

Germany: Growth with obstacles

December 12, 2018

Author:

GREGOR EDER
+49.89.3800.65856
gregor.eder@allianz.com

Executive Summary

- The world economy continued to grow strongly in 2018. Global economic output is likely to have increased by 3.1%, after a plus of 3.2% last year. While economic momentum in the USA even accelerated due to a strongly procyclical fiscal policy, growth slowed in most other economic regions.
- Uncertainty about further economic development remains considerable, partly in view of the protectionist US trade policy and geopolitical risks. We continue to believe that common sense will prevail and that negotiations can avoid a noticeable escalation of conflicts. Under this premise, the expansion of global trade in goods and services is likely to continue, albeit at a somewhat slower pace.
- At the end of 2018, the German economy provides a mixed picture. While various economic indicators had already indicated a slowdown in growth momentum over large parts of the year, real gross domestic product grew solidly in the first half of the year. In the third quarter, however, the economy then utterly slumped. This was mainly due to the automotive industry, which had considerable problems with the certification of vehicles according to the new WLTP emissions test procedure.
- We assume that the problems in the automotive sector associated with the new emission test will be largely resolved by the end of the first quarter of 2019 at the latest, and anticipate a "counter-movement" to the slump in growth in the third quarter for both the current and the coming quarter.
- Despite the recent setback, the overall economic situation in Germany can still be described as good. The domestic economic conditions for a continuation, albeit more moderate, of the upswing are still in place. This applies in particular to private consumption. The disposable income of private households will continue to grow quite strongly in nominal terms in 2019.
- All in all, despite the increased risks we expect the overall economic utilization in Germany to increase further in the coming year. With real GDP growth of 1.7% (2018: expected 1.5%), however, the rate of the previous years (2016 and 2017: 2.2% each) will no longer be reached.

Global economic environment

The world economy continued to grow strongly in 2018. Global economic output is likely to have increased by 3.1%, after a plus of 3.2% last year. While economic momentum in the US even accelerated in the course of the year due to a strongly procyclical fiscal policy, growth weakened in most other economic regions. The slowdown was particularly pronounced in the emerging markets world. Many emerging economies experienced strong capital outflows as a result of higher interest rates in the US. In addition, the uncertainty surrounding the trade dispute initiated by the US is a particular burden on these countries. The capital shifts and the increased uncertainty can be seen in particular in the losses in value on the equity, bond and currency markets in these countries. Overall, uncertainty about future economic developments at the global level has increased in recent months. Against this background, it is important to clearly describe the global framework conditions, on which our economic forecast for 2019 is based on.

- The lasting uncertainty about the further development of the trade dispute has led to a clouding of economic sentiment worldwide. This increases the likelihood of negative effects on economic activity at the global level. However, we maintain our view that an escalation into a full-scale trade war remains unlikely, as there is simply too much at stake to allow all parties to turn their backs on a negotiated solution. Under this premise, the expansion of global trade in goods and services is likely to continue, albeit at a somewhat slower pace. After an increase of 3.8% this year, we expect a plus of around 3 ½% for 2019.
- Since October, the price of Brent crude has plummeted. A barrel currently costs around USD 60. By way of comparison, Brent was still quoted at USD 85 per barrel at the end of September. The global economic slowdown is leading to lower demand for oil, which in turn is putting pressure on the price of oil. For 2019, we expect an annual average oil price of around USD 65 to 70 per barrel (2018: USD 72 per barrel).
- If the economy remains solid, the US central bank Fed will continue to normalize its monetary policy and to raise its key interest rate. We expect three rate hikes of 25 basis points each by the end of 2019. In addition, the Fed will continue to gradually reduce its balance sheet total. In the euro zone, the ECB's exit from its ultra-loose monetary policy is still taking place in mini-steps. The ECB will probably terminate its bond purchasing program at the end of 2018. We expect an initial increase in the refinancing rate in the final quarter of 2019.
- The USD/EUR exchange rate was subject to significant fluctuations in the course of this year. By the end of the first quarter, the euro had appreciated by 4% against the US dollar. Since then, the single European currency has been in a devaluation trend that has more than compensated for the appreciation at the beginning of the year. The USD/EUR exchange rate is currently quoted at slightly below 1.14. By the end of 2019, we expect the USD/EUR exchange rate to essentially fluctuate in a range between 1.15 and 1.20. On the one hand, the Fed's ongoing cycle of interest rate hikes is likely to weigh on the euro. On the other hand, a number of factors, such as the ongoing economic upswing in the euro zone and the ECB's expected interest rate turnaround, will support the euro.
- Political uncertainty in Europe remains at an elevated level. Our forecast is not based

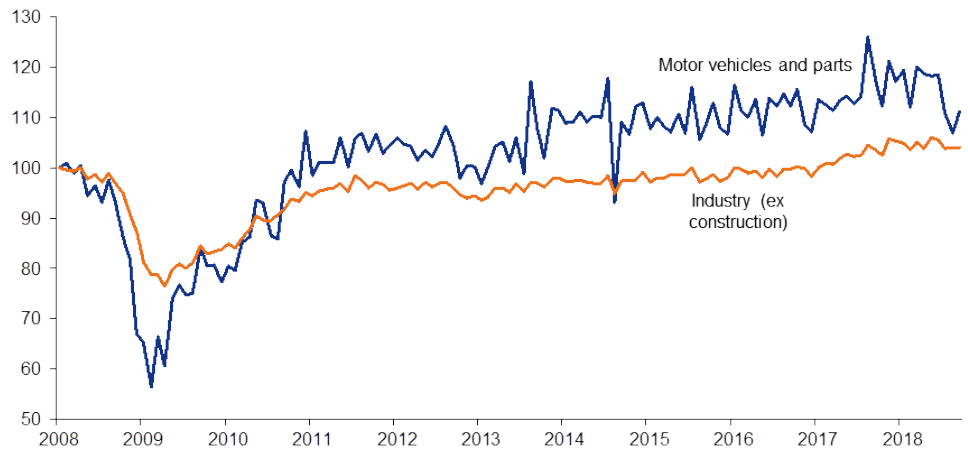
on an escalation of risks, nor is it based on a rapid resolution of risks. In addition to the continuing Brexit uncertainty, our attention is currently focused above all on Italy: the budget target of 2.4% of GDP is in clear contradiction to the EU financial rules, as it would bring Italy's public debt back on an upward trend. In our baseline scenario, we assume that fiscal policy will give in – not least because of the disciplining effect of the financial markets.

Growth with obstacles

At the end of 2018, the German economy provides a mixed picture. While various indicators such as the ifo business climate index and the purchasing managers' indices had already indicated a slowdown in growth momentum over large parts of the year, real gross domestic product rose solidly in the first half of the year, supported by strong domestic demand. In the third quarter, however, the economy then slumped and seasonally adjusted real gross domestic product fell by 0.2% compared with the previous quarter. This was mainly due to the automotive industry, which had considerable problems with the certification of vehicles according to the new WLTP emission test procedure. Compared to the second quarter, production in the automotive sector collapsed by over 7 ½%, thus also driving industrial production as a whole into the red. In terms of production by all sectors of the economy, the sector dampened growth by 0.3 percentage points compared with the previous quarter. Without the slump in the automotive sector, the German economy would not have shrunk by 0.2% in the third quarter, but would have grown at least slightly. On the consumption side of gross domestic product, the problems in the automotive industry were reflected in declining exports and a slightly shrinking private consumption.

Production in the automotive sector collapses in the summer months

Production: Industry (ex construction) and manufacture of motor vehicles and parts, index (2008=100), seasonally and working day adjusted



Sources: Bundesbank, own calculations.

We assume that the problems in the automotive sector associated with the new emission test procedure will be largely resolved by the end of the first quarter of 2019 at the latest. The latest sector data on production, new car registrations and export activity show first signs of improvement. This suggests a certain countermove to the slump in growth in the third quarter for both the current and the coming quarter. How strong this rebound will be, however, will depend not least on how lastingly the political risks already described, such as Italy, the trade conflict and Brexit, will weigh on economic

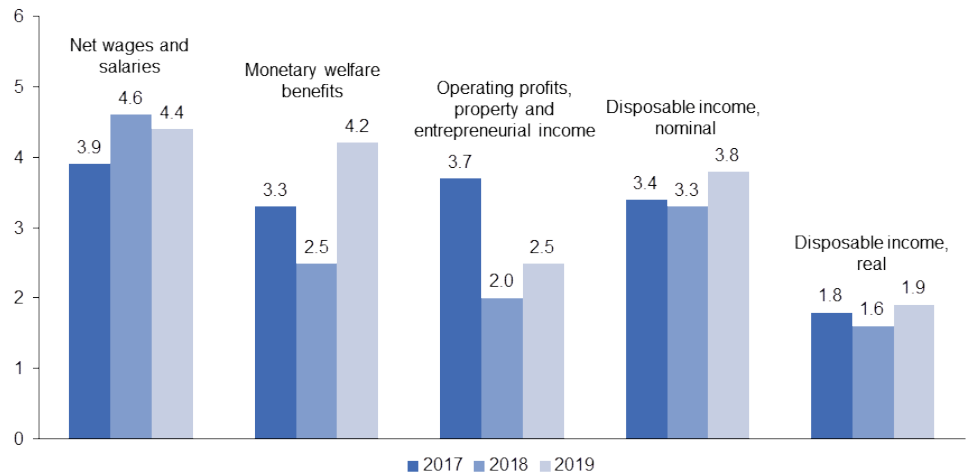
sentiment. Our economic outlook is based on the assumption that the associated uncertainty will continue into 2019.

Despite the recent setback, the overall economic situation in Germany can still be described as good. The domestic economic conditions for a continuation, albeit more moderate, of the upswing are still in place. Corporate earnings are positive, financing conditions remain favourable, corporate and household indebtedness is relatively low, employment growth is creating additional income and the real purchasing power of disposable income is rising. We therefore assume that domestic demand has already picked up again in the final quarter of 2018.

The disposable income of private households will grow quite strongly in nominal terms also in 2019. After an increase of around 3.3% this year, we expect an even higher increase of 3.8% for the coming year. The acceleration in the increase is mainly due to the tax relief that will come into force and the additional monetary social benefits. Despite inflation rates of close to 2% and an expected slight increase in the savings rate, the purchasing power gains are sufficient for a continuous expansion of real private consumption, which is expected to rise by 1.4% on average in 2019, after an increase of about 1% this year. A major reason for the comparatively restrained development of private consumption in the past year is the significant increase in the savings rate. It rose from 9.9% of disposable income in 2017 to an expected 10.3%. The reluctance on the part of private households to buy cars in the second half of the year is likely to have contributed to this increase.

Continued strong nominal income growth

Percentage change over previous year



Sources: Statistisches Bundesamt, own forecasts.

With a view to investment demand in 2019, fundamentals speak in favor of a continuation of the upward trend: capacity utilisation is still above average and the earnings and liquidity situation of companies is good. However, the continuing uncertainty, particularly in connection with the trade conflict, is likely to weigh on investment activity. For 2019, we therefore expect a slowdown in growth in real investment in machinery and equipment to 3% (2018: around 4 ½%). By contrast, construction remains clearly on the upswing, even though capacity bottlenecks are limiting growth here. As in 2018, real construction should increase by more than 3% in 2019.

The outlook for foreign trade is currently particularly uncertain. The trade conflict with the US continues to smoulder. An escalation, both in the US-China relationship and in the US-EU relationship, is still within the realm of possibility. Thus the Damocles sword of import duties on car exports to the US still hovers over the automobile sector. In addition, the sector is confronted with declining demand for cars in China. Overall, we expect real export growth of 2.3% in 2019. As in 2018, German exports would thus grow more slowly than global trade in goods and services. On the other hand, imports should continue to grow significantly thanks to robust domestic demand. We expect a plus of just under 4%, after an increase of around 3 ½% in 2018.

Germany: Economic indicators and forecast*

	2016				2017				2018				2019				2016	2017	2018e	2019f	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4					
GDP real (not calendar-adjusted)	0.9	0.4	0.2	0.4	1.1	0.5	0.6	0.5	0.4	0.5	-0.2	0.5	0.5	0.5	0.4	0.4	2.2	2.2	1.5	1.7	
Private consumption	0.6	0.1	0.3	0.7	0.7	0.8	0.1	0.2	0.5	0.3	-0.3	0.4	0.5	0.5	0.4	0.3	2.1	1.8	1.0	1.4	
Government spending	1.8	0.7	0.1	0.4	0.5	0.4	0.3	0.4	-0.5	0.8	0.2	0.4	0.4	0.4	0.4	0.4	4.0	1.6	0.9	1.6	
Investment in machinery/equipment	0.0	-1.8	1.0	-0.7	2.2	2.7	1.2	0.5	2.1	0.1	0.8	0.7	0.8	0.8	0.8	0.8	2.3	3.7	4.4	3.0	
Construction	2.5	-1.6	0.3	1.3	2.5	0.7	-0.1	0.2	1.6	0.9	0.9	0.8	0.8	0.8	0.7	0.7	3.8	2.9	3.2	3.3	
Domestic demand	1.3	-0.3	0.6	0.9	0.5	0.8	0.3	0.3	0.4	0.7	0.8	0.5	0.5	0.5	0.4	0.4	3.0	2.0	2.0	2.2	
Exports	1.0	1.3	-0.4	1.3	2.3	1.1	1.2	1.7	-0.3	0.8	-0.9	0.8	0.8	0.8	0.7	0.7	2.3	4.6	2.0	2.3	
Imports	2.1	-0.4	0.4	2.7	1.1	1.9	0.5	1.4	-0.3	1.5	1.3	1.0	0.9	0.9	0.7	0.7	4.1	4.8	3.4	3.9	
Industrial production (excl. construction)**	1.6	-0.5	0.2	0.2	1.1	1.7	1.3	0.9	0.1	0.6	-1.2	0.8	0.8	0.5	0.5	0.5	1.3	3.4	1.9	1.7	
Unemployment rate (EU def.)	%	4.4	4.2	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.4	3.3	3.2	3.2	3.1	3.1	4.2	3.7	3.4	3.1
Unemployment rate (nat. def.)	%	6.2	6.1	6.0	6.0	5.9	5.7	5.7	5.5	5.4	5.2	5.2	5.0	5.0	4.9	4.8	4.8	6.1	5.7	5.2	4.9
Employed persons (national def.)	y-o-y	1.3	1.3	1.3	1.4	1.5	1.4	1.5	1.4	1.5	1.3	1.3	1.2	0.9	1.0	0.9	0.8	1.3	1.4	1.3	0.9
Consumer prices	y-o-y	0.3	0.1	0.5	1.1	1.9	1.7	1.7	1.7	1.5	2.0	2.1	2.4	2.2	2.0	1.9	1.5	0.5	1.7	2.0	1.9
Consumer prices (HICP)	y-o-y	0.1	0.0	0.4	1.0	1.9	1.6	1.7	1.6	1.3	1.9	2.1	2.3	2.3	2.0	1.8	1.5	0.4	1.7	1.9	1.9
Producer prices	y-o-y	-2.7	-2.5	-1.5	0.2	2.9	2.8	2.7	2.5	1.9	2.4	3.0	3.3	3.2	3.0	2.4	1.8	-1.6	2.7	2.7	2.6
Current account balance	EUR bn	69.5	69.7	64.0	64.5	65.8	58.7	69.2	69.0	72.4	68.6	56.5	60.0	60.0	59.0	58.0	57.0	268.8	262.6	257.6	234.0
	% of GDP																	8.5	8.0	7.6	6.7
Budget balance	EUR bn																	25.7	34.0	52.5	35.5
(Maastricht-definition)	% of GDP																	0.8	1.0	1.6	1.0

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

e = estimate; f = forecast

All in all, overall economic utilization will thus continue to rise in 2018 and 2019. However, with real GDP growth of 1.5% this year and 1.7% next year, the rate of the previous years (2016 and 2017: 2.2% each) will no longer be reached.

If the overall economic expansion continues, the labor market will prove to be robust. However, employment growth is likely to slow gradually. The number of people in employment, which increased by about 576,000 in the current year, will increase by 400,000 next year. In particular, the declining increase in the working-age population and the increasing shortage of skilled workers speak in favour of this slowdown. Unemployment is likely to fall relatively steadily. We estimate that the number of unemployed will fall by around 150,000 in 2019, compared with 193,000 this year.

Public debt below the 60% mark again for the first time since 2001

As in 2017, the public sector's budget balance in the year ending is likely to have been higher than originally expected. Revenues developed quite dynamically, mainly thanks to the good economic situation, and are expected to have risen by a good 4% compared with the previous year. Expenditure growth was less pronounced at around 3%. One of the reasons for this may have been that – due to the delayed formation of the government – there was a rather long phase of provisional budget management in the current year. Overall, we expect a budget surplus of EUR 52.5 billion for 2018, which corresponds to 1.6% of German economic output. At 59.9% of gross domestic product, public debt is likely to have fallen below the 60% mark for the first time since 2001.

For 2019, we expect strong expenditure growth in the region of 4 ½%. This is mainly due to the pension policy measures already adopted, as well as investment measures and additional expenditure in the area of development aid. The generally good economic situation and rising wages will lead to a further significant increase in income from taxes and social security contributions. With an increase of 3.3%, however, growth momentum will be noticeably more moderate than this year. Among other things, the increase in child allowances will have a dampening effect.

Overall, the degree of expansion of German fiscal policy will continue to increase in 2019. The budgetary impact of the fiscal policy measures adopted to date will be around 0.6% to 0.7% of GDP in the coming year (after 0.2% of GDP in the current year). The budget surplus will fall noticeably. With an expected surplus of EUR 35.5 billion or 1% of GDP, however, it will remain substantial.

Germany: Public-sector revenue and expenditure

in EUR bn	2014	2015	2016	2017	2018e	2019f
Revenue	1308.3	1354.3	1414.2	1473.9	1537.7	1588.7
of which:						
Taxes	668.7	698.0	732.0	766.4	798.9	827.7
Social contributions	482.0	500.8	523.8	548.6	570.9	591.4
Expenditure	1298.8	1334.9	1388.6	1439.9	1485.2	1553.1
of which:						
Inputs	137.4	142.2	150.0	156.3	159.7	165.0
Employee compensation	224.0	229.2	236.5	246.7	256.6	266.8
Property income payable (interest)	51.2	46.4	41.6	33.8	31.8	30.8
Subsidies	26.4	27.0	27.8	28.4	28.7	29.3
Monetary welfare benefits	451.3	469.9	486.3	506.1	520.8	545.8
Welfare benefits-in-kind	239.7	252.4	268.6	278.4	287.9	298.8
Other current transfers	73.2	74.8	75.7	75.3	76.8	86.0
Gross investment	60.0	64.2	66.8	72.4	79.6	86.0
Financial balance	9.5	19.4	25.7	34.0	52.5	35.5
memorandum:						
State spending ratio ¹⁾	44.3%	43.9%	44.2%	44.1%	44.0%	44.4%
Financial balance ¹⁾	0.3%	0.6%	0.8%	1.0%	1.6%	1.0%

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

Sources: Statistisches Bundesamt, own forecasts

Economic policy called for to secure long-term growth

Economic policy reforms are needed to keep the economy on course for growth in an increasingly difficult environment. In its autumn report, the German Council of Economic Experts analysed numerous reform areas. Tax policy in particular has a long list of homework tasks: A complete abolition of the solidarity surcharge, which has long since ceased to be used for transfers to the eastern federal states, a reduction in corporate taxes to prevent Germany from falling behind other countries as a business location, a reduction in the tax burden for lower and middle incomes, which is very high in Germany by international standards, and finally a reform of property tax and property transfer tax, which make the acquisition of residential property particularly difficult in times of rapidly rising property prices. With a public budget surplus estimated at 1.6% of gross domestic product this year and public debt that will fall below 60% of economic output in 2018 for the first time in a long while, there is financial room for manoeuvre. Therefore, future investments would not have to suffer from tax cuts, as is often reflexively argued in the political arena. In view of the sharp rise in total government expenditures – EUR 265 billion since 2010 (compared with just under EUR 21 billion for investments) – this objection appears to be quite preposterous. The main problem is probably that the coalition treaty does not provide for tax cuts. In view of significantly

reduced growth prospects, however, coalition members should not be deterred from necessary reforms. A tax policy that increases the net income of private households and makes Germany more attractive as an investment location will strengthen growth through higher private consumer and investment spending. What is good for Germany will also help our European partners, who urgently want stronger impetus from Germany.

ABOUT ALLIANZ

The Allianz Group is one of the world's leading insurers and asset managers with more than 86 million retail and corporate customers. Allianz customers benefit from a broad range of personal and corporate insurance services, ranging from property, life and health insurance to assistance services to credit insurance and global business insurance. Allianz is one of the world's largest investors, managing over 650 billion euros on behalf of its insurance customers while our asset managers Allianz Global Investors and PIMCO manage an additional 1.4 trillion euros of third-party assets. Thanks to our systematic integration of ecological and social criteria in our business processes and investment decisions, we hold the leading position for insurers in the Dow Jones Sustainability Index. In 2017, over 140,000 employees in more than 70 countries achieved total revenue of 126 billion euros and an operating profit of 11 billion euros for the group.

ABOUT EULER HERMES

Euler Hermes is the global leader in trade credit insurance and a recognized specialist in the areas of bonding, guarantees and collections. With more than 100 years of experience, the company offers business-to-business (B2B) clients financial services to support cash and trade receivables management. Its proprietary intelligence network tracks and analyzes daily changes in corporate solvency among small, medium and multinational companies active in markets representing 92% of global GDP. Headquartered in Paris, the company is present in over 50 countries with 5,800+ employees. Euler Hermes is a subsidiary of Allianz, listed on Euronext Paris (ELE.PA) and rated AA- by Standard & Poor's and Dagong Europe. The company posted a consolidated turnover of €2.6 billion in 2016 and insured global business transactions for €883 billion in exposure at the end of 2016. Further information: www.eulerhermes.com, LinkedIn or Twitter @eulerhermes.

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

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

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

NO DUTY TO UPDATE

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