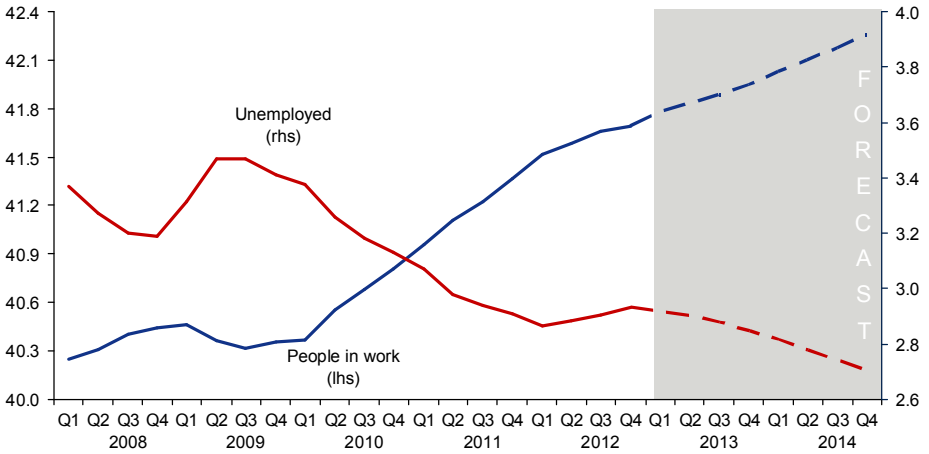
The number of people in work (unadjusted) stood at 41.40 million in February 2013, an increase of 282,000 (+0.7%) on a year earlier. Most recently (January 2013)the number of people in work liable to social insurance stood 395,000 up on a year earlier (+1.4%), whereas the number of people employed exclusively in the low-wage sector fell by 31,000 (-0.6%).

Looking at the individual sectors, January 2013 brought particularly strong y-o-y growth in business services (+168,000), the manufacturing industry (+59,000) and in the healthcare and social services (+95,000) sectors, while the temporary employment segment reported a negative trend (-61,000).

Chart 9

Germany: Workforce and unemployed

Millions



Sources: EcoWin, own forecasts.

In a year-on-year comparison, the number of people out of work in March of this year rose by 2% to 3.098 million. While the risk of becoming unemployed remains relatively low, the opportunities available for getting off the dole by finding employment are no longer looking quite as good. This trend is also reflected in the BA-X. The German Employment Agency's labor market index (BA-X) slipped back to 157 points in February, putting it 17 points down on the prior-year level (174 points). It is understandable that companies are being slightly more restrained with their new hires in light of the ongoing economic uncertainty. What is more, the strong job creation trend seen in recent years will likely curb any need for additional employees. Having said that, the BA-X is still at a relatively high level.

The combination of a rise in the number of people in work and a slight increase in unemployment is due primarily to the strong immigration to Germany. According to an estimate by the German Federal Statistics Office, the number of people coming to Germany in 2012 outstripped the number of people emigrating by at least 340,000. This is compounded by the fact that labor force participation among older employees is currently increasing considerably.

Given the upbeat leading indicators, we are likely to see a stronger pickup on the labor market in the course of 2013. As a result, we expect the jobless total to fall slightly in the course of 2013 and 2014. In 2013 as a whole the average number of people out of work is likely to remain practically unchanged at 2.90 million and drop to 2.77 million in 2014. The average number of people in work will probably rise by 0.6% to 41.86 million in 2013 and by 0.7% to 42.14 million in 2014. This would mean that within the space of five years – since 2009 – employment will have risen by around 1.75 million.

2.7 Continued budget surplus

The total government budget, which recorded a surplus (EUR 4.2bn) in 2012 for the first since 2007, is likely to remain in the black in 2013 and 2014, too. We expect 2013 to bring a surplus of a good EUR 8bn (0.3% of GDP), rising to as much as almost EUR 21bn in 2014 (0.7% of GDP). These surpluses are likely to push the debt ratio, which was still sitting at 81.6% of GDP in 2012, down quickly to below the 80% mark.

In 2013, growth in government revenue is likely to be far less pronounced than in 2012, at 2.3% compared with 3.4%. This is largely attributable to the marked reduction in the contribution rate to the statutory pension insurance system, which has been lowered from 19.6% to 18.9%. Despite a slight increase in the basic tax allowance, income tax is likely to continue to increase at an above-average rate due to the expected further acceleration in labor income growth.

Looking ahead to next year, we expect government revenue growth to speed up a bit again to 3.2%, supported in particular by stronger economic growth. So the conditions on the revenue side are conducive to a stable development in government finances.

Germany: Public-sector revenue and expenditure

in EUR bn	2010	2011	2012	2013	2014
Revenue	1087.4	1154.9	1194.1	1221.9	1260.5
of which:					
Taxes	548.8	589.5	618.7	637.2	659.5
Social contributions	421.1	436.9	448.7	455.4	469.1
Expenditure	1191.0	1174.5	1189.9	1213.5	1239.8
of which:					
Inputs	120.9	126.4	130.6	133.8	137.9
Employee compensation	195.3	199.7	203.2	208.3	214.5
Property income payable (interest)	63.4	65.9	65.0	63.4	62.7
Subsidies	27.9	26.9	23.7	23.7	23.7
Monetary welfare benefits	429.6	425.4	430.5	437.4	446.2
Welfare benefits-in-kind	203.3	207.8	214.4	220.8	225.2
Other current transfers	54.1	53.8	56.2	57.9	59.6
Gross investment	41.9	42.7	39.5	40.3	41.5
Financial balance	-103.6	-19.6	4.2	8.4	20.7
memorandum:					
State spending ratio[1)]	47.7%	45.3%	45.3%	45.0%	44.1%
Financial balance[1)]	-4.1%	-0.8%	-0.8%	0.2%	0.7%

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

Sources: Statistisches Bundesamt, own forecasts.

We do, however, expect the government to exercise slightly less spending discipline in 2013 and 2014 than it has over the past two years. After spending was cut by 1.4% in 2011 and increased only moderately by 1.3% in 2012, we expect spending to be upped by 2.0% in 2013 and by 2.2% in 2014. Lower interest expenditure in both years should put a damper on this. The higher salaries agreed by the collective bargaining parties in the public sector compared with previous years, however, means that more is likely to be spent on employee salaries. The same applies to monetary social benefits. For the time being, spending on unemployment benefits is not falling any further. Pension insurance spending growth is likely to accelerate slightly.

Despite the slightly faster spending growth, the government spending ratio, which fell from 48.2% of GDP in 2009 to 45.0% in 2012, is likely to continue on a downward trend. We expect to see a ratio of 44.6% in 2013 and 44.1% in 2014.

2.8 The productivity enigma

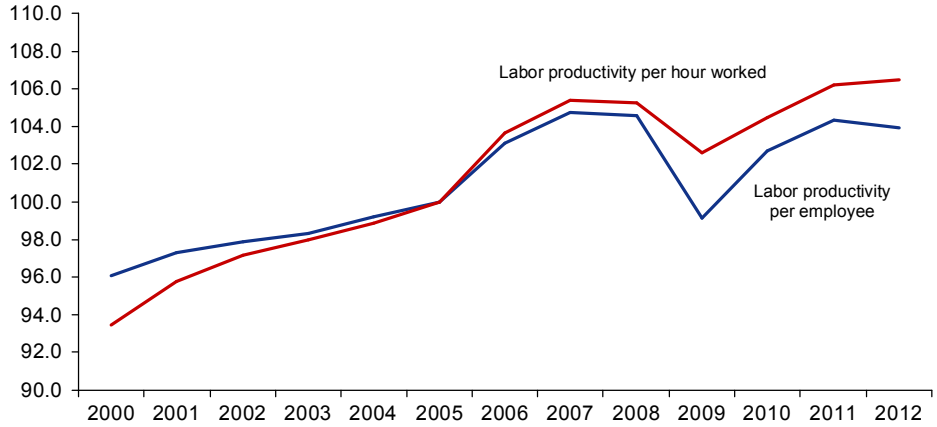
The number of people in work in Germany continued to rise in the fourth quarter of last year, despite the fact that both capacity utilization and gross domestic product were on the decline. Labor productivity per person in work at the end of 2012, for example, was 0.7% lower than at the end of 2011. Falling labor productivity rates are more the rule than the exception in times of an economic slump, but it is unusual to see a rise in employment at the same time.

The labor productivity trend is all the more striking if we look back several years. Within the five years between 2007 and 2012, productivity per person in work dropped by 0.8%. A glance at productivity per hour worked does not reveal a much better picture either. Hourly productivity in 2012 was only 1.0% higher than in 2007; this translates into an average annual increase of only 0.2%.

Chart 10

Germany: Labor productivity per employee and per hour worked

2005=100



Source: Deutsche Bundesbank.

A look at the individual sectors of the economy reveals that the poor productivity development in the German economy is a very broad-based phenomenon. In 2012, hourly productivity in the manufacturing industry, the construction sector, business services and agriculture and forestry was lower than it was five years ago, while in other sectors, such as real estate and other service providers, the rate was only marginally higher than in 2007.

The low productivity growth seen in 2012 as against 2007 is unlikely to be due to any vast differences in the overall capacity utilization rate between the two years. Although 2007 was a good year for the economy, the overall capacity utilization rate is unlikely to have been below average to any considerable degree in 2012 either. We believe that one possible explanation for the weak productivity trend is the sluggish investment behavior seen in recent years. In relation to gross domestic product, equipment investment has been at a relatively low level for years now. It is also possible that the low-wage sector has become much larger, pushing average labor productivity rates down. This is, however,

unlikely to explain the trend over the past two years, when the increase in employment subject to social security contributions significantly outpaced the increase in the number of individuals exclusively in marginal employment. Labor productivity development could also have been influenced by the fact that wage restraint made the use of labor in relation to capital more attractive, and could even have made higher production levels profitable without any clear increase in total labor income. If the latter holds true, there is a good chance that employee compensation will start to show a more pronounced increase and that labor income growth will start to accelerate in the future.

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

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The statements contained herein may include prospects, 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. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events) (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the Euro/U.S. Dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.