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Economic forecast 2014/2015

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1. GLOBAL ECONOMIC SITUATION AND OUTLOOK

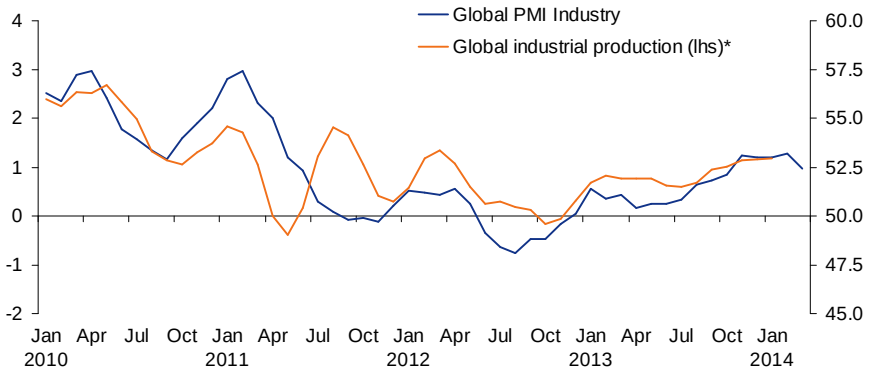
The global economy regained some momentum in the course of 2013. One of the areas where this trend left its mark was industrial production, which showed annualized growth of 3.6% compared with the previous 6-month period in the months from July to December. In the period between January and June, industrial production expanded by only 2.4%. The slightly more dynamic development in the second half of the year was thanks primarily to the advanced economies. Looking at 2013 on average, total industrial production rose by 2.3%. Global output also rose by 2.3% in the same period – the lowest rate of growth seen since the major recession of 2009, not least due to the weak start to the year.

Overall, however, there is a good chance that the economic recovery that had started to emerge in 2013 will continue. Despite slipping back slightly in March, the purchasing managers' index for the manufacturing industry is still well above the 50-point expansion threshold. Readings above the threshold point towards an expansion in economic activity. The data on industrial production in January 2014 suggest that the year got off to a good start, with global industrial production up by 0.2% in a month-on-month comparison. The industrialized nations achieved fairly substantial growth to the tune of 0.5% – quite a feat given the weather-induced slump of 0.8% in the US. Meanwhile, industrial production in the emerging markets stagnated.

Chart 1

PMI signals ongoing rise in output

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.

Nonetheless, 2013 is not likely to be a picnic either, as the past few weeks and months have already shown. Example 1: The turbulence that hit numerous emerging market currencies at the end of January. We do not, however, believe that this turbulence heralds any sustained growth slowdown in the group of up-and-coming economies as a whole. Rather, they reflect the fact that investors on the international financial markets are starting to prepare for a gradual normalization in monetary policy. This means that in the future, less capital is likely to be headed in the direction of the emerging markets than in the past. This change of tack on the part of investors will naturally hit countries who rely heavily on the inflow of foreign capital due to high current account deficits and/or a substantial volume of liabilities denominated in foreign currencies particularly hard. So it comes as no surprise that the currencies of countries like Turkey, South Africa and Russia rank among the biggest losers of the recent turbulence. Example 2: The

annexation of Crimea and the tension with Russia. Whereas the most recent currency fluctuations on the emerging markets have not had, and presumably will not have, any real impact on our economic forecast for this year, it could be rather a different story if the conflict between Ukraine and Russia escalates further. At the moment, however, we do not expect the conflict to spread to other parts of Ukraine, despite the increasing integration of Crimea into Russian Federation territory. In particular, we do not expect Russia to take any targeted action to destabilize the eastern parts of Ukraine. In this base scenario, any impact on the economy, and in particular on the European economy, should be kept to a minimum. If, however, the EU responds to a further escalation of the crisis by imposing far-reaching economic sanctions, such as export bans or restrictions on energy imports from Russia, a move that would likely provoke corresponding counter-sanctions imposed by Russia, this could bring the economic recovery in the eurozone – which remains fragile – to a halt, at least temporarily.

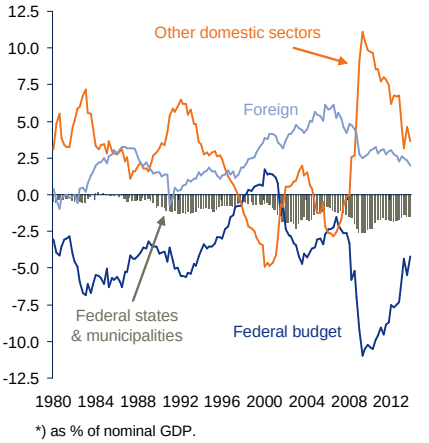
In detail, our assessment of the economic prospects for individual regions and countries is as follows:

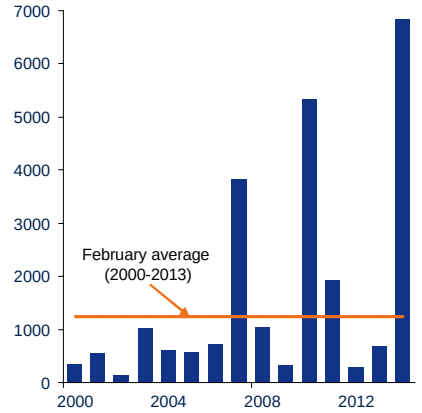
USA

Despite the tight hold on the fiscal policy reins, the US economy grew by 1.9% in 2013. Private consumption proved astoundingly stable, helped by the fact that private households attempted to cushion the blow of increases in taxes and levies largely by cutting their savings rate was another key trend. Supported by increased inventory replenishment and solid export development, growth moved up a gear in the second half of 2013 to an annualized rate of more than 3%.

The US economy has, however, made a somewhat rocky start to 2014. Movements in economic indicators were anything but consistent, suggesting, on the whole, that the economy lost momentum in the first two months of this year. Much of this fragility, however, would appear to be due to the unusually cold winter and its disruptive effect on production. Supply-side indicators seem to support this theory. The number of people in work who had to cut their working hours due to the bad weather, for example, was up considerably on the historical average in December and February. Due to a drop in the weekly working hours per employee, the volume of labor in January/February was 0.2% lower than in Q4 2013. Catch-up effects in production as the weather situation starts to normalize should result in above-trend production growth over the coming months.

Chart 2





Sources: EcoWin, Bureau of Labor Statistics.

The main factor supporting more positive fundamental economic momentum in general this year is the direction in which fiscal policy is headed. Fiscal policy measures are likely to put far less of a damper on growth (less than 0.5 percentage points) than they did last year (around 1.5 percentage points). What is more, we do not expect to see any more acute budget policy clashes for the time being now that Congress has agreed on the federal budget for the entire fiscal year, waving through an increase in the government debt ceiling until March 2015. Less fiscal policy uncertainty should make companies keener to invest. 4½ years on since the end of the recession, non-financial corporations still had considerable scope for making investments out of their own pockets at the end of 2013. It is rare to see financing surpluses over such a prolonged period in a historical comparison.

Household balance sheets also improved further in the course of 2013. The ratio of credit market debt to net assets fell again and closed 2013 very close to the average level seen in the 1990s. All in all, the negative impact that the deleveraging has been having on consumption and economic activity should become less and less significant. At the same time, there is still real potential for strong growth in the residential construction segment. Residential construction investment in 2013 corresponded to only 3.1% of gross domestic product, still well down on the longer-term average of around 4½%. The number of new households formed – the main factor determining the longer-term demand for residential property – is likely to return to normal as the labor market continues to strengthen. Within this context, it is encouraging to see that the burden placed on the financial sector by loan defaults and payment delays has gradually abated. This development has prompted banks to relax their mortgage lending standards ever so slightly on the whole over the last few quarters, although the lending terms admittedly remain much more stringent than before the financial crisis. A further relaxation in lending standards, particularly for first-time buyers, would promote more dynamic construction activity. Finally, external trade could also make a positive contribution to growth this year, especially with higher domestic oil production likely to keep a muzzle on import growth.

All in all, we expect to see economic growth of 2.9% this year and 2.6% next year.

Euro area

The EMU sentiment indicators have been on a clear upward trajectory for months now and investor confidence is starting to return. Headlines like "Spain and Italy as safe havens" are testimony to this. And sure enough, the yield spreads of the problem countries have narrowed dramatically of late compared with ten-year German government bonds. Although they have not retreated to the levels seen prior to the euro debt crisis, the yields on ten-year government bonds from Ireland, Italy, Portugal and Spain are now below, or close to, the levels seen in early 2010. And it is not just government issues that are selling like hot cakes; banks and non-financials in the problem countries are also starting to make a comeback with more issues on the capital markets.

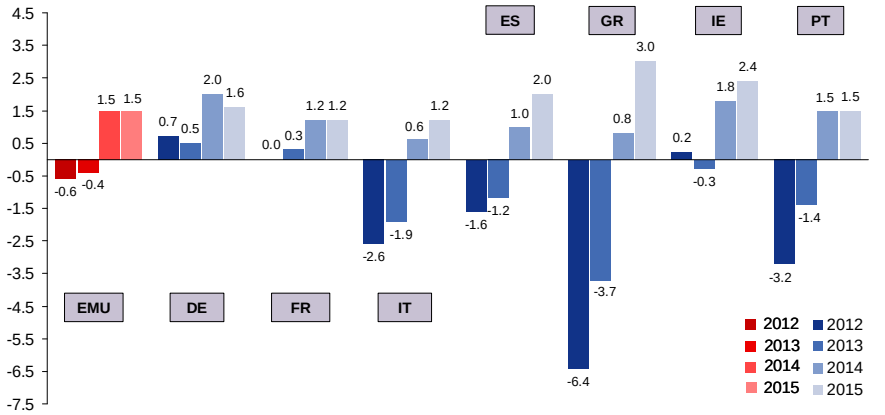
The chances of a sustained economic recovery and a long-term return to calmer financial markets, in the aftermath of the crisis, are looking good. We can nevertheless make out three main risks lurking on the horizon: first, tension could rear its head within the banking system again as a result of the Asset Quality Review and the stress tests. Second, with the European elections as a potential trigger, the commitment to integration could well wane, i.e. we could see a renationalization of politics (as in a way of thinking and acting that is more strongly governed by national interests/is more populist). Third, there is the risk that, as the pressures of the crisis subside or also as a result of political instability, the EMU countries could start making less of an effort with the necessary budget consolidation and with the required structural reforms.

In our base scenario, we expect GDP growth of 1.5% in the euro area for this year and next, with EMU economic growth becoming more geographically balanced. We do not foresee core countries such as France, Italy or the Netherlands turning into Europe's new problem children; rather, they are likely to benefit from the general economic improvement in the EMU. The countries on the continent's periphery, which are emerging from the depths of the crisis, should all report positive economic growth this year, in all likelihood outperforming the EMU average in some cases, particularly in 2015.

Chart 3

Eurozone: Rising output in 2014 and 2015

Real GDP growth (%)



Sources: Eurostat, own forecasts.

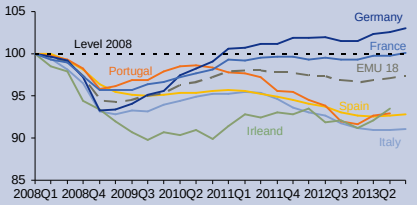
Current indicators suggest that the eurozone could report GDP growth of 0.5% for the first quarter of 2014 (following 0.3% in the closing quarter of 2013). In the first quarter, the purchasing manager's index for the service and industrial sector combined stood at 53.1 points, much higher than in the closing quarter of 2013. The European Commission's economic sentiment index climbed above its long-term average of 100 points in December, moving even higher to 102.4 points in March. Investment development over the coming quarters will play a decisive role in determining the quality of the economic recovery in the euro area.

Are investments in the eurozone making a comeback?

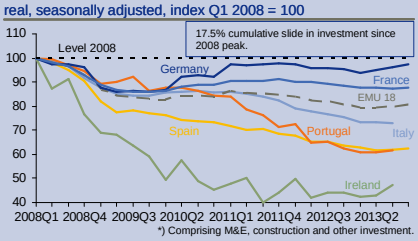
The EMU economic recovery is not only becoming broader-based in geographical terms. As the year progresses, economic growth is also likely to enjoy increasing support from economic forces from within the eurozone itself.

The financial crisis and the European debt crisis sent investment activity in the eurozone nose-diving – compared to the high reached in the first quarter of 2008, the volume of gross capital investment slid by more than 17% in cumulative terms. This downward trend explains much of the reduced economic output seen in the euro area since 2008. This is because, although investment demand accounts for a much smaller proportion of overall demand than private consumption does (investment ratio of 18% vs. consumption ratio of 56%), it makes a key contribution to economic fluctuations.

EMU: Moderate recovery, but 2008 GDP level still not reached
Gross domestic product
real, seasonally adjusted, index Q1 2008 = 100

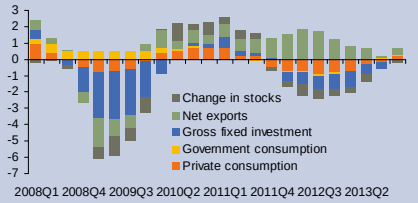


EMU: Investment activity still well below pre-crisis level
Gross fixed investment*
real, seasonally adjusted, index Q1 2008 = 100

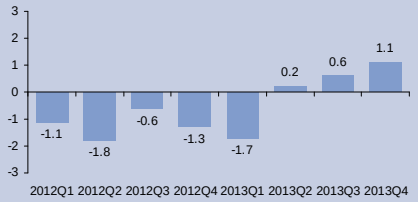


*) Comprising M&E, construction and other investment.

EMU: Slide in investment behind bulk of drop in GDP since 2008
Real GDP: Contribution to growth in percentage points



EMU: Appreciable pickup in investment of late
Gross fixed investment
real, seasonally adjusted, % change on previous quarter



Sources: Eurostat, own calculations.

Looking at the individual sectors, the corporate sector and private households have been particularly keen to cut their investment activity.[1] This waning propensity to invest is likely due to widespread uncertainty, weak earnings development in the corporate sector, underutilized capacities, restrictive financing conditions and, last

[1] See ECB monthly report for January 2014, pp. 49 et seq.

but not least, the need to cut debt levels in the private sector. The need for consolidation limited the financial leeway for investments in the public sector, too.

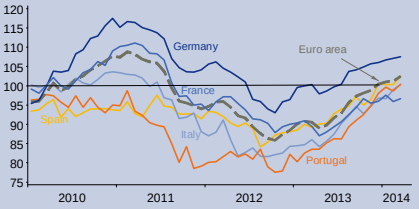
In the crisis-ridden EMU countries of Spain, Portugal and, in particular, Ireland, gross capital investment has fallen by more than 30% since the first quarter of 2008, a development that has come hand-in-hand with a marked slump in macroeconomic investment ratios. The ratio of gross capital investment to GDP in Ireland has almost halved over this period (end of 2012: 13%). A glance at the gross capital investment components – equipment investment, construction investment and other investment – shows that this development is not merely of a cyclical nature, but is also the result of structural adjustments designed to guide these countries back to the path to balanced growth. Residential construction investment in Spain, for example, has halved since 2008, when excessive construction activity was the order of the day.

By contrast, investment activity in Germany and France has been less volatile than in the (former) program countries. Nonetheless: even in the EMU's two largest economies, the investment level is still down by almost 7% and 13% on the pre-crisis level respectively, whereas GDP levels have since exceeded, or at least bounced back, to the 2008 level.

It would appear that investment activity in the eurozone reached its absolute low point in the first half of 2013 – in the fourth quarter of 2013, gross capital investment was actually up considerably by 1.1% in a quarter-on-quarter comparison. So will investment activity in the euro area continue on the recently plotted path to recovery? The overall conditions for an investment comeback, as a driving force behind growth, are favorable.

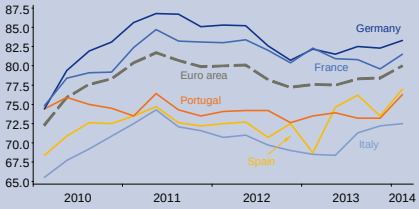
EMU: Improved backdrop for investment

Confidence rising
Economic Sentiment Indicator*)



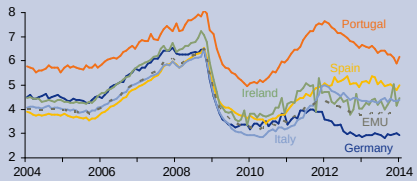
*) The EU Commission's Economic Sentiment Indicator (ESI) is a composite indicator comprising confidence indicators of individual business sectors and consumers. Source: EcoWin.

Capacity utilization turning the corner
Industrial capacity utilization



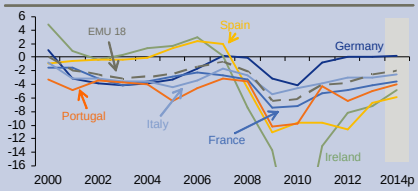
Source: EcoWin.

Financial market fragmentation easing
Interest rates for new business with non-fin corporations*



*) Loans up to EUR 1m, variable or with initial fixed rate up to 1 year. Source: ECB.

More leeway for public-sector investment
Public sector financial balance, as % of GDP



Sources: Eurostat, own forecasts.

Investment projects that were shelved in the past are likely to be addressed again as the sense of uncertainty among private economic players continues to wear off, capacity utilization levels rise and unit sales prospects in the corporate sector start to look brighter. The improvement in corporate financing conditions, thanks to the gradual decline in segmentation on the financial markets, is another factor supporting the theory of stronger growth in corporate investment, in particular.

Measures have been taken at EU level to make it easier for small and medium-sized companies, in particular, to access funding. In addition, what is likely to be less need for consolidation will translate into more budgetary leeway for public-sector investments.

Despite the "catch-up effects", however, gross capital investment in the eurozone is only expected to grow at a moderate pace, because burdens such as lending restrictions and the need for balance sheet adjustments in the private and public sector will not disappear overnight.[2] We expect fixed capital investment to increase by 2.7% in 2014 and by 3.0% in 2015 (2013: -2.8%).

All in all, we are confident that the consolidation and reform efforts in the peripheral countries will bear fruit. But with our forecast of 1.5% GDP growth in the euro area, what lies ahead is not so much a dramatic economic upswing, but rather "only" a moderate economic recovery. There is still a long way to go before the EMU countries can achieve healthy, unhindered growth, first because restructuring state finances will be a long and drawn-out process. Second, debt reduction in the private sector will take years. Third, many EMU countries will have some time to wait before acceptable conditions prevail on their labor markets again. The fact that the unemployment rate in the eurozone has stabilized and is on the decline in some of the problem countries provides a beacon of hope – as does the fact that the employment level in the EMU was up ever so slightly in Q4 2013 for the first time in ages, rising by 0.1% q-o-q (the fact that employment in Ireland and Portugal was recently up by 3.2% and 0.5% y-o-y respectively, although the eurozone employment figure was still down by 0.5% on Q4 2013, is particularly encouraging).

Given the discussion about the risks of deflation, the ECB currently appears ready to act in terms of further easing, with regard to both key rates and unconventional measures,. Looking at 2014 and 2015, average inflation in the EMU countries is likely to come in at 0.9% and 1.5% respectively. The drop in inflation rates is buoying private consumption thanks to a rise in real disposable household income. We do not see any deflation risks in individual EMU countries despite the drop in prices, as the downward trend can be explained by necessary cost and price adjustments. What is more, the economic sentiment is improving in these countries, too. Given the economic situation and outlook, we believe that a further key rate cut is neither necessary nor likely. We expect the ECB's key interest rate to remain unchanged at 0.25% until at least the end of this year. Further liquidity assistance, on the other hand, is necessary, because the interbank market is not functioning properly, the residual term of the three-year tenders is now less than one year and it is vital to ensure that the AQR/stress tests do not plant any seeds of doubt regarding the solidity of the banking system and state finances (the ECB has promised to continue with the unlimited supply of liquidity for refinancing operations until mid-2015).

[2] See also Allianz Euro Monitor 2013, https://www.allianz.com/v_1392371045000/media/economic_research/publications/working_papers/de/EUROMONITOR2013d.pdf, pp. 22 et seq. and 37 et seq.

Euro area: Economic indicators and forecasts*

		2013				2014				2015						
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2013	2014f	2015f
GDP real		-0.2	0.3	0.1	0.2	*0.6*	*0.4*	*0.4*	*0.4*	*0.4*	*0.3*	*0.3*	*0.3*	-0.4	*1.5*	*1.5*
Private consumption		-0.1	0.2	0.1	0.1	*0.2*	*0.2*	*0.3*	*0.3*	*0.4*	*0.3*	*0.2*	*0.2*	-0.5	*0.8*	*1.2*
Government spending		0.3	0.0	0.4	-0.2	*0.2*	*0.2*	*0.1*	*0.1*	*0.2*	*0.3*	*0.2*	*0.3*	0.3	*0.4*	*0.8*
Investment		-1.7	0.2	0.6	1.1	*0.5*	*0.7*	*0.6*	*0.6*	*0.9*	*0.8*	*0.6*	*0.6*	-2.8	*2.7*	*3.0*
Exports		-0.9	2.3	0.0	1.2	*1.0*	*1.2*	*1.3*	*1.0*	*1.2*	*1.0*	*0.9*	*0.8*	1.3	*4.3*	*4.3*
Imports		-1.1	1.7	1.0	0.4	*1.0*	*1.0*	*1.1*	*1.0*	*1.2*	*1.3*	*0.9*	*0.9*	0.1	*3.8*	*4.5*
Industrial production (excl. construction)		0.3	0.7	0.0	0.5	*0.5*	*0.7*	*0.6*	*0.6*	*0.9*	*0.8*	*0.7*	*0.7*	-0.7	*2.0*	*3.0*
Unemployment rate	%	12.0	12.0	12.0	11.9	*11.9*	*11.8*	*11.7*	*11.5*	*11.4*	*11.2*	*11.1*	*11.0*	12.0	*11.7*	*11.2*
Consumer prices	y-o-y	1.9	1.4	1.3	0.8	0.7	*0.8*	*0.9*	*1.4*	*1.5*	*1.7*	*1.5*	*1.5*	1.4	*0.9*	*1.5*
Producer prices	y-o-y	1.2	-0.1	-0.6	-1.1	*-1.5*	*-0.2*	*0.2*	*1.1*	*1.8*	*1.8*	*1.8*	*1.9*	-0.2	*-0.1*	*1.8*
Current account balance	EUR bn, sa	47.9	56.8	46.2	63.4	*65.0*	*60.0*	*55.0*	*55.0*	*60.0*	*60.0*	*60.0*	*60.0*	214.3	*235.0*	*240.0*
	% of GDP													2.2	*2.4*	*2.4*
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.

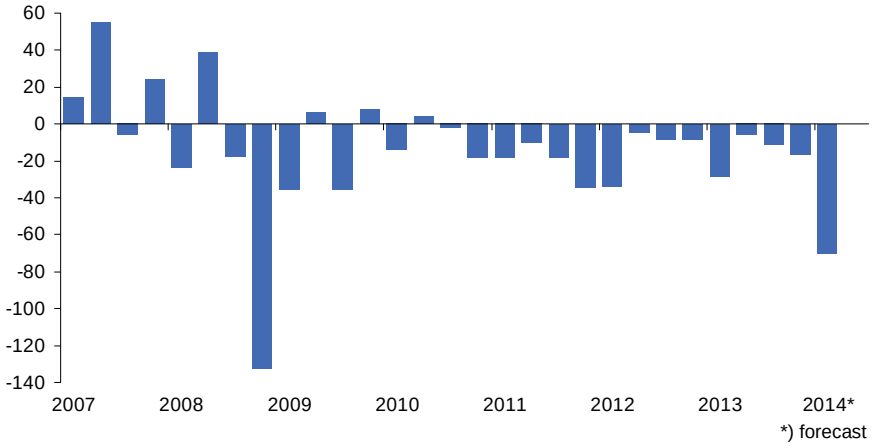
Emerging markets

The emerging markets reported only moderate growth – by their standards – last year. In actual fact, the pace of growth was down slightly on the previous year, at 4.4%. There are a number of reasons for this: First, the fact that growth in the advanced economies remained very subdued on the whole put a damper on import demand in these countries. Naturally, this left a visible mark on the emerging markets, some of which are heavily reliant on exports. Global goods trade expanded by only 2.7% in 2013, the second-lowest value since the global recession of 2009. Second, however, it is largely "homemade" causes that are to blame for the dip in economic momentum in a whole number of emerging markets. Let us cite only a few brief examples: Russia has been battling with a poor investment climate, high capital outflows and, as a result, falling potential growth for years now. These problems are only set to become even more of an issue with the most recent developments in the Ukraine crisis. In countries like Turkey, South Africa and India, macroeconomic imbalances – and in some cases substantial ones – have been stacking up in the form of substantial current account deficits and/or heavy reliance on foreign loans in recent years. These imbalances have to be resolved now that international investors are gradually starting to divert more attention back to the industrialized nations (gradual monetary policy exit), and lower growth is the price that has to be paid. China is another example. The world's second-largest economy is having to juggle several challenges at once: the battle against excessive lending and at least a local property bubble, as well as the fight against exploding debt levels among provinces and municipalities. At the same time, the government is trying to nudge its export and investment-driven growth model towards a more consumption-oriented one. All of this also comes at the expense of growth.

Chart 4

Russia: Private capital outflows rising sharply again

Net capital flows in Russian private sector, USD bn



Sources: Russian Central Bank, Russian Economics Ministry.

As far as this year is concerned, current economic indicators, such as the purchasing managers' indices for the manufacturing sector and incoming order levels in the industrial sector, point to a slight increase in economic momentum for the emerging markets. But it is not only the three major regions of Asia, Latin America and eastern Europe that are separated by vast differences: conditions vary considerably within the individual regions themselves, too. In Asia, growth is expected to tail off slightly to 6.1% this year, largely owing to the ongoing economic slowdown in China. In most of the other Asian up-and-coming economies, on the other hand, GDP growth is likely to be slightly higher than it was last year, thanks, among other things, to improved export momentum. Looking ahead to 2015, we then forecast regional GDP growth of 6.2%. A pronounced economic recovery is emerging in Latin America, albeit with Mexico – which is likely to benefit from a vast improvement in the macroeconomic environment - as virtually the only driving force behind the upswing. We predict regional GDP growth to the tune of 2.7% this year. This rate of growth is then likely to pick up slightly to 3.1% in 2015, when the Brazilian economy is also expected to gain some momentum. In eastern Europe, the growth chasm between the individual countries will be very pronounced. Not least due to the economic consequences of the Ukraine crisis, growth in Russia in 2014 is unlikely to push past the 1% mark. On the other hand, most of the eastern European EU countries are expected to report much more energetic economic development. The reason behind this trend is clear: trade and capital ties mean that the region relies heavily on economic developments in the eurozone. Consequently, the eurozone recovery will spark more lively development among its eastern neighbors, too. All in all, we predict GDP growth to the tune of 1.7% for the eastern European emerging markets this year (as against 1.4% last year). In 2015, we expect to see growth of 2.4%.

All told, we expect the emerging markets to grow by 4.5% this year, which would make 2014 the third year running in which this group of countries reports clearly below-average growth compared with the boom years of 2003 to 2007 (2003 - 2007: average annual increase in GDP of 7.3%). Real economic growth is then expected to pick up slightly to 4.8% in 2015 – bolstered by another phase of more dynamic economic activity in the eastern European and Latin American emerging markets. But even with these growth rates, which are fairly moderate on the whole, 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 seven years ago, for example (2007: 29.4%, 2013: 39.6%; 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, despite the lower pace of expansion.

Growth rates in main economic regions

GDP, real % change over previous year

	2009	2010	2011	2012	2013[1)]	2014[2)]	2015[2)]
Industrialized countries	**-3.7**	**2.6**	**1.5**	**1.3**	**1.1**	**2.2**	**2.0**
European Union	-4.5	2.0	1.7	-0.4	0.1	1.7	1.8
Euro area	-4.4	1.9	1.6	-0.6	-0.4	1.5	1.5
Germany	-5.1	4.0	3.3	0.7	0.4	2.0	1.6
USA	-2.8	2.5	1.8	2.8	1.9	2.9	2.6
Japan	-5.5	4.7	-0.5	1.4	1.5	1.2	1.2
Emerging markets	**1.5**	**7.5**	**6.1**	**4.5**	**4.4**	**4.5**	**4.8**
Asia	5.9	9.5	7.5	6.1	6.2	6.1	6.2
Latin America	-1.5	6.0	4.2	2.8	2.2	2.7	3.1
Central and Eastern Europ	-6.1	3.4	3.9	2.1	1.4	1.7	2.4
World	**-2.1**	**4.1**	**3.0**	**2.4**	**2.3**	**3.0**	**3.0**

1) estimates; 2) forecast.

Sources: EcoWin, own forecasts.

All told, we estimate that global output will increase by 3% in 2014 (country weighting based on current exchange rates in each case). The main factor driving this development will be the higher overall output in the advanced economies. This pace of growth is likely to be maintained in 2015, too. Growth differentials in the eurozone are likely to narrow further.

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

- Global trade will show more dynamic development. After an estimated 2¾% last year, we expect it to grow by 4½%-5% in 2014. Looking ahead to next year, we expect to see a further pickup and an increase in the international movement of goods and services to the tune of around 5%. This means that global trade will probably remain less elastic in its response to increased global economic activity than in the years prior to the financial crisis.

- Crude oil prices (Brent) are expected to fluctuate between 105 and 110 USD/barrel this year. Since the middle of 2012 the oil price has been fluctuating in a fairly narrow range, averaging a good 108 USD/barrel. Increased supply from non-OPEC countries is helping to stabilize the oil price. Provided that global economic growth continues to hold steady, the price range should edge up slightly to 110-115 USD/barrel in 2015. Above all, the current conflict between Russia and Ukraine harbors considerable risks for the oil price outlook. Should the crisis escalate further, and economic sanctions on Russia prompt restrictions on Russian energy supplies to Europe, oil prices are likely to spike at least in the short term. This stems from the resulting drop in the real supply of oil and the appreciable rise in uncertainty about the economic and political repercussions of the conflict.

- As far as monetary policy is concerned, signs of a turnaround have started to emerge on both sides of the Atlantic with the Fed's tapering moves and the drop in the ECB's

total assets (although this does not stem from any active measures taken by the ECB). Nevertheless, monetary policy is likely to remain expansive. We expect the Fed and the ECB to keep their key rates close to zero until into the first half of 2015.

- Against the US dollar, the euro is expected to weaken again as the year progresses. Neither the interest rate differentials at the short end of the capital market nor the USA's economic lead over the eurozone point to a sustained high valuation for the euro. At the end of 2014 the exchange rate is likely to stand at 1.30 USD/EUR. We see it at a similar or indeed slightly lower level at the end of next year.

2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

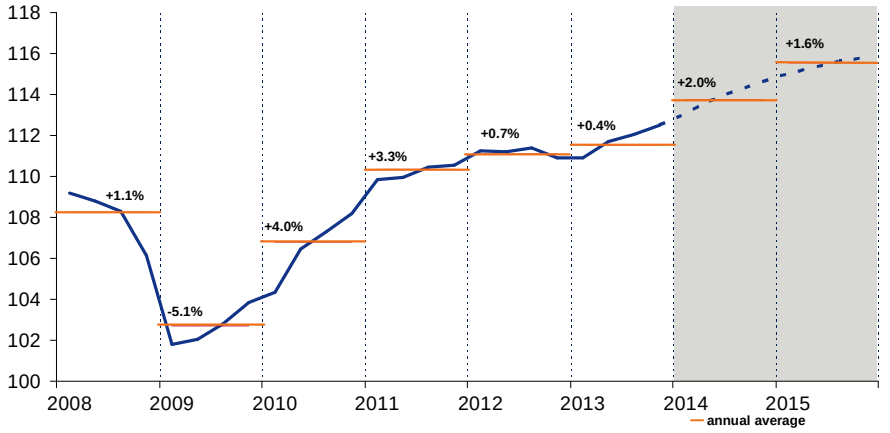
2.1 Economy making headway

The German economy got off to a buoyant start in 2014, with incoming orders and industrial production in January and February of this year well up on their level a year earlier. Retail sales in January and February were much higher than at the end of 2013, with exports and imports also making considerable gains in January. The unemployment rate also showed much more favorable development than we normally see at the start of the year. As things stand at present, we expect all components of aggregate demand - exports, consumption and investment - to have contributed to the economic growth at the start of 2014. We put GDP growth for Q1 2014 at 0.6% as against the previous quarter and 2.0% compared with the same quarter of the previous year (after adjustments to reflect the number of working days).

Chart: 5

Growth in Germany getting back into gear

Real GDP, index 2005 = 100



Sources: EcoWin, own forecasts.

We do not predict any major changes to cloud the rosy economic conditions for Germany – favorable financing conditions, real income gains thanks to low inflation, a marked increase in employment and a brighter economic outlook for the eurozone – as the year progresses, at least provided that the Ukraine crisis does not escalate in geopolitical terms. We expect to see positive impetus from both exports and the domestic economy throughout the whole of 2014. Despite the appreciation in the euro,

which is putting a damper on exporters' price competitiveness, German exports will likely be able to grow, in volume-based terms, more or less in tandem with global trade (4.5-5%) in 2014, not least thanks to brighter export prospects in key sectors such as the automotive industry. With capacity utilization levels on the rise, machinery and equipment investment, which was still on a clear downward trend in 2013 on average, will pick up considerably in 2014. We expect to see investments head north in all construction segments (residential construction, commercial and public-sector construction) this year. The mood among consumers is extremely positive. Boosted by higher growth in salaries, transfer payments and entrepreneurial earnings, private consumption is also expected to grow at a faster rate in 2014 than it did in 2013. All in all, we predict that the German economy will grow by 2.0% both on average and in the course of 2014.

This should allow Germany's economy to start 2015 with slightly above-average capacity utilization levels. As things stand, we believe that the upswing will continue in 2015, although the economic momentum is likely to taper off somewhat as the year progresses. We expect the introduction of the minimum wage to deal a real blow to job creation. Several tenths of the associated cost increases will also be reflected in inflation. The introduction of the minimum wage is not expected to have any positive impact on overall purchasing power. The rise in unit wage costs, which is expected to pick up further in 2015, is also likely to have at least a slightly negative impact on business expectations and presumably also on the corporate sector's willingness to invest. As a result, we expect gross domestic product to grow by only 1.6% in 2015. Unemployment, which will drop considerably in 2014, is likely to stagnate in the course of 2015.

Germany: Economic indicators and forecasts*

		2013				2014				2015						
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2013	2014f	2015f
GDP real		0.0	0.7	0.3	0.4	*0.6*	*0.6*	*0.4*	*0.4*	*0.4*	*0.3*	*0.2*	*0.2*	0.4	*2.0*	*1.6*
Private consumption		0.3	0.6	0.2	-0.1	*0.5*	*0.6*	*0.4*	*0.5*	*0.4*	*0.3*	*0.2*	*0.3*	0.9	*1.5*	*1.6*
Government spending		0.2	-0.4	1.2	0.0	*0.2*	*0.2*	*0.3*	*0.2*	*0.3*	*0.3*	*0.3*	*0.3*	0.7	*1.0*	*1.1*
Investment in machinery/equipment		-1.4	0.5	0.1	1.4	*2.0*	*1.5*	*1.5*	*1.5*	*1.0*	*0.8*	*0.6*	*0.6*	-2.4	*5.6*	*4.6*
Construction		-1.5	1.7	2.1	1.4	*1.0*	*-0.5*	*0.5*	*0.5*	*0.8*	*0.8*	*0.6*	*0.6*	0.1	*3.6*	*2.7*
Domestic demand		0.3	0.4	0.6	-0.7	*0.7*	*0.5*	*0.4*	*0.4*	*0.4*	*0.3*	*0.2*	*0.3*	0.5	*1.3*	*1.7*
Exports		-1.0	2.4	0.2	2.6	*1.2*	*1.2*	*0.8*	*1.0*	*0.8*	*0.6*	*0.6*	*0.4*	0.8	*5.6*	*3.4*
Imports		-0.5	1.9	0.8	0.6	*1.5*	*1.2*	*1.0*	*1.2*	*0.8*	*0.8*	*0.7*	*0.7*	0.9	*4.7*	*4.0*
Industrial production (excl. construction)**		0.5	1.2	0.6	0.4	*1.1*	*1.0*	*1.1*	*0.8*	*0.7*	*0.7*	*0.4*	*0.4*	0.2	*3.8*	*3.0*
Unemployment rate (EU def.)	%	5.4	5.4	5.3	5.2	*5.1*	*5.1*	*5.0*	*5.0*	*4.9*	*4.9*	*4.9*	*4.9*	5.3	*5.0*	*4.9*
Unemployment rate (nat. def.)	%	6.9	6.9	6.8	6.9	6.7	*6.7*	*6.6*	*6.5*	*6.5*	*6.5*	*6.5*	*6.5*	6.9	*6.6*	*6.5*
Employed persons (national def.)	y-o-y	0.6	0.5	0.5	0.6	*0.7*	*0.8*	*0.8*	*0.8*	*0.6*	*0.5*	*0.4*	*0.3*	0.6	*0.8*	*0.5*
Consumer prices	y-o-y	1.5	1.5	1.6	1.3	*1.2*	*1.3*	*1.2*	*1.7*	*1.8*	*1.8*	*1.8*	*2.0*	1.5	*1.4*	*1.8*
Consumer prices (HICP)	y-o-y	1.8	1.5	1.7	1.3	1.0	*1.2*	*1.3*	*1.8*	*1.9*	*1.8*	*1.8*	*2.0*	1.6	*1.3*	*1.9*
Producer prices	y-o-y	0.8	-0.1	-0.3	-0.7	*-0.8*	*0.2*	*0.8*	*1.3*	*1.7*	*1.7*	*1.9*	*1.9*	-0.1	*0.4*	*1.8*
Current account balance	EUR bn	48.7	52.9	50.2	56.0	*54.0*	*54.0*	*53.0*	*52.0*	*51.0*	*50.0*	*49.0*	*48.0*	206.0	*213.0*	*198.0*
	% of GDP													7.5	*7.6*	*7.0*
Budget balance	EUR bn													0.3	*4.3*	*4.9*
(Maastricht-definition)	% of GDP													0.0	*0.2*	*0.2*

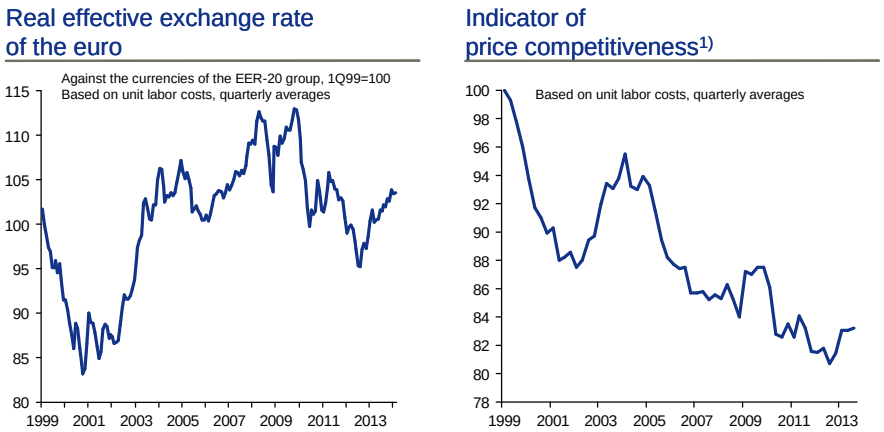
*) quarterly figures: percentage change over previous period, seasonally and working day adjusted, except where noted, yearly figures: percentage change, not working day adjusted; **) yearly average working day adjusted.

f = forecast.

2.2 Strong export growth

Demand from abroad has picked up considerably. In January of this year, incoming orders from abroad were around 6% higher than they were six months ago and almost 12% higher than they were in January of last year. A large chunk of the recent order growth has been attributable to non-EMU countries, although orders from the eurozone are now also well up on the prior year.

Chart 6



1) A decline means an increase in competitiveness.

Source: Deutsche Bundesbank.

The sharp rise in demand from abroad is all the more remarkable given the pressure that the marked appreciation of the euro is putting on the price competitiveness of German exporters. After all, the trade-weighted external value of the euro has risen by a good 8% since mid-2012. The buoyant forces driving the global economy would currently appear to be so strong that they are drowning out the voice of the external value as the determining factor of demand from abroad. We expect global trade growth to be much higher than in 2012 and 2013, coming in at 4.5-5% in 2014. Based on our estimates, the volume of German exports of goods and services is likely to increase by 5.6% in 2014 after a mere 0.8% percent last year, before rising further by 3.5% in 2015. The growth in German exports is, however, expected to continue to lag behind the expansion in world trade (around 5%), as the fairly high value of the euro will gradually leave its mark on exports.

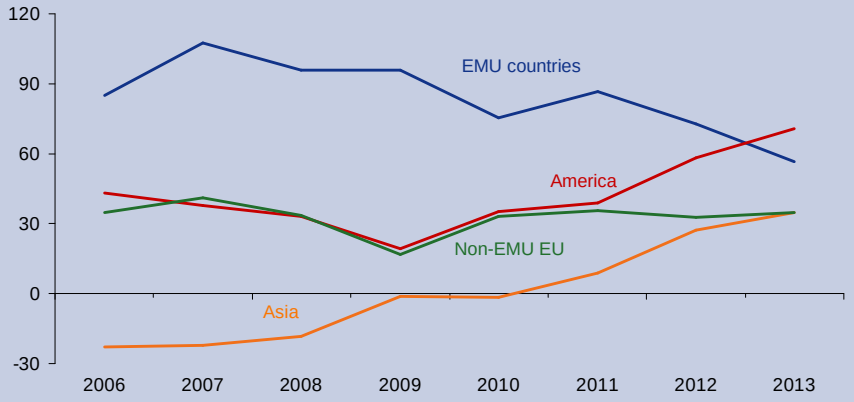
Germany's current account surplus: changes in the regional structure

Since the European Commission analyzed Germany's current account surplus in an in-depth review as part of its Macroeconomic Imbalance Procedure, recently announcing that it deemed it to represent an imbalance, the surplus has once again moved into the spotlight of economic debate. This is corroborated by the fact that Germany reported a new record surplus of EUR 206 billion last year, with some forecasts suggesting that this figure will continue to rise.

But the analysis of the total foreign trade surplus fails to pick up on the sustainable changes in its regional composition. The current account with eurozone countries no longer lies at the core of the surplus. In 2007 – shortly before the outbreak of the economic crisis – Germany's surplus with EMU countries reached a high of EUR 107.6 billion and almost 60% of the country's total surplus. Last year, this figure came in at only around EUR 56.4 billion, i.e. around 27% of the surplus as a whole. But the drop in

Germany: Rising surplus with America and Asia

Current account balance in EUR bn



Source: Deutsche Bundesbank.

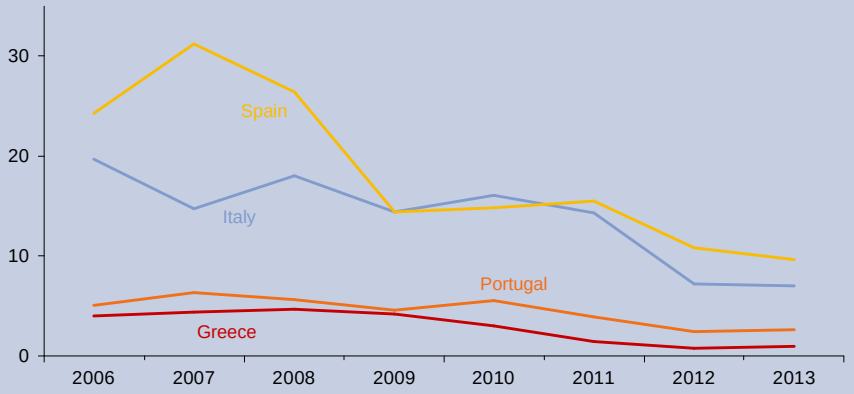
Germany's surplus is not only due to lower exports to the EMU countries as a result of the crisis, but also – and indeed more so – to higher imports from the EMU. As a result, it is safe to assume that the imbalance is being increasingly resolved.

The reduction in Germany's surplus vis-à-vis the southern European countries at the heart of the debt crisis is even more pronounced than its surplus vis-à-vis the rest of the eurozone. Germany's cumulative surplus vis-à-vis Italy, Spain, Portugal and Greece fell from EUR 56.6 billion in 2007 to EUR 20.4 billion last year.

Given the marked decline in Germany's surplus vis-à-vis the eurozone on the one hand, but the new overall surplus high on the other, the country's surpluses vis-à-vis other regions must have increased considerably: these regions are Asia and the Americas. Germany has traditionally had a trade surplus vis-à-vis the Americas and, in particular, the US.

Germany: Falling surplus with south European EMU countries

Current account balance in EUR bn



Source: Deutsche Bundesbank.

This surplus has, however, risen – following a temporary dip – from EUR 37.7 billion in 2007 to EUR 70.7 billion last year, with almost EUR 44 billion attributable to the US.

As far as Asia is concerned, Germany's current account has actually shifted from a clear deficit to a clear surplus in recent years. Whereas in 2007, Germany still had a current account deficit of EUR 22 billion with Asia, it reported a surplus of EUR 34.9 billion in 2013. Looking at the oil-rich countries in the Middle East, Germany has a surplus of EUR 24.1 billion. The fact that Germany's current account with China was in the black to the tune of EUR 5.5 billion in 2013, after still accounting for a deficit of EUR 23.1 billion back in 2007, is even more surprising.

Today, China is one of Germany's biggest trading partners. China comes in 5th in the list of Germany's main export partners and 2nd when it comes to imports. But whereas German imports from China were still more than 80% ahead of German exports to China in 2007, the gap in 2013 came in at a mere 7%.

Marked changes have been emerging since 2010 in particular. In 2013, Germany imported fewer goods from China than in 2010 in terms of value (-EUR 3.0 billion), but exported far more goods to China (+EUR 13.5 billion). There are likely to be myriad reasons behind the declining value of imports from China. More than one third of the goods imported from China are data processing devices, electrical and optical goods. Their import value fell by around EUR ½ billion in the period from 2010 to 2012 (values for 2013 not yet available). So falling prices are likely to have played a key role in this respect. The second most important goods category when it comes to imports from China is clothing, which accounts for around 10%. The import value of this category fell by EUR 0.2 billion between 2010 and 2012. China's waning cost advantages compared with other emerging markets are likely to be a factor here.

In the future, we believe that German exports to China will also show only moderate development, as will imports from China. This theory is supported by the fact that German car producers are increasingly manufacturing their vehicles on location and by forecasts of weaker demand for capital goods due to measures to revamp China's economic model.

German merchandise trade with China more balanced

Source: Statistisches Bundesamt.

The example of Germany's foreign trade with China shows just how many different factors can shape the development of its current account. Sweeping recommendations on how to reduce the current account surplus along the lines of "Germany has to take action to boost its consumption" are not the way forward.

In early 2014, imports were growing at a faster rate than exports. Fairly buoyant domestic demand is expected to fuel further increases in the import volume in the course of 2014 and 2015 as well. Looking at 2014 on average, we expect the import volume to expand by 4.7%, before growing by 4.0% in 2015.

With commodity prices on the decline and the euro on the up, the terms of trade, i.e. the relationship between export and import prices, have improved considerably in 2013 and in early 2014. Import prices have been falling at a much faster rate than export prices, pushing the foreign trade surplus up. We expect that the improvement in the terms of trade will come to an end in the course of this year, but that import prices will drop back a bit again in 2014 on average, while export prices will more or less stagnate. Since the volume of exports will also rise considerably in 2014, the 2014 current account is likely to reach a new high with an expected surplus of EUR 213 billion (2013: EUR 206 billion). In 2015, the surplus is then expected to fall slightly as import prices gradually start to pick up and export growth declines (2015: EUR 198 billion).

2.3 Accelerated expansion in consumer demand

Last year saw private consumption increase by 0.9% in real terms, despite the fact that nominal disposable income showed the most subdued increase since 2009, at 2.2%. Lower inflation and a higher propensity to consume helped fuel this relatively positive trend in real consumer demand.

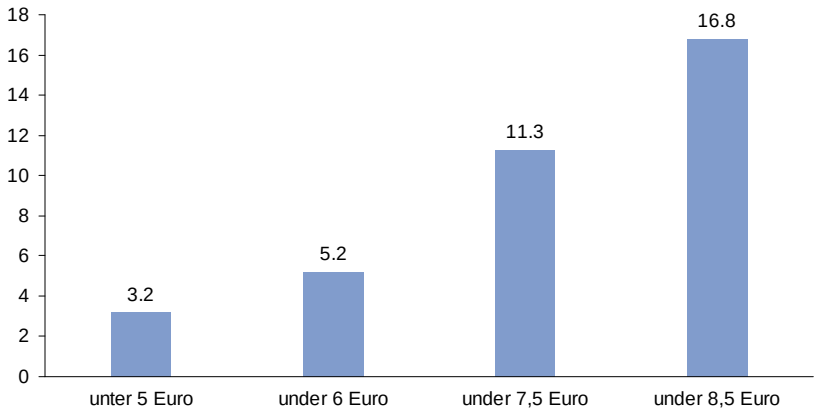
We expect to see consumer demand gain further ground this year as income development accelerates. As far as disposable income is concerned, we expect to see an increase of 3.1% in 2014 and as much as 3.4% in 2015. With moderate inflation of 1.4% expected to be on the cards for this year, and an inflation rate of 1.8% forecast for next year, we predict that real incomes will increase by a good 1.5% in both 2014 and 2015. This will lay the foundation for higher growth in real private consumption compared with the last two years.

Effective earnings per employee, which rose by only 2.2% in 2013, are likely to grow by more than 2.6% this year and 3.3% next year. This stronger growth is attributable, in particular, to the upward pay drift resulting from the recovery, although the introduction of the minimum wage is also expected to be a factor in 2015. According to an analysis conducted by the Rhineland Westphalia Institute for economic research (*Rheinisch-Westfälisches Instituts für Wirtschaftsforschung* (RWI), economic report (*Konjunkturbericht*) no. 65, March 12, 2014), the nationwide introduction of the minimum wage of EUR 8.50 per hour would have increased the actual overall wage per hour by around 1% based on the wage level and structure for 2012. Due to the wage increases witnessed since 2012, the option of applying interim regulations in the period leading up to 2017 and the expected exemptions, we predict that the minimum wage will increase actual earnings per hour by around 0.5% in 2015. The impact on actual earnings per employee is likely to be a little higher, as we expect to see above-average employment losses among individuals in marginal employment. Based on our estimates, total gross income from employment will rise by 3.4% in 2014 and 3.9% in 2015 after 3.0% last year. At 3.3% this year and 3.2% next, total net income from employment, however, is unlikely to grow at the same rate as gross earnings, particularly due to the process by which taxpayers are shifted into higher tax brackets even when real incomes have not grown (bracket creep) and the expected increase in the long-term care insurance contribution rate in 2015.

Chart 7

Wage breakdown 2012

Cumulative shares in %



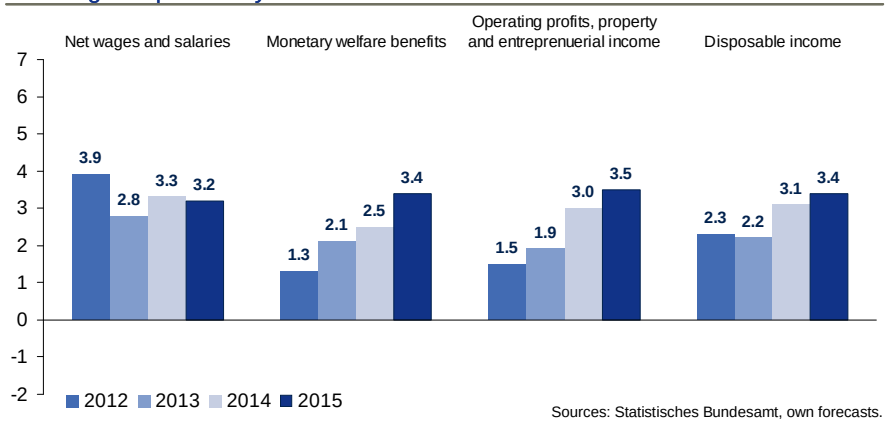
Source: Hagen Lesch, Alexander Mayer, Lisa Schmidt, Das deutsche Mindestlohngesetz, IW policy paper 4/2014.

The development in monetary social benefits will be impacted by a whole number of factors in 2014 and 2015. On the whole, however, we will see a return to higher growth in these benefits due to the broader scope of benefits for pensioners. We estimate that the increase in monetary social benefits will come in at 2.5% in 2014 and 3.4% in 2015 compared with 1.3% in 2012 and 2.1% in 2013. The "mothers' pension" and the option of retiring at 63, with no deductions, for individuals with 45 contribution years will create additional benefits worth a good EUR 4 billion this year and around EUR 9 billion next year. Measures that will cut spending on monetary social benefits include the reduction in the general pension increase for 2015 by 0.8 percentage points due to the decision not

Chart 8

Germany: Private household incomes rising more strongly again in 2014 and 2015

% change on previous year



Sources: Statistisches Bundesamt, own forecasts.

to cut the pension contribution rate, the drop in unemployment and the fact that fewer claims will be made for social benefits due to the introduction of the minimum wage. Income from entrepreneurial activity and assets, which has charted only a moderate increase of 1.5% and 1.9% respectively over the past two years, is expected to bounce back

to stronger growth as the economy gains ground. We expect to see an increase of 3.0% in 2014 and 3.5% in 2015.

The expected rise in real income is likely to be reflected in corresponding growth in real consumption, as we do not expect to see any significant changes in the savings rate (2013: 10.0%, 2014: 10.1%, 2015: 10.1%). In real terms, private consumption is expected to increase by 1.5% in 2014 and by 1.6% in 2015.

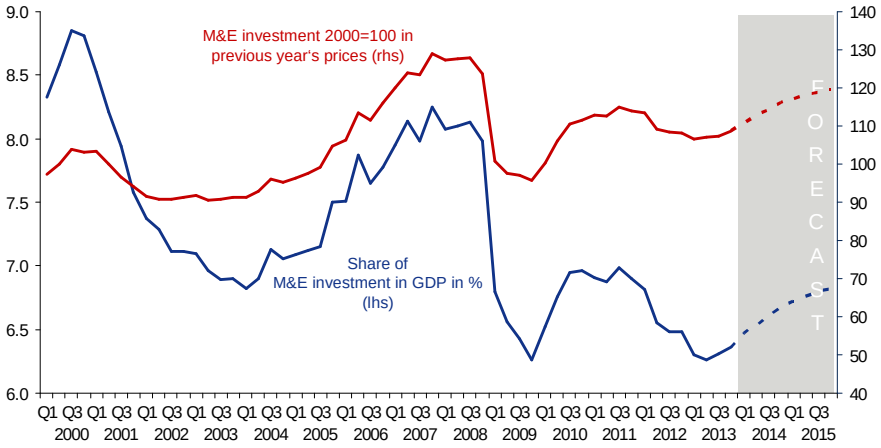
2.4. Equipment investment starting to bounce back

The downward trend in investment activity has been halted, and equipment investment has been on the rise again (in seasonally adjusted terms) for three quarters now. Nevertheless, equipment investment fell again, namely by 2.4% on average, in 2013.

The pickup in capacity utilization, very favorable financing conditions and healthy corporate earnings figures provide a favorable backdrop for a further recovery in investment activity. Corporate surveys are also pointing towards positive business expectations and a far better assessment of the business situation. Now that the European sovereign debt crisis has eased, a substantial element of uncertainty regarding the economic outlook has been minimized. It is still difficult to forecast to what extent the Russia/Ukraine crisis will stoke new uncertainty with the potential to choke the propensity to invest. Provided that there is no further major escalation – which we believe to be the likely scenario – we believe that any impact on overall investment activity will be very limited.

Chart: 9

Germany: Investment stabilizing



Sources: Statistisches Bundesamt, own forecasts.

Given the above, we expect to see considerable growth in equipment investment of 5.6% this year and 4.6% next year. Nevertheless, the ratio of equipment investment to GDP will still be down ever so slightly on the average for the period since 2000 (7.2%) at the end of 2015, when it is predicted to come in at 6.8%. Despite the current positive trend, the investment slump has not yet been laid to rest entirely.

2.5 Construction sector remains buoyant

Construction investment, which reported only minimal growth of 0.1% last year, looks poised to make a return to higher growth rates both this year and next. This is supported by the rosy prospects that now prevail in all three construction segments: residential construction, commercial construction and public-sector construction.

Residential construction is still on the rise, with investment in this area up for what is now the fourth year running. This positive trend is not likely to change in 2014 or 2015 either. The impressive 12.9% increase in the number of construction permits issued for residential properties in 2013 will lay a solid foundation for further growth in construction activity. We expect to see residential construction investment grow, in real terms, by 3.8% in 2014 and 2.5% in 2015.

The overall environment for residential construction is exceptionally favorable. Mortgage interest rates remain very low, household income prospects are looking much better than they did a few years ago, immigration from abroad is fueling more demand for residential space and return-oriented construction principals are generating far higher returns than they could achieve with many other forms of investments based on the current rent levels. By way of example, the number of construction permits issued for apartments in multiple-family dwellings, where return aspects are often a key consideration, rose by an astounding 22.3% in 2013. The introduction of the "rent brake", however, is likely to take the edge off this momentum. The high level of construction equipment utilization, suggesting that capacity limits could soon be reached, is also likely to keep a lid on residential construction investment growth.

Commercial construction, which contracted slightly in both 2012 and 2013, is expected to bounce back to growth in 2014. Rising capacity utilization levels in the corporate sector are likely to be the decisive factor behind this positive turnaround. In general, the alleviation of the uncertainty created by the European debt crisis is expected to whet a new appetite for expansion investments. Our estimates predict an increase in real commercial construction investment of 1.8% this year and 3.3% in 2015.

Public-sector construction investment has been increasing significantly since Q2 2013, most likely due to the improved financial standing of municipalities and the reconstruction work required after the floods. Flood relief funds will continue to contribute to the revival in public-sector construction this year, too. Announcements promising increased spending on transport infrastructure and on crèches, schools and further education establishments are unlikely, in the main, to have any positive impact on public-sector construction activity until 2015. We expect to see real public-sector construction investments increase by 7.0% in 2014 and 3% in 2015.

All in all, real construction investment is likely to expand by 3.6% in 2014 and 2.7% in 2015.

2.6 Moderate increase in inflation

The increase in consumer prices in Germany has been sitting below the 1.5% mark since the fall of 2013. Prices in February 2014 edged up by only 1.2%, growing by as little as 1.0% in March 2014. One of the reasons behind this disinflationary trend can be found in energy prices, which account for 11% of the basket of goods used to measure inflation

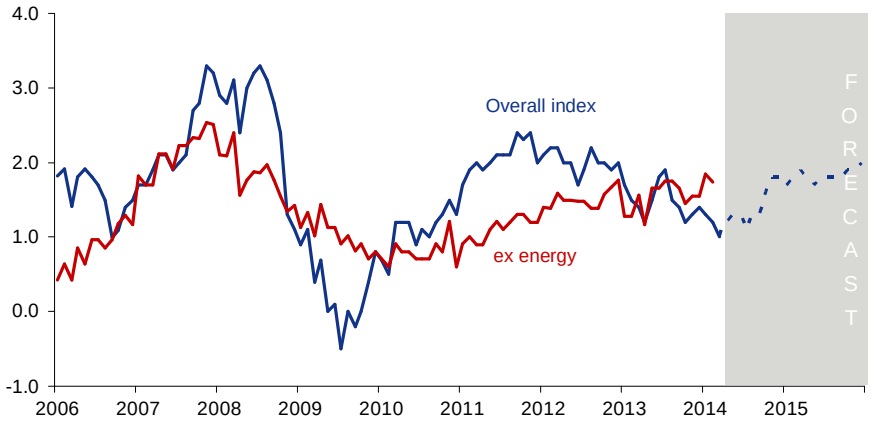
and were down by 1.6% y-o-y in February 2014. The drop in the prices of mineral oil products like fuel and light heating oil is particularly pronounced. By contrast, food prices have risen by 2.2% during the same period.

Foreign trade is one factor putting a real damper on prices. Import prices in February 2014 were down by 2.7% on a year earlier, marking the continuation of a downward trend in import prices that started two years ago. Here too, energy prices are one of the culprits (February 2014: -8.1%). This is largely due to the relatively strong external value of the euro and the fact that the global economy is experiencing only a moderate revival.

Chart: 10

Germany: Consumer price index

% change on previous year



Sources: Statistisches Bundesamt, own forecasts.

We forecast an increase in consumer prices to the tune of 1.4% in 2014. The increase in the second half of the year is likely to be somewhat more pronounced than in the first six months, as we do not expect to see any further drop in energy prices. The domestic economy is not expected to provide much inflation impetus in 2014, mainly because the development in unit wage costs remains moderate. The marked increase in income from employment of 3.4% will only translate into a 1.4% increase in wage costs thanks to real economic growth of 2.0%. We expect energy prices to increase only slightly in 2014. While we expect to see an average oil price for the year that is on a par with the current level of USD 105 – 110 a barrel, we predict that electricity costs in Germany will continue to rise, not least as a result of the decision to increase the EEG (German Renewable Energy Sources Act) levy.

Looking ahead to 2015, we expect consumer prices to start growing at a slightly faster rate of 1.8% again, driven primarily by a marked increase in unit wage costs. The expected increase in income from employment of 3.9% combined with real economic growth of 1.6% will push wage costs per production unit up by 2.3%. The introduction of the statutory minimum wage on January 1, 2015 will be a key factor here, with our estimates suggesting that the minimum wage will be responsible for pushing labor costs up by around half a percent in 2015 alone. Unlike in 2014, foreign trade is likely to have slight price-raising effects in 2015. In particular, we can envisage a moderate increase in energy prices, but also in the prices of other import goods.

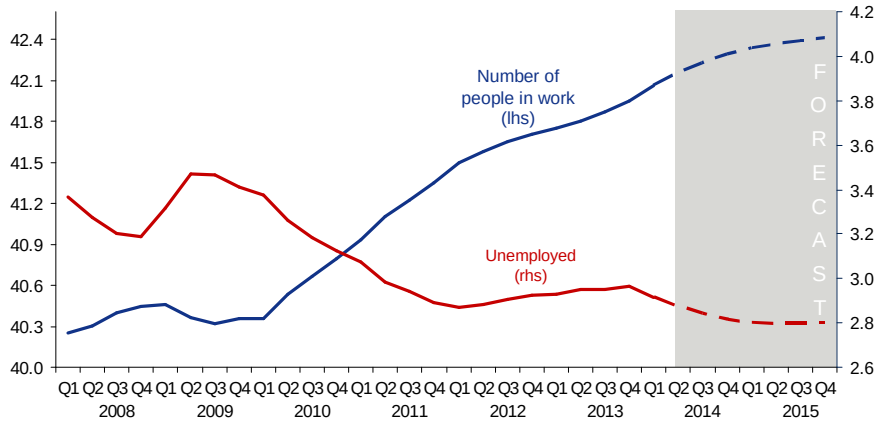
2.7 Improvement on the labor market continues for the time being

The positive trend on the German labor market seen in recent years continued at the start of 2014. January 2014 saw the number of people in work, in seasonally adjusted terms, exceed 42 million for the first time. In February 2014, the number of people in work was up by around 315,000 y-o-y, which corresponds to an increase of 0.8%. At the same time, the number of people out of work (based on the definition used by the International Labor Organization) fell by 200,000 during the same period, bringing the unemployment rate down to 5.1% (after seasonal adjustments). The seasonally adjusted unemployment rate (based on the definition used by the German Employment Agency) came in at 6.7% in March 2014, down by 0.2 percentage points in a year-on-year comparison. Unlike the ILO unemployment rate (*Erwerbslosenquote*), the German Employment Agency's unemployment rate (*Arbeitslosenquote*) also includes individuals in marginal employment (working less than 15 hours a week) and people who want to work in the future but were not actively looking for work of late.

Chart 11

Germany: Number of people in work and unemployed

millions



Sources: EcoWin, own forecasts.

The fact that the increase in the number of people in work is not being accompanied by a similar reduction in the jobless totals can be explained by an increase in the number of people of working age. In 2012, for example, Germany reported a positive immigration balance of just under 370,000 people. In addition, labor force participation among older people has been rising steadily for years now, a trend that is having a positive impact on employment. In 2012, for example, around half of 60-64 year-olds were active participants in the labor market, compared with only a quarter or so ten years ago.

A detailed analysis, however, shows that the improvement on the labor market is not distributed equally across all sectors. The business services sector, for example, recently saw the most pronounced increase in employment subject to social security contributions with growth of around 98,000 employees in a year-on-year comparison, followed by healthcare and social services (+81,000). In the manufacturing industry, the increase in the number of people in work was still fairly pronounced at 49,000, whereas the figure actually stagnated in the financial sector.

In all likelihood, the positive trend on the labor market will continue in the course of 2014. The jobless total is likely to fall by almost 150,000 in the course of 2014. Looking at

the year on average, we predict that the total figure will drop by almost 90,000 to 2.86 million. In absolute terms, the increase in employment will be much more pronounced than the drop in unemployment in 2014 given that the high level of immigration from abroad is expected to continue. We expect the number of people in work to increase by a good 300,000 both in the course of the year and looking at 2014 on average.

We do not believe that the labor market prospects for 2015 are quite as rosy as they are this year. The introduction of the minimum wage is likely to put a real damper on any increase in employment, with the number of people in marginal employment actually expected to drop. We expect to see the number of people in work rise by only 100,000 in the course of 2015, meaning that 100,000 fewer people will be in work than would be the case were it not for the minimum wage. The jobless total is likely to stagnate in 2015, with an average of around 2.80 million people expected to be out of work next year.

2.8 Small budget surplus

The German budget, which reported a small surplus in 2012 and 2013, is likely to remain in the black in both 2014 and 2015, too. We expect to see a surplus of a good EUR 4 billion this year and around EUR 5 billion next year.

With the economy in good shape, government revenue is likely to continue to witness strong growth. Within this context, the increase in tax revenues in 2014 will be hindered slightly by the increase in the basic income tax allowance. Given that the contribution rate for pension insurance will not be cut this year, and with plans to lift the contribution rate for long-term care insurance next year, revenue from welfare contributions will increase considerably in 2014 and, in particular, in 2015. All in all, we expect government revenue to grow by 3.2% in 2014 and by 3.4% in 2015, compared with 2.5% last year.

Government spending discipline is visibly on the wane. After a cumulative government spending increase of only 2.4% over the past three years, spending is likely to increase by a cumulative total of 6.4% in 2014 and 2015. The 2014 pension package (mothers' pension, retirement at 63, incapacity benefits) will drive considerably faster growth in monetary social benefits. We still expect to see spending on in-kind social services increase considerably, in particular as a result of the increase in long-term care insurance benefits, among other factors. Spending on expenditure for employee compensation is also expected to increase at a faster rate than in previous years. One factor slowing down government expenditure will be interest expenses, which are set to fall again. All in all, we expect government spending to grow by 2.9% in 2014 and 3.4% in 2015.

Although this will see government revenue and spending develop more or less in tandem with each other, more spending discipline would allow a higher budget surplus in view of the rising macroeconomic utilization levels, which are expected to be above-average in 2015. This would also make sense in the interest of strict budget consolidation, as the possibility of economic setbacks putting pressure on the budget cannot be ruled out.

Germany: Public-sector revenue and expenditure

in EUR bn	2010	2011	2012	2013	2014[2)]	2015[2)]
Revenue	1089,8	1157,2	1193,8	1223,4	1262,9	1306,3
of which:						
Taxes	549,9	592,8	617,7	636,4	658,0	679,1
Social contributions	421,2	437,0	448,9	459,1	474,7	494,6
Expenditure	1194,1	1178,7	1191,5	1223,1	1258,6	1301,3
of which:						
Inputs	121,7	126,5	130,9	135,2	139,5	143,9
Employee compensation	195,7	199,5	203,8	208,4	214,2	221,5
Property income payable (interest)	63,5	65,7	63,8	59,1	57,3	57,3
Subsidies	28,8	27,2	24,6	25,7	25,7	25,7
Monetary welfare benefits	430,2	425,8	430,3	440,1	452,0	468,2
Welfare benefits-in-kind	203,0	207,5	213,1	223,9	232,8	242,1
Other current transfers	53,5	53,8	57,1	65,9	68,3	70,4
Gross investment	41,6	43,6	41,4	42,8	46,2	49,0
Financial balance	-104,3	-21,5	2,3	0,3	4,3	4,9
memorandum:						
State spending ratio[1)]	47,9%	45,2%	44,7%	44,7%	44,4%	44,6%
Financial balance[1)]	-4,2%	-0,8%	0,1%	0,0%	0,2%	0,2%

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

[2)] Forecasts based on agreed changes in taxes and expenditure for 2014 and 2015.

Sources: Statistisches Bundesamt, own forecasts.

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

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In 2013, around 148,000 employees in over 70 countries achieved total revenues of 110.8 billion euros and an operating profit of 10.1 billion euros. Benefits for our customers reached 93.9 billion euros.

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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