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## Economic forecast 2015

Allianz

# Working Paper

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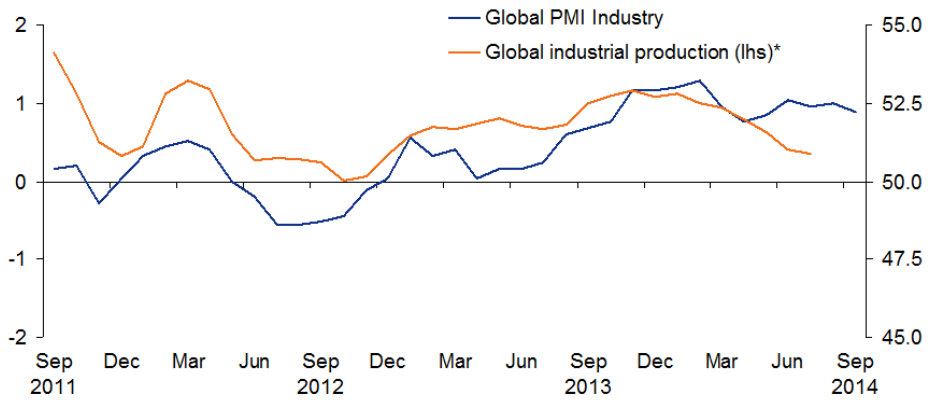
## 1. GLOBAL ECONOMIC SITUATION AND OUTLOOK

In the first half of 2014 the global economy charted but a modest expansion course. Even though, following on from a weak start to the year, the pace of expansion increased in the second quarter, in annualized terms the growth momentum seen in the first half of the year did not exceed that of 2013 as a whole. This is the result of rather divergent developments in the individual countries and regions, where economic output also varied widely in the respective quarters.

Special factors such as unusual weather conditions doubtless also had a part to play. In the US the above-average cold winter put such a damper on domestic end-consumer demand that overall output contracted in the first quarter of the year. Accordingly catch-up effects contributed to a significant move in the opposite direction in the second quarter. In Japan, by contrast, economic output charted the opposite course. As expected, the increase in value added tax in April caused significant anticipatory effects followed by a drop in demand, so that overall the economy practically ground to a halt.

### Purchasing managers index signals rising 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.

Moderate growth went hand in hand with a weakness in global goods trade. After relatively lively developments during the course of the second half of 2013, on balance no additional gains could be realized in the first half of this year. Even if the international global goods trade picks up during the rest of the year, it is likely once again to report only slightly stronger growth than global economic output as a whole.

At the beginning of the second half of the year key indicators are painting a fundamentally positive picture as regards global economic development. The global purchasing managers' index for the manufacturing industry, for instance, has remained stable in recent months, hovering resolutely above the threshold that is indicative of expansion. This suggests quite some upside potential for industrial production around the globe. However, the level reached by the overall indicator owes much to a very optimistic view of business activity in US industry.

It is evident that the fragile geopolitical situation, in particular the conflict between Russia and Ukraine, impacts negatively on business confidence in Europe. Were this conflict to escalate yet again, the risk of an economic downturn would appear considerable, particularly if this were to cause the investment climate to take a turn for the worse or to hamper the energy trade between Russia and EU member states.

Although the geopolitical situation might have led us to expect otherwise, most recently commodity prices eased the burden on net import countries, with the crude oil price (Brent) falling dramatically ever since June and trading in the 90-100 USD/barrel range in recent weeks. This amounts to an almost 15% drop compared to the average in 2013 and the first half of 2014. Increases in purchasing power resulting from this development may provide a considerable boost to economic recovery in a great many industrialized nations.

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

## USA

After a disappointing start to 2014, the US economy got back into its stride in the second quarter. Real GDP was up 4.6% (annualized rate) compared to the prior period. Growth was broad-based with all demand components making a contribution. It is particularly pleasing to note that the weak phase in residential construction has come to an end. In addition, exports experienced a significant turnaround and private investments saw a marked expansion. Even though it appears unlikely that the US economy has been able to sustain this high momentum, current economic data indicate continued above-average growth in the third quarter.

We also expect solid growth for the rest of the year. Unlike in the previous three years, when the cut-back in government spending had slowed down economic growth by 0.4 percentage points per year on average, fiscal policy is unlikely to exercise significant downward pressure for the time being. In view of the improvements in the financial situation of private households and favorable financing conditions, private domestic demand is also likely to continue to strengthen. It seems equally probable that a greater increase in wages will provide a boost to the recovery of labor income in the coming year. Following sustainable improvements on the labor market we also expect residential construction to regain momentum. Given that sales growth is on the up, we are also likely to see an improvement in the willingness to invest on the part of the corporate sector.

All in all, in spite of the disappointing start to the year, we predict economic growth to average out at 2.2% for 2014. Next year the US economy is likely to grow by 2¾%.

## Euro area

At present, the glass seems to be half empty rather than half full: although the acute financial crisis seems to be a thing of the past, the overall picture is dominated by the poor state of the economy, the debate about the drawn-out process of government budget consolidation and ECB policy, which seems to have increasingly fewer courses of action at its disposal. Starting with the latter aspect, it seemed a bit overhasty to follow up the June package of measures to ease monetary policy with yet more measures in early September. With the key interest rate at 0.05% and a deposit rate of -0.2%, interest policy measures appear to have been exhausted. We expect current interest levels to remain unchanged until the middle of next year, because in our assessment it is only then that EMU inflation rates are likely to move towards the 1.5% mark. Whether the unconventional measures that have been announced will succeed in expanding the ECB's total assets by approx. EUR 700bn as a minimum, appears rather unlikely. After all, at EUR 82.6bn the take-up of the first four-year tender (TLTRO) was rather low (presented in a positive light, this means that there is simply no such great demand for liquidity).

This is compounded by doubts about the purchase program for covered bonds (CBPP3) because of the limited size of the market, combined with what is, in any case, a high level of demand compared to the available supply. Also, the scope of the ABS purchase program (ABSPP) is questionable, not least because of dissent regarding the issue of guarantees.

In one respect, however, the steps taken by the ECB and its communications have clearly had the desired effect: in the light of diverging monetary policy expectations on this and on the opposite side of the Atlantic, the euro has recently embarked on a marked downward trajectory. For the future we do not consider large-scale purchases of government bonds (according to EMU country weightings) to make sense in view of low/decreasing EMU yields. We also do not regard ideas such as "helicopter money" to be realistic and instead feel that the ECB has reached the end of the road. Against this background it does not come as much of a surprise that the voices of those calling for a move in financial and structural policies, with the aim of using fiscal policy to stimulate the economy - Germany, in particular, is finding itself at the receiving end of these calls - and implementing structural reforms to promote growth, are growing ever louder, especially those of the other EMU heavyweights France and Italy.

These two countries in particular are struggling to rein in their new borrowing to a significant extent. We do not consider a loosening of fiscal rules - as recently called for by the French and Italian governments - to be on the cards. After all, before amending the rules and regulations (which is likely to be a long and drawn-out process, since reaching another political consensus at EU level appears difficult) the Commission will in all probability push ahead with implementing the EUR 300bn investment plan that has already been announced in the hope that it will provide a boost to the economy in the eurozone. But no matter how attractive a coordinated campaign for growth at a European level may seem, in our view these measures will be unable to compensate for the lack of structural reforms at a national level, which are a prerequisite for sustainable consolidation successes and for improving debt sustainability in the long term. What cannot be ruled out, however, is an informal loosening of fiscal regulations, for instance by rewarding ambitious reform efforts with an extension of the deadline for achieving savings targets. We would, however, caution against the flexibility principle being deployed too loosely, for example when no significant reform successes are evident. This would send a detrimental signal to both other EMU member states and the financial markets, causing long-term damage to the hard fought for credibility of the tightened EU fiscal rules resolved in 2012. In these circumstances a return of the EMU confidence crisis cannot be ruled out.

At 90% the government debt ratio in the euro area stood significantly above the 60% debt criterion in the second quarter, and this figure is set to increase in future. Because despite the - in part - major reform and savings efforts we have seen, as a result of the flagging economy in many places, the debt mountain is likely to continue to grow in many EMU countries in 2014 compared to economic output. Moderate growth prospects for the eurozone will result in the debt reduction process becoming ever more drawn out.

## 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 | 0.3 | 0.2 | 0.0 | *0.3* | *0.1* | *0.3* | *0.4* | *0.3* | *0.3* | -0.4 | *0.8* | *1.2* |
| Private consumption | | -0.2 | 0.2 | 0.2 | 0.1 | 0.2 | 0.3 | *0.2* | *0.1* | *0.3* | *0.4* | *0.2* | *0.2* | -0.6 | *0.7* | *1.0* |
| Government spending | | 0.2 | 0.0 | 0.3 | -0.3 | 0.7 | 0.2 | *0.0* | *0.1* | *0.2* | *0.3* | *0.2* | *0.3* | 0.1 | *0.8* | *0.8* |
| Investment | | -1.6 | 0.1 | 0.5 | 0.9 | 0.2 | -0.3 | *0.5* | *0.6* | *0.7* | *0.8* | *0.6* | *0.6* | -2.8 | *1.3* | *2.4* |
| Exports | | -0.8 | 2.3 | 0.1 | 1.4 | 0.1 | 0.5 | *1.2* | *0.8* | *1.2* | *1.0* | *0.9* | *0.8* | 1.5 | *3.0* | *4.0* |
| Imports | | -0.8 | 1.6 | 1.1 | 0.7 | 0.8 | 0.3 | *1.1* | *1.0* | *1.2* | *1.2* | *0.9* | *0.9* | 0.4 | *3.3* | *4.2* |
| Industrial production (excl. construction) | | 0.2 | 0.7 | 0.0 | 0.6 | 0.2 | 0.0 | *0.6* | *0.5* | *0.7* | *0.7* | *0.6* | *0.6* | -0.7 | *1.2* | *2.4* |
| Unemployment rate | % | 12.0 | 12.0 | 12.0 | 11.9 | 11.7 | 11.6 | *11.5* | *11.3* | *11.2* | *11.0* | *10.9* | *10.8* | 12.0 | *11.5* | *11.0* |
| Consumer prices | y-o-y | 1.9 | 1.4 | 1.3 | 0.8 | 0.7 | 0.6 | 0.3 | *0.7* | *0.7* | *1.1* | *1.3* | *1.5* | 1.4 | *0.6* | *1.2* |
| Producer prices | y-o-y | 1.2 | -0.1 | -0.6 | -1.1 | -1.6 | -1.1 | *-1.3* | *-0.7* | *0.2* | *1.0* | *1.7* | *1.8* | -0.2 | *-1.2* | *1.2* |
| Current account balance | EUR bn, sa | 52.2 | 61.8 | 49.9 | 66.7 | 55.6 | 62.0 | *60.0* | *55.0* | *55.0* | *60.0* | *65.0* | *60.0* | 230.6 | *232.6* | *240.0* |
| | % of GDP | | | | | | | | | | | | | 2.4 | *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.

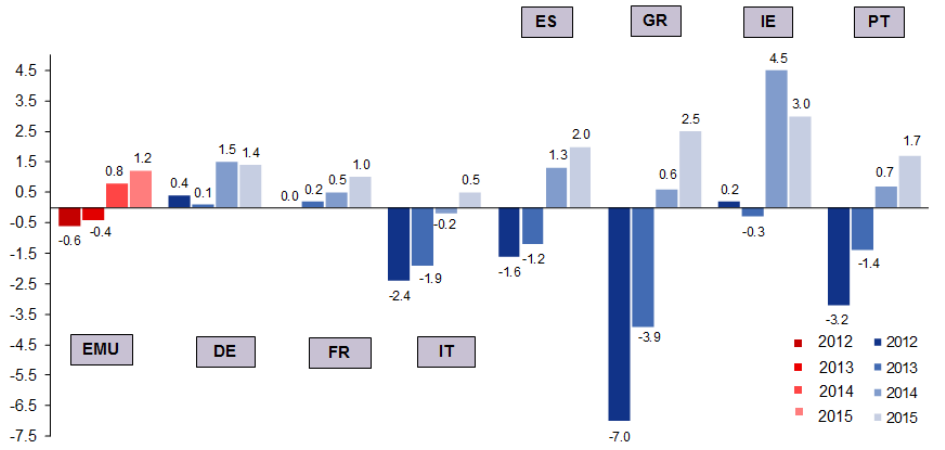
After the second quarter of 2014 saw economic growth take a breather, the third quarter may well record a certain rebound. However current economic indicators also suggest that economic development is likely to remain relatively subdued in the final quarter, too. Until the end of 2015 we expect to see a moderate revival in the euro area economy, with GDP growing by just shy of 0.3% on average quarter-on-quarter.

We primarily expect positive impulse from the steady - albeit gradual - strengthening of domestic demand in the eurozone. Notwithstanding significant consolidation challenges in the private sector, both the tentative decrease in unemployment and a slight acceleration in wage increases (with inflation remaining on the low side for the time being) point to a pickup in private consumption. In the near future investments are likely to suffer from increasing geopolitical uncertainty, but provided the conflict does not escalate, we expect the corporate sector to grow more and more used to greater geopolitical risks. Still favorable financing conditions, improved access to credit and a significant need to catch up, particularly in the former crisis countries, are likely to bolster investment in the euro area over the coming year. In view of the drop in the euro, the increased competitiveness of some EMU economies and a positive economic trend in both the US and the United Kingdom, growth prospects for EMU exports are clearly positive. However, the increase in imports which is to be expected as a result of strengthened domestic demand, makes it likely that, in purely arithmetical terms, exports will make only a modest contribution to positive growth.

Looking at the year on average, we predict economic growth of 0.8% for 2014 and 1.2% for 2015. The overall EMU figure conceals some major differences. What is new is that as regards growth prospects the distinction of periphery and core countries no longer seems to make sense. Instead, we will increasingly have to differentiate between "reformed" countries and countries "with reforms outstanding". For instance, some former program countries such as Ireland and Spain are likely to finally reap the rewards of their reform efforts and expand significantly more strongly than the EMU average, whereas economic recovery will continue to remain relatively weak, inconsistent and vulnerable in countries which have demonstrated an insufficient willingness to reform so far - such as France and Italy.

EMU: Former crisis countries starting catch-up process

Real GDP growth (%)




Sources: EcoWin, own forecasts.

To conclude, in our view the eurozone economy faces three major risks. At present the biggest danger to the economic upswing would be a serious escalation in the conflict between Russia and Ukraine. The second danger is that ECB measures will not yield the desired result, with the economy remaining sluggish and the persistent ultra-loose monetary policy beginning to have negative side effects. Thirdly, there is the risk that EMU countries may let up on their reform and consolidation efforts, making no progress as far as debt reduction is concerned.

## Emerging markets

The emerging markets currently present anything but a homogenous picture. As a group they have been reporting moderate growth during the course of the year so far - by their standards. However, looking at the different regions individually, some significant differences emerge. Whereas Mexico and Colombia, for instance, are recording solid growth overall, Brazil, the largest economy in Latin America, is in recession. At present business sentiment in Brazil is worse than it has been since the global recession in 2008/2009. Since mid-2013 investment activity has been on the decline, with the key reasons being inconsistent economic policy, continuing structural problems and a high tax burden as well as excessive regulation. In eastern Europe, too, we see a genuine growth gap. In recent quarters a great many eastern European EU member states still reported a tangibly higher growth momentum than they had done one or two years previously. A significant reason for this trend is the, albeit modest, economic upswing in the euro area. But in Russia and the Ukraine the situation is altogether different. Both economies are suffering from the economic consequences of the armed conflict in Ukraine and are on the brink (Russia) or slap in the middle of a recession (Ukraine). However, weak economic development in Russia is not exclusively a result of this conflict. The Russian economy has been struggling with massive structural problems for some time now, cooling off gradually in recent years.

## Eastern Europe: Effects of the crisis in the Ukraine rather limited so far

Following approximately two years of lackluster growth in all major eastern European EU countries with the exception of Poland, over the course of 2013 the economy picked up markedly. The albeit modest economic recovery in the euro area, the most important sales market for eastern European exports, played a key role in this development. Following a solid start to 2014, economic growth data in the second quarter, as well as a turn for the worse in economic sentiment in countries such as Poland, point to slackening growth momentum in the region as a whole. Does the Russian-Ukrainian conflict pose a threat to economic recovery in eastern Europe?

Below we will briefly examine two key elements where the crisis in the Ukraine has the potential to affect the economic development of eastern European EU countries for the worse, i.e. international trade and the business climate (with possible consequences for consumption and investment).

Effect 1 - international trade: Looking at trade relations of eastern European EU member states, it becomes evident that for these countries the two parties in conflict, Russia and Ukraine, play a rather subordinate role as export markets. For instance, Russia's share of respective total exports primarily comes in at between 3.5% and 5.5%. Eastern European countries dispatch the bulk of their exports to other EU countries, i.e. between 75% and 85%. One exception, however, are the Baltic states where Russia's share amounts to up to 20%, with the EU share correspondingly lower. While, in terms of exports, eastern European EU member states only depend on Russia to a lesser extent, imports present a somewhat different picture. Last year more than 12% of Polish imports and just shy of 30% of Lithuanian imports came from Russia. That this proportion appears rather high overall can be explained by the great dependency of eastern European countries on Russian energy supplies: the Baltic states rely on Russian gas for 100% of their gas consumption, in Hungary and Poland no less than 60% of gas comes from Russia. Although, as has been shown, Russia's share of the respective overall exports is low compared to the average of all countries, the current downward trend in the bilateral goods trade with Russia is fairly pronounced. Polish exports to Russia, for instance, in the first seven months of the year were down more than 8% on a year earlier. In July alone the value of goods tumbled almost 12% year-on-year.

Effect 2 - business climate: in eastern European EU member states the mood has been looking increasingly gloomy over the course of this year. This is particularly true for Poland where the purchasing managers index for the manufacturing industry was stagnating more or less at below 50 points in the third quarter, having hovered around the 55-point mark at the beginning of the year. Economic sentiment in Hungary, too, has taken a turn for the worse in recent months. By contrast the mood of the Czech economy is proving remarkably resilient: recently the purchasing managers' index for the manufacturing industry was able to climb markedly and at just over 55 points it currently clearly exceeds the 50-point expansion threshold. Without a doubt the Ukrainian crisis plays a decisive part in the deterioration of business sentiment in eastern Europe. The comparatively significant downturn in Poland is also likely to have been caused by the fact that among the major eastern European EU member states Poland, in terms of its economic output, relies most strongly on Russia and the Ukraine as export destinations. But doubtless the geographical proximity of the country to the conflict region also exerts a negative influence on business sentiment in Poland. The longer the conflict, the bigger the risk

that increased economic uncertainty will also lead to a greater reluctance to make purchases and to invest. This, in turn, would considerably exacerbate the growth-inhibiting effect of the conflict between Russia and the Ukraine on eastern European EU member states, because this would then not only make itself felt primarily in the field of exports, but also as far as domestic demand is concerned.

Our economic forecast is based on the key assumption that we will not experience a significant worsening of the Ukrainian conflict. In this base scenario we predict that the growth-inhibiting effects on eastern European EU member states triggered by the conflict will remain moderate and that the region will carry on benefitting from the expected continuation of the moderate upswing in the euro area. In the event, however, that the armed conflict flares up again and that tensions between Russia and the west continue to increase, the picture would be entirely different: a lacking growth impetus from the eurozone, combined with the likely downturn in business sentiment and spreading reluctance to consume and invest would highly likely serve to plunge the region into a recession.

Compared to Latin America and eastern Europe the economic situation in the Asian emerging markets is more positive and much less heterogeneous, with the growth differentials between the individual countries far less pronounced. In India there are increasing signs of a more lively economic development than in the two previous years. In China, the world's second largest economy, by contrast the trend towards a gradual slowdown in growth continues. The country is locked in a very difficult process of change away from a markedly export and investment driven growth model towards a more consumer-oriented one. At the same time China is facing considerable macroeconomic imbalances such as excessive lending, local property bubbles and exploding debt levels among provinces and municipalities, not least due to the growth model prevailing so far.

In principle the stabilizing economy in the industrialized nations, as well as a slight revival in global trade, suggest that the growth momentum in the emerging markets is slightly on the up. For Latin America we predict regional GDP growth of 2.4% for the coming year, following on from a disappointing increase of - according to our estimates - 1.2% this year. The Mexican economy is likely to benefit from the improvement in the macroeconomic environment as well as from the structural reforms that have been embarked on, thus contributing significantly to greater economic growth in the region. For Brazil we expect, as a minimum, the economy to stabilize slightly in 2015.

This year, as well as next, the economic output of the Asian emerging markets is likely to increase by 6.2% respectively, maintaining the rate of expansion recorded in 2013. In China the trend towards a slowdown in economic growth will continue; however we do not expect to see a real nosedive in the economy. On the other hand we predict countries such as India and Thailand to see increasing economic momentum, meaning that the speed of expansion in the Asian emerging markets will remain unchanged overall. Among all the emerging market regions the future economic development of eastern Europe remains most uncertain at present as a result of the conflict between Russia and the Ukraine. Assuming that this conflict will, at least, not escalate significantly, we expect the growth momentum of most eastern European EU member states to resemble that of the current year. These countries are likely to continue to reap the benefits of the moderate economic upturn in the euro area. Altogether, we predict that the eastern European region will expand by a rate of 2.1% in 2015, which will be markedly higher than this year's (forecast for 2014: +0.9%), the reason being that we have not assumed a further downturn in economic output in Russia and the Ukraine for 2015 as a whole.

All in all, we expect the emerging markets to grow by 4.1% this year, the weakest growth seen since the global recession in 2009. Real economic growth is then expected to pick up slightly to 4.6% in 2015 - bolstered by a phase of more dynamic economic activity in the eastern European and Latin American emerging markets. 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. In fact, in recent years this contribution has even been growing. This can be explained by the increased share of the emerging markets in global output. In 2007 this share stood at 29.5%, climbing to 39.4% in 2013 (based on current exchange rates in each case).

## Growth rates in main economic regions

GDP, real % change over previous year

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014[1)] | 2015[1)] |
|---|---|---|---|---|---|---|---|
| **Industrialized countries** | **-3.7** | **2.6** | **1.4** | **1.1** | **1.2** | **1.7** | **2.0** |
| European Union | -4.5 | 2.0 | 1.7 | -0.3 | 0.1 | 1.3 | 1.6 |
| Euro area | -4.4 | 1.9 | 1.6 | -0.6 | -0.4 | 0.8 | 1.2 |
| Germany | -5.6 | 4.1 | 3.6 | 0.4 | 0.1 | 1.5 | 1.4 |
| USA | -2.8 | 2.5 | 1.6 | 2.3 | 2.2 | 2.2 | 2.8 |
| Japan | -5.5 | 4.7 | -0.5 | 1.4 | 1.5 | 1.0 | 1.2 |
| **Emerging markets** | **1.5** | **7.4** | **6.1** | **4.5** | **4.5** | **4.1** | **4.6** |
| Asia | 5.9 | 9.5 | 7.5 | 6.1 | 6.2 | 6.2 | 6.2 |
| Latin America | -1.6 | 6.0 | 4.2 | 2.7 | 2.4 | 1.2 | 2.4 |
| Central and Eastern Europe | -6.1 | 3.4 | 3.9 | 2.1 | 1.4 | 0.9 | 2.1 |
| **World** | **-2.1** | **4.1** | **2.9** | **2.3** | **2.4** | **2.5** | **3.0** |

1) forecast.

Sources: EcoWin, own forecasts.

We estimate that global output will grow by 3.0% next year, after reaching 2.5% this year (country weighting based on current exchange rates in each case). Both the advanced and the up-and-coming economies are likely to make an equal contribution to what will be a slightly more dynamic development than that seen this year.

Among others our economic forecast is based on the assumption that we will not experience a significant worsening of geopolitical tensions. This applies, in particular, to the conflict between Russia and the Ukraine. We expect the current status quo between the Ukraine, the separatists and Russia to continue in the main, which means that the economic sanctions imposed on Russia and Russia's corresponding counter measures will also not be tightened dramatically. However we predict the sanction spiral, which may, not least, also mean restrictions on energy imports from Russia, to tighten further if the military conflict were to expand and eastern Ukraine were to fall largely under Russian control. If this risk scenario were to occur, our economic forecast certainly would not hold true.

Below we set out the additional overall framework of our economic forecast:

- Global trade will show more dynamic development in the coming quarters. After approximately 3% this year, we expect it to grow by 4%-4½ % in 2015. This means that the international movement of goods and services will probably continue to react less strongly to increased global output than in the years prior to the financial crisis.

- Following the slump below the USD 100 mark in recent months, crude oil (Brent) is likely to average 103 USD/barrel over the year as a whole, approximately USD 6 below the prior-year mark. With growth in crude oil demand remaining subdued, we expect prices to range between 100-105 USD/barrel in the coming year. In view of the fragile geopolitical situation, however, sharp temporary fluctuations cannot be ruled out.

- The US Fed has made continuous cuts to the volume of securities purchased during the course of the year so far, and we expect it to wind up its asset purchase program for good at the end of October. In 2015 the Fed is likely to make further corrections to its extraordinarily expansive monetary policy by raising the key interest rate towards the 1% mark. We predict an initial interest rate hike for next spring. It is very likely, however, that the ECB will embark on rate hikes later than the Fed, i.e. not before mid 2015. The exit from ultra-loose monetary policy is likely to focus on interest rate policy to start with, because the ECB has already promised to provide unlimited liquidity until the end of 2016 and the new, targeted, more long-term refinancing operations will take place until mid-2016.

- The euro is likely to remain weak vis-à-vis the US dollar in view of interest differentials at the short end of the capital market and the economic advantages of the US. At the end of 2014 we expect the USD/EUR exchange rate to come in at 1.18. After an estimated value of 1.32 in 2014 on average we predict average levels just shy of 1.20 USD/EUR for the coming year.

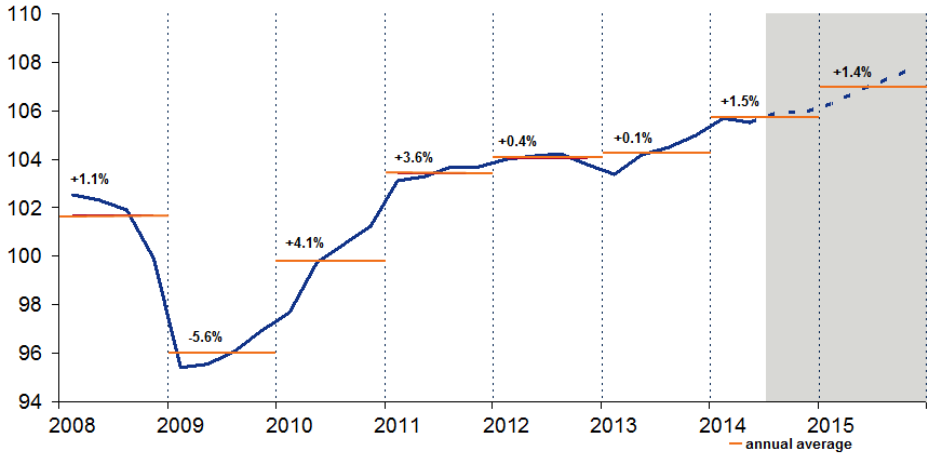
## 2. ECONOMIC SITUATION AND OUTLOOK IN GERMANY

### 2.1 Upswing temporarily faltering

After a good start to the year the upswing has temporarily stalled. In the second quarter the German economy contracted slightly and business expectations have clouded over substantially compared with early in the year. A key factor behind this is the uncertain geopolitical backdrop, first and foremost the Russia/Ukraine conflict. In addition, the economic recovery in the eurozone is far from smooth – Italy and France remain a cause for concern. And with the economy in a number of emerging markets, such as Brazil and Turkey for instance, also no longer purring, the global economic backdrop is currently problematic.

Germany: Return to stronger growth in course of 2015

Real GDP, index (2005 = 100)




Sources: EcoWin, own forecasts.

However, these burdens on the German economy are counterbalanced by a series of positive factors. The upswing in employment has continued until only recently, with growing employment creating income. In conjunction with rather low inflation and rapidly rising effective wages, the purchasing power of incomes is increasing at greater speed. Consumer demand is likely to deliver more impetus. The construction industry also continues on an upward trend, although production temporarily dropped in the second quarter. On the part of the government we expect higher investments in infrastructure. High levels of immigration from abroad, as well as extremely favorable financing conditions, lead to a continuing positive outlook for the residential construction sector. The drop in value of the euro, which is likely to continue somewhat, will improve export opportunities, even if global trade will continue to report moderate growth. All in all we expect German gross domestic product to grow only slightly in the second half of the year. It is likely to increase by 0.3% in the third quarter and to stagnate in the fourth. The increase we estimate for the third quarter is largely not due to economic developments but rather to production levels which were kept low by special factors in the second quarter (anticipatory effects in the first quarter resulting from weather conditions, as well as long weekends). This would result in estimated average growth of 1.5% in 2014.

However, the outlook for the German economy for 2015 is characterized by considerable uncertainty. At the same time the economic potential offered by the positive factors mentioned above should not be underestimated. We expect the upward forces to keep the upper hand. Supported by the lower value of the euro and a slight acceleration in global trade, we predict that exports will provide a stronger impetus than in 2014. Income from wages and transfer payments is rising strongly, fueling consumer demand. However, employment growth will slow down, not least as a result of the introduction of the minimum wage. Sharply rising costs and increasing import prices are pushing consumer price inflation back up again. In view of somewhat higher capacity utilization and healthy earnings. investment activity is expected to pick up moderately in spite of persisting uncertainties. All in all, we predict economic growth of 1.4% for 2015.

## Major revision of national accounts

In its 2014 major revision the German Federal Statistics Office implemented the European System of Accounts 2010 (ESA 2010), replacing the ESA 1995 in force to date, and comprising adjustments to the results of the national accounts for the period 1991 to 2013. Apart from the ongoing, general review of the figures a variety of conceptual amendments, which effect the calculation of economic parameters, have been incorporated into the ESA 2010.

In quantitative terms, among these changes it is primarily the amended capture of research and development spending on part of the government and the corporate sector which will make a key difference. From now on this spending will be capitalized and identified as gross capital investments, which results in an average increase of this item of 12.3% per year. The direct consequence of this is an increase in gross domestic product. However, particularly as a result of the extension of the definition of investment, depreciation has risen by 20%, which is why parameters such as net national income or national income have seen little change, in spite of the increase in GDP. Yet another change is the turn away from the gross recording method for cross-border job processing that results in a significant decrease in the import and export ratio (by 3.1 and 3.3 percentage points respectively on average per

year), but only has a minor impact on the external contribution. Other conceptual changes such as the adjusted capture of military weapons systems or the amended delineation of low-value assets have a comparatively minor effect on the national accounts.

All in all, across the entire revised period from 1991 to 2013 average nominal GDP growth as a result of these changes stands at 3.1% per year. For 2010 the German Federal Statistics Office has published a detailed review analysis, which illustrates the quantitative impact and the focus of this revision: during that year as a result of these conceptual changes GDP increased by EUR 66.7bn or 2.7%, with the adjustment of research and development spending alone accounting for EUR 57.1bn or 2.3%. Altogether, including corrections other than these conceptual changes, GDP for 2010 is 3.3% above the previous value.

It is also worthy of mention that, as a result of the German Employment Agency adjusting its employment statistics, the number of people in work has been revised upwards by 320,000 individuals (0.8%) per year on average.

Despite predicted GDP growth of 1.5% in 2014 and 1.4% in 2015 there is no hiding the fact that the German economy has recorded but weak growth ever since 2012. In the four years between 2012 and 2015 it is likely to expand by only 0.8% on average. In the preceding four-year period from 2008 to 2011 the average even amounted to a mere 0.7%. In any case, the purported strength of the German economy does not come through in these figures.

### 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 | | -0.4 | 0.8 | 0.3 | 0.4 | 0.8 | -0.1 | 0.1 | 0.0 | 0.4 | 0.5 | 0.4 | 0.4 | 0.1 | 1.5 | 1.4 |
| Private consumption | | 0.2 | 0.6 | 0.3 | -0.3 | 0.5 | 0.1 | 0.7 | 0.5 | 0.4 | 0.3 | 0.2 | 0.3 | 0.8 | 1.2 | 1.7 |
| Government spending | | 0.0 | 0.0 | 0.6 | -0.1 | 0.2 | 0.4 | 0.6 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 | 0.7 | 1.1 | 1.3 |
| Investment in machinery/equipment | | -4.0 | 2.8 | -0.6 | 2.6 | 1.7 | 0.4 | -2.3 | 1.0 | 1.2 | 1.5 | 1.0 | 1.0 | -2.4 | 3.6 | 3.1 |
| Construction | | -2.8 | 3.0 | 1.8 | 0.7 | 4.2 | -3.9 | -0.3 | 1.0 | 1.2 | 1.0 | 0.8 | 0.8 | -0.1 | 3.5 | 2.5 |
| Domestic demand | | -0.2 | 0.7 | 0.7 | 0.0 | 0.9 | -0.2 | -0.2 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.7 | 1.3 | 1.3 |
| Exports | | 0.7 | 1.4 | 0.7 | 1.7 | -0.2 | 1.2 | 1.9 | 0.0 | 1.0 | 1.5 | 1.3 | 1.2 | 1.6 | 3.7 | 4.7 |
| Imports | | 1.2 | 1.3 | 1.7 | 0.7 | -0.1 | 1.1 | 1.7 | 0.8 | 1.2 | 1.2 | 1.2 | 1.0 | 3.1 | 3.6 | 5.0 |
| Industrial production (excl. construction)**) | | 0.5 | 1.4 | 0.6 | 0.6 | 0.6 | -0.6 | -0.3 | 1.2 | 0.7 | 0.7 | 0.4 | 0.4 | 0.4 | 1.6 | 2.2 |
| Unemployment rate (EU def.) | % | 5.3 | 5.3 | 5.2 | 5.1 | 5.1 | 5.0 | 4.9 | 4.9 | 4.9 | 4.9 | 4.9 | 4.9 | 5.2 | 5.0 | 4.9 |
| Unemployment rate (nat. def.) | % | 6.9 | 6.9 | 6.8 | 6.9 | 6.8 | 6.7 | 6.7 | 6.6 | 6.6 | 6.6 | 6.6 | 6.6 | 6.9 | 6.7 | 6.6 |
| Employed persons (national def.) | y-o-y | 0.6 | 0.6 | 0.6 | 0.5 | 0.7 | 0.8 | 0.8 | 0.9 | 0.7 | 0.6 | 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 | 1.1 | 0.8 | 0.6 | 0.6 | 0.7 | 1.0 | 1.5 | 1.5 | 0.9 | 1.0 |
| Consumer prices (HICP) | y-o-y | 1.8 | 1.5 | 1.7 | 1.3 | 1.0 | 0.9 | 0.8 | 0.5 | 0.5 | 0.7 | 0.9 | 1.5 | 1.6 | 0.8 | 0.9 |
| Producer prices | y-o-y | 0.8 | -0.1 | -0.3 | -0.7 | -1.0 | -0.9 | -0.8 | -1.1 | -0.7 | 0.2 | 0.9 | 1.7 | -0.1 | -1.0 | 0.5 |
| Current account balance | EUR bn | 47.1 | 48.5 | 44.5 | 50.4 | 51.5 | 51.2 | 58.2 | 55.0 | 54.0 | 53.0 | 52.0 | 50.0 | 189.2 | 215.9 | 209.0 |
| | % of GDP | | | | | | | | | | | | | 6.7 | 7.5 | 7.3 |
| Budget balance | EUR bn | | | | | | | | | | | | | 7.3 | 13.5 | 9.0 |
| (Maastricht-definition) | % of GDP | | | | | | | | | | | | | 0.3 | 0.5 | 0.3 |

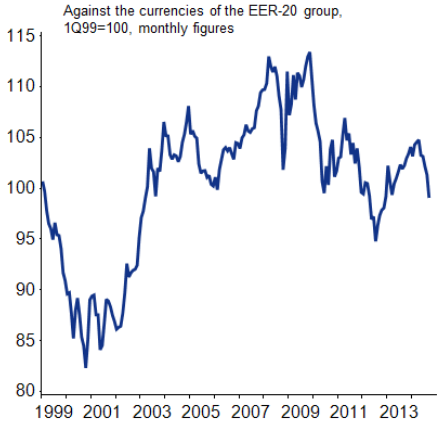
*) quarterly figures: percentage change over previous period, seasonally and working day adjusted, except where noted, yearly figures: percentage change, not working day adjusted; **) yearly average working day adjusted. f = forecast.

## 2.2. Exports running short on momentum

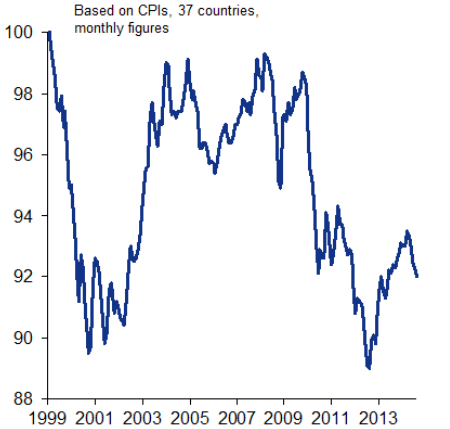
Over the course of the year so far demand from abroad has been largely stagnating. Even the strong increase in incoming orders from abroad in July of this year of 6.9% compared to June does not alter this picture fundamentally, because it is likely to have been

excessive as a result of an above-average proportion of major orders and the relatively late start to the summer vacation in some federal states. On a regional level exports differed widely during the first half of this year, which comes as little surprise given the multifaceted picture presented by the global economy. In a year-on-year comparison German exports to Russia, Turkey, India, Brazil, South Africa and Australia in particular were on the decline. Above average increases were recorded for exports to China, the United Kingdom, the US, Spain, Poland, the Czech Republic and Hungary.

Real effective exchange rate of the euro




Indicator of price competitiveness[1)]



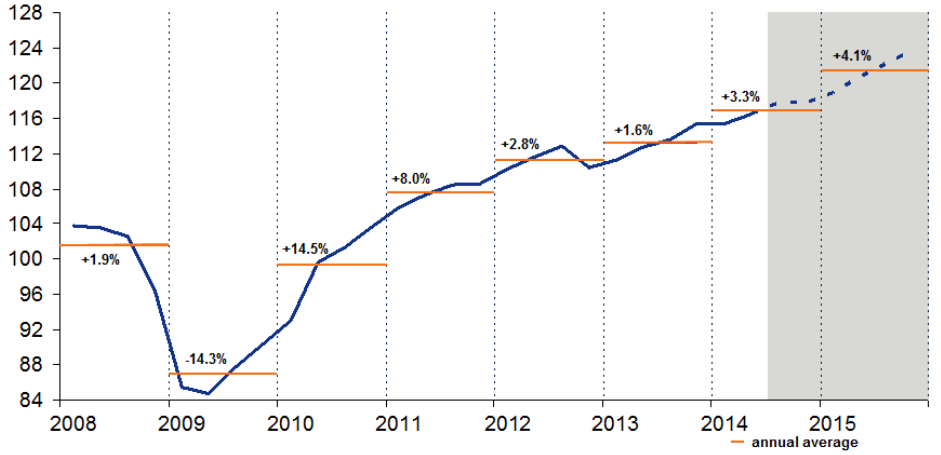

1) A decline means an increase in competitiveness.

Sources: EcoWin, Deutsche Bundesbank.

Despite the trade sanctions against Russia German exports will probably pick up slightly in the last few months of this year and substantially in the course of 2015. The global economy is more robust than might appear the case given the political and military crises. The economy in a number of ailing emerging markets is likely to gradually get back into stride. Demand from the eurozone will probably pick up progressively as former crisis countries get back on their feet. The improved price competitiveness of the German exports sector will remain intact in 2015 as well, even if domestic cost pressures intensify somewhat. In real terms we expect German exports to rise by 4.1 percent in 2015 after 3.3 percent in 2014 and 1.6 percent in 2013.

Germany: Only moderate growth in exports since 2012

Real exports, index (2010 = 100)




Sources: EcoWin, own forecasts.

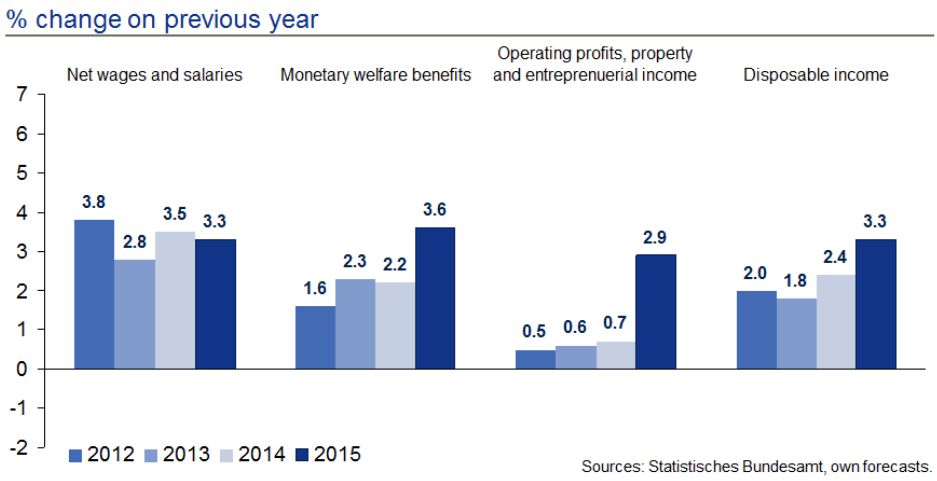
In view of the relatively strong domestic economy we predict real imports to outdo exports to some extent, growing by 4.1% this year and 4.8% next year. However, since the terms of trade, i.e. the price ratio of exports and imports, should still improve somewhat this year, the surplus of the balance of trade and the current account is likely to increase yet again. Next year, by contrast, this is likely to change as a result of rising import prices. We expect to see a current account surplus just shy of EUR 200bn in 2015, following on from EUR 207bn in 2014 and EUR 192bn in 2013.

## 2.3 Consumption as driving force

Although private consumption has been heading north for years now, in real terms growth rates are mostly rather low. Following on from real gains to the tune of 0.7% in 2012 and 0.8% in 2013, for this year we expect to see growth of 1.1%. For one, at 2.4% the disposable income of households will increase somewhat more strongly this year than in the previous two years (+2.0% or + 1.8%). For another, the drop in purchasing power caused by inflation will, at 1.1%, turn out to be lower than in 2012 and 2013 (+2.0% or 1.5%). There is even still a little room for maneuver for the rather low savings rate to claw its way up from 9.1% last year to 9.3% this year.

We can now also identify a significant acceleration in income growth. Of late contractual wages were up by a good 3%. In the coming year, we expect the introduction of the minimum wage to drive up actual earnings per employee by an estimated ¾ of a percentage point. Although we still expect the minimum wage to put a considerable damper on jobs growth, overall labor income should nevertheless rise by 4.0% in 2015, following on from 3.7% this year and 3.8% last year. Transfer payment growth will also pick up significantly. As a result of the extension of the mothers' pension and the option of retiring at 63, with no deductions, for individuals who have been paying into the pension system for a long period of time, which came into force in mid-2014, we expect monetary social benefits to rise by 3.6% next year, following on from 2.2% this year.

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




All in all, we predict that the disposable income of private households will outdo this year's figure by almost one percentage point, rising by 3.3% in 2015. Regrettably, the real purchasing power of incomes will not rise to the same extent. The higher increases in wage costs, combined with import prices which are unlikely to fall further, will lead to rates of inflation heading for the 2% mark. Aggregate real income, which rose by an

estimated 1.3% in 2014, should increase by 1.6% in 2015. We do not expect the savings rate to change significantly, since the incentive to up one's savings is minimal as a result of ultra-low interest rates. In 2015 we predict the savings rate to remain unchanged at 9.3% compared to 2014. So, in real terms, private consumption should go up by 1.6% in 2015. This would at least make it the second highest growth rate in the last ten years (after +2.3% in 2011). Consumer sentiment, which remains fairly upbeat at present, provides a good starting point for a positive consumer economy.

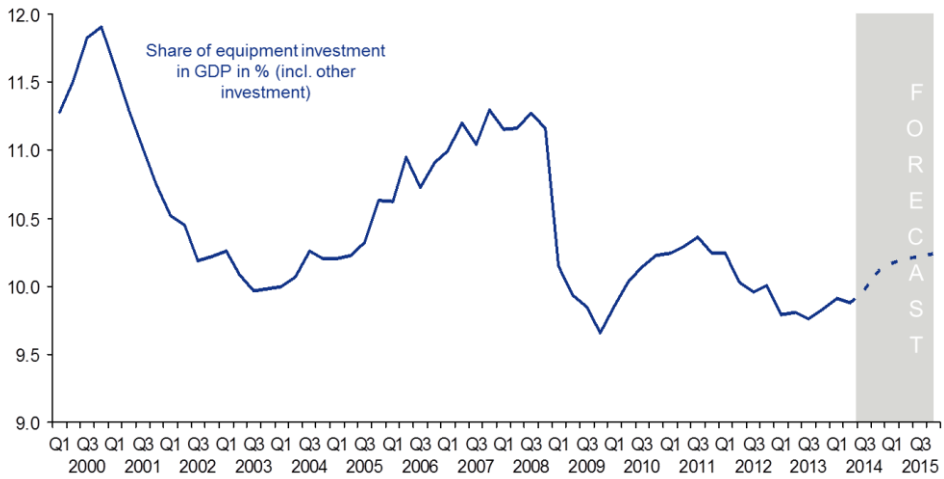
## 2.4 Investments making a moderate recovery

Including research and development outlays in investment activities was the most important of the recent conceptual changes to the national accounts, driving up the share of investment in GDP from 17.2% to 19.7% in 2013. However, this does not change the sluggish development of fixed capital investment in 2012 and 2013, where it fell by 0.7% in each case. This year there are at least signs of a recovery. We expect equipment investment to go up, in real terms, by 4.7% in 2014, construction investment by 3.8% and other fixed capital investment, including research and development spending, by 1.9%.

In spite of rather favorable financing conditions and the relatively good operating performance of the corporate sector, the investment forecast is subject to considerable uncertainty. This is due to geopolitical tensions, and the conflict between Russia and the Ukraine in particular, which cause uncertainty, choking the propensity to invest. In our experience, equipment investment, which contracted slightly in the second quarter of this year after two strong previous quarters, has a tendency to react rather sensitively to such disturbances. Assuming that geopolitical tensions will not escalate but rather abate somewhat in the course of next year, there is a good chance that equipment investment will continue on the road to recovery towards the end of 2015 and during 2015. We predict capacity utilization to continue on its slight upwards trend, which is why the expansion motive is also likely to gain in importance. We forecast equipment investment growth for 2015 to the tune of 3.4%, while other investment is likely to rise by 2%.

However, the recent pickup does not fundamentally change the underlying downward trend in the investment ratio in Germany over the longer term. At 9.9 percent the share of fixed capital formation in GDP was almost as low as the 9.7 percent nadir seen in the economic crisis 2009.

Germany: Investment ratio very low




Sources: Statistisches Bundesamt, own forecasts.

Compared to equipment investment, construction investment has been charting a significantly more favorable course in recent years, even if it did slip back by 0.1% last year. The outlook for the construction industry remains very positive, with strong expansion continuing to be the order of the day in residential construction. Ultra-low financing terms, high immigration from abroad which fuels the demand for residential space and the prospect of real estate value increases are all providing an important impetus. The envisaged "rent cap", however, is likely to take the edge off this momentum. We predict investment in residential construction to rise by 4% this year, followed by 3% the next.

After commercial construction contracted in the two previous years, this year we estimate growth to the tune of 2.5%. This means that the commercial construction segment will chart a similar course to equipment investment. This is unlikely to change substantially in future either. We expect real construction investment to report growth of around 3% in 2015.

Public investment in construction has been on a downward trend ever since 2010. This year, however, we predict a marked increase of 6%. However, the investment to clear up last year's flood damage is a special factor which also plays a part. Since municipal finances are no longer as unfavorable as in previous years and, at federal level, the need for infrastructure investment is equally considerable, we expect public investment in construction to rise by 3% next year, despite investments in repairing the flood damage having run their course.

All in all, we expect construction investment to expand by 3.1% in 2015. In total, fixed capital investment is likely to notch up an increase of 3.0% in 2015, following on from a 3.4% rise this year.

## 2.5 Inflation on a modest upwards trend

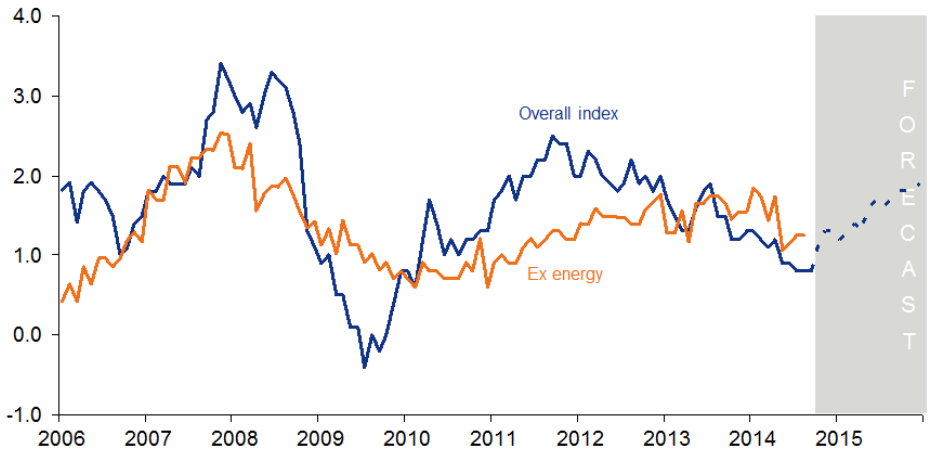
The latest year-on-year increase in consumer prices remained low at 0.8%. The drop in fuel and heating oil prices continues to exercise a beneficial effect. Stripping these out, the rate of inflation would stand at 1.1%. The extremely low increase in food prices at 0.3% is also curbing inflation.

We nevertheless expect the external effects currently putting downward pressure on prices to gradually wane. The drop in the euro is likely to put an end to the decline in import prices. We also do not expect crude oil and gas prices to drop further. As a consequence domestic forces driving inflation, particularly wage costs, are likely to exercise a greater effect on the development of the consumer price index. Unit labor costs, which rose by 2.2% last year, are expected to rise again markedly this year by around 2%. Next year, the upwards trend in labor costs is set to strengthen even further. We expect unit labor costs to increase by around 2.5% in 2015.

The rise in consumer prices, which we expect to come in at 1.0% in 2014, is likely to edge up towards the 2% mark during the course of 2015 as a result of these cost increases. We believe that inflation will average 1.6% in 2015.

Germany: Inflation set to pick up again

Consumer price index, % change on previous year




Sources: Statistisches Bundesamt, own forecasts.

## 2.6 Upswing on the labor market slowing down

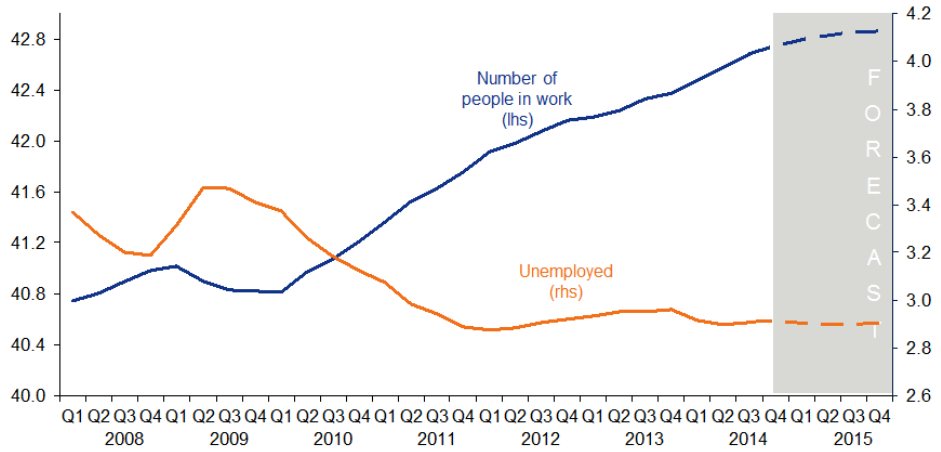
The German labor market has remained in good shape despite the dip in the economy in the second quarter. So far this year the number of people in work has risen by around 280,000 in seasonally adjusted terms while the jobless total has fallen by around 25,000. The fact that the number of people in work is rising much more sharply than the jobless total is falling is largely attributable to the high immigration of workers into Germany and rising labor force participation among older people and women. Encouragingly, the year-on-year increase in the number of jobs liable to social insurance of 1.8 percent most recently remains well above the increase in overall employment (0.8 percent). On average employment will probably rise by around 370,000 in 2014 and unemployment fall by around 40,000.

Economic growth next year is unlikely to be as labor-intensive as this year. With GDP growth pretty much in line with the 2014 figure, Allianz expects the number of people in work to rise by only 100,000 over the course of the year and on average by just over 200,000. The introduction of the minimum wage will curb jobs growth substantially. The number of people in the low-wage sector is likely to drop appreciably. All told, the number of people in work at the end of 2015 is likely to be some 100,000 lower than it would have been had the minimum wage not been introduced.

In spite of the aging domestic population the number of people in work was driven up markedly in recent years as a result of immigration and growing labor force participation. The immigration of workers from abroad is likely to continue in 2015 in a similar fashion to 2014. As a result of the introduction of the retirement pension without deductions for long-serving employees, the trend towards higher labor force participation among older employees is likely to wane. Considering these factors we expect unemployment to largely stagnate during the course of 2015. On average in 2015 an estimated 2.90m people will be out of work after 2.91m this year.

Germany: Number of people in work and unemployed

millions




Sources: EcoWin, own forecasts.

## 2.7. Budget surplus increased

In our estimation, the German budget will record a surplus in 2014 and 2015 for the third and fourth year in succession. We expect to see a positive balance of EUR 13.5bn this year and EUR 9bn next year, following on from EUR 7.3bn last year. Overall, however, fiscal policy is not steering a consolidation course. As a result of the increases in expenditure as part of the pension package and additional infrastructure spending the budget for 2014 and 2015 is on the expansionary side. The 0.3% increase in the contribution rate to long-term care insurance at the beginning of 2015 should be offset by the slight reductions in the pension insurance contribution rate and the top-up contribution to statutory health insurance. Long-term care services will also be expanded.

Government revenue is likely to expand considerably, by 3.0% this year and 3.4% the next, buoyed by the robust labor market and labor income rising more sharply. We also expect tax revenue to rise by a good 3% in both 2014 and 2015. As regards social security contributions we expect an increase of just shy of 3.5% for 2014 and a good 4% for 2015.

Government spending discipline is visibly on the wane. While expenditure rose by 1.0% in 2012 and 2.3% in 2013, we predict an increase of 2.5% in 2014 and 3.8% in 2015. It should also be remembered that the falling interest burden is also curbing the rise in overall expenditure appreciably. The pension package will clearly speed up the increase in monetary welfare benefits in 2014 and 2015. In-kind benefits will also continue to rise strongly. Employee compensation outlays are also expected to increase at a faster rate than in previous years.

As a result, next year we predict government spending to rise more sharply than government revenue for the first time since 2010. Were expenditure to increase by just under 4%, as expected for 2015, over a longer spell, this would certainly not chime with the objective of maintaining a balanced budget for the long term.

### Germany: Public-sector revenue and expenditure

| in EUR bn | 2010 | 2011 | 2012 | 2013 | 2014[2)] | 2015[2)] |
|---|---|---|---|---|---|---|
| **Revenue** | 1110.4 | 1179.5 | 1217.4 | 1248.6 | 1285.7 | 1329.6 |
| of which: | | | | | | |
| Taxes | 551.8 | 594.7 | 619.8 | 637.9 | 657.0 | 678.0 |
| Social contributions | 426.2 | 442.2 | 454.3 | 465.4 | 480.7 | 500.9 |
| **Expenditure** | 1214.5 | 1201.3 | 1213.7 | 1241.4 | 1272.3 | 1320.7 |
| of which: | | | | | | |
| Inputs | 118.2 | 122.7 | 126.5 | 131.5 | 135.2 | 139.5 |
| Employee compensation | 203.5 | 208.2 | 212.7 | 217.6 | 224.1 | 231.7 |
| Property income payable (interest) | 63.3 | 67.1 | 62.8 | 55.5 | 51.1 | 50.1 |
| Subsidies | 29.2 | 28.0 | 24.4 | 24.7 | 25.4 | 26.0 |
| Monetary welfare benefits | 430.4 | 424.8 | 429.7 | 439.9 | 452.3 | 469.4 |
| Welfare benefits-in-kind | 204.4 | 209.8 | 215.8 | 226.9 | 239.4 | 250.1 |
| Other current transfers | 51.4 | 51.6 | 54.5 | 62.0 | 64.3 | 66.3 |
| Gross investment | 58.1 | 59.7 | 61.0 | 61.3 | 66.9 | 73.6 |
| **Financial balance** | -104.0 | -21.8 | 3.7 | 7.3 | 13.5 | 9.0 |
| memorandum: | | | | | | |
| State spending ratio[1)] | 47.1% | 44.5% | 44.1% | 44.2% | 43.8% | 44.1% |
| Financial balance[1)] | -4.0% | -0.8% | 0.1% | 0.3% | 0.5% | 0.3% |

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

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

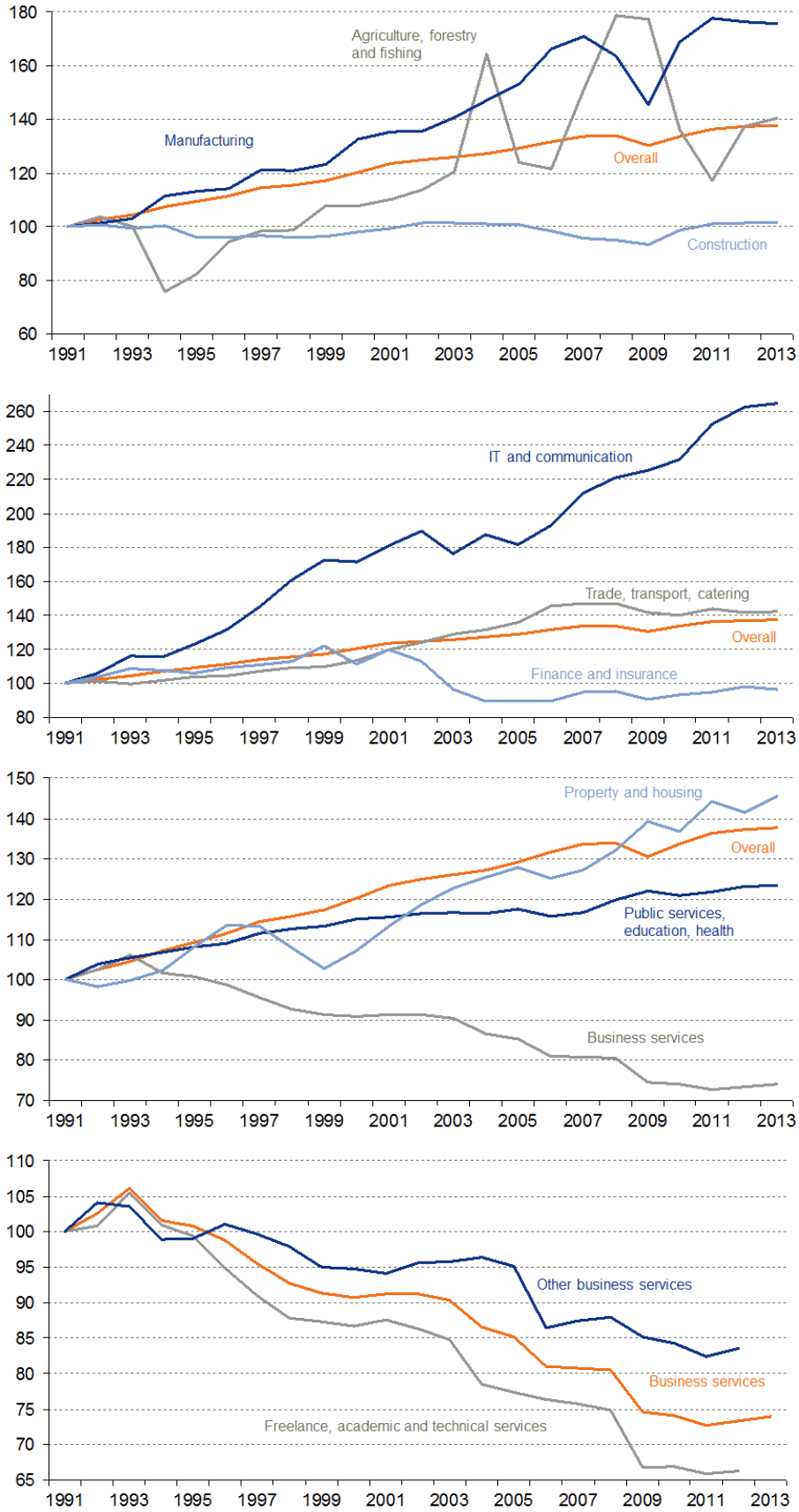
Sources: Statistisches Bundesamt, *working document*, own forecasts.

## 2.8 Weak productivity development

The strong employment growth seen in recent years has been accompanied by and large by modest economic growth. This points to weak productivity growth. In 2012 and 2013 labor productivity per employee dropped slightly (by -0.7% and -0.5% respectively), per hour worked it increased modestly (+0.6% and + 0.4%). This year, little has changed as regards this modest productivity development. We predict an increase in labor productivity per employee by 0.7% and per hour worked by 0.3%.

In view of the demographic curbs on the labor supply, Germany will only be able to achieve economic growth which is able to cope with the ever increasing proportion of pensioners in the population if it manages to generate considerable gains in productivity. This is why the current weak productivity trend is hugely relevant from an economic point of view. First and foremost a root-cause analysis is key. If weak productivity is a result of insufficient investment activity, measures need to be taken to boost the propensity to invest. If, however, weak productivity stems from changes in the employment structure, such as a rising proportion of people in work who are less productive, educational measures that will result in driving up qualifications are the order of the day. It is our assumption that low productivity gains are not due to a single factor but to a rather complex combination of factors. Below we will therefore investigate in which sectors weak productivity is most pronounced, in order to identify additional pointers in this regard.

Economic sectors: Labor productivity per hour*
(1991=100)




* GDP/gross value added (price adjusted, chain index 2010=100) per employee hour worked (converted to base 1991=100).

Source: Statistisches Bundesamt.

According to the revised national accounts productivity development varies considerably in Germany from sector to sector. With productivity gains in the region of 160% since 1991, the information and communications sector reports the most positive development. The manufacturing industry, too, has generated productivity gains that are visibly above average. However, the most striking development is the exceptionally sharp decline in labor productivity per hour worked among business service providers. These include legal and tax consultancy, management consultancy, architects and engineers, research and development, but also leasing, travel agencies and the area of the provision and supply of labor, which has risen sharply. In this large, heterogeneous sector numbering 5.5 million people in work - which amounts to 13% of all people in work - labor productivity has tumbled by around 26% since 1991. Naturally such a weak development has a significant effect on overall productivity. If the productivity of business service providers had risen to the same extent since 1991 as the other sectors on average, overall output and labor productivity in Germany would now both be 11% higher and the average annual increase in productivity since 1991 would be approximately 0.5 percentage points higher.

One might assume that the drop in productivity among business service providers is not due to the area of largely highly qualified freelance, academic and technical service providers (2.56 million people in work), but to that of other business service providers (2.94 million people in work) which include the supply of temporary labor and the leasing business. However, this is not the case. Since 1991 freelance, academic and technical service providers have been reporting a disproportionately high drop in productivity of approximately 34%. This paradoxical development might be indicative of problems in the areas of statistical capture and methodology, e.g. difficulties in price adjustments of the gross value added or in collecting the number of hours worked per person in work from business service providers. From 1991 to 2013 the deflator of the gross value added has risen by around 30%, perfectly in line with other domestic inflation indicators. The number of hours worked per person in work is charting an equally plausible course. For business service providers it decreased by approximately 15% from 1991 to 2013, with the drop reported by freelance, academic and technical service providers squarely below average. It therefore seems just as unlikely that this sharp decline in productivity is due to an overestimate of inflation as to an overestimate of the number of hours worked per person in work.

As a consequence productivity development of business service providers over a period of more than twenty years remains a mystery. Resorting to explanations such as the outsourcing of services in this area or the growing significance of the supply of temporary labor does not seem to provide a solution. The only thing of help in this respect would be a more detailed analysis on the part of those in charge of the statistical sources, i.e. the German Federal Statistics Office and other authorities.

It would nevertheless be misguided to attribute the weak overall productivity development of the recent past to the course charted by a single sector such as that of business service providers. In the last two years, apart from the information and communications sector and agriculture, no other major sector was able to report a marked increase in labor productivity. In our view it is therefore reasonable to surmise that the low overall level of investment and the correspondingly moderate growth in the capital stock have increasingly become obstacles to advancements in productivity.

Various current analyses of a potential German investment gap arrive, in part, at rather diverging results. According to calculations by the German Institute for Economic Research (DIW) and the German Chamber of Industry and Commerce (DIHK) there is a

need for additional investments to the tune of EUR 80bn per year to close the German investment gap, with action needed in both the private and the public sector. Deutsche Bank Research by contrast concludes that one cannot speak of an investment gap in Germany as a whole, rather only the public sector suffers from a shortfall to the tune of EUR 4-7bn per year.

We share the view of Deutsche Bank Research that an investment ratio which is on a downward trend - in Germany since the beginning of the 1960s - and is relatively low in an international comparison does not necessarily indicate a massive investment gap in Germany. An intertemporal, as well as an international, comparison of investment ratios does not constitute a suitable method to analyze a potential investment gap, because country-specific special factors - such as German reunification in our case - may significantly distort the overall picture. There is also no consensus on how high the optimum investment ratio of a country needs to be, and the efficiency of investment is not considered either in a direct international comparison of investment ratios.

So the marked drop in gross capital investment in Germany during the mid-1990s must be interpreted, in part, as a normalization of investment activity following on from increased investment during the reunification boom. In turn, the stabilization during the middle of the last decade can be attributed to improvements in the overall framework, particularly the implementation of the Hartz-IV reforms.

We nevertheless conclude that Germany is suffering from an investment slump, with private net capital investment amounting to less than 2% of economic output. What is particularly crucial is the downward trend reported for some years now by the capital stock in a key sector of the German economy such as the manufacturing industry. For a country such as Germany, where production is capital-intensive, we consider this development to pose a threat to growth and prosperity. That the total German capital stock continues on its moderate growth path is little consolation in this respect.

In the public sector the investment slump is even more pronounced, with government net capital investment even recording negative growth since 2003 with few exceptions. This means that in the public sector not even annual depreciation of investments is compensated for. It is true that investments on the part of the German Federal Government saw high growth rates, at least in part, between 2009 and 2012 - which is due to the economic stimulus programs introduced to stabilize the economy after the severe recession in 2009. However the negative rates of change, in recent times, in the gross fixed assets of municipalities are indicative of weak investment on the part of the public sector.

A further sign that the overall framework in Germany could be more investment-friendly is, in our view, the modest increase in foreign investment. While direct German investment abroad saw a strong increase, especially after 2004, foreign direct investment in Germany charted a significantly less dynamic course over the same period.

As a consequence, in our view an increase in investment in Germany is essential:

- The future dwindling supply of labor - as a result of the aging population - increasingly begs the question of how German prosperity might be maintained. As a consequence increased investment activity is therefore necessary to prevent a reduction in overall growth potential by means of productivity increases. This is only possible if the productivity of the workforce can be driven up by increased investment. This means that social security systems depend on rising investment.

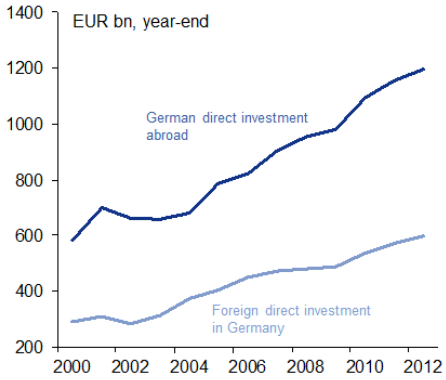
The foreseeable shortage of skilled personnel in Germany, too, calls for increased investment in the area of education to improve the qualification levels of those in work.

- As a result of the high degree of international interconnectedness of the German economy, an upturn in domestic investment activity will go hand in hand with a rise in imports which, in turn, will help curb the foreign trade surplus.

- An expansion of the capital stock may also serve to improve the quality of the German economic upturn, by strengthening domestic demand thanks to direct demand and resulting indirect supply effects, thus enabling more broad-based economic growth.

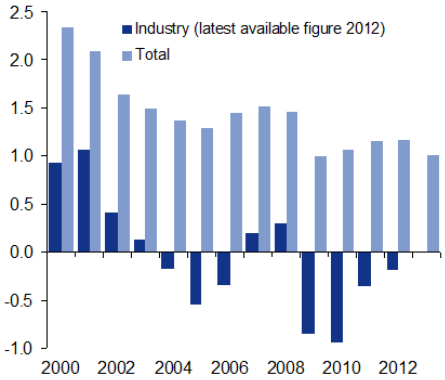
## Does Germany suffer from weak investment?

### Direct investment*




*primary and secondary, consolidated.

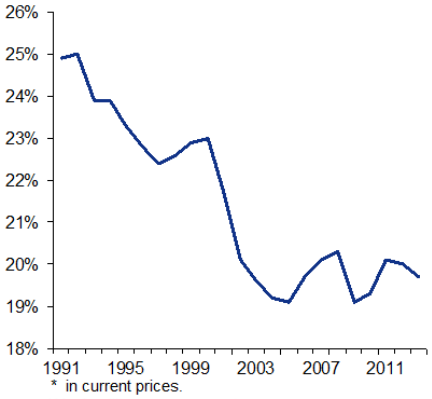
### Domestic capital stock




Sources: Bundesbank, Statistisches Bundesamt.

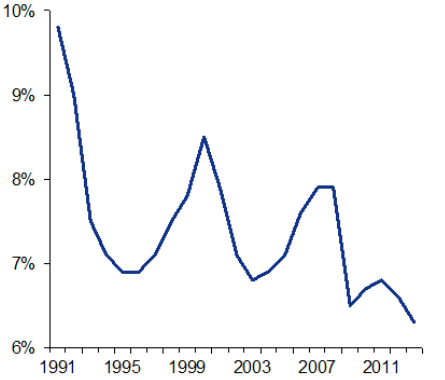
## Share of gross fixed capital formation in GDP*

### Total gross fixed capital formation



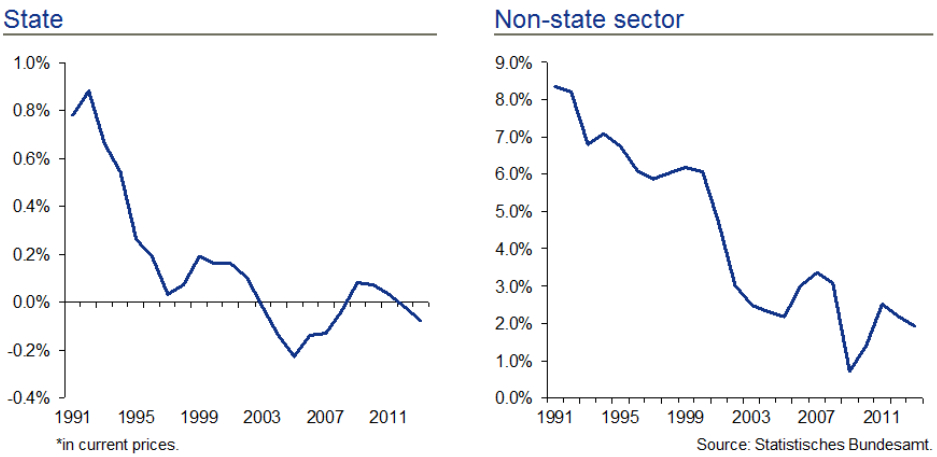

* in current prices.
** incl. military weapon systems.

### Equipment investment**



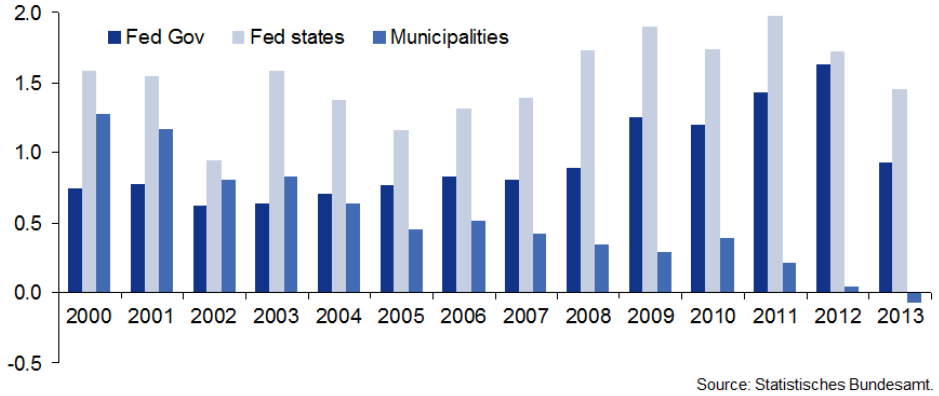

Source: Statistisches Bundesamt.

## Share of net fixed capital formation in GDP




## Gross fixed assets of the state

% change on previous year, seasonally adjusted

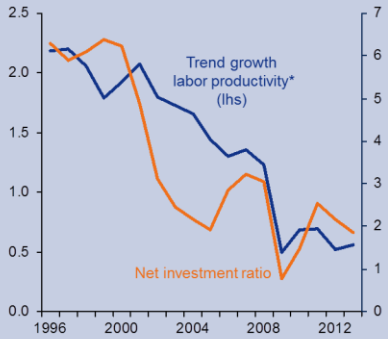



## Labor productivity and capital intensity

The downward trend of the investment ratio since the 1990s went hand in hand with a slowdown in the rate of increase of labor productivity. Taking the average change per year during a 5-year period as a basis for labor productivity, both time series appear to be very much in sync, with a correlation coefficient of 0.8.

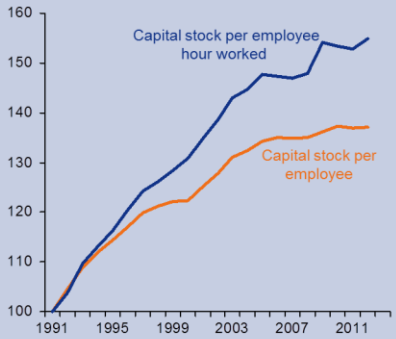
Since the middle of the last decade capital intensity, i.e. the extent to which jobs are backed by physical capital, has clearly been leveling off. This holds true irrespective of whether the number of people in work or the hours worked (volume of labor) are used in the calculation. Whereas capital intensity rose by an average of 3% per year during the period 1992-1998, in the seven-year period from 2006-2012 it amounted to well under 1%.

Labor productivity and net fixed capital formation




*Real GDP per employee hour worked. Change over 5 years converted to annual rate.

Capital intensity (indices, 1991=100)



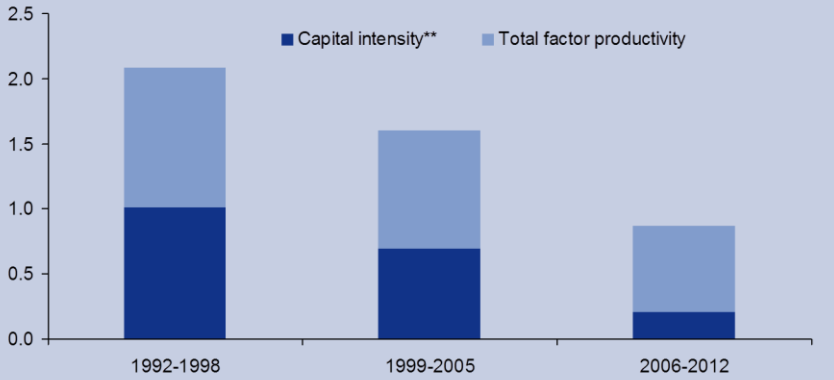

Sources: Statistisches Bundesamt, own calculations.

The correlation between productivity growth and the increase in capital intensity can be illustrated by means of a Solow growth accounting process.[1] It is possible to express the rise in labor productivity as the sum of the weighted growth rate of capital intensity and a residual component (growth rate of total factor productivity). The latter is considered a measure of progress; ultimately, though, it may well also bundle errors of measurement. The weighting factor for capital intensity is the income proportion of the capital factor.

All in all, such an accounting process indicates that the slowdown in the increase of productivity can be attributed to both a slower rise in total factor productivity and a reduced rate of capital intensification. However, it appears that capital intensification has the greater part to play. In recent years (2006-2012) approximately a quarter of the growth in labor productivity could be attributed to this component on average. In the 1990s, it was about half.

Contributions to labor productivity growth*

Average annual growth, %




* Real GDP per employee hour worked.
** Change in capital stock per employee hour worked weighted with factor 0.3.

Sources: Statistisches Bundesamt, own calculations.

[1] Such an accounting process is based on the assumption that economies of scale remain constant in production and that goods and factor markets are competitive. In general such calculations are based on the capital employed by market-oriented manufacturing companies. Our calculations, however, are based on the data on the macroeconomic capital stock published by the German Federal Statistics Office.

As always, the evaluations are subject to the following cautionary notes.

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In 2013, around 148,000 employees in over 70 countries achieved total revenue of 110.8 billion euros and an operating profit of 10.1 billion euros. Payouts to customers came in at 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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